

Ninth Tranche of the Development Account Project

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# Enhancing the Contribution of Preferential Trade Agreements to Inclusive and Equitable Trade

COUNTRY STUDY SERIES

## Enhancing the contribution of preferential trade agreements to inclusive and equitable trade: the case of Mongolia

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The Development Account is a capacity development programme of the United Nations Secretariat aiming at enhancing capacities of developing countries in the priority areas of the United Nations Development Agenda. The ninth tranche of the Development Account is aimed at supporting Member States in designing and implementing strategies and policies towards sustainable, equitable and inclusive development. Trade is an important part of this process, as expanding trade and investment has driven growth in many developing countries, leading to major reductions in poverty and overall increases in welfare. However, substantial variations in performance among countries persist and, as a consequence, not all countries - and much less all groups and individuals within countries - have been able to benefit equally from trade. In particular, the least developed countries, landlocked developing countries, and other countries with special needs, have not benefited from trade as much as some other developing countries. In order for these countries to foster further economic and social development, they need better access to markets alongside further development of productive and supply capacity.

Towards that end, the project 'Enhancing the Contribution of Preferential Trade Agreements to Inclusive and Equitable trade', led by the Economic and Social Commission for Asia and the Pacific (ESCAP), in partnership with the Economic Commission for Africa (ECA) and the Economic Commission for Latin America and the Caribbean (ECLAC) aims to increase the potential benefits of preferential trade agreements for a set of developing countries identified to be in crucial need for assistance. The project aims to increase the capacity of these countries in identifying the potential benefits and costs of preferential trade agreements, increasing their means to effectively negotiate development-focused preferential trade agreements, and better utilize already negotiated concessions for their benefit. The identified beneficiary countries are: Burkina Faso, Guinea, Mauritius, and Senegal (Africa); Ecuador, Guatemala, Honduras and Jamaica (Latin America); and Bangladesh, the Islamic Republic of Iran, Mongolia, Myanmar, and Viet Nam (Asia-Pacific). The project will involve capacity building national workshops in the pilot countries, followed by a capstone regional dialogue for the different countries to share experiences and learn from another. Furthermore, the training materials, in addition to background documents and other materials derived from the workshops, will be made available online through a public knowledge sharing platform for all interested users as reference material.

The most significant output of the project will be enhanced capacity among government officials and trade negotiators to formulate inclusive development-friendly preferential trade agreements so that trade arising from such policies has inclusive and equitable results: improvements in labour standards and wages; the elimination of child labour; positive impacts on gender equality; and enhanced contribution to general welfare, in particular for marginalized excluded groups.

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## 1. Introduction

In the new era of globalization, every country aims to boost the income of its people and improve the quality of life by revising the terms of trade using demand opportunities in foreign markets, by increasing the efficiency of trade participation, and by improving trade balance. However, integration of a national economy with the world economy through exchange of goods and services, capital flows, technology, information, and labour migration, ultimately requires greater liberalization of trade.

Over the years of transition, Mongolia has gradually implemented policies to liberalize its foreign trade and foreign investment regimes with the objective of promoting economic growth and economic sectors through an active trade policy, and increasing the country's exports. Ever since, the impact of liberalization on the economy of Mongolia and, in particular, on the lives of its people, has become a hotly debated issue.

However, during the transition, Mongolia went through several turbulences; the country had to go through a long and hard way towards restructuring its obsolete economic system, opening its market, liberalizing trade, putting in place a system with a greater degree of competition and a broad-based ownership of assets, all of which have helped in overcoming the economic downturn of the initial years of transition and stabilizing the economy.

For the purpose of current study, liberalization is viewed purely in its trade and economic dimensions – defined as removal of self-imposed barriers to trade and services; establishment of bilateral trade and economic cooperation agreements; and participation in multilateral trading arrangements.

Trade liberalization through preferential trade agreements may have enormous impact on trade and investment flows among countries. Preferential access to foreign market is obviously a source of economic efficiency, which ultimately leads to economic growth, employment generation, poverty and inequality reduction.

This study will attempt to present a clear understanding about the economic and social impacts of such preferential trade agreements on Mongolian economy and society, and to draw some policy conclusions. Within this framework the current study, there are multiple objectives as follows: (1) to provide background information on trade and economic situation in Mongolia; (2) to throw light on economic growth, trade, poverty and employment nexus in the Mongolian context; and, (3) to analyze preferential trade agreements of Mongolia and their impact on the country's economy.

Hopefully, Mongolian experience would be helpful to other countries encountering similar situations and challenges, and which may be useful in policy reforms in their external sectors, in particular, which are designed at establishing preferential trade agreements.

## 2. Trade and economic situation in Mongolia

Mongolia is a landlocked country, sandwiched between two giant neighbors – the Russian Federation and China – and located in the plateau of Central Asia, very far from seas and oceans and key international road and transport networks. The nearest seacoast<sup>1</sup> from the country is located at a distance of over 1700 km.

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<sup>1</sup> Batnasan Namsrai., *"Foreign trade: operational management and legal regulations"* Ulaanbaatar, 2003

Mongolia is the 17th largest country in the world in terms of the size of its territory of 1,564 million square kilometers and is larger than the combined size of the United Kingdom, Germany and France. The geography of this vast territory is characterized by towering mountains in the west, wide and open steppes in the east, the great Gobi Desert in the south and taiga forest in the north. Its climate is characterized by long winters with frequent snow blizzards and *dzud* or severe winter conditions; spring with persistent winds; hot and dry summers with low precipitation; and a short vegetation season.

The country's population is relatively small though. As of 2015, the country's population was just over 3.2 million, of which 45.7 percent lived in the capital city of Ulaanbaatar and 15.8 percent lived in the central region, where the capital is located. At the same time, none of the 21 administrative units outside the capital contained more than 5.0 percent of the population. Thus, population in rural areas is spread over vast distances, which makes Mongolia one of the most sparsely populated countries in the world.

Geography, location and demographics plays a critical role in Mongolia's economic development. The country's small population compared with its vast territory is a cause of some national weakness. Especially population in rural areas potentially suffer certain economic and social disadvantages due to the problems of distance and remoteness. Markets in rural areas are small while the costs for providing infrastructure such as roads, schools and health centers to remote areas are high.

It is basic economics that a market will come into existence only if the potential gains from market transactions exceed the transaction costs. Because of the small market, caused by scattered and small population, low level of income; markets have not developed in rural areas. The more scattered the population, the more inefficient to make an investment, and more expensive it becomes to produce and consume. Thus, businesses in rural areas are not well developed and rural agricultural sector fails to attract both foreign and domestic investments.

Geographical location is a principal driver of opportunities and the cost of living in Mongolia, especially considering the poor state of roads in remote regions, and the relatively high cost transportation externally and internally. Yet paradoxically rural isolation is eliminated by the transport infrastructure, with rural communities facing problems both in terms of market access and costs of production. Therefore, economic survival is difficult for rural businesses struggling to compete relative to businesses in urban areas. In addition, being a landlocked country Mongolia itself is isolated from world markets. Great distances, extreme weather conditions and a sparse and isolated population, are all contributing to the low competitiveness of Mongolia's export products on the global market.

Pre-transition Mongolia was a least industrialized country, very much dependent on the former Soviet bloc nations for assistance and grant aid. However, within the bloc, Mongolia's economy was one that was the most dependent on foreign grant aid and assistance, the country successfully traded within the bloc under the concessional terms of trade guaranteed by the Council of Mutual Economic Assistance (CMEA)<sup>2</sup>. Per capita GDP at that time was only USD1664.6 and the country's total trade turnover was close to only USD1.5 billion.<sup>3</sup>

At the beginning of the 1990s, the people of Mongolia made a historic decision to overhaul both its political and economic systems and made their transition to market economy. Two decades later, after

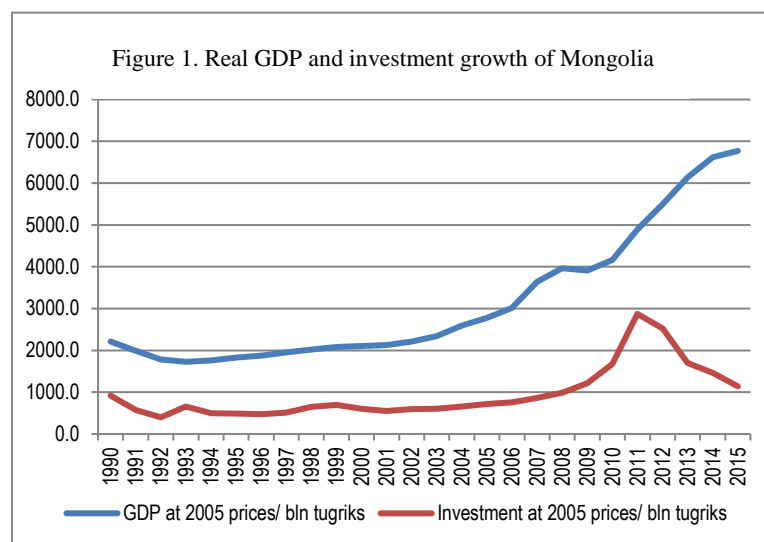
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<sup>2</sup> CMEA or better known to the West then as COMECON, which was an economic organization from 1949 to 1991 under the leadership of the former Soviet Union that comprised the countries of the Eastern Bloc, including Mongolia. COMECON was meant to prevent countries in the Soviets' sphere of influence from moving towards that of the United States and South-East Asia.

<sup>3</sup> The World Bank *"Country meta-data of Mongolia"* 2012

the collapse of centrally planned economy, Mongolia, a country that was dependent on foreign aid and assistance and with a small economy, had made giant strides of success in its economic transition.

After the disintegration of the socialist bloc in 1991, Soviet aid, which had until then played a critical role in the country's economy, came to a screeching halt and stopped altogether. This aid then amounted to almost 30 per cent of the GDP.<sup>4</sup> At the same time, Mongolian economy was dealt another severe blow with the dissolution of the CMEA, which then accounted for more than 90 per cent of Mongolia's external trade<sup>5</sup>.



The combined effect of these dramatic external shocks inevitably pushed the country's economy to its brink. Between 1990 and 1993, the country's GDP fell by 20 per cent and total investment shrunk by 28.2 per cent.<sup>6</sup> Industrial and construction sectors went through a plummeting by 25 and 70 per cent respectively.<sup>7</sup>

Like many other former socialist economies, Mongolia experienced hyperinflation in the first few years of transition, followed by steady disinflation in subsequent years.

The annual inflation rate reached an unprecedented peak of 325.5 per cent in 1992 and 183.0 per cent in 1993, which then fell rapidly, dropping to a single-digit unit by 2000.<sup>8</sup> The sharp decline in domestic production and the loss of external markets led to the emergence of 'twin deficits' – on fiscal and current accounts.

In the mid-1990's, the Mongolian Government, for the purpose of stabilizing the economy, opted for a transition strategy, which in economic jargon is popularly known as "shock therapy". Prices were liberalised, state-owned enterprises were privatized, free trade regime was introduced, balanced budget were achieved, an independent central bank and a fully convertible flexible currency were introduced.

These measures to stabilize the economy and promote foreign and domestic investments have enabled Mongolia to rescue its economy from a deep crisis in the early years of transition. GDP, which was declining at an average by 7.3% a year in 1990 and 1993, was growing by an average of 3.0% a year during the years between 1994 and 2000.<sup>9</sup> In 2003, Mongolia's per capita GDP reached the pre-transition level of per capita income.<sup>10</sup> (See Figure 1)

<sup>4</sup> S. R. Osmani "Towards an employment-oriented pro-poor development strategy for Mongolia: A background paper" UNDP, 2007

<sup>5</sup> S. R. Osmani "Towards an employment-oriented pro-poor development strategy for Mongolia: A background paper" UNDP, 2007

<sup>6</sup> NSO "Mongolia in a market system" statistical yearbook 1989-2002, p. 94

<sup>7</sup> NSO "Mongolia in a market system" statistical yearbook 1989-2002, p. 136, 190

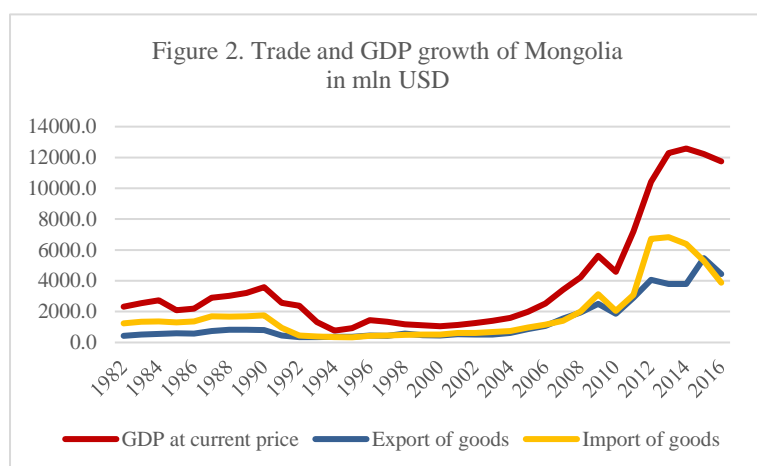
<sup>8</sup> NSO "Mongolia in a market system" statistical yearbook 1989-2002 p 108

<sup>9</sup> Authors calculation based on statistical yearbooks of respective years

<sup>10</sup> Authors calculation based on statistical yearbooks of respective years

The collapse of the socialist system, the abrupt transition to a market economy and the accompanying measures adopted to stabilize country's economy had dramatic consequences on employment, poverty and income disparity, as well as on the living conditions of people of the country as a whole.

An upward trend of economic growth has been observed since 2000, and average annual growth rate of GDP during 2001 – 2012 reached 8.2 per cent.<sup>11</sup> The economy had grown more than 10% per year between 2011 and 2013, largely on the strength of mining-based exports and high government spending, before slowing down to 7.8% in 2014 and 2.3% in 2015. (See **Figure 2**) Mongolia's per capita GNI reached USD 4377.3 in 2012 which thereafter steadily declined to USD 3967.8 in 2015.<sup>12</sup>



Obviously, trade liberalization was the most important element of Mongolia's open economic policy during the transition period. At the beginning of economic transition, Mongolia's trade policy was focused more on internal economic situation with an emphasis on protecting domestic production. Trade liberalization was expected to deal rapidly and most efficiently with two major flaws of centrally planned economic system, namely, (1) the distorted price structure, inherited

from the previous system, and (2) centralized, highly integrated and inefficient production system.

During the years of transition, Mongolia gradually implemented policies to liberalize its foreign trade and foreign investment regimes, promote economic growth and economic sectors through active trade and investment policies, and increase the country's exports. It is clear that trade policy was also aimed at strengthening Mongolia's position in the regional and global markets, and integration into regional and world economies.

Trade liberalization in Mongolia started under conditional agreements with IMF and the World Bank as part of Structural Adjustment Program and later, under multilateral trade regulations of World Trade Organization (WTO). On 29 January 1997, Mongolia officially entered WTO and was one of first economies in transition to become its member. Following this, Mongolia made major improvements in its trade and business environments. Mongolia pledged to reduce tariff and nontariff barriers to trade.

Mongolia liberalized its trade by removing self-imposed barriers to trade and services by concluding bilateral trade and economic cooperation agreements and by participating in multilateral trade arrangements. Mongolia reduced its average nominal tariff rate and eliminated almost all licenses for export and import commodities. In 1997, import customs duties were removed, between 1999 and 2000 import tariffs were imposed at 5.0%,<sup>13</sup> in 2001 it was 7.0% and from 2002<sup>14</sup> the current tariff rate of 5.0% was introduced,<sup>15</sup> which compared to many countries is fairly low and this shows that the country is committed to a more liberal trade. Mongolia reduced barriers to FDI in many industrial sectors, excluding air transportation, telecommunication services and state-owned power industry.

<sup>11</sup> Authors calculation based on statistical yearbooks of respective years

<sup>12</sup> The World Bank "Country meta-data of Mongolia" 2012

<sup>13</sup> WTO "Trade policy review of Mongolia" 2007 p28

<sup>14</sup> WTO "Trade policy review of Mongolia" 2007 p28

<sup>15</sup> WTO "Trade policy review of Mongolia" 2007 p28

Mongolia stopped all export and domestic subsidies in all economic sectors, facilitated customs standards, sanitary and phytosanitary restrictions, and product specifications.

A few export items were still a subject to export duties. Today, it is applicable only to raw cashmere, camel wool and ferrous and non-ferrous metal scraps, including copper, aluminum and iron. Export prohibitions affect drugs, narcotics, and certain kinds of hazardous and toxic chemicals. There is no quantitative restriction on either exports or imports. Export licensing is required for specific items such as paleontological and archaeological finds, fire guns, weapons, blood and blood products and radio-active elements. Import licenses are required only for items such as weapons, ammunition, explosives, etc. The country has acceded to many related international trade conventions, including Harmonized System Convention, TIR convention and Settlement of Investment Disputes etc.

Subsequently, some very important changes have taken place in the economy during this period that could have a potentially far-reaching benefit for the sustainability of future trade. More importantly, the country has achieved trade expansion by diversifying both the export destination and import sources far beyond the former Soviet bloc. Aside from the former Soviet bloc countries, China, Japan, Republic of Korea, Germany, United Kingdom, and Kazakhstan have become major trading partners of Mongolia. (See **Table 1**)

And since 1990, Mongolia's trade turnover has grown almost 7 times over compared to its pre-transition level.<sup>16</sup> In 2016, Mongolia's trade turnover reached its peak during which total export value of the country was USD 4,916.3 million and total import USD 3,358.1 million.<sup>17</sup>

**Table 1. Top 10 trading partners of Mongolia in 1990 and 2016 (USD millions)**

		1990				2016	
		export	import			Export	import
<b>1</b>	Former Soviet Union	78.33	77.51	<b>1</b>	China	78.98	30.98
<b>2</b>	Czech Republic	4.53	3.68	<b>2</b>	EU	13.13	11.12
<b>3</b>	Germany	2.07	4.05	<b>3</b>	Switzerland	4.69	0.30
<b>4</b>	Hungary	2.07	2.22	<b>4</b>	Russian Federation	1.13	26.22
<b>5</b>	Bulgaria	2.53	1.84	<b>5</b>	Singapore	0.34	0.44
<b>6</b>	China	1.71	2.41	<b>6</b>	Japan	0.29	9.85
<b>7</b>	Poland	1.70	1.43	<b>7</b>	United States	0.21	4.15
<b>8</b>	Romania	1.53	0.68	<b>8</b>	Hong Kong, China	0.21	0.43
<b>9</b>	Democratic People's Republic of Korea	1.18	0.60	<b>9</b>	Republic of Korea	0.17	5.89
<b>10</b>	Japan	1.15	1.06	<b>10</b>	Kazakhstan	0.01	0.87
	Total	96.79	95.48		Total	99.18	90.23

Source: National Statistics Office Mongolia

Mining and animal husbandry raw materials and textile constitute the bulk of Mongolia's export. In 2015, the percentage share of these products accounted for as much as 95% of the total export. Hence, Mongolian economy has remained vulnerable and dependent, to a large extent, on external factors, including price and demand of raw materials, especially owing to the economic situation of its main markets - China and, to a lesser extent – the Russian Federation.

<sup>16</sup> Authors' calculation based on statistical yearbook of respective years.

<sup>17</sup> General Customs Administration of Mongolia "Foreign trade commodity statistics 2012"



In general, the trade policy of Mongolia, since its transition to market economy, was targeted at promptly adapting to changing economic environment, as well as addressing the country's economic challenges, mitigating the impact of transition and integration into world economy.

Mongolia has abundant natural resources and has vast potential for economic development. Today, the country's economy is at a crucial crossroads of a new phase of its development, thanks in particular to the development of world class giant mining deposits.

Oyu Tolgoi (OT), the copper and gold mine in the South Gobi, holds over 35 million tons of copper and 1,275 tons of gold. In October 2009, the Government of Mongolia signed an investment agreement with Ivanhoe Mines of Canada and Australian mining giant, Rio Tinto for the development of OT. Its production began in 2013 and when it will reach its projected capacity by 2017-2018, it will annually supply 1.8 million tonnes of copper concentrate, which is close to 3 per cent of world output.

Another giant deposit Tavantolgoi (TT) has more than 6 billion tons of coal, one third of which is coking coal. Although Tavantolgoi has been in operation since 1967, its production has fallen short of planned targets and expectation. Coal production at Tavantolgoi increased sharply when the state-owned mining company Erdenes TT and a consortium of private corporations Energy Resource Group started mining at Tavantolgoi.

These investment projects present a unique development opportunity for the Mongolian economy as a whole. At the same time, the mining boom presents large policy challenges. International experience has demonstrated that resource-rich countries tend to under-perform compared with resource-poor countries and this tendency has been called the "resource curse".

The key challenge is to sustain economic growth over a long period of time. Also, there is an obvious risk that Mongolia might revert to a high, but jobless growth path that was experienced in the past decade. The massive increase of mining production would be converted as a strong upward pressure on the exchange rate as well as upward pressure on domestic wage rates and on inflation, all of which would further undermine the already poor competitiveness of the tradable sectors of the economy and work against economic diversification and a more broad-based economic development of the country.

The changing situations and opportunities demand the rethinking of new development objectives for the country. Also, there is a need to formulate new trade policy objectives that will ensure equitable and stable economic growth. Therefore, the role of effective policymaking is very important.

### **3. Economic growth, trade, poverty and employment in Mongolia**

As mentioned earlier, in the early 1990s Mongolian government opened up its market by liberalizing trade and denationalization of state properties. The combined effect of trade liberalization and privatization led to a dramatic increase in poverty, inflation, economic insecurity, and rising inequality in income distribution.

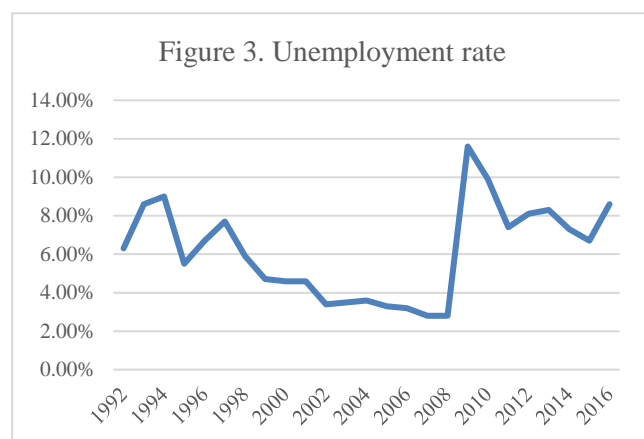
Economic growth, in the sense of expansion of material production, may be achieved through various means, each involving a distinct configuration of production and employment structures, and income distribution. Economic growth in Mongolia has gone through four distinct phases of development since its transition to market economy. (See **Table 2**)

**Table 2. Economic growth phases in Mongolia since its transition to market economy**

	1990-1993	1994- 2001	2002-2014	from 2015
Annual GDP growth rate	- 6.7	2.6	8.0	1.6
Poverty	-	35.6-36.0	21.6 - 38.8	-
Unemployment	6.3 - 8.6	4.6 - 9.0	3.4 - 11.6	7.5 - 8.6

*Source: Adopted from relevant years' statistical year books of Mongolia*

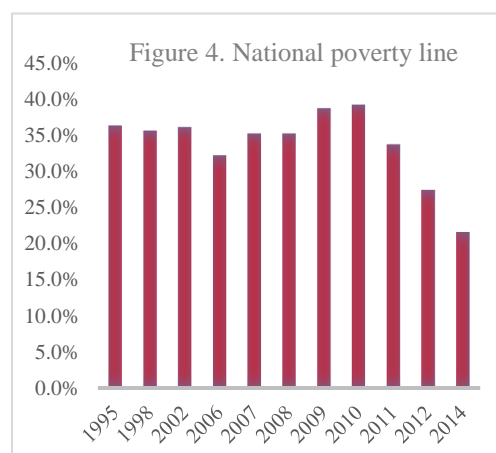
At the beginning of transition or between 1990 and 1994, with the entry into market economy, a set of relative prices were introduced that rendered unprofitable a large portion of the country's



economy. These unprofitable enterprises, which were built during the years of socialism without any consideration for economic efficiency, were allowed to go out of business, reducing output, employment and income. This led to a fall in aggregate demand and, through multiplier process, to substantial reduction in income. The downturn was exacerbated by the lack of managerial skills; shortages of capital, equipment, raw materials and fuel; questionable banking practices, corruption, slack financial oversight and banking services, coupled with other

market distortions. Following privatization, many industrial and agricultural enterprises, including state owned livestock cooperatives – *negdels*, fell into inexperienced hands that ultimately led them to bankruptcy and thousands of people lost their jobs. Also, livestock privatization and the dissolution of *negdels* have led to a decline in the quality of infrastructure and services supporting herders, thus adding to their vulnerability. Alongside trade liberalization and privatization, the drastic economic decline created disturbing social problems as poverty and unemployment, which even today continue to be at an unacceptably high rate. (See **Figure 3**)

Mongolians used a number of strategies to survive the uncertainties of the economic transition. Many responded to the massive economic changes through internal migration in search for better opportunities, working in the growing informal sector, trying to have fewer children, and working also in the agricultural sector. This was the first time that the Mongolians were faced with the problems of poverty and unemployment, which forced many urban residents to move to the countryside to engage in livestock herding. Mongolian traditional pastoral livestock sector helped to survive in this difficult



period. Between 1990 and 1994, the number of agricultural workers increased by 30.1 per cent and many of them almost had no knowledge about agriculture.<sup>18</sup> Consequently, agricultural productivity fell sharply.

Slight economic growth was observed between 1994 and 2001, however there was almost no improvement in the rate of poverty and unemployment during this period. The poverty headcount ratio which was 36.3 percent in 1995 fell marginally to 35.6 percent in 1998 and again rose to 36.1 percent in 2002. (See **Figure 4**) When macroeconomy experienced steady growth, the economy maintained its level of employment. In other words, economic growth

<sup>18</sup> Government of Mongolia and UNDP "Human development report of Mongolia 2003" p 36

failed to expand production and this growth process did not generate new jobs, that offers opportunities to all segments of the society to benefit from economic expansion. This 'jobless recovery' continued into the start of the new millennium.

Mongolia's economy returned to a relatively high growth rate since the transition to market economy and the average annual growth rate of GDP was 8.0 per cent during 2002-2014.<sup>19</sup> During this period, economic growth was in income generation briefly that helped reduce the rate of poverty quite rapidly. In current US dollar term, Mongolia's GDP has increased more than 10 times compared with the 2002 level;<sup>20</sup> and household consumption expenditure has increased more than seven-fold. By 2008, GDP per capita, in US dollar terms, had recovered to the pre-transitional 1989 level.<sup>21</sup> This means that average standard of living in Mongolia returned to pre-transition level almost two decades later after the country went through the trauma of transition and other shock therapies.

However, despite the leading role played during this period by the mining sector as the engine of growth, this growth has been *rigid* for job creation. There are several reasons, including, *first*, the growth of output has not concentrated in labour-intensive sectors; *second*, more capital-intensive techniques are used, especially in the growing mining sector; and, *third*, the terms of trade were more convenient for capital-intensive mining sector. Therefore, over this time, on the one hand, faster growth has translated into poverty reduction, and on the other hand, unemployment has increased.

Even though, according to official statistics poverty today is still a much more widespread phenomenon in Mongolia than unemployment and very small share of the poor in Mongolia are unemployed. Most of the poor in Mongolia are 'working poor' instead of being unemployed, and so, there is a pending need to pay attention to the quality of employment.

As to distributional impact of mining, inequality between geographic regions and social groups has increased and the rapid mining boom has produced an income pyramid of population, with a small part of the population considered "wealthy", while the rest of the population are in the "middle" and "poor" strata. As indicated in the "Household Socio-Economic Survey 2012", the consumption share of the poorest quintile of the population is equal to 7 percent of the country's total consumption and the second poorest quintile is 12 per cent. In contrast, the richest quintile has consumed 41.8 per cent and the second richest - 22.4 per cent, while the medium quintile is 16.3 per cent. The richest quintile has consumed more than 2/5 of total goods sold in the consumer market.<sup>22</sup>

As indicated in the 2014 Household Socio-Economic Survey, 21.6 percent of the total population were living in poverty, which although is a decrease of 17.2 points from its peak in 2011 and by 14.5 points from the beginning of this period. During this period, unemployment rate has grown from 3.4 to 7.9 per cent.<sup>23</sup>

Since 2014 Mongolia's economic growth fell sharply. GDP growth rate in 2015 was 2.3 per cent and only 1.0 per cent in 2016. This resulted chiefly due to the sharp fall in the global commodity prices, including Mongolia's main export products such as copper, coal, and gold.

The economy has undergone some very important structural changes during the transition period that have important implications for the sustainability of future growth.

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<sup>19</sup> Authors' calculation based on statistical yearbooks of respective years

<sup>20</sup> Authors' calculation based on statistical yearbooks of respective years

<sup>21</sup> Authors' calculation based on statistical yearbooks of respective years

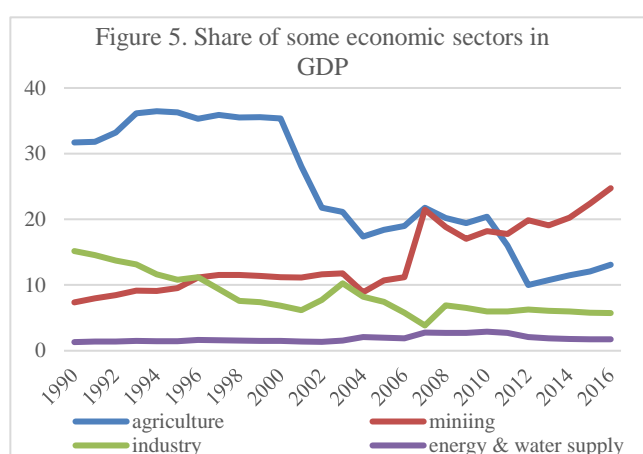
<sup>22</sup> NSO "Statistical yearbook of Mongolia – 2015"

<sup>23</sup> NSO "Statistical yearbook of Mongolia – 2015"

The most important structural change occurred in the country's ability to generate its own resources for capital accumulation and growth. At the end of socialism or late 1989, gross national capital formation accounted for 44.6 per cent of GDP, 2/3<sup>rd</sup> of which were financed from foreign sources, primarily the former Soviet Union.<sup>24</sup> As the economy collapsed, gross national capital crashed to just over 17.8 per cent of GDP by 1994, of which one half consisted of domestic savings.<sup>25</sup> Since, gross national capital formation has recovered quite well, and by 2015 it accounted for 27.4 per cent of GDP.<sup>26</sup> What is important is that in recent years national savings have grown rapidly, amounting to almost two thirds of gross national capital formation, whereas foreign savings has dropped.<sup>27</sup> These figures provide evidence to the fact that economic growth is now based on a more secure and more sustainable foundation than it did any time before.

Mongolia's economy has successfully reoriented its external sector, which is another important accomplishment in the economy. At the beginning of transition, Mongolia's trade policy was more focused on internal economic situation with an emphasis on protecting domestic production. Then trade policy shifted fundamentally in favor of export orientation with the active promotion of FDI. Resultatively, the ratio of export to GDP almost doubled compared to the concluding years of socialism. More importantly, the country achieved this trade expansion by diversifying both the

destination of its exports and the sources of its imports far beyond the borders of the former Soviet bloc.



Nonetheless, trade has come to be rooted much more on the fundamental strengths of the economy, such as, market competitiveness, rather than on political favors from the Soviet bloc that existed before the transition. During the transition years, Mongolia's export rapidly shifted, in terms of its composition, from labour-intensive agricultural and manufacturing

sector to a highly competitive and internationalized capital-intensive mining sector. This confirms that the growth of the Mongolian economy has also become much more sustainable. (See **Figure 5**)

Since the transition Mongolia has finally learnt that in an increasingly globalized world, small countries like Mongolia stand little chance before larger and stronger competitors. However, in such a huge world of production there should be certain commodities with which these small economies could have a comparative edge. The country identified trade and its trade-led growth the base, and has learnt that comparative edge is much more important than artificial political favor. It is hoped that the country will continue to rediscover its comparative edge under changing circumstances. (See **Figure 6**)

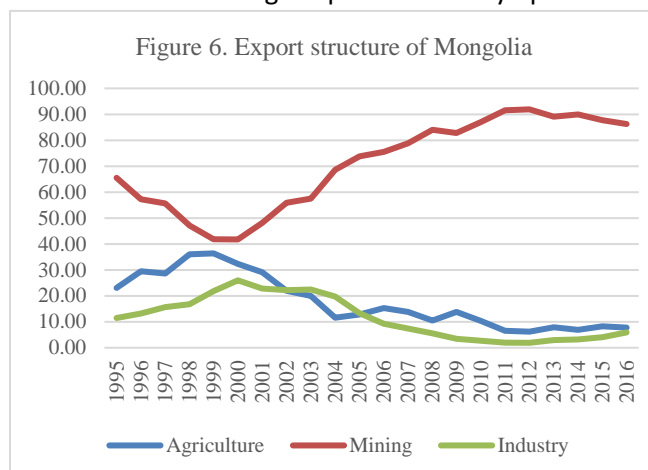
<sup>24</sup> The World Bank "Country meta-data of Mongolia" 2016

<sup>25</sup> The World Bank "Country meta-data of Mongolia" 2016

<sup>26</sup> The World Bank "Country meta-data of Mongolia" 2016

<sup>27</sup> The World Bank "Country meta-data of Mongolia" 2016

It is clear that as Mongolia pursues a fairly open trade regime, the economy should be rooted in those



industries in which the country has a comparative edge. Mongolia's comparative advantage lies in natural resource-intensive industries, of which there are two major types including livestock-based processing industries such as textiles, leather and dairy, and the mining industry. Those sectors complement each other. Mining is capital intensive and generates large part of income necessary for further economic growth, while agriculture is labour intensive and generates jobs for people.

From the point of view of poverty reduction, the pattern of growth must be such that the poor people are able to benefit from the growth process. Resulting the capital-intensive nature, the mining sector does not generating much work place, hence this sector is less contributing to the poor to benefit from the growth process. However, budgetary revenue and foreign exchange earnings generated in the mining sector, aggregate demand generated by the export of minerals are necessary for poverty reduction. Incomes generated in the mining sector should provide investible resources that could stimulate the development of sectors where there is greater scope for labour absorption on the one hand, and on the other, stimulating demand.

During last two decades, majority of foreign and domestic investment invested in mining sector. However opposite phenomenon could be observed in agricultural sector. Given the high incidence of rural poverty in Mongolia, it is clear that agriculture must remain an important part of pro-poor strategy.

Despite the leading role played by the mining industry as the engine of growth in recent years, agriculture has not been successful in growth and productivity. A market will come into existence only if the potential gains from market transactions exceed the transaction costs, this is, as we know, basic economics. Because of the small-volume market, caused by low level of income, sparse and scattered population, either markets have not developed at all; businesses in the rural areas have not developed well enough, and rural agricultural sector does not attract either foreign or domestic investors. And so, although Mongolia has made significant gains in economic development during the transition, poverty, unemployment and inequality are very high, especially in the rural areas. Therefore, open regime of trade and FDI alone are not enough for tackling such social problems as poverty, unemployment and inequality. The solution of these problems demand sound and integrated economic policies both at the domestic and international levels.

#### 4. Trade preferences & Mongolia

Land-locked and remoteness from world seas and key international transport routes, small and sparse population, vast territory, and extreme weather conditions are all factors that contribute to economic underdevelopment and weakening of competitiveness of Mongolia's export products on the global market.

In spite of technological improvements in transport and logistics, landlocked developing countries continue to face structural challenges to access world markets. On the whole, in terms of overall development and external trade, landlocked countries often lag behind their maritime neighbors. Trade and economic performances of those countries are often dependent on their transit

opportunities. Landlocked developing countries face such persistent challenges because of the difficulty of trade, geographical remoteness, and non-access to specialization and associated benefits. The difficulty of transportation over great distances today remains a serious drawback despite huge technological advances.

Landlocked countries are paying high transportation costs in their export and import; and as a result, goods produced in landlocked countries have low competitiveness in the world market. Owing to their limited export earnings, such countries tend to have access only to poor technologies, exhibit low productivity, and are characterized by low income and low living standard. Therefore, an International Conference held under the auspices of the United Nations in Almaty, Kazakhstan in September 2003 adopted a Declaration that recognized landlocked countries as a special group among the poorest of developing countries with limited capacities and dependence on a very limited number of commodities for their export earnings.<sup>28</sup> Some studies confirm that the GDP per capita of landlocked countries is lower than by 57 percent compared with maritime countries.<sup>29</sup>

Similarly, like other landlocked countries, Mongolia's geographical location is becoming a principal driver of higher cost of production and lower competitiveness, considering the poor development of external and internal logistical infrastructure. High transportation costs in land-locked-countries usually generate cost disadvantage relative to coastal countries when competing in global markets. Thus, Mongolia is paying a relatively high transportation cost for exportation and importation of goods.<sup>30</sup>

The vast territory, and the small and sparse population are not only rendering businesses and trade in some sector unprofitable. It is also contributing to transport infrastructure inefficiency. Extreme weather conditions generate seasonal characteristics in some businesses and increase the cost of living and production in Mongolia.

To address the challenges and compensate above costs that limit land-locked country's potential gains from trade and economic cooperation, Mongolia needs to focus on the following priority areas of trade policy.<sup>31</sup>

*First*, landlocked developing countries need to place emphasis on developing their external and internal logistical infrastructures. Hence, investments in the development of logistical infrastructure, both of construction and maintenance, are crucial for the reduction of transport costs.

*Second*, investment in the production sector that produces goods with a lowest transportation costs could be an important way to reduce transportation cost. These include production of goods, such as services, luxury or high-tech products, some products with higher value or less transport cost relative to their value.

*Third*, trading goods to or from the closest markets with a less transport cost, could increase opportunity to compete in the foreign markets. Thus, regional integration and cooperation strategies are instrumental in reducing transport cost.

Policies focusing on mitigating the effects of land-locked-ness needs to address country-specific obstacles to accessing global markets and region-specific challenges to market integration. As for

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<sup>28</sup> Edited by Selim Jahan and Batnasan Namsrai "Human development textbook" UNDP 2007 p 187

<sup>29</sup> Edited by Selim Jahan and Batnasan Namsrai "Human development textbook" UNDP 2007 p 187

<sup>30</sup> The World Bank "Doing business 2013" p 282

<sup>31</sup> Edited by Selim Jahan and Batnasan Namsrai "Human development textbook" UNDP 2007 p 187

Mongolia, first and second ways are seeming to be difficult in terms of investment financing at this stage of our development.

In the new era of globalization, every country aims at boosting people's incomes and the quality of life, by improving the terms of trade using demand opportunities in foreign markets, increasing the efficiency of trade participation, and improving trade balance. As for Mongolia, the country desperately needs a sound and strong regional trade strategy that targets well-defined market segments, particularly in specific geographical regions. Now this is becoming important than ever before, when the country has gone a long way towards sustainable growth, as an increase in trade volume has converted Mongolia as a one of the important suppliers of commodities to the world market. Resulting from the country's specific unique problem of "land-locked-ness" Mongolia's trade policy should be aimed at reducing higher transportation costs, at ensuring producers' greater competitiveness in the global market, and at guaranteeing its citizens a wealthier standard of living.

However, one of the ultimate goals of trade policy is to integrate Mongolia into regional and world economy. To date, Mongolia has signed only one EPA and that with one of its major trading partners - Japan. With a growing array of cooperation and liberalization agreements, Mongolia is seeking ways to diversify its trading partners, improve terms of trade, and to lower trade tariffs. At present, the country is seeking ways to sign effective FTAs with its major trading partners within the framework of multilateral trade regulation.

According to GATT 94 any member country of WTO can have preferential market access by joining WTO and by signing bilateral or regional Free Trade Agreements. Currently, Mongolia trades with more than 170 countries, the dominant ones being the Russian Federation and China. Total annual trade turnover reached USD 8.27 billion in 2015, of which trade with its immediate neighbors accounted for 70.8 per cent. The remaining portion of trade turnover falls to developed countries such as EU, Switzerland, Singapore, Japan, USA and others.

If we look back at Mongolia's foreign trade practices during the years of transition, the country has benefited from preferential access to its key markets including EU, the United States and Japan under the Generalized system of preference of WTO, GSP and GSP+ of European Union and under the Economic Partnership Agreement with Japan.

Compared with other sectors of industry, textile and clothing industries have benefited much greater than other sectors of the economy. Apart from other main commodities (as copper, coal, gold, meat and leather etc.), the clothing and cashmere sectors are specially considered as industries with considerable competitive edge for Mongolia. This sector is one of the major manufacturing and employing sectors that provides approximately 1/3<sup>rd</sup> of all the industrial work places of the country. This sector includes cashmere and wool processing, garment and clothing factories, which produces approximately one sixth of the total industrial production and its exports accounts for more than 6.1 per cent of total export.<sup>32</sup>

Mongolian cashmere has an outstanding position in world market share and its production ranks second in the world, accounting for more than one quarter of world production after China. As with many other raw materials, cashmere prices are volatile, which directly affects country's export revenue and herders' income.

In 2015, Mongolia had almost 56 million head of livestock, of which goats and sheep accounted for 42.1 and 44.6 per cent respectively. Goat population has been growing, accordingly, Mongolia produced 8.9 thousand tons of raw cashmere, which constituted close to 30 per cent of the total world supply. Mongolian goats and sheep are adapted to harsh climate and can survive drought, heat,

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<sup>32</sup> According to authors calculation

shortage of grazing pasture and water, and pasture range. Sheep wool is an important basic material for making high-quality woolen fabrics and carpets.

The textile industry produces fiber and animal-based products such as cashmere, yak hair, sheep wool, and camel hair. On the other side, this industrial sector is closely linked to livestock breeding sector, which engages about 0.3 million herders or one fourth of the total labour force of the country. The existence of this sector not only affects the living standard of those working in the sector, but also a



large number of herders through a backward linkage.

The textile industry consists of five different types of companies, each of them has its own characteristics, markets and opportunities. The first type of companies are early-stage processing plants, which directly procure raw greasy cashmere, wool or animal hair from herders or traders, scour it and produce fine de-haired cashmere or washed wool for domestic or export markets. The second type of companies are garment manufacturers.

The third type of companies are vertically integrated cashmere plants, that combine a number of operations from processing of raw materials to spinning, dyeing, garment manufacturing and production of other knit and woven products. Unfortunately, the interests of these three types of companies do not necessarily coincide. The fourth type of companies are carpet manufacturers. There are two major carpet producers - one in Ulaanbaatar and the other one in the northern town of Erdenet. The fifth type of companies are subcontracted Mongolian sewing companies in the garment industry. These companies mainly have Asian-owned foreign investment, operating in the industrial district of Ulaanbaatar. These sub-contracted businesses employ a large number of mainly unskilled, in-house trained workers, and most importantly, using the existing Mongolian trade preferences for the export quota system, that exports mainly to markets in the EU and the United States.

Today there are at least four major types of fibers: cotton, wool, cellulosic fiber and synthetic fiber. Whereas the Mongolian textile industry produce and exports four different types of natural fibers including cashmere, yak hair, sheep wool, and camel hair. Each one of them has a particular characteristic and is discussed separately in its international context.

During the last two decades starting from 1990, global cashmere production almost tripled while international demand for cashmere products remain strong despite the increased selling of low-quality articles. Mongolian cashmere and wool once had good international reputation. However, a major issue of concern for domestic producers of cashmere products continues to be the quality of goat hair, which has been deteriorating.

Mongolian textile and clothing products were first introduced in the western market in the mid-1990s based on preferential market access to EU and the United States. During those days, Mongolia promoted FDI and granted 100 percent tax holiday for foreign invested companies in the first two years since inception, and 50 percent waiver in the next 3 years.

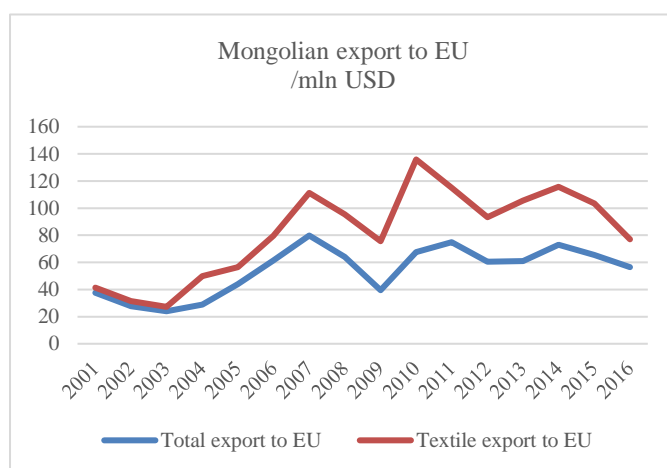
In the mid-1990's the United States granted Mongolia GSP or Generalized System of Preferences, for the purpose of making the best of trade opportunities, growing the economy and coming out of poverty. GSP is a United States' trade program designed to promote economic growth in the developing world by providing preferential duty-free entry for up to 4,800 products from 129 designated beneficiary countries and territories. In addition to promoting economic opportunities in



developing countries, the GSP program also supports progress of beneficiary countries in affording worker rights to the people, in enforcing intellectual property rights, and in supporting the rule of law.

At the same time, EU has also guaranteed unlimited quota for Mongolia-origin textile products and within the framework of EU's "Generalized Scheme of Preferences" (GSP) export duties to EU markets were minimized or completely waived off. Later the EU granted additional preferential access to its market within the framework of GSP Plus. GSP Plus is a component of the EU's Generalized Scheme of Preferences ('GSP') for developing countries and offers additional trade incentives to developing countries already benefitting from GSP to implement core international conventions on human and labour rights, sustainable development and good governance.

GSP Plus is a scheme that rewards developing countries that shows a credible commitment to implementing those conventions by granting duty reductions on exports to the EU on some 6,000 tariff lines (66% of the EU common customs tariff). Nine of the GSP Plus countries on the list including Mongolia, are already benefiting from the current scheme, and they continue to benefit from the generous enhanced market access under the GSP Plus starting from 1 January 2014.



Favorable condition in external and internal markets supported the development of textile and clothing industry starting from the mid 1990's, and its share in total export reached 40 per cent in 2000.

The United States, after China's membership to WTO, also guaranteed preferential market access to that country. This move deprived Mongolia of its advantage in the textile and clothing trade in the United States market. Despite the competitive advantage of Mongolian textile and clothing industry in the US market, the

country still enjoys from its preferential access in EU markets, and continues to export textile and clothing products at an inevitably high level. Today, EU constitutes the second largest export market for Mongolia and the export of textile and clothes occupy a large chunk of Mongolia's export to EU.

It is clear that growth concentration in labour-intensive sector creates more jobs, and capital-intensive sectors are generating more income. From the viewpoint of pro-poor policy, income generated in capital intensive sector should support the development of labour intensive sector. In Mongolia's context, because of poor policy making, mining sector contributed little to the development of non-mining sectors. Instead of mining sector, trade preferences supported the development of labour intensive textile and agricultural sectors of Mongolia.

There are several reasons to highlight the importance of the role of trade preferences in the country's economic development as follows:

*First*, trade preferences have supported the development of labour intensive sectors both directly and indirectly when the economic growth of the country was concentrated in capital-intensive mining sectors; and used more capital-intensive techniques, especially in the growing mining sector; and external and internal conditions were more convenient for capital-intensive mining sector. Thereby, trade preferences helped to keep work places in certain sectors and generated domestic demand for animal husbandry raw materials. Through backward and forward linkages, those preferences also generated many jobs both in urban and rural economy, especially in the service sector.

*Second*, the trade preferences provided a unique development opportunity to the textile industry. The development of textile industry generated mostly unskilled work place, thus the development of this sector gave opportunity to the poor to be actively integrated into economic processes. From the pro-poor growth aspect, the development of textile industry fully responds to the skills of the poor in a manner that is most consistent with their interests. It also generated jobs in regions where the poor people are basically concentrated and in the sector where poor people had lost their jobs. And the textile industry itself used more labour-intensive techniques.

*Third*, trade preferences generated more favourable terms of trade for certain sectors of economy and gave opportunity for those sectors to become more efficient. On the one hand, trade preferences gave opportunity to trade at world market prices, and on the other hand, it has improved the productivity in certain sectors.

However, employment is a bridge between economic growth and poverty reduction, and in Mongolia the lack of employment is not a main problem. Most of the poor in Mongolia are 'working poor' as the core problem is not in unemployment, but rather in the inefficiency in productivity, and the quality of employment. Thus, employment quality and productivity are believed to be the missing link in order to translate economic growth to poverty reduction in Mongolia. In the Mongolian context, most of the poor people are living in rural areas, because income generated in agricultural sector is often seasonal and productivity of this sector is very low, so their livelihood is vulnerable to a large extent from external shocks, such as diseases and weather conditions. Herders in remote areas have very limited opportunities for participation in markets through the sale of raw materials and the purchase of necessary goods. As a result, many herders in remote areas still engage in barter with small traders, and trade their raw materials even when it is unprofitable to do so.

The preferences, all together generated favorable conditions not only for the textile industry itself, but through backward linkages those preferences helped to improve the living standards of rural herders, which have been sharply declining because of the decline in the price of the livestock raw materials in foreign markets during the transition.

*Fourth*, trade preferences have softened a strong upward pressure on the exchange rate as well as upward pressure on domestic wage rates and on inflation and production of goods in the sector and to some extent, reduced the living cost, primarily of the poor in the country.

Mongolia's case is an example which illustrates that trade preferences are powerful instruments of trade policy and industrial development. From the viewpoint of pro-poor policy, trade preferences are aimed at establishing more favourable conditions to labour intensive sectors, which in their turn could make a significant contribution to poverty reduction.

## **5. Summary**

If we look back at Mongolia's foreign trade practices during the years of transition, the country has benefited from preferential access to its key markets including EU, the United States and Japan under the Generalized system of preference of WTO, GSP and GSP+ of European Union and under the Economic Partnership Agreement with Japan.

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wool processing, garment and clothing factories, which produces approximately one sixth of the total industrial production and its exports accounts for more than 6.1 per cent of total export.<sup>33</sup> And this industrial sector is closely linked to livestock breeding sector, which engages about 0.3 million herders or one fourth of the total labour force of the country. The existence of this sector not only affects the living standard of those working in the sector, but also a large number of herders through a backward linkage.

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<sup>33</sup> According to authors calculation

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