



Mongolia Sources of Growth

World Bank Country Economic Memorandum, 2007

Presentation

by Sudarshan Gooptu

Lead Economist, World Bank

Ulaanbaatar, October 2007.

What this Economic Report is all about...

- Uses a state-of-the-art analytical framework, along with direct and indirect evidence, to identify “bottlenecks” to **sustained and broad-based** growth in Mongolia.
- Key Questions:
 - What will it take to keep the current high rates of economic growth to continue in Mongolia?
 - What needs to be done to ensure that the fruits of this growth process benefits all in Mongolia, especially the poor?



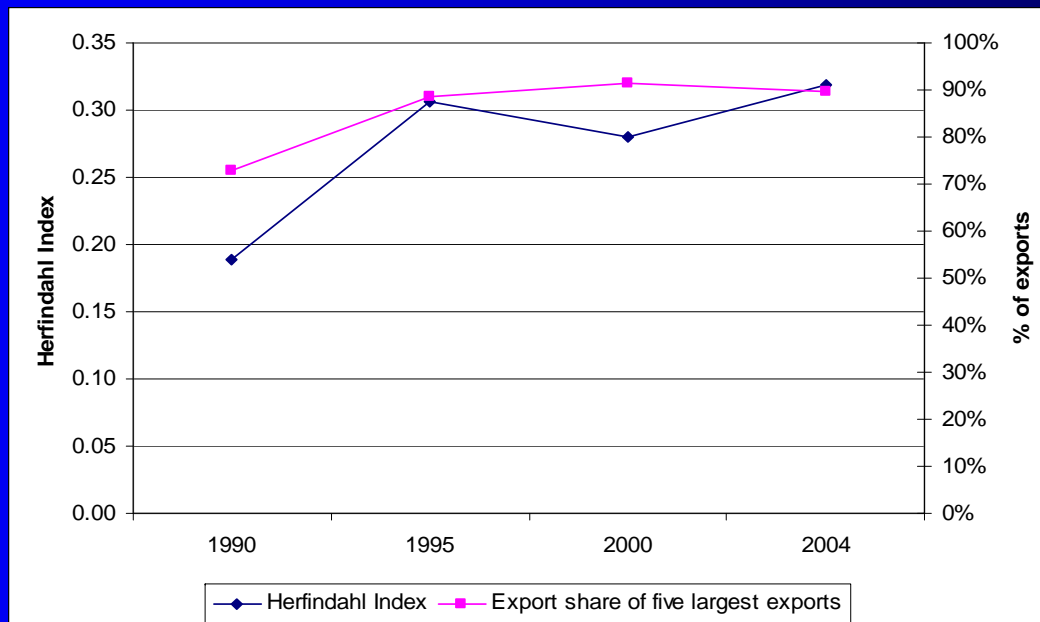
Here are a few facts...

- Looking at overall macroeconomic economic indicators, Mongolia is in the midst of good times.
- Looking deeper one sees that:
 - ❑ Over the past ten-year period, the sources of real GDP growth have become very concentrated, and heavily dependent on mining and livestock-based activities.
 - ❑ Mongolia's heavy dependence on a few commodity exports—cashmere, copper and gold—have made its economy very vulnerable to fluctuations in commodity prices and natural disasters.
 - ❑ Employment generation has been elusive despite having a young and educated labor force.
 - ❑ The population of the country is becoming increasingly concentrated in and around Ulaanbaatar.

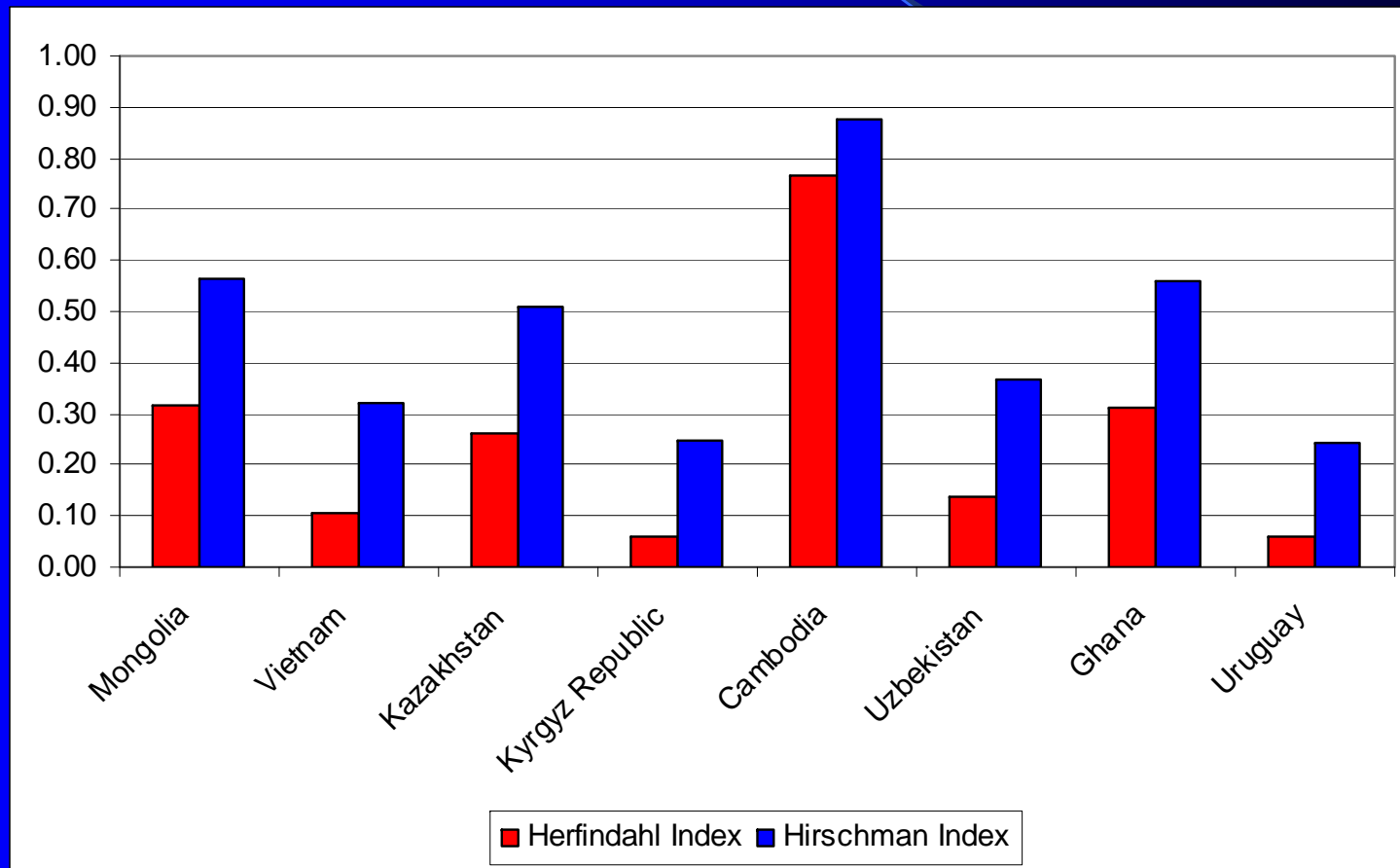


Dependence on primary goods has grown in the past few years

- Two economic activities - livestock herding and mining - represented more than 40 percent of real GDP in 2005
- Three commodities – copper, gold and cashmere – accounted for 67 percent of Mongolia's exports in 2005
- The vast majority of manufactured exports were textiles and apparel



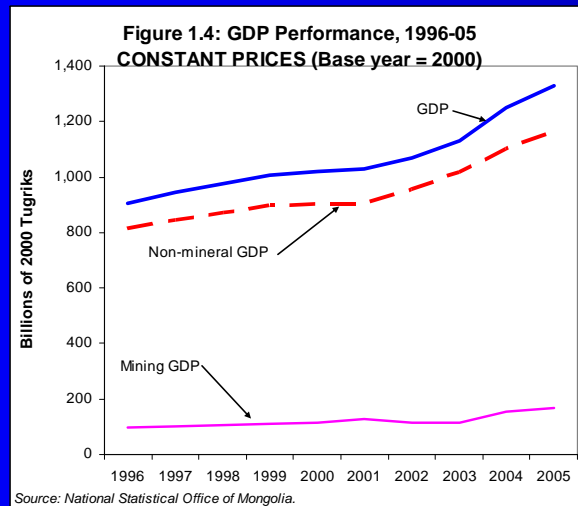
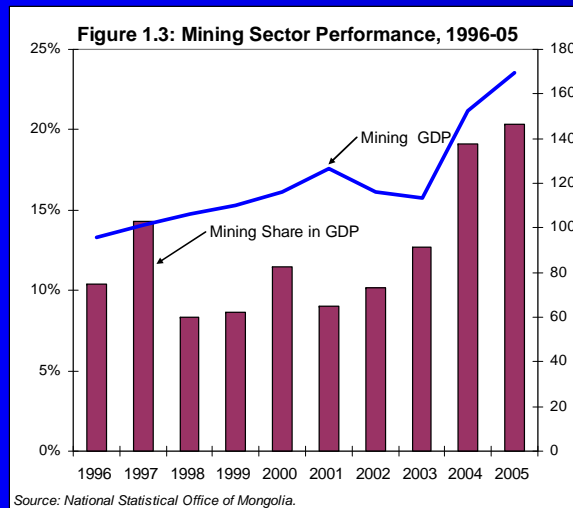
Mongolia is the 37th least diversified economy among a group of 100 countries



Source: Database on export diversification (PRMED).
The higher the index, the lower the degree of diversification



Recent Mining Sector expansion can be a good thing...



- Despite the apparent near doubling of the share of mining activity in GDP between 2001-05, when one examines the same ratio at constant prices, the effect is much less pronounced— mining has only increased its share in GDP by two percentage points over the decade.
- This serves to underscore that the recent expansion of the sector has primarily emanated from the price effect.

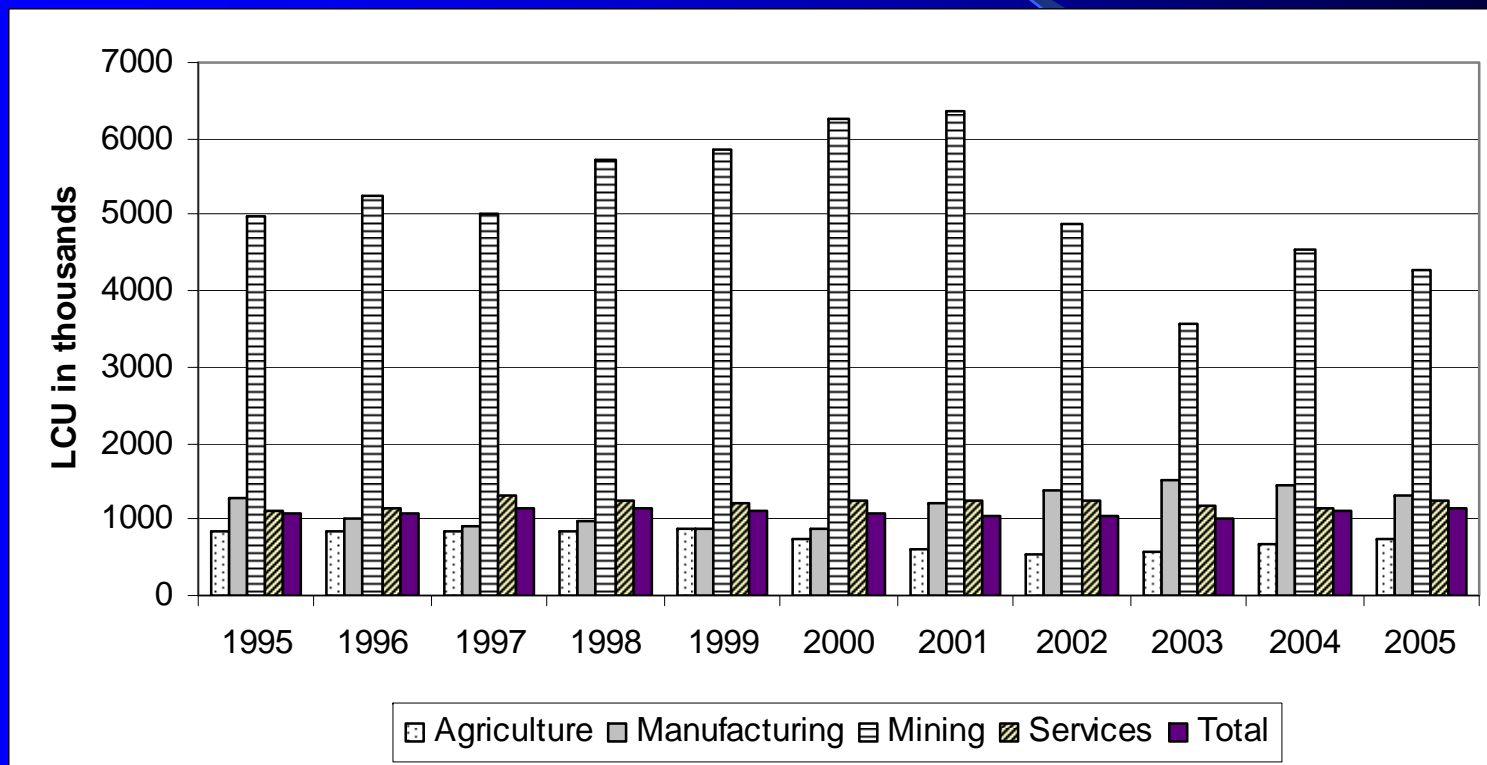


Environmental Impacts need to be managed

- Mongolia's pastoral land and natural resources (including forest and wildlife resources) are vast and clearly a huge potential source of future economic growth.
- Given the dominance of the economy on natural resources and livestock sectors, it is even more critical to minimize environmental degradation and prudently manage Mongolia's vast pastoral land.
- This will help keep the productivity of these scarce resources high, and depletion of the country's "true wealth" low (when valued in terms of the potential from its exhaustible and non-renewable resources).



Value added per worker in Mongolia is low except in mining



Source: Staff estimates based on data from Mongolian Statistical Yearbook (2004) and Government of Mongolia



The future will depend on what is done today

The government has taken some recent measures which are steps in the right direction:

- Reform of the tax code and strengthening of tax administration
- Development of a more robust public financial management system, that is far more open and transparent
- Anti-corruption efforts aimed at disclosure and strengthening institutions for prosecution of corruption

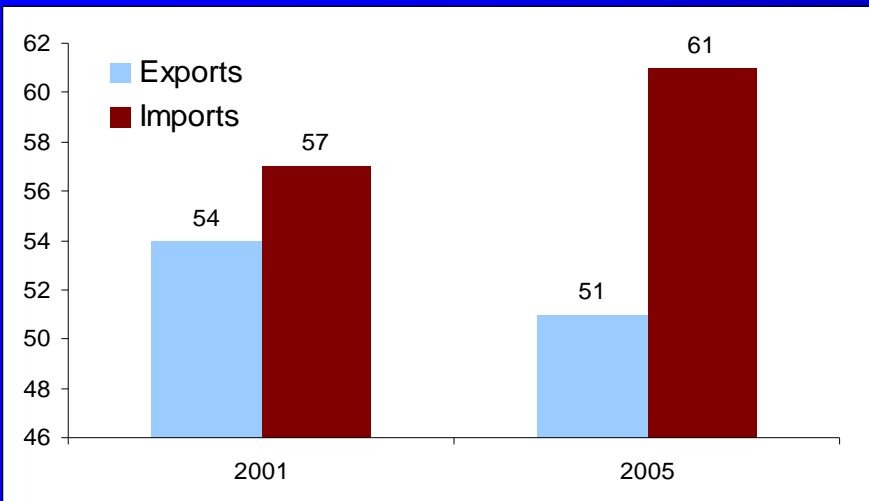


Mongolia's strategic location presents vast opportunities

Regional integration: Increased trade links with China and Russia

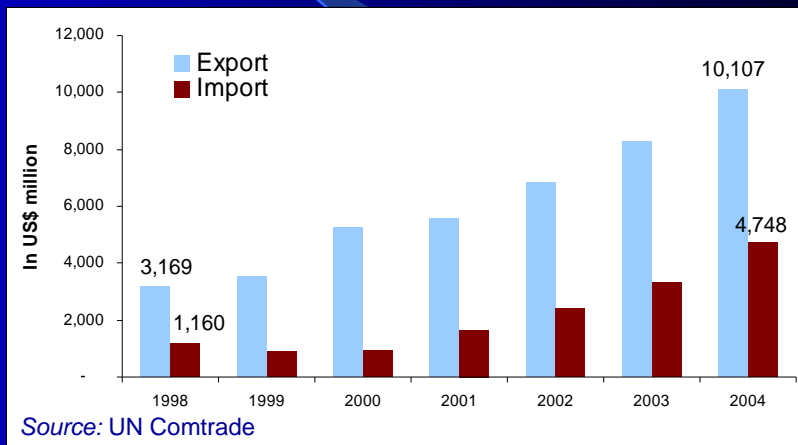
- Opportunities from increasing trade between its neighbors
- 30% annual growth in international rail freight transit through Mongolia

Share of Russia – China trade to total Mongolia trade (%)



Source: Mongolia Statistical Yearbook

Russian Trade with China



Source: UN Comtrade

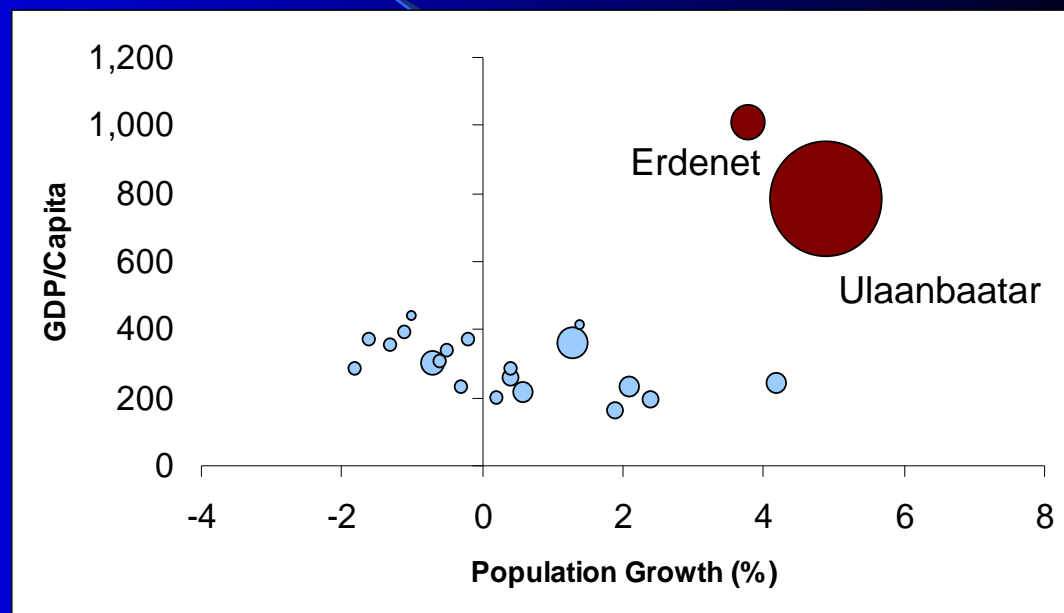
- Trade with Russia and China accounts for almost 60% of Mongolia's external trade



Supported by domestic integration

- Opportunities for better sub-national connectivity in vast and thinly populated country
- Leveraging mining related infrastructure to ensure sustainable provision of infrastructure services to mining towns and adjoining communities

Size and Growth of UB and Aimag Centers
(Size of circle represents current population)



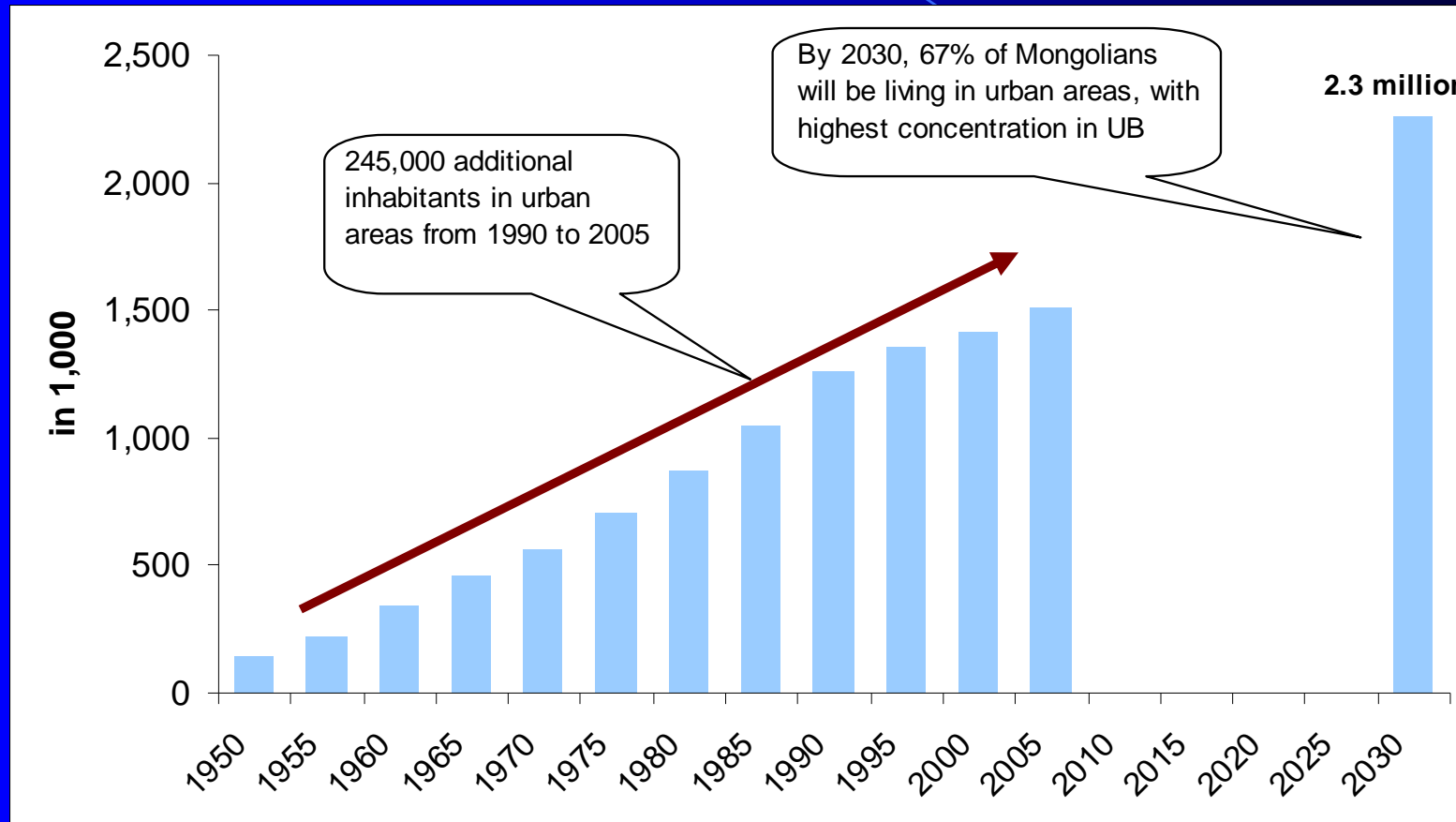
Source of raw data: Mongolia Statistical Yearbook

However, opportunities stemming from recent growth could be limited by considerable challenges in infrastructure service provision



Rapid urbanization that needs to be managed and planned for

Mongolia's Urban Population



Source: United Nations

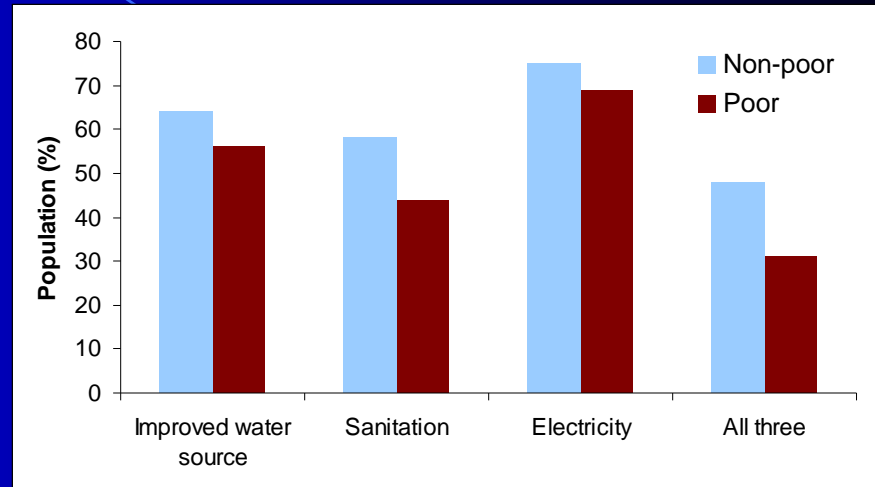
By 2030, 67% of Mongolia will be urbanized



Inequitable distribution of infrastructure services and regressive pricing regime

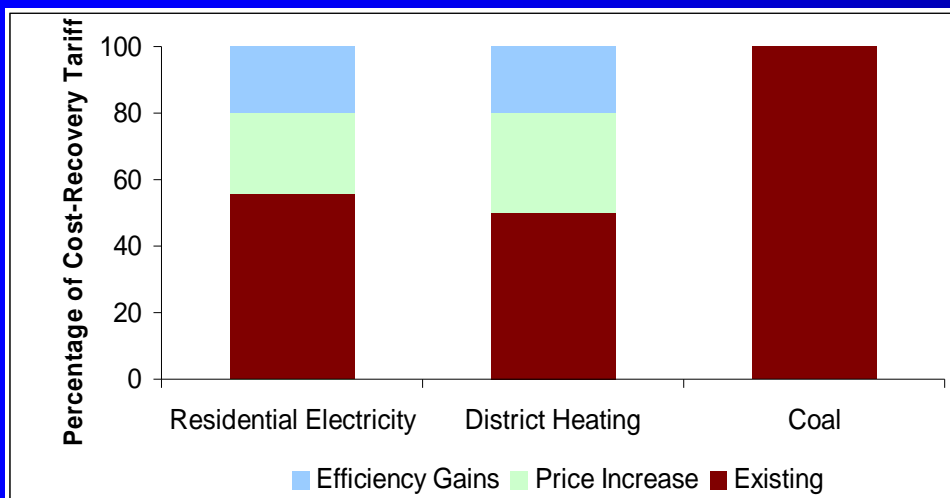
- Non-poor have better access to infrastructure services
- Only 30% of the poor have access to all three services (improved water source, sanitation, and electricity)

Access to Infrastructure Services by Poverty Status



Source: Mongolia Household Income and Expenditure Survey Report

Utilities Consumed by Non-poor Are Priced Below Cost



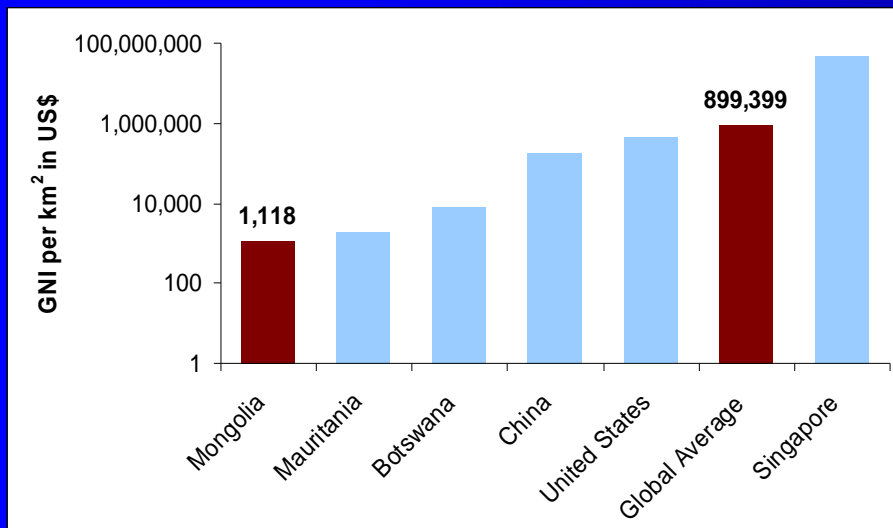
Source: World Bank, Mongolia Infrastructure Strategy Report 2007.

- Fuel used by apartment dwellers are priced below cost
- Ger area residents pay the full cost for the coal they use



Absence of economies of scale

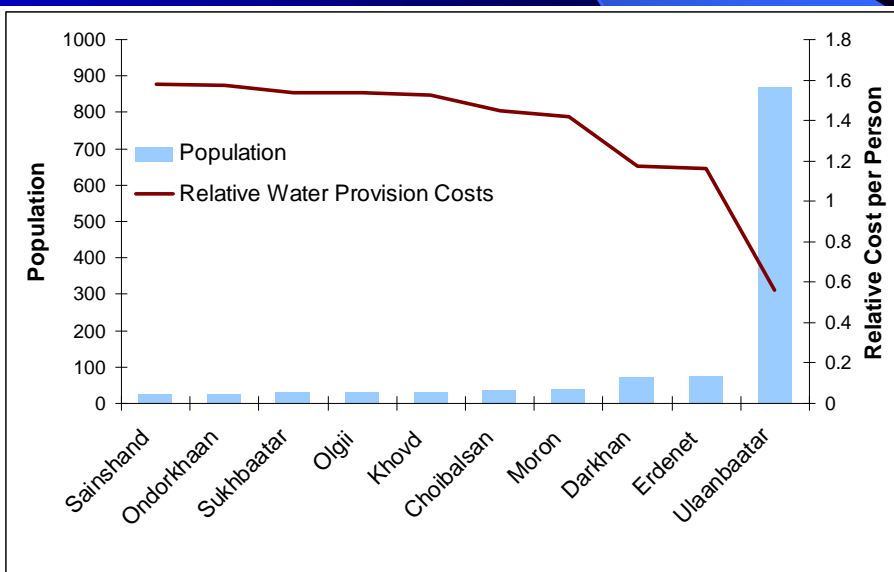
Mongolia: Income Density (2005)



Source: World Bank, Mongolia Infrastructure Strategy Report, 2007

- Income density per sq km is low relative to global average
- Lowers economic feasibility of network extension

Mongolia: Relative Water Provision Cost, 2005 (relative to a benchmark city of 250,000 residents)



Source: World Bank, Mongolia Infrastructure Strategy Report, 2007.

- Due to low economies of scale in water provision, small cities face higher costs per capita



Business Environment

Rankings slipping

Ease of...	2006 rank	2005 rank	Change in rank
<i>Doing Business</i>	45	41	-4
Starting a Business	55	54	-1
Dealing with Licenses	34	35	+1
Employing Workers	61	57	-4
Registering Property	17	17	0
Getting Credit	65	59	-6
Protecting Investors	19	18	-1
Paying Taxes	56	53	-3
Trading Across Borders	162	161	-1
Enforcing Contracts	41	40	-1
Closing a Business	115	113	-2

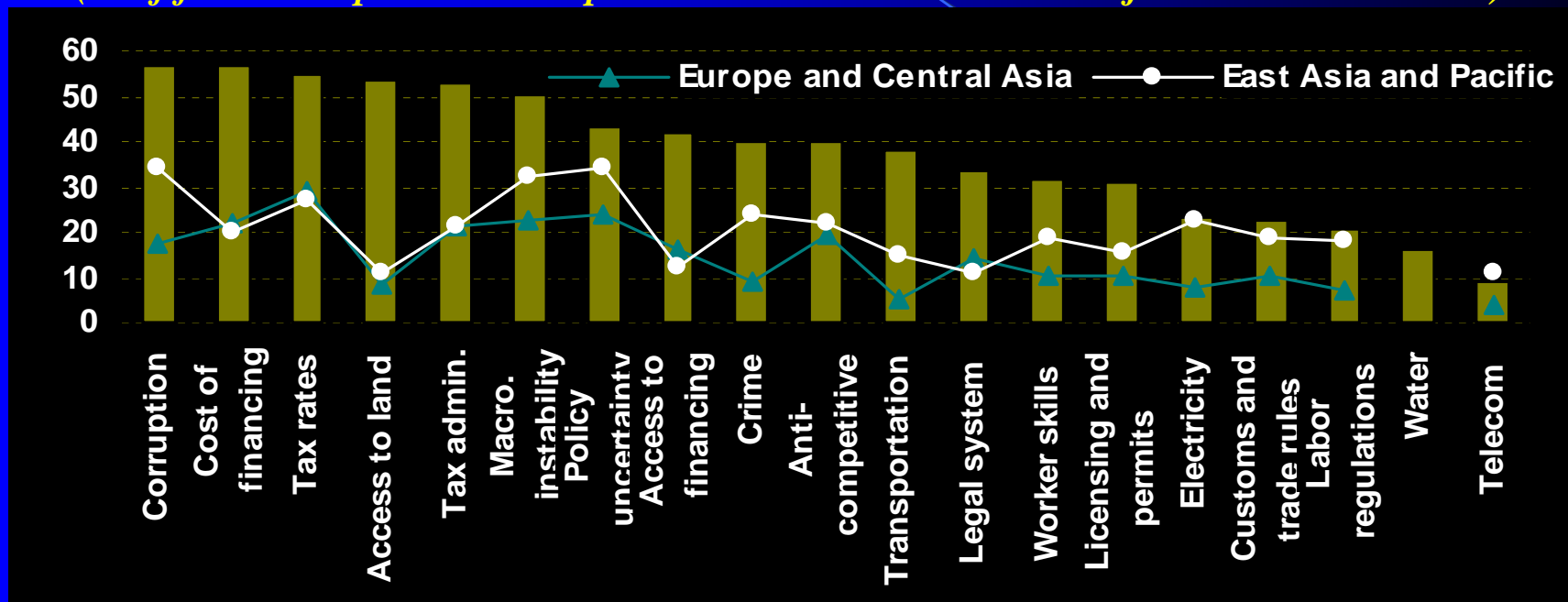
Source: Doing Business, 2007



Business Environment

What Mongolian businesses have to say

(% of firms that perceives the particular constraint to be a major or severe obstacle)



- ▶ Corruption is the most frequently cited impediment to doing business in Mongolia
- ▶ ...and the share of Mongolian firms that view corruption as a major or severe obstacle is higher in Mongolia than in most of the 62 other countries for which comparable investment climate survey data are available



Business Environment - The basic diagnosis...

Why corruption and a lack of accountability and transparency in government-business interactions are the central impediments

Table 1 : Corruption pervades every sphere of business activity

% of firms that view corruption as a major or severe obstacle	56.5	% of firms paying bribes for electricity connection	26.0
Value of gift expected to secure government contract (% of contract)	4.3	% of firms paying bribes for telephone line	23.0
% of firms indicating that political ties are important for business	47.1	% of firms paying bribes for water connection	15.0
% of cases where unofficial payments needed for registration	15.2	% of exporters paying bribes for customs clearance of exports	25.0
% of cases where unofficial payments needed to obtain licenses and permits	22.2	% of importers paying bribes for customs clearance of imports	22.6

Source: Mongolia Productivity and Investment Climate Survey, 2004.

- ▶ The evidence indicates that corruption and a lack of transparency and accountability pervade almost every sphere of business activity



Do Mongolian firms “innovate”?

- Diversification of the production structure requires “discovery” of an economy’s cost structure
 - Firms must adapt new technologies to local conditions and “discover” which products they can produce at low enough cost to be profitable
- Mongolia’s manufacturing base is narrow but this is not because firms do not attempt to export new products; every year in the period 2002-06
 - New exports were 30% of exports at the 4 digit level
 - Of these, 70 to 80% were new manufactured exports
 - But half of new exports were discontinued next year, and manufactured exports represented a large share of these new exports discontinued the following year



What are the “binding” constraints?

- *Infrastructure bottlenecks* that have led to costly transport, complex logistics, and long transit times.
- *Distortionary taxes*, including lately in mining sector activities, and complex customs and trade rules that have increased the implicit cost of doing business in Mongolia.



What are the “binding” constraints? (contd.)

- *Need for better coordination.*
 - *laws and regulations*
 - *trade and logistics*
 - *sector strategies and implementation plans*
 - *resource use and environmental degradation.*
- *Growing corruption and inadequate contract enforcement*
- *The high cost of capital*



The “How to...?”

- To get “quick wins” there is the need to deal with these impediments to sustained growth through:
 - investment climate reforms,
 - productive public investment projects with large spillover effects, and
 - by addressing workforce issues to deal with their underutilization and skills mismatches.
- It will not only foster mining sector development, but should help diversify Mongolia’s non-mineral exports
 - To enter new markets (at home and abroad) and create jobs.
 - To motivate firms to provide additional products/services, and
 - To improve quality and efficiency.

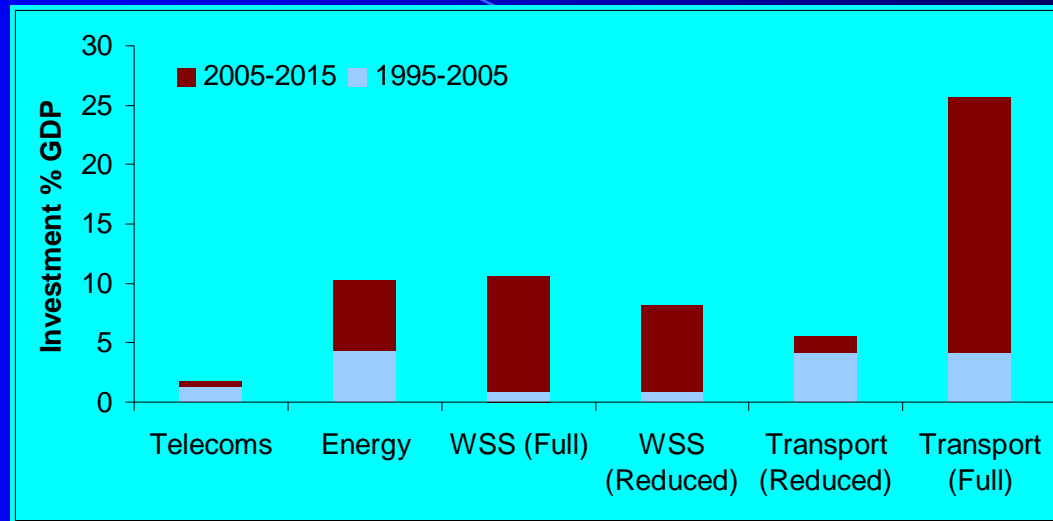


EXAMPLE: Need for Better Coordination in CASHMERE SECTOR

- Firms need services requiring simultaneous, large scale investments in order to:
 - expand output of existing products;
 - improve quality;
 - expand the number of exported goods;
- Large informal exports of raw cashmere to China are an indirect signal that the government has failed to address coordination issues in important sectors such as the cashmere industry
 - Herders lack finance, information and infrastructure to improve cashmere quality
 - Processors lack incentives and are reluctant to form strategic links with herders
- Some of the consequences are:
 - Shortages of quality raw cashmere
 - force processors to operate below capacity
 - an obstacle to FDI from luxury makers of cashmere goods
 - Environmental degradation



INFRASTRUCTURE: Mongolia's investment needs for the next 10 years: Getting the priorities right



Source: Mongolia Infrastructure Strategy Report

- GoM proposed total infrastructure investment can reach up to an unaffordable and unsustainable 48% of GDP
- According to estimates in the World Bank Infrastructure Strategy Report (2007), reducing the list of investments would still amount to an unprecedented 22% of GDP
- Financing constraints would necessitate tough choices and prioritization among investment options
- However, financial engineering is no substitute for sound project design (tax payers and users must pay)



Even then there are risks that will have to be contended with...

- Threats of “Dutch Disease” that has plagued most mineral rich countries.
- Fiscal policy stance and populist spending programs (threats to fiscal and debt sustainability)
- Domestic policies that may influence the investment climate and the country’s attractiveness to foreign direct investment, including taxation policies.
- Perceptions of corruption and weak governance that tend to raise the costs of doing business
- Environmental risks.



This calls for...

- Good management of windfalls with the goal of maintaining macroeconomic stability, and with due consideration to fiscal and debt sustainability.
- Prudent investment of the windfalls to support productive investments and broad-based growth;
- Institutionalizing counter-cyclical fiscal policy through the budget rather than off-budget vehicles, and
- Implementing the new anti-corruption law and the *Extractive Industries Transparency Initiative* (EITI) in mining must take precedence as well. This requires the Government to maintain an ongoing financial commitment to collect, compile and publish its mineral revenue statistics over time.



as well as...

- **Improved pastoral and livestock management practices.** This needs to recognize the critical link between land, water and livestock in designing risk mitigation interventions.
- **A multi-dimensional approach** to dealing with environmental impacts of mining activities and air pollution control in the densely-populated urban-areas (such as Ulaanbaatar).



Policy Recommendations

Dealing with Infrastructure Bottlenecks

Overall Direction of Reform Measures

- Prioritize infrastructure public investments.
- Formalize sector investment strategies in infrastructure sectors with due consideration to appropriate costing and fiscal sustainability.
- Issue regulations to guide public-private partnerships in infrastructure construction and service delivery.

Policy measures to introduce now

- **Pricing**
 - Aligning prices with costs of provision to free up resources for maintenance and expansion
 - Implementation of transparent, well-targeted subsidy mechanisms to protect the poor
- **Efficiency and governance**
 - Efficiency improvements to help mitigate necessary price increases
 - Improved governance including policy and regulatory reform to help attract new sources of investments from within and outside Mongolia
- **Better planning**
 - Better allocation of resources to ensure high economic returns and greater poverty reduction impacts
 - Prioritize potential projects and maximize the roles of private sector and civil society



Policy Recommendations

Dealing with Distortionary Tax Regime

Overall Direction of Reform Measures

- Carefully design **Mining Taxation Package** and **Investment Agreements** with Mining Companies.
- Improve **tax administration**.
- Improve **inspections regime** and undertake efforts to disseminate information on firms/consumer rights and requirements in the context of audits and inspections.
- Improve **Customs Administration**

Policy Measures to implement now

- Reconsider and re-evaluate the mining royalty rates, the windfall profits tax, and the share of equity participation by the State in mining projects.
- Efficient Management of Savings: Establish clear fiscal rules for management of Development Fund resources and mining revenues.



Policy Recommendations

For Better Coordination

Overall Direction of Reform Measures

- Reduce **transport costs and complex logistics** that are faced by firms that rely on trade for their growth opportunities (in mining and non-mining sectors).
- Government policies should *accompany* rather than attempt to *offset* the ongoing **migration and economic concentration** that one is seeing in Mongolia today.
- The role of **Information and Communications Technology (ICT)** in facilitating the acquisition, dissemination and use of knowledge across a country is critical in today's rapidly growing Mongolian economy, more so given the vast geographical territory that needs to be covered by information.

Policy Measures to implement now

- Carefully select public infrastructure investments to link economic nodes/hubs and that have non-sector specific benefits.
- Begin discussions on harmonizing customs and border trade regulations for goods and services with Mongolia's key neighboring trading partners.
- Provide information to herders about cashmere/meat products market demand and prices.
- Encourage cashmere processors to form strategic links with downstream agents and improve their productivity.



Policy Recommendations

To combat Corruption and improve Contract Enforcement

Overall Direction of Reform Measures

- Implement **Freedom of Information legislation** facilitating easy access for all to government information.
- **Fiscal and public financial transparency** of central and local budgets.
- Periodic implementation and **publicizing of country governance, anti-corruption and public expenditure tracking surveys**.
- Facilitate **citizen monitoring** of overall progress in reform program implementation.
- Upgrade **professional skills and ethics** of public employees through focused training efforts.

Policy Measures to implement now

- EITI Implementation: Establish multi-stakeholder committee. Agree on reporting templates. Prepare for disclosure and dissemination of EITI report on government's mining related payments and revenues.
- Implement Asset and Income Declaration Law for senior civil servants, candidates running for public office, public sector officials, and Parliamentarians.
- Revise procurement regulations and competitive bidding thresholds so as to create a level playing field in public sector procurement of goods and services.



Policy Recommendations

Dealing with High Cost of Capital

Overall Direction of Reform Measures

- Improve financial intermediation
- Develop inter-bank market.
- Consolidate banking sector to help reduce administrative overhead costs and excessive competition for deposits.
- Desirability and alternatives to deposit insurance should be evaluated.

Policy Measures to implement now

- Laws and regulations for SCCs, NGOs and Finance companies should more closely regulate deposit taking activity and promote soundness of small and micro financial intermediaries.
- Improve credit reporting and registration of securities interests.
- Prohibit/strictly control cross-ownership of financial and non-financial enterprises.



**Country Economic Memorandum
is available on**

<http://www.worldbank.org/mn/publications>

