THE BANK OF MONGOLIA

INFLATION REPORT

2019 DEC

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 statement

Keeping the policy rate unchanged and setting the reserve requirements

Number: 2019/04

Date: 20 December 2019

The Monetary Policy Committee meeting was held on 20 December 2019. The Committee decided to keep the Policy rate unchanged at 11 percent and the reserve requirement on banks' liabilities in togrog at 10.5 percent while increasing the requirement on liabilities in foreign currency by 3 percentage points to 15 percent.

Annual headline inflation reached 5.2 percent nationwide as of November 2019. Inflation fluctuations are mainly attributed to price swings of few items related to supply changes, while the demand induced core inflation remains stable and inflation is expected to be consistent with the Central bank's target.

Although a relatively favorable level of export prices, expansion of fiscal spending, and sustained investments in mega projects are supporting the economic growth, it is expected to decelerate due to uncertainties in the external environment. In the upcoming year, fiscal expenditure and rising wages are likely to support domestic demand. Nevertheless, on account of weaker growth in the mining sector and deceleration in investments, economic activities are expected to be limited.

In relation to weakening economic growth and bank lending, the Monetary Policy Committee discussed the option of reducing the policy rate. However, considering the performance of fiscal spending and uncertainties in the external environment the Committee decided to keep the policy rate unchanged, this time.

Furthermore, the Committee decided to increase the reserve requirement on banks' liabilities in foreign currency by 3 percentage points, with the purpose of sustaining the relative yield of togrog and consequently to minimize exchange rate fluctuations.

EXECUTIVE SUMMARY

Demand-driven inflationary pressure remains relatively stable, while contributions from supply-driven factors to headline inflation has been declining in recent months. Inflation reached 5.2 percent nationwide and 5.0 percent in Ulaanbaatar, as of November 2019. Following dissipation of previous year's base effect associated with prices of supply-related items including, meat, solid fuel, and gasoline, inflation has been decelerating in recent months. Inflation forecasts have been revised downwards for the end of 2019, while it is expected to stabilize around the target level in 2020. Demand-driven inflation is expected to rise following fiscal loosening, wage increases, and exchange rate pressures, though the extent of such increase would be limited in accordance with reduced economic activities. A number of factors including, weather conditions, quotas imposed on meat exports, changes in fiscal stance in accordance with the upcoming election and changes in prices of imported goods resulting from uncertainties in the external environment could be sources that may affect inflation outlook.

Economic growth outlook of the coming year has not been revised significantly, though it did not reach expectations in the reporting quarter. Gross capital formation and household consumption have been supporting total demand growth, while transportation, services, agriculture, trade, and manufacturing sectors have been contributing the most to total supply growth. Mining growth significantly shrank, due to the production of minerals and commodities excluding coal, undermining expectations. Non-mining growth did not surpass expectations as well, with lower-than-projected activities in construction, trade, manufacturing and services sectors. Potential output growth has been hovering around 5-6 percent in recent quarters and the output gap is estimated to be around potential level. Economic growth outlook has been revised down for 2019, while it has remained relatively stable for 2020. Mining growth is projected to be lower following expectations of worsening of external demand and deteriorating terms of trade. Non-mining growth, on the other hand, is expected to be spurred by loosening of the fiscal stance. A number of factors including, unfolding of trade conflicts between power nations and restrictions placed on coal imports by Chinese authorities, implementation status of actions necessary for removal from the FATF grey list and progress of Oyu tolgoi underground mine development could be sources that may affect economic growth outlook.

Falling employment and rising unemployment have been signaling the slowdown of labor market activities in recent quarters. Among main indicators of the labor market, the labor force participation rate has remained stable in recent quarters, while employment rate has been exhibiting decline and unemployment rate has begun to increase. Besides unemployment rate standing at around 10 percent, an additional 4 percent of extended labor force is being under-utilized. Among indicators of household income, growths of the national average wage and median wage have accelerated and remain at double-digits, while real wage growth has been gradually picking up. Labor productivity growth has been accelerating and unit labor cost growth has been on a downward trend in recent quarters.

Fiscal policy has been expansionary in accordance with the approved budget for 2019 and sovereign debt remains within the limits imposed by law. With equilibrated budget revenue exceeding planned projections and budget expenditure remaining under-utilized, equilibrated balance has been in surplus. The amount of debt newly issued by the government in 2019 slightly surpassed the amount of debt repayments, rendering the ratio of government debt repayments to new issuance to increase from previous year. The amount of sovereign debt, illustrated in present value terms, continues its path to gradual decline while remaining within the limits imposed by law.

Growths of money supply and credit issued by depository institutions have been gradually decelerating since the beginning of 2019. Increases in net foreign reserves and credit issued by banks have been mainly supporting money supply growth. Particularly, bonds issued in international markets, foreign direct investment, donor support, and monetized gold have been supporting the growth of net foreign reserves and thus, expanding foreign assets. Deceleration in consumer loan growth following implementation of macro-prudential policy and slowing down of business loan growth have reduced contributions from credit growth to money supply growth. Continued improvements in credit repayments have been one of the factors leading to a decline in shares of non-performing and past-due loans.

Exchange rate of togrog against USD, which had been gradually appreciating since late August, began to depreciate rapidly in mid-October, owing to a number of factors such as, impact on market participants' sentiment regarding announcement of inclusion in the FATF grey list, restriction placed by banks on sales of foreign currencies and reduced incoming flow of foreign currencies. The extent of nominal effective exchange rate depreciation was relatively lower as togrog depreciated less against euro and yuan. Real effective exchange rate appreciated, implying deterioration of trade competitiveness compared to previous year.

Capital market activities continued to remain sluggish in the third quarter, with TOP-20 index exhibiting fall. Though growth of housing rental prices decelerated, it surpassed growth of housing prices. Moreover, ratios of housing price-to-rent and housing price-to-income decreased in line with rising average household income and thus, implying relatively stagnant activities in the real estate market.

Uncertainties in the external environment remain elevated and the tendency for external demand to slow down continues. Outlook for Mongolian external demand in 2020 weakened from previous projection, with economic growth outlook for China, the US, and Eurozone being revised downwards and Russia remaining unchanged. Though trade conflict between the US and China has progressed on reaching a Phase One deal, raised expectations of further deals not to prolong the conflict and has been positively impacting prices of our main exporting commodities and improving terms of trade in 2019, future course of actions remain uncertain. Terms of trade is expected to return to its weakening trend in 2020, as global economic growth slows down and commodities demand falls. Prices of copper, coking coal and crude oil are projected to be lower than previous forecast in 2020, while prices of iron ore and gold are expected to remain unchanged from previous forecast.

Rising exports revenue, declining imports expenditure, shrunk in services account deficit yielded improvements in the current account balance and further contributed to lowering the balance of payment deficit. Exports of coal, gold, and iron ore, as well as reexport of trucks abroad, supported the growth of export revenue. Growth of imports, which mainly comprised of expenditures on machineries, equipment, investment-related items, and diesel fuel, decelerated. Though income account deficit expanded, current account balance improved, mostly owing to increases in surplus in goods balance and reductions in services account deficit. Surplus in the capital and financial account, on the other hand, worsened in the reporting quarter, mainly due to a number of factors including, higher utilization of external loan disbursement, lower incoming flow of foreign direct investment and larger net incoming flow of external loans. Gross international foreign reserves stands at a level sufficient to cover 8 months of imports.

I. INFLATION

The Bank of Mongolia's monetary policy aims 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 November 2019, inflation reached 5.2 percent nationwide and 5.0 percent in Ulaanbaatar (Figure I.1).

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

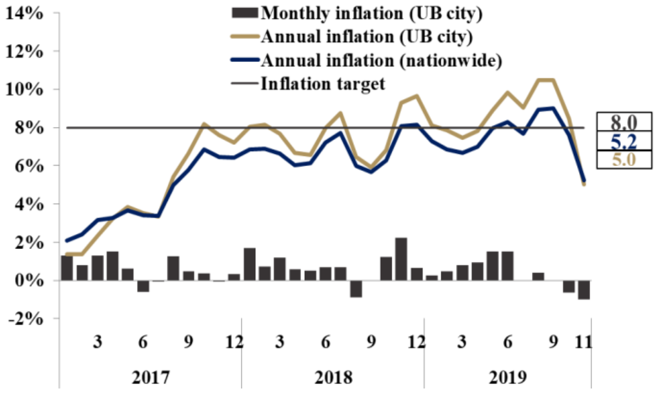
Supply related factors have pushed the prices of a few items and induced significant fluctuations in inflation. Food inflation which had been accelerating in recent months began to slow down since October (Figure I.2). Moreover, lower prices attributed to air transportation services and absorption of previous year's base effects have led to declines in contributions from imported goods, solid fuel and gasoline prices to headline inflation in October and November. Combined contributions from meat, solid fuel, and gasoline prices, which had been explaining 50 percent of headline inflation at the beginning of 2019, decelerated to explaining 21 percent or 1.1 percentage point of headline inflation by November (Figure I.3).

Though domestic prices of meat have been declining since July in line with its seasonal pattern, the extent of such decline did not exceed that of previous year's and thus, its contribution to annual headline inflation was increasing (3.4 percentage points in September). Following that, prices of meat decreased substantially in October and November and therefore, its contribution to headline inflation fell to 1.7 percentage points.

Previous year's base effect associated with prices of solid fuel has begun to subside since September and it contributed 0.3 percentage points negatively to headline inflation in November. Prices of wood fuel increased

Figure I.1

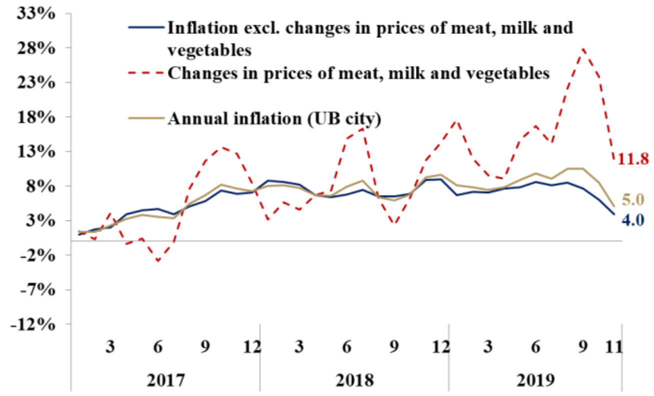
Inflation



Source: NSO

Figure I.2

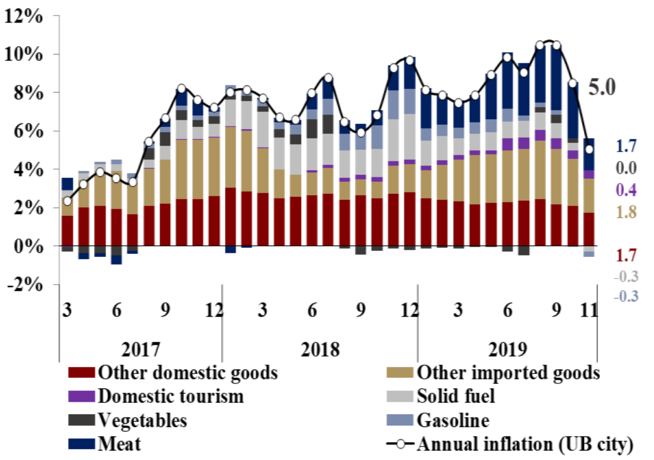
Headline and core inflation



Source: NSO, Bank of Mongolia

Figure I.3

Contributions to annual headline inflation in Ulaanbaatar, by main categories



Source: NSO, Bank of Mongolia

slightly owing to its seasonal demand, while prices of processed coal remained stable.

At the global market, prices of crude oil remained relatively stable at around 60-63 USD per barrel in the third quarter. Mainly owing to that, domestic prices of gasoline remained stable and its contribution to headline inflation shrank to -0.1 percentage point, following the absorption of previous year's base effect.

In the third quarter of 2019, inflation exceeded previous forecast by 0.3 percentage points, reaching 10.0 percent. Such discrepancy can be mainly attributed to the prices of a few items, where supply factors and one-off effects remained high. For instance, supplies of meat and vegetables increase and their prices decline according to their seasonal patterns. However, the timing and extent of decline in the prices of meat and vegetables in 2019 were considered relatively late and low compared to previous year, rendering 0.4 percentage points higher-than-expected food inflation. Among non-food items, prices of air transportation services declined by approximately 10 percent in August and September in total, rendering 0.2 percentage points lower-than-expected non-food inflation.

Inflation outlook

Though inflation in the third quarter exceeded forecasts slightly, the inflation forecast towards the end of 2019 is lowered and revised downwards. Specifically, substantial decline in prices of meat and vegetables in accordance with their seasonal patterns in November (base period effect associated with meat price hike by the end of 2018 is expected to dissipate in the upcoming months), reduced prices associated with air transportation services and lower-than-previously-expected price increases in solid fuel and imported goods are leading to downward revision in inflation forecast.

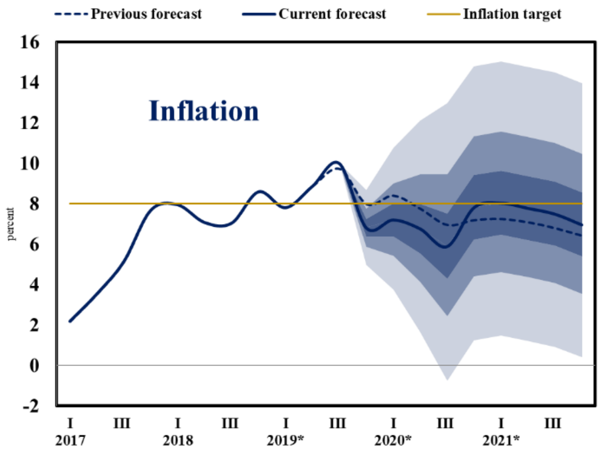
Table I.1 Changes in inflation outlook

Assumptions on near term forecasts of inflation	
Previous forecast 2019Q3-2020Q2	**Current forecast 2019Q4-2020Q3**
Prices of meat	**Projection revised down**
Prices of meat spiked in May 2019 and unlike its seasonal pattern it did not decline in June. Hence, price forecasts were revised up.	Prices of meat began to decline since July 2019 and continued its downward trend in October and November. Hence, price forecasts are revised down.
Prices of imported goods	**Projection revised down**
Prices of imported goods started to increase towards the end of 2018 and it is likely to remain elevated till the third quarter of 2019.	Prices of imported goods in the third quarter of 2019 were consistent with previous projections. Price increases in October were below expectations, resulting in forecasts revising down.
Prices of domestic goods	**Projection unchanged**
Prices of processed coal to remain unchanged. Prices of domestic tourism increased significantly in June 2019. Consequently, price forecasts of domestic goods were revised up.	Prices of processed coal to remain unchanged. Prices of domestic tourism decreased slightly in October 2019.
Prices of administered items	**Projection unchanged**
Prices of electricity and heating increased as planned. University tuition fees were raised in August 2019. Further price changes were not expected.	University tuition fees were raised as planned. Further price changes are not expected.
Prices of gasoline	**Projection revised up**
Following oil price developments in the international markets, domestic prices of gasoline declined in June and July 2019. Demand related upside pressure on prices of crude oil were low.	Domestic prices of gasoline remained stable in the third quarter of 2019 and demand related upside pressure on prices of crude oil remained low. With regards to additional expenditure on diesel fuel for use in the winter months, price forecasts are revised up.

Source: Bank of Mongolia

Figure I.4

Inflation forecast



Source: Bank of Mongolia

Figure I.2

Inflation forecast[1]

	2018	2019*	2020*
	actual	*projections*	
Inflation, CPI[2]	8.6	6.4-7.2	5.6-8.8

Source: Bank of Mongolia

[1] Confidence interval of 30 percent
[2] Fourth quarter average inflation of each year

Looking ahead, inflation is expected to stabilize around its target level. Though inflation is projected to gradually slow down to 6 percent in the first three quarters of 2020, mainly owing to supply-driven factors, it is expected to pick up slightly in the fourth quarter, due to elevated base period effect and stabilize around the target level. Demand-driven inflation is expected to rise following the fiscal loosening, wage increases, and exchange rate pressures, though the extent of such increase would be limited under the reduced outlook for economic growth.

Uncertainties that may affect the inflation outlook:

- Potential shortage or oversupply of goods and services have significant implications on the inflation forecast. For instance, depending on weather conditions and state of this winter and upcoming summer, price increases of meat, vegetables, and administered items may exceed projections and thus, may alter inflation forecasts.
- Risks associated with projections of meat prices largely stem from the number of exporting companies to be issued approval licenses by Chinese requirements and the extent of quotas to be imposed upon meat exports by the Ministry of Food, Agriculture and Light Industry.
- In the event of fiscal stance loosening beyond the level approved for 2020 following the parliamentary election, such measure bears uncertainties of intensifying the growth in domestic demand and increasing demand-driven inflationary pressure.
- Sluggish global economic growth, building-up of geopolitical risks and tensions, and consequently rising uncertainties in the external environment bear adverse consequences of affecting prices of minerals and commodities in the international markets as well as capital inflows to our economy. As a result, there are heightened risks of a weaker balance of payments, further depreciation of togrog and higher prices of imported goods.

II. ECONOMIC GROWTH

The economy expanded by 6.3 percent in the first 9 months of 2019. From the demand side, growth of gross capital formation and household consumption have supported the economic growth, while net exports made negative contributions, as was the case in previous 9 quarters (Figure II.1). Productions in the majority of economic sectors expanded, except for the mining sector. In particular, productions of transportation, services, agriculture, trade, and manufacturing sectors supported economic growth the most (Figure II.2).

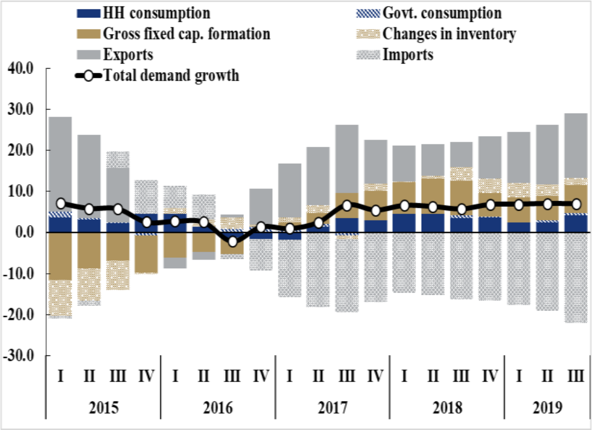
Investments: Total investments increased by 24.0 percent in the third quarter of 2019, mainly driven by expenditures made towards construction, machineries, and equipment and contributed 9.0 percentage points to total demand growth. Increases in fiscal capital expenditure of 42 percent and growth in business loans facilitated the availability of greater financing sources necessary for investments.

Though incoming foreign direct investment is not expected to exceed previous year's amount in 2019, the amount of fiscal capital expenditure was stated to increase by 1.56 trillion togrogs (93 percent) from previous year in the approved budget for 2019 and its utilization rate stood at merely 66.8 percent as of first three quarters, rendering significant hikes to be expected for gross capital formation in the fourth quarter.

Consumption: In the reporting quarter, household consumption increased by 12.4 percent and contributed 6.7 percentage points to total demand growth. Though household income has been exhibiting steady growth in the past 11 consecutive quarters, the level of household expenditure remained higher than that of household income in the reporting quarter. Consumer credit, one of the main sources for financing such gap between income and expenditure, had been exhibiting rapid growth in the past years (Figure II.4).

Figure II.1

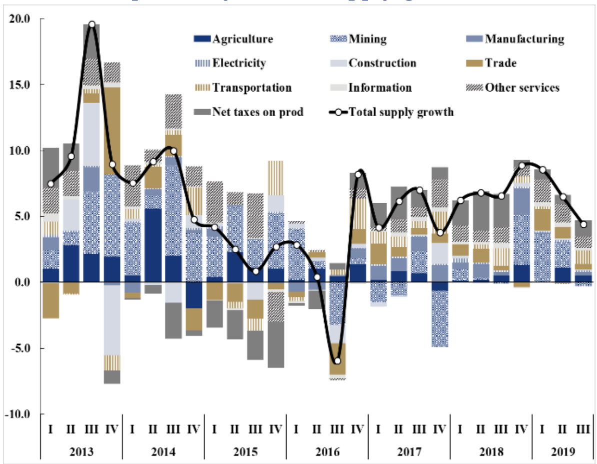
Gross capital formation and household consumption contributed the most to total demand growth in the reporting quarter.[3]



Source: NSO

Figure II.2

Majority of production sectors, excluding mining contributed positively to total supply growth.



Source: NSO

[3] Growth calculated from sum of 4 quarters

Government expenditure expanded by 5.8 percent in real terms and supported total demand growth by 0.6 percentage points. According to the approved budget, fiscal expenditure on goods and services is expected to increase by around 18.6 percent in 2019 and 21.2 percent in 2020 in nominal terms, respectively.

Net exports: Net exports weighed down the economic growth by 12.1 percentage points. In the reporting quarter, on top of commodity prices remaining relatively high, the volume of coal exports transportation through Chinese borders remained relatively undisturbed. Despite exports expanding by 15.3 percent, in real terms, the rate of expansion in imports exceeded that of exports, resulting in weaker net exports. Exporting volumes of non-monetary gold, coal and iron ore explained a significant portion of the growth in real exports.

On the other hand, imports expanded by 29.0 percent, in real terms, in the reporting quarter. For instance, increases in the volume of coal exports led to a 20 percent growth in diesel fuel imports. In addition, increases in gross capital formation, mainly driven by fiscal capital expenditure resulted in a 10 percent growth in investment-related imports including, building materials, machineries, and equipment. However, the growth of consumer imports, which had previously exceeded 20 percent throughout 2018 in line with economic recovery and rebound in household consumption, has been slowing down in the last three quarters and exhibited 2.4 percent fall in the reporting quarter (Figure II.4).

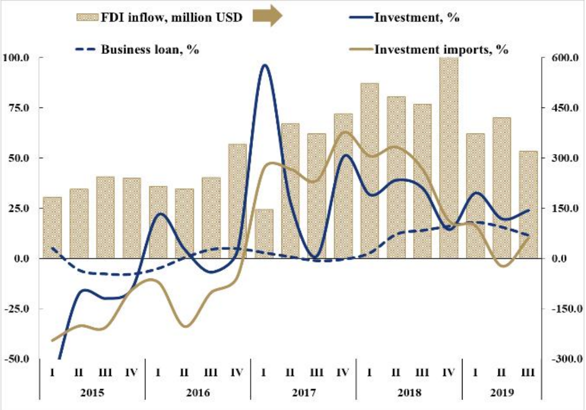
Economic sectors

Production in the mining sector shrank by 1.4 percent in the reporting quarter, owing to lower productions of copper concentrates and gold. On the other hand, the production of coal and iron ore expanded in the reporting quarter, mainly on the back of prices remaining relatively high in the international markets (Figure II.5).

The trade sector grew by 3.1 percent, contributing 0.4 percentage points to total supply growth. In line with lower mining production, sales growth of fuel

Figure II.3

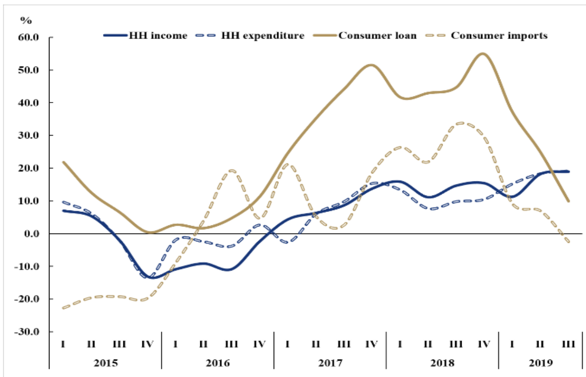
Expansions in fiscal capital expenditure and business loans were main drivers to growth in gross capital formation.



Source: NSO, Bank of Mongolia

Figure II.4

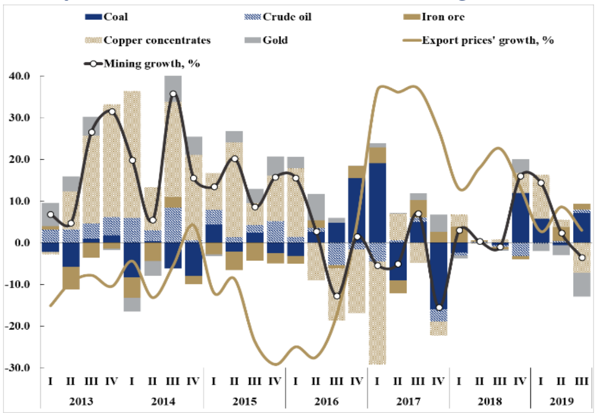
Household income remains short of expenditures, though it has been exhibiting growth in the past 11 consecutive quarters.



Source: NSO, Bank of Mongolia

Figure II.5

Declines in production of copper concentrates and gold mainly contributed to contraction in mining sector.



Source: NSO, Bank of Mongolia

products slowed down and resulted in lower-than-expected growth in trade sector.

Production in the construction sector expanded by 4.9 percent, though it did not reach expectations in line with under-utilization of fiscal capital expenditure. A majority of such expansion is observed in the construction of factories, schools, hospitals, roads, and railway transportation.

The manufacturing sector grew by 5.3 percent in the reporting quarter, contributing 0.3 percentage points to total supply growth, though it undermined the expectations. Production of food items, coking coal, textiles, and construction materials did not meet expectations, explaining forecast differences in manufacturing.

Recovery of economic activities, expansion of tax base and intensification of foreign trade have been supporting tax revenue on goods and services, which in real terms expanded by 10.9 percent and contributed 1.2 percentage points to total supply 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 for development of a mega mining project and its indirect impact have been spurring non-mining sector growth and thus, supporting potential output growth since the last quarter of 2016. Consequently, the growth of potential output has been hovering around 5-6 percent in recent quarters (Figure II.7).

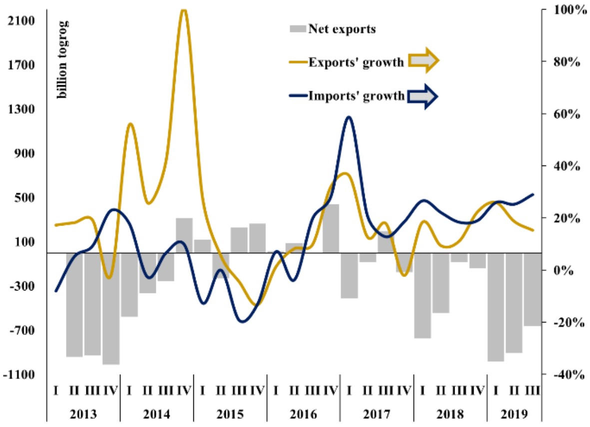
Output gap

Mainly supported by the non-mining sector, aggregate production had exceeded its potential level during 2011-2013, rendering a positive output gap. However, positive developments in the non-mining sector were reversed throughout 2014-2016, resulting in a negative output gap. Output gap turned positive again since the latter half of 2018. As of the third

[4] Estimated by Kalman filter.

Figure II.6

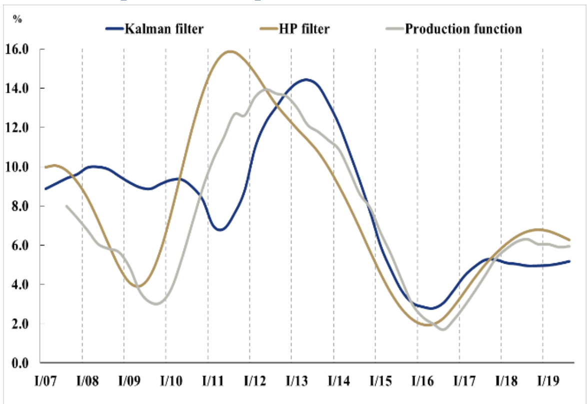
Imports' growth surpassed that of exports, resulting in net exports weighing total demand growth down by 12.1 percentage points in the reporting quarter.



Source: NSO

Figure II.7

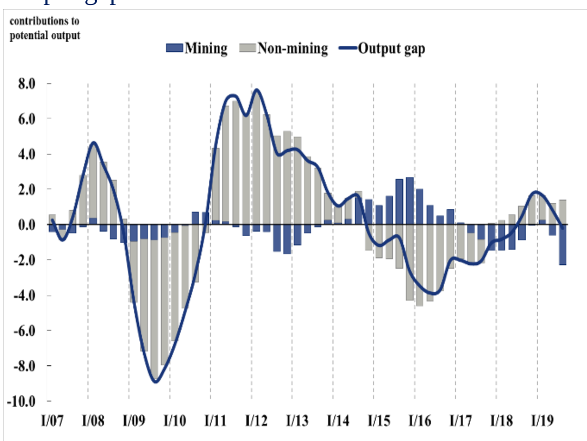
Growth of potential output



Source: expert's estimation

Figure II.8

Output gap[4]



Source: expert's estimation

quarter of 2019, output gap is estimated to be close to its potential level, owing to the significant decline in mining production (Figure II.8).

Though with increased coal production, mining output gap had been exhibiting a tendency to close since the second half of 2018, it turned significantly negative in the third quarter of 2019 owing to reduced production of minerals and commodities, excluding coal and lower gold content in Oyu tolgoi copper concentrates.

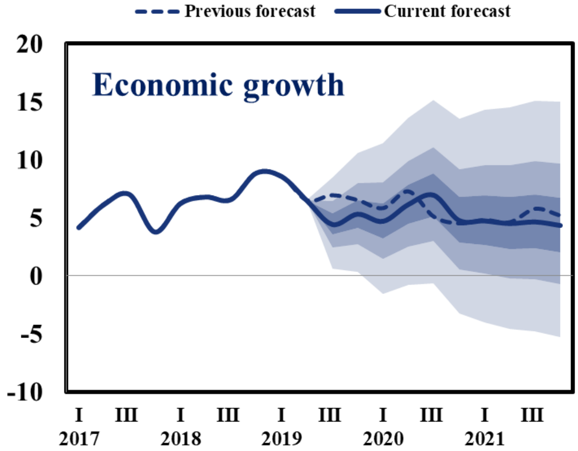
Non-mining output gap has remained positive since 2018, mainly supported by growth of mining exports and investment. Non-mining output gap slightly widened from previous quarter due to growth of transportation sector and taxes on goods and services.

Economic growth outlook

Economic growth did not reach expectations in the third quarter of 2019, with mining production slowing down and non-mining growth undermining projections. Mining production slowed down, as gold content in Oyu tolgoi copper concentrates continued to fall and productions of minerals and commodities, excluding coal fell short of expectations. Non-mining growth undermined projections as well, with lower-than-expected productions in construction, trade, manufacturing, and other services sectors. A number of factors including, under-utilization of fiscal capital expenditure, decreased processing of meat for exports, decelerated manufacturing of coking coal and textiles and lowered sales of diesel fuel for use in the mining sector explained such developments in the non-mining growth.

Figure II.9

Forecasts of annual growth of quarterly GDP



Source: Bank of Mongolia

Table II.1.1

Economic growth forecasts[5]

	2018 *гүйц.*	2019*	2020*
		төсөөлөл	
GDP growth, %	7.2	4.6 – 7.2	3.7 – 7.5
Mining growth, %	5.7	3.6 – 6.2	0.9 – 4.7
Non-mining growth, %	7.7	4.9 – 7.5	4.5 – 8.3

Source: Bank of Mongolia

Table II.1.2

Changes in economic growth outlook

Assumptions on near term forecasts of economic growth

Previous forecast (2019)	Current forecast (2019)
AGGREGATE DEMAND	Expectation weakened
Consumption	**Expectation improved**
Growth of household consumption in the third quarter of 2019 exceeded projections.	
Investment	**Expectation improved**
Growth of gross capital formation in the third quarter of 2019 exceeded projections. Expansion in fiscal capital expenditure was the main driver for such growth.	
Net exports	**Expectation weakened**
Growth of exports is revised slightly down, with projections for lower gold exports. Growth of imports is revised up, with third quarter figure exceeding projections by 10 percentage points.	
AGGREGATE SUPPLY	Expectation weakened
Mining	**Expectation weakened slightly**
Productions of gold and coal are revised down, with lower gold exports and coal inventory rising by 37 percent as of October 2019.	
Non-mining	**Expectation weakened slightly**
Growth of manufacturing sector is revised down, with productions of coking coal and processed meat undermining projections again in the third quarter of 2019. Growth of services' sector is expected to slow down further, with decelerating credit growth. Growth of road freight transportation is expected to contract by the end of 2019, with restrictions placed on coal exports through Gashuunsukhait border.	

Source: Bank of Mongolia

[5] Confidence interval of 30 percent

Economic growth outlook is revised downwards for 2019 and remains unchanged as previous projection for 2020. Mining and non-mining growths are expected to slow down in 2019 and economic growth outlook is revised downwards from previous projection. Expectations of weakening external demand and deteriorating terms of trade caused the mining growth outlook for 2020 to be revised down from previous projection, while loosening of the fiscal stance is expected to spur activities in the non-mining sector, allowing economic growth outlook to remain unchanged around previous projection (Figure II.9).

Mining sector: Strict border restrictions imposed by Chinese authorities on coal imports since mid-November harmed coal production, resulting in projections for mining growth to contract in 2019 from previous year. Continued deterioration in the gold content of Oyu tolgoi copper concentrates and outlook of weaker external demand and lower prices of copper and coal are projected to impact mining production negatively, with contraction in mining growth to persist in 2020.

Non-mining sector: Though increased fiscal capital expenditure by the end of year is expected to support the growth in construction, trade, and services' sectors, the non-mining growth is projected to slow down in 2019 from previous year as activities in transportation sector are affected by restrictions on coal exports and activities in manufacturing, financial and insurance services are expected to remain in moderation. Growth in agriculture sector is expected to be stable, with outlook for weather conditions remaining within the average of past years and natural losses of livestock being relatively low. Non-mining growth is projected to pick up in 2020, mainly driven by increases in fiscal capital expenditure, higher production of processed fuel supporting the manufacturing sector and rises in public sector employee wages boosting household consumption.

Uncertainties that may affect the economic growth outlook:

Though trade conflict between the US and China has progressed on reaching a Phase One deal, future courses of actions remain uncertain. In the case of the trade conflict between power nations prolonging even further, it bears adverse consequences for Chinese economic growth and commodity prices and results in risks for the Mongolian economy such as weakening external demand, declining export revenue and materializing external and domestic economic imbalances.

Restrictions have been imposed by China authorities on coal imports from Mongolia since mid-November 2019 and it is expected to last through the early months of 2020. In the case of such restriction prolonging even further, it bears risks of hurting coal exports and production as well as activities in transportation sector.

Another factor that could affect economic growth outlook is the implementation status of actions necessary for removal from the FATF grey list by Mongolian authorities in the near term. Failure to be removed from the list within the planned timeframe carries risks with regards to a downgrading of credit ratings, increased costs of external borrowing, unfavorable investment environment, difficulties in processing global financial transactions and payment systems, and reduced capital inflows.

Progress of Oyu tolgoi underground mine development has also become a source of uncertainty. In the case of investment for the underground mine project falling short of plans owing to geological and environmental reasons as well as political circumstances, the economic growth may be lower than projected.

Commencement of crude oil processing plant’s operation in the upcoming years would not only boost the production but also alleviate the pressure on the exchange rate and foreign reserves by reducing dependence on fuel imports. Implementation duration and feasibility study associated with this project are uncertain at the moment.

III.1. Labor market

Falling employment and rising unemployment have been signaling the slowdown of labor market activities in recent quarters.

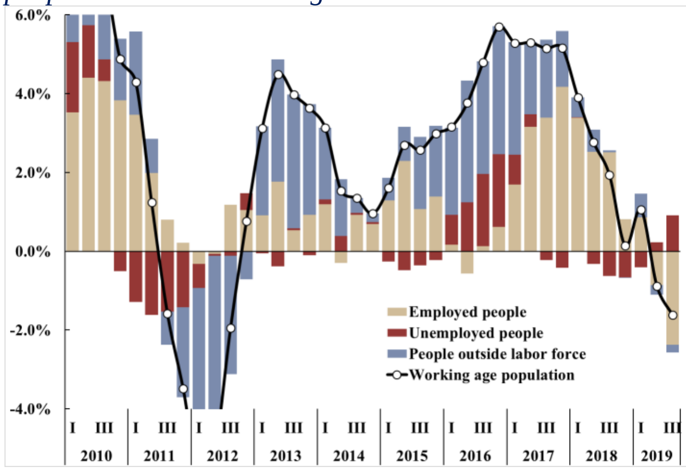
The number of working-age population has been exhibiting downwards trend, as of moving averages of past 4 quarters. Out of which, number of employed people has been declining and number of unemployed people has been rising, while economically inactive population has remained relatively stable (Figure III.1.1).

Among the main indicators of the labor market, labor force participation rate[6] has remained stable at around 61 percent on average in recent quarters. Employment rate[7] has been exhibiting decline since the beginning of 2019 and recently stood at around 55 percent. Unemployment rate[8] has begun to exhibit an increase in the recent quarters up to 10 percent, in contrast to its falling trend since 2016 (Figure III.1.2).

Among newly announced composite indicators that illustrate labor force under-utilization, time-related under-employed people took up 0.8 percent of labor force, while number of people viable for employment but included in economically inactive population took up 3.9 percent of extended labor force as of third quarter of 2019. Such indicators illustrate that besides unemployment rate standing at 9.9 percent, an additional 4 percent of extended labor force[9] is being under-utilized (Figure III.1.2).

Figure III.1.1

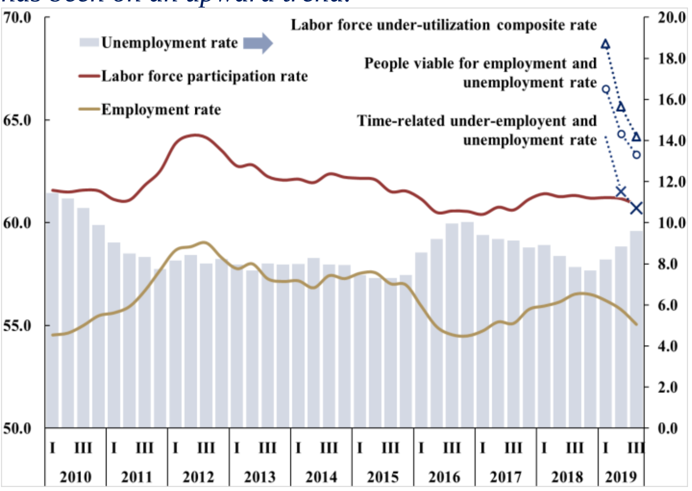
Within the working age population, number of employed people has been declining and number of unemployed people has been increasing.[14]



Source: NSO

Figure III.1.2

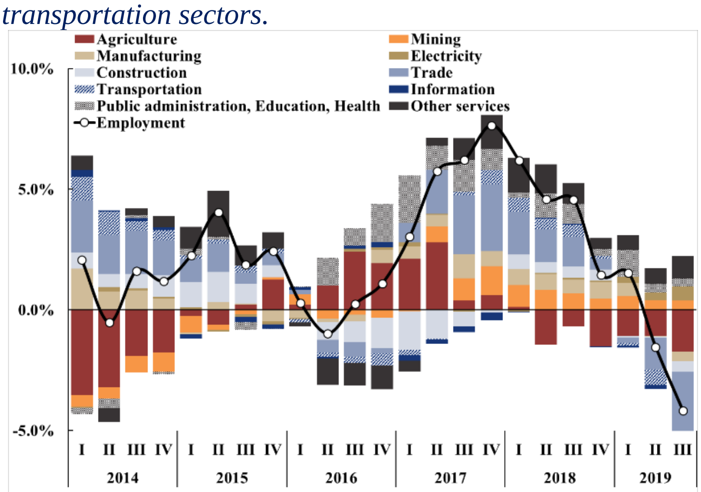
Labor force participation rate remains stable, while employment rate has been declining and unemployment rate has been on an upward trend.[15]



Source: NSO

Figure III.1.3

Employment contracted in agriculture, trade and transportation sectors.



Employment growth, as of moving averages of past 4 quarters, slowed down to 4 percent decline. Falling employment in agriculture, trade, manufacturing, and construction sectors mainly contributed to such decline, while employment in mining, energy, public administration, education, and health sectors exhibited expansion (Figure III.1.3).

The extent of the decline in number of people registered as unemployed has been rising in recent months. Number of people newly registered for unemployment has been decreasing, while number of people removed from the registry, either for reasons of commencing employment or shifting to inactive status in seeking employment, has remained relatively stable (Figure III.1.4).

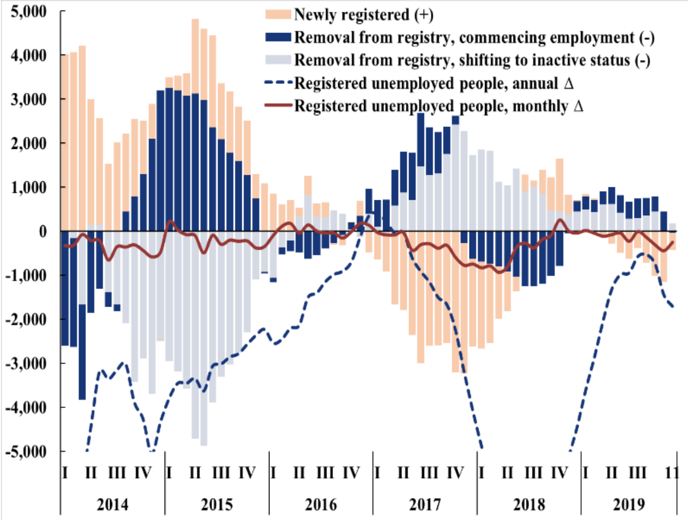
Among indicators of household income, growths of the national average wage and median wage[10] have accelerated since the beginning of 2019 and continue to record at double-digit. Consequently, real wage growth, the main indication for the purchasing power of citizens and which previously stalled in 2018, has increased to approximately 4-5 percent. In addition, average monetary income of households[11] continues to record double-digit growth since the end of 2017 (Figure III.1.5).

In terms of main economic sectors, average wage ranges from 750 to 2690 thousand togrogs. The national average wage standing at 1166.4 thousand togrogs and national median wage standing at 843.0 thousand togrogs indicate levels closer to

Source: NSO

Figure III.1.4

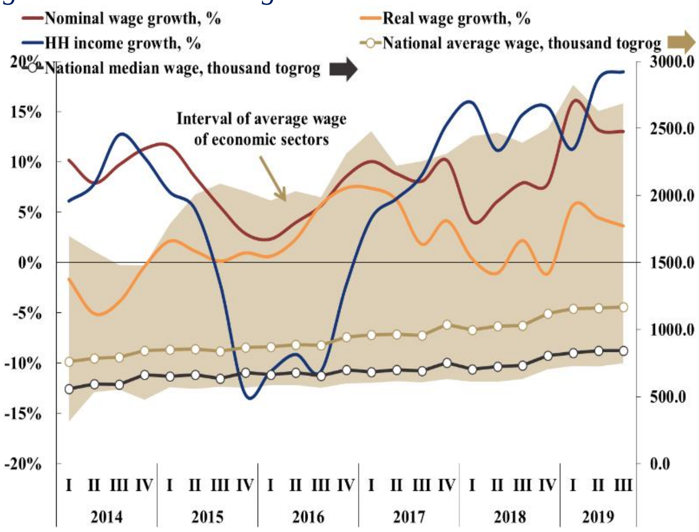
Registration of unemployed people has been declining, while de-registration of employed people has been rising.



Source: General Office for Labor and Welfare Services

Figure III.1.5

Real wage growth has been accelerating, following rapid growth in nominal wages.



Source: NSO

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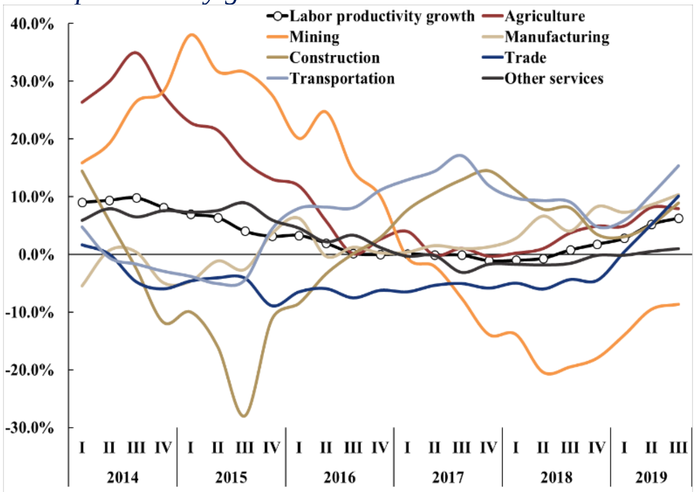
[6] Labor force/Working age population, average of past 4 quarters.
[7] Employed people/Working age population, average of past 4 quarters.
[8] Unemployed people/Labor force, average of past 4 quarters.
[9] Extended labor force = Labor force + People viable for employment (included in population outside labor force).
[14] Average growth of past 4 quarters of working age population and total employment.
[15] NSO has started to conduct Labor force survey under the framework of "Updated methodology in measuring employment statistical indicators" since the first quarter of 2019 and has extended the sample size and estimated new indicators in illustrating labor force under-utilization.
[10] Source: Social security payments' report by the Social Insurance General Office.
[11] Source: Household Socio-economic survey by the NSO.

the lower bound of sectoral interval (Figure III.1.5).

Recent trend of economic recovery outpacing the growth of employment has indicated an acceleration of labor productivity growth[12] in recent quarters. In particular, labor productivity has been improving in the majority of the sectors, except for the mining (Figure III.1.6).

Figure III.1.6

Labor productivity growth continues to accelerate.[16]

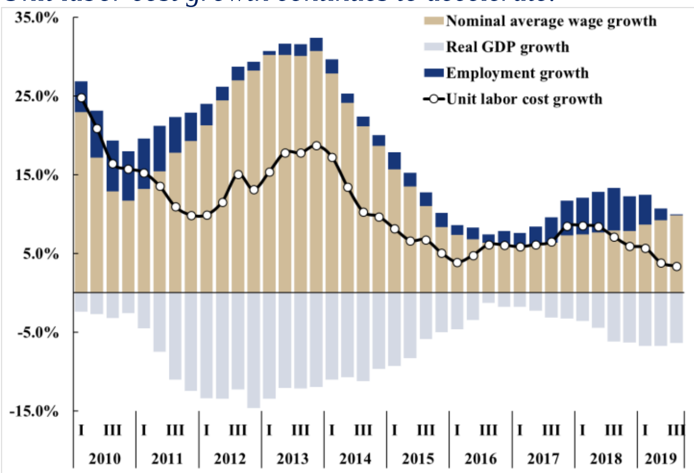


Source: NSO, expert's estimation

Though wage expenditure growth remains high at double digits, acceleration of economic growth and falling employment have been yielding unit labor cost growth[13] to be on a downward trend in recent quarters (Figure III.1.7).

Figure III.1.7

Unit labor cost growth continues to decelerate.



Source: NSO, expert's estimation

[12] Average of GDP per employed person.
[13] Average labor cost or wage expenditure per unit of GDP.
[16] Average growth of past 8 quarters of labor productivity and unit labor cost.

III.2 Money and financial market

III.2.1 Monetary and credit indicators

Annual growth of M2 money supply has been gradually slowing down since the beginning of the year and reached 11.7 percent as of October 2019. A significant portion of such growth has been supported by increases in net foreign reserves and credit issued by banks.

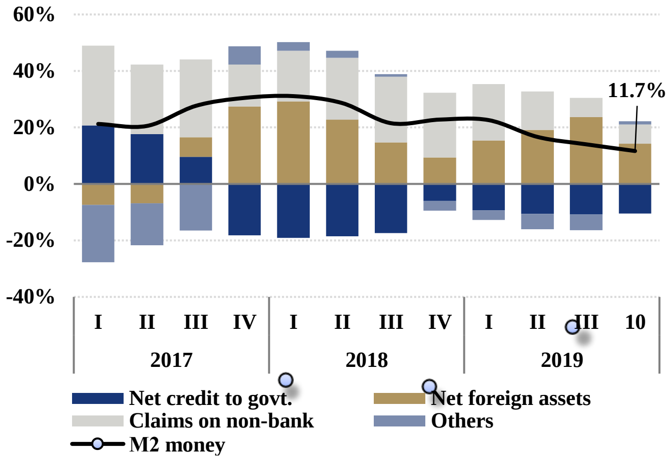
From the assets side, additional accumulation of approximately 600 million dollars to Central bank's net foreign reserves rendered a contribution of 14.3 percentage points to money supply growth as of October 2019. Throughout the past year, a bond issued in international markets by "MIK HFC LLC", foreign direct investment for Oyu Tolgoi project, financing received from donor institutions under "Extended fund facility" program and growth in monetized gold by the central bank have been supporting such accumulation in net foreign reserves.

Credit growth issued by depository institutions to households and companies (claims on nonbank) has contributed 6.8 percentage points to money supply growth. Such contribution from credit growth by depository institutions to money supply growth has been falling, as consumer loan growth has been slowing down since the beginning of 2019 and business loan growth that had remained at 16-18 percent in the first half of 2019, has been decelerating in the second half.

Net credit to government has been declining due to repayments of loans issued to the government being made in accordance with the planned schedule and increased amount of government funding available in the banking system. On one hand, current accounts of government held at the central bank and social insurance fund accounts held at commercial banks have been rising, owing to budget equilibrated balance being in surplus of 545 billion togrogs as of the first ten months of 2019. On the other hand, principal repayments of domestic bonds issued by the government have been made in accordance with the planned

Figure III.2.1.1

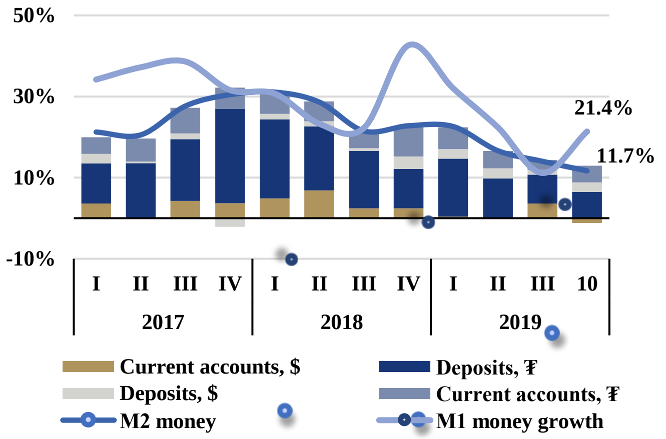
Contributions to annual growth of M2 money supply, by assets



Source: Bank of Mongolia

Figure III.2.1.2

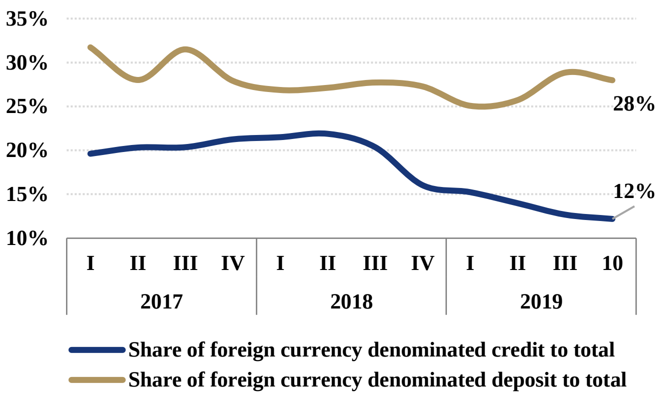
Contributions to annual growth of M2 money supply, by liabilities



Source: Bank of Mongolia

Figure III.2.1.3

Dollarization of bank credits and deposits



Source: Bank of Mongolia

schedule, allowing a decline in net credit issued by the banks to the government.

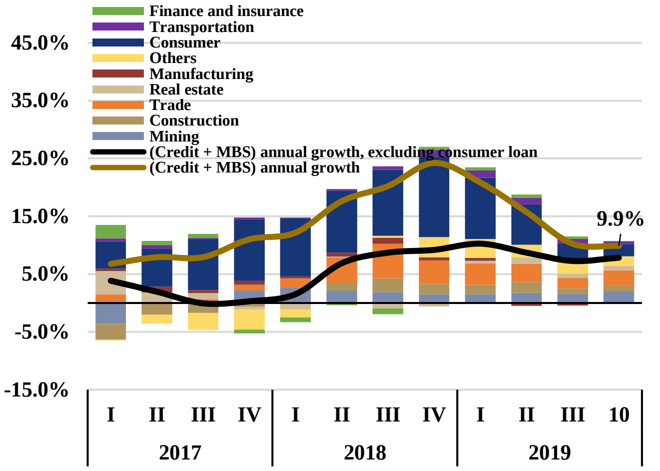
From the liabilities side, money supply growth continues to be mainly supported by deposit and current accounts in domestic currency. Deposit and current accounts in domestic currency contributed 10.5 percentage points and foreign currency denominated deposit and current accounts contributed 1.2 percentage points to money supply growth. Several state-owned enterprises withdrew foreign currency denominated funds from the banking system in October 2019 and thus, current accounts in foreign currency shrank, resulting in deposit dollarization to fall by approximately 1 percentage point to 28 percent.

Combined outstanding level of total credit issued by depository institutions[17] and mortgage loans converted to mortgage backed securities (MBS[18]) increased by 9.9 percent as of October 2019. Consumer loan growth contribution to total credit growth, which stood at around 14 percentage points by the end of 2018, continues to shrink and reached 2 percentage points as of October 2019. Business loan growth, which had remained stable at around 16-18 percent in the first half of 2019, slowed down to 12 percent in the third quarter, mainly owing to a deceleration of growth for credit issued to construction, trade, transportation, and financial, and insurance sectors.

Looking at the composition of outstanding level of total credit, combined share of credit issued to mining, trade, and other services' sectors expanded by 3 percentage points to 37 percent, while combined share of credit issued to manufacturing, real estate sectors and for consumption purposes fell by 3 percentage points to 55 percent. Share of credit issued to the construction sector stood at around 8 percent.

Figure III.2.1.4

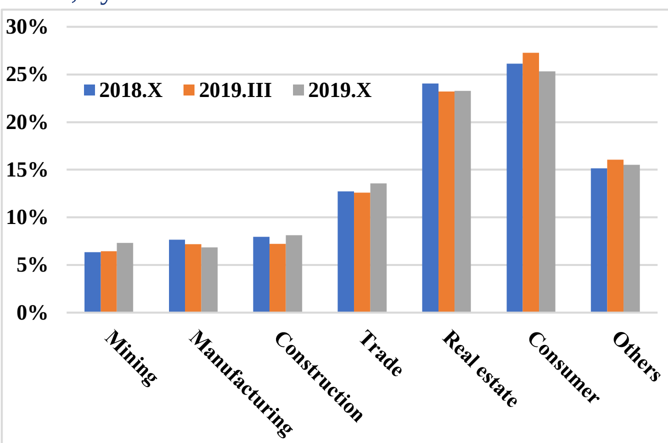
Contributions to annual growth of credit issued by depository institutions, by sectors



Source: Bank of Mongolia

Figure III.2.1.5

Composition of outstanding amount of credit issued by banks, by sectors



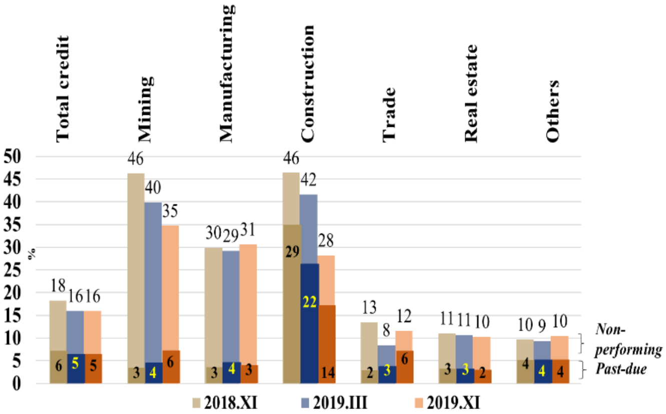
Source: Bank of Mongolia

[17] Depository corporations consist of banks and deposits and loans cooperatives.
[18] 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.
[4] Total loans issued for individuals comprise of mortgage loans, SME loans, and consumption, wage, pension and other types of consumer loans.

Non-performing and past-due loans comprise 16 percent of total outstanding credit as of October 2019, recording a decrease of 2 percentage points from previous year. The amount of non-performing and past-due loans increased in October 2018, following the outcome of the asset quality review. Another factor affecting such decline in shares of non-performing and past-due loans is continued improvements in credit repayments in 2019. For instance, credit repayments were higher by 14 percent as of the first 10 months of 2019.

Figure III.2.1.6

Share of non-performing and past-due loans to total outstanding amount of credit, by sectors



Source: Bank of Mongolia

III.2.2 Interest rates

The Monetary Policy Committee of the Bank of Mongolia decided to keep the policy rate unchanged at 11 percent during its scheduled meeting on September 19, 2019.

The interbank market rates has fluctuated around the policy rate. For instance, in October 2019 the interest rate on uncollateralized loans or overnight lending rate was 11.24 percent or remained around the previous month's level. As for the collateralized loans, interest rate on direct trading of central bank bills decreased by 0.04 percentage points to 10.94 percent, interest rate on interbank deposits decreased by 1.14 percentage points to 10.8 percent, and interest rate for repo deals collateralizing the central bank bills was 11.1 percent, around the previous month's level. Consequently, the weighted average of interbank market rate decreased by 0.06 percentage points to 11.06 percent from previous month. The average absolute volatility of the weighted average of interbank market rate in the first ten months was 0.09 percent. It is a decline of 0.16 percentage points from that of previous year.

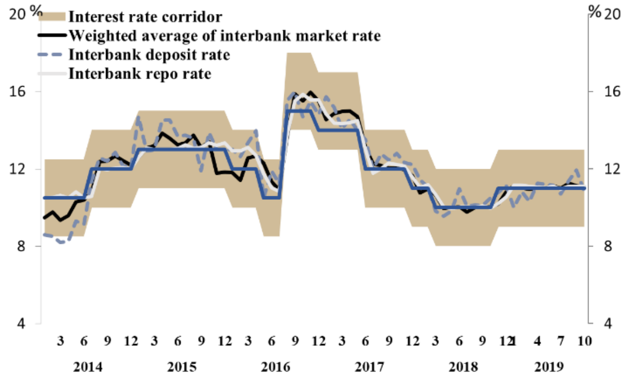
As of October 2019, the interest rate on newly issued loans and the interest rate on new deposits decreased from that of previous year. In particular, the interest rate on credits issued in MNT decreased by 0.84 percentage points from that of previous year to 16.69 percent, and interest rate on MNT deposits decreased by 0.58 percentage points to 11.13 percent. Consequently, interest rate margin narrowed by 0.27 percentage points to 5.55 percent, compared to that of previous year. Interest rate on newly issued loans was 16.68 percent on average in September 2019 which is the lowest point since October 2014.

In the case of foreign exchange loans, interest rate on newly issued loans decreased by 1.12 percentage points from that of previous year to 8.9 percent and the deposit rate decreased by 0.59 percentage points to 4.19 percent.

Since the nominal exchange rate of MNT depreciated against USD, the relative yield on MNT has declined by 0.32 percentage points from previous quarter to 0.24 percent in October 2019. The relative yield on MNT has remained positive since the beginning of 2019.

Figure III.2.2.1

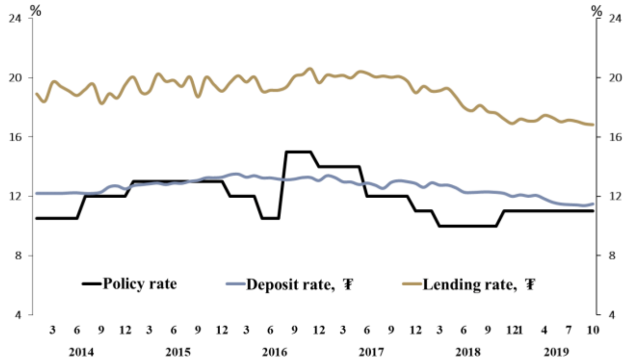
Weighted average of interbank market rate remains close to the policy rate.



Source: Bank of Mongolia

Figure III.2.2.2

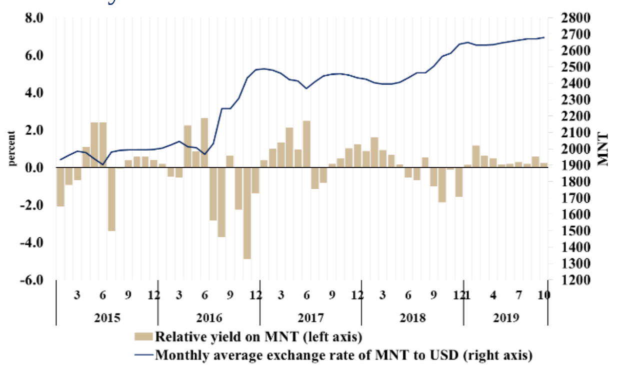
Interest rate on newly issued loans and new deposits have dropped.



Source: Bank of Mongolia

Figure III.2.2.3

Relative yield on MNT has declined.



Source: Bank of Mongolia

III.2.3 Exchange rate

MNT rate depreciated against USD by 7.7 percent year-over-year, reaching 2667.3 MNT per USD at the end of third quarter of 2019. While the exchange rate of MNT appreciated gradually from the end of August until the beginning of October, it was swiftly reversed and depreciated since mid-October, reaching 2715.2 MNT per USD at the end of November 2019. /Figure III.2.3.1/

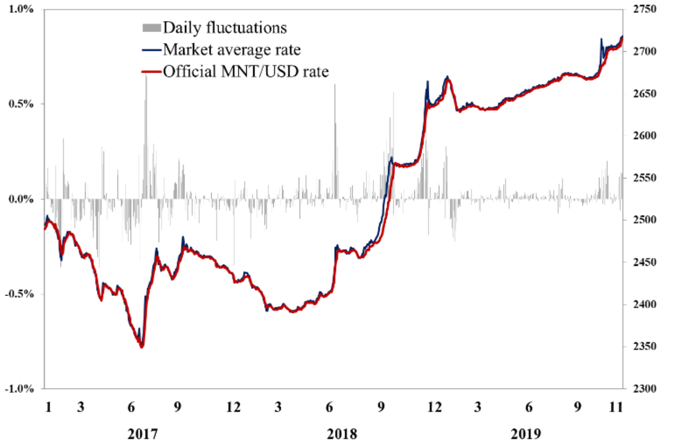
News and rumors about Mongolia getting on the "FATF grey list" have affected the expectations of market participants, resulting in the sudden depreciation of the currency. Banks started to put limits on the amount of currency to sell to prevent substantial currency conversions, which created a supply shortage and thus accelerated the currency depreciation. Moreover, foreign currency inflows declined by 19 percent in November, in contrast to its tendency of increased currency inflows observed in the past 4 years and net currency flows in the banking system was in a deficit of 115.9 million USD. Consequently, the depreciation pressure of the currency was exacerbated.

Nominal effective exchange rate (NEER), weighted by trade turnover, depreciated by 4.0 percent year-over-year in September 2019 /Figure III.2.3.2/. While MNT depreciated rapidly against USD and Ruble, its appreciation against Euro by 0.7 percent, and RMB by 2.8 percent have helped the nominal exchange rate to depreciate less /Figure III.2.3.3/.

Real effective exchange rate (REER) appreciated by 4.8 percent year-over-year in September 2019. During the same period, domestic price increased more rapidly than the foreign price. Thus relative price increased by 8.4 percent implying a deterioration of Mongolia's competitiveness.

Figure III.2.3.1

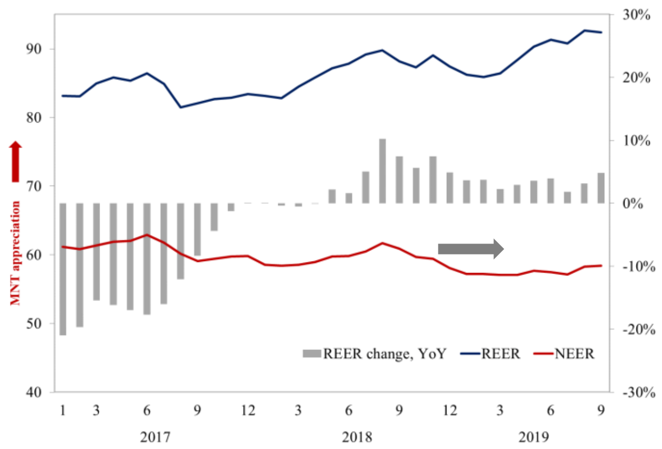
Cross rate of MNT to USD



Source: Bank of Mongolia

Figure III.2.3.2

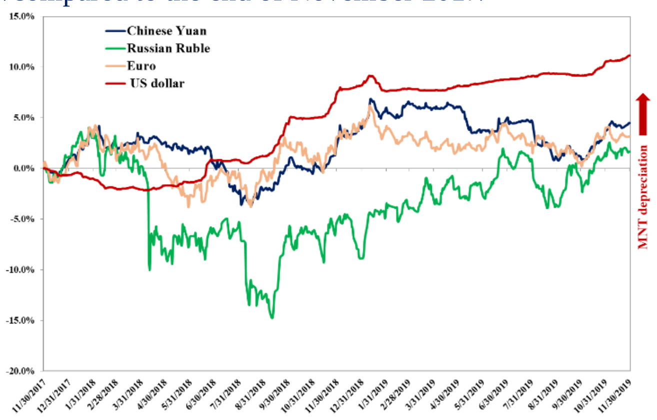
Real effective exchange rate of MNT



Source: Bank of Mongolia

Figure III.2.3.3

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



Source: Bank of Mongolia

III.2.4 Capital market

In the reporting quarter, the capital market activity continued to weaken and Top-20 index continued to drop. Price-to-rent ratio declined as rental price growth was faster than housing price growth despite the growth of rental price decelerated from previous quarter. The price-to-income ratio declined as the household average income increased. Declines in both ratios indicate the weakening in the housing market.

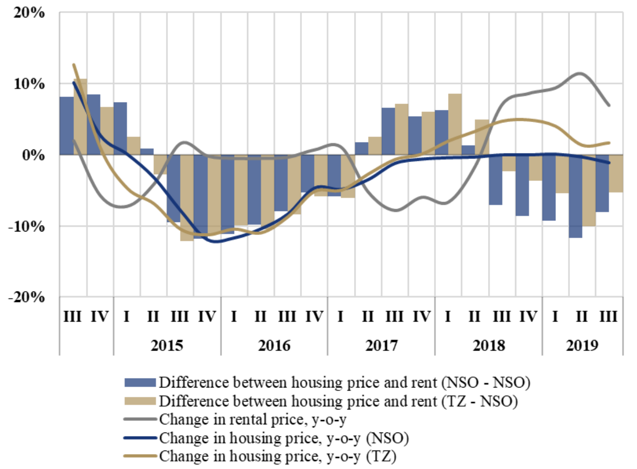
The annual growth in rental price, which accelerated for over a year, has declined to 7.0 percent in the reporting quarter (Figure III.2.4.1). The housing price index reported by the Tenkhleg Zuuch increased by 1.7 percent annually and 2.2 percent from previous quarter. The growth in housing prices was mainly driven by the increase in prices of old houses. On the contrary, the housing price index estimated by the NSO decreased by 0.8 percent from previous quarter and 1.1 percent annually in the 3rd quarter of 2019 (Table III.2.4.1).

The price-to-income ratio declined by 0.01 percentage points in the reporting quarter as household average income increased by 2.5 percent, exceeding the growth of housing price. Moreover, declining trend of price-to-rent ratio continued as the rental price growth remained faster than housing price growth for the past 5 quarters. Such declines in price-to-income and price-to-rent ratios imply a weaker housing market activity and a limited risk of housing bubble (Figure III.2.4.2).

In the reporting quarter, the capital market activity remained weak and Top-20 index continued to drop. In particular, the market capitalization increased by 1.2 percent from previous quarter, reaching 2.5 trillion MNT while TOP-20 index continued to decline in the reporting quarter, dropped by 0.5 percent from previous quarter down to 19,935. Downward trends in market capitalization and Top-20 index persisted in October 2019 due to the majority of Level I and Level II stock prices dropped (Figure III.2.4.3).

Figure III.2.4.1

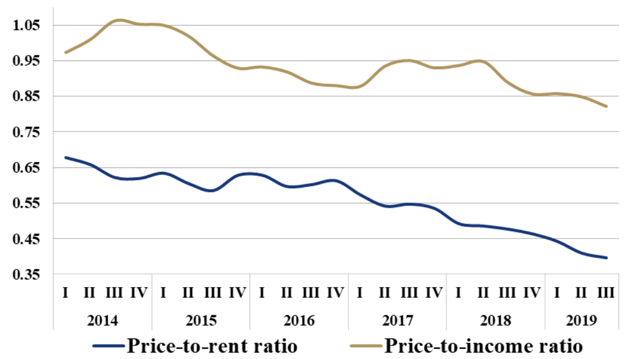
Rental price of housing has decelerated.



Source: NSO, Tenkhleg Zuuch

Figure III.2.4.2

The housing market has been weak, and risk of overheating looks limited.



Source: NSO, Bank of Mongolia

Table III.2.4.1

Real estate sector indicators

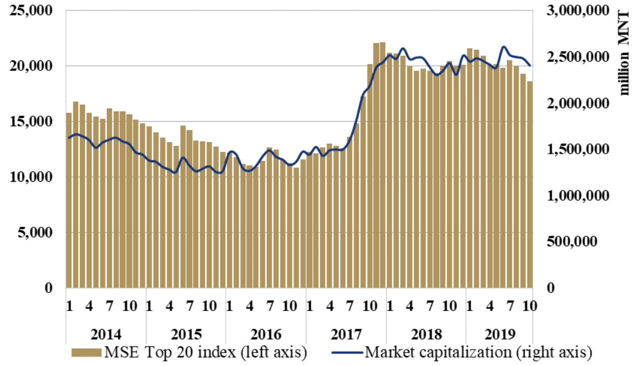
		2019Q2	2019Q3
Change in housing price, %			
NSO	q-o-q	-0.4	-0.8
	y-o-y	-0.3	-1.1
Tenkhleg Zuuch	q-o-q	-1.0	2.2
	y-o-y	1.4	1.7
Change in rental price, %	q-o-q	0.6	2.5
	y-o-y	11.4	7.0
Price-to-income ratio		0.41	0.4
Price-to-rent ratio		0.85	0.82

Source: NSO, Tenkhleg Zuuch, Bank of Mongolia

The stock market sales reached a total of 21.3 billion MNT in the reporting quarter, which is a 48 percent lower figure from previous quarter. While IPOs of several companies in the past quarters boosted the market sales, the absence of IPO in the reporting quarter weakened the sales activity. The market turnover ratio dropped by 0.8 percentage points from previous quarter to 0.9 percent in the 3rd quarter of 2019 (Figure III.2.4.4).

Figure III.2.4.3

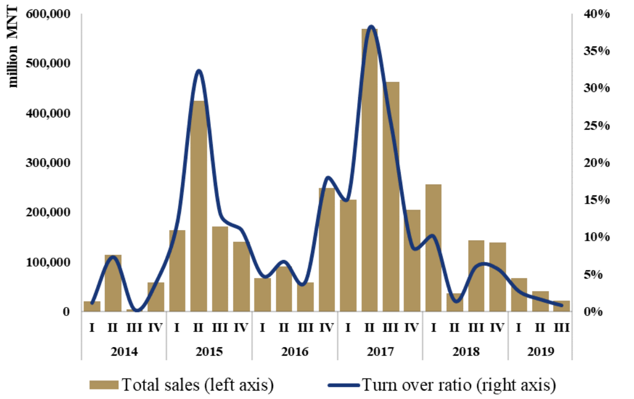
The weakening in MSE Top 20 index continued.



Source: Mongolian Stock Exchange

Figure III.2.4.4

Downward trend in the stock market activity continues.



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 440 billion MNT and the budget expenditure to increase by 2367 billion MNT from previous year (Table III.3.1).

As of October 2019, the equilibrated revenue exceeded its projections by 6.7 percent, while due to underutilization, the budget expenditure fell short of its scheduled amount by 19.3 percent, resulting in a surplus of 545 billion MNT in the equilibrated balance. In the remaining 2 months, additional spending of 3.3 trillion MNT is expected, assuming the budget expenditure to be utilized totally as planned. The budget spending in the past 2 months of 2018 was 2.0 trillion MNT.

Total equilibrated revenue: In the first 10 months of 2019, 90.6 percent of total equilibrated revenue is made up of tax revenue. The equilibrated revenue increased by 1'325 billion MNT from previous year (annual growth of 17.6 percent). In particular, the increase in income tax revenue (400 billion MNT), tax revenue on imported items (396 billion MNT), revenue from social insurance collection (294 billion MNT), tax revenue from domestic goods and services (150 billion MNT), and VAT return by 88 percent (90 billion MNT).

Total expenditure and net credits: Looking at components of budget expenditure, the capital expenditure is expected to increase by 1.56 trillion MNT and wage, pension, and benefits are expected to increase by 470 billion MNT in 2019 from that of 2018.

Budget expenditure utilization has reached 80.7 percent of the scheduled amount in the first 10 months of 2019. Budget expenditure increased by 1121 billion MNT or 15.6 percent year-over-year. Of which, capital expenditure increased by 49.4 percent (or 517 billion MNT), expenditure on goods and services by 20.6 percent (or 520 billion MNT), subsidy and transfer by 12.7 percent (or 308 billion MNT) while net lending excluding loan repayments declined by 42.3 percent (or 123 billion MNT). The interest payments, which had

Table III.3.1

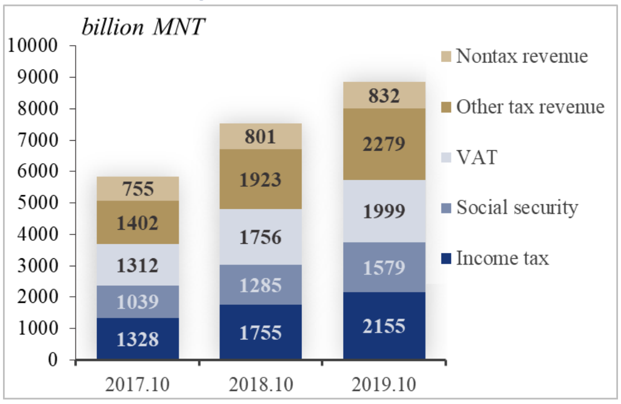
Fiscal indicators

billion MNT	2018	2019	2019.10	
	Act.	App.	Act.	%
Total revenue	**10063**	**11066**	**9826**	**103.6**
Future heritage fund	621	1069	908	94.7
Stabilization fund	207	322	74	30.9
Equilibrated revenue	**9235**	**9676**	**8844**	**106.7**
Tax revenue	8207	8566	8012	108.1
Non-tax revenue	1028	1110	832	95.4
Total expenditure	**9223**	**11590**	**8299**	**80.7**
Primary expenditure	8176	10724	7531	70.2
Current expenditure/-interest payı	6301	7365	5802	90.1
Capital expenditure	1608	3215	1563	54.7
Net credit	267	144	167	117.3
Interest expenditure	1047	866	767	97.1
Total equilibrated balance	**12**	**-1914**	**545**	
in percent of GDP	0.0%	-5.5%	1.5%	
Primary balance	1059	-1049	1313	
in percent of GDP	3.3%	-3.0%	3.6%	

Source: Ministry of Finance, Bank of Mongolia

Figure III.3.1

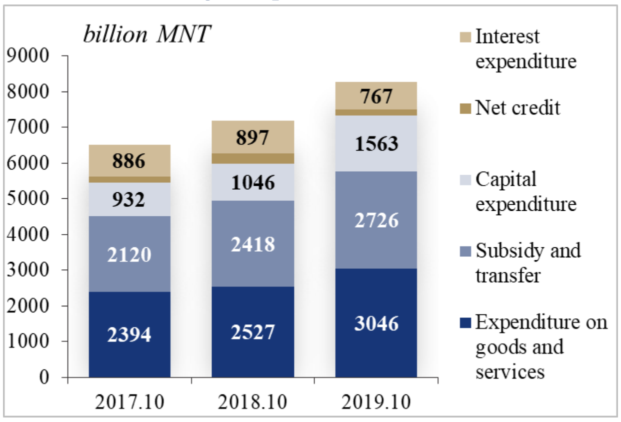
Structure of budget revenue



Source: Ministry of Finance

Figure III.3.2

Structure of budget expenditure



Source: Ministry of Finance

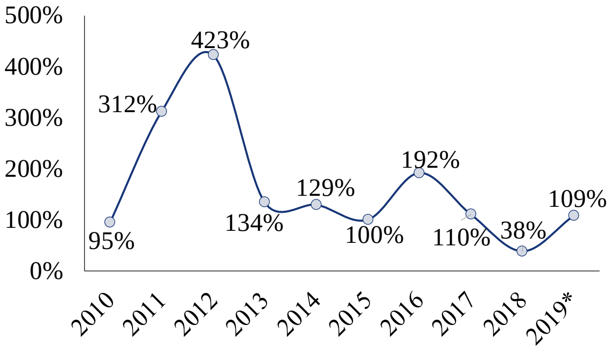
exceeded 1 trillion MNT in the past 2 years, is expected to decline to 900 billion MNT in 2019. Total amount of interest payments made in the first 10 months of the year is 14.5 percent (or 130 billion MNT) lower than that of previous year.

The ratio of newly issued debt-to-debt repayment: According to the approved budget of 2019, the government is expected to pay 2.4 trillion MNT for domestic treasury bill repayment and loan repayments and to issue new long-term domestic treasury bills, project loans and program loans worth 2.6 trillion MNT. Thus, the ratio of newly issued debt-to-debt repayment is expected to increase up to 109 percent (Figure III.3.3).

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 (Table III.3.2). Moreover, debt service payments as a share of budget revenue have fallen since 2016 and are expected to drop below 10 percent in 2019 and reach 8.1 percent in 2020.

Figure III.3.3

Ratio of newly issued debt-to-debt repayment



Source: Bank of Mongolia

Table III.3.2

Present value of government debt and debt services

billion MNT	2017 Act.	2018 Act.	2019* App.	2020* App.
Government debt	20212	18946	19552	22089
in % of GDP	74.4	58.9	55.3	54.3
Debt limit/GDP	85.0	80.0	75.0	70.0
Debt service payments	1156	1046	866	960
in % of budget revenue	16.0	11.3	8.9	8.1
Budget balance	-1742	12	-1912	-2075
in % of GDP	-6.4	0.0	-5.1	-5.1

Source: Ministry of Finance, Bank of Mongolia

IV. EXTERNAL CONDITIONS OF THE ECONOMY

IV.1 Assumptions regarding the external conditions[19]

The price outlook of main exporting commodities of Mongolia and growth forecasts of main trading economies are revised down for 2019 compared to the previous report.

External demand[20] outlook is revised down from previous forecast as the growth outlook for China is revised down for 2020.

Considering the potential negative impact of the trade dispute on the Chinese economy, external sources have kept the growth forecast for China unchanged at 6.2 percent for 2019 and revised it down by 0.1 percentage points to 5.9 percent for 2020. While the growth forecast of the Euro area is unchanged at 1.2 percent, that of Russia is revised down from 1.2 to 1.1 percent for 2019 in line with a downward trend in world economic growth and that of Russia remains unchanged for 2020.

Russian economy outperformed the expectations in the third quarter of 2019. The growth was mainly supported by 2.4 percent growth in industrial sector, 0.5 percent growth in government expenditure, and 2 percent growth in imports. These factors are expected to keep on supporting growth in the forecasting period, the growth projection of Russia remains unchanged for 2020. Oil price outlook has a strong implication on Russian economic growth. The OPEC, its allies decided to cut daily production by 500,000 barrels until the end of the first quarter of 2020 on the 6th December 2019 meeting, keeping the oil price outlook at the current level and thus affecting the growth forecast positively. Moreover, the

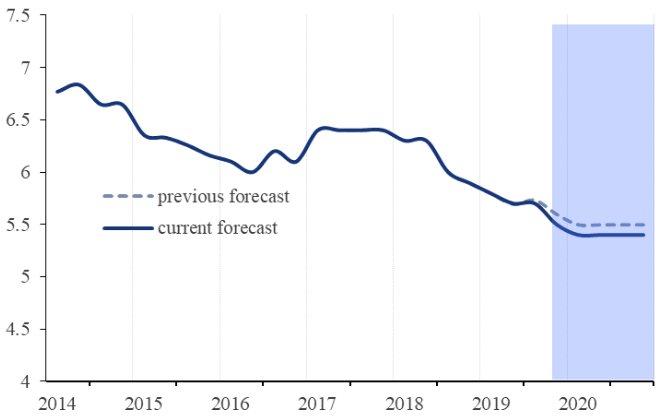
Table IV.1.1
Change in Key Judgments of External Environment

Previous forecast of 2019	Current forecast of 2019
External demand	**Revised down**
The US-China trade tensions elevated, still Chinese growth forecast remains unchanged this time. Growth in Russia, Euro area and the USA are revised down.	The US-China trade dispute remains unresolved. Chinese growth forecast remains unchanged. Growth in Russia, Euro area and the USA are revised down.
Terms of Trade	**Revised up**
Price outlooks of copper, coal, and crude oil are deteriorated owing to elevation 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 trends remain.	Copper price outlook is expected to be around the level of previous forecast, coal and iron ore price increased marginally as US-China reaches agreement on "Phase 1" deal. Regardless the external sector uncertainty persists, price of gold is expected to increase, resulting in better terms of trade for 2019.
Foreign interest rate	**Unchanged**
The Fed funds rate was cut by 0.25 percentage points in September 2019. Fed rate is assumed to remain unchanged throughout 2019.	The Fed funds rate remains unchanged in December 2019.
Foreign inflation	**Revised up marginally**
The growth projection of main trading partners have declined except for China. Foreign inflation is revised down mainly due to stagnant oil price. Inflation in China accelerated as prices of pork and imported goods rose, but expected to decline as Chinese demand weakens in the forecasting period.	The growth projection of main trading partners have declined except for China. Foreign inflation is revised down mainly due to stagnant oil price. Inflation in China is expected to accelerate as prices of pork and imported goods rose in the forecasting period.

Source: Bank of Mongolia

Figure IV.1.1

Forecast of external demand, year-over-year percent



Source: Bloomberg, the EIU

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

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

speed-up of infrastructure projects under the national strategic development plan is expected to steer the growth to 1.7 percent in 2020.

The Euro area economy expanded by 1.2 percent in the third quarter of 2019 in line with previous expectations. The growth was mainly supported by improved growth of consumption from 1.1 percent in the second quarter to 1.5 percent in the third quarter of 2019. On the other hand, the growth was adversely impacted by the investment growth in Euro area, that declined from 8.8 percent in previous quarter to 8.0 percent, and a further decline in industrial production of the region from -0.6 percent to -2 percent following the plunge in industrial sectors in Germany (which consists 29 percent of regional GDP), France (which consists 21 percent of regional GDP), and Italy (which consists 16 percent of regional GDP). While ECB's non-conventional expansionary policy and relatively loose fiscal policy are expected to support the regional growth, the growth projection of Euro area is revised down by 0.1 percentage point for 2020 due to lingering global uncertainties, slower business investments, reduced foreign trade, and lower automobile production due to new standards on automotive industry.

Growth in China fell below expectations, reaching 6.0 percent in the third quarter of 2019. The growth was adversely affected by the gross investments, retail trade, and manufacturing. Still, China's economy is expected to grow by 6.2 and 5.9 percent in 2019 and 2020. Although the US and China reached the agreement and signed the "Phase One" deal, uncertainty remains on how the trade conflict evolves going forward. Although both sides have interests in resolving the dispute, some international experts no longer expect a real outcome before the US Presidential election in 2020. To ease the impact of the trade dispute on the economy, the Chinese authorities are expected to utilize monetary and fiscal policies. In particular, the People's bank of China (PBOC) decided to change the benchmark rate from a floating rate to a base market rate to reduce the cost of lending from the beginning of next year. Moreover, funding of local government special bond is expected to be expanded in 2020 within the fiscal policy. In particular, to alleviate the risks confronted to the economy, the Chinese government issued 1 trillion yuan (equal to 47 percent of 2019 quota) of local government special bond, which is a part of the 2020 quota, in November 2019. It was delivered in advance to support infrastructure investment and spur economic growth at the end of 2019 and the first quarter of 2020. Nevertheless, the growth in China is revised down by 0.1 percentage points for 2020 as the impact of such expansionary fiscal and monetary policy neutralizes by the second half of 2020 and global uncertainty persists.

Terms of Trade: Projection for terms of trade is revised up at the end of 2019, but its outlook remains on a downward trend for 2020.

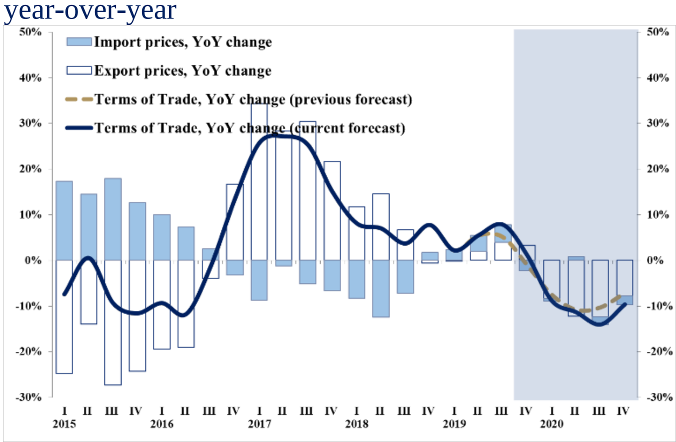
In the third quarter of 2019, export prices and terms of trade improved above expectations. It was thanks to the increased prices of coal and iron ore with expectations of the US-China trade deal to be resolved and supply shortage in iron ore market as well as higher than expected price of gold with precautions of uncertainty in external environment and weaker growth outlook of emerging markets.

While copper price outlook remains unchanged, price outlook of gold and iron ore are revised up, improving the terms of trade projection at the end of 2019. For 2020, export prices are expected to fall as prices of copper, coal, and iron are on a declining trend, thus terms of trade is expected to worsen.

Foreign interest rate: The Fed's FOMC decided to keep the Fed funds rate on 1.5-1.75 percent on the meeting in December 2019 as the employment numbers turned out higher than expected in November, economic growth is expected to be moderate and unemployment rate is expected to remain at a low level until the upcoming Presidential election. The market sentiment has shifted toward a stable Fed funds rate, as the growth outlook is not likely to hike and policies are expected to focus on counterbalancing pressures from the external environment.

Figure IV.1.2

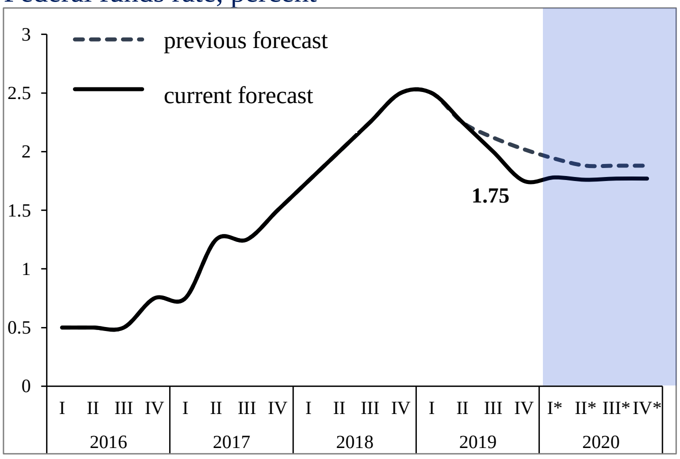
Changes in Terms of trade, export, and import prices, year-over-year



Source: Bank of Mongolia estimates

Figure IV.3.5

Federal funds rate, percent



Source: Bloomberg

Foreign inflation: projection is revised down, as issues of the US-China trade conflict and "Brexit" deal remains unresolved, global growth is expected to slow down and the price of oil is expected to remain on a downward trend at the international market as the stock of US shell oil increased. Inflation in the Euro area is revised down to by 0.1 percentage points to 1.2 percent in 2019 while keeping the inflation forecast unchanged at 1.2 percent for 2020 considering a weaker economic activity despite the depreciation pressure of euro due to the ECB's expansionary policy. Inflation projection in China is revised up by 0.4 percentage points to 2.5 percent for 2019 and by 0.1 percentage points to 2.4 percent for 2020. The PBOC have been implementing expansionary policy to support domestic demand and mitigate the impact of the trade conflict and the food price is expected to increase due to the African swine flu have pushed the inflation outlook. Inflation projection in Russia is revised down to be at 4.5 percent and 3.6 percent at the end of 2019 and 2020, according to the analysts of Bloomberg and the EIU. The Bank of Russia loosened its monetary policy stance, cutting its key rate down to 6.25 percent during the Board of Director's monetary policy meeting in December 2019. The projection considers factors such as stable price of oil and expectations of potential tightening of the US sanctions on Russia, potential inflationary pressure from the domestic demand and loose monetary policy.

Uncertainties in the external conditions

- Though trade conflict between the US and China has progressed on reaching a Phase One deal, future courses of actions remain uncertain. In the case of the trade conflict between power nations prolonging even further, it bears adverse consequences for Chinese economic growth and commodity prices and results in risks for the Mongolian economy such as weakening external demand, declining export revenue and materializing external and domestic economic imbalances. In addition, even the currently imposed import tariffs could hit China's growth further and the commodity prices. The impact of such tariffs on capital flows to emerging and developing economies remains unclear.
- Price of crude oil at the global market may fluctuate further (Although the probability of such risk has lowered compared to the previous forecast). While the US sanction on Iranian oil exports remains unresolved, oil production in Venezuela is likely to fall, and the US oil reserve remains at a low level. Therefore, a potential risk of supply shortage at the global oil market remains.
- The departure of the United Kingdom and Ireland from the EU remains unresolved and the uncertainties regarding the Brexit deal could slow down the regional growth, posing a greater risk.

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

While projections of the price of gold, iron ore, and crude oil remain unchanged for 2020, projection of copper price is revised up and projection of coking coal is revised down for 2020.

Copper: Average price of copper per ton at the London Metal Exchange was 5757 USD in October and rose to 5860 USD in November, and 6130 USD as of 16th December 2019. The copper price increased with the expectation of the US and China to reach agreement on the trade conflict and "Phase One" deal, lower reserves at warehouses, and the US employment numbers that turned out higher than expected in November 2019. If the USA's exports to China doubles over the next two years as announced by the Chinese government, it could affect positively to the demand of industrial metals. In the baseline forecast, the demand of metals is assumed to remain modest in the forecasting period, as the growth of developed and developing economies is expected to slow down and the world economic activity slugs. The copper market was in supply shortage of 330'000 tons in the third quarter of 2019 and reserves at warehouses dropped down to 114'000 tons as of 4th of December 2019, lowest level in the past 7 months. Such small supply-side shortage in 2019 is expected to persist in 2020. According to the 16th December 2019 update, the Bloomberg analysts revised copper price projection up to 6017 USD (on average) and 6174 USD for 2020 based on the market outlook.

Gold: Average price of an ounce of gold was 1513 USD in October and fell to 1464 USD in November, and 1448 USD as of 16th December 2019. Once the US-China trade tension was raising concerns of investors, the announcement of the "Phase One" deal resulted in the price of gold to drop. Still, demand for gold, considered as a safe haven, remains elevated due to the uncertainties regarding economic and political instabilities in the large nations. Central banks' gold purchases increased by 12 percent year-over-year reaching 547.5 tons as of third quarter of 2019. Looking forward, central banks of Russia, Turkey, and China are likely to increase their gold purchase. While demand for gold is projected to remain elevated in 2019-2020, due to slow down in developed economies, the gold price is expected to be relatively unstable in 2020. According to the 16th December 2019 update, the Bloomberg analysts revised the gold price projection slightly down to 1394 USD (on average) for 2019 and kept it unchanged at 1500 USD for 2020.

Coking coal: Average price of Australian coking coal was 149 USD per ton in October, and dropped to 137 USD in November and 137 USD as of 16th December 2019. The price decline was mainly due to increased coal reserves in line with a drop in Chinese production of steel and coke to reduce environmental pollution and decline in Chinese coal imports by 19 percent year-over-year reaching 20.8 million tons in November due to further tightening at borders since mid-October. China's restriction on coal imports is likely to resume until the end of the year as the overall coal imports of China increased 10.2 percent year-over-year reaching 299.3 million tons in the first 11 months of 2019, exceeding the import volume of 2018. Until 2021, the Chinese government plans to build thermal and coking coal plants to reach a total capacity of 976 million tons. Moreover, Russian coking coal exports to the global coal market are expected to expand from 29 million tons in 2018 to 31 million tons in 2021. Based on the assumptions that the Chinese government is expected to resume its tight regulation on coal imports until the end of the year, Russian coal supply is expected to expand gradually, China's production of steel is expected to decline by 0.6 percent in 2020, and its demand is expected to decline by 3.1 percent, the Bloomberg analysts revised coking coal price projection down to 180 USD (on average) for 2019 and 140 USD for 2020 as of 16th December 2019 update.

Iron ore: Average price of iron ore was 88 USD per ton in October, and dropped to 82 USD per ton in November and reached 85 USD per ton as of 16th December 2019. The price of iron ore declined as the steel reserves at the largest cities in China declined by 2.06 million tons or 20.7 percent reaching 7.86 million tons as of 23rd November 2019. Price of iron ore is not likely to decline significantly, as the steel demand is not likely to recover with declining growth in the US and Chinese industrial production and although Brazilian Vale iron ore mining company has resumed its production after a dam collapse, its expected date of returning to the normal production level was delayed to the second half of 2020. China's steel production is expected to decline from 800 million tons in 2019 to 775 million tons in 2020, the demand of steel and iron ore is expected to decline due to slowdown in global economic growth. Thus, the Bloomberg analysts kept the iron ore price projection at 92 USD (on average) for 2019 and 77 USD for 2020 as of 16th December 2019 update.

Crude oil: A barrel of Brent oil was sold at 60 USD in October, and at 62.4 USD in November and reached 65.2 USD as of 16th December 2019. The price increased as the announcement was made that the US and China reached the "Phase One" deal. The US shell oil reserve increased by 4.7 million barrels reaching 452 million barrels on 13th of December as opposed to the expected decline. The OPEC, its allies decided to cut their production until the end of the first quarter of 2020 and reduce the daily production additionally by 500,000 barrels on the 6th December 2019 meeting. Looking forward, oil market is expected to have supply shortage of 0.2 million barrels per day as the OPEC resumes its production to limited amount, oil supply by Saudi Arabia was in short of 400'000 barrels in November 2019, and the supply by non-OPEC oil suppliers are expected to be short of 270'000 barrels from the expectations in July. Considering the factors that demand of oil remains subdued as the global economic growth slows down and the US shell oil production is expected to pick up, the Bloomberg analysts kept the crude oil price projections at 64 USD (on average) for 2019 and 60 USD for 2020 as of 16th December 2019 update.

IV.3 Balance of Payments

The balance of payments was in a deficit of 191.7 million USD (1.4 percent of GDP[21]) in the 3rd quarter of 2019, which is a deterioration of 428 million USD quarter-over-quarter but an improvement of 112 million USD year-over-year. The current account deficit tapered down to 256 million USD as the surplus in goods balance improved and deficit in services account was reduced. Increased flow of external loan disbursements and banks' foreign assets contributed to a surplus of 283 million USD in the financial accounts (Figure IV.2.1).

The current account deficit declined by 55 percent year-over-year to 256 million USD (1.9 percent of GDP) in the third quarter of 2019. Although the deficit in income accounts widened, deficit in services account narrowed and surplus in goods account improved on the back of rapid growth of export revenues and weaker growth of imports, thus supporting the improvement in current account deficit.

Goods balance was in a surplus of 269 million USD. Export revenue grew by 18 percent year-over-year in the reporting quarter as a result of robust growth in exports of coal, gold, iron ore, and reexport of tracks while exports of copper and crude oil had negative contributions (Table IV.2.2).

Imports growth, which started to decelerate from the beginning of the year, was 4.4 percent year-over-year in the 3rd quarter of 2019. It was predominantly driven by imports of machinery, equipment, and capital goods used in mining activities and imports of diesel fuel. Conversely, the import of passenger cars is in a downward trend as a consequence of the macroprudential policy implemented from the beginning of the year and less spending on imports of non-diesel fuels following the fall in the global price of oil have contributed negatively on imports (Table IV.2.2).

Services account deficit narrowed by 169 million USD (47% year-over-year) mainly driven by the increase in transportation, travel, engineering, and rental services' income as well as reduced

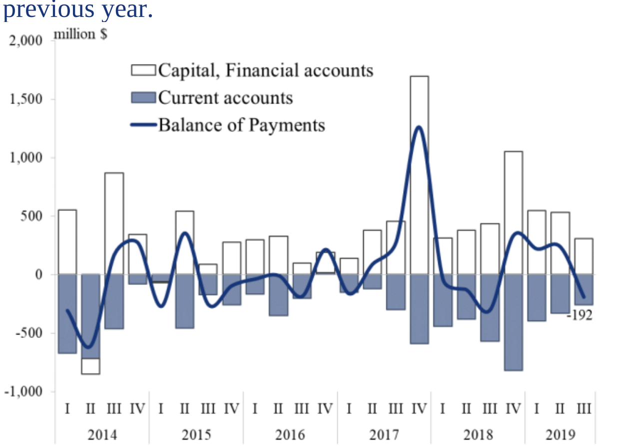
Table IV.3.1

Changes in Key assumptions of BOP projection (2019)

Previous forecast of 2019	Current forecast of 2019
Exports	**Revised down**
Coal export volume is expected to be around last year's level, export volumes of iron ore, flourspar and cashmere to increase. The commodity price outlook remain in downward trend but prices of coal, iron ore, and gold outperformed. Gold price outlook is revised upwards. But the medium-term risks of commodity price decline have escalated with the recent developments in the US-China trade dispute.	Coal, iron ore export volumes are revised up while gold export volume is revised down. The commodity prices are expected to remain stable in the last months of 2019. But the risks of commodity price decline remains in case of further trade escalation.
Imports	**Revised down**
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.	Budget capital expenditure is expected to fall short of it's approved level → construction material imports ↓. The passenger cars imports declined faster than expected. The growth ↓ → fuels except diesel ↓.
Services	**Revised up**
Iron ore exports ↑ → iron ore transport 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.	Income of transport, travel and business services have increased. The forecast was adjusted with downward performance in expenditures of construction, financial, business, and trade in 3rd quarter.
FDI	**Revised up**
Oyu Tolgoi FDI has been revised down due to difficulties arised in continueing the development of underground mining projection.	The constuction of Oyu Tolgoi's underground mine project will continue as initially expected in 2019. Oyu Tolgoi FDI will decline in 2020.
Бағцын ХО	**Unchanged**
MIK issued 300 million USD bond. ER issued 440 million USD bond and refinanced the part of its previous debt. Other than that, no new bond will be issued, no principal repayments of bonds are expected.	Assumptions in the projection remains unchanged.
Other FDI	**Revised up**
The IMF EFF program financing has been revised up marginally. Loan disbursements in private sector tends to decline and loan repayments in public and private sector is expected to increase. Inflow of currency and deposit increased in July.	The IMF EFF program financing has been revised down. Loan disbursements in private sector tends to decline and loan repayments in public and private sector is expected to increase. Inflow of currency and deposit increased.

Figure IV.2.1

Balance of payments was in deficits in the 3rd quarter as financial account surplus narrowed from that of the previous year.



Source: Bank of Mongolia

payments for construction, financial, technical, trade and business services (Figure IV.2.3).

Income account was in deficit of 411 million USD in the third quarter of 2019 which is an increased deficit of 116.4 million USD or 40 percent growth year-over-year. This was due to increasing outflows through FDI income (38 percent or 130.8 million USD from the previous year) on the back of increased profitability in banks and corporates. Particularly, the outflow of reinvestment earnings increased by 78 million USD year-over-year to reach 66.4 million USD. Moreover, interest payment of Oyu Tolgoi increased by 20.3 million USD year-over-year reaching 116.8 million USD has contributed to larger income outflows through FDI income. The deficit in primary income accounts for 160 percent of current account deficits in the reporting quarter (Figure IV.2.4).

The financial account was in a surplus of 283 million USD in the third quarter of 2019, which is a 32 percent or 132 million USD drop, year-over-year. It is mainly attributed to increased net outflows in other investments by 95 million USD from previous year. Other investments shrank due to increased foreign assets held by banks, loan repayments made by some large enterprises, and increased net outflows of trade loans by 67.5 million USD from previous year reaching 91.5 million USD on prepayments.

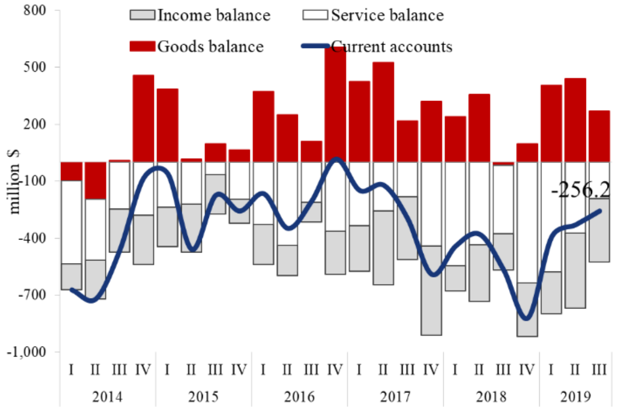
External loans amounted to a net inflow of 43 million USD in the third quarter of 2019 while it had a net outflow of 137.3 million USD in the third quarter of previous year. The increase in net inflows of external loans is mainly explained by a decline in long-term loan repayments of banks by 55 percent or 130.8 million USD and hike in loan disbursements of enterprises by 8 times reaching 201 million USD.

Net inflow of FDI declined by 10 percent or 47.3 million USD year-over-year reaching 420.5 million USD and has negatively affected the overall financial accounts. It was due to a decline

[21] 4-quarter cumulative GDP.

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 coal, gold, and iron ore while it was negatively impacted by lower revenues in crude oil and copper.

	2018 III	2019 III	Y-o-Y	Contri-bution %
Total Exports	**1,701**	**2,007**	**18.0%**	**18.0%**
Coal	718	894	25%	10.4%
Gold	-	148	-	8.7%
Iron ore	84	171	102%	5.1%
Tracks	0	16		0.9%
Cashmere	55	64	17%	0.6%
Fluorite, leucite, nepheline	51	62	21%	0.6%
Crude oil	104	92	-11%	-0.7%
Copper concentrates	474	359	-24%	-6.8%
Other	216	201	-7%	-0.9%

Total imports increased due to higher consumption of investment goods' imports in the 3rd quarter.

	2018 III	2019 III	Y-o-Y	Contri-bution %
Total imports	**1,633**	**1,705**	**4.4%**	**4.4%**
Capital goods	683	753	10.2%	4.3%
Consumer goods	436	426	-2.4%	-0.6%
Of which: Passenger cars	142	134	-5%	-0.5%
Fuels	327	335	2.6%	0.5%
Of which: Diesel	161	192	20%	1.9%
Other fuels	166	143	-14%	-1.4%
Industrial inputs	186	190	2%	0.2%
Others	1	1	-	0%

Source: Bank of Mongolia

in Oyu Tolgoi's FDI (specifically, investor's loan) by 47 million USD from that of previous year.

Gross international reserves (GIR): stands at 3985.6 million USD at the end of September 2019 and 4033.8 million USD at the end of October 2019. It is an adequate level to cover 8 months of imports, which is calculated as an average of the last three months' import payment made in hard currency (Figure IV.2.6). While the balance of payments was in deficit of 7 million USD in October 2019, the addition of 55.3 million USD in monetarized gold has supported the reserve accumulation.

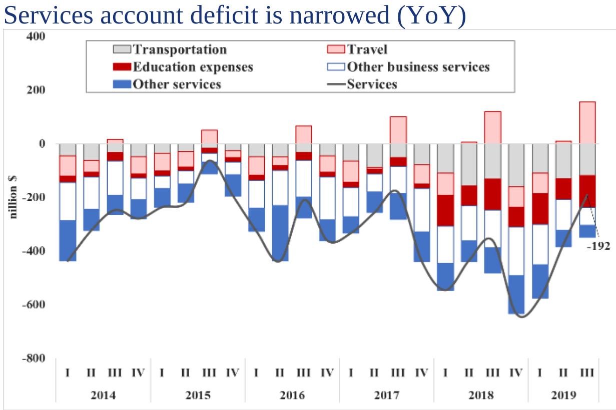
Terms of Trade deteriorated by 3 percent from previous month and 10 percent year-over-year in October 2019. It was due to a 7 percent decline in export prices (YoY) and a 3 percent increase in import prices (YoY).

The customs prices of copper concentrate declined by 19 percent (as gold contents within the Oyu Tolgoi copper concentrate started to diminish), the customs' prices of crude oil declined by 21 percent (price declined at the global commodity market), cashmere price declined by 18 percent, the customs' prices of fluorite, leucite, and nepheline declined by 17 percent, and the customs' prices of zinc declined by 5 percent year-over-year in October 2019. Conversely, price of coal reported by the customs increased by 5 percent (due to increasing share of coking coal in the total coal exports), price of iron ore increased by 41 percent (price of iron ore remained high at the global commodity market), and price of canned meat products increased by 4.3 percent year-over-year in October 2019. Overall, the price of exports declined by 7 percent year-over-year.

Price of imports increased by 3 percent year-over-year in October 2019, mainly driven by an increase in import prices of consumer goods except for cars and prices of capital goods notwithstanding a large decline in imported fuel prices (-16% year-over-year).

Figure IV.2.3

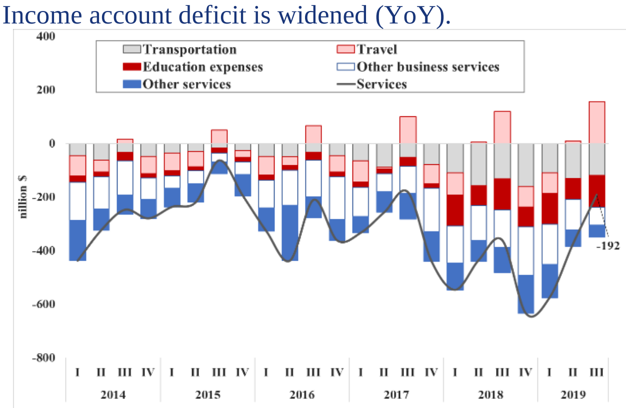
Services account deficit is narrowed (YoY)



Source: Bank of Mongolia

Figure IV.2.4

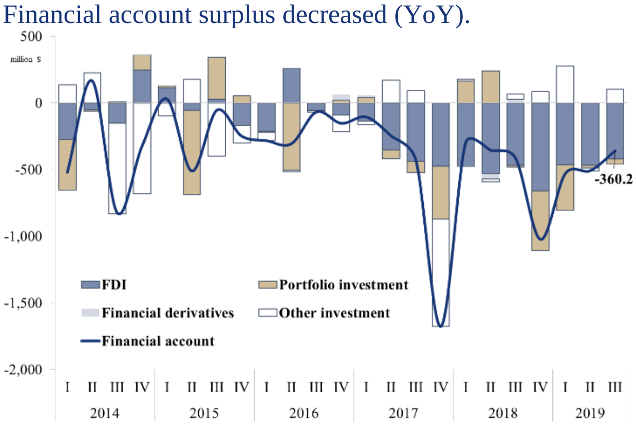
Income account deficit is widened (YoY).



Source: Bank of Mongolia

Figure IV.2.5

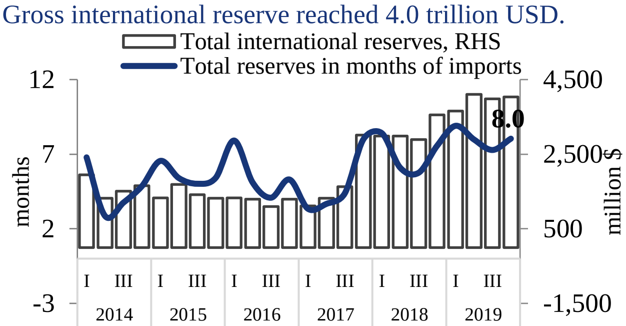
Financial account surplus decreased (YoY).



Source: Bank of Mongolia

Figure IV.2.6

Gross international reserve reached 4.0 trillion USD.



Source: Bank of Mongolia

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