# FOREIGN DIRECT INVESTMENT IN MONGOLIA

# THE CASE STUDY OF THE MINING SECTOR

By

Banzragch Khulan

**THESIS**

Submitted to

KDI School of Public Policy and Management

in partial fulfillment of the requirements

for the degree of

MASTER OF PUBLIC POLICY

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## ABSTRACT

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The role of FDI has become more and more important today, especially for developing countries. Passed a decade since economic entities in Mongolia are operating under market conditions. Attraction of foreign investment into Mongolia's economy has now become the key factor to propel Mongolia's development.

The swift growth of the private sector in the last decade, combined with more foreign investment in communications and mining, make the Mongolian economy and business environment look promising. Comparing to other countries, it is a young industry, growing in the last few years. There are only a few plants, compared with worldwide ones.

Today the mining sector is Mongolia's single largest industry. My paper will not only seek to diagnose the state of Mongolian mining sector and identify problems, constraints and bottlenecks to new investment, growth and increased contribution of

mining to the national economy, but also try to formulate options and alternatives that may be considered by the government to improve efficiency, competitiveness, sector management, and the investment climate.

**TABLE OF CONTENTS**

## *I. Background*

### *Country profile*

Mongolia is located in northeast Asia between Russia and China. The country has a total area of 1,565,600 $km^2$, almost three times the size of France. The country shares a 4,673 km long border with China on its eastern, western and southern sides and a 3,485 km long border with Russia to the north. The population of Mongolia is about 2.4 million people, giving it one of the lowest population densities of any country in the world. Approximately 700,000 people live in Ulaanbaatar, the capital and largest city. Other major cities include Darkhan, an industrial center near the Russian border in the north, and Erdenet, a copper mining center, also in the north. Some 40% of the population live in the countryside, primarily subsisting as nomadic livestock herders, while the rest live in the cities or small settlements spread throughout the country.

The latitude of Mongolia, between 42 and 52 degrees north, is roughly the same as that of Central Europe or the northern United States and southern Canada. However, because the country is far from the ocean and has a relatively high median altitude, the climate is characterized by an extreme continental climate with large temperature fluctuations and low total rainfall. Total annual rainfall in Ulaanbaatar averages 220 mm (~10 inches). Most precipitation falls during the short summer, while winter is generally dry and extremely cold. High temperatures in summer average about 25 C (77 F), while winter low temperatures average -25 C (-13 F).

While Mongolia's extreme climatic conditions limit crop agriculture, the country is well suited for livestock production. Nomadic herding of livestock, primarily sheep, goats, horses, cattle, yaks and camels, is the foundation of the Mongolian economy, and forms the basis of the nation's cultural traditions. Approximately 65% of national territory is covered by extensive grasslands, while the Gobi desert dominates the south of the country. Forests and mountains cover approximately 12% of the total land area, for the most part in the nation's northernmost regions.

The most glorious period of Mongolian history began in 1206 when Chingghis Khan united the Mongol tribes and embarked on a series of military conquests from northeast Asia to the Middle East and Europe. Throughout the 13th century the heirs of Genghis Khan expanded the Mongol Empire to the point where it became the largest empire in human history, stretching from Vietnam to Central Europe. By the mid 14th century, however, internal power struggles caused the empire to splinter, and by the late 17th century the Manchu Qing Empire of northern China had subjugated all of what are today known as Outer and Inner Mongolia.

Following the collapse of the Qing Empire and subsequently the Russian Revolution, the Russian Red Army assisted Mongolia in expelling Chinese forces from Mongolian territory. In 1921 Mongolia secured its independence from China and became the world's second communist country. For the next 68 years Mongolia remained closely aligned with the Soviet Union, and developed political and economic systems following Soviet models. However, with the coming of glasnost in the Soviet Union and the beginning of Soviet troop withdrawals from Mongolia in 1989, protests for greater democracy began in Ulaanbaatar. As in many East European countries, these protests led to the fall of the Communist government and fully democratic, multi-party elections were held in 1990.

A new Constitution guaranteeing human rights and private ownership of property was adopted in January 1992. More than 10 political parties took part in democratic elections held in 1992 and 1996 for the 76 seat National Ikh Khural, or Mongolian Parliament. In 1992, the Mongolian People's Revolutionary Party (MPRP) won 60% of the popular vote and 70 of 76 seats in parliament. In 1996, the Democratic Union won 50 of 76 seats in the Ikh Khural, while the MPRP and its allies took the remaining 26 seats.

Although having succeeded in halting rampant inflation and making great progress in privatizing Mongolia's state owned assets, disagreements among the many political parties in the Democratic Union's fragile coalition led to political stagnation in parliament, and ultimately to the dissolution of the multi-party coalition. During regularly scheduled parliamentary elections held in July of 2000, the MPRP was returned to power in parliament. In an election that were deemed free and fair by international election observers, the MPRP won a landslide victory, taking 72 of 76 of seats in parliament. However, in elections held in 2004 the Parliament is consisting of four different party members and none of them has dominating sits.

In addition to parliamentary elections, Mongolian voters also directly elect the president to a 4-year term of office.

Mongolia began its transition to a market-based economy in 1991. It is sparsely populated with 2.4 million inhabitants, and GDP per capita was US$450 in 2002 (Table I.1). Infrastructure, including transportation and communications, is underdeveloped. Mongolia's main economic activities are mining, agriculture, and services. Clothing, especially cashmere products, and foodstuffs are also important. Copper, gold, and cashmere account for some three quarters of exports. Agriculture, especially nomadic herding of goats for cashmere, has suffered from droughts and

harsh winters (dzuds). Mongolia is ranked 117th overall on the UN Human Development Index. Some one-third of the population live in poverty.

Table I.1

Main social and economic indicators, 2002

| | | | |
|---|---|---|---|
| Land area | 3.8 million $km^2$ | Urban share of population | 56.7% |
| Population | 2.5 million | Nominal GDP (current market prices) | Tog 1,240.8 billion |
| - Density | 1.5 persons per $km^2$ | | |
| Annual population growth | 1.3% | GDP per capita | US$450 |
| UN human development index | | GDP per capita average growth rate (1999-02) | 1.3% |
| - Overall ranking | 117th | Nominal GDP at current prices (1995 shares in brackets): | |
| - Category | Medium human development | - Primary | 33% (50%) |
| | | - agriculture, hunting and forestry | 20% (38%) |
| - Ranking within category | 62nd | - mining and quarrying | 13% (12%) |
| | | - Manufacturing | 6% (12%) |
| UN human poverty index in | | - Services | 61% (38%) |
| developing countries | 38th | - wholesale and retail trade | 27% (17%) |
| - Ranking | | - transport, storage and communications | 14% (6%) |
| Life expectancy at birth | 65.5 years | Enrolment ratio in education (2000) | |
| Infant mortality rate per '000 | 61.0 | - pre-school | 28.7% |
| Adult literacy | 98.5% | - primary | 98.8% |
| | | - secondary | 61.1% |

*Source: World Bank, World Development Indicators; United Nations Development Programme, Human Development Report 2004; and the Mongolian authorities.*

## *II. Economic overview*

### *Historical context*

Up to 1990 the Mongolian economy was based on the centrally planned model adopted more than six decades earlier. Nearly all production and distribution activities were concentrated in large-scale state-controlled monopolies. Reflecting Mongolia's landlocked location and political orientation, more than 90% of both exports and imports took place with other centrally planned economies, principally the members of COMECON. The Soviet Union was the source of almost 100% of industrial inputs (with the exception of raw materials) and consumer goods and was the destination of the vast majority of exports. External technical and financial assistance reached the equivalent of 30% of GDP annually during the 1980s.

Sweeping economic changes were initiated in 1990, when a peaceful revolution ended communist rule. It embarked on an ambitious programme of reforms to establish a market-oriented economy, reduce the role of the state, promote the private sector through changes in the legal and institutional framework, and expend and diversify external relations, which included membership of international financial organizations.

Early actions included the elimination of restrictions on private ownership of livestock, adjustments in 'farmgate' and selected retail prices, customs and income tax reform, the creation of a two-tier banking system, and exchange rate depreciation.

The difficulties were compounded by cessation of external financial assistance, decline of export in prices for copper and cashmere and the decision of CMEA members to value trade and effect settlements in convertible currencies as of 1991. While Mongolia was not unique in suffering from the end of Soviet financing, the impact on the country was devastating in the light of its low per capita income, the short life expectancy of 63 years and widespread social exclusion. In response to these developments, Mongolia's economy weakened from mid-1990 and continued to deteriorate in the first half of 1991, despite the structural reforms that were implemented. As a consequence, unemployment rose sharply. Budget revenues declined and expenditure rose; credit and monetary expansion accelerated; and inflation, which had previously been almost non-existent, picked up sharply. Between 1990 and 1993, industrial output declined by over 22% and incomes remained over 10% below their 1989 levels.

The period from 1993 to 1996 saw some recovery in the economy, particularly in the services, livestock and mining sectors. In 1996 and 1997, the privatization program coupled with reforms in the public sector as well as increase in world copper prices and a fall in the price of petroleum contributed to an improvement in economic growth, which reached 2.4 % and 3.3% respectively. From 1996 to 1997 the inflation fell sharply from 45% to 20%. The exchange rate was stabilized through a package of measures including raising the interest rate on Central Bank bills. Strong export prices and high export volumes resulted in a small surplus in the external current account. Tax reforms were implemented to reduce excessive tax burdens and to eliminate distortions in the system, including the elimination of most import duties, simplification and reduction of corporate and personnel income taxes, widening of the sales tax base, and a rationalization of excise tax.

During 1998-1999, falling world commodity prices for cashmere, gold, and copper on international market, resulted in a terms of trade shock of approximately 9% of GDP and in a collapse of income and fiscal revenues to the Mongolian government.

Table II.1

Mongolia: Selected Economic Indicators, 1997-2001
Nominal GDP (2001): US$ 1,028 million; Population (2001): 2,425 million;
GDP per capita (2001): US$425

| | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| | | | | | (Percentage change unless otherwise stated) |
| GDP per capita (US$, current) | 444.7 | 405.0 | 372.8 | 406.4 | 424.6 |
| Real GDP | 4.0 | 3.5 | 3.2 | 1.1 | 1.1 |
| Agriculture | 4.8 | 6.4 | 4.2 | -16.8 | -17.9 |
| Industry | -4.7 | 4.2 | 1.1 | 2.4 | 11.8 |
| Services | 3.3 | 0.3 | 3.5 | 17.0 | 5.0 |
| Construction | -2.7 | -1.1 | 1.6 | -14.6 | 13.0 |
| Trade, supply | 17.1 | -3.1 | 1.3 | 25.7 | 8.0 |
| Consumer prices (period average) | 36.6 | 9.4 | 7.5 | 11.6 | 8.0 |
| Consumer prices (end period) | 20.5 | 6.0 | 10.0 | 8.1 | 8.0 |
| | | | | | (In % of GDP) |
| General government revenue | 25.5 | 27.6 | 27.2 | 33.6 | - |
| General government expenditure | 34.5 | 41.9 | 39.4 | 40.5 | - |
| Current balance | 1.6 | -0.7 | -0.2 | 3.1 | 5.6 |
| Overall balance | -8.6 | -14.3 | -12.2 | -6.8 | -4.5 |
| | | | | | (Percentage change unless otherwise stated) |
| Net foreign assets | 63.8 | -31.6 | 96.9 | 33.6 | - |
| Net domestic assets | -6.3 | 56.5 | -23.6 | -17.9 | - |
| Domestic credit | -5.1 | 60.1 | -11.1 | -8 | - |
| Credit to enterprises | 13.2 | 18.5 | -39.7 | 29.5 | - |
| Broad money M2 | 19.8 | 8.8 | 31.7 | 18.1 | 27.9 |
| Reserve money | 26.2 | 13.5 | 51.8 | 19.4 | 8.2 |
| Broad money velocity (GDP/BM) | 4.9 | 5.2 | 4.2 | 4.0 | 3.4 |
| Annual interest rate on CB bills (%) | 40.9 | 22.5 | 11.4 | 8.6 | 8.6 |
| | | | | | (Million US$ unless otherwise stated) |
| Total revenue and grants | 222.5 | 239.9 | 266.5 | 351.1 | 439.3 |
| (In % of GDP) | 29.3 | 27.4 | 27.2 | 33.6 | 38.9 |
| Current revenue (In % of GDP) | 24.7 | 26.5 | 26.8 | 33.1 | 38.0 |
| Total expenditure and net lending | 287.6 | 342.1 | 364.7 | 429.7 | 489.7 |
| (In % of GDP) | 34.5 | 41.9 | 39.4 | 41.1 | 43.3 |
| Current expenditure (In % of GDP) | 23.1 | 27.2 | 27.1 | 30.1 | 32.4 |
| Current account balance, excl. official transfers | 14 | -129 | -124 | -167 | - |
| (In % of GDP) | 1.3 | -13.2 | -13.7 | -17.2 | - |
| Trade balance | 30 | -120 | -112.9 | -140.2 | -150.4 |
| (In % of GDP) | 3.2 | -11.7 | -12.5 | -15.1 | -13.3 |
| Exports, fob | 569 | 462 | 454.2 | 535.8 | 459.9 |
| (% change) | 34.3 | -18.7 | -1.8 | 18.0 | -14.2 |
| Imports, cif | 538 | 582 | 567.1 | 676.0 | 610.3 |
| (% change) | 5.4 | 8.2 | -2.6 | 19.2 | -9.7 |
| Gross official international reserves | 138 | 123 | 105.4 | 140.7 | 160.1 |
| (In weeks of imports) | 13.3 | 11.0 | 9.7 | 10.8 | 13.6 |
| | | | | | (Millions US$ unless otherwise stated) |
| Foreign financing | 65.1 | 102.1 | 98.2 | 78.6 | 50.4 |
| (In % of GDP) | 7.8 | 12.5 | 10.6 | 7.5 | 4.5 |
| Domestic financing | -27.7 | 33.9 | 4.9 | 11.9 | -22.1 |
| (In % of GDP) | -3.3 | 4.2 | 0.5 | 1.1 | -2.0 |
| Capital and Financial Accounting | 53 | 116 | 69.5 | 89.8 | 121.3 |
| Medium and long-term capital | 104.3 | 124.1 | 124.2 | 136.4 | 135.2 |
| Short-term capital | -77.3 | 4.5 | -54.7 | -46.6 | -13.9 |
| Short-term interest rate (%) | - | 34.2 | 36.5 | 25.8 | 22.2 |
| Direct investment | 605 | 755 | 847 | 786.8 | 848.3 |
| Exchange rate MNT per US$ (end of period) | 813 | 915 | 1072 | 1097 | 1102 |
| Exchange rate MNT per US$ r (period average) | 795 | 854 | 1023 | 1078 | 1098 |

| | | | | | |
|---|---|---|---|---|---|
| Unemployment (%) | 6.7 | 5.6 | 4.7 | 4.6 | 4.7 |

*Source: Ministry of Finance and Economy, NSO and IMF staff estimates*

Bank loan portfolios deteriorated deepening the insolvency of the major commercial banks and non-performing loan portfolios reached 41% as real lending rates approached 40%. Attributable to the re-imposition of a 5% import duty and on the depreciation of the Mongolian national currency in the face of the large external shocks (falling copper prices and increase in fuel prices, 90% of which is imported from Russia) inflation declined to 9.5%. Exports to the US increased by 57.5% in 1999 to US$46.3% million, making the US the third leading market for Mongolian products, behind China and Russia. This is attributable to two factors, the lack of quotas for textiles for the US and a redirection of copper exports from Russia to China. The year 1999 saw an overall stabilization in economic conditions and provided a solid basis for the Mongolian government to move ahead with reforms.

Notably for mineral investors, on July 1, 1997 the Mongolia Parliament adopted the new Minerals Law of Mongolia, to ensure that investments in the country's mining sector would be internationally competitive. The Minerals Law provides for fully transparent processing of exploration and mining license applications and guarantees secure tenure and transfer rights for license holders. The adoption of the new Minerals Law and growing international recognition of Mongolia's favorable geological setting, have resulted in an influx of both large and small international mining companies pursuing mineral exploration and mining opportunities in Mongolia.

Mining Industry constitutes over 8.6 percent of GDP and 56.0 percent of exports, demonstrating that mining has become an influential part of the country’s economy. The National Statistics Office reported that in 2002, the mining sector yielded Togrog 341,571.3 million products accounting for 50.4% of the total industrial output.

***Recent economic trends***

While volatile, real GDP has grown in each year since 1993, and averaged 3.3% during 1994-03. After stagnating at around 1% in 2000 and 2001, growth recovered in 2002 to 4% and to 5.6% in 2003 (Table I.2). As a result, GDP per capita, after falling significantly in the early 1990s, exceeded 1993 levels by almost two thirds in 2002, although still well below pre-transition levels. Growth largely reflected a turnaround in agriculture and a continued buoyant services sector. Agricultural output again expanded (for the first time since 1999) with improved weather conditions.

Labor productivity remains low, however. Non-agricultural growth remained relatively strong, averaging 10% annually during 2000-02. Services grew substantially, accounting in 2003 for 61.0% of GDP (48.5% in 1999) and about half of employment. Export growth was helped by higher mineral prices. Inflation, reduced to 1.6% in 2002, increased to 4.7% in 2003, when unemployment also rose from 3.4% to 3.5%.[1] The informal sector, including gold mining and transportation services, is estimated to account for as much as one third of GDP.

Table II.2
Selected macroeconomic indicators, 1999-03

| | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| **National accounts** | | | *(Per cent)* | | |
| Real GDP growth (constant 1995 prices) | 3.2 | 1.1 | 1.0 | 4.0 | 5.6 |
| Nominal GDP growth (current prices) | 13.2 | 10.1 | 9.5 | 11.2 | 17.8 |
| Private consumption | 14.2 | 15.5 | 14.3 | 14.8 | 7.0 |
| Government consumption | 7.2 | 15.9 | 18.7 | 8.8 | 7.1 |
| Gross fixed capital formation | 17.9 | -0.5 | 9.2 | 2.7 | 38.1 |
| Net exports of goods and non-factor services | -16.8 | -32.0 | 24.3 | 25.2 | 7.8 |
| Unemployment rate (%) | 4.7 | 4.6 | 4.6 | 3.4 | 3.5 |
| **Productivity** | | | *(Percentage change)* | | |
| Total labor productivity | 0.5 | 1.7 | -1.7 | .. | .. |
| Total capital productivity (1990 = 100) | 2.6 | 0.4 | -0.7 | .. | .. |
| **Prices and interest rates** | | | *(Per cent)* | | |
| Inflation (CPI, percentage annual change) | 10.0 | 8.1 | 8.0 | 1.6 | 4.7 |
| Bank loan interest rate | 37.7 | 30.3 | 31.8 | 26.6 | 25.6 |
| Bank deposit interest rate | 19.8 | 13.8 | 13.2 | 14.0 | 14.0 |
| Central Bank Bills (weighted average rate) | 11.4 | 8.6 | 8.6 | 9.9 | 11.5 |
| **Money and credit (end period)** | | | *(Percentage change)* | | |
| Broad money supply (M2)[b] | 31.7 | 17.5 | 27.9 | 42.0 | 49.6 |
| Credit to private sector (end period) | -39.7 | 29.5 | 141.9 | 72.4 | 54.4 |
| **Exchange rate** | | | | | |
| Togrogs per US$ (period average) | 1,072.4 | 1,097.0 | 1,102.0 | 1,125.0 | 1,168.0 |
| Nominal effective exchange rate | -12.2 | 22.4 | -2.5 | -14.1 | -15.0 |
| Real effective exchange rate | -6.2 | 13.9 | 26.8 | -5.8 | -10.5 |
| **Fiscal policy** | | | *(Per cent of GDP unless otherwise indicated)* | | |
| Current fiscal balance | -0.3 | 3.2 | 5.7 | 4.4 | 8.1 |
| Current revenue | 26.8 | 34.0 | 38.5 | 37.9 | 40.0 |
| Tax revenue | 19.7 | 25.6 | 29.4 | 28.9 | 30.9 |

[1] This official unemployment figure is expected to be a gross underestimate, and 17% is suggested as a more realistic level based on international measurement standards (Asian Development Bank, 2003a).

| | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| Current expenditure | 27.1 | 30.8 | 32.9 | 33.5 | 31.9 |
| Total revenue (including grants) | 27.5 | 34.4 | 39.4 | 38.4 | 40.7 |
| Total expenditure | 39.4 | 42.2 | 43.9 | 44.4 | 45.2 |
| Overall balance | -11.9 | -7.7 | -4.5 | -6.0 | -4.5 |
| Total public debt | 100.1 | 97.1 | 93.6 | 91.9 | 92.9 |
| Domestic | 8.7 | 8.7 | 4.8 | 3.1 | 0.3 |
| **Saving and investment** | | | | | |
| Gross national saving | 14.2 | 9.8 | 8.5 | 9.5 | .. |
| Gross domestic investment | 37.0 | 36.2 | 35.8 | 29.0 | .. |
| Saving-investment gap | -22.8 | -26.4 | -27.3 | -19.5 | .. |
| **External sector** | | | | | |
| Current account balance (excluding official transfers) | -13.9 | -18.1 | -16.7 | -16.0 | -14.6 |
| Net merchandise trade | -13.1 | -15.1 | -16.8 | -20.5 | -15.7 |
| Exports | 52.6 | 57.7 | 51.7 | 46.9 | 49.2 |
| Imports | 65.7 | 72.8 | 68.5 | 67.4 | 64.9 |
| Services balance | -1.6 | -1.9 | -2.2 | -0.8 | -3.9 |
| Capital and financial account | 7.9 | 9.7 | 11.6 | 14.1 | 0.4 |
| Direct investment | 3.5 | 5.8 | 6.2 | 7.0 | 10.3 |
| Balance of payments | 4.7 | 0.1 | 1.5 | 6.0 | -7.6 |
| Terms of trade (percentage change) | -4.8 | 10.8 | -9.5 | -6.9 | 2.1 |
| Merchandise exports (percentage change) | -1.8 | 18.0 | -2.4 | 0.1 | 19.7 |
| Merchandise imports (percentage change) | -2.6 | 19.2 | 2.5 | 8.6 | 9.8 |
| Service exports (percentage change) | -8.9 | 9.2 | 46.5 | 62.6 | 12.7 |
| Service imports (percentage change) | -4.8 | 11.6 | 42.7 | 42.9 | 32.6 |
| Gross official reserves (US$ million) | 155.9 | 190.9 | 206.7 | 268.2 | 203.4 |
| (in weeks of imports of goods) | 14.3 | 14.7 | 15.6 | 18.6 | 12.8 |
| Total external debt (US$ million; end period, % of GDP in brackets)[c] | 828.0 (91.4) | 837.0 (86.3) | 902.0 (88.8) | 985.0 (88.9) | 1,109.0 (92.6) |
| Debt service ratio[d] | 5.7 | 3.8 | 5.3 | 4.5 | 4.8 |

.. Not available.

a Estimates.

b M1 (currency) + quasi money (togrog denominated time deposits and foreign currency deposits).

c Excludes Russian debt and quasi-fiscal operations by the Bank of Mongolia. Russian debt was resolved in December 2003 with 98% written off subject to a cash settlement paid by Mongolia of US$250 million.

d Debt service in per cent of exports of goods and services.

*Source:* Bank of Mongolia, *Annual Report 2003,* and information provided by the Mongolian authorities.

With gross domestic investment significantly exceeding gross national saving, the current account balance is in substantial deficit. It peaked at 18.1% of GDP in 2000

(excluding official transfers) before falling to 14.6% in 2003. This largely reflected a negative trade balance, equivalent to 15.7% of GDP in 2003 (20.5% in 2002), and a relatively small services deficit (3.9% of GDP in 2003). These deficits have been met by capital inflows, particularly overseas aid, official loans from bilateral and multilateral donors, and more recently rising foreign direct investment. International reserves accumulated continuously from 1999 to reach US$268.2 million in 2002, but fell to US$203.4 million in 2003 (12.8 weeks of merchandise imports). While external public debt remained high, at US$1.1 billion, or 92.6% of GDP, in 2003, the debt service ratio of 4.8% was relatively low due to the high proportion of concessional debt. Government policy is to restrict debt servicing to below 10% of GDP.[2] Mongolia retired all external arrears in 2002, and resolved the treatment of pre-1991 Soviet Union debt in December 2003.[3]

Improved macro-stabilization and ongoing structural reforms have contributed to the economy's recovery. These policy reforms featured strongly in the Government's 2000-04 Action Programme, and were reinforced in its Economic Growth Support and Poverty Reduction Strategy (EGSPRS), adopted in July 2003. Fiscal and public sector accountability, planning, and management were improved in 2003, with implementation of the 2002 Public Sector Management and Financial Law (PSMFL), and adoption of a Medium-Term Budget Framework as well as a single treasury account to centralize government cash balances. The General Budget Law was amended in 2003 to strengthen fiscal governance by preventing government recourse to non-transparent quasi-fiscal operations that had added substantially to public debt. The authorities have continued to improve monetary management. Legislative changes in 2003 prohibited the Bank of Mongolia (BOM) from undertaking quasi-fiscal activities, such as borrowing funds overseas or providing loan guarantees, and an independent Supervisory Board has been established to oversee its operations, including ensuring that accounting, auditing, and reporting requirements meet international standards. The Government has generally resisted protectionist pressures and adopted, by and large, open trade and investment regimes.

[2] Government of Mongolia (2003)

[3] The 11.4 billion transferable rouble debt was set at US$11.4 billion (as per Paris Club practice). The Russian Federation agreed to write off 98% of the debt on payment of the balance (US$250 million). This was paid in 2004, partly by Government borrowings from the BOM, including US$100 million in foreign exchange.

One of the most important decision of the Government in promoting business sector in 2003 was the reduction of corporate income tax from 40 to 30 percent, which related to the economic entities who has yearly income more than 100 million togrogs.

In the end of 2003, as a result of long-term effective discussions and agreements between the Governments of Russia and Mongolia, Russian Government declared that Mongolia has paid all its debts must be pay to Russian Federation. This was a big contribution of the Government of Mongolia to economic and social development of the country.

## *III. Business and Investment*

### *General information*

According to the Foreign Investment Law of Mongolia, "Foreign Investment" means every kind of tangible and intangible property, which is invested into Mongolia by a foreign investor for the purpose of establishing a business entity with foreign investment or for the purpose of jointly operating with an existing business entity.

According to UNCTAD survey global FDI inflows declined in 2002, falling by a fifth to $651 billion – the lowest level since 1998. This is largely due to slow economic growth in most parts of the world, dim prospects for recovery, falling stock market valuations, lower corporate profitability, a slowdown in the pace of corporate restructuring in some industries and the winding down of privatization.

As for Mongolia, foreign direct investment (FDI) increased continuously from US$93.0 million in 1999 to US$204.3 million in 2003 (based on registration details), an average annual rise of 28%. FDI inflows as a percentage of GDP increased from 9.5% to 17.3%. Cumulative FDI inflows (1990-03) stood at US$1.0 billion, of which US$0.6 billion occurred after 2000. Some two thirds of total investment is foreign. FDI is found mainly in mining, including exploration and petroleum (33.4%), trade and foodstuffs (13.0%), light industry (8.3%), and processing of animal-originated raw materials (5.0%). FDI has come mainly from China (33.2%), followed by Canada (13.2%), Korea (8.1%), and Japan (6.0%). Foreign companies provide substantial employment (creating over 67,000 new jobs) and underpin Mongolia's export base. They account for almost all of its mining exports (100% of copper, molybdenum, and oil, and 73% of fluorspar) and substantial exports of wool.

Mongolia was ranked 69th in UNCTAD's Inward FDI Potential Index for the period 1999-01, and 48th on its Inward FDI Performance Index, suggesting that it was a "front runner" economy with high FDI potential and performance.[4]

***Incorporation procedures***

Foreign investors have the following options of establishing business in Mongolia: a wholly foreign owned business entity or a local branch or subsidiary of a foreign enterprise; a new business entity jointly established by foreign and/or Mongolian investment; investing directly in shares or other securities of a business entity operating within the territory of Mongolia.

The first stage of establishing a company in Mongolia is to register a company name. All names of registered companies are recorded on a database at the State Registration Agency. Company names can be confirmed in a matter of minutes.

Following the registration of the company name, the foreign investor should apply to the Foreign Investment and Foreign Trade Agency (FIFTA) for a 'Certificate of Foreign-Invested Company'. According to Foreign Investment Law the company that has at least 25% of foreign interest is classified as foreign-invested company.

On receipt of the Foreign-Invested Company Certificate, the investor should apply to the State Registration Agency for the State Registration Certificate. The foreign investor in order to complete the application, he must transfer into the country the minimum MNT10 million in capital in the form of cash and equipment. The cash must be deposited into a temporary account in a Mongolian commercial bank. If the capital contribution is in the form of equipment, it must be brought into Mongolia at least as far as the Customs checkpoint at the border. Possession of a State Registration Certificate allows the holder to convert the temporary bank account into a permanent bank account.

Once the company has been incorporated, the State Registration Certificate, the Certificate of Foreign Invested Company and the company stamp are issued. The company's bank account is then made permanent.

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[4] The Inward FDI Potential Index is calculated as an unweighted average of the scores assigned to eight quantifiable economic and social factors (i.e. real GDP growth, GDP per capita, total exports, telephone lines, energy use, education, and R&D expenditure) thought to affect an economy's attractiveness to foreign investors. The Inward FDI Performance Index is the ratio of a country's share in global FDI flows to its share in global GDP and, therefore, ranks countries according to the FDI received relative to their economic size. (UNCTAD, 2004).

*Registering Business in Aimags /provinces.* All foreign companies must register with FIFTA and the State Registration Agency in Ulaanbaatar; regardless of where in Mongolia they will be based. After initial registration, companies that are located in provinces must deposit copies of the 'Certificate of Foreign-Invested Company' with the Aimag Governor's Office of Business Registry.

*Specialized Licensing.* Several types of business activities require special approval. This approval generally takes the form of a license or an official recommendation and is a typical prerequisite for registration with FIFTA and the State Registration Department. Government resolution No. 260 lists manufacturing and service activities requiring a license or special permission.

***Corporate taxation.*** The main law governing corporate taxation is the Economic Entity and Organization Income Tax (EEOITL), which was most recently amended in November, 2001. All domestic corporations and resident foreign corporations are taxed on their net worldwide income from all sources. Non-resident and temporary resident corporations are taxed on their new Mongolian source income.

Taxable entities comprise of all domestic companies, co-operations, partnerships, foreign companies and joint ventures of all forms of ownership, permanent establishments which generate income in Mongolia and commercial banks, credit or insurance agencies, non-governmental organizations, religious organizations as well as legal bodies which generate income.

*Progressive Rate of Taxation*

| **Taxable Income (in MNT)** | **Rate** |
|---|---|
| 0-100,000,000 | 15% |
| Over 100,000,000 | MNT15,000,000 + 40% on amount over MNT100,000,000 |

Generally, all ordinary and necessary expenses paid or incurred on any trade or business operations are deductible regardless of whether or not they are allocable to taxable income. For corporations, deductible expenses include direct expenses verified by documents.

| **Asset Group** | **Useful life (years)** |
|---|---|
| 1. Building, construction, premises | 40 |
| 2. Equipment and machinery | 10 |

| | |
|---|---|
| of which: | |
| Scientific tools and equipment, | |
| Export and mining equipment, | |
| Environmental tools and equipment, | |
| Special tools and equipment of infrastructure sector, | |
| and computers | 5 |
| Other assets | 10 |

*Income Tax Preferences.* A business entity with foreign investment in the following areas are granted income tax preferences starting on the date on which production activities commence:

- Mining and processing of mineral resources, oil and coal, metallurgy, chemical production, machinery, electronics - 5 years of tax exemption and 50% tax relief in the subsequent 5 year period;

***Transport.*** Because of vast distances and poor roads, the domestic and international air transportation system of Mongolia is relatively well developed. Mongolia currently has four international air carriers providing airline services, including MIAT, Air China, Korean Airlines and Aeroflot. The national airline, MIAT, provides domestic services to approximately 20 locations, and flies internationally to Russia, Japan, China, Singapore, Korea, and Germany. MIAT flies an Airbus 310, Boeing 737 and two Boeing 727 planes internationally and has smaller aircraft for domestic use. The airline is well placed to take advantage of the growth in tourist and business travel that is expected as the country develops. To facilitate this growth, the Ulaanbaatar airport was recently renovated with a loan from the Asian Development Bank and Mongolia has signed international air agreements to develop air links with several additional countries. Furthermore, a feasibility study of constructing the second international airport that meets ICAO standards has started.

The ground transportation system of Mongolia is not well developed, although the central region of the country is relatively well served by both rail and roads. Mongolia has 11,063 kilometers of improved roads, although only 1,303 kilometers are paved, which shows the pure development of the road sector in Mongolia. The Millennium Road project that will play important role in making connections with the Euro-Asian

infrastructure network and the Trans-Asian Road network, as well as for gaining access to the ocean has been formally agreed to. Diesel and trolley buses companies as well as several taxi companies serve the major cities. Trucks or cars are used to exchange cargo between the countryside and Ulaanbaatar or other towns along the rail system.

The main railway line in Mongolia passes through Ulaanbaatar and connects the Chinese rail system in the south with the Russian Trans-Siberian line in the north, a distance of some 1400 kilometers. Rail carries the bulk of Mongolian cargo tonnage, due to spur rail lines that connect to the major coalmines and the Erdenet copper mine. The rail system is run by a Mongolian-Russian joint venture. Within the guidelines for development of the railway transportation until 2011, reconstruction of rail systems started under a Japanese grant.

Several rail freight forwarding companies such as Mongoltrans, Tuushin, and International Freight Forwarding Center are operating in Mongolia. These firms maintain links with foreign firms to coordinate the delivery of cargo to and from the border. The representative office of the Maersk Sealand a world leader in global container transportation was opened in 2001. This allowed a shipment to and from Ulaanbaatar without middlemen in China, ensuring the safety of the cargo from origin to destination and dealing with the customs formalities.

***Banks.*** The Banking Lawand Law on Central Bank adopted by the Parliament in 1996 served as a basic legal instrument for the establishment of a two-tier banking system in Mongolia. According to the Law on Central Bank, the Central Bank of Mongolia has the authority to implement the monetary policy.

As a result of establishment of two-tier banking system, the commercial activities of the Central Bank have been relegated to commercial banks. Currently, there are 17 commercial banks operating in Mongolia. Most of these banks are of a mixed ownership, and are authorized to conduct transactions with foreign banks.

A commercial bank must have a minimum capital of 1 billion togrog (approximately 1 million USD). Trade and Development Bank of Mongolia has a leading position in Mongolian financial and banking market in terms of all indices such as contribution to the economy, liquidity, total capital, service quality and operations scope. The Bank has been acting as an agent for implementing loan facilities rendered by the World Bank and German Government to the Government of Mongolia and has been providing accounting and settlement services for intergovernmental loans from China, South Korea and India.

***Non-Banking Financial Institutions.*** One of the most positive changes in the financial sector was the expansion of NBFI activities. During 1999, only 2 NBFIs were in operation and in 2000 only 7, while in 2001 this number soared to 28 organizations.

The assets of these NBFIs totaled MNT 23 billion, 64 percent of which belonged to NBFIs with foreign direct investment. This is a clear indication of asset growth fueled by "newcomers," and the effectiveness of the lending activities of these financial institutions.

Assets were composed of loans (56%), reserves (24%), and other assets (12%), with the majority of these financial institutions specializing in lending. Their non-performing loans represented only 0.3% of total loans or MNT 35 million.

***Mongolian Stock Exchange.*** The Mongolian Stock Exchange (MSE) was created in 1991. The Mongolian privatization program, to a greater extent than in other countries, was connected with the development of the capital market.

The MSE currently performs duties such as registration of companies' shares under privatization, deposit, trade, settlement, public information, intermediation in shareholding companies to distribute dividends, and assistance to shareholding companies in organizing its meetings, etc.

## *IV. Legal framework*

This section briefly discusses the most important laws and provisions that are of general interest to persons intending to establish and run business operations in Mongolia.

Currently, there are more than a hundred items of business related legislation, such as tax laws, environmental and minerals laws, banking laws, business operation laws, economic relation regulations and labor relation laws.

***Foreign Investment Law.*** Like many transition economies, Mongolia has adopted a comprehensive investment law setting out the framework for foreign investment. The Foreign Investment Law enacted in 1993 (latest amendments adopted in January, 2002) contains four sections dealing with:

(a) General provisions relating to foreign investment, including a definition of foreign investment and an outline of the types and forms of foreign investment allowed.

(b) Protection of foreign investment including legal guarantees and the right and duties of foreign investors including protection in the event of expropriation.

(c) Operation of business entities with foreign investment including registration and dissolution of businesses, exemptions from customs duties and sales tax, land use and other practical issues relating to the operation of business entities within Mongolia.

(d) Settlement of disputes.

The 1993 Law defines 'foreign investment' as all tangible assets invested in Mongolia by a foreign investor for the purpose of establishing a business entity on the territory of Mongolia for the purpose of operating jointly with an existing business entity of Mongolia. According to the Law, a 'foreign investor' is a foreign legal person or individual (foreign national or stateless person not residing permanently in Mongolia and citizens of Mongolia with a permanent residence abroad) investing in Mongolia. According to Foreign Investment Law the company that has at least 25% of foreign interest is classified as foreign-invested company.

Foreign investment may take place in all areas of production and services; and in all parts of the territory of Mongolia where performing production and services is not prohibited by the laws of Mongolia.

Foreign investment may occur through investment in:

- Freely convertible currencies and reinvested earnings in Togrog.
- Movable and immovable property rights.
- Intellectual and industrial property rights.

Foreign Investment may take the following legal forms:

- A wholly foreign-owned business entity or a local branch or subsidiary of a foreign enterprise.
- A business entity jointly with a Mongolian investor.
- Investing directly through the acquisition of shares or other securities of an existing Mongolian business entity using freely convertible currency or togrogs yielded by an investment.
- Direct application for and award of, rights to exploit or process natural resources according to laws, regulations or product-sharing agreements.
- Marketing and/or management contract.

- Financial leasing or franchising.

The 1993 Law on Foreign Investment provides that in any case where the law is in conflict with an international treaty by Mongolia, the international treaty will prevail.

Article 10 of the Law on Foreign Investment allows foreign investors to repatriate profits, capital contribution to registered capital, dividends and other financial assets or benefits resulting from asset sales. Article 10 also allows investors to repatriate proceeds derived by withdrawing from, or dissolution of an investment.

The Law on Foreign Investment guarantees the following rights and privileges for foreign investors:

- Foreign direct investment is protected by the Mongolian Constitution and by the Law on Foreign Investment complemented by relevant legislation and regulations, as well as by international treaties and agreements to which Mongolia is a signatory.
- It is prohibited to expropriate assets or capital of foreign investors.
- Foreign investors receive treatment equal to that enjoyed by domestic investors in relation to the right to own, utilize and exploit assets and capital.
- Foreign investors are granted the following additional rights.
- The right to own, utilize and dispose of investment assets and to repatriate capital invested in Mongolia.
- The right to manage and to participate in the management of economic entities with foreign investment participation.
- The right to assign and transfer their duties to other legal entities.

Disputes between foreign and Mongolian investors, as well as between a foreign investor and a Mongolian legal entity, are resolved in the courts of Mongolia unless provided otherwise by international treaties, to which Mongolia is a signatory, or by a contract between the parties to the dispute.

Since adopting the Law on Foreign Investment, the government has been providing tax holidays and other incentives to foreign investors. Details on such incentives are provided under "Taxation" below.

It is important to note that official government policy is to phase out tax incentives gradually and also to phase out other fiscal benefits that are inconsistent with

Mongolian agreements with the World Trade Organization (WTO) and the International Monetary Fund (IMF). Under the protection of 'grandfather' provisions, existing investors benefiting from such incentives will not be deprived of their incentives during the phasing-out period.

The Foreign Investment Law also contains a provision for a so-called Stability Agreement whereby investors will receive a certificate specifying any incentives the investor is entitled to under law. This provision aims to guarantee that large investments will benefit from a stable taxation environment after the initial investment has been made.

The Government has agreed to conclude Stability Agreement with any foreign investor that brings in at least US$2.0 million. The duration of such Agreement may be up to 10 years if the amount involved is from US$ 2.0 million to 10.0 million; is the amount over US$10.0 million the duration of the agreement may be up to 15 years.

***Company Law.*** The Company Law of Mongolia is the most important and authoritative legislation that governs all operations and activities of business entities in Mongolia. The power of this law is expressed in its Article 98.3: *As of the effective date of this Law the provisions of other laws pertaining to companies shall continue to be effective to the extent that they are not inconsistent with the provisions of this Law.*

The Mongolian Company Law permits creation of two basic forms of business entities (Article 3):

- An open or joint stock company whose shareholders' capital is divided into shares which may be freely traded by the public; and a closed,
- Or limited liability company whose shareholders' capital is divided into shares, where the right to dispose of such shares is limited by the company's charter.

The state may also participate in business through companies with state ownership. Any company may establish one or more branches or representative offices by issuing authorization to an executive of such an office. Authority to conduct business operations commences on the date of the entity's registration in the state register at the local government office.

Entities are required by law to include abbreviations identifying their form of organization as part of their registered names, as follows:

- "XK" (joint-stock company).

- "XXK" (limited-liability company).

Capital contributions for company shares may be made in cash; contributing assets or intellectual property. Owners' equity in "XK" shall be at least MNT10 million and in case of "XXK" it shall be at least MNT1 million.

***Contract Laws.*** Mongolia's principal laws of contract formation, performance, assignment, remedies for non-performance etc. are found in the current Civil Code, enacted in November 1994 and amended number of times later on, latest version approved in spring of 2002. Issues relating to contracts concluded before the enactment date continue to be governed by the prior Civil Code.

Contracts involving legal entities or land, as well as most other contracts shall be in writing and be certified by notary public. The Civil Code principles of contract also govern stock exchange transactions, unless pre-empted by other laws. Performance of contractual obligations may be secured by penalties, pledges, including secured loans by banks, money deposits, and sureties. Evidence of each form of security shall be given in writing, and if the subject of the security is immovable property, public registrar's certification shall be provided.

***Bankruptcy.*** The procedures for placing a company in liquidation are outlined in the Company Law. A company is legally classified as 'in liquidation' if one of the following conditions have been satisfied:

- Shareholders' meeting resolution;
- By court order, if the company is bankrupt, no shareholder can be located, other legal grounds.

The Bankruptcy Law sets out the basic procedures for declaring companies bankrupt, as well as for their dissolution and protecting the interests of their creditors. However, the same provisions are covered in the Company Law, where also Civil Code provisions are mentioned. Problems include the lack of provision whereby a company can restructure with the agreement of its creditors in order to avoid bankruptcy. In the case of many state-owned enterprises, these enterprises are technically bankrupt but continue to trade.

***Labor Law.*** The Labor Law enacted in 1999 and amended in 2001 governs labor relations of state entities and foreign enterprises with Mongolian nationals, as well as purely Mongolian employment contracts. The Law also addresses health and safety requirements, minimum wage levels and maximum hours of work regulations, collective employment agreements and resolution of employment disputes.

Employment discrimination on the grounds of social or property status, race, color or nationality, sex, religion or political views is prohibited, as are unwritten contracts of employment. The standard working day is set at 8 hours (subject to modification by mutual agreement) and the maximum working week is 40 hours. Basic annual leave for workers is 21 days, increased both for additional years of service and work under difficult conditions.

- ***Insurance.*** The Insurance Law was adopted in 1997 and sets out the legal basis for insurance activities and government regulation, and regulates the relations between insurance agencies and individuals and legal entities.

According to the Insurance Law, the authorized capital of an insurance company must be at least MNT 100 million. The Civil Code and the Company Law regulate the establishment, liquidation and restructuring of insurance companies unless otherwise stated in the Insurance Law. There are no restrictions on foreign companies to operate in the Mongolian market. The Insurance Law also specifies that foreign citizens and entities have the right to establish insurance services in Mongolia on an equal basis with Mongolian citizens and entities.

*Land reform. Land Reform and the Rights of Foreign Investors.* There are a number of important legal documents regarding foreigners' rights in relation to land ownership. Two specific legislations have been recently ratified by Mongolian Parliament, namely Law on Land (new version) and Law on Mongolian Citizens' Ownership of Land.

In general, there are more than 20 laws on land and environmental issues. International Financial Institutions such as the Asian Development Bank, the World Bank and the International Monetary Fund, as well as the European Union, are encouraging further land reform in a broad sense, including the development of the legal framework.

The key legal instruments are:

- Constitution of Mongolia (1992);
- Law on Foreign Investment (1993);
- Civil Code (1994);
- Law on Land Fees (1994);
- Law on Immovable Property Registration (1997);

- Law on Minerals (1997).

The Constitution (1992) states that foreign citizens, legal persons and stateless persons may lease land for a specified period of time under the conditions and procedures laid out in law. Newly approved Law on Land gives the authority to enter into contracts on land lease with foreign legal person, governments and international organizations to the Government of Mongolia. In general, land may be leased for at least 15 years and for up to 60 years with a single extension of up to 40 years. In other words, the maximum duration of a lease in any given case is 100 years.

Ownership of Land (coming into effect in May 1, 2003) restricts the ownership to Mongolian nationals. The same restriction applies to foreign nationals that are married to Mongolian citizens. 0.9% percent of total area will be privately owned. The privatization of land for private use in urban areas (0.01% of total land) will be done freely to all Mongolian citizens. Families in capital city are entitled to 0.07 ha, aimag centers - 0.35 ha and soum centers - 0.5 ha of land. Subsequent acquisitions of land will require payment. Individuals that possess land on leasehold terms (including farming) have the preemptive right to purchase it form the state.

***Environmental Aspects of Laws and Institutions Governing Mineral Exploration and Mining.*** The Minerals Law contains provisions to address the environmental imp act of mining activities (Articles 28-31). Relevant environmental protection agencies need to approve any exploration or mining activities. Licensees are required to prepar e an environmental impact assessment, and an environment protection plan, which ne eds to be updated annually to ensure that pollution caused by the exploration activities does not exceed maximum limits. Investors are also required to report on steps taken to protect the environment and natural resources. However, licensees are not obligated to completely rehabilitate areas affected by mining activities, and to eliminate enviro nmental dangers. They must deposit an amount equal to 50 percent of the environmen tal protection budget in a special bank account, to be refunded upon full implementati on of the environmental protection plan. The Minerals Law does not refer, however, s pecifically to artisanal mining and also does not make any provisions for socio-econo mic impact assessments.

The State Inspection of MIT is responsible for monitoring exploration and mining acti vities and ensuring compliance with the laws on geology and mining, including enviro nmentally benign and sustainable exploitation and use of mineral resources. The Mini stry of Nature and Environment (MNE) shares MIT's mandate for carrying out inspect ions of exploration and mining activities to ensure compliance with environmental la

ws. At the local level, provincial and district governments are responsible for organizi ng and ensuring implementation of mining legislation and compliance with environm ental protection, health and safety regulations, under the supervision and/or in collabo ration with MNE and MIT inspectors. In 2002, with the goal of addressing the overlap ping authorities of MIT and MNE, GoM issued a resolution on the reorganization of i nspectorates, which provides for the establishment of a single Inspecting Agency repo rting directly to the Prime Minister.

Existing environmental provisions have not led to environmental protection as it had been expected. The review of the environmental and social practices for mining, spon sored by the World Bank in 2003, identifies weaknesses in the legislative framework a nd institutional capacity. These include instances of sub-standard environmental minin g practices due to a general weak environmental inspection and enforcement system, l imited coordination and overlapping authority between regulatory agencies concerned and the mining industry, and emerging socio-economic problem areas such as the rapi dly developing artisanal mining community. The review proposes solutions to address these problems, whose implementation could also be supported by an ongoing IDF G rant to MNE, and also by the new MIT-MNE joint inspecting authority that was recent ly established

## *V. Industry profile: Mining. FDI in mining sector and its role in economic growth*

The minerals industry has evolved into a truly global industry that is highly competiti ve, generally capital intensive, technologically complex, and risky. With few exceptio ns its development is dependent on and shaped by competitive global commodity mar kets, geological mineral endowment, and national legal, regulatory, and fiscal conditio ns. The industry is increasing influenced by a limited number of well-financed, techno logically advanced international mining companies. These companies are highly selec tive, risk averse, and sensitive to changes in the investment climate. A 1991 UN/Worl d Bank survey identified six factors used by these companies to evaluate mineral proj ects and potential investments:

- Geological prospectivity and mining tradition,
- Clear mining rights and title (legal/regulatory framework),
- Attractive and competitive fiscal conditions (fiscal legislation),
- Ownership and control of operations (legal/regulatory framework),
- Political stability and transparency of governance (institutional capacity),

- Availability of infrastructure.

Given the capital sums required, low probability of success, and volatile markets, gov ernments increasingly have abandoned direct involvement in mining. Recognizing the potential of private investment, many emerging economy governments have embarke d on mining sector reforms that restrict the role of the state to sector management and regulation. They have adopted legal/regulatory frameworks that provide equal access t o mineral rights, security of tenure, and the freedom to exploit, market, and assign mi nerals. They have established globally competitive fiscal regimes, and created instituti onal structures that seek to ensure stability, good governance, and regulatory consisten cy. They generate and provide, as a public good, basic geological data to encourage in terest in mining. Appropriate mining reforms, consistently applied, have attracted sign ificant local and foreign direct investments, produced sustained growth in industrial o utput, export earnings and GDP, and resulted in meaningful indirect benefits in local c ommunity development, formation of SMEs, and job creation.

Mongolia, with its good geology and undoubted mineral endowment, stands to benefit by continuing to reform its mineral sector, improving its fiscal competitiveness, and e ncouraging private exploration and development of its vast land mass. Mining (and quarrying) contributed 12.7% of GDP in 2003 (8.6% in 1999), and accounted for 3.4% of total employment. Mineral processing, mainly of gold, copper, molybdenum, coal and fluorspar, is Mongolia's single largest industry, accounting for over 60% of industrial output and two-thirds of export earnings (copper and gold). Most foreign investment is in mining. State-owned firms dominate mineral production. Erdenet Copper Mining Company, a government joint venture 49% owned by the Russian Government, is the only copper and molybdenum mining company. It accounts for about 40% of export receipts and 25% of government revenue. Four state-owned companies mine coal and another, Mongolrostsvetment (also a Mongolian-Russian Government joint venture), produces over 90% of fluorspar output.[5] Erdenet and Mongolrostsvetment, Mongolia's two largest companies, are not scheduled to be privatized, and instead are seeking technical alliances to improve competitiveness. Several major gold and copper mines are due to commence production shortly.

*Mining Reform in Argentina*

*Argentina's new government announced an ambitious program of macroeconomic and sectoral reforms in 1991. A major effort was undertaken to reduce the presence of the*

[5] Mongolia is the world's fourth largest fluorite producer.

*state in the economy, the currency was fixed to the US dollar to stop inflation, and im pediments*
*to new investment were remedied. In the mining sector, which had been moribund for years despite highly prospective geology, reforms included opening ground held by fe deral and provincial government corporations to new private investment, rewriting th e mining law, passing a new mining investment act with internationally competitive fis cal incentives, introducing a modern computerized mine title and registry system, upg rading geological information systems to international standards. The results have be en very successful: since 1993 Argentina mineral production has increased from US$3 41 million to US$1,310 million; annual exploration expenditures are over US$150 mil lion and capital expenditures US$350 million. Mineral exports of minerals have risen tenfold from US$78 million to US$ 700 million, and, minerals exports are greater by v alue than beef.*

*Artisanal mining* in Mongolia is not a longstanding traditional activity but primarily a response to the adverse effects of economic restructuring, which has resulted in job losses, inflation, and declining real incomes. People have had to find their own solutions to these problems, most often outside the formal economy. Artisanal mining is a viable solution for many because it is a highly labor intensive, technologically simple, and low-cost activity. Much artisanal mining has emerged around reclamation of gold-bearing tailings discarded by inefficient commercial placer mines. The surge in commercial development of Mongolia's extensive placer deposits in the early 1990s left large amounts of waste material that provided a relatively rich and readily accessible resource base for artisanal miners that can be tapped with simple, affordable tools; the recovered gold is easily marketable.

Mongolia's geology is complex and its mineral potential vast. Mongolia occupies the i nterior portion of the Eurasian Plate, a series of accreted terranes and micro plates that decrease in age to the south. The Tuva Terrane, in the north, is made up of Proterozoic and Lower Palaeozoic rocks, while the Southern Block contains an important compon ent of Permian to Jurassic intrusive. A major Caledonide (Variscan) deformation crato nized northern Mongolia, while a Hercynian event deformed and crystallized its centr al and southern regions. Post-Permian events have included anorogenic (mainly alkali c) intrusions and Mesozoic vulcanism of relatively limited extent in eastern Mongolia, in response to Mesozoic relaxation and rifting. Cenozoic basalts occur locally along d eep crustal fractures, in which seismic activity continues today. Within this diverse ge ological setting is an extensive series of mineral resources, with over 6,000 known sh owings/deposits of 80 different minerals. The most economically significant of these a

re base metals, gold, and fluorite.

Artisanal gold mining started as a seasonal activity involving hundreds of people; in the past seven years it has escalated into a year-round livelihood involving an estimated 30,000 people. While it has provided significant economic opportunities for poor Mongolians during difficult economic times, commercial miners and local government authorities have been critical, asserting that it is outside the legal and regulatory framework, and risky, degrades the environment, and exposes miners to hazardous work conditions and toxic chemicals. Because artisanal miners in Mongolia have no rights or claims to land or minerals, conflicts have emerged between informal miners and licensed commercial mining operations, usually when there has been direct competition for access to mineral resources. Local authorities have tried to reduce conflict by negotiating arrangements with the commercial mining companies to allow asrtisanal mining, but many companies prefer to rely on security forces to defend their interests. Conflicts between local authorities and informal miners have thus far been minimal, although local authorities have also used police to evict miners. Informal miners have not resisted eviction and harassment but are upset and pushing for a resolution to normalize their situation.

Artisanal mining has become part of Mongolia's informal social safety net. In 2001 the government attempted to accommodate artisanal mining by enacting an interim regulation of this informal activity. That regulation proved ineffective and unworkable; it lapsed after one year and was not renewed. The government is now proposing to create a legal framework for artisanal mining and is drafting a new law.

Gold production rose tenfold during the 1990s in line with the Government's "gold programme" adopted in 1991. In 2003, over 120 companies mined gold totalling 10.8 tones, almost entirely from placer (alluvial) deposits. Most gold is sold to the central bank, despite the market being deregulated in 2001 to allow producers to export directly. The gold export tax of 10% was also abolished in January 2002.[6] Copper, mainly concentrate, is exported primarily to Russia. Erdenet, faced with financial problems in 1999, has restored limited profitability by rationalizing costs,

[6] This was introduced in 1999. To compensate for the removal of the tax and maintain tax revenue, the VAT was amended to make gold exempt from VAT (instead of being simply zero-rated if exported), thereby removing eligibility for VAT credits on inputs for goods and services.

including through labor reductions.[7] Another company, Erdmin, exports pure copper (cathodes) extracted from Erdenet's tailings, but operates at about half capacity. Coal production, of 5.7 million tones in 2003, is used mainly for electricity generation. A license to exploit the Ulaan Ovoo coal mine was granted to a Mongolian-Chinese joint venture in 2003.[8] Coal mining is to be increasingly privatized, including the Baganuur and Shivee-Ovoo joint-stock companies once they have been restructured.

The Government released the 2000-10 Geology and the Minerals Sector Programme in 2002 (Government Resolution No. 103): mining is a priority sector, and it intends to double the mining sector's contribution to GDP. New program focus on a market-driven, private-sector-oriented industry that is regulated by the government. The Minerals Law, adopted in 1997, provides a competitive and enabling environment for exploration and development that promotes private-sector participation and foreign investment. Policy guidelines, issued in 2002, outlined mineral development goals for 2002-10, and reinforced the Government's commitment to a favorable legal environment for private exploration and processing based on market-driven projects regulated by the Government.

Mongolia’s mineral taxation system. Mongolia’s mining tax system includes corporate taxes, personal income taxes, mineral royalties, value-added taxes, customs and excise duties, social insurance, and stability arrangements.

Tax incentives apply to mining investments. These include a three-year income tax exemption and 50% reduction for the subsequent three years for mining enterprises with foreign investors. Eligible heavy machinery and mining equipment (excluding drilling equipment) are exempt from tariffs and VAT. To provide a stable tax structure for long-term projects, a licensee proposing to invest above US$2 million in a project can apply for a ten-year stability agreement (15 years if investment exceeds US$10 million) with the Finance Ministry.[9]

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[7] Erdenet Copper Mining Company is a high cost producer averaging US$0.57 per pound of copper in 2002 (World Bank, 2004d). It is also largely responsible for maintaining the third largest city, Erdenet, and has various farming and other non-mining activities as well as an extensive social support programme, which added about 5% to costs in 2002.

[8] The Chinese partner is to construct 350 kilometres of the Millennium Road.

[9] These agreements cover income tax rates but not, it appears, the rules determining taxable income (World Bank, 2004).

Foreigners can hold exploration licenses, including for mining, provided they operate as locally incorporated companies. All licenses are issued on a first-come first-served basis and there is no discrimination between private and state-owned mineral enterprises.[10] There are no annual work or expenditure requirements. Exploration licenses are issued for three years, extendable twice for two years each time. Mining licenses are issued for 60 years, renewable once for 40 years. Licensed exploration holders have exclusive right to mine discovered minerals without state involvement, and to sell at market prices either domestically or abroad. Total exploration and mining license fees from July 1997 to September 2004 amounted to US$16.2 million. Royalties are set at 7.5% for placer gold and 2.5% for other minerals (including hard rock gold).[11] Income of mining companies is taxed at the standard rates of 15% on the first Tog 100 million, and 30% (reduced from 40% in 2004) thereafter. All mining tax revenue accrues to the Central Government and there are no formal revenue-sharing arrangements with regional provinces.

The Mineral Resources Authority of Mongolia (MRAM) regulates mining, and is responsible for issuing licenses, conducting geological surveys and compiling industry information. There were 4,692 licenses, mainly for exploration, as at September 2004. Approximately 16% were held by wholly foreign-owned entities registered in Mongolia, 75% by local companies and individuals, 8% by joint ventures, and 0.7% by foreign companies (not registered in Mongolia) or individuals. Exploration budgets totaled US$35.3 million in 2003 (US$20.5 million in 2002), 95% incurred by foreign operators. In 2003, private investment in mine development fell from US$41.6 million to US$33.2 million.

Unlike the light industry, the mining sector is a primary industry, which produces input factors for other industries. At the same time, the development of the mining sector encompasses social development. The best example is Erdenet town, which was erected surrounding the Erdenet mining company.

Deposits with forecast reserves include copper, gold, molybdenum, lead, tungsten and other rare elements. Along with a wide variety of building materials, the country is abundant in fertile deposits for limestone, cement raw material, various types of brick sand, flour spar, brown, hard and coking coal. The ongoing geological surveys cover

[10] Government can only participate in exploration and mining through registered business entities.

[11] The royalty on placer gold was increased from 2.5% to 7.5% in 2003. Mineral royalties are deductible for income tax purposes.

only the surface areas, and not much below ground prospecting is done within the current geological surveys.

The country's geological system is unique. It is characterized by an aged bedrock and structures with a centuries-long record of geological process. Such a peculiar geological setting requires a special exploration and surveying techniques and treatment. G. Ankhbayar views that the foreign geologists in Mongolia apply the same methods as they use at home, which may not be suitable for Mongolian geological realities. D. Ganbaatar agrees that development of such a methodology would positively affect the results of geological surveys and studies.

Since the Mongolian Government's announcement of the mining industry as a priority sector of Mongolia's economy, significant steps have been taken to create favorable conditions for foreign investors. Mining companies are no longer liable for customs duties and VAT for imported technological mobile and stationery (such as dredge) equipment and machinery, effective last year. The royalty for all types of minerals has been reduced universally to 2.5% of sales. Gold mining was due for 12.5% royalty for both hardrock and placer deposits, however, the rate was reduced to 7.5% for placer deposits and 2.5% for hardrock deposits effective 2002.

The Government has been concluding Stability Agreements with companies investing over US$ 2 million into Mongolian mining sector. The purpose of the agreement is, according to D. Ganbaatar, to protect investors' rights in case of changes in the taxation legislation. Once signed the agreement, an investor is empowered to operate safely under the same tax environment as the investor enjoyed since the start-up of his business.

The Department of Geology and Mineral Resource Regulation, MIT, plans to improve the terms and conditions of the Stability Agreement and public services rendered to foreign investors, to mitigate bureaucratic pressure from local authorities and provide one-stop services.

D. Ganbaatar explains the motive to refine the Stability Agreement as follows: "A major investor's operation covers not only a licensed area, but also the whole region which embodies the licensed area. For instance, if Ivanhoe Mines Company, operating now in Khanbogd soum of Umnogovi province, starts mining Oyu Tolgoi, it becomes necessary for it to construct railway, power line and water supply as well as copper

and gold mines". A coking coal mine Tavan Tolgoi, which possesses billions worth reserves, is still unexploited due to lack of infrastructure.

The Government has set a complex plan on the whole region: along with Oyu Tolgoi and Tavan Tolgoi, there are other prospective deposits of Tsagaan Suvarga copper and molybdenum and Olon Ovoot gold deposit. Additional gold and copper surveys are planned for potential areas. Ivanhoe Mines and companies from Japan and South Korea are exploring the area. The Government has initiated talks on establishing railway and power line, as well as building a power plant based on Tavan Tolgoi coal mine provided large deposits are established.

Mongolia is rich in minerals such as coal, copper, uranium, iron ore, wolfram, molybdenum, phosphate, crude oil and others. Today over 6000 deposits of about 80 minerals are estimated to exist as resources, and out of 400 revealed deposits 160 are being exploited. In addition, about 170 deposits for construction materials have been revealed, of which 35 are being exploited.

The new Minerals Law of Mongolia, passed in 1997, has greatly improved the legal environment for investors by clearly defining legal rules, simplifying the licensing process and reducing royalty and exploration fees. The Petroleum Law of Mongolia, adopted in 1991, has also provided a favorable legal environment for investors to operate in this field.

*Gold mineralization* on Mongolian territory has occurred with varying intensity during the late Precambrian, early Cambrian, Paleozoic, Mesozoic and Cenozoic time periods. However the most significant gold mineralization is associated with magnetic activity during Permian, Triassic, and Jurassic time periods. Placer gold deposits were formed during the Cretaceous, Neogene, Pliocene, and Holocene time periods.

The known economically significant gold mineralizations in Mongolia occur in 3 deposit types: veins, mineralized zones, and placers. Although vein occurrences are the most widespread all gold deposit types, the bulk of proven recoverable gold reserves are associated with mineralized zones and placer deposits.

On the basis of geological data ten main gold metallogenic provinces have been delineated within Mongolia. However true gold potential of the western and southern regions of Mongolia is largely conjectural due to the fact that to date little detailed geological exploration has been conducted in these regions. Emphasis of geological exploration in these areas has only focussed on placer deposits and quartz vein

mineralization. Nevertheless, the number of occurrences determined based on limited data clearly suggests a high gold potential overall for the region.

Additionally, available geologic data indicate that as yet undiscovered occurrences gold will likely be found in the following geological formations:

(a) Gold-bearing conglomerates of Cretaceous and Tertiary age should be expected in southern and western Mongolia.

(b) Gold mineralization associated with ancient volcano-sedimentary areas in Central Mongolia.

(c) Ancient epithermal gold occurrences (island arc associations) may be expected in the Kharkhira, Ulzeet, and Southern Mongolian gold provinces.

*Base Metals.* Copper-molybdenum (Cu-Mo) mineralization in Mongolia is occurs primarily in three types of deposits, late Paleozoic to early Mesozoic Cu-Mo porphyries, copper-nickel (Cu-Ni) magmatic segregations associated with grabbo of unknown age, and Paleozoic to Mesozoic stratabound Cu. The Cu-Mo deposits described above occur in four main base metal provinces in Mongolia, located in the Altai, northern Mongolia, and southern Mongolia.

In addition to these Cu-Mo deposits, Mongolia also has a large number of middle to late Mesozoic lead-zinc (Pb-Zn) deposits which occur in a variety of deposit types. The main Pb-Zn deposit types include skarns, mineralized explosive pipes, veins, and mineralized zones. The known base metal deposits were formed for the most part in the middle to late Mesozoic.

*Fluorite.* Fluorite mineralization is widespread throughout Mongolia in rocks of late Paleozoic to late Mesozoic age. The major period of formation of economically important mineralization took place during late Mesozoic to late Jurassic and early Cretaceous time periods. The fluorite mineralization occurs in two economic types: epithermal vein and metasomatic ore bodies.

Late Mesozoic fluorite mineralization is associated with rare earth and lead-zinc mineralization but not in economic quantities. Three major fluorite provinces have been defined in Mongolia, the North Mongolia, Trans-Mongolian, and South Mongolian fluorite provinces, with the Trans-Mongolian province having the largest reserves and being the most actively mined.

Rare-Earth Elements. Rare earth elements (REE) in Mongolia are primarily felsic and alkalic rocks of late-Mesozoic, early Mesozoic, and late Paleozoic age. Known deposits of REE are subdivided on the following basis:

- REE mineralization with alkalic granitoids and volcano-plutonic complexes (metasomatic zones).
- Tungsten (W) vein and stockwork mineralization in granitoids.
- Tin (Sn) vein and skarn mineralization in granites and carbonate rocks.

Within Mongolia six REE provinces have been identified, the Altai, North Mongolian Hentii, Hangai, Southeast Mongolian, and South Mongolian provinces. REE occurrences are widely distributed throughout Mongolia, and available data indicate that the Altai and South Mongolian provinces are the most promising for future discoveries of Ta, Nb, Zr, Y, W and REE.

*Uranium.* Soviet and Mongolian geologists began exploring for uranium in Mongolia in the 1940's. Prior to1966, numerous uranium occurrences were discovered associated with deposits of coal. From 1967 to 1988 more systematic exploration for uranium was undertaken, and four major uranium deposits were defined in Mongolia, the Priargun, Gobi-Tamtsag, Hentei-Daur and Northern Mongolia uranium provinces. Uranium deposits of economic value were discovered in the Dornod, Gurvanbulag, Mardai areas of eastern Mongolia and the Kharaat area of southern Mongolia. The proven uranium resources of Mongolia in these deposits is about 62,000 metric tons, while the uranium resources of the entire country are estimated to be 1,307,000 metric tons. Uranium mining in Mongolia began in 1989 with opening of the Mardai open pit mine in eastern Mongolia. The ore is processed in the Russian Priargunsky ore dressing plant and the mine was operated as a joint Russian - Mongolian venture until 1993. In 1998 Mongolian-Russian-American joint company was established to reopen the mine. Unfortunately, due to low market price and financial problems of the company the mine has been closed again.

Mongolia's vast territory contains large regions that have not yet had their mineral potential fully evaluated. Thus the country is highly attractive for mineral exploration, especially for gold and other metals, which can be easily traded on international commodity markets. While production of most minerals decreased during the 1990's due to the rapidly changing economic conditions during the transition to a free market economy, gold production nevertheless increased by a factor of 10. At the same time, the pace of mineral exploration by Mongolian and particularly foreign investors has

increased tremendously. However, in spite of the recent dramatic increase in mineral exploration activity approximately 75% of Mongolia's territory still remains open to new mineral exploration licensing.

While in the past the evaluation of Mongolia's mineral potential was hampered by limited infrastructure, a command economy, and other governmental restrictions, these barriers to mineral exploration are now coming down. Thus the improving business climate combined with the existence of an extensive geological database and indications of many types of deposits of gold, copper, base metals, and other minerals has led to increased foreign investment in mineral exploration and development.

Consequently, Mongolia now offers many promising opportunities for investors seeking to enter Mongolia's mining sector. These opportunities are facilitated by a supportive government attitude and the presence of many unexplored regions with high mineral potential. Furthermore, the Mongolian Government and many Mongolian companies are eager to work with foreign investors who can provide new capital investment, technology transfer, and modern mine management, and who can open new markets for Mongolian mineral products.

*Licensing situation.* As of April 24, 2003, 2,640 exploration license holders operated on 40.4 million hectare area, and 620 mining license holders were mining on 79,000-hectare area. Companies with foreign investment owned 529 exploration and 124 mining licenses among the above and the rest belonged to domestic companies.

As of December 31, 2002, 585 mining license fields were exploited, of which gold mining licenses accounted for 322, 70 for coal mining, 44 for fluor spar, 102 for construction materials and 47 for other minerals. Of this, 118 were held by companies with foreign investment and joint ventures.

In 2002, the gold mining solely yielded a net profit of Togrog 10.3 billion, furnishing Togrog 14.9 billion to the central budget for royalty, corporate income and other taxes. It is, however, Togrog 5.7 billion less compared with that of 2001. Such a drop in the gold mining industry's contribution to the budget was factored by 2002 VAT annulment, as well as the increase of the royalty for placer deposits from 2.5 to 7.5%. At present, gold, copper, flour spar and tungsten are the base minerals mined in Mongolia.

So far, geological surveys have covered about 30% of the territories of Mongolia, a country with 1.566 million sq. m territories and 2.4 million population.

Seventy percent of Mongolia's territories remain unexplored, which could be ventured out for any hidden mineral resources. On the other hand, deposits with established reserves are not fully exploited.

Low exploration is explained by poor infrastructure development, as D. Ganbaatar, Head of Department on Geology and Mineral Resource Regulation, Ministry of Industry and Trade (MIT), views. He noted that the infrastructure issue in other countries finds a socio-economic solution by being established in densely populated areas. Such an approach, however, may prove impractical in Mongolia, where approximately 3,000 people reside in one soum, a province center. He adds that investments in railway, road and electricity pipes in such areas could be hard to justify its costs, which may account to billions of Togrogs. Mongolia's approach is first, to discover a rich deposit in a certain area and then, develop an infrastructure network surrounding the deposit. Actually, many of the deposits with established reserves are located along the railway and road network.

Mining sector gross industrial output is projected to increase sharply from US$ 266,3 million in 2002 to US$ 496,2 million in 2008. However, due to highly capital intensive nature of the industry the contribution of the mining sector to GDP is expected to increase slightly from 10,4 percent in 2003 to 10,7 percent in 2008, reflecting an anticipated growth in output of copper and gold with start up of Erdenet Cu Leach Plant, Oyu Tolgoi copper and Boroo gold mines.

Table V.1. Mining sector expected contribution to GDP

| | ***2002*** | ***2003*** | ***2004*** | ***2005*** | ***2006*** | ***2007*** | ***2008*** |
|---|---|---|---|---|---|---|---|
| | ***actual*** | ***actual*** | ***actual*** | ***estimate*** | | ***Projection*** | |
| ***In percent*** | 8,7 | 10,4 | 10,3 | 9,7 | 10,4 | 10,7 | 10,7 |
| ***In billion of togrog*** | 107,4 | 141,8 | 157,2 | 163,9 | 194,4 | 221,6 | 246,3 |
| ***In million of US$*** | 96,7 | 123,7 | 135,0 | 135,7 | 157,3 | 175,0 | 189,7 |

*Source: WB, Mongolia sources of Growth Study – Mining Projections*

At current levels of production copper would play an important but decreasing role in economy due to continuing decline in the quality of copper ore grade at Erdenet mine and depleting deposits. However, recent developments in Mongolia's mining sector b ode well for Mongolia's economy. With current discoveries and exploration of new d eposits mineral production in Mongolia is set to increase radically. Taking into accou

nt the anticipated new investments the gross copper output is estimated to increase fro m about US$ 151,5 million in 2003 to US$ 318,1 million in 2007 and US$ 412,2, mill ion by 2008, thus improving the early output projection of the industry by US$ 91,2 a nd 170,4 million which is equivalent to 5,6-9,6 percent of GDP.

Table V.2. Comparison of the current and new projections on copper output

| | ***2002*** | ***2003*** | ***2004*** | ***2005*** | ***2006*** | ***2007*** | ***2008*** |
|---|---|---|---|---|---|---|---|
| | ***actual*** | ***actual*** | ***actual*** | ***estimate*** | | ***Projection*** | |
| ***Current projection*** | 140,2 | 164,7 | 213,8 | 215,3 | 217,3 | 226,9 | 241,7 |
| ***New projection*** | 136,9 | 151,5 | 169,8 | 191,2 | 212,7 | 318,1 | 412,2 |
| ***Difference*** | -1,0 | -13,1 | -44,6 | -24,1 | -4,6 | 91,2 | 170,4 |
| ***Difference as % of GDP*** | -0.1 | -1.1 | -3,5 | -1,7 | -0,3 | 5,6 | 9,6 |

*Includes the copper output of Erdenet. Erdenet Cu Leach Plant, Erdmin and Oyu Tolgoi mines*

*Source: WB, Mongolia sources of Growth Study – Mining Projections*

The Government mining revenues generated from the corporate income taxes (most o f the mining companies fall in to the top tier 40 percent tax brackets), and royalty fees for the use of environmental resources. The government mining sector total revenues are estimated to grow at 10,4 percent annual rate over the medium term.

Table V.3. Government mining revenues projection (in billions of Togrogs)

| ***Year*** | ***Compan y tax*** | ***Royalty*** | ***Total mining revenue*** | ***Tax rev as % of GDP*** | ***Royalty rev % of GDP*** | ***Total rev as % of GDP*** |
|---|---|---|---|---|---|---|
| ***2002*** | ***16,2*** | ***8,3*** | ***24,5*** | ***1,3*** | ***0,7*** | ***2,0*** |
| ***2003*** | 23,5 | 9,7 | 33,2 | 1,7 | 0,7 | 2.4 |
| ***2004*** | 20,0 | 14,5 | 34,5 | 1,3 | 1,0 | 2,3 |
| ***2005*** | 20,9 | 14,7 | 35.6 | 1,2 | 0,9 | 2,1 |
| ***2006*** | 24,8 | 14,6 | 39,4 | 1,3 | 0,8 | 2,1 |
| ***2007*** | 29,8 | 17,0 | 46,8 | 1,4 | 0,8 | 2,3 |
| ***2008*** | 29,9 | 19,4 | 49,3 | 1,3 | 0,8 | 2,1 |
| ***Annual growth*** | 9,0% | 13,1% | 10,4% | | | |

*Source: WB, Mongolia sources of Growth Study – Mining Projections*

***Current situation: case study***

Oyu Tolgoi (Turquoise Hill), a large copper and gold deposit, was discovered in Khanbogd soum of the South Gobi province in Mongolia. Originally held by BHP in 1996, Ivenhoe Mines signed an option to earn 100 percent interest in 2000 and now holds a 100 percent interest in the project, subject to BHP Billiton's 2 percent Net Smelter Return Royalty. Ivenhoe Mines is a Canadian copper and iron mining company that have mining and exploration interests throughout Australasia. It currently holds exploration licenses covering approximately 90,000 square kilometers in central and southern Mongolia.

Oyu Tolgoi deposit, located in the south Gobi Desert of Mongolia, according to the preliminary resource estimation announced by Ivanhoe Mines, has reserves of 588 million tones, grading 0.53 grams per tone of gold and 0.41 percent copper containing 10 million ounces of gold and 5.3 billion pounds of copper.

Drilling at 460 m deep in the Oyu Tolgoi concession has yielded high ore content of gold and copper in rocks. Copper porphyry deposits with high gold grading rarely occur worldwide. As said by experts, a copper processing plant for Oyu Tolgoi project will be earned within a few years. If only copper was found in the deposit, it would be risky to invest in a processing plant, as it would take many years to earn a profit in the investment. But with regard to Oyu Tolgoi, the concession has both gold and copper that will be mined at the same time. This allows low-cost gold mining, which further gives a higher probability of paying off the investment from the gold mining in relatively short period".

Ivenhoe Mines spent US$8 million on exploration in Mongolia in 2002. The company raised US$ 50,7 million in private-placement financing in April 2003.

Today the Erdenet, copper mining concern is the only plant operating a placer deposit in the mining sector of Mongolia, which is believed to have reserves that will last for the next 20 years. Copper concentrate from Erdenet is main exported product of Mongolia. The gold deposit at Oyu Tolgoi has a 1.8 gram higher content than Erdenet and Tsagaan Suvarga copper mines in terms of gold grading per ton of ore. However, its copper reserve is 3 times lower than the Erdenet. Construction of a copper processing plant at Oyu Tolgoi would have several advantages.

Oyu Tolgoi is only approximately 80 km from north of the Chinese border offering advantages in a cheap work force, as well as having a suitable location in entering the professional construction industry and gigantic copper market of China. R. Freidland,

Chairman of Ivanhoe Mines Co., Ltd says: 200 km long railway between China and Oyu Tolgoi and Tavan Tolgoi coked coal mine is planned for the next 2 years.

But the main concern in using the deposit is to solve water problems. Exploration work has already started, and hydraulic experts from Canada will arrive soon. Positive findings from the exploration will lengthen the lifetime of the plant, which will be built in the future.

Douglas McGay, Business Manager of Ivanhoe Mines said**:** "Ivanhoe obtained the exploration license on a basis of an agreement with BHP. The first exploration by Ivanhoe on the project site started with US$ 6 million investment." Ivanhoe Mines intends to construct a copper mining plant in 2010 at the project.

Having discovered the Oyu Tolgoi mine, Ivanhoe Mines's shares on Toronto Stock Exchange is at CDN$ 3.25, having doubled increase during the last year from the previous price of Can$ 1.6 per share. D. McGay: "17 million shares at CDN$ 3.25 were issued starting from March 2002 to support exploration works. The result was an earning of US$ 35.8 million".

The 10-year project plan will pay attention to conducting additional studies and continues explorations in the Oyu Tolgoi project area. US$ 10 million has been proposed for a further exploration.

R. Freidland said: "Findings from an exploration in the Kharmagtai area, 120 km of south of Oyu Tolgoi**,** has shown that the area has intercepted strong gold and copper porphyry mineralization. The exploration will be extended to Shuteen area, 100 km east from Kharmagtai". Seven exploration sites are designed to be conducted in coming two years with the expectation and hope that new deposit will be discovered.

Intensive infrastructure development will begin this year, which includes construction of paved and dirt roads, electrical transmission lines, telecommunications and construction of a plant capable of mining from Oyu Tolgoi.

In reference to laws and legislation in Mongolia R.Freidland said: "In 2001, the Government favorable business environment through its decision to set different percentages for gold royalties at 2.5% for hard rock deposit and at 7.5% for alluvial deposits. The exemption of VAT also helped to promote investment in the gold mining industry."

He added: that however, the fees for certification required for running business operations and mining license costs are relatively high compared with other countries. For instance, the tax is 40% in the case of mining operations after obtaining the

licenses. While in countries, such as Chile and Australia that have achieved the same result in attracting foreign investment at most, with tax rate of 18% and 32% respectively.

Experts have different points of view on the advantages and disadvantages of constructing a copper processing plant in Oyu Tolgoi mine.

D. Algaa, Director of Mining Association said: "In 20 years the Erdenet will run out its copper reserves leaving us no choice but to construct a processing plant elsewhere. As Mongolia lacks the economic capacity to construct a plant on its own, assistance from international investors is one of the most worthwhile options. The mining sector is one of the most risky industries, often demanding large amounts of capital just for explorations. Oyu Tolgoi will be a great chance for Mongolia to open itself up to the international market".

N. Kherlen, Head of Cadaster Office said: "The Mongolian GDP will grow by having more international investors in Mongolia, and increase earnings from income and value added taxes. On other hand, the Oyu Tolgoi mine will be a lever for infrastructure development in rural areas so construction of this plant is valuable to Mongolia".

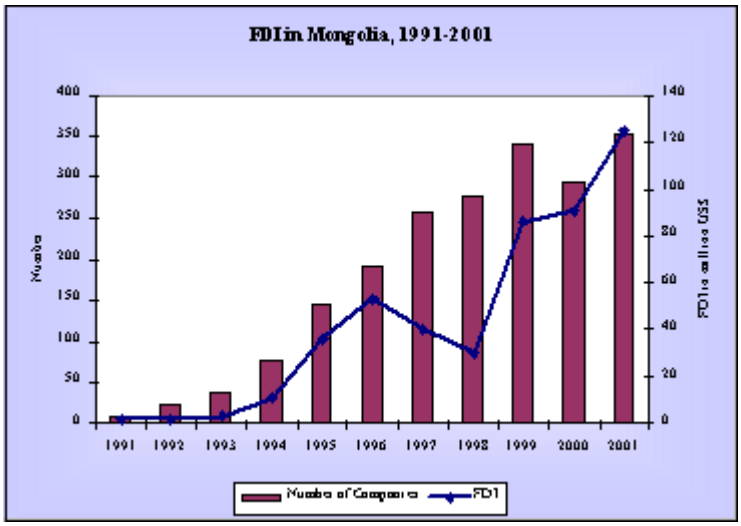
Regarding to environmental impacts, the mining expert says: "Mongolia should have a realistic approach to the construction of a copper processing plant at Oyu Tolgoi. In having a plant, Mongolia will be open to new technology and know – how, but on other hand, the country might turn into a raw material base for developed countries. In addition, as the project expands, there will be large impacts on the country's economy and environment. The long-term environmental effects are unknown and the area could be turned into a waste. Although the Minerals law is said to be good, it has restricted the Governments participation in the mine. Therefore, the Government has to constantly cooperate with Ivanhoe Mines".

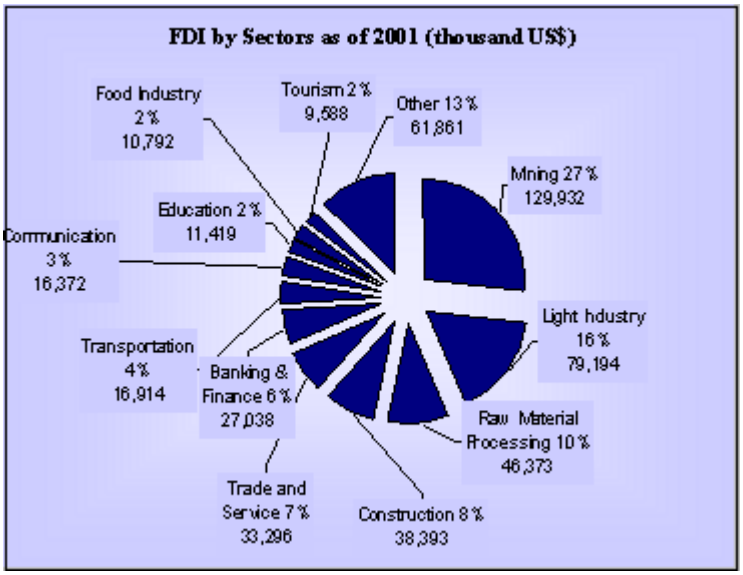
At the moment Stability Agreement between the Government and Ivenhoe Mines Co. are undergoing.

***Recent FDI flows***

FDI for 1999-2001 was concentrated in mining and oil followed by light industry, trading and services and animal products processing. According to FIFTA, the majority of investment was in the mining sector accounting for 27% of all accumulated FDI. The strong presence of the mining sector in FDI can be explained

in part of the high capital-intensity of mining industry. Investors from China, USA, Bulgaria, Canada and Russia are main investors in this sector.




Source: FIFTA

Second largest sector for foreign investment was the light industry sector reaching 16% of FDI. Most of the foreign invested companies are operating in knitting and sewing industrial fields. Japan, China, Hong Kong, Taiwan, South Korea and USA are leading countries in this sector by the amount of FDI.

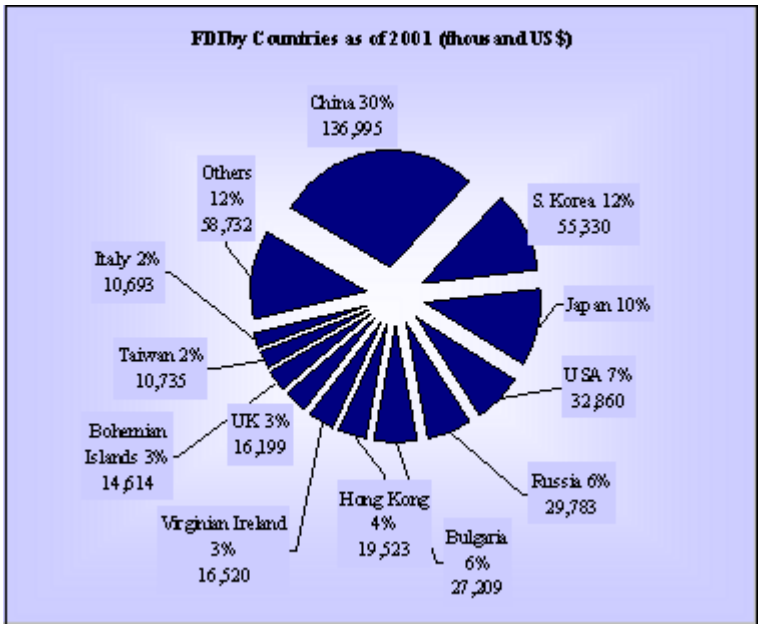
Countries such as China, USA, Italy, Great Britain, Liechtenstein and Japan have invested in processing of animal origin raw materials. In 2001, 27 foreign invested companies with investment from China, Russia, Kazakhstan, Poland, Germany, Switzerland, Norway and Great Britain are registered in the meat and meat products

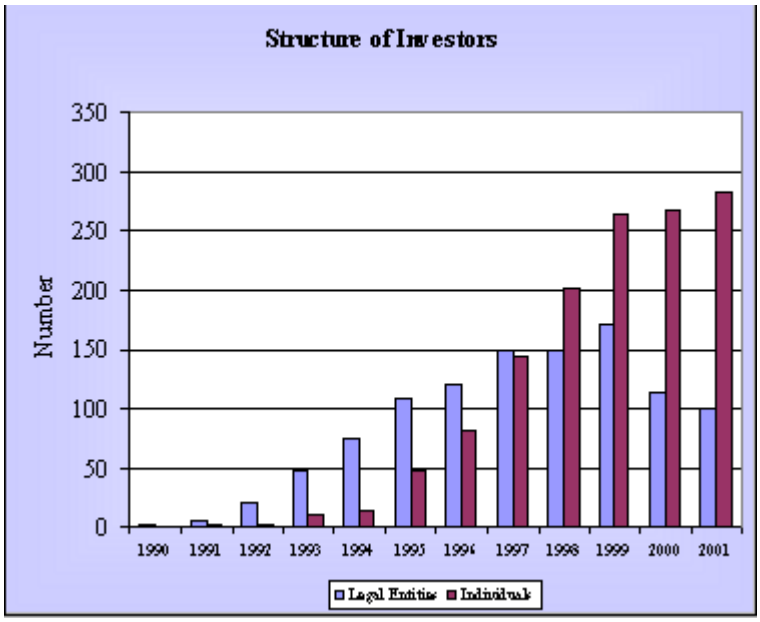
industry.

In 2001, most of the registered foreign invested companies are in trade and public catering sector. This in part due to the relatively low minimum investment amount required comparing with the other leading sectors. The leading companies by the amount of investment are China, Singapore, Great Britain, South Korea, Italy and Japan.

As of end 2001, about 2,000 foreign investment companies from approximately 70 countries with total investment of US$481 million were registered in the country. Among them, 71% are joint ventures and 29% are wholly owned foreign invested companies. Between 1998-2001 over US$300 million was committed with the average investment size per company of over US$238,000. High establishment of the joint venture companies reflects the importance of good local contacts and partners, their experience and ability to interact with local government providing a strong framework for the foreign investor to operate successfully.

Among investors, 45% are legal entities and 55% are foreign citizens and individuals with 72% (US$ 353 million) and 28% (US$136 million) of total investment respectively. Thus, US$333 thousand imposed to each investor company/organization and US$104 thousand to an individual. The number of investor companies and legal entities are reducing while investment by individuals is rising.






*Source: FIFTA*

The breakdown of foreign direct investment by country of origin demonstrates the major involvement of China, followed by South Korea, Japan, USA, and Russia. By 2001, China (not including Hong Kong, China) accounted for approximately 30% of all accumulated FDI (US$137 million). The total amount of invested capital by prevalent companies (60%), Whereas investors from the two neighboring countries have established mainly small enterprises investing around US$10-50 thousand, Japanese, American and Italian firms have invested an average of between US$350,000 and US$1 million per project (about 9.2%). It shows that, in spite of foreign investor's interest is growing in Mongolia, the big investments by international companies remained in very low level excepting merchants and dealers.

By the location, 91.2% of the total registered investment made in the capital city of Ulaanbaatar and 8,8% (i.e. about 23.86 million USD) in the provinces. Among them 25% registered in Orhon, 18.68% in Dornod, 8.8% in Darhan-Yyl and 5.8% in Bayan-Ulgii provinces respectively. In another word FDI basically made in the cities and provinces with more developed infrastructure.

To date, foreign invested companies have created more than 67,000 new jobs for domestic workforce and 2,500 foreigners are working at the professional, technical and management levels. Foreign invested companies operating in Mongolia provided totally MNT10.5 billion as tax incomes to the state budget, which possess 14.2% of the total tax incomes in 2000.

*Pros and Cons of Investing in Mongolia.* In comparison with other locations, namely the former Soviet Union and Eastern Europe where wage rates and operating expenses are equally competitive, Mongolia's access to particular raw materials, such as cashmere and minerals, the extensive incentive packages for investors and good local partners and contacts turn out to be the decisive factors for FDI. The lack of import quotas to the US and the countries of the European Union was an important deciding factor in the garment and textile industries.

In spite of the easy access to the potentially enormous markets of Russia and China, market access to the Europe and North America, particularly in the garment and cashmere industries has to be enlarged. High transportation cost because of the long distance from major markets is another concern. Even with its small size and limited spending power, the internal market is relatively high.

The pristine environment together with low labor costs and the particular niche market for adventure and 'off the beaten track' tourism is a major deciding factor for investment in tourism sector. However, the short duration of the tourist season is a particular disadvantage in this sector. Continued expansion in the tourism sector requires development of the transport and hotel infrastructure, both requiring substantial capital investment. Closer liaison between the Russian and Mongolian authorities to increase the frequency of the Trans-Siberian Railway is required according to many investors in tourism.

Frequent changes in government personnel and lack of transparency in decision-making and procedures by government officials, particularly in the enforcement of taxation and customs system were considered as main disadvantages for investment in Mongolia. Lack of advance tax ruling mechanisms adversely affects many investors' ability to develop their investments and there are considerable inconsistencies in the application of tax provisions.

For those companies relying heavily on tax incentives, there is concern about future profitability once the term of the incentives for individual companies expires. Particular concerns were noted by investors in the cashmere sector relating to the deteriorating quality of Mongolian cashmere, due to the decline of the government's long-term breeding programme. For those in the mining and mineral exploration sectors, the introduction of the gold export tax was a severe blow and activity in this sector by foreign investors has slowed.

Mining activities can provide considerable revenue for the government through taxes and royalties. Most mines in Mongolia are likely to be small to medium in size and ge

ographically diverse. They could very well create significant domestic demand for sm aller suppliers of good and services. In addition, the large informal mining sector and related services could transform themselves into viable SMEs. With expected moderat e growth in mining over the next ten years, there is a significant potential to develop S MEs to provide basic goods and services related to mining expansion.

The acquisition of land is often a prerequisite for increasing mining production. For lo cal populations making a living from traditional agriculture, monetary compensation i s often not a viable solution. The most advanced compensation agreements being used globally for displaced landowners combine mine employment with the creation of spi n-off businesses relating to mining activities, and some training/capacity building. Suc h an approach effectively compensates landowners by helping them acquire the capab ilities to use financial resources as alternative assets to land. Globally, mining compan ies have also responded to the need to support social programs that benefit the surroun ding communities by developing foundations that are capable of leveraging funds for community development and social programs from other sources such as private dono rs and public funds.

***Establishing adequate infrastructure to meet mining sector growth.*** A mining prospe ct's proximity to road, railway, and power infrastructure has a major impact on the cap ital costs of development. Geological prospects that would normally be viable become uneconomic if the costs of providing the necessary infrastructure are too high. Mongo lia needs to give serious consideration on how best to develop infrastructure over the next ten years, as the location of new roads, railways and power plants will have majo r impact on mining development. Almost all medium and large mine developments lik ely to occur in Mongolia will require significant new power, water, and transportation infrastructure. Mongolia's largest prospect, Oyu Tolgoi, is located in one of the most r emote parts of the country and has no water, power, or transportation within more tha n 300 kms. While it is possible to find water through drilling in the vicinity, a road or railway needs to be built to the site to connect with China, which would be a major m arket for the project. It will also be necessary build a power plant or provide high-volt age transmission lines from either the Mongolian or Chinese national grid. The prospe ct's operators are examining the possibility of building a railway line from China to th e deposit site financed by a range of possible options including using state funding. H owever, it is certain that the cost of providing the necessary infrastructure will dramati cally increase the capital cost of developing this prospect and may end up delaying its commissioning. The Tumurtiin zinc mine also is far from a railway line.

***The importance of government policies.*** While minerals can contribute significantly t o growth, governments and their policies for managing mineral wealth will ultimately define whether this potential is fulfilled or lost. Thus, a number of key issues need to be considered by the Mongolian economic and fiscal authorities. These include the ab sorptive capacity of the Mongolian economy and the policies required to overcome its constraints efficiently, the country's investment environment and the competence of it s institutions, particularly the fiscal and financial institutional framework, and the vari ations of the real exchange rate vis-à-vis variations of growth in the export indicators of non-traditional export sectors. Their objective should be to avoid policies or progra ms that lead to fiscal unsustainability, unproductive investments, rent seeking behavio r, and "Dutch disease" effects.

Fiscal and Debt Unsustainability. A large increase in fiscal revenues requires sound cri teria for public investment and expenditure to translate it into production factor accum ulation and productivity growth, lest the government falls prey to an expansive fiscal policy leading to excess investments and social welfare programs that saddle it with re current costs beyond its medium-term financial capacity. Loans to finance the consequ ent fiscal deficit could worsen the government's fiscal position and compromise debt s ustainability. Over time this can lead to high inflation and macroeconomic and politic al instability.

Perhaps the worst response to a substantial increase in fiscal revenues from a mining b oom is for governments to create or expand state-owned enterprises. These undertakin gs are likely to fail, leaving a legacy of fiscal debt and losses. Eventually, revenues fro m mining drop, subsidies to other sectors can no longer be paid, and protection becom es too expensive. Then, these sectors exposed to fierce competition are forced to contr act, leading to slower or even negative growth rates.

Rent Seeking Behavior. When government institutions are weak increased fiscal reven ues from growing mining output may further affect growth if rent seeking and patrona ge penetrate the government. Growth is impaired because, although public investment increases, its productivity drops. Corruption usually reduces the quality of infrastruct ure, which increases the cost of doing business for the government and the private sec tor and leads to lower output and growth. Without good governance, a rapid increase o f fiscal revenues originated in natural resources windfalls or aid flows will likely be as sociated with a decline in the quality of expenditure and lack of transparency and acco untability in the use of these resources.

Absorptive capacity constraints. Even without corruption or rent seeking behavior, a l arge increase in mining fiscal revenues could lead to unproductive public and private i nvestments because of absorptive capacity constraints, such as weaknesses in public e xpenditure and financial management, weaknesses in policies determining the broad i nvestment climate, and infrastructure bottlenecks. Under these circumstances, public i nvestments in projects with very low or even negative social returns could be carried out. In absence of profitable alternatives in which to invest additional income, private investments would turn to the real estate market, leading to construction booms and re al estate speculation that can eat up most of the windfall.

Unproductive investment booms can have strong historical foundations and have been a typical trap for developing countries eager to diversify their economies.

Dutch Disease. A significant increase in mineral production can also affect the compet itiveness of the non-minerals export industry, notably manufacturing, commonly calle d "Dutch Disease." Due to the mining output expansion, input factors, especially labor, will move toward the mining industry, usually drawn by increased wages. This slows manufacturing growth, which can affect the entire economy, as manufacturing industr y is considered to have greater dynamic externalities and learning effects than mining. Thus, an expansion of mining at the expense of the manufacturing industry can reduc e productivity growth. The intensity of this effect will depend, however, on the level o f unemployment, as the mining production expansion taps into idle labor. The risk of Dutch Disease is minor for the Mongolian economy as, like many low income develo ping countries, it has idle capacity to utilize for expanding mining production, if requi red.

Productivity growth. An economy can also lose if mining expansion causes an appreci ation of the exchange rate that impairs the competitiveness of domestic manufacturing as imports become cheaper and exports less competitive. Such a situation, however, i s conditioned by the way the additional income or revenues from mining are managed. If, for example, mining revenues are largely invested in improving the quality of labo r, i.e., through better health and education services and infrastructure, the decline in pr oductivity growth can be compensated in the medium term. Moreover, because of the large productivity gap between industrialized and low-income developing countries, it is possible that a low-income country could experience a sustainable real appreciation of its currency if low-cost productivity increases were achieved. Thus, as long as the additional revenues from mining expansion are used to unlock low-cost productivity g ains, an appreciation of the exchange rate will affect neither manufacturing nor econo

mic growth.

### *VI. Conclusion*

Mongolia has fully shifted to market economic principles and there has passed a decade since economic entities in Mongolia are operating under market conditions. Attraction of foreign investment into Mongolia’s economy has now become the key factor to propel Mongolia’s development.

Mongolia, with its good geology and undoubted mineral endowment, stands to benefit by continuing to reform its mineral sector, improving its fiscal competitiveness, and encouraging private exploration and development of its vast land mass.

While production of most minerals decreased during the 1990's due to the rapidly changing economic conditions during the transition to a free market economy, gold production nevertheless increased by a factor of 10. At the same time, the pace of mineral exploration by Mongolian and particularly foreign investors has increased tremendously. However, in spite of the recent dramatic increase in mineral exploration activity approximately 75% of Mongolia's territory still remains open to new mineral exploration licensing.

At the moment mining industry is the most prioritized and promoted sector in Mongolia. The industry is increasing influenced by a limited number of well-financed, technologically advanced international mining companies. These companies are highly selective, risk averse, and sensitive to changes in the investment climate. According to the survey made by UN/World Bank, factors used by these companies to evaluate mineral projects and potential investments are: geological prospectivity and mining tradition; clear mining rights and title (legal/regulatory framework); attractive and competitive fiscal conditions (fiscal legislation); ownership and control of operations (legal/regulatory framework); political stability and transparency of governance (institutional capacity); availability of infrastructure.

Significant increases in mining production can lead to increased regional demand for intermediary goods and services. Part of this demand will be for infrastructure, such as roads (or ports) whose development - along with mines and processing facilities – can mobilize large and medium enterprises. That infrastructure creates positive, although static, externalities, such as reductions in transportation costs, better access to markets, and requirements for maintenance. Another part of demand will be for intermediary

inputs, such as machinery, equipment, chemical reagents, transport services, and electric power, opening possibilities for developing a diversified chain of suppliers. There is scope, therefore, to improve the information available to buyers and sellers about each other's needs and capacities to strengthen the links between large mining operations and local suppliers.

As new mines come on-stream there is potential to develop SMEs to supply support goods and services. This could reduce the cost of importing substitute goods and have a marked impact on local employment with the additional benefit of linking mines and local communities. Programs are required to incubate and nurture fledgling SMEs, as the general skills base in Mongolia is low, especially in IT, accounting, marketing, promotion, finance, and general management.

Mongolia needs to give serious consideration on how best to develop infrastructure over the next ten years, as the location of new roads, railways and power plants will have major impact on mining development. Almost all medium and large mine developments likely to occur in Mongolia will require significant new power, water, and transportation infrastructure.

Artisanal mining has become part of Mongolia’s informal social safety net. It is not a longstanding traditional activity but primarily a response to the adverse effects of economic restructuring, which has resulted in job losses, inflation, and declining real incomes. Artisanal mining is a viable solution for many because it is a highly labor intensive, technologically simple, and low-cost activity. In 2001 the government attempted to accommodate artisanal mining by enacting an interim regulation of this informal activity. That regulation proved ineffective and unworkable; it lapsed after one year and was not renewed. The government should create a legal framework for artisanal mining.

The Government has to improve the terms and conditions of the Stability Agreement and public services rendered to foreign investors, to mitigate bureaucratic pressure from local authorities and provide one-stop services. The motive to refine the Stability Agreement is as follows: "A major investor's operation covers not only a licensed area, but also the whole region which embodies the licensed area".

There is also potential in the informal mining sub-sector, where there is broad demand, large numbers of unregistered micro-enterprises have emerged, and structured assistance could lead to more sustainable development of the rural economy. Although the transformation of informal miners into responsible SMEs will require considerable capa

city building and support of all involved stakeholders, it should be regarded as an opp ortunity to promote local community development.

The legal framework for mining seldom gives local communities rights to participate i n the benefits of mining activities. Since the 1990s, however, there has been increasin g recognition that communities should share in those benefits through (i) land acquisit ion and compensation; (ii) economic benefits sharing, and (iii) social programs. Minin g companies required to compensate communities for land they acquire should recogn ize that the value of land is often less important than the need to adjust traditional way s of living to the changes that the mining operation will bring. Thus, the most advance d compensation agreements provide displaced landowners employment in the mine; h elp create spin-off business relating to mining activities, training, and capacity buildin g. Only this type of approach can effectively compensate landowners and assist them i n acquiring the capabilities to use financial resources as an alternative asset to land.

What are the advantages of mining sector of Mongolia? There is a vast territory under which reserves can be found anywhere. There are several hidden deposits as large as Oyu Tolgoi (Turquoise Hill; newly discovered deposit with large amount of copper and gold) and there are two big markets; China and Russia, in the north and south. Recently, the Chinese economy is mushrooming, which will probably mean more demand for mineral resources. The country is rich with all mineral resources, except diamonds.

Mongolian mining is a young industry, growing in the last few years. There are only a few plants, compared with worldwide ones. The figure for gold mining is 12 tons a year, which is satisfactory for us. This amount is what one African company alone mines. Still, the mining industry is relatively large in the country.

With the government budget, around 140 tons alluvial and hard rock deposits, with different reserves, were explored during the 90s. Private investors have already invested for mining of the most of these deposits by today. Copper is special compared with gold. Efficient production is achieved only if the copper deposit is very large. The price on the market entirely depends on the level of infrastructure development. As a market rule, the sequence for running business is investment first and then market. Once there is a market, any business can earn a profit. Supply and demand rather than just government policies directly triggers the investment.

Regarding the legal issues, major legislation implemented in the sector includes laws

on minerals, land, environment and land subsoil. According to foreign investors, the Minerals Law can be ranked high in Asia in terms of its content and principle, including, for example, an article containing precise regulation to serve and issue license for the first-comers.

While in the past the evaluation of Mongolia's mineral potential was hampered by limited infrastructure, a command economy, and other governmental restrictions, these barriers to mineral exploration are now coming down. Thus the improving business climate combined with the existence of an extensive geological database and indications of many types of deposits of gold, copper, base metals, and other minerals has led to increased foreign investment in mineral exploration and development.

Consequently, Mongolia now offers many promising opportunities for investors seeking to enter Mongolia's mining sector. These opportunities are facilitated by a supportive government attitude and the presence of many unexplored regions with high mineral potential. Furthermore, the Mongolian Government and many Mongolian companies are eager to work with foreign investors who can provide new capital investment, technology transfer, and modern mine management, and who can open new markets for Mongolian mineral products.

Tax incentives apply to mining investments include a three-year income tax exemption and 50% reduction for the subsequent three years for mining enterprises with foreign investors. The extensive incentive packages for investors and good local partners and contacts turn out to be the decisive factors for FDI. Mining is a fairly risky business. According to the practice in other countries, risk is taken into consideration when determining the tax amounts. But Mongolia fell short in doing so. 2.5% tax for all types of mineral resources must be paid as a royalty, which is deducted from the income from sales. The former 10% VAT paid from the sale of gold was cancelled by the amendment made last year. Therefore, the gold royalty for alluvial deposits is 7.5% and hard rock deposit 2.5%. It is not internationally competitive. Tax system should be changed taking risk into consideration.

While minerals can contribute significantly to growth, governments and their policies for managing mineral wealth will ultimately define whether this potential is fulfilled o r lost. Thus, a number of key issues need to be considered by the Mongolian economi c and fiscal authorities. These include the absorptive capacity of the Mongolian econo my and the policies required to overcome its constraints efficiently, the country's inve

stment environment and the competence of its institutions, particularly the fiscal and f inancial institutional framework, and the variations of the real exchange rate vis-à-vis variations of growth in the export indicators of non-traditional export sectors.

The mining industry demands a lot of investment. Those engaged in mining activities usually start their business with long and short-term bank loans. The interest rate for loans, along with tax, should be based on risk in the industry. There should not be only two ideas of tax discount and tax exemption because any entrepreneur is supposed to pay taxes. In other words, the investment put in by a businessman should be paid back.

How to improve investor confidence in the administration of the tax system: There are several improvements that could boost this confidence. First the corporate income tax law should include a loss carryover provision consistent with international best practi ce. Second, this law should prescribe the tax treatment of exploration and developmen t expenditures. These expenditures can be substantial, but the current law does not add ress their tax deductibility. Third, the tax treatment of mine reclamation and closure co sts should be addressed in the corporate income tax law. Fourth, the corporate income tax law should confirm the deductibility of mineral royalties in determining taxable in come.

The government must be mindful that, based on the experience of other countries, sta bility agreements can be counterproductive if they are not handled in a transparent an d consistent manner, and in accordance with clear guidelines.

I hope that new investors entering the mining sector will experience changes. The current companies in the mining sector were established around 10 years ago and therefore they do not feel the change much. Amendments in the law to exempt them from customs duties and import taxes will be experienced more by newcomers. Otherwise, the taxes and duties will not apply to investors who already brought equipment and machinery to Mongolia. Government need to continue efforts to control corruption in it’s service and in the courts – it exists at present but it is not too late to bring it under control.

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