



Policy Brief

On Foreign Investment Absorption Capacity in Mongolia: A Macroeconomic Assessment

By
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Highlights

- Mongolia has experienced large foreign investment inflows, averaging more than half of GDP in 2011-12 and above 10% of GDP since 2017, which drove major economic booms. However, these inflows have failed to translate into economic diversification.
- These inflows are volatile and procyclical and are associated with macroeconomic overheating during booms (high inflation, currency appreciation) and sharp contractions during busts.
- Foreign direct investment (FDI) inflows, which are the primary source of external investment, have not automatically translated into sustainable economic growth, but have instead coincided with macroeconomic volatility, budget pressures and currency appreciation, weakening the competitiveness of non-mining sectors of the economy.
- Poor absorption stems from interconnected factors: procyclical fiscal policy, limited efficiency of public investment, shortages of skilled labor, weak technology transfer, weak institutions, and a shallow financial sector.
- Solving these issues requires a wide array of reforms, including countercyclical fiscal rules, stronger public investment management, and support for non-mining sectors such as agriculture and tourism, all anchored in improved institutional and regulatory credibility.

Is Investment Absorption Capacity a Binding Constraint in Mongolia?

Mongolia has experienced episodes of large inflows of foreign investment, driven primarily by direct investment attracted by the mining sector. Yet these high levels of investment have not translated into sustained productivity growth or economic diversification. This disconnect points to binding constraints in the country's investment absorption capacity.

Empirical evidence shows that the effect of FDI on growth is often conditional on the quality of a host country's absorption capacity. A panel study of eight developing East Asian economies including Mongolia (Cao et al., 2022) found that FDI positively affects growth, and that human capital, R&D, and infrastructure strengthen this relationship only after a certain threshold is reached. A more recent panel analysis (Shah et al., 2026) shows that in developing countries, the effect of FDI becomes significantly stronger only after human capital exceeds 9.35 years of education. Further evidence (Dao & Khuc, 2026) from 87 developing countries (2001–2021) confirms that the FDI-growth relationship is conditional on host-country absorptive capacity, with economic freedom and public debt management emerging as the more significant factors.

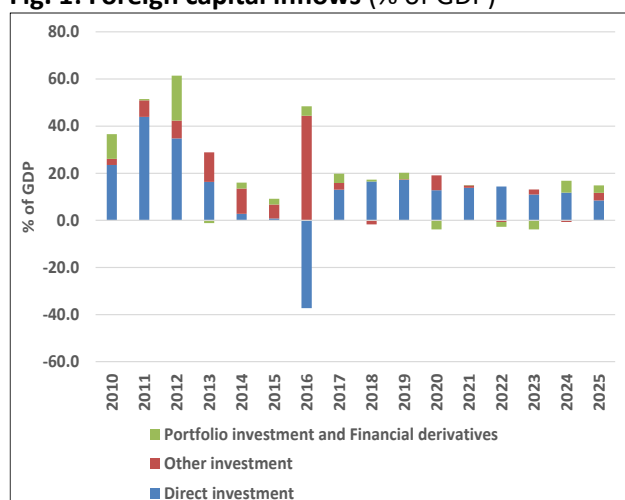
This evidence has direct implications for Mongolia. The country has historically had high levels of educational attainment, which, judged against this threshold, should provide a foundation for absorbing FDI. However, education is a necessary but not sufficient condition. Investment absorption capacity is an economy's ability to turn incoming capital into productive assets without any negative effects on economic development. It rests mainly on good macro-fiscal frameworks, well-functioning labor markets, sound institutions, the ability to adopt new knowledge, and an effective financial system. If the investment absorption capacity is strong, the country should be able to turn every extra dollar into economic growth, creating more jobs and raising economic productivity. If, however, the absorptive capacity is weak, the side effects are rising inflation,

currency appreciation and budget deficits.

Mongolia is heavily reliant on mineral-related FDI. Large capital inflows into the country's economy drive strong fiscal and investment spending. However, these inflows tend to lead to rising inflation and exchange rate pressure. They are also accompanied by surges in imports of capital goods and services, while spillovers to the non-mining sectors of the economy remain limited. As a result, Mongolia's economy remains limited in its ability to absorb capital inflows efficiently.

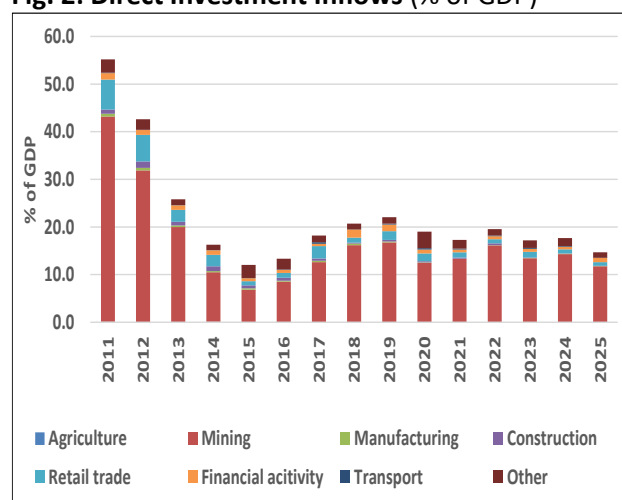
Foreign investments in Mongolia have been historically prone to large swings. For example, it peaked at 51-61% of GDP in 2011-12, dropped to 9% by 2015, rebounded to 20% in 2019, and fell to 14.7% in 2025. Throughout this period, FDI has dominated capital inflows (Fig. 1) and has tracked the construction phases of major mining projects. The surge in 2011-13 (Fig. 2) was driven by the development of Oyu Tolgoi, alongside high commodity prices. The subsequent decline in 2014-16 reflected falling commodity prices, weaker foreign demand, and changes to FDI regulation. In 2016, two distinct forces shaped Mongolia's investment picture¹. The first was regulatory: the 2012 Strategic Entities Foreign Investment Law had created prolonged uncertainty for foreign investors in strategic sectors, and although it was repealed in 2016, investor confidence had already weakened. The second was transactional: Oyu Tolgoi LLC finalized a large project financing agreement for the underground mine, with the loan drawdown recorded as a net incurrence of direct investment liabilities and the concurrent repayment of shareholder loans generating an almost equal outflow.

Fig. 1: Foreign capital inflows (% of GDP)



Source: CEIC database, authors' calculations

Fig. 2: Direct Investment Inflows (% of GDP)



Source: CEIC database, authors' calculations

In recent years, Mongolia has sought to reduce its dependence on the mining industry and has been channeling

¹ In the first graph, which reports on net foreign capital inflows, these two transactions offset each other, leaving the net result near zero and slightly negative. In the second graph, which reports gross direct investment inflows only, the project financing drawdown is captured as a positive inflow while the offsetting repayments are excluded, so the value remains positive. The analytical implication is that the divergent 2016 figures reflect both a structural decline in investor confidence driven by earlier regulatory missteps and a large financial restructuring within an existing major project. The gross inflow does not signal renewed investor interest; it reflects a single, offsetting transaction. The net figure captures the reality that foreign capital was effectively flowing out during a period of policy uncertainty

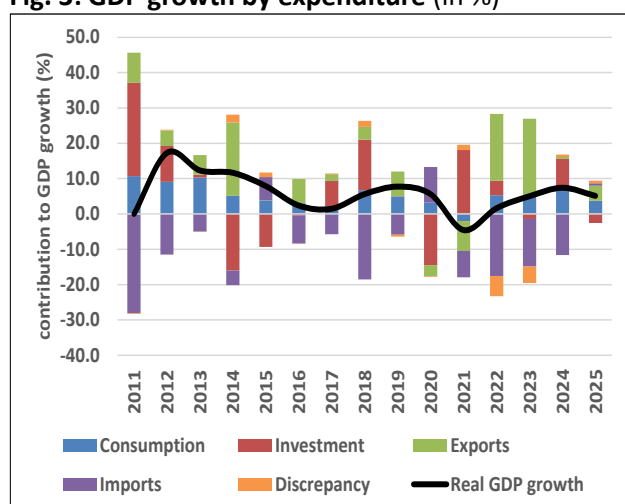
investments into other sectors of the economy, such as energy, tourism, and textile processing². However, the mining sector still accounts for about 75% of FDI inflows. By source, Mongolia's foreign investment liabilities span its two large neighbors — the PRC (13%) and Russia (1%) — as well as Japan (4%), Singapore (9%), the USA (4%), the Netherlands (48%), and other EU members. Nonetheless, foreign investments remain exposed to the usual risks, such as price swings, policy changes, and geopolitical turbulence that affect trade and investor confidence.

Key Dimensions of Absorption Capacity

Macroeconomic Capacity

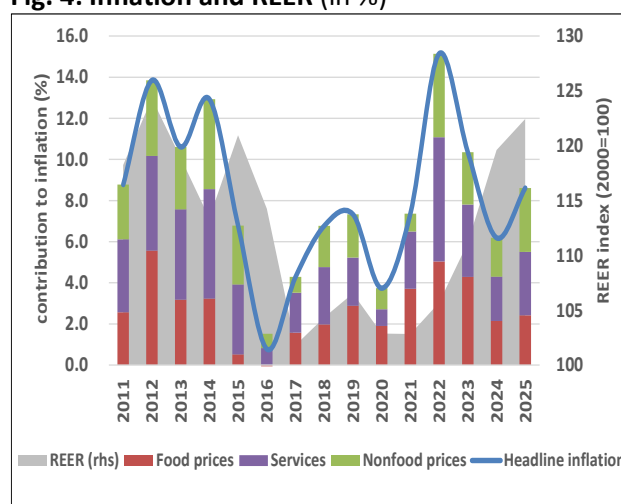
Mongolia's macroeconomic volatility reflects the economy's limited capacity to absorb large and lumpy investment inflows without overheating. Output volatility remains high, with periods of explosive growth during the construction boom of 2011–2013 (GDP growth reached 17.3% in 2011), followed by a slowdown in 2015–2016 when GDP growth fell to 1.5% in 2016. Growth then recovered over the next three years to 5.6%, 7.7%, and 5.6% in 2017–2019, respectively (Fig. 3). The COVID-19 shock in 2020 compounded vulnerabilities from the previous downturn in commodity prices. In 2023, the economy rebounded by 7.2%, driven by a surge in mining output and exports. The economy moderated in 2024 as the agricultural sector was hit by a severe winter disaster (dzud) in 2023–2024, which caused massive livestock losses (approximately 7.2 million animals, or about 11% of the national herd). Agricultural production rebounded in 2025, with output expanding 33.2% as herds recovered. This recovery, together with increased production at the Oyu Tolgoi mine, which alone accounts for approximately 17% of Mongolia's total export revenue, lifted output, leading to GDP growth of 6.9% in 2025.

Fig. 3: GDP growth by expenditure (in %)



Source: CEIC database, authors' calculations

Fig. 4: Inflation and REER (in %)



Source: CEIC database, authors' calculations

Commodity price volatility in 2025 illustrates the extent to which Mongolian economy can be affected by external shocks. The prices of the two main export commodities moved in opposite direction. Global copper

² World Bank Group (2026). Mongolia: Country Private Sector Diagnostic, September 10, 2026. Retrieved from: <https://www.worldbank.org/en/news/press-release/2026/09/10/targeted-reforms-could-unlock-new-private-investment-and-jobs-in-mongolia-s-cashme>

prices surged on average by 8.8%, while coal prices fell sharply by 17.0%. Because coal related revenues in Mongolia have a significant impact on tax revenue, total budget revenues fell from 39.1% of GDP in 2024 to 35.3% in 2025. The revenue slowdown forced the government to tighten spending and draw on the Fiscal Stability Fund. Copper exports, in contrast, in USD rose by 75%, largely offsetting the 34.8% loss of coal revenue. According to the World Bank (2025), Mongolia's macro-fiscal volatility is among the highest in the world, placing it among 14 countries with economic growth and public debt surpassing the 75th percentile worldwide. The IMF's Debt Sustainability Analysis assesses the risk of sovereign default as moderate in the near term but high over the medium to long term, reflecting how new increases in social spending and public wages deplete fiscal buffers. In an adverse scenario, exchange rate shocks and weaker commodity prices can push debt into unsustainable territory.

The economy overheats during investment booms and contracts sharply when investment slows down or commodity prices fall. Mining investment booms, accompanied by massive foreign capital inflows, have created high-paying jobs and boosted demand for housing, services, and goods in a supply-constrained economy. Competition for limited skilled labor and local resources added to wage and cost pressures. These demand-side pressures fueled inflation in 2012-14, 2018-19, and 2022 (Fig. 4). After averaging 15.1% in 2022, inflation eased but remained high at 8-10% in 2024-25, driven by robust domestic demand, increased government spending, and energy tariff hikes. Inflationary pressure also resulted in real appreciation of the local currency, which eroded the competitiveness of non-mining sectors, with the currency appreciating by over 20% (the real effective exchange rate rose by 21.2% during 2023–2025).

There is a structural gap between the design and practice of Mongolia's counter-cyclical policy. In terms of policy framework, Mongolia has done everything right. It adopted numerical fiscal rules under the Fiscal Stability Law of 2010 and has progressively built-up sovereign fund arrangements to save windfall revenues. In April 2024, Parliament passed the Law on the Sovereign Wealth Fund, consolidating the Future Heritage Fund, a Savings Fund, and a Development Fund, with the Chinggis Khaan Sovereign Wealth Fund operating entity formally established in February 2025. This institutional evolution reflects lessons from earlier failures. The Mongolian Development Fund (est. 2006) was financed by a windfall tax on copper and gold but collapsed by 2009 after its revenue base proved limited and its budget fell into imbalance. It was followed by the Human Development Fund (HDF), which distributed mining wealth through universal cash transfers. The scheme became fiscally unsustainable — the ADB³ noted HDF payments "created inflationary pressures and made the economy vulnerable to external shocks" - and was eventually replaced by the Future Heritage Fund in 2017.

However, repeated amendments to the Fiscal Stability Law, including changes to the debt ceiling and structural deficit limits, have undermined its credibility as a policy anchor. The original framework capped public debt at 40% of GDP and the structural deficit at 2%, but these ceilings were revised multiple times. These amendments were driven more by repeated non-compliance than by design flaws. The debt ceiling was raised from 40% to 60% of GDP in 2015- 2016 to accommodate increased borrowing, and the return to the original limit was postponed to 2021. The IMF in its 2025 Article IV Consultation warned that frequent changes to fiscal rules undermine their credibility as a policy anchor, because each amendment has been followed by fiscal expansion

³ ADB (2012). Rapid Economic Development Calls for Infrastructure Investments and Macroeconomic Stability. Asian Development Bank, News from Country Offices, 11 April 2012. Retrieved from: <https://www.adb.org/news/rapid-economic-development-calls-infrastructure-investments-and-macroeconomic-stability>

during booms, precisely when strict compliance with the rules is most needed.

Consequently, windfall revenues in 2021–2024 were not saved as intended. COVID-19 emergency spending was financed partly by redirecting mineral royalties away from the Wealth Fund, and this reduction in savings was later formalized through amendments to the fund's revenue rule. Government mining revenue more than doubled from 2022 to 2024, enabling a procyclical 67% increase in spending. As a result, only a small part of commodity boom revenues in 2021–2022 was saved, while budget spending increased by 14.2%, 23.6%, and 35.3% from 2022 to 2025, fueling inflation. Mongolia is not lacking in sound fiscal frameworks; what it lacks is fiscal discipline.

External Sector Capacity

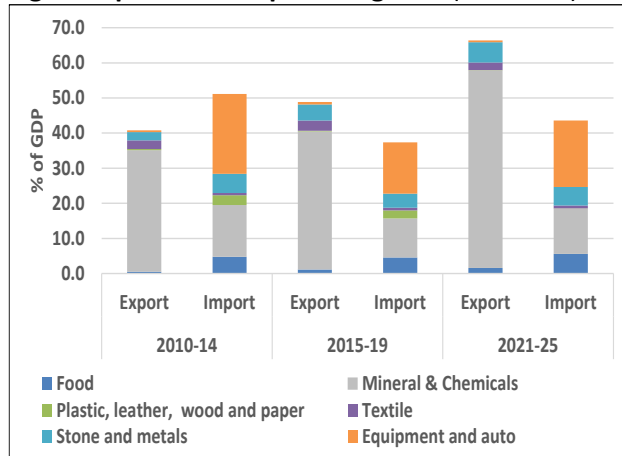
Brunei provides a lesson that bridges the fiscal and external dimensions of Mongolia's absorption problem. Brunei has maintained fiscal discipline and a well-funded sovereign wealth fund. However, over the past decade, its GDP grew only 0.7% annually, while oil and gas still account for about 75% of government revenue and almost 90% of exports⁴, and hydrocarbon reserves are projected to be depleted within 22 years⁵. The lesson for Mongolia is that savings do not guarantee diversification. A fiscal framework alone cannot convert resource wealth into durable, diversified productive capacity before the resources are exhausted. Building a diversified export structure is therefore the central challenge for strengthening external sector capacity.

Mongolia's external sector rests on a narrow export base, particularly copper, coal, and gold (Fig. 5), making foreign exchange earnings vulnerable to commodity price swings. Exports are concentrated not only in terms of products but also in a single market. China takes about 90% of Mongolia's exports and supplies about 40% of its imports, with most mining exports shipped to the PRC. Such concentration means that changes in PRC demand are transmitted directly to Mongolia's economy. A slowdown in demand or a shift in its policy may reduce both exports earnings and budget revenues. Given such narrow exports base, commodity price volatility creates this vulnerability. The narrow product base compounds this vulnerability to commodity price volatility. For instance, in 2025, a 20% decrease in coal prices offset an 8.8% increase in copper prices, leaving export growth at 0% for that year.

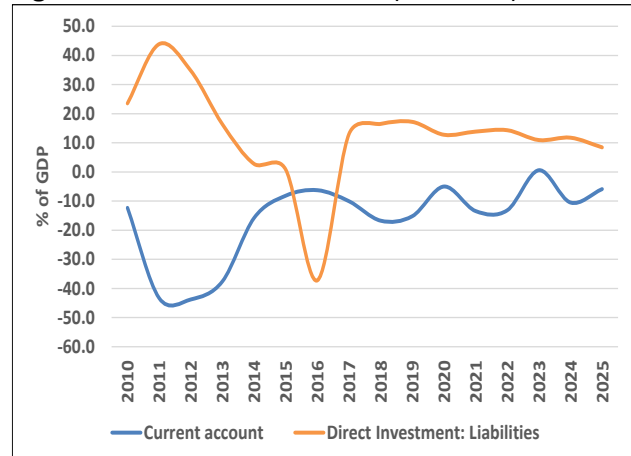
FDI inflows have generated episodes of real exchange rate appreciation that have undermined the competitiveness of non-mineral exports. This is consistent with the resource movement and spending effect of the Dutch disease identified by Taguchi & Ganzorig, 2018, whereby a boom in the mining sector has crowded out manufacturing activity and has failed to contribute to and even weakened capital accumulation. More than 85% of total exports are minerals, whereas textiles make up no more than 5% of the total. According to trade statistics, wool and fine animal hair (textile inputs) represented approximately 2.5% of total exports in 2024-25, while meat and edible meat offal, another non-mining export, constituted 1.1-1.4% of total exports. Therefore, each investment boom would squeeze non-resource exports, further exacerbating the imbalance in Mongolia's export structure.

⁴ Trading Economics. Retrieved from: <https://fr.tradingeconomics.com/brunei/exports>

⁵ According to ASEAN Briefing, total proven reserves projected to be depleted by 2048 at current extraction rates. Retrieved from: <https://www.aseanbriefing.com/news/bruneis-economic-diversification-efforts-moving-beyond-oil-and-gas/>

Fig. 5: Exports and imports of goods (% of GDP)

Source: CEIC database, authors' calculations

Fig. 6: Current account and FDI (% of GDP)

Source: CEIC database, authors' calculations

FDI inflows and the current account balance (Fig. 6) are also inversely related (Fig 6). When FDI surges, the current account falls into a deficit, driven by a surge in imports, payments for services, and primary income repatriated to FDI investors. This happens mainly because of the import of heavy machinery required for Mongolia's mining sector. From 2010 to 2025, equipment imports averaged 41% of total imports, peaking at 53% during the 2011 FDI boom. As a result, the majority of incoming FDI flows out as payments for imports, services, and foreign labor. The IMF (2025) has projected that FDI will stay at roughly 8-9% of GDP from 2026 to 2030, with the current account deficit at 12.0-12.3% of GDP, implying that the trend of foreign capital inflows leaking out as import payments is a structural feature.

As a landlocked economy, Mongolia's border infrastructure and logistics place direct physical limits on converting investment into exports. The government has designated international dry ports at Zamiin-Uud, Altanbulag, and Bichigt to expand border capacity and reduce transit bottlenecks⁶. Mongolia has also signed a memorandum of understanding (MoU) to participate in the CAREC Advanced Transit System and Information Common Exchange (CATS/ICE)⁷, a regional electronic transit system designed to simplify customs procedures and modernize cross-border trade. In addition, Mongolia participates in the CAREC Program, which supports transport corridors, trade facilitation, and border modernization to facilitate the development of its transport infrastructure.

A flexible exchange rate is another essential complement to fiscal discipline in managing external shocks and supporting competitive non-mining exports. A flexible exchange rate allows the national currency to adjust when commodity prices fall or external demand weakens, absorbing part of the shock. The IMF has consistently recommended greater exchange rate flexibility. However, this flexibility must be paired with fiscal discipline, otherwise, the stabilizing effect of exchange rate flexibility would be overwhelmed by procyclical spending.

Public Investment Management Capacity

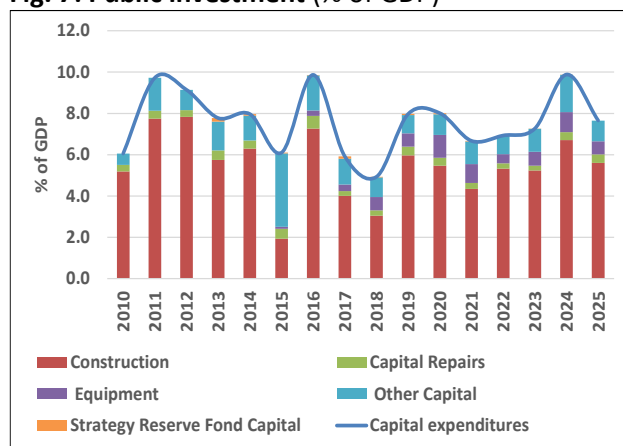
⁶ 24th CAREC Ministerial Conference, Bishkek Retrieved from: <https://carecprogram.org/uploads/CAREC-MC-2025-Statements-06-ENG-MON.pdf#1#1>

⁷ CAREC Program, Joint Meeting of the CAREC Regional Trade Group and the Customs Cooperation Committee (CCC). Retrieved from: <https://carecprogram.org/?event=joint-meeting-of-the-carec-regional-trade-group-and-the-customs-cooperation-committee>

Because existing fiscal rules are poorly enforced, fiscal policy has in practice been procyclical. During upswings, budget spending and quasi-fiscal operations through the SOEs and the Development Bank of Mongolia have expanded, reducing the accumulation of fiscal reserves (World Bank, 2025). The IMF (2025) similarly notes high volatility and thin buffers despite Mongolia's long history of fiscal rules. During investment booms, the economy grows strongly and budget revenues rise with mining taxes and royalties (Fig. 8). Notably, public investment in construction also rises as a share of GDP. By contrast, during investment downturns, as growth slows and budget deficits widen, public investment is cut accordingly (Fig. 7).

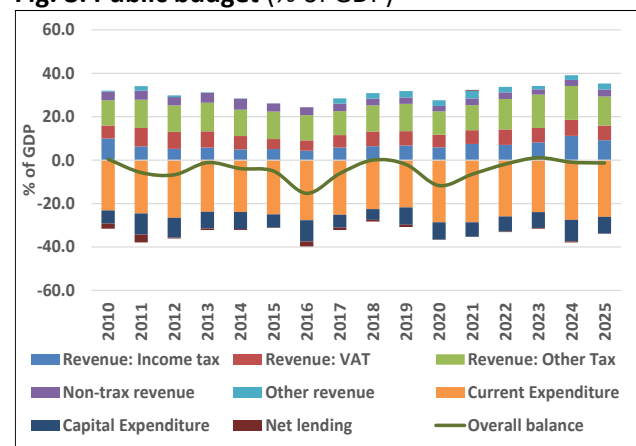
The boom-bust spending is not the problem in itself. Rather, it is a symptom, the underlying problem is how projects are being selected. During a boom cycle, projects proliferate quickly on the back of windfall revenue, without consideration for the recurrent costs they require later. Owing to weak strategic planning, poor alignment between national and sectoral strategies, politically driven selection, and underestimated costs that cause delays, the efficiency of public investment is estimated by the World Bank (2025) at 22 cents of added public capital stock per dollar of investment, far below that of peer countries. The National Audit Office has identified projects that drag on for decades, with no ex-post evaluations to capture lessons learned.

Fig. 7: Public investment (% of GDP)



Source: CEIC database, authors' calculations

Fig. 8: Public budget (% of GDP)



Source: CEIC database, authors' calculations

During bust cycles, when revenues fall, maintenance costs of existing projects are the first in line to be cut since current spending enjoys social and political protection. Deferred maintenance accelerates the physical decay of existing infrastructure, creating an additional cost on top of the excessive spending driven by procyclical fiscal policy (Fig. 8). The net effect is that Mongolia's public investment management magnifies the economic cycle instead of dampening it.

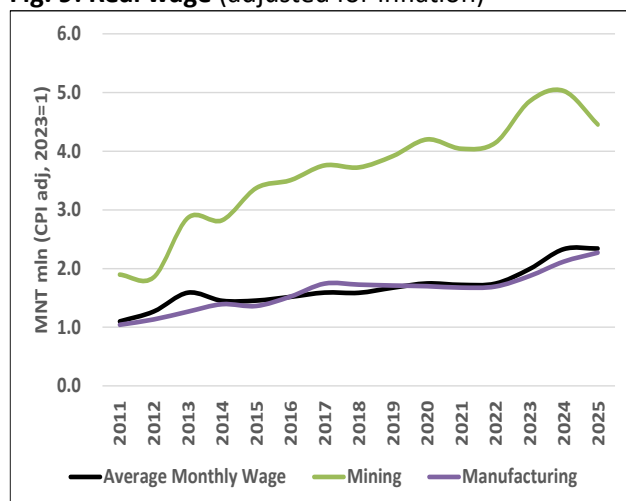
Structural and Labor Market Capacity

Investment booms in Mongolia repeatedly run into the same structural constraints in the labor markets. The mining sector would sharply push wages up due to higher demand: from MNT 0.5 million average monthly nominal wage in mining and quarrying in 2010 to MNT 5.2 million in 2025, increase of close to 150 percent in real terms (Fig. 9). As the Dutch Disease syndrome would predict, the mining sector simultaneously attracts labor away from other industries while raising wages nationwide. Meanwhile, economic productivity has lagged behind. Penn World Table data show Mongolian TFP trailing the global average and several regional peers (Fig. 10). This gap between wages and productivity d the competitiveness of the non-mining sector,

erodes profits, and increases inflation.

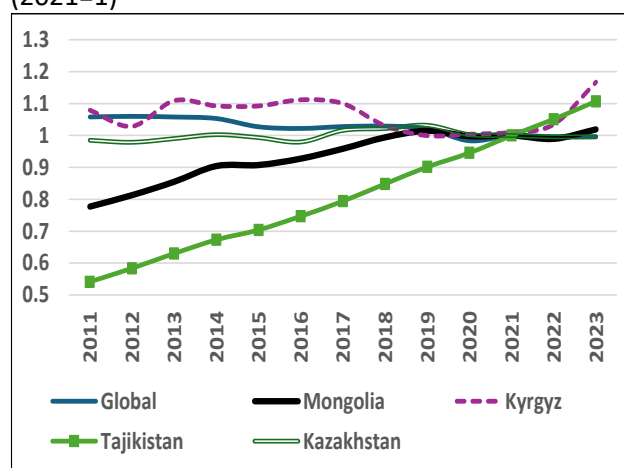
Mongolia's small population and workforce can turn wage pressure into a deeper structural mismatch between the skills that the market demands and skills that are currently available. Outside of the mining sector, skilled labor is very limited, especially in sectors like construction, manufacturing, and engineering. Manufacturing faces the most acute shortages of the three, concentrated in food processing, textiles, and clothing. The Ministry of Labour and Social Protection (2024) reports labor under-utilization of 10.6 percent against unemployment of 6.7 percent, leaving 3.9 percentage points of hidden slack. The gap is evident mainly due to training institutions not being well-aligned with the modern industry requirements. During booms, mining-linked infrastructure projects mostly stall on labor shortages, producing delays, and heavily relying on foreign expertise. As a result, there is a constraint on converting financial investments into productive physical and human capital.

Fig. 9: Real wage (adjusted for inflation)



Source: CEIC database, authors' calculations

Fig. 10: TFP in Mongolia and regional peers (2021=1)



Source: Penn World Table, authors' calculations

Technology Transfer Capacity

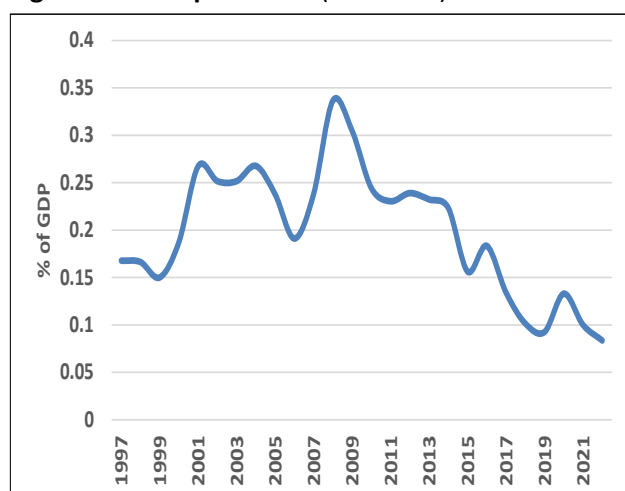
Mongolia's R&D spending stood at 0.09% of GDP in 2025, down from a peak of 0.34% in 2008 (Fig. 11). According to the Global Innovation Index 2025⁸, Mongolia ranks 78th out of 139 economies, with particularly weak scores in Institutions (98th), Market sophistication (95th), and Knowledge and technology outputs (93rd). Notably, Mongolia ranks 87th in innovation inputs but 69th in innovation outputs, meaning that the country extracts relatively more output from limited inputs but that the overall input base is too thin to generate sustained technological upgrading. This reflects a structural gap in the mechanisms that convert foreign investment into domestic technological capability. Knowledge spillovers from FDI operate primarily through backward linkages, whereby foreign firms demanding higher-quality inputs from domestic suppliers, forcing those suppliers to upgrade their production processes and quality control systems. For example, Singapore was able to acquire knowledge through its Local Industry Upgrading Programme which encourage foreign companies to enter into long-term contracts with local suppliers and help them upgrade⁹.

⁸ World Intellectual Property Organization (WIPO) Global Innovation Index 2025. Retrieved from: <https://www.wipo.int/gii-ranking/en/mongolia/section/economy-profile>

⁹ OECD (2020). Production Transformation Policy Review of the Dominican Republic. Retrieved from: <https://www.oecd.org/content/dam/oecd/en/publications/reports/2020/07/production-transformation-policy-review-of-the->

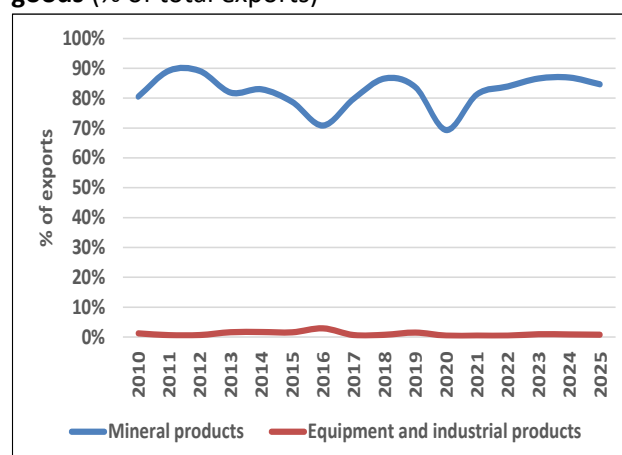
For Mongolia, where mining accounts for 75% of FDI inflows and more than 85% of merchandise exports, and the share of industrial goods' exports accounts for slightly above 2% (Fig. 12), the backward linkage channel remains a challenge because specialized mining inputs, including machinery, equipment, and technical services, are imported. Available statistics says little about whether domestic firms are providing higher-value imported inputs or absorbing technological knowledge. However, the ADB's assessment of Mongolia's mining supply chain (Sandagdorj & Enkhbold, 2024) confirms that local producers supply mainly low-value goods and services, with limited participation in higher-technology segments. This pattern is consistent with the broader finding that backward linkages depend both on foreign companies' incentives to share knowledge and on the absorptive capacity of domestic suppliers to meet international quality standards.

Fig. 11: R&D Expenditure (% of GDP)



Source: CEIC database, authors' calculations

Fig. 12: Exports of mineral products and industrial goods (% of total exports)



Source: CEIC database, authors' calculations

Institutional Capacity

Mongolia's low scores on regulatory quality and government effectiveness therefore weaken the effectiveness of reforms across all dimensions of absorption capacity — fiscal rules, public investment management, labor policy, technology transfer, and financial deepening alike. Institutional credibility is not a standalone constraint but a cross-cutting one. Mongolia's formal frameworks are largely in place, but their implementation lags — a pattern documented across international governance indicators and domestic business surveys.

The World Bank's Worldwide Governance Indicators (WGI) for 2025¹⁰ show that Mongolia's institutional performance on key dimensions is below global averages (Fig. 13). Government Effectiveness stands at -0.61, ranking 145th globally. Regulatory Quality stands at -0.37, ranking 124th globally (Fig. 14). These indicators measure the quality of public services, the credibility of government decisions, and the ability to implement sound policies that promote private sector development.

These international indicators align with domestic business surveys. The Mongolian National Chamber of

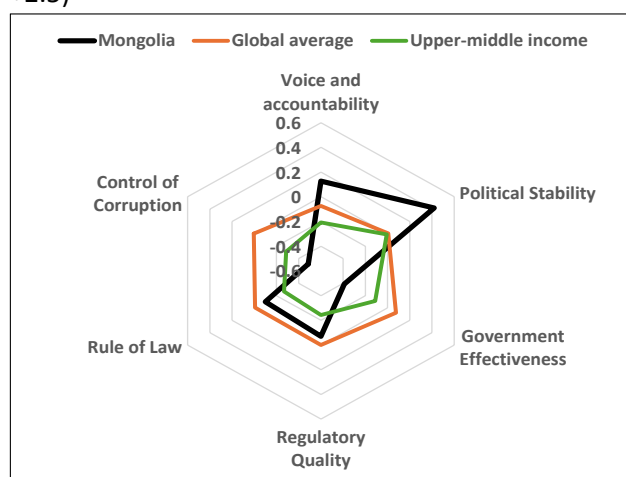
[dominican-republic_d95e5f63/1201cfea-en.pdf](#)

¹⁰ World Bank. (2025). Worldwide Governance Indicators, 2025 Revision. Retrieved from www.govindicators.org.

Commerce and Industry's (MNCCI) 2023 national business environment survey, covering 4,606 enterprises across 21 provinces and Ulaanbaatar, found that the governance and legal environment received the lowest rating among five assessment categories — 2.40 out of 5 — with entrepreneurs calling for clearer rules, improved inter-agency coordination, and reduced bureaucracy.

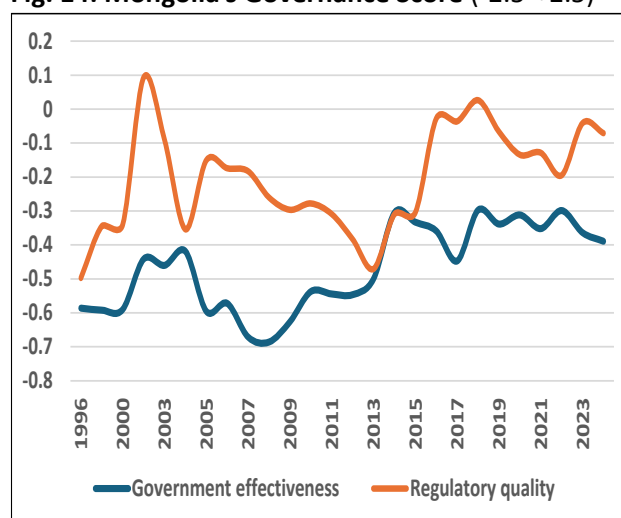
Statistical capacity presents a more mixed picture. Mongolia's Statistical Performance Indicator (SPI) score stands at 83.7 out of 100, ranking 47th out of 217 countries — up five positions from 2023 and 14.4 points above the global average. Data services scored 96.3, while data infrastructure remains the weakest pillar at 70 points. This uneven capacity constrains evidence-based policymaking and limits the ability to track whether public investment delivers results.

Fig. 13: Worldwide Governance Indicators (-2.5-+2.5)



Source: WGI Index, World Bank

Fig. 14: Mongolia's Governance Score (-2.5-+2.5)



Source: WGI Index, World Bank

The institutional weaknesses documented above directly constrain Mongolia's capacity to absorb FDI. When regulatory frameworks are unstable and enforcement is uneven, the risk-adjusted return on investment falls for both foreign and domestic firms, discouraging the very private sector activity that converts capital inflows into productive capacity. The IMF's 2026 Article IV¹¹ explicitly identifies improving the business environment to attract FDI as a structural reform priority, linking governance and the rule of law directly to investment outcomes. Research on FDI spillovers confirms that absorptive capacity depends not only on physical infrastructure and human capital, but also on institutional quality, the predictability of rules, the enforceability of contracts, and the reliability of dispute resolution mechanisms. Mongolia's low scores on regulatory quality and government effectiveness therefore represent a binding constraint on the economy's ability to translate FDI inflows into sustained productivity growth.

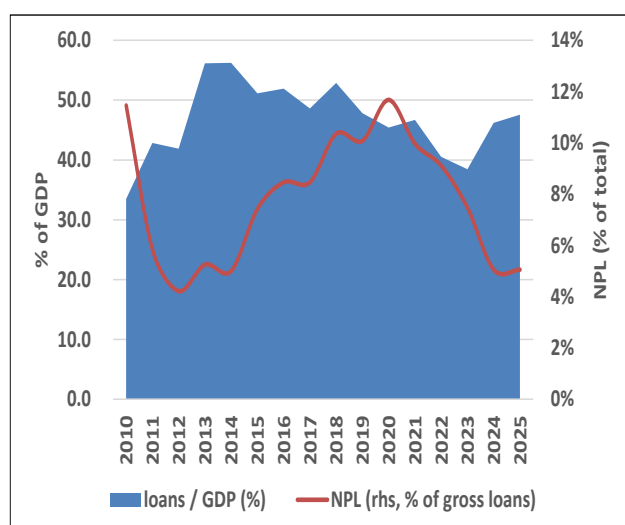
Financial Sector Capacity

¹¹ International Monetary Fund. (2026). Mongolia: 2026 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for Mongolia (IMF Staff Country Report No. 2026/219). Retrieved from <https://www.imf.org/en/news/articles/2026/08/06/pr26274-mongolia-imf-executive-board-concludes-2026-article-iv-consultation>

Mongolia's underdeveloped financial system is a further constraint on investment absorption capacity. Its capital markets are mostly illiquid and process a low volume of trades annually. As of April 2026, there were only 162 listings on the Mongolian Stock Exchange, with a total market capitalization of MNT 13.3 trillion (USD 3.7 billion). In addition, bond markets are underdeveloped with limited secondary market activity, although some changes are underway. The last corporate bond issuance was issued in July 2025, and government bond activity has been similarly limited. Banks dominate the financial system, but they are also limited in depth and breadth: a credit-to-GDP ratio of 47.5 percent in 2024–2025 (Fig. 15) is modest, leaving large capital-intensive projects underserved. Outstanding bank loans reached MNT 45.9 trillion at end-April 2026, growing 16.4 percent year on year. As a consequence, mining sector funding largely comes from overseas, bypassing domestic financial markets altogether.

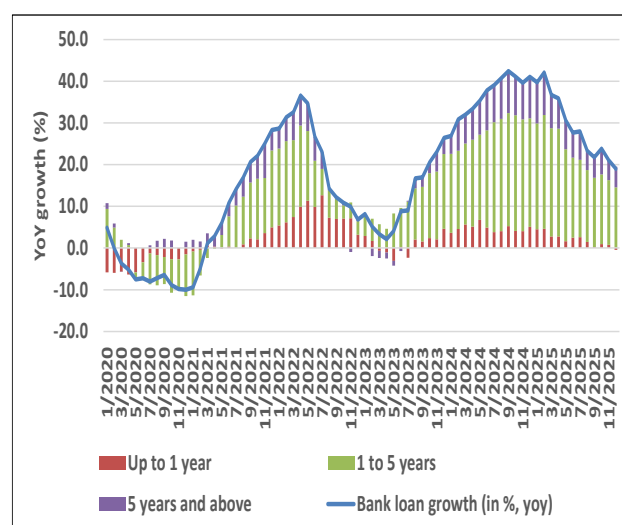
Non-mining industries, which lack access to foreign capital, must rely on domestic banking, which lends money predominantly at short maturity. Loans with tenors beyond five years rarely make up a significant proportion of total portfolios, but deposits are of even shorter term (Fig. 16). This maturity mismatch between assets and deposits, that leaves banks unwilling to extend long-term financing. The banking sector is by itself exposed to the commodity cycles that drive investment volatility. Record mining revenues fuel credit booms that contribute to overheating and, eventually, loan defaults. However, non-performing loans that peaked after the 2015–2016 slowdown, peaking at 12 percent during the COVID-19 pandemic in 2020, have fallen back below 6 percent by 2025. Even with that improvement, the sector's limited scale and depth remain among the biggest constraints on the diversification of the Mongolian economy.

Fig. 15: Banking sector indicators (in %)



Source: CEIC database, authors' calculations

Fig. 16: Bank loans (contribution to growth, %)



Source: CEIC database, authors' calculations

Moving beyond the Resource Trap

Mongolia's absorption problem stems not a lack of capital, but from structural weaknesses across the economy. Investment levels in Mongolia are consistently high, but concentrated in a few key industries, particularly mining, with limited spillover to the rest of the economy. The brief covered seven dimensions of absorption capacity: macroeconomic management, external sector resilience, public investment efficiency, labor market

capacity, technology transfer, institutional capacity, and financial sector depth. Weaknesses in each reinforce those in others, creating a vicious cycle of weak capital absorption.

Mongolia's procyclical economic policy amplifies the boom-bust swings that commodity-linked FDI already generates. During boom periods, windfall revenues are spent on projects with low returns (generating only 22 cents of productive capital out of each dollar invested) rather than saved or invested productively. That spending surge boosts demand for imported goods and labor. With no countervailing mechanism in place, the currency appreciates, which transmits the shock to non-mining exports, reducing their global competitiveness. In addition, a constrained labor market cannot supply the skilled workers that industry needs, raising wages without matching gains in economic productivity. When the boom cycle ends, the financial sector, built on short-term lending, cannot supply long-term funding needed to cushion the downturn. As a result, each dimension amplifies the weaknesses of the others.

Altogether, these issues highlight the new investment inflow risks will amplify macroeconomic volatility, rather than build the institutional foundation for stable growth. Breaking this cycle requires coordinated reforms across all seven dimensions at once, rather than isolated policy changes. For example, tightening fiscal regulations while leaving public investment management untouched does little to close the spending efficiency gap. Similarly, upgrading worker skills without deepening the financial market produces qualified labor in non-mining sectors that still cannot access the capital needed in order to operate and expand. Reforms must therefore target the interconnections outlined above: countercyclical fiscal policy, efficient public investment, adequate external buffers, labor supply matched to demand, better governance, technology transfer, and a deep financial system.

Policy Priorities to Strengthen Absorption Capacity

1. Improve Institutional Capacity: Readiness and Legal Credibility

The IMF finds that "institutional and regulatory frameworks are unstable and enforceability is weak," while the "State's footprint in the economy remains high, operating under changing rules, which hampers private sector initiative and deters FDI." The World Bank similarly identifies weak inter-ministerial coordination and unclear roles in public investment management as creating an implementation gap in which well-designed policies are not consistently executed.

Institutional credibility is not a standalone reform but a foundation on which other absorption-related policies depend. The IMF's 2026 Article IV recommends improving the business environment to support investment and attract FDI, strengthening governance and the rule of law, and moving toward a more diversified and private sector-led growth model. On fiscal governance, the IMF recommends strengthening public financial management and fiscal transparency to enhance budget credibility, including a well-defined medium-term fiscal framework and stronger governance of mining funds. The World Bank's Public Finance Review similarly recommends simplifying fiscal rules and institutionalizing a more independent Fiscal Stability Council. These reforms would reduce policy uncertainty for investors, improve the reliability of public investment, and create the institutional conditions under which FDI inflows can generate broader economic benefits.

Strengthen policy coordination and project preparation. A minister-level coordination mechanism already

exists to align policy across national and sectoral levels, but its effectiveness can be improved. Making it more functional and transparent with clearer roles across agencies would strengthen coordination on investment priorities. Equally important is better alignment between development policy planning and budgeting: project pipelines should be derived from, and financed in line with, agreed national and sectoral strategies, rather than assembled separately from the budget cycle. The same alignment should extend to regional and provincial levels, so that sub-national plans and budgets remain consistent with national priorities. There is also scope to learn from international experience in national planning, particularly how other countries integrate sub-national policy and budgeting into their planning frameworks. A unified appraisal methodology for investment projects would support this alignment and provide a common basis for selection across ministries. Without stronger coordination, investment can flow into isolated projects with limited spillovers to complementary infrastructure such as construction, energy, logistics, and domestic supplier networks.

Improve macro-fiscal data integration, analysis, and transparency. Building on the coordination measures above, a more integrated approach to national, sectoral, and provincial policy and budget planning would connect planning and budgeting across levels. This would require a unified framework governing how data are defined, collected, and used, so that planning and budget decisions rest on the same evidence base. Supported by macro-fiscal data and its analysis, such integration would enable transparent decision-making at all levels. Expanding digitalization of macro-fiscal analysis, including AI-assisted tools and Big Data platforms, would further strengthen evidence-based decision-making and spending efficiency and help direct funding toward productive projects rather than recurrent expenditures such as salaries, social welfare, and subsidies.

Strengthen investor services and legal credibility. The Investor Protection Center (established 2026) and the Investment and Trade Agency should be resourced to provide comprehensive support across the full investment cycle — not information alone — including aftercare, grievance handling, and coordination across permitting agencies. This should be complemented by continued strengthening of dispute-resolution mechanisms and contract enforcement, building on existing investor grievance mechanisms and arbitration guarantees.

2. Strengthen Fiscal Rules and Rebalance Spending Toward Productive Investment

Mongolia already has a fiscal framework and a medium-term budget process designed for countercyclical management, but commodity-revenue volatility has repeatedly led to in-year amendments that reduce its effectiveness. As a result, fiscal policy has tended to move with the cycle: budget spending and quasi-fiscal operations expand during booms, limiting the accumulation of fiscal buffers, and contract during downturns. Two priorities would strengthen the framework.

Simplify and enforce fiscal rules. The World Bank (2025) recommends simpler fiscal rules with greater capacity for the Fiscal Stability Council; this brief adds that the Council would benefit from genuine independence and adequate resources to enforce the rules credibly. As long as absorption capacity remains limited, the priority during commodity price surges should be to refrain from injecting additional revenue into the economy until absorption improves. Rather than amending the revenue threshold in approved Medium-Term Fiscal Framework, the government should route revenues above that threshold automatically into the designated stabilization instrument. This would allow buffers to accumulate without relying on discretionary political decisions and would avoid the inflationary cycle in which salary and social welfare increases drive prices up,

which in turn generates pressure for further wage adjustments.

Rebalance spending toward productive investment. Recurrent spending accounts for roughly three-quarters of the 2026 budget allocation, while capital investment is only about one-quarter, and the IMF has flagged political pressure to raise wages and pensions as a key fiscal risk. Historically, commodity revenue surges have been absorbed primarily by recurrent spending, contributing to procyclical fiscal expansion. When revenues rise, a greater share should instead be directed toward developing sectors that complement mining — such as energy, logistics, and local supplier networks — as well as value-added manufacturing that moves processing and production downstream. This requires integrated investment management that views the national economy as a whole, identifying where public capital can unlock private activity across sectors rather than financing isolated projects. An explicit floor for capital expenditure as a share of GDP, with maintenance of existing assets ring-fenced from in-year cuts, would help protect productive spending through the cycle. During bust cycles, maintenance has tended to be cut first, accelerating the physical decay of infrastructure and creating long-run costs.

3. Diversify the Economy by Leveraging Funds into Infrastructure and Value-Added Manufacturing

Reducing dependence on mining requires directing investment — including resource revenues and incoming FDI — into complementary infrastructure and value-added manufacturing, rather than into recurrent expenditure. The appropriate policy instruments are sound investment policy and well-structured investment contracts, not increases in salaries and subsidies. Two priorities follow.

Move from subsidy-led support to systematic value-chain development in agriculture and textiles. Mongolia has significant potential in these sectors: agriculture accounts for roughly 11–17 percent of GDP and employs about a third of the workforce, while the country is one of the world's largest producers of raw cashmere and livestock products. Yet this potential remains largely unrealized. A structural decline in global coal prices would directly reduce government revenues, since coal accounts for a significant share of mining income, making diversification urgent rather than optional. Past support has relied heavily on subsidies and concessional credit, which have not addressed the structural bottlenecks limiting competitiveness: inadequate logistics, weak quality standards, limited access to market information, and fragmented value chains. A more effective approach would evaluate previous subsidy mechanisms, redirect resources toward public goods such as infrastructure, certification, traceability, and research, and support integrated value chains from raw material quality through processing to market access.

The diversification experience of other resource rich and landlocked economies is difficult to replicate, because institutions, geography, and policy capacity vary greatly. However other landlocked economies like Laos, Kazakhstan and Uzbekistan can provide some examples. Uzbekistan have moved from raw cotton exports to domestic textile processing with government policy support. Laos has leveraged the China-Laos railway to boost tourism. Kazakhstan, a landlocked resource-rich CAREC economy has built genuine agricultural processing capacity, even though oil still accounts for half of export earnings and one-third of government revenues.

Shift the emphasis from attracting FDI to absorbing it. As long as absorption capacity remains the binding constraint, investment contracts, including those linked to major mining projects, can be structured to require

local content in complementary infrastructure such as energy, logistics, and supplier networks, and in workforce skills, so that incoming capital is retained and multiplied within the domestic economy. This would require strengthening government negotiation and contract-management capacity, so that agreements function as instruments of absorption policy rather than one-off revenue arrangements.

4. Aligning Skills Policy with the investment pipeline

Addressing the skilled labor bottleneck will require strategic, forward-looking workforce planning. Expanding vocational training to match market needs in sectors like textiles, agriculture, construction, and engineering will help expand the skilled domestic workforce. However, workforce projections must be based on a three-to-five-year horizon to allow targeted training of Mongolian workers for specific industries, relying less on foreign workforce, and keeping productivity gains inside the country. The World Bank (2025) in particular, advises aligning higher education with labor market demands by expanding ties between universities and industry through formal partnerships, internship programs, and cooperative learning.

5. Strengthen Technology Transfer and Innovation

Three policy directions emerge from the evidence. First, supplier development programs should pair foreign affiliates with domestic firms for capability upgrading, following models such as Singapore's LIUP or Ireland's linkage program, which increased local purchases fourfold and supplier productivity by 36% over a twelve-year period. Second, R&D incentives should encourage joint research between foreign firms and Mongolian institutions, particularly in mining technology, processing, and agricultural value chains. Third, quality certification and standards should be aligned with international norms—the World Bank has explicitly recommended improving SME capabilities through quality certification and technology adoption as a pathway to private sector diversification. Without these interventions, Mongolia's low R&D base and thin supplier network will continue to constrain the conversion of foreign capital into lasting domestic technological learning.

6. Deepen the Domestic Financial Sector

Recent capital market progress has given Mongolia a base to build a more ambitious financial system. In 2025, local companies raised USD 2.6 billion from international markets. Building on this, the government should encourage the issuance of green and sustainability bonds, following the precedent set by TDB's green and social bonds and Golomt Bank's USD 50 million green bond, which attracted six of the world's top asset management companies. Ulaanbaatar's municipal bond issuance, with IFC support for battery energy storage, introduces a new instrument for climate-resilient infrastructure financing. The World Bank (2025) adds that the country's carbon-reliant growth model drives air pollution and public health damage, making green financing instruments particularly important for the country's future sustainable growth.

On the banking side, enabling businesses to borrow against securities and establishing a financial framework for high-potential startups to raise money inside the country would deepen the reach of domestic capital. The sector's current capital adequacy ratio is near 17 percent, which is comfortably above the regulatory minimum. This gives the banking sector the buffer needed to implement these policy changes. In addition, macroprudential measures should complement these reforms by limiting lending to the real estate and mining sectors and steering loan portfolios toward SMEs in agriculture, tourism, and manufacturing.

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