

MONGOLIA IN TRANSITION TO A MARKET-ORIENTED ECONOMY

NOBUAKI MATSUNAGA*

When Genghis Khan established the Mongol Empire in 1291, it was the greatest empire in history. But the Mongolian people were later subjected to 230 years of Chinese rule from 1691 to 1921. After three years of constitutional monarchy, the Mongolian People's Republic was founded in 1924 and experienced the second longest history of socialism and centrally-planned economy after the neighboring "big brother", the Soviet Union. However, in January 1990 demonstrations for democracy took place, and in August the first democratic election was held. A new coalition government was established and in September it made plans for a transition to a market-oriented economy. Mongolia thus took the first step towards a market-oriented economy, but there have been many difficulties hindering the transition and the further development of her economy.

This paper is intended as an investigation of the Mongolian economy in transition to a market-oriented economy. Needless to say, development strategy is very important to consider, but it cannot be discussed here for lack of space. We have to leave it to another paper. In the present paper, the distinctive characteristics of the Mongolian economy will be described in Chapter I; the economic

* Associate Professor, Graduate School of International Cooperation Studies, Kobe University.

structure will be examined in Chapter II; and the background, the contents and the major problems of economic reform will be presented in Chapter III.

I. INITIAL CONDITIONS

When we consider how best to develop and assist the Mongolian economy, it is necessary to make clear the given initial conditions. The characteristics of the history, land and population, geographical conditions, livestock sector, mineral resources, aid-dependent economy and human resources will be explained briefly in this chapter.

1. Long History of Socialist Economy

Up to 1921, when the country recovered its independence with the assistance of the Soviet Union, Mongolia had long been ruled by the Chinese dynasty. Since then, she has transformed herself from a nomadic rural economy to a mixture of traditional stock farming and modern industries (mainly mining and semi-processing of raw materials). In the 1930s, a pro-Soviet government came into power, and thereafter Mongolia gradually inclined towards a Soviet-type centrally-planned economy. Collectivization of stock farming was then introduced with a resultant sharp decrease in

livestock.

But the real step towards a socialist, centrally-planned economy was made after WWII, particularly after 1960 when all property, including livestock, became cooperative- or state-owned and private ownership was prohibited. Large and medium-scale industries, finance, external and internal trade, railroad and air transport, communications, and farms all became state-owned; and stock farming, retail trade and small scale industries became cooperative-owned. Economic development was implemented by the government along five year plans, the first of which started in 1948. In 1962, Mongolia joined the CMEA (Conference of Mutual Economic Assistance) and became more dependent on assistance from and trade with other member countries, particularly with the Soviet Union.

In the eighth five year plan (1985-90), limited economic reforms were introduced into the socialist regime: limited autonomy was granted to public sector enterprises for investment, long-term bank loans for investment were introduced and wholesale prices were increased in 1986; investment autonomy of public sector enterprises was expanded in 1987; agricultural pricing and marketing in excess of state orders was

liberalized in 1988; and in 1989, intra-public-sector-enterprise pricing was liberalized and operating autonomy was expanded, restrictions on private herd ownership were eased and the monopoly of state trading corporations was eliminated.

At last, fundamental reforms were introduced in 1990 when the first democratic election was conducted and the new government declared the transition to a market-oriented economy: restrictions on private ownership of herds were eliminated; selected retail prices were liberalized; and a foreign exchange auction system was introduced in 1990. But thus far about two generations of Mongolian people have experienced a centrally-planned command economy, remote from market mechanism and entrepreneurship. This will be the most difficult problem for the Mongolian economy to develop in the future.

2. Small Population in a Large Land

Mongolia has a population of only 2.2 million as of 1991,¹ which is less than that of Singapore, a city-state with a population of some 2.7 million. This means the domestic market is too small

to establish self-contained manufacturing industries and thus external trade policies to overcome this handicap are important, although it may be relatively easy to make development and assistance plans because of its smallness.

The rate of population growth has been high (2.7%) in the past 10 years, but the land is sparsely populated because of its largeness (1,567 thousand km², about 4 times larger than Japan, which has a population of 125 million). The sparsely populated economy is difficult to integrate into one national economy, if there is a lack in effective transportation and communication networks; therefore, such kinds of infrastructure are necessary for Mongolian development.

Though the country is free from the excessive population problem that other Asian countries are suffering, it does have the problem of urban concentration. The rate of urban population to the total is 56%, which is higher than most Asian countries: Nepal 10%, Bangladesh 16%, Laos 19%, Thailand 23%, India 27%, Indonesia 31%, Pakistan 32%, the Philippines and Malaysia 43%, China 56%; only South Korea 72% and Japan 77% were higher than Mongolia in 1990.²

1 Unless otherwise specified, all data in this paper are from the State Statistical Office of Mongolia, *Annual Statistical Yearbook*, 1992, and World Bank, *Mongolia: Country Economic Memorandum*, 1991.

2 World Bank, *World Development Report*, 1992.

The three biggest cities together contain one-third of the population: the capital Ulaanbaatar alone has more than one-fourth (580 thousand), the second biggest Darhan (90 thousand), and the third Erdenet (60 thousand). The population is so concentrated in urban areas that most development and assistance projects may be easier to implement, but it will take longer and cost more to extend the effects to rural areas.

3. Land-locked Country Sandwiched between Two Superpowers

Geographically, Mongolia is a land-locked country sandwiched between two superpowers, China and Russia. This has both advantages and disadvantages. Mongolia can gain from trade between these two countries with their huge populations. Many entrepôt states had prospered along the Silk Road in the past. However, problems of transportation may prevent this advantage from being realized. For one thing, the gauge of railway is different from that in China, which requires costly reloading at the border and takes too long. For another thing, road transport is very inefficient because of poor road and vehicle maintenance for lack of money and necessary parts.

The geographic position of Mongolia

can be a serious disadvantage as long as economic and political disorder continues in Russia, making it difficult to realize the possible gains from trade. In addition, as a land-locked economy, Mongolia has to produce light and high value-added commodities to overcome the disadvantages of high transport costs.

4. Resilient Livestock Sector

Mongolia has an average elevation of about 1,600 meters above sea level, resulting in a frigid, semi-arid continental climate. The winters are long and severe with average temperatures below the freezing point from October to March. These climatic conditions, however, are suitable for livestock raising, and more than ten sheep and cattle per capita are bred (some 25.5 million heads as of the end of 1991, about 60% of which are sheep).

In the 1980s, agricultural production made up about 20% of GDP, and, on average, around 30% of the labor force was engaged in agriculture. Most of them were in the livestock sector, and about 40% of exports are of agricultural origin (foodstuffs, raw materials and livestock-related products such as wool, leather, and skin).

The importance of the livestock sec-

tor is greater than these figures indicate, since most of their products have been underpriced by the government. Due emphasis should be placed on this sector in future planning, as it could play an important role as a cushion to absorb the variety of disorders generated in the transition to a market-oriented economy. The livestock sector is capable of playing such a role, as it is the most self-sufficient and least dependent on governmental supports. Therefore this sector is quite resilient against the present economic crisis.

5. Rich Mineral Resources

Mongolia is relatively rich in such mineral resources as coal, copper, molybdenum and fluorite. These minerals, copper concentrate in particular, were the main exports to CMEA countries before the system collapsed in 1991, but they were viable as exports only in this system where higher prices than the international level were accepted as "friendship prices". Now that international competitiveness is crucial to export these resources, it is necessary to reduce the costs by improving efficiency in production and transport. Coal is relatively abundant in Mongolia and it is indispensable in both industrial production and

urban life for heating and electricity. The biggest problem at present is how to maintain the supply of these minerals when the ex-Soviet Union can no longer provide the spare parts, gasoline and capital goods essential to their production, transport and exploitation.

6. Aid-dependent Economy in Collapse

Economic development in Mongolia was dependent on assistance from the Soviet Union until 1990. Dependence was so strong that Mongolia's development process was almost suspended and an economic crisis ensued when the Soviet Union itself collapsed in 1991 and could no longer supply gasoline, fertilizer, spare parts, etc. to Mongolia. The assistance had been given to Mongolia through financing the fiscal deficits equivalent to some 17% of GDP.

As long as Mongolia cannot finance her development projects for herself, she has to find another country or countries which will assist Mongolia as the Soviet Union did before 1991. It will be impossible for Mongolia to succeed in self-sustained economic development in the near future unless the Mongolian government decides to accept a lower standard of living similar to that of 30 years ago.

The Japanese government may face the difficult decision of whether or not to take over the role of the dominant assistance country from the Soviet Union.

7. Well-developed Human Resources

Though the new Mongolian government inherited an aid-dependent economy from the former Socialist government, it also inherited well-developed human resources which should be used for current economic development. The former government made extraordinary efforts in social services such as general education and health care: the enrolment rates in primary and secondary education reached almost 100% in the 1980s; the adult literacy rate 98%; and the population per physician and medical personnel (105 and 205 persons respectively) and the life expectancy at birth (male 64.6 years and female 66.5) have already reached the level of middle-income countries. It is becoming increasingly difficult to maintain this high level of human resources under the present economic crisis, but it seems tremendously important to maintain and make good use of such precious resources under a market-oriented economic system.

8. Least-developed Country

According to Statistics

It is said that Mongolia is a least-developed country. It is true that per capita GDP in 1991 is \$58.86 converted by free market rates of 100-150 tugriks per dollar, or \$216 by the official commercial rate of 40 tugriks per dollar, and that they are well below the threshold of \$300 which is used for the definition of least-developed countries. These figures, however, are rather problematic; the official rates did not reflect the real state of the Mongolian economy, and they were changed many times by the government from T3 to T5.6 = \$1 in June 1990, to T7.1 (the barter trade rate) or T40 (the commercial rate) in June 1991, and to T150 in January 1993. Also, the free market rates changed rapidly reflecting a temperamental condition of the thin foreign exchange market: T100-150 in 1991, T150-250 in 1992 and T250-300 in the beginning of 1993. If we use the official rate of T5.6 or T7.1 in 1991, per capita GDP would be \$1544 or \$1218.

There are only a few estimates of per capita GDP which took the purchasing power of the tugrik into consideration: \$800 in 1986 estimated by DAC and \$300 in 1988 by a Mongolian news-

paper. Purchasing power parity is calculated for a basket of goods and services that an average family purchases. However, the basket of a Mongolian is so different from that of American, for example, that such an estimation is extremely difficult and unreliable. In any case, Mongolian people may be able to survive with some cattle, but their lives are poor and hard according to western standards.

II. ECONOMIC STRUCTURE

The Mongolian economy had experienced relatively high growth until 1989: the real annual rate of growth is 4.5% for GDP, 5.0% for Gross Social Product and Net Material Product in the 1980s. These high rates of growth were achieved with a huge amount of assistance from the Soviet Union, as we have seen earlier. Such an aid-dependent development method has seriously distorted the economic structure of Mongolia. In this chapter, production, employment, expenditure, public finance, the balance of payments and external trade will be examined.

1. Production

It is rather difficult to have an accurate understanding of the Mongolian eco-

nomy with such concepts as the Gross Social Product or Net Material Product that were used in the centrally-planned economy before 1991. Therefore, GDP estimates by the World Bank will be used whenever possible. Basic differences between them are (1) Net Material Product does not include depreciation and services and (2) subsidies are not deducted in NMP. Therefore, NMP is smaller than GDP, for example by 19% in 1989.

As Table 1 indicates, on average, about 20% of GDP was created in the agricultural sector (including agriculture, livestock and forestry), 40% in the industrial sector (construction, mining and manufacturing), and another 40% in the service sector (transport, communications, trade and others in the material sector; and government, education, health, finance, housing, science, culture, etc. in the nonmaterial sector). In the 1980s, the industrial sector increased its share from 36.3% to 41.1%, the agricultural sector increased slightly from 18.6% to 20.4%, but the service sector decreased from 45.1% to 38.5%.

In the longer run, however, the rising trend of the industrial sector and the declining trend in the agricultural sector are apparent: the industrial sector in-

Table 1: COMPOSITION OF GDP, at current factor cost (%)

Sector	1980	1985	1986	1987	1988	1989	1990
Material	81.3	83.4	83.0	82.9	82.6	83.6	83.5
Agriculture	18.6	18.8	21.8	19.5	19.4	20.4	20.2
Industry	29.2	32.8	32.8	33.5	33.0	34.1	33.8
Construction	7.1	5.7	6.2	6.8	7.2	7.0	5.7
Transport	13.6	13.8	13.5	13.1	12.7	11.6	11.3
Communications	1.3	1.7	1.7	1.7	1.8	1.8	1.9
Trade	9.7	9.1	5.3	6.6	7.1	7.1	9.1
Other	2.0	1.6	1.8	1.7	1.5	1.6	1.4
Nonmaterial	18.7	16.6	17.0	17.1	17.4	16.4	16.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
GDP Growth Rate		4.7	8.3	4.5	5.1	4.2	-2.1

Source: Calculated from the data of World Bank.

Note: GDP growth rate is at constant market price in 1990.

creased its share in Net Material Product from 9.3% in 1940 to 28.4% in 1970 and 40.5% in 1990, whereas the agricultural sector decreased from 61.0% to 25.3% and 20.2% respectively.³

These trends of industrial expansion and agricultural contraction are a common feature to economic development, but in Mongolia over-hasty industrialization was pursued at the cost of agriculture and of dependence on huge amounts of assistance, equivalent to some 30% of GDP, that was received from the Soviet Union. The high rate of the industrial sector in GDP (40%) is comparable to or even higher than more developed Asian LDCs (Malaysia 41%, Indonesia 40%,

Thailand 39%, the Philippines 35%, India 29%, Pakistan 25% in 1990) and much higher than some Least Developed Countries in Asia (Laos 20%, Bangladesh 15%, Nepal 14%). China (42%) is another socialist country in Asia that has hastened industrialization.⁴ Such a high rate of industrialization is characteristic of most socialist countries, and they have a common problem of inefficiency and declining economic growth.

Table 2 shows the composition of the industrial sector in detail. In 1989, one year before the economic turmoil began, the following 6 subsectors alone occupied 74.4% of total industrial production: food 18.8%, textiles 12.0%,

³ State Statistical Office of the MPR, *National Economy of the MPR for 70 years*, 1991.

⁴ World Bank, *World Development Report*, 1992.

Table 2: COMPOSITION OF INDUSTRIAL PRODUCTION, at fixed prices (1987)

Sector	1980	1985	1986	1987	1988	1989	1990	1991
Power	9.7	11.0	11.2	11.2	11.6	11.7	12.3	13.4
Fuel	3.9	3.7	3.7	3.9	4.2	3.8	3.6	3.6
Iron	3.6	3.6	3.5	3.7	3.7	3.6	3.2	1.8
Nonferrous ores	8.8	13.5	13.0	12.6	12.3	11.4	12.2	11.2
Construction materials	7.2	7.6	10.1	10.8	10.9	10.6	10.8	5.0
Wood	10.7	7.9	7.6	7.3	7.0	6.9	6.0	4.2
Textiles	8.1	11.8	11.6	11.4	10.9	12.0	11.5	10.1
Clothing	7.0	5.0	4.9	4.6	4.5	4.9	4.7	4.7
Leather	11.3	9.9	9.1	9.5	9.5	9.6	10.6	14.5
Print	1.2	0.8	0.8	0.9	0.9	0.9	0.8	0.8
Glass	0.3	0.4	0.3	0.4	0.4	0.4	0.4	0.3
Food	23.1	20.3	19.4	19.0	18.7	18.8	18.2	24.0
Chemicals	3.9	3.2	3.5	3.6	4.1	4.1	4.2	2.1
Other	0.9	1.2	1.2	1.3	1.4	1.3	1.4	4.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Calculated from the data of World Bank and State Statistical Office of Mongolia.

Note: "Other" in 1991 includes 2.1% of private sector.

Table 3: AGRICULTURAL PRODUCTION, at fixed prices (1986)

Sector	1980	1985	1986	1987	1988	1989	1990
Gross Production	1746.1	2464.5	2552.5	2468.7	2536.2	2650.7	2551.8
Crop production	18.3%	33.1	32.0	30.3	30.0	30.3	27.4
Animal production	81.7%	66.9	68.0	69.7	70.0	69.7	72.6
Material Inputs	741.1	1116.4	1125.9	1133.0	1168.6	1094.4	1026.2
Crop production	46.8%	45.1	47.5	50.1	47.9	52.4	50.5
Animal production	53.2%	54.9	52.5	49.9	52.1	47.6	49.5
Net Material Product	1004.9	1348.1	1426.6	1335.7	1367.1	1556.3	1525.6
Crop production	-2.7%	23.2	19.7	13.6	14.7	14.7	11.9
Animal production	102.7%	76.8	80.3	86.4	85.3	85.3	88.1

Source: Calculated from the data of World Bank.

Note: Gross Production, Material Inputs, Net Material Product (in millions of Tugrik)

power 11.7%, nonferrous ores 11.4%, construction materials 10.9% and leather 9.6%. The problem in the industrial sector is not only the concentration in a few subsectors, but also the high rate of im-

port content (more than 50% of intermediate inputs) in the power and non-ferrous subsectors, and the rising trend of these subsectors in the 1980s. In contrast, among the subsectors with low im-

port content (less than 10%; food, textiles and leather) only textiles increased the share in industrial production.⁵ Therefore, industrialization so far pursued increased the import requirement and the dependence on external assistance.

In Table 3, the share of crop and animal production is shown, along with the total agriculture production in gross and net value (the latter is gross output less material inputs) at fixed prices. In the 1980s, the share of crop production in gross value rose from 18.3% to 30.3%, but that of animal production fell from 81.7% to 69.7%. This trend, however, is not seen for Net Material Product because a disproportionately large amount of material inputs were allocated to crop production (about 50% of material inputs for 30% of gross production). In 1980, a larger amount of material inputs were poured into crop production than its gross value, thereby making its net material product negative.

This reflects the government policy to expand crop production, more than half of which is grains, at the cost of stock farming; crop production more than doubled (2.5 times), whereas gross production of livestock decreased by 3.4%

in gross value at fixed prices from 1980 to 1989 (the sole exception is milk production which increased as much as 2.5 times). In real terms, wheat production grew as much as 3.0 times, potatoes 4.1 times and vegetables 2.3 times, but meat production, in contrast, increased only slightly by 5.6% in the same period. Livestock increased from 23.8 million heads in 1980 to 24.8 million heads in 1989 (by 3.8%), but these numbers are still lower than 26.2 million heads in 1940.

2. Employment

As Table 4 shows, 665.8 thousand people were employed in 1991, and the number has consistently increased in the 1980s by 2.5% annually. On average, 7 workers out of 10 were employed in the material sector and the remaining 3 in the nonmaterial sector. As the share to total employment, the former declined from 76.0% in 1980 to 71.3% in 1989, whereas the latter rose from 24.0% to 28.7%. If we add transport, communications, trade and others to the nonmaterial sector, we can get the "service sector" similar to that in market economies. Such a service sector increased its share from 37.9% to 44.4% in the same period. In the longer run, this sector expanded

5 These figures are calculated from the State Statistical Office of Mongolia, *Input-Output Table 1987*.

Table 4: EMPLOYMENT BY SECTOR (%)

Sector	1980	1985	1986	1987	1988	1989	1990	1991
Material	76.0	73.6	73.4	72.8	72.0	71.3	72.0	68.2
Agriculture	39.7	33.3	32.0	30.9	29.8	29.4	27.4	27.0
Industry	16.0	18.6	18.0	19.3	19.3	18.9	20.8	18.0
Construction	6.0	6.0	6.1	6.2	6.3	6.6	7.9	7.8
Transport	6.3	6.9	7.5	7.5	7.7	7.4	7.8	6.5
Communications	0.8	1.0	1.0	1.0	1.0	1.1	1.1	1.2
Trade	6.4	7.4	7.6	7.6	7.5	7.5	6.5	6.5
Other	0.4	0.3	0.3	0.3	0.3	0.4	0.5	1.2
Nonmaterial	24.0	26.4	26.6	27.2	28.0	28.7	28.8	31.8
Housing, municipal services	2.8	3.6	3.6	3.9	3.9	4.2		
Science, R & D	1.8	1.8	1.8	1.9	2.1	2.2		
Education, culture, art	9.6	10.5	10.4	10.5	11.4	11.8		
Health care, social security	6.3	6.6	6.8	7.1	7.0	7.1		
Banking, finance, insurance	0.4	0.4	0.4	0.4	0.4	0.5		
Government	2.2	2.5	2.4	2.3	2.1	1.9		
Other	1.0	1.1	1.1	1.1	1.1	1.1		
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
(thousands)	511.2	561.6	580.9	598.4	616.1	633.2	651.4	665.8

Source: Calculated from the data of World Bank and State Statistical Office of Mongolia.

more drastically from 20.2% in 1960 to 31.8% in 1970 and 37.9% in 1980, and the material sector shrank from 87.0% to 80.6% and 76.0% in the same period.⁶

Agriculture enjoyed the biggest share (29.4% in 1989), but its share has declined sharply from 39.7% in 1980 by 10%. By contrast, the second biggest, industry (including mining and manufacturing), raised its share from 16.0% to 18.9%; the third biggest, education/culture/art, from 9.6% to 11.8%; and the fourth biggest, health care/social security,

from 6.3% to 7.1% in the same period. In the longer run, these trends are more striking: agriculture fell from 60.8% in 1960 to 47.0% in 1970, industry rose from 12.1% to 15.5%, education/culture/art expanded from 2.8% to 7.8%, and health care/social security from 3.7% to 5.2% respectively.⁷

If we compare the composition of employment in Table 4 with that of GDP in Table 1, the following points become apparent. First, the nonmaterial sector increased the share of employment from

6 State Statistical Office of the MPR, *op. cit.*, 1991.

7 *Ibid.*

24.0% to 28.7%, but decreased the share of GDP from 18.7% to 16.4%, whereas the material sector is just the opposite; the employment share declined from 76.0% to 71.3% and the GDP share rose from 81.3% to 83.6%. This would suggest that social services provided by the nonmaterial sector (especially education and health care) have been expanded by transferring the resources from the material sector (particularly agriculture) in order to develop the high level of human resources essential to economic development.

Secondly, agriculture employed about 30% of workers to produce 20% of GDP, whereas industry produced more than 30% of GDP with less than 20% of workers in the 1980s. This contrast indicates lower productivity in agriculture, but it also reflects the government policy to keep the relative price of agricultural products low, thereby promoting industrialization at the cost of agriculture. This is apparent if we see the composition of investment by sector. As will be shown later in Table 6, 30-40% of investment was allocated to the industrial sector and only 15% to the agricultural sector in the 1980s. But it is surprising that the agricultural sector increased the GDP share slightly from 18.6% to

20.4%, notwithstanding it decreased the employment share from 39.7% to 29.4% in the 1980s. The absolute number of workers in agriculture also decreased from 202.7 thousand in 1980 to 186.0 thousand in 1989. This fact illustrates the resilience of agriculture, especially the livestock sector.

Thirdly, the employment share of the service sector (communications, transport, trade and other) rose from 13.9% to 16.4% but the GDP share declined from 26.6% to 22.1% in the 1980s. This stems either from the decline in relative prices or the decline in labor productivity of this sector due to a lower level of investment. As Table 6 shows, the annual investment allocated to this sector was 12.1% in 1980 and 15.5% in 1989, which denies the second possibility. Actually labor productivity of this sector was relatively high, much higher than agriculture and nonmaterial sectors. Therefore relative prices of such services as transport, communications, trade, etc., were decreased in the 1980s, reflecting the government attitude toward these services.

3. Expenditure

In 1989, just before the external shocks caused economic turbulence in

Table 5: USES OF NET MATERIAL PRODUCT, at current prices (%)

Uses	1970	1980	1985	1986	1987	1988	1989	1990
Personal consumption	57.9	64.6	59.7	65.2	68.2	67.6	62.8	73.0
Public consumption	12.4	20.8	23.4	27.2	28.1	28.7	25.5	25.9
Capital accumulation	34.1	48.3	55.8	58.0	45.3	41.6	42.1	29.0
Fixed investment	33.8	53.2	64.1	35.4	45.3	37.7	37.5	10.2
Change in stocks	5.8	3.1	8.8	8.2	-1.6	-2.7	1.6	2.6
Changes in incomplete project	-5.4	-8.1	-17.2	14.4	1.6	6.6	3.1	16.2
Net exports	-4.4	-33.8	-38.9	-50.4	-41.7	-37.9	-30.4	-28.0
Exports	13.6	24.8	30.2	35.4	37.6	34.9	27.1	28.5
Imports	18.0	58.6	69.1	85.8	79.3	72.8	57.5	56.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Calculated from the data of World Bank.

Note: Imports includes turnkey projects. Statistical discrepancy is not shown here.

Mongolia, private consumption absorbed 63.8% of GDP, public consumption 23.2%, and capital accumulation 46.1%. Such excessive absorption was financed by net imports equivalent to 33.1% of GDP.⁸ In the longer run, it is impossible to get the composition of GDP usage, so let us employ the data on Net Material Product instead. Table 5 indicates the uses of NMP at current prices from 1970 to 1990. Public consumption rose from 12.4% in 1970 to 20.8% in 1980 and 25.5% in 1989, capital accumulation rose from 34.1% in 1970 to 48.3% in 1980, peaked at 58.0% in 1986 and declined to 42.1% in 1989. Personal consumption expanded from 57.9% in 1970 to 64.6% in 1980 and then stagnated to

62.8% in 1989.

In the 1980s, 40-60% of GDP was used for capital accumulation, most of which was fixed investment, and it was financed by net imports equivalent to 30-40% of GDP. This high rate of domestic investment was comparable only to another socialist country (China 38%) and a highly developed city-state (Singapore 37%). In other Asian countries, 30% of GDP was spent for investment in South Korea, 28% in Thailand, 26% in Malaysia, 22% in Indonesia, 17% in the Philippines, 24% in India, 18% in Pakistan, 23% in Sri Lanka, 20% in Nepal, 12% in Bangladesh and 31% in Laos in 1988.⁹

The problem is whether such an

⁸ World Bank, *Mongolia: Country Economic Memorandum*, 1991.

⁹ World Bank, *World Development Report*, 1990.

Table 6: COMPOSITION OF INVESTMENT BY INDUSTRY (%)

Sector	1980	1985	1986	1987	1988	1989	1990	1991
Material	67.7	65.9	68.8	63.5	66.0	64.4	55.2	63.7
Industry	40.4	34.2	39.3	30.7	27.5	29.2	27.2	43.2
Agriculture	13.3	14.5	13.0	13.5	15.4	15.3	10.4	7.1
Construction	1.9	7.7	2.9	5.2	7.0	4.4	4.5	0.8
Transport	5.3	6.3	9.4	10.1	12.2	10.7	9.7	8.3
Communications	5.1	1.9	2.1	1.3	1.1	1.4	0.7	1.4
Trade	1.7	1.3	2.1	2.7	2.8	3.4	2.7	2.8
Nonmaterial	32.1	34.0	31.3	36.4	34.1	35.5	44.8	36.3
Education, culture, art	3.8	5.4	4.4	5.3	4.9	5.7	10.8	6.5
Science, R & D	2.6	2.2	2.9	3.1	2.4	2.9	3.9	8.1
Housing, municipal services	18.8	19.5	17.1	21.6	21.6	23.4	30.9	18.3
Other	6.9	6.9	6.9	6.4	5.2	3.5	2.6	3.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
(Million tugrik)	3104.0	4633.8	4762.5	4552.2	4536.0	4804.2	3383.9	4033.0
[Subsector of Industry]	-----							
Generation of electricity	2.6	12.7	12.4	8.6	3.7	8.0	13.8	23.9
Petroleum refineries	6.7	2.3	4.5	4.1	4.3	2.3	6.4	8.0
Nonferrous metals	5.4	2.5	3.0	2.3	4.7	4.9	2.8	1.8
Chemicals	0.9	3.6	5.4	5.5	2.2	1.0	2.0	0.1
Building materials	12.3	6.1	5.5	4.7	5.0	4.5	6.1	2.1
Textiles	5.4	0.5	1.5	1.7	2.7	2.3	0.8	1.8
Food	1.0	2.4	2.5	0.4	2.2	2.8	3.4	1.2
[Subtotal]	34.3	30.1	34.8	27.3	24.8	25.8	35.3	38.9

Source: Calculated from the data of World Bank and State Statistical Office of Mongolia.

excessive investment was used for productive purposes to accelerate a long-term development for Mongolian economy or not. Table 6 indicates the investment composition by sector. About two-thirds of investment were allocated for the material sector and one-third for the nonmaterial sector. In detail, around 30-40% for industry, some 15% for agriculture, another 15% for service (including transport, communications and trade) and about

20% for housing. In industry, a total of 20-30% of investment was allocated for such basic and modern sectors as generation of electric energy and heating, petroleum refineries, nonferrous metals, chemicals, and building materials, but a total of less than 10% of investment was allocated for such comparative advantage sectors as food, textiles, clothing, leather & fur, and wood processing.

Looking at the branch composition

of capital stock, the general picture is much the same as the annual investment flow above; productive fixed assets comprised 63.5% and 62.8% of all fixed assets at the end of 1989 and 1991 respectively, whereas nonproductive fixed assets were 36.5% and 37.2% respectively. But if we look at the composition by kind, the picture becomes totally different; building comprised 65.0% and 70.7% of all fixed assets, whereas power and working machines and measuring instrument 17.8% and 16.0%, means of conveyance 6.5% and 5.9%, productive instrument and property 7.4% and 4.5%, and working and productive livestock 3.3% and 2.8% at the end of 1989 and 1991 respectively. In other words, more than 60% of all fixed assets were allocated to such productive sectors as industry and agriculture, but a lot of buildings were included in such categories, consequently purely productive fixed assets might comprise only 30% or less. In summary, excessive investment so far made was not allocated for productive uses to accelerate long-term development for the Mongolian economy.

4. Public Finance

The state budget covers the central government and the local governments

which include 3 cities (Ulaanbaatar, Darhan and Erdenet), 18 aimaks (prefectures) and 351 somons (counties). The state budget occupies a very large part of the whole economy, and it is of critical importance for long-term economic development as well as short-term stabilization. Therefore it will be examined here in detail.

It is common for socialist countries to have extremely large public sectors, thereby having a large state budget. Mongolia is not an exception; the budgetary revenue occupied about 50% of GDP and the budgetary expenditure some 60% in the 1980s. The resultant budget deficits, equivalent to some 10% of GDP, was totally financed by foreign loans, almost all of which were from the Soviet Union. As is shown in Table 7, the deficits increased suddenly from 6.9% in 1985 to 17.7% in 1986, but this simply reflects a change of accounting; until 1985 the compensation account was separated from the government borrowing notwithstanding the former consisted of Soviet aid and the export price differential, and it is nothing but a form of financing government deficits. If we add the compensation account to government borrowing, we can get the real amount of budget deficits, which is shown in the

last row of Table 7, and which accounts for some 17% of GDP on average in the 1980s.

Such huge deficits were fully financed by the Soviet Union through concessional loans until 1988, and 90% and 80% of the deficits were covered by loans in 1989 and 1990 respectively, thereby resulting in a cumulative debt on the Soviet Union of one million rubles at the end of 1990. Since the Soviet Union itself collapsed in 1991, the cessation of

Soviet aid forced Mongolia to finance the fiscal deficits by herself. But with a sharp decline of economic activity, tax revenue decreased, state expenditures tended to expand, and the deficits grew. Consequently, the government resorted to domestic borrowing from the central bank with a resultant increase in credit supply. The expansion of money supply caused a rise in inflation, causing a reduction in the people's standard of living.

Table 7: STATE BUDGET as percentage of GDP (%)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Total Revenue	51.1	50.1	51.0	51.1	52.0	52.5	46.8	46.8	45.4	48.9	50.9
Total Expenditure	59.1	55.8	56.3	56.9	58.3	59.3	64.5	65.5	65.0	65.3	64.4
Overall Balance	-7.9	-5.7	-5.4	-5.9	-6.3	-6.9	-17.7	-18.7	-19.5	-16.5	-13.5
Government Borrowing(1)	7.9	5.7	5.4	5.9	6.3	6.9	17.7	18.7	19.5	16.5	13.5
Domestic	-0.4	-1.3	-0.9	-0.3	-0.5	-0.4	-0.6	-0.3	-0.1	1.5	-0.9
Foreign	8.4	7.1	6.3	6.2	6.8	7.3	18.3	19.1	19.6	15.0	14.4
Compensation Account (2)	7.2	8.8	9.9	10.6	11.4	11.4					
Soviet Aid	6.3	7.2	7.6	7.6	7.9	8.1					
Export Price Differential	1.0	1.6	2.4	3.0	3.5	3.3					
※Real Deficits=(1)+(2)	15.2	14.5	15.3	16.5	17.6	18.2	17.7	18.7	19.5	16.5	13.5

Source: Calculated from the data of World Bank.

Table 8: COMPOSITION OF STATE BUDGET REVENUE (%)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Total Revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
(Local Government)	30.8	28.6	27.6	28.1	29.8	28.1	33.3	33.1	43.4	48.6	34.2
Tax Revenue	90.5	91.3	91.3	92.0	91.8	91.2	90.4	89.7	90.6	90.9	82.4
Turnover Taxes	60.6	61.2	59.0	58.8	57.7	55.6	51.9	50.0	48.0	46.0	43.4
Import price differential	43.5	42.6	39.0	37.3	35.7	35.5	35.5	34.6	33.6	33.2	29.5
Domestic turnover taxes	17.1	18.6	20.0	21.6	22.0	20.2	16.4	15.4	14.4	12.8	14.0
Profit Taxes	28.1	28.4	30.9	31.8	32.8	34.3	36.9	38.2	41.0	43.4	37.8
Nontax Revenue	9.5	8.7	8.7	8.0	8.2	8.8	9.7	10.3	9.4	9.1	17.6

Source: Calculated from the data of World Bank.

State revenue consists of tax and nontax revenue. As Table 8 shows, tax revenue accounted for about 90% of total revenue, and nontax revenue, most of which was social security and payroll taxes, accounted for the remaining 10% in the 1980s. The main sources of tax revenue were turnover taxes and profits taxes; the former declined in share from 60.6% in 1980 to 46.0% in 1989, whereas the latter rose from 28.1% to 43.4%. Profits taxes are levied on state enterprises and cooperatives who are making profits; profits are defined as the difference between gross sales revenue and production costs (the latter includes turnover taxes on inputs, depreciation and production taxes). Loss-making enterprises are exempt from profits taxes and receive financial support from the government, so it should be noted that the pure transfer to the government is smaller than the table shows.

Turnover taxes comprise import price differential and domestic turnover taxes; the former reduced in share from 43.5% in 1980 to 33.2% in 1989, whereas the latter increased from 17.1% in 1980 to 22.0% in 1984 and declined to 12.8% in 1989. Import price differential represented the difference between the import contract price and the domes-

tic wholesale price of the imported goods, which was transferred to the budget revenue, but from 1991 it was replaced by an uniform tariff of 15%. Domestic turnover taxes are levied on such public utilities as electricity and water supply, and on such domestically produced goods as vodka, beer and adult footwear; among them vodka contributed some 70% of all domestic turnover taxes.

State expenditures consist of current and capital expenditures; the former absorbed about 80% of the total budget (or 50% of GDP), though the share fell from 83.7% in 1980 to 76.8% in 1989 (see Table 9). The biggest item of current expenditure was "social and cultural" expenses absorbing about 35% of the total expenditure or more than 20% of GDP. This covers such expenditures as education, science, culture, health and social security, and comprises pensions, social security payments, free food and medicine, subsidies and transfers to households and public establishments. The second biggest item (30%) is "national development" expenditure, which include interest payments and purchases of goods and services for expanding material production (export subsidies were also included until 1990). "Administration and defense" is the third largest

Table 9: COMPOSITION OF STATE BUDGET EXPENDITURE (%)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Total Expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
(Local Government)	38.2	37.2	35.2	34.6	35.6	35.4	40.3	44.1	47.0	49.1	49.9
Current Expenditures	83.7	86.2	85.7	84.1	85.2	83.2	81.2	79.7	77.4	76.8	81.1
National Development	30.2	30.2	33.3	33.2	34.6	33.2	32.0	31.0	28.6	29.8	31.2
Social and Cultural	37.5	38.9	37.3	36.5	36.3	36.0	34.9	35.0	35.5	34.9	38.7
Administration and Defense	14.6	15.2	13.9	13.3	13.2	12.8	13.2	12.5	12.2	11.1	10.1
[Wages and Salaries]	17.1	17.8	16.2	16.0	16.1	16.0	15.0	14.2	14.3	13.9	13.4
[Subsidies and Transfers]	na	na	na	na	na	na	41.6	39.0	36.1	37.9	38.6
Investment	16.3	13.8	14.3	16.0	14.8	16.8	18.8	20.3	22.6	23.3	18.9
Material Sectors	5.6	4.1	4.3	5.1	4.8	5.7	7.9	8.3	10.4	11.2	12.8
Nonmaterial Sectors	10.7	9.8	10.1	10.9	10.0	11.1	11.0	12.0	12.2	12.0	6.1

Source: Calculated from the data of World Bank.

Note: na = not available.

Table 10: THE CONSOLIDATED BALANCE OF PAYMENTS

[Millions of dollars]	1980	1985	1986	1987	1988	1989	1990
Trade balance	-274.4	-436.5	-587.3	-542.1	-628.7	-743.8	-318.4
Exports	402.5	566.9	740.8	816.9	829.1	795.8	468.1
Imports	676.9	1003.4	1328.1	1359.0	1457.8	1539.6	786.5
Turnkey projects	-185.1	-362.3	-510.7	-468.4	-391.9	-374.0	-264.5
Services balance	-31.2	-14.4	37.6	20.1	-12.2	-116.6	-68.1
Unrequired transfers	146.5	-0.1	-0.1	-0.3	-0.3	3.9	7.4
Current account	-344.2	-813.3	-1060.5	-990.7	-1033.1	-1230.5	-643.6
Capital account	344.1	844.2	1060.4	1024.9	1037.9	1236.6	590.5
Overall balance	-0.1	30.9	-0.1	34.2	4.8	6.1	-53.1
*Real Trade balance	-459.5	-798.8	-1098.0	-1010.5	-1020.6	-1117.8	-582.9
Export/import ratio (%)	59.46	56.50	55.78	60.11	56.87	51.69	59.52
*Export/import ratio (%)	46.69	41.51	40.29	44.70	44.82	41.59	44.54
Barter trade rate (%)							
Exports	96.42	94.69	95.13	94.61	93.38	90.59	91.37
Imports	97.30	97.75	97.42	96.56	96.77	95.53	85.65

Source: Calculated from the data of World Bank.

Note: *Real Trade balance is the sum of trade balance and turnkey projects.

*Export/import ratio is the percentage of exports divided by imports and turnkey projects.

item, and it declined slightly from 14.6% in 1980 to 11.1% in 1989.

“Wages and salaries” and “subsidies and transfers” are different classifications from those above, and together

they absorbed more than 50% of total expenditure in the second half of the 1980s. The former reduced the share from 17.1% in 1980 to 13.9% in 1989, but it would be extremely difficult to re-

duce further. The latter accounted for about 40% of the total expenditure between 1986 and 1989, and this is a category that is to be reduced in order to improve the fiscal situation.

5. Balance of Payments and External Trade

As we have seen, Mongolian foreign trade was characterized by chronic deficits equivalent to 30-50% of net material product. As Table 10 indicates, the trade balance was consistently in deficit through the 1980s, and the amount rose from \$274.4 million in 1980 to \$743.8 million in 1989. But as turnkey projects aided by the Soviet Union were nothing but imports of merchandise and services, the real trade balance, which includes turnkey projects, was also in deficit, and the amount was much greater; \$459.5 million in 1980 and \$1117.8 million in 1989 (about 34% of GDP calculated on official, overvalued exchange rates). Current balance was also in deficit every year through the 1980s, and was financed by an equally large amount of capital inflow, mainly from the Soviet Union.

The export/import ratio shows that only 60% of imports were possible by exporting the Mongolian products, and

this ratio falls well below 50% if turnkey projects are included in imports. The barter trade rates were much higher than 90%, and these rates also indicate the trade with the Soviet Union. Another characteristic of Mongolia's foreign trade is the high rates of export and import dependence; exports and imports accounted for 24% and 58% of GDP in 1989 respectively. The extraordinarily high rate of trade dependence, of trade partner concentration and of aid dependence made the Mongolian economy extremely vulnerable to such external economic shocks as the breakdown of the Soviet economy and the CMEA trade system in 1991.

Another factor made the economy more vulnerable and the recent economic situation worse in Mongolia; the concentration of exports on primary goods and the concentration of imports on indispensable inputs for production. As Table 11 shows, about 40% of exports were "fuel, mineral and metals", most of which were copper concentrate, 30% were "raw materials" and 10% were "food" in the second half of 1980s. "Other consumer goods" accounted for 15%, most of which were products of wool, cashmere, skin and leather. Thus most exports were primary goods and their products, whose

Table 11: COMPOSITION OF EXPORTS AND IMPORTS (%)

	1980	1985	1986	1987	1988	1989	1990
【Exports】	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Capital goods	0.3	0.2	0.0	0.0	0.1	0.0	0.0
Fuels, mineral and metals	26.4	42.2	40.1	39.4	41.7	42.8	48.1
Chemical fertilizer and rubber	0.0	0.0	0.0	0.0	0.1	0.0	0.6
Building materials and elements	0.4	0.6	4.0	4.5	3.4	4.0	3.9
Raw materials for food industry	13.4	6.1	9.4	7.6	8.1	6.5	5.3
Other raw materials	30.9	24.6	20.1	22.0	22.8	20.5	15.5
Food	19.0	9.4	11.0	10.6	8.1	8.7	6.6
Other consumer goods	9.5	16.8	15.4	15.8	15.7	17.5	20.1
【Imports】	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Capital goods	33.1	36.3	36.1	32.2	30.2	29.6	31.1
Fuels, mineral and metals	24.1	28.7	28.4	30.8	33.5	27.3	27.2
Chemical fertilizer and rubber	6.3	5.9	5.4	6.1	5.6	6.3	5.3
Building materials and elements	1.9	1.4	1.3	1.9	1.4	2.3	1.9
Raw materials for food industry	2.9	1.4	1.0	1.3	0.1	0.8	0.3
Other raw materials	2.4	2.8	2.3	2.5	3.3	4.0	3.8
Food	8.5	6.3	6.2	6.5	7.2	7.7	8.8
Other consumer goods	21.0	17.2	19.1	18.4	18.5	21.9	21.6

Source: Calculated from the data of World Bank.

elasticities of demand were low. The low elasticities tend to handicap an economy; the lower the price elasticity of demand, the less the effectiveness of currency devaluation; the lower the income elasticity of demand, the more likely the terms of trade worsen, and so the export earnings tend to decline in the long run. Mongolia has to increase the export of manufactured goods whose elasticities are high enough to overcome such a handicap.

On the import side, about 30% were "capital goods" such as machinery and vehicles, another 30% were "fuel, mineral and metals", most of which were

gasoline, 6% were "chemical fertilizer and rubber" and 20% were "other consumer goods" like household appliances. This means that two-thirds of the imports (the former three categories) were inputs indispensable for domestic production, so that even a temporary cessation of their supply would cause a serious reduction in economic activities as actually happened in recent years. These imported inputs have price elasticities so low that the devaluation of tugrik would increase the amount of exports necessary to import the same quantity before the devaluation, so that the devaluation

tends to be ineffective or simply detrimental. In addition, since the income elasticities of machinery, vehicles, gasoline and electric appliances are high, imports tend to increase rapidly, causing deterioration of the balance of payments as the Mongolian economy begins to develop again. In this situation, some import substitution must be considered.

III. ECONOMIC REFORM

Mongolia embarked upon a broad economic reform in 1990, when the first democratic election was executed after 70 years under a socialist regime. This fundamental change of economic regime was brought about by an economic crisis in Mongolia caused by the recent collapse of the Soviet economy and the CMEA system. The cause of the present economic crisis will be summarized in section 1; developments of economic reform will be reviewed briefly in section 2; and the major problems of the reform will be examined in section 3.

1. Background of Economic Crisis

As we have so far seen, the Mongolian economy had been so dependent on the CMEA system in general and Soviet assistance in particular, that the collapse of the Soviet Union and the CMEA sys-

tem in 1991 has brought about an overall disorder in economic activities, thereby making it difficult to satisfy the minimum needs of the Mongolian people.

But the decline in GDP was recorded before 1991: -2.1% in 1990 and -9.2% in 1991. What can explain this negative growth in 1990? Until 1988, Mongolia's fiscal deficits were fully financed by Soviet aid. But as economic reform was initiated in the Soviet Union in 1987, her economy fell into confusion and the government faced the problem of rapidly growing fiscal deficits in 1988, as much as 80 billion rubles (about 11% of her GDP). As a consequence, only 90% of the budget deficits of Mongolia were financed by the Soviet Union in 1989.

This 10% cut in foreign finance had a strong deflationary effect to Mongolia; foreign borrowing dropped from 19.5% of GDP in 1988 to 15.0% in 1989; tax revenue, mainly profits tax, was increased from 41.2% of GDP to 44.4% for financing budget deficits. In 1990, only 80% of the budget deficits were financed by the Soviet Union, nontax revenue (mainly fees obtained from cooperatives and state enterprises) was increased from 4.5% of GDP to 8.9% with a resultant deflationary effect on GDP. As explained earlier, Soviet aid has been com-

pletely terminated from 1991 to date, and this caused a sharp drop in GDP of 9.2% in 1991 with a cumulative effect since 1989.

More specifically, the sharp decline of production was caused by the even deeper cut in such indispensable imports as gasoline, spare parts and basic materials, approximately 80% of which were from the Soviet Union. Total imports fell by 50% in 1990, 43% in 1991, and 16% in the first seven months of 1992 compared with the same period of the previous year. Fuel imports in the first seven months of 1992 shrank to one-third of the same period of 1991.¹⁰

Gross agricultural production declined by 3.7% in 1990 and 7.6% in 1991, but a slight rise (1.6% in 1990) and drop (0.5% in 1991) in livestock output concealed a substantial reduction in crops (12.7% and 25.8% respectively). A contrast is apparent here: the livestock sector is self-sufficient and hence resilient to external shocks, while the crop sector is fragile because of its high dependence on external inputs.

Industrial production decreased by 5.7% in 1990, 20% in 1991 and another 20% in the first seven months of 1992.

But the effects were not equal among industries: gross product of building material industry fell by 63.4% in 1991, chemical industry by 61.5%, engineering and metal-working industry by 57.8%, wood processing industry by 46.2%, glass and faience industry by 34.1%, textile industry by 32.0%, non-ferrous metal industry by 29.2%, fuel industry by 22.7%, clothing industry by 22.1%, printing industry by 19.8%, electric and thermal energy industry by 15.8%, but gross product of food industry, and leather, fur & shoe industry increased by 20.0% and 4.4% respectively.¹¹

The overall decline in economic activity reduced exports substantially: 41% in 1990 and 22% in 1991. A slight rise in exports is expected in 1992, but the soft market for Mongolia's traditional exports, copper concentrate, has set back the export recovery. The external trade with the Soviet Union had been settled in terms of transferable ruble, but it was changed to convertible currency since 1990. This made Mongolia's foreign exchange reserves negative and caused the current economic crisis. Now the emergency assistance only makes it possible to import the minimum require-

10 UNDP, *Mongolia: New Orientation for National Development*, 1992.

11 *Ibid.*

ments for the Mongolian people.

Such a decline in economic activity has given rise to a significant increase in unemployment: 55.4 thousand or some 8% of workers were unemployed at the end of 1991. The unemployment problem is more serious in urban areas: the rate of unemployment is expected to become as high as 16% in urban districts and one-third of the total unemployed are registered in such cities as Ulaanbaatar, Darhan and Erdenet in 1991. In addition, more workers are underemployed and earn insufficient income for normal life, a problem which is increasing.¹² Unemployment and underemployment problems are thus brewing social unrest, which in turn may cause political instability in the future.

A substantial fall in production has caused hyper-inflation as a result of a lack of goods and services. If we compare the level of production of some basic necessities in the first half of 1992 with that of 1990, electricity fell by 20%, meat and dairy products by 50% and wheat flour by 15%. As a result, the consumer price index rose to 377 in September 1992 as compared with January 1991 when most prices had been

liberalized. But the disaggregated price indices were quite different: housing goods 599, clothes and shoes 405, food stuffs 398, transport and communications 219, medicine 197, rent and energy 162.¹³ Thus the price of social services rose relatively slowly, but it has become increasingly difficult to get such services recently.¹⁴

Another cause of the recent inflation is a rapid increase in money supply through an expansion of domestic credit. Up to 1990, almost all government deficits equivalent to 17% or so of GDP have been financed through Soviet aid, but after 1991 when the Soviet economy collapsed and external assistance ceased, the Mongolian government had no choice but to resort to a huge sum of borrowing from the central bank. As a result, money supply expanded drastically with a natural consequence of inflation: M-1 and M-2 increased by 54% and 77% respectively from January 1991 to January 1992; by 122% and 147% respectively from January 1991 to September 1992.¹⁵

13 Bank of Mongolia.

14 According to UNDP, *op. cit.*, "in the last four months of 1991, inflation averaged 7% a month and is estimated to have been 120% for the year as a whole. However, the monthly inflation rate has increased in 1992, with an average of 14% for the first seven months."

15 Bank of Mongolia.

12 *Ibid.*

In summary, as the Soviet aid was cut in 1989 and 1990, the Mongolian government had to increase the tax and nontax revenue to make up the deficit and it had a strong deflationary effect on her economy. But the real shock came in 1991, when the collapse of the Soviet Union and the CMEA system caused a sharp cut in imports of Mongolia with a resultant decline in domestic production, which in turn brought about hyper inflation and unemployment problems as well as a serious drop in exports. The drop in exports led to a further cut in imports and a vicious circle set in: a lack of necessary imports reduced the domestic production even further which included the production for exports. The aid-dependence of Mongolian economy exacerbated the situation: the terminated assistance meant a substantial cut in imports, which in turn caused a shrink in production and in exports; huge public deficits became financed by government borrowing from the central bank in place of external assistance from the Soviet Union, thereby aggravating inflation through a sharp increase in money supply.

2. Developments of Economic Reforms

Every economic activity, including agriculture, was under the control of the

state and central planners in Mongolia since the 1930s. In the middle of the 1980s, stimulated by Perestroika in the Soviet Union, Mongolia set out in some economic reforms, but its objective was limited to improving the efficiency of the traditional command economy. The real step towards economic reform was taken in September 1990 when the first democratic election was executed and a new coalition government was formed, which pledged to construct a market oriented economy.

The economic reforms are classified into five categories: price liberalization, privatization of state enterprises, financial sector reform, fiscal reform and external sector reforms. In this section, we will review the recent developments of these economic reforms and examine the major problems in the next section.

(1) Price Liberalization

The Mongolian government has liberalized prices in accordance with the agreement reached with the IMF. In the beginning of 1991, goods and services under state control accounted for some 40% in sales value. This figure fell to 20% by September 1991 and to 10% by July 1992. By the end of 1992, all prices and tariffs are to be liberalized,

but some of them will remain under state control.

As of March 1992, only prices of the nine categories remain under state control: petroleum and diesel fuel, telephone calls, housing and water charges, electricity and heating, public transport, flour, ordinary bread, coal and firewood for heating, and medicine. Farmgate prices for agricultural products have been liberalized, but some of them (live animals, meat, wool, cashmere, grain, potatoes, vegetables, milk, sour cream and eggs) remain under the state order system to ensure the provision of essential food supplies to the population, to increase exports, and to create state reserves.

Almost all retail prices were doubled with the same, simultaneous increase in wages and salaries in January 1991. Wholesale prices and farmgate prices were raised simultaneously but by less than 100%. Since then, factor prices also were liberalized. Wages and salaries, in particular, became freely determined by private enterprises, and they usually increased much higher than inflation. But wage increases in the public sector were kept below the inflation rate to prevent a wage-price spiral, resulting in a wage differential between workers

in private and public sectors.

Thus a price structure which had the same characteristics of most socialist countries was totally changed: low energy prices, subsidized cheap food and housing, free social services, cheap capital goods, very expensive consumer goods (especially, imported consumer goods), and low wages and salaries were changed to become similar to international levels.

(2) Privatization

The privatization process is under way not only in the industrial sector but also in the agricultural and service sectors. This process was initiated by the new law on cooperation in 1988, which promoted private sector cooperatives. In 1990, restrictions on private ownership of herds were eliminated, and finally in 1991 the Privatization Law was passed by the Parliament and the program for privatization was initiated.

In the first six months of 1992, the private sector was estimated to produce about 50% of agricultural output and 15% of gross industrial output.¹⁶ According to the data of State Statistical Office of Mongolia, the number of establish-

16 UNDP, *op. cit.*

ments substantially changed between April 1991 and June 1992: state and public enterprises and organizations occupied 54.5%, cooperatives 30.3% and private individual enterprises 15.2% in 1991; in 1992 the former two fell to 13.7% and 22.2% respectively, while the latter rose sharply to 61.9%.

In the agricultural sector, 22 thousand families have become private owners, and over 60% of livestock has been transferred to private ownership in 1991. In place of former agricultural cooperatives, 227 share-holding companies, and 58 limited companies and cooperatives have been established.¹⁷ As a result, the share of livestock numbers changed drastically between 1989 and 1991: state organization, including state farms, dropped the share of ownership slightly from 8.5% to 7.9%, cooperatives declined sharply from 63.8% to 37.9%, and the private sector almost doubled from 27.7% to 54.9%.

When state farms are privatized, their assets such as agricultural equipment and herds are to be distributed to each farmer according to the number of vouchers he or she owns. The vouchers are given equally and free of charge to

each citizen, including children, so the number of vouchers is proportional to family size. If the farmer gets the vouchers, say from his relatives or friends, he can get more assets previously owned by state farms. Most privatization, however, is not for the agricultural sector. At the end of 1990, the industrial sector had 51.6% of productive fixed assets of the national economy, and the agricultural sector only 20.4%.

According to the government program, approximately 60% of the country's fixed assets amounting to some 24 billion tugriks are to be privatized. Out of these, 18 billion tugriks of assets are under "large" privatization, which includes some 500 large state-owned enterprises to be privatized. Under "small" privatization 6 billion tugriks of assets, or about 3.4 thousand economic units, are to be privatized. For the period from June 1991 to July 1992, over 50% of assets under large privatization and around 70% of assets under small privatization have been privatized.¹⁸ Some large enterprises are scheduled to remain in state ownership: mining, energy, rail and air transportation, communications and water supply.

17 *Ibid.*

18 *Ibid.*

In most cases, when state-owned enterprises are privatized, they are sold to the workers of those enterprises. They have to satisfy certain conditions in order to get them, otherwise the enterprises are to be sold by auction to other persons who can afford them. The conditions are (1) to collect the vouchers equivalent to the value of the enterprise's assets estimated by the State Privatization Commission; (2) to have the consent of all workers in the enterprise; and (3) to demonstrate to the commission that they have a well-designed management plan for the future.

The privatization process is thus difficult, but their future is expected to be more difficult since about 60% of state-owned enterprises have been in deficit. Their deficits were so far financed by the government through subsidies, but loss-making enterprises must go bankrupt after privatization.

(3) Public Finance Reform

As mentioned earlier, the government has run deficits as high as 17% of GDP, almost all of which were financed by Soviet assistance until 1990. When the Soviet Union collapsed and the assistance terminated in 1991, it became necessary for the Mongolian government

to reform her fiscal system. The first step was taken in January 1991 when the tax system was restructured. Before tax reform, profits taxes, import price differentials and domestic turnover taxes averaged around 40%, 35% and 15% respectively of total revenues in the second half of the 1980s. These taxes were replaced by corporate and personal income taxes, customs duties at a uniform 15% rate, and more broadly based sales taxes respectively. In September 1991, additional measures were introduced to supplement the new revenue sources: an increase in customs duties to 25%, the doubling of sales taxes on liquor, tobacco and gold, and automatic payroll deductions of social security payments.

On the expenditure side, some government ministries were already rationalized in 1987 and 1990 to reduce the current expenditure, which accounted for about 80% of total expenditures, but it was not very effective. Then the expenses for national development and capital investment were cut drastically: their shares in GDP declined from 20.0% in 1990 to 10.0% in 1991, and from 12.1% to 5.3% respectively. Subsidies and transfers accounted for about half of current expenditure, though most of them were distributed to the national develop-

Table 12: COMPOSITION OF TRANSFERS TO PUBLIC ENTERPRISES AND SUBSIDIES by sector (%)

	1986	1987	1988	1989	1990	1991
Total Transfers and Subsidies	100.00	100.00	100.00	100.00	100.00	100.00
Agriculture	29.39	31.15	28.25	28.61	31.11	2.75
Industry	14.22	15.90	18.74	19.36	26.33	55.81
Construction	3.06	1.53	1.11	0.90	1.05	1.65
Transport	1.69	1.79	2.06	1.32	1.86	2.32
Trade	35.08	31.77	28.98	27.22	20.43	0.00
Housing	4.10	4.38	7.29	9.85	5.99	6.52
Other services	12.46	13.47	13.56	12.75	13.22	30.96

Source: Calculated from the data of World Bank.

Note: Data in 1991 is budget.

ment expenditures. They were sharply cut in 1991 and their share in GDP dropped from 16.2% in 1990 to 5.8% in 1991.

The sectoral distribution of transfers and subsidies is shown in Table 12. All items were reduced in real terms, but the reduction was not even by sector: trade and agricultural sectors together accounted for more than half of the total until 1990, but they became almost null as export subsidies and farmgate price subsidies were eliminated in 1991; the industrial sector received 55.8% of the total subsidy in 1991, most of which was for electric and heating energy production; other services received 31.0% in 1991, which comprised geologic research and veterinary services. Social security payments are not listed in this table, but they reached 21.2% of total expenditures in 1991, almost double the share in

1990.

By these attempts to reduce national expenditures, their share in GDP decreased from 64.2% in 1990 to 47.2% in 1991. Yet the share of national revenue in GDP also dropped from 50.7% to 32.1% in the same period resulting in a rising share of fiscal deficits from 13.5% to 15.1%. This decrease in budget revenue arose from two elements inherent in the transitional period. First, a low level of general economic activities, which was caused by the recent economic turmoil, resulted in a low level of tax revenues. Second, new tax sources did not generate the expected amount of revenue for lack of an effective tax administration for new taxes, while the traditional sources of revenue were already abolished. The newly introduced customs duties, in particular, were expected to generate about 20% of total revenues,

but yielded only 4.9% in 1991 due to long lines at the border and an ineffective tax administration. It will take much time to stabilize the economy and to overcome such problems in the transitional period, so external assistance will be necessary for the time being.

According to *The Action Program of the Mongolian Government*, 1992, further reforms are scheduled to improve the present fiscal condition. The tax law adopted in 1991 will be abolished and the new tax law will be established in 1993. The existing tax law has charged enterprises the corporate taxes on net revenue at six different rates, between 8% and 46%, depending on their size. The new tax law will stipulate a unified or two rate tax on total profits (with depreciation and labor costs now deducted). Tax deductions given to state enterprises and individuals will be reduced significantly. The new sales tax will be imposed on goods directly and the number of items covered by the law will be increased. Taxes are to be levied on immovable property. Budgetary subsidies to the fully or partly state-owned enterprises will be cut drastically from 1993 and completely stopped thereafter. On the other hand, tax exemptions will be granted to such economic entities that

contribute to the improvement of food supply or to the growth of exports by producing internationally competitive goods using advanced technology.

(4) Financial Reform

Until May 1991, when the new Banking Law became effective, there had been only one bank, the State Bank, which performed both central and commercial banking functions. The State Bank was then divided into a central bank (the Bank of Mongolia) and a foreign trade bank (the State Bank of Mongolia). From November 1991, commercial banking functions were transferred to seven newly established commercial banks: Investment and Technological Innovation Bank, Mongolian Cooperation Bank, Transportation Bank, the Insurance Bank, Agricultural Bank, Industrial Bank and Public Bank of Mongolia.

The central bank has tightened monetary and credit policies in order to contain inflation which was caused by price liberalization in January 1991. The major tool of monetary policy was minimum cash reserve requirements for commercial banks which were increased from 8.5% to 40% in 1992. The interest rate on central bank loans to commercial banks has been gradually increased, first

to 30% in April 1992, then to 35-60% in August and to 120% in September. However, these policies have limited effects on inflation because the interest rates set before the new banking law are held low and because the banks still hold a huge amount of loans made to the loss-making state enterprises.

The new banking law stipulates that all commercial banks enjoy the right to set interest rates according to their own policies and collect commissions for money deposits and credits as well as establishing their own exchange rates for purchase and sale of foreign exchange to the non-bank public, and that three commercial banks have the right to carry out international foreign exchange transactions.¹⁹ But the actual extent of their own discretion is yet unknown.

(5) External Sector Reforms

Mongolia's external economic relations had been almost limited to the CMEA countries, but the government opened up her economy to western countries in 1990 when the first democratic election was conducted and the transition to a market-oriented economy was declared. Since then, Mongolia has opted

for steering a course toward market relations and conducting an open-door foreign policy. At present, Mongolia is a member country of the World Bank Group (IBRD, IDA and IFC), the Asian Development Bank and the IMF, and is applying for membership in GATT. The open-door policy is particularly important in Mongolia where technology transfer is necessary through foreign investments and external trade. In addition, it is the most effective way to cope with the difficult problem of domestic monopoly.

Up to 1989, when the monopoly of state trading corporations was eliminated, external trade had been handled solely by five foreign trade corporations and the large state-owned enterprises. In 1991, direct export rights were granted to selected manufacturers and foreign trading rights were issued on a non-discriminatory basis to private and public enterprises. Almost all export restrictions have been lifted; only the items connected to environmental protection and a few kinds of raw materials still need a licence today. However, only 5% of exports were provided by the private sector in 1992 since the main export oriented enterprises are still state-owned. Some 80% of imports and exports are barter trade with the ex-Soviet Union,

19 *Ibid.*

and the barter trade is still under the state order system. The government plans to abolish the state order system and the import licence in the near future.

The state-owned enterprises, which exported 95% of total exports in 1992, had to surrender their foreign exchange earnings at the official rate until 1989, but thereafter they can retain part of them and sell them in a free market. Foreign exchange earned above state orders and earned by private exporters can be retained in full. The exchange rate was $T3 = \$1$ until June 1990, but was devaluated to $T5.6$, then to $T7.1$ in May 1991. The foreign exchange regime was changed to the present three-market structure in June 1991: the commercial rate was revaluated to $T40 = \$1$, the rate for barter trade was kept $T7.1 = \$1$, and the free market rate ranged between $T100$ - $T150 = \$1$ in 1991. The commercial rate was devaluated again to $T150 = \$1$ in January 1993, but the prevailing market rate was between $T250$ - $T300 = \$1$ at that time. Hence the official rate is still overvalued. The rate may be devaluated again in the near future because it failed to achieve the target agreed with the IMF, which is to keep the differential between the official and market rates to less than $T90$ per dollar.

When Mongolia opened up her economy to the world in 1990, the Foreign Investment Law was enacted. Since then, foreign investment has been a priority for the government, but the law has not been effective enough to attract many foreign investors. As many as 149 economic units had been established as joint venture by July 1992, but only 34 economic units started their business activities (15 in industry, 10 in service, 6 in trade, 2 in public catering and 1 in construction). Out of 149 joint venture economic units, 75 are with the ex-Soviet Union, 31 with China, 5 with East European countries, and only 31 are with capitalist countries (10 with Hong Kong; 7 with Japan; 2 with USA, Canada, Germany and Taiwan; and 1 with Austria, England, Switzerland, South Korea, Singapore, and Macao). Thus foreign investments are concentrated on the ex-CMEA countries and on the mining industry. In February 1991, the Petroleum Law was enacted which permitted foreign investors to hold mining rights for 20 years, but foreign investments are not expected to occur very soon.

The new Foreign Investment Law is under discussion in parliament and is scheduled to enter into force in 1993. It is revised to create more favorable con-

ditions for foreign investors, including investment guarantees, tax exemptions for 5-13 years depending on the industry, region and so on. To encourage further investments, free economic zones or processing zones will be set up in some regions upon the creation of appropriate economic and legal prerequisites. But a basic problem is a fear of economic control by Chinese investors, which makes the policy decision difficult politically. Another problem is a lack of policy coordination among foreign investment, international trade and industrial policies, though they should promote economic development in close cooperation.

3. Problems of Economic Reform

We have seen minor problems of economic reforms in reviewing their developments. There are some major problems inherent to an economy in transition, which will be discussed in this section: problems of a shock therapy approach to economic reform, price liberalization without effective markets, and economic inequality in the transitional period.

(1) Shock Therapy Approach to Economic Reform

There are two types of economic re-

form: shock therapy and gradualism. The former is an approach to transforming a centrally-planned economy to a market-oriented economy as soon and thoroughly as possible. The following measures are carried out together at one time: to liberalize trade and prices, to open up the economy to the world, to unify foreign exchange rates through devaluation, to reduce budget deficits mainly by cutting subsidies, to privatize state enterprises, and to increase interest rates with financial reform. This approach was adopted in Poland from 1990, Czechoslovakia and Romania from 1991 and Russia from 1992. The latter is a gradual approach to a market-oriented economy, and the above mentioned measures are introduced step by step in accordance with economic conditions; it takes longer to complete the transition to a market-oriented economy.

The IMF and the World Bank are in favor of the shock therapy and have so far recommended or persuaded the ex-socialist countries including Mongolia to adopt such an approach. As we have seen in the former section, the government of Mongolia had started economic reforms in 1990 and has carried out most of them in a short time. About 90% of prices were liberalized in sales value

by July 1992, and almost all prices are scheduled to be liberalized by the end of the year. Wages and salaries became determined freely by the private enterprises from 1991. For one year to July 1992, over 50% of assets under large privatization and around 70% of assets under small privatization were transferred to private ownership. Some 50% of agricultural output and 15% of industrial output were produced in the first half of 1992. Subsidies were sharply cut and their share in GDP fell from 16.2% in 1990 to 5.8% in 1991. The minimum reserve requirements were increased from 8.5% to 40% in 1992, and the interest rate to commercial banks boosted to 120% in September 1992. Almost all export restrictions have already been lifted, and in the near future the state order system and the import licence are to be abolished. The foreign exchange rate was devalued several times in two and half years from 3 tugriks to 150 tugriks per dollar.

In 1992, the UNDP recommended Mongolia a similar approach to what the IMF and the World Bank had recommended for other countries. According to a policy recommendation submitted by UNDP to the Donor Consultation meeting held in Ulaanbaatar, 14-15 October

1992, the short term strategy should be as follows.

"The basis of the government's short term strategy to overcome the crisis lies in conducting policies to speed up the process of transition to a market economy. To achieve this objective the government will take the following measures: to complete privatization in the shortest possible time; to liberalize the remaining prices under state control; to revise existing legislation to make it appropriate to a market economy; to reduce the current shortages of food and consumer goods; and to improve the operations of the fuel, energy and export oriented industries."²⁰

The Mongolian government accepted the recommendation in principle. A kind of shock therapy has been adopted in Mongolia and it will be strengthened from now on. But this approach has turned out to be rather problematic in East European countries and Russia. According to the data of the EBRD,²¹ in Poland, where a shock therapy was introduced in 1990, the real GDP declined by 12% in 1990, 9% in 1991 and 0% in 1992, the CPI (Consumer Price Index)

²⁰ *Ibid.*

²¹ European Bank for Reconstruction and Development, *Annual Economic Review*, 1992.

rose by 249% in 1990, 60% in 1991 and 40-45% in 1992; the unemployment rate increased from 6.1% in 1990 to 11.4% in 1991 and 13% in 1992. In Czechoslovakia, where such an approach was adopted in 1991, the real GDP decreased by 16% in 1991 and 7% in 1992, the CPI rose by 54% in 1991 and 12% in 1992, and the unemployment rate was 6.6% in 1991. In Romania, where a shock therapy was implemented in 1991, the real GDP fell by 13% in 1991 and 8% in 1992, the CPI rose by 223% in 1991 and 160% in 1992, and the unemployment rate ascended from 2.9% in 1991 to 7% in 1992. Finally, in the Russian Republic, where the program for economic reform was adopted in 1990 and the radical reforms were carried out in 1992, the real NMP dropped by 3.6% in 1990, 11.0% in 1991 and 20% in 1992, the retail prices rose by 152% in 1991 and 2200% in 1992, and the unemployment rate was 3% in 1992 but is increasing sharply in 1993.

As well documented in these countries, the shock therapy first caused a sharp drop in output and a steep rise in prices. These shocks tended to diminish in the following years, but the effects accumulated, thereby increasing unemployment year by year. The "transition

costs" proved to be very high in these countries where no one had experienced unemployment.

Similar effects were found in Mongolia after a broad economic reform was initiated in 1991: the real GDP shrank by 9% in 1991 and 5~13% in 1992, the CPI rose by 54% in 1991 and 145% in the first seven months of 1992, and unemployment more than doubled from 24.8 thousand at the end of 1990 to 55.4 thousand persons (about 8%) at the end of 1991.

But as we have seen in section 1, such drops in GDP are partly attributable to the cumulative effect of diminishing aid from the Soviet Union. It is, therefore, expected in the future that the economy will be damaged more seriously if economic reform is carried out thoroughly and quickly as the UNDP recommended. A more gradual approach is necessary to consider in order to lower the transition costs.

(2) Price Liberalization without Effective Markets

The World Bank and the IMF almost always recommend to liberalize prices and to get them right. It may be an appropriate policy for advanced market economies, but it is not at all

appropriate for an economy in transition from a centrally-planned economy because effective markets do not yet exist. Theoretically, effective markets require several conditions: negligible transaction costs, no government intervention, and perfect competition; the last one is well known to be made of homogeneous goods or services traded, many suppliers and consumers, perfect information, and free entry and exit.

It is apparent that most are not satisfied in Mongolia. Now that the central planning and state order system is eliminated or diminishing, "market infrastructure" such as economic laws and institutions for transactions must be set up in a short time. But it takes rather long to establish this infrastructure and then to accumulate sufficient experiences to make transaction costs low enough. In addition, most Mongolian people are not used to market transactions, and the number of merchants and brokers are not enough for well-functioning markets. Furthermore, the previous state order system still remains with the influential bureaucracy of the old regime likely to intervene into markets.

But the biggest problem is monopoly and monopsony broadly found in Mongolia. In the CMEA system, production of a

certain good was concentrated in a very few enterprises so as to achieve economies of scale. In most industries, there exists only one enterprise to produce a particular good in Mongolia. Then if prices are liberalized, enterprises tend to increase prices to get monopolistic profits which are much higher than those in perfectly competitive markets. A low level of infrastructure such as transport and communication facilities prevents import competition from easing such a problem. A small scale market with 2.2 million consumers would make foreign investors hesitate to come and produce in Mongolia. These obstacles tend to hinder prices from finding a correct level and from functioning as signals to allocate scarce resources optimally. It will take a long time to overcome these obstacles, and this is another reason why a gradual approach is necessary for Mongolia.

More importantly, it may be that the dichotomy of markets and planning itself has the problem of oversimplification. Both markets and planning have advantages and disadvantages; the market-price mechanism has its limits, known as market failure. Planning is better used for greater modification in real variables against an earlier situation even in a

market economy. As Janos Kornai properly pointed out, "Within a given system, planning is given a greater role in more highly concentrated industries, in fundamental decisions involving greater risks and relating to indivisible major units, and in the control of effects not measurable with prices," such as externalities and public goods.²²

Theoretically, a price change will induce both changes in production and in consumption, then a proper industrial structure and an expenditure composition will result. But supply and demand responses may be too slow because of a high concentration of industries, high risks, technical indivisibilities and/or high adjustment costs to cope with a new condition, or there may be no response at all from the supply side simply because there exists no producers. Price liberalization may stimulate or promote their activities, but it will not in itself create capitalists, entrepreneurship or managerial talent.

In such a case, some industrial policies, including small business assistance, are necessary in order to supplement the market mechanism. It is expected that an economy in transition takes longer to

cope with a totally different price structure, and that the government should adopt positive industrial policies to promote or to create essential producers. In any case, market and planning must go hand in hand, and we should not fall into the false dichotomy.

One important price, the foreign exchange rate, illustrates the above mentioned problems very well. Mongolia's currency was devaluated from 40 to 150 tugriks per dollar in January 1993. This is one of the attempts to reduce trade deficits equivalent to 30~40% of GDP. But this will not only be ineffective to improve the balance of payments position, but also will it be detrimental to Mongolia's economy and people.

First, provided the present condition that over 80% of exports are minerals and raw materials with low price elasticities of demand and that two-thirds of imports are indispensable inputs for production whose price elasticities of demand are also low, the devaluation will not improve the balance of payments position very much. In order to reduce trade deficits, Mongolia's trade structure must be changed by altering her production and consumption structures, but it will take rather long.

Secondly, not a nominal rate but a

22 Kornai, J. *Anti-Equilibrium*, 1971.

real rate must be kept low for improving the external balance, but devaluation tends to cause high inflation through rising import prices in Mongolia, quickly resulting in a further devaluation. A spiral will tend to start between devaluation and inflation. Import substitution policies are needed to mitigate such a spiral, but it takes long for the policies to produce a sufficient effect.

Thirdly, devaluation improves an external trade balance, theoretically, by reducing domestic expenditures and by switching the expenditures from tradable to non-tradable goods, but such expenditure reduction and switching are extremely difficult to realize in the present condition when real expenditures were already reduced by a sharp drop in imports and domestic production (real income per capita declined by 42% between 1990 and 1991). If such an expenditure reduction does happen in Mongolia, political instability is most likely to result through social unrest.

Another important price, the interest rate, has similar problems. First, the deposit rates of savings accounts were increased from 8% in 1991 to 8~36% in 1992, but the inflation rates (general CPI) were much higher: 54% in 1991 and 145% in the first eight months

of 1992. The real rates of interest were thus negative, so that individuals' time savings deposits declined in real value by 48.2% from January 1 to September 1, 1992.²³ Price stabilization is necessary to make the real interest rates positive.

Secondly, a lack of confidence has aggravated the problem; Mongolia's bank system has not yet established the confidence of the public, particularly in the status quo where only a limited amount of savings can be drawn from a bank freely. People tend to hoard their money instead of putting it in a bank. As long as such a restriction and the high rate of inflation last, it will be difficult for the bank to win confidence and collect money from the public. It will take some time to stabilize prices and to recover the public's confidence.

Thirdly and more fundamentally, real saving or the release of productive resources may not be possible in Mongolia. Her economy may be too poor to produce a significant amount of surplus for investment. Or most fundamentally, this country may have a common problem to most developing countries: a lack of capacity to invest. In such a case, nothing will change by liberalizing the

23 Bank of Mongolia.

interest rates. Economic recovery and development are the essential prerequisites to produce some surplus for investment, and a long-range policy is necessary to build the capacity to invest.

(3) Economic Inequality in the Transitional Period

Economic liberalization is likely to increase economic inequality among individuals in general and between urban and rural areas in particular. When greater opportunities occur through economic liberalization, some can seize the opportunities by chance or with talents, and others miss or are not offered them or are incapable of utilizing them. The greater the opportunities open to individuals, the greater the inequality among them. The process is cumulative as the Bible states: haves get richer and have-nots get poorer. As long as the principle of equal opportunity holds, such an inequality is regarded as a necessary evil for economic development, and the losers are to be helped by the social welfare measures or the social safety net.

The problem is that the principle of equal opportunities does not hold in most cases. First, good opportunities tend to concentrate in urban areas, where most foreign aid is spent and where most eco-

nomic activities are carried out. External economies in urban areas attract more and more money, activities and people to the cities, and the cities grow bigger and bigger to generate more external economies. Thus city dwellers can enjoy more and better opportunities than rural people. This is a common tendency in almost all countries, but it is conspicuous in developing countries who receive a disproportionately large amount of foreign assistance. Mongolia is a perfect example. The fiscal deficits of as much as 17% of GDP had been financed by foreign aid; one-third of the total population concentrate in the largest three cities, and it is extremely difficult or costly to extend social services to sparsely populated rural areas. Such social services as general education and health care are planned to be cut in rural areas so as to reduce budgetary deficits, but this will further worsen the present unequal opportunities between urban and rural dwellers with the resultant economic inequality.

Secondly, materials shortage and price inflation in the transitional period tend to widen the gap between haves and have-nots. One reason is that real asset holders are more resistant to shortages and inflation than workers, and farmers

and factory workers can tide over the period of hardship much better than office workers. An underground economy develops in such a period, and it expands the gap between them. Another reason is that foreign currencies are the best means to protect value against inflation, but everyone does not have equal access to US dollars. Now that foreign exchange earned above state orders and earned by private exporters can be retained or sold in free markets, some enterprises and traders can be immune to price inflation and currency devaluation. On the other hand, the unemployed, the aged, the handicapped, widows, orphans, pensioners, and other weaker members of Mongolian society are so dependent on their savings or some payments fixed in domestic currency, that they are quite vulnerable to inflation.

According to the UNDP, "At present there are a total of 69,000 families, approximately 350,000 people, living below the official minimum income level, of which 30,600 are elderly with low income, 12,000 are invalids, and 22,400 are single mothers with many children," and "every second person in this country has received benefits from the social security system".²⁴ Differentiating effects

of inflation is therefore strong in Mongolia. Social security and insurance services are necessary to protect such people, unfortunately it will also increase government deficits.

Thirdly, economic reform may worsen economic inequality among individuals. Privatization by vouchers, for example, was meant to make each citizen an equal stockholder of public enterprises. In reality, however, not all enterprises are making profits and have stock worth owing. If an enterprise is doing very well, everyone wants to get its shares, but the first priority is given to the workers who are engaged in that enterprise. The others can get the remaining shares, but usually none are left for outsiders. Public servants, in particular, have less access to profitable stocks since they did not work for any enterprises.²⁵ The same holds true of the unemployed, the aged, the handicapped, widows, orphans, pensioners, and so on. The vouchers mean almost nothing to them, and they sometimes exchange their

25 A few of them, however, may have better access to useful information to gain money. The members of the State Privatization Commission, for example, have access to "insider information" of enterprises to be privatized and can easily make money by utilizing the information. Generally speaking, in a period of economic chaos, those who have accurate and up-to-date information can make money.

24 UNDP, *op. cit.*

vouchers for a bottle of vodka or something. Thus many vouchers tend to concentrate in the hands of a small number of people. Those people will then have a larger share of profit-making enterprises. This is just an example of how people become economically unequal through economic reform. Similar problems happen in many ways in the transitional period.

But a more fundamental problem is whether or not such a concentration of capital is necessary for economic development. According to the Kuznets curve argument, income distribution of a very poor country gets uneven as her economy begins to develop, but it becomes more even as her economy develops further. Higher inequality was considered to be inevitable for accelerating economic growth by concentrating income in a small number of capitalists who are most likely to invest. Then a trickle-down effect was expected to equalize the income distribution in the second phase. But this argument was denied by the fact that some Asian NIEs succeeded in rapid economic growth with even distribution of income.²⁶ A recent study examined the data of income dis-

tribution and concluded "that high growth need not come at the expense of improved equality and the sharing of the poor in growth, provided appropriate policies are in place."²⁷ For Asian NIEs, the policies were land reforms, agricultural development and a strategy of labor-intensive growth. The problem boils down to what is the appropriate economic strategy for Mongolia, but it lies outside the scope of this paper. We must leave that topic for another paper.

26 Chenery, H.B. et al., *Redistribution with Growth*, 1974.

27 James, W., S. Naya and G.M. Meier, *Asian Development*, 1989, p.205.