

Mongolia Business Forecast Report Q1 2015

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Abstracts

Core Views

Our core scenario remains for the second phase of the Oyu Tolgoi (OT) mine expansion to commence in early 2015, which will help underpin growth in the coming years as investment and production pick up. We forecast real GDP growth of 8.0% in 2015 and 8.1% in 2016, from 7.4% in 2014. That said, persistent uncertainties clouding Mongolia's political and business environment outlook suggest that risks remain to the downside. We expect policy implementation will remain hampered by strong opposition in parliament.

The Mongolian togrog is likely to remain range-bound over the coming months and we forecast the unit to end 2014 at MNT1,850/USD as investors remain on the sidelines despite the recent resolution of the tax dispute regarding the expansion of the OT mine. Over the longer-term, we forecast a mild appreciation, reaching MNT1,800/ USD in 2015 and MNT1,700/USD in 2016, supported by improved economic growth prospects.

Headline inflation remains firmly in double-digit territories, stoked by the Mongolian togrog's depreciation and the government's housing stimulus. With the Bank of Mongolia (BoM)'s latest 150 basis points (bps) hike in its monetary policy meeting in July to 12.00%, we expect the central bank to keep its key policy rate on hold. The combination of weaker economic activity, currency stability and a slowdown in monetary aggregates suggest that there is little need to hike interest rates further. The central bank will allow the rate hike to take effect over the coming months, easing inflationary pressures in the country.

The Mongolian government continues to make considerable expenditure through the Development Bank of Mongolia, which is operating off-budget. We remain concerned about the country's overall fiscal deficit over the coming years as it will remain elevated.

Moreover, the government is facing increasing political and social pressure to further increase its fiscal spending to offset the impact from the weakening economy. This presents risks to the country's long-term fiscal sustainability.

Major Forecast Changes

We have downgraded our real GDP forecast for 2014 to 7.4% from 11.7% as a weak H114 performance will weigh on the outlook for the year. With rising twin current account and fiscal account deficits stoking inflationary pressures higher and the Mongolian togrog weaker, we believe the risks to growth are to the downside, and note that assistance from a multilateral organisation may be needed should a crisis occurs.

We have revised our 2014 year-end currency forecast to MNT1,850/ USD from MNT1,935.00/USD previously and expect the unit to remain range-bound over the coming months. Beyond 2014, we expect mild appreciation, revising our year-end forecast to MNT1,800.00/USD in 2015 and MNT1,700.00/USD in 2016 (from MNT1,850.00/USD and MNT1,685.20/USD, respectively).

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The Mongolian government will face major domestic challenges over the coming decade as the country's mining boom takes off, and it seeks to strike a balance between distributing the revenues in a way that is acceptable to the population, while avoiding stoking inflation. Moreover, we believe it will face a tough task in managing the social change that the mining boom will create, including immigration and the growing gap between rich and poor. In foreign policy, the government's chief priority will remain avoiding falling too much under the influence of neighbours Russia and China, though we believe the latter in particular will prove almost impossible.

CHAPTER 2: ECONOMIC OUTLOOK

SWOT Analysis
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We have downgraded our forecast for real GDP growth in Mongolia from 11.7% to 7.4% in 2014 as a weak H114 performance will weigh on the outlook for the year. That said, we forecast an acceleration to 8.0% in 2015 as the economy rebalances the second

phase of the Oyu Tolgoi expansion commences .

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The Mongolian government's overall fiscal deficit will continue to be a concern in 2015. Although the expansion of the second phase of the Oyu Tolgoi project in 2015 will boost revenues on the back of an increased collection of duties, they will be insufficient to cover the government's high expenditures, which are mostly recorded off the budget through the Development Bank of Mongolia.

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Since the Bank of Mongolia hiked its key policy rate by 150 basis points to 12.00% in its policy meeting in July, inflation has edged down marginally. We maintain our forecast that the central bank will keep interest rates on hold until H115, as slowing credit growth and greater currency stability will ease price pressures over the coming month.

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The Mongolian togrog is likely to remain range-bound over the coming months and we forecast the unit to end 2014 at MNT1,850/USD as investors remain on the sidelines despite the recent resolution of the tax dispute regarding the expansion of the Oyu Tolgoi mine.

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At face value, Mongolia's long-term economic prospects appear nothing short of formidable, such is the size of untapped natural resource wealth in the country, and we expect the country to remain one of the fastest-growing economies globally through to 2023 (at an annual average clip of 7.0%). That said, we do not expect the coming decade to be smooth sailing. Structural factors such as the magnitude of investment spending, the unprecedented scale of money creation, a gradual erosion of the local business environment, and question marks over the sustainability of long-term Chinese commodity demand all point to a more volatile growth trajectory for Mongolia in the years ahead.

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