Euler Hermes Economic Research

Country Report

Mongolia

Fast growing but risky

General Information

GDP	USD10.271bn (World ranking 130, World Bank 2012)
Population	2.8 million (World ranking 139, World Bank 2012)
Form of state	Parliamentary government
Head of government	Norov ALTANKHUYAG
Next elections	2017, legislative

Strengths

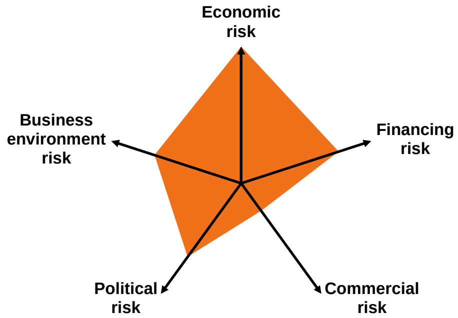
- Large natural resources (copper and coal)
- Strong economic growth
- Proximity with China
- Large FDI inflows

Weaknesses

- High external vulnerability
- Poor macroeconomic policy management
- Weak banking sector

Country Rating

D3



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
China	89%	1	37%	China
Canada	4%	2	26%	Russian Federation
Russian Federation	1%	3	9%	United States
Korea, Republic of	1%	4	6%	Korea, Republic of
Italy	1%	5	5%	Japan

By product (% of total)

Exports		Rank		Imports
Metalliferous ores and metal scrap	64%	1	21%	Petroleum and related materials
Gold, non-monetary	9%	2	10%	Road vehicles
Coal, coke and briquettes	9%	3	7%	Miscellaneous manufactured articles, n.e.s.
Textiles fibres and their wastes	8%	4	7%	Specialised machinery
Petroleum and related materials	3%	5	5%	Cereals and cereal preparations

Source: Chelem (2012)

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Strong growth is expected in 2014 (+9.5%) and 2015 (+8%) but below trend

Recently Mongolia has enjoyed very strong growth (+12% growth over the 4 past years), benefitting from large mineral resources (copper and coal). Such endowments have been a key driver for growth, boosted by rising commodity prices, high demand from China, and huge capital inflows to the mineral sector. Indeed, this translated into a high investment to GDP ratio (55%) and the implementation of a significant mining project (Oyu Tolgoi mine). Accordingly, domestic demand expanded strongly, with the mining and construction sectors showing very sharp growth. Late 2013, these trends seem to have moderated and growth forecasts were revised slightly downward in line with weaker commodity prices and a more moderate outlook for China. However, 2013 GDP growth was robust (close to 11%) supported by large monetary and fiscal stimulus.

GDP growth should remain strong in 2014 (9.5%) and 2015 (+8%) thanks to the development of the mineral sector and rising infrastructure spending. It will however be below recent levels. On the domestic side the policy mix is likely to be less supportive as the first phase of the Oyu Tolgoi project comes to an end and lowers the construction sector's growth rate. On the external front, exports performance decreased on the back of weak exports commodities prices (especially copper and coal) and the deceleration of the Chinese demand. Going forward, exports are projected to recover gradually but the pace will be constrained by less buoyant demand from China. This is likely to be a medium term change as the Chinese government's strategy focus on strengthening resource independency.

Monetary policy: on test

The credibility of the monetary policy framework is increasing but its effectiveness needs to be demonstrated. The authorities announced their intention to introduce an inflation targeting framework in the medium term. In the meantime, achieving low inflation (below 10%) and comfortable FX reserves are the goals announced by the monetary institutions.

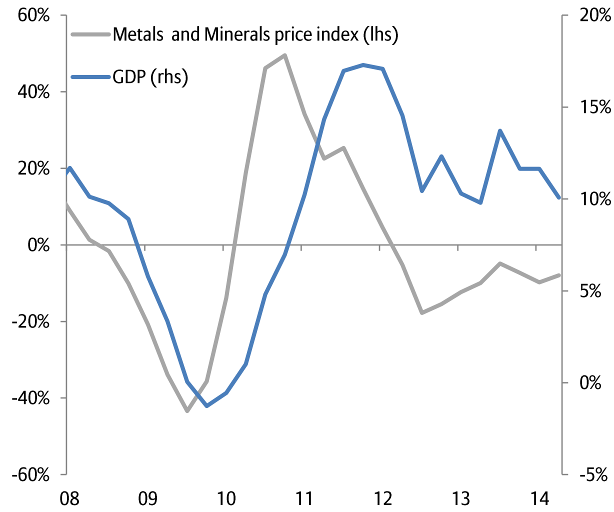
The latest policy actions were encouraging, especially the increase in exchange rate flexibility. Monetary policy responsiveness has also risen. Rising inflationary pressures saw the Central Bank of Mongolia conduct a tightening cycle (+225 bp) between April 2011 and December 2012. In early 2013 (January 2013) as inflationary pressures were fading, growth was weakening and FDI outflows were accelerating, the Central Bank eased its monetary stance. This saw a cut in the policy rate (-275 bp between December 2012 and June 2013) with a liquidity injection, both to banks and support selected sectors. Shortly thereafter, these policy decisions drove rising inflationary pressures, renewed risks for the financial sector (due to strong credit growth), and pressures on the exchange rates. This led the authorities to re-adopt a hawkish and more cautious stance with policy rates increased by +150bp between June and September 2014. In the short term, this stance is likely to be maintained as inflation is still high. Banking risk also is elevated due to strong, concentrated credit growth and relatively poor financial management (lack of regulation and supervision).

Key economic forecasts

	2012	2013	2014f	2015f
GDP growth (% change)	11,7	12.4	9.5	8.0
Inflation (%, average)	15.0	9.2	11.0	8.2
Fiscal balance (% of GDP)	-10.8	-11.1	-8.0	-5.0
Public debt (% of GDP)	63.0	67.0	66.0	61.0
Current account (% of GDP)	-32.6	-27.7	-22.9	-18.0
Public External debt (% of GDP)	48.3	52.0	51.0	45.0

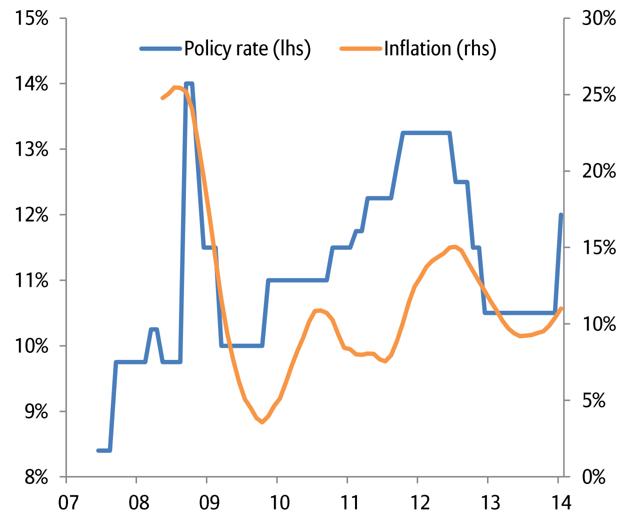
Sources: IMF, IHS, Euler Hermes

GDP growth (%)



Sources: National sources, IHS, Euler Hermes

Monetary policy and inflation



Sources: National sources, IHS, Euler Hermes

Public finances: a dangerous trend

Public finances have deteriorated since 2012 when the government unveiled a large stimulus program to support growth. Spending was largely focused on infrastructure but also increased public sector wages. It has been exacerbated by weaker revenues than anticipated. Accordingly, the public deficit widened from -4.8% in 2011 to -10.8% in 2012, we look for a slight reversal to -10.1% in 2013. Public debt is estimated to jump to 67.3% in 2013 from 38.8% in 2011.

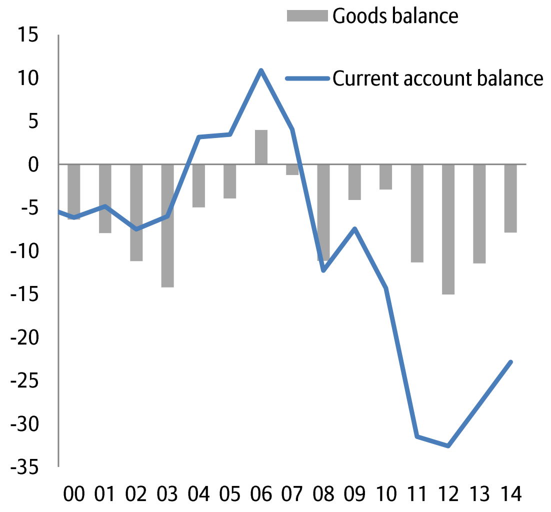
The government has committed itself to moderate public expenditures and improve medium term solvability. To achieve this target a fiscal stability law was implemented to recommend keeping the structural public deficit at below -2% of GDP; the 2014 budget takes into account more conservative projections for revenues and gradual reduction in expenditures are expected. In the short term, the public deficit is expected to decreased but remain elevated in 2014 (at about -8% of GDP) due to still high expenditures amid slowing exports revenues.

External accounts are expected to strenghen

High external debt (public external debt close to 50% GDP, this is close to the debt ceiling of 70%), much lower foreign reserves, large current account deficit (-27% of GDP) are the main Achilles Heel of the Mongolian economy. Combined with huge public deficit, these vulnerabilities make the economy highly sensitive to investor sentiment. These imbalances are projected to lessen gradually. The pace of the adjustment is likely to be slow owing to the fact that exports revenues are limited by less robust demand from China and the overhaul of the macroeconomic policy management.

Finally, even if the country is more resilient, a risk of balance of payment crisis cannot be overruled. If the authorities were to continue expansionary policies to support growth amid slowing exports revenues, risks of a Balance of Payment crisis could become serious. Exchange rate should depreciate sharply, raise inflationary pressures and GDP growth could fall by -2% in in 2015.

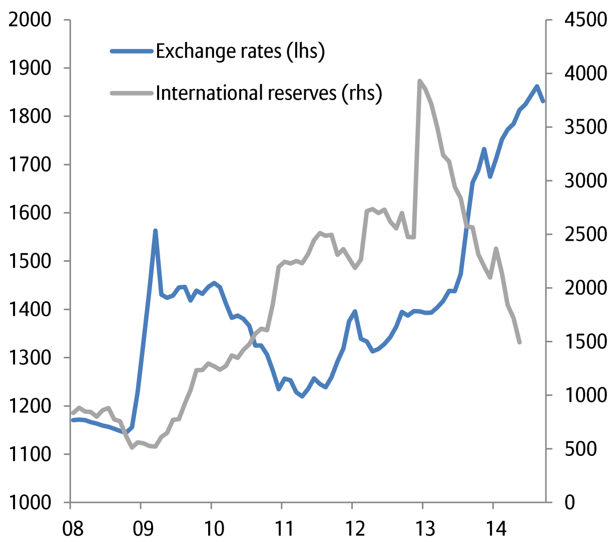
Current account and goods balance (% of GDP)



Sources: National sources, IHS, Euler Hermes

Foreign exchange reserves

(millions USD) and exchange rates



Sources: National sources, IHS, Euler Hermes

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