Mongolia’s Future and Declining Raw Material Prices

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Abstract

Mongolia is a country whose Gross Domestic Income relies heavily on raw material prices. The recent downturn in important commodity prices like copper or coal affect national income, taxes and the social welfare system. Mongolia should try to diversify its industries further to become less dependent on commodity business cycles. Mongolia should also try to lower the rate of corruption, which in many countries is highly correlated with mining businesses. Modern high tech companies and business technologies are corruption averse. Relationships based on corruption are short-lived and instable. This is what those companies do not like. A country like Mongolia that strives towards high wealth and less dependence on commodities should try to get rid of corruption.

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A fabulous rise lies behind Mongolia. The GDP per capita (in USD) has doubled throughout the last ten years.¹ New homes, factories, offices and roads were built everywhere. Infrastructure has improved considerably. And in the country living conditions became better. Wealth has increased everywhere.

Now in 2015, though, Mongolia is facing a decline in raw material prices. Compared to 2008, the coal price fell by more than 50 per cent. The copper price was facing the same fate – after a high in February 2011 it plunged by more than half. The implications are:

- Reduced turnover of companies,
- Reduced tax income,
- Forced cost reductions in all areas,
- Standstill on construction sites,
- Less income for the people,
- New projects are put off.

Many Mongolians observe the standstill and wonder how everything will go on – now that more and more mines make losses and may have to close.

What should Mongolia do?

**Arrange with income fluctuations**

First of all, a country that depends on raw material prices has to cope with larger income fluctuations than other countries. Raw materials belong to the goods with the largest price fluctuations on the market. Who lives off raw materials has to be able to get along with boom and depression times. In boom times, not all money may be spent. Instead, some money has to be held back and a financial bolster must be created. All investment projects launched must have a positive present value even in depression times. Social benefits should be retained within a reasonable extent. If too high, they cannot be covered in crisis times.

**Recommended investor behavior**

There is much that investors can do to bridge recession times. However, a wrong behavior may lead to the collapse of the country’s entire economy. The rule is: renunciation. In crisis times investors must dispense with dividends and coupon payments. They should not ask for debt redemption. Short-term loans should be prolonged. Of course, investors have the right to claim their dividend, coupon and redemption payments. If

they do, though, they provoke bankruptcy which will then result in further standstill, more unemployment and decreasing income.

As a general rule, all activity which has to do with raw materials should be financed with as much equity as possible. This way, the companies can cope with recession times without greater difficulties. Mongolian companies that have loans due have to contact their investors early enough to discuss the situation and to adjust due date and interest rates.

**Recommended state behavior**

Being rich of commodities is challenging for a country's administration as well. Public revenue suffers much under fluctuating raw material prices. While in boom times tax revenue is unusually high, in recession times it is unusually low and poses a threat. In the first months of 2015, the Mongolian tax revenue sank by 11 per cent. The state budget deficit increased to 18 per cent of the spending. This is a high figure – taking in consideration for how long the crisis may go on. Due to the lack of funds, the Mongolian state had to cut its investments down to 30 per cent of the intended volume. However, social spending remained as high as 90 per cent of their planned value.

It is clear that a core of social spending has to be maintained. People need stability of what they can expect. Poverty and misery must be prevented. If the current revenue is not enough to cover at least social spending, the state has to issue new debt. This implies a good analysis of the long-term expectable revenue. However, having exaggerated hope of too high raw material prices is wrong. Overestimating revenue sales prices will cause the debt crisis to continue and worsen.

**The corruption problem**

Corruption and raw materials are closely linked in many countries all over the world. Both are also present in Mongolia. However, everywhere there are attempts to drive back corruption. The Mongolians can be proud of their consistent fight against corruption.

This is reasonable, because corruption is especially dangerous in raw material dependent countries:

- In boom times, when raw material prices are high, many investments appear profit-yielding. Large bribery payments can be diverted easily. Projects seem to be profitable even if large bribes are paid. From an outside perspective it is impossible to perceive if an involved decision maker siphoned off bribe money.

- In recession times, when raw material prices are low, corruption strikes back. Now income is missing in virtually each and every corner. Money paid into bribery is lost and enriches only individuals, while large parts of the population suffer. Paid in to a social fund, that money could buffer social spending.

Transparency International developed a corruption index. Mongolia is listed on position 80 out 175 countries, reaching almost 40 out of 100 possible points. However, 40 points are too few. Mongolia has to tackle corruption more widely.

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² 100 points means that the country is corruption-free.
The World Bank inquires on a regular basis if the countries are fighting corruption actively. Therefore, it developed the Control of Corruption Index which indicates the country's efforts. Mongolia does not come off well here, only reaching 28 out of 100 possible points. This means, that the Mongolian state's efforts are not intensive enough to get corruption under control and distribute the funds fairly among everyone.

Corruption and debt

At the next economic recovery the latest, Mongolia needs new foreign investment capital. Therefore it has to make sure not to jeopardize its reputation with investors. Corruption is an immense threat to reputation.

International investigations showed that the payback of debt is less likely for corrupt countries. There is a positive relationship between corruption and the probability that a country declares a moratorium. Figure 1 shows the empirical results. In the corruption class of Mongolia (CPI Value 40) countries have a probability of declaring a moratorium at some point between 32% and 68%. It is no honor to belong to this group of countries.

<table>
<thead>
<tr>
<th>Corruption index (CPI Value)</th>
<th>Corruption strength</th>
<th>Moratorium probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>100-&gt;80</td>
<td>No Corruption</td>
<td>0%</td>
</tr>
<tr>
<td>80-&gt;60</td>
<td>Moderate Corruption</td>
<td>11%</td>
</tr>
<tr>
<td>60-&gt;40</td>
<td>Medium Corruption</td>
<td>32%</td>
</tr>
<tr>
<td>40-&gt;20</td>
<td>Strong Corruption</td>
<td>68%</td>
</tr>
<tr>
<td>20-0</td>
<td>Extreme Corruption</td>
<td>80%</td>
</tr>
</tbody>
</table>

Annotation: According to Transparency International, in 2014 Mongolia had a CPI-Value of 39. It lies therefore at the boundary between medium and strong corruption.
Definition: A moratorium of a country is a deferral of all future payments to its debtors. The probability of a moratorium refers to a period of 30 years.
Source: Transparency International Corruption Perception Index CPI; Club de Paris – Paris Club, own calculation, TU Chemnitz.
What should Mongolia now do?

As a raw material dependent country, Mongolia has to expect larger revenue variation than other countries. Just because of that it needs to reduce its dependence from the raw material sector, and produce a wider variety of goods and services. In order to do that, it needs cooperation with modern and well-operating firms from all over the world. Such firms will by no means tolerate corruption. Instead, they require political stability, a reliable judicial system and a climate friendly to investments without bureaucratic hindrances.

Generally, countries with natural resources are exposed to corruption. A country like Mongolia, aiming to be internationally accepted, should not have anything to do with corruption. Modern companies want to do their business without having to deal with the uncertainty produced by corruption. Corruption is dangerous for everybody involved. It leads to insecurity. Nobody will know the earnings of a deal exactly because of the number of repercussions corruption may have. These include, but are not limited to, being caught, being excluded from futures deals, having to pay money back or being punished. Relationships based on corruption are short-lived and instable. That is why deals that include corruption are expensive for all parties involved. A country that strives towards high wealth does not need such deals.

The Mongolian state has to take into account massive fluctuations of raw material revenues. If possible, Mongolia should create a state fund in good times that serves social expenditures in bad times. All necessary steps must be taken to maintain creditworthiness, which allows borrowing money even in recession times. For that, the state has to prove its willingness to pay debt back in boom times. The state has to rely on long-term, conservative raw material price estimations to reliably predict possible long-term social spending.

Food and other daily needed goods should be of domestic origin. The state should promote according activities or protect domestic production by levying duties. If basic goods are imported, their cost will be high during crises. That is because in a crisis, the value of the own currency, relative to foreign currencies like Dollar, Euro, Yen or Renmimbi, goes down. Foreign currencies become more expensive and all imported goods become more expensive as well. For the poorest this will result in privation as they will no longer be able to afford certain goods. Domestic production of basic goods is the best remedy against this.

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