



Bank of Mongolia



BANK OF MONGOLIA

INFLATION REPORT

2016

June

“Inflation report” has been prepared and become publicly available in accordance with the flexible inflation targeting monetary policy framework and under the guidance of article 34.1 of the Law on Central bank (The Bank of Mongolia). This report will be prepared on a quarterly basis and published on the website of the Bank of Mongolia in every March, June, September and December.

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EXECUTIVE SUMMARY

In the reporting period, Mongolia's external demand and external economic outlook indicators worsened a little compared to the previous quarter. The main trading partner Chinese economic growth which determines Mongolia's external demand slowdown reached 6.7 percent in the 1st quarter of 2016 continuously. A slowdown in Chinese economic growth was mainly caused by sharp decline of the investment in mining and industrial sector of the north-east region, despite its government investment in infrastructure sector has increased in the reporting period. After the policy measures implemented during 2015, cause of prices on real estate and its sales increased, real estate sector has improved significantly in the first quarter. It is expected that Chinese economic growth will reach target level of 6.5 percent in 2016 through expansionary monetary policy implementation, but the forecasts on economic growth will decline continuously in the future. Despite the labor market conditions improving continuously, the economic growth in Euro zone have a slight deceleration while the USA kept its economic growth at same level of the previous quarter. Cause of contribution of service sector, Russian economic contraction was lower than expected in the reporting period. Despite the oil price stand at low level compared with previous years is impacting negatively on Russian economy, it is enhancing real income and bringing positive impacts on domestic demand for our main trading partner countries (net importing countries).

Although the prices of the major exporting products of Mongolia in the reporting quarter increased, compared with y-o-y it is still standing at lower level. The increase on China's real estate sector, escalation of construction sector and steel industry have been increasing copper and coal imports also enabled its rise in prices in the reporting quarter. The Federal Reserve Bank kept its policy rate, some developing countries' central banks changed to minus rate policy have increased investors' interest on gold purchasing which influenced gold prices' rise. As for the oil market, the lifting of sanctions of Iran and cancellation of the ceiling for the daily oil production by OPEC which led to subsequent rise of supply caused the decline of oil price.

While the increase of capital account surplus caused by the impact of foreign direct investment, the balance of payments deficit reduced due to the decrease in the current balance deficit in the reporting quarter. Despite the decline in concentrate metal grade of Oyu tolgoi open pit is weakening its export that influencing to the balance of payment negatively, but it is forecasted to impact positively to the balance of payment driven by increase of foreign direct investment from underground second phase investment. The economic growth more increased than forecasted and the pace of growth increased slightly compared with the previous quarters. Depending on increase of Oyu tolgoi production, the mining sector growth reached 16 percent more than previous forecasts which made main contribution to the economic growth. But non-mining sector has been shrinking for the last 4 consecutive quarters; downturn reached 1.2 percent in the reporting quarter. While in contrast all other sectors including processing industry made the most slowdown to the economic overall growth by 0.7 percentage points, trading sector declined by 0.6%, transport and communication sector decreased by 0.2% and the net tax of product slowed by 0.1% respectively. The negative output gap has increased slightly compared with the previous quarter in the first quarter of 2016. Total output has been standing at lower level than average level of long-term during last 2 years mainly due to contraction of non-mining sector production which was lower than potential level. But from the second half of 2014, there was more production compared than average level of long-term in the mining sector.

In the reporting period the total demand increased slightly compared with previous quarter 3 mainly due to contraction of investment. While a rise in government consumption and export and decrease of import consumption supported to the economic growth, contraction in investment and consumption effected to the economic growth negatively. Deceleration of growth and reduction of foreign investment due to the continued decline in commodity prices, deceleration of the overall growth and deteriorating conditions of business environment are causing downward pressure on private investment. The economic recession leading to budget revenue shortages and continuing drop off in government investment.

The labor market conditions deteriorated continuously in the reporting period. According to the Employment Force survey conducted by the National Statistical Office, employment declined in reporting quarter and unemployment rose sharply. Not count in employment of industrial workers increased by more than 1,000, other

sectors of the economy employment rate has declined. The continuous contraction in investment for the last consecutive years has been causing the labor demand to decline. Annual inflation reached 1.7 percent at the end of the first quarter of 2016 which was forecasted and declined by 7.6 percentage points compared with the previous year due to price decline of goods not including administrative prices. The inflation reduced by 0.2 percentage points caused by most of goods' prices standing relatively stable in the reporting quarter. Supply-driven inflationary pressure has declined due to depreciation of unit labor costs, food price downgrade and increase of unemployment in global.

Money supply increased in the reporting quarter which was contracted consecutive 4 quarters caused by increase in net foreign assets of depository institutions and MNT savings of individuals, even though the loan growth of commercial banks is still weakening. Loans financed by the Bank of Mongolia and the spending by the Development Bank brought a rise in total credit in the financial sector, a trend at which loans financed by banks' equity continued to decline y-o-y have been observed in reporting quarter. Outstanding loans in all economic sectors except mining and individuals' consumption loans decreased consecutive 4 quarters. The amount of newly issued loan which has been shrinking during last 6 quarters has increased in reporting quarter caused by increase on consumer loan and construction sectors loan. Weakening economic activities and poor domestic demand have increased risks of loans and have negative impacts on repayment. Along with the policy rate, the inter-bank rate has decreased while deposit rate increased caused of contraction of deposit market. Despite the slight depreciation of togrog, its return on deposits (relative return) remains higher than the interest earnings on deposits denominated in foreign currency that are adjusted for currency depreciation. Furthermore, due to the increasing level of risk and tighter lending criteria, the upward trend of the interest rate on loans persists.

Although an increase in the total market capitalization due to selling from "Mongol Post" share holding company sold 34 percent of bills or 6.26 billion MNT to the primary market in the reporting quarter, but TOP-20 index down continued. The housing prices slumped throughout the last 3 consecutive quarters has not any more change in the reporting period. Demand for housing purchases seems yet to recover due to the contraction in lending by the banking sector and decrease in household real income. When the number of new housing is declining, housing supply still remaining relatively high compared with its demand.

The economic growth for 2016 is projected to keep same level as previous year, but for 2017 is forecasted to accelerate. Mining sector production which was main contributor for economic growth in 2015 is projected to decline in 2016-2017 due to poor concentration of Oyu Tolgoi open pit copper concentrate. The positive impacts of the underground mine investment of Oyu Tolgoi project, the construction, trade, net tax of production and service sector is projected accelerate which will take recover in non-mining sector that provide condition for total economic growth remaining in same level of previous year. The economic growth is forecasted to accelerate in 2017 due to 2-3 times increase in the underground mine investment of Oyu Tolgoi project that extend non-mining production. Annual inflation is forecasted to be stable in the upcoming two quarters, and from the end of 2016 it is projected to increase and reaching higher level than target level in 2017. The increase in the economic growth projection serves as the factor to raise the inflation projection.

High risks from Chinese economic growth persist changes from the forecast. In particular, increase in construction and steel production which was the main changes in Chinese economy remaining uncertainties on its maintain that create uncertainties for global market production prices in the upcoming future. Risks from declining Chinese growth persists and may affect economic forecasts through uncertainties in commodity price forecasts, changes in the terms of trade, external demand and the exchange rate. Investment in non-mining sector still being a reason of domestic economic forecast uncertainty. Lack of improvement in credit ratings and higher risk premium have been contributing to increased costs for drawing funds in the international financial market. According to the reports of business confidence survey, tendency of recovery in investment to the non-mining sector is yet to be observed in the near term. In the event that fiscal revenue falls short of its planned amount, there are risks of widening fiscal deficit and decreasing fiscal investment.

I. ECONOMIC OUTLOOK

I.1 External assumptions of the forecast¹

Compared to the previous projections, China's and Euro zone growth forecast remained unchanged, while Russia's growth forecast revised upwards. Terms of trade is projected to improve as commodity prices increase from the previous quarter projections.

External demand

Over the forecast horizon, external demand projection has been increased by 0.04 percentage points for 2016, due to positive growth outlook for Russia and relatively stable growth in China and the Euro zone. China's gradual slowdown indicates declining external demand in 2017.

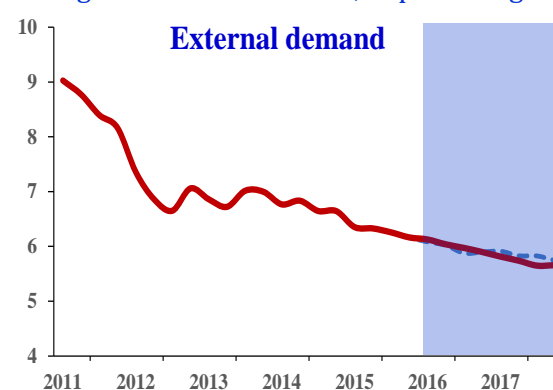
China's inflation rate lowered and unemployment rate reached at 4 percent in 2016 Q1, reflected in a gradual increase in household consumption. China plans to increase budget expenditures supporting infrastructure investment, which leads to manufacturing sector growth. China's annual growth rate forecast for 2016, therefore, remained unchanged at 6.5 percent.

The ECB's loose monetary policy² and weak oil price have been supporting private consumption and investment. However, subdued growth in emerging markets is the key challenge for the eurozone's trade outlook. Therefore, the annual growth rate for the Euro zone also remained unchanged at 1.5 percent for 2016.

Russia's declining inflation, 7.3 percent in April 2016, reflects that there is ample room for further monetary easing. Meanwhile, the government is planning to fund budget deficit by injecting USD 6 billion of the Reserve Fund, from which also further would be used in mitigating economic risks amid weak oil price. Russia's annual growth rate forecast for 2016 revised upwards to -1.3 percent, from -1.4 percent than previously projected.

Chart I.1.1

Change in external demand, in percentages



¹ Projections of economic growth and inflation in foreign economies are taken as averages of Roubini Global Economics 2016 May report, EIU 2016 May report and median values of Bloomberg analysts' forecasts and IMF WEO 2016 April forecasts and relevant descriptions are summarized from these reports. The Bank of Mongolia analysts have not made any remarks and evaluations on these matters.

Foreign interest rate

In April, the Federal Reserve decided to keep interest rates at 0.5 percent, as the U.S businesses have delayed investments and net export declined and inflation remained below the target level of 2 percent. However, as seen from the better than expected statistics the Federal Reserve is likely to hike interest rate in June or July.

In May 27, Janet Yellen, chair of the Federal Reserve, announced that rate hike would be appropriate in coming months as the decline in oil prices stabilized and inflation is expected to reach the target level of 2 percent in coming months.

Terms of trade

Terms of trade is likely to improve in 2016 due to increasing export commodity prices, compared with the previous forecasts. It is expected to weaken in 2017 as compared to previous forecasts, driven by strengthening oil prices since 2017.

Chart I.1.2

Fed rate, in percentages

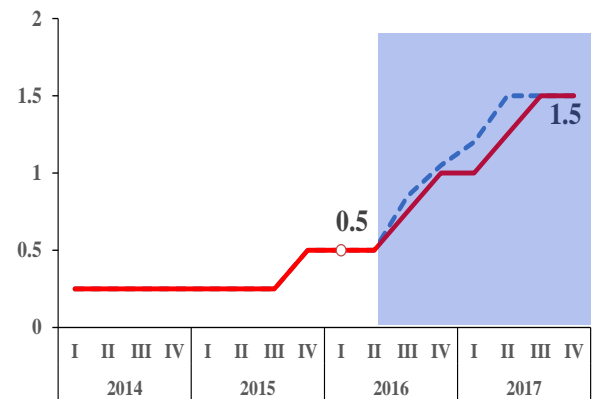
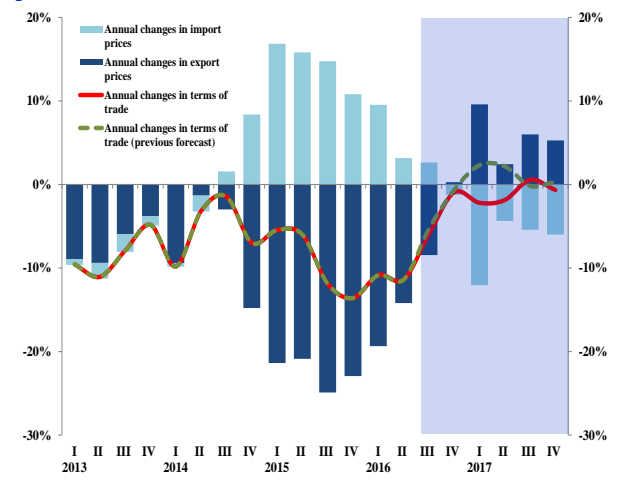


Chart I.1.3

Terms of trade, changes in export and import prices



China's construction sector and steel industry accelerated and demand for commodities increased in February and March. Hence, the average copper price forecasts for 2016 and 2017 have been increased by USD 22 per ton and USD 8 per ton, and the average coking coal price forecasts for 2016 and 2017 have been also increased by USD 4 per ton and USD 8 per ton, respectively. The Federal Reserve delayed hiking interest rates and investment demand for gold increased. As such, the average gold price forecasts for 2016 and 2017 have been increased by USD 66 per ounce and USD 32 per ounce, respectively. However, gold, iron ore and coking coal prices are expected to decline since 2016 Q3, as the Federal Reserve is likely to hike rates in coming months and China's industries have been afflicted with excess capacity and inefficiency.

China's inflation rate forecast for 2016 and 2017 has been increased by 0.1 percentage points due to the lagged effects of People's Bank of China's monetary policy easing implemented in 2015. Retail sales in the U.S increased by 3 percent y-o-y, inflation reached 1.1 percent and the economy added more jobs than expected in April 2016. Hence, the U.S inflation rate forecast for 2016 and 2017 has been increased by 0.02 and 0.1 percentage points, respectively. Regardless of unconventional monetary policy of the European Central Bank, the Eurozone inflation is expected to reach below the target level. As such, we remained the Eurozone inflation forecast for 2016 unchanged, while the forecast for 2017 has been increased by 0.02 percentage points. Russia's inflation rate has been decreasing as the economic activity remains weak and tight monetary policy. Monetary policy would likely to remain tight until the inflation rate reaches 4 percent; therefore the inflation rate forecast has been lowered by 0.3 and 0.2 percentage points for 2016 and 2017, respectively.

1.2 Forecast, uncertainties

Economic growth

GDP growth forecast is based on the assumptions that declining oil price in the world market would not affect domestic fuel prices through taxes and nominal exchange rate depreciation and nominal exchange rate of togrog would remain relatively stable.

The growth forecast was revised slightly compared to the previous quarter projection, due to the gold content of Oyu Tolgoi mine is expected to decline from Q2 2016, not Q3 2016 assumed in the previous quarter.

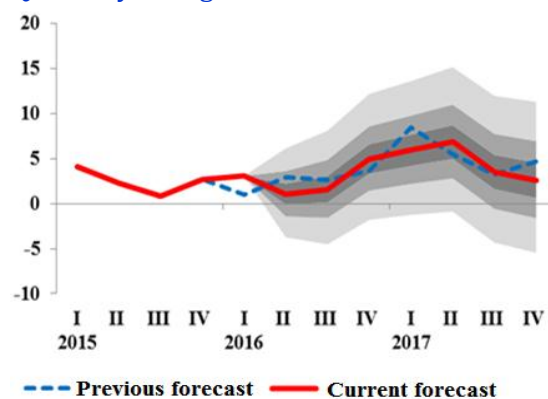
GDP growth forecast in 2016 is expected to remain unchanged at 2-3 percent and subsequently increase in 2017.

In 2016, mining production, which was the major contributor of economic growth in 2015, is projected to decline on a year-on-year basis. This is mainly due to gradual decline in the gold content of Oyu Tolgoi mine. Non mining production, such as construction, service sector etc, however, is expected to recover driven by Oyu Tolgoi phase II development. Declining government consumption over the last few years is expected to support growth, in case the government would spend as planned in 2016.

GDP growth in 2017 accelerates as commodity prices increase and 2-3 fold increase in investment of Oyu Tolgoi underground mining development. Oyu Tolgoi investment indirectly affects pick-up in non-mining production. On the other hand, gold content decline in Oyu Tolgoi mine indicates further decline in mining production in volume terms. Total output is expected to reach at potential output at the end of 2016, and expected to exceed the potential output in 2017.

Chart I.2.1

Quarterly GDP growth forecast



	2015 <i>actual</i>	2016* <i>forecast</i>	2017*
GDP growth	2.3	2-3	3.5-5.5
Inflation, Consumer price index ³	1.6	4-5	7.5-9.5

³ Average inflation rate for the fourth quarter on each year

Inflation

For 2016, the inflation forecast was slightly increased due to meat prices rose higher than expected in April-May and the expectations of strengthening non-mining production demand through the policy rate cut affected non-food inflation to rise than previously estimated in 2016-2017.

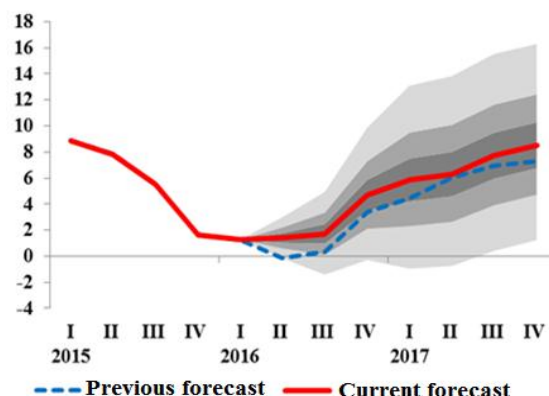
Annual inflation rate is expected to remain stable in the coming two quarters and likely to escalate from the end of 2016 and to exceed the target level in 2017.

Annual food inflation rate is estimated to decline gradually until 2016 Q4 and likely to increase in 2017. Last year meat prices sharply dropped, with meat supply rising from a year ago. A low base effect of declined meat prices would likely to pull down food and annual inflation until 2016 Q3.

World food prices dropped over the past four years and likely to gradually increase at the end of 2016 and in 2017. This increase linked to pushing up food inflation in the medium term. The pick up in investment and employment related to the Oyu Tolgoi phase II development is expected to support economic growth, reflected in higher than expected non-food inflation in 2017.

Chart I.2.2

Annual inflation forecast



Forecast uncertainties

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

External risks

- The recent announcement that the Chinese government will invest USD 720 billion in infrastructure projects in the coming three years was a significant step toward a pick up in real estate sector, leading to new home sales increase, acceleration in steel production and a gradual recovery in commodity prices in March-April. However, it is still uncertain that real estate sector growth will remain stable. Particularly, China plans to consolidate steel industries and reduce steel production by 100-150 million tonne in 2016, leading to a decline in iron ore and coking coal demand.
- The outlook for China continues to be a key source of uncertainty for the economic forecasts. China's public sector debt rose to a record 240 percent of GDP and non-performing loans are rising fast. This would likely to increase companies' debt burden, banking sector instability and economic growth decline.
- The uncertainties surrounding gold prices have risen due to Fed's policy rate hike would be possible at the June or July's policy meeting.

Internal risks

1. Unexpected interruption o surplus in the supply of goods could be a source of significant pressure on inflation. Particularly, the risks that could alter the trajectory of the forecasts include sudden increases in the prices of administrated goods and services and development of supply driven inflationary pressure.
2. Inflation forecast might change due to severe weather conditions. Droughts and heavy snowfall might lead to livestock loss increase and harvest reduction, reducing economic growth and causing supply driven inflationary pressure.
3. The uncertainty surrounding non-mining investment remains a key challenge to non-mining sector recovery. Purchasing managers' index results indicate that business sentiment is still weak and likely to increase gradually in the coming quarters. Moreover, the cost of foreign investment is increasing due to poor credit rating for Mongolia and increased risk premium.
4. If the budget revenue fails to reach its planned amount, there is a risk that budget deficit could further rise, leading to lesser public investment.

II. CURRENT ECONOMIC DEVELOPMENTS

II.1 Inflation

II.1.1 Inflation target, performance

Nation-wide annual inflation rate reached at 1.7 percent in March 2016, 0.2 percentage point lower from a quarter ago and 7.6 percentage points lower from a year ago. Nation-wide annual inflation rate remained under the target level in the last three quarters. (Chart II.1.1.1).

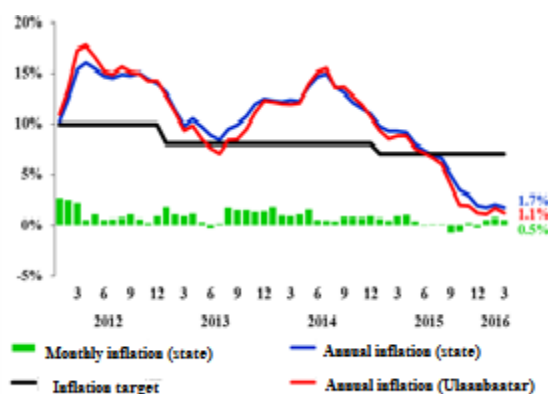
In 2016 Q1, the inflation rate remained at the close level as 2015 Q4, caused by: 1) Meat prices rose by 36.2 percent in 2016 Q1 and expected to increase in Q2 due to seasonal effects, 2) stopped reduction in inflation for main trading partners and world food prices, which led to decline in the prices of consumption imports. (Chart II.1.1.2)

In March 2016, the contribution of food prices to annual inflation declined by 2.1 percentage point y-o-y and rose by 1.2 percentage point q-o-q, due to meat prices volatility over the last months. Particularly, meat prices rose by 27.6 percent in 2016 Q1, after declined by 19.2 percent in 2015 Q4. As of March 2016, mutton and beef prices increased by MNT 1500-2000 from the end of 2015.

The contribution of non-food prices to annual inflation decreased by 5.6 percentage point y-o-y and 1.2 percentage point q-o-q, due to a high base effect and shrinking domestic demand. In the coming months, food prices are expected to increase due to its seasonal pattern. From 2016 Q2, however, the contribution of food prices to annual inflation is expected to remain negative. On the other hand, the contribution of non-food prices is expected to remain stable in the upcoming months, and in the coming two quarters annual inflation is expected to remain at the close level of 2016 Q1 and start picking up from 2016 Q4. (Graph II.1.1.3).

Chart II.1.1.1

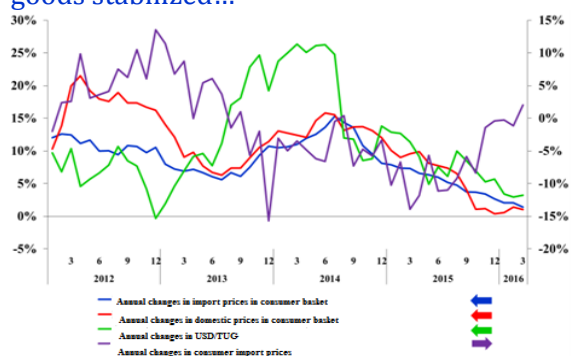
Inflation rate stabilized in the last quarter..



Source: NSO

Chart II.1.1.2

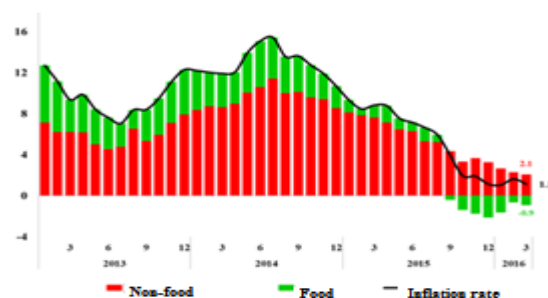
The rate of tugrug depreciation is slowing and the declining import price of consumer goods stabilized...



Source: NSO, BoM

Chart II.1.1.3

Food price inflation has rapidly declined...



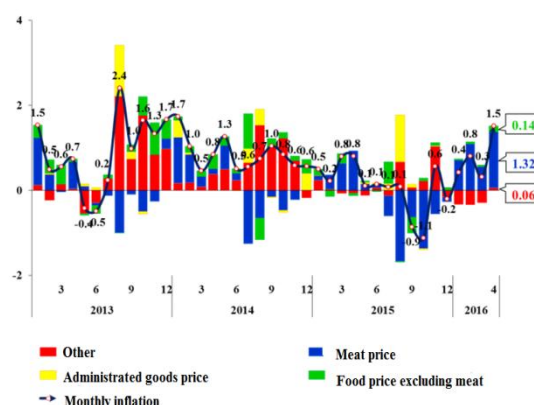
Source: NSO, BoM

III.1.2 Inflation and its components

Consumer prices in Ulaanbaatar increased by 1.5 percent in 2016 Q1, while declined by 0.7 percent on average in 2015 Q3 and Q4. Monthly inflation was 0.51 percent in 2016 Q1 on average, at the same level as 2015 Q1 and 0.42 percentage points higher from the average monthly inflation of 2015, due to meat price increase. Although meat prices sharply declined due to a supply increase at the end of 2015, meat prices are recovering over the past few months. The contribution of prices of other goods, excluding food and administrated goods (illustrated in red in chart II.1.2.1) to annual inflation was negative in 2016 Q1, while positive in 2015 H2. This was mainly caused by falling fuel prices by 18.3 percent in 2016 Q1 due to mild winter. Non-meat food and administrated goods prices, however, remained relatively stable in the past few months. (Chart II.1.2.1).

Chart II.1.2.1

Inflation rate in Q1 2016 stood at 1.5 percent...⁵

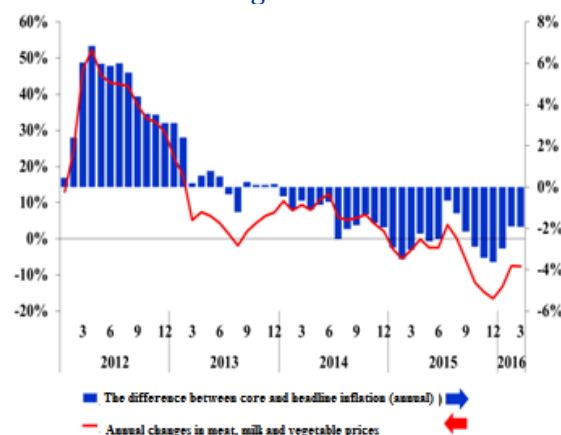


Source: NSO, BoM

Ulaanbaatar annual inflation reached at 1.1 percent in March 2016, the same as 2015 Q4 and 7.7 percentage points lower from a year ago. Core inflation⁴ fell to 3.1 percent in March, 8.8 percentage points lower from a year ago and 1.7 percentage points lower from a quarter ago. In general, slowing prices of meat led to headline inflation to decline more than expected; leading to core inflation still has remained higher than headline inflation over the last 28 months. The difference between headline and core inflation has been shrinking since January 2016 due to increase in meat prices, though widened in 2015 Q4, mainly driven by rapid decline in meat prices. Prices of meat, milk and vegetables on average, not included in core inflation estimation, declined by 7.7 percent y-o-y in March. Change in prices of these products also declined by 4.5 percent y-o-y and rose by 8.8 percent q-o-q. (Chart II.1.2.2).

Chart II.1.2.2

The difference between core and headline inflation is declining...⁶



Source: NSO, BoM

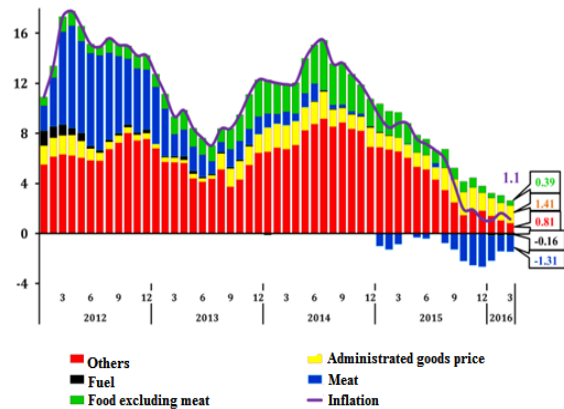
⁴ A total of 37 types of products which are subject to high fluctuations are excluded from the consumer basket.

⁵ Quarterly inflation in Ulaanbaatar has been considered.

⁶ Annual inflation in Ulaanbaatar has been considered.

By looking at the components of Ulaanbaatar annual inflation, meat prices contributed -1.53 percentage points to headline inflation, non-meat food prices 0.47, administrated prices 1.42 and other goods prices 1.08 (illustrated in red in the chart). Compared to the average of 2015 Q4, the contribution of meat prices to headline increased by 0.94 percent, while the contribution of non-meat food prices declined by 0.24 percentage points, fuel prices 0.16, administrated goods prices 0.30 and other goods prices 0.62 (Chart II.1.2.3).

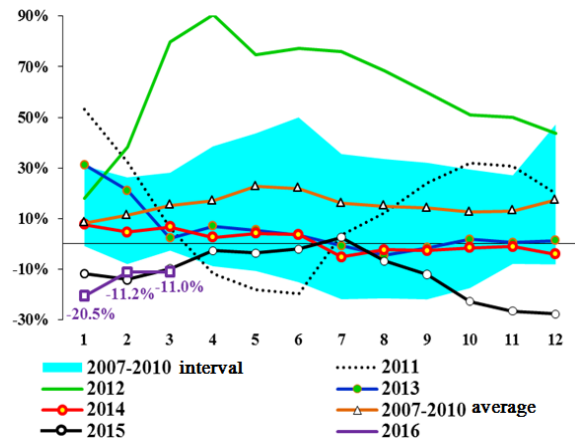
Chart II.1.2.3
Meat prices increased, however, contributed negatively to decline in the inflation rate....⁷



Source: NSO, BoM

Meat prices sharply rose by 37.6 percent in 2016 Q1, however still remained lower from a year ago. The annual growth rate of meat prices was at -14.3 percent on average, 2.8 percentage points lower than 2015 and 11.4 percentage points higher than 2015 Q4. The sharp rise was caused by; low meat prices during 2015 H2 recovered sharply in the near term. (Chart II.1.2.4).

Chart II.1.2.4
Meat prices increased by 37.6 percent in Q1 2016...



Source: NSO, BoM

⁷Contributions to the annual inflation rate in Ulaanbaatar has been considered.

II.2 Demand, supply

II.2.1 Domestic demand

Total demand grew by 3.0 percent y-o-y in 2016 Q1. Government consumption and foreign trade positively contributed to GDP growth, while investment and household consumption had negative contributions.

Consumption

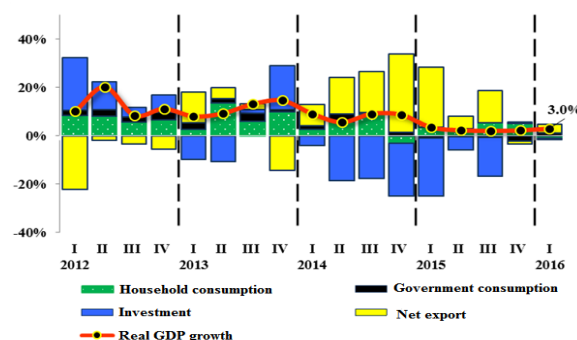
Household: Household consumption fell by 1.6 percent y-o-y in 2016 Q1, mainly driven by declined food consumption by households. It contributed -1.1 percentage points to GDP growth.

A 12.7 percent y-o-y decline in household income, which was caused by decline in wages and income from private businesses (farming, agriculture etc.) led to shrinking household consumption. Monthly real household income has decreased over the past five months. (Chart II.2.1.2)

The decline in household income has been pulling down average household expenditure. Particularly, the average household expenditure declined by 4.0 percent in real terms, a four-fold decrease from a year ago, and has been continuously shrinking since 2015 Q2. Non-food expenditures widened in 2016 Q1, while shrinking in 2015 H2. (Chart II.2.1.3)

Chart II.2.1.1

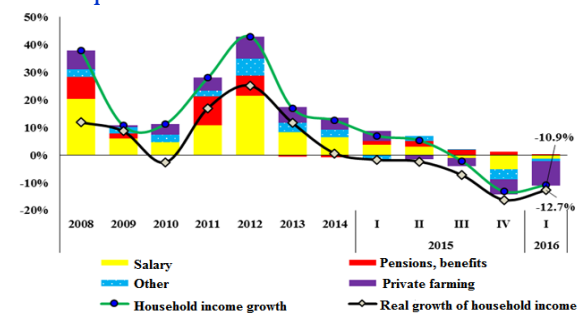
Real GDP growth is slowing. Net export contributed significantly to GDP growth in Q1 2016...



Source: NSO

Chart II.2.1.2

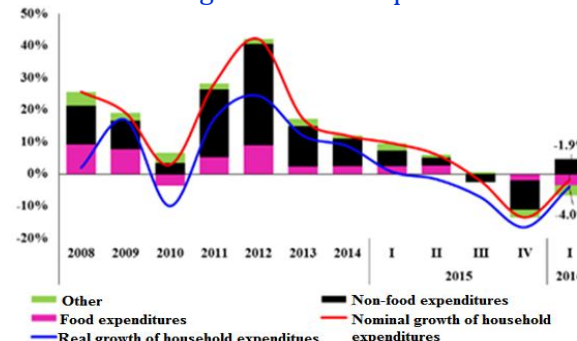
Household income has been slowing for the last 5 quarters...



Source: NSO

Chart II.2.1.3

Real growth of household expenditures has been decreasing for the last 4 quarters...



Source: NSO

Government: Government expenditure rose by 8.1 percent y-o-y in 2016 Q1, contributing 1.2 percentage points to GDP growth. (Chart II.2.1.4)

According to the general budget performance of 2016 Q1, 88.3 percent (MNT 1095.2 billion) of budget revenue was collected and 73.8 percent (MNT 1710.9 billion) of budget expenditure was incurred. In 2016 Q1, budget deficit reached at MNT 615.7 billion, better than estimated (MNT 1077 billion) in the consolidated fiscal plan. (Table II.2.1.1).

Budget

According to the general budget performance of 2015, 98.4 percent of budget revenue (MNT 5973.9 billion) was collected, the same percent of budget expenditure (MNT 7137 billion) was incurred and budget deficit reached at MNT 1163.1 billion. The share of equilibrated budget revenue to the nominal GDP was 25.8 percent, 2.4 percentage point lower from a year ago, while the share of budget expenditure to the nominal GDP was 30.8 percent, 1.3 percentage point lower from a year ago. (Table II.2.1.1).

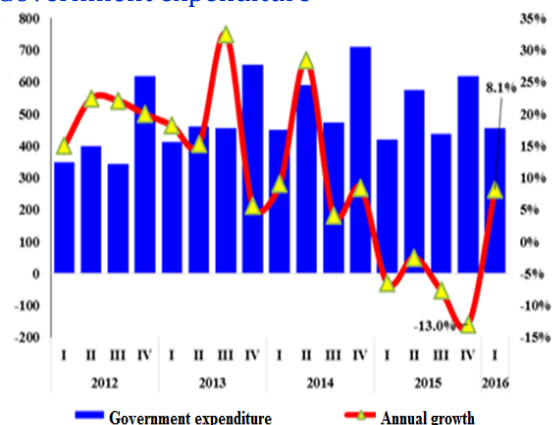
Investment

Total investment (capital formation) declined by 4.3 percent y-o-y in 2016 Q1 and made a negative contribution of 0.6 percentage points in the quarterly growth of the real GDP. Private investment⁸ declined by 23.6 percent in 2016 Q1, largely reflected in the decline in total investment. Government investment, which had a negative impact on total investment throughout 2015, jumped by 74.2 percent in 2016 Q1 and contributed plus 10.1 percentage points to total investment. (Chart III.2.1.5).

Total investment is expected to have positive impact on the GDP growth since 2016 H2, after the Oyu Tolgoi phase II development, though it had been a negative impact on GDP growth over the last two years.

Chart II.2.1.4

Government expenditure



Source: NSO

Table II.2.1.1

Fiscal revenue

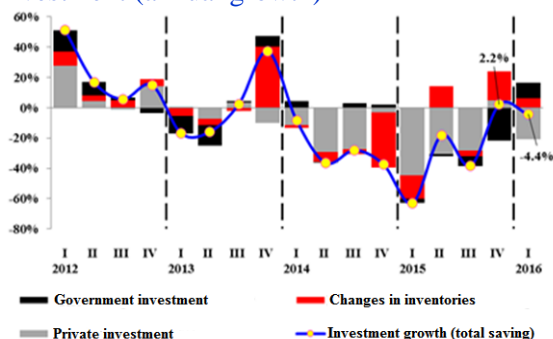
	2014		2015		2016	March 2016		
	Auc.	Amend2	Auc.	Auc. %	Approved	Exp.	Auc.	Auc. %
Balanced revenue	6277	6074	5974	98.3%	7063	1241	1095	88.3%
Expenditure	7145	7253	7137	98.4%	7954	2318	1711	73.8%
Balanced budget	-868	-1179	-1163	98.6%	-891	-1077	-616	57.2%

Contribution to GDP in percent				
Balanced revenue	28.2%		25.8%	25.6%
Expenditure	32.1%		30.8%	28.8%
Balanced budget	-3.9%		-5.0%	-3.2%
Nominal GDP	22 227		23 167	27 590

Source: Ministry of Finance

Chart II.2.1.5

Investment (annual growth)



Source: NSO

⁸ Private investment is calculated by subtracting public investment from gross fixed capital formation.

Net export

Net export which had been a negative impact on GDP growth at the end of 2015, contributed positively to growth (+3.5 percentage point) in 2016 Q1, largely due to an increase in exports by 4.9 percent.

The increase in exports was mainly explained by a 33.4 percent y-o-y increase of copper ores and concentrates⁹ in volume terms in 2016 Q1. Meanwhile, 0.6 percent decrease in imports contributed positively to net exports. (Chart II.2.1.6).

Total exports of goods and services fell by 5.1 percent in nominal terms in 2016 Q1. On the contrary, imports of consumer and capital goods and fuels declined, reflecting an 8.3 percent decrease (USD 128.2 million) in total imports in nominal terms. (Chart II.2.1.7)

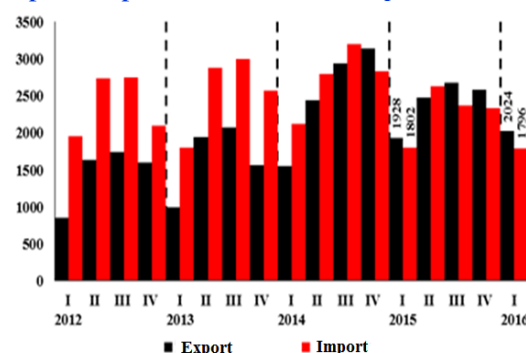
Since 2016 Q2, total imports have been expected to increase and reach at the same level as 2015. In association with the Oyu Tolgoi phase II development total imports are expected to exceed the level of 2015 at the end of 2016.

Domestic demand shrank by 2.8 percent in 2016 Q1, indicating that the rapid pace of declining domestic demand over the last six quarters slowed. Government consumption negatively contributed to domestic demand in 2016 Q1, while total investment had negatively contributed to demand over the last two quarters.¹⁰ (Chart III.2.1.8)

⁹ As of 2015, copper concentrates amounted 48.8 percent of total exports.

Chart II.2.1.6

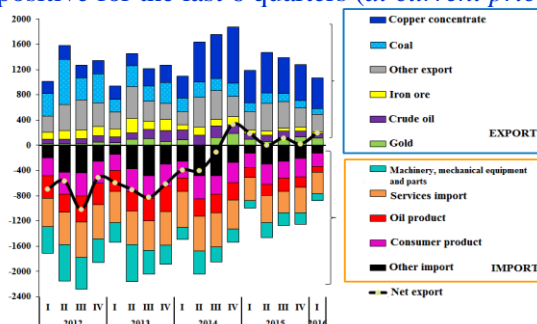
Export, import, at 2010 constant prices



Source: NSO

Chart II.2.1.7

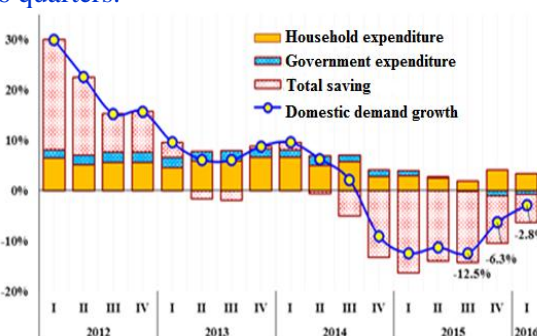
Net export of goods and services has been positive for the last 6 quarters (at current prices)



Source: BoM

Chart II.2.1.8

Domestic demand has been declining for the last 6 quarters.



Source: NSO

II.2.2 Supply

Gross domestic product grew by 3.1 percent y-o-y in 2016 Q1. Non-mining sector contracted for the past 4 consecutive quarters and its slowdown reached 1.2 percent y-o-y in 2016 Q1. Mining sector expanded by 16.2 percent y-o-y and became the largest contributor to the total economic growth. Nominal GDP increased by 2.0 percent y-o-y in 2016 Q1 and reached at MNT 4.7 trillion.

Mining sector positively contributed to the GDP growth (+4.0 percentage points), construction sector +0.3 percentage points, agriculture sector +0.2 percentage points and other services sector¹¹ +0.2 percentage points. However, manufacturing sector negatively contributed to growth (-0.7 percentage points), trade sector -0.6 percentage points, transportation sector -0.2 percentage points and net tax on products -0.1 percentage points.

In 2016 Q1, the mining sector growth was mainly caused by a two-fold increase of gold production, around 50 percent increase in copper concentrates and 20 percent increase in oil production. Out of which, Oyu Tolgoi production of copper concentrates jumped by 75 percent y-o-y.

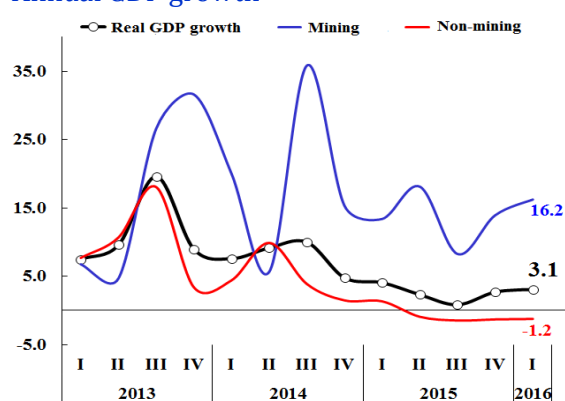
Weak commodity prices amid contraction in Chinese steel consumption and an excess supply from commodity exporting countries, continued to dampen profitability of domestic miners and led to a decrease in mining production. Particularly, in 2016 Q1 iron ore and coal production declined by 74 percent and 7 percent y-o-y, respectively.

Construction sector growth climbed to around 30 percent y-o-y at the beginning months of 2016, largely due to construction of residential buildings increased by 57 percent y-o-y. On the contrary, construction of non-residential buildings dropped by 18 percent y-o-y and general engineering related construction also contracted by 4 percent y-o-y.

¹¹Other services sector comprises of activities related to real estate, financial and insurance, professional and scientific, health, education, public administration, defense, accommodation and services.

Chart II.2.2.1

Annual GDP growth



Source: NSO

Table II.2.2.1

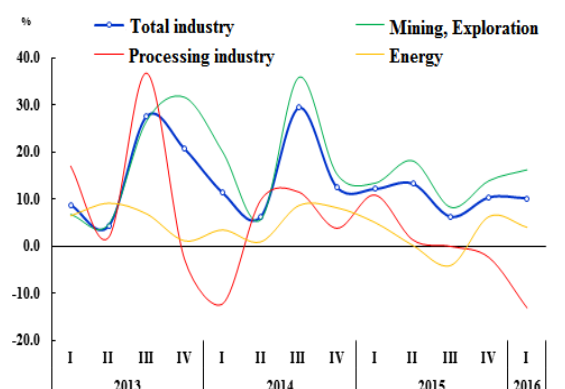
Annual and quarterly growth of production sectors /In order of contribution to the 2016 Q1 growth/

	2015 YoY %	2015Q4 YoY %	2016Q1	
			YoY %	QoQ %*
GDP growth	2.3	2.7	3.1	3.9
Mining	13.0	13.9	16.2	12.2
Construction	-1.4	33.6	27.5	81.2
Other services	2.9	-13.6	0.6	66.9
Agriculture	10.7	12.6	3.7	54.2
Electricity	2.7	6.3	4.0	-3.9
Information	2.0	-3.4	0.5	4.9
Net tax on products	-21.1	-38.4	-1.4	241.5
Transportation	5.7	42.3	-2.6	-73.2
Trade	-3.6	1.9	-5.3	-30.9
Manufacturing	1.3	-2.4	-13.1	-20.9

* seasonally adjusted

Chart III.2.2.2

Annual growth of industrial sectors



Source: NSO

Agriculture sector growth slowed and reached 3.7 percent y-o-y over the first 3 months of 2016. Livestock loss jumped to 830.5 thousand heads (56.3 thousand heads in 2015 Q1) in 2016 Q1, under the severe weather conditions.

Manufacturing sector sharply dropped by 13.1 percent in 2016 Q1, the highest slowdown among the weak sectors. Out of which, food products, particularly cereal, pastry, textile and iron products contracted larger-than-expected.

As the economy slows down, trade turnover, imports as well as sales are on a downward trend. Specifically, trade sector, which had been declining since the end of 2014, contracted by 5.3 percent in 2016 Q1, largely driven by wholesale sales dropped larger than retail sales.

Transportation sector fell by 2.6 percent y-o-y in 2016 Q1, mainly due to road freight transport decreased by 16 percent y-o-y, though rail freight transport increased by 13 percent y-o-y.

Real tax income imposed on goods, which had decreased for a consecutive 10 quarters since the end of 2013, contracted by 1.4 percent y-o-y in 2016 Q1. By looking at the components of net tax on goods, VAT on imported goods dropped by 9.3 percent y-o-y, VAT on domestic goods by 11.8 percent y-o-y, excise taxes by 1.9 percent and customs duties by 3.4 percent, respectively.

Table III.2.2.2

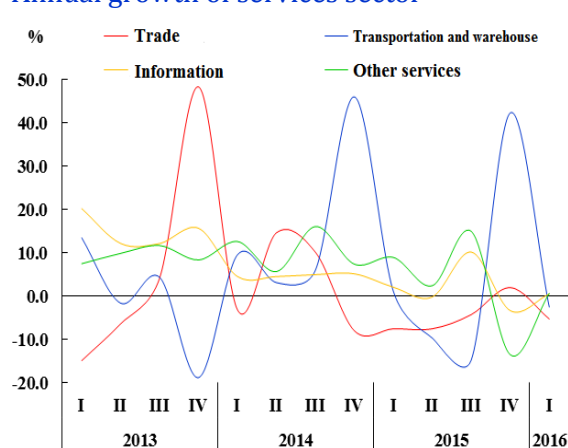
Production of major mining commodities
/in volumes/

	2015		2015Q4		2016Q1	
		YoY%		YoY%		YoY%
Coal in million tons	24.1	-3%	7.6	-15%	5.2	-7%
Copper concentrates in thousand tons	1334.7	24%	388.6	17%	379.9	48%
Oyu Tolgoi	788.5	40%	231.8	16%	229.5	75%
Gold in tons	14.6	27%	4.6	22%	1.8	93%
Iron ore in million tones	6.2	-40%	1.6	-40%	0.1	-74%
Crude oil in million barrel	8.8	18%	2.4	20%	2.2	19%

Source: NSO, Oyu Tolgoi Co.,Ltd

Chart III.2.2.3

Annual growth of services sector



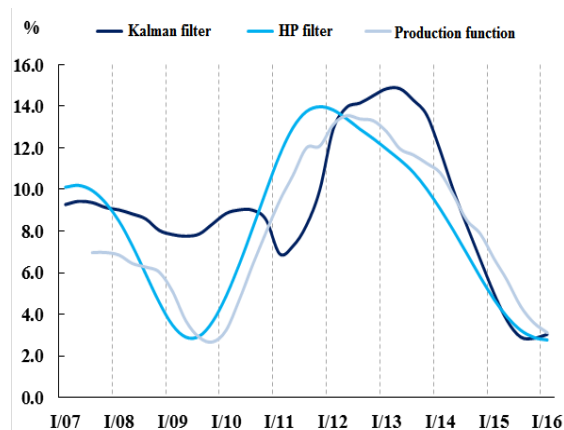
Source: NSO

II.2.3 Potential output, output gap

Potential output growth¹² strengthened through 2010-2013, while since 2014 has slowed sharply due to weakening non-mining sector growth. On the other hand, mining sector potential growth has remained to reach over 10 percent since 2010. The rapid pace of decline in potential output growth stabilized slightly in 2015 H2 and reached at the same level as the previous quarter in 2016 Q1. Gold content in Oyu Tolgoi mine is expected to decrease, negatively affecting mining potential output growth in the remaining periods of 2016. (Chart II.2.3.1).

Chart II.2.3.1

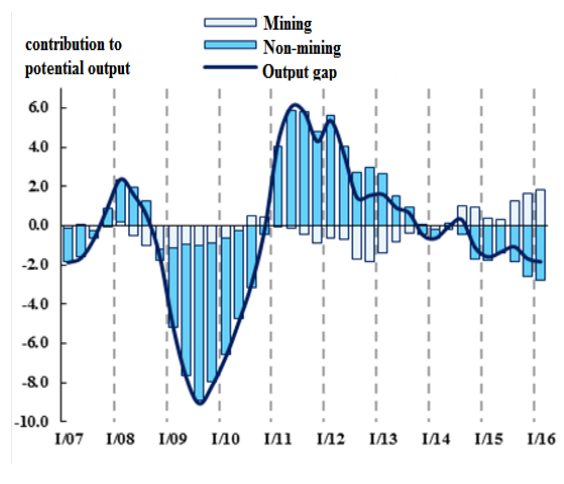
Growth of potential output



During the period of 2011-2013, total production exceeded its potential level and the output gap¹³ was positive due to non-mining sector production. The output gap, however, has been negative for the last two years. This was largely due to negative output gap of non-mining production since the end of 2013, even though the output gap of mining production has remained positive since the second half of 2014. As of 2016 Q1, the negative level of output gap has increased slightly from a quarter ago. (Chart II.2.3.2).

Chart II.2.3.2

Output gap /mining and non-mining/



¹²A combination of 1) purely statistical HP filter, 2) production function approach which takes into account each factors of production and 3) multivariate Kalman filter which makes use of macroeconomic indicators and their inter-relations are used.

¹³ Computed by the multivariate Kalman filter.

II.3 Labor market

The employment decreased in all sectors except for manufacturing and the unemployment rate reached 11.6 percent, the highest level since 2010 Q1. The declining trend of labor force participation rate continued and the nominal and real wage growth weakened. In 2016 Q1, the labor productivity increased due to declining employment.

II.3.1 Employment and unemployment

Conditions on the labor market deteriorated and continued to remain negative. In 2016 Q1, the employment decreased from a year ago, the unemployment rate increased sharply and the labor force participation rate remained on a downward trend.

In 2016 Q1, total payroll employment declined by 2.5 percent y-o-y, reaching at 1'089'303, though increased by 2.0 percent y-o-y in 2015 Q4 due to seasonal effects¹⁴. The decline in total payroll employment was mainly explained by the employment decrease in all sectors except for manufacturing. Particularly, payroll employment for services sector decreased by 3.4 percent (equal to 13'769 people), for agriculture sector -2.5 percent (equal to 8'320 people) and for trade sector -3.7 percent (equal to 6'316 people).

By examining the employment status, non-payroll employment and the number of members of cooperatives increased, while the number of self-employed people, livestock herders, payroll employees and employers decreased.

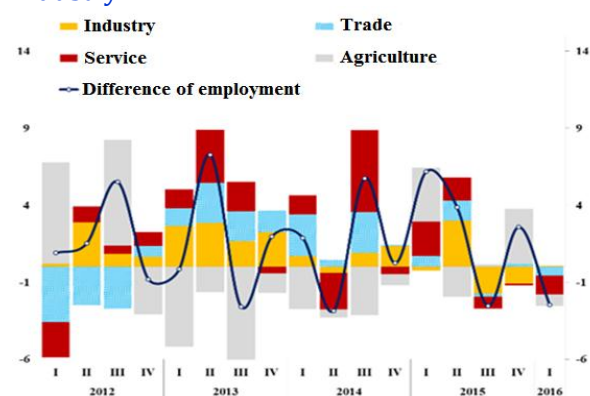
The unemployment rate reached 11.6 percent in 2016 Q1, 4.2 percentage points increase from a year ago. The unemployment rate has increased for the consecutive two quarters, reaching at the highest level since 2010 Q1.

Total economically active population for the first three months of 2016 rose by 16 percent (equal to 3942 people) and reached at 29024 people, consistent with the Labor Force Survey result which concluded that the unemployment rate has been increasing.

Since 2011 Q2, the labor force participation has remained on a downward trend. In 2016 Q1, the labor force participation rate reached 60 percent, 1.5 percentage points lower y-o-y, due to the number of economically active population¹⁵ rose only by 27'355 from a year ago, though the number of the working age population increased by 95'106. In other words, the

Chart II.3.1.1

Employment decreased in all sectors except industry.



Source: NSO, LFPS¹⁷

Table II.3.1.1

Labor market indicators

Year	2012	2013	2014	2015	2015Q1	2016Q1
Employees (thousand per)	1018.2	1038.2	1040.7	1067.6	1116.9	1089.3
Annual growth	-0.8%	2.0%	0.2%	2.6%	6.2%	-2.5%
Agriculture	318	305	322	335	328	320
Industry	182	205	224	207	209	210
Trade	137	152	174	154	172	166
Service	381	377	384	371	407	393
Unemployed (thousand per)	87.8	87.2	87.0	96.5	88.6	143.5
Annual growth	13.4%	-0.6%	-0.3%	10.9%	-18.5%	62.0%
Labor force participation	61.6	60.9	60.3	60.5	61.5	60.0
Annual growth	-2.6	-0.7	-0.6	0.2	-0.2	-1.5
Unemployment	7.9	7.8	7.7	8.3	7.4	11.6
Annual growth	0.9	-0.1	-0.1	0.6	-2.0	4.2

Source: NSO, LFPS

¹⁴ Considering the past 5 years, total payroll employment increased by 2.17 percent in Q1 as compared to Q4 from the previous year.

¹⁷ Labor force participation survey

economically inactive population (retired and studying people) accounts for the majority of the working age population. Particularly, the number of the economically inactive population rose by 9 percent y-o-y and 7.8 percent q-o-q in 2016 Q1.

III.3.2 Wage, productivity

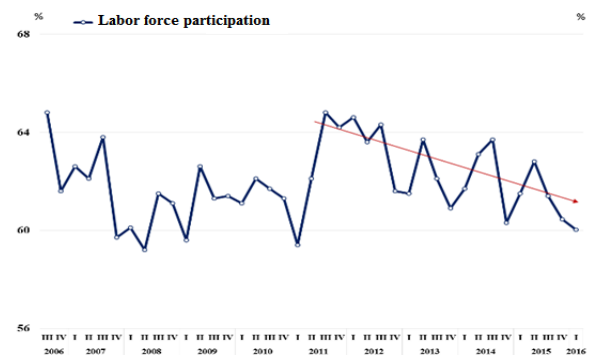
In 2016 Q1, the nominal and real wage growth weakened and the unit labor costs (ULC) declined as the productivity increased.

The nation-wide average nominal wages increased by 2.3 percent y-o-y and reached at MNT 871'400 in 2016 Q1. However, the average nominal wage growth continued to weaken in recent quarters (Chart III.3.2.1). Considering the economic sectors, the average nominal wages declined for agricultural workers (-7.2%) and public administration employees (-2.2%), while increased for the workers of the mining sector (9.9%), manufacturing (6.9%), trade sector (0.1%) and services sector (1.2%).

Annual real wage growth reached 1.2 percent in 2016 Q1 (16.4 percent in 2012), continuously falling for the consecutive four years. The labor productivity, which was at record high (18 percent) in 2011, has been continuously declining over the past few years and reached its lowest level since 2010 (1.8 percent) in 2015. However, the labor productivity gradually recovered and reached 4.7 percent in 2016 Q1.

Chart II.3.1.2

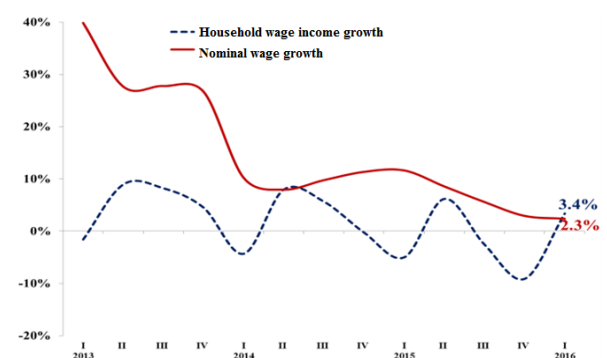
Labor force participation rate has been on a downward trend.



Source: NSO, LFPS

Chart III.3.2.1

Nominal wage growth has slowed down.



Source: NSO, analysts' estimation

Chart III.3.2.2

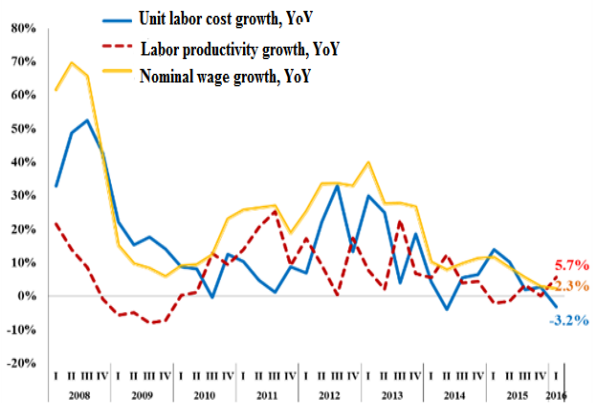
Labor productivity growth...



Source: NSO, analysts' estimation

Unit labor costs¹⁶ (ULC) measure the average cost of labor per unit of output. ULC growth has been slowing over the past four years. In 2016 Q1, ULC declined by 3.2 percent y-o-y, mainly due to the increase in labor productivity from a year ago. Declining ULC indicates that supply-driven inflationary pressures eased by the way of reducing production costs.

Chart III.3.2.3
Unit labor cost has been showing tendency to decline.



Source: NSO, analysts' estimation

¹⁶ Unit labor cost = Employed people*Nominal wage/Real production = Nominal wage/Labor productivity in real terms

II.4 Money and financial markets

II.4.1 Money and credit indicators

Money indicators' growth showed positive signs in 2016 Q1, however total loans outstanding of the banks have been slowing. M2 rose by 2.1 percent y-o-y, while total loans outstanding of the banks declined by 3.7 percent y-o-y.

The negative impact of net foreign assets (declining over the past three years) on money supply eased and it explains the money supply growth from the assets' side. The decline in net foreign assets eased due to the increase in net foreign assets of depository corporations. The contribution of net domestic assets to money supply growth (+15 percentage points in 2015 Q4) slowed to 13 percentage points in 2016 Q1, due to weakening domestic economic performance.

From the liabilities' side, the money supply growth was mainly explained by the increased deposit accounts in domestic currency of the individuals. Total deposit accounts in domestic currency grew by 5.4 percent y-o-y, contributing to the money supply growth for 3 percentage points. On the contrary, total current accounts in domestic currency increased from a year ago, while decreased from a quarter ago. Total current and deposit accounts in foreign currency deteriorated in 2016 Q1, largely due to current accounts in USD declined by 12 percent from a year ago, caused by shrinking current accounts in USD of the corporations.

Currency outside depository corporations and M1 increased from a year ago, hence declined from a quarter ago caused by deteriorating business activity and shrinking money demand.

Chart II.4.1.1

Contributions to the annual growth of M2, assets side

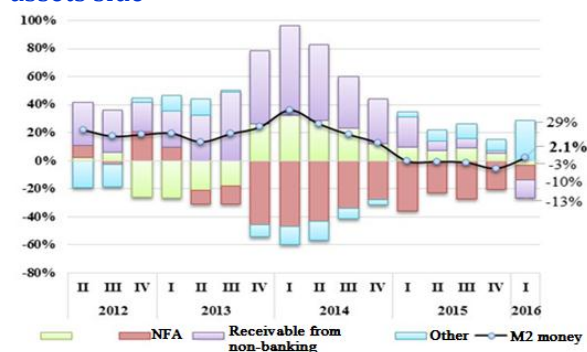


Chart II.4.1.2

Contributions to the annual growth of M2, liabilities side

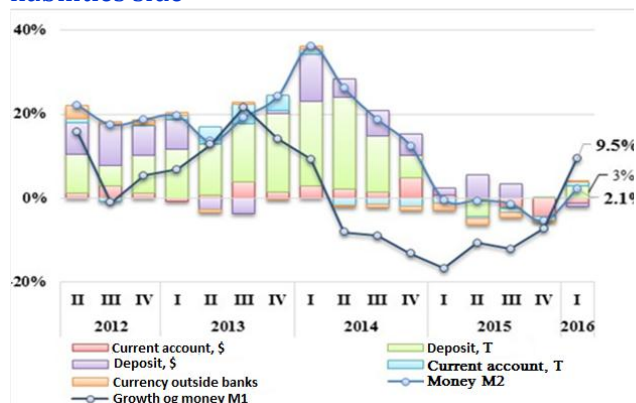


Chart II.4.1.1

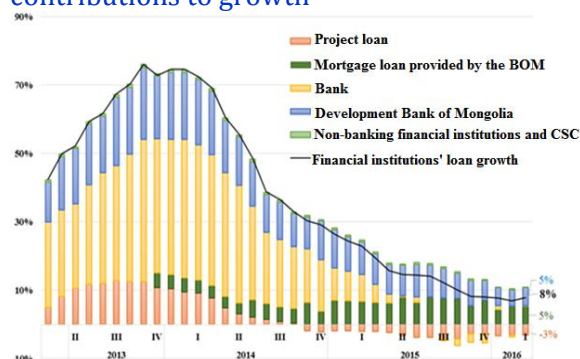
Money supply: assets and liabilities side

In billion tug	2013	2014	2015	2016Q1
Net foreign assets	934	-1702	-3909	-4086
Net domestic assets	8527	12338	13959	14200
Money supply /M2/	9461	10636	10050	10114
Money M1	2093	1817	1685	1584
Currency outside banks	582	499	459	427
Current account, ₺	1511	1317	1227	1157
Quasi money	7368	8819	8365	8530
Deposit, ₺	4917	5410	5434	5467
Deposit, \$	1476	1970	1949	2105
Current account, \$	974	1439	982	958

Annual growth of total loans has been slowing for the last 9 quarters. The loan growth of the financial corporations¹⁸ deteriorated by 8 percent y-o-y in 2016 Q1. Total outstanding loan of the financial corporations reached at MNT 18.4 trillion, out of which banks account for 61 percent, the Development Bank of Mongolia (DBM) 24 percent and mortgage loan financed by the Bank of Mongolia (BOM) 12 percent, respectively.

Chart II.4.1.3

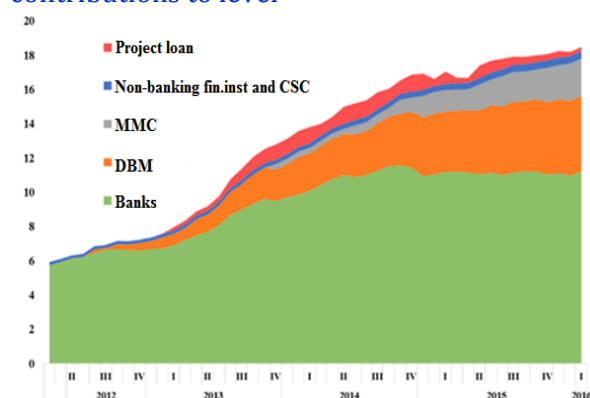
Total credit issued by financial institutions, by contributions to growth



Total credit growth was mainly comprised of quasi-fiscal financing provided by BOM and DBM. Total outstanding loan financed by DBM grew by 25 percent y-o-y, contributing positively to the total loan of the financial corporations for 5 percentage points. Moreover, mortgage loan financed by BOM increased 1.7-fold y-o-y and contributed to the total loan of the financial corporations for 5 percentage points.

Chart II.4.1.4

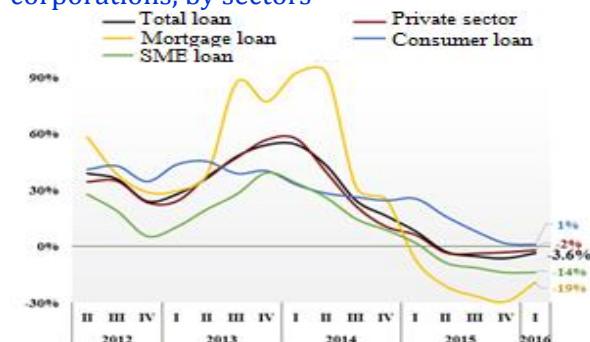
Total credit issued by financial institutions, by contributions to level



Total outstanding loan of the depository corporations¹⁹, which was on a downward trend for the last four quarters, declined by 3.6 percentage points y-o-y in 2016 Q1. By looking at the types of loan provided by the depository corporations, the amount of consumption loan²⁰ continued to increase, while the amount of mortgage loan and the loan financing for small and medium sized enterprises continued to decline. The growth rate of consumption loan, which has been declining gradually since last year, reached 1 percent y-o-y in 2016 Q1, despite the amount of consumption loan increased. Meanwhile, lending rates of the consumption loan have increased over the past three years, largely due to increased demand for loan for retirees, which was mainly caused by decreasing nominal and real income for the households.

Chart II.4.1.5

Annual credit growth of depository corporations, by sectors



¹⁸ Financial institutions comprise of banks, savings and loan associations, Mongolian Mortgage Corporation, Development Bank of Mongolia and non-banking financial institutions.

¹⁹ Depository corporations comprise of banks and savings and credit cooperatives.

²⁰ Consumption loan comprises of salary loan, consumption loan, pension loan and credit card and savings pledged loan.

Loan growth for the most sectors has been deteriorating. Total outstanding loans for manufacturing sector have been decreasing for the past two quarters, and for real estate and trade sectors for the past five quarters. Total outstanding loan for the mining sector, declined in the first three quarters of 2015, grew by 5 percent y-o-y in 2016 Q1.

Chart II.4.1.6

Annual credit growth of depository corporations, by economic sectoral classifications

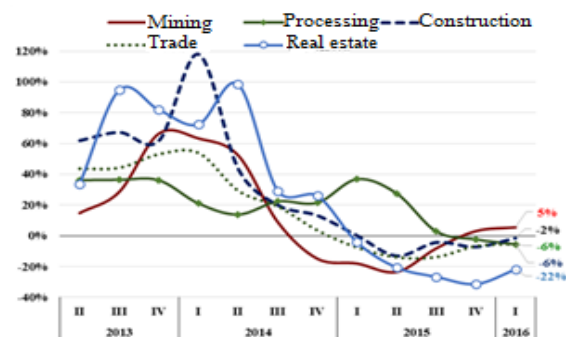


Chart II.4.1.7

Annual growth of loans newly issued by banks, contributions by economic sectoral

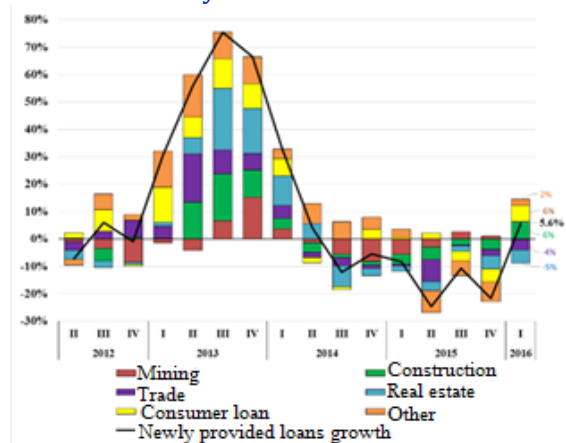
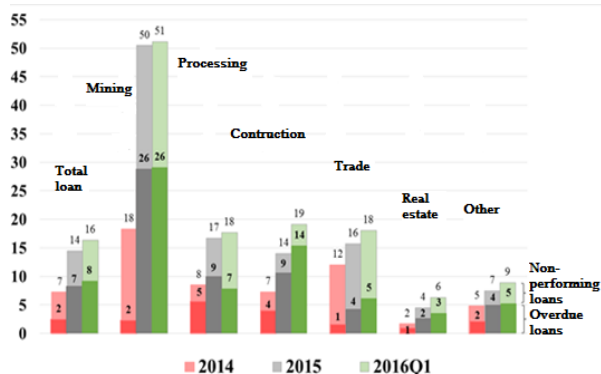


Chart II.4.1.8

Non-performing and past due loans, by shares in the total loans outstanding to the specific sector



In line with slowing economic growth and weakening business activities, the amount of past due loans has been increasing and the quality of loans has been deteriorating. The share of over-due and non-performing loans increased by 2 percentage points from the end of 2015 and reached 16 percent in 2016 Q1. By looking at the sectoral classifications, the amount of over-due loans for construction sector grew rapidly, indicating high risk of increasing non-performing loans.

II.4.2 Interest rate

The Monetary Policy Committee (MPC) decided to cut the policy rate by 1.0 percentage point to 12.0 percent. After the decision, interbank market rates decreased in line with the policy rate cut during two months, however still remained on an upper bound of the rate corridor. Particularly, in April 2016, repo auction and overnight lending and deposit rates on the interbank market are 0.1-1.9 percentage points higher than the policy rate. To keep the interbank market rates at the target level, MNT 216.5 billion was mopped up from the interbank market, and the amount of central bank bills reduced by MNT 334.5 billion through the standing facilities of the central bank in 2016 Q1.

Chart II.4.2.1

Interbank market rates remain at the upper limit of the interest rate corridor.

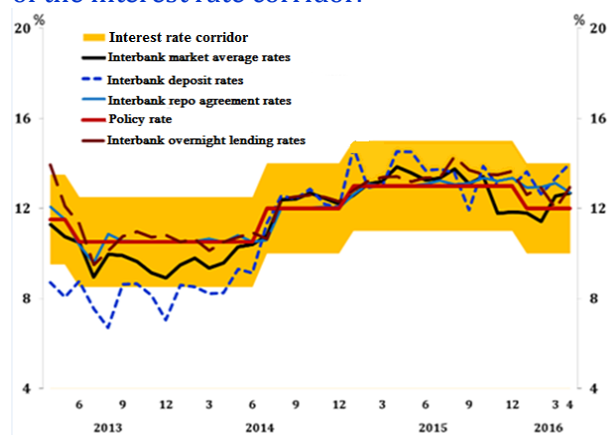


Chart II.4.2.2

Short-term government security rate decreased.

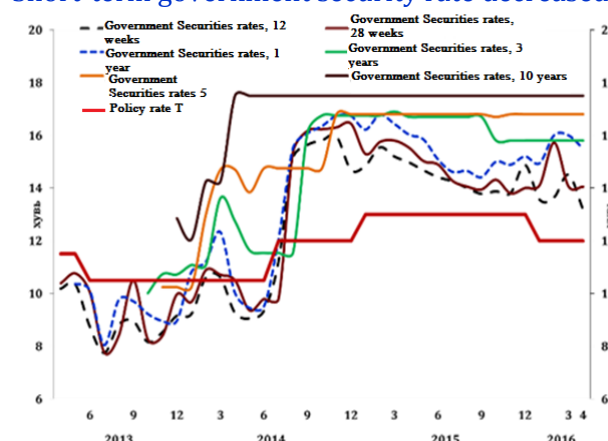
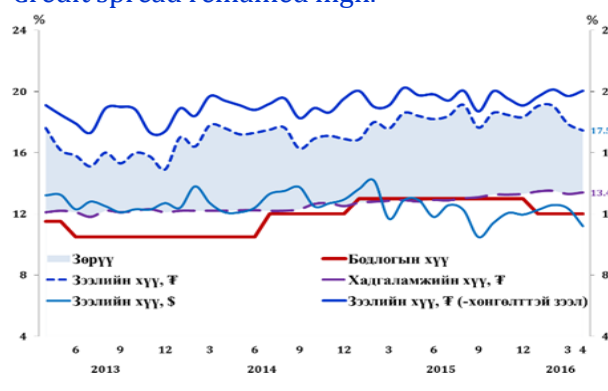


Chart II.4.2.3

Credit spread remained high.



The rate of the short-term government securities fell to 13.2²¹ percent in April 2016. The purchase of the short-term government securities declined, due to the rate cut and bearish demand. Since February 2016, there has not been any purchase offers of the government securities.

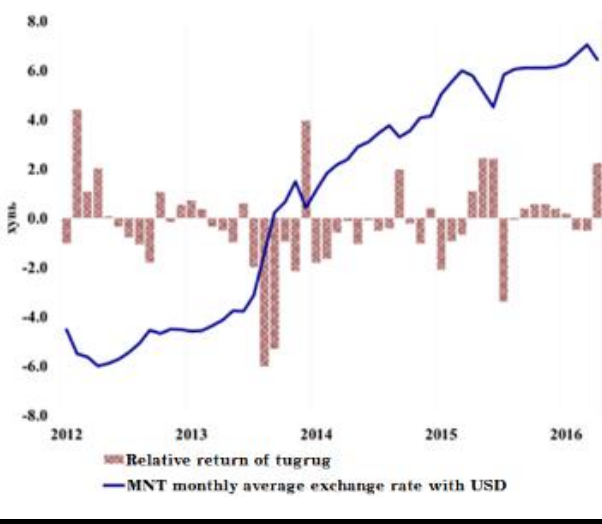
By looking at the lending and deposit rates of banks, the lending rate on loans denominated in tugrug declined by 0.2 percentage points and the deposit rate on deposits denominated in tugrug rose by 0.5 percentage points in April 2016. Hence, excluding the discounted loans, the lending rate increased by 0.96 percentage points y-o-y. The decline in the lending rate was mainly due to the low lending rates on discounted loans financed by the BOM and DBM. As of the end of 2016 Q1, the amount of discounted loans financed by the BOM and DBM increased by 5 percent from a quarter ago. This also led to the decline in lending rates on loans denominated in tugrug. Sluggish economic growth, growing the amount of over-due and non-performing loans and decreasing the supply of tugrug caused the increase in lending rates on loans financed by the banks' own assets. The difference between the lending and deposit rates, excluding the lending rates on discounted loans, increased by 0.9 percentage points from a quarter ago and climbed to 6.7 percent in 2016 Q1.

The relative return of tugrug remained positive, due to tugrug has appreciated by 1.7 percent against USD at the end of April 2016. Monthly deposit rates denominated in tugrug increased and monthly deposit rates denominated in foreign currency remained stable, leading to positive return of tugrug. In addition, loan

²¹ Rate of government securities with maturity of 12 weeks (3 months) in the primary market

dollarization has been decreasing in line with the exchange rate volatility. The share of loans denominated in foreign currency to total loans declined by 2 percentage points from a quarter ago.

Chart II.4.2.4
Relative return of tugrug remained positive...



II.4.3 Exchange rate

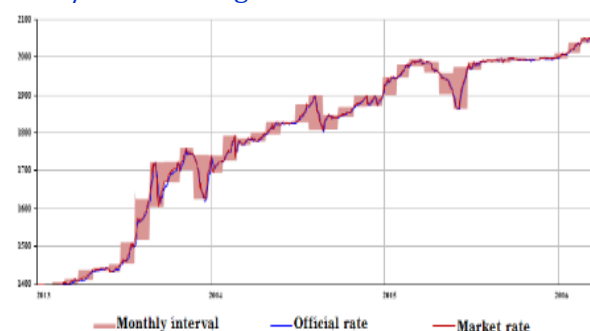
The MNT/USD exchange rate slightly depreciated through the beginning of 2016, despite it remained relatively stable at the end of 2015. /Chart II.4.3.1/. In 2016 Q1, nominal MNT/USD exchange rate depreciated by 1.5 percent (MNT 30.6) q-o-q and by 3.3 percent (MNT 64.4) y-o-y, reaching at MNT 2024.6. According to the preliminary balance of payments for 2016 Q1, overall balance of payment deficit was USD 37.8 million, out of which current account deficit was USD 11.1 million. Due to this, the demand for dollars was greater than the supply for dollars.

Despite the balance of payment deficit, the deficit which was decreased by USD 233.3 million or 86.1 percent YoY reduced the pressure of tugrug depreciation. Declining quasi-fiscal expenditures by the DBM and the BOM and budget expenditures, slower loan growth of banks and weaker demand in the economy reduced the burden of tugrug depreciation as compared to 2013-2014 /Chart II.4.3.2/.

The nominal effective exchange rate (NEER) appreciated by 3.1 percent YoY, relative price²² rose 0.5 percent, and the real effective exchange rate (REER) appreciated by 2.6 percent YoY and 2.5 percent QoQ in 2016 Q1 /Chart II.4.3.3/. Although the dollar weakened against MNT, tugrug appreciated against the main trading partners' currencies, leading to the real effective exchange rate appreciation. Particularly, the MNT nominal rate appreciated by 1.4 percent YoY and 0.1 percent QoQ against CNY and 11.7 percent YoY and 4.7 percent QoQ against RUB in 2016 Q1.

Chart II.4.3.1

MNT/USD exchange rate



Source: BOM

Chart II.4.3.2

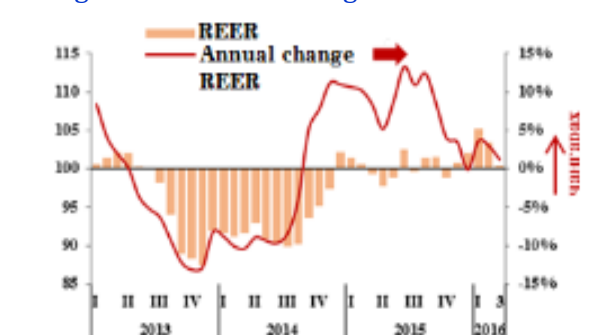
Changes in the MNT/USD exchange rate



Source: BOM

Chart III.4.3.3

Changes in the real exchange rate of MNT



Source: BOM

²² Computed as a ratio between the weighted average of trading partners' consumer price indices with the shares to total value of foreign trade as weights and the consumer price index of our country.

II.4.4 Real estate market

Production in construction sector increased by 29.8 percent y-o-y in 2016 Q1, herein housing production grew by 56.6 percent, while non-housing production declined by 17.6 percent y-o-y.

Housing purchase price (hereinafter referred to as housing price) continued to decline and the housing rental price (hereinafter referred to as rental price) increased.

Since 2013 Q3, housing demand had increased in line with the implementation of “Mortgage program with the discounted rate of 8 percent” and thus, housing prices had began rising. However, such upward trend has not remained constant and housing prices have been declining for the past 4 quarters, due to sluggish housing demand against adequate supplies. Housing price index estimated by the National Statistical Office (NSO) remained constant as the previous quarter and declined by 11.6 percent from a year ago in 2016 Q1. In addition, housing price index estimated by “Tenkhleg Zuuch” LLC has been a downward trend and decreased by 10.5 percent y-o-y in 2016 Q1. Particularly, old housing prices declined by 13.9 percent and new housing prices by 7.2 percent y-o-y in 2016 Q1.

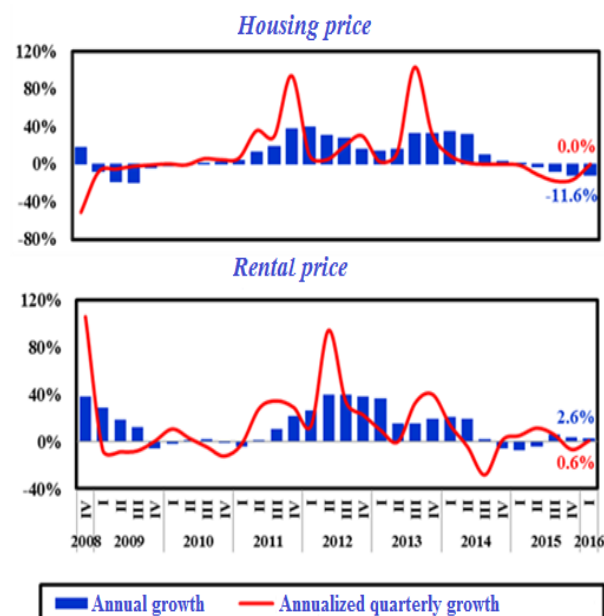
Declining rental prices has loosened. Despite rental and housing prices had been declining in a same path, rental prices have increased over the past 3 quarters. In particular, rental prices rose by 2.6 percent y-o-y and by 0.1 percent q-o-q in 2016 Q1. (Chart II.4.4.1).

More rapid rate of continued growth in housing prices than rental prices indicates the existence of a housing bubble. Also, the existence of a housing bubble can be seen from the common indicators such as, “price-rent ratio” and “price-to-earnings ratio”. “Price-rent ratio” converges to 1 over a long period of time and its continues increase demonstrates increasing demand for profits on the market (Chart II.4.4.3). From 2013 H2 to 2015 H1, housing bubble was brewing. However, since 2015 H2 the risk of housing bubble has been reduced as the economy was weakened, individuals’ income deteriorated and demand for housing decreased. In particular, since 2015 Q3 the growth of the price-rent ratio has reached negative and the price-rent ratio has declined due to continuously increasing housing rental prices and decreasing housing prices. (Chart II.4.4.2).

In order to observe the trends in housing and rental prices in the near future, annual growth rates and annualized quarterly growth rates²³ are compared. Through this estimation, if annualized quarterly growth rates are higher than annual growth rates, the latter is expected to increase in the near term and vice versa. As

Chart II.4.4.1

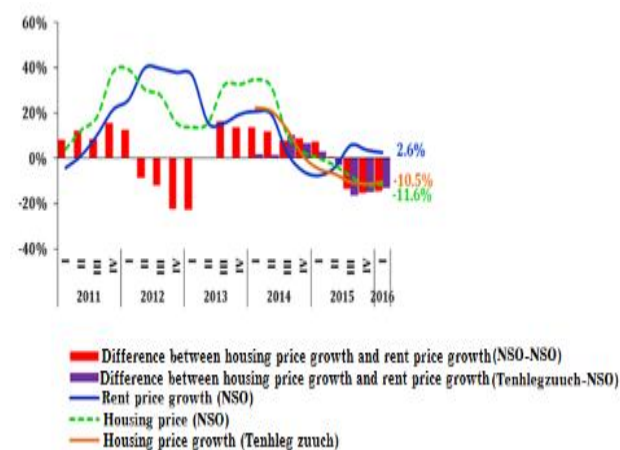
Housing prices have been falling, while rental prices have been increasing...



Source: NSO, analysts' estimations

Chart II.4.4.2

Housing prices have been falling, while rental prices have been increasing...



Source: NSO, analysts' estimations

²³ Annual growth = $\left(\frac{P_t}{P_{t-4}} - 1\right)$. Annualized quarterly growth = $\left(\left(\frac{P_t}{P_{t-1}}\right)^4 - 1\right)$. (p = housing and rental price indices)

seen from the last few quarters' execution, the growth in housing prices expected to remain negative in the near term (Chart II.4.4.1). Nevertheless, construction and building material prices have remained constant since the beginning of 2015 as seen from the construction cost index.

As seen from the housing demand and supply, housing prices are expected to decline. Housing supply exceeds the demand due to purchases of new homes declined, despite new housing construction have been shrinking. Particularly, according to the estimation of "Tenkhleg Zuuch" LLC, approximately 15600 new homes registered to be built in the remaining quarters of 2016. Hence, the supply of new housing is expected to increase, however the demand of new housing is not keeping up with the supply due to declining households' purchasing power and the shortage of money supply in the financial market.

Price-to-earnings ratio has increased. Price-to-earnings ration had been declining since 2014, indicating the decline in both housing prices and earnings²⁴ with the latter declining at a more rapid rate. Along with the deceleration of the economic growth, household income has been declining. Household income declined sharply compared with housing price over the past two quarters, thus led to price-to-earnings ratio has increased from a quarter ago. In particular, housing prices declined by 11.6 percent, while households' income declined by 10.9 percent y-o-y and by 0.1 percent q-o-q in 2016 Q1. According to data released by the Property Rights Registration Agency, 3660 newly built apartments were sold and issued certificates in 2016 Q1. This figure shows 20 percent decline in the sale of newly built apartments from a year ago and 2.7 percent decline from a quarter ago.

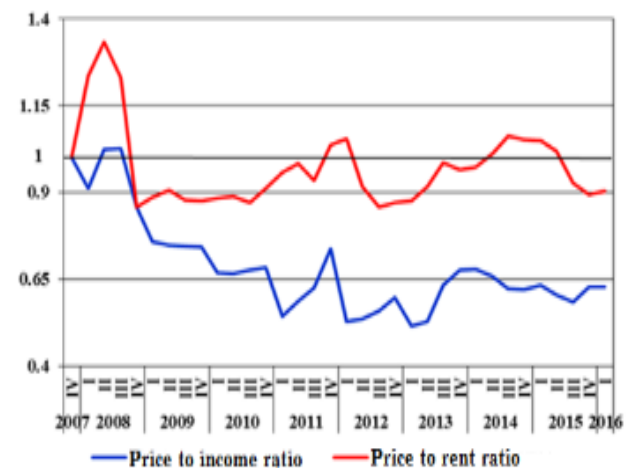
Stock market indicators, which had been declining continuously since September 2014, have fluctuated over the last quarters. TOP-20 index declined in 2016 Q1, while total market capitalization has decreased since January 2016. Moreover, the balance of payments statistics indicate that foreign investors' assets at the Mongolian Stock Exchange decreased by USD 10.6 million in 2016 Q1, thus led to a decrease in stock market capitalization and worsening market activity. TOP-20 average indicator reached 11191.2 unit, 17.2 percent lower from a year ago and 8.9 percent lower from a quarter ago. Stock market capitalization declined by 1.0 percent y-o-y, grew by 2.8 percent q-o-q and reached MNT 1.27 trillion in 2016 Q1.

In 2016 Q1, MNT 8.3 billion securities were sold, of which MNT 6.26 billion (74.9 percent) securities were sold in the primary market, particularly, 34 percent (33.8 million shares) of the shares of "MONGOL POST" company were issued in the primary market. (Chart II.4.4.4).

²⁴ 2015 Q3.

Chart II.4.4.3

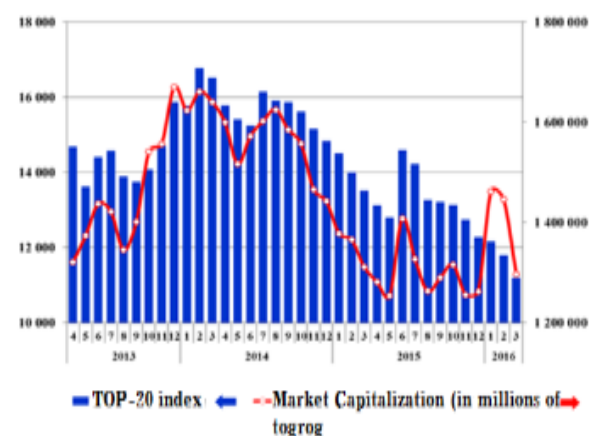
Housing price bubbles have been declining in the recent quarters...



Source: NSO, analysts' estimations

Chart II.4.4.4

Stock market capitalization and TOP-20 index have been falling...



Source: Mongolian Stock Exchange

The Mongolian Mortgage Corporation (MMC) organized the 8th securitization operation of the mortgage loans with 8 percent discounted rate issued by banks, and the BOM purchased these securities. MMC securitized a portfolio of MNT 186.3 billion worth of mortgage loans through a special purpose company called “MMC assets 8” on January 20, 2016. MMC securitized the outstanding balance of mortgage loans with 8 percent discounted rate, out of which BOM purchased 90 percent of total. Through a total of 8 securitization operations, MNT 2.36 trillion loans were transferred to MMC, of which securities worth of MNT 2.12 trillion (90 percent of total) were purchased by BOM. Bond repayments are being made in accordance with the repayment schedule of mortgage loans and the outstanding balance stood at MNT 1.68 trillion as of 2016 Q1. (Table II.4.4.1) Moreover, the mortgage loans with 5 percent discounted rate have been granted since March 15, 2016.

Table II.4.4.1

MNT 186.3 billion of mortgage loans were securitized by MMC in 2016 Q1.

	Issued date	
1	December 16, 2013	322 901.700
2	June 25, 2014	222 051.700
3	October 21, 2014	324 595.800
4	January 14, 2015	452 278.100
5	May 20, 2015	294 343.300
6	August 5, 2015	261 699.200
7	November 23, 2015	293 862.300
8	January 20, 2016	186 330.300
	Total	2 358 062.400

Source: Mongolian Mortgage Corporation

II.5 Balance of payments

The current account deficit was recorded at USD 11 million in 2016 Q1, USD 17 million lower than previous year. The capital and financial account balance dropped by USD 177 million and reached surplus of USD 141 million. As such, total balance of payments was in deficit of USD 38 million and gross international reserves declined by this amount. Net statistical errors and omissions amounted to USD -168 million.

II.5.1 Current account

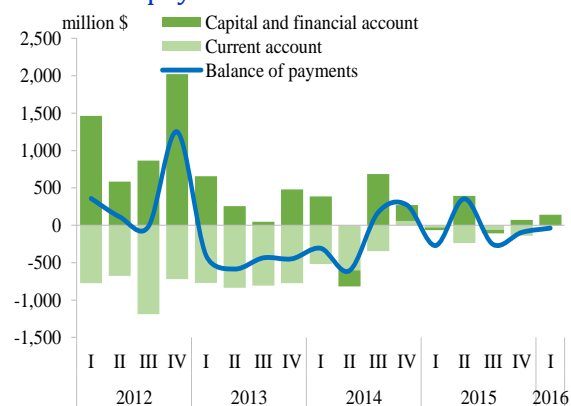
In the reporting quarter, a decline in the current account deficit was mainly caused by a drop in income account and an increase in current transfers from the previous year.

The cumulative trade balance on goods deteriorated by 5 percent y-o-y and reached surplus of USD 410 million due to goods' exports declined by 11 percent y-o-y, corresponding to an amount of USD 122 million. Moreover, copper exports declined by 6 percent y-o-y, equal to USD 31 million and crude oil exports deteriorated by 20 percent y-o-y, equal to USD 19 million due to weaker commodity prices. Weakening external demand and declining commodity prices led to a decrease of 30 percent y-o-y, equal to USD 42 million in coal exports and a decline of 50 percent y-o-y, equal to USD 29 million in iron ore exports.

Goods' imports declined by 16 percent y-o-y, corresponding to an amount of USD 101 million. Oil imports declined by 44 percent y-o-y, equal to USD 69 million, consumer goods' imports by 9 percent, equal to USD 20 million and capital goods' imports by 10 percent y-o-y, equal to USD 20 million.

Chart II.5.1.1

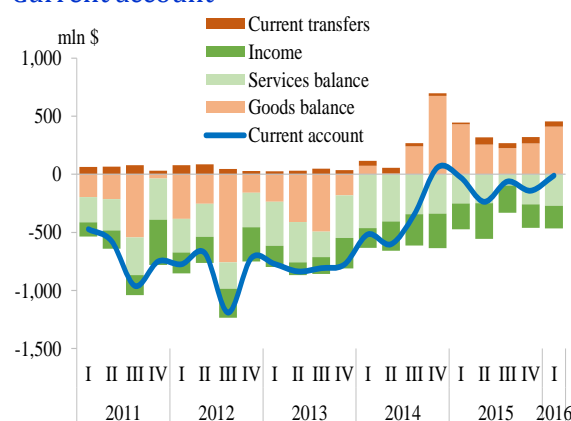
Balance of payments



Source: BOM

Chart II.5.1.2

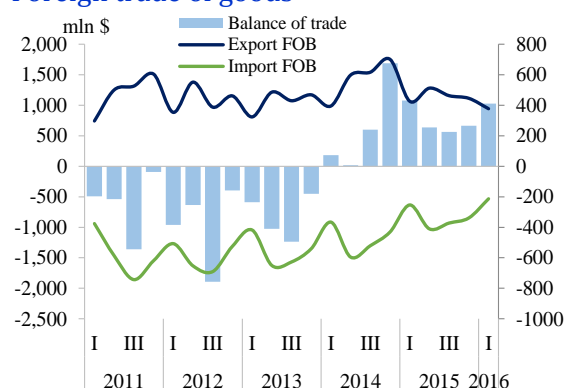
Current account



Source: BOM

Chart II.5.1.3

Foreign trade of goods



In 2016 Q1, income from trade in services declined by 2 percent y-o-y, equal to USD 2 million, while the corresponding expenditure rose by 5 percent y-o-y, equal to USD 20 million. These led to the increase of services account deficit by USD 22 million. Expenditure from trade in other services rose by USD 33 million in net terms due to the increase in other types of business expenditures including business management advisory services, architecture, engineering and technical services received by large mining corporation, though transport expenditures deteriorated by USD 10 million and travel and tourism expenditures by USD 2 million in net terms.

A total of credit by the Mongolian government, private entities and citizens from non-resident lenders, debt instruments, interest payments on deposits and current accounts and dividend payments declined by 17 percent y-o-y, equal to USD 36 million. This led to the contraction of income account. On the other hand, current transfer surplus showed 3 fold increase y-o-y and reached USD 45 million.

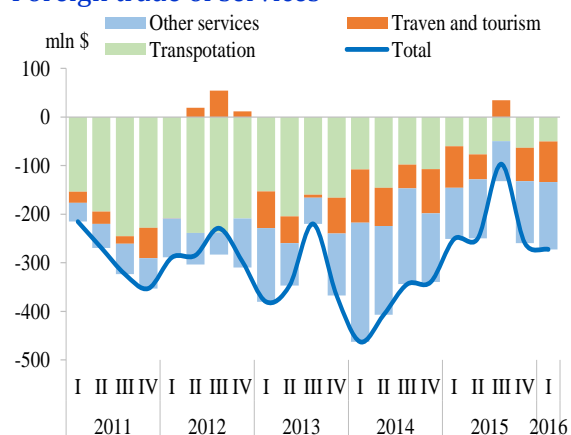
III.5.2 Capital and financial account

Capital account balance reached surplus of USD 21 million in 2016 Q1, down by 3 percent from the previous year equaled to USD 1 million.

Financial account reached surplus of USD 120 million, up by USD 178 million from the previous year. This was mainly due to an increase in foreign direct investment by USD 278 million in net terms as compared to the previous year. (Chart II.5.2.1).

Chart II.5.1.4

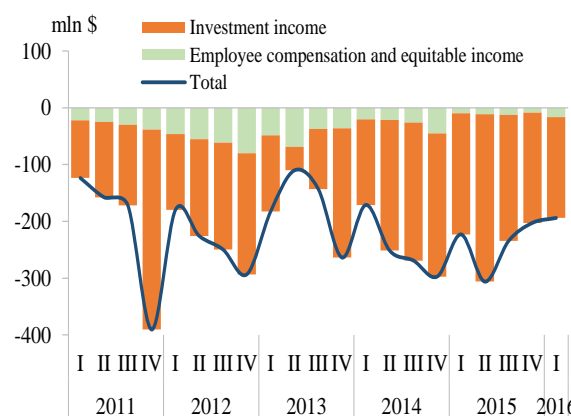
Foreign trade of services



Source:BOM

Chart II.5.1.5

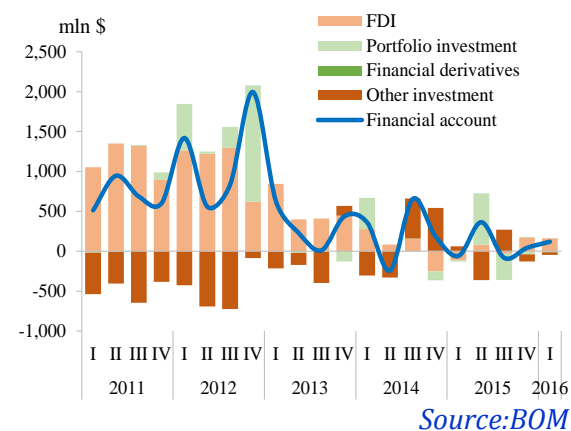
Income account



Source:BOM

Chart II.5.2.1

Financial account

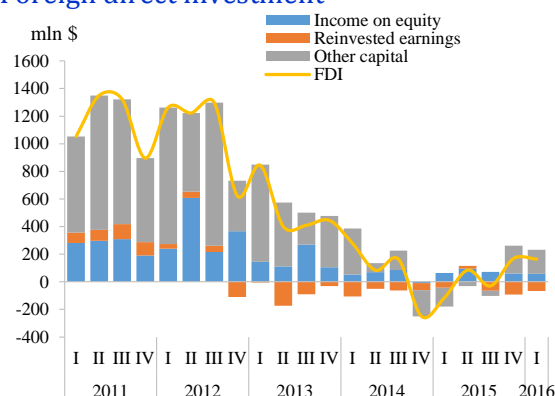


Source:BOM

Foreign direct investment increased by USD 278 million y-o-y and reached USD 165 million in net terms in 2016 Q1. This was mainly due to loan financing of the large corporations financed by the foreign investors increased by USD 309 million from the previous year and reached USD 174 million. (Chart II.5.2.2).

Chart II.5.2.2

Foreign direct investment

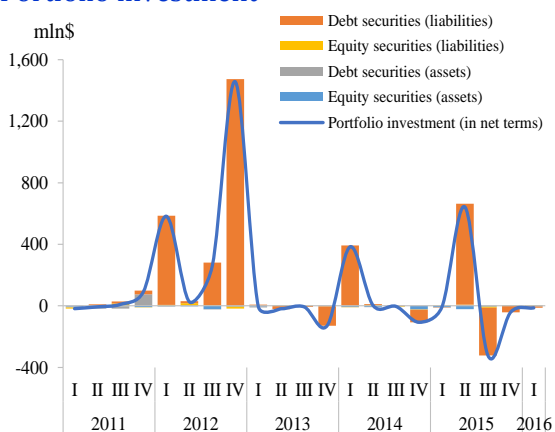


Source:BOM

Portfolio investment reached deficit of USD 13 million in 2016 Q1 in net terms. (Chart II.5.2.3).

Chart II.5.2.3

Portfolio investment

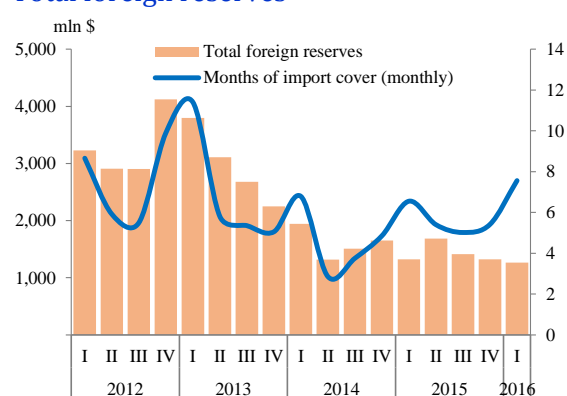


Source:BOM

As the balance of payments was in deficit of USD 38 million, **total foreign reserves** declined by 4 percent y-o-y and reached USD 1,265 million at the end of March 2016. Such amount is sufficient for 7.6 months of retained imports of goods payable in foreign currency that was measured as the average of last 3 months of imports and thus, meets the international criteria of 3 months of imports. (Chart II.5.2.4).

Chart II.5.2.4

Total foreign reserves



Source:BOM

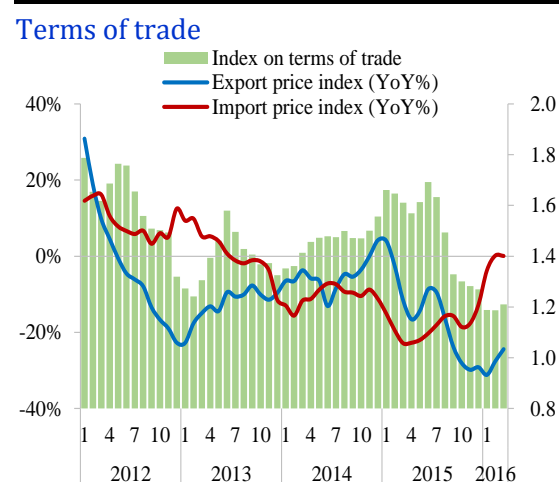
II.5.3 Terms of trade

Terms of trade declined by 15 percent y-o-y as of the end of 2016 Q1. This was mainly due to export price index decreased by 19 percent and import price index by 5 percent y-o-y.

Export price decline was mainly caused by a decline in copper concentrates by 26 percent, in crude oil by 22 percent, in iron ore by 51 percent and in coal by 39 percent y-o-y.

On the other hand, a decrease in the prices of oil products by 29 percent y-o-y led to the decline in import price index, while an increase in the prices of industrial products by 14 percent y-o-y led to the increase in import price index.

Chart II.5.3.1



Source: BOM, MCGA

II.6 External environment

In 2016 Q1, the U.S and China's economic growth slowed down, while the Eurozone's economic recovery continued at a steady pace. Consumption and investment growth supported the Chinese economy, however export decline due to weaker external demand led to the decline in economic growth in the recent quarter. The U.S economy slowed as the industrial production and investment deteriorated due to weaker commodity prices. Strengthening the Eurozone's domestic demand due to weaker oil prices and unconventional monetary policy supported the economic growth. Russia's inflation rate decreased and services sector showed recovery, thus economic contraction is expected to recover gradually.

The prices of the main exporting commodities increased in March-April 2016. This was mainly due to the dollar has weakened as the U.S Federal Reserve delayed raising interest rates in May meeting and China's construction sector accelerated, thus coal, iron ore and copper imports increased. A deal to freeze oil output by OPEC and non-OPEC producers fell apart in April meeting and Iran is ready to raise oil production back to its pre-sanction level, thus led to weakening oil prices.

II.6.1 Economic developments in main trading partner economies

Chinese economy

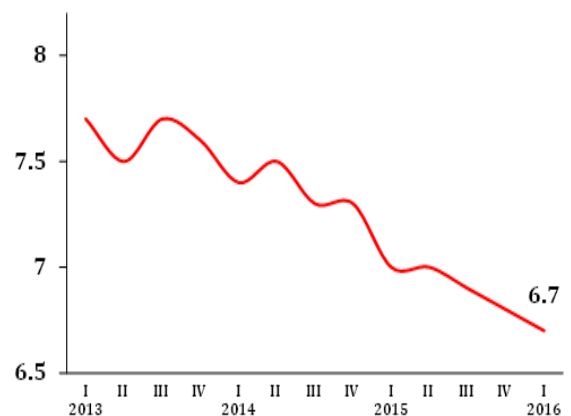
The Chinese economy grew by 6.7 percent in 2016 Q1. Retail sales increased by 10.5 percent y-o-y, investment in real estate sector by 10.7 percent y-o-y and household consumption and public sector investment supported the economic growth. On the other hand, total export declined by 4.2 percent y-o-y due to weak external demand. This affected negatively to economic growth. In 2016 Q1, new home sales and prices in large cities increased. This led to an acceleration in steel industry activity and 6.8 percent increase in industrial production in March 2016. To support the economy, the Chinese government announced to reach fiscal deficit around 3.5-4 percent of GDP and invest USD 720 billion on 303 transport infrastructure over the next three years. This announcement positively affected manufacturing sector's activity. However, mining and manufacturing industries in north-eastern China are facing the problem of oversupply and inefficiency. This pressures the recovery of manufacturing sector.

In March 2016, the Chinese government announced that economic growth is expected to fluctuate between 6.5 and 7 percent this year. To spur economic growth, People's Bank of China has loosened monetary policy for the fifth time since February 2015. It cut reserve requirement ratio by 0.5 percentage points. Thus, China attempts to reach an annual average growth rate at least 6.5 percent through 2020, by loosening fiscal and monetary policy.

China's debt has soared to 250 percent of GDP as of the end of 2015. Chinese policymakers assured that debt problem will not affect the overall economy. However, market analysts suggest that

Chart II.6.1.1

Chinese economic growth, in percentages (YOY)



China should improve debt management since raising China's debt may lead to financial and banking sector's instability.

Russian economy

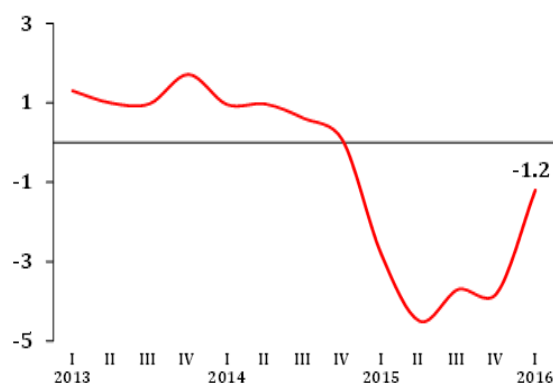
The Russian economy contracted by 3.7 percent y-o-y in 2015 and 1.2 percent in 2016 Q1. Retail sales declined by 5.4 percent y-o-y in 2016 Q1, while deteriorated by 12.7 percent in 2015 Q4. Acceleration in services sector activity supported the growth, while increasing net capital outflow affected negatively the growth in 2016 Q1. Specifically, oil export declined by 42 percent y-o-y and other goods and services export by 23 percent y-o-y, thus current account surplus deteriorated by 61 percent y-o-y due to falling oil prices.

Inflation fell to 7.3 percent in March 2016, however budget deficit reached 2.7 percent of GDP and ruble depreciated by as much as it may seem. Due to this reason, the Central Bank of Russia decided to keep the key rate at 11 percent in April.

Russia maintained rate in April but shifts to easing bias during the second half of the year, due to declining inflation and increasing oil prices gradually.

Chart II.6.1.2

Russian economic growth, in percentages (YOY)



U.S economy

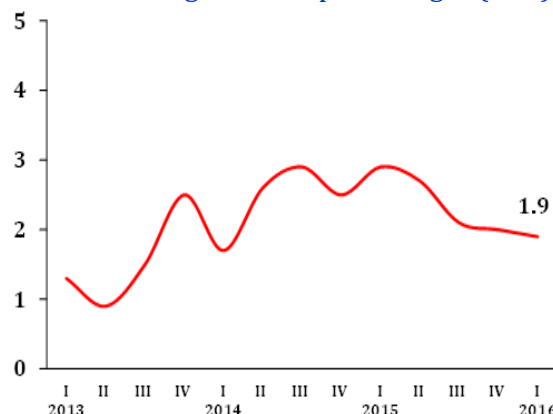
The U.S economy increased by 1.9 percent y-o-y in 2016 Q1, lower than expected. Consumer spending, which accounts for about 70 percent of U.S economic activity, increased at a 1.9 percent rate, investment declined by 3.5 percent q-o-q and export by 2.6 percent. The dollar strengthened since the Federal Reserve hiked interest rates in December 2015 and crude oil price fell to 12 year low in January 2016. Due to this export declined and investment in oil sector weakened y-o-y in the first three months of this year. Furthermore, industrial production deteriorated by 2 percent y-o-y in March 2016 and industrial sector's activity has been weakening.

Business investments had been delayed and net profits of the companies declined due to China's stock market volatility, thus led to a decline in economic growth in 2016 Q1. However, analysts indicate that as seen from the statistics in April the U.S economy is expected to grow at a stable rate in the coming quarters. Particularly, S&P500 index increased 13 percent from January low, the economy added 192,000 jobs on average in the first four months, and the unemployment rate fell to 4.9 percent and new home sales increased in April. This may support the growth in the coming quarters.

The Federal Reserve decided to keep the policy rate in April, as the first quarter's growth was lower than expected and inflation

Chart II.6.1.3

US economic growth, in percentages (YOY)



reached below the target level. Looking ahead, the Federal Reserve is expected to decide whether to raise its policy rate through careful consideration of outlook for main economic indicators.

Eurozone economy

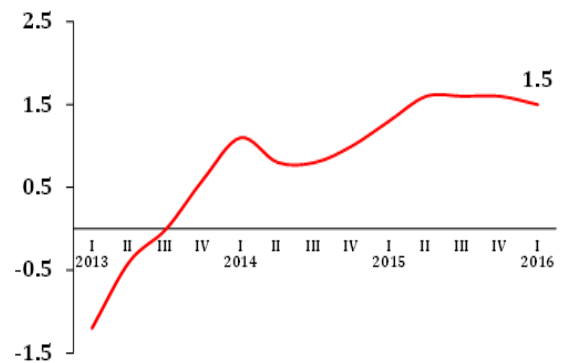
The Eurozone economy grew by 1.5 percent y-o-y in 2016 Q1. Although Greece's economy continued to weaken and contracted by 0.4 percent q-o-q, the German and French economy increased at a 0.7 and 0.5, respectively.

Unemployment rate in the Eurozone fell to 10.2 percent in 2016 Q1. And, continued monetary easing and declined oil prices indicate strengthening domestic demand. Further monetary easing supports domestic demand; however does not affect reaching the inflation rate to a target level of 2 percent.

The inflation rate fell to 0 percent in 2016 Q1, while remained at 0.1 percent in 2015 Q4. Regardless of unconventional monetary policy of the European Central Bank, the inflation rate is not expected to achieve the target level of 2 percent until 2018.

Chart II.6.1.4

Eurozone economic growth, in percentages (YOY)



III.6.2 Prices of exporting commodities of Mongolia

Copper: Copper prices, which stood on average at USD 4675 per ton in 2016 Q1, rose to USD 4873 per ton in April 2016. This was mainly driven by the fact that China's construction sector intensified and copper imports in February and March increased by 50 percent and 36 percent y-o-y, respectively. Moreover, the dollar weakened as the Federal Reserve kept the policy rate unchanged in April and heavy rains battered Chile over the April middle and copper mines suspended for 6 days. Due to this copper prices increased in April.

Gold: Gold prices, which stood on average at USD 1181 per ounce in 2016 Q1, increased to USD 1242 per ounce in April 2016. Weak dollar due to Fed's decision to hold the policy rate unchanged supported the prices. Moreover, gold prices increased as Japan, Swedish and the Danish central bank shifted to negative interest rate policy and gold became the ultimate dollar hedge investment.

Brown coal: Brown coal prices, which stood on average at USD 40 per ton in 2016 Q1, rose to USD 47 per ton in April 2016. This was due to BHP Billiton's brown coal production declined by 24 percent y-o-y and supply decreased, whereas China's brown coal import increased by 47 percent y-o-y in April.

Coaking coal: Benchmark prices of Australian premium hard coaking coal supplied to Japan, which stood at USD 81 per ton in 2016 Q1, increased to USD 84 per ton in April. As such, coaking coal price in the Australian market rose to USD 81 per ton. The increase in coaking coal prices was driven by coaking coal production declined in Shanxi and coaking coal import increased by 72 percent MoM in March 2016.

Crude oil: Brent crude oil prices which was USD 34 per barrel in 2016 Q1, increased to USD 41 per barrel in April 2016. Weak oil price during the first quarter was due to supply increased as Iran returned to world oil market. However, in April Kuwait's oil workers went on strike. Due to this, oil price has increased in April.



BANK OF MONGOLIA