

ASIA PACIFIC ECONOMICS

MONGOLIA COUNTRY BRIEF

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Over the last decade Mongolia's GDP has advanced by an average 6% annually, with growth led by the agriculture and mining sectors. However, activity slowed sharply in 2009 due to the global financial crisis. In response to a weakening balance of payments, the Mongolian authorities obtained a stand-by line of credit with the IMF which thus set the stage for a rebound in 2010.

Going forward, GDP growth should be strong, but concerns remain on rising inflation, the government's pro-cyclical fiscal policies, and a fragile banking system. If these risks are managed well, we expect the nation will be in a position to capitalise on three key themes:

1. Mongolia's rise as a key coal exporter
2. Diversification of export destinations
3. Growing urbanisation driven by rising incomes

SOCIAL AND POLITICAL SETTING

Mongolia is one of the most sparsely populated countries in the world. It is landlocked by China and Russia, and with a land area of 1,564,116 sq km, is equivalent in size to the US state of Alaska. The nation's population of 3.13 million has an average age of 26.2 years, with the 15-64 year age group accounting for around 69% of the total population. The country has a GDP per capita of around \$3000 (ranked 164 amongst 228 countries, slightly above Vietnam and below India), and a third of its citizens live below the poverty line.

DEVELOPMENT INDICATORS

Population (m)	3.13
Annual population growth rate (%)	1.5
Urban population (% of population)	62

Sources: US Central Intelligence Agency, ANZ Economics

Mongolia's political climate remains stable. The Mongolian People's Party (MPP), led by Prime Minister Sükhbaataryn Batbold, returned to office with a strong parliamentary majority at the 2008 elections. However, despite having a legal system whose rules and procedures are transparent, and an independent anti-corruption agency; Mongolia's scored 2.7 out of 10 on Transparency International's 2010 Corruption Index.

Mongolia has maintained good diplomatic relations with its two neighbours, China and Russia, who are also key trading partners. China accounts for 48% of trade flows; Russia, 21%.

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ECONOMIC ENVIRONMENT

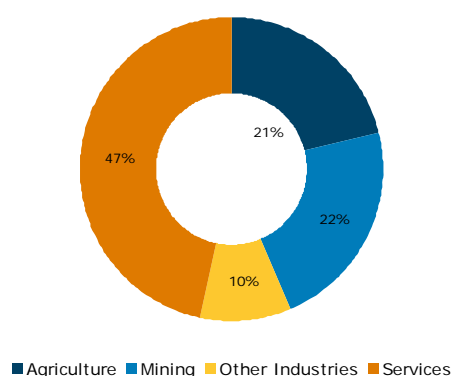
Agriculture and mining are the main economic drivers. In the 1980s Mongolia was primarily an agrarian, centrally planned economy, bolstered by Soviet assistance. The economy collapsed following the fall of the Soviet Union, and the following years witnessed painful structural reforms and privatisation, after which agriculture, mining and services became the main contributors to growth. Currently, agriculture accounts for 21% of GDP; mining, 22%; and the services sector, which mainly includes transport and communications, finance and public administration, 47%. Construction, manufacturing and utilities sectors combined contribute around 10%.

MONGOLIA: KEY ECONOMIC INDICATORS

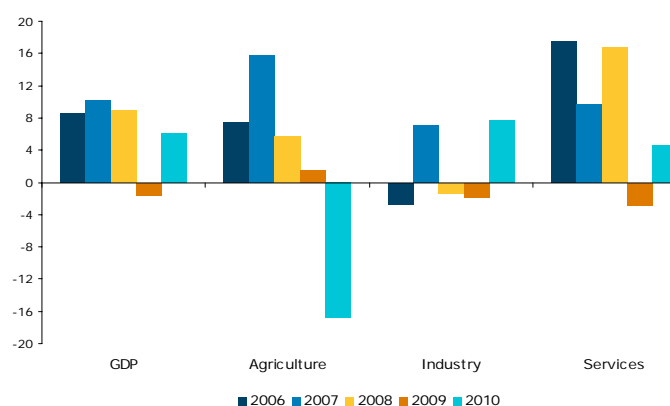
ECONOMIC DATA	2007	2008	2009	2010 (est.)	2011 (est.)
Real GDP Growth (y/y)	10.2	8.9	-1.3	6.1	10.3
Exports (USD m)	1,889	2,534	1,876	2,899	3,825
Imports (USD M)	2,117	3,244	2,070	3,177	4,874
Current Account Balance (\$m)	265	-722	-411	-931	-1,302
(% of GDP)	6.7	-14	-9.8	-15.2	-15.1
Inflation (y/y)	14.1	23.2	1.9	14.3	20.0
Broad Money (y/y)	56.3	-5.1	26.9	61.6	45.0
Domestic Credit Growth (y/y)	78.4	52.5	-7.6	23.2	45.1
Public External Debt (USD m)	1,529	1,602	1,977	2,023	2,064
(% of GDP)	38.9	31.0	43.3	30.8	22.8
Foreign Direct Investment (\$m)	360	836	496	1,574	1,130
Foreign Exchange Reserves (USD m)	1,001	658	1,328	2,290	3,586
Import Cover (mths)	3.8	3.0	4.1	4.9	7.1
Nominal GDP (Togrog bn)	4,600	6,556	6,591	8,255	10,382
GDP per capita (\$)	1,491	1,921	1,552	2,470	3,046

Growth rebounded in 2010. GDP expanded by an estimated 6.1% in 2010 compared with a contraction of 1.3% in 2009. The sharp reversal in growth was brought about by a rebound in the value of mineral exports, which had collapsed during the global financial crises (GFC). Most sectors posted respectable year-on-year growth in 2010: wholesale and retail trade grew by 23%; construction, 16%; manufacturing, 6%; and mining, 6%. However, agriculture, which had weathered the GFC relatively well, contracted by 17% due to the *dzud* (a natural disaster where a summer drought is followed by a severe winter that prevents livestock from grazing).

Mongolia: GDP by Sector (2009)



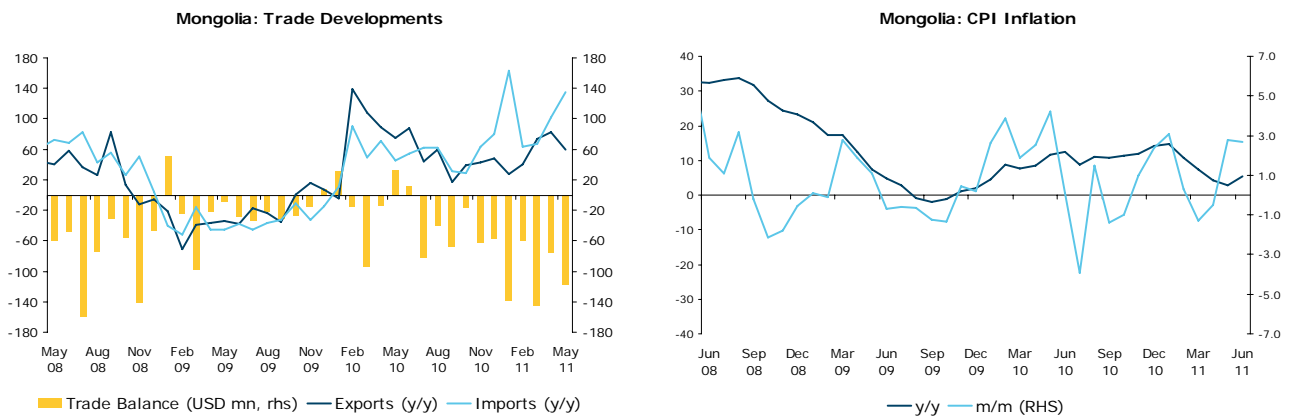
Mongolia: Economic Growth (y/y)



Sources: World Bank, IMF, ANZ Research

MONGOLIA COUNTRY BRIEF

Mongolia's trade deficit has widened since mid-2010. In 2009, with commodity prices falling, the economy experienced a sharp deterioration in its balance of payments and fiscal outturn: Mineral exports collapsed, revenues dropped, the local currency fell, and foreign reserves were quickly depleted necessitating a \$236m standby arrangement with the IMF. Although mineral exports made an impressive comeback in 2010 on the back of surging commodity prices, dzud-affected agricultural exports dragged down overall export growth. Moreover, imports rose at a fast pace (especially fuel, transport and machinery imports), as construction of new mines and infrastructure projects were in full swing. As of May 2011, exports grew 59.4% y/y, while imports grew an impressive 134.9%. The trade balance registered a deficit of \$118.1m.



Sources: ADB, National Statistics Office, Bloomberg, ANZ Economics

Inflation jumped in 2010, increasing from 4.5% y/y in January 2010 to 14.4% in December. Much of the rise in CPI was a result of food inflation, with both internal and external factors playing a role. Meat prices skyrocketed as animal husbandry was severely damaged by the dzud, while food and fuel inflation was imported from China and Russia (as global food and fuel prices increased further), the two economies Mongolia relies on for a substantial portion of food and fuel consumables.

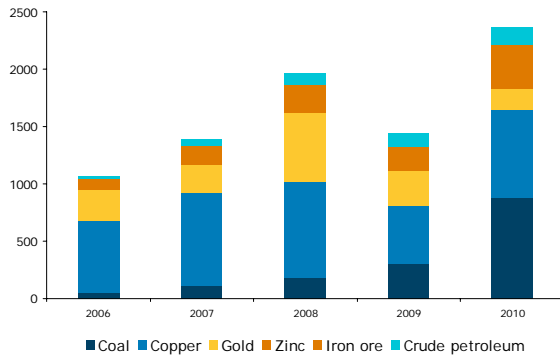
Foreign direct investment into Mongolia reached a record high of an estimated \$1.57bn in 2010. Generally, around half of inward FDI flows was directed to the mining and exploration sector. In Oct 2009, the Mongolian authorities estimated that the mineral and energy sector would require \$7.1bn of investments from 2010 to 2015. Minerals and energy aside, a dramatic upgrade in the transport infrastructure is also required: only 3.5% of roads are paved, while the rail network remains underdeveloped. The Asian Development Bank estimates that around \$4.5bn of transport infrastructure investment will be needed by 2020. In response to these funding needs, the Mongolian authorities set up the Development Bank of Mongolia in May 2011. The Bank plans to issue \$700mn in sovereign bonds to fund lending programmes to the energy, infrastructure and industry sectors.

MONGOLIA'S MINERAL STORY

Mongolia contains some of the world's largest deposits of gold, copper and coal. Much of the production of these minerals is intended for exports with China accounting for the lion's share, around 75%, followed by Canada, the UK and the US. Up to 2010 copper and gold made up more than half of Mongolia's total mineral exports, but in that year coal experienced a 135% y/y rise in volume terms, taking its share of mineral exports to 30%. Other prominent mineral exports include iron ore, zinc, molybdenum and crude petroleum. Mongolia also has sizable deposits of uranium and rare earths (ranking second in world deposits for both mineral classes), fluorite, silver, phosphates and industrial minerals. While Australian mineral deposits outrank Mongolia's across the board—with the exception of coal and molybdenum—(see table below), Mongolia is now an important player in the global mineral market given its close proximity to key mineral markets: China, Russia, India, Japan and Korea.

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Mongolia: Mineral Exports (USD mn)



MONGOLIA VS AUSTRALIA: KEY MINERAL DEPOSITS

MINERAL*	UNITS	MONGOLIA	AUSTRALIA
Coal	Bn tons	150	183
Copper	Mn tons	23	80
Gold	Tons	2763	7399
Uranium	Th tons	60	1223
Molybdenum	Th tons	219	276
Iron Ore	Mn tons	453	28000
Silver	Th tons	10	70
Tin	Th tons	10	176
Tungsten	Th tons	70	196
Lead	Mn tons	3	31

* Ranked by Mongolian key mineral exports, coal being the largest component.

CHANGES (%) IN KEY COMMODITY EXPORTS FROM DEC 2009 TO DEC 2010

COMMODITY	% CHANGE IN \$ VALUE	% CHANGE IN VOLUME	% CHANGE IN UNIT PRICE	% OF TOTAL EXPORTS (2010)
Copper	54	-3	58	27
Gold	-47	-57	23	6
Coal	188	135	23	30

Sources: National Statistics Office, World Bank, Mongolia Ministry of Mineral Resources and Energy, Geoscience Australia, ANZ Economics

Substantial mineral deposits remain untapped. A number of large mining projects are underway with the most prominent being the Tavan Tolgoi coal mine and the Oyu Tolgoi copper and gold project. The former commenced production in 2003 and is estimated to contain around 5 billion tons of coal reserves, with coking coal reserves exceeding Australia's total coking coal reserves; while the latter, with its investment agreement sealed in 2009, is likely to be the largest copper-gold mining project in the world, and is expected to account for around 30% of Mongolia's GDP in the medium term.

KEY MONGOLIAN MINE PROJECTS

MINE	RESOURCE	RESERVE	COMMENTS
Oyu Tolgoi (OT)	Copper	28 mt	OT is a combined open pit and underground mining project in Khanboad Sum within the South Gobi, bordering China. The site was discovered in 2001 and is being developed as a joint venture between Canadian miner Ivanhoe , British/Australian miner Rio Tinto and the Mongolian Government. OT is the largest financial undertaking in Mongolia's history and upon completion is expected to account for more than 30% of the country's GDP. Copper production is expected to reach 450,000 tonnes (500,000 short tons) annually. The OT Copper & Gold reserves are the largest mineral reserves in the world.
Tavan Tolgoi (TT)	Coal	5,000 mt	TT is an existing open pit coal mine. Production commenced in 2003 and recent estimates put production at 900,000 mtons / annum. Its coal reserves are estimated to contain five billion tons however the mine is 400km from the nearest railway. The TT coking coal reserves exceed all of the coking coal reserves in Australia
Nariin Sukhait	Coal	380 mt	Three companies operate this mine: locally-based Mongolian Alt Corp , China's Qinhua-MAK JV and a subsidiary of Ivanhoe, South Gobi Energy Resources . Located 47km from the Chinese border, approval to build a rail link to the border is on hold. Contains both thermal and coking coal.
Gatsuurt & Boroo	Gold	22 t	Owned and operated by Canadian miner, Centerra Gold . Boroo commenced in 2004 and produces around 400,000 oz / annum. Australian miner Ausenco is currently involved at the mine with several construction projects.
Ulann Ovoo	Coal	209 mt	Owned and operated by Canadian miner, Prophecy Mining . Contract mining at this site is undertaken by Leighton Asia , a subsidiary of the Australian Leighton Group. Mine production is expected to exceed 2m t/annum in 2011. This northern mine is near the Russian border and 160km from the Mongolian-China rail link.
Chandgana Tal & Khavtgai	Coal	800 mt	Owned by Prophecy Mining . Close to power infrastructure, rail links and paved highway.

Sources: ANZ, Mongolia Ministry of Mineral Resources and Energy

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A sovereign wealth fund will manage the revenue windfall from the Oyu Tolgoi project. The Human Development Fund, to be managed independently from 2013 onwards, will play a key role in responsibly managing revenues totalling around \$30bn over the next fifty years. The authorities are currently examining sovereign wealth fund models in comparable economies. The table below benchmarks four funds from similarly developing countries that are also well endowed with resources. In general, these funds adhere to the Santiago principles¹ for best practice. Chile's success is based on a fiscal responsibility law (Mongolia was required to adopt similar legislation by the IMF); while the funds in Kazakhstan and Timor-Leste have made progress in raising incomes and diversifying activity away from agriculture and minerals into manufacturing and services. Botswana's Pula fund has helped the country achieve one of the fastest growing per capita incomes in the world.

COMPARABLE SOVEREIGN WEALTH FUNDS

COUNTRY	FUND	ASSETS (\$ BN)	MINERAL
Chile	Social and Economic Stabilization Fund	21.8	Copper
Timor Leste	Timor- Leste Petroleum Fund	7.7	Oil
Kazakhstan	Kazakhstan National Fund	34	Oil
Botswana	Pula Fund	6.9	Diamonds

Sources: ADB, SWF Institute, ANZ Economics

POLICY ENVIRONMENT

Monetary policy is based on a managed FX float and monetary targeting regime, but is, in effect, eclectic and pro growth. Authorities at the Bank of Mongolia (BoM) have tried, with limited success, to target reserve money (the primary target) and M2 (secondary) to manage inflation. The principal instrument is the 7-day central bank bill. However, in practice the policy framework has recently (since the 2008-09 financial crisis) relied on an eclectic mix of nominal currency appreciation, changes in reserve requirements and opportunistic FX intervention to try and maintain a stable rate of money growth (In 2011, reserve money rose 42.8% ytd, while M2 rose 20.1%)

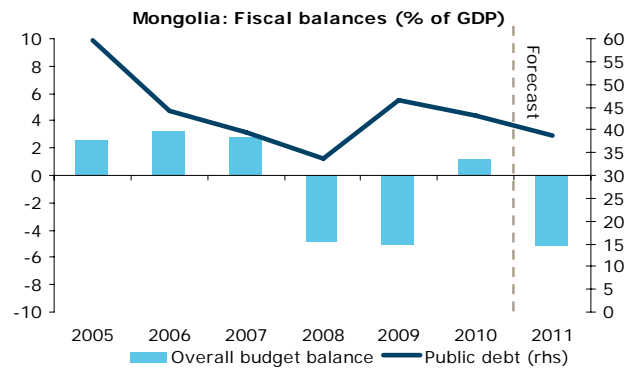
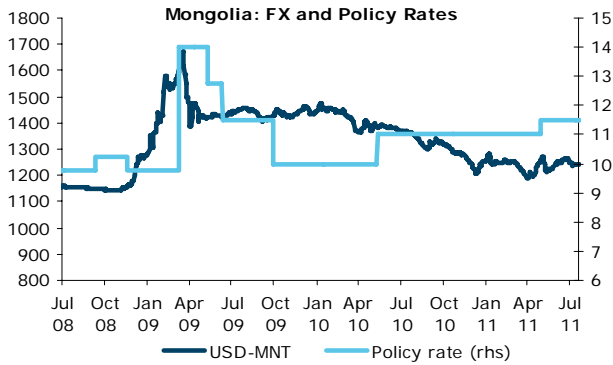
Authorities remain reticent about further interest rate normalisation. This is because they want to keep real domestic borrowing costs low to facilitate a recovery in private credit in the aftermath of the commodity price bust-led disruption of 2008-09.

Although policy eclecticism appears to be working, with a recent deceleration in the year-on-year inflation rate to 5.5% in June, over the near term, the policy framework remains somewhat vulnerable to a sharp or sustained pull back in commodity prices, as: (1) rates haven't normalised yet; (2) FX mismatches on bank and corporate balance sheets pose risks; and, in particular, these threats could amplify if (3) a financeable external balance is not sustained. However, Mongolia's FX reserves have grown to \$2.3 bn. This has resulted from \$236 m in disbursements from the IMF, as well as improvements in the basic external balance (current account deficit + foreign direct investment). And, rising FX reserves alongside greater FX flexibility provide a stronger buffer than in previous years against unforeseen current or capital account shocks.

Looking further ahead, authorities plan a shift toward an inflation-targeting framework. If successful, this will heighten the effectiveness of monetary management but it needs a more enabling fiscal environment that does not hinder monetary transmission or BoM's institutional credibility.

¹ The Santiago principles are generally accepted principles and practices for sovereign wealth funds aimed at providing them with a strong legal, institutional, investment and risk management framework. The principles can be found in detail at <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf>

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Sources: IMF, World Bank, Bank of Mongolia, ANZ Research

Despite adoption of a Fiscal Responsibility Law (FRL), the authorities' fiscal stance remains pro-cyclical, limiting the economy's shock absorption capacity. Mongolia implemented a FRL as part of its IMF program requirements in 2010. By implementing a VAT tax, raising windfall tax revenues, creating a Fiscal Stability Fund (FSF) and committing to gradually reducing the budget deficit cap to 2% of GDP by 2014, Mongolia's fiscal framework was widely expected to smooth economic growth and strengthen the fiscal position against volatile commodity cycles. However, the 2011 budget belies, at least for now, the expectation of a shift toward greater prudence. Poorly targeted social transfers ahead of upcoming elections in mid 2012, and the potential for booking larger public sector contingent liabilities at the Development Bank of Mongolia raise fiscal risks. The fiscal deficit is now expected to exceed the FRL-stipulated 5% ceiling for 2011.

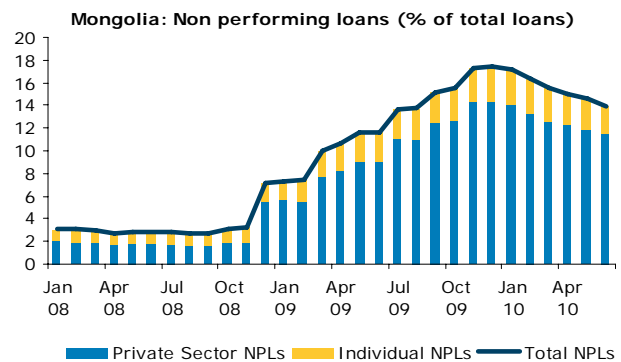
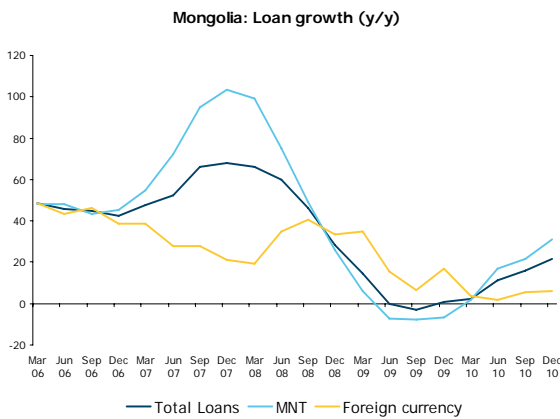
Despite the risk of extra spending above the budget ceiling, financing is not expected to be problematic in view of larger-than-expected advance tax payments, and greater issuance of togrog debt; although it remains to be seen whether authorities desist from drawing down funds from the FSF. Moreover, the general government debt trajectory is also not expected to come under pressure in view of the strong nominal growth rate of the economy.

Nonetheless, a larger budget deficit and pro-cyclical stance limits the government's fiscal ability to counteract large amplitudes in international commodity prices whilst raising the risk of economic overheating.

FINANCIAL ENVIRONMENT

Loan growth is up from its trough in 2009, although rising NPLs and lending concentration are key risks. As of Jun 2010, total number of loans rose by 12.6% (y/y), bolstered by individual and private loan growth, which surged 20.1% and 7.2% respectively. The share of Non-performing loans (NPLs) rose rapidly in the post GFC period, reaching a peak 17.4% of total loans during Dec 2009. During the crisis years, the government took the Anod Bank (then the country's fifth largest commercial bank) into conservatorship, and also established a State Bank after the Zoos Bank (sixth largest private bank with loss loans worth MNT60bn) failed in 2009. The NPL ratio, which was the highest for loans to the private sector, fell thereafter but still remained high at 14% of total loans as of Jun 2010. Although the NPL ratio has fallen, volume of NPLs on domestic bank balance sheets has increased, which has constrained their ability to lend. An additional issue is the concentration of lending, with the top 20 borrowers accounting for a third of all loans outstanding. Moreover, loan diversification across sectors is also poor. The IMF estimates that construction, mining, trade, agriculture and manufacturing account for 60% of loans and 80% of NPLs. As a result, a major corporate default or a sectoral shock has the potential to destabilize the financial system.

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Sources: National Statistics Office, ANZ Research

MNT and foreign currency deposit growth has been robust, but the financial system is vulnerable to exchange rate shocks. Togrog-denominated currency deposits rose strongly in 2010, despite low real interest rates. A 'blanket' deposit guarantee law, along with the expectations of a currency appreciation have been the main drivers of MNT deposit growth. Foreign currency deposits have also risen, and account for a third of the total deposits in the country. The IMF² believes that a sharp correction of the MNT could leave the financial system vulnerable through: a) indirect credit risk, which could arise from bank exposure to borrowers with MNT-denominated incomes but foreign currency liabilities; or b) solvency risk through currency mismatches on bank balance sheets (MNT-denominated loan receivables vs. foreign currency payables). Moreover, private borrowing from abroad is on the rise, as firms and commercial banks take advantage of the spreads between local and foreign borrowing rates.

ECONOMIC OUTLOOK, KEY THEMES AND RISKS

Mongolia's growth prospects in the near future are positive, on balance. High global commodity prices should boost mineral exports, while investment in new mining and infrastructure projects should aid job and wealth creation. As a result, GDP growth in the medium term should remain robust, and is likely to average around 10-12% in the absence of an external shock. Prudent management and redistribution of future mineral revenues could help Mongolia transition from a low-income to a middle-income country.

THREE KEY GROWTH THEMES:

- **Mongolia's emergence as a key player in the coal market,** especially for coking coal. Mongolia has traditionally been an exporter of gold and copper, and the Oyu Tolgoi project will re-enforce this. However, coal warrants close attention, given that this sector reported the largest surge in exports last year. ANZ's Commodity research team expects Mongolia to be a prominent coking coal market player in 2013³.
- **The diversification of export destinations.** China, as Mongolia's major trading partner, has a large influence on Mongolian export prices and, therefore, terms of trade. Last year, according to *Reuters*, China purchased Mongolian coal at an average price of \$61/tn vs. \$103/tn from elsewhere, possibly saving an estimated \$6.9bn. To improve its terms of trade, Mongolia plans to increase the share of its exports to other destinations as evidenced by construction of a new railway line that will open up coal 'offer price' competition between China and Russia.
- **Increasing urbanisation.** With the increase in incomes from the mineral boom, we expect a corresponding increased migration to urban areas. This should generate further demand for both physical and social infrastructure, requiring greater domestic and foreign investment.

² IMF's Mongolia Financial Stability Assessment (FSA) May 2011. <http://www.imf.org/external/pubs/ft/scr/2011/cr11107.pdf>

³ For more details, kindly refer to the *ANZ Commodity Informer*, 20 May 2011 or email ANZResearch@anz.com for a copy.

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POLICY CHALLENGES:

- **Inflation is likely to remain elevated.** This is due to both supply (high global food prices) and demand factors (new mining projects, untargeted social transfers by the government) along side rapid monetary expansion that has recently exceeded the central bank's target rates. These underscore the need for further tightening beyond the tolerance of a stronger togrog rate.
- **Emergence of Dutch Disease.** Substantial real exchange rate appreciation derived from large commodity revenues, amidst the absence of stronger counter-cyclical fiscal, policies could result in a Dutch Disease which could harm non-mineral sectors like agriculture and manufacturing. A sovereign wealth fund that keeps much of the windfall offshore and constrains the draw downs of balances by politicians through a rules-based system is important for medium-term stability and competitiveness.
- **An increase in NPL volumes on bank balance sheets has constrained domestic lending.** To guard against credit risk events, better capitalisation of banks and enhanced monitoring of the financial system is of paramount importance. Additionally, foreign currency lending and borrowing also requires further regulations to mitigate risks arising from unfavourable exchange rate movements.

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