WAR IN UKRAINE AND ITS IMPACTS ON MONGOLIA'S ECONOMY

FRIEDRICH EBERT STIFTUNG

MONGOLIAN INSTITUTE FOR INNOVATIVE POLICIES

MONGOLIAN GEOPOLITICS #22

The views expressed in this publication are not necessarily those of the Friedrich-Ebert-Stiftung.

Author: A.Odonbaatar

Layout: Yo.Batbold
Cover illustration: I.Tuguldur

ISBN 978-9919-9927-1-2

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Mongolia's economic growth was 1.4 per cent in 2021. Many experts, including international analysts, had predicted up to 5.2 per cent growth for 2022 due to the bilateral trade with China and Russia returning to the pre-pandemic level.[1] Then the Russia–Ukraine war broke out, and all predictions were adjusted. The war has impacted Mongolia's trade with Russia and Europe. Additionally, China's escalation of restrictions following the COVID-19 pandemic has reduced Mongolia's commodity exports to China.

The World Bank readjusted its growth prediction for Mongolia, from the optimistic 5.2 per cent to 2.5 per cent, but even lower for the worst-case scenario, at 0.7 per cent.[2] The S&P Global Ratings have kept Mongolia at the "B" credit rating and forecasted the country's economic outlook as stable, mostly due to expectation of the full operations of the Oyu Tolgoi copper mine and increased export of Tavan Tolgoi coal.[3] Although the S&P Global Ratings see Mongolia's economy potentially reaching high growth of 6.8 per cent by 2024, Mongolian economists are predicting stagflation due to low growth, growing inflation, high unemployment and policy mismanagement.

Following its geopolitical fate, Mongolia will experience a tough socioeconomic situation when it pays off its bonds and Chinese currency swap loans in 2023, which it is required to do at that time but also which it must do to retain its populist politics in the 2024 parliamentary and provincial elections. Unless Mongolia's trade with China resumes in the second half of 2022, Mongolia will find itself in a situation similar to what it experienced during the Second World War, when its two great power neighbours were entangled in war, globally and, for China, internally. As the Ukraine war intensifies, Mongolia will be caught up in the geopolitical competition between Russia and the West. This will require Mongolian political leaders to make hard foreign policy decisions. And those decisions, which they are sure to make, will have undesired impacts on the country's economy. This paper explains in brief how the war in Ukraine is affecting Mongolia's economy and concludes with thoughts on how the impact will worsen the country's economic situation and what could mitigate the worst of it.

Mongolia's economic dependency on Russia

Unlike the socialist period when the Mongolian economy was totally dependent on Soviet subsidies, investments, technologies and markets, the country's economic dependency on Russia has significantly reduced. Russia ranks low (less than 1 per cent) among Mongolia's top export destinations, whereas 80–90 per cent of Mongolian exports go to the Chinese market. This is understandable because both Mongolia and Russia export similar types of mineral products (copper, coal, molybdenum, tin, tungsten and gold), and Russia doesn't buy animal products from Mongolia. Due to high customs tariffs and difficulty entering the Russian market, Mongolia's top export product (cashmere and wool) producers prefer to reach out to markets within the sphere of the Organisation for Economic Co-operation and Development (OECD), especially in Europe.

One enduring dependency on Russia is the high demand for its imports. Russia is the second-largest importing partner (28–30 per cent), after China, and ranks higher than other import partners (Japan, South Korea and the United States). Mongolia is highly dependent on Russia's oil products and electricity, especially during the high-demand winter periods. Except for a small amount of petroleum imported from China, all types of oil products (gasoline, diesel and aviation kerosene) from Russia account for more than 90 per cent of Mongolia's total imports. Chinese imports represent less than 10 per cent of total imports.[4] Under a production-sharing agreement, China's Petrochina Dachin Tamsag LLC exports crude oil from Mongolia to China and then imports 40 per cent of the refined petroleum products back to Mongolia.[5]

In addition, Russia is the only land gateway for Mongolia to trade with Eurasian and European States, with Mongolian truckers plying its roads to transport products from Eastern and Western Europe to Mongolia. However, the total trade with European States is not significant when compared to Mongolia's trade with the Asian–Pacific countries through China. Russia is also an air gateway for Mongolian passengers bound to Europe. The trans-Mongolian railway is crucial not only for Sino–Russo trade but also Mongolia's trade with Europe because it is the shortest route between China and Russia.

Despite intergovernmental talks and requests, mostly from the Mongolian side, Russia's business and investment interests in Mongolia are low or basically non-existent, especially since Russia ended joint mining ventures in 2016.[6] There were some surging interests from Russia in mining sector investment (coal, silver and uranium deposits) and railway extension projects following the commodities boom cycle in 2000–2014. But these interests soon waned due to Mongolia's political instability and the commodities bust cycle. A new commodities surge appears to be ongoing with the potential re-routing of the gas pipeline between Russia and China through Mongolia. Otherwise, there is a little business interest in Mongolia.

Negative impacts on the Mongolian economy

The Russia–Ukraine war immediately affected Mongolia's trade with Ukraine, Eastern and Western Europe and Turkey. When many international flights began bypassing Russian airspace, Mongolia began losing its collection of overflight fees and had to delay its plan to set up an air freight logistics centre, even as the new international airport began operations after several years of delay.

The toughest challenge has become how to respond to the international sanctions on Russia, led by the United States and the European Union. Although Mongolian banks had been cautious in dealing with Russia since the previous sanctions in the aftermath of Russia’s takeover of Crimea in 2014–2015, this time it has become extremely difficult to deal with Russian businesses. Any violation could trigger a penalty or place Mongolia on the “grey” or “black” listing of international financial institutions and thus increase the barriers to attracting investments, loans and trade.

An immediate although temporary impact has been on Mongolia’s dollar reserves. When the West imposed sanctions on Russia this time, Mongolian and Russian currency speculators bought a large amount of the US dollars in Mongolian banks and exchanges. This led the Bank of Mongolia and other banks to impose temporary restrictions on the trade of US dollars in March and May 2022, which made it difficult for businesses and customers to engage in transactions using US dollars.[7]

Many hopes are now banking on the Chinese imports of Mongolian coal and other mining products, which will refresh the foreign currency reserves (especially US dollars) to a level that will relieve the concerns of Mongolian banks. But the Chinese border remains closed, and Chinese coal imports are slow. This will only continue to depreciate the Mongolian currency. For instance, in February, the US dollar rate was 2,857 tugrug; currently it is 3,150 tugrug.[8] Mongolian government officials and businesses are caught in an extremely difficult situation as the world's power economies strengthen their sanctions on Russia and impose penalties on countries trading with Russia.

Fuel imports

Fuel imports are a major concern for Mongolian government officials, businesses and even ordinary people. As noted, Mongolia remains largely dependent on Russian fuel exports and has been unable to find other importers to refine the crude oil from its oil deposits. Nor has Mongolia been able to explore alternative sources of fuel (such as coal liquefaction).[9] A fuel shortage is a tripwire for any government because it increases the fuel price, which in turn sparks a price increase on all goods and services. A fuel shortage will impact all industries, especially mining, construction, agriculture and services.

Whenever Mongolia encountered a fuel shortage in the past, Mongolian leaders and government officials rushed to Moscow to secure the supply and to subsidize the fuel price.[10] This was the case at the start of the Russia–Ukraine war in February 2022. The government directed an increase of the fuel supply (it typically maintains a 30-day supply) to at least 45 days and dispatched government delegates to Moscow to secure that supply. It also introduced a temporary exemption of the excise tax on the most popular brand of diesel fuel (AI-92). These moves were in preparation for the typical fuel consumption hikes that begin in March, when the weather allows for mining, construction and agricultural activities. The government's silence on the Ukraine war and even attempts to restrict anti-Russian and pro-Ukrainian voices and demonstrations likely reflect the natural fear for stability of the fuel imports from Russia.

The war with Ukraine raises three acute concerns for the Mongolian government and fuel suppliers: (i) the reliability and sustainability of the supply; (ii) price stability or increase; and (3) method of payment under international sanctions. For Russian oil companies, such as the large Rosneft, the size of the Mongolian market is small. For the Kremlin, fuel is the strongest leverage over Mongolian political leaders. Fuel was a key theme during the Russian Foreign Minister’s visit to Ulaanbaatar on 5 July 2022.[11] Following that visit, the Mongolian government announced that Russia will continue to export AI-92, but at a lower price, and the Mongolian government will subsidize the fuel importers.

Electricity

Power is another worrisome issue. The country’s energy demand is growing as the industrial sector (mining and construction) expands. Daily electricity consumption by businesses and households are on the rise. However, the energy systems in the Central, Western and Eastern regions are not fully integrated. The concentrated urban areas (Ulaanbaatar, Erdenet and Darkhan), where more than half of the country’s population lives, rely on Soviet-built thermal power plants. The maintenance of these outdated thermal power plants is dependent on spare parts, especially turbines, made in Russia. Mongolia imports 10–13 per cent of its electricity from Russia for use in the Central and Western regions.[12] In other words, Russia’s electricity provision is critical if Mongolia’s major power plant malfunctions or the demand during the winter months overwhelms its capacity when households and businesses increase the use of electricity for heating under the government’s policy to reduce air pollution from coal burning.

Since 1990, many efforts have aimed to reduce the dependency on Russia, to increase Mongolia's capacity to meet the growing energy demand and to privatize the energy sector. But none have succeeded. For example, Power Plant No. 5 plan never materialized due to competition among politically affiliated business factions, with successive governments changing its proposed location five times. Mongolia's plan to construct a hydropower plant at the Eg River with funding from the Export–Import Bank of China and then a Shuren hydropower plant on the Selenge River was stalled by Russia's concern for the environmental impact on its Lake Baikal.[13]

Whenever there is a proposal to increase private ownership or introduce free-market pricing of electricity, politicians and the public object for understandable reasons. Thus, Mongolia remains dependent on spare parts and turbines from Russia and on electricity from the Russian grid. If Mongolia cannot receive the necessary Russian-made spare parts or the funding to refurbish two main power plants (No. 3 and No. 4), the government needs to heavily rely on electricity imports from Russia or to introduce restrictive measures, as it did in the 1990s.

Other critical imports

There are many other critical imports from Russia that have direct and indirect impact on Mongolia's economy. The first is fertilizers, especially nitrogen fertilizers, used in the mining and agriculture sectors.[14] If Mongolia cannot receive nitrogen fertilizers (a critical component for explosives used for mining), mining production will slow. It will impact the country's commodity exports to China and also interrupt the coal mining operations for the domestic market. All major power plants as well as smaller plants for off-grid heating and electricity will need to buy coal during the summer months for the winter operation.

Another important import is grain.[15] Although the Mongolian government is implementing a policy of food self-sufficiency, businesses still import a large amount of high-quality grain from Russia (equivalent to 25–30 per cent of Mongolia's total grain production). If Russia stops or reduces the grain exports, it will affect Mongolia's flour consumption, grain plantation (as a seed) and beverage industry (alcoholic beverage production).

Another important export that is critical for the gold mining industry is cyanide, for which Mongolia is totally dependent on Russian exporters. There are many other imports (spare parts for Russian-made machinery) that could be added to the list of concerns, but their impacts could be managed or Mongolia could switch to alternative exporters. Many Russian companies want to keep their business with Mongolia because their international partners or buyers have diminished. But the Kremlin's measures to restrict imports of specific products or to stop trading with countries that oppose Russia's invasion of Ukraine will increase the pressure on Mongolian authorities and businesses. These situations require that Mongolian government officials and businesses understand the vulnerabilities and become creative in finding ways to diversify exporters.

Positive impacts on the Mongolian economy

In the bigger picture, Mongolia still is considered as a geopolitically important neighbour. The Kremlin will likely maintain a friendly policy towards Mongolia, and some Mongolians hope that Russia's economic interests will grow. That growth is unlikely, though, because Mongolia is an unattractive business environment for Russian investors: It is a small market.

There is no Russian-speaking diaspora. It has underdeveloped infrastructure. And it is politically unstable. Some Russians, especially those affiliated with the Kremlin, may have some interest in the energy sector, mining and infrastructure development, but aiming at the Chinese market.

Russia might push forward the trans-Mongolian pipeline project even though the Chinese side has remained silent since the Kremlin's announcement of constructing this pipeline through Mongolia. Apparently, only Russia and Mongolia have been working to expedite the pipeline. For example, just a few days after the Russian invasion of Ukraine, Mongolian Deputy Premier Amarsaikhan Sainbuyan and Alexey Miller, Chairman of the Gazprom Management Board, signed a plan for a joint working group involving the government of Mongolia and Gazprom for 2022–2024.[16]

Mongolian government officials are seeking ways to overcome Russia's objection to the Eg River hydropower plant by welcoming Russian participation in the project, even though the purpose of the plant is to reduce Mongolia's dependency on Russian electricity imports. This idea was put forward by Prime Minister Oyun-Erdene during his July meeting with the visiting Russian Foreign Minister.[17]

At the people-to-people level, Mongolia has become one of the possible travel destinations for Russian travellers because the Chinese borders remain closed and the OECD countries are reluctant to receive them. After a long overdue request from the Mongolian side, the Russian authorities agreed in 2014 to introduce reciprocal visa-free travel between the two countries. This policy encouraged many Mongolian travellers who are nostalgic for Russian culture, are curious about adventure trips and/or are Buddhist worshippers wanting to visit the well-known Buryat monks.

But the pandemic situation and now Russia's war in Ukraine have reduced the number of Mongolian travellers.

Many Mongolians are also reconsidering their travel plans to Russia because it could affect their visa applications or future travels to Western countries. According to Border Troop statistics, travellers from Russia to Mongolia have increased significantly, with a daily average of 500 travellers.[18] This includes foreigners and Russians using Mongolia's international connections to Seoul, Tokyo, Istanbul and Frankfurt because flights to Russia have been suspended. Based on inconclusive research and rumours, some Buryats, Kalmyks and Tuvans are seeking a longer stay in Mongolia to dodge the military draft because the Russians are sending ethnic minorities to the war zone in Ukraine. Many Russians who live in the autonomous regions and republics near Mongolia travel across the border for touristic or economic reasons. Following the increased number of travellers, some Mongolian airlines and travel companies are looking for business opportunities to facilitate this type of travel need, especially on the Russian side.

Concluding thoughts

If the war prolongs or even expands, its impacts on Mongolia's economy will be extensive. The macroeconomic indicators already signal that the country's economy is going into a stagflation period.[19] The inflation rate is more than 16 per cent; unemployment is around 10 per cent; the price rate of consumer goods increase is more than 16 per cent; and overall economic growth is down by 1.5 per cent. The government has increased social spending and passed a budget in expectation of a large scale of commodity exports to China. But commodity prices, especially for copper and coal, are falling while the price of diesel, which is a critical fuel import for the country's industry, is on the rise. Because commodity exports remain slow and at small scale, it will impact the US dollar reserves and intensify the depreciation of the Mongolian currency. In 2023, the government needs to pay off its large foreign debts (the Chinggis, Gerege and Samurai bonds). This situation will worsen if the war in Ukraine continues and Chinese borders remain closed.

Business activity in September, which typically jumps after the long August holiday, will be an indicator of the current and potential impact on the country's political and social stability. But all signs indicate that government-imposed drastic measures will be unavoidable. The government most likely will also need to seek some type of structural adjustment programme from the international financial institutions, as it did in the 1990s.

There are two high hopes that might ameliorate the country's economic situation. One is the completion of the Oyu Tolgoi underground mine production and the start of full operations of copper mining. The other is China's increased coal imports from Mongolia as the economy there picks up speed. The most important positive factor, however, would be an end to the Ukraine war.

Endnotes

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6 Sergey Radchenko and Lkhagva Erdene, "The mysterious sale of Mongolia's Erdenet mine", Kennan Institute, 9 July 2016. Available at www.wilsoncenter.org/article/the-mysterious-sale-mongolias-erdenet-mine.

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Friedrich-Ebert-Stiftung Mongolia
Landmark building
Sukhbaatar district, 1th khoroo
Chinggis avenue 13
Post box 831
14251 Ulaanbaatar
Mongolia
Facebook: @fesmongolia
Email: info.mongolia@fes.de
Web: https://mongolia.fes.de/