

External Factors of Mongolian Economy

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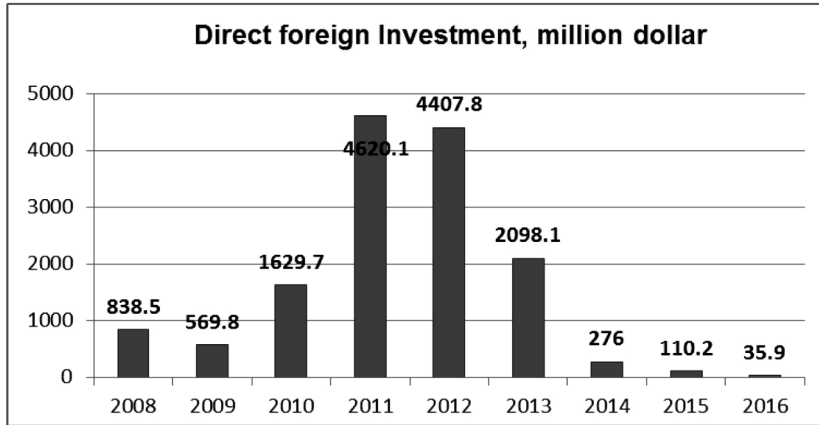
The proper determination of factors able to provide the sustainable development is one of the prominent issues for economic renovation and reform. For Mongolia, a small country with transition and dependent economy, an external environment and foreign economic relations are the basic factor of its growth. Therefore, I want to focus on this issue.

The current era of economic globalization and interdependence of nations is growing. Today, not only does China have a significant influence on the global economy but it also has a major impact on the developing Asian economies, as well as, on its neighbor Mongolia. Here, I attempt to highlight Foreign Direct Investment (FDI) importance as the Mongolian economy. FDI has been the engine of Mongolian economic growth.

In 2011, had come to our country foreign direct investment of \$ 4.62 billion, a decline from year to year to \$ 110.2 million in 2015 or decreased by 41.9. And in the first 6 months of this year foreign direct investment decreased by \$ 35 million. This can be seen as the clearest example of how confidence of investors went down in our country.

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Figure one. FDI (million USD)



Source: Finance Ministers statement August 10, 2016

FDI flows and stocks increased significantly in recent years, but remain below their potential. In 2015 FDI flows decreased due to the Government's policies on the business and delays in decision-making regarding mining activities.

Figure two. FDI Stock

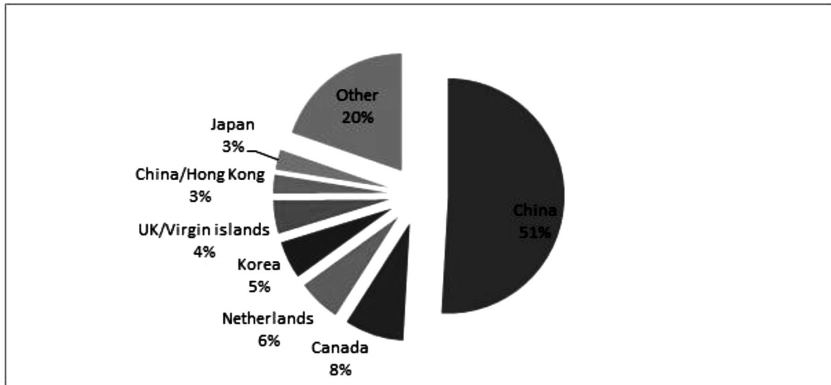
| Foreign Direct Investment | 2013 | 2014 | 2015 |
|---------------------------|----------|----------|----------|
| FDI Stock (million USD) | 15,729.2 | 16,692.8 | 16,752.7 |

The country's ranking in terms of its business climate is improving steadily, and Mongolia ranks 56th out of 189 countries in the 2016 Business report, published by the World Bank.

In order to attract FDI, the Government launched a programme to improve the country's legal framework. In particular, it decided to lift the moratorium on new mining exploration licenses. However, foreign investors remain hesitant since the Government suspended 106 permissions in 2014 due to a corruption investigation. Mongolia possesses numerous assets, including raw materials, sizable livestock and many other sectors with high potential for development (mining, food processing, telecommunications,

tourism). All sectors of Mongolia’s economy are open to FDI. However, the instability of economic policies and regulations, its landlocked situation, the corruption and an inefficient transportation system are important obstacles to investors.

Figure three. Mongolia’s main top FDI’s



Source: FIFTA

Figure four. Country Comparison for the Protection of Investors

| | Mongolia | East Asia & Pacific | United States | Germany |
|-------------------------------------|----------|---------------------|---------------|---------|
| Index of Transaction Transparency* | 6.0 | 5.0 | 7.0 | 5.0 |
| Index of Manager’s Responsibility** | 8.0 | 5.0 | 9.0 | 5.0 |
| Index of Shareholders’ Power*** | 6.0 | 6.0 | 9.0 | 5.0 |
| Index of Investor Protection**** | 6.7 | 5.4 | 8.3 | 5.0 |

Source: Doing Business - 2016.

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*Note: *The Greater the Index, the More Transparent the Conditions of Transactions. **The Greater the Index, the More the Manager is Personally Responsible. *** The Greater the Index, the Easier it Will Be For Shareholders to Take Legal Action. **** The Greater the Index, the Higher the Level of Investor Protection.*

| Foreign Direct Investment | 2013 | 2014 | 2015 |
|-------------------------------------|-------|-------|-------|
| Number of Greenfield Investments*** | 14.0 | 6.0 | 4.0 |
| FDI Inwards (in % of GFCF****) | 43.3 | 11.0 | 9.1 |
| FDI Stock (in % of GDP) | 125.0 | 136.9 | 142.8 |

Source: UNCTAD - 2016

*Note: * The UNCTAD Inward FDI Performance Index is Based on a Ratio of the Country's Share in Global FDI Inflows and its Share in Global GDP. ** The UNCTAD Inward FDI Potential Index is Based on 12 Economic and Structural Variables Such as GDP, Foreign Trade, FDI, Infrastructures, Energy Use, R&D, Education, Country Risk. *** Green Field Investments Are a Form of Foreign Direct Investment Where a Parent Company Starts a New Venture in a Foreign Country by Constructing New Operational Facilities from the Ground Up. **** Gross Fixed Capital Formation (GFCF) Measures the Value of Additions to Fixed Assets Purchased by Business, Government and Households Less Disposals of Fixed Assets Sold Off or Scrapped.*

Tax Rates

Value Added Tax (VAT)

10%

Company Tax

Progressive rate from 10% to 25%

Withholding Taxes

Dividends: 10/20%, Interests: 10/20%, Royalties: 10/20%.

Social Security Contributions Paid By Employers

20%

Individual Taxes

| | |
|------------|-----|
| Income tax | 10% |
|------------|-----|

Figure five. Country Comparison for Corporate Taxation

| | Mongolia | East Asia & Pacific | United States | Germany |
|---|----------|---------------------|---------------|---------|
| Number of Payments of Taxes per Year | 41.0 | 25.1 | 10.6 | 9.0 |
| Time Taken for Administrative Formalities (Hours) | 148.0 | 208.0 | 175.0 | 218.0 |
| Total Share of Taxes (% of Profit) | 24.4 | 34.3 | 43.9 | 48.8 |

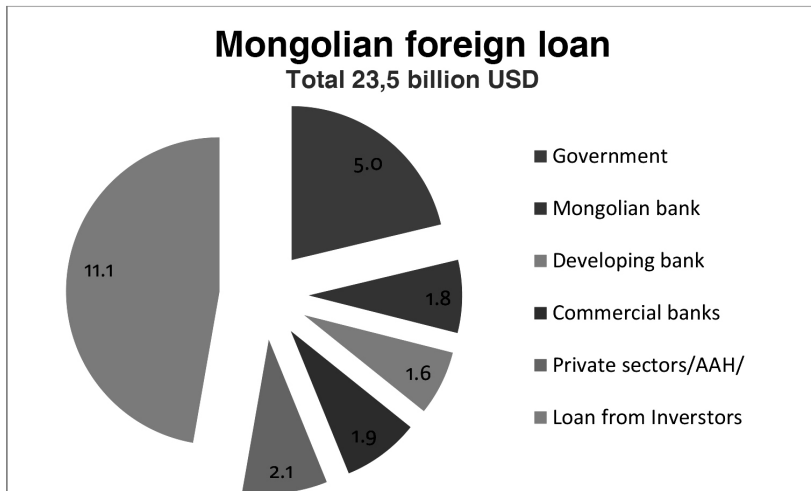
Source: *Doing Business - 2016.*

Figure six. Business Setup Procedures

| Setting Up a Company | Mongolia | East Asia & Pacific |
|----------------------|----------|---------------------|
| Procedures (number) | 5.00 | 7.09 |
| Time (days) | 6.00 | 27.21 |

Source: <https://en.portal.santandertrade.com/establish-overseas/mongolia/investing-3>

Figure seven. Foreign loan



Foreign trade:

At the end of 2015 Foreign trade turnover was US \$ 8.46 billion and compared to 2011 decreased to 2.95 billion dollars. In the first half of this year export performance of \$ 2.2 billion and imports dropped to \$ 1.5 billion and by 13 per cent from the previous year.

Positive trade balance, may say, was achieved during the last 2 years, thanks to the government policy aimed at the action plan. But the exchange rate has depreciated nearly by 58% over the past 4 years, investment and directly related to the citizens' purchasing power and living standards of the population, decreased

The current economic difficulties in Mongolia were not influenced by any external factors, but by poor and ineffective state policies.

More importantly, some critical policy decisions, taken by the government on foreign direct investment (FDI) exacerbated the impact of falling export prices. For instance, there is a continued struggle to push forward the second phase of the mega project Oyu Tolgoi, as well as, prolonged discussions and delays surrounding the construction of a railway, which is expected to reduce significantly the cost of coal selling to China.

Credit ratings:

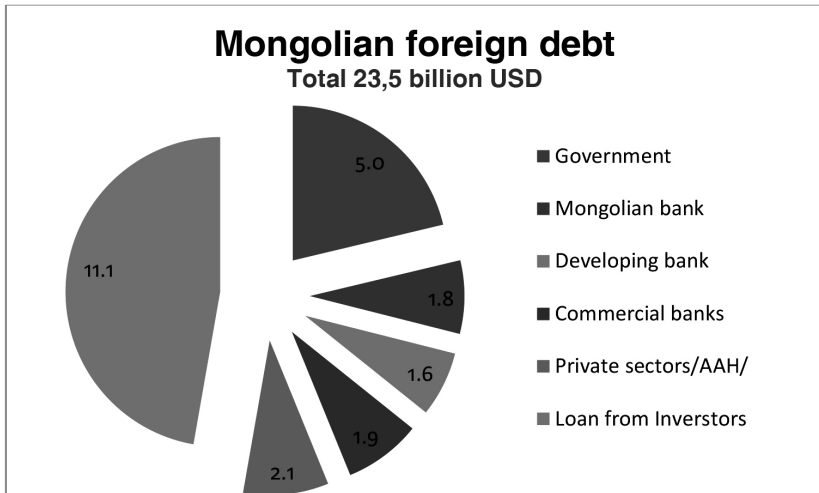
Credit ratings of Mongolian international standard here is reduced by Standard Poor's / S & P / agency in the last 4 years, 4 brackets. As a result, the government as well as our foreign trade companies have limited opportunities to borrow in less favorable conditions, interest from foreign exchange. For example, a fund for repaying the Chinggis Bond's principal payment of 500 million USD at the end of next year needs to be established now.

Foreign debt:

While much of that decline can be attributed to a slowdown in China and weak prices for Mongolia's major exports of coal and copper, voters also blame the government for missteps and rising debt. As of the first half of 2016, Mongolia's total foreign debt stood at 23.5 billion USD, which was 210 percent higher than the nation's GDP. The debt of the Cabinet reached five billion USD, Mongol Bank's was 1.8 billion USD, Development Bank's

was 1.6 billion USD, the debt of commercial banks was 1.9 billion USD, the nation's private sector's loans reached 2.1 billion MNT, and loans taken out by investors reached 11.1 billion USD.

Figure eight. Foreign debt



Mongolia, which can be considered one of Asia's most vulnerable markets, has been through ups and downs during the past five years. Once praised as the world's fastest growing economy, economic growth has recently approached recession levels amid the commodity market, China's economic slowdown, and the rapid drop in FDI experienced from the delay of Oyu Tolgoi, and other mining disputes. Mongolia is a strong commodity export economy, and approximately 90% of these exports go to China, making it most vulnerable to the current commodity market and China's economic slowdown. Furthermore, its economic performance has been hindered by the unpredictable actions of the government, which has been another strong factor for driving away FDI. The current economic landscape necessitates a shift in this previous anti-FDI attitude to avoid a recession, and notable improvements have already taken place this year, which will help improve Mongolia's reputation for foreign investment.

Mongolia is heading in the right direction, based on events that have taken place in recent months, and now is a right time.

- In Mongolia, what issues need rapid solutions?

- Personally, I think, political stability is one, very important factor. Another one would be industrial diversification which is key for sustainable development. Mining is of course very important. It is driving force to lead rapid economic growth for couple of years. But the industry is very fluctuant. It's very vulnerable because it is closely related to commodity market price. I think diversification of industry, especially agriculture, stock breeding and tourism is needed. Mongolia and Japan signed EPA to boost bilateral economic trade between the two countries. Now we need to cooperate in above the sector. Mongolian businesses want to export products to Japan, they need to produce high quality products to meet the requirement.

Transparency, accountability and responsibility of government is quite important for the development of our country. As for the development side, I would like to say Mongolia's effort to make grand design for mid or long term sustainable development. Such kind of grand design is very important. "Long-term Sustainable Vision 2016-2030" was approved by parliament this February supported by UNDP and Mongolian Government adopted "Foreign economic program 2015-2020" in December, 2015. It's too close correlated each other.

While announcement of the Oyu Tolgoi investment agreement was positive, the desired effect on FDI has not fully taken place due to delays in implementation of mega-projects, prices of raw materials continuing to collapse on the international stock market. However, the agreement provides political and legal stability for investors in Mongolia by restoring confidence in the government. The government was seeking to build a "very friendly business environment" by giving foreign companies the same regulatory treatment as local counterparts.

There is other good news, I mean the Investment agreement signed for Tavan Tolgoi power plant (TTPP) on June 26, 2016. TTPP will be built by 2023. The TTPP will supply energy to the Oyu Tolgoi project domestically, allowing the country to keep the money spent on imported energy, create new jobs, increase the value of Oyu Tolgoi project, and attract more foreign

investors. Japanese Marubeni Corporation and MCS will jointly implement the project. Establishing the investment agreement for the TTPP project in a time when the economic partnership agreement (EPA) between Mongolia and Japan became effective was the first project to prove the results of the EPA between the two countries.

Mongolia is heavily dependent on mining, which accounts a 80 percent of its GDP. To reduce that dependence, the landlocked nation between China and Russia has adopted an economic development plan of diversification.

CONCLUSION

The Government of Mongolia, with the objective of improving its internal transport network and increasing trade and transit links between Mongolia and its neighboring countries, the People's Republic of China (PRC) and the Russian Federation, has undertaken the upgrading of the Western, Central and Eastern Regional Road Corridors. Those corridors are strategically important for the socio-economic and regional development of Mongolia, as well as, improving the trilateral relationship between the 3 countries.

First, the effective cooperation in the framework of the Silk Road Economic Belt, the Steppe Road, and Eurasian Economic Union will boost the building of the China-Russia-Mongolia economic corridor and promote practical cooperation projects including railways, roads, energy resources, logistics, transportation, finance and agriculture. This will effectively promote the building of China-Russia-Mongolia economic corridor and boost the regional economic cooperation and development of the entire Eurasian continent also the East Asian region.

In international trade, there is a long-standing empirical finding: the gravity model. According to this theory, the larger the GDPs of trading partners, the more they will trade with one another, and the greater the distance between partners, the less they will trade.

Second, the pushing forward the mega projects such as China's proposed China-Mongolia-Russia Economic Corridor, The Asian

Infrastructure Investment Bank (AIIB) and the One Belt, One Road initiative and other projects are the keys to start developing Mongolian economy. In that connection Mongolia must take the initiative in its hands.

Third, what are the consequences of the recent legislative elections for businesses and investors operating in Mongolia? Will Mongolia's economic difficulties decrease, continue, or worsen?

On June 29th the Mongolian People's Party (MPP) defeated the ruling Democratic Party (DP) in parliamentary elections, taking 65 of the 76 seats in the Parliament. The MPP will have all possibilities as it returns to power after four years as an opposition party. They face a dramatic economic downturn, poor investor confidence, simmering popular discontent, and massive public debt.

Mongolia is heavily dependent on its mining sector - mineral resources make up a staggering 94% of its exports - and few countries have been as profoundly hamstrung by the crash in commodity prices as Mongolia. Mongolia is similarly heavily dependent on China, and has suffered from China's ongoing slowdown. Without access to seaports or adequate transport infrastructure, Mongolia has nowhere else to sell its mining products.

Finally, overall the MPP must make efforts to 1) diversify the economy, 2) cultivate human capital through better education, 3) bolster infrastructure to help its commodities reach additional markets beyond China, and 4) tackle the massive public debt in a sustainable fashion.