

### 3G MONGOLIAN ECONOMY: GDP GREW 16.7% YOY IN 2011 Q3, DOUBLE DIGIT INFLATION IS BACK

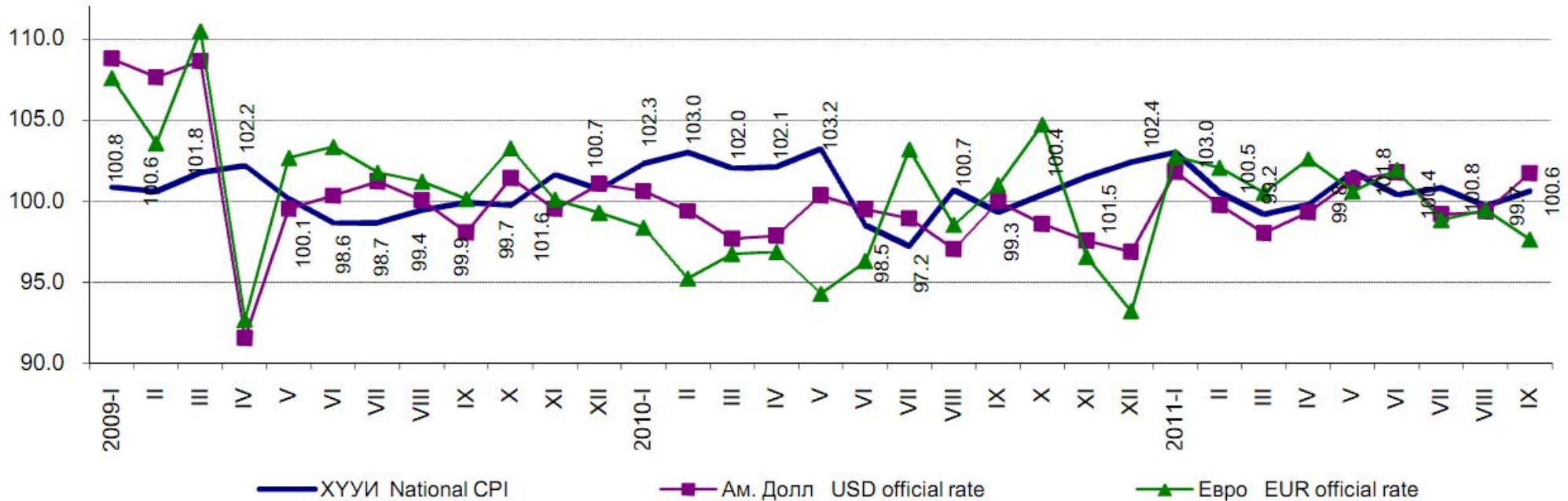
Against the backdrop of the latest global economic and financial downturn with lack of a definitive solution to the crisis in Europe, 2011 Q3 YTD Bulletin of National Statistics Office of Mongolia, which has been included in Citi Investment Research & Analysis's so-called 3G ("global growth generators") list which also includes Bangladesh, Egypt, Indonesia, Nigeria, the Philippines, Sri Lanka, Vietnam, India and China, the only BRIC members to make the cut, shows:

- Nominal (raw)GDP growth in Q3 2011 is 31.4% yoy compared 2011H1's 29.1%  
Real GDP growth in Q3 is (at base 2005 year prices) is 16.7% yoy compared to 2011H1's 14.3%.
- MNT appreciated 4.9% yoy compared to 6.5% yoy in August and compared to 8.7% yoy in July against USD, but depreciated 2.29% YTD compared to 0.1% YTD in August and compared to appreciating 0.75% YTD in July, average exchange rate for September 2011 was 1259.99MNT compared to 1238.6MNT in August and compared to 1246.9MNT in July and compared to 1324.8MNT in September 2010.

#### 8.3 ГАДААД ВАЛ ТЫН ЗАХ З EXCHANGE RATES OF FOF

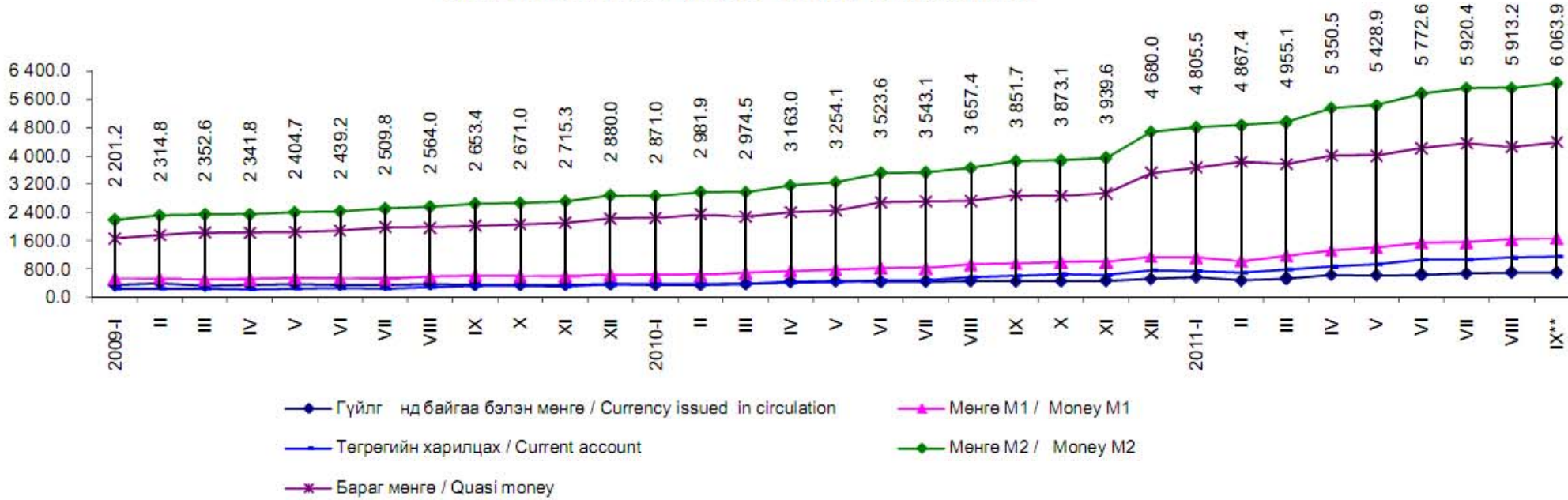
Хугацаа, саяа		Ам. доллар
<i>Periods, by months</i>		<i>USD</i>
2011	I	1 256.42
	II	1 253.41
	III	1 228.45
	IV	1 219.90
	V	1 235.71
	VI	1 257.29
	VII	1 246.93
	VIII	1 238.63
	IX	1 259.89

**Хэрэглээний үнийн улсын индекс,  
ам.долл ба еврогийн ханшийн өсөлтийн харьцаа, сар бүрийн эцэст, өмнөх сар=100%  
National CPI, USD and EUR growth, at the end of every month, previous month=100%**



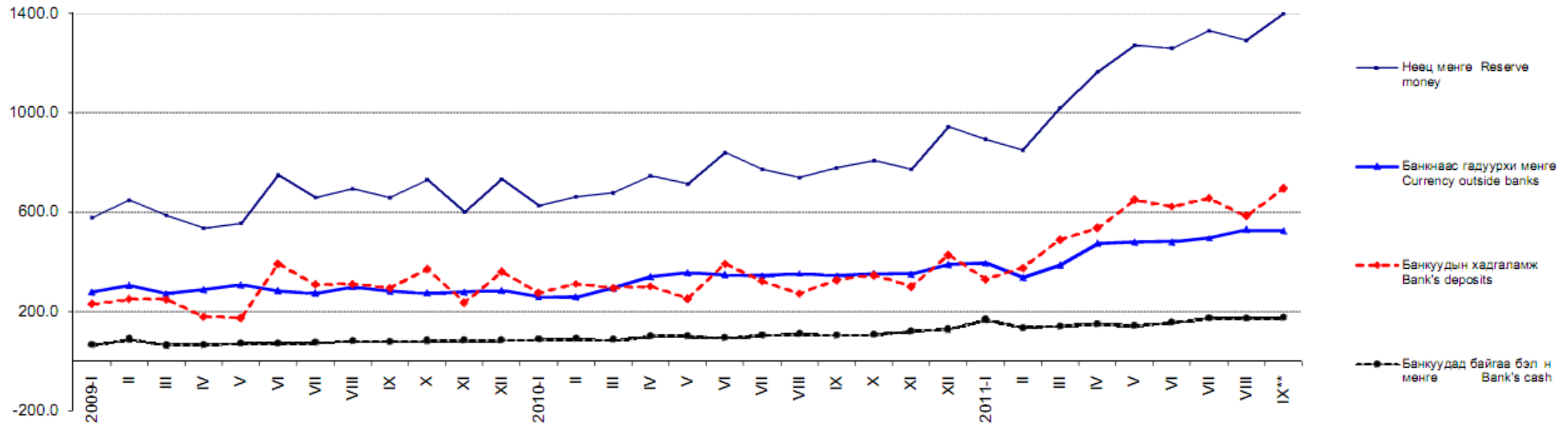
- CPI up 10.5 % yoy compared to 9% in August and 10.1% in July, 5.9% YTD and up 0.6% mom compared to up down 0.3% in August and up 0.8% in July, mainly due to increases of 1.6 percent in clothing, footwear and cloth, and 4.6 percent in housing, water, electricity and fuels.
- money supply(M2) up 57% yoy compared to 62% yoy in August and compared to 67% yoy in July and up 2.5% mom compared to down 0.2% mom in August and compared to up 2.6% mom in July, currency in circulation is up 56% yoy compared to 51% yoy in August and compared to 49% yoy in July and down 0.1% compared to up 4.75% mom in August and compared to up 5% mom in July

**Мөнгөний үзүүлэлт, са бүрийн эцэст, тэрбум төг**  
**Money indicators, at the end of every month, bln.tog**



Эх үүсвэр: \* Монголбанкны статистикийн сарын бюллетень  
 Source: \* Monthly statistical bulletin, Bank of Mongolia  
 Тайлбар: \*\* Урьдчилсан гүйцэтгэлээр  
 Note: \*\* Preliminary estimates

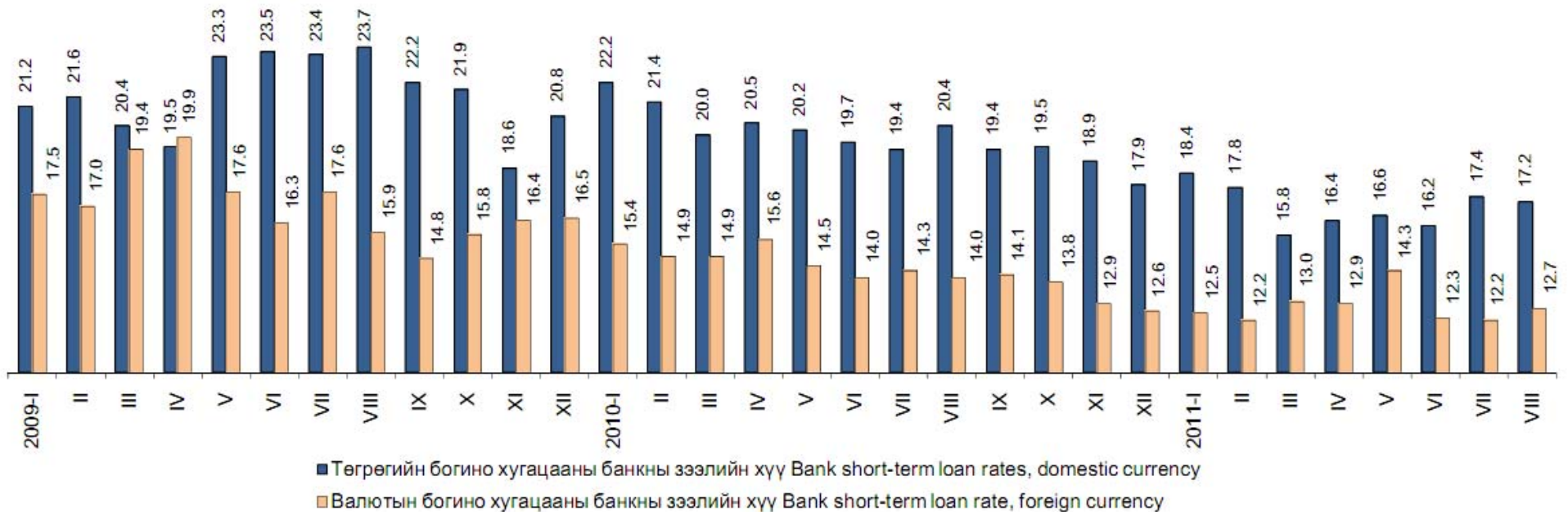
Нөөц мөнгө, сар бүрийн эцэст, тэрбум төг  
Reserve money, at the end of every month, bln.mog



Тайлбар: \*\* Урьдчилсан гүйцэтгэл р  
Note: \*\* Preliminary estimates

- loans outstanding up 64% yoy compared to 62% yoy in August and compared to 57% yoy in July and up 3.9% compared to up 4% mom in August and compared to 2.8% mom in July, principals in arrears down 9.7% mom compared to down 6% mom in August and compared to up 2.1% mom in July and down 20% yoy compared to down 22% yoy in August and compared to down 35% yoy in July, NPL-s down 13% yoy compared to 8.4% yoy in August and compared to down 8 % yoy in July and down 4.9% mom compared to down 1.6% mom in August and compared to 2.2% mom in July

**Зээлийн жилийн хүү, са бүрийн эцэст, хувиа**  
**Annual loan's rate, at the end of every month, by percent**



- budget surplus YTD is 237B MNT(186M USD) compared to 227B MNT(181M USD)in August and compared to 125B MNT surplus in July and compared to budget deficit of 19B MNT yoy, this is mainly due to the revenue growth pace exceeded the expenditure growth by 15.4 percentage points.
- budget tax revenues up 48% yoy compared 50%yoy in August and compared to 54% yoy in July, mainly due to the increases of 73% percent in taxes on goods and services, 2.3 times in other taxes, 88 percent in taxes on foreign trade, 48% increase in social security contribution, 36.1 percent in ownership tax, although there was decreases of 3.9 percent in income tax
- non-tax revenue increased by 92% yoy compared to 2 times yoy in August mainly due to the increases of 2.5 times in revenues from budget entities,3.7 times in revenues from dividends, 49% percent in revenues from interest and fines, 50% percent in revenues from oil petroleum

- expenditure and net lending of the General Government Budget increased by 41 percent mainly due to increases of 68 percent in subsidies and transfers, 29 percent in expenditure of goods and services, 53.9 percent in capital expenditure, although there was decreases of 11 percent in lending minus repayments
- Total external trade turnover increased by 96% yoy compared to 88% yoy in August compared to 80% in July to 8.3B USD compared to 7B USD in August and compared to 5.7B USD in July, exports up by 73% compared to 61% yoy in August and compared to 52% in July to 3.48B USD compared to 2.89B USD in August and compared to 2.3B USD in July, imports continue up 2.1 times as in previous two months to 4.2B USD compared to 3.4B USD in July, trade deficit is up 5.6 times yoy compared to up 7.6 times in August and compared to 8.4 times in July to 1.3B USD compared 1.1B USD in July.
- total industrial output YTD increased by 9.7% yoy compared to 8.9% yoy in August and compared to 6.8% yoy in July mainly due to 4.4 percent to 2.2 times increases in mining and quarrying products such as crude oil, coal and iron ore; and 1.2 percent to 10.8 times increases in industrial main products of manufacturing sector such as fruit compote, bread, knitted goods, combed down, juice, sausages, alcohol, beer, cement, briquette, cigarettes, soft drinks, carpet and electrical conductor wire.

In the first 9 months of 2011 at national level, there were construction and installation work with worth of 258.1 bln.tog, reflecting an increase of 114.4 bln.tog or 79.6 percent yoy

- In the first 9 months of 2011, 13338.9 thous.t. freight and 2867.5 thous.passengers (double counting) were carried by railway transport. Compared to the same period of the previous year, the number of carried freight rose by 1198.6 thous.t or 9.9 percent and the number of carried passengers rose by 239.1 thous.persons or 9.1 percent
- In the first 9 months of 2011, 1.9 thous.t freight and 430.0 thous.passengers (double counting) were carried by air transport. Compared to the same period of the previous year, the number of carried freight increased by 653.3 t or 52.3 percent, the number of carried passengers rose by 131.3 thous.persons or 43.9 percent.

According to Media Office of Government of Mongolia (open-government.mn) on October 7, 2011, Prime Minister of Mongolia S.Batbold has said in opening speech of autumn session of Parliament among other things

- Since 2010 major mining and infrastructure projects have been immediately started to be implemented, engine of boosting development has been turned on.
- Economy that had negative growth of 1.6% in crisis, last year grew about 6%. By this year end it is likely that it will reach 20%.
- GDP per capita now is reaching 3000 USD. If economic growth is stable it would be possible to condition to form to reach 5000USD by end of 2012
- Total tax revenues increased 50.3% yoy including customs revenues increasing 1.6 times to 1.23 trillion MNT(about 1 billion USD)
- Unemployment rate is back into single digits 8.7%

According to IMF, International Monetary Fund (IMF) mission visited Mongolia during September 14 – 20, 2011, to hold Post-Program Monitoring discussions. The team met with the Mongolian authorities and others to discuss recent macroeconomic developments and policies and at the conclusion made the following statement:

- The Mongolian economy has made a remarkable turnaround from the recent crisis. This success reflected the authorities' commitment to pursue sound macroeconomic policies, a recovery in copper prices, and timely support from the international community. With coal output rapidly increasing and two massive mining projects in the pipeline, Mongolia has a bright economic future and an opportunity to spread prosperity to all of its citizens.
- We have had in-depth discussions with the authorities on the economic outlook and policy challenges. We believe that Mongolia has a bright economic future as it continues to develop its vast mineral resources. In the near term, however, we see substantial risks to the economic outlook.
- First, the economy is overheating. Inflation is already high and likely to rise further, which is exacting an especially heavy burden on the poor, and eroding the ability of Mongolia's private sector to operate effectively. Rather than contending with these pressures, macroeconomic policies have returned to the boom-bust approach that culminated in the last crisis in 2009. Second, this heightened domestic risks of macroeconomic instability come at a time when the global economic outlook is worsening. Should international commodity prices fall sharply Mongolia's exports and budget revenues would both be hit hard. The policies to address both high and rising inflation and to lessen vulnerabilities are clear: restrain fiscal spending and tighten monetary policy.
- The 2011 budget already included a sharp increase in spending of around 30 percent. This is a key factor behind the current overheating. Now the government has proposed a further increase in spending of 6½ percent of GDP just in the fourth quarter of this year. Such an increase would be highly risky and ill-advised. GDP growth in the second quarter already exceeded 17 percent and imports of consumer goods have risen by more than 80 percent. Further fiscal spending would only add to fuel to this overheating economy at a time when it least needs it.
- Similarly, in the 2012 budget, spending should be kept at or below the level that parliament already approved in the medium-term budget framework. Within that budget envelope the government should introduce a targeted system of social transfers.
- Finally, the newly created development bank is of significant concern. The development bank should not be used as a means to circumvent the fiscal stability law or as a vehicle for off-budget government spending. Doing so will add to fiscal risks, reduce fiscal transparency, and undermine the credibility of the landmark fiscal stability law passed last year.

- The recent tightening of monetary policy is welcome, but more needs to be done. The central bank should use a variety of tools. The policy interest rate should be further increased. For much of the year it has remained below the pace of increase of underlying inflation, allowing for a very rapid pace of credit growth (now reaching nearly 50 percent in real terms). Interest rate hikes alone, however, will not be sufficient. In addition, a range of macro-prudential measures should be implemented to help slow the pace of credit growth. These include measures to increase capital adequacy requirements, start to require provisions on new lending, raise reserve requirements, and tighten liquidity ratios. At this stage in the business cycle it is especially important to proactively manage risks and strictly enforce prudential regulations in order to prevent the buildup of future credit quality problems in the banking system (as become painfully evident in 2009).

According to World Bank in August 2011

#### Macro

- In 2011H1 the economy has grown at a whopping 17.3 percent year on year, compared to 9.9 percent in the first quarter.
- Transportation and construction grew at 39.9 percent and 38.4 percent, respectively, while retail and wholesale trade grew at 24.7 percent
- Mongolians are spending more on consumption as a result of higher incomes
- The mining and manufacturing sectors recorded respectable growth rates of 8.3 and 12.9 percent yoy in the second quarter, respectively.

#### Inflation

- Mongolia is again experiencing high levels of inflation. UB inflation was up 11.4 percent yoy in July, up from 5.5 percent in the previous month.
- Core inflation, excluding volatile energy and food prices, increased even faster, by 13.7 percent yoy
- the livestock herd continues to recover from the dzud and China's food prices, especially meat, continue to rise (34 percent yoy in July), food prices are likely to remain high
- inflation is being stoked by increased government spending (up 27 percent, with most of it on wages and transfers), high spending by the private sector—producers and consumers alike—as reflected in the large import bill relative to last year: imports are up by 106 percent.

#### External trade

- A booming mining industry, especially the Oyu Tolgoi copper mine, spurred these imports, especially of transport equipment and machinery. This pushed Mongolia's trade deficit to US\$ 1349 million in July 2011.
- On the export side, coal has surpassed copper as the largest export, comprising 38 percent of all exports, having grown 129 percent yoy in July
- China is the sole destination for Mongolia's coal exports and it is the largest thermal coal consumer in the world. Mongolia's exports of coal are expected to grow with new coal mines coming on board.

- Crude oil exports were up 42 percent yoy in June owing to higher oil prices, while copper volumes are declining, as are Chinese metal imports from Mongolia.
- Gold, greasy cashmere, and combed goat down were other poor performers in the export sector.

#### Banking sector

- Credit in the banking sector is growing very fast. The stock of outstanding loans grew by 46 percent yoy in real terms in July 2011.
- It is therefore imperative that the BoM enforces prudential norms on all Mongolian banks, and ensures that they maintain adequate buffer capital to absorb potential losses.
- The stock of the Non-Performing Loans currently stands at MNT 382 billion including those of the two failed banks. Together with loans in arrears, the ratio to total outstanding loans is about 10 percent in July and decreasing.
- However, because the volume of outstanding loans is rising fast, this should not be a reason for complacency.
- The volume of MNT deposits reached a record MNT 2.6 trillion in July, a 73 percent yoy increase.
- However, since real interest rates on local currency deposits are currently again in negative territory because of rising inflation, the attractiveness of local currency deposits must stem from the public's expectation of an appreciating currency.
- Compared to July 2010, the average monthly exchange rate against the US\$ appreciated by about 9 percent, or about one percent compared to the previous month. Nominal interest rates on US\$ deposits are high by international standards: for certain time deposits they are as high as 14 percent. Such high rates are a cause for concern, as they may reflect liquidity problems rather than an unusually high profitability of project lending.

#### FISCAL

- On a 12 month rolling basis, the fiscal surplus reached 7.4 percent of GDP yoy in July.
- Annual revenues and grants grew by 46 percent in real terms in July yoy, in addition to increases in royalties, VAT, customs duties and corporate income tax.
- On the expenditure side, there was a very large increase (27 percent yoy) in expenditures in July, with capital expenditures up by 57 percent and current transfers up 48 percent, owing to cash handouts to citizens through the Human Development Fund (HDF).
- Such large increases in public expenditures risk throwing Mongolia back to a pro-cyclical fiscal stance.
- To counteract this tendency, the Fiscal Stability Law (FSL), passed in 2010, locked in counter-cyclical policies.
- However, because the core of the FSL—the structural balance of minus 2 percent of GDP—only starts in 2013, risks exist concerning its implementation, especially with elections around the corner in 2012. The FSL was supported by a large majority in parliament and will assist Mongolia in avoiding the typical pitfalls of growth for resource rich countries, especially the Dutch Disease. In the Netherlands, the Dutch Disease was eventually —cured|| through a similarly broad-based political agreement centered on fiscal and wage restraint. If the Dutch example holds a lesson, it would be for Mongolia's parliament to hold the course to implementing the letter and the spirit of the law, and to pass a supportive new budget law in the fall session.

#### OUTLOOK

- Mongolia's economic outlook depends heavily on global macroeconomic factors: the current uncertainty and poor growth prospects for the global economy are cause for concern.
- If there is another global recession, Mongolia's small, open economy will be affected.
- In that case, China's policy reaction will be crucial for Mongolia.
- If China reacts as fast and as strongly as it did in 2008 /9 then the effects of a global recession on Mongolia will be mitigated, largely owing to Chinese demand for minerals from Mongolia.
- Beyond this, it is up to Mongolia to capitalize on its excellent long term prospects by continuing the reform agenda it embarked on during the 2008/9 crisis.

According to Frontier Research,

- While Mongolia has enjoyed significant economic growth over the past decade it is still a very small economy on the verge of another major expansion. Much of Mongolia's fortunes will depend on future copper and coal prices which are significantly higher now than baseline scenarios in past GDP growth projections. While commodity prices might moderate we see a higher base as the more realistic scenario.
- Mining is the driving force behind the Mongolian economic expansion but also the reason for the current trade deficit; major investments lead to large imports of machinery and equipment. We see this reversing from 2013 when exports will start outpacing imports. Currently mining comprises 22% of overall GDP and the sector expanded an impressive 40% in 2010. Agriculture, the second largest sector expanded at "just" 21%. This trend will continue in the future not only accelerating growth but also making the country more prone to "Dutch disease". The challenge for Mongolia is to not fall in the trap that many other resource rich countries ran into. The fact that 85% of total exports go to China and more that 60% of mining exports are either coal or copper further concentrates Mongolia's prospects. Nevertheless we are optimistic that Mongolia will overcome most challenges since the country should be able to deliver coal and copper more cost efficiently than any other producer to two major markets; China and Russia. The current reliance on China forces Mongolia to sell coal at a 40% discount; while this is obviously a disadvantage it means current revenues are coming from a low base with more upside in the long run. For this reason, market diversification is needed and hence railways will be crucial; while there are plenty of plans for new lines, financing is difficult and significant results are probably many years down the road.
- On the monetary front inflation has been very volatile ranging from 30% to flat out deflation in the course of just one year (2008/2009). Inflation has recently picked up again and is currently 9% and with recent rapid money growth, food price increases and expected fiscal expansion we expect this to be towards 14% by the end of 2011 only to moderate post-election in 2012.
- From 2013 the new fiscal stability law will come into force limiting the ability of the government to spend and borrow. It will then also become easier for the Bank of Mongolia to manage money flows as most major mining equipment investments for Oyo Tolgoi will have been dealt with. The Mongolian Tögrög (MNT) has been the second best performing currency vs. the USD in 2010 and we expect further mild appreciation or at least stability due to large capital inflows. With continued high real GDP growth the real

exchange rate will have to adjust, either through nominal appreciation or inflation. It will likely be a combination of both with most adjustment coming through inflation. A sharp depreciation would cause issues for both government debt (relatively modest at 43% of GDP) and the banking sector. It would also import inflation thus the BOM will remain vigilant to prevent any major moves.

· The regulatory framework and the banking sector, while improving, are still fragile. In a small economy like Mongolia many interests are linked leaving the system open to shocks. We do see efforts by politicians to implement reforms and believe that after the election next year the need for populist policies will diminish. Overall, as expected in any frontier growth market, there are many opportunities but also plenty of challenges in Mongolia. On balance we are confident that Mongolia is set for some spectacular growth and that risk factors will not derail its progress, perhaps only slow it down.

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### **About Frontier Securities**

Frontier Securities, based in Ulaanbaatar, Mongolia is a Mongolia's pioneer boutique international investment bank with a seat on Mongolian Stock Exchange working to provide clients with best of both worlds: investment bank with on-the-ground presence and expertise in frontier markets with full cross border service capabilities and international financial markets experience/know-how with particular strengths in Asian financial markets of Hong Kong, Tokyo and Singapore. Information about the firm is available at [www.frontier.mn](http://www.frontier.mn).

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