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Asia Pacific

Mongolia Macro View

Takeaways from Ulaanbaatar: Key Stalled Issues Started Moving

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- *Citi organized macro meetings with officials, economists and mining/business experts.*
- **Cautiously constructive** – Long-term potentials intact. Previous stalled issues appear to be moving again with the fast learning of the new government administration. Mood for resource nationalism likely to stay, but government is acting pragmatic. We think the revision to the Strategic Entities Foreign Investment Law, withdrawal of the controversial mining law draft, and the proposal of a new investment law (that repeals the SEFIL) are positive steps towards regaining foreign investment confidence.
- **Exports could recover in the coming months.** Negotiations between the Government and Rio Tinto appear to be moving ahead, and there seems to be a strong consensus on the importance of facilitating OT exports. The June schedule for new exports of copper from Oyu Tolgoi looks intact. Recent resumption of coal exports at Erdenes Tavan Tolgoi to Chalco is also exports positive.
- **Current election cycle ending…** The Presidential Election on June 26 would mark an end to the current election cycle. Polls suggest that incumbent President Elbegdorj will likely be re-elected. We expect a period of (relative) political stability and policy continuity (at least for two years, before the next round of elections in 2016).
- **Initial success at taming inflation; making room for BoM to cut.** The Price Stabilization Program and the diversification of petrol import sources appear to have calmed down inflation lately. We expect CPI for 2013E to average around 10.8%yoy. However, we forecast inflation could end the year somewhat higher on better economic activities, fiscal expansion and monetary accommodation. This in turn could make room for additional monetary easing (we built in another 50bps policy rate cut this year), should exports and FDI uncertainties linger.
- **Fiscal expansionary mode, more clarity on fiscal accounting needed in likely budget amendment.** MED and DBM have a list of investments lined up; however, there remain concerns on how fiscal budget can fund all these investment plans and yet not breach the 2% structural deficit ceiling stipulated in the Fiscal Stability Law. The use of DBM as an off budget financing vehicle has been frequently criticized. Our fiscal deficit project of 6.3% of GDP for 2013E factors in half of DBM's investment plans that are of a more 'social' nature.
- **Expect more international debt issuance despite approaching debt ceiling.** DBM is seeking a potential dim sum bond issuance this year, while there is less urgency for further issuance of the sovereign dollar bond as the previous proceeds still have to be fully disbursed.
- **Market implication:** We see mild MNT depreciation to continue in the near term and room for Mongolia dollar bonds to outperform.

Takeaways from Ulaanbaatar: Key Stalled Issues Started Moving

We organized macro meetings with various government officials, economists, business/mining experts in Ulaanbaatar on 8-9 May.

Unblocking some bottlenecks

We turn somewhat more constructive after our research trip last week. Although there have been few doubts on Mongolia's long-term mining boom story, comments from international press have been bearish and many foreign investors have turned much more cautious, at least for the near term. Sense of cautiousness has been mounting on political noises since last June's Parliament elections, the several hiccups in mining projects and changes in key policies which together are perceived as rising resource nationalism.

We expect macro improvements in 2H. NSO just released that real GDP grew at 7.2%yoy in 1Q13, vs. 16.7%yoy seen in 1Q12 and 12.3%yoy for 2012 (Figure 2). The economy slowed down in 1Q13 mainly on the 7.8%yoy drop in merchandise exports (Figure 4). The sluggish Chinese demand and fall in commodity prices in 1Q:— for coal (by ~9%), copper and gold (both by ~5%) continue to take a toll on the economy, as these three key commodities respectively account for 43%, 19% and 3% of total exports. Despite this, we are maintaining our full-year GDP growth at 13.8%yoy as our expectation of sizable export increase in 2H remains intact as large mines come on stream. In particular we have noted several previous stalled issues appear to be moving again with the fast learning of the new government administration. Officials and economists we met continue to expect double-digit growth for this year and beyond. It appears to us that officials are less concerned about the near-term slowdown, which was mostly thought of as a temporary phenomenon, and instead they are focused on how to facilitate stable growth in the long run. We especially are encouraged to see positive developments on the following fronts:—

- **Banking on exports prospects from new production and gradual recovery in Chinese demand:**

1. **Commercial production of Oyu Tolgoi's (OT) copper on schedule.** Ongoing negotiations between the Government and OT regarding cost overruns and tax pre-payments appear to be progressing positively. Meanwhile, Rio Tinto and the Government have agreed to continue funding the US$6.2bn Phase I project. There seems to be a strong consensus on the importance of facilitating Oyu Tolgoi exports with expectations that Rio Tinto will get its necessary permits in a matter of weeks to pave the way for export shipment by June. Given high margins of copper, (unlike coal) demand for copper remains larger than available supply, OT's already prepared stock of bagged and to-be-bagged copper, export revenue could trickle in as soon as relevant permits are granted. If materialized, this would satisfy the key underlying assumption of export boost in our GDP forecast.

2. **Coal production from state-owned Erdenes Tavan Tolgoi (ETT) has resumed.** Back in January, ETT suspended coal delivery to Aluminum Corporation of China (Chalco), as the fall in coal prices plus transportation costs had rendered coal delivery at the agreed selling price as not economically viable. Notwithstanding the difficult environment for coal prices, coal shipments from ETT resumed following the resolution of dispute with Chalco in late-April. According to press interview of the Mining Minister, the coal exports have resumed based on Gashuun Sukhait border port price. Despite volatile coal prices, the business decisions to first mine coking coal (instead of thermal coal)

and/or export washed coal would help support mining companies' profit. Export efficiency could be enhanced by 2015 — when current truck load/off-loading is replaced by the use of the 267km railway segment from the TT coal field to the Chinese border. This will provide additional cost savings, which is estimated to range from US$8-20 per metric ton of delivered coal. Last week's announcement that the Government and Mongolian Mining Corporation have reached a preliminary settlement agreement on the railway is also a key step forward to resume the railway project.

- **FDI has fallen dramatically since Aug12 (Figure 3)** as foreign investment confidence was hampered by regulation uncertainties amidst rising resource nationalism, coupled with the winding down of Phase I of Oyu Tolgoi. We think the investment climate could improve, especially post election and as Rio sorts out financing for Phase II of OT. Actually FDI rebound in Mar13, making up for the lackluster performance seen in the first two months of the year, suggests that the on-the-ground investment climate was not as dire as the international press was portraying at that time. The impression we have received from our meetings with local and foreign mining experts is that they are turning relatively more constructive, post the several developments over the recent weeks.

3. **Private firms are now exempted from parliamentary approval** (but registration still needed) **in the revision on the Strategic Entities Foreign Investment Law (SEFIL).** The SEFIL enacted in May 2012 was thought to be the main culprit to have caused the sharp fall in FDI, as it restricted foreign investments in key sectors (like mining, banking, media and telecom) to 49% and subjected each case to parliament approval. The latest amendment made on 19 April has re-opened doors to foreign-private investors; however, it has further tightened investments by foreign state-owned-enterprises where now all such investments and regardless of size would require approval by Mongolia's cabinet. This straight clause will remain a key impediment for Chinese SOEs to expand business in Mongolia.

   Furthermore, we expect a repeal to the SEFIL through a New Investment Law coming. MED has proposed a New Investment Law that aims to enforce investment stability, such that investments made under today's regulation won't be arbitrarily changed over a certain period (i.e. ensuring new rules would be guaranteed from further law amendments, long-term investment plans could thereby weather through different election/government cycles). This proposal has been submitted to Parliament and approval could come before the spring plenary session closes on July 10.

4. **President Elbegdorj has withdrawn the controversial Mining law Draft.** In a likely political move ahead of the election, the President led the legislation drafting back in Jan; but the draft was met by strong opposition from miners and the Mongolian Business Council. Ministry of Economic and Development (MED) has confirmed that the proposed draft has been withdrawn and will be resubmitted after the election. We were also reassured that the two draft terms that were considered as non-business friendly would be removed. The two previously proposed terms refer to:— 1) requiring exploration decisions to be approved by hyper-local level (including villages), and 2) the Government will be entitled to free stake in all companies developing strategic deposits, where the percentage ownership is decided on a case by case basis.

5. **Phase II of Oyu Tolgoi would bring in FDI.** We have confirmed that OT will likely recycle proceeds from Phase I into Phase II. Rio also announced last week that financing for Phase II has been arranged with 14 banks from 10 different countries. An international backing of finance certainly reflects investors from around the world remain confident in the long-term mining prospect of this project. With financing sorted out, FDI for OT Phase II could trickle in the later part of the year.

Quelling inflation with innovative ways

Post our trip, we have also turned more confident in near-term sustainability of at least low double-digit inflation. CPI inflation has calmed down from its recent peak of 16%yoy in May 2012 to 9.8% and 10.4% in March and April (Figure 5). We expect CPI for 2013E to average around 10.8%yoy, and depending on the base effect and food prices, we could again see individual months of single-digit CPI prints. However, we remain skeptical of BoM's 8% inflation target by year-end; we forecast inflation could end the year somewhat higher on better economic activities, fiscal expansion and monetary accommodation. After-all, M2 and credit growth as of April13 remain high at 13.1%yoy and 30.8%yoy, respectively; abundant liquidity likely to instill demand inflation later in the year. But for the near term, two recent developments will likely contain inflation:—

1. **The implementation of Price Stabilization Program since last Oct appears to be yielding initial success.** The Government and BoM have made joint efforts to stabilize prices of oil, meat, flour, addressing transportation bottlenecks of imported consumption goods, and promoting construction to stabilize housing prices. Especially, the measures to stabilize prices of staples via building food reserves will likely help ease food price spikes as it accounts for 20% of the CPI basket.

2. **Diversifying petrol importing source is helping to lower prices.** Mongolia has no oil refining industry and its first oil refinery is expected to be built by 2015. Mongolia in the past imported ~90% of its petroleum from Russia, and petro imports account for ~20% of Mongolia's total imports. Mongolia suffered from a sequence of price hikes by its largest Russian supplier 'Rosneft' late-2012 and early 2013. This in turn adds on to the inflation bill, as petrol accounts for 6% of the CPI basket. Therefore, in 1Q, Mongolia stepped up on diversifying its petrol import sources to Switzerland, South Korea and China. In particular, Mongolia made an agreement with PetroChina to exchange crude oil drilled in Mongolia with end products refined in Inner Mongolia. We have also heard that negotiations with Russia counterparts to stabilize import price were made. Moreover, as part of the price stabilization program, BoM has offered banks cheap credit to lend to oil import companies, to reduce volatility in retail petrol price.

We now expect another 50bps cut in policy rates this year. The central bank has unexpectedly cut rates twice by 175bps this year (Figure 6). We believe BoM's accommodative stance is likely to stay, and could further cut rates given its success in using supply-side measures to tame inflation. We sense the BoM is taking a leading role to buffer any slowdown in economic activities that arise from external demand uncertainties and still soggy investment climate.

Concrete investment plans, funding coming in place, but how to jive with the FSL?

In general, we continue to see fiscal expansion to continue in the years ahead. The above mentioned BoM facilitation of loans to bottlenecks in the economy would in turn create additional liquidity for the economy. Aside from mining related investments, MED and DBM have lined up a series of large-scale infrastructural projects which are either under way or will commence in the near term including: autoroads, railway to connect first from TT to the Chinese border, power plant to supply electricity for OT and TT. The railway would also have a second phase extension to connect to Russia. DBM has sponsored feasibility studies to build a US$10bn Sainshand Industrial Complex that is located between OT, TT and the oil fields in the Eastern provinces, aiming to cater for mining related value adding services, oil processing, factories for construction materials, etc. For revenue generating projects, the government intends to employ the public-private partnership (PPP) model by sponsoring one-third of the project cost by fiscal funds, which could in turn help attract private investments for the remaining two-thirds. Aside from concerns of investment efficiency, this fiscal pump priming should lay the ground work for future economic growth.

The challenge remains on how to fund all the above mentioned public expenditures and yet comply with the Fiscal Stability Law (FSL). While we are encouraged to see projections for recurrent spending are conservative (i.e., no large pay hike for civil servants) nor cash transfers for this year, we worry that large-scale capital expenditures would not be met by fast enough revenue growth. Officials that we met also acknowledge that the +47%yoy VAT and +76%yoy custom duties revenue growth assumptions stated in this year's budget are aggressive, given that the declines in trade related tax incomes have been lackluster thus far this year (-7.2%yoy in Jan-Apr13). This could likely result in budget amendment (possibly in the Fall); which would likely revise lower the revenue assumptions and some capex plans may have to be deferred to next year in order to comply with the FSL's 2% structural deficit ceiling.

We expect general government balance for 2013E to reach a deficit of 6.3% of GDP. Actually fiscal discipline in the first-four months of the year has been promising, the general government budget balance achieved further surplus improvement in April (of MNT136bn) as tax revenues rose 9.4%yoy YTD while expenditures only rose 4%yoy. However, planned expenditures are high for the full year. Even assuming that the Government makes the necessary cuts in planned expenditure after building in realistic revenue and GDP assumptions in the amended budget to achieve the 2% structural deficit ceiling, one should also factor in DBM spending into the calculation. (Note that supranationals and rating agencies have been very critical on Mongolia's usage of DBM as their off-budget vehicle, see World Bank's *Mongolia Economic Update* published in April for detail analysis.) According to DBM, the proceeds from its previous international bond of $580mn has been used; and we assume these are mostly allocated to the previous year's fiscal books. For the remainder of the year, project financing estimated by DBM is around US$1.6bn — of which $1bn would be allocated from the Chinggis bond proceeds, a potential dim sum bond issuance of the equivalent of US$200-300mn and other local bond issuances. The spending will focus on auto road (42% of total), mining (15%), social housing/SME fund (13%), construction materials (9%), energy (9%), railway (7%) and utility (6%). We assume around 50% of these projects are for social developments and therefore cannot directly generate revenue. As a result, an additional 4.3ppt should be added to the comprehensive fiscal deficit.

The public debt ceiling stipulated in the FSL should act as the key guarding post to prevent fiscal runaway in the near term. The Debt Sustainability Analysis done late last year by IMF and World Bank staff projected Mongolia's external and public debt ratios would improve substantially over the medium term. In addition, the FSL specified a cap on public debt (which includes Chinggis and DBM bonds) at 50% in net present value (NPV) terms in the transition year of 2013 and the cap is to reduce to 40% by 2014 and thereafter. (Two related side notes that deserve mentioning: 1) there are ongoing discussions on how to define NPV; and 2) the Government is banking on double-digit GDP growth to ensure that it can meet the 40% ratio by 2014).

According to officials estimates, there is around MNT1.1 trn (or US$730-780mn) of room before reaching the 50% ceiling for this year. So aside from the potential DBM dim sum bond of US$200-300mn mentioned above, there is approximately US$500mn room for additional Chinggis bond issuance this year (which still have an outstanding $3.5bn quota from the GOM bond issuance mandate). However, we don't sense an urgency that the Government will tap the international market near term as the previous US$1.5bn has not fully been disbursed and the timing to tap depends on progress in the funded projects.

Coming to the end of the current election cycle

This election cycle that began with parliamentary polls in late June 2012 will end with the Presidential Election on June 26. According to the latest poll, Politbarometer (published on April 13) by Sant Maral Foundation, incumbent President Tsakhiagiin Elbegdorj leads by a wide majority, ahead of the other candidate (a former champion wrestler) Bat-Erdene. The other candidate Natsag Udval (first female candidate nominated in Mongolia's president election history) was not ranked in the poll. The likely winning of the incumbent President Elbegdorj, plus the fact that he is from the Democratic Party (DP) which is the majority party in the ruling coalition, will help ensure political and policy stability (at least for another 2 years before the next round of elections in 2016), and some project implementations could even gather steam. Having said that, we are mindful of potential big-ticket election promises (which could change the fiscal and/or inflation picture). And if Mr. Elbegdorj wins, the winning margin would also have an implication on his future policy stance of opening up to FDI/resource nationalism.

Post election, we expect more "pragmatism". Rhetoric of resource nationalism is expected to be replaced with "pragmatism" post the Presidential Election, especially given the sharp decline in FDI. In fact, the "silent" withdrawal of the controversial revised mining bill and the recent revision to the more draconian version of the SEFIL is already a growing sign of "pragmatism". As mentioned above, we could see a move to repeal SEFIL through a New Law on Investment and the passage of a friendlier mining law post elections, these if materialized could restore some market confidence on Mongolia. Also in order for ETT equity listing in Hong Kong in 2014, the New Securities Law that is currently in Parliament reviewed, if not passed in this session, could be passed in the next session after the Elections. An updated Securities Law will pave the way for dual listing of companies, more financial products (e.g. asset backed securities, ETFs, other derivatives), capital market access for pension funds, banks/non-banks/insurance companies, and offering depository receipts and custodial services.

Market Implications:

We still expect mild MNT nominal depreciation in near term, but would resume appreciation in medium and longer term. The MNT has depreciated by approximately 10% since the low seen in April 2012, or ~3% since the beginning of the year, on politics, falling FDI and exports. Spot is at 1438 on 15 May (Figure 7). We expect MNT to still see mild depreciation in the near term, until export, FDI and growth prospects materially improve in 4Q. Our year-end forecast is MNT1400/USD.

Mongolia dollar bonds have room for outperformance. As mentioned above, we change our view on Mongolia and turn marginally more positive, expecting room for further outperformance in the coming months. We had previously been more negative on Mongolia dollar bonds on the back of weak policy credibility and the sharp commodity price slump that undermined the country's already weak external and fiscal picture. (see p.15 of *Asia Macro and Strategy Outlook - It's Raining Yen… Hallelujah?*). We have generally been quite cautious on Mongolia in the last few months given policy uncertainty, especially on the back of resource nationalism noise and pro-cyclical fiscal (and more recently) monetary policies. This noise has prompted Mongolia sovereign and quasi-sovereign spreads to significantly underperform other "higher yielding" Asia peers since late last year, most recently driven by negative rating actions (S&P put Mongolia's outlook on negative in April, Moody's puts a negative outlook on Mongolian banks), a commodity price slump that could undermine growth prospects (especially the slump in coal prices) and pressure on external finances amid a sharp deterioration in FDI. Mongolia 22s are now trading about 65bps wider than Sri Lanka 22s on z-spreads (Figure 7 and 8).

However, in the coming months, we see catalysts for marginal outperformance of Mongolia vis-à-vis Sri Lanka that could narrow the spread difference back to the 30-40bps range. To summarize from the above, we see three key catalysts:

(1) Better exports prospects as early as June as we get further signs Oyu Tolgoi will start exporting copper and the recent resumption of coal production and shipments at ETT.

(2) Rhetoric of resource nationalism is expected to be replaced with "pragmatism" post Presidential Elections.

(3) Dollar bond supply from Mongolia does not look too imminent. Meanwhile, Sri Lanka banks are in the pipeline for another $1bn issuance in the near term.

In comparison to Sri Lanka, the lack of policy clarity and consistency is still much higher risk in Mongolia than in Sri Lanka – we think Sri Lanka has demonstrated significantly more fiscal discipline than Mongolia given harder budget constraints it faces. However, if some of the structural bottlenecks for investment in Mongolia can be partially resolved through improved policy clarity on investments, the more significant upside to Mongolia's real GDP growth vs. Sri Lanka could help it absorb its less responsible fiscal policy without seriously undermining debt dynamics and solvency. While external position is deteriorating more in Mongolia recently, we note that Sri Lanka's stabilization of external finances also remains relatively fragile given reliance on foreign commercial borrowings. Even at US$3.5bn of reserves as of March (declining from $4bn in end 2012), Mongolia's reserve coverage ratio relative to short-term liabilities is still far stronger than that of Sri Lanka.

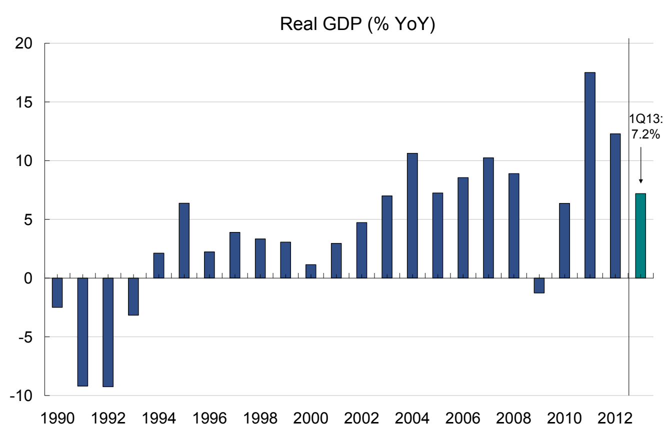
Thus, while the policy uncertainty will still warrant Mongolia trading at premium to Sri Lanka, we think the spread gap could narrow from the current 65bps range to eventually about 30-40bps if some of the negative investment headwinds can be addressed.

Figure 1. Mongolia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013	2014
Mongolia									
Nominal GDP, US$ bn	3.4	4.2	5.6	4.6	6.2	8.8	10.3	12.4	15.7
GDP per capita, US$	1323	1616	2106	1691	2245	3129	3575	4246	5312
Population, mn	2.6	2.6	2.7	2.7	2.8	2.8	2.9	2.9	3.0
Real GDP, % yoy	8.6	10.2	8.9	-1.3	6.4	17.5	12.3	13.8	11.0
CPI, % yoy	8.1	15.1	22.1	4.2	13.0	10.2	14.0	10.2	10.0
CPI, % avg	4.5	—	28.0	8.0	10.1	9.2	14.3	12.0	10.0
Policy interest rate, % eop	—	8.40	9.75	10.00	11.00	12.25	13.25	11.00	11.50
Long term yield, % eop	26.93	21.83	20.58	21.67	20.07	16.61	18.11	15.61	16.81
lc/US$, eop	1164	1172	1275	1433	1233	1378	1378	1400	1331
lc/US$, avg	1181	1171	1167	1434	1349	1256	1353	1418	1352
Current account (US$ bn)	0.2	0.3	-0.7	-0.4	-0.9	-2.8	-3.2	-2.8	0.5
% of GDP	6.5	6.3	-12.8	-8.9	-15.0	-31.5	-31.3	-22.6	3.2
Trade balance (US$ bn)	0.1	-0.2	-0.7	-0.3	-0.3	-1.8	-2.4	-2.2	-2.0
Exports (US$ bn)	1.5	1.9	2.5	1.9	2.9	4.8	4.4	5.6	6.8
Imports (US$ bn)	1.5	2.2	3.2	2.1	3.2	6.6	6.7	7.7	8.8
FDI, net	—	0.4	0.8	0.6	1.6	4.6	3.9	3.2	3.0
International reserves (US$ bn)	0.6	0.8	0.6	1.3	2.2	2.3	3.9	4.4	4.9
Consolidated government balance (% of GDP)	7.6	2.6	-4.5	-5.2	0.5	-4.8	-8.3	-6.3	-5.2
Public debt (% of GDP)	40.6	36.0	30.6	48.7	42.1	55.0	47.8	50.0	40.0

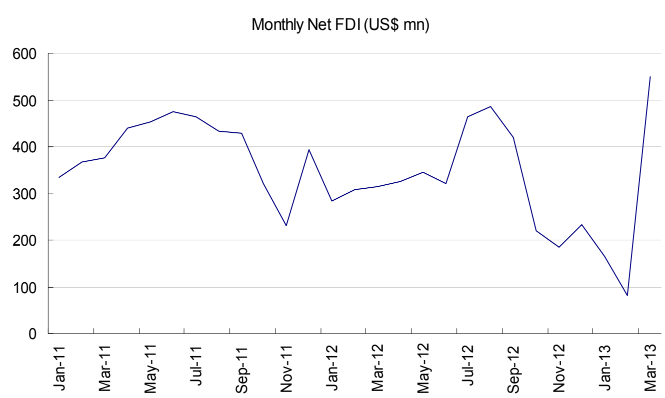
Source: CEIC Data Company Limited, IFS, IMF, Haver, Moody's and Citi Research estimates

Figure 2. Annual and 1Q13 Real GDP Growth – slowed in 1Q13



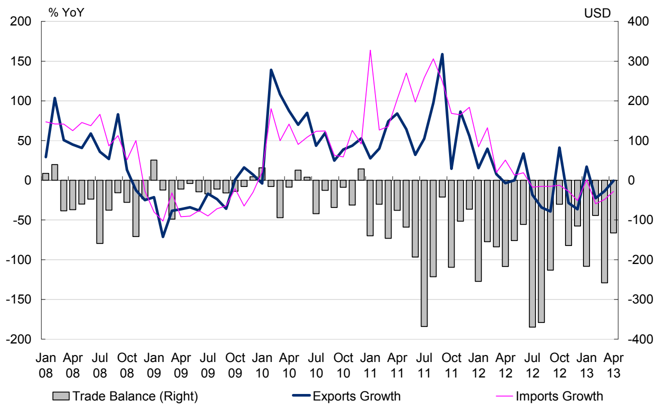
Source: CEIC, NSO and Citi Research

Figure 3. Recent falling FDI trend actually rebounded in Mar13



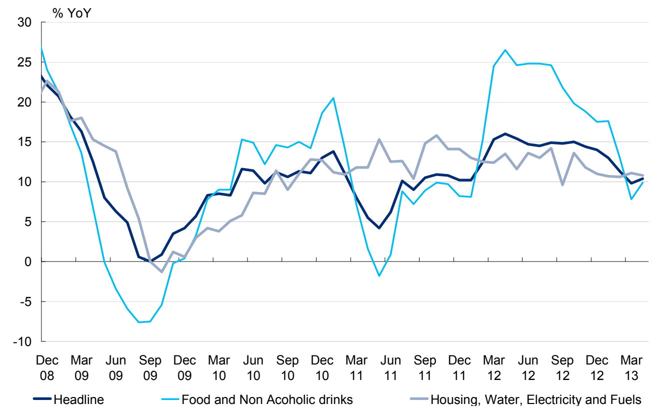
Source: BoM and Citi Research

Figure 4. Export trend still subdued, but less negative in April. Imports growth in negative on the winding down of Phase I of OT



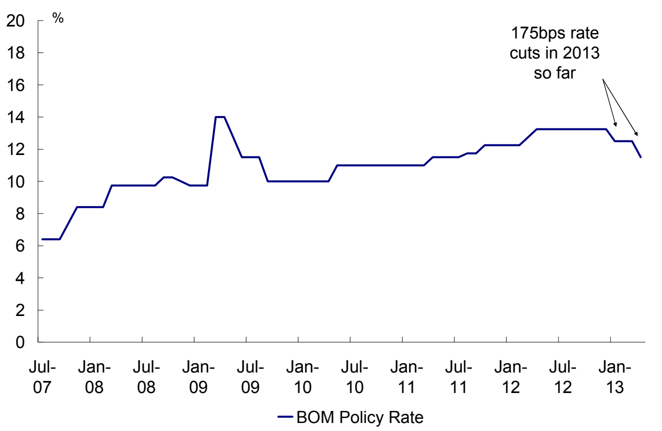
Source: CEIC and Citi Research

Figure 5. CPI inflation appears to be stabilizing in low double digits



Source: CEIC and Citi Research

Figure 6. We expect another 50bps rate cut in 2013E

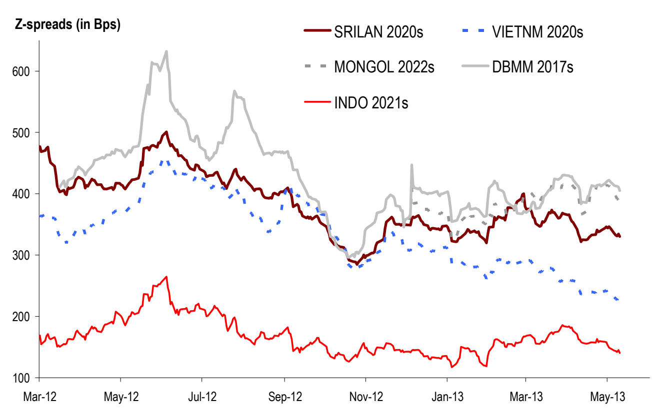


Source: BoM, CEIC and Citi Research

Figure 7. MNT likely to stay in depreciating mode in near term

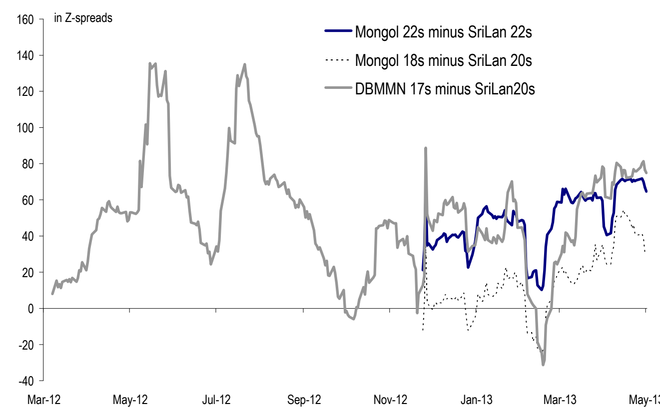
Source: Bloomberg and Citi Research

Figure 8. Comparing Absolute Spread Levels of Select Asia "High Yield" Sovereign names (in Z-spreads)



Source: Bloomberg, Citi Research

Figure 9. Comparing Historical Spread Differences between Mongolia (B1/BB+neg/n.r.) and Sri Lanka (B1pos/B+/BB-)



Source: Bloomberg, Citi Research

Appendix A-1

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