MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades Mongolia's sovereign rating to B3, places it on review for further downgrade

Global Credit Research - 26 Aug 2016

NOTE: On September 26, 2016 the press release was corrected as follows: The following was added as the sixth paragraph of the press release: "The long-term local currency country risk ceiling remains unchanged at Ba3. The long-term foreign currency deposit ceiling is revised to Caa1 from B3, while the foreign currency bond ceiling is unchanged at B1. All short-term ceilings remain at Not Prime. These ceilings act as a cap on ratings that can be assigned to the foreign- and local-currency obligations of entities domiciled in the country." Revised release follows.

Singapore, August 26, 2016 -- Moody's Investors Service has today downgraded Mongolia's government issuer rating to B3 from B2, and initiated a review for further downgrade.

The key driver for the downgrade is the sharp deterioration in fiscal metrics, which Moody's does not expect will reverse materially in the next few years. Compounded by weak growth and already very low foreign exchange buffers, this will significantly exacerbate fiscal challenges and liquidity risks facing the government.

The review will allow Moody's to assess the speed and effectiveness of the policy response to these heightened challenges, and their implications for growth and the management of external liquidity, which would depend partly on the availability and cost of external financing.

Moody's expects to complete the review within three months.

Concurrently, Moody's has downgraded the government's senior unsecured debt rating to B3 and the senior unsecured MTN rating to (P)B3. The review for downgrade also applies to these ratings. The short-term issuer rating remains unchanged at Not Prime.

The long-term local currency country risk ceiling remains unchanged at Ba3. The long-term foreign currency deposit ceiling is revised to Caa1 from B3, while the foreign currency bond ceiling is unchanged at B1. All short-term ceilings remain at Not Prime. These ceilings act as a cap on ratings that can be assigned to the foreign- and local-currency obligations of entities domiciled in the country.

RATINGS RATIONALE

RATIONALE FOR DOWNGRADE TO B3: DETERIORATING DEBT AND FISCAL METRICS

Mongolia's core fiscal and economic fundamentals have worsened materially since the rating was affirmed in January of this year. That trend exacerbates the sovereign's already high exposure to a reversal in investor sentiment, exacerbating domestic and external liquidity pressures.

Mongolia's fiscal deficit has widened very significantly in recent months, due to revenue underperformance and a sharp increase in spending in the first half of this year, which coincided with the run-up to national elections at the end of June. This will raise the government's near-term financing needs and add to external vulnerability pressures. While some of the spending is likely one-off rather than recurrent, we estimate that the government's fiscal consolidation efforts will now start from a much weaker base, with a budget gap of around 15% of GDP, versus our earlier expectations of about 5% of GDP for 2016. In 2017, we assume that growth in expenditure will slow markedly while revenues may recover somewhat. Still, we expect the deficit to be only marginally smaller, at around 14% of GDP.

Larger fiscal deficits will translate into a marked increase in the debt burden. In addition, with more than three-quarters of government debt denominated in foreign currency, the recent depreciation in the Mongolian togrog will inflate the value of existing debt. Any further weakening of the currency would raise the debt burden further. Higher domestic interest rates will also push up refinancing costs. Overall, we estimate that government debt could rise to 71% of GDP in 2017 from 63% in 2015, considerably higher than what we projected previously and above the 53% median debt-to-GDP ratio amongst B-rated sovereigns in 2016.

Debt affordability, as measured by interest payments to revenues, has already worsened significantly over recent years, to 12.2% in 2015 from 2.5% in 2012. The rise in risk premia that we think will largely persist for some time implies that debt servicing costs will deteriorate further.

Efforts to strengthen the fiscal position will be more challenging in the current adverse growth environment. The 450 basis point hike in central bank interest rates on 18 August, and any further tightening of monetary policy should pressure on the exchange rate persist, will likely dampen GDP growth in the next two years. Already, recent developments point to a weaker and delayed recovery compared with our previous expectations. On the back of a decline in mining and construction activity, GDP growth moderated to 1.4% year-on-year during the first half of 2016, from 2.0% during the same period in the last year. With little prospect of an imminent pick-up in the mining sector, we expect real GDP for the full year to rise 1.5% year-on-year, weaker than the 2.8% that we previously forecast. In 2017 and 2018, the implementation of the Oyu Tolgoi copper mining project should lead to some pickup in growth, pushing GDP growth up to around 3.5-5.0%. This would still remain significantly below Mongolia's GDP growth in the past decade and, in turn, weigh on the effectiveness of fiscal consolidation measures.

In an environment of sharply higher government financing needs, uncertainty about the nature and effectiveness of policies to reduce them and weaker growth, already very low foreign exchange reserves could come under further pressure and accentuate already material government liquidity risks.

RATIONALE FOR REVIEW TO DOWNGRADE

Recent developments have created considerable uncertainty regarding both the current fiscal position in Mongolia and its future trajectory. That uncertainty has in turn undermined investor confidence in Mongolia's credit profile, potentially impeding its access to international debt markets. The review will allow Moody's to determine whether the rating remains appropriately positioned in the 'B' range or whether external financing pressures are more consistent with a Caa1 rating.

While the new government has announced its intention to narrow deficit and debt levels, and its wider deficit projections suggest its willingness to be more transparent than previous administrations in its calculation of budgetary data, a high degree of uncertainty exists about the level and nature of the budget gap, the impact on the government's debt burden and how the government plans to achieve its broader economic policy goals.

The review period will allow Moody's to assess the government's plans to address the worsening position, and their impact on growth and external metrics. More details on the 2016 Budget, which is due within the review period, should also emerge.

Moody's will also gauge the impact of the fiscal deterioration on Mongolia's ability to continue to meet its substantial external finance needs over the coming years, and the implications for its foreign exchange reserves buffer.

WHAT COULD STABILIZE THE RATING AT THE CURRENT LEVEL

At the end of the review period, Moody's could maintain the current B3 rating with a stable outlook, if it were to conclude that the government's response to the worsening fiscal position was likely to stabilize the fiscal position, support the resumption in growth and inward investment and allow Mongolia to retain access to international debt markets at affordable rates.

WHAT COULD STABILIZE THE RATING AT THE CURRENT LEVEL, WITH A NEGATIVE OUTLOOK

Moody's could maintain the current B3 rating with a negative outlook if it were to conclude that, notwithstanding the emergence of policies intended to stabilize the fiscal position and support growth, there were likely to remain persistent negative pressure on Mongolia's credit metrics over the next 12-18 months, whether related to the effectiveness of fiscal tightening, the impact on GDP growth or a diminishing likelihood for Mongolia to meet its widening gross borrowing requirements and ability to refinance its external debt repayments.

WHAT COULD CHANGE THE RATINGS DOWN

Triggers for a further downgrade at the end of the review would most likely stem from the lack of a well-defined set of policies aimed at curbing rising fiscal deficits and the growing debt burden, heightening the risk of investor confidence quickly deteriorating and external metrics and liquidity worsening sharply, to such an extent that Mongolia's credit metrics are no longer comparable with B3-rated sovereigns.

GDP per capita (PPP basis, US$): 12,147 (2015 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 2.3% (2015 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 1.9% (2015 Actual)

Gen. Gov. Financial Balance/GDP: -5% (2015 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -4.8% (2015 Actual) (also known as External Balance)

External debt/GDP: 185.6% (2015 Actual)

Level of economic development: Low level of economic resilience

Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 23 August 2016, a rating committee was called to discuss the rating of the Mongolia, Government of. The main points raised during the discussion were: The issuer's fiscal or financial strength, including its debt profile, has materially decreased. The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's susceptibility to event risks has not materially changed.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2015. Please see the Ratings Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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