CHAPTER 3

MONETARY SECTOR

3. MONETARY SECTOR

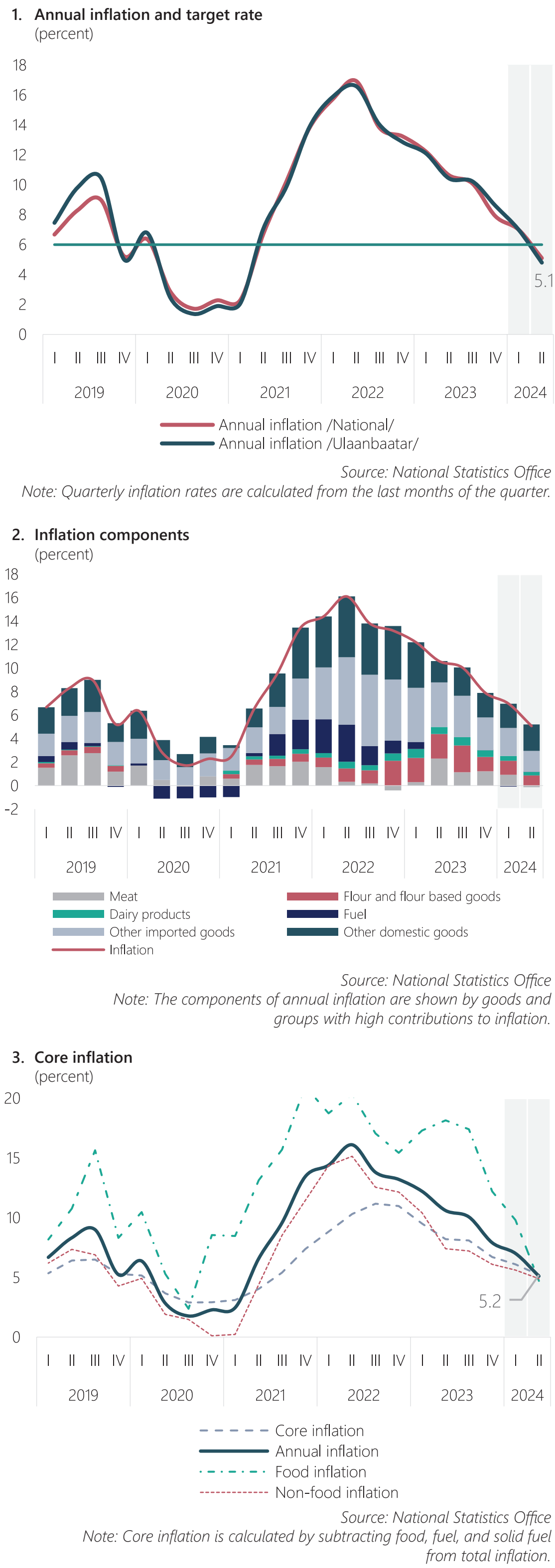
OVERVIEW

Inflation declined from 10.6 percent in June 2023 to 5.1 percent in June 2024. This disinflation is attributed to lower import prices resulting from a slowdown in international prices and the stabilization of the exchange rate. The Bank of Mongolia cut the policy rate twice in the first half of 2024, bringing it down to 11 percent. Broad money recorded substantial growth, reflecting the effects of the lower policy rate and fiscal expansion, along with credit growth. Deposit growth was supported by rising household real incomes, as real interest rates increased with disinflation and the exchange rate remained stable. Additionally, credit growth accelerated, and the share of non-performing loans in total loans fell to 5.9 percent, reaching an eight-year low.

CHAPTER 3

3.1 INFLATION AND MONETARY POLICY

Figure 3.1. Inflation



35. In the second quarter of 2024, the downward trend of inflation continued and reached 5.1 percent nationwide, indicating a decrease of 5.6 percentage points from the same period last year. Price increases in food, educational services, clothing, footwear, cloth and health, and medical care services contributed to the inflation rate by 1.4 percentage points, 0.7 percentage points, 0.6 percentage points, and 0.5 percentage points. The decline in inflation was attributed to the following group of goods and services by percentage points: 3.7 to food and non-alcoholic beverages, 0.7 to clothing, footwear, and cloth, 0.3 to furnishings, household equipment and tools, and 0.3 to transport.

36. Inflation trend from imported goods continued to decline, and inflation from domestic goods and services stabilized. Inflation from imported goods reached 3.9 percent, falling by 4.4 percentage points from the same period last year. It made up 35.3 percent of the total inflation. The price of some imported goods in the consumer basket decreased in the global market, and the exchange rate remained stable, mainly contributing to lower inflation from imported goods. Inflation from domestic goods and services decreased by 6.5 percentage points to 6.1 percent, compared to 12.6 percent in the same period last year in the second quarter of 2024. The slowdown in inflation from domestic goods and services was mainly due to a decline in food and services prices.

37. In the second quarter of 2024, the downward trend of food and non-food inflation was maintained. Food inflation, which was 18.2 percent in the same period last year, decreased to 4.8 percent and accounted for 28 percent of the inflation. The increase in prices of bread, flour, rice, dairy products, eggs, and vegetables explains 93 percent of the food inflation. Since May 1, 2024, the import of wheat flour has been exempt from customs duties. Despite the increased imported flour supply, domestic flour prices have risen by 0.3 to 2.5 percent each month. Conversely, the price of meat and meat products fell by 1.4 percent compared to the same period last year, influenced by the effect of the base period of high growth in 2023. Inflation of non-goods and services hit 5.2 percent, indicating 2.2 percentage points compared to the same period last year. It accounted for 72 percent of the annual inflation. Non-food inflation was driven by price increases in clothing, footwear, and cloth by 5.4 percent, housing, water, electricity, and fuel by 4.7 percent, and health, medical care, and services by 6.6 percent.

38. Demand-driven inflation accounted for 68 percent of the annual inflation, while supply-driven inflation comprised 32 percent. Demand-driven (core) inflation reached 5.2 percent, dropping by 3.0 percentage points from 8.2 percent in the same period last year. Although the increase in wages of civil servants, pensions, and social benefits had a smaller-than-expected impact on inflation from the demand side, it accounted for about 68 percent of the total inflation. Additionally, the effect of last year's high growth period has diminished, and the stable exchange rate of MNT against foreign currencies has contributed to reducing demand-driven inflation. Supply-driven inflation decreased by 10.6 percentage points compared to the same period last year, reaching 4.8 percent.

39. The decline in food prices mainly contributed to the slowdown in the inflation rate in Ulaanbaatar. Inflation in Ulaanbaatar has reached 4.8 percent, reflecting a decrease of 5.6 percentage points compared to the same period last year. This decline can be attributed to several factors: food products at 3.5 percentage points, clothing, footwear, and cloth at 0.8 percentage points, and transportation at 0.5 percentage points. The reduction in food price growth is primarily linked to the base effects from the previous year, during which prices for certain domestic food items surged. Specifically, the impact of meat on inflation decreased by 2.8 percentage points, while the contributions of bread, flour, and rice declined by 1.0 percentage points. Conversely, education services experienced a notable price increase of 21.1 percent in August 2023, resulting in a 0.5 percentage point rise in overall inflation for Ulaanbaatar.

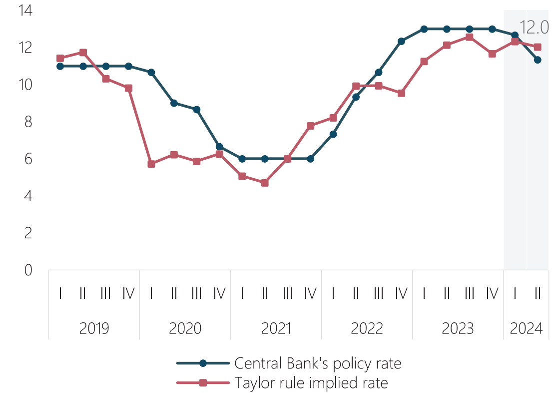
40. Global container shipping prices remain elevated, while the food price index has declined. Since February 2024, the World Container Index (WCI) has been rising rapidly; however, it decreased to $5,428 per 40-ft container in August. This represents a 196 percent increase compared to the same period last year and is 282 percent higher than the pre-pandemic average. The FAO Food Price Index (FFPI) reached 120.8, indicating a 3.1 percent decline from its corresponding value one year ago in July 2024. Price indices for vegetable oil, meat products, and sugar increased, and the price index for cereals decreased, while the dairy index was almost unchanged as of the last month. Last month, The inflation rate declined in Kyrgyzstan, the United States, Turkey, and Georgia. In contrast, the inflation rate rose in China, Russia, South Korea, Japan, Kazakhstan, the Eurozone, Sri Lanka, and the United Kingdom.

41. The monetary policy rate is at an appropriate level in line with the current state of the economy. On May 13, the Monetary Policy Committee reduced the policy rate by 1 percentage point, bringing it to 11 percent. The Taylor rule suggests how central banks should set the policy rate. In the second quarter of 2024, the Taylor rule was estimated at 12.0 percentage points, slightly higher than the central bank's average policy rate of 11.3 percentage points. While the amount of newly issued loans by banks is anticipated to increase compared to the previous year, there are concerns regarding potential disruptions in the supply of imported goods due to container congestion at the Tianjin port. This situation poses a risk of rising inflation, suggesting that it is prudent to maintain the current policy rate in the short term.

42. Money supply growth has exceeded the short-run money growth objective for the last year. The monetary overhang, which determines whether the money supply in the market is at an appropriate level, was estimated at 3.2 percent in the second quarter of 2024. This indicates that the short-run money growth objective is higher than the long-run money growth objective. Although the monetary overhang has decreased for two consecutive quarters, it remains positive, representing that the money supply is above the equilibrium level.

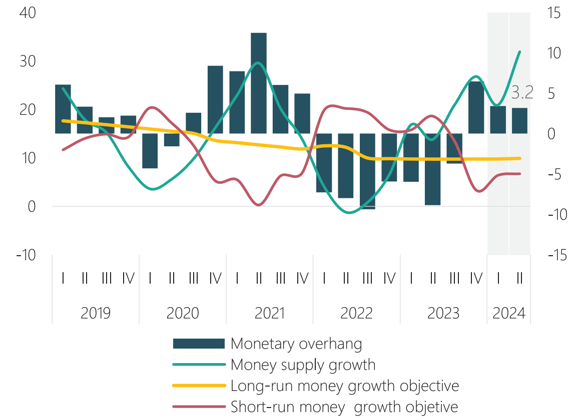
Figure 3.2. Policy rate

1. **Policy rate and Taylor's rule**
(percent)



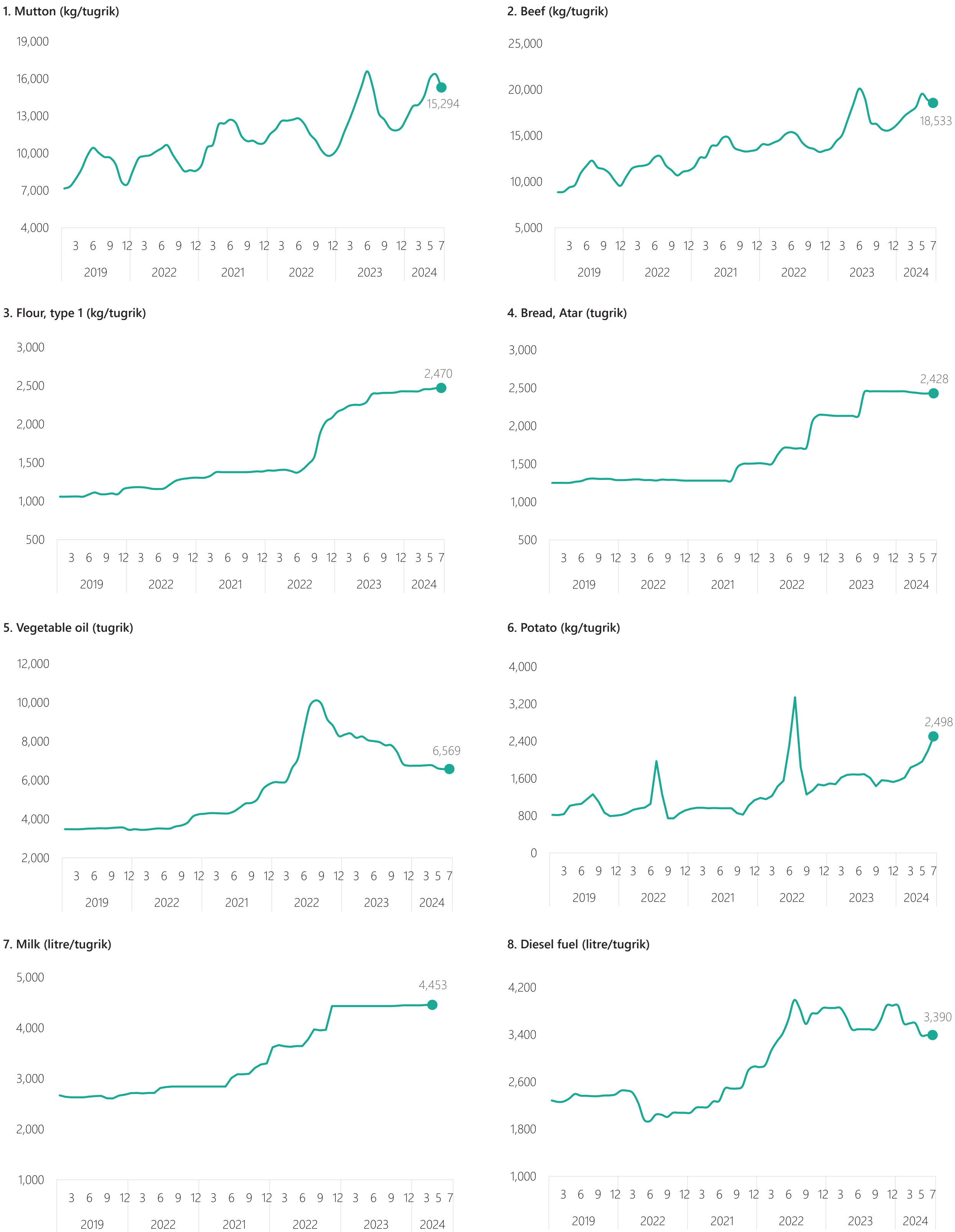
Source: National Statistics Office, MED estimation
Note: The implied rate calculated by Taylor's rule represents the appropriate value of the central bank's policy rate. It is an equation containing variables such as the policy rate set in the previous quarter, inflation, expected inflation, nominal interest rate, and a fixed coefficient.

2. **Money growth objectives**
(percent)



Source: Bank of Mongolia, MED estimation
Note: The long-run money growth objective is calculated by the sum of the targeted inflation rate and the difference between the GDP growth trend and the money velocity. The difference between the long-run money growth objective and the monetary overhang determines the short-run money growth objective. Monetary overhang determines whether the money supply in the market is at an appropriate level, and a value greater than 0, in this case, 3.2 percent, indicates the need to reduce the money supply.

Figure 3.3. Prices of selected items



Source: National Statistics Office
Note: This graph shows monthly fluctuations in the prices of some items within the consumer basket.

BOX 4. ENERGY SECTOR REFORM

Current situation

In 2023, Mongolia generated 8.5 billion kWh of energy, reflecting a 6.1 percent increase compared to the previous year. However, the country imported 22 percent of its energy supply, amounting to 2.4 billion kWh. Over the past five years, electricity consumption has grown at an average annual rate of 6 percent. It is projected to continue increasing at a rate of 5 to 6 percent in the coming years, intensifying domestic energy demand. Currently, approximately 80 percent of the total distributed electricity is utilized by households and businesses, while 11 percent is attributed to losses and 9 percent is consumed for the internal operations of power plants.

According to the preliminary plan for 2024, Mongolia's total electricity consumption is projected to reach 7.6 billion kWh. Of this total, 92 percent is expected to be consumed in the Central region, while the Eastern region accounts for 4 percent, the Western region for 2.8 percent, and the Altai-Uliastai region for 1.4 percent.

Table 4. Electricity costs and tariffs by region

	Central region	Eastern region	Western region	Altai-Uliastai region
1 kWh electricity cost	256 tugrik	260 tugrik	358 tugrik	277 tugrik
1 kWh electricity average tariff	216 tugrik	200 tugrik	169 tugrik	174 tugrik
Unit loss (percentage)	40 tugrik (-18.5%)	60 tugrik (-30%)	189 tugrik (-112%)	103 tugrik (-59%)

Source: Ministry of Energy, 2024

In 2024, the projected cost of electricity in the Central region is 256 MNT per kWh, while the average tariff is set at 216 MNT, resulting in a 40 MNT per unit loss. Additionally, the actual cost of 1 Gcal of heat is 63,000 MNT; however, the average price is only 33,800 MNT, indicating a loss of 46 percent per unit. If tariffs remain unchanged, the Energy Regulatory Commission estimates that losses for energy-producing companies will amount to 274 billion MNT in 2024, with short-term liabilities projected to reach 559 billion MNT. To address these challenges, it is imperative to pursue the liberalization of the energy sector, reduce government involvement, and transition the sector to a market-oriented framework.

As of the first quarter of 2024, the average monthly expenditure for a household in Mongolia is 2.5 million MNT, with 2 to 3 percent allocated to electricity and heating. According to a 2024 study conducted by the World Bank, Mongolia's current energy tariffs and subsidies increase inequality by providing more favorable conditions for wealthier households. Many low-income families reside in areas without access to central heating, resulting in minimal or no consumption of heating resources.

However, wealthier households exhibit significantly higher electricity consumption than other groups due to their occupancy of larger apartments and private residences. As a result, these affluent households disproportionately benefit from energy subsidies, contributing to the widening inequality gap within the energy sector.

Economic impact of tariff increase

According to current tariffs, household expenditures on electricity and heating represent approximately 3% of total expenses. Even with the anticipated tariff increases proposed by the Energy Regulatory Commission, the share of electricity and heating costs in household budgets is expected to rise to around 5 percent. Therefore, the overall impact of these tariff reforms on household livelihoods will likely be relatively modest. Additionally, energy costs for enterprises are low, comprising about 1.0 percent of total operational expenses.

Table 5 Share of electricity and heat cost in total expenditure

Sectors	Number of taxpayers	Total expenditure /billion tugrik/	Electricity and heat costs /billion tugrik/	Share of electricity and heat cost in total expenditure
Trade	37,521	56,040	**298**	0.5%
Service	5,497	1,663	**90**	5.4%
Mining	702	21,759	**42**	0.2%
Processing industry	2,561	3,998	**39**	1.0%
Agriculture	7,642	4,508	**31**	0.7%
Communication	2,224	2,444	**19**	0.8%
Construction	1,317	2,808	**17**	0.6%
Transportation	2,709	4,669	**16**	0.3%
Health	1,535	1,281	**7**	0.6%
Education	565	390	**4**	1.0%
Total	**62,273**			**1.1%**

Source: E-barimt database, 2023

Tariff reform will impact inflation directly through increases in energy sector prices and indirectly by raising energy costs in other production sectors. As a result of higher electricity and heating prices, inflation is projected to increase by approximately 2.5 percentage points. Additionally, the limited production capacity within the energy sector will restrict electricity availability for industrial use, negatively affecting economic growth. Without new investments in installed capacity, or if equipment degrades at 2 percent per year, economic growth could decline to as low as 0.2 percent by 2028.

CHAPTER 3

3.2 FINANCIAL SECTOR

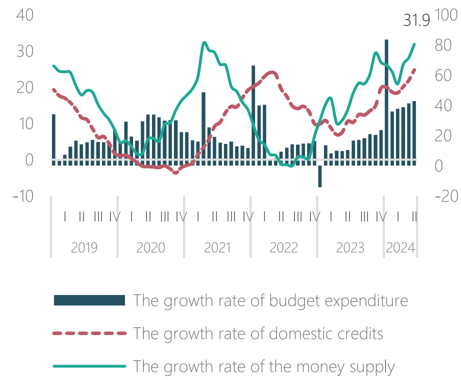
43. Broad money increased, as fiscal stimulus and rising credit. In the first half of 2024, the money supply reached MNT 41.5 trillion, increased by 31.9 percent from the same period last year. The growth driven, in part, MNT denominated deposits and current accounts, and foreign currency denominated current accounts grew by 16.7 percent, 10.5 percent and 5.8 percent a year over, respectively. Also, currency outside depository corporations saw a modest increase of 0.7 percent, increased the base money. Meanwhile foreign currency denominated deposits declined by 1.9 percent.

44. Increased lending to real estate, trade, and mining sectors, coupled with the growth of salary and pension-backed loans added to total outstanding loans. Total outstanding loan amounted to MNT 33.3 trillion, marking an increase of 31.2 percent from the same period of last year. Corporate loans accounted for MNT 13.8 trillion, increased by 19.7 percent. Provision of loans to mining, trade, and manufacturing sectors rose by 44.2 percent, 13.2 percent, and 19.1 percent, respectively. Combined, these sectors account for about 59 percent of overall corporate loans. On the other hand, the stock of outstanding personal loans reached MNT 19.5 trillion, grew by 40.8 percent. Top contributors were salary and pension-backed loans, surged by 50.5 percent to MNT 6.9 trillion, and consumption and savings backed loans rose by 25.6 percent to MNT 1.8 trillion, while mortgage increased by 50.8 percent to MNT 4.9 trillion.

45. Loan issuance has seen a surge, while the lending rate lowered. By the second quarter of 2024, newly issued loans reached 16.3 trillion MNT, surged by 52.4 percent (or MNT 5.6 trillion) a year over. For instance, loan issuance to corporates enterprises increased remarkably by 55.8 percent, whereas loans to individuals increased by 39.1 percent. While the weighted average lending rate of banks estimated 15.9 percent decreased by 0.3 percentage points from a year ago.

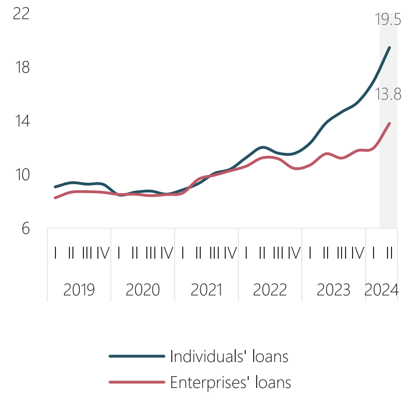
Figure 3.4. Broad money and credit indicators

1. **Broad money growth**
(percent)



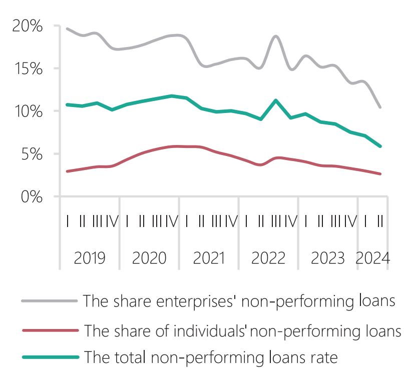
Source: The estimation by MED, Bank of Mongolia statistics.

2. **Outstanding loans**
(trillion MNT)



Source: The estimation by MED, Bank of Mongolia statistics.

3. **Non-performing loans to total outstanding loans**
(percent)



Source: The estimation by MED, Bank of Mongolia statistics.

46. The non-performing loan ratio fell to the lowest level in the last 8 years due to a higher repayment rate. By the second quarter of 2024, non-performing loans accounted for MNT 2.0 trillion, decreased by 2.5 percent from a year earlier. Its share of outstanding loans declined to 5.9 percent, dropping to the lowest level in eight years. Overall loan repayments reached MNT 3.3 trillion, increased by 37.7 percent a year over, which sized up the capital adequacy. In loan repayments growth, enterprises loan repayment contributed 21.7 percentage points, while individuals contributed 16.0 percentage points.

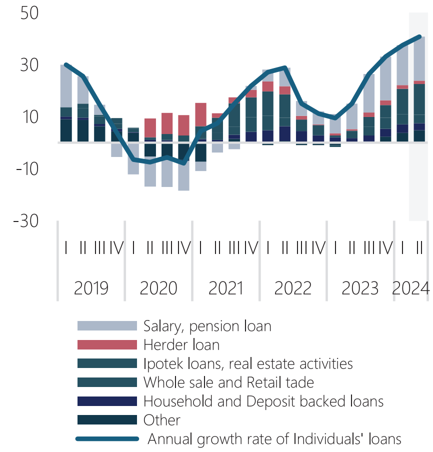
47. National currency denominated saving accelerated. In the second quarter of 2024, overall saving reached MNT 24.0 trillion, increased by 23.8 percent year-on-year. The weighted average interest rate on deposits reached 11.6 percent, up by 0.7 percentage points from the same period last year. As MNT appreciated, people transferred their foreign currency denominated deposits to MNT denominated deposits. Despite interest rate hike and MNT appreciation, improvement in household real income supported the saving growth further.

48. The interbank rate declined. In the second quarter of 2024, the interbank rate reached 11.0 percent, which is 1.6 percentage points lower than the previous quarter and 2.0 percentage points lower than the same period last year. However, deposit rates did not drop in correspondingly, which indicates the high financing need of that commercial bank. While the real effective lending rate was 17.2 percent, unchanged since last year. The narrowing spread indicates increased competition in the banking sector, suggesting that banks are implementing strategies to retain more deposits. A further reduction in interest rate differences, due to cuts in policy rates, is expected to improve economic activity and support credit growth.

49. Stock market is also growing. In the second quarter of 2024, the market capitalization reached MNT 11.3 trillion, expanded by 2.8 percent and accounted for 16.5 percent of GDP. The size of capital market and trading activity have experienced significant improvements in recent years, primarily driven by introduction of bank IPO on the primary market. During the reporting quarter, the total volume of securities trading reached MNT 645.8 billion, increased by 1.4 times over the same period.

Figure 3.5. Growth contribution

1. Individuals' loans growth
(percentage)



Source: Bank of Mongolia statistics

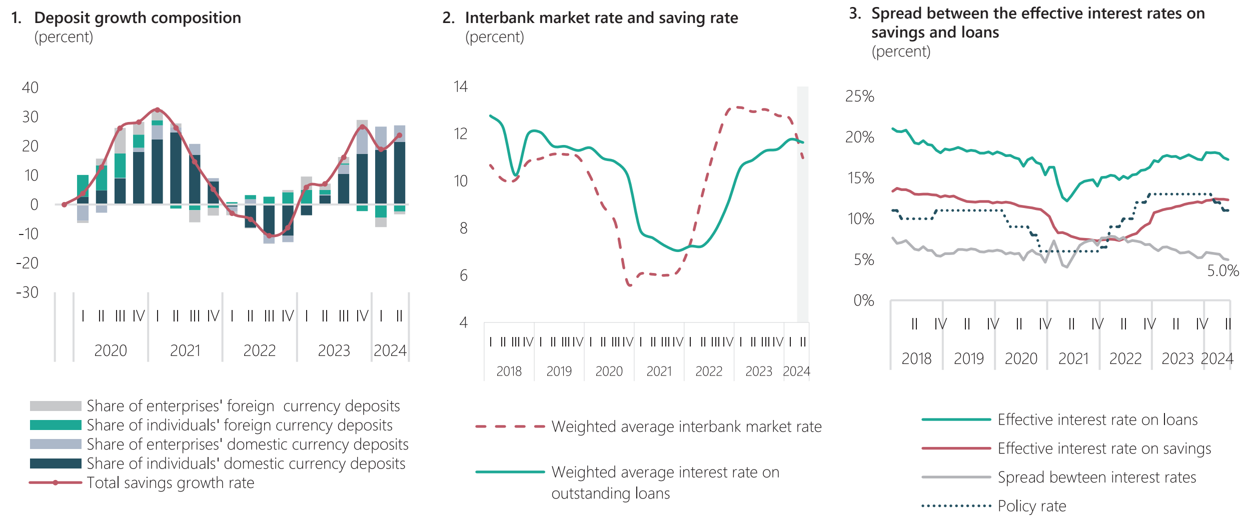
2. Corporate loans growth
(percentage)

Source: Bank of Mongolia statistics

3. Weighted average lending rate
(percentage)

Source: Bank of Mongolia statistics

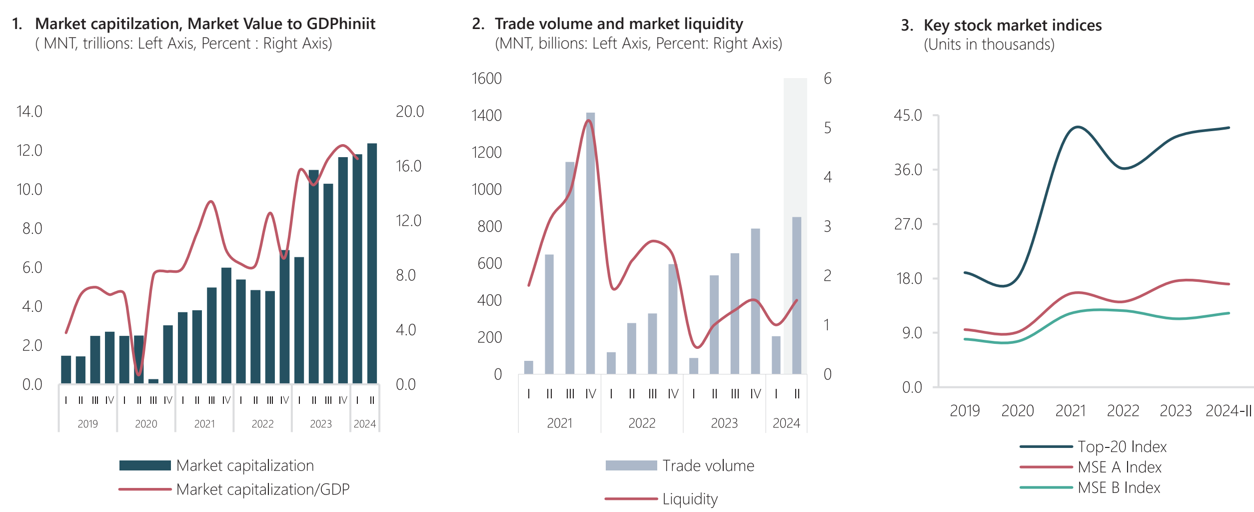
Figure 3.6. Components of annual growth in total deposits and indicators of deposit interest rates



Source: The estimation by MED, Bank of Mongolia statistics
Notes: Effective interest rate=(1+nominal annual interest rate/number of compounding periods per year))^(Number of compounding periods per year)-1
Project and program loans granted at interest rates lower than the market rate are included.

50. Liquidity in the stock market has improved, with an increase in trading of primary market debt instruments. In the second quarter of 2024, a total value of MNT 57.1 billion stock traded across 63 trades. In primary market, MNT 15.2 billion of stock were traded, whereas 41.9 billion MNT of transaction was made in the secondary market. Trading of shares in the primary market increased by 1.7 times compared to the previous quarter, while trading in the secondary market decreased by 64.7 percent. Additionally, company debt instruments totaled MNT 522.5 billion in trading, with MNT 520.0 billion in primary market and MNT 2.5 billion in secondary market. During this period, the TOP-20 index rose by 20.3 over the year. The liquidity ratio of the securities market reached 1.4 percent, representing an improvement of 0.4 percentage points year-on-year.

Figure 3.7. Stock market



Source: Stock Exchange and Financial Regulatory Commission.
Note: Stock market capitalization is compared to gross domestic product (GDP)