THE BANK OF MONGOLIA

INFLATION REPORT

2019

JUN

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 the 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 June 19, 2019, the Monetary Policy Committee decided to keep the policy rate unchanged at 11 percent. /Detailed information is provided in the monetary policy statement/

EXECUTIVE SUMMARY

Although the momentum of domestic demand remains strong, there are high risks and uncertainties in the external environment. Domestically, economic growth is supported by increasing investments, greater budget expenditure, monetary policy stance, and growing business loans. Although the economy continues to grow at a rapid pace, the central bank is expected to meet its objective to stabilize inflation around 8 percent.

Inflation fluctuated in the first months of the year mainly due to supply-driven factors. Annual inflation reached 7.9 percent nationwide in May 2019. While, inflation in Ulaanbaatar reached 8.8 percent, of which 4 percentage point is attributed to the change in prices of meat, gasoline, and solid fuel. In the first 4 months of the year, price of meat had been increasing in line with its seasonal pattern. However, due to supply disruption in the domestic market, price of meat increased sharply and consequently explains 2.4 percentage point of the headline inflation for Ulaanbaatar. According to the near-term forecast, price of meat is likely to decline following its seasonal pattern. However, considering the current chain of domestic meat supply, infrastructure, demand for exports, and its seasonal pattern, price of meat may exceed our expectations in the last quarter of the year. Domestic price of gasoline depends on the price of oil at the global market. In case of solid fuel, its price is expected to remain stable as the relevant authorities are expected to regulate the price and supply of processed coal. This year, the fiscal stance is loosening wages are increasing, thus would lead to demand-driven inflationary pressure. Nevertheless, the central bank is expected to meet its objective to stabilize inflation around 8 percent. **Inflation excluding prices of meat, solid fuel and gasoline, which are prone to supply related factors, remains stable between 4-5 percent.**

Economic growth in the first quarter of 2019 exceeded our expectations, on the back of rapid growth in the mining sector, in particular, increased mining production of copper, coal, and iron ore. Since the exporting volume of crude oil and iron ore are expected to increase further, the growth projection for the mining sector is revised up in this report. Growth in the construction, trade, and services sectors were supported by continued investments to the mining construction activity and greater household consumptions. On the other hand, greater investments resulted in greater imports of diesel fuel and equipment. In addition, as the fiscal capital spending fell short of the scheduled amount, the non-mining sector growth was weaker than our previous projection. In the remainder of the year, the fiscal capital spending is expected to accelerate and support the construction and services sectors, while growth in the agricultural sector is likely to stabilize, consequently resulting in greater growth in the non-mining sector. Owing to macroprudential policy measures, consumer loan is decelerating, while business lending is growing at a stable pace from previous year and supporting domestic investments. Investments made in the last two years are likely to remain supportive of the medium-term economic growth. Although economic momentum is picking up, quality of business loans is not improving sufficiently and therefore limits the credit supply. Domestically, the economic growth remains strong, while risks and uncertainties in the external environment build up, due to unresolved trade tension between major global economies.

The fiscal spending fell short of the scheduled amount and the equilibrated balance was in surplus in the first 4 months of the year. Nevertheless, our previous assumptions of loose fiscal stance during 2019-2020 remain unchanged, since the fiscal capital spending is expected to accelerate and spending on wages, pension, and transfers are increasing from previous year. Growth projections for the mining sector and imports in 2019 are increased from previous report. Thus, our projection of fiscal revenue is revised up and the degree of fiscal loosening is slightly narrowed.

Uncertainties are building up in the external environment and the external demand is likely to decelerate. As the trade tension between the USA and China worsens, there is a growing risk of adverse impact on global economic growth, commodity prices and capital flow to emerging markets. However, potential policy actions by the Chinese authorities in response to the trade tensions, are uncertain. Considering the tension and uncertainties in the external environment, weakening trend in the external demand outlook is not changed in this report.

In the reporting quarter, the balance of payments recorded a surplus, as exports revenue increased, imports spending decelerated and portfolio investments increased. In case of exports, revenue from coal, gold, copper, iron ore, and meat and meat-related items were significant contributors. On the other hand, imports of equipment, parts, and diesel fuel expanded rapidly. External debt service payments and dividend payments for foreign investors increased in the reporting quarter, thus led to a deficit in the income account and continued to pressure the balance of payments.

Due to increased uncertainty in the external environment, commodity prices at the global market weakened and thus Mongolia's terms of trade worsened in the first quarter of 2019. This year, the price of gold is expected to increase, while prices of copper, coal, and iron ore are likely to decline and consequently our projection of export price is revised down.

I. INFLATION

The Bank of Mongolia's monetary policy is aimed at stabilizing inflation, measured by the consumer price index, at around 8 percent during 2019-2020 and around 6 percent in the medium term. As of May 2019, inflation reached 7.9 percent nationwide and 8.8 percent in Ulaanbaatar. (Figure I.1).

Following economic recovery, prices of both food and non-food items are increasing, thus pushing the headline inflation up, while the demand-driven inflationary pressure remains stable.

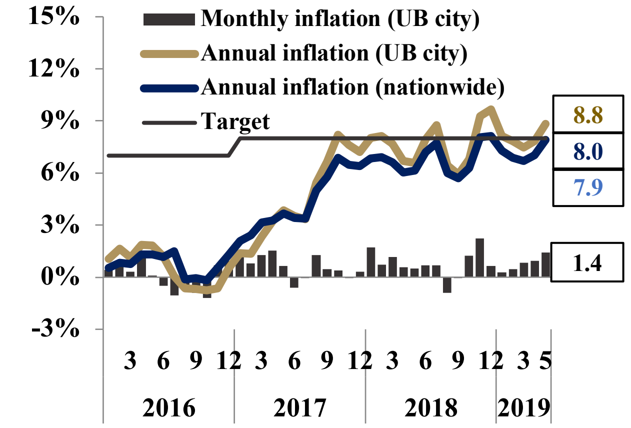
Supply related factors have pushed prices of a few items and played significant role in inflation fluctuations. In particular, price of meat, solid fuel, and gasoline had explained significant portion of inflation in the past months. Although their combined impact was declining from early 2019 and had reached 37 percent or 2.9 percentage point of inflation in Ulaanbaatar (*7.8 percent*), due to rising prices of meat and gasoline in May, their combined impact increased back to 45 percent or 4.0 percentage point of an 8.8 percent inflation (Figure I.3).

Following its seasonal pattern, the domestic price of meat had been increasing in the first four months of the year. However, in mid-May, domestic supply of meat was cut short by 30-50 percent, due to issues of meat origination and security raised by the inspection authority and the fact that exporting companies of heat-processed meat were building their stock directly from the domestic retail market, rather than meat-producing plants. Consequently, the price of meat spiked in May and its impact on headline inflation increased by 1 percentage point to 2.4 percentage point. Overall in May, price of meat increased by 10.8 percent from previous month and by 25.9 percent from previous year.

Price of solid fuel declined by 3.1 percent in April and remained stable in May, thus its contribution to the headline inflation declined by 1.2 percentage point from the first quarter, reaching

Figure I.1

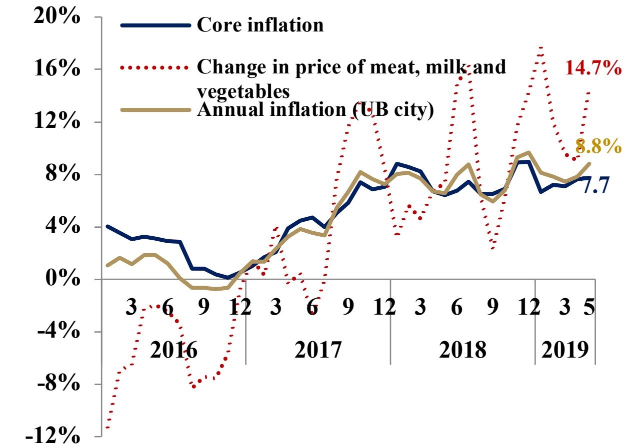
Inflation



Source: NSO

Figure I.2

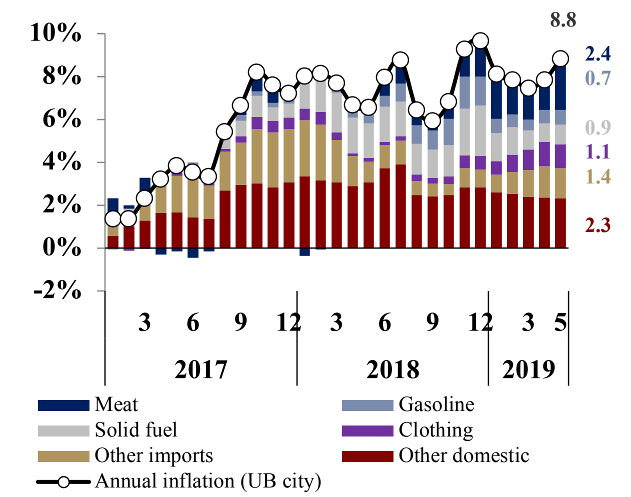
Headline and core inflation



Source: NSO, Bank of Mongolia

Figure I.3

Headline annual inflation in Ulaanbaatar, broken down by main items



Source: NSO, Bank of Mongolia

0.9 percentage point. At the global market, price of a barrel of crude oil increased from 54 USD at the beginning of 2019 to 68 USD in March and to 72 USD in April. Following the price development at the global market, importing price of oil increased at the border and domestic price for a liter of gasoline increased by 30 MNT in April and by 140 MNT in May. Consequently, its contribution to headline inflation increased by 0.1 percentage point from the first quarter to 0.7 percentage point.

In the first quarter of 2019, change in price of food items fell short of previous forecast, while that for non-food items were close to previous projection. Overall, the headline inflation reached 7.8 percent, which was 0.1 percentage point lower than previous forecast. For instance, price of meat, which has the largest weight among food items in the consumer basket, increased by 10.7 percent in the first quarter of 2019. Previously it was forecasted to increase by 11.3 percent, consistent with its seasonal pattern. Nevertheless, a sharp increase in May has pushed the supply related inflation pressure up.

Table I.1 Change in inflation outlook

Assumptions of near term inflation forecast

Previous forecast 2019Q1-2019Q4	Current forecast 2019Q2-2020Q1
Price of meat	**Forecast increased**
Exporting volume of meat in 2019 is expected to be as large as in previous year, and thus price of meat is expected to fluctuate similar to that of 2018.	Price of meat spiked in May, due to supply disruptions. Considering the event, price forecast is increased.
Price of imported items	**Forecast unchanged**
Price of imported items started to increase towards the end of 2018, and is likely to remain elevated till the end of third quarter of 2019.	Price of imported items started to increase towards the end of 2018, and is likely to remain elevated till the end of third quarter of 2019.
Administered prices	**Forecast decreased**
Planned increase in prices of electricity and heating is postponed to April, 2019.	Planned hike in price of heating is postponed to June. Price of electricity increased in April and is expected to increase step-by-step in June and July.
Price of gasoline	**Forecast increased**
Following decline in oil prices, domestic price of gasoline declined in December of 2018 and January of 2019. Upside risk in prices has declined.	Following the golbal price of oil, the domestic price of gasoline increased in April and May. Consequently, the price forecast is revised up.
Price of domestic goods	**Forecast decreased**
Price of solid fuel increased again in December and gradually declined in January. Expected to remain stable in the first 2 quarters of 2019.	Price of solid fuel declined in April and price of processed coal is not exptected to change.

Source: Bank of Mongolia

Figure I.4 Inflation forecast

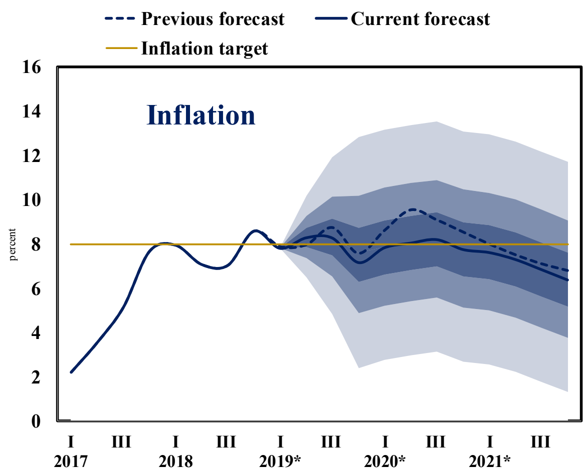


Table I.2

Inflation forecast

	2018	2019*	2020*
	actual	*forecast*[1]	
Inflation, CPI[2]	8.6	5.8 – 8.3	6.5 – 9.0

Source: Bank of Mongolia

[1] 30 percent confidence interval

[2] Average inflation in the fourth quarter of each year.

Inflation forecasts for the end of 2019 and 2020 are reduced from the previous report to 7.2 percent and 7.8 percent, respectively. Several factors were considered in reducing the inflation forecasts. Growth of consumer loans is slowing down and its outstanding level has declined year-to-date, thus alleviating the depreciation pressure on the exchange rate and inflationary impact of wage hikes. In addition, the budget expenditures were delayed and the exchange rate of MNT appreciated against Chinese RMB. Contribution of administered prices declines as the expected hike in price of heating is postponed and price of electricity is expected to be increased in a couple of steps.

In 2020, however, price of food is expected to increase at the global market and it is considered in the current inflation forecast. The fiscal capital spending is expected to increase and thus push inflation through both direct and indirect channels. The supply-related inflation pressure is expected to recede gradually. Nevertheless, the headline inflation is expected to stabilize around its target, during the forecasting period.

Uncertainties that may alter the inflation forecast:

- Potential shortage or oversupply of goods and services have significant implications on the inflation forecast. For instance, depending on the weather conditions, supply of meat and vegetables may fluctuate, leading to price fluctuations. Similarly, potential change in administered prices may alter the inflation forecast.
- The government is currently discussing ways to stabilize the domestic supply of meat, considering the exports of meat and meat products. It may affect the domestic price of meat and meat products.
- Similar to previous election years, if the fiscal stance loosens beyond our expectations, it may lead to demand-driven inflation pressure.
- The trade tension between the USA and China has surged again and creates uncertainties in the external environment. If the situation worsens, it would adversely affect Chinese growth, prices of our exporting goods and capital inflow to emerging economies, and consequently weaken our balance of payments, create depreciation pressure on the exchange rate and push the prices of imported goods up.

II. ECONOMIC GROWTH

Gross domestic product expanded by 8.6 percent in the reporting quarter. From the demand side, increased gross capital formation and household consumption have supported economic growth, while net exports made negative contributions (Figure II.1). Economic recovery is observed in every sector and thus aggregate supply has expanded. The mining, trade, and services sectors in particular, faired rapid growth. (Figure II.2)

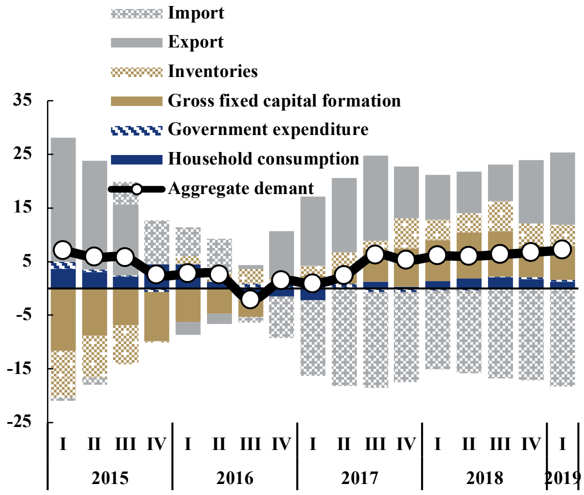
Investment: In the reporting quarter investments increased by 29.5 percent and thus contributed 12.1 percentage point to the growth of aggregate demand. Such expansion was largely spent on nonresidential construction activities and purchasing of machinery and equipment. Although the foreign direct investments and fiscal capital expenditure declined in the reporting quarter, the foreign direct investments accumulated in the previous quarters were utilized in economic activities and business loans expanded from previous year, leading to greater investments in the economy. Moreover, inventories expanded by 2.4 percent, as the stock of coal and copper increased.

According to the approved budget, the fiscal capital expenditure is expected to double in the reporting year, which is an addition of 1608 billion MNT to previous year's level. Such expansion would support the gross capital formation significantly. However, only 67.9 percent of capital spending scheduled in the first quarter was disbursed. Hence, the fiscal capital spending is expected to accelerate in the remainder of the year and thus support gross capital formation.

Business lending, which had bottomed out in the second quarter of 2015, has started to show recovery since the second quarter of 2018 and its growth reached 18 percent in the first quarter of 2019. In particular, credit issued for the trade,

Figure II.1

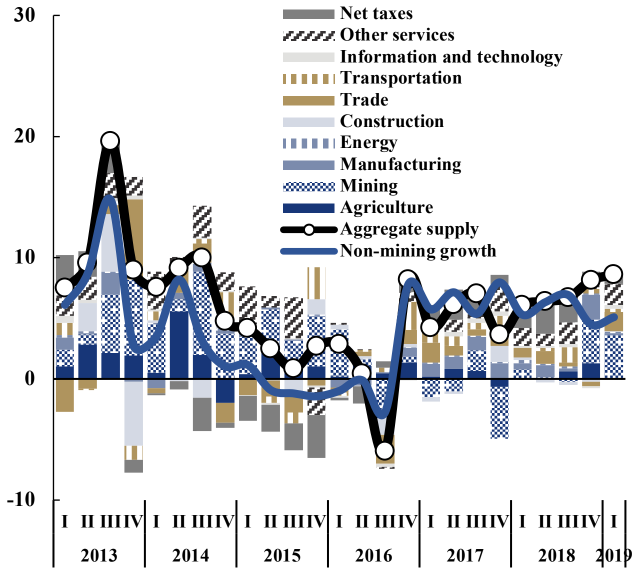
In the reporting quarter, gross capital formation and household consumption made the largest contribution to economic growth.[4]



Source: NSO

Figure II.2

The mining sector made significant contribution to economic growth.



Source: NSO

construction, and mining sectors, is growing rapidly.

Household consumption: In the reporting quarter household consumption increased by 4.1 percent and thus contributed 2.7 percentage point to economic growth. Increased household income and improvements in the market sentiment were the main factors supporting growth. In particular, household income has been increasing constantly for nine quarters since the first quarter of 2017. Similarly, household expectations regarding their future income and job opportunities[3], have improved. Nevertheless, household expenditure continued to exceed household income, following the trend of recent years.

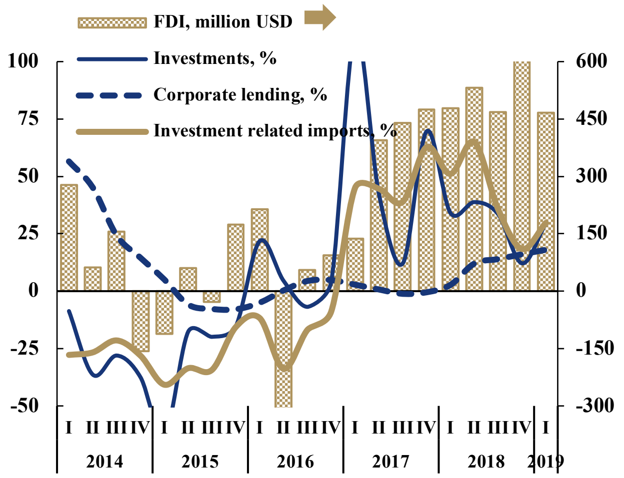
Government expenditure increased by 2.5 percent year-over-year, in real terms and thus supported aggregated demand by 0.4 percentage point. According to the approved budget for 2019, fiscal expenditure on goods and services is expected to increase by around 20 percent from previous year, in nominal terms.

Net exports: Net exports weighed down economic growth by 6.6 percentage point. In the reporting quarter, real exports increased by 26 percent year-over-year, on the back of increased exports of coal, non-monetized gold, copper concentrate, copper ore, and iron ore. In addition, commodity prices remained relatively high and the transportation process of coal exports was not disrupted. Imports, on the other hand, increased by 26.5 percent in real terms.

Increasing household consumption has resulted in greater imports of consumer items. In the reporting quarter consumption related imports expanded by 9 percent, year-over-year. It is in contrast to growth that constantly exceeded 20 percent, throughout 2018 (Figure II.4). In addition, increasing investments resulted in greater imports of investment-related items. For

Figure II.3

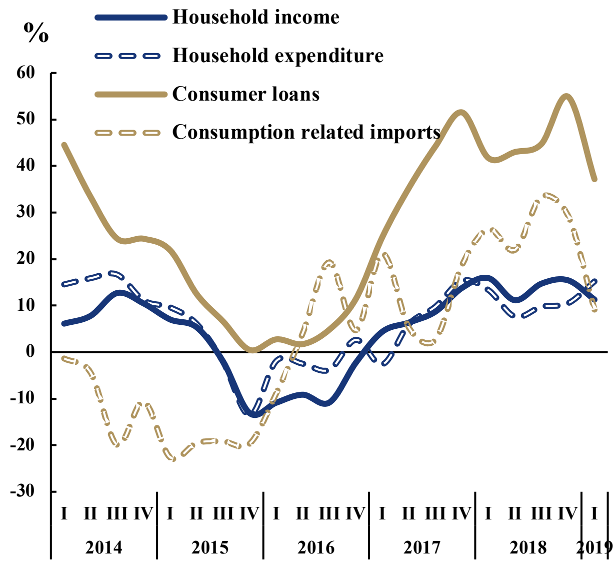
In the reporting quarter, business lending accelerated and investment increased, thus resulted in greater imports of investment related items.



Source: NSO, Bank of Mongolia

Figure II.4

Household consumption is growing on the back of greater household income and rapid growth of consumer loans.



Source: NSO, Bank of Mongolia

[4] Growth calculated from sum of 4 consecutive quarters
[3] NRCC – Consumer confidence index

instance, imports of machinery, equipment, parts, and construction material have exceeded our previous expectations.

Economic sectors: In the reporting quarter the mining sector expanded by 14.4 percent year-over-year, as mining production remained at high levels, except for gold. The mining activities were motivated by a relatively high level of prices of coal, iron ore, and copper at the global market (Figure II.5).

The trade sector increased by 13.9 percent year-over-year and thus made a contribution of 1.6 percentage point to economic growth. In particular, trade of fuel products and investment-related machinery and equipment soared, on the back of increased mining activities and greater investments.

Production in the construction sector has recovered from its plunge in recent quarters and recorded a growth of 6.4 percent. However, the expansion fell short of previous expectations, as the scheduled fiscal capital expenditures were not fully disbursed.

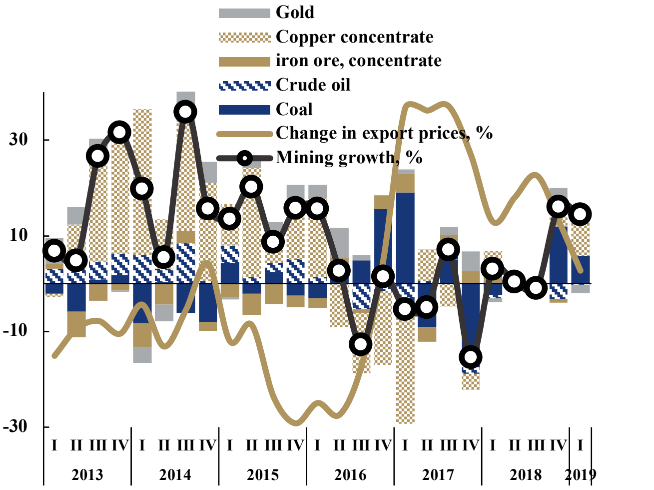
Although household consumption increased, due to weaker growth in production of construction materials and ferrous materials, the manufacturing sector expanded by only 2.6 percent, which was much lower than previous expectations. Nevertheless, it contributed 0.2 percentage point to economic growth.

Economic recovery and increased imports have supported the tax revenue. The net tax revenue increased by 6 percent, making a contribution of 0.8 percentage point to economic growth in the reporting quarter.

Potential output: Growth of potential output had been accelerating and constantly exceeded 10 percent during 2011-2013, however it started to slow down since 2014. Increased investment to the construction of a major mining project since the last quarter of 2016 and its indirect impact

Figure II.5

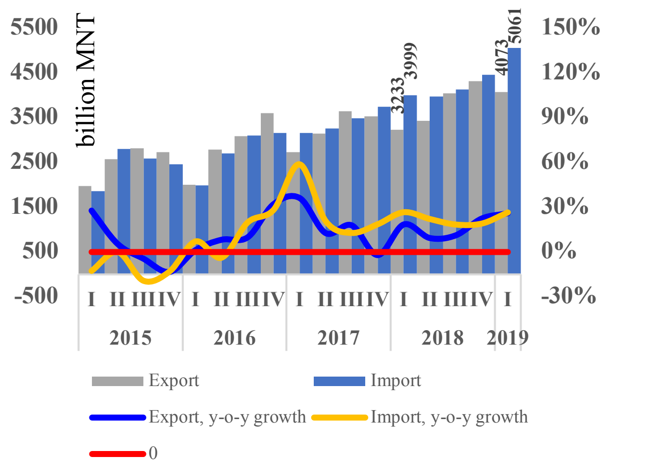
Mining production of commodities excluding gold has increased, leading to 14.4 percent growth in the mining sector.



Source: NSO and Bank of Mongolia

Figure II.6

Both imports and exports expanded rapidly in the reporting quarter, hence the net exports weighed down economic growth by 6.6 percentage point.



Source: NSO

have been supporting the potential output. Consequently, its growth recovered from 2.5 percent to 6 percent within the last 3 years (Figure II.7).

Output gap: During 2011-2013, growth in the non-mining sector exceeded its potential level and thus the output gap was positive. However, during 2014-2016, the positive developments in the non-mining sector were reversed and the output gap turned negative. In recent quarters, output gap is recovering (Figure II.8).

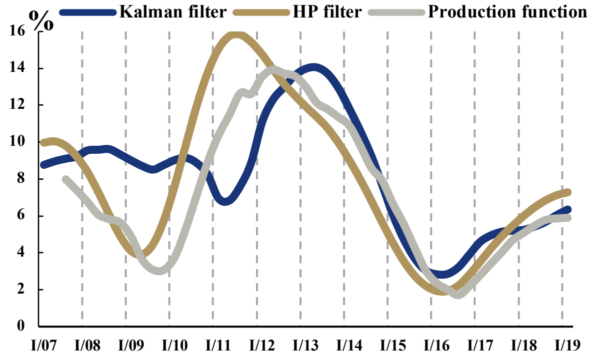
The mining sector was booming beyond its potential level since 2013, owing to greater production of copper and gold. However, since mid-2016 as metal concentration within copper concentration declined, the mining sector production fell below its potential level. Starting mid-2018, as production of coal accelerated from previous year, the output gap in the mining sector has been positive.

In case of the non-mining sector, output gap had been negative during 2014 and mid-2017, due to the domestic and external environment. Owing to indirect effect of commodity exports and increased investments, it has remained positive since the end of 2017.

Economic outlook: Economic growth in the first quarter of 2019 exceeded previous forecast by 1.3 percentage point. In particular, the mining sector outgrew by 12.2 percentage point, while the non-mining sector fell short of expectations by 2.5 percentage point. Such improvement in the mining sector was mainly supported by the higher price of coal and greater production of copper, iron ore, and coal (by 1.2 million ton or 10 percent). The production of copper and iron ore exceeded previous expectations by 24 and 22 percent respectively. The non-mining sector, on the other hand, fell short of expectations as 1) the scheduled fiscal capital spending was not fully disbursed, 2) consequently manufacturing of construction materials were lower and production of coking coal declined, and thus led to lower growth in the manufacturing sector, and 3) growth

Figure II.7

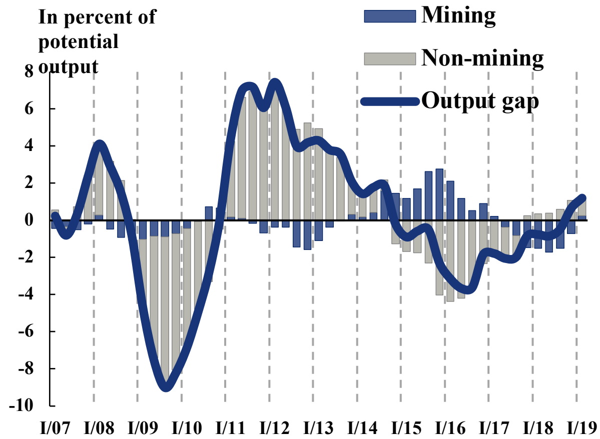
Potential output growth



Source: Bank of Mongolia

Figure II.8

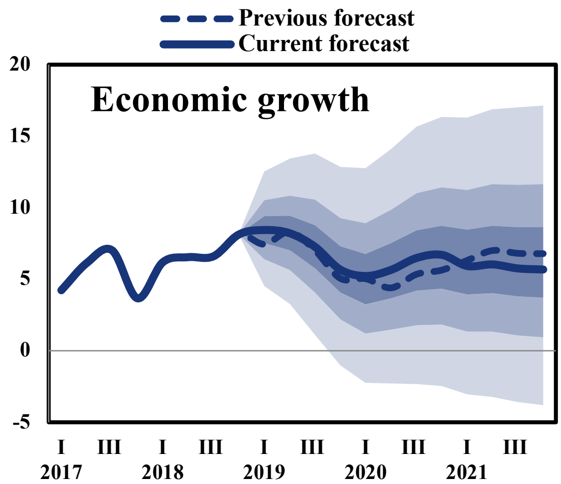
Output gap



Source: Bank of Mongolia

Figure II.9

Annual growth projections of quarterly GDP



Source: Bank of Mongolia

in the transportation sector fell short of expectations as long-distance transportation of coal exports declined.

Economic growth forecast for this year is revised up. In particular, the mining sector forecast is improved on the back of impressive performance in the first quarter, while growth projection for the non-mining sector is weakened slightly. In the following year, the gold content in Oyu Tolgoi copper concentration is expected to decline. However, the fiscal capital spending is expected to increase and the non-mining sector is projected to accelerate, resulting in greater growth projection from previous report. (Figure II.9)

Price forecast for oil, iron ore, and gold are improved for this year and the mining production and exports of commodities excluding copper concentrate are expected to increase, consistent with the first quarter of 2019, and support growth in the mining sector. However, starting 2020 prices of commodities are expected to weaken except for gold and the exporting volume of copper concentrate is not likely to increase. In addition, the gold content within Oyu Tolgoi concentrate is expected to drop and thus lead to lower growth in the mining sector.

This year several factors are likely to support growth in the non-mining sector. For instance, although the fiscal capital spending is falling behind schedule, it is expected to be fully disbursed in the second half of the year and support the construction, trade, and services sectors. In addition, production of coking coal is expected to decline in the first half of the year, before picking up in the second half and support the manufacturing sector. As the weather condition is expected to be close to its historical average, growth in the agricultural sector is projected to stabilize around its rate in previous year. In the following year, according to the Medium Term Fiscal Framework Statement, current and capital spending are expected to increase and support the non-mining sector.

[5] 30 percent confidence interval

Table II.1.1

Economic growth projections

	2018 *actual.*	2019*	2020* *projection*[5]
GDP growth, %	6.9	5.9 – 8.8	3.9 – 7.8
Mining growth, %	5.1	3.5 – 6.4	0.4 – 4.3
Non-mining growth, %	7.5	6.6 – 9.5	4.9 – 8.8

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 up
Consumption	Expectation weakened slightly

•Expanding household income and wage income are expected to support growth of private consumption. Households have positive sentiment toward the future.

• According to the approved budget, government spending on goods and services is expected to increase by 20 percent from 2018. In the first quarter the deflator for government spending exceeded previous expectations and is likely to be kept for the remainder of the year.

Investment	Expectation improved

• FDI inflow in 2019 is expected to be lower from 2018. This quarter, the difference is narrowed.

• In the first quarter, investments exceeded previous expectations.

• Expectations of business owners and managers remain positive, growth of business loans is picking up gradually and private investment would increase at a stable rate.

• According to the approved budget, government capital spending is expected to double (by 1.6 trillion MNT) in 2019.

Net exports	Expectation weakened

• Consistent with the performance in the first quarter of 2019, exporting volume of crude oil, iron ore, and cashmere is revised up and thus the growth projection of total exports is revised up by 3.1 perentage point from the previous report.

• The difference in projection and actual performance of total imports in the first quarter can be attributed to the deflator for imports, which was lower than previous expectations. The projection of total imports for the year was adjusted by such discrepancy. In addition, since the projection of investments is revised up, imports of investment items are expected to increase. Similarly, following export transportations, import of diesel fuel is likely to pick up. Overall, growth projection for total imports is revised up by 5.1 percentage point.

AGGREGATE SUPPLY	Revised up
Mining	Expectation improved

• Forecast for iron ore and crude oil production is revised up.

Non-mining	Expectation weakened slightly

• As the coking coal treating production is not increasing signifacantly, growth projection for the manufacturing sector is revised down.

• Although the export projection of iron ore is revised up in the second and third quarters, in the fourth quarter exports of coal and iron ore are expected to decline, thus lead to slighly lower growth projection for the transportation sector.

However, such spending usually leads to greater imports of investment items. In addition, since the external demand is expected to decelerate and the mining sector boom is likely to cool off, the indirect impact on growth in the non-mining sector is expected to weaken slightly.

Source: Bank of Mongolia

Uncertainties that may affect the economic outlook:

- Deepening trade tension between the USA and China has become the main source of uncertainty, and it has significant implications for Mongolian economic outlook. Although the Chinese authorities are likely to support its economic growth through domestic investments, international analysts[6] are doubtful whether such actions are sustainable in the longer run. In case the trade tension worsens, China's economic growth may decelerate even further. Such event may lead to lower demand for Mongolia's exports, lower price of commodities and weaker growth relative to our current forecasts.
- Another source of uncertainty is the possibility of Mongolia falling into the "Grey list" of the FATF. In the event that it does, there is a risk of Mongolia's credit rating to weaken, cost of international borrowing to increase, international transactions and payment systems to stall, investment environment to deteriorate and the capital flow to slow down.
- In the following years, economic growth can be boosted in case the crude oil processing plant and the Tavan Tolgoi-Zuunbayan railway are constructed and the new airport is opened for operation. However, currently, the timing and feasibility studies of such projects remain uncertain.

[6] Economic Intelligence Unit (EIU)

III. DOMESTIC ECONOMIC CONDITION

III.1. The labor market

The labor market indicators are assessed as moving average of 4 quarters, to remove quarterly fluctuations. The number of working age population and the number of people employed continued to expand, while number of unemployed people declined. However, number of economically inactive population increased in the first quarter of 2019 (Figure III.1.1).

Among the main indicators of labor market, labor force participation rate[7] has remained stable around 61 percent in recent quarters. However the employment rate[8] declined to 56 percent, contrary to its upward trend since 2016. The number of unemployed population, measured as moving average in the last 4 quarters, has been declining. However, in the reporting quarter alone, it increased by 30 thousand from previous year.

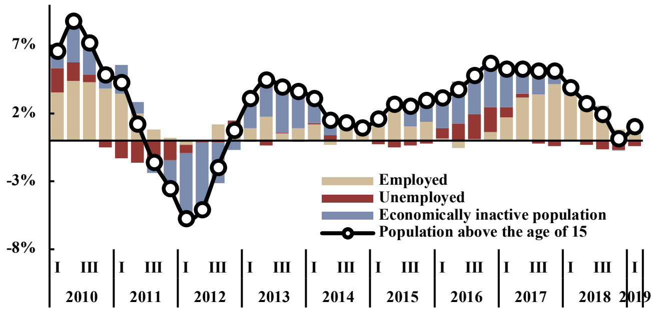
Consequently, the unemployment rate[9] increased to 8.2 percent, contrary to its downward trend since 2016 (Figure III.1.2).

Starting this quarter, a set of new composite indicators for labor force underutilization is reported. For instance, as of first quarter of 2019, time-related underemployment rate is at 2.3 percent, while 5.3 percent of the extended labor force is considered to be viable for employment but not included in the official labor force. When such groups are included in the unemployment rate (11.8 percent in the reporting quarter), labor of 18.7 percent of the extended labor force[10] is not fully utilized (Figure III.1.2).

In recent quarters number of employed people increased by 1.5 percent on average. Such improvement is mainly observed in the sectors of mining, manufacturing, energy, public administration, education, and health. On the

Figure III.1.1

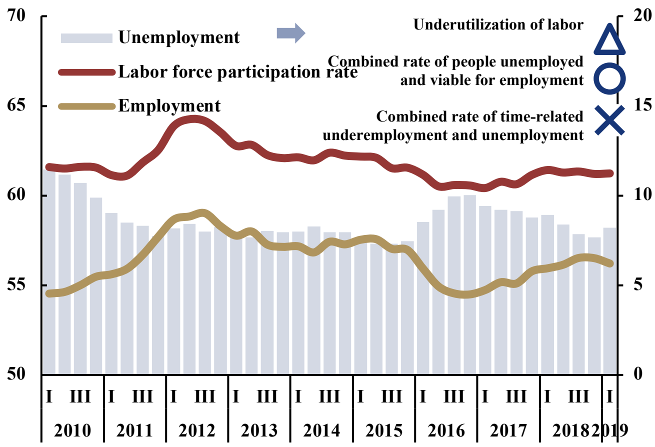
Working age population (over the age of 15) continues to expand, employment has increased and number of unemployed people is declining.[15]



Source: NSO

Figure III.1.2

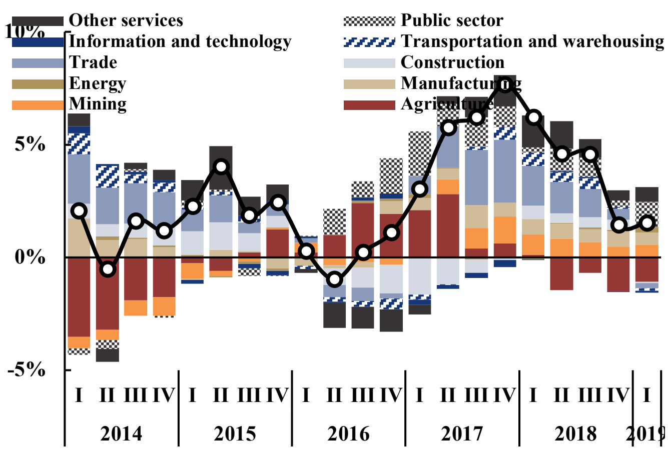
The labor force participation rate remained stable, while the employment rate declined and the unemployment rate increased.[16]



Source: NSO

Figure III.1.3

Employment in the mining, manufacturing, energy, public administration, education, and health related sectors is increasing.



Source: NSO

other hand, following its trend labor is switching from the agricultural sector to the above mentioned sectors (Figure III.1.3).

Number of people registered as unemployed, showed a tendency to decline at the end of 2017 and early 2018. In recent quarters, no significant change was observed and the number of unemployed people remained relatively stable (Figure III.1.4).

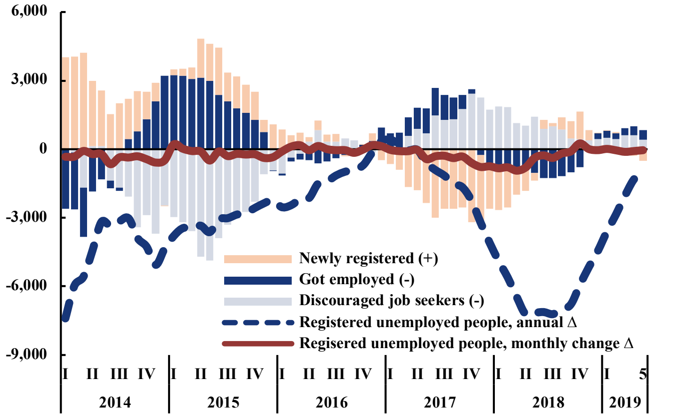
Among the household income indicators, the national average and median wages have accelerated from previous quarters. As of first quarter of 2019, the wages increased by 16 and 17.3 percent, respectively in nominal terms. Consequently, the real wage growth, which indicates the purchasing power of the people, has accelerated to 5.7 percent following a stagnation in the previous year. Nevertheless, growth rate of household average monetary income[11] has decelerated from previous quarters and reached 11.3 percent (Figure III.1.5).

In terms of main economic sectors, average wage ranges between 730 to 2825 thousand MNT, while the national average wage[12] is at 1157.9 thousand MNT and the median wage at 827.8 thousand MNT, which is much closer to the lower bound of the sectoral interval (Figure III.1.5).

When the wage growth is assessed relative to the ownership or form of the organization, wages in the public sector increased by 22 percent on average in the reporting quarter, after a stagnation in recent years. Wages in the limited liability companies expanded by 15 percent on average and wages in other forms of

Figure III.1.4

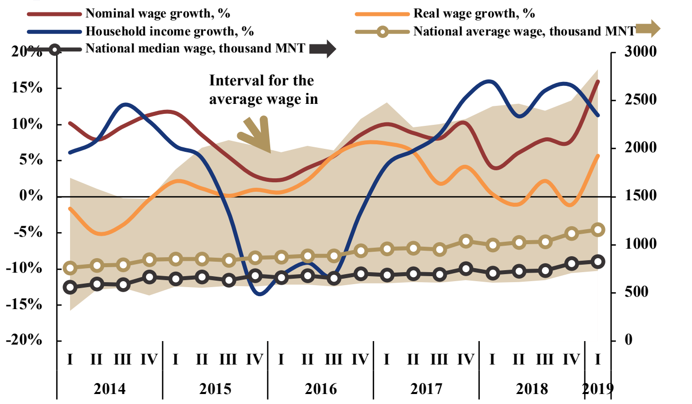
Number of people registered as unemployed has not changed significantly.



Source: General Office for Labor and Welfare Services

Figure III.1.5

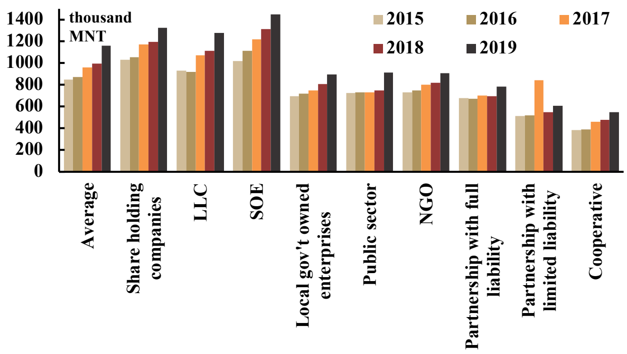
As the nominal wage increased rapidly, the real wage improved.



Source: NSO

Figure III.1.6

Wages in public sector increased.



---

[7] Share of economically active population within population above the age of 15, average of the last 4 quarters
[8] Share of employment within population above the age of 15, average of the last 4 quarters
[9] Share of unemployed people within economically active population, average of the last 4 quarters
[10] Extended labor force = Labor force/Economically active population + Labor viable for employment/Economically inactive population
[15] Moving average of the growth rate of population above the age of 15 and total employment
[16] Since the first quarter of 2019, the NSO has started to conduct the Survey on Labor Force under the framework of "New Methodologies In Measuring Indicators of Employment", and is currently extending the sample size and generating new indicators to measure labor force underutilization.
[11] Source: Household Socio-Economic Survey by the NSO
[12] Source: Social security payments' report by the General Office for Labor and Welfare Services

organizations increased by over 10 percent (Figure III.1.6).

In terms of economic activities, wages in the public administration, education, and health sectors have increased by 22 percent on average, as mentioned above. Wages in other sectors excluding the electricity and transportation sectors increased by over 10 percent. In particular, most notable raises are observed in the sectors of finance, insurance, real estate, construction, and mining (Figure III.1.7).

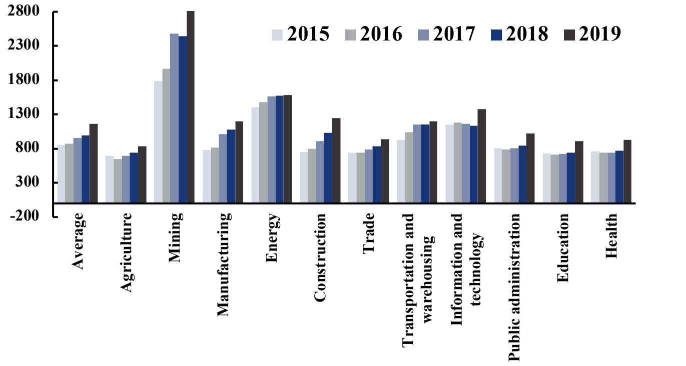
The fact that economic recovery outpaced the growth of number of labor employed, indicates a trend of acceleration in labor productivity[13] in recent quarters. In particular, labor productivity is improving in the agriculture, manufacturing, and transportation sectors, while deteriorated in the mining and construction sectors (Figure III.1.8).

Although labor cost is on an increasing trend, as the economic recovery picked up its pace, unit labor cost[14] has been declining in recent quarters (Figure III.1.9).

Source: NSO

Figure III.1.7

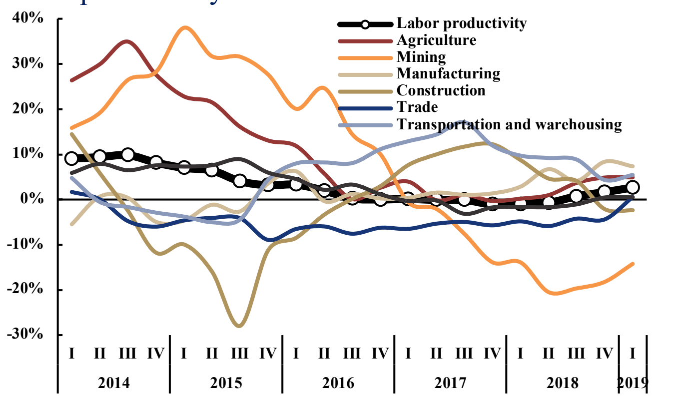
Following wage hike in the public sector, wages are increasing in other economic sectors.



Source: NSO

Figure III.1.8

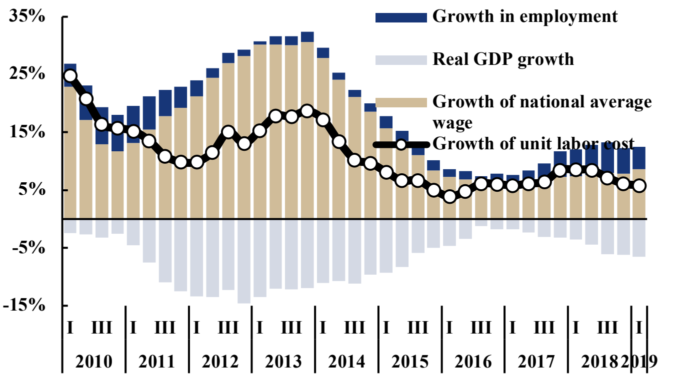
Labor productivity continues to accelerate.[17]



Source: NSO, expert's estimation

Figure III.1.9

Unit labor cost continues to decelerate.



Source: NSO, expert's estimation

[13] Average of GDP per worker
[14] Average labor cost or wage cost per unit of GDP
[17] 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

The M2 money supply has been steadily growing since the third quarter of 2018. As of April 2019, its annual growth reached 22.6 percent, mainly supported by increasing net foreign reserves and credit issued by banks. Business lending has been steadily growing from its level in previous year, while growth of consumer loans[18] is decelerating year-to-date, resulting in lower credit growth in the banking system.

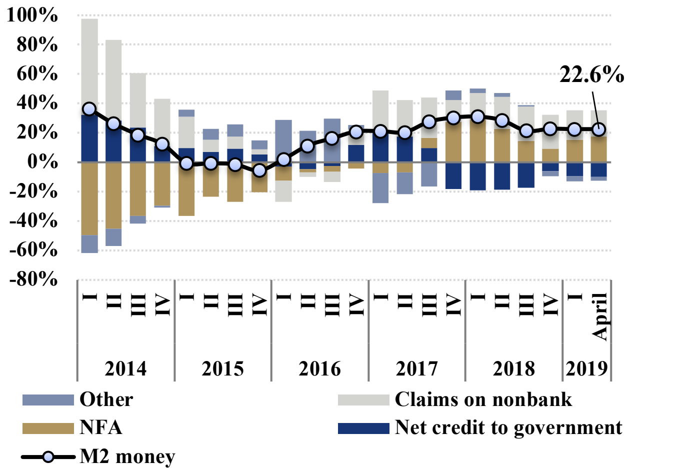
As of April 2019, the central bank's net foreign reserves have increased by 800 million USD from previous year, and thus contributed 17.3 percentage point to growth of money supply. In the first quarter of 2019, accumulation of net foreign reserves was mainly supported by foreign funds raised by the private sector. Since then, 100 million USD was added, owing to foreign direct investments for the Oyu Tolgoi project and the non-mining sectors including trade, manufacturing, and transportation.

In the domestic market, growth of credit issued by depository institutions remains the main factor explaining money supply growth and it has contributed 18 percentage point. As the growth of consumer loans slows down due to macroprudential policy measures, growth of business loans remains stable around 18 percent. A majority of growth in business credit is issued for the trade, construction, and mining sectors. In particular, the combined share of credit issued to the mining and trade sectors is growing steadily in recent months.

Credit dollarization in the banking system has declined at the end of 2018, since a significant amount of FX credit issued for the construction, mining, and trade sectors were converted to MNT. The credit dollarization remains stable around 15 percent as of April

Figure III.2.1.1

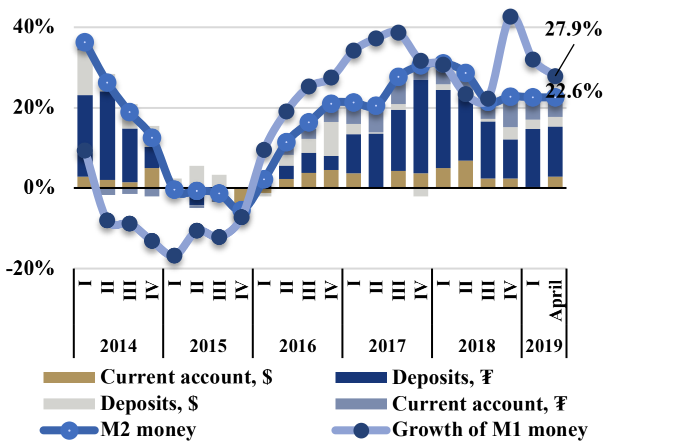
Annual growth of M2 money and its contributions, asset side



Source: Bank of Mongolia

Figure III.2.1.2

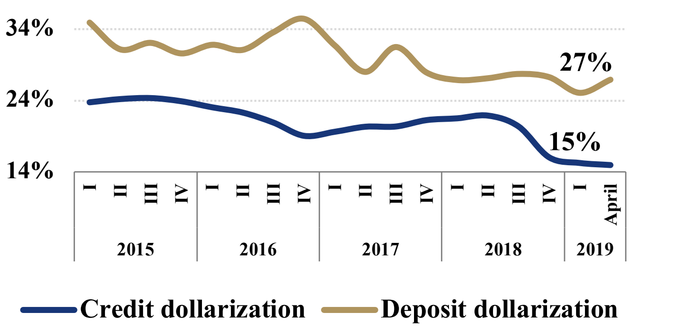
Annual growth of M2 money and its contributions, liability side



Source: Bank of Mongolia

Figure III.2.1.3

Dollarization of bank credit and deposits



Source: Bank of Mongolia

Figure III.2.1.4

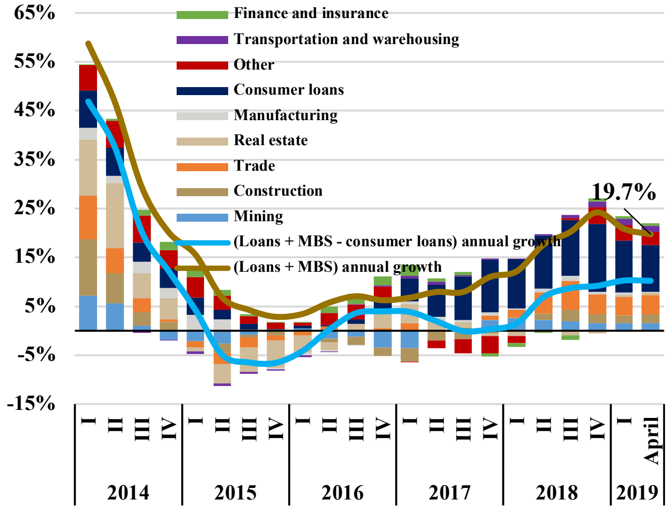
2019, and such low level supports the resilience of the financial system.

The equilibrated balance of budget is in surplus of 290 billion MNT, as of April 2019. The surplus was mainly due to increased budget revenue on the back of a rapid recovery in the mining sector and increased trade turnover. At the same time, the budget expenditure fell short of the scheduled amount, leading to budget surplus. Consequently, the domestic financial need for fiscal purposes remains small and net credit to government continues to shrink.

From the liability side, growth of money supply is mainly supported by deposits and current account in MNT. In particular, deposits and current account in MNT explain 17.4 percentage point of money supply growth in April 2019, while the FX denominated deposits and current account contributed 5.2 percentage point. In the reporting period, outstanding value of FX held in current account of a SOE increased significantly and has resulted in a higher rate of deposit dollarization in the banking system.

Outstanding level of credit issued by depository institutions[19] and mortgage loans that were converted to mortgage backed securities (MBS[20]), increased by 19.7 percent as of April 2019. Nonperforming and past-due loans comprise 17 percent of total outstanding loans, which is a 2-percentage point increase year-to-date. In particular, a majority of the nonperforming and past-due loans were issued for the manufacturing and trade sectors.

Break down of annual credit growth issued by depository institutions



Source: Bank of Mongolia

Figure III.2.1.5

Share of bank loans issued to economic sectors

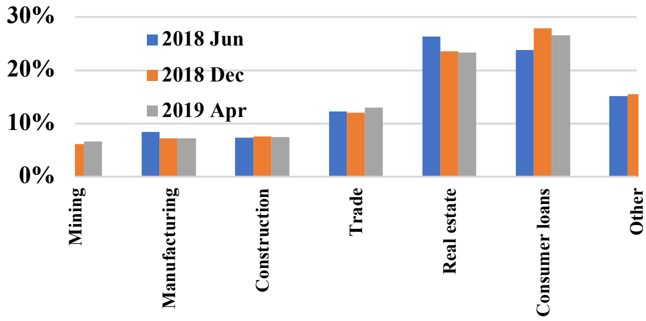
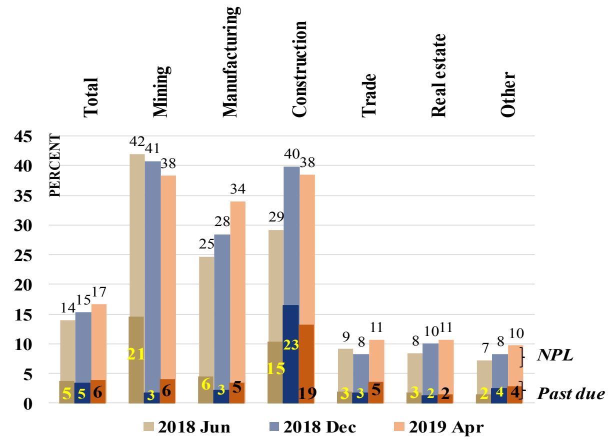


Figure III.2.1.6

Ratio of nonperforming and past due loans to loans issued to each economic sector.



Source: Bank of Mongolia

[18] Consumer loan consists of wage and pension loans, credit card, automobile loans, herders' loans and other consumer loans.
[19] Depository corporations consist of banks and deposits and loans cooperatives.
[20] 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.

III.2.2 Interest rate

The Monetary Policy Committee of the Bank of Mongolia decided to keep the policy rate unchanged at 11 percent, during its scheduled meeting on March 2019. Consequently, the weighted average of interbank market rate has been fluctuating around 11 percent since December 2018. In particular, arithmetic mean of the weighted average of the interbank market rate between December 2018 and April 2019 is at 10.98 percent, while the standard deviation is at 0.12 percent.

In April 2019, direct trading rate on central bank bills increased by 0.03 percentage point from previous month and reached 10.95 percent. The overnight lending rate and deposit rate increased by 0.15 and 0.94 percentage point to 11.29 and 11.25 percent, respectively. Interest rate on repo deals that collateralize the central bank bills has declined by 0.03 percentage point to 11.06 percent. Consequently, the weighted average of the interbank market rate increased by 0.08 percentage point to 11.02 percent, from previous month.

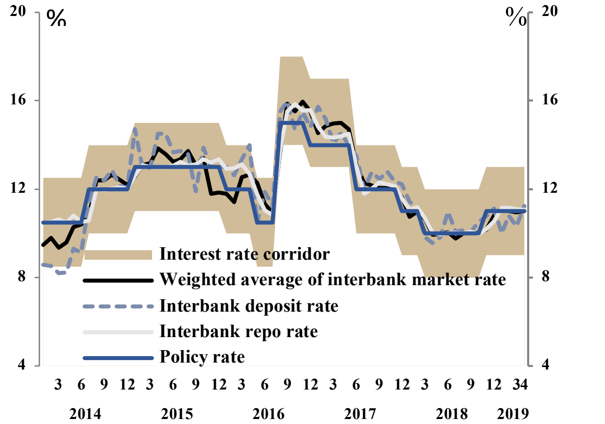
Interest rate on newly issued loans and deposits increased in April, 2019. In particular, interest rate on credits issued in MNT increased by 0.21 percentage point from previous months to 17.28 percent, while rate on MNT deposits increased by 0.38 percentage point to 11.08 percent. As such, interest rate margin narrowed by 0.16 percentage point to 6.2 percent. When assessed by economic sectors, interest rate on newly issued loans for agricultural activities were the highest at 20 percent, while it was the lowest for real estate activities at 12.2 percent.

In the case of foreign exchange loans, interest rate on newly issued loans decreased by 0.85 percentage point from the previous month to 9.6 percent, while deposit rate decreased by 0.18 percentage point to 4.39 percent.

Since the exchange rate of MNT depreciated against USD, the relative yield on MNT has declined by 0.15 percentage point to 0.48 percent in April 2019.

Figure II.2.2.1

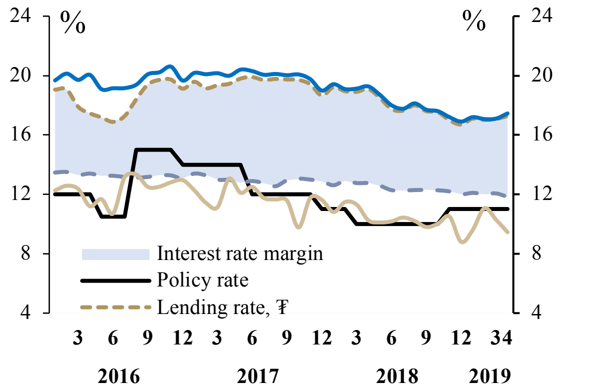
Weighted average of interbank market rate is close to the policy rate.



Source: Bank of Mongolia

Figure II.2.2.2

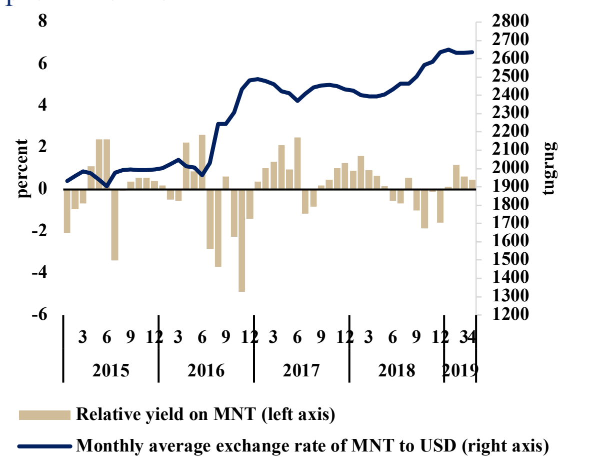
Interest rates on newly issued loans and deposits have increased.



Source: Bank of Mongolia

Figure II.2.2

Relative yield on MNT has been positive in the past 4 months



Source: Bank of Mongolia

III.2.3 Exchange rate

The MNT exchange rate depreciated against USD by 0.06 percent from previous quarter, reaching 2645.16 MNT per USD on average in May 2019. (Figure III.2.3.1)

While depreciation pressure on MNT/USD exchange rate increased at the beginning of 2019, MNT appreciated back from mid-January and remained stable till the end of May 2019.

Such development was a result of stabilization in market sentiment, relatively small conversion in foreign currency deposits and current accounts held by individuals and firms, and greater net inflow of foreign currency.

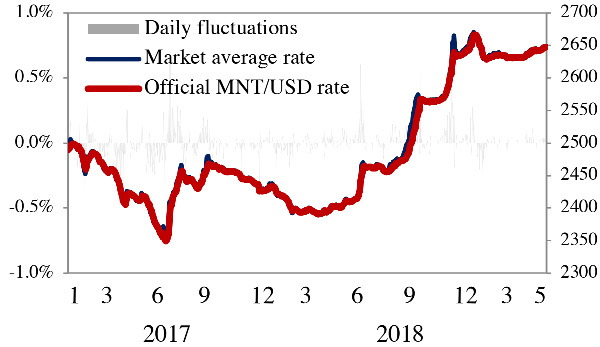
Specifically, net inflow of foreign currency increased by 87.2 million USD from the beginning of the year and reached a surplus of 55.1 million USD in May 2019. While foreign currency inflows weakened by 7.5 percent in that period, foreign currency outflows decreased by 16.8 percent due to a decline in imports quarter-over-quarter. On the other hand, the market expectation regarding the Fed's actions has changed from a hike to a cut in 2019, resulting in stable exchange rates in developing economies.

NEER[21], weighted by trade turnover, depreciated by 1.8 percent in April 2019 compared to the beginning of the year. It was mainly supported by depreciation of MNT against RMB and RUB by 2.4 and 4.2 percent, respectively. Conversely, MNT appreciated against EUR by 1.4 percent (Figure III.2.3.2).

Real effective exchange rate (REER) appreciated by 1.0 percent from beginning of the year, as the relative price, a ratio of domestic and foreign prices, increased by 2.8 percent (Figure III.2.3.3).

Figure III.2.3.1

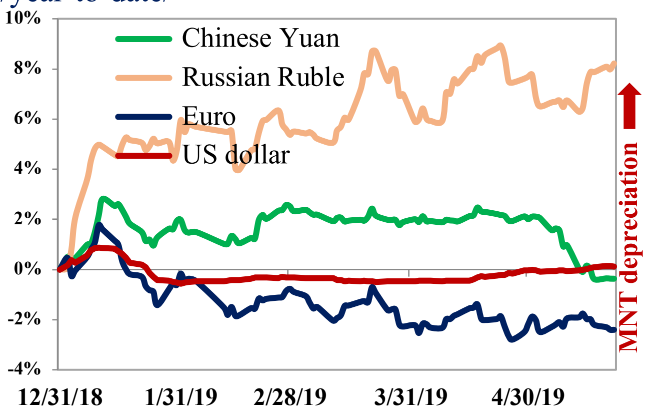
Cross rate of MNT to USD



Source:Bank of Mongolia

Figure III.2.3.2

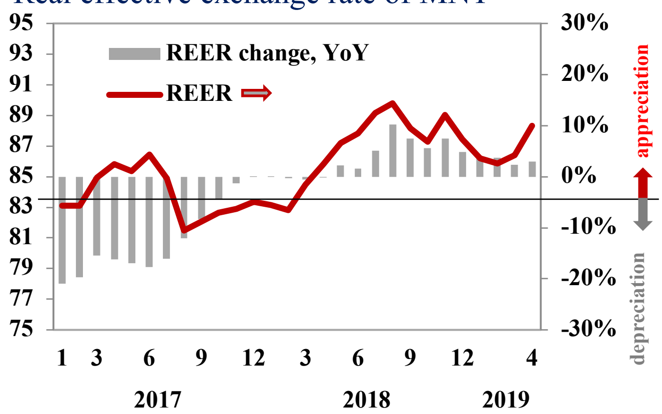
Change in cross rate of MNT to major currencies /year-to-date/



Source:Bank of Mongolia

Figure III.2.3.3

Real effective exchange rate of MNT



Source:Bank of Mongolia

[21] NEER and REER index are average exchange rate of MNT against currencies of 22 trade partners weighted by trade shares and its increase (decrease) indicates appreciation (depreciation) of MNT.

III.2.4 The capital market

In the reporting quarter, rental price and purchasing price of housing remained close to its level in previous quarter. The purchasing power for housing has improved as household average income increased and the price-to-income ratio declined. The price-to-rent ratio is on a declining trend. In case of the stock market, although the market capitalization and the MSE TOP 20 index have improved from previous quarter, the market turnover rate has declined and the investor sentiment and activities at the stock market are deteriorating.

In the reporting quarter, the housing market remained stable (Figure III.2.4.1). The housing price index reported by Tenkhleg Zuuch was close to its level in previous quarter and thus its annual growth dropped to 4.1 percent. In particular, annual growth of new housing price slowed down by 3.2 percentage point to 5.4 percent. The housing price index reported by the NSO, which remained stable over the past year, has increased slightly in the reporting quarter and thus recorded an annual growth of 0.1 percent. Rental price was close to the level in previous quarter and recorded an annual growth of 9.4 percent (Table III.2.4.1).

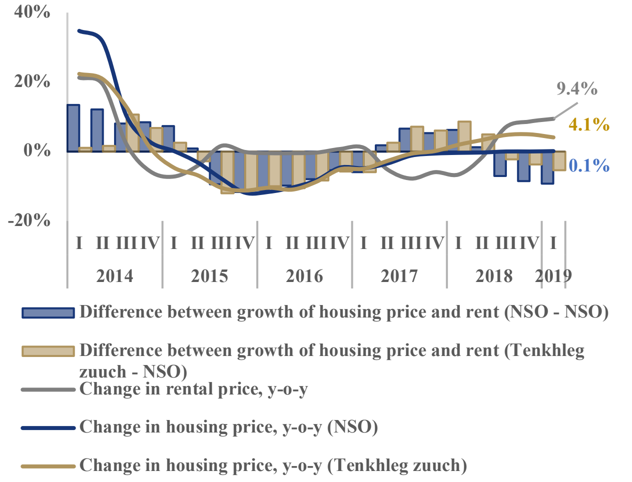
The purchasing power for housing is improving. Household average income improved by 4.8 percent from previous quarter and by 11.3 percent from previous year, resulting in a 0.04 unit drop in the price-to-income ratio. The price-to-rent ratio, on the other hand, remained close to the level in previous quarter, and implies stability in the housing market and minimal risk of housing bubble. (Figure III.2.4.2).

Among the main indicators of the stock exchange market, market capitalization and the TOP-20 index have improved from previous quarter. Yet, the market turnover ratio has declined, and the investors have become inactive.

The market capitalization reached 2.46 trillion MNT on average at the end of the first quarter of 2019, which is a 1.9 percent expansion from previous quarter and a 2.6 percent decline from previous year. The TOP-20 index, on the other hand, reached 20901 on average in the reporting quarter, which is a 1.2 and 5.5 percent hike from previous quarter and previous year, respectively. Due to rising prices of first-grade stocks such as "APU"

Figure III.2.4.1

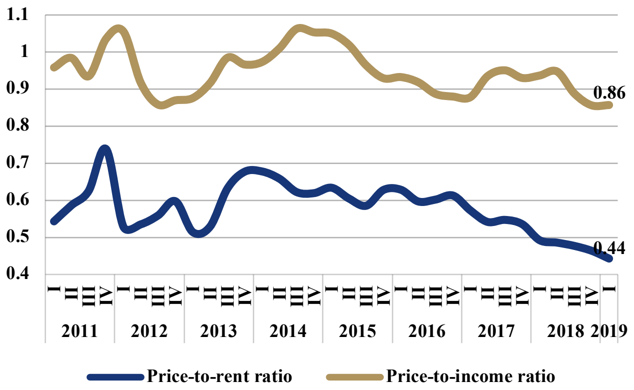
The housing market remained stable in the reporting quarter.



Source: NSO, Tenkhleg Zuuch

Figure III.2.4.2

The price-to-income ratio declined due to improvements in household average income.



Source: NSO, Bank of Mongolia

Table III.2.4.1

Real estate sector indicators

		2018Q4	2019Q1
Change in price of housing, %			
NSO	*q-o-q*	0.0	0.1
	y-o-y	0.0	0.1
Tenkhleg Zuuch	*q-o-q*	0.5	0.0
	y-o-y	4.9	4.1
Change in rental price, %	*q-o-q*	3.7	0.0
	y-o-y	8.6	9.4
Price-to-income ratio		0.48	0.44
Price-to-rent ratio		0.86	0.86

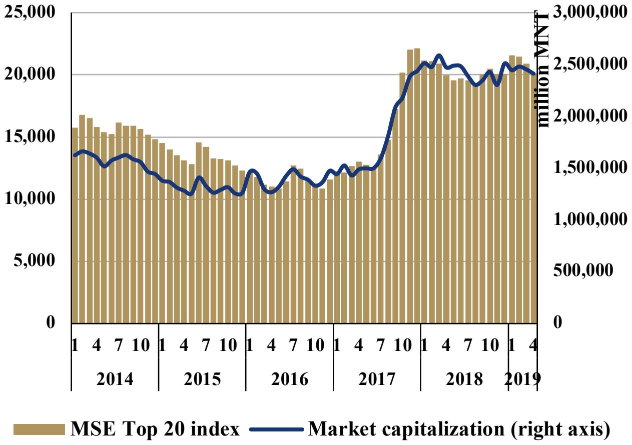
Source: NSO, Tenkhleg Zuuch, Bank of Mongolia and "Mandal Daatgal", the TOP-20 index climbed up by 7.5 percent month-on-month in January, however, it is on a declining trend since February (Figure III.2.4.3).

As several companies including "Tumen Shuvuut" and "Ard Credit NBFI" have successfully launched their IPOs, the market sentiment and activities improved in February and March of 2019. Nevertheless, the total trading value reached 67.5 billion MNT in the reporting quarter, which is a 73.5 and 51.4 percent lower value from previous year and previous quarter, respectively. Consequently, the market turnover ratio dropped by 3.1 percentage point from the previous quarter, reaching 2.7 percent. Although a drop in the turnover ratio is common in the first quarters of a year, it is 3.5 times smaller than the historical average and implies weaker investor sentiment at the market (Figure III.2.4.4).

The portfolio investments made by nonresidents to the Mongolian Stock Exchange reached 21.5 million USD in the reporting quarter, which is a 4.2 percent decline quarter-on-quarter or 21.8 percent decline year-over-year. On the other hand, foreign direct investments made by nonresidents to local entities have increased by 7.3 percent quarter-on-quarter or 9.4 percent year-over-year (Figure III.2.4.5).

Figure III.2.4.3

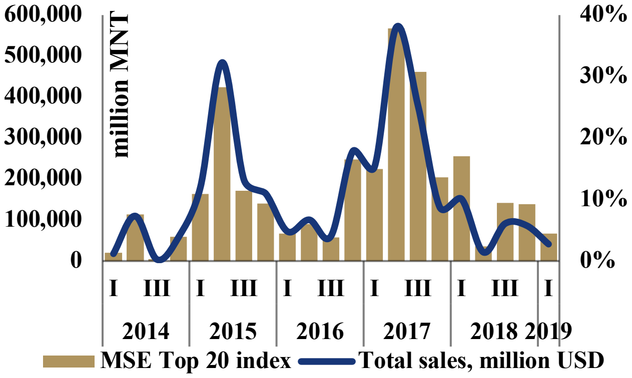
Market capitalization is showing tendency to decline towards the end of the reporting quarter.



Source: Mongolian Stock Exchange

Figure III.2.4.4

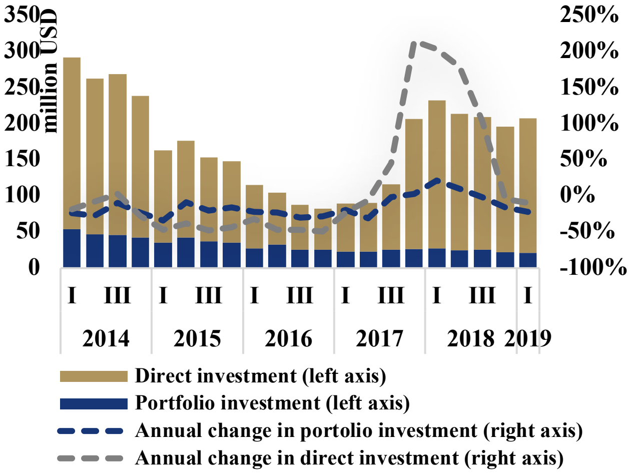
The stock market activities are subdued.



Source: NSO, Bank of Mongolia

Figure III.2.4.5

Portfolio investments made by non-residents continued to decline.



Source:Mongolian Central Securities Depository

III.3 The consolidated budget and sovereign debt

The consolidated budget: According to the budget approved by the Parliament of Mongolia for 2019, the equilibrated budget revenue is expected to increase by 440 billion MNT and the budget deficit to widen by 2367 billion MNT from 2018 (Table III.3.1). As a result, the fiscal stance is expected to loosen by 3.8 percentage point in 2019 (Figure III.3.1).

The Ministry of Finance expects the equilibrated revenue to be supported by the VAT and excise taxes in 2019. In particular, i) the return and bonus scheme for the 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 the 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. Spending on wage, pension, and other social transfers is expected to increase by 470 billion MNT.

Total equilibrated revenue: In the first 4 months of the year, the tax revenue increased and generated 91.2 percent of the total equilibrated revenue. Compared to the same period of last year, it is an expansion of 635 billion MNT (28.6 percent). In particular, the income tax revenue, social insurance collection, the VAT revenue, excise tax on imported items and royalties expanded by 229, 166, 56.2, 31.5 and 33.9 billion MNT, respectively.

Total expenditure and net credit:

In the first 4 months of 2019, although 76.7 percent of scheduled budget expenditure was disbursed, it is still a large amount compared to previous years. Total spending on goods and services, subsidies and transfers, and capital, which comprise over 90 percent of total budget expenditure, has increased by 20 percent from previous year. Such expansion can be attributed to

Table III.3.1

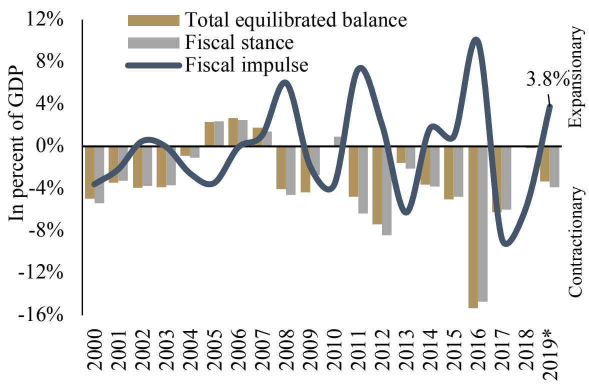
Fiscal indicators

billion MNT	2018	2019	2019.04	
	actual	approv.	actual	%
Total revenue	**10063**	**11066**	**3507**	**102.5**
Future heritage fund	621	1069	353	106.1
Stabilization fund	207	322	22	20.4
Equilibrated revenue	**9235**	**9676**	**3132**	**105.0**
Tax revenue	8207	8566	2858	106.9
Import tax revenue	2628	2832	874	101.8
VAT	1412	1539	463	100.8
Customs duty	682	743	220	100.4
Excise tax	534	550	191	106.2
Income tax	2086	1992	809	110.6
Social security collection	1621	1718	608	100.3
Tax on domestic sales	1170	1340	423	107.1
VAT return	-114	-258	-177	118.1
Other tax income	815	942	322	105.0
Non-tax revenue	1028	1110	274	88.8
Total expenditure	**9223**	**11590**	**2845**	**76.7**
Primary expenditure	8176	10724	2596	75.9
Current expenditure minus inter	6301	7365	2228	80.9
Capital expenditure	1608	3215	313	43.2
Net credit	267	144	54	-98.5
Interest expenditure	1047	866	250	87.2
Total equilibrated balance	**12**	**-1914**	**287**	
in percent of GDP	0.0%	-5.4%	0.8%	
Primary balance	1059	-1049	536	
in percent of GDP	3.2%	-3.0%	1.5%	

Source: Ministry of Finance, Bank of Mongolia

Figure III.3.1

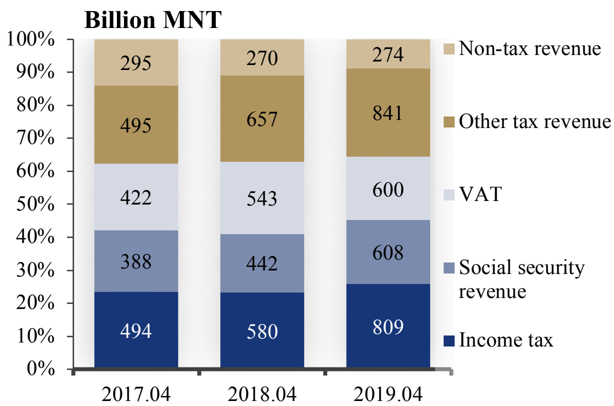
The fiscal stance and fiscal impulse



Source: Bank of Mongolia

Figure III.3.2

Structure of the budget revenue



Source: Ministry of Finance

increased fiscal investments, hike in public sector wages and greater disbursement of social welfare spending. Interest payments, which had exceeded 1 trillion MNT in the past 2 years, is expected to diminish to 900 billion MNT and the total interest payments in the first 4 months of the year were 22 percent smaller from the same period of previous year.

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

In previous year, 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).

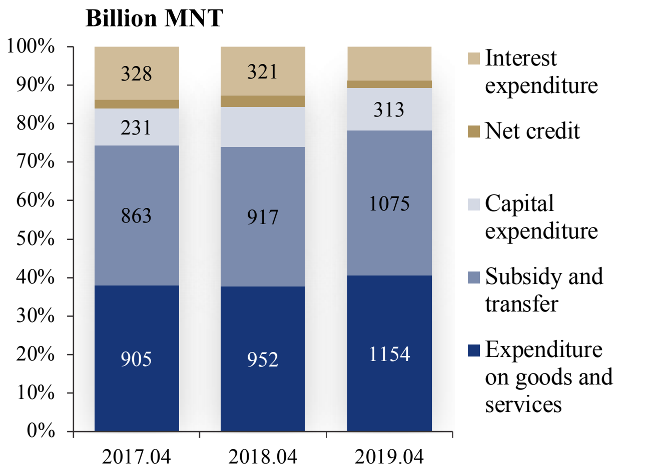
In 2019, the government is expected to issue new domestic debt worth 968 billion MNT and external debt worth 1676 billion MNT through project loans and program loans. Thus the ratio of *newly issued debt-to-debt repayment* is likely to pick up.

Present value of government debt:

According to the budget approved by the Parliament, the present value of government debt is set to be within legal boundaries and drop below 50 percent of GDP, during 2019-2020 (Table III.3.2). Moreover, debt service payments as a share of budget revenue has been falling since 2016 and is likely to drop below 10 percent in 2019.

Figure III.3.3

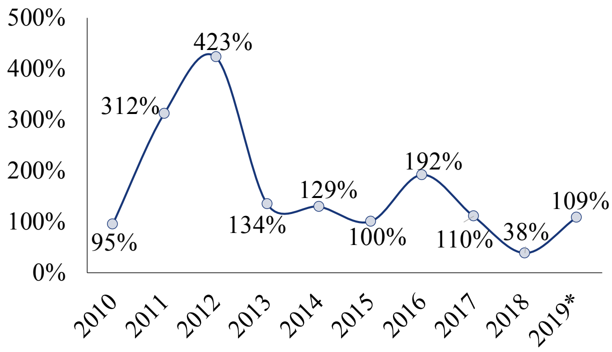
Structure of the budget expenditure



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	actual	approv.	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, Bank of Mongolia

IV. EXTERNAL CONDITIONS OF THE ECONOMY

IV.1 Assumptions regarding external conditions[22]

Growth forecast of Chinese economy is not changed, that of Russian economy is revised up and that of the Euro area is revised down for 2019. Prices of copper, coal, and iron ore are revised down from previous projections, while prices of gold and crude oil are improved.

External demand[23] outlook for 2019-2020 remains unchanged. As published in external sources, economic growth forecast of Chinese economy remains unchanged at 6.2 percent in 2019, that of Russia is revised up from 1.5 to 1.7 percent, and that of the Euro area is revised down from 1.4 to 1.3 percent.

Chinese economic growth reached 6.4 percent year-over-year in the first quarter of 2019, which is consistent with previous expectations. It was mainly supported by 8.3 percent growth in retail trade, 6.3 percent growth in investments for real estates and 8.3 percent growth in industrial output. Going forward, the Chinese authorities are expected to implement policies to rebalance the growth, since it is expected to slow down due to the ongoing trade conflict with the US and risks accumulated in the financial market.

While fiscal and monetary policies are expected to loosen to support economic growth in 2019-20, these policies cannot last long as the policy room is limited in the long run.

The 11th trade discussion among the US and Chinese officials took place in May 2019, during which a trade agreement was anticipated. However, the US President Donald Trump's announcement regarding the trade talks conclusion with no agreement has created volatility at the market.

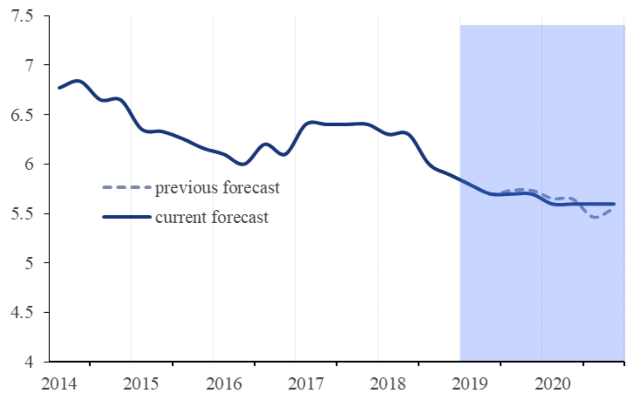
Table IV.1.1
Change in key judgments of external environment

Previous forecast of 2019	Current forecast of 2019
External demand	**Unchanged**
China growth forecast remains unchanged while the US-China trade discussion continues. Growth in the Euro area is revised down marginally.	China growth forecast remains unchanged but risks escalated with the US-China trade dispute. Growth in Russia is revised up slightly while the growth in Euro area is revised down marginally.
Terms of Trade	**Revised down**
Downward trends in copper, coal, iron ore. Prices of gold and oil have a tendency to bounce back.	Price outlooks of copper, coal, and iron ore are deteriorated owing to elevation of the US-China trade dispute. Prices of gold and crude oil are assumed to remain stable in the baseline projection.
Foreign interest rate	**Revised down**
The Fed is expected to hike Fed funds rate once in 2019.	The Fed is expected to lower Fed funds rate once in 2019.
Global Inflation	**Revised down**
The growth in trading partner countries fell below the expectations, Foreign inflation is likely to fall due to Geopolitical issues in China and the Euro Area, Sanctions on Russia, and a decline observed in oil prices.	The growth in trading partner countries remains below the expectations, Foreign inflation is likely to fall due to Geopolitical issues in China and the Euro Area, Sanctions on Russia, and a decline observed in oil prices. However, food inflation in China accelerated.

Source:Bank of Mongolia

Figure IV.1.1

Forecast of external demand, year-over-year percent



Source: Bloomberg, the EIU

[22]Forecasts of economic growth and inflation in main trading partners and the relevant explanations were compiled from June 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.

[23]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)

To ease the impact of the ongoing trade dispute, the Chinese authorities cut reserve requirement ratio 5 times since the beginning of 2018. The reserve requirement ratio now stands at 13.5 percent for large banks and 11.5 percent for small banks. The statement of the Central Bank Governor, pointing that there were some room to cut reserve requirement ratios differently for small and large banks, created an expectation of a further cut in July 2019. Moreover, the Chinese authorities plan to carry out the fiscal stimulus by reducing tax and fees on enterprises by nearly 2 trillion RMB and by issuing local government bonds within the fiscal framework. In the reporting period, new loans issued by the banks reached 5.8 trillion RMB or 865.6 billion USD, while 717.2 billion RMB was raised by the special local government bonds which is 9 times as larger than previous year. The Chinese government projects GDP growth to be 6.0-6.5 percent and inflation to be 2.9 percent in 2019. The US and Chinese presidents are expected to continue the trade discussions during the G-20 Summit and the market expects potential positive outcome from the trade discussions.

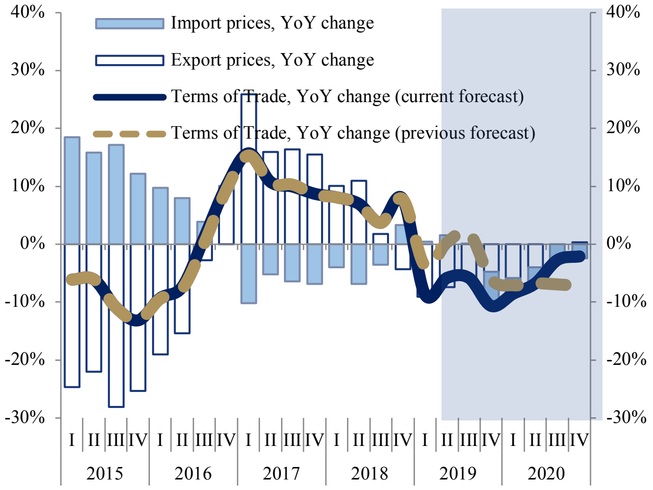
Growth in Russia fell below expectations, reaching 0.5 percent in the first quarter of 2019. The sluggish growth was mainly attributed to an increase in VAT rates starting from the beginning of 2019 in line with the government's tax policy strategy throughout 2019-24. In particular, due to higher VAT rates, private consumption grew by 1.2 percent in the first quarter of 2019 (was 2.6 percent in the previous quarter), retail sales grew by 1.8 percent (was 2.8 percent in the previous quarter), construction sector grew by 0.2 percent (was 4.1 percent in the previous quarter), and agricultural sector grew by 1.1 percent in the first quarter of 2019 (was 4.1 percent in the previous quarter). Nevertheless, growth forecast for the Russian economy is revised up from 1.5 percent to 1.7 percent for 2019, according to the analysts of Bloomberg and the EIU. Similarly, consumption growth outlook is updated from 1.7 to 2.5 percent in 2019-20. In the second half of 2019, projects under the national strategic development plan, aimed at improving the infrastructure and services, are likely to intensify and support the growth. Growth forecast for 2020 is be kept at 1.7 percent, 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. The Central Bank of Russia cut its key rate by 0.25 percentage points to 7.5 percent per annum in June 2019 and the Bank revised its 2019 GDP growth forecast down to the range of 1.0-1.5 percent, and inflation forecast in the range of 4.2-4.7 percent. The decision considered an increased uncertainty and weaker outlook of global trade and growth due to the reemergence of trade dispute and concern regarding the potential impact of slower global growth on the Russian economy. The analysts emphasized such policy decision was consistent with the IMF recommendations in May 2019. The IMF analysts expect Russian economy to grow by 1.6 percent in 2019 and 1.7 percent in 2020, due to volatilities in oil prices.

The Euro area economy expanded by 1.2 percent in the first quarter of 2019, which was in line with previous expectation. The growth was mainly supported by household consumption, government consumption and exports. Although the unconventional monetary policy of the ECB ("since the regional growth outlook remains below expectations, the ECB will use all plausible policy tools, including asset purchase program, to achieve the objective if necessary" stated by the president of the ECB in June 2019) and relatively loose fiscal stance are expected to continue supporting domestic demand, growth in the Euro area is expected to slow down further due to the escalations of trade conflict and slower economic growth of its main trading partners. In particular, the growth outlook was revised down by 0.1 percentage point to 1.3 percent for 2019 and unchanged at 1.5 percent for 2020. Moreover, the business sentiment weakens as the Brexit issue remains uncertain, the ECB kept its policy rate unchanged and its guidance for steady interest rate signals rather modest growth in the Euro area.

Terms of trade projection is revised down till the second quarter of 2020 and it improves starting the third quarter of 2020, compared to the previous forecast. In the first quarter of 2019, export prices and terms of trade have weakened below expectations, following the decline in commodity prices at the global market due to increased uncertainties in the external environment and resurgence of trade tensions.
In 2019, export prices are expected to fall as prices of copper, coal, and iron ore are on a declining trend, while price of gold would be higher. In 2020, however, price of iron ore is expected to remain unchanged and prices of gold and crude oil (owing to supply shortages in the 3rd quarter of 2020) are expected to rise and thus support the terms of trade.

Figure IV.1.2

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

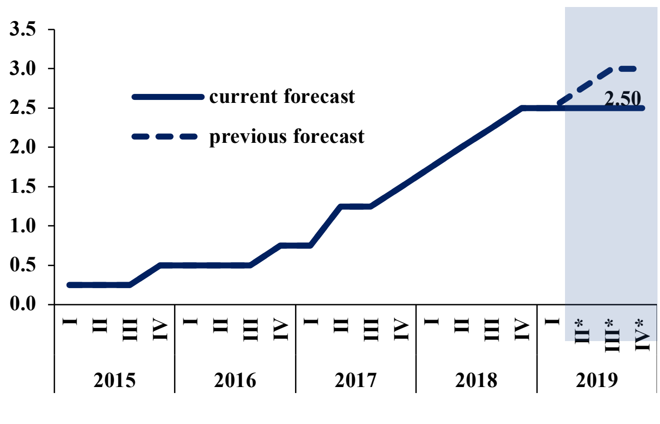


Source: Bank of Mongolia

Foreign interest rate: The US employment fell below expectations in May 2019 and inflation has been running below the objective. Considering the uncertainties regarding rising trade tensions, the Fed's FOMC stated that it would use necessary tools to sustain the expansion during the press conference on June 19, 2019. The market sentiment has shifted toward a cut in Fed funds rate opposed to a hike, since the growth outlook in the US is unlikely to improve in 2019 and inflation is projected to fall.

Figure IV.1.3

Federal funds rate, percent



Source: Bloomberg

Global inflation projection is revised down, as the US-China trade conflict remains unresolved, economic growth in main trading partner countries fell below market expectations, global growth is expected to slow down and the price of oil is expected to remain on a downward trend at the international market as the stock of US shell oil increased. Inflation in the Euro area is revised down to 1.3-1.4 percent in 2019-20 considering a depreciation pressure of euro due to uncertainties regarding the Brexit debate and the trade conflict. The People's Bank of China (PBOC) lowered its reserve requirement ratio to support domestic demand and mitigate the impact of the trade conflict. While the growth of domestic demand is not likely to accelerate, the food price is expected to increase throughout the year due to the African swine flu, pushing inflation outlook in China up to 2.2-2.9 percent in 2019-20.

Inflation projection in Russia is revised down from 4.9 to 4.0 percent at the end of 2019-20, according to the analysts of Bloomberg and the EIU. The projection considers factors such as lower average price of oil and expectations of potential tightening of the US sanctions on Russia. The Bank of Russia loosened its monetary policy stance, by cutting its key rate down to 7.5 percent during the Board of Director's monetary policy meeting in June 2019. According to the Bank of Russia estimates, economic growth is expected to be 1.0-1.5 percent in 2019, inflation to be 4.2-4.7 percent which is close to the target of 4 percent, exchange rate of ruble to depreciate slightly to 66.5 RUB/USD. Despite the strong economic performance that exceeded expectations, the US headline inflation was 1.7 percent, below the Fed target of 2 percent, in the first quarter of 2019. The US inflation is expected to be around 1.5-1.9 percent in 2019-20, according to the Fed estimates, as growth of private consumption and investment is expected to slow down with the US-China trade conflict and dissipating impact of previous tax cut.

Uncertainties in the external conditions

- As the US-China trade tensions have reemerged, the risk of additional import tariffs, that could come into effect starting the second half of 2019, looms. Uncertainty remains on whether the two countries could reach an agreement. The USA has threatened to set 25 percent tariffs on additional US$325 billion worth of Chinese goods. In return, China has been signaling that it may restrict the export of rare-earth metals to the United States[24]. Moreover, the US banned Chinese major technology company Huawei's activity while China plans to blacklist the US firms. These threats are increasing the risk of deeper trade dispute.
- The adverse impact of the recent increase in import tariffs remains uncertain. The import tariffs could hit China's growth and consequently the commodity prices. In addition, the impact of such tariffs on capital flows to emerging and developing economies remains unclear.
- Oil price at the global market remains prone to severe fluctuations. The OPEC, its allies, and Russia have postponed their next meeting to July 2019 after the G20 summit. If the trade tension worsens, it could lead to slower global growth and lower oil prices, then the OPEC members are likely to further limit production. Thererefore, there is a potential risk of supply shortage at the global oil market following the impending decision of the upcoming OPEC meeting and the US sanctions on Iran and Venezuela.
- The expected departure of the United Kingdom and Ireland from the EU on October 31, 2019 and uncertainties regarding the Brexit deal could slow down growth in the region and greater risk.

[24] China supplied about 80 percent of rare-earth metals imported by the United States in 2014-2017.

IV.2 Prices of Mongolia's main exporting commodities at the global market

Commodity prices dropped in the reporting quarter due to a weakening outlook of China's growth projections and increased tension regarding the trade conflict between the US and China.

Copper: Average price of a ton of copper was 6300 USD in February 2019 and fell to 6039 USD in May 2019. The recent downturn was due to the heightened trade tensions following the announcement that the US President Donald Trump and Chinese President Xi Jinping have failed to reach an agreement during the meeting in May 2019. In the coming quarters, demand for copper would depend on China's economic growth, macroeconomic policy, and the international geopolitics. The copper price is assumed to remain modest in the following periods, as the growth of industrial production in China, main consumer of copper, slowed down in the first months of 2019. There is a risk of further deterioration in the copper price outlook if the trade tension remains elevated. Consequently, the Bloomberg and the IMF analysts revised copper price projections down to 6017 USD per ton on average for 2019. 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.

Gold: Average price of an ounce of gold was at 1313 USD in February 2019 and fell to 1279 USD in May 2019. The price drop was mainly due to temporary halt in the trade tension between the US and China during March-May 2019 and the delay of the "Brexit with no deal" risk by 6 months. However, starting mid-May, the demand for gold (safe haven) has increased and led to higher prices as the trade conflict escalated, expectations of rising Fed funds rate weakened, demand projection for gold jewelry increased in 2019-2020, and the global growth outlook weakened. In particular, the price of an ounce of gold exceeded 1400 USD in June 2019. According to an update in late May 2019 update, the analysts of Bloomberg revised gold price projections up to 1317 USD in 2019. The increasing geopolitical risks with Iran is another factor that pushes gold prices up.

Thermal coal: Average price of thermal coal was 81 USD per ton in February 2019 and dropped to 70 USD in May 2019. The thermal coal price declined mainly due to a 15 percent year-over-year increase of China's thermal coal stocks at its major port warehouses, reaching 16 million tons in May 2019. Expectation of Chinese authorities to cut coal production and continue to tighten customs clearance throughout the year is leading to lower demand and price of thermal coal. China's thermal coal production is expected to increase by 3 percent, reaching 465 million tons, while demand for thermal coal to be around 523 million tons and imports to reach 61 million tons in 2019, resulting in a small excess in supply. Price of thermal coal is not likely to increase in 2019 as the economic growth in developing countries weakens and Australia's coal mining is expected to increase by 2 percent reaching 254 million tons, since the extension projects at Australia's major coal mines are completed. The Bloomberg and the IMF analysts revised thermal coal price projections down to 80 USD in 2019.

Iron ore: Average price of iron ore reached 85 USD per ton in February 2019 and increased to 91 USD per ton in May 2019. It was associated with a supply shortage due to a dam collapse at the Vale iron ore mine in Brazil and a transportation delay followed by the train crash in Australia. Furthermore, slowdown in Chinese growth and 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 may negatively affect the demand and price of iron ore. The price of iron ore is not likely to rise and iron ore production is expected to increase by 17-27 million tons in 2019 as the extension works at the Vale mine and Rio mine in Brazil completes. Thus, the analysts of Bloomberg and the IMF projects average price of iron ore at 56 USD per ton for 2019.

Crude oil: A barrel of Brent oil was sold at 65 USD on average in February 2019 and rose to 69 USD in May 2019. The price remains elevated due to potential risk of adverse supply shocks related to the US sanctions on oil exporters, Iran and Venezuela, and rising tensions due to the attack on two oil tankers near Strait of Hormuz where 19 percent of the global oil supply passes through. The price outlook for crude oil is revised up, by the analysts of Bloomberg and the IMF, to be 68 USD per barrel due to the following considerations. A potential decision to continue its limit on daily productions at 1.2 million barrels by the OPEC and non-OPEC countries, during its meeting scheduled in July 2019, is expected. In addition, productions in Venezuela, Iran, and Libia as opposed to the US, are expected to decline. Moreover, according to the American Petroleum Institute, the US crude oil stockpiles rose sharply to a record since 2017, as demand for oil remained subdued in the second quarter of 2019.

IV. 3 Balance of Payments

The balance of payments was in a surplus of 219.6 million USD (1.7 percent of GDP[25]) in the first quarter of 2019, which is a narrowing of 114.4 million USD quarter-over-quarter but a widening of 261.8 million USD year-over-year. The current account deficit narrowed on the back of increasing surplus in goods balance. On the other hand, bond issuance in the private sector contributed to a higher surplus in financial accounts and the overall balance of payments (Figure IV.3.1).

Current account deficit declined by 11 percent year-over-year to 393 million USD (3.0 percent of GDP) in first quarter of 2019. Despite a large, persistent deficit in services and income accounts, the current account deficit narrowed as a consequence of greater surplus in the goods balance, where exports continued to grow and growth of imports decelerated. Export revenue grew by 19.5 percent year-over-year in the reporting quarter as a result of robust growth in coal, gold, copper, iron ore, fluorite, leucite, nepheline, and canned meat products, while crude oil exports had negative contributions (Table IV.3.2).

Although growth of imports had reached 35 percent year-over-year in 2018, it has been decelerating year-to-date and reached 13.7 percent at the end of first quarter of 2019. Expansion in imports was mainly driven by imports of fuels, aircraft, capital goods related to FDIs, and passenger vehicles (Table IV.3.2). On the other hand, imports of consumer goods excluding passenger vehicles did not grow and imports of wheat declined as the base year effect related to crop losses dissipated.

Deficit in services account widened by 29.4 million USD (5.4 percent year-over-year) mainly driven by an increase in financial services expenditure (mostly services related

Table IV.3.1

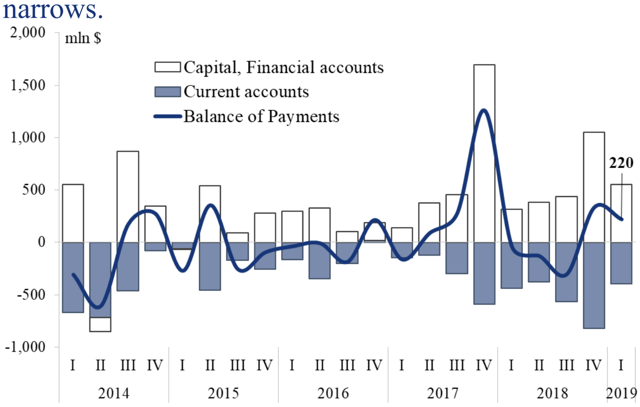
Changes in key assumptions of BOP projection (2019)

	Previous forecast of 2019	Current forecast of 2019
External demand		**Revised up**
	Export volumes are expected to expand, in coal, meat, and meat products. The gold content of copper concentrate is not going to increase. The price outlooks of copper, crude oil and iron ore are deteriorated.	Export volumes are expected to expand, mainly in coal, iron ore, and cashmere. The price outlooks of copper, coal, and iron ore are deteriorated.
Imports		**Unchanged**
	Imports of capital goods and construction materials would increase in line with expansion of fiscal investment. Imports of capital goods and diesel were revised with 2019Q1 performance.	Projection on mining sector activity is now revised up. Import of diesel is expected to increase in line with coal exports. Import growth of consumer goods except passenger cars decelerated at a faster pace.
Services		**Revised down**
	Deficit in freight transportation to widen as coal exports increase. Income of passenger transportation to increase as new airport starts its activities. Services expenditure of education, travel, businesses are expected to remain elevated in line with economic growth.	Deficit in services account was inflated by 530 million USD in 2018 according to an annual revision. Despite the decline in cost of coal transportation, outflow is expected to remain lofty. The starting date of the new airport was postponed. Services expenditure of education, financial, businesses, trade, and constructions are expected to remain elevated.
FDI		**Revised up marginally**
	FDI is to increase: Investor's loan repayment is expected to decrease.	Non-OT FDI has been revised up marginally.
Portfolio investments		**Mostly unchanged**
	MIK issued 300 million USD bond at the international market. Other than that, no new bond will be issued, no principal repayments of bonds are expected.	MIK issued 300 million USD bond. ER issued 440 million USD bond and refinanced the part of its previous debt.
Other investments		**Revised down**
		Currency and deposits accounts was revised down as net outflow of the account were larger than expected.

Source: Bank of Mongolia

Figure IV.3.1

Balance of payments improved as current account deficit narrows.



Source: Bank of Mongolia

to Oyu Tolgoi) of 50 million USD (Figure IV.3.3). On the other hand, deficit in construction services narrowed by 34 million USD.

The income account was in deficit of 297.4 million USD in the first quarter of 2019, which is an expansion of 84.5 million USD or 39.6 percent year-over-year. This was due to increasing outflows related to FDI income, which expanded by 81 percent or 107 million USD from the previous year to 238.6 million USD on the back of increased profitability in banks and corporates. Particularly, outflow of reinvestment earnings increased by 74.3 million USD year-over-year to reach 85.9 million USD and the interest payment on investors' loans increased by 46.4 million USD year-over-year to reach 114.5 million USD.

Income account, mainly composed of debt service and dividend payments to foreign shareholders, continues to impose substantial pressure on the overall balance of payment. The deficit in primary income account constitutes 76 percent of current account deficit in the reporting quarter.

The financial account was in a surplus of 530 million USD in the first quarter of 2019, which is a 78 percent or 232.6 million USD increase, year-over-year. The widening is mainly attributed to the additional net flow of 502 million USD year-over-year in portfolio investments. In particular, "MIC HFC" LLC, a wholly-owned subsidiary of MSE listed 'MIC HOLDING' JSC, issued bonds worth 300 million USD at the international market in the first quarter of 2019, while the government of Mongolia had paid 130 million USD for the principle on remaining Chinggis bond in same period of last year. The newly issued bond's annual coupon is 9.75 percent with a tenor of 3 years. Consequently, the portfolio account had a net inflow of 340 million USD.

Figure IV.3.2

Larger trade surplus resulted into a narrowed current account deficit (YoY).

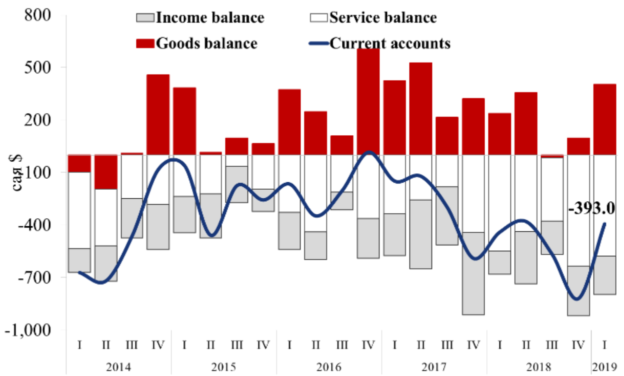


Table IV.3.2

Growth in export revenue is mainly attributed to greater revenue from coal, gold, copper concentrates, and iron ore.

	2018 I	2019 I	Y-o-Y	Contri-bution %
Total Exports /mln $/	**1,482**	**1,772**	**19.5%**	**19.5%**
Coal	509	642	26%	8.9%
Gold	124	196	-	4.8%
Copper concentrates	463	504	9%	2.8%
Iron ore	64	107	67%	2.9%
Fluorite, leucite, nepheline	25	41	62%	1.0%
Meat, meat products	24	31	26%	0.4%
Crude oil	101	88	-13%	-0.9%
Other	273	253	-7%	-1.4%

Growth of imports have decelerated.

	2018 I	2019 I	Y-o-Y	Contri-bution %
Total imports /mln $/	**1,130**	**1,286**	**13.7%**	**13.7%**
Capital goods	400	519	30%	10.5%
Of which: Aircrafts	0	54	-	4.8%
Consumer goods	322	351	9%	2.6%
Of which: Passenger cars	91	126	39%	3.1%
Fuels	231	267	16%	3.2%
Industrial inputs	176	147	-16%	-2.5%
Others	2	2	-29%	0%

[25] 4-quarter cumulative GDP.

On the other hand, FDI, external loans, and change in foreign assets held by banks and entities had negative impact on overall financial accounts. Specifically, compared to previous year, a net inflow of trade loans declined by 154.2 million USD, that of external loan declined by 44.3 million USD, FDI dropped by 12.1 million USD, and the external assets held by banks and entities increased by 59.1 million USD.

Moreover, the external loan disbursements under the Extended Fund Facility Program to the Government of Mongolia was 8 million USD in the reporting quarter as opposed to 31 million USD in first quarter of previous year, causing a decline in external loan accounts.

Gross international reserves (GIR) stands at 3664.2 million USD at the end of March 2019, and 3759.0 million USD at the end of April 2019. It is an adequate level to cover 9.2 months of imports, which is calculated from the average of the last three months' import payments in hard currency (Figure IV.3.6). A surplus in the balance of payments have supported the reserve accumulation.

Terms of Trade improved by 13.8 percent year-over-year, while it worsened by 2 percent from previous month in April 2019. The monthly worsening was mainly due to a 12-percent increase in import prices driven by higher prices of imported capital goods and imported fuels despite a 10 percent improvement in export prices.

The price of exports increased by 12.3 percent year-over-year in April 2019. In particular, the customs price of copper concentrate increased by 13 percent[26] (with higher gold contents in Oyu Tolgoi copper concentrate), customs prices of coal increased by 10 percent (with larger share of coking coal in the total coal

Figure IV.3.3

Services account deficit is widened (YoY)

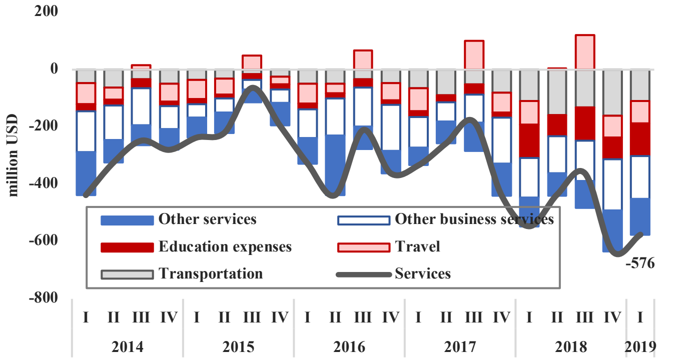
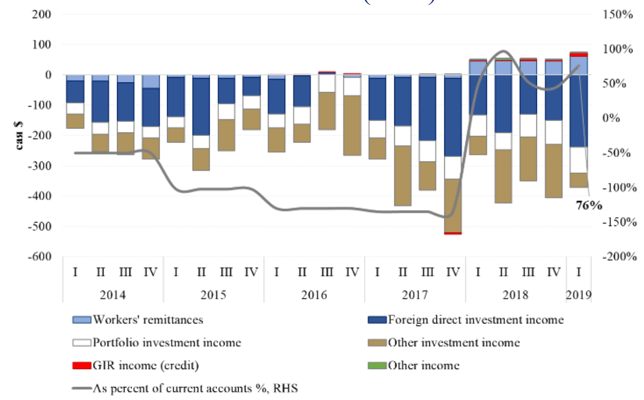


Figure IV.3.4

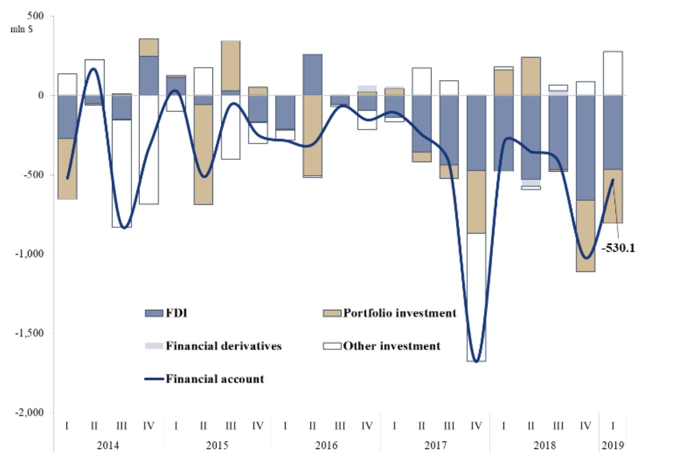
Income account remains in deficit (YoY).



Source: Bank of Mongolia

Figure IV.3.5

Financial account surplus increased (YoY).



Source: Bank of Mongolia

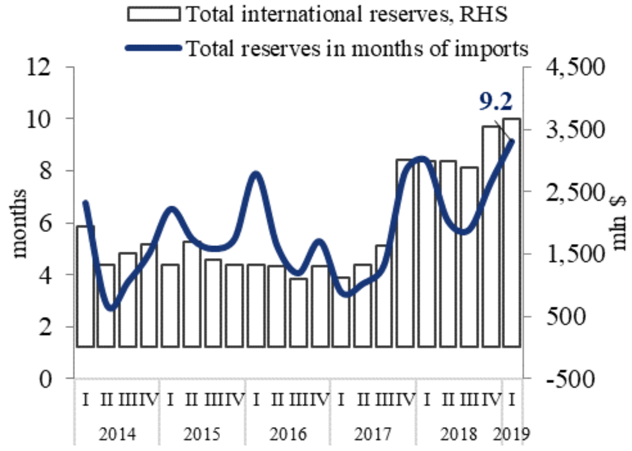
[26] If we exclude the positive impact of improvements in the gold content in the Oyu Tolgoi's copper concentrates, the copper price would have negative contribution to the overall terms of trade consistent with lower price at the global commodity market.

exports), customs price of iron ore increased by 42 percent (due to rise in iron ore price at the commodity market), and customs price of fluorite, leucite, and nepheline increased by 9 percent year-over-year. Conversely, the customs prices of crude oil, zinc, meat, and canned meat products declined by 3 percent, 7.2 percent, 13 percent, and 9 percent year-over-year, respectively.

Price of imports declined by 1.3 percent year-over-year in April 2019, mainly due to stable price of imported consumer goods and lower prices of imported capital goods and fuel.

Figure IV.3.6

Gross international reserve reached 3.6 trillion USD.



Source:Банк of Mongolia

THE BANK OF MONGOLIA