Ministry of Finance, Mongolia

Managing Fiscal Revenues From Extractive Industry:

The Case of Mongolia

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Contents

Mongolia's Economy and Mining Sector

- One of the fastest growing economies globally with an average real GDP growth rate of 8.9% p.a. (2003-2014)
- Abundant mineral resource base that can be leveraged for industrialization
- Favorable and sustainable business environment for FDI and trade
- Fiscal policy and debt management improvement by newly adopted laws
- Strengthening financial sector

Nominal GDP		GDP/ Capita	Real GDP Growth			
$11.5b (2013)	$12b (2014)	$4,320 (2014)	17.3% (2011)	12.3% (2012)	11.6% (2013)	7.8% (2014)

Mongolia's World Class Mineral Reserves

Main Mineral Resources	Estimated Reserves (Q1 2015)
Copper (mm tons)	45,796.2
Coal (mm tons)	21,695.9
Gold placer (tons)	537,566
Gold hard rock deposit (tons)	34.7
Tin (mm tons)	14.9
Iron (mm tons)	360.4

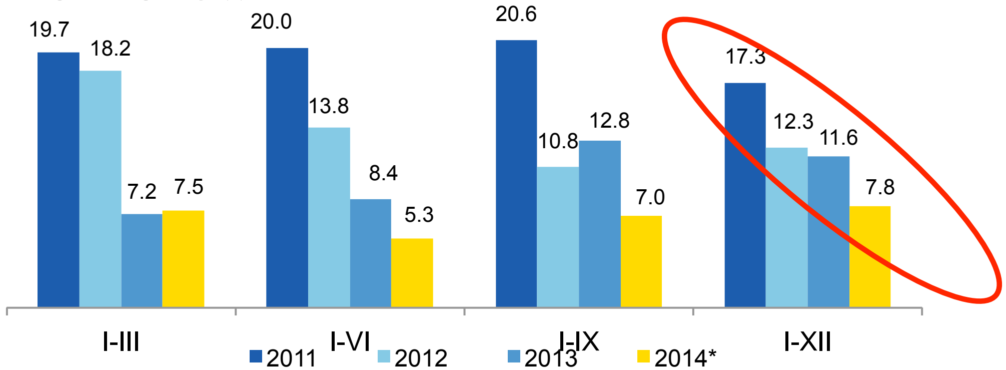
Over the past decade, a boom in mining exploration confirmed the existence of large mineral deposits – notably copper, uranium, oil, coal, iron ore, and gold. Investments are underwriting world-class mineral projects: Examples,

- Oyu Tolgoi (OT), signed in 2009, is likely to become one of the five largest copper and gold mines in the world;
- Tavan Tolgoi (TT) mine has potential to supply high quality coking coal for more than 100 years.
- There are also several other ongoing mining projects.

Mongolia's Economy and Mining Sector

As a result, Mongolia has experienced rapid economic growth generated by rising international commodity prices and new mineral discoveries. In 2010-2014, overall economic growth was mostly driven by the mining industry boom.

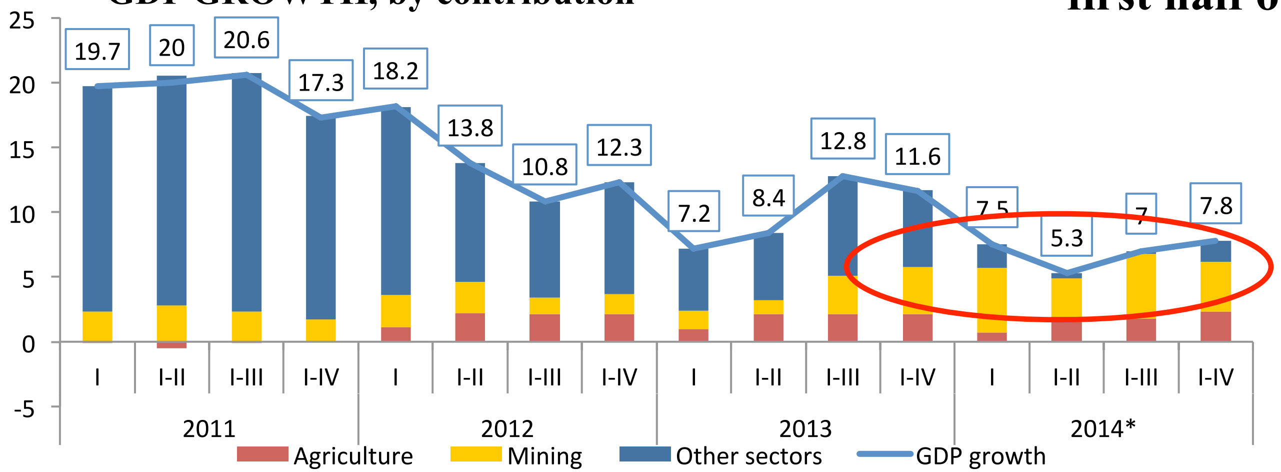
GDP GROWTH



However, the economy has become more volatile as commodity prices have declined.

GDP growth fell from 17.3 percent in 2011 to 7.8 percent in 2014 (and to 3.0 percent in the first half of this year).

GDP GROWTH, by contribution



Economic growth is mainly determined by mining sector growth

Attempts to Establish a Sovereign Wealth Fund

- Since 2007, the Government has tried to establish a fund that accumulates revenue from the mining sector and can be used for the development of the country:
    - **The Mongolian Development Fund(MDF)** was set up by law in 2007
    - **The Human Development Fund (HDF)** was established by law, and replaced the MDF, in 2009.
- The main purpose of these funds was to accumulate the excess revenues from the mining sector, and to target resources for the economic and human development of the country.

Challenges and Problems

- During parliamentary elections in 2004 and 2008, political parties competed with one another by making political promises such as cash allowances, untargeted social welfare measures, etc.;
- The MDF and HDF have been used as vehicles to fulfill these populist political promises;
- Spending rules of MDF and HDF were to distribute money for child welfare, to cover budget deficits, and to spend on cash allowances.

Lessons learned:

- High inflation, and economic overheating due to the large amount of cash allowances and social welfare spending;
- Pro-cyclical fiscal policies;
- Inefficient public resource spending;
- Increasing public debt rather than accumulating wealth. This has created intergenerational inequity.

Recent Reforms in Fiscal Frameworks

- In 2011, the leaders of all political parties signed a memorandum stipulating non-competition with one another by giving political promises such as cash handouts to the citizens.
- The idea of a fiscal stability mechanism was at the center of the economic policy debate in Mongolia. Thus, several laws have been passed to meet that goal. For example,
  - The Fiscal Stability Law (FSL), passed in 2010, set principles on the macro-fiscal management framework, created special fiscal requirements, established a Fiscal Stability Fund, and put certain limits on the power of parliament in regard to budget approval.
  - The Integrated Budget law, passed in 2011, provided comprehensive principles and guidance on the budgeting process.

Recent Reforms in Fiscal Frameworks

Special Requirements of the FSL

1. The structural balance of the consolidated budget shall have a deficit of no more than 2% of GDP;
   - SFB >= -2% of GDP.
2. Budget revenue shall be estimated on a structural basis;
   - Major minerals: Coal, copper (more than 3% of total budget revenue)
   - Prices of major minerals are estimated based on past 12 years moving average, plus 3 year's projection.
3. The total budget expenditure growth rate shall not be greater than the greatest of the non-mineral GDP growth rate of that particular year and the average of the non-mineral GDP growth rate for 12 consecutive years;
   - Expenditure Growth(t) =< Greatest of [Non mineral GDP(t)] or [Average of Non-mineral GDP growth of past 12 years].
4. NPV of Government debt shall not exceed 40% of GDP (effective from 2018).

Stabilization fund

to reduce volatility in the budget by accumulating the excess revenues from the structural basis revenue.

Implementation of the FSL

	2012	2013	2014	2015*
SFB, /% of GDP/	-6.8	-1.2	-3.7	-5.0
Government debt/GDP	43.6	47.3	48.2	58.3

Special requirements, except NPV of the government debt, of the FSL took effect in 2013.

However, in 2015, the parliament amended the law and postponed the effective dates of special requirements until 2018.

Future Heritage Fund

The purpose of the fund is to diminish the unpredictability in government revenue and expenditure. In future, we need a saving fund which will accumulate money for the future generations when resources will be depleted, or to reduce future liabilities such as pension expenditures.

- Currently, Government of Mongolia is restructuring the HDF into the Future Heritage Fund /FHF/.
- The fund have to ensure intergenerational equity, and help to avoid "Dutch disease."
- The Government has submitted a draft law on the "future heritage fund" to the parliament. The law is expected to be discussed in the current legislative session.

FHF revenue sources:

- ❑ 70 percent of total royalties;
- ❑ Dividends on the state's share of strategic deposits;
- ❑ 20 percent of mining sector revenue in excess of base-year outturn;
- ❑ Returns on state investments;
- ❑ Additional revenues related to changes in the legal environment.

Conclusions

The main lessons from the Mongolian experience include the following:

- **Budget revenue, which is estimated on structural basis, reduces pro-cyclicality of the budget.**
- **Clear rules, which restrict government spending from the fund on social welfare, increase government credibility.**
- **The fund ensures intergenerational equity, and helps to avoid over-reliance on mineral extraction.**
- **Solid institutional arrangements and good governance are crucial to create a successful sovereign wealth fund.**
- **Mongolia needs continued improvement in personnel capacities in managing financial assets in the global market.**

THANK YOU FOR YOUR ATTENTION