THE BANK
OF MONGOLIA

INFLATION REPORT

2019
MAR

CONTENTS

MONETARY POLICY STRATEGY, DECISION

Monetary policy strategy

According to the Law on Central Bank, the **main objective of the Bank of Mongolia is to stabilize togrog.** Within this objective, in the medium run the Bank of Mongolia implements monetary policy to stabilize annual inflation rate measured by consumer price index around its target rate set in the Monetary Policy Guideline. By stabilizing inflation at a low rate, the Bank intends to safeguard the real income and 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 international best practice, monetary policy strategy of the Bank of Mongolia is gradually switching to 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 inflation by influencing market interest rate and consequently aggregate output, asset prices, expectations, exchange rate, and domestic demand. Coupled with the policy rate, starting 2018 the Bank of Mongolia has been applying macroprudential policy measures such as setting adequacy ratios for the banking sector as a whole to cool down overheating credit market, to curb overcrowding of financial products in certain sectors and to limit financial dollarization.

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

Monetary policy decision

During its scheduled meeting held on March 21, 2019, the Monetary Policy Committee decided to keep the policy rate unchanged at 11 percent, and to revise the upper limit on debt-service-to-income ratio on on newly-issued and term-changed consumer loans excluding pension loans at 60 percent effective April 1, 2019. /Detailed information is provided in monetary policy statements./

EXECUTIVE SUMMARY

Assumptions regarding external demand and commodity prices are revised down in this report, despite the resolution of disruption to export transportations, and a temporary halt in the trade tension between the USA and China. Economic growth in 2018 has exceeded previous projections, and domestic demand is expected to stabilize in 2019. Consequently, demand-driven inflation is projected to pick up gradually, and headline inflation is expected to remain close to the Central Bank's target.

Last year, headline inflation accelerated following prices of certain items that were driven by supply factors, while the demand related pressure has been relatively stable. Due to price fluctuations induced by supply-related factors, inflation picked up in the last months of 2018. Annual headline inflation reached 8.1 percent nationwide and 9.7 percent in Ulaanbaatar at the end of 2018. Fluctuations in prices of meat, gasoline, and solid fuel made up 5.3 percentage point of headline inflation in Ulaanbaatar. Starting this year, however, prices of solid fuel and gasoline are declining. Such trend is expected to be kept in 2019, as the government is expected to regulate the supply of processed coal and the price of crude oil at the global market is expected to weaken. Regarding the price of meat, there is an upside risk related to increased demand from China, insufficient domestic stock of meat and weather conditions. Such factors may push meat prices above its seasonal trend and thus result in supply-driven inflation. In the reporting year, rising wages, household and government consumptions and investments are likely to create demand-driven inflation, yet overall inflation is projected to be close to the target rate.

Economic growth in 2018 exceeded previous projections, owing to increased investments and production in the mining sector. In particular, timely resolution of the disruption to coal export transportation and increased production of coal and crude oil, supported growth in the mining sector in the last quarter of 2018. Growth in the non-mining sector, on the other hand, did not meet expectations, as imports of equipment, diesel fuel, and transportation services surged following increased investment and coal exports. Besides, fiscal capital spending did not fully materialize. For 2019, mining sector growth forecast is revised up based on the assumptions that coal export transportations would normalize and volume of exports would increase. However, a declining trend in the mining sector is unchanged, as commodity prices are on a declining trend, except for gold. In case of the non-mining sector, growth is expected to pick up. In particular, fiscal spending and wages are expected to increase and support household spending, which in return would support demand for construction, trade, manufacturing and services sectors and tax revenue. Although recovery in the domestic economy is expected to pick up its pace, weakening external demand and unresolved trade and geopolitical tension between major global powers are creating uncertainties.

The fiscal stance is expected to loosen during 2019-2020, after tightening in the past years, while the outlook for business credit growth is likely to depend on the dynamics of non-performing loans. Contrary to previous expectations, equilibrated budget balance ended 2018 with a surplus. It was supported by increased customs duty received on expanding imports, declining debt service payments following the restructuring of external debt with high interest rates through cheaper external loans and fiscal capital spending which fell short of the approved budget. Although fiscal stance in 2019 would depend on the actual materialization rate of fiscal expenditure, compared to lower spending in 2018 the stance is expected to loosen in 2019. As the need to finance budget deficit through domestic funding declined in recent quarters and growth of household consumer loans is decelerating following recent macroprudential policy measures, growth of credit for business purposes is picking up gradually. Nevertheless, outlook for business credits would largely depend on the dynamics of non-performing loans.

Assumptions regarding external demand are revised down from the previous report while weakening trend in exporting commodity prices is kept unchanged. Economic growth outlook for China, the leading trading partner, remains on a declining trend in 2019, due to trade tension and risks accumulated in its financial system. Moreover, growth forecast for the Euro area is revised down, due to political, social and labor market issues and economic outlook of its trading partners.

In the reporting quarter terms of trade improved slightly, as prices of exporting commodities remained higher than the previous year and price of importing items declined. Although price forecast of gold and coal improved, forecasts of other exporting commodities are lowered and expected to remain on a declining trend. Consequently, terms of trade is projected to weaken slightly in 2019.

Balance of payments was in deficit in the first three quarters of 2018, before turning to surplus in the last quarter. Disruption to coal exports transportation was resolved, and export revenue grew on the back of higher prices. On the other hand, increasing imports of investment and consumer items resulted in a greater deficit in current account. In case of financial account, foreign direct investments, and portfolio investments resulted in a greater surplus. Consequently, the balance of payments recorded a surplus in the fourth quarter of 2018, yet a deficit for the whole year. In addition to overall deficit, disruption to coal exports has negatively affected the market expectations, and rising interest rate in the global market created depreciating pressure on the exchange rate of togrog against USD. Since the end of last year, nominal exchange rate is stabilizing, due to the Central Bank's intervention at the foreign exchange market and the proceedings of bonds issued by the private sector. Unresolved trade tension between the USA and China and uncertainties regarding the commodity prices and capital flow, pose downside risks to the balance of payments.

I. INFLATION

Monetary policy is aimed at stabilizing inflation around 8 percent during 2019-2020 and around 6 percent in the medium run. As of February 2019, headline inflation reached 6.9 percent nationwide and 7.9 percent in Ulaanbaatar, while core inflation reached 7.2 percent, which is consistent with the inflation target (Figure I.1). Core inflation, which excludes the price of items that fluctuate significantly depending on weather conditions and seasonal factors such as meat, milk, and vegetables, reached 8.3 percent in the fourth quarter of 2018.

Although prices of food and non-food items are increasing, demand-pull pressure on inflation remains subtle. In previous months, driven by supply-related factors, prices of meat, solid fuel and gasoline had created significant inflationary pressure. However, its impacts are starting to diminish and currently explain 3.5 percentage points or 44.7 percent of the annual headline inflation rate in Ulaanbaatar (Figure I.3).

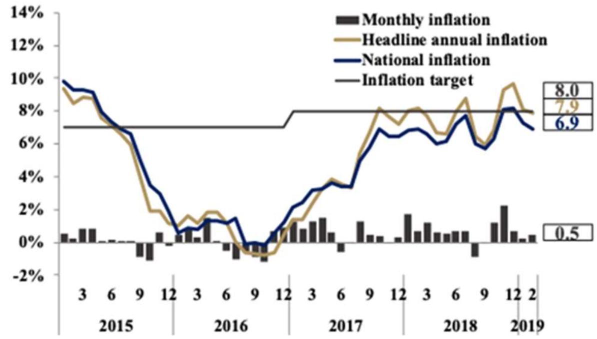
Domestic price of meat increased by around 2000 MNT or by 28.5 percent year-over-year in 2018, as exporting volume of mutton and goat meat increased by 156 percent year-over-year in the fourth quarter and cost of transportation increased. As of February, price of meat has increased by 650 MNT or 7.2 percent, since the end of last year. Prices of gasoline and solid fuel on the other hand, declined by 6 and 6.1 percent in January, respectively. In February, price of solid fuel remained unchanged.

Inflation reached 8.6 percent in the last quarter of 2018, exceeding the target level. It can be mainly explained by the change in prices of meat and solid fuel. For instance, price of meat increased contrary to its seasonal pattern, due to rising demand for exports and cost of transportation. Change in price of solid fuel reached a historical peak of 64.6 percent, following the regulation to restrict burning of unprocessed coal in the city, as a measure to reduce air pollution.

Inflation forecast for 2019 is revised down as 1) price of gasoline declined in January and pressure from importing price of fuel is likely to be subtle, 2) the city plans to restrict use of unprocessed coal and likely to control the price of processed coal, which would anchor price of solid fuel, and 3) the plan to hike price of electricity and heating is

Figure I.1

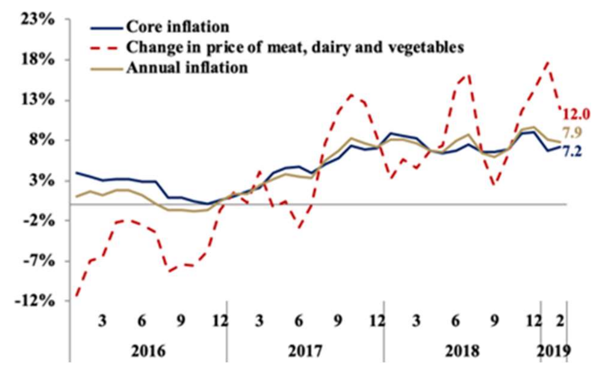
Inflation



Source: NSO

Figure I.2

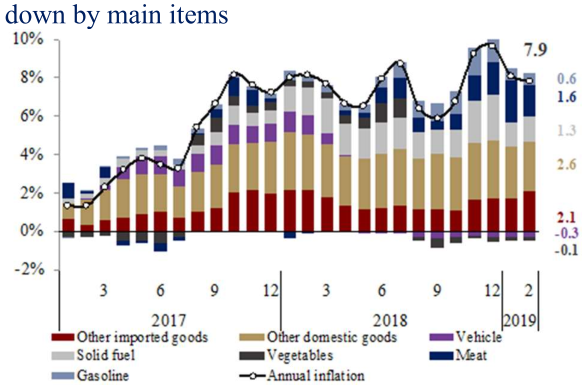
Headline and core inflation



Source: NSO and Bank of Mongolia

Figure I.3

Headline annual inflation in Ulaanbaatar, broken down by main items



Source: NSO and Bank of Mongolia

postponed to April of 2019. On the other hand, price of imported items is expected to increase as the exchange rate of MNT depreciated beyond previous forecasts and depending on Chinese demand, domestic price of meat may exceed its seasonal pattern.

Although inflation is forecasted to remain close to the targeted level, following recovery in the non-mining sector and expansion of household income, wages, and government expenditure, inflation is expected to increase.

Uncertainties regarding inflation forecast:

- Potential shortage or oversupply of goods and services have significant implications on inflation forecasts. For instance, depending on weather conditions, supply of meat and vegetables may fluctuate, leading to price fluctuations. Similarly, potential change in administered prices may alter inflation forecast.
- The swine flu in China is not expected to be contained in 2019. If demand for Mongolian meat increases, a potential shortage of meat supply in the domestic market may result in higher prices.
- Rising wages and government expenditure may result in demand pressure, thus push inflation beyond its current forecast.
- Starting May 2019, the government plans to restrict the use of unprocessed coal in Ulaanbaatar and is expected to control its price to a certain degree. However, it is uncertain whether the NSO would change the unprocessed coal in the consumer basket with the processed coal.
- In 2019, leaders of the USA and China have met twice and decided to postpone the implementation of trade tariffs. Although it has created positive expectations in the market, the duration of such fragile truce remains uncertain, creating uncertainty regarding price of commodities.
- There is an upside risk on the global price of oil and thus the price of fuel products, since the US trade sanction on Iranian oil exports is not fully resolved, and the Venezuelan production is likely to diminish, thus creating supply-side shock in the global market.

Table I.1

Change in inflation outlook

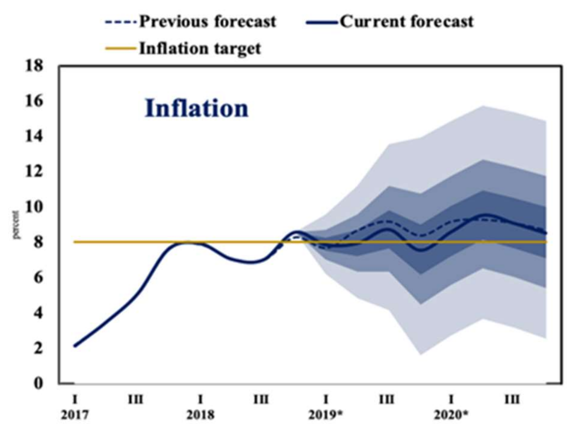
Assumptions of near term forecast on inflation

Previous forecast 2018Q4-2019Q3	Current forecast 2019Q1-2019Q4
Price of meat	**Forecast increased**
As price of meat accelerated in 2018, it deviated from its seasonal trend and started to increase since October. Moving further, it is expected to be consistent with its seasonal trend and increase in the first half of 2019.	Exporting volume of meat in 2019 is expected to large as in previous year, and thus price of meat is expected to fluctuate similar to that of 2018.
Price of imported items	**Forecast increased**
Exchange rate depreciation in the second half of 2018, led to acceleration in prices of imported items. Imported prices are expected to increase further.	Price of imported items started to increased towards the end of 2018, and is likely to remain elevated till the end of third quarter of 2019.
Administered prices	**Forecast increased**
Planned increase in prices of electricity and heating is postponed to January, 2019	Planned increase in prices of electricity and heating is postponed to April, 2019
Price of gasoline	**Forecast decreased**
Domestic price of gasoline increased in October and November, following change in oil prices and transition to winter fuel. Hence price of gasoline is expected to remain stable at current level	Following decline in oil prices, domestic price of gasoline declined in December of 2018 and January of 2019. Upside risk in prices has declined.
Price of domestic goods	**Forecast decreased**
Price of solied fuel increased in October and November, and expected to remain stable in the first 2 quarters of 2019.	Price of solid fuel increased again in December and gradually declined in January. Expected to remain stable in the first 2 quarters of 2019.

Source: Bank of Mongolia

Figure I.4

Inflation forecast



Source: Bank of Mongolia

Table I.2

Inflation forecast[1]

	2018 *actual*	2019* *forecast*	2020*
Inflation, CPI[2]	8.6	6.5 – 9.5	7.0 – 10.0

Source: Bank of Mongolia

[1] 30 percent confidence interval
[2] Average inflation in the fourth quarter of each year.

II. ECONOMIC GROWTH

Gross domestic product expanded by 8.1 percent in the last quarter of 2018 and by 6.9 percent in the year of 2018. From the demand side, increased gross capital formation and household consumption have supported economic growth, while net exports made negative contributions (Figure II.1).

From the supply side, production in mining, services, manufacturing, and agricultural sectors made significant contributions to economic growth (Figure II.2).

Investments expanded by 12.1 percent year-over-year in real terms and thus explains 5.4 percentage points or a majority of overall economic growth. Total investments can be broken down to increased foreign direct investments to the mining sector and recovery in business loans issued by banks since the second quarter (Figure II.3).

As construction activity in the Oyu Tolgoi underground project is continued and the mining companies increased their investments, stock of machinery, equipment, and non-residential constructions have expanded, thus resulted in greater gross capital formation. In addition, change in the accumulation of inventories is supported by increased equipment and working assets.

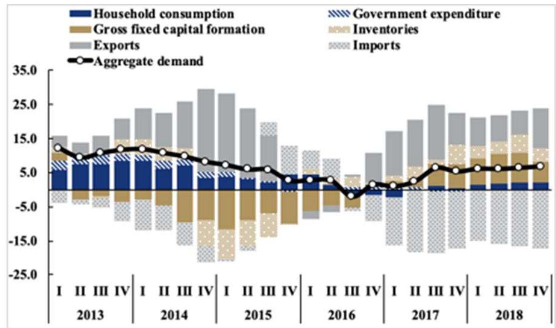
After a slump of 3 years, business loans started to pick up since the second quarter of 2018 and has expanded by 17.8 percent by the end of 2018. A majority of the expansion in business loans is issued to the mining, construction, and trade sectors.

Greater investments are leading to rapid growth in investment related imports such as equipment, machinery, parts, and construction materials.

Household consumption increased by 3.3 percent year-over-year and made up 1.5 percentage points of growth in aggregate demand. Such expansion is funded by household income which has constantly been increasing for the past eight quarters since early 2017 and consumer loans, of which yearly growth rate remained over 40 percent since the last quarter of 2017. Consequently, import of consumer goods is picking up, and its growth has been over 20 percent

Figure II.1

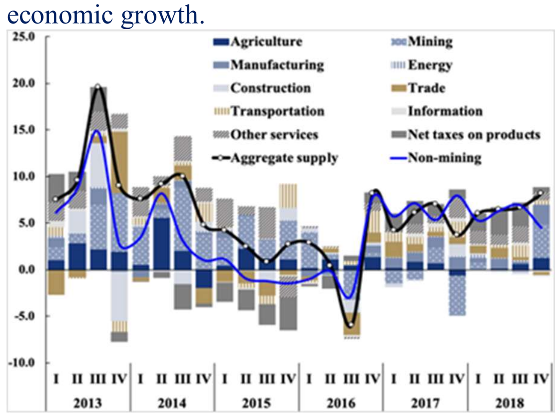
In the reporting quarter, contributions of gross capital formation to economic growth receded, while exports expanded rapidly and thus trade deficit has narrowed.[4]



Source: NSO

Figure II.2

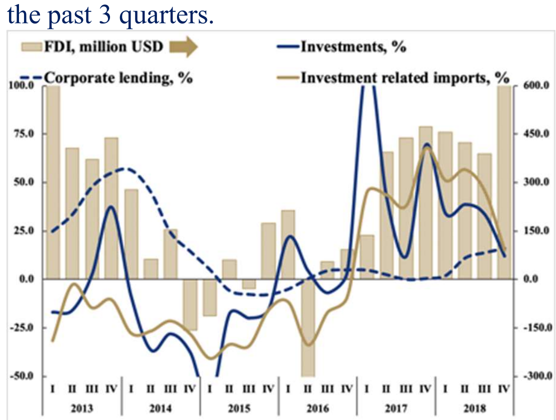
Mining sector made significant contribution to economic growth.



Source: NSO

Figure II.3

Following huge inflow of capital, imports of investment related goods continued to expand. Business lending is showing signs of recovery in the past 3 quarters.



Source: NSO and Bank of Mongolia

[4] Growth calculated from sum of 4 consecutive quarters

in the past four quarters (Figure II.4). Finally, household income fell short of household expenditure in the reporting quarter, consistent with its trend in recent years.

Net exports made up 1.5 percentage points of growth in aggregate demand. Mainly supported by exports of coal and copper, real exports increased by 22.4 percent year-over-year. In the reporting quarter, price of commodities remained relatively high, and the border capacity for exports was comparatively stable. Imports, on the other hand, increased by 19.1 percent in real terms.

In the reporting quarter, production of coal and oil exceeded previous expectations; thus, growth in mining sector reached 16 percent, exceeding previous forecasts.

Global demand for coal exceeded previous assumptions, thus resulted in greater production, relative to previous projections (Figure II.5). In addition, production of oil exceeded previous projections as well, owing to the rapid resolution of the production disruption.

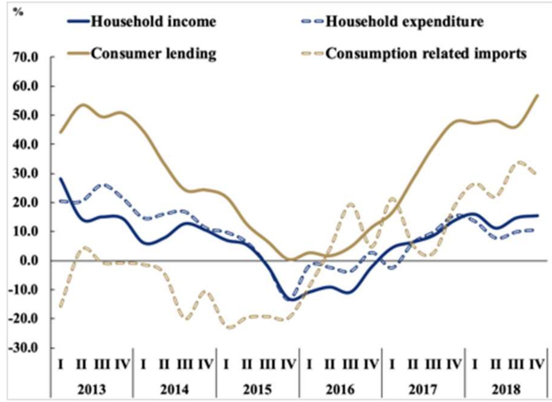
Government expenditure declined by 5.5 percent in real terms, thus cut 0.8 percentage points out of aggregate demand growth. In the last quarter of 2018, fiscal spending fell far from the plan, and therefore 95.6 percent of approved spending on goods and services were materialized for the whole year. In case of 2019, according to the approved budget fiscal spending on goods and services is expected to expand by around 20 percent.

Potential output: Change in potential output exceeded 10 percent per annum during 2011-2013, yet started to decelerate since 2014. Starting the last quarter of 2016, supported by the spillover effect of major construction activities in the mining sector, the non-mining sector started to show recovery and thus boosted potential output. Hence change in potential output picked up from 2.5 percent to 6 percent in the past three years (Figure II.7).

Output gap: During 2011-2013, production in non-mining sector exceeded its potential output and thus kept output gap positive. During 2014-2016, on the other hand, production in non-mining sector shrank, and thus the output gap turned negative. In recent

Figure II.4

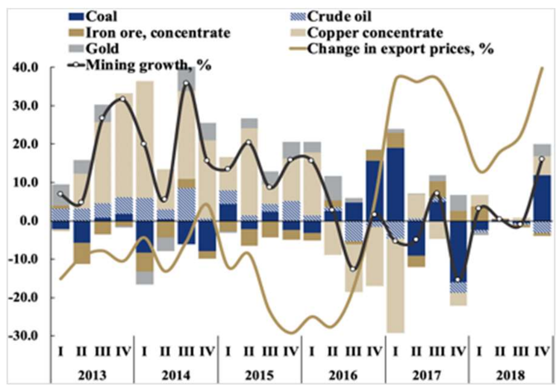
Household consumption is supported by increasing household income and rapid growth of consumer loans.



Source: NSO and Bank of Mongolia

Figure II.5

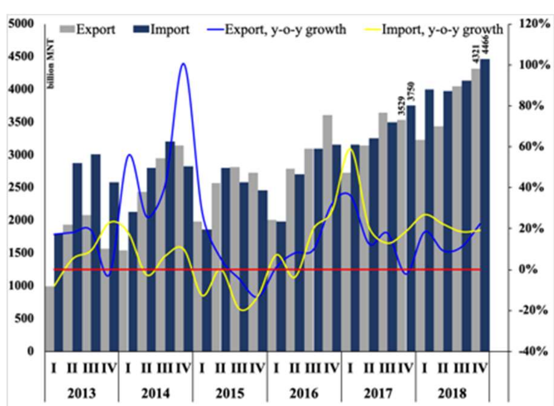
Following significant expansion in coal production, the mining sector expanded by 16 percent.



Source: NSO and Bank of Mongolia

Figure II.6

In the reporting quarter, export revenue increased rapidly and exceeded growth of import payments, thus foreign trade deficit has narrowed.



Source: NSO

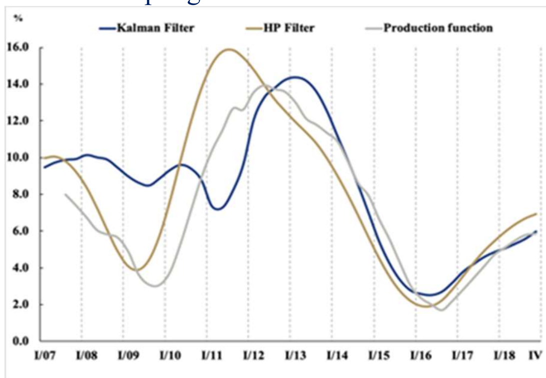
quarters, the output gap is estimated to be improving (Figure II.8).

As production of copper and gold increased in 2013, production in the mining sector exceeded its potential level. However, starting mid-2016, metal concentration within copper ore weakened and thus production fell short of its potential level. In the last quarter of 2018, production of coal has recovered, and hence the output gap in the mining sector has declined in absolute terms.

In case of the non-mining sector, output gap had been negative during 2014-2017 due to both domestic and external factors. However, it turned positive since the end of 2017, supported by greater mining exports and investments.

Figure II.7

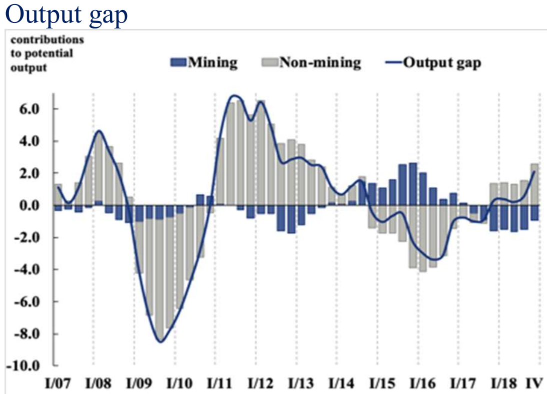
Potential output growth



Source: Expert's estimation

Figure II.8

Output gap



Source: Expert's estimation

Economic outlook:

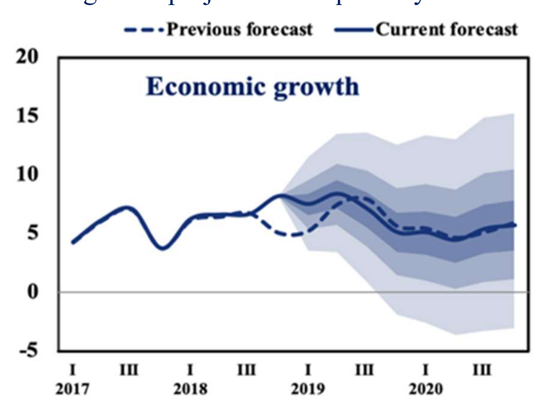
Compared to the previous report, economic growth exceeded projections by 0.9 percentage points in 2018. In particular, the non-mining sector growth fell short of projections by 0.5 percentage points, while the mining sector growth exceeded projections by 6.0 percentage points.

In the previous report, due to disruption of coal transportation and reduction of crude oil exports[3], growth in the mining sector was expected to be weaker in the last quarter of 2018. However, as such disruptions were resolved quickly, production of coal and oil exceeded previous expectations by 4.5 million tons and 727 thousand barrels, respectively, thus pushing growth in mining sector above the previous projections.

In case of non-mining sector, however, the difference can be attributed to the fact that 1) fiscal capital spending fell short of the approved level by 22 percent in 2018 and thus growth in construction sector fell short of expectations, 2) although coal exports increased, since imports for transportation services increased production in the transportation sector did not reach previous forecasts, and 3) due to expectations of rising prices wholesales of gasoline and fuel items increased in the third quarter and fell back in the last quarter, thus the trade sector shrunk and net taxes fell short of previous projections.

Figure II.9

Annual growth projections of quarterly GDP



Source: Bank of Mongolia

[3] Natives of the Dornod aimag protested the PetroChina Daqin Tamsag company's activities, as it overconsumed the underground water in the 21st region of oil production and did not complete construction of the road connecting the oil exploration region and Bayankhoshuu port. Consequently, its crude oil export transportations were halted during September 24th and October 29th, by the Dornod aimag governor's decree.

Growth in 2019 is forecasted to pick up, while growth projections for 2020 remain largely unchanged. For 2019, price forecasts of gold and coal are improved and exporting volume of coal is revised up; thus production in the mining sector is forecasted to pick up.

In relation to rising coal exports, the transportation sector is expected to widen, while widening fiscal stance is expected to support construction and other services sectors, and thus the non-mining sectors in 2019 (Figure II.9)

In the reporting year, coal export transportation is expected to normalize and export volumes to pick up. Although copper ore from Oyu Tolgoi mining is expected to decline, its gold concentration is projected to pick up slightly, and thus growth in the mining sector is expected to stabilize. In 2020, copper ore from Oyu Tolgoi mining is likely to improve, and the coal processing is expected to increase, thus support recovery in the mining sector.

According to the approved budget, capital and current spending are increasing and thus likely to support construction and public services sectors. In addition, rising coal exports and trade turnover are expected to support the transportation sector, and thus overall growth in the non-mining sector is projected to pick up. In addition, weather conditions are expected to be warmer than the historical average, therefore, animal loss is expected to be minimal and growth in animal husbandry to stabilize. In 2020, the spillover effect of major construction activities in the mining sector is expected to recede. Although aggregate demand is likely to be supported by fiscal spending on capital, investment-related imports are expected to pick up at the same time, and overall growth in the non-mining sector is projected to stabilize.

Uncertainties that may potentially affect the economic outlook:

Although the trade tension between the USA and China seems to be put on a temporary hold, it remains uncertain whether it would be resolved or not. The trade tension is expected to affect the outlook of key exporting commodity prices at international markets and prospects of commodity-exporting small open economies. However, the magnitude of such potential impact remains uncertain as well.

Table II.1.1

Economic growth projections[5]

	2018	**2019***	**2020***
	actual	***projection***	
GDP growth, %	6.9	5.6 – 8.4	3.0 – 7.3
Mining GDP, %	5.1	0.6 – 3.4	2.7 – 6.3
Non-mining GDP, %	7.5	7.0 – 9.8	3.2 – 7.5

Source: Bank of Mongolia

Table II.1.2

Change in economic growth outlook

Change in economic growth outlook

Previous projection (2019)	**Current projection (2019)**
AGGREGATE DEMAND	**Revised upwards**
Consumption	**Expectation improved slightly**
• Expanding household income and wage income are expected to support growth of private consumption • According to the approved budget, government spending on goods and services is expected to increase by 20 percent from 2018.	
Investment	**Expectation improved**
FDI inflow to remain at relatively high levels • Expectations of business owners and managers to be positive, growth in business loans has been gradually picking up, leading to higher domestic private investment. • According to the approved budget, Government capital spending is expected to double (by 1.6 billion MNT) in 2019.	
Foreign trade	**Expectation weakened**
• Following expectations of higher prices, gold exports is expected to increase and coal exports is likely to expand, as the border capacity is improved. However, price projection of copper is weakened from previous report and Chinese growth is expected to decline, and lead to weaker external demand. Imports is expected to increase, following expansion of household consumption, private investment and government capital spending.	
AGGREGATE SUPPLY	**Revised upwards**
Mining	**Expectation improved slightly**
Forecast for coal and gold production is revised up.	
Non-mining	**Expectation weakened**
• Market confidence to remain positive, FDI inflows to remain at high levels, and developments in the mining sector to continue. • Government current and capital spending is expected to support construction of schools and hospitals, and thus boost the construction sector. • Foreign trade turnover is improved and thus expected to support the transportation sector.	

Source: Experts' judgement

[5] Confidence interval of 30 percent

In addition, a quasi-ban set at the Chinese port on coal imports from Australia, is another source of uncertainty for the coal market.

In the reporting year, if the Erdenes-Tavan Tolgoi JSC successfully launches its IPO at the international market and commences its mining and infrastructure developments, it would have significant positive implications on economic growth. Moreover, if the construction of the crude oil processing plant to be funded through subsidized lending by the Indian government, is completed in 2020 and commences production, it would not only expand production but also ease pressure on the exchange rate and foreign reserves through the substitution of fuel imports. However, the production process may induce greater imports of investment goods and thus lead to greater deficit in the current account.

The weather condition remains warmer than its historical trend. If such trend results in fewer precipitation, growth in the agriculture sector may fall short of projections.

III. DOMESTIC ECONOMIC CONDITION

III.1. Labor market

In the fourth quarter of 2018, the working age population declined by 0.8 percent year-over-year, reaching 2,173 thousand. Specifically, the number of economically inactive population stood at 828 thousand, which is an expansion of 0.6 percent year-over-year. While, the number of economically active population declined by 1.6 percent, reaching 1,331 thousand. Since some people switched from economically active status to inactive status, labor force participation rate has dropped by 0.5 percentage points from the previous year, reaching 61.9 percent.

Within the economically active population, the number of people employed declined by 0.8 percent year-over-year, reaching 1256 thousand. Since such change in employment was similar to change in the number of working age population, the rate of employment stood at 57.8 percent, which is close to its level a year ago.

Number of unemployed people, on the other hand, diminished by 11.4 percent, reaching 89 thousand. As such diminishing trend is kept, the unemployment rate reached 6.6 percent, which is a 0.7 percentage points lower level from a year ago.

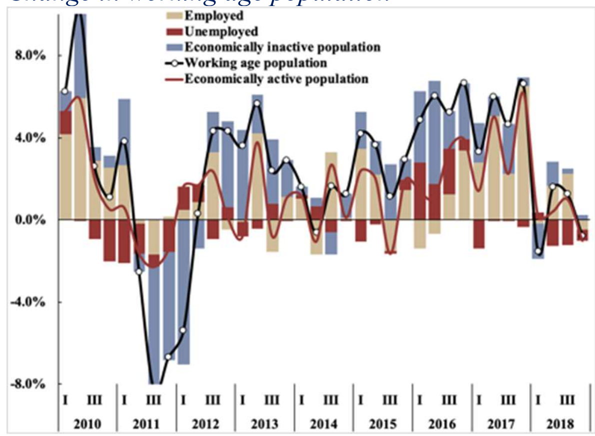
In the last quarter of 2018, total employment increased by 7-9 percent in certain economic sectors. For instance, total employment reached 100, 67, 60, and 25 thousand in manufacturing, construction, mining and energy sectors, respectively. On the other hand, total number of people employed declined by 3.5 percent in agricultural sector reaching 367 thousand, by 3.6 percent in education, health and public sectors reaching 218 thousand, and by 11.2 percent in transportation sector reaching 64 thousand.

In terms of employment status, number of people engaging in animal husbandry declined by 2 percent year-over-year, reaching 332 thousand, and number of self-employed people declined by 6.7 percent to 231 thousand. Number of wage-earning people expanded by 0.4 percent year-over-year to 625 thousand, unpaid laborers contributing to household production increased by 2.3 percent to 46 thousand, and number of employers increased by 83.4 percent to 20 thousand.

In case of key income indicators, national average wage[6] rose by 7.8 percent year-over-year reaching 1,120.3 thousand MNT and national median wage increased by 7.0 percent year-over-year reaching 806.6 thousand MNT as of the fourth quarter of

Figure III.1.1

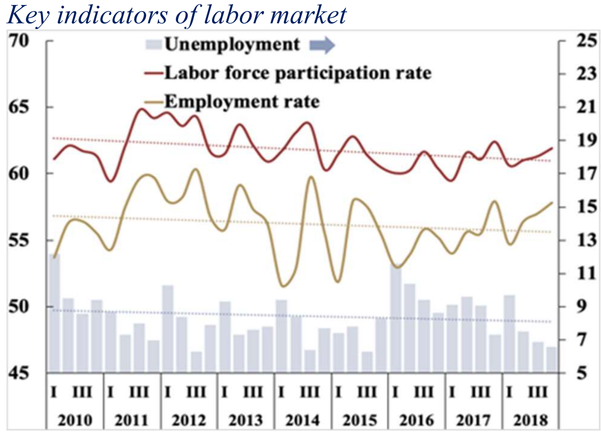
Change in working age population



Source: NSO

Figure III.1.2

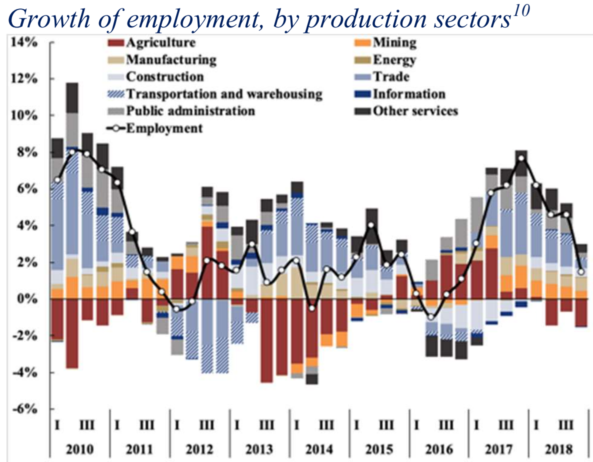
Key indicators of labor market



Source: NSO

Figure III.1.3

Growth of employment, by production sectors[10]



Source: NSO

2018. However, real wage, which is adjusted by the consumer price index and reflects people's purchasing power, weakened by 1.1 percent year-over-year. Average monetary income of households[7] grew by 15.4 percent year-over-year to 1,202 thousand MNT; of which average salary income expanded by 19.5 percent year-over-year reaching 599 thousand MNT (Figure III.1.4).

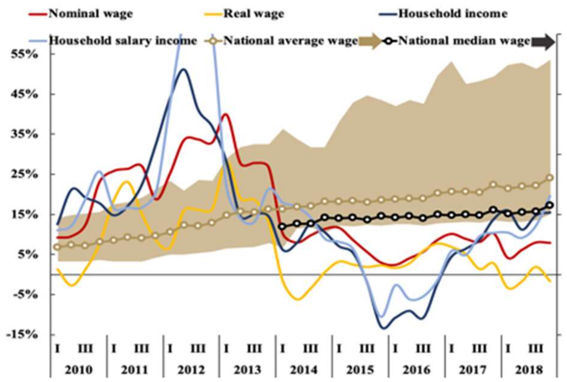
With regards to the main economic sectors, the average wage is between 704 and 2,501 thousand MNT. Average wages are rising rapidly in sectors of mining, manufacturing, construction, agriculture, trade, and other services.

Although average labor productivity[8] had been on a downward trend in recent years, it is showing signs of recovery since the previous quarter. In the last quarter of 2018, labor productivity improved by 9.0 percent year-over-year. When broken down by key economic sectors, labor productivity is improved in agriculture, mining, manufacturing, transportation, and other services sectors, while weakened in construction and trade sectors (Figure III.1.5).

In the reporting quarter, average unit labor cost[9] declined by 1.1 percent year-over-year, which is consistent with its trend in the past quarters. Among key economic sectors, unit labor cost has picked up in construction, trade, and energy sectors, while declined in agriculture, manufacturing and transportation sectors. (Figure III.1.6).

Figure III.1.4

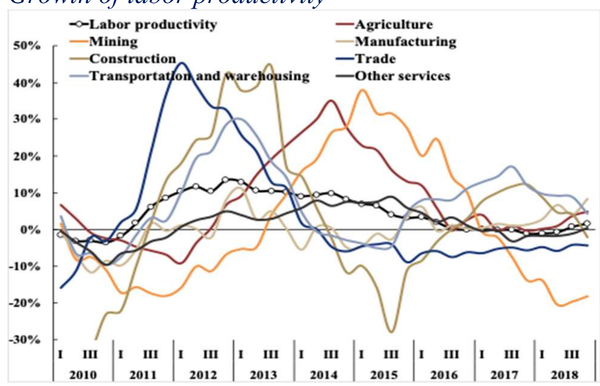
Growth of wage and household income



Source: NSO, expert's estimation

Figure III.1.5

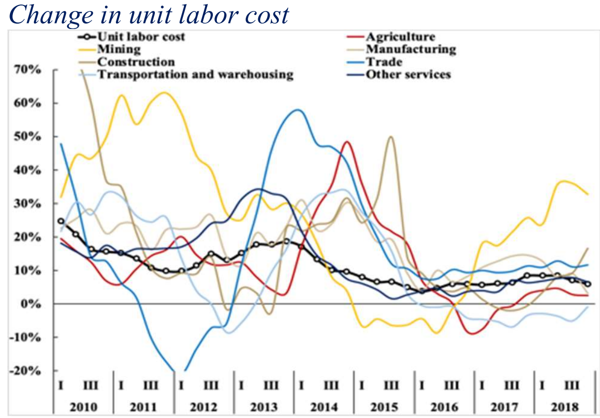
Growth of labor productivity[11]



Source: NSO, expert's estimation

Figure III.1.6

Change in unit labor cost



Source: NSO, expert's estimation

[6] Source: Social security payments' report by the General Office for Labor and Welfare Services

[10] Growth of employment calculated by moving averages of 4 consecutive quarters

[7] Source: Household Socio-Economic Survey by the NSO

[8] Average of GDP per worker

[9] Average labor cost or wage cost per unit of GDP

[11] Growth of labor productivity and unit labor cost are calculated by moving averages of 8 consecutive quarters

III.2 Monetary and financial markets

III.2.1 Monetary and credit indicators

Growth of money supply increased slightly from last quarter, while credit growth is supported by expansion in consumer loans. In January 2019, however, growth of consumer loans has slowed down; hence its contribution to money supply growth is subsiding. As of January 2019, M2 money grew by 24.5 percent year-over-year, supported by the expansion of net foreign assets, household consumer loans[12] and corporate loans.

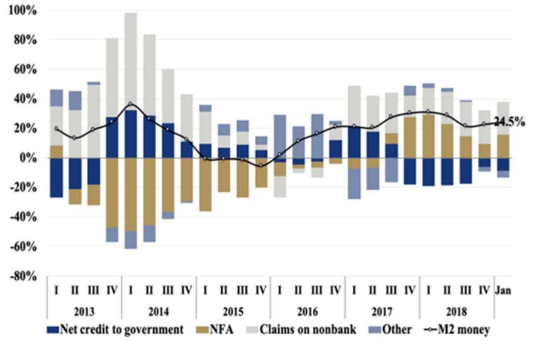
Although the expansion of net foreign reserves decelerated in the last quarter of 2018, supported by greater foreign funds raised by the private sector, its growth picked up in January 2019. On the one hand, investments for the underground project of Oyu Tolgoi mining and other foreign direct investments are increasing. Growth of imports and external debt services weighed on the accumulation of net foreign reserves in the last quarter of 2018. Thus, change in net foreign reserves contributed 9 percentage points of the money supply. In January, however, change in net foreign assets explains 15 percentage point of money supply growth.

In the domestic market, credit growth remains the main factor explaining money supply growth. At the end of 2018, the equilibrated balance of budget was in surplus of 12 billion MNT, which supported the banks' liability side. In addition, rapid growth in consumer loans at the end of 2018, sustained growth of credit issued by depository institutions, which explains 23 percentage point of money supply growth.

From the liability side, money supply growth is mainly supported by deposits and current account in MNT. In recent months, dollarization in liability is on a declining trend. Growth of liabilities in MNT and deposits and current accounts in foreign exchange, explain respectively 16 and 8 percentage points of growth in money supply as of January 2019. Outstanding level of credit issued by depository institutions[13] and mortgage loans that were converted to mortgage backed securities (MBS[14]), increased by 22.4 percent as of January 2019. Rapid growth of consumer loans is starting to cool-off since early 2019, and its contribution to overall credit growth is expected to diminish further on the back of macroprudential measures.

Figure III.2.1.1

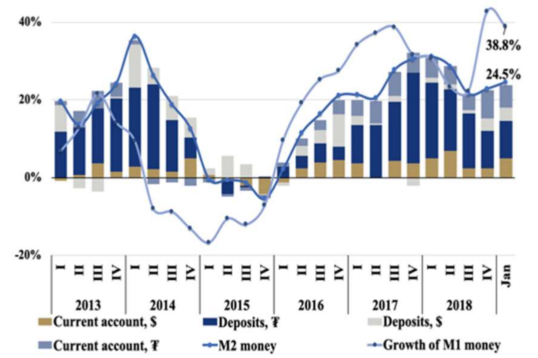
Annual growth of M2 money and its contributions, asset side



Source: Bank of Mongolia

Figure III.2.1.2

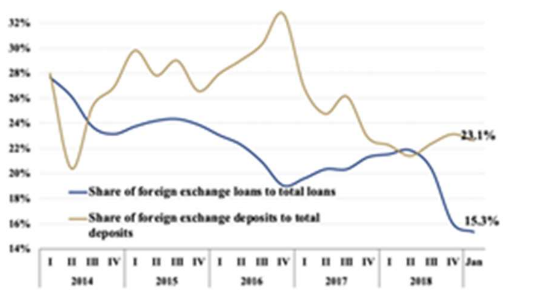
Annual growth of M2 money and its contributions, liability side



Source: Bank of Mongolia

Figure III.2.1

Dollarization of bank credit and deposits[15]



Source: Bank of Mongolia

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[12]Consumer loan consists of wage and pension loans, credit card, automobile loans, deposit backed loans and other consumer loans.

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

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

[15] Adjusted by exchange rate

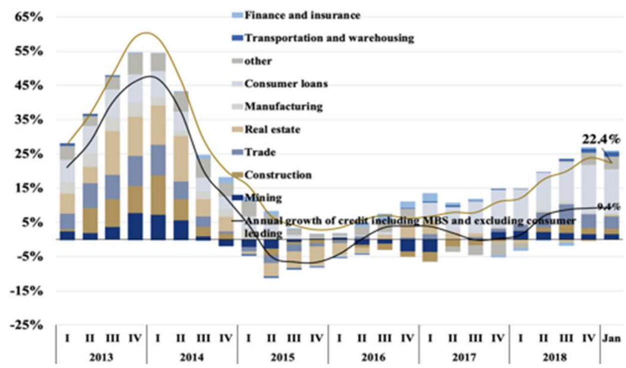
As for business loans, following recovery in real production and improvements in business sentiment, growth of credit issued for mining, trade, construction, and manufacturing sectors is picking up and thus explains 7.1 percentage point of overall credit growth.

Resilience of the banking sector is improving, as dollarization declines amid a recovery in business loans issued by depository institutions. Credit dollarization in the banking system declined by 6.5 percentage points from the second quarter of 2018 to 15.3 percent. Such decline can be mainly observed in credits issued to mining and trade sectors, which made up a significant portion of overall credit growth. On the other hand, rising dollarization in credit issued to the manufacturing sector in recent quarters can be explained by a few large foreign exchange credits issued to some companies that produce and export non-mining output.

Banks' balance sheets were adjusted in October 2018, following the Asset Quality Review conducted in 2017, under the framework of the Extended Fund Facility program. Since then, past due loans and nonperforming loans in the banking sector have declined. In particular, past due and nonperforming loans in the trade and construction sectors have declined by close to 300 billion MNT, since October 2018. Share of nonperforming and past due loans to total credit issued to trade sector, has declined by 13 percentage points since the end of 2016, reaching 8 percent as of January 2019.

Figure III.2.1.4

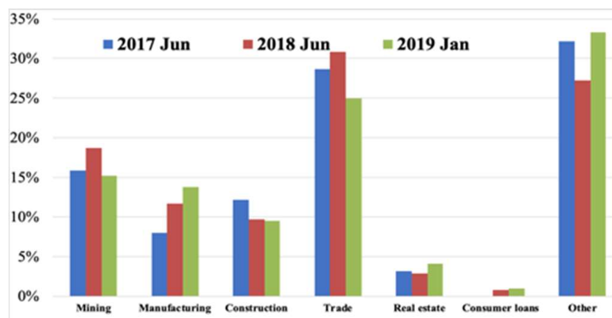
Break down of annual credit growth issued by depository institutions



Source: Bank of Mongolia

Figure III.2.1.5

FX loans issued by banks to economic sectors



Source: Bank of Mongolia

III.2.2 Interest rate

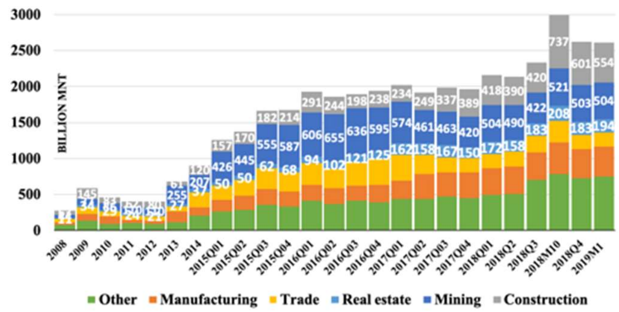
The Monetary Policy Committee decided to keep the policy rate unchanged at 11 percent, during its scheduled meeting in December 2018.

In January 2019, interest rate on repo deals that collateralize central bank bill increased by 0.6 percentage point from previous month to 11.2 percent, overnight lending rate increased by 1.21 percentage point to 12.2 percent, overnight deposit rate decreased by 1.1 percentage point to 10 percent and direct trading rate on central bank bills remained relatively unchanged. Hence, the weighted average of the interbank market rate increased by 0.3 percentage point from the previous month to 11.1 percent

In January 2019, the interest rate on newly issued credit increased, while interest rate on deposits declined. In particular, interest rate on credit issued in MNT increased by 0.4 percentage points from previous months to 17.1 percent, while rate on MNT deposits decreased by 0.6 percentage point to10.6 percent. As such, interest rate margin widened by 1.0 percentage points to 6.5 percent.
In the case of foreign exchange loans, interest rate on newly issued loans increased by 0.8 percentage points from the previous month to 9.6 percent, while deposit rate increased by 0.1 percentage points to 4.6 percent.

Figure III.2.1.6

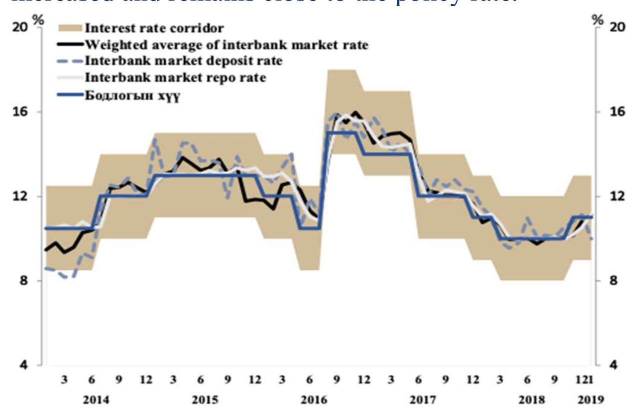
Outstanding level of past due and non-performing loans



Source: Bank of Mongolia

Figure III.2.2.1

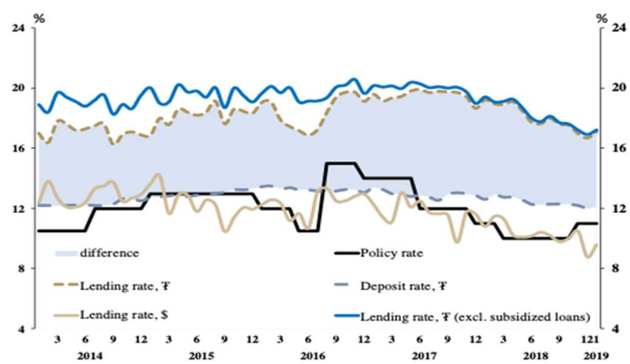
Weighted average interest rate at the interbank market increased and remains close to the policy rate.



Source: Bank of Mongolia

Figure III.2.2.2

Weighted average interest rate on newly issued loans increased.



Source: Bank of Mongolia

III.2.3 Exchange rate

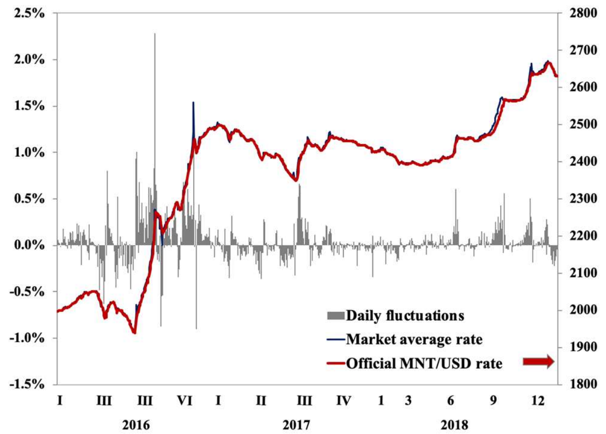
Exchange rate of MNT to USD depreciated by 6.0 percent or 147.4 MNT from the previous quarter, reaching 2594.5 MNT on average in the fourth quarter of 2018 and reaching 2633.4 MNT in February 2019. /Figure III.2.3.1/

While MNT/USD rate remained stable in the first half of the fourth quarter of 2019, it depreciated radically starting from mid-November. The depreciation was triggered by change in market sentiment and expectations due to the amplified logjam of coal trucks at the Gashuun-Sukhait-Ganqimaodu port as the Chinese authorities announced its decision to cut its coal imports down. Moreover, the US and China trade tension has escalated, the US Federal Reserve has raised its short-term rate 4 times year-to-date, setting it at 2.5 percent as of December 2018. Such actions pushed the yield on USD up, and investors' appetite for USD increased, leading to stronger USD against other currencies, including MNT. Then, logjam issue at the border was resolved, and coal transportation resumed its regular pace in December, stabilizing the market expectations regarding the exchange rate.

Appreciation tendency in the nominal effective exchange rate of MNT (NEER)[16] since the beginning of 2018 was reversed in September 2018 and NEER depreciated by 2.3 percent in January 2019 compared to that of the previous year. It was mainly supported by the depreciation of MNT against RMB and EUR by 3.5 and 2.4 percent, respectively. On the other hand, MNT appreciated against RUB by 7.5 percent (Figure III.2.3.2). Regardless of NEER depreciation, the real effective exchange rate (REER) appreciated by 3.7 percent year-over-year, as domestic prices rose, and the foreign relative price declined by 5.7 percent. (Figure III.2.3.3).

Figure III.2.3.1

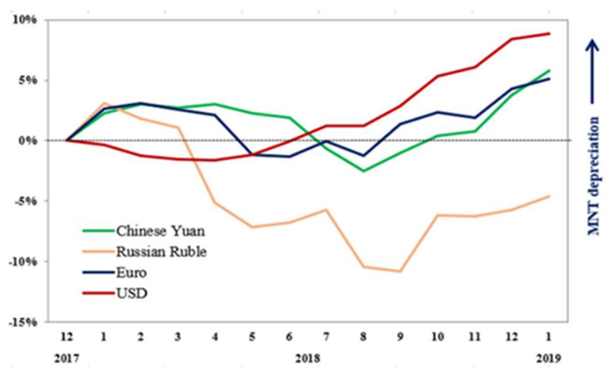
Cross rate of MNT to USD



Source: Bank of Mongolia

Figure III.2.3.2

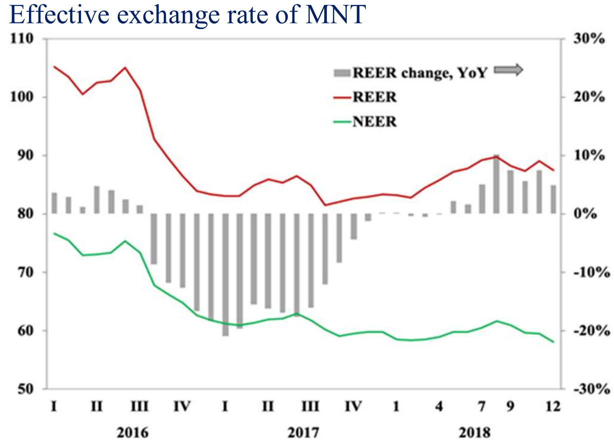
Change in cross rate of MNT to major currencies /compared to end of 2017/



Source: Bank of Mongolia

Figure III.2.3.3

Effective exchange rate of MNT



Source: Bank of Mongolia

[16] NEER and REER indices are weighted average rates of MNT against 22 trade partners' currencies, and its increase (decrease) indicates appreciation (depreciation) of MNT.

III.2.4 Capital market

In the reporting quarter, rental price improved faster than the purchasing price, while price-to-income ratio and price-to-rent ratio both declined from the previous quarter, implying an improvement in household purchasing power. In case of the stock market, although market capitalization is strengthening from its lowest point in November 2018, the market turnover rate has dropped, and market activities are declining.

In the reporting quarter, rental price continued to improve and has exceeded the change in housing price. (Figure III.2.4.1). Although the housing price index reported by the NSO remained stable over the past year, a similar index reported by Tenkhleg Zuuch continued to improve. In the last quarter of 2018, price of new housing increased by 8.6 percent year-over-year, while price of old housing improved by 5.2 percent, leading to overall growth of 4.9 percent in housing prices. Rental price, on the other hand, increased by 8.6 percent year-over-year, keeping its upward trend from the previous quarter (Table III.2.4.1).

Household average income expanded by 15.4 percent year-over-year and by 2.9 percent from the previous quarter; thus, the price-to-income ratio declined. As household purchasing power improved, number of new mortgager increased by 33.8 percent[17] from the previous quarter. In addition, the price-to-rent ratio declined by 0.03 unit from previous quarter (Figure III.2.4.2). Change in price-to-rent ratio and price-to-income ratio remained subdued since 2013-2014, implying minimal risk of overheating in the real estate market.

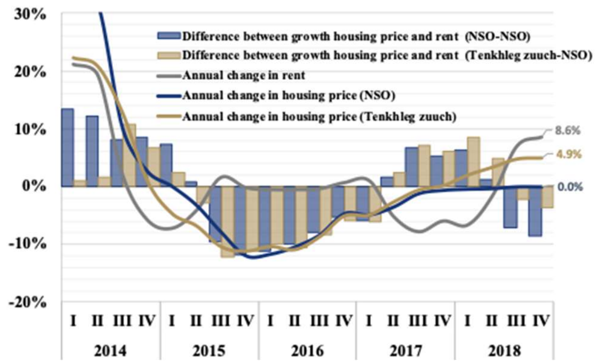
Market capitalization and MSE TOP 20 index, key indicators of stock market activities, improved from previous quarter (Figure III.2.4.3).

For instance, market capitalization reached 2.41 trillion MNT at the end of the fourth quarter of 2018, which is a 3.4 percent expansion year-over-year, and a 2.9 percent improvement from previous quarter.

MSE TOP 20 index, on the other hand, decreased by 5.8 percent from previous year reaching 20197.3 unit. It is a 2.8 percent improvement from previous quarter. Successful issuance of initial public offering by Ard Insurance company in October 2018, was one of the factors supporting the market capitalization. In November however, prices of few first and second-grade stocks such as Tavantolgoi and Materialimpex companies declined, pushing the market capitalization

Figure III.2.4.1

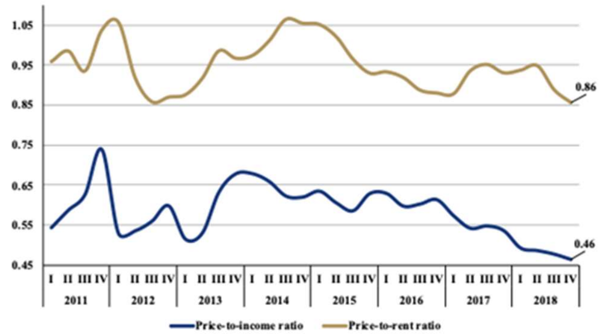
Change in price of housing and rental price stabilized around levels in previous quarter.



Source: NSO, Tenkhleg-Zuuch

Figure III.2.4.2

Ratios of price-to-income and price-to-rent weakened from previous quarter.



Source: NSO, Bank of Mongolia

Table III.2.4.1

Real estate sector indicators

		2018Q3	2018Q4
Change in price of housing, %			
NSO	*q-o-q* *year-over-yea*	0.0 0.0	0.0 0.0
Tenkhleg Zuuch	*q-o-q* *year-over-yea*	1.9 4.8	0.5 4.9
Change in rental price, %	*q-o-q* *year-over-yea*	6.7 7.1	3.7 8.6
Price to income ratio		0.48	0.46
Price to rent ratio		0.89	0.86

Source: NSO, Tenkhleg-Zuuch, Bank of Mongolia to its lowest point of 2018. The market capitalization showed signs of improvement towards the end of December[18].

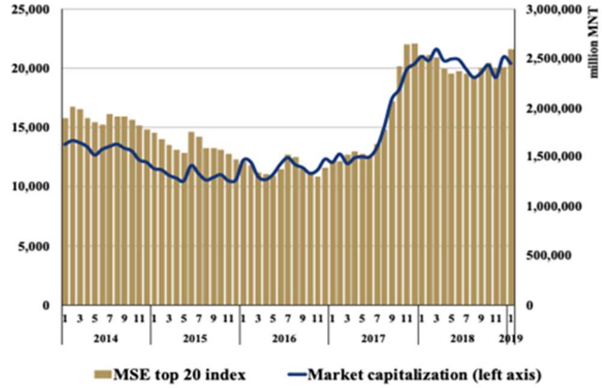
Although recent IPOs are supporting market capitalization, total trading at the Mongolian Stock Exchange decreased by 2.5 percent from previous quarter reaching 138.9 trillion MNT, which is a 32 percent shrink year-over-year.

Market turnover reached 5.8 percent in the reporting quarter, which is a 0.3 and 3.0 percentage point decline from previous quarter and previous year, respectively. Weakening market turnover rate, indicates weaker sentiment at the market (Figure III.2.4.4).

In the reporting quarter, portfolio investments worth 22.4 million USD were made to the Mongolian Stock Exchange by non-residents, which is an 11.1 and 15.8 percent decline from previous quarter and previous year, respectively (Figure III.2.4.5). Foreign direct investments made by non-residents, declined by 6.0 percent and 3.7 percent from previous quarter and previous year (Figure III.2.4.5).

Figure III.2.4.3

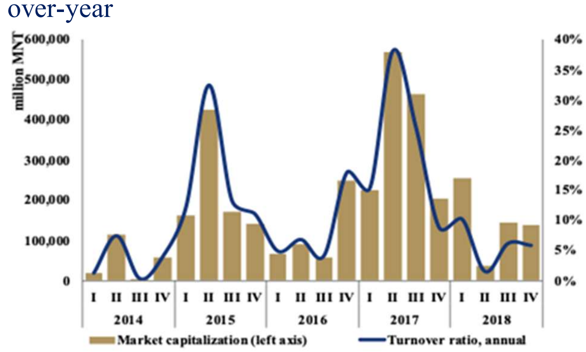
Market capitalization improved from previous quarter.



Source: Mongolian Stock Exchange

Figure III.2.4.4

Activities at the stock market has weakened year-over-year



Source: NSO, Bank of Mongolia

Figure III.2.4.5

Investment made by non-residents declined from previous year.

Source: Mongolian Central Securities Depository

[17] Includes 8 percent subsidized mortgage lending issued using banks' own funding. Source: Bank of Mongolia.

[18] Source: Market info, https://marketinfo.mn/

III.3 Consolidated budget and sovereign debt

Consolidated budget: In 2019, according to the budget approved by the Parliament of Mongolia, equilibrated budget revenue is expected to increase by 440 billion MNT and budget deficit to expand by 2370 billion MNT from 2018 (Table III.3.1). As a result, the fiscal stance is expected to expand by 5.4 percentage points in 2019 (Figure III.3.1).

The Ministry of Finance expects equilibrated revenue to be supported by VAT and excise taxes in 2019. In particular, i) the return and bonus scheme for VAT is expected to improve the supervision and reporting practice of the tax authority and ii) increased construction activities in the mining sector would create demand for investment related imports and thus generate greater tax revenue through import taxes, excise taxes, and royalty. Structure of budget expenditure, on the other hand, implies an expansion of 1607 billion MNT on capital expenditure, which is a 100 percent growth year-over-year, and increased spending of 470 billion MNT on wage, pension, and other social welfare.

Equilibrated revenue: The equilibrated revenue is expected to be comprised of tax (91.5 percent) and non-tax (8.5 percent) revenue. Compared to the previous year, tax revenue is approved to be 25.8 percent (272.8 billion MNT) higher than previous year. Of which, a significant portion is expected to be generated through income tax (75.4 billion MNT). Moreover, VAT (56.2 billion MNT), social insurance (44.8 billion MNT), the excise tax on imports (31.5 billion MNT) and royalties (33.9 billion MNT) are expected to generate additional revenue.

Total expenditure and net credit:

In the first 2 months of 2019, 65.2 percent of approved budget expenditure was realized. Of which, 90 percent was spent on subsidies and transfers (15.1 percent growth year-over-year) and current spending on goods and services (17.9 percent growth year-over-year). In particular, spending on wages and salaries (21.3 percent), social security returns, program on mothers with wages (initiated in 2019), child's money (35.1 percent) and elderly support (148.1 percent) were increased by 60.0, 40.1, 13.4, 9.4 and 5.6 billion MNT respectively.

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

Table III.3.1

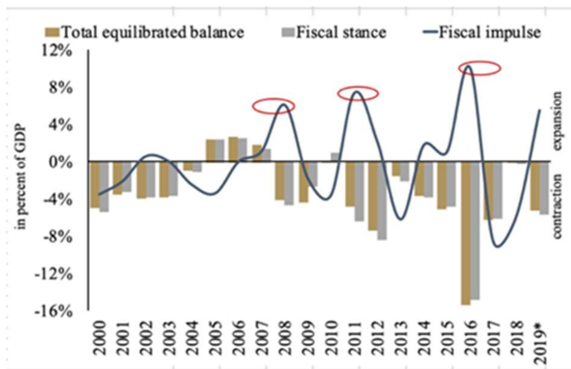
Fiscal indicators

billion MNT	2018	2019		2019.02	
	actual	approved	projected	actual	%
Total revenue	**10063**	**11066**	**11101**	**1638**	**101.8**
Future heritage fund	621	1069	612	175	104.7
Stabilization fund	207	322	330	8	19.6
Equilibrated revenue	**9235**	**9676**	**10159**	**1454**	**103.9**
Tax revenue	8207	8566	9012	1331	107.3
Import tax revenue	2628	2832	2744	409	102.0
VAT	1412	1539	1599	212	103.0
Customs duty	682	743	792	98	101.2
Excise tax	534	550	353	100	101.0
Income tax	2086	1992	2392	391	104.9
Social security collection	1621	1718		263	111.8
Tax on domestic sales	1170	1340		230	109.4
VAT return	-114	-258		-110	84.7
Other tax income	815	942		149	104.0
Non-tax revenue	1028	1110	1147	123	77.2
Total expenditure	**9223**	**11590**	**11590**	**1152**	**65.2**
Primary expenditure	8176	10724	10663	1089	70.0
Current expenditure minus interest expe	6301	7365	7365	1038	75.0
Capital expenditure	1608	3215	3154	57	15.0
Net credit	267	144	144	-5	4.9
Interest expenditure	1047	866	927	63	63.7
Total equilibrated balance	**12**	**-1914**	**-1431**	**302**	
in percent of GDP	0.0%	-5.1%		0.8%	
Primary balance	1059	-1049	-504	365	
in percent of GDP	3.2%	-2.8%		1.0%	

Source: Ministry of finance and Bank of Mongolia

Figure III.3.1

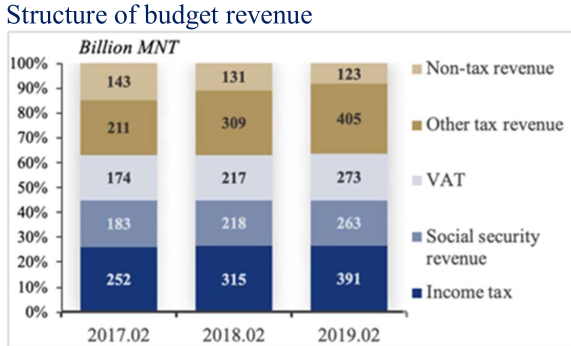
Fiscal stance and fiscal impulse



Source: Bank of Mongolia

Figure III.3.2

Structure of budget revenue



Source: Ministry of Finance

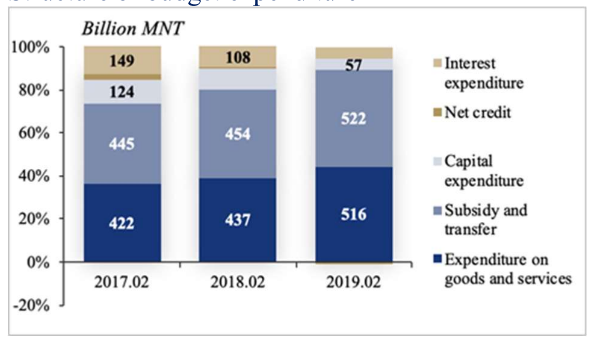
In previous year, the equilibrated budget balance was in surplus, and 620 billion MNT from the government's current account and 630 billion MNT from accumulated receivables in the Future Heritage Fund and transfers of certain special funds were drawn to pay domestic and external debts. As such, a total of 3762 billion MNT was paid for principles and servicing of government bonds and loans. On the other hand, 1440 billion MNT was received as program loans and foreign project loans, thus pushed the *ratio of newly issued debt-to-debt repayment* down to 38 percent. (Figure III.3.4).

In 2019, the government is expected to issue new domestic debts worth 968 billion MNT and external debts worth 1676 billion MNT through project loans; thus the *ratio of newly issued debt-to-debt repayment* is likely to pick up.

Present value of government debt: According to the Medium Term Fiscal Framework Statement, the present value of government debt is set to be within legal boundaries during 2019-2020 (Table III.3.2). Since the debt-to-GDP ratio is expected to decline and the cost of financing is decreasing due to the IMF program, ratio of debt service payments to budget revenue is likely to fall further and come down to less than 10 percent in 2019.

Figure III.3.3

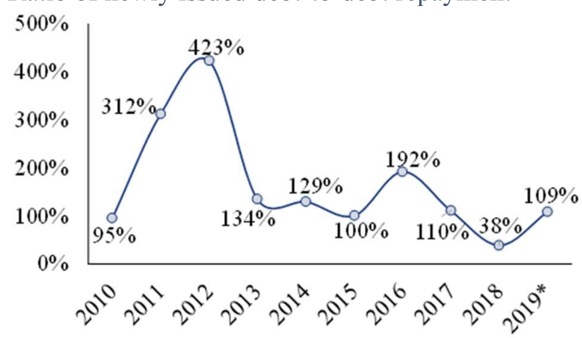
Structure of budget expenditure



Source: Ministry of Finance

Figure III.3.4

Ratio of newly issued debt-to-debt repayment



Source:Bank of Mongolia

Table III.3.2

Present value of government debt and debt services

	2016	2017	2018	2019*	2020*
billion MNT	actual	actual	approved	proj.	proj.
Government debt	18964	22752	21035*	19552	19391
in percent of GDP	79	85	66	55	48
Debt limit/GDP	88	85	80	75	70
Debt service payments	988	1156	1047	866	
in percent of total budget revenue	16.9	16.0	11.3	8.9	

Source: Ministry of Finance and Bank of Mongolia

IV. EXTERNAL CONDITIONS OF THE ECONOMY

IV.1 Assumptions regarding external conditions[19]

Growth forecasts of China and the Euro area in 2019 have been revised down. Prices of copper and coal are revised up from previous projections and price of crude oil is expected to remain stable.

External demand[20] outlook for 2019 is revised down from the previous report while outlook for 2020 remains unchanged. Within the forecasting horizon, slower growth in China, Russia, and the Euro area are expected to weaken external demand for Mongolia. As published in the external sources, economic growth forecast of China in 2019 is now revised down from 6.3 to 6.2 percent, that of the Euro area is revised down from 1.8 to 1.4 percent and that of Russia remained unchanged at 1.5 percent.

Chinese economic growth met expectations of 6.4 percent year-over-year in the fourth quarter of 2018, mainly supported by 8.8 percent growth in retail sales, 5.9 percent growth in investment in real estates and 5.7 percent growth in industrial production. Moreover, the Chinese growth is expected to slow down due to the impact of ongoing trade conflict with the USA and accumulated risks at the financial market. The Chinese authorities are expected to loosen fiscal and monetary policies to support economic growth.

The PBOC cut reserve requirements for banks 4 times in 2018; currently, it stands at 14.5 percent for large banks and 12.5 percent for small banks and further cuts (3 times) are expected in 2019. Furthermore, China is expected to carry out fiscal stimulus by cutting taxes and fees amounting to nearly 2 trillion RMB and by issuing local government bonds within the fiscal framework. China's National People's Congress wrapped up its annual session with targets of growth and inflation unchanged. GDP growth target is 6.0-

Table IV.1.1

Changes in Key Judgments of External Environment

Previous forecast of 2019	Current forecast of 2019
External demand	Revised down
Chinese growth to slow. No recovery on the Russian economy.	China growth forecast remains unchanged while US-China trade discussion continues. Growth in the Euro area is revised down marginally.
Terms of Trade	Revised down moderately
Prices of main export commodities are expected to have downward trends while oil price is expected to be stable.	Downward trends in copper, coal, iron ore remain. Prices of gold and oil have a tendency to bounce back.
Foreign interest rate	Revised down
The Fed funds rate is expected to hike twice in 2019. USD is likely to appreciate	The Fed is expected to hike Fed funds rate once in 2019.
Global Inflation	Revised down slightly
The growth in trading partner countries are expected to slow down, oil price is expected to be stable.	The growth in trading partner countries fell below the expectations, Foreign inflation is likely to fall due to Geopolitical issues in China and Euro Area, Sanctions on Russia, and a decline observed in oil prices.

Source: Expert's judgment

Figure IV.1.1

Forecast of external demand, year-over-year percent

Sources: Bloomberg, Roubini, EIU

[19]Forecasts of economic growth and inflation in main trading partners and the relevant explanations were compiled from February 2019 edition of EIU Global Forecasting Report, and the median of forecasts conducted by Bloomberg analysts. The external sector forecasts and their reasoning do not incorporate the views and analysis of Bank of Mongolia.

[20]External demand of Mongolia is calculated as the weighted average of main trading partners. (where China 0.90, Russia 0.02, and Euro Area 0.08)

6.5 percent, and inflation target is 3 percent for 2019. Moreover, to ease the impact of the ongoing trade dispute, the Chinese authorities announced that they would cut taxes worth 300 billion USD for the small and medium enterprises starting from April 2019 and reduce the financing cost for the small and medium enterprises by 1 percent. The prime minister of China highlighted during the press release of the Congress that he expects a positive outcome from the trade discussions although it has been postponed from March to April 2019.

Growth of manufacturing and consumption contributed to the economic growth of 1.9 percent in Russia in the fourth quarter of 2018, which was consistent with previous expectations. Growth forecast for the Russian economy is expected to be 1.5 percent for 2019 according to the analysts of Bloomberg and EIU, as the unemployment and inflation rates remain at fairly high levels, oil prices remain subdued, tax reforms and fiscal contractions are expected in 2019-21, and the sanctions of western countries on Russia is not likely to be loosened in the near term. On March 2019, the Bank of Russia Board of Directors decided to keep the key rate at 7.75 percent per annum and the Bank maintains its 2019 GDP growth forecast in the range of 1.2-1.7 percent. As stated in the President of Russia's plan to revive economic growth and improve living standards in 2018-24, the investments in the infrastructure (country's highways, local airports, railway, seaports) would be one of the priority areas of focus. These infrastructure projects would be financed with 3 trillion RUB to be issued through the government wealth fund, Russia Direct Investment Fund, in cooperation with foreign investors and the sovereign wealth funds of Asia and the Middle East as proclaimed by the minister of finance Anton Siluanov. Therefore, increasing investments in infrastructure is expected to support the country's economic growth throughout the year.

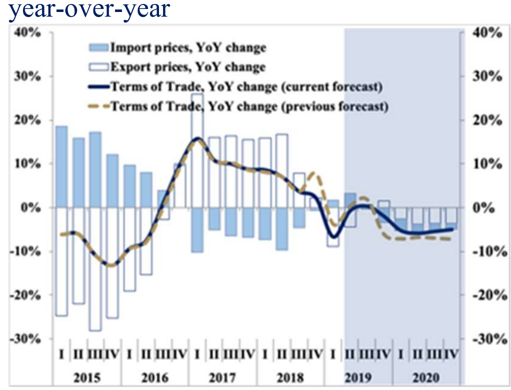
Growth in the Euro area decelerated down to 1.2 percent in the last quarter of 2018. In addition to the political and social disorders that took place in some countries, the slowdown was mostly attributed to the contraction of investments as the global market uncertainty unfolds, slowdown in foreign trade, and implementation of the new EU environmental standards which weighed down on production of automobiles. Although the unconventional monetary policy of the ECB and relatively loose fiscal stance would continue to support domestic demand, growth in the Euro area is expected to slow down further due to economic conditions of main trading partners falling below expectations, unstable growth in labor market, and some restrictions on trade policy. In particular, the growth outlook was revised down by 0.4 percentage point to 1.4 percent for 2019 and by 0.1 percentage point to 1.5 percent for 2020.

Terms of Trade projection is revised down for the first three quarters of 2019 and it improves starting from the fourth quarter of 2019, compared to the previous forecast. In the fourth quarter of 2018, the export prices and terms of trade fell below expectations, as the commodity prices fell at the global market.

In 2019, export prices are expected to fall owing to a downward trend in prices of copper, coal, and iron ore, despite higher price of gold. The terms of trade is expected to improve on the back of lower import prices, as price of oil outweighs higher price of food at the global market.

Figure IV.1.2

Changes in terms of trade, export, and import prices, year-over-year



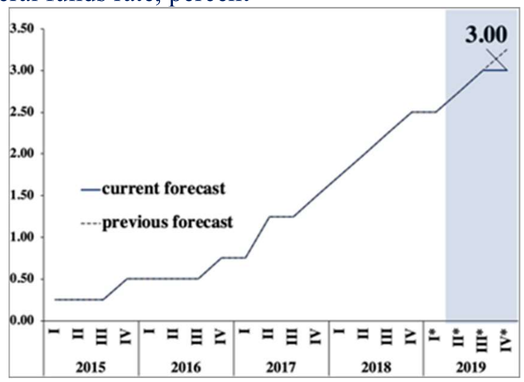
Source: Bank of Mongolia estimations

Foreign interest rate

The US labor market has been active with increasing employment throughout 2018, the labor force participation rate reached 63.2 percent in January 2019, the economy added 223 thousand jobs on average each month, and unemployment rate fell to 3.9 percent. Analysts expect the US Federal Reserve to hike its rate once in 2019, decelerating its pace of hike, as the US economic performance exceeded its potential in 2018, inflation rose with greater real income and expectations of stable growth in private consumption.

Figure IV.1.3

Federal funds rate, percent



Source: Bloomberg

Global inflation projection is revised down, as economic growth in main trading partners fell below market expectations and a downward trend in the price of oil is expected to be kept at the international market. Inflation is expected to be around 1.4-1.5 percent in European developed countries and the depreciation pressure on euro looms as the ECB proceeds with its unconventional expansionary monetary policy. The People's Bank of China (PBOC) lowered its required reserve ratio to support domestic demand and mitigate the impact of the trade conflict. Inflation in China is expected to be around 1.9-2.2 percent in 2019, assuming growth of domestic demand does not accelerate. However, there is a potential risk for inflation to accelerate as the food price increases due to the African swine flu. Inflation in Russia is projected to be around 4-5 percent in 2019, according to the analysts of Bloomberg and the EIU. Factors such as, monetary policy outlook or the Bank of Russia is expected to be stable as the key rate would be unchanged, average price of oil remains low, and potential tightening in the US sanctions on Russia are considered. Moreover, the Bank of Russia has lowered its end-of-year annual inflation forecast in 2019 from around 5.0-5.5 percent to 4.7-5.2 percent in its Monetary Policy Statement published in March 2019, considering the fact that the impact of VAT hike on headline inflation has largely materialized. The US economic performance exceeded its potential in 2018, and has led to the acceleration of core inflation and pushed headline inflation to 2.2 percent, above the Fed inflation target of 2 percent. The US inflation is expected to be around 1.9-2.2 percent in 2019-20, as the private consumption growth is expected to remain stable and the impact of tax cut dissipates.

Uncertainties in the external conditions

- The US and China trade conflict is likely to be prolonged, and the import tariffs may come into effect starting 2019. The import tariffs could hit Chinese growth, and consequently the commodity prices. In addition, impact of such tariffs on capital flows to emerging and developing economies remains uncertain.
- Oil price at the global market remains prone to severe fluctuations. Although the OPEC, its allies, and Russia reached a deal to cut production for the next 6 months starting from 2019, a new installment of oil pipelines in the US is likely to increase the supply of shale oil. On the supply side, the upcoming expiration of exemptions granted to 8 countries from US sanctions on Iranian oil, and the interruptions on Venezuela's oil explorations are creating more uncertainties. On the demand side, track of global economic slowdown would shape the price outlook.
- Regional geopolitical risks, populist movements and related chaos in some European countries, and the Brexit effect are the main risks that could slow down growth in the region. These could also lead to unfavorable external condition and risk accumulation.

IV.2 Balance of Payments

The balance of payments, which was in deficits in the first three quarters of 2018, recorded a surplus of 334 million USD (2.6 percent of GDP) in the reporting quarter. Consequently, a deficit of 475.3 million USD which was accumulated in the first three quarters is narrowed down to a deficit of 141.2 million USD for the whole year. The current and capital account deficits widened to 705 million USD as services account deficit plummeted. On the other hand, the Development Bank of Mongolia issued a 500 million USD bond at the international market, resulting in 901 million USD surplus of financial accounts in the reporting quarter (Figure IV.2.1).

Current account deficit, amounted to 7 percent of GDP in 2017, enlarged to 14.6 percent in 2018, of which 5.6 percentage point was in the last quarter of 2018. It was largely a consequence of strong growth in imports, a large persistent deficit in services account, and buildup of monetarized gold at the Bank of Mongolia (rather than exporting gold). Export revenue grew by 6.9 percent year-over-year in the fourth quarter as a result of robust growth in coal exports, higher copper price and enlarged exports of fluorite, leucite, nepheline, meat, and meat products (mostly canned beef and mutton) (Table IV.2.1). In the reporting quarter, Bank of Mongolia purchased non-monetized gold weighing 5.9 ton net, refined and accumulated them in the form of monetized gold. While it does not get reported as gold exports, the monetized gold added 276 million USD to the gross international reserves in the fourth quarter of 2018.

Imports grew by 26 percent year-over-year in the fourth quarter, mainly driven by imports of capital goods (8 percentage points), imported fuels (9 percentage points), and imports of consumer goods (9 percentage points). In the mining and construction sectors, machinery, equipment, and technology were upgraded following economic recovery and the development of the Oyu Tolgoi underground project. Consequently, imports of capital goods and construction materials expanded. Furthermore, diesel fuel increased in line with increasing transportation of coal exports. Most of the growth in consumer imports are associated

Table IV.2.1

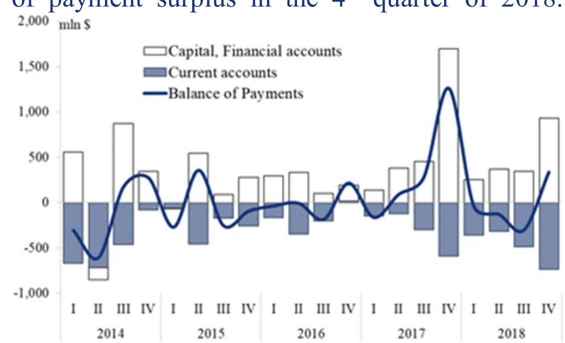
Key changes in assumptions of BOP projection

Previous projection in 2019	**Current projection in 2019**
Exports	Revised up
Potential fall in the customs' capacity for coal exports in early 2019, Forecast of crude oil export is revised down in line with its performance. Coal and copper prices are revised up slightly.	Coal export volumes are expecte to expand, including meat and meat products. The gold content of copper concentrate is not goin to increase. The price outlooks o copper, crude oil and iron ore ar deteriorated.
Imports	Revised up
Imports of capital goods and construction material will increase as the budget capital expenditure expands. Domestic demand is revised up.	Domestic demand projection is revised up. Import of diesel is increased in line with higher coal exports.
FDI	Unchanged
FDI is to increase: Investor's loan repayment is expected to decrease.	Assumptions are the same as in the previous projection.
Portfolio investments	Revised up
No new bond to issue, no principal repayments of bonds are expected.	MIK issued 300 million USD bond at the international market. Other than that, no new bond to issue, no principal repayments o bonds are expected.

Source: Experts' judgment

Figure IV.2.1

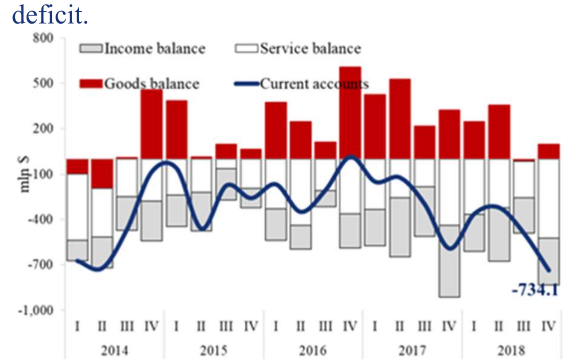
While current account deficit widened, a higher surplus in financial account resulted in a balance of payment surplus in the 4th quarter of 2018.



Source: Bank of Mongolia

Figure IV.2.2

Trade surplus decline and widening of services deficits resulting in a greater current account deficit.



Source: Bank of Mongolia

with 74 percent growth in imports of passenger cars (Table IV.2.2).

In the fourth quarter of 2018, deficit in services accounted for 4.0 percent of GDP or more than 70 percent of the current account deficits.

> <u>"Survey on expenditure of Mongolian residents studying abroad"</u>
>
> The Bank of Mongolia conducted an expenditure survey on Mongolian residents studying abroad in 2018, with the purpose of expanding the coverage and improving statistical quality. The survey results have been fed into the balance of payments statistics since June 2018. Prior to the survey, the net costs of studying abroad were registered in the services accounts without recognizing the income and expenditure separately. Now, (i) scholarship income, (ii) income of students working abroad are registered under the income accounts and total education expenses are registered under the services accounts of the balance of payments. The respective adjustments are reflected in these accounts. Particularly, education expenses increased by 56 million USD year-over-year, and compensation of employees increased by 56 million USD, with zero net effect on the overall balance of payments.

In the reporting quarter, rising deficit in transportation services in foreign trade, growth in education expenses of students studying abroad (4.3 times year-over-year), higher financial services expense, and travel expenses have widened the deficit in services account (Figure IV.2.3). Deficit in business services and construction services narrowed marginally.

Income account was in deficit of 382 million USD which is a reduction of 141 million USD year-over-year. This was due to lower dividends paid out to shareholders by banks and entities by 155 million USD, and increased workers' remittances by 58.0 million USD from the previous year. Despite the narrowing in deficit, income account continues to impose substantial pressure on the overall balance. For instance, the ratio of deficit in the primary income to current

Table IV.2.2

Growth in export revenue is mainly attributed to greater revenue from coal, copper concentrates, fluorite, leucite, meat, and meat products.

	2017 IV	2018 IV	Y-o-Y	Contri-bution %
Total Exports	**1,617**	**1,729**	**6.9 %**	**6.9%**
Coal	532	664	25%	8.2%
Copper concentrates	458	525	15%	4.1%
Gold	193	-	-	-12%
Crude oil	102	76	-25%	-1.6%
Iron ore	82	102	24%	1.2%
Fluorite, leucite, nepheline	29	74	156 %	2.8%
Meat, meat products	33	90	176 %	3.5%
Other	190	199	5%	0.6%

Table IV.2.3

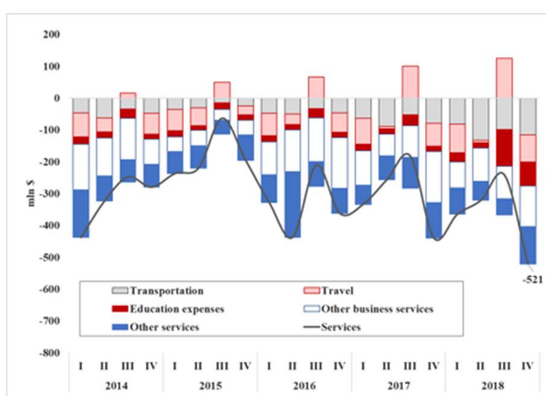
Imports of capital goods, consumer goods and fuels remain elevated.

	2017 IV	2018 IV	Y-o-Y	Contri-bution %
Total imports	**1,205**	**1,524**	**26%**	**26%**
Capital goods	506	599	18%	8%
Consumer goods	356	461	29%	9%
Of which: Passenger cars	76	132	74%	5%
Fuels	194	298	54%	9%
Industrial inputs	146	165	12%	1.5%
Others	2	2	-25%	0%

Source: Bank of Mongolia

Figure IV.2.3

Services account deficit is widened.



Source: Bank of Mongolia

account was equivalent to 22 percent in 2012, then increased to 135 percent in 2017, and came down to 52 percent in the reporting quarter (Figure IV.2.4).

Financial account was in a surplus of 901 million USD in the fourth quarter of 2018, which is 46 percent or 776 million USD decline, year-over-year. This decline is mainly attributed to a contraction of 682 million USD in external loans (Figure IV.2.5).

In the reporting quarter, a net inflow of 623 million USD was made through FDI (31 percent increase year-over-year), a net inflow of 449 million USD was made through portfolio investment (14 percent increase year-over-year), and trade credits had registered net inflow of 27.0 million USD (184 percent increase year-over-year).

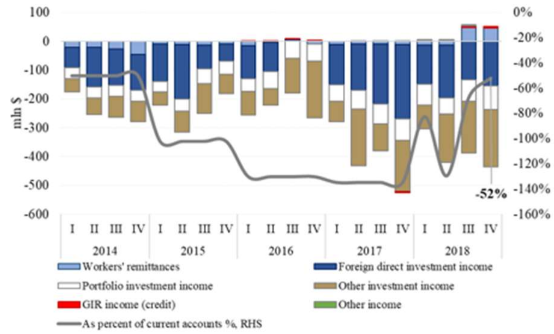
Development Bank of Mongolia issued a 500 million USD bond with 5-year maturity and 7.25 percent interest rate at the international market in October 2018 and it increased the net inflow of the portfolio accounts. On the contrary, the external loans had a net outflow of 162 million USD (131 percent decline year-over-year). This is due to a reduction in disbursements under the Extended Fund Facility Program, and external loan repayments exceeding new disbursements regardless of the year-over-year increase in disbursement issued by banks and entities. For example, the disbursements under the Extended Fund Facility Program was 90 million USD in the reporting quarter as opposed to 500 million USD in the last quarter of previous year, causing a sharp decline in external loan accounts. Moreover, DBM repaid the principal payments of its previous loans from a foreign bank amounting to 126 million USD using cash flow from its newly issued bond.

As for FDI, it increased due to greater inflows of investments to the Oyu Tolgoi underground project, from previous year.

Gross international reserves (GIR) stands at 3541.6 million USD at the end of 2018, and 3617.2 million USD at the end of January 2019. It is an adequate level to cover 7.5 months of imports, which is calculated as an average of the last three months' imports paid in hard currency

Figure IV.2.4

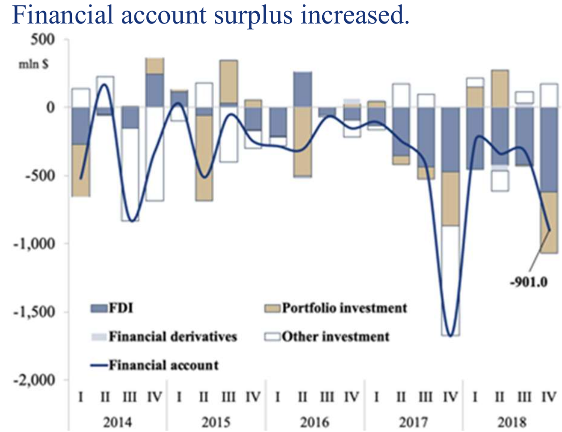
Income account remains in deficit.



Source: Bank of Mongolia

Figure IV.2.5

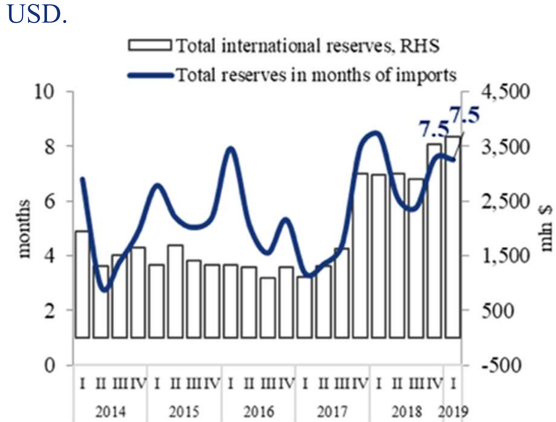
Financial account surplus increased.



Source: Bank of Mongolia

Figure IV.2.6

Gross international reserve reached 3.6 trillion USD.



Source: Bank of Mongolia

(Figure IV.2.6). A surplus in the balance of payments of 334 million USD and increase in monetized gold of 276 million USD contributed positively on the reserve accumulation.

Net international reserves (NIR) decreased by 177 million USD, from previous quarter. On the asset side, foreign currency deposits and treasury bills held by the Bank of Mongolia increased, as well as the monetarized gold. On the liabilities side, current accounts and deposits in foreign currency declined.

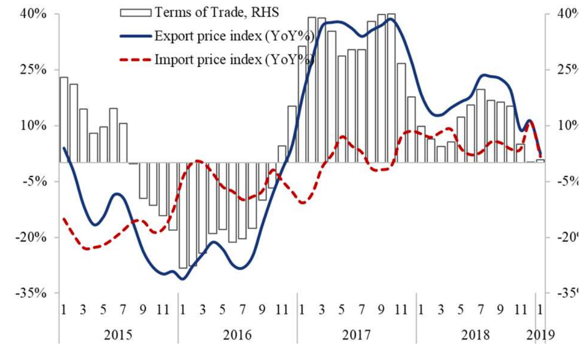
Improving trend of **Terms of Trade** that was observed in the fourth quarter of 2018 is kept in January of 2019, with an improvement of 0.8 percent year-over-year. While the average price of imports rose, the price of exports increased more, thus supporting the terms of trade.

As of January 2019, the custom's prices of copper concentrate, coal, and iron ore increased by 3 percent (with higher gold contents in Oyu Tolgoi copper concentrate), 11 percent, and 6 percent year-over-year, respectively. On the other hand, the customs prices of crude oil, gold, zinc, meat, and canned meat products declined by 19 percent, 4 percent, 18 percent, 10 percent, and 12 percent year-over-year, respectively. Overall, the price of exports increased by 2.5 percent year-over-year in January 2019.

Price of imports increased by 1.7 percent year-over-year in January 2019, mainly driven by the price of consumer goods and capital goods, while the import price of fuel declined.

Figure IV.2.7

Terms of trade is remained at the level that of previous year.



Source: Bank of Mongolia, Customs Office

IV.3 Global market prices of main exporting commodities of Mongolia

Commodity prices dropped in the reporting quarter due to an appreciation of USD, a downward revision of China's growth projections, and uncertainty arising from the trade conflict between the USA and China.

Copper: Average price of copper was 5949 USD per ton in December 2018 and increased to 6300 USD per ton in February 2019. The recent upturn was due to the optimistic market expectations regarding resolution of the US-China trade conflict, following the announcement of another meeting scheduled between the US President Donald Trump and Chinese President Xi Jinping in March 2019. In the coming quarters, copper demand will depend on China's economic growth, macroeconomic policy, and international geopolitics. There is a rising concern of copper demand to fall, as economic growth in China, the main copper consumer, slowed down to the lowest point in 2018 since 1990. Moreover, world copper output is expected to increase from 21.5 million tons in 2018 to 23.5 million tons in 2020, thus drove price projections down for the medium term. As a result, Bloomberg, Australian Department of Industry, Innovation and Science, and the IMF analysts revised copper price projections down to 6,167 USD per ton on average for 2019.

Gold: Price of an ounce of gold was at 1282 USD on average in December 2018 and rose to 1313 USD in February 2019. At the market, demand for gold (safe haven) increased and led to higher prices given the lower likelihood of federal funds rate to hike, prospects of the Brexit, and downward revision in projections of world economic growth by international organizations. Along these lines, international geopolitical risks have escalated (with a prolonged trade conflict), boosting in gold purchases by central banks. For instance, the gold purchase amounted to 27.7 trillion USD or 651.5 tons in volume, which is the highest sum since 1967. Looking forward, as the expectations of federal funds rate to hike has lowered, demand for gold jewelry is projected to increase in 2019-2020, the trade conflict between the US and China is prolonged, and economic growth of developing countries is declining, the analysts of Bloomberg revised gold price projections up to 1312 USD in 2019.

Thermal coal: Average price of thermal coal was 86 USD per ton in December 2018 and dropped down to 81 USD in February 2019. The price decline was mainly driven by excess short-term supply in the domestic market while China's imports of thermal coal were 10.2 million tons, 55 percent declined year-over-year in December 2018 and coal stocks at major ports' warehouses increased 32 percent year-over-year in January 2019. The thermal coal price is expected to be shaped by several factors, including the outcome of Chinese environmental policy, the regulation of air pollution, and potential shut down of several coal mines with strengthened enforcement of safety regulations at coal mines following certain incidents. The thermal coal demand is expected to fall in 2019 due to the potential extension of the Chinese ban on coal imports, set at the end of 2018 and tighter customs clearance at the ports. The Bloomberg analysts expect thermal coal price to decline going forward, as China is expected to cut its thermal coal imports by 6 million tons to 186 million tons in 2019, Australia's thermal coal export is predicted to drop, and economic growth of developing countries is declining. Consequently, the thermal coal price projections were revised down to 92 USD in 2019.

Iron ore: Average price of iron ore reached 71 USD per ton in December 2018 and increased marginally to 72 USD per ton in January 2019. It was associated with 7 percent decline in iron ore production by BHP in 2018, a dam collapse at Vale mine in Brazil, and a potential risk of transportation delay and supply shortage after the train crash in Australia. A slowdown in Chinese economic growth followed by low profits of iron ore companies could weigh down on demand for iron ore. Moreover, the expectation of Chinese authorities to cut coal production and tighten customs clearance in 2019 could have negative impact on demand and price of iron ore. Thus, the analysts of Bloomberg, Australian Department of

Industry, Innovation and Science, and the IMF projects average price of iron ore at 57 USD per ton for 2019.

Crude oil: A barrel of Brent oil was sold at 55 USD on average in December 2018 and rose to 62 USD in January 2019. The price remains elevated due to potential risks of adverse supply shocks related to the US sanctions on oil exporters, Iran and Venezuela. Although the price for crude oil increased in January, it tends to fluctuate substantially along with uncertainty regarding the US-China trade conflict. The EIU analysts expect the oil market to be more balanced in 2019 compared to 2018, since Saudi Arabia and Russia lifted oil production in a large extent following the US sanction on Iranian oil exports. Certain risks could potentially cut oil demand and lower oil price projections in the future. Such as, the consensus of the OPEC and non-OPEC countries to limit the daily productions down to 1.2 million barrels would continue till the end of April 2019, expectations of increasing productions in the US, Iranian oil supply is likely to exceed the expectations in the first half of 2019, and cautions regarding slower growth in the world economy. Taking these factors into account, the Bloomberg analysts revised their price projections down from 70 USD to 61 USD per barrel, and the EIU analysts revised their price projections down from 77 USD to 75 USD per barrel in 2019. Moreover, oil consumption, which increased by 1.7 percent in 2018, is expected to rise by less than 1.5 percent in 2019, due to slower economic growths of the US and China. According to the EIU analysts, such dynamics may result in lower price.

THE BANK OF MONGOLIA