THE BANK
OF MONGOLIA

INFLATION REPORT

2018

JUNE

Monetary policy strategy and decision

Monetary policy strategy

According to the Central Bank law, the **main objective of the Bank of Mongolia is to stabilize togrog**. Within this objective, in the medium run the Bank of Mongolia implements monetary policy to stabilize 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 carrying out its monetary policy, the Central Bank alters the policy rate in response to changes in aggregate demand, to stabilize the inflation rate by influencing the market interest rate and consequently the output, asset prices, expectations, exchange rate, and domestic demand. Coupled with the policy rate, in the international case it is common to apply macroprudential policy measures such as setting adequacy ratios to the banking sector as a whole to cool down overheating credit market, curb overcrowding of certain financial products in certain sectors and limit financial dollarization.

Successful implementation of the inflation targeting strategy of monetary policy depends on the Central Bank's ability to sustain market confidence and manage its expectations effectively. To this end, the Bank of Mongolia publishes 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.

Monetary policy decision (March 2018)

The Monetary Policy Committee of the Bank of Mongolia upon meeting in March 2018 decided to decrease the policy rate by 1.0 percentage point to 10.0 percent. Annual inflation measured by the consumer price index reached 6.9 percent nationwide and 8.1 percent in Ulaanbaatar city as of February 2018. External demand improved beyond expectations and high commodity prices supported balance of payments and economic outlook. Although demand driven inflation increased gradually following recovery of economic activities, annual inflation was forecasted to stabilize around the target level in the near future. This decision to reduce policy rate was made in order to reduce the interest rate of short term funding in the banking sector, and thus support the business sector recovery through lending rate. In addition, regarding the macroprudential policy, the Committee decided to set the reserve requirements on domestic and foreign currency liabilities at 10.5 and 12 percent, respectively, to discourage dollarization of liabilities on the banks' balance sheets. From this point on, the Committee plans to implement macroprudential policy measures along with monetary policy in a similar manner.

EXECUTIVE SUMMARY

Inflation remains around its target rate. Supply factors and one-time price changes made significant contributions to current inflation. On the other hand, prices of other goods, especially of imported goods, are decelerating. In the reporting quarter, inflation was slightly higher than previously forecasted, due to one-time price change of certain items, mainly solid fuel. Although it is expected to rise due to demand-driven factors following economic recovery, in the following years inflation is forecasted to remain relatively stable around its target rate.

Economic growth continues to accelerate following recovery in market confidence, continued expansion of the mining sector, and favorable conditions in the external sector. From the expenditure side, household consumption, investments and exports were the main drivers of economic growth. Imports grew rapidly due to economic recovery, greater investments in the mining sector and higher exports. Increasing investments can be attributed to improvements in investors' confidence and ongoing construction activities in the mining sector. Gradual growth of household real income in the past 5 quarters resulted in greater household consumption. Favorable level of export prices boosted export revenues. From the production side, growth of mining, trade, financial and insurance services sectors were the main driving forces of economic recovery.

The labor market continues to recover. Economically active population increased, and the labor force participation rate has improved. Although employment in the agricultural sector declined, number of people employed in the relatively high productivity sectors expanded. For instance, employment increased in mining, manufacturing, construction, and transportation sectors. Due to slowdown in agricultural sector, number of people employed in the sector dropped in the reporting quarter. Increased labor supply pushed wages in the mining sector down, whereas average earnings in construction, trade, manufacturing, and agricultural sectors rose. Although household income is rising, real wages declined year-over-year since growth of national average wage lagged the growth of prices.

Terms of trade performed slightly worse compared to previous expectations, but economic growth of main trading partners and foreign demand exceeded its previous forecasts. In the first quarter of 2018, economic growth in the USA, Euro area, and China exceeded expectations, but that of Russia was lower. In case of China, growth of retail sales and private and real estate investments were the main drivers of growth. Economic recovery beyond expectations in Finland and Spain pulled growth in the Euro area. As for the USA, its labor market continues to expand, and domestic demand is accelerating. As the USA toughened its sanctions against Russia, investors sentiment worsened, leading to lower growth rate than previous forecasts.

Global market prices of Mongolia's main export commodities continue to rise. Coupled with expectations of lower supply, strong demand for copper in China pushed copper price up. According to international analysts, gold price is expected to increase in the medium run supported by geopolitical risks and accommodative stance of monetary policy in the international economy. Due to China's domestic policy and other supply factors, coal price rose in the reporting quarter. Although this trend is expected to linger in the short term, a slight drop in coal price is expected in the medium term due to supply and demand factors. Price of iron ore decreased in the reporting quarter and the downward trend is likely to remain during the forecasting period. Plans to expand mining production and buildup of steel stocks in China are the main factors leading to lower price forecast for iron ore. Oil prices continue to rise, mainly because of the US policy, but the future of oil prices remain largely unclear, which creates uncertainty in the market.

Balance of payments improved year over year following higher surplus in financial accounts, which exceeded the deficit in current and capital accounts. Although exports revenue increased and remained buoyant, surplus of the goods account diminished due to rapid growth of imports induced by greater domestic demand, construction activities in the mining sector and shortage in the harvest of main agricultural goods. In addition, due to increased demand for transport and financial services, deficit of services account widened; and due to increased payments of foreign credits and bonds, primary income account worsened as well, thus making negative contributions to balance of payments. On the other hand, increased cash flow to the mining industry boosted the financial account surplus, thus deficit of the overall balance of payments declined in the reporting quarter.

Budget deficit was lower from previous year, and the fiscal policy stance is expected to tighten further. Structural revenue increased from previous year, thus exceeded its initially approved level, since tax revenues on imported goods expanded following improvements in both domestic and external economic conditions. Growing spending on capital and current transfers, in particular on social welfare, were the main cause of increased fiscal expenditures. As fiscal revenue is expected to exceed its initial plans, budget deficit is expected to be lower than the approved level in the reporting year, thus fiscal impulse is likely to improve from previous year. Shrinking fiscal deficit supports the government in maintaining its present value of debt within the limits set by the law in following years.

Monetary indicators continue to gain momentum and depository institutions are gradually increasing their loans, yet past due and nonperforming loans are not declining. Growth of money supply is supported by increased capital inflow following improvements in the investors' sentiment and banks' capital to issue new loans following subsiding needs to domestically finance budget deficit. As expectations stabilize in the economy and volatility of exchange rate subsides, appetite for togrog deposits over FX deposits increased in the liability side of the banking sector. Growth of consumer loans and foreign exchange loans issued to the mining and trade industries are further increasing, yet no significant decline is observed in the past due and nonperforming loans in all sectors, excluding trade sector.

Interest rate margin increased slightly in the reporting quarter following higher lending rate on togrog credits and lower rate on togrog deposits. Following the policy decision to reduce policy rate by 1 percentage points in March, interbank rates on repo loans, central bank bills, overnight loans, and deposits declined, and so did the interest rate on short term government bonds in secondary market. In the reporting quarter, interest rates on newly issued togrog loans by banks remained close to previous quarter, and as interest rates on togrog deposits declined, margin between the rates widened. Interest rates on both foreign currency deposits and loans decreased.

Depreciating pressure on the exchange rate of togrog diminished in the reporting quarter, and the exchange rate has been relatively stable. Due to China's policy to strengthen the RMB exchange rate in the first quarter, togrog depreciated against RMB year to date, thus led to depreciation of the nominal effective exchange rate. Real effective exchange rate, however, appreciated following changes in relative prices. Since 2017, relative yield of togrog has been positive, most of the time.

Households' demand to purchase housing on the real estate market is not fully recovered. After three years of decline, price of housing stabilized starting second half of 2017, but housing rents are showing signs of decline in recent quarters. Although growth of household income is supporting their purchasing power, demand in the real estate market remains relatively weak. Indicators of stock market, which was less active in the past 2-3 years, have shown rapid improvements starting the latter half of 2017. However, market values of major listed companies diminished slightly in the reporting quarter.

Economic growth is expected to accelerate. Export commodity prices are forecasted to remain high in 2018 and metal concentration of copper ores is expected to increase, thus support growth in the mining sector. Stable economic growth is expected to be supported by steady inflow of foreign direct investments, expansion of positive externalities of the mining sector and improvements in the financial intermediation following receding uncertainties in the banking sector.

Uncertainties and risks regarding the external conditions are derived from outlook of export commodity prices and external demand for our commodities, which are highly prone to developments regarding international geopolitical issues and trade sanctions. Domestic sources of uncertainties regarding economic forecasts are potential harsh weather conditions during summer and winter as well as key investment decisions regarding mega projects.

I.1 Forecast of Inflation and Economic Growth

Forecasts for this quarter are based on assumptions that the policy rate will remain unchanged, monetary and fiscal policy measures agreed under the IMF Extended Fund Facility program will be implemented, and construction activities and investments in the mining sector will continue.

Inflation

Inflation is expected to remain relatively stable and close to the target rate throughout the forecasting period. While impact of supply-side factors are forecasted to remain weak, impact of demand-side factors associated with economic recovery are forecasted to increase but not to accelerate. Effects of supply factors on inflation such as changes in CPI basket, higher automobile tax, and sharp rise of solid fuel price are expected to diminish. Price of meat, which rose significantly in the beginning of the year due to harsh winter conditions, is expected remain higher than previous year and contribute to higher food price inflation. Price impact of imported goods on inflation is decreasing in recent months. Non-food inflation is expected to increase slightly in 2019 from previous year, mainly due to recovery of non-mining sectors, while inflation of food items is forecasted to fall.[1]

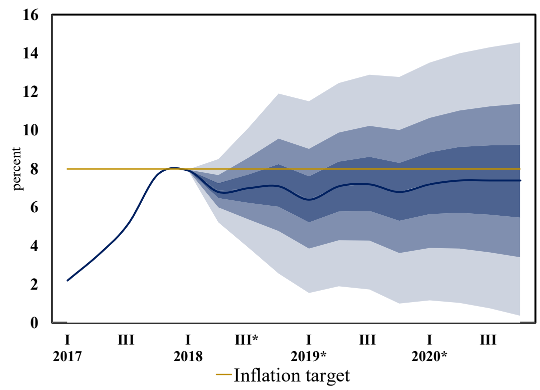
Economic growth

Economic recovery is expected to continue further. As prices of commodities are expected to remain high at the level of 2018 and gold concentration in mining ores of Oyu Tolgoi mining is expected to increase, growth in mining sector is forecasted to pick-up. However, in 2019 due to expectations of lower commodity prices, mining productions are forecasted to shrink.

As for the non-mining sector, although economic recovery is expected to be supported by higher capital inflow and improvements in the market sentiment, compared to previous year growth is forecasted to be slightly lower in 2018 and slightly higher in 2019. Slightly lower economic growth in 2018 can be explained by expectations of firstly, lower production in the agricultural sector due to loss of livestock and lower rate of new livestock delivery caused by harsh winter of this year and lower growth of manufacturing sector in relation to reduced meat processing, secondly, lower growth of transportation

Figure I.1.1.1

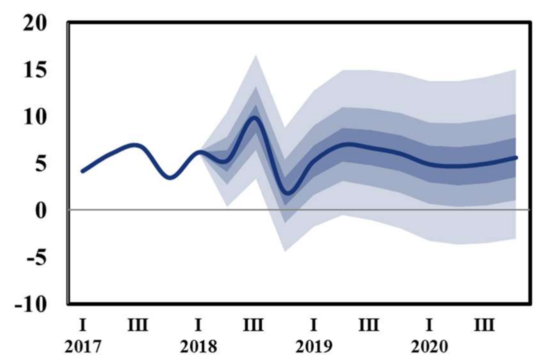
Inflation forecast



Source: The Bank of Mongolia

Figure I.1.1.2

Annual growth forecast of quarterly GDP



Source: The Bank of Mongolia

Table I.1.1.1

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

	2017 *Actual*	2018* *forecast*	2019*
GDP growth	5.1	4.2 – 7.2	4.3 – 8.3
Inflation, CPI[2]	7.7	6.0 – 8.5	6.0 – 9.0

Source: The Bank of Mongolia

[1] It is assumed that weather conditions would remain relatively stable and not cause significant supply-driven inflationary pressure on food inflation in 2019.

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

sector, since it is highly unlikely that the coal exports would exceed the high levels of previous year, and lastly limited activities in the financial intermediation and insurance sector due to lower levels of credit issued for business purposes. As for 2019, weather conditions are expected to be more hospitable, credit issuance and financial services are expected to accelerate following the completion of measures taken under the Asset Quality Review, and investments are projected to reach its usual level, thus productions in non-mining sectors are projected to expand relative to 2018.

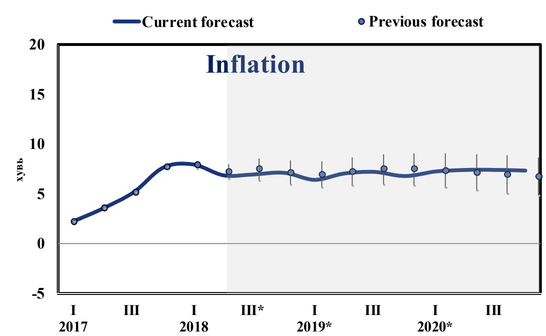
I.2 Changes in forecasts, and its uncertainties

Inflation

In the reporting quarter, inflation was slightly higher than previously forecasted, yet moving further it is expected to be lower than previous forecasts. Although higher price of solid fuel in the first quarter of 2018 pushed inflation beyond our previous forecasts, effects of demand factors and prices of imported goods were lower than previous forecasts. In 2019, headline inflation rate is forecasted to be close to previous forecast, but marginally higher in 2020, mainly due to non-food inflation following increased economic activities. Downward revision of non-mining growth forecast in 2018 and upward revision for 2019, are the main cause of lower inflation forecasts for 2018-2019 and slightly higher forecasts for 2020.

Figure I.2.3.1

Inflation forecast



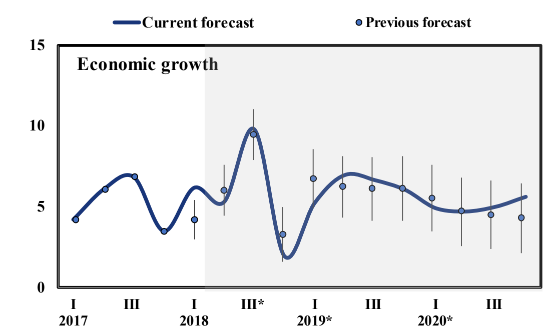
Source: The Bank of Mongolia

Economic growth

In the first quarter of 2018, mining sector growth exceeded previous expectations, thus pushed overall economic growth beyond the previous forecasts. Increased production of iron ore and copper concentrate and higher concentration of gold in copper concentrate were the main driving factors. On the other hand, growth of non-mining sectors was lower than previous forecasts mainly due to weaker-than-expected impact of construction activities in the mining industry on the construction sector, and negative impact on unofficial trade and transportation sector; and the downward trend in the number of livestock available for food production which adversely affected the manufacturing industry. Nevertheless, previous forecasts for growth approximately hold for the remainder of 2018. Economic growth may exceed baseline forecasts if mega projects excluding Oyu Tolgoi, which are currently under negotiations, are approved and implemented.

Figure I.2.3.2

Forecast of quarterly GDP growth, y-o-y



Source: The Bank of Mongolia

Uncertainties regarding forecasts

Actual performance may deviate from forecasts or the future forecasts may be adjusted due to potential changes in economic structure and policies, changes in assumptions and their realization, and unforeseeable changes in internal and external factors. Some uncertainties and factors that might alter macroeconomic policies and domestic and external environment include:

Uncertainties regarding domestic economic conditions

- Potential shortage or surplus of supply may change inflation forecasts. For instance, any unannounced or unanticipated changes in administered prices (e.g. fuel prices) or effect of weather conditions during the summer on supply of meat and vegetables may alter inflation forecast.
- Government's plan to raise wages in public sector in 2019 is currently unresolved. Although policy actions to raise public sector wages are included in the "Guidelines to improve socioeconomic condition in Mongolia for 2019", necessary financial adjustments are not included in the medium term fiscal statements.
- Commencing dates and financing arrangements of some mega projects which would have significant impact on the real sector, and its potential impact on foreign direct investments are still uncertain.
- Potential non-tariff sanctions on exports leading to lower growth in mining and transportation sectors, harsh weather conditions during winter or summer resulting in lower agricultural production, or a decrease in external demand of main export commodities caused by unexpected decisions and developments in external sector all pose risks of lower economic growth relative to the current forecast.
- Rapid growth of outstanding level of consumer loans and its share in total loans in the banking sector, may lead to potential risk accumulation in the financial sector and thus may have negative consequences on economic growth.
- Any unanticipated change in economic policy is a potential source of discrepancies in forecasts.

Uncertainties regarding external conditions

- Economic outlook and challenges of China, the world's second largest economy, continue to be an enormous risk factor and a source of uncertainty for the Mongolian economy, as well as the global economic condition. Chinese policy actions regarding its medium-term debt management plans remain uncertain, and Chinese authorities are expected to tighten their financial regulations and management to protect their economy in the following 3 years. However, continued accumulation of private sector debt has destabilizing impact on its financial system, and international analysts warn that it might be detrimental to its economic growth.
- Forecasts of Chinese economic growth and trade remain significant factors of influence on the outlook for external environment. Chinese government's medium-term plans and shift of focus to maintain sustainable economic growth driven by domestic demand, to decrease air pollution, and to curb credit growth will be portrayed as limited investments in the manufacturing and real estate sectors and gradual lowering of growth target in the medium term. Such developments pose potential negative consequences on our external demand. These policies are expected to reduce growth in the real estate sector and limit production of steel, thus squeeze demand for coal and iron ore. In addition, potential trade war between the US and China may create uncertainties at the global commodity market and lead to lower prices of base metals.
- Although the Russian economic condition is improving, its outlook relies heavily on the global oil prices, and is likely to affect the oil prices in return. Moreover, uncertainties regarding its monetary and fiscal policy actions, as well as the persistent deficit in its budget despite fiscal spending cuts are the main factors of risk to its economic outlook.
- Any geopolitical friction or economic sanction in the global arena would pose negative consequences on the external demand for Mongolia's exports. Trade war between major economies, and its negative consequences on the international financial transactions and payment systems present tremendous uncertainty on Mongolian economy.

I.3 Assumptions regarding external conditions[3]

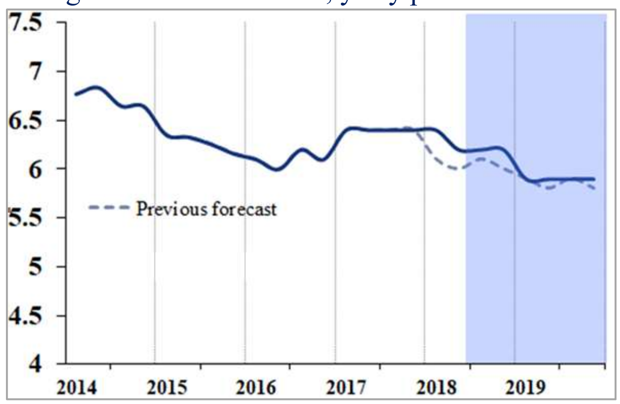
Forecasts of export commodity prices and economic growth of main trading partners in 2018 have been revised up. External demand conditions are expected to be more accommodative for the domestic economy, compared to the previous quarter.

External demand

External demand outlook for 2018 and 2019 used in macroeconomic analysis and forecasting in the first quarter of 2018, is improved. Within the forecasting period, economic growth in China, Russia, and the Euro area is expected to support external demand for Mongolian exports. As published in external sources, 2018 economic growth forecast of China has been revised up from 6.4 to 6.6 percent, while that of Russia and the Euro area were increased from 1.7 to 2.1 and from 2.2 to 2.4 percent, respectively.

Figure I.1.2.1

Change in external demand, y-o-y percent



Source: Bloomberg, Roubini, IMF, EIU, BREE

Chinese economic growth in the first quarter of 2018 exceeded previous expectations, mainly supported by growth of 10.2 percent in retail sales, 8.9 percent in private sector investments, and 10.4 percent in real estate investments. As the factors supporting economic growth are expected to remain buoyant, economic growth forecasts for 2018-2019 are revised up from previous levels. Growth of Chinese economy exceeded expectations in 2017, reaching 6.7 percent, yet mounting debt continues to weigh on its growth outlook. During its meeting on March 5, 2018, the National People's Congress of China, set the GDP growth target for 2018 at 6.5 percent. Chinese authority's hesitation to increase the growth target signals its intention to limit risks in the financial sector. Such measures are expected to support economic stability and sustainable growth in the medium and long run.

Russian economy grew by 1.6 percent in the first quarter of 2018 which was lower than previously assumed. In the reporting quarter, total investments and household consumption grew by 3.6 and 3.0 percent respectively, thus made positive contributions to overall growth. Growth forecast of Russian economy is revised up by 0.4 percent to 2.1 percent for 2018, and by 0.1 percent to 1.7 percent for 2019, taking into account the stable condition of factors supporting growth in the medium term, combination of contractionary fiscal policy and expansionary monetary policy in 2018-2019, oil price outlook and potential appreciation of RUB.

As for the Euro area, unconventional monetary policy of the European Central Bank, relatively loose fiscal stance coupled with improved economic conditions in some of its trading partner countries and encouraging developments in the labor market are likely to support growth and stable economic expansion in the region.

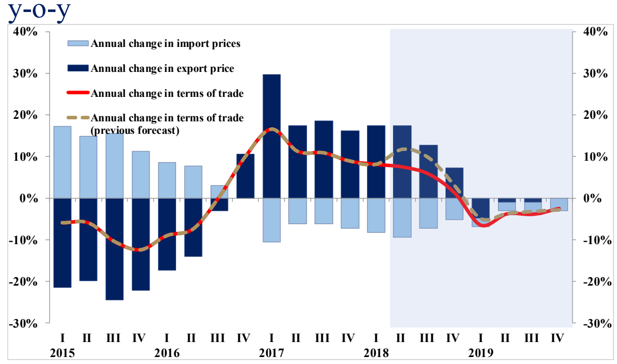
[3]Forecasts of economic growth and inflation in main trading partner countries and the relevant explanations were compiled from April 2018 edition of the Roubini Global Economics Outlook report, May edition of the EIU Global Forecasting Report, median of forecasts conducted by Bloomberg analysts and April 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.

Terms of trade

In the upcoming four quarters, terms of trade is projected to worsen compared to the previous forecast, but the outlook is expected improve in the medium term. Export prices exceeded expectations as prices of copper, gold, coal and oil remained at high levels. However, sudden increase in oil prices to $67 per barrel, exceeding previous expectation of $59 per barrel, pushed import prices beyond previous assumptions, thus led to weaker than expected terms of trade in the first quarter. Prices of main commodities in 2019 are projected to remain approximately the same as previous forecasts, thus projection for terms of trade is assumed to be not changed significantly.

Figure I.1.2.2

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



Source: The Bank of Mongolia estimation

Foreign inflation

In the reporting quarter, foreign inflation forecast is increased to reflect economic growth of main trading partners which exceeded previous expectations, and higher price of oil at the global market. Due to expansion of domestic demand in European advanced economies and unconventional expansionary monetary policy measures of the European Central Bank, euro is expected to depreciate and inflation is assumed to reach 1.5 percent in 2018 and 1.6 percent in 2019. Decision to reduce reserve requirements by the People's Bank of China and expectation of stable growth of domestic demand in the rest of 2018 were the main factors pushing inflation up to 2.2 percent in the first quarter of 2018. Such expansion of domestic demand is not expected to accelerate further, and inflation is assumed to be 2.3 and 2.4 percent, in 2018 and 2019 respectively. Expansionary monetary policy, high oil prices, and increased economic activity in Russia are likely to push inflation closer to the Bank of Russia target of 4.0 percent by the end of the year. As for the USA, steady decline in unemployment rate and expansion of household/private consumptions resulted in an inflation rate of 2.2 percent. The rise in household/private consumption is projected to remain steady and to support economic growth, pushing inflation to 2.4 percent by the end of the year.

Risks and uncertainties

In its June edition of Global Economic Outlook report, the World Bank highlighted some risk factors that might negatively influence emerging economies, such as trade war between the US and China and potential loss of investors' confidence in relation to the newly formed Italian government. During the following forecasting period, such risk factors may pose negative consequences on commodity prices and thus adversely affect foreign demand and prices of Mongolian exports. The US president, Donald Trump, expressed his intentions to impose tariffs on imports from China worth 150 billion USD. The announcement was met with strong criticism from the World Trade Organization, Canada, and the EU. Analysts emphasize that the main intention of such action is to protect domestic industries in the US from cheap imports of metals from China and to decrease trade deficit the US government bears. The US trade deficit with China reached a historic high level of 375.2 billion USD in 2017. Expectations of sour relations between the US and China may pose negative impact on growth of steel and aluminum producing countries and overall prices of base metals in the global market.

II.1 Domestic Economic Conditions

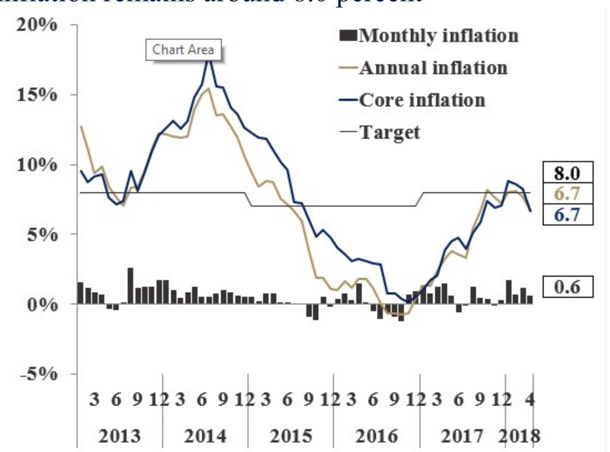
II.1.1 Inflation

According to the Monetary Policy Guideline for 2018, the Bank of Mongolia set to stabilize inflation rate around the target of 8.0 percent. Inflation, measured by consumer price index, reached 6.7 percent in Ulaanbaatar and 6.0 percent nationwide in March 2018, thus remained within the Central Bank's target.

If we consider the components of the annual inflation, contributions of one-time price changes[4] (Figure II.1.1.2) in addition to supply driven price changes of dairy, vegetables and gasoline were considerably high. Price contributions of goods driven by domestic demand, such as clothing, services, and food items (excluding meat, dairy, and vegetables), were relatively mild. As the inflationary effect of sharp exchange rate depreciation in 2016 diminishes, price contributions of import goods (food items and goods excluding automobiles) have been declining for the past 3 months. The difference between headline and core inflation, which excludes goods of high price volatility[5], remains low in the first months of 2018 (Figure II.1.1.1).

Figure II.1.1.1

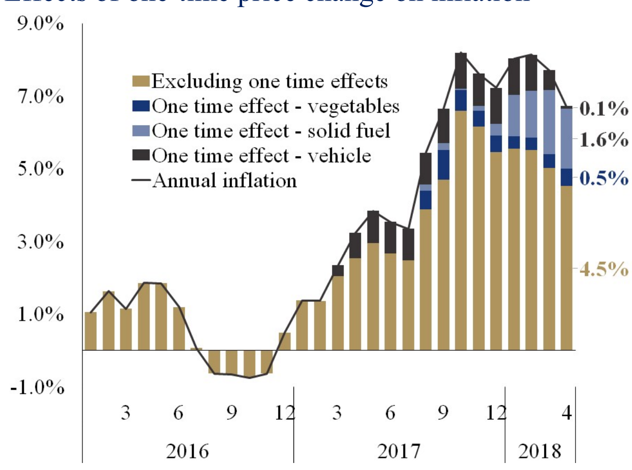
Inflation remains around 8.0 percent



Source: NSO

Figure II.1.1.2

Effects of one-time price change on inflation



Source: The Bank of Mongolia, NSO

Difference between forecast and actual inflation

Average inflation in the reporting quarter was 7.9 percent, 0.2 percentage points higher than the previous forecast of the Bank of Mongolia. This discrepancy can be attributed to price changes in 1) solid fuel for household consumption and 2) imported goods. According to its seasonal pattern of demand, price for solid fuel increases from August to November and decreases in the first half of the year. Yet in the first quarter of 2018, prices rose by approximately 30 percent, thus resulting in one-time price impact on inflation. On the other hand, prices of imported goods, especially clothing and food items, rose rapidly throughout 2017 due to changes in exchange rate, only to drop in the first quarter of 2018.

[4] Prices of solid fuel, automobiles (change in import tax) and vegetables (harvesting season)

[5] Core inflation is calculated by removing price changes of 41 items related to meat, dairy, and vegetables from the headline inflation measured by consumer price index.

Inflation and its components

Annual inflation rate in Ulaanbaatar reached 6.7 percent in April 2018, thus establishing a downward trend of 2 months. Monthly changes in prices of most consumer goods are in line with its seasonal trends, while for some items change in price was relatively drastic. For instance, in the first several months of the year, prices of food items increased following its seasonal pattern, while prices of domestic (excluding solid fuel) and imported goods declined. Prices of clothing to be specific, declined beyond its seasonal pattern.

Regarding other items, prices of gasoline and diesel fuel in domestic market increased following the global market developments, while prices of alcoholic drinks, and tobacco increased in the first four months of 2018, mainly due to excise tax hike.

Prices of the following items had significant impact on the annual headline inflation.

Item	Weight	Percent contribution to annual inflation
Solid fuel[6]	0.03	1.68%
Alcoholic drinks	0.06	0.48%
Vegetables	0.02	0.43%
Automobiles	0.01	0.11%
Total	0.12	2.70%

Figure II.1.1.3

Difference between forecast and actual performance

Figure II.1.1.4

Contributions to monthly inflation in Ulaanbaatar, by main items

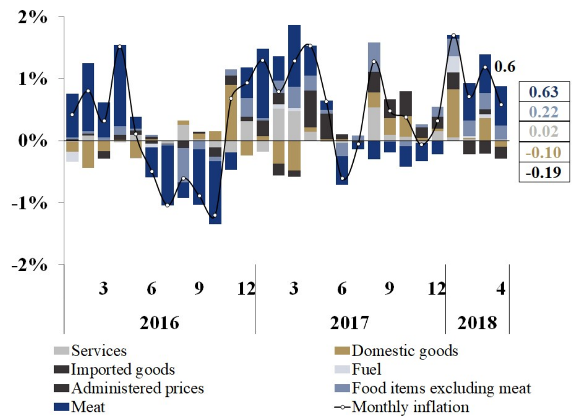
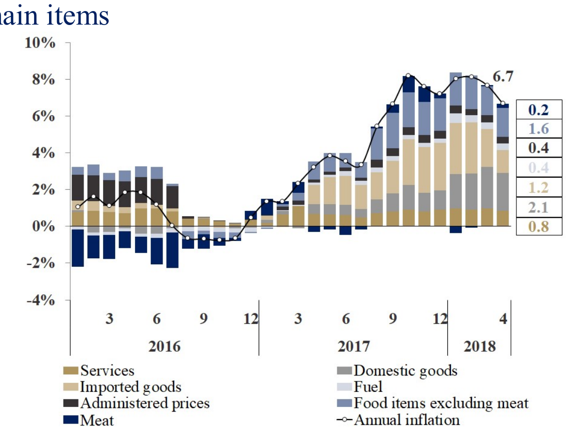


Figure II.1.1.5

Contributions to annual inflation in Ulaanbaatar, by main items



Source: The Bank of Mongolia, NSO

[6] By April of 2018, price of solid fuel, which consists of a sack of burning coal and firewood, increased by 55.8 percent since July 2017, and constituted 1.68 percentage points of headline inflation on its own.

II.1.2 Real Sector

II.1.2.1 Economic growth

Annual growth of GDP reached 6.1 percent, owing to prices of export commodities remaining at high levels in the first quarter of 2018, improved confidence of both domestic and foreign economic agents, and continued large-scale construction activities in the mining sector. From the demand side, improved confidence of market participants supported growth of household consumption and investments, thus significantly boosted overall economic growth. As for the supply side, growth of all sectors, excluding transportation and warehousing services, contributed to economic growth. Specifically, growth in mining, manufacturing, energy and other services sectors as well as net taxes made significant contributions to GDP growth.

Aggregate demand: Household consumption, investments and government expenditures supported economic growth in the reporting quarter, while net exports made negative contributions. (Figure II.1.2.1.1). Although exports expanded following increased foreign demand, it was overshadowed by rapid growth of imports. All subgroups of imports expanded in the first quarter from previous year. In particular, imports of machineries as investment, manufacturing inputs, and oil products made significant boost.

Domestic demand[7] increased for the past 6 consecutive quarters, mainly driven by growth of investments (gross capital formation). In addition, household consumptions are showing signs of recovery and boosted domestic demand in the last 3 quarters (Figure II.1.2.1.2)[8].

Aggregate supply: Supported by large-scale construction activities in the mining sector, the non-mining sectors have been expanding for the 6th consecutive quarters, yet its growth decelerated to 6.8 percent in the reporting quarter. As for the mining sector[9], production of iron ore and copper concentrate, and gold concentration in the copper concentrate increased, bringing growth to 4.2 percent year-over-year. (Table II.1.2.1.1).

Figure II.1.2.1.1

Growth of investments and household consumption contributed to growth.

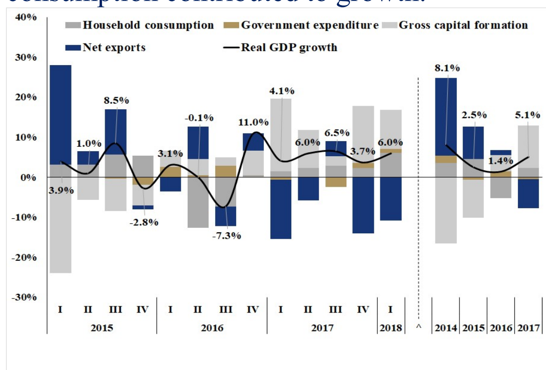


Figure II.1.2.1.2

Domestic demand expanded in the past 6 consecutive quarters.

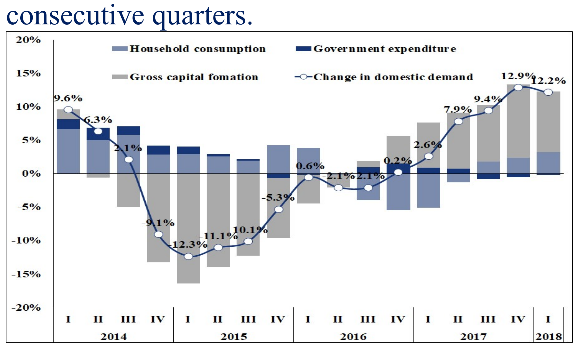


Table II.1.2.1.1

All sectors, except transportation and agriculture, contributed to economic growth.

	I	II	III	IV	I
Contributions to real GDP	4.2	6.0	6.8	3.5	6.1
Mining	-1.7	-1.2	1.2	-4.8	1.1
Non-mining	5.9	7.3	5.6	8.2	5.1
Agriculture	0.2	1.0	0.8	-0.6	0.0
Manufacturing	1.2	1.1	1.3	1.5	0.4
Energy	0.1	0.1	0.1	0.1	0.3
Construction	-0.4	-0.4	-0.3	0.8	0.1
Trade	1.8	1.0	0.9	1.2	0.8
Transportation and warehouse	1.0	0.9	0.7	2.0	0.0
Information technology	0.0	0.2	0.2	0.2	0.1
Other services	0.2	0.9	0.6	2.1	1.5
Net taxes	1.9	2.5	1.3	0.9	1.9

Source: NSO

[7] Represents the final demand of domestic economic agents and is estimated as the total of household and government expenditures, and investments.
[8] Calculated as sum of value in current quarter and the 3 preceding quarters.
[9] Although the overall mining production contracted in the previous 4-5 quarters, it was due to low metal concentration and copper ore in the Oyu Tolgoi open-pit mining. Rather, production in most of the remaining mining companies had been expanding.

Growth contributions of mining, trade, manufacturing, and energy sectors were significant. Following economic recovery, net taxes on products expanded and accounted for 1.9 percent of the 6.1 percent overall growth. Due to disruption in coal export transportation, growth of transportation services suffered, thus affected the overall economic growth adversely.

Household income and expenditures: Household expenditures increased by 9.6 percent year-over-year and accounted for 6.1 percent of the quarterly GDP growth in the first quarter. Increased spending on milk and dairy products, water and non-alcoholic drinks, transportation, vacation, entertainment, and medical services account for the greater household expenditure.

For the past 5 consecutive quarters, real household income exceeded its level from same period of previous year. Nominal household income rose by 15.9 percent, while the real household income increased by 7.4 percent. Wage raises and increased income from privately owned businesses were the main factors supporting income growth. (Figure II.1.2.1.3).

Despite the significant rise in household income, it has been falling short of household expenditures since the fourth quarter of 2015. The gap is financed by various loans for consumption purposes[10], which is inevitably shown by an average annual growth of 37 percent in consumer credits for 9 consecutive quarters since the beginning of 2016.

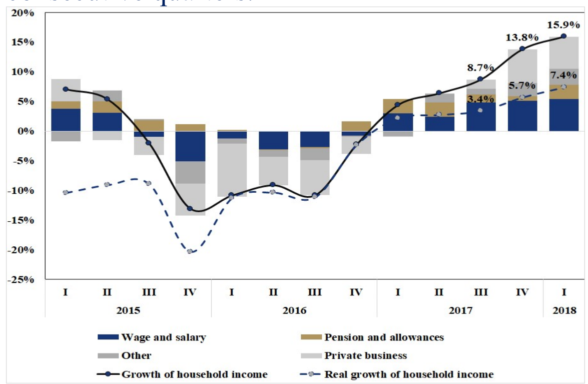
Compared to same period last year, spending on food items increased by 7.1 percent, non-food items by 12.9 percent, and other goods and services by 21.6 percent. Thus, in the reporting quarter nominal household expenditures rose by 13.3 percent, which is a 5.0 percent expansion in real terms (Figure II.1.2.1.4).

Since approximately 40 percent of the CPI basket is composed of imported goods, increasing household spending leads to greater imports of consumer goods. Imports of consumer goods, which had been declining for 11 consecutive quarters since 2013, bounced back starting the second half of 2016 and is now on its 8th consecutive quarter of expansion. Its growth gained momentum in the last 2 quarters, reaching 26.4 percent in the first quarter of 2018.

Despite greater real income, households' purchasing power regarding housing remains limited, resulting in

Figure II.1.2.1.3

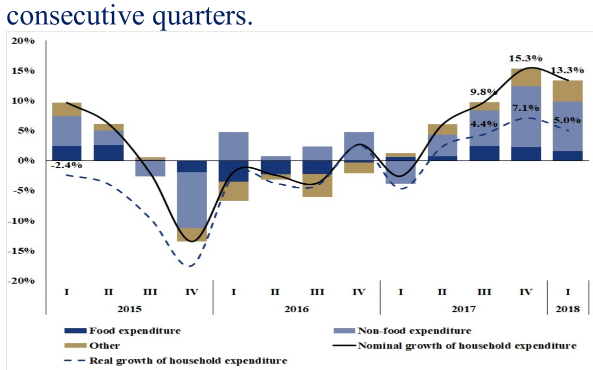
Household real income grew in the past 5 consecutive quarters.



Source: NSO

Figure II.1.2.1.4

Household real consumption grew for the past 4 consecutive quarters.



Source: NSO

Table II.1.2.1.2

Production is growing in all sectors except transportation.

	2016	2017	2018Q1
Growth of GDP	**1.2**	**5.1**	**6.1**
Taxes	0.5	18.6	16.1
Other services	1.1	5.1	5.4
Mining	0.2	-6.9	4.2
Trade	-2.3	9.7	7.3
Manufacturing	-1.3	22.8	6.4
Energy and Electrici	1.5	4.2	9.0
Construction	-6.3	-0.8	14.6
Information	-1.7	7.9	4.4
Agriculture	6.2	2.3	0.3
Transportation	11.4	16.7	-0.1

*Ranked by growth contributions in 2017Q4.

Source: NSO

Figure II.1.2.1.5

[10] Loans for consumption include wage, pension and other consumption loans.

a relatively inactive real estate market[11]. Recovery of construction sector, mirrored by a 14.6 percent growth in the reporting quarter, is mostly constituted by continued construction activities of structure and earthwork in the mining industry (Table II.1.2.1.1).

Production in agricultural sector, which generates more than 10 percent[12] of the household average income, remained roughly unchanged relative to same period of previous year (a growth of 0.3 percent). In the first quarter of 2018, livestock loss was 3.1 times higher and number of newborn livestock was 22.2 percent lower year-over-year.

Government expenditures

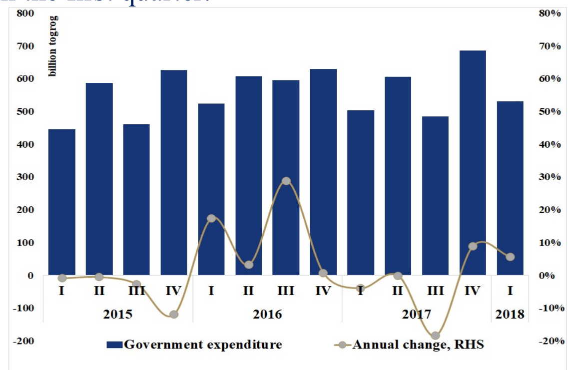
In the reporting quarter, government expenditures expanded by 5.7 percent year-over-year and contributed 0.9 percentage points of GDP growth. In the first quarter of this year, structural revenue of the consolidated budget reached 1810.9 billion togrogs, and expenditures reached 1836.6 billion togrogs, resulting in a deficit of 25.8 billion togrogs in the structural balance. Budget deficit and payments regarding domestic and foreign bonds totaled 1084 billion togrogs, and much of the payments, 853 billion togrogs, were financed from the government deposit account held at the Bank of Mongolia. The remaining expenditures were financed through the Future Heritage Fund transactions and foreign project loans. According to the approved budget, government expenditures are projected to increase by approximately 5.0 percent in 2018. (Figure II.1.2.1.5).[13]

Investments

Total investment (capital formation) rose by 28.9 percent year-over-year in the reporting quarter and made a contribution of 9.8 percent to growth of quarterly GDP. In particular, fixed capital formation surged by 48.1 percent year-over-year and accounted for 9.6 percent of the growth, while change in stock expanded by 0.8 percent, which made up 0.1 percent of overall growth.

Growth of fixed capital formation was mainly boosted by growth of investments in machinery, equipment and non-residential construction activities related to the second phase of Oyu Tolgoi mining project. Changes

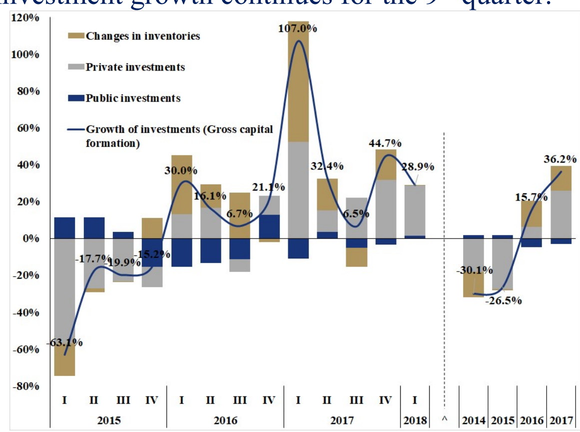
Government expenditures increased by 5.7 percent in the first quarter.



Source: NSO

Figure II.1.2.1.6

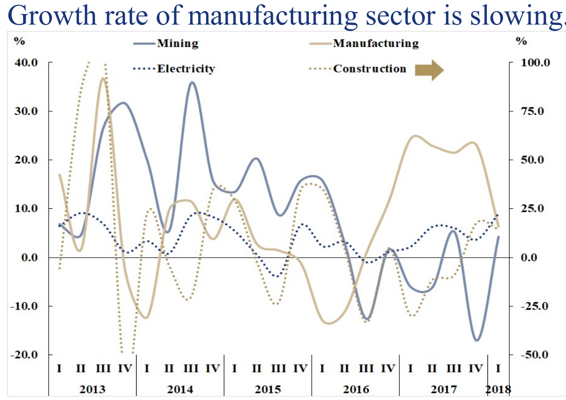
Investment growth continues for the 9th quarter.



Source: NSO

Figure II.1.2.1.7

Growth rate of manufacturing sector is slowing.



Source: NSO

[11] More information on the real estate market can be found in section II.1.4.4 – Real estate markets.
[12] Income generated from animal husbandry.
[13] More information about the government consolidated budget and sovereign debt can be found in section II.1.3.

in stocks was about the same as in previous year. (Figure II.1.2.1.6).

As quality of loans remain weak in most of the sectors, issuance of business loans is not increasing significantly[14]. Foreign direct investments, excluding Oyu Tolgoi investments, declined by 65 percent in 2017 but is showing signs of improvement compared to last year, and expected to reach the levels of 2016.

Imports of trucks, equipment and machinery, and construction materials increased due to large-scale construction activities and investment in the mining sector. As a result, the trade sector grew by 7.3 percent, accounting for 0.8 percent of overall growth in the reporting quarter (Figure II.1.1.1.7).

Although growth rate of the manufacturing sector slowed down to 6.4 percent year-over-year, it made up 0.4 percent of overall economic growth. Expansions in consumption and investments were the main underlying factors of growth in the manufacturing sector. Increased consumption boosted production of food items excluding meat, textile products, and consumer goods, such as tobacco. Increase in investments mostly boosted manufacturing of cement, construction materials, and items of steel excluding machinery to be used in construction activities of the mining industry (Figure II.1.1.1.8).

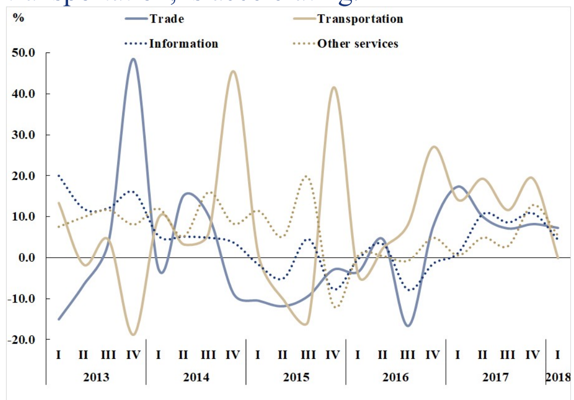
Foreign trade

In the first quarter of 2018, net exports decreased by 79.8 percent year-over-year, and made a negative contribution of 10.8 percent on economic growth. Although exports increased by 18.6 percent, imports expanded by 26.9 percent, effectively resulting in lower net exports (Figure II.1.1.1.9).

Exports: In the reporting quarter, volume of exports expanded mainly due to export growth of non-monetized gold by 165.4 percent, iron ore by 30.2 percent, zinc ore by 20.0 percent, and other minerals, such as fluorspar, nepheline, and leucite, by 47.8 percent. However, exports of copper ore and concentrate, thermal coal and crude oil declined by 9.5, 17.5 and 11.3 percent, respectively. As a result, net exports reached a deficit of 86.7 million USD in the reporting quarter. (Figure II.1.1.1.10).

Figure II.1.2.1.8

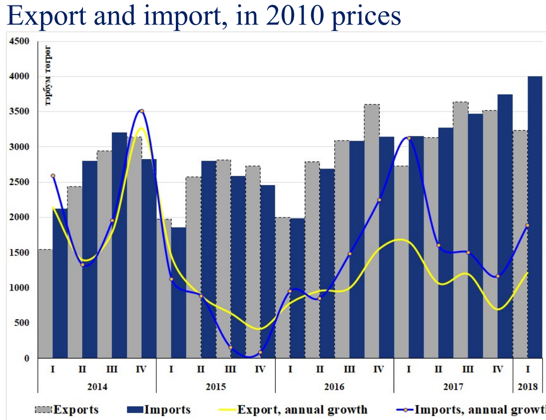
Growth of all types of services sector, except transportation, is accelerating.



Source: NSO

Figure II.1.2.1.9

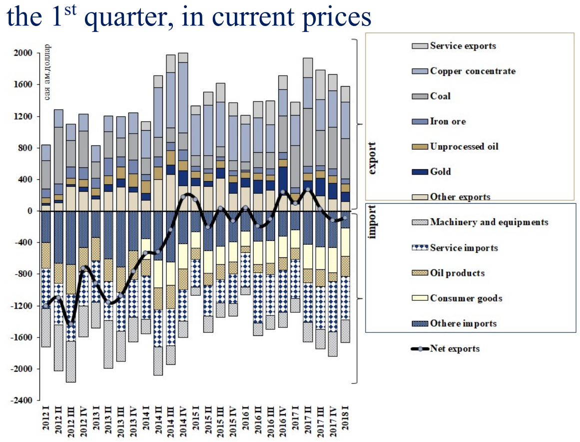
Export and import, in 2010 prices



Source: The Bank of Mongolia

Figure II.1.2.1.10

Net exports was in deficit of 86.7 million USD in the 1st quarter, in current prices



Source: The Bank of Mongolia

[14] More information about money and loans can be found in section II.1.4.1.

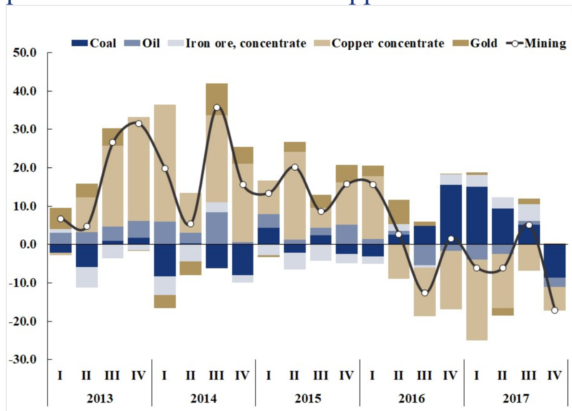
Growth of 4.2 percent in mining sector contributed 1.1 percentage points to the economic growth. However, non-tariff barriers set on export transportations and passage through the border, affected mining and production of coal and crude oil negatively. Thus pushed growth of the mining sector down. (Figure II.1.1.1.11). Due to diminished transportation of coal exports, production of transportation services decreased, thus leading to a contraction of 0.1 percent in the reporting quarter. Transportation sector had been growing at a higher pace since the second quarter of 2016.

Imports: In the reporting quarter, all subgroups of imports increased, thus total imports grew by 45 percent in nominal terms. Economic recovery, increased exports of mining output, expansion in the manufacturing sector and household income resulted in greater imports of machinery and equipment for mining, manufacturing inputs, and consumer goods. More specifically, imports of construction materials increased by 105 percent, intermediate goods by 83 percent, machinery and equipment for mining purposes by 33 percent, and consumer goods by 26 percent year-over-year.

Receipt of net taxes of products increased in recent quarters following economic recovery and increased production and purchase of domestic and imported goods necessary for mining and construction activities. A growth of 16.1 percent in net taxes of products made a contribution of 1.9 percent to the overall economic growth.

Figure II.1.2.1.11

Mining sector expanded following increased production of iron ore and copper concentrate.



Source: NSO, analysts' estimations

II.1.2.2 Potential output and output gap

During 2011-2013, growth of potential output accelerated to over 10 percent, yet slowed down significantly following lower investments since 2014. Starting last quarter of 2016, owing to positive externalities of large scaled construction activities in the mining sector on non-mining sectors, growth of potential output increased to 4.5 percent from 2 percent within the last 2 years. (Figure II.1.2.2.1).

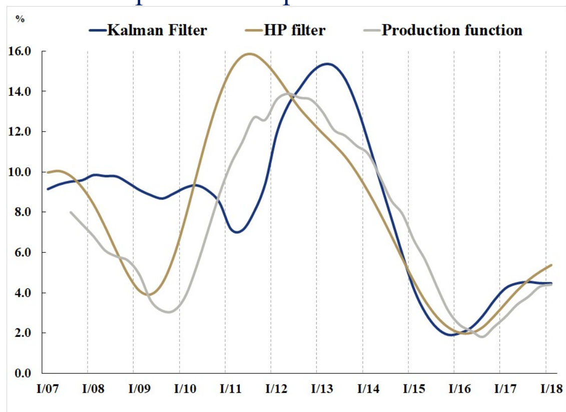
Output gap remained positive from 2011 to 2013 as total production of non-mining sectors exceeded its potential level. However, during 2014-2016, as non-mining productions declined, output gap turned negative. While overall production was around its potential in 2017, in the last 2 quarters output gap turned positive. In the reporting quarter, output gap slightly improved from previous quarter, mirroring recovery of activities in both mining and non-mining sectors.

For the mining industry, total productions had been exceeding its potential level from 2013 owing to increased production of copper and gold. However, since 2016 total production fell below its potential level due to lower concentration of metal in copper concentrates. In the reporting quarter, metal concentration in copper concentrates improved and production of iron ore accelerated, leading to improvements in the mining output gap from previous quarter. (Figure II.1.2.2.2).

For the non-mining industry, output gap remained negative from 2014 to 2017 mainly due to domestic and foreign economic factors. Starting 2017, owing to increased mining production excluding copper and greater investments, output gap turned positive. In the first quarter of 2018, growth of net taxes on products and trades significantly boosted output gap beyond the previous quarter.

Figure II.1.2.2.1

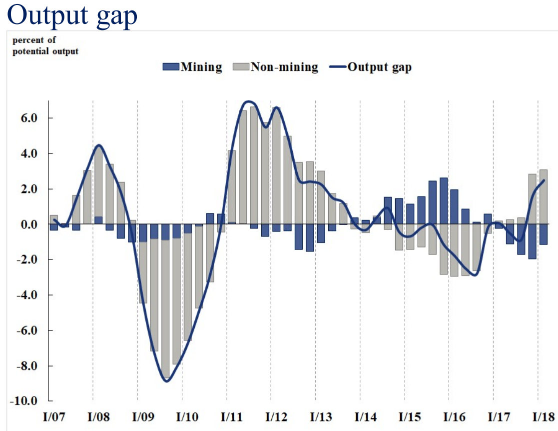
Growth of potential output



Source: Analysts' estimations

Figure II.1.2.2.2

Output gap



Source: Analysts' estimations

II.1.2.3 Labor market

As of first quarter of 2018, number of working age population declined by 1.6 percent year-over-year to 2,089 thousand people. In recent quarters, number of people employed was increasing among population over the age of 15, yet in the reporting quarter number of unemployed people spiked and number of people either employed or economically inactive declined, resulting in shrink of working age population.

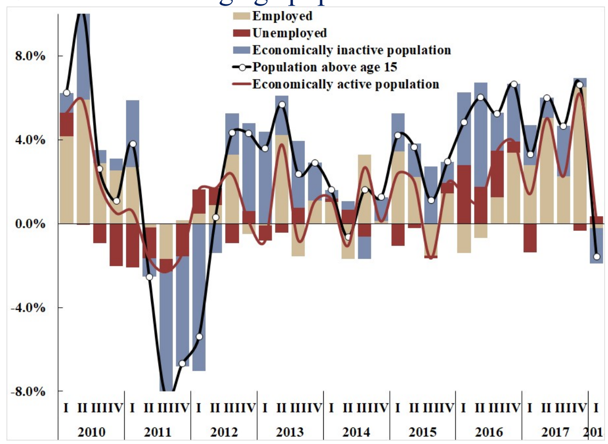
No significant recovery was observed in most of labor market indicators. Working age population declined, and economically active population rose by 0.3 percent year-over-year to 1,266 thousand. As a result, labor force participation rate[15] improved by 1.1 percent to 60.6 percent. Although the rate of employment[16] increased by 0.7 percent year-over-year to 54.7 percent, it is primarily due to the fact that contraction in number of employed people was lower than the shrink in size of working age population. Number of people unemployed increased by 6.6 percent year-over-year, reaching 123 thousand. Thus, unemployment rate[17] worsened by 0.6 percent from previous year reaching 9.7 percent.

In the first quarter, number of employed people decreased by 0.4 percent year-over-year to 1,143 thousand. Such decline can be attributed to sluggish growth of employment in mining, manufacturing, trade, and transportation sectors and shrink of employment in agriculture and public sector.

If we consider changes in employment by status, number of wage-earning employees was increasing from the end of 2016, while number of private business owners increased from the second half of 2017. As for the first quarter of

Figure II.1.2.3.1.

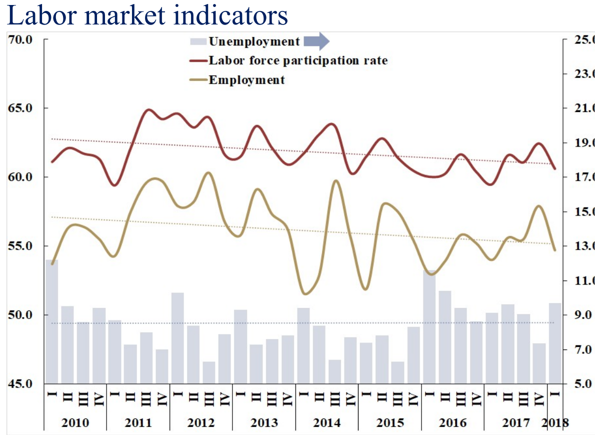
Growth of working age population



Source: NSO

Figure II.1.2.3.2.

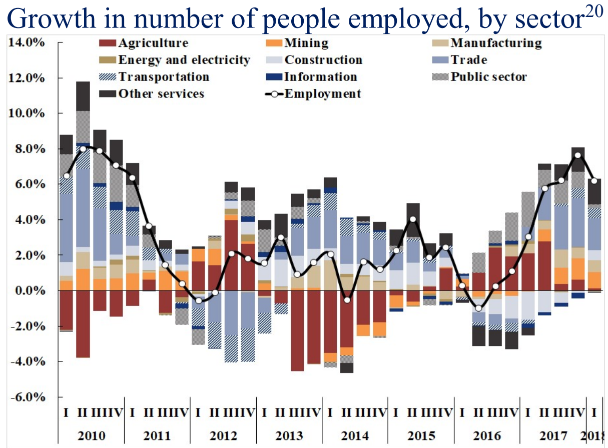
Labor market indicators



Source: NSO

Figure II.1.2.3.3.

Growth in number of people employed, by sector[20]



Source: NSO

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[15] Share of economically active population in total working age population
[16] Share of employed people in total working age population
[17] Share of unemployed people in total economically active population
[20] Growth of employed people estimated by moving average of the previous 4 quarters

2018, number of wage-earning employees, private business owners, and non-wage-earning workers for domestic activities and services slightly increased. Yet it was offset by contraction in number of people working in animal husbandry, resulting in lower number of people employed.

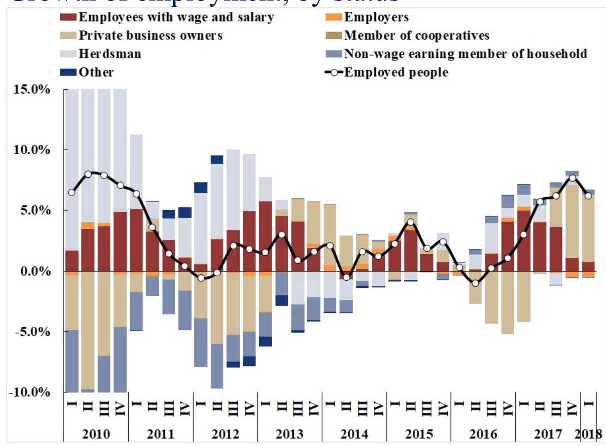
Number of economically inactive population declined by 4.2 percent year-over-year to 824 thousand in the reporting quarter. In recent quarters, number of people not ready to work, caring for children, or retired increased, while the elderly population declined. In the reporting quarter however, as number of people retiring or studying declined, thus overall economically inactive population shrank.

National average wage increased by 4.1 percent year-over-year in the first quarter to 998 thousand togrogs, while national median salary increased by 3.1 percent to 609 thousand togrogs. In the reporting quarter, growth of nominal salary decelerated, and real income adjusted by CPI, which is reflects purchasing power of households, declined by 3.0 percent. The total household income, however, increased by 15.9 percent year-over-year reaching 1,132 thousand togrogs, of which earnings from salary increased by 10.4 percent to 557 thousand togrogs.

Average wage in main economic sectors ranged between 609 to 2,443 thousand togrogs in the first quarter of 2018. In recent years, growth of average wage and earnings in manufacturing, mining and trades sector accelerated to a higher rate. In the reporting quarter, growth of average wage and earnings in manufacturing and construction sectors made significant contribution to growth of national average wage.

Figure II.1.2.3.4.

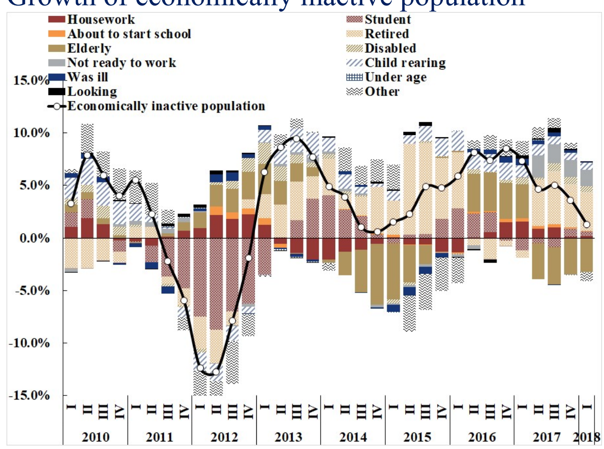
Growth of employment, by status



Source: NSO

Figure II.1.2.3.5.

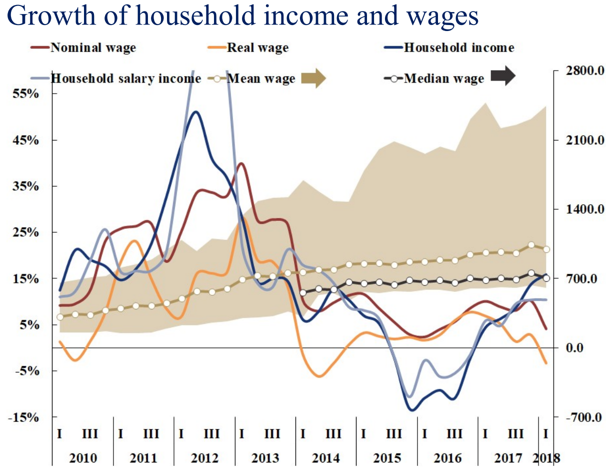
Growth of economically inactive population[21]



Source: NSO

Figure II.1.2.3.6.

Growth of household income and wages



Source: NSO, analysts' estimations

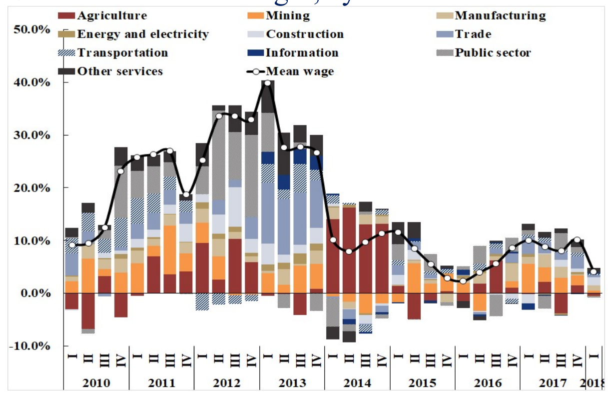
[21] Growth of economically inactive population estimated by moving average in the previous 4 quarters

Labor productivity[18] improved by 6.5 percent from the same period of previous year to approximately 2,725 thousand togrogs. In recent years, growth of total labor productivity is showing signs of deceleration. In case of productivity in main sectors of economic activity: productivity in mining industry deteriorated drastically, trade sector continued to deteriorate, and no significant change was observed in the agricultural sector, while sectors of transportation, construction, and manufacturing are showing signs of improvement.

Unit labor cost[19] decreased by 2.3 percent year-over-year to approximately 0.37 togrogs in the first quarter of 2018. In recent years, growth of unit labor cost is gradually accelerating, while a sharp increase is observed in the mining sector. In case of manufacturing, construction, other services, agriculture, and trades sectors, unit labor costs are gradually increasing, while in transportation sector it continues to decline.

Figure II.1.2.3.7.

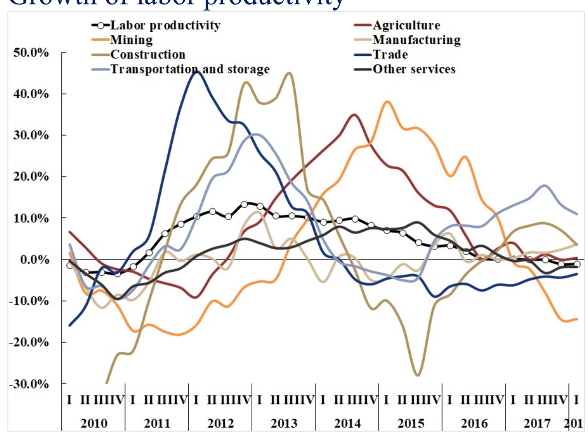
Growth of nominal wages, by sector[22]



Source: NSO, analysts' estimations

Figure II.1.2.3.8.

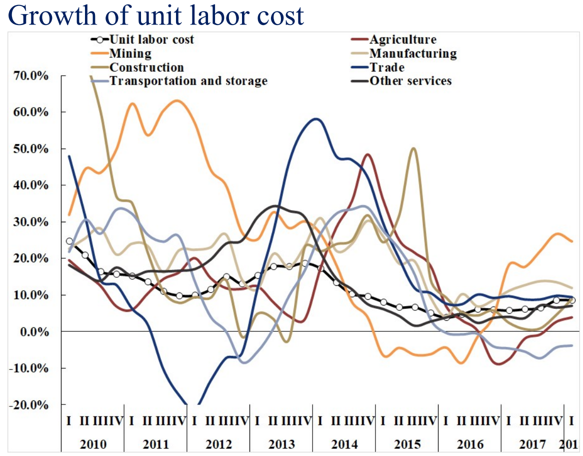
Growth of labor productivity[23]



Source: NSO, analysts' estimations

Figure II.1.2.3.9.

Growth of unit labor cost



Source: NSO, analysts' estimations

[18] Average GDP per worker
[19] Average labor cost or salary expense per unit of GDP
[22] Growth of national average wage, and contributions from each sector
[23] Growth of labor productivity and unit labor cost estimated as moving average in the previous 8 quarters

II.1.3 Consolidated government budget and sovereign debt

Consolidated budget

In the first quarter of the reporting year, structural balance of the national consolidated budget was in deficit of 26 billion togrogs with a primary balance[24] in surplus of 204 billion togrogs. Consolidated budget deficit and total expenditures as shares in nominal GDP declined in 2018 from previous year, thus the fiscal policy is expected to further tighten. Furthermore, present value of government debt service as well as the total government debt in terms of nominal GDP are expected to decline further, as budget deficits and payments for domestic government bonds were financed through foreign funding at lower interest rates.

Figure II.1.3.1

Fiscal indicators

	2016	2018		2018.03	
billion togrog	Act.	App.	Plan.	Act.	%
Total revenue and grants	7922	7863	8957	1994	111.3
Future heritage fund	358	509	518	117	105.2
Stabilization fund	326	123	141	66	219.9
Structural revenue	7239	7231	8298	1811	109.7
Tax revenue	6303	6269	7272	1618	113.7
Non-tax income	936	962	1026	193	85.0
Total expenditure and net lending	8981	9652	9652	1837	68.6
Primary expenditure	7825	8501	8383	1607	69.1
Interest payment	1156	1151	1269	230	65.3
Budget balance	-1742	-2420	-1354	-26	
in percent of GDP	-6.5%	-8.0%	-4.3%	-0.1%	
Primary balance	-586	-1269	-85	204	
in percent of GDP	-2.2%	-4.2%	-0.3%	0.7%	

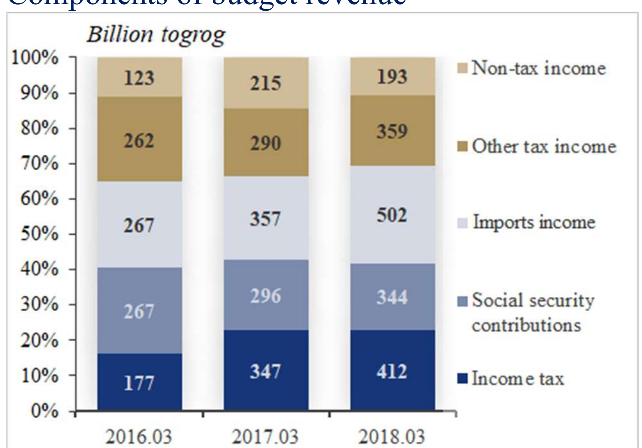
Source: Ministry of Finance, The Bank of Mongolia

Structural revenue

Collection rate of structural revenue in consolidated budget reached 109.7 percent by March 2018. Of total structural revenue 89.4 percent was collected through taxes, while the rest, 10.6 percent, was from non-tax sources. Revenue collection performed exceedingly well compared to previous year and its target mainly owing to positive developments in both domestic and external environment, increased aggregate demand, along with increases in customs duty and excise taxes on some import goods[25]. More specifically, revenue from corporate income tax increased by 28.4 billion togrogs, personal income taxes by 36.8 billion togrogs, value-added tax on import goods by 60.7 billion togrogs, excise tax on import goods by 48 billion togrogs, customs duty on import goods by 38.5 billion togrogs and mining royalties by 37.3 billion togrogs.

Figure II.1.3.2

Components of budget revenue



Source: Ministry of Finance

Total expenditures and net lending

In the reporting quarter budget expenditures increased by 4.4 percent year-over-year, reaching 1837 billion togrogs. According to approved

[24] Calculated by subtracting interest payments from the structural balance

[25] Excise taxes on imported gasoline and diesel were changed in August and November of 2017, and January of 2018; excise taxes on imported automobiles and customs duty on imported tobacco were raised on May 1st, 2017; excise taxes on imported alcoholic drinks and spirits and tobacco were raised on January 1st, 2018. (*Source: www.legalinfo.mn*).

budget, total expenditures are expected to increase by 7.5 percent or 671 billion togrogs in 2018 from previous year. Majority of such expansion is allocated to capital spending and current transfers. In particular, spending on pension or social security (retirement and pension programs, disability insurance, survivor benefits, and veteran assistance) is planned to increase by 14 percent, or 200 billion togrogs, and spending on social welfare programs (monetary and conditional assistance, nutritional assistance programs, elderly care and support, and other various funds for social support) is planned to increase by 240 percent, or 120 billion togrogs.

Fiscal stance and fiscal impulse

As Mongolia's economic growth and budget revenue collection are highly dependent on the change in commodity prices and mining sector, overall structural balance is adjusted by output gap to estimate the fiscal stance (cyclically adjusted fiscal stance).

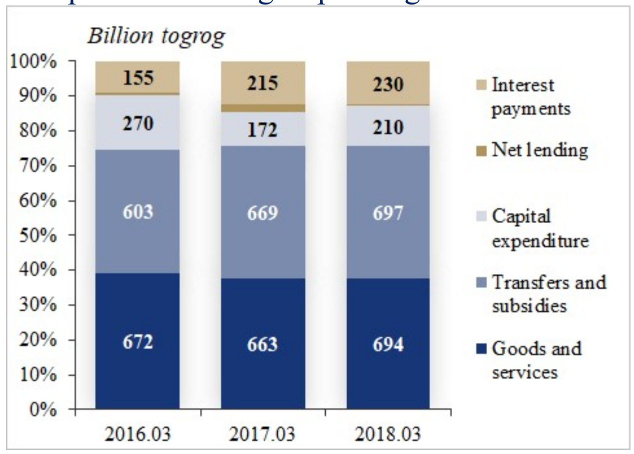
Fiscal impulse is expected to be -1.2 percent in 2018, meaning that the share of budget deficit in GDP will be lower than in 2017 by such percent, and indicates contraction in fiscal policy from previous year (Figure II.1.3.4).

Ratio of *newly issued debt-to-debt repayment*

Ratio of *newly issued debt-to-debt repayment* persisted over 100 percent in recent years, a trend indicating buildup of government debt in Mongolia. However, in 2018 this ratio is expected to be 59 percent, as the government is set to pay 4318.2 billion togrogs for its debt principle, loans and debt service, and to issue bonds and loans worth 2560.3 billion togrogs. (Figure II.1.3.5). According to the Bank of Mongolia forecasts, primary balance is expected to reach a deficit of 83 billion togrogs in 2018, and the deficit and various debt payments are expected to be financed through various funds and government accounts held at the Bank of Mongolia.

Figure II.1.3.3

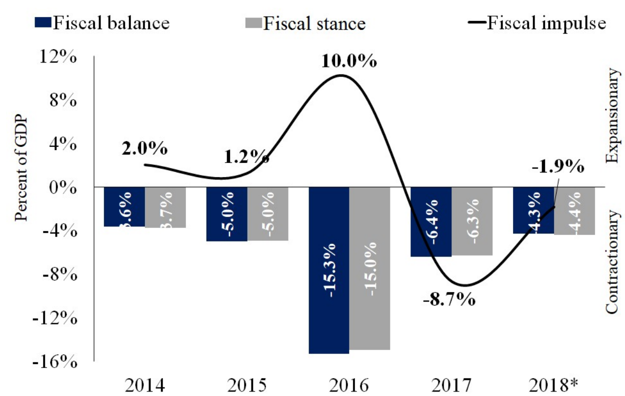
Components of budget spending



Source: Ministry of Finance

Figure II.1.3.4

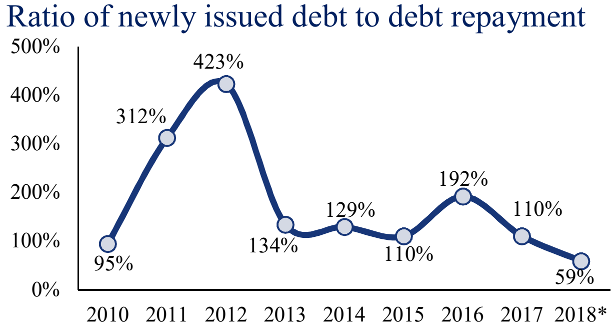
Fiscal stance and fiscal impulse, annual



Source: The Bank of Mongolia

Figure II.1.3.5

Ratio of newly issued debt to debt repayment



Source: The Bank of Mongolia

Present value of the Government gross debt

Present value of the Government debt in 2018-2020 is projected to be within the legal limits (Figure II.1.3.6).

Figure II.1.3.6

Present value of Government debt and Debt service

	2016	2017	2018	2019	2020
billion togrog	Act.	Act.	App.	Act.	Act.
Total government debt	18964	22751.58	24310	25429	26296
in percent of GDP	79.4	84.9	80.0	75.0	70.0
Debt cap/GDP	88.0	85.0	80	75	70
Debt service	987.6	1155.9	1151		
in percent of budget revenue	16.9	16.0	15.9		

Source: Ministry of Finance

II.1.4 Monetary and Financial Market

II.1.4.1 Monetary and credit indicators

Monetary indicators continued to accelerate in the first quarter of 2018, and total credit growth of banks is gradually increasing. Buildup of net foreign reserves and increasing consumer loans were the primary contributors of money supply growth. In the reporting quarter, M2 money rose by 31.1 percent, while loans outstanding increased by 12.2 percent year-over-year.

In the first quarter, net international reserves of the Bank of Mongolia expanded by approximately 1.5 billion USD from a year earlier and accounted for 29 percent of money supply growth. The increase in net international reserves was supported by foreign financing through the IMF's Extended Fund Facility program, as well as foreign direct investments for the construction of underground mining site at the Oyu Tolgoi project.

As the budget deficit was mainly financed through foreign funds, financing needs through domestic debt and bond diminished. As a result, amount of government bonds held by the domestic banks is rapidly decreasing, which in turn created room for the banks to issue credit. Taking advantage of the situation, the banks are gradually increasing their loans, yet most of them are issued for consumption purposes[26].

In the reporting quarter, net claims on the government had negative impact of 19.0 percentage points on money supply growth, while credit issued by depository corporations and claims on other financial corporations boosted money supply growth by 18.0 percentage points.

Figure II.1.4.1.1

Annual growth of M2 money by items, assets side

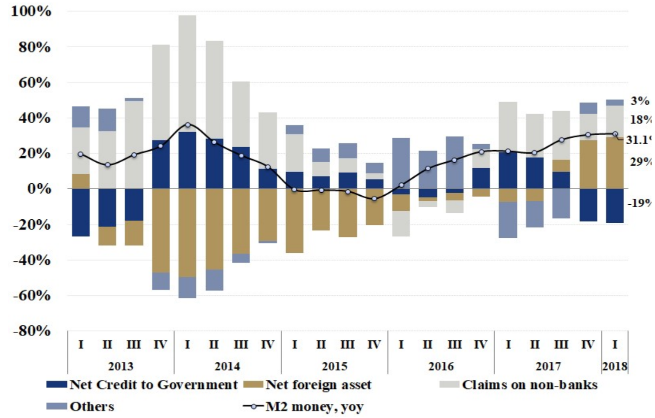


Figure II.1.4.1.2

Annual growth of M2 money by items, liabilities side

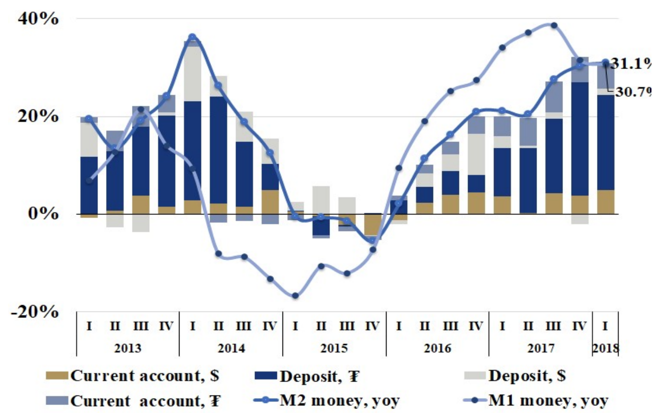


Table II.1.4.1.3

Money supply, assets and liabilities

Billion togrog	2014	2015	2016	2017	2018Q
Net foreign assets	-2009	-4158	-4580	-1252	-147
Net domestic assets	12643	14207	16723	17114	1753
Money supply/M2/	10634	10049	12143	15861	1606
M1 money	1816	1685	2125	2826	277
Currency outside banks	499	459	563	612	57
Checking accounts,₮	1317	1227	1562	2214	220
Quasi money	8818	8364	10018	13035	1329
Deposits,₮	5410	5434	5791	8622	885
Deposits, $	1969	1948	2790	2532	251
Current account, $	1439	982	1438	1881	192

Source: The Bank of Mongolia

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

From the liability side, growth of togrog deposits was the main driver of money supply growth. Togrog deposits increased by 37 percent year-over-year, and accounted for 19.5 percentage point of money supply growth. As overall expectations in the economy and the market stabilized and volatility of the togrog exchange rate declined, dollarization of liability in the financial system decreased by 11.0 percent compared to the end of 2016, reaching approximately 22 percent in the reporting quarter.

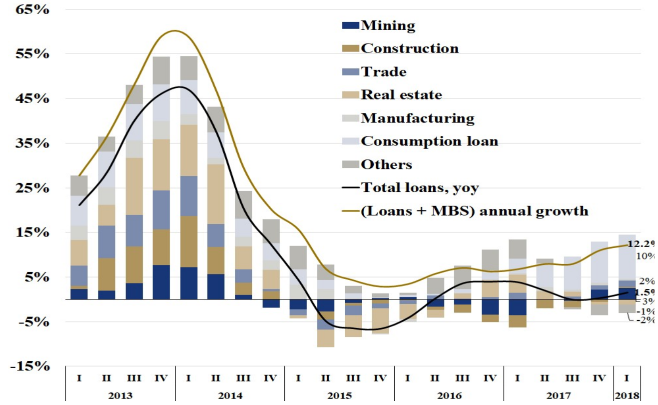
Total outstanding loans issued by depository corporations[27] including mortgage-backed securities[28], increased by 12.2 percent. Of which, 10 percentage points or majority is attributed to the growth of consumer loans. In case of economic sectors, credit to the mining and trade sectors increased, in relation to greater production in the mining sector. In trade sector, repayment of existing loans improved, encouraging issuance of new loans. In the reporting quarter, 30.0 percent of the newly issued loans and 31.0 percent of paid-off loans can be attributed to the abovementioned two sectors. However, as loans to these sectors are mainly issued in foreign currencies, credit dollarization is on the rise.

About 50 percent of total outstanding loans in foreign currencies were issued to the mining and trade sectors. In the past 2 quarters, credit dollarization in these sectors continued to rise, in an environment where official reserves of foreign exchange increased, and sharp volatility of exchange rates receded. As for the other sectors, credit dollarization continues to decline gradually.

One reason banks are issuing more of consumer loans over business loans is the lack of improvement in the quality of loans in business sectors of the economy. In the reporting quarter,

Figure II.1.4.1.4

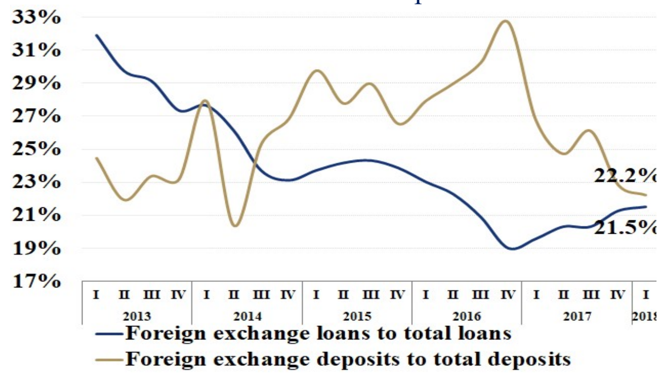
Contributions to annual credit growth of Depository corporations, by economic sectors



Source: The Bank of Mongolia

Figure II.1.4.1.5

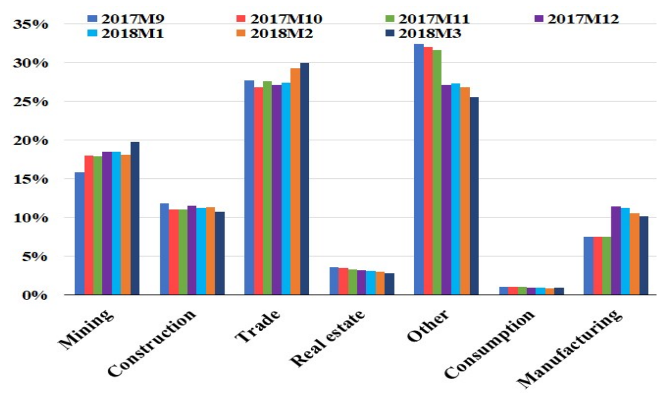
Dollarization of bank loans and deposits



Source: The Bank of Mongolia

Figure II.1.4.1.6

Structure of foreign currency loans of banks, by economic sectors



Source: The Bank of Mongolia

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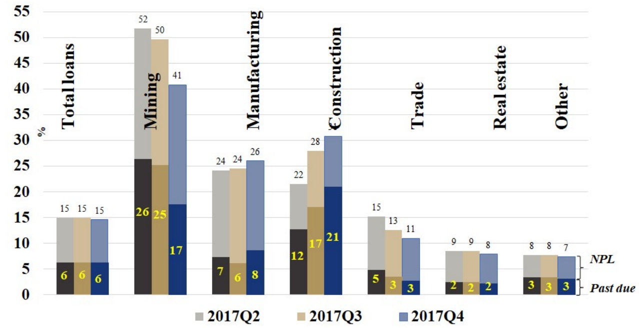
[27] Depository corporations consist of banks and deposits and loans cooperatives.

[28] Banks securitize mortgages by selling mortgage portfolios to the Mongolian Mortgage Corporation, and the growth of these securities are considered to be part of credit growth.

share of nonperforming and past due loans in the financial system increased by 0.8 percent since the beginning of the year, reaching 15.4 percent. Among business sectors, improvements in the quality of loans can be only observed in the trade sector. About 60 percent of total past due loans were issued to the mining and construction sectors, while approximately 45 percent of total nonperforming loans were issued to the mining and manufacturing sectors.

Figure II.1.4.1.7

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



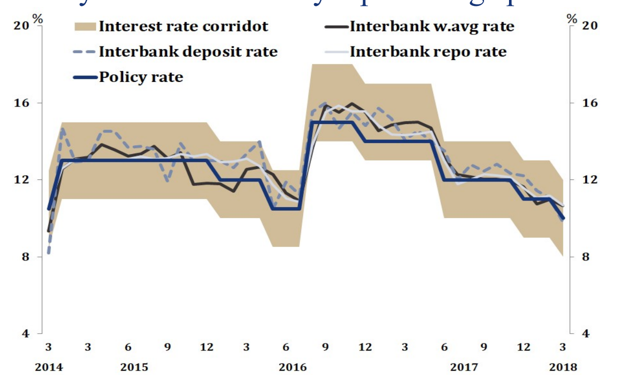
Source: The Bank of Mongolia

II.1.4.2 Interest rates

The Monetary Policy Committee of the Bank of Mongolia decided to lower the policy rate by 1 percentage point (100 basis points) to 10.0 percent during its March 2018 meeting. Following the reduction of policy rate, at the interbank market interest rate of repo deals collateralizing central bank bills dropped by 0.9 percentage points to 10.7 percent; interest rate on direct deals with central bank bills declined by 1.12 percentage points to 10.6 percent; interest rate of overnight loans declined by 0.8 percentage points to 10.6 percent, and the interbank deposit rate decreased by 2.4 percentage points to 9.8 compared to the previous quarter. Thus, weighted average of the interbank rate declined by 1.0 percentage points to 10.7 percent.

Figure II.1.4.2.1

Policy rate is reduced by 1 percentage points.

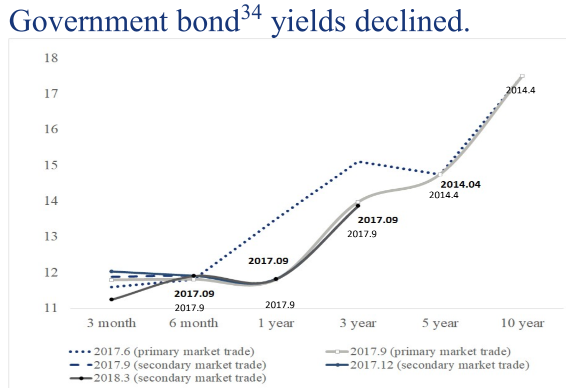


Source: The Bank of Mongolia

Government bonds were not offered in the primary market in the first quarter of 2018. In the secondary market, however, only 3-month government bonds were traded, and its yield declined by 0.78 percentage points from previous quarter to 11.2 percent.

Figure II.1.4.2.2

Government bond[34] yields declined.



Source: The Bank of Mongolia

Interest rate of togrog credits increased, and that of deposits declined, effectively widening the interest rate margin to 6.4 percent. Interest rate on newly issued loans increased by 0.14 percentage

[34]Government bonds with maturities over 5 years was not issued at the primary market since 2014 and was not sold at the secondary market. In addition, no government bonds with maturities over 3 months was traded on the secondary market since September 2017.

points from previous quarter to 19.12 percent in the reporting quarter, mainly due to lower performance of credit repayment and high risks in the construction sector, and increased credit demand in the mining sector[29]. Interest rate of togrog deposits declined by 0.12 percentage points to 12.76 percent from previous quarter.

Interest rates on foreign currency denominated credits decreased by 0.31 percentage points to 11.31 percent, while interest rates on foreign currency deposits declined by 0.15 percentage points to 5.24 percent.

In the reporting period, the relative yield of togrog decreased by 0.31 percentage points from previous quarter and reached 0.94 percent. Although interest rates on togrog and foreign currency deposits remained stable relative to previous quarter, exchange rate of togrog against USD appreciated by 0.31 percent and pushed relative yield of togrog down.

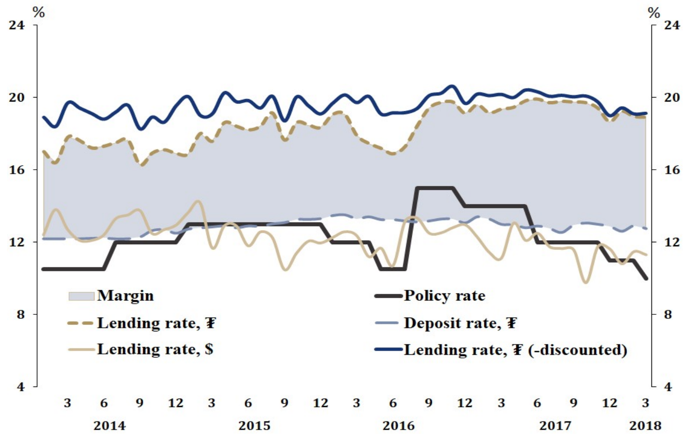
II.1.4.3 Exchange rates

As of April 2018, average exchange rate of togrog to USD appreciated by 52.3 togrogs or 2.1 percent from the previous quarter and by 27.2 togrogs or 1.1 percent year-over-year, reaching 2394.7 togrogs. (Figure II.1.4.3.1). Appreciation of togrog can be attributed to rising copper and coal prices in the global market, increased export revenue, greater foreign direct investments, and lower deficits in balance of payments compared to the same period last year. Moreover, public's expectations[30] regarding exchange rate played a role in the appreciation.

Starting 2018, exchange rate of togrog against USD had been appreciating till mid-February, due to improved net inflow of foreign capital[31], and remained less volatile till the end of the quarter. The difference between amount of USD bought

Figure II.1.4.2.3

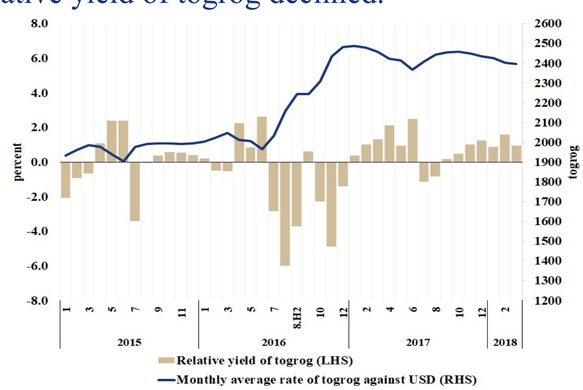
Interest rate margin between loans and deposit widened.



Source: The Bank of Mongolia

Figure II.1.4.2.4

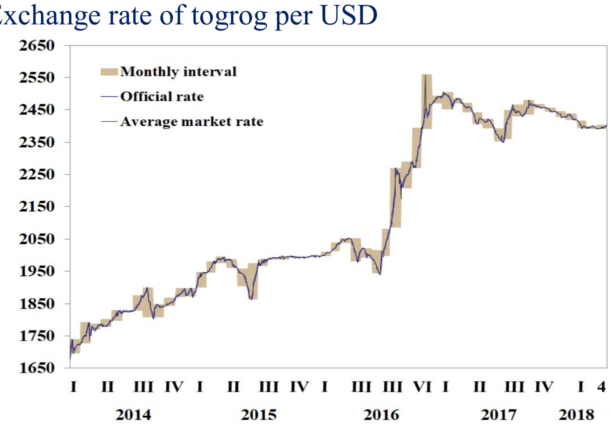
Relative yield of togrog declined.



Source: The Bank of Mongolia

Figure II.1.4.3.1

Exchange rate of togrog per USD



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29 Discounted credits are excluded

30 Bank of Mongolia, *Survey on expectations of households and enterprises,* first quarter of 2018

31 Net inflow of foreign capital increased by 184.8 million USD or 139 percent from the previous quarter and by 484.3 million USD year-over-year.

and sold by the banks diminished[32] in the reporting quarter, leading to relatively stable exchange rate.

Nominal effective exchange rate (NEER) of togrog depreciated by 2.0 percent from previous quarter, and relative prices declined by 3.3 percent. Real effective exchange rate (REER), however, appreciated by 1.3 percent driven by rising inflation (Figure II.1.4.3.2). In particular, inflation rate measured by CPI increased by 3.6 percent from the beginning of the year or by 7.7 percent from same period of previous year, causing the real exchange rate to appreciate and the margin between nominal and real rate to widen.

By the end of the reporting quarter, togrog depreciated against Chinese RMB by 9.8 togrogs or 2.6 percent from the previous quarter (Figure II.1.4.3.3). Appreciation of RMB against USD by 3.2 percent[33] was the main reason leading to togrog depreciation relative to RMB.

Figure II.1.4.3.2

Real effective exchange rate of togrog

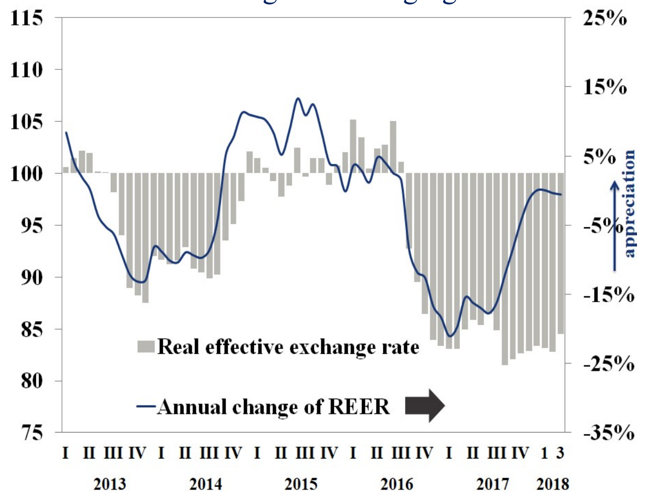
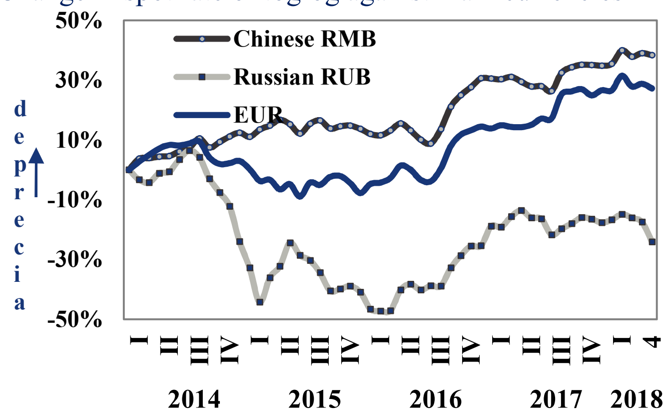


Figure II.1.4.3.3

Change in spot rate of togrog against main currencies



Source: The Bank of Mongolia

[32] If the amount of USD sold by the banks in the fourth quarter of 2017 is normalized to one unit, then difference between amount of USD bought and sold during the quarter was -0.12, while it reached 0.01 in the first quarter of 2018, showing relatively balanced demand and supply of USD.

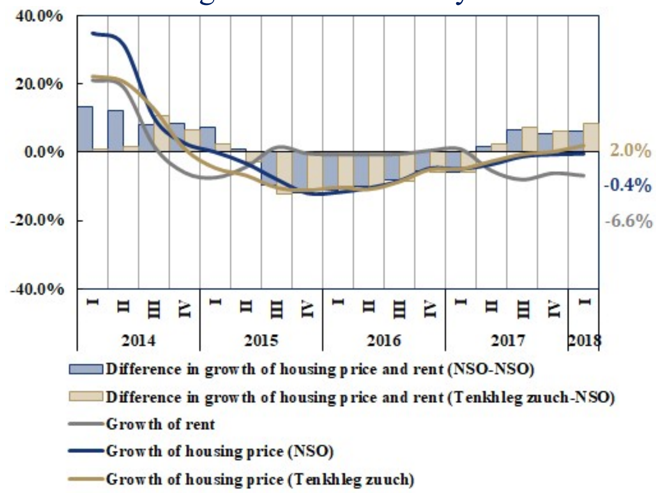
[33] From the beginning of the year to the end of the first quarter of 2018.

II.1.4.4 Real estate market

In the reporting quarter, price of housing sales remained relatively stable, while housing rent declined from previous year. Housing price index reported by the National Statistical Organization (NSO) remained unchanged compared to the previous quarter but was 0.4 percent lower year-over-year. As for the housing price index estimated and reported by the "Tenkhleg Zuuch" company, it showed growth after 3 years, and is 2.0 percent higher year-over-year and 9.0 percent higher compared to the previous quarter. More specifically, price of old housing increased by 1.0 percent and that of new housing rose by 3.6 percent year-over-year. Housing rent on the other hand, declined by 6.6 percent from same period last year and 0.7 percent from previous quarter (Figure II.1.4.4.1).

Figure II.1.4.4.1

Price of housing remained relatively stable.

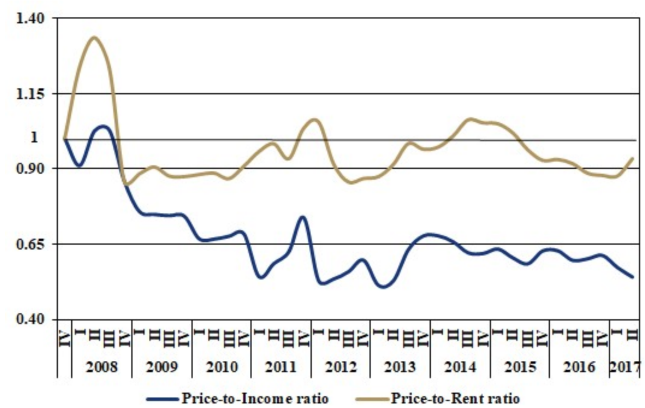


Source: NSO, Tenkhleg Zuuch

Housing price-to-income ratio declined in the reporting quarter following increased income. More specifically, household income rose by 8.8 percent from previous quarter and by 15.9 percent year-over-year. Although such improvements boosted household purchasing power, it remains weak when it comes to purchasing housing. As for the price-to-rent ratio, it slightly increased from previous quarter as rents declined. Price-to-rent ratio remained relatively stable in the past year (Figure II.1.4.4.2).

Figure II.1.4.4.2

Demand for housing is low in recent quarters.



Source: NSO, analysts' estimations

Rising trend in price of construction materials in the last three years was sustained in the reporting quarter.

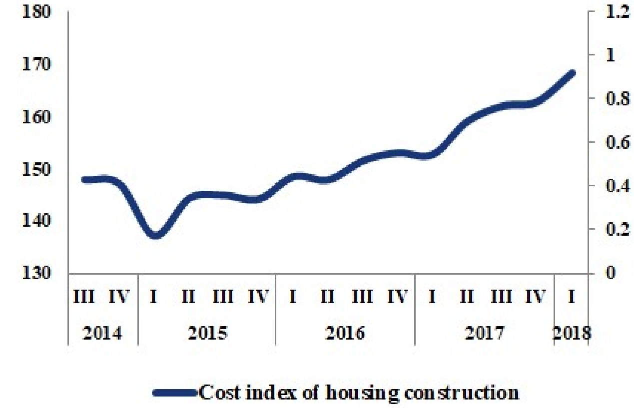
In the reporting quarter, cost index of construction materials increased by 3.4 percent compared to previous quarter and by 10.2 percent year-over-year. Starting from the second quarter of 2017, construction cost index is showing signs of acceleration (Figure II.1.4.4.3).

Growth of stock market indicators slowed from previous quarter. TOP-20 index of the Mongolian Stock Market reached 21,057.7

units in the first quarter of 2018, which is a 70.6 percent growth from same period of previous year and 1.8 percent growth from previous quarter. Total market capitalization reached 2.53 trillion togrogs, showing growth of 72.3 percent year-over-year and of 8.2 percent from previous quarter (Figure II.1.4.4.4). Such improvements in stock market indicators are the result of increasing stock prices of several companies such as APU, Gobi, SUU Companies, and the Mongolian Postal Office in the second half of 2017.

Figure II.1.4.4.3

Cost index of construction materials increased in the reporting quarter

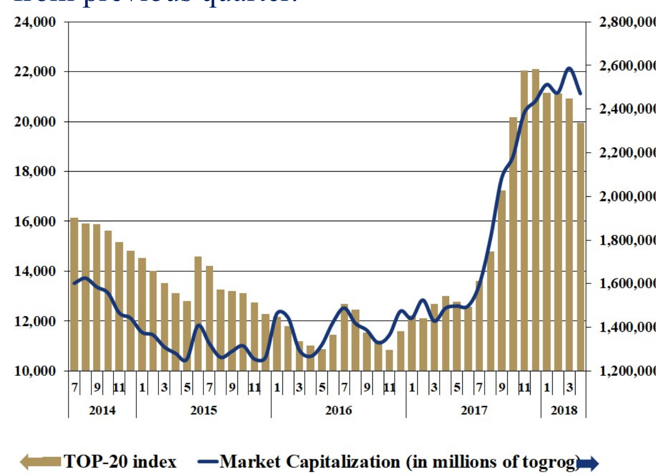


Source: NSO, General Authority of Property Rights Registration

In the reporting period, a total of 200.0 million stocks of LendMN was publicly offered at the primary market and sold for 5 billion togrogs. In the secondary market a total of 73.5 million stocks of 114 companies were traded for 12.6 billion togrogs. As for portfolio trades, a total of 20.0 million LendMN stocks were traded for 500.0 million togrogs and 165.1 thousand stocks of the Darkhan-Nekhii company were sold for a total of 3.0 billion togrogs[35].

Figure II.1.4.4.4

Growth of stock market indicators slowed down from previous quarter.



Source: Mongolian Stock Exchange

35 Source: Mongolian Stock Exchange

II.2 External Economic Conditions

In the first quarter of 2018, economic growth of the USA, Euro area and China exceeded market expectations, while growth of Russia fell short of expectations. Prices of main export commodities also increased due to expectations of OPEC to cut oil supply, depreciation of USD, expectations of increasing shale oil productions in the USA, economic performance in China exceeding expectations, trade relations between the US and China, and increased imports of coal, iron ore and copper following Chinese authorities' policy to curb air pollution.

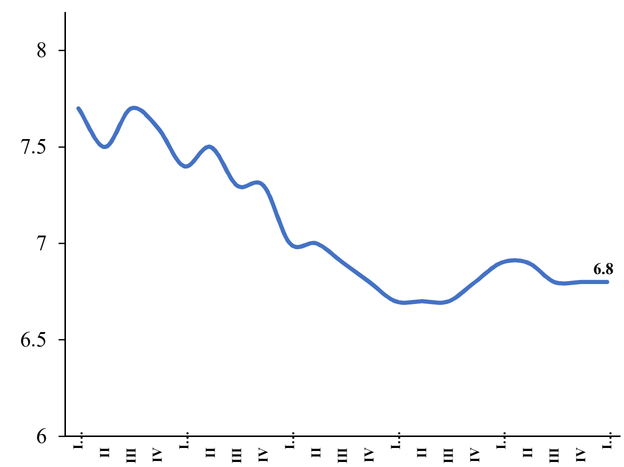
II.2.1 Economic conditions of main trading partners

Economic conditions of China

Chinese economic growth exceeded previous expectations to reach 6.8 percent in the first quarter of 2018. Retail trade, private investments and investments to the real estate sectors grew by 10.2, 8.9 and 10.4 percent respectively, making the greatest contributions to overall economic growth. Sales of housing increased by 11.4 percent in the first quarter and prices of apartments in large cities did not decline. Although investments to real estate sector reached its peak since March 2015, growth of manufacturing production reached 6.8 percent year-over-year, which was below expectations. Although the authority's policy plan to alleviate risk in the economy by reducing budget deficit to 3.5 percent of GDP in 2018, would have negative consequences on the manufacturing and real estate sector in the medium term, during his public statement in March 2018, the ministry of finance emphasized the plan to increase infrastructure investments by 30 billion RMB and to introduce tax cuts.

Figure II.2.1.1

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



Source: Bloomberg, Roubini

Private consumption made up 58.8 percent of growth in 2017, and further increased to 77.8 percent in the first quarter of 2018, thus boosted growth. In the first quarter Caixin PMI industrial index reached 51.5, and entrepreneurs' confidence index increased to 74.3, the highest since the third quarter of 2011. Such developments indicate improved confidence of private business owners and consumers in the reporting period. Compared to the same period of previous year, inflation measured by consumer price index reached 2.1 percent, while producer's price index increased by 3.1 percent following the price of raw materials and commodities.

Chinese authority plans to conduct expansionary fiscal and monetary policy measures to keep economic growth stable around the target rate of 6.5 percent. In accordance with this policy, the People's Bank of China lowered its required reserve ratio by 1.0 percentage point to stimulate economic growth, bringing ratio for small or medium sized banks to 14.0 percent from 15.0 percent and to 16.0 percent from 17.0 percent for large banks. Moreover, plans of the People's Bank of China to increase annual savings interest rate (1.5 percent) and lending interest rate (4.35 percent) to discourage credit growth and to prevent exchange rate depreciation in the first quarter, was halted and it decided to keep the interest rates unchanged through 2018 in response to economic growth exceeding expectations in the first quarter. There is a risk of Chinese RMB depreciating against the USD in relation to the expectation of the Federal Reserve to hike its key interest rates twice in 2018, increased uncertainty regarding trade between the two economies, and expectations of tax policy reform and tax cut by the US. President, Donald Trump.

Chinese economic conditions remain highly dependent on the conditions of debt and deficit in financial accounts. Private sector debt increased to approximately 215 percent of GDP by the end of 2017, which signals risk accumulation in the economy. In recent years, the Chinese government shifted their macroeconomic policy focus to stable and sustainable growth based on domestic demand, lowered their target growth rate consistently and limited their investments to real estate and manufacturing sectors in the medium and long term. To reach their goal of "doubling the GDP levels of 2010 by 2020" set forth from the 12th National Congress Convention, the economic growth needs to be maintained at 6.5 percent during 2018-2020. According to international analysts, moving further, investments to real estate and manufacturing sectors would decline less than previously estimated and growth of household consumption would remain stable, pushing overall growth up by 0.2 percent during 2018-19. (EIU, Bloomberg, World Bank, IMF & Roubini).

Analysts of the IMF and EIU estimated the Chinese household, corporate, and government debt to reach 250-320 percent of their GDP by 2022 and warns that appropriate debt management policy measures need to be taken to decrease risk of banking sector instability. Such event may worsen the Chinese economic condition in the medium term.

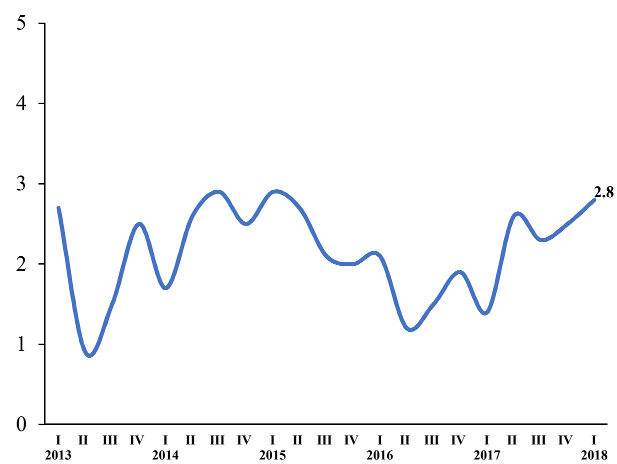
Economic conditions of the USA

Economic growth in the first quarter of 2018 reached 2.8 percent, exceeding previous expectations. Such growth was supported by declining unemployment rate, recovery in labor market, increased investments and domestic demand. Main drivers of economic growth were expansion of domestic demand by 2.9 percent and government expenditures by 1.2 percent. To alleviate the negative impact of Harvey and Irma hurricanes on the states of Florida and Texas in late August and early September, non-housing construction investments were increased by 12.3 percent in the first quarter of 2018. Private consumption, which makes up approximately 70 percent of the US GDP, rose by 2.8 percent in the first quarter, down from 3.8 percent in the previous quarter, and investments increased only by 4.6 percent in the first quarter, down from 8.2 percent in the previous quarter.

Judging from the indicators in the first quarter, analysts expect the US economic growth to increase steadily throughout 2018.

Figure II.2.1.2

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



Source: Bloomberg, Roubini, EIU, IMF

In April 2018, one of the determinant indices of the stock market, S&P500, rose by 1.1 percent from its levels of January; 200 thousand jobs were created on average per month, and unemployment rate remained stable at 4.1 percent, which are expected to further stimulate domestic demand and economic growth. Moreover, the US President, Donald Trump, revealed his decision to impose tariffs of 25 and 10 percent on imported steel and aluminum, respectively, and tariffs of 25 percent on Chinese import goods worth 150 billion USD to reduce trade deficit and support domestic industrial production.

Implementation of his planned tax cuts and expansion of investments to infrastructure would yield positive impact on economic growth in the short term. However, diminishing productivity in manufacturing industries, expectations of fiscal deficit widening from 3.5 percent of GDP in 2017 to 5.7 percent in 2019, increasing public debt and economic and political uncertainties regarding some protectionist policies are likely to create downward risk to overall growth.

The Federal Reserve increased its short-term funding rate in March and June by 0.25 percent each time to 1.75-2.0 percent, in response to economic growth exceeding expectations in the first quarter, recovery in labor market, and acceleration of inflation rate. The Federal Reserve is expected to gradually tighten its policy stance depending on domestic and external economic outlook. Analysts emphasized the increased likelihood of the Federal Reserve hiking its policy rate twice again within this year.

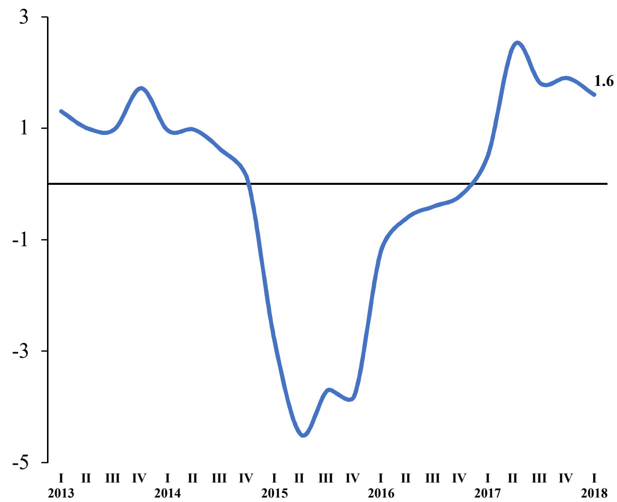
Economic conditions of Russia

Russian economy grew by 1.5 percent in 2017, but failed to meet expectations with its growth rate of 1.6 percent in the first quarter of 2018. Total investments expanded by 3.6 percent and household consumption increased by 3.0 percent, thus boosting economic growth. In addition, exports increased by 17.8 percent, owing to higher oil prices, and current account balance witnessed a surplus of 21.7 percent. Nevertheless, further tightening of sanctions by the US on Russia in March and April, weakened investors confidence and encouraged capital outflow. Industrial production index of Russia, which reached 52 in the fourth quarter of 2017, decreased to 50.2 percent in the first quarter of 2018, and as of April 2018, unemployment rate reached 4.9 percent, lowest since January 2009.

Russian central bank reduced its policy rate by 25 basis points to 7.5 percent in response to inflation reaching 2.4 percent in March 2018, budget deficit totaling to 2.4 percent of GDP, and depreciation of RUB. The Central bank is likely to reduce its policy rate again this year, judging by the fact that inflation as of April 2018 was at 2.4 percent which is lower than its target of 4 percent, oil prices are gradually increasing, and exchange rate of RUB is slightly appreciating.

Figure II.2.1.3

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



Source: Bloomberg, Roubini, EIU, IMF

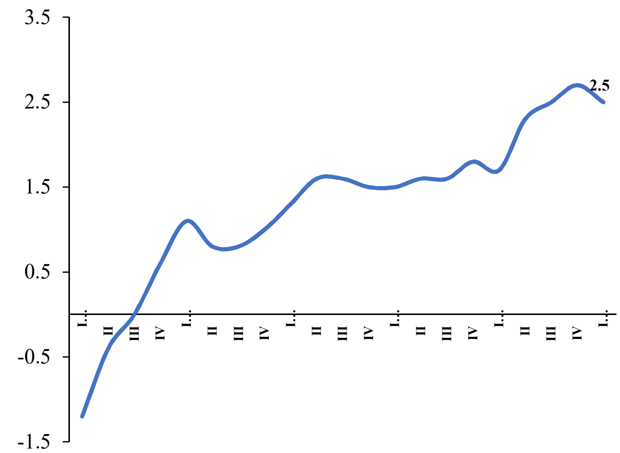
Economic conditions of the Euro area

The Euro area economy grew by 2.5 percent in the first quarter of 2018, higher than previously forecasted. Although the German and French economies which respectively account for 29 and 21 percent of the region's GDP expanded by 0.3 and 0.4 percent below the expectations, economies of Spain and Finland which account for 11 percent of the area's GDP, expanded by 0.7 and 1.2 percent respectively, thus exceeding expectations.

Unemployment rate declined to 8.5 percent in April 2018, reaching its lowest since December 2008, and supported domestic demand. In addition, domestic demand remains resilient owing to improvements in economic conditions of main trading partners and unconventional expansionary monetary policy measures. The PMI index reached 56.2 percent in April 2018 and household consumption increased by 1.5 percent, which further stimulated growth in the area. Although the unconventional monetary policy is supporting domestic demand, inflation rate declined from 1.4 percent in the fourth quarter of 2017 to 1.3 percent in the first quarter of 2018. Despite the nonconventional monetary policy measures of the European Central Bank, inflation rate is unlikely to reach its target rate of 2.0 percent.

Figure II.2.1.4

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



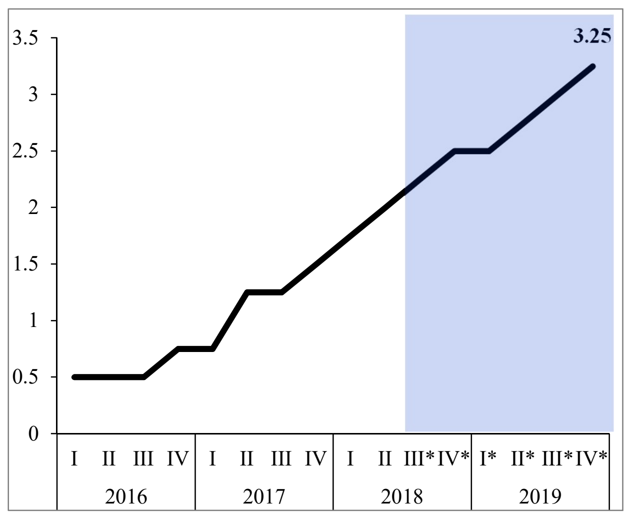
Source: Bloomberg, Roubini, EIU, IMF

Foreign interest rates

The Federal Reserve Bank increased their short-term funding rate by 0.25 percent twice in the first and second quarter of 2018 to 1.75-2.0 percent, encouraged by declining unemployment, improved labor market indicators, rising real income and expectations of consumption to stabilize. The Federal Reserve is expected to further increase their short-term funding rate twice more in 2018 and three times in 2019. In addition to increasing their short-term interest rate, the Federal Reserve has started to shrink its balance, resulting in lower price of long-term assets and higher yield. The yield on 10-year US treasury bond reached 3.0 percent, highest in 7 years, and yield of 30-year bonds reached 3.1 percent in April 2018.

Figure II.2.1.5

Federal Reserve short term interest rate, in percent



Source: Bloomberg

II.2.2 Global market prices of main exporting commodities of Mongolia

Copper: Price of copper increased to $7,075 per ton in the first quarter of 2018 from its level of $6,834 per ton in the last quarter of 2017. The increase in copper price can be attributed to lower than expected rate of slowdown in Chinese construction sector, increasing demand for copper by 7.3 percent in the first quarter, depreciation of USD despite the Federal Reserve Bank increasing their short-term interest rate, and expectations of supply disruption due to the pending labor contract renewal process in mines of Chile and Peru. According to the Australian Department of Industry, Innovation and Science, the demand and supply for copper is expected to increase by 2.0 and 1.7 percent, respectively, in 2018. In relation to increased investment in Chinese energy, construction, and manufacturing sectors in 2018, China's demand for copper is expected to increase by 2.9

percent in 2018 and by 2.5 percent in 2019, thus copper price is expected to be around $6,858 per ton in 2018 and around $7,282 in 2019.

Gold: Price of gold increased from $1,303 per ounce in the last quarter of 2017, to $1,311 in the first quarter of 2018. Such elevation was mainly supported by depreciation of USD, and several geopolitical risks. Investors' appetite for gold is expected to increase mainly due to expectations of further tightening by the Federal Reserve Bank, uncertainty in the USA-China trade relations, continuation of negative interest rate policy in Japan and the Euro zone to support economic recovery, and expectations of lower inflation in advanced economies. Due to such improved sentiment, price of gold is forecasted at $1,310 in 2018 and $1,343 in 2019.

Thermal coal: Price of thermal coal increased to $101 per ton in the first quarter of 2018 from $79 per ton in the last quarter of 2017. Increasing price was supported by 18 percent reduction in the production of one of the world leading mining company BHP Billiton, and 38 percent increase in China's coal imports, which was triggered by lower production of coal in China, in relation to its policy to clamp down air pollution. According to the Australian Department of Industry, Innovation and Science, supply of thermal coal is expected to increase by 2 percent or from 250 million tons to 254 million tons during 2018-19, following the completion of construction work in the mines of New Southern region (Rollerton, Hunter Valley, Ravensworth). In addition, cost of renewable energy is declining, its impact is expanding, and China's demand for coal may decelerate in the medium run. Such factors pushed price forecasts to $91 per ton in 2018 and $83 per ton in 2019.

Coking coal: The Australian benchmark price for coking coal decreased to $212 per ton in the first quarter of 2018 from $239 per ton in the last quarter of 2017. China's diminishing demand for coking coal, a slight increase of production (1 percent year-over-year) in Shangxi province (one of China's leading producers of coking coal), and a 31.8 percent year-over-year decline in imports of coking coal in the first quarter were the main driving factors of lower price. The Australian Department of Industry, Innovation and Science reports that total mining volume will slightly increase to 196 million tons in 2018 from 190 million tons in 2017, and boost supply. In the medium to long run, as China's demand is expected to decrease, and supply from Canada and Australia is likely to increase, price of coking coal is forecasted to be $197 per ton in 2018 and $172 per ton in 2019.

Iron ore: Price of iron ore decreased from $71 per ton in the last quarter of 2017 to $69 in the first quarter of 2018. Declining price is driven by lower demand in China and large stock of steel in Chinese warehouses. To be specific, stock of construction materials in steel reached its highest level in the last 5 years at 9.7 million tons. According to the Australian Department of Industry, Innovation and Science, the Brazilian mines of Vale and Minas Rio are expected to ramp up their production by 17-26.5 million tons in 2019, and the BHP Billiton Ltd. is projected to keep their production at 275-280 million tons until the end of 2018, increasing supply. Based on such expectations price is forecasted to be $63 per ton in 2018 and $60 per ton in 2019.

Crude oil: Price of Brent oil increased to $64 per barrel in the first quarter of 2018 from $57 in the last quarter of 2017. Sanctions on Venezuela and the US decision to leave the Iranian Nuclear Deal both had reducing impact on production of crude oil in these countries. As supply cut was expected in the global market, prices increased in the first quarter. According to the revised estimations of the EIU, global demand for crude oil is expected to increase by 1.6 percent in 2018 and in response to the increased demand, supply from both OPEC and non-OPEC countries are likely to increase by 1.8 percent. Price of crude oil is forecasted to be around $66 per barrel in 2018-2019, considering the fact that geopolitical risks and uncertainties may limit oil supply, production of shale oil in the US expected to reach 12 million barrels a day in last quarter of 2019, and crude oil demand is forecasted to expand by 1.1 percent annualy till 2023.

II.2.3 Balance of Payments

II.2.3.1 Balance of payments

Deficit in balance of payments was 42 million USD in the reporting quarter, which is an improvement from same period of previous year. In the first quarter of 2018, the current and capital accounts witnessed a deficit of 348.1 million USD, and financial account reached a surplus of 239.0 million USD, pushing the overall balance of payments to a deficit of 42.0 million USD, or 0.4 percent of the annual GDP[36] (Figure II.2.3.1.1).

The main factors that contributed to balance of payment deficit were increasing imports, payment of 500 million USD for the Chinggis bond, and foreign currency outflows through banks.

Current and capital account deficit reached 348.1 million USD in the first quarter of 2018, which is a 218 million USD deterioration compared to same period last year (Figure II.2.3.1.2). Ratio of the current account deficit to GDP is 3.0 percent.

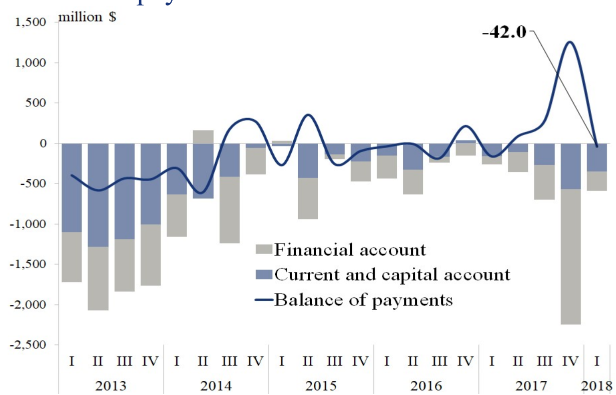
Export revenue from copper, gold, and iron ores increased and export of other commodities remained stable in the reporting period. However, starting second half of 2017, due to congestion at the Gashuun-Sukhait port, coal exports declined from same period of previous year. Total imports increased by 46 percent from same period of previous year mainly due to increased demand for machinery, diesel fuel and construction materials, encouraged by construction activities and investments in the mining sector, and increased domestic demand. In addition, due to insufficient harvest in previous year, more wheat and crops were imported, further boosting total imports. (Figure II.2.3.1.3).

High levels of deficit in the balance of payments' services account remained unchanged in the reporting quarter, as cost of foreign services spiked in relation to the transportation of imported goods and Oyu Tolgoi construction activities.

Deficit in primary income account persisted in the reporting quarter, reaching 298.0 million USD, which is 41.6 million USD, or 16.0 percent expansion from previous year. Increased payments of interest and dividends of bonds and foreign loans were the main reason for the persistence. More specifically, in 2012 the primary income account deficit accounted for approximately 22 percent of the current account deficit, but rose to 102 percent in 2015, 130 percent

Figure II.2.3.1.1

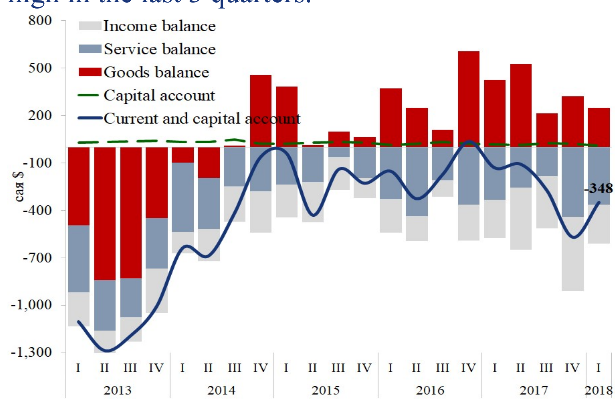
Lower surplus in the financial account weakened balance of payments.



Source: The Bank of Mongolia

Figure II.2.3.1.2

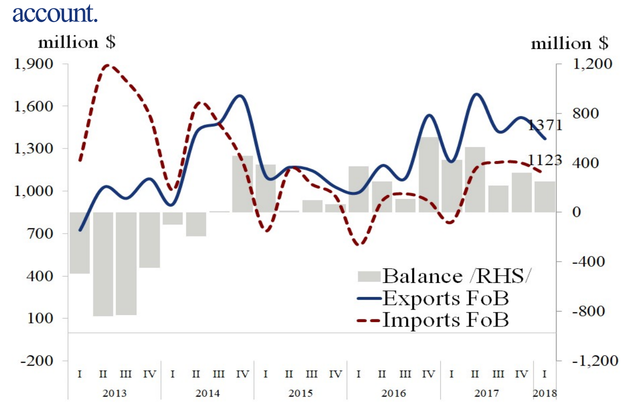
Deficit of the current and capital accounts were high in the last 3 quarters.



Source: The Bank of Mongolia

Figure II.2.3.1.3

Imports grew rapidly, reducing surplus of the goods account.



Source: The Bank of Mongolia

36 Cumulative of 4 quarter nominal GDP

in 2016, and 135 percent in 2017. As for the first quarter of 2018, the ratio of primary income account deficit to the current account deficit decreased to 83 percent, a change which can be attributed to the fact that interest payments of significant foreign loans were not expected in the first quarter of the year and that corporate dividend payments decreased (Figure II.2.3.1.4).

Financial account had a surplus of 239.0 million USD in the first quarter of 2018, which is a 126 percent or 133.1 million USD higher figure year-over-year. Foreign direct investments increased by 318 million USD, thus supported the financial account surplus. (Figure II.2.3.1.5).

Net inflow of foreign direct investments reached 455 million USD in the first quarter of 2018, which is a 232.0 percent growth compared to same period last year. Majority of such increased investments was made to the Oyu Tolgoi underground development.

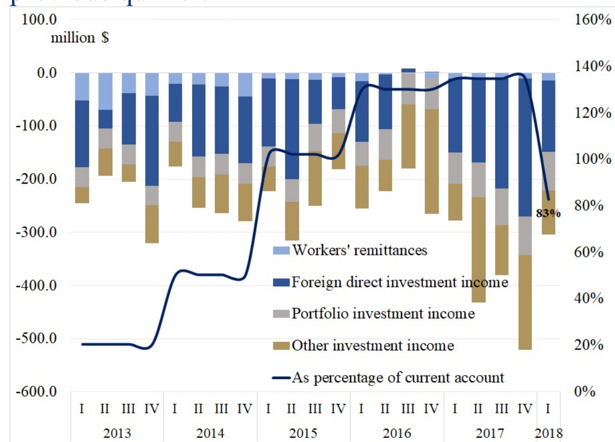
II.2.3.2 Terms of trade

Terms of trade improved in the first quarter of 2018 by 6.9 percent year-over-year. Prices of exports rose more rapidly than the prices of imports and contributed to the improvements in terms of trade (Figure II.2.3.1).

Acceleration of export prices in 2017 slowed down around the beginning of 2018, yet overall export prices increased by 13 percent year-over-year in the first quarter. Persistently high prices of copper, gold, and coal and increasing crude oil price at the global market were the main contributors. More specifically, crude oil price increased by 22 percent, copper price by 19 percent, gold price by 9 percent, and thermal coal price by 17 percent, while iron ore price decreased by 16 percent. As importing prices of fuel, investment items and consumer items increased, overall import price increased by 8.3 percent year-over-year.

Figure II.2.3.1.4

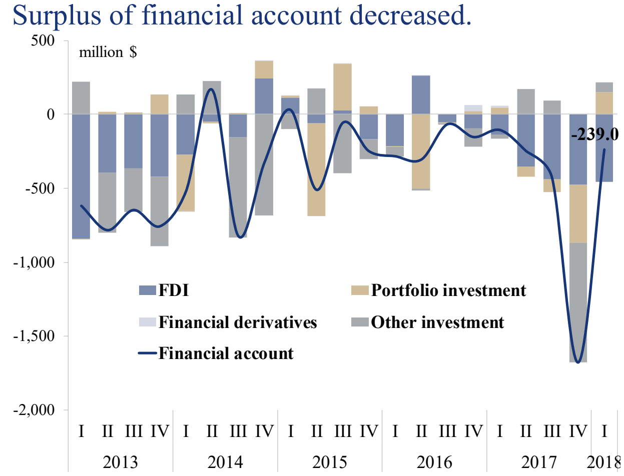
Deficit of primary income account declined from previous quarter.



Source: The Bank of Mongolia

Figure II.2.3.1.5

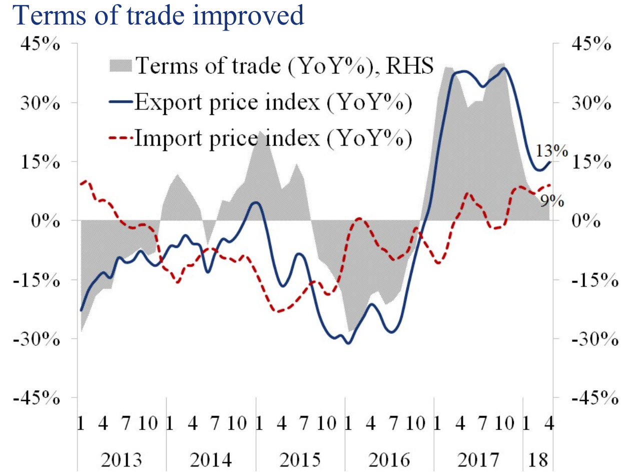
Surplus of financial account decreased.



Source: The Bank of Mongolia

Figure II.2.3.2.1

Terms of trade improved



Source: The Bank of Mongolia, Mongolian Customs

THE BANK OF
MONGOLIA