Mongolia's Economic Outlook

Recovery and Resilience

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Executive Summary

Mongolia's economy has fared well since the COVID-19 pandemic ended, and it is likely to show continued resilience in growth in 2023 and beyond. The benefits of the government's New Recovery Policy, designed to support Mongolia following the pandemic, are starting to feed into and catalyse the recovery.

The policy's six pillars also look to build an ecosystem of change to facilitate Vision 2050[1]– a long-term plan to turn Mongolia into a leading Asian country in terms of its social development, economic growth, and its citizens' quality of life. The overarching goal is to double the country's GDP.

The bedrock for this paradigm shift will be the large share of Mongolia's economy that comes from trade (approximately 120 per cent of GDP), the country's geographical position, and the new trading relationships that it forms in the next few years. In particular, the degree to which Mongolia diversifies its cross-border trade – above and beyond its close, resource-driven relationship with China and others – will be essential.

Its sector-diversification push is already starting to take hold. Mongolia's further diversification of its trade relationships should align with its domestic diversification in production and employment. Boosting agriculture, textile manufacturing, and enhancing the depth, breadth, and scale of the digital economy with applications to industrial technology will help elevate Mongolia's long-term productivity, innovation, and higher value-added production. It can then lever its trading relationships, particularly through global supply chains.

In the meantime, dependence on demand for its resources, particularly from China, constitutes both a benefit and a vulnerability for Mongolia as underlined in the data. Mongolia's mineral products constitute approximately 81 per cent of total exports, 90 per cent of which are exported to China. A more diversified economy will catalyse higher productivity and lead to higher income levels for the economy.

The government's prioritisation of energy distribution systems will help spur Mongolia's energy transition in multiple sectors, engage multiple stakeholders, and bring the economy closer to meeting its climate commitments of reducing greenhouse gas emissions. Mongolia's mitigation target of a national 22.7 per cent reduction in such emissions by 2030[2] will be a significant challenge given that 8 per cent of its energy needs come from coal production.

[1] https://cabinet.gov.mn/wp-content/uploads/2050_VISION_LONG-TERM-DEVELOPMENT-POLICY.pdf

[2] https://unfccc.int/sites/default/files/NDC/2022-06/First%20Submission%20of%20Mongolia%27s%20NDC.pdf

Mongolia’s contribution to regional and global supply chains is also growing and will continue to be essential to the quality of its export growth. Agriculture – where growth has reached a seven-year high – mining, raw materials, and animal products are the key supply chain sectors. However, supply bottlenecks and higher input and import prices (particularly in oil and food) due to supply disruptions and the Russia-Ukraine conflict (World Bank, 2023) constitute risks.

Central banks in both developed and developing economies have continued to raise interest rates to restrain and offset greater-than-expected inflation pressures, including in Mongolia. Higher US interest rates could pose a particular challenge for macroeconomic stability in Mongolia through multiple pathways. Combined with a broadly stronger US dollar, this could include a problematic US dollar-denominated debt build-up, if economic fundamentals were to deteriorate.

More broadly, the likelihood of intermittent risk aversion and volatility in financial markets could mean capital and investment outflows from Mongolia as part of a global search for safe-haven assets away from investments deemed to be higher risk. The latter could include Mongolia’s assets and those of other emerging market economies. In the foreign exchange market, Mongolia’s tugrik could come under pressure if accompanied by further commodity price shocks.

The ongoing Russia-Ukraine conflict continues to pose risks, particularly to Mongolia’s inflation outlook, including through higher fuel and agriculture-related prices, such as wheat and fertiliser. Additionally, there is likely to be a continued loss of airline revenues for Mongolia’s sector in the light of its geographical proximity to Russia. Sanctions are likely to continue to pose challenges in payment systems to Russian companies on which Mongolia depends for fuel.

Overall, Mongolia has scope for robust growth in 2023 and beyond. Safeguards need to be put into place to improve macroeconomic and financial stability, but geographical and sector-specific diversification in trade will ensure that the economy is more resilient against shocks and financial headwinds. Mongolia’s openness, and the strength of its trading relationships, constitute both an opportunity and entail continued risks.

Key Messages on Mongolia's Outlook

- Mongolia's economy has fared well and is likely to show continued resilience in 2023 and beyond.
- The government's new revival package of reforms aims to build an ecosystem of change to facilitate Vision 2050.
- With trade at approximately 120 per cent of its GDP, Mongolia's economy benefits from global growth, but is vulnerable to external shocks.
- Mongolia's mineral sector is large in relation to the size of its overall economy suggesting a multiplier effect from commodity price shocks.
- Mongolia's growth diversification will be supported by increased participation in regional and global supply chains.

Key Messages on Mongolia's New Recovery Policy

- Connecting land ports via roads and railways to boost economic clustering and trade diversification will be key to growth.
- Energy recovery will help transition heat and electricity sources, through renewable energy and cost-effective storage and distribution systems.
- Industrial recovery aims to leverage innovation and digital technology for higher value-added exports; supply chain participation is key.
- Urban and rural recovery will be linked to mitigating Ulaanbaatar's high population density through satellite cities and free economic zones.
- Green development is urgent in light of Mongolia's pronounced vulnerability to climate change and the energy intensity of its production.
- Recovery of public sector efficiency is aimed at increasing the efficiency and capacity-building of the state, including state-owned enterprises.

Introduction

Mongolia's recovery is expected to continue with the economy set to grow by 5.4 per cent in 2023 and more than 6 per cent in 2024 (ADB, 2023; World Bank 2023). Its growing role in regional supply chains in the mineral, energy, and food sectors will also underpin its crucial cross-border trading partnerships. At approximately 120 per cent of GDP, Mongolia has a high trade share, making it both a beneficiary of greater global growth, but also vulnerable to shocks and economic uncertainty, including through higher import prices.

This paper assesses Mongolia's New Recovery Policy (NRP) vis-à-vis the country's macroeconomic outlook and its major trading relationships.

The paper analyses the components of the NRP in Section 1 with an analysis of how macroeconomic stability and supply chain participation are important for the plan's successful implementation. This is followed, in Section 2, by an assessment of the challenges and opportunities linked to the NRP. Mongolia's investment and trade landscape is then discussed in Section 3 with particular focus on its institutional, trade, and investment relationships with its major trading partners. Section 4 presents risks to the outlook – including in relation to the Ukraine-Russia war. Section 5 offers key conclusions.

1

Mongolia's economy in context:

New Recovery Policy

The New Recovery Policy (NRP) should boost economic growth over the long term. Its goal of enhanced participation in regional supply chains will help contribute to its success in tackling the six priority areas linked to the country's reform plan. This report examines the six areas and assesses Mongolia's potential role in global supply chains. The paper finds that economic diversification that leverages Mongolia's mineral and energy sectors will be essential. Beyond this, growth will depend on diversified trade relationships.

The NRP's six pillars:

1

Border ports recovery

This is aimed at connecting land ports via roads and railways, and developing air transport, all of which will aid in economic clustering and the diversification of trade. Such development will bolster Mongolia's resilience to its main risks. With China continuing to be Mongolia's largest export market and source of imports by a significant margin[3], Mongolia's economic performance remains closely linked and vulnerable to China's demand for domestic commodities (coal, copper, and iron ore). Additionally, the war in Ukraine, and the knock-on economic impact on food and energy prices, continues to exert risks for Mongolia's import bill.

2

Energy recovery

Mongolia's reliance on coal suggests that the development of renewable energy and cost-effective storage systems will help resolve intermittency issues in heat and electricity sources. The NRP call for improvement in the transmission and distribution of energy, including more effectively integrating into the Northeast Asian integrated energy grid, would add to a more diversified system. An essential component of the energy recovery pillar is the financing of renewable energy systems and the storage needed to combat intermittency. Doubling energy sources comes with the challenge of financing an independent economic system for the energy sector.

3

Industrial recovery

The overarching aim is to develop factories to process and upgrade mining and agricultural production. The application of digital technology and participation in international value chains is essential in increasing the share of high value-added exports. Mongolia's industrial sector (and its exports) risk being driven by mineral extraction and will benefit from digital and technological innovation. Additionally, the provision of raw materials to increase oil refinery reserves and production needs to be calibrated with energy recovery goals and Mongolia's climate change commitments.

[3] International Monetary Fund Direction of Trade Statistics:
https://data.imf.org/?sk=9D6028D4-F14A-464C-A2F2-59B2CD424B85&sId=1515619375491

4

Urban and rural recovery

Success in this pillar is linked to the transformation of Ulaanbaatar, in effect mitigating its high population density through satellite cities and free economic zones. Programmes ensuring balanced urban and rural development in coordination with economic and infrastructure projects will effectively promote economic clustering in regions and cities outside of the capital. Building out economic centres across Mongolia's aimags[4] with requisite transport and sustainable infrastructure is a key precursor to narrowing the urban rural divide.

5

Green development recovery

This is urgent in light of Mongolia's pronounced vulnerability to climate change, and particularly its rapid desertification (Meng et. Al., 2021). Containing and reversing desertification through the usage of digital technologies, in both infrastructure and manufacturing value chains, will be essential in meeting climate commitments. Alongside this, continued private and public sector coordination will spur green development and the green finance that would underpin Mongolia's energy transition.

6

Recovery of public sector efficiency

This pillar is aimed at increasing the efficiency, institutional functioning and capacity-building of the state, including Mongolia's critical state-owned enterprises. Greater efficiency will require limiting fiscal expenditures and the over-collateralisation of Mongolia's mineral revenues. Additionally, digitalisation will strengthen and streamline governance and tax collection. More broadly, given Mongolia's debt dynamics, large investment projects could trigger adverse exchange rate pressures if fiscal sustainability is threatened.

[4] An aimag denotes an administrative subregion in Mongolia.

There are several factors that will determine the outcome for each pillar. The first is the ability to maintain financial and macroeconomic stability. The second is the ability to effectively participate in global value chains. Global and domestic inflation continue to be of concern, necessitating a continued policy response. Although Mongolia's inflation looks to have peaked, it remains above 11 per cent at the time of writing[5]. Higher transport costs and elevated import prices will mean further stickiness. Having kept its benchmark interest rate unchanged at 6 per cent through the COVID-19 pandemic, Mongolbank has now raised its official interest rate to 13 per cent[6] with the prospect of further rises.

1.1. Mongolia's macroeconomic stability is essential

Resource-dependent growth and continued inflationary pressures – in part around the cost of food – make Mongolia's economy particularly vulnerable to any further economic and geopolitical shocks. This implies higher uncertainty for the outlook for 2023 and beyond. The food price shock has been mitigated by the government's policy of bolstering food security through tax exemptions (on customs tax), subsidies for domestically grown vegetables , and exemptions on wholesale imports of rice, sugar, and vegetable oil.[8]

Mongolia's double deficit in both its external and government accounts[9] is problematic, potentially made worse by unanticipated government spending[10], exposing the economy to a raft of further vulnerabilities. For example, Mongolia's disproportionate and continued reliance on external funding could continue to impact its access to affordable finance and credit ratings.[11] The magnitude of the deficits, and the link between them, underscores the need for appropriate coordination between fiscal and monetary policy in stabilising the economy.

This makes a further decline in the tugrik exchange rate likely. While this could constitute a competitive boost for exports, the decline means a loss of purchasing power for key production imports. Fitch Ratings affirmed Mongolia's B rating with a stable outlook, but this is partly at risk due to energy price volatility (World Bank, 2022).[12]

[5] https://www.mongolbank.mn/en/inflation

[6] https://www.mongolbank.mn/en/policy-interest-rate

[7] https://montsame.mn/en/read/292394

[8] https://www.who.int/westernpacific/news-room/feature-stories/item/mongolia-transforms-food-system-to-ensure-safer-food--increase-health-security

[9] A twin deficit is defined as an incidence whereby there is both a current account deficit in a country's external accounts in addition to a fiscal deficit: https://archive.unescwa.org/twin-deficits

[10] Furceri and Zdzienicka (2018) find empirical links underpinning the twin deficit phenomenon.

[11] https://www.fitchratings.com/research/sovereigns/mongolia-08-06-2022

[12] https://www.fitchratings.com/research/sovereigns/fitch-affirms-mongolia-at-b-outlook-stable-18-05-2022

Mongolia's resource-dependence necessitates diversification. Efforts to facilitate an improved and diversified investment climate will be particularly important for Mongolia's US$49bn (MNT150tn) investment goal because of its dependence on commodities.[13] Resolution of delays with major investors, including Rio Tinto,[14] over the development costs of the Oyu Tolgoi copper mine has been a notable step forward. An improved investment climate will have positive knock-on impacts in terms of further foreign direct investment (FDI) in mining and – critically – its non-mining sector (IFC 2018, UNCTAD 2013).

1.2. Mongolia's contribution to global and regional supply chains

As with other exporting and open economies, Mongolia's increased participation in supply chains is essential to upgrading the value of its exports and having more sophisticated, higher value-added, production – all of which are key to increasing productivity and income to meet the Vision 2050 agenda. [15] Mongolia's agriculture and light industry sectors offer it a comparative advantage, and a pathway for diversification (including in textiles, notably wool, cashmere, and hide).

Factors that will underpin Mongolia's resilience and its participation in regional and global supply chains:

- **Enhancing the efficiency and connectivity of the central economic corridor**

  This is essential to Mongolia's industrial and energy recovery and for the long-term diversification and resilience of its exports. Successful economic corridors are intimately linked with Mongolia's ability to participate in regional supply chains. Past analysis indicates that Mongolia's comparative advantage in key industries, such as light manufacturing, has been significantly diluted by weaknesses associated with its economic corridors (World Bank, 2019).

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[13] https://www.eureporter.co/world/mongolia/2022/04/11/mongolia-economic-forum-2022-international-partnerships-to-deliver-49bn-investment-plan-for-mongolia/

[14] https://www.riotinto.com/news/releases/2022/Oyu-Tolgoi-partners-reach-comprehensive-agreement-and-approve-commencement-of-underground-mining-operations

[15] Vision 2050 is Mongolia's long-term development policy to become a leading Asian country by 2050. For further details see: https://cabinet.gov.mn/wp-content/uploads/2050_VISION_LONG-TERM-DEVELOPMENT-POLICY.pdf

- **Boosting investment in agribusiness**

  Mongolia has a comparative advantage in agribusiness, particularly downstream industries utilising livestock products. Yet, its share in worldwide exports of agribusiness commodities is insignificant – Mongolia has exported more than 70 per cent of its cashmere to China without adding value (ibid, 2019). Cashmere exports reached US$332.9m in 2021, an increase of 39 per cent from the previous year, and US$444.4m in 2022, an increase of 33.4 per cent.

- **Mongolia's industrial and technology parks**

  These will play a key role in elevating the agribusiness sector and participation in global supply chains. Within Vision 2050, the New Recovery Policy, and the government's 2020-2024 action programme, Mongolia has set the goal of increasing production capacity of animal-based raw materials, while establishing industrial and technology parks in Darkhan-Uul, Khovd, and Dornod provinces. Parliamentary approval of the law to exempt equipment for processing food and agricultural raw materials from customs duty will continue to incentivise inward investment.

Looking ahead, Mongolia's firms and its manufacturing producers face several economic and financial challenges in participating in sector-specific supply chains. Greater participation would link to improved connectivity. Mongolia's agribusiness sector depends on a fast-paced retail sector characterised by tight delivery schedules and high-quality standards – (ibid, 2019). Greater connectivity and border port recovery within the China-Mongolia-Russia corridor is expected to facilitate greater ease of participation in local and regional supply chains. Without it, the country's productive capacity would not progress and could be vulnerable to unexpected shocks.

2

Mongolia's reform agenda:

Assessing challenges and opportunities

Despite the significant downside risks to the outlook, the raft of measures and strategies contained in the NRP support a doubling of Mongolia's GDP by 2030 through investment and structural reforms.[16]

The NRP's six-pillar focus aims to strengthen the economic, infrastructural, and financial pathways following the COVID-19 pandemic. It also aims to facilitate an ecosystem of economic transformation for the government's longer-term Vision 2050 development policy.[17]

[16] EBRD (2022-23), "Country Assessments: Mongolia", European Bank for Reconstruction and Development, [PDF] Accessed at: https://www.ebrd.com/transition-report-2022-23

[17] https://cabinet.gov.mn/wp-content/uploads/2050_VISION_LONG-TERM-DEVELOPMENT-POLICY.pdf

Mongolia's unique position as a landlocked resource exporter between China and Russia means that it faces a particular set of economic, social, and infrastructural challenges. Its unique political economy – one dominated by its resource sector and its close historical relationship with Russia and China – suggests that three policies would help advance its six pillars: deeper digitalisation, a step-change in diversification, and an improved investment climate.

A further three-part policy push aligns with the NRP's six pillars:

- **Deeper digitalisation**

  Together with the productivity pathways that it catalyses, digitalisation will help advance connectivity, trade facilitation, border capacity, and economy-wide productivity, including within state-owned enterprises. High-tech jobs would also reinforce diversification of manufacturing into the non-mineral sector and create a multiplier effect (for jobs) (Moretti, 2013) and clustering effect (for further inward investment) (Fujita et al., 2000).

- **A step-change in diversification**

  A focus for policymakers for some time, diversification will help ensure that Mongolia's economy becomes more resilient in its growth path and better able to withstand shocks. Diversification to expand both who Mongolia trades with and the number of sectors contributing to growth is already starting to take shape. The push for digitalisation and its spill-over into human capital development in its labour force will ensure the development of innovative jobs and higher productivity. As with other resource-abundant economies (such as Oman and Indonesia), human capital and intellectual capital accumulation play a critical role in successful diversification[18] (Lashitew et. Al., 2020).

[18]In this context, the term diversification denotes growth in per capita non-resource sectors in domestic and export markets (Lashitew et. Al., 2020).

- **An improved investment climate**

  Policy clarity is essential in attracting and managing the inward foreign investment that is required for the advancement of the six-pillar strategy. Mongolia's plans to institute and further build out its sovereign wealth fund (SWF) [19] – to invest in and more efficiently manage domestic mineral resources – will set the pathway for further diversification. This has been the experience of other resource-abundant economies – including notably, Indonesia – that have effectively implemented best practices for SWF management and engaged with international development finance institutions to limit volatility in their investment environment during financial market uncertainty (Papadavid, 2016).

Within Mongolia's strategy pillars (see Section 1) there are substantial goals, the achievement of which should transform the economy.

- Mongolia's aim to invest in and increase its **border capacity** threefold[20] will prove beneficial if the closest ports are connected through road, rail, and air in a way that facilitates trade. Partnership and coordination with its neighbours are essential, particularly but not solely at China's port of Tianjin which is a crucial entry point (Nasanjargal et al., 2018). Complementary strategies to improve efficiency, logistics and communication with Mongolia's administrative and customs services will boost broad-based growth across its 21 provinces, including in rural areas.

- The **industry pillar** seeks to boost productivity, employment, and diversification through new technology. Within this, increased digital infrastructure is a key to success. In addition, a sought-after increase in Mongolia's information, communications, and technology imports as a share of total imports will be of great value to this goal.[21]

[19] https://www.ifswf.org/members/future-heritage-fund

[20] https://www.kcl.ac.uk/news/mongolias-challenges-opportunities

[21] World Bank World Development Indicators indicate that Mongolia's ICT imports comprise approximately 3.5 per cent of total imports.

- Sharing prosperity between **rural and urban areas** is predicated on regional integration along with economic and social connectivity (Papadavid and Miller, 2015).[22] This links to building essential services and modern infrastructure within and to Ulaanbaatar's 'ger' housing district. Transport and logistics infrastructure are to support economic clustering around rural housing centres through the urban and rural revival pillar, to mitigate Ulaanbaatar's high population density. Success here is also linked to land port recovery.

- **The energy recovery pillar** focuses on changes to transmission and energy distribution networks. Alongside this, the flexibility and reliability of Mongolia's electrical grid is being prioritised, including increasing its ability to absorb energy produced by renewable resources (Usov, 2022). Key projects funded by the European Bank for Reconstruction and Development (EBRD) will help decarbonisation, and a new transmission line [23] will help cut annual CO2 emissions by 140,000 tonnes per year by reducing electricity transmission losses and increasing the absorption of renewable energy. [24]

- Climate change mitigation measures **within the green development recovery pillar** are particularly important for Mongolia given its dependence on coal for energy consumption and export revenues. Additional challenges include its susceptibility to climate change and air pollution. With coal consumption constituting the main source of primary energy (70 per cent), continued transition into hydropower, solar energy, and wind power are important. Regulations aimed at increasing and regulating the use of renewables will further boost the transition. Carbon intensity of industry energy consumption has been on a downtrend[25], but has flatlined.

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[22] Sustainable economic recovery in Mongolia: challenges and opportunities; Webinar Overseas Development Institute, 23 March 2023: https://odi.org/en/events/sustainable-economic-recovery-in-mongolia/

[23] An EBRD sovereign loan of up to US$70.4 million will help build and commission a 220-km double-circuit 220kV transmission line between the towns of Sainshand and Choir.

[24] See: https://www.ebrd.com/work-with-us/projects/psd/51505.html

[25] https://www.iea.org/countries/mongolia

- Mongolia's policy efforts to boost **green finance** will also support its national roadmap for sustainable finance. The IFC's investment into Mongolia's first green bond, to be issued by Khan Bank, is likely to spur further issuance. The IFC is investing US$15m (of the US$60m, five-year bond) with the offering attracting another US$45m from the Netherlands FMO (US$35m) and MicroVest (US$10m).[26] The financing of renewable energy, green buildings, green mobility, and climate-smart agriculture will support the commitment of a 22.7 per cent reduction in greenhouse gas emissions by 2030.

- **Governmental and state-owned enterprise (SOE) productivity** is of particular importance given the significant involvement of SOE's in Mongolia's mining assets. Past macroeconomic and public sector management of Mongolia's transition amid multiple shocks also underscores the importance of SOE reform (Helbe et al., 2020). The recent, multi-fold increase in debt held by SOEs has been significant (from 2019 to 2021 debt held by mining SOEs increased 4.3 times, with total liabilities reaching US$2.3bn, an equivalent of 15 per cent of GDP). Mining profitability remains disproportionately impacted by global copper and coal prices (NRGI, 2022).

- **Mongolia's digitalisation agenda** is particularly important in underpinning long-term productivity and innovation.[27] The newly established Ministry of Digital Development and Communications [28] signed a memorandum of understanding with Estonia's e-Governance Academy to digitalise a wide range of government services.[29] The World Bank's US$40.7m package has aimed to further digitise public services and boost digital skills training and digital-enabled jobs. This builds on the World Bank's Smart Government II Project[30] to support digital transformation.

[26] https://pressroom.ifc.org/all/pages/PressDetail.aspx?ID=27449

[27] The State Productivity Revival policy aims to improve the efficiency of the government by digitalising services, strengthening penalties for corruption and official crimes, and streamlining the administrative structures and government organisations by transferring functions to the private sector and professional associations.

[28] https://montsame.mn/en/read/286665

[29] The scope of work includes introducing digital identity and electronic signatures, advising civil servants on digital skills and developing digital strategies.

[30] https://projects.worldbank.org/en/projects-operations/project-detail/P176631

3

Mongolia's evolving trade and investment climate

Mongolia's economic strategy is based in part on attracting foreign investment to achieve its US$49bn investment goal, which is expected to double the country's GDP. Prime Minister Luvsannamsrain Oyun-Erdene's governance agenda targets higher transparency and accountability as its guiding principles. Additionally, prioritising privatisation – including in relation to state-owned enterprises and their subsequent public offerings– has also played a significant role in this agenda. Maximising Mongolia's supply chain participation will also be essential in achieving its investment target.

The two mechanisms underpinning this are:

- **Mongolia's regional industrial complexes**

  These will boost the country's comparative advantage in mineral exports and industrial innovation, as well as underpinning higher value-added production. Spill-overs from enhanced efficiency will drive associated (downstream and upstream) industries. This is particularly relevant for Mongolia's agriculture sector where processing has rural employment impacts, including in its wool and cashmere sectors.[31]

- **Diversified and digitalised trade partnerships**

  Growing these will facilitate more breadth and scale in cross-border trade and investment, beyond the current import share that is closely tied with the country's immediate neighbours. Energy and food price shocks stemming from the conflict in Ukraine are likely to continue to be a key risk to the outlook. This could have an adverse impact on Mongolia's already large current account deficit. Diversification of trade could mitigate this.

3.1. China-Mongolia trade and investment: diversification ahead?

Mongolia's trade with China is significant: its exports to and investments from China are significantly larger compared with its other trading partners. As Mongolia's largest investor, China accounts for approximately 30 per cent[32] of inward FDI, 68 per cent of which is in mining. Mining products also make up approximately 93 per cent[33] of bilateral trade. Mongolia's government[34] continues to flag its intent to diversify its trade as a means of added growth and diversification away from any Chinese economic headwinds.

[31] https://www.adb.org/sites/default/files/linked-documents/39229-033-ssa.pdf

[32] See Li, Y., (2021), "Challenges and Countermeasures of China's Direct Investment in Mongolia in the Background of the Belt and Road Initiative" Advances om Economics, Business and Management Research, Vol. 166.

[33] https://www.dfat.gov.au/geo/mongolia/mongolia-country-brief

[34] Wong, K., (2023), "As Mongolia diversifies economy away from single markets like China, prime minister courts global investors" South China Morning Post, 21 March 2023.

Mongolia's close-knit economic relationship with China, and China's recovery in both its services and manufacturing sectors, could, however, continue to catalyse Mongolia's growth in the following ways:

- Infrastructural investment has been an important cornerstone of the countries' economic partnership and particularly Mongolia's connectivity. With China's post-COVID-19 opening, TIR transport and customs[35] operations at the Zamyn-Uud-Erenhot border crossing – the biggest land port on the China-Mongolia border, accounting for 70 per cent of bilateral trade – have resumed. China's infrastructure investment is aligned with fostering both urban and rural economic development, industrial recovery, and border ports' connectivity.

- Given China's dominance in the solar power[36] market, and Mongolia's private sector-led solar power development, there is potential for Chinese investments to catalyse the NRP pillars of industrial energy recovery and green development in Mongolia. Mongolia has imported nearly a quarter of its energy consumption in the past[37] and its solar-energy based electricity has been estimated at approximately half the cost of energy production from coal. This provides an opportunity for further bilateral China-Mongolia trade diversification.

- China-Mongolia bilateral trade will continue to form an important growth pillar particularly in the light of the two countries' mutual economic interests and efficiencies associated with their geographical proximity. Trade agreements, particularly under the concessions implemented under the Asia-Pacific Trade Agreement[38], will illustrate this. They will underpin Mongolia's industrial activity given its participation in supply chains.

[35] TIR is a global system of international procedures for road transport, formed under the customs convention on the international transport of goods under TIR carnets: https://unece.org/transport/tir

[36] https://www.energyintel.com/00000186-0963-d2f7-a387-affb8b360000

[37] https://montsame.mn/en/read/128648

[38] http://fta.mofcom.gov.cn/enarticle/enpacific/enasiapacificnews/202101/44180_1.html

Mongolia will look to diversify both the geography and the sector-specification of its trade as it looks to bolster domestic economic resilience. And yet, its economic partnership with China will continue to provide benefits in the form of strong trade in goods and services, as well as infrastructure investment that will boost Mongolia's connectivity. Importantly, China and Mongolia's existing bilateral treaties – including a new double taxation avoidance pact – could help scale investment and business exchange within the most-favoured-nation status.[39]

3.2. Russia-Mongolia trade and investment: risks ahead

Mongolia's bilateral trade with Russia has been dominated by its large import share from its northern neighbour, driven in part by a common 3,452km border. New opportunities have been discussed in relation to cross-border trade in consumer goods and industrial cooperation. During 2021, Russia's main exports to Mongolia included refined petroleum, raw iron, railway freight cars, and insulated wire. The increase in paperless, electronically based, customs clearance has been positive for goods in transit between China and Russia (UNESCAP, 2019), but is still limited. An increase on this front will help facilitate border port recovery and industrial growth for Mongolia.

On the policy front, Mongolia-Russia discussions point to a new plan for trade, economic and investment cooperation.[40] On the investment side, as with China, infrastructural agreements pertaining to land port and border port access will be essential in facilitating port recovery in tandem with industrial growth. Additionally, greening the China-Mongolia-Russia (CMR) economic corridor[41] will be instrumental in Mongolia's green and energy recoveries. This will help green development in the light of Mongolia's largely outdated energy infrastructure and limited grid coverage (which prompts the use of coal-burning stoves through the winters).

[39] This ensures that investors from the other contracting country receive the same treatment as that extended to investors from each party's own country and investors from a third country.

[40] http://government.ru/en/news/48331/

[41] https://www.un.org/ohrlls/sites/www.un.org.ohrlls/files/mr._shigang_zhang_senior_prog_managt_officer_unep_greening_the_chinamongoliarussia_economic_corridor.pdf

3.3. EU-Mongolia trade and investment: a growing partnership

As Mongolia looks to diversify its international trade relationships, the EU can serve as a source of inward investment and trade in a way that supports economic transformation. Mongolia's free economic zones and the improvement in its domestic transport systems could provide the EU[42] with investment opportunities.

The institutional and policy initiatives that will have knock-on economic impacts for Mongolia's growth outlook, include:

- EU-Mongolia collaboration in relation to renewable energy potential.[43] This is an essential source of investment cooperation, given that Mongolia's industry persists in being highly energy intensive, consuming 4.5 times more energy than the EU-27 average for each unit of economic output (EC, 20022). Given Mongolia's EU GSP+[44] status, further inward investment into mining plants for the export market (and particularly in rare earths materials), is likely.

- The EU TRAM (Trade Related Assistance for Mongolia)[45] has facilitated coordination between the public and private sectors to foster Mongolia's WTO Trade Facilitation Agreement, its export diversification and supply chain participation. TRAM also aims to strengthen the competitiveness of the non-mineral sector, through reducing trade costs. The Khushig Valley free enterprise zone is likely to induce spill-over effects of inward investment into vocational and skills training.

- EU financial and technical support for Mongolia's efforts to boost employment and transparency in public finances is likely to boost state-owned enterprise productivity through greater openness, accountability, and innovation. The first-ever EU Budget Support programme (signed in May 2020) with the Ministry of Finance will provide EUR50.8m over four years[46] for employment reforms.

[42] Building on Mongolia's participation in the General Scheme of Preferences Plus and the 2017 ratification of the EU-Mongolia Partnership and Cooperation Agreement (PCA): https://www.europarl.europa.eu/delegations/en/eu-mongolia-partnership-and-cooperation-/product-details/20200408DPU25247

[43] https://www.adb.org/news/features/unlocking-mongolias-rich-renewable-energy-potential#:~:text=The%20country's%20combined%20wind%20and,clean%20electricity%20generation%20per%20year.

[44] https://gsphub.eu/country-info/Mongolia

[45] http://tram-mn.eu/

[46] https://www.eeas.europa.eu/delegations/mongolia/european-union-extends-budget-support-mongolia-until-end-2024_en?s=171

- Mongolia-EU economic partnership is likely to continue to strengthen. French President Emmanuel Macron's recent visit to Mongolia[47] underscores this given the emphasis on supporting the country's energy transition. Germany's presence has also helped promote sustainable development including through the Integrated Mineral Resources Initiative and skills training.[48]

3.4. South Korea-Mongolia trade and investment: a high-tech partnership

Mongolia's economic and trade partnership with South Korea has been largely focused on spill-overs linked to the high-tech sector and associated production and human capital development in Mongolia. A spate of memorandums of understanding (MOU) have been put in place – on pursuing trade deals, climate change measures and investments, construction and urban development, and bilateral cultural exchange. A key MOU calls for the two countries to establish a ministerial-level committee on rare metal cooperation to push for joint projects, technology cooperation, and personnel and information exchanges.[49]

Additionally, South Korea is important to Mongolia's trade due to its location. If shipping through China's Tianjin port became less viable, Busan[50] is also seen as an alternative logistics hub for Mongolia. The Mongolia-South Korea relationship could play a key role in the logistics for Mongolia's foreign trade. Mongolia's government has stated that South Korea is seen as a key partner, and the newly signed agreements between the two will help facilitate Mongolia trade globally.

[47] https://tvpworld.com/70008251/macron-visits-mongolia-to-discuss-trade-climate-and-war-in-ukraine

[48] An illustration of this is the German Mongolian Institute for Resource and Technology in Ulaanbaatar offering undergraduate and postgraduate programs in engineering.

[49] Rare earth minerals are essential to many high-tech manufacturing processes and are used in electric vehicles, wind turbines, portable electronics, microphones and speakers.

[50] Further private-sector influx of Mongolian workers and businesses into Busan could help Mongolia better capitalize on its potential to become a new logistics point on the sea route. A visa exemption for both countries is an important step to cementing a strategic partnership under a current geopolitical setting.

3.5. US-Mongolia trade and investment: boosting sustainability

The US-Mongolia Strategic Partnership and economic relationship has been supported by the 4th bilateral Economic Policy Dialogue[51] where there has been enhanced cooperation in key areas, including minerals, clean energy, and digitalisation.

The US-Mongolia partnership is also aimed at capacity building and trade promotion[52] linked in part to establishing an air transport agreement between the two governments. These agreements will help scale the bilateral trade relationship and promote diversification and border ports and industrial recovery.

The US Millennium Challenge Corporation Water Compact[53] (from March 2021) is expected to expand Ulaanbaatar's water supply by more than 80 per cent – which is crucial for the country's green development and energy recovery. Access to safe drinking water is problematic in some areas owing to high mineralisation. Just 20 per cent of the population has access to piped sanitation, while only 59 per cent have piped water supply connections (Fan, 2020).

The USAID Mongolia Energy Governance programme has been strengthened and could help promote public sector efficiency with the correct policy channels put in place.

[51] https://www.state.gov/joint-statement-on-advancing-the-u-s-mongolia-economic-partnership/

[52] This includes through full implementation of the United States-Mongolia Agreement on Transparency in Matters Related to International Trade and Investment.

[53] https://www.mcc.gov/news-and-events/release/release-040521-mongolia-entry-into-force

3.6. UK-Mongolia trade and investment: financial partnership essential

The UK-Mongolia relationship is likely to grow. The country's inclusion in the UK's Enhanced Framework Trade Preference Arrangements[54] will enable it to expand its trade ties with the UK and build on its long-standing diplomatic links: 2023 marks the 60th anniversary of Mongolia-UK diplomatic relations.

The UK relationship offers Mongolia the opportunity to diversify its cross-border trade and investment. There has been an explicit intention to engage actively to facilitate UK-Mongolian bilateral trade and economic cooperation. Mongolia's geographical position between China and Russia, the scope of its natural resources, and the degree of trade openness suggest that its economic partnerships, including with the UK, will be essential for its long-run growth.

Significant UK-Mongolia institutional collaboration is ongoing for work on investment protection and legal reform. There has been a continued building out in the long-standing relationship between the London Stock Exchange and the Mongolian Stock Exchange. There is ongoing collaboration between the National Geological Office of Mongolia and the British Geological Survey, as well as efforts to introduce advanced technologies, equipment, and best practice to the fields of geology, mining, and heavy industry of Mongolia.

[54] https://www.gov.uk/government/publications/trading-with-developing-nations

4

Risks to the outlook

As with other resource-dependent emerging markets, Mongolia is facing multiple economic headwinds and risks. An overall environment of financial risk aversion – owing to higher borrowing costs and the risk of further banking instability – might impinge on Mongolia's ability to finance its debt and raise further finance. Additionally, when it comes to country-specific risk, continued volatility in energy and food prices, alongside the Ukraine-related sanctions imposed on Russia will influence Mongolia's import and consumer price dynamics.

- **Slower global growth is a risk**

  With trade at approximately 122 per cent of its GDP, Mongolia has an open economy. It is thus vulnerable to risks stemming from a global growth slowdown – particularly in relation to China, its most significant trading partner and export market by a large margin. The size of Mongolia's mineral sector in relation to the size of its overall economy also suggests further commodity price shocks will have a multiplier effect on Mongolia's economic growth.

- **Global monetary tightening will be a challenge**

  Monetary policy makers across the globe – including Mongolbank – have started to raise interest rates to restrain and offset greater-than-expected inflation pressures. The increase in interest rates in the US could pose a particular challenge for macroeconomic stability in Mongolia through multiple pathways. Higher US interest rates (combined with a stronger US dollar) could prompt a US dollar-denominated debt build up.

- **Intermittent risk aversion in US and global financial markets,** as a result of higher US rates and a stronger US dollar, could mean a reversal of capital flows into safe haven assets. This could come at the expense of assets and currencies that are deemed to be higher risk by investors. Mongolia's tugrik could come under pressure if accompanied by a downtrend – or further shocks – in commodity prices, its external position, or its economic growth story within the region.

- **Diversification is key to Mongolia's economic growth and stability**

  Its current recovery is export-led, dominated by its resource sector, and reliant on a handful of countries, mainly China. In 2021, Mongolia's total exports amounted to US$9.2bn (of which 82.7 per cent went to China, 9.4 per cent to Switzerland, and 2.8 per cent to Singapore). Mineral products constitute approximately 81 per cent of total exports. A more diversified economy will enable higher productivity and a transition to higher income levels for the economy.

- **Higher borrowing costs may impact Mongolia's bond issuance**

  The timing of Mongolia's liability management could be influenced by higher borrowing costs. This would have a knock-on impact on Mongolia's fiscal stance. Mongolia's debt sustainability risks remain high (IMF, 2022) and a further increase in (global and domestic) borrowing costs will likely have an impact on its debt sustainability as well as the ability to issue debt and access affordable finance in global markets.

- **The Russia-Ukraine conflict continues to pose risks for Mongolia**

  This is particularly the case with inflation. Largely owing to its geographical position and the sanctions that have been imposed on Russia (Mitchell, 2023), Mongolia continues to feel the conflict's economic impact. It is likely to continue to push up the price of fuel and key commodities, such as wheat and fertiliser. Rising prices, alongside the depreciation of the tugrik, suggests that households' purchasing power, and food security in general, will continue to be impacted (Mikhnev, et. Al., 2022).

- The Russia-Ukraine conflict could also mean that there is a continued loss of airline revenues and difficulty in importing necessary productive sector inputs from Russia. The economic and financial impacts of the conflict and the sanctions range from challenges in paying Russian companies on which, per Prime Minister Oyun-Erdene, Mongolia is "wholly dependent" for fuel. Additionally, sanctions on companies and banks have meant that Mongolian counterparties will likely continue to face payment issues.

Conclusion

Mongolia has, for some time, registered robust growth rates and achieved greater income expansion thanks to its vast natural resources. This has meant that bilateral trade and inward investment have become crucial parts of its growth story. Its openness, and the strength of its trading relationships, constitute both opportunities and risks.

Chief among Mongolia's key macroeconomic risks are the heightened financial market uncertainty associated with global monetary tightening and commodity price volatility. Geopolitical risk and the economic fallout of the Ukraine conflict will also continue to disrupt Mongolia's growth outlook.

In emerging from the COVID-19 pandemic, the government's six-pillar policy of enhancing state-owned enterprise productivity, connectivity, regional coordination, industrial technology, climate change readiness, and the effective distribution and use of its energy infrastructure – is more essential than ever. It could be that progress in meeting these and the longer-term targets stipulated in Vision 2050 will be challenging in the light of the spectrum of risks.

In looking ahead to 2023 and beyond, the composition of Mongolia's export base – both in terms of its geography and its sector composition – indicates that diversification is essential in building economic resilience and in its trade and investment relationships. Mongolia's trade and investment relationship with China has formed a cornerstone of its growth. And yet, it is still an order of magnitude higher when compared to other economic giants, including the EU and the US. A paradigm change is needed to underpin long-term growth.

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