THE BANK
OF MONGOLIA

INFLATION REPORT

2020
JUN

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BANK OF MONGOLIA

INFLATION REPORT

June 2020

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 the 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 wealth of households, facilitate an environment conducive to banking and financial system stability, and promote investments and sustainable economic growth in the long run. The **Bank of Mongolia's inflation target for 2020 will be stabilized at 8 percent** and around 6 percent in the medium term.

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, since 2018 the Bank of Mongolia started to implement 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 the 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 market expectations.

Please download the data, figures and tables included in the inflation report at
https://www.mongolbank.mn/listmonetarypolicy.aspx?id=05

EXECUTIVE SUMMARY

Despite implementation of a set of fiscal and monetary policy measures supporting domestic demand and financial stability, economic activities are expected to contract sharply in 2020 due to COVID-19 pandemic leading to weaker external and domestic demand and lower commodity prices and extension of restrictive measures to prevent its spread. Inflation is projected to remain at low levels under the circumstances that supply-driven shortages do not take place.

Impact of demand and supply-driven factors to inflation is expected to remain subdued. Annual inflation has consistently been falling in the past 4 months and has reached 3.3 percent nationwide and 3.5 percent in Ulaanbaatar city as of May 2020. From the demand side, though inflation is positively impacted by measures implemented by the central bank and the government that are aimed at supporting consumption, the negative impact of COVID-19 pandemic surpasses. With regards to supply factors, domestic fuel price fell by 300 MNT on average in April, followed by a further 100 MNT decrease in May 2020, in line with oil price movements in international markets. Moreover, meat supply has remained stable in recent months, mainly owing to increased meat reserves and restrictions placed on meat exports. Under the conditions that sudden price fluctuations induced by supply-driven factors do not take place, inflation is expected to remain below the target level throughout 2020-2021.

Economic growth is expected to contract sharply in the first half, followed by a gradual recovery in the latter half of 2020, owing to continued spread of COVID-19 pandemic and dramatic changes in the domestic and external economic environment within a short period of time. Economic growth in the first quarter of 2020 fell below projections as the spread of COVID-19 led to a reduction in taxes on products and induced contraction in economic activities of transportation, trade and services' sectors, as well as 29.5 percent shrinkage in mining sector with production of main commodities, excluding gold, declining. Production of mining sector is unlikely to return to normal levels in the short-term, as the external and domestic economic outlook has worsened, and duration of restrictive measures has been extended. Furthermore, production of non-mining sectors is negatively affected by a reduction in investment plans attributed to large-scale projects and downwards revision in mining sector growth. Thus, economic growth projections, as a whole, have been revised downwards.

Developments related to the spread of COVID-19 pandemic remain to be the main source of uncertainty affecting the economic outlook. On top of that, further trade conflicts and geopolitical tensions between powerful nations, the process of Oyu Tolgoi underground mine development according to its plan, risks of fiscal revenue shortage and resulting reduction in fiscal capital expenditure and implementation of domestic large-scale projects are considered the sources of uncertainty regarding projections.

Money supply growth has been slowing down in the past 5 consecutive quarters and is expected to stabilize at relatively low levels in the latter half of 2020. Credit growth in the coming months is expected to be constrained by increased market risks associated with the spread of COVID-19 pandemic and reduced economic activities in the external and domestic environment. Annual growth of M2 money supply has slowed down to 1.6 percent as of April 2020, due to 1) decline in credit outstanding of banking system induced by continued contraction in outstanding consumer loan and reduction in business loan growth as well as 2) sluggish growth in net foreign assets which comprises majority of money supply growth.

Uncertainties in the external environment have heightened and external demand is weakening. Persistent spread of COVID-19 pandemic has induced the global economic growth outlook to be revised significantly downwards. Though circumstances regarding COVID-19 have improved and production activities have resumed to normal levels in China, continued implementation of restrictive measures in European countries and aggravated spread of the virus in South and North American countries have had the impact of reducing external demand and delaying economic recovery in China. In addition, worsening relations between the US and China have exacerbated uncertainties. External demand outlook is highly dependent on the rate of containment for COVID-19 pandemic and ability to lower risks of spread.

Balance of payments is expected to worsen in 2020. As of the first 4 months of 2020, the balance of payments was in deficit of 665 million USD or 4.9 percent of GDP[1]. A widening in current account deficit of 442 million USD from the previous year was mainly explained by a significant contraction in export revenue associated with COVID-19 pandemic. However, outflow of services and income accounts which contribute significantly to current account deficit declined by approximately 511.5 million USD and 176.2 million USD, respectively. A decrease in financial account surplus of 291 million USD was mainly explained by reduced net flows of FDI, portfolio investment, and trade credit. Further worsening of the balance of payments' deficit is defined through heightened uncertainties in the external and domestic economy.

Terms of trade deteriorated by 19.5 percent from the previous year, though it improved by 3.3 percent from the previous month in April 2020. Improvement from the previous month was mainly driven by a decline in import prices. Despite projections for lower crude oil prices and higher gold and iron ore prices facilitating favorable terms of trade, prices of other exporting commodities have been revised downwards and thus, significant improvements in terms of trade are not expected in the latter half of 2020.

[1] Sum of accumulated 4 quarter GDP

I. INFLATION

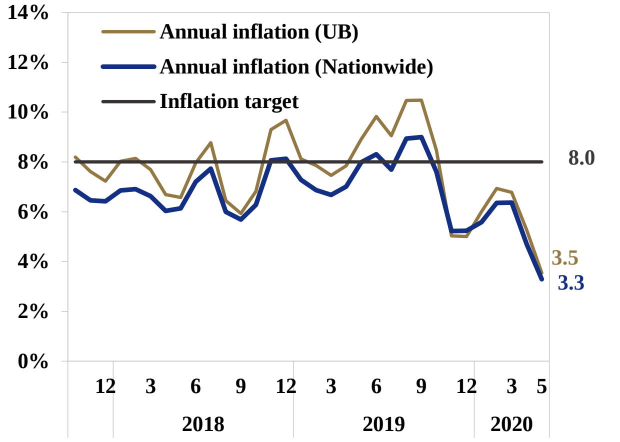
The Bank of Mongolia's monetary policy aims at stabilizing inflation, measured by a consumer price index, at around 8 percent during 2019-2020 and around 6 percent in the medium term.

Inflation outlook and its dynamics

Headline inflation reached 3.3 percent nationwide and 3.5 percent in Ulaanbaatar city as of May 2020, below the Central bank inflation target (Figure I.1).

Figure I.1

Inflation



Source: NSO

As economic activities slow, pressure on **demand-driven price increases continued to ease**, at the same time, **fuel prices fell due to the excess supply.**

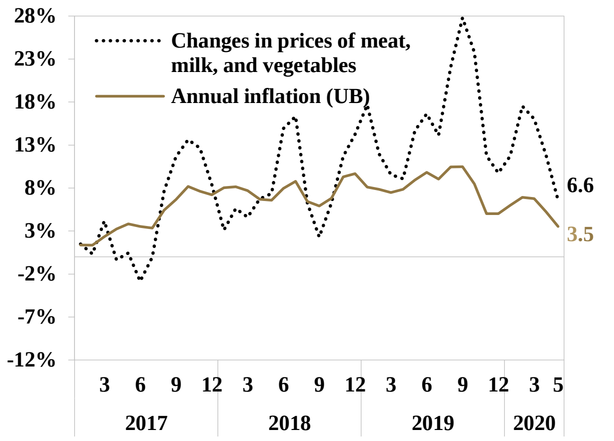
Demand-driven inflation has been decelerating as a downward trend in mining and non-mining sectors' growths in the past several quarters has been aggravated with COVID-19 pandemic.

Although household income increased and private consumption expanded with a rise in wages and pensions at the beginning of 2020, the credit growth continued to slow, including a slump in consumer credit.

Price increases associated with the supply side, which had significantly contributed to inflation in the past, have stabilized and prices of some commodities contributed to inflation reduction. The base effect of the price of administrative services is fading gradually (Figure I.2).

Figure I.2

Annual growth in headline inflation and seasonal food items



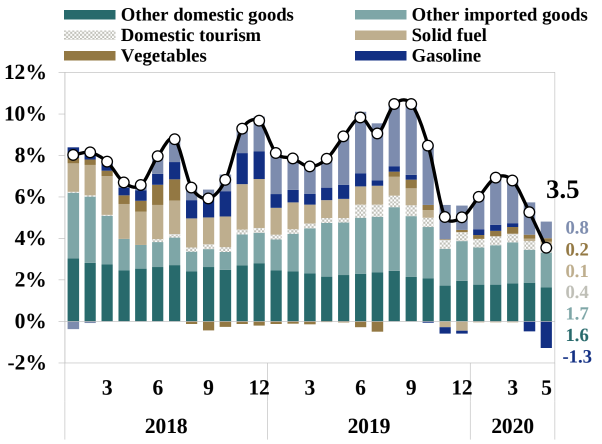
Source: NSO, Bank of Mongolia

Domestic fuel prices fell by 250-300 MNT in April and further 80-160 MNT in May in line with movements of oil prices in international markets, undermining inflation by 1.3 percentage points (Figure I.3).

Prices of meat increased below its seasonal patterns in the past 3 months and the previous year's base effect of a sharp rise in meat prices induced by supply shortage has subsided by May 2020. As a result, meat prices' impact on inflation has slowed sharply and it contributed 0.8 percentage points of inflation (Figure I.2, Figure I.3).

Figure I.3

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



Source: NSO, Bank of Mongolia

Table I.1 Changes in inflation outlook

Assumptions on near-term forecasts of inflation	
Prevous forecast 2020Q1-2020Q4	**Current forecast 2020Q2-2021Q1**
Prices of Meat	**Projection revised down**
Prices of meat have been fluctuating around its seasonal pattern since January 2020. Hence, price forecasts are revised down.	Prices of meat rose at a slower rate than its seasonal patterns in March and April. Hence, price forecasts are revised down.
Prices of imported goods	**Projection unchanged**
As the MNT rate depreciated, the price of imported goods rose slightly above expectations. Hence, price forecasts for imported goods are revised up.	Prices of domestic goods rose slightly above expectations in the first quarter but fell short of its seasonal patterns in April.
Prices of domestic goods	**Projection revised down**
Prices of domestic goods increased in line with expectations.	Prices of domestic goods rose at a slower rate than expected in April. Hence, price forecasts are revised down.
Prices of administered items	**Projection unchanged**
Prices of administered items are assumed to remain unchanged.	Prices of administered items are assumed to remain unchanged.
Prices of gasoline	**Projection revised down**
Declining global demand for oil and a sharp drop in oil prices has led to a drop in domestic fuel prices through cheaper custom prices of fuel. The domestic fuel prices fell by about MNT 50 per liter in March.	Domestic fuel prices fell in line with expectations in the first quarter and in April, fell further in May.

Source: Bank of Mongolia

Comparison between inflation projections

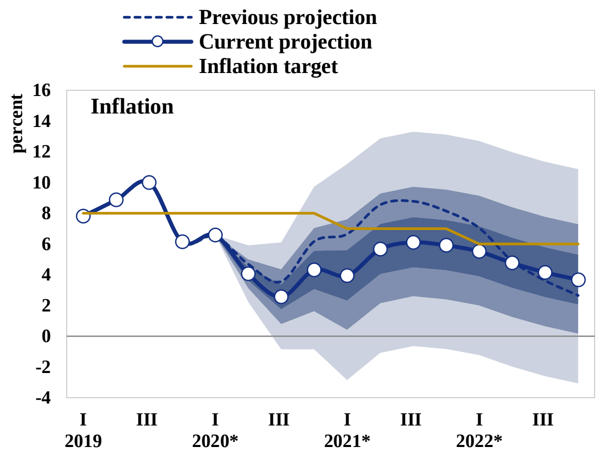
Headline inflation reached 6.6 percent in the first quarter of 2020; 0.1 percentage points higher than expected. Food prices rose by 10.7 percent year-on-year in the first quarter of 2020, in line with expectations. However, an increase in non-food prices, particularly, a 5.4 percent year-on-year growth in imported goods was slightly higher than expected.

Inflation outlook

The inflation outlook is revised downwards. Despite the upward pressure on the inflation coming from the exchange rate, the inflation forecast is revised down with a negative impact of COVID-19 on the economy that has outpaced expectations and a weaker economic outlook. Moreover, a decline in global oil prices is expected to persist, leading to lower inflationary impact to domestic gasoline prices in the forecasting horizon.

Figure I.4

Inflation forecast



Source: Bank of Mongolia

The inflationary impact of supply-driven factors is expected to remain relatively subdued in 2020. Domestic fuel prices are expected to recede in line with the decline in oil prices ininternational markets and a steady supply of meat in the spring months have contributed to the reduction of supply-side inflationary pressures. Other supply-side shocks, such as vegetable prices and administered prices are assumed to be relatively small in the projection.

On the demand side, inflation is expected to be driven upwards by the measures taken by the central bank and the government to support consumer spending. However, headline inflation is projected to decelerate in the upcoming quarters, owing to weaker domestic economic activity induced by COVID-19 pandemic.

Inflation is expected to remain low in the coming quarters but is expected to gradually pick up in 2021 and stabilize around the medium-term target as the economy recovers.

Table I.2

Inflation forecast[2]

	2019 *actual*	2020*	2021*
		projection	
Inflation, CPI[3]	6.1	4.3 [3.1-5.6]	5.9 [4.3-7.6]

Source: Bank of Mongolia

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.
- If the spread of COVID-19 prolongs, with the lockdowns and other restrictions, the economic activity weakens further, and inflation outlook may deteriorate. On the other hand, 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 throughout the world and the potential subsequent wave of outbreaks in the coming winter.
- Building up of international geopolitical risks and heightened uncertainties in the external environment, which in turn may bear negative consequences for commodity prices in the international market and capital inflow to our economy and may lead to depreciating pressure on togrog exchange rate, having an inflationary impact.

[2] Confidence interval of 30 percent

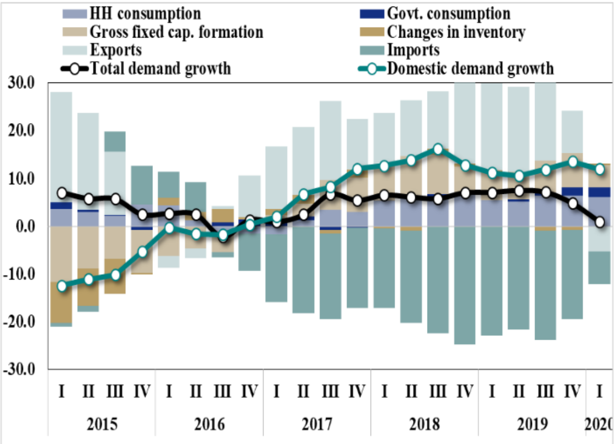
[3] Fourth quarter average inflation of each year

II. ECONOMIC GROWTH

Economy contracted by 10.7 percent as of the preliminary estimates for the first quarter of 2020. From the demand side, household and government consumption mainly supported economic activities, while investment and net exports had the impact of slowing down economic growth. Though total demand contracted, domestic demand growth was positive at 4.5 percent in the reporting quarter (Figure II.1).

Figure II.1

Decline in gross capital formation and exports' revenue mainly contributed to contraction of total demand.[4]

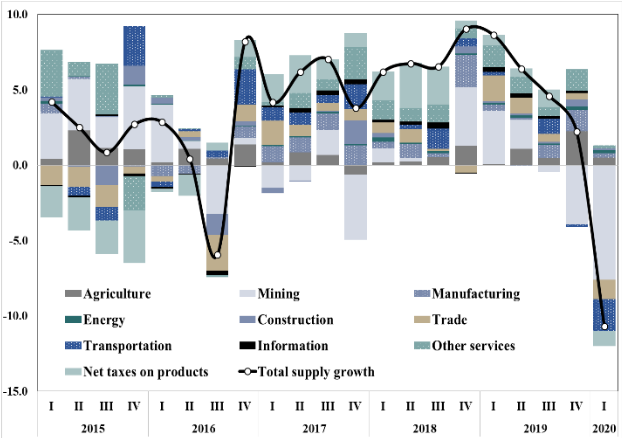


Source: NSO

Negative impact on economic activities induced by COVID-19 pandemic and preventative measures to cope with its spread has been more prominently observed in sectors such as mining, transportation, and services. Slowing down of activities in domestic economy has led to decline in net taxes on products. However, impact on production of agriculture, energy, and construction sectors has been rather insignificant (Figure II.2).

Figure II.2

Restrictive measures related to COVID-19 pandemic have yielded significant negative impact on economic growth.



Source: NSO

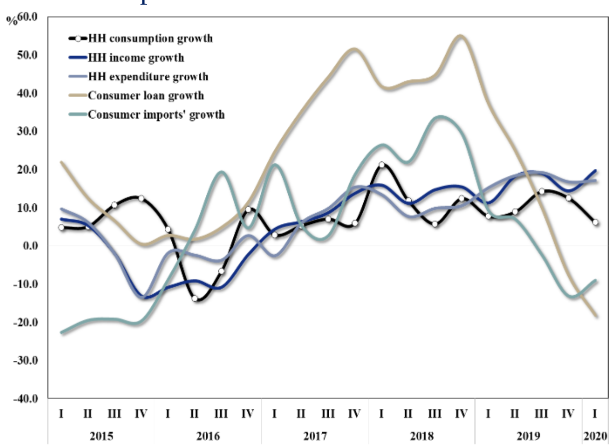
Consumption

Household consumption expanded by 6.1 percent from the previous year and contributed 4.6 percentage points to total demand growth. Implementation of measures namely, increasing wages for public sector employees and pensions in line with inflation and relieving from pension loan repayments has had impact on real household income and been supporting consumption. Consumer loan issued by banks, which had been promoting consumption in recent years, continues to slow down (Figure II.3).

During the specific circumstances of pandemic, households increased their consumption on food items, while cutting back their consumption on services including, restaurant food and durable items such as clothes, textiles, and automobiles.

Figure II.3

Household consumption growth decelerated, though it remained positive.



Source: NSO, Bank of Mongolia

[4] Growth computed from the sum of the past 4 quarters

Public consumption or public expenditure on goods and services grew by 13.3 percent in real terms from the previous year in the reporting quarter and contributed 2.0 percentage points to total demand growth.

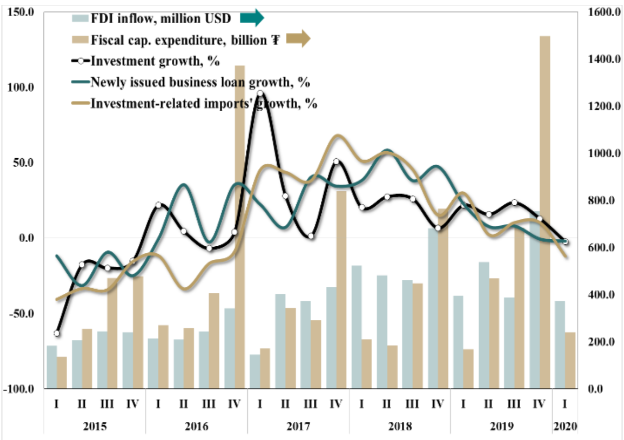
Investment

Uncertainties have arisen with regards to expectations of market participants and investment environment due to the pandemic, causing gross capital formation to decline by 2.4 percent from the previous year in the reporting quarter and contributed 0.9 percentage points to total demand contraction.

Though business loan issuance has been growing, incoming flow of FDI, especially expenditures related to Oyu Tolgoi underground mine development decreased slightly from the previous year in the reporting quarter, leading to a reduced tendency for investment by private entities. Public investment, on the other hand, expanded by 43.4 percent from the previous year, despite undermining its planned amount (Figure II.4).

Figure II.4

Gross capital formation declined.



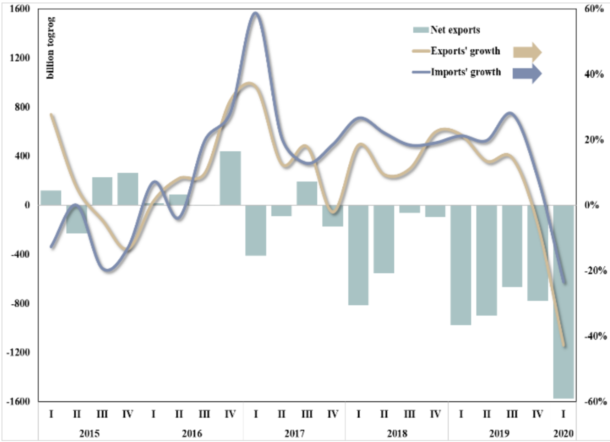
Source: NSO, Bank of Mongolia

Net exports

Net exports contributed 16.1 percentage points to total demand contraction. Exports declined by 42.7 percent in real terms in the reporting quarter, while imports of goods and services decreased by 23.4 percent in real terms from the previous year (Figure II.5).

Figure II.5

Foreign trade deficit considerably widened.



Source: NSO

Owing to COVID-19 pandemic, prices of majority of commodities, excluding iron ore and gold, have been falling in international markets. Moreover, a decline in exports revenue was driven by measures associated with the pandemic restricting transportation of coal and crude oil exports as well as metal content of copper concentrates from Oyu Tolgoi open pit being reduced in accordance with the specific type of ore being extracted.

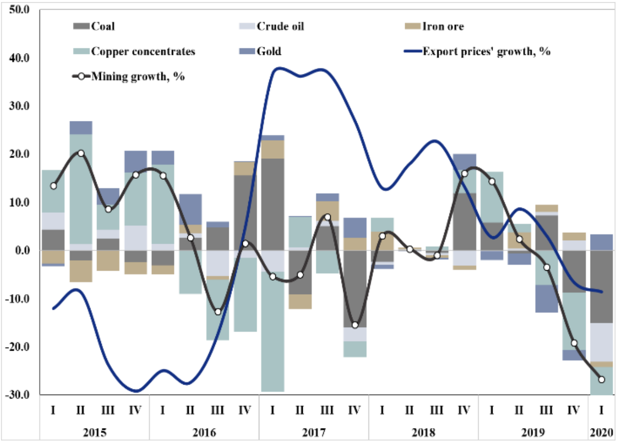
Decrease in imports was driven by reduced expenditure on durable consumption goods including, automobiles and investment items such as, heavy machineries and equipment as well as lower price and volume of fuel products. Furthermore, the fall in total services' imports was explained by a contraction in transportation, tourism, and non-resident consultant services.

Economic sectors

Production of main commodities, excluding gold, fell, causing mining sector to contract by 29.5 percent in the reporting quarter and undermine economic growth by 7.6 percentage points. Particularly, production of coal, crude oil, and copper concentrates declined by 52.6 percent, 72.4 percent, and 6.6 percent, respectively (Figure II.6). In addition, the gold content of Oyu Tolgoi copper concentrates was reduced by 4.6 times or 78.3 percent from the previous year and contributed significantly to a contraction in the mining sector.

Figure II.6

Mining sector contracted by 29.5 percent due to weaker external demand.



Source: NSO, Bank of Mongolia

Transportation sector value-added shrank by 30.5 percent in the reporting quarter, with declining coal exports impacting the transportation sector. In line with reduced activities in transportation sector, a drop in sales of gasoline and fuel products as well as heavy machineries and equipment for investment purposes led to trade sector contracting more than expectations at 11.1 percent.

Construction sector value-added exceeded projections and expanded by 11.6 percent from the previous year, mainly due to increased demand for residential housing.

Despite elevated services provided by public institutions, fall in sectors namely, financial and insurance as well as non-public services caused other services' sector value-added to grow at merely 0.7 percent from the previous year.

Agriculture sector growth exceeded expectations to reach 14.3 percent, as the births of baby livestock were relatively high in the first quarter of 2020.

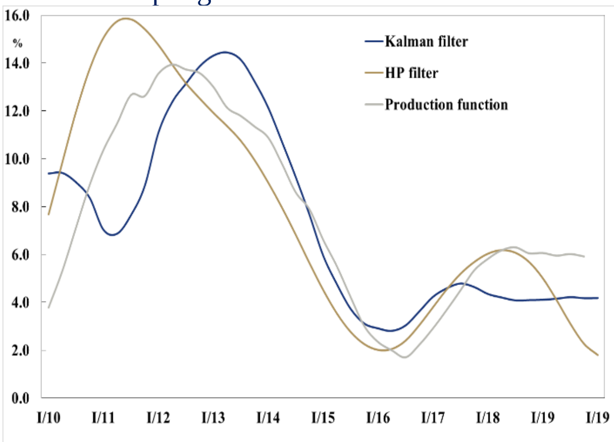
Revenue from net taxes on products declined by 8 percent in the reporting quarter, as economic activities slowed down, and imports of automobiles dropped.

Potential output

Growth of potential output had been accelerating and constantly exceeded 10 percent during 2011-2013, followed by deceleration from 2014 until mid-2016. Since the last quarter of 2016, increased investment for development of a mega-mining project and its indirect impact have been spurring non-mining sector growth and thus, supporting potential output growth. However, the growth of potential output has been decelerating in recent quarters, as economic activities slowed down (Figure II.7).

Figure II.7

Potential output growth



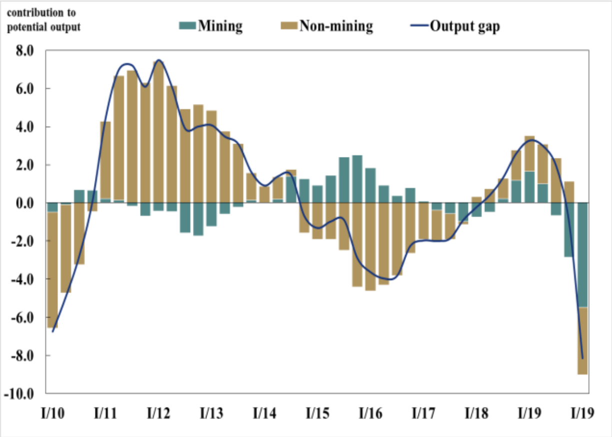
Source: Estimation by experts

Output gap

Mainly supported by increased activities in non-mining sector, aggregate production had exceeded its potential level during 2011-2013, rendering a positive output gap. However, positive developments in the non-mining sector were reversed throughout 2014-2016, resulting in a negative output gap. The output gap turned positive gradually since the latter half of 2018 and had been maintained as such during 2019. For the first quarter of 2020, output gap is estimated to have considerably fallen as the economy significantly contracted due to COVID-19 pandemic (Figure II.8).

Figure II.8

Output gap[5]



Source: Estimation by experts

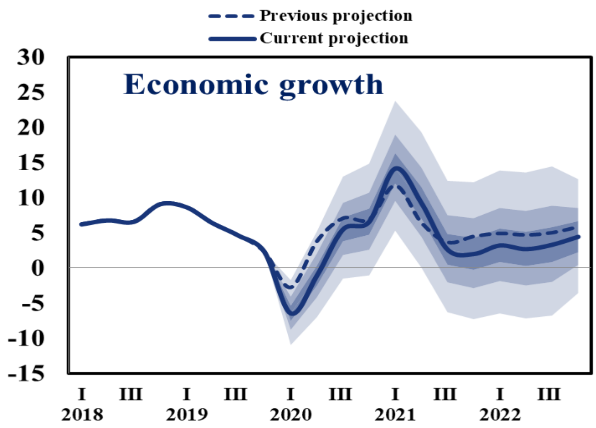
Economic outlook

Economic growth did not reach expectations in the first quarter of 2020. It was mainly due to measures imposed to prevent the spread of COVID-19 having impact to slow down economic activities and leading to trade and services sector growth and revenue from net taxes on products to fall below expectations as well as indirect impact from significant contraction in mining sector being realized as shrinkage of transportation activities.

Economic growth projections have been revised downwards in 2020, as domestic and external sources of negative impact of COVID-19 pandemic on the economy have been underestimated compared to previous expectation. On the other hand, economic growth outlook has been revised upwards in 2021, as it is expected that external demand recovers, foreign direct investment intensifies, the metal content of Oyu Tolgoi copper concentrates improves, and thus, mining sector growth picks up (Figure II.9, Table II.1.1).

Figure II.9

Forecasts for annual growth of quarterly GDP



Source: Bank of Mongolia

Mining: Production of mining sector is projected to significantly decline in 2020, as production volumes of several commodities have been revised down from previous projection in line with duration extension of restrictive measures and performances in the first quarter of 2020. Mining sector growth in 2021 is to be supported through recovery in the metal content of Oyu Tolgoi copper concentrates and improvements in export volumes of major commodities including, copper, coal, and crude oil.

Non-mining: Under the assumptions that large-scale project developments are delayed, investment plans are downgraded, fiscal capital expenditure is reduced in line with shortages in fiscal revenue collection, economic activities slow down and thus, circumstances for weaker demand prevails; projections for construction, trade and services' sectors as well as revenue from net taxes on products have been revised down from previous projection. In addition, a fall in coal exports is expected to negatively impact the transportation sector. However, non-mining sector growth is projected to improve in 2021, as external demand recovers, foreign direct investment increases, and indirect impact from pick up in mining sector activities is realized.

[5] Estimated by Kalman filter

Table II.1.1

Economic growth forecasts[6]

	2019	2020*	2021*
	actual	*projections*	
GDP growth, %	5.1	-2.0 – 0.2	6.4 – 10.7
Mining, %	-0.6	-7.9 – -5.7	11.3 – 15.6
Non-mining, %	6.7	-0.4 – 1.8	5.2 – 9.5

Source: Bank of Mongolia

Uncertainties that may affect the economic outlook

Developments related to the spread of COVID-19 pandemic remain to be the main source of uncertainty affecting the economic outlook. Though circumstances regarding COVID-19 have improved and production activities have resumed to normal levels in China, continued implementation of restrictive measures in European countries and aggravated spread of the pandemic in South and North American countries have had the impact of reducing external demand and delaying economic recovery in China. In addition, worsening relations between the US and China have exacerbated uncertainties. Weaker external demand and economic growth in China translates to reduced demand for commodities and lower prices.

Some analysts have been warning about the risks of the subsequent wave of COVID-19 pandemic. In this case, difficulties arising from the imposition of further restrictive measures could persist until the latter half of 2020 and even in 2021.

Furthermore, considering the event that local transmission of COVID-19 takes place, there are risks of economic downturn aggravating. Specifically, declaration of heightened state of preparedness nationwide could result in a halt of trade, services, and production activities, interruption in foreign trade, a surge in unemployment, and stagnation of economic activities, leading to further economic contraction.

Table II.1.2

Changes in the economic growth outlook

Changes in economic growth outlook (2020)

AGGREGATE DEMAND	Expectations weakened.
Consumption	Expectations improved.
• Household consumption has been supported by implementation of measures namely, relieving from pension loan repayments and increasing wages of public sector employees and pensions. • Households have been expanding their consumption of food items, under the specific circumstances of COVID-19 pandemic. • Government consumption growth is expected to pick up due to implementation of a set of fiscal measures aimed at easing economic difficulties.	
Investment	Expectations deteriorated.
• Uncertainties have arisen in investment environment due to the COVID-19 pandemic. • With regards to Oyu tolgoi underground mine development, provisions of consultant services by non-resident advisors have been interrupted and some construction works of vertical shafts have been delayed, resulting in lower than previously expected incoming flow of FDI. • Business loan issuance continues to decelerate. • Fiscal capital expenditure is expected to be revised downwards.	
Net exports	Expectations slightly deteriorated.
• Outlook for prices of copper, coal and crude oil in the international markets and volume of coal exports has been revised down from previous projection. • Outlook for imports of fuel products and investment-related heavy machineries and equipment has been revised down from previous projection, as developments in the mining sector and transportation of exporting products have slowed down and crude oil prices have been falling.	
AGGREGATE SUPPLY	Expectations weakened.
Mining	Expectations deteriorated.
• Exports and consequently, production of coal, crude oil and iron ore are projected to decline, as economic activities have been slowing down and external demand has been weakening in Chinese economy due to the COVID-19 pandemic.	
Non-mining	Expectations deteriorated.
• Preventitative measures and restrictions related to the COVID-19 pandemic are expected to negatively affect value added of services and manufacturing sectors. • Transportation of coal and iron ore exports is projected to decelerate due to the COVID-19 pandemic, leading to decline in revenue of transportation sector. • Sales of fuel products are expected to fall, in line with reduced production and transportation activities in mining sector. • Revenue from net taxes on products is projected to decrease, as economic activities have been slowing down and growth of imports has been decelerating.	

Source: Bank of Mongolia

[6] Confidence interval of 30 percent

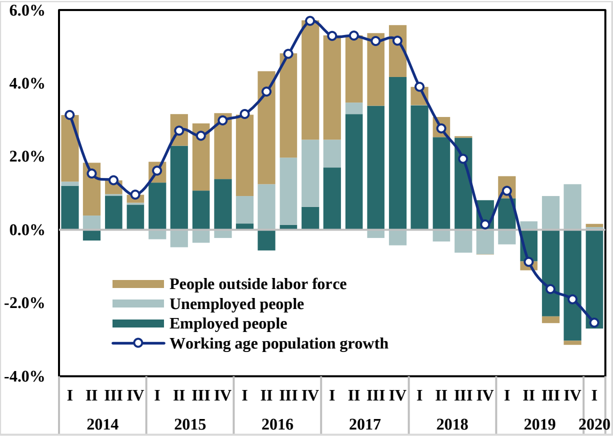
III. DOMESTIC ECONOMIC CONDITIONS

III.1. Labor market

Considering the latest movements in the structure of working-age population as an average of 4 quarters, employed people have been falling, while unemployed and people outside labor force have remained relatively stable.

Figure III.1.1

Employed people have been falling in recent quarters.[7]

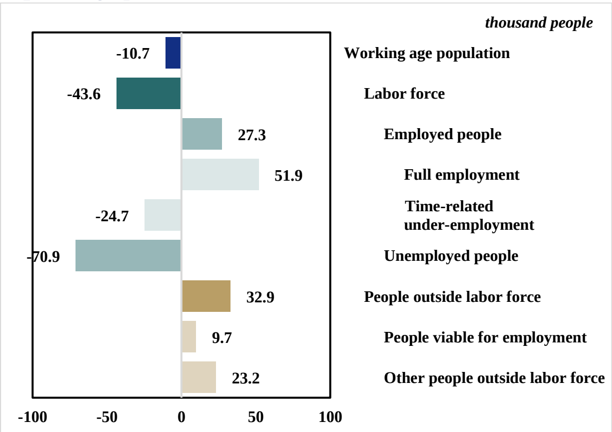


Source: NSO

With regards to developments in the first quarter of 2020 only, unemployed people[8] fell and shifted towards employed and people outside labor force.

Figure III.1.2

There was a shift from unemployed people to employed and people outside labor force in the reporting quarter.

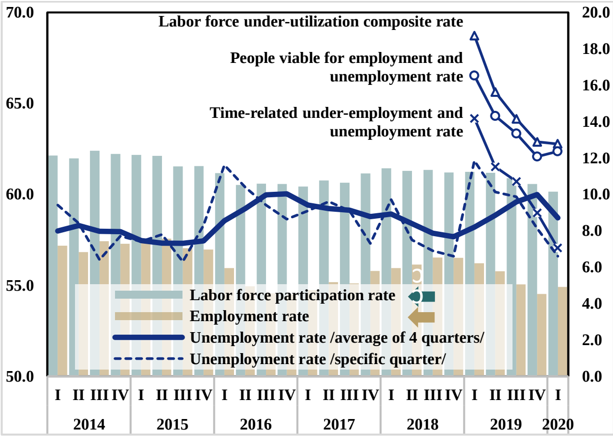


Source: NSO

Taking into account indicators that illustrate fundamentals in the labor market, the labor force participation rate has been falling in recent quarters. Since the reporting quarter, the employment rate has begun to exhibit tendency to grow and the unemployment rate to decline.

Figure III.1.3

Unemployment and labor force under-utilization composite rates have been declining.



Source: NSO

Unemployment rate declined to 6.6 percent and labor force under-utilization composite rate improved to 12.8 percent in the reporting quarter.[9] Such improvement was mainly explained by fall in unemployed as well as time-related under-employed people, while people viable for employment outside labor force increased slightly compared to the previous quarter.

Employment and social security

Employment has maintained its tendency to fall as an average of recent quarters.[10] In particular, employed people in agriculture, trade, manufacturing, and transportation sectors have been contracting, while those employed in energy, public administration, education, health, construction, and other services' sectors have been growing.

[7] Average growth of the past 4 quarters

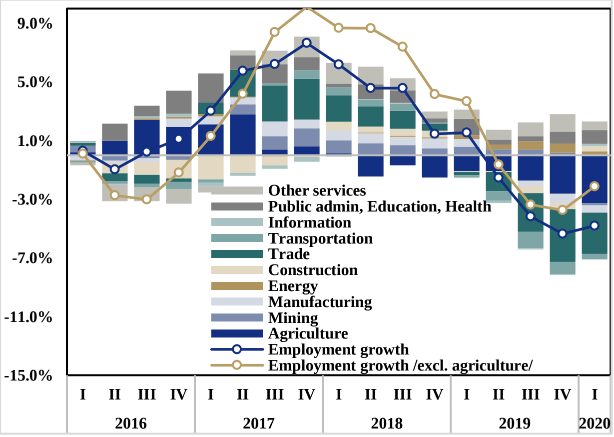
[8] Any attempt has been made to seek jobs earning wages or to conduct businesses earning income in the past 30 days.

[9] This illustrates that besides unemployed people, an additional 6.2 percent of the extended labor force is being under-utilized.

[10] Around 65.7 thousand people (5.6 percent of total employment) have been surveyed by the NSO in the reporting quarter to have not worked in the past 7 days, though they are engaged in full-time jobs. Out of this, 15.7 thousand people (1.3 percent of total employment) have not worked temporarily due to specific circumstances of the pandemic.

Figure III.1.4

Employed people in agriculture and trade sectors have been contracting.

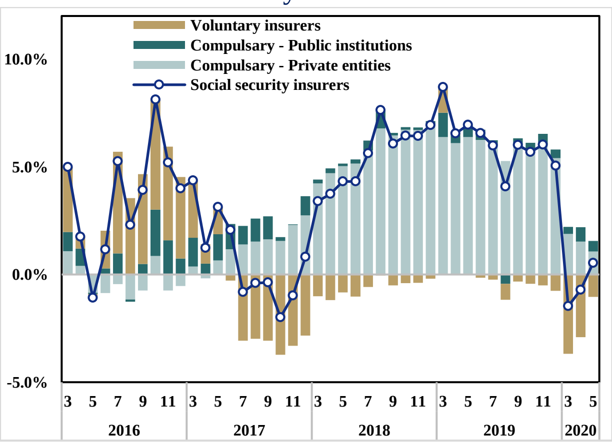


Source: NSO

Growth of compulsory social security insurers employed in public and private institutions has slowed down to 2 percent as of the first 5 months of 2020, while the number of voluntary insurers decreased by 6 percent from the previous year. Measure of providing exemptions from social security payments for compulsory insurers employed in private institutions subject to having their activities and business revenue impacted by the pandemic and voluntary insurers between April and September 2020 was effective in maintaining the number of social security insurers stable.

Figure III.1.5

Growth of social security insurers has decelerated.



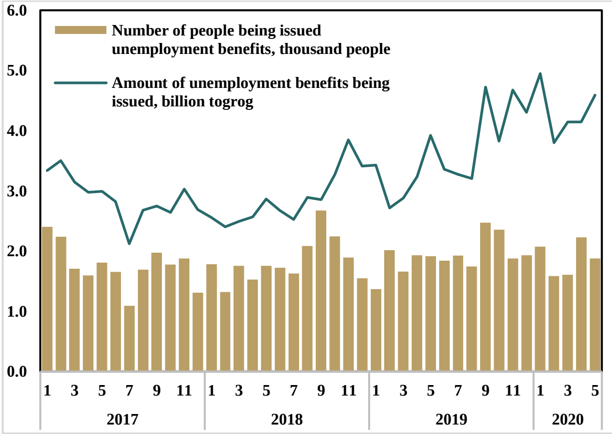
Source: Social Insurance General Office

Unemployment

As of the first 5 months of 2020, unemployment benefits amounting to 21.6 billion MNT (33.7 percent growth from the previous year) were issued to 9.4 thousand people (5.5 percent growth from the previous year) from social security fund. Measure has been taken to provide financial support of 200 thousand MNT on a monthly basis between April and June 2020 from the unemployment insurance fund to insurers employed in private entities subject to having their activities impacted by the pandemic and business revenue reduced by more than 50 percent.

Figure III.1.6

Number of people being issued unemployment benefits from social security fund has not significantly increased.

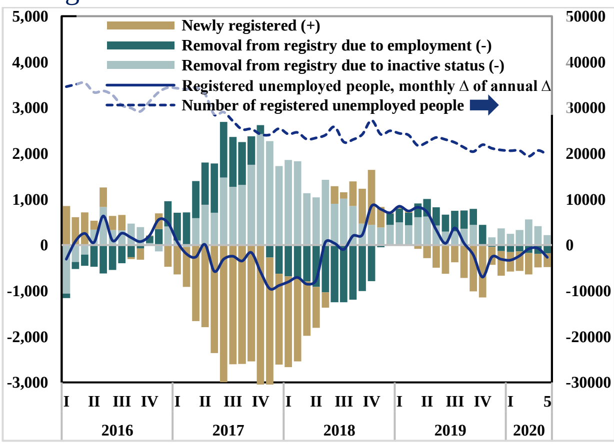


Source: Social Insurance General Office

As of May 2020, there were around 19.8 thousand registered unemployed people (15.8 percent decline from the previous year). Significant changes have not been observed in the structure of registered unemployment in recent months. As such, tendencies for falling newly registered unemployed people and rising removal from the registry due to inactive status have been maintained.

Figure III.1.7

Number of registered unemployed people has been falling.



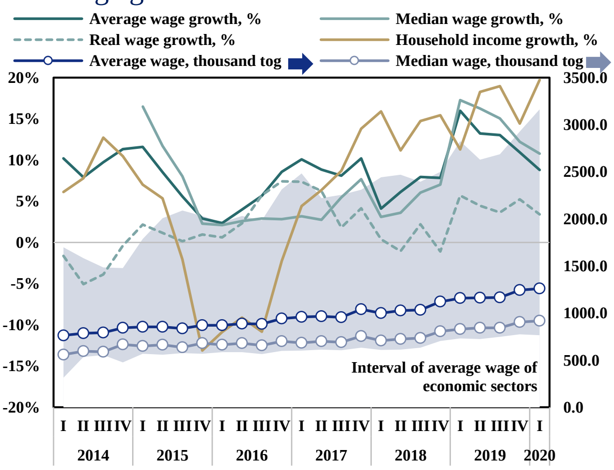
Source: General Office for Labor and Welfare Services

Wages and household income

National average and median wage amounted to approximately 1260 and 917 thousand MNT, respectively, with their annual growth slightly decelerating to 9-10 percent in the first quarter of 2020. Real wage growth, which illustrates the purchasing power of citizens, has been sustained at around 4-5 percent in the recent quarters.

Figure III.1.8

Real wage growth remains stable



Source: NSO

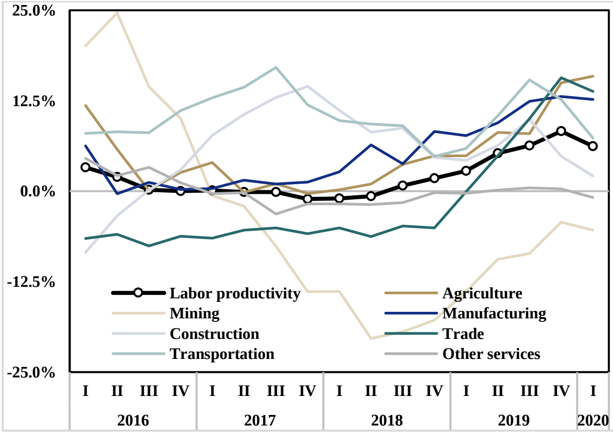
Among economic industry classifications, average wages of employees working at health, education, energy, mining, agriculture, and information sectors expanded by more than 10 percent, while average wages of people employed at transportation and professional scientific sectors remained unchanged and that of international organizations contracted. With regards to the legal status of establishments, average wages of employees working at partnership, cooperatives, public institutions, and state-owned enterprises increased by more than 14 percent, while that of limited liability private companies grew by the least proportion of 5 percent.

Labor productivity and unit labor cost

Labor productivity[11] has been rising by 6 percent as an average of the latest quarters; though its growth decelerated in the reporting quarter, mostly owing to a significant contraction in economic activities. Labor productivity has been rapidly expanding in agriculture, trade, and manufacturing sectors and declining in mining and services sectors.

Figure III.1.9

Tendency for labor productivity growth to decelerate began to prevail.[12]

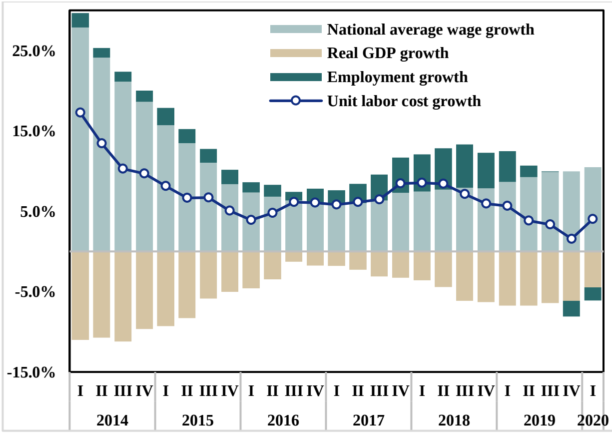


Source: NSO, Estimation by experts

Unit labor cost[13] has been growing by 4 percent as an average of the recent quarters. Unit labor cost growth accelerated in the reporting quarter, as the expansion of wage expenditure was coupled with significant contraction in economic activities, leading to a deceleration in labor productivity growth.

Figure III.1.10

Tendency for unit labor cost growth to accelerate began to prevail.



Source: NSO, Estimation by experts

[11] Average of GDP per employed person.
[12] Average growth of the past 8 quarters.
[13] Average labor cost or wage expenditure per unit of GDP.

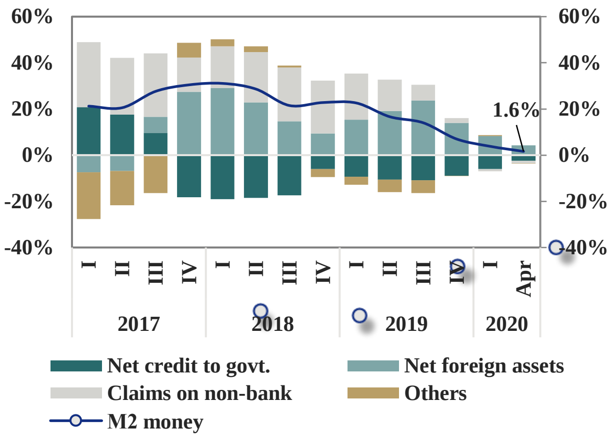
III.2 Money and financial market

III.2.1 Monetary and credit indicators

Annual growth of M2 money supply has been gradually slowing down for the past 5 consecutive quarters and reached 1.6 percent as of April 2020. Decline in the growths of credit issued by banks and net foreign assets have contributed to such deceleration in money supply growth. On the other hand, in the first 4 months of 2020, the government has financed most of the budget deficit with its accumulated financial resources, contributing positively to the money supply growth.

Figure III.2.1.1

Contributions to annual growth of M2 money supply, by assets



Source: Bank of Mongolia

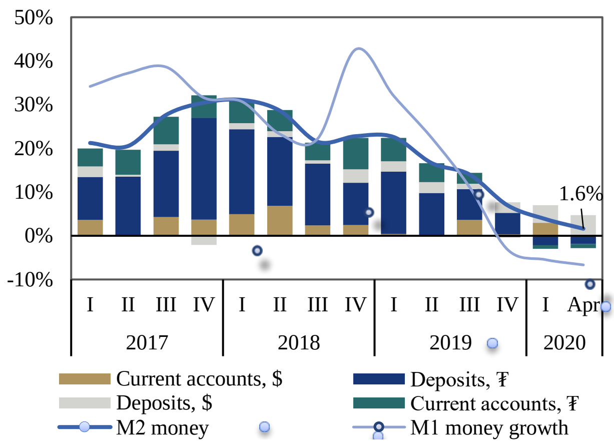
In the first 4 months of the year, net foreign assets fell by about 300 million USD owing to the balance of payments deficit. As a result, the impact of net foreign assets growth on M2 money growth has receded.

Last year, the fiscal deficit and principal debt payments were financed through the external and domestic financing of the general budget and the remaining 1.1 trillion MNT was accumulated as the government funding in the banking system. However, in the first 4 months of 2020, the required budget funding reached 921 billion MNT[14], of which about 500 billion MNT was financed from the reserves accumulated in the treasury fund, increasing the government's net lending.

The growth of credit issued by banks (and receivables from non-banks) has slowed since 2019 and its impact on M2 money supply growth continued to decline.

Figure III.2.1.2

Contributions to annual growth of M2 money supply, by liabilities

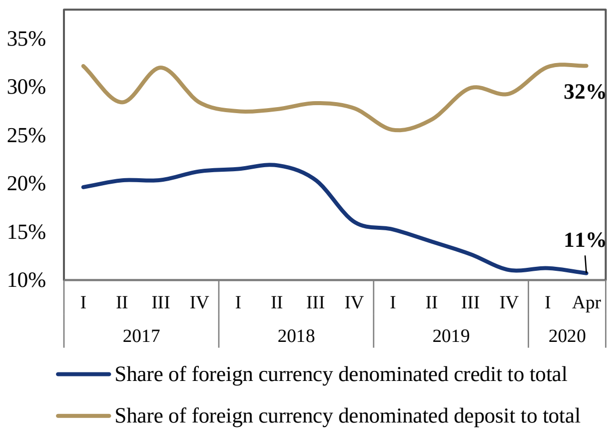


Source: Bank of Mongolia

Money supply growth, from the liabilities side, was mainly supported by the expansion of deposit accounts in foreign currencies. As the growth of deposit accounts denominated in foreign currencies picking up since February 2019, bank deposit dollarization has been increasing.

Figure III.2.1.3

Dollarization of bank credits and deposits

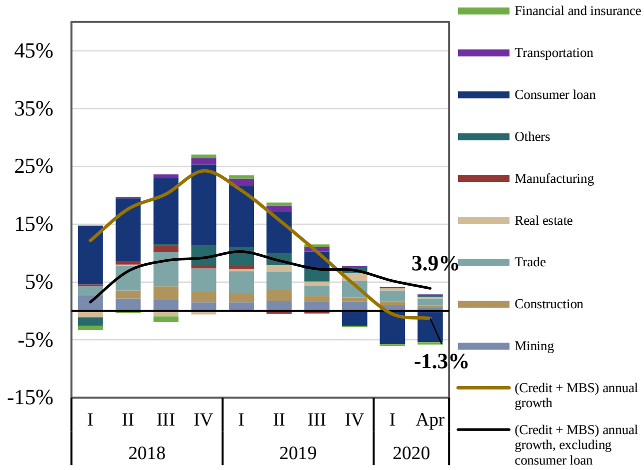


Source: Bank of Mongolia

[14] Of which, 643 billion MNT is spent on financing the budget deficit, while the remaining 278 billion MNT is spent on the repayments of domestic and foreign debts.

Figure III.2.1.4

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



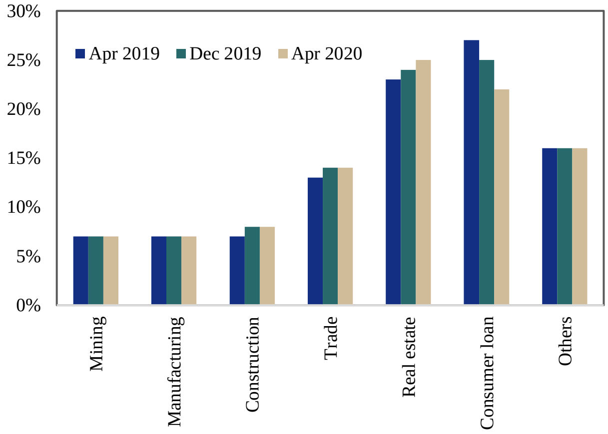
Source: Bank of Mongolia

Combined outstanding level[15] of total credit issued by depository institutions[16] and mortgage loans converted to mortgage-backed securities (MBS[17]) decreased by 1.3 percent as of April 2020. Moreover, an outstanding amount of consumer loans declined by 17 percent. Excluding the effect of measures of relieving pension loan repayments, the outstanding amount of consumer loans declined by 4.3 percent year-on-year. The growth of consumer loans other than herders' loan has continued to decelerate. In particular, salary loans decreased by 410 billion MNT, and automobile purchase loans by 120 billion MNT.

As of April, business loan growth slowed to 3.3 percent. This is due to the decline in loan growth of both SMEs and large enterprises. For instance, as of April 2020, outstanding loans to SMEs declined by 2.5 percent year-on-year, while credit growth of large enterprises slowed down to 1.5 percent. The decline in business loans was mainly in trade, mining, construction, and manufacturing sectors. In terms of currency type, domestic currency loans increased by 2 percent year-on-year, while foreign currency loans decreased by 31 percent year-on-year.

Figure III.2.1.5

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



Source: Bank of Mongolia

Looking at the composition of the outstanding amount of total credit, share of consumer loans has diminished. Specifically, the share of consumer loans to total credit fell by 5 percentage points year-on-year to reach 22 percent. On the other hand, combined shares of loans issued to trade, real estate, and construction sectors to total credit increased by 5 percentage points compared to that of previous year.

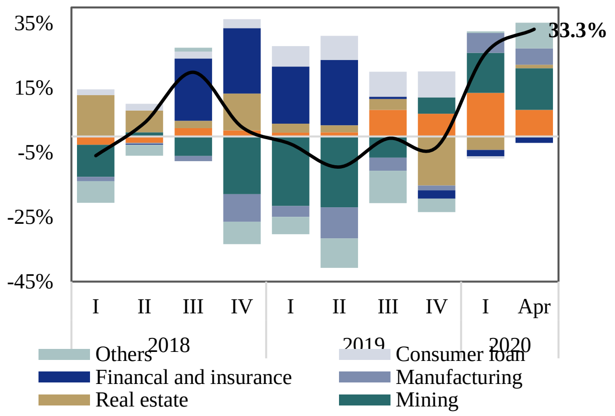
The bank loan repayments slowed, and past-due loans increased. In the first 4 months of 2020, annual growth in past-due loans increased steeply to 33 percent. In particular, total past-due loans increased by 485 billion MNT in the first 4 months of the year, most of which were in the manufacturing, mining, construction, and trade sectors. The share of past-due loans in total loans increased by 3 percentage points from the beginning of the year, reaching 8 percent in April. Non-performing loans account for 11 percent of the total loans of the banking system. If the impact of the pandemic resumes to

[15] It is 2.1 percent growth adjusting the impact of pension loan repayments write-offs.
[16] Depository corporations consist of banks and deposits and loan cooperatives.
[17] Banks securitize mortgages by selling mortgage portfolios to the Mongolian Mortgage Corporation, and the growths of these securities are considered to be part of credit growth.
[4] Total loans issued for individuals comprise mortgage loans, SME, consumption, wage, pension, and other types of consumer loans.

aggravate and economic activity declines further, there is a risk that the quality of bank business loans will continue to deteriorate.

Figure III.2.1.6

Annual growth of past-due loans of banks, by sectors



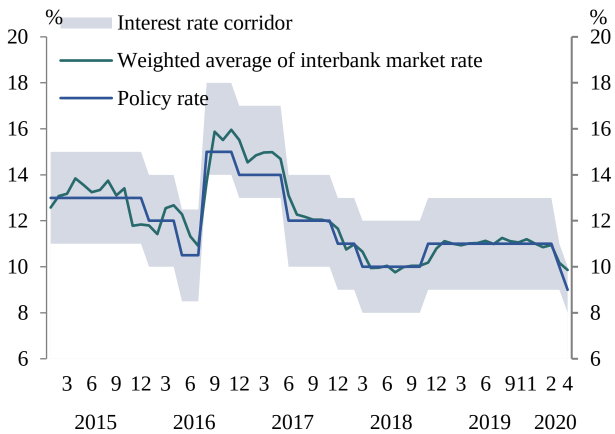
Source: Bank of Mongolia

III.2.2 Interest rate

The Monetary Policy Committee of the Bank of Mongolia decided to lower the policy rate by 2 percentage points to 9 percent and narrow the interest rate corridor to +1, -1 percent from the policy rate during its scheduled meeting in March and an unscheduled meeting in April 2020.

Figure III.2.2.1

Interbank market rates

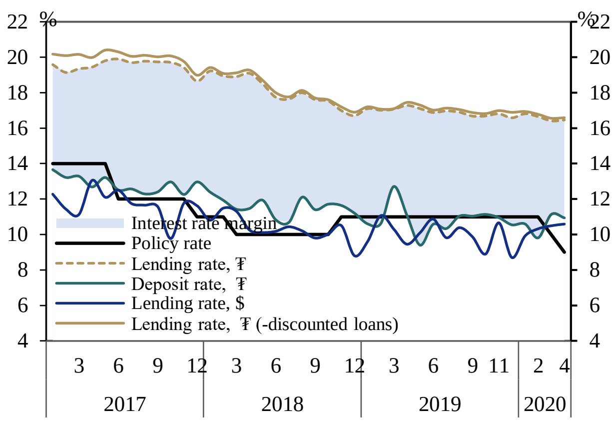


Source: Bank of Mongolia

In April 2020, the weighted average of interbank market interest rate decreased by 0.31 percentage points from the previous month and reached 9.87 percent. This was mainly attributable to a 0.86 percentage points decrease of interest rate on overnight loans to 9.69 percent, 0.61 percentage point decrease in interest rates on direct trading of central bank bills to 9.36 percent, and a 0.21 percentage points drop in repo transactions secured by the central bank bills to 9.71 percent. However, the interest rate on interbank deposits increased by 0.34 percentage points to 11.82 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. Repo transactions secured with treasury bill is traded at the rate of 11.5 percent[18].

Figure III.2.2.2

Interest rate on newly issued loans and new deposits



Source: Bank of Mongolia

Decrease in the interest rate on newly issued loans and a relatively stable interest rate on new deposits resulted in a narrower interest rate margin. In April 2020, interest rate on credits issued in MNT decreased by 0.82 percentage points from that of previous year to 16.46 percent, and interest rate on MNT deposits decreased by 0.18 percentage points 10.94 percent. Consequently, interest rate margin narrowed by 0.68 percentage points from that of previous year to 5.52 percent.

As for loans in foreign currency, the interest rate on newly issued loans increased by 1.14 percentage points from that of previous year to 10.59 percent and the interest rate on new

[18] Since May 2018, there have been no repo transactions in the interbank market that have pledged government securities.

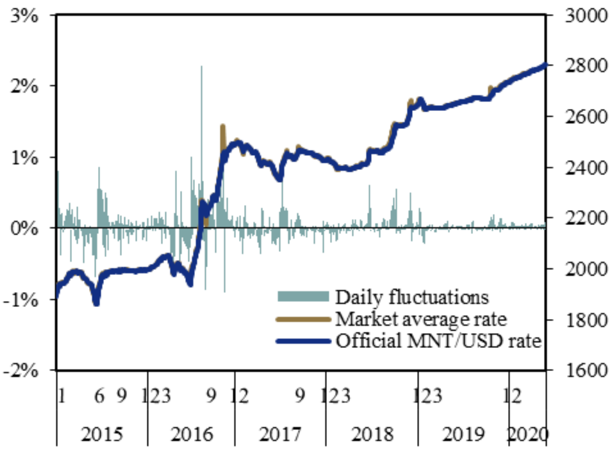
deposits increased by 0.93 percentage points to 5.32 percent in April 2020. Consequently, the interest rate margin of foreign currency loans and deposits widened by 0.21 percentage points from that of previous year to 5.27 percent.

III.2.3 Exchange rate

Since the beginning of 2020, the MNT has been gradually depreciating against the US dollar, depreciating by 71.6 MNT or 2.6 percent at the end of May 2020.

Figure III.2.3.1

Cross rate of MNT to USD



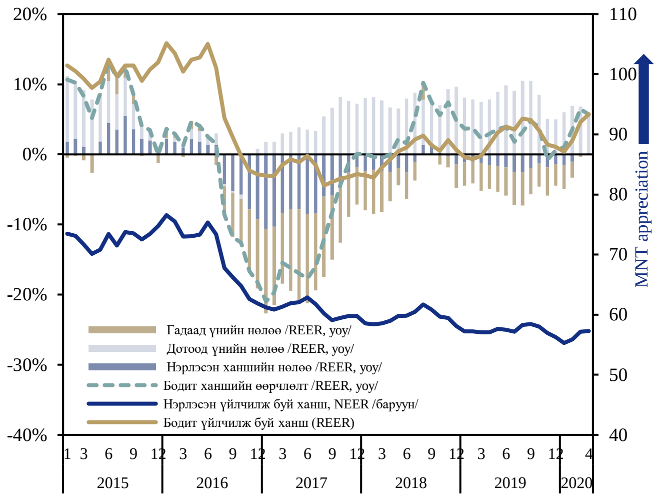
Source: Bank of Mongolia

Togrog depreciation against the US dollar was mainly driven by a negative foreign currency net flows over the past 3 months. In particular, the foreign currency inflows declined by 36 percent year-on-year in May owing to a sharp drop in coal export revenue during COVID-19.

Despite togrog depreciation against the US dollar, the nominal effective exchange rate (NEER), weighted by trade turnover, appreciated by 0.4 percent year-on-year in April 2020 /Figure III.2.3.2/. MNT appreciated against RUB by 9.1 percent and depreciated against RMB by 0.3 percent.

Figure III.2.3.2

Real effective exchange rate of MNT

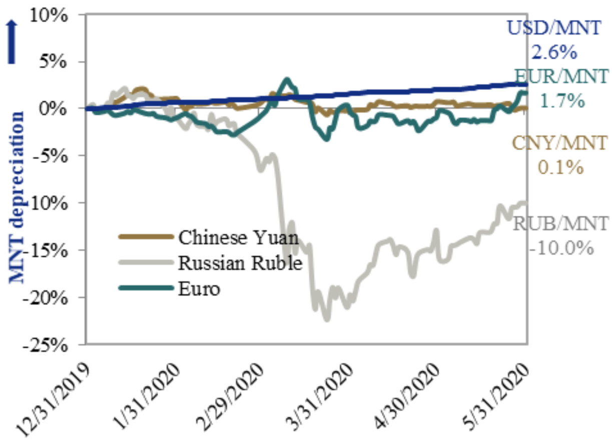


Source: Bank of Mongolia

Real effective exchange rate (REER) appreciated by 5.7 percent year-on-year in April 2020. On top of the appreciation of the nominal exchange rate, domestic price increased more rapidly than the foreign price, thus relative price increased by 5.0 percent.

Figure III.2.3.3

Change in MNT exchange rate against major currencies /from the beginning of 2020/

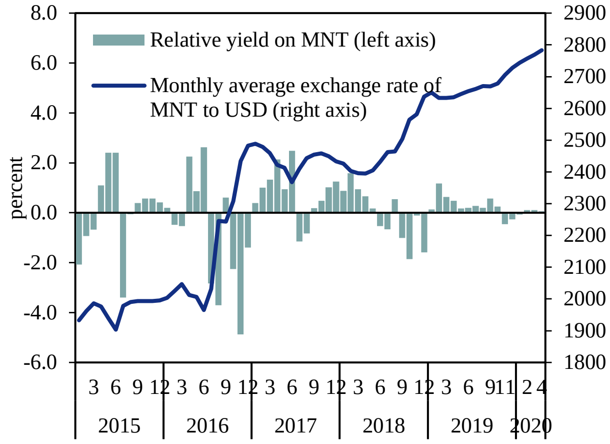


Source: Bank of Mongolia

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

Figure III.2.3.4

Relative yield on MNT



Source: Bank of Mongolia

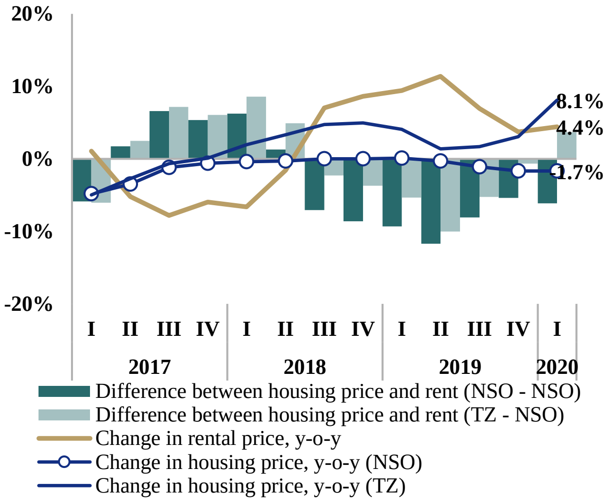
III.2.4 Capital Market

Policy measures taken to prevent the spread of COVID-19 in the reporting quarter have negatively affected the activity of the stock market, and the TOP-20 stock market index continues to decline. In the housing market, the price-to-rent ratio remained stable, while the price-to-income ratio declined as the average household income increased.

Housing market

Figure III.2.4.1

Growths in housing prices and rents



Source: NSO, Tenkhleg-Zuuch

The housing price index estimated by the NSO increased by 0.1 percent from the previous quarter and decreased by 1.7 percent annually in the 1st quarter of 2020 (Figure III.2.4.1). In terms of housing rents, the annual growth was slightly higher than previous quarter, reaching 4.4 percent. However, the housing price index reported by the Tenkhleg Zuuch LLC increased by 4.9 percent from the previous quarter and 8.1 percent annually in the 1st quarter of 2020 because of the annual increase in new housing prices. (Table III.2.4.1).

In recent quarters, the housing price per 1 square meter has been relatively high, and the sales and order prices of high-class and business-class spacious apartments have been increasing, as evidenced by the housing price index calculated by Tenkhleg Zuuch LLC. On the other hand, because the NSO estimates that the total housing sample is divided into three groups by pre-1970, 1970-2001, and post-2002 periods, high-rise apartment buildings that have recently been commissioned account for a relatively small share of the housing price index. Due to the nature of methodologies used in the calculation, housing price indices have varied in recent quarters.

Table III.2.4.1

Real estate sector indicators

		2019-Q4	2020-Q1
Change in housing price, %			
NSO	q-o-q	-0.6	0.1
	y-o-y	-1.7	-1.7
Tenkhleg-Zuuch	q-o-q	1.8	4.9
	y-o-y	3.1	8.1
Change in rental price, %	q-o-q	0.6	0.7
	y-o-y	3.7	4.4
Price-to-income ratio		0.40	0.36
Price-to-rent ratio		0.81	0.81

Source: NSO, Tenkhleg-Zuuch, Bank of Mongolia

In the 1st quarter of 2020, the price-to-income ratio declined as household average income increased by 9.7 percent quarter-over-quarter, exceeding the growth in housing prices.

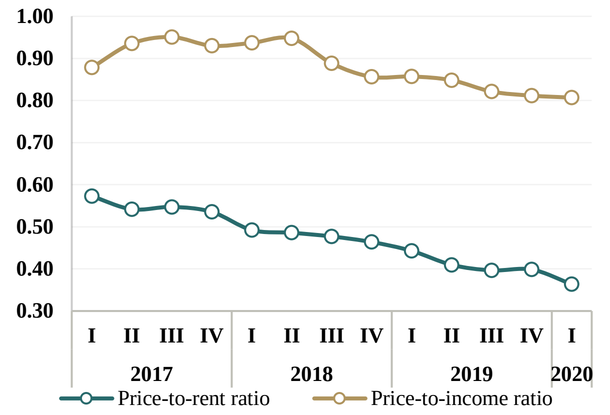
The number of new mortgage borrowers increased by 28.3[19] percent from that of the

[19] *Source: Bank of Mongolia.* Loans disbursed by banks from their own resources and under the "Mortgage sustainable financing" program are considered together.

previous year. In addition, the price-to-rent ratio remains stable (Figure III.2.4.2).

Figure III.2.4.2

Price-to-income ratio and price-to-rent ratio

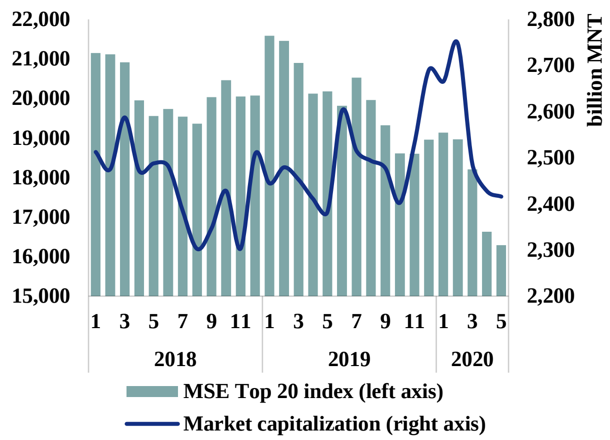


Source: NSO, Bank of Mongolia

Stock Market

Figure III.2.4.3s

Main indicators of the stock market



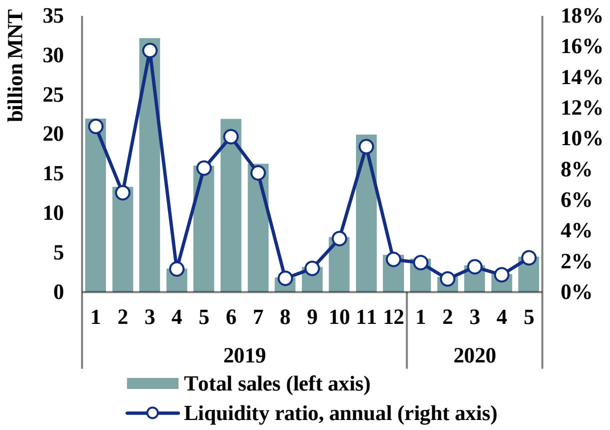
Source: Mongolian Stock Exchange

In the first quarter of 2020, the market capitalization increased by 3.6 percent from the previous quarter reaching 2.63 trillion MNT. However, as of May 2020, it decreased to 2.42 trillion MNT, a decrease of 12 percent compared to the peak in February. TOP-20 index continued to decline from the beginning of 2020, reaching its lowest level since 2017 in May 2020 (Figure III.2.4.3).

In particular, uncertainties in the domestic and external conditions in the economy regarding COVID-19 have negatively affected businesses, and the TOP-20 index declined by 14.9 percent from the beginning of the year reaching 16,288.4 in May 2020. This was mainly induced by the decline in Class I share prices, such as "Suu", "Lendmn NBFI", "Gobi", "APU", "Mandal Daatgal", and Class II share prices, such as "State Department Store" and "Ard Financial Group" [20].

Figure III.2.4.4

Liquidity ratio



Source: NSO, Bank of Mongolia

In the first 5 months of 2020, a total of 16.3 billion MNT worth of securities were traded at the stock market, which is a decrease of 81.1 percent compared to the previous year. In recent months, "Frontier Lend Group", "Ard Financial Group" and "Mongol Post" have led the way in terms of trade value, while "Lendmn NBFI", "Standard Agriculture Group" and "Mandal Daatgal" have led the way in terms of trade volume. As the stock market's trading activity weakened, the stock market liquidity ratio[21] remained low, reaching 2.2 percent in May, 4 times lower than that of previous year (Figure III.2.4.4).

[20] *Source: Marketinfo.mn*

[21] $Liquidity\ ratio = \frac{Total\ trading\ value}{Market\ capitalization}$; The liquidity ratio is an indicator of the current condition of activity of the stock market, and a high ratio indicates that investors are optimistic about the market, thus increase their investment, boosting the trading activities.

Box. Review of monetary and macroprudential measures taken by the Bank of Mongolia during COVID-19 pandemic

The continued spread of COVID-19 has fueled uncertainties in the external and domestic economic conditions and resulting in weakening domestic demand, contracting business activities in the economy, difficulties in loan repayments, and slower financial intermediation. Therefore, the Bank of Mongolia is implementing a comprehensive monetary and macro-prudential policy aimed to mitigate the negative effects of the pandemic on the economy, maintaining the stability of the economy and financial system, and supporting further economic activity. These include:

Monetary policy measures

According to the decision of the Monetary Policy Committee (MPC) of the Bank of Mongolia, three monetary policy measures have been implemented in sync to improve the liquidity of banks, reduce the cost of financing, and support the conditions for stable financial intermediation. These are:

1. The policy rate was reduced by 2 percentage points to 9 percent.
2. The reserve requirement on banks' liabilities in the local currency was reduced by 2 percentage points, increasing the excess/free liabilities in the local currency.
3. The interest rate corridor was narrowed to ±1 percentage point from the policy rate.
   The upper limit of the interest rate corridor determines the interest rate on financing instruments by the central bank, and the main purpose of this measure is to reduce the cost of financing that banks receive from the central bank.

Macroprudential measures

Within the framework of macroprudential policy, the following decisions have been made to reduce the financial burden on individuals and enterprises and maintain the stability of the financial system. These include:

1. The Monetary Policy Committee decided to extend the maturity of consumer loans once for a period of up to 12 months. The decision has facilitated lenders experiencing difficulties in their loan repayments to reduce their monthly loan repayments.
2. The Council for Financial Stability decided to extend the classification period of consumer and mortgage loans to 90 days for standard loans. The Council also decided that borrowers could change the structure of consumer and business loans once without downgrading the quality of the loan or a one-time amendment in the relevant contract would not be considered as a restructured asset.

Other measures

Bank of Mongolia decided to resume the subsidized mortgage program until the end of 2020. Under the program, the Bank of Mongolia will provide financing up to 220 billion MNT and commercial banks will provide financing up to 120 billion MNT for the subsidized mortgage loans. The program is targeted at low- and middle-income groups. In addition, a total of 800 billion MNT (including the mortgage financing) will be disbursed to increase banks' liquidity, if necessary, in the form of "Erdenes" bond purchase and gold advances to increase the gross international reserves. To implement these policy measures, the relevant amendments have been made to the "Regulation on Mortgage Financing" in accordance with the "Law on preparedness, response to COVID-19 pandemic and mitigation of its socioeconomic impact" approved by the Parliament.

III.3 The consolidated budget and sovereign debt

The consolidated budget: Within the approved budget, the equilibrated budget revenue is expected to increase by 996 billion MNT (+ 9.2%) and expenditure by 2 trillion 443 billion MNT (+ 21.4%) (Table III.3.1) in 2020 from the previous year, and fiscal policy is expected to weaken.

Table III.3.1

Fiscal indicators

billion MNT	2019	2020	2020.05	
	Act.	App.	Act.	%
Total revenue	**11937**	**12900**	**3564**	**79.6**
Future heritage fund	1040	977	211	69.0
Stabilization fund	95	125	10	7.7
Equilibrated revenue	**10802**	**11798**	**3343**	**81.1**
Tax revenue	9749	10656	3056	82.7
Non-tax revenue	1053	1142	288	67.3
Total expenditure	**11429**	**13873**	**4922**	**77.9**
Primary expenditure	10568	12913	4584	77.4
Current expenditure/-interest payr	7347	9060	3739	85.1
Capital expenditure	2818	3806	826	56.1
Net credit	403	47	20	33.2
Interest expenditure	861	960	338	86.0
Total equilibrated balance	**-628**	**-2075**	**-1579**	
in percent of GDP	-1.7%	-5.1%		
Primary balance	233	-1115	-1241	
in percent of GDP	0.6%	-2.7%		

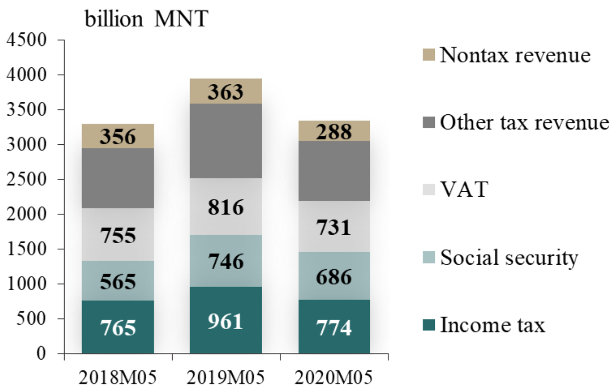
Source: Ministry of Finance

As of May, the equilibrated budget revenue was 18.9 percent lower than planned and the budget expenditure was 22.1 percent lower than planned, resulting in a deficit of 1 trillion 579 billion MNT in the equilibrated balance.

As of May 2020, **total equilibrated revenue** declined by 608 billion MNT (-15.4%) from that of previous year and 91.4 percent of the equilibrated budget revenue was made up of tax revenue. In particular, income tax decreased by 187.1 billion MNT, revenue from royalties by 103.9 billion MNT, import-related tax revenue by 103.8 billion MNT, non-tax revenue by 75.1 billion MNT, social insurance revenue by 60.2 billion MNT, VAT revenue on domestic goods and services by 23.1 billion MNT, excise tax revenue on domestic alcohol products by 21.4 billion MNT. The VAT refunds increased by 17.9 billion MNT (Figure III.3.1).

Figure III.3.1

Structure of budget revenue

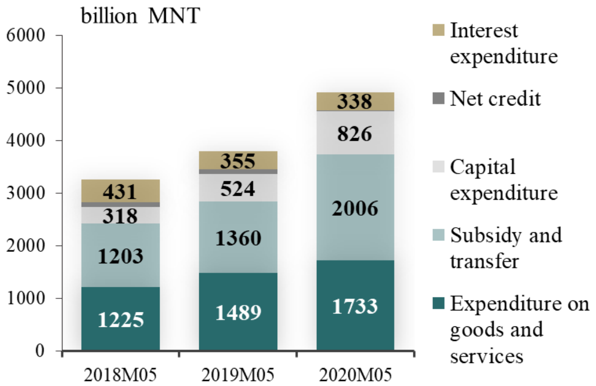


Source: Ministry of Finance

Total expenditure and net credits: Looking at components of approved budget expenditure of 2020 compared to the previous year, capital expenditures are expected to increase by 988 billion MNT (+35%), current transfers by 835 billion MNT (+25%), expenditures on other goods and services by 424.5 billion MNT (+10.6%), of which wage expenditures by 371 billion MNT (+16.4%). The net lending excluding loan repayments is expected to decrease by 356 billion MNT.

Figure III.3.2

Structure of budget expenditure



Source: Ministry of Finance

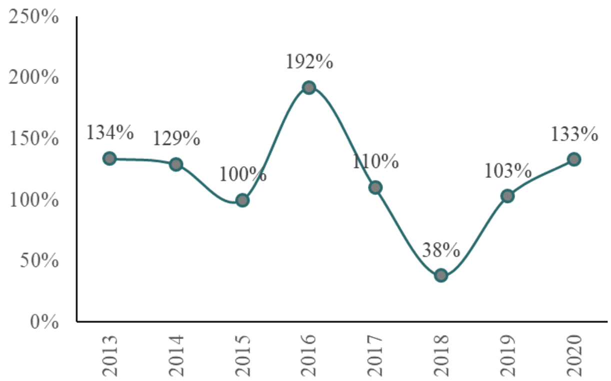
As of the first 5 months of 2020, the budget expenditure utilization rate was 77.9 percent, of which capital expenditures' utilization was 56.1 percent. The total budget expenditure increased by 1'116.4 billion MNT (29.3%) year-on-year.

Of which, expenditures on subsidies and transfers increased by 646.5 billion MNT, capital expenditures increased by 301.8 billion MNT, expenditures on goods and services increased by 244.1 billion MNT. Loan service payments decreased by 17.3 billion MNT and net loan repayments decreased by 58.1 billion MNT (Figure III.3.2).

The ratio of newly issued debt-to-debt repayment: According to the approved budget of 2020, the government is expected to pay 1.9 trillion MNT for external loan repayments, domestic treasury bill repayments, and loan repayments and to issue new long-term domestic treasury bills, external project loans and program loans worth 2.6 trillion MNT. Thus, the ratio of newly issued debt-to-debt repayment is expected to increase to 133 percent (Figure III.3.3).

Figure III.3.3

The ratio of newly issued debt-to-debt repayment



Source: Ministry of Finance

Total government debt at present value: According to the budget approved by the Parliament, the present value of government debt is set to be within legal boundaries in 2020 (Table III.3.2). Moreover, debt service payments as a share of budget revenue have fallen since 2016, reaching 8 percent in 2019, and will remain at previous year's level according to the approved budget forecast for 2020.

Table III.3.2

Present value of government debt and debt services

billion MNT	2017 Act.	2018 Act.	2019 App.	2020* App.
Government debt	20212	18946	23915	22089
in % of GDP	74.4	58.9	56.1	54.3
Debt limit/GDP	85.0	80.0	75.0	70.0
Debt service payments	1156	1046	861	960
in % of budget revenue	16.0	11.3	8.0	8.1
Budget balance	-1742	12	-628	-2075
in % of GDP	-6.4	0.0	-1.7	-5.1

Source: Ministry of Finance, Bank of Mongolia

IV. EXTERNAL CONDITIONS OF THE ECONOMY

IV.1 Assumptions regarding the external conditions [22]

Compared to the previous forecast, the outlook for external demand has deteriorated owing to the downward revision in the growth forecasts of Russia and the Euro area despite the upward revision in the growth outlook of China[23].

China's economic growth forecasts range from 1.0 to 2.2 percent in 2020 with an average of 1.6 percent or 0.3 percentage points increase higher than previous projection as the spread of COVID-19 in China is under control and domestic demand is slowly recovering. The growth forecast for 2021 is revised up by 2.1 percentage points to 8.0 percent. As the first-quarter GDP has overperformed the expectations, Bloomberg economists revised up China's growth forecast to 3.5 percent in the second quarter, 5.3 percent in the third quarter, 6.1 percent in the fourth quarter, and to reach an overall growth of 2.0 percent for 2020, or 0.6 percentage points upward revision from previous forecast.

China's industrial production rebounded in late March to more than 90 percent capacity, but the recovery has been slow in the service sector. Although the authorities are expected to support the domestic demand and the growth through fiscal and monetary policies, the risks persist such as the uncertainties regarding the pandemic has not waned, the spread of COVID-19 is still emerging in other parts of the world, and a "second wave" is likely to occur in countries where the outbreaks are controlled.

Table IV.1.1

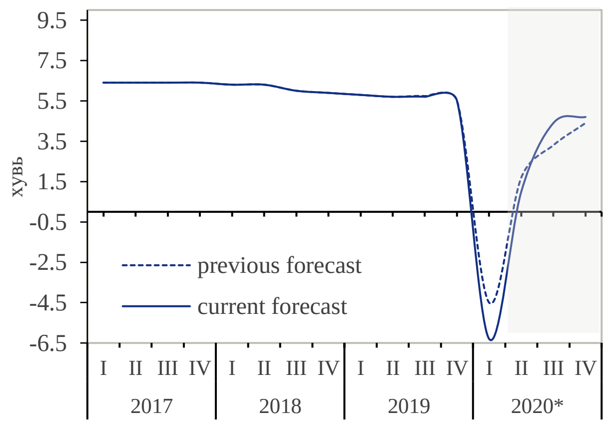
Change in Key Judgments of External Environment

Previous forecast of 2019	Current forecast of 2019
External demand	**Revised down**
"Phase 2" trade deal is expected. China's growth is revised down significantly, Russia's growth is revised up slightly. The growth forecasts of Euro Area and the USA remains unchanged this time.	"Phase 2" trade deal is expected. China's growth is revised up slightly. The growth forecasts in Russia, Euro Area and the USA are revised down.
Terms of Trade	**Revised up marginally**
Economic activity weakened due to the outbreak of COVID-19 in China, and commodity prices outlook is revised down. Gold prices are expected to rise due to increased uncertainty in the external environment and the risks associated with COVID-19. Oil prices fell as the OPEC deal ends.	Commodity prices are revised down from earlier forecasts as China's economic activity has been slowly improving but not returned to normal levels. However, due to lower oil and food prices, the import price forecast is revised down and terms of trade has improved slightly from the previous forecast, but the downward trend continues
Foreign interest rate	**Revised down**
The Fed cut Fed funds rate twice down to 0.0-0.25 percent in March 2020.	The Fed kept Fed funds rate at 0.0-0.25 percent in June 2020. The Fed funds rate is expected to be kept at around zero until the end of 2022.
Foreign inflation	**Revised down**
The global inflation is not likely to increase. The mainly driven by followings: the growth projection of main trading partners, except Russia, remains close to the previous projection, COVID-19→ China's growth slowed down, OPEC deal ends → oil price declined. Inflation in China is expected to be around the previous forecast in the forecasting period as prices of pork continued to rise and price of imported goods rose.	The global inflation is not likely to increase due to lower-than-expected growth in trading partners except China and higher growth in China and lower oil prices. Inflation in China is expected to be lower than previously expected. While the impact of pork prices on inflation remains high, Chinese domestic demand has not returned to normal, resulting in downward revision in the inflation outlook.

Source: Bank of Mongolia

Figure IV.1.1

Forecast of external demand, y-o-y percent



Source: Bloomberg, EIU, The IMF, Roubini

Analysts forecast **Russia's economic growth** in 2020 to be between -3.3 to -5.5 percent and an average growth forecast of -4.8 percent[24] is 6.4 percentage points down from previous

[22]Forecasts of economic growth and inflation in main trading partner countries were compiled from external outlook as of May 18, 2020, March 2020 edition of EIU Global Forecasting Report, May 2020 edition of Roubini Global Economics and the median of forecasts conducted by Bloomberg analysts. It does not include the assessment of the Bank of Mongolia.

[23]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).

[24] The average of the forecasts from the EIU, Roubini, and Bloomberg as of May 18, 2020.

forecast of 1.6 percent. The growth forecast for 2021 is revised up by 0.8 percentage points on average to 1.7-2.5 percent. Russia's growth forecast for this year is revised down mainly due to underperformance of the economy in the first quarter, the tightened quarantine measures in the second quarter due to the spread of COVID-19, weaker oil demand and prices, and trade sanctions by western countries that remains intact. However, the implementation of national infrastructure projects is expected to accelerate the growth in the latter half of 2020 with the amount of about 23 percent of GDP to be spent on projects covering 13 economic sectors such as health, infrastructure, environment, and e-economy between 2018 and 2024.

The Bank of Russia expects the economy to shrink by 4-6 percent in 2020 as Russia's industry, household consumption, and investment fell sharply below expectations. The central bank is expected to cut interest rates to a record low of 5.5 percent. The government announced that the budget deficit is expected to reach 8.5 percent of GDP this year. Nevertheless, the impact of the negative shock on the budget is expected to be relatively small, with an average oil price forecast of 42 USD per barrel as stated the government budget draft for 2020.

The recovery in emerging economies, higher oil demand and price outlook, bolstering of national infrastructure projects, and boost in investments are expected to support the growth outlook for 2021.

Analysts forecast the **Euro Area's growth** in 2020 to be between -0.6 to -7.5 percent and an average growth forecast of -5.4 percent is 5.4 percentage points down from previous forecast. The growth forecast is revised down mainly attributable to the risks of COVID-19, global economic uncertainty, and further lockdowns imposed on key regional economies such as Germany, France, and Italy in the second quarter of 2020. The growth forecast for 2021 is revised up by 1.9 percentage points on average to 0.7-5.0 percent.

Expected pick up in emerging economies' growth and external demand, and continuance of conducive fiscal and monetary policies in key regional economies are expected to support next year's regional economic recovery. In addition to the European Central Bank's negative interest rate policy and unconventional monetary policy, additional instruments to support the financial markets and the real economy, and expansionary fiscal policies in some countries in the region are expected to support the economic recovery. For instance, the European Central Bank decided to increase its bond purchases by 600 billion euros to a total of 1.35 trillion euros by the end of June 2021, to combat COVID-19 pandemic and mitigate its impact on the economy. According to the ECB's updated forecast, the economy is expected to contract by 8.7 percent in 2020, and inflation will reach 0.3 percent and remain below the target of 2 percent.

European finance ministers have unveiled a 500-billion-euro recovery package to boost the European economy from the "The Great Lockdown" as part of a policy to boost the economy and mitigate the effects of Covid-19. The budget will be used to support the most vulnerable sectors in the countries most affected by the pandemic.

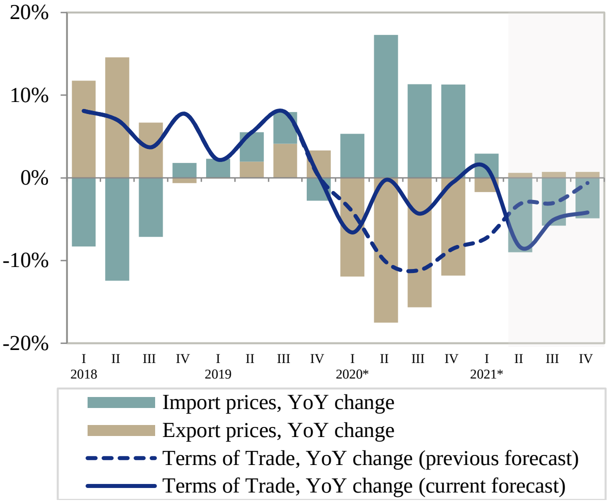
Terms of Trade

Terms of trade is expected to deteriorate in 2020, but the rate of decline is gradual from previously forecasted (Figure IV.1.2). This is mainly driven by lower import price forecasts due to lower oil and food prices than expected and higher export price forecasts of gold and iron ore.

In terms of coal and copper, China's economic outlook is not likely to recover rapidly this year, thus, demand and prices are expected to fall. From 2021, while the commodity prices are expected to remain at this year's level, import prices are expected to rise as oil and food prices climb, and as a result, terms of trade is expected to deteriorate from 2020 levels.

Figure IV.1.2

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

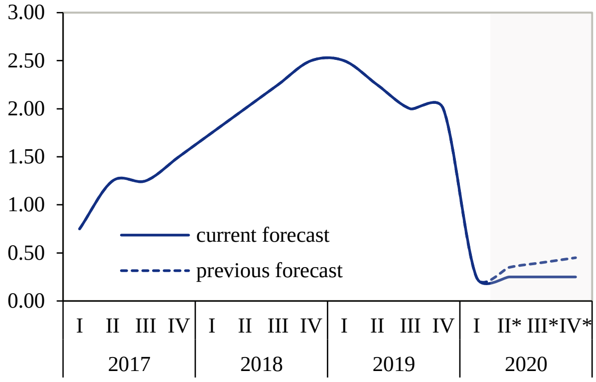


Source: Bank of Mongolia

Foreign interest rate: The Fed's FOMC decided to keep the Fed funds rate on 0.0-0.25 percent on the meeting in June 2020. The Fed sees the economy contracting by 6.5 percent and the unemployment rate to reach 11 percent this year due to the pandemic. Moreover, the Fed intends to keep the policy rate at near zero percent until 2022, as the economy is expected to recover gradually from the recession and grow by 5.0 percent and 3.5 percent, the unemployment rate to reach 6.5 percent and 5.5 percent, respectively, in 2021 and 2022. The Fed is also taking measures to support financial market liquidity. As part of policy measures to alleviate the negative effects of the external environment from COVID-19 and promote employment, FED announced to purchase of around 80 billion USD in treasuries and 40 billion USD in agency mortgage-backed securities (MBS) monthly basis. In addition to maintaining the liquidity of financial markets, the Fed is introducing tools to support the financing of enterprises and small and medium-sized businesses in the real sector.

Figure IV.3.5

The Federal funds rate, by percent



Source: Bloomberg

Global inflation outlook is revised down from previous forecast. Inflation outlook in China is revised down from 4.7 percent to 4.2 percent for 2020 according to a forecast average of Bloomberg, the IMF, and Roubini. This was mainly attributable to a gradual recovery in domestic demand that has not reached normal levels and a subsiding impact of swine flu on inflation.

Inflation outlook in Russia is revised up from 3.3 percent to 3.8 percent for 2020 according to a forecast average of Bloomberg, the IMF, and Roubini, below the central bank's target of 4 percent. The impact of national projects, expansionary monetary policy, and rising food prices have resulted in an upward revision in the inflation outlook.

Inflation outlook in the United States is revised down from 1.8 percent to 0.7 percent for 2020 according to a forecast average of Bloomberg, the IMF, and Roubini. This is triggered by an unemployment rate that is projected to rise from 3.7 percent in 2019 to 11 percent in 2020, reduced transportation costs due to lower oil prices, and sluggish housing prices.

Inflation outlook in the Euro Area is revised down from 0.8 percent to 0.5 percent for 2020 according to a forecast average of Bloomberg, the IMF, and Roubini. The regional economic activity has weakened, and the euro is expected to depreciate with the expansionary monetary policy by the ECB have contributed to the downward revision on inflation forecasts.

Uncertainties in the external conditions

The extent and duration of the spread of COVID-19 and the potential subsequent wave of outbreaks are the main uncertainties in the external economic environment. If the outbreaks reemerge and the spread accelerates, it could hurt the Mongolian economy, mainly through lower exports and fiscal revenues as China's economic growth slows and commodity prices fall. Moreover, the risk of escalating trade disputes between the United States and China, expectations of a Brexit and post-Brexit trade agreement, and volatility in the oil prices remain unclear.

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

Commodity price fluctuations were high due to weak growth in trading partners amidst the outbreak of COVID-19, the risk of escalating trade disputes between the United States and China, as well as elevated uncertainty and risk in the global economy.

Copper: The average price of copper per ton at the London Metal Exchange was 5057 USD in April 2020 and rose to 5240 USD in May 2020. The recovery in China's economic activity, which accounts for 50 percent of the global copper demand, and the fact that the manufacturing sector is operating at a potential of more than 90 percent have had a positive impact on the copper market, pushing copper prices up. On supply side, increasing COVID-19 outbreaks in major copper producers such as Peru and Chile could lead to supply shortages in 2020. On demand side, if China's manufacturing sector resumes its recovery, it could support the copper prices up. Copper prices are expected to fall to an average of 5143 USD per ton in 2020 and 5211 USD per ton in 2021, according to forecasts by the World Bank, the IMF, and Bloomberg.

Although copper prices are expected to rise in 2021 as the global economy recovers, there are risks that could harm the metal demand in the medium term. The risks include further escalation of trade disputes between the United States and China and the increased spread of COVID-19 around the world that could slow growth in developed and developing countries.

Gold: Gold price averaged 1686 USD per ounce in April 2020 and rose to 1730 USD per ounce in May 2020. The demand for gold, considered a risk-free investment, soared as the uncertainty in the global economy heightened with the increased spread of COVID-19 and risk of escalating trade disputes. The gold price is expected to average 1694 USD per ounce in 2020 and 1689 USD per ounce in 2021, exceeding previous forecast, according to forecasts by the World Bank, the IMF, and Bloomberg. Looking forwards, the gold price volatility is expected to remain high throughout 2020 due to the potential risk of growth outlooks of the developed countries to weaken further and market uncertainty to increase in the event of a subsequent wave of the pandemic.

Coking coal*:* The price of coking coal traded at the Australian market averaged 132 USD per ton in April 2020 and dropped to 115 USD per ton in May 2020. The price decline was induced by lower demand for coal due to increased domestic production and reserves in China, an increase in the spread of COVID-19, and the risk of the trade dispute to escalate further. Bloomberg analysts revised down the forecast of coking coal prices to 123 USD per ton on average in 2020 and 132 USD per ton in 2021. China's large and medium-sized enterprises are currently operating at a potential of more than 90 percent, and if the steel industry continues to recover, it will support the prices in the latter half of 2020. Although the upward revision in China's economic growth is expected to push up coking coal demand and prices in 2021, the domestic coking coal supply is expected to increase in the medium term. China plans to build thermal and coking coal plants with a total capacity of 976 million tons by 2021.

Iron ore: The price of iron ore averaged 82 USD per ton in April 2020 and rose to 88 USD per ton in May 2020. Coke and steel production in major Chinese cities continued to operate at a potential of more than 90 percent, and the regional production shutdown, which accounts for 10 percent of Vale's total production, was suspended due to the spread of COVID-19 in Brazil have resulted in a rise in iron ore prices. Iron ore prices are revised up to an average of 84 USD per ton in 2020 and 80 USD per ton in 2021, according to forecasts by the World Bank, the IMF, and Bloomberg. The price forecast is revised up in 2020 due to the possibility of a supply shortage amid the rapidly increasing spread of COVID-19 in the main iron ore supplier countries. However, in 2021, the risk of supply disruptions is expected to decrease and demand is expected to remain stable.

Crude oil: A barrel of Brent oil was sold at an average of 25 USD in April 2020 and rose to 35 USD in May 2020.

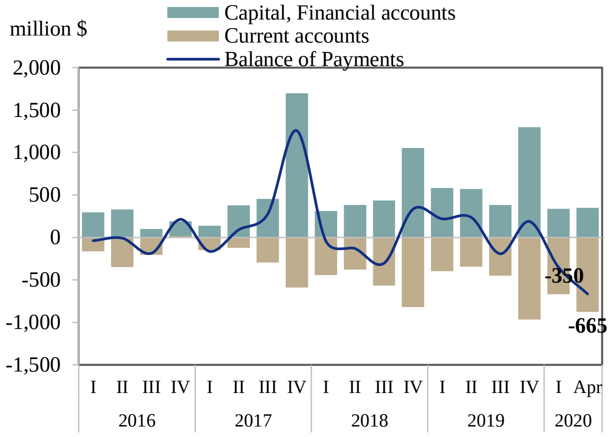
Prices fell sharply in April as the demand plummeted with the increasing spread of COVID-19 throughout the world, and the oil-producing countries failed to reach an agreement on the production cut. However, oil prices rose again in May as the OPEC + cut production from May 1 and the US oil reserves in warehouses fell sharply than expected. The oil price forecast is revised down to an average of 37 USD per barrel in 2020 and 41 USD per barrel in 2021, according to forecasts by the World Bank, the IMF, and Bloomberg. Oil prices are expected to remain subdued throughout 2020 as oil demand remains weak reliant on global economic activity. For 2021, while demand is expected to recover, the oil supply is not likely to pick up rapidly, resulting in a marginal upward revision to the oil price forecast.

IV.3 Balance of Payments

In the first 4 months of 2020, the balance of payments was in a deficit of 665 million USD or 4.9 percent of GDP[25], which is a deterioration of 988 million USD year-on-year. The current account deficit widened by 442 million USD year-on-year as export revenue declined due to COVID-19, the financial account surplus contracted by 291 million USD year-on-year through a decrease in FDI, portfolio investments and lower net flows in trade credits, and errors and omissions of the balance of payments decreased by about 245 million USD[26] year-on-year (Figure IV.3.1).

Figure IV.3.1

As the current accounts' deficit widens, the balance of payments was in a deficit in the first 4 months of 2020.



Source: Bank of Mongolia

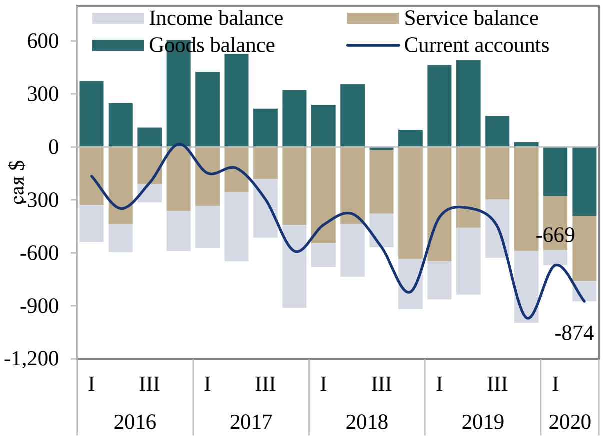
The current account deficit was 874 million USD (6.5% of GDP) in the first 4 months of 2020. The current account deficit widened as the export revenues contracted by 1.2 billion USD from that of previous year due to COVID-19. On the other hand, services deficit narrowed by 457 million USD, income account deficit by 180 million USD, and imports by 165 million USD as the economic activity weakens.

Figure IV.3.2

[25] 4-quarter cumulative nominal GDP.

[26] Unexplained capital outflows increased.

Reduction in export revenue resulted in a wider current account deficit.



Source: Bank of Mongolia

Goods' balance was in a deficit of 390 million USD in the first 4 months of 2020. Export revenue decreased by 1.2 billion USD or 45 percent year-on-year. More than half of the decline (25 percentage points) is explained by a decrease in coal exports, and the rest is due to a decrease in exports of copper concentrate, gold, crude oil, and cashmere (Table IV.3.2). 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, and exports have resumed since late March, but the recovery has been slow. In addition, the gold content of Oyu Tolgoi copper concentrate continued to decline, copper export revenues declined by 215 million USD (-31%) from that of previous year, accounting for 8.6 percent of total export revenue decline. Gold purchases increased 2-3 times since last year, but gold exports have been delayed in view of the lockdown. Also, in the wake of COVID-19, China's demand for cashmere fell dramatically and cashmere exports declined by 67 million USD from that of previous year, accounting for 2.7 percentage points of the total export revenue decline. However, exports of iron ore, transported by rail, resumed normally, and contributed positively to the exports.

Table IV.3.2

The export revenues of coal, copper concentrate, gold, crude oil, and cashmere declined.

	2019 1-4	2020 1-4	YoY change	Contri-bution %
Total exports	**2,512**	**1,374**	**-45.3%**	**-45.3%**
Coal	961	334	-65%	-25.0%
Copper concentrate	701	486	-31%	-8.6%
Gold	196	80	-59%	-4.6%
Crude oil	118	21	-82%	-3.9%
Cashmere	87	20	-77%	-2.7%
Meat, meat products	39	5	-86%	-1.3%
Iron ore	159	189	19%	1.2%
Others	250	238	-5%	-0.5%

Source: ГЕГ, Bank of Mongolia

Imports growth slowed for the fifth consecutive quarter, contracting by 7.4 percent year-on-year in the first 4 months of 2020.

Table IV.3.3

Imports of diesel, passenger cars, and capital goods declined.

	2019 1-4	2020 1-4	YoY change	Contri bution%
Total imports	**1,712**	**1,586**	**-7.4%**	**-7.4%**
Consumer goods	498	450	-9.8%	-2.9%
Of which; Passenger cars	171	119	-30%	-3.0%
Capital goods	663	638	-3.9%	-1.5%
Fuels and diesels	347	286	-17.6%	-3.6%
Of which; Diesels	207	149	-28%	-3.4%
Other fuels	140	137	-2%	-0.1%
Industrial inputs	201	211	5%	0.6%
Other	2	2	-	0%

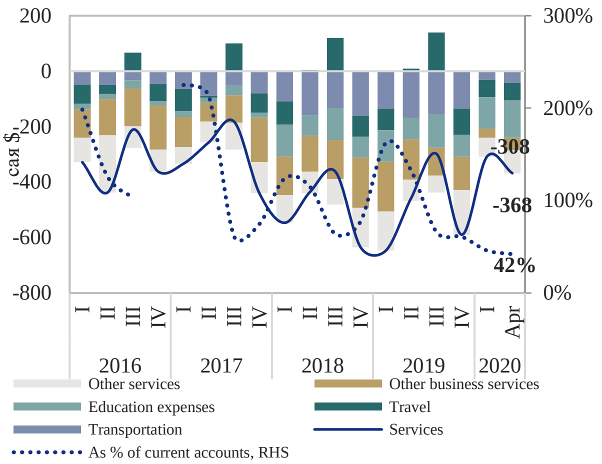
Source: ГЕГ, Bank of Mongolia

Diesel fuel imports declined as the world oil prices dropped sharply in the wake of COVID-19 pandemic combined with the reduced coal export volumes of Mongolia. Imports of machinery and equipment and passenger cars in the mining sector continued to decline due to weaker domestic demand and declining economic activity.

In the first 4 months of the year, **services account** deficit narrowed by 457 million USD or by 55 percent year-on-year reaching -368 million USD. This was mainly driven by a reduction in costs of business, trade, financial, and travel services and a smaller deficit in freight services as the foreign trade turnover decreased.

Figure IV.3.3

Services account deficit has narrowed.



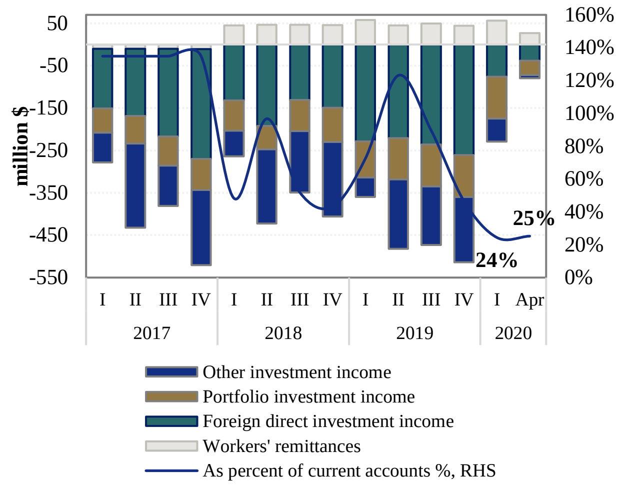
Source: Bank of Mongolia

Income account was in a deficit of 215 million USD in the first 4 months of 2020, decreased by 171.6 million USD or 44 percent year-on-year. This was mainly due to the decreased outflow of FDI income by 161.7 million USD or 35 percent year-on-year. In particular, as a result of depressed profitability of banks and enterprises, the outflow of reinvestment earnings decreased by 191 million USD from that of previous year, reaching a net inflow of 101 million USD.

Moreover, as a precautionary measure against COVID-19, coal and oil exports were suspended during February and March 2020, and oil prices fell sharply, reducing the outflow of dividends under oil product sharing agreements by about 80 percent to 6 million USD. The deficit in primary income accounts for 50 percent of current account deficits in the reporting period.

Figure IV.3.4

Income accounts deficit narrowed.



Source: Bank of Mongolia

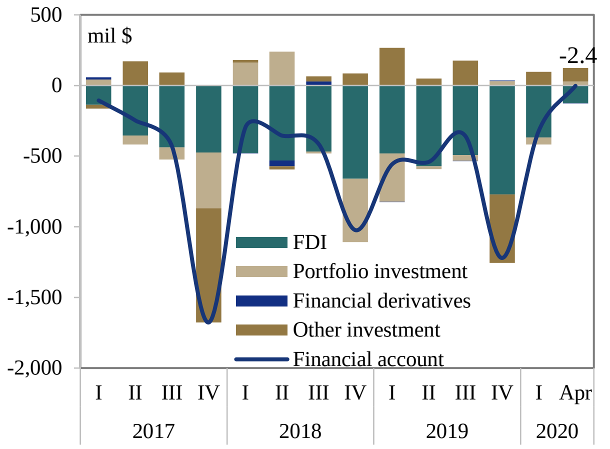
The financial account was in a surplus of 323 million USD in the first 4 months of 2020, a decrease of USD 291 million USD year-on-year. This was mainly driven by a decrease in net outflows of other investments by 50 percent year-on-year reaching 190 million USD, a decrease in FDI net inflows by 22 percent to 491.4 million USD, and a decline in net inflows in portfolio investments that almost halved down to 21 million USD.

In the reporting period, the low profitability of Oyu Tolgoi and other enterprises resulted in 212 percent or 191 million USD decrease in the reinvestment earnings, resulting in a net outflow of 101 million USD. The equity capital of Oyu Tolgoi and other enterprises decreased by 94.3 million USD down to 270 million USD, which contributed to the decrease in net FDI inflows.

The portfolio investment decreased by 347 million USD from that of previous year to a net inflow of 21 million USD. This was due to a base-year effect when MIK HFC LLC issued a bond worth of 300 million USD at the international market last year.

Figure IV.3.5

Financial account surplus declined.



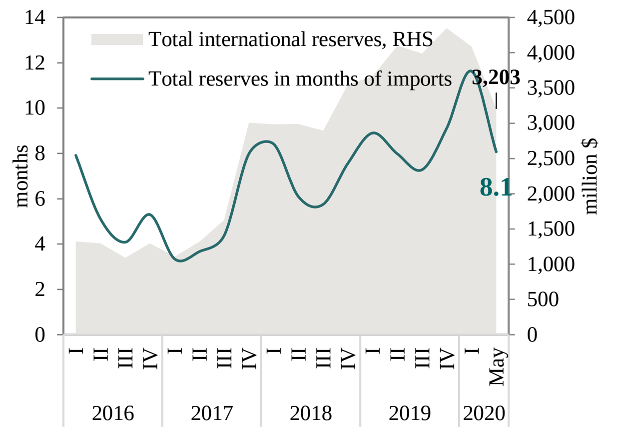
Source: Bank of Mongolia

Other investment account was in a net outflow of 382.4 million USD in the first 4 months of the previous year but decreased to 190.2 million USD in the first 4 months of this year. In the first 4 months of 2019, some enterprises repaid their external debts, and trade loan was in a net outflow of 88 million USD. Conversely, in the first 4 months of 2020, some coal companies received advance financing and trade loan was in a net inflow of 87 million USD as some enterprises collected the receivables.

Gross international reserves (GIR): decreased by 1.1 billion USD from the beginning of the year reaching 3202.9 million USD at the end of May 2020[27]. It is an adequate level to cover 8 months of imports, which is calculated as an average of the last three months' import payment made in hard currency (Figure IV.2.6). The decline in GIR was mainly driven by the balance of payments deficit of 665 million USD in the first 4 months and the repayment of TDB foreign bond worth of 500 million USD in May 2020.

Figure IV.3.6

Gross international reserve stands at a level to cover 8.1 months of imports[28].



Source: Bank of Mongolia

Terms of Trade deteriorated by 19.5 percent from that of previous year in April 2020. Although import prices fell by 11.6 percent, export prices fell by 29 percent year-on-year, resulting in weaker terms of trade.

The export custom's price of copper concentrate declined by 29 percent, the custom's price of crude oil by 71 percent, the custom's price of coal by 6.4 percent, the price of cashmere by 73 percent, the price of zinc by 33 percent, and the prices of fluorite, leucite, and nepheline declined by 29 percent in the first 4 months of 2020. Conversely, the custom's price of iron ore increased by 3.6 percent year-on-year.

The 11.6 percent decline in import prices was mainly driven by lower foreign inflation and decline in the prices of imported consumer goods, investment products, and fuels due to lower global oil prices.

27 The difference between the balance of payments and GIR is explained by changes in monetized gold.

28 Imports paid in hard currency

Table IV.3.

Changes in Key assumptions of BOP projection (2020)

Previous forecast of 2020	Current forecast of 2020
Exports	**Revised up marginally**
Oyu Tolgoi's gold concentrate in the copper ore declines. To prevent COVID-19 → coal, iron ore exports are temporarily halted → coal and iron ore export forecasts↓, Chinese growth↓ → coal, copper concentrate, iron ore, crude oil price forecasts↓, Gold price ↑ → gold export revenue↑.	Advance financing for gold miners→ Gold purchase, exports↑, Oyu Tolgoi's gold concentrate in the copper ore declines. The recovery in coal exports is slower than previously expected, **Prices**: Coal, copper, oil price forecasts↓, Gold, iron ore forecasts ↑.
Imports	**Revised down**
Oyu Tolgoi FDI↑, crude oil processing plant↑, fiscal capital expenditure↑ → Imports of capital goods↑. Economic activity↓, coal exports↓ → fuel imports ↓, passenger cars' imports↓, industrial inputs ↓.	Oyu Tolgoi FDI↓, crude oil processing plant↑, fiscal capital expenditure cut → Imports of capital goods ↓. Economic activity↓, coal exports↓ → fuel imports ↓, passenger cars' imports↓, fiscal economic support packages→ consumer imports↑.
Services	**Revised down**
Coal, iron ore exports ↓ → income and expense of transport services↓. COVID-19 → International flights are canceled → Travel accounts income ↓, passenger transportation income↓, Oyu Tolgoi FDI↑ → business and financial services expenses ↑. Economic activity ↓ → business services expenses ↓.	Coal, iron ore exports ↓ → income and expense of transport services↓. COVID-19 → International flights are canceled → Travel accounts income ↓, passenger transportation income↓, Oyu Tolgoi FDI ↓→ business and financial services expenses↓. Economic activity ↓ → business services expenses ↓.
FDI	**Revised down**
Oyu Tolgoi's FDI for 2020 increased according to a renewed plan. The crude oil processing plant project will be financed by FDI.	Due to COVID-19, the construction of the Oyu Tolgoi underground mine has slowed down slightly and investment will decline. The crude oil processing plant project will be financed by FDI. Companies' profitability declined and reinvestment earning projection is revised down.
Portfolio investment	**Unchanged**
TDB $500 million bond, that was assumed to be refinanced, is now revised to be repaid.	TDB $500 million bond was repaid.
Other investments	**Revised down marginally**
The IMF EFF program financing plan is revised up for 2020. In the private sector, loan disbursements are expected to decline and loan repayments are expected to increase. The net outflow of currency and deposit is expected to decline.	The IMF EFF program financing plan is revised up for 2020 (Mainly ADB financing). The loan disbursements in the private sector is revised down.

Source: Bank of Mongolia

THE BANK OF MONGOLIA