Mongolian Economic Outlook (June 2013)

Real GDP Growth

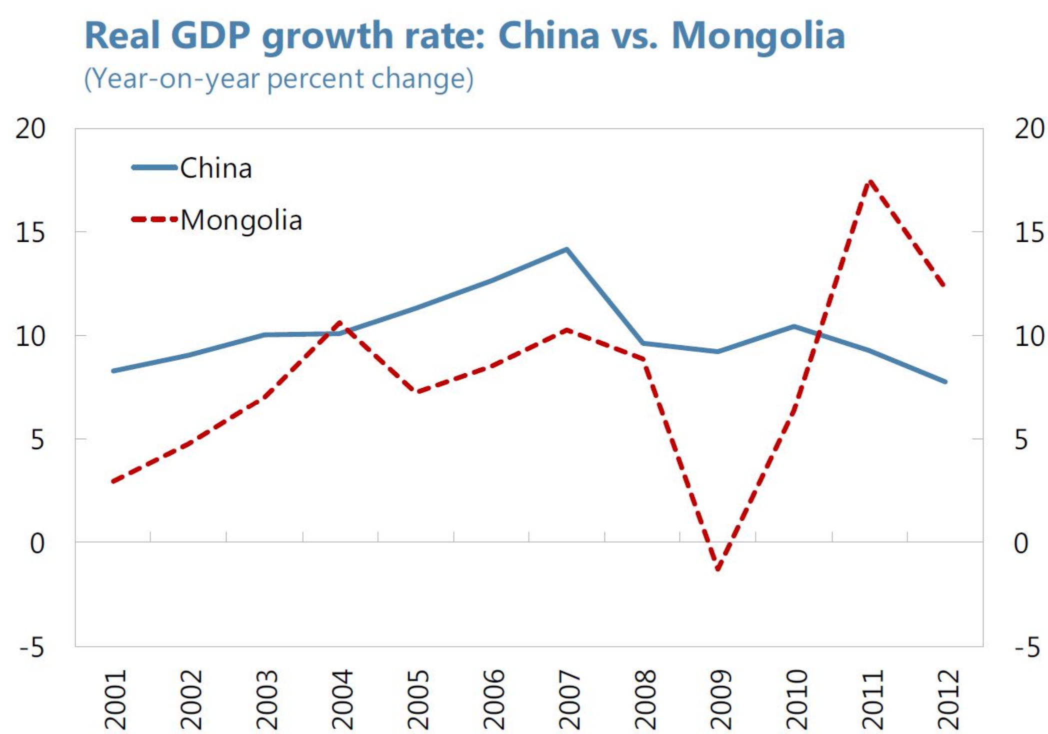
Frontier has revised its baseline growth forecast for 2013 to **6 percent** in May, significantly lower than street estimates. The forecast is based on uncertainty over key growth factors. The downward revision reflects the recent trends of **negative export growth** and **sharply weakening FDI inflow**. The ramp-up in mineral production of Oyu Tolgoi mine is expected to lift mineral output significantly starting from this summer. But, the start of the **commercial production of OT will delay** by a few months and that would have large adverse impact to the economy. The economy may be dragged also because majority of **public investment** using Chinggis bond proceeds will not start this year.

Underlying Economic Condition

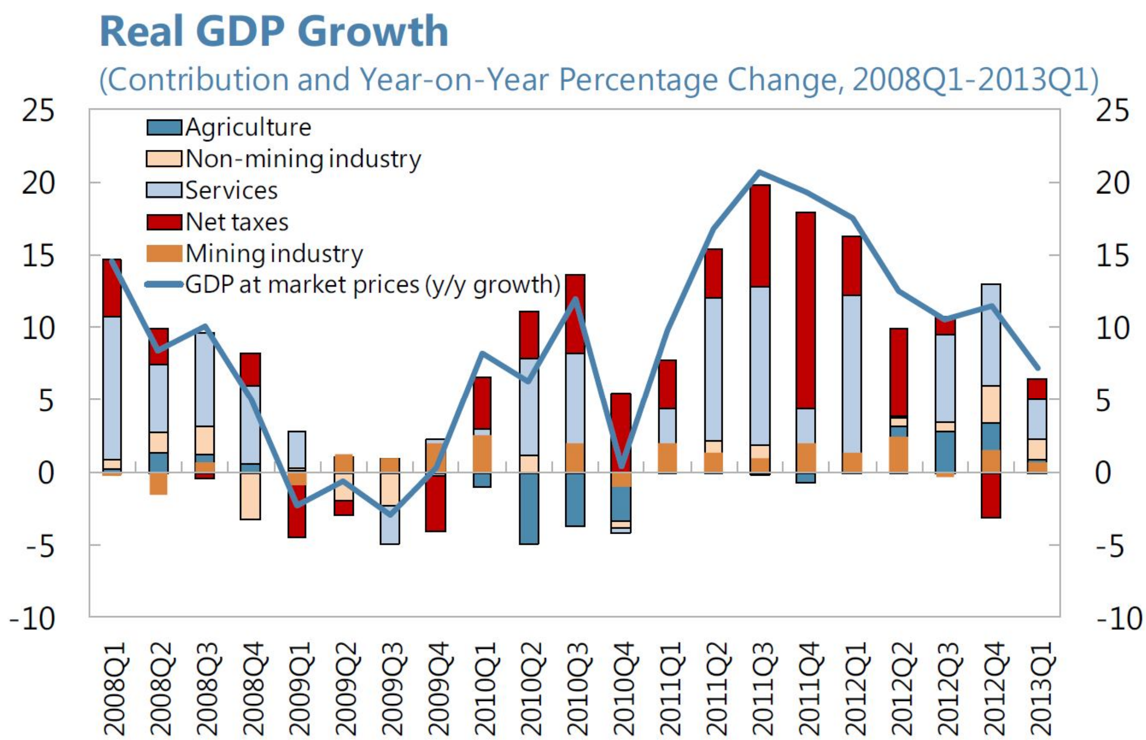
1st quarter GDP has slowed down to around **7%**, slowest growth rate since 4th quarter 2010. We expect **2nd quarter GDP** will slow down further to only **2%**. The growth rate will pick up substantially after the commercial production of Oyu Tolgoi. But, the **3rd quarter GDP** might be almost **zero** if the commercial production of OT delays and ETT's coal production will not increase so much.

Downward pressures to Street forecasts

ADB forecasts GDP will grow **16.5%** in 2013 and **World Bank** forecasts **13%**. However, because of the much weaker underlying economy proven by the result of the 1st quarter and delay of the commercial production of Oyu Tolgoi, we believe **their forecasts will be revised down** in a future.



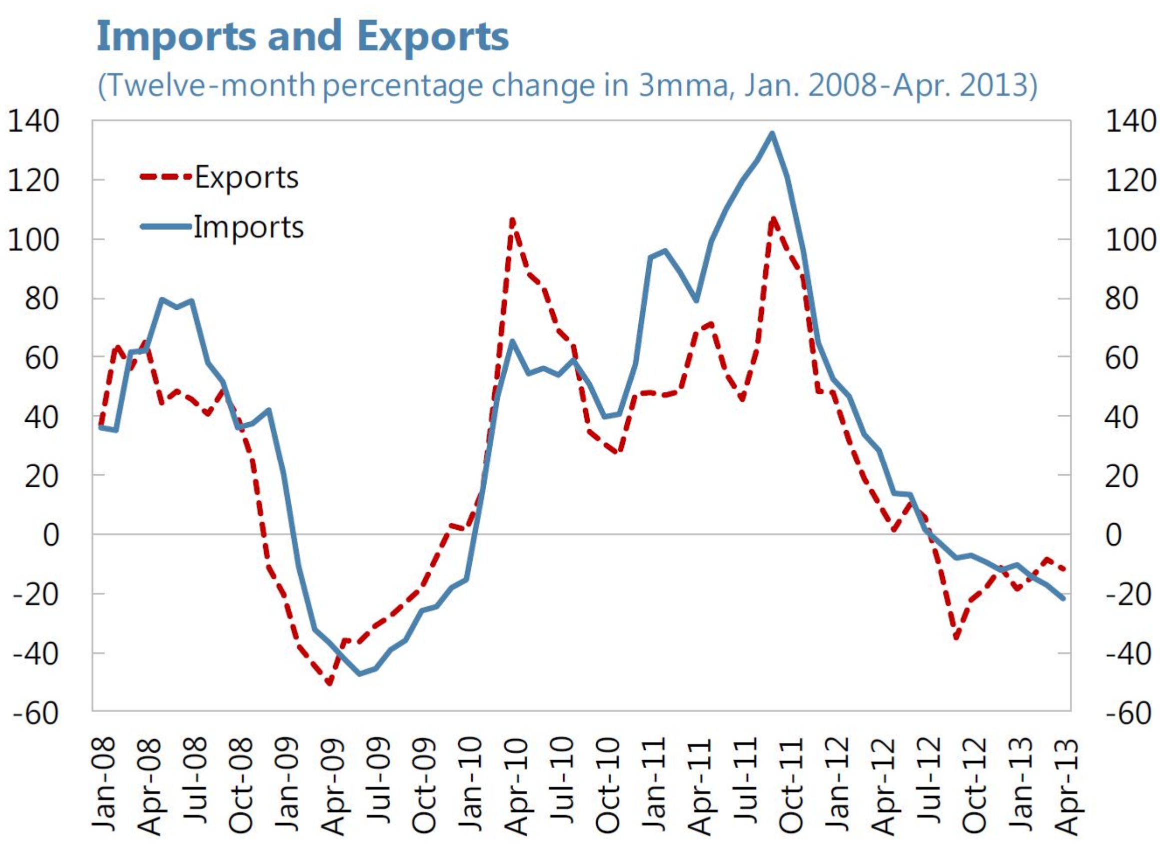
Source: Mongolian Authorities; and IMF staff estimates



Source: Mongolian Authorities; and IMF staff estimates

Imports and Exports

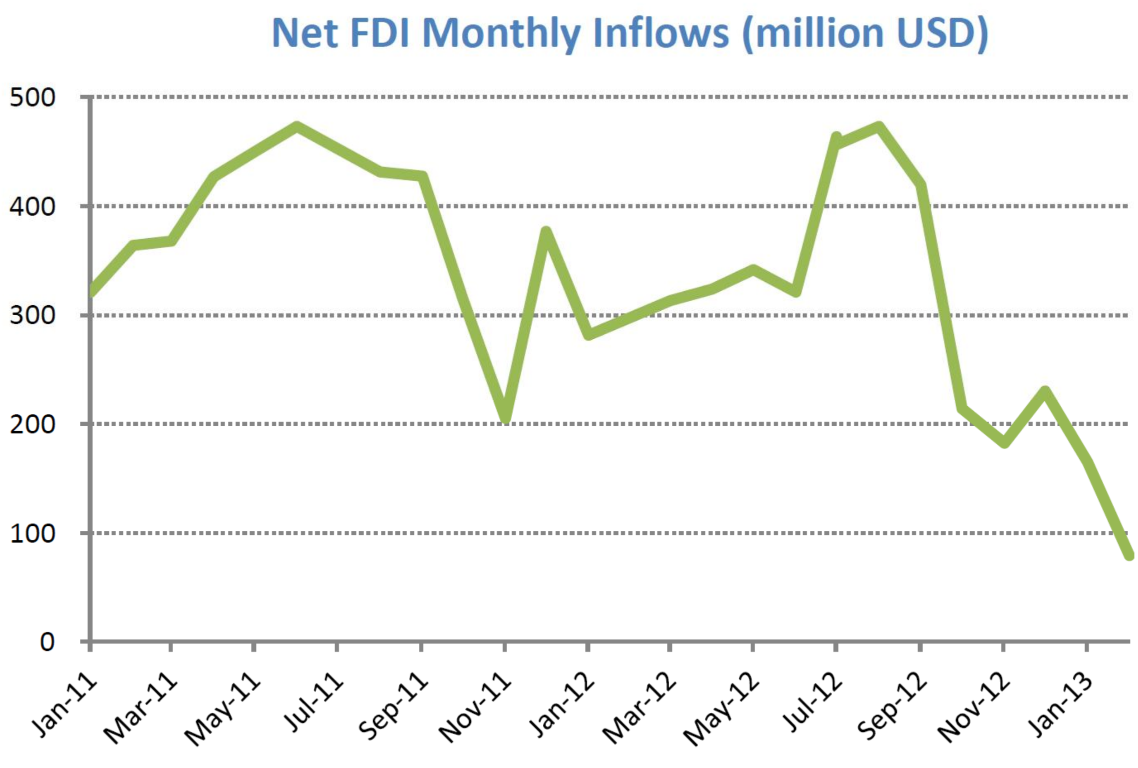
The trade balance is likely to remain weak in 1st half of 2013 but is expected to rebound sharply after August due to the start of the OT production. Because of the strong fiscal spending and growing domestic demand, the external imbalance reached a record level in 2012. In fact, total exports slumped almost 10% due to a sharp drop of coal exports while total imports increased by 2% last year. In 2013, **the trade balance still remains in significant deficit** as exports continue to decline due to weakening coal exports. Export is expected to pick up after September this year, while import will likely remain weak.



Source: Mongolian Authorities; and IMF staff estimates

Net FDI

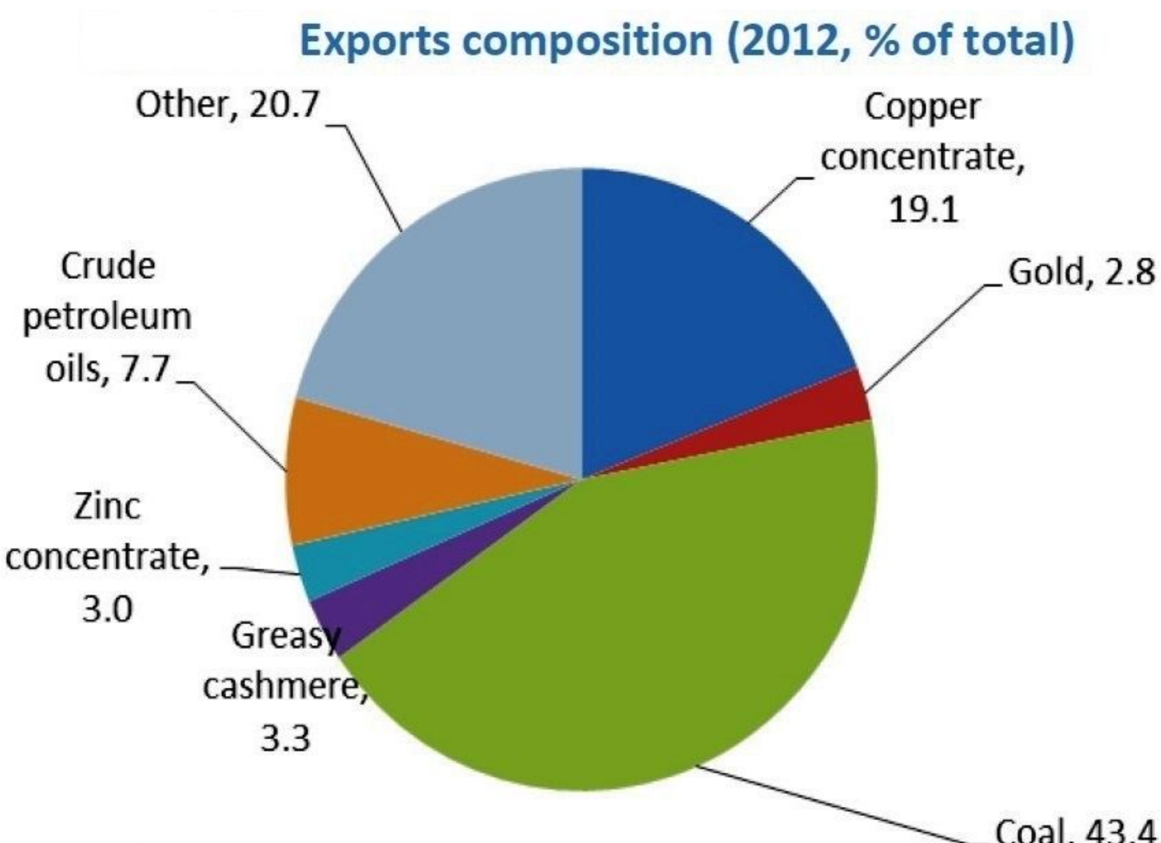
The rapid slowdown of the FDI inflow is becoming a significant downside risk to the economy. In 2012, the net FDI inflow declined by almost 20% to USD 3.8 billion, from USD 4.6 billion of the previous year. In the 1st quarter of 2013, the net FDI inflow slowed down to less than half of the previous year. The sharp deterioration of the FDI inflow is because of the **cautious stance of foreign investors** on the investment climate in Mongolia as they have enacted SEFIL (Strategic Entities Foreign Investment Law) in June 2012. With very small domestic capital markets and weak performance of Mongolian related foreign listed companies, the sharp drop of the FDI inflow has a **significant economic effect** as it has been the main source of private investment for the last two years. However, as Government has **amended SEFIL in April**, reflecting the concerns of investors, the **FDI should gradually pick up** in the latter half of this year.



Source: Mongolian Authorities, WB staff estimates

Export Composition

In 2012, mineral exports accounted for almost 90% of total exports. The largest exported product was coal, accounting for 40%, followed by copper with 20% and crude oil with 10%. The three major products (copper, coal and oil) together accounted for 70% of total exports. In terms of major destination countries of export, China imported more than 90% of total exports from Mongolia. In 2013, copper will take significant share out of coal. And, **in 2014, copper might gain the largest share of the export** once OT will start to contribute full year. In terms of exporting destinations, we expect the **ratio of China will gradually decrease** in the next few years because of the slowdown of the Chinese economy and anti-Chinese sentiments and policies in Mongolia to prevent Chinese from investing in Mongolia. However, because of the landlocked nature and the problem of infrastructure of Mongolia, it is difficult to export to other countries. The ratio of Chinese will still remain at least 70-80% in the next 3-4 years.



Source: Mongolian Authorities, WB staff estimates

Share of Non-Mining Industries in total Export

The composition of export products has changed a lot since 2007. Before, copper accounted for 40% of total exports, followed by textile and gold. The significance of copper among exports declined rapidly as coal exports rose since 2010. As mineral exports increased, the export share of non-mining industries has been rapidly declining since the start of mining boom in 2006. Non-mining industries had taken 60% of total export in 2005 and 30% in 2007. However, the share stood only at 10% in 2012. But, we expect the **share of non-mining industries will increase from now on** because of the favorable policies to encourage the industries to grow by the Government. **Agriculture sector**, which provides more than one third of employment, will be one of the most promising export industries as they can export food products massively to china. In fact, the growth rate of the industry was more than **20%** last year which was the highest in all industries. Unlike mineral sector's export, exporting agricultural products to china will **not bear any sensitive issues** between the two countries.

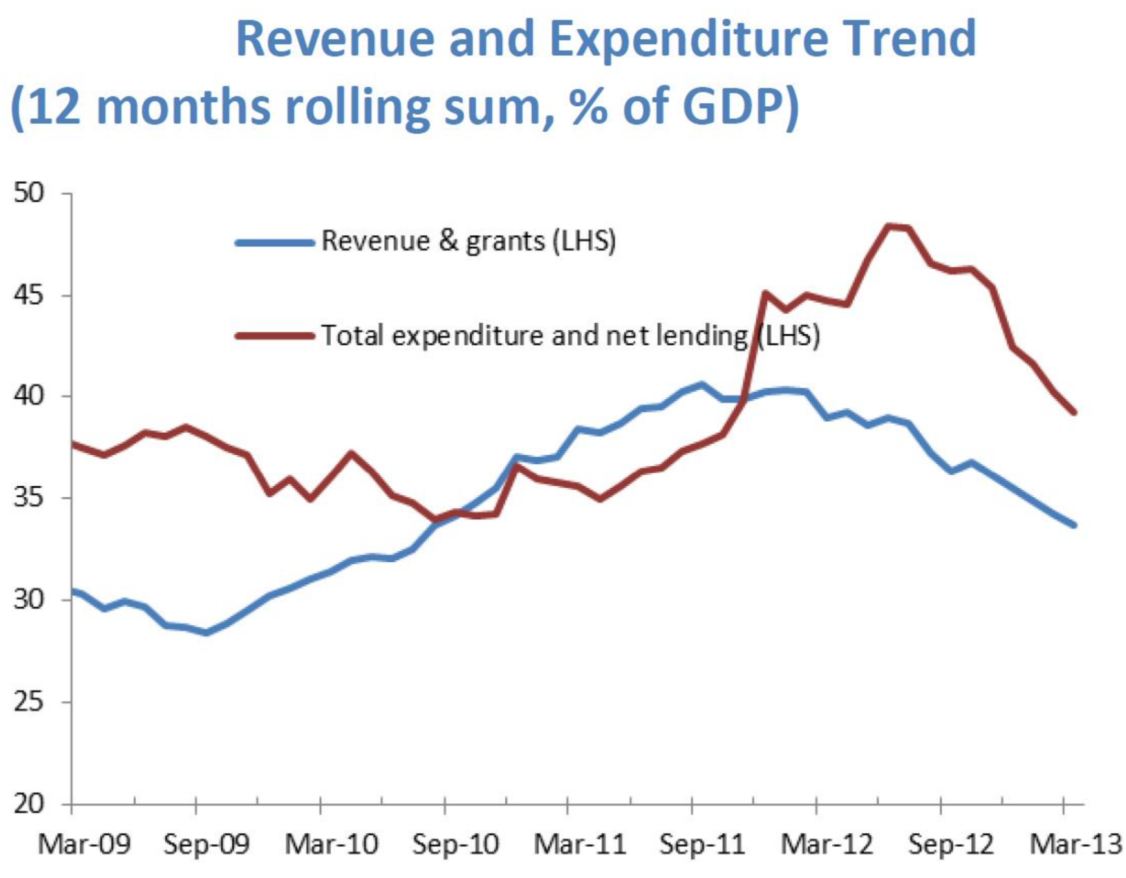
Share of non-mining industries in total export

	2007	2008	2009	2010	2011	2012
Mineral product	**66.8**	**67.9**	**66.4**	**81**	**89.2**	**89.2**
Copper	*43.0*	*32.9*	*26.4*	*26.6*	*20.0*	*19.1*
Gold	*12.4*	*23.6*	*17.7*	*6.2*	*2.3*	*2.8*
Coal	*6.2*	*7.3*	*16.0*	*30.3*	*46.7*	*43.4*
Crude oil	*2.8*	*4.0*	*6.0*	*5.3*	*5.2*	*7.7*
Non-mineral products	**33.2**	**39.7**	**33.6**	**19**	**10.8**	**10.8**
Textile	*13.5*	*8.9*	*10.2*	*7.4*	*5*	*5.3*
Natural stones	*12.1*	*23.7*	*16.4*	*6.1*	*2.3*	*2.8*
Hides, skin	*2.1*	*1.6*	*1.5*	*1.1*	*1.1*	*0.7*

Source: Mongolian Authorities, WB staff estimates

Revenue and Expenditure

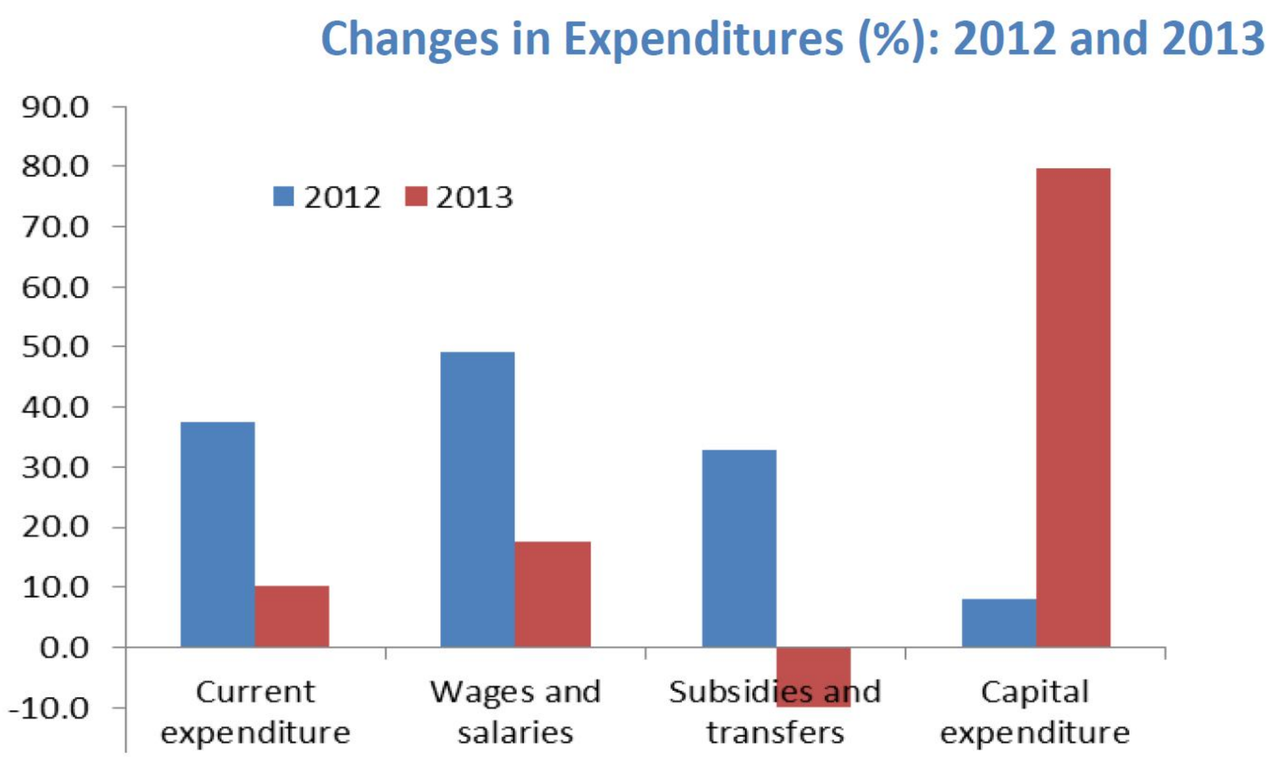
World Bank warns that continuous expansionary and pro-cyclical fiscal policy remains a potential risk to the stable and sustainable growth of the economy. Lessons from the 2008-2009 economic crisis had led Parliament to adopt a Fiscal Stability Law (FSL) in 2010 to meet revenue and expenditure's growth. However, Mongolia's fiscal policy has resumed its pre-crisis pro-cyclical pattern driven by increasing requests for more spending. As significant fiscal deficits continue to increase, capability of the ministry of Finance to cope with sudden mineral market shock would be highly limited as there is not sufficient saving to play as a fiscal buffer in times of the shock. **Painful adjustment of spending** would inevitably have to follow to absorb the revenue shortage, which would **shrink the economy spirally**. Establishment of sovereign wealth fund should be a great idea to save money for the future. Therefore, we encourage the idea should be implemented in few years.



Source: Mongolian Authorities, WB staff estimates

Changes in Expenditure

World bank also warns that the **rapid increases in capital expenditures** also risk undermining the quality of new projects as the public investment management system and the construction sector's capability to absorb extensive new projects cannot be scaled up quickly. Institutions for project appraisal, procurement, contracting and monitoring have not developed yet and are being strained by the rapid increases in the capital budget, resulting in the **poor quality** of these projects. The rapid increase in fiscal spending is also outpacing the **production capacity** of the economy. Mongolia is a small open economy with limited labor and intermediate goods. As public investment is scaled up rapidly beyond the production limit of an economy, insufficient supply of skilled labor and other production factors would likely **increase the costs of production**, leading to high inflation and **poor quality of public investment**. In addition, **foreign skillful labor** is more difficult to get business these days because of policies and the guidance by the Government. And, that is damaging the quality as well.



Source: Mongolian Authorities, WB staff estimates

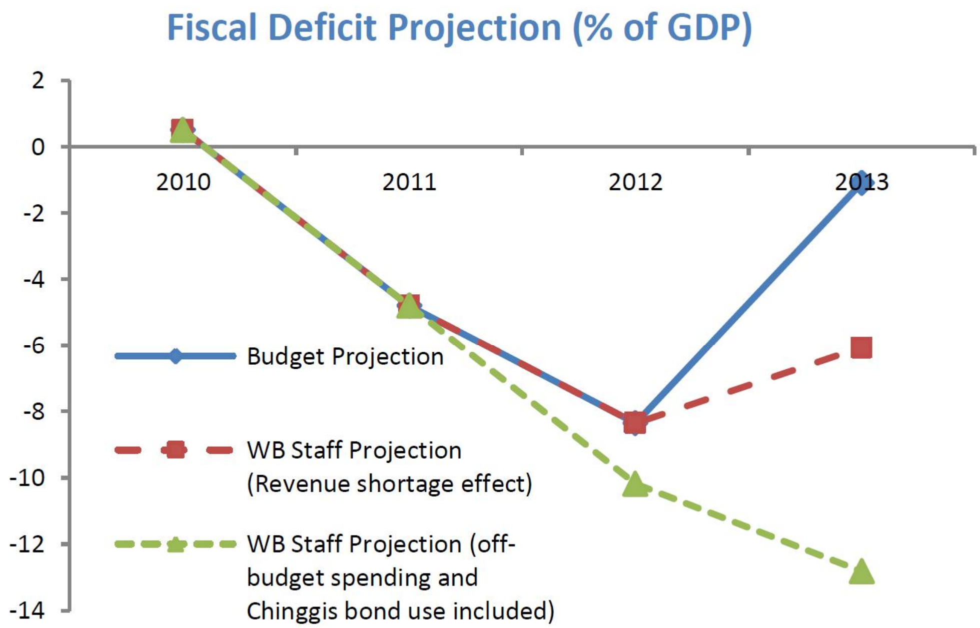
Commercial Production of OT

The commercial production of Oyu Tolgoi will not start in the second quarter as originally planned. Instead, we expect the **mine will start production in August**. Therefore, the increase of the mineral output will delay by almost a quarter. Also, net near term effect of the start of Oyu Tolgoi operations on the balance of payments will be limited in 2013, as gross export proceeds will go mostly to repaying investment costs at the beginning.

In addition, **project finance** worth 4-6 billion USD which was expected to be approved by the Government within the 2nd quarter has not been approved yet. Therefore, the delayed growth contribution of the **OT underground mine** production will be likely to impact growth rate in the medium- and long-term as the full production capacity will not start as originally expected.

Fiscal Deficit Projection

In 2013, the **fiscal outlook is hopeless**. The fiscal deficit is likely to reach around 10% of GDP, although the approved budget keeps it at the 2 percent ceiling of the Fiscal Stability Law. The current revenue projection of the budget was made based on the over-estimated revenue forecast of the 2012 budget and is again likely to overestimate revenue by around 20%. The revenue outturn for the first three months in 2013 confirms this misplaced optimism. Total revenue increased only by 6% between January and March compared with the same period of the last year while the annual revenue projection of the budget is increasing by almost 50%. The budget also includes extra revenue (of about 300mil USD) expected from the re-negotiation of the OT investment agreement which is unlikely at this time. The World Bank projects an **overall budget deficit** to reach 6 percent of GDP and the **structural deficit** at over 7 percent due to the revenue shortage. However, given the weaker economic and revenue forecast, we expect an **overall budget deficit to be bigger than their forecast**.



Source: Mongolian Authorities, WB staff estimates

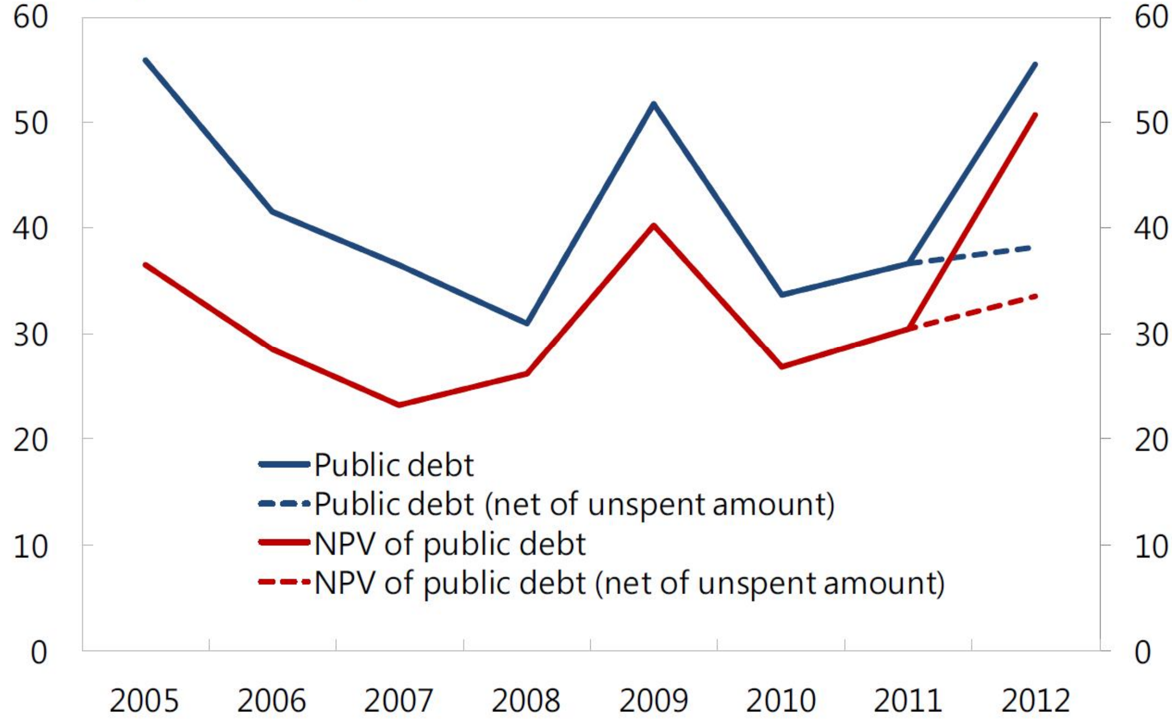
Public Debt and Sovereign Spread

Rising public debt can result in significant burden in the future. Public debt has rapidly risen in 2012 as the large fiscal deficits have been financed by **big external borrowing**. In particular, massive borrowing of over USD 2 billion in 2012 through the DBM and the Chinggis bond mean that those external loans have to be eventually repaid or rolled over at the time those bond will mature in 5-10 years. At the time of maturity, the **large repayment burden** may limit the fiscal allowance seriously. Should the rapidly increasing trend of the fiscal deficit and public debt continue, it would also likely have **adverse impact on the future borrowing cost**. Increased contingent liability to guarantee off-budget financing vehicles including the DBM and PPP projects could also become significant fiscal burden in the future.

Although Government plans to issue **additional 3.5 billion USD debt**, it is difficult for investors to favor the deal unless Government clearly explains how 2 Bil USD raised has been spent. Instead, they might sell the existing bond if they do not like the explanations. At the moment, **Mongolian Sovereign spread** is stable. However, in case the spread widens, the funding cost of the issuance will be higher.

Public debt

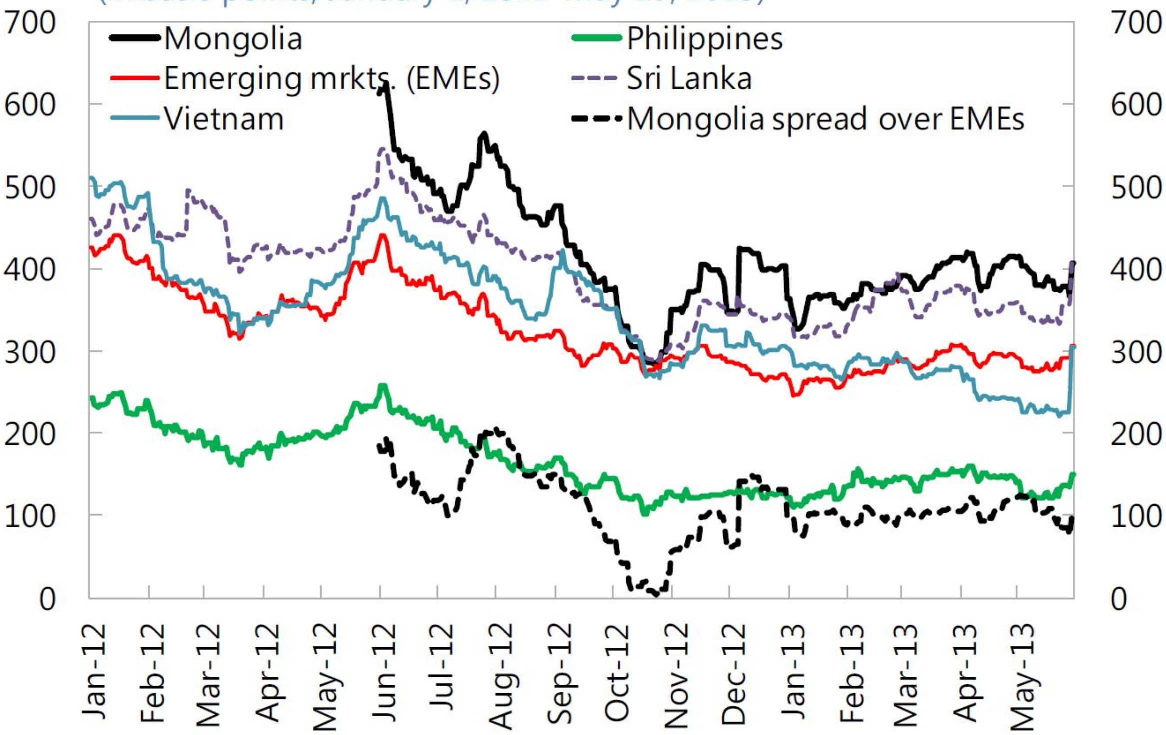
(in percent of GDP)



Sources: Mongolian authorities; and IMF staff esimates.

JP Morgan EMBI Global Sovereign Spreads

(in basis points, January 1, 2012-May 29, 2013)



Source: Bloomberg LP.

Conclusion

After looking at the most recent economic data, we have confirmed our **cautious stance** on the economy. We still keep the **baseline GDP forecast** for 2013 as **6%**. After 1st quarter GDP has grown 7%, 2nd quarter and 3rd quarter GDP will probably bottom at almost zero. As soon as the commercial production of OT starts, 4th quarter GDP will sharply rebound to high teens.