



Harnessing Natural Resource Wealth for Inclusive Growth— Country Experiences and Lessons Learned: the Case of Mongolia

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Introduction

- Mongolia is a landlocked, low income country, large in territory, but with a population of less than 3 million, a third living in the capital city.
- It has semi-arid climate, and the economy has traditionally been dominated by pastoral animal husbandry, with agriculture still the largest economic sector.
- However, it is well endowed with natural resources, including huge deposits of copper and coal, as well as gold and other rare minerals.
- Mining is to be the main driver of economic growth on the back of two large mining projects at Oyu Tolgoi (OT) and Tavan Tolgoi (TT).
- TT is one of the largest undeveloped coal deposits in the world, while OT is the largest undeveloped copper reserve in the world.
- OT is projected to more than double the mining sector size and increase Mongolian GDP by 36.4 % by 2020.
- In what follows I will give you a brief overview of the mining sector developments before discussing the related macro-fiscal issues. I will close with some tentative conclusions and lessons to be drawn from Mongolia's experience.

Mining Sector Management and its Evolution

- Mongolian mining experienced roughly 3 stages since its transition to a market economy
- Until 1989, mining and all other sectors were full state monopolies
 - Mongolian-Russian JV mining operations such as Erdenet and Mongolrostsvetmet dominated
- Early transition legislation, such as the 1989 Law on Subsoil, the Constitution of 1992 and the 1994 land law, defined natural resources as the property of the State
 - Legislation did not provide for long-term land ownership, leaving mining licensing to ad hoc government review and approval.
 - This is a reflection of both the socialist past and the traditions of nomadic animal husbandry based on common property of pastureland, which still affects the present transition from a pastoral agriculture to a mining-based economy
- The 1996 elections put new democratic forces in power for the first time, and launched a broad range of reforms, including reforms in the mining sector.
- The 1997 Minerals Law established a separate Mining Agency and the first investor-friendly legal framework for the mining sector
 - It defined the state's role as the enabling provider and regulator and laid out procedures for a "first come, first serve" licensing regime of exploration licensing for fees, with preferential right to mining licensing and stability agreements for big projects.

Mining Boom and its Unintended Consequences

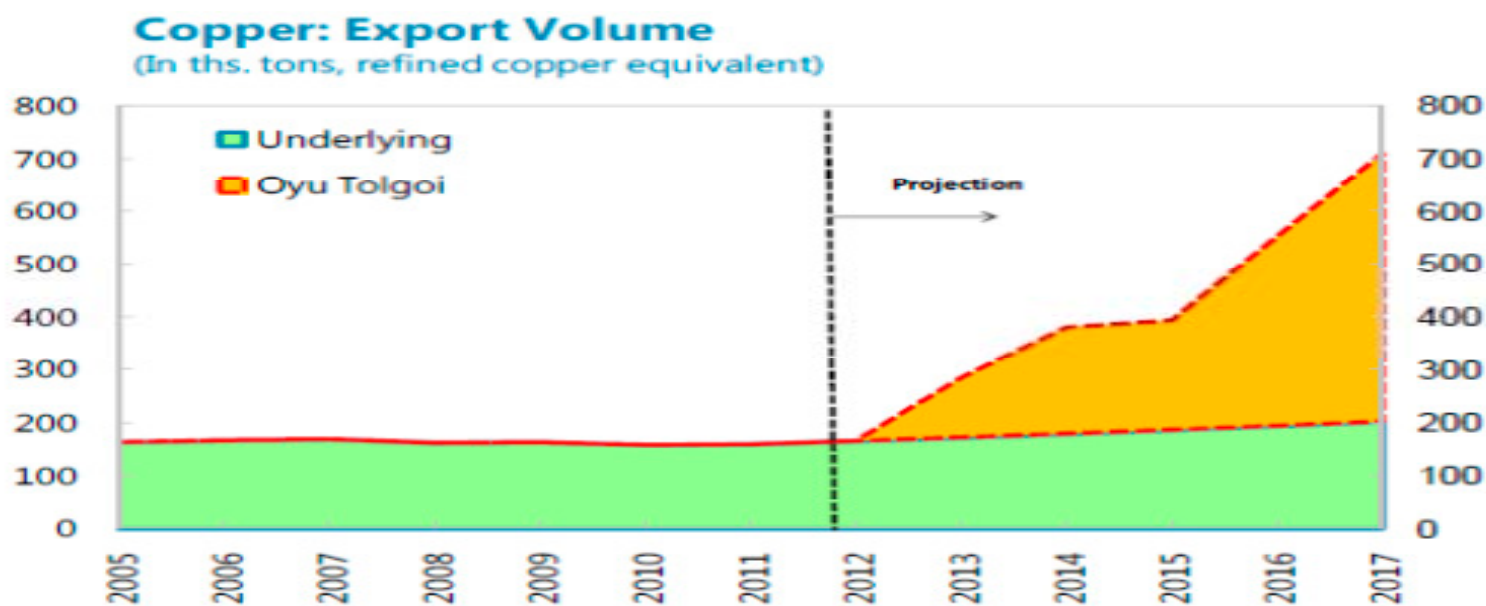
- The law was praised as *“one of the strongest legal presentations of mineral licensee rights and obligations in the world, and clearly the most investor-friendly and enabling law in Asia”* (M.E. High, in Julian Derkes (eds) 2012. Change in Democratic Mongolia. Brall, Boston, p. 255 . 2012).
- Indeed, it led to an explosive growth in FDI into the mining sector, especially following the 2001 abolition of a tax on gold exports.
- The share of the mining sector tripled from 10% of GDP in 2002 to 33% in 2007.
 - Not just FDI-led, but small-scale informal artisanal mining by domestic companies and individuals, mostly in gold, expanded quickly.
- However, these artisanal mining operations generated environmental concerns and conflicts with local cattle breeders and led to some protest movements.
- Response to these vexing controversies, which arise frequently in resources-rich economies, was not effective.
 - Politicians often played on anti-mining sentiments for short-term political support.
- As a result, from around 2002, the political support for mining, including the strategic attitude to big mining based on FDI started to sour.
- The number of foreign-held exploration licenses and the extent of territory covered became a big political issue during the 2008 and 2012 parliamentary elections and started affecting policies.

Gradual Erosion of the Liberal Mining Regime

- The legal and fiscal framework reverted to favoring a more dominant role for the State.
- The 2006 amended Minerals law introduced the concept of “Strategic Mining Deposit” under which the State has rights to up to 50% interest in mining operations (Art. 5).
- These developments led to FDI decline and a prolonged impasse on signing of the Investment Agreements on the OT project.
- Only after co-opting the main opposition in a coalition government by the winning party, and revocation of the windfall gains tax and amendment of the mining legislation finally resulted in the approval of the OT project on March 1, 2010.
- Given the enormous size of the deposits, it is not entirely surprising that negotiations over the terms have dragged long and been highly contentious politically, and the process was also sustained by the strengthening of international commodity prices.
- Still, anti-mining and anti-OT sentiments continued to affect policies and, the 2012 elections produced a new coalition government with a more critical view of the OT agreement and key positions were given to politicians who opposed to the liberal mining regime.
- The Government’s demand to revise the OT agreement coupled with its refusal to approve the cost overruns and further expenses resulted in postponing the August 2013 launch of underground mining, which is responsible for 80% of the production.

Mining Sector Prospects, according to plans . . .

- The mining boom is changing the Mongolian economy fast, growth averaging 8% over the past decade resulting in a 5-fold increase in per capita GDP. If things do not get derailed, the mining sector share in export earnings will reach 95% once the OT mine becomes fully operational and GDP per capita could triple. Fiscal mineral revenue was projected to quintuple by 2018 compared with 2011.
- However, the Government “achieved” borrowed 34 % equity participation, prepayments of taxes and sales revenue from OT to pay for the cash transfers promised during the election campaign, all of which have to be repaid first.



Sources: Mongolian authorities; and IMF staff estimates.

The Macro-Fiscal Nexus in Practice

- Resource exhaustibility requires channeling the mining boom into investment in developmental capital, including human and institutional.
- For small economies with considerable natural resources such as Mongolia, the long horizon in fact means a paradigm shift to a mining-driven development strategy.
- Then, preventing the “resource curse” of rent seeking and inefficient spending become the main policy priorities, while the “Dutch disease” becomes almost an unavoidable condition of your new comparative advantage.
- The short run macroeconomic challenge is accommodating the large capital inflow and credit boom without undermining macroeconomic stability by countercyclical fiscal policy, well-coordinated with monetary and exchange rate policies.
- But this macro-fiscal management is made harder by the intense lobbying and electoral cycle in an increasingly oligarchic and populist democracy as Mongolia, given the legal and institutional weaknesses.
- Therefore, ensuring optimal degree of saving and investment calls for additional, more effective arrangement of institution buttressing.

Mongolian Experience of Macro-Fiscal Management

- Intensive reforms undertaken early on to reform the fiscal sector have managed to change fundamentally the traditional understanding of government role and functions, thus preparing the ground for subsequent reforms.
- However, the mining boom magnitude is such that, despite the relative advantages of early reforms and as well as the ongoing efforts to strengthen fiscal management, there are big challenges.
- The economy is still subject to regular boom bust cycles and the fiscal policy remains highly pro-cyclical despite repeated Fund programs and institutional innovations.
- Moreover, as the Government's dependence on mineral revenues grew, its spending has become more wasteful, and the policy pro-cyclicality increased, and adjustments fall mostly on investment.
- Indeed, fiscal policy is the weakest link of the whole macroeconomic framework, leading to persistently elevated inflation and continued exchange rate depreciation.
- Overheating is exacerbated by the off-budget spending by the Development Bank of Mongolia, although its high import content alleviates pressure on the domestic economy. The government has issued international bonds on the mining inflow expectations and plans substantial further borrowing abroad.

The Current Fiscal Framework Working (?)

- 2012 – 2016 Action Plan creates a medium-term framework for annual budgeting and a declining schedule of public debt ceiling to 40% of nominal GDP by 2014.
 - The 2010 Fiscal Stability Law (FSL), with a stabilization (and savings) fund for mineral revenue
 - The 2011 Integrated Budget Law spelling out sanctions for FSL breach
 - The 2012 Social Welfare Law, introducing means-tested benefits to replace universal cash transfers

- The structural primary balance smoothing rule targets a fiscal balance from “structural revenues” based on the price benchmark calculated as a 16 years MA, with automatic transfer to a Stabilization Fund when actual mineral revenue exceeds the structural revenue,

- The FSL ceiling on expenditure growth (without distinction between capital and current spending) linked to the growth of non-mineral GDP is to be enforced from 2013

- However, the implementation of the new framework is not satisfactory and needs to be intensified for avoiding fiscal fragmentation and contingent liabilities, especially improving the Development Bank governance and its coordination with the fiscal management

- The surplus placed in the Stabilization Fund is to be greater than 5% of GDP from 2018 with excesses invested with a long-term perspective. A new Sovereign Wealth Fund could be an opportunity to strengthen the framework (?)

Future Challenges

- Cyclical decline in international commodity prices and the deceleration of FDI and of economic growth, against the background of the unbridled government spending present severe short-term challenges.
- Some of the projects financed by international bonds mediated through the DBM may bring on unaccounted fiscal risks through off-budget financing of non-revenue generating projects, and plans to expand local government power add to fiscal risks.
- Saving some of the mineral revenue to reduce aggregate demand and channeling them into priority investments is the strategic objective, so far not succeeding.
- Ultimately, the biggest danger is losing the opportunity through inefficient investments based on over-optimistic and hasty industrial policy/diversification schemes
 - Examples are unrealistic railway plans through Russia to Japan and Korea markets versus to China and downstream enrichment and oil refining plans not in line with comparative advantage
- Therefore, quickly strengthening the government's technical capacity of capital budgeting, project appraisal, selection, implementation and procurement is of paramount importance.

Lessons from Mongolia

- In the context of a fledgling democracy with weak traditions of property rights, managing the politics and avoiding unproductive fervor of resources nationalism and excessive expectations from mining projects is very important for successful management of resource boom episodes.
- Transparent and stable dealings with investors, with a healthy respect for their motives, constraints, and an understanding of their limited responsibility for national development should be promoted.
- Misinformed resource nationalism, often condoned and stoked by populist politicians, can disrupt and hold back the mining sector development, even force your hand in the wrong way in the negotiations with TNCs.
- In relatively small countries, even one big mining project would mean a paradigm shift for the economy. Thus, societal consensus and informed leadership becomes critical and coherent development strategy based on mining need to be developed and accepted.
- Most importantly, institutional strengthening of the fiscal management of mining revenues for their effective use for sustainable growth has to be the common goal of the host country and her partners, and IFIs with expertise in macroeconomic and project management can help a lot.
- Given the unavoidable dominant role of the government in the mining sector, its ability to manage the mineral revenues, especially capital budgeting, including the implementation of individual mega-projects, become the decisive factor of success.

Lessons for Mongolia

- Macroeconomic failures are the main reason for the “resources curse”, but is exacerbated by undeveloped property rights, weak rule of law, contract enforcement traditions, and requires institutional and governance reforms.
- Resource boom and anticipated rents feed into populism and lead to bad policies. Misguided industrial policy or subsidization of affected non-resources sectors, often supported by foreign borrowing collateralized on the mineral potential, can aggravate the problem of competitiveness caused by the Dutch disease.
- Therefore, the challenge is to isolate the management of mineral revenues from politics in order to prevent wasteful spending, hidden unproductive subsidies and public schemes, and rent-seeking.
- Focus should be concentrated on protecting the technical side of fiscal management from political cycle and interference and on integrating the Economic Development Ministry’s planning activities into capital budgeting and fiscal control by the Ministry of Finance.
- Improving FDI and business climate and financial intermediation are more important for a buoyant non-mineral sector dynamism than risky industrial policy. A mining boom itself provides an exceptional opportunity for deepening financial markets to support the other sectors.

Conclusions/ tentative policy suggestions

- Redouble efforts to further the Institutional strengthening of the fiscal management to curb its pro-cyclicality and to fully implement the current arrangements within the fiscal responsibility law.
- Redirect government efforts to tackling priority bottlenecks and let markets drive the economic transformation process of expanding non-resources exports to China , which is already very dynamic. More needs to be done in terms of comprehensive regulation of environmental standards, including full regularization of artisanal mining and water management to prevent conflicts.
- Even without borrowing, an IMF seal of approval may be needed to reverse investor sentiment. Recent weakening of the copper price, FDI decline and loss of macro control evidenced by the drastic exchange rate depreciation and jump in inflation, triggered by the OT delay, suggest the need for such assistance.
- In order to lock in the needed reforms to ensure sustainable and stable policy framework, a more effective, possibly internationally assisted resources fund arrangement is needed. One possibility is to set up a saving/investment fund run by a politically insulated management with a simple golden rule to use resources revenue for investment only, similar to that of Botswana.