EMERGENT ADVISORY

Mongolia and the road to economic development

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At the APEC meetings in Bali in October 2013, Mongolia intensified its campaign to join the forum. This is the latest of significant steps that the landlocked North Asian country is taking on its journey towards economic development.

Mongolia's transition from a closed, centrally planned economy to one of the fastest growing economies in the world is a fascinating story. The country has the potential to be one of the all too rare successes for small economies that develop major mineral wealth. But there are also risks ahead that could frustrate this bold ambition.

The transition from centrally planned to open, market oriented economy

Prior to the fall of the Soviet Union, Mongolia was one party, communist state. The USSR provided significant support for the country and its influence was readily apparent in all parts of life.

However, in 1991 when the USSR collapsed, it ceased its support for Mongolian economy and it, in turn, collapsed. From 1990 to 1993 the economy was in a recession, which at its deepest in 1992 saw the economy contract by 9.4%.

This triggered a period of tumultuous change for the small country. At the time, the prognosis was grim. Landlocked, Mongolia was unable or unwilling to look to its neighbours for assistance. With the USSR undergoing its own traumatic transformation, China was an unappealing option with most Mongolians harbouring a deep distrust of China arising from the experience of 200 years of occupation during the Qing dynasty.

Politically, the country moved towards democracy despite its lack of experience. The pro-democracy movement started publicly in 1989, drawing heavily on the model of *perestroika* in the USSR. In 1990 the constitution was amended to allow for a multi-party system and established the office of President. The first parliamentary and presidential elections were held in 1992.

While there have been great challenges, the transition has been successful with Mongolia being seen as the first Asian country to successfully transition from Communism to democracy. There have been 6 elections and 5 changes of Government, each of them largely peaceful.

The country also moved steadily towards an open, pro market economic system. Given its geo-political situation, several leaders at the time articulated what has come to be known as the Third Neighbour policy. Mongolia looked to partners beyond its geographical neighbours to become trade and finance partners in the country's future. Essentially, it aspired to see global capital markets as Mongolia's Third Neighbour.

By the end of the 20th century, Mongolia had made a successful transition to democracy and across the political spectrum there was general support for an outward looking, pro-market, economic system. However, at this stage the country remained a small, largely agrarian economy. It largest exports were cashmere, and copper from the mid-scale mining complex at Erdenet in the north of the country.

The emergence of a mining economy

Mongolia is a country known to be rich with minerals. During the twentieth century the Russians fostered the development of a range of mines around the country. Coal, uranium, copper and gold were all known to be present. But developments were generally small in scale and of limited economic significance.

From 2001 to 2003 a drilling programme by Canadian exploration company, Ivanhoe Mines, now known as Turquoise Hill Resources, indicated that the area called Oyu Tolgoi, was the site of a world-class orebody.

The Oyu Tolgoi deposit is now recognized as one of the world's largest copper-gold orebodies. Drilling and evaluation continue to this day, with current estimates indicating that the Oyu Tolgoi orebody contains in excess of 41 billion pounds of copper and 20 million ounces of gold.

However, the path to its development was complex. Building a large scale mine in a small landlocked country with little exposure to the outside world is a major challenge, with only a few major mining companies capable of meeting the challenge.

The project required access to significant financial resources and technical expertise. In 2006, Turquoise Hill Resources and Rio Tinto entered into a strategic partnership that provided funding for the development of the project and eventually has seen Rio Tinto become the major shareholder in Turquoise Hill Resources Limited.

The approval process was challenging, complicated by the Global Financial Crisis of 2008. In late 2009, Turquoise Hill Resources and Rio Tinto signed a comprehensive Investment Agreement with the Government of Mongolia for the construction and operation of the mining complex. The agreement created a 66:34 partnership between Turquoise Hills Resources (controlled by Rio Tinto) and the Mongolian Government.

The signing of the Investment Agreement was a major boost for the Mongolian economy. The decision of global mining giant, Rio Tinto, to invest in a $6 billion project in Mongolia sent a strong signal of confidence to other investors. This sparked an influx of investors into the country and a boom in the national economy. In 2010 and 2011 Mongolia was the fastest growing economy in the world.

However, the gloss on this good news story was soon tarnished as tensions emerged between Rio Tinto and the Government of Mongolia. In the lead up to the 2012 parliamentary elections, political pressures to amend the terms of the 2009 investment agreement became acute. The Democratic Party, which campaigned on a platform of amending the agreement, won the election, and appointed a vocal resource nationalist to the post of Mines Minister.

A tense stand off emerged as both parties held their ground. However, while the public statements were frosty and taciturn, little by little the project moved forward.

The mine was commissioned in June 2013. First sales into China were shipped in mid 2013. A difficult negotiation over project financing for the second phase saw the parties grapple with capital expenditure estimates for the expansion as well as arguments over the magnitude of operating costs.

It is likely that the development of Oyu Tolgoi will continue to progress steadily, with regular periods of tension between the Government of Mongolia and the foreign investors in the project. Neither party has an interest in the project failing and both parties need the other side.

The more compelling challenge will be the extent to which this major project will be the catalyst for the emergence of a larger and more modern economy.

It is well understood that major resource development poses significant challenges for small economies. Appreciating currency and rapidly escalating wages in the mining sector can place significant pressure on the non-mining sector of the economy.

Rapid development of the capital city and regional centres can place pressure on infrastructure and the demand for government services in excess of the government's capacity to raise funds.

It is also likely that there will be increased disparities in wealth as the benefits of mining and foreign investment are accrued unevenly.

Governments are likely to be challenged by the capacity of government officials to respond effectively to the new regulatory requirements, partly because of inexperience, and partly because many of their best people are likely to be recruited by mining companies.

There are good reasons to believe that Mongolia will be able to make a success of this transition. Despite public controversy over the term of Rio Tinto's investment in the Oyu Tolgoi mine, opinion polling indicates widespread support for foreign investment in mining in the country.

Membership of APEC would be a major achievement for Mongolia and a further step towards becoming a significant new mineral economy in Asia.

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