



 KCS Country Risk & Threat Advisory

KCS Group Europe
Risk & Threat Advisory Paper

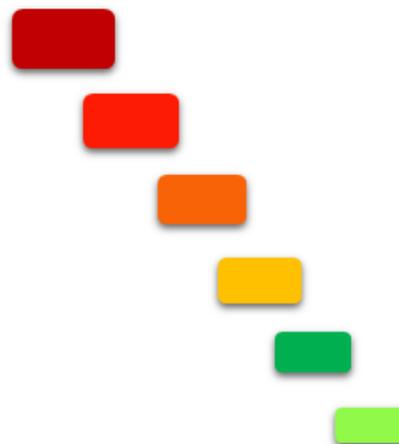
Political Risk Advisory Briefing: Mongolia
February 2020

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	Country: Mongolia
	Population: 3,103,428
	Source: CIA World Factbook

Mongolia has a Possible risk rating of 4.0

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| 6 Very High | The assorted threats described in the report are almost certain to have a derogatory effect. |
| 5 High | The threats are extremely likely to negatively affect the business. |
| 4 Very Possible | There is a strong likelihood of problems arising in this country. |
| 3 Possible | There is a fair chance of problems arising in this country. |
| 2 Low | There is a low likelihood of any threats impacting business. |
| 1 Very Low | There are virtually no impediments to successful business in this country. |



Overview

As the second largest landlocked country in the world, hemmed in by two superpowers, it is not a surprise that Mongolia's politics has been dominated by outside influence for centuries, from Beijing and then from Moscow. Now, between these two resurgent powers, Mongolia's position is once again in a state of flux, this time for the better.

Social, political and economic change in Mongolia is gathering momentum, despite enduring problems and frequent setbacks. A country that has for centuries passed under the radar, trapped by geography and the politics of others, can now point to real areas of promise and growth, centred around natural resources.

Naturally, problems remain, stubbornly enduring despite widespread discontent among the population. Corruption at the highest echelons of power, aided by weak checks and balances, is the primary barrier to Mongolia's success. Similarly, providing infrastructure in the most sparsely populated country on the planet is a unique challenge that has yet to be overcome. This is compounded by the fact that almost half of all Mongolians live in Ulaanbaatar, the most polluted capital in the world, severely limiting the economic impact of necessary infrastructure projects.

The presence of an increasing number of multinational firms with interests in the resource rich country (primarily copper and coal) has kick-started much-needed investment. Levels of debt, specifically owed to China, will be a concern for the country moving forward. Conversely, the resulting infrastructure projects will help exploit resources as the country attracts more private foreign investment. With solid growth in recent years, following something of an economic meltdown, companies should be interested in Mongolia, but must be aware of the pitfalls, risks and staggering levels of untapped wealth.

Politics

The Revolution of 1921 was a seminal moment in the history of Mongolia, tying the next 70 years of their future to Soviet Russia as a satellite state, the Mongolian People's Republic, never to be invited to become a member of the USSR. The dominant figure of the era, Yumjaagiin Tsedenbal, led the country on a path of moderate socialism, siding with the Soviets over China during the Sino-Soviet split of the 1950s. Throughout this period Mongolia remained broadly underdeveloped, suppressed by its leaders. There was no great leap forward.

This stagnation ended abruptly in 1990, when a *perestroika* inspired youth forced the ruling elite to resign in a peaceful, bloodless revolution. The now Mongolian People's Party (MPP), formerly the Mongolian People's Revolutionary Party (MPRP), was the party that ruled Mongolia during the one-party Soviet period. In 1990, the Mongolian constitution was amended, removing the MPRP's role as the sole guiding force in the country, legalizing opposition parties, creating a standing legislative body, and establishing the office of President. Unlike the majority of Eastern Bloc countries, Mongolia has not had a succession of dominant strongmen since 1990. Term limits have been respected by successive Presidents and their administrations, a surprising anomaly in this part of the world.

An "Oasis of Democracy"?

As with many of these countries after the collapse of communism the ruling elite simply rebranded as the MMP and carried on where they had left off, moving from the planned economy to a more restrained social democratic system, all the while whilst retaining a monopoly on power and resources. While their grip on power has not been absolute since independence, they have reinvented and re-established themselves as one of the enduring force in Mongolian politics. The Mongolian parliament, the State Great Khural, is currently dominated by the MPP, who won 64 of 76 seats in 2016.

Now, the political sentiment of the country is less compliant. There has been steadily rising anger over a long-running corruption case. It seems that the parliamentary speaker, forced out in February, and other political figures had looked to raise 60 billion tögrög (roughly USD\$23 million) by essentially selling off government positions to the highest bidder, removing the independence of the judiciary, prosecutors and the head of the Anti-Corruption Agency entirely, paving the way for a true oligarchy. In many ways this is not too dissimilar to what has happened in Poland and other CIS states. Recent times have seen attempts to dismantle the state's separation of powers. It is certainly cause for concern, yet it does seem to have broad support from the wider population. The fall of the last President, Tsakhiagiin Elbegdorj, the resignation of the speaker and enduring protests have, in a way, rattled the ruling elite.

The cross-party oligarchy that is said to be ruling Mongolia, known as "MANAN", is the focus of much of this discontent. The MANAN, or "fog" in Mongolian, has become synonymous with a shadowy oligarchy. In Mongolian, the word MANAN also combines the acronym of the two major political parties, the Democratic Party and the Mongolian People's Party. Citizens, specifically the youth, much like in 1990, are angered with levels of corruption, the slow rate of development, as well as the pollution suffocating Ulaanbaatar and the areas surrounding

the vast open pit mines, whilst those in charge reap the rewards of Mongolia's movement into mining and resource extraction.

Despite a huge MPP majority, there is widespread dissatisfaction with the rate of progress and development. As details of the infrastructure projects between China and Russia are unveiled in the coming years, the economic future of Mongolia will certainly look brighter to outsiders. However, it would be unwise to discount the ideas and dissatisfaction of its people in this equation. Mongolia is a deeply nationalistic country, with a strong, historic undercurrent of Sinophobia, something played on heavily by the new President along the campaign trail.

President Khaltmaagiin Battulga, elected in 2017 after the Democratic Party's perceived mishandling of the economy, is a business magnate, wannabe political strongman and the founder of Genco, one of Mongolia's largest holding companies spanning a dizzying array of industries. While it is too early to judge whether he is sincere about economic change, in mid-November he secured a major political victor, in removing the power-sharing deadlock between the prime minister and Parliament, strengthening the executive significantly in the process.

His tenure will be deemed a success or failure on the expectation of converting immense resource wealth into high standards of living for the many. A great deal of Mongolians, however, worry that this is simply the dawn of a more forceful political era, something they have witnessed across both their borders with increasing unease. It will be fascinating to see how the relationship between the democratic will of the people and economic interests of those in power plays out over the coming decades.

Economy & Business Environment

Like most Eastern Bloc economies in the early 1990s, Mongolia's went off a fiscal cliff as support from Moscow abruptly ended. Now, Mongolia's largest trading partner is China, with whom it exchanges over 90% of its imports and exports. While perhaps unsurprising, this overreliance is a serious concern for Mongolia, with President Battulga recently outlining it as an area in need of rebalancing. Other problems are equally serious. A 2010 flirtation with tough new laws on foreign investment ended quickly. Although it was never enacted, it did spook potential investors and bring into question Mongolia's suitability as a safe place to do business. Since then Mongolia seems to have trodden a fine line to give both companies and the country a reasonably fair split in resource revenue.

Equally, Mongolia's mounting debts and interest payments have become a burden, stunting growth. This is merely compounded by the fact that Mongolia is the least densely populated

country in the world, with 1.9 people per square kilometre. For comparison, the UK has 272 people per square kilometre. Whilst the population of the country is steadily rising, Mongolia is stunted from a human capital point of view – there are almost double the number of ethnic Mongolians living in China than there are in Mongolia.

A steady increase in the proportion of youth will gradually enlarge the proportion of working-aged individuals in the country, that is if they do not seek alternative futures abroad. If they remain in-country they will, naturally, demand new opportunities and a higher quality of life for themselves and their families. The government must, therefore, succeed in developing the economy, infrastructure and raise living standards or be cast aside, just as the Democratic Party was two years ago.

Similarly, a great disconnect exists between rural and urban areas and the opportunities available in both. It is something that Mongolia has yet to really tackle. 40% of the country's workforce is still semi-nomadic, perpetually ignored by the authorities as they herd across the steppe. Increasingly, they are forced into polluted shantytowns outside cities, called *Gers*, with few amenities and little access to services or the formal economy. Successfully assimilating these groups into Mongolian society will take decades, subsequently hampering development. As for those who do not conform, or refuse, the future looks very bleak. It is not, however, all doom and gloom.

Progress on the horizon

There is no doubt that balanced development will be a huge undertaking, especially given the economic gravitational pull of China, with offers of cheap loans, and the enduring fragility of the Mongolian economy. Mongolia has recently agreed a \$5.5bn (£4.2bn) aid package with the IMF, involving the World Bank, Japan, South Korea and China, in order to stabilise the economy. In return the Great Khural will push through much-needed reforms in light of the recent volatility in commodity prices, a by-product of the slowing down of the Chinese economy. This resulted in the tögrög becoming the world's worst performing currency in 2016. Despite a recent upturn, the vulnerability of Mongolia to these price fluctuations is stark and in dire need of address.

The China-Mongolia-Russia Economic Corridor (CMREC) may go some way in rectifying this in the long term, entrenching Mongolia in the global economy and helping multinational energy companies extract resources with greater ease and in greater quantities. The limited human resources and financial capability available to Mongolia means the country requires concerted and competitive international participation for the development of the economy, although this will naturally be driven by Chinese interests and infrastructure in the region. Investors

interested in the region must find a healthy balance between the two, ingratiating themselves with powerbrokers, whilst not becoming beholden to them.

For better or worse the economic success of Mongolia is tied to Russian and China. The rapid economic change currently bulldozing its way into the Chinese interior to the south will have far-reaching consequences for the fate of Mongolia and its economy. Railways are the key. Powerbrokers in China and Mongolia are eager to strengthen relations through CMREC, one of the key corridors under the Belt and Road Initiative (BRI). CMREC will tie Mongolian mines and cities to Northern Chinese industrial cities, reducing freight times, increasing capacity and creating new land and sea export opportunities. The opportunities available to secondary and service industries here will revolutionise the northern interior of China. The city of Yinchuan is seeing a transformation as it becomes one of China's first "smart cities".

Mining & Resources



When an underdeveloped country suddenly gains access to vast reserves of any natural resources one is, perhaps rightly, inclined to think of the 'resource curse' and err on the side of caution. Mongolia is sitting on vast amounts of coal (10% of the world's known reserves), copper, gold, uranium and other valuable metals. The potential under their feet is staggering, offering both opportunity and risk. Whilst this has not brought open conflict to Mongolia, it has not been plain sailing, least of all for foreign investors. In 2006, much to the shock of Rio Tinto

and Ivanhoe Mines, Mongolia implemented an unannounced 68% windfall tax on copper and gold sales, the world's highest, endangering their presence in the country.

The Rio Tinto operated Oyu Tolgoi copper and gold mine represents the largest financial investment in Mongolian history, with some of the largest known reserves in the world. The giant mine is one-third owned by Mongolia's government and two-third held by Canada's Turquoise Hill Resources. Of Turquoise's 66% share, Rio owns 51%.

The mine, both open pit and underground, is so large that in a few years it will represent almost a third of the country's entire GDP. Eggs in baskets doesn't really begin to cover it. Although the law was repealed a few years later it certainly unsettled the faith held in the Mongolian establishment. Then, in 2012, Chalco Aluminium, a Chinese state-controlled company dropped a bid for Ivanhoe's stake worth almost a billion dollars, citing Mongolia's tough new foreign investment laws and open hostility from those in power, which would have required parliamentary approval. Commentators cited the lack of Mongolian legal framework for these types of projects. Of course, entrenched legal precedence takes time to mature.

These issues have recently resurfaced. Perhaps unsurprisingly, with the increased output of the mine and the development of further shafts, the Mongolian government is now looking for more favourable terms from the mining company on their most valuable asset. Rio Tinto initially resisted in the strongest possible terms but both sides now seem to have relented somewhat after a legal ruling in country. Specifics on how the new consensus will be more beneficial to Mongolia have yet to be revealed.

Similarly, Mongolia surprised the industry in 2018 when it created the vast Tost Tosonbumba nature reserve in the Gobi Desert, cancelling dozens of mining contracts within its boundaries in the process. These licenses were purchased legally before the decision to protect Tost. As a result, the mining companies had to be compensated by the government. This sort of act, while undeniably excellent for the Mongolian environment, still brings into question the degree of security even the biggest foreign companies have when operating in-country, not to mention spooking potential investors moving forward. Despite these incidences, the sheer scale of reserves in Mongolia and its proximity to China mean that it is simply too big to be ignored – for example, lithium, required for hybrid car batteries, is now being mined for the first time.

As the industry develops, investor-government relations will become better established and more cohesive. Until then, Mongolia will continually be holding itself back, if only due to a lack of experience in handling the keys to its future.

Growing Infrastructure

Although great change is afoot, primarily due to foreign investment, the infrastructure across the country is threadbare at best. Most paved roads are largely confined to Ulaanbaatar and the surrounding areas. The rest are single dirt tracks winding their way across the steppe, unsurprising given population density. Equally, there is only one main railway line, the Trans-Siberian Railway, completed in 1955. Little progress materialised in the ensuing 60 years.

Russia and China plan to build a transportation and infrastructure corridor through Mongolia, consisting of thousands of kilometres of rail and road, as part of the ambitious new Silk Road and CMREC projects. Whilst Mongolia's investment in the project will be comparatively small, they will benefit (perhaps for the first time) from their position as the halfway house between Russian and China. Mongolia will thus get a unique chance, with others effectively funding its own infrastructure. Of course, these powerful countries will expect much in return, both economically and politically, but if Mongolia's domestic standing and capability improves, then this is to be welcomed.

Despite the grand scale of these projects, it remains to be seen how useful these will be for the wider population. China has come under much criticism, specifically in Africa, for building infrastructure projects that do not aid the country as a whole, but are aimed primarily at facilitating resource extraction. In Mongolia most of the coal is exported along a purpose-built road across the border to Yinchuan. In some cases, it is now the mining companies that are offering to build the railroads to facilitate their own success.

Positive developments include a large oil pipeline ("Power of Siberia, opened 2nd December) linking Russia, Mongolia and China, as well as a large new airport in the capital offering a huge increase in capacity, built by the Japanese and ready for delivery this year. Each infrastructure initiative will help facilitate and consolidate new opportunities for the development in areas previously constricted, not just in the mining industry, but also in agriculture, stock farming, light industry, tourism and partial free trade areas. In 2016, Presidents Putin, Xi and Elbegdorj signed off on 32 infrastructure projects. Many more have followed since. The potential is there, but first it must be unlocked with vast, costly and labour-intensive operations.

Elsewhere, the presence of a fledgling tech industry is also worthy of note. Young Mongolians returning from studying or working in tech abroad, particularly Japan, are driving an entirely new industry. This will be crucial in revolutionising finances and banking, but also in education and communications for the half of all Mongolians that live comparatively cut off outside the capital.

Foreign Affairs

China and the Soviet Union have dominated the historical and economic Mongolian narrative since the 1600s, when the Qing Dynasty (1635-1912) invaded. This has had an enduring effect of restricting the country and economy, isolating it on the steppe for centuries. Only since 1991 has Mongolia enjoyed any degree of self-determination, albeit in greatly diminished circumstances. Similarly, relations with other nations have been curtailed by Mongolia's recent history and geography. The UK was the first western country to begin modern diplomatic relations with Mongolia, and that was as late as 1963. However, change is certainly on the horizon.

Membership to the Asia-Pacific Economic Cooperation (APEC) forum has been a goal for Mongolia for decades. Naturally, this would aid growth and economic cooperation, moving Mongolia away from this overreliance on a couple of other countries, whilst promoting its role as a growing power. Participation in APEC will provide Mongolia with more opportunities for market expansion and sustainable economic development in the long term. However, a continuing rejection of new members has been in place since 1998 and looks set to continue, frustrating those in politics and business alike. It may require China and others to flex their clout for Mongolian membership.

Mongolian forces have served on peacekeeping missions across much of Africa, Kosovo and Afghanistan. In the past the force has been armed with sales from Russia. Recent war games in Siberia, attended by both Mongolia and China are perhaps a sign of realignment between the three, bordering on a newfound regional hegemony. For better or worse, this is certainly the astute move for the foreseeable future – you simply cannot fight geography.

Corruption & Freedoms

According to the World Bank, Mongolia ranks in the top third of countries in terms of ease of doing business – above Spain and Poland, and much higher than any of the BRIC countries. Equally, in 53rd place out of 126 countries worldwide, Mongolia has gradually improved year on year in terms of rule of law (WJP Rule of Law Index 2019). In terms of 'Order & Security' it ranks amongst the highest in Asia.

Conversely, the Corruption Perception Index states that Mongolia has remained worryingly stagnant (93rd of 180), hovering amongst the likes of China, Kosovo and Bahrain. Corruption is a major problem throughout Mongolian government and law enforcement. There is also insufficient oversight by either official agencies or the independent media. The immunity enjoyed by Members of Parliament from prosecution encourages corruption and shields

offenders from punishment. The anger felt by the population on these issues is deeply rooted, and while it is confined to the cities, its ability to disrupt industry is a complete unknown.

Much of this corruption and crony capitalism is between the ruling class and energy companies. According to Transparency International, a *“lack of transparency and corruption surrounding the negotiation process of such deals and of the distribution of mining royalties have led to large scale citizen protests over the distribution of mining royalties.”* Equally, the underdeveloped legal system and the lack of experience in tackling these types of cases leaves much to be desired. Either way, foreign investors must tread carefully.

President Battulga himself has been implicated in an energy scandal, involving McKinsey & Company, over kickbacks paid to government officials, including Battulga, in return for consulting contracts in mining and infrastructure. He is already facing criticism over a move to give himself far-reaching powers, including the ability to remove judges and senior members of the nation’s legal system, via his role as chairman of the National Security Council.

As a young, increasingly urban and educated population gains a greater understanding of their rights and the obligations of the state, pushing aside the older generations, this may change. In a way, the recent election has put the ruling elite on notice, with those willing to adapt to the likeliest to survive. Unlike other former Soviet countries, the Mongolians do at least have a fair opportunity to remove and elect their leaders. The poor distribution of resource rights, environmental issues and, crucially, living standards, will be the yardstick by which future politicians will be judged.

Equally, environmental damage has been perpetuated by poorly enforced and inadequate laws in pursuit of profit. This has predominantly affected nomadic herders, those who benefit least. Mining not only uses vast quantities of water, leading to desertification and contaminating what is left, it also displaces those in the area, cutting them off from traditional grazing areas, with little compensation to boot. Companies would do well to focus on these issues as part of their strategy in-country. If only because, as the country’s institutions develop, those who abused their positions in the past will find it to their cost.

Criminal Element & Terrorism

There is no recent history of terrorism in Mongolia, nor does Mongolia have a strong history of organised crime, being one of the least affected countries in Asia.

Conclusion

Mongolia represents a challenging yet exciting prospect as the wheels of industry begin to turn and the vast steppe is unlocked with foreign investment. Businesses of all sizes and sectors ignore Mongolia at the risk of being completely shut out by more risk-inclined and intrepid competitors, especially as Mongolia increasingly consolidates its links with Russia and China. That is not to say, however, that European and American have been less forward than their Asian counterparts – much exploration, particularly in mining, is now being done by smaller, Western players.

These developments, however, will run concurrently with the ramifications of Chinese-led development projects and the increasing dependence that that brings. Geography has helped to stunt Mongolian growth in the past, that time is now coming to a close. While mining and natural resources are quite obviously Mongolia's way forward, the overreliance on this sector may prove to be very volatile, particularly in the short term, if Mongolia does not make use of what it has to secure lasting development and prosperity. Good governance and the correct application of the country's resources are key.

A passing knowledge of this part of the world may not inspire confidence. And yet Mongolia treads a different path to the '-stan' countries of Central Asia, with a competitive political system, relatively free press and open elections. Conversely, the Mongolian banking, judicial and monetary institutions are, perhaps unsurprisingly, unprepared to absorb the scale of the likely change to the economy. As with all countries, this will take many years, perhaps generations, of trial, error and consolidation. The Mongolian population, particularly the youth, are rightfully dissatisfied with their current lot - the teething problems of oligarchy, low living standards and a strong post-Soviet hangover. While economic inequality may persist for many decades the train of transformation of Mongolia now appears unstoppable.