Fitch Ratings

Sovereigns

Full Rating Report

Mongolia

Ratings

Foreign Currency

Long-Term IDR	B+
Short-Term IDR	B

Local Currency

Long-Term IDR	B+
Country Ceiling	B+

Outlooks

Foreign-Currency Long-Term IDR	Stable
Local-Currency Long-Term IDR	Stable

Financial Data

Mongolia

(USDm)	2010
GDP	5,694.6
GDP per head (USD 000)	2.1
Population (m)	2.7
International reserves	2,006.1
Net external debt (% GDP)	4.8
Central government total debt (% GDP)	42.7
CG foreign-currency debt	1,849.2
CG domestically issued debt (MNTm)	848,578.6

Analysts

Andrew Colquhoun
+852 2263 9938
andrew.colquhoun@fitchratings.com

Vincent Ho
+852 2263 9921
vincent.ho@fitchratings.com

Related Research

Other Research

- *Sovereign Rating Methodology (August 2010)*
- *Global Economic Outlook (October 2010)*
- *Macro-Prudential Risk Monitor (November 2010)*
- *Emerging Asia Vulnerability to Global Quantitative Easing (October 2010)*

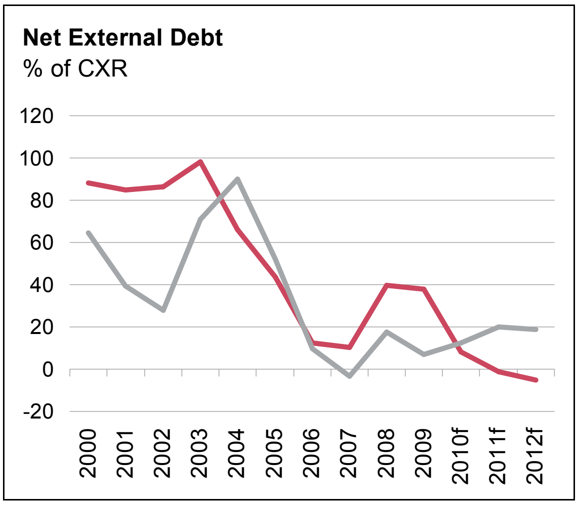
Rating Rationale

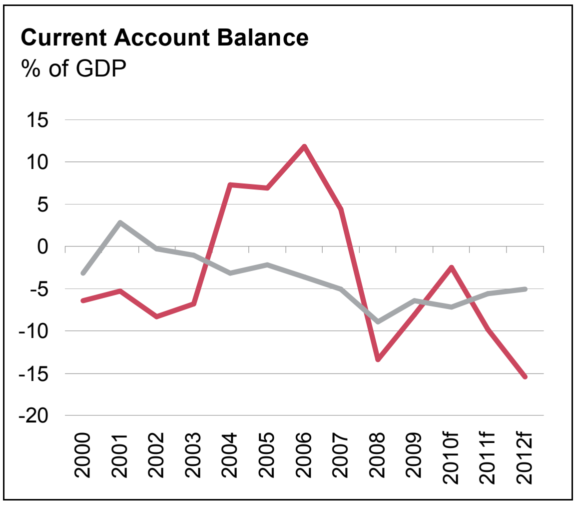
- Fitch Ratings upgraded Mongolia's Foreign- and Local-Currency Long-Term IDRs to 'B+' on 23 November 2010. The upgrade reflects a rise in official reserves, economic recovery, some stabilisation in the financial system and strengthening in the policy framework under a successfully concluded IMF programme. However, the authorities' commitment to the new policy framework is largely untested and the small, low-income economy remains heavily exposed to commodity prices. These factors continue to justify a rating in the 'B' range.
- The IMF Board completed its final review of Mongolia's Stand-By Arrangement (SBA) in September 2010 and commended the authorities for their successful implementation. With official foreign-currency reserves (FXR) at a record high USD1.7bn at end-September 2010 (up from USD0.5bn at end-March 2009), Mongolia opted not to draw the final USD46.4m SBA tranche.
- Economic activity has rebounded strongly from the trough of the recession in Q309, supported by recovering commodity prices. Real annual output was about 3% above the Q408 pre-crisis peak by Q310. Projected solid growth in Mongolia's main export market, China, supports the former's economic prospects.
- Fiscal management is now on a much stronger legislative footing after the passage of a Fiscal Stability Law (FSL), mandating a narrowing in the structural budget deficit and establishment of a commodity stabilisation fund for 2011. However, detail on how the deficit will be managed in 2011 remains lacking, and the authorities' commitment to the new policy framework will be tested ahead of parliamentary elections in 2012. Overall, Fitch expects Mongolia's government debt/GDP ratio to remain in line with medians for the 'B' category (sovereigns rated 'B+', 'B' and 'B−') until 2012.
- Mongolia experienced a banking crisis in 2009. The IMF estimates that this will cost about 6.6% of GDP to resolve. The sector is showing signs of recovery, with deposits up 38% in the year to September 2010. However, the sector remains hobbled by a non-performing loan (NPL) ratio of 14.3% of GDP. Legislation on a formal recapitalisation scheme remains stuck in parliament, highlighting ongoing barriers to reform.
- Mongolia's longer-term economic prospects are bright, underpinned by a generous and diverse endowment of natural resources including coal, copper and gold. However, its ability to manage the resulting inflows sustainably without succumbing to boom-bust cycles remains open to question.

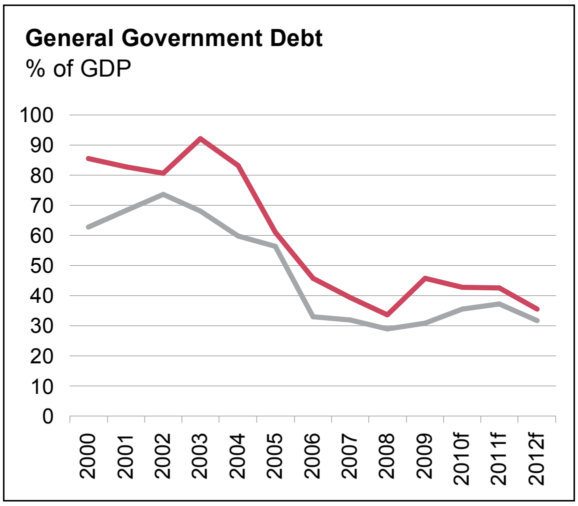
Key Rating Drivers

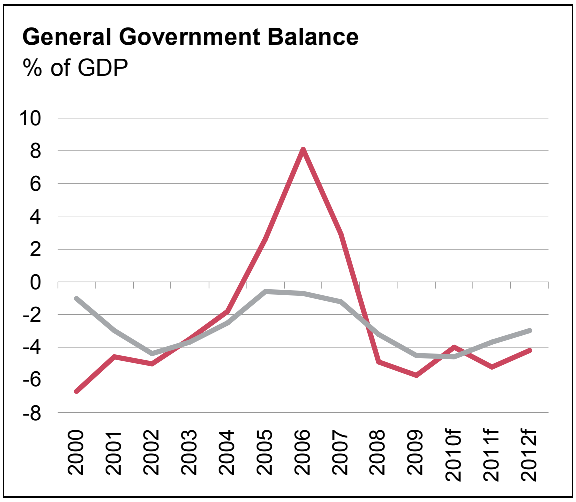
- Fiscal and monetary policy discipline would boost Mongolia's chances of sustainable growth and of further rating upgrades. Conversely, significant policy slippage, including strong growth in spending beyond the ability of the economy to absorb easily would add to negative pressure on the ratings.
- The emergence of further problems in Mongolia's relatively weakly capitalised banking system requiring further extensive sovereign support could trigger a negative rating action.
- Mongolia's small, resource-driven economy remains vulnerable to external shocks such as commodity-price volatility, which may be severe enough to trigger negative rating action.

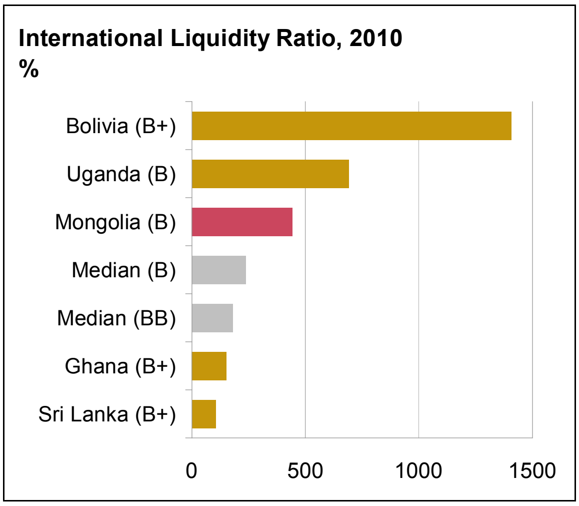
Peer Comparison

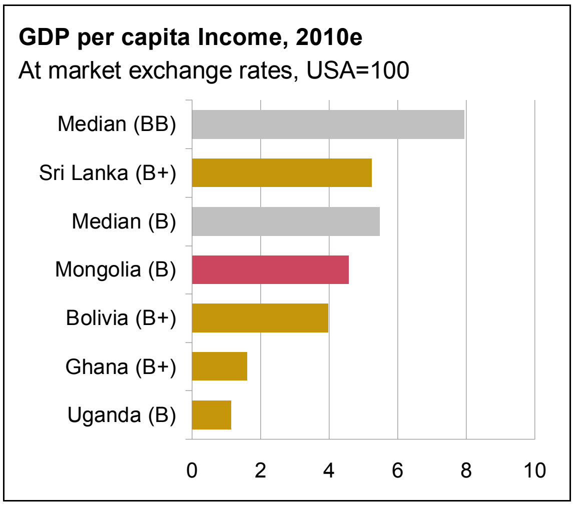












Mongolia

Medians

Rating Factors

Peer Group

Rating	Country
BB-	Armenia
	Gabonese Republic
	Kingdom of Lesotho
	Nigeria
	Serbia
B+	**Mongolia**
	Angola
	Bolivia
	Cape Verde
	Georgia
	Ghana
	Kenya
	Sri Lanka
	Venezuela
	Vietnam
B	Argentina
	Benin
	Cameroon
	Dominican Republic
	Lebanon
	Mozambique
	Rwanda
	Suriname
	Uganda
	Ukraine

Rating History

Date	Long-Term Foreign Currency	Long-Term Local Currency
23 Nov 2010	B+	B+
19 Jan 2009	B	B
18 Jul 2005	B+	B+

Source: Fitch

Summary: Strengths and Weaknesses

Rating factor	Macroeconomic	Public finances	External finances	Structural issues
Status	Neutral	Neutral	Strength	Neutral
Trend	Stable	Stable	Stable	Stable

Note: Relative to 'B' category
Source: Fitch

Strengths

- Mongolia's rich and diverse natural resource endowment (including coal, copper, gold and uranium) underpins the country's economic prospects, although managing revenue sustainably will be challenging.
- The sovereign's net foreign asset position of 7% of GDP (end-2010 projected), underpinned by a rapid recovery in official reserves since the mid-crisis trough in March 2009, is a rating strength.
- Mongolia's government debt ratios are in line with 'B' range medians, but the government debt-service burden is lower, reflecting the fact that more than 90% of its debt is owed to official multilateral and bilateral creditors.
- Mongolia outperforms 'B' medians on several external finance metrics, with a higher liquidity ratio and a lower net external debt ratio. However, Mongolia arguably needs stronger external liquidity to act as a buffer against commodity-driven volatility (see below).
- Mongolia has strong governance indicators for the 'B' range, and a relatively favourable business climate according to the World Bank's "Ease of Doing Business" framework.

Weaknesses

- Mongolia has a track record of weak and pro-cyclical policy management. Although the country now has a solid fiscal framework on paper, it is too early to say with confidence that the authorities will abide by policy discipline over the medium term.
- Mongolia's small (USD5.7bn in 2010) and resource-driven economy is likely to remain heavily exposed to global shocks, including commodity-price volatility. Its high commodity dependence is a weakness.
- Mongolia's average income level lags behind 'B' medians both in market exchange rate and purchasing power parity terms.
- Despite progress in resolving the banking crisis of 2009, in which two banks failed, the banking sector's still-high NPL ratio and weak capitalisation continue to weigh on the sovereign ratings.

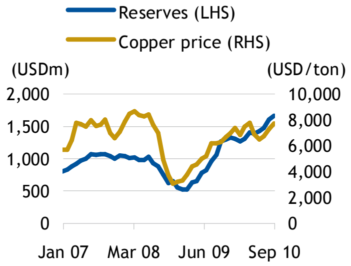
Local Currency Rating

Mongolia's small local-currency government debt market (worth just 3% of GDP) and high financial-system dollarisation, partly reflecting a history of high and volatile inflation, constrain the government's MNT financing options and justify a Local-Currency IDR in line with the Foreign-Currency IDR at 'B+'.

Country Ceiling

Mongolia has open current and capital accounts. However, the country has a history of balance-of-payments volatility and its level of financial integration with the rest of the world remains quite low. These factors warrant a Country Ceiling in line with the Foreign-Currency IDR at 'B+'.

Chart 1: Reserves, Copper Price



Source: CEIC

Outlook and Key Issues

Fitch upgraded Mongolia's Foreign- and Local-Currency Long-Term IDRs to 'B+' on 23 November 2010, in recognition of improvements in the sovereign credit profile under the aegis of the country's successfully concluded IMF programme. However, the authorities' commitment to new-found policy discipline is largely untested and the small, low-income economy remains heavily exposed to commodity prices, factors that continue to justify a rating in the 'B' range.

IMF Programme Successfully Concluded

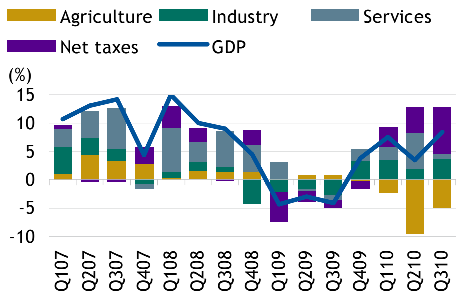
Mongolia's successful conclusion of its IMF programme in September 2010 sets the seal on the country's progress since crisis hit in late 2008. The IMF Board approved a USD224m SBA programme (equal to 300% of Mongolia's IMF quota) on 1 April 2009. FXR reached a trough of USD0.5bn at end-March 2009, down 50% from the end-July 2008 peak of USD1bn, as falling copper prices exposed the pro-cyclically loose spending of the boom years and undermined the current account, leading to a drain on FXR as the authorities sought to prop up the currency. Mongolia opted not to draw the final USD46m tranche of its SBA in September 2010, as FXR had recovered to USD1.6bn by end-August. This is equivalent to about five months of imports by Fitch's calculations (FXR climbed higher to USD1.7bn by end-September).

The economy has recovered, led by the commodities sector, taking annual output to 3% above the Q408 pre-crisis peak by Q310. Real-terms industrial output rose 12% in the year to September, led by 24% growth in manufacturing. All sectors contributed to growth in Q310 except for agriculture, which contracted 20.4%, subtracting about 5 percentage points (pp) from growth. This reflects the impact of the harsh winter of 2009/2010, which wiped out about 20% of the country's livestock, according to the World Bank.

Relatively high inflation mars the otherwise broadly favourable economic picture. CPI inflation ran at 10.6% in the year to September 2010, well above the 7.8% rolling 12-month average, led by food-price inflation of 14.3%. The Bank of Mongolia (BoM) has so far increased its main policy rate just once since the crisis, by 1pp to 11% in May 2010, arguing that food prices are driving overall inflation as the result of a supply shock that monetary policy can do little about. However, the 30% rise in government wages and pensions implemented in October, and payment of the second tranche of a flat MNT120,000 (USD85) per person handout, may risk a further increase in inflation without counter-action by the BoM.

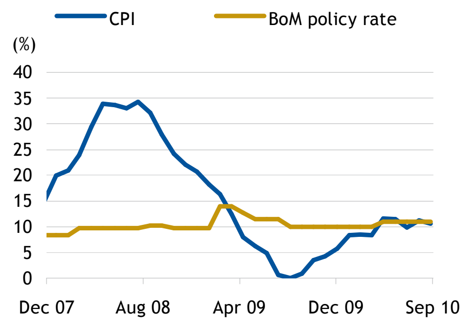
Chart 2: Growth Contributions

Year-on-year



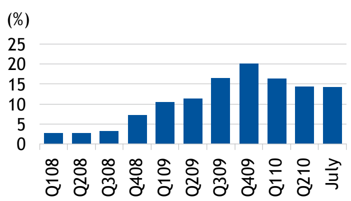
Source: CEIC, Fitch

Chart 3: Monetary Conditions



Source: CEIC

Chart 4: Non-Performing Loans (% All Loans)



Source: Bank of Mongolia

Recovery in the Banking Sector

Economic recovery has in turn supported a turnaround for the banking sector, although problems remain and the sector continues to weigh on the ratings. Deposit growth ran at 38% in the year to September 2010, while the proportion of foreign-currency deposits was 29%, down from a high of 39% in July 2009.

The system has so far been parking excess liquidity in BoM bills in preference to growing private sector lending rapidly; the proportion of bank assets invested in BoM bills was 13.4% in September 2010, up from 3.6% at end-2008. There is some risk that the excess liquidity could trigger faster inflation if bank willingness to lend to the private sector suddenly returned and the BoM was unwilling to tighten policy sharply. However, NPLs remain high at 14% system wide (9% excluding two failed banks), weighing on banks' capitalisation and ability to resume strong lending growth, although the NPL ratio had fallen from 20% at end-2009. Loans to the private sector rose 8.6% in the year to September, only just above the 12-month average of 8.2% and negative in real terms.

The resolution of Mongolia's 2009 banking crisis is not yet complete. The IMF's most recent public estimate for the final bill is 6.6% of 2010 GDP, of which about 1.2% of GDP was spent on Zoos, a failed bank. The rest will be spent on Anod, another failed bank, and on capital injections required to bring some institutions up to the 12% minimum capital adequacy threshold — although the legal framework for government injection of capital is not yet in place.

Fitch understands that the mechanism for capital provision will be government issuance of T-bills for discount at the BoM. Consistently with its treatment of the fiscal impact of bank resolutions in other jurisdictions, Fitch accounts for these costs "below the line". The agency does not therefore expect an impact on the headline fiscal balance. However, it counts the recapitalisation bills as part of the fiscal debt (see the table "Impact of Bank Recapitalisation").

Impact of Bank Recapitalisation

	2009	2010	2011	2012
Exc. bank recap				
Deficit	-5.7	-4.0	-5.2	-4.2
Debt	45.8	36.1	37.2	31.2
Inc. bank recap				
Deficit	-5.7	-10.6	-5.2	-4.2
Debt	45.8	42.7	42.6	35.6

Source: Fitch

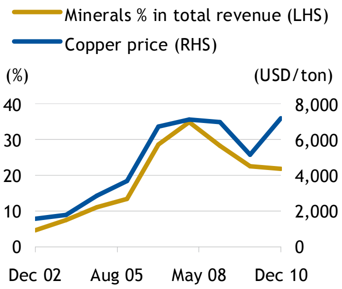
Short-Term Improvement in Public Finances

The strengthening economy has also provided the conditions for an improvement in the public finances so far in 2010. However, some of the improvement is likely to unwind in 2011, partly due to a loosening in spending. The cumulative general government deficit in the year to September 2010 was just 0.2% of projected 2010 GDP, against 5.5% for the same period in 2009. Revenue contributed 3.2pp of the improvement, with the windfall tax alone accounting for 1.8pp. Expenditure fell 2.5pp, with the public wage bill dropping 1.6pp, after a public pay freeze through to September.

However, public sector wages are set to accelerate following a 30% pay award from October, which Fitch estimates may cost 1.8% of 2011 GDP, while the Windfall Profits Tax expires in 2011 without a clear compensating replacement, after raising a projected 5% of GDP in revenue in 2010 (the World Bank estimates a net revenue loss of 2%-3% of GDP).

A draft 2011 budget submitted to parliament on 12 November budgeted for a deficit of 8.6% of GDP, although this would appear inconsistent with the FSL, and Fitch expects the draft to be substantially revised. The agency expects the cash deficit to run at 5.2% in 2011 against 4% in 2010.

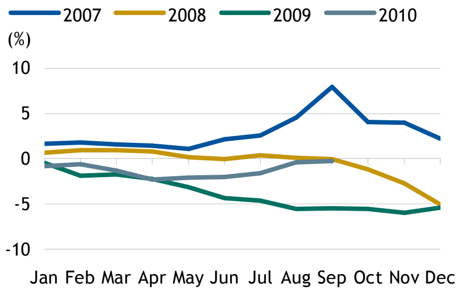
Chart 7: Mineral Revenues



Source: Mongolian MoF, CEIC, Fitch

Chart 5: Budget Balances

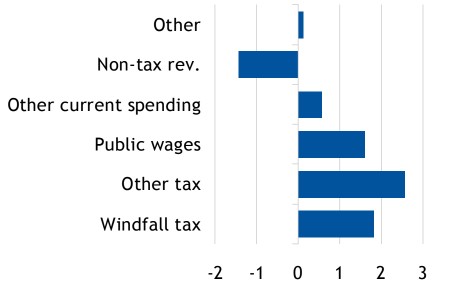
Cumulative, % of GDP



Source: Mongolia MoF, Fitch

Chart 6: Deficit Reduction Factors

9M10 against 9M09, pp of GDP



Source: Mongolia MoF, Fitch

The Importance of Mineral Revenue

Dependence on mineral revenue is expected to remain a central feature of Mongolia's budget. Mineral revenue contributed 35% of Mongolia's budget revenue in 2007, dropping to 22% in 2009.

The country can boost the resilience of its public finances against commodity-driven volatility by sticking to the structural fiscal consolidation plan in the FSL and by building up the Stabilisation Fund. Without these measures, exposure to commodity-price fluctuation will continue to weigh on Mongolia's ratings.

Uncertain Financing Prospects in 2011

Forecasting sovereign financing conditions for 2011 is difficult. Mongolia may be set to receive substantial privatisation receipts from the sale of a 30% stake in the company owning the rights to the Tavan Tolgoi coal mine. The timing, valuation and structure of the transaction remain unclear, although on 1 November a state mining company official said an IPO would be concluded before end-2011.

The estimate of 10% of 2011 GDP in revenue, equal to about USD750m, is based on a reported value of UD2bn from a cancelled auction in February 2010. The authorities have also expressed interest in issuing a sovereign bond on the international markets; Fitch projects a USD0.5bn bond for 2011 (although the issue may yet happen in late 2010). If neither funding source materialised, the reduced availability of international financial institution financing (projected at 2% of GDP in 2011, down from 2.5% in 2010) could force the sovereign to curtail spending.

The Mongolian sovereign's financial relationship with Ivanhoe Mines Ltd, the leading company developing the Oyu Tolgoi site, is complex. Fitch understands that the Mongolian sovereign has so far borrowed USD870m from Ivanhoe (15.3% of 2010 GDP) to finance its 34% stake in Oyu Tolgoi's holding company, to be repaid out of future dividends. The authorities have indicated to Fitch that loan repayment is conditional on the project generating revenue. Fitch does not account for the Ivanhoe transaction in Mongolia's explicit sovereign debt due to the flexibility of the repayment profile.

Public Finances: Sources and Uses

(% GDP)	2009	2010f	2011f	2012f
Uses	**11.0**	**6.0**	**6.7**	**5.7**
Budget balance	5.7	4.0	5.2	4.2
Amortisation (by place of issue)	5.3	2.0	1.5	1.5
Domestic	3.8	1.1	0.7	0.6
Foreign	1.6	0.9	0.9	0.9
Sources	**11.0**	**6.0**	**6.7**	**5.7**
Gross borrowing (by place of issue)	8.1	4.4	9.5	2.3
Domestic	4.8	2.0	0.4	0.3
Foreign	3.3	2.5	9.1	2.0
Privatisation	0.0	0.3	10.7	0.2
Other (fiscal account build-up/drawdown)	2.9	1.2	-13.4	3.2

Source: Fitch

Improved Policy Framework — On Paper

One of the key areas of improvement delivered by the IMF SBA has been an improvement in Mongolia's economic policy framework. The key improvement from the sovereign credit perspective has been the FSL introduced in 2010. The main features of the law are as follows:

- structural budget formulation using an estimated "long-term" copper price;
- a path for the structural budget deficit: 5% for 2011, declining to 2% by 2013;
- excess cash copper revenue to be saved in the Stabilisation Fund;

- expenditure to grow no faster than nominal GDP (with effect from 2012); and
- debt ceiling of 40% GDP (with effect from 2013).

On paper, Mongolia now has a strong fiscal policy framework, particularly assessed against 'B' range norms. However, Mongolia has a track record of weak and pro-cyclical policy management, and there is strong political pressure to spend some of the country's resource windfall in an economy where average income is only USD2,100 (2010 projection), particularly ahead of parliamentary elections in 2012. The authorities budgeted 32% growth in current expenditure for 2010, including MNT120,000 (USD85) direct handouts per person, and 30% increases to public sector wages and pensions that took effect in October.

Against this backdrop of spending increases whose effect will persist, it remains unclear how the authorities intend to narrow the deficit in line with the target in 2011, risking the credibility of the new framework from the start. There has so far been a lack of disclosure on how the "long-term" copper price will be set, although the authorities have indicated to Fitch that the price will be intended as a fair estimate and will not be deliberately set low.

The other main reform introduced under the SBA has is a law strengthening bank supervision and resolution procedures. However, a law allowing compulsory recapitalisation of banks, if necessary diluting existing owners with government capital, remains stuck in parliament. This weakens the beneficial impact of reforms already enacted and testifies to the ongoing ability of well-connected vested interests to resist reforms.

Maintained Policy Discipline Key to Surmounting Challenges Ahead

A key question for Mongolia's outlook is to what extent the authorities will abide by policy discipline now that they are no longer subject to close IMF supervision. The authorities have yet to indicate whether they wish to enter into a new formal arrangement with the IMF or other key donors, although as Mongolia's obligations to the IMF exceed 200% of quota, the country will remain subject to post-programme monitoring.

Mongolia is governed by a "grand coalition" of the two main parties, the Mongolian People's Revolutionary Party and the Democratic Party, who between them hold 73 of the 76 seats in parliament. The coalition has major achievements to its credit, including the agreement with operators on the Oyu Tolgoi mine after years of delay, and successful implementation of the IMF programme.

Fitch considers there to be some risk that the temptation to stay in office to secure a say in the allocation of revenue flowing from mineral projects may erode Mongolia's competitive party system and contribute to a weakening in standards of governance, which are a rating strength. Maintaining strong standards of governance will be particularly important in ensuring appropriate use of forthcoming mineral revenue streams. The run-up to the 2012 elections is likely to yield further information on trends in this area.

Mongolia's history of macroeconomic and balance-of-payments volatility underscores the need for a disciplined policy framework to provide buffers against some of the turbulence to which the economy will undoubtedly remain exposed. Mongolia's commodity exposure of 70% for 2010 was well above the 10-year 'B' range median of 38% and the 'BB' range median of 33%. If anything it is set to rise further in the medium term as large natural-resources projects move towards production. In particular, Fitch looks for the establishment of the Stabilisation Fund in accordance with the FSL in 2012.

The authorities plan to set up mineral processing facilities near the Oyu Tolgoi copper and gold mine, and to endow a Development Bank from mineral revenue.

These policies appear to be aimed at locating more of the value-added activity arising from Mongolia's resources on the country's own soil. If achieved, this would benefit Mongolia's income levels and the diversity of its economy, and strengthen the credit profile.

However, Fitch cautions that governments in general have poor track records in allocating resources efficiently to foster higher-value-added development. The scale of resources to be allocated and the strategy for disbursing them have yet to be agreed, and so this is not yet a key area of concern for the rating profile.

External Finances: Sources and Uses

(USDm)	2009	2010f	2011f	2012f
Uses	**503**	**380**	**841**	**1,523**
Current account balance	342	141	690	1,333
MLT amortisation	161	239	151	189
Sovereign	72	55	63	105
Non-sovereign	89	184	88	84
Sources	**503**	**380**	**841**	**1,523**
Gross MLT borrowing	362	270	700	327
Sovereign	314	220	600	127
Non-sovereign	49	50	100	200
Net FDI	488	950	1,100	1,600
Net portfolio debt	53	0	0	0
Net portfolio equity	-3	0	0	0
Other credit flows nes	-171	-162	-137	-150
Net E&O	129	0	0	0
Change in fx reserves	-355	-678	-822	-255

Source: Fitch

Forecast Summary

	2006	2007	2008	2009	2010f	2011f	2012f
Macroeconomic indicators and policy							
Real GDP growth (%)	8.6	10.2	8.9	-1.6	8.0	7.5	8.0
Consumer prices (annual average % change)	5.1	9.0	25.1	6.3	9.0	9.0	10.0
Short-term interest rate (%)[a]	6.4	5.6	9.6	11.2	10.7	11.0	12.0
General government balance (% of GDP)	8.1	2.9	-4.9	-5.7	-4.0	-5.2	-4.2
General government debt (% of GDP)	45.7	39.4	33.7	45.8	42.7	42.6	35.6
MNT per USD (annual average)	1,180	1,170	1,166	1,438	1,436	1,421	1,407
Real effective exchange rate (2000=100)	87.5	83.5	100.8	91.0	93.5	96.2	99.1
External finance							
Current account balance (USDm)	372	172	-690	-342	-141	-690	-1,333
Current account balance (% of GDP)	11.8	4.4	-13.4	-8.1	-2.5	-9.8	-15.4
Current account balance plus net FDI (% of GDP)	17.9	13.5	2.9	5.4	14.2	5.8	3.1
Net external debt (USDm)	290	293	1,352	975	275	-45	-207
Net external debt (% of GDP)	9.2	7.4	26.2	23.2	4.8	-0.6	-2.4
Net external debt (% of CXR)	12.4	10.4	39.5	37.7	8.3	-1.2	-5.0
Official international reserves including gold (USDm)	719	1,002	656	1,327	2,006	2,830	3,085
Official international reserves (months of CXP cover)	4.4	4.5	1.9	5.4	7.0	7.7	6.7
External interest service (% of CXR)	0.6	0.5	0.5	1.5	0.9	0.7	0.6
Gross external financing requirement (% int. reserves)	-99.5	-11.1	87.2	76.6	28.6	41.9	53.8
Memo: Global forecast summary							
Real GDP growth (%)							
US	2.7	1.9	0.0	-2.6	2.7	2.5	2.6
Japan	2.0	2.4	-1.2	-5.2	3.0	1.6	1.7
Euro area	3.1	2.7	0.4	-4.0	1.8	1.7	1.9
World	3.8	3.7	1.4	-3.7	2.4	2.1	2.2
Commodities							
Oil (USD/barrel)	65.4	72.7	97.7	64.0	77.0	80.0	85.0

[a] Bank of Mongolia policy rate (annual average)
Source: Fitch

Comparative Analysis: Macroeconomic Performance and Policies

Mongolia

	2010						
	Bolivia 'B+'	Ghana 'B+'	Sri Lanka 'B+'	Mongolia 'B+'	Uganda 'B'	'B' median	'BB' median
Real GDP (5yr average % change)	4.6	6.0	6.2	6.8	7.0	6.1	3.5
Volatility of GDP (10yr rolling SD)	1.3	1.0	2.7	3.7	1.5	2.4	3.1
Consumer prices (5yr average)	6.5	13.9	11.5	10.9	8.6	9.4	7.0
Volatility of CPI (10yr rolling SD)	3.9	7.3	5.7	6.5	4.1	5.2	2.9
Years since double-digit inflation	2.0	0.0	2.0	2.0	1.0	n.a.	n.a.
Unemployment rate	6.8	-	5.5	3.5	-	8.7	8.9
Type of exchange rate regime	Crawling peg	Managed float	Managed float	Managed float	Free float	n.a.	n.a.
Dollarisation ratio (2009)	52.0	32.7	23.0	38.3	26.0	29.4	53.1
REER volatility (10yr rolling SD)	7.5	5.7	6.1	8.4	5.1	7.2	8.9

Source: Fitch

Strengths

- The country's longer-term macroeconomic prospects are bright. The IMF projects real GDP growth to average 19% per year during 2013-2016 as development of the country's natural resources intensifies. However, insulating the economy from commodity-driven boom-and-bust cycles is likely to grow more challenging for policymakers.
- Mongolia's new macroeconomic policy framework, including the FSL, is on paper a strength for the 'B' range, although the strength of the authorities' commitment to the new framework remains to be demonstrated.

Weaknesses

- Weak and pro-cyclical policy management, particularly in 2006-2008, left the country heavily exposed to the global financial crisis and collapse in copper prices in 2008-2009.
- Mongolia's small economy (2010 projected GDP of USD5.7bn) has a history of more volatile inflation and growth than for rating peers. The economy is likely to remain heavily dependent on mining and agriculture.

Commentary

Mongolia's economy grew 8.4% yoy in Q310, taking GDP back above the end-2008 pre-crisis peak. All sectors made a positive contribution except agriculture, which suffered from the severity of the 2009/2010 winter. Agriculture's real GDP contribution has averaged 22% since 2005, underlining the importance of this effect. The biggest positive contributor to growth was taxes net of subsidies, reflecting the turnaround in commodity prices.

Fitch's central expectation of a sustained, if weak, global economic recovery, if realised, would offer some support to commodity prices and so to Mongolia's prospects. China ('A+'/Stable) is Mongolia's dominant external trade partner, taking 73% of the country's exports in 2009. Fitch expects China's economy to grow by 8.6% in 2011 and 8.7% in 2012. This would be positive for Mongolia, although experience in 2008-2009 demonstrates that commodity prices can fall sharply even while China is growing strongly.

Inflation ran at 10.6% yoy in September 2010, above the 12-month average of 7.8%. This was partially due to food prices growing 14.3%, but generous fiscal policy measures, including a 30% increase in public sector wages and pensions from October, and a USD85 handout from mineral revenue per person risk fuelling demand-side inflationary pressure.

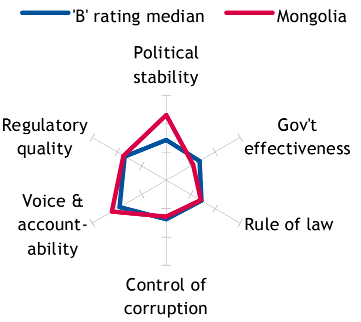
Comparative Analysis: Structural Features

Mongolia

	2010						
	Bolivia ‘B+’	Ghana ‘B+’	Sri Lanka ‘B+’	Mongolia ‘B+’	Uganda ‘B’	‘B’ median	‘BB’ median
GNI per capita PPP (USD, 2009)	4,140	1,430	4,480	3,480	1,140	3,810	9,530
GDP per capita (USD, mkt. exchange rates)	1,841	750	2,428	2,109	525	2,539	5,128
Human Development Index (percentile, 2009)	38.1	16.5	44.1	37.0	13.8	37.6	56.9
Ease of Doing Business (percentile, 2009)	12.1	50.0	42.9	67.6	39.1	39.4	47.3
Trade openness (CXR and CXP % GDP)	36.4	68.1	31.2	59.5	33.2	n.a.	n.a.
Gross domestic savings (% GDP)	20.0	6.0	18.4	40.7	12.6	15.2	15.7
Gross national savings (% GNP)	22.5	18.5	24.3	44.3	14.1	17.6	18.6
Gross domestic investment (% GDP)	17.2	30.4	26.6	45.6	21.1	22.5	20.0
Private credit (% GDP)	35.0	23.1	26.9	36.9	12.6	25.9	35.1
BSR indicators	D1	n.a.	D1	n.a.	n.a.	n.a.	n.a.
Bank system CAR	13.3	18.2	14.0	16.0	21.0	n.a.	n.a.
Foreign bank ownership (% assets)	17.0	55.0	20.0	49.6	77.9	n.a.	n.a.
Public bank ownership (% assets)	6.6	30.0	48.0	3.5	4.1	22.3	17.3
Default record (year cured)[a]	1997	2005	-	2003	2000	n.a.	n.a.

[a] Payment arrears on RBL debt owed to the Russian Federation, 2002 and 2003
Source: Fitch and World Bank

Chart 8: Governance



Source: World Bank, Fitch

Strengths

- Mongolia’s generous and diverse endowment of natural resources (including copper, gold, coal and uranium) is a key structural strength. However, the country is still some years away from realising the full benefits, and the authorities will need to guard against the temptation to spend the revenue unsustainably.
- The economy’s scoring under the Ease of Doing Business framework outperforms ‘B’ range peers.
- Governance standards match or exceed ‘B’ peers. Mongolia’s scoring in the 2010 Corruption Perceptions Index was 2.7, in line with the ‘B’ median.

Weaknesses

- Mongolia has a relatively low average income level for the ‘B’ rating range and it is well below the ‘BB’ range median, both at market exchange rates and on a purchasing-power parity basis.
- Despite post-crisis improvements, a high NPL ratio and weakened capitalisation weigh on Mongolia’s banking system.
- The Mongolian sovereign’s payment history is blemished by arrears on Russian rouble debt owed to the Russian Federation in 2002-2003.

Commentary

Operator Ivanhoe Mines Ltd expects Oyu Tolgoi to produce 544,000 metric tonnes of copper and 650,000 ounces of gold annually for at least 10 years when it enters full production in 2013. This would be worth about USD4.8bn at average prices over 2010 to 24 November, or more than 80% of projected 2010 GDP. Eurasia Capital comments the Tavan Tolgoi coal mine is the world’s ninth-largest and could produce 15 million tonnes of coal per year, worth up to USD2.0bn at the Chinese mine price (average over 2010 to 24 November), depending on the mix of coal types. However, this project is further away from the production stage.

Mongolia joined the Extractive Industries Transparency Initiative (EITI) in 2006. The EITI attempts to reconcile reported tax payments from companies with government-declared tax payments for the natural resources sector. Discrepancies dropped to MNT431m in 2008 from MNT25bn in 2006, indicating improved transparency in this important area.

Comparative Analysis: External Finances

Mongolia

	2010					Last 10 years	
	Bolivia 'B+'	Ghana 'B+'	Sri Lanka 'B+'	Mongolia 'B+'	Uganda 'B'	'B' median	'BB' median
GXD (% CXR)	80.9	96.6	161.2	82.8	89.1	98.9	104.2
GXD (% GDP)	31.2	59.9	48.1	48.2	26.3	48.2	41.3
NXD (% CXR)	-83.5	57.0	93.9	8.3	12.5	24.2	13.1
NXD (% GDP)	-32.3	35.3	28.0	4.8	3.7	11.0	5.1
GSXD (% GXD)	47.4	71.6	77.6	74.7	62.3	63.9	49.2
NSXD (% CXR)	-93.7	34.0	78.7	1.4	-4.1	22.4	5.8
NSXD (% GDP)	-36.2	21.0	23.5	0.8	-1.2	10.5	2.2
SNFA (USDm)	6,522.4	-3,843.8	-11,628.6	409.5	214.7	-906.6	-56.1
SNFA (% GDP)	35.2	-21.0	-23.5	7.2	1.2	-9.9	-0.8
Ext. debt service ratio (% CXR)	7.3	9.3	10.0	8.1	3.8	8.7	15.6
Ext. interest service ratio (% CXR)	2.1	2.3	3.4	0.9	0.5	2.6	4.5
Liquidity ratio (latest)	1,406.8	152.9	102.9	443.2	690.6	163.7	142.7
Current account balance (% GDP)	4.5	-12.3	-2.7	-2.5	-7.3	-4.9	-1.8
CAB plus net FDI (% GDP)	6.1	-4.0	-1.7	14.2	-3.3	-1.3	1.5
Commodity dependence (% CXR, latest)	66	47	19	70	39	38.2	32.6
Sovereign net FX debt (% GDP)	-36.2	21.0	26.9	0.8	-0.9	-	-

Source: Fitch

Strengths

- Mongolia's external liquidity ratio is well above 'B' range norms and rising, due to growing official reserves. This strength is mitigated by the commodity-driven volatility of the balance of payments, as shown in 2008-2009. This underscores Mongolia's need for a generous external liquidity buffer.
- Mongolia's net external debt ratios are already below peer medians and are expected to strengthen further as FDI into the country continues.
- The Mongolian sovereign's net foreign asset position is a rating strength.

Weaknesses

- Mongolia's high commodity dependence imparts volatility to the external finances and is a rating weakness.

Commentary

Mongolia's external finances are projected to strengthen by 2012 on the back of strong non-debt FDI inflows, primarily into the natural resources sector. The Oyu Tolgoi project alone is expected to require around USD4bn in investment to bring on-stream. Fitch projects that the country will become a modest net external creditor in 2011, a sharp turnaround from 40% of GDP net debt at end-2008.

Mongolia negotiated a CNY5bn swap agreement with the People's Bank of China in 2010 to provide liquidity for the development of Chinese yuan markets in Mongolia. The development of yuan banking is at an early stage and does not yet materially affect the rating profile, although Fitch will continue to monitor developments.

The scale of development of Mongolia's natural resources in the medium term is likely to complicate analysis of Mongolia's external finances, particularly on a comparative basis against rating peers. It is likely that the country will be running a double-digit current account deficit by 2012, largely offset by FDI financing from project developers.

Comparative Analysis: Public Finances

Mongolia

	2010					Last 10 years	
	Bolivia 'B+'	Ghana 'B+'	Sri Lanka 'B+'	Mongolia 'B+'	Uganda 'B'	'B' median	'BB' median
Budget balance (% GDP)	-0.9	-8.3	-8.2	-4.0	-3.0	-2.8	-2.1
Primary balance (% GDP)	0.0	-1.9	-2.8	-3.2	-2.0	0.3	0.7
Revenues and grants (% GDP)	31.9	34.2	15.0	37.5	15.4	31.4	24.3
Volatility of revenues/GDP ratio	12.2	12.4	5.4	8.6	9.5	10.3	6.1
Interest payments (% revenue)	2.9	14.9	36.5	2.1	6.7	6.2	11.0
Debt (% revenue)	93.1	175.9	548.1	113.8	151.2	159.3	172.5
Debt (% GDP)	29.7	60.2	82.0	42.7	23.3	42.6	40.6
Net debt (% GDP)	56.3	53.6	81.8	33.9	4.1	35.9	35.5
FC debt (% total debt)	49.7	71.3	49.7	84.0	70.5	74.6	62.8
CG debt maturities (% GDP)	2.0	12.5	18.1	2.0	5.5	3.9	4.8
Average duration of CG debt (years)	-	1.0	-	-	13.7	1.6	3.5

Source: Fitch

Strengths

- Mongolia's government revenue is high compared with the 'B' range and even 'BB' range peers. The sovereign's revenue volatility is below the 'B' median, although considerably higher than the 'BB' median.
- Fiscal liquidity is relatively strong, with a low interest/revenue ratio and modest debt maturities, reflecting the fact that more than 90% of Mongolia's government debt (excluding local-currency debt issued for bank-recapitalisation purposes) is owed to official multilateral or bilateral creditors.
- Mongolia's new fiscal framework enshrined in the FSL is strong on paper, although the strength of commitment to implementation remains to be seen.

Weaknesses

- Mongolia has a poor track record of fiscal management, with heavily pro-cyclical spending during 2006-2008 contributing to the crisis of 2008-2009.
- The Windfall Profits Tax, which contributed about 9% of revenue in 2009 and 13% in 9M10, is due to expire in 2011 without a replacement source of revenue having been decided.

Commentary

Mongolia's 12-month-rolling cash general government deficit narrowed sharply to just 0.2% of projected 2010 GDP in the year to September 2010, down from 10.5% a year earlier, as revenue growth of 55% on a year earlier shot ahead of still-strong expenditure growth of 25%. However, a 30% rise in pensions and public sector wages will affect the fiscal balance in Q410.

Mongolia has expressed interest in tapping international debt capital markets. The authorities have indicated to Fitch that the proceeds are intended to be used to finance infrastructure spending. Fitch factors in a USD0.5bn issue worth 7% of projected 2011 GDP, compared with the sovereign's estimated 2011 financing need of about 7.5%.

Fiscal Accounts Summary

(% of GDP)	2007	2008	2009	2010f	2011f	2012f
General government						
Revenue	**40.9**	**36.1**	**32.9**	**37.5**	**36.3**	**35.8**
Expenditure	**38.0**	**41.0**	**38.6**	**41.5**	**41.5**	**40.0**
O/w interest payments	0.4	0.3	0.5	0.8	0.8	0.8
Primary balance	3.3	-4.6	-5.2	-3.2	-4.4	-3.4
Overall balance	**2.9**	**-4.9**	**-5.7**	**-4.0**	**-5.2**	**-4.2**
Memo: Balance including bank recapitalisation	2.9	-4.9	-5.7	-10.6	-5.2	-4.2
General government debt	**39.4**	**33.7**	**45.8**	**42.7**	**42.6**	**35.6**
% of general government revenue	96.3	93.5	139.2	113.8	117.5	99.4
Memo: Of which bank recap related	0	0	0	6.6	5.4	4.4
General government deposits	16.5	10.0	10.0	5.8	17.1	11.2
Net general government debt	22.8	23.7	35.8	36.9	25.5	24.1
Central government						
Revenue	**38.1**	**24.0**	**23.7**	**27.8**	**26.9**	**26.5**
O/w grants	0.6	1.6	3.1	3.9	3.9	3.9
Expenditure and net lending	**36.0**	**28.8**	**28.6**	**30.7**	**30.7**	**29.6**
O/w current expenditure and transfers	28.5	23.5	23.2	25.6	25.6	26.0
- Interest	0.4	0.3	0.5	0.8	0.8	0.8
O/w capital expenditure	5.3	4.1	4.2	4.4	4.4	3.3
Current balance	9.0	-15.2	-17.5	-12.4	-16.1	-13.0
Primary balance	2.5	-3.3	-3.7	-2.2	-3.1	-2.3
Overall balance	**2.1**	**-3.6**	**-4.2**	**-2.9**	**-3.8**	**-3.1**
Central government debt	39.4	33.7	45.8	42.7	42.6	35.6
% of central government revenues	103.2	140.7	193.0	153.6	158.4	134.2
Central government debt (MNTbn)	**1,810**	**2,030**	**2,775**	**3,490**	**4,260**	**4,325**
By residency of holder	0	0	0	0	0	0
Domestic	22	2	229	849	829	809
Foreign	1,789	2,029	2,546	2,641	3,432	3,516
By place of issue	0	0	0	0	0	0
Domestic	22	2	229	849	829	809
Foreign	1,789	2,029	2,546	2,641	3,432	3,516
By currency denomination	0	0	0	0	0	0
Local currency	22	2	229	849	829	809
Foreign currency	1,789	2,029	2,546	2,641	3,432	3,516
In USD equivalent (eop exchange rate)	1,529	1,600	1,765	1,849	2,427	2,512
By maturity						
Less than 12 months (residual maturity)	73.5	165.7	161.8	153.3	183.4	186.6
Average maturity (years)	-	-	-	-	-	-
Average duration (years)	-	-	-	-	-	-
Memo						
Non-financial public-sector balance (% GDP)	-	-	-	-	-	-
Net non-financial public-sector debt (% GDP)	-	-	-	-	-	-
Nominal GDP (MNTbn)	4,599.5	6,019.8	6,055.8	8,175.3	9,991.4	12,147.7

Source: Ministry of Finance and Fitch estimates and forecasts

External Debt and Assets

(USDm)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010f
Gross external debt	**919.6**	**1,110.8**	**1,364.5**	**1,398.9**	**1,362.9**	**1,494.4**	**1,741.8**	**2,256.3**	**2,716.0**	**2,747.0**
% of GDP	78.7	87.3	94.2	77.0	59.1	47.5	44.3	43.7	64.5	48.2
% of CXR	117.3	123.2	128.1	90.4	77.4	63.9	61.6	65.9	105.1	82.8
By maturity										
Medium- and long-term	905.2	1,066.6	1,314.5	1,398.9	1,362.9	1,494.4	1,741.8	2,186.4	2,590.8	2,697.0
Short -term	14.4	44.2	50.0	0.0	0.0	0.0	0.0	69.9	125.2	50.0
% of total debt	1.6	4.0	3.7	0.0	0.0	0.0	0.0	3.1	4.6	1.8
By debtor										
Monetary authorities	**46.8**	**42.0**	**48.9**	**44.3**	**1.3**	**1.4**	**1.2**	**0.8**	**169.1**	**212.7**
General government	**852.2**	**984.9**	**1,240.3**	**1,360.0**	**1,313.1**	**1,415.3**	**1,529.9**	**1,603.0**	**1,811.3**	**2,051.9**
O/w central government	852.2	984.9	1,290.3	1,360.0	1,311.8	1,413.9	1,528.7	1,600.5	1,764.7	1,849.2
Banks	**53.0**	**81.7**	**74.2**	**38.9**	**34.1**	**63.0**	**160.4**	**365.8**	**353.4**	**292.5**
Other sectors	**14.4**	**44.2**	**50.0**	**0.0**	**15.7**	**16.1**	**51.5**	**287.5**	**551.3**	**402.6**
Gross external assets (non-equity)	**254.1**	**330.3**	**316.9**	**377.3**	**594.5**	**1,204.9**	**1,449.1**	**904.6**	**1,740.9**	**2,472.2**
International reserves, incl. gold	206.6	267.4	203.6	207.8	333.2	719.4	1,002.4	655.9	1,327.3	2,006.1
Other sovereign assets nes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposit money banks' foreign assets	47.5	62.9	113.3	169.5	261.3	485.5	446.7	248.7	413.6	466.1
Other sector foreign assets[a]	-	-	-	-	-	-	-	-	-	-
Net external debt	**665.5**	**780.5**	**1,047.7**	**1,021.6**	**768.4**	**289.6**	**292.7**	**1,351.7**	**975.1**	**274.8**
% of GDP	56.9	61.3	72.3	56.3	33.3	9.2	7.4	26.2	23.2	4.8
% of CXR	84.9	86.5	98.3	66.0	43.7	12.4	10.4	39.5	37.7	8.3
Net sovereign external debt	645.6	717.5	1,036.7	1,152.2	980.0	695.9	527.5	947.1	484.0	45.8
% of GDP	55.2	56.4	71.6	63.5	42.5	22.1	13.4	18.3	11.5	0.8
Net bank external debt	5.5	18.9	-39.0	-130.6	-227.2	-422.4	-286.4	117.1	-60.2	-173.6
Net other external debt	14.4	44.2	50.0	0.0	15.7	16.1	51.5	287.5	551.3	402.6
Net international investment position	**-**	**-**	**-**	**-**	**-**	**-889.0**	**-356.3**	**313.8**	**212.7**	**956.7**
% of GDP	-	-	-	-	-	-28.2	-9.1	6.1	5.1	16.8
Sovereign net foreign assets	**-**	**-**	**-**	**-**	**-**	**-697.3**	**-529.4**	**-902.2**	**-195.8**	**409.5**
% of GDP	-	-	-	-	-	-22.1	-13.5	-17.5	-4.6	7.2
Debt service (principal & interest)	**89.5**	**93.8**	**354.5**	**95.3**	**40.9**	**55.3**	**106.5**	**201.0**	**199.5**	**267.6**
Debt service (% of CXR)	11.4	10.4	33.3	6.2	2.3	2.4	3.8	5.9	7.7	8.1
Interest (% of CXR)	-1.1	1.2	1.1	1.0	0.9	0.6	0.5	0.5	1.5	0.9
Liquidity ratio (%)	245.2	234.8	82.8	218.0	922.5	1,074.6	1,131.1	721.0	335.7	443.2
Net sovereign FX debt (% of GDP)	55.2	56.4	71.6	63.5	42.5	22.1	13.4	18.3	11.5	0.8
Memo										
Nominal GDP	1,168.9	1,272.6	1,448.2	1,815.7	2,306.2	3,149.1	3,929.9	5,163.7	4,211.9	5,694.6
Gross sovereign external debt										
Inter-company loans	-	-	-	-	-	-	-	-	-	-

[a] No data; assumed 0
Sources: NBP, IMF, World Bank and Fitch estimates and forecasts

Debt Service Schedule on Medium- and Long-Term Debt at 26 November 2010

(USDm)	2009	2010	2011	2012	2013	2014	2015+
Sovereign							
Official bilateral	25.5	18.9	22.1	45.9	58.7	77.0	513.3
O/w Paris Club	20.6	15.2	17.8	36.9	47.3	62.0	
Multilateral	46.7	35.6	40.6	59.2	99.3	84.0	1,028.0
O/w IMF	6.6	2.4	2.4	22.7	66.8	55.6	19.2
Other	0.0	0.0	0.0	0.0	0.0	0.0	0
Bonds placed in foreign markets	0.0	0.0	0	0	0	0	500.0
Non-resident holdings of domestic debt	0.0	0.0	0	0	0	0	0
Interest	17.4	17.2	17.9	18.4	18.2	17.6	
Total sovereign debt service	**89.6**	**71.7**	**80.6**	**123.5**	**176.2**	**178.6**	**2,041.3**
Private sector							
Amortisation	88.6	184.4	88.0	84.1	57.3	57.3	308.4
Interest	21.3	11.4	7.1	4.5	2.1	0.9	
Total private debt service	**109.9**	**195.8**	**95.1**	**88.6**	**59.4**	**58.2**	**308.4**
Memo							
Non-sovereign public sector	n.a.						

Sources: Ministry of Finance, Central Bank and Fitch

Balance of Payments

(USDm)	2007	2008	2009	2010f	2011f	2012f
Current account balance	**171.8**	**-690.0**	**-341.7**	**-141.3**	**-690.3**	**-1,333.4**
% of GDP	4.4	-13.4	-8.1	-2.5	-9.8	-15.4
% of CXR	6.1	-20.2	-13.2	-4.3	-18.6	-32.1
Trade balance	**-52.4**	**-627.2**	**-188.8**	**-121.0**	**-647.5**	**-1,213.8**
Exports, fob	1,950.7	2,529.1	1,885.4	2,451.0	2,696.1	2,965.7
Imports, fob	2,003.1	3,156.3	2,074.2	2,572.0	3,343.6	4,179.5
Services, net	**109.4**	**-110.8**	**-143.2**	**-160.0**	**-194.3**	**-241.3**
Services, credit	573.9	499.4	414.6	450.0	495.0	544.5
Services, debit	464.5	610.2	557.8	610.0	689.3	785.8
Income, net	**-97.5**	**-172.7**	**-195.4**	**-145.0**	**-200.0**	**-310.0**
Income, credit	9.4	16.6	24.4	18.1	25.0	38.7
Income, debit	106.9	189.3	219.8	163.1	225.0	348.7
O/w: Interest payments	14.8	17.0	38.7	28.6	25.0	22.9
Current transfers, net	**212.3**	**220.7**	**185.7**	**284.7**	**351.5**	**431.7**
Memo						
Non-debt-creating inflows (net)	434.8	810.4	484.8	950.0	1,100.0	1,600.0
O/w equity FDI	360.0	822.1	487.6	950.0	1,100.0	1,600.0
O/w portfolio equity	74.8	-11.7	-2.8	0.0	0.0	0.0
O/w other	-11.3	-	-	13.0	13.0	0.0
Change in reserves (-=increase)	-288.1	339.8	-355.1	-677.7	-325.6	-254.6
Gross external financing requirement	-80.1	874.0	502.6	380.2	841.0	1,522.6
Stock of international reserves, incl. gold	1,002.4	655.9	1,327.3	2,006.1	2,333.7	2,588.3

Sources: IMF and Fitch estimates and forecasts