Mongolia Monthly Economic Brief

June 2015

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- Real GDP growth continued to slow - 4.4% in the first quarter.
- Balance of payments recorded a deficit of $320 million in the first four months.
- FDI recorded a net outflow of $71 million in the first four months.
- The long-awaited agreement on OT underground mine development was announced in May, improving market sentiment in recent weeks.
- Revenue shortfalls reached 18% in the first five months, requiring a supplementary budget to ensure the credibility of the fiscal plan.

Key Economic Developments

Mongolia's economic growth in Q1 2015, slowed to 4.4% (y/y), down from 8% in the previous quarter. Investment sharply contracted by 61.6% from the same quarter a year ago, amidst continued dampening of FDI inflows. Final consumption also remained sluggish, increasing by 2.7% (y/y) in the first quarter, after a contraction by 2.4% in the previous quarter. Substantial improvement in net exports due to robust exports and subdued imports underpinned economic growth.

Mineral GDP growth softened to 13.8% (y/y) in the first quarter from 20.5% in the previous quarter. Slowing production growth of copper concentrates, oil and gold moderated mining GDP growth. Mining industrial production in April and May increased by 13.6% (y/y), moderately picking up from 13% in the first quarter. Coal production declined by 4.5% in the first five months on a year-on-year basis. Copper concentrate production increased by 19.4% in the first five months from a year ago.

Non-mineral GDP growth dropped to 1.5% (y/y) in the first quarter, from 4.1% of the previous quarter. The wholesale and retail sector contracted by 7.6% on a year-on-year basis, likely reflecting substantial declines in imports. Manufacturing grew 11.1% from a year ago, largely due to a strong increase in textile products. Agricultural GDP growth softened to 9.2%. Construction GDP expanded by 31.8% in the first quarter on account of the completion of some large commercial buildings and apartments. In April and May, manufacturing industrial production declined by 5.3% and electricity production grew by only 0.2% on a year-on-year basis, indicating that non-mining sector production remained weak in the second quarter.

The composition of jobs indicates deteriorating quality of labor market conditions. The official unemployment rate in the first quarter was down from 9.4% in the same quarter the previous year, despite the slowing economy. Employment in jobs more associated with informal sector, however, absorbed more labor force than formal sector jobs, indicating deteriorating quality of employment. Self-employed businesses, unpaid family work, and animal husbandry accounted for 49.8% of total jobs in the first quarter, which rose from 46.3% in 2013.

Inflation continued to moderate. UB headline inflation was 7.5% (y/y) in May, down from 8.8% in the previous two months. National headline inflation moderated to 8% in May, from 9.2% the previous month. Core inflation (UB) continued to moderate to 10% (y/y) in May, down from 11% in April.

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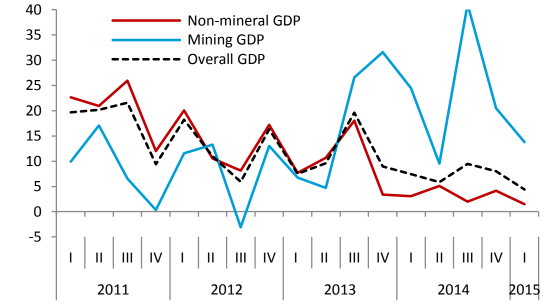
Figure 1. Growth slowed to 4.4% in Q1 due to slowing productions in both mining and non-mining sectors.

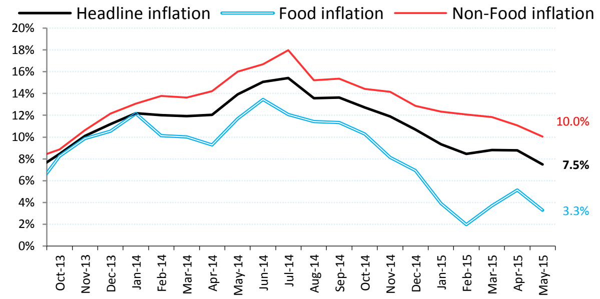
Real GDP growth trend (y/y, %)



Source: NSO, WB staff estimates

Figure 2. National CPI inflation moderated to 8% in May.

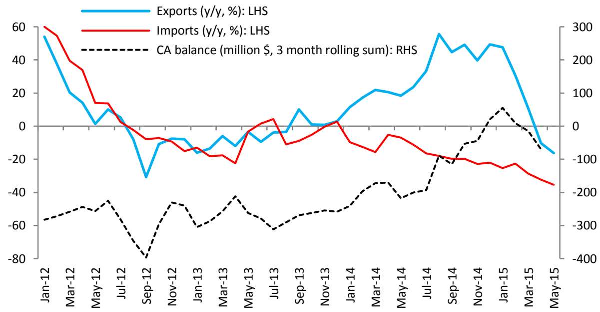
Food and non-food inflation (Ulaanbaatar, y/y, %)



The current account deficit slightly widened to $80.4 million in April amidst a narrowing trade surplus. After a surplus of $86.9 million in January, the current account recorded a deficit of $210.8 million in Feb-Apr. The trade balance recorded a $422.3 million surplus in the first five months but the monthly trade surplus continued to decline from $225 million in January to $4.3 million in May. Exports declined in May by 15.8% (y/y) due to weakening mineral exports. Coal exports declined by 46% (y/y) in May largely due to a 49% drop in export volume. However, copper concentrate exports increased by 17% (y/y) in May, rebounding from a 14% contraction in April. Oil exports also dropped by 27% (y/y) amidst lower prices. Total imports (CIF term) declined by 32% (y/y) in May reflecting sluggish domestic demand. Investment-related imports continued to sharply drop by 28% and consumption goods also fell by 33% in May from a year ago. Over the first five months, oil product imports dropped by 39% and non-oil imports dropped by 30% on a year-on-year basis.

Figure 3. Current account balance continued to deteriorate in April amidst slowing exports.

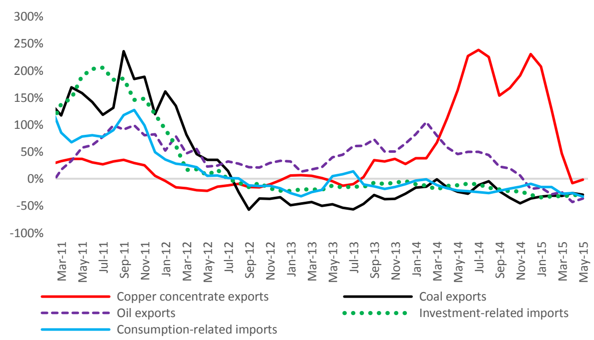
Growth of exports and imports (3 month moving average) and current account balance (3 month rolling sum)



Source: BoM, WB staff estimates

Figure 4. Mineral export growth slowed and weakening domestic demand continued to dampen imports in May.

Y/Y growth of key export/import goods (3 month rolling sum, %)



The capital and financial account displayed a net outflow of $125.7 million over the first four months. FDI recorded a net outflow of $71 million, a significant deterioration compared to the net inflow of $332 million a year before, largely due to repayment of inter-company borrowings. FDI, however, turned into a slight net inflow of $38 million in April. A net financial inflow of $455 million was recorded in the currency and deposit account in the first four months reflecting the drawdown of the bilateral currency swap line with China.

The balance of payments deficit reached $320 million over the first four months, reflecting a $49 million deficit in April. Trade surplus and reserve buffers from the bilateral currency swap line with China helped eased the BoP pressures from continued declines in FDI inflow.

Gross international reserves declined in April reflecting the BoP deficit, but rebounded in May due to a new external borrowing. Gross reserves dropped to $1,267 million in April, down by 382 million over the first four months from $1,649 million at the end of 2014. Gross reserves, however, rose to $1,590 million in May, reflecting a new external borrowing by the Trade and Development Bank (TDB). The TDB issued 5-year international bonds of $500 million under government guarantee with a 9.375% rate in May. The bond proceeds were absorbed by the central bank international reserves through a long-term swap arrangement.

Exchange rate depreciation slowed since mid-April. After a 3.8% depreciation in the first four months amidst continued BoP deficit, the exchange rate appreciated over 6 percent against the USD in two months, from MNT 1989 at end-March to MNT 1862 on June 13. The currency appreciation reflected growing expectations on the agreement on the long-delayed OT's underground investment. The exchange rate has been back on a depreciating trend since June 16.

An agreement on the development of OT underground mine was announced on May 18. The agreement included outstanding shareholder issues including tax, royalties and management services payments. Once the project begins, after the approval of the feasibility study and project financing of around $4 billion in the coming months, the second phase development of OT mine is expected to ramp up FDI inflows in the coming years.

Figure 5. BoP remained in deficit in Jan-Apr amidst weak FDI despite liquidity buffers from the PBoC swap line.

Net capital flows and BoP balance (in millions of US$, 3 month moving average)

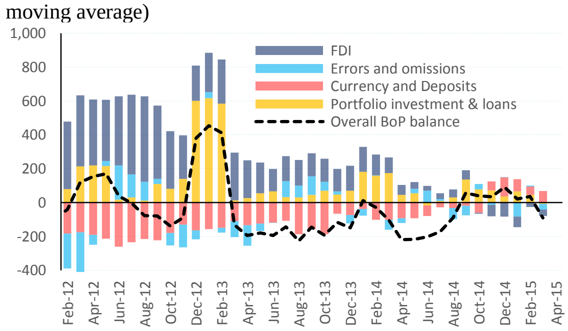
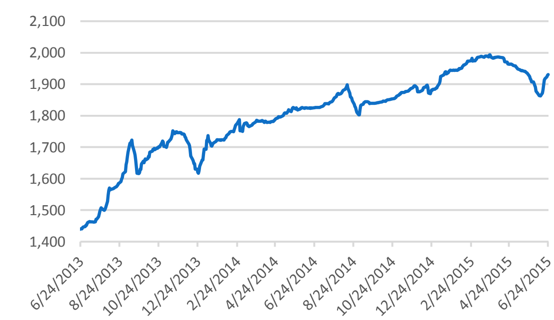


Figure 6. The exchange rate has been depreciating since mid-June after two months' appreciation.

Daily nominal exchange rate (MNT/USD)



Source: BoM, WB staff estimates

Non-performing loans (NPLs) continued to grow in April-May with the NPL ratio climbing to over 4% of total loans. Outstanding NPLs (excluding the failed banks in 2008-9) reached 4.2% of total loans in May, up from 3.9% in March and 3.1% at the end of 2014. Past-due loans reached 5% of outstanding loans in May, up from 4.9% in April and 2.2% at the end of 2014.

Bank liquidity remained tight in May amidst subdued foreign currency loans, phasing-out of the Price Stabilization Program, and declining bank deposits. Bank credit growth (including securitized mortgaged loans) decelerated to 8.4% (y/y) in May from 12.4% in April and 20% at the end of 2014. Foreign currency loans continued to decline in May on a year-on-year basis amidst import declines and higher risk weights imposed on unhedged borrowers. MNT loans including securitized mortgage loans displayed a 16% y/y growth in May, down from 20.6% the previous month, reflecting the gradual withdrawal of PSP loans and the slowing economy. Bank deposit growth remained weak. Bank deposits declined 3.3% in May from a year ago. Broad money growth further slowed to a negative 3.8% growth (y/y) in May amidst slowing domestic credit growth and continued declines in net foreign assets.

BoM continued to phase out the PSP loans but the mortgage program continued to grow. BoM's outstanding PSP credit continued to decline to MNT 0.7 billion in May. Outstanding discounted mortgage loans reached MNT 2.3 trillion in May, growing 13.7% over the last five months. MNT 1.23 trillion of the mortgages were securitized into RMBSs through Mongolia Mortgage Corporation (MIK) as of May and the BoM purchased about 90% of RMBSs. BoM claims on banks declined to MNT 1.9 trillion in May from MNT 2.6 trillion at the end of 2014 reflecting the unwinding of PSP loans and BoM's RMBS purchases from MIK. Claims on non-bank sectors (including MIK) increased to MNT 2.1 trillion in May from MNT 1.7 trillion at the end of 2014 reflecting the purchases of RMBSs.

Figure 7. NPLs reached 4.2% of total loans in May.

Size and ratio of NPLs and past-due loans (billions of MNT, %)

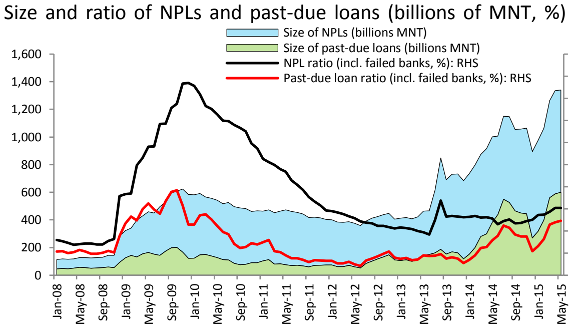
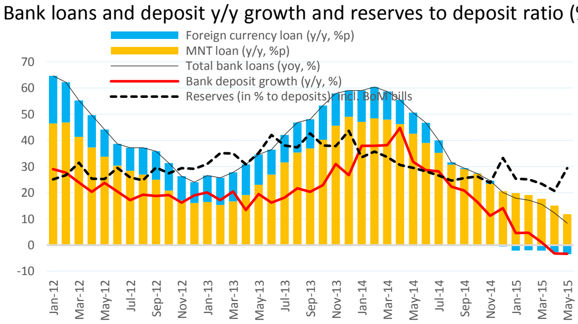


Figure 8. Bank loan growth continued to decelerate and deposit growth remained weak.

Bank loans and deposit y/y growth and reserves to deposit ratio (%)



Source: BoM, WB staff estimates

Widening revenue shortages continue to undermine the credibility of the fiscal plan, requiring a supplementary budget. Budget revenue shortfalls reached 18% of the budget in the first five months. Tax revenue shortfalls amounted to 11% of the budget mainly due to weak trade-related taxes. Under tight payment controls by the budget authorities, budget execution in the five months remained only at 70% of the spending plan. While the budget execution rates of wages and welfare transfers were above 90% of the plan, execution of discretionary spending stayed weak particularly in capital expenditures (30% of the budget plan). The MTFF approved on May 18 projected revenue shortfalls to reach MNT 498 billion (7% of budget) in 2015. High domestic sovereign borrowing costs persisted amidst tight banking sector liquidity, with government bond yields remaining around 15%. A supplementary budget would enable the authorities to properly prioritize spending that are consistent with realistic revenue estimates and the FSL.

Figure 9. Budget revenue shortfall widened in May and budget spending remains tight.

Y/Y growth of revenue and spending (year-to-date rolling sum, %)

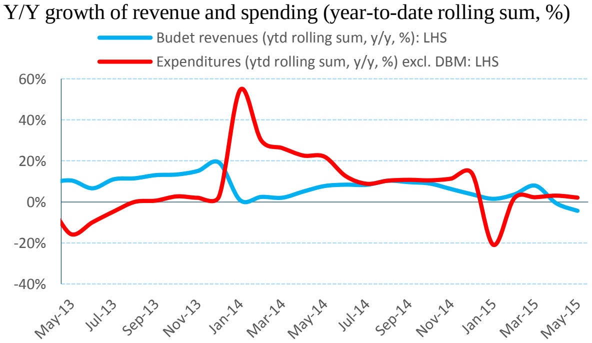
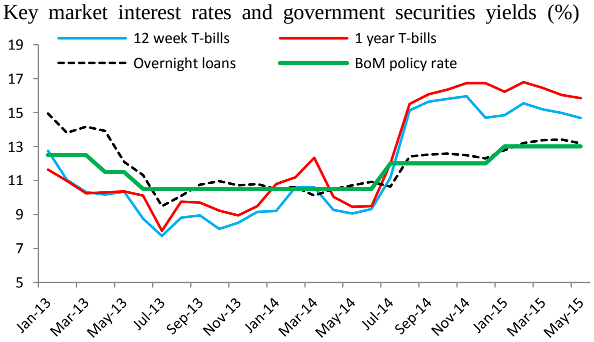


Figure 10. Domestic sovereign borrowing costs remained substantially elevated since late 2014.

Key market interest rates and government securities yields (%)



Source: MoF, BoM, WB staff estimates

Monthly Focus

Medium Term Fiscal Framework set a fiscal adjustment path for 2016-18

The MTFF for 2016-18 was approved by the parliament on May 21. The MTFF revised downward the revenue projections for 2015-18 and set a path of aggregate expenditure ceilings to meet the requirements of the FSL.

Further spending cuts are called for in 2015 in light of large revenue shortfalls. The MTFF projects annual budget revenue shortages in 2015 to reach MNT 498 billion due to declining imports, weaker copper and oil prices and sluggish growth, and calls for budget spending cuts by the same amount to comply with the FSL.

The fiscal plan underscores the importance of realistic revenue projections. The plan notes that overstated revenue projections have undermined the credibility of the budget in the past years. The MTFF projects the economy to grow at 5% on average in 2016-18 due to weak external environment, and revises downward revenue projections from the previous MTFF by 7.4% for 2015, 3.4% for 2016, and 4.3% for 2017.

The MTFF calls for spending adjustment to contain the budget deficit within 4% of GDP in 2016 and further reduce it within 3% in 2017 and 2% in 2018 according to the FSL. The plan notes that the budget deficit could reach over 19% of GDP in 2016, should all spending proposals be included in the budget. The MTFF proposes to contain budget spending growth at 5% in 2016 and less than 2% in 2017-18 by consolidating spending proposals. The following measures are proposed to contain the deficit within 4% of GDP in 2016 required by the FSL:

- Reduce discretionary recurrent spending and contain interest payment by reducing T-bill issuance to finance the budget deficit.
- Allow only on-going public investment projects and contain DBM-financed budgetary investment projects. Reduce foreign loan disbursements by prioritizing new foreign loan projects.

Proper implementation of the MTFF would strengthen the credibility the fiscal adjustment plan. A further adjustment of the 2015 budget is needed to reflect the realistic revenue projection of the MTFF. Proper reflection of the plan into the 2016 budget is also critical for credible implementation of the fiscal adjustment plan envisioned by the FSL. In this regard, an ad-hoc increase of the revenue forecast during the parliament review – which was one of the factors behind the overstated revenues of the 2015 budget – needs to be avoided.

Specifying medium-term spending priorities and reform measures would further improve the credibility of the MTFF. While proposing more realistic revenue projections than in the previous years, the current MTFF is still focused on the next year's budget and is yet to include medium-term fiscal strategies including revenue mobilization and expenditure prioritization policies in the next three years.

Figure 11. The new MTFF lowers revenue projections based on more realistic assumptions…

Revenue Projection (trillion MNT): 2015 MTFF (2016-18) vs. 2014 MTFF (2015-17)

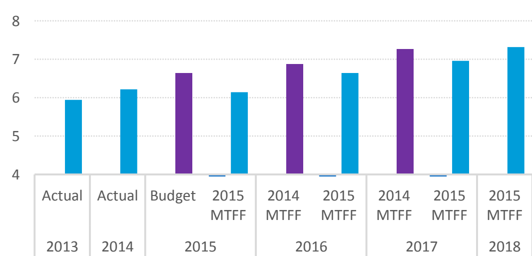
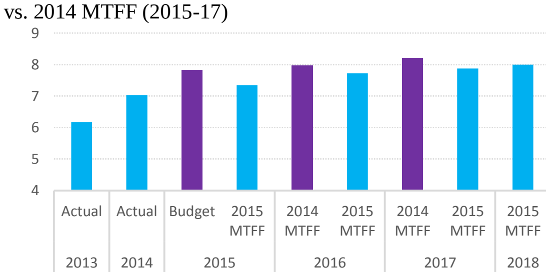


Figure 12. … and set lower budget expenditure ceilings needed to meet the FSL deficit ceilings.

Budget expenditure ceilings (trillion MNT): 2015 MTFF (2016-18) vs. 2014 MTFF (2015-17)



Source: MoF, 2015 Budget, 2014 MTFF (2015-17), 2015 MTFF (2016-18)