THE BANK OF MONGOLIA

INFLATION REPORT

2020 MAR

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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

Lowering the policy rate, setting the reserve requirements on liabilities in togrog and the interest rate corridor

Number: 2020/01
Date: 11th of March 2020

The Monetary Policy Committee meeting was held on the 11th of March 2020. The Committee decided to lower the policy rate by 1 percentage point to 10 percent, lowering the reserve requirement on banks' liabilities in togrog by 2 percentage points to 8.5 percent, and changing the range of interest rate corridor to be +1, -1 percentage points from the policy rate.

Annual headline inflation reached 5.6 percent nationwide and 6.0 percent in Ulaanbaatar city as of January 2020. The demand induced inflation is expected to be moderate in line with resuming downward trend in economic growth. However, supply-driven volatility in inflation could arise if supplies of some imported foods are hindered.

The increased uncertainties regarding the spread of COVID-19 have emerged the risk of aggravating the slowdown in economic growth due to weaker external demand, lower commodity prices, and sluggish external and domestic economic activities. Furthermore, the impact of COVID19 on the economy would depend on the scale of the virus' spread, length of containment period, and policy measures to prevent the spread of the virus. While the possibility of weaker export revenue looms, a continued decline in the consumer imports and a sharp fall in oil price at the global market would reduce the depreciation pressure on the exchange rate.

The Monetary Policy Committee decided to take the above mentioned comprehensive policy measures to relieve financing costs of banks, to support financial intermediation, and to stimulate economic growth by considering the current macroeconomic and financial outlook and its prospects, main driving factors, and uncertainties and risks in the domestic and external environment. The decision is aimed to ensure economic and financial stability while keeping the inflation rate around the target rate.

EXECUTIVE SUMMARY

This edition of the inflation report comprises of information presented to the Monetary Policy Committee regarding domestic and external conditions in the Mongolian economy as well as some additional updates. As inflation reports convey a set of information used for conducting macroeconomic projections, which in turn serve as the basis for monetary policy decisions, there was a necessity to incorporate additional updates regarding developments that occurred following the Monetary Policy Committee meeting. Sudden fluctuations in commodity prices and international financial markets have been observed and policy measures being pursued by various countries have been adjusting since the Monetary Policy Committee meeting on the 11th of March 2020. Though global economic outlook projections are being revised constantly, main sources including those of central banks, governments, the IMF, and the World Bank have not been fully revised to be incorporated as additional updates. As such, information regarding the global economic outlook has been kept as that being used during the Monetary Policy Committee meeting.

Economic growth is to be supported by expansionary fiscal stance driven by rising capital expenditure and lower household debt burden enabled through measures of relieving pension loan repayments. However, economic growth is expected to slow down in the first half of 2020 due to reduced external and domestic demand and lower commodity prices induced by the spread of COVID-19. Though fluctuations in inflation may increase owing to supply constraints, expectations of inflation being stabilized at the Central bank target level remain under the circumstances of slowing down of economic activities and absence of supply-side shocks.

A crucial condition for the inflation target being met is the avoidance of any supply constraints emerging due to the global lockdown. Inflation reached 6.4 percent nationwide and 6.9 percent in Ulaanbaatar city as of February 2020, out of which 2.3 percentage points were attributed to increases in meat prices. Meat supply is not expected to encounter shortages this spring, as the amount of meat stock has increased, and meat exports have been restricted. Given the conditions of meat prices fluctuating according to its seasonal pattern, a contribution from increases in meat prices to inflation is not expected to enlarge. Base period effects associated with prices of solid fuel and gasoline, which had been main contributors to inflation, have dissolved and supply-driven inflation has subsided. However, there may be risks of rising inflation fluctuations stemming from inactive imports of some food necessity items, due to measures dealing with the global spread of COVID-19. Despite expansionary fiscal stance, increases in wages of public sector employees, and relieving measures of pension loan repayments having an inflationary impact in 2020, inflation is expected to be lower due to weakening external demand and reduced domestic economic activities. Under the circumstances of the absence of any sudden fluctuations driven by supply-side shocks, inflation is projected to decline throughout the first half of 2020 and gradually increase during the second half to reach the Central bank target level by the end of the year.

Economic growth has been slowing down in the past 5 consecutive quarters and it is expected to substantially contract in the first half of 2020 due to the spread of COVID-19. Mining growth significantly contracted undermining expectations in the 4^{th} quarter of 2019, with declines in production of main commodities except for iron ore and crude oil. For instance, restrictions in coal transportation and reduction of 3 times in gold content of Oyu tolgoi copper concentrates contributed to such contraction in mining activities. On the other hand, non-mining growth exceeded expectations slightly, with activities in the agriculture and manufacturing sectors exhibiting relatively higher growth. The spread of COVID-19, which has been fueling to uncertainties and slowing down external and domestic economy, is expected to render much more negative consequences for activities in mining, services, transportation sectors and net taxes on products, compared to agriculture, information, and energy sectors in 2020. Though the economy is expected to be supported by lower household debt burden enabled through measures of relieving pension loan repayments and rising fiscal capital expenditure, growth projections for 2020 have been revised downwards substantially due to the negative impact associated with the emergence of COVID-19.

Uncertainties associated with macroeconomic projections stem from a number of sources including, the extent and duration of the spread of COVID-19 and impact of measures dealing with the pandemic on the external and domestic economic environment, further developments in the trade war, Oyu tolgoi underground mine development plan and implementation process of the railway and other major domestic projects.

Money supply growth has been slowing down in the past 4 consecutive quarters. Credit growth decelerated in the reporting quarter, mainly due to continued slack in consumer loan growth induced by macroprudential policy measures and lack of significant growth in business loans. Such deceleration in credit growth mainly contributed to slowing down of money supply growth, which has remained to be mostly driven by growth in foreign assets. Credit growth is expected to continue its deceleration path in the first half of 2020 and gradually recover in the second half to stabilize around 10 percent.

Uncertainties in the external environment have increased substantially and external demand has fallen. It is considered impossible at the moment to quantify the extent of shock on the global economy induced by the global spread of COVID-19, which continues to affect much more population. Though conditions in China have relatively eased with manufacturing and service activities beginning to recover, Chinese external demand and economic growth are expected to be negatively impacted by worsening conditions in the US and European economies. Furthermore, though the US and China have officially reached an agreement on "Phase One" trade deal in January 2020, risks and uncertainties regarding international relations and geopolitical issues remain in place.

Despite increases in current account deficit, the balance of payments recorded a surplus in the reporting quarter with financial account surplus remaining high. Though imports of diesel fuel, which had been driving imports' growth, contracted in the 4th quarter of 2019, current account deficit widened due to a reduction in export revenue from copper concentrates, coal and spar, and deterioration in income account deficit. On the other hand, improvement in financial account surplus was mainly driven by increases in net incoming flow attributed to Oyu tolgoi and other investments.

Prices of copper, coal, and iron ore in the international markets in the 4th quarter of 2019 were lower than expectations, leading to terms of trade remaining below projections. Even though projections of lower crude oil prices and higher gold prices in 2020 are expected to positively contribute to terms of trade, its outlook is deteriorating for 2020 as risks of lower prices of exporting commodities except gold remain elevated.

I. INFLATION

The Bank of Mongolia's monetary policy aims at stabilizing inflation, measured by a consumer price index, at around 8 percent during 2019- 2020 and around 6 percent in the medium term (Figure I.1).

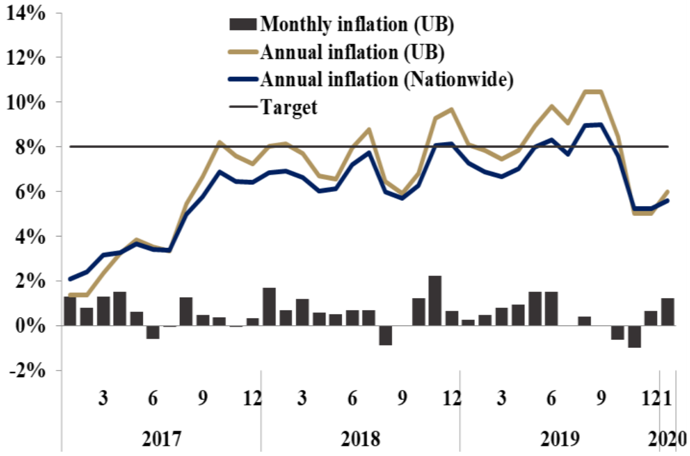
Economic activities have been slowing down in the second half of 2019, rendering demand-driven prices increases to remain relatively subdued in the last quarter.

Moreover, price increases associated with the supply side have stabilized, as prices of solid fuel and gasoline, which had significantly contributed to inflation in 2018, have remained relatively stable in 2019 (Figure I.3). With regard to solid fuel, prices of wood fuel increased slightly in November 2019 and January 2020, while prices of processed coal remained stable, enabling lower contributions to inflation reduction as of January 2020. Despite temporary fluctuations observed in the prices of oil in the international markets, domestic gasoline prices did not experience any sudden movements in the reporting period. Prices of diesel fuel increased slightly in December 2019 and January 2020, leading to contributions of 0.3 percentage points by domestic fuel to inflation.

Though prices of meat declined in the 4th quarter of 2019 in line with its seasonal patterns, its contribution to annual inflation remains elevated, taking up 33 percent as of February 2020 (Figure I.2). Owing to negative expectations emerging due to the possible domestic contagion of COVID-19, tendencies to stock up on food items were observed among the general public during the last week of January 2020, and prices of meat increased substantially by around 1000 togrog during that week. Prices of meat then remained stable in February 2020 and contributed around 2.3 percentage points to inflation (Figure I.3). Headline inflation reached 6.4 percent nationwide and 6.9 percent in Ulaanbaatar city as of February 2020 (Figure I.1).

Figure I.1

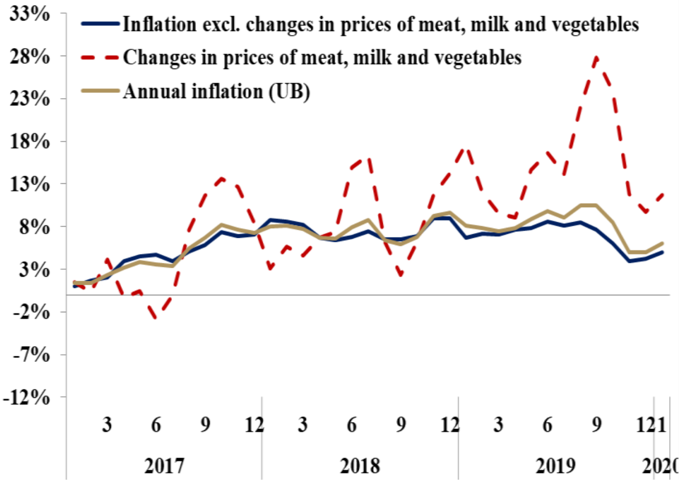
Inflation



Source: NSO

Figure I.2

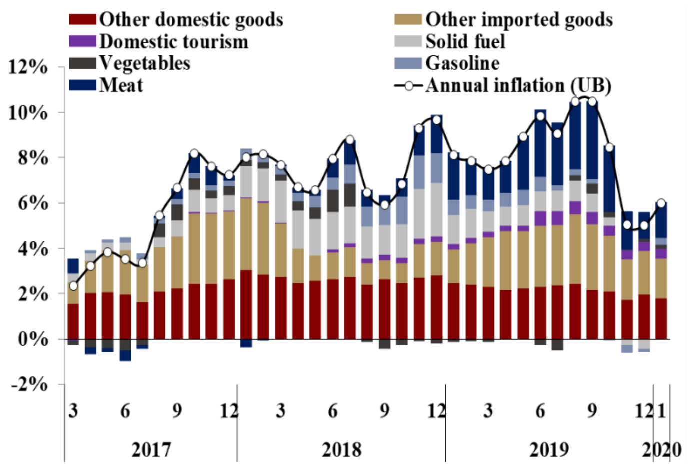
Headline and core inflation



Source: NSO, Bank of Mongolia

Figure I.3

Contributions to annual headline inflation in Ulaanbaatar, by main categories of items



Source: NSO, Bank of Mongolia

Comparison between inflation projections

Mainly driven by lower than expected price increases in demand-driven and food items, headline inflation reached 6.1 percent in the 4th quarter of 2019, undermining projections by 0.7 percentage point. Food inflation was lower than projections by 0.2 percentage points, mostly owing to significant declines in meat prices in November and December 2019. Moreover, non-food inflation undermined projections by 0.5 percentage point, as prices of wood fuel remained unchanged contrary to expectations of increase throughout the heating season, and prices of imported goods increased at a rate lower than expectations in November 2019.

Inflation projections have been revised downwards for 2020-2021, as price increases in domestic goods, services, and imported goods in the upcoming quarters are expected to be lower due to the slowing down of economic activities associated with the spread of COVID-19 (Figure I.4).

Inflation outlook

Inflationary impact of several supply-driven factors is expected to remain relatively subdued in 2020. For instance, despite meat prices increasing to high levels in February 2020, the outlook for meat prices remains favorable without any sudden jumps driven by supply shortages, as a sufficient amount of meat stock for domestic consumption has been accumulated. Moreover, the outlook for oil prices in the international market is on a downwards trend, leading to lower inflationary impact from domestic gasoline prices.

With regards to the demand side, inflation is expected to be driven upwards by factors including, relieving of pension loan repayments, increases in wages of public sector employees, and expansion in fiscal policy stance. However, headline inflation is projected to decelerate in the

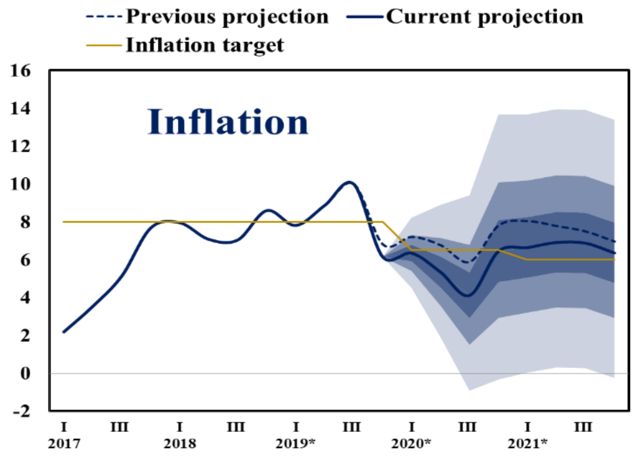
Table I.1 Changes in inflation outlook

Assumptions on near term forecasts of inflation	
Previous forecast 2019Q4-2020Q3	**Current forecast 2020Q1-2020Q4**
Prices of meat	**Projection 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 meat which had been fluctuating according to its seasonal pattern increased by around 1000 togrog in the last week of January 2020. Hence, price forecasts are revised up.
Prices of imported goods	**Projection revised down**
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 imported goods increased at a lower rate than previously expected in the last quarter. Hence, price forecasts are revised down.
Prices of domestic goods	**Projection revised down**
Prices of processed coal to remain unchanged. Prices of domestic tourism decreased slightly in October 2019.	Prices of domestic goods increased at a lower rate than previously expected in the last quarter. Hence, price forecasts are revised down.
Prices of administered items	**Projection unchanged**
University tuition fees were raised as planned. Further price changes are not expected.	Prices of administered items are assumed to remain unchanged.
Prices of gasoline	**Projection revised up**
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.	Prices of gasoline in the last quarter of 2019 were consistent with expectation and external risks of further price increases remain subdued. However, prices of diesel fuel increased slightly in January 2020.

Source: Bank of Mongolia

Figure I.4

Inflation forecast



Source: Bank of Mongolia

Table I.2

Inflation forecast[1]

	2019	2020*	2021*
	actual	*projection*	
Inflation, CPI[2]	6.1	4.8-8.1	4.8-8.0

Source: Bank of Mongolia

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

upcoming quarters, owing to weaker external demand, lower foreign inflation, and reduced domestic economic growth induced by the spread of COVID-19.

Given the conditions that the spread of COVID-19 is brought under control, with economic activities recovering and economic growth stabilizing in the latter half of 2020, demand-driven inflation is expected to gradually pick up in 2021. On the other hand, inflation is projected to stabilize around the medium-term target level in 2021 with continued declines in oil prices in the international market and foreign inflation.

Uncertainties that may affect inflation outlook:

- Potential shortage or oversupply of goods and services have significant implications on inflation projections. For instance, depending on the weather conditions of this upcoming summer, prices of meat and vegetables may be subject to sudden fluctuations, prices of administered items may increase by exceeding projections and these factors may alter inflation forecasts.
- Supply driven price increases may take place under the circumstances of border constraints imposed on imports of several food items induced by longer than expected spread of COVID-19.
- Building up of geopolitical risks and tension between countries and heightened impact of the spread of COVID-19 on the global economy may fuel to uncertainties in the external environment, which in turn may bear negative consequences for commodity prices in the international market and capital inflow to our economy and may lead to depreciating pressure on togrog exchange rate having an inflationary impact.
- In the event of fiscal stance loosening beyond the level approved for 2020 with regards to the parliamentary election, such measure to boost fiscal capital expenditure bears risks of increasing inflationary pressure through higher imports.

II. ECONOMIC GROWTH

Economic activities slowed down in the 4th quarter to have a preliminary estimate for the real GDP growth reach 5.1 percent in 2019. From the demand side, growth of gross capital formation and household consumption has been supporting total demand growth since the second half of 2017, while net exports have been making negative contributions (Figure II.1). From the production side, activities in the majority of sectors except for mining and transportation remained elevated and contributed to total supply growth. Growth of agriculture, manufacturing, energy, and services were relatively high among production sectors (Figure II.2).

Investment: Gross capital formation grew by 12.9 percent in the 4th quarter of 2019, mainly driven by expenditures made towards construction, machinery, and equipment and contributed 5.0 percentage points to total demand growth. Increases in fiscal capital expenditure of 96 percent in the 4th quarter significantly contributed to the growth of gross capital formation.

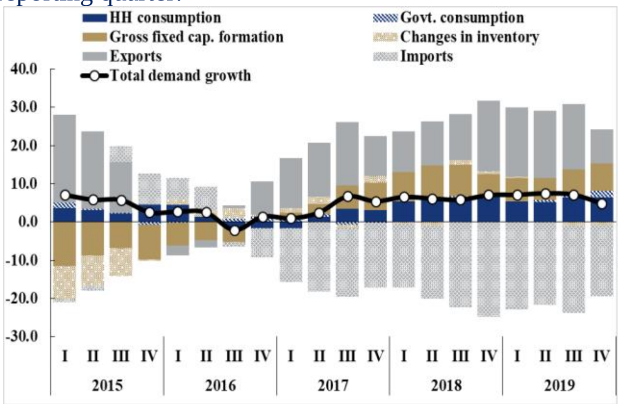
Consumption: Household consumption expanded by 12.5 percent and contributed 6.4 percentage points to total demand growth in the reporting quarter. Though household income has been exhibiting steady growth in the past 3 years, the level of household expenditure continued its trend of exceeding the level of household income. Consumer loan, one of the main sources for financing such a gap between income and expenditure and which had been exhibiting rapid growth, has begun to decelerate since the 4th quarter of 2018 and contracted by 7.7 percent in the reporting quarter (Figure II.4).

Government expenditure expanded by 23.9 percent in real terms and supported total demand growth by 2.8 percentage points.

Net exports: Net exports weighed down total demand growth by 12.4 percentage points. Exports decreased by 6.1 percent in real terms, while imports increased by 8.3 percent in real terms in the reporting quarter, leading to net exports having negative contributions to total demand growth.

Figure II.1

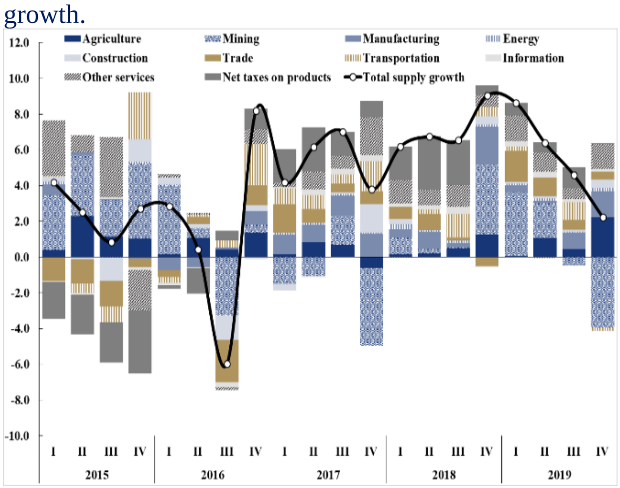
Gross capital formation and household consumption contributed the most to total demand growth in the reporting quarter.[3]



Source: NSO

Figure II.2

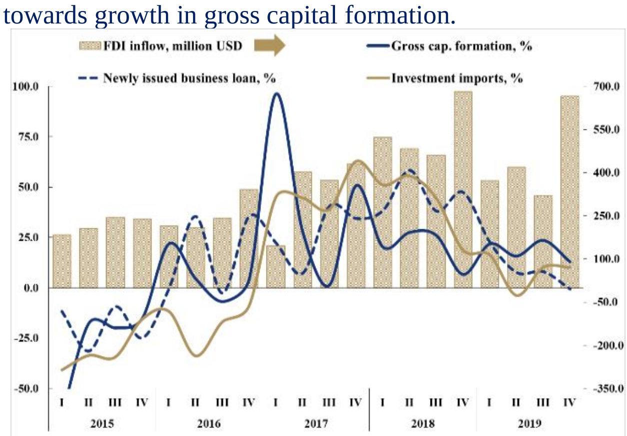
Majority of production sectors, excluding mining and transportation contributed positively to total supply growth.



Source: NSO

Figure II.3

Expansion in fiscal capital expenditure was the main driver towards growth in gross capital formation.



Source: NSO, Bank of Mongolia

[3] Growth calculated from sum of 4 quarters

Declines in exporting volumes of copper concentrates and coal were major contributors to reduced total exports in real terms, while exporting volumes of gold and iron ore expanded in the reporting quarter. Coal exports were restricted in accordance with the import quota imposed by the Chinese authorities. Moreover, exports of copper concentrates were affected by the falling gold content in Oyu tolgoi concentrates.

Increases in imports of investment-related items and gasoline and fuel items, excluding diesel were major contributors to total imports' growth, while imports of consumer goods contributed negatively. Expansion in fiscal capital expenditure, which contributed towards increases in gross capital formation, has been driving the growth of investment-related imports including, building materials, machinery, and equipment. However, growth of consumer imports, which had previously exceeded 20 percent throughout 2018 in line with economic recovery and rebound in household consumption, has been decelerating throughout 2019 and exhibited a 13.2 percent fall in the reporting quarter (Figure II.4). Out of such contraction in consumer imports, 8.5 percentage points were attributed to imports of automobiles. For instance, a total of 48,874 automobiles were imported in 2017, while it reached 64,039 and 69,471 in 2018 and 2019 respectively.

Economic production sectors

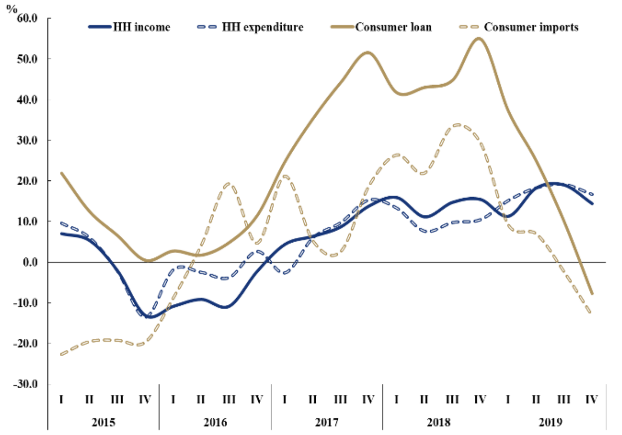
Mining sector contracted by 16.2 percent in the reporting quarter, with declines in production of main commodities except for iron ore and crude oil, and contributed to slowing down total supply growth by 3.9 percentage points. Production of gold undermined expectations in the reporting quarter (Figure II.6).

Value-added of transportation sector contracted by 1.7 percent in the reporting quarter, mostly owing to reduced coal exports. In line with weaker activities in transportation sector, sales of gasoline declined, leading to trade sector growth to fall below projections to reach 3.4 percent.

Construction sector growth was at 7.7 percent, undermining expectations, as fiscal capital expenditure did not reach its planned amount. Increased construction activities of factories,

Figure II.4

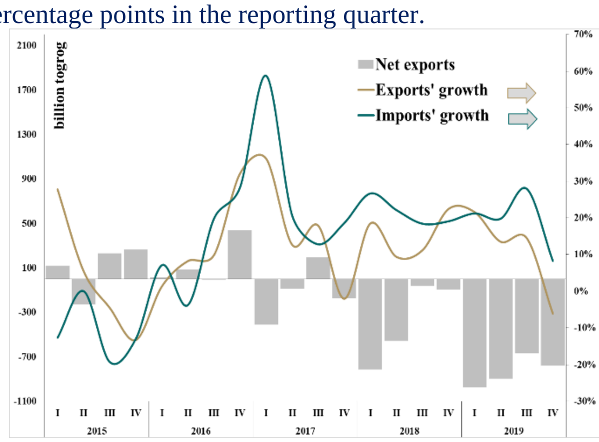
Household income remains short of expenditures, though it has been exhibiting growth in the past 3 consecutive years.



Source: NSO, Bank of Mongolia

Figure II.5

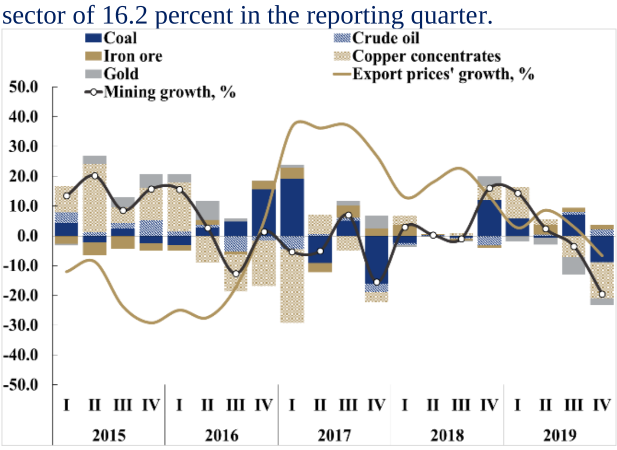
Exports decreased by 6.1 percent in real terms and imports increased by 8.3 percent in real terms, resulting in net exports weighing total demand growth down by 12.4 percentage points in the reporting quarter.



Source: NSO

Figure II.6

Declines in production of main commodities, except for crude oil and iron ore contributed to contraction in mining sector of 16.2 percent in the reporting quarter.



Source: NSO, Bank of Mongolia

schools, and auto road were major contributors to the sector growth.

Agriculture sector growth exceeded projections to reach 8.3 percent in 2019, mainly due to significant increases in livestock slaughtered for domestic meat consumption. In line with higher processing of meat, manufacturing sector growth picked up to reach 16.1 percent in the reporting quarter.

Growth of net taxes on products slowed down considerably to 0.6 percent in the reporting quarter, as imports' growth was below expectations and imports of automobiles declined. Thus, the contribution from net taxes on products to total supply growth was relatively small.

Potential output

Growth of potential output had been accelerating and constantly exceeded 10 percent during 2011-2013, followed by deceleration from 2014 until mid-2016. Since the 4th quarter of 2016, 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. Growth of potential output has been hovering around 5-6 percent in recent quarters (Figure II.7).

Output gap

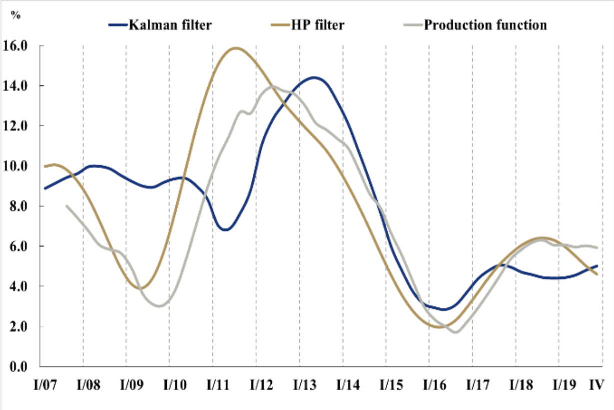
Mainly supported by activities in the non-mining sector, aggregate production had exceeded its potential level during 2011-2013, rendering a positive output gap. However, positive developments in the non-mining sector were reversed throughout 2014-2016, resulting in a negative output gap. The output gap turned positive again since the latter half of 2018. As of 3rd and 4th quarter of 2019, output gap is estimated to be close to its potential level, owing to significant decline in mining production (Figure II.8).

With increased coal production, mining output gap had been exhibiting a tendency to close since the latter half of 2018. However, it turned negative in the latter half of 2019, as gold content in Oyu tolgoi copper concentrates fell by 3 times and coal production declined.

Non-mining output gap has remained positive since 2018, mainly supported by growth of mining

Figure II.7

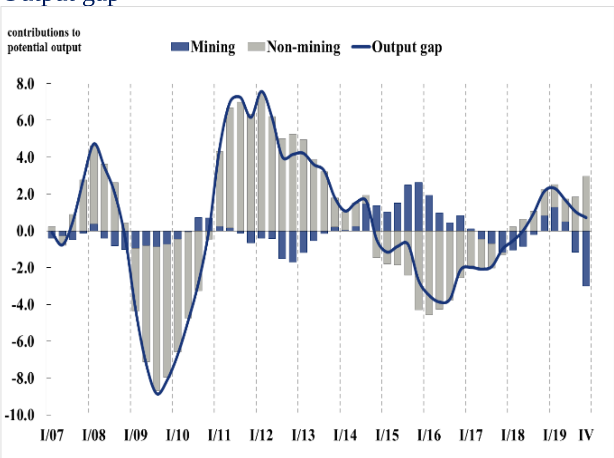
Growth of potential output



Source: Expert's estimation

Figure II.8

Output gap[4]



Source: Expert's estimation

[4] Estimated by Kalman filter.

exports and investments. Non-mining output gap slightly widened from previous quarter due to the growth of agriculture, manufacturing, and other services' sectors in the reporting quarter.

Economic growth outlook

Economic growth was below expectations, as mining production substantially contracted in the 4th quarter of 2019. Coal exports began to be restricted since mid-November 2019, leading to reduced coal production and thus, substantial contraction in the mining sector. Non-mining sector growth exceeded projections slightly, as number of livestock slaughtered and processed for meat consumption increased in line with seasonal preparation for the winter and boosted production in agriculture and manufacturing sectors. Moreover, enhanced coverage of manufacturing companies being surveyed by the NSO in the reporting quarter contributed towards higher sector growth.

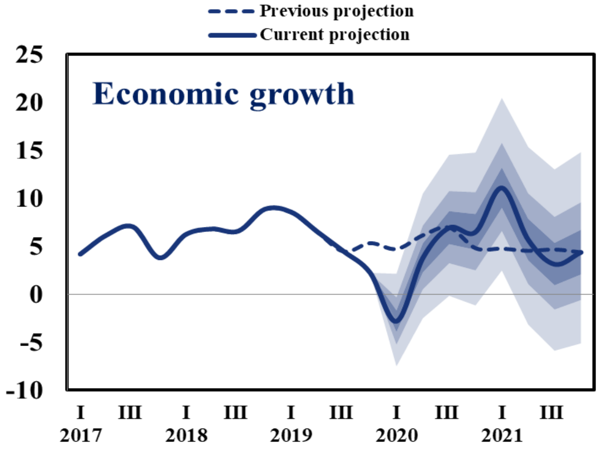
Economic growth outlook has been revised downwards for 2020 and upwards for 2021. Measures being implemented to cope with the spread of COVID-19 are expected to slow down activities in majority of production sectors in 2020. Economic growth outlook is revised upwards and production in mining and non-mining sectors are expected to recover in 2021 under the circumstances that external demand bounces back, metal content in copper concentrates improves and development of mega projects continues on track (Figure II.9).

Mining: Since the beginning of 2020, mining production is projected to contract, with exports of commodities such as coal and iron ore declining due to the spread of COVID-19 and slowing down of external demand. Mining production is expected to pick up in 2021, as external demand recovers and gold content in Oyu tolgoi copper concentrates improves.

Non-mining: Though expansions in fiscal capital expenditure and foreign direct investments are projected to boost production in some sectors in 2020, preventative measures implemented against the spread of COVID-19 are expected to slow down activities in tourism, restaurants, hotels, services and trade sectors. Furthermore, non-

Figure II.9

Forecast of annual growth of quarterly GDP



Source: Bank of Mongolia

Table II.1.1

Economic growth forecast[5]

	2019 *actual*	2020* *projection*	2021*
Real GDP growth, %	5.1	2.6 – 5.6	3.3 – 7.7
Mining growth, %	-0.6	-2.5 – 0.6	2.6 – 7.0
Non-mining growth, %	6.7	4.0 – 7.0	3.5 – 7.9

Source: Bank of Mongolia

5 Confidence interval of 30 percent

mining sector growth is projected to contract in the first half of 2020 and begin to bounce back in the second half, as exports of mining commodities decline, transportation sector growth remains subdued and net taxes on products reduce due to lower imports. Agriculture sector growth is projected to remain stable in 2020, given the conditions that the weather outlook is maintained within the long term average. Non-mining sector growth is expected to further pick up in 2021, as external demand recovers, and domestic demand improves due to a more stable economic environment.

Uncertainties that may affect economic growth outlook

Main source of uncertainty surrounding macroeconomic projection this time is the impact of the spread of COVID-19 pandemic on the global economy. As declared by the WHO, the spread of COVID-19 has reached levels of pandemic and caused economic activities in not only China but also in the US and European countries to substantially contract and prices of commodities to fall. There are risks of the extent of reduction in our exports' revenue and contraction in our economic growth to be larger than projected. On top of that, there are additional risks of quarantine measures taking place for a longer duration than expected, foreign trade stalling, activities in trade, services, construction, and manufacturing sectors significantly deteriorating and economic activities as a whole stagnating.

Mongolia's removal from the FATF "Greylist" would ease uncertainties in the future. Removal within a short time frame would diminish risks of downgrading of credit ratings, increased costs of external borrowing, difficulties in processing global financial transactions and payment systems, unfavorable investment environment, and reduced capital inflows.

Uncertainties regarding an initial public offering by Erdenes Tavan Tolgoi JSC on international markets under unfavorable external environment and financing mechanism for railway road construction persist.

Estimates of additional investments required for Oyu tolgoi underground mine development have yet to be finalized.

Table II.1.2

Changes in economic growth outlook

Assumptions on near term forecasts of economic growth	
Previous forecast (2020)	**Current forecast (2020)**
AGGREGATE DEMAND	**Expectation weakened**
Consumption	**Expectation improved**
HH consumption growth figures for the past 7 quarters have been revised upwards due to balancing of supply and use tables for 2018. Owing to such higher base period growth, projections for 2020 have been revised upwards. Though consumption is expected to be limited due to the spread of Covid-19, positive impact is to be realized through measures of relieving of pension debt repayments.	
Investment	**Expectation improved**
Investment expenditure for Oyu tolgoi underground mine development in 2020 has increased and around 228 million USD is expected to be invested towards development of Crude oil processing plant in 2020.	
Net exports	**Expectation weakened**
Exports of coal, crude oil, iron ore and other commodities have been revised downwards, as economic activities slowed down and tranportation of mining commodities contracted, owing to the spread of Covid-19.	
Imports of diesel fuel and other items declined, due to lower economic activities and reduced transportation of mining commodities induced by the spread of Covid-19.	
Foreign trade deficit projections have widened, as contraction in exports exceeded that of imports.	
AGGREGATE SUPPLY	**Expectation weakened**
Mining	**Expectation weakened**
Productions of coal, crude oil and iron ore are expected to contract, as economic activities in China and external demand slowed down, owing to the spread of Covid-19.	
Non-mining	**Expectation weakened**
Value added of services and manufacturing sectors are expected to be negatively impacted by the preventative measures implemented against the spread of Covid-19.	
Transportation of mining commodities is expected to contract and revenue from transportation sector is projected to decline due to the spread of Covid-19.	
In line with reduced activities in mining production and transportation, trade sales of fuel products are expected to decrease.	
In line with lower imports' growth, net taxes on products are expected to be on a downwards trend.	

Source: Bank of Mongolia

III. DOMESTIC ECONOMIC DEVELOPMENTS

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 reduced slightly (Figure III.1.1).

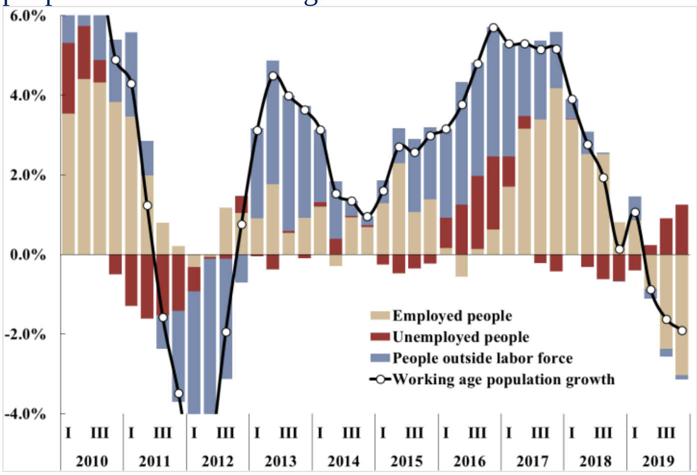
Among the main indicators of the labor market, labor force participation rate[6] has remained stable at around 61 percent on average in recent quarters. Employment rate[7] has been exhibiting decline since the beginning of 2019 and recently stood at around 55 percent. Unemployment rate[8] has begun to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

Among newly announced composite indicators that illustrate labor force underutilization, time-related under-employed people took up 0.9 percent of labor force, while number of people viable for employment but included in economically inactive population took up 4.3 percent of extended labor force as of 4th quarter of 2019. Such indicators illustrate that besides unemployment rate standing at 8.1 percent, an additional 5 percent of extended labor force [9] is being under-utilized (Figure III.1.2).

Employment growth, as of moving averages of past 4 quarters, slowed down to a 5 percent decline. Falling employment in agriculture, trade, manufacturing, construction, and transportation sectors

Figure III.1.1

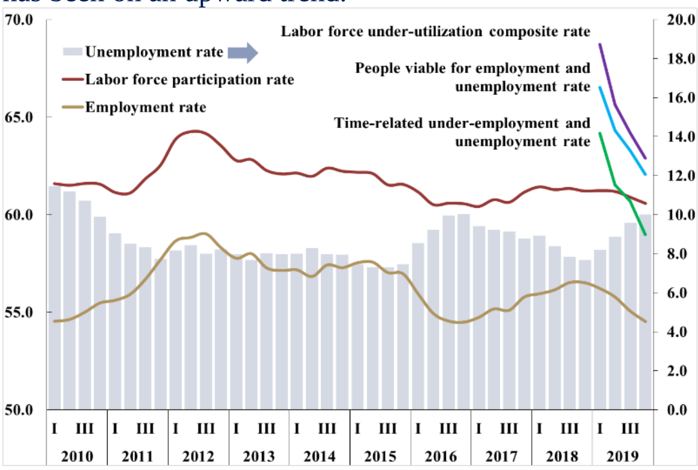
Within the working age population, number of employed people has been declining and number of unemployed people has been increasing.[14]



Source: NSO

Figure III.1.2

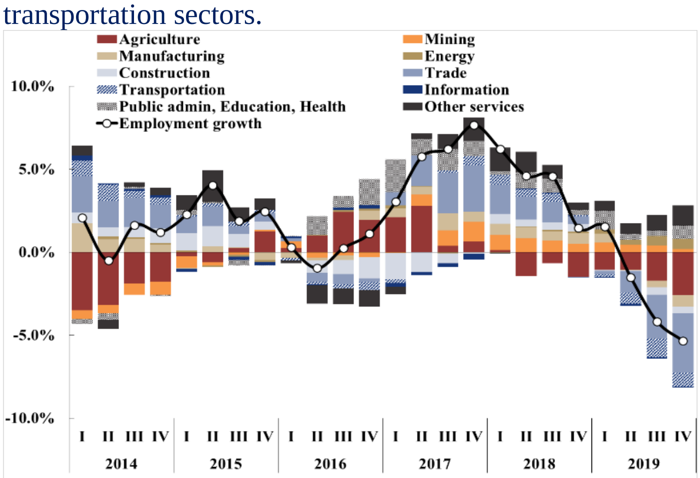
Labor force participation rate remains stable, while employment rate has been declining and unemployment rate has been on an upward trend. [15]



Source: NSO

Figure III.1.3

Employment contracted in agriculture, trade and transportation sectors.



Source: NSO

mainly contributed to such decline, while employment in energy, public administration, education, and health sectors exhibited expansion (Figure III.1.3).

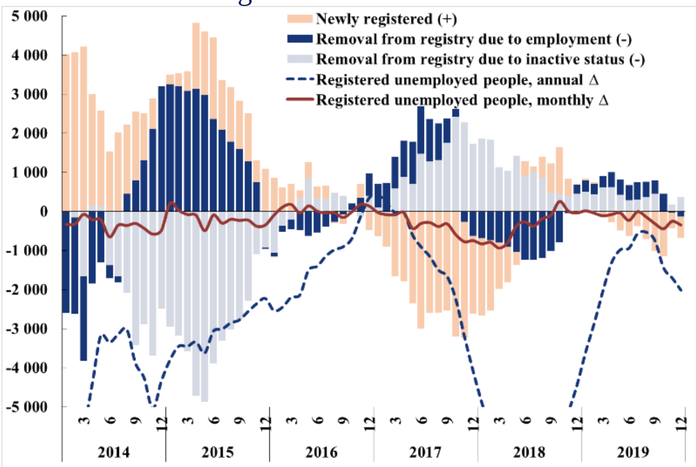
The extent of the decline in number of people registered as unemployed has been rising in recent months. Number of people newly registered for unemployment has been decreasing, while number of people removed from the registry for shifting to inactive status in seeking employment has been increasing (Figure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

Among the main indicators of household income, growths of the national average wage[10] and median wage have accelerated since the beginning of 2019 and continue to record at double-digit. Consequently, real wage growth, the main indicator 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 grow since the beginning of 2017 and recorded double-digit growth as of 4th quarter of 2019 (Figure III.1.5).

Average wages of main economic production sectors ranged from 775 to 2929 thousand togrogs, while the national average and median wages stood at 1243 thousand and 905 thousand togrogs, respectively (Figure III.1.5).

Figure III.1.4

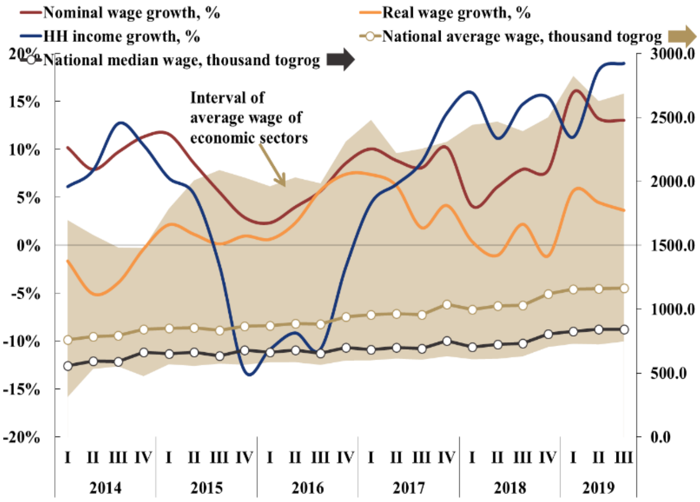
New registration of unemployed people has been declining, while de-registration of unemployed people due to inactive status has been rising.



Source: General Office for Labor and Welfare Services

Figure III.1.5

Real wage growth has been relatively maintained.



Source: NSO

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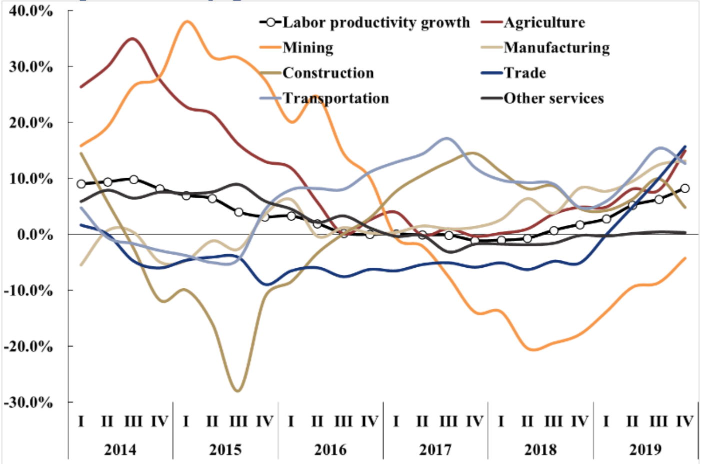
[6] Labor force/Working age population, average of past 4 quarters.
[7] Employed people/Working age population, average of past 4 quarters.
[8] Unemployed people/Labor force, average of past 4 quarters.
[9] Extended labor force = Labor force + People viable for employment (included in population outside labor force).
[14] Average growth of past 4 quarters of working age population and total employment.
[15] The 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.

Recent trend of falling employment has led to an acceleration of labor productivity growth[12] in recent quarters. In particular, labor productivity has been improving in majority of production sectors, except for mining and other services (Figure III.1.6).

Figure III.1.6

Labor productivity growth continues to accelerate.[16]

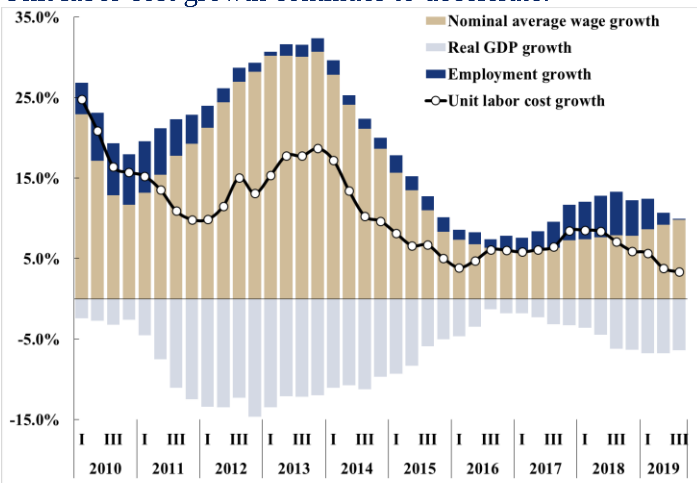


Source: NSO, expert's estimation

Recent trends of wage expenditure growth remaining high and falling employment have yielded unit labor cost growth[13] to be on a downward trend in the past 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 throughout the past 4 consecutive quarters and reached 4.6 percent as of January 2020. Continued decline in the growth of credit issued by banks has been the major contributor to such deceleration. Increases in net foreign assets remain to have been supporting a significant portion of money supply growth.

Expansion of net foreign assets by approximately 800 million dollars rendered a contribution of 12 percentage points to money supply growth. (For detailed description on changes in net foreign assets which are directly associated with the balance of payments, refer to the section on the balance of payments.)

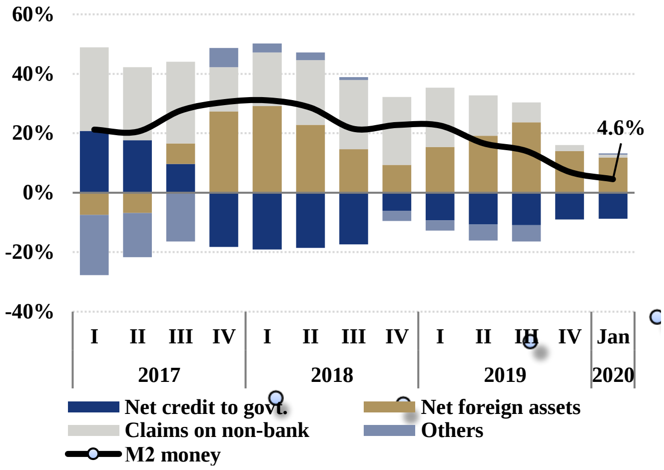
Deceleration in credit growth has been mainly driven by a contraction in consumer loan and gradual weakening of business loan growth. With regards to consumer loans, though new issuance of card and herders' loan has been rising, outstanding amount of wages, pension, automobiles, and other consumer loans continues to fall. Looking at credit growth by currency classifications, an outstanding amount of credit issued in togrog expanded by 10.5 percent, while an outstanding amount of credit issued in foreign currencies declined by 26 percent.

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. Fiscal deficit and principal debt repayments have been financed through external and domestic sources accumulated in the general budget in 2019, with the remaining amount being held as current accounts at the central bank.

Money supply growth, from the liabilities side, was mainly supported by expansion of deposit accounts in domestic and foreign currencies. In accordance with the growth of deposit accounts denominated in foreign currencies picking up

Figure III.2.1.1

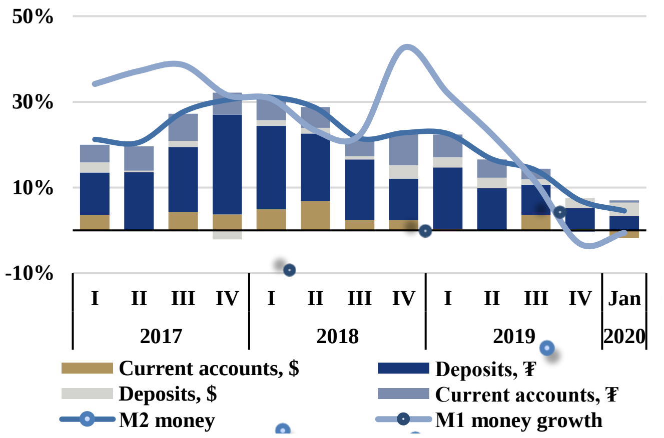
Contributions to annual growth of M2 money supply, by assets



Source: Bank of Mongolia

Figure III.2.1.2

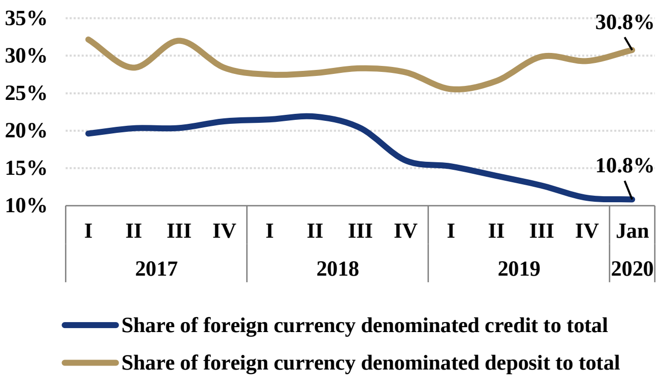
Contributions to annual growth of M2 money supply, by liabilities



Source: Bank of Mongolia

Figure III.2.1.3

Dollarization of bank credits and deposits



Source: Bank of Mongolia

Figure III.2.1.4

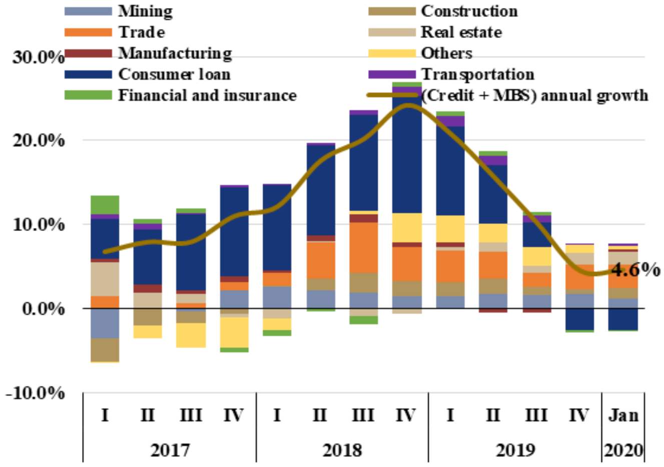
since February 2019, bank deposit dollarization has been increasing.

Combined outstanding level of total credit issued by depository institutions[17] and mortgage loans converted to mortgage-backed securities (MBS[18]) increased by 4.6 percent as of January 2020. A majority of credit growth has been attributed to loans issued to mining, construction, trade, and real estate sectors. Owing to the implementation of macroprudential policy measures since 2019, an outstanding amount of consumer loan declined by 7.7 percent or approximately 400 billion togrogs and significantly contributed towards the deceleration of credit growth. Furthermore, another factor contributing to such deceleration of credit growth was sluggish increases in loan issued to small and medium enterprises in the latter half of 2019.

Looking at the composition of the outstanding level of total credit, share of consumer loans have been reducing. Specifically, a share of consumer loans to total credit fell by 3 percentage points to reach 25 percent. On the other hand, combined shares of loans issued to mining, trade, real estate, and construction sectors to total credit increased by 4 percentage points to reach 53 percent.

Quality of credit issued by banks has not been significantly improving. Around 15 percent of total credit is attributed to non-performing and past-due loans. Out of total non-performing and past-due loans, loan issued to mining, construction, manufacturing, trade, and real estate sectors comprised 70 percent. Among production sectors, quality of loan issued to mining and construction sectors improved, while quality of loan issued to manufacturing, trade, and for consumer purposes deteriorated.

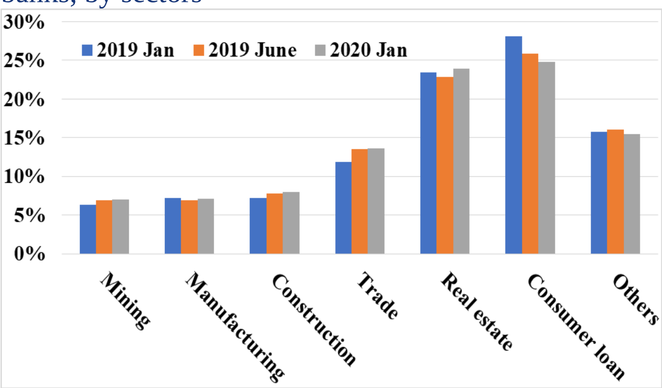
Contributions to annual growth of credit issued by depository institutions, by sectors



Source: Bank of Mongolia

Figure III.2.1.5

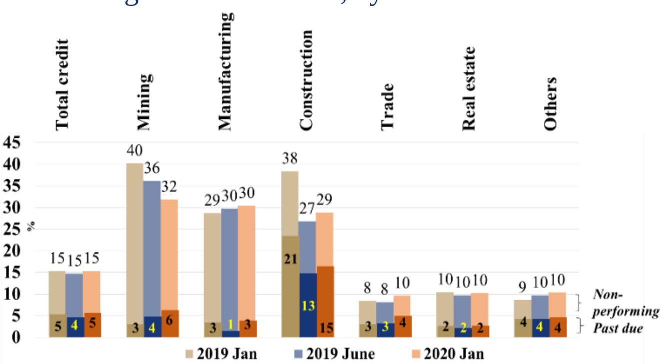
Composition of outstanding amount of credit issued by banks, by sectors



Source: Bank of Mongolia

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

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[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, consumption, wage, pension and other types of consumer loans.

III.2.2 Interest rate

The Monetary Policy Committee of the Bank of Mongolia decided to keep the policy rate unchanged at 11 percent during its scheduled meeting in December 2019 and to lower the policy rate by 1 percentage points to 10 percent on its scheduled meeting in March 2020.

In January 2020, the weighted average of interbank market rate decreased by 0.16 percentage points to 10.86 percent from previous month. Interest rate for repo deals, secured by the central bank bills, decreased by 0.28 percentage points to 10.63 percent, interest rate on direct trading of central bank bills decreased by 0.06 percentage points to 10.77 percent, overnight lending rate decreased by 0.47 percentage points to 11.04 percent. Meanwhile, interest rate on interbank deposits increased by 0.51 percentage points to 12.11 percent.

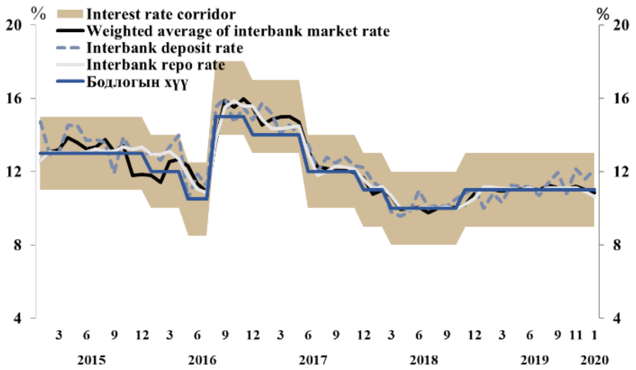
Decrease in the interest rate on newly issued loans and the stable interest rate on new deposits resulted in a narrower interest rate margin. In January 2020, interest rate on credits issued in MNT decreased by 0.29 percentage points from that of previous year to 16.81 percent, and interest rate on MNT deposits remained around 10.6 percent. Consequently, interest rate margin narrowed by 0.28 percentage points from that of previous year down to 6.22 percent.

As for loans in foreign currency, interest rate on newly issued loans increased by 0.3 percentage points from that of previous year to 9.91 percent and interest rate on new deposits decreased by 1.03 percentage points to 3.57 percent. Consequently, interest rate margin of foreign loans and deposits widened by 1.35 percentage points from that of previous year to 6.35 percent.

The relative yield on MNT remained positive for the first 10 months of 2019 and it fluctuates around 0 for the past 3 months as the nominal exchange rate of MNT depreciates against USD.

Figure III.2.2.1

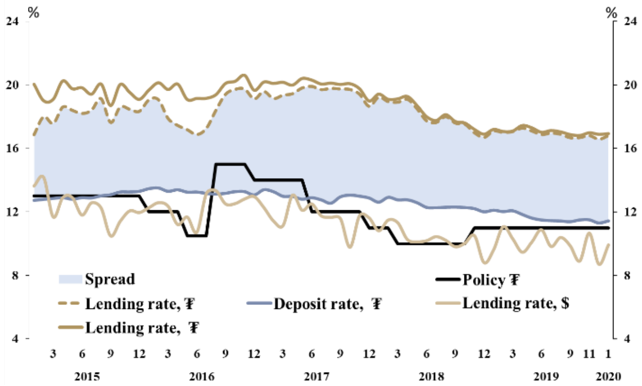
Weighted average of interbank market rate remains close to the policy rate.



Source: Bank of Mongolia

Figure III.2.2.2

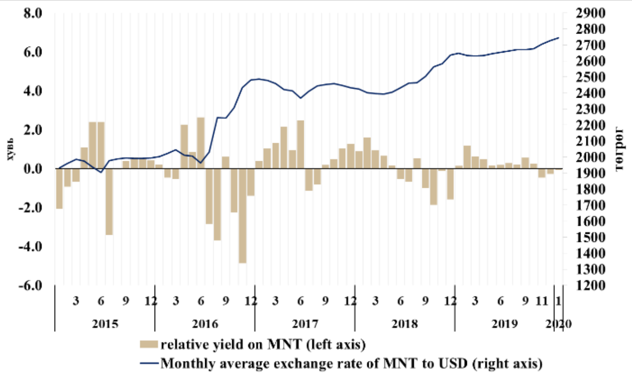
Interest rate on newly issued loans and new deposits have dropped.



Source: Bank of Mongolia

Figure III.2.2.3

Relative yield on MNT has declined.



Source: Bank of Mongolia

III.2.3 Exchange rate

In the 4th quarter of 2019, the average exchange rate of MNT against USD depreciated by 109.1 MNT or 4.2 percent to 2703.5 MNT from that of previous year. Since the beginning of the year, the MNT has been gradually depreciating against the US dollar, reaching MNT 2,761.7 at the end of February. This is a 1.0 percent depreciation from the beginning of the year /Figure III.2.3.1/.

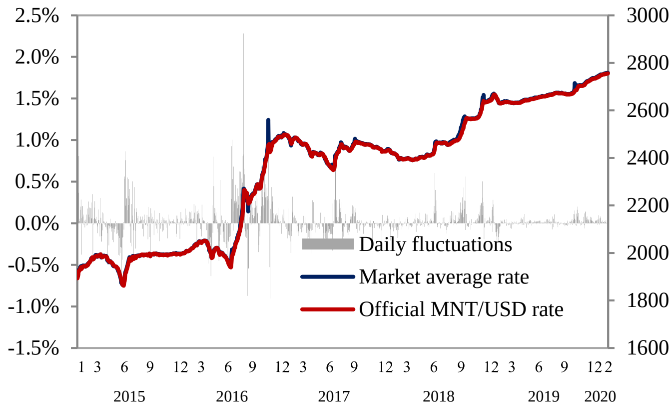
In January 2020, foreign currency inflows increased by 2.3 percent and foreign currency outflows decreased by 8.2 percent from previous month, resulting in a net surplus of foreign currency through the banking system. However, due to the spread of COVID-19 in China, coal exports are suspended, and inflows decreased in February from previous month, resulting in a net foreign exchange deficit, thus causing the depreciation of MNT. Decline in both export prices and volumes will put pressure on the togrog to depreciate, while a decline in imports and a downward trend in the oil price will ease the pressure on the currency.

The nominal effective exchange rate (NEER), weighted by trade turnover, depreciated by 3.4 percent year-over-year in January 2020 /Figure III.2.3.2/. This was mainly due to the 11.9 percent depreciation of MNT against Ruble year-over-year. Moreover, MNT depreciated against Euro and RMB slightly or by 1.6 percent and 0.6 percent respectively /Figure III.2.3.3/.

Real effective exchange rate (REER) appreciated by 1.0 percent year-over-year in January 2020. Despite the weakening of the nominal exchange rate, domestic price increased more rapidly than the foreign price, thus relative price increased by 4.4 percent.

Figure III.2.3.1

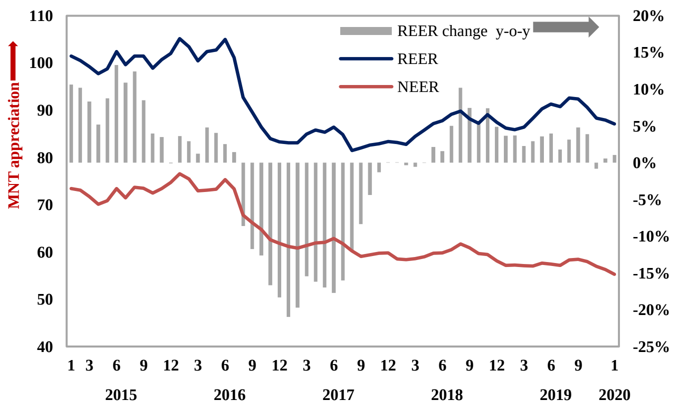
Cross rate of MNT to USD



Source: Bank of Mongolia

Figure III.2.3.2

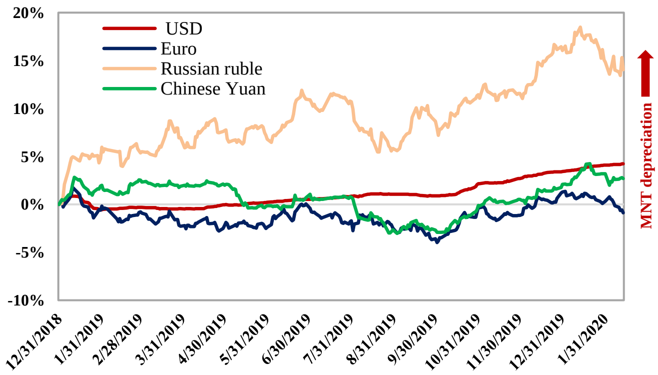
Real effective exchange rate of MNT



Source: Bank of Mongolia

Figure III.2.3.3

Change in MNT exchange rate against major currencies /compared to the beginning of 2019/



Source: Bank of Mongolia

III.2.4 Capital market

In the fourth quarter of 2019, the capital market activity improved while TOP-20 index[19] continued to drop. As for the housing market, the price-to-income ratio, which reflects the purchasing power of housing, has been stable, while the price-to-rent ratio has continued to decline.

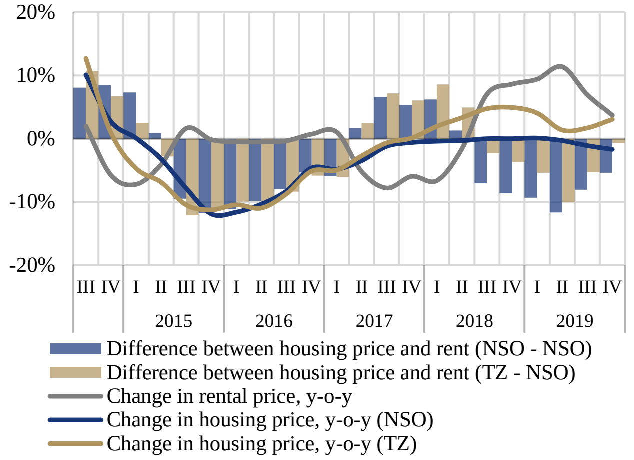
The housing price index reported by the Tenkhleg Zuuch increased by 1.8 percent from previous quarter and 3.8 percent annually in the 4th quarter of 2019. The growth in housing prices was mainly driven by the increase in prices of old houses. On the contrary, the housing price index estimated by the NSO decreased by 0.6 percent from previous quarter and 1.7 percent annually in the 4th quarter of 2019 (Figure III.2.4.1).

The price-to-income ratio, calculated from the NSO housing price index, remained stable in the 4th quarter of 2019 although household average income increased by 1.1 percent. In addition, new mortgage loans were issued [20] to 3256 borrowers in the reporting quarter, an increase of 28.3 percent from previous quarter. The price-to-rent ratio decreased by 0.01 percentage points from previous quarter and the risk of housing bubble remains low (Figure III.2.4.2).

In the reporting quarter, the market capitalization increased by 1.8 percent from previous quarter reaching 2.54 billion MNT (Figure III.2.4.3). This was mainly due to the active trading of shares and higher stock prices of "Ard financial group", "Invescore", and "Ard credit NBFI". In particular, "Ard financial group", "Ard credit NBFI", and "Mandal insurance" led the trading activities, and in the 4th quarter of 2019, a total of 31.7 billion MNT worth of securities were traded on the stock market, an increase of 48.8 percent from previous quarter.

Figure III.2.4.1

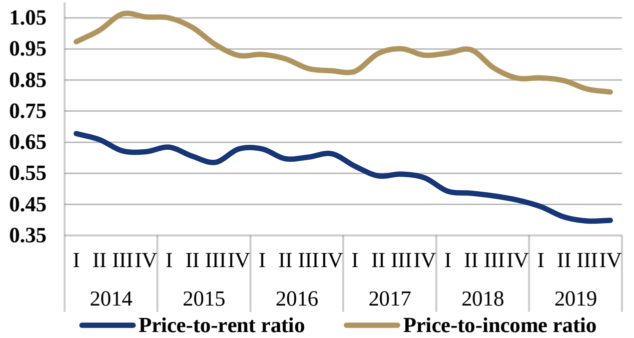
Rental price of housing continued to decelerate and housing market remains stable.



Source: NSO, Tenkhleg Zuuch

Figure III.2.4.2

Risk of overheating looks limited and purchasing power remains stable.



Source: NSO, Bank of Mongolia

Table III.2.4.1

Real estate sector indicators

		2019 Q3	2019Q4
Change in housing price, %			
NSO	q-o-q	-0.8	-0.6
	y-o-y	-1.1	-1.7
Tenkhleg Zuuch	q-o-q	2.2	1.8
	y-o-y	1.7	3.1
Change in rental price, %	q-o-q	2.5	0.6
	y-o-y	7.0	3.7
Price-to-income ratio		0.40	0.40
Price-to-rent ratio		0.82	0.81

Source: NSO, Tenkhleg Zuuch, Bank of Mongolia

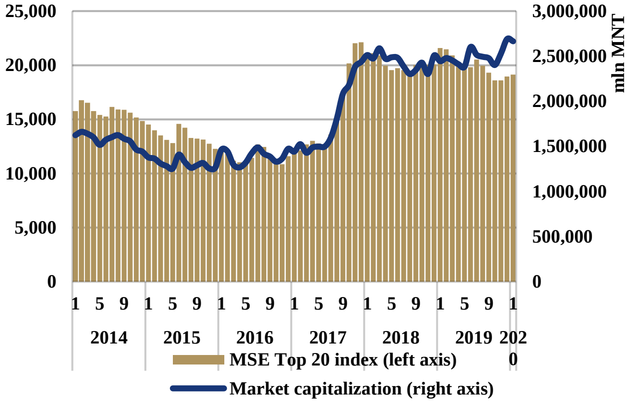
The stock market liquidity ratio increased by 0.3 percentage points from previous quarter to 1.2 percent in the 4th quarter of 2019 due to a slight increase in securities trading, which had slowed down for the last four quarters (Figure III.2.4.4).

The TOP-20 index, however, declined by 6.1 percent from previous quarter's average, reaching 18,725. This was mainly due to a decline in Class I and Class II shares, such as "Gobi", "LendMN NBFI" and "Tumen Shuvuut".

Increased uncertainty in the external and domestic economy in 2020 is hurting businesses and increasing the risk of continue weakening of the TOP-20 index.

Figure III.2.4.3

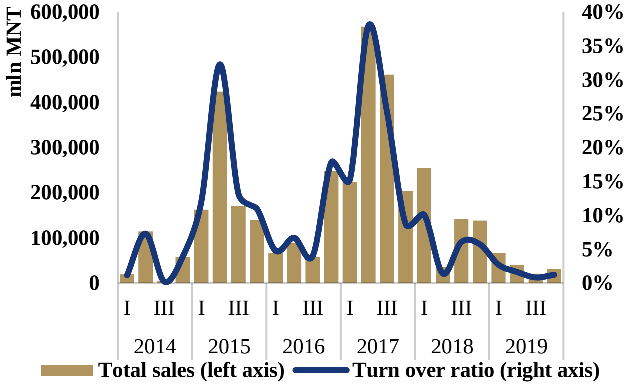
While market capitalization has improved q-o-q, the weakening in MSE Top 20 index continued.



Source: Mongolian Stock Exchange

Figure III.2.4.4

Stock market activity improved slightly.



Source: NSO, Bank of Mongolia

[19] Quarterly average

[20] Source: Bank of Mongolia. Loans disbursed by banks from their own resources and under the "Mortgage sustainable financing system program" are considered together.

III.3 The consolidated budget and sovereign debt

The consolidated budget: Within the approved budget, the equilibrated budget revenue is expected to increase by 996 billion MNT and expenditure by 2443 billion MNT (Table III.3.1) in 2020 from previous year, and fiscal policy is expected to weaken from last year.

As of February, the equilibrated budget revenue was 2.6 percent higher than planned and the budget expenditure was 40 percent lower than planned, resulting in a deficit of 120 billion MNT in the equilibrated balance.

Total equilibrated revenue: As of February, 91.7 percent of the equilibrated budget revenue was made up of tax revenue. Compared to the same period of previous year, the equilibrated income decreased by 85 billion MNT (5.8 percent). In particular, other tax revenues decreased by 56.3 billion MNT, domestic goods and services tax decreased by 29.2 billion MNT, import-related tax revenue decreased by 20.0 billion MNT, and tax refunds increased by 43.9 billion MNT, while social insurance revenue increased by 36.7 billion MNT and income tax increased by 13.8 billion MNT (Figure III.3.1).

Total expenditure and net credits: Looking at components of budget expenditure compared to that of previous year, capital expenditures increased by 988 billion MNT, current transfers by 835 billion MNT, expenditures on other goods and services by 424.5 billion MNT, and wage expenditures by 371 billion MNT in the first 2 months of 2020. The net lending excluding loan repayments is expected to decrease by 356 billion MNT.

As of the first 2 months of 2020, budget expenditures underperformed by 60 percent or the expenditure utilization rate was only 40 percent, of which capital expenditures' utilization was 28.5 percent. The total budget expenditure increased by 337 billion MNT (29.2 percent) year-over-year. Of which, expenditures on subsidies and transfers

Table III.3.1

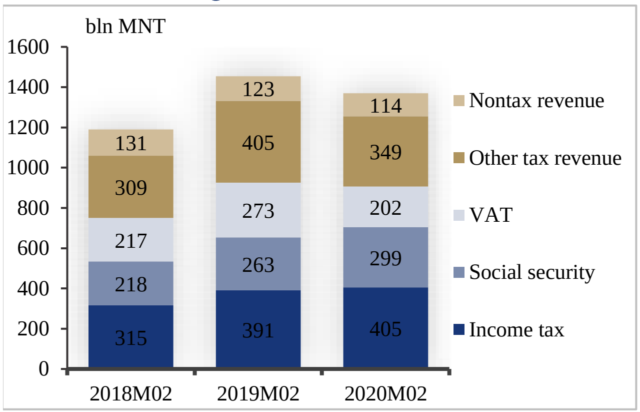
Fiscal indicators

billion MNT	2019	2020	2020.02	
	Гүй.	Бат.	Гүй.	%
Total revenue	**11937**	**12900**	**1464**	**100.**
Future heritage fund	1040	977	149	90.
Stabilization fund	95	125	4	17.
Equilibrated revenue	**10802**	**11798**	**1369**	**102.**
Tax revenue	9749	10656	946	105.
Non-tax revenue	1053	1142	114	76.
Total expenditure	**11429**	**13873**	**1489**	**60.**
Primary expenditure	10568	12913	1404	58.
Current expenditure/-interest paym	7347	9060	1240	70.
Capital expenditure	2818	3806	172	28.
Net credit	403	47	-8	-31.
Interest expenditure	861	960	86	97.
Total equilibrated balance	**-628**	**-2075**	**-120**	
in percent of GDP	-1.7%	-5.1%		
Primary balance	233	-1115	-34	
in percent of GDP	0.6%	-2.7%		

Source: Ministry of Finance

Figure III.3.1

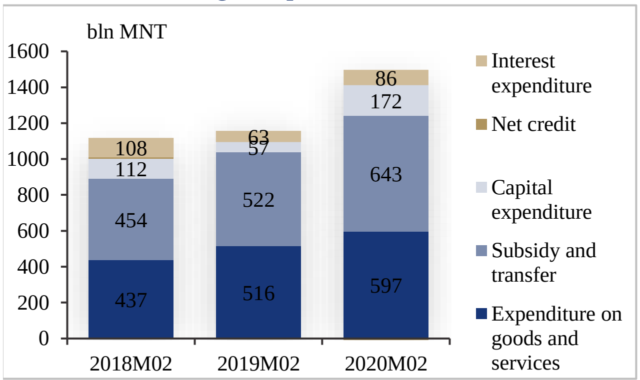
Structure of budget revenue



Source: Ministry of Finance

Figure III.3.2

Structure of budget expenditure



Source: Ministry of Finance

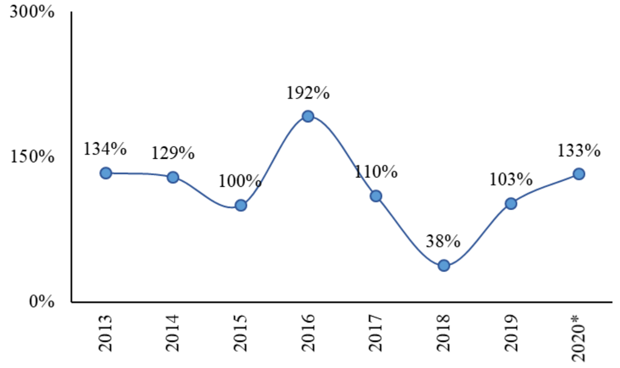
increased by 121 billion MNT, capital expenditures increased by 115 billion MNT, expenditures on goods and services increased by 81 billion MNT, and loan payments increased by 23 billion MNT.

The ratio of newly issued debt-to-debt repayment: According to the approved budget of 2020, the government is expected to pay 1.9 trillion MNT for external loan repayments, domestic treasury bill repayments and loan repayments, and to issue new long-term domestic treasury bills, external 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 133 percent (Figure III.3.3).

Total government debt at present value: According to the budget approved by the Parliament, the present value of government debt is set to be within legal boundaries in 2020 (Table III.3.2). Moreover, debt service payments as a share of budget revenue have fallen since 2016, reaching 8 percent in 2019, and will remain at previous year's level according to the approved budget forecast for 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 Гүй.	2018 Гүй.	2019 Гүй.	2020* Бат.
Government debt	20212	18946	23915	22089
in % of GDP	74.4	58.9	56.1	54.3
Debt limit/GDP	85.0	80.0	75.0	70.0
Debt service payments	1156	1046	861	960
in % of budget revenue	16.0	11.3	8.0	8.1
Budget balance	-1742	12	-628	-2075
in % of GDP	-6.4	0.0	-1.7	-5.1

Source: Ministry of Finance, Bank of Mongolia

III. EXTERNAL CONDITIONS OF THE ECONOMY

IV.1 Assumptions regarding the external conditions[21]

Owing to the spread of COVID-19, the growth outlook of China, the main trading partner, and the outlook of export prices have been revised down from previous forecast.

External demand[22] outlook is revised down from previous forecast as the growth outlook for China is revised down for 2020.

China's industrial, transportation, and service sectors have slowed due to COVID-19 and the growth forecast for 2020 was revised down by 0.5 percentage points to an average of 5.4[23] percent, while the growth forecast for 2021 remains at 5.8 percent. If the situation continues to deteriorate, there is a high risk that China's economic outlook to degrade. According to Bloomberg analysts, China's growth is likely to fall to 1.4 percent in 2020 in a pessimistic scenario. The growth forecast of the Euro Area remains at 1.2 percent on average for 2020 and revised up by 0.2 percentage points from previous forecast to 1.5 percent for 2021[24]. The growth forecast of the Russian economy is revised up by 0.1 percentage points from previous forecast to 1.8 percent for 2020 and 1.9 percent for 2021.

China’s economy expanded by 6.0 percent in the 4th quarter of 2019 in line with previous expectations. The growth was mainly supported by industrial growth of 5.9 percent, which was 5.0 percent in previous quarter. The "Phase Two" of trade discussions among the United States and China remains unresolved until the 2020 US presidential election and it is too early to predict how long the negative impact of COVID-19 on economic growth will last, and the effectiveness of the government's counteractive policy responses.

Table IV.1.1

Change in Key Judgments of External Environment

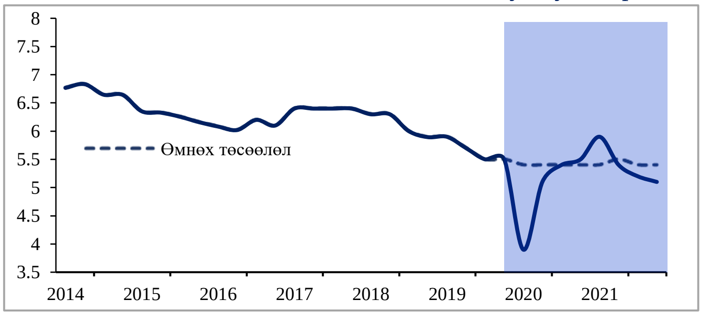
Changes in Key Judgments of External Environment

Previous forecast of 2020	Current forecast of 2020
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.	"Phase 2" trade deal is expected. China's growth is revised down, Russia's growth is revised up slightly. The growth forecasts of Euro Area and USA remains unchanged this time.
Terms of Trade	**Unchanged**
Copper price outlook is expected to be around the level of previous forecast, coal and iron ore increased marginally as the US-China reaches agreement on "Phase One" deal. As the external uncertainty persists, price of gold is expected to increase.	Economic activity weakened due to the outbreak of COVID-19 in China, and commodity prices outlook is revised down. Gold prices are expected to rise due to increased uncertainty in the external environment and the risks associated with COVID-19. Oil prices fell as the OPEC deal ends.
Foreign interest rate	**Revised down**
The Fed kept the Fed funds rate unchanged in December 2020.	The Fed cut Fed funds rate twice down to 0.0-0.25 percent in March 2020.
Global Inflation	**Unchanged**
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 global inflation is not likely to increase. The mainly driven by followings: the growth projection of main trading partners, except Russia, remains close to the previous projection, COVID-19→ China's growth slowed down, OPEC deal ends → oil price declined. Inflation in China is expected to be around the previous forecast in the forecasting period as prices of pork continued to rise and price of imported goods rose.

Source: Bank of Mongolia

Figure IV.1.1

Forecast of external demand, y-o-y percent



Source: Bloomberg, EIU, Roubini Global Economics

[21]Forecasts of economic growth and inflation in main trading partner countries were compiled from March 2020 edition of EIU Global Forecasting Report, February 2020 edition of Roubini Global Economics 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

[22]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).

[23] The average of the forecasts from the EIU, Roubini, and Bloomberg as of February 27, 2020

[24] The average of the forecasts from the EIU, Roubini, and Bloomberg as of February 27, 2020

Moreover, international analysts warn that China's domestic economic activity is not strong enough and the growth may fall short of expectations since Chinese industrial growth forecast in the 1st quarter of 2020 is revised down from 5.1 percent, in previous forecast, to 4.0 percent due to the prolonged Lunar New Year holiday.

Chinese authorities are trying to offset the negative impact of COVID-19 on the economy through fiscal and monetary policies. For example, the Chinese government is supporting economic activity through policies to reduce the cost of borrowing and provide subsidized loans. The VAT for small-scale taxpayers in Hubei Province has been exempted, and the VAT collection rate for small-scale taxpayers in other provinces has been reduced from 3 percent to 1 percent from March 1 to May 31, 2020. Moreover, the government is taking other tax relief measures, such as to reduce or eliminate types of tax fees for enterprises from February 18 to June 30, 2020. This frees up funding of 650 billion USD. Moreover, local government special bond issuance is expected to increase in 2020 from previous year. The People's Bank of China lowered its benchmark 1-year Loan Prime Rate (LPR) by 1 percentage points, in an attempt to inject more liquidity into the financial market and prevent economic risks. The LPR is expected to be cut three more times this year. In addition, the reserve requirements of banks are expected to be reduced by 1.5-2.0 percentage points. As of March 10 update, China’s growth forecast is revised down by 0.5 percentage points to 5.4 percent for 2020 as the uncertainty of COVID-19 increases and the positive effect of the expansionary fiscal and monetary policies to support domestic economic activity may be limited. Growth prospects will depend on when China will take the outbreak of COVID-19 under control within China and how it continues to spread to other parts of the world.

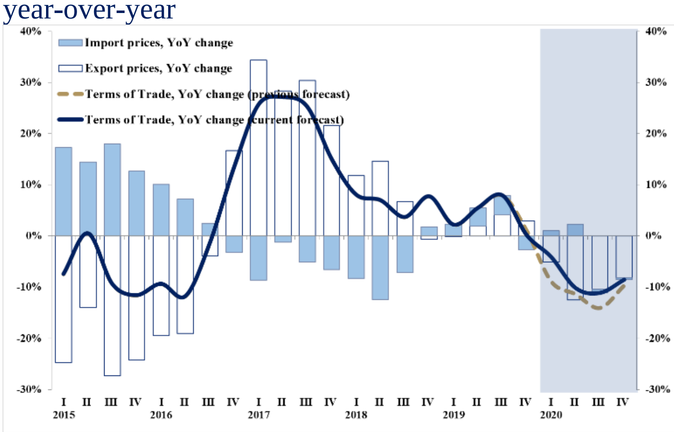
Russian economy outperformed the expectations in the 4th quarter of 2019 due to 0.2 percent exports decline, smaller drop than the expectation of -1.1 percent. Oil price outlook has a strong implication on Russian economic growth. As the agreement between the OPEC and non-OPEC allies expires in April 2020, the oil market will experience a substantial oversupply and drop in oil prices which will hurt exports, budget revenues and growth. However, the impact of the negative shock on the budget could be relatively small, as the Russian government has projected an average oil price forecast of 42 USD per barrel in the government budget draft for 2020. Russia's growth forecast for 2020 has been kept around previous forecast, as the implementation of approved national infrastructure projects will intensify and support growth in 2020.

The Euro area economy expanded by 1.0 percent, lower than expected, in the 4th quarter of 2019. The growth was mainly supported by improved growth of total investments from 3.2 percent in the third quarter to 6.7 percent in the fourth quarter of 2019. On the other hand, the growth was adversely impacted by the consumption growth in Euro area, that declined from 1.5 percent in previous quarter to 1.4 percent in the fourth quarter of 2019. The ECB’s non-conventional expansionary policy and relatively loose fiscal policy are expected to support the regional growth in coming quarters. However, the Euro Area’s growth forecast for 2020 has been kept around previous forecast as business investment is expected to slow due to increased risk of COVID-19 and uncertainty in the global economy.

Terms of trade deteriorated slightly, underperforming the expectations, in the 4th quarter of 2019 owing to lower copper, coal, and iron ore prices. Copper, coal, iron ore, and oil prices for 2020 are revised down marginally as Chinese economic outlook worsens and commodities demand declines. The price forecast for gold, which is considered a risk-free investment, has increased. From 2021, the commodity demand and prices are expected to recover. Although export price forecasts have weakened, import prices are expected to decline due to oil prices, and terms of trade is expected to improve slightly.

Figure IV.1.2

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

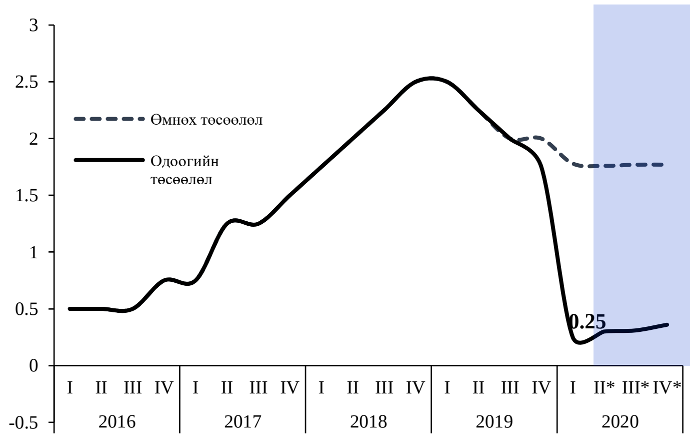


Source: Bank of Mongolia

Foreign interest rate: The Fed's FOMC decided to keep the Fed funds rate on 1.5-1.75 percent on the meeting in January 2020 as the employment numbers were strong and economic growth was expected to be moderate. However, as the spread of COVID-19 increases, the economic activity has weakened, and the Fed's FOMC decided to cut its Fed funds rate by 0.5 percentage points and 1.0 percentage points down to 0.0-0.25 percent on two unscheduled meetings in March 2020 as part of its policy to mitigate the negative effects of the external environment and promote employment. Moreover, the Fed decided to buy an additional asset purchases worth of 700 billion USD, allowing banks to access collateralized loans with maturities up to 90 days, and reduced the required reserve ratio to zero. The Fed is also taking measures to support financial market liquidity.

Figure IV.3.5

Federal funds rate, percent



Source: Bloomberg

Global inflation: Global inflation was higher-than-expected in the 4th quarter as pork-related food price inflation persisted and the growth in key trading partners were in line with expectations while the risk of global trade conflicts softened. The Chinese inflation outlook is revised up to an average of 4.2 percent for 2020 as the impact of swine flu on food inflation persists and food production and deliveries have been disrupted by COVID-19 despite lower demand-driven pressure on inflation due to slower domestic demand in coming months. Despite an increasing pressure on inflation owing to an easing monetary policy and implementation of sustainable economic policies-national projects, Russia's inflation is expected to average 3.6 percent, below the central bank's target of 4 percent, by the end of 2020 mainly due to lower oil prices and the outbreak COVID-19. In the United States, unemployment is at its lowest level in 50 years, household consumption is expected not to decline drastically, and some imported products will be free of tariffs, the inflation is expected to average 1.8 percent for 2020, the same as previous forecast. The Euro Area's inflation forecast for 2020 remains at 1.2 percent, as previous forecast. The regional growth is expected to weaken as the global economic activity slows down and euro is expected to depreciate marginally owing to the expansionary monetary policy by the European Central Bank.

Uncertainties in the external conditions

The main uncertainty of the external environment is how long the outbreak of COVID-19 will last and how it will affect China's economy and its external demand. If the spread of the virus is prolonged and turns into a global pandemic, it could hurt the Mongolian economy, mainly via lower exports and fiscal revenues with a slower China's economic growth and decline in commodity prices.

Geopolitical risks include expectations for a "Phase II" trade agreement between the United States and China, the expectations of a Brexit and post-Brexit trade agreement, and the risk of oil prices falling below 30 USD a barrel.

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

The downward revision in China's growth outlook, the uncertainty in trade disputes between the United States and China, and the prolonged negative impact of COVID-19 on metal demand were the main reasons for declining commodity prices in the reporting quarter.

Copper: The average price of copper per ton at the London Metal Exchange was 5688 USD in February 2020 and dropped to 4846 USD as of March 25, 2020. The slowdown in China, which accounts for 50 percent of the global copper demand, and the risk that COVID-19 outbreak will not subside in the short term have weighed on market sentiment. In the forecasting period, the continued spread of COVID-19 slows the growth in the developed and developing countries, and the slowdown in global economic growth is expected to affect the metal demand negatively in the medium term. Deteriorating copper demand due to COVID-19 and stable copper supply could lead to a market surplus of 800,000 tons, the largest surplus since 2001. As of March 25 update, copper prices are expected to fall to an average of 5,751 USD in 2020.

Gold: Gold prices averaged 1,586 USD an ounce in February 2020 and rose to 1,620 USD as of March 25, 2020, due to the outbreak of COVID-19 and intense tensions between the United States and Iran in early 2020. The demand and price of gold, considered as a safe-haven, remains elevated largely due to the uncertainties in the global economy regarding COVID-19. Looking forwards, the gold price volatility is expected to remain high throughout 2020 as growth outlook in the developed countries weakens and gold purchases by central banks are expected to increase. As of March 25 update, the gold price is expected to average 1,509 USD in 2020.

Coking coal: The price of coking coal was 160 USD per ton in February 2020 and kept at 160 USD per ton as of March 25, 2020. Due to the spread of COVID-19 and the extension of the Chinese Lunar New Year holiday, coke and steel production operated at 40-50 percent of its potential in February, and coal reserves were maintained. However, coal reserves at the ports are expected to decline because of the Chinese government's decision to exempt the domestic auto freight tolls until June 30. The domestic coking coal production is anticipated to increase in the short term as the

Chinese economy, which currently is at 80-85 percent of its potential, is expected to return to normal levels and steel production recovers. At the same time, China plans to build thermal and coking coal plants with a total capacity of 976 million tons by 2021, which will increase supply in the long run. However, the demand is expected to decline due to COVID-19 and the subsequent slowdown in steel and industrial growth which will reduce demand for coking coal, and prices could fall by the end of 2020. Reserves of China's major power plants increased to 17.6-17.7 million tonnes or 31 days of reserves as of March 25, and Australian supply is stable, the coking coal price outlook for 2020 remains at 160 USD per ton as of March 25 update.

Iron ore: The price of iron ore fell to an average of 81 USD per ton in February 2020 and 80 USD per ton as of March 25, 2020. Increased steel reserves in major Chinese cities and weak coke and steel production, around 40-50 percent of its potential, due to the outbreak of COVID-19 have led to a decline in iron ore prices. The price of iron ore is unlikely to bounce back in 2020 since the demand for steel and iron ore are expected to fall with a sluggish Chinese industrial growth in 2020 and deteriorating global economic activity. As of March 25 update, the iron ore price is expected to average 71 USD per ton in 2020.

Crude oil: A barrel of Brent oil was sold at an average of 50 USD in February 2020 and fell drastically to 27.4 USD as of March 25, 2020. The demand and price of oil have fallen due to the emerging spread of COVID-19 throughout the world. On the supply side, the oil market is expected to have a supply surplus in 2020. The OPEC and non-OPEC allies (Saudi Arabia and Russia) have ended their three-year agreement in March 2020 after Russia refused to support a proposal to cut oil production by an additional 1.5 million barrels per day and extend the agreement by six months. As a result, starting from April 1, the oil market will experience a substantial oversupply, and prices will remain low. Moreover, US oil production is expected to increase, and the demand is expected to remain subdued until the spread of COVID-19 is controlled. As of March 25 update, the oil prices are expected to fall to an average of 49 USD per barrel in 2020.

IV.3 The Balance of Payments

In the 4th quarter of 2019, the balance of payments was in a surplus of 189 million USD or 1.4 percent of GDP[25], which is an improvement of 380 million USD from previous quarter but a deterioration of 145 million USD year-over-year. The current account deficit remained around previous year's level, at 835 million USD. While the service account deficit narrowed from that of previous year, trade account surplus decreased slightly, and income account deficit widened. The financial account was in a surplus of 1,052 million USD in the reporting period, an increase of 29 million USD year-over-year, due to increased FDI and increased inflows of banks' currency and deposits (Figure IV.3.1).

The current account deficit was 835 million USD (6.4% of GDP) in the 4th quarter of 2019, an increase of 2 percent year-over-year. While the service account deficit narrowed, a larger deficit in the income account and smaller surplus in the goods account have negatively affected the current account balance.

The good's balance was in a surplus of 29.5 million USD in the reporting quarter. Export revenue decreased by 3.2 percent year-over-year, mainly due to exports of copper concentrate, coal, fluorspar, cashmere, meat, and meat products (Table IV.3.2).

The copper export revenues declined as the gold content in Oyu Tolgoi's copper concentrate continued to decline, coal exports slowed in December 2019 due to custom's restrictions on the amount of coal imports of China, and exports of processed meat products declined due to additional requirements placed for export processed meat standards. On the contrary, exports of gold, iron ore, crude oil, refined mining products, and reexports of machinery and equipment increased.

Import growth slowed from the beginning of the year and remained unchanged in the 4th quarter at previous year's level. Imports of machinery, equipment, and capital goods used in mining activities increased, but imports of consumer goods declined, especially driven by a rapid fall in imports of automobiles. Attributed to the slowdown in coal exports, diesel consumption did not increase, while imports of A92

Table IV.3.1

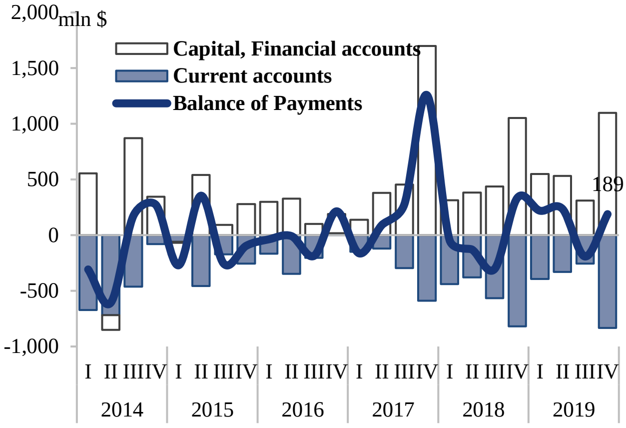
Changes in Key assumptions of BOP projection (2020)

Previous forecast of 2020	Current forecast of 2020
Exports	Revised down
Coal export is expected to reach 39 mln tonnes. Oyu Tolgoi's gold concentrate in the copper ore declines. Export price is expected to fall.	Oyu Tolgoi's gold concentrate in the copper ore declines. To prevent COVID-19 → coal, iron or exports are temporarily halted → coal and iron ore export forecasts↓, Chinese growth↓ → coal, copper concentrate, iron ore, crude oil price forecasts↓, Gold price ↑ → gold export revenue↑
Imports	Revised down
Oyu Tolgoi FDI ↓, Fiscal capital expenditure↑ → Import of capital goods remain unchanged. Coal exports ↑→ diesel imports ↑, Passenger cars' import continues to decline.	Oyu Tolgoi FDI↑, crude oil processing plant↑, fiscal capital expenditure↑ → Imports of capital goods↑. Economic activity↓, coal exports↓ → fuel imports ↓, passenger cars' imports↓, industrial inputs ↓.
Services	Revised down
Coal exports ↑ → coal transport ↑. The number of tourists ↑ → travel income ↑.	Coal, iron ore exports ↓ → income and expense of transport services↓. COVID-19 → International flights are canceled → Travel accounts income ↓, passenger transportation income↓, Oyu Tolgoi FDI↑ → business and financial services expenses ↑. Economic activity ↓ → business services expenses ↓.
FDI	Revised up
Oyu Tolgoi FDI has been revised down due to difficulties in continuing the development of underground mining projection.	Oyu Tolgoi's FDI for 2020 increased according t a renewed plan. The crude oil processing plant project will be financed by FDI.
Portfolio investment	Revised down
External bonds that are due in 2020 are assumed to be refinanced.	The portfolio investment, that was assumed to b refinanced, is now revised to be repaid.
Other investments	Revised down
The IMF EFF program financing has been revised down. Loan disbursements in the private sector and loan repayments in the public sector are expected to decline.	World bank's EFF financing that was expected i 2019 was delayed to 2020, increasing the EFF financing for 2020. In the private sector, loan disbursements are expected to decline and loan repayments are expected to increase. The net outflow of currency and deposit is expected to decline.

Source: Bank of Mongolia

Figure IV.3.1

Balance of payments was in surplus in the 4th quarter as increased financial account surplus covered the deficit in current accounts.



Source: Bank of Mongolia

gasoline, petroleum coke, wax, and other oil products increased (Table IV.3.2).

Services account deficit narrowed by 136 million USD (21% year-over-year) mainly driven by the decreased deficits in transportation, business, trade, and construction services. However, financial and travel service costs have increased (Figure IV.3.3).

Income account was in a deficit of 415 million USD in the 4th quarter of 2019, increased by 61.6 million USD or 17 percent year-over-year. This was mainly due to an increased outflow of FDI income by 90.4 million USD or 22 percent year-over-year. In particular, as a result of improved profitability of banks and enterprises, inflows of reinvestment earnings increased by 62.5 million USD from that of previous year, reaching 57.6 million USD. Moreover, interest payment of Oyu Tolgoi increased by about 20 percent year-over-year has contributed to larger income outflows through FDI income. The deficit in primary income accounts for 50 percent of current account deficits in the reporting quarter (Figure IV.3.4).

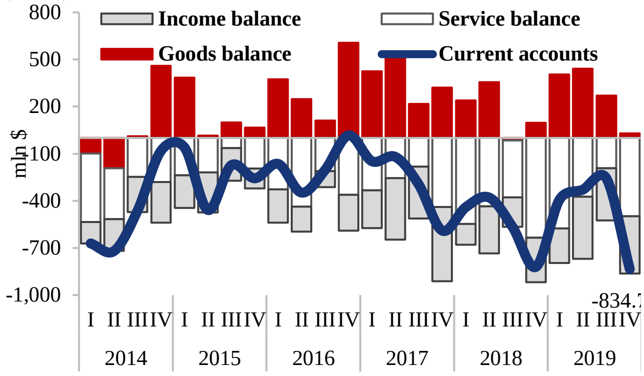
The financial account was in a surplus of 1,052 million USD in the 4th quarter of 2019, an increase of USD 29 million USD year-over-year. This was mainly driven by an increase in net inflows of other investments by 441 million USD from previous year. The net inflows of banks' currency and deposits increased, and the net inflows of trade loans increased by 40.8 million USD to 38.2 million USD with the settlement of foreign receivables by some enterprises.

External loans amounted to a net inflow of 83 million USD in the reporting quarter as opposed to a net outflow of 120.4 million USD in the last quarter of previous year. The increase in net inflows of external loans is mainly explained by a decrease in long-term loan repayments of banks by 18 percent or 34.4 million USD, decrease in short-term loan repayments by 64 percent or 28.6 million USD, and decrease in long-term loan repayments of enterprises by 76 percent or 418.3 million USD.

Net FDI inflows increased by 11 percent or 71.3 million USD year-over-year, reaching 731 million

Figure IV.3.2

Larger deficit in income account and narrower surplus in goods balance resulted in a wider current account deficit (YoY).



Source: Bank of Mongolia

Table IV.3.2

While export revenues of gold, iron ore, and crude oil increased, the export revenues of copper concentrate, coal, and meat declined.

	2018 IV	2019 IV	Y-o-Y	Contri-bution %
Total Exports	**1,729**	**1,674**	**-3.2%**	**-3.2%**
Gold	-	74	-	4.3%
Iron ore	102	154	52%	3.0%
Crude oil	76	95	25%	1.1%
Machinery, equipment, parts	12	32	153%	1.1%
Mining products	25	41	63%	0.9%
Cashmere	34	17	-49%	-1.0%
Meat, meat products	90	63	-30%	-1.6%
Fluorite, leucite, nepheline	74	50	-32%	-1.4%
Coal	664	640	-4%	-1.4%
Copper concentrates	525	375	-29%	-8.7%
Other	128	134	5%	0.3%

Imports of capital goods are increased, and imports of consumer goods are declined.

	2018 IV	2019 IV	Y-o-Y	Contri-bution %
Total imports	**1,525**	**1,529**	**0.2%**	**0.2%**
Capital goods	601	662	10.2%	4.0%
Consumer goods	461	400	-13.2%	-4.0%
Of which: Passenger cars	132	93	-29%	-2.6%
Fuels	298	308	3.4%	0.7%
Of which: Diesel	163	162	-1%	-0.1%
Other fuels	135	146	8%	0.7%
Industrial inputs	165	158	-4%	-0.5%
Other	1	1	-	0%

Source: Bank of Mongolia

[25] 4-quarter cumulative GDP.

USD. Despite a decline in equity investment of enterprises excluding Oyu Tolgoi by 143.6 million USD reaching 44.6 million USD, reinvestment income increased by 75.3 million USD reaching 68 million USD, and the increase in direct investment of Oyu Tolgoi JSC (including investor's loans and equity investments) by about 40 percent, contributing to the net FDI inflows.

A net outflow of 30.2 million USD in portfolio investments, a decrease of 479.4 million USD year-over-year, contributed to the reduction of the financial account surplus. In October 2018, the Development Bank issued a five-year bond of 500 million USD with an annual interest rate of 7.25 percent, which explains the main difference in the portfolio investments from previous year.

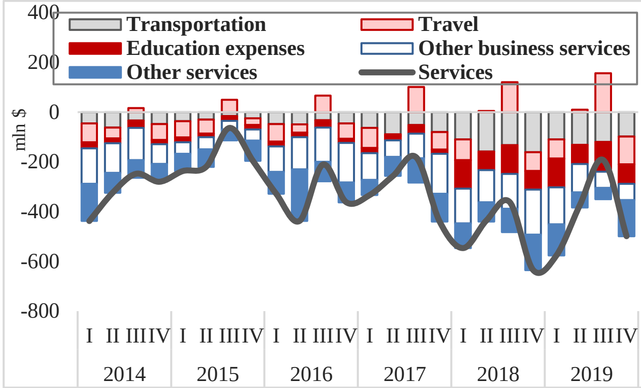
Gross international reserves (GIR): stand at 4348.6 million USD at the end of 2019 and 4378.9 million USD at the end of February 2020[26]. It is an adequate level to cover 11 months of imports, which is calculated as an average of the last three months' import payment made in hard currency (Figure IV.3.6).

Terms of Trade deteriorated by 14 percent quarter-over-quarter and 8 percent year-over-year in the 4th quarter of 2019. It was due to a 7 percent decline in export prices (YoY) and a 1 percent increase in import prices (YoY). Terms of Trade deteriorated by 13 percent from previous month and 1 percent year-over-year in February 2020.

The export custom's price of copper concentrate declined by 23 percent (as gold contents within the Oyu Tolgoi copper concentrate continued to diminish), the customs' prices of fluorite, leucite, and nepheline declined by 29 percent, and the custom's price of molybdenum declined by 9 percent, the export prices of mining, electrical goods, machinery, and equipment fell by significant percentages in the 4th quarter of 2019. Conversely, the custom's price of iron ore increased by 40 percent (supply shortage remains at the global market), the custom's price of coal exports increased by 7 percent with the decline in

Figure IV.3.3

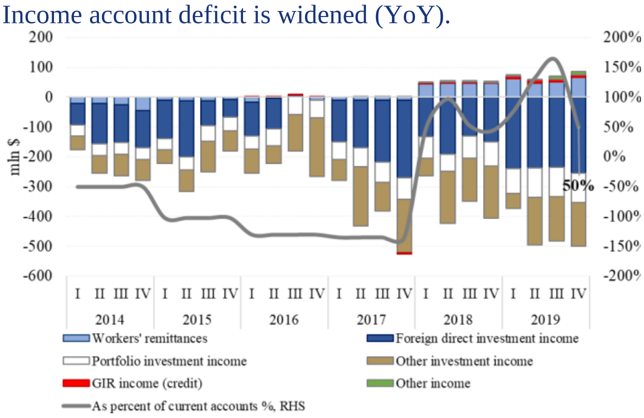
Services account deficit is narrowed (YoY) due to narrower deficit in transport, business, and constructions services.



Source: Bank of Mongolia

Figure IV.3.4

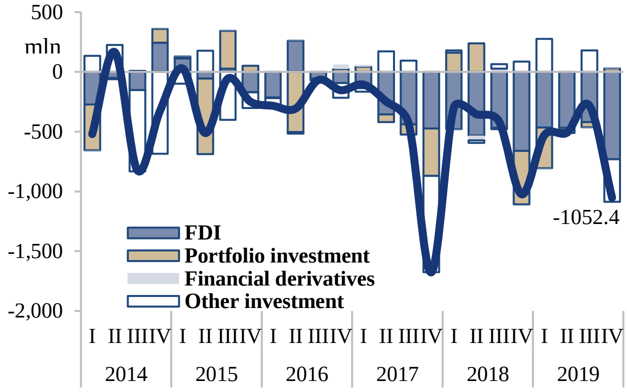
Income account deficit is widened (YoY).



Source: Bank of Mongolia

Figure IV.3.5

Financial account surplus decreased (YoY).



Source: Bank of Mongolia

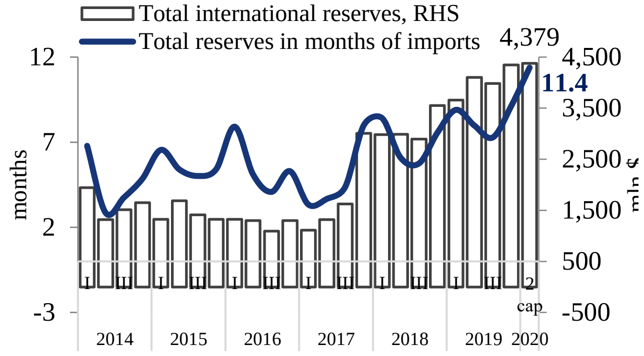
[26] A difference between the balance of payments and change in gross international reserves is explained by changes in monetarized gold.

Chinese coal production and reserves, and the custom's price of crude oil increased by 1 percent in the 4th quarter of 2019. Overall, the price of exports declined by 7 percent year-over-year. Import prices remained at previous year's level.

In February 2020, the custom's price of copper concentrate declined by 15 percent, the custom's price of coal declined by 16 percent, the price of fluorite, leucite, and nepheline decreased by 42 percent, the price of molybdenum decreased by 20 percent while the price of iron ore increased by 55 percent and the price of gold increased by 22 percent, resulting in 7 percent decline in overall export price. The price of imports fell by 6 percent year-over-year in February 2020 mainly driven by a decline in the price of imported investment products.

Figure IV.3.6

Gross international reserve reached 4.3 trillion USD.



Source: Bank of Mongolia

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