BANK OF MONGOLIA

INFLATION REPORT

2016
Sep

"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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TABLE OF CONTENTS

EXECUTIVE SUMMARY

Mongolia's external demand in Q2 improved from the previous quarter and was slightly higher than in forecasts based on previous quarter performance. In 2016, despite external environment has been improving compared with the previous quarter, the Bank of Mongolia assumes that there are a few major uncertainties in external environment. Therefore, 2017 projections for external demand lowered compared to the previous forecast, due to weak economic growth of China. The Chinese government's soft monetary and fiscal policy has fostered sluggish activity in the manufacturing sector. However, the economy is expected to remain stagnant in 2017. Projections for Eurozone's economic growth in 2017 have lowered compared to the previous forecast, mainly due to Britian's vote to leave the EU negatively affected investors' confidence. Projections for Russia's economic growth in 2017 have improved from previous forecasts due to Russia's soft fiscal policy.

Terms of trade in Mongolia saw moderate improvement in the reporting quarter; however it was below the level of 2015. While export prices are expected to improve terms of trade in 2016, it could worsen again due to increasing import prices in 2017. Terms of trade improved as coal prices sharply increased due to supply shortfall in May and June 2016. However, prices are expected to fall again as China announced that it will use renewable energy resources instead of coal. Copper prices are expected to remain low for the next few years as China has sufficient copper reserves and demand has fallen. Gold prices are expected to increase as the Federal Reserve delayed hiking its policy rate. Oil and food prices, the main contributor of import prices, are expected to increase assuming that it has already reached the low level.

Balance of payment deficits increased in the reporting quarter as the current account deficits increased, while financial account surplus has risen due to foreign loans that the Government of Mongolia borrowed. As of the second half of 2016, reductions in the metal content of Oyu Tolgoi's open-pit mine has led to decreased exports, while the start of investments in the underground mine has led to an increase in foreign direct investment, resulting in both positive and negative impacts on the balance of payments.

Economic growth was lower than expected in Q2 and decelerated compared to the previous quarter, mainly due to the stagnant growth in non-mining sectors. Weak aggregate demand and tightened credit conditions and criteria of the banks[1] have negative affects on economic and business activities. Non-mining sectors have continued shrinking overall in the last five quarters, while the mining industry has risen in the reporting quarter due to coal supply shortfall of China. Throughout the last two years, actual output of the non-mining sector remained below its potential level, and total output remained below its long-run average.

Demand-side growth indicates that economic growth in 2016Q2 was sustained by government expenditure exceeding the amount planned, and increased foreign trade in real terms due to positive changes in coal, gold and copper prices. In contrast, diminishing private investment and household consumption negatively affected the growth. Private investment deteriorated due to lack of recovery in foreign direct investment, slowing economic growth, and a worsening business environment. The labor market condition has continued to worsen in the reporting quarter, thus led to diminishing household consumption.

Decreasing employment and increasing unemployment levels have occurred alongside slowed growth in nominal and real wages. According to the business confidence survey, companies are expected not to increase

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[1] Bank lending survey conducted by the Bank of Mongolia (BoM).

job vacancies and wages for the next two years. Lack of investment has continued to worsen the demand for labor and labor market forecasts.

Annual inflation remained near its anticipated level of BoM in 2016 Q2 and has been lower than its target level for the last one year. As aggregate demand shrinks, food and non-food inflation both decreased. Food price deflation has been occurred for the last three quarters, due to increased supply of meat. Non-food inflation fell to 3.0 percent in 2016 Q2, while it was 9.8 percent in 2015 Q2.

Money and credit indicators saw continuous growth in the last two quarters. On the asset side, an increase in fiscal and quasi-fiscal expenditures led to an increase in domestic net assets. On the liabilities side, rapid growth in foreign currency transactions and deposits in Q2 has increased money supply. In Q2, quasi-fiscal financing by the Bank of Mongolia (BoM) and the Development Bank of Mongolia (DBM) constituted the majority of financial institution lending, while loans backed by banks' own capital remained stagnant. Credit conditions and criteria have tightened due to slowing economic growth and increasing uncertainty in the economy and credit risk. Bank lending rate increase was mainly caused by increased overdue loans and lower credit quality.

Stock market indicators, which have continuously declined since September 2014, experienced high fluctuations in the last two quarters. An average indicator of the TOP-20 index increased in July 2016 and the housing price index has been declining from a year ago, while it has increased from a quarter ago in Q2.

Declining mining production is linked to the decline in economic growth in 2016, but forecasts show a transition to positive growth due to acceleration in production of Oyu Tolgoi's underground mining in 2017. Mining production is expected to decelerate as the metal content of Oyu Tolgoi's open-pit mine would likely to decrease in 2016-2017. Non-mining production is expected to accelerate in 2016-2017, as Oyu Tolgoi's underground mining has positive affects on construction, trade, net taxes on products and services sector. Demand side growth shows that despite Oyu Tolgoi's investment increased government expenditure would positively affect economic growth in 2016.

Economic activity predicted to improve in 2017, but the actual output is expected to remain below its long term trend, indicating reducing demand-pull inflation pressures. Inflation is expected to decline in the first half and increase in the second half of 2017. Deflation will continue until the first half of 2017, due to declining meat and vegetable prices.

In the current estimations, uncertainty on external and internal environment has increased. There is a high risk that China's rising debt would negatively affect financial stabilityand lead to economic slowdown. Moreover, China's rebalancing might increase economic uncertainty. Due to this, the main exporting commodities' prices are likely to decline throughout the forecast horizon. Uncertainty increases for the Eurozone economy, mainly due to the UK leaving the Eurozone. Russia's economic recovery will depend on oil price outlook and fiscal policy implementation.

In terms of internal environment, fiscal policy remains the main source of uncertainty. The main risk in the domestic environment is mostly concerned with fiscal policy measures. In other words, effective reduction and management of budget deficits and public debt as well as implementation of prudent fiscal policy measures would play a significant role in ensuring macroeconomic and financial stability in the upcoming years. Due to external and internal shocks affecting the economy, sudden movements in exchange rate could be observed and uncertainties surrounding the recovery of FDI inflows, Development Bank of Mongolia financing as well as implementation and financing sources of Tavan Tolgoi related and other mega projects remain.

I. ECONOMIC OUTLOOK

I.1 External assumptions for the forecast[2]

Economic growth is expected to remain as previously forecasted in China, the Eurozone and Russia in 2016, while the Eurozone growth is expected to decline in 2017. Despite the increased price forecast for gold and coal prices and favorable terms of trade in the second half of 2016, terms of trade is projected to decline in 2017 as oil prices would increase.

External demand

Compared to the previous forecast, 2016 projections for external demand[3] growth increased by 0.1 percentage points due to improved expectations for economic growth in Russia, despite growth in China and the Eurozone is expected to remain as previously forecasted. In contrast, 2017 projections for external demand growth declined by 0.1 percentage points due to projected weak Eurozone growth. External demand is expected to decline and remain weak in the next two years.

Despite China's economic restructuring negatively affects economic growth, the government's soft monetary and fiscal policy would likely to foster sluggish activity in the manufacturing sector. Therefore, China's economic growth forecast in 2016 and 2017 remained unchanged at 6.5 percent and 6.3 percent, respectively. The Eurozone growth is expected to remain unchanged at 1.5 percent in 2016, while it is likely to fall to 1.2 percent from 1.6 percent (previous forecast) in 2017 due to Brexit will have negative affects on the Eurozone's foreign investment, trade and economic activity. Meanwhile, Russia's economic growth is projected to increase in 2016 and 2017 compared to the previous forecast. Despite unfavorable external conditions from extended sanctions by the EU until January 2017 and stagnant oil prices, analysts expect that the Russian economy will recover and grow by 1.1 percent in 2017 due to the Russian government's

Chart I.1.1

Change in external demand, in percentages

External demand

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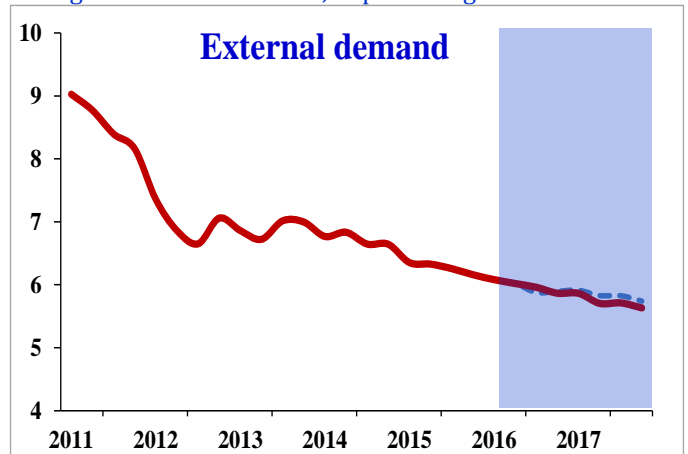
[2]Projections of economic growth and inflation in foreign economies are taken as averages of Roubini Global Economics 2016 May report, EIU 2016 May report, median values of Bloomberg analysts' forecasts, and IMF-WEO 2016 April forecasts. Relevant descriptions are summarized from these reports. The Bank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

[3]Foreign demand is calculated as the weighted average of economic growth in Mongolia's main trading partners, with foreign trade shares as weights.

measures[4] to reduce budget deficit to 3.2 percent of GDP by selling public companies.

Foreign interest rate

The Federal Reserve remained its policy rate unchanged at 0.5 percent in July due to sluggish investment and below target inflation, despite the US economy added 287,000 jobs in June and private consumption increased.

The US economy grew less than expected and political and economic instability continued to persist in the world economy. However, analysts expect that the Federal Reserve would hike its policy rate at least one time in December due to favourable labor market conditions.

Chart I.1.2
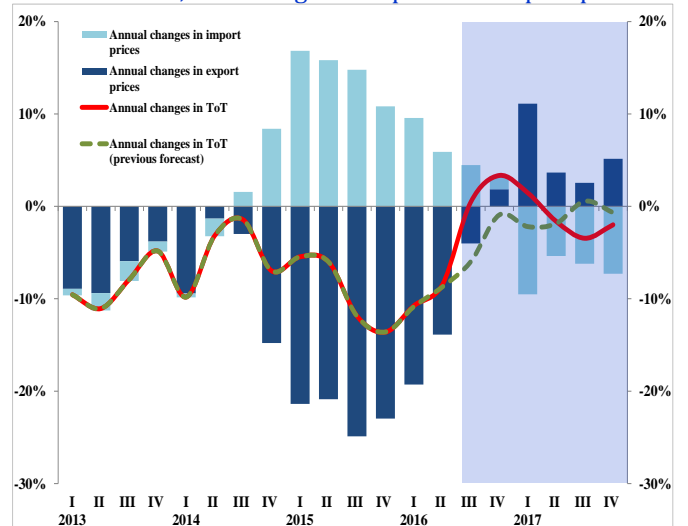
The Federal Reserve rate, in percentages
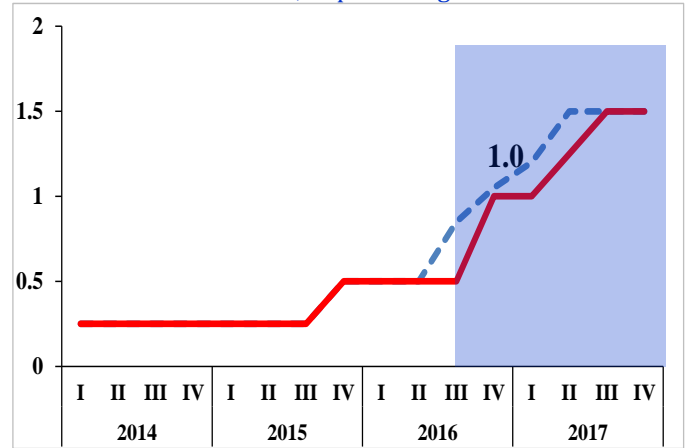
Terms of trade

Compared to the previous forecast, terms of trade is set to improve in 2016 due to an increase in gold and coal prices, however to weaken again in 2017 due to a decrease in copper and coal prices and an increase in oil prices.

Chart I.1.3

Terms of trade, and changes in export and import prices

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[4] Hence, analysts expect increased uncertainty arising from macro-level factors in Russian economy, such as financing difficulties of budget deficit.

Copper demand increased and prices rose from increased construction sector activity in China in the first half of 2016. However, in June-July imports declined, thus prices decreased. Copper prices are expected to decline in the second half of the year, due to sufficient copper inventories in China. Therefore, copper price forecast saw a decline of USD 24 and USD 296 in 2016 and 2017, respectively. The Federal Reserve delayed hiking its policy rate and investment demand for gold has increased. Therefore, gold price forecast saw an increase of USD 158 and USD 100 in 2016 and 2017, respectively. Coal prices are expected to increase in the second half of 2016 as domestic coal production declined in China. Hence, analysts expect that coal prices would decline in 2017, due to an announcement of the Chinese government to replace coal with natural gas and use solar and wind energy in the next 5 years.

In terms of foreign inflation, inflation rates in China, the Eurozone, and Russia are expected to decline compared to previous forecasts. Inflation remains below its target level in China and the Eurozone, regardless of soft monetary policy stance of the People's Bank of China (PBOC) and the European Central Bank (ECB). Russia's low economic activity and tight monetary policy contributed to a decrease in inflation, with inflation forecasts at 6.5 percent at the end of 2016 and 5.8 percent in 2017.

I.2 Forecast, uncertainties

Economic growth

Domestic economic forecasts are based on the assumptions that domestic fuel prices would not be affected by tax regulations and that meat supply would remain high without price shocks.
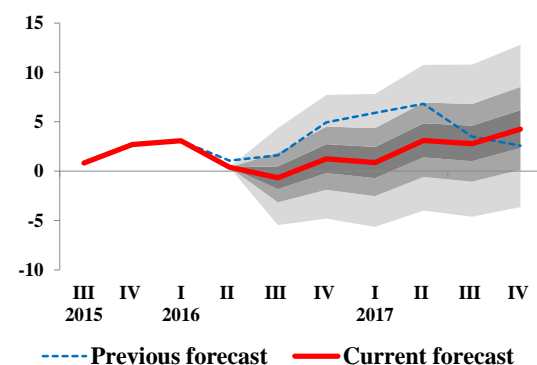
The economic growth forecast has been revised down from the previous forecast. First, non-mining sector is expected to remain lackluster with slowing growth. Second, investment in Oyu Tolgoi's underground mine production is projected to decline more than previously expected. Due to this, production in construction and processing industries and net taxes on products dropped and sluggish growth in non-mining sector continued in the reporting quarter. Furthermore, sharply declined private consumption and policy rate hike led to the downward revision for the GDP growth forecast. Business confidence survey[5] shows that contraction in staffing levels index indicates a weaker business outlook in non-mining sector in Q2. In contrast, mining production was higher than expected due to positive changes in coal production. Coal exports increased as China has cut local coal production and increased renewable energy to reduce pollution.

According to the baseline forecast, economic growth will continue to stall in 2016 and improve modestly in 2017. Non-mining production is expected to improve, while mining production is expected to decline at the end of 2016, leading to economic growth to weaken in 2016. Mining production in 2016 and 2017 is projected to decline from the previous year, due to reduced metal contents in Oyu Tolgoi concentrates. However, non-mining sector is expected to improve in the second half of 2016 and 2017, due to indirect effects of investment increase in Oyu Tolgoi's underground mine production and production increase in several mining products. On the demand-side, increased government consumption and investment affected positively economic growth.

Economic growth will increase in 2017, but real production level will remain below long-term trends, signifying low demand-side inflation pressures.

Chart I.2.1

Quarterly GDP growth forecast

	2015 *гүйц.*	2016* *төсөөлөл*	2017*
GDP growth	2.3	0.2-1.2	2-4
Inflation, CPI[6]	1.6	0-1	3-5

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[5] The Bank of Mongolia conducts the survey every quarter.
[6] Average inflation in Q4 of each year

Inflation

Inflation forecast has been revised down, due to weakening economic demand.

According to the baseline forecast, annual inflation will decline from its current level until 2017 Q2 and increase again. Throughout the forecast period, inflation will remain below the target level, as indicated in the Monetary Policy Guidelines of 2017.

Food and non-food inflation will continue to decrease until the second half of 2017. Decline in meat and vegetable prices affects food inflation to decline until the first half of 2017. Moreover, food prices are projected to increase as the world food price index, which has declined over the past four years, is expected to grow in 2017.

Non-food inflation is expected to decrease in 2016 and remain at a low level in 2017 from declining economic activity and weakening aggregate demand. Therefore, inflation is expected to remain relatively stable in 2017.

Chart I.2.2

Inflation forecast

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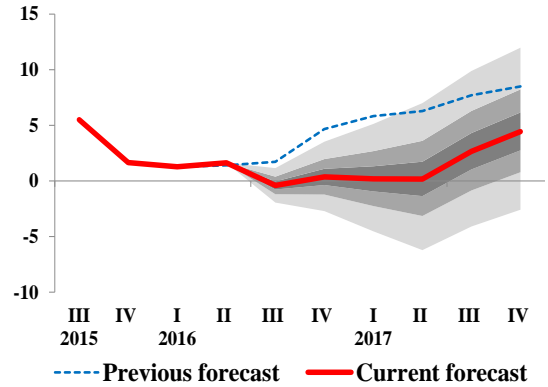
Forecast uncertainty

The baseline forecast is based on the circumstances of; unforeseen macroeconomic policy and structural changes will not occur over the forecast period. Forecasts may differ from its actual or changes may occur across periods due to changes in economic policy, structural changes, shifts in the assumptions used, and/or other unforeseen circumstances. The following uncertainties may affect macroeconomic policy and external and domestic factors, and hence current economic conditions.

External economic uncertainties

- China's economic growth remains the main source of uncertainty. China's growing debt problem may pressure financial stability and lead to weakening economic growth.
- The construction sector may be at risk as China's real investment growth rate reaches a 15-year low. While the government helped real estate prices revover by increasing infrastructure investment and reducing the mortgage rate and the down payment to 20%, prices decreased again in the last two months. If the construction sector slows, it may decrease copper and steel production as well as demand for steel's main components of iron ore and coking coal.
- Steel production may decline in 2017, due to the pollution problem in China, sluggish contruction sector and sufficient steel stocks. It may decrease iron ore and coking coal production.
- The Federal Reserve may hike its policy rate in December 2016, thus the emerging markets may see significant capital outflow.
- Russia's economic growth recovery will depend on oil price and fiscal and monetary policy outlook. Oil price outlook remains weak, due to declining China's economic growth and increasing crude oil production in Canada, Nigeria, Libya and other oil-exporting economies. There is continued uncertainty on whether Russia's economy will recover, depending on monetary policy stance and high budget deficit.

Domestic economic uncertainties

- The main risk in the domestic environment is mostly concerned with fiscal policy measures. In other words, effective reduction and management of budget deficits and public debt as well as implementation of prudent fiscal policy measures would play a significant role in ensuring macroeconomic and financial stability in the upcoming years.
- Slowing economic growth and increased non-performing loans pose a risk of continued disruption to bank loans. In turn, this will negatively affect macroeconomy and the financial sector stability.
- Foreign exchange rates may face volatility from external or domestic shocks and changes in public expectations. If the upcoming debt repayment is not managed well, foreign exchange reserves and exchange rates will be at risk of significant pressure.
- There is continued uncertainty on whether foreign direct invetsments will increase, and on the start date or financing sources for large-scale projects related to investment and economic recovery plans, such as Development Bank financing and investments in Oyu Tolgoi and Tavan Tolgoi.

- Interruptions in the supply of goods can have significant pressure on inflation. The weather-related risks, unprecedented increase in prices of administrated goods, or other types of supply-pull inflation can alter the trajectory.
- Uncertainty may also arise from changes to economic policy without prior notice.

II.   CURRENT ECONOMIC DEVELOPMENTS

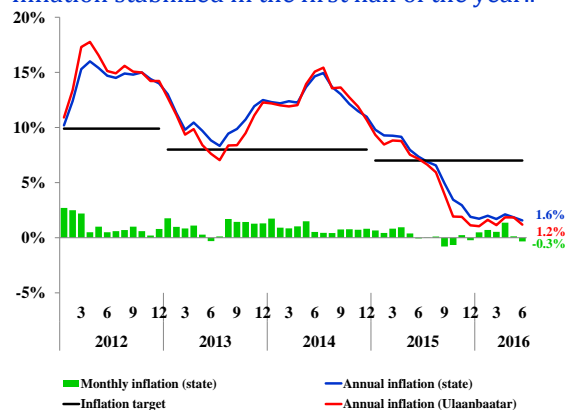## II.1 Inflation

II.1.1 Inflation target, performance

Consumer price index-based annual inflation reached 1.6 percent in June 2016, falling by 0.1 percentage points QoQ and 5.8 percentage points YoY. Annual inflation has been consistent with the target level over the last year. (Chart II.1.1.1).

Declining annual inflation stabilized in the first half of 2016, due to the following: 1) Meat prices grew by 37.6 percent and 10.6 percent in Q1 and Q2, 2) the decline in main trading partner economies' inflation and world food prices stabilized. (Chart II.1.1.2)

The contribution of food prices to headline inflation dropped in June 2016, by 1.7 percentage points YoY and 0.1 percentage points QoQ. This was mainly due to the sharp increase in meat prices, adhering to its seasonal pattern. Particularly, meat prices declined by 23.7 percent in 2015 Q4, while rose by 52.1 percent in the first half of 2016. As of the end of June, the price per kilogram mutton and beef increased by MNT 2000-2200 compared to the previous year's end. The contribution of non-food products to headline inflation declined in June, by 0.1 percentage points QoQ and 4.3 percentage points YoY, due to high base effects and weakening domestic demand. Food prices are expected to decline and have negative affects on annual inflation in the coming months, adhering to its seasonal pattern. Specifically, meat and vegetable prices are expected to decline. Price pressures of non-food products on inflation are not expected to rise much in the coming months. Demand-pull inflation pressure is not expected to increase due to shrinking domestic demand and administrated goods' prices will be stable in the coming months (Chart II.1.1.3).
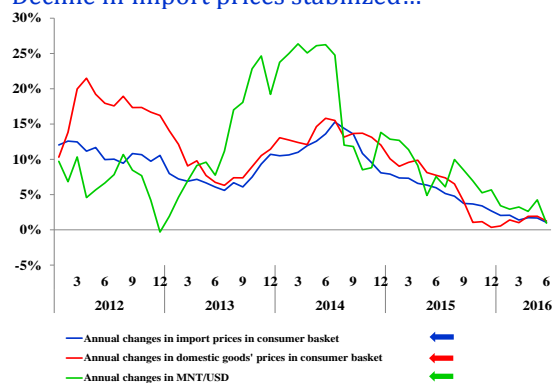
Chart II.1.1.1

Inflation stabilized in the first half of the year..
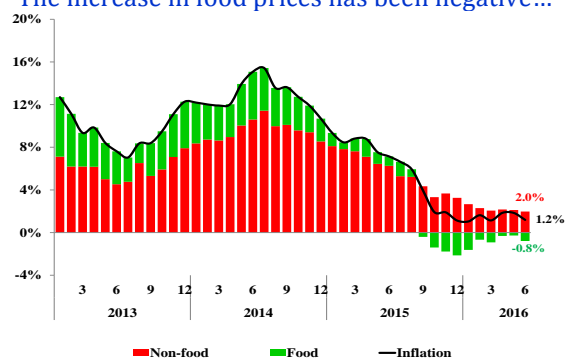

Source: NSO

Chart II.1.1.2

Decline in import prices stabilized…

Source: NSO, BoM

Chart II.1.1.3

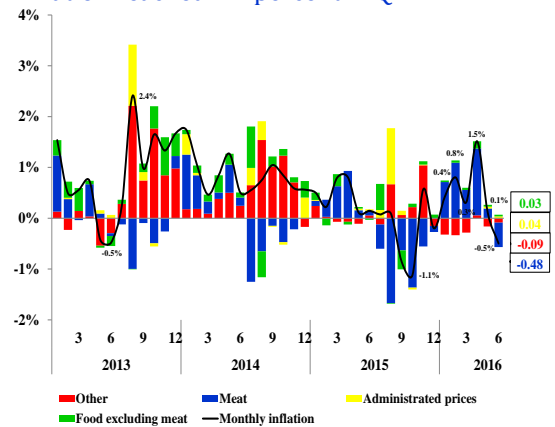The increase in food prices has been negative…

Source: NSO, BoM

11

II.1.2 Inflation and its components

Inflation in Ulaanbaatar, which was 1.5 percent in Q1, reached 1.1 percent in Q2. Monthly inflation reached 0.37 percent in Q2, which was near to its previous year's level, while 0.14 percentage points lower from 2016 Q1. Inflation was mainly caused by meat price fluctuations. Meat prices increased in April and May, while declined in June, due to its seasonal pattern. Prices of other products and services excluding food and administrated goods (illustrated in red in Chart II.1.2.1) have been declining. Food prices excluding meat and administrated goods' prices have stabilized in the last few months. (Chart II.1.2.1).

Annual inflation in Ulaanbaatar reached 1.2 percent in June 2016, falling by 6.0 percentage points YoY. Core inflation[7] was 2.9 percent in June, 0.1 percentage points lower from a quarter ago and 6.7 percentage points from a year ago. Although core inflation has been higher than headline inflation through the last 31 months, the gap has narrowed in recent two quarters. This was mainly due to the sharp increase in meat prices in the first half of 2016. Average prices of meat, milk, and vegetables that are excluded from the calculation of core inflation declined by 6.3 percent in June (Chart II.1.2.2).

Analyzing the components of inflation in Ulaanbaatar shows that meat and meat products, non-meat food products, administrated goods and services, petroleum, and other products (illustrated in red in the chart) contributed -1.07, 0.61, 1.40, -0.18, and 0.87 percentage points, respectively. Compared to the Q1 average, the contribution of meat and non-meat products increased by 0.46 and 0.15 percentage points, while the contribution of petroleum and administrated goods and services, and other products dropped by 0.02 and 0.21 percentage points, respectively (Chart II.1.2.3).

Chart II.1.2.1

Inflation reached 1.1 percent in Q2...[8]

Source: NSO, BoM

Chart II.1.2.2

The difference between core and headline inflation has declined...[9]
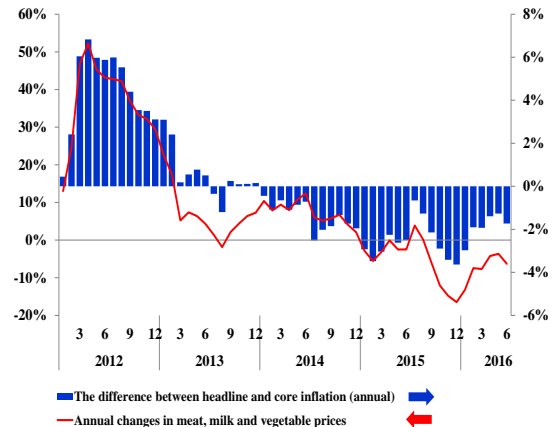
Source: NSO, BoM

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[7]Calculated through excluding a total of 37 types of products subject to high fluctuations from the consumer basket.
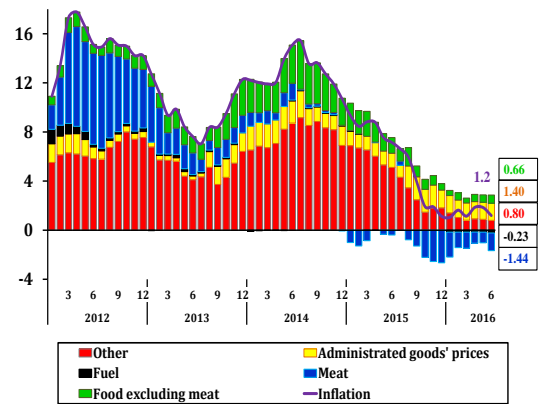
[8]Considering quarterly inflation in Ulaanbaatar

[9]Considering annual inflation in Ulaanbaatar

Meat prices dropped sharply in the second half of 2015, due to excess supply. However, following its seasonal pattern, meat prices increased a total of 52.1 percent in the first half of 2016 (37.6 percent in Q1, 10.6 percent in Q2). Despite a sharp increase in meat prices, it has been lower than previous year's level. In the reporting quarter, the average annual price growth of meat was -7.7 percent, lower by 3.7 percentage points from the 2015 average and 6.5 percentage points from the 2016 Q1 average. While fluctuations in meat prices mostly adhered to its seasonal patterns, the range was higher than previous year's averages. The sharp rise in meat prices in the second half of 2015 created opportunities for the price to increase again in a short time (Chart II.1.2.4).

Chart II.1.2.3

Despite meat prices increased, it has been a negative impact on inflation...[10]

Source: NSO, BoM

Chart II.1.2.4

Meat prices increased by 10.6 percent in Q2...
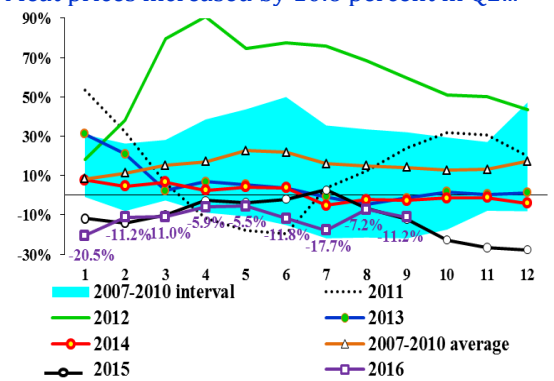
Source: NSO, BoM

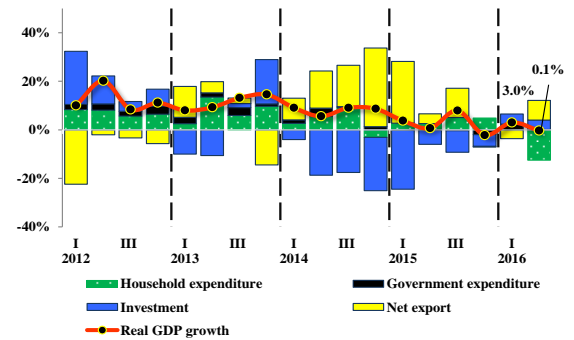[10]Considering annual inflation in Ulaanbaatar, broken down by component.

II.2 Demand and supply

II.2.1 Demand

Domestic demand increased 0.1 percent YoY in 2016 Q2. Government expenditure and investment, and foreign trade had positive contributions to economic growth, while household expenditures had negative contributions in the reporting quarter.
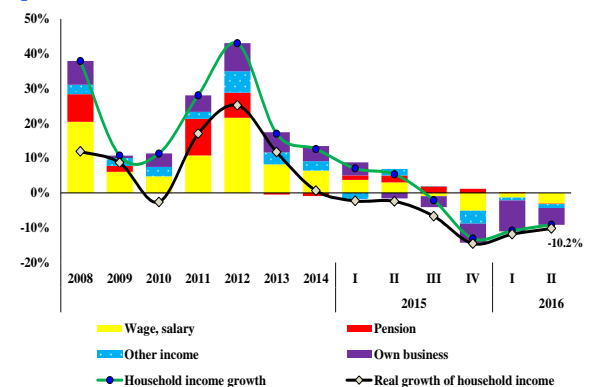
Consumption

Household: Household expenditures decreased 18.9 percent YoY and contributed -12.4 percent to quarterly GDP growth. Shrinking household consumption across the last quarters can be attributed to declining food consumption.

The decline in household consumption was caused by the household income decrease of 10.2 percent YoY. The decline in salary income and own business income (livestock farming, agriculture, etc.) contributed to a decrease in household income. As such, household income has continuously declined across the last 6 quarters (Chart II.2.1.2).

Monthly household expenditure declined alongside income. This can be observed from the decline in average household consumption over the five consecutive quarters from 2015 Q2. Household expenditures declined in Q2, by 0.6 percent QoQ and 2.5 percent YoY. Non-food household expenditures increased modestly, while other expenditures decreased from a year ago. Household expenditure is not expected to recover for the next two quarters, due to declining household income and low economic activity (Chart II.2.1.3)

Chart II.2.1.1

Household expenditures contributed -12.4 percent to real GDP growth.

Source: NSO

Chart II.2.1.2

Real household income decreased across the last 6 quarters.

Source: NSO

Chart II.2.1.3

Real household expenditures decreased across the last 5 quarters...

Source: NSO

14
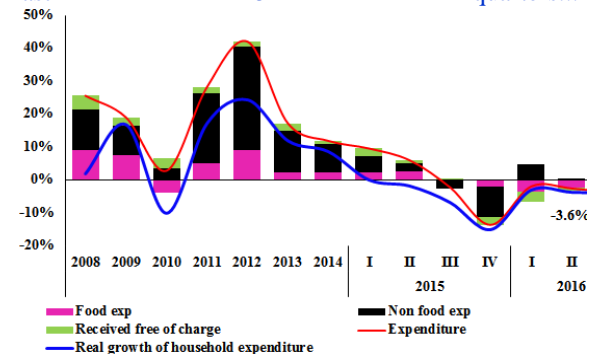
Government: Government expenditure increased by 1.4 percent YoY and contributed 0.2 percentage points to the quarterly GDP growth in 2016 Q2. Government expenditure increased due to increased unbudgeted expenditures in the first half of 2016. Government expenditure is not expected to decline in the second half of 2016 as seen from the Fiscal Plan of 2016 (Chart II.2.1.4)

According to the budget performance in 2016 Q2, total equilibrated budget revenue collection was 82.5 percent (MNT 2541.2 billion), total expenditure incurred was 75.2 percent (MNT 3665.1billion) of its planned amount and total equilibrated deficit stood at MNT 1123.9 billion (Table II.2.1.1)

Investment

Total investment (capital formation) increased 15.6 percent YoY in 2016 Q2 and contributed 3.9 percentage points to quarterly GDP growth[11]. Increase in inventories[12] by 43.2 percent YoY in Q2 was the main reason for an increase of 15.6 percent in investments. This change in inventories is also related to the increase in inventories of enterprises (Chart II.2.1.5).

Investment has deteriorated over the last two years and contributed negatively to economic growth. However, in the last two quarters of 2016 investment has increased from a year ago, due to investments in Oyu Tolgoi underground mine.

Chart II.2.1.4

Government expenditure
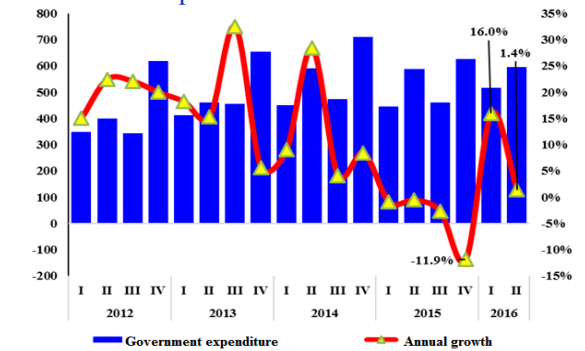
Source: NSO

Table II.2.1.1

Fiscal revenue

| In billion MNT	2014	2015	2016	2016 Q2		
	Actual.	Actual.	Amend.	Amend.	Actual.	In percent
Balanced revenue	6277	5974	7063	3077	2541	83%
Total expenditure	7145	7137	8003	4872	3665	75%
Balanced budget	-868	-1163	-940	-1795	-1124	63%
Contribution to GDP, in percentages						
Balanced revenue	28%	26%	26%			
Total expenditure	32%	31%	29%			
Balanced budget	-4%	-5%	-3%			
Nominal GDP	22227	23167	27590			

Source: Ministry of Finance

Chart II.2.1.5

Investment (annual growth)
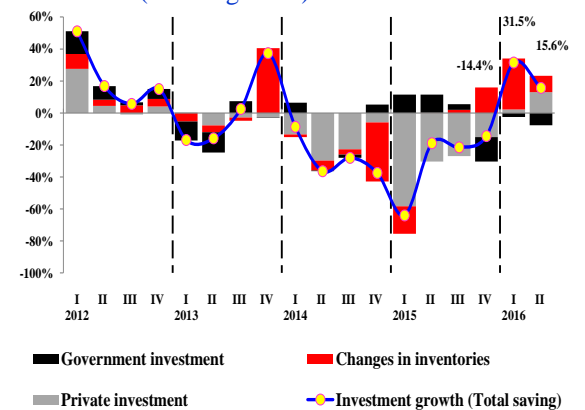
Source: NSO

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[11] Total investment (capital formation) deteriorated by 18.9 percent and contributed 5.8 percentage points to economic growth in 2015 Q2.

[12] Private investment is calculated by gross capital formation minus government investment.

Net export

Net exports, which contributed negatively to economic growth in Q1, contributed 8.5 percentage points to growth in Q2. This was mainly due to an increase in real exports by 10.7 percent and a decrease in imports by 2.3 percent from a year ago. The increase in the volume of exports in Q2 was due to increased exports of copper concentrates, coal and non-monetary gold[13] by 15.3, 77.9 and 167.9 percent YoY, respectively (Chart II.2.1.6).

Imports are expected to increase and reach the previous year's level since the second half of 2016, and exceed the previous year's level at the end of 2016 due to Oyu Tolgoi underground mine construction.

Exports of goods and services decreased by 4.2 percent YoY in Q2 in nominal terms. In contrast, imports declined by 20.4 percent or USD 231.5 million YoY, due to the decline in imports of industrial, investment and petroleum products (Chart II.2.1.7)

Total domestic demand has been shrinking over the last 7 quarters. Total capital formation has deteriorated over the last 9 quarters and caused weakening domestic demand[14] (Chart II.2.1.8)
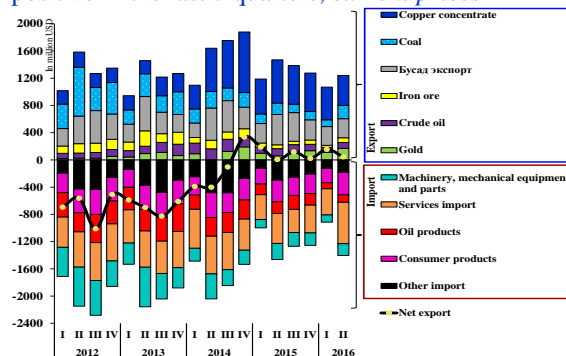
Chart II.2.1.6

Exports and imports, at the constant price of 2010
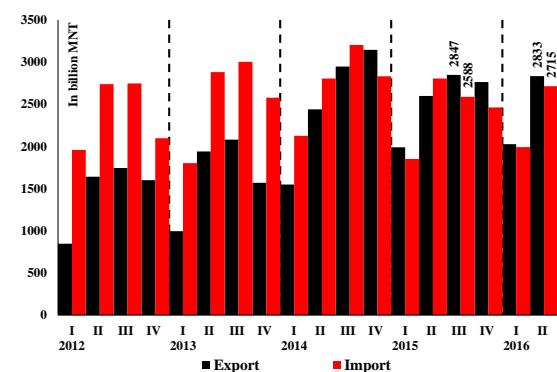
Source: NSO
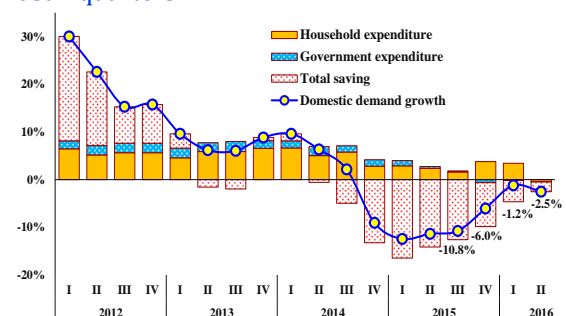
Chart II.2.1.7

Net exports of goods and services has remained positive in the last 7 quarters, *current prices*

Source: BoM

Chart II.2.1.8

Domestic demand has been shrinking over the last 7 quarters

Source: NSO

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[13] As of 2015, exports of copper concentrates, coal and non-monetary gold constituted 69.7 percent of total exports.

[14] In Chart III.2.1.8, growth contributions of household and government expenditure and total investments are calculated as the sum of the current quarter and the previous 3 quarters.

II.2.2. Supply

Gross domestic product rose by 0.1 percent in 2016 Q2 and the economic growth reached 1.4 percent in the first half of 2016. Non-mining sector, in decline for the last 5 quarters, fell 0.6 percent as well as mining sector deteriorated by 3.3 percent in Q2.

Agriculture, mining, trade and transportation sectors contributed 0.8, 0.7, 0.3 and 0.2 percentage points to Q2 growth, respectively. Net taxes on products, processing and construction sectors contributed 1.3, 0.6 and 0.2 percentage points to Q2 growth, respectively. In contrast, information and communication, other services and electricity sectors did not contribute significantly to economic growth.

Agriculture sector grew by 3.5 percent in Q2. Considering the farming sector, 70.2 million head of livestock counted as of the end of June, which was 3.7 million higher from the previous year. Considering the agronomy sector, the area of planted wheat was near to previous year's level in 2016.

The increase in mining production, exept Oyu Tolgoi's copper concentrates accounted for the majority of mining sector growth. In particular, production in gold, iron ore, coal, Erdenet copper concentrates and crude oil increased by 73, 36, 26, 22 and 8 percent YoY in Q2. Copper concentrates volume of Oyu Tolgoi's open-pit mine, which was accounted for the majority of mining sector growth during 2013-2015, have stabilized and the metal content has declined since Q2, thus Oyu Tolgoi's copper concentrates did not significantly contribute to sectoral growth.

Trade sector, which has declined in the last 6 quarters, grew by 3.4 percent in Q2, due to increased wholesale trade. Transportation sector grew by 5.2 percent in Q2, due to increased freight turnover in railway transport.
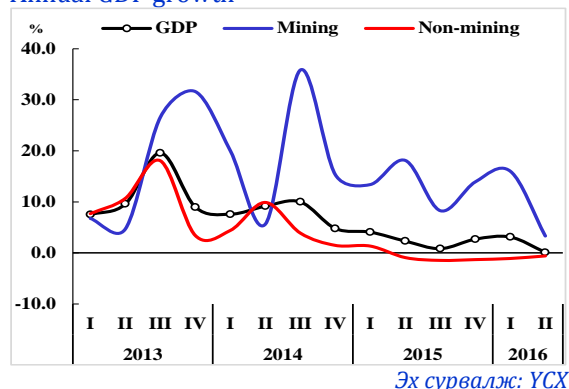
Chart II.2.2.1

Annual GDP growth

Эх сурвалж: ҮСХ

Table II.2.2.1

Annual and quarterly growth of production sectors
/In order of contributions to Q2 growth/

	2015	2016Q1	2016Q2	
	YoY %	YoY %	YoY %	QoQ % *
Real GDP growth	**2.4**	**3.1**	**0.1**	**-2.8**
Agriculture	10.7	3.4	3.5	10.0
Mining	14.1	16.0	3.3	-15.0
Trade	-7.0	-4.1	3.4	29.7
Transportation	4.5	-2.6	5.2	4.2
Information	-2.1	0.5	4.4	1.8
Other services	5.9	0.5	0.4	0.5
Electricity	3.1	4.0	5.7	2.2
Construction	-0.6	27.5	-5.2	-64.6
Manufacturing	1.3	-13.0	-11.2	7.4
Net tax on products	-22.7	-1.4	-11.2	-43.1

* seasonally adjusted

Chart II.2.2.2

Annual growth of industrial sectors

Source: NSO

17
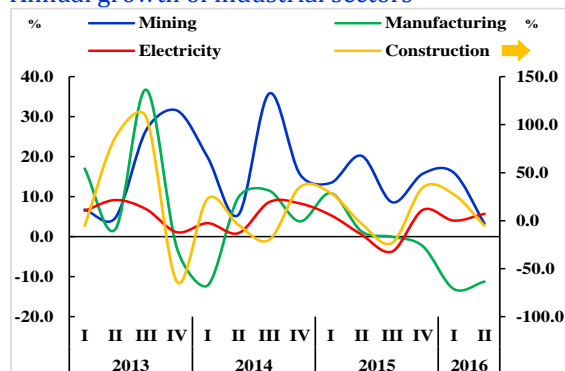
Among the sectors with a negative contribution to the economy, processing sector declined by 11.2 percent in Q2. Out of which, food, textile, fuel, non-ironic chemicals and iron ore production continued to decline in the last few quarters, due to weak economic activity.

Construction sector declined by 5.2 percent in Q2, not adhering to its seasonal pattern. This was mainly due to; non-residential building construction and engineriing construction such as road, dyke declined. In contrast, residential construction and energy infrastructure construction grew by 8 and 27 percent YoY and contributed positively to sector growth.

Net taxes on products, which had continuously declined since the end of 2013 alongside declining imports and domestic manufactuing activity, declined by 11.2 percent in Q2. This was mainly due to declined taxes on imported goods and VAT refund.
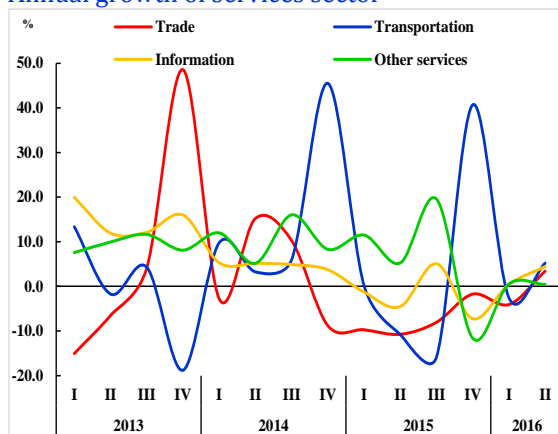
Chart II.2.2.3

Mining sector output
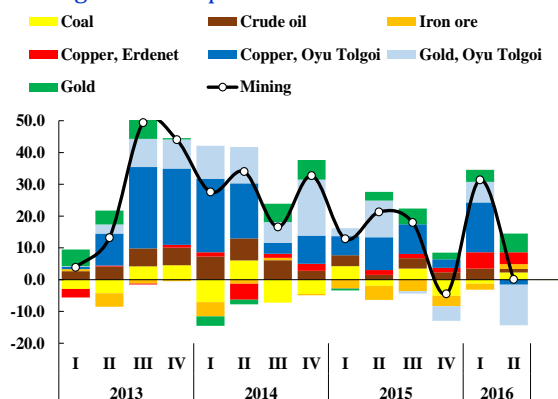
Source: NSO, Oyu Tolgoi LLC, additional estimations

Chart II.2.2.4

Annual growth of services sector

*Source: NSO*

II.2.3 Potential output, output gap

Potential output growth[15] accelerated in 2010-2013, but since 2014 it has been declining due to weakening mining sector. Declining potential output growth has stabilized in the last few quarters, but declining trend has been continuing (Chart II.2.3.1).

Potential output growth
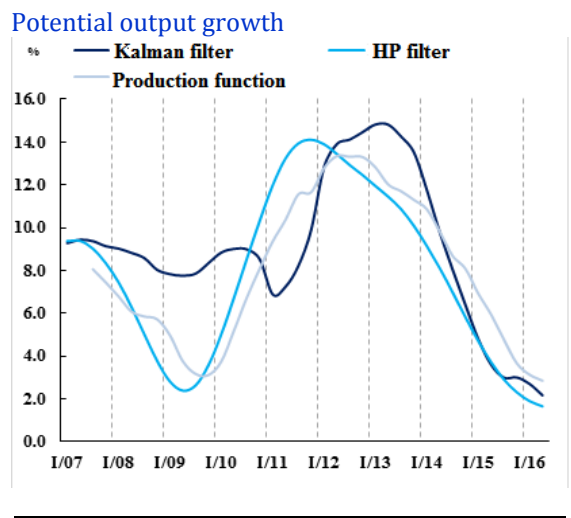
Total output exceeded its potential from 2011-2013 and the output gap[16] was positive due to the positive contribution of non-mining sector. In the last two years, total domestic output remained below its potential with a negative output gap. Although mining output exceeded its potentiak since the second half of 2014, the negative output gap of non-mining output has contributed negatively to the overall output gap. As of 2016 Q2, negative output gap has increased (Chart II.2.3.2).

Output gap /mining and non-mining/

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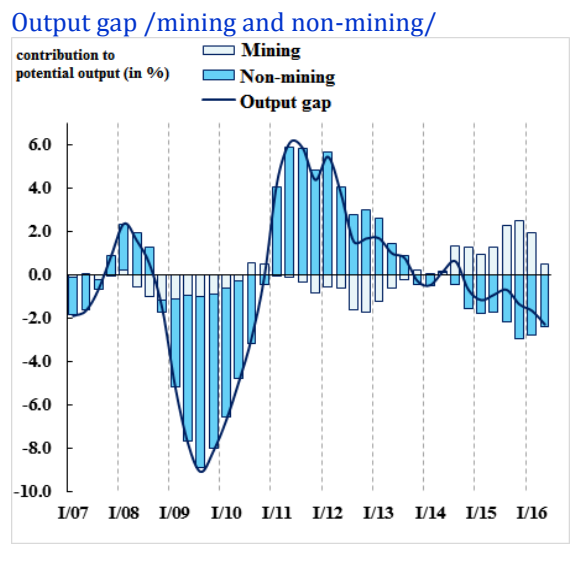
[15] A combination of 1) the purily statistical HP filter, 2) the production function approach which takes into account each factors of production and 3) the multivariate Kalman filter based on the macroeconomic indicators and their inter-relations are used.

[16] Computed by the multivariate Kalman filter.

II.3 Labor market

In the reporting quarter, employment increased in agriculture and services sectors, while declined in manufacturing and trade sectors. Unemployment increased 2.6 percent YoY. The declining trend in labor force participation has continued.

Nominal and real wage growth has continued to slow. Productivity growth had declined, due to weak economic activity.

II.3.1 Employment and unemployment

Labor market conditions have not improved in Q2. Employment has increased, adhering to its seasonal pattern. However, declining trend in unemployment, employment and labor force participation has remained in the last quarters.

The number of employees declind by 1.2 percent and reached 1,131,841 in Q2. Out of which, the number of employees grew by 4.5 percent (13,524) in agriculture and 3.6 percent (14,266) in services sector, while declined by 9.27 percent (17,420) in trade and 9.3 percent (23,870) in manufacturing sector.

The employment status of employed people shows that the number of paid employees, employers and unpaid employees for household production increased, while the number of self-employed, members of partnerships and cooperatives and herders decreased.

Unemployment rate reached 10.4 percent in Q2, 2.6 percentage points increase from a year ago. The number of newly registered unemployed people at the Labor Exchange Central Office grew by 16 percent (1171) and reached 35,253 in Q2. These results are in line with the conclusion that unemployment rate has increased compared to the previous year.

Chart II.3.1.1

Employment increased in agriculture and services sectors, adhering to its seasonal pattern.
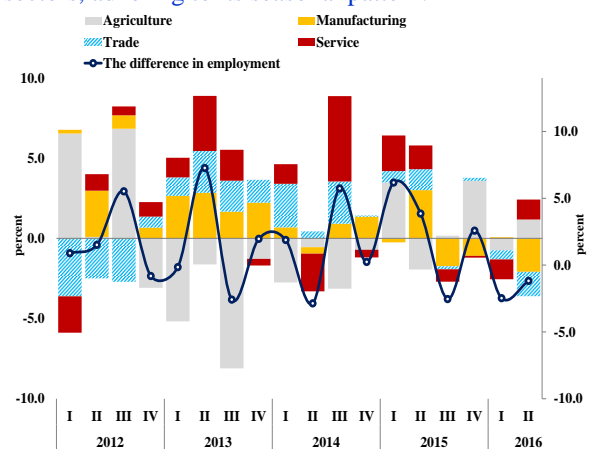
Source: NSO[20]

Table II.3.1.1

Labor market indicators

Year	2012	2013	2014	2015	2015Q2	2016Q2
Employees (thous. people)	1018.2	1038.2	1040.7	1067.6	1145.3	1131.8
Annual growth	*-0.8%*	*2.0%*	*0.2%*	*2.6%*	*3.9%*	*-1.2%*
Agriculture	318	305	322	335	300	314
Manufacturing	182	205	224	207	257	233
Trade	137	152	174	154	188	171
Service	381	377	384	371	400	414
Unemployed (thous.	87.8	87.2	87.0	96.5	97.3	131.9
Annual growth	*13.4%*	*-0.6%*	*-0.3%*	*10.9%*	*-4.0%*	*35.5%*
LFPR*, %	61.6	60.9	60.3	60.5	62.8	60.2
Annual growth	*-2.6*	*-0.7*	*-0.6*	*0.2*	*-0.3*	*-2.6*
Unemployment, %	7.9	7.8	7.7	8.3	7.8	10.4
Annual growth	*0.9*	*-0.1*	*-0.1*	*0.6*	*-0.6*	*2.6*

*Labor force participation rate

Source: NSO

The downward trend in labor force participation has continued since 2011. The working age population[17] increased by 44,054 people, while the economically active population increased by 21,090 people, thus the labor force participation rate declined by 2.6 percent YoY and reached 60.2 percent in Q2. Therefore, a large proportion of the growth in the working age population is attributed to the increase in the economically inactive population. The economically inactive population increased by 13.5 percent YoY in Q2.

III.3.2 Wage and productivity

Nominal wage growth, which has been on a downward trend since 2013, increased in the reporting quarter. Labor productivity has been deteriorating since 2014.

The average nominal wage increased 4 percent YoY in Q2 and reached MNT 888,000. Across sectors, nominal wages decreased for educational sectors (-6.5%) and international institutions and representatives (-5%), while increased for transportation and warehouse sectors (10.8%), construction sector (10.3%) and heating, gas supply, ventilating and air-conditioning sectors (7.5%) (Chart II.3.2.1).

Real wage growth has stabilized since 2015 Q1 and reached 2.8 percent in Q2. Labor productivity growth, calculated by dividing real GDP[18] by total labor force, increased and reached 2.0 percent in Q2, due to declining the number of employees.
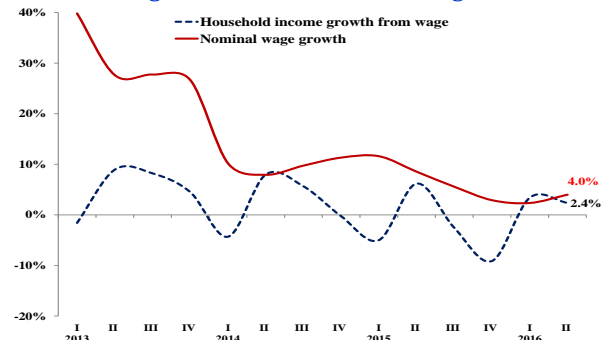
Chart II.3.1.2

Declining trend in labor force participation continues.
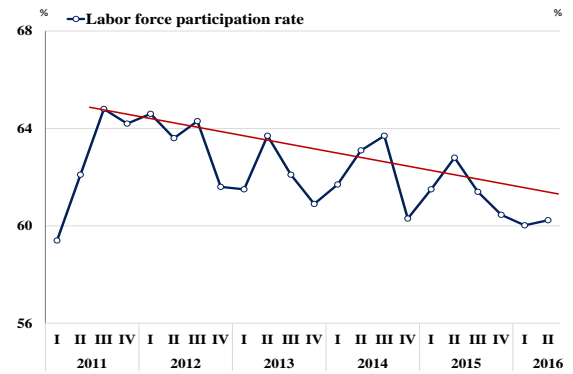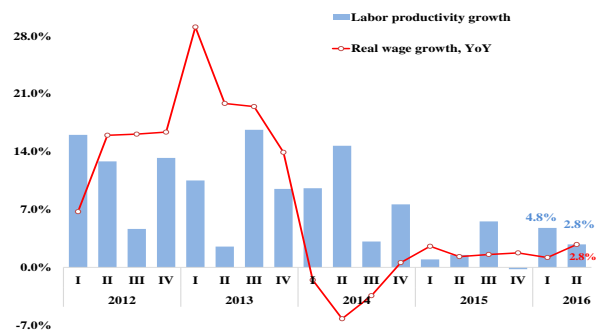

Source: NSO

Chart II.3.2.1

Nominal wages have been deteriorating.

Source: NSO, analysts' estimations

Chart II.3.2.2

Labor productivity growth has been declining.

Source: NSO, analysts' estimations

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[20] Labor force study

[17] According to the Labour Law of Mongolia, the working age population is defined as those aged 15 to 59. In contrast, according to the international standard that the General Authority for State Registration follows, the working age population refers to those aged 15 and over.

[18] Real GDP was calculated through adding the real GDP of the previous 3 quarters to the current quarter.

The unit labor cost[19] (ULC) growth, the main indicator for the average labor cost required to produce one unit of production, increased in Q2. Unit labor cost increased by 2.5 percent in the reporting quarter, due to nominal wage growth exceeded labor productivity growth.

Inflation expectations survey, conducted in Q2, indicates that economic agents expect employment will increase in the coming 6 months.
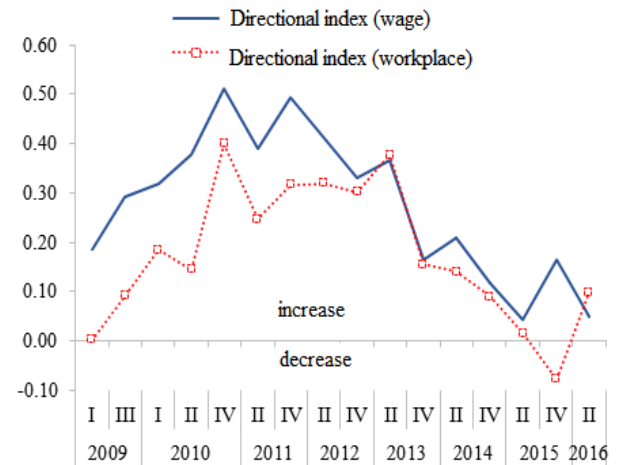
Unit labor cost growth has been increasing.
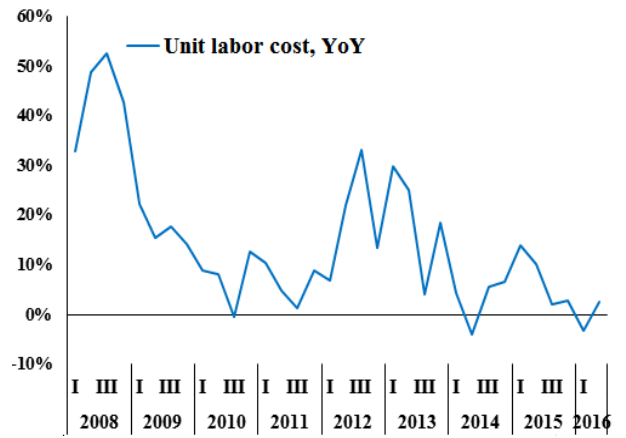
Source: NSO, analysts' estimations

Economic agents expect that employment will increase in the coming 6 months.

Source: Inflation expectations survey

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[19] 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 and credit indicator growths increased in 2016 Q2. Money supply increased by 11.4 percent and total outstanding loans for banks grew by 5.8 percent in Q2.

On the one side, the increase in money supply can be attributed to the increase in net foreign assets. The contribution of net foreign assets to money supply declined, due to diminishing imports of goods and services and current account deficit and declining public sector external debt. On the other side, net domestic assets grew by 13 percent and contributed 16 percentage points to money supply growth in the reporting quarter. This was mainly due to increased budget spending, quasi-fiscal programs and concessional mortgage loans financed by the BoM and the Government of Mongolia.

The increase in money supply was mainly due to the increase in current and deposit accounts denominated in foreign currency of individuals and enterprises, which are the main sources of financing in the banking system. Deposit of individuals and coporations denominated in domestic currency increased by 6.4 percent YoY and contributed 3.5 percentage points to money supply growth. Total outstanding deposit and current accounts denominated in foreign currency has declined in the last 2 quarters, while increased by 16 percent YoY in Q2.

Chart II.4.1.1

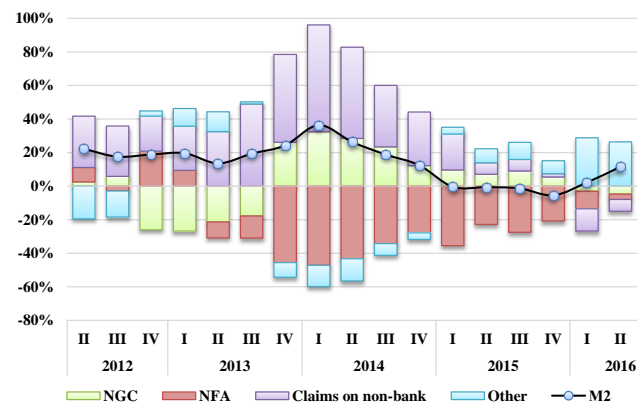Contributions to the annual growth of money supply, assets side

Chart II.4.1.2

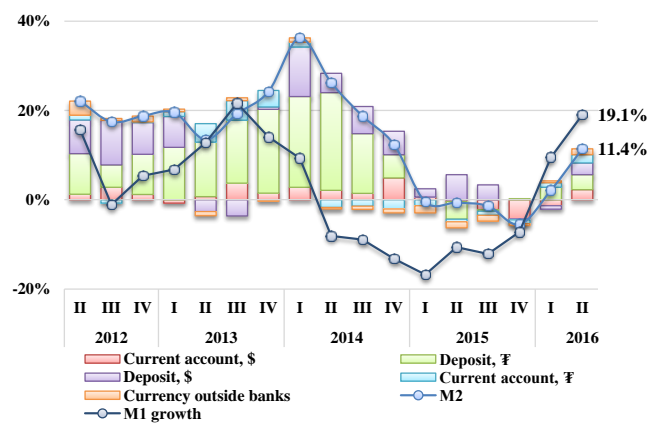Contributions to the annual growth of money supply, liabilities side

Table II.4.1.1

Money supply: assets and liabilities side

In billions of MNT	2013	2014	2015	2016Q2
Net foreign assets	934	-1702	-3909	-3506
Net domestic assets	8527	12338	13959	14673
Money supply /M2/	9461	10636	10050	11188
M1	2093	1817	1685	1981
Currency outside banks	582	499	459	562
Current account, MNT	1511	1317	1227	1420
Quasi money	7368	8819	8365	9207
Deposit, MNT	4917	5410	5434	5632
Deposit, USD	1476	1970	1949	2282
Current account, USD	974	1439	982	1293

23

The loan growth of financial institutions[21] reached 7.2 percent and the amount of outstanding loans issued by all financial institutions reached MNT 18.4 trillion in Q2. Banks represent 63 percent of total outstanding loans, the Development Bank of Mongolia represents 23 percent, and the mortgage loans financed by the BoM represent 12 percent.

Quasi-fiscal financing by the BoM and DBM constitutes the majority of loan growth. Bank loans financed by its own assets increased in the reporting quarter, due to increased loans granted to some companies in June. Total outstanding loans issued by the DBM grew by 13 percent YoY and contributed 3 percentage points to the loan growth of financial institutions. Mortgage loans financed by the BoM also increased by 1.5 times YoY and contributed 4 percentage points to the loan growth of financial institutions.

Total outstanding loans by depository corporations[22] grew by 0.6 percent YoY. Across sectors, consumption and private sector loans increased, while mortgage and SME loans of individuals declined. Total outstanding consumption loans[23] increased due to increased pension loans, but the growth pace has been declining and reached 2 percent YoY in Q2. Pension loans have increased, caused by declining nominal and real income of households.

Classifying by economic sectors, the loan growth in most sectors has been declining. Total outstanding loans in processing and real estate sectors have declined in the last 3 quarters, while in construction sector declined in the last 6 quarters. In constrast, total outstanding loans in trade sector, which had declined since the beginning of 2015, grew by 6 percent YoY in Q2, due to 40 percent of total loans was registered in trade sector.

Chart II.4.1.3

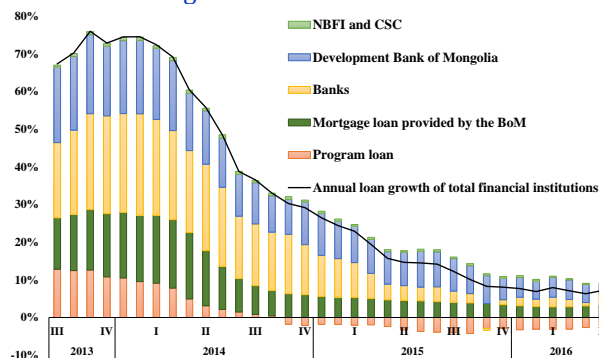Total credit issued by financial institutions, by contributions to growth

Chart II.4.1.4

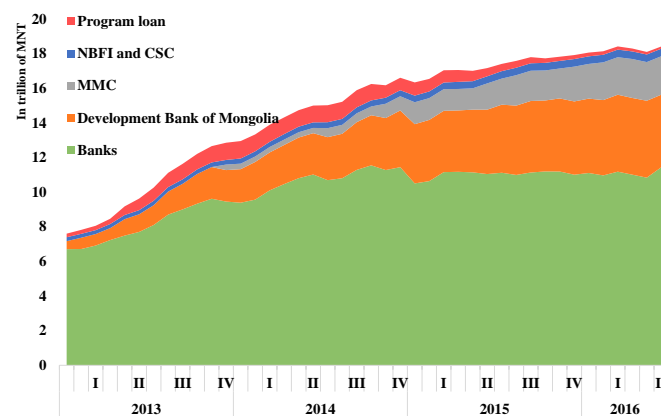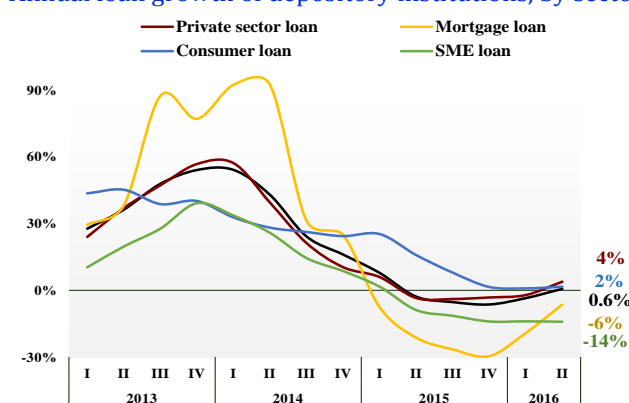Total credit issued by financial institutions, by contributions to level

Chart II.4.1.5

Annual loan growth of depository institutions, by sectors

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[21] Financial institutions are comprised of banks, savings and loan associations, Mongolian Mortgage Corporation (MMC), Development Bank of Mongolia (DBM) and nonbanking financial institutions (NBFI).
[22] Depository institutions comprise of banks and savings and loan associations.
[23] Consumer loans are comprised of salary, consumer, pension, card, and savings secured loans.

Newly issued bank loans, which had declined during 2015, grew by 28 percent in Q2, due to increased newly issued loans to trade sector, financial and insurance services and individuals. Diminishing households' income led to the increase in pension loans by 62 percent YoY and consumption loans by 12 percent YoY in Q2, thus the increase in pension and consumption loans contributed 8 percentage points to newly issued loan growth. Although the growth of newly issued bank loans reached 28 percent YoY, excluding the large loans granted to specific companies the growth was 10 percent YoY in Q2 and consumption loans constituted the majority of newly issued loans.

Non-performing and over due loans have been increasing, due to slowing economic growth and business activity. The proportion of over due and non-performing loans in total loans increased by 2 percentage points since the end of 2015 and reached 16 percent in Q2. Across sectors, the amount of over due loans in mining and construction sectors has rapidly increased, indicating that there exists high risk of increasing non-performing loans. Moreover, non-performing and over due loans have been increasing in other sectors, indicating that banking sector remains at high risk.

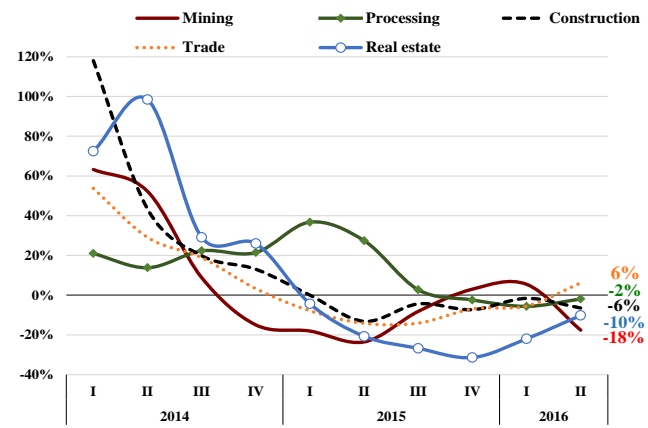Annual credit growth of depository institutions, by sectors
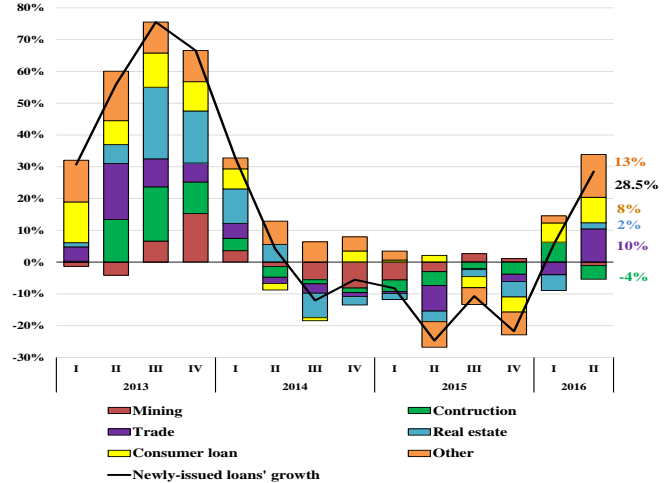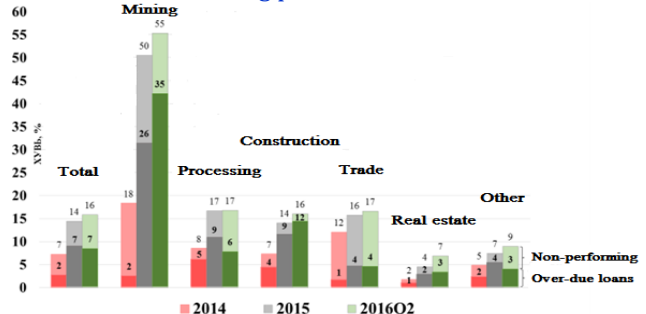
Annual growth of newly issued bank loans, contributions by sector

Non-performing and over-due loans, by percentage of total loans outstanding per sector

II.4.2 Interest rate

As its meeting on May 2016, the Monetary Policy Committee (MPC) of the BoM decided to cut the policy rate by 1.5 percentage points to 10.5 percent. Since the decision, the interbank market rates declined, but remained at the upper limit of the interest rate corridor. Particularly, the repo rate, overnight lending and deposit rates have been 0.3-0.7 percentage points higher from the policy rate in the interbank market in July 2016. To keep the interbank market rates at the target level, the BoM mopped up MNT 119 billion in net terms from the interbank market and the Central Bank Bill (CBB) declined by MNT 211.4 billion in Q2.

The short-term government treasury bill yield declined to 13.2[24] in April 2016 and remained at the current level as of July 2016. The short-term government treasury bill yield declined and the purchasing offer of the long-term government treasury bill has stopped since February 2016, indicating weakening trading activity of government treasury bill in the secondary market.

Regarding banks' lending and deposit rates, the lending rate denominated in MNT[25] decreased by 1.1 percentage point YoY, while the deposit rate denominated in MNT increased by 0.3 percentage points in Q2. As of July 2016, excluding concessional loans, the lending rate denominated in MNT has remained at the beginning of this year's level. This shows that the lending rate has decreased, due to concessional loans financed by the BoM and DBM. The lending rate of the loans financed by banks' own assets increased, due to weakening economic activity and increasing non-performing and over due loans. Excluding the low interest rate loans, the lending and deposit rate gap decreased by 0.2 percentage points from the beginning of 2016 and reached 6.0 percent. Excluding the concessional loans, the lending and deposit rate gap remained high.

Chart II.4.2.1

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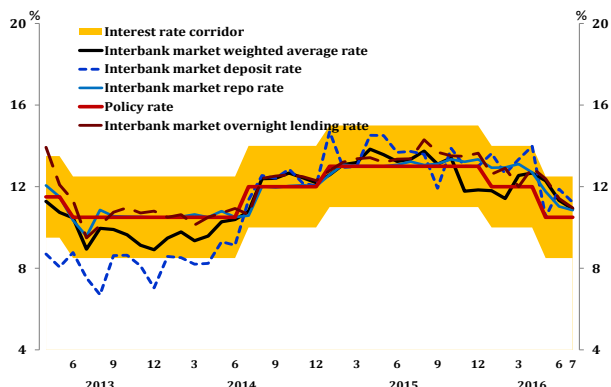

Chart II.4.2.2

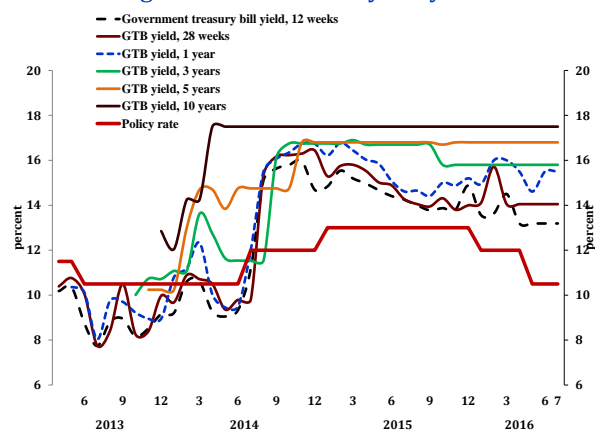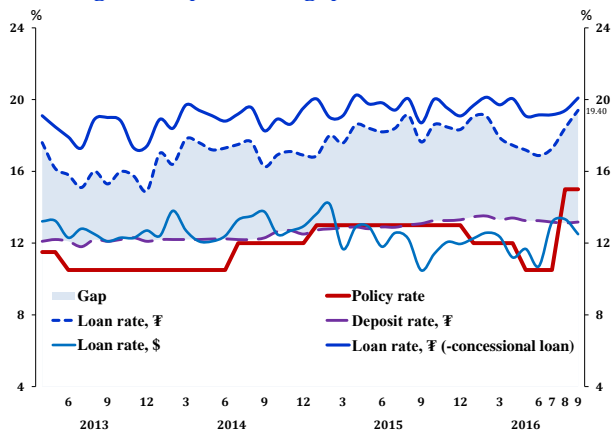Short-term government treasury bill yield declined.

Chart II.4.2.3

Lending and deposit rate gap increased.

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[24] Government treasury bill yield with the maturity of 12 weeks (3 months) in the primary market
[25] Lending rate including concessional loan rates

The relative return of togrog sharply declined and remained negative in the reporting month, due to togrog has depreciated by 3.4 percent against USD from the previous month. Declined relative return of togrog led to 14 percent increase in current and deposit accounts denominated in foreign currency.

Chart II.4.2.4

Relative return of MNT has been negative.

Relative return of MNT —— Monthly average rates for MNT/USD

27

II.4.3 Exchange rate

Togrog has appreciated modestly against USD in Q2 2016 /Chart III.4.3.1/. Togrog has appreciated by 1.5 percent or MNT 30.3 against USD in Q2 from the previous quarter, while depreciated by 2.8 percent or MNT 54.8 and reached MNT 1994.3 in Q2.

In the reporting quarter togrog has appreciated, but macro fundamentals have changed in direction to togrog depreciation. Particularly, terms of trade slightly increased from a quarter ago, while deteriorated from a year ago and current account deficit increased YoY. Moreover, the balance of payment was in deficit, due to declined surplus of capital and financial accounts /Chart II.4.3.2/. Togrog has appreciated in a short time, mainly due to increased dollar supply in line with USD 500 million worth of bonds issued by the Government of Mongolia and USD 250 million worth of loan.

The nominal effective exchange rate (NEER) appreciated by 3.4 percent YoY, while the relative price rose by 0.3 percent YoY and the real effective exchange rate (REER) appreciated by 3.8 percent YoY in Q2 /Chart II.4.3.2/. This was due to togrog has appreciated against RUB and CNY. Togrog appreciated by 3.1 percent YoY and 2.4 percent QoQ against CNY, while depreciated by 10.5 percent QoQ and appreciated by 15.7 percent YoY against RUB.
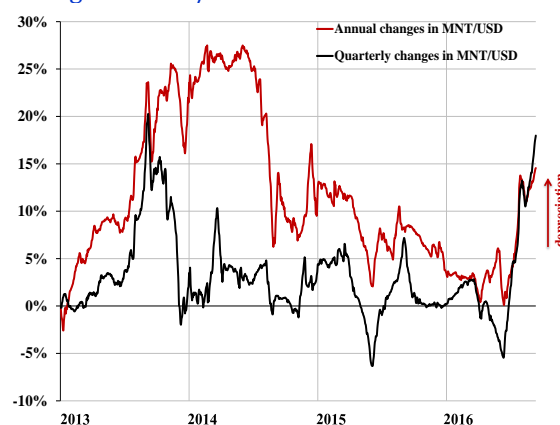
Chart II.4.3.1
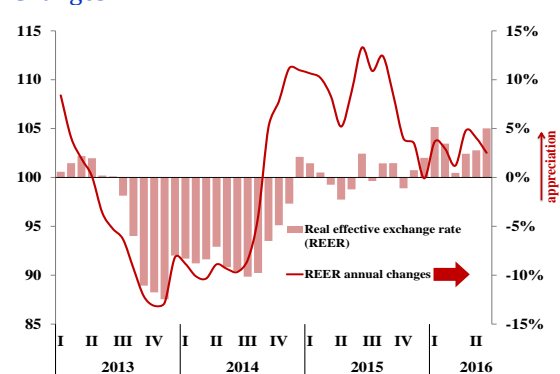
MNT/USD exchange rate
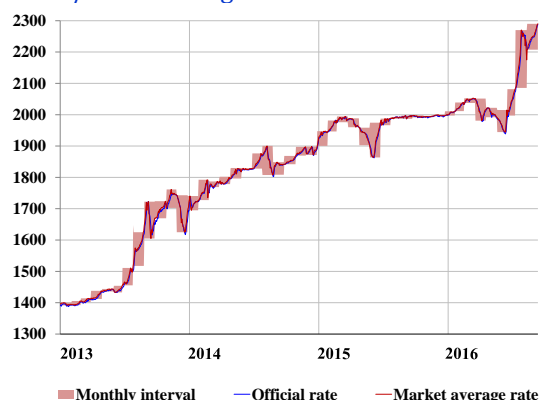
Source: BoM

Chart II.4.3.2

Changes in MNT/USD

Source: BoM

Chart II.4.3.3

Changes in REER

Source: BoM

II.4.4 Real estate market

Housing prices continued to decrease, while rental prices continued to increase. The housing price index, published by the National Statistical Office (NSO), declined by 1.5 percent QoQ and 10.4 percent YoY. The housing price index, conducted by Tenkhleg Zuuch LLC, also showed a declining trend, with an 11 percent decline YoY in Q2. The average price of old apartments and new apartments fell by 15.8 percent and 6 percent YoY, respectively. Meanwhile, rental prices showed a tendency to increase for the last 4 quarters, but have stabilized in the reporting quarter. In particular, rental prices rose by 4.6 percent YoY and 3.3 percent QoQ and the annualized growth rate of rental prices reached 14 percent in Q2 (Chart II.4.4.1).

The housing purchasing power of individuals has been decreasing, as observed from the stable levels of the housing price-to-income ratio and the decline in the price-to-rent ratio. This indicates that the housing bubble is subduing and demand is declining. As of 2016 Q2, housing prices decreased by 1.5 percent, rental prices by 3.3 percent, and household income by 3.7 percent YoY (Chart II.4.4.2).
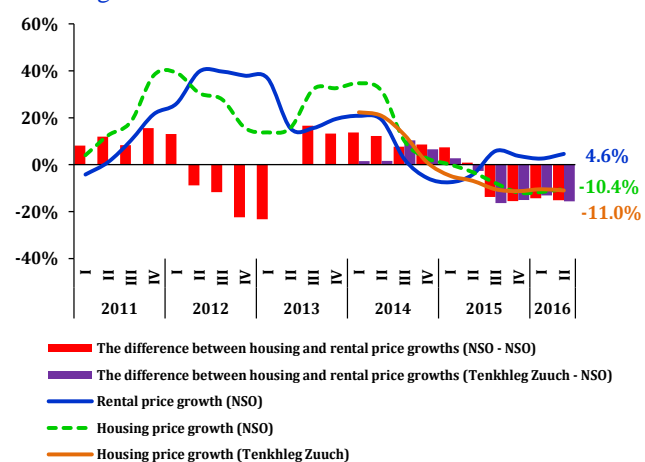
According to the construction cost index, construction material costs have remained relatively stable since 2015 Q2 to Q4. However, the costs showed a tendency to increase in 2016. Due to this, the construction cost index increased by 2.5 percent YoY, while declined by 0.4 percent QoQ in Q2 (Chart II.4.4.3).

Housing purchases by individuals have been decreasing. According to the Property Rights Registration Agency (PRRA), 3,952 new apartments were sold and issued certificates, a decrease of 15.9 percent YoY and 8 percent QoQ, adhering its seasonal pattern.

Although the number of newly built apartments has decreased by 9 percent QoQ, it remains above housing demand. According to Tenkhleg Zuuch LLC, approximately 13,560 apartments will be entering the housing market in the remaining period of 2016.
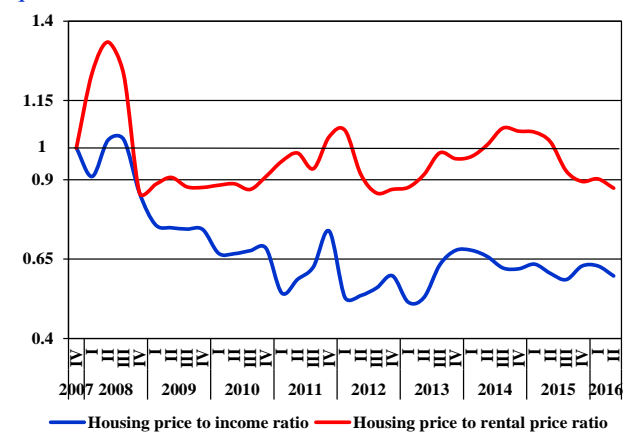
Chart II.4.4.1

Rental prices have been increasing, while housing prices declining...

- The difference between housing and rental price growths (NSO - NSO)
- The difference between housing and rental price growths (Tenkhleg Zuuch - NSO)
- Rental price growth (NSO)
- Housing price growth (NSO)
- Housing price growth (Tenkhleg Zuuch)

Source: NSO, analysts' estimations

Chart II.4.4.2

The housing price bubble has been subdued across the last quarters...

- Housing price to income ratio
- Housing price to rental price ratio

Source: NSO, analysts' estimations

Chart II.4.4.3

The construction cost index has been rising.

- Newly registered housing
- Construction cost index
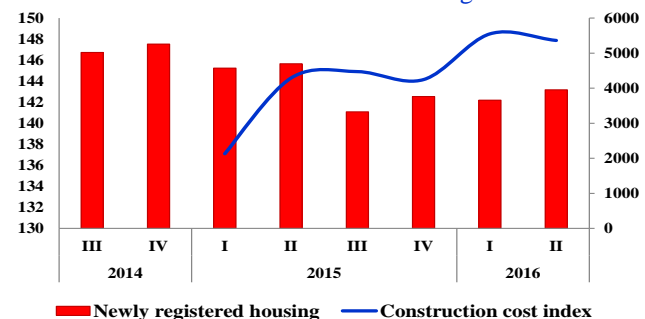
Source: NSO, PRRA

Stock market indicators have remained highly volatile over the last two quarters, while it had declined since September 2014. In the reporting quarter, TOP-20 average indicators have declined until May, whereas have increased again since June. Meanwhile, market capitalization reached MNT 1.42 trillion in Q2, which was a 1.0 percent increase YoY and a 9.7 percent increase QoQ. The TOP-20 average indicators decreased by 11452.0 units or 21.5 percent YoY, but increased by 2.3 percent QoQ (Chart II.4.4.4).

In Q2, total volume of shares were traded at MNT 4.9 billion. Out of which, 52 percent of shares amounting to MNT 2.54 billion considered block trading and 47.8 percent of shares amounting to MNT 2.33 billion considered ordinary trading. Particularly, "Mon-It Buligaar" LC, "Mongol post" LC, "APU" LC, "Khusug trade" LC and "Shimtleg" LC traded 7.95 million shares through block trading.

Stock market capitalization and TOP-20 index increased from a quarter ago.

■ TOP-20 index ⬅   ⭕ Market Capitalization (in millions of MNT) ➡
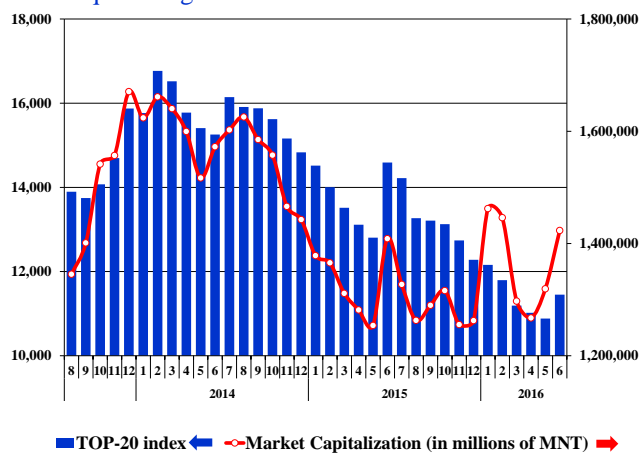
Source: Mongolian Stock Exchange

Table II.4.4.1

MNT 143.3 billion of mortgage loans were securitized by MMC in 2016 Q2...

	Issued date	Volume (in millions of MNT)
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
9	April 6, 2016	143,300.000
	TOTAL	**2,501,362.400**

Source: MMC

30

II.5 Balance of payments

Despite the current account of deficit amounting to 27% of GDP in 2011-2012, the capital and financial accounts surplus led to a positive balance of payments. Although the current account deficit has been decreasing since 2013, so has the capital and financial account surplus due to declining foreign direct investment, resulting in a negative balance of payments (Chart II.5.2.2). As of 2016Q2, the current account deficit amounted to USD 137.4 million and the capital and financial account surplus amounted to USD 249.9 million. As such, the total balance of payments was in deficit of USD 8.2 million. [26]

II.5.1 Current account

Declining global market prices of mining products, which constitutes approximately 90% of Mongolia's exports, have led to reduced total exports. However, the fall in foreign direct investment has led to a higher decline in investment-related imports than in total exports. As such, the balance of trade has been positive for 10 consecutive quarters and has contributed to lessening the current account deficit (Chart II.5.1.1)

Although, bought services and outgoing transfer payments by Mongolian individuals and enterprises have outweighed the sold services and incoming transfer payments, contributing to the current accounts deficit.

Despite declining transport costs due to fewer imports, expert services bought from abroad have steadily increased and contributed to the services deficit. In 2016Q2, increase in the costs of other services such as business consultants for large mining companies, and construction, finance. Architecture, engineering, and technical have led to a services deficit increase of USD 149 million YOY. (Chart II.5.1.2)

An increase in Mongolia's net international investment position has led to an increase in interest and dividend payments made abroad, contributing to the income account deficit. While the current account deficit has been decreasing overall, the proportion of income account deficit within it has continued to grow. For example, the income account deficit amounted to 22% of the current account deficit in 2013 and 70% in 2014, growing to 206% in 2015 and 132% in the second quarters of 2016. (Chart II.5.1.3)
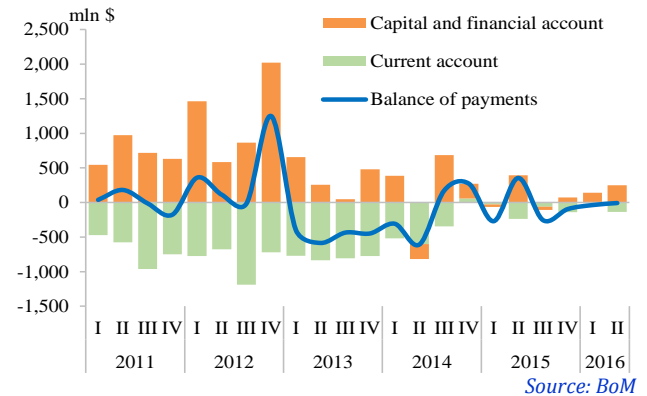
Chart II.5
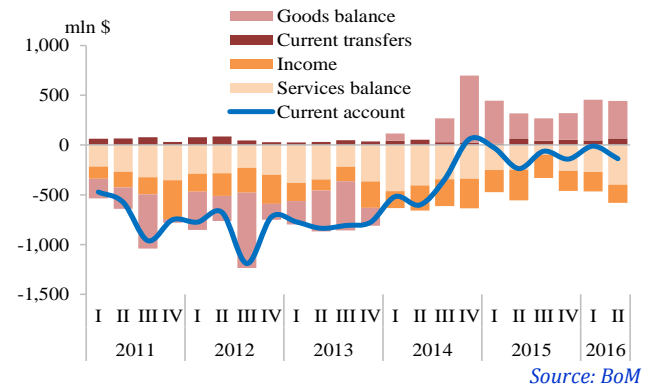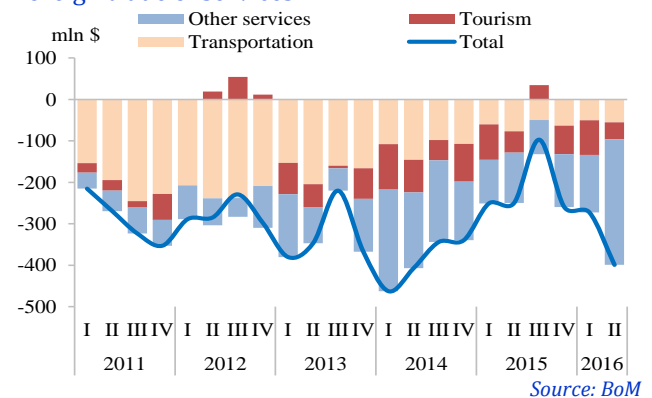
Balance of payments

Source: BoM

Chart II.5.1.1

Current account

Source: BoM

Chart II.5.1.2

Foreign trade of services

Source: BoM

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[26] Net statistical errors and omissions amounted to USD -120.7 million in the reporting period.
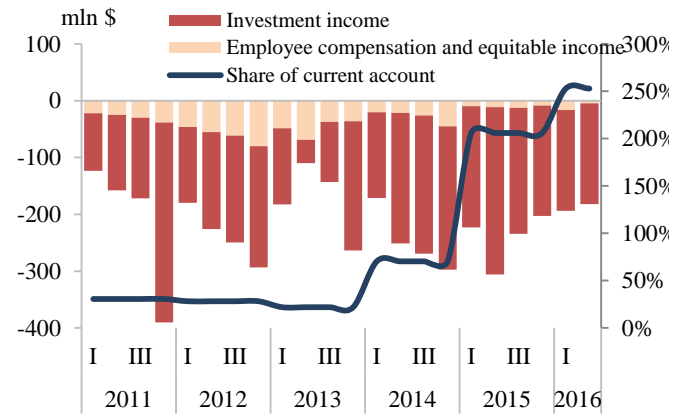
II.5.2 Capital and financial account[27]

The financial account saw a high from 2011-2013 due to foreign investment (FDI) inflows and balanced the current account deficit. However, due to both foreign and domestic economic shifts, FDI and consequently the financial account surplus began decreasing 2014. This decline was balanced by the portfolio and other investment account surplus. For example, despite foreign direct investment reached USD 238.5 million deficit in net terms (excluding the Oyu Tolgoi underground mine financing), financial account was in surplus due to bonds issued by the Government of Mongolia as of 2016 Q2 (Chart II.5.2.1).

The balance of payments deficit amounted and the official foreign exchange reserves fell to USD 1,297 million as of June 2016, a 23% decrease YoY. The reserves are sufficient for 5.1 months of retained imports of goods payable in foreign currency that was measured as the average of last 3 months of imports. (Chart II.5.2.2)

Chart II.5.1.3

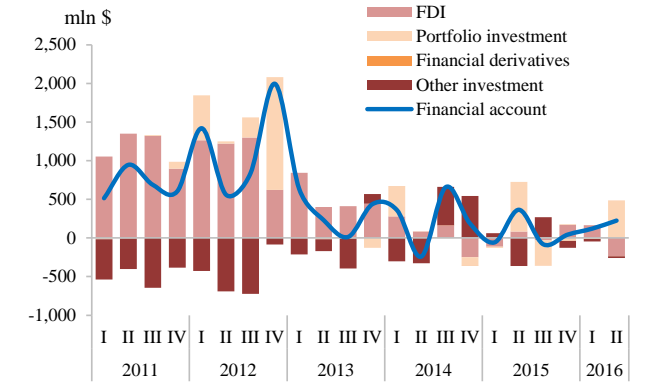Income account

Source: BoM, General Authority for Customs and Taxation
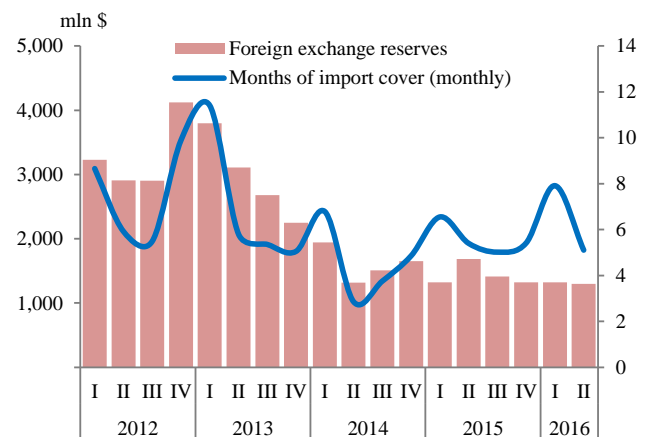
Chart II.5.2.1

Financial account

Source: BoM

Chart II.5.2.2

Foreign exchange reserves

Source: BoM

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[27] In 2016 Q2 actual estimates, capital and financial account was updated by Oyu Tolgoi's loans in line with the underground mine development and the loans in net terms paid by the company's investors.

II.5.3 Terms of trade

Terms of trade deteriorated by 25 percent y-o-y as of the end of 2016Q2. Such decline was primarily contributed by the decline in export prices, despite lower import prices.

A 27 percent decline in export prices was mainly caused by a 20 percent decline in the prices of copper concentrates, a 19 percent decline in the prices of crude oil, a 17 percent decline in the prices of iron ore and a 29 percent decline in the prices of coal.

On the other hand, terms of trade improved as crude oil price index deteriorated by 26 percent YoY.

Chart II.5.3.1

Terms of trade

Source: BoM, GACT

33
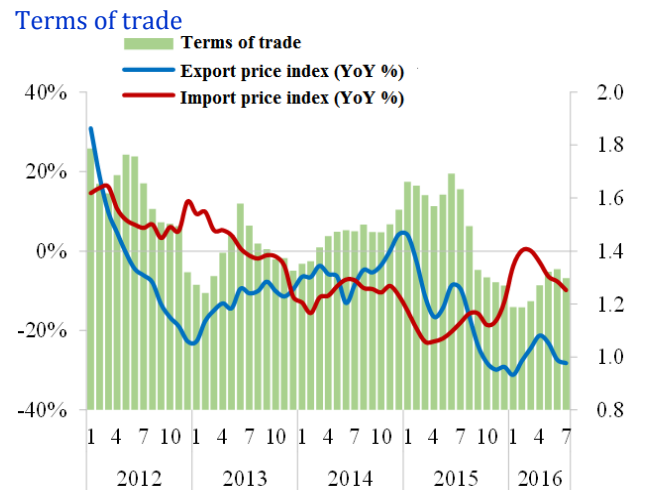
II.6 External environment

In 2016 Q2, the Eurozone's economic growth slightly beated estimations, while the US and China's growth decelerated. China's consumption and retail sales growth supported the economy, but falling exports due to weak external demand and declining investments in real estate sector contributed to slow economic growth. Declining invesments and industrial production negatively contributed to the US economy in the reporting quarter. Meanwhile, weak oil price and unconventional monetary policy by the ECB supported the Eurozone's domestic demand and economy. Russia's economic growth will likely see recovery due to reduced inflation, labor market recovery, and accelerating services sector.

Gold prices fell after the announcement of the Federal Reserve to remain the policy rate at current level. Meanwhile, coal, copper and iron ore prices increased in July as the US dollar has weakened due to the Federal Reserve rate hike delay and China has decreased coal, iron ore and coal imports. Oil prices remained relatively low (USD 45-48) in the reporting quarter due to a growing oil supply surplus as Saudi Arabia and Iran has been increasing oil production, despite declining oil production in Nigeria and the Middle East caused by political instability.

### II.6.1 Economic developments in main trading partner economies

Chinese economy

The Chinese economy grew 6.7 percent in 2016 Q2. China's consumption has been growing and affected positively to economic growth, due to a soft budget policy implemented by the government since Q1 and increased infrastructure investment. In contrast, declining fixed asset investment growth negatively contributed to the growth. Particularly, services sector growth reached 7.5 percent in June as retail sales growth reached 10.6 percent, while it was 10 percent in the first 5 months. Meanwhile, fixed asset investment growth fell to 8.3 percent in Q2, while it reached 10.5 percent in Q1. Public sector investment growth reached 23.5 percent, while private sector investment increased only by 2.8 percent YoY in Q2.

China's capital outflow has increased, due to rebalancing and economic slowdown. However, growing China's exports offsetted this effect. Housing prices have risen and sales have grown rapidly due to stimulus measures implemented since 2014. In September 2015, the minimum down payment for first home buyers was lowered from 30 percent to 25 percent and a further discretionary 5 percentage point cut was authorised in February 2016. However, housing prices have fallen again over the last 2 months, caused by ineffieciency and excess supply in construction sector. Due to this,

Chart II.6.1.1

Chinese economic growh, in percentages /YoY/

34
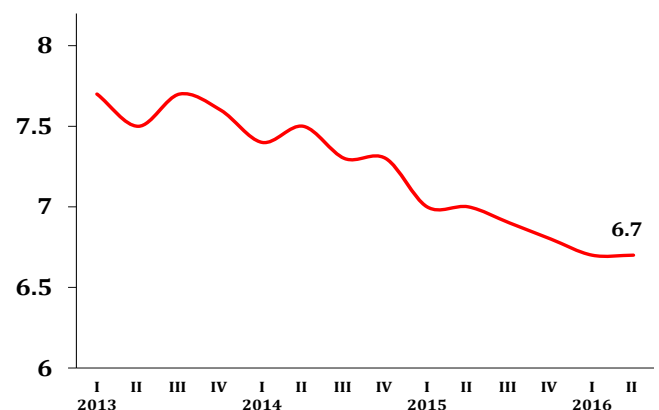
commodity prices are projected to decline, but analysts expect that prices will increase following infrastructure investment. Thus, China is trying to achieve economic growth above 6.5 percent over the 2016-2020 period by implementing soft monetary and fiscal policy.

Russian economy

The Russian economic growth reached -0.6 percent in Q2, better than estimated, due to a recovering construction sector and growing industry, transport and agriculture sectors.

Inflation has been declining since the beginning of 2016 and reached 7.3 percent in May. Thus, the Monetary Policy Committee of the Central Bank of Russia decided to reduce its policy rate by 50 basis points to 10.5 percent. Despite declining inflation, budget deficit is increasing and source of financing for the deficit remains unclear. Due to this, the Monetary Policy Committee decided to remain its policy rate at 10.5 percent in July.

Russian economic growth, in percentages /YoY/
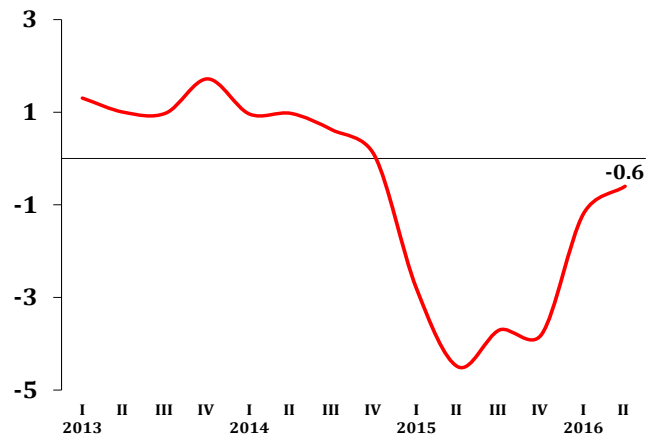
US economy

The US economy grew at a lower than expected pace of 1.2 percent in Q2, due to a 9.7 percent decline in total investment followed by oil and construction sector investment decline. In contrast, private consumption positively contributed to GDP growth as favourable labor market supports the household consumption. In July, unemployment rate fell to 4.9 percent, labor market participation rate remained at 62.8 percent and average wage increased. This led to a 4.2 percent increase in private consumption.

The Federal Reserve kept interest rates unchanged at 0.5 percent in July, as inflation remained below its target level and the economy grew at a lower than expected. Moreover, the Fed is unlikely to hike interest rates due to increasing market uncertainty. However, the Fed officials announced at least one rate hike in 2016, leading to a hike in interest rate in December.

US economic growth, in percentages /YoY/
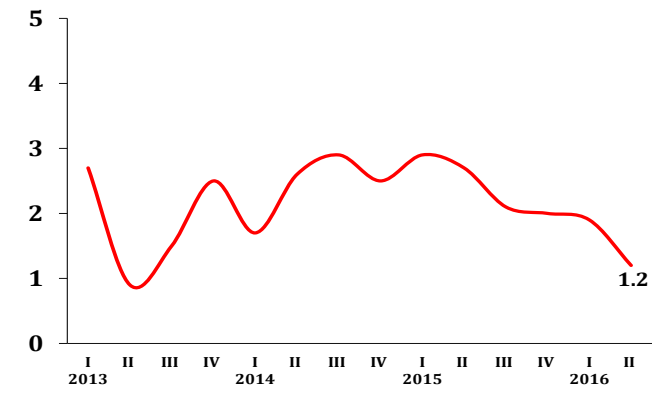
Eurozone economy

The Eurozone economy grew 1.6 percent in Q2, due to weak oil price and soft monetary and fiscal policy. Unemployment rate in Eurozone fell to 10.1 percent in Q2, while it was 10.2 percent in Q1.

PMI index, which indicates business activity, increased by 1.3 points and reached 52.8 in June 2016. However, due to the UK leaving the Eurozone /BREXIT/ business confidence declined by 0.2 points and reached 51.8 in August. BREXIT increases uncertainty in Europe with a strong risk of recession in the United Kingdom, thus analysts have reduced regional economic growth estimates for 2017.

Chart II.6.1.4

Eurozone growth, in percentages /YoY/
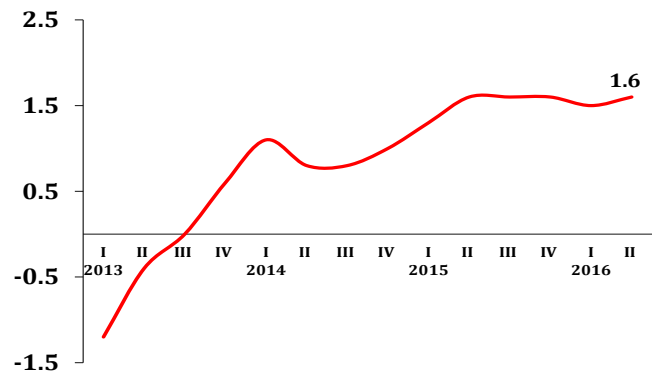
III.6.2 Prices of Mongolia's main exporting commodities

Copper: The price per 1 ton of copper was on average USD 4,736 in 2016 Q2, reached USD 4,865 in July and fell to USD 4,757 in August. Deceleration in China's construction sector led to a 14.3 percent decrease in copper imports in July, the lowest level since August 2015. Despite China announced cutting outputs of refined copper by 350,000 metric tons in 2016, copper prices have been declining for the past few months.

Gold: The price per 1 ounce of gold was on average USD 1,260 in 2016 Q2 and increased to USD 1,343 in August. Gold demand has been falling due to depreciation in China and India's domestic currency and an increase in consumption tax. In contrast, due to political and social instability such as the UK leaving the Eurozone, Turkey's massive distraction, terrorist attacks in France, etc investors are willing to invest in gold. Moreover, the Federal Reserve delayed hiking interest rates, leading to an increase in gold demand and prices.

Brown coal: The price per 1 ton of brown coal was on average USD 51 in 2016 Q2 and grew to USD 58 in August. China began to cut coal output to fight air pollution and coal imports have risen by 30.7 percent YoY in July. Due to this, coal prices have increased for the past few months. However, analysts expect that coal prices will decrease again in 2017.

Coking coal: The benchmark prices of Australian well-qualified coking coal supplied to Japan was on average USD 84 per ton in 2016 Q2 and grew to USD 92 per ton in August. Also, Australian coking coal market price reached USD 113 per ton. Coking coal prices increased, mainly due to an 11.8 percent increase in coal imports in China followed by coal output cut.

Crude oil: Brent crude oil price per barrel was on average USD 45 in 2016 Q2 and fluctuated around USD 45 in July-August. Oil outputs have been declining for non-OPEC countries such as Nigeria and the Middle East due to political instability. In contrast, Saudi Arabia and Iran have been increasing oil output moderately, leading to remained oil prices at low level.

BANK OF MONGOLIA