# Mongolia Economic Brief

April 2016

THE WORLD BANK
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- The budget deficit is widening fast, with a large revenue shortfall.
- Early budget spending control measures are needed to contain rising expenditures, as weak commodity prices would continue to constrain revenues.
- Government was able to raise $750 million via syndicated loans and a sovereign bond issuance.
- Despite the recent external financing, the underlying pressure on the balance of payments is expected to remain high in 2017.
- Mineral exports have been hit hard by weaker terms of trade. Imports continued to fall, but at a slower pace in the first quarter.
- BoM's housing mortgage assets were transferred to the government in March.

**The budget deficit sharply widened in the first three months of 2016.** The deficit reached MNT 618 billion in Jan-Mar, a fourfold increase from MNT 145 billion in the same period last year. The budget deficit over the first three months reached 2.6% of annual GDP, two-thirds of the annual deficit target (MNT 940 billion or 4% of GDP).

**Revenue collections fell by 11% (year-on-year [y/y]), following a 3% annual decline in 2015.** Mining revenues were severely hit by the weak commodity market, with royalties plummeting by 73% from a year ago. Personal income tax revenues remained close to last year's level, but corporate income tax (CIT) collections more than halved, likely due to falling CIT collections from mining companies. Most of the consumption and import-related taxes exhibited sluggish growth, reflecting subdued economic activity.

**Budget expenditures increased by 24.4% y/y in the same period.** Recurrent expenditures rose by 15% from last year's first quarter, with strong increases in interest payments on government debt, purchases of goods, and social welfare transfer spending including the Child Money Program transfers. Capital expenditures almost doubled in the first three months compared with the same period last year.

**Spending control measures are likely to be needed to contain the deficit within target.** The expected OT-2 investment is expected to gradually support import-related taxes in the second half. Nevertheless, overall revenue collections are likely to remain far weaker than the annual budget plan unless the commodity market significantly improves in the near future. Spending increases at the current rate would make it difficult to contain the deficit within the 4% of GDP ceiling of the Fiscal Stability Law without abrupt spending cuts in the latter half of the year.

**Significant external financing has been mobilized.** The government announced that a $250 million five-year syndicated loan was mobilized at Libor + 625 basis points, the proceeds of which were received in March. In addition, the government issued a $500 million five-year sovereign international bond at a

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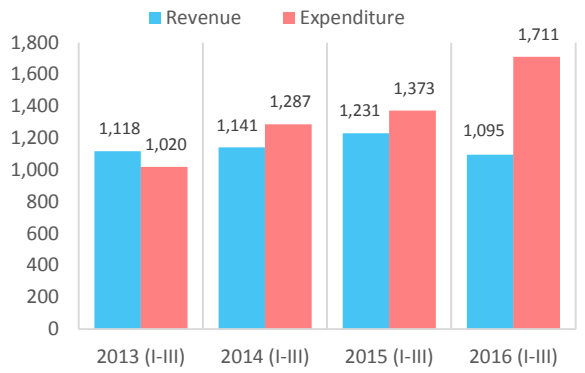
coupon rate of 10.875 percent in April. The effect of the new external borrowings on projected gross government debt in 2016-17 could be ameliorated, if used to substitute domestic bond issuances or saved for future debt repayments. Increasing reliance on external debt, however, demands high vigilance on the rising exposure of the debt portfolio to exchange rate risks.

Figure 1. Budget deficit sharply widened in Jan-Mar as expenditures rose by 24% and revenues dropped 11 percent.

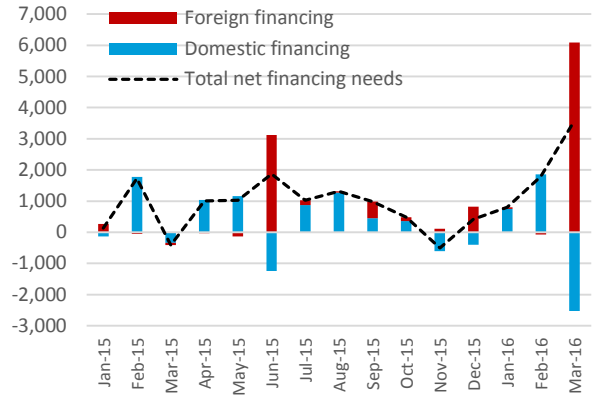
Budget revenues and expenditures (billion MNT): Jan-Mar




Source: MoF

Figure 2. Large external borrowing was mobilized to finance the growing budget deficit.

Monthly composition of deficit financing sources (billion MNT)




**The balance of payments deficit reached $125 million in Jan-Feb.** Despite an $85 million current account surplus and a $152 million drawdown on the currency swap facility with the PBoC, the balance of payments remained under strain from substantial net financial outflows via currency and deposit accounts ($216 million) of the private sector and corporate loan repayments ($126 million). Foreign direct investment (FDI) remained weak, at $11 million net inflow in Jan-Feb. Gross international reserves declined to $1,197 million in Feb, from $1,323 million at end-2015.

**New government external borrowings are expected to ease the pressures on the balance of payments (BoP).** A moderate BoP surplus is expected in Mar due to the inflow of the $250 million syndicated loan. Gross international reserves moderately rose to $1,265 million in March, reflecting the inflow of the syndicated loan proceeds. A $500 million portfolio investment inflow from the recent sovereign bond issuance will further support the BoP in Apr. The proceeds of the new external debt-financing could provide substantial liquidity buffers for the remainder of the year, mitigating the underlying BoP pressures from a projected deterioration in the current account balance and continued private sector financial outflows.

**The pressure on the balance of payments is expected to remain high for 2017.** Falling mineral exports and increasing imports are expected to widen the current account deficit in 2017, elevating the pressures on balance of payments, despite an expected recovery in FDI. Further straining the external accounts are the concentrated debt repayments scheduled in Mar 2017 ($580 million) and Jan 2018 ($500 million). Repayment of these debts would substantially erode foreign exchange buffers unless substantial amount of the maturing debt is rolled-over or refinanced.

**The nominal exchange rate appreciated fast against the USD in April, following a moderate depreciation by 2.7% in the first three months of 2016.** After the limited movement in the last

four months of 2015, the central bank allowed gradual depreciation of the exchange rate against the USD in Jan-Mar on the back of low inflation, while curbing the pace of depreciation through intervention. Due to limited exchange rate flexibility compared with main trade partners, the real effective exchange rate is still stronger compared with one year ago. In the first three weeks of April, the togrog appreciated by 3.3%, along with a recent weakening of the USD against most other currencies.

Figure 3. The BoP recorded a $125 million deficit in Jan-Feb.

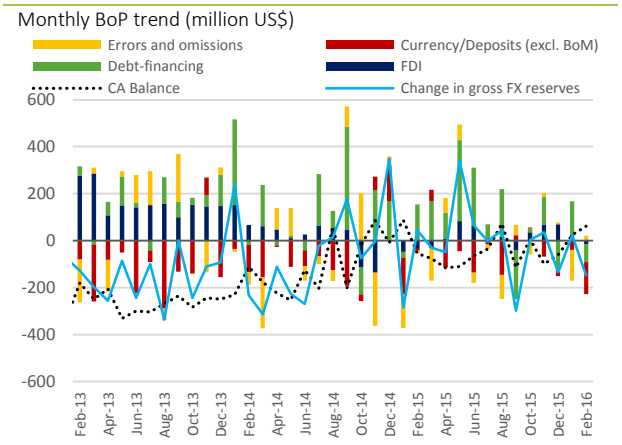
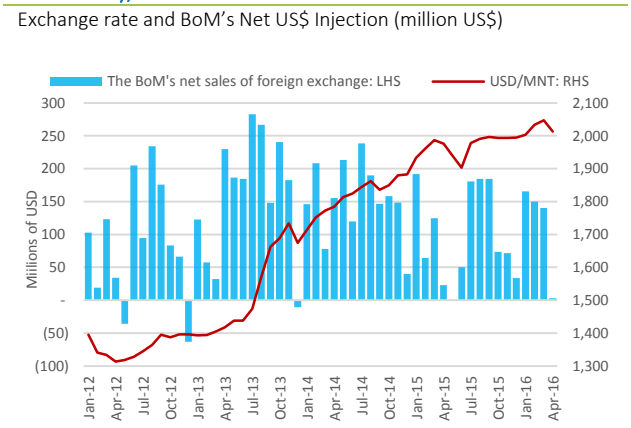



Figure 4. The exchange rate depreciated in Jan-Mar only moderately, with increased BoM intervention.




Source: BoM

**Mining production remained strong in the first quarter, but weaker terms of trade in key export commodities dampened export earnings.** Mining industrial production increased by 36.7% y/y in the first quarter despite the weak commodity market conditions, driven by double digit growth in copper production (48%) and crude oil (19%). The sales value of commodity exports, meanwhile, declined by 13.5% due to a fall in key commodity prices, reducing total export earnings by 11% in the first quarter. Despite strong y/y increases in export volumes of copper (33%) and crude oil (16%), sharp drops in the prices of copper (-29.5%) and crude oil (-31%) reduced export values of copper by 6% and crude oil by 20%. Coal export earnings also dropped by 29.8% in Jan-Mar, with a stagnant export volume growth (0.8%) and the falling sales price (-30.4%). Gold exports, meanwhile, increased by 13.6% y/y.

**Non-mining economic activities remained subdued in the first quarter.** Manufacturing industrial production fell by 14.8% y/y in Jan-March after a 19.8% contraction in the previous three months. Electricity supply including domestic production and imports rose by 3%, indicating slow economic activities. In agriculture, the natural losses of adult livestock in the first quarter reached 1.5% (830 thousand animals) of total livestock at end-215 (55,979 thousand animals), a significant increase from a 0.1% natural loss ratio in the same period last year. Gross nominal value of construction, meanwhile, increased by 29.8% y/y over the same period, a significant rebound from 3.6% growth in the previous quarter, with strong residential construction off-setting a contraction in public construction.

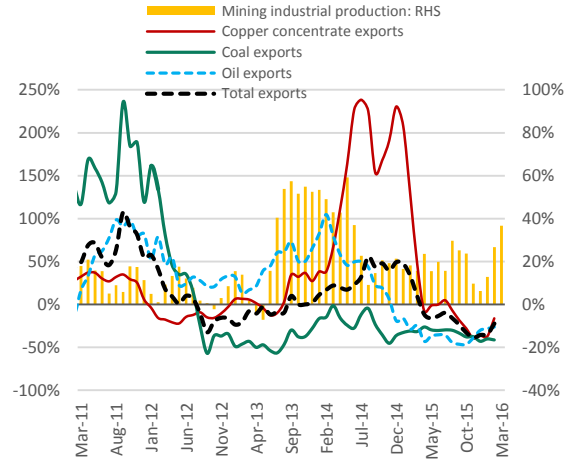
**Imports fell by 15.3% Jan-Mar reflecting weak domestic demand, a slower pace than last year.** Consumption goods imports fell by 8.8% y/y in Jan-Mar, a slower contraction than a 24.5% drop in the previous three months. Contraction in imports of capital goods also softened to 11.7% in the same period, from a 16% drop of the previous quarter. Oil product imports,

meanwhile, continued to drop sharply by 44% reflecting weaker oil prices.

**The nation-wide headline inflation and the UB-city inflation remained low at 1.7% and 1.1% y/y respectively in Mar.** A 5.5% drop in energy and fuel prices and a 9.6% drop in meat price significantly contributed to lower inflation. Core inflation in the capital city also remained stable at 3.1%.

Figure 5. Mining production remained strong, but weak commodity prices reduced export earnings by 13.5% in Q1.

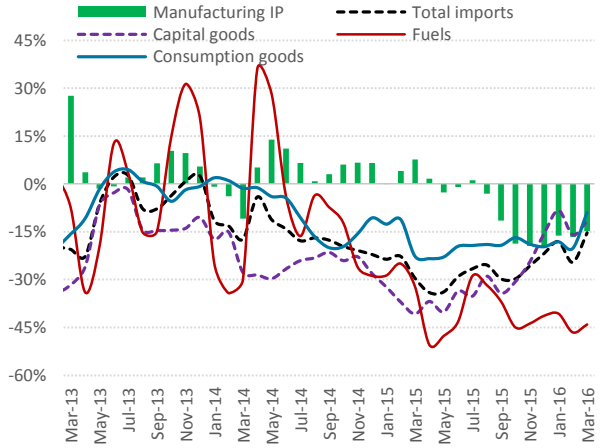
Growth in mining production and exports of key commodities (y/y, %, 3 month rolling sum)




*Source:* NSO, BoM

Figure 6. Imports dropped 15.3% in Q1 amid weak domestic demand, but import contraction is gradually softening.

Growth in manufacturing industrial production and imports (y/y, %, 3 month rolling sum)




**The BoM injected substantial liquidity to banks in Feb.** Following the policy rate cut by 100 basis points in Jan, the outstanding claims of the BoM on banks increased from MNT 1,235 billion in Jan to MNT 1,705 billion in Feb, despite a continued withdrawal of the Price Stabilization Program loans.

**A subsidized herder loan program was launched by the government in March.** The program intends to support herders and farmers, by providing cheaper financing via the state-owned State Bank at a 10 percent interest rate, much lower than the market rate of around 30% available to herders. The State Bank issued MNT 30 billion to 8,083 herders under the new policy lending program over one month since Mar 15. Given the limited funding capacity of the State Bank, the central bank will likely be the key financiers for the program, together with the Development Bank of Mongolia.

**Credit conditions remain tight, with signs of gradual improvement in recent months.** Outstanding bank loans continued to decline by 2.9% y/y in Mar, but at a slowing pace from a 7.5% drop in Dec 2015. Adjusted bank loan growth, which includes the off-balance-sheet securitized mortgages, picked up to 4.2% from 1.7% y/y over the same period. Non-performing loans (NPLs) increased by 17% in the first three months, compared with end-2015, reaching MNT 968 billion in Mar. The NPL ratio rose from 7.1% to 8.2% over the same period.

## Box: Transfer of the BoM's Mortgage Assets to the Government

**In March, the BoM transferred assets related to the subsidized Housing Mortgage Program to the Government.** Approximately MNT 2.5 trillion of mortgage assets was transferred from the BoM to the new Future Pension Reserve Fund (FPRF) of the government established in Feb. The transferred assets included the outstanding Residential Mortgage Backed Securities (RMBSs) and BoM loans to banks that were extended under the subsidized mortgage program over the last three years. The transfer of these assets from the BoM to the government, however, was not compensated by the government, resulting in a substantial loss in the BoM's balance sheet.

**The mortgage program now belongs to the government budget, but will be implemented by the BoM.** The cash flows generated from the FPRF's mortgage assets are to finance new subsidized mortgages originated by banks, and ultimately support future pension payment from 2030. The BoM will manage the FPRF, as an agent of the government, setting the size and terms of subsidized mortgages. BoM would also likely continue to fund the mortgage program by providing loans to the government, using the mortgage assets of the FPRF as a collateral.

**The interest rate of subsidized mortgages was further lowered from 8% to 5% in March.** The cheaper mortgage loans are available for apartment purchases in specific areas, including: (i) new settlement areas decided by the Ulaanbaatar Municipality; (ii) Ger districts for re-development plans; (iii) three sub-urban districts in UB; and (iv) the rural areas of 21 aimags. The maturity of the subsidized mortgages was also extended from 20 years to 30 years to ease the repayment burden of borrowers.

**The intention to transfer the mortgage program to the Government is welcome, but we would like to reiterate the following points for further consideration by the authorities:**

- Mixing the pension and mortgage functions is complicated and nontransparent. The name of the new fund is misleading as the FPRF is mainly to serve as a new financing vehicle for subsidized mortgages, while supporting future pension payments remains only as its long-term objective. Furthermore, strengthening financial sustainability of the pension system requires budget resources beyond the cash flows generated from the mortgage program.
- New policy loans issued by the FPRF to commercial banks should be properly recorded as budget spending and compete with other spending priorities, with legislative oversight.
- Further BoM financing to the Housing Mortgage Program needs to be terminated. New BoM financing to the mortgage program, if any, should be recorded as government's borrowing, and controlled under the FSL's debt limit.
- Targeting of mortgage eligibility is needed to reduce the fiscal burden while effectively supporting affordable housing for low and middle-income families.
- Proper compensation is needed by the government for the transferred mortgage assets to cover the capital loss in the BoM's balance sheet. The government could issue treasury securities at market rates to the BOM in exchange for the assets. A large loss in the BOM's balance sheet would result in potential recapitalization costs for the government, possibly compromising the BOM's independence and ability to conduct monetary policy.