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## Why Mongolia?

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Mongolia is a country better known for its vast wilderness, nomadic culture, and Chingis Khaan than its business potential, but a growing number of international interests are warming to this untouched destination with good reason. A mining boom has brought wealth and Mongolia's GDP had grown at rates as high as 17% in 2011, until depressed global commodity prices and unpredictability of policies have put brakes on that growth. As a sandwiched country between giant China and Russia, Mongolia has a huge opportunity to bridge Asia and Europe by becoming one of the Asian connectivity hubs. It is not hard to prove that foreign investments in Mongolia, a large, sparsely populated, landlocked country in Central Asia, promise to enrich and fundamentally change the country.

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| **Population, million** | **3.1** |
| **GDP, current USD billion** | 11.8 |
| **GDP per capita, current USD** | 3,840 |
| **Life expectancy at birth, years** | 69.1 |

Source: World Bank WDI, Economic Update April 2016

### The Largest Land Empire

In the 13th century, Chingis Khaan successfully formed the largest empire on earth. The Mongol empire was controlling almost half of the world, from the Korean peninsula in the east to Poland in the west, and from Siberia in the north to Vietnam and the Gulf of Oman. After his death, the Empire was divided up among his sons. One of the grandchildren of Chingis Khaan, Kublai Khaan became the first emperor of the Yuan dynasty. The last Mongolian king, Ligden Khaan died in 1634, which left the Mongol empire broken. Until 1911, the Qing dynasty indirectly controlled Mongolia through ways of political and economic influence. With Russian assistance, Mongolia declared independence once again in 1921. At the break up of the Soviet Union, Mongolia had to decide a way forward and the country transitioned to a market led democracy. A new constitution was followed in 1992 as well as a multi political party and two tier banking system was implemented.

### Economy

Mongolia is now a lower middle income, resource rich, and developing country. The lower middle income status was granted in 2012, at the peak of its mining sector



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fuelled economic boom. Before that Mongolia's economy and workforce were predominantly comprised of herders and agrarians. Nowadays, Mongolia's economic strength has come from its rich deposits of natural resources. It is needless to mention that it is bordered by two of the world's biggest economies, China and Russia. Its reliance on natural resources has earned the country the nickname Minegolia, given by Parag Khanna, and has made it vulnerable to fluctuations in global demand, particularly from China, for what it digs out of the ground. As China's economy has slowed in recent years, and given that China accounts for more than 3/4 of Mongolia's trade, GDP growth has slowed considerably from the heady days of 17% growth back in 2011. Rapid natural resource-led development generates risks of inflation, volatility, and exchange rate appreciation, as foreign capital surges into the country, demand for its exports increase significantly, and government coffers fill with royalties and taxes from the new activity. With more money in the budget, the risk of rent seeking and corruption increases. Without strong institutions, access to the new wealth can be limited, leading to the potential for growing societal inequality. Not surprisingly, scholars have found that many countries actually experience worse performance in spite of their "good fortune," an outcome they refer to as the resource curse.

Since 2012, Mongolia has borrowed billions of dollars in sovereign debt. In March last year, Moody's gave it a negative outlook, citing the rising debt burden, a projected widening of budgetary imbalances and mining revenue shortfalls. Public debt increased above the legislated limit of 40%, however, and double-digit inflation occurred, stoked by the loose monetary policy and a rapid depreciation of the exchange rate. In addition to these issues the balance of payments remains in deficit. It is recorded a US$21.7 million surplus in January 2016, following a US$95.6 million deficit in the final quarter of 2015 (World Bank, April 2016). This moderate surplus and a currency swap facility with the People's Bank of China helped ease the balance of payment pressure in January last year. The reduction in investment and related economic activity is translating into lower employment growth, lower incomes, lower profits, lower government revenues and ultimately either less, or a lower quality, of public services like health, education and public infrastructure. The Mongolian Government has continued to increase expenditure, running budget deficits, with public debt increasing further. Their tool of preference was the expansion of domestic investment in the construction sector, for example through the building of apartments in Ulaanbaatar and cash handouts to households. This expenditure was financed through the use of commercial bonds. This source of financing comes without the conditions of concessional loans, providing flexibility in how the money may be used.

The low economic growth being experienced at present can mainly be attributed to a few factors. The first concerns the fall in commodity prices, which has resulted in lower than expected revenue from the mining sector. This is creating a serious problem, since the **forecasted figures have already been used as income in future budget calculations.** This has been aggravated by the economic downturn in China, which has led to a decline in demand for imports from Mongolia (90 % of Mongolia's exports are sent to China).

Mongolia's **infrastructure expansion program is also far from complete**. Most of the extracted minerals have to be transported by truck as the country's railway network is still being developed. Russia continues to own 50 % of the shares in the Mongolian railway company. Moscow does not want to give these up, though this may mean that projects are blocked as a result. The problem is that the Chinese track gauge is different from the Russian, with the result that shipments to China have to be re-loaded on to another train. A parliamentary decision in October 2014 on the construction of two new tracks to Chinese gauge specification has done little to remedy the situation. Road building, both outside and inside the capital Ulaanbaatar has been advancing funded by Sovereign Chingis Bond. There have also been problems for the country's energy supply system. As the mining sector alone now accounts for 40% of electricity consumption, an **expansion of the power supply network is now urgently needed** if this sector is to expand in the long term. This essentially means consolidating the transmission system, especially in areas outside Ulaanbaatar.

**If diversified wisely, agriculture is a promising sector** - its growth in 2015 was maintained at 10.7% and the livestock population reached the largest ever number of over 61 million total heads this spring. The current foundation of the sector is nomadic animal husbandry as it is. It bears the risk of being hit by harsh weather conditions or fully dependent on nature. There have been various attempts of different governments in the past to diversify this sector through semi intensive farming and bio cropping combined with better natural disaster prevention management and more productive business models. Those have, however, remained well-meant attempts which were not strategically approached at implementation level.

**Tourism has become increasingly important for the Mongolian economy** as the country looks to diversify away from mining since a slump in commodity prices added to economic pressure. Mongolia has seen a 6% increase in tourism at the start of the tourism season in May as compared to last year. A smart link of traditional nomadic herding to the tourism sector could open up the development perspective of niche tourism. The biggest challenge is infrastructure, namely the airline industry development and the expansion of paved roads around the country. And it is still struggling to find a niche position in the global market between targeting mass tourism and individually oriented, ecological, customized tourist services. Recently, Ulaanbaatar city and municipal government jointly formed a MICE (Meeting, Incentives, Conferencing, and Exhibition) committee in order to attract business tourists after successfully organizing Asia Europe Meeting (ASEM) in Ulaanbaatar city in 2016.

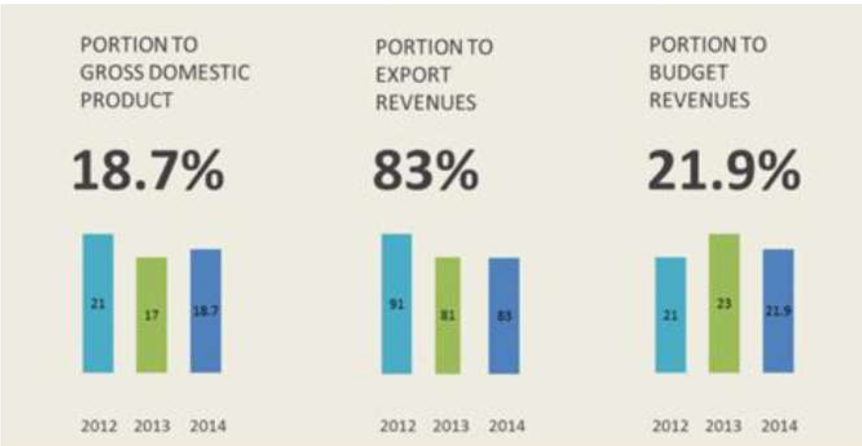
While all these factors clearly represent a challenge for the mining-led development, there is still scope for foreign companies in particular to gain a foothold in the Mongolian market.

To sum up, over the last 15 years, **Mongolia has transformed from an agriculturel based economy to a resource dependent economy.** Like other resource dependent countries Mongolia has a highly volatile dualistic economy, with those exposed to the mining sector experiencing increased real incomes, and those outside the sector experiencing a fall in real incomes. The new level of resource dependency has created difficulties for Mongolia's management of its economy, as has been the case for the majority of resource dependent countries. Fluctuating government revenues and economic growth rates harm investor and consumer confidence and create problems with developing a sustainable budget strategy. The growth in Mongolia's resource sector has negatively impacted the non-resource economy through a volatile exchange rate (falling 54% between 2012 and 2014), resulting in high inflation and demand side effects.

**Mining**

Mining experts estimate Mongolia possesses as much as US$1 trillion worth of untapped precious metals and minerals in at least 6000 sites. Mongolia's mining output has long been dominated by coal production. It also has been exploiting its mineral wealth to a limited extent, driven mainly by the demand for copper and coal by the Soviet Union/Russia. Mongolia had also invested in exploration and development of various pre-production copper-gold, coal, uranium, tin, and molybdenum and tungsten assets. The mining sector has already been the largest contributor to Mongolia's rise to lower-middle income country status. It has provided the Government with the fiscal space to invest in public infrastructure, social services and to directly increase the incomes of households through the use of cash payment schemes.

**Minerals sector's contribution to economic development**




*Source: Ministry of Mining presentation 2016*

The recent boom, starting in the early 2000s, was driven largely by the discovery of large copper and gold deposits in the South Gobi Province combined with the rise in global commodity prices. These two events led to an investment boom in Mongolia, with companies and Mongolia's state owned enterprises (SOEs) racing to increase capacity of old mines and to develop new mines in the hope of benefiting from the historically high prices. Coal production increased from 10.6 million tones in 2008 to a peak of 33 million tones in 2011, with exports to China rising more than 340% to 22.53 million tones, briefly overtaking exports from Australia. Oyu Tolgoi (OT) was a linchpin in Mongolia's strategy of opening up to international resource investments. Average annual production was expected to be at least 450kt of copper and 330koz of gold, making OT one of the world's top copper mines and a significant gold producer. The deposit had 2.7 billion metric tons of copper, 1.7 metric oz of gold, resulting in a 50 year mine life, not to mention the potential for further additions (exploration of the prospective surrounding area). Erdenes Mongol LLC is a principal investment firm. It is a state-owned company in Mongolia's key economic sectors, including mining, infrastructure and energy. It seeks to invest in real assets, existing companies, and new projects. The Mongolian government aims to manage its resources through Erdenes Mongol with the various stakeholders including OT.

Foreign investors were not the only ones interested in Mongolia's resources. Mongolian Mining Corporation (MMC) successfully raised $650 million in their listing in Hong Kong in 2010 for 20% of the company's shares, making it the first domestic billion-dollar mining company. The company's principal mine comprised one-sixth of the original Tavan Tolgoi license area. In 2017, Erdene Resources announced the closing of its previously announced bought deal financing for gross proceeds to the Company of C$13.8 million.

## Politics

Mongolia's young democracy is characterized by a multi-party competitive system representing a broad range of views and a vibrant civil society. Mongolia is a constitutional republic functioning as parliamentary democracy. It is commonly regarded as **Asia's showcase democracy**, though the prevailing political structures do need to be made more robust. Land-locked Mongolia is dependent on Russia and China for access to global markets. Russia is a long-standing ally, Mongolia's primary supplier of energy, and joint partner on several state-owned assets, including Ulaanbaatar Railways. China remains the largest trading partner. Wedged between these super powers, the Mongolian government actively seeks to develop a "third neighbor" with the West, namely the USA, the European Union and other Asian nations such as Japan, Korea, and India in order to reduce dependence and work towards ist own foreign policy objectives.

During the last two decades, two parties came to dominate Mongolian politics. In June 2016, MPP (Mongolian People's Party), which has governed for most years, won an 85% majority with 65 seats in the 76-member parliament. DP (Democratic Party) won 9 seats, down from 37; the Prime Minister and the Speaker of the Parliament were among those kicked off their seats. Although Mongolian bonds jumped on the election results - the US$ 500 million Chingis Bonds due 2021 surged 3.5 points to 105.5/106.25 cents on the dollar, until clarity on the MPP's economic and fiscal goals come in the months ahead, it is too early to tell the impact of the election on sovereign risk. Right now, political parties are in the middle of fierce competition to nominate their candidates for the Mongolian presidential election, which will be held in June 2017.

## Conclusion

After 350 years of foreign domination, Mongolia became politically independent in 1990 by introducing democracy and market economy and is now working to secure its nascent economic independence. Since it opened up, it has been learning its lessons about the rules of the game of the global community, especially global markets, by going through failures and successes. A dedicated search for a new identity, constructive public discourse and engagement, awareness about clear long-term strategies, and the need to stick to agreements are a few of many lessons learnt in this process.

According to investors (FRONTIER Securities, Mongolia Economic Outlook April 2016), **Mongolia's long-term prospects remain strong**, but its resilience will be tested by short-term challenges from a deteriorating external environment, in the absence of proper external and fiscal buffers. The weak global commodity market and China's slowdown will influence economic prospects. Additionally, the public external debt rising to 65% of GDP in 2015 makes Mongolia even more vulnerable, as the concentrated debt repayment of US$1,080 million in 2017-18 will likely pose a near term challenge (World Bank, April 2016). According to the World Bank, the recovery of foreign investment would begin to support the recovery of the non-mining sector. The Mongolian government is working with the International Monetary Fund and other partners on a US$5.5 billion economic stabilization package by implementing the Extended Loan Facility program.

However, Mongolia's ongoing development will depend on a number of internal factors. The country itself is in **need of political change towards consistency and predictability of policies**, which will give international investors proper security and win back the trust lost. Infrastructural shortcomings also need to be rectified if Mongolia is to become a more attractive proposition on the international stage. With growth having recently been in decline since the economic upturn of the 2011 boom year Mongolia's political leaders have shown **a greater awareness of the problem** and have seemed prepared to alter their political strategy. The title given to the sixth Mongolian Economic Forum, which took place in March 2016 – "Lessons, Challenges, and Solutions" – indicates the learning process taking place.

**China has long been the dominant force in the Mongolian economy**, and not just because of its geographic proximity. Chinese investors have in the past shown themselves to be more risk-averse and as a result have been able to keep one step ahead of other countries. As the ADB figures show, Europeans could soon have an opportunity to re-establish themselves on the Mongolian market and to intensify their involvement in this area with a view to securing a slice of the commodity market in the years ahead. Mongolia's presence in the "One belt and One road" project is vital and the government values the significance this project places on interdependence.

**Companies wishing to invest in Mongolia therefore require a long-term strategy and, ideally, a strong local partner on their side**. Germany's Aurubis has shown with its billion-dollar deal that perseverance can be rewarded with success. The German Federal Government indicated that the plan for an ore concentrator at the MAK mine would be a project worth funding and decided to provide an untied loan guarantee worth in the region of 745 million USD. Finland's Outotec and Germany's Ferrostaal Group will be lead contractors in the construction of a copper smelting plant to launch this year. Zes Erdeniin Khuvi JSC has hired Ferrostaal as general contractor to build the plant for an estimated 45 million USD, while Outotec will run equipment procurement. Plans include production of grade A copper, as per the London Metals Exchange designation, and 99.95% purity copper cathode for export. The Mongolian Government has recently indicated that changes should be made to the legal framework in order to facilitate the import of European technology and the export of copper concentrate to the EU. Moreover, the French giant, Areva, has been working in Mongolia for a while followed by Mitsubishi Group. Mongolia has already become a strategic partner of Rio Tinto Group. Sumitomo Corporation and Japanese KDDI Corporation are expanding their shares in the Mongolian telecom's sector. The world's leading financial institution, Goldman Sachs, holds shares in the biggest commercial bank in Mongolia. The Kerry Group and Samsung Group are actively participating in Mongolian property development and infrastructure. This clearly shows that the big names are already here to create mutually beneficial cooperation in the birthplace of Chingis Khaan!