



Investment Reform Map for Mongolia

A Foundation for a new Investment Policy & Promotion Strategy

Mongolia Investment Policy and Agriculture Investment Promotion (IPAIP) Project

Final Report
June 2018

IN PARTNERSHIP WITH



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Final Report

June 2018

INTERNATIONAL FINANCE CORPORATION

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TABLE OF CONTENTS

List of Acronyms.....	i
List of Figures	iii
List of Tables.....	iv
Acknowledgements	v
Executive Summary.....	1
Introduction	11
Chapter 1. Investment Performance and Potential	15
I. Overview of Mongolia’s investment performance	15
II. Mongolia’s openness to trade and integration to global and regional value chains.....	20
III. Assessment of Mongolia’s investment potential	22
IV. Policy directions.....	36
Chapter 2. Legal and Regulatory Framework on Investment	39
I. Investment Entry: Restrictions to foreign participation in the local economy	39
II. Investment Climate constraints play a role.....	45
III. Investment Protection: International and domestic legal framework.....	51
IV. Recommendations	57
Chapter 3. Institutional Framework for the Promotion of Investment	59
I. Assessment of investment promotion in Mongolia	59
II. Recommendations	63
Chapter 4. Formulation of an Investment Policy Statement and Reform Action Plan	67
I. An investment policy statement for Mongolia	67
II. Suggested reform action plan	69
Annex A: Analysis of Economic Complexity	72
Annex B: Findings of Global Investment Competitiveness Report 2017	76
Annex C: Analysis of Major BITs signed by Mongolia	78
Annex D: Good Practice Institutional Arrangements and Frameworks for Investment Promotion	81
The importance of putting in place the right institutional arrangements to support investment policy and promotion	81
Good practices in national FDI promotion frameworks.....	81
The roles of ‘lead’ investment promotion agencies.....	83

LIST OF ACRONYMS

ASEAN	Agreement of South East Asian Nations
BEFI	Business entity with foreign investment
BIT	Bilateral Investment Treaty
BoP	Balance of Payment
BRI	Belt and Road Initiative
DB	Doing Business
DFIRR	Department of Foreign Investment Regulations and Registration
DSU	Dispute Settlement Understanding
DVA	Domestic Value Addition
EAP	East Asia Pacific
ECI	Economic Complexity Index
EPA	Economic Partnership Agreement
EU	European Union
FDI	Foreign Direct Investment
FET	Fair and Equitable Treatment
FIFTA	Foreign Investment and Foreign Trade Agency
FIL	Foreign Investment Law
FTA	Free Trade Agreement
GATS	General Agreement on Tariffs and Trade
GCF	Gross Capital Formation
GDP	Gross Domestic Product
GET	Global E-commerce Talent
GoM	Government of Mongolia
GSP	Generalized System of Preferences
GVCs	Global Value Chains
HHI	Herfindahl-Hirschman Index
ICSID	International Center for the Settlement of Investment Disputes
IIA	International Investment Agreement
IMA	Invest Mongolia Agency
IPAIP	Investment Policy and Agriculture Investment Promotion
IPAs	Investment Promotion Agencies
IPC	Investor Protection Council

IPS	Investment Policy Statement
IRM	Investment Reform Map
ISDS	Investor-State dispute settlement
MAI	Multilateral Agreement on Investment
MFN	Most Favored National
MIGA	Multilateral Investment Guarantee Agency
MIL	Mongolia Investment Law
MoE	Ministry of Economy
MoFA	Ministry of Foreign Affairs
MoFALI	Ministry of Food, Agriculture, and Light Industry
M&E	Monitoring and Evaluation
NDA	National Development Agency
NQI	National Quality Infrastructure
NT	National Treatment
OECD	Organization for the Economic Cooperation and Development
OSS	One-stop-shop
PCI	Product Complexity Index
PIP	Public Investment Plan
PTA	Preferential Trade Agreement
RCEP	Regional Comprehensive Economic Partnership
SEFIL	Strategic Entities Foreign Investment Law
SIRM	Systemic Investor Response Mechanism
SCM	Subsidies and Countervailing Measures
SOE	State-owned enterprise
TRIMs	Trade Related Investment Measures
UNCTAD	United Nations Conference for Trade and Development
US	United States
USD	U.S. dollar
WIR	World Investment Report
WBG	World Bank Group
WTO	World Trade Organization

LIST OF FIGURES

Figure 1.	Mongolia’s inward FDI inflows (US\$ billion, 2000-2017)	15
Figure 2.	FDI flows to GDP ratio (%): Mongolia vs. lower middle-income countries (1990-2015) and FDI performance index (Mongolia vs benchmarks, 2001-2015).....	16
Figure 3.	Stock of FDI as % of GDP (2015) and stock of FDI % of GDP for benchmark countries	17
Figure 4.	Stock of FDI (by source countries; 2017)	17
Figure 5.	FDI concentration: Herfindahl index (by FDI source country, 2012).....	18
Figure 6.	Mongolia: FDI by sector (2017).....	19
Figure 7.	Mongolia: FDI Typology (percentage; 2012-2016).....	19
Figure 8.	Mongolia: GVC integration (2014).....	21
Figure 9.	Results of the Agribusiness Sector Scan	24
Figure 10.	China imports of meat products.....	25
Figure 11.	Pillars of a comprehensive linkages program.....	31
Figure 12.	Mongolia’s export destinations (including China)	32
Figure 13.	Mongolia’s export destination (excluding China).....	33
Figure 14.	Exports to Japan, 2007-2015	33
Figure 15.	Mongolia exports of Electronic Microcircuits, 2010-2014	34
Figure 16.	A two-pillar approach as the foundation for a new FDI vision and strategy.....	36
Figure 17.	OECD FDI Regulatory Restrictiveness Index, 2016	40
Figure 18.	OECD FDI Regulatory Restrictiveness Index by sector, 2016.....	41
Figure 19.	Relation between FDI flows and FDI regulatory restrictiveness score.....	41
Figure 20.	Doing Business Ranking, 2017 & 2018	46
Figure 21.	Doing Business Distance to Frontier, 2018	46
Figure 22.	Ease of Trading Across Borders, 2018	47
Figure 23.	World Governance Indicators for Mongolia and EAP countries, 2011 & 2016.....	48
Figure 24.	Government Effectiveness, 2016	48
Figure 25.	Regulatory Quality, 2016.....	48
Figure 26.	Rule of Law, 2016.....	49
Figure 27.	Global indicators on Regulatory Governance Index, 2016	49
Figure 28.	Nature of Grievances reported by respondent companies (percentage).....	51
Figure 29.	Country risk ranking for expropriation and currency inconvertibility and transfer restrictions	56

Figure 30. Mongolia’s export specialization in primary products and manufactures (2013).....	72
Figure 31. Diversification vs. ECI Mongolia and selected economies.....	74
Figure 32. ECI vs FDI Complexity, Mongolia and selected economies	75
Figure 33. Diversification vs. opportunity value, Mongolia and selected economies	75
Figure 34. Investor experience with political risk	76
Figure 35. Importance of investment climate factors.....	77
Figure 36. A Model National Investment Attraction Framework	82

LIST OF TABLES

Table 1. Mongolia, PCI, export values, and destination.....	35
Table 2. Summary of Global indicators on Regulatory Governance for Mongolia, 2016	50
Table 3. Summary of the gap analysis between Mongolia’s major IIAs.....	53
Table 4. Reported ISDS cases against Mongolia	54
Table 5. Investment Promotion Functions and Resources 1993 – 2018	60
Table 6. Recommended Reform Action Plan	69
Table 7. Mongolia’s export specialization in primary products and manufactures (2013)	73
Table 8. What IPAs can do and what IPAs should do	84

LIST OF BOXES

Box 1. Linkages between Domestic and Foreign Investment	29
Box 2. Common characteristics of best-practices IPAs	83
Box 3. Example of account management results from the Georgian National Investment Agency	86

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EXECUTIVE SUMMARY

Key Messages

The following are the key messages and actions recommended to help the Government of Mongolia (GoM) formulate a new investment policy and strategy to better leverage existing foreign direct investment (FDI), attract new forms of FDI, and help diversify the economy:

- Economic diversification should be front and center in the minds and actions of policy-makers, promoters, and regulators. However, diversification does not mean or should not be interpreted as “neglecting the extractive sector” or moving away from it. The sector has certainly contributed a lot to Mongolia’s economy and is likely to remain the main source of FDI for some time.
- For optimal results, Mongolia may adopt an approach resting on **two pillars**:
 - Pillar 1: Find ways to maximize FDI in natural resources; and,
 - Pillar 2: Identify opportunities to attract FDI in other, non-mineral activities.

The **first pillar** means both continuing to attract FDI in mining but also implementing a strategy to increase domestic value addition (DVA) and linkages between foreign and domestic investors. This builds upon existing private sector initiatives to gauge the availability of domestic suppliers for the needs of mining operators for goods, services, inputs in general. Additionally, the GoM may want to examine the potential for some downstream activities in the extractives sector where it makes sense economically. There could be a few “niches” where the costs of developing these opportunities would not exceed the benefits but be attractive value propositions (e.g. coal washing).

The **second pillar** entails looking at the potential for FDI in other sectors of the economy based on investor signals and where Mongolia has potential to be competitive. Initial findings from interviews with the private sector and the GoM indicate that the following sectors and sub-sectors have some potential for attracting FDI: tourism and hospitality; e-commerce, and agribusiness. Mongolia could focus its FDI promotion efforts on these sectors with under-developed potential and examine how current policies are conducive to more private investments in these sectors.

- It is important to recognize that efforts to develop linkages between foreign and domestic investors will remain a challenge and require sustained efforts from both the private sector and the GoM given the narrow FDI base and the narrow pool of suppliers, issues of quality and reliability of outputs, etc. Again, the extractive sector may be the most likely sector for some linkages in the short term, but the new strategy should also consider linkages in other sectors such as tourism.

- To upgrade and diversify its economy, Mongolia will need to attract *efficiency-seeking investment*, which is not coming to the country at the moment. This would require an effort to expand the export basket. The analysis on economic complexity suggests that Mongolia may wish to focus on those products that entail greater processing steps, and which deliver a final consumer good whose product complexity index (PCI) is greater than the average PCI of Mongolia. In terms of diversifying the countries which it may export to, Mongolia may want to differentiate between those goods which are exported largely to neighboring countries versus those which have the potential to be exported to a more diverse set of destinations.
- In terms of the overall investment policy in Mongolia, the analysis shows that although the country is de jure open to FDI, it still registers low amount of FDI relative to comparator countries. Experience shows that to attract FDI, statutory (*or de jure*) openness is not sufficient because other constraints in the overall investment climate can easily deter investment in an economy. Private investors, both domestic and foreign, still express concerns over general investment climate constraints ranging from Doing Business indicators, to good governance, and regulatory quality and predictability.
- Significant and prolonged efforts to improve the *general investment climate* will remain necessary. The 2013 Investment Law significantly improved the investment regime, yet the *legal framework for investment entry* can still be further improved. Requirements on foreign equity participation, ownership of real state, and work visas need to be reviewed as to ensure the overall transparency and predictability in application of the investment policies ultimately resulting in increased investor confidence in Mongolia as an investment destination.
- The GoM may want to focus on the *effective implementation* of current laws (including the Investment Law) and regulations. This includes creating awareness within the Government on the obligations undertaken by Mongolia in the treatment of investors, doing away with the practice of reneging on commitments and revoking licenses and permits without due process and legitimate reason, for instance. It is further recommended to regularly review inconsistencies and discrepancies among legal instruments, including domestic and international ones.
- Finally, Mongolia needs to rebuild a credible investment promotion capacity. In the short-to-medium-term, it is recommended to centralize the investment promotion functions and capacity within the National Development Agency (NDA), supported by a strong and focused capacity-building and modernization program, including:
 - a. Allocating appropriate staff and budget to the agency;
 - b. Identifying sectors with the greatest potential to attract FDI;
 - c. Developing and implementing an FDI attraction action plan focusing on the identified target sectors;
 - d. Design a framework for FDI linkages to increase overall in-country value addition, develop or attract new technologies and capabilities and better integrate local firms into supply chains of foreign investors where possible;

- e. Ensuring synergies and collaboration between the Investment Promotion Unit and other units within NDA;
- f. Establishing a workable coordination mechanism between NDA and relevant Government ministries in both pursuing the investment reform agenda and in developing and implementing investor promotion and outreach campaigns in the targeted or priority sectors;
- g. Defining a role for MOFA's overseas missions in coordination with the NDA to reach out to investors in priority markets; and
- h. Developing a policy advocacy role within NDA.

By achieving successes in the above areas in the coming years, the Investment Promotion Unit in the NDA could eventually build the case for re-establishing a separate, dedicated Investment Promotion Agency – potentially as a “spin-out”.

Analysis and Findings

Mongolia faces several political economy challenges to economic development that are common for economies relying primarily on natural resources. One of the principal issues in Mongolia is a lack of political stability and frequent government changes, leading to significant shifts in government policy. The policy volatility is also, partly, an expression of ambivalent public sentiments towards FDI. Weak governance and a lack of transparency are further impediments to effective policymaking. The existence of State-owned enterprises (SOEs) may inhibit private sector development and poses a fiscal risk. Geopolitically, Mongolia is impacted by its landlocked position between Russia and China, which influences efforts to establish ties with “third neighbors”. The effective design and implementation of an investment policy to attract FDI and maximize its benefits needs to take into account these factors.

Given the current budget constraints, FDI is a critically important source of capital for the GoM to support its broad economic and development agendas. Over the last several years, Mongolia has suffered from a decline in the value of its key commodity exports of coal and copper, leading to budget shortfalls and sovereign debts. As a result, in 2017, the GoM together with a coalition of international financial institutions and bilateral partners reached a US\$5.5 billion financial arrangement to stabilize the economy, restore confidence, and pave the way to economic recovery.¹ The concomitant reform program will require significant budget tightening and increased fiscal discipline. Consequently, the GoM will be limited in its capacity to financially support investment projects in important sectors, therefore relying on FDI to support its economic development.

FDI inflows to Mongolia have shown high volatility over the last decade. From 2000 to 2011, Mongolia registered an intense and sustained increase in FDI inflows on the back of the dramatic expansion of the mining sector. However, after 2012, weaker commodity prices added to deteriorating

¹ See IMF Press Release No. 17/193: <https://www.imf.org/en/News/Articles/2017/05/24/17193-imf-executive-board-approves-financial-arrangement-for-mongolia>.

investors' sentiment in Mongolia, ultimately leading to a dramatic decline in FDI inflows. Mongolia is also affected by a dual form of inward FDI concentration: first, Mongolia receives over half of its FDI from two countries (Canada and China) which could make Mongolia vulnerable to the economic outlook of these economies, as well as increasing the volatility of investment flows. Second, FDI inflows are also heavily concentrated from a sectoral perspective: extractive industries represent 71 percent of the inward FDI.

The typology of inward FDI is problematic for economic diversification and upgrading. Reflecting the above, natural resource-seeking FDI concentrate 81 percent of total FDI project value since 2012. Market-seeking FDI accounts for almost 16 percent, largely due to investments in electricity distribution, auto and financial services. The analysis of FDI types finds no significant inflow of efficiency-seeking investments or strategy-seeking into Mongolia during the 2012-2016 interval.

The current export specialization of Mongolia justifies a call for diversification into more complex products. The specialization is comprised of a small number of industries and it is biased towards low-complexity products related to natural resources, with few advanced manufacturing. Mongolia's position in the product space is characterized by *low levels of diversification and complexity*. The results regarding opportunity value provide a slightly more optimistic picture: Mongolia's low diversification suggests that any improvement in this area would probably translate into greater connectivity in the product space, and therefore greater ability to tap into more complex industries.

Mongolia should focus its FDI policy and promotion on sectors and markets where the country can be competitive. This will both enhance the country's chances of success in attracting FDI and will ensure the more efficient use of scarce Government resources. Initial findings from interviews with the private sector and the Government indicate that the following sectors and sub-sectors have some potential for attracting more *FDI: mining, tourism and hospitality, agribusiness and e-commerce*.

- **Mining.** Only a small share of mineral resources is currently being put into production in Mongolia. The GoM could encourage companies, including foreign investors, to explore this untapped potential. However, as with other sectors, the instability of the legal environment provides a major constraint to FDI; security of tenure and tender are not guaranteed; and licenses are often revoked or granted in an ad-hoc manner. Also, and more importantly, securing more FDI into this sector will not help Mongolia in any way with the concentration and lack of diversity of its FDI inflows but only make them even *more concentrated*. Moreover, Mongolia is already known by serious mineral investors around the world and more promotion is not an optimal use of the scarce promotion budget and human resources. However, in mining, a focus on downstream-related activities could be a sensible focus of the new investment strategy as this would contribute to economic and export diversification and upgrading.
- **Tourism and Hospitality.** Travel and tourism industry's total contribution to Mongolia's GDP set to reach more than US\$2bn by 2028 (up from US\$1.23bn in 2017)², while in neighboring markets like China, Russia, South Korea and Japan, outbound trips are on the rise. In spite of these promising trends, Mongolia's the tourism industry is confronted with some key obstacles including: incentives design and implementation have resulted in too many tour operators with

² Travel & Tourism Economic Impact 2018 Mongolia, World Travel & Tourism Council.

no specialization of travel companies; lack of competition in the airline industry has resulted in limited capacity; the tourism legislation is reportedly outdated and not in line with modern business practices in the sector; Government tourism marketing budget is extremely low; and lack of tourism data prevents the accurate measurement of tourism flows and the subsequent design of policies, strategies and implementation plans.

- **Agribusiness.** A recent sector scan conducted by the WBG and NDA has identified a few sectors as having good medium-term opportunities for attracting new FDI. The five sub-sectors with greater FDI potential are: cashmere final products; red meat processing; Intensive cattle breeding; dairy products; and dairy cattle farming. Nevertheless, a few challenges remain for investment in the sector and will need to be addressed by the GoM, including: low quality of primary raw commodity production, due to poor veterinary oversight, severe sanitary issues, inadequate traceability of animal stock origin and lack of vaccinations. Insufficient quality infrastructure and a lack of cold storage facilities at the borders presents another challenge to be addressed.
- **E-commerce.** This is a growing industry in Mongolia with untapped potential: more than 85 percent of the population use smart phones, yet only an estimated 25 percent of Mongolian consumers shop online.³ The private sector is still not well established and reports the following constraints to the e-commerce ecosystem where Government policies may play a strong role: online payment system (difficulties working with banks accepting online payment and trust issues with consumers regarding online security); Global E-commerce Talent (GET), (increasing the skills base for e-commerce and mobile applications which are currently still weak); and transportation and shipping (issues of time, cost and reliability due to heavy traffic in UB, and the lack of consolidation of warehouses in rural areas). Beyond e-commerce, other ICT-related activities could have potential. For instance, there has been evidence of foreign investor interest in Mongolia's potential to host server farms. Average electricity tariffs in Mongolia are competitive compared to those of neighboring countries⁴, although when it comes to the quality of electricity supply, Mongolia is at a competitive disadvantage.⁵

Most economic sectors in Mongolia are open to foreign participation but improvements to the entry regime are still needed. Only a few sectors have significant restrictions to FDI, including air, transport, and mining and quarrying.⁶ It is important to note that these sectors, particularly air and transport, are essential to the diversification agenda (e.g., tourism) and thus that these restrictions might be hindering private sector development in Mongolia. Foreign investors are subject to a *minimum investment requirement*, which is both difficult to justify economically or legally and can dissuade some potential investors with smaller-scale projects. Small or medium size projects are necessary and can also, when aggregated, benefit the economy of Mongolia and support its diversification. A larger project “bias” can be counterproductive. Foreign investors may lease land

³ As cited in the Mongolia Country Commercial Guide on the US Government's export.gov site.

⁴ Mongolia's average electricity tariff from 2014-16 was 7.13 cents/kWh, compared with: 9.57 cents in Kazakhstan; 10.23 in Russia and 14.10 in China. Figures from the World Bank's Global Indicators Group report “Electricity Tariffs, Power Outages and Firm Performance: A Comparative Analysis”, March 2017.

⁵ Mongolia ranks 95th globally for quality of electricity supply in the World Economic Forum's 2017-18 Global Competitiveness Index. Kazakhstan ranks 82nd; China 65th and Russia 59th.

⁶ The OECD Index on Regulatory Restrictiveness to FDI looks at four types of measures: (i) foreign equity restrictions, (ii) screening and prior approval requirements, (iii) rules for key personnel, and (iv) other restrictions on the operation of foreign enterprises.

for use up to 60 years based on a contract, and extension is possible for up to 40 years under the contract's primary condition. Extension of the contract is only possible once, which limits the use of the land for up to 100 years. Although this can be considered a reasonable period, investors may want to have more certainty on both the renewal of the primary contract and additional period. More importantly, the contract enforcement issue in Mongolia is reported as one of the major concerns for investors. Even when an investor has a valid land contract, the contract is not always honored by the Government entity. Finally, investors also complain about the time it takes for an investor to obtain, renew or extend a visa.

Mongolian Investment Law can be improved, although its revision should be carefully considered and based on ample investor consultations. The MIL provides some of the key guarantees that foreign and domestic investors need. For instance, investors can freely transfer their assets and revenues out of Mongolia after fulfilling their tax obligations. Investors are also protected against expropriation with a guarantee of full compensation. Further, international or domestic arbitration to settle a dispute with the State are options available to investors, although under certain conditions. Improvements to these guarantees are possible, using best practices and international investment agreements (IIAs) concluded by Mongolia as benchmarks. However, the costs of launching yet another revision process of the investment law in a country where it has changed so often have to be balanced against the benefits of these changes. Investors seem accustomed to the investment law, despite its imperfections. Any change that is contemplated should be discussed extensively with the investor community, for example using existing platforms such as the Investor Protection Council's *Public Private Consultative Council* (see below) and following the consultative process under the Law on Legislation. Otherwise, leaving the Law as it is for 2 or 3 more years may be the best course of action given the history of policy instability.

The GoM should rather focus on how laws are *implemented* in practice. *De facto* restrictions, when taken together, can deter some private investors from operating in Mongolia. For example, some investors complain that other Ministries refuse to honor incentives and rights stipulated in the Investment Law. And, many investors worry about the unjustified use of "exit bans" against foreign and domestic business executives. Also, a law was drafted last year to require money earned by foreign-owned mining operations to be remitted to local Mongolian banks; the proposal was abandoned, but concerns over the implementation of core protection guarantees remained. In line with those concerns, the country risk for expropriation and currency inconvertibility and transfer restrictions remains high.

Mongolia should continue in the path of openness to investment and work further in creating a more conducive and friendly environment for private investment. An investor survey conducted by the WBG indicates that the lack of regulatory transparency and arbitrary Government action were the main factors causing grievances in Mongolia. To respond to investor grievances in a systematic way, in late 2016 the Government established with WBG support an *Investor Protection Council (IPC)*⁷ under the Cabinet Secretariat enabling investors to bring a grievance to the Government before it escalates into a full-fledged dispute. It is reported that IPC has resolved 12 cases to date.

⁷ The IPC was established in December 2016 by Prime Minister's order (#136).

Investors still hope that the IPC operates in a more systematic and optimal way. For example, it is essential to define the systematic way of handling and tracking cases, including a method to filter, analyze, and prioritize grievances. Efforts underway to strengthen the IPC should be continued and supported. PPCC (Public Private Consultative Council) can also play a key function to contribute improving investment climate by ensuring involvement of private sector in amending, drafting relevant laws, regulations and policy documents.

Investment promotion efforts have lost both in terms of momentum and effectiveness in Mongolia. Successive Governments have insisted on introducing their own agency or their own promotion initiatives, often starting from scratch rather than building on previous efforts. This series of institutional changes over the past 20 years has had major implications. First, investors report being unclear as to which organizations they should approach on certain issues or to obtain information. Second, the frequent changes have severely eroded the promotion capacity and dispersed the cadre of staff knowledgeable about investment promotion.

The transition from Invest Mongolia to NDA has significantly “de-prioritized” investment promotion. Invest Mongolia had around eight people engaged in investment promotion activities; NDA now has only four people active in its investment promotion team and they mostly do public relations and marketing for the NDA itself (e.g. preparation of NDA brochures) rather than investor-targeted promotion per se. Similarly, the investor aftercare activities of NDA are currently limited to *reactively* providing information to existing investors upon request while in the past the IPA could follow-up each of the grievances with concerned line ministry or state/local institution.

In rebuilding FDI promotion, Investment Aftercare could be a good starting point. One obvious place for the NDA to start would be to introduce an *investor aftercare* program. This could be initially small and expand over time based on needs and demand. Investor aftercare involves identifying potential for reinvestment by existing foreign investors, as well as domestic/foreign joint ventures, and facilitating its realization, whilst simultaneously identifying investors with potential for disinvestment and avoiding it. Investor aftercare is often regarded as a “low-hanging fruit” approach by Investment Promotion Agencies (IPAs) in the sense that it targets investors already established and operating within the country. These investors already know the country, its advantages and constraints, and the IPA knows or should know who and where these investors are. It is much easier to convince an already established investor than to attract a potential investor who is not already in Mongolia. Aftercare is a more cost-effective approach to investment generation.

Successful attraction of FDI is never the achievement of a single body, but also requires effective coordination of many public and private stakeholders. As the investment promotion capacity within the NDA is strengthened, it needs to be built around a strong partnership model. For example, the Ministry of Foreign Affairs (MoFA) may have a role to play in terms of the location of its overseas missions to enhance outreach into key markets for new FDI. The MoFA has an outreach capability that the other organizations lack and therefore should be seriously considered as partner in any proactive investor outreach efforts.

Summary table of Recommended Reforms

Investment lifecycle stage	REFORM ACTIONS		
	Short Term (1 to 1.5 years)	Medium Term (1.5 to 3 years)	Long Term (3 years and above)
Vision and Strategy			
	1. Develop a new investment strategy and policy to (a) maximize the benefits of FDI in extractives and (b) identify and realize FDI opportunities in other sectors. The new policy should be enshrined in an Investment Policy Statement (IPS) or other official document issued by the GoM.	Implementation	Implementation
	2. Formulate and implement a strategy to increase DVA and linkages related to the extractives sectors.	Implementation	Implementation
	3. Consider the potential conclusion of FTAs with relevant countries.	Negotiation of FTAs	Implementation
	4. Focus on attracting FDI in sectors that have higher economic complexity than Mongolia's current basket.	Implementation	Implementation
	5. Designate one department or unit which will collect FDI data on a regular basis.	Implementation	Implementation
Investment Climate - Legal & Regulatory framework			
Investment Climate	Design and launch an ambitious program to improve the investment climate and good governance in the country (IC reform and Governance Reforms are long-term endeavors but need to be initiated in the short term)		

<p>Entry and Establishment</p>	<p>Consolidate in one legal instrument restrictions to foreign participation.</p>	<ol style="list-style-type: none"> 1. Standardize land lease contracts as to establish clear conditions on primary contracts and requirements for extension. 2. Review visas regime for investors to ensure that foreign investors, managers and personnel are protected in their rights to stay, exit and re-enter the country as per the visa stipulations. 3. Review local content requirements on an economy-wide basis and specifically those applied in the mining sector. 	
<p>Protection and Retention</p>	<ol style="list-style-type: none"> 1. Adopt SIRM bylaw to define workflow, roles, and responsibilities 2. Allocate adequate financial and human resources to the lead agency. 3. Develop and implement an ICT tool to track grievances, collect data, and provide feedback to investors 4. Train key officials from core Government agencies on how to treat investment and investors. 5. Check inconsistencies and discrepancies among legal instruments, including domestic or international one. 	<ol style="list-style-type: none"> 1. Incorporate NT, MFN, and FET provisions (already offered through IIAs) into domestic laws 2. Provide specific protection against ‘indirect’ expropriation. 3. Strengthen the FTA/IIA implementation function with the relevant ministries. 4. Review core investment protection guarantees in current IIAs to guide future negotiations 5. Consider concluding bilateral/regional trade and investment agreements. 6. Expand training program to relevant government officials. 7. Review legal instruments regularly to find inconsistencies and discrepancies 	<ol style="list-style-type: none"> 1. Train officials and Government agencies at all levels, national and provincial, economy-wide and sectorial, on how to treat investment and investors. 2. Amend domestic laws and renegotiate international treaties if necessary based on the review of legal instruments for any discrepancy and inconsistency.

<p>Institutional Framework for Investment Promotion</p>	<ol style="list-style-type: none"> 1. Re-establish and strengthen the investment promotion unit within NDA. 2. Develop and implement an FDI attraction action plan focusing on the identified target sectors. 3. Establish a coordination mechanism to encourage the NDA to work closely with other relevant Government ministries in both pursuing the investment reform agenda and in developing and implementing investor outreach campaigns targeted on the identified priority sectors. 4. Define a role for MoFA's overseas missions in coordination with the NDA to reach out to investors in priority markets. 	<ol style="list-style-type: none"> 1. Develop a policy advocacy role for the Investment Promotion Unit. 2. Design a framework for FDI linkages to increase overall in-country value addition, develop or attract new technologies and capabilities and better integrate local firms into supply chains of foreign investors where possible 	<ol style="list-style-type: none"> 1. Recognize the re-establishment of a separate, dedicated Investment Promotion Agency as a medium- to longer-term ambition.
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INTRODUCTION

The Investment Reform Map (IRM)

A sound policy framework for investment is critical for foreign direct investment (FDI) to deliver a positive impact over the host economy. This type of external capital can facilitate the transfer of technology and know-how while also upgrading the country's workforce and firms through linkages and spillovers, diversification into new sectors and activities, integration of domestic firms into global value chains (GVCs), among other benefits. Yet, the likelihood of these positive effects depends on various characteristics of the receiving economy, among which a policy framework conducive to investment activities is key.

The IRM is an exercise of analytics and dialogue to develop the investment policy needed to attract the type of FDI that can help a country fulfil its development vision. In the case of Mongolia, this goal is closely linked to the ability of FDI to facilitate the diversification of the productive structure. The IRM is grounded on two analytical concepts of the investment policy framework designed by the World Bank Group (WBG). The first is the investment lifecycle, which sees FDI as a dynamic relationship with the host economy, and not merely as a one-time transaction. This view corresponds to an investment policy capable of addressing issues along various stages of the relationship between foreign investors and the host economy, including FDI attraction, entry, retention and expansion, and linkages. Second, this framework sees FDI as a heterogenous phenomenon, which can be broadly categorized along four types: natural resource-seeking, efficiency-seeking, domestic market-seeking, and strategic asset-seeking.⁸ This taxonomy allows to group investments across different location determinants, different development effects, and ultimately different types of policies.

With the previous framework in mind, this IRM is a tool to help the Government of Mongolia (GoM) to capitalize on these FDI opportunities. The analysis develops a tailored diagnostic with the objective to enable a dialogue with the country's policymakers and other relevant stakeholders that will lead to an agreed Reform Action Plan. The IRM provides policymakers the key analysis they need to consider their FDI policy reforms options and priorities. The IRM entails: (i) analyzing FDI trends in Mongolia; (ii) diagnosing investment promotion and policy barriers and opportunities; (ii) developing an action plan for reforms to realize the potential impact of FDI in the local economy; and (iii) ensuring policy coherence through cooperation and coordination of investment-related policymaking institutions and their implementing agencies.

⁸ Strategic asset-seeking FDI is generally based on the existence of intangible assets at the level of the firm. The methodology used in this IRM for identifying investment types is based on sector FDI data, hence unable to provide any categorization based on firm-level data. For this reason, the FDI type analysis as conducted in this IRM does not include strategic asset-seeking investments.

The IRM is also an example of the WBG’s strategy on private sector development. A fundamental notion in this strategy is that of “creating markets”, whose goal is to maximize development finance for value-adding investments, promote judicious use of scarce public resources, and crowd-in private capital. The success of this strategy requires enabling policy and regulatory environments that effectively de-risk private sector participation. In all, the IRM follows these guiding notions, with an analysis that emphasizes those regulatory and legal barriers that hinder the development of FDI activity in Mongolia.

IRM Reform Context: Mongolia’s political economy

The effective design and implementation of an investment policy to attract FDI and maximize its benefits needs to consider Mongolia’s political economy. Mongolia faces several challenges to economic development that are common for economies relying primarily on natural resources. These challenges have at their core the combination of potential adverse social, environmental, fiscal, and economic impacts that may arise from a natural resource-focused economy referred to as the “resource curse”.

The volatility of commodity prices has led to budget constraints for the GoM. Over the last several years, Mongolia has suffered from a decline in the value of its key commodity exports of coal and copper, contributing to budget shortfalls and sovereign debts. As a result, in 2017, the GoM and a coalition of international financial institutions and bilateral partners reached a US\$5.5 billion financial arrangement to stabilize the economy, restore confidence, and pave the way to economic recovery.⁹ The concomitant reform program will require significant budget tightening and increased fiscal discipline. An expansionary policy to counter the global commodity price decline in 2012-2014 led to an unsustainable public debt dynamic (up to 87.2 percent of GDP in 2016 from 24.1 percent in 2011). Consequently, the GoM will be limited in its capacity to financially support investment projects in important sectors, therefore relying on FDI to support its economic development.

One of the principal issues in Mongolia is a lack of political and policy stability. Frequent government changes¹⁰ have led to significant shifts in public policy and sometimes even to policy reversals, having several negative effects on FDI. Firstly, the resulting uncertainty and unpredictability for foreign investors is often seen as the key deterrent to invest. Secondly, it prevents the GoM from reaping the benefits of a long-term investment policy strategy and to build sufficient capacity to implement such strategy. Particularly harmful in that regard is that every change of administration also entails the replacement of large parts of the civil service. Turnover has increased year after year (from 5 to 14 percent between 2007 and 2014), weakening morale, reducing accumulated experience, and ultimately diminishing the effectiveness and capabilities of the civil service. Thirdly, a high frequency of election cycles results in repeatedly high public spending to sway voters, thereby crowding out private investment. To mitigate these effects, political stability and policy continuity is key.

⁹ See IMF Press Release No. 17/193: <https://www.imf.org/en/News/Articles/2017/05/24/17193-imf-executive-board-approves-financial-arrangement-for-mongolia>

¹⁰ Mongolia has had 9 different governments in the last 10 years, 6 in the last 5 years.

Weak governance and a lack of transparency are widely recognized as the root cause for a lack of effective policymaking.¹¹ According to the United States Department of State, increasing transparency as well as strengthening judicial independence and more generally the rule of law are key challenges to improve Mongolia’s investment climate.¹² Rent-seeking behavior and forms of state capture severely impact FDI and economic development. These governance issues translate into problems in terms of credibility of fiscal budget, quality of regulations, capabilities of civil service and investor confidence. Therefore, increasing transparency of the resource extraction process and generally improving governance is essential (see Chapter 2 – Legal and Regulatory Analysis). Mongolia’s Three-Pillar Development Strategy is a step in that direction. One of the three pillars aims at creating accountable and sustainable governance with discipline and integrity, focusing on such areas as “Policy stability”, “Stability of public institutions”, and “Ethical, fair and transparent public service”.¹³

The policy volatility is also partly an expression of ambivalent sentiments towards FDI. In Mongolia, FDI is highly politicized, since it is mainly occurring in the mining sector. As is common in economies primarily based on natural resource-seeking FDI, the distribution of gains and rents from the resource extraction is an issue of politically charged debates, especially because exploitation is performed by foreigners. As a result, investors are not only facing policy changes, but more generally an adverse environment making it difficult to effectively operate in the country. Specific to Mongolia, there are often negative sentiments towards the private sector more generally, which is partly an expression of resource nationalism, and partly a remnant of almost 70 years of socialist rule. These often find their expression in more favorable attitudes towards public investment to be used for large infrastructure projects as well as for state-owned enterprises (SOEs).

The existence of SOEs may inhibit private sector development. The GoM maintains SOEs in the banking and finance, energy production, mining, and transport sectors. As of 2015, the Mongolia’s SOEs (with ≥ 50 percent ownership) included 89 companies.¹⁴ Stakeholder consultations have revealed that these SOEs are oftentimes operating under more favorable conditions than both foreign and domestic private investors, therefore potentially crowding out private investment. Although corporate governance standards are sufficient *de jure*, the *de facto* Board of Directors appointments are often of political nature,¹⁵ thus limiting competition. Furthermore, the operation of SOEs leads to scarce public resources being drained, which could be spent on other policy programs.

SOE liabilities further pose fiscal risks. Contingent liabilities through SOEs were estimated at 2 percent of GDP in 2015¹⁶, adding to the fiscal risks of Mongolia’s recent increase in public debt. As of 2015, the country’s SOEs had gross liabilities of MNT 10.4 trillion¹⁷, mainly reflecting weak financial monitoring of SOE liabilities. External government guarantees (10 percent of GFDP in 2016) issued over the past years to SOEs such as the Development Bank of Mongolia (DBM), Trade

¹¹ For further analysis of the state of governance in Mongolia, see Chapter 2 for analysis specific to FDI and further the upcoming Mongolia Systematic Country Diagnosis Report prepared by the World Bank Group, as well as an accompanying background paper: Watts, Michael J. 2017. “Governance and the Policy Cycle in Mongolia: Political Settlements, Power Asymmetries, and Competitive Clientelism”.

¹² U.S. Department of State. 2017. Investment Climate Statement for 2017: Mongolia. Link: <http://www.state.gov/e/eb/rls/othr/ics/investment-climatestatements/index.htm?year=2017&dclid=269836>

¹³ Montsame. 2018. Three-Pillar Development Policy Approved. Link: <http://montsame.mn/en/read/13480>

¹⁴ U.S. Department of State. 2017. Investment Climate Statement for 2017: Mongolia. Link: <http://www.state.gov/e/eb/rls/othr/ics/investment-climatestatements/index.htm?year=2017&dclid=269836>

¹⁵ Ibid.

¹⁶ Fiscal Risk Report for Mongolia, World Bank (2016)

¹⁷ Ibid.

Development Bank (TDB), and MIAT Airlines, are another source of risk. To address this issue, the Parliament recently approved the State Property Privatization Guidelines for 2018-2020, along with a list of SOEs to be partially privatized¹⁸. A key feature of these guidelines concerns the bidding process of the privatized shares through open trading at the Stock Exchange, seeking to ensure full public participation, equity and fair competition¹⁹. Government's privatization list includes two of the six largest SOE debtors (State Bank Mongolian Airlines - MIAT).

Internationally, Mongolia is impacted by its location between Russia and China. Being a landlocked country next to Russia and China influences Mongolia's policies from an economic and a geopolitical standpoint. Its landlocked position means that Mongolia has limited ability to trade, and that it is strongly dependent on its direct neighbors, with China receiving the majority share of Mongolia exports and Russia supplying much of Mongolia's energy requirements. Financial assistance and development under *China's Belt and Road Initiative* (BRI) will only strengthen that position.²⁰ This might influence efforts to integrate more closely with third neighbor countries, be it through trade and investment agreements or other political arrangements.

IRM: Structure

The analysis presented hereby forms part of a comprehensive diagnostic conducted by the WBG as a first step to help develop Mongolia's IRM. The report is divided in 4 chapters:

- **Chapter 1** on Investment Performance and Potential aims to answer various questions related to the FDI that Mongolia receives. It documents the levels and types of FDI received in the country, and how such pattern of FDI accruals relates to the export specialization of the country. In addition, it identifies a set of sectors that could be attractive for a diversification strategy, as well as the business environment dimensions that stand against leveraging FDI in those sectors.
- **Chapter 2** on the Legal and Regulatory framework in Mongolia, after stressing the need to launch an ambitious program to improve the investment climate and good governance in the country focuses on the laws and regulations directly governing investment in Mongolia. Such analysis allows for the identification of measures that are key constraints to private investment in Mongolia along the investment lifecycle covering the stages of (a) entry and establishment and (b) retention and expansion. The analysis conducted not only looks at the text of legal instruments (de jure) but also at the associated de facto practices to assess the level of implementation of the legal and institutional framework.
- **Chapter 3** analyzes the institutional framework currently in place in Mongolia for the promotion of investment. In doing so, this section provides good international practices as examples that Mongolia could follow while building effective institutions for the attraction and retention of investment.
- Finally, **Chapter 4** on the Formulation of an Investment Policy Statement and Reform Action Plan provides the Government with general guidance for the drafting of an Investment Policy Statement (IPS) and the suggested Reform Action Plan.

¹⁸ The Government Action Plan includes partial privatization within a broader policy effort to improve the profitability and governance of SOEs.

¹⁹ World Bank. 2018. Mongolia: Macro Weekly Update. June 4-8, 2018.

²⁰ Mongolia Country Report, Economist Intelligence Unit. 2nd Quarter 2018,. The Economist Intelligence Unit is part of The Economist Group providing forecasting and advisory services. Link: <http://country.eiu.com/mongolia>

CHAPTER 1:

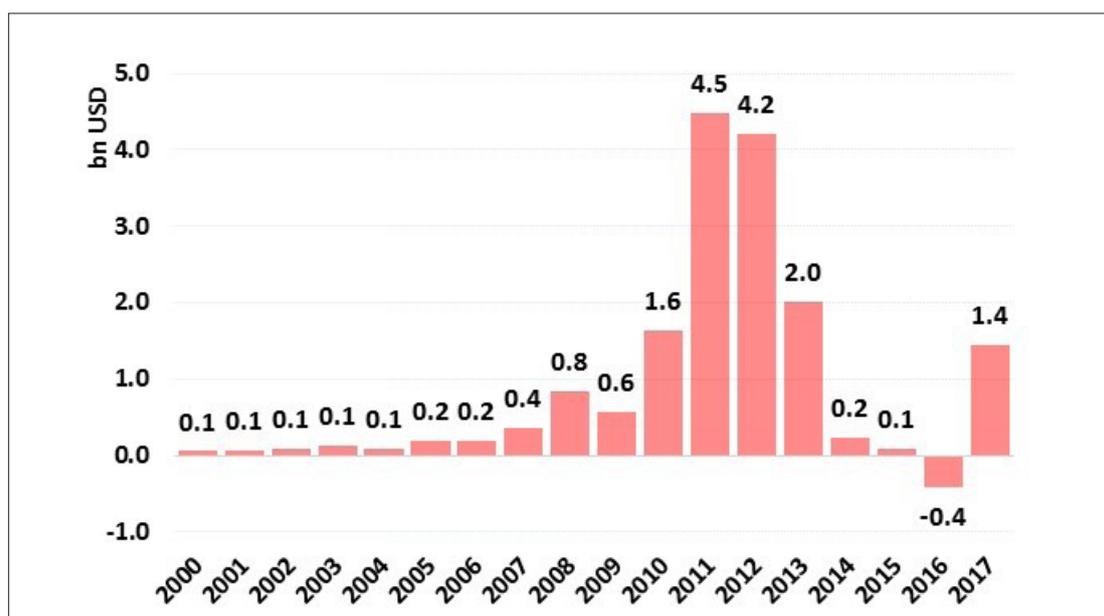
Investment Performance and Potential

This section analyzes the pattern of FDI in Mongolia, providing an account of the value, origin, and sector concentration of FDI inflows to the country, as well as an evaluation of FDI inflows across the investment typology. This analysis is carried in a comparative fashion, against a group of benchmark countries, with data from both national statistics and global datasets on FDI.

I. Overview of Mongolia's investment performance

FDI inflows to Mongolia registered a boom-to-bust trend during the last decade (*Figure 1*). Prior to 2000, FDI inflows remain marginal, with annual average inflows of only US\$13 million between 1990 and 1999. From 2000-2011, Mongolia registered an intense and sustained increase in FDI inflows, on the back of the dramatic expansion of the mining sector and, in particular, the development of the Oyu Tolgoi surface mine. Such trends allowed Mongolia to reach an all-time peak of US\$4.5 billion in 2011, with FDI accounting for more than two thirds of total investment in the country between 2010 and 2011; but also fuelling an unsustainable current account deficit, which reached 27 percent of GDP in 2012. After 2012, weaker commodity prices added to deteriorating investors' sentiment in Mongolia, ultimately leading to a drastic drop in FDI inflows.

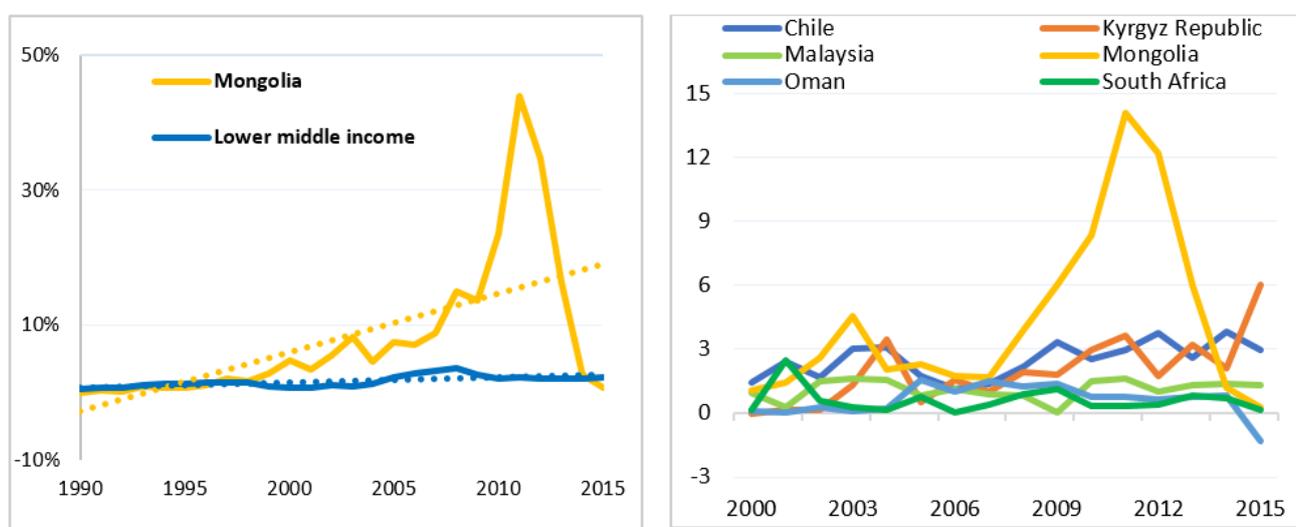
Figure 1. Mongolia's inward FDI inflows (US\$ billion, 2000-2017)



Source: The Central Bank of Mongolia, BoP statistics

The previous pattern of FDI accruals determines Mongolia's FDI performance index. This ratio, calculated as the ratio of Mongolia's share of global FDI over its share of global GDP, was significantly above the average trend for economies within the same per capita income range (lower middle income), as *Figure 2* illustrates. The same figure provides a comparison with a set of benchmark countries,²¹ carried throughout the analysis. Mongolia's FDI performance index largely outperformed this set of benchmark countries during the expansionary FDI cycle of 2009-2013. In contrast, current levels fall below the best performers in this group (Kyrgyz Republic, Chile).

Figure 2. FDI flows to GDP ratio (%): Mongolia vs. lower middle-income countries (1990-2015) and FDI performance index (Mongolia vs benchmarks, 2001-2015)

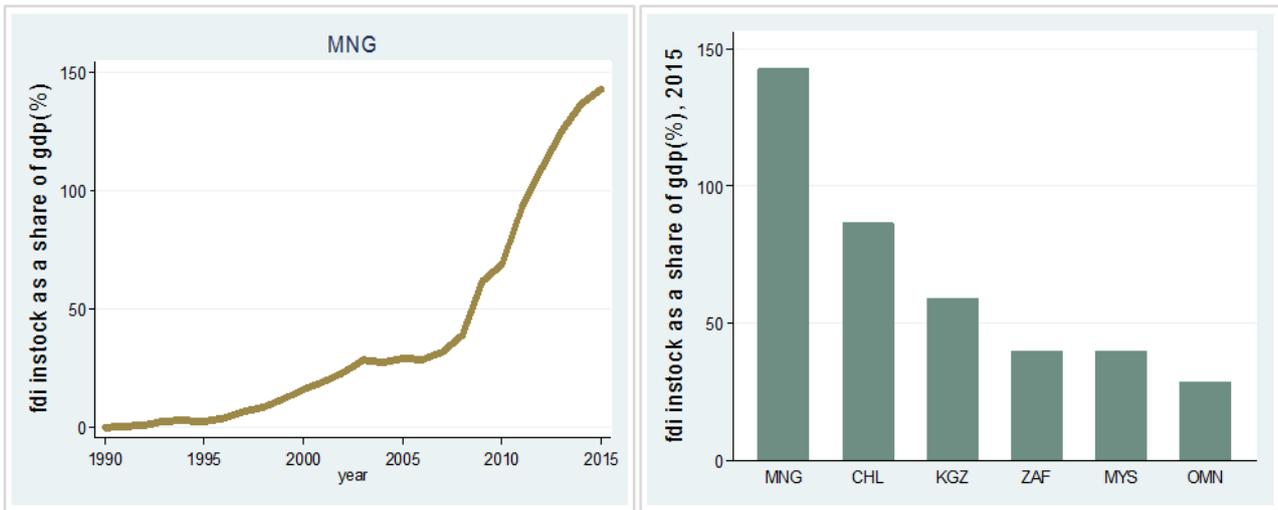


Source: UNCTAD/WIR and WBG team calculations using WBG data

The previous pattern of FDI accruals has also boosted Mongolia's stock of FDI-to-GDP - a proxy for de facto FDI openness. As *Figure 3* illustrates, this indicator registers a sustained increase after 2008. Thus, in 2015, the stock of FDI-to-GDP reached a historical peak of 143 percent of GDP, substantially above the ratios found in the benchmark countries.

²¹ Including these countries does not imply that Mongolia should aim to replicate their development experience. Instead, these countries offer a valuable comparison, insofar they share some structural features with Mongolia. For instance, the analysis includes Kyrgyz Republic, Chile and Oman, as examples of countries that are also natural resource exporters, at very different levels of income. In addition, the comparative analysis includes a set of emerging economies (South Africa, Malaysia) that have been able to diversify their productive structure away from commodities, while at the same time being able to register significant per capita income gains.

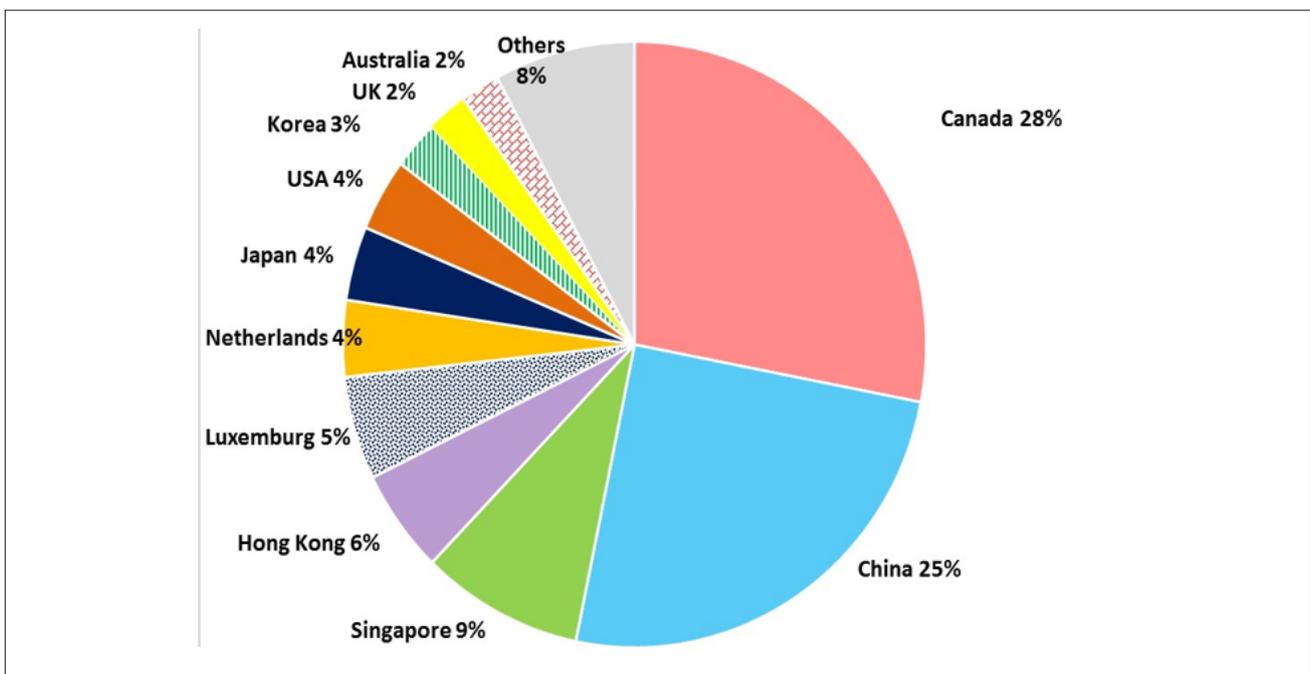
Figure 3. Stock of FDI as % of GDP (2015) and stock of FDI % of GDP for benchmark countries



Source: UNCTAD, WIR

FDI across source countries also shows a significant degree of concentration. As *Figure 4* illustrates, over half of Mongolia’s FDI stock originates in two countries (Canada and China). Having China as a key source of FDI is a general feature of countries in the region that have a marked comparative advantage in natural resources. More importantly, the relative importance of a few number of countries as sources of FDI could make Mongolia vulnerable to the economic cycle of these economies, as well as increasing the volatility of investment flows. Finally, the data also reveals the importance of financial hubs in Asia (Hong Kong, Singapore) and Europe (Luxembourg, Netherlands) as channels for FDI into Mongolia.

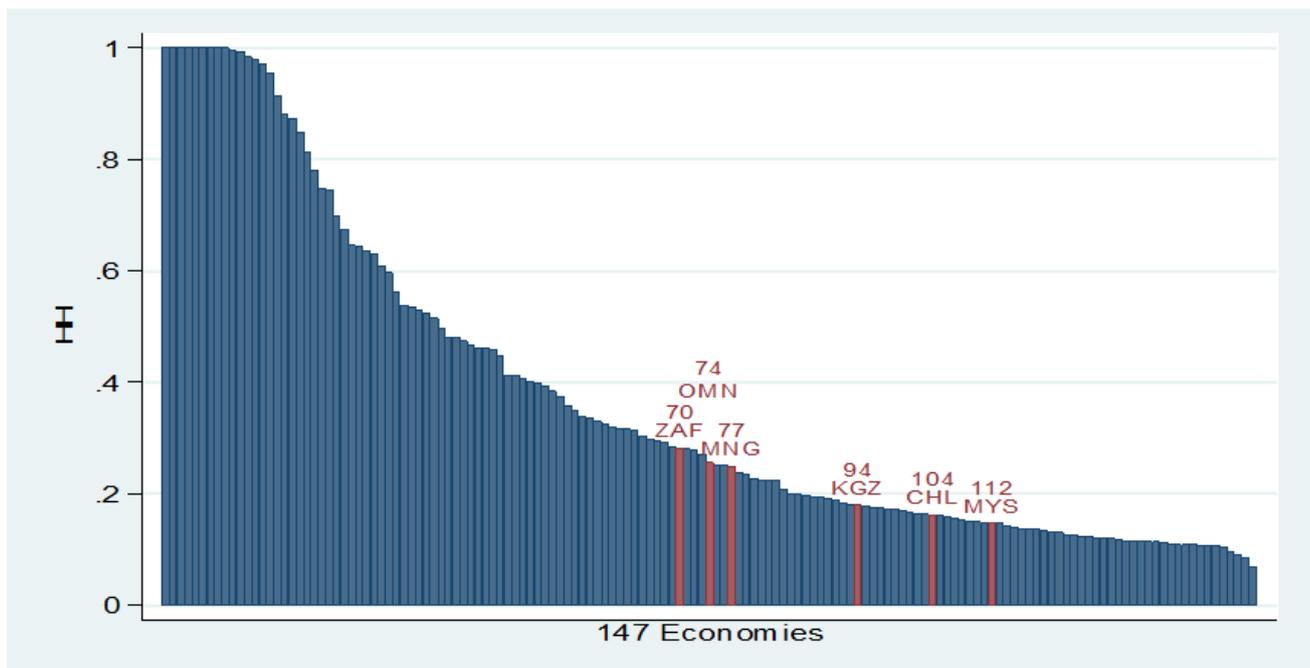
Figure 4. Stock of FDI (by source countries; 2017)



Source: The Central Bank of Mongolia

In a global comparison, Mongolia shows a moderate degree of FDI concentration²² across sources, but generally higher than its country benchmarks. As *Figure 5* shows, the previous pattern of FDI accruals leaves Mongolia in the middle of the global ranking of FDI concentration, with the country placed in the (77th position out of 147 economies. South Africa and Oman share relatively similar levels of this index, while the rest of benchmark countries (Kyrgyz Republic, 94th; Chile, 104th; Malaysia, 112th) register a more diversified pattern of FDI across investor countries.

Figure 5. FDI concentration: Herfindahl index (by FDI source country, 2012)

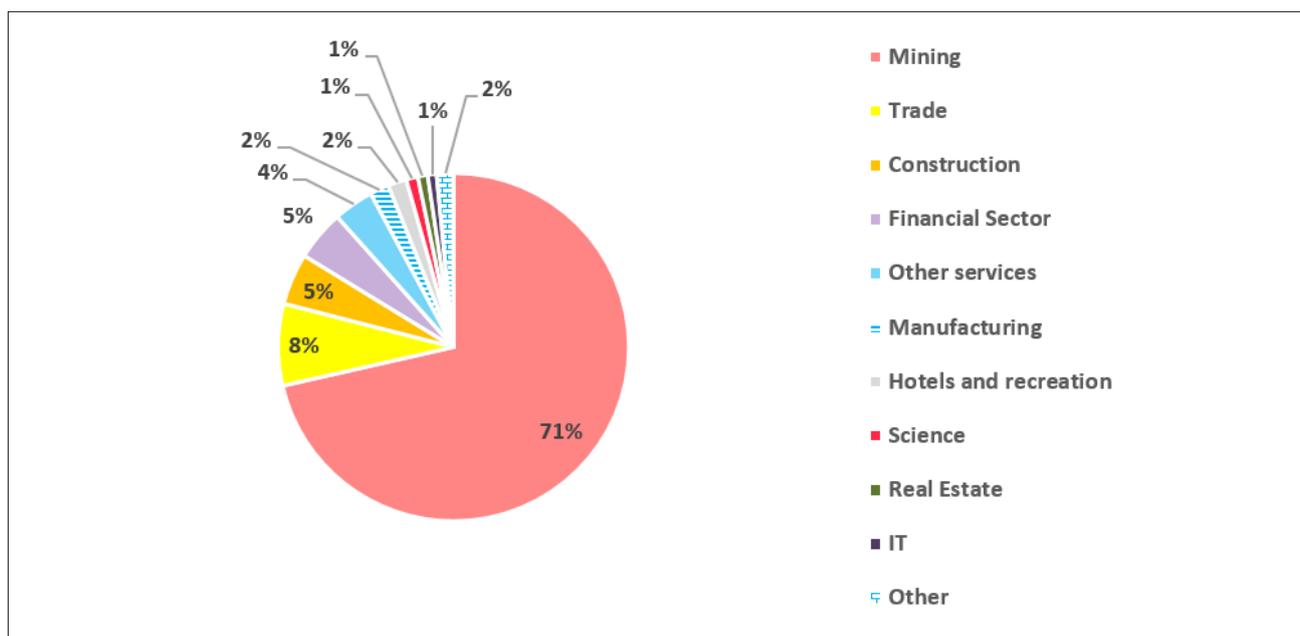


Source: WBG-Investment Policy team calculations

FDI to Mongolia is also very concentrated in terms of sectors attracting FDI. As shown on *Figure 6* below, mining industries are the main sector destination for FDI coming to Mongolia. Aside from extractives, FDI goes to various service industries, particularly trade, finance, other services, as well as construction.

²² One commonly accepted measure of FDI concentration is the Herfindahl-Hirschman Index (HHI), calculated by squaring the share of each FDI source, and then summing the resulting number. A larger HHI relates to a higher degree of concentration, and potentially a greater source of volatility for FDI accruals.

Figure 6. Mongolia: FDI by sector (2017)



Source: The Central Bank of Mongolia

The previous distribution of FDI across sectors conditions the type of FDI that Mongolia receives. Based on FDI received between 2012-2016, *Figure 7* translates greenfield FDI data across sectors into the FDI types, i.e. natural resource-seeking, market-seeking, efficiency-seeking, and strategic asset-seeking. The distribution of FDI types in Mongolia reveals the relative importance of natural resource-seeking FDI, which concentrate 81 percent of total FDI project value since 2012. Market-seeking FDI accounts for almost 16 percent, largely due to investments in electricity distribution, auto and financial services. The remaining share (3 percent) is categorized as strategic asset-seeking, mainly in the Tourism sector.²³ The analysis of FDI types finds no significant inflow of efficiency-seeking investments into Mongolia during the 2012-2016 interval.



Figure 7. Mongolia: FDI Typology (percentage; 2012-2016)

Source: Computation based on COMTRADE and fDiMarkets data

²³ In the traditional FDI typology Tourism is associated with market-seeking FDI, while strategy-seeking FDI has to do with mergers and acquisitions and in particular the purchase of established brands or technology. The categorization of investment in Tourism as strategic asset-seeking allows to single out a sector where the existence of a unique cultural or natural patrimony acts as the strategic asset for attracting FDI.

The low levels of efficiency seeking investment received in Mongolia suggests a significant investment competitiveness challenge in Mongolia. Investment competitiveness refers to the ability of countries to not only attract but also retain and integrate private investment into their respective economies. Enhancing investment competitiveness thus requires establishing a business environment in which both domestic and foreign companies can efficiently enter the market, expand operations, and develop more and better linkages with local, regional, and global economies (World Bank, 2017). Investment competitiveness, while being a key consideration for FDI at large, it is particularly important for attracting efficiency-seeking FDI, as this type of investment will only flow into a host economy that can contribute to the firm gaining a competitive edge in international markets. In all, the findings suggest that Mongolia is facing severe competitiveness challenges that preclude greater inflows of efficiency-seeking FDI in the country.

The previous limitations of FDI in Mongolia should be a focus of concern for economic policymaking. The Government is currently developing an FDI strategy, which should reflect on the concentration of FDI across source countries, as well as on identifying the right mix of FDI types that can help Mongolia advance its development goals. Receiving most of its FDI from a handful of countries can be a potential source of volatility in FDI accruals. And having its investments concentrated in a handful of sectors -particularly natural resources- is symptomatic of Mongolia's competitiveness drawbacks. In all, diversifying further the sources and sectors of FDI in Mongolia could make this type of external capital a more stable source of investment, a matter of particular importance for a country where public investment is affected by efficiency and transparency challenges.

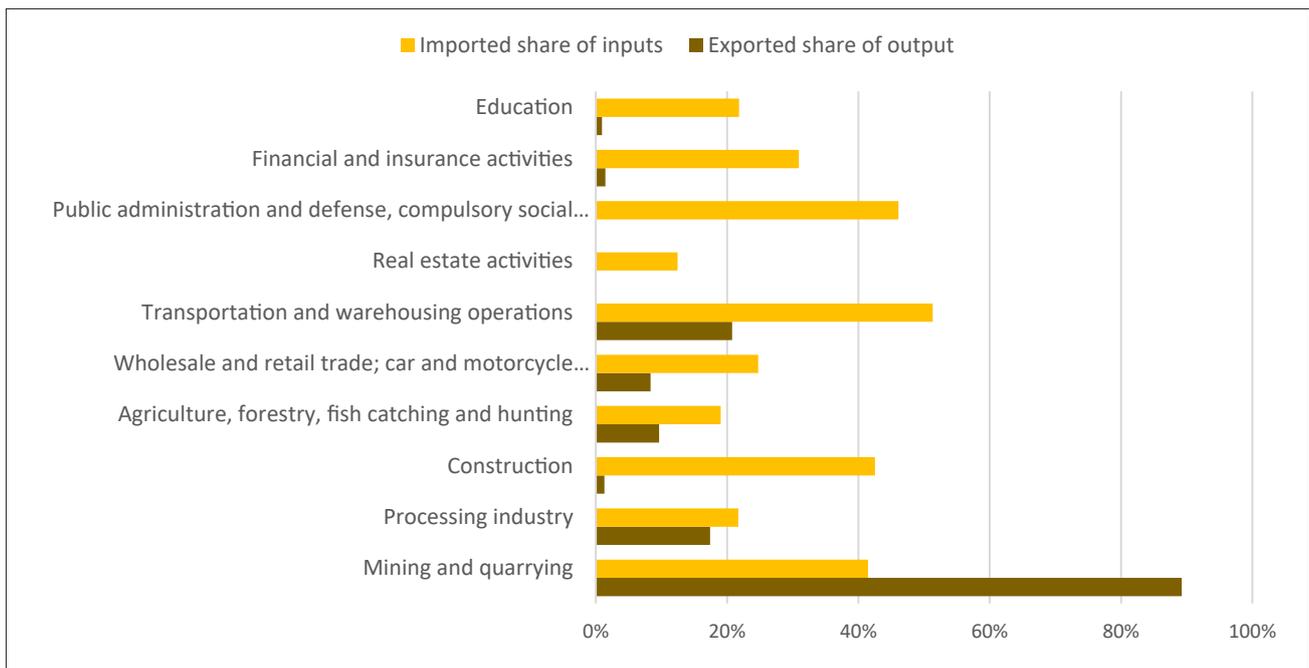
Going forward, a comprehensive privatization program recently submitted to the Parliament for approval *could*-if well designed and implemented- contribute to improving the current FDI distribution in Mongolia. While a key consideration for privatizing some of the State-Owned Enterprises (SOEs) aim to ensure fiscal and debt sustainability, it can also lead to greater diversification in the FDI that Mongolia receives, with some of the most important State-Owned Enterprises (SOEs) being in sectors like Finance or Transportation.

II. Mongolia's openness to trade and integration to global and regional value chains

Mongolian exports enjoy preferential access to some of the most important foreign markets. Australia, Canada, the European Union (EU), Japan, New Zealand, Norway, the Russian Federation/Belarus/Kazakhstan, Switzerland, Turkey, and the United States all provide preferential access to imports from Mongolia under their Generalized System of Preferences (GSP) arrangements. Since 2006, Mongolia has been eligible for the GSP+ arrangement in the EU.

Integration to global and regional value chains, however, remains limited. Some of Mongolia's economic sectors are importing a large share of their inputs, which implies a certain level of backward integration into GVCs (see *Figure 8*). In a forward manner, however, few industries are exporting a significant share of their output. Mining is the exception, which reflects the low level of economic complexity in Mongolia's export basket (see below), and confirms the idea that the predominant activity of FDI into the mining sector is limited to extraction activities. GVC participation in Mongolia has not changed much over the last decade.

Figure 8. Mongolia: GVC integration (2014)



Source: WBG calculations based on data from the Central Bank of Mongolia

What are the implications over Mongolia’s productive structure? The previous analysis on productivity and trade justifies a diversification strategy focused on goods and services with greater added value. The economic literature finds a strong relationship between the structure of an economy and its ability to generate sustained growth. Thus, most developed countries are characterized by a productive transition that favoured more complex goods (Abdon, Bacate, Felipe, & Kumar, 2010). On the other hand, countries that maintain a high concentration of their economic activity in natural resources tend to face limitations in their development path. These limitations can stem from various side effects of depending on exports of commodities, including deteriorating terms of trade (Prebisch, 1950), export earnings volatility (Easterly & Kraay, 2000), Dutch disease problems (Corden & Neary, 1982) or the poor quality of the institutional environment (Sachs & Warner, 1995), (Ross, 2001), (Collier & Hoeffler, 2005). Mongolia shares some of the pervasive features derived from an excessive concentration in natural resource exports, particularly with regards to the volatility of the economic cycle, or the tax revenue dependence on commodity export receipts (Mongolia Economic Forum-MEF 2018).

Recent studies shift the focus of attention from the relative weight of sectors in the economy to the characteristics of the goods produced. In this work, the ability of an economy to move to the production of complex or sophisticated goods is a key element to guarantee a successful structural transformation (Hausmann & Klinger, 2006); (Hausmann, Hwang, & Rodrik, 2007). The basic premise of this literature is that the productive specialization of a country is indicative of its state of economic development, with most advanced economies specialized in goods and services intensive in knowledge and technology. In this sense, (Hausmann, Hwang, & Rodrik, 2007) show that the

level of sophistication of a country's export basket is a predictor of future growth. Most of these contributions rely on two fundamental ideas: the degree of similarity between the requirements of production and the degree of sophistication or complexity of a good, an idea that is formalized through a variable of productive capabilities (Hidalgo & Hausmann, 2009).

Based on the previous methodology, Annex 1 provides our analysis of Mongolia's structural transformation record. This analysis finds the country with a trade specialization concentrated in a limited number of sectors, generally of little sophistication or complexity. Such specialization leaves Mongolia with very low levels of export diversification and complexity. Thus, the analysis finds little contribution of FDI to the structural transformation of the country, with current FDI accruals having a similar level of product complexity than the overall export specialization.

Summing up, the current export specialization of Mongolia largely justifies a call for diversification into more complex products. Mongolia's export specialization is characterized by several features. First, the country exports competitively in a small number of industries. Second, its presence in the most knowledge-intensive sectors (e.g. machinery) is very limited. Finally, and for most industrial categories, the country tends to specialize in products whose complexity is lower than the average for that industrial category. Consequently, Mongolia's position in the product space is characterized by low levels of diversification, and complexity. The results regarding opportunity value provide a slightly more optimistic picture. Mongolia's low diversification suggests that any improvement in this area would probably translate into greater connectivity in the product space, and therefore greater ability to tap into more complex industries. All things considered, Mongolia's position in the product space validates the two-pillar policy introduced in the executive summary of this report. The first pillar would aim to transform Mongolia's economy by fostering domestic value addition in the mining industry. In the product space, such approach would likely result in the development of comparative advantages in the most complex sectors within the raw materials category, where Mongolia already has a solid footprint. The second pillar entails laying out the foundation for developing new comparative advantages, in sectors that may not be related to Mongolia's competitiveness, but where there is investment potential. Improvements in information and transportation infrastructure, or the business environment could help in making these *latent* comparative advantages a reality.

Leveraging efficiency-seeking FDI as a path towards diversification through the previous two pillars is also in line with the World Bank's policy advice to Mongolia regarding diversification. In short, this advice proposes the establishment of effective institutions that can improve the mix of productive assets, while refraining from targeted sector interventions (i.e., industrial policies). Given Mongolia's low level of diversification, horizontal policies that enhance the skills of the workforce or improve the business environment appear as the most adequate policy response.

III. Assessment of Mongolia's investment potential

Mongolia should focus its FDI policy and promotion activities on sectors and markets where the country can be competitive. This will both enhance the country's chances of success in attracting FDI and will ensure the more efficient use of scarce Government resources. Mongolia has only a small domestic market but it is "sandwiched" between China and Russia, two of the world's largest markets, not to mention proximity to Japan, Korea, and other large consumer markets

in East Asia. Nevertheless, trade agreements and trade logistics barriers still make exporting to these markets difficult and costly. Therefore, as discussed in more detail elsewhere in this IRM, a major Government effort in the coming years must focus on opening-up these markets through implementable trade agreements and protocols, improvements in trade logistics and reducing the regulatory barriers and costs of trade. This will be an important step to opening-up Mongolia as a more viable location for export-based FDI. One of the key tasks of a country's national investment promotion agency is to explore which sectors make the best targets for proactive promotion, both from the perspective of commercial viability and potential impact in Mongolia.

Initial findings from interviews with the private sector and the Government indicate that the following sectors and sub-sectors have some potential for attracting FDI. There seem to be opportunities in the medium term for attracting FDI in several key sectors ranging from downstream processing activities linked to mining, tourism and hospitality, leather and agriculture, and agribusiness. These FDI “sparks” would need to be examined in further detail.

1. Mining sector

Only a small portion of mining resources are currently being put into production in Mongolia. As such, there appear to be plenty of scope for new deposits in a variety of minerals. Government could encourage companies, including foreign investors, to explore this untapped potential. However, as with other sectors, the instability of the legal environment provides a major constraint to FDI; security of tenure and tender are not guaranteed; and licenses are often revoked or granted in an ad-hoc manner. Also, and more importantly, securing more FDI into this sector will not help Mongolia in any way with the concentration and lack of diversity of its FDI inflows but only make them even more concentrated. Moreover, Mongolia is already on “the map” for mineral investors around the world.

Suggested actions at the sectorial level:

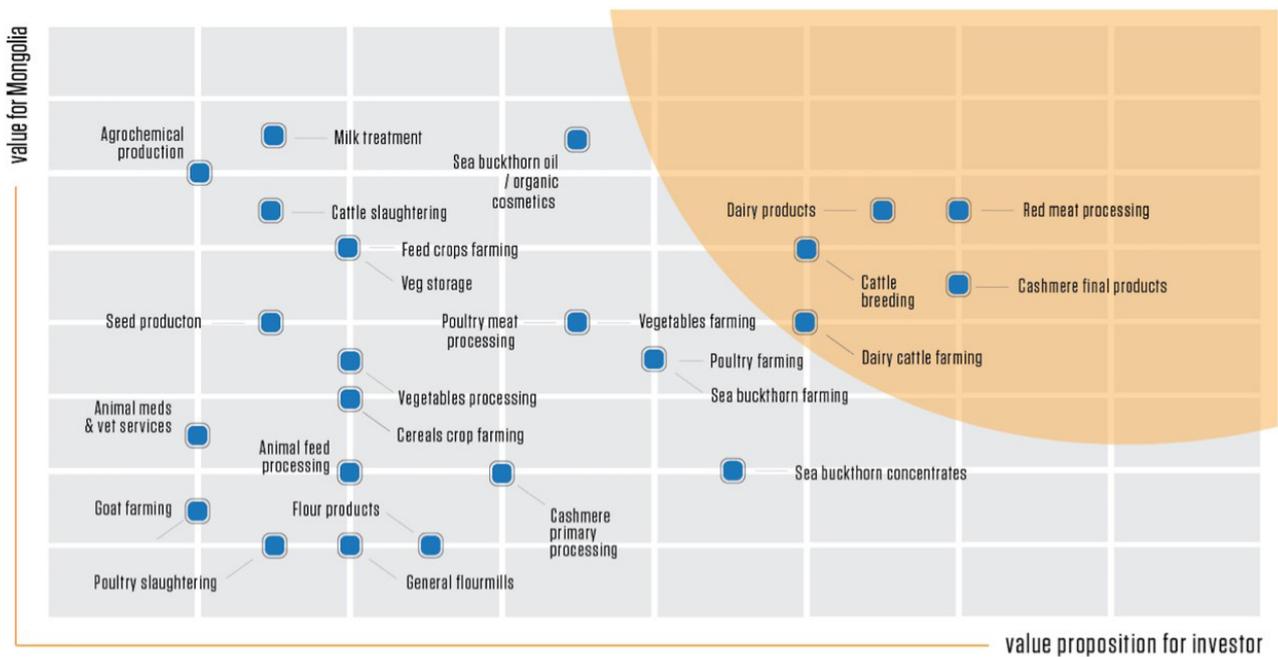
- Consider granting explorations licenses for further FDI in extractives.
- Make sure that Government prepares and implements a focused policy and strategy on leveraging this type of investment for diversification. In the new strategy, consider a focus on downstream and processing activities rather than just more exploration and extraction of raw material.

2. Agribusiness

In agribusiness, a recent sector scan conducted by the World Bank Group for and with NDA has identified a few sectors as having good medium-term opportunities for attracting new FDI. The five sub-sectors identified build upon the chart in *Figure 9*, which outlines both the value for Mongolia and the value proposition for investors.

For agribusiness, the five sub-sectors with greater FDI potential are: cashmere final products; red meat processing; Intensive cattle breeding; dairy products; and dairy cattle farming. The following includes the analysis and specific policy recommendations for each of these sectors.

Figure 9. Results of the Agribusiness Sector Scan



Source: WBG Agribusiness Sector Scan (2017)

Sub-sector 1: Cashmere – Wool – Leather

- The productive sectors based on animal products – cashmere, leather, and wool – appear to be ready to shift from primarily raw material exports to more sophisticated production of consumer goods. Interviews with sector representatives and the Ministry for Agriculture and Light Industry (MOFALI) highlighted the potential for joint venture agreements or contract manufacturing to bring about such activity. Indeed, there is nascent interest from foreign – Dutch, Chinese, and Italian – firms in providing upgrading support to Mongolian producers, and this could be leveraged to produce high quality, “Made-in-Mongolia”, garments.
- Currently, the sectors have limited overseas contacts and little access to markets, making it unattractive for FDI looking to serve regional demand. In general, there has been little public investment into transportation and storage infrastructure, causing many hides to be wasted or sold below-market value. This problem severely afflicts the meat and dairy sectors as well.
- Moreover, the discretionary and unpredictable nature of taxes and tariffs complicate exports.
- If these constraints could be remedied, the sector would have good potential both for direct and FDI-driven exports. Currently, some domestic firms have invested in improving logistics and quality control for the sector. A promising effort by the Government is the so-called “Leather Industrial Zone” which is in the pre-development phase outside of Ulaanbaatar.

Suggested actions at the sectorial level:

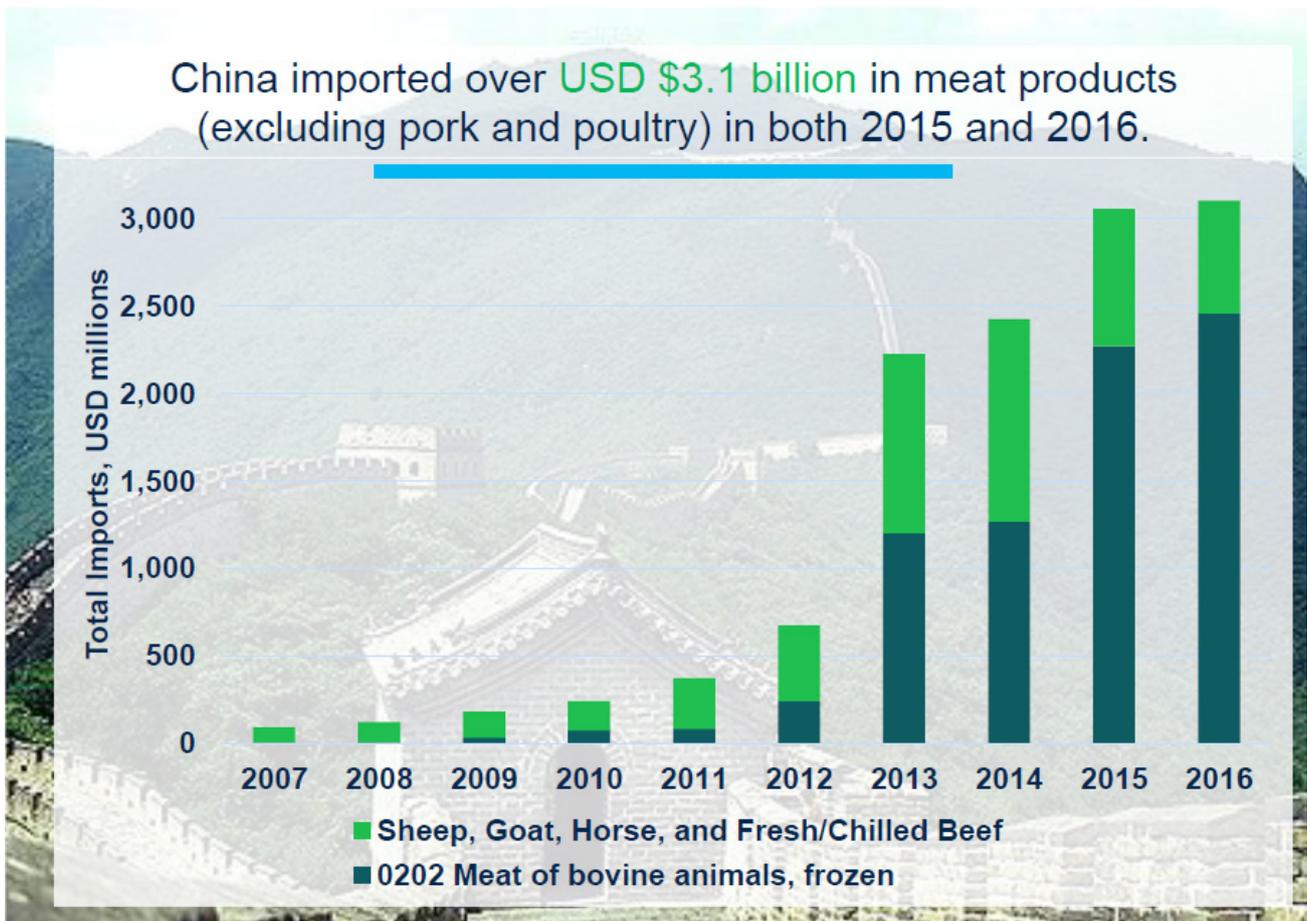
- Adopt a plan to build the “Made in Mongolia” branding for textile and garments.

- Put in place mechanisms to help Mongolian companies in the sector build their capacity, establish connections with overseas partners (including potential JV partners).
- Consider public investment in transportation and storage infrastructure that will support the sub-sector operators.
- Put in place a program to reduce discretion and unpredictability in tax and tariff implementation (to facilitate exports and thus attract efficiency-seeking investors).
- Consider expansions of dedicated industrial zones such as the Leather Industrial Zone.

Sub-sector 2: Meat

- Findings from a “Red Meat Value Chain” report pointed to the benefits of closer cooperation and long-term relationships between upstream suppliers and downstream buyers, including the potential for deeper cooperation with Chinese buyers and investors. The demand is clear with China now importing over US\$3 billion in beef and mutton annually (Figure 10). The challenge now is how to shift the livestock sector towards a more commercial focus.

Figure 10. China imports of meat products



Source: WBG Agribusiness Sector Scan (2017)

Suggested actions at the sectorial level:

- Implementing critical legislation, such as the legislation on animal health that was adopted recently, and upgrading the country's national quality infrastructure (NQI).
- For Mongolia to begin to capture some of the Chinese and other emerging markets for meat products, the Government will need to continue to make progress on connectivity, bilateral trade negotiations, trade facilitation, and veterinary services. To increase investor confidence, Government also needs to be sensitive to investor concerns about investor protection and policy instability.
- The private sector will need to invest in market intelligence and continue to improve managerial, marketing, and branding skills. Although this is a private sector responsibility, Government could support these upgrading efforts by the private sector with a range of tools (e.g., information on market opportunities, incentives for training, etc.)
- The WBG is currently developing a a Quality Infrastructure (QI) toolkit which might be useful to relevant authorities in Mongolia. The aim of the toolkit is to provide guidelines for reformers in partner and client countries on the diagnostic, design, implementation, and measurement of QI reforms.

Sub-Sector 3: Dairy

- Several key issues impacting the attractiveness of the dairy sub-sector have been identified by the WBG. The price of milk in Mongolia is still high, higher than in Russia for instance. This is due to low cow quality, high cost of feed, high cost of transport from feed to farm, and lack of economies of scale. Issues need to be resolved simultaneously to have impact: after getting a better pedigree of cows, there is a need to increase the quality of animal feed to maintain a higher productivity. Mongolia needs to import higher quality cows (e.g., from Europe) but transport costs are prohibitive for most farmers.

Suggested actions at the sectorial level:

- Government could carefully examine the possibility of subsidizing transport costs for dairy farmers who need to import high pedigreed cows.
- Government could advise farmers on pedigrees for cows that can survive in Mongolia's harsh climate.
- Government can consider some form of support to smallholders to become sustainable farmers.
- To promote the use of sophisticated dairy equipment needed to raise productivity, Government can consider exempting this equipment from import tariffs (currently import tariff exemption is for agricultural equipment like tractors).

3. Tourism and Hospitality

Mongolia is ranked 99 out of 140 countries by the UN World Tourism Organization.²⁴ Tourism has been highlighted as a potential sector to examine in terms of high FDI and linkages potential for the medium to long-term. To date, there has not been any systematic analysis to assess the needs of both business and leisure tourists or the quality and quantity of available suppliers from the domestic sector. As such, a sector scan for tourism covering potential source markets, specific sub-sectors, and investment climate constraints would be useful in determining FDI potential.

Roundtables with the National Tourism Organization and private sector representatives of the tourism industry identified some of the key obstacles facing their industry. The private sector has a good sense of the constraints facing their industry of which Government plays a role. For example, these relate but are not limited to:

- Incentives design and implementation have resulted in too many tour operators (600+) but at the same time, there is no specialization of travel companies in areas such as biking / trekking or MICE.
- Competition issues within the airline industry which has resulted in limited airline capacity of 500,000 seats/ year – half of which is controlled by MIAT. This prevents growth in other tourism sub-sectors such as accommodations.
- Legal issues, for example, the country’s tourism law is outdated (25 years old) and does not reflect the new changes in the tourism industry (e.g., hostels not recognized), which also aggravates the shadow economy.
- Institutional issues. Government tourism marketing budget is extremely low—possibly as low as US\$40,000, which is the average marketing budget of a private company. Need consistent promotion of Mongolia—Nomadic by Nature.
- Lack of data which prevents the accurate measurement of tourism statistics and the subsequent informed design of strategies and implementation plans.

Suggested actions at the sectorial level:

- Make a policy decision on whether Tourism is a priority sector for the country.
- If it is, undertake a full review (sector scan) of the tourism sector, which would include reviewing existing materials relating to tourism potential for FDI, the barriers to investment, and comparator analysis with other countries in the region and beyond.

²⁴ The ranking is composed by taking into account the number of international visitor arrivals, the revenue generated by inbound tourism, and the expenditures of outbound travelers.

4. E-commerce

Another potential area of FDI which needs further examination is e-commerce. The private sector is still not well established, and reports the following constraints to the local e-commerce ecosystem where Government policies may play a strong role. They include issues with:

- Online payment system: difficulties working with banks accepting online payment and trust issues with consumers regarding online security.
- Global E-commerce Talent (GET): increasing the skills base for e-commerce and mobile applications which are currently still weak.
- Transportation and shipping: issues of time, cost and reliability due to heavy traffic in UB, and the lack of consolidation of warehouses in rural areas.

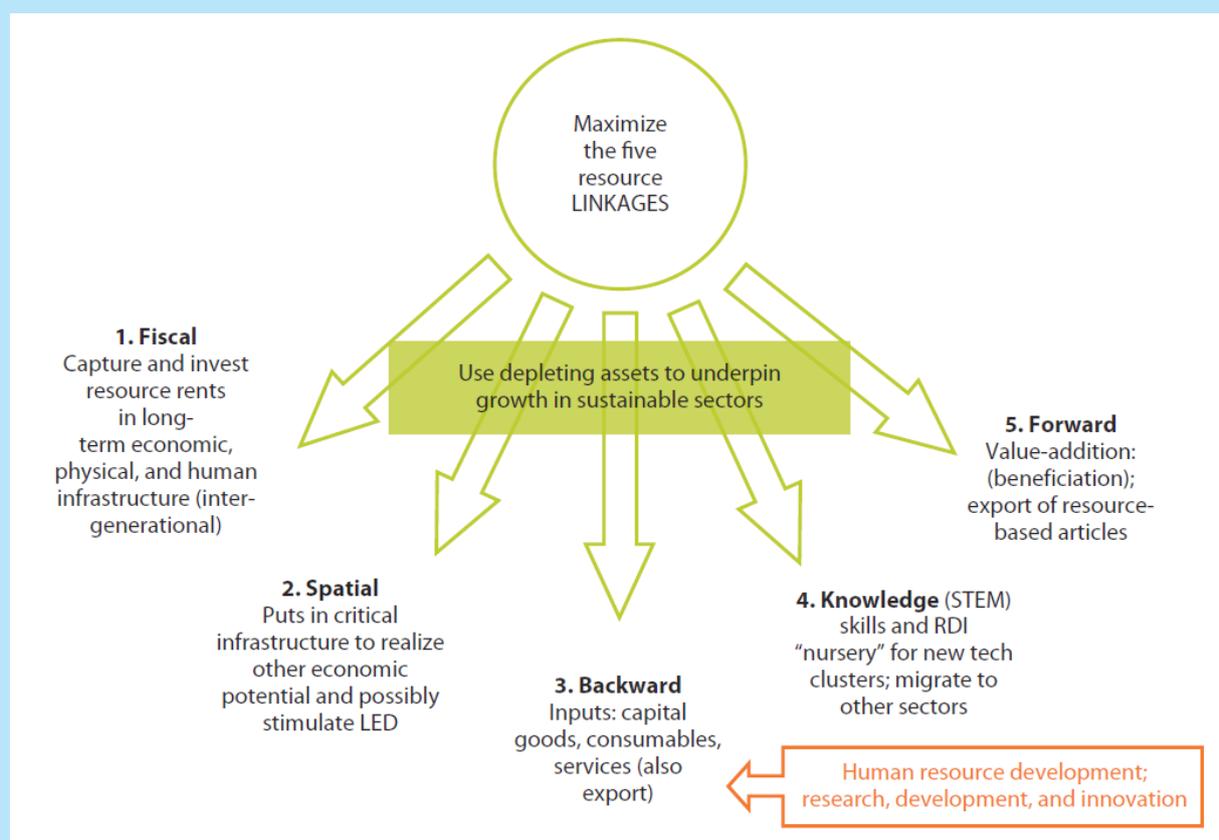
Suggested actions at the sectorial level:

- Confirm investor interest in e-commerce.
- Establish an e-commerce task force or working group comprised of key public and private sector stakeholders.
- Identify in a systematic and participatory manner the main barriers for increasing investment in the sector.
- Develop a concrete e-commerce action plan to tackle these barriers.

Preliminary observations on fostering linkages between foreign and domestic investors. Evaluating a country's "FDI potential" does not consist only in determining how much more FDI or even how different types of FDI could be attracted to the country, but also how to foster linkages between domestic and foreign investors, thereby bringing more benefits to the domestic economy. As the linkages situation in Mongolia has not been analyzed in detail yet (but could be if the GoM would be interested), the IRM report will only offer limited and preliminary observations on this topic. Box 1 below defines what linkages are and what benefits they bring. This illustration pertains to linkages in the extractives sector but it can be equally valid for other sectors.

Box 1: Linkages between Domestic and Foreign Investment (Natural Resources)

The extractives sector has in many countries not generated many linkages, spillovers or direct employment for local firms (with the exceptions of Norway and Canada). Foreign firms often work as enclaves in developing countries, importing staff, goods and services from abroad. In many cases, local firms find it difficult to provide inputs into the production process, due to lack of access to qualified staff, lack of managerial skills, lack of knowledge about international product standards, and lack of access to finance.²⁵ To counter this trend, countries have five different types of linkages policies at their disposal:



Note: LED = local economic development; STEM = science, technology, engineering, and math; HRD = human resource development; RDI = research, development, and innovation.

Backward linkages involve the participation of local firms in the production process. The potential for these upstream activities is oftentimes limited to less complex goods, such as basic mining equipment, as well as ancillary services, which create a small amount of jobs, but at the same time are unlikely to significantly contribute to economic upgrading.

²⁵ Halland, Håvard, Martin Lokanc, and Arvind Nair. 2015. *The Extractive Industries Sector: Essentials for Economists, Public Finance Professionals, and Policy Makers*. World Bank Studies. Washington, DC: World Bank. doi:10.1596/978-1-4648-0492-2. License Common Creative. Attribution CC BY3.0 IGO., p. 93.

Forward linkages related to natural resources are also difficult to achieve. Although many countries have sought to encourage downstream mineral processing by e.g. export restrictions of unprocessed commodities or subsidies for downstream processing commodities, these initiatives have often had limited success. Hausman, Klinger, and Lawrence (2007)²⁶ fail to find positive effects of these so-called ‘beneficiation policies’, since the capabilities required for downstream processing are generally very distinct from those in the extraction of resources. The authors highlight that key determinants for the location of smelters or refineries are mostly low-cost power, access to land, pollution controls and other regulatory requirements, or access to low-cost finance, rather than access to raw mineral ore.

Because both backward and forward linkages (vertical diversification) are difficult to achieve, horizontal economic diversification should be at the center of government efforts to foster economic development. The example of Chile, the World’s largest exporter of copper, showcases the possibility of economic diversification without significant downstream activities.²⁷

Knowledge linkages are critical in that regard, because many skills in the natural resource sector are transferable to other sectors, for example skills in mechanical engineering, civil engineering, accounting, finance, business management and technical trade such as mechanics or electrical installation.²⁸ Raising domestic knowledge and skills is likely to promote the absorption of technology transfer and spillovers to other sectors.

Using fiscal revenues and subsequent public investment in physical and human capital (**fiscal linkages**) and extractive industries infrastructure (**spatial linkages**) are further important ways to achieve horizontal diversification and long-term benefits for an economy.

Given the narrow FDI base and economic structure of Mongolia, the creation of linkages -as well as Mongolia’s participation into GVCs- is and will be a significant challenge for two reasons. First, the extractive and agri-business sectors -especially since the latter mostly consist of un-processed food for exports-, do not necessarily lend themselves well for supply chain linkages in tradable inputs although, as the box illustrates, several options are still available.

And secondly, For the development of an effective linkages program or strategy to achieve potential impact, Mongolia will first need to attract a critical mass of FDI in a certain sector.

It should be noted that spillover effects from FDI might still occur even if linkages remain limited. The spillover effects can be developed through: (i) human capital effects as FDI firms invest in training

²⁶ Hausman, Ricardo, Bailey Klinger, and Robert Lawrence. 2007. “Examining Beneficiation.” Working Paper, Center for International Development, Kennedy School of Government, Harvard University.

²⁷ See for example Agosin, Manuel R., Christian Larrain, and Nicolas Grau. 2010. “Industrial Policy in Chile.” IDB Working Paper Series No. IDB-WP-170, Inter-American Development Bank, Washington, DC.

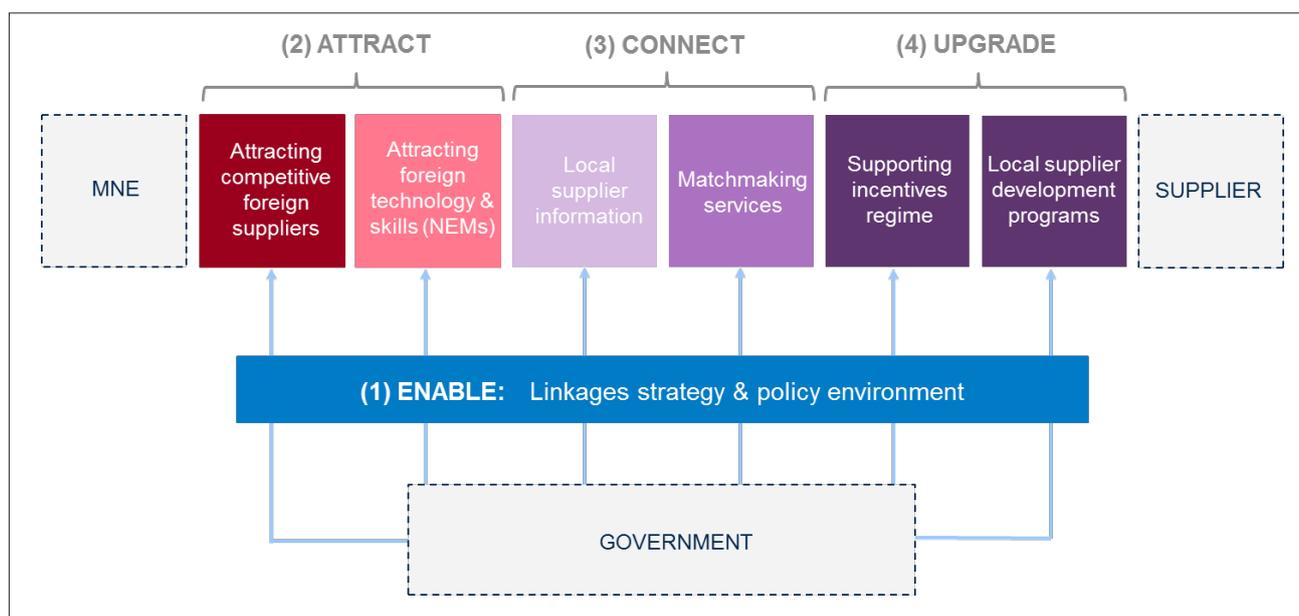
²⁸ Ibid., p. 95

their labor force, and other companies may benefit through labor mobility; and (ii) demonstrations effects which relates to direct limitation or reverse-engineering in areas such as products design, marketing, production and sales techniques. For example, in the agri-business sector, it might be less of a backward linkages issue but rather compliance with certification standards so support local producers in getting certified to be able to export to foreign markets.

Since FDI linkages do not develop automatically due to various market failures and constraints described earlier, it is important that governments take a systematic approach to the promotion of FDI linkages, technology transfer and domestic value addition. Well-designed linkages programs require a thorough understanding of the mutual benefits to both FDI and local firms and involves clear goal setting, an effective institutional framework and strong lead agency to support its implementation. The entry point for any meaningful program or strategy must be the demand side, *i.e.* the localization opportunities and needs as seen by foreign investors. This is where Investment Promotion Agencies (IPAs) play an important role.²⁹

When considering the market failures in Mongolia highlighted earlier, the promotion of FDI linkages typically entails four fields of action as also shown in *Figure 11* below: (1) creating an enabling policy environment; (2) strategic attraction of FDI; (3) linkages promotion services; and (4) upgrading of local capabilities of firms and workforce.

Figure 11. Pillars of a comprehensive linkages program



Source: WBG - Investment Policy and Promotion Unit

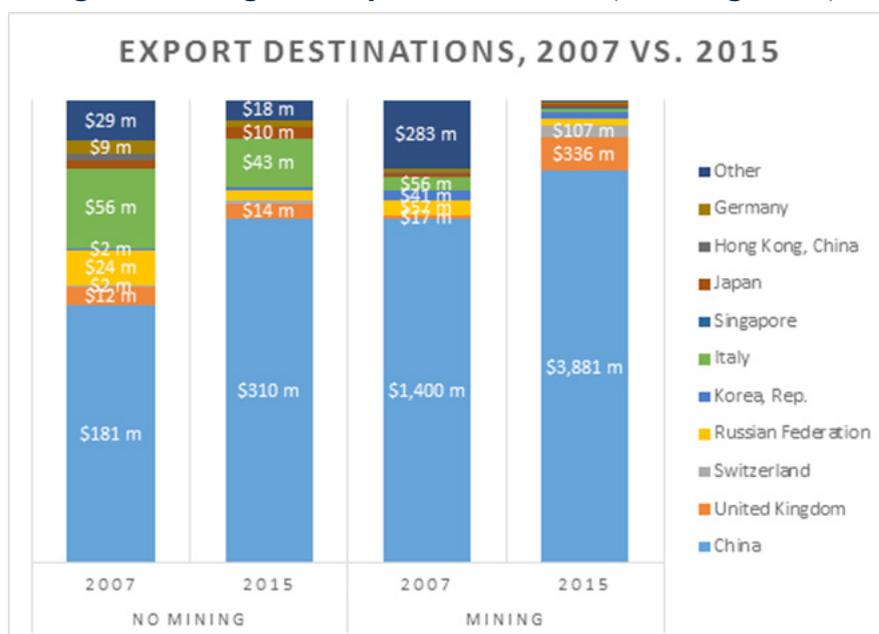
A substantial body of literature exists to support the idea that exports is a leading indicator for the attraction of efficiency-seeking FDI. Exports which are competitive enough to compete in global markets may indicate to policy makers that the country can compete effectively for efficiency-

²⁹ Chapter 3 below provides best practices on the role of IPAs in promoting FDI linkages.

seeking FDI in that sector. To fully maximize the full benefit of exports to the domestic economy, it makes sense for countries to focus on exports of products with a product complexity above the current specialization of the country. This helps a country upgrade its trade specialization.

The GoM has highlighted on numerous occasions the need to diversify the Mongolian economy, in terms of sectors beyond natural resources, sources of FDI, and export markets. They cite figures which indicate that several decades ago, Mongolian exports to China and Russia were roughly the same, but as of today, 80 percent of Mongolian exports go to China and around 10 percent to Russia. These statements are supported by the data outlined in *Figure 12*. Exports of non-mining products to China almost doubled while those in mining more than doubled from the period of 2007 – 2015.

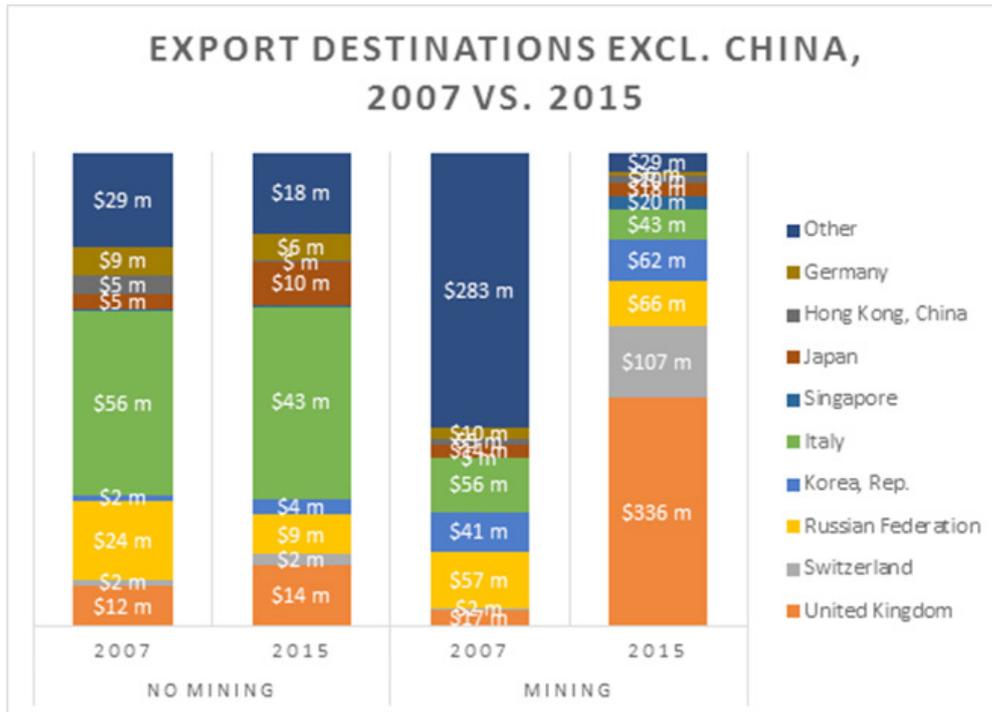
Figure 12. Mongolia's export destinations (including China)



Source: WBG, Hausmann et al, *Atlas of Economic Complexity* (2017)

As indicated in the earlier analysis on economic complexity, Mongolia may wish to focus on those products that entail greater processing steps, and which deliver a final consumer good whose product complexity index (PCI) is greater than the average PCI of Mongolia. In terms of diversifying the countries which it may export to, Mongolia may want to differentiate between those goods which are exported largely to neighboring countries versus those which have the potential to be exported to a more diverse set of destinations. In terms of non-China exports (*Figure 13*), data indicates that compared to 2007, in 2015, the value of Mongolia's non-mining exports to most countries decreased apart from the UK (US\$12m-US\$14m), Japan (US\$2m-US\$4m), and Korea (US\$5m-US\$10m). A more detailed look at Japan and Korea is given below.

Figure 13. Mongolia's export destination (excluding China)



Source: WBG, Hausmann et al, Atlas of Economic Complexity (2017)

The doubling of exports to Japan and Korea may warrant a closer look. It may indicate the competitiveness of Mongolia's exports, which may be a case for attracting efficiency-seeking FDI. Exports to Japan have increased by 2-fold from US\$2m in 2007 to US\$4m in 2015. Of interest are the exports of products with higher complexity on the order of approximately US\$2.5m for diodes, transistors, and similar semi-conductors. Interviews with Government representatives also confirmed the existence of Japanese FDI in batteries and integrated circuits.

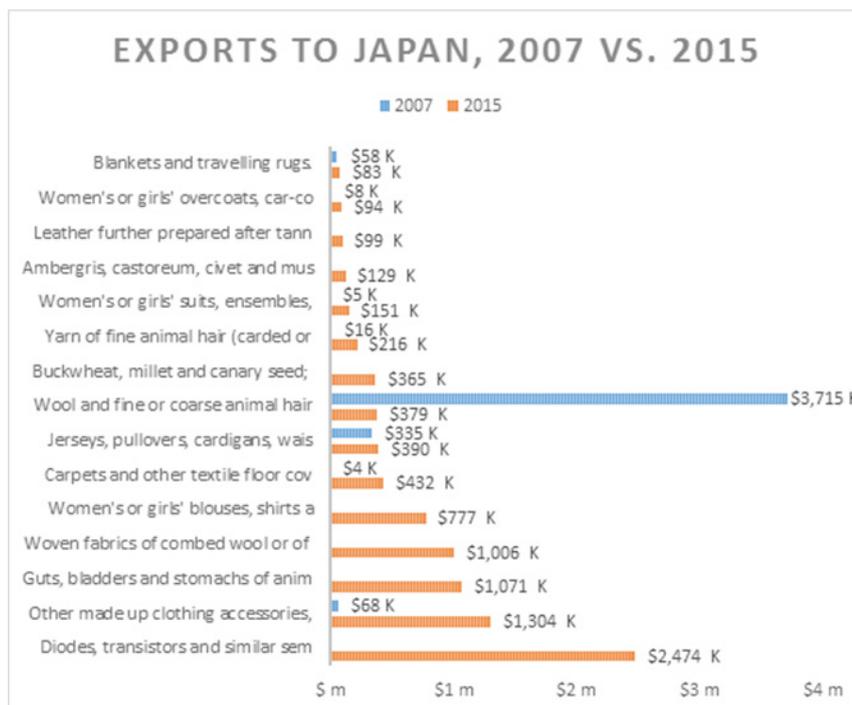
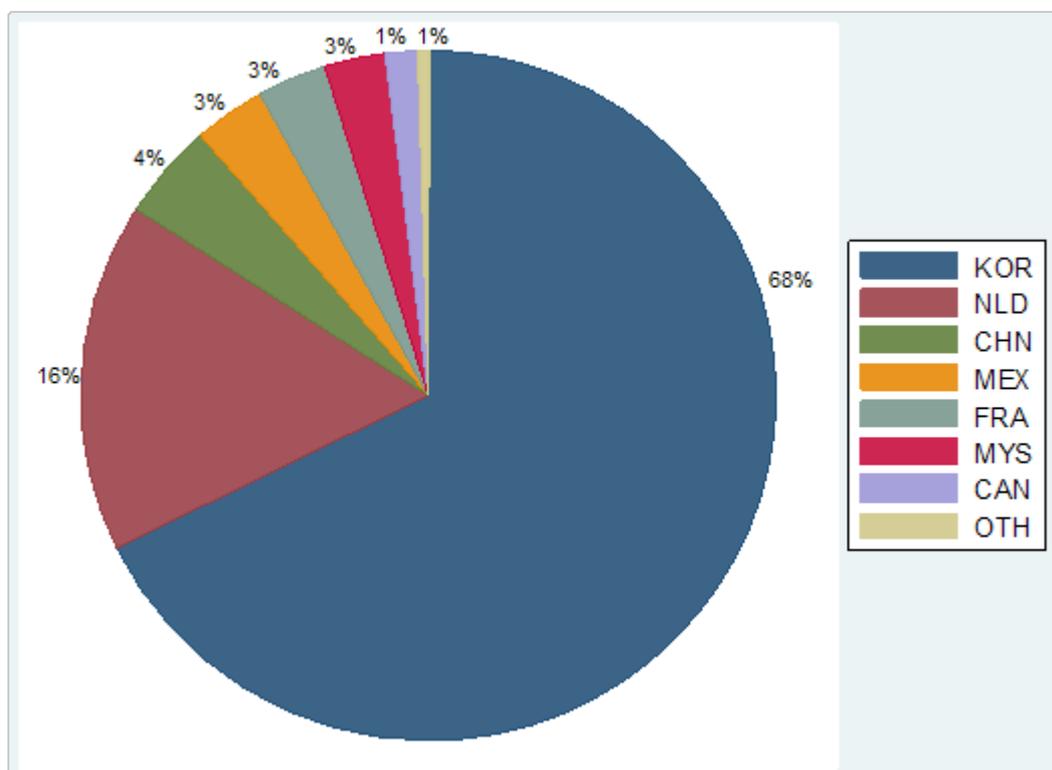


Figure 14. Exports to Japan, 2007-2015

Source: WBG, Hausmann et al, Atlas of Economic Complexity (2017)

In terms of exports to Korea, our desk research for the period 2010-2014 indicates that Mongolia exports 68 percent of its electronic microcircuits there, followed by the Netherlands (16 percent). For batteries (SITC: 7781), Mongolia exported 96 percent of its total to Korea.

Figure 15. Mongolia exports of Electronic Microcircuits, 2010-2014



Source: WBG, Hausmann et al, Atlas of Economic Complexity (2017)

In terms of other countries and sectors with high PCI, Mongolia may want to look closer at the following sectors and export destinations to confirm the viability and real investor interest in these sectors. “Confectionary sugar” (i.e. sugar for chocolate and candy) has been highlighted since its complexity (-.681) is approximately equal to Mongolia’s economy-wide economic complexity (-.666).

For example, it appears that electronics could be a relatively promising sector, especially considering the wider region. From the data, it appears that there has been some investment from Sharp (Chinese Taipei) in 2016, which confirms the narrative we heard on the ground. The findings from this preliminary desk research need to be validated with interviews with Government and the private sector.

Table 1. Mongolia, PCI, export values, and destination

Product Name	Export Value	RCA	SITC2	PCI	Main destination
Reciprocating Pumps	1,340,000	0.19	Electronics	1.67	Singapore
Misc. Power Machinery	136,000	0.006	Electronics	1.54	Germany
Electronic Microcircuits	4,760,000	n/a	Electronics	1.41	UK
Diodes Transistors and Photocells	3,170,000	0.1	Electronics	1.22	Japan
Misc. Electrical Machinery	172,000	0.005	Electronics	1.19	UK
Misc. Telecom Equipment	276,000	0.047	Electronics	1.14	Germany
Telecom Parts & Accessories	129,000	0.002	Electronics	1.03	Germany
Misc. Animal Entrails	266,000	0.23	Food Processing	0.463	China
Batteries	1,260,000	0.083	Electronics	0.319	South Korea
Chocolate	258,000	0.029	Food Processing	0.308	China
Aircraft Tires	98,500	0.52	Aircraft	0.254	Singapore
Aircraft Parts and Accessories	3,310,000	0.13	Aircraft	0.168	Germany
Sporting Goods	317,000	0.033	Electronics	-0.036	China
Equine	37,800	0.042	Meat & Eggs	-0.142	China
Misc. Prepared Meats	128,000	0.022	Meat & Eggs	-0.239	Russia
Large Aircraft	23,900,000	0.73	Aircraft	-0.319	Denmark
Horse Meat	4,970,000	33	Meat & Eggs	-0.398	Russia
Misc. Edibles	311,000	0.015	Food Processing	-0.453	South Korea
Baked Goods	169,000	0.017	Food Processing	-0.457	China
Raw Sheep Skin with Wool	63,800	0.25	Leather	-0.512	China
Confectionary Sugar	498,000	0.13	Food Processing	-0.681	China
Bovine and Equine Entrails	239,000	0.091	Meat & Eggs	-0.777	China
Aircraft	2,400,000	0.64	Aircraft	-0.845	US
Misc. Animal Origin Materials	8,950,000	2.84	Leather	-0.921	Germany
Bovine Meat	1,590,000	0.1	Meat & Eggs	-0.94	Russia
Prepared Fruit	117,000	0.026	Food Processing	-0.966	China
Bovine and Equine Leather	7,980,000	1.15	Leather	-1.214	Italy
Internal Combustion Engines	112,000	0.07	Aircraft	-1.259	Canada
Misc. Hides and Skins	39,300	0.12	Leather	-1.381	US
Raw Calf Skins	2,870,000	7.54	Leather	-1.402	China
Sheep and Lamb Leather	10,900,000	27.6	Leather	-1.911	China
Leather of misc. Animal Hides	13,700,000	15.4	Leather	-1.989	China

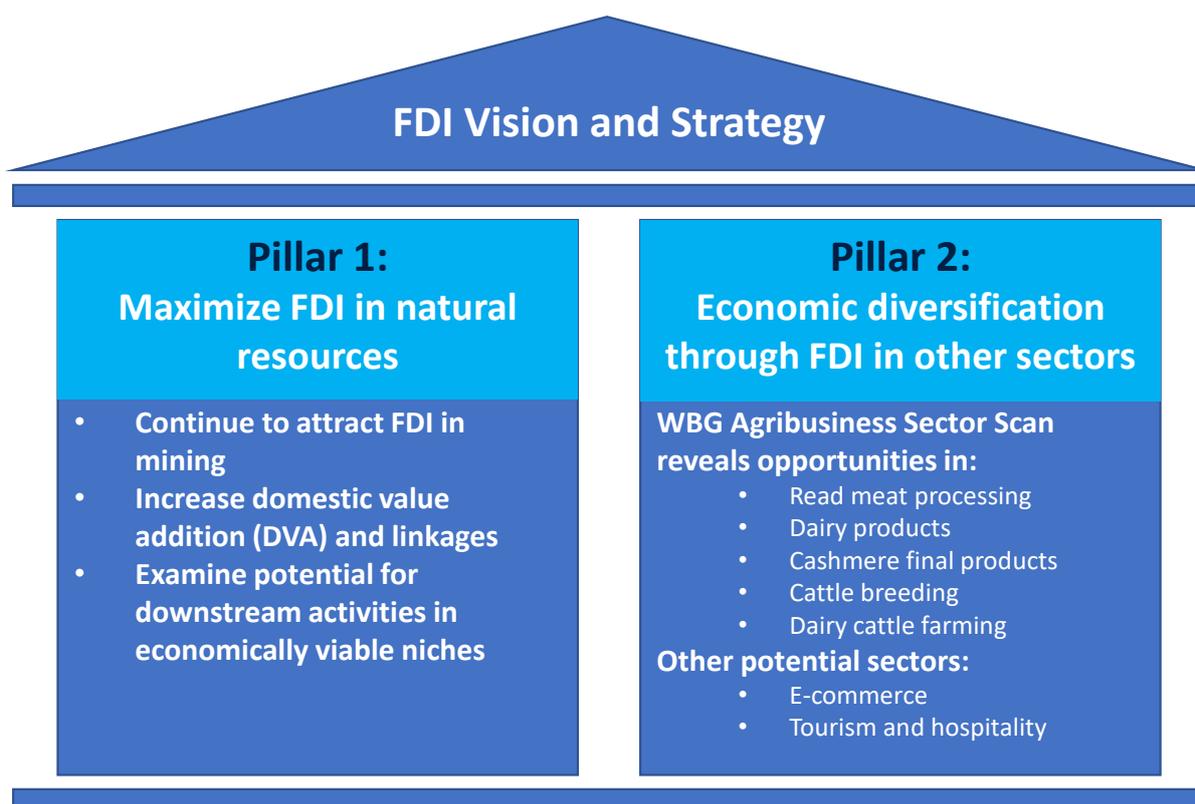
Source: WBG, Hausmann et al, Atlas of Economic Complexity (2017)

IV. Policy directions

The above analysis of Mongolia’s FDI performance and potential suggests that the following actions could be usefully considered by the Government as part of an IRM or a new FDI strategy. These should be discussed during forthcoming stakeholder consultations in Mongolia to determine their inclusion into an Action Plan:

- Whenever an important policy or regulatory decision is being considered in relation to either new or existing FDI, a key driver and criterion should be whether the decision under consideration will support the diversification agenda of Mongolia. Given Mongolia’s current low level of economic complexity and extremely high dependency on natural resources this objective should be front and center in the minds and actions of policy makers, promoters and regulators. In creating a new vision and strategy to maximize the benefits of FDI, Mongolia may adopt an approach resting on **two pillars** for optimal results (see *Figure 16* below):

Figure 16. A two-pillar approach as the foundation for a new FDI vision and strategy



Source: WBG-Investment Policy & Promotion unit

The **first pillar** of the approach means both continuing to attract FDI in mining but also implementing a strategy to increase *domestic value addition (DVA)* and linkages between foreign and domestic investors. This builds upon existing private sector initiatives to gauge the availability of domestic suppliers for the needs of mining operators for goods, services, inputs in general. Additionally, the GoM may want to examine the potential for some downstream activities in the extractives sector where it makes sense economically. There could be a few “niches” where the costs of developing these opportunities would not exceed the benefits but be attractive value propositions (e.g. coal washing).

The **second pillar** entails looking at the potential for FDI in other sectors of the economy based on investor signals and where Mongolia has potential to be competitive. Initial findings from interviews with the private sector and the Government indicate that the following sectors and sub-sectors have some potential for attracting FDI: *tourism and hospitality; e-commerce, and agribusiness*. Mongolia could focus its FDI promotion efforts on these sectors with under-developed potential and also examine how current policies are conducive to more private investments in these sectors.

This two-pillar approach specific to investment policy aligns well with the GoM’s “*Three-pillar Development Policy*”, which seeks to transform Mongolia’s economy which away from dependence on mining towards a multi-pillar economy. The GoM has identified agriculture, tourism, industry, trade and infrastructure sectors as key targets to develop, as well as to generally increase economic competitiveness.

- Exploit potential opportunities relating to services FDI. The above analysis has some limitations, to the extent that the complexity analysis is only available for primary and manufacturing sectors. The lack of national data available exacerbates this problem which means that further analytical work is required in the field. However, it is known that services have helped many developing countries “leapfrog” through different development stages. The skills required with services FDI can be developed in one generation versus manufacturing capacity which can take several generations. A closer look at Mongolia’s potential in this area is warranted.
- Mongolia could consider signing more Free Trade Agreements (FTA’s). It would help to facilitate exports of Mongolian goods and services to strategic markets, thereby also increasing Mongolia’s appeal to efficiency-seeking investment and investors (by definition, efficiency-seeking investors produce goods and services in the host economy for export to third countries rather than for the domestic market). Given that a key feature of the new FDI strategy is to promote efficiency-seeking FDI, considering additional FTA’s would be sensible. It would also help to attract and facilitate entry of foreign investors originating in the FTA signatory countries.
- Assign Government agencies to focus on attracting FDI in sectors which have higher economic complexity than Mongolia’s current basket, specifically, FDI from Korea and Japan, and sectors relating to diodes, batteries, and integrated circuits whose exports from Mongolia appear to be increasing (although what Mongolia seems to export to Korea are recycled batteries not batteries made in Mongolia).

- MoFALI and NDA should work more closely together to identify these potential investment leads, alongside Japanese and Korean foreign missions.
- Identify other potential leads through targeted outreach to other foreign missions such as the US Government which already plays a very pro-active role in tracking and encouraging investment.
- As an immediate step, the Government needs to designate one department or unit which will collect FDI data (potential, committed, and realized) on a regular basis. This unit would also need to have access and the capacity to analyze and collect data from external sources. This unit would need to have close ties and regular information exchange with other agencies including the registration office, NDA, the Central Bank.

CHAPTER 2:

Legal and Regulatory Framework on Investment

This chapter, while highlighting the need for a broad and ambitious program to improve the overall investment climate and governance situation in the country, will focus on laws and regulations that directly related to investment policy. The analysis allows for the identification of measures that are key constraints to private investment in Mongolia along two key areas: (i) entry and establishment of investment, and (ii) protection and retention of investment. The analysis presented hereby not only considers the text of legal instruments (*de jure*), but also the associated *de facto* practices (when information was available) to assess the level of implementation of the legal framework.

I. Investment Entry: Restrictions to foreign participation in the local economy

The evolution of the investment policy of Mongolia is a complicated and turbulent one, which largely reflects fluctuating attitudes of successive governments toward FDI. There has been a “pendulum swing” in investment policy-making, with phases of pro-investment policies abruptly turning into anti-foreign investment stands. On several occasions, the officially open and welcoming stance toward FDI has been contradicted or undermined by a series of legislative changes. Illustrating this point in relation to the entry of investors, the Foreign Investment Law of Mongolia of 1993 (FIL 1993) sent mixed or negative signals to the investor community by imposing a comprehensive *ex-ante* screening of every foreign investment project. The stringent and discretionary entry process was therefore already at odds with the official liberal approach to FDI entry with foreign investment open in all areas of production and services with a few exceptions that were common practices around the world, e.g., weapons or drugs, gambling. The screening was not implemented in practice and no foreign investor was apparently turned down; but the fact that the possibility existed generated some uncertainty.

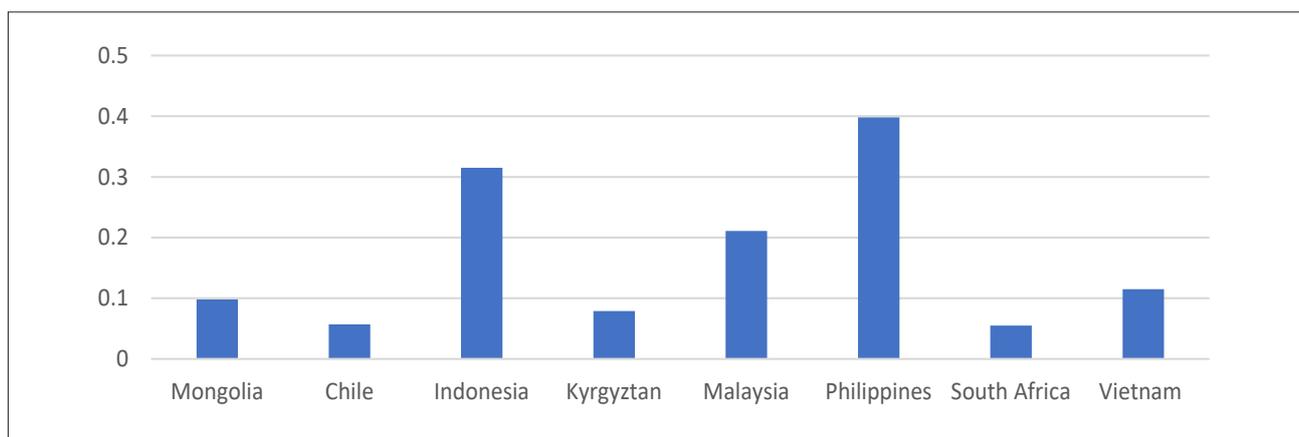
In May 2012, amid an election campaign where national security issues and anti-foreign investment arguments were front and center in the national debate, a law called Strategic Entities Foreign Investment Law (SEFIL 2012) was hastily drafted and enacted by Parliament, without public consultation, purportedly to block a very large foreign investment that was about to be concluded in the mining sector. This law essentially required all foreign investments, by private or State-owned entities, in ‘strategic’ sectors (i.e., mining, banking, telecom and media) to be approved by the GoM; and those investments that exceed a 49 percent equity stake, to be approved by the Parliament. The SEFIL did block the acquisition in question but it also deterred other foreign investment plans into the Mongolian economy. In fact, this Law is one of the key factors that are often cited in Mongolia for having contributed to the significant decline in FDI inflows along with external factors such as the slowdown of the Chinese economy and the fall in commodity prices. It has clearly contributed to establish a climate of indecision in the investment community and eroded investor confidence.

In October 2013, to the relief of the investor community, the new Mongolian Investment Law (MIL 2013) was developed and enacted with support from the WBG. MIL replaced the short-lived SEFIL. One of the most important changes in the 2013 Law was to replace the screening of both private and SOE investments in strategic sectors (when the investment exceeded certain thresholds) by a system whereby screening is limited to investment by foreign SOE in strategic sectors (i.e., mining, bank/finance, and media and communication) when the foreign SOE owns 33 percent or more of the equity in the Mongolian entity. The Law also clarified investors' rights and obligations, provided for tax stabilization certificates and established the powers and responsibilities of the agency that regulates and promote investment.

Mongolia is among the most open economies for foreign investment in the EAP region. Following international developments in trade and investment liberalization, most economic sectors in Mongolia are open to foreign participation. (Figure 17). According to the OECD Index on Regulatory Restrictiveness to FDI -which considers four types of measures: (i) foreign equity restrictions, (ii) screening and prior approval requirements, (iii) rules for key personnel, and (iv) other restrictions on the operation of foreign enterprises for 22 sectors- only a few sectors have significant restrictions to FDI, including air, transport, and mining and quarrying. (Figure 18).

Figure 17. OECD FDI Regulatory Restrictiveness Index, 2016

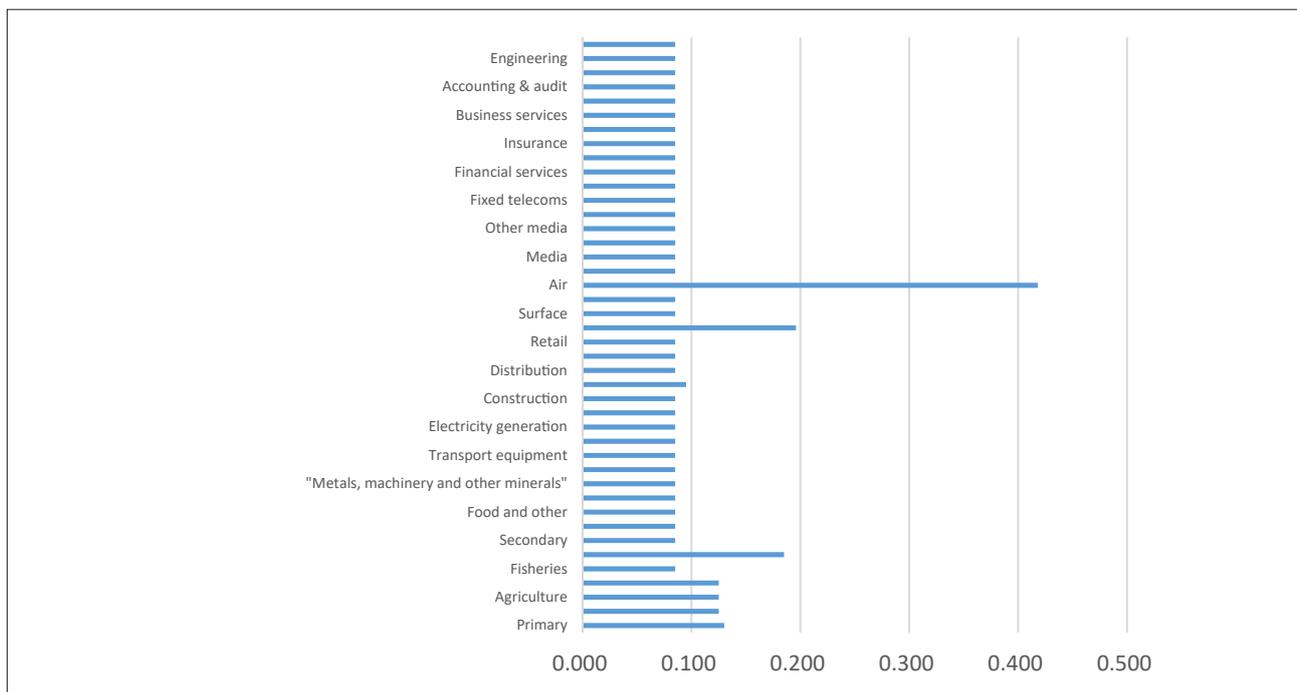
Restrictions are evaluated on a 0 (open) to 1 (closed) scale



Source: OECD.stat (2016)

Figure 18. OECD FDI Regulatory Restrictiveness Index by sector, 2016

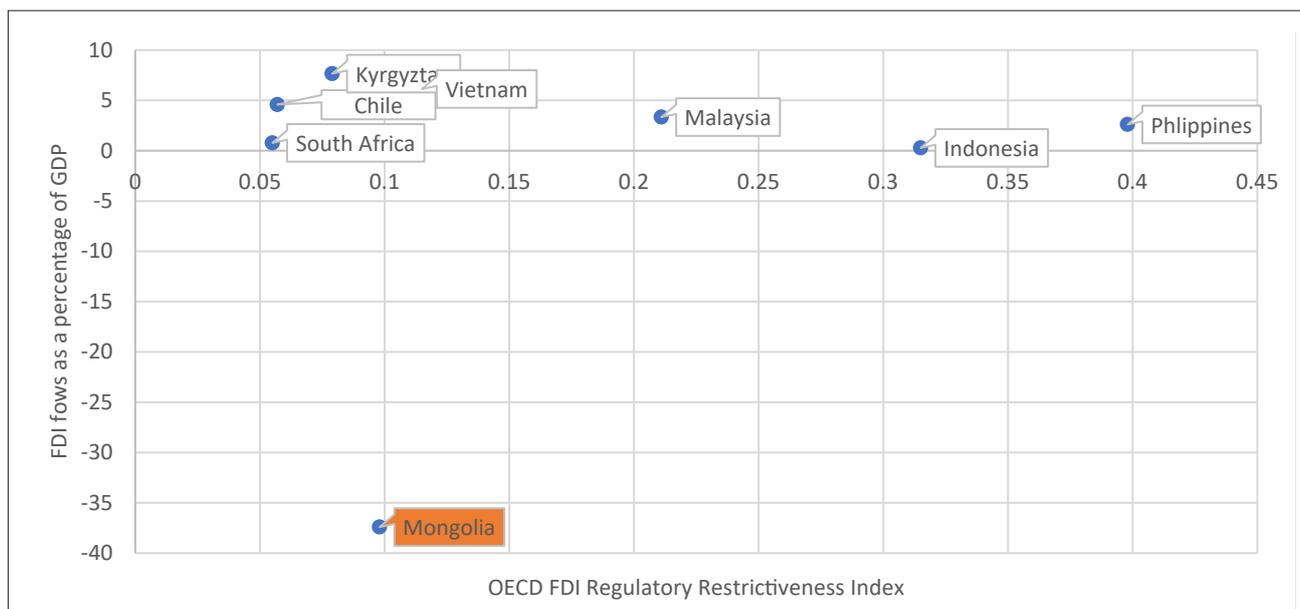
Restrictions are evaluated on a 0 (open) to 1 (closed) scale



Source: OECD.stat (2016)

As shown in *Figure 19*, Mongolia is far from reaching the level of FDI as compared to other countries that score similarly in the level of FDI regulatory restrictiveness. In this regard, it is important to consider that the openness of sectors where private and foreign participation is allowed is the first step but there are also other areas in the legal regime that would need to be aligned as to provide a conducive environment for investors to make business in the country.

Figure 19. Relation between FDI flows and FDI regulatory restrictiveness score



Source: OECD.Stat 2016 and UNCTAD 2016

The following are key areas for the entry of investors in Mongolia.

Restrictions to private investment. Under the current investment legal framework, any investor, domestic or foreign, may invest in any sector without any limitation or Governmental approval. Both categories of investors, in principle, can establish and own all forms of legal entities and engage in all types of economic activities on an equal footing. The only exception applies to foreign State-owned enterprises that seeks to acquire more than a third of the equity of a Mongolian company in a few strategic areas (minerals, telecom, media, banking/financial sectors).

Minimum foreign equity. Although the Investment Law provides for national treatment, foreign investors are subject to a minimum capital requirement. For a foreign firm to start business operations in Mongolia, it must be incorporated either as a business entity with foreign investment (BEFI) or as a representative office. A BEFI must have at least 25 percent of foreign equity and a minimum foreign contribution of US\$100,000. Should be noted that mandatory minimum foreign contribution can result in a burdensome requirement for investors specially the ones that are willing to start an investment with a low sum to decide whether or not to put the full amount of the investment in the country. A representative office does not require a minimum foreign equity; however, it does not have the power to earn revenue from business activity in Mongolia.

Ownership of real state. The Constitution of Mongolia limits the right to own land to citizens of Mongolia. Per the Investment Law, land is considered as a non-tax promotion for investment. Foreign investors may lease land for use up to 60 years based on a contract, and extension is possible for up to 40 years under the contract's primary condition. Extension of the contract is only possible once, which limits the use of the land for up to 100 years. Although this can be considered a reasonable period, investors may want to have more certainty on both the renewal of the primary contract and additional period. More important is the contract enforcement problem in Mongolia which has been pointed out as one of the major concerns for investors. Even when the investor has a valid land contract, there have been occasions where the contract is not honored by the Government.

Related to land rights, on November 2017, the Mongolian Parliament introduced rules to tax indirect transfer of land rights and exploration and mining licenses as part of the 2018 Fiscal Budget. The amendments affect companies operating in all industries in Mongolia that hold land rights and mineral licenses.

The new regime subjects to 10-30 percent withholding tax on a gross basis the transfer of land rights, including land possession or usage rights and mineral licenses, including exploration or mining rights. The regime also introduces a new categorization of all or part of a transaction involving the transfer of the rights as a direct transfer and tax the beneficial owner, resulting in a 30 percent Tax on the determined taxable base. In addition to the new tax, the amendments also introduce obligations for right holders, e.g., companies holding the rights should disclose and register their beneficial owners with the Legal Entity Registration Office and tax authority and notify and register the rights with the relevant authorities for any change in beneficial ownership. If companies do not comply with such requirements, sanctions are contemplated that could terminate the right. Worth noting that because these amendments were introduced as part of the 2018 Fiscal Budget, the application of the Law of Legislation was not mandatory, which means that no previous

consultation was conducted leaving investors out of the discussions of rational and implications of such increase in tax.

Work visas. Three visa options are available: business visa (B visa), foreign investor visa (T visa) and work permit visa (HG visa). There are single-entry and multiple-entry B visas. Single-entry B visas are valid for a period of up to 90 days, and multiple-entry B visas are valid for either 6 months or 1 year. Multiple-entry B visas are valid for one time stay of a visitor not exceeding 30 days upon entry into Mongolia. In other words, visitor may enter Mongolia multiple times within the period of issued visa, but every stay may not exceed 30 days. Whereas visitors with single-entry B visa may enter Mongolia one time only and stay for a period of up to 90 days (depending on issued visa). Single-entry B visas are valid for 90 days upon its issuance until the entry into Mongolia, and multiple-entry B visas are valid for 183 days. T visa are issued to individuals, who are foreign investors or chief executive officers of a foreign invested company, or its branch or representative offices. These are valid for either 6 months or 1 year. Unlike multiple-entry B visas, holders of T visas are required to obtain residence permit (residence card) and therefore may stay the full period of their visa. HG visa are issued to foreign citizens, who work in Mongolia under labor contract. HG visas are valid for up to 1 year, depending on employer's request. Holders of these visas are required to obtain residence card from Immigration Agency and work permit from Labor and Welfare General Agency. If a foreign citizen is found to have been employed without a work permit issued by the relevant authority or conducted activities other than the purpose of a his/her arrival, the person shall be prohibited to re-enter Mongolia within three years.

Investors have reported irregularities in the application of the visa's regime. The complains are around the time it takes for an investor to get the visa issued and the procedure to renew or extend it. A specific example of arbitrariness of the relevant authorities is that investors are subject to the prohibition to re-enter Mongolia within three years because they stay in the country waiting for the visa to be renewed.

Local content requirements. A foreign employee quota is set by the Government every year for local and foreign companies in Mongolia. This usually ranges from 5 percent to 80 percent depending on the sector in question. Generally, however, the default quota for companies is 5 percent. Likewise, the employer must pay a workplace fee. Employer must pay on monthly basis a workplace fee, equal to twice the minimum wage set by the Government, for every foreign employee they hired.

For the mining sector, special requirements apply. A mining license holder and their sub-contractors are obliged to provide employment for citizens of Mongolia and up to 10 per cent of their employees may be foreign citizens. When the number of hired foreign personnel exceeds the percentage specified above, the license holder shall pay on monthly basis an amount equal to 10 times of the minimum wage level for each exceeding employment.

Although the 2013 Investment Law dramatically altered the investment landscape in Mongolia to a more conducive one, the legal framework for investment on entry can still benefit from improvement. Mongolia's Investment Law does not provide a consolidated negative list placing restrictions on foreign investments. As a result, the policies concerning foreign investment particularly as regards limits on foreign equity participation, partnership requirements, and the identification of restricted

sectors are arduous to navigate and difficult to predict. This affects the overall transparency and predictability in application of the investment policies and leaves a lot of discretion with the authorities to make the decision. This will ultimately result in decreasing investor confidence in Mongolia as an investment destination.

The 2016 Free Trade Agreement and Economic Partnership Agreement (EPA) between Mongolia and Japan provides for the lists of non-conforming measures (NCM) of Mongolia which serve as the identification document for measures that may be barriers to foreign investment in Mongolia. The restrictive measures include the following:

1. Foreign natural or legal persons are not allowed to own land in Mongolia. However, they may lease one for periods up to 60 years. The exact duration of the lease shall be determined by contact and subject to the relevant laws and regulations.
2. A foreign state-owned enterprise that intends to hold 33% or more of total shares of an entity operating in the mining, telecommunications and broadcasting sector of Mongolia, is required to obtain a prior approval in accordance with the Investment Law.
3. A foreign investor that intends to operate in the finance sector, or open a branch or representative office is required to obtain a prior approval from the Mongolia Bank.
4. A foreign person or entity is prohibited from operating or establishing business activities in savings and loan cooperatives.
5. A foreign investor that intends to operate in the petroleum sector of Mongolia is required to obtain permission from the relevant authorities and enter a production sharing agreement, which may contain performance requirements.
6. The relevant authority may issue labor permits for foreign employees within the limits of the quota adopted by the Government every year.
7. Minimum investment threshold for each foreign investor who invest in Mongolia by holding 25 percent or more of interest in a legal entity shall be US\$100,000.
8. Only a Mongolian entity other than a foreign-owned domestic company can conduct a detailed environmental impact assessment.
9. The shareholding of foreign investors in an entity which is allowed to manufacture explosive substances and blasting instruments in Mongolia shall be less than 49 percent of total shares of the legal entity.
10. Foreigners shall be treated differently from Mongolia nationals in terms of charges and fees for hunting wild animals.
11. Foreign persons or entities are prohibited from harvesting and picking natural plants for any purpose.

12. Foreign persons or entities are allowed to participate in trading at the exchange of agricultural and husbandry products only through intermediation of a permanent member of the exchange market.
13. The Government owns no less than 51 percent of the outstanding shares of a company established for the exploitation of a radioactive mineral reserve that was explored and proved by a state fund. An investor who holds shareholdings in such company may be imposed performance requirements.
14. Investors are required to process raw skins and hides in the places in Mongolia specified by the relevant authorities.

Moreover, under the EPA, Mongolia reserved its right to adopt or maintain any measure to balance, for national security reasons, amount of investments in an individual sector to be established, acquired or expanded by foreign investors. Mongolia also reserved its right to adopt or maintain any measure intended for food security and in the following sub-sectors: manufacturing of wool and cashmere, railway transportation, air transportation for commercial purposes, construction in real estate development and trading, radio and television services, and mining.

II. Investment Climate constraints play a role

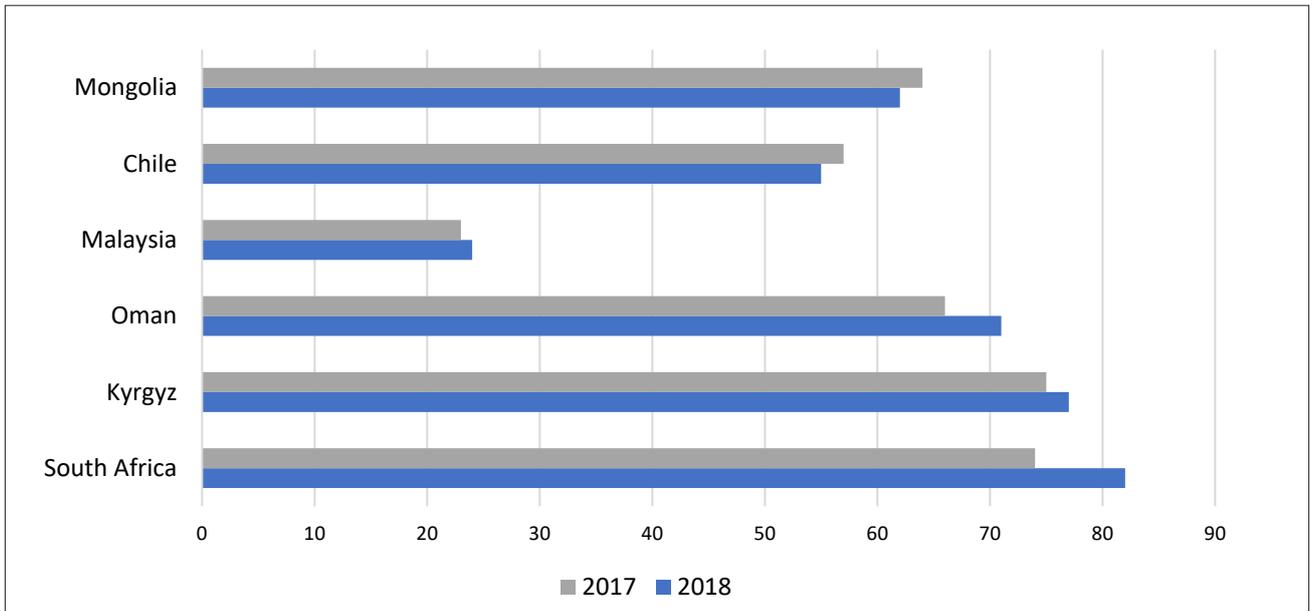
Although Mongolia is de jure open to FDI, it registers low numbers of FDI relatively to comparator countries (*Figure 19*). To attract FDI, openness is not sufficient as other constraints in the overall investment climate and in the governance/Rule of law environment can act as strong deterrents to private, particularly foreign, investment into the national economy. The entry barriers that exist and are reported by investors seem to be essentially general investment climate barriers ranging from doing business in the country to good governance and regulatory quality.

Per the 2018 WB Doing Business indicators, Mongolia ranks at 62 out of 190 economies in the ease of doing business. Mongolia ranks low among the economies of peer countries, and its performance is uneven. While the country ranks favorable on some areas, with the highest ranking on the getting credit (20), dealing with construction permits (23), protecting minority investors (33), and registering a property (50) indicators, it lags most countries on several others, such as getting electricity (139), trading across borders (110), resolving insolvency (93), and enforcing contracts (88).

Although Mongolia's performance has improved from the 2017 results, the low rankings reflect many of the challenges related to the underdeveloped private sector in the country. The ease of getting electricity and trading across borders coupled with not high numbers on starting a business and the ease of paying taxes leads to competitiveness challenges in Mongolia. Weak contract enforcement will also discourage entrepreneurship and investors' confidence in the Mongolian business climate. *Figure 20* shows the comparison of the overall ranking of Mongolia vis-à-vis other countries in the region and the relationship with the previous year. *Figure 21* shows the distance to frontier on the different indicators for Mongolia and the average ranking for EAP countries.

Figure 20. Doing Business Ranking, 2017 & 2018

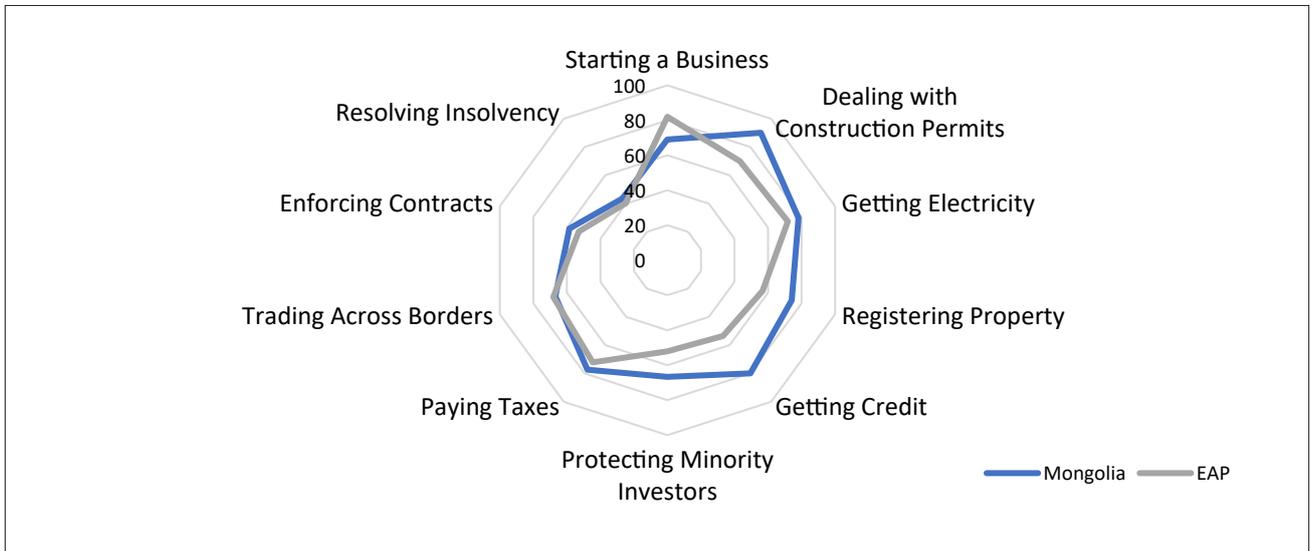
(Scale: Rank 190 center, Rank 1 outer edge)



Source: OECD.Stat 2016 and UNCTAD 2016

Figure 21. Doing Business Distance to Frontier, 2018

(Scale: Score 0 center, Score 100 outer edge)



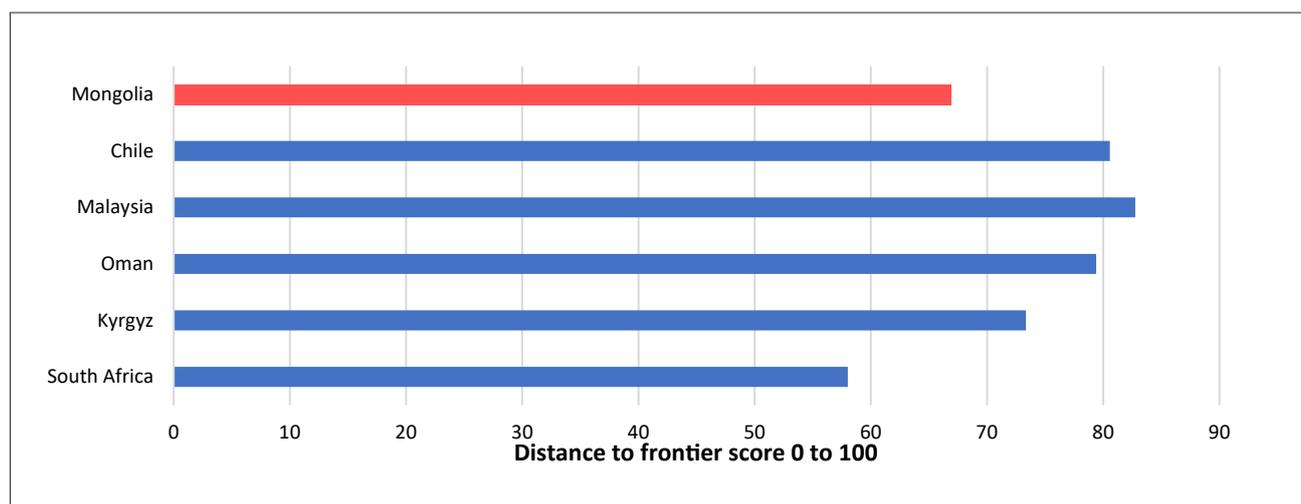
World Bank Group - Doing Business (2018)

Particularly worrisome for the attraction of efficiency-seeking investment into Mongolia is its performance in the trading across borders indicator. Efficiency-seeking investors are, by definition, going to import and export extensively into and from the host economy; they need fast, cheap and economical procedures for trading. This is an area of DB where Mongolia’s performance is lagging. For example, in Ulaanbaatar, export and import time and cost are reported as follows:

- Export border compliance: 62 hours and USD 191;
- Export documentary compliance: 168 hours and USD 64;
- Import border compliance: 48 hours and USD 210;
- Import documentary compliance: 115 hours and USD 83.

Figure 22. Ease of Trading Across Borders, 2018

(Scale: Rank 190 center, Rank 1 outer edge)

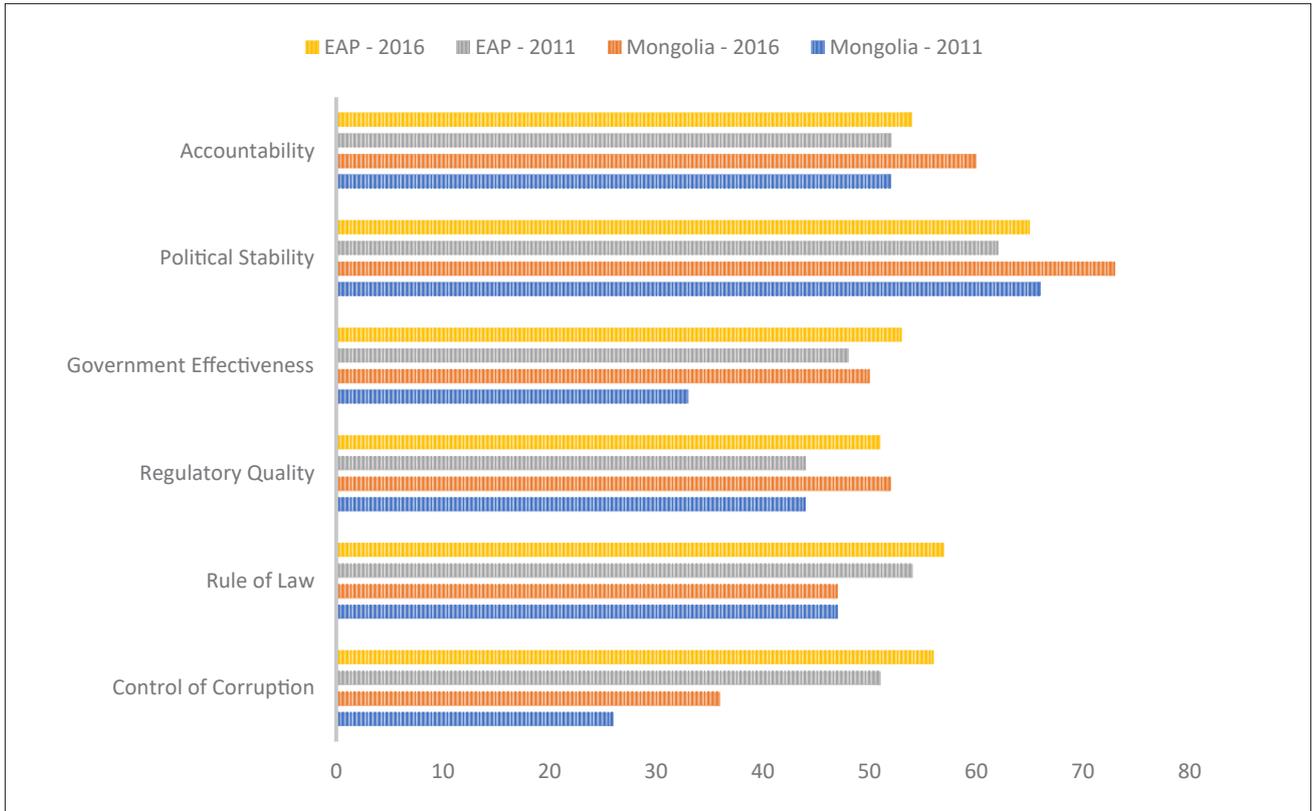


Source: World Bank Group - Doing Business (2018)

Governance needs significant improvement. While the 2016 WBG Governance Indicators, shown in *Figure 23* below, show some improvement in Mongolia’s performance over the last five years in the areas of Government effectiveness and, to a lesser extent, accountability and regulatory quality, Mongolia still lags significantly behind its peer countries in the areas of corruption and Government effectiveness.

Figure 23. World Governance Indicators for Mongolia and EAP countries, 2011 & 2016

(Percentile Rank 0-100, indicates rank of country among all countries in the world. 0 corresponds to lowest rank and 100 corresponds to highest rank)



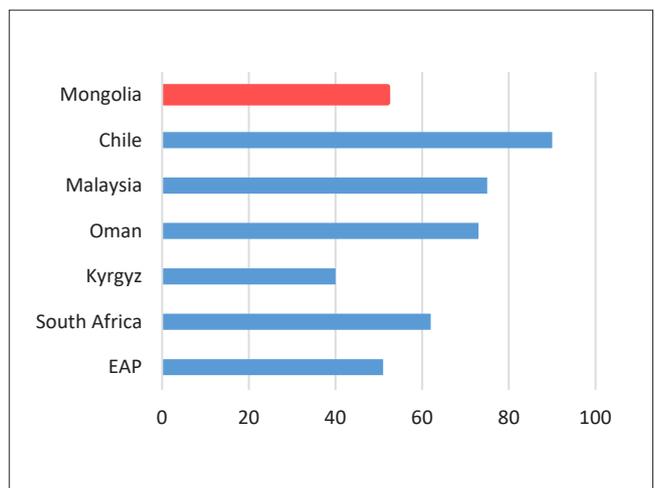
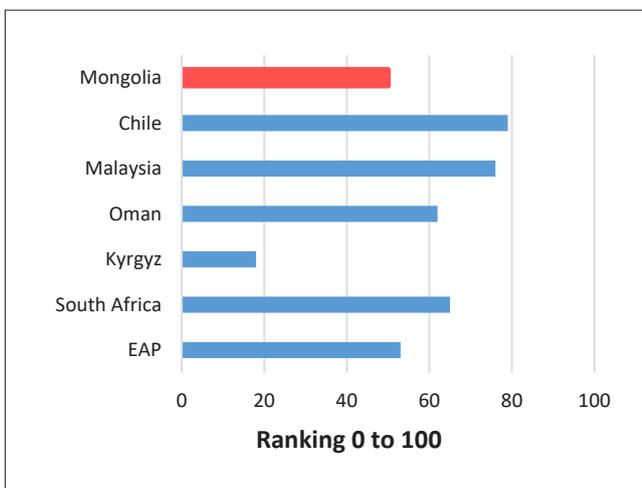
Source: World Bank Group - Worldwide Governance Indicators (2016)

Figure 24, Figure 25 and Figure 26 below show how Mongolia compares to peer countries in the indicators that relate directly to political risk and where Mongolia underperforms: Government effectiveness, regulatory quality, and rule of law, respectively.

Figure 24. Government Effectiveness, 2016

Figure 25. Regulatory Quality, 2016

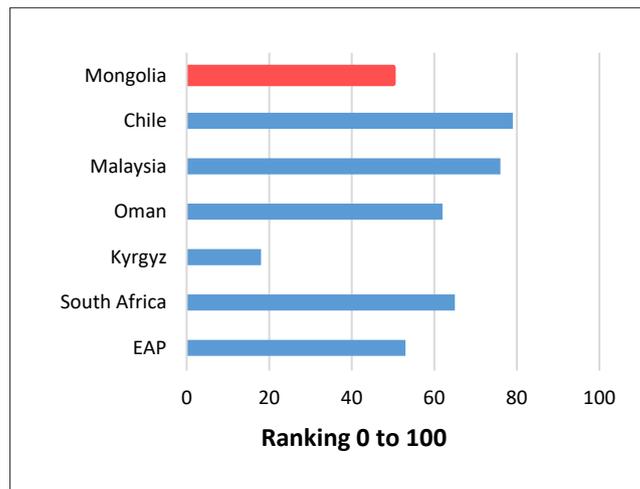
(Percentile Rank 0-100, indicates rank of country among all countries in the world. 0 corresponds to lowest rank and 100 corresponds to highest rank)



Source: World Bank Group - Worldwide Governance Indicators (2016)

Figure 26. Rule of Law, 2016

(Percentile Rank 0–100, indicates rank of country among all countries in the world. 0 corresponds to lowest rank and 100 corresponds to highest rank)

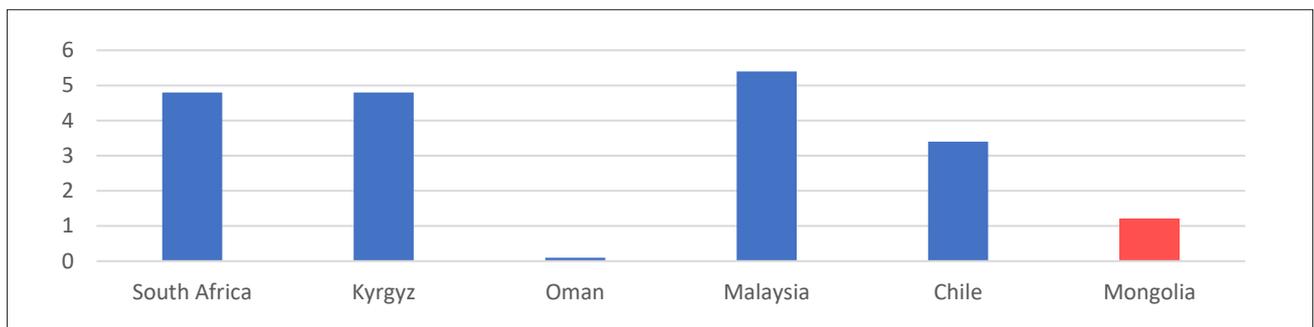


Source: World Bank Group - Worldwide Governance Indicators (2016)

Mongolia ranks extremely low in the WBG Global Indicators of Regulatory Governance. This indicator covers transparency of rulemaking, public consultation in rulemaking, impact assessment, and accessing laws and regulations hindering private sector development. An important aspect of an enabling business environment considers the quality of the standards and the efficiency with which they are implemented. Poor policy design and implementation represent an unnecessary source of uncertainty and administrative burden for business and can foster corruption and informality. *Figure 27* below compares Mongolia to peer countries and *Table 2* below summarizes the key aspects of each of these indicators.

Figure 27. Global indicators on Regulatory Governance Index, 2016

(Rank 0 to 6 in three core areas: publication of proposed regulations, consultations around their content, and the use of regulatory impact assessment. 0 corresponds to lowest rank and 6 corresponds to highest rank)



Source: World Bank Group - Global Indicators of Regulatory Governance (2016)

Table 2. Summary of Global indicators on Regulatory Governance for Mongolia, 2016

Indicator	Situation in Mongolia
<i>Transparency of Rulemaking</i>	<p>Ministries or regulatory agencies do not develop forward regulatory plans – that is, a public list of anticipated regulatory changes or proposals intended to be adopted/implemented within a specific time frame.</p> <p>Ministries or regulatory agencies do not publish the text or summary of proposed (not yet adopted) regulations before their enactment.</p> <p>Ministries or regulatory agencies do not have the legal obligation to publish text of proposed regulations before their enactment.</p>
<i>Public Consultation in Rulemaking</i>	<p>Ministries or regulatory agencies do not solicit comments on proposed (not yet adopted) regulations from the public.</p> <p>There is no rulemaking body required by law to solicit these comments on proposed regulations.</p>
<i>Impact Assessment</i>	<p>Ministries or regulatory agencies do not conduct an impact assessment of proposed (not yet adopted) regulation.</p> <p>There are no criteria used for determining which proposed regulations are subjected to an impact assessment.</p> <p>There is no specialized Government body tasked with reviewing and monitoring regulatory impact assessments conducted by other individual agencies or Government bodies.</p>
<i>Accessing Laws and Regulations</i>	<p>Laws that are currently in effect are available in a single space updated regularly.</p>
<i>Challenging Regulations</i>	<p>Affected parties cannot request reconsideration or appeal regulations to the relevant administrative agency.</p>

Source: World Bank Group - Global Indicators of Regulatory Governance (2016)

With the purpose to enhance quality in rulemaking by ensuring public participation while developing laws and regulations, the Government recently enacted the “Law on Legislation”. This new Law clarifies who has the right to draft legislation, the format of the bills, the respective roles of the Government and Parliament, and the procedures for obtaining and employing public comment on pending legislation. This important Law, if implemented efficiently, could bridge the gap of uncertainty in the policy and rule-making process in Mongolia fostering the overall investment climate.

Based on the above analysis, our recommendation to the Government is to design and launch a comprehensive program to improve the investment climate and the governance/Rule of Law environment. While such program demands a long-term view and sustained efforts, it is clear that it should be decided as soon as possible and that implementation should start sooner rather than later.

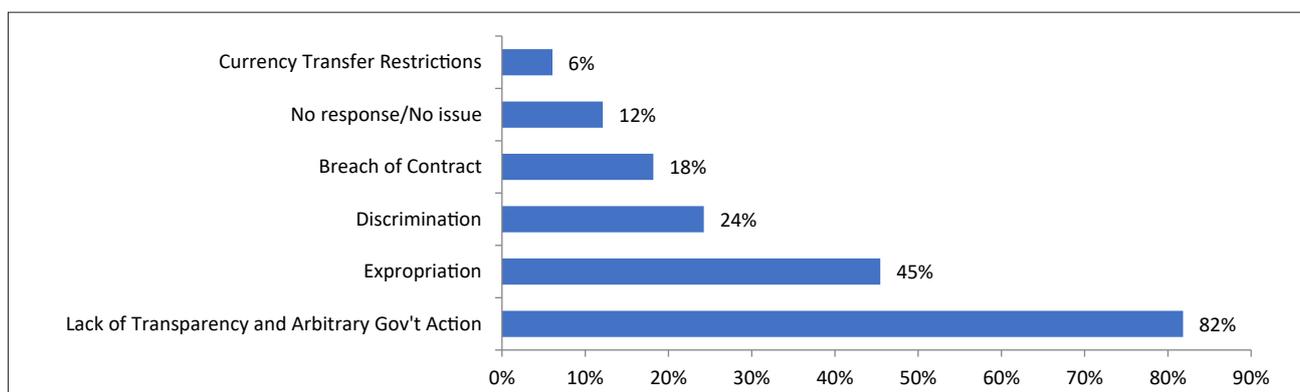
III. Investment Protection: International and domestic legal framework

Political risk has become one of the most relevant concerns for investors in developing countries. Although global economic uncertainty remains as the major concern, investors participating in the Global Investment Competitiveness Report (GIC) 2017 continue classifying political risk as one of the most important obstacles to FDI in developing countries.³⁰ While all political risks can pose serious constraints to FDI, the main concerns of investors are directly related to the conduct of the Government, such as lack of transparency and predictability (50 percent), adverse regulatory changes (49 percent), delays in obtaining necessary Government permits and approvals (47 percent), and restrictions in transferring and converting currency (42 percent). GIC 2017 also shows that political risk and lack of confidence may lead already established investors to cancel their plans to expand or reinvest in the host countries, and sometimes to leave the country. To minimize political risks, investors seek both strong legal protection and a predictability and efficiency in implementing laws and regulations. A more detailed analysis of GIC report is provided in Annex 2.

An Investor Survey conducted by WBG team in 2014 in Mongolia confirmed that Investor protection is a critical issue for investors in the country. Nearly 80 percent of the responding companies felt their investment was at risk of leaving the country because of lack of investor protection. The total amount of investment at risk of being lost due to inadequate investor protection was estimated to be US\$1.9 billion, or 90 percent of their total investments. Investors were of the view that lack of regulatory transparency and arbitrary government action were the main factors causing grievances (82 percent). Expropriation and discrimination were the next most pressing issues for the companies interviewed (*Figure 28*).

Based on these findings, it is essential for Mongolia to have a robust legal framework and to implement investment protection guarantees. A good legal regime for investor protection can improve the investment climate and help attract high-quality investment. Also, positive testimonials of investors already established in the host country rank among the best investment promotion tools to attract new FDI. Evidence shows that over time, satisfied investors tend to diversify their operations in

Figure 28. Nature of Grievances reported by respondent companies (percentage)



Source: WBG - Investor Protection Survey for Mongolia (2014)

³⁰ “World Bank Group. 2018. Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspectives and Policy Implications. Washington, DC: World Bank. <https://openknowledge.worldbank.org/handle/10986/28493>

host-countries, evolving from lower value-added towards higher value-added activities.³¹ Both domestic laws and IIAs can contribute to this objective. At first, it is important to have protection guarantees in the domestic investment law to provide legal predictability and local remedies. It is also crucial to provide legal guarantees for investment protection through IIAs and incorporate them into the domestic legal framework. And, implementing and enforcing legal instrument in a transparent manner is the key consideration for investors to make a business decision.

The Mongolian Investment Law (MIL 2013) adopted in October 2013 provides some of the key guarantees that foreign and domestic investors need. For instance, investors can freely transfer their assets and revenues out of Mongolia after fulfilling their tax obligations.³² MIL 2013 also protects investors against unlawful expropriation and guarantees full compensation.³³ Further, international or domestic arbitration to settle a dispute which may arise regarding the contract concluded with the state authority of Mongolia is available.³⁴

The IIAs in force also provides the country's obligations to protect investors.³⁵ From our analysis of major IIAs concluded by Mongolia we find that there is no obvious gap that would require any urgent action on the part of the Government (Table 3).³⁶ However, there is a variation in core elements from one treaty to the other, such as the definition of investment, standard of treatment, and dispute settlement. This is the result of negotiations and negotiators may be aware of these very well, but it is important to let Government officials in different Ministries know the differences between the level of legal obligations undertaken vis-à-vis each country, and eventually to reduce these differences as well as any gap between IIAs and the domestic investment law. Among the five Mongolia BITs reviewed for this report,³⁷ the 'Foreign Investment Promotion and Protection Agreement (FIPA)' concluded with Canada in 2017 provides a very high level of investor protection.³⁸ For example, NT and MFN in under FIPA apply to the full cycle of an investment, including the investor's entry and establishment in the host country and its participation in existing enterprises.³⁹ In other treaties, NT and MFN obligation is usually limited to the post-establishment

³¹ For example, Intel started its investment in Costa Rica with an Assembly & Test plant in April 1997, and then expanded with a second plant for a new product platform in 2003. Intel built a third building and launched new services in its "shared services" group by 2005. In 2014, Intel invested in R&D activities for testing of microprocessors prior to large-scale production. With the initial and subsequent investments, Intel invested more than US\$770 million in its Costa Rica campus, generating direct employment for more than 2,900 workers and an additional 2,000 indirect jobs. Another example is Honeywell in Czech Republic where the company continuously expanded its investment from sales and development to manufacturing and R&D units.

³² Mongolia Investment Law, Article 6.7-6.8.

³³ Mongolia Investment Law, Article 6.3-6.5.

³⁴ Mongolia Investment Law, Article 6.9

³⁵ Mongolia has 44 BITs, and seven of which are either not in force or were terminated and replaced by another agreement. Counterparts include not only major trading partners such as China, Canada, Korea, Russia, but also countries in the Middle-East and other Asian economies (Indonesia, Vietnam, etc.). Treaties with investment provisions: Mongolia-Japan EPA. Other related international agreements: GATS, TRIMS, TRIPS, MIGA, ICSID, New York Convention, and 29 Double-Taxation Treaties (DTT).

³⁶ This includes five countries (China, Netherland, Singapore, Canada, and Korea) whose FDI covers 85% in 2012.

³⁷ This includes five countries (China, Netherland, Singapore, Canada, and Korea) whose FDI covers 85% in 2012.

³⁸ FIPA entered force on March 7, 2017. Full text in English is available at Canadian Government website, http://international.gc.ca/trade-commerce/trade-agreements-accords-commerciaux/agr-acc/mongolia-mongolie/fipa-apie/text-texte/canada_mongolia-mongolie.aspx?lang=eng

³⁹ Mongolia reserves the right to adopt or maintain any measure that does not conform to the obligations with respect to the following sectors or matters (Annex 1):

- Government securities (i.e. acquisition, sale or other disposition by nationals of the other Party of bonds, treasury bills other kinds of debt securities issued by the GoM, a province or local Government)
- Nationality requirements for ownership of land
- Social services (i.e. health, public welfare, public education, social insurance and security)
- Any measure to ensure local production of the majority of consumer demands for strategic food production (i.e. livestock-meat, milk, flour, wheat, grain seed, and drinking water)
- Any measures relating to admission of investment in its railway transportation sector
- Any measures relating to admission of investment in real estate development and ownership and trading by foreign citizen and legal entities

phase of the investment, which means the obligation does not extend to acquisition and/or establishment of investments. Also, unlike all reviewed BITs, FIPA has a clear definition of ‘indirect expropriation,’ which is an important issue for investors. Finally, FIPA particularly adopts FET in accordance with the customary international law regarding the minimum standard of treatment of aliens. These high standards of FIPA can be important legal grounds even for investors from other countries, as they can rely on MFN provisions to argue the most favorable standard available for them. A more detailed analysis of the reviewed BITs is provided in Annex 3.

Table 3. Summary of the gap analysis between Mongolia’s major IIAs

Provision	Gap analysis
<i>Preamble</i>	Importance of fostering economic cooperation between contracting parties, promoting favorable conditions for reciprocal investments and recognizing the impact that such investment may have in generating prosperity in host countries.
<i>Definition of investment</i>	Broad asset based definition which starts with the phrase “every kind of asset”. Only exceptions are BIT with Canada, which gives “enterprise-based” definition of investment.
<i>Investments and Disputes Covered</i>	All reviewed BITs cover investment in both pre-existing and post-BIT investment. As for disputes covered, three reviewed BITs with China, Netherland, and Korea carve out pre-existing disputes.
<i>Standard of treatment</i>	No uniform practice accorded to both investors and their investments. Almost all reviewed BITs use different language, although all of them, in one way or the other, accord FET, NT, MFN and Full Protection and Security to investments. Only BIT with Canada applies NT and MFN for the pre- and post-establishment investments, and provide reference to international law as the minimum standard of treatment.
<i>Expropriation</i>	All reviewed BITs require compensation to be paid for direct expropriation, and mention indirect expropriation. Only BIT with Canada provide definition on indirect expropriation. Three reviewed BITs with Singapore, Canada, and Korea prescribe the Hull Formula for calculation and payment of compensation, and rest of two BITs only requires compensation without (unreasonable) delay.
<i>Transfer of funds</i>	All reviewed BITs contain provision of transfer of funds and most of them provide for the transfer freely.
<i>Dispute settlement</i>	All five reviewed BITs provides legal grounds for Investment-State Disputes (ISDS) and State-State Disputes (SSDS). Two BITs with Singapore and Korea provides voluntary ADR as an alternative to arbitration. Only BIT with Canada limits the scope of claims to treaty claims only, whereas all other reviewed BITs cover any disputes relating to investment. Only BIT with Canada has provisions about the exclusion of policy areas from ISDS.

Source: WBG-Investment Policy & Promotion unit

There have been four ISDS cases against the State of Mongolia to date: one case was awarded against the Government; one was settled; and two cases are pending. All four cases occurred in the natural resource or energy sectors – three in mining and one in electricity, and the issue of indirect expropriation should be considered as important claims that Mongolia has faced. Considering its high administrative and legal costs, it is necessary that governments take measures to prevent and/or confront increasing ISDS.⁴⁰ Based on the first 102 ICSID cases, the process of resolving investment disputes takes on average 3.6 years.⁴¹ And these disputes cost on average around US\$3 million in administrative cost and US\$10.4 million in damages.⁴² Table 4 below provides a list of ISDS cases against Mongolia.

Table 4. Reported ISDS cases against Mongolia

Claimant	IAs	Sectors	Alleged Breaches	Time	Status
<i>Khan Resources (Canada, Netherlands, British Virgin Islands)</i>	Energy Charter Treaty	Mining	Indirect expropriation, FET, Full protection and security, Arbitrary, unreasonable, and discriminatory measures, Umbrella clause	‘11~ ‘15	Awarded (80M USD for Investor)
<i>China Heilongjiang (China)</i>	Mongolia - China BIT	Mining	Indirect expropriation	‘10~	Pending
<i>Paushok (Russia)</i>	Mongolia - Russia BIT	Mining	Indirect expropriation, FET, Full protection and security, NT, MFN, Customary rules of int’l law, Arbitrary, unreasonable, and discriminatory measures	‘07~	Pending
<i>Alsthom Power (Italy)</i>	Mongolia -Italy BIT	Electricity	N/A	‘04~	Settled

Source: UNCTAD Investment Dispute Settlement Navigator (2018)

⁴⁰ In 2016, the rate of new treaty-based ISD cases continued unabated, as 62 cases were initiated, bringing the total number of known cases to 767.

⁴¹ The longest ICSID case took 10.5 years per award (*Pey Casado vs. Chile*), and even the shortest case took 1.2 years (*Cable TV vs. St. Kitts & Nevis*).

⁴² Damages in *Occidental vs. Ecuador* was US\$ 1.76 billion, *COBS vs. Slovak Republic* was US\$ 877 million, *Cargill vs. Mexico* was US\$ 77.3 million.

The Investment Law is not perfect but its revision does not seem to a top priority. MIL 2013 has been in place for five years and there is no pressing demand from the private sector to effect changes to this Law.⁴³ There is no question that improvements to the MIL in general and its investor guarantees in particular are possible, using best practices and international investment agreements (IIAs) as benchmarks. However, the costs of launching yet another revision process of the investment law in a country where it has changed so often have to be balanced against the benefits of these changes. Although the current law may not be perfect, there is now a strong appetite within the private sector for legal stability. Any change that is contemplated should be discussed extensively with the investor community and receive its support. Otherwise, leaving the Law as it is for 2-3 years may be the best course of action given the history of policy instability.

Although there is no urgent demand for a revision of the Investment law, it would be beneficial to upgrade the investor protection guarantees of the domestic legal framework to the level of the most advanced IIAs concluded by Mongolia. According to GIC survey 2017, 45 percent of investors answered that investment protection guarantee in a country's domestic law is 'critically important,' whereas only 15 percent of respondents considered bilateral investment treaty as so. (*Annex 2*) Thus, although International treaties signed and ratified by Mongolia prevail when they are conflicting over domestic laws,⁴⁴ it is helpful to consider including important guarantees that are currently missing or weaker in the current MIL 2013. Based on the review of the MIL and selected IIAs as part of this IRM, the first recommendations would be to consider incorporating NT, MFN, and FET standards in domestic investment law, as current MIL 2013 does not have such provisions. In addition to the protection against expropriation and principle of full compensation in MIL 2013,⁴⁵ it would be helpful to provide guidelines for determination of when an 'indirect expropriation' takes place.

Even when de jure protection to investors are guaranteed, the Government should consider how these are implemented in practice. De facto restrictions, when taken together, can deter some private investors from operating in Mongolia. For example, some investors complain that other Ministries refuse to honor incentives and rights stipulated in the Investment Law.⁴⁶ Many investors worry about the unjustified use of "exit bans" against foreign and domestic business executives.⁴⁷ Also, a law was drafted last year to require money earned by foreign-owned mining operations to be remitted to local Mongolian banks. The proposal was finally abandoned, but concerns over the implementation of core protection guarantees remained.⁴⁸ In line with those concerns, the country risk for expropriation and currency inconvertibility and transfer restrictions remains high in absolute

⁴³ Recently, MIL 2013 has been amended 5 times (3 times in 2015 and twice in 2016).

⁴⁴ See Mongolia's Constitution (Article 10) and the Law on International Treaties. (Article 2.2); Article 2.2 of Law on International Treaties provides: "Should provisions of the international treaties to which Mongolia is a party provide otherwise, the provisions of such international treaties shall prevail."

⁴⁵ Mongolia Investment Law, Article 6.3-6.5.

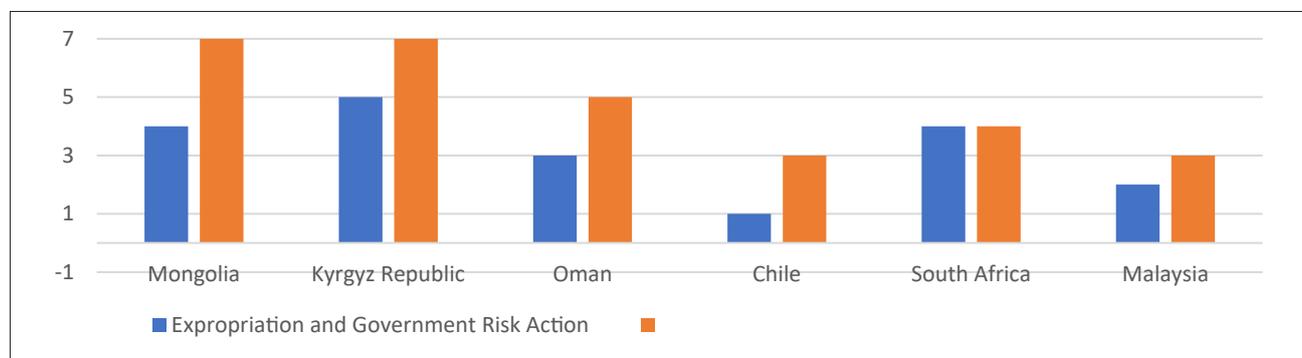
⁴⁶ Investment law provides that the tax incentives shall be rendered provided to investors by "deducting the employee training expense from the taxable revenue", but the Corporate Income Tax Law does not reflect those expenses in the list of authorized tax deductions. And, investors can use land by a contract up to 100 years, but Land on Law says that the term for investors' use shall be decided by the Government, not the contract.

⁴⁷ The exit ban refers to preventing business executives from leaving the country when they are suspected of a criminal offense, but have not been formally charged. The latest statistics provided by Ministry of Justice and Internal Affairs indicates that there are 200 expatriates and 500 nationals banned from leaving the country based on different grounds.

⁴⁸ Although the Mongolian Law on Investment clearly states that "[i]nvestors shall have a right to transfer their following assets and revenues out of Mongolia without hindrance" (Article 6.7), investors worry that this draft attempts to limit investors' rights on transferability and convertibility.

and relative terms as reported by Credendo 2017. *Figure 29* below shows the country risk ranking for Mongolia and peer countries with respect to those risks.⁴⁹

Figure 29. Country risk ranking for expropriation and currency inconvertibility and transfer restrictions



Source: Credendo (2017)

The top priority for Mongolia is to make systematic investor grievances response mechanism (SIRM) fully operational. A decade of adverse and sudden policy or regulatory changes in Mongolia without consultations with the private sector and arbitrary government conduct has severely eroded investor confidence. To help provide better investment protection and regain investor confidence, the WBG team has proposed the implementation of a Systemic Investment Response Mechanism (SIRM), which is an early warning and tracking mechanism to identify and resolve complaints that arise from government conduct. With the support of WB, GoM established an Investor Protection Council (IPC) under the Cabinet Secretariat in 2016 to enable investors to bring a grievance to the Government before it escalates into a full-fledged dispute. It is reported that IPC has resolved 12 cases of investor grievances. However, the investors still hope that the IPC operates in a more systematic and optimal way. For example, it is necessary to have clearly defined or systematic way of handling and tracking cases, including to filter, categorize, and prioritize them. Efforts underway to strengthen the IPC should be continued and supported.

The establishment of an effective Public Private Dialogue (PPD) is helpful to ensure transparency and openness between the government and the private sector, which will in turn create investor confidence and trust for the government. The absence of a structured PPD in Mongolia has been identified as a reason for lack of investor confidence and mistrust of the government. Due to the absence of this structure, consultations between the government and the private sector have been ineffective, ad hoc, and informal. This has prevented timely interventions to deal with investors complaints before they become a national problem. In December 2017, the Cabinet Secretariat announced the establishment of a Public and Private Consultative Council (PPCC) as an open platform to discuss investment related proposals and suggestions. This platform is expected to support IPC and SIRM by receiving suggestions regularly from entities whose legal rights are at risk of being violated and preventing the unexpected adoption of policies and laws that can damage investment climate.

⁴⁹ Peer countries are benchmarking countries for economic analysis in Chapter 1, which include natural resource exporters at various income levels (Kyrgyz Republic, Oman, Chile) as well as emerging economies with a more diversified productive structure (South Africa, Malaysia).

IV. Recommendations

SHORT-TERM

- Mongolia is quite open to foreign investment and investors. However, it does not have a consolidated negative list placing restrictions on foreign investments. A negative list of restricted sectors will help investors identify limits on foreign equity participation, partnership requirements, and the identification of restricted sectors are arduous to navigate and difficult to predict. This approach would improve the overall transparency and predictability in application of the investment policies in Mongolia.
- Mongolia could benefit from a comprehensive review of the measures in place restricting foreign investment as to determine if its rationale still stands taking into account the context of the country and the need to attract FDI, in particular for strategic sectors.
- Even when de jure restrictions to foreign investment are minimal, the Government should consider that more important than what is written in laws and regulations is how these are implemented in practice. De facto restrictions can deter investors from operating in Mongolia.
- There are several examples of grievances caused by inconsistent legal instruments and failure to enforce contracts with Governments. It is important to solve these individual cases, but what is more essential is to have a systematic mechanism to respond and prevent grievances. The Systematic Investor Response Mechanism (SIRM) is an effective tool for enabling Governments to address critical constraints investors can face, such as lack of transparency obligations and breach of contract. In so doing, SIRM helps minimize the cost associated with lack of transparency and thus help attract new investors, anchor existing ones and minimize potential arbitration procedures which can be extremely costly for Governments.
- To operationalize SIRM, it is recommended to adopt SIRM bylaw as a concrete legal foundation and develop IT tool to track and monitor cases. It is also essential to allocate proper staff and budget to the IPC to enable it to discharge its important mission while, at the same time, continuing to build the capacity of IPC staff. PPCC can also play a key function is to contribute in improving investment climate by ensuring involvement of private sector in amending, drafting relevant laws, regulations and policy documents.

MEDIUM-TERM

- Land lease contracts need to be standardized as to establish clear conditions on primary contracts and requirements for extension.
- Maintaining minimum foreign participation is considered a barrier to FDI and the Government should consider eliminating such requirement.

- The visas regime for investors need to be reviewed as to ensure that investors and foreign workers are protected in their rights to stay, exit and re-entry the country as per the visa stipulations. Delays in renewing visas are causing complaints that will discourage investors to make business in Mongolia.
- Local content requirements can be counter-productive and make is more difficult to attract investment. The Government should consider revisiting its local content requirements on an economy-wide basis and specifically those applied in the mining sector.
- There are variations in core elements from one IIA to the other, such as the definition of investment, standard of treatment, and dispute settlement. This is the result of negotiation and negotiators may be aware of these very well, but it is important to let other Government officials know the differences in legal obligation from one treaty to another and to try to reduce these variations over time.
- In Mongolia, Government effectiveness, regulatory quality, and rule of law are perceived to be low according to worldwide indicators. In particular, Mongolia ranks very low in the WBG Global Indicators of Regulatory Governance given the lack of a participatory policy and rule making process. As a result, there is lack of confidence from investors in Mongolian institutions which can also deter or discourage investment.
- The focus of the Government should be placed on the effective implementation of the current laws (including but not limited to the Investment Law) and regulations; create awareness of duties of investment laws/regulations by Government officials and public bodies, and make sure practices of renegeing on commitments or revoking licenses and permits, without due process and legitimate reason, are abandoned. it is recommended to regularly review inconsistencies and discrepancies among legal instruments, including domestic or international one.



CHAPTER 3:

Institutional Framework for the Promotion of Investment

This chapter analyzes the institutional framework currently in place in Mongolia for the promotion of investment and outlines a set of short- medium- and long-term recommendations. To complement this chapter which focuses on the Mongolian context, a section on international good practice institutional arrangements and frameworks for Investment Promotion is provided in Annex D.

I. Assessment of investment promotion in Mongolia

An extensive Institutional instability. Parallel to the “pendulum swing” in the investment policies (noted at the beginning of the report and reflected in the succession of investment laws in the last 20-25 years), there has also been very little stability in the institutional arrangements for investment policy and promotion in Mongolia over the past two decades.

A series of institutional changes over that period has had several major implications. First, investors report being unclear as to which organizations carry which mandate and which organizations they should approach on certain issues or to obtain information. Second, the frequent changes, often resulting in changes in staffing have worked against the Government, making it very difficult to build a strong capacity and cadre of experts in investment promotion. Successive Governments have insisted on introducing their own agency or their own promotion initiatives, often starting from scratch rather than building on previous work. The investment promotion efforts have lost both in terms of momentum and effectiveness in Mongolia.

The following table shows the main institutional changes in investment promotion arrangements that have taken place in Mongolia over the past 20 years.

Table 5. Investment Promotion Functions and Resources 1993 – 2018

Claimant	Foreign Investment and Foreign Trade Agency (FIFTA) 1993 – September 2012	Invest Mongolia Agency 2013 – June 2016	National Development Agency 2016 to date
<i>Promotion functions</i>	<ul style="list-style-type: none"> Advisory service: pre- to post-registration Business forums, exhibitions, B2B 	<ul style="list-style-type: none"> Advisory service pre-registration and aftercare Business forums Delegation visit 	<ul style="list-style-type: none"> Advisory service pre-registration and aftercare
<i>Other functions:</i>	<ul style="list-style-type: none"> Registration of foreign investment Aftercare service Project supporting team Statistics 	<ul style="list-style-type: none"> Issuing tax incentives and stabilization certificate Investment agreements 	<ul style="list-style-type: none"> National development policy and planning Sector policy Investment research and policy Investment registration
<i>Staff (promotion functions only):</i>	12 (+8 in project support)	8	Negligible (4 staff members currently working on promotion)

Source: WBG Investment Policy & Promotion unit

The Foreign Investment and Foreign Trade Agency (FIFTA) of Mongolia was established in 1993 as the executing body for trade and FDI matters. In its early days, FIFTA operated with twin departments comprising (1) promotion, and (2) registration and services; the latter was estimated to occupy about 90 per cent of FIFTA’s time and resources. The agency did not have a defined strategy for investment promotion and there was little clear articulation of the reasons why the country was seeking to attract FDI, other than a general view of positive impacts on economic development and job creation. Nevertheless, FIFTA undertook various promotional activities such as business forums, overseas delegation visits and G2B and B2B events. However, ‘servicing’ investment clients’ needs tended to be equated with ‘registration’, and there was little investor aftercare activity.

In 2013, following the 2012 elections, a new Government changed the location within Government and the status of FIFTA, which became the *Department of Foreign Investment Regulations and Registration* (DFIRR) of the new Ministry of Economic Development. DFIRR lost FIFTA’s export and SME promotion remit. However, in respect to investment promotion little changed, with DFIRR remaining essentially reactive in terms of promoting to potential investors. The investment promotion efforts were set within a new Investment Registration Division, once again emphasizing that the Government saw investment promotion essentially as investment registration.

DFIRR was short-lived. The new Investment Law adopted later in 2013 created a new investment promotion agency, *Invest Mongolia Agency* (IMA), under the Ministry of Economic Development to replace DFIRR. Mandated to both promote and regulate investment activities, the agency was responsible for issuing tax stabilization certificates and for monitoring the activities of certificate holders but it had no formal role in registering companies or investors anymore, as this responsibility was vested with the State Registration Office exclusively. The number of staff and budgets available to investment promotion activities were reduced relative to FIFTA, although IMA continued to conduct some business forums and overseas events.

However, a further institutional change came in 2016 when the new Government replaced IMA with the new National Development Agency, or NDA. The NDA was given a broader range of responsibilities than IMA. With regards to investment, the NDA's role is to develop the comprehensive national development policy, establish priority sectors, maintain prudential ratios between sectors and infrastructure, define the comprehensive policy on investment, define and facilitate the policy, regulation and registration of foreign investment, develop policies with regards to concessions, public-private-partnerships and feasibility studies of major national-level projects, and to advise on the Public Investment Plan (PIP).

Investment promotion capacity has been greatly reduced, through these successive changes and high staff turnover.

The current state of affairs. In spite of many good individuals staffing the agency, the NDA feels and looks like a traditional, central, planning body with its attention focused mainly on high-level Government policy statements and public investment planning often seen elsewhere in Eurasia. Market-economics and private sector needs do not seem to be the guiding principles. In other words, the prevailing mind-set seems to be that if the Government sets a policy saying that the private sector will invest in a given sector or region then it will happen, with little consideration given to whether the plans are commercially viable or attractive from the investor's perspective. Current thinking concerning possibilities for private investment is very largely supply-side driven with little awareness of the demand side of the equation.

In theory, besides its planning mandate, the NDA also, carries the mandate as the country's national investment promotion agency. However, in the NDA organizational chart, the division ostensibly carrying the promotion responsibilities has a broader mandate, as indicated by its name: the *Registration, Information and Promotion division*. The NDA essentially has little operating budget beyond staff salaries, thereby making it almost impossible for the agency to pursue active investment promotion activities.

Partly through these frequent changes (FIFTA-IMA-NDA) and partly because of the current budget crisis in Mongolia the attraction of FDI into the Mongolian economy has effectively stalled in recent years, even in the resources sector where the country has been traditionally strong. The Government is seeking to re-energize growth and to diversify the economy into new higher-value economic sectors - in particular, the attraction of new market-seeking and efficiency-seeking FDI as an important source of competitiveness, diversification, and growth for Mongolia.

In the transition from Invest Mongolia to the NDA investment promotion has been significantly "de-prioritized". From the position where Invest Mongolia had around 8 people engaged in investment promotion activities and undertook and delivered several annual promotion events, the NDA now has only 4 people in its investment promotion team and they mostly do Public Relations and marketing for the NDA itself (e.g. preparation of NDA brochures, etc.) rather than investor-targeted promotion work. Similarly, the investor aftercare activities of NDA are currently limited to reactively providing information to existing investors if requested while in the past the IPA could follow-up each of the grievances with the concerned line ministry or state/local institution.

No other Government ministries or agencies – MoE, MoFA, MoFALI and others – appear to have any investment promotion capacity and very little by way of investment policy strengths. In fact, it could be argued that Mongolia has almost lost all its investment promotion capacity.

Need to re-establish a robust and modern investment promotion capacity. Promotion for new foreign investment has become highly competitive, both globally and perhaps especially in the Asia region, with regional neighbors such as China, Vietnam, Thailand, the Philippines and others pouring considerable resources and efforts into the activities of their IPAs. The key challenge in such an environment is how can different locations differentiate themselves in such a noisy marketplace. The role of the IPA is critical in this effort.

Both developed and developing countries around the world have recognised the need to allocate sufficient funding and staffing to their investment promotion programs. More than half of the world's IPAs report having a budget of at least US\$1 million dedicated to investment promotion: of the higher-performing IPAs, more than 90% have a budget greater than US\$1 million (while nearly two thirds have a budget greater than US\$2 million). When it comes to staffing, two thirds of high-performing IPAs have at least 16 staff dedicated to investment promotion.

Global experience shows clearly that country-wide promotion activities (such as generic investor conferences, overseas ministerial visits, etc.) are nowhere near as effective in generating investment leads as modern sector-targeted promotional efforts, in other words targeting sectors, markets and even specific investors identified through market research and intelligence gathering as fitting the location's strengths. Successful IPAs around the world have reinvented their approaches in this way, adopting three main strategies:

- First, they identify and focus their promotional efforts principally on those sectors and markets where there is a strong business case for attracting investment to their location.
- Second, they articulate in detail the business case and build it into sector-specific promotional materials.
- Third, they plan and execute targeted outreach campaigns to specifically reach investors identified as being potentially most interested in their location.

The NDA is currently weak both in terms of the very limited resources available for investment promotion and in terms of its understanding of modern investment promotion techniques, although for the latter, the WBG initiated in late 2017-early 2018 a series of investment promotion capacity-building workshops. Currently the NDA has almost no capacity to take on the management and implementation of targeted investment outreach campaigns without significant additional resources and considerable capacity building assistance.

However, Mongolia will certainly need a dedicated investment promotion capacity in due course if it is to achieve its longer-term goals of securing additional and new types of FDI (to, inter alia, foster economic diversification). The capacity can perhaps remain small at first as it will take some time for the FDI opportunities to build up and while the country opens-up for and develops stronger propositions for attracting FDI. In an ideal world and in the longer term, it could make sense to establish a completely new, quasi-independent, investment promotion agency. But in the context of Mongolia's current difficult fiscal situation and past institutional instability, using existing institutional structures, focusing their efforts, and reinforcing their capacity seem to be a more pragmatic approach – at least in the short- to medium-term.

Within the existing institutions, the NDA seems the most sensible place to locate that promotional capacity from a national and cross-sectoral point of view, ensuring synergies across sectors, and the development of expertise in marketing and promotion, etc. At the same time, as noted above, significant capacity building would be needed to support such efforts (initially very focused).

Investment Aftercare could be a good starting point. One obvious place for the NDA to start would be to introduce an investor aftercare program; again, this could be initially small and expand over time based on needs and demand. Investor aftercare involves identifying potential for reinvestment by existing foreign investors, as well as domestic/foreign joint ventures, and facilitating its realization, whilst simultaneously identifying investors with potential for disinvestment and avoiding it. Investor aftercare is often regarded as a “low-hanging fruit” approach by IPAs in the sense that it targets investors already established and operating within the country. These investors already know the country, its advantages and constraints, and the IPA knows or should know who and where these investors are. It is much easier to convince an already established investor than to attract a potential investor who is not already in Mongolia. Aftercare is a more cost-effective approach to investment generation.

However, the successful attraction of FDI is never the achievement of a single body, but also requires effective coordination of many public and private stakeholders. Therefore, as the investment promotion capacity within the NDA is strengthened it needs to be built around a strong partnership model. For example, the MoFA may have a role to play in terms of the location of its overseas missions to enhance outreach into key markets for new FDI. The MoFA has an outreach capability that the other organizations lack and therefore should be seriously considered as a partner in any proactive investor outreach efforts.

II. Recommendations

The above analysis of Mongolia’s institutional framework for investment promotion suggests that the following actions could be usefully considered by the Government as part of an Investment Road Map or a new FDI strategy. These recommendations have been divided into short-term, medium-term and long-term recommendations and should be discussed during forthcoming stakeholder consultations in Mongolia to determine their inclusion into an Action Plan:

SHORT-TERM:

- ***Re-establish and strengthen the investment promotion unit within the NDA:***

The first step will be to rebuild a credible investment promotion capacity within the NDA. Given the weak state of the Mongolian market for new FDI, this need not be a large unit, perhaps 6-8 full-time dedicated staff, initially concentrating on building the business propositions for FDI and targeting a small number of niche sectors most likely to win new FDI. Gradually, this resource should grow, perhaps in within 3-5 years, as the market for FDI improves and as NDA has success in attracting new FDI.

- This unit needs to be **investor-facing**, both in its mindset and in its methodologies to attract new FDI. First and foremost, the role of this new unit should be to seek to attract investor interest and to influence their location decision-making in favour of Mongolia. This will

require the unit to develop a culture that is quite different from that currently found in the NDA, which, as mentioned above, has a mindset of public-sector planning. This will be an important transition for the investment promotion work as internationally-mobile investors typically do not respond well to public-sector language or bureaucracy.

- Focus on Aftercare: one key early function for the new unit should be investor aftercare. Perhaps one staff could be allocated responsibility to develop better relationships with existing investors in target sectors to work with them to generate new investment projects. NDA will find that this resource will need to grow over the first few years as more FDI enters the country.
- Build (or rebuild) the investment promotion capacity: NDA's investment promotion capacity can be enhanced in two main ways:
 - o via the recruitment of investment promotion professionals from the international or local market and
 - o by enhancing the knowledge and skills of its existing staff with the assistance of external professional organizations.

It is likely that the first option will be constrained by NDA's budget difficulties and by public sector recruitment rules. However, given the skill sets of existing NDA staff and the serious lack of investment promotion or experience, there is a need to bring more promotion professionals into the system. Additional staff will need to be found either from the private sector or elsewhere in Government, and be trained in the skills and knowledge used by good practice IPAs around the world to successfully attract market-seeking and efficiency-seeking FDI. Typical knowledge and skills needed by such staff are the following:

- Understanding of different private sector business models
- How global value chains operate and are disaggregated across geographic markets
- Strategic motivations driving FDI
- Global and regional FDI trends
- Investment promotion models around the world
- International good practice tools, techniques, and methodologies to attract FDI
- Investor information gathering and dissemination
- Project management and time management skills
- Communications and negotiation skills

This means that the re-building of the investment promotion capacity within NDA will need to be supported by a strong and focused capacity building program to help build these skills.

- *Allocate appropriate staff and budget resources:*

One of the common reasons for the failure of IPAs around the world is that insufficient financial or human resources are allocated to support the investment promotion work. This is a necessary ingredient for successful investment promotion. Sufficient staff and operating budget needs to be provided by the Government to enable the lead agency (in this case the NDA) to deliver the new investment promotion strategy for the country. To start with, a promotion unit or team of 6-8 staff with experience in investment promotion could be more than sufficient. If the NDA is

not able to provide an operating budget to support investment promotion activities including outreach activities, then we would recommend not to go ahead with any plans to strengthen the investment promotion functions. The allocation of a few additional staff alone is completely insufficient for the successful attraction of new FDI. The unit must be able to undertake outreach activities, including selected overseas travel, marketing materials, etc.

- ***Identify sectors with the greatest potential to attract FDI:***

Part of the early work of the new unit will be to identify sectors and sub-sectors with real potential to attract new FDI. It is important that any targeted outreach or marketing efforts be directed where there is the most likelihood of success. It will be a waste of resources to try to attract FDI in sectors where Mongolia does not have a viable proposition for investment in that sector. Therefore, targeting will be a major key to potential success.

Using market intelligence, sector studies, interviews with investors, etc., the IP Unit must identify those sectors with potential, around which effective marketing and outreach campaigns can be structured. See the recent World Bank Agribusiness Sector Scan⁵⁰ for an example of the methodology that might be utilized in selecting priority sectors for FDI.

- ***Develop and implement an FDI attraction action plan focusing on the identified target sectors:***

Best practice agencies worldwide typically work to a specific action plan with clear goals, activities to be implemented, targets and key performance indicators to measure success. The Action Plan – or Investment Promotion Plan as it is often called – is an essential management tool to guide and steer the work of the investment promotion unit and to provide the basis on which budgets are allocated and success is measured.

- ***Ensure the working relationship between the Investment Promotion Unit and other units within the NDA and across Government:***

Global best practice shows clearly that, in the mind of investors, promotional services offered to investors do not sit well together with policy or regulatory functions. There is a potential conflict of interest in the investors' minds when the same people are both trying to be the friend and facilitator for the investor whilst at the same time being the approver and auditor.

The NDA will need to try to create “Chinese walls” between the promotion unit and other departments that the investor might eventually need to work with, e.g. one stop shop, registration, stabilization certification, investment agreements and so on. So, a strong recommendation of this report is not to burden the investment promotion unit with additional non-compatible functions. One way to handle this could be to give the promotion unit a separate branding, e.g. Invest in Mongolia or Locate in Mongolia or something similar. In other words, the investment promotion agency would in fact be a department of the NDA but outwardly will appear as a quasi-independent agency. From this point on in this report we will refer to the new unit as Invest in Mongolia or “the agency”.

- ***Establish a coordination mechanism to encourage the NDA to work closely with other relevant Government ministries in both pursuing the investment reform agenda and in developing and implementing investor outreach campaigns targeted on the identified priority sectors:***

⁵⁰ Sector Competitiveness for FDI Attraction in Agribusiness”, Investment Policy and Agriculture Investment Promotion (IPAIP) Project, World Bank, May 2017.

The investment promotion unit within the NDA will need to work out which other Governmental units or ministries it needs to work with to provide potential investors with the promotional and facilitation services that they will require. An early step for the new agency would be to do a stakeholder mapping from the investors' perspectives. Then, having identified the key players across Government, the agency will need to reach out to start forming a closer operational relationship in order to support investors' needs.

- ***Define a role for MoFA's overseas missions in coordination with the NDA to reach out to investors in priority markets:***

The MoFA may have a role to play in terms of the location of its overseas missions to enhance outreach into key markets for new FDI. The MoFA has an outreach capability that the other organizations lack and therefore should be seriously considered as a partner in any proactive investor outreach efforts. However, in the spirit of prioritization of markets discussed above, not all overseas missions will be relevant to the strategy of the new IP agency, just those in the markets where FDI is most likely to come from. Once the new agency is established dialogue should be commenced with the MoFA to work how this relationship might best work.

MEDIUM-TERM:

- ***Design a framework for FDI linkages to increase overall in-country value addition, develop or attract new technologies and capabilities and better integrate local firms into supply chains of foreign investors, where possible:***

Supporting this objective, the following areas need to be developed: (i) improving the common understanding and coordination on FDI linkage programs; (ii) establishing a fact base about the scope and scale of the FDI linkages opportunity in non-extractive sectors; and (iii) provide capacity building towards establishing proactive support services in this area to investors and the domestic private sector in Mongolia.

- ***Develop a policy advocacy role for the new Investment Promotion Unit:***

One of the important roles of IPAs worldwide is policy advocacy and this is a capacity that the new IP agency in the NDA will need to develop. Whilst the promotion agency will not be the lead reform body or regulator, it will nevertheless be in a position to gather good intelligence from investors on what works and doesn't work in terms of Mongolia's investment climate. The IPA should be in a position to push this information to the relevant reform bodies to assist the reform efforts. In other words, to advocate for reform on behalf of the investors.

MEDIUM- TO LONG-TERM:

- ***Recognize the re-establishment of a separate, dedicated Investment Promotion Agency as a longer-term ambition:***

While the recreation of a separate, dedicated IPA does not seem feasible Mongolia's current economic and political climate (at least in the short-term), good practice from around the world shows that agencies dedicated to promotion activities, and which are institutionally separate from other bodies dealing with regulatory functions, tend to be the top performers. By achieving successes in the coming years, the Investment Promotion Unit in the NDA could eventually build the case for a "spin-out" standalone IPA.

CHAPTER 4:

Formulation of an Investment Policy Statement and Reform Action Plan

A **reform action plan** is a document that captures the recommendations of reforms, organizes them by order of priority or feasibility (short-term, medium-term, long-term), identifies the responsible entity and sometimes a specific timeline and/or resources needed. This is a powerful tool for a Government to build consensus around a number of policy, legal or institutional changes (or other forms of actions), and then to follow-up and make sure that reforms are being implemented; it also helps to hold the entities assigned with a specific task accountable.

An **Investment Policy Statement (IPS)** is a document of a different nature. It is often adopted by a Government to signal a shift in policy, a new drive to attract foreign investment, a new strategy; it is aimed at reassuring investors and at guiding Government agencies, at local and national level, on what the new strategy or policy of the Government vis a vis FDI, or the new priorities are. It is a high-level document that is usually followed by an investment legislation that is used to operationalize and implement the policy.

I. An investment policy statement for Mongolia

In the case of Mongolia, an IPS could affirm that the Government desires to encourage private sector investment in the country to help meet its development goals, accelerating economic growth and create jobs. The vision and development objectives have been outlined in the previous sections. The IPS will confirm that Mongolia recognizes and appreciates that both domestic and foreign private sectors have important roles to play. In particular the IPS would recognize that foreign direct investment, including through non-equity modes of investment (or NEMs, which include contractual relationships between foreign and domestic investors in the form of franchising, licensing, contract manufacturing, services outsourcing and other similar forms), can bring multiple benefits to the domestic economy: the injection of new capital, the creation of employment, including high-skilled jobs, the transfer of technical and managerial know-how, and improved access to international value chains and distribution networks of multinational enterprises, etc.

The Government views the continuous upgrading of the business environment as an important prerequisite for obtaining its development objectives. The objectives of these reforms will be achieved by:

- a) Providing an efficient, effective and transparent system for attracting and carrying out investment;
- b) Enhancing and modernizing the legal, regulatory, and administrative framework for investment; and
- c) Promoting the development and application of good international standards and practices regarding investment.

Using as guidance good practices found in international investment agreements to which Mongolia is a Contracting Party, the Government will endeavor to implement in a consistent manner the core guarantees which are fundamental when investors decide to invest or reinvest in each location. In pursuit of investment policy reforms, the Government will endeavor to promote the following key international principles in investment policy:

- **Ensure non-discrimination between domestic and foreign investors:** Accord to all foreign investors and investments in relation to the establishment, expansion, operation, and protection of their investments treatment no less favorable than that accorded in like situations to domestic investors, with exceptions as provided for in domestic laws, regulations and policies.
- **Also ensure non-discrimination among foreign investors:** Treat establishment, expansion and operation of investors and investments from one country no less favorably than that accorded to investors from any other economy in like situations, without prejudice to relevant international obligations and principles.
- **Ensure effective property protection:** Safeguard all investments from expropriation, or from measures taken that will have a similar effect, except when such expropriation is for a public purpose and on a non-discriminatory basis, in accordance with national laws and principles of international law, and against the prompt payment of adequate and effective compensation.
- **Pursue good regulatory practices:** Ensure that all laws, regulations, administrative guidelines and policies pertaining to investment are enacted following proper notice and consultation and are available publicly in a prompt, transparent, and readily accessible manner.
- **Promote effective investment retention:** Implement effective mechanisms to manage investors' grievances to foster confidence, ensure that investment is retained, and increase regulatory and administrative transparency.
- **Use "smart" incentives when needed and promote full transparency in awarding incentives:** Encourage the use of "smart" incentives when needed aimed at attracting domestic and foreign investment, as well as fostering investor behaviors in response to key public policy objectives; produce a consolidated inventory of investment incentives; and ensure adherence to the principles of accountability, non-discrimination, clarity and transparency in the process of granting incentives to investors.
- **Maintain environmental and social standards:** Strive to ensure that all labor, health, safety, and environment regulations are adhered to by domestic and foreign investors.
- **Ensure that distortive performance requirements are not adopted.** Performance requirements that distort or limit the expansion of trade and investment are not introduced or adopted.
- **Facilitate entry and sojourn of personnel:** Facilitate the entry and sojourn of foreign technical and managerial personnel and their families for engaging in activities connected with foreign investment.
- **Pursue high standards of governance:** Endeavour to combat corruption at all levels and strive to ensure that all public agencies maintain high standards of governance.

Considering the investment policy principles outlined above, the Government might want to consider implementing the first phase of a reform action plan during 2018-2020, aimed at advancing its vision for domestic and foreign investment. Competition for investment and changing global circumstances necessitate a dynamic investment policy framework. To ensure responsiveness to the ongoing changes in the global economy, subsequent phases of reforms and reform action plans will be developed and implemented.

II. Suggested reform action plan

The Reform Action Plan defines the reform priorities and sets forth recommendations into more specific action items. It is organized following the institutional and legal constraints to investments, which have been identified in the previous sections along the investment lifecycle (Table 6 below).

Table 6. Recommended Reform Action Plan

Investment lifecycle stage	Reform Actions	Timeline
<i>Vision and Strategy</i>	1. Develop a new investment strategy/policy to maximize the benefits of FDI in extractive (Pillar 1) and identify and realize opportunities for more FDI in other sectors including in services(Pillar 2).	Short-term decision, long-term effort
	2. Formulate and implement a strategy to increase DVA and linkages related to the extractives sectors.	Short-term decision; long-term effort
	3. Study the potential conclusion of FTAs with relevant countries in order to enhance Mongolia’s participation in the global economy, in regional value chains, and be more attractive to efficiency-seeking investors (who need to export their output to third countries).	Short-term decision; medium-term effort
	4. Focus on attracting FDI in sectors which have higher economic complexity than Mongolia’s current basket.	Short-term decision; long-term effort
	5. Designate one department or unit which will collect FDI data (potential, committed, and realized) on a regular basis.	Short-term decision, then continued implementation into MT-LT
<i>Entry and Establishment</i>	1. Consolidate in one legal instrument any and all de jure restrictions to foreign direct investment.	Short-term
	2. Review each existing measure restricting foreign participation and determine if it can be removed. This could be done by looking at the NCM under the EPA with Japan.	Short-term
	3. Standardize land lease contracts as to establish clear conditions on primary contracts and requirements for extension.	Medium-term

Investment lifecycle stage	Reform Actions	Timeline
	4. Review visas regime for investors to ensure that foreign investors, managers and personnel are protected in their rights to stay, exit and re-enter the country as per the visa stipulations.	Medium-term
	5. Review local content requirements on an economy-wide basis and specifically those applied in the mining sector.	Medium-term
	6. Launch a comprehensive program to improve the Investment Climate (including “doing business”) and good governance	Short-term decision and sustained, long-term implementation
<i>Protection and Retention</i>	1. Adopt SIRM bylaw to define internal workflow in Lead agency, such as roles and responsibilities.	Short-term
	2. Develop ICT tool to track cases and collect data, and to provide feedback to investors.	Short-term
	3. Empower SIRM Lead Agency to coordinate relevant Government agencies and resolve grievances, and operationalize PPCC to facilitate public-private dialogue	Short-term
	4. Incorporate NT, MFN, and FET provisions (already offered through IIAs) into domestic laws, and provide specific protection against ‘indirect’ expropriation.	Medium-term
	5. Strengthen the FTA/IIA implementation function in the relevant ministries to operationalize joint committees.	Medium-term
	6. Review core investment protection guarantees in current IIAs to guide future negotiations, and consider concluding bilateral/regional trade and investment agreements.	Medium-term
	7. Train officials and Government agencies at all levels, national and provincial, economy-wide and sectorial, on how to treat investment and investors.	Short/Medium/Long-term
	8. Review inconsistencies and discrepancies among legal instruments continuously and guarantee investor protection stipulated in domestic and international law.	Short/Medium/Long-term

Investment lifecycle stage	Reform Actions	Timeline
<i>Institutional Framework</i>	1. Re-establish and strengthen the investment promotion unit within the NDA (with adequate staffing and financial resources)	Short-term
	2. Identify sectors with the greatest potential to attract FDI.	Short-term
	3. Develop and implement an FDI attraction action plan focusing on the identified target sectors.	Short-term
	4. Ensure the working relationship between the Investment Promotion Unit and other units within the NDA and across Government.	Short-term
	5. Establish a coordination mechanism to encourage the NDA to work closely with other relevant Government ministries in both pursuing the investment reform agenda and in developing and implementing investor outreach campaigns targeted on the identified priority sectors.	Short-term
	6. Define a role for MoFA's overseas missions in coordination with the NDA to reach out to investors in priority markets.	Short-term
	7. Develop a policy advocacy role for the new Investment Promotion Unit.	Medium-term
	8. Design a framework for FDI linkages to increase overall in-country value addition, develop or attract new technologies and capabilities and better integrate local firms into supply chains of foreign investors where possible.	Medium-term
	9. Recognize the re-establishment of a separate, dedicated Investment Promotion Agency as a longer-term ambition.	Medium- to Long-term

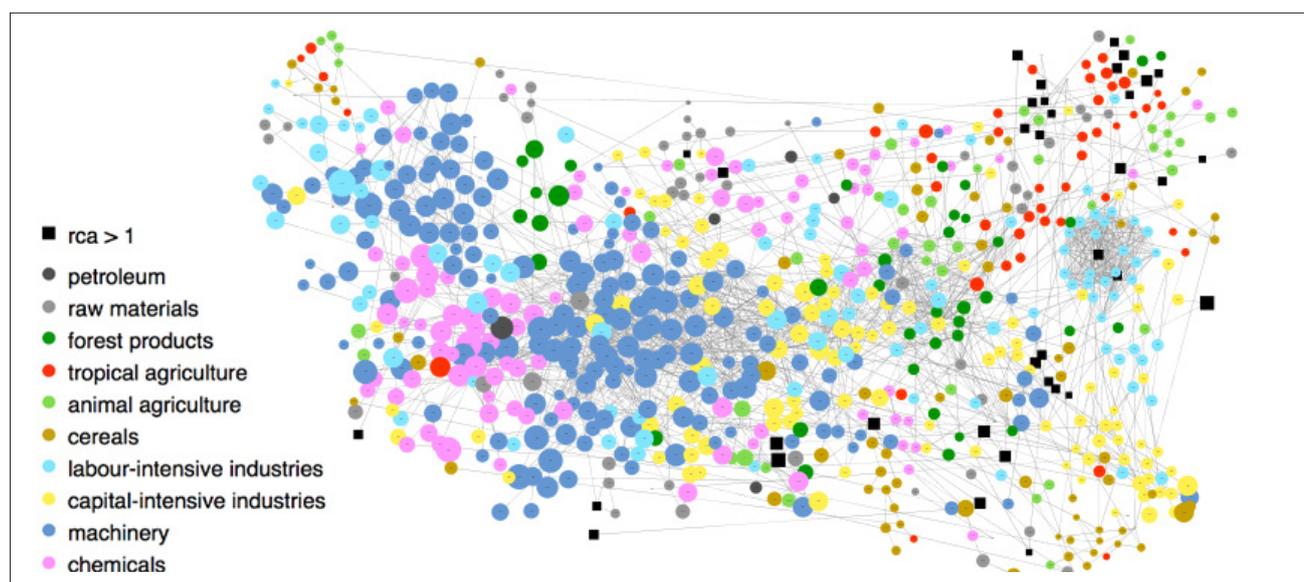
ANNEX A:

Analysis of Economic Complexity

This annex details the application of the economic complexity analysis to Mongolia, whose findings are summarized in section II. The starting point for this analysis is Figure A-1, which combines a network image with the tradable sectors in which the country has Revealed Comparative (i.e. $RCA > 1$)⁵¹, represented in the image through black squares⁵². By and large, these industries are located to the right of the image, which concentrates a large number of sectors of low sophistication or complexity, particularly in agriculture and labour-intensive industries.

Second, Table 7⁵³ confirms Mongolia's specialization in low-complexity products, with several natural resource categories (petroleum, raw materials, animal agriculture, cereals) accounting for

Figure 30. Mongolia's export specialization in primary products and manufactures (2013)



Source: WBG calculation based on Feenstra et al. (2005) and COMTRADE

⁵¹ For its elaboration, we use export data classified according to the Standard International Trade Classification (SITC), which allows for a network with 774 nodes and approximately 1500 inter-sectoral links. Two characteristics of the nodes provide additional information about a given sector. First, we group the sectors using the Leamer (1984) classification, which leads to 10 sector categories. Second, the node diameter is directly proportional to its Product Complexity Index (PCI), a variable constructed following Hidalgo & Hausmann (2009), which evaluates the degree of sophistication or complexity of the sector.

⁵² The network representation is created with the software Cytoscape. RCAs are calculated following (Balassa, 1965).

⁵³ This table includes the number of tradable sectors available for each Leamer category and its mean PCI (2nd and 3rd column). The average PCI for each category of Leamer allows us to categorize as low complexity industries those included in petroleum, raw materials, forest products, tropical agriculture, animal agriculture and cereals. Labor and capital-intensive industries exhibit a higher average level of complexity, while chemicals and especially machinery concentrate the industries with the greatest product complexity. The last two columns of the table show the number of sectors exported by Mongolia with $RCA > 1$, as well as their average PCI across Leamer categories.

more than 70 percent of the sectors with RCA. In contrast, Mongolia's participation in higher complexity industries⁵⁴, e.g., machinery or chemicals, is marginal.

Moreover, the average complexity of Mongolia's exports within many of the sector categories is, on average, lower than the average complexity for that category⁵⁵. This applies to both commodity and non-commodity categories, suggesting the ample room for export upgrading in Mongolia, both through diversifying into new products and developing more complex and knowledge-intensive exports within the current specialization in natural resources.

The previous analysis is complemented with the analysis of the evolution of Mongolia across various indicators. First, the degree of diversification, which counts the number of sectors exported with revealed comparative advantage. Second, the *Economic Complexity Index (ECI)*⁵⁶, originally elaborated in (Hidalgo & Hausmann, 2009), which assesses the overall complexity of the export basket. Third, an index of FDI complexity that evaluates the contribution of FDI to the process of productive upgrading in Mongolia. Fourth, the degree of connectedness or opportunity value (Hidalgo & Hausmann, 2009), which measures the relative difficulty to diversify into complex industries and assesses the prospects of Mongolia for transitioning into new industries. In all, these variables allow us to evaluate the process of structural transformation in Mongolia vis-à-vis a group of selected economies.

Table 7. Mongolia's export specialization in primary products and manufactures (2013)

	<i>product space</i>		<i>sectors with rca > 1</i>	
	sectors	mean pci	sectors	mean pci
● petroleum	6	-0.24	1	-2.55
● raw materials	62	-0.79	11	-1.48
● forest products	39	-0.08		
● tropical agriculture	46	-0.98		
● animal agriculture	52	-0.68	8	-1
● cereals	80	-0.92	6	-1.05
● labour-intensive industries	98	0.04	2	-1.17
● capital-intensive industries	118	0.02	6	-0.73
● machinery	179	0.85	2	-0.82
● chemicals	94	0.46		

Source: WBG calculation based on Feenstra et al. (2005) and COMTRADE

⁵⁴ As the table shows, the average PCI for machinery and chemical industries are 0.85 and 0.46, the highest among all industrial categories.

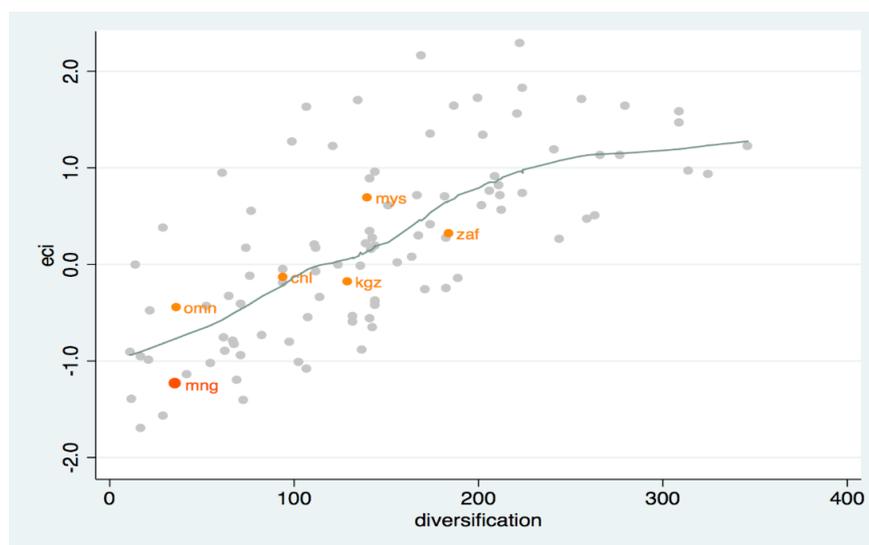
⁵⁵ This conclusion follows from comparing the second (average complexity of products included in the corresponding sector category) and fifth column (average complexity of products that Mongolia exports with revealed comparative advantage) in Table 7.

⁵⁶ The ECI is standardized, so that a value of 0 implies a level of complexity similar to the global mean, while values equal to 1 (-1) relate to economic complexity levels a standard deviation above (below) the world average. In general, higher diversification goes hand in hand with higher economic complexity. Yet, for any given level of diversification there exists large variation in economic complexity.

Figure 31 reveals very low levels of diversification and complexity for Mongolia. First, its diversification level is the lowest among the benchmark countries, with 36 sectors being exported with revealed comparative advantage. This level of diversification⁵⁷ is far below that of the most diversified economies in the benchmark group (South Africa, Malaysia); but also of Chile or Kyrgyz Republic, economies that have been able to partially break away from their specialization in natural resources. Second, Mongolia registered a value of ECI of -1.24 in 2013, which placed the country in the 109th position in the ECI ranking, the lowest among the selected economies. In contrast, Chile and Kyrgyz Republic hold ECI values close to the global average, while Malaysia reaches an ECI that is approximately two standard deviations above that of Mongolia. All things considered, the analysis highlights the low level of complexity reached by Mongolia, even when compared to countries that have a strong natural resource base and trade specialization (e.g., Oman, Kyrgyz Republic).

The analysis also allows to gauge the contribution of FDI to the overall level of economic complexity in Mongolia. This notion is illustrated in Figure 32 through an index of FDI complexity,⁵⁸ plotted

Figure 31. Diversification vs. ECI Mongolia and selected economies



Source: WBG calculation based on Comtrade and Atlas of Economic Complexity

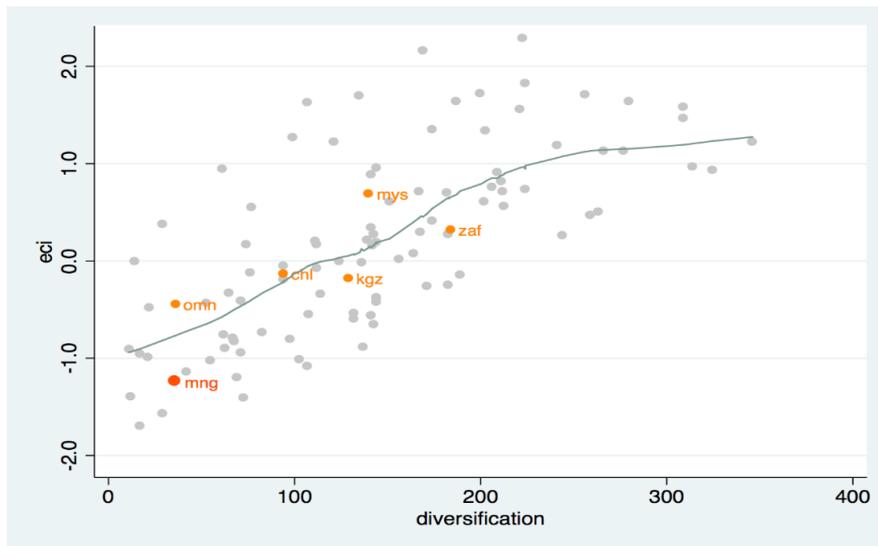
against the ECI for both Mongolia and benchmark countries. The graph shows that the FDI complexity in Mongolia corresponds with the low levels of ECI.⁵⁹ In other words, FDI accruals to Mongolia do not modify much the overall complexity of the Mongolian economy. Most of the benchmark countries behave in a relatively similar way, with FDI complexity mimicking the level of complexity of the national economy. The clear exception is Chile, a country where FDI inflows are unambiguously channelled towards low complexity industries, largely in natural resources.

⁵⁷ Although not shown in the graph, the level of diversification in Mongolia has steadily declined since 2006, when the country held RCAs in over 50 industries.

⁵⁸ The index is a weighted average of the PCI associated with industries where there is FDI activity, with the weights being the share of FDI in the sector over total FDI in tradable industries received in the country. Just as in the case of the ECI, the FDI complexity index is standardized, so that a value of 0 corresponds with the global average for the index.

⁵⁹ Mongolia's FDI complexity is -0.85, which places the country in the 103th position in the global ranking of this indicator.

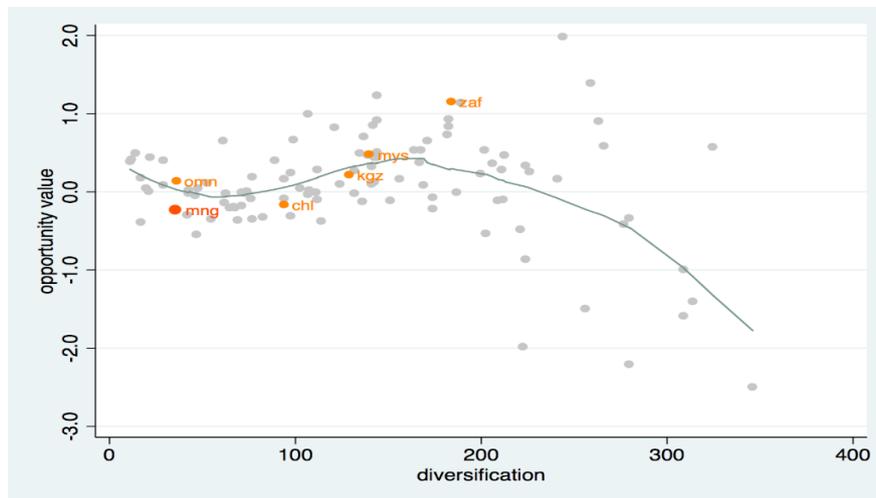
Figure 32. ECI vs FDI Complexity, Mongolia and selected economies



Source: WBG calculation based on Comtrade and Atlas of Economic Complexity

Finally, *Figure 33* shows that a greater diversification in **Mongolia would likely be translated into improved connectivity in the product space**.⁶⁰ Specifically, Mongolia is still far from the diversification levels found in South Africa, a country where further increases in the level of diversification is not likely to provide a closer proximity to high complexity. All things considered, the analysis justifies the goal of diversification in Mongolia, which would likely result into an increased level of connectivity, and accordingly an improved capacity to tap into more sophisticated industries.

Figure 33. Diversification vs. opportunity value, Mongolia and selected economies



Source: WBG calculation based on Comtrade and Atlas of Economic Complexity

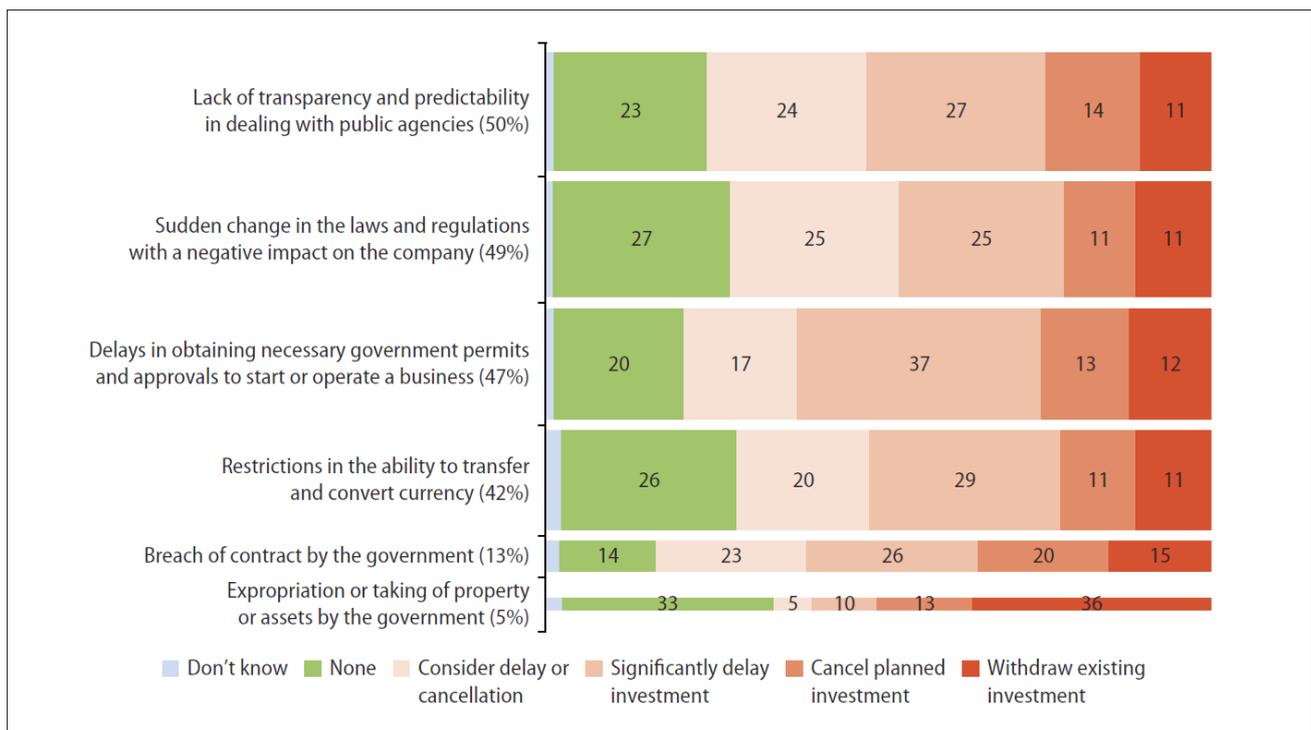
⁶⁰ The degree of connectivity is formalized through the opportunity value (Hausmann et al., 2011), a variable that combines two considerations: the proximity of the country's export basket to those industries that are not part of it, and the degree of complexity of the latter. In this way, a country has a greater opportunity value if its export specialization is relatively close to a large number of complex industries. This idea makes the relationship between diversification and opportunity value to eventually change sign, as shown in Figure 31. For relatively low levels of diversification, increases in this indicator correspond to increases in opportunity value. However, this relationship eventually changes sign, with heavily diversified economies having an increasingly limited universe of industries to add to their export basket. Specifically, the relationship between diversification and opportunity value becomes negative based on levels of diversification of about 180 industries.

ANNEX B:

Findings of Global Investment Competitiveness Report 2017

Investors participating in the Global Investment Competitiveness Report (GIC) 2017,⁶¹ continue classifying political risk as one of the most important obstacles to FDI in developing countries. More than three-quarters of investors surveyed in this report encountered some type of political risk in their investment projects in developing countries. While all political risks can pose serious constraints to FDI, the main concerns of investors are directly related to the conduct or action of the Government and the lack of investor protection. For example, almost half encountered lack of transparency and predictability, adverse regulatory changes and delays in obtaining necessary Government permits and approvals to start or operate a business. Over 40 percent encountered restrictions in transferring and converting currency. (Figure 34)

Figure 34. Investor Experience with Political Risk



Source: GIC Report 2017/2018

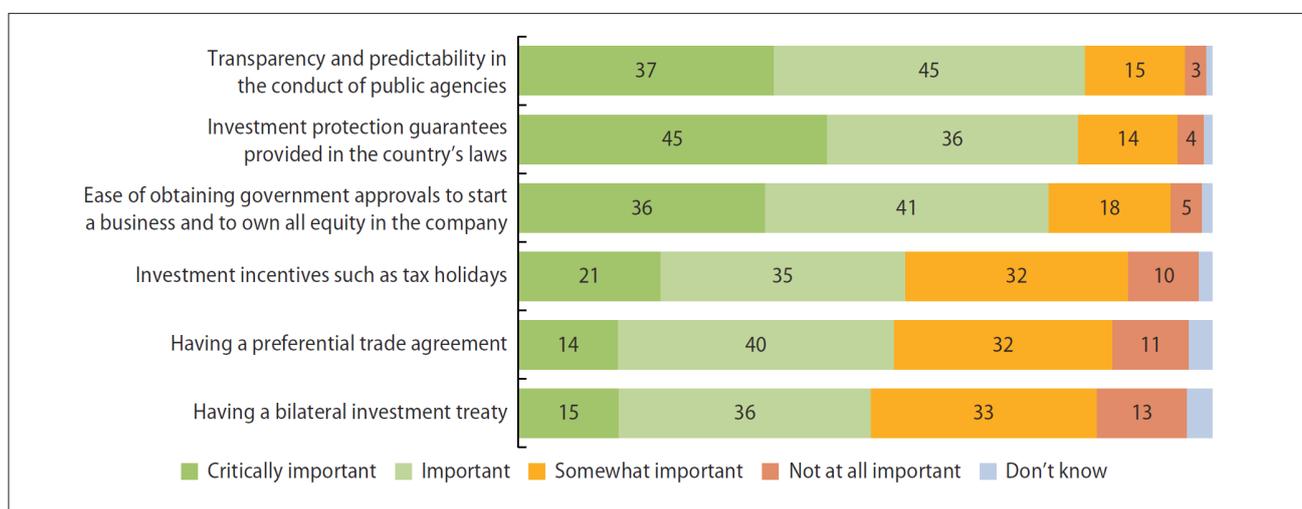
Political risk and insufficient investor protection result in the failure to retain current investment and attract reinvestment. Lack of confidence of already established investors may lead them to cancel their plans to expand or reinvest in the host countries, and sometimes to leave the country. According

⁶¹ World Bank Group. 2018. Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspectives and Policy Implications. Washington, DC: World Bank. <https://openknowledge.worldbank.org/handle/10986/28493>

to GIC 2017 survey in *Figure 34*, one in four investors who experienced lack of transparency and predictability, sudden changes in the laws and regulations, or delays in obtaining government permits and approvals canceled a planned investment or withdrew an existing investment owing to political risks. More severe cases of political risk occur less frequently but with far worse impact. Only 13 percent of respondents experienced breach of contract by the Government, but 35 percent of those investors canceled a planned investment or withdrew an existing one. While only 5 percent of respondents experienced expropriation, almost half of them canceled or withdrew an investment. Thus, investment protection should be a critical element of a Government’s strategy both to retain investment and attract new investment or reinvestment. In fact, it has been proved in a significant number of economies that the lion’s share of the total annual FDI inflows is made by investors already established in the host country – both in the form of reinvested earnings or new investments. UNCTAD estimates that the share of reinvested earnings in total FDI outflows in select developed countries varies from year to year, but has averaged 45 percent during 2007-2013.⁶² Although the importance of reinvested earnings may differ from county to country, it is generally agreed that reinvestment represent an important component of FDI.

On the other hand, a good legal regime for investor protection can improve the investment climate and help attract high-quality investment. According to GIC 2017, investors seek both strong legal protection and a predictability and efficiency in implementing laws and regulations (*Figure 35*). Also, positive testimonials of investors already established in the host country rank among the best investment promotion tools to attract new FDI. Evidence shows that over time, satisfied investors tend to diversify their operations in host-countries, evolving from lower value-added towards higher value-added activities.⁶³

Figure 35. Importance of investment climate factors



Source: GIC Report 2017/2018

⁶² UNCTAD, World Investment Report 2014 (Economies included are Belgium, Bulgaria, the Czech Republic, Denmark, Estonia, Germany, Hungary, Japan, Latvia, Lithuania, Luxembourg, the Netherlands, Norway, Poland, Portugal, Sweden, Switzerland, the United Kingdom and the United States.)

⁶³ For example, Intel started the investment in Costa Rica for Assembly & Test plant in April 1997, and expand a second plant in 2003 for a new product platform. Continuously, Intel built a third building and launched new services in its “shared services” group by 2005. In 2014, Intel invested on R&D activities for testing of microprocessors prior to large scale production. From these initial and expansion investment, the Intel invested more than US\$770 million in Costa Rica campus, which reflected employment for more than 2,900 workers and an additional 2,000 indirect jobs. Another example is Honeywell in Czech Republic that the company continuously expanded its investment from sales and development to manufacturing and R&D units.

ANNEX C:

Analysis of Major BITs signed by Mongolia

Contracting country	China	Netherlands	Singapore	Canada	Korea
Definition					
<i>Definition of Investment</i>	Asset-based	Asset-based	Asset-based	Enterprise-based	Asset-based
<i>Investments covered</i>	both pre-existing and post-BIT investments	both pre-existing and post-BIT investments	Applies to both pre-existing and post-BIT investments	Applies to both pre-existing and post-BIT investments	Applies to both pre-existing and post-BIT investments
<i>Disputes covered</i>	Carves out pre-existing disputes	Carves out pre-existing disputes	Not stipulated	Not stipulated	Carves out pre-existing disputes
Standard of Treatment					
<i>National Treatment</i>	Post-establishment	Post-establishment	None	Pre- and post-establishment	Post-establishment
<i>Most-Favored-National Treatment (FET)</i>	Post-establishment FET unqualified	Post-establishment FET unqualified	Post-establishment FET unqualified	Pre- and post-establishment FET qualified	Post-establishment FET unqualified
<i>By reference to international law</i>	NONE	None	None	minimum standard of treatment	None
<i>Full Protection & Security</i>	NO CLAUSE	Standard	NO CLAUSE	Standard	Standard
<i>Expropriation</i>	Indirect expropriation mentioned	Indirect expropriation mentioned	Indirect expropriation mentioned	Indirect expropriation mentioned	Indirect expropriation mentioned
<i>Indirect expropriation</i>	No definition	No definition	No definition	Defined	No definition
<i>Compensation</i>	Without unreasonable delay	without delay	non-discriminatory / effectively realizable and shall be made without unreasonable delay	Non-discriminatory / prompt, adequate, and effective	Non-discriminatory / effective, adequate and be paid out without undue delay
<i>Rights to Transfer Funds</i>	Y	Y	Y	Y	Y
Dispute Resolution					
<i>State-State Disputes</i>	Y	Y	Y	Y	Y
<i>Investor-State Disputes</i>	Y	Y	Y	Y	Y
<i>Alternative to Arbitration</i>	NONE	NONE	Voluntary ADR	NONE	Voluntary ADR
<i>Scope of Claims</i>	Covers any dispute relating to investment	Covers any dispute relating to investment	Covers any dispute relating to investment	Covers treaty claims only	Covers any dispute relating to investment
<i>Limitation of provisions subject to ISDS</i>	N	N	N	Y	N
<i>Exclusion of policy areas from ISDS</i>	N	N	N	Y	N

Definition of investment: The definition of the term ‘investment’ in BITs is critical because only the assets or interests of investors that fall within its scope are entitled to the protection of the treaty. Most treaties in Mongolia, including with China, Netherland, Singapore, and Korea, adopt an asset-based definition of investment, in which the treaty covers “every kind of asset” or “any kind of asset,” accompanied by an open-ended list of assets covered, which would include portfolio investment and intangible assets.⁶⁴ Unlike the other treaties, the Mongolia-Canada BIT stipulates “enterprise-based definition,”⁶⁵ akin to the traditional concept of a direct investment and which excludes portfolio investment and real estate.⁶⁶ Although the treaty does not explicitly exclude the types of portfolio investment, this definition seems to show the intention of negotiators to focus on traditional direct investments.

National Treatment (NT) and Most-Favored Nation Clause (MFN): It is notable that Mongolia-Canada BIT sets very broad and high standards of protection even at the pre-establishment stage. Usually, as one can see in other BITs like China, Netherland, Singapore, and Korea, NT and MFN obligation is limited to the post-establishment phase of the investment, which means the obligation does not extend to acquisition and/or establishment of investments. However, NT and MFN obligation in the Mongolia-Canada BIT applies to the full cycle of an investment, including the investor’s entry and establishment in the host country and its participation in existing enterprises.⁶⁷ Of course, this also covers the post-establishment phase, the treatment of the investment after its entry. It is notable that Mongolia provides very high standard of protection to Canadian investors, which is intended to be good incentives for them. Also, with this high standard in place, investors from other countries with BITs with Mongolia can benefit from the Canadian provisions by relying on MFN provisions. In other words, foreign investors may choose the most favorable investor protection standard available by using the most favored nation clause to their benefit. In this situation, considering that investors in any case using MFN can access that treatment, the highest level of protection in IIAs needs to be reflected as standards in the domestic law. This will increase the clarity and transparency in the legal framework and greatly improve the quality of the protection standards available to investors. The difference is that by adding it to the domestic law, we make it applicable for all investors as opposed to just ones from BIT contracting countries.

Fair and Equitable Treatment and Full Protection: Fair and Equitable Treatment (FET) and full protection and security are present in most investment treaties. FET standard requires States to ensure more broadly principles of good faith, transparency, proportionality, due process and non-discrimination are complied with in all Government conduct vis-à-vis investors. The failure by a host Government to protect the investment against threats renders that Government liable to

⁶⁴ OECD, Negotiating Group on the Multilateral Agreement on Investment (MAI): definition of investor and investment (Note by the Chairman), p2, available at <http://www1.oecd.org/daf/mai/pdf/ng/ng952e.pdf>

⁶⁵ In Mongolia-Canada BIT, “investment” means: “investment” means: 1. an enterprise; 2. shares, stocks and other forms of equity participation in an enterprise; 3. bonds, debentures and other debt instruments of an enterprise; 4. a loan to an enterprise, etc.

⁶⁶ OECD, Negotiating Group on the Multilateral Agreement on Investment (MAI): definition of investor and investment (Note by the Chairman), p2, available at <http://www1.oecd.org/daf/mai/pdf/ng/ng952e.pdf>

⁶⁷ Article 4 (National Treatment) 1. Each Party shall accord to investors of the other Party treatment no less favorable than that it accords, in like circumstances, to its own investors with respect to the *establishment, acquisition, expansion, management, conduct, operation and sale* or other disposition of investments in its territory.; Article 5 (Most-Favored-Nation Treatment) 1. Each Party shall accord to investors of the other Party treatment no less favorable than that it accords, in like circumstances, to investors of a non-Party with respect to the *establishment, acquisition, expansion, management, conduct, operation and sale* or other disposition of investments in its territory.

compensate an investor for resulting injuries. All reviewed BITs have this standard of treatment provisions, and the BIT with Canada particularly says the investments' treatment in accordance with the customary international law regarding the minimum standard of treatment of aliens.⁶⁸

Transfer of Funds: The ability of a foreign investor to make international monetary payments freely both into and out of a host country is crucial to the success of any foreign investment. All reviewed BITs contain the right to transfer funds abroad. This right is unconditional in four of the BITs. Only the BIT with Canada includes several exceptions that allow the Mongolian Government to derogate from the free transfer obligation. Under this agreement, the Mongolian Government can exceptionally limit investors rights to transfer by the equitable, non-discriminatory and good faith application of measures relating to maintenance of the safety, soundness, integrity or financial responsibility of financial institutions.

Expropriation: A fundamental concern of all foreign investors is that host country Governments will seize their assets. Such uncertainty over the security of property rights is the essence of political risk. These days, investors are particularly concerned about 'indirect expropriation,' in which host states invoke their legislative and regulatory powers to enact measure that reduces the benefits investors derive from their investment, but without changing or cancelling investor's legal title to their assets or diminishing their control over them. All reviewed BITs protect investors from both direct and indirect expropriation, and the BIT with Canada clearly provides the definition of 'indirect expropriation.'⁶⁹ As for compensation due to expropriation, not all reviewed IIAs explicitly provide that expropriation will be non-discriminatory, due process will be followed in the process of expropriation and prompt, effective and adequate compensation will be paid. These are key elements of 'good practice' expropriation provisions and some of them are in fact also provided in the reviewed IIAs. The US State Department's Investment Climate Statement 2017 reports that there is currently at least one US investment expropriation case without fair compensation.⁷⁰ Given this report, it is particularly important that the guarantee on expropriation be strengthened both from a de jure perspective and in its de facto implementation. Although the precise boundary between legitimate regulation and acts that violate a treaty's indirect expropriation provisions is often difficult to determine, it is necessary to be cautious that Government conduct would not in any way be equivalent to this indirect expropriation.

⁶⁸ Article 6 (Minimum Standard of Treatment) 1. Each Party shall accord to covered investments treatment in accordance with the customary international law minimum standard of treatment of aliens, including fair and equitable treatment and full protection and security.

⁶⁹ Annex B.10 (Expropriation) 1. Indirect expropriation results from a measure or series of measures of a Party that has an effect equivalent to direct expropriation without formal transfer of title or outright seizure.

⁷⁰ "In at least one expropriation case, however, the Government restored a mining license it had unilaterally modified years previously, but declined to pay compensation for undisputed financial loss as required by the BIT and independently required by the domestic law specifically cited in rendering the modification. Under the BIT, such uncompensated expropriation is appealable through arbitration proceedings. However, the cost of arbitration can make it impractical for aggrieved parties."

ANNEX D:

Good Practice Institutional Arrangements and Frameworks for Investment Promotion

The importance of putting in place the right institutional arrangements to support investment policy and promotion

International experience reveals a wide range of possible institutional frameworks and the need for robust coordination. Worldwide, there is a wide range of public and sometimes private institutions tasked with attracting and/or facilitating investment. Investment promotion functions are usually undertaken by separate bodies within Government – often called investment promotion agencies (IPAs). Even in countries where a specialized IPA exists it is not unusual to see certain sectoral ministries or agencies, including at local or provincial level, and special economic zones also undertaking some investment promotion functions, sometimes with good coordination with the IPA and in other cases without any coordination, which is less optimal as it can generate some duplication.

An overly complex or crowded “landscape” of institutions engaging in promotion activities can lead to wasteful overlap, stakeholder conflicts, investor confusion and frustration, and service gaps, if it is not based on clear national strategies and well-coordinated actions across Government. A good national FDI attraction strategy, if well-implemented, should shape the institutional landscape, ensuring that promotional and regulatory objectives are properly balanced and that the various promoting institutions operate in a complementary way. The national IPA normally plays an overall coordinating role to ensure national consistency in the promotion message and in the services that investors receive.

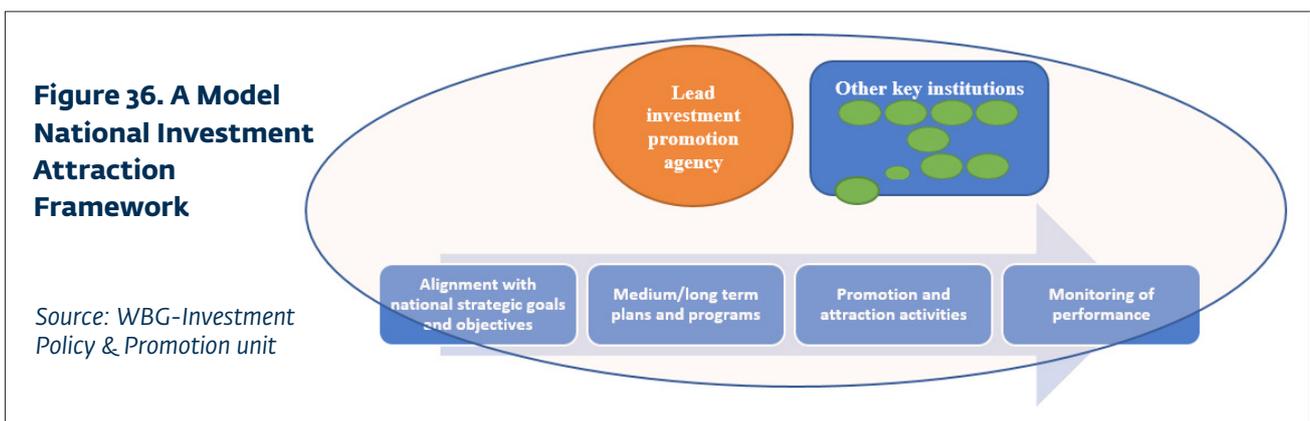
It is critical for any country that aspires to attract (and retain) more FDI or different types of foreign investment – as Mongolia needs to do with a suggested focus on efficiency-seeking investments – to ensure that its investment policy and promotion institutional arrangements are coherent and effective and private sector focused, and that the different participating agencies complement each other, capitalize on any synergies, and avoid sending out potentially confusing or even conflicting messages to potential investors.

Good practices in national FDI promotion frameworks

Countries can build a coordinated, efficient institutional framework for investment attraction using many different approaches. However, institutional frameworks delivering better results share a number of common characteristics⁷¹, notably:

⁷¹ Premkumar 2000; Weiss 1987; Herzberg and Wright 2006; Serrano 2003; Ilias, Shayerah, Charles E. Hanrahan, M. Angeles Villarreal. 2013.

- **Political commitment:** Political commitment plays a key role in initiating and ensuring sustainability of long-term coordination, collaboration, and effort in the alignment of the initiatives of different institutions. Any initiative involving different Government agencies needs to be clearly supported by high-level politicians and authorities.
- **Overall strategic framework with clear action plan:** A clear alignment with a strategy at the national level stating what the main shared objectives for FDI attraction and retention are and how they should be achieved and measured is essential. Organizations that are part of the collaborative framework for investment policy and promotion must share and endorse the (foreign) investment strategy that should include tactical and operational instruments to facilitate the attraction of FDI. A clear implementation action plan is required to guide day-to-day actions.
- **Adequate resources to undertake the job.** In other words, sufficient staff and operating budget resources to deliver the activities agreed in the action plan.
- **Strong lead institution, with adequate resources to deliver agreed strategy:** A national institution must take the initiative for the successful implementation of an effective cooperative framework to deliver coherent signals to potential investors. One agency in charge of getting the ball rolling is always highly desired and needed, in other words a lead agency. Strong lead agencies have:
 - Political or legal empowerment (preferably both)
 - Strong commitment to fostering and coordinating close cooperation across the network of organizations, and a clear understanding of its benefits for the country.
 - Committed leaders supported by committed public officers in the institution.
 - Mandated authority over investment promotion related issues.
 - Appropriate communication and information sharing with all involved organizations.
 - The right human and financial resources and the technical and managerial capacity.
 - A strong customer-focus, aimed at satisfying potential and established investors' needs.
- **Accountability and measurement of performance:** The institutional arrangements need to design and implement a relevant monitoring and evaluation (M&E) framework (with output, outcome, and impact metrics) to provide robust quantitative information enabling the assessment of its overall performance.



The roles of 'lead' investment promotion agencies

A variety of lead agency models can be effective. Lead agencies can be large or more modestly sized, depending on available resources, size of the FDI market, etc. Countries must designate the lead agency in a way that is appropriate to their specific circumstances. Successful practices show the need for the lead agency to be a Governmental body and for its leadership role to be accepted and fully supported by the rest of the institutional landscape and key Government departments to ensure adequate funding and capacity, in other words that it is recognized as carrying the national mandate as the lead or coordinating body for investment promotion.

The lead agency may take the form of a single quasi-independent agency given specific 'lead' responsibilities, or indeed it may be a separate unit within an agency with wider investment functions. The following box lists the best practice characteristics of best practice investment promotion agencies.

Box 2: Common characteristics of best-practices IPAs

- Attached or linked to a high-level Government office (such as that of the President or the Prime Minister) with central Government granting a high level of priority to investment (or FDI).
- Institutional and financial autonomy (or semi-autonomy) to emulate private-sector like flexibility to execute the strategy and avoid undue political influences.
- Strong collaboration and information flows with private sector.
- Clear mandate focused on
 - Attracting investors, facilitating their entry, securing their retention and expansion, and translating their activities into more and more benefits for the local economy through the professional, proactive, and persistent provision of well-designed services and excellent customer service
 - Advocating reforms for a better investment climate
- Regulatory functions (including the One-Stop Shop) are performed by a separate Governmental institution to ensure proper delivery of this essential function without compromising IPA's equally essential promotion role.
- Focused investment promotion efforts on strategic sectors/industries having the best competitive opportunities to yield highest benefit to cost.
- Mix of employees with public and private sector experience that ensures the IPI is relevant to both its public-sector stakeholders and its private sector clients.
- Sufficient and sustained funding to perform their mandates, without having to struggle every year or charge fees, providing continuity of strategic effort and direction.

Source: Adapted from "Best Practices for Investment Promotion," Robert Whyte and Armando Heilbron, World Bank Group, 2011

One of the most important questions for IPAs worldwide is what their core functions should be. Often IPAs carry “add-on” mandates, such as one stop shops or investment-related regulatory and administrative functions (e.g. incentives). However, one of the most fundamental of best practice principles in investment policy is the separation of regulatory and promotional functions. Even the most investor-friendly regulatory environment requires regulators and administrators to implement Government policies that impose requirements on investors or define what an investor can and cannot do.

However, a combined promoter-regulator agency potentially faces a conflict of interest, when its performance is both judged on how many investors it can attract and on how well it stops the “wrong kind” of investments. Similarly, investors are likely to question the motives of such an institution when it is acting as a promoter. Consequently, a promoter-regulator may find it difficult to get the access it needs to effectively promote investment opportunities and provide aftercare.

Table 8. Distinguishing between what IPAs can do and what IPAs should do

		Must do (Core mandates)	May do as additional functions, but require independent set up and resources	Incompatible with Investment Promotion
Investment promotion	Marketing			
	Information provision			
	Facilitation of meetings, site visits, and government procedures			
	Investor aftercare			
	Advocacy			
Promotion of:	Exports			
	Outward investment			
	SME linkages to FDI			
	SME development			
Administration/regulation	Administration of government procedures (e.g., One Stop Shop, licenses, incentives)			
	Manage state land or assets			
	Administer/negotiate government concessions (e.g., infrastructure, extractive industries)			
	Administer public-private partnerships			

Source: WBG-Investment Policy & Promotion unit

This argues against IPAs acting as statutory one-stop shops with the authority to issue licenses and permits (see further arguments below), although it leaves room for the IPA to provide facilitation services to investors to assist them through the entry and operations processes. Table 8 above illustrates what best practice data tells us about the most effective mix of functions for an IPA, and Box 2 at the end of this annex provides some evidence of the greater effectiveness of dedicated promotion agencies. The mandate should clearly establish the IPA as a tightly focused marketing body for the attraction of FDI into the country and as a good service provider to investors.

Core investment promotion functions are focused on the attraction, retention and growth of foreign investors (including joint ventures). They do not include domestic investment, SME development, or business start-ups (unless foreign owned).

Core investment promotion functions consist of:

- Sector targeting and outreach for FDI (including joint ventures)
- Foreign investor facilitation
- Foreign investor aftercare
- Investment policy advocacy
- Creating linkages between foreign and domestic firms

Another common difficult question referred to above is what should be the relationship between the IPA and the country's one-stop-shop (OSS). The answer depends, to a great extent, on the nature of the OSS, but, in any case, great care needs to be taken in defining this relationship. For many Governments, the IPA seems the obvious place to put the OSS. However, if the OSS is, for example, a centralized approval and permitting body then putting it in the IPA runs the same risks as described above.

Investors report being wary of one agency that simultaneously says “we are here to help and facilitate (hand-hold) your entry into our country but we are also the agency that will judge your requests for registration, permits, incentives, etc.”. Agencies that carry both functions also tend to focus more attention and resources on the OSS and often promotion effectiveness suffers. For these reasons, the World Bank's advice is that such an OSS should be placed at arms' length to the IPA, preferably reporting to another Government body.

WBG experience indicates that the only OSS model likely to be successfully implemented by an IPA which is also successful at promotion is the account manager model. Even in weak investment climates, where Government procedures are presumably the most burdensome, IPAs have demonstrated that they can make an important difference in investor attraction and retention through the application of the account manager model.

As aforementioned, IPAs have an important role to play in the design and implementation of FDI linkages programs. Since IPAs tend to be the main contact point for foreign investors in the host economy, they are best placed to understand the localization and sourcing needs of investors. As such, their feedback is critical and helps to better target linkages support services, making them more efficient and sustainable.

Box 3: Example of account management results from the Georgian National Investment Agency (GNIA)

In 2013, GNIA was informed that German chemical manufacturer Henkel was looking to establish a new factory in the Caucasus region. In 2016, Henkel selected the Georgian municipality of Gardabani for the new factory, which will produce 40 cement-based products for distribution throughout the region. In the intervening three years, GNIA provided services to Henkel dozens of times, including:

- Appointing a single main point of contact for Henkel within the GNIA (the account manager),
- Providing sector-specific and tax-related information,
- Accompanying Henkel on visits of potential sites for the factory, and
- Assisting Henkel apply for and achieve various permits, including construction permits.

During the three-year period, it would have been easy for GNIA to give up on the company as a likely investor, to forget to follow-up at a crucial stage, or even simply to lose touch. However, GNIA understood that investment promotion, even for a single client, is a long-term business and doggedly stuck with the company throughout its decision-making and establishment processes. The building of a relationship over time, diligent follow-up, and patience allowed GNIA to maximize its position relative to other potential locations for Henkel and eventually realize an important investment for the country.

Source: Georgian National Investment Agency

A recent survey conducted by the WBG shows that three services are offered, in particular, by a substantial share of “high-performing IPAs”, i.e. those receiving higher levels of FDI: (i) services designed to link foreign companies to domestic suppliers; (ii) services to link domestic companies to foreign technologies; and (iii) services designed to link foreign companies to domestic technical, vocational, or educational institutions.

NDA can offer a range of tools and services to help connect foreign investors to local firms. While the concrete division of labor depends a lot on the organization, resources, and capacity of public institutions – no matter the structure - IPAs help facilitate FDI linkages through the following range of services:

- Developing and maintaining high-quality information on potential suppliers in Mongolia.
- Providing targeted B2B matchmaking services.
- Launching a targeted investment promotion campaign to attract capable overseas suppliers or technology partners.
- Coordinating closely with relevant agencies for local supplier development and educational institutions to ensure that the FDI perspective is adequately considered any domestic firm- or skills-upgrading programs.



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