

Home remedy for **OUR ECONOMY**

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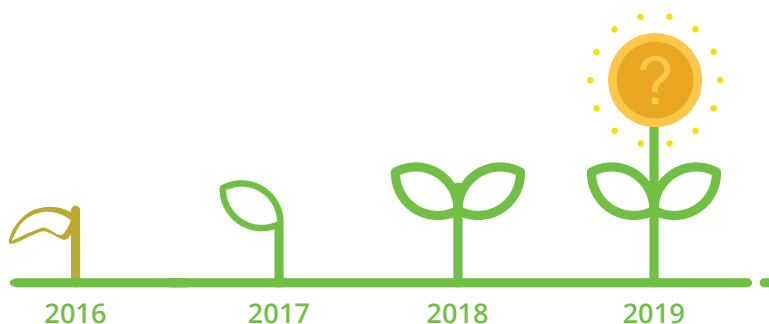
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Home remedy for

OUR ECONOMY

Two days ago, Prime Minister U.Khurelsukh reported to the public on what his cabinet has achieved in their first 100 days. During his one-hour speech he focused on what his 30 priorities or major work streams were and announced that the economy that was in 'intensive care' in 2016 was

transferred to the 'general ward' in 2017. He then declared that, if the economy was a person, he would be discharged from the hospital this year, treated with a home remedy, so that he can get a job next year and achieve stable income in 2020.

TREATMENT IN THE LAST 100 DAYS

Having been formed on 20 October 2017, U.Khurelsukh's cabinet, which consists of 15 double-deel ministers, saw their 100th day on 28 January 2018. From a macroeconomic perspective, we can take a look at two of the programs this government has started.

Firstly, our budgetary policy is changing. Having seen soft loans flowing into the country from abroad as part of the IMF program, the government has stopped pulling cash from domestic banks with high interest rates. This meant that commercial banks now have no choice but to grant loans to the private sector instead of the government. Tugrug rates have stabilized.

The State Bank, which is based on leftover capital from bankrupt commercial banks, made half of their 70 directors redundant. This bank now has over 500 branches across the country, operating at a national level. The State Bank was first established by a government decree issued in 2009, and 25 per cent of its shares are owned by the Ministry of Finance and 75 per cent by the Deposit Insurance Corporation of Mongolia (DICOM). Normally neither the government nor DICOM is supposed to own a commercial bank. It looks like the process has started to privatize this bank.

Secondly, the first step to freeing fuel prices has been made. The cancellation of excise tax on AI-80 and AI-92 petrol was a step in the right direction to have consumers, rather than the government, set prices. Establishing an oil refinery was discussed for many years as part of the wider dialogue on achieving independence in fuel supply. The work is about to start now to determine the location of this refinery and build it with a soft loan from the Indian government.



TREATMENT IN THE NEXT 880 DAYS

Prime Minister U.Khurelsukh pointed to 'unemployment, poverty, and lack of discipline, accountability, and order' as key culprits for the conditions our economy is found in today.

He went on to announce that "The government will execute the right economic management for the remainder of its term. We will ensure discipline and order at all levels of public service and make 2018 a year of accountability. We will reduce the budget deficit and implement specific initiatives in every economic sector. For example, we will liberalize air transport and develop tourism. We will no longer have three shifts in our schools. All schools will be double shift. We will introduce flexibility in retirement age. We will not increase personal income tax, which will remain at 10 per cent.

TREATMENT METHOD

Despite his accurate diagnosis of our current economic circumstances, the Prime Minister seemed to have treatment methods that are unclear and not supported by scientific grounds.

The lack of discipline and accountability traces back to the absence of justice and the rule of law. Justice starts with getting rid of the corruption nested in the government. This corruption has originated from political party financing. Therefore, given he is also the leader of the majority party in the parliament, the Prime Minister must urgently reform the law on political parties by using his 65 fellow party members in the parliament and his 15 ministers who also happen to be MPs. Also, justice will not prevail unless those who stole from the public are held accountable regardless of their political affiliations.

The Prime Minister must disclose who stole and misused Ulaanbaatar's land, especially the Bogd Mountain, Tuul River, and Yarmag areas, and ensure they pay for what they did. If he does that, half of the corruption problem will be solved.

The difference between fish and government lies in where you start the cleaning if it is rotten. You clean the fish from the bottom even if the rot has started from the top. But when it comes to the state or the government, you must start from the top because that is where the rot came from. After all, the Prime Minister said a hundred days ago "I am not afraid. I am not even afraid of losing my life. There is only one thing I am afraid of. I am afraid of the people losing faith and hope."

Unemployment and poverty are now huge problems because government involvement in the economy has grown so big. The money that is supposed to go into education and health is now being spent on making up the deficits of state-owned companies who feed from the

The housing mortgage (Ipotek) scheme will continue and it will have 120 billion MNT from the public budget this year. This will bring the total amount to 300 billion MNT, combined with the 180 billion MNT centralized at Mongolbank through repayments. Starting from April 2018, we will not allow raw coal to enter Ulaanbaatar if it is for industrial purposes."

A lot of expectations of this cabinet resolving major problems have been created by the clear, organized, and energetic manner in which Prime Minister U.Khuresukh delivered his plan and statements of intent. However, the Prime Minister has hardly mentioned anything about where the government and the private sector fit in to achieve all those objectives, how they will make it work, and in what ways market mechanisms will be used.

public budget. State-owned companies must be given to the people (by being turned to public companies), instead of being allocated to political party members. Sixty per cent of the shares of all mining, air and rail transport, and water and electricity companies must be privatized first.

Finally, all prices must be freed, and the Pricing Council has to be abolished. Fair competition must be supported and government authorities distanced from the companies they own. If the Prime Minister does this, the reform he wants to make will be made by the market itself. His 15 ministers have 30 eyes, but the people have 6 million eyes, so everything the Prime Minister and his cabinet does will be watched and seen.

If the Prime Minister initiates these three things and sees through them, the people will achieve the prosperity and happiness he mentioned.

2018.01.31



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MONGOLIA IS A YOUNG DEMOCRACY.

THE BODY OF LAW IS IMPROVING ALL THE TIME

Christopher Melville was formerly a managing partner at Hogan Lovell's Mongolia office before founding the new legal services firm M&E. Based in Mongolia since 2012, he has advised a number of clients, including corporate businesses, international financial institutions, and the Mongolian government.

Defacto: Good evening. Let's get right to it. Please tell us about Hogan Lovells, and why it has closed its office here in Mongolia.

CM: I have been working in Mongolia with Hogan Lovells for 5-6 years now. As you are aware, Hogan Lovells is one of the top-ten law firms worldwide, with over 2,500 lawyers operating from 46 offices. The way the office was set up in Mongolia was, let me say, rather opportunistic, in the sense that it's not the typical place that Hogan Lovells might look to open an office in the first place. There is a tendency and a strategy to focus on key financial markets. At the end of the day, I think it was a strategic decision to close the office. The firm had a perception that the Mongolian economy had not developed in the way that was anticipated. At the time of those discussions with Hogan Lovells, it was always my intention to remain here, because I think there is a lot of potential in the economy. And so I effectively pushed them towards allowing me, together with my partner, Erdenedalai, to buy out the current practice.

Defacto: For how long have you been practicing with Mr. Erdenedalai?

CM: He has been with us at Hogan Lovells for five years. He was the Mongolian partner at Hogan Lovells.

Defacto: I noticed that Hogan Lovells was working with mostly Mongolian lawyers on its staff, as partners, in the country.

CM: Yes, that's right. The concept was to bring international quality standards of legal advice and service to clients, and obviously advising on Mongolian law, as well. So, effectively, looking at assisting foreign investors to come into the country. At the same time, though, we did do a lot of work for the Mongolian government and for a number of Mongolian clients.

Defacto: Which means that you will be doing essentially the same things that Hogan Lovells was doing: providing services to businesses here. Let's go back to your point that Hogan Lovells found that the Mongolian economy was not going the way they were expecting. What are your thoughts about why?

CM: I think Hogan Lovells platform was international and therefore had quite a high cost base from the beginning because we paid Mongolian lawyers at international rates,

which was significantly higher than the rest of the Mongolian market. If the economy is not going in the direction that you want—if there's not significant amounts of foreign investment—then it's quite difficult to sustain the business on that basis. So that was certainly a factor. Although we did some very good work.

My philosophy for the *new firm M&E* is to operate from a lower cost base. I also think the economy has turned around, or at least showing signs of doing so. Therefore, it seems to me good timing and a good opportunity to take things forward with a smaller and less expensive platform.

Defacto: What were the main fields of law practiced in Mongolia?

CM: Generally speaking, we have been providing corporate support for foreign investors and/or foreign-invested companies within Mongolia, which I think remains the main target client and base. We've also done a number of financing transactions. For example, bilateral financings by international financial institutions, such as the EBRD and IFC, or commercial banks. Also, we've been quite active in international arbitration where that involves Mongolian parties, providing local Mongolian law support. And then infrastructure, which is a critical area for the development of the Mongolian economy.

Defacto: What kinds of big infrastructure projects have you been doing, for example?

CM: For a number of years, we were advising on the *Egiin Gol hydropower project*. We also had a role on the Tavan Tolgoi power plant. And then, more recently, advising on a number of solar power projects.

Defacto: Why are law firms necessary for these big transactions or infrastructure projects? And where do you think Mongolian law firms can improve, in terms of better services.

CM: On that first question, I used to work in Moscow in the late 1990s, which were very interesting times in that market. And there was a tendency for transactions to be done either very quickly or not properly documented or, as we say in the UK, "done on the back of a cigarette packet". Over time, I did work very closely with Russian clients, and gradually things became more sophisticated. Because, in essence, if you don't properly document and understand what you're doing at the

beginning of a transaction or project process then inevitably that only leads to difficulties down the line.

One of the things that I do encounter in Mongolia is that Mongolian clients are not really used to cross-border international transactions. So frequently it's the case where no lawyers are involved at all. And when it comes to loan transaction, for example, there's a tendency just to sign documentation that's put in front of you—to make life easier and to take the money—without necessarily understanding all the nuances and details of the transaction. You've got sophisticated international institutions on the one hand, and an inexperienced counterparty on the other. So one of the challenges in this market is to make sure that both parties understand each other. That is also the case when it comes to due diligence because people are not necessarily familiar with the due diligence process. And some foreign investors try to take advantage of that, but at the end of the day that's only going to result in a dispute.

Defacto: So at which level of the negotiations do you need to involve lawyers?

CM: Well, in part that's a question of cost for the client. They can involve us right at the beginning of the process. For example, when you do the initial term sheet. But ordinarily, we get involved when it comes to documentation, which can be very significant. For example, the legal documentation behind the Tavan Tolgoi power plant extends to over one thousand pages.

Defacto: And those are required by law to be published in two languages: Mongolian and English. You do the initial work in English?

CM: Generally speaking, that's right.

Defacto: Are fees based on the size of the project, or on hours worked?

CM: For Mongolian clients, the retainer system of fees is quite common here, so paying a fixed amount in fees per month. That requires close monitoring to make sure the law firm and the client are satisfied with the arrangement, and that one is not abusing the other. For example, asking for too much work to be done for that amount of money or not instructing the lawyers to do anything, and then the lawyers are getting money for nothing. It's always a balance.

Defacto: Regarding issues of litigation and arbitration, several times the Mongolian government has been called to London arbitration. Some they won; some they lost. You've been involved in one such arbitration, specifically with Khan Investments, which was the case of the Mongolian government unilaterally taking over the licenses. Their company sued for \$326 million, but the government settled for only \$70 million. How was the final number so much lower?

CM: It's clearly the case of the investor who feels that they

are wronged will look to absolutely maximize the amount of damages that they are seeking. And at the end of the day, the critical question was about the value of the licenses. A lot of the major arguments during that arbitration were around what the valuation should be, what the valuation mechanism should be. The arbitration award effectively ended up around \$100 million, plus interest. And then the government did a good job, I believe, of negotiating the \$100 million down to a settlement of \$70 million.

Defacto: Such arbitration cases are happening in Hong Kong or London, for example. Why couldn't these companies arbitrate in Mongolian courts?

CM: I think the real issue, when we talk about foreign arbitration, is the unpredictability of the Mongolian courts: judgments, experience of commercial matters, etc. That is really what drives foreign investors, certainly on larger projects, to look for neutral jurisdiction.

In our experience of situations where clients had cases before the Mongolian courts was that you never really know the outcome. Even when you think you have strong argument, there's a certain randomness to things. While I personally think the body of laws in Mongolia are improving and fairly solid, at times it can be vague, and the courts are not bound by precedent. If a court has made a ruling on a similar case previously, then future court decisions would have to take that into account.

Mongolia is a young democracy. The body of law is improving all the time. But certain laws clearly need to be updated, for example insolvency law, or bankruptcy law, hasn't been updated in over twenty years. We live in a very different environment than the one in 1997. Bankruptcy is quite important for some of the new types of transactions that foreign investors are looking at at the moment. We're seeing quite a lot of interest in derivatives and repurchase transactions. In that context, bankruptcy law is very critical for correct implementation of these types of transactions. So that's another area where improving that type of legislation would potentially increase access to finance for Mongolian banks and companies.

But I think another factor would be the newness of the market economy which means that people are still coming to terms, and trying to understand, commercial and corporate transactions.

Defacto: Chris, you're quite knowledgeable, and you've lived here for five years now. What do you think is the number one thing we need to do to improve our legal procedures?

CM: I would like to see a bit more public consultation because I think it's still the case that sometimes laws are rushed through quickly. I know this is one of the topics that you talk about often: more civil society involvement. But on the other hand you also have the *US-Mongolia agreement on transparency* which needs to be implemented.

2018.01.27

This interview has been edited for space and clarity


Full interview available here:

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MORE TROUBLES AT ERDENET

Presenter: The Erdenet mine's foreign bank accounts have reportedly been frozen in an incident related to a \$102 million loan where the larger copper deposit was put up as collateral. Operations are continuing at the mine for the moment, but it could face insolvency if unable to access its funds, Ikon.mn reported.

The issue goes back to 2011, when then-Prime Minister S. Bayar signed off on \$120 million in loans to Just Group from South Africa's Standard Bank. That company went belly up in 2013, however, taking down one of Mongolia's largest banks and leaving Mongolia with the bill. The mine is concurrently wrapped in a legal battle over ownership, as the government has announced its intentions to nationalize the mine from the private company Mongolian Copper Corp., despite a Supreme Court ruling last year that rebuffed a prior attempt at doing so.

This entire story is based on unnamed sources. What has the government said about this issue, and can we trust that it's real?

Defacto: Well, this information about former Prime Minister Bayar signing off on it during his prime ministership is not exactly correct, though I have seen it in other news sources. Actually, the Just Group loan was granted by the CEO of Erdenet Mining Corporation at the time.

Presenter: So the former prime minister might not have anything to do with the issue?

Defacto: I wouldn't say that, since it did occur during his administration. Because of the size of this, it probably couldn't have happened without the knowledge or consent of certain high-ranking government officials.

But what had happened was that Just Group had received a credit line from South Africa's Standard Bank, like other petroleum importing companies in the country because there was big cash flow, collateral was there, and it was more or less secured. And Standard Bank was the kind of bank that entered developing countries first, before other AAA banks. So they had been working for Mongolia for quite some time, in particular with this Just Group.

Presenter: So they are a bank that typically pioneers frontier markets, as Mongolia was at the time.

Defacto: Yes, and what happened was that Just Group was a fuel importer (i.e. diesel), and supplying Erdenet Mining Corporation and Mongolian Railway. Erdenet was using the services of Mongolian Railway, but they were not paying on time. But then they said "Whatever Mongolian Railway owes, our company will pay, and in exchange we will have the right to buy copper concentrate from you". So this whole thing had been working well for quite some time.

Since 2007, Just Group received several loans from Standard

Bank. And it was working well because it was good for Erdenet to pay bills, like to Mongolian Railway, to Just Group in the form of concentrate—a kind of barter exchange. And this scheme worked well until 2012, when the Democratic Party won and, as happens in Mongolia when a new party comes to power, they replaced the heads of all state-owned companies, which cut their ties with private companies who were seemingly supporting the other party. And so the barter-exchange agreement—that is, the cash flow—stopped in 2012 because Just Group could not sell anymore copper concentrate. Consequently, Standard Bank asked Erdenet to pay because they had made a guarantee, and Erdenet said "No, it's not our document; we have not signed". Arbitration then ensued.

Now, the London arbitration court decided that Erdenet must pay more than \$100 million, and they must pay immediately or face daily fines. Now the country is in a dilemma in two ways. First, Mongolia became a member of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, the so-called "**New York Convention**", which enforces other countries' arbitration laws inside one's own country. The convention has been around since 1958, but Mongolia didn't join until 1994. According to the convention, the London arbitration court will ask the Mongolian court to enforce their decision. Mongolia's court will probably receive the original documents, and then will likely make another investigation as to the veracity of the claims, etc.

Secondly, Erdenet will probably pay that money now, taking the money—or whatever is remaining—from Just Group and anyone else who was a signatory of the agreement. But what if Mr. Batkhuu, head of Just Group, has no property and is unable to pay? He owned a savings bank and wanted to sell it, but the central bank did not allow him to sell. Somehow the State Bank took over his bank, and so there should be former assets within State Bank. Those former assets of Mr. Batkhuu should be applied to the repayment, and not Erdenet. But this would be a long-term process.

So what can be done to make sure that Mongolian state-owned companies are not controlled by political parties? Well, **all state-owned assets should be privatized through shareholding companies**. Allow people to buy shares, maybe putting a limit on any one shareholder to no more than five percent, so that many people can acquire a stake.

Presenter: So Erdenet is involved in this ownership battle, where the government is arguing that it's in the best interest of the country if they manage it. Do you think this incident hurts that argument?

Defacto: Sure. **The best way to combat the secrecy of political party financing and corruption is through privatization and public shareholding.**

TAXES ROLLED BACK

Presenter: The prime minister has given in to public demand on the unpopular tax hikes amid protests and outrage. Taxpayers will be subject to only the 10% flat tax that they had been in previous years, GoGo News reported Prime Minister Ukhnaa Khurelsukh announcing in a piece that looked back on his administration's first 100 days in office. Mr. Khurelsukh said that the tax rollback cancels the progressive taxes that would have gone up to 25% for the highest income brackets, with the approval of the International Monetary Fund after negotiations. Taxes that have been already paid will be reimbursed to citizens, the prime minister added. Meanwhile, taxes on interest earned on savings are still in place and the higher retirement age is left intact, although it will be implemented at a slower pace of three extra months per year.

How is Mongolia able to simply cancel the taxes? Because these were put in place to generate more revenue due to the financial constraints of last year.

Defacto: Originally, that was the idea, and they were also included in the conditions of the IMF bailout program. Then people went into the streets, demanding that they abolish the new taxes. It was hurting many middle-class Mongolians who earn per month, on average, ₮1.5 million (~\$600). And the government capitulated. Now people wonder why they had implemented the tax law, only to repeal much of it a

few months later. This shows our parliament's capacity—or incapacity—to make lasting law. However, the good thing is that, if something is deemed detrimental to the economy, they can change it.

This has compelled companies to maneuver around the tax law, since ultimately they are the ones footing the bill, as taxes are taken from salaries. Instead of paying salaries above the particular tax bracket, they started to compensate employees differently. As a result, the amount of additional revenue flowing to the state budget was not that much.

Presenter: For taxpayers, it might be a small win, but the Democratic Party have not given up; they were leading protests in Sukhbaatar Square this past week. Why do they continue their opposition?

Defacto: It's politics. As Tsagaan Sar approaches, they want to draw people's attention to economic issues, particularly foreign debt, decreasing living standards, increasing unemployment, etc. However, the blame for **this "load" on the backs** of the Mongolian people should be shared by the Democratic Party. They contributed as much to the problem as the MPRP. This is of course a free country, and so they can protest how they want. But the role of the opposition should be as a contributor to better decisions through discussion and new ideas.

7% GDP GROWTH

Presenter: Mongolia is getting more and more good news about the prospects of an economic rebound as Moody's Investors Services predicts 7 percent economic growth in 2021. Moody's predicted strong GDP growth on the back of strong demand for its natural resources. It predicated its growth projections as long as Mongolia can follow the guidelines put out by the International Monetary Fund with its \$5.5 billion economic bailout last year. More evidence of greener pastures comes from the Bank of Mongolia's announcement that the balance of payments topped its highest surplus in five years. The bank cited rejuvenated foreign investment and proceeds from the so-called Gerege bond as the biggest contributors to \$1.45 billion surplus. Is it time to celebrate and spend, or are there more trials ahead?

Defacto: Not yet. With regard to Moody's rating, Mongolia went from "bad" to "less bad"—although that's still going in the right direction. However, it's not high enough to encourage proper investment. That being said, Mongolia's economy will be less vulnerable to fluctuations in the prices of commodities such as gold, copper, and particularly coal. And the demand for these will probably remain high.

We still have a way to go to reach B and higher ratings. With Moody's, we went from CAA to B3. Standard and Poor's and Fitch both rate Mongolia at B-. But is the economy really getting better? After all, we have been paying off old debt with new debt. Foreign debt is now at 80% of our GDP.

The 7% economic growth means less pressure on the budget. Meanwhile, government has to cut all extra expenses

in order to ensure that we are living within our means. There needs to be more opportunity for the private sector to do their jobs. And as we mentioned earlier, this is a chance to privatize state-owned companies.

This review has been edited for space and clarity

Full review available here:

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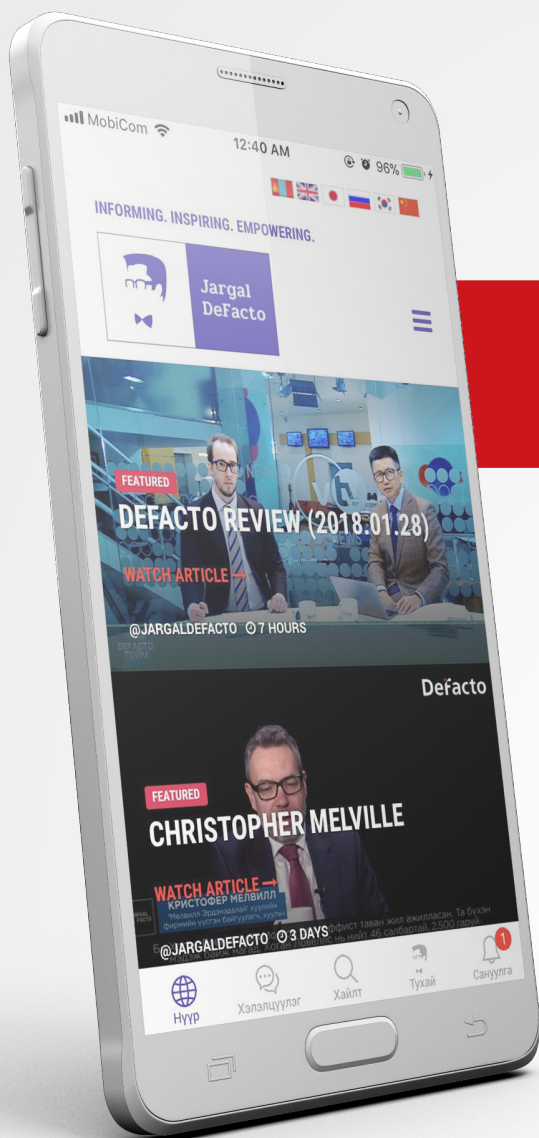
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