A Six-Point Action Plan for Mongolia: Enabling Business to Create Employment and Growth

RECOMMENDATIONS FROM MONGOLIA'S BUSINESS COMMUNITY

Economic Policy and Competitiveness Research Center, Mongolia

Summary report

August 2012

FOREWORD

The next four years represent a challenge for Mongolia. We face a difficult external environment, and over the past few years Mongolia has have made slow progress in building the foundations for healthy and balanced economic growth. We need this growth to create jobs and wealth for the Mongolian people.

As members of the business community, we can and should help with this. We need to attract the investment required to fund this growth. To do this, however, we need the support of the Government. We have developed this report, together with the Economic Policy and Competitiveness Research Center and supported by McKinsey and Company, to describe how we can work together for the benefit of the Mongolian people. We look forward to discussing it with the incoming Government.

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A Six-Point Action Plan for Mongolia: Enabling Business to Create Employment and Growth

I. INTRODUCTION

We are at a critical point in our development. The economic environment for 2013-16 will be challenging, and the foundations of our growth are weak.

Externally, global economic growth is failing. The US economy has yet to recover, and Europe is held back by the debt crisis. China – Mongolia's key market – is in a worse slowdown than 2008, with growth falling by a third. Prices of commodities – nearly 80% of Mongolia's exports, and 20% of GDP – continue to fall, putting strains on the state budget.

Domestically, our economy is unbalanced and vulnerable. A significant part of our GDP growth in the past few years has been due to OT, TT and construction. High inflation and shortage of capital hurts business and erodes people's wealth.

Our challenge is to create employment and wealth for the Mongolian people: this requires economic growth, focused on building essential capital assets that generates new national income. Growth will not be possible without significant investment in upgrading the country's basic infrastructure, but we lack the ability to fund this on our own. We plan to spend USD 24bn of investment in infrastructure over the next five years; the annual state budget is USD 5.5bn, and Mongolia's total banking assets only USD 7.6bn.

The investment to fill this significant gap must come from competent national and international investors: yet we are putting at risk the basic conditions to remain attractive as an investment destination. Investors need strong legal protection, a stable regulatory and policy environment, prudent economic management, and leadership that resists reactionary and populist pressures. We do not yet provide this: investors increasingly view Mongolia as 'unsafe'.

With decisive, reform-minded political leadership, we can turn this situation around. We propose here a Six-Point Plan to put us on a sustainable path to growth:

1. Stabilize the economy;
2. Create policy and regulatory stability;
3. Reduce government's role in business, streamline bureaucracy;
4. Develop a prioritized and fundable infrastructure plan;
5. Stabilize and strengthen the mining sector;
6. Deliver critical major infrastructure projects.

In the Democratic Transition, Mongolia committed to three fundamental reforms: respect for human rights; open, democratic government; and an economy led by the private sector, not dominated by domestic or foreign state-owned companies. Mongolia's support for human rights and political participation is beyond question. Where Mongolia has struggled is in the third reform: developing an independent, private-sector economy. Our Six-Point Plan will advance Mongolia rapidly to this goal of developing competitive industries that create jobs *(Appendix 1)*. With Government's focused leadership, we are confident that business will create the growth and employment that Mongolia needs.

II. A SIX-POINT ACTION PLAN FOR THE INCOMING GOVERNMENT

1. Stabilize the economy

Our economic management and financial system need strengthening in four areas.

First, we need to ***exert stronger fiscal discipline, fully adhering to the Fiscal Stability Law***. Due to high government spending, Mongolia's inflation – averaging 13% over the past 5 years, and now around the third highest in the world – is unsustainably high. This damages people's wealth, and leads foreign lenders to doubt our economic stability, making loans more expensive.

To bring this down to a sustainable level – below 10% in the short-term, and in the medium-term to around half that – we need to cap the structural fiscal deficit at 2% of GDP, and cap the debt:GDP ratio at 40%.

Second, the volatility of our currency hurts domestic business, due to our heavy dependence on imports and exports. To control this, ***MongolBank needs full independence and freedom from political control***, like many other central banks around the world. The Development Bank should also have full political independence, and not become a funder of the recurrent state budget.

Third, our economy has significant and concentrated commodity price exposure, made worse by our using mineral wealth to finance current consumption. We need to reduce this exposure by ***implementation of the Human Development Fund and funding of a Stabilization Fund in line with the laws passed***. The HDF should be used to save for specific purposes only, and the stabilization fund only to manage commodity price and currency exposure.

Fourth, our banking system lacks scale and liquidity, and is heavily exposed to mining and real estate as collateral. We need to improve the banking system's access to capital, and increase competition in the sector to do this *(Appendix 2)*. We need to ***create the infrastructure to improve availability of loans***, particularly credit bureaus and asset registries. We can also improve supply of capital and competition by ***issuing at least one new banking license to reputable international banks*** through an open and transparent process.

2. Create policy and regulatory stability

Policy instability prevents us from making real progress on investment plans *(Appendix 3)*. Critical issues are constantly reopened, implementation is blocked, ministries do not collaborate with each other. Parliamentarians and even Ministers attempt to reopen agreements already passed; Parliamentarians introduce legislation to block Cabinet's initiatives. The world does not yet view us as reliable in keeping commitments, and views Mongolia as 'unsafe' for investment: this drives away capital, or raises the cost of financing. Our legal environment must protect investment and ensure it can make stable returns commensurate with the risks taken: laws on foreign investment need to be clear, stable, and fairly enforced.

In order to support investment and diversification for the economy, a ***new legal framework on tax stabilization*** is critical. This framework must apply to both foreign and domestic investors, and across all sectors without preference. Currently stability and investment agreements and certification procedures are applied only to foreign investors in the mining sector. They need to be expanded across all industrial sectors where they are needed: their approval should be through a simple, efficient, fair, transparent and non-bureaucratic process.

The recent Law of Mongolia on the Regulation of Business Entities Operating in Sectors of Strategic Importance has generated much concern among investors, as nobody knows how the law's provisions will be implemented. We urgently need to ***define processes for foreign investment review and approval that are transparent, simple and fair***. Australia is a good model to follow. It has clear and objective standards for national security review that all investors understand *(Appendix 4)*.

Free and fair competition promotes innovation and offers each customer a range of solutions. The ICT sector is a good example: government promoted healthy competition, and the private sector responded with innovation and jobs. As a result every citizen is now connected via nationwide telephone and internet network. Government over-regulation and restrictions will lead to mismanagement and loss of service quality, which will negatively impact growth.

We must ***resist the temptation to pass additional laws restricting investment***. The export tax increase under discussion in particular is dangerous. As market prices in China cannot change, all it will do is take profits away from Mongolian companies, reducing their ability to invest. We should also ***create a consultation process for new legislation and regulation***, to include business formally in the discussion,

rather than forcing companies to lobby behind closed doors. Parliament should not try to direct government's actions by legislating in response to current events.

Our regulatory framework also deters investment. Approval processes are slow; Aimag and Soum government is given too much power in land use permitting, no mechanism to appeal decisions exists, resulting in abuses. Simple approval processes require participation of multiple different ministries and agencies. We need to create a ***single point of authority for each type of approval***, *and* ***create an efficient and quick appeals process*** that allows businesses to challenge unreasonable decisions. We also should enforce ***sanctions against officials who do not perform their regulatory duties*** in accordance with the law.

Our systems of industrial standards date from the Soviet era: low quality goods and services are procured at high prices. Enforcement is intrusive and costly, and application of tax rebates for equipment import is highly unreliable. We need an ***overhaul of the standards system***, with the National Standards Office 'importing' systems of standards from abroad to cover new types of equipment, and selecting standards with higher energy-efficiency and environmental requirements.

We need a ***smarter approach to our economic relations with China***. China is our main market, and Chinese companies will invest and do business in Mongolia. We want the most capable and most reputable Chinese companies to come. At present, we are scaring many of those companies away, due to the perception of 'anti-China' political sentiment.

3. Reduce government's role in business, streamline bureaucracy

Government should not 'manage' the economy: instead focus on creating conditions that attract investment. Let the private sector decide where to invest. This is important in sectors with heavy investment needs, like mineral processing *(Appendix 5).*

State-owned companies should be run as economic entities free from political influence, with professional boards, not receiving favorable treatment, and if possible subject to market discipline by partial privatization. ***State assets – land, mineral resources and companies – should be sold or transferred at market prices*** in transparent public transactions.

Division of responsibilities between agencies must be simplified, with every decision having a single responsible agency. Ministers should have authority to negotiate agreements in their area, and submit to Parliament for a straight 'yes-or-no' vote without modifications. ***The formation of inter-ministerial working***

groups for major projects should be stopped: they are slow and ineffective. In their place, we should ***create a 'delivery unit' to improve Government's capability and efficiency***. We have a limited pool of talent in government, spread thin across multiple agencies. To support complex infrastructure deals we need to concentrate these skills in one place – a unit reporting to a part of government that has an overall coordination role, such as the PM or Finance Ministry. There are standard international processes for infrastructure projects: we need to create the capability in Government to follow these efficiently *(Appendix 6)*.

4. Develop a prioritized and fundable infrastructure plan

Our list of infrastructure projects is too ambitious, does not consider business' priorities, and often promotes projects that cannot be funded commercially or through the state budget.

From this list, the new Government needs to ***create a shortlist of priority projects that must to be delivered in the next 1-2 years***. Other projects will be developed later: this shortlist should only be those projects that pass a 'market test'; i.e. that business urgently needs, and can be commercially funded now. The priorities for this are covered in Point 6, below.

All of Government needs to align behind this shortlist, and support it beyond the life of one Government: this will therefore require cross-party agreement. We will need ***real accountability and clear responsibilities for execution***. All government ***agencies must be held publicly accountable*** for supporting their part of this plan.

5. Stabilize and strengthen the mining sector

We possess two world-class mining assets – TT and OT. TT's development is in disarray, with constant political interference in the licensing process, appropriation of contract prepayments, and repeated forced changes to ETT's IPO plans. This is hurting our credibility abroad, could affect ETT's valuation, and threatens to halt development of the asset.

To get TT back on track, ***political interference must stop***; the company must have ***professional directors and executives with relevant experience***, not political appointees; it ***must not be used as a route to raise funds*** for the state budget, or ETT will be bankrupt before the asset is developed. Overall technical and commercial plans for the resource's development must be agreed, and the West Tsankhi development strategy must be fixed and work started.

The constant calls to re-open the OT investment agreement, from Parliamentarians and Ministers, are a major threat to our credibility abroad. ***Reopening the OT agreements must be resisted***: the costs would greatly outweigh the benefits. It would raise the cost of all foreign capital or potentially make it unavailable; lower valuations for Mongolian assets (including ETT's IPO); and scare away considerable amounts of investment in the mining sector. The new ***Government needs to publicly stand by the existing agreement*** to give confidence to existing and future investors.

Beyond a handful of projects, we do not have a mining 'boom'. The 1,325 other mining projects contribute less than 20% of GDP. A sector this concentrated is a major risk: we need to open the sector to capable, reputable mid-tier firms to further responsible exploration: to do this we need to advance infrastructure development. This is discussed below.

Given Mongolia's abundant coal reserves, coal-bed methane has great potential: however existing mining laws do not define ownership/usage rights. Clarifying this will allow for development of these assets and use in power generation.

6. Deliver critical major infrastructure projects

Much-needed critical infrastructure projects have not been delivered in recent years. We will only make progress if we focus on a shortlist of projects, as discussed above. We see the following as the main priorities:

1. Power and heat generation: Without CHP-5, Mongolia will run out of power and heat in the coming year. Today, it is technically impossible to supply heat and power to the new housing projects. Further expansion of capacity will be needed after that to avoid dependence on imports from China for the South Gobi mines. On current projections, Mongolia will need an additional 744 MW capacity by 2015, and another 1370 MW by 2020. Lack of power and heat in UB constrains urban development, and increases vulnerability to disruptions during winter.

2. Power and heat transmission: Our grid is old and near obsolescence, and heating infrastructure also needs to be upgraded. New transmission capacity will be needed in the South Gobi.

Power sector asset construction should be accompanied by reform of the power market itself, to bring in private sector investment. The previous Government's commitment to allow generation assets to earn market prices that pay for the cost of building and maintaining the plants by 2016 should be honored. Any subsidies must be paid to end-users, not to the assets, else it will be impossible to

finance their construction. Rate-of-return regulation should be implemented for existing assets, including transmission and distribution *(Appendix 7)* and a power market, based on bilateral contracts, should be introduced.

3. South Gobi to China rail links: Transportation represents 50-60% of export coal's price. We currently lose around 5 US cents per km per ton of coal exported due to a lack of rail; based on current exports of 20 mtpa this is worth USD 100m per annum of potential savings. The rail links should be built to minimize the cost of getting the material to the China market, including the choice of standards for the gauge.

4. Urban roads and airport: The poor condition of UB's roads and airport increases congestion and vehicle maintenance costs, limits growth of tourism, and leaves a negative impression on potential foreign investors. The city's unique role and increasing population would justify amending existing laws on its legal status to enable greater financial independence, e.g. autonomy to collect/manage tax revenues and issue bonds, and contracting autonomy for infrastructure projects.

5. Water sector: Water policy and regulation is currently split between numerous ministries and agencies, without clear division of responsibilities. Ensuring adequate water supply requires strengthening the Water Authority's regulatory role, particularly in tariff setting and licensing.

III. SUMMARY OF RECOMMENDATIONS

The recommendations of our Six-Point Plan are summarized below. The Appendix attached describes some key examples.

1. Stabilize the economy

- Strictly implement the Fiscal Stability Law, keeping structural fiscal deficit at 2% of GDP and the debt:GDP ratio below 40%.
- Keep MongolBank and the Development Bank free from political influence.
- Implement the Human Development Fund law: do not use funds to make cash transfers to the people.
- Build financial infrastructure for the banking system (credit bureaus and asset registry).
- Allow entry of at least one reputable international bank.

2. Create policy and regulatory stability

- Define objective and transparent processes for investment review under the new Foreign Investment Law, with clear timeframes.
- Create a simple process and objective criteria for tax stabilization, with certification based on investment amount, applying to all sectors and to both domestic and international investors.
- Do not pass new laws affecting investment, including the export tax increase.
- Create an appeals process for regulatory decisions, and consultation process for new legislation/regulation.
- Modernize and simplify industry standards.

3. Reduce government's role in business, streamline bureaucracy

- Avoid trying to develop or manage industries: let the private sector do that.
- Make the SOEs commercial businesses, with proper governance, accountability to shareholders and no special treatment.
- Ensure all transactions with state assets are done on a market basis.
- Establish 'single-point accountability' for regulatory approval decisions.

- Request reports from businesses on what approval processes and regulation are not working.
- Create a ‘delivery unit’ for major projects.

4. Develop a prioritized and fundable infrastructure plan

- Develop a shortlist of urgent infrastructure projects that business needs and are commercially viable.
- Ensure that all of government aligns behind and supports this plan, and there is cross-party agreement not to change it.
- Allocate clear tasks to specific agencies, and hold them publicly accountable for execution.

5. Stabilize and strengthen the mining sector

- Give TT a professional board; cease political interference in it; create an overall development plan for the asset; and do not use TT for short-term budget funding.
- Resist pressure to reopen the OT agreements: publicly defend them.

6. Deliver critical major projects

- Prioritize CHP-5, start licensing processes for subsequent power assets.
- Upgrade the transmission network and district heating network in UB.
- Invest in transmission network to build links to South Gobi mines, and potentially power sales into China.
- Allow new powergen capacity to receive market-based wholesale pricing that pays for construction and maintenance of the assets: pay any subsidies directly to end-users.
- Implement rate-of-return regulation for old assets, including transmission.

Appendices

APPENDIX 1: MONGOLIA'S ECONOMIC DEVELOPMENT POTENTIAL

This Six-Point Plan will enable business to attract investment, develop and grow, and deliver the employment and wealth that the country needs. This section outlines how we see this happening over the next four years.

The main source of employment and growth for the next decade will be mining, sectors related to mining, and agriculture-related sectors. This is the core engine of economic development: if it functions well, it will lift the rest of the economy automatically.

Mining sector growth will stimulate growth in mining services and supply. The majority of the value Mongolian businesses could capture lies in maintenance and spares, on-site technical services, transport and logistics, fuel and food. This could be a significant source of employment, often in highly skilled technical fields *(Appendix 8)*.

Government does not need to stimulate development of this sector. Other countries that tried that, such as South Africa, found that it led to inefficiency, corruption and higher costs, without helping the sector or the people. All Government needs to do is ensure, through HSEC monitoring, that mines follow good procurement practices, involving local suppliers where they are competitive. A competitive supply base will quickly develop around this. The government and mining companies together can also help to raise awareness among local enterprises of quality standards and requirements to enable local SMEs to compete on a level playing field. Oyu Tolgoi's efforts in this area should be reviewed.

Agriculture is the traditional heart of the economy, and will continue to play an important role, accounting for nearly 20% of reported GDP and up to 35-40% of employment. Price volatility for livestock remains a challenge, as does achieving economies of scale with a nomadic population. A program of vaccinations and education for the herders on commercial planning would increase livestock productivity and open trade and export opportunities. Irrigation investments in water-rich regions could improve crop productivity to move the country closer to self-sufficiency.

At current prices, Mongolia's livestock is a significant asset – worth around $20bn in aggregate – that is not counted in the country's reported GDP. These

measures would further increase the value of Mongolia's livestock business and rural wealth, to the point where herders would no longer need subsidies from government.

Several areas in downstream processing could have both compelling economic returns and strategic value, such as oil refining using local resources, transport fuel production using coal-to-liquids, or perhaps construction aggregates. When domestic powergen needs are met, power export is also a possibility. However resources need to be focused on the highest-potential projects, since downstream processing generally makes low returns. Government should avoid promoting downstream processing projects where there is no clear private-sector demand, strategic risk is high and economics are weak.

Tourism accounts for 9% of GDP already, and has significant potential to grow. Its primary need is upgraded transport infrastructure, and liberalization of air transportation through privatizing MIAT and allowing competition on air routes to lower ticket prices. The sector would also benefit from a clear strategy around where it will focus – e.g., like Botswana, that concentrated successfully on attracting high-end tourists.

IT and telecommunications services will also grow substantially. Only half of provincial towns have high-speed internet access today. A healthy IT services and communications sector with national coverage is important to several industries. There is also considerable potential to increase the level of IT usage in Mongolian businesses to improve productivity – for instance, very few use a modern ERP system today – and in Government's operations.

APPENDIX 2: IMPROVING BANKING SECTOR COMPETITIVENESS THROUGH ENTRY OF FOREIGN BANKS

Significant academic research suggests that the impact of foreign entry on local bank competition is significant, and, in most cases, beneficial for the country, development of the banking sector, and even health of local banks. For example, in Turkey, impact of entry of foreign banks was significant for economic development in attracting external capital to finance local projects, and lowering prices for customers for banking services. Furthermore, capabilities such as financial analysis, planning and credit analysis significantly improved. In Korea, the effects of impact of foreign entry were similar and even improved the cost efficiency of Korean banks without affecting profitability *(Exhibit 1)*.

EXHIBIT 1

Entry of foreign banks in Turkey and Korea

Situation	Actions	Impact
▪ Prior to 1980, Turkey's bank dominated financial sector was uncompetitive and inefficient with a limited range of products ▪ Turkey suffered from high and volatile inflation and capital inflows causing real exchange rate appreciation ▪ Of the 42 banks in 1980, only 4 were foreign banks	▪ Turkey relaxed rules about bank entry and eliminated controls on interest rates and financial intermediation in 1980 ▪ By 1990, 19 new foreign banks entered Turkey's banking market	▪ According to a study by Bhattacharya in 1993, impact of foreign banks were: – Instrumental in attracting external capital to finance local projects – Lowered prices for banking services ▪ According to the World Bank, the impact of foreign entry includes strong evidence that foreign banks had a positive impact on financial and operations planning, credit analysis and marketing, and human capital
▪ Korea's financial sector was protected and consisted of mostly Korean banks before the 1990s ▪ Banking sector was heavily government controlled, with the government determining capital allocation	▪ From early 1990s, Korea launched a 5 year liberalization plan ▪ In 1998, the Foreign Investment Promotion Act opened up the financial sector to foreign investors ▪ Financial sector FDI increased significantly in 1999 to facilitate financial restructuring undertaken in aftermath of the 1997 financial crisis	▪ By 2000, 43 banks from 16 countries had established Korean branches ▪ Empirical evidence shows that foreign banks entry into Korean banking market helped: – Improve the cost efficiency of Korean domestic banks, while not affecting profitability – Made more foreign capital accessible to fund domestic projects ▪ Academic research also supports view that impact of foreign entry on local bank competition is felt immediately

SOURCE: "How does foreign entry affect domestic markets" by Stijn Claessens

APPENDIX 3: THE IMPORTANCE OF FAIR AND STABLE POLICIES IN ATTRACTING MINING SECTOR INVESTMENT

The way resource-rich countries manage their mineral wealth can determine the pace of their development. Countries that performed best were those that attracted investment and capabilities to develop the mining sector, and used the proceeds to diversify the economy.

Botswana is an excellent example. Despite having no infrastructure and being land-locked, good government policies led to one of the fastest growing economies, where poverty reduced to below 30 per cent of the population *(Exhibit 2)*.

EXHIBIT 2

Botswana's creation of a stable FDI environment

Situation …

- No physical infrastructure; hardly any university graduates; widespread famine until 1996
- Unique development problems such as lack of independent access to the sea, lack of a national currency, and inability to impose customs tariffs

… Actions taken …

Government policies

- Prudent long-term fiscal policy and management
- Enactment of laws and regulations to facilitate the operations of the private sector
- Provision of infrastructure, large investments in education: according to the UN Development Program, Botswana "benefited from the sale of minerals and skillfully invested this in human development"
- Historical democratic institutions:
- Transparent political system (free elections inherited from pre-colonial era)
- Strong state accountability: corruption has been kept very low
- No power concentration: the cattle-exporting group also ensured that rising diamond production did not lead to overvalued exchange rate

… Results

Significant economic success

- One of the fastest-growing economies in the world since the first discovery of diamonds in 1967
- Proportion of population living under the poverty line has declined from 59% in the 1980s to below 30%

Key success factors

- **Sustainable budget index (SBI):** all mineral revenues must be spent on investment defined as development expenditure on capital projects and recurrent spending on health and education (intangible capital)*
- **Pula fund:** a fund where financial assets are invested only on a long-term basis in a transparent and accountable manner

SOURCE: OECD; IMF; EIU; literature search; team analysis

Chile followed a similar path, pursuing polices that established fair 'rules of the game' resulting in economic diversification and poverty reduction *(Exhibit 3)*.

EXHIBIT 3

Chile's creation of a stable FDI environment

Situation …

- Early 1970s: socialist economic policy resulting in hyperinflation, food rationing, and ultimately social chaos
- 1973-89: The military dictatorship implemented liberal economic policies that resulted in sustained growth over the next 15 years
- Peaceful return to democracy in 1989

… Actions taken …

Government policies

- 1983: New mining code strengthened private rights in mining concessions, though the state-owned copper mining company retained more than half of the country's copper production
- 1990s: Deregulation and privatization of most industries and sectors (only exceptions were Codelco and the National Petroleum Company, ENAP), and major private-sector- led investments in public infrastructure
- 1990s: Large-scale investments in the mining sector
- 2000s: Focus on fiscal surplus and tight monetary policy
- Copper proceeds from Codelco used according to regulations: (i) Copper Stabilization Fund (CSF), established in 1985, is aimed primarily at stabiliz-ing fiscal revenues; (ii) Reserved Copper Law assigns 10% of Codelco's gross revenues to be transferred in equal parts to the 3 branches of the armed forces for equipment purchase

… Results

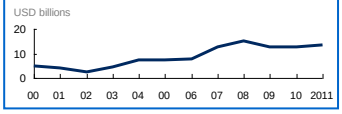
Poverty alleviation

- Chile has the best indicators of social development in developing world
- Overall, poverty reduced from 42% in 1990 to less than 18%
- Clear economic diversification

Key success factors

- Disciplined course of business-friendly reform: clear separation of regulator and operator (Codelco), low-burden corporate tax regime, effective tax-collection system
- ProChile1 actively promotes Chilean products and services abroad and promotes diversification in the country
- Other economic sectors have benefited from the presence of mining and have delivered inputs to mining and associated economic activities

Rising inward FDI



1 ProChile is the export promotion bureau responsible for implementing and enhancing Chile's trade policy

SOURCE: OECD; IMF; EIU; literature search

APPENDIX 4: ELEMENTS OF A HEALTHY FDI ENVIRONMENT, AND COMPARISON OF MONGOLIA WITH LEADING COUNTRIES

There are several common features that make up a healthy environment for foreign investment.

Features that attract FDI can be grouped into economic liberalization factors (e.g., removing barriers on ownership, local content requirements, etc.); sound business environment factors (e.g., political and macro-economy stability, favorable industrial and trade policies, good infrastructure, skilled and educated workforce, etc.); and investment promotion factors (e.g., reduced regulatory burden, investment incentives, etc.). Countries that have attracted significant FDI successfully typically work hard to maintain this environment.

Singapore, for example, has performed very well in attracting FDI, despite being small in geography and population, and having almost no natural physical advantages. Through rigorous strategic planning, prioritizing FDI, creating a business-friendly environment and empowering efficient government agencies to attract funds, and programs to recruit talent, Singapore created FDI-driven growth that lasted several decades *(Exhibit 4*).

EXHIBIT 4

Singapore's attraction of FDI

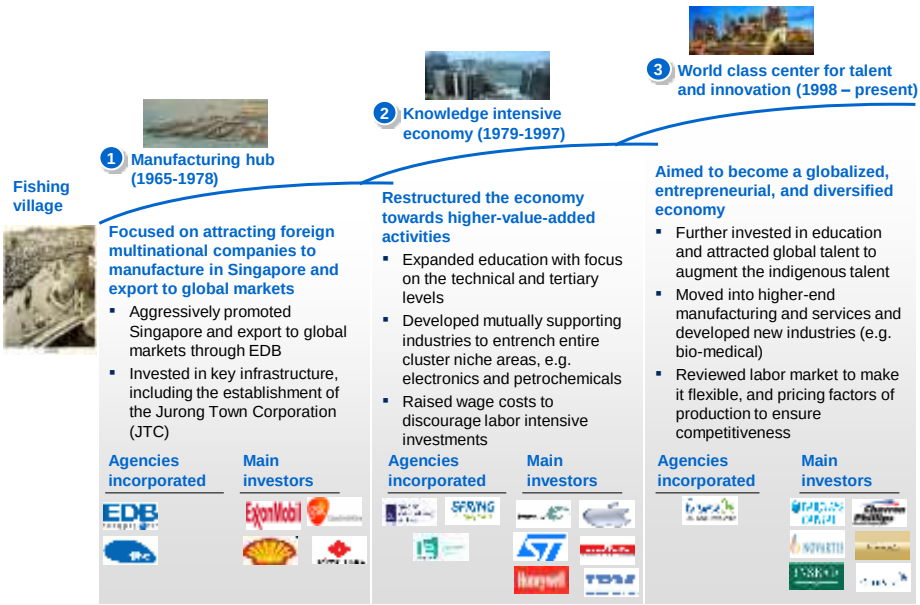
Rigorous policy planning	▪ Long-term analysis and planning for direction of economic policy carried out by MTI; economic reviews led to reorientation (e.g., focus on PC and disk drives in the 1980s post-oil crisis) ▪ Dedicated planning unit in the EDB with approximately 10 employees in Strategic Planning and Knowledge and 60 in Planning and Policy ▪ EDB annual reviews help to bring together market intelligence and trends, identify focus sectors and areas, and reallocate resources accordingly
Prioritization of FDI	▪ Strategic clarity that FDI matters for growth as Singapore's lack of natural resources and small insular position constrains endogenous wealth creation ▪ EDB makes things happen to attract FDI, e.g., setting up of university courses, infrastructure investment ▪ Strong support by leadership to attract investors – Lee Kuan Yew used to gather CEOs of potential investors to reassure about doubts and assert commitment
Creation of a business-friendly environment, incl. low taxation	▪ Singapore typically tops the World Bank's ease of doing business rankings ▪ Eliminating unnecessary red tape is constant government concern. For example, businesses can submit suggestions online to Pro Enterprise Panel to cut red tape (e.g., outdated regulations) ▪ Effort to create a probusiness environment: EnterpriseOne Portal, which centralizes all relevant information, e-services, walk-in centers of government agencies
Government agencies as efficient one-stop shops	▪ Public services mainly provided through government agencies (e.g., EDB ~500 employees, IE ~370 employees vs. 200 employees in the MTI), which are operated similarly to private entities ▪ Government agencies (EDB, Spring, IE) set up as one-stop shops where all customer needs can be addressed (capital, capability building, advisory services, market intelligence) ▪ Customer services center for initial point of contact
Culture of excellence	▪ Talent recruitment – high-performing students and graduates attracted to public sector ▪ Talent retention – incentives through performance-based pay (15%-50% performance-dependent bonus) and fast promotions ▪ Talent development – emphasis on functional and managerial training; early on-the-job responsibilities include client relationships

SOURCE: Literature search; industry interviews

Over time, the role of Singapore's agencies evolved with the changing needs of Singapore's development *(Exhibit 5).*

EXHIBIT 5

Singapore's changing priorities for FDI during its development



SOURCE: "Toward a Better future"; The World Bank

Australia is a good example for how to design a foreign investment approval process, particularly for mining investments. Although notifying the Australian Government is necessary for many types of FDI activity, the response of the Government is relatively predictable, as it is based upon clearly articulated and well-known criteria; it is fast (30 days, 90 days if complicated, with notification periods of 10 days in both cases); and because the rules are clear, applications are rarely rejected, as investors have clear guidance as to which deals will and will not be approved (there has been only 1 business refusal in 10 years). Potential investors feel comfortable providing information requested by the Australian Government because of its track record in keeping information confidential. Through the consistent application of rules and the provision of efficient and transparent responses to notifications,, Australia managed to create a justified perception that government approval for the overwhelming majority of FDI into Australia is a 'non-issue'.

In comparison with these countries, Mongolia has much to do to improve its foreign investment conditions *(Exhibit 6)*. In particular, the recent Foreign Investment Law is viewed negatively by foreign investors as it increases uncertainty around the review and approval process: unlike Australia, the exact procedures are not clearly specified. This has caused many mining companies significant problems in raising funding, as investors cannot be sure whether investments will require or receive regulatory approval, and therefore view Mongolia as an increasingly 'unsafe' destination for investment.

EXHIBIT 6

Cross country comparison of Mongolia's FDI climate

Poor | Medium | Good

Example elements for success for FDI	Mongolia	Singapore	Australia	Ireland
Stable policies	New FDI law Potential export tax	Very stable	New mining profit tax (2012)	Very stable
Reliable legal system	Untrusted No enforcement of arbitration	Very strong	Very strong	Reliable but slow on tender processes
IP protection	Rank 58/60 (IMD)	Rank 7/60 (IMD)	Rank 10/60 (IMD)	Rank 15/60 (IMD)
Country marketing	Poor, hardly existing	Singapore economic development board	Austrade program	IDA Ireland
No discrimination for foreign investors	New FDI law 3rd neighbor policy	Air transport Media	Agency review Rare refusal	EU limitation for air market
Fast validation process for FDI	90 days (more if Hural approval needed)	No approval needed	30 days (90 if complicated)	No screening process
Political stability	Rank 57/60 (IMD)	Rank 11/60 (IMD report)	Rank 18/60 (IMD)	Rank 12/60 (IMD)
Low corruption	Rank 53/60 (IMD)	Rank 2/60 (IMD)	Rank 6/60 (IMD)	Rank 20/60 (IMD)
Low red tape	Rank 56/60 (IMD)	Rank 1/60 (IMD)	Rank 18/60 (IMD)	Rank 11/60 (IMD)
Low corporate tax	Max: 25% Rank 28/60	Max: 17% Rank 8/60	Max: 30% Rank 45/60	Max: 12.5% Rank 4/60

SOURCE: IMD; World Bank; Austrade; Ireland Development Agency; Singapore Economic Development Board; Mongolia Strategic Investment Law

APPENDIX 5: THE RISKS OF INVESTING IN DOWNSTREAM INDUSTRIES

Governments of many resource-rich countries have, in the past, pursued a strategy of developing downstream processing industries to create employment. In most cases, this has been a mistake: these industries require very significant investment, and are extremely competitive: the end-result can be significant costs to the country when these industries fail. In Malaysia, for example, the government tried to build a steel processing industry, but failed due to poor economics and execution. The government ended up bailing out significant losses from this failed political venture *(Exhibit 7).*

In Mongolia's case, any downstream mineral processing that we build will compete with Chinese plants, which in many sectors are extremely cost-competitive. We have very a limited budget, and must be extremely careful in evaluating investments of this kind. Government should subject plans like this to a stringent 'market test' – the private sector must be willing to finance and build them without Government policy support. If that condition does not exist, the projects will almost certainly fail.

EXHIBIT 7

Malaysia's failure to create downstream mineral processing

Situation …

Perwaja Steel

- Perwaja Steel was a heavy industrial project conceived of Prime Minister Dr. Mahatir, who wanted Malaysia to move into downstream industry production
- In 1982, a $465 million joint-venture between a state owned enterprise and Nippon Steel Corp was entered into to develop a billet-making plant and a direct-reduction facility to smelt ore into hot briquetted iron
- Nippon Steel only held 30% of the project and likely did not incur heavy initial upfront investment (likely received equity in exchange for expertise in development)

… what happened …

1980's – Foreign Partner Exit / Plant Closed

- Project faltered early on due to not being able to compete commercially with other countries
- In 1987, the direct-reduction plant, which never functioned properly, was closed and Nippon gave up its 30% stake in the project and the government took entire ownership of project

1990's – Posed Huge Risk to Entire Country

- Audit report in December 1995 declared that Perwaja was insolvent
- Malaysia had to honor Perwaja's huge debt obligations in 1996 because a default on one loan could have triggered cross-default clauses in loan agreements with other creditors, exposing Malaysia to a potential banking crisis

Failed Privatization

- Privatization in 2003 didn't turn out well due to a soft economy and the company's inability to raise the necessary funding
- Perwaja was losing up to USD 10 million monthly due to only utilizing 35% of total capacity for local demand

… situation today

"Perwaja looked like no more than a shining example of a politically conceived, commercially questionable and poorly executed enterprise. Despite lavish funding, a robust economy much of the time and protection from competing imports in the form of both tariffs and quotas, the company was never able to produce steel profitably"

– Barry Wain, American author researching Perwaja Steel

SOURCE: Press search

APPENDIX 6: DEVELOPING A GOVERNMENT DELIVERY UNIT

Lack of human capability and capacity is a common problem in many governments. In developing countries, where experienced staff that are can deal with the international community are few, it can be a major obstacle to development – critical projects fail to raise funding, important infrastructure projects fail to be delivered on time, and bureaucracy drives away foreign partners. In the past few decades many countries – including Singapore, Malaysia, and even developed countries like the United Kingdom – have addressed this situation by establishing a 'delivery unit' in government. In the UK, this unit reports directly to the Prime Minister, and was used to quickly advance high-impact projects, drawing top talent from the private and public sector *(Exhibit 8)*.

EXHIBIT 8
The UK's Delivery Unit

UK Delivery Unit

- Established in 2001 under Tony Blair's administration - initially attached to Cabinet Office but transferred to Treasury
- Led by Professor Michael Barber who initially focused on education as key focus area
- Delivery Unit in the UK intimately involved in setting strategic direction and reviewing focus areas of specific high-impact projects, building recommendations based on comprehensive multi-year programs involving data analysis
- Model was considered a success and replicated in Ireland and Malaysia in later years

Key success factors of UK's delivery unit

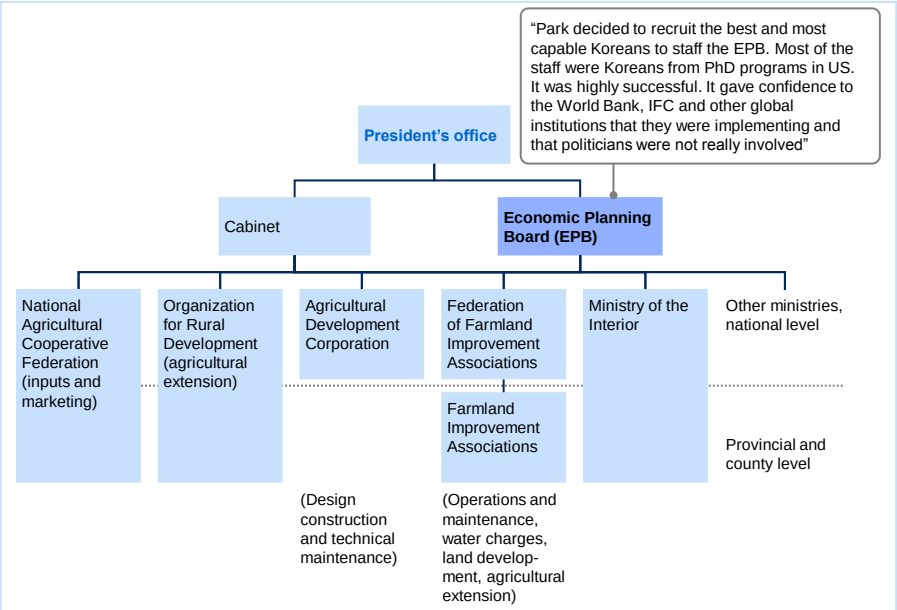
High Performing Team	▪ High-caliber team hired from both the private sector (investment banking, strategy consulting) and select top performing public sector employees ▪ Compensation packages designed to ensure competitive pay and ability to retain best talent in UK, and to bring private sector efficiency to public sector
Selective Project Focus	▪ Program was designed so that delivery for very selective, high impact targets were measured ▪ Active measures taken to ensure that Unit focused only on narrow, measurable, high impact projects
Intensive focus on targets	▪ Michael Barber was affectionately known as 'Mr Targets' due to his intense focus on effective target setting ▪ Detailed targets with implementable action plan co-created with Ministries/agencies prior to program start
Monthly Reporting	▪ Stringent monthly reporting to Prime Minister on progress against targets implemented to ensure 'pressure' on delivery Ministries/agencies to make progress – Minister would present findings ▪ 'Red/Amber/Green' system used to show status

SOURCE: Press search

South Korea, in early stages of its economic development, established a Economic Planning Board that reported directly to the Prime Minister and effectively was the "key advisor" to the President on critical projects. President Park, who established the EPB, recruited the best and most capable Koreans with international experience to develop the economic development plan, infrastructure plan, and facilitate funding with the World Bank and IFC *(Exhibit 9)*.

EXHIBIT 9

Korea's Economic Planning Board



SOURCE: Economic development institute of World bank

Lack of capability in out government is slowing down our most critical projects, as shown with TT, CHP-5 and delays in raising funds for other critical infrastructure. Creation of a delivery unit would help remedy this.

APPENDIX 7: POWER MARKET REFORM

Many other countries with rapid power demand growth have successfully implemented competitive power markets. Despite starting from regulated power environments, countries such as El Salvador, Bolivia, Panama, and Nicaragua have successfully adopted competitive generation markets - where there is decentralization, prices are unregulated, and generation companies operate under bilateral supply contracts with distributors and end-users. Implementing similar reforms in Mongolia would make it considerably easier to fund new power generation investments. As El Salvador's experience shows, the benefits can be significant for both customers and the government *(Exhibit 10)*.

EXHIBIT 10

El Salvador's creation of a competitive power sector

El Salvador's power sector problems

- Prior to 1997, El Salvador's power sector was controlled by the Comisión Hidroeléctrica del Río Lempa (CEL), an autonomous, vertically integrated national service, which controlled generation, transmission and distribution services
  - Ministry of Economy determined end-user tariffs by decrees
  - CEL awarded rights for exploitation of natural resources, owned transmission and distribution grids
- Due to lack of competition, El Salvador was unable to make the necessary investments in capacity and power infrastructure needed to support future economic growth

Post mid-1990s power sector transformation

Reforms taken

- From 1996-2000, power sector was reformed to create a competitive market structure, attract necessary investment and improve the sector.
  - In 1998, government passed the General Electricity Law starting competition with several horizontally integrated generation and distribution companies that had free access to transmission and distribution networks.
  - Reform the power sector began with a single buyer buying electricity from independent power producers (IPPs)
  - Through a series of reforms, followed the Chilean model, of deregulating where competition is feasible and concentrating regulation on monopoly aspects
  - Market reform followed a cost based spot market where generators are dispatched based on their marginal production costs – so the marginal cost of the last unit called to meet demand determines the market clearing price
- Power reform staff consisted of qualified top-level staff with proven commitment to reform and track record meeting extremely tight deadlines
- Government spent significant time and resources in constituency building to reduce public resistance
- Strong high level political support provided to push forward privatization

Results of reforms to power sector

- Restructuring of power sector has led to increase in generation capacity, overall better pricing, lower losses, higher, collections, and greater access
- Private participation is high with 18 of 22 generation plants and 5 distribution companies owned by the private sector, and
- El Salvador is often cited as a 'success' story by World Bank and academics in power sector reform; further reforms continues to further improve sector

SOURCE: World Bank; Press search

APPENDIX 8: DEVELOPING THE MINING SERVICES SECTOR: CHILE AND AUSTRALIA'S EXPERIENCE

The development of Mongolia's mining sector can and should develop a strong domestic services and supply industry. This greatly increases the overall economic benefit to the country of mining. Countries like Chile, Ghana and Australia that have successfully built large domestic supply and services sectors, creating much-needed jobs and diversifying the economy. In Chile, for example, nearly 90% of engineering services are provided by local Chilean companies *(Exhibit 11)*.

EXHIBIT 11

Chile's development of a mining services sector

Situation in 70's …

- Mining made up 89% of Chilean exports
- A low and highly volatile growth rate - average growth rate was 4.9% in the 1960s, 2.5% in the 1970s, and 3.6% during the 1980s
- The country suffered two major recessions (1975 and 1982-83) with output contractions of up to 15%
- Only 10% of engineering services came from Chilean providers

… policy moves from 80-90s…

- Fiscal prudence and a stable macroeconomic policy framework
- Nurturing of clusters through partnership between government and companies
- Establishment of Fundacíon Chile to transfer management and technological skills for use in natural resource sectors, through undertaking R&D, adapting foreign technology and aids in the diffusion of technology
- Policy which supported participation of local engineering competence in big projects to gain experience from international mining companies
- Local content requirement with collaboration with foreign companies to ensure commercial viability
- Established a uniform tariff rate of 10% on all imports, with the exception of a few agricultural products

… impact

- In the period 1986-1998 Chile had growth rates averaging 7.3%, similar to those of the Asian tigers
- The proportion of engineering services from Chilean providers had increased to 90%
- Only 41% of exports were mining products
- Growth of other export industries, notably wine and fruit production and development, and salmon farming, where Chile is now the world's second largest exporter

SOURCE: Press search

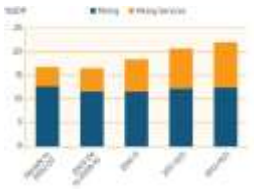
In Australia, for every A$1 of mining revenue, nearly A$0.40 is spent on mining goods and services. Australia's mining services has naturally evolved in the private sector without explicit government mandated policies.

With its highly-educated population, Mongolia is in a good position to develop both the 'higher end' technical and professional services, as well as the maintenance and operations-focused services such as transportation, maintenance and repair, inventory management, and camp and catering services *(Exhibit 12)*.

EXHIBIT 12

Opportunities for Mongolia to develop mining services

Mining services is a significant portion of total mining revenues



- In Australia, for every $1 of mining revenue, 40¢ is spent on goods and services
- Mining service industry growth has been customer-driven and public policy has not played an important role
- While the construction side of mining services declines when mining investment peaks, mining output will rise and boost mining service firms involved in contract mining and maintenance

Opportunities around developing mining related sectors are significant, particularly in mining services for Mongolia

- Mongolia has an opportunity to have world-class geophysicists, geologists, and mineral economists, combined with cutting edge technology and the highest safety, and environmental standards
- Existence of market leading/large firms working with large mining projects enable skills and knowledge transfer (and access to innovation and R&D capacity) and adequate source of finance for the development of technical services
- In order to meet the demand of large mining projects to secure its supply chain, warehousing and inventory as well as maintenance and repair services businesses would need to be developed
- Shortage of specialized skills, access to capital, scale capacity issues need to be solved and necessary infrastructure need to be developed in order to support overall mining related sector development

SOURCE: International Mining for Development Center