BANK OF MONGOLIA

INFLATION REPORT

2018

MARCH

Monetary policy strategy and decision

According to the Central Bank law, **main objective of the Bank of Mongolia is to stabilize togrog.** Within this objective, in the medium run the Bank of Mongolia implements monetary policy to stabilize annual inflation rate measured by the consumer price index around its target rate set by the Monetary Policy Guideline. By stabilizing inflation at a low rate, the Bank intends to safeguard the real income and asset of households, facilitate an environment conducive to banking and financial system stability and promote investments and sustainable economic growth in the long run. Thus, based on the international best practice, monetary policy strategy of the Bank of Mongolia is gradually adopting inflation targeting framework.

In case of sudden fall or overheating of domestic demand, the Bank of Mongolia alters the monetary policy rate to change the money market interest rate and thus affect the inflation rate through its policy transmission to total output, asset prices, market expectations, exchange rate and domestic demand. In addition to policy rate, in the international case it is common to apply macroprudential policy measures such as adequacy ratios to the banking sector as a whole to cool down overheating credit market, curb overcrowding of certain financial products in certain economic sectors and limit financial dollarization.

Successful implementation of the inflation targeting monetary policy strategy depends on the Central Bank's ability to sustain market confidence and manage its expectations effectively. To this end, the Bank of Mongolia publishes inflation report each quarter to inform the public on the performance and forecasts of macroeconomic indicators, inflation, near term economic outlook and factors that influence overall economic outlook such as external environment, financial sector, aggregate demand, aggregate supply, employment, prices and costs. Informing the public on monetary policy decisions consistent with the Central Bank's target and inflation forecasts, and on objective of the decision makers, serves the purpose of facilitating the Central Bank transparency, building public confidence in the Central Bank, thus supporting the Central Bank's policy objective to stabilize inflation around its medium term target rate by managing the market's expectations.

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EXECUTIVE SUMMARY

Although inflation increased steadily in 2017, it has been consistent with the monetary policy target[1] and is expected to stabilize around the target rate in 2018. In the first half of 2017, contents of the consumer basket, methodology of consumer price index and its weights were modified and prices of certain items increased due to tax hike. In the latter half, overall inflation increased due to deflation in the base year and supply factors. Although in recent months, risk of both demand and supply pressure on inflation is increasing, impact of tax hike and other one-off effect of certain items from the previous year are expected to fade in the remaining months of 2018.

Overall economic growth is driven by production acceleration in the mining sector and the non-mining sector, which is supported by the increased investments to the mining sector. Higher prices of export commodities and recovery in market confidence are among the main driving forces of economic growth. Demand related positive developments are boosting employment and household consumptions. Thus, ending a contraction of 4 consecutive quarters, the household consumption started to support domestic demand in the latter half of the year. From the supply side, growth in transportation, manufacturing and trade sectors as well as increased net taxes made significant contributions to economic recovery. Due to indirect impact of higher production and construction activities in the mining sector, non-mining sector has been growing continuously in the past 5 quarters. Agriculture sector on the other hand is contracting due to lower harvest caused by harsh weather conditions. Similarly, mining sector itself has declined due to lower metal concentration within the Oyu Tolgoi copper concentrate, the non-tariff export ban set on coal exports at the border and lower mining production of coal relative to the previous year.

Employment increased in all economic sectors and number of people unemployed has declined. However, as the employment growth exceeded total production, output per labor declined. Although the number of people employed with salaries and wages remained the same as previous year, the number of people running their own private business increased by nearly 50 percent.

External demand and terms of trade improved as economic growth of main trading partners and prices of main commodities increased beyond expectations. In the reporting quarter, growth of Chinese economy exceeded previous forecasts, following higher exports and services. In case of Russia, increased household consumption and private investments supported economic recovery. In addition, the OPEC's November decision to cut oil productions in 2018 boosted Russia's economic outlook. Economic growth in the Euro area reached its highest point since 2011, mainly due to expansionary fiscal and monetary policy measures, receding political uncertainties, improvement in the outlook of its main trading partners and recovery in the labor market. In case of the USA, unemployment declined, labor market indicators remained resilient, and investments and exports recovered, thus pushed economic growth above its previous forecasts.

Although economic growth in the Euro area exceeded previous forecasts and the international research agencies revised their growth forecasts up, external demand is still expected to contract in the following years. For instance, alerted by high debt of the private sector, Chinese authorities are reducing their growth targets gradually and starting to curb investments to the manufacturing and real estate sectors in

[1] Inflation is at 6.4 percent nationwide and 7.2 percent in Ulaanbaatar city, and core inflation is at 7.0 percent.

the medium term. Consequently, such policy action would reduce production of copper and steel, and create risk of lower iron ore imports from Mongolia. In case of Russia, steady growth of household consumption, mix of contractionary fiscal and expansionary monetary policies, stable oil prices and appreciating ruble exchange rates are likely to support economic recovery. Nevertheless, high budget deficit poses risk to its overall economic outlook.

Global prices of Mongolia's main export commodities have been on the rise. Coupled with high and steady demand for copper, potential disturbance to copper supply at some major Latin American copper mines due to issues regarding labor contract renewals, has led to higher copper price. In case of gold, depreciating USD exchange rates and increased yield on bonds are pushing its price up. As Chinese authorities started to diminish their coal mining in an attempt to reduce air pollution, coal price is rising. Lower stock of oil at the US warehouses is leading to higher demand for oil. Copper price outlook is supported by forecast of higher copper demand and higher investment to electricity, construction and manufacturing sectors in China. The gold price outlook is also supported by the Federal Reserve's decision to hike its short term interest rate step by step, uncertainties regarding the tax reform and low and stable inflation rate in developed economies. Coal price on the other hand is expected to decline in the medium run due to expectations of lower demand from China and greater supply from Australia, Canada and South Africa. Global supply of oil is forecasted to increase as the US oil exporters are expected to profit from the tax reform and mining productions in non-OPEC countries are likely to increase.

Although the current account balance worsened, greater surplus in the financial accounts led to improvement in the overall balance of payments. In case of the current account, following increased external debt and other payments of Mongolia deficit of income account widened, and due to increased foreign trade and economic activities deficit of balance on transportation and business service also widened. In addition, the current account is further worsened by higher cost of foreign service related to the construction activities in mining sector and export limited by the delay in coal transportation at the border. In case of the financial account, the surplus was supported by funding through the "Extended Fund Facility" program, receipts of the government's newly issued "Gerege" international bond and investments to the underground mining of the Oyu Tolgoi project.

Budget deficit in 2017 was lower than previously estimated, owing to overperformance of equilibrated revenue and underperformance of total expenditure. Equilibrated revenue collection exceeded forecasts following greater foreign trade turnover and economic recovery. In particular, following the tax hike, excise tax revenue collected from automobile sales increased by over 60 billion togrog from previous year. Debt service fee, which has been increasing significantly in recent years, reached 16 percent of total equilibrated revenue in 2017. As the budget deficit declined, the fiscal impulse implies a tighter stance of fiscal policy from previous year.

Monetary indicators continue to accelerate and credit growth is rising gradually. Coupled with greater foreign exchange reserves, lower budget deficit and greater external funds to finance the budget deficit are freeing up more financial resources for new credit. Thus credit to the consumption and mining sector increased significantly from previous year and made the greatest contribution to money supply growth. From the liability side of the banking sector, supported by recovery in expectations regarding macroeconomic conditions, dollarization rate has declined and deposits and current accounts in togrog are on the rise, leading to greater growth of money supply.

In recent quarters, newly issued loans for consumption and trade sectors are on the rise. Yet, due to poor quality of credit, newly issued loans to other sectors remain subdued.

Interest rates on loans and deposits continued to decline. In the reporting quarter, the Monetary Policy Committee of the Bank of Mongolia decided to reduce policy rate by 1 percentage points. Following the policy decision, the interbank weighted average interest rate declined in the same period. As interest rate on togrog credit declined and interest rate on deposits remained fairly the same, interest rate margin of togrog declined. Relative return of togrog increased in the same quarter due to appreciation of togrog exchange rate following improved balance of payments and recovery of confidence in the market.

Despite improvements in the asset market, real estate market remains inactive and the households' purchasing power of real estate has not improved. The real estate market remains inactive and the price of housing is stable. Price-to-income and price-to-rent ratios, which indicate the demand for housing and households' purchasing power, continued to decline. Following economic recovery and improvements to the market valuation of major companies, total market capitalization and the MSE-TOP 20 index made a sharp upturn and the capital market is recovering.

Economic growth is expected to pick-up slightly and remain stable following recovery in economic activities, increased inflow of capital and positive sentiment in market. Growth of mining sector is expected to recover in 2018, owing to improved outlook of terms of trade and higher metal concentration in the Oyu Tolgoi copper concentrate. Although higher foreign direct investments and growth of credit to private sector are expected to boost the non-mining sector, its growth is forecasted to decline gradually. Due to seasonal effects, price of meat is forecasted to increase in the first half of the year and decrease in the remainder of the year, leading to lower food price inflation compared to 2017. Inflation overall is forecasted to stabilize around its target rate in 2018. Although the economic recovery is likely to induce demand pressure on inflation, the one-off effect and other supply related factors are expected to fade later in the year.

Uncertainties regarding external demand are mainly related to the Chinese economic outlook, which defines the greater portion of Mongolia's external demand. Chinese authorities' choice of policy and change in commodity prices relative to expectations are main source of uncertainty. In addition, political and geopolitical issues, and economic and trade sanctions pose risk to the external environment. In case of the domestic economic environment, uncertainties regarding the commencement of mega projects, persistence of the non-tariff ban on coal exports, weather related loss of agricultural production and other supply sensitive shocks are the main source of risks and uncertainties on economic growth and inflation.

I. ECONOMIC OUTLOOK

I.1 Forecast of inflation and economic growth

Forecasts for this quarter are based on the assumptions that the policy rate shall remain unchanged, monetary and fiscal policy measures agreed under the IMF's Extended Fund Facility program will be implemented and investment to the mining sector will increase.

Inflation

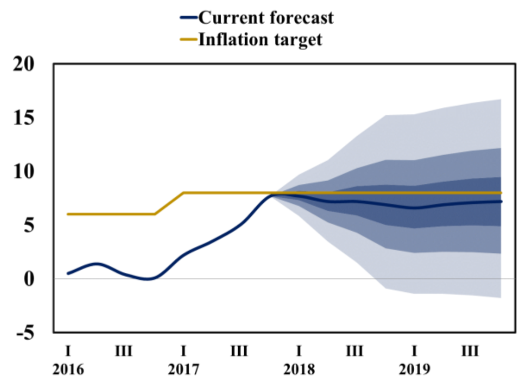
Although inflation was accelerating in 2017, it is expected to stabilize in the following years. Following its seasonal pattern, meat price is forecasted to increase in the first half of 2018 and decrease in the remaining half, and its contribution to food price inflation is expected to be lower relative to 2017. Effects of changes to the CPI basket, higher tax rates and sharp rise of solid fuel prices are expected to diminish and clear off starting first quarter of 2018, leading to lower non-food price inflation. Although demand driven inflation is expected to pick up gradually due to recovery in economic activities, some supply side factors and one-off impact of certain changes are expected to fade, thus inflation is forecasted to stabilize around its target rate.

Economic growth

In 2017 economic growth increased to 5.1 percent and is expected to rise slightly and stabilize in the coming years. Although non-mining sector had been the driving force of economic growth in the past several years, its growth is expected to decline in 2018, while growth of the mining sector is expected to pick up. In particular, recovery in terms of trade coupled with increasing metal concentration of copper concentrate at the Oyu Tolgoi mine is expected to prop up mining growth to a higher rate than last year. Although foreign direct investments and credit towards the non-mining sector are expected to contribute to the sector, its growth outlook is declining gradually.

Chart I.1.1

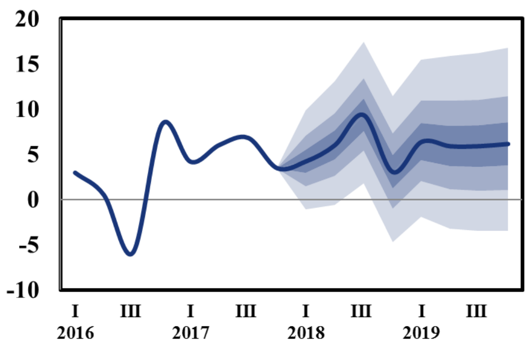
Inflation forecast



Source: Bank of Mongolia

Chart I.1.2

Annual growth forecast of quarterly GDP



Source: Bank of Mongolia

Table I.1.1

Annual GDP growth and inflation forecasts (30% confidence interval)

	2017 *actual.*	**2018*** *forecast*	**2019***
GDP growth	5.1	4.0 – 7.5	3.5 – 8.5
Inflation CPI[2]	7.7	5.0 – 8.8	4.9 – 9.5

Source: Bank of Mongolia

[2] Average of inflation in 4th quarter of each year

I.2 Assumptions regarding external conditions[3]

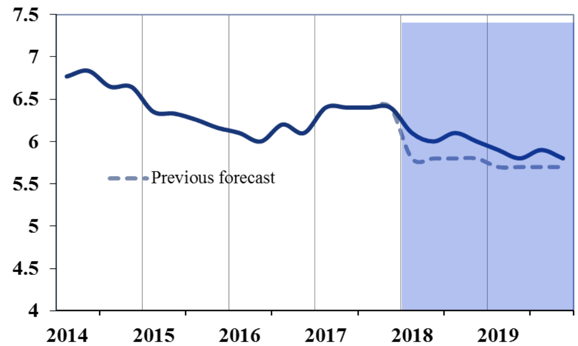
Current forecasts of export commodity prices and economic growth of main trading partners in 2018 are revised up from previous forecasts. Hence, support from external demand on domestic economy is expected to be greater than previous quarter. (External demand is assumed to be greater in this quarter as economic outlook of the Euro area, Russia and China are expected to pick up, and prices of gold, copper, iron ore, thermal coal and oil are assumed to be higher than previous forecasts, leading to improved forecast of terms of trade.)

External demand

External demand outlook for 2018 and 2019 are improved compared to its forecasts previously published as of end of 2017. During the current forecasting period economic growth of China, Russia and the Euro area are expected to support Mongolian economy through higher external demand. As published in external sources, growth forecast of Chinese economy in 2018 is revised to 6.3 percent up from its previous forecast of 6.1 percent, while that of Russia and the Euro area improved to 1.9 percent from 1.7 percent and to 2.0 percent from 1.7 percent, respectively. In the last quarter of 2017, household consumption in Russia grew by 4.1 percent and investments increased by 3.8 percent, thus boosting the economic growth to exceed previous forecast. And its growth forecast for 2018-19 is increased, as the main driving forces for Russian economy are expected to remain strong in the coming years.

Chart I.2.1

Change in external demand, y-o-y percent



Source: Bloomberg, Roubini, IMF, EIU, BREE

Prices of petroleum and oil remain significant determinants of Russian economic outlook and are expected to be propped up following the OPEC's decision on November 30, 2017 to clamp down oil production till the end of 2018. Furthermore, considering a mix of contractionary fiscal and expansionary monetary policy, stabile oil prices, appreciating ruble exchange rate and stable outlook for household consumption in the medium term, growth forecast of the Russian economy is increased by 0.2 percentage points to 1.9 percent in 2018, while it is unchanged at 1.8 percent in 2019. Economic growth in the Euro area is assumed to remain stable in the coming years, supported by non-traditional monetary policy of the ECB, relatively loose fiscal stance, diminishing uncertainty in the political arena, improved economic outlook in its main trading partners and positive labor market indicators. Its growth is assumed to stabilize around 1.7-1.9 percent during 2017-2019. In particular, assumptions for growth rate is increased by 0.2 percentage point to 1.9 percent in 2018, while it is reduced by 0.1 percentage point to 1.6 percent in 2019. In China, economic growth reached 6.8 percent in the last quarter of 2017, thus exceeded previous assumptions. Growth of service, exports and manufacturing sectors contributed

[3] Forecasts of economic growth and inflation in main trading partner countries and their relevant explanations are retrieved from February 2018 edition of the Roubini Global Economics Outlook report, February edition of the EIU Global Forecasting Report, median of forecasts conducted by Bloomberg analysts and January edition of the IMF's WEO report. The external sector forecasts and their reasoning do not incorporate the views and analysis of the Bank of Mongolia.

significantly to overall economic growth. During 2017-2019, Chinese economic growth is assumed to stabilize around 6.2-6.4 percent, mainly driven by the same sectors. As private sector debt continues to increase at an alarming pace, during the "Central Economic Work Conference" held between December 18-20, 2017, the Chinese government is directed to accelerate its policy actions to curb debt in the following 3 years. Economic growth assumptions for 2018 and 2019 are increased by 0.1 percentage point to 6.4 percent and 6.2 percent respectively. The change in assumptions is backed by the international consensus on the possibility of soft-landing in the medium to longer term.

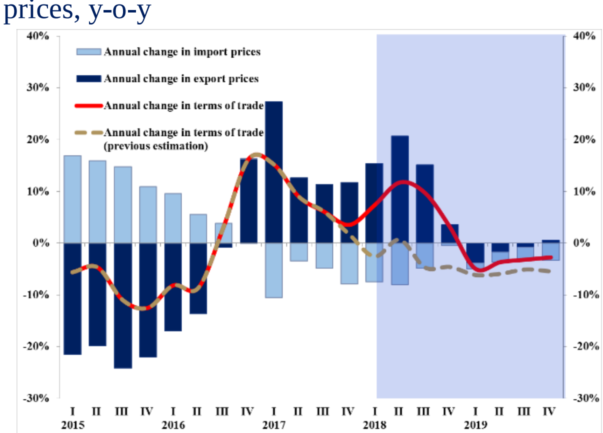
Terms of trade

Compared to previous forecast, outlook for terms of trade is improved. While, prices of copper, gold, iron ore, thermal coal and oil are expected to increase in 2018, prices of thermal coal and iron ore are forecasted to dip in 2019.

As a major consumer of both copper and coal, Chinese economic growth exceeding expectations in the last quarter of 2017, is the main reasoning for increasing forecasts for average price of copper in 2018 by $673 per ton to $7013 per ton, of iron ore by $2 per ton to $62 per ton, of thermal coal by $12 per ton to $87 per ton, and of coking coal by $26 per ton to $183 per ton. In addition, price forecast of oil is increased by $2 per barrel to $58 per barrel.

Chart I.2.2

Changes in terms of trade, export and import prices, y-o-y



Source: Bank of Mongolia estimations

In the reporting quarter, foreign inflation exceeded previous forecast, mainly due to higher economic growth in main trading partners and higher commodity prices. Supported by strong domestic demand, Chinese inflation is expected to increase to 1.8 percent in 2018. In case of Russia, loose monetary policy, steady oil prices, recovery in economic activities and stable macroeconomic environment are expected to push inflation close to its target of 4 percent. At the end of 2017, inflation in the USA reached 2.1 percent exceeding the Federal Reserve's target rate, potentially caused by continuously declining unemployment rate and increasing household consumption. As household consumption growth is expected to remain stable in the following years, it is forecasted to increase inflation slightly to 2.3 percent in 2018-19.

In the following forecast period, the main risk to Mongolia's external demand and the price of commodities is the possibility of a trade war between the USA and China. For instance, in order to support domestic production, on March 8, 2018 Mr. Donald Trump, the president of the USA, signed an order to set tariff of 25 percent on steel and 10 percent on aluminum imports, on the basis of national security. However, the tariff excludes Canada and Mexico, which contribute 27 percent of steel and 43 percent of US aluminum imports in total. According to the EIU, such action was mainly motivated by the expected reform of the NAFTA and it is strongly opposed by the IMF, WTO and global exporters of steel and aluminum. According to external sources, Mr. Trump intends to protect the domestic metal producers from cheap imports from China. Yet in 2017, Chinese export of steel and aluminum to the USA accounted for only 2.2 and 9.5 percent of the total US metal imports, respectively. Consequently, trade quarrel between the USA and China is not expected to yield any positive impact on countries that export steel, aluminum and other related metals.

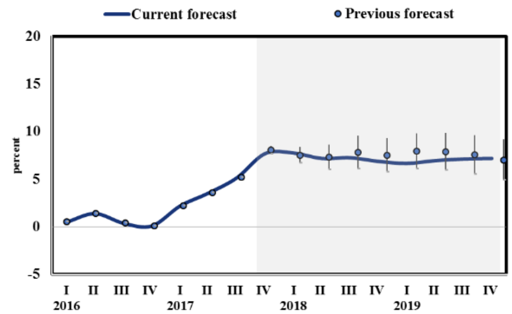
I.3 Changes in forecasts

Inflation

Inflation at the end of 2017 was 0.3 percentage point lower than its forecast made in the previous quarter. Prices of meat, domestic goods and solid fuel grew less than previously forecasted, thus explain the discrepancy of inflation forecast. Compared to previous quarter, inflation forecast is reduced mainly due to receding supply pressure, especially the change in price forecasts of fuel and imported goods. For instance, forecast of fuel price inflation is reduced from 7.5 percent to 7.2 percent and for imported goods it is declined from 9.9 percent to 9.8 percent.

Chart I.3.1

Inflation forecast



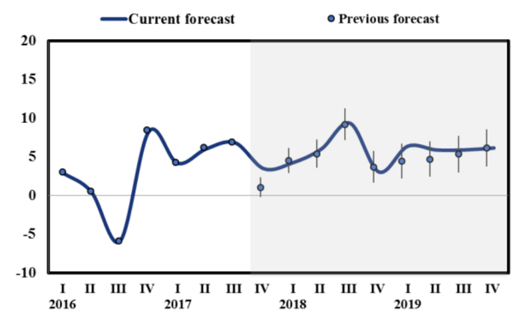
Source: Bank of Mongolia

Economic growth

In 2017 mining sector growth was 3.1 percentage points lower and non-mining growth was 2.0 percentage points higher than previous forecasts, thus overall economic growth exceeded previous forecast by 0.8 percentage points. There were two underlying causes for such discrepancy. First, transportation sector which was previously expected to contract due to coal export tariff set at the border, expanded and second, construction sector growth exceeded previous forecast owing to construction activity in the mining sector. As for growth in 2018, current forecast does not vary significantly from previous forecast, while mining sector outlook is lowered slightly and construction sector outlook is improved.

Chart I.3.2

Forecast of quarterly GDP growth y-o-y



Source: Bank of Mongolia

I.4 Uncertainties regarding forecasts

Forecasts may differ from actual performance or may be adjusted in the following quarter due to unanticipated changes in economic policy, structural reforms, discrepancies in assumptions, and unanticipated developments in internal and external condition. The following uncertainties may alter macroeconomic policy and domestic and external environment, thus result in discrepancies in the forecasts.

Uncertainties regarding domestic economic condition

- Positive sentiment in the market supported by short and medium term policy measures and long term structural reforms under the IMF's Extended Funds Facility (EFF) program may draw short term, profit seeking, highly volatile capital inflow. Thus, financial and macroeconomic policy should focus on managing such volatile capital in a prudential manner, building the financial market's resilience in the medium to long run and preventing potential financial distress which can be a result of excessive credit growth fueled by short term volatile liabilities.
- Excess supply or potential shortage of goods may result in discrepancies in inflation forecasts. For instance, possibility of harsh weather conditions poses risk of higher meat prices in spring.

- Main downside risks to economic growth are risk of deteriorating conditions of non-tariff barrier on coal export, which would lead to lower growth in transportation and mining production, and risk of worsening weather conditions beyond expectations, thus leading to lower output in the agricultural sector.
- Commencing date and financing arrangements of some mega projects to support real sector under the EFF program are still uncertain. In addition, it remains uncertain whether such projects would attract additional foreign direct investment to the country or not.
- As consumption loan soars in the banking sector and its share to total loans grows rapidly, moving forward unaddressed it may result in financial sector risk accumulation thus bring about negative consequences on the economic growth.
- Last but not least, any unanticipated policy change is a potential source of uncertainties regarding forecasts.

Uncertainties regarding external condition

- Any risk regarding outlook of the Chinese economy remains a significant source of uncertainties for the Mongolian economy. For instance, Chinese government's medium term policy on debt management remains uncertain. According to the IMF, private sector debt in China is expected to grow continuously and reach 300 percent of GDP by 2022, thus is likely to shake the financial soundness and result in lower economic growth.
- As the Chinese government intends to reduce air pollution and curb down credit growth, investment to real estate sector is expected to be negatively affected, thus lead to lower production of copper, steel and most importantly lower import of iron ore from Mongolia.
- Although manufacturing sector of China is still expected to grow at a stable rate through 2018-19 and continue to support global demand for copper, moving forward as the Chinese authorities intend to focus on consumption and service driven economic growth over manufacturing, it is uncertain whether the strong demand for copper would be sustained in the longer run.
- Any geopolitical frictions or economic sanctions in the global arena may have negative consequences on Mongolia's external demand environment.

II. CURRENT ECONOMIC DEVELOPMENTS

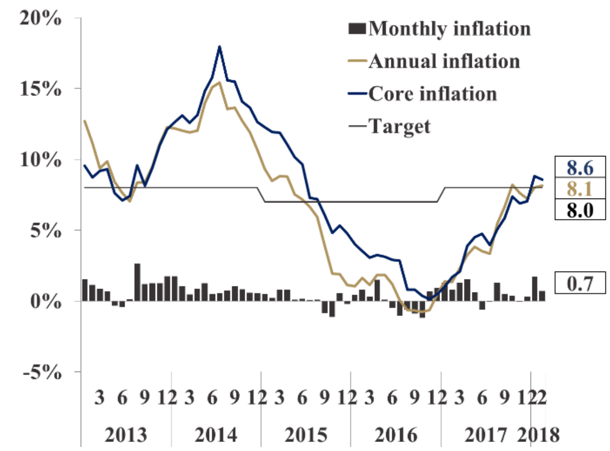
II.1 Domestic economy

II.1.1 Inflation

In the Monetary Policy Guideline for 2017, the Bank of Mongolia's target for inflation rate is set not to exceed 8 percent. Starting at 0.5 percent in the beginning of 2017, inflation accelerated through the year reaching 6.4 percent nationwide and 7.2 percent in Ulaanbaatar city, thus remained within the targeted rate. Base impact of previous year, recovery in economic activities, changes in some tax rates, modification of the CPI basket, weights and its methodology, and loss of harvest due to harsh weather conditions were the underlying factors of rising inflation. Difference between the headline and the core inflation[4], which excludes items with highly volatile prices, remained marginal in 2017 and the core inflation reached 7 percent at the end of 2017.

Chart II.1.1.1

Inflation remains around 8.0 percent…



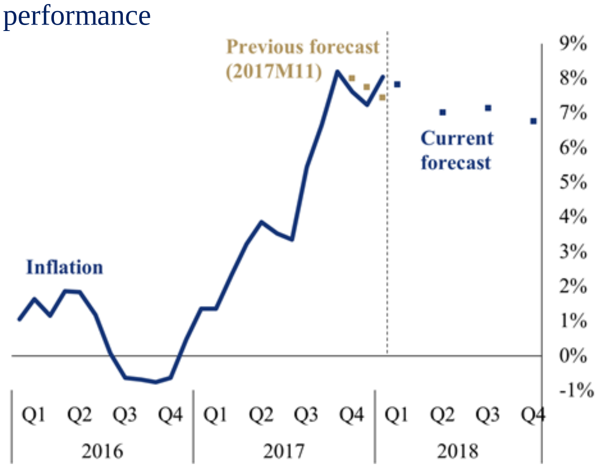
Source: NSO

Difference between forecast and actual performance

Although the Bank of Mongolia estimated average inflation in the last quarter of 2017 at 8.0 percent, the actual performance was at 7.7 percent. The discrepancy between forecast and the actual figure can be explained by i) base effect of previous year and greater demand pressure on inflation due to increasing economic activities, and ii) overestimated pass through effect of exchange rate on import prices. For instance, prices of meat and solid fuel were lower than previously forecasted.

Chart II.1.1.2

Difference between forecast and actual performance



[4] Core inflation is calculated by removing price changes of 41 items related to meat, milk and vegetables from the headline inflation based on CPI.

Inflation, and its contributions

In February 2018, annual inflation rose to 8.1 percent. Such increase in prices of consumer goods and services was higher than previously forecasted and it is mainly due to the price of solid fuel in the last 4 months of the year. (Chart II.1.2.1). Considering seasonal pattern in the past years, price of solid fuel was expected to increase in November, yet it remained constant. On the other hand, defying expectations of lower price in January and February, it increased by 18.3 percent in January.

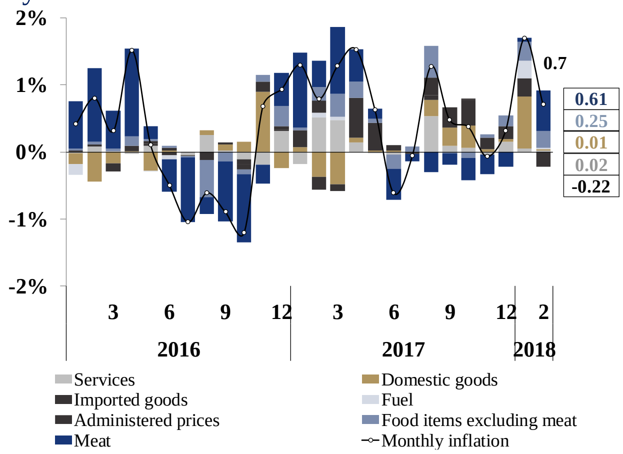
Regarding other items, following global price fluctuations of oil, and excise tax on gas, diesel fuel, alcohol and tobacco, prices of diesel fuel, alcohol and tobacco rose in January of 2018, consistent with the forecasts.

Prices of following goods and products made significant contributions to annual headline inflation.

Item	Weight	Contribution to annual inflation
Solid fuel[5]	0.03	1.47%
Car, wheels	0.05	1.11%
Milk and dairy	0.04	0.61%
Alcohol and tobacco	0.06	0.55%
Fuel (only direct impact)	0.06	0.40%
Private education	0.03	0.38%
Medicine	0.02	0.35%
Vegetables	0.02	0.27%
Total	0.30	5.15%

Chart II.1.1.3

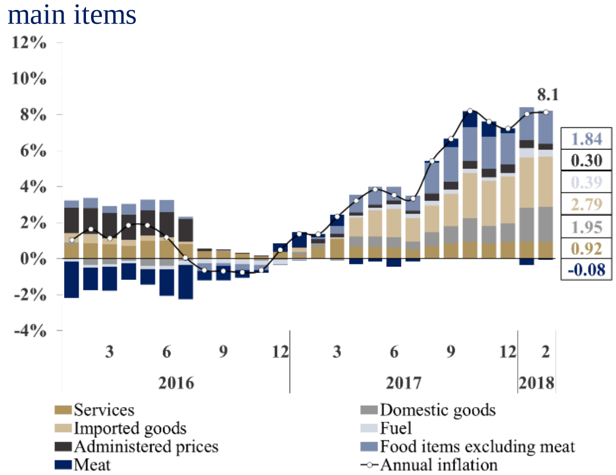
Contributions to monthly inflation in Ulaanbaatar, by main items



Source: NSO, Bank of Mongolia

Chart II.1.1.4

Contributions to annual inflation in Ulaanbaatar, by main items



Source: NSO, Bank of Mongolia

[5] Price of solid fuel, which consists of a sack of burning coal and firewood, increased by 47.3 percent between July 2017 and February 2018, thus made a contribution of 1.47 percentage points to headline inflation.

Box 1: Impact of increasing fuel prices on inflation

Higher prices of fuel in domestic market increases cost of other goods and products, thus results in higher prices in general. Hence, increasing fuel prices not only affect CPI through its own weight in the consumption basket, but also have an indirect impact on inflation by affecting the prices of other goods and services in the consumption basket. Here we estimate direct and indirect effect of a 4.9 percent increase in fuel prices in January 2018, on headline inflation.

According to the restructured CPI basket (base year is 2015), total weight of fuel products of type A-80, A-92, diesel and gasoline is 5.9 percent. A 16.9 percent annual increase in growth of diesel price in January 2018 creates a direct impact of 0.28 percentage points on annual inflation.

Literature focusing on indirect impact of fuel prices, usually estimates its impact on general consumption prices. In other words, most of the studies try to estimate the impact of fuel price shock based on the interlinkages of macroeconomic indicators such as economic growth and inflation. Furthermore, some studies estimate its impact by disaggregating the CPI basket.

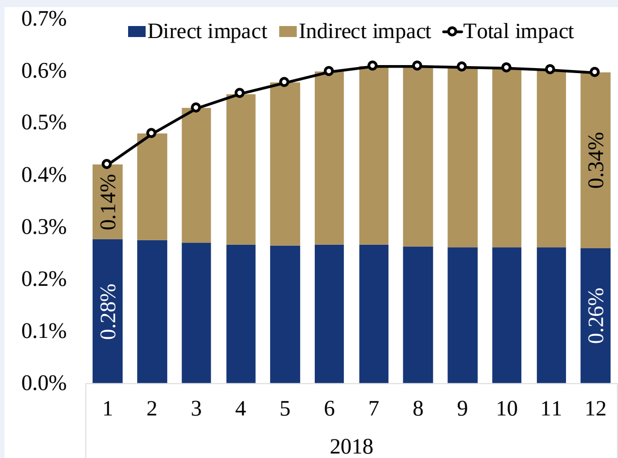
In case of Mongolia, Davaajargal L (2013)[6] estimated the impact of fuel price shock on the disaggregated CPI basket using FAVAR methodology. According to this study, although the size of the impact on each item differs, the maximum impact is reached in 1 year of the shock and gradually clears out within 2-3 years.

If we apply the finding of the above mentioned study, impact of the diesel price hike in January of 2018 is expected to increase headline inflation by 0.3 percentage points after 4 quarters.

To summarize, a 4.9 percent growth of fuel prices in January 2018 is expected to add 0.6 percentage points to the end of year annual inflation, considering both direct and indirect impacts.

Chart 1

Impact of annual change in fuel prices on annual headline inflation /as percentage of annual inflation/



[6] Davaajargal L ((2013) "Impact of fuel prices on inflation", Bank of Mongolia Research Book, series 8, pages 66-87

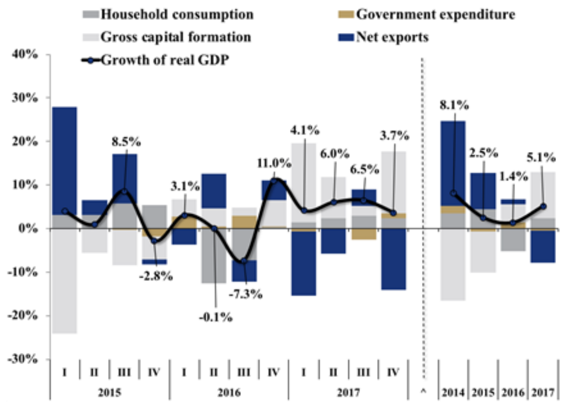
II.1.2 Real sector

II.1.2.1 Economic growth

Following recovery in economic activities, real GDP growth reached 3.5 percent in the last quarter of 2017 and 5.1 percent for the whole year. Main contributors to growth are, upswing of external demand for main export commodities, major construction activities in the mining sector in relation to the second phase of the Oyu Tolgoi project, increasing foreign direct investments following improved investor sentiment towards the domestic economy, and rising household consumption. From the supply side, increased production in mining sector excluding copper, and growth of trade, manufacturing and transportation sectors contributed the most.

Chart II.1.2.1.1

Growth of investments and household consumption made the greatest contribution to growth in 2017.

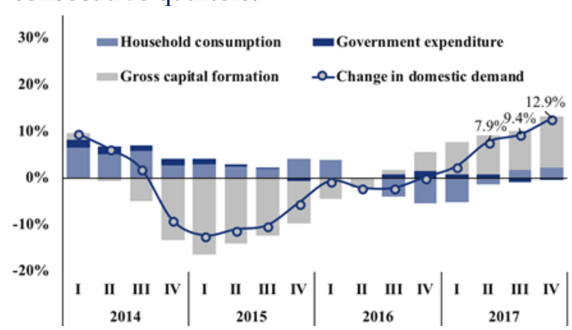


Source: NSO

Aggregate demand: In the reporting quarter, growth of household consumption, investments and government expenditure made positive contributions to overall economic growth, while net exports contributed negatively. (Chart II.1.2.1.1). Domestic demand[7] has been growing continuously in the last 5 quarters. Gross capital formation (investments) has been supporting overall demand for 6 consecutive quarters while household consumption which had contracted for 4 consecutive quarters, boosted domestic demand in the latter half of 2017. (Chart II.1.2.1.2)[8].

Chart II.1.2.1.2

Domestic demand expanded in the past 5 consecutive quarters.



Source: NSO

Aggregate supply: In the reporting quarter, from the supply side growth in sectors of transportation, manufacturing, trade and other services[9], and net taxes made the greatest contribution to economic growth, while agriculture and the mining sector made negative contribution to overall growth. Non-mining sector showed strong growth in the last 5 quarters consecutively and grew by 11.4 percent year-over-year in the reporting quarter. Such strong performance is a reflection of indirect effect of increased mining activities and construction work to expand a major mining site. On the other hand, mining sector[10], which has been declining continuously in the past 5-6 quarters, shrunk by 17.1 percent in the reporting quarter. Such contraction is mainly due to lower concentration of metal and diminished extraction of copper concentrate and coal. (Chart

[7] Represents the final consumption of domestic economic agents and estimated as the total expenditure of households, government, and investors.
[8] Shows the total value of the current quarter and 3 preceding quarters.
[9] Other service mostly consists of services of finance and insurance.
[10] In the previous 4-5 quarters, although total mining production declined due to the lower metal concentration and volume of copper ore extracted from the Oyu Tolgoi mining project, production increased in most of the other mining sites.

II.1.2.1.3).

Household consumption

Household income and expenditure: Although household consumption declined by 9.0 percent in 2016, it supported GDP growth throughout 2017. In the reporting period, household consumption grew by 5.1 percent year-over-year and made a contribution of 2.3 percentage points to quarterly GDP growth. In the fourth quarter, households spent more on items such as milk and dairy products, water, drinks, transportation, vacation and leisure, and medicine and medical equipment. Following a decline of 2 years since 2015, household income remained higher in 2017 from previous year mainly due to higher earnings from salary and private business. (Chart II.1.2.1.4).

Greater household spending followed greater household income. For instance, compared to the previous year spending on food, non-food and other items expanded by 10.7, 15.9 and 18.7 percent, respectively. Overall, real household expenditure expanded by 7.1 percent year-over-year. (Chart II.1.2.1.5).

Although households' purchasing power of real estate is limited and the real estate market remains inactive[11], residential construction activities increased in 2017. Such growth and stability of the residential construction activities mark the end of sharp decline of past several years. In the reporting quarter, the construction sector in overall grew by 17.8 percent year-over-year, boosting economic growth by 0.8 percentage points. The underlying growth driver was the acceleration of construction activity for the Oyu Tolgoi underground mining project. In addition, increased on- and off-budget spending on infrastructure, road and bridge projects in 2017 further supported the construction sector. (Chart II.1.2.1.8).

Agriculture sector, where 10 percent[12] of the household average income is generated, declined by 6 percent in the reporting quarter, year-over-year, thus taxing overall growth by 0.6 percentage points. In particular, production of animal husbandry did not meet expectations, while the production of farming shrunk. In case of farming, unaccommodating weather conditions in most of the farming regions have led to 50, 26 and 13 percent lower harvest of wheat, potato and other vegetables across the country in 2017. In the same year Mongolia's total livestock reached 66.2 million which is a 7.6 percent growth year-over-year. Although number of livestock

Chart II.1.2.1.3

Growth of non-mining GDP has been accelerating in the last 5 quarters.

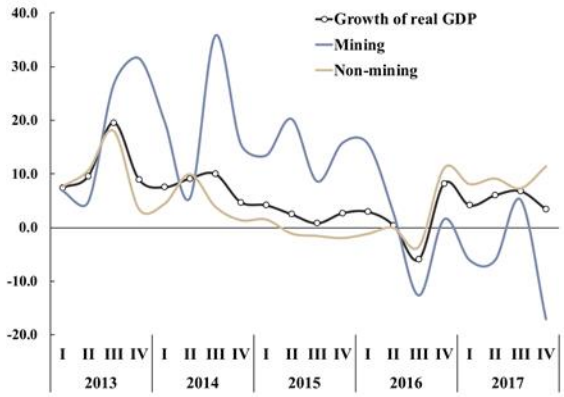
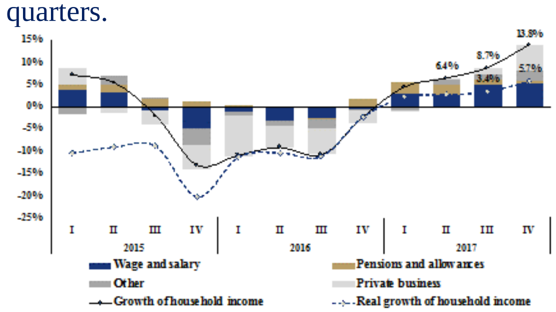


Chart II.1.2.1.4

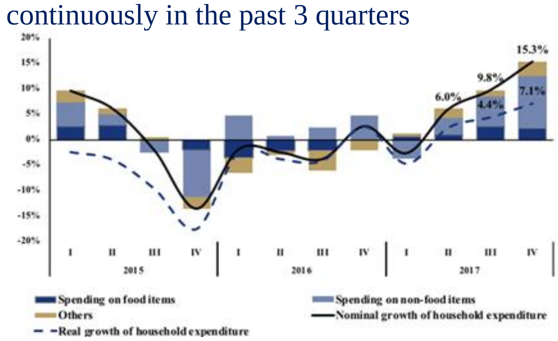
Household real income grew in the past 4 quarters.



Source: NSO

Chart II.1.2.1.5

Household real expenditure increased continuously in the past 3 quarters



Source: NSO

[11] Detailed information on real estate market can be found on section II.1.3.4 – Other capital market.

[12] Income generated from animal husbandry

lost due to natural causes was relatively lower and similar to past years 20 million new offspring were added, 14 million livestock was slaughtered for consumption purposes, which is a relatively high figure.

Government expenditure

In the reporting quarter, government expenditure increased by 8.9 percent year-over-year, thus contributing 1.2 percentage points to overall GDP growth. Nevertheless, for the whole year government expenditure contracted by 3.2 percent and reduced overall GDP growth by 0.5 percentage points. (Chart II.1.2.1.6).[13]

Investment

Total investment (capital formation) expanded by 44.7 percent year-over-year in the reporting quarter, thus boosted overall GDP growth by 14.3 percentage points. In particular, 9 percentage point accounts for investment for capital accumulation, which alone increased by 36 percent year-over-year, while the remaining 5.3 percentage point is invested for inventories, which grew by 76.6 percent year-over-year. Most of the capital accumulation was made for machinery and equipment, residential construction and other construction activities. Work in progress increased in the same quarter, leading to greater build-up of inventories. (Chart II.1.2.1.7).

Although growth of trade sector had been decelerating since 2014, it made a rapid upturn in the past 5 quarters. Main factors supporting such upturn were improved business sentiment, recovery in overall economic activities, and increased sale of heavy machinery, mining equipment and fuel following recovery of activities in mining sector, mining investments and construction for mining. Consequently, the trade sector expanded by 8.2 percent year-over-year, thus made a contribution of 1.2 percentage points to the overall economic growth in the reporting quarter. (Chart II.1.2.1.9).

Manufacturing sector growth accelerated in the past 5 quarters, thus marking the end of a persistent deceleration since 2015. Increased productions of food items such as meat, drinks and alcohol, woven knitwear items, washed coking coal, and construction items used for the mining projects such as cement and other materials were the main driver of growth. Consequently, manufacturing sector expanded by 23 percent year-over-year, thus boosting the economic growth by 1.5 percentage points in the reporting quarter (Chart II.1.2.1.8).

Table II.1.2.1.1

Sectors that are highly dependent on mining sector are growing rapidly.

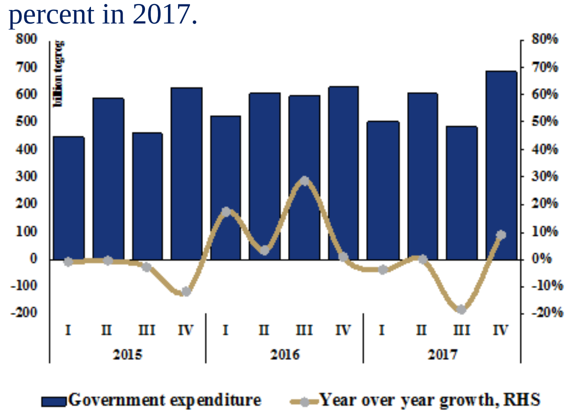
Sectors*	2016 YoY %	2017 YoY %	2017Q4 YoY %	2017Q4 QoQ % **
Growth of GDP	**1.2**	**5.1**	**3.5**	**26.3**
Other services	1.1	5.1	12.9	-0.9
Transportation	11.4	16.7	19.3	125.3
manufacturing	-1.3	22.8	23.0	30.8
Trade	-2.3	9.7	8.2	89.1
Taxes	0.5	18.6	15.1	18.0
Construction	-6.3	-0.8	17.8	804.3
Information	-1.7	7.9	10.8	5.6
Electricity	1.5	4.2	3.7	1.3
Agriculture	6.2	2.3	-6.0	-20.6
Mining	0.2	-6.9	-17.1	-30.2

**Ranked according to contributions to growth in 2017Q4.*
***Seasonally adjusted*

Source: NSO

Chart II.1.2.1.6

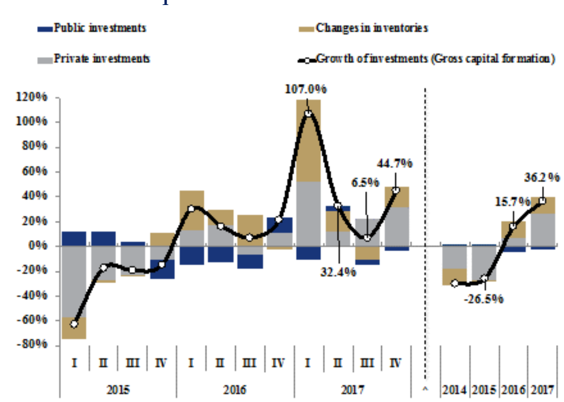
Government expenditure contracted by 3.2 percent in 2017.



Source: NSO

Chart II.1.2.1.7

Investment continued to increase for 8 consecutive quarters.



Source: NSO

[13] Detailed information on the government consolidated budged and sovereign debt can be found in section II.1.2.

Foreign trade

In the last quarter of 2017, net exports shrunk and thus reduced overall economic growth by 14.1 percentage points. In particular, imports increased by 18.9 percent year-over-year, while exports only grew by 2.3 percent (Chart II.1.2.1.10).

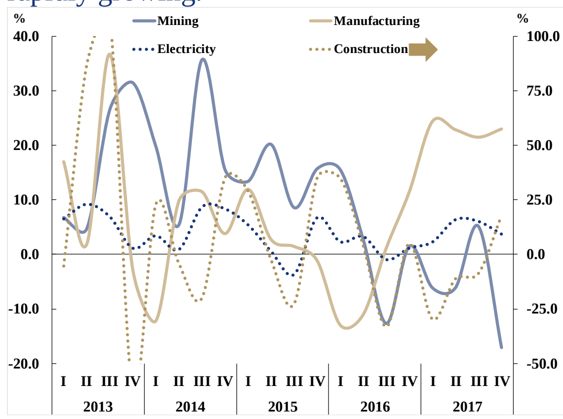
Exports: In the reporting quarter, volume of export was lower than previous year. For instance, exports of non-monetized gold declined by 49.9 percent, while export of coal and oil both shrunk by 21.8 and 10.5 percent, respectively. On the other hand, exports of copper ore and concentrate increased by 10.2 percent, while for other minerals such as spar and nepheline, export growth reached 72.6 percent. Thus, net export balance reached a deficit of 128 million USD in the reporting quarter, despite some surplus in the previous 4 quarters (Chart II.1.2.1.11).

Commodity prices at the global market reached high levels and have been relatively stable. Such relatively high prices motivated mining production in past 4-5 quarters and thus supported the non-mining sector as well. Nevertheless, mainly due to declining extraction and metal concentration of copper concentrate at the Oyu Tolgoi mine, the mining sector as a whole has been on a diminishing track since the latter half of 2016. In particular, the mining sector shrunk by 17.1 percent year-over-year in the reporting quarter, thus made a negative contribution of 4.8 percentage points to overall economic growth. In addition to lower extraction and metal concentration of copper ore, non-tariff barrier set on coal export transportation at the border and past year's high base effect of coal export were the main contributing factors for such decline. For instance, in the reporting quarter coal mining declined by 22 percent year-over-year, gold concentration within the Oyu Tolgoi's copper concentrate dropped by 30 percent and oil mining shrunk by 9 percent. On the other hand, iron ore mining production rose by 15 percent and gold mining increased by 13 percent during the same period (Chart II.1.2.1.12).

Although export of washed coking coal had been increasing in the past 4-5 quarters thus continuously making 6-7 percentage points positive contribution to overall manufacturing production, due to non-tariff barrier at the border and high base effect, production of washed coking coal declined by 7.6 percent in the reporting quarter and cut 0.5 percentage points from the manufacturing sector growth.

Chart II.1.2.1.8

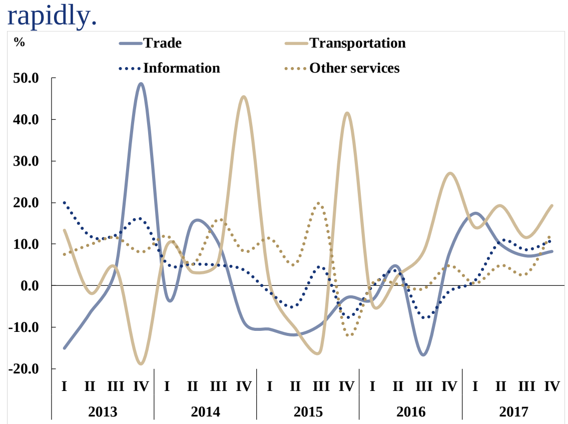
Within industries, manufacturing sector is rapidly growing.



Source: NSO

Chart II.1.2.1.9

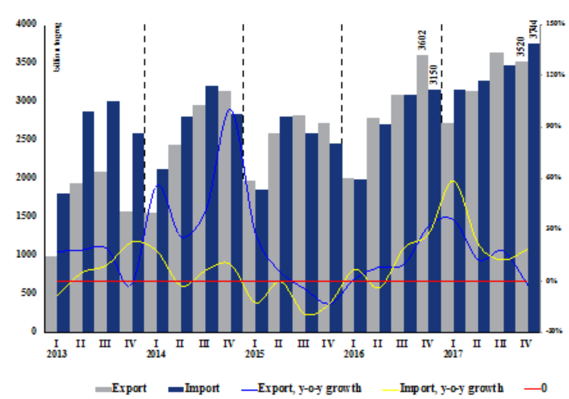
Most of the services sectors are expanding rapidly.



Source: NSO

Chart II.1.2.1.10

Export and import in 2010 prices.



Source: Bank of Mongolia

Following increased activities in the mining sector, transportation sector has been growing over 10-20 percent in year-over-year terms since the second half of 2016. For instance, the transportation sector expanded by 19.3 percent year-over-year and boosted economic growth by 2 percentage points, which marks the greatest contribution to overall growth. Main driving factor of such growth was the increased transportation through roads. Defying expectations, negative impact of non-tariff barrier at the border and consequent friction on coal exports was not noticed in transportation sector. In addition, railway transportation of imports and transit items supported the growth of transportation sector (Chart II.1.2.1.9).

Imports: In the reporting quarter, nominal imports increased by 26.2 percent year-over-year. In particular, imports of all sub-items excluding fuel imports expanded. Recovery of economic activities, increased mining commodity exports, increased manufacturing production and higher household income led to higher demand for imports of mining equipment and machinery, input for manufacturing and consumer products. For instance, in the reporting quarter imports of machinery and equipment, manufacturing inputs and consumer products increased by 65, 24 and 18.7 percent, respectively.

Although it had been declining since the late 2013, net taxes[14] have been growing by over 15-20 percent in the past 5 quarters. Increased production and sales of both domestic and imported goods used in the mining sector construction activities, and widened tax base following the VAT law reform were the underlying factors of increased net taxes. In the reporting quarter, net taxes increased by 15.1 percent year-over-year, thus boosting overall growth by 0.9 percentage points. Such growth is mainly driven by VAT revenue collected from domestic and imported goods and higher rate of customs duties.

Chart II.1.2.1.11

Net exports deficit reached 128 million USD in the 4th quarter, in current prices.

Source: Bank of Mongolia

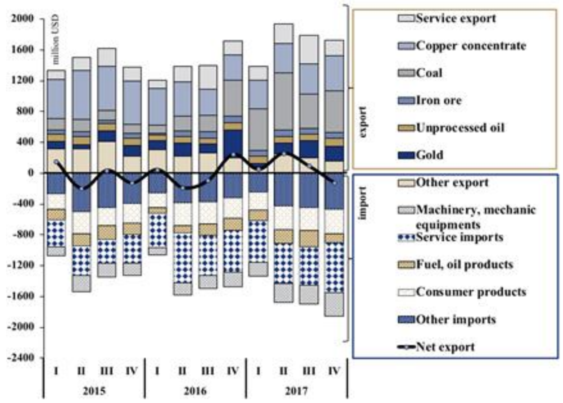
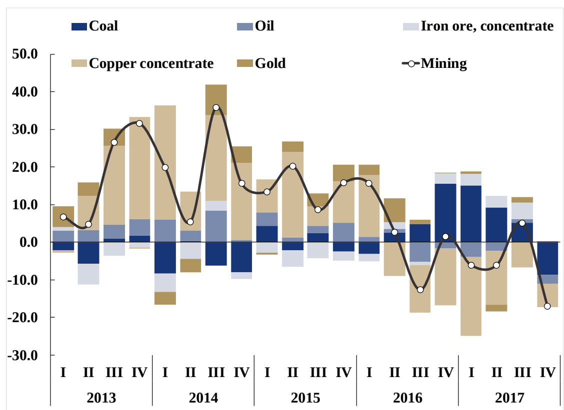


Chart II.1.2.1.12

Mining sector contracted following lower mining production of coal, copper concentrate and oil.



Source: NSO, author's calculations

[14] Consists of VAT on domestic goods and imported items, customs duties and excise tax.

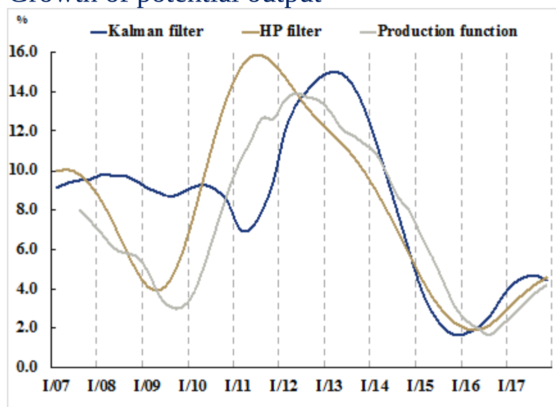
II.1.2.2 Potential output and output gap

Potential output growth exceeded 10 percent during 2011-2013, yet due to declining investments and weak investors' sentiment, it started to decelerate starting 2014. Increased activities in the mining sector following the recovery and expansion of major mining site since the last quarter of 2016, supported the non-mining sector indirectly, thus the overall growth of potential output. In the past 2 years, growth of potential output reached 4 percent and is expected accelerate (Chart II.1.2.2.1).

As non-mining production expanded beyond its potential level, during 2011-2013 the output gap was positive. During 2014-2016 however, due to shrinking mining sector, the output gap turned negative. Nevertheless, the output gap is estimated to be positive in the last quarter, owing to increased construction activities for the mining site and growing transportation related to coal exports. Regarding the mining sector, although it has been producing beyond its potential level since the late half of 2014, its contribution to overall output gap diminished since mid-2016 due to lower metal concentration within copper concentrate. Hence the mining sector is putting negative pressure on the overall output gap in the last 2 quarters (Chart II.1.2.2.2).

Chart II.1.2.2.1

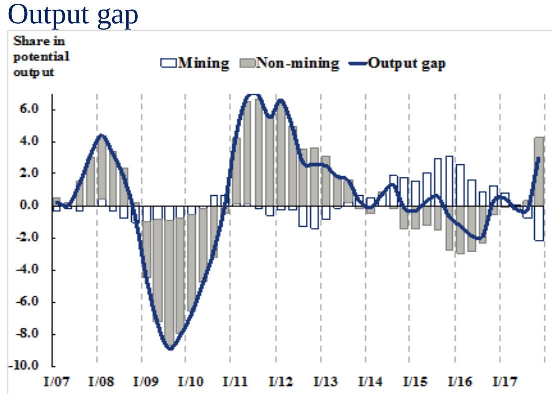
Growth of potential output



Source: Author's calculations

Chart II.1.2.2.2

Output gap



Source: Author's calculations

II.1.2.3. Labor market

Labor market conditions continued to improve as employment increased, unemployment rate declined and labor force participation rate increased… Labor force participation rate rose by 2 percentage points in the reporting quarter to 62.4 percent. Increased employment pushed economically active population to expand by 10.3 percent year-over-year and by 4.4 percent from previous quarter. Number of people employed increased by 11.8 percent in the last quarter of 2017, year-over-year.

Table II.1.2.3.1.

Labor market indicators

Year	2015	2016	2016 Q4	2017 Q3	2017 Q4
Number of people employed (in thousands)	1067.6	1132.8	1132.8	1190.9	1266.9
annual growth	*2.6%*	*6.1%*	*6.1%*	*4.1%*	*11.8%*
Agriculture	335	352	352	343	380
Manufacturing	207	209	209	237	233
Trade	154	173	173	188	207
Services	371	399	399	424	447
Number of unemployed (in thousands)	96.5	107.0	107.0	119	100
annual growth	*10.9%*	*10.9%*	*10.9%*	*-0.1%*	*-6.2%*
Work force participation rate, %	60.5	60.4	60.4	61.1	62.4
annual growth	*0.2*	*-0.1*	-0.1	*-0.5*	0.5
Unemployment, %	8.3	8.6	8.6	9.1	7.3
annual growth	*0.6*	*0.3*	*0.3*	*-0.3*	*-1.3*

Source: NSO[15]

[15] Study on work force

Number of people employed in the agricultural sector increased by 7.9 percent, while in the non-agricultural sector it grew by 13.6 percent. In particular, increased employment in trade (20%), manufacturing (11.4%) and services sector (12%) boosted overall employment growth by 9.4 percentage points.

Unemployment rate declined to 7.3 percent, which is a 1.3 and 1.8 percent lower figure compared to the previous year and previous quarter, respectively. Such performance was mainly driven by increased employment in every sector and declining number of unemployed people, in particular a decline of 6.2 percent year-over-year.

Despite the positive developments in number of employment, number of unemployed people remains higher than in 2015. It can be attributed to working age population growth and people's increased tendency to apply and report through recruitment agencies.

In the reporting quarter, as growth of employment exceeded real GDP growth[16] (5.1%), output per labor declined by 6 percent. In case of non-agricultural sectors, employment increased by 13.6 percent while value added in the sector grew by 5.6 percent, thus reducing output per labor by 7 percent.

Nationwide average nominal wage is reported at 1038.9 thousand tugrug, which is a 10.2 percent higher figure from previous year. Real average wage on the other hand grew by 2.8 percent. (Chart II.1.2.3.3). Average wage in the non-mining sector is higher than the same period of previous year. Regarding labor supply, number of employers declined from the previous year, while number of people running their private business increased by 49.6 percent and number of people earning wage or salary income rose by 12.3 percent.

Chart II.1.2.3.1.

Employment increased in all sectors .

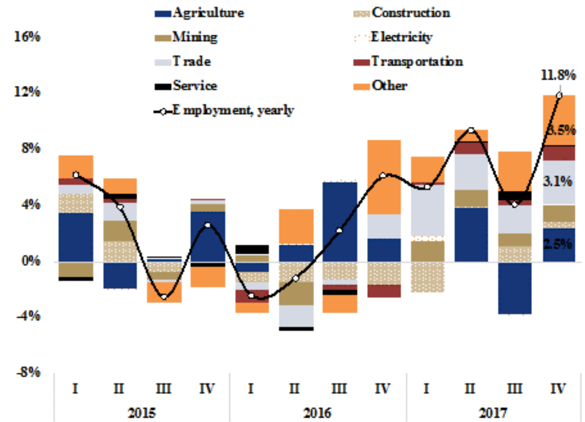
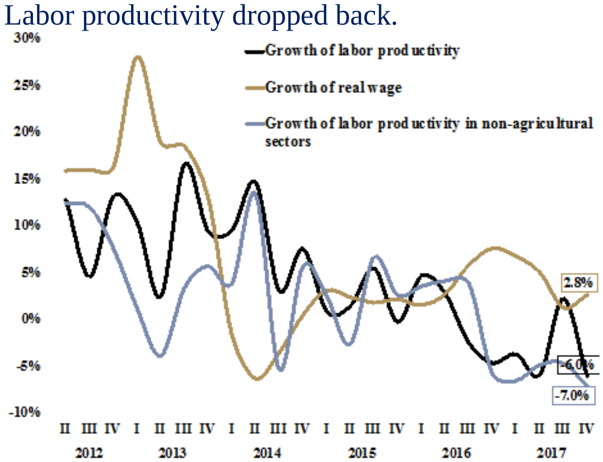


Chart II.1.2.3.2.

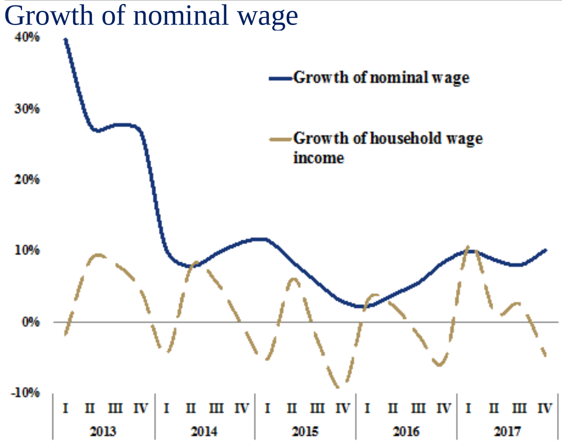
Labor productivity dropped back.



Source: NSO, author's calculations

Chart II.1.2.3.3.

Growth of nominal wage



[16] GDP is calculated as the moving sum of last 4 quarters.

II.1.3 Government consolidated budget and the sovereign debt

Actual performance of consolidated budget

Preliminary figures state that the collection rate of equilibrated revenue within the consolidated budget reached 108.2 percent in 2017. 87 percent of the total revenue is collected through taxes while the remaining 13 percent is derived from non-tax sources. In case of the budget spending, it is underperformed by 5.4 percent, thus led to a budget deficit of 1741.9 billion togrog, which is less than the level previously estimated (Table II.1.3.1).

Equilibrated revenue of the consolidated budget

Increased imports following recovery of economic activities pushed the equilibrated revenue to 7239.1 billion togrog, which is a 23.7 percent growth from the previous year, a difference of 1387.0 billion togrog. According to the breakdown of the tax revenue, corporate income tax increased by 451.5 billion togrog, VAT on imports by 347.5 billion, customs duties on imports by 184.0 billion, VAT on domestic goods and services by 180.8 billion togrog and personal income tax rose by 141.3 billion togrog in 2017. In addition, following the tax hike, revenue from excise tax on automobiles increased by 61.5 billion togrog , year-over-year (Chart II.1.3.1).

Total expenditure and net lending

Performance of the total expenditure and net lending reached 94.6 percent. According to the breakdown of the expenditure, performance of current spending reached 96.8 percent (228.8 billion togrog less), capital spending was at 86.4 percent (259.1 billion togrog less) and net lending was at 92.9 percent (25.3 billion togrog less). In 2017, total budget expenditure decreased by 538.9 billion togrog from 2016. High budget deficit of recent years led to higher spending on debt service payments, thus interest payments in 2017 was equivalent to 16 percent of the equilibrated income (Chart II.1.3.2).

Table II.1.3.1

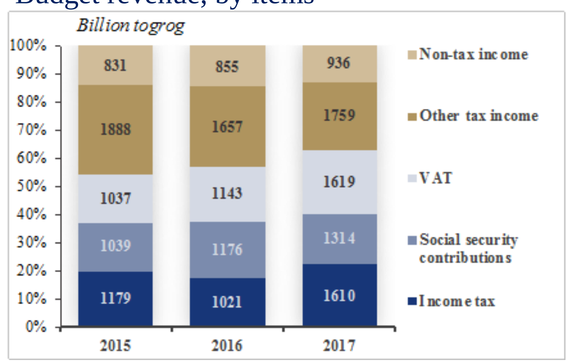
Fiscal indicators

	2016	2017		2017	
billion togrog	Act.	Amend1.	Amend2.	Act.	%
Total revenue and grants	5852	6511	7113	7923	109.0
Future heritage fund	-	267	333	358	107.3
Stabilization fund	-	209	242	326	134.3
Equilibrated revenue	5852	6036	6537	7239	108.2
Tax revenue	4997	5050	5661	6303	110.1
Imports related revenue	1449	1559	1814	1860	102.5
Mining related revenue	325	185	226	235	103.9
Other	3223	3306	3622	4208	116.2
Non-tax income	855	986	964	936	97.1
Total expenditure and net lending	9520	9088	9494	8981	94.6
Primary expenditure	8532	7877	8338	7825	93.9
Interest payment	988	1211	1157	1156	99.9
Budget balance	-3668	-3052	-2618	-1742	66.5
in percent of GDP	-15.3	-11.7	-10.0	-6.4	
Primary balance	-2680	-1841	-1461	-586	
in percent of GDP	-11.2	-7.1	-5.6	-2.2	

Source: Ministry of Finance

Chart II.1.3.1

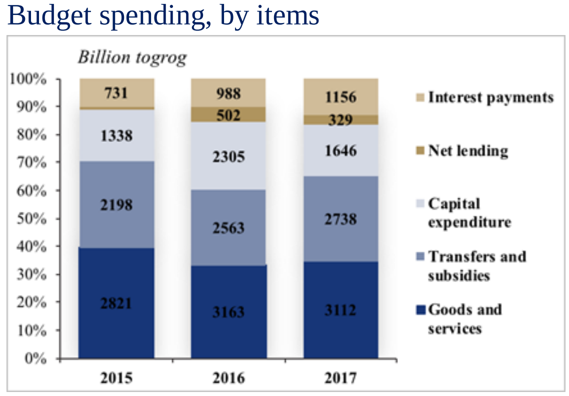
Budget revenue, by items



Source: Ministry of Finance

Chart II.1.3.2

Budget spending, by items



Source: Ministry of Finance

Fiscal stance and fiscal impulse

As Mongolia's economic growth and the performance of the budget revenue are highly prone to volatile commodity prices and the mining sector, total equilibrated fiscal stance is adjusted by output gap to estimate the fiscal stance (cyclically adjusted fiscal stance).

Fiscal deficit as a percent of GDP declined by 8.5 percentage points, thus fiscal impulse reached -8.5 percentage points in 2017, suggesting a tighter fiscal stance relative to 2016. (Chart II.1.3.3).

Ratio of newly issued debt to debt repayment[17]:

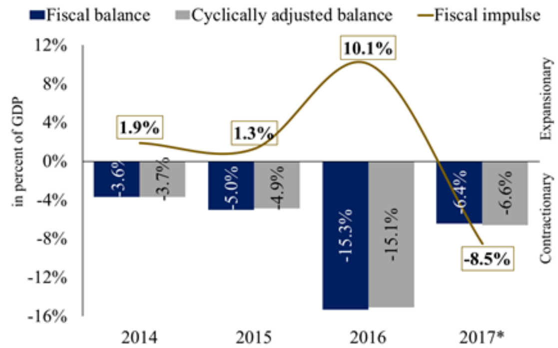
Ratio of newly issued debt and debt repayment constantly exceeded 100 percent in recent years. This suggests debt build-up of the government of Mongolia.

In 2017, a total of 6720.5 billion togrog was paid as payment for both principle debt and its service. As the government issued new debts worth 8236 billion togrog in the form of bonds and credit, the ratio of newly issued debt to debt repayment reached 123 percent (Chart II.1.3.5).

Present value of the sovereign debt: Total present value of the government debt reached 74.4 percent of GDP at the end of 2017, thus it is within the limits set by the law (Chart II.1.3.6).

Chart II.1.3.3

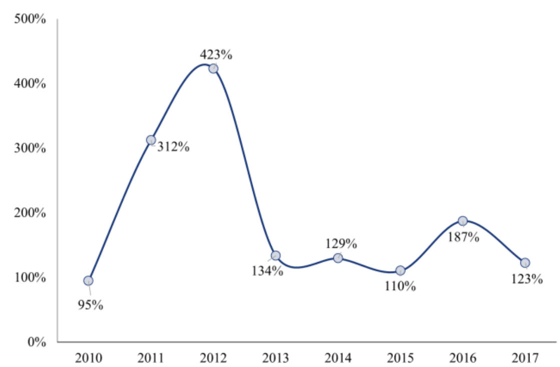
Fiscal stance and fiscal impulse, annual



Source: Bank of Mongolia, author's calculations

Chart II.1.3.5

Ratio of newly issued debt to debt repayment



Source: Bank of Mongolia, author's calculations

Chart II.1.3.6

Present value of the sovereign debt

	2015	2016	2017	2018*	2019*	2020*
billion togrog	Act.	Act.	Act.	Approved	Forecast	Forecast
Total government debt	12124	18861	22752	24310	25429	26296
in percent of GDP	52.3	79.0	74.4	80.0	75.0	70.0
Of which: external debt	38.5	56.0	55.1	-	-	-
Debt cap/GDP	58.3	88.0	85.0	80	75	70

Source: Ministry of Finance

[17] "Ratio of newly issued debt to debt repayment" is calculated by dividing the total government bonds and credits newly issued in the reporting year to the total of repaid government bond, credit and its service fees paid in the same period.

II.1.4 Money and financial market

II.1.4.1 Money and loan indicators

Monetary indicators continued to accelerate in the last quarter of 2017 and growth of bank loans gradually increased. Growth of net foreign reserves and new loans issued for consumption purposes were the main drivers of growth of money supply. In the reporting quarter M2 money expanded by 30.5 percent and loans outstanding increased by 11 percent year-over-year.

An addition of 1.5 billion USD was made to net foreign reserves year-over-year, thus it made a contribution of 27 percentage points to total money supply growth. External funding from donor countries under the "Extended Fund Facility" program, receipt of the government's "Gerege" international bond and foreign direct investments for the Oyu Tolgoi underground mining project contributed to the foreign reserves.

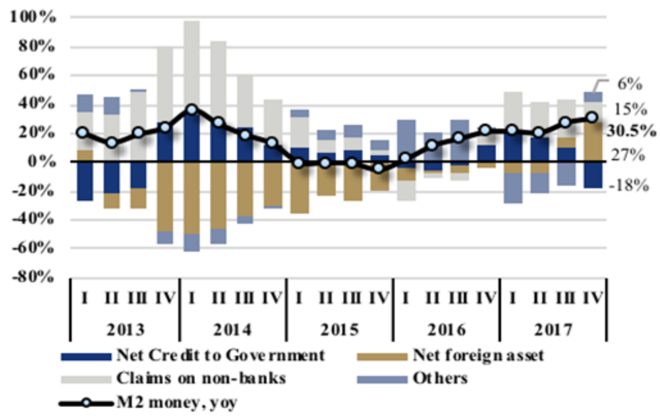
Funds at banks to issue new loans increased as foreign exchange inflow increased, budget deficit declined and external funding to finance budget deficit expanded. Thus, outstanding value of loans issued for consumption[18] and mining activities increased respectively by 35 and 48 percent year-over-year, boosting overall money supply growth by 13 percentage points.

From the banking system's liability side, main driver of money supply growth was togrog deposits. In particular, compared to same period of the previous year togrog deposits increased by 50 percent thus boosting overall money supply growth by 23.3 percentage points alone.

De-dollarization of financial system liability and growing togrog deposits and current accounts indicate stabilization of expectations and confidence regarding macroeconomic environment.

Chart II.1.4.1.1

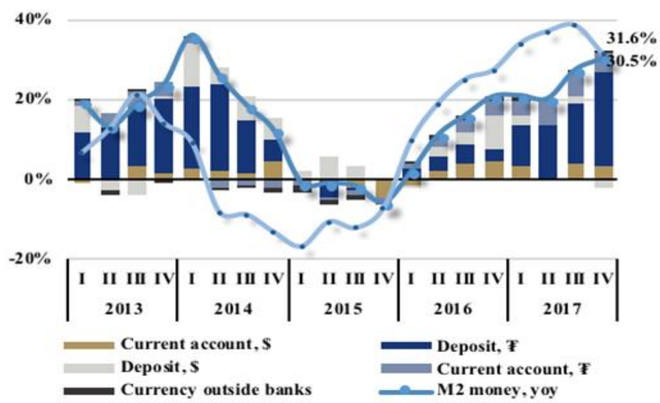
Annual growth of M2 money by items, asset side



Source: Bank of Mongolia

Chart II.1.4.1.2

Annual growth of M2 money by items, liability



Source: Bank of Mongolia

Table II.1.4.1.1

Money supply: asset and liabilities

Billion togrog	2014	2015	2016	2017
Net foreign assets	-2009	-4158	-4580	-1252
Net domestic assets	12643	14207	16723	17114
Money supply/M2/	10634	10049	12143	15861
M1 money	1816	1685	2125	2826
Currency outside banks	499	459	563	612
Current account,₮	1317	1227	1562	2214
Quasi money	8818	8364	10018	13035
Deposits,₮	5410	5434	5791	8622
Deposits, $	1969	1948	2790	2532
Current account, $	1439	982	1438	1881

Source: Bank of Mongolia

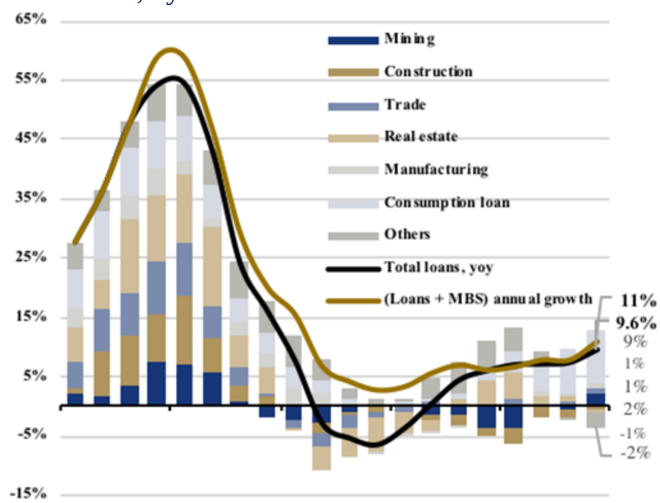
[18] Consumption loans consist of wage, pension and deposit collateralized loans, credit card balance and other consumption related loans.

Outstanding loans (including mortgage backed securities sold to the MMC) of the depository institutions[19] rose by 11 percent year-over-year. In particular, business loans issued for mining, manufacturing and the trade sector increased. High growth of loans issued for mining sector can be mainly explained by the base year effect, while in case of the trade sector it is mostly related to one off, large credits issued to few customers by certain banks. The discounted mortgage credit program continues to grow and thus supports overall credit growth.

New loans are mostly issued for consumption purposes and to the trade sector. Growth of credits collateralizing wages and other consumption credits contributed 8 percentage points to the growth of newly issued loans. In case of trade sector, large sums of newly issued loans in the past 2 quarters were related to one-off special credits issued to few customers by certain banks. However, credit to other sectors are not increasing, as the quality of credit does not improve.

Chart II.1.4.1.3

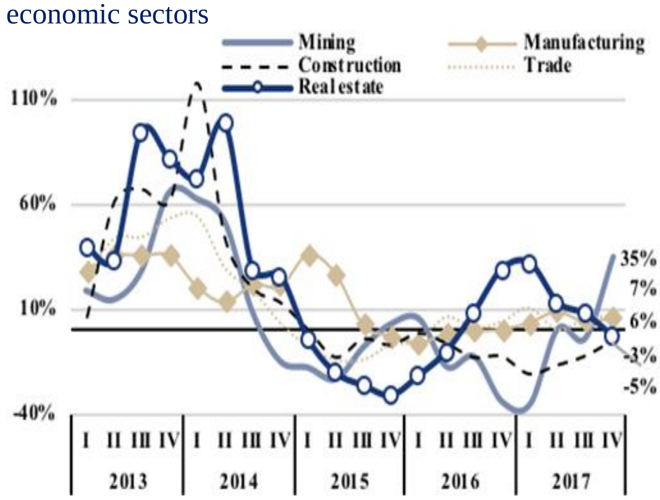
Contributions to annual credit growth of depository institutions, by economic sectors



Source: Bank of Mongolia

Chart II.1.4.1.4

Annual credit growth of depository institutions, by economic sectors



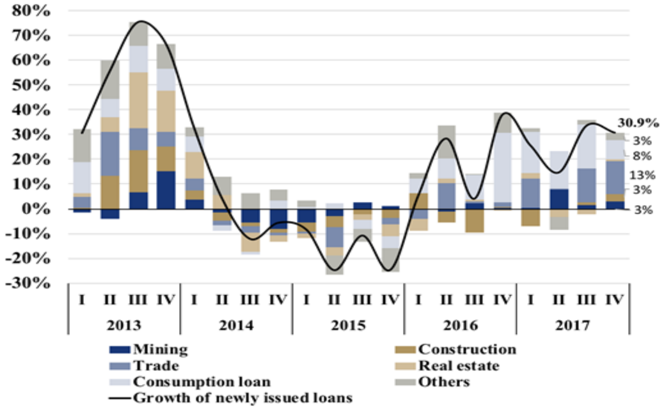
Source: Bank of Mongolia

[19] Depository institutions consist of banks, and deposits and loans cooperative.

Percent of nonperforming and past due loans to banks' total loans outstanding remains same as the previous quarter. Although the nonperforming and past due loans in the mining and trade sector declined, it is not the case for sectors such as manufacturing and construction. Considering economic sectors, 42 percent of total nonperforming and past due loans belong to the mining and manufacturing sectors. Regarding the past due loans, 53 percent of them were issued to the mining and the construction sector.

Chart II.4.1.5

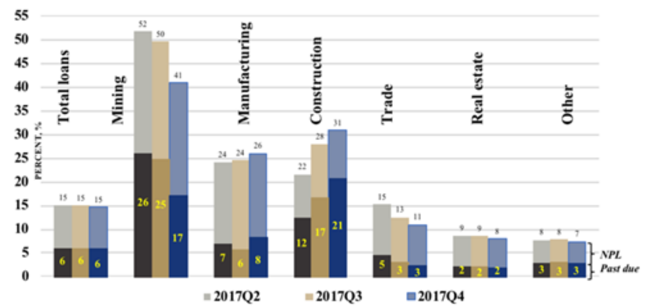
Annual growth of newly issued bank loans, by economic sectors



Source: Bank of Mongolia

Chart II.4.1.6

Nonperforming and past due loans, as percent of total loans in economic sectors



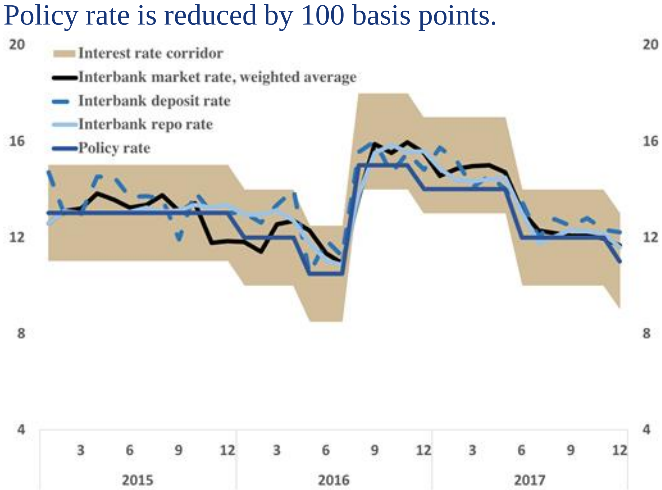
Source: Bank of Mongolia

II.1.4.2 Interest rate

During its meeting in December 2017, the Monetary Policy Committee of the Bank of Mongolia decided to reduce policy rate by 100 basis points to 11 percent. Following the policy rate reduction, interest rate of repo deals collateralizing the central bank bills dropped by 70 basis points to 11.6 percent, interest rate on direct deals with the central bank bills declined by 4 basis points to 11.8 percent, interest rate on overnight repo deals dropped by 70 basis points to 11.4 percent, and the interbank deposit rate declined by 20 basis points to 12.2 percent. Thus, weighted average of the interbank market rate declined by 40 basis points from the previous quarter to 11.7 percent.

Chart II.1.4.2.1

Policy rate is reduced by 100 basis points.



Source: Bank of Mongolia

Interest rates on government bonds remain stable. For instance, interest rate of 1-year government bond issued at the primary market remained unchanged from previous quarter at 11.8 percent in October of 2017[20]. Interest rate on government bonds with maturities less than 3 months, sold at the secondary market reached 12.03 percent in December of 2017, which is 15 basis points higher than the previous quarter. Outstanding value of total government bond reached 3.7 trillion togrog in the reporting period, which is a decline of 19 percent from previous quarter. The outstanding value of the government bond is declining as the budget deficit is financed through external funds under the IMF's "EFF" program and the budget revenue performance is exceeding its planned figure.

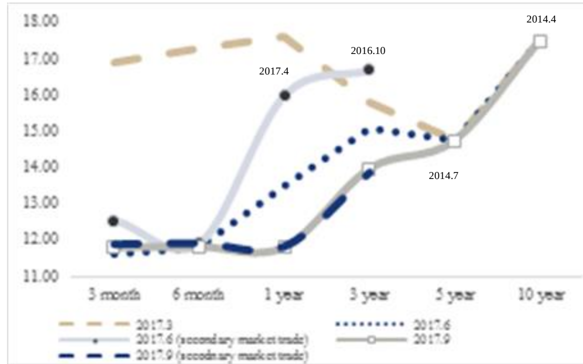
Banks are lowering their interest rate on togrog deposits and credit. For instance, in December 2017, interest rate on togrog credit[21] declined by 110 basis points to 18.82 percent and interest rate on togrog deposit declined by 10 basis points to 12.87 percent. As the change in credit interest rate exceeded that of deposits, interest rate margin on togrog declined to 5.9 percent.

Interest rates on foreign exchange credit and deposits remained unchanged from previous quarter.

In the reporting quarter, relative return on togrog increased by 0.24 percent from previous quarter to 1.25 percent. Although the interest rate on both togrog and foreign exchange deposits remained fairly unchanged from previous quarter, 0.63 percent appreciation of togrog exchange rate against the USD pushed its relative return up.

Chart II.1.4.2.2

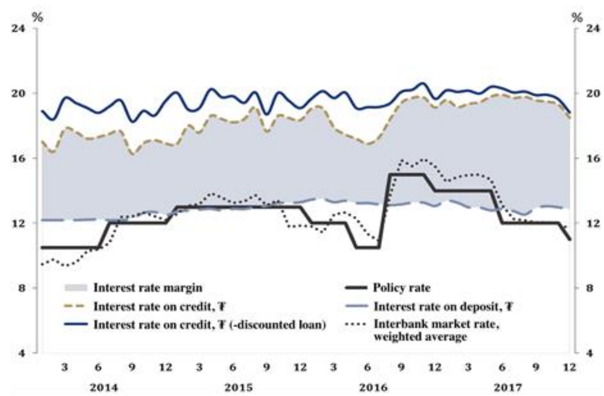
Interest rate on Government bond is stable.[22]



Source: Bank of Mongolia

Chart II.1.4.2.3

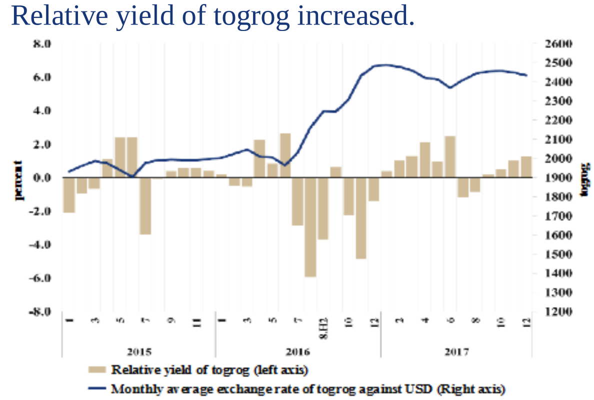
Interest rate margin between loans and deposit declined.



Source: Bank of Mongolia

Chart II.1.4.2.4

Relative yield of togrog increased.



Source: Bank of Mongolia

[20] No government bond was issued at the primary market in November and December.

[21] Interest rate on credits excluding discounted credits.

[22] Government bond with maturities over 5 years was not issued at the primary market since 2014 and was not sold at the secondary market.

II.1.4.3 Exchange rate

In the last quarter of 2017, nominal effective exchange rate[23] (NEER) appreciated by 1.2 percent and foreign relative prices declined by 3.4 percent compared to the previous quarter. In the same period real effective exchange rate[24] (REER) appreciated by 1.6 percent. /Chart II.1.4.3.1/. Improvements in the balance of payments, recovery of confidence in economic environment and positive market expectations[25] were the main factors leading to exchange rate appreciation. Widening gap between the nominal and real exchange rates can be attributed to acceleration of inflation starting mid-2017. An underlying economic cause of exchange rate appreciation is the 1.5 billion USD surplus of balance of payments. In particular, increased commodity prices at the global market, flow of funds under the IMF's EFF program, refinancing of both government and the Development Bank's bonds at the international market and increased foreign direct investments added to the balance of payments surplus.

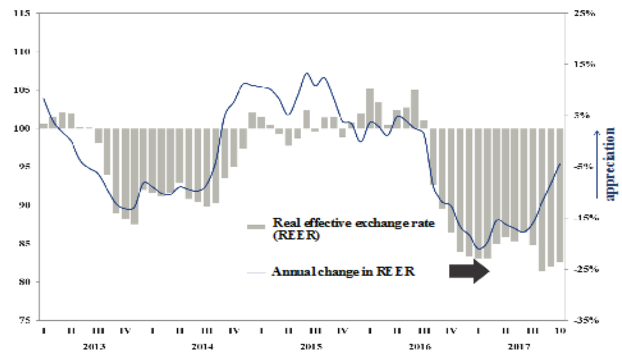
To detail the change in spot rate of togrog against selected currencies between the end of third quarter in 2017 and the end of January in 2018: togrog appreciated by 1.9 percent against the USD /Chart II.1.4.3.2/ and depreciated against other currencies of interest, by:

- 3.5 percent against RMB
- 1.6 percent against JPY
- 1.3 percent against RUB
- 3.5 percent against EUR /Chart II.1.4.3.3/.

As Chinese yuan, Japanese yen, Russian ruble and the euro appreciated against the USD more rapidly than the appreciation of togrog against the USD, togrog depreciated against these currencies. Increased investments to infrastructure and protectionist policy in the USA were the main cause of USD depreciation.

Chart II.1.4.3.1

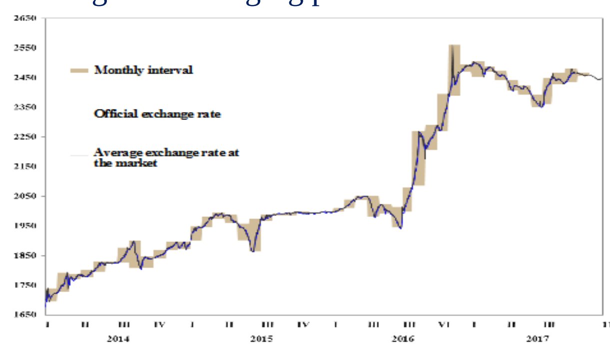
Real effective exchange rate



Source: Bank of Mongolia

Chart II.1.4.3.2

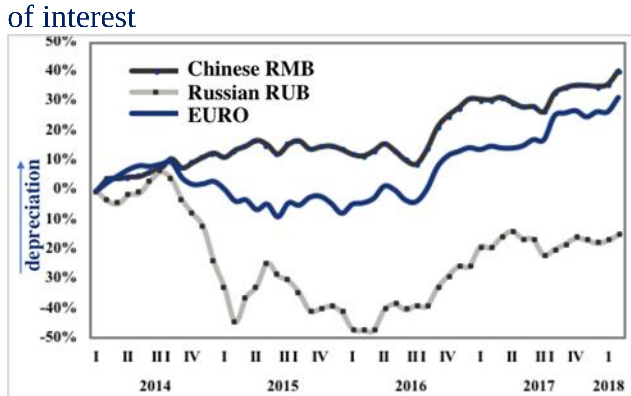
Exchange rate of togrog per USD



Source: Bank of Mongolia

Chart II.1.4.3.3

Change in spot rate of togrog against currencies of interest



Source: Bank of Mongolia

[23] NEER estimates the nominal exchange rate of togrog against selection of currencies used in foreign trade. Exchange rate of togrog against certain currencies, for instance USD, reflects the exchange rate used in deals made in such currency only, thus does not reflect the foreign trade conditions, completely.

[24] REER estimates the real exchange rate of togrog against selection of currencies used in foreign trade.

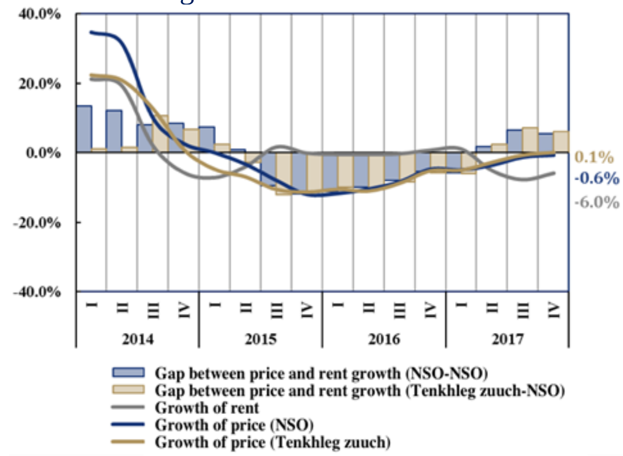
[25] Inflation expectation survey of the Bank of Mongolia in the 4th quarter of 2017.

II.1.4.4 Real estate market

Price of housing remained stable, while housing rent declined from previous quarter. In the 4th quarter of 2017, housing price index published by the NSO remained unchanged from previous quarter, while it was 0.6 percent lower than same time of the previous year. In the same period, housing price index published by "Tenkhleg Zuuch" agency increased slightly from previous quarter and rose by 0.1 percent year-over-year. In particular, price of new housing increased by 0.8 percent, while price of old housing declined by 0.8 percent year-over-year. In the reporting quarter, housing rent declined by 6.0 percent year-over-year and increased by 2.2 percent quarter-over-quarter. (Chart II.1.4.4.1).

Chart II.1.4.4.1

Price of housing remained stable

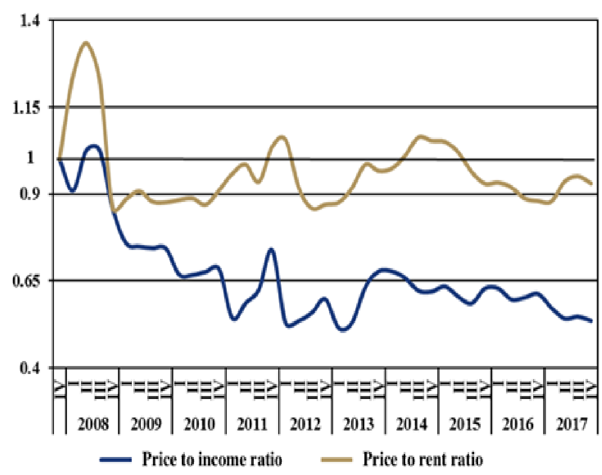


Source: NSO, Tenkhleg Zuuch

Housing price-to-income and price-to-rent ratios are declining from already low levels, thus imply weak purchasing power of households. As housing rents increased in the reporting quarter, price-to-rent ratio declined from previous quarter. Household income increased by 2.2 percent quarter-on-quarter and 13.8 percent year-over-year, and pushed the price-to-income ratio down in the reporting quarter. (Chart II.1.4.4.2).

Chart II.1.4.4.2

Demand for housing is low in recent quarters.



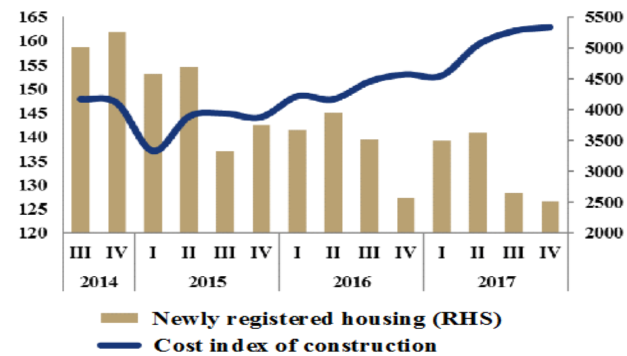
Source: NSO, author's calculations

Prices of construction materials have been on a rising trend in the past three years as well as in the reporting quarter. Cost index of construction materials increased by 0.5 percent quarter-on-quarter and by 6.4 percent year-over-year. (Chart II.1.4.4.3).

In the reporting quarter, according to the Property Rights Registration Agency (PRPA), a total of 2513 new apartments were sold and issued new certificates, which is a 5 percent lower figure compared to previous quarter and 2.1 percent decline year-over-year. In the same period, banks issued mortgage loans worth 163.3 billion togrog to 2347 households, which is a 17.7 percent higher figure from previous quarter, while a 6.7 percent decline year-over-year. Loans issued under the discounted mortgage program[26] constitute 77.4 percent of total outstanding mortgage loans.

Chart II.1.4.4.3

Cost index of construction materials increased.



Эх сурвалж: YCX, ЭХЭБГ

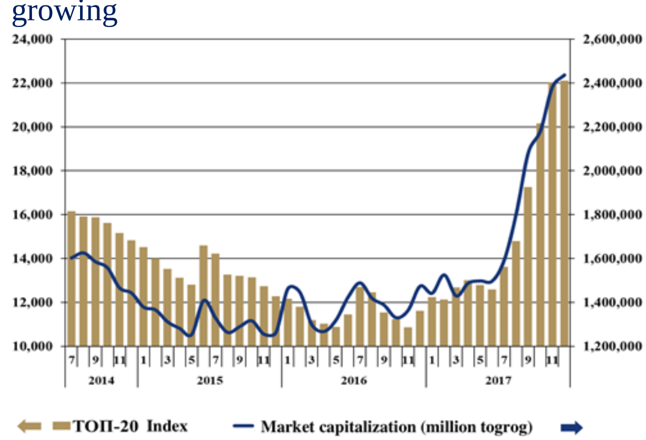
Indicators of the capital market are showing resilient growth. In the last quarter of 2017, TOP-20 index of Mongolian Stock Exchange reached 21437.3 units, which is a 90.9 percent growth from previous year and 40.9 percent higher figure from previous quarter. Total market capitalization reached 2.33 trillion togrog in the reporting quarter, which is a 67.9 percent growth from previous year and 27.7 percent growth from previous quarter. (Chart II.4.4.4). Stocks which performed exceedingly well are stocks of APU, SUU, Gobi and Mongol Post companies.

In the reporting quarter stocks worth 58.1 billion togrog was traded, of which close to 70 percent was traded in December as portfolio.

Trading of APU company stocks was halted by the Financial Regulations Committee, due to its takeover of Evergreen Ltd in November of 2017 and restored in December. Such development was a significant cause of increased trading activity in December.

Chart II.1.4.4.4

Total market capitalization and TOP-20 index of the Mongolian Stock Exchange are rapidly growing



Source: Mongolia Stock Exchange

[26] Program to develop sustainable funding scheme for mortgage loans.

II.2 External demand

In the last quarter of 2017, economies of Russia, Euro area, China and the USA performed better than previously forecasted. Similarly, prices of commodities at the global market increased mainly due to USD depreciation, expectation of OPEC's decision to cut oil supply, greater production of shale oil in the USA, economic growth of China which exceeded the market expectations and increased importing demand for coal, iron ore and copper in the winter months in relation to Chinese policy to curb down air pollution.

II.2.1 Economic condition of main trading partners

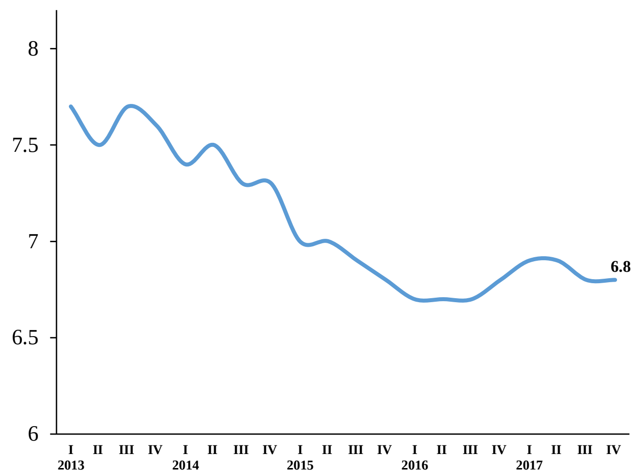
Chinese economy

Following growth of 6.9 and 6.8 percent in the 2nd and 3rd quarter of 2017, Chinese economic growth in the 4th quarter reached 6.8 percent and exceeded previous growth forecasts. In particular growth of services and export sectors were the main contributors to overall economic growth. Services sector, which generates 52.9 percent of the total GDP, expanded by 8.3 percent in the reporting quarter. In case of exports, its growth picked up from 7.5 percent in the 3rd quarter to 9.1 percent in the last quarter. Mirroring greater confidence of consumers and entrepreneurs in the market and positive turnover in the manufacturing sector, the Caixin PMI index reached 51.5 in the last quarter. Following the strong growth performance, CPI inflation reached 1.8 percent. Producer's price index increased by 5.4 percent following the prices of commodities. A breakdown of the GDP growth in 2017 suggests that services sector contributed 58.8 percent of overall growth, while gross investments and net imports of goods and services made contributions of 32.1 and 9.1 percent, respectively.

To protect the exchange rate of RMB and curb down credit growth, the PBOC is highly likely to increase interest rates on 1-year deposit (1.5%) and credit (4.35%) in the first quarter of 2018. Furthermore, RMB is expected to depreciate against the USD due to expectations of interest rate hike by the US Federal Reserve 4 times in 2018 and the tax reform proposed by president Trump.

Chart II.2.1.1

Economic growth of the PRC, in percent /y-o-y/



Source: Bloomberg, Roubini

Chinese economic conditions remain highly dependent on the conditions of debt and financial account deficit. In this regard, the Chinese authority is expected to restructure its social and economic policies to engineer sustainable economic growth based on domestic demand in the following years. The policy restructuring involves reducing economic growth targets steadily and limiting investments to the manufacturing and real estate sectors in the medium to long run. Following the 19th party congress held during October 18th-24th, 2017 where the 5-year plan on economic outlook and policies were discussed, "Central Economic Work Conference" was held during November 18th-20th to discuss the detailed plan of policy implementations in 2018. During the Work Conference, it was decided to focus more on high quality economic development and less on the rate of growth, and to reach the goal of

"Doubling the GDP levels of 2010 by 2020" which was set forth by the 12th party congress, before the targeted deadline. To reach the GDP goal, the Chinese economy must expand by 6.3 percent on average between 2018-2020. As the deceleration of investments to real estate and manufacturing sectors is expected to be slower than previously estimated and the household consumption growth is expected to remain steady, international analysts expect economic growth to pick up between 2018-2019. (EIU, Bloomberg & Roubini).

The IMF remains cautious regarding the total debt of households, government and the private sector, which is estimated to reach 300 percent of GDP in 2022, and its potential consequences on the stability of business environment and banking sector. To this end, the IMF warns the Chinese authorities to consider prudential debt management measures, which may reduce economic growth in the medium term.

The US economy

In the USA, economic growth reached 2.5 percent year-over-year in the final quarter. Such expansion was mirrored by lower unemployment rate, improved labor market indicators and greater investments and exports. In particular, investment and exports, which grew by 4 and 4.9 percent respectively, were the greatest contributors of growth.

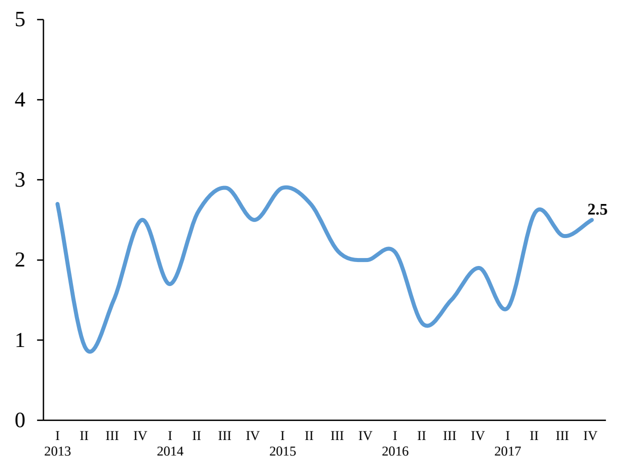
Although 33 thousand jobs were lost due to the Harvey and Irma hurricanes which passed through the states of Florida and Texas in late August and early September of 2017, employment continued to grow and unemployment declined to 4.1 percent. As 148 thousand new jobs were created, labor market indicators are strong. Household consumption which accounts for close to 70 percent of the GDP, grew by 2.4 percent in the 3rd quarter and its growth accelerated to 3.8 percent in the following quarter.

Although the US president Donald Trump's plan to reduce taxes and increase investments to the infrastructure would support economic growth in the short term, international research agencies note that aging population, declining productivity in the manufacturing sector, expectations of increasing budget deficit from 3.5 percent in 2017 to 4.1 percent of GDP in 2019, growing sovereign debt, and economic and political uncertainties resulting from protectionist policies may pose negative risks to economic growth.

Following economic recovery and accelerating inflation, the Federal Reserve raised its short-term interest rate to 1.5 percent in the last quarter of 2017. Research agencies speculate that the Federal Reserve would hike interest rate not three, but four times this year.

Chart II.2.1.2

Economic growth of the USA, in percent /y-o-y/



Source: Bloomberg, Roubini

Russian economy

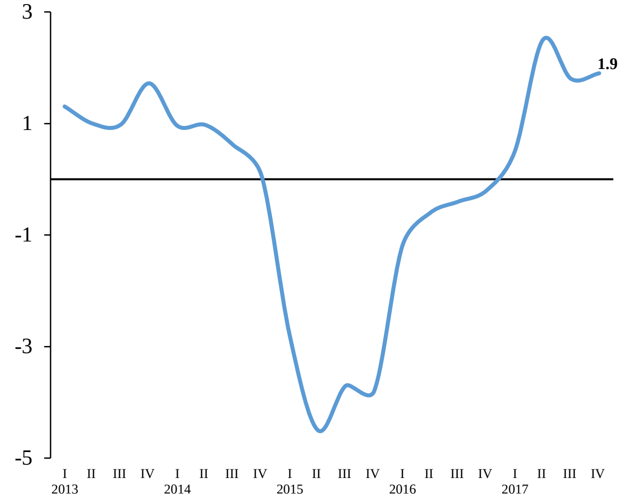
Economic growth exceeded previous forecasts and reached 1.9 percent year-over-year in the last quarter of 2017. A breakdown of the overall growth implies that the household consumption, retail sales, exports and total investments were the components that expanded the greatest. In particular, household consumption grew by 4.1 percent in the last quarter and investments expanded by 3.8 percent, as well. Furthermore, the PMI index reached 52 in the last quarter, after declining to 51.5 in the third quarter.

Retail sales and exports also increased by 4.3 and 3.8 percent, respectively, thus contributing to overall growth. Mirroring economic recovery, unemployment rate declined to 5.1 percent as of December 2017, which is the lowest since January 2009.

Annual inflation on the other hand reached 2.6 percent in the same quarter, which is lower than the Central Bank's target of 4 percent. Hence, the Central Bank of Russia loosened its monetary policy throughout 2017. In particular, the policy rate was reduced by 50 basis points in September to 8.5 percent, by 25 basis points to 8.25 percent in October, and again by 50 basis points to 7.75 percent in December.

Chart II.2.1.3

Economic growth of the Russian Federation, in percent /y-o-y/



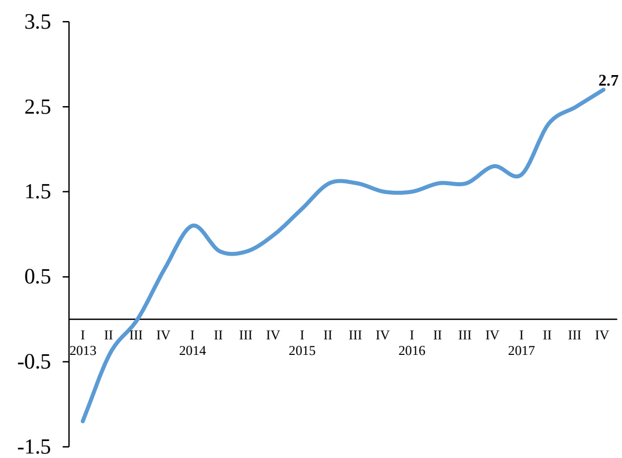
Source: Bloomberg, Roubini

The Euro area economy

The Euro area economy expanded by 2.5 percent in the third quarter and by 2.7 percent in the fourth quarter of 2017, reaching the highest point since the first quarter of 2011. Strong economic performance was mostly aided by economic recovery in its trading partners, receding political uncertainty and loose monetary policy by the ECB. As of December 2017, PMI index reached 60.6 percent, which is the highest level since April 2011. Household consumption expanded by 1.8 percent, thus contributed to overall economic growth, while inflation remained unchanged from its previous quarter at 1.4 percent in December. According to international research agencies, impact of non-traditional extra loose monetary policy on wage growth is weak, thus inflation remains below the target of 2 percent. Within the Euro area, although economies of Germany and Spain, which contribute 29 and 11 percent of the total GDP respectively, grew less than previously forecasted, economic growth of France, which generates 21 percent of the region's GDP exceeded expectation, thus boosted overall growth in the region.

Chart II.2.1.4

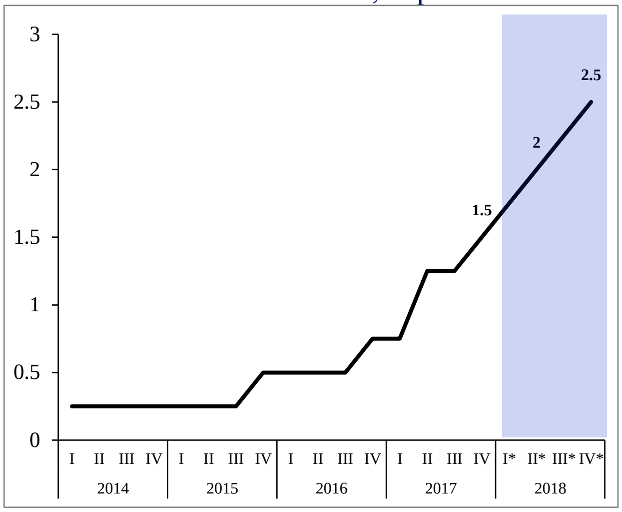
Economic growth in the Euro area, in percent /y-o-y/



Source: Bloomberg, Roubini

Chart II.2.1.5

Federal Reserve short term rate, in percent



Source: Bloomberg

Foreign interest rate

Motivated by declining unemployment, positive developments in the labor market, accelerating inflation rate, expanding real income of households and stabilizing household consumption in the US, the Federal Reserve raised its short term rate to 1.5 percent in the last quarter of 2017. International analysts are expecting the Federal Reserve to hike 4 times in 2018, starting as early as March and 3 more in 2019. Federal Reserve's tendency to hike its short term interest rate and policy shift to slim down its balance sheets starting 4th quarter of 2017, are expected to reduce price of long term assets and push their yields up. For instance, yield on the US 10-year treasury bonds doubled in the last 20 months, reaching 2.8 percent. In addition, interest rate on 30-year mortgage credit increased by 1 percentage point. Such increasing trend of interest rates on long term assets may raise the issue of debt sustainability in developing countries as well as difficulty of restructuring existing external debts denominated in USD, in the medium term.

II.2.2 Global prices of main exporting commodities

Copper: At the end of 2017, average price of copper reached $6834 per ton, which was the highest in the last three years. Price of copper further increased to $7065 per ton at the end of January, 2018. Higher price implies strong demand for copper supported by stable economic growth in China. On the other hand, expectation of disruptions to copper supply due to labor contract renewals at major copper mines (Chile and Peru) was a supply side factor pushing the prices up. The Australian Department of Industry, Innovation and Science (Quarterly publication on resources and energy) estimates global demand for copper to increase by 2 percent per annum during 2016-2018, and global supply to increase by 1.7 percent per annum. According to the EIU, demand/consumption of copper in China, the largest consumer of copper worldwide, is forecasted to increase by 3.4 percent in 2018, as its investments to energy, construction and manufacturing sectors are expected to expand. Considering the factors that may push the prices, forecast of copper price is elevated by $673 per ton in 2018 and by $1122 per ton in 2019, from previous forecasts.

Gold: Price of an ounce of gold increased from $1290 in the third quarter of 2017 to $1303 in the last quarter, mainly due to increased geopolitical risk, depreciation of USD exchange rate and rising yield of US treasury bond. Price of gold is highly sensitive to political and geopolitical issues, in particular the US president Donald Trump's sudden decisions on economic and political issues and its impact on the US and North Korea relations. According to the analysts of "Bloomberg Markets", although the sensitive relation between the US and North Korea would continue to create geopolitical uncertainties, tight monetary policy by the Federal Reserve and uncertainty regarding the tax reform in the US are expected to push investors to seek riskier and highly profitable investment opportunities. Considering the likelihood of the Federal Reserve further tightening its policy, uncertainty regarding

Mr. Trump's tax reform and low and stable inflation rate in developed countries, forecast of gold price is revised up by $7 in 2018 and reduced by $11 in 2019, compared to previous forecasts.

Thermal coal: Price of coal increased from $77 per ton in the third quarter of 2017 to $79 in the last quarter. In this quarter, price forecast of thermal coal is revised up by $12 in 2018 and by $13 in 2019. As the Chinese authority reduced thermal coal mining in an attempt to reduce air pollution, Chinese import for thermal coal increased in the reporting quarter. Furthermore, due to seasonal effect Chinese demand for thermal coal is pushed up. According to the customs data, in January of 2018 Chinese import of thermal coal increased by 27.8 million tons from previous month mainly due to extremely cold weather, thus reached its peak level since January 2014. Higher price of thermal coal was supported by accelerating economic growth in China and insufficient supply of renewable energy. According to the Australian Department of Industry, Innovation and Science, expansions of coal mines in the New Southern regions of Australia ("Rollerton", Hunter Valley, Ravensworth) are expected to be completed and push coal mining to grow by 2 percent per annum on average between 2018-19. Thus, coal supply is expected to increase from 250 million tons to 254 million tons. In the medium term, price of thermal coal is expected to decline as production of renewable energy pushes the market, cost of production declines, China's demand for coal diminishes and supply of high quality coal from South Africa and Australia increases.

Coking coal: Benchmark price of Australian coking coal[27] increased from $183 per ton in the third quarter of 2017 to $239 per ton in the 4th quarter. Forecast of coking coal price is revised up by $26 in 2018 and by $28 in 2019. High demand from China and possibilities of lower supply of coking coal pushed its price up. This year labor contracts at coal mines in the New Southern region of Australia ("South32' Appin", "Hunter valley") are expected to be renewed, thus create disruptions to coking coal supply and put upward pressure on prices. On the other hand, according to the Australian Department of Industry, Innovation and Science, coking coal mining production is forecasted to increase slightly from 190 million tons in 2017 to 196 million ton in 2018. In the medium to long term, China's demand is expected to diminish, while supply from Australia and Canada is expected to increase, thus create downward pressure on coking coal prices in the medium run.

Iron ore: Average price of iron ore increased from $65 per ton in the third quarter to $69 per ton in the last quarter and reached $73 per ton at the end of January 2018. From previous forecasts, current forecast is increased by $2 per ton in 2018 and by $6 in 2019. As the Chinese authorities limited production of coal and steel in the winter months, demand for steel exceeded its supply. China's iron ore imports grew by 20 percent from previous month and reached close to 100 million tons at the end of January 2018. Shortage of supply from Brazil and Australia pushed the price up in the reporting period. According to the "Barclays Plc" analysis, due to Chinese policy, profitability of steel producing companies is expected to decline thus further reduce their production. The Australian Department of Industry, Innovation and Science estimates the Brazilian "Vale" and "Minas Rio" mines to increase their annual production by 17-26.5 million ton until 2019, once its construction on mining extension is completed. In addition, the "BHP" company is expected to keep its production at 275-280 million ton till the end of 2018, thus further boost supply and deflate prices.

Oil: Price of Brent oil increased from $55 per barrel on average in the third quarter of 2017 to $67 at the end of December and $69 at the end of January 2018. Price forecast of Brent oil is slightly revised up by $2 per barrel in 2018 and by $4 in 2019. Main factor leading to higher prices is the reduction of oil reserves at the US warehouses, 17 days in a row. "Bloomberg Markets" reported that the daily production of oil in the USA exceeded 10 million barrels on February 5th, 2018, which is the first time in the last 48 years. According to the EIA, this level is equivalent to the volume of production preceding the day when the OPEC and non-OPEC countries (Saudi Arabia 10.6 million and Russia 11 million) started to curb down oil productions. In addition, tax reform in the USA is

[27] Australian premium coking coal

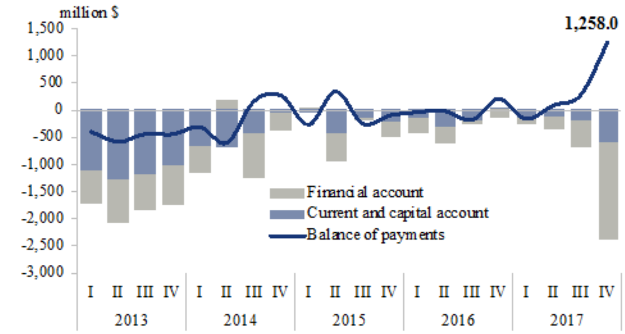
expected to increase the profits of oil exporters, thus boost supply of oil. In 2019 uncertainty regarding supply of oil is diminished as Russia and the Saudi Arabia announced potential of extending the OPEC agreement to trim oil supply. According to the renewed forecasts of EIU, global consumption of oil is expected to grow by 1.6 percent in 2018 and following the increased demand, oil supply by non-OPEC countries and the USA is expected to grow by 1.8 percent.

II.2.3 Balance of payments

Balance of payments improved relative to both previous quarter and previous year. As of 4th quarter of 2017, current and capital account balance is at a deficit of 596.1 million USD, financial account reached a surplus of 1635.8 million USD, and thus overall balance of payments reached a surplus of 1044.1 million USD, which is equivalent to 11.3 percent of GDP[28]. (Chart II.2.2.1).
Balance of payment surplus was supported by increased revenue from commodity exports, foreign exchange inflow under the IMF's EFF program, receipts of the government's newly issued "Gerege" international bond and foreign direct investments.

Chart II.2.2.1

Greater surplus in the financial account promoted surplus of the overall balance of payments

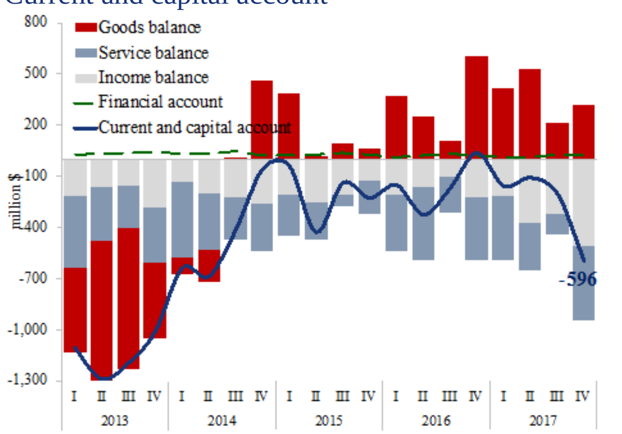


Source: Bank of Mongolia

Deficit of current and capital account increased by 633 million USD in the 4th quarter of 2017 from previous year, reaching 596.1 million USD. (Chart II.2.2.2). Despite the surplus in balance of goods, deteriorating balance of income account due to increased foreign payments and dividends from Mongolia and greater demand for imports of transportation and business services following recovery in economic activities and trade turnover, pushed the current and capital account balance to deficit. As a result, in 2017 current account deficit reached 13.4 percent of GDP.

Chart II.2.2.2

Current and capital account



Source: Bank of Mongolia

Export revenues of copper, coal and other commodities increased in the reporting quarter. However, traffic congestion at the Gashuun-Sukhait border port caused by the non-tariff barrier on coal exports in the latter half of 2017, set limited export growth. In the same quarter, imports grew by 34.4 percent from previous year mainly due to increased demand for consumption, machinery, equipment, parts, diesel fuel and construction materials following economic recovery and increased investment to the mining sector (Chart II.2.2.3). In addition to increased imports, demand for transportation, logistics, trade and business related services as well as foreign services regarding the

[28] 4 quarter cumulative, nominal

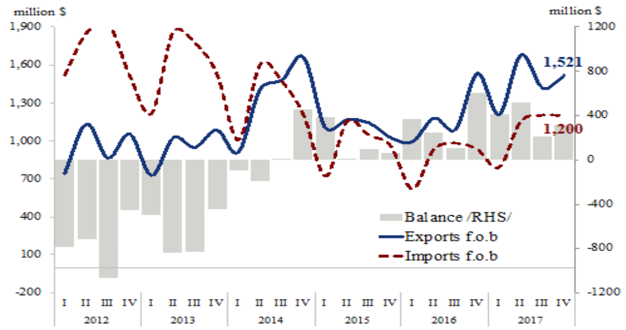
construction at the Oyu Tolgoi project increased in the same quarter, thus contributed to the current account deficit.
Deficit of current income account reached 543.9 million USD in the reporting quarter, which is a 281.0 million USD or 107 percent deterioration from previous year. Increased payments of interest and dividends to foreign credit and investments were the main items leading to greater deficit and source of pressure on the overall balance of payments. In particular, share of primary income balance in overall current account deficit was close to 20 percent in 2012, while it reached 102 percent in 2015, 130 percent in 2016 and 257 percent in 2017 according to preliminary figures. In case of 2017, 81 percent of such expansion can be attributed to income of foreign direct investment. In particular, income of reinvested earnings increased by 250 percent (in absolute terms) from previous year, which is a difference of 268.0 million USD. (Chart II.2.2.4).

Financial account surplus reached 1789.0 million USD in the 4th quarter of 2017, which is an expansion of 1635.8 million USD from previous year or 1067 percent growth. In the reporting quarter, foreign direct investments increased by 378.8 million USD, portfolio investments grew by 416.5 million USD and foreign borrowing increased by 801.0 million USD, thus supported the financial account surplus. (Chart II.2.2.5).
Other investments account or foreign borrowing reached a surplus of 923.3 million USD in the 4th quarter of 2017, which is a 655 percent growth from previous year. Main contribution to such surplus was donor funding of 496.7 million USD received from the World Bank, Asian Development Bank and the government of Japan under the EFF program.

Foreign exchange official reserve: Owing to improved balance of payments in the reporting quarter, official reserves of foreign exchange reached 3.0 billion USD at the end of 2017, which is sufficient to cover foreign exchange payments for 8 months of imports. (Chart II.2.2.6). Since the beginning of the year, the official reserves was added 1711.8 million USD and net foreign reserves expanded by 1481.1 million USD. From the asset side, funds received under the IMF's EFF program and gold purchased by the

Chart II.2.2.3

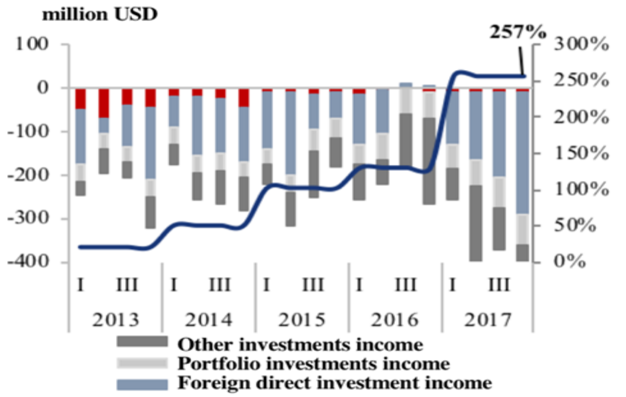
Import grew rapidly and surplus of goods balance deteriorated.



Source: Bank of Mongolia

Chart II.2.2.4

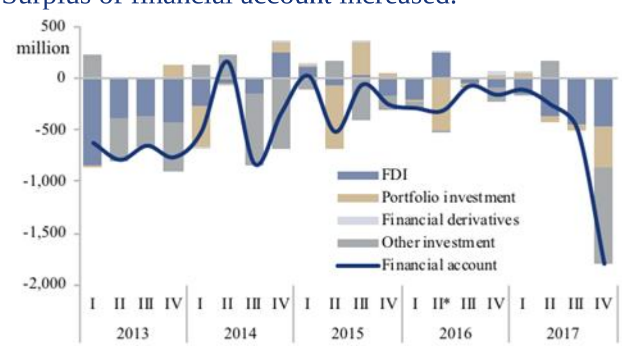
Deficit of income account increased.



Source: Bank of Mongolia

Chart II.2.2.5

Surplus of financial account increased.



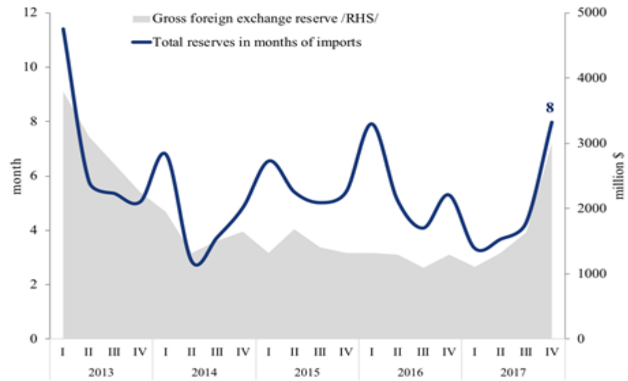
Source: Bank of Mongolia

Bank of Mongolia contributed to the net reserve accumulation. From the liability side, declining obligations in foreign exchange to the banks supported net reserve accumulation.

Terms of trade improved by 13 percent from previous year in the last quarter of 2017, owing to rapid growth of export prices which surpassed the growth of import prices. (Chart II.2.2.7). Price of exports increased by 27 percent mainly due to higher commodity prices at the global market. For instance, border prices of coal, copper, zinc, oil and gold increased by 47, 34, 32, 13 and 7 percent in the reporting quarter. On the other hand, price of imports increased by 8.6 percent mainly due to higher importing prices of consumption and investment items, as well as fuel.

Chart II.2.2.6

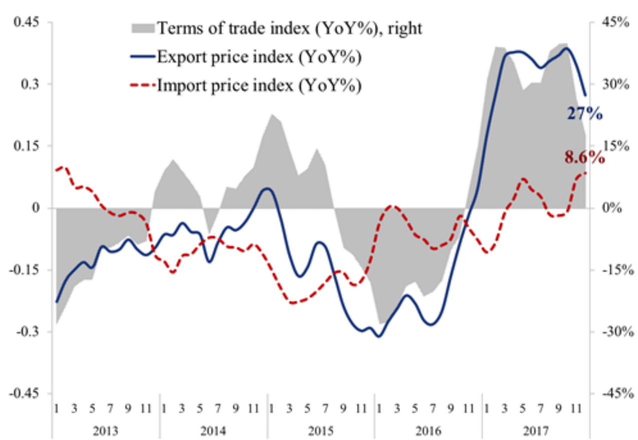
Official reserves of foreign exchange reached 3.0 billion USD.



Source: Bank of Mongolia

Chart II.2.2.7

Improvements in the terms of trade are observed.



Source: Bank of Mongolia, Mongolian Customs

BANK OF MONGOLIA