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## Factors Contributing to Foreign Direct Investment in Mongolia

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**ABSTRACT.** Since the 1980s, globalization has led to a rapid increase in the growth of foreign direct investment (FDI) all over the world. Mongolia for more than a decade has been in the process of radical transformation and has taken significant steps to build a market-based economic structure. Foreign Direct Investment plays a very important role in achieving rapid economic growth in the developing countries. This can be achieved by taking advantage of available mobilizing domestic savings, foreign capital, technology transfers, establishment of new premises and favorable foreign policies. It is now widely acknowledged that FDI has potential benefits that can accrue to developing countries. This view is mainly based on the neo liberal and development economists. They suggest that FDI is crucial for economic growth as it provides the much needed capital for investment, increases competition in host countries economies, and helps local firms to become more productive by adopting more efficient technology or by investing in human or physical capital [1]. FDI is also said to contribute to growth in a substantive manner because it's more stable than other forms of capital flows. This paper investigates the key drivers of foreign direct investment (FDI) in Mongolia.

**Keywords:** FDI; GDP growth; Factors; sectors.

Part 1: **INTRODUCTION:** Many developing countries have developed a renewed interest in FDI as a source of capital due to the decline in official development assistance (ODA) in the 1990s. According to UNCTAD (2007), in 2005 total FDI inflow in the world was 945.8 billion USD, of which developed countries received 590.3 billion USD which is 62.4 percent of the total FDI inflow in the world, whereas in the same year developing countries received only 314.3 billion USD FDI. It was only 38.6 percent of the total FDI inflow in the world. Thus, developing countries are dominated by the developed countries in attracting FDI. One of the most striking developments during the last two decades is the spectacular growth of FDI in the global economic landscape. This unprecedented growth of global FDI in 1990s around the world make FDI an important and vital component of development strategy in both developed and developing nations and policies are designed in order to stimulate inward flows.

In 2003 Mongolia adopted an Economic Growth and Poverty Reduction Strategy, that built upon a series of policy reforms to accelerate growth and make it more pro-poor. This strategy features private sector-led growth, and launches measures for improvement in the business environment, particularly for rural entities and small and medium enterprises (SMEs), including finance for these activities; development of energy, road, communication and information technology infrastructure; and promotion of FDI and external trade. The strategy also calls for restructuring to make Mongolia's economy more competitive: privatization and regulatory, land and social service reform. It foresees substantial efforts to create income-earning opportunities for the poor, and to rationalize social service delivery and give it a pro-poor focus. Over the medium term, strategy implementation will involve resources equivalent to 40 % to 45 % of Mongolia's GDP.

After a sharp deterioration caused by the initial shock of transition and collapse of Soviet trade and aid, Following the democratic revolution the new Government of Mongolia quickly adopted policy that supported the creation and appropriate regulation of both foreign and domestic markets. Their aim of coaxing FDI inflows into Mongolia led to the rapid adoption of the Foreign Investment Law of Mongolia in 1993, later amended in 1998 and 2002. Moreover the law established a favorable environment for FDI, the amendments reduced value-added tax on imported goods, improved services for registration and operation of companies and introduced provisions that enabled cooperation between Mongolian and foreign investors. This led to Mongolia catching the eye of international investors as one of the most favorable investment locations in Asia.

Mongolia's real GDP started growing again in 1993, and in 2010 it has reached highly precedent levels. The mining sector, agricultural sector, and rapid expansion of services growth during this period have generated a general turnaround in the. At present, Mongolia is experiencing unprecedented economic growth, with real GDP increase averaging 7 % since 2002. Soaring copper and gold prices, which have greatly boosted exploration and FDI in the minerals sector, have ignited this growth, and this has been reinforced by recovery of livestock herds, previously decimated by three exceptionally hard winters. Rising activity in these sectors has also spilled over into construction, financial services and retail, so that growth is now fairly broad-based. As of 2006, improved terms of trade, driven by robust economic expansion and the run-up in minerals prices, led to a current account surplus in 2006, and better-than-expected mining income and other revenues have created a budget surplus. In 2008, however, the deficit increased by 855.6 mln. US. dollars compared with the 2007 (2 % of GDP) with a rise in imports financed by FDI, and a fiscal deficit (almost 5 % of GDP) due a decline in copper prices and several fiscal policy measures, notably cuts in the value added tax (VAT), personal income tax and corporate income tax. Despite the heightened pace of economic activity, inflation has declined and is now in single digits. The real effective exchange rate of Mongolia's Tugrik has appreciated by 13 % as at the end of 2010 this is as a result of improvement in the terms of trade and expanded capital inflows from FDI and official aid,.

Part 2: LITERATURE REVIEW. Traditional theory suggests three primary motivations for FDI: foreign-market-seeking FDI; efficiency seeking FDI and resource-seeking FDI (Dunning, 1977, 1993). However, as the traditional FDI theory is used to explain foreign investment from the perspective of a developed economy, in the case of Mongolia a developing country, the theory need to be applied in part rather than as a whole. On a concept bordering traditional theory, King and Levine (1993b) argued that financial development increases the return on innovation by providing three services. These services include the following: effective evaluation of investment projects through the acquisition of information; ability to pool and mobilize household savings for innovative endeavors; and, ability to share and diversify risks to enhance innovation of intermediate goods.

Caves (1996) considers that the efforts made by various countries in attracting foreign direct investments are due to the potential positive effects that this would have on economy. FDI would increase productivity, technology transfer, managerial skills, knowhow, international production networks, reducing unemployment, and access to external markets [2].

Borensztein (1998) supports these ideas, considering FDI as ways of achieving technology spillovers, with greater contribution to the economic growth than would have national investments [3]. The importance of technology transfer is highlighted also by Findlay who believes that FDI leads to a spillover of advanced technologies to local firms (Findlay, 1978).

Dunning John H. (2004) in his study "Institutional Reform, FDI and European Transition Economics" studied the significance of institutional infrastructure and development as a determinant of FDI inflows into the European Transition Economies [4]. The study examines the critical role of the institutional environment (comprising both institutions and the strategies and policies of organizations relating to these institutions) in reducing the transaction costs of both domestic and cross border business activity. By setting up an analytical framework the study identifies the determinants of FDI, and how these had changed over recent years.

Tomsaz Mickiewicz, Slavo Rasosevic and Urmaz Varblane (2005), in their study, "The Value of Diversity: Foreign Direct Investment and Employment in Central Europe during Economic

Recovery”, examine the role of FDI in job creation and job preservation as well as their role in changing the structure of employment. Their analysis refers to Czech Republic, Hungary, Slovakia and Estonia. They present descriptive stage model of FDI progression into Transition economy. They analyzed the employment aspects of the model [5]. The study concluded that the role of FDI in employment creation/ preservation has been most successful in Hungary than in Estonia. The paper also find out that the increasing differences in sectoral distribution of FDI employment across countries are closely relates to FDI inflows per capita. The bigger diversity of types of FDI is more favorable for the host economy. There is higher likelihood that it will lead to more diverse types of spillovers and skill transfers. If policy is unable to maximize the scale of FDI inflows then policy makers should focus much more on attracting diverse types of FDI.

### Part 3: SITUATION ANALYSIS OF FOREIGN DIRECT INVESTMENT IN MONGOLIA FROM OTHER COUNTRIES

3.1: GENERAL SITUATION. As the end of 2010, since 1990, over 10709 foreign invested companies (including the oil sector) have been registered from 104 countries with the total direct investment of 4.8 billion USD and 76.8% of the total investment volume has been made in 2005-2010. And only in 2010 the foreign direct investment has reached 1,025.mln USD of 769 companies. In terms of sectors, mining and geological prospecting took almost the half of the total investment and counts 65.3%, trade and catering service - 18.9%, banking and finance – 2.7%, light industry – 2.2%, construction and production of construction materials – 1.5%, processing of animal originated materials – 1.1%.

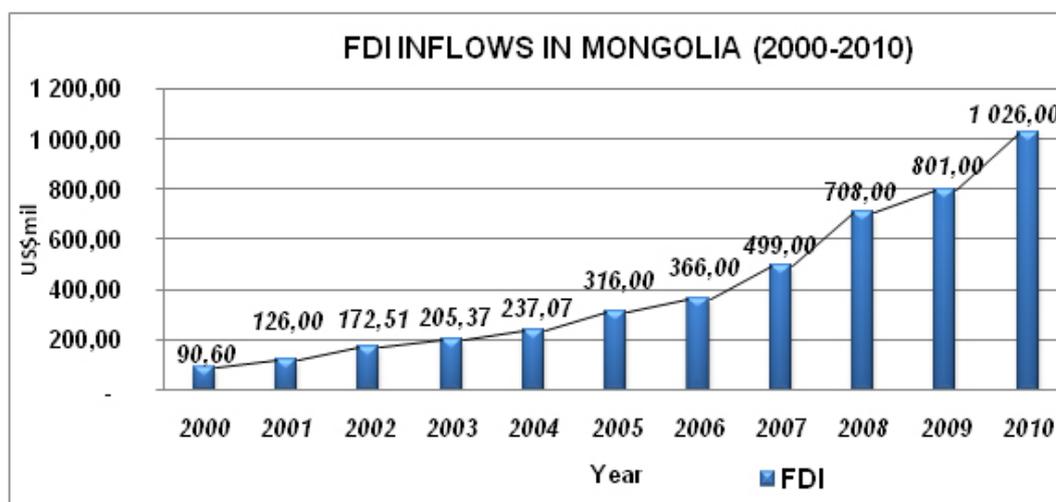


Figure 1: SOURCE: Mongolia Ministry of Commerce Report 2010

No	Sector's name	%	Total	1990-2004	2005	2006	2007	2008	2009	2010
1	Goelogical prospecting,oil exploration, mining	65.3	3,158,716.42	493,972.74	183,961.91	195,390.34	336,985.65	485,189.08	643,454.56	819,762.15
2	Trade and catering services	18.9	913,702.04	162,764.31	53,376.62	103,388.43	111,528.37	187,447.85	1,332,636.45	162,560.01
3	Others	4.8	231,785.68	92,880.36	52,884.35	47,739.57	13,882.50	6,875.86	3,510.34	14,012.70
4	bank and financial services	2.7	131,390.33	67,105.45	9,671.09	11,982.63	21,936.52	4,495.96	3,219.31	12,979.37
5	Light industry	2.2	107,908.16	85,001.91	1,792.13	1,454.22	1,205.34	18,208.00	92.82	153.75
6	Engeneering consractionand construction materials	1.5	74,317.26	55,237.94	772.73	1,791.75	4,273.45	1,894.74	9,366.55	980.1
7	Processing of animal originated raw materials	1.1	55,411.01	53,516.29	825.35	292.5	540			236.89
8	Information, Telecommunication	0.7	36,108.56	19,623.03	6,267.60	480.86	6,916.70	1,442.57	1,252.80	125
9	Transportation	0.6	28,039.30	20,951.90	933.33	24.6	657.15	174.13	2,496.20	2,892.00
10	Production of foods and beverages	0.5	21,984.49	15,297.57	303.96	1,424.37	710	100.5	298.08	3,850.00
11	Tourism	0.4	18,870.70	13,028.04	1,490.23	1,637.36	486.7	1,365.63	491.34	371.4
12	Culture, education, science, and printing	0.3	14,683.80	10,656.24	12.99	391.47	67	5.06	3,495.61	60.48
13	Agriculture, animal husbundry	0.3	14,813.78	9,305.76	2,787.10	362.6	208.43	1,242.38	504.15	403.36

14	Health and beauty services	0.3	12,491.40	4,011.72	56.3	5.25	395	101	430.12	7,492.00
15	Furniture production	0.1	5,886.75	5,400.63	22	14.15	81.3	335.06		33.6
16	Energy	0.1	5,515.80	5,415.32	100.48					
17	Community service	0.1	2,803.29	2,474.73	33.19	162.5		49.8		83.07
18	Jewelry and gifts	0.1	2,648.18	1,224.43	1,353.75		70			
19	electric appliances manufacturing	0	1,809.20	1,615.02	194.18					
20	Houseware production	0	1,432.50	1,411.50		3	18			
	FDI-by Sector's TOTAL	100	4,840,318.65	1,120,894.91	316,839.28	366,545.59	499,962.11	708,922.55	801,158.33	1,026,995.88

Figure 2: SOURCE: National Statistical Council of Mongolia 2010

Mongolian authorities state that their goal is to establish a private sector-led, export-oriented economy that will support rapid economic growth. They believe that FDI will play a vital role in facilitating such a transformation, and in achieving a more sustainable pattern of economic growth. To this end, the Government has undertaken a series of political and economic reforms designed to promote FDI. A central aspect of this policy is the mass privatization of state-owned enterprises. Driven by Mongolia's staggering mineral wealth, the nation is entering what some are calling a mineral resource 'supercycle'. The development of two large resource extraction projects (Oyu Tolgoi and Tavan Tolgoi) has brought global attention to this still underdeveloped nation and an incredible economic trajectory that saw the MNT become the second best performing currency against the US\$ in 2010 and predicted double digit GDP growth set to outpace all emerging and most established markets.

### 3.2: COUNTRY SPECIFIC

**China:** As the neighboring to Mongolia country, China's investment in Mongolia is higher than other countries investment by value and number of companies registered. But average value per an investment is lower. Chinese FDI covers nearly all sectors; primary agro-processing, trade and service and etc. China is currently the leading source of FDI as measured by both amount of investment and number of companies. Chinese FDI growth occurs in such sectors as geology-mining (\$US259 million), trade and catering service (\$US122.7 million), engineering construction, construction materials (\$US32.4 million), and light industry (\$US23.8 million).

**Russia:** Compared with China, Russian's investment not so high as what might be expected relying on the former wide relationship with Mongolia. But due to existing Russian Federation's legislation on outflow investment which request complicated procedures and screening investment projects, not much investment were introduced from Russia to Mongolia date. But on the former collaboration in geological prospecting, Russian FDI in mining sector is higher. Recent FDI from Russia has been significant in such sectors as geology-mining (\$US9.2 million), construction and construction materials (\$US5.5 million), banking and financial services (\$US4.1 million), and the food industry (\$US 4million). In banking and financial services, investment in the Chingis Khaan bank is significant.

**Republic of Korea:** South Korea's contribution in FDI in Mongolia is growing up rapidly during last 2-3 years, and recently reached 61 million USD, overcoming Japanese investors' share. South Korea's FDI in communication sector is competing with Japanese one on mobile phone operator service activities allowing getting down its service charge and upgrading quality. FDI from the Republic of Korea has been increasing year-by-year, with involvement in various industrial and service sectors, including geology-mining (\$US13 million), light industry (\$US6.7 million), transportation (\$US5.7million), and engineering, construction and construction materials (\$US4.6 million).

**Japan:** The Japanese contribution to FDI in Mongolia is around \$50 million, with continuous investment growth during 1993-2000 (see Table 1). FDI from Japanese investors has been focused particularly in the following sectors: light industry (\$US28.1 million), telecommunications (\$US8.1 million), trade and catering services (\$US3.1 million), and processing of animal origin raw materials (\$US1.8 million). The FDI contributions of Mongolia-Japanese Buyan Holdings and Sunshiroh JVCs in light industry are significant. The presence in Mongolia of branches of Japanese companies, such as Itochu, Sumitomo, Marubeni, Nissho Iwai, Osaka Cashmere, Mitsubishi and others, may have influenced this growth. Japanese FDI covers the light industry,

telecommunications, culture, education, science and media, trade and catering services, processing raw materials of animal origin, and transportation sectors. In comparison with other countries, Japanese FDI is significant in the telecommunications and light industry sectors (see Tables 2-4, FDI by countries in certain sectors). The Japanese companies Sanshiro, Buyan Holdings, T&I, Mana, Tuya, and STM International are active in cashmere processing, Hasabe International, Sansar Bridge, and Sararo are involved in the hotel and restaurant services sector, Jiguur and Daisogen are active in the tourism sector, Soyol Erdem and Nakhia have a presence in education, and Tavan Bogd is involved in the trade and service fields. Monnis-autoservice, JM Internet motors and other companies are engaged in the trading of Japanese cars. The two Japanese incorporated companies Mobicom and Buyan Holdings, are listed in the top 10 foreign investors in Mongolia. The Japanese share of FDI in the telecommunications sector is around 50%. In the telecommunications sector, the most successful foreign incorporated company is the Mongolian-Japanese company "Mobicom" JVC.

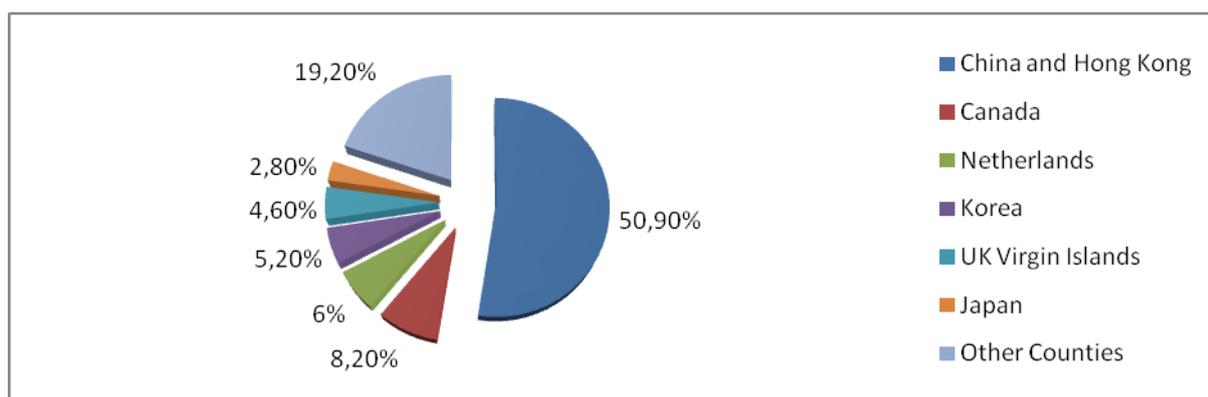


Figure 3: The proportion of FDI by various countries

#### Part 4: Result determinant factors of foreign direct investment in Mongolia

Previous researchers have identified quite a few determinants for the location of FDI. In their study on state characteristics and the location of FDI within the US, Coughlin et al. (1991)

In general there are at least nine different approaches to factors that lead to FDI locating to different countries. However in Mongolia the following have been factors of FDI growth. These are:

(1) ownership advantages as determinants of FDI (including monopolistic advantage and internalization theory) based on imperfect competition models and the view that MNEs are firms with market power (Hymer, 1960, Caves, 1971 and Buckley and Casson, 1976);

(2) policy variables as determinants of FDI when FDI is seen as the result of a bargaining process between Multinationals and Governments (Barrel and Pain, 1996);

(3) determinants of FDI according to the diversified FDI and risk diversification model (Hanson et al, 2001, Grossman and Helpman, 2002);

(4) determinants of FDI based on competitiveness and agglomeration effects (Gugler and Brunner, 2007) Assume that a foreign firm will choose to invest in a particular state if and only if doing so will maximize profit. The FDI in a particular state depends on the levels of its characteristics that affect profits relative to the levels of these characteristics in the other states. They identify state land area, per capita income, agglomeration, labor market conditions (wage rates, the degree of unionization, the unemployment rate), transportation network, taxes, and the state expenditures to attract FDI as the determinants of FDI across the states within the US. Per capita income and densities of manufacturing activities affect market demand that, in turn, affects the revenue. State land area, labor market conditions, transportation network, taxes and expenditures to attract FDI affect the cost. Their results indicate that states with higher per capita incomes and higher densities of manufacturing activities attract relatively more FDI. In addition, higher wages deter FDI, while higher unemployment rates attract it. Overall, higher taxes deter FDI; more extensive transportation infrastructures and larger promotional expenditures are associated with higher FDI. Similarly, Bagchi-Sen and Wheeler (1989) find that population size, population growth, and per capita retail sales are important determinants of the spatial distribution of FDI among metropolitan areas in the US. Friedman et al. (1996) find that market

potential, wage, skilled labor measured by per capita number of scientists and engineers, construction cost, major port, and funds spent on attracting FDI have significant impact on the location of foreign branch plants in the US. Braunerhjelm and Svensson (1996) further show that agglomeration, exports, and R&D are important factors affecting Swedish MNCs' FDI location. Mody and Srinivasan (1998) find that during the 1980s, US and Japanese multinationals were attracted by some similar country characteristics like low wage inflation, low country risk, good infrastructure, and an educated work force. Both groups of investors were also strongly attracted to locations with significant past investment.

#### Part 5: SUMMARY AND POLICY SUGGESTIONS

**SUMMARY:** From the study, it appears that much of the FDI in Mongolia is mainly concentrated in the Geological prospecting, oil exploration, Mining, trade and services sectors. This is a good sign since the Mining sector in Mongolia has stagnated for a very long period due to lack of competitiveness. Introducing FDI in this sector has potential to not only create more linkages with the rest of the economy but also will assist domestic firms to improve on their competitiveness among other benefits. The dominance of these firms' products in the market suggests that FDI has potential of operating as monopolies which could be harmful. However, due to liberalization of the Mongolian market this could potentially attract other firms in to these segments to take advantage of the abnormal profits enjoyed. FDI plays a very crucial role in the economic growth of Mongolia. However, inefficient guidelines and corruption result into increased cost of FDI's operating in the country. The government has tried so much to make it easier for the FDI's to operate in Mongolia. This paper was aimed at analyzing what the government has done to improve FDI climate. In conclusion, this study entailed a firm survey of FDI firms in Mongolia for the period 2007. Drawing from a sample of 130 foreign firms spread out in three sectors the study sought to identify the FDI determinants in Mongolia. The study findings suggest most of the FDI in Mongolia is market seeking and is export oriented. The main FDI determinants in Mongolia are market size, political and economic stability, bilateral trade agreements and a favorable climate. The three main impediments that the Mongolia government must address in order to attract FDI are political instability, crime and insecurity and institutional factors.

#### POLICY SUGGESTIONS

- Mongolia as a nation needs to strengthen its membership in various international trade blocks to be able to negotiate effectively on matters of their economic development
- There is need for institutional reforms, financial sector reforms, political reforms that will assist the country to realize its full potential
  - provide general education and a good infrastructure; streamline entry procedures; reduce (non)-tariff barriers to trade; and reduce transaction costs (and corruption) wherever they are too high
  - requires improvements in its legal framework, finance and loans system (e.g. in financing start-ups and expanding firms), communications and transport to help future investment and economic growth. It needs a long-term strategy to coordinate economic policy, together with strong information and marketing operations

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**Факторы, способствующие прямым иностранным инвестициям в Монголии**<sup>1</sup>Ариунзул Джавзандордж<sup>2</sup>Лу Де Хун

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**Аннотация.** С 1980-х годов, глобализация привела к быстрому увеличению роста прямых иностранных инвестиций (ПИИ) во всем мире. Монголия для более чем десяти лет была в процессе радикальной трансформации и предприняла значительные шаги по созданию рыночной структуры экономики. Прямые иностранные инвестиции играют очень важную роль в достижении быстрого экономического роста в развивающихся странах. Это может быть достигнуто за счет использования доступных мобилизации внутренних сбережений, иностранного капитала, передачи технологий, создания новых помещений и благоприятной внешней политики в настоящее время широко признается, что ПИИ имеет потенциальные выгоды, которые можно извлечь для развивающихся стран. Эта точка зрения основывается главным образом на неолиберальной и развития экономистов. Они полагают, что прямые иностранные инвестиции имеют решающее значение для экономического роста, поскольку он обеспечивает столь необходимый капитал для инвестирования, повышает конкуренцию в экономике принимающих стран, а также помогает местным фирмам стать более продуктивным путем принятия более эффективных технологий или путем инвестирования в человеческий или физический капитал. ПИИ также сказал, чтобы способствовать росту существенным образом потому, что это более стабильный, чем другие формы потоков капитала. В работе исследуются основные факторы прямых иностранных инвестиций (ПИИ) в Монголии.

**Ключевые слова:** прямые иностранные инвестиции; рост ВВП; факторы; секторов.