FITCH AFFIRMS MONGOLIA AT 'B'; OUTLOOK STABLE

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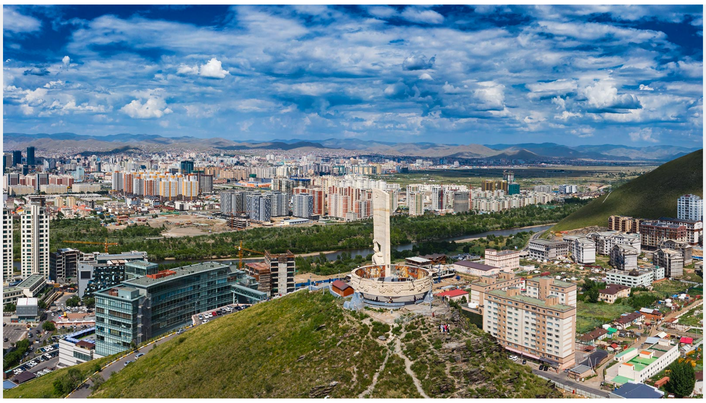

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Fitch Ratings has affirmed Mongolia's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'B' with a Stable Outlook.

Strong Growth, External Vulnerabilities: Mongolia's ratings are underpinned by favourable medium-term growth prospects and high per capita income relative to 'B' rated peers. The ratings are constrained by the country's high reliance on external funding and commodity exports to China amid high external debt and low foreign-exchange reserves. Mongolia scores well on World Bank Governance Indicators relative to 'B' peers, but has suffered from political volatility around issues of resource nationalism.

Growth Rebound: We forecast real GDP growth of 5% in 2023, similar to 2022, on stronger mining activity and steady domestic demand. Growth will likely accelerate in 2024. Coal exports are rebounding after China's removal of border pandemic controls. Export capacity will rise further once cross-border rail links become fully operational in the next one-two years. The strategic Oyu Tolgoi copper mine's underground phase started production in March 2023, although most of the volume gains will only come from 2025. Other mining and infrastructure projects could support medium-term growth.

External Finances Stabilising: The export rebound is helping rein in the current account deficit (CAD), which we expect to shrink to about USD1.7 billion-1.8 billion (about 9% of GDP) in 2023-2024, from about USD2.3 billion (over 13% of GDP) in 2022. We expect inflows of FDI to cover the CAD. Official foreign-exchange (FX) reserves recovered to USD3.7 billion in April 2023, from a trough of USD2.7 billion in August 2022, while bank deposit dollarisation stabilised at 37% of total deposits in March 2023, having risen from 24% at end-2021.

External Finances Remain Precarious: Net external debt, at 160% of GDP in 2023 will be around 6x the 'B' median, although over 30% of this is intercompany lending (FDI), and over 20% is the government's bilateral and multilateral loans on concessional terms, both of which we expect will continue to be stable sources of funding. Reserve coverage ratios, though improved, remain weaker than the 'B' median. Gross reserves are supported by about USD1.7 billion in swap liabilities to the People's Bank of China, which we expect to be rolled over, and similar amounts of FX liabilities to domestic banks.

Maturity Management: Just over USD150 million in government external debt is due in the rest of 2023, with the proceeds of a USD650 million issuance in January mostly used to repay and exchange bonds maturing in May. The Development Bank of Mongolia (DBM) has set aside reserves to repay a JPY30 billion (USD220 million) government-guaranteed bond in December. The government is authorised to guarantee DBM bonds maturing in October (about USD437 million outstanding), which we assume will be used to roll them over. Government external debt maturities in 2024 are USD680 million.

Narrow Fiscal Deficit: We forecast general government fiscal deficits at under 1% of GDP in 2023-2024, after a surplus of 1% of GDP in 2022, reflecting our expectation that higher spending will offset the boost to revenue from the mining sector and inflation. Last year's fiscal outturn marked a significant turnaround from the 3% of GDP deficit in 2021. The government originally budgeted a deficit of under 2% of GDP in 2023, but has since raised its projection for mining revenue by over 1% of GDP.

Underlying Fiscal Stance Expansionary: We estimate that the non-mineral primary deficit will remain at around 11%-12% of non-mining gross value-added (GVA), down from 21% in 2020, but 4pp-5pp worse than in 2017-2019, largely a result of increases to pensions and child support payments legislated in a 2022 supplementary budget, costing over 3% of GDP (5% of non-mining GVA). In our view, there are no credible fiscal anchors, and impetus for fiscal consolidation will be limited in the run-up to legislative elections in June 2024.

Commodity Dependence, Risks: The outlook for external finances is highly sensitive to commodity revenues, which account for 90% of total external receipts and 30% of government revenue. For example, a 10% shortfall in coal volume relative to our baseline would imply a USD500 million (4% of GDP) hit to the CAD in 2023 and a USD100 million hit to government revenue.

Debt Declining; Sizeable Contingent Liabilities: Government debt edged down to 60% of GDP in 2022 from about 61% of GDP in 2021 on strong nominal growth and an improved fiscal balance. We expect debt to continue on a downward path broadly in line with the 'B' median, reaching about 55% of GDP by 2024, including DBM debt assumed to be rolled over with a government guarantee. However, the government has significant potential contingent liabilities, including unguaranteed state-owned enterprise debt of over 15% of GDP and the Bank of Mongolia's (BOM) negative equity position of about 7% of GDP.

Inflation Peaking; Monetary Stance Mixed: We expect headline inflation to average 12% yoy in 2023, from an average of over 15% in 2022, before moderating to 9% in 2024, slightly above the BOM's 4%-8% target. Full normalisation of trade with China and lower global commodity prices should exert a downward pull on inflation, although international sanctions on Russia are still leading to elevated import costs.

The BOM raised its policy rate to 13% in December, bringing cumulative hikes in 2022 to 700bp. However, the impact of this could be blunted by nearly MNT3 trillion (6% of GDP) in liquidity injections from the redemption in central bank bills in 2022. Government-approved customs exemptions for diesel and gasoline imports in 2Q23 appear to run contrary to the BOM's moves to tighten policy.

Banking System Stable: Non-performing loans have remained steady at about 10% of total sector loans, although underlying asset quality issues may be masked by high nominal growth, ongoing subsidised lending programmes and a moratorium on mortgage repayments, which only ended in December 2022. The BOM completed an asset quality review of domestic systemically important banks (D-SIBs), and three of the five D-SIBs have already launched IPOs to reduce shareholder concentration, meeting a BOM requirement to do so by June 2023.

ESG - Governance: Mongolia has an ESG Relevance Score of '5[+]' for Political Stability and Rights and '5' for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. Theses scores reflect the high weight that the World Bank Governance Indicators have in our proprietary Sovereign Rating Model. Mongolia has a medium World Bank Governance Indicator ranking at the 47th percentile.