Assessing Transition Policies: the Case of Mongolia

Hiroshi UENO*

Introduction

The purpose of this paper is to derive implications for better policies of economic transition by assessing the performance of Mongolian transition policies. The paper structure is as follows. Chapter 1 sets up a model of Mongolian economy at the outset of its transition in 1989, a descriptive model without any mathematical equations. Chapter 2 describes transition policies of the government of Mongolia, IMF and the World Bank (WB). Chapter 3 assesses their performance mainly based on their goals and economic outcomes. And Chapter 4 derives implications for better transition policies from the results of assessment in Chapter 3.

1. Model of Mongolian Initial Conditions

1.1. Initial Conditions

Economy, population and land. Mongolia had achieved substantial GDP growth during the period of command economy thanks to heavy assistances from the ex-Soviet Union. Even though it had slowed down in 1980s, the real GDP had grown at 6.8% per annum during 1981 through 1985 and at 5% per annum during 1985 through 1989[1]. In 1991, the GDP per capita was US$58 to $86 at the free market rates, of Tg.100～150 per US dollar, US$210 at the official commercial rate of Tg.40 per US dollar, or US$1,218 at the official barter trade rate of Tg.7.1 per US dollar[2]. Inflation was 53% in 1991[3]. Population was small at 2.2 million in 1989 on a vast land of 1.6 thousand square kilometers. It is a land-locked country sharing the borders with two of the largest economies in the world, China and Russia.

Characteristics at the beginning of the transition. First, Mongolia was the second longest socialist country only second to Russia. Since its independence from China in 1921, it had been a socialist

---

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

1 APIC[1999], p.13.

2 Matsunaga[1993a], p.66.

3 NSOM[1998], p.117.

country for about 70 years up to 1990 when the government announced to construct a market-oriented economy. Starting from its independence movement in 1921, it had been always supported by the ex-Soviet Union. Its economic and political tie with the ex-Soviet Union had been so strong that it had been called "16th republic of the Soviet Union," with very strong influence from the Soviet Union.

Second, Mongolia had been heavily dependent on the assistance from the Soviet Union, the assistance having been about 30% of GDP throughout 1980s. Most of the assistance was loans, creating a huge debt to the Soviet Union amounting to about 10 billion transferable ruble (TR) at the end of 1989 or about US$16 billion at the official exchange rate of US$1.6 per TR in 1989.

Third, Mongolian economy had been deeply entrenched in the Council for Mutual Economic Assistance (CMEA, formerly called COMECON) system, and had been assigned the role of a primary commodity provider to the Soviet Union and CMEA countries. Its exports were mainly mineral resources represented by copper concentrate and livestock products such as meat, wool, fur and leather; its imports were mainly energy, machinery and spare parts. In 1989, 91% of the export went to CMEA countries including the Soviet Union and 7% went to the Soviet; 94% of the import came from CMEA countries including the Soviet Union and 83% came from the Soviet Union[4].

Fourth, Mongolia was also heavily assisted by the Soviet Union in terms of engineers and managers. It is said that about 100 to 200 thousand Russians were in Mongolia before the collapse of the Soviet Union[5]. Though most of them were military related personnel, there also were a substantial number of managers and engineers taking leadership and command in factories and government offices. Most of them left Mongolia along with the collapse of the Soviet Union. This departure created a vacuum of management and engineering in many areas particularly constraining the operation of mining and manufacturing industries and utility industries.

Fifth, the degree of nationalization of the economy in Mongolia was neither at the extremely high levels of Russia or Kazakhstan (a former republic of the Soviet Union) nor at the very low levels of China or Vietnam around the period of 1985 and 1990. That is, the share of state-enterprises in the total employment was at the medium level of 44% in Mongolia, as compared to the high levels of 93% in Russia (1985) and 93% in Kazakhstan (1988) or to the low levels of 19% in China (1978) and 10% in Vietnam (1985)[6].

Sixth, its economic structure was artificially distorted in favour of the industry sector against its

4 NSOM[1999], pp.140-141.
5 JICA[1997], p.3.
6 Shimomura[1996], Table8.5 on p.249.

comparative advantage in livestock. The share of industry (mining plus manufacturing) in the national income excluding services had been pushed up from a meager 9% in 1940, to 32% in 1985, and then to its highest at 36% in 1990[7].

Seventh, however, Mongolia is rich in mineral resources, and the mining sector also has a comparative advantage. The mining sector was the largest contributor to government revenues and had the largest share in exports at the beginning of the transition. Its share in the total export was 50% in 1992[8].

Eighth, the livestock sector has the highest comparative advantage. But the number of livestock had declined from its peak of 26.2 milliom heads in 1940 down to 22.7 million in 1987 because of (a) the government's priority in industrial development in expense of livestock sector and (b) unsuccessful operation of Negdel, livestock cooperatives organized by the government. It regained its growth after 1987 thanks to partial privatization policies of the government (see Chapter 3), and the number of livestock reached 24.7 million by 1989[9].

Nineth regarding the factors of production, Mongolia was and is rich in human resources and poor in capital. Particularly, human resources were and are strong because its population was well educated in 1989. The adult literacy rate reach 91% in 1990[10]. Based on its July 1991 study, the World Bank [1991b] reported that:

> "The main features of Mongolian education sector are: adult literacy of 97 percent; high enrollment ratios; compulsory free education; educations' high share (14.2 percent) in the budget; and narrowly focused technical, vocational and tertiary education curricula typical of centrally-planned economies."[11]

Tenth, there were large twin deficits. As a socialist economy depending on the Soviet Union, Mongolia ran the twin deficits of huge size. The trade deficit was 21% of GDP in 1990, the budget deficit (with its revenues including grant aids) was 13% of GDP in 1991, and the government's total expenditure was 47% of GDP in 1991[12].

Eleventh, there were three external shocks. Above are the initial conditions of the economy at around 1990. But there were three external shocks that need to be added to the initial conditions be-

7 NSOM[1997], p.96, and SOM[1997].
8 NSOM[1997], p.120.
9 NSOM[1998], p.134.
10 WB[1991b], p.158.
11 WB[1991b], p.75.
12 JICA[1997], pp.98 and 100.

cause they exerted major blows to Mongolian economy. They were (a) complete stoppage of the assistance from the Soviet Union in 1991, (b) collapse of CMEA system in 1991, and (c) the home-going of most of Russian managers and experts along with the collapse of Soviet Union in December 1991. Their effects are discussed during the course of analyzing transition policies in Chapters 2 and 3.

1.2 The Model of Mongolian Initial Conditions

To describe transition economies and their initial conditions, the three-tier framework proposed by K. Ohno [1996] is useful. This paper uses his framework to model the initial conditions of Mongolia's transition. K. Ohno [1996] claims that the structure of a typical transition economy consists of three tiers, i.e., the tiers of (a) a traditional economy system at the bottom, (b) a market economy system above it, and then (c) a command economy system being imposed over the two systems (see Figure 1). Slightly expanding his idea, this paper assumes that the three tiers are embodied in three blocks in a transition economy: (a) a traditional economy block, (b) a market economy block, and (c) a command economy block.

Command economy system
Market economy system
Traditional economy system

Figure 1. Three-Tier Framework of a Transition Economy
Source: K. Ohno[1996], p76; modified by the author.

The traditional system is the economic production and distribution system not based on marginal productivities and competition but based on symbiosis and certain community rules which can be economic and non-economic. It normally operates based on a certain community. Its economy is typically represented by low productivities, small scale operations, low capital-labor ratios, and very small markets defined as trading areas. The rules typically try to reduce free riders, to avoid the tragedy of commons, and through these two to maximize the welfare of the community. In other words, it tries to achieve the results of cooperative game.

The market economy is already well defined. It is the production and distribution system based on marginal productivity and on the free economic activities by economic agents. It tries to maximize individual economic agent's welfare rather than the community's or state's welfare, even though these two welfares can be achieved at the end of the agents' maximization of their welfare.

The command economy system resembles the traditional system. But it produces and distributes goods and services based on a plan designed by a highly centralized state planning committee. It operates based on large-scale, state-wide bureaucracy and on the police power plus the dictatorial power of a single party. The plan tries to achieve the efficiency of production by using the division of labor among regions and republics and using the economy of scale by concentrating the production in one place. The system preferrs monopoly or oligopoly. The production is separated from the efficiency in consumption. And it tries to maximize the welfare of the country rather than the welfare of individual agents including consumers and producers. Then the transition is defined, according to K. Ohno [1996], as the transfer of labor, capital and land from the command and traditional blocks to the market block.

Five groups of transition economies including Mongolia were modeled by the degree of their involvement in the three tiers (Table 1 below). Mongolia could have been included in the model of Commonwealth of Independent States (CIS, a group of former republics of ex-Soviet Union), but separated for the convenience of this paper. Mongolia is quite different from CIS countries in only one aspect: the aspect of the degree of involvement in state-enterprises (refer to the third column in Table 1).

The degree of involvement in the command system was measured by two indicators, the involvement into CMEA (Council for Mutual Economic Cooperation) system and state-enterprise system. As for CMEA, China and Vietnam were not involved in. As for measuring the involvement in state enterprises, the paper uses Shimomura [1996] which offers the percentage share of state enterprises in total employment at the beginning of their economic reforms (column three in Table 1)[13]. As for the strength of the existing traditional tier, the author relied on his own judgment on the strength of community values over individual values in each group.

As for the strength of the market economy tier, it was judged by the degree of experience in private enterprises and market activities before committing to the command system. Mongolia had almost no experience in those activities of enterprises and markets since it had shifted directly into the command system from its traditional self-sufficiency economy under the rule of China's Ching Dynasty (though the name was changed to Republic of China at its final stage of ruling Mongolia) at the time of independence in 1921. For CIS countries, the author guessed they were the same as Mongolia, but this judgment begs confirmation by additional studies. Eastern European countries adopted command economies only after the world war two, and before the war they already had strong activities in private enterprises and market operations. Russia had reasonable modern economic activities before its communist revolution in 1917. China and Vietnam committed to the command economy after the world

13 Shimomura[1996], Table8.5 on p.249.

war two, and they had substantial modern economic activities before the war, but their levels of market economy activities were not as strong as that of Eastern Europe.

Table 1. Modeling Initial Condition of Transition Economies

	Involvement in Command Economy Tier		Strength of Traditional Economy Tier	Strength of Market Economy Tier
	CMEA	State Enterprise		Market Economy Experience
Russia Model	Strong	Strong(93%)	Weak	Medium
CIS Model	Strong	Strong(93%)	Medium	Almost none
Mongolia Model	Strong	Medium(44%)	Medium	Almost none
China and Vietnam Model	None	Weak(19% and 10% respectively)	Strong	Medium
Eastern Europe Model	Strong	Medium (Author's guess)	Weak	Strong

Source: author; the percentage shares in column three are from Shimomura[1996] Table 8.5 on page 249.

In sum, the initial conditions of Mongolia around 1990 can be modeled as the economy almost close to a two-tier system with almost no experience in market economy. It had a strong involvement in CMEA system and a medium level of commitment to state enterprises. It was involved in a traditional economic system at the level of medium strength relative to other transition countries.

2. Transition Policies in Mongolia

2.1 Brief History of Transition and Adjustment Arrangements

As indicated in Table A-1 in Annex, a very quick transition to a market economy was initiated by the government of Mongolia in 1990. It was initiated by the government alone, and there was no supporting program by IMF nor by the World Bank in 1990. The government announced to construct a market-oriented economy in 1990. The government adopted a new three-year development plan "Memorandum on Economic Reform and Medium-Term Policies" (the Memorandum) in September 1991. This had a quantitative framework for 1991-1994 with special emphasis on the first two years[14] (Table A-2 in Annex). Though the Memorandum was produced by the government, it was a joint product of the government and IMF. IMF started its mission to Mongolia in August 1990, one year before the announcement of Memorandum and held many talks with the government. IMF also supported the Memorandum by approving its first stand-by arrangement in October 1991. It must be noted, however,

14 WB[1991b], p.50.

that its ownership was truly in the hand of the government as one of IMF officials recalled that at that time the government was more enthusiastic about the transition than the IMF mission, wanting to undertake all radical reforms. Furthermore, IMF's support in 1991 was a standard stand-by agreement mainly aiming at arresting the widening external and domestic balances, and the conditionalities based on the first ESAF arrangement of IMF came much later in 1993. Also the World Bank's first adjustment credit "Banking and Enterprise Sector Adjustment Credit" came much more later in 1997. All these suggest that transition and adjustment policies in early 1990s were not imposed by the international organizations but adopted by the government itself. Hence, a typical criticism to international organizations that they impose transition policies on borrowers does not hold at least in the case of Mongolia's transition.

2.2 Transition Policies of the Government

In 1990, the GDP declined by 2.1 percent and there were sharp increases in unemployment and inflation[15]. There were shortages of consumer goods, and the government introduced consumer rationing in January 1991. Starting with the 1991 Memorandum, the government began to implement an ambitious transition program of stabilization and economic reforms (Table A-3 in Annex). The government adopted a big-bang (or all-out) approach being in agreement with IMF and World Bank[16]. The program assumed that (a) stabilization would take about two years to achieve and (b) growth would resume in 1994[17]. The program's aims were (a) arresting the economic decline, (b) setting the stage for sustained recovery, (c) containing inflation, and (d) making progress towards balance of payments viability[18].

Along with the program, the government took up a comprehensive set of transition policies, including (a) monetary and fiscal policies; (b) price and activity liberalization policies; (c) transition and adjustment policies such as privatization, financial sector reform, fiscal reform, public management reform and external arrangements; and (d) social safety-net policies (Table A-3 in Annex). It was planned that the stabilization would take two years and that the economic growth resume in 1994 (Table A-2 in Annex). This implies that the government took a big-bang approach as its intended transition policy.

According to IMF, results of the program are favorable in 1993, and macroeconomic objectives

15 Denizer and Gelb [1992], p.6.
16 Denizer and Gelb [1992].
17 WB[1991b], p.47 and WB[1991a], p.2.
18 WB[1991b].

were largely met in 1993[19]. But a problem was that broad money grew rapidly during 1992 and 1993 because of the extension of direct credits to finance agricultural activities and because of the large growth in foreign-currency denominated deposits in 1993.

2.3 Transition Policies of the First ESAF

IMF started its operation in Mongolia with a stand-by facility which was approved in October 1991 and expired in December 1992. It was a balance of payment support. Its first Extended Structural Adjustment Facility (ESAF) was approved in June 1993 and originally planned to expire June 1996 but extended to 1997 because of some delay in its first year program. Objectives of the first ESAF were to (a) limit the decline of GDP to -1.3% in 1993, restore a sustainable economic growth of 2.5% in 1994 and accelerate it to 5% in 1993; (b) reduce inflation down to 2.7% per month by December 1993, and bring the annual inflation rate to single digit as soon as possible; (c) increase net official international reserves; (d) reduce arrears in external payments; (e) reduce budget deficit; and (f) liberalize prices and trade[20]. To attain these objectives, it required the government to implement (a) tight monetary policies; (b) tight fiscal policies and fiscal reforms; (c) floating exchange rates and further liberalization of trade; (d) further privatization and public enterprise reforms; (e) promotion of foreign direct investment (FDI); and (f) alleviation of the social cost on the vulnerable groups that are associated with the transition (Table A-4 in Annex). In addition following measures are suggested in the ESAF but not included in its policy framework paper (PFP); (g) to enact a new land law to privatize crop lands; and (h) the government to secure elementary veterinary services to continue. Even though some structural adjustment measures were included in the first ESAF, its main stress was on stabilization and liberalization.

Within the first ESAF, the government achieved the benchmark and performance criteria of the first year program but could not achieve those of the second year program. At the end of the second year, three major variables were not in line with the assumptions and performance criteria: (a) GDP growth rate dropped to 2.5% in 1996, (b) the external current account deficit, excluding official transfer, widened to 11% of GDP, and (c) the budget deficit widened to 9.5% of GDP in 1996. Two major causes of these deviations are the fall of copper prices, (affecting all of growth rates, external deficits and budget deficits) and the policy reversal toward increased budget spending because of June-1996 general election. As a result, the third year of the first ESAF was canceled in 1997[21].

---

19 IMF[1994a] and IMF[1994b], p.1.
20 IMF[1994b], p.1.
21 IMF[1997a], p.1.

2.4 Transition Policies of the Second ESAF

The new government, elected in June 1996, which was the government of Democratic Coalition Party, is a willing reformist government and increased the politically sensitive price of energy by 60% in September 1996, and the Bank of Mongolia closed and liquidated two large insolvent banks in December 1996. The government negotiated a Banking and Enterprise Sector Adjustment Credit (BESAC) with the International Development Association (IDA) and a Financial Sector Program Loan (FSPL) with Asian Development BanK (AsDB), and requested the second ESAF to IMF. IMF agreed the second ESAF for the three-year period of July 1997 through June 2000. It was and is a bold reform program with three objectives: (a) establishing macroeconomic stability, especially sharp reduction of inflation; (b) reducing the size of the state sector; and (c) fostering private sector development[22]. As for inflation, the government's specific objective was to reduce inflation from its current rate of about four percent per month in 1996 to one percent by the end of the first year of the program, with further reductions to a single digit annual rate by the end of the three-year program period (Table A-5 in Annex). As for the policy of smaller state sector, the government was to (a) cut expenditures, (b) move the pension system towards a self-financing basis, (c) improve the targeting of the Social Assistance Fund, (d) privatize intensely, and (e) apply a hard budget constraint to public enterprises. As for the private sector development, the government was to prepare a private friendly environment by (a) making resources available by reducing the size of public sector, (b) widening investment opportunities for the private sector by reducing inflation, (c) strengthening the banking system, (d) developing a more transparent and efficient legal system, and (e) preparing better environment for foreign direct investments (FDIs).

Above are stated policies of the second ESAF. But what emerge from looking at the detailed transition policies in the Table A-5 in Annex, are emphases on (a) stabilization, (b) financial sector reform, (c) fiscal reform, and (d) social sector reform. That is, the second ESAF still focuses on monetary and fiscal policies.

2.5 Transition Policies of the World Bank

Since the World Bank (WB) has been participating in the preparation of Policy Framework Paper (PFP) for Mongolia which is the most important document of the ESAFs, The World Bank's transition policies for mongolia in principle are the same as those of IMF. Besides, The World Bank did not

22 IMF[1997a], p.1.

start its own structural adjustment credit until recently. Its first structural adjustment credit was Banking and Enterprise Sector Adjustment Credit (BESAC) in 1997, which was a sector adjustment credit (1997-1999) concentrating on banking and enterprise reform. It had three major components: (a) bank reforms including the liquidation of two large banks (People's Bank who was the largest bank in terms of asset and Insurance Bank) and the establishment of two new banks and an asset recovery agency (MARA that stands for Mongolian Asset Recovery Agancy), general mechanisms for preventing bad loans, and establishment of debt recovery mechanism in Trade and Development (which was the second largest bank); (b) enterprise reforms including viability assessment and restructuring/liquidation of Darkhan Minimetal and Bagahangai Meat SOEs, preparation of the privatization program for all remaining SOEs, and preparation and establishment of Insolvency Law; and (c) imposition of hard budget constraints on state owned enterprises (SOEs) (Table A-6 in Annex).

3. Assessment of Transition Policies in Mongolia

3.1 Summary of Mongolian Transition Policies

Mongolian transition policies were intended to be a big-bang (or all-out) approach expected to be completed within three years. Government officers and politicians (both MPRP and democratic coalition members alike) wanted to undertake transition policies quickly and comprehensively. Though there were some changes along its transition process, in overall Mongolia took a typical and fairly comprehensive approach in transition policies.

Its transition policies can be easily understood by separating them into two phases: the initial phase from 1990 through 1997 and the second phase from 1997 to the present. The initial phase was characterized by the Government Memorandum (1991-94) and the first ESAF (1993-97 after an extension) and terminated in 1997 when the third year program of the first ESAF was cancelled. The second phase is still going on and characterized by the second ESAF (1997-2000) and the BESAC of the World Bank.

For the purpose of assessing the transition policies, only the initial phase is analyzed. Reasons are (a) the second phase is still going on and too early to be evaluated, and (b) the second phase did not change its nature from the initial phase and it has just added more details to structural adjustment components. Transition policies in the initial phase can be summarized as follows:

(a) Stabilization policies with purposes of achieving low inflation rates and reducing external current account deficits: including (i) tight monetary policies and (ii) tight fiscal policies;

(b) Liberalization and proper pricing measures: including the liberalizasion of (i) domestic prices,

(ii) controlled domestic activities, (iii) exchange rates, and (iv) trade activities;

(c) System transformation and adjustment measures: covering (i) privatization, (ii) public enterprise reform, (iii) financial sector reform, (iv) fiscal reform, (v) social security reform, (vi) trade system reform, (vii) external debt policies, and (viii) public management reform;

(d) Private sector development and market nurturing measures: including (i) preparation of market friendly environment, (ii) some activist measures such as government provision of veterinary services to herders, and (iii) promotion of foreign direct investment;

(e) Planning and public investment programming measures; and

(f) Social safety net measures.

The following section assesses each of these policy measures one by one and tries to conclude with the assessment of the overall transition policies.

3.2 Assessment of Each Component

The transition policies summarized above are evaluated one by one in this section.

Stabilization policies. The purposes of the policies are to (i) reduce inflation, (ii) reduce current account deficit, and (iii) reduce budget deficit. The policies were depicted in the Memorandum on Economic Reform and Medium-Term Policies (1991-1994, the Memorandum) of the government and in the first ESAF (1993-1997 after the extension of its duration). Table A-7 in Annex shows the comparison between the plan and actual performance of the three stabilization targets: inflation, trade deficits and budget deficits. Planned figures in the Table are all coming from the Memorandum. According to the Table, the government planned its big-bang to be three years from 1991 through 1994.

With respect to the period, the inflation rates did not achieve the plan of 20% per annum in 1994 but went down dramatically from the highest inflation rate of 325% in 1992 to 66% in 1994. It was quite an achievement even though the rate did not come close to the plan. Trade deficit was reduced dramatically and even went into trade surplus of plus 14.3% of GDP in 1994, which exceedingly surpassed the plan of minus 6.5% of GDP. The main cause of this superb performance, however, is not the stabilization policies themselves but international price hike of Mongolia's major exports: copper and cashmere. That is, Mongolia was lucky. Nonetheless it seems the stabilization policies worked well also. The budget deficits were reduced quite well, achieving minus 5.3% of GDP in 1994 which was much lower than the planned minus 8.5%. Again, the main cause of this performance is not the stabilization policies but increased revenues from rising export receipts from copper and cashmere, but the stabilization policies must have helped. In overall, we would say the stabilization policies were success during the big-bang period with the strong help from the international price hike.

If we look at much longer term up to 1999, the picture becomes not so favorable. The performance of inflation was superb, achieving only 6% in 1998 and stayed at 10% in 1999. But both trade balances and budget balances worsened to minus 16% and minus 12% of GDP respectively in 1998, though they improved a little in 1999 up to minus 10% and 9% respectively. That is, after hitting their peak performance of the trade surplus of 14% of GDP in 1994 and the budget deficit of only minus 1% in 1995, the twin deficits reemerged in 1998 and 1999.

Again the major cause of this worsened performance is the decline in international prices of major exports: copper, gold (which emerged as one of the largest exchange earners in Mongolia recently), and cashmere. However, it would be safe to say that stabilization policies were not pursued rigorously enough by the government during the latter half of 1980s. In overall, stabilization policies were success in the former half of 1990s, but it seems the policies were relaxed in the latter half and failed.

Liberalization policies. The objective was to dismantle all the controls over (a) domestic prices except for public utilities, (b) domestic economic activities particularly trading of goods and transportation, (c) exchange rates, and (d) external trade activities. Rationing of meat, flour and bread was terminated in 1993. All the prices except for public utility tariffs and housing rents were liberalized by 1995 when the control over prices of meat and flour were removed.

Controls over the entry into domestic and international economic activities were removed by the termination of controls on exports of meat and live animals in 1994. Exchange rates were unified into one rate in 1992 and then free floated in 1993. Mongolia liberalized external trade regime dramatically. At present a very small number of goods are under licensing/registration requirements, principally for security reasons. Mongolia became a member of the World Trade Organization (WTO) in January 1997, and eliminated all import duties except for alcoholic spirits in 1997. A small number of export taxes remain: those on nonferrous and scrap metals, raw cashmere and new camel wool. By this way, the objective of liberalization was fully achieved.

Trade liberalization is a necessity to small economies such as Mongolia, and it was a success for Mongolia. It contributed to reducing inflation rates since the high inflation rates of early 1990s (325% in 1992) were caused by the shortage of goods. Goods are now freely available for consumption and inputs for economic activities, though it also increased imports. The trade liberalization stimulated exports, particularly cashmere and gold, and created a large number of merchants for cross-border and third country tradings between China and Russia. The merchants have accumulated a sizable commercial capital. The liberalization policies produced growing service sector, which became one of three engines of economic growth started in 1994[23]. This service sector growth absorbed a substantial number of the unemployed and contributed to the stabilization of the society. In overall, the liberalization policies were success.

Privatization policies. These were planned in two phases: the first phase for herd, small-and-medium enterprises and large enterprises, and the second phase for the remaining large state owned enterprises (SOEs) starting from 1997 and still going-on at present. The first phase was completed as planned and was a success. Assets in some 4,500 enterprises, accounting for 44% of the state's total property value were subjected to the first phase privatization, out of which 79% in terms of value were privatized by the end of 1994. 100% of small and medium size enterprises and services, and over 97% of the livestock sector has been privatized by the end of 1995[24]. These privatization were done using vouchers given to all population free of charge. As a result, the private sector's share in GDP jumped to an estimated 64% in 1995[25]. The herd privatization to herders was a particular success. As its results, herd size grew rapidly and the livestock sector became one of the growth engines of the economy. Also the sector absorbed a large number of the unemployed, and the share of agriculture including the livestock sector within the total labor force has increased. This contributed to the social stability. A cash privatization started in 1995 when the State Privatization Commission (the Commission) identified more than 400 public enterprises as candidates for sales[26].

However, the privatization of large enterprises, particularly in the industrial sector, was less satisfactory. Their management, corporate governance and accountability were not improved much. This failure seems to be caused by old managers remaining in those privatized enterprises because the wide dispersion of ownership created by the voucher scheme prohibited removing the old managers. Besides this problem, IMF [1997c] cites other causes as follows:

> "Cash privatization encountered problems due to important inadequacies in the legal framework and a shortage of liquid savings. Sales were also frustrated by the use of reservation prices which frequently exceeded market values. Most of the cash sales were from the sale of assets rather than enterprises."

To address these problems, the new Democratic Government elected in the 1996 general election transformed the Commission into State Property Committee (the Committee), passed a new Law on State and Local Property in 1997, and started a new ambitious privatization program, commonly called the

23 Other two engines were livestock and mining sectors. They are discussed in later sections.

24 GOM[1996], p.3.

25 IMF[1997b], p.15.

26 IMF[1997c], p.16.

second phase privatization. The second phase is still continuing at present. It planned to privatize all SOEs except for some enterprises on a negative list. That is, by the end of 2000, it wants to privatize 60% of the remaining government asset values or 540 enterprises under 100% government ownership, 293 enterprises under partial (less than 49%) ownership of the government, and state agricultural farms that were not privatized in the first phase. The method of cash privatization was changed. There are still minimum prices, but if no bid reaches the minimum, the Committee will either liquidate the enterprise if it has no debt, or give it to creditors in a debt-equity swap. To address the shortage of domestic savings, foreign buyers are promoted[27]. The second phase started with a substantial sales receipts but later stagnated when it went into really large enterprises.

In overall, the privatization policies were success. Herd privatization was a particular success. But two problems remain: the first is the non-improvement of corporate management after privatization, and the second is the slowdown in privatizing large enterprises in the second phase. One implication from the two problems for the future privatization is that if no buyer shows up, it is better to keep it as SOE and install new, young well-trained managers, preferably foreign managers, replacing old managers. For this, the best arrangement is a management contract or some versions of it which are called "contractual arrangements". It has to be reminded that Mongolian Telecommunication Corporation under this type of contractual management was and is a sheer success. Telephone services in Mongolia now is one of the best among those in developing countries. This is another example of the success of privatization policies.

Public enterprise reform. There was no transition policy in this field. Policy in this field appears only in the second ESAF and BESAC of the World Bank in the second phase of transition. It was the problem that the first phase transition policies did not address the problems of public enterprises except for privatization. In this sense, this particular transition policy failed. Most SOEs were and are operating at 10% to 15% levels of their capacity. Proper measures must have been taken against these dying SOEs. The proper measures could be (a) replacing their managers with young, well-trained managers, (b) letting them strike contractual arrangements, (c) putting them under hard budget constraints, or (d) liquidating them.

Financial sector reform policies. These policies were first success and then failure. In overall, they were more failure than success. Objectives of the policies were (a) replacing the notorious monobank with a modern two-tiered banking system, and (b) letting the system provide reasonable financial serv-

27 IMF[1997c], p.17.

ices to the economy. The policies successfully achieved the former but were not successful in achieving the latter. That is, the new system was installed almost properly but the system, particularly commercial banks in the system, has not been delivering reasonable services. Commercial banks have kept lending to badly performing borrowers, and have been charging very high interest rates on their loans at between 50% to 150% per annum because of bad loans. They are offering no long-term loans, most of their loans being of less than six months. They are not willing to lend, their loan sizes are small, and many banks have bankrupted.

One good example to illustrate this problem is the case of Reconstruction Bank, even though this case is not the direct consequence of the first phase bank reform measures but that of the second phase. The second phase liquidated People's Bank (the largest bank at that time), and Insurance Bank (the fourth largest bank) in December 1996, and created two new banks to inherit remaining healthy assets from the two failed banks. They were Reconstruction Bank and Savings Bank. The Reconstruction Bank started with healthy assets but quickly became illiquid toward the end of 1997, within only one year from its healthy start. The bank was finally liquidated at the end of 1999 after a fiasco of merger and re-separation.

From above example, it is obvious that there are some defects in either designing or implementing the bank reform program. From which, design or implementation, did these failures occur? It is suspected that they came from the implementation side: the weak capacity of the commercial banks and the weak supervision capacity of the Bank of Mongolia (BOM), the central bank. The reform needed capable bank managers. In other words, the bank reform policies did not have proper components or had weak components for training the officers of the central and commercial banks, and the government and IMF were not careful enough in supervising the central bank and commercial banks during and after the implementation of the bank reform program. In other words, the failure came from the unawareness of low capacity of managers at both central and commercial banks.

Fiscal reform policies. Objectives of the fiscal reform policies were two fold: (a) to establish a standard revenue and expenditure system, and through this system (b) to achieve a smaller expenditures and a smaller budget deficits. The former was in principle satisfied, even though officers of the Ministry of Finance (MOF) seemed to have difficulties in absorbing all the detailed reform measures. But the trouble is the latter: the budget deficits have been steadily increasing after 1995 (Table A-7 in Annex). Because of this development caused by lax management of expenditures and revenues, the third year program of the first ESAF was canceled. The causes of this deficit increases again seem to have been on the side of capacity to implement: less capacity to control expenditures and less capacity to collect taxes. These capacities must be augmented if transition policies to be successful. There is one more issues here yet. The abolition of all import duties implemented in 1997 substantially reduced the government revenues, though it was the right policy to achieve a liberal economy. To ameliorate this problem, the government reintroduced a flat 5% duty on all imports in July 1999. Even though IMF is against this reintroduction, it will be useful to keep this flat duty for a while until the problem of budget deficits subsides. Of course, it should be repealed as soon as the budget deficits disappear. In overall, the fisral reform policies were more failure than success.

Social security reform policies. Objectives of these policies were two-fold: (a) to reduce budgetary support to the social security system, but at the same time (b) not to reduce the support to the poor and the vulnerable by proper targeting operations. As for the former, a new user-fee policy that requires beneficiaries to pay 10% of the cost was introduced in the health sector around 1995. This 10%, however, is not large enough in preventing government officers to retreat into hospitals for several weeks every year without apparent health reasons, and certain officers are exempted from the 10% user-fee. Up until recently, expenditures for the social sector including education services are the largest in the bedget accounting for roughly 40% of the total budgetary expenditures. As for the latter objective, increases in the amount of social benefits were made several times even though these did not fully compensate the loss arising from inflation. No targeting was undertaken except for the program by Poverty Alleviation Program (PAP) which started in August 1994 and is working successfully. In overall, the two objectives are not met yet, and the implementation of social policies seem to be being delayed.

Trade system reform policies. The policies were success since much of the reform measures proposed were already implemented including the negotiations of most-favored-nation trade agreement with U.S.A. which was a real success in inviting FDIs. Mongolian trade system is one of the most liberal in the world and working well. Some issues remain though. One issue is an unfair trade relations with trade partners, particularly with China. In the trade of meat and animal products, Mongolia imposes only 5% ad-valorem tariff on imports, but China imposes about 40% tariff on imports from Mongolia. Similar unfairness exists with other countries mainly because Mongolia liberalized its trade much in advance to other countries. This must be rectified by a bilateral agreement with each trade partner including China. Another issue is the reintroduction of 5% import duties in 1999. Even though this is against the trade reform policies, this should be maintained for the purpose of reducing budget deficits.

External debt policies. Arrears in external payments were cleared but reappeared, which is becoming a chronic problem. The installation of debt management and monitoring system was not implemented up to the present. Hence, these debt policies were failure. Even though it is not an immediate problem at this moment, debt is a slow but sure time-bomb that Mongolia has to carefully watch. In addition, the debt policies did not discuss at all about potentially devastating problem of Transferable Ruble debt to Russia, which is about US$14billion officially. Mongolia who's GDP is about US$1billion cannot repay this huge sum of debt, but all parties including the government have avoided discussing this issue. But the renegotiation and resettlement of the debt with Russia is scheduled to take place this year 2000.

Public management reform policies. The government eliminated State Planning Committee and rationalized ministries in 1990, which was a success dismantling the old command mechanism and reducing the size of the government. Then though it is not listed in the first ESAF, the government launched a new public management reform program called Management Development Program (MDP) in 1993 supported by UNDP. MDP had many components, among which the most salient component was a public administration reform program. The program was intended to undertake a New Zealand type government reform but failed. It created a huge restructuring of ministries centering around a newly created Strategy and Planning Department within each ministry. The program was successful in reducing a little the size of government, but it essentially was a simple rearrangement of old departments and divisions under different fancy names and did not have any essential ingredients of New-Zealand-type reforms such as the decentralization of decision powers in implementation to executing agencies, output based budgeting, contract based management, and management based on results. The result was the confusion on who would do what and who would have decision power on what. The new government established in 1996 realized this problem and abolished MDP in March 1997. But strangely the rearrangement of each ministry along the MDP design continued mainly because the ownerships of the MDP design were in the hands of ministries, i.e., the MDP made each ministry to produce its own rearrangement program based on a sample design created by a team of UNDP consultants. The new government, meanwhile, started a fresh new administration reform initiative PSMFL in 1997, whose design this time diligently followed genuine New-Zealand-type reforms supported by the New Zealand government. This initiative produced a new act Public Sector Management and Finance Law (PSMFL), which has been being discussed by the Parliament in 1999 and even now in 2000.

There are two problems associated with PSMFL exercise that are closely interlinked: capacity problem and design problem. As it was clearly revealed in the failure of banking reform exercises, administrative capacity is quite low in Mongolia or existing administrative capacity is quite inadequate to administrative jobs working under the environment of market economy. New-Zealand-type reforms assume and require a quite well developed capacity regarding contract design, particularly output design, contract monitoring and enforcements, diligent compliance with contracts, impartial and rational judgments of outputs, and a proper reward and punishment system since decision-making powers are delegated to lower implementation agencies. Decentralization of decision powers requires good supervising capacity, and particularly the capacity to monitor and supervise contracts is essential.

On the other hand, the government officers in Mongolia lack these capacity and even do not have experience in contract monitoring and supervision. From this point of view, adoption of New-Zealand-type reform is too early and not suitable for Mongolia at this moment. This is the design problem of PSMFL exercise. Now seems to be the time to train the officers and increase their capacity in monitoring and supervising the market economy itself rather than to get into the complicated contractual arrangement in the government. The further reform of public administration using a New-Zealand-type model should be done much later.

Hence, the public administration policies were success in getting rid of old guards such as the State Planning Committee and Price Committee but were not successful in building up a new capacity of public administration.

Policies for preparing market friendly environment. These are in principle success, though there still remain lots of red-taping and bureaucracies. Substantial liberalization was made, most necessary laws were established, and a stock market is operating. Only one serious problem is the failure of the banking sector and this was already discussed in a previous paragraph.

FDI promotion policies. Mongolia promulgated a new Foreign Investment Law (FIL) in 1990, and enacted a revised FIL in 1993. The revised law offered and offers many preferential treatment to foreign direct investments (FDIs). However, FDIs did not increase much staying at around US$50 million per annum and then declined to US$35 and US$39 million in 1997 and 1998 respectively. Causes of low performance are the small market of 2.4 million consumers for domestic sales and high domestic and international transportation costs for export since Mongolia has a huge size in terms of land and is land-locked. Because of these, foreign investors feel other East Asian countries are more attractive than Mongolia. In addition, foreign investors complain that there is no one-stop-agency for FDI and there are so much bureaucracies and red-tapings. However, FDIs in 1999 is expected to serge to the level of US$70 million, and the sectors where they were investing were meat processing, vehicles and food processing. This is quite an increase and moreover, the investments are in much needed manufacturing industries, a departure from the traditional sectors of mining and cashmere[28]. The chairman of

28 The Economic Intelligence Unit, Country Report: China, Mongolia, 4th quarter 1999, p.45.

the Foreign Investment and Foreign Trade Agency (FIFTA) said that causes are the country's more liberal environment and the more dissemination of that information to the world. In overall, the policies are successful except for those bureaucracies and red-tapings. In addition to current policies, the government should (a) more advertise to the world about its proximity to two large markets in the world, China and Russia, and its liberal environment, and (b) establish a one-stop-agency to overcome the bureaucracy and red-tapings.

Development planning and public investment programs. It is interesting to look at the policy development with respect to development planning institutions. The government abolished such an old guard as State Planning Committee and created Ministry of National Development (MND) in 1990 only to handle the planning side without budgeting functions. But when National Development Board, which was a descendant of MND, became too strong because it handled all ODAs, the government abolished it in 1996 transferring all planning functions to the Ministry of Finance (MOF). The responsibility of negotiating official development assistance (ODA) terms were not defined properly. In effect, ODA loans were negotiated by MOF and grant aids and technical assistance were negotiated by the Ministry of External Relations. The development planning became a pure indicative plan without implications to budgetary investments nor to ODA investments. Then the government recognized that it is necessary to ensure consistency and progress in the implementation of the transition program, particularly for the implementation of the second ESAF. For this purpose, the government established High-Level Economic Policy Advisory Committee (HLEPAC) in 1997 consisting of five top key decision makers: the Prime Minister, his Senior Economic Advisor, the Minister of Finance, the Governor of the Bank of Mongolia, and the Chairman of the Parliamentary Standing Committee on Budget, Finance and Economic Policy.

As for public investment programs (PIPs), they were recommended by the first ESEF in 1993 but were not implemented until recently. Ministry of Finance and Japan International Cooperation Agency has jointly produced the first trial of a rolling three-year PIP for 2000-2002 in March 2000.

In sum, the government first abolished the old planning regime, which was a right decision, but then started to recognize the need for a mechanism to coordinate and make progress in implementation of transition policies. As for the policies, HLEPAC is necessary and that policy was implemented, but PIP was not implemented even though it is necessary. That is, the policies were right but a half success.

Social-safety-net policies. The most important contributions to this objective were made by the livestock sector assisted by the livestock privatization policy in 1990 and by the service sector, particularly the commerce subsector, assisted by the liberalization policies as discussed in previous sections. These two sectors absorbed most of the unemployed resulting from the transition. But the restructuring and targeting of social benefits recommended by the first ESAF were not achieved yet except for one. The exception is the Poverty Alleviation Program (PAP) started in 1994. It was and is successful and properly targeting at the vulnerable such as the rural unemployed. But it is a small program. Except for PAP, not much have been done, and we have to wait and see. Hence, the social-safety-net policies per se have failed to achieve substantial results up to the present.

3.3 Assessment of the Overall Transition Policies

The big-bang approach as designed was a failure in terms of its definition of speed and comprehensiveness. In effect, Mongolian transition policies designed in its first phase were implemented gradually being dictated by the feasibility of each component. As a result of this gradual implementation, that Mongolia achieved reasonable economic performance in terms of GDP growth rates, inflation, reserve build-up, arresting the rise of unemployment, etc. It suggests that the contents as a whole, but not the speed nor the comprehensiveness, of the policies can be said successful. This success in terms of economic performance, however, cannot entirely be attributable to the policies alone. The reasonable performance of the economy was also significantly assisted by a set of other favorable factors of the economy itself and external environment. They are such factors as (a) availability of a substantial amount of official development assistance (ODAs) close to 15% of GDP, (b) rich mineral resources that are earning precious foreign exchanges, (c) surge in international prices of its major exports such as copper, cashmere and gold during the first half of 1990s, (d) a vast land and expertise suitable for herding, (e) its small economy that make it possible to change policies quickly, and (f) the location between two of the biggest countries in the world, China and Russia. Besides many policies were half success. Hence, the success should be viewed with a heavy discount.

4. Implications

This chapter derives implications for general transition policies from the above assessment of Mongolian case. Since Mongolia took standard transition policies, this chapter also tries to evaluate some criticisms against the standard transition policies, through the evaluation of success and failure of Mongolian policies.

Coerced or not. Some scholars and government officers have been criticizing the standard transition plicies saying that the transition policies have been imposed on governments of transition countries by international organizations. But the evidence tells that it was not true to Mongolia. In Mongolia, all parties including the ruling party MPRP[29], opposition parties and bureaucrats were more enthusiastic for radical reforms than IMF was. Mongolia chose its transition policies not because of the coercion by the international organizations but because of its own desire, though there were heavy consultations with IMF at the beginning. The same seems to apply to other transition economies but this needs to be verified.

Big-bang vs. gradualism approaches. When transition policies in general are discussed, it is necessary to examine the dispute between the two schools who are advocating two different approaches of the big-bang approach and the gradualism approach. The big-bang approach is defined by two characteristics: (a) quick implementation normally within two years and (b) all-out comprehensive reform[30]. The gradualism approach does not have a standard prescription but is characterized by (a) a longer time horizon, say ten years, and (b) a piecemeal and practical approach undertaking a reform whenever it is feasible to implement it and postponing it whenever it is not[31]. It must be remembered though that there is not much dispute between the two approaches regarding the contents or components of standard transition policies. Only one dispute regarding the contents is the one between the policy allowing no government interventions and the policy allowing some government interventions.

With respect to speed, Mongolia clearly took a big-bang approach as its design, as discussed in Chapter 2. But in reality, its transition is taking a long time more than ten years and it has not completed the transition even at the end of 1999. The big-bang approach in Mongolia is a failure with respect to its speed. Virtually all transition economies took more than two years to complete their transitions. Even East Germany, the quickest of all, took more than two years to complete its privatization and integration into West Germany. Hence, it can safely be said that the big-bang approach in general was a failure in terms of its speed.

With respect to the simultaneous comprehensiveness, Mongolia also took a big-bang approach as its design. Unfortunately it was not realized, and each component was implemented piecemeal in a different year. For example, such policies as the liberalization of domestic and international economic activities were implemented quickly at the early stage of the transition, but the price liberalization took long time up to year 1995. For another example, the livestock-and-small-enterprise privatization were completed quickly at the early stage, but the large enterprise privatization has been taking long time and is not smoothly moving even at the end of 1999. Actually, almust components were implemented

29 MPRP stands for Mongolian Peoples Revolutionary Party.

30 WB[1991c], p.117.

31 Shimomura[1996], p.252.

piecemeal. Hence, this aspect of Mongolian big-bang approach was also a failure.

What was the cause of this piecemeal implementation as against the big-bang design? The answer is simple: it was caused by the different feasibility of each component in terms of quick implementation in Mongolia. One component was able to be implemented quickly, but another component was not because of a variety of reasons. The three major reasons in Mongolia were (a) as the first and foremost reason, the lack of implementation capacity and knowledge on the side of the organization and officers responsible for implementing a particular component; (b) as the second, inherent nature of a component itself in terms of difficulty or ease of its implementation; and (c) as the third, whether or not the assisting donor(s) of a particular component had prepared specific measures to counter the implementation difficulties or in other words, whether or not the donor had been aware of the difficulties encountered. These three seem common to all transition economies, and hence we can expect many piecemeal implementation in other transition economies.

In sum, the big-bang policy in Mongolia was a failure in terms of the speed and comprehensiveness[32]. In reality, Mongolia took or was forced to take a gradualism approach in its implementation because of different feasibility of components, even though it intended to undertake the big-bang approach.

Actual transformation of Mongolian economy was implemented gradually, and in overall the results of this gradual implementation can be considered success in terms of economic indicators. GDP started to grow reasonably quickly in 1994; inflation went down to 6% in 1998, and the absolute number of unemployment started to decline in 1998.

As conclusions, (a) the big-bang approach is inappropriate for countries with weak implementation capacity; (b) the comprehensiveness seems not to be a requirement, and components of transition policies can be implemented piecemeal according to the Mongolian experience; (c) implementation can be done in accordance with the feasibility of each component, and of course, as far as feasible, the quicker the implementation is the better; and (d) donors should pay more attention to the implementation side of transition policies along with their designs since transition countries tend to lack the implementation capacity.

Two-track approach to enterprises. China is considered to have been successful in transition policies since its economy grew at the fastest speed of all transition economies. In contrast to Eastern European transition econonies, China did not privatize or liquidate most of its low performing state

32 It has to be noted that this section has not examined the contents of transition policies, which are examined in the following sections.

owned enterprises (SOEs) but kept them alive with substantial subsidies. At the same time, however, China liberalized the sectors of agriculture and village enterprises, and these two became the sources of growth. Vietnam took a similar approach of maintaining SOEs and encouraging new enterprises, and its economy boomed[33]. This approach is called the two-track approach. Some scholars think the approach is superior to the big-bang approach trying to privatize all SOEs, because the approach did not create the production collapse (which is a sharp decline of production) that all transition economies experienced right after their adoption of the big-bang approach.

Should Mongolia have adopted this two-track approach so as to have avoided the production collapse from 1990 through 1994? A short answer to this question is "no", not necessarily because the big-bang approach Mongolia took is a superior policy to the two-track approach but because the big-bang approach was an only feasible approach at that time for Mongolia. Mongolian industries at the outset of its transition were firmly entrenched in the CMEA system. More than a half of industrial inputs and spare parts had been imported from the Soviet, and 90% of total exports had went to CMEA countries in 1989[34]. In addition, most industries had been receiving a huge financial assistance from the Soviet Union up to 1989. Sudden disappearance of the CMEA markets and Soviet assistance in 1991 made it impossible for the government of Mongolia to sustain those state-owned-enterprises (SOEs) with its meager budgets. The government did not have much foreign exchange to buy the inputs for those industries and could not sell their products to CMEA countries. Collapse of the production was

33 One digression here on China and Vietnam is worth an attention. An amazing lesson from the economic success story of China and Vietnam is that economic transition can be separated from political transition. It was and still is believed that an economic liberalization and transition cannot be achieved without political liberalization and transition. Contrary to this belief, the economies of both countries have boomed under the strict rules over political and social aspects by their socialist regimes. Putting these experience into a more economic picture, economically liberalized sectors in both countries have thrived within the economies which in principle are command system. Furthermore, their experience would even suggest that if proper liberalization policies for an economy are taken, the regime of command economy in this country could be better than the liberal economic regime, since China and Vietnam have achieved higher GDP growth rates without the production collapse as against Eastern European countries who have experienced sharp production collapses and have not achieved high growth rates like China and Vietnam. Why could this happen? There could be two explanations. The first explanation could go like this. Because the liberalized economic sectors and the command economic sectors coexist, individuals and enterprises have incentives for rent seeking and corruption by shifting goods and financial resources from the low priced, controlled segment of the economy to the high priced, liberalized segment (see Shimomura [1996], table8.5 on p.249). To prevent this from happening, the government of this economy must be able to keep a tight grip on them, strictly supervising and applying stiff penalties on wrongdoings. For this supervision purposes, the command regime is helping. The second explanation could go like this. China and Vietnam really were not of command economy and had a large sector of private economic activities at the outset of their economic transitions. For example, shares of SOEs in total employment were only 18.6% for China in 1978 and 9.5% for Vietnam in 1985 (Denizer and Gelb [1992]). Hence, liberalizing some controlled sectors only enhanced already existed private sectors. These two hypotheses must be examined further to arrive at true conclusions.

34 SOM[1997], p.112.

inevitable. Since the government could not financially support them, an only choice was to privatize them or to let them stop their operation.

In addition, very rapid privatization of herds and small-and-medium enterprises was a success in Mongolia, creating its GDP growth and absorbing the unemployed. Hence, the quick privatization policy taken by the government of Mongolia was an only feasible and also right policy. China and Vietnam could adopt the two-track approach since their industries were not so entrenched in CMEA system and not so heavily relying on financial assistance from the Soviet Union. The two track approach is not applicable to those countries who had been heavily entrenched in CMEA system.

A policy to improve efficiency and productivity of SOEs without privatization or contractual arrangements. Mongolia took this policy in the latter half of 1980s, trying to increase productivity by giving incentives: for example, incentives such as offering extra awards for high performers. It did not work as far as the ongoing framework (at that time) of state-ownership and command production was maintained. But, for example, once the policy of private ownership of herds in excess of planned production was introduced in 1988, and once the policy of private cooperatives were introduced in 1988, livestock production started to increase. It suggests that the policies to improve efficiency of existing SOEs but with the framework of state-ownership and without freedom of economic activities (i.e. command production) do not work. In the 1980s, similar incentive policies to increase productions but keeping the old framework of state-ownership and command production were also attempted by East European countries and even by China. But their results were not satisfactory. It seems that the strategy to utilize existing organizations such as SOEs and existing managers does not work in transition. Rather it is better to privatize SOEs and to substitute new managers for the old.

Privatization and other options for SOEs. As discussed above, rapid privatization was an only feasible and desirable policy for countries entrenched deeply in CMEA system such as Mongolia. The rapid privatization was a success in the livestock and small-and-medium-size-enterprise sectors in Mongolia producing GDP growth and absorbing the unemployed. Also it is the quickest way to create private entrepreneurs. Hence it also is a good policy for a country that does not have many entrepreneurs at initial stage of its transition.

In Mongolia, however, many privatized enterprises showed and are still showing very poor performance. Why? Reasons are related to the ways privatization took place there. Mainly four types of privatization took place: (a) direct giving-away of herds to herders; (b) purchasing of shares of a SOE by incumbent managers (which is called "management buyont") and employees with their vouchers (which were given higher priorities in privatization than the vouchers of general public); (c) purchasing of shares of a SOE by many general public with their vouchers; and (d) purchasing of a SOE by one or several major buyers who gathered many vouchers in exchange for money or goods. The first was an outright success, and the fourth was also success. But the second and the third were failures resulting in non- or under-performance of the privatized enterprises. The second created private enterprises that were managed by the same old managers. The managers did not offer incentives nor impose penalty to employees, and the shareholder-cum-employees neither demand proper returns to their share nor offered incentives to the old managers. Its result was the same operation as before just trying to survive without any radical reforms. The third was similar: the shareholders were so widely spread to many people that no one had and has majority shares to demand proper returns to his/her share, and none of shareholders was seriously interested in the management of the enterprise. Hence, again the same old managers remained in the office and did no do any reforms. Lessons from this experience are that privatization should (a) not allow management buyout nor give priorities to employees; (b) prepare a mechanism to concentrate share ownership to one or several shareholders; and (c) educate and encourage shareholders to demand the company managers reasonable returns to their shares and to exercise their right to change the managers if the reasonable returns were not made. Furthermore, the experience suggests that managers and management itself of an enterprise do matter a lot, being more critical than privatization. Then, an another implication is that when a privatization cannot expect to have new and capable managers, it is worth thinking about (d) striking contractual arrangements with the private sector including a management contract, or (e) arranging a joint venture with foreign firms. Another problem faced with by Mongolia was non-existence or shortage of capable company managers. A solution to this problem was and is (f) to create business schools and train young people in business management.

If all of above including privatization and excluding (e) are not available, not many options are available. They are (g) restructuring the target SOE and making it self-sustaining without subidies; (h) imposing a hard budget constraint and letting it struggle to survive or die; (i) changing incumbent managers for new capable managers, and if it does not work changing again; or (j) providing subsidies and keeping it arrive. The last option (j) is only available for rich governments such as China, and is not feasible for poor governments such as Mongolia as discussed earlier. The restructuring option (g) will not work if incumbent managers remain there. The essence here is that poor government should not try to keep SOEs with subsidies but let it die if it cannot survive by itself.

Early privatization of agriculture. Mongolian experience suggests that early privatization and liberalization of agriculture sector is one of the most important among many transition policies. It must be remembered that the livestock sector was and is one of three growth engines in Mongolia after its start of transitions in 1990. Its growth was made possible by the early privatization of agriculture, particularly of herds. In a sense this saved Mongolia from a potential social unrest due to shortages of food and of employment opportunities. In addition, this is a fact that the livestock sector started its growth even before 1990 responding to limited measures of privatization in 1988. It suggests that the agriculture sector including the livestock subsector is very sensitive to privatization and can respond quickly to it. It also has to be remembered that economic growth of China first started from the liberalization and privatization of backyard farming in its agriculture sector. These imply that early privatization of agriculture will help a transition by many ways: (a) increasing its supply of staple food to the population; (b) absorbing the unemployed, working as a safety net for the most affected by a transition and for the poor, and through these (c) pushing up the GDP.

Early liberalization of domestic economic activities, particularly commercial activities[35]. Mongolian experience suggests that this early liberalization along with the trade liberalization is also one of the most important of all transition policies. In Mongolia, the surge in the commercial activities was one of causes of the economic recovery in 1994. This commercial activities were a result of the liberalization of domestic economic activities and of external trade. Mongolian experience suggests that the early liberalization can make possible for a commercial sector to (a) supply goods to domestic markets, goods that are unavailable at the beginning of transition; (b) absorb the unemployed; (c) accumulate the commercial capital within the sector for future investments; and through these (d) push the GDP up. It also seems that this policy can be implemented fairly independently to other policies without requiring preceding policies.

Liberalization of trade and external current accounts along with floating exchange rates. These helped Mongolian economy a lot. The early liberalization of these two together with the domestic activity liberalization created numerous private international traders. Among them, the traders between China and Russia were particularly successful. Their gain of foreign currencies helped reducing the speed of depreciation of the national currency Tugruk. Imports by traders helped stabilizing inflation: even though the currency depreciation had strong inflationary effects at the beginning, more availability of commodities in domestic markets stabilized the inflation. The trade liberalization increased the imports and the Bank of Mongolia had little foreign reserves. Hence, the government had no choice but

35 This liberalization can be defined as (a) freedom to enter any markets, (b) freedom to produce, buy or sell any products, and (c) freedom to privately keep the sales money. The freedom to set prices is discussed in a later section.

to float exchange rates. Otherwise, the government has to ration imported goods. The rationing actually took place at the beginning of the transition, but it was lifted within a short period of time.

One lesson from this experience is that trade liberalization must be implemented together with floating exchange rate. As for the early liberalization, it helped Mongolian economy by boosting the international trading activities between third countries. However, this was realized because of a Mongolia's specific character, i.e., sharing borders with both China and Russia. For transition economies other than Mongolia, this benefit may not be realized. Hence, it is not clear whether the early liberalization of trade and exchange rates would be beneficial to the transition countries in general.

Price liberalization. This is the must in any transition but should be done gradually in accordance with the availability of goods. As discussed in sections on the big-bang policy and on Mongolian liberalization policies in Chapter 3, Mongolia took a gradual liberalization process of prices using many years up to 1995. When there is a severe supply shortage of goods in domestic markets and consequently sharp price rises are expected (such as Mongolia's experience during 1990 through 1993 at which time the government imposed a rationing system on many commodities including foods and energy), a slow and step-by-step liberalization is a sensible approach, not because of economic efficiency reasons but because of the reason for protecting the vulnerables. If prices were liberalized in such a situation, all goods would be purchased by the rich and the poor would starve because they cannot afford to buy. The prices must be liberalized, though, as soon as reasonable supply of goods become available to domestic markets.

Liberalization of external capital accounts. According to the experience of East Asian financial crises started in 1997, this liberalization must be done with great caution and with much preparation. This is not the direct implication from Mongolian experience though. Mongolian experience may suggest opposite, because it liberalized the capital accounts quite early and did not suffer any contagion effects from East Asian financial crises. But it has to be noted that there was almost zero portfolio investment and zero loans by foreign private financial institutions to Mongolia because foreign capitals had not been interested in a small and stagnant Mongolian economy and because of an ESAF's strict rule of no commercial loans. If there had been, it would have been a disaster to this country. One additional point is that it is said that domestic banks and companies have large amount of foreign currency in offshore accounts. If it is so, this deprives the economy of precious foreign currency. Liberalization of capital accounts should be cautious and should be done after establishing a healthy and capable financial institutions and strong supervising capacity of the central bank. Since these two are rare in most of developing countries, the capital account liberalization must be done much later in most developing countries.

Transition policies should differ from adjustment policies. Review of transition policies in Mongolia and their assessment reveal that on the side of international organizations there seems to exist a misunderstanding that transition policies are a combination of stabilization policies and structural adjustment policies. This combination has been a standard package used for many developing countries by the international organizations in the past. However, it has to be made clear that transition policies cannot be and should not be the combination. The package was and is a tool for developing countries already in a market economy but with some structural distortions. But transition economies were not in a market economy. That is, the former already has market mechanisms in it but latter did not have the market mechanisms in it, and it had to create the mechanisms. This is a fundamental difference. Transition economies have to dismantle old controlled economy system and create a market economy. This is why a standard transition policy contains a liberalization component. Removing old control system and distortions alone, however, do not guarantee the private enterprises and markets to spring up. This is particularly true to countries with less or no experience of private enterprises and of market economy before becoming socialist economies, and with less or no such activities currently practiced. For these countries including Mongolia, it is difficult to expect the strong response of private sector and markets to macro stability and liberalization alone. The experience of Mongolia proves this by "production collapse" after the removal of control and distortions in its economy. Even though the collapse was mainly caused by disappearance of Soviet subsidies and CMEA markets, the non-existence of private enterprises and markets is the second cause of the collapse.

For those countries which had had no or little experience with private enterprises and market mechanisms before their adoption of the command economy system, their transition policies should contain two new components in addition to the combination of stabilization and adjustment. They are (a) liberalization components that include dismantling the entrenched mechanisms of a command economy, and (b) private enterprise development and market creation components. A standard package of transition policies including that of Mongolia, however, lacked the latter component. Sometimes the package contained a component for private sector development, but the component was so weak. For example, Mongolian transition policies for the private sector development contained only (a) establishment of various laws to formulate an environment for a market economy, (b) establishment of a stock market, (c) removal of regulatory barriers for foreign direct investment (FDI), and (d) establishment of national accounting standards for financial management of enterprises. These were simply the measures to prepare an environment for private enterprises. But the problem of those countries including

Mongolia is that there is no or few number of private enterprises to respond and no or few markets to operate under that environment. Their transition policies need to include the private enterprise development and market creation component. This subject is further discussed in the next section.

No or weak response from the manufacturing sector and the crop farming sector in Mongolia. Transition policies aim at transforming a command economy into a market economy. To achieve this, the policies require the liberalization component and the private enterprise development and market creation component as discussed in the previous section. The former was and is included in standard transition policies but the latter is not. The reason why the latter was not a part of standard transition policies is simple. Standard policies represented by ESAFs of IMF assume the private sector would immediately respond after liberalization. This means that ESAFs implicitly assume that there always is a fully functional market system underneath incumbent command economies. For example, however, Mongolia had no or little market system and had no or little private sector. Hence, the private sector could not respond to the transition policies in Mongolia. IMF failed to see this underdevelopment of the private sector and the market. The transition policies of Mongolia should have had a component for these two. This section focuses on this issue of the private enterprise development and market creation component. The following sections first discuss the private enterprise development and then the market creation.

Private enterprise development. In Mongolia, the private sector's responses to the transition policies were weak in general. But there are differences in responses by sectors. Livestock and services sectors responded strongly but manufacturing and crop sectors did not. Follwing analyses of the causes of the difference in their response can provide some insights into general transition policies.

The livestock sector responded strongly in Mongolia. The reasons seem to be (a) the herds were privatized and (b) Mongolia had ample experience in stock breeding before and during the command economy period since it has been the mainstay of Mongolian economic activities for thousands years. The services sector, particularly the trade and commerce subsector, responded strongly because it is the easiest activity to start with little experience and with a little capital. The mineral sector responded reasonably well since it had international markets to sell under the CMEA system. But the manufacturing sector did not respond at all and in effect kept shrinking for the entire transition period from 1990 through 1999. Reasons seem to be (a) Mongolia had no experience in private manufacturing before and during the command economy period, and (b) the manufacturing sector inherently require more capital and technologies than livestock and service sectors. In addition, (c) CMEA system of the social regime forced Mongolia to specialize in livestock products and minerals to export to CMEA countries, and to import almost all other consumption goods and industrial inputs from Russia and CMEA countries. As a consequence at the beginning of its transition, Mongolia had had a very distorted economy, lacking many sub-sectors in the manufacturing sector. Without any base and without any inputs from CMEA countries after CMEA's collapse, the manufacturing sector could not respond. As for the crop farming sector, it did not respond because (a) Mongolia did not have much experience in private farming before and during the command economy period, (b) landed farmers did not exist, and (c) crop lands were not fully privatized, substantial portions having been kept by either the successor organizations of old state farms, or governments of Soums (villages), Aimags (prefectures) or the country.

Above suggests that (a) a sector cannot respond quickly to transition policies if it does not have previous experience of private activities in the sector, (b) a sector cannot respond quickly without private ownership of capital including land[36], and (c) a private manufacturing sector cannot respond quickly without many entrepreneurs and without capital and technologies. Standard transition policies failed to see these and did not offer specific measures to address these issues. Transition policies for countries who had had no or little experience in private activities and enterprises, need to have additional components to address these issues.

Market creation. As for the market creation, a functioning market requires such elements as market places, market transaction systems and transport-cum-distribution systems. These take long time to emerge spontaneonsly in countries without market economy experience such as Mongolia. To shorten the time necessary for these systems to emerge, governmental help is necessary. And it would be better if transition policies include the component for this purpose.

In transition economies who had had strong market system experience before their command system experience, the private sector will respond quickly to the transition policies. But in countries without such experience, no response.

To address above issues of private enterprise development and of market creation, a government need to take an activist's role by providing more active measures. For example, the active measures for Mongolia would be as follows.

For the private sector development:

(a) keep the current import duties of low flat rate for a while to protect and nurture new enterprises, and then eliminate the duties within a certain period to let the new enterprises compete

36 Experiences in the telecommunication lease contract in Mongolia and in some contractual agreements in other countries suggest that contractual arrangements including lease contracts can work exactly like giving ownership to managers if the contracts are written properly.

with imported goods;

(b) provide finance to the private sector but without heavy subsidies;

(c) provide the discounting facility for letters of credit;

(d) help the private sector to organize sectoral producers associations so that they can voice their needs to the government;

(e) organize deliberation committees to listen to the needs of the private sector particularly exporters and importers; and

(f) negotiate and agree with Chinese and Russian governments on the mutually equal treatment of trade, particularly agree with China to reduce the high import duties at around 40% on meat products from Mongolia, and by this way open up a huge Chinese market for Mongolian meat products.

For market creation:

(a) help the private sector to build wholesale market places, commodity grading systems, auction systems and transaction systems in terms of design, capital, land and technology, or build them publicly and lease them out to the private sector;

(b) help the private sector to establish transport-cum-distribution systems, help in terms of capital and land; and

(c) provide a national network of services of telecommunication and transportation (particularly roads).

In sum, in countries which had no or little experience of private enterprises and market economies, the transition policies need to include additional components that allow the government to take an activist's role undertaking such measures as discussed in the previous paragraph.

Low flat-rate import tariff rather than zero tariff. As discussed above, transition economies with the twin deficits should keep this policy of low flat-rate tariff for reasonable years. The policy seems necessary and useful for ten years or more for transition economies until they get out of their twin deficits. It will (a) create precious revenues for the government, and (b) protect (for designated years) fledging private enterprises. The latter is more important to those who had less or no experiences of a market economy and of private enterprises such as Mongolia. It also is useful to primary-commodity exporting countries such as Mongolia since the primary export tends to create Dutch disease weakening sectors other than those related to the export sector. This policy should be included in standard transition policies, even though this was discouraged by the ESAFs in Mongolia.

Flexibility in policies. One important principle in transition policies is flexibility. As evidenced in copper prices for Mongolia, the external environment for transition countries changes quite dramatically. As seen in the case of banking reform in Mongolia also, the situation of a sector unfolds very quickly as a transition develops. Transition countries are undertaking a unprecedented radical transformation of their systems without much experience (and hence there are lots of uncertainties in their transition process) and doing it very quickly Sometimes transition measures produce results fairly quickly, and some of them reveal themselves to be defective. Then, they may need to be eliminated or may need to be delayed. Transition policies should be quickly adjusted to those new developments. In this sense, ESAF's flexibility of its policies based on its annual reviews is a proper mechanism in approaching transitions.

Besides the need for flexibility in response to environmental changes, some transition policies must change as the transition progresses. A good example is that at the beginning of the transition, Mongolian policy was to raise interest rates to a quite high level to reduce domestic demand for imports and to reduce inflation rates. But later close to the end of 1990s, the government and ESAF wanted to reduce interest rates to encourage the development of the private sector (though it was cautiously stated not to ignite renewed inflation). Like this, policy should change according to economic policy priorities at a certain point of transition. ESAF recognizes this well as evidenced above.

Long-term real sector prospect and public investment programing. Long-term strategy making and investment budgeting based on the strategy seem to be important and necessary components of transition policies. The strategy making here means several things. First a transition economy needs a long-term, say 10 to 20 years, vision of where it will and want to go. And, based on that vision, a three-year transition program should be prepared. Second, this three year program requires two components: macro economic framework and real sector growth prospects. Though the former is taken care of by standard transition policies, the latter is missing in transition policies. On the background of IMF-WB's policy framework paper (PFP) for a transition economy, there is always macro framework such as GDP growth rates, inflation rates, external balances and fiscal balances. It has to be reminded, however, all these come not only from the monetary sector but also from the real sector, i.e., agriculture, industry and service sector activities undertaken mainly by the private sector. A transition policy needs to analyze prospects of the real sector and combine it to macro indicators such as GDP, inflation and so on. This real sector prospect will (a) suggest the private sector where to go, and (b) enable the government to identify what would be the possible bottlenecks for the private sector activities and where to invest to alleviate the bottlenecks.

There are two dangers that could be generated from above strategic planning approach. They are

(a) implicit revival of state directives on economic activities, and (b) directed credits to white elephants or unviable sectors. These dangers must be avoided and be carefully checked.

Remaining issues. There are many issues that should be further studies regarding transition policies. But this section lists only three areas that need to be further studied. First, the implications derived above are of descriptive nature, and they must be tested with more rigor using statistical numbers and methods, which were not done by this paper. Second, the implications described above are kinds of hypotheses derived only from the assessment of Mongolian transition policies. These must be tested with respect to other transition economies. Third, transition policies seem not to have their own transition models. IMF and the World Bank have their toolboxes containing many transition tools. But they seem not to have (a) models of economic structures of transition economies, and (b) understandings of mechanisms that each model reacts to each tool. These must be studies to provide better advices to transition governments.

References

APIC [1999]: Kokusai Kyoryoku Suishin Kyoukai (Association for Promoting International Corparations), *Mongolu, Kaihatsu Tozyou-koku Kunibetsu Keizai Kyouryoku Sirizu dai* 3 *han (Mongolia: Japanese Economic Cooperation for Developing Countries, Asian Series No*18, 3rd Edition), Tokyo, March 1999.

BOM [1999]: the Bank of Mongolia, *Monthly Bulletin,* December 1999.

Denizer and Gelb [1992]: Denizer, Cevdet and Alan Gelb, *Mongolia, Privatization and System Transformation in an Isolated Economy,* Policy Research Working Paper 1063, December 1992.

GOM [1996]: Government of Mongolia, *Reports on Economic and Social Development of Mongolia,* a position paper submitted to the Tokyo Donors Meeting in February 1996, 1996.

IDCJ [1993]: Kokusai Kaihatsu Senta (Zai) (International Development Center of Japan), *Gaimusyou Itaku, Keizai Kyouryoku Keikaku Sakutei no tameno Kiso Chousa Kunibetsu Keizai Kyouryoku Keikaku, Mongolu (Study for Establishing Japanese Economic Cooperation Policies for Mongolia),* Tokyo, March 1993.

IDE [1997]: Ajia Keizai Kenkyusho (Institute of Development Economics), *Kunibetsu Keizai Kyouryoku Shishin Sakutei no tameno Kiso Cyousa, Mongolu, Houkokusyo (Study for Establishing Economic Cooperation Guidelines for Mongolia),* Tokyo, March 1997.

IMF [1991]: International Monetary Fund, *The Mongolian People's Republic: Toward a Market Economy,* Occasional Paper 79, April 1991.

IMF [1994a]: International Monetary Fund, *Mongolia, Staff Report,* November 2, 1994.

IMF [1994b]: International Monetary Fund, *Mongolia, Enhanced Structural Adjustment Facility, Policy Framework Paper* 1994-97, November 2, 1994.

IMF [1996]: International Monetary Fund, *IMF Economic Reviews, Mongolia,* February 1996.

IMF[1997a]: International Monetary Fund, *Mongolia, ESAF, Policy Framework Paper* 1997-2000, July 8, 1997.

IMF[1997b]: International Monetary Fund, *Staff Report for the* 1997 *Article IV Consultation,* July 1997.

IMF[1997c]: International Monetary Fund, *Mongolia, Recent Economic Developments,* July 1997.

Ishikawa[1990]: Ishikawa, Shigeru, *Kaihatsu Keizai Gaku no Kiso Mondai (Fundamntal Issues in Development Economics),* Iwanami Shoten, Tokyo, 1990.

Ishikawa[1994]: Ishikawa, Shigeru: "Kaihatsu ni okeru Seifu to Shizyou, Sekai-ginkou no Kouzou-chousei-seisaku to "Higashi Ajia" (Government versus Markets in Development: East Asia and Structural Adjustment Policies of the World Bank), *Aoyama Kokusai Seikei Ronshu (The Aoyama Journal of International Politics, Economics and Business)* No.31, Aoyama Gakuin University, Tokyo, September 1994.

JICA[1997]: Kokusai Kyouryoku Jigyou Dan (Japan International Cooperation Agency): *Mongolu, Kunibetsu Enjyo Kentoukai Houkokusho (Mongolia: Report on the Japanese Cooperation Policies),* Tokyo, March 1997.

Matsunaga[1993a]: Matsunaga, Nobuaki, "Mongolia in Transition to a Market-Oriented Economy", *Kokusai kyouryoku Ronshu (Journal of International Cooperation Srudies),* Vol.1 No.1, Kobe Daigaku Kokusai Kyoryoku Kenkyu-ka (Graduate School of International cooperation Studies), Kobe University, June 1993.

Matsunaga[1993b]: Matsunaga, Nobuaki, "Mongolu no Keizai Kaihatsu, Enjoy Izon Datsukyaku wo Mezashite (Economic Development of Mongolia: Towards Graduation from Development Assistances)", *Kokumin Keizai Zatsushi (Journal of Economics and Business Administration),* Vol.167 No.6, Keizai Keiei Gakkai, Kobe University, Kobe, June 1993.

NSOM[1998]: National Statistical Office of Mongolia, *Mongolian Statistical Yearbook* 1997, 1998.

NSOM[1999a]: National Statistical Office of Mongolia, *Mongolian Statistical Yearbook* 1998, 1999.

NSOM[1999b]: National Statistical Office of Mongolia, *Statistical Bulletin,* December 1999.

I. Ohno[1996]: Ohno, Izumi, "Shijyo Dounyu Senryaku to Ikou Pafomansu, Guraduarizumu no Sai-hyouka (Market-Economy-Transition Strategies and Transition Performance: Reappraisal of Gradualism)", *Kaihatsu Enjyo Kenkyu (Development Corporation Studies)* Vol.2 No.1, Kaigai

Keizai Kyouryoku Kikin Kaihatsu Enjyo Kenkyusho (OECF Development Research Institute), Tokyo, 1996.

K. Ohno[1996]: Ohno, Kenichi, *Shijyo Ikou Senryaku: Sin-keizai Taisei no Souzou to Nihon no Chiteki Shien (Transition Steategies Towards Market Economy: Creation of New Economic Systems and Intellectual Cooperation of Japan),* Yuhikaku, Tokyo, 1996.

Shimomura[1996]: Shimomura, Yoshitami, "The Experiences of Transitional Economies in East Asia: Implications for Central Asia", in Borris Rumer, ed., *Central Asia in Transition: Dilemmas of Political and Economic Development,* M.E. Sharpe, Armonk, New York, USA, 1996.

SOM[1997]: State Statistical Office of *Mongolia, Mongolian Economy and Society in* 1996, 1997.

SSO[1991]: State Statistical Office of the Mongolian People's Republic, *National Economic of the MPR for* 70 *years,* 1921-1991, *Anniversary Statistical Yearbook,* Ulaanbaator, Mongolia, 1991.

WB[1991a]: the World Bank, *Proposed Credit to the Mongolian People's Republic for an Economic Rehabilitation Project,* November 22, 1991.

WB[1991b]: the World Bank, Mongolia; *Country Economic Memorandum, Towards a Market Economy,* December 2, 1991.

WB[1991c]: the World Bank, World *Development Report* 1991, *The Challenge of Development,* Oxford University Press, New York, USA, June 1991.

WB[1992]: the World Bank, *Mongolia, Toward a Market Economy,* a World Bank Country Study, 1992.

WB[1996]: the World Bank, *From Plan to Market, World Development Report* 1996, Oxford University Press, New York, USA, June 1996.

WB[1997a]: the World Bank, *Banking and Enterprise Sector Adjustment Credit (Mongolia),* March 1997.

WB[1997b]: the World Bank, Mongolia, *Country Economic Memorandum, Policies for Faster Growth,* August 1997.

WB[1998]: the World Bank, *Country Assistance Strategy of the World Bank Group for Mongolia,* April 1998.

Yasuda[1996]: Yasuda, Satoshi, *Mongolu Keizai Nyumon: Taka no Mai heno Ouenka (Introduction to Mongolian Economy: Cheers for the Eagle Dance),* Nihon Hyoronsha, Tokyo, 1996.

Yusuf and Buski[1992]: Shahid Yusuf and Shahid Javad Buski, "Developing Mongolia", *World Bank Discussion Papers,* No.145, the World Bank, January 1992.

Annex

Table A-1. Brief History of Transition and Structural Adjustment Arrangements

Dec.10,1989	An unauthorized gathering of people took place for the first time at Sukhbaatar Square in front of Government House of Mongolia, where any gatherings were prohibited.
Mar.1990	After popular demonstrations, Mongolian Peoples' Revolutionary Party (MPRP), a single party up to this point, accepted a multi-party system.
Jul.1990	The first multi-party election was held. As a result, a new coalition government of MPRP, National Progress Party and Social Democratic Party was established.
Aug.1990	IMF membership mission, the first IMF mission, visited Mongolia.
Sep.1990	The coalition government announced to construct a market-oriented economy.
Nov.1990	IMF's Fiscal Affairs Department mission visited Mongolia.
Feb.14,1991	Mongolia joined IMF and the World Bank.
Beginning of 1991	Assistance from Soviet was terminated, and the trade system of CMEA (Council for Mutual Economic Assistance) collapsed.
May.1991	Establishment of State Property Privatization Law.
May.1991	The first donors' meeting for Mongolia was held in Tokyo by the international community.
Sep.1991	A new three-year development plan "Memorandum on Economic Reform and Medium-Term Policies", was adopted.
Oct.4,1991	IMF approved its first Stand-by Arrangement, which expired Dec.31, '92.
Nov.1991	WB approved its first BOP assistance "Economic Rehabilitation Credit".
Feb.1992	The new constitution was promulgated, abandoning the socialism.
June.1992	By the general election, MPRP returned overwhelmingly capturing 72 of 76 parliamentary seats.
June.1993	IMF approved the first ESAF (a three year program of June 93-June 96). It was extended to 93－97 because of delay on the Mongolian side.
Jun.1996	By the general election, the Democratic Union won the government seat against MPRP.
1996	The first ESAF was allowed to lapse because unmet condition regarding fiscal deficit.
Mar.1997	WB approved its first SECAC "Banking and Enterprise Sector Adjustment Credit".
July.1997	IMF approved the second ESAF (97－2000), which is a three-year program.

Source: Credit and facility documents of IMF and the World Bank.

Table A-2. Plan by the Memorandum, 1990-1994

	1990	1991	1992	1993	1994
	(percentage change)				
Output					
Real GDP	-2.1	-15.0	-5.0	0.0	3.0
Nominal GDP	-2.0	44.5	37.7	25.0	18.5
Prices					
GDP deflator	0.0	70.0	45.0	25.0	15.0
Consumer prices	0.0	130.0	50.0	30.0	20.0
	(percent of GDP)				
Total investment*	32.1	14.1	14.0	14.0	14.0
Gross national savings*	3.4	4.0	3.0	5.2	7.5
Current account deficit*	28.7	10.1	11.0	8.8	6.5
Budget and Money					
Revenue	50.7	62.7	48.5	48.5	48.5
Expenditure	64.1	76.9	60.4	58.5	57.0
Overall deficit	-13.4	-14.2	-11.9	-10.0	-8.5
Broad Money	60.5	56.6	54.9	53.8	53.5
Currency in circulation	-7.1	10.7	9.7	8.1	7.2

Source: World Bank [1991b]. Original source: "Memorandum on Economic Reform and Medium-Term Policis," September 10, 1991.
*The program does not provide data on these items beyond 1991.

Table A-3. Major Transition Policies Undertaken by the Government, 1990-1992

(a) Stabilization policies

(i) Monetary policies:

- Increased interest rates to higher levels (91); the BOM started tightening monetary and credit policy in 1992 in order to contain inflation, by the increase in minimum cash requirements for commercial banks from 8.5% to 40% as their assets and by the increase in interest rates from BOM to commercial banks up to 30% in April, then to 35-60% in August and to 120% in September 1992*; devalued the currency**; and imposed ceilings on bank lending (92-93).

(ii) Fiscal policy:

- Expenditure side: substantially reduced budgetary subsidies for imported goods and loss-making enterprises from 16.2% in 1990 to 5.8% of GDP in 1991*; and reduced expenditures for capital investment from 12.1% in 1990 to 5.3% of GDP in1991*.
- Revenue side: increased custom duties from 15% to 25%; doubled sales taxes on liquor, tobacco and gold (91)*; and introduced automatic payroll deductions of social security payments (91)*.
- Overall budgeting balance: reduced this from -13.4% of GDP in 1990 to -4.2% in 1993.

(b) Liberalization policies

(i) Domestic prices:

- Liberalization of prices: liberalized prices starting from selected retail prices (90); increased retail prices of most goods (91); and deregulated all prices except for public resources, utility tariffs, housing rents, selected medicines, flour, bread, meat and rationed votka (92).

(ii) Controlled domestic activities:

- Assigned responsibility for transportation policy to a single coordinating authority, General Department of Transportation (92); and eliminated the control over transportation and distribution of goods.**

(iii) Exchange rates:

- Devalued tugrik vis-a-vis US dollar for commercial transactions, still maintaining multi-exchange-rate system (90); introduced foreign exchange auction system (90); and devaluated tugrik to Tg40/US $ (91);

(iv) Controlled external activities:

- Granted direct export rights to selected manufacturers (91); started issueing foreign trading rights on nondiscriminatory basis (91); eliminated mandatory state orders for exports (92); and issued foreign trading licenses on a nondiscriminatory basis except for copper, scrap, cashmere, timber, and elk horns (92).

(c) Transition and adjustment policies

(i) Privatization and state-owned-enterprise (SOE) reform:

- Privatized the ownership of herds from the socialism cooperatives (NEGDELs) to private herders (90); and passed Privatization Law and initiated a program for small-and-medium enterprise privatization (91).

(ii) Financial sector reform:

- Legalized a two-tiered banking system, and established two commercial banks out of the mono-bank (90).
- Lengthened maturity structure of term deposits (91).
- Passed Banking Law, and deposit and lending rates started to be determined by commercial banks, and the Bank of Mongolia established as a central bank (91); and simplified interbank clearing and payment arrangements (91).
- Issued Central-Bank-bills for the first time to be a principal instrument to regulate bank liquidities along with reserve requirements (93).

(iii) Fiscal reform:

- Established Customs Affairs Department and Tax Service Department (90).
- Eliminated budgeting transfers to public enterprises (loans remaining) (92); introduced weekly monitoring of budgetary revenues and expenditures (92); and as for revenue side: replaced profit taxes, import price differentials and domestic turnover taxes with corporate and personal income taxes, customs duties and sales taxes respectively (91)*.

(iv) Public management reform:

- Eliminated State Planning Committee, and rationalized government ministries (90).

(to continue)

(Table A-3 continued)

(v) External policies:
- Negotiated and gained most-favored nation trade agreements with countries in the convertible currency area (90).

(d) Market nurturing (enhancing) policies and private sector development
(i) Foreign direct investment (FDI) promotion:
- Promulgated a new Foreign Investment Law (90).

(ii) Financial market:
- Established stock market regulations (91); passed Bankruptcy Law (92); and established a stock exchange (92).

(e) Social safety net for the most affected and the poor
- Adjusted wages, pension benefits, and private savings deposits to ameliorate impacts of price increase.

Sources: WB, Mongolia, Country Economic Memorandum Towards a Market Economy, December 2, 1991.
WB, Mongolia, Towards a Market Economy, 1992.
*Matsunaga [1993a] p.83.
**IDCJ [1993].

Table A-4. Intended Transition Policies of the First ESAF, 1993-1997

(a) Stabilization Policy Measures
(i) Monetary measures:
- Objective: reduce the annual inflation rates to single digits as soon as possible with tight financial policies.
- Maintain positive real interest rates.
- Reduce further net credit to the government; strictly limit the increase in directed credit to public enterprises; make repayment of directed credits by SOEs, especially by petroleum corporation, power companies, flour mills, and meat procurement company (94); limit the expansion in net domestic assets of the banking system while the broad money is to grow along with inflation; increase the minimum reserve requirements of commercial banks (93); and additionally issue Central-Bank bills (93-94).

(ii) Fiscal measures:
- Improve the current fiscal balance by one percent of GDP each year (94-97); hold increases in the civil service wage bill below the rate of inflation (94-97); phase out subsidies, excluding urban transport and rural electricity (94-95); and strictly limit borrowings from the banking system.

(iii) External policy measures:
- Objective: further build up net official international reserves.
- Eliminate all external arrears (94); and settle outstanding short-term credit with Russia (94).

(b) Liberalization and proper pricing measures
(i) Domestic prices:
- Proper utility tariffs: establish a regulatory commission to review tariffs for utilities (94); raise commercial electricity and heating tariffs (94); and raise domestic heating tariffs for resideutial use (95).
- Price: further liberalize prices; and adjust the retail price of gasoline and the petroleum products (94).

(ii) Domestic activities:
- Abolish remaining mandatory state orders on production and procurement (93); and abolish consumer rationing system (93).

(iii) Exchange rates and trade measures:
- Establish a full floating exchange rate system (93).
- Abolish most of export licenses and import licenses (93); and phase out the centralized distribution of imported goods (93).
- Maintain a unified market-determined exchange rate system (94-97); and abolish the foreign exchange surrender requirements (94).

(iv) External measures:
- Further liberalize trades; and abolish the ban on raw cashmere export (94-97).

(to continue)

(Table A-4 continued)

(c) Transition and adjustment measures
(i) Privatization and rationalization:
• Complete the distribution of privatization vouchers(93); and sell the total asset planned to be sold in 93 (93).
• Prepare the list of SOEs to be privatized (94); emphasize the financial autonomy of large SOE manufacturers; identify nonviable SOEs and establish an action plan to rationalize them (94); and sell SOEs earmarked for cash privatization in 95 (95).
(ii) Financial sector reform:
• Non performing loans: prepare the action plan for non performing loans (94); and start strengthening of BOM supervisory capacity and rationing of the bank structure (94).
• Maintain in 1994 and then eliminate ceilings on commercial bank lending (95).
• Establish a regular refinancing facility (95); and initiate open market operations (95).
(iii) Fiscal reform:
• Introduce treasury function and monthly reporting system in MOF (93); review all remaining customs duty exemptions with a view of eliminating as many as possible (94); establish appropriate accounting rules for depreciation and asset revaluation for Corporate Income Tax purposes (94); phase out sales tax exemptions (95); extend the sales tax to include services (96); and modify corporate and personal income taxes to achieve greater uniformity in rates (96).
• Introduce a new social security system and implement phased increases in the employer and employee contribution rates (94-96); and implement needs-based criteria for financial support to education, and reduce the rates of administrators and teachers to students (94-96).
• Strengthen tax administration (95, 94-97).
(iv) External measures:
• Export: avoid recourse to export quotas, taxes, bans, and minimum export prices, and restrict export licensing (94-97).
• Import: avoid quantitative restrictions and licensing of imports (94-97).
• Trade: terminate existing bilateral arrangements and avoid new arrangements (94-97).
• External debt: establish and maintain debt register for monitoring public and private existing and future external debt (93-97); and no commercial borrowings (94-97).
(d) Market nurturing and private sector development measures
• FDI: identify and eliminate the remaining regulatory barriers to foreign investors (94).
• Friendly environment measures: enact Corporate Entity Law for corporate governance (93); develop national accounting standards and apply them to selected SOEs (94); and enact a new land law to transfer responsibility for cropping to individual household farmers (94).
• Activist measures: secure, within the limits imposed by the fiscal policy, that elementary veterinary services continue to be available to herders.
(e) Planning public investment and economic management capacity
• Prepare and update a rolling three-year public investment program (94-97); and complete key sector studies and plans, i.e. energy and roads (94).
• Improve statistical data on balance of payments, fiscal, price and wage (94-97).
• Increase budgetary finance for public investment.
• Develop the capacity of economic management.
(f) Social safety net measures
• Restructure and improve targeting of social benefits (94-96).

Source: IMF, Mongolia, ESAF, Policy Framework Paper (PFP), 1994-97, a document prepared for the Second Annual Arrangement (1994-95), November 2, 1994.

Table A-5. Intended Transition Policies of the Second ESAF, 1997-2000

(a) Stabilization measures

(i) Monetary measures:

- Maintain significantly positive real interest rates on Central Bank bills and on refinance and rediscount rates (97-98); impose ceiling on net domestic assets of the banking system; impose ceiling on net credit to government from the banking system; and impose floor on the net international reserves of the Bank of Mongolia.

(ii) Fiscal measures:

- Cut expenditures, especially cuts in current expenditures be larger than the loss of revenue, thus increasing the current account surplus from 1 percent in 1997, to 4 percent in the year 2000; impose ceiling on net domestic financing of the general government budget deficit; do not borow nonconcessional external loans; impose floor on privatization receipts; eliminate all budgetary subsidies to public enterprises except for urban public transport (97); eliminate all government loans to enterprises, except to those undergoing restructuring (97); and contain the growth of the overall wage bill to 30% in 1997.

(iii) External measures:

- Settle existing external payment arrears (end-97); and remain current on external payments (97-00).

(b) Liberalization and proper pricing

(i) Domestic prices:

- Move to full-cost-recovery utility tariffs and energy prices (January 1, 98); and increase energy prices by an amount to achieve full operating cost recovery.

(ii) Foreign exchange:

- Foster the development of the interbank foreign exchange market (97-98); and refrain from intervening in the foreign exchange market, except for short-term smoothing operations (97-00).

(iii) Trade and external payment:

- Phase out the tax on scrap metal exports (97-00); repeal cashmere and camel wool export taxes (97-00); avoid new restrictions (licensing, quota, and taxes) on imports, except for drugs, etc. and on exports except for limits for environmental, cultural and security purposes (97-00); do not impose or intensify import restrictions for balance of payments reasons; and do not intensify restrictions on payments and transfers for current international transactions.

(c) Transition and adjustment measures

(i) Privatization and public enterprises reform:

- Privatize most public assets and nearly all state enterprises (97-99); implement plans to restructure Energy Authority, in line with the AsDB recommendations (97-00); implement restructuring of six enterprises, in line with World Bank recommendations (97-98); apply internationally recognized accounting standards to large public enterprises (97-00); and implement housing privatization (97).

(ii) Financial sector reform:

- Channel all lending to commercial banks through refinance and Central-Bank-bill discount facilities, except for onlending foreign concessional loans (97-98); maintain monthly credit ceilings for all banks that violate minimum reserve requirements and prudential ratios (97-98); prevent banks failing to meet requirements and/or liquidity ratios from further lending and from purchasing Central-Bank-bills until they implement remedial action (97-00); and gradually develop a functioning interbank money market, in line with bank restructuring (98-00).
- Complete liquidation procedures for Ardyn and Insurance banks (97); complete special inspections of the Savings Bank and the Reconstruction Bank (97); Strengthen management and banking skills of Savings Bank and Reconstruction Bank (97-98); implement individual restructuring plans for two large banks (97-00); continue to prohibit commercial bank lending to loan defaulters (97 onwards); strengthen capabilities of BOM Banking Supervision Department by increasing its resources (97-00); complete external audit of BOM (97); and continue to require annual independency audited financial statements for all banks (97 onwards).
- Enact amendments to Civil and Criminal Codes, Insolvency Law, and other legislative steps, to force repayment from defaulting borrowers (97).

(to continue)

(Table A-5 continued)

(iii) Fiscal measures:

- Extend sales tax to an additional 300 enterprises (97); prepare and implement VAT (98); improve efficiency of income taxes (98); expand fees and charges for government services, buildings, and office space (98); develop tax handles for local government levels (98); develop and implement strategy to improve tax compliance (97); complete administrative reforms to achieve a unified national tax administration (98); hold increases in civil service wage bill to 30 percent in 97, including severance payments (98); limit severance payments to a maximum of six months of the most recent wages (97-00); consolidate all bank accounts of government ministries in the BOM to improve financial control and monitoring (97); and implement an interim treasury system and consolidate all government accounts into a single treasury account at the central bank.

(iv) Social sector reform:

- Reform education and health sectors by eliminating redundant facilities and improving operation of remainder (97-00).
- Review operation of current pension system to make it substantially self-financing (97-98).
- Formulate measures to move to a self-financed social security system (97).

(v) External debt:

- Continue discussion on ways and means of settling the outstanding stock of nontransferable ruble debt (97-00); develop and maintain a debt registry at the Ministry of Finance (97-00).

(vi) Public management reform:

- Implement pilot projects in one ministry and three implementing agencies to promote output oriented provision of services within strict overall budgetary constraints (97).

(d) Market nurturing and private sector development measures

- Develop mechanism to consolidate private ownership and improve corporate governance (98); review the existing Foreign Investment Law and regulations and revise as necessary to simplify and clarify procedures (97); and reform gold monopsony arrangements with the central bank to encourage private sector participation (97-00).

(e) Planning and public investment

- Establish a High Level Economic Advisory Committee for economic management (97).
- Expand coverage of national accounts statistics to include private sector (97); and enhance statistics on the balance of payments, external debt, official grant statistics and establish timely data reporting system to the BOM (97).

(f) Social safety net measures

- Provide unemployment benefits and retraining facilities, to those made redundant from civil service and enterprise reform (98).
- Review social welfare arrangements to improve the targeting of the assistance to the poor and vulnerable groups (98).

Table A-6. Intended Sectoral Transition Policies of BESAC*, 1997-1999

(a) Stabilization measures: hard budget constraint

- Eliminate all government subsidies to enterprises, with the exception for urban transport enterprises (97-98); and stop all government loans, except to enterprises in electricity and heating (97-98); reduce the level of arrears in enterprise loan payments to the budget to zero by 99 (99).

(b) Transition and adjustment measures

(i) Privatization and public enterprise reform:

- Assess, approve and implement restructuring/liquidation plans for Darkhan Minimetal and Bagahangai Meat plants (98); present Draft Insolvency Law to Parliament, satisfactory to IDA (97); and prepare privatization program for state-owned enterprises (97).

(ii) Financial sector reform measures:

- Place People's Bank and Insurance Bank under receivership (97); establish and license the new Savings Bank and the new Reconstruction Bank (97); submit 1997 budget to Parliament with Tg 16 billion specifically earmarked to finance the bank restructuring exercise (97); establish MARA, with powers and responsibilities acceptable to IDA (97); and prepare privatization plans to privatize all state-owned banks (98).
- Issue a Central Bank Regulation, requiring all banks to report on a monthly basis their ten largest loans outstanding (97); and establish a Credit Information Bureau (CIB) consolidating periodic reports from all commercial banks of borrowers in default (97);
- Establish DWU (Debt Workout Unit) in T&D bank (97); and arrange a twinning arrangement for the Trade and Development Bank (97-99).

*BESAC stands for Banking and Enterprise Sector Adjustment Credit of the World Bank, approved in 1997.

Table A-7. Plan and Performance of Three Stabrization Indicators

Year	91	92	93	94	95	96	97	98	99
(1) Inflation (%)									
Planned (Memorandum)	130	50	30	20					
Actual	53	325	183	66	53	59	18	6	10
(2) Trade Deficit (current mil US$)									
Planned (Memorandum)	-10.1	-11.0	-8.8	-6.5					
Actual Export	348	388	383	356	473	424	452	317	336
Import	361	418	379	258	415	451	468	472	426
Balance (mil $)	-13	-30	4	98	58	-27	-16	-155	-90
(% of GDP)	-2.7	-6.7	1.0	14.3	6.4	-3.2	-1.7	-16.3	-9.9
GDP (current bil Tg)	19	47	166	283	429	587	759	856	975
Exchange Rate (Tg/$) (end of period)	40	40	397	414	474	694	813	902	1072
GDP (current mil US$)	475	(447)*	418	684	905	846	934	949	909
(3) Budget Deficit (current bil Tg)									
Planned (Memorandum)	-14.2	-11.9	-10.0	-8.5					
Actual Revenue	6	12	55	86	145	163	221	240	259
Expenditure	—	—	62	101	149	211	284	342	344
Balance			-7	-15	-4	-48	-63	-102	-85
(% of GDP)			-4.2	-5.3	-0.9	-8.2	-8.3	-11.9	-8.7

*Simple average of 1991 and 1993, since no exchange rate data available.

Source: National Statistical Office of Mongolia, Mongolia Statistical Yearbook, 1998 and 1997. State Statistical Office, Mongolian Economy and Society in 1996. Government of Mongolis, Monerandum on Economic Reform and Medium-Term Policies, September 1991.