THE BANK
OF MONGOLIA

INFLATION REPORT

2019
SEP

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 wealth 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, since 2018 the Bank of Mongolia started to implement 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 the 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 on September 17, 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

Fiscal stance and domestic demand are expected to support economic growth. However, due to weakening external demand, downward trend in commodity prices, and deceleration of foreign direct investments economic growth is expected to slow down in the upcoming quarters. In relation to economic recovery, demand-driven inflationary pressure is expected to increase gradually this year and decelerate starting next year. Nevertheless, according to the baseline forecast inflation is expected to stabilize around the central bank's target in 2019. In case of 2020, inflation is expected to decline gradually, however, supply related factors are likely to create greater fluctuations.

Supply-driven factors of inflation are not likely to subside in the short term. Annual inflation reached 8.9 percent nationwide in August 2019. Inflation in Ulaanbaatar is 10.5 percent, of which 4.2 percentage point is attributed to change in prices of meat, gasoline, solid fuel, administered prices, and services. Shortage of meat supply resulted in sudden jump in domestic price of meat and it remained elevated through June and July. Consequently, change in price of meat alone explains 2.75 percentage point of annual headline inflation in July. This year, exporting demand for meat and meat products to China is expected to be significant and consequently domestic price of meat would depend greatly on management of domestic meat supply in light of the rising external demand. In case of gasoline, pressure from the global price of oil products remains limited. However, the extent of timing required to normalize oil production in Saudi Arabia following the oil attack is a significant source of uncertainty in the oil market. In case of solid fuel, its price contribution to headline inflation is not expected to increase as the relevant authorities are managing the price and supply of processed coal. Food inflation is forecasted to decline in the second half of 2020, since price of food items at the global market is expected to fall next year and we assume no disruption to domestic supply of meat.

In the reporting quarter, mining sector growth exceeded previous forecast as production of iron ore and crude oil, and content of gold in copper concentrate were greater than previous expectations. The non-mining sector growth on the other hand, fell short of previous expectations and consequently growth projections for 2019 and 2020 are revised down. Within the non-mining sector growth of construction, transportation, and manufacturing sectors were lower than previous expectations mainly due to underutilization of budget expenditures and sluggish activities of coal processing and transportation. In the forecasting horizon external demand is expected to weaken, terms of trade is likely to deteriorate, foreign direct investment is expected to decelerate, and thus adversely affect the mining production, its investments, and growth of non-mining sectors that are strongly related to the mining sector. In addition, investments to the Oyu Tolgoi underground project is expected to be lower than previously assumed and thus growth projections of related sectors are revised down.

Although the budget expenditure on goods and services and capital expenditure in the first 7 months of the year are lower than the scheduled amount, we expect the utilization rate of budget spending to accelerate and reach the level approved by the Parliament for 2019. Similarly, in 2020 we expect the fiscal expenditures to reach the level specified in the Medium Term Fiscal Framework Statement. As a result, fiscal stance is expected to loosen in 2019 and 2020 and support domestic investments and consumption. On the other hand, such expansion in fiscal capital expenditures would spur imports of machinery and equipment.

In case of the private sector, stabile growth of business loans is supporting domestic private investments. However, credit growth outlook is likely to depend on change in quality of loans issued for business purposes.

According to the baseline forecasts, economic growth is expected to remain relatively high in 2019 and slow down to its potential level in 2020. Risks and uncertainties of the baseline scenario include trade tension between major economies, risk of Mongolia falling into the “Grey list”, construction plan of Oyu Tolgoi’s underground project, and implementation of major projects including the railway construction.

Growth of money supply is mainly supported by credit growth in the banking system and expansion of foreign assets. Although growth of consumer loans is declining year-to-date as a result of macroprudential policy measures, since credit issued for individuals’ SMEs have accelerated and business loans are expanding at a stable rate, growth of total outstanding loans is stabilizing around 15-16 percent per annum.

In recent months, supply of newly constructed housing is increasing and leading to weaker growth in housing price and acceleration in rental price. Consequently, the price-to-rent ratio is declining and indicates limited risk of overheating in the housing market. In case of the stock market, investors’ sentiment has deteriorated and the market indicators have weakened in the reporting quarter.

Uncertainties are building in the external environment and the outlook for external demand remains weak. Authorities of the US and China have announced their decision to raise import tariffs on each other and consequently the trade tension is heating. Risk of lower growth in advanced economies remains significant. Although the terms of trade for Mongolia was supported by improvement in the price of iron ore from previous year and weaker price of oil, it deteriorated in the reporting quarter since price of coal and copper were lower than in previous year. Nevertheless, price projection of gold and iron ore are revised up in this report considering supply shortage of iron ore, uncertainties related to the trade tension, and the Federal Reserve’s actions.

The balance of payments recorded a surplus in the second quarter of 2019 on the back of greater export revenue, lower spending on imports, smaller deficit in services account, and increased inflow through portfolio investments. On the one hand, revenue from export of iron ore, cashmere, spar, leucite, and nepheline increased, while spending on imports of mining machineries, equipment, investment goods, and oil products has shrunk from previous year. Although the surplus in balance of payments was relatively high in the reporting quarter, net inflow of foreign direct investment was lower than previous year and payments for external debt service and dividends to foreign investors were significant.

I. INFLATION

The Bank of Mongolia's monetary policy is aimed at stabilizing inflation, measured by consumer price index, at around 8 percent during 2019-2020 and around 6 percent in the medium term. As of August 2019, inflation reached 8.9 percent nationwide and 10.5 percent in Ulaanbaatar. (Figure I.1).

Although economic growth is recovering and household income is increasing, demand-driven inflationary pressure remains stable.

Supply related factors have pushed prices of a few items and induced significant fluctuations in inflation. In particular, prices of meat, solid fuel, gasoline and administrated services explain significant portion of inflation in the past months. Due to rapid growth of meat price, combined contribution of these items accelerated to 40 percent or approximately 4.3 percentage point of the headline inflation in August (Figure I.3).

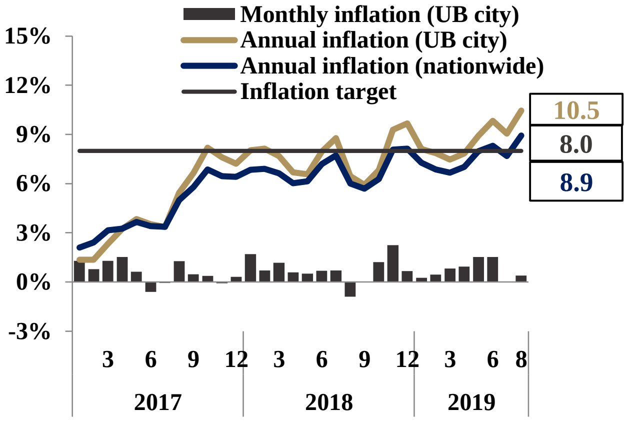
Due to disruption in domestic supply price of meat spiked in mid-May. Although it was expected to decline in mid-June following its seasonal pattern, price of meat remained stable. As a result, price of meat increased by 34.2 percent from previous year and thus contributed 3.0 percentage point of annual headline inflation.

Since the government decided to ban use of raw coal and initiated the processed coal program in May, price of solid fuel has been stable. As a result, its contribution to annual headline inflation remains unchanged at 0.9 percent.

At the global market price of crude oil had been declining since May and had reached 60 USD per barrel by July. Following such decline at the global market, domestic price of gasoline decreased by 40-50 MNT per liter in June and July. Consequently, its contribution to headline inflation decreased to 0.3 percentage point. In September however, due to a terrorist attack in

Figure I.1

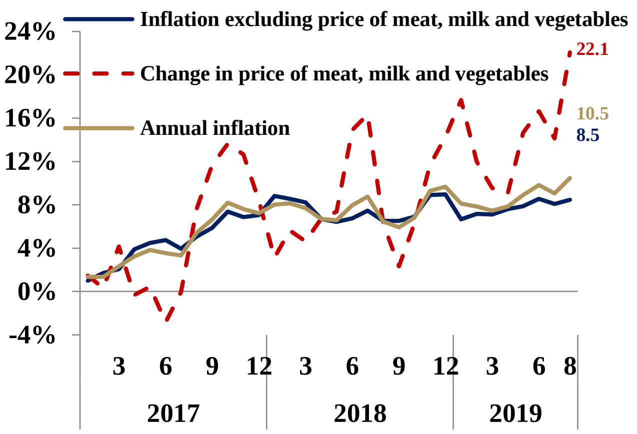
Inflation



Source: NSO

Figure I.2

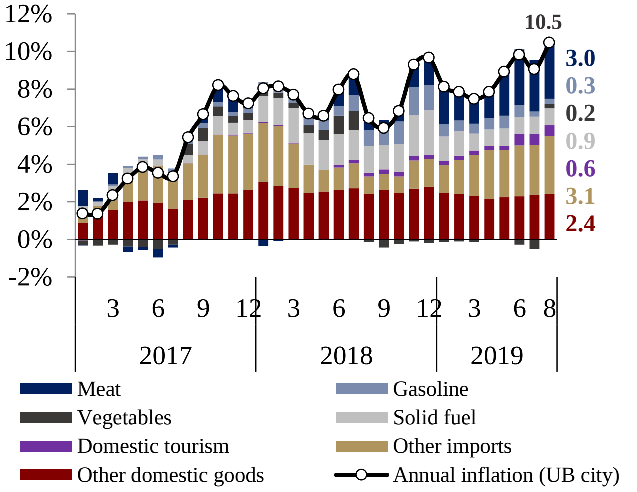
Headline and core inflation



Source: NSO, Bank of Mongolia

Figure I.3

Headline annual inflation in Ulaanbaatar, broken down by main items



Source: NSO, Bank of Mongolia

Saudi Arabia, price of a barrel of Brent oil increased by 10 percent, which may create pressure on domestic price of gasoline and headline inflation.

In the second quarter of 2019, inflation exceeded previous forecast by 0.5 percentage point, reaching 8.9 percent. Such discrepancy can be mainly attributed to rising prices of few items caused by supply factors and one-time effect. For instance, according to its seasonal trend price of meat was previously expected to decline towards mid-June and result in an annual growth of 16 percent. However, contrary to its seasonal trend price of meat did not decline from previous month and its annual growth reached 24.6 percent. Such discrepancy explains 0.4 percentage point of the headline inflation. Among the non-food items, price of domestic tourism services increased significantly in June, recording an annual growth of 56.8 percent. As a result, non-food inflation exceeded previous forecast by 0.1 percentage point.

Since inflation in the second quarter exceeded previous forecast and university tuition fees were raised for the school year of 2019-2020, inflation forecast for the end of 2019 is revised up. In 2019, fiscal stance is expected to loosen from previous year and thus create demand pressure on inflation. As a result, demand-driven inflation pressure is expected to increase gradually. Supply factors of inflation is likely to remain unchanged. In 2019 change in price of meat has not been consistent with its seasonal trend due to disruption in domestic supply and increased meat processing for export purposes. Hence it is creating inflationary pressure.

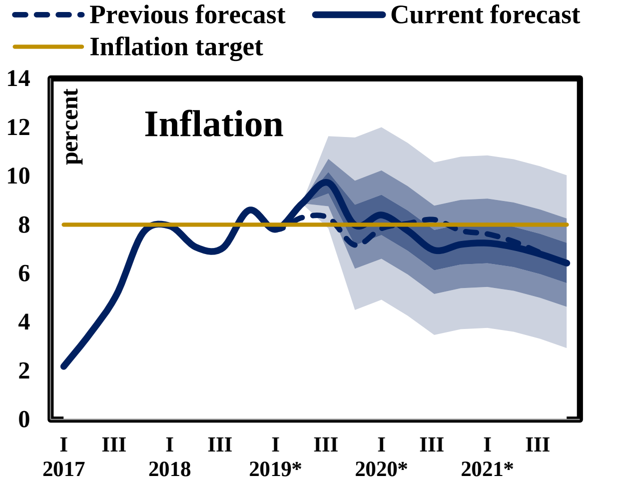
Table I.1 Change in inflation outlook

Assumptions on near term forecast of inflation	
Previous forecast 2019Q2-2020Q1	**Current forecast 2019Q3-2020Q2**
Price of meat	**Forecast is revised up**
Price of meat spiked in May due to supply disruptions. Considering this event forecast of meat price is revised up.	Price of meat spiked in May of 2019 and unlike its seasonal pattern it did not decline in June. Hence price forecast is revised up.
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.
Price of domestic goods	**Forecast is revised up**
Price of solid fuel declined in April and price of processed coal is not expected to change.	Price of processed coal to remain unchanged. Price of domestic tourism on the other hand increased significantly in June and consequently forecast of domestic goods is revised up.
Administered prices	**Forecast is revised up**
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 electricity and heating increased as planned. University tuition fees are raised in August.
Price of gasoline	**Forecast is revised down**
Following the global price of oil the domestic price of gasoline increased in April and May. Consequently, the price forecast is revised up.	Following the global price of oil the domestic price of gasoline declined in June and July. Demand related upside pressure on crude oil has diminished.

Source: Bank of Mongolia

Figure I.4

Inflation forecast



Source: Bank of Mongolia

Table I.2

Inflation forecast[1]

	2018	2019*	2020*
	actual	*forecast*	
Inflation, CPI[2]	8.6	7.2-8.8	6.4-8.0

Source: Bank of Mongolia

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

Since we continue to assume that the supply and price of processed coal would be managed by the relevant authorities, contribution of solid fuel price to overall headline inflation is expected to be close to the level in previous quarter. Slowing world economic growth and increasing reserve of crude oil in advanced economies are the main factors underlying deceleration of oil price at the global market. On the other hand, its price is likely to depend on the time required to normalize production of oil in Saudi Arabia following the oil attack and whether other suppliers, in particular the US, would fill the gap in supply.

In the upcoming year price of food items at the global market is expected to fall. In addition, if we assume no disruptions to domestic supply of meat, food inflation is forecasted to decline in the second half of 2020 and overall inflation to stabilize around the target level.

Uncertainties that may affect the inflation forecast:

- Potential shortage or oversupply of goods and services have significant implications on 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.
- China is in high demand for meat and meat products due to the swine flu and thus supports meat exports of Mongolia. In this regard, the government's regulation and action to manage meat exports and domestic supply are crucial factors for price of meat.
- Similar to previous election years, in 2020 if the fiscal stance loosens beyond the level specified in the Medium Term Fiscal Framework Statement, it would boost domestic demand and create demand-driven inflation pressure.
- Slowing growth of global economy, rising geopolitical risks and tensions, and consequently increasing uncertainties in the external environment would adversely affect the global price of minerals and commodities and capital inflow to our economy. As a result, it is likely to weaken the balance of payments, create depreciating pressure on exchange rate of togrog, and thus push prices of imported goods up.

II. ECONOMIC GROWTH

The economy expanded by 7.3 percent in the first half of the year, which is the highest growth in the last 6 years. From the demand side, increased gross capital formation and household consumption have supported economic growth, while net exports made negative contributions (Figure II.1). Productions in most economic sectors have expanded, except for the manufacturing and transportation sectors. In particular, production in mining, services, agriculture, and information and communications sectors have increased rapidly (Figure II.2).

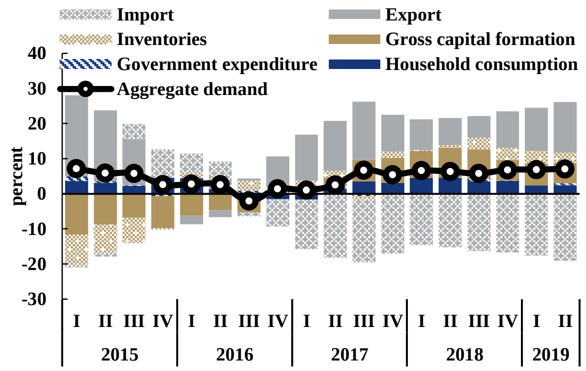
Investments: Total investments increased by 19.8 percent in the second quarter of 2019 and have contributed 8.2 percentage point to overall economic growth. Such investments were made mainly towards construction and machineries. Fiscal capital expenditure increased by 53 percent from previous year and business loans are increasing, resulting in greater financial resources for investments.

If fiscal capital expenditure stated in the approved budget for 2019 is fully utilized, it would lead to an expansion of 1.52 trillion MNT from previous year and thus support gross capital formation. FDI, on the other hand is not expected to exceed the level in previous year.

Consumption: In the reporting quarter household consumption increased by 6.0 percent and thus contributed 3.4 percentage point to economic growth. Steady expansion of household income in the past 10 consecutive months, was the main factor supporting household consumption. While household sentiment regarding the current economic condition and job opportunities, remains positive, their expectations regarding business environment and income have weakened from a year ago[3]. Although household income continued to expand in the last couple of years, it remains short of household expenditures and the gap was mainly financed through consumer loans, which resulted in rapid growth of consumer credit. In order to slow down such rapid growth, the Bank of

Figure II.1

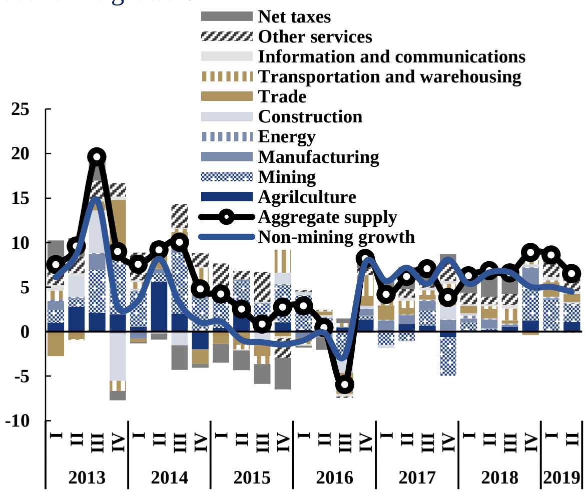
In the reporting quarter, gross capital formation and household consumption made the largest contribution to economic growth.[4]



Source: NSO

Figure II.2

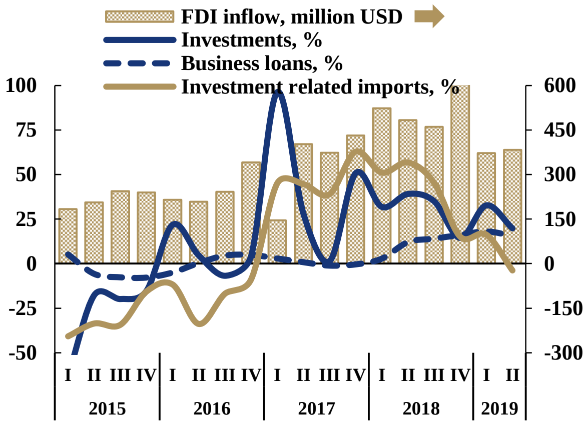
The mining sector made significant contribution to economic growth.



Source: NSO

Figure II.3

Growth of commercial loans is recovering and fiscal investment is expanding, thus resulted in greater capital formation.



Source: NSO, Bank of Mongolia

[3] NRCC – Consumer confidence index

[4] Growth calculated from sum of 4 consecutive quarters

Mongolia implemented macroprudential policy measures. As a result, growth of consumer loans has declined in the past 2 quarters.

Government expenditure increased by 18.7 percent year-over-year in real terms and thus supported aggregated demand by 2.6 percentage point. According to the budget approved for 2019, budget 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 8.0 percentage point. In the reporting quarter, real exports increased by 18.7 percent year-over-year, while imports increased rapidly and resulted in weaker net exports. In the reporting quarter, exports of iron ore, molybdenum ore, spar, and leucite explain a significant portion of growth in total exports. Although price of coal was relatively high, volume of coal exported through the Shiveekhuren port diminished by 9.8 percent year-over-year. Such poor performance was the result of a quota set by the Mongolian government on number of trucks for coal transportation and new standards and requirements set by Chinese authorities.

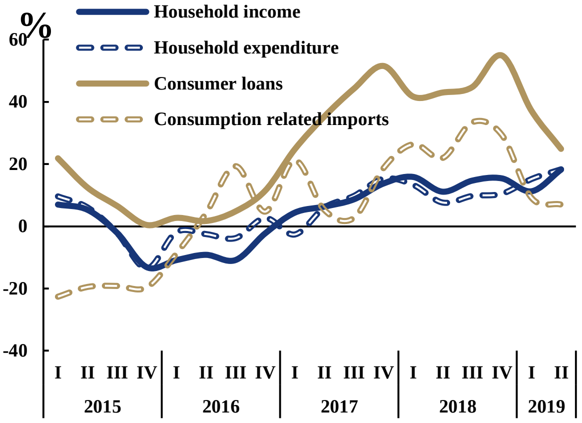
Consistent with the economic recovery and booming household consumption, imports of consumer items had been increasing over 20 percent per annum in 2018. However, in the last two quarters its growth decelerated and reached 7 percent year-over-year in the reporting quarter (Figure II.4). In addition, imports of diesel fuel increased by 28 percent from previous year and thus total imports expanded by 25.3 percent. Among durable goods, imports of automobile is growing rapidly. For instance, in 2018 a total of 64 thousand passenger automobiles were imported, while in the first 8 months of 2019 the number reached 50.8 thousand. However, during the months of June, July, and August imports of passenger cars declined by 7, 3, and 15 percent year-over-year, respectively.

Economic sectors

Production in the mining sector increased by 11.7 percent year-over-year in the reporting quarter mainly on the back of increased production of iron

Figure II.4

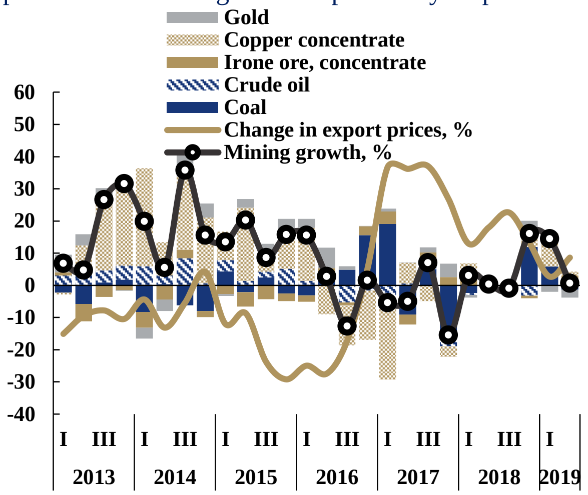
Household income expands for the tenth consecutive month. Yet it remains short of household expenditures.



Source: NSO, Bank of Mongolia

Figure II.5

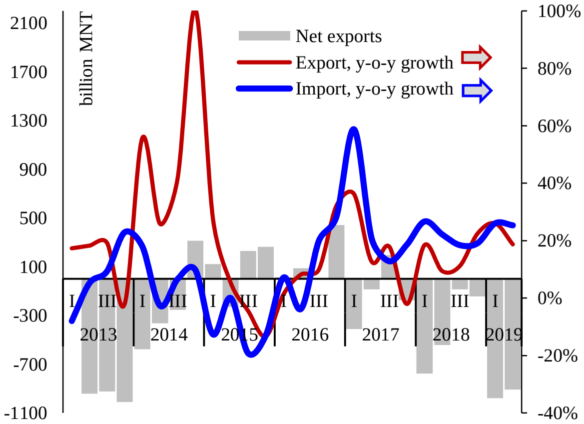
Following increased mining of iron ore and crude oil, and improvement in the gold content of copper ores, production of mining sector expanded by 11 percent.



Source: NSO, Bank of Mongolia

Figure II.6

In the reporting quarter, imports increased more rapidly compared to exports and thus net exports weighed overall growth down by 8 percentage points.



Source: NSO

ore and crude oil and improvements in the gold content of copper concentrate. Stronger price of iron ore at the global market was a significant factor boosting production of iron ore beyond our expectations (Figure II.5).

The trade sector expanded by 8.1 percent year-over-year and thus contributed 0.9 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 expanded by 4.2 percent year-over-year. A majority of the expansion is observed in the construction of factories, school buildings, roads, and railway. Nevertheless, its performance was lower than previous expectations because scheduled fiscal capital expenditures were not fully utilized.

Ending its continued expansion in the past quarters, the manufacturing sector shrunk by 1 percent year-over-year and thus weighed down growth by 0.1 percentage point. In particular manufacturing of food items, coking coal, textile, and construction materials declined significantly.

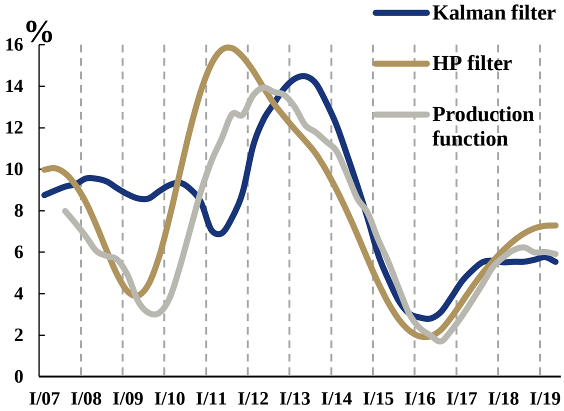
Recovery in economic activities, expansion of tax base, and greater foreign trade have supported the tax revenue. As a result, net tax revenue increased by 4.8 percent year-over-year, resulting in positive contribution of 0.7 percent to economic growth in the reporting quarter.

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 have been supporting the potential output. Consequently, its growth has recovered and fluctuates between 5-6 percent in recent quarters (Figure II.7).

Figure II.7

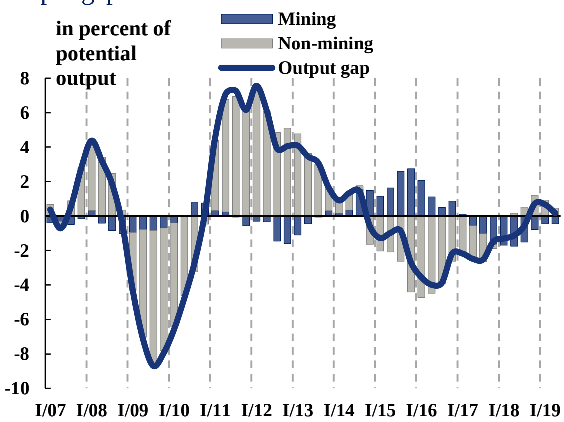
Growth of potential output



Source:Expert's estimation

Figure II.8

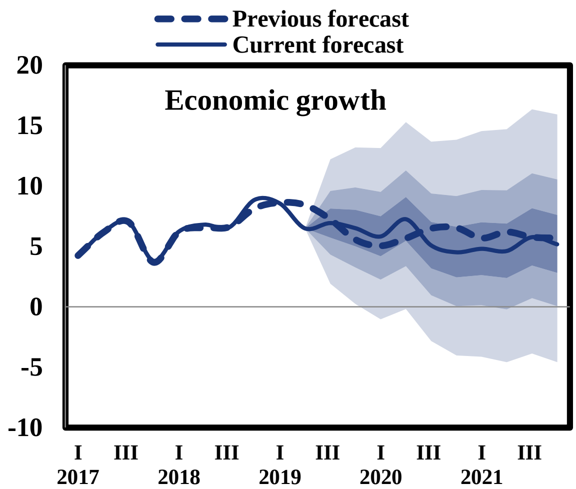
Output gap[5]



Source: Expert's estimation

Figure II.9

Annual growth projections of quarterly GDP



Source: Bank of Mongolia

[5] Estimated by Kalman filter

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 remains positive (Figure II.8).

As for the second quarter of 2019, production in the mining sector is inching closer to its potential level and the mining sector output gap is near closing. It was supported by increased mining of iron ore and improved gold concentration of copper ore relative to previous year.

In case of the non-mining sector, the output gap remains positive since 2018, mainly supported by greater investments and mining exports. However, as production in the manufacturing and transportation sectors declined, the output gap narrowed from previous quarter.

Economic outlook

In the second quarter of 2019, although the expansion of mining sector exceeded previous forecast by 7.1 percentage points, production growth in the non-mining sector was 2.5 percentage points lower than previous expectations and thus overall economic growth fell short of previous forecast by 0.8 percentage point.

Stronger performance in the mining sector is associated with greater mining production of crude oil and iron ore and improvement in the gold content of Oyu Tolgoi's copper concentrate from previous year (deteriorated from previous quarter). In case of the non-mining sector, its growth fell short of previous expectations as production in manufacturing and transportation sectors shrank, while growth of net tax revenue was lower than previously forecasted.

Baseline forecasts for economic growth in 2019 and 2020 are revised down from previous report. As a result of data revision by the NSO, economic growth for 2018 was revised up by 0.3 percentage point and created base year effect for economic growth

Table II.1.1
Economic growth forecasts[6]

	2018	2019*	2020*
	actual	*forecast*	
GDP growth, %	7.2	5.4 – 8.4	3.5 – 7.5
Mining growth, %	5.7	4.3 – 7.3	1.1 – 5.1
Non-mining growth, %	7.7	5.7 – 8.7	4.2 – 8.2

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 down**
Consumption	**Revised down**
• According to final data for 2017 and preliminary data for 2018, private consumption for previous years were revised up and thus created base effect.	
Investments	**Revised up**
• According to final data for 2017 and preliminary data for 2018, change in inventories for previous years were revised down. Consequently its forecast is lowered. • Although the projection and actual data for change in inventories are reduced, the actual value of gross fixed capital formation improved beyond previous expectations. As a result, projection of total investments is revised up. •Currently entrepreneurs and managers have positive expectations towards the future and business loans are recovering. Such factors are likely to support growth of investments in 2019. In addition, according to the approved budget for 2019 fiscal capital expenditure is expected to increase by 93 percent or 1563 billion MNT from previous year.	
Net exports	**Expectations weakened**
• Consistent with the developments in the first half of the year, assumptions regarding export volumes of iron ore and copper concentrate are improved. As a result projection of export revenue for 2019 is revised up by 3.6 percentage points. • Growth of imports for 2019 is revised up by 4.6 percentage points due to stronger growth in the second quarter.	
AGGREGATE SUPPLY	**Revised down**
Mining	**Expectations weakened slightly**
• Although forecast of iron ore mining production is improved, forecast for coal mining and exports are reduced due to the transportation quota set on coal exports.	
Non-mining	**Expectations weakened slightly**
•Since the production of coking coal treatment and meat processing did not meet previous expectations in the second quarter, growth projection for the manufacturing sector is revised down. • Consistent with lower projection for imports, projection of net tax revenue is revised down.	

Source: Bank of Mongolia

[6] 30 percent confidence interval

forecast. Although growth forecast for the mining sector in 2019 is revised up due to stronger performance in the first half of the year, growth forecasts of manufacturing and transportation sectors and net tax revenue were revised down. In case of 2020, overall economic growth forecast is also reduced due to risk of declining Oyu Tolgoi investments, lower external demand, and weaker terms of trade (Figure II.9).

Uncertainties that may affect the economic growth outlook

Deepening trade tension between the USA and China is adversely affecting growth of major economies and terms of trade for Mongolia. In case the trade tension worsens, external demand for Mongolia may decelerate, exports revenue may decline, and create risk of internal and external imbalance.

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, if the crude oil processing plant is constructed and starts operating, it would support production and reduce Mongolia's dependence on imported fuel, thereby alleviate pressure on exchange rate and foreign exchange reserves. However, currently, the timing and feasibility study of the project remain uncertain.

III. DOMESTIC ECONOMIC CONDITION

III.1 Labor market

The labor market indicators are assessed as moving average of 4 quarters, to remove quarterly fluctuations. The number of working age population has decelerated for the first time since 2012. In particular number of employed people and economically inactive people declined significantly (Figure III.1.1).

Among the main indicators of labor market, labor force participation rate[7] has remained stable at around 61 percent in recent quarters. However, the employment rate[8] is declining from 56 percent starting 2019. Similarly, the unemployment rate[9] has increased in recent quarters, contrary to its downward trend since 2016 (Figure III.1.2).

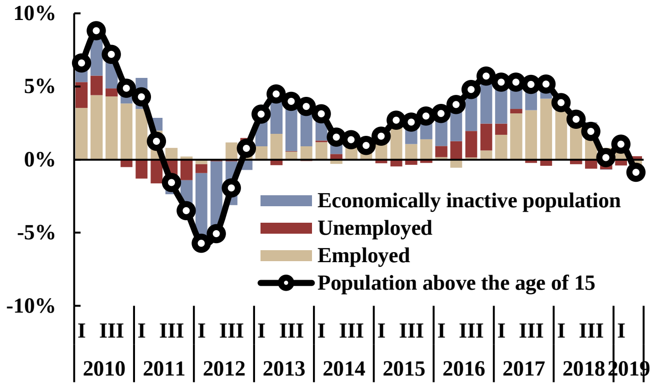
In case of the labor market composite indicators which estimate labor force underutilization, time-related underemployment rate is at 1.4 percent in the second quarter of 2019, while 4.7 percent of the extended labor force is considered to be viable for employment but not included in the official labor force. When such groups are included in the unemployment rate (10.1 percent in the reporting quarter), 15.6 percent of the extended labor force[10] is not fully utilized (Figure III.1.2).

Growth of employed people, which is calculated as the moving average of past 4 quarters, has declined first time since the second quarter of 2016. Although employment increased in the mining, energy, public administration, education, and health sectors, employment in agriculture, trade, and transportation sectors have declined (Figure III.1.3).

Number of people registered as unemployed, was on a downward trend at the end of 2017 and early 2018. In recent quarters, no significant change was observed, and the number of unemployed people remains relatively stable. Number of people newly registered for

Figure III.1.1

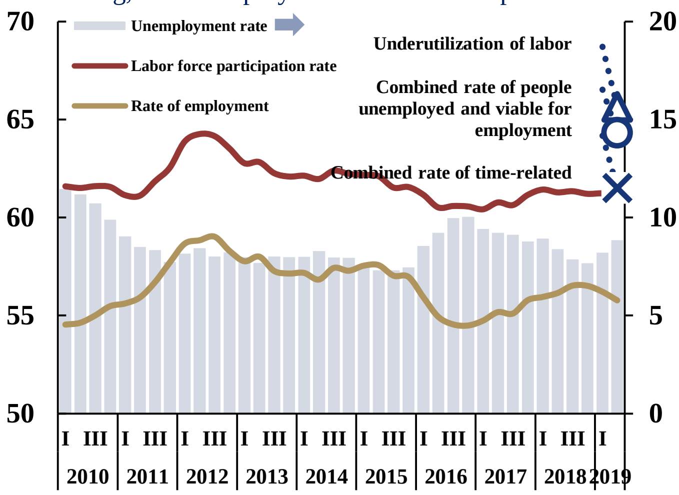
Within the working age population, number of people employed has declined and number of unemployed people increased. [15]



Source: NSO

Figure III.1.2

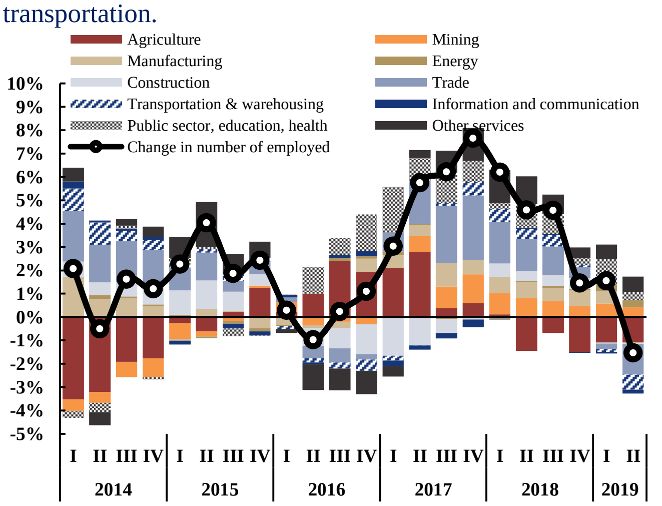
Labor force participation rate remains stable, employment rate is declining, and unemployment rate is on an upward trend. [16]



Source: NSO

Figure III.1.3

Employment declined in sectors of agriculture, trade and transportation.



Source: NSO

unemployment has declined and number of people who got employed and consequently were removed from the registry is increasing (Figure III.1.4).

In case of household income indicators, the national average wage and median wage[11] have accelerated from previous quarters and continued to record double-digit growth in the second quarter of 2019. Consequently, real wage, which indicates purchasing power of the people, has increased by approximately 5 percent following a stagnation in the previous year. In addition, average monetary income of households[12] continues to improve (Figure III.1.5).

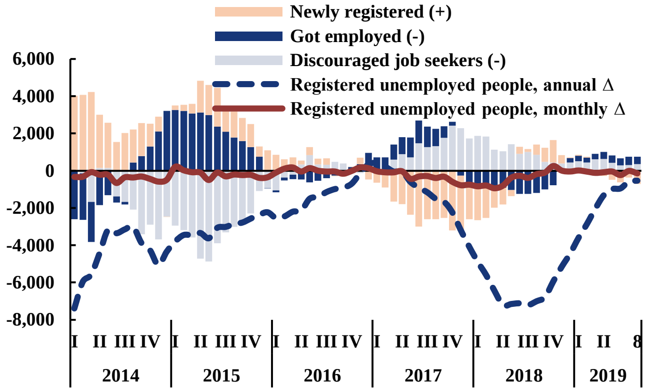
In terms of main economic sectors, average wage ranges between 725 to 2629 thousand MNT. The national average wage is at 1161.2 thousand MNT and the median wage at 842.9 thousand MNT, which is closer to the lower bound of sectoral interval (Figure III.1.5).

When 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 organizations with ownership type other than limited liability companies increased by over 10 percent (Figure III.1.6).

In terms of economic sectors, wages in the public administration, education, and health sectors have increased by 21 percent on average. Wages in other sectors excluding the mining, manufacturing, energy, and transportation sectors increased by over 10 percent. Wage growth was significant in sectors

Figure III.1.4

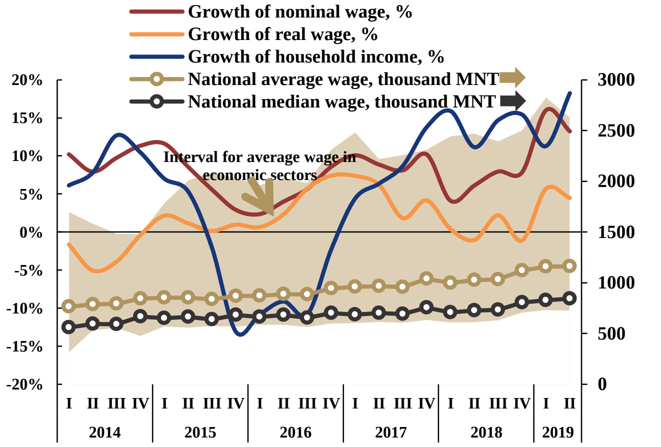
New registration for unemployment is declining while deregistration due to employment is increasing.



Source: General Office for Labor and Welfare Services

Figure III.1.5

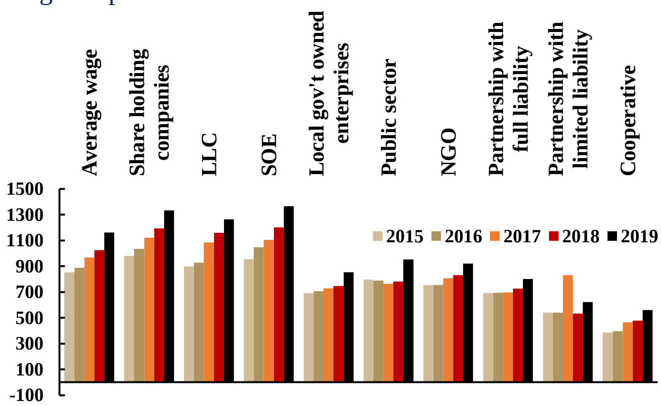
Following rapid growth of nominal wages, real wage is accelerating.



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 population 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] Four quarter 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: Social security payments' report by the General Office for Labor and Welfare Services
[12] Source: Household Socio-Economic Survey by the NSO

of construction, finance and insurance, and real estate (Figure III.1.7).

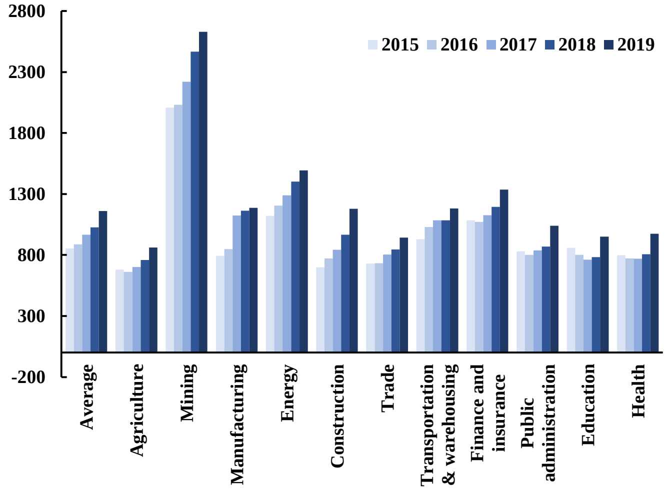
The fact that economic recovery outpaced the growth of employment, indicates a trend of acceleration in labor productivity[13] in recent quarters. In particular, labor productivity is improving in most of the sectors excluding the mining sector (Figure III.1.8).

Although cost of labor continues to increase at a rapid pace, since economic recovery is accelerating unit labor cost[14] has been on a downward trend in recent quarters (Figure III.1.9).

Source: NSO

Figure III.1.7

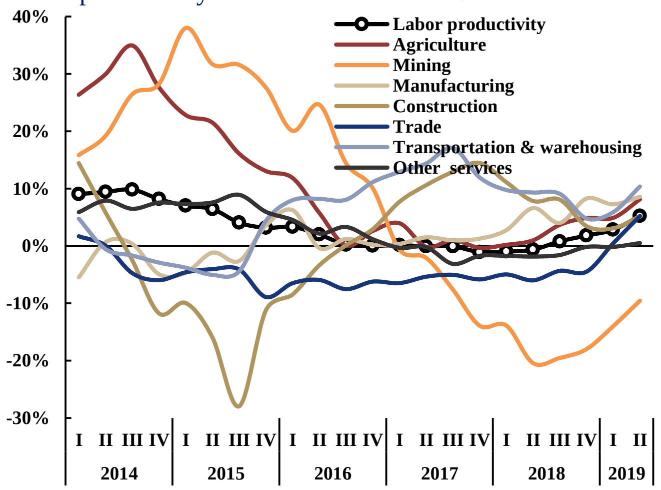
Following wage hike in the public sector, wages are increasing in other economic sectors.



Source: NSO

Figure III.1.8

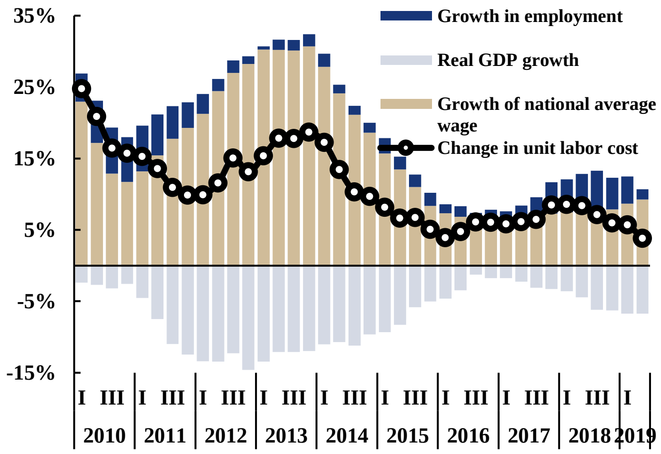
Labor productivity continues to accelerate.[17]



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

Annual growth of M2 money supply reached 17.9 percent as of July 2019. It is mainly supported by growth of 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.

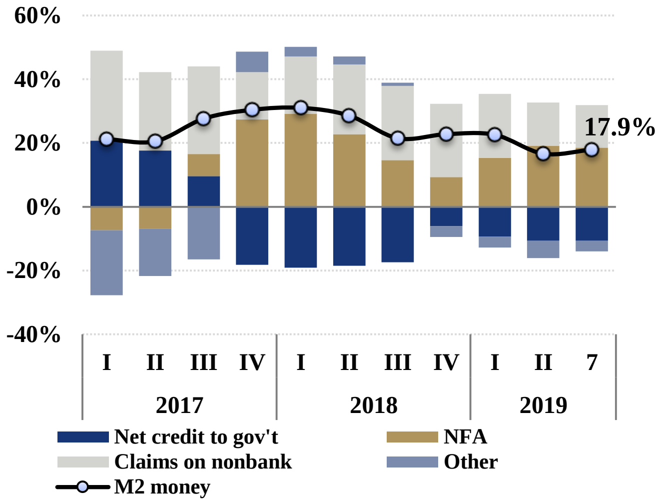
From the asset side, the central bank added 640 million USD to its net foreign reserves from previous year, and thus contributed 18.6 percentage point to growth of money supply in July 2019. Foreign funding received by the Development Bank of Mongolia and the private sector as well as monetized gold at the Bank of Mongolia have supported the accumulation of net foreign reserves.

Credit issued by depository institutions (claims on nonbank) has contributed 13.3 percentage points to growth of money supply. While growth of consumer loans slows down due to macroprudential policy measures, growth of business loans remains stable at around 15 percent. A majority of growth in business credit is issued for the trade, construction, and mining sectors.

The equilibrated balance of budget is in surplus of 540 billion MNT, as of July 2019. The surplus was mainly supported by increased budget revenue on the back of a rapid recovery in the mining and service sectors and increased trade turnover. At the same time, only 81.8 percent of the budget expenditure scheduled for the first 7 months was utilized, leading to surplus in budget. Consequently, the need to finance budget deficit from the domestic

Figure III.2.1.1

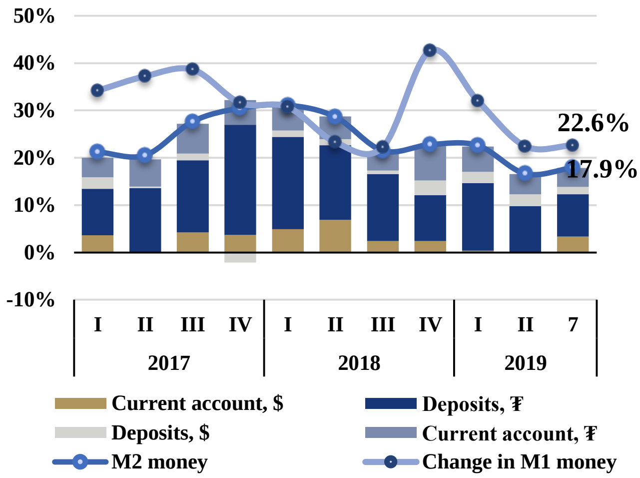
Annual growth of M2 money and its contributions, asset side



Source: Bank of Mongolia

Figure III.2.1.2

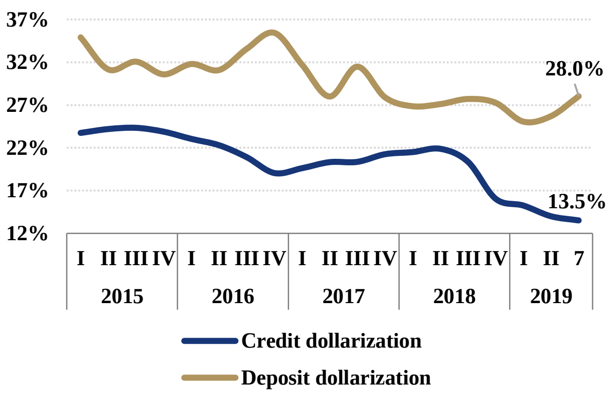
Annual growth of M2 money and its contributions, liability side



Source: Bank of Mongolia

Figure III.2.1.3

Dollarization of bank credit and deposits



Source: Bank of Mongolia

financial market remains limited and net credit to government continued to shrink.

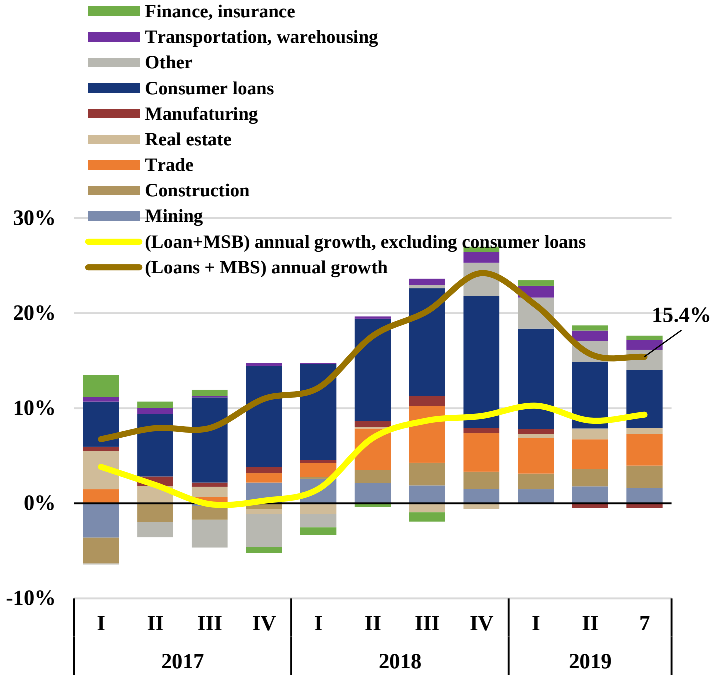
From the liability side, growth of money supply is mainly supported by deposits and current account in MNT. In particular, deposits and current account in MNT explain 12.9 percentage point of money supply growth in July 2019, while FX denominated deposits and current account contributed 5 percentage point. In the reporting month, contribution of FX denominated deposits and current account to money supply increased by 2.5 percentage points, from early 2019. It is mainly associated with increasing FX assets of SOE's deposited at banks.

Outstanding level of credit issued by depository institutions[19] and mortgage loans that were converted to mortgage backed securities (MBS[20]), increased by 15.4 percent as of July 2019. Outstanding level of consumer loans on the other hand declined by approximately 240 billion MNT from the end of 2018. In particular, outstanding level of loans extended for herders and balance of credit cards increased by approximately 160 billion MNT. However, loans collateralizing wage, pension, and automobiles and other consumer loans diminished by 400 billion MNT in total.

As mentioned above although loans issued for consumption are declining, credit issued for SME[21] is increasing rapidly. A significant portion of such loans are issued for SME activities for trade and other services.

Figure III.2.1.4

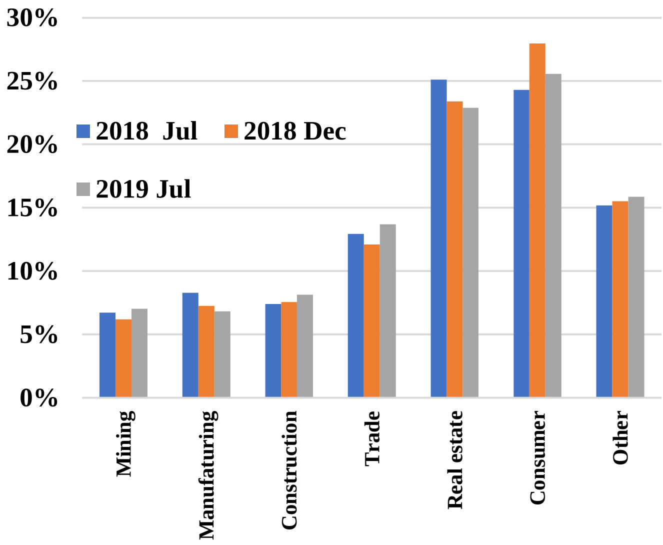
Break down of annual credit growth issued by depository institutions



Source: Bank of Mongolia

Figure III.2.1.5

Share of bank loans issued to economic sectors



Source: Bank of Mongolia

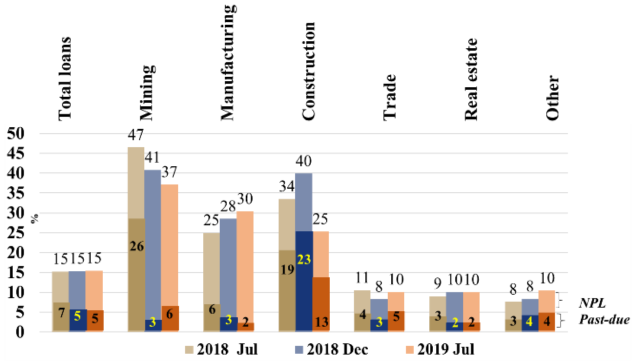
[18] Consumer loan consists of wage and pension loans, credit card, automobile loans, herders' loans and other consumer loans.
[19] Depository corporations consist of banks and deposits and loans cooperatives.
[20] Banks securitize mortgages by selling mortgage portfolios to the Mongolian Mortgage Corporation, and growth of these securities are considered to be part of credit growth.
[21] Total loans issued for individuals comprise of mortgage loans, SME loans, and consumption, wage, pension and other types of consumer loans.

At the end of 2018, 26 percent of total outstanding loans were issued for the mining, trade, and construction sectors, while as of July 2019 the share increased to 29 percent. In case of the manufacturing sector, outstanding level of credit is not increasing and its share is declining.

Nonperforming and past-due loans comprise 15 percent of total outstanding loans, which is similar to the ratio in same period of previous year. In case of economic sectors, quality of loan is improving in the mining and construction sectors, while it is deteriorating in the manufacturing sector.

Figure III.2.1.6

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



Source: Bank of Mongolia

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 June 19, 2019.

The interbank market rates have been fluctuating around the policy rate. For instance, in July 2019 interest rate on uncollateralized loans or overnight lending rate increased by 0.33 percentage point to 11.47 percent from previous quarter. In case of the collateralized loans, interest rate on direct trading of central bank bills increased by 0.03 percentage points to 10.95 percent, interest rate on interbank deposits increased by 0.39 percentage point to 10.7 percent, and interest rate for repo deals collateralizing the central bank bills decreased by 0.12 percentage point to 10.97 percent. Consequently, the interbank market rate increased by 0.05 percentage point to 10.99 percent, from previous quarter.

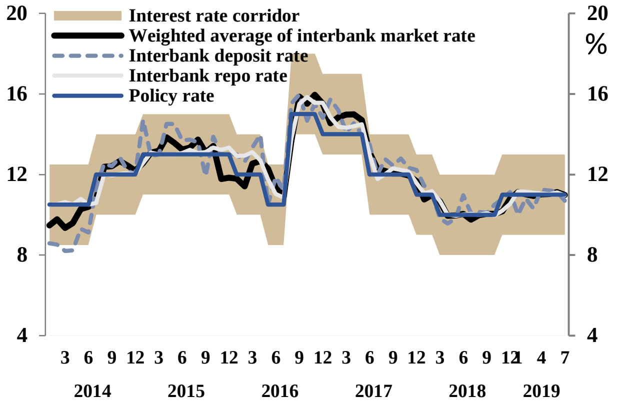
As of July 2019, interest rate on newly issued loans increased from the end of 2018, while interest rate on new deposits declined. In particular, interest rate on credits issued in MNT increased by 0.27 percentage point from end of 2018 to 16.97 percent, while interest rate on MNT deposits decreased by 0.87 percentage point to 10.33 percent. Consequently, interest rate margin widened by 1.14 percentage point to 6.64 percent, compared to the end of 2018. When assessed by economic sectors, interest rate on newly issued loans for agricultural activities were the highest at 20.2 percent, while it was the lowest for real estate activities at 13.1 percent.

In case of foreign exchange loans, interest rate on newly issued loans increased by 1.02 percentage point from the end of 2018 to 9.82 percent and deposit rate increased by 0.3 percentage point to 4.8 percent.

Since interest rate on MNT denominated deposits declined and nominal exchange rate of MNT depreciated against USD, the relative yield on MNT has declined by 0.36 percentage point from previous quarter to 0.27 percent in July 2019.

Figure II.1.4.2.1

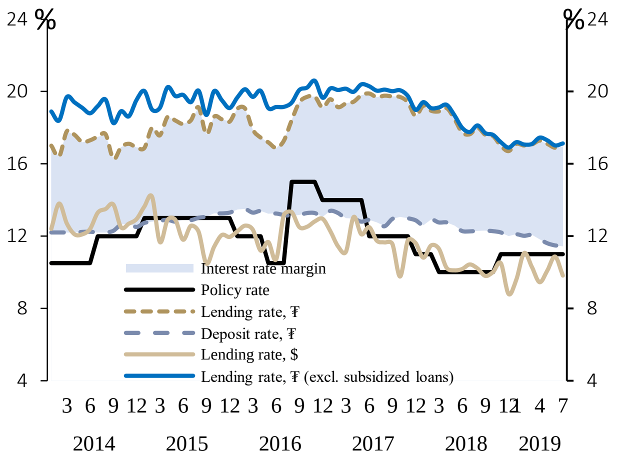
Weighted average of interbank market rate remains close to the policy rate.



Source: Bank of Mongolia

Figure II.1.4.2.2

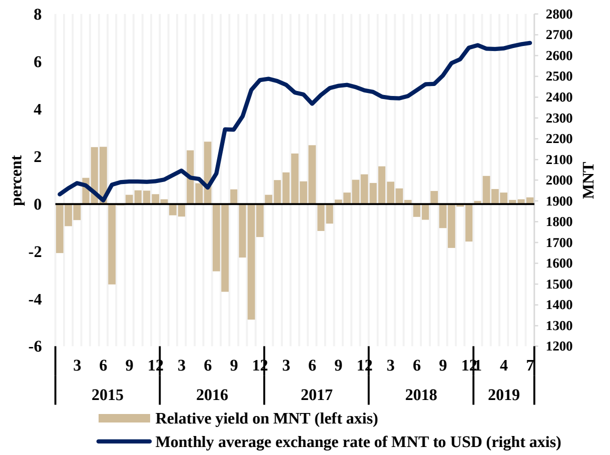
Margin between lending and deposit interest rates have widened.



Source: Bank of Mongolia

Figure II.1.4.2

Relative yield on MNT has been positive starting 2019.



Source: Bank of Mongolia

III.2.3 Exchange rate

Exchange rate of MNT rate depreciated gradually against USD since the beginning of the second quarter, reaching 2666 MNT per USD at the end of July 2019. It is a depreciation of 0.7 percent or 18 MNT from the beginning of the year.

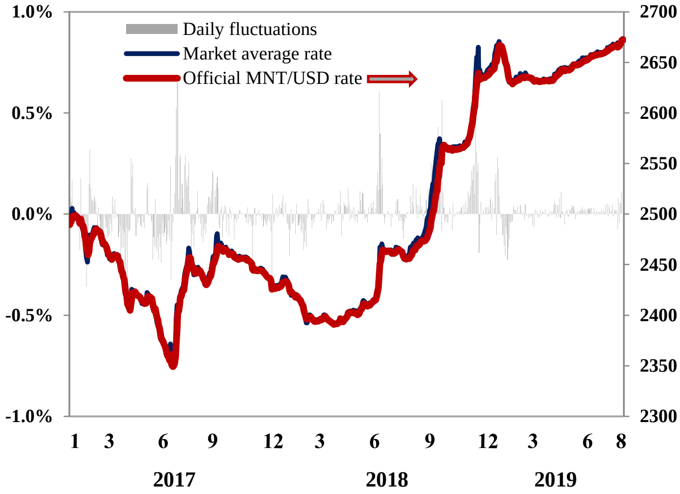
In July 2019, the Federal Reserve of the USA cut the Fed funds rate for the first time since the Global Financial Crisis, down to 2.25 percent. It is expected to cut once again in 2019 and lower the expected yield on USD, thus reducing pressure of depreciation on exchange rates in developing economies. However, MNT depreciated against USD in July 2019 as a result of seasonal pattern with lower capital inflows and increased outflows. Net outflow of foreign currency has increased in the first half of the year. In particular, foreign currency inflows increased by 0.9 percent from beginning of the year, while outflow increased by 45.5 percent and resulted in net outflow of 100.5 million USD.

While MNT depreciated against USD, nominal effective exchange rate[22], weighted by trade turnover, appreciated by 0.4 percent in June 2019 from the beginning of the year (Figure III.2.3.2). It was mainly supported by appreciation of MNT against RMB and EUR by 1.5 and 1.0 percent, respectively. Conversely, MNT depreciated against RUB by 4.5 percent (Figure III.2.3.3).

Real effective exchange rate (REER) appreciated by 5.9 percent from the beginning of the year. During the same period, domestic price increased more rapidly than the foreign price. Thus relative price increased by 5.1 percent and implies deterioration of Mongolia's competitiveness.

Figure III.2.3.1

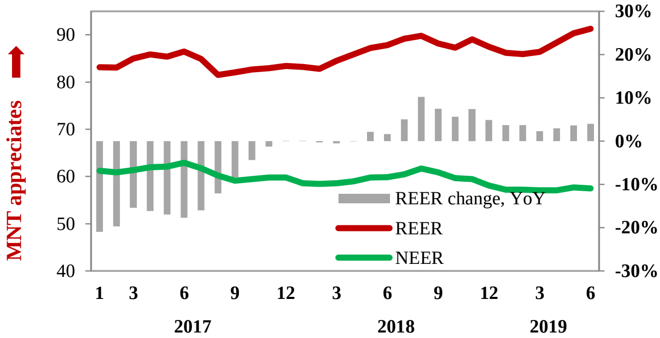
Cross rate of MNT to USD



Source: Bank of Mongolia

Figure III.2.3.2

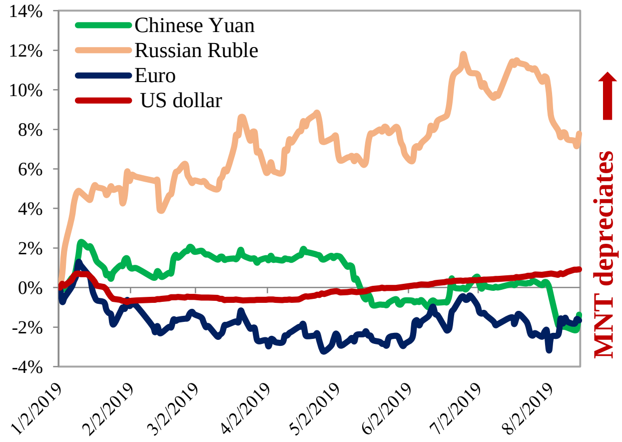
Real effective exchange rate of MNT



Source: Bank of Mongolia

Figure III.2.3.3

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



Source: Bank of Mongolia

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

III.2.4 Capital market

In the reporting quarter the housing market remained relatively stable. For instance, price of housing decelerated, while rental price accelerated. Purchasing power for housing is improved as household average income increased and the price-to-income ratio declined. In case of the stock market, market indicators are not improved, the MSE Top 20 index declined and investors' sentiment weakened in the reporting quarter.

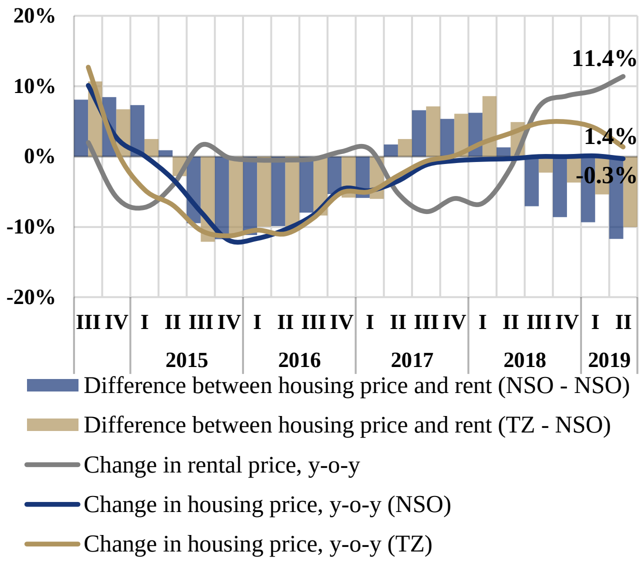
In the reporting quarter, price of housing declined from previous quarter and rental price is on an upward trend (Figure III.2.4.1). The housing price index reported by the Tenkhleg Zuuch declined by 1.0 percent from previous quarter but increased by 1.4 percent from previous year, which is a 2.7 percentage point lower annual growth rate from previous quarter. In recent months, as supply of high standard new housing increased, annual growth of new housing price declined by 3.0 percentage points and consequently resulted in weaker growth of housing price in general. Similarly, the housing price index estimated by the NSO decreased by 0.4 percent from previous quarter and 0.3 percent annually. As for the rental price, it increased by 0.6 percent from previous quarter and by 11.4 percent annually (Table III.2.4.1).

In the second quarter of 2019, household average income improved by 7.7 percent from previous quarter, resulting in a 0.03 unit drop in the price-to-income ratio and thus continued to support stronger purchasing power for households. The price-to-rent ratio declined by 0.01 unit on the back of weaker housing price and stronger rental price. Such development implies stability in the housing market and limited risk of housing bubble. (Figure III.2.4.2).

In the reporting quarter, although the market capitalization improved slightly from previous quarter, investors' sentiment weakened and the MSE Top 20 index continued to drop. In particular, the market capitalization shrank by 2.47 trillion MNT from previous year, which is a 0.6 percent annual drop or 0.3 percent gain from previous quarter. As of July, the market capitalization is on a downward

Figure III.2.4.1

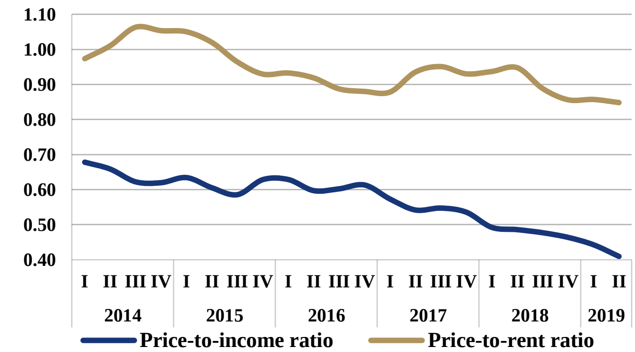
Price of housing is decelerating, while rental price is accelerating.



Source: NSO, Tenkhleg-Zuuch (TZ)

Figure III.2.4.2

Risk of overheating in the housing market is limited and households' purchasing power is improving.



Source: NSO, Bank of Mongolia

Table III.2.4.1

Real estate sector indicators

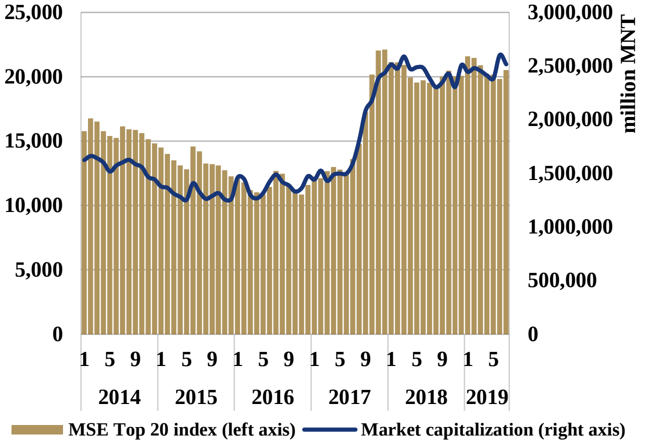
		2019Q1	2019Q2
Change in price of housing, %			
NSO	q-o-q	0.1	-0.4
	y-o-y	0.1	-0.3
Tenkhleg Zuuch	q-o-q	0.0	-1.0
	y-o-y	4.1	1.4
Change in rental price, %	q-o-q	0.0	0.6
	y-o-y	9.4	11.4
Price-to-income ratio		0.44	0.41
Price-to-rent ratio		0.86	0.85

Source: NSO, Tenkhleg Zuuch, Bank of Mongolia trend. In case of the MSE Top 20 index, since the stock prices of companies that comprise a significant portion of the index have declined, the index dropped by 6.0 percent from previous quarter reaching 20,035.9 (Figure III.2.4.3).

The stock market sales reached a total of 41 billion MNT in the reporting quarter, which is a 39.2 percent lower figure from previous year. When “Monos Khuns” and “Invescore” companies launched their IPOs in May and June of 2019, the market activities were boosted slightly. The market turnover ratio, which is calculated as a ratio of market sales to market capitalization, dropped by 1 percentage point from previous quarter to 1.7 percent. It indicates weaker activities at the stock market from previous years (Figure III.2.4.4).

Figure III.2.4.3

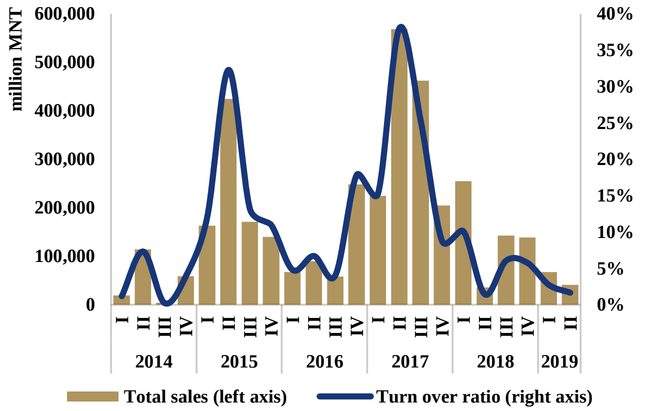
The MSE Top 20 index has declined constantly in the reporting quarter.



Source: Mongolian Stock Exchange

Figure III.2.4.4

Activities at stock market weakens.



Source: NSO, Bank of Mongolia

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 331 billion MNT and the budget expenditure to increase by 2271 billion MNT from 2018 (Table III.3.1). In the reporting period, the equilibrated revenue exceeded its projections, while due to underutilization budget expenditure fell short of its scheduled amount by 18 percent, resulting in a surplus of 535 billion MNT in equilibrated balance. According to near term forecasts of the Bank of Mongolia, during the months between August and December a total of 3.6 trillion MNT is likely to be accrued as revenue and an additional spending of 6.0 trillion MNT is expected.

Total equilibrated revenue: In the first 7 months of the year, the equilibrated revenue increased by 983 billion MNT from previous year (annual growth of 19.5 percent). In particular, the income tax revenue increased by 30.9 percent (358 billion MNT), tax revenue on imported items by 21.7 percent (306 billion MNT), revenue from social insurance collection by 28.0 percent (239 billion MNT), tax revenue from domestic goods and services by 14.7 percent (96 billion MNT), and VAT return by 95.8 percent (88 billion MNT).

Total expenditure and net credit:

Budget expenditure utilization has reached 81.8 percent of the scheduled amount in the first 7 months of the year and 45.5 percent of the year. Components of total expenditure, except for interest expenditure and net credit, have all increased over 10 percent from previous year. In particular:

- Expenditure on goods and services by 388 billion MNT or 22 percent.

- Capital expenditure by 306 billion MNT or 55 percent.

Table III.3.1

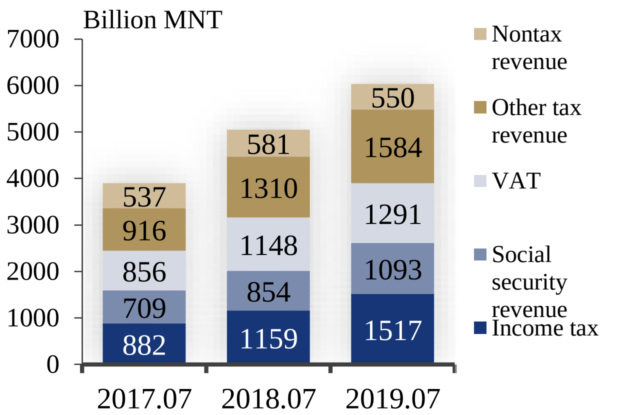
Fiscal indicators

billion MNT	2018	2019	2019.07	
	Act.	App.	Act.	%
Total revenue	**10173**	**11066**	**6786**	**104.6**
Future heritage fund	621	1069	714	102.9
Stabilization fund	207	322	37	27.6
Equilibrated revenue	**9345**	**9676**	**6035**	**106.6**
Tax revenue	8228	8566	5485	108.2
Non-tax revenue	1117	1110	550	92.6
Total expenditure	**9317**	**11588**	**5500**	**81.8**
Primary expenditure	8271	10722	5038	81.0
Current expenditure/-interest payme	6304	7363	4056	86.2
Capital expenditure	1680	3215	868	59.5
Net credit	286	144	114	186.3
Interest expenditure	1046	866	462	93.0
Total equilibrated balance	**28**	**-1912**	**535**	
in percent of GDP	0.1%	-5.2%	1.4%	
Primary balance	1074	-1047	997	
in percent of GDP	3.3%	-2.8%	2.7%	

Source: Ministry of Finance, Bank of Mongolia

Figure III.3.1

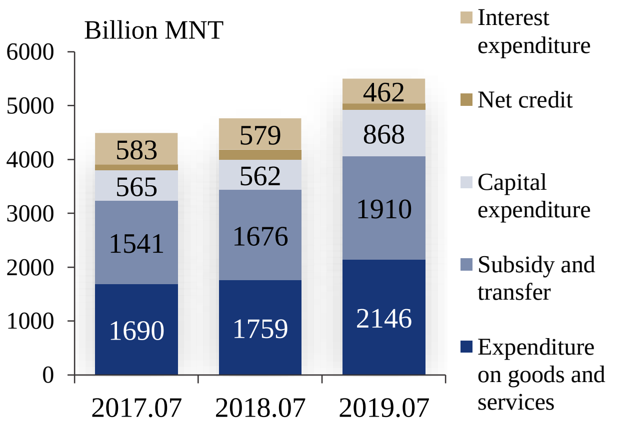
Structure of budget revenue



Source: Ministry of Finance

Figure III.3.2

Structure of budget expenditure



Source: Ministry of Finance

- Subsidy and transfer by 234 billion MNT or 14 percent.

In case of the interest payments, although it had exceeded 1 trillion MNT in the past 2 years, in 2019 it is expected to decline to 880 billion MNT. Total amount of interest payments made in the first 7 months of the year is 20.3 percent lower than in the same period of previous year.

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 during 2019-2020 and drop below 50 percent of GDP in 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.

Table III.3.2

Present value of government debt and debt services

	2016	2017	2018	2019*	2020*
billion MNT	Act.	Act.	Act.	Appr.	proj.
Government debt	18861	20212	18217	19552	19391
in % of GDP	78.8	74.4	55.9	55.3	47.8
Debt limit/GDP	88.0	85.0	80.0	75.0	70.0
Debt service payments	988	1156	1046	866	583
in % of budget revenue	16.9	16.0	11.2	8.9	5.2
Budget balance	-3668	-1742	28	-1912	-2004
in % of GDP	-15.3	-6.4	0.1	-5.1	-4.7

Source: Ministry of Finance, Bank of Mongolia

IV. EXTERNAL CONDITIONS OF THE ECONOMY

IV.1 Assumptions regarding the external conditions [23]

Growth forecasts of main trading economies are revised down for 2019 compared to the previous report. Price outlook for main exporting commodities of Mongolia remain on a downward trend.

External demand[24] outlook for 2019-2020 is revised down. Considering the potential negative impact of the trade dispute on Chinese economy, external sources have kept the growth forecast for China unchanged at 6.2 percent. The world economic growth outlook remains on a downward trend. For instance, growth forecast of the Euro area is revised down from 1.3 to 1.2 percent and that of Russia is revised down from 1.7 to 1.2 percent.

Consistent with the previous expectation, Chinese economy expanded by 6.2 percent year-over-year in the second quarter of 2019. Growth was mainly supported by retail trade and government spending, while adversely affected by industrial output and the real estate sector. The Chinese authorities are loosening the monetary and fiscal policies to ease the impact of ongoing trade conflict with the US and rebalance its growth. However, effectiveness of such policies remains uncertain. Authorities of the US and China met the 12th time in August 2019, during which a trade deal was expected. However, the US President Donald Trump announced that they failed to reach an agreement. Consequently, both sides raised their tariff rates and imposed additional tariffs on remaining imports, thus leading to market volatility.

Table IV.1.1 Change in Key Judgments of External Environment

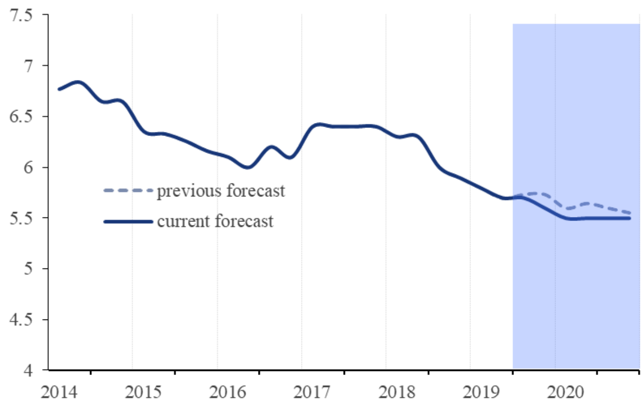
Changes in Key Judgments of External Environment

Previous forecast of 2019	Current forecast of 2019
External demand	**Revised down**
China's growth forecast remains unchanged but risks escalated with the US-China trade dispute. Growth for Russia is revised up slightly, while growth in the Euro area is revised down marginally.	The US-China trade tension is elevated,yetChinese growth forecast remains unchanged this time. Growth in Russia, the Euro area and the USA are revised down.
Terms of Trade	**Changed marginally**
Price outlooks of copper, coal, and iron ore have weakened due to deterioration of the US-China trade dispute. Prices of gold and crude oil are assumed to remain stable in the baseline projection.	Price outlooks of copper, coal, and crude oil have weakened due to deterioration of the US-China trade dispute. Price of gold, a risk-free asset, jumped up. Price of iron ore hiked in the first 7 months of 2019 due to supply shortages. The price projections are revised up marginally while the downward trend is maintained.
Foreign interest rate	**Unchanged**
The Fed is expected to lower Fed funds rate once in 2019.	The Fed funds rate was cut by 0.25 percentage points in September 2019. Fed rate is assumed to remain unchanged throughout 2019.
Global Inflation	**Revised down**
Economic growth in trading partner countries remain below the expectations, foreign inflation is likely to fall due to geopolitical issues in China and the Euro Area, sanctions on Russia, and decline observed in oil prices. However, food inflation in China accelerated.	Economic growth projection of main trading partners have declined except for China. Foreign inflation is revised down mainly due to stagnant price of oil. Inflation in China accelerated as prices of pork and imported goods increased, but expected to decline as Chinese demand weakens in the forecasting period.

Source: Bank of Mongolia

Figure IV.1.1

Forecast of external demand, year-over-year percent



Source: Bloomberg, EIU

[23] Forecasts of economic growth and inflation in main trading partner countries 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.
[24] External demand of Mongolia is calculated as the weighted average of main trading partner countries. (where China 0.90, Russia 0.02, and Euro Area 0.08)

To ease the negative impact of such tensions on the domestic economy, the Chinese authorities have taken several policy measures. In particular, the PBOC cut the reserve requirement ratio three times since the beginning of 2019. Currently the reserve requirement ratio is set at 13 percent for large banks and 11 percent for small banks. This measure releases a total fund of approximately 900 trillion-yuan to support micro, small, and medium-size enterprises. A further cut of 0.5 percentage point in the reserve requirement ratio is expected in December 2019. While the next high level trade discussion is expected to take place in Washington DC in October 2019, the trade experts and deputies of the two country are planning to meet during September 16-20. The early meeting in September has created positive expectations in the market with some optimism towards the final trade talks. Although both sides are eager to resolve the trade dispute, some international experts no longer expect a deal before the US presidential election in 2020.

Russian economy expanded by 0.9 percent in the second quarter of 2019, which was below market expectation. The sluggish growth is mainly attributed to slowdown in growth of consumption from 1.6 percent in the first quarter to 1.0 percent in the second quarter of 2019. Growth of consumption was discouraged by increase in VAT rates starting early 2019. Analysts of the Bloomberg and the EIU assume that diminishing world trade and production, increased uncertainties in the policy environment, and sluggish world economic growth are likely to result in weaker domestic demand and investments to the real estate market of Russia. Hence they have revised growth forecast for the Russian economy down to 1.2 percent in 2019. In order to support its economic growth in light of the weakening global demand, the Central Bank of Russia cut its key rate by 0.75 percentage points to 7.0 percent per annum during the months of June and September 2019. In addition, the Bank revised its GDP growth forecast for 2019 from a range of 1.0-1.5 percent down to the range of 0.8-1.3 percent, and inflation forecast from a range of 4.2-4.7 percent down to the range of 4.0-4.5 percent. However, according to the IMF team report in August 2019, Russian economic growth may accelerate to 1.9 percent in 2020 depending on the volatilities in oil prices and progress of national infrastructure projects, which were recently approved.

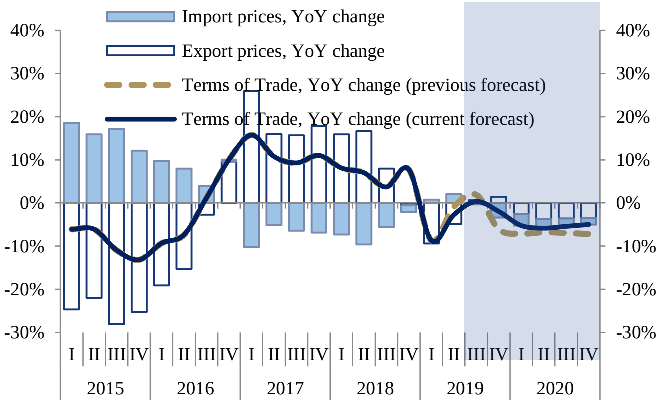
Growth in the Euro area fell below expectations, reaching 1.1 percent in the second quarter of 2019. This was mainly due to the adverse impact of escalation in trade conflict between the US and China on European exports. Growth of exports fell from 3.2 percent in the first quarter to 2.5 percent and growth of investments declined from 3.7 percent in the first quarter to 3.3 percent in the second quarter of 2019. Growth of household consumption, on the other hand, supported economic growth in the second quarter by accelerating from 1.1 percent in the first quarter to 1.3 percent in the second. In order to support economic growth, the ECB has decided to reduce the interest rate on its deposit facility by 10 basis points to -0.50 percent, to continue the reinvestments of the principal payments from maturing securities purchased under the APP, and to restart the net purchases under the Governing Council's asset purchase program (APP) at a monthly pace of €20 billion starting November 1. Moreover, the modalities of the new series of longer-term refinancing operations (TLTRO III) will be changed. While such expansionary policy is expected to support domestic demand, uncertainties surrounding the ongoing Brexit matter and escalation in trade tensions were the main reason to trim 0.2 percentage point from growth forecasts for 2019 and 2020, respectively to 1.1 and 1.3 percent.

Terms of trade

Projection for terms of trade is revised up slightly in the second half of 2019 due to improved price projections of gold and iron ore. However, the terms of trade outlook remains on a downward trend. In the second quarter of 2019, export prices and terms of trade fell below expectations as the commodity prices fell at the global market due to lingering uncertainties in the external environment, lower economic growth, and weaker domestic demand in developed economies.

Figure IV.1.2

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

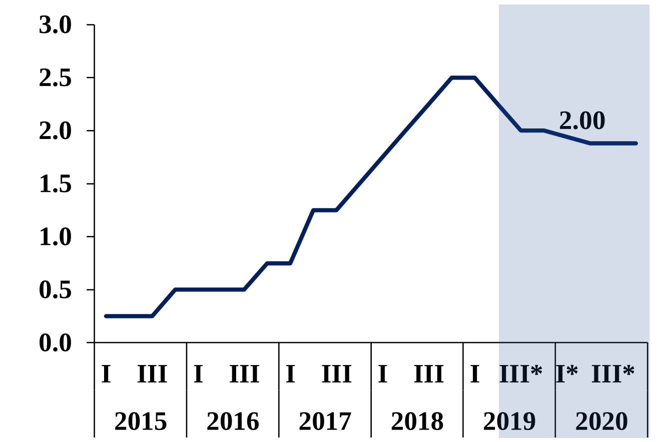


Source: Bank of Mongoliaны тооцоолол

Foreign interest rate: The Fed's FOMC cut the Fed funds rate by 0.25 percentage points on July 31st to 2.0-2.25 percent and by another 0.25 percentage points on September 18th, 2019 to 1.75-2.0 percent. These actions were intended to prevent risk in an environment where business sentiment remains weak, inflation pressure is limited, global growth is slowing down, and uncertainties regarding the world trade policies are building. The market largely expects another cut in the Fed funds rate with the purpose of easing the adverse impact of external environment on US economy.

Figure IV.3.5

Federal funds rate, percent



Source: Bloomberg

Global inflation: Inflation forecast for the Euro area is revised down by 0.1 percentage points to 1.3 percent in both 2019 and 2020, as uncertainties regarding the US-China trade conflict and the Brexit deal remain unresolved and EUR is expected to depreciate as a result of the ECB's expansionary monetary policy. The People's Bank of China (PBOC) lowered its required reserve ratio several times and let RMB to depreciate to support domestic demand and mitigate the impact of the trade conflict. However, expansionary impact of these measures is likely to subside and domestic demand is not likely to accelerate, thus inflation forecast for China is revised down by 0.1 percent to 2.1 for 2019 and remains unchanged at 2.3 percent for 2020. As Russian economic growth forecast for 2019 is revised down and domestic demand is not expected to accelerate, its inflation forecast for 2019 is revised down by 0.3 percentage points to 4.7 percent. Inflation forecast for 2020 remains unchanged at 4.0 percent. Although the unemployment rate remains low in the US, since household income is not expected to increase and positive impact of the tax cut is dissipating, its inflation forecast is revised down by 0.1 percentage points to 1.8 percent for 2019 and by 0.2 percentage points to 2.0 percent for 2020.

Uncertainties in the external conditions

- The USA and China are still negotiating over the trade dispute and it remains uncertain whether a resolution is plausible or not. Since the dispute is not fully resolved, additional import tariffs have come into effect in the second quarter of 2019. Although the US expected the representatives of the two sides to come together on July 31 for the 12th time and proceed with trade talks, President Donald Trump's tweet implying failed negotiations has stirred the tension further. As a result, the US raised the initial tariff rate of 10 percent to be set on imports worth 300 billion USD starting September 1 to 15 percent and increased the tariff of 25 percent set on imports worth 250 billion USD to 30 percent. Although, the latter action was scheduled to come into effect on October 1, it was postponed by 14 days. In response, through their government media the Chinese government announced its decision to raise the tariff of 5 percent set on US goods worth 75 billion USD to 10 percent.
- Uncertainties regarding Chinese economic growth and its macroeconomic policy actions are the most significant external risk factors in our forecasts. As a result of their decision to raise their import tariffs, Chinese economic growth may slow down further, commodity prices would fall, and capital flow to emerging markets would be adversely affected. It remains uncertain how much the Chinese economic growth and its demand for imported commodities would be affected by change in investments in the Chinese real estate sector and the government's policy.
- Price of crude oil at the global market may fluctuate further. Although the price of crude oil jumped by 20 percent following the Saudi Arabia oil attack, the hike seems to be reversing. It is uncertain whether Saudi Arabia could prevent similar attacks in the future or not. In addition, less is known on how such event would shape the geopolitical risks and how soon the producers would close the gap in supply.
- 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 pose greater risk.

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

Commodity prices dropped in the reporting quarter as outlook for China’s growth is not likely to improve and uncertainties regarding the trade conflict between the US and China have increased.

Copper: Average price of copper at the London Metal Exchange declined to 5714 USD in August 2019, as market sentiment weakened mainly due to building uncertainties regarding the prolonged trade dispute between the US and China. In particular, economic growth of China, which alone accounts for 45 percent of global refined copper consumption, has slowed down to its lowest level of the past 27 years in the second quarter of 2019. In addition, consumption of refined copper in the EU, Japan, and the US have also declined. In case the trade dispute is not resolved, Chinese economic growth may further decelerate and result in lower demand for refined copper. However, from the supply side a small shortage is expected during 2019-2020, which is likely to prevent the price of copper from falling significantly. Starting 2021 however, 18 new copper refineries are expected to start operating and thus support global production of refined copper.

Gold: Average price of an ounce of gold increased to 1495 USD in August. Demand for the asset considered as safe haven increased mainly due to weaker outlook of global economy, expectations for the Federal Reserve to lower its key rate, and poor relations of the US with Iran and Turkey. In addition to elevated geopolitical tension at the international arena, central banks’ appetite for gold have suddenly peaked and reached 374.1 ton in the first half of 2019, which records the highest annual growth in the past 19 years. Since the Federal Reserve is likely to reduce its key rate and risks are building as economic outlook for advanced economies are deteriorating, price of gold is likely to fluctuate further towards the end of 2019 and in 2020. As a result, its price projection is revised up.

Coking coal: Higher price of coking coal in the first half of the year was supported by 10 percent increase in the Chinese production of steel and the ongoing environmental inspections conducted by the Chinese government on its domestic coal mines. According to the Fenwei Energy Information Services of China, in Chinese provinces of major coal production price of coal is expected to be relatively stable in the short term. In addition, the Shandong province is closing some of its coal mines and reducing its production capacity by 10 million tons in 2019 and by 6.6 million tons in 2020. As a result of the Chinese government’s decision to close its inefficient coal mines, domestic production declined sharply and its consumption of imported coal increased. Moving further however, the government is likely to support domestic production. China plans to construct energy and coking coal plants with a combined capacity of 976 million tons by 2021. Some of these plants are expected to start operating in the second half of 2019 and therefore increase domestic production by 200 million tons. Consequently, domestic supply may increase, and its imports of coking coal may decline. Currently, China consumes 500 million ton of coking coal annually and 12 percent of total consumption, which is approximately 64 million tons, is supplied through imports. Since the Chinese government is expected to resume its tight regulation on coal imports (currently has set a 12 million ton imports quota on Australian coal) and China’s production of steel is likely to decelerate, demand for coking coal is expected to decline and adversely affect its price in 2019.

Iron ore: Price of iron ore constantly increased in the first half of 2019 and reached 117 USD at the end of July 2019, a historic high. On the one hand Chinese demand for steel exceeded market expectations, while on the other hand a dam in Brazil collapsed in early 2019 and led to supply shortage, both of which boosted the price of iron ore. In August however, due to building risk of trade dispute and associated expectations of lower demand, price of iron ore declined to 93 USD and remains on a downward trend. Nevertheless, price of iron ore is not likely to decline significantly, as the Brazilian government is penalizing the Vale iron ore mining company and setting a limit on its productions. As a result, it is likely to take a year to normalize its production. Furthermore, there are several factors that may drag the price of iron ore down. For instance, Chinese government is setting import tax on stainless steel sheets and rolls imported from the EU, Japan, South Korea, and Indonesia for 5 years, Chinese domestic steel factories are overproducing and thus draining their profitability and likely to reduce their demand for iron ore, and China is tightening its surveillance and inspection for environmental and hazard issues.

Crude oil: A barrel of Brent oil was sold at 63 USD on average in June 2019 and declined to 59 USD in August 2019. However, as a result of the drone attack in Saudi Arabia, its price jumped to 68 USD on September 16. Under the OPEC's agreement to cut production in its member states, production in Saudi Arabia, Russia, and Lebanon are declining and their stock remains low. In addition, due to economic sanction set on Iran and Venezuela, their oil exports are decelerating. The Saudi Arabia oil attack has created uncertainties regarding the oil supply. From the demand side however, weakening growth of global economy is expected to curb demand for oil. For instance, the International Energy Agency has reduced its projection for daily global oil consumption by 1.08 million barrels in 2019 due to the ongoing trade dispute between the two major oil consuming economies. Although the agency has not touched its projection for 2020, the downside risk for demand prevails.

IV.3 Balance of Payments

The balance of payments was in a surplus of 236.4 million USD (1.8 percent of GDP[25]) in the second quarter of 2019, which is an improvement of 16.8 million USD quarter-over-quarter and 366.2 million USD year-over-year. The current account deficit tapered down to 329.1 million USD as the surplus in goods balance improved. On the other hand, increased flow of portfolio investment and banks' foreign assets contributed to a surplus of 508.9 million USD in the financial accounts and a surplus in the overall balance of payments (Figure IV.3.1).

Current account deficit declined by 13 percent year-over-year to 329.1 million USD (2.7 percent of GDP) in the second quarter of 2019. Although the income accounts were in deficit, deficit in services account narrowed and surplus in goods account improved on the back of rapid growth of exports and weaker growth of imports, thus supporting the improvement in current account deficit.

Goods balance was in a surplus of 440 million USD. Export revenue expanded by 3.3 percent year-over-year in the reporting quarter. Significant expansion was observed in exports of iron ore, cashmere, fluorite, leucite, nepheline, and aircrafts[26], while crude oil exports declined from previous year (Table IV.3.2).

Growth of import spending decelerated from 35 percent year-over-year in 2018 to 13.7 percent in the first quarter and further down to -1.2 percent in the second quarter of 2019. It was mainly driven by drop in imports of machinery, equipment, and capital goods used in mining activities, lower imports of wheat compared to previous year, during which loss of domestic crop resulted in significant import, and less spending on imports of non-diesel fuel following the fall in global price of oil.

On the other hand, imports of passenger cars, diesel fuel, and some food items boosted import spending in the reporting quarter (Table IV.3.2).

Table IV.3.1

Changes in Key assumptions of BOP projection (2019)

Key changes in assumptions of BOP projection Previous forecast of 2019	Current forecast of 2019
External demand	**Revised up**
Export volumes are expected to expand, mainly in coal, iron ore, and cashmere. The price outlooks of copper, coal, and iron ore are deteriorated.	Coal export volume is expected to be around last year's level, which is a deterioration from previous assumption. However, export volumes of iron ore, flourspar, and cashmere are revised up. The commodity price outlook remains on a downward trend but prices of coal, iron ore, and gold outperformed in the reporting quarter. Gold price outlook is revised up. But due to recent developments in the US-China trade dispute, medium-term risks for commodity price to decline have increased.
Imports	**Unchanged**
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.	Oyu Tolgoi FDI↓→Imports of investment goods↓. Coal exports volume↓→ diesel imports↓. The growth of passenger cars and other durable goods' imports have decelerated. Import statistics have been revised down for aircrafts on lease.
Services	**Revised down**
Deficit in services account was inflated by 530 million USD in 2018 according to an annual revision. Although the cost of coal transportation has declined, total cost of transportation services remains significant. Date for the new airport to start operation is postponed. Services expenditure of education, financial, businesses, trade, and constructions are expected to remain elevated.	Iron ore exports ↑ → iron ore transportation revenue ↑. Coal exports are revised down, cost of coal transportation didn't decline as expected, share of foreign companies in coal transportation↑. The assumptions on services expenditure of education, financial, businesses, trade, and constructions remain unchanged.
FDI	**Revised down**
FDI to increase: Investors' loan repayment is expected to decrease.	Oyu Tolgoi FDI has been revised down due to difficulties arised in the development of underground mining projection.
Portfolio investments	**Unchanged**
MIC issued 300 million USD bond. ER issued 440 million USD bond and refinanced some of its previous debt. Other than that, no new bond will be issued and no principal repayments of bonds are expected.	Assumptions in the projection remains unchanged.
Other investments	**Revised down**
Currency and deposits account was revised down as net outflow from the account was larger than expected.	Currency and deposits account was revised down as net outflow from the account was larger than expected.

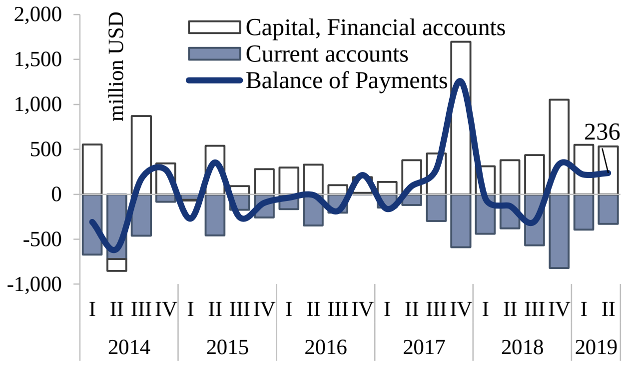
Services account deficit narrowed by 61.6 million USD (14% YoY) mainly driven by increase in transportation revenue by 36 million USD and declining services payment by 51 million USD. In particular, the transportation was supported by greater exports of iron ore, while payments for technical, trade and business services declined significantly (Figure IV.3.3).

Income account was in deficit of 435.5 million USD in the second quarter of 2019 which is an increase of 69 million USD or 19 percent year-over-year. This was due to increasing outflows through FDI income (16 percent or 66.4 million USD from the previous year). Particularly, interest payment of Oyu Tolgoi increased by 46 million USD year-over-year reaching 112 million USD, and thus resulted in larger outflows through FDI income. Moreover, interest payment of the government external loans increased by 13.2 million USD reaching 51 million USD and interest payment on external loans of enterprises increased by 26 million USD reaching 35 million USD. Thus, outflow of portfolio income account increased by 42.6 million USD year-over-year to reach 98.2 million USD. Income account, mainly composed of debt service and dividend payments to foreign shareholders, continues to impose substantial pressure on the overall balance. The deficit in primary income accounts for 132 percent of current account deficits in the reporting quarter.

The financial account was in a surplus of 508.9 million USD in the second quarter of 2019, which is a 43 percent or 154 million USD increase, year-over-year. It is mainly attributed to improved net inflow of 256.1 million USD year-over-year in portfolio investment. In particular, "Energy Resource" LLC, issued bond worth 440 million USD with 5-year maturity and interest rate of 9.25 percent at the international financial market in the second quarter of 2019 and restructured its previous bond, issued in May 2017 with a 3-year maturity, amounting to 412 million USD (the principle and

Figure IV.2.1

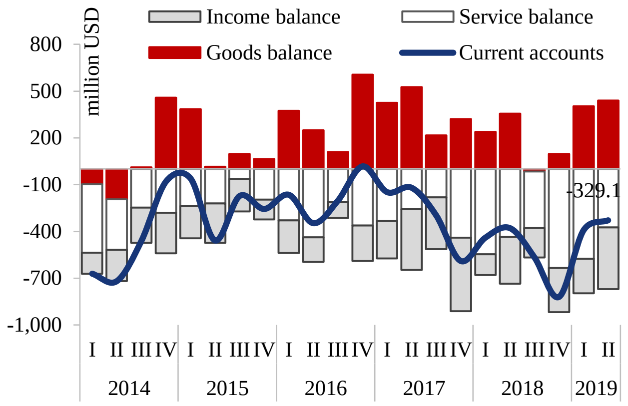
Balance of payments was in surplus in the 2nd quarter as financial account surplus surpassed the current account deficits.



Source: Bank of Mongolia

Figure IV.2.2

Larger trade surplus and narrower service deficit resulted into narrowed current account deficit (YoY) despite the increased deficits in income accounts.



Source: Bank of Mongolia

Table IV.2.2

Export revenue increased mainly due to higher revenue in iron ore, cashmere, and fluorite while it was negatively impacted by lower revenues in crude oil and gold.

	2018 II	2019 II	Y-o-Y	Contri-bution %
Total Exports	**2,099**	**2,167**	**3.3%**	**3.3%**
Coal	895	899	0%	0.2%
Copper concentrates	551	559	1%	0.3%
Iron ore	92	145	58%	2.5%
Cashmere	205	229	11%	1.1%
Fluorite, leucite, nepheline	39	52	33%	0.6%
Crude oil	111	92	-18%	-0.9%
Gold	20	-	-	-1.0%
Airplane	-	16	-	0.8%
Other	184	176	-4%	-0.4%

[25] 4-quarter cumulative GDP.
[26] Air companies leased newer aircraft and re-exported old aircraft.

interest payments). The Government of Mongolia paid 142 million USD as remainder of the Dim Sam bond principle in June 2018. Consequently, the portfolio accounts recorded a net inflow of 17.7 million USD in the second quarter of 2019, as opposed to a net outflow of 238.5 million USD in the previous year.

On the other hand, net inflow of FDI declined by 12 percent or 62 million USD year-over-year reaching 469 million USD and has negatively affected the overall financial accounts. Specifically, compared to previous year, Oyu Tolgoi's equity capital declined by 28 percent or 50 million USD and other entities' equity capital declined by 34 percent or 50 million USD, resulting in an overall deterioration of 101.3 million USD in equity capital reaching 192 million USD. A net inflow in other capital, that was 179.4 million USD in the previous year, reached 233 million USD in the reporting quarter.

A net inflow of other investments increased by 3 million USD reaching 24.6 million USD where net inflows of external loans declined by 123 million USD year-over-year and external assets of banks and enterprises increased by 111.9 million USD. The decline in net inflows of external loans is mainly explained by drop in long-term loan disbursements of banks by 77 percent or 51 million USD and drop in loan disbursements of enterprises by 52 percent or 73.2 million USD. Moreover, the financing under the Extended Fund Facility Program to the Government of Mongolia was not disbursed in the reporting quarter, as opposed to the disbursement of 100 million USD in the second quarter of previous year, causing an annual decline in external loans account.

Gross international reserves (GIR): stands at 4101.4 million USD at the end of June 2019. It is an adequate level to cover 8 months of imports, which is calculated as an average of the last three months' imports payment made in hard currency (Figure IV.3.6). A surplus of 236 million USD in the balance of payments and addition of 207.6

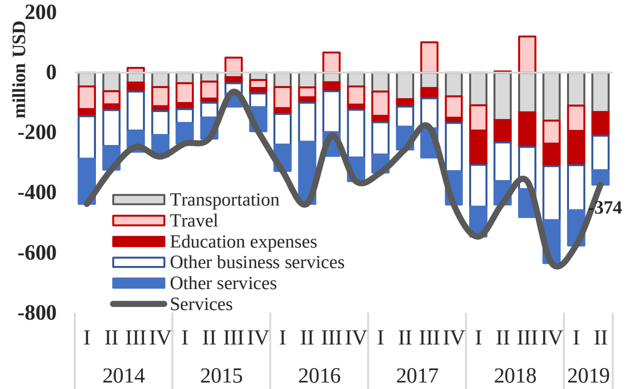
Imports contracted in 2nd quarter of 2019.

	2018 II	2019 II	Y-o-Y	Contri-bution %
Total imports	**1,586**	**1,566**	**-1.2%**	**-1.2%**
Capital goods	712	685	-3.8%	-1.7%
Consumer goods	424	453	7.0%	1.9%
Of which: Passenger cars	134	154	15%	1.3%
Fuels	257	256	-0.4%	-0.1%
Industrial inputs	191	170	-11%	-1.3%
Of which: Wheat	22	1	-	-1.3%
Others	2	2	-	0%

Source: Bank of Mongolia

Figure IV.2.3

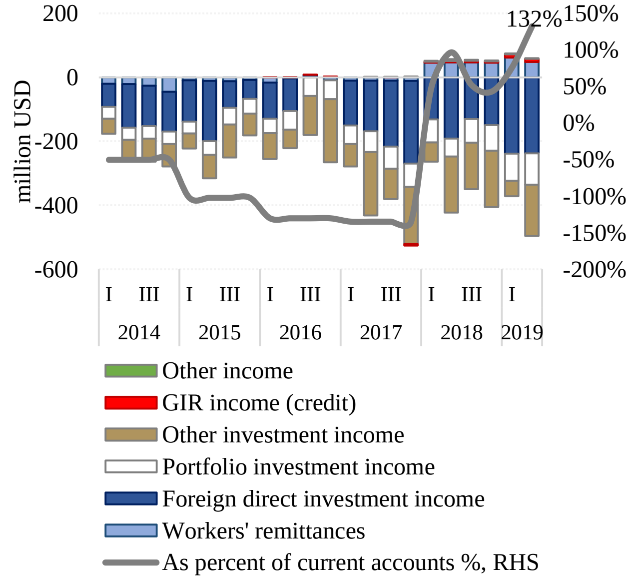
Services account deficit is narrowed (YoY)



Source: Bank of Mongolia

Figure IV.2.4

Income account deficit is widened (YoY).



Source: Bank of Mongolia

million USD in monetized gold have supported the reserve accumulation in the second quarter of 2019.

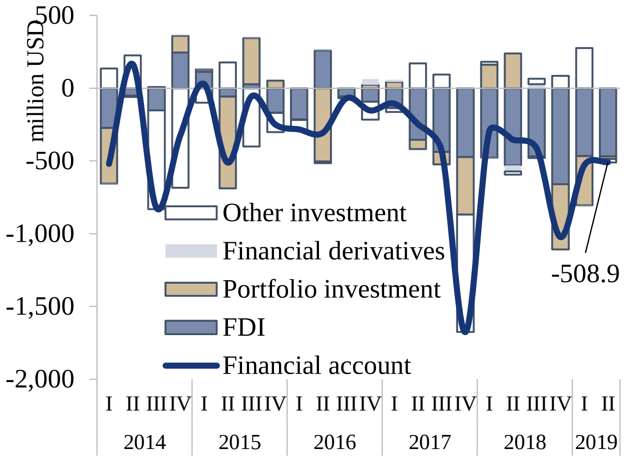
Terms of Trade improved by 1.7 percent year-over-year and by 3.1 percent from previous month in July 2019. Improvement in the terms of trade from previous year was due to a 1.5 percent increase in export prices and a 0.3 percent decline in import prices year-over-year.

Price of coal reported by the customs increased by 8 percent (due to increasing share of coking coal in the total coal exports), price of iron ore increased by 63 percent (price of iron ore increased at the global commodity market), price of molybdenum increased by 14 percent, and price of canned meat products increased by 4.3 percent year-over-year in July 2019. Conversely, the customs prices of copper concentrate declined by 18 percent (as gold contents within the Oyu Tolgoi copper concentrate started to diminish in July), the customs prices of crude oil declined by 19 percent (price declined at the global commodity market), the customs prices of zinc declined by 15 percent, the customs prices of fluorite, leucite, and nepheline declined by 11 percent, and cashmere price declined by 11 percent year-over-year in July 2019. Overall, the price of exports increased by 1.7 percent year-over-year.

Price of imports declined by 0.3 percent year-over-year in July 2019, mainly driven by lower price for imports of capital goods and fuel (-12.5% year-over-year) despite a marginal increase in import prices of industrial materials and some consumer goods.

Figure IV.2.5

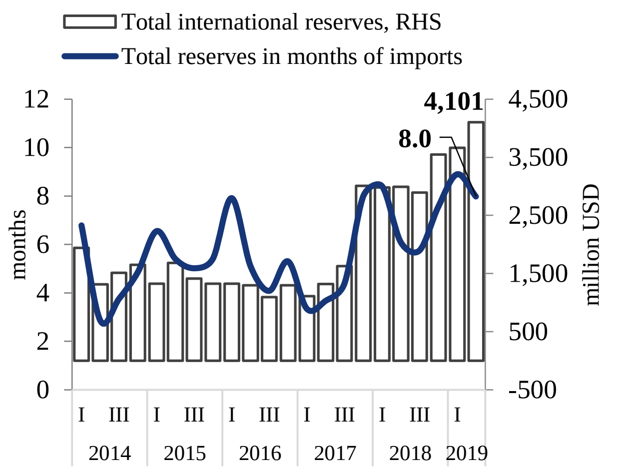
Financial account surplus increased (YoY).



Source: Bank of Mongolia

Figure IV.2.6

Gross international reserve reached 4.1 trillion USD.



Source: Bank of Mongolia

THE BANK OF MONGOLIA