In the last three months of 2015, exports sharply declined amid a deepening minerals market downturn. Exports dropped 36% (y/y) in the last three months, a weakening from a 12% drop in the previous nine months. Coal exports fell 43% (y/y) in the same period, suffering from weaker export price and volume due to subdued demand from China. Copper concentrate exports also fell 37% (y/y), amid a 43% drop in export prices, despite the higher export volume by OT. Annual total exports declined to $4,669 million in 2015, a 19.1% fall from $5,774 million in 2014.

Falling oil prices and subdued domestic demand, however, kept the trade balance in a $188 million surplus in the fourth quarter. Total imports (C.I.F. terms) fell by 21% (y/y) in the fourth quarter. Annual imports declined to $3,797 million in 2015, a 27.5% decline from $5,236 million in the previous year. A collapse in global oil prices translated into a 43.5% drop in oil product imports in the fourth quarter. Machinery and equipment imports, however, rebounded by 18.7% and 6.8% (y/y) in Nov and Dec respectively after continuous sharp declines since late 2012, signaling a possible rebound in 2016.

The balance of payments recorded a $ 95.6 million deficit in Oct-Dec. The current account deficit reached $135 million in the fourth quarter, with a $420 million deficit in services and income accounts offsetting a trade surplus. Net FDI inflows rebounded to $216 million in the same period due to increased intercompany lending in Dec. A $100 million ADB loan and $257 million bank loans also helped reduce the balance of payments deficit. On the back of the mitigated balance of payments pressure in Oct-Dec, the BoM repaid $234 million to the bilateral currency swap line facility with the People’s Bank of China in Dec, after a $632 million drawdown in Jan-Sep.
Gross international reserves moderately declined to $1,323 million in Dec, about three months’ import cover, after maintaining the $1.4 billion level in Sep-Nov. Gross reserves fell by $326 million over the twelve months, from $1,649 million at the end of 2014.

The exchange rate against the US$ weakened to MNT 2,011 in Jan. The nominal exchange rate stayed in the range of MNT 1,900-2,000 per US$ since mid-Aug despite substantial depreciation in most of the commodity-dependent currencies. Following heavy intervention in Jul-Sep, the central bank significantly reduced its intervention in the foreign exchange market in the final three months of last year on the back of the relatively stable balance of payments conditions. In January, depreciation pressure seems escalating amid the heightened volatility in the global financial market.

The project financing agreement on OT’s underground mine was signed on Dec 16, 2015. The project financing is expected to bring US$4.4 billion into Mongolia over the coming years, supporting Mongolia’s growth and external accounts. The actual timing and size of investment in 2016 are likely to depend on subsequent steps to be taken in the first half of the year, including the completion of 2015 feasibility study, formal decisions by the boards of related companies, and the issuance of necessary permits.

GDP growth remains slow. Growth slowed to 1.8% (y/y) in the third quarter from 3% in the previous six months. A 36.1% drop in investment continued to dampen growth in the third quarter. Final consumption grew 5.7% (y/y) in the same period, led by an 8.4% increase in private consumption, offsetting a 7.7% y/y decline in government consumption. An improvement in net exports supported growth, with sharp import compression outpacing declining exports. In Oct-Dec, industrial production only slightly increased by 1.8% (y/y), indicating continued sluggish growth in the final three months of 2015.

Mining industrial production growth slowed to 6.2% (y/y) in the fourth quarter, signaling a slowdown in mineral GDP growth. A sharp drop in coal production and moderating copper concentrates production growth from the OT mine have dampened mining industrial production. In January, OT reported that its copper and gold production rose by 36% and 10.9% respectively in 2015. The mining company, however, expected a
decline in its gold and copper production in 2016, which could weigh on Mongolia’s growth and the current account.

Non-mining industries remained substantially weak in Oct-Dec. Manufacturing industrial production fell by 19.8% (y/y) in the fourth quarter. Electricity production also remained subdued, increasing by only 2% (y/y) in the same period. Leading indicators for transportation and communication industries (e.g., carried freight and passengers, communication services sale) also weakened in the fourth quarter. The annual agriculture data released in Jan showed that the number of livestock increased by 9.2% over the last year but crop harvests declined due to drought by 59% (Cereals and wheat), 31% (vegetables), and 12.7% (hay) in 2015.

Headline inflation further slowed to below 2%. Nation-wide and UB-city consumer price inflation rates decelerated to 1.9% and 1.1% respectively in Dec on a yearly basis. The recent disinflation trend is largely attributed to sharp drops in meat prices, driven by increased meat supply from herders. Core inflation also slowed to 4.8% in Dec.

**Figure 3. Industrial production indicates subdued growth in Q4 2015, following a 2.5% GDP growth in Jan-Sep.**

Real GDP growth (y/y, %) and industrial production (3 month rolling sum, y/y %)

<table>
<thead>
<tr>
<th>Year/Quarter</th>
<th>Overall GDP</th>
<th>Non-mining</th>
<th>Mining</th>
<th>Industrial production (3 month rolling sum, y/y)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>-5.0</td>
</tr>
<tr>
<td>2012</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>-5.0</td>
</tr>
<tr>
<td>2013</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>-5.0</td>
</tr>
<tr>
<td>2014</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>-5.0</td>
</tr>
<tr>
<td>2015</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>-5.0</td>
</tr>
</tbody>
</table>

**Source:** NSO, WB staff calculations

Mongolia’s external financing conditions have considerably tightened in late Jan, with its benchmark sovereign bond yields rising over 11%. The market yield of the 5-year Chinggis bonds soared to over 11% on Jan 21, a sharp increase from around 9% in the previous week, after a gradual rise from less than 8% in early Dec. The tighter external financing conditions came amid an overall increase in the borrowing costs of emerging economies in recent months. However, the recent sharper tightening of Mongolia’s external financing conditions compared to its peers in Jan seems to reflect recent political developments. The market yield of the 10-year Chinggis bond picked up to over 10% in late Jan, from 9% one month ago. The sovereign dim sum bond yield also jumped close to 14% from lower than 12% over the same period. The inverted yield curve, the higher bond yield of the 5-year Chinggis bond than its 10-year counterpart’s, indicates higher short-term risks facing Mongolia in 2016-17 perceived by international investors.

Significant short term liquidity was injected by the BOM to commercial banks in Dec through its various lending facilities including overnight loans. The BoM’s claim on banks jumped from MNT 1,299 billion in Nov to MNT 1,686 billion in Dec. The BoM has been providing short-term liquidity to the banking sector at the end of each year since 2011, to improve end-year prudential indicators and to ease liquidity strain of the banking system. As a result of the liquidity injection, the system-wide reserve ratio of banks rose to 28% of total deposits in Dec, from 15.8% in Nov—a level which was close to the legal reserve requirement ratio of 12%.

The BoM lowered its policy rate by 100 bps to 12% on Jan 14, 2016 amid tight credit...
conditions. The decision came as bank loan growth to the private sector, including the securitized mortgages, continued to slow to 2.7% (y/y) and the NPL ratio remained close to 7.1% in Dec, while inflation further decelerated to below 2%.

The 2015 budget recorded a MNT 1,163 billion deficit, close to the MNT 1,176 billion target of the second supplementary budget. Annual budget revenues declined to MNT 5,976 billion, a 5.4% drop from the 2014 revenue outturn. The weak revenue performance was largely due to a substantial drop in VAT and excise taxes while higher gasoline tax and royalty payments provided limited buffers to tighter fiscal conditions. Annual general government spending was contained at MNT 7,136 billion, close to the previous year’s level, in response to the revenue shortage. The revenue outturn fell short of the first supplementary budget adopted in January by 10% (MNT 600 billion), underscoring the importance of realistic revenue projections for credible fiscal planning.

Figure 5. Mongolia’s bond yields soared to over 11% in late January, a sharper rise than its peer countries.

Figure 6. BoM lowered its policy late to 12% in Jan, following substantial liquidity injection to the banking sector in Dec.

Box: Proposed New Scheme for the Subsidized Housing Mortgage Program

In January, the authorities proposed measures to: (i) further expand the subsidized Housing Mortgage Program by lowering subsidized interest rate from 8% to 5% and providing support for down payments; and (ii) transfer the existing mortgage assets of the BoM to the government.

The intention to transfer the mortgage program to the Ministry of Finance from the Central Bank is welcome, but the following issues could be further considered in the subsequent regulations and measures to be taken:

- The cost of the program should be properly recorded as budget spending and financing should be on-budget rather than through the Central Bank.
- Spending for the mortgage program should be decided within an affordable budget envelope, competing with other spending priorities, particularly given the tight fiscal situation.
- Targeting of mortgage eligibility is needed to reduce the fiscal burden while effectively supporting affordable housing for low and middle-income families.
- It is not clear how the government will pay the BoM for the mortgage assets. Without proper compensation, the BoM’s balance sheet may suffer a large capital loss.

Weak economic prospects also demand careful assessment on whether it is sustainable and prudent to support the construction sector by continuously boosting housing demand through BoM’s liquidity
injections or budget subsidies.