

03

COUNTRY RISK+

Mongolia is a developing nation, which carries several risks for investors due to factors such as geopolitical, economic, and financial market influences.

The following list presents the top five risks for Mongolia surveyed by the World Economic Forum's 2022 Executive Opinion Survey, which was administered between April and September 2022. Leaders answered the following questions: "What five risks will pose a critical threat to your country in the next two years?" and were asked to select these from a list of risks.

- 1. Debt crisis**
- 2. Human-made environmental damage**
- 3. Geoeconomic confrontation**
- 4. Employment and livelihood crises**
- 5. Interstate conflict**

In addition to the World Economic Forum, international organizations working with Mongolia such as the International Monetary Fund, the Asian Development Bank, the World Bank Group, and leading credit ratings agencies including Moody's, Standard and Poor's, and Fitch Ratings regularly analyzes risks to Mongolia's business environment.

The Financial Stability Council regularly identifies medium-term economic risks in Mongolia. Established in 2007, the council is comprised of the Governor of the Bank of Mongolia, the Minister of Finance, the Chairman of the Financial Regulatory Commission, and the CEO of the Deposit Insurance Corporation. Its mission to address, control, and reduce systemic risks and coordinate the efforts of its member organizations to maintain the stability of Mongolia's financial system. The council has established the "Financial Stability Report" annually since 2012, determining the medium-term economic risks facing Mongolia.



According to the Financial Stability Council, there are external risks affecting Mongolia's economy, such as China's "Covid-Zero" policy, the Ukraine war, and the weakening of international financial markets, which are posing significant challenges to economies worldwide. Mongolia is particularly vulnerable due to the border closures of its only two neighboring countries, which constitutes the largest risk to its economy.

This section highlights the medium- and long-term risks facing Mongolia based on research and reviews by international organizations, local experts, and political and social researchers.

Based on the research and reviews of international organizations, local experts, and political and social researchers, this section highlights the medium and long-term risks facing Mongolia. It includes:

1. Medium-term – Financial stability risk

- Inflation
- Balance of payments risk
- Credit defaults
- Difficulties to businesses
- Fiscal deficit
- External debt pressure

2. Economic vulnerability

3. Political risk

4. Corruption and judiciary

5. Foreign policy challenge

6. Challenges for mega projects

7. Climate risk

3.1

FINANCIAL STABILITY RISK

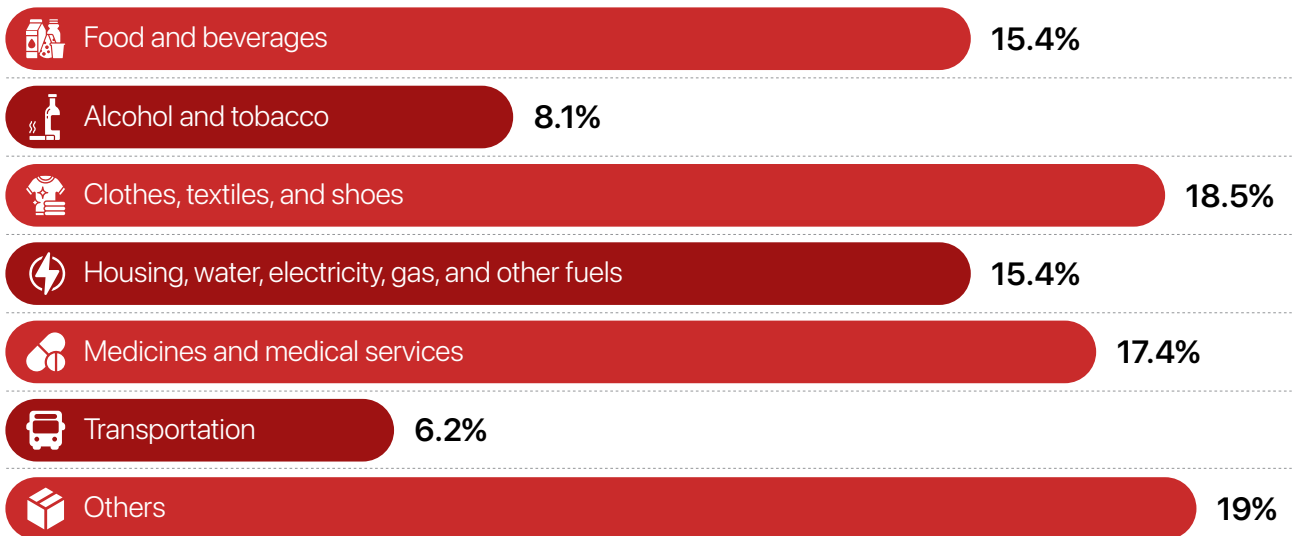
Inflation

The Bank of Mongolia has been working to stabilize inflation growth in 2021-2023 at around 6% per annum and in the range of +/- 2 percentage points. At the end of 2022, inflation reached 13.2%, well above the central bank's target. It is likely to remain high over the coming quarters.

Drivers of consumer price index increase (by sector)

Figure 1.32

DRIVERS OF CONSUMER PRICE INDEX INCREASE (BY SECTOR)



Source: NSO

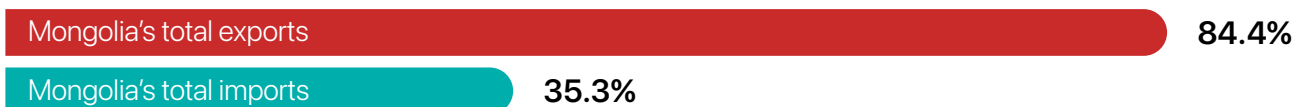
The largest contributor to inflation has been the increase in the price of imported goods.

Until recently, Mongolia's inflation was driven by supply-side and global factors, such as high international prices, a decline in domestic meat production, and supply disruptions related to China's border restrictions and sanctions against Russia, according to the International Monetary Fund.

However, China's easing of its Covid-Zero policy and opening of its border are positive signs for Mongolia's economy, which is expected to reduce custom delays and have a positive impact on the price of imported products.

Figure 1.33

MONGOLIA-CHINA TRADE IN 2022 (BY PERCENTAGE)



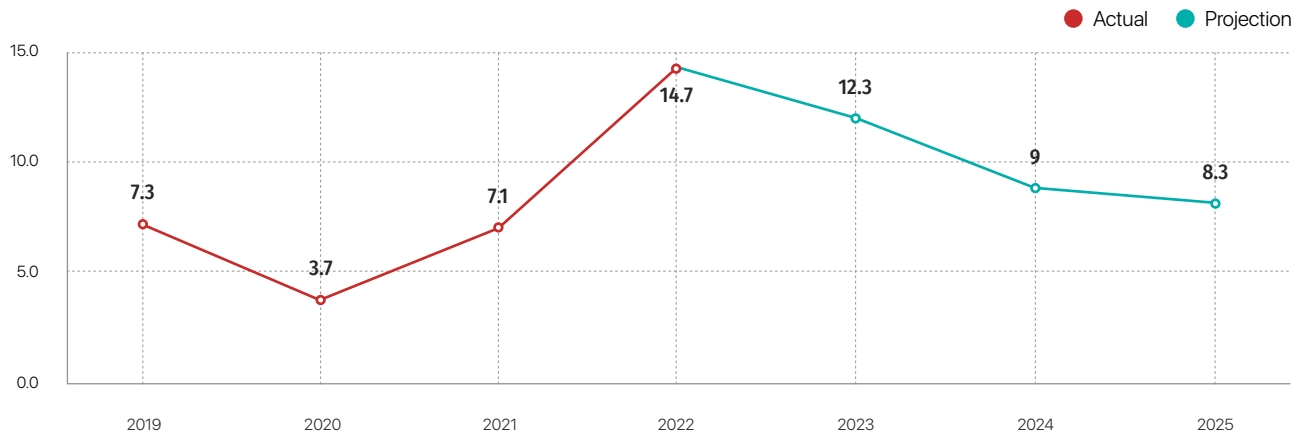
Source: NSO

In addition to the high risk of inflation caused by the increase in prices in the global supply chain, the ongoing conflict in Ukraine and the continued depreciation of Mongolia's currency, the tugrik (MNT), remain risks.

To stabilize inflation expectations and target levels in the medium term, the Central Bank of Mongolia increased the interest rate to 13 percent in December 2022.

Figure 1.34

INFLATION, ANNUAL PERCENTAGE CHANGE



Source: IMF, October 2022

The IMF suggested that to reduce inflation, quasi-fiscal operations should be quickly phased out and the government of Mongolia should support the Bank of Mongolia’s effort to contain inflation.

Foreign exchange rate risk

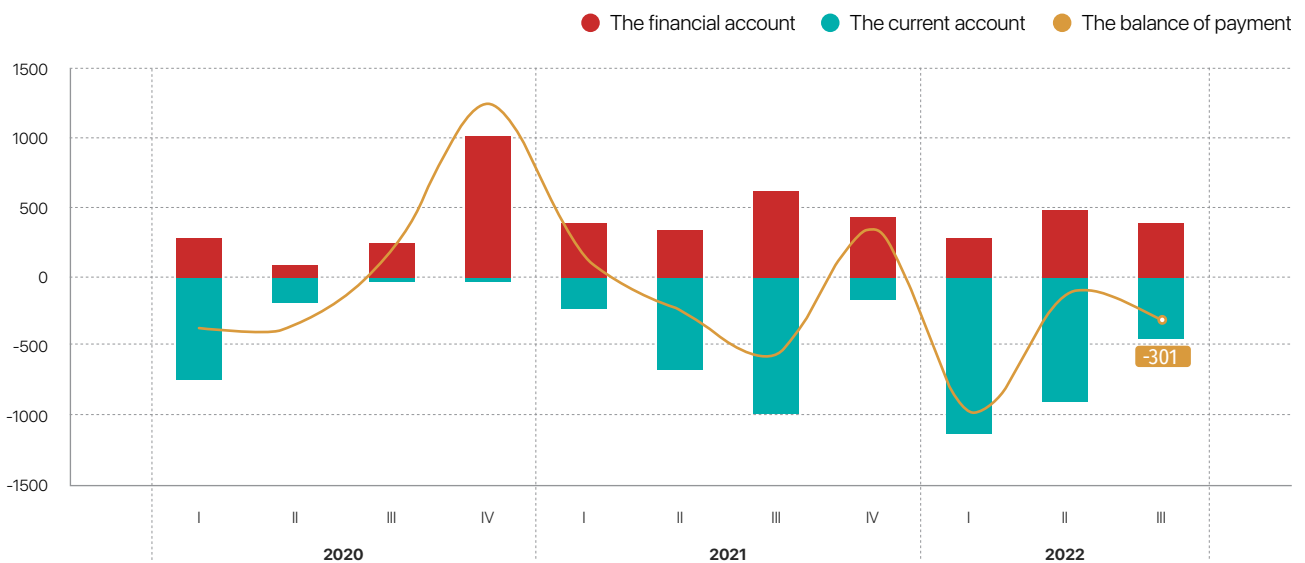
The impact of China’s “Zero Covid” policy on Mongolia’s mining export volume resulted in a slowdown in the first half of 2022 and contributed to a balance of payments deficit due to increased transportation costs, posing a risk to the exchange rate. However, exports increased in the second half of 2022, leading to a positive trade balance.

Despite this improvement, a significant bond repayment was made at the end of 2022, the Ministry of Finance reported a projected balance of payments deficit of \$1 billion by the end of the year.

The balance of payment is the method countries use to monitor all international monetary transactions at a specific period.

Figure 1.35

THE BALANCE OF PAYMENT, USD MILLION

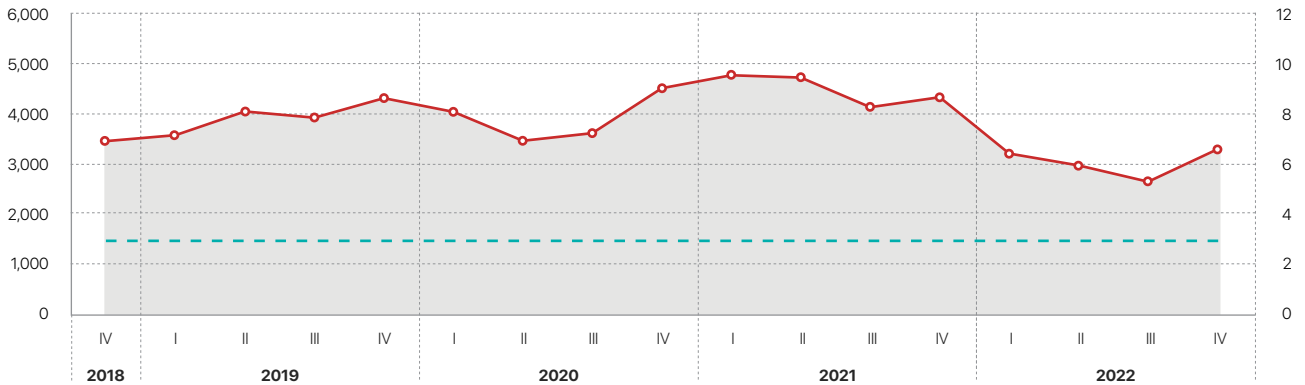


Source: NSO, Ministry of Finance

The foreign exchange reserves shrank in the mid-year due to the Bank of Mongolia’s significant intervention to prevent a sharp decline of the tugrik against the USD. Regardless, the foreign exchange reserves improved towards the end of the year as export revenue started to recover.

Figure 1.36

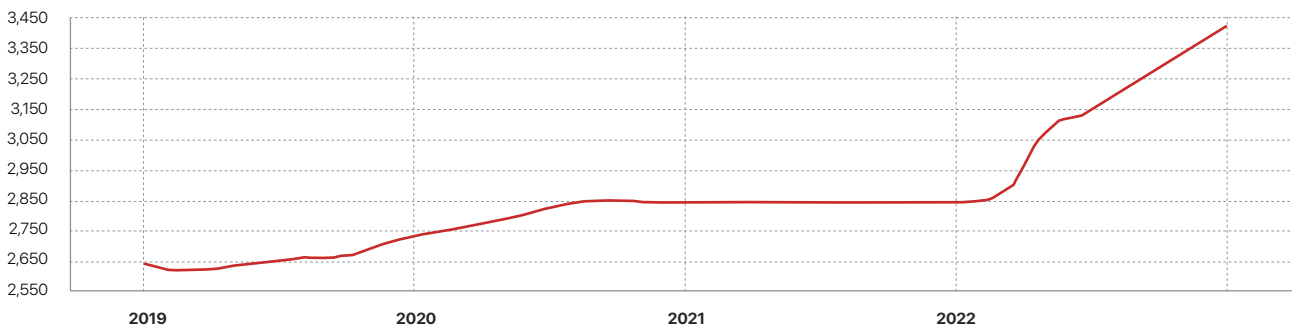
FOREIGN CURRENCY RESERVE, IN US\$ MILLION



Source: Mongolbank

Although foreign exchange inflows are improving, the overall risk remains as MNT continues to depreciate against the USD and CNY.

EXCHANGE RATE BETWEEN THE US DOLLAR AND THE MONGOLIAN TUGRIK



Source: Mongolbank

Household debt risk

After the pandemic, Mongolia prioritized economic recovery through policy initiatives, leading to a expansion in bank lending and a sharp increase in consumer and mortgage loans. The Financial Stability Council's September 2022 report noted that despite the recovery of the labor market and an increase in real household income, the total outstanding consumer loans in the financial sector rose at an even faster rate. The end of pandemic-related incentives for loan repayments and regulations in 2022 may affect loan repayment and credit quality.

Figure 1.38

YEARLY BANK PERSONAL LOAN GROWTH

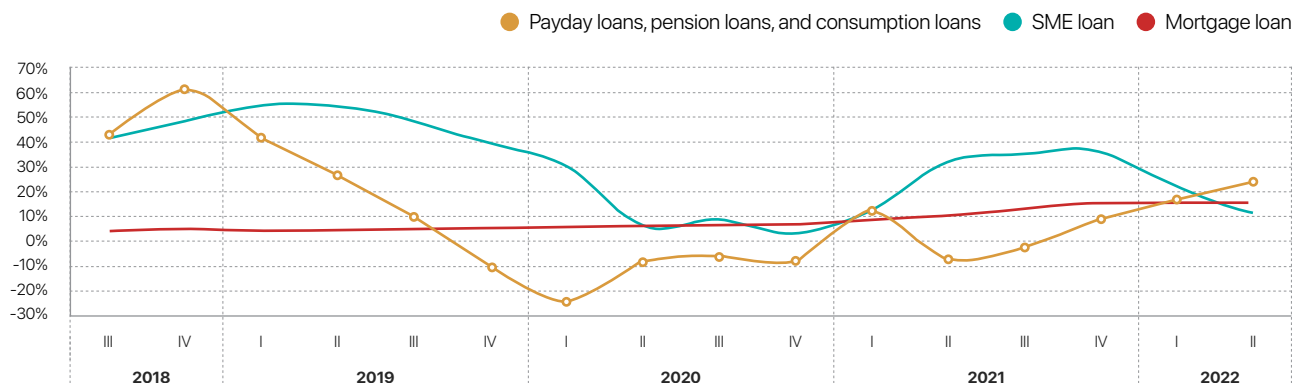
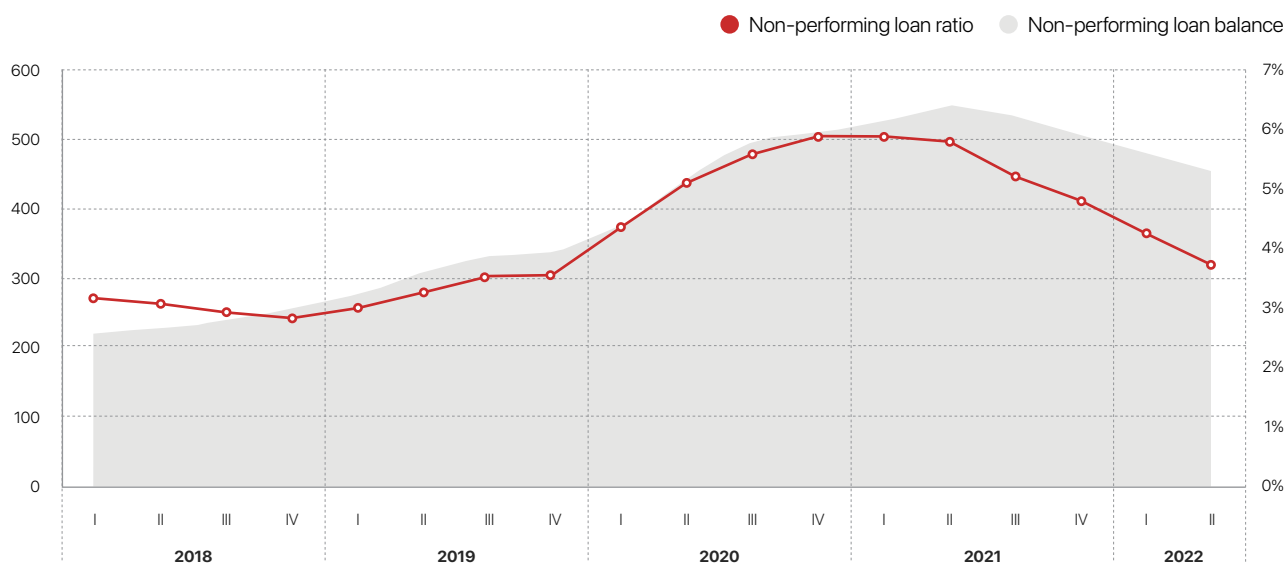


Figure 1.39

SHARE OF NON-PERFORMING LOANS IN THE TOTAL OUTSTANDING LOANS OF BANKS (MNT BILLION)



Source: Mongolbank

Risks to businesses

To reduce the Covid impact on the economy, the Government of Mongolia is implementing an MNT 10 trillion MNT program to support economic recovery. But due to high inflation, depreciation of the MNT, and instability in the global economy, production costs have increased, and companies' profitability has decreased.

As a result, the number of businesses closing is outpacing the number of new businesses being established.

	2018	2019	2020	2021	2022
Total	172,466	189,801	206,207	230,608	246,361
Temporarily ceased	73,612	83,943	100,210	114,429	114,232
Non-operating	100,750	114,279	129,878	149,075	160,005
Operating	71,716	75,522	76,329	81,533	86,356

Source: NSO

Fiscal deficit

The fiscal balance has improved with the post-pandemic recovery; however, the level of fiscal spending remains high. During the pandemic, most of the increased public spending was allocated to social care and benefits. However, in 2022, the most of it was directed towards budget investments.

Figure 1.40

MONGOLIA'S 2022 BUDGET PERFORMANCE

Revenue	10,201.5
Expense	11,345.8
-1,144.3	Balance

Source: Ministry of Finance

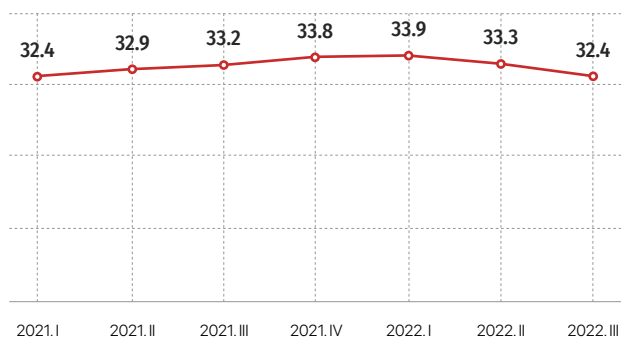
The potential for increased fiscal spending during the 2024 parliamentary elections poses a risk of a larger budget deficit. Regardless, China's easing of its Covid-zero policy, which allows for smooth customs operations at the border, has reduced the risk of interruptions in the export of mineral products and fiscal revenues.

Debt risk

Mongolia's external debt pressure remains high.

Figure 1.41

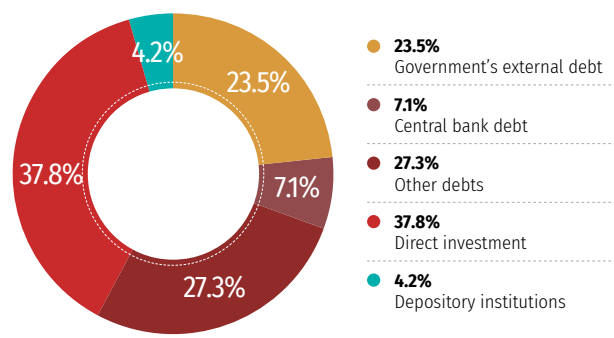
MONGOLIA'S GROSS EXTERNAL DEBT, US\$ BILLION



Source: Mongolbank

Figure 1.42

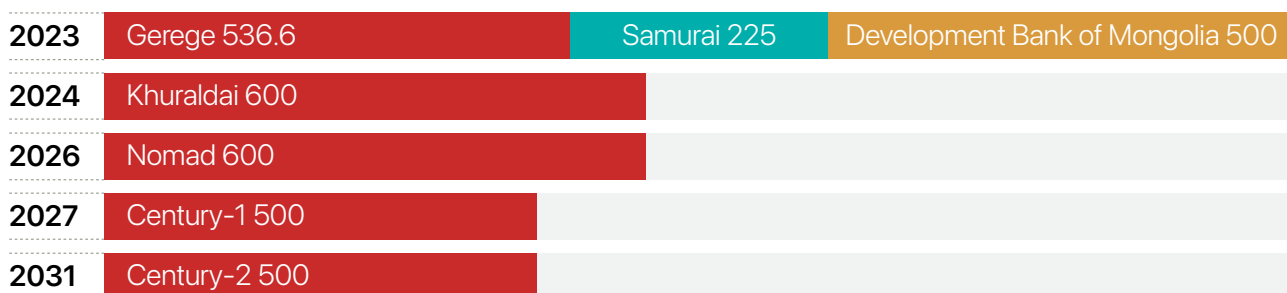
STRUCTURE OF MONGOLIA'S EXTERNAL DEBT, AS OF 3RD QUARTER OF 2022



Source: Mongolbank

Figure 1.43

MONGOLIA'S BOND PAYMENT SCHEDULE, US\$ MILLION



Source: Ministry of Finance, Development Bank of Mongolia

In December 2022, the government paid off the remainder of Chinggis bond in \$136 million transactions.

The repayment obligations of sovereign bonds with massive amounts were one of the major risks in the near term. The Financial Stability Council warned in September 2022 that financial conditions in the global environment are tightening, and there is a risk of higher funding costs for refinancing government bonds and loan payments.

Shortly after that in 2023, Mongolia successfully issued a new bond worth \$650 million with an interest rate of 8.65%. Although the interest rate is high, the bond subscription amounted to \$4 billion, showing higher demand. The Minister of Finance stated that the financing of this bond will be used for the \$1.1 billion bond repayment in 2023 and 2024, and the remaining \$450 million will be collected from the state budget. Finance Minister Javkhlan Bold concluded that Mongolia was able to avoid a default risk with the issued bond.

Fitch Ratings assigned Mongolia's US dollar bonds a 'B' rating in January 2023. The rating agency sees that one of the good signs of the macroeconomic situation is a resumption of stronger economic growth and expert trends without the emergence of imbalances, and the maintenance of a favorable business environment conducive to robust foreign direct investment inflows.

Mongolia has a large share of external debt in foreign currency and the foreign currency depreciation causes another risk. As specified by the World Bank, foreign currency debt as a share of total debts was high in Mongolia - 88 percent - as of October 2022.

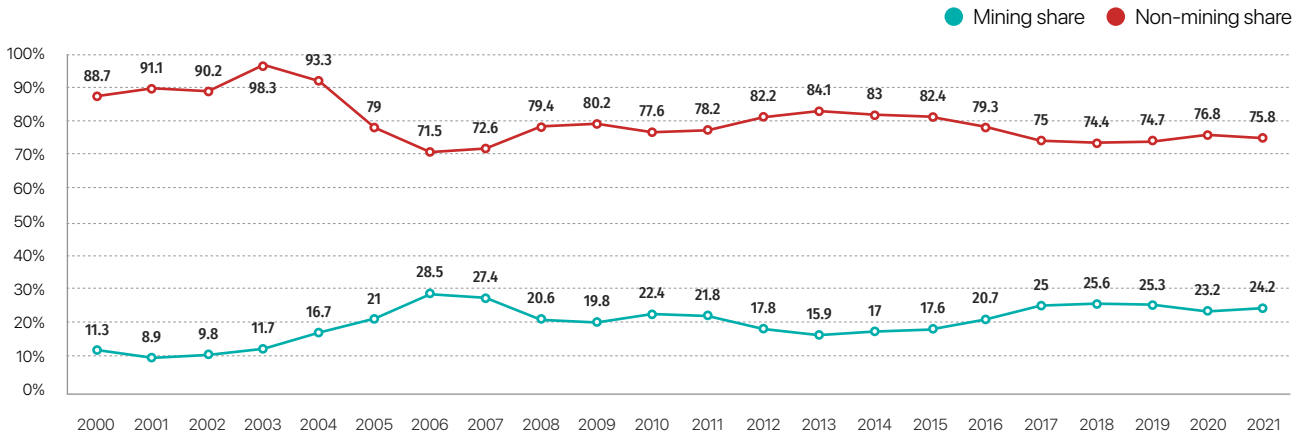
3.2

ECONOMIC VULNERABILITY

Mongolia's economy depends heavily on the export of commodities, making it vulnerable to fluctuations in the global market. Especially, after the discovery of major deposits in the early 2000s, the country has been becoming more and more reliant on its commodity sector. Today, mining accounts for nearly one-quarter of GDP, up from one-tenth in 2000.

Figure 1.44

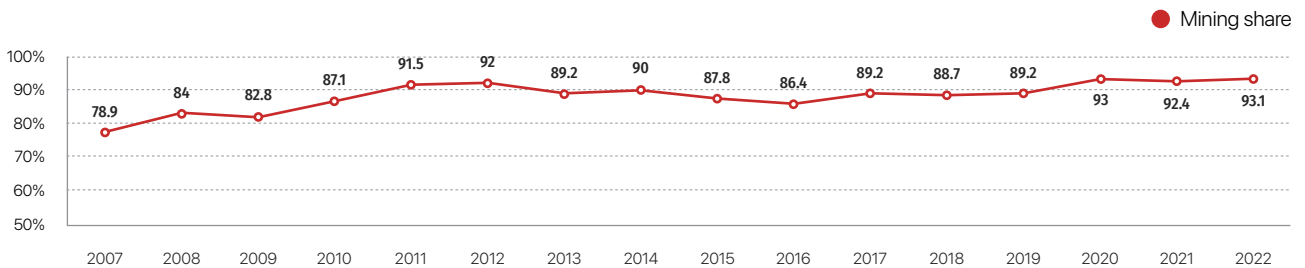
MINING INDUSTRY SHARE OF GDP IN PERCENTAGE



Source: NSO

Figure 1.45

MINING SHARE OF TOTAL EXPORT IN PERCENTAGE



Source: NSO

	Total fiscal revenue (in trillion ₮)	Mineral sector revenue in total fiscal revenue (in trillion ₮)	Percentage of the mineral sector in total fiscal revenue
2023 (forecast)	19	5	26.3%
2021	14.2	4.1	30%
2020	10.4	2.7	25.9%
2019	11.9	2.9	24.5%

Source: The Mongolian Ministry of Mining and Heavy Industry

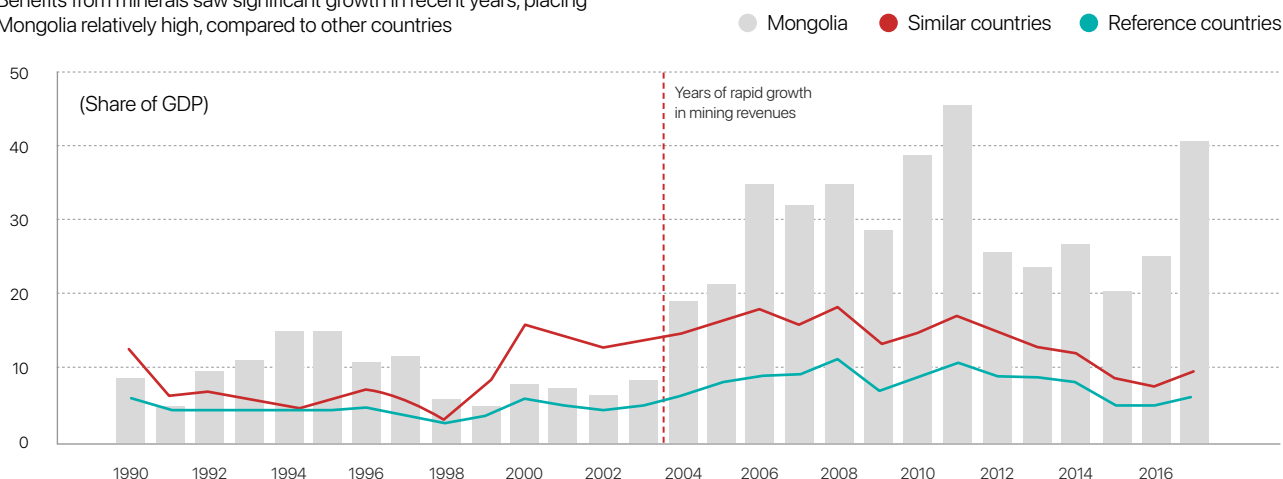
Figure 1.46

MINING INFLUENCE IN MONGOLIA'S ECONOMY



Source: The World Bank, NSO

Benefits from minerals saw significant growth in recent years, placing Mongolia relatively high, compared to other countries



Source: The World Bank

Mongolia is exporting over 14 types of minerals, with China being its largest single importer.

Fitch Solution pointed out that the main risk to Mongolia's economic outlook is the potential for any unexpected slowdown in China's economy which currently purchases more than 90% of Mongolia's largely mineral-based exports. The major positive development for Mongolia in recent months is mainland China's shift away from its Covid-zero policy.

Another highlighted issue is the inefficient allocation of assets earned from mining revenues. Mongolia has not only consumed almost all its mineral earnings but has also borrowed heavily against them, passing on negative wealth to the next generation. According to the World Bank, out of every dollar generated from mineral wealth in the last 20 years, Mongolia has consumed 99 cents and saved only 1 cent through its Stabilization and Future Heritage Funds. They concluded that the use of mineral revenue was mostly determined by political convenience, not economic merit.

3.3

POLITICAL RISK

Mongolia's political environment is peaceful and stable and power is transferred peacefully by democratic elections. The country has a relative social advantage, given the low crime rate and low social unrest.

In the eight Parliamentary Elections held peacefully since the 1992 Constitution came into effect, power has alternated between the two major parties, the Mongolian People's Party and the Democratic Party. In 2020, the Mongolian People's Party achieved a landslide victory in both the parliamentary and local elections. This ensured the continuity of foreign investment policy as well as the stability and consistency of ongoing political and economic decisions.

The average lifespan of the government in Mongolia is 1.8 years.

New cabinets usually do not make major policy changes if the ruling party remains unchanged. The current government has been reshuffled twice without a complete restructuring since its formation in 2021.

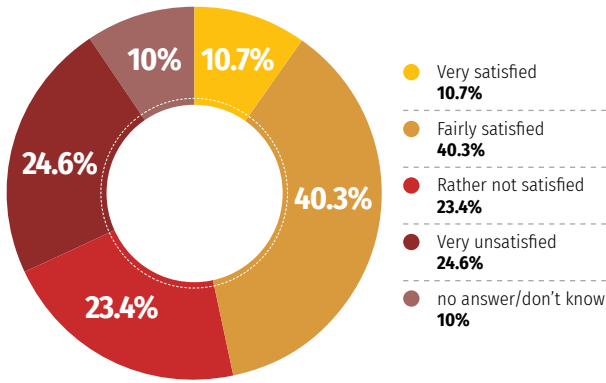
Though, Mongolia's political landscape still has its challenges, the most immediate one being that of social instability. The risks of unrest within Mongolia have been growing quickly due to surging inflation, foreign currency shortages, and an increase in awareness of corruption.

In December 2022, thousands of protesters had been demonstrating against soaring inflation and government corruption in Ulaanbaatar, the capital city of Mongolia, for more than 10 days. The protesters were triggered by allegations that surfaced a few months ago of government officials profiting from illegal sales of coal to China.

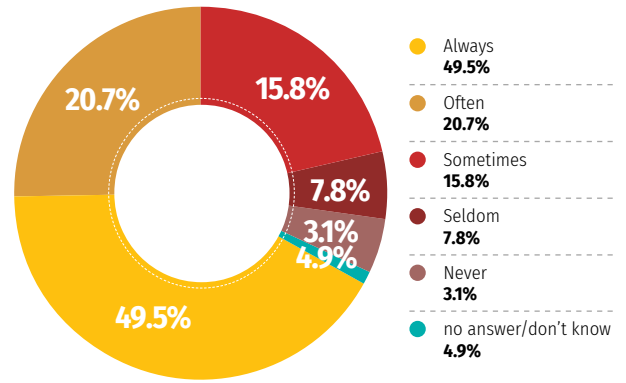
The experience in other economies suggests that especially the shortages in foreign reserves presage greater unrest, noted Fitch Solutions.

The Sant Maral Foundation, a reputable and politically impartial polling organization in Mongolia, conducted a survey of 1,200 respondents in 2022. The results showed a significant lack of trust in the government among the public.

Satisfaction with Government, nationwide



Which political party is best placed to solve today's problem?



How often do you feel that government policies fail to solve the most important problem you named?

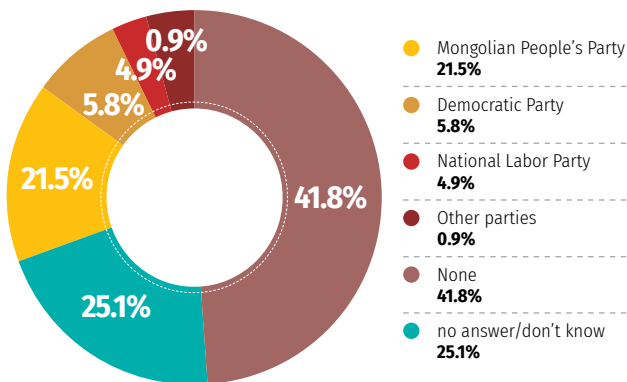
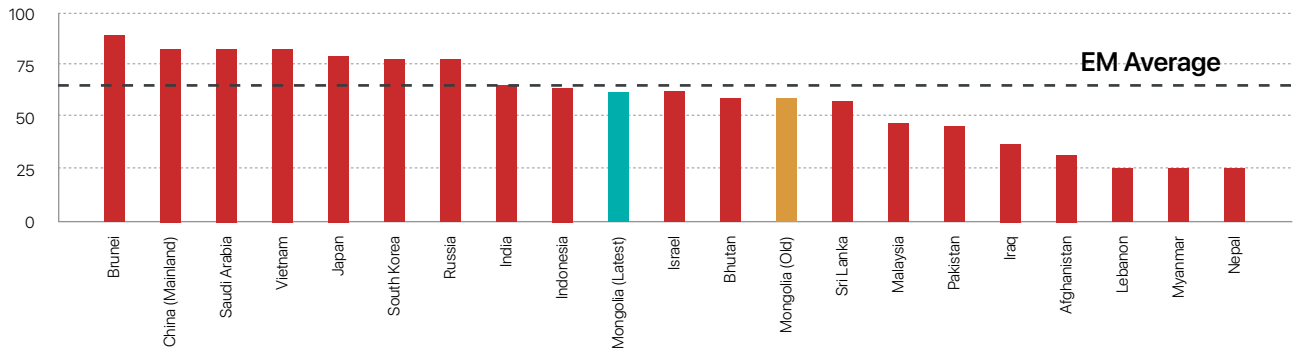


Figure 1.47

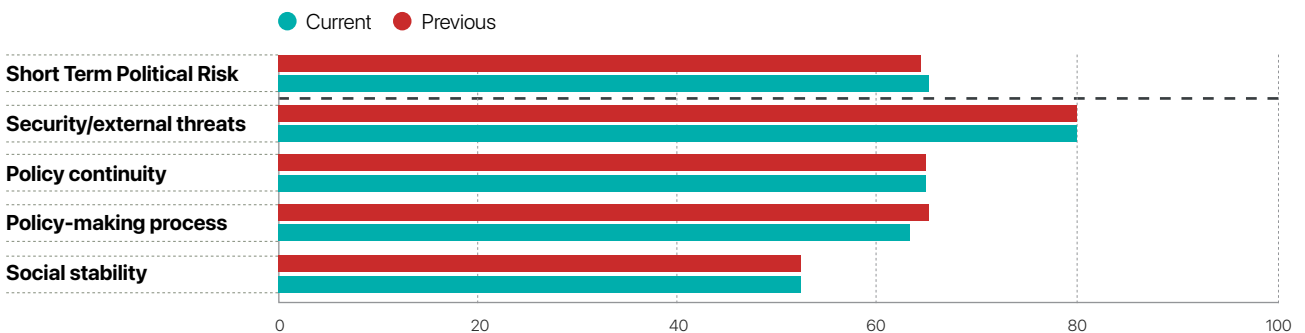
MONGOLIA – SHORT-TERM POLITICAL RISK INDEX, 2022



Note: Higher scores denote lower risk. Source: Fitch Solutions

Figure 1.48

MONGOLIA'S BOND PAYMENT SCHEDULE, US\$ MILLION



Note: Higher scores denote lower risk. Source: Fitch Solutions

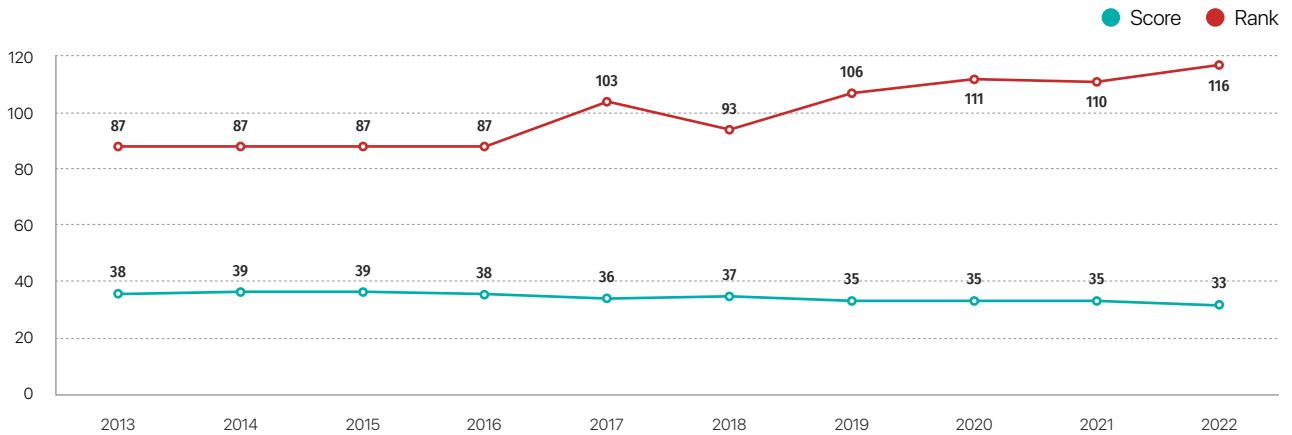
3.4

CORRUPTION AND JUDICIARY

Mongolia's position on corruption indices remains poor. Mongolia scored 33/100 and ranked 116th out of 180 countries in the 2022 Transparency International's Corruption Perception Index.

Figure 1.49

MONGOLIA'S CORRUPTION PERCEPTION INDEX



Source: Transparency International

The US Embassy in Mongolia highlighted that conflicts of interest, lack of transparency, limited access to information, an underfunded civil-service system, low salaries, and limited government control of key institutions are the factors contributing to corruption.

In Mongolia, the Independent Authority Against Corruption (IAAC) is the government agency that takes a leading role in both promoting the understanding of anti-corruption and investigating corruption cases.

The IAAC receives annual declarations of assets and income of public officials, and, in the event of significant changes, the agency inspects and monitors the legitimacy of the person's income.

The Law of Mongolian Criminal Procedure Code states that, an investigator from the IAAC shall investigate a corruption case based on a complaint, decide on whether to open an inquiry case, and immediately notify the prosecutor.

To improve the legal environment for reporting corruption cases, the government has submitted a bill on the legal status of whistleblowers to the Parliament for

discussion in 2021. The bill provides for the protection of whistleblowers who inform on illegal activities for the sake of public interest in addition to a reward system.

The Mongolian government is taking measures to improve transparency, including implementing electronic tenders for most government procurement and contracting. In the framework of e-governance development, the country is actively working to reduce the bureaucracy of the civil service through digitalization and has successfully integrated more than 800 public services.

As the independence of judges is an important factor in fighting against corruption, the Mongolian parliament revised the Law of the Judiciary to bring it into line with the amended constitution in 2021. The law limits the powers of the government, parliament, and the president to influence the selection and removal of judges and vests the Judicial Disciplinary Council with responsibility for disciplining jurists, except in matters involving criminal acts.

The 2022 Mongolia Investment Climate Statement released by the US Embassy in Mongolia noted that investors have praised these judicial reforms, saying they are helping to restore judicial independence severely.

3.5

FOREIGN POLICY CHALLENGE

Mongolia is a landlocked country, bordering only two neighbors, Russia, and China, which makes it geographically dependent on its neighbors. The country also shares similar values in democracy and human rights with the United States.

Like many small states, Mongolia's challenge is determining how to maneuver the great power competitions without compromising its sovereignty and undermining its institutions of democratic governance, according to Friedrich Ebert Stiftung Mongolia (FES Mongolia) – a Mongolian branch of the oldest non-profit political foundation in Germany.

Especially after the Ukraine war intensified, Mongolia was caught up in the geopolitical competition between Russia and the West.

Mongolia is highly dependent on Russia's oil products and electricity. In addition, Russia is the only land gateway for Mongolia to connect Eurasian and European countries and an air gateway for Mongolian passengers bound for Europe. The trans-Mongolian railway is crucial for Mongolia's trade with Europe.

After Western countries-imposed sanctions against Russia, some of Mongolia's trade routes and air routes to Europe were closed. The country's southern neighbor China, which accounts for the most of Mongolia's exports, has enacted the Zero-Covid policy, as a result of which cross-border trade was significantly delayed. These dealt a major blow to Mongolia's economy.

Under the current global circumstances, Mongolia is still facing numerous challenges to maintain its neutral status in terms of foreign policy.

Mongolia has established comprehensive strategic partnerships with China and Russia, two of the world's great powers, and signed strategic partnership agreements with Japan, India, the United States, and South Korea.

Concerning these partnerships, FES Mongolia researchers have made interesting comparisons.

In regards to the specific concerns of these major powers, Russia aims to exert its influence on issues with

geostrategic significance, such as defense, energy, and railways. China wants Mongolia to support its policies regarding Taiwan, Xinjiang, and Tibet, while also seeking Mongolia's assurance of non-alliance in military and political matters. Japan's focus is on Mongolia's economic development, particularly the implementation of IMF policies in the mid-term.

Similarly, South Korea places a priority on economic cooperation with Mongolia, while also viewing Mongolia as a crucial country for its interactions with North Korea and a means of accessing Central Asia and Russia. In contrast, the United States prioritizes Mongolia's commitment to democracy and rule of law as a basis for the partnership.

India's partnership with Mongolia highlights international cooperation as well as collaboration against terrorism while listing all possible areas of cooperation despite the challenges of geographic distance.

China and Russia jointly pressured Mongolia to join the Shanghai Cooperation Organization. As a result, Mongolia became an observer in 2005. Meanwhile, Mongolia has been sending its soldiers to the UN Peacekeeping missions. The year 2022 marks the 20th anniversary of Mongolia's participation in the United Nations peacekeeping.

The country seeks partnerships and investment from Western countries under the third neighborhood policy. The UN Secretary-General, Antonio Guterres, visited Mongolia in 2022 and applauded Mongolia as "a symbol of peace" and an increasingly important contributor to the work of the UN.

"Mongolia may be landlocked, but its constructive foreign policy of dialogue and cooperation is central to building bridges and promoting sustainable development in the region and further afield."

Antonio Guterres, the UN Secretary-General

3.6

CHALLENGES FOR MEGA PROJECTS

Megaprojects are significant priority factors in the development and expansion of Mongolia's economy. Nevertheless, Mongolia faces the same mega-project challenges that are being experienced around the globe. Since 1990, the largest and most successful project in Mongolia is the Oyu Tolgoi project. The conflict between stakeholders, the Mongolian government, and Rio Tinto led to occasional negotiations due to project cost increases over initial projections as well as the delays in the project schedule of this major underground development which holds 80% of total reserves.

Another example is an oil refinery project, which is under development with the help of US\$1.2 billion in soft loans from the Government of India, which commenced construction in 2019. The refinery was scheduled to open in 2024 according to initial estimates. Though the Covid-19 pandemic caused several disruptions and the critical negotiations to finance the oil pipeline between the refinery and oil deposits have stalled.

The Erdeneburen hydropower plant is one of the recent cases. It is planned to be built on the Khovd River in western Mongolia. The project, which has a designed installed capacity of 90 megawatts and the capacity to generate 366 million kWh a year, will supply power to five provinces. This China-financed project has faced popular opposition due to environmental concerns and local community livelihood disruption.

A similar prominent case is the Egiin Gol Power Plant, which initially began in 1991 and was funded by China's government but faced environmental opposition from Russia. After 16 years of back and forth and wasted efforts and time, it was finally stopped in 2007.

The key mega-project challenges in Mongolia can be categorized as follows:

3.7

CLIMATE RISK

The impacts of climate change are already recognizable in Mongolia. Between 1940 and 2015, the average temperature in Mongolia increased by 2.24 Celsius degrees. The temperature during peak heat was greater, and the average temperature during the coldest period slightly increased.

At the same time, the average annual precipitation decreased by 7% from 1940 to 2015. The frequency of thunderstorms and short high-intensity rainfall events is getting more common compared to long-cut rain that moistens the soil.

Political risks:

The average implementation period of a mega project is 6–8 years, including the strategic planning, construction, and operational phases. But this does not align with Mongolia's political cycle. Both Parliament and the Cabinet have a four-year term, and the Cabinet has a de facto cycle of 1.8 years. This can cause significant problems in policy succession and delays in decision-making. Politicians show no interest in advancing a megaproject during their term if it is not in their best interests.

Geopolitical risks:

Given Mongolia's location between the giant neighbors of Russia and China, megaprojects sometimes involve the interests of these two countries.

Timing risks:

The majority of megaprojects in Mongolia are related to mining extraction and export. Therefore, the ability to attract foreign investment is usually correlated with favorable commodity prices in global markets at any time.

Public support:

Most people have never set foot in Mongolia's pristine territory, where nature remains undisturbed. This becomes a factor for discussion among the locals, given the huge awareness of the negative impact of major mining and energy projects which can lead to a public backlash. To win votes from the public, populist politicians tend to diminish the reputation of megaprojects in their messaging, a factor that can be a major challenge for operating companies.

As a result of these climate changes, summer droughts are becoming more regular with an increased level of dust particles. Dry hot summers followed by cold winters increase the risk of dzud. A dzud is a peculiar weather phenomenon unique to Mongolia. It is an emergency related to extreme cold or snow. About 70% of the grassland in the country is under the influence of desertification due to climate change.

These environmental degradations, disasters, and imbalances in the ecosystem are giving rise to several serious risks and challenges for Mongolia, especially in

the areas of agriculture and food production, as well as people’s overall quality of life.

Mongolia is recognized as vulnerable to climate change impacts, ranked 64th out of 181 countries in the 2021 ND-GAIN Index, which captures a country’s vulnerability to climate change and other global challenges, and its readiness to improve resilience.

Figure 1.50

ND-GAIN COUNTRY INDEX SCORE OVER TIME

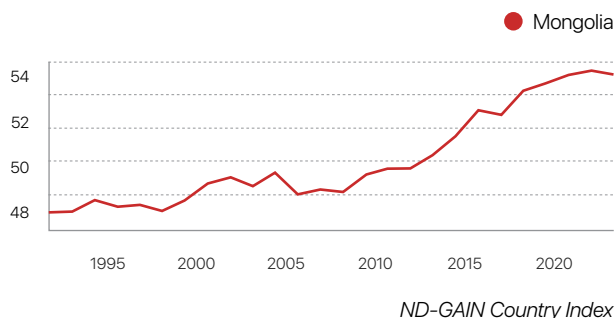
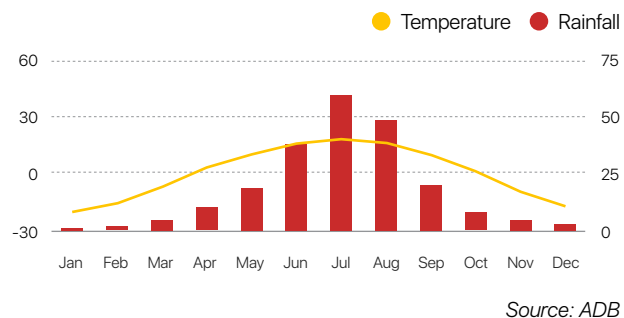


Figure 1.51

AVERAGE MONTHLY TEMPERATURE AND RAINFALL IN MONGOLIA, 1991-2020



Source: ADB

The Mongolian government is taking policy measures against these.

Mongolia ratified the Paris Climate Agreement in 2016 and released its Third National Communication to the United Nations Framework Convention on Climate Change. Furthermore, the country has adopted national and sectoral strategies and policies such as National Action Plan on Climate Change (2011-2021), the Green Development Policy (2014-2030), the Intended Nationally Determined Contributions under the Paris Agreement (2015-2030), the State Policy on Renewable Energy (2015-2030), and Mongolia’s Sustainable Development Vision 2030.

At a recent high-level meeting of the 76th session of the UN General Assembly, Khurelsukh Ukhnaa, the President of Mongolia, announced an initiative to plant one billion trees. The implementation of the national “One Billion Trees” initiative was officially started in October 2021. The President also urged other countries to allocate up to 1% of the GDP toward environmental protection.

Successful implementation of the national “One Billion Trees” initiative is expected to improve 4% of the 129 million hectares of land that is currently severely affected by desertification. 7.9% of the country’s territory is currently covered by forests and the national objective aims at increasing this indicator to 9% by 2030. Moreover, the action is expected to reduce greenhouse gas emissions by 600,000 tonnes, according to early estimates. The “One Billion Trees” national movement will be rolled out in three phases over the next decade: preparation, intensification, and maintenance.

Recent years have seen rapid urbanization, with more than 50% of the country’s population living in Ulaanbaatar. This transition in lifestyles and livelihoods has presented many challenges including unplanned settlements and air, water, and soil pollution.

A UNICEF study estimated the lost opportunity cost caused by air pollution in Mongolia’s economy over the last 5 years at US\$1.4 million. Generations of Mongolian Governments have made attempts to reduce air and environmental pollution, although they have been mostly ineffective.

A marked improvement in air quality in the city was noticed after the government implemented a ban on raw coal in Ulaanbaatar, instead encouraging the usage of refined coal briquettes in 2019.

However, the air quality indicator continued to deteriorate rapidly since 2021, remaining one of the biggest challenges for Mongolia.