THE BANK
OF MONGOLIA

INFLATION REPORT

2020
APR

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EXECUTIVE SUMMARY

This edition of the inflation report comprises the changes in the domestic and external conditions and outlook of the Mongolian economy since the March meeting of the Monetary Policy Committee.

Although economic growth is to be supported by expansionary fiscal stance and measures of relieving pension loan repayments this year, it is expected to slow down significantly due to reduced external and domestic demand and lower commodity prices induced by the spread of COVID-19. Expectations of inflation being stabilized at the Central bank target level remain in the absence of supply shortfall.

A crucial condition for the inflation target being met is the avoidance of any supply constraints emerging due to the global lockdown. Inflation reached 6.4 percent nationwide and 6.8 percent in Ulaanbaatar city as of March 2020, out of which 2.1 percentage points were attributed to increases in meat prices. Meat supply is not expected to encounter shortages this spring, as the amount of meat stock has increased, and meat exports have been restricted. Given the conditions of meat prices fluctuating according to its seasonal pattern, a contribution from increases in meat prices to inflation is not expected to enlarge. Oil prices drop at the global market have provided room for domestic gasoline prices to fall. For instance, in March 2020, the price of gasoline declined by an average of 50 MNT, and the price of A-92 gasoline is assumed further to be reduced by 300 MNT and other types by 100 MNT in mid-April. However, there may be risks of rising inflation fluctuations in the case where imports of some food products slow down. Under the circumstances of the absence of any sudden fluctuations driven by supply-side shocks, inflation is projected to decline throughout the first half of 2020 and gradually increase during the second half to reach the Central bank target level of 6 percent by the end of the year.

Economic growth is expected to contract substantially in the first half of 2020 due to COVID-19 pandemic. The growth projections for 2020 have been revised downwards as the spread of COVID-19 has been fueling to uncertainties and weakening external and domestic economy. COVID-19 is expected to render much more negative consequences for activities in mining, services, transportation, construction sectors, and net taxes on products, compared to agriculture, communication, and energy sectors. Uncertainties associated with macroeconomic projections stem from a number of sources including, the extent and duration of the spread of COVID-19 and impact of measures dealing with the pandemic on the external and domestic economic environment, further developments in the trade war, Oyu Tolgoi underground mine development plan and implementation process of the railway and other major domestic projects.

Money supply growth has been slowing down in the past 4 consecutive quarters and is expected to continue to slow in the first half of 2020. Credit growth in the banking system slowed to 0.7 percent[1] in February 2020 mainly driven by a contraction in consumer loans and gradual weakening of business loan growth. Such deceleration in credit growth mainly contributed to slowing down of money supply growth, which has remained to be mostly driven by growth in foreign assets. Credit growth is expected to continue its deceleration path in the first half of 2020 and gradually recover in the second half.

[1] It is 4.1 percent, adjusting the impact of pension loan repayment write-offs.

Uncertainties in the external environment have fueled and external demand has fallen. Global economic growth outlook has plummeted from previous estimates as the outbreaks of COVID-19 continue to spread worldwide. Though China has contained the spread of COVID-19, the quarantine has been lifted and production has resumed, the service sector has not recovered much and Chinese external demand and economic growth are expected to be negatively impacted by worsening conditions in the US and European economies. In the future, the outlook for external demand will depend on how long it takes for countries to control the spread of COVID-19.

As foreign trade deficit widens, the balance of payments is expected to deteriorate in 2020. In the first 2 months of 2020, the balance of payments was in a deficit of 82.8 million USD, which is a worsening of 265.5 million USD from that of previous year. This was due to an increase in the current account deficit by 169 million USD year-over-year driven by a reduction in export revenue and a decline in financial account surplus by 191 million USD year-over-year through a decrease in FDI and portfolio investments.

Export prices fell by 7 percent and import prices by 6 percent, **Terms of Trade deteriorated** by 13 percent from previous month and 1 percent year-over-year in February 2020. Even though projections of lower crude oil prices and higher gold prices in 2020 are expected to positively contribute to terms of trade, its outlook is deteriorating for 2020 as the outlook for non-gold export prices deteriorate and there is a high risk of further decline.

I. INFLATION

The Bank of Mongolia's monetary policy aims at stabilizing inflation, measured by a consumer price index, at around 8 percent in 2020 and around 6 percent starting from 2021. Headline inflation reached 6.4 percent nationwide and 6.8 percent in Ulaanbaatar city as of March 2020 (Figure I.1).

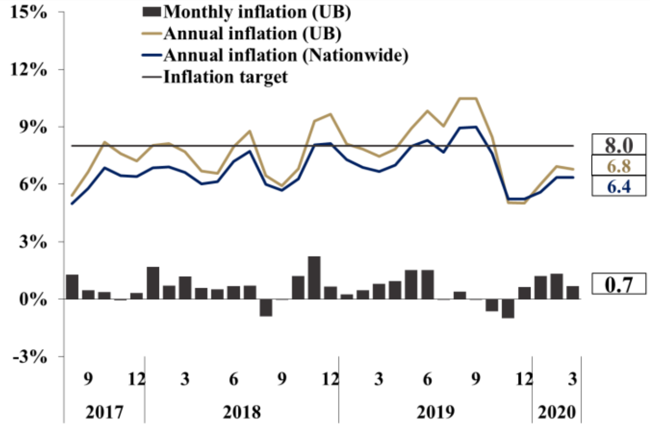
Economic activities have been slowing down, rendering demand-driven prices increases to remain subdued. The average price of oil fell to $34 a barrel in March 2020 due to the spread of COVID-19, which weakened the global oil demand and the major oil suppliers failed to reach an agreement. In April, oil prices have started to recover as OPEC+ member countries have reached certain agreements. Domestic fuel prices fell by 20-50 MNT in March, contributing 0.2 percentage points of inflation.

The prices of meat started to increase in January 2020 in line with its seasonal patterns, as well as owing to emerged negative expectations of COVID-19. In the last week of January 2020, prices of meat increased substantially and its contribution to inflation remained significant. Prices of meat then remained relatively stable in February and March 2020 and contributed 2.1 percentage points to inflation (Figure I.3).

In March 2020, prices of food declined from previous month according to the NSO weekly price survey of some main commodities in Ulaanbaatar city. In terms of price trends, vegetable prices rose throughout the month, meat prices rose until mid-March and fell, while other food prices rose in the middle of the month (rice prices fell) and remained stable since then.

Figure I.1

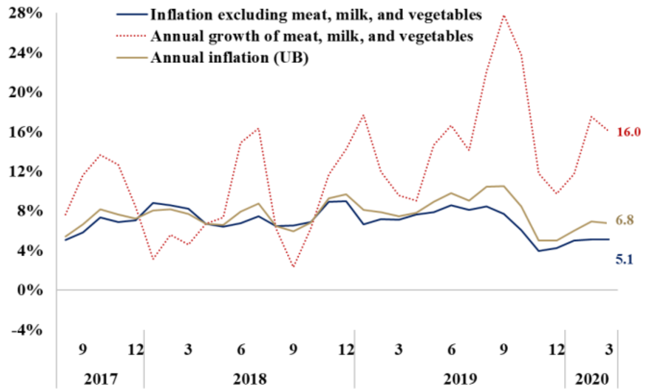
Inflation



Source: NSO

Figure I.2

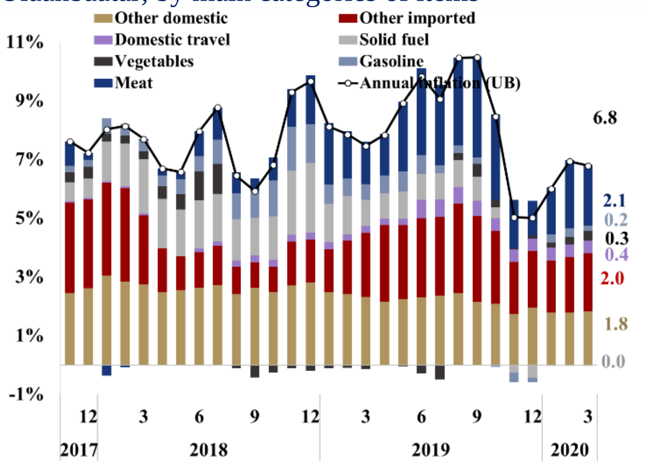
Headline and core inflation



Source: NSO, Bank of Mongolia

Figure I.3

Contributions to annual headline inflation in Ulaanbaatar, by main categories of items



Source: NSO, Bank of Mongolia

Inflation outlook

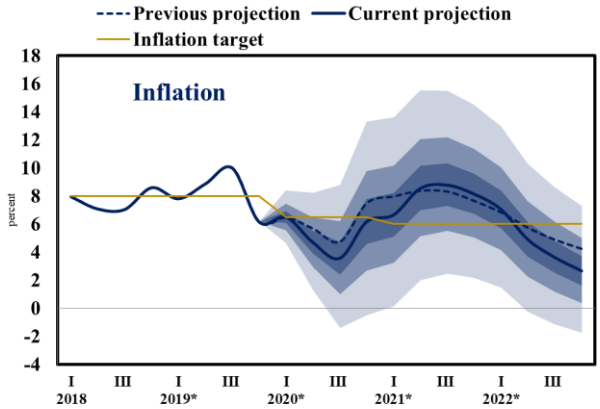
Inflation projections have been revised downwards, as inflation pressure is expected to be lower due to the slowing down of domestic and external economic activities associated with the increased spread of COVID-19 and the reduction of supply-side inflationary pressures (Figure I.4).

Inflationary impact of several supply-driven factors is expected to remain relatively subdued in 2020. For instance, a sufficient amount of meat stock for domestic consumption has been accumulated and meat exports have been restricted, so the outlook for meat prices remains favorable without any sudden jumps driven by supply shortages. Moreover, as the oil prices in the international market decline, domestic fuel prices are expected to fall again in the second quarter of 2020.

With regards to the demand side, inflation is expected to be driven upwards by factors including, relieving of pension loan repayments, increases in wages of public sector employees, and expansion in fiscal policy stance.

Figure I.4

Inflation projection



Source: Bank of Mongolia

Table I.2

Inflation forecast[2]

	2019	2020*	2021*
	actual.	***projection***	
Inflation, CPI[3]	6.1	6.2 [4.3-7.8]	8.1 [6.5-9.6]

**Projection*

Source: Bank of Mongolia

However, headline inflation is projected to decelerate in the upcoming quarters, owing to weaker external demand, and a substantial reduction in domestic economic growth induced by the spread of COVID-19.

Inflation is expected to increase by the end of the year due to a base-year (2019) downturn effect and demand-driven inflation is expected to gradually pick up in 2021 and stabilize around its target level in medium-term with the recovery of economic activities and economic growth when the spread of COVID-19 is contained.

Uncertainties that may affect inflation outlook:

- Potential shortage or oversupply of goods and services have significant implications on inflation projections. For instance, depending on the weather conditions of this upcoming summer, prices of meat and vegetables may be subject to sudden fluctuations, prices of administered items may increase by exceeding projections and these factors may alter inflation forecasts.
- Supply driven price increases may take place under the circumstances of supply disruptions of several food items induced by longer than expected spread of COVID-19 and the restriction measures throughout the world.
- In the event of fiscal stance loosening beyond the level approved for 2020 with regards to the parliamentary election, such measure to boost fiscal capital expenditure bears risks of increasing inflationary pressure through higher imports.

[2] 30 хувийн магадлалтай итгэх интервал
[3] Он тус бүрийн 4 дүгээр улирлын дундаж инфляци

- Over performance of public investment-related works and services could increase the risks of increasing the current account deficit and pressuring on togrog to depreciate.

II. ECONOMIC GROWTH

Economic activities slowed down in the 4th quarter to have a preliminary estimate for the real GDP growth reach 5.1 percent in 2019. From the demand side, growth of gross capital formation and household consumption has been supporting total demand growth since the second half of 2017, while net exports have been making negative contributions. From the production side, activities in the majority of sectors except for mining and transportation remained elevated and contributed to total supply growth. Growth of agriculture, manufacturing, energy, and services were relatively high among production sectors.

Monthly indicators of the real sector

In the first 2 months of 2020, the real sector indicators show that economic activity continues to weaken.

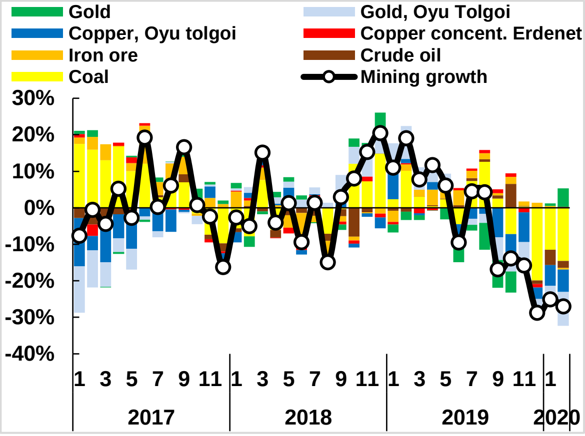
Mining production decreased by 26.1 percent year-over-year in the first 2 months the year. Oyu Tolgoi copper concentrate of -16.8 percentage points, coal production of -12.9 percentage points, and crude oil extraction of -3.1 percentage points have contributed negatively to the growth. On the other hand, gold and iron ore productions contributed positively by 2.8 percentage points and 0.1 percentage points, respectively (Figure II.1).

Manufacturing production declined by 10.6 percent in January and expanded by 10.1 percent in February, with an overall decline of 1.8 percent in the first 2 months of the year. Chemical production contributed -2.2 percentage points, steel production -1.3 percentage points, textile production -1.2 percentage points, and construction materials -1.1 percentage points negatively to total the manufacturing production. On the other hand, beverage production contributed 3.7 percentage points, flour 0.9 percentage points, dairy products 0.5 percentage points, and leather 0.4 percentage points positively to the production (Figure II.2).

Nominal net tax revenue declined by 17.9 percent in the first 2 months of 2020 due to lower imports and

Figure II.1

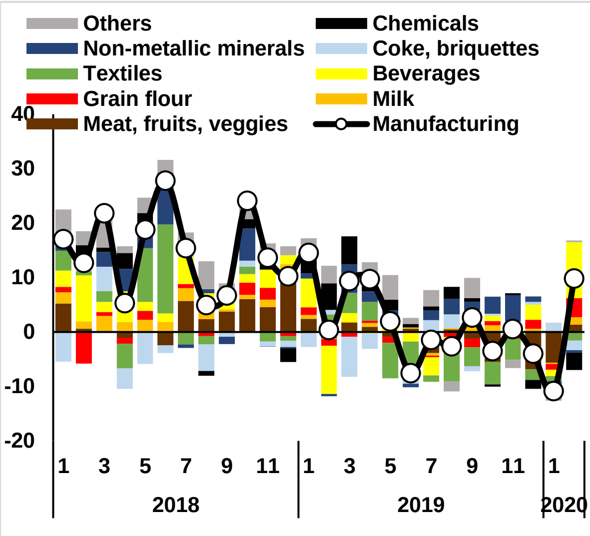
Production in the mining sector contracted by -26.1% in the first two months of 2020 owing to decline in production of mining products, except gold and iron ore.



Source: NSO, Bank of Mongolia

Figure II.2

Production in manufacturing contracted by 1.8 percent in the first two months of 2020.



Source: NSO, Bank of Mongolia

weaker economic activity. Value-added tax revenue contributed -13.5 percentage points and excise tax revenue contributed -3.7 percentage points negatively to the change in net tax revenue (Figure II.3).

Monthly labor market data shows that the declining trend in transition of people registered as unemployed has intensified in recent months. Number of people newly registered for unemployment has been decreasing, while number of people removed from the registry for shifting to inactive status in seeking employment has been increasing (Figure II.4).

Economic growth outlook

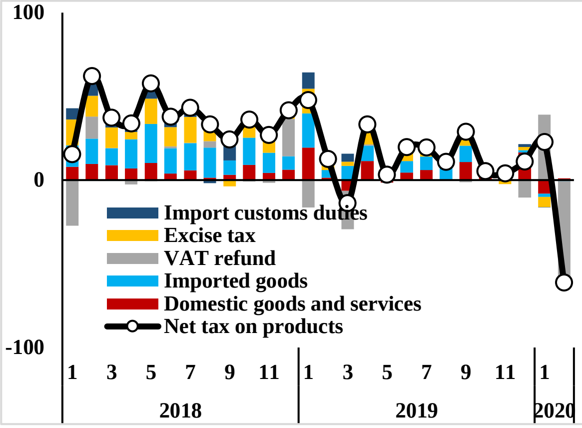
Economic growth outlook has been revised downwards for 2020. This was mainly due to the continued spread of COVID-19 and its impact on the economy, which is expected to last until the end of second quarter this year, and the fact that relevant indicators in some sectors of the economy were below expectations. Economic growth outlook remains unchanged for 2021 and production in mining sectors is expected to recover under the circumstances that external demand bounces back, metal content in copper concentrates improves and development of mega projects continues on track while production in non-mining sectors stabilizes (Figure II.5).

Mining: Coal and oil exports are revised down for the first half of the year, given the sharp decline in external demand, the slowdown in transportation due to decontamination procedures despite the lifting of the ban on coal exports in late March, and uncertainty regarding when oil exports will resume. In line with this, the mining sector growth is revised down for this year, and it is expected to pick up next year as external demand recovers, gold content in Oyu Tolgoi copper concentrates improves, also owing to the contribution of base effect in the wake of this year's downturn.

Non-mining: The outbreak of COVID-19 in Europe and North America and the extension of the high-alert status by the State Special Commission until April 30 continued to weaken economic activity, particularly in manufacturing, services, trade, transportation, and construction and a downward trend in net tax revenues is likely to continue. If restrictions are

Figure II.3

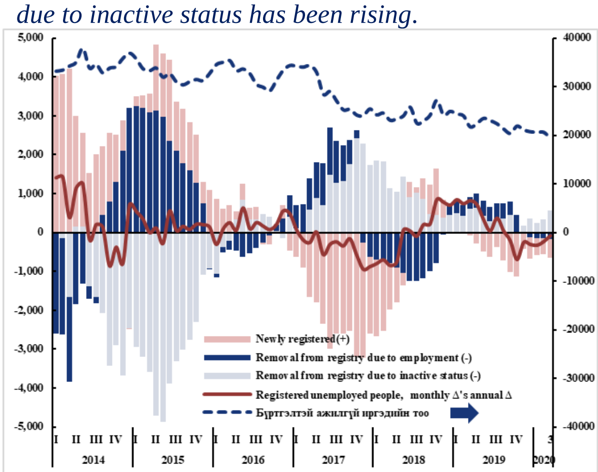
Nominal net tax revenue in the first 2 months of 2020 decreased by 17.9 percent year-over-year.



Source: Ministry of Finance, Bank of Mongolia

Figure II.4

New registration of unemployed people has been declining, while de-registration of unemployed people due to inactive status has been rising.



Source: Department of Labor and Welfare extended further, the difficulties in these sectors will deepen. In addition, domestic construction materials production declined in the first 2 months of this year, and imports of construction materials fell 28 percent from a year earlier, thus growth in the construction sector is revised down for this year.

However, the impact of COVID-19 on the sectors of agriculture, communication, and electricity is considered to be relatively small, and the growth forecast for these sectors remains unchanged. Growth in the non-mining sector will recover next year as external demand increases, the economy stabilizes, and domestic demand recovers.

Uncertainties that may affect economic growth outlook

The main source of uncertainty surrounding macroeconomic projection is the rapid spread of COVID-19 pandemic and its impact on the global economy. There are risks of domestic and foreign demand to weaken further and the contraction in our economic growth to be larger than projected if the spread of COVID-19 prolongs and the global economic demand declines sharply, and commodity prices fall. Moreover, if quarantine measures taking place for a longer duration than expected, activities in trade, services, construction, manufacturing, and transportation sectors are at risk of significantly deteriorating.

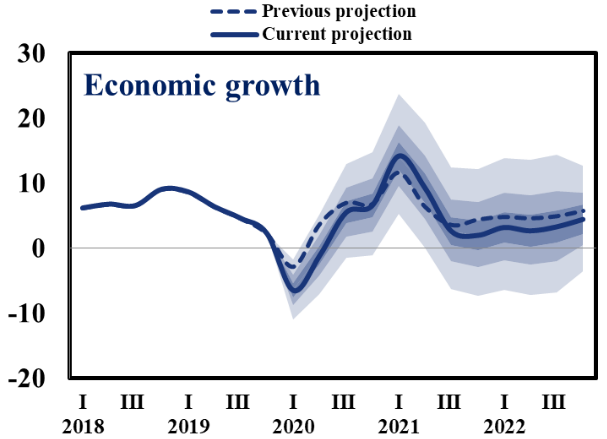
Mongolia's removal from the FATF "Greylist" would ease uncertainties in the future. Removal within a short time frame would diminish risks of downgrading of credit ratings, increased costs of external borrowing, difficulties in processing global financial transactions and payment systems, unfavorable investment environment, and reduced capital inflows.

Uncertainties regarding an initial public offering by Erdenes Tavan Tolgoi JSC on international markets under unfavorable external environment and financing mechanism for railway road construction persist.

Estimates of additional investments required for Oyu Tolgoi underground mine development have yet to be finalized.

Figure II.5

Forecast of annual growth of quarterly GDP



Source: Bank of Mongolia

Table II.1.1

Economic growth forecast *

	2019	2020**		2021**	
	actual	*projection*			
		гол ч	*interval*	*гол ч*	*interval*
Real GDP growth, %	5.1	1.8	[0.3, 3.3]	6.1	[3.9, 8.3]
Mining growth, %	-0.6	-5.9	[-7.4,-4.4]	9.0	[6.8,11.2]
Non-mining growth, %	6.7	3.8	[2.3, 5.3]	5.4	[3.2, 7.6]

**Confidence interval with a probability of 30*
***Projection*
Source: Bank of Mongolia

Table II.1.2

Changes in economic growth outlook

Assumptions of near term forecasts of economic growth for 2020

Previous forecast (as of March 2020)	Current forecast (as of April 2020)
AGGREGATE DEMAND	**Expectation weakened**
Consumption	**Expectation unchanged**
• As there was no information update, the consumption forecast was maintained at the previous month's forecast.	
Investment	**Expectation unchanged**
• As there was no information update, the investment forecast was maintained at the previous month's forecast.	
Net exports	**Expectation weakened**
• Exports of coal, oil, and other commodities have been revised downwards as economic activity weakened and the transportation of mining commodities contracted owing to the prolonged spread of COVID-19 pandemic. • Imports of diesel and other fuels declined due to lower economic activities and reduced import transportation of mining commodities induced by the spread of COVID-19. Foreign trade deficit projections have widened as contraction in exports exceeded that of imports.	
AGGREGATE SUPPLY	**Expectation weakened**
Mining	**Expectation weakened**
Production of coal and crude oil are expected to contract, as economic activities in China slows down owing to the preventative measures implemented against the spread of COVID-19	
Non-mining	**Expectation weakened**
• The slowdown in external demand and the slowdown in the construction sector will have a negative impact on the value added of the construction sector. • Growth in the construction sector is expected to slow due to a shortage of construction materials and the risks of the COVID-19. • The growth of financial and insurance services is expected to slow owing to the slowdown in the economy.	

Source: Bank of Mongolia

III. DOMESTIC ECONOMIC DEVELOPMENTS

III.1 Money and financial market

III.1.1 Monetary and credit indicators

Annual growth of M2 money supply has been gradually slowing down throughout the past 4 consecutive quarters and reached 5.2 percent as of February 2020. Continued decline in the growth of credit issued by banks has been the major contributor to such deceleration. Increases in net foreign assets remain to have been supporting a significant portion of money supply growth.

Expansion of net foreign assets by approximately 800 million dollars rendered a contribution of 12 percentage points to money supply growth. (For detailed description on changes in net foreign assets which are directly associated with the balance of payments, refer to the section on the balance of payments.)

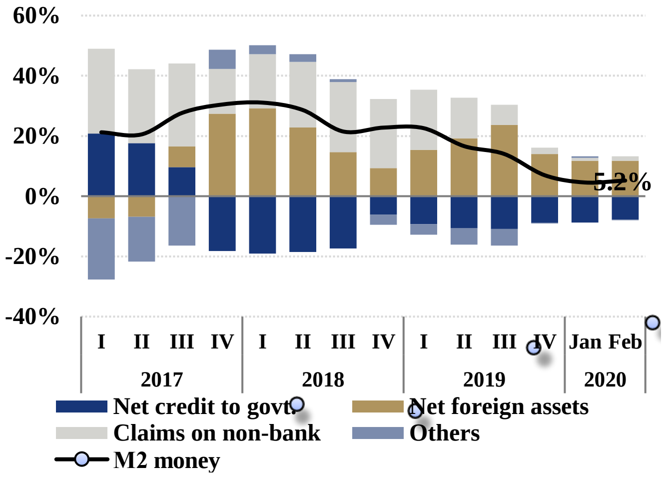
Deceleration in credit growth has been mainly driven by a contraction in consumer loan and gradual weakening of business loan growth. With regards to consumer loans, though new issuance of card and herders' loan has been rising, outstanding amount of wages, pension, automobiles, and other consumer loans continues to fall. Looking at credit growth by currency classifications, an outstanding amount of credit issued in togrog expanded by 5.6 percent, while an outstanding amount of credit issued in foreign currencies declined by 27.8 percent.

Net credit to government has been declining due to repayments of loans issued to the government being made in accordance with the planned schedule and increased amount of government funding available in the banking system. Fiscal deficit and principal debt repayments have been financed through external and domestic sources accumulated in the general budget in 2019, with the remaining amount being held as current accounts at the central bank.

Money supply growth, from the liabilities side, was mainly supported by expansion of deposit accounts in domestic and foreign currencies

Figure III.1.1.1

Contributions to annual growth of M2 money supply, by assets

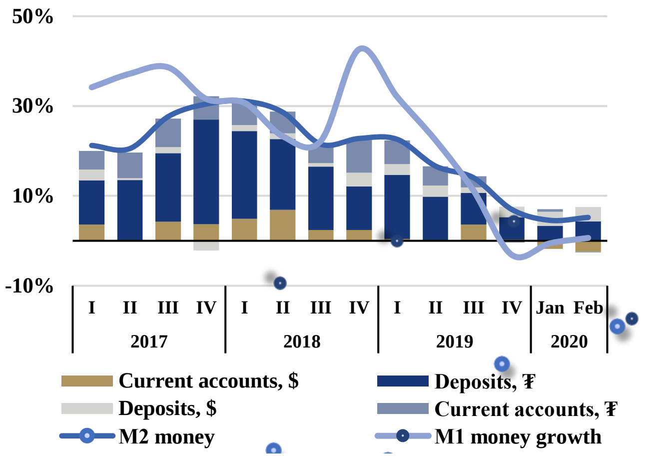


Non-bank receivables include loans and securities. As a result of relieving pension loans repayments, loans were written off and receivables (securities) from government agencies increased.

Source: Bank of Mongolia

Figure III.1.1.2

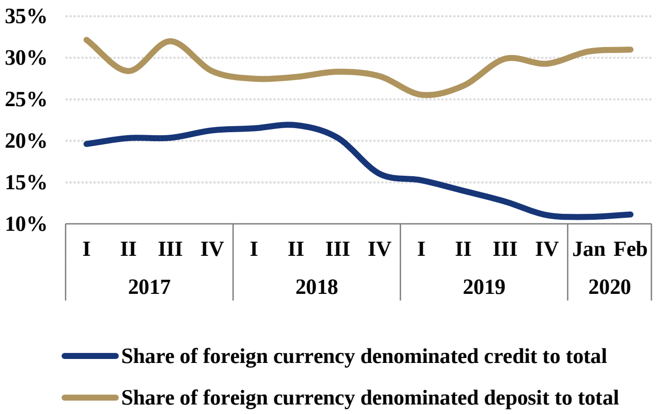
Contributions to annual growth of M2 money supply, by liabilities



Source: Bank of Mongolia

Figure III.1.1.3

Dollarization of bank credits and deposits



Source: Bank of Mongolia

(Figure III.1.1.2). In accordance with the growth of deposit accounts denominated in foreign currencies picking up since February 2019, bank deposit dollarization has been increasing.

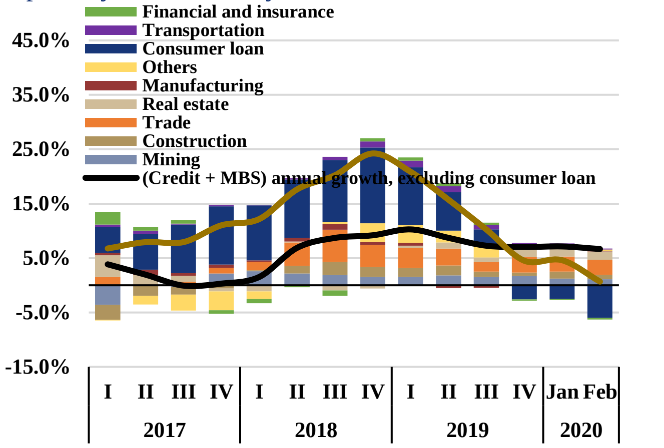
Combined outstanding level of total credit issued by depository institutions[4] and mortgage loans converted to mortgage-backed securities (MBS) increased by 0.7 percent[5] as of February 2020. A majority of credit growth has been attributed to loans issued to mining, construction, trade, and real estate sectors. Owing to the implementation of macroprudential policy measures since 2019 and measures of relieving pension loan repayments, an outstanding amount of consumer loan declined by 18.5 percent or approximately 1 trillion MNT and significantly contributed towards the deceleration of credit growth. Of which, about 670 billion MNT is attributed to the write-off of pension loans. Furthermore, another factor contributing to such deceleration of credit growth was sluggish increases in loan issued to small and medium enterprises in the latter half of 2019.

Looking at the composition of the outstanding level of total credit, share of consumer loans have been reducing. Specifically, a share of consumer loans to total credit fell by 5 percentage points to reach 23 percent[6]. On the other hand, combined shares of loans issued to mining, trade, real estate, and construction sectors to total credit increased by 6 percentage points to reach 54 percent.

Quality of credit issued by banks has not been significantly improving. Around 17 percent of total credit is attributed to non-performing and past-due loans. Out of total non-performing and past-due loans, loan issued to mining, construction, manufacturing, trade, and real estate sectors comprised 70 percent. Among production sectors, quality of loan issued to mining and construction sectors improved, while quality of loan issued to manufacturing, trade, and for consumer purposes deteriorated.

Figure III.1.1.4

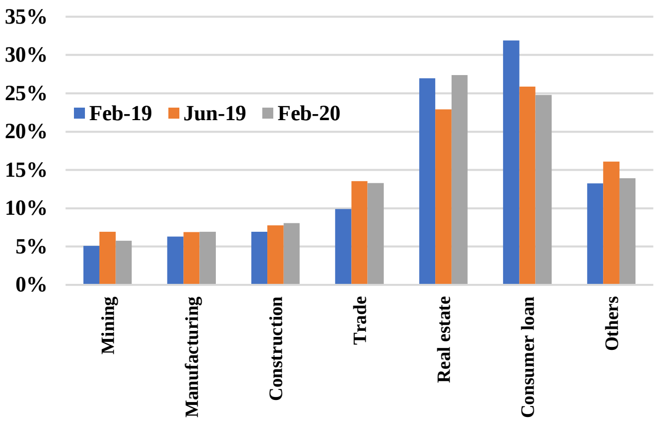
Contributions to annual growth of credit issued by depository institutions, by sectors



Source: Bank of Mongolia

Figure III.1.1.5

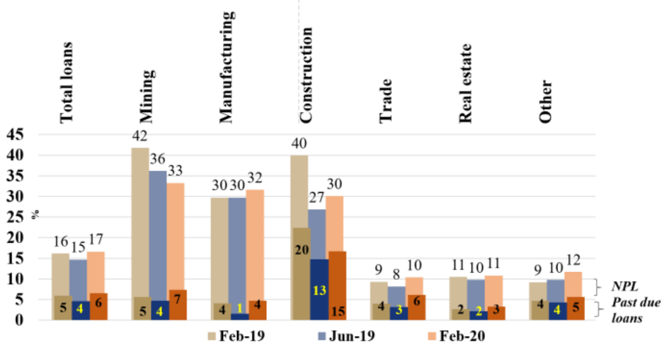
Composition of outstanding amount of credit issued by banks, by sectors



Source: Bank of Mongolia

Figure III.1.1.6

Share of non-performing and past-due loans to total outstanding amount of credit, by sectors



Source: Bank of Mongolia

[4] Depository corporations consist of banks and deposits and loans cooperatives.
[5] It is 4.1 percent, adjusting the impact of pension loan repayment write-offs.
[6] It is 25 percent, a 3 percentage points decline, adjusting the impact of pension loan repayments write-offs.

III.1.2 Interest rate

The Monetary Policy Committee of the Bank of Mongolia decided to lower the policy rate by 1 percentage points to 10 percent during its scheduled meeting in March 2020 and by another 1 percentage points to 9 percent on its unscheduled meeting in April 2020.

In February 2020, the weighted average of interbank market interest rate increased by 0.09 percentage points from the previous month and reached 10.95 percent. This was due to an increase of 0.37 percentage points in repo transactions secured by the central bank bills reaching 11 percent and a 0.02 percentage point increase in interest rates on direct trading of central bank bills to 10.79 percent. The interest rate on overnight loans decreased by 0.04 percentage points to 11 percent, and the interest rate on interbank deposits decreased by 0.2 percentage points to 11.91 percent. Interbank deposit rates have been elevated in recent months as commercial banks expect market risks to be high and seek high returns on unsecured loans.

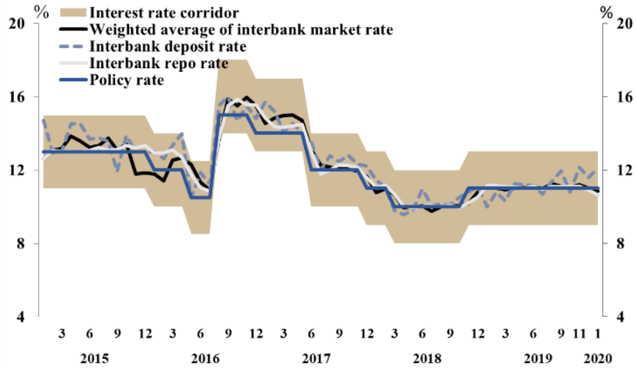
The interest rate on newly issued loans in local currency and interest rate on new deposits have declined. In February 2020, the average interest rate on loans newly issued by banks in local currency decreased by 0.36 percentage points that of the previous year to 16.65 percent, while the interest rate on deposits in local currency decreased by 0.79 percentage points to 9.81 percent. Consequently, the interest rate margin (for local currency loans and deposits) widened by 0.43 percentage points from that of previous year reaching 6.84 percent.

As for loans in foreign currency, interest rate on newly issued FC loans decreased by 0.74 percentage points from that of previous year to 10.32 percent and interest rate on new FC deposit rate decreased by 0.71 percentage points to 3.76 percent in February 2020. Consequently, interest rate margin (for foreign currency loans and deposits) narrowed by 0.03 percentage points from that of previous year to 6.56 percent.

The relative yield on MNT remained positive for the first 10 months of 2019 and it fluctuates around 0 for the past 4 months as the nominal exchange rate of MNT depreciates against USD.

Figure II.1.4.2.1

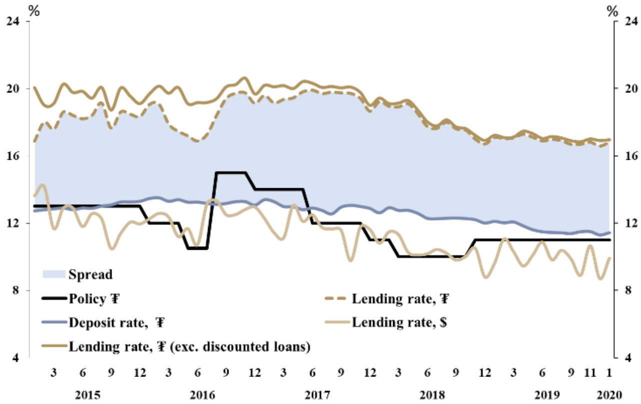
Weighted average of interbank market rate remains close to the policy rate



Source: Bank of Mongolia

Figure II.1.4.2.2

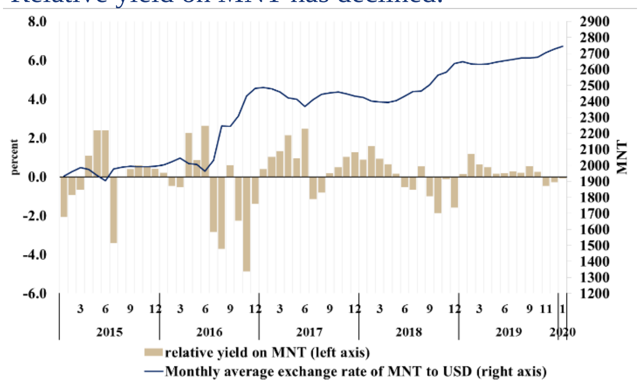
Interest rate on newly issued loans and new deposits have dropped.



Source: Bank of Mongolia

Figure II.1.4.2.3

Relative yield on MNT has declined.



Source: Bank of Mongolia

III.1.3 Exchange rate

Since the beginning of 2020, the MNT has been gradually depreciating against the US dollar, reaching MNT 2781.9 as of April 15, 2020. This is a 1.7 percent depreciation from the beginning of the year /Figure III.1.3.1/.

Togrog depreciation was mainly driven by the following. Exports declined by 42 percent or 700 million USD in the first three months of this year, the current account deficit widened by 63 percent or 169 million USD, the balance of payments was in a deficit of 82.8 million USD in the first two months and expected to have a deficit of about 360 million USD in the first quarter of 2020.

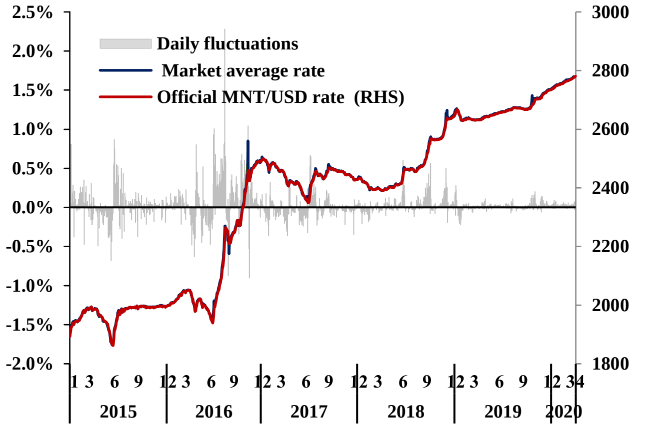
The outbreak of COVID-19 has led to a decline in capital outflows from developing countries, as well as a gradual reduction in policy rates to support the economy, increasing pressure on the exchange rate. Moreover, the sharp decline in global oil prices is putting additional pressure on the prices of some oil-exporting countries. In particular, since the beginning of 2020, the Mexican peso, the Russian ruble, and the Kazakhstani tenge have depreciated by 22.4%, 21.0%, and 11.4%, respectively. The currencies of mineral exporters South Africa, Brazil, Chile, and Indonesia have depreciated by 33.4%, 30.1%, 13.4%, and 13.41%, respectively, since the beginning of the year.

The nominal effective exchange rate (NEER), weighted by trade turnover, depreciated by 2.3 percent year-over-year in February 2020 (Figure III.1.3.2) This was mainly attributable to the 7.8 percent depreciation of MNT against Ruble year-over-year. Moreover, MNT depreciated against RMB and Euro slightly or by 0.8 percent and 0.7 percent respectively (Figure III.1.3.3).

Real effective exchange rate (REER) appreciated by 3.6 percent year-over-year in February 2020. Despite the weakening of the nominal exchange rate, domestic price increased more rapidly than the foreign price, thus relative price increased by 5.7 percent.

Figure III.1.3.1

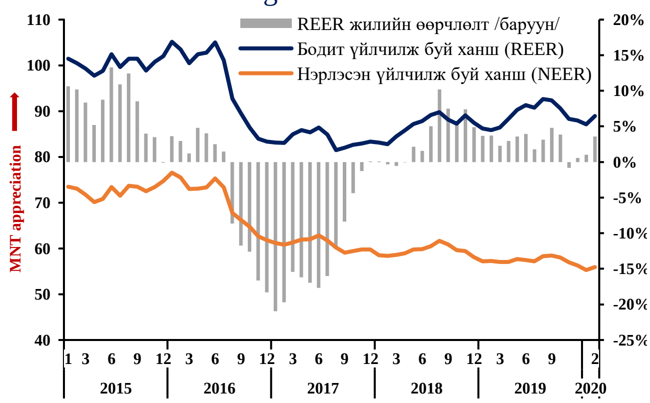
Cross rate of MNT to USD



Source: Bank of Mongolia

Figure III.1.3.2

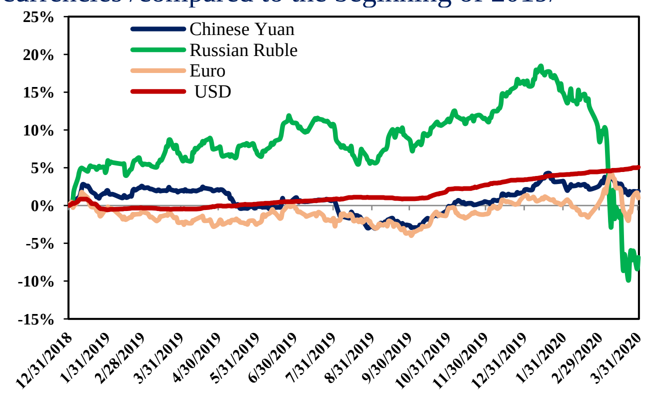
Real effective exchange rate of MNT



Source: Bank of Mongolia

Figure III.1.3.3

Change in MNT exchange rate against major currencies /compared to the beginning of 2019/



Source: Bank of Mongolia

III.1.4 Capital market

The economic activity weakened because of COVID-19 and the TOP-20 index continued to decline in the first months of 2020. As for the housing market, the price-to-income ratio, which reflects the purchasing power of housing, has been stable, while the price-to-rent ratio has continued to decline in the 4th quarter of 2019.

The outbreak of COVID-19 is affecting both external and domestic economic activities and uncertainties. The domestic capital market indicators have deteriorated since the beginning of the year.

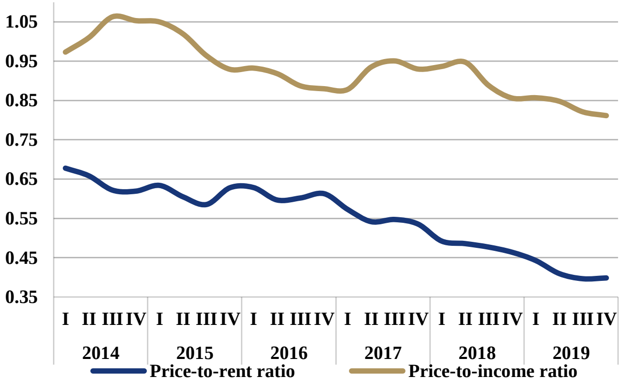
For example, the TOP-20 index declined by 0.9 percent from the previous month's average, reaching an average of 18,965.42 in February 2020. This was mainly due to a decline in Class I and Class II shares such as Gobi, Ard Daatgal, APU, and Mongol Basalt.

In the first two months of 2020, a total of 6.2 billion MNT worth of securities were traded on the stock market, a decrease of 83 percent from that of the previous year.

If the spread of COVID-19 prolongs, there is a risk that business activity to shrink and stock market indicators to continue to deteriorate.

Figure III.1.4.1

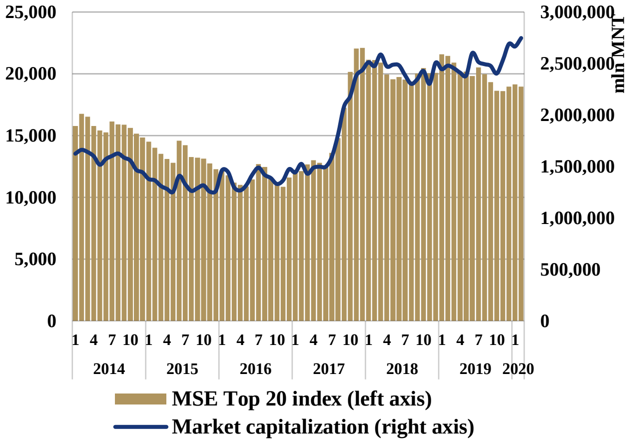
Risk of overheating looks limited and purchasing power remains stable.



Source: NSO, Bank of Mongolia

Figure III.1.4.2

While market capitalization has improved q-o-q, the weakening in MSE Top 20 index continued.



Source: Mongolian Stock Exchange

III.2 The consolidated budget and sovereign debt

The consolidated budget: As of the first quarter of 2020, the equilibrated budget revenue was 5.1 percent lower than planned and the budget expenditure was 30.9 percent lower than planned, resulting in a deficit of **276 billion MNT in the equilibrated balance**.

Total equilibrated revenue: Total equilibrated revenue **decreased by 89.6 billion MNT** compared to the same period of previous year. This was caused by slowing economic activity and delays in coal and crude oil exports with the outbreak of COVID-19, and a 5.7 percent year-over-year contraction in imports in the first quarter.

In particular, **mineral royalty revenue decreased by 64.6 billion MNT, crude oil revenue decreased by 26.2 billion MNT, and import-related tax revenue decreased by 27.3 billion MNT**, while social insurance revenue increased by 20.5 billion MNT and income tax increased by 9.1 billion MNT (Figure III.2.1).

Total expenditure and net credits:

In the first quarter of 2020, the budget expenditure utilization rate was 69.1 percent, of which capital expenditures' utilization was 31.7 percent. Compared to that of previous year, total expenditures increased by 380.7 billion MNT (or 19.3 percent). Looking at components of budget expenditure, subsidies and transfers increased by 179.8 billion MNT, expenditures on other goods and services increased by 138 billion MNT, and capital expenditures increased by 73 billion MNT (Figure III.2.2).

Total financing needs: A total financing of 553 billion MNT was needed in the reporting quarter. Of which 276 billion MNT was needed to finance the budget deficit, 200 billion MNT was for repayments of foreign loans, 41 billion MNT for repayments of domestic securities, and 36 billion MNT for repayments of domestic loans.

Source of funding: Of the financing needs, 274 billion MNT was financed by program loans, 80 billion MNT by foreign project loans, and 199 billion MNT was spent from the government's current and savings account balances.

Table III.2.1

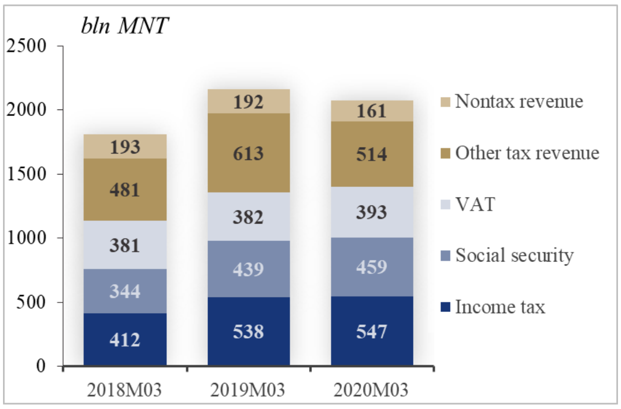
Fiscal indicators

billion MNT	2019 Act.	2020 App.	2020.03 Act.	2020.03 %
Total revenue	**11937**	**12900**	**2225**	**94.4**
Future heritage fund	1040	977	144	103.2
Stabilization fund	95	125	6	20.1
Equilibrated revenue	**10802**	**11798**	**2074**	**94.9**
Tax revenue	9749	10656	1913	97.2
Non-tax revenue	1053	1142	161	73.9
Total expenditure	**11429**	**13873**	**2350**	**69.1**
Primary expenditure	10568	12913	2164	58.6
Current expenditure/-interest paym	7347	9060	1947	76.0
Capital expenditure	2818	3806	241	31.7
Net credit	403	47	-24	142.1
Interest expenditure	861	960	185	96.1
Total equilibrated balance	**-628**	**-2075**	**-276**	
in percent of GDP	-1.7%	-5.1%		
Primary balance	233	-1115	-91	
in percent of GDP	0.6%	-2.7%		

Source: Ministry of Finance

Figure III.2.1

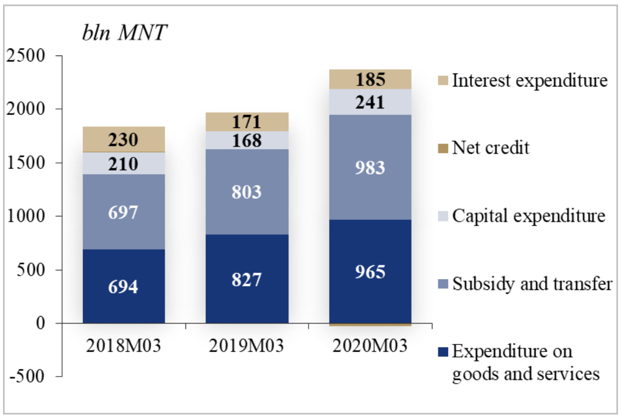
Structure of budget revenue



Source: Ministry of Finance

Figure III.2.2

Structure of budget expenditure



Source: Ministry of Finance

IV. EXTERNAL CONDITIONS OF THE ECONOMY

IV.1 Assumptions regarding the external conditions[7]

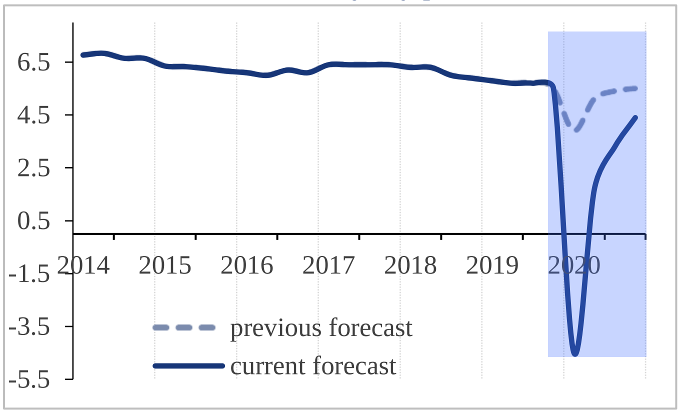
Compared to the previous forecast, the outlook for external demand has deteriorated sharply due to the spread of COVID-19 throughout the world.

External demand[8] outlook is revised down from previous forecast as the growth outlook of China for 2020 has plunged and the growth outlook for the Euro Area, the United States, and Russia have slowed down.

China's economic growth forecast for 2020 has been sharply reduced to 1.3 percent[9], while its 2021 forecast was revised up by 0.1 percentage points to 5.9 percent. The statistics for the first 2 months of 2020 were significantly lower than expected, which was one of the main reasons for the downward revision.

Figure IV.1.1

Forecast of external demand, y-o-y percent



Source: Bloomberg, The EIU, Roubini

For instance, Bloomberg economists forecast China's growth to be -11 percent in the first quarter, 3.7 percent in the second quarter, 6 percent in the third quarter, 6.6 percent in the fourth quarter, and overall growth of 1.4 percent for 2020. Recovery has been slow in some sectors of China's economy (especially in the service sectors), and the spread of the virus to Europe and the United States has hurt China's external demand. Going forward, the growth outlook will largely depend on how the spread of COVID-19 continues throughout the world. According to the pessimistic scenario of The EIU (Economist Intelligence Unit) projections, China's growth could fall to -1.5 percent in 2020. Although the spread of the virus has been controlled in China, the quarantine has been lifted, and the authorities are expected to support the economy through fiscal and monetary policies, the impact of such policies might be limited depending on responses by economic agents.

Russia's growth forecast has been revised down from 1.7 percentage points to 1.6 percent for 2020 and 1.8 percentage points to 1.7 percent for 2021. Compared to the previous forecast, the export revenue, fiscal revenue, and the growth outlook are expected to be negatively affected as China's growth forecast slowed sharply in the first half of the year, oil prices fell at the international markets, and trade sanctions were not eased (the US might further tighten sanctions on Russia).

Moreover, the economic activity is limited in Russia owing to an increased spread of COVID-19 and the tightening of quarantine measures. While COVID-19 led to a sharp drop in demand in the global economy, on the supply side, oil-exporting countries failed to reach an agreement on the production cut, and prices fell sharply. However, the OPEC and non-OPEC allies agreed to cut

[7] Forecasts of economic growth and inflation in main trading partner countries were compiled from March 2020 edition of EIU Global Forecasting Report, February 2020 edition of Roubini Global Economics and the median of forecasts conducted by Bloomberg analysts.
[8] External demand for Mongolia is calculated as the weighted average of main trading partner countries (where China 0.90, Russia 0.02, and Euro Area 0.08).
[9] The average of the forecasts from the EIU, Roubini, and Bloomberg as of March 27, 2020.

supply at OPEC+ meeting in April, it began to have a positive effect on prices. The oil price outlook, implementation of national infrastructure projects, and measures taken by the central bank and the government to stabilize and support the economy are expected to have a significant impact on the growth outlook for 2020.

Euro Area's growth forecasts have been revised down to an average of 0 percent for 2020 and 1.1 percent for 2021, down by 1.2 and 0.4 percentage points from the previous forecast, respectively[10]. COVID-19 has led to curfews in many countries and a sharp drop in growth forecasts for the region's key economies, including Germany, France, Spain, and Italy, has brought about a downward revision. The regional economy's outlook will largely depend on how quickly outbreaks are brought under control and how swiftly the economies return to normal levels. While the European Central Bank's policy of reducing financial losses in times of crisis and maintaining the financial system and economic stability is supporting the economy, European governments need stronger fiscal stimulus packages to support the economy and overcome financial difficulties.

Terms of trade

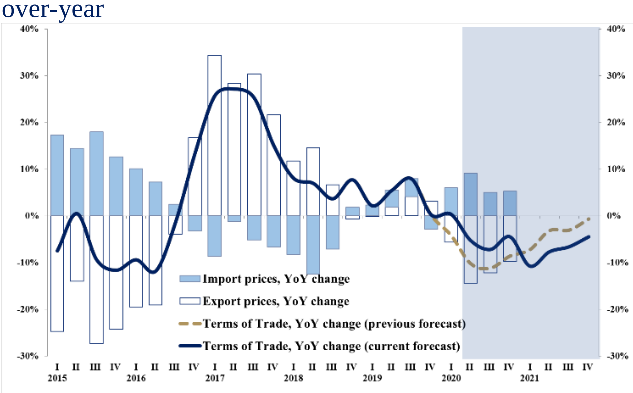
Price forecasts for copper and iron ore have deteriorated this year as global economic growth slows and demand for commodities declines. Even though projections of lower crude oil prices and higher gold prices in 2020 are expected to positively contribute to terms of trade, its outlook is deteriorating for 2020 as the outlook for non-gold export prices deteriorate and there is a high risk of further decline. The commodity prices are expected to rise next year as demand for commodities recovers.

Foreign interest rate: The US Federal Reserve lowered the FED funds rate to 0.0-0.25% in March as the number of people seeking unemployment benefits due to COVID-19 reached a record high of 7.1 million at the end of March and economic growth is expected to slow down.

As part of policy measures to mitigate the negative effects of the external environment from COVID-19 and promote employment, FED announced to increase the purchase of bonds by 700 billion USD and offered banks low-interest-rate collateralized loans up to 90 days and reduced required reserves to zero. The Fed is also taking measures to support financial market liquidity and has vastly increased its purchases of securities.

Figure IV.1.2

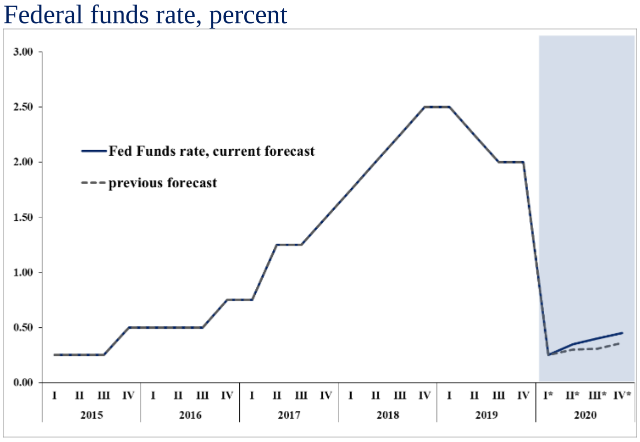
Changes in Terms of trade, export, and import prices, year-over-year



Source: Bank of Mongolia

Figure IV.1.3

Federal funds rate, percent



Source: Bloomberg

[10] The average of the forecasts from the EIU, Roubini, and Bloomberg as of March 30, 2020.

Global inflation

Inflation outlook in China has declined owing to weaker demand in the economy caused by COVID-19, the decline in supply-side as food price increases related to swine flu, that has pushed up inflation in recent quarters, has started to decline and lower fuel prices.

Russia's inflation is expected to exceed the central bank's target of 4 percent for 2020, as the pass-through effects of the ruble depreciation have increased despite downward pressure on demand factors coming from weakening economic activity.

In the United States, inflation is expected to remain below the central bank's target of 2 percent in 2020 due to rising unemployment, declining household consumption, falling oil prices, and the absence of tariffs on some imported products.

The inflation outlook in the Euro Area in 2020 has been revised down. In addition to the base that prices kept below the European Central Bank's target, negative shocks such as weakening economic activity, declining household incomes, and declining oil prices associated to COVID-19 would contribute to the downward revision on inflation forecasts.

Uncertainties in the external conditions

The external economic environment remains highly dependent on the extent and duration of the spread of COVID-19 and the impact of measures dealing with the pandemic. These are the main uncertainty of the external environment. Prolonged extent to bring the spread of COVID-19 under control in countries and the risk of a reemergence of outbreaks where the spread has been controlled could have a negative impact on our economy through the impact of China's economic growth and commodity prices. Geopolitical risks include expectations for a "Phase II" trade agreement between the United States and China, the post-Brexit international economy, and disagreement between oil-producing countries.

IV.2 Prices of Mongolia’s main exporting commodities at the global market

The slowdown in global growth outlook and the prolonged negative impact of COVID-19 on metal demand were the main reasons for declining commodity prices.

Copper: The average price of copper per ton at the London Metal Exchange was 5688 USD in February 2020 and dropped to 5183 USD in March 2020. The slowdown in China, which accounts for 50 percent of the global copper demand, and the risk that COVID-19 outbreaks will not subside in the short term have weighed on market sentiment. In the forecasting period, the slowdown in global economic growth caused by COVID-19 is expected to affect the metal demand negatively in the medium term. Deteriorating copper demand due to COVID-19 and stable copper supply could lead to a market surplus of 800,000 tons, the largest surplus since 2001. As of April 3 update, copper prices are expected to fall to an average of 5,454 USD (where Roubini $5400, BREE $5989, Bloomberg forward price $4982) in 2020.

Gold: Gold price rose to an average of 1,586 USD an ounce in February 2020 as uncertainty in the global economy and investors continued to shift to risk-free investment. However, the gold price decreased marginally and averaged 1,577 USD in March as the US Federal Reserve stepped up its efforts to stabilize the market. The gold price volatility is expected to remain high throughout 2020 depending on the spread of COVID-19 pandemic, length of containment period, and the stability of the world's major economies. As of second half of March update, the gold price is expected to average 1,557 USD (Roubini $1500, BREE $1474, Bloomberg forward $1650) in 2020.

Coking coal: As a consequence of COVID-19 outbreak, coke and steel production operated at 40-50 percent of its potential in February, coking coal consumption declined, and reserves increased. By the end of March, when the spread of COVID-19 is brought under control, China's industry is expected to reach 90-95 percent potential and return to normal levels going forward. Coal consumption is expected to continue to decline in the medium to long term, putting negative pressure on prices, but short-term fluctuations are likely to be largely dependent on the impact of COVID-19 on global economic activity and China's economic recovery. As of the second half of March update, Bloomberg analysts forecast coking coal prices at 160 USD per ton and BREE at 160 USD per ton for 2020.

Iron ore: The price of iron ore averaged 94 USD per ton in January, declined sharply from the beginning of February to an average of 81 USD per ton in February, and remained at an average of 83 USD per ton in March 2020. Coke and steel production fell sharply in February due to measures to prevent the spread of COVID-19 and rebounded in March which helped keep prices high. However, iron ore prices are expected to decline over the forecast period. Expectations of a slowdown in the global economy and a decline in demand for steel and iron ore are the main reasons why prices will not increase this year. As of second half of March update, iron ore prices are expected to average 71 USD for 2020 where Bloomberg projects 79 USD per ton and BREE projects 62 USD per ton.

Crude oil: A barrel of Brent oil was sold at an average of 50 USD in February and fell drastically to 22.7 USD in March 2020. On the demand side, the slowdown in the global economy and stricter restrictions to halt the spread of COVID-19 have affected oil prices. On the supply side, the OPEC and non-OPEC allies (Saudi Arabia and Russia) failed to reach an agreement on the production cut, and prices fell sharply owing to a supply surplus. However, despite the OPEC+ decision to cut supply at an unscheduled meeting in April, prices are expected to remain subdued as oil demand remains weak reliant on global economic activity. As of second half of March update, the oil prices are revised down to an average of 46 USD per barrel in 2020 (BREE 57 USD, EIU 45 USD, Bloomberg forward 38 USD).

IV.3 The Balance of Payments

In the first 2 months of 2020, the balance of payments was in a deficit of 82.8 million USD, which is a deterioration of 265.5 million USD year-over-year. The current account deficit widened by 169 million USD as exports declined due to COVID-19, and the financial account surplus contracted by USD 191 million year-over-year through a decrease in FDI and portfolio investments (Figure IV.2.1).

The current account deficit was 439.7 million USD in the first 2 months of 2020, an increase of 63 percent year-over-year. Despite slowing economic activity and declining imports of goods and services, exports fell by 30 percent, as a result of restrictions on coal and oil exports to prevent the outbreak of COVID-19, has negatively affected the current account balance. In the first 3 months, coal export volumes fell 61 percent from a year earlier.

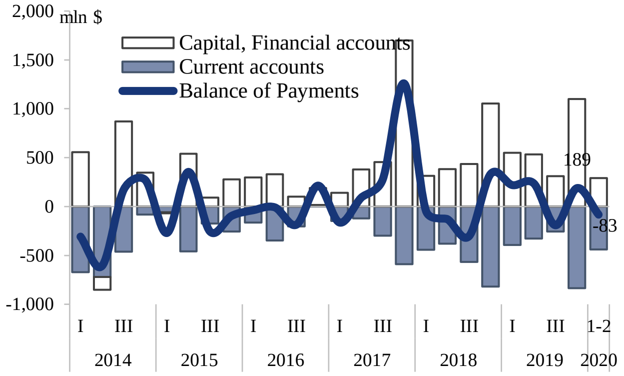
Goods' balance was in a deficit of 94 million USD in the first 2 months of the year and is expected to reach a deficit of 126 million USD in the first 3 months according to preliminary statistics. Thus, goods' balance is in deficit for the first time since the third quarter of 2018.

Export revenue decreased by 42 percent year-over-year in the first 3 months of 2020. More than half of the decline (22 percentage points) is explained by a decrease in coal exports, and the rest is due to a decrease in exports of copper concentrate, crude oil, gold, zinc, meat, and meat products (Table IV.2.2). As part of measures to prevent the outbreak of COVID-19, coal and crude oil exports have been suspended for more than 40 days since mid-February. In addition, the gold content of Oyu Tolgoi copper concentrate continued to decline, copper export revenues declined, gold exports decreased by three times compared to that of previous year, and exports of heat-processed meat products declined because of additional standard requirements. Exports of iron ore and silver increased.

Imports decreased by 5.7 percent year-over-year in the first 3 months of 2020. Diesel fuel consumption fell by 23 percent in view of limited coal exports.

Figure IV.2.1

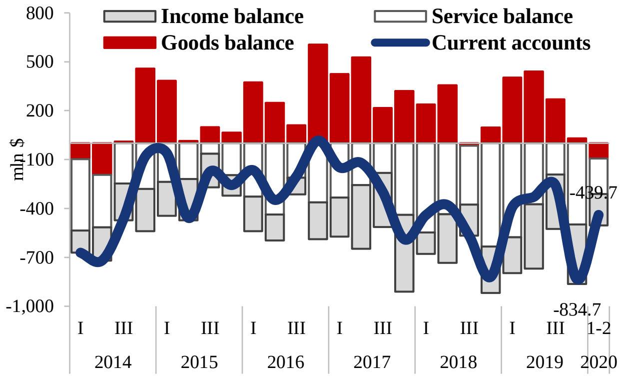
Balance of payments was in deficit in first 2 months of 2020 as deficit in current account widened and surplus in financial account narrowed.



Source: Bank of Mongolia

Figure IV.2.2

Decline in exports and narrower surplus in goods balance resulted in a wider current account deficit.



Source: Bank of Mongolia

Table IV.2.2

Decline in commodity exports except iron ore resulted in 41.5 percent y-o-y decrease in total exports in the first 3 months of 2020.

	2019 I	2020 I	Y-o-Y	Contri-bution %
Total Exports	**1,772**	**1,036**	**-41.5%**	**-41.5%**
Coal	642	252	-61%	-22.0%
Copper concentrates	504	351	-30%	-8.6%
Gold	196	80	-59%	-6.5%
Crude oil	88	18	-80%	-4.0%
Meat, meat products	31	5	-83%	-1.4%
Iron ore	107	141	32%	1.9%
Other	205	188	-9%	-1.0%

Source: Mongolian Customs, Bank of Mongolia

Imports of mining machinery and equipment and passenger cars declined with weak domestic demand and slowing economic activity. But imports of some strategic food items, such as sugar and wheat, increased (Table IV.2.2).

In the first 2 months of the year, **services account** deficit narrowed by 158 million USD or by 42 percent year-over-year reaching -217 million USD. This was mainly driven by a slowdown in the economy and a reduction in costs of business, trade, financial, and transportation services (Figure IV.2.3).

Income account was in a deficit of 193 million USD in the first 2 months of 2020, increased by about 5 percent year-over-year. This was mainly due to increased accrual interest costs on corporate bonds, increased net outflow of portfolio investment income by 18 percent year-on-year to 65 million USD, and increased net outflow of other investment income by 23 percent to 33 million USD over higher interest payments on government external loans. However, net outflows of FDI income decreased due to the suspension of oil exports in February this year, dividends under oil product sharing agreements were zero, and reinvestment earnings outflows decreased by 20 percent year-over-year as a result of reduced profitability of banks and enterprises in the first two months of this year (Figure IV.2.4).

The financial account was in a surplus of 280 million USD in the first 2 months of 2020, a decrease of USD 191 million USD year-over-year. Net **FDI inflows** decreased by 42 percent or 156 million USD year-over-year, reaching 215 million USD as the direct investment of Oyu Tolgoi JSC was lower than that of previous year.

In the first 2 months of this year, **portfolio investment** decreased by 320 million USD from that of previous year, with a net inflow of 28.9 million USD. In the same period last year, MIK HFC LLC issued a bond worth of 300 million USD at the international market while no new bonds were issued in the first 2 months of this year.

Table IV.2.3

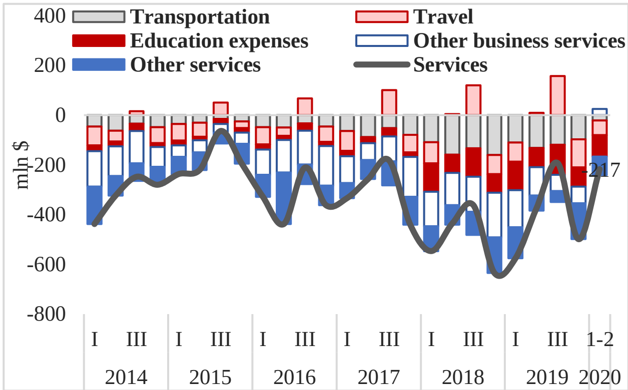
Imports of consumer goods, diesel, and construction materials are declined.

	2019 I	2020 I	Y-o-Y	Contri-bution %
Total imports	**1,232**	**1,162**	**-5.7%**	**-5.7%**
Capital goods	465	456	-1.9%	-0.7%
Consumer goods	351	320	-9.0%	-2.6%
Of which: Passenger cars	126	86	-32%	-3.2%
Fuels	267	239	-10.6%	-2.3%
Of which: Diesel	163	125	-23%	-3.1%
Other fuels	104	113	9%	0.8%
Industrial inputs	147	146	-1%	-0.1%
Other	2	1	-	0%

Source: Mongolian Customs, Bank of Mongolia

Figure IV.2.3

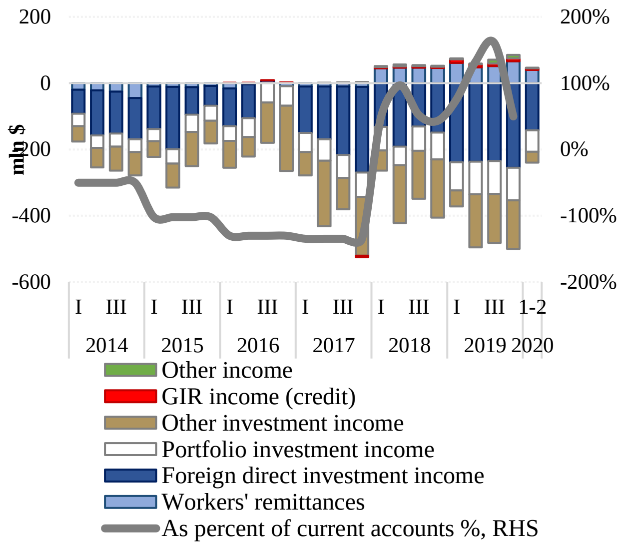
Deficits in business, financial and transportation services narrowed.



Source: Bank of Mongolia

Figure IV.2.4

Income account deficit is widened due to increased outflow in portfolio investment and other investment income accounts.



Source: Bank of Mongolia

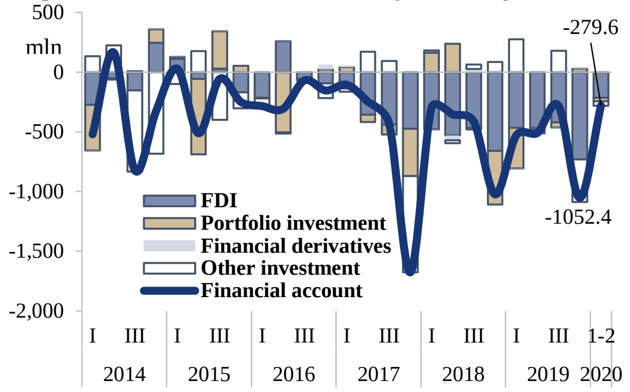
External loans had a net inflow of USD 162.6 million in the first 2 months of 2020 whereas it had a net outflow of 107 million USD in the first 2 months of 2019. The government's long-term external borrowing (due to the World Bank's loan disbursement in January within the IMF's EFF program) increased by 82 million USD year-over-year to 116.3 million USD, and banks' net inflows increased by 171 million USD year-over-year to 59 million USD as a result of a slight decrease in repayments and increase in disbursements of the long-term bank loans.

Gross international reserves (GIR): decreased by 292 million USD from the beginning of the year reaching 4086.8 million USD at the end of March 2020. Despite the decline in the GIR, imports paid in hard currency, an average of past three months, decreased by 26 percent, and the level of import coverage by reserves increased to 11.6 months (Figure IV.2.6).

Terms of Trade deteriorated by 13 percent from previous month and 1 percent year-over-year in February 2020. In February 2020, the custom's price of copper concentrate declined by 15 percent, the custom's price of coal declined by 16 percent, the price of fluorite, leucite, and nepheline decreased by 42 percent, the price of molybdenum decreased by 20 percent while the price of iron ore increased by 55 percent and the price of gold increased by 22 percent, resulting in 7 percent decline in overall export price. The price of imports fell by 6 percent year-over-year in February 2020 mainly driven by a decline in the price of imported investment products.

Figure IV.2.5

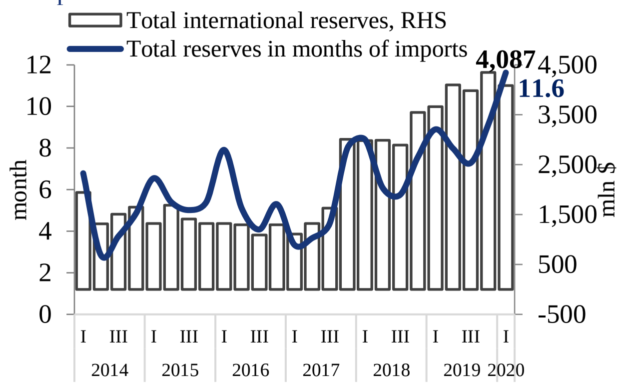
Surplus in financial account is mainly driven by FDIs.



Source: Bank of Mongolia

Figure IV.2.6

Gross international reserve is at level to cover 11.6 months of imports.



Source: Bank of Mongolia