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Author(s): Li Narangoa

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“Mongolian leaders have decided the nation must find ways to take care of itself, rather than rely on its neighbors.”

Mongolia Searches for Breathing Room

LI NARANGO

Sandwiched between Russia and China, Mongolia has long been dominated by the two giants that surround it. Indeed, for most of the past four centuries, the choice between its neighbors' influence has been an either-or proposition. With the brief exception of Japan's intervention on the Asian mainland during World War II, there were no external powers that Mongolia could conceivably approach to soften the harsh Russia-China alternative. In recent years, though, the situation has changed dramatically. For the first time in modern history, Mongolia has asserted its sovereign right to engage in numerous bilateral relationships outside the old Russia-China dynamic, focusing on both strategic affairs and economics. In 2013 alone, the nation signed 63 bilateral and international agreements.

This diplomatic success can be attributed in part to Mongolia's active foreign policy, but more importantly to its mineral resources: The country is resource-rich, yet lacks infrastructure and industrial development. To develop its mining industry, Mongolia has had to rely on foreign investment. Even as it gains confidence in the broader international arena, Mongolia continues to depend economically on its two neighbors—particularly on China's demand for raw materials and on Russia's energy resources. Relations with both countries remain sensitive as a result.

Although most observers consider Mongolia's democracy a success, its political institutions still lack transparency and efficiency, and corruption is a growing concern. The three essential elements for the nation's economic development are a stable and predictable political framework, continued foreign investment, and access to markets and energy. These goals, coupled with recent

historical memory, drive political decision making in Mongolia.

ONCE AN EMPIRE

The Mongol empire of the thirteenth century was the largest land empire in world history. One of its most important legacies was to unify parts of the region into what are now Russia and China. Ironically, the Mongols themselves were fragmented between these two behemoths that they had created, and in recent centuries ended up aligned with or subordinated to their neighbors. Early in the twentieth century, the Mongols attempted to build a unified state, but in vain. The 1915 Kyakhta Treaty put Mongolia under Chinese suzerainty and destroyed the dream of a greater Mongolian state that would include Inner Mongolia. Later, however, rivalry between Russia and China offered an opportunity to create the modern state north of the Gobi Desert. Mongolia was protected by the Soviets, who conceded China's rule over Inner Mongolia, south of the Gobi Desert. Although the Mongolian People's Republic was recognized as a sovereign country, the Soviets strongly influenced its foreign policy. It was thus considered a Soviet satellite state until the end of the Cold War.

Since then, Mongolia has been determined to claim its full sovereign rights. It introduced a democratic multiparty political system and adopted a new constitution and national security laws accordingly in 1992. Learning from its past dependence on its giant neighbors, it began promoting an active foreign policy, called the Third Neighbor Policy, which rests on seeking substantive ties with other countries. Mongolia has been successful in gaining friends as “Third Neighbors” across the world, partly due to its new democratic political system, but also thanks to its underground resources.

LI NARANGO is a professor at the Australian National University's College of Asia and the Pacific.

The most important of the Third Neighbors are Japan, South Korea, Canada, Australia, Turkey, Germany, and the United States. Despite this vigorous diplomacy, relations with the two immediate neighbors have not been neglected. China is Mongolia's biggest trading and investment partner, and Russia is the biggest energy supplier for the growing domestic mining industry. The trade volume between Mongolia and China in 2013 was about \$5.4 billion, or 51 percent of Mongolia's total foreign trade of \$10.5 billion. In the same year, Mongolia imported 700,000 tons of crude oil from Russia, equal to 54 percent of its total domestic consumption.

LOVE-HATE WITH CHINA

Mongolia's current engagement with China can be characterized as a love-hate relationship. Politicians and businesspeople recognize the importance of the Chinese market and investments in Mongolia, and thus promote a closer relationship, while remaining cautious about overreliance. The two nations in 2011 upgraded their ties to a "strategic partnership," providing for extensive collaboration. In October 2013, Mongolian Prime Minister Norov Altankhuyag and Chinese President Xi Jinping signed a protocol to deepen this partnership. But the general public has quite a different opinion. Many Mongols feel threatened by China, in terms of the economy as well as national security.

China is the biggest market for Mongolian mining products. According to the Mongolian National Statistics Office, export earnings totaled \$4.27 billion in 2013, and 87 percent came from Chinese markets. Minerals like copper, coal, and gold represented 81 percent of Mongolia's total exports and 30 percent of GDP. Recently, leaders of both countries have suggested increasing the annual two-way trade volume to \$10 billion. Closer economic collaborations, frequent trust-building exchanges, and high-level state visits have taken place. Over 5,000 Chinese companies are active in Mongolia, and more than 8,000 Mongolian students are studying in China.

In the past 20 years, China's growing economy has provided Mongolia with significant opportunities. China accounts for about 50 percent of the coal consumed in the world, while Mongolia is

becoming one of the world's mining giants. Most of the big mining sites, such as Tavan Tolgoi and Oyu Tolgoi, are located in South Gobi within 200 kilometers of the Chinese border, so transport is cheap. However, China's appetite for coal and gold, as well as the close geographical proximity, also brings new challenges for Mongolia—particularly, how to control illicit markets for these products, and illegal migration across the border. Another issue is how to balance trade and investment so that Mongolia does not risk becoming vulnerable to possible political and economic changes in China.

Drawing on past experiences with China, Mongolian politicians have become ever more calculating and pragmatic in their dealings. Strategic collaboration with Beijing is driven by an economic rationale: Chinese investment and markets are essential for developing the mining industry, the lifeline of the national economy. Yet this priority appears to be at odds with Mongolia's own national security. Political opponents often debate the economic rationale versus the risk of excessive

Chinese influence. All seem to agree that the Mongolian economy should not be too dependent on China.

GAUGING DEPENDENCE

A recent debate about whether to build a broad- or narrow-gauge railway reflects this dilemma well. Mongolia does not have direct access to a seaport. To transport products overseas from the mines in South Gobi, Mongolia has to link its railway either with the Chinese network to the south or with the Russian one to the east. China has a narrow-gauge system, the type used most in the world, while Russia uses the broad-gauge system. Following extensive debate, in 2010 the decision was made in favor of the more expensive broad-gauge railway extension to Russia, rather than a more economically beneficial narrow-gauge link to China for transporting Mongolia's mining products.

Reaching Far Eastern Russian seaports costs much more not only because the distance is greater, but also because a broad-gauge railway is more expensive to build and operate. In terms of both cost and economic benefit, a narrow-gauge line linking to the Chinese port near Tianjin would have been the natural choice. Moreover, building a narrow-gauge railway might help

*Mongolia has had to pay
a price for asserting
its independence.*

reduce Russian dominance of Mongolia's railway transport. Russia currently owns 50 percent of Mongolia's rail system, and the two countries alternate the system's chairmanship, meaning that Mongolia has to negotiate with Moscow over whatever changes it wants to make to the existing railways. Even so, Mongolia's leaders chose the broad-gauge link to Russia's Far East because they wanted a route to the sea that did not go through China.

The debate, however, did not stop with that decision. Following Mongolia's economic downturn in the past few years, some business and political leaders have begun looking into the possibility of building narrow-gauge railways to link the mines with China. Recently, the government submitted a bill to the parliament to build a narrow-gauge railroad connecting the border towns of Gashuun Sukhait in Mongolia and Gants Mod in China as a means of stimulating trade. This would not only shorten the transport time but also reduce costs, because reloading goods from a broad-gauge to a narrow-gauge train is quite expensive.

An anti-narrow-gauge group, represented by a former minister of infrastructure, Battulga Khaltmaa, has campaigned against the bill, considering it a threat to national security. Battulga has even called narrow-gauge rail supporters "traitors." In a documentary television program he accused government leaders of selling their country to China by making the Mongolian economy fully dependent on it, and alleged that Beijing has a long-term strategy to take over Mongolia. Chinese workers, he said, would come to build the railroad, but they would build their industrial facilities outside Mongolia. The broadcast was hugely successful, and there was a wave of support for his argument.

The general public, as a result, is divided. Battulga has said he will lead demonstrations if the legislation passes. President Tsakhiagiin Elbegdorj met with him at the end of June and urged him not to destabilize Mongolia's political and social environment.

Historical memory is still fresh. Mongolians fear losing their sovereign rights, while Chinese mourn the loss of Mongolia's territory. Russia's annexation of Crimea through a March 2014 referendum aroused populist Chinese sentiment,

causing many to remember that China had recognized the independence of Mongolia in 1945 on the basis of a referendum there. A map of China along with an outline of Mongolia highlighted on China's northern border was retweeted on Twitter more than 15,000 times within four days in May 2014. The Chinese individual who posted the map stated: "Crimea has broken away from Ukraine through a referendum, and there are still some among you who applaud this? Or don't you know? In October 1945, the Soviet Union also encouraged northern Mongolia to hold a referendum, and with less than 50,000 voting participants, ripped away 15 percent of China's sovereign territory." This kind of talk only strengthens fear of China among many Mongolians.

RUSSIA REGRETS

Relations with Russia are also sensitive, but less fraught. Mongolia lacks the energy resources needed to develop its abundant mining potential, and therefore relies heavily on

Russia for energy. Ninety-five percent of its diesel and petroleum and ninety percent of its electrical power come from Russian sources. Mongolia has been looking to diversify its energy resources by

purchasing oil from Kazakhstan, as well as searching for oil and gas fields within its own territory and adopting a strategy for renewable energy. At the same time, Mongolia has hoped to benefit from the energy trade between its neighbors by serving as a transit point for Russian gas and oil exports to China, though this hope has yet to be realized.

Deciding to use broad-gauge railroads to gain access to Russian seaports does not mean that Mongolia is leaning back toward the Russians. This was a careful geostrategic calculation aimed at developing multiple transport options. Mongolia's relations with Russia are not as complicated as they are with China—there is no Russian historical claim over Mongolian territory—but nearly 70 years of Russian political dominance have left a strong imprint in the memory of both countries. Although Mongolia has increasingly gained economic and political independence (most importantly with its multiparty democratic political system), Moscow

Mongolia's political institutions still lack transparency and efficiency, and corruption is a growing concern.

has been slow to recognize these changes. After all, the Soviet Union helped start the Mongolian mining industry in the 1970s, and was the country's major trade partner.

Several independent (and rational) decisions by Mongolia in recent years have disappointed Moscow. Russia, for example, had expected to be awarded the contract to develop mining at Oyu Tolgoi; also, the Russian railway company would have been involved in building a railroad connecting the trans-Mongolian line and mining sites. Instead, the Oyu Tolgoi contract was given to the Canadian Ivanhoe Mine Corporation in 2009—and no railway was built.

Having lost on Oyu Tolgoi, Russia was counting on the contract for the big coal mine at Tavan Tolgoi. To ensure that Mongolia would give it special consideration, Russia canceled 97.8 percent of \$172 million in recent Mongolian debt, on top of having written off the massive Soviet-era debt. While Russia was expecting half the spoils, the Tavan Tolgoi contract in July 2011 was split among three bidders: the Russian railroad, China's Shenhua, and US-based Peabody Energy. Moscow may have misread Mongolia's political landscape and bid on the wrong players. Just as impor-

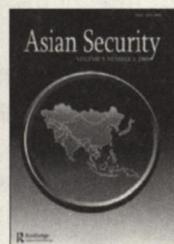
tant, Russia has not gotten over its old image of Mongolia as a pliable client.

NO DEAL

Mongolia has had to pay a price for asserting its independence, and has also been equally disappointed by its neighbors. For the past decade or so, the country has been trying to convince its two neighbors to transport gas from Russia to China through its interior, arguing this would be a shorter route and more cost-effective overall. For Mongolia there is the prospect of using a share of the gas and receiving transit fees. In May 2014, however, Moscow and Beijing signed a 30-year, \$400 billion deal for Gazprom to deliver Russian gas to China, without going through Mongolia. From Russia's point of view, the route through Mongolia may have been shorter, but negotiating conditions with a third partner would have taken time, and both parties wanted to go ahead with the plan as soon as possible.

Additionally, just as Mongolia is trying to diversify its coal exports, the Russian government wants to open new energy markets to avoid dependency on Europe, which receives nearly a third of its gas from Russia. From the Kremlin's point of view,

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the Western market appears to be unstable, given tensions over the Ukraine crisis and the European Union and America's resort to economic sanctions. For China the tensions between the West and Russia provided an auspicious occasion to strike a gas bargain with Russia. For both parties, moreover, transit through Mongolia might have brought unnecessary uncertainty in the future.

The gas pipeline was not the first time—nor is it likely to be the last—that Mongolia has lost out on a transit arrangement. In 2000, Russia and China signed an agreement to establish an oil pipeline from Siberia to China via Mongolia. But the project was dropped when Moscow opted for an eastbound Eastern Siberia–Pacific Ocean oil pipeline from Taishet to Nakhodka, with an offshoot to China's northeast.

A new possibility emerged this year when Russia decided to gradually shift westbound oil flows toward Asia, due to the tensions with the West over Ukraine. Russia exports about 16 percent of its crude oil to Asian markets. By 2035 it aims to double that share to a third, but these plans require increasing the pipeline capacity to Asia. In this context, the Russian oil giant Transneft seemed to be reexploring the idea of establishing an oil pipeline through Mongolia to China. Again, however, the option was dropped—this time in favor of a Russian government deal in June 2014 to swap oil with Kazakhstan. Under this deal, Kazakhstan will send oil to China through an existing pipeline, and Russia will transfer the same amount and the same quality of oil to Kazakhstan. There will be no cost for replacing the oil. This move is obviously a more cost-effective way of delivering oil to China. But once more, Mongolia has been left out. China and Russia do not seem to see it as a reliable partner.

In Mongolia, public reaction to the pipeline disappointments has been mixed. Some say the country has lost economic benefits because its Third Neighbor policy upset its immediate neighbors, especially the Russians. Some suggest it is actually a good thing for Mongolia to avoid overly friendly relations with China and Russia, while others lament the lost opportunities as proof that the country will always be given the lowest priority when Russia and China deal with each other. Some accept this as a reality—that the giant

neighbors will never consider Mongolia's national interest.

In any case, Mongolian leaders have decided the nation must find ways to take care of itself, rather than rely on its neighbors. They know that Mongolia needs to diversify its energy supply. The government has been trying to find alternative energy sources and to extract Mongolia's own gas and oil, hoping to become self-sufficient in fossil fuels by 2020. The parliament approved the National Renewable Energy Program in 2005 and the Renewable Energy Law in 2007 to promote wider use of alternatives. There are considerable reserves of renewable energy resources (solar, wind, and hydro), and electrical power has also been expanded.

Mongolia has five coal-powered plants, and a consortium of POSCO Energy of South Korea, GDF Suez of France, Sojitz of Japan, and Mongolia's Newcom Group plans to start building another power plant to further supply the country's electricity needs. The project will start in 2015 and be completed by 2019, and is expected to generate 450 megawatts annually. The US Energy Information Administration estimates that Mongolia has 3.24 billion barrels of recoverable shale oil resources; New Jersey-based Genie Energy signed a contract

Mongolia has asserted its right to engage in bilateral relationships outside the old Russia-China dynamic.

in 2013 to explore for deposits in the central part of the country. Mongolia is also exploring coal-to-gas or liquid projects involving Chinese and South Korean as well as domestic companies. The government is planning to build a refinery in the southeast, and in July 2014 the parliament passed a new petroleum law to increase investment in extraction. The Ministry of Mining, the Petroleum Authority, and Minex Mongolia Company are hosting an international investment conference on exploring for Mongolian oil and oil shale in September 2014 in Ulaanbaatar, the capital. However, extraction of energy from oil shale appears not to be very cost-effective, and can be environmentally harmful.

INEFFICIENT INSTITUTIONS

The nation's economic growth has been slowing in the past couple of years, but this slowdown is relative to its earlier overheated growth; GDP is still expanding at a two-digit pace. (Growth fell to 11.7 percent in 2013 from 12.4 percent in 2012.)

According to the Bank of Mongolia, GDP per capita last year reached an all-time high of \$1,796. Even so, foreign investment fell 54 percent in 2013, the inflation rate stood at 13.7 percent in May 2014, and the currency has been depreciating fast. The leadership has been panicking about the slowdown and thinks the reason behind it is the decline in foreign investment. The government has been taking active measures to stimulate growth, including embarking in May 2014 on a 100-day initiative incorporating projects to boost infrastructure, mining, manufacturing, tourism, and the development of small- and medium-sized businesses. It is also revisiting laws enacted during the first decade of this century to curb environmental damage and corruption, given the possibility that these laws have affected investor confidence.

The 100-day program showed few if any visible effects. Despite the growth of the past few years, 35 percent of Mongolia's population still live below the poverty threshold. About 750,000 people inhabit the *ger* (yurt) district in the outskirts of Ulaanbaatar with no adequate water supply or sanitary facilities. The social welfare system has still not returned to levels provided in the pre-democratic reform period. Mining income has not yet been effectively channeled to the welfare system, and social inequality has been increasing.

Recently enacted mining law amendments will increase the area available for mining and exploration to 20 percent of the nation's land, from around 8 percent, and extend the period of exploration from nine years to twelve. Also, a June 2010 suspension of new exploration licenses has been lifted. Officials say these changes could lead to \$1 billion in new investment over the remainder of 2014. Still, it is ironic that the current government, which won the 2012 election by appealing to popular resource nationalism and environmental sustainability, has retreated from this position and now promotes mining by foreign investors.

As the Mongolian columnist Jargalsaikhan Dambadarjaa has pointed out, inefficient political institutions have been the principal cause of the country's economic slowdown. The Democratic Party won the election in 2012, but did not secure a majority of seats in the parliament. As a result, it had to form a coalition government with two small populist parties, and this has made the political environment less stable. The legislative framework is also uncertain, as old laws are frequently amended and new laws issued. Corruption is still prevalent, despite new measures to reduce it.

Political institutions are lacking in transparency, efficiency, and credibility.

ENVIRONMENTAL PERIL

Relationships in the region remain sensitive and complicated. Notwithstanding official talk about regional collaboration and security, all three countries act in their national economic and strategic interests, and often fail to consider the security of the region's people and environment. Mongolia's choice to build the broad-gauge railway to transport coal through Russia, as well as the Russian-Chinese decisions to build gas and oil pipelines that detour to avoid Mongolia, will increase carbon emissions in the region. Most residents in the capital city heat their homes with raw coal, the primary source of the air pollution that has made Ulaanbaatar the world's second-most polluted city, according to a 2011 report by the World Health Organization. Gas or oil heating not only would improve residents' health; it would also reduce the emissions of coal-hauling trucks and trains, and thus benefit broader regional air quality. Had Russian-Chinese gas and oil pipelines been built through Mongolia, that also could have helped reduce air pollution by reducing the use of raw coal as heating fuel.

Moreover, the Russian-Chinese pipeline through Altai goes over a narrow, 50-kilometer section of the border between Russia and China, in an area that is home to the Golden Mountains

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"China's environmental challenges may be the single most powerful determinant of whether the government can maintain its fragile legitimacy and stability.... Officials must continue to raise living standards—by making China the manufacturing hub of the planet—while at the same time addressing citizens' fury at the government's apparent inability to curb the pollution choking the country."

Judith Shapiro

"The Evolving Tactics of China's
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of the Altai World Heritage Property. The trans-boundary biosphere reserves provide habitat for many rare and iconic species, such as the endangered snow leopard. Yet developers failed to listen to environmentalists, seeing only the economic incentives.

Mongolia's unstable economic policies and regulations with regard to foreign investors, coupled with inefficient political institutions, have slowed mining-sector development and economic growth as a whole. The economy remains extremely dependent on the mining sector. Diversification is vital for the economy's long-term sustainability and for Mongolia's national security. Although GDP per capita reached an all-time high in 2013, it is still equivalent to only 15 percent of the world's average.

The recent revision of mining law aims to revive declining foreign investment, but it could prove counterproductive if the government does not provide a stable and predictable political framework, as well as efficient political institutions. Increasing

the area where mining is permitted to 20 percent of the land may energize the environmentalist movement and increase resource nationalism in the future, if not sooner. Extracting oil from oil shale may help the energy supply, but the financial and environmental costs could be considerable.

In many ways, Mongolia cannot escape the historical and geographical quandary of being sandwiched between giant neighbors. The resource boom has brought new dilemmas for its young democracy. In an effort to reduce its dependence on Russia and China, the country has sought to diversify diplomatic relations, energy supplies, and (to a lesser extent) its economy. It has gained many friends by introducing a democratic political system, and today neither China nor Russia can exert political pressure on Mongolia as each once did. Indeed, both have gradually recognized Mongolia's political and economic independence. Yet the historical memory of long subordination to the neighbors continues to overshadow Mongolian development. ■