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Mongolia Business Forecast Report Q2 2014

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Abstracts

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Core Views

Recent rhetoric and policy actions from the government of Mongolia suggest that a resolution to the stand-off with mining majorRio Tinto over the Phase 2 expansion of the Oyu Tolgoi (OT) mine will eventually come to a resolution in early 2014. We expect both parties to reach an agreement to move forward by the December 12 deadline, which points to a resumption of Phase 2 operations and investment in one of the world's largest untapped copper and gold mines in 2014. Such a scenario would provide a much needed tonic to both Mongolia's investment climate and long-term growth prospects.

In line with our expectations, a precipitous decline in foreign direct investment (FDI) has forced the Mongolian authorities to ink a more market-friendly investment law. While this is encouraging, more work needs to be done to provide a stable and transparent business environment for foreign companies. Indeed, we note that future business environment improvements will be more difficult to achieve as the country's weak fiscal position pressures the government to repeatedly seek more favourable terms for contracts, presenting risks of policy changes to the foreign investors and businesses. With headline inflation also starting to creep upwards, we believe that the Bank of Mongolia (BoM) will have to tighten rates in 2014. Our projection for 100 basis points (bps) worth of interest rate hikes should help ease the inflationary pressures stoked by stimulatory spending by the government in H213.

At face value, the Mongolian government has worked wonders on its public finances in 2013, with the nominal budget deficit on course to come in at 1.5% of GDP, down from a 12-year high of 7.7% in 2012. However, these numbers fail to take account of the considerable expenditure undertaken by the Development Bank of Mongolia (DBM), which is operating off-budget, as well as deferring significant portions of its capital expenditure. With this in mind, we doubt whether the authorities will be able to keep within the 2% of GDP structural deficit limit mandated by the Fiscal Stability Law (FSL) in 2014, and failure to acknowledge this will continue to hurt fiscal credibility.

Major Forecast Changes

We had previously been calling for 125bps of hikes next year, but given the growing stresses seen in the banking sector, we have decided to revise this down to 100bps. We noWexpect the central bank to hike rates to 11.50%.

Key Risks To Outlook

Upside Risk: An early start of the second phase of expansion at Oyu Tolgoi (OT) would help galvanise investment activity. Downside Risk: In a worst-case scenario, a collapse in Chinese economic growth and, by extension, demand for commodity imports in H114 would seriously hamper Mongolia's growth prospects. Further delays in the resolution of the Oyu Tolgoi expansion could weaken investor confidence, which could force the BoM to hike rates beyond the 100bps we forecast (to the detriment of the banking sector), in order to shore up the currency.

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Further Policy Improvements Harder To Come By the Mongolian parliament approved significant amendments to a variety of laws in H213, such as a roll-back of the Investment Law. We believe these changes acknowledge the country’s reliance on foreign capital to sustain an elevated pace of growth and development, and expect this need to keep the government on track in maintaining a friendly business environment. That said, we believe greater improvements will be increasingly difficult to deliver as the ruling Democratic Party (DP) is increasingly hampered by fiscal constraints and a nationalistic coalition partner.
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Transforming Minerals Into Wealth 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 accep Table 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.

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We maintain that Mongolia will enjoy a pick-up in real GDP growth in 2014 towards a forecasted 14.6% from 11.5% in 2013, with new projects such as Oyu Tolgoi (OT) supporting export growth. However, there remain sizeable risks that a sustained

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gridlock between the government and foreign investors over the operations of the country's largest mines could weigh on the export performance. Moreover, instability in the Chinese banking sector could lead to a sharper slowdown in the mainland economy, which could thereby weigh on
Mongolia's growth through weaker export demand.

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Government To Defer Spending In 2014, Yet Again The Mongolian government succeeded in keeping its fiscal deficit for 2013 within the limits set out by the Fiscal Stability Law of 2.0% of GDP. That said, expenditure deferral was the main reason supporting the 76.7 % contraction from a deficit of MNT1.1trn in 2012. We expect the government to try to maintain its expansionary fiscal stance, although we believe that its failure to lift the deficit cap will force it to defer spending in 2014. Even if the law was amended, we see scope for market forces to cap any increase in debt and similarly force the government to delay spending.

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We believe that the Bank of Mongolia (BoM) will have to begin hiking interest rates in 2014, as inflationary pressures have been accelerating. We forecast the monetary authority to hike its benchmark interest rates by 100 basis points (bps) to bring the policy rate to 11.50%, which we expect to be sufficient to offset some price pressures stoked by the government's stimulatory programmes. That said, we see risks that the BoM may be forced to allow prices to head higher especially if banking sector stresses escalate on the back of a sharp economic slowdown.

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Although Mongolia's merchandise trade deficit narrowed 11.6% y-o-y in 2013, we believe that this is unlikely to be repeated given the country's need for foreign investment to enable it to extract its mineral riches. Our poor outlook for demand and prices of key export commodities further supports our view for a widening trade deficit. That said, we note that should there be any deterioration in the country's business environment, foreign investors could head for the exit, and force a sharp adjustment to Mongolia's external accounts.

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the Mongolian Economy To 2023

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Fierce But Volatile Growth In Store

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 2022 (at an annual average clip of 8.9%). 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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