Economic Policy Reform and Competitiveness Project

POLICY BRIEF: PUBLIC DEBT, THE ENERGY SECTOR AND PRIVATE INVESTMENT

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Issue Background

Mongolia's total public debt approaches the level of GDP (estimated at $1.3 Billion for 2004). Of this, nearly half is attributable to the energy sector and more loans continue to be procured from international agencies. Most of the loans are on concessionary terms. During the early stages of transition, these loans and emergency donor funding literally prevented much of Mongolia from "freezing in the dark." Now that emergency conditions prevailing during early transition years are no longer present, it is time to take a hard look at options other than further country indebtedness as a means to improve the service delivery of energy for Mongolia at competitive rates.

As grace periods for energy loans are coming to an end repayment of principal and interest will become an additional burden on the state budget and a serious drag on energy companies. More loans will also further deteriorate Mongolia's sovereign risk rating and overall country risk profile. While Mongolia's political risk rating is classified as low, investors and risk rating services have assigned Mongolia a *very high risk* classification on:

- Foreign debt as a percentage of GDP
- International liquidity, as months of import cover
- Budget deficit as a percentage of GDP
- Current account balance as a percentage of GDP

The "very high" financial and economic country risk ratings given to Mongolia translates into a higher country premium: higher cost of borrowing for the GoM—if and when Mongolia accesses international debt markets—and a higher premium demanded by international investors when investing in Mongolia. Simply put, higher risk means higher costs for Mongolia. For example, the effect of reducing country risk premium by 100 basis points (one per cent) on a 30-year $50m investment would lower the cost of capital by almost $9.8m. Global investors tend to prefer countries with lower risk premiums.

Under these macroeconomic constraints, capital investment requirements for improving the quality and coverage of service delivery in the energy sector in Mongolia cannot be satisfied through public sector borrowing. Instead, the state needs to focus on developing the right framework of incentives for attracting foreign and domestic private investment in the sector to:

- Reduce country debt and debt service burden and overall country risk ratings
- Reduce the size of the state relative to the economy, shifting from "producer" to "regulator" in the energy sector
- Improve the technological and operational efficiency of energy sector enterprises
- Mitigate environmental impacts.

Recommendations

The policy agenda for the energy sector should pursue the following objectives:

1. Shift from public debt financing of the capital investment requirements of the sector to private sector financing of these needs to improve the coverage and quality of service delivery, attract foreign direct investment in the sector, reduce the size of the state, and shift its role from producer to regulator
2. Enact a Concession Law to attract private domestic and foreign investment for infrastructure financing in energy and other sectors as a lower risk alternative to outright asset sales
3. Perform an overall "country due diligence" from a foreign investor's point of view by revising laws and regulations as necessary to reduce foreign investors' risk perceptions, enact changes and publicize these broadly through appropriate channels and targeted "investors' road shows"
4. Concerted efforts around macroeconomic policies aimed at reducing the fiscal budget deficit, foreign debt, improving international liquidity, and current account balances to improve overall country risk ratings and thus reduce the country risk premium that foreign investors would demand for investments in the sector, i.e., get a better deal for Mongolia
5. A moratorium on public loans for the sector to reduce fiscal drag and a transparent process of privatization with ample lead times and involvement of competent investment bankers to attract world class operators.

Sources

For a detailed discussion of Mongolia's country risk assessments and comparisons see EPRC's report "Country risk and country risk premium estimation for Mongolia." Ulaanbaatar: August 2004.
For an investor's point of view on privatization see EPRC's PowerPoint presentation on "Privatization: The investor's point of view." Ulaanbaatar: April 2004.