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WHY ONLY THE LENDER SHOULD BEAR THE EXCHANGE LOSS?

DeFacto **REVIEW**

➤ DEBT FORGIVENESS PLAN

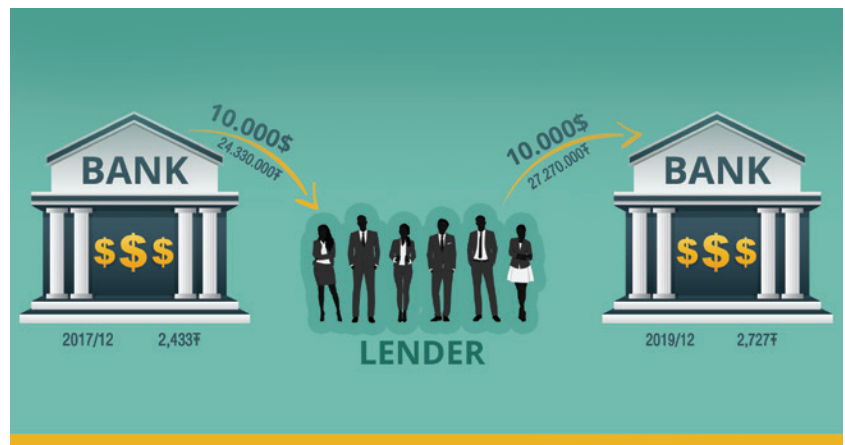
The initiative to forgive pension backed loans passed with a 79.5% majority on Friday, January 10th, 2020. A government plan to forgive pension backed loans has sparked significant discussion since it was announced on January 1st. The plan for the government to pay for loans taken against pensions was recommended by the National Security Council whose membership consists of the President, Speaker of Parliament and the Prime Minister, and approved by parliament.

➤ SOME NEW JUDGES APPOINTED

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WHY ONLY THE LENDER SHOULD BEAR THE EXCHANGE LOSS?



This question is being asked more and more often by Mongolian enterprises. Knowing that the lender company is selling their products and services in tugriks, Mongolian commercial banks are constantly pushing the loan exchange to them. With lower interest rates and greater availability, companies are obtaining the loan exchange, but in two-three years especially companies that implement big projects are getting under loan burden. According to the exchange rates while they got loan, even they paid the loan with interest rates several times, some lenders are still in bankrupt and at risk of losing business.

Thus, the loan exchange loss is becoming a real threat to the Mongolian private sector. Some entrepreneurs, through the Mongolian National Chamber of Commerce and Industry (MNCCI), have sent the appeal to commercial banks urging them to change their loan exchange conditions because the exchange rate fall did not depend on entrepreneurs. However, banks did not accept it.



THE REALITY

- The Bank of Mongolia's data shows that at the end of 2018, loan exchange held about one third of all bank's total loans, almost half of overdue loans and one quarter of non-performing loans. Throughout 2019, some companies have distrained pledged assets, while others have reduced their loan exchange by negotiating with the bank at new rates transfer to tugriks. However, at present, one fifth of total loans, 37% of overdue loans and 23% of non-performing loans are still in loan exchange. The loan exchange carries high risks ...

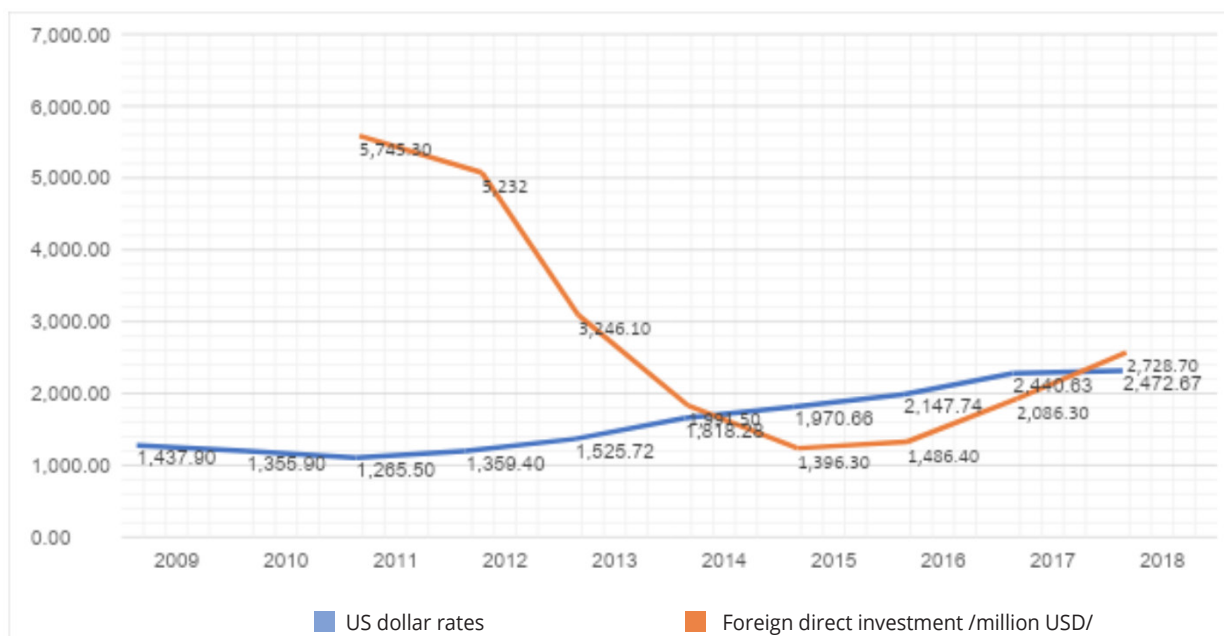
Loan exchange to total loans /Percent/	2018.12.31	2019.11.30
Regular loan	32.56%	22.03%
Overdue loan	45.30%	37.14%
Non-performing loan	23.92%	22.82%

Source: *Bank of Mongolia*

The success of businesses in Mongolia is largely dependent on whether long-term, low-interest investment sources are available which is, thus, a key factor for the competition in most sectors. That is why even non-exporting companies are still taking loan exchange because of its terms and conditions. The main reason for the shortage of loan tugriks are the relatively small domestic savings.

Companies are expressing that it is unfair to bear the loan exchange loss only by an enterprise alone because the exchange risk is a macroeconomic issue that is consequence of government policy. Here is shown the rise of a dollar rate in the last decade.

US dollar rates from 2009 to 2018 and foreign direct investments to the economy of Mongolia



Foreign direct investments ►►

- This also illustrates why enterprises were in difficulty because of their loan exchange. The MNCCI issues a certificate confirming unforeseen or force majeure circumstances. In 2017-2019, gave this certificate to 143 citizens and businesses but only half of them were able to fulfill their contractual obligations due to the rise in exchange rates.

Companies are at a loan payment risk when they take out their loan in the foreign currency but sale the products in the local currency. When the national currency weakens by 10%, the risk of non-repayment of loan exchange companies increases by almost 70% compared to the companies that are on a national currency loan (*Schmidt-Eisenlohr, 2017*).

This risk affects not only the company, but also the bank itself, which affects the economy of the entire country. Since 2010, the loan exchange deficit in the private sector of the developing countries is growing. Apart from the export-oriented businesses, but as well as non-export businesses are taking loan exchange (Chui et al, 2016).

THE RESOLUTION

The loan exchange risk depends more on the stability of the local currency rate. Ten years ago, the Mongolian tugrik and the Korean won were ratio in one, but today the tugrik has weakened twice. The Korean economy is booming, meaning that its ratio of foreign and local currency is stable.

This is connected to the fact that in Mongolia, foreign currency is decreasing while local currency is increasing. There are two options for a country to increase its foreign currency earnings: to increase export and attract more foreign investment. Although lending's can be taken from abroad, it weakens the tugrik if export earnings cannot be increased. The Mongolian case proves it. In December 2012, for the first time in history, the government issued a bond called 'Chinggis' on the international market, but failed to diversify its economy and increase exports, resulting in an exchange rate of 1350 MNT per dollar to 2700 MNT seven years later. Since then, the economy has not recouped and the government, on the verge of bankruptcy, got the help under certain conditions from the International Monetary Fund. One of these conditions is the reform of the Mongolian banking system, but it has been failing for three years.

Eastern European countries, which had similar experiences during the 2008 world financial crisis, are minimizing their

risk because of tighter financial regulations and tougher loan exchange requirements under the European Union.

It is time for both the Bank of Mongolia and the Mongolian Development Bank to tighten their loan exchange requirements and implement clear policies. Maybe, this should be not allowing non-export businesses to provide loan exchange and providing hedging services, decrease interest rates on loan in tugriks and extending them.

For developing countries such as Mongolia, there is no other option but to increase foreign direct investment to keep exchange rate steady. However, according to the Bank of Mongolia's balance-of payment statistics, since 2014 foreign direct investment has stagnated to this date. In order to attract foreign and domestic investment, it is necessary to enable fair competition in each sector, to change state owned-companies to stock companies, to reduce the political influence in commercial banks, and to manage that banks and customers are in equal responsibility to exchange rate losses.

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DeFacto **REVIEW**

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DEBT FORGIVENESS PLAN

The initiative to forgive pension backed loans passed with a 79.5% majority on Friday, January 10th, 2020. A government plan to forgive pension backed loans has sparked significant discussion since it was announced on January 1st. The plan for the government to pay for loans taken against pensions was recommended by the National Security Council whose membership consists of the President, Speaker of Parliament and the Prime Minister, and approved by parliament.

Debts of up to 6 million MNT will be paid off by the government and the initiative will cost the government a total of 776 billion MNT. Debt-free pensioners on the other hand are to be provided with a 1 million MNT grant. This plan will result in a depreciation of the MNT as it will entail the government dumping 776 billion MNT into the economy in a matter of months. The plan caused heated debate over the last couple of weeks and even the announcement of the proposal caused a 10 MNT depreciation against the USD. The Speaker of the Parliament claims that inflation will not increase by more than 1% as a result of the initiative and I am not aware of how this figure was reached but they seem to be little more than false expectations. Inflation in Mongolia is already at 5.2% and most experts concur that the effects of the plan will manifest itself within 6 months so it is entirely possible that it will coincide with the June elections.

An IMF spokesperson claimed that this plan violated the conditions of a 2017 bailout provided to Mongolia and the President also stated that it would need IMF approval during his New Year's speech announcing the plan. The IMF Resident Representative to Mongolia stated that the plan is inconsistent with the goals of the IMF supported program agreed to in 2017 and increases public debt to 2% of GDP. A tense negotiation with IMF will surely ensue as the government had previously committed to reducing spending and increasing taxes in pursuit of balancing



the books. The government had also pledged to implement fiscal reform in order to maintain budget discipline and improve the manner in which it regulates the banking and finance sectors. As the government is doing the exact opposite of what it has to do, further financial help may be cut or scrutinized. Therefore, the risks are unfortunately multifaceted as foreign investors would also think twice before investing in Mongolia.

We need to understand that experts and economist are all opposed to such a decision and the government needs to understand that a one-time pardon will not elevate Mongolians out of poverty. A fundamental structural change is essential to lift Mongolians out of poverty and misery. In my opinion, all experts, NGOs and public organizations need to band together and influence decision makers by availing them to the negative effects of such shortsighted policies. Moreover, as the IMF has already stated that the plan violates the terms of the 2017 agreement, it may also seek to influence the government into revisiting its decision.

SOME NEW JUDGES APPOINTED

The President suspended the judicial powers of 17 judges in connection to the Salkhit Silver Ore deposit but his reluctance to appoint replacements creates uncertainty in the operation of the courts, especially the Civil Chamber of the Supreme Court. The vast powers of the Presidency over the judiciary include the appointment of all judges, nomination of the State Prosecutor and their Deputy, appointment and dismissal of the Chairman of the General Council of Courts as well as its members.

On December the 30th, the President appointed a High court judge, 6 judges in the first instance courts in Ulaanbaatar and provinces as well as 5 rotational judges in first instance and administrative courts. I am not a professional lawyer so my opinions may be a little incorrect but in June 2019, the President temporarily suspended 17 judges deemed to be connected to the Salkhit Silver Ore deposit. Experts and lawyers agree that High Court operations were somewhat limited due to the appointments taking longer than expected but it is not as simple as that.

Firstly, the judges were not dismissed but temporarily suspended and criminal proceedings against them are currently under way. Those deemed to have no connection to the case may return to their duties and those found to have a connection will have their cases transferred to the judiciary. Given the relatively lengthy court proceedings in Mongolia, this case is unlikely to be resolved in the immediate future. If we look at international precedent in the appointment of high court judges, it



SOME NEW JUDGES APPOINTED

is always a lengthy, highly politicized process. I would like to look back at a case in Mongolia in 2013 where President Ts.Elbegdorj dismissed 13 judges. As a lawyer, he understood that the appointment of judges is a lengthy process, so he made a structural change and sacked all the judges, introducing a new structure and naming. Instead of district courts carrying the name of their respective districts, they are now referred to as first- and second-degree district courts. He then reappointed all judges except the 13 that were suspended.

I believe that it is in President Kh.Battulga's best interests to keep the judiciary system as efficient and transparent as possible so it is unlikely that he will follow suit. We do however need to understand that it is a long process and that it will take time to appoint the 17 judges.

HEDGE FUND TO BE FORMED TO KEEP AI-92 PETROL PRICE STABLE

During its meeting on Wednesday, January 8th, 2020 the Mongolian cabinet reached a decision to create a hedge fund to stabilize the price of AI – 92 petrol. The government also stated that oil prices had been increasing as a result of the Iran-American conflict but are beginning to fall. Maintaining a competitive petroleum price in Mongolia is a thorn in the side of most governments who have implemented a variety of measures to keep prices down. I don't believe that the establishment of the hedge fund is connected to the Iran-American conflict, but it may have something to do with the upcoming election.



The intent behind the introduction of new measures to keep petroleum prices stable is always good. In the past, the government attempted to subsidize petroleum and to establish flexible excise taxes tied to the value of the MNT. Petroleum companies attempted to keep prices low by buying in bulk, but this required significant capital upfront and an enormous amount of investment in logistical infrastructure. At this time, it is worth mentioning that the petroleum reserves of all companies operating in Mongolia can dry run in a month, so hedging is the solution.

The price of petroleum depends on the price of oil and there are two institutions in the world that set the spot price for crude oil: the EU and WTI. According to my knowledge the big trading companies started effectively engaging with hedge funds in order to protect its turnover from unforeseen events such as a potential US-Iranian war. Through hedging, the buyer and seller agree on a particular price for a certain amount of time. For example, an agreement can be reached at 10 USD per ton for a 12-month period regardless of fluctuations in the price of crude oil.

However, hedging is a relatively new instrument that was created in the last 5-10 years. There are plenty of hedge funds around the world dealing with oil, petroleum, commodities. The competitive advantage of the hedge funds come from the information they try to gather and knowing what would happen in six months, 12 months and so on. Ordinary individuals are not privy to such information as it does not have access to the professionals and expertise that hedge funds do. As this is the first attempt by the Mongolian government to set up a hedge fund, they may not be able to employ the true professionals so they may enter into a partnership with the big hedge funds who have their own leverages, connections and strategies. 95% of Mongolian petroleum is supplied by Rosneft so a strong hedge fund would be

able to perform tough negotiations with them and other companies on our behalf.

In 2015, the Prime Minister of India, Narendra Modi visited Mongolia and offered a soft loan package from the India EXIM Bank. Those funds were directed towards the establishment of the first refinery in Mongolia. We know that the proposal is ready and that June 2018, the Prime Minister of Mongolia visited Dornogovi province and did the grand opening. It is expected to be in service by 2024. The factory will have the capacity to refine 1.4 million tons a year.

It is a complicated process, but the refinery can be erected in a year or two. There was however little information on who will supply the crude oil, but they may have a couple of options which are currently not being disclosed to the public. Some may say that we have crude oil in Dornod province, but it is high in paraffin and other residuals and therefore requires a lengthy purification process that would influence the end price. Mongolian oil is not ideally suited for processing, but its residuals can be utilized in cosmetics and other industries, and this is why China is importing our crude oil in significant quantities.

An oil refinery in Mongolia is extremely important as we are currently importing all of our petroleum. However, we must also consider the reduction in gasoline cars that will come about in the future. Electric cars will come into use more and more with some European countries estimating that half of the cars in their cities will be electric by 2025. There have been some claims that the refinery will not be able to sustain a profitable operation, but I haven't seen the numbers, so it is difficult to render an opinion.

*This review has been edited here for space and clarity.
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