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## EXECUTIVE SUMMARY

The Asian Development Bank's (ADB's) existing Country Operational Strategy (COS) for Mongolia was prepared in 1994. It aimed at facilitating the transition to a market economy by (i) creating an environment in which a competitive and efficient market economy can flourish, (ii) developing the human resources and skills necessary for a market economy, and (iii) developing the infrastructure needed for a market economy. The COS emphasized efficient resource use, promotion of competitive private markets, and a fiscally and environmentally sustainable growth, all to be achieved through investments in physical infrastructure. The COS did not explicitly address the issue of poverty which had risen to high levels in the initial years of the transition, as it was considered that economic growth would generate sufficient opportunities for the poor to lift themselves out of poverty.

The transition to a market economy has proceeded satisfactorily, and the private sector is now the main producer of goods and services in the country (60 percent of the gross domestic product [GDP] in 1998). Mongolia has successfully implemented substantial reform programs and investment projects undertaken by the Government and supported by aid agencies including ADB. Furthermore, in the period covered by the first COS, economic growth was positive and at reasonably high rates. However, two major areas that need more attention developed.

First, economic growth did not reduce poverty as had been expected. This was mainly because economic growth (generated by externally supported, capital-intensive public investments in infrastructure) was noninclusive; it failed to (i) generate employment for the Mongolians on a wide basis, and (ii) diversify the industrial base of the economy. The increased share of the private sector in the GDP was mainly the result of the privatization policy, which was successful, but did not result in substantial additional employment.

Second, the need for policy reforms specifically designed to strengthen key elements of good governance in various sectors of the economy was often left unaddressed in donor-supported projects, including those supported by ADB. Projects were often undertaken without due regard to medium-term strategic resource allocation priorities, and mostly disconnected from the need to integrate recurrent and capital budgets within a medium-term framework consistent with available resources (including foreign financing). Other efficiency-raising and incentive-improving elements of good governance, including administrative reforms, often were also absent from projects in various sectors. In short, the absence of good governance at the economy-wide level often prevented the efficient use of the gains from economic growth.

Looking to the future, ADB's new strategy is built on the foundation of lessons learned during the period covered by the first COS (1994-1999). In summary, the strategy places poverty reduction at the same level of importance as the need to foster economic growth. It further emphasizes the need to incorporate elements of good governance in any project supported by ADB. Recognizing the success of the first COS in fostering the transition to a market economy, the new strategy puts the main emphasis on the private sector to lead the economic growth process and to reduce poverty. However, unlike the economy's performance during the first COS, when an increased private sector share in the GDP was achieved mainly through privatization, the new strategy will support efforts to revive and expand economic activity in the existing private sector while continuing with privatization.

In more operational terms, the strategy will foster economic growth and combat poverty by switching the main mechanism for growth generation from public sector investments in

infrastructure to employment-generating investments aimed at engaging the private sector. In the process, the strategy will also support mechanisms to improve governance.

The strategy's primary contribution to poverty reduction will come from support for activities that aim to increase the productivity of the economy (through better governance) and the people (through viable employment generation). The strategy aims at diversification of competitive industries and services, expanding demand for skilled labor, continued structural reform to remove the barriers to private sector growth, and reduction of the fiscal burden on the private sector over the medium term.

On this basis, and as agreed to by the Government, the ADB's new COS for Mongolia is first and foremost a poverty reduction strategy, in which the choice of core sectors for ADB interventions is dictated by the main objective of growth with poverty reduction, and where growth is to be achieved through means that contribute the most to poverty reduction. This strategy differs from the traditional growth-oriented strategies that select the sectors for ADB interventions on the basis of considerations other than the sectors' potential for poverty reduction, and then incorporate elements of poverty reduction in each intervention. In the new COS, the additional emphasis on good governance at the economy-wide level and within all sectors will further contribute to the main objective of poverty reduction by improving the efficiency of the utilization of the gains from economic growth. The new strategy envisages considerable interlinkage among sector interventions so as to enhance the results achieved from each project.

As monitoring progress under the new COS and of any new developing patterns that may need to be addressed is important to the success of the strategy, monitoring indicators have been defined to accommodate this need.

Two facts form the basis for the design of the new strategy for ADB operations in the next five years. First, a study of the nature and composition of poverty in Mongolia shows that (i) poverty is income-based (i.e., the result of lack of employment and insufficient incomes), and not a result of education or health deprivation, social exclusion, or other forms of assetlessness; (ii) poverty is mainly found in urban areas and the majority of the poor are the unemployed, households headed by women, civil servants, early pensioners, and small herders; (iii) while the majority of the poor remain close to the poverty line, they are sinking more and more to lower levels of poverty, which puts them beyond the reach of employment opportunities for self-help to get out of poverty; and (iv) although poverty at this time is not caused by lack of access to social services, inaction to resolve it could soon lead to the development of new forms of poverty based on health and education deprivation. Resolving these forms of poverty may not be simple.

Second, although infrastructure investments in Mongolia contribute to economic growth, they generate noninclusive growth. They are capital intensive projects that are financed by foreign assistance and, by their nature, have a long-term delay before contributing to economic activity and poverty reduction; in the short to medium term, they do not generate viable employment on a wide basis for Mongolians. They also fail to diversify the industrial base of the economy.

An effective poverty reduction strategy needs to (i) generate viable employment on a wide basis (because poverty is income-based) within the short to medium term; (ii) generate this income and employment mainly in urban areas, particularly the *aimag* (provincial government) centers where the poor are; (iii) rely mainly on the private sector to deliver the needed

employment opportunities; (iv) provide for a one-time intervention to put in place a strong safety net for the very poor who might be beyond the reach of self-help opportunities; and (v) while combating income-based poverty, maintain an active hand in keeping up social service delivery to avoid facing new forms of poverty at a later stage.

The poor in the different income groups will require different strategies: (i) for people above the poverty line but likely to become poor: small-enterprise development, microfinance, skills development and labor advisory programs, livestock and agriculture; (ii) the poor below but close to the poverty line: microfinance, skills development and labor advisory programs, sustaining access to social services, livestock and agriculture, development of social infrastructure; (iii) the very poor: income generation activities, training and labor advisory programs, sustaining access to social services, development of social infrastructure; (iv) the ultra poor: public works for the able-bodied, targeted social assistance for the really vulnerable, including disabled, aged, orphans, multichildren households.

The above facts also dictate the choice of sectors and the nature of projects within each sector to be supported by ADB so as to achieve the main objective of the strategy. The selected sectors will be at the core of ADB operations because of their potential for (i) contributing to the private sector's growth, (ii) generating viable employment that can lead to poverty reduction, and (iii) maintaining and improving social service delivery to avoid the development of new forms of poverty.

The strategy identifies five core sectors: the financial sector (for its potential to remove the single most important barrier to private sector investment and savings, which is the fragile and thin banking system, and for developing microfinance schemes); agriculture sector (for its potential to generate viable small-industry employment and income); the public sector (for its potential to reorient the machinery of the Government to become more conducive to and supportive of private-sector-led growth and to improve service delivery by seeking to devolve responsibility for public service delivery to lower appropriate levels of the Government in a phased manner); social sector (education, health, and social protection for the potential to empower the labor force with market-related human capital investment, maintain standards of health, raise the general public's health awareness, and improve accessibility of education and health care); and urban development (for its potential to support health improvement and enhance living conditions).

This means that ADB will no longer provide lending for civil aviation, telecommunications, energy, and transport under the new COS, as the basic infrastructure in these sectors is already well in place and other aid agencies are prepared to continue investments in them. It should be made clear that investment in infrastructure remains important to the economic development of Mongolia in the long run. However, the contribution to employment and economic activity downstream normally occurs with a long lag of about 5-10 years. The new strategy, while acknowledging the importance of such investment, recommends that for the next few years the focus should be on employment-generating activities with shorter time lags. Recognizing the importance of energy prices in the social sector and their impact on the fiscal budget, ADB will continue to provide advisory assistance to seek means of providing affordable and decentralized energy. A study of the importance of the road sector to contributing to poverty reduction and human development could also be undertaken to provide a basis for considering future investments.

Within the five sectors, selection of projects will be based on their expected contribution to poverty reduction or improvements in human development. A selected project will undergo

further careful examination to ensure that strong elements of governance reforms within the sector can be incorporated in its design.

The strategy has been prepared within a participatory framework, involving consensus-building among all key stakeholders. The process was facilitated by translating the strategy into Mongolian. It has been discussed at high-level forums at Cabinet level and with the Parliament. Participatory workshops were held to include representatives from, among others, government and opposition groups, civil society, nongovernment organizations, the private sector, and external aid agencies. In addition, bilateral discussions were held with stakeholders.

## I. BACKGROUND

### A. Macroeconomic Performance

1. The Mongolian economy has achieved reasonably high rates of economic growth (averaging 3-3.5 percent per year) along with impressive inflation reduction in recent years. The Government has successfully introduced numerous structural reforms spanning a broad range and which are supporting the achievement of macroeconomic stability and encouraging private-sector-led growth.<sup>1</sup>

2. Since the start of its transition to a market economy, Mongolia has achieved commendable progress in privatization, and structural reforms in many areas. Macroeconomic performance during 1997-1998, however, was severely affected by the economic crises in Asia and Russia. The chain impact started with weak economic conditions in the region that led to a sharp drop in demand for and prices of Mongolia's main commodity exports (copper and cashmere), while Russia's aggressive entry into the international gold markets negatively affected Mongolia's gold exports. Export earnings dropped significantly, reducing the Government's tax revenues and dividend payments from the copper export company Erdenet. Furthermore, foreign direct investment (FDI) and foreign assistance from aid agencies in major Asian countries declined sharply. As large enterprises faced cash shortages, a drawdown on bank deposits and the growing volume of nonperforming loans led to a severe worsening of the already stressed banking system which, in turn, put further pressure on the budget. Nevertheless, the economy continued to grow at a reasonably high rate in 1998, when real GDP growth reached 3.5 percent (down from 4 percent in 1997). Mongolia has experienced unstable but positive real GDP growth rates for five consecutive years since 1994.

3. Under the impact of a combination of exogenous factors (financial crises in Asia and Russia, and the sharp fall in international prices of Mongolia's main commodities), mistaken past policy implementation (leading to a crisis in the financial sector that now puts further pressure on the budget), and the public sector's own deficient financial and management governance, the fiscal deficit deteriorated in 1997 and reached substantially high levels in 1998 and 1999. The public sector fiscal imbalance began to seriously threaten the Government's ability to persevere in its reforms agenda in other areas—including the reform of public sector governance. The banking system's performance deteriorated sharply in 1998 as a result of the impact of the large external shocks on the liquidity and profitability of major corporate clients, persistent managerial and governance problems in several big banks, political uncertainty, and inadequate supervision.

4. Mongolia's short- and medium-term prospects are subject to some uncertainty due to the still fragile banking sector, the difficulty of managing an economy in transition, the heavy dependence on copper prices, and the import-intensive nature of the economy.

5. Regarding structural reforms, although a bank reform program has been implemented, the sector needs further restructuring and consolidation. Public administration is being streamlined, the privatization program has been accelerated, tax reforms have been implemented, and the trade regime is among the most liberal in the world. The Government abolished all import duties except those on tobacco and alcohol effective June 1997. However, due to the deterioration in the fiscal position, a temporary uniform 5 percent import tariff was introduced in May 1999. The Government plans to further consolidate the banking sector and to

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<sup>1</sup> Details are provided in CER: MON 99032: *Country Economic Review, Mongolia*, November 1999.

persevere with macroeconomic stabilization policies within the framework of the International Monetary Fund's (IMF) ongoing Enhanced Structural Adjustment Facility (ESAF) program.

## **B. ADB's First Country Operational Strategy for Mongolia**

6. ADB's first Country Operational Strategy (COS) for Mongolia was prepared in 1994. The main objective was to facilitate Mongolia's transition to a market economy by (i) creating an environment in which a competitive efficient market economy can flourish, (ii) developing the necessary human resources and skills, and (iii) providing the needed infrastructure. Mongolia's transition to a market economy was to be supported by:

- (i) creating the necessary environment by (a) policy reforms, (b) redefining the role of the government, (c) liberalizing prices, (d) promoting trade, (e) supporting privatization, (f) developing the financial sector, (g) strengthening the legal system, and (h) promoting regulatory systems;
- (ii) developing human resources skills by (a) strengthening training institutions; (ii) training managers, accountants, and lawyers; and (b) developing entrepreneurs; and
- (iii) providing the needed infrastructure by (a) supporting the development of transport systems, (b) developing storage and distribution systems, (c) improving communications, and (d) improving the energy supply.

7. To achieve the main objective of facilitating the transition to a market economy, ADB's strategy considered it necessary to support reforms and investments aimed at promoting (i) more efficient resource use, (ii) a more competitive private sector, and (iii) efficient and sustainable—fiscally and environmentally—growth. The strategy envisaged that efficient and sustainable growth would best be achieved by emphasizing public sector investments in infrastructure, which was mainly in line with the focus of the Government's Public Investment Program (PIP) for 1993-1996.

8. Two constraining factors existed at the time the first COS was designed. First, a weak revenue base constrained the availability of counterpart funds. This led ADB to envisage a higher than normal lending that did not require counterpart funds from the budget—program lending (program loans comprise about 30 percent by number and amount of ADB lending to Mongolia), credit lines, and the establishment and maintenance of off-budget revenue-generating entities (such as the Road Fund). Second, administrative and technical weaknesses within the government led ADB to envisage a substantial number of capacity-building and advisory technical assistance grants.

9. In the first COS, the Government's position that investment in agriculture, health, education, poverty reduction, and other social development sectors would remain secondary and within budgetary limits became the foundation for emphasizing fiscally sustainable growth. In the same vein, ADB's strategy contended that poverty, the need for social safety net improvements, and the unemployment problems would be resolved with a competitive private sector and buoyant growth.

## II. SUMMARY OF DEVELOPMENT ISSUES AND OUTLOOK

### A. Performance in Cross-Cutting Issues

#### 1. Economic Growth

10. Mongolia experienced unstable but positive real GDP growth rates for five consecutive years since 1994 as a result of which, despite fast population growth, income per capita increased from \$334 in 1994 to \$452 in 1998. The extensive dependence of the country on exports of primary commodities means that even small changes in the international market prices of these commodities can affect the GDP to a noticeable degree. The agriculture and livestock sector provides about a third of Mongolia's GDP. Livestock provides close to 75 percent of the value added in the sector. Industry is the highest earner of foreign exchange. The leading industries—nonferrous metals production (copper and molybdenum concentrates)—account for about half the gross industrial production.

11. Economic growth in Mongolia remains noninclusive. Industry, with the main focus on mining, generates growth without generating widespread employment, while agriculture, with its focus on livestock, fails to generate viable year-round employment and income. A main outcome of this environment has been the substantial increase in nonformal economic activity in recent years, which provides temporary employment and income.

#### 2. Human Development and Poverty

12. As in many countries of the former Soviet Union (FSU), Mongolia's social development was impressive before independence. Health, education, and social protection were universal and at very high levels. About 40 percent of government expenditures were devoted to social development. In addition, state enterprises financed various social schemes. As a result, poverty was very low and social living standards and human development relatively high. With the transition to a market economy and privatization, social expenditures decreased. In the initial years of transition, with high inflows of development aid replacing the former subsidies from Moscow, and high export earnings, the Government could maintain a relatively high involvement in the social sector, housing, and heating finance. More recently, public expenditures on health and education, while lower than before, still remain high by international standards. The largest share of the budget is devoted to education (15 percent in 1998), social security (15 percent), and health (6 percent). Appendix 1 presents details on human development and poverty in Mongolia.

13. The observed phenomenon in Mongolia of increasing or stable poverty in an environment of continuing economic growth can, for the most part, be explained by the interaction of several factors: (i) the fact that the Government emphasized sectors that do not traditionally contribute to viable employment generation within the short to medium term, e.g., the choice and composition of projects and policies to accelerate growth have emphasized physical infrastructure, which may take a longer time to demonstrate an impact on economic activity and employment; (ii) during a time when growth was high but was generated only in a few sectors (mining, cashmere, livestock, and petty trade), the economy failed to diversify to generate more sustainable and inclusive growth; (iii) most externally financed infrastructure projects lacked the ability to generate immediate (within 2-3 years) improvements in the living standards and the income of the people, as they were built on the basis of highly capital-intensive technology with little employment effects and only very long-term trickle-down impact

on poverty; and (iv) policy reforms were successfully implemented, but did not result in structural changes in the real economy.

### **3. Gender and Development**

14. Mongolia has a history of substantial gender equality due to its nomadic lifestyle and former socialist tradition. In today's Mongolia, however, gender-related problems that work to the disadvantage of the males are increasing, and no high-level gender advocacy has been established in the Government's administrative system to plan for and oversee their correction. A study of gender and development, initiated as part of the new COS, will have its results published in due course; the main points appear in Appendix 2. Briefly, results show that the female population appears to be getting more educated than the male population, particularly at higher stages of education. Standards of health are relatively good for both genders.

15. Traditional factors that have worked in most societies against equal opportunities for women however, are also at work in Mongolia. One noticeable trend is that households headed by females have a high tendency to be poor. Future reforms in the public sector are also expected to work against women in the civil service, as a high portion of the civil servants in the overstuffed sectors of the Government are females.

### **4. Environment**

16. Because of the past regime's disregard for environmental concerns, environmental pressures have risen (e.g., water and air pollution, deposits of toxic wastes, desertification, deforestation, groundwater depletion, soil erosion, and overgrazing). But since 1990 the philosophical and legislative position of the Government with respect to environmental issues has changed. There is now greater concern for the environment and new legislation has been adopted. The institutional, monitoring, and enforcement framework is, however, still weak. ADB has been providing technical assistance to help the Government deal with these issues and to incorporate environmentally sound technologies and subcomponents to ADB-financed projects. ADB has been helping the Government to strengthen environmental management capability, including reviewing the comprehensive environmental law, developing national environmental standards, institutionalizing the environmental impact assessment process, strengthening environmental monitoring capabilities, preparing a permit system, and developing a public awareness and information program. The environmental impact of livestock production on the ecological systems in Mongolia needs to be carefully examined. ADB has been assisting in the formulation of policies, strategies, and an action plan for sustainable management of extensive livestock production systems. The Government's priority is to use grant rather than loan funds to address environmental issues.

### **5. Governance**

17. A major barrier to improving economy-wide efficiency is poor governance within sectors, including lack of predictability under the rule of law and stable guidelines; lack of transparency in financial transactions, personnel management, and use of decision-making power; lack of accountability within the decision-making hierarchy; and the weak incentive systems for promoting efficiency. Improving governance will allow better utilization of the benefits of economic growth. Experience from other countries shows that improved governance economy-wide encourages foreign investment and contributes further to increased growth. Appendix 3 presents a more in-depth discussion of governance issues in Mongolia.

## **B. The Government's Development Strategy**

### **1. Medium-Term Plan**

18. The major objective of the Government's development strategy during 1999-2002 is to accelerate economic growth so as to enhance the living standards of the population. To achieve this, Mongolia intends to consolidate recent progress in macroeconomic stabilization and enhance private-sector-led economic activity by deepening structural reforms, rapidly increasing FDI, and expanding domestic savings.

19. The key components of the Government's growth strategy are (i) macroeconomic stabilization, (ii) private sector development, (iii) financial sector development, (iv) new approaches to infrastructure development, (v) promotion of foreign direct investment, (vi) promotion of export-oriented industries, and (vii) a human development and social sector development strategy.

20. The Government intends to place priority on creating an economic system that is flexible and open, provides for the free flow of foreign capital, ensures a competitive environment, and is underpinned by stable government policies and a reinvigorated modern financial sector that encourages economic growth. Improved living standards and development of human resources are vital medium-term objectives.

21. The Government, with support from ADB, aims at developing a more coherent and realistic fiscal framework supported by effective institutional arrangements, accountability, and transparency in the medium term so as to ensure better achievement of macroeconomic and sector development objectives and to ensure that public expenditure programs are sustainable. The Government recognizes that such effective planning will require that the PIP processes be integrated into strategic planning and budgeting processes. This would avoid the existing dual budgeting and aid-agency-driven processes.

22. The Government's medium-term economic adjustment and reform strategy is to maintain the stabilization and social protection programs within a prudent medium-term expenditure framework and to accelerate and complete structural and enabling reforms that facilitate private-sector-led development as well as public management reforms. This stabilization and adjustment program is complemented by investments in social and economic infrastructure that aim to reduce poverty and strengthen Mongolia's competitiveness. A large component of the program lies within the IMF's ESAF 1999-2001 policy framework and action program to which the Government is fully committed.<sup>2</sup>

23. The Government's medium-term development strategy is aimed in the right direction and will be complemented by ADB's new COS. The key components of the growth strategy are fully reflected in ADB's new COS. In particular, the Government's continued commitment to structural reforms (including privatization, banking, and public sector reforms) and to better human development strategies will go a long way to provide strong support for ADB policies.

### **2. Public Investment Plan**

24. The current budgetary process represents a form of dual budgeting. The externally financed development budget is prepared using the PIP but with little integration with the

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<sup>2</sup> International Monetary Fund, Enhanced Structural Adjustment Facility Policy Framework Paper, May 1999.

preparation of the capital budget and projections or treasury management and monitoring. The Government has recognized the need for effective public expenditure management processes, including a focus on improving budgeting and its integration with strategic development planning. The current PIP processes are intended to be integrated into the core budgeting processes, particularly the preparation of the capital budget.

25. The PIP strategy is to allocate resources for addressing the critical state of transport, communications, energy and urban settlements infrastructure, and to upgrade and improve the capacity of these areas to underpin improved economic growth. However, one of the emerging constraints to sustaining the capital investment program including the externally financed PIP is lack of a domestic budget to provide counterpart funds to the increasing portfolio of capital works and development projects in most sectors. Despite the projections of increased PIP over the medium term, the level of counterpart funds as a percentage of total funds being allocated under the PIP is decreasing compared with that during 1995-1998.

## **C. Constraints on Growth and Development**

### **1. Economic Constraints**

26. A fragile and thin banking sector, which is unable to perform effective financial intermediation within the economy, is the biggest barrier at this point to Mongolia's private sector growth. High real interest rates of more than 30-40 percent in the last three years and limited alternative sources of domestic capital have all but eliminated long-term credit. As banks lack asset, liability, and credit structuring skills, they resort to minimizing credit risk by lending only for short periods.

27. The development of the real sector is constrained by lack of long-term investment financing, obsolete technology, weak management and financial systems, poor marketing, and lack of information about business opportunities. Facilitating greater inflows of FDI is the key to overcoming these constraints and sustaining not only a higher level of output, but more broadly based economic growth. By its nature, FDI provides long-term investment funding, modern technology, technical know-how, access to regional and global markets, information about business opportunities as well as natural expansion of the tax base. FDI contributes to domestic innovation and competitiveness through its participation in international markets. The main factors constraining the growth of FDI are (i) lack of transparency in the legal environment, and (ii) shortage of skilled labor.

28. Continuing policy inefficiencies in the public sector, which slow down privatization plans and delay measures to reduce regulations, act as barriers to private sector business development. Many, if not most, public enterprises are handicapped by lack of corporate governance and ineffective financial management skills and supporting systems. The absence of a coherent plan to focus on restructuring these entities to operate as true commercial enterprises, and of efforts to strengthen the financial and management capabilities of these enterprises and enhance full cost recovery is a barrier to private sector efforts to produce the same services more efficiently.

29. Delayed establishment of a legal infrastructure to support private sector growth is another factor that inhibits the private sector's economic activity. Access to land has emerged as a constraint to business growth for both new entrants and existing companies wanting to expand. Investors seeking urban land are constrained by the case-by-case process of securing leases on land and the need for a more efficient land lease instrument. Prolonged delays in

Parliamentary consideration of the Land Privatization Law and the Cadastral Law<sup>3</sup> have meant that land use and acquisition options for businesses and households remain uncertain. Urban land leases up to 60 years are available, but are issued subject to the uncertainties of bureaucratic discretion. In addition, the fact that land leases are not transferable impedes infrastructure development on leased land. Private ownership of cropland is prohibited, which impedes investment in agriculture and the use of land title as collateral.

30. In a similar vein, the delayed buildup of capacity for business and management skills is a constraint to economic growth. Given the lack of a strong entrepreneurial, new entrepreneurs need assistance in such basics as studying the feasibility of a potential business, developing a business plan, setting and maintaining accounts, and identifying markets and marketing products and services. Structured technical assistance that draws on and uses experts that have substantial private business experience and proven success in small business development has an important role to play in this regard.

31. The dominance of copper creates a volatile pattern of economic growth due to heavy dependence on fluctuating international copper prices. This is a source of instability to sustainable private sector growth, as in this environment it is difficult to plan for long-term investment and borrowing. The emerging growth of other minerals may contribute to the instability, for, like copper, they produce an unstable pattern of growth. They also divert investment opportunities away from more viable growth-generating investments.

## 2. Demographic and Geographic Constraints

32. Mongolia is a land of 1.6 million square kilometers, approximately half the size of India and four times that of Japan. It is landlocked with Russia to the north, and the People's Republic of China (PRC) to the east, south, and west. The trans-Siberian railway connecting Russia and the PRC passes through the capital, Ulaanbaatar, and is the principal carrier of industrial products and international trade. The country has one of the world's lowest population densities of 1.5 persons per square kilometer. Mongolia has 22 *aimags* (provinces), including the capital city Ulaanbaatar; 346 *soums* (in the case of Ulaanbaatar, city districts); and 1681 *bags* (villages) or *khoroos* (sections of city districts). About 34 percent of the population are nomadic, and some 53 percent live in urban areas. The vastness of the territory, small population, remoteness of the cities and towns, and insufficient development of infrastructure result in increased cost of social services and high costs of improving living standards.

33. One of the pressing problems that have emerged during recent years is migration from the rural to the urban areas. The consequences of this movement are alarming. On the one hand, the main impact of rural out-migration is that remote areas are becoming less populated and provision of social services deteriorating due to the high cost of providing services to a reduced number of qualified recipients. On the other hand, it increases the burden of providing infrastructure services such as supply of electricity, heating, water, housing, and transport to the urban centers. Poverty, too, is higher in urban centers (except Ulaanbaatar) than in the rural areas. Mongolia's demographic and geographic peculiarities require innovative and country-specific approaches. This applies particularly to finding new solutions for the high costs of providing public infrastructure including transport, heating, and social services. The Government is currently developing a regionalization strategy, which places more emphasis on the development of six regional centers as against the existing 24 provincial capitals.

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<sup>3</sup> The Cadastral Law was approved by Parliament in December 1999.

## D. Potential Strengths

34. A number of factors, if used efficiently, will assist Mongolia in achieving more sustainable and inclusive economic growth.

35. Mongolia's efforts to move toward an open trade regime, liberalization of prices, inflation control, and maintenance of market-determined exchange rates improve resource allocation, facilitate the development of private markets, and encourage trade and investment. Further resource allocation improvements will come from the ongoing reforms in the banking sector, which will facilitate the channeling of savings to investors. Improved public expenditure and services management with the introduction of a pilot program of governance reforms in the public sector has the potential to improve public management and resource management.<sup>4</sup>

36. A relatively healthy, young, and literate labor force that is adapted to rapid change is among Mongolia's assets. An educated and younger labor force acquires new skills faster, adjusts to new systems more quickly and adapts to new technologies and production techniques more rapidly.

37. The potentially large and accessible export markets in the PRC and the Asian region can work to Mongolia's advantage in its efforts at growth. Such markets provide good opportunities for traditional exports of copper and cashmere, revitalized exports of meat and wool products, and new exports of minerals other than copper. The demand for Mongolian products is expected to increase due to the continuing high growth of PRC's economy; however, the collapse of the Russian economy remains a major concern. The expected postcrisis improvement of Asian trade and growth provides further potential for Mongolia to increase its trade in the region.

38. Mongolia has a number of competitive assets that can form part of a development strategy to overcome the natural disadvantages of being landlocked (which raises cross border transport costs) and a small population (that results in a limited domestic market and high per capita cost of infrastructure). These include tourism, livestock-related agroindustry, light manufacturing, business services, tertiary institutes, and technology-based industries.

39. Despite its relatively short season, tourism has the potential for making a larger albeit still modest contribution to economic growth from the marketing of adventure and nature tours. However, like many other small-scale industries and services, tourism is constrained by lack of investment in products and facilities (e.g., more modern hotels), and a structure that generates relatively low amounts of trickle-down income and employment. An effective strategy needs to recognize the connections between growth in tourism and spillover effects from wider banking and financial sector reform and private sector investments in physical infrastructure. Public expenditure in the tourist industry has put in place a solid basic infrastructure (including airport, basic road structure, telecommunications and other basic facilities) that can now support a flourishing private sector tourism industry.

40. Mongolia has good potential for growth in live-stock related agroindustry and light manufacturing which, with the right supportive policies, can have a competitive advantage as well as promote and sustain a more broad-based growth.

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<sup>4</sup> The pilot reforms are supported under the ADB-financed Loan 1713-MON: *Governance Reform Program Loan*, for \$25 million, approved on 2 December 1999.

41. Mongolia's relatively low-cost, literate, and predominantly young labor force is culturally adapted to industrial production. Furthermore, the business and investment environment is politically stable. These characteristics make Mongolia attractive to light industrial investments. Therefore, with the right policies to increase the supply of skilled labor and to cut down on bureaucratic rigidities, FDI in Mongolia can expand faster.

42. Mongolia also has some capacity to provide industrial support for basic assembly-oriented light industries. This support may facilitate the diversification of light industry in the long term into more complex, higher value-added products more rapidly than in other newly industrialized countries. Such higher value-added industries will normally not develop in a newly industrializing country until there is a large concentration of light industry already in place. However, for Mongolia there is the potential to accelerate this process for two reasons. First, the workforce is already experienced in industrial work, unlike many newly industrialized countries where the workforce is almost entirely rural. The fact that the workforce is already experienced means that it is also more culturally adapted to industrial development than in the rural workforce. This cultural adaptation reduces the concerns of operational problems when new management techniques are introduced along with new production technology. Second, some of the associated industries needed by more specialized light industry already have a base in Mongolia, although they need substantial development and modernization. For example, there may be scope for textile production to be supported to some extent by domestic chemical production, which is at present limited to fertilizer output. These potentials should be explored. If viable, they may allow more horizontal and vertical integration within light industry.

43. There is scope for the development of a broader range of services supporting business, especially since Mongolia is located between the rapidly growing economy of PRC and the potentially fast growing Russian economy. A full range of financial services connected not only with regional trade and possibly future reexport activities, but also with the flow of FDI to Mongolia may be developed. These services could include expansion of the present insurance and equipment leasing businesses. New brokering and other financial intermediation services, which will follow the development of a modern banking system, have some potential over the medium term. There is also scope in the medium term for management consultancy, marketing and market information services to be provided to both domestic and foreign firms seeking to access the large new markets of Russia and the PRC.

44. Scope also exists for expanded profitable activities in a wide range of tertiary institutes and technology based industries, with the existing educational and research institutes and highly literate and mathematics-oriented human resources available in Mongolia. Some examples are computer programming and support services, interpretation of satellite images, and interpretation of a wide range of geological data. The growth of these essential services should not be restricted by unnecessary licensing or other restrictions. An additional benefit will be the reduction in claims on the budget as many, if not most of these, activities are currently dependent on budget support for their survival. Services such as banking, hotels, restaurants, secretarial and translation agencies, printing, and business equipment servicing will continue to expand in response to anticipated demand.

## **E. Foreign Resources**

45. The availability of foreign resources for Mongolia remains chronically well below the investments envisioned in the Government's medium-term plans. However, on a per capita basis, Mongolia is receiving substantially high amounts of foreign assistance compared with

other developing countries. Therefore, it would be unrealistic to expect that availability of foreign resources could be substantially enhanced in the future.

46. FDI represents a potential source of economic growth that remains largely untapped. Despite a small domestic market and limited supporting infrastructure, the country's open trade regime provides a natural incentive to attract joint ventures and other forms of direct and indirect investment partnerships with local business. However, significant barriers remain - including cumbersome regulatory and administrative requirements - which need to be dismantled to enhance foreign investment.

## F. Private Sector Participation

47. The private sector is the main producer of goods and services in the country. In 1998, the private sector accounted for more than 60 percent of GDP. While statistics may not be wholly accurate, it is estimated that private sector shares of production in individual sectors are about 85 percent in agriculture, 76 percent in construction, 70 percent in trade, and 40 percent in industry. This high private sector share in production has been achieved mainly through a successful program of privatization. However, the private sector so far has been unable to compensate for the reduced size of employment in the civil service (Table 1).

**Table 1: Structure of Employment ('000)**

Sector	1990	1992	1993	1994	1995	1996	1997	1998
Total	784	806	780	790	795	792	788	779
Private	0	350	480	570	580	600	605	612
Public	784	456	300	220	215	192	183	167

Source: National Statistical Office.

48. The major impediments to the faster expansion of private sector activity are government regulations, the paralyzed banking sector, and a deficient business environment including insufficient labor market-related training and markets. While small-scale industry promotion in agriculture and the service sector has the potential for increasing private sector involvement, this possible source of income and employment generation cannot be tapped efficiently without a reorientation of the educational activities to provide more market-related training. Other areas of reforms to support private sector development include strengthening the possibilities for better financial intermediation, encouraging foreign investment capacity enhancement, and business enterprise development.

49. The promotion of private sector-led growth would depend on the Government's perseverance in pursuing the needed economic adjustments and structural reforms. The IMF has recommended that the Government's goals for the medium term should be to:

- (i) maintain low inflation through fiscal consolidation and an appropriately tight monetary policy;
- (ii) restore international reserves to a more comfortable level;
- (iii) pursue a vigorous reform agenda to restore confidence in the banking system, which the IMF considers to be at the forefront of the structural reform agenda;

- (iv) implement a comprehensive public administration reform program;
- (v) pursue an aggressive agenda of enterprise privatization and investment policies to create a supportive environment for domestic and foreign private sector growth; and
- (vi) pursue significant fiscal consolidation intended to halt and reverse the increase in debt-to-GDP ratio and place the budget on a more sustainable footing.

### **III. DEVELOPMENT ASSISTANCE EXPERIENCE AND OUTLOOK**

50. The lessons learned from the first COS and the preceding discussion indicate that ADB's new strategy needs to pay close attention to its design, Mongolia's implementation capacity, and the monitorability of objectives.

#### **A. Design of the Strategy**

51. Many of the areas of emphasis in the first COS remain valid and relevant to ADB's new strategy and will continue to be emphasized. The objectives of continued policy reforms are to redefine the role of the Government, promote trade, support privatization, strengthen the legal system, and promote regulatory systems, to name a few. However, ADB's strategy will need to be reoriented when it comes to deciding on the appropriate mechanism to be used for generation of economic growth. Here, the design of the strategy will need to be modified from noninclusive growth (based on capital-intensive public investments in infrastructure) to focus on a more inclusive growth policy (based on employment-generating private sector engagement) aimed at poverty reduction and improved governance in the sectors. Operationalization of this design is discussed in paragraphs 136-144.

#### **B. Implementation Capacity**

52. Mongolia's implementation and absorptive capacity remain limited. Lack of counterpart funds in general has been a limiting factor in project implementation, while policy and institutional support in all sectors continues to be required. The Government's weakness in strategic planning and finance, including prioritization among and within sectors and coordination among agencies and toward foreign assistance, is also to be considered.

53. Developing the human resources skills for a market economy is a continuous task that needs to be further emphasized and remains a constraint to economic growth and development. Training for managers, accountants, and lawyers, as well as other types of vocational and business training to establish a sufficiently comprehensive basic supply of job expertise remains a crucial task. Public and private training institutions also need to be strengthened.

#### **C. Monitorability of Medium-Term Objectives**

54. The objectives of the first COS were defined in broad terms such that monitoring of progress achieved under the strategy remained in abeyance. The main objective of facilitating the transition to a market economy was unmeasurable, and the achievement could best be evaluated on a subjective basis. The kind of economic growth generated in the course of the strategy was also left undefined. For these reasons, progress made during implementation of the COS could not be monitored.

55. The Government and ADB are aware that unmonitored reforms without periodical stocktaking and appropriate strengthening of supervision may undermine the reform efforts. It is therefore essential that the new COS establish right at the start a monitoring mechanism and identify indicators that can help evaluate the progress made in achieving the objectives of the strategy as the reform efforts proceed.

56. The monitoring indicators are discussed in Appendix 4. Briefly, a success scenario for the strategy is defined as one in which poverty is reduced while the rate of economic growth does not diminish compared with that in recent years. Therefore, indicators of poverty (absolute and relative) and income growth (GDP) are used to determine the success of the strategy. It is important for ADB to maintain a continuous monitoring mechanism for the COS so as to keep abreast of developing patterns that may need more focus in ADB projects. An example of this possibility is the further deepening of poverty, while absolute poverty is declining. A further example is the deterioration of human development standards, while income-based poverty is declining. Under both scenarios, ADB could achieve success in its strategy, only to face new forms of poverty and deprivation.

57. Factors that could work to undermine achievement of the strategy's objectives are discussed in paragraphs 143-144. The most prominent among them are the role of the Parliament in reform implementation, political instability, Mongolia's continued dependence on volatile international commodity prices, and the possibility of reduced availability of ADF concessional funds to maintain an adequate ADB presence in Mongolia.

#### **D. External Assistance and Aid Coordination**

58. Given Mongolia's heavy reliance on the externally financed development budget, the efficiency and effectiveness of aid mobilization and management processes are important for best results. While Mongolia has been successful in mobilizing aid more than FDI, the institutional arrangements for planning and management of external assistance remain a constraint to effective public expenditure management.<sup>5</sup> The rapid growth in the size and composition of the aid program has increased the complexity of aid coordination and management, the efficiency of which is constrained by the unclear and fragmented responsibility of Government agencies in this area. Successive governments have not focused on external assistance management as a core budget and expenditure management issue.

59. At the Seventh Consultative Group Meeting for Mongolia in June 1999, the Government and the aid agencies agreed to form a number of subgroups to focus on individual aid subjects and, with participation from the Government, to establish mechanisms to monitor progress made under externally supported projects. This would allow an important improvement in future planning processes for aid complementarity and effectiveness.

60. ADB's new strategy has been developed with an awareness of other aid agencies' strategies so as to avoid duplications and overlap, and to ensure that basic development needs of the country are addressed. This is particularly important in the infrastructure sectors, especially transport and energy, where other aid agencies remain active (Appendix 5).

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<sup>5</sup> Foreign aid disbursements amounted to nearly \$176 million in 1997, equivalent to about 20 percent of GDP, while the inflow of foreign direct investment amounted to only \$21.7 million or the equivalent of about 2.5 percent of GDP. Aid disbursement in 1998 was 21 percent of GDP.

61. ADB is Mongolia's largest source of external assistance. By 31 December 1999, ADB had approved 21 loans amounting to \$427.5 million. All public sector loans are from the ADB's concessional facility, the Asian Development Fund (ADF). In the mid-1990s, ADB lent an average of \$60 million-\$65 million per year to Mongolia. Due to the ADF resource constraints since 1998, the annual indicative planning figures for Mongolia were reduced by about one third to \$40 million. In the medium term, however, Mongolia is expected to have the demand for and have the capacity to absorb a higher level of ADB concessional assistance.

62. Under ADB's assistance, the transportation and communications sector accounted for 29 percent of the total lending to Mongolia, followed by the finance and industry sector with 26 percent, energy with 25 percent, agriculture with 10 percent, and the social sectors with 10 percent.

63. ADB's development impact is evident in many sectors in Mongolia. In key infrastructure sectors such as energy, and transport and communications, ADB's policy dialogue assisted the Government in (i) separating the policy and regulatory functions from operations, (ii) commercializing management and operations, and (iii) improving tariff adjustments and cost recovery. In industry and agriculture, ADB's program loans assisted the Government in implementing difficult policy and reform agendas covering liberalizing prices, deregulating the trade regime, and developing a legal and regulatory framework. In the social sectors, ADB is helping the Government to rationalize structures and facilities, promote cost recovery, and privatize the provision of social services wherever possible.

64. Despite the economic uncertainty, fiscal constraints, and institutional weaknesses in all sectors, ADB's portfolio in Mongolia is, in general, performing satisfactorily and implementation is proceeding on schedule.

#### **IV. ADB's FUTURE ROLE IN MONGOLIA**

65. ADB's first COS had the main objective of facilitating Mongolia's transition to a market economy by:

- (i) creating the necessary environment through policy reforms, redefining the role of the government, liberalizing prices, promoting trade, supporting privatization, developing the financial sector, strengthening the legal system, and promoting regulatory systems;
- (ii) developing the required human resources skills; and
- (iii) developing the necessary infrastructure.

66. The new COS is built on the understanding that, of the three means to developing a market economy as described, items (i) and (ii) were substantially successful. Mongolia's transition to a market economy is, for the most part, accomplished as the private sector is now the main producer of goods and services. Item (iii), which was the means for generating economic growth under the first COS, achieved its objective, but in its path created a new problem of persistent poverty that needs to be addressed now. A fourth item needed for an efficient market economy (good governance at the economy-wide level) was not sufficiently emphasized and was often ignored.

## A. The New Country Operational Strategy

67. The main objective of the new COS is to foster economic growth and reduce poverty. The strategy aims at achieving this objective by emphasizing income and employment generation through the private sector. In this way, the new COS continues to emphasize items (i) and (ii) under the first COS as they remain valid for the new strategy. The new COS further emphasizes good governance as an overarching economy-wide objective for the strategy. Broad consensus for the new strategy has been reached among stakeholders: through a participatory workshop and a high-level forum in Mongolia involving Government, other parliamentary groups, civil society and the private sector; through detailed discussions with the Government; and in close coordination with other aid agencies. The participatory process was facilitated by translating the draft strategy into Mongolian.

68. The new operational strategy will focus on support for:

- (i) removing barriers to increased economic activity within the private sector and creating an environment conducive to private-sector-led growth. These involve, among others, (a) restructuring and reform of the financial sector to broaden and deepen financial intermediation, and (b) reorienting the public sector to support private-sector-led growth by acting more as a supervisory and regulatory entity operating within a framework of good governance, and to improve its service delivery by devolving responsibility for provision of services to lower levels of Government in a phased and organized manner.
- (ii) generating employment on a wide scale by (a) using microfinance combined with labor market-related training to generate viable self-employment in urban areas (where unemployment is high) and (b) agroprocessing industries in the rural areas to transform employment opportunities from temporary (dependent on the crop season) to year-round.
- (iii) maintaining standards of human development and improving access, where needed, by providing interventions in the social sectors. The strategy acknowledges that inaction on the part of the Government and the aid agencies to make affordable forms of social services widely accessible to the poor means that the present relatively healthy and educated poor will give way to those that may lack basic education and have lower standards of health. It also means that self-help opportunities (such as employment generation) will not as easily enable the poor to lift themselves out of poverty.
- (iv) reaching the severely poor and those unable to lift themselves out of poverty on their own efforts, by strengthening and reforming the social protection system.
- (v) improving efficiency economy-wide level mainstreaming governance reforms.

69. To maximize the effectiveness of the new COS, the ADB's operational program in Mongolia will:

- (i) select sectors and projects based on their potential for strengthening economic activity in the private sector, generating employment aimed at poverty reduction, and contributing to human development;

- (ii) select projects based on their potential for poverty reduction, and strengthen them with improved governance; and
- (iii) consider interlinkages between sectors to make the strategy more coherent by allowing sector interventions to support each other and the overall objective of the strategy.

70. In light of the complexity of poverty issues in general, the design of the strategy has been based on a study to identify the nature of poverty in Mongolia (to determine what type of poverty reduction measures are needed), identify the poor (to determine how best to reach them), and determine what has already been done to assist them (so that complementary strategies can be developed).

## **B. Nature and Extent of Poverty<sup>6</sup>**

71. Poverty in Mongolia is at present not a transitory problem resulting from the economic transition, but a structural phenomenon that defies the traditional “trickle-down” theories of growth and poverty reduction. Standards of human development have remained at high levels since the transition to a market economy began. However, the incidence of poverty in terms of the number of people below a consumption and income-based poverty line increased from 15 percent of the population in 1991 to 36 percent in 1996, and since then has remained rather stable.<sup>7</sup> At the same time, the severity of poverty has increased. That is, poor people are getting poorer, but not more people (as a percentage of population) are descending into poverty. A possible explanation is that the informal and rural sectors are functioning as an informal safety net to support the unemployed and the poor. The increasing depth of poverty indicates that the current development process does not generate sufficient opportunities for viable employment and income so that the poor become poorer by depleting their last remaining assets, and as a result of a breakdown of family and social support structures. This pattern reduces the chances for the poor to lift themselves out of poverty on their own efforts. The persistence of poverty despite continued positive economic growth is a serious cause for concern.

### **1. The Poor**

72. The Government has identified orphans, the physically handicapped, single household pensioners, female-headed households, households with more than four children, the unemployed, and small herders in remote areas to be particularly vulnerable to poverty.

73. In 1998, a higher portion of the poor lived in urban areas (57 percent in 1998, unchanged from 1995) than in rural areas (43 percent). Ulaanbaatar, with 27 percent of the country’s population, had 26 percent of the poor, and poverty incidence was slightly lower than the national average (34 percent, compared with 35 percent in 1995). Poverty was concentrated in the provincial urban areas, which account for 25 percent of the country’s total population, but 32 percent of the poor (raising the incidence of poverty to 45 percent, up from 42 percent in 1995). Rural areas together accounted for 48 percent of the population, but only 43 percent of the poor (lowering their poverty incidence to 33 percent, slightly lower than that in 1995).

<sup>6</sup> Details are provided in Appendix 1.

<sup>7</sup> These data are based on a definition of the poverty line by the Mongolian National Statistical Office, which is well below the international definition of one dollar per day. See Appendix 1, Tables A1.1 and A1.4.

74. Poverty is particularly severe among female-headed households although the situation is improving. In 1995, 63 percent of such households were poor. This ratio has decreased to 47 percent. In 1998, about 25 percent of the very poor households and 18 percent of the poor households were headed by women. Most of these households are in urban areas (44 percent of Ulaanbaatar's poor households, and 53 percent of provincial centers' poor households), rather than in rural areas (24 percent of the poor households).

75. Unemployment is strongly correlated with poverty in the urban areas, where 52 percent of the poor are unemployed (compared with 20 percent of the rural poor). The national average for the unemployed poor is 30 percent. The high correlation between unemployment and poverty in the urban areas can be explained for the most part by the breakdown of the pre-1990 economic structure in which major industries were concentrated in urban areas; their closure after the transition left most of the workers without many alternatives for employment.

76. Better general education is a strong factor in increasing employment opportunities in urban areas. About 68 percent of the urban labor force with tertiary education are employed, compared with 27 percent of those without formal schooling. However, this tool has limitations. A full one third of the educated urban labor force remains without employment. In the rural areas, 68 percent of those without formal schooling are employed, meaning that job opportunities are not influenced by education.

77. In the rural areas, some 90 percent of the poor are employed in agriculture (which does not provide year-round employment). Another 6 percent serve as health, education, and government workers. In the urban areas, the distribution of the poor is less skewed: 24 percent are in agriculture-related activities; 26 percent in health, education, and civil service; and 19 percent in hotel, restaurants, and other services. Only 9 percent of the poor are in the manufacturing industries.

78. About 61 percent of the urban poor's income is in the form of monetary receipts (salary, pension, and social benefits), with another 13 percent in the form of gifts, and 11 percent from nonfarm businesses. The rural poor receive 26 percent of their income from monetary receipts, 41 percent from consumption of own-products, 16 percent from livestock, and 15 percent from gifts. The rural poor appear to have a more evenly distributed set of sources of income, which cushions the shock of losing one.

## **2. Causes of Poverty**

79. Poverty was the result of the external shocks of 1991, including the loss of capital inflows and trading arrangements with the FSU, and the transition to a market economy (including privatization, public sector restructuring, and price liberalization); economic contraction and hyperinflation (1990-1993); and the loss of financing for social services and social safety net mechanisms.

80. In the urban areas, a real wage decline has been the main mechanism through which poverty arose. By 1996, real average wage was 40 percent lower than in 1991 and 20 percent lower than in 1994. Only agriculture showed a wage increase due to massive layoffs from the privatized farms. The most negatively affected were public servants: wages for highly specialized health workers and doctors as well as those in public administration were 10-30 percent below the average formal sector wage.

81. Transition and privatization brought with them increased—though often unregistered—unemployment, and the phenomenon of an increased number of orphans and street children. Increasing poverty is making access to health care and schooling difficult. In education, families cope by allowing girls to pursue higher education, while boys enter the labor market at a younger age. This is income-based deprivation, as opposed to lack of access.

82. Standards of health and education for the poor remain reasonably high, indicating that poverty in Mongolia is mostly a question of lack of income-generating opportunities. Since 1996, the country has made substantial progress in improving accessibility and standards of health. Modern, cost-effective health reforms and health insurance were introduced and the sector was transformed from a curative and hospital-oriented system to a system advocating preventive health and family doctors. Despite the reduced funding (from 5.8 percent of GDP in 1991 to 3.6 percent in 1998), most health indicators are improving due to the better organized and rationalized new system. From 1993 to 1997, infant mortality per thousand live births fell from 62 to 40, and the total maternal deaths fell from 124 to 72 per thousand.

83. As for education, the country had universal literacy before 1990. Although the transition to a market economy somewhat reduced access to schools, the Government intends to achieve universal literacy once more in the next few years. In Mongolia, funding for education is the joint responsibility of the central and local governments; central government transfers depend on local fiscal resources. This setup goes a long way to ensure access to education for the poor. For the five richest provinces and cities, the central Government provides no transfers to local budgets; for the poorest provinces, almost the entire education budget is provided by the central Government. Since January 1999, localities are funded based on several quantifiable variables (including the number of students) to encourage the schools to increase enrollment rates, reduce redundant workers, and increase wages to attract and retain qualified teachers.

### **3. Current Poverty Reduction Efforts**

84. To address poverty, in 1994 the Government introduced the National Poverty Alleviation Program (NPAP) with the objectives of (i) reducing poverty through employment promotion, (ii) protecting human capital through social infrastructure rehabilitation, (iii) addressing poverty among women-headed households, and (iv) strengthening the social safety net. NPAP is financed through aid agencies and a special poverty alleviation fund (PAF).

85. In addition to the NPAP, various central and local governments and line agencies have initiated other poverty reduction programs such as the unemployment reduction project (1995), the women's welfare program (1996), the children development program, a pre-school program, and poverty reduction projects at the local level. There is no clear picture of the success of these programs as implementation and flow of funds are not transparent and there are problems with accountability. Some officials see an urgent need to rationalize the poverty reduction programs in Mongolia (Appendix 1). ADB has assisted Mongolia to combat poverty through five loans in social infrastructure development areas, for a total of \$39 million. Other ADB lending to Mongolia for agriculture sector development, employment generation, energy and transport have further contributed to poverty mitigation.

## **V. INSTRUMENTS OF ADB SUPPORT AND IMPLICATIONS OF THE PROPOSED ROLE AND STRATEGY**

### **A. Poverty Reduction Strategy**

86. The preceding analysis indicates that poverty in Mongolia is an income phenomenon, and not a result of lack of access to either education or health. The strategy for Mongolia, therefore, needs to focus first on viable income generation rather than improvements in human development. This income needs to be generated in urban areas, particularly the provincial centers. As poverty incidence is stable but deepening, more attention is needed to better targeting the severely poor, even if the country may not be able to afford large-scale social assistance and transfers. To be effective and financially viable, poverty reduction through income generation will need to focus on the people close to and above the poverty line and should be approached through viable income generation and microfinance. Severe poverty will need to be dealt with by reforming the social safety net. Special social protection should aim at directly reaching the severely poor.

### **B. Private Sector Engagement**

87. A major priority for Mongolia is to foster stable growth so as to strengthen employment prospects, improve living standards, and obtain more resources for assisting those less able to take advantage of the opportunities provided by rapid change. It is equally important that the growth achieved be all-inclusive (i.e., it must benefit as many of the population as can be accommodated by careful design).

88. ADB's private sector development strategy in Mongolia could provide direct assistance to (i) financial and capital market institutions; (ii) infrastructure projects; (iii) industrial, agribusiness, and small and medium-size enterprises; and (iv) tourism. In support of these policies, ADB's public sector strategy aims at reorienting the public sector to create conditions more conducive to and supportive of private-sector-led economic growth.

89. The core focus of the new strategy for the private sector is on efforts to diversify private-sector-led activities to generate employment and viable income for the people including the poor. Diversification of activity in the private sector will have to take shape in the rural and the urban areas and will have to be supported and strengthened by the financial sector (microfinance and banking reforms), the public sector (better governance), the education sector (labor-market related education), and agriculture (agro-industry).

90. Within the urban areas, development of small and medium-size enterprises is a potentially promising source of income-generating economic activity. At present, credit, taxation and other supply-side constraints have limited the creation and expansion of small businesses; however, there is scope for lessening the bottlenecks. Support toward strengthening business advisory facilities including preparation of business plans, balance sheets and income statements will be critical in strengthening the prospects for access to credit and growth. Improvements in the incentive framework to foster greater public-private interfacing will also instill greater commercial orientation among local entrepreneurs. Growth will potentially lead to private sector involvement in infrastructure development and other sectors traditionally associated with the public sector.

91. In the rural areas scope exists for the revival of viable private sector economic activity by diverting the focus of agriculture sector interventions away from livestock improvement and toward livestock-based agro-industry. This type of activity must be supported by market research to identify the best strategy for sizes and types of agro-industries.

92. Vocational training combined with microfinance in both rural and urban areas can further strengthen the employment-generating activities of the private sector.

### **C. The Role of Good Governance**

93. Appendix 3 discusses the benefits from improved governance and the various aspects of governance reforms that will need focus in the new strategy. Significantly, the new strategy broadens the concept of governance reforms to include the whole economy, as good governance is not exclusive to the government.

94. Improving governance within sectors can reduce the transactions costs of doing business and thus facilitate the flow of investment and enhance the efficiency with which capital is used. Governance reforms also lead to better provision of infrastructure services and thus to lower production costs for firms, e.g., relatively cheaper transport costs. Such reforms can also result in better delivery of social services and in improved human capital. These issues are discussed in more detail for the case of Mongolia in Appendix 3.

95. Transparency refers to the clarity and availability of information, financial and otherwise, on the activities of government. Examples of areas in Mongolia in which there is a need for better transparency include the absence of information on rules for obtaining business licenses, inconsistencies in accounting practices across government agencies, and ambiguity in the rules governing promotion of civil servants.

96. Mongolia is in the process of strengthening its legal and regulatory framework in partnership with the aid community. An impressive legislative program has been completed in recent years. However, serious problems related to interpretation and enforcement have to be addressed: non-compliance with laws, legislative gaps, and institutional difficulties evidenced by serious capacity problems in the judiciary, government, and regulatory agencies. The result is a less than stable and predictable legal and regulatory framework for setting the rules of transactions for commercial activities, protecting individual rights and the competitive character of markets, and ensuring the efficient settlement of disputes in accordance with the law. Over the medium term the reforms will focus on improving the performance of the courts and the quality of the judiciary in dealing with an increasingly complex legal and regulatory framework. Extensive technical assistance in these areas will be provided by aid agencies.

97. Accountability refers to the extent to which public officials can be held accountable for their actions. Accountability is limited when officials do not have to report to the public (or their representatives) on the use of taxes, when there is a long lag before audit reports of government agencies are completed, or when the government can conveniently divert public finances into extrabudgetary funds. These issues to a large extent are being addressed under ADB's recently approved Governance Reform Program Loan.<sup>8</sup>

98. Predictability pertains to the clarity and uniformity in the enforcement of laws and regulations. Where the judiciary is weak, laws can be interpreted in different ways to favor

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<sup>8</sup> Loan 1713-MON: *Governance Reform Program Loan*, for \$25 million, approved on 2 December 1999.

some parties over others. In this instance, there is a high degree of unpredictability. Where the police are corruptible, enforceability of even traffic regulations is highly unpredictable.

99. Each of the above features of governance is influenced by the degree to which the stakeholders are engaged in decision-making processes. There is greater transparency, accountability, and predictability in government decision making when information on government activities can be and are systematically monitored by citizen watchdog organizations.

100. All in all, when the need for governance reforms is not addressed, economy-wide efficiency will suffer and gains from economic growth will not be utilized to their full extent.

101. A strong local capacity to manage the country's development affairs constitutes an essential part of good governance. The experience of successful developing economies, particularly, fast-growing economies of Asia, clearly demonstrates a strong correlation between competent and motivated national capacity and accelerated economic growth.

102. Since the start of the market-related reforms of the early 1990s, Mongolia benefited from the build-up of development management capacity due to the involvement of government officials and Mongolian consultants in the implementation of projects. In recent years, however, this capacity has been deteriorating dramatically because of a number of factors: (i) political instability and rapid changes in the Government; (ii) downsizing of the civil service due to economic crisis and budget deficits; and (iii) the mismatch between the inadequate skills and knowledge of officials in a civil service inherited from the centrally planned system and the new requirements of a market-based economic system. Each of these has placed a serious constraint on the effective functioning of national capacity-building efforts.

103. The chronic underfunding of the civil service and political interference in the appointment of civil servants has further undermined the effective functioning of the civil service, leading a high level of staff turnover, movement of better qualified staff to the private sector and external assisted projects as well as providing a fertile ground for corruption among government officials. This rapid breakdown of government service seriously affects the effectiveness of ADB's programs and projects in the country.

104. Elements of ADB's past efforts at local capacity building have not always produced sustainable results. For example, domestic consultants and Government officials were often trained on the job in the course of implementation of ADB projects, only to leave for better employment or training opportunities elsewhere or abroad afterwards. Often, by the time ADB began to implement a follow-up project in the same area, the process of training domestic consultants and Government officials had to start anew. This discontinuity in local capacity building has intensified in recent years, with frequent changes of the Government. Further, when the local counterparts for ADB's projects and programs are selected on an ad hoc basis as individuals, rather than as institutions, project capacities are not institutionalized for future use by the country and ADB. To ensure the increased effectiveness of ADB's operations, its future capacity-building efforts should be more systematic and be guided by a long-term perspective.

105. ADB's medium-term strategy in the area of capacity building could focus on:

- (i) establishing a medium-term capacity-building plan together with the Government, in ADB's priority sectors. Such a plan should spell out the Government's

responsibility in reducing staff turnover, eliminating the practice of political appointment, and increasing staff incentives. ADB, in turn needs to ensure that minimum requirements for institutionalized capacity building are part of the design of each project and program. Some of ADB's resources for advisory technical assistance could be used exclusively on longer term scholarships at foreign and domestic institutes so that a critical mass of competent national capacities is created.

- (ii) strengthening the policy and program units of the Government agencies in the areas of policy analysis, program and project appraisal, supervision and evaluation.
- (iii) supporting the establishment of consultancy companies as business wings of universities and research institutes in the areas of project preparation and implementation.
- (iv) promoting the involvement of NGOs and private institutions in areas of project preparation and implementation.

#### **D. Sector Strategies**

106. With limited resources that ADB can allocate to Mongolia, the objectives of growth and poverty reduction can best be achieved by focusing the future program on a few, selected core sectors. The sectors should have the best potential for expanding employment-generating opportunities in the private sector so as to maintain and improve human development standards, thus preventing the development of poverty based on social service deprivation, while the ADB is combating income-based poverty.

107. On this basis, five core sectors have been selected: finance (for its potential to remove the single most important barrier to private sector investment and savings, which is the fragile and thin banking system, and to develop microfinance schemes); agriculture (for its potential to generate viable small-industry employment and income); the public sector (for its potential to reorient the machinery of the Government to become more conducive to and supportive of private-sector-led growth); the social sector (education, health, and social protection for the potential to empower the labor force with market-related human capital investment, maintain standards of health and raise the general public's health awareness, and improve the accessibility of health care); and urban development (for its potential to support health improvement and enhance living conditions).

##### **1. Finance**

108. ADB's strategy in the financial sector will aim at removing barriers to private sector growth and generating employment by improving the efficiency of financial intermediation and facilitating the development of alternative sources of financing. Special emphasis will be on governance reforms within the sector to introduce greater transparency and accountability at all levels of financial institutions and operations, and to build up the needed human skills in the banking industry to ensure its proper functioning in the future. This will imply, among others, improving checks and balances to effectively disallow abuses from shareholders and directors and strengthening stakeholder (market) discipline in all aspects of banking in particular and in the financial sector in general. Although improved governance represents a critical component in support of bank privatization, it will also be emphasized in areas such as the independence of

the central bank and financial reporting requirements in the context of prudential regulations and loan recovery and enforcement of overdue claims. Strengthening the financial safety net operations including the lender of last resort function and deposit insurance schemes may also be supported by an improved realignment of incentives and fostering greater transparency.

109. The financial sector strategy will support poverty reduction both directly and indirectly. Direct support will be primarily through the development of microfinance services. This will build on existing assistance and should be consistent with principles of subsidiarity, recognizing that any microfinance assistance needs to mobilize those institutions and agents that can best deliver microfinance credit. Indirect support will primarily involve promoting private-sector-led economic growth. This builds on financial sector reforms that increase resource mobilization to support increased and sustainable GDP growth targets above those achieved to date. Higher economic growth will directly support employment-generation activities and an increase in the taxable revenue base to permit greater expenditures in the social sectors. Financial sector reforms are also expected to reduce the budgetary support provided to date in the form of bank restructuring bonds and liquidity support for the banks. The freeing up of these scarce funds may also increase the expenditures in direct support of poverty reduction.

110. Accordingly, financial sector reforms will involve strengthening financial sector intermediation through a combination of activities in support of bank restructuring, bank privatization, and improved regulatory oversight; and will introduce corporate governance and improved market discipline and further consolidation of the banking system. ADB's strategy in the sector is to develop a competitive, viable, and stable financial system emphasizing support for (i) deepening the financial reforms based on improved asset quality in the banking system and a more efficient banking intermediation process, and (ii) in the outer years of the strategy (2003-2005), gradually broadening the financial sector by establishing the supporting financial infrastructure needed to develop the debt and equity markets and voluntary contractual savings institutions. Parallel with these activities, the strategy will put in place mechanisms for building human skills in the industry to ensure that lack of human capacity does not undermine the proper functioning of the banking system.

111. In addition, and to follow up on implementation of policy reforms (i.e., the setting up of a supporting, functional legal and regulatory environment), ADB will target the extension of credit through on-lending operations (i) to small and medium-size enterprises, (ii) to rural enterprises and households, (iii) for microfinance activities, and (iv) for housing purposes. These activities are expected to contribute directly toward economic growth (i.e., microfinance) and indirectly support poverty reduction.

112. ADB's strategy for the financial sector recognizes that to be successful microfinance support needs to be directed toward recipients with the capacity to build viable income-generating economic activities. The new strategy will therefore attempt to combine possibilities for microfinance with labor-market-related vocational training envisaged as part of the reforms in the education sector.

## **2. Public Sector**

113. ADB's strategy will emphasize public sector reform activities at three interrelated levels: (i) central Government, (ii) local government, and (iii) enterprise or unit. In parallel with the administrative reforms, output-oriented budgetary reforms will be introduced at both the central and local government levels. An outcomes-based public expenditure management system will be established within the Ministry of Finance and, through the administrative reforms, agency or

local government budgeting will be linked systematically with this system. In addition to the strong efficiency improvement impact, the governance reforms will also be substantially in line with the Government's strengthened anti-corruption agenda.

114. The strategy implies, among others: (i) strengthening the fiscal discipline and strategic budgetary planning by putting in place a combined system of top-down budgeting process and a micro-based budgeting framework in which budgetary provisions also take performance-based budgeting into account, (ii) performance-based management at the central and local levels, (iii) transparent and efficient fiscal and administrative relations between local and central governments as formulated in the implementation strategy developed during the first phase, and (iv) continued corporatization or privatization of state-owned enterprises. However, interlinkages could also be considered between public sector governance reforms and projects in which basic elements of good governance (e.g., strengthened accountability mechanisms, improved transparency and availability of information, and improved predictability of policy and actions) could be incorporated, as needed in ADB's interventions in the sector.

### **3. Agriculture**

115. The agriculture and livestock sector is the main provider of employment in Mongolia. ADB's new strategy will build on this source of strength by emphasizing measures aimed at generating viable employment and income through (i) supporting private-sector-led expansion of economic activity, particularly in the livestock-based agroprocessing industry; (ii) strengthening the enabling legal and regulatory environment to stimulate private sector activity; (iii) improving support services to overcome constraints to agricultural development, (iv) promoting the improved provision of financial services in rural areas; and (v) supporting improvements in land tenure.

116. The development of small-scale agroprocessing industries would require background support particularly from new rural credit facilities, the development of new export markets for meat products (including markets outside the two immediate neighboring economies of Mongolia), improvement in quality and appearance, diversification of product variety, and building up canning and plastic package industries. This will be helped by the fact that privatization of the sector has proceeded very well and a competitive environment where numerous small enterprises are active has already developed. Also of assistance is the rapid increase in recent years in the number and concentration of livestock. ADB support will address extensively the agroprocessing industry's main problems including lack of working capital and insufficient market study.

117. The strategy will make substantive efforts to create scope for new ways of public private partnerships, particularly in the fields of agroprocessing and corporate lending (such as credit unions). It will emphasize supporting alternative forms of businesses as a way of creating a competitive environment rather than following on existing institutional reforms so far that have emphasized the privatization of former state enterprises, thereby leaving the monopoly structures in place.

118. In summary, the bulk of ADB support in agriculture will be devoted to livestock-based agroprocessing as a priority area for the following reasons:

- (i) There is a reliable raw material basis for a livestock-based agroprocessing industry (livestock number has reached a record of 33 million).

- (ii) Agroprocessing will diversify the export sources of the country. Right now Mongolia is overly dependent on only two export commodities (copper and cashmere) which makes the country overly susceptible to fluctuations of world market price.
- (iii) Rural-based agroprocessing has large employment generation and have poverty reduction effects. A major portion of the country's poor and unemployed people are in rural town centers and semi-urban areas, where a value-added industry can be promoted.
- (iv) Effective agroprocessing will take away the current pasture pressures. A recent ADB study identified deteriorating pastures as a serious issue caused, to a major extent, by marketing and processing bottlenecks.
- (v) With ADB's assistance, significant investment has already been made in road infrastructure connecting Mongolia to Russia and the PRC, which is conducive to development of an agro-based export industry.

119. In agriculture, perhaps more than in any other sector in which ADB will be involved, the strategy will remain focused on a few areas with the highest potential to contribute to poverty reduction. Therefore, for ADB to be able to devote more resources to its efforts to generate employment and income through the expansion of agro-industry, it will need to reduce its engagement in other agriculture areas.

#### **4. Social Sector**

##### **a. Education**

120. ADB's poverty reduction strategy requires that assistance to the education sector focuses on two main areas: (i) developing an education system that can successfully meet the needs of the population in a new labor market (to fight the existing unemployment-poverty problem), and (ii) addressing the issues relating to equity of access to education (to prevent the development of new forms of poverty based on social service deprivation). Attention will be devoted to the development of market-related training (including vocational training) and skills development programs to address the need for a more skilled labor force; to nonformal education in rural areas to address the problem of school dropouts; and to distance learning programs, to bring education within the reach of more people. Policy reforms will continue, with emphasis on rationalization and productivity improvement measures, diversification of service delivery, and decentralization. Increased private sector involvement in the education sector will be emphasized, but stress continued access for all.

121. In 1998 the Government prepared and adopted a comprehensive policy framework and a medium-term action plan for technical education and vocational training (TEVT). That work, supported by ADB technical assistance,<sup>9</sup> was required under the policy covenants of the Education Sector Development Program.<sup>10</sup> The framework aims at establishing a private-sector-led, market-driven TEVT system where the Government's role will be limited to setting quality standards, certification and maintaining an enabling policy regime. ADB's strategy will address the vocational and skills development needs of the country and will aim at creating a system in

<sup>9</sup> TA 2719-MON: *Institutional Strengthening in the Education Sector*, for \$950,000, approved on 19 December 1996.

<sup>10</sup> Loan 1507-MON: *Education Sector Development Program*, for \$6.5 million, approved on 19 December 1996.

which individuals will obtain job training so as to receive start-up capital from microfinance projects to create new employment opportunities rather than relying exclusively on a demand-driven mechanism (in which existing private sector employers seek trained labor). The Government's involvement in vocational training will eventually be replaced with private sector involvement, leaving the public sector with the task of performing oversight functions only.

122. Vocational training facilities will be established with the aim of engaging the private sector in their operation and takeover as early as possible. The strategy will also seek to move the government toward an effective role in the skills development sector, i.e., accreditation, setting of skills standards, policy formulation and monitoring, and skills testing.

123. The education sector is also responsible for providing the basic human capital investment for future generations. An education sector that cannot provide access to education for the poor, or segments of the population in remote areas, will contribute to the creation of new forms of poverty in the future. Therefore, ADB's strategy will encourage access by developing decentralized and remote education, as well as other forms of non-formal training. Additional contribution from the education sector in the area of building better human capital will come from the inclusion of basic health education within the education sector.

124. In the new strategy, the education sector will therefore be charged with providing back-up support to intended reforms in other sectors within a coherent and overarching plan. For example, it will combine forces with the financial sector reforms by providing labor market-related vocational training for the intended recipients of microfinance to improve the chances for a successful microfinance scheme that creates viable employment opportunities. This will allow the development of viable small businesses and promotes employment. The education sector will also complement the health sector by including relevant health-care education in the general curriculum.

#### **b. Health and Social Protection**

125. In the health sector, ADB's advantage compared with other sources is mostly in the areas of management reforms, decentralization, and training. The new strategy will focus on ADB's involvement in these areas, as opposed to investments in health infrastructure and heavy equipment.

126. The strategy will focus on (i) general health education, (ii) training of health-care staff in primary health, (iii) vocational training related to the health-care industry, (iv) capacity building, and (v) health finance management on a wide basis. Additionally, the experience from pilot projects in the health sector in the past (such as emphasizing family doctors) will be consolidated and used to expand the successful aspects of past efforts.

127. In the new strategy, some aspects of reforms in the health sector, such as general public's education on preventive health care and vocational training, will be combined with envisaged reforms in the education sector. Health finance management will be addressed in accord with the public sector governance reforms.

128. In 1995, the Government introduced a system of social insurance for health, old age, and unemployment. Although coverage is high (but limited to the formal sector), the services are of poor quality. Due to the low enterprise contributions since 1997, the pension fund is largely cross-financed through the budget. However, pension arrears are seldom and short-lived. A system of social assistance for poor families and disadvantaged groups (such as female-

headed households, large families, or the handicapped) was set up in 1996. Since then, social assistance expenditures have been increasing due to deepening poverty trends.

129. Of particular concern to the Government is the increasing number of street children, and the poor coordination of the various social assistance programs. In 1996 the Government introduced the NPAP, cofinanced by the World Bank, United Nations Development Programme, and some bilateral sources. The program with its three major components (microfinance, public employment programs for rehabilitation of rural infrastructure, and capacity building) is currently being evaluated and proposals have been made to extend it. It was found, among others, that public works programs are helpful in rehabilitating rural basic infrastructure (bridges, school buildings), but are not sustainable reducing poverty as they provide only short-term (2-3 months) employment.

130. Apart from the immediately needed investments in the context of the ADB's proposed Social Safety Net Project (2000), the new strategy does not envisage substantial involvement for social protection, given the sector's restraints and the fact that other aid sources are already covering the field. However, ADB will strengthen its investments in income-generation programs, particularly through a range of microfinance and other banking activities linked to its involvement in restructuring the financial sector. In addition, on a limited scale and on a targeted approach, ADB may consider support for reforming social protection for the very poor under its governance program (possibly on the lines of the community-based targeting mechanisms of the Mahalla system in Uzbekistan).

131. Particularly in rural areas, poverty is a major cause of children's absence and dropping out from school. More emphasis will therefore be given in ADB's educational assistance to maintaining boarding schools and restructuring the heating system in schools.

## **5. Urban Development**

132. ADB's strategy in urban development will include (i) access to basic social services to improve the health and quality of life for urban settlers; (ii) improving the quality and supply of housing, particularly in the poor *ger* (traditional dwelling) areas; and (iii) strengthening institutional, financial, and management capacities in public utilities and housing, together with improving related policies, regulatory activities, and operations.

133. The strategy acknowledges the ongoing trend toward regionalization in Mongolia, which aims at creating six main regional centers with more concentrated population, in place of the existing 24 provincial centers. Therefore, the main focus of ADB's assistance will be to provide support for these emerging urban centers after a careful municipal study of these needs.

134. The strategy will also be designed to accommodate specific conditions in Mongolian urban centers. A flexible urban infrastructure will be considered to respond appropriately to a state of housing development that is still in flux.

135. ADB's assistance for urban development will be coordinated with interventions in other sectors so as to maximize effectiveness in each area. Municipal services will be combined with and provide backup support to the energy sector's efforts at providing decentralized and affordable sources of household energy. Support from the roads sector will come in the form of urban transport access roads. Urban development, in turn, can provide support for strengthening the health sector efforts at preventive and primary health care by providing healthy living conditions, reliable water supply and sanitation services.

## **E. Operationalizing the New Strategy**

136. ADB interventions in all sectors will be required to contribute to the achievement of the overarching objective of economic growth with poverty reduction. In light of the importance of improved governance in utilizing the gains from economic growth, strong elements of governance reforms will be incorporated in all interventions as well.

137. To achieve this objective, it will be necessary to obtain sufficient information about the design of projects—including the goal, objectives, rationale and scope—and the measures intended to be taken under each project at the early stage of inclusion in the pipeline of ADB assistance. At this stage, the mechanisms used to achieve poverty reduction and governance reforms will include:

- (i) First, projects that do not offer a strong potential for poverty reduction will be either rejected altogether or required to undergo modification to improve their poverty reduction potential.
- (ii) After a project has been accepted for inclusion in the pipeline, it will be required to include in its design strong elements of governance reforms needed in its sector.

### **1. Reform Interlinkages Among Sectors**

138. Special emphasis will be placed in the new strategy toward integrating interventions in related sectors and to overcoming sector boundaries through better cooperation and joint project design. Although interlinking reforms among sectors may somewhat complicate implementation, it offers a better chance of achieving the needed results as reforms in one sector are supported and strengthened by measures undertaken in other, related sectors. These interlinkages are discussed in Appendix 6.

139. ADB's internal procedures, although open to such possibilities, make it difficult in practice to design, process, and monitor the implementation of such interlinked reforms. For project processing, this is mainly the result of internal organization being divided along sector lines. This difficulty notwithstanding, it is essential that a strategic view of poverty reduction and governance reforms in Mongolia be taken over and above sector lines, to achieve better results under individual projects.

### **2. Monitoring Indicators**

140. Effective medium-term development planning by ADB requires utilizing experience and lessons learned from past efforts. For this purpose, indicators of performance monitoring will need to be defined and risks in implementing the strategy identified. The new strategy for Mongolia has the overarching objective of fostering economic growth and combating poverty. Therefore, its success can be defined and measured by the degree of poverty reduction achieved, along with economic growth. The exact definition of poverty reduction will be essential, as it is possible to observe one form of poverty to be declining, while other forms of poverty are developing. (See Appendix 4.)

141. Mongolia's income-based poverty may be more amenable to measurement than other forms of poverty. The strategy calls for poverty reduction by employment generation (as opposed to, for example, increased production efficiency leading to higher wages) through the

private sector (as opposed to the public sector). Therefore, variables under the following four categories can be used as monitoring indicators: (i) poverty, (ii) human development, (iii) economic conditions, and (iv) sector contributions. (See Appendix 4 for details.)

### 3. Main Targets

142. The main goal of the strategy is to assist Mongolia to achieve and surpass international targets for poverty reduction and human development as established by “Strategy 21”.<sup>11</sup> On this basis, the targets are to:

- (i) reduce by at least 25 percent the proportion of people in extreme poverty by 2005, and by half by 2015;
- (ii) reduce by at least half the proportion of people below the Government’s officially defined poverty line by 2005, and by a further 25 percent by 2015;
- (iii) achieve universal primary education by 2005;
- (iv) reduce by half the mortality rates for infants and children under 5 years of age, and by two-thirds the mortality rates for mothers by 2005; and
- (v) increase access, with the objective of eventually providing universal access, to reproductive health services for all females of the appropriate age by 2015.

### 4. Risk Factors

143. Exogenous factors that can prevent the achievement of successful results for ADB’s strategy should be identified. However, in the case of failure to achieve the desired results for the strategy, simple identification of the impact of exogenous factors will not absolve ADB and the strategy. Having identified these exogenous factors in advance, ADB must be ready to fine-tune or adjust its implementation efforts to minimize their impact.

144. For Mongolia, realistic examples of exogenous risk factors include the role of the Parliament, the possibility of a resurgence of political instability, the possibility of reduced availability of concessional ADF resources in general and for Mongolia in particular, and the country’s dependence on international market prices for primary commodities and its nondiversified industrial base. (See Appendix 4.)

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<sup>11</sup> International targets for poverty reduction and human development were established by the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD) in 1996 and are known as “Strategy 21”. See ADB’s policy paper, R179-99: *Fighting Poverty in Asia and the Pacific: the Poverty Reduction Strategy of the Asian Development Bank*, 19 October.

**APPENDIXES**

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## Poverty in Mongolia<sup>1</sup>

### A. Introduction

1. The population of Mongolia by end-1998 was estimated at 2.4 million, with an annual growth rate of 1.4 percent. The population is predominantly young, with the majority at the beginning of the working age. At end-1998, about 38 percent were below 16 years; 55 percent were within the working age range, and 7 percent were the elderly. The cohorts born during 1960-1980 when the country's population increased dramatically due to high fertility rates give the labor force a favorable demographic composition, in which they will be participating up to the year 2020. This means an increased need for education, vocational training, and employment generation, as well as for investing in child development (including health concerns) to sustain the future development of Mongolia.

2. The population density is 1.5 persons per square kilometer. The vastness of the territory, small population, remoteness of the cities and towns, and insufficient development of infrastructure result in high costs of social services and for improving living standards. One pressing problem that has emerged during recent years is the migration from rural to urban areas. The consequences of this movement are alarming. On the one hand, the main impact is that remote areas are becoming less populated and provision of social services is deteriorating due to the reduced number of qualified recipients. On the other hand, rural out-migration affects the ecology of urban centers and increases the burden of providing infrastructure services such as supply of electricity, heating, water, housing, and transport. Mongolia's demographic and geographic peculiarities require innovative and country-specific approaches. This applies particularly to finding new solutions for the high costs of providing public infrastructure including transport, heating, and social services. The Government is currently developing a regionalization strategy, which places more emphasis on the development of 6 regional centers as against the existing 24 provincial capitals.

3. As in many other countries of the former Soviet Union, the legacy of social development was impressive. Before independence, health, education, and social protection were universal and of high quality. In addition, state enterprises financed various social schemes. As a result, poverty was low and social living standards and human development high, reaching levels comparable with those of countries of the Organization for Economic Cooperation and Development (OECD).

4. With the transition to a market economy, Mongolia experienced a substantial fall in concessional aid, deterioration in financial conditions of State-owned enterprises; a chronic energy crisis (as substantial imports of energy supply on concessional terms from Russia stopped, domestic energy prices rose sharply, and local production declined), rising unemployment (due to labor retrenchment, bankruptcies, and privatization); substantial decline in real wages and consumers' purchasing power (as prices rose to international levels due to a policy of free trade and exchange rate), fiscal and financial sector crises; and a faltering social safety net. In this environment, social expenditures decreased and living standards deteriorated.

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<sup>1</sup> This Appendix draws on information and reports provided by the Mongolian National Statistical Office, the National Poverty Alleviation Program, the United Nations Development Programme (UNDP), and the World Bank.

5. A summary snapshot of changes in social living standards and poverty in Mongolia is presented in Table A1.1. Although the changes did not result in a substantial deterioration of human capital standards in Mongolia, they brought with them a sharp increase in poverty.

**TABLE A1.1: A Snapshot of Poverty in Mongolia**

	1991 (or before)	Recent Years	1998
<b>1. Population</b>			
Growth rate (%)	1.77	1.63 (1995)	1.4
<b>2. Income Measures</b>			
GDP per capita (current prices, in \$)	333.7	328.9 (1995)	452.0
Real GDP growth rate (%)	-9.2	4.0 (1997)	3.5
<b>3. Poverty</b>			
Population below the poverty line (%)			
Defined by the Government (income)	15	26 (1994)	28.9
World Bank (living standards)	15	36 (1995)	36
National Statistical Office (living standard)		36.3 (1995)	35.6
<b>4. Profile of the Poor</b>			
Population that are poor (%)			
Urban		38.5 (1995)	39.4
Provincial Centers		41.9 (1995)	45.1
Rural		33.1 (1995)	32.6
Households headed by women			
As % of very poor			24.6
As % of poor			18.3
<b>Impact of Education</b>			
Share of households with educated (tertiary level or vocational) head (%)			
Very poor households			
Urban			31
Rural			21
Poor households			
Urban			47.3
Rural			18.8
<b>5. Employment</b>			
Registered unemployed (no.)	54,000 (1992)	63,700 (1997)	49,837
as percent of registered workforce	6.3	7.5	6.5
% of unemployed with low or no education			42
% of women in total unemployed		51 (1997)	53
Unemployed as % of the very poor			
Urban			38.8
Rural			26.5

DPT = diphtheria, pertusis, tetanus; GDP = gross domestic product

Source: National Statistical Office and various ministries.

.../continued

TABLE A1.1: A Snapshot of Poverty in Mongolia (cont'd.)

	1991 (or before)	Recent years	1998
Unemployed as % of the poor			
Urban			27.3
Rural			11.9
<b>Impact of Education</b>			
% of the uneducated that are unemployed			
Urban			23.3
Rural			4.9
% of the educated (tertiary level) unemployed			
Urban			11.3
Rural			9.6
Criteria and Information	1991 (or before)	Recent years	1998
	1991 (or before)	Recent years	1998
<b>6. Health Standards</b>			
Infant mortality (per thousand live births)	62.6 (1991)	39.6 (1997)	35.4
For children under 5	93.2 (1991)	55.6 (1997)	47.8
Average life expectancy (years)	45 (1960)		64
Maternal death (per thousand)	93 (1991)	116 (1994)	80
Population per physician	336 (1990)	399 (1997)	411
Population per hospital bed	79 (1990)	128 (1997)	133
Immunization (% of age group)			
Measles	83.8 (1993)	90.4 (1997)	
DPT3	79.5 (1993)	92.0 (1997)	
Fertility rate (births per woman)	5.5 (1985)	2.4 (1997)	
<b>7. Education Standards</b>			
% of population 15 years and older			
With no education	9.4 (1989)		4.2
With primary education	20.5 (1989)		15.3
With secondary education	18.1 (1989)		24.5
With tertiary education	8.5 (1989)		11.5
School enrolment (total)	94.9 (1989)		77.1
Female	91.1 (1989)		80.9
Male	99 (1989)		73.4
<b>8. Government Efforts</b>			
Expenditure in % of GDP			
Education	10.8	5.5 (1995)	5.5
Health	5.9	3.7 (1995)	3.3
Social security and welfare	5.6	5.4 (1995)	6.1
Expenditure as % of total public expenditure			
Education	22.9	15.8 (1995)	14.7
Health	12.4	10.7 (1995)	8.9
Social security and welfare	11.8	15.7 (1995)	16.5

## B. Economic Development

### 1. Income and Growth

6. The start of the transition to a market economy for Mongolia brought with it a collapse of economic activity and growth. The first three years of the transition (1991-1993) was marked by actual declines in gross domestic product (GDP). However, Mongolia has experienced unstable but positive real GDP growth rates for five consecutive years since 1994 as a result of which income per capita increased from \$334 in 1994, to \$452 in 1998. Despite the negative impact of exogenous factors, including two main economic (Asian and Russian) crises, the domestic economy continued to grow in 1998, when real GDP growth reached 3.5 percent (down from 4 percent in 1997).

7. A most impressive achievement in Mongolia's macroeconomic stabilization is the continuous and drastic decline in the inflation rate. During 1991-1996, while price inflation remained at very high levels, wage increases in the private sector and for Government employees lagged substantially behind, leading to sharp declines in real wages. In recent years, however, inflation dropped from 53 percent in 1995 to 6 percent in 1998, thereby reducing the speed of the fall in real wages and purchasing power of the consumers.

### 2. Employment

8. Due to its young population structure, Mongolia has a relatively small labor force (Table A1.2). Only an estimated 859,300 workers were registered at end-1998. This was approximately 68 percent of the population of working age, and 35 percent of the total population. Every year the country needs to absorb 25,000 new entrants to the labor market. However, labor opportunities in the formal market seem to be restricted. Privatization in agriculture and the production decline in industry have decreased formal employment since 1997.

9. The number of registered unemployed workers decreased from 64,600 at the end of 1997 to 49,800 at the end of 1998. Official unemployment seems to have stabilized at about 6.5 percent<sup>2</sup>, as many retrenched workers find new jobs in the nonagricultural informal sectors, such as bazaar trade and restaurants, although many of these prove non-viable. Young women increasingly choose to go to the university or enter the household economy. With a very young population structure and continued labor retrenchments, new job creation is one of the biggest current challenges for Mongolia.

**Table A1.2: Employment ('000)**

Item	1992	1995	1996	1997	1998
Population	2,215.0	2,317.5	2,353.3	2,387.0	2,420.5
Population of working age	1,124.6	1,186.7	1,212.8	1,229.6	1,256.8
Labor force	860	839.8	847.2	852.9	859.3
Employed labor	806	794.7	791.8	788.3	809.5
Unemployment rate (%)	6.3	5.4	6.5	7.5	5.8
Male	6.4	5.0	6.3	7.8	6.4
Female	6.1	6.1	7.2	7.3	5.2

Source: Government of Mongolia

<sup>2</sup> Hidden unemployment is estimated at 12 percent.

10. Outside agriculture and the informal sector, most employees are in State-owned enterprises (SOEs) and in the government service. By the end of 1998, there were 108,845 civil servants in the Government.<sup>3</sup> The SOEs had 57,706 employees. Together, the civil servants accounted for 20.5 percent of total employment, compared with 17.7 percent in private firms and 53.5 percent in agriculture and self employment.

11. Public administration reforms in the central ministries in 1996 reduced the number of civil servants. The number of ministries at that time was reduced from 16 to 9 and the total number of employees in central administration was cut by 40 percent. However, the majority of public servants remained in the social sectors and under the local governments. Health and education reforms have so far not resulted in a major reduction of the labor force.

12. In public administration, the monthly salary is less than \$50, slightly below the average national wage. At the same time, work pressure is increasing as the functions of the ministries were broadened as a result of the restructuring of the ministries in 1996. As a result, many highly skilled staff and managers are leaving civil service to find employment in the private sector. It is expected that the governance reforms will increase the wages of public servants while further reducing their numbers.

### 3. The Informal Sector<sup>4</sup>

13. The informal sector in Mongolia consists of small-scale, mostly family-based economic activities unrecorded in official statistics, and usually not subject to the same set of regulations and taxation as the formal sector. Examples include taxicab drivers, newspaper vendors, small kiosk operators, individuals selling used tools, and boot repairmen. The Mongolian Parliament in 1993 approved a law that would impose a flat monthly tax on these enterprises.<sup>5</sup>

14. In 1997 it was estimated that the percentage of able-bodied people in Ulaanbaatar who are not formally employed and do not provide a reason for not being employed had doubled between 1991 to 1996. In the same period, the percentage of able-bodied persons that were not employed, but did not register in the labor exchange office dropped from 42 to 13 percent. This had allowed the official unemployment figures to remain relatively low and stable. It was further estimated that some 34-42 percent of the able-bodied population of working age in Ulaanbaatar were engaged in the informal sector (including part-timers, moonlighters, and working pensioners). A mirror image of this picture is the share of income other than wages and salaries in the statistics on household income (see paragraph 37).

15. The main reasons for the expansion of the informal sector in Mongolia can be summarized as follow:

- (i) Crisis response. It is possible that with the start of the transition process and contraction of the formal economy, an abundant supply of labor was released from the formal sector and was attracted to the informal activities. One set of estimates indicated that between 1990 and 1995, the average privatized

<sup>3</sup> Mainly in health and social protection (26,217), and in education (38,804).

<sup>4</sup> This section draws on a study by James H. Anderson's Reaction to Crisis, Response to Policy: An Analysis of the Size, Origins, and Character of Mongolia's Informal Sector, July 1997. The study was financed by the World Bank.

<sup>5</sup> "Income Tax Law of the Citizens who Individually Engage in Business Activities and Services Whose Income Cannot be Determined Every Time."

enterprise reduced employment by 35 percent. At the same time, sharp declines in real wages forced employees of the formal sector to supplement their incomes by engaging in activities in the informal sector.

- (ii) Migration. Rural to urban migration has helped to increase the available supply of labor for informal activities. It is difficult to obtain a true picture of the contribution of this factor to the expansion of the informal sector because the majority of the immigrants are unregistered and, as such, cannot be employed in the formal sector; they bypass all official statistics.
- (iii) Demand for goods and services that is inadequately met by the formal sector. Ease of entry and operation makes the informal sector attractive to people with little or no job skills. The lack of official regulations and barriers also encourages employment in this sector. Also, the work rules and hours are determined individually and as convenient.
- (iv) Impact of the banking crisis on the attractiveness of small-scale enterprises. These economic activity units have remained more or less independent of the banking crisis (operating on a cash basis), while many formal businesses have been affected by unavailability or delayed availability of their deposits at the banks. Furthermore, business relations between operators in the informal sector are more personal, and start-up capital can often be obtained more easily.

16. The informal sector has had a strong poverty-reducing impact within the urban areas. It is estimated that without the informal sector's income, 53 percent of Ulaanbaatar's households would fall below the poverty line.

### **C. Human Development**

17. By standards of human development (basic education, health care, nutrition, sanitation and water), poverty and inequality in access to social have remained rather low in the period since the transition to a market economy began.

18. Before 1990, health, education, and social protection were universal and of high quality. About 40 percent of government expenditures were devoted to social development. In addition, state enterprises financed various social schemes. As a result, poverty was low, and social living standards and human development high. In the initial years of the transition, with a high inflow of development aid replacing the former subsidies from Moscow and high export earnings, the Government could continue to maintain a relatively high involvement in providing social services, housing, and heating.

19. Public expenditures on health and education still remain high. The largest share of the budget is devoted to education (15 percent in 1998), social security (15 percent) and health (6 percent). These shares are high by international standards (Table A1.3).

**Table A1.3: Social Public Expenditures**

Item	1989	1991	1992	1993	1994	1995	1996	1997	1998
GDP (Tug million )	10,730					429,207	586,528	758,926	875,859
Current price (per capita, Tug)	53.1	50.4				187,108	251,740	321,130	365,505
Per capita in constant 1993 prices, Tug '000	106.0	88.9	78.7	74.8	75.3	78.8	79.6		
Public expenditures (million Tug)					101,326	149,439	211,264	287,648	324,791
Education									
Percent of GDP (current)		10.8	6.9	5.8	5.8	5.5	5.3	5.6	5.5
Percent of total public expenditures (current)		22.9	26.5	15.6	16.2	15.8	17.2	14.7	14.7
Per capita (1993 Tug)		9,380	5,354	4,265	4,328	4,275	4,426		
Health									
Percent of GDP (current)		5.9	4.4	3.8	4.1	3.7	3.6	3.5	3.3
Percent of total public expenditures (current)		12.4	15.7	10.3	11.5	10.7	11.5	9.1	8.9
Per capita (1993 Tug)		5,080	3,180	2,813	3,057	2,900	2,954		
Social security and welfare									
Percent of GDP		5.6	3.3	3.4	4.8	5.4	4.9	5.6	6.1
Percent of total public expenditures (current)		11.8	12.8	9.3	13.3	15.7	17.5	14.9	16.5
Per capita (1993 Tug)		4,808	2,580	2,541	3,544	4,249	4,521		

Source: National Statistical Office.

## 1. Education

20. Funding for education is the joint responsibility of the central and local governments; central government transfers depend on local fiscal resources. For the five richest provinces/cities, the central Government provides no transfers to local budgets. For the poorest provinces, almost the entire education budget is provided by the central Government. Since January 1999, localities have been funded based on several quantifiable variables (including the number of students) to encourage schools to increase enrollment rates, reduce redundant workers, and increase wages to attract and retain qualified teachers.

21. In 1989, the literacy rate for the population 15 years of age and older was 96.5 percent. In 1998, this ratio stood at 95.8 percent, as the Government continued the policy of providing free primary and secondary education. Although tertiary and vocational training are no longer free, the percentage of the population attending these higher levels has increased from 8.5 (tertiary) and 9.6 (vocational) percent in 1989 to 11.5 and 12.3 percent, respectively, in 1998. This is possibly a recognition of the importance of higher and specialized education for a labor suited to a market economy.

22. School enrollment has dropped from 95 percent in 1989 to 77 percent in 1998. For children aged 8-15, this ratio is now at 87.3 percent (compared with 98 percent in the initial stages of the transition). This indicates that the issue of attending school is more than simply the Government providing free schooling services. Household living standards, cost of school supplies, availability and operation of schools, and the need for family labor (mainly child labor) at a time when the size of privatized livestock is increasing can all contribute to a drop in school enrollment. This is a point of concern, as it indicates that poverty reduction strategies may face the difficult task of reaching a more illiterate generation of the poor.

23. A reversal of school attendance patterns between male and female students also reflects the economic conditions. In 1989, 99 percent of the male and 91 percent of the female of schooling age attended school. In 1998, these ratios had changed to 73.4 percent for the male and 81 percent for the female. This could be explained by the fact that when child labor is needed in the family (mostly for tending the livestock), boys are considered a more natural candidate.

## **2. Health**

24. Health standards in Mongolia stand at very good levels. Infant mortality dropped from 110 per thousand live births in 1960 to 35 in 1998 and average life expectancy increased from 45 to 64 years. In this period, fertility rates declined continuously and for all income groups. All income groups are covered by universal and free vaccination services provided by the Government. The average number of births per mother and average weights of infants at birth remain similar between mothers of the poor and nonpoor income groups. Reforms in the health sector have shifted the emphasis from self-referrals by patients to specialists and hospitals, to family doctor systems, thereby reducing wastage, and making hospital beds more accessible to the poor in times of real need.

## **3. Housing**

25. Housing standards are also rather similar among various income groups. Nationwide, 80 percent of the poor and 83 percent of the population above the poverty line live in gers (although these are gers of different sizes). The proportion of the poor living in apartments and houses are 17 and 15 percent, respectively. In urban areas, 20 percent of both groups own their dwellings; therefore, there is little disparity in this area. However, general conditions for housing remain poor and in need of substantial improvement for all groups.

## **D. Poverty**

26. The following study of poverty in Mongolia is based on a country-specific income distribution leading to the definition of a country-specific poverty line. It does not define the poor according to the international definition of a poverty line—i.e., \$1 per day per person.

### **1. Background**

27. Poverty increased from 15 percent of the population in 1991 to 36 percent in 1996. Since then, it has remained at that high level, whereas the depth of poverty has continued to increase. This means that poor people are getting poorer, but not more people (as a percentage of population) are descending into poverty. A possible explanation is that the informal and rural sectors are functioning as an informal safety net in which short-term informal employment, extended family and tribal support systems, and bazaar-type trade provide for a means of survival for the unemployed and the poor.

28. In 1991 the Government of Mongolia established a poverty line based on a per capita income equivalent to meet a calorie norm of 1,872 kilocalories (Kcal) per person per day in rural areas and 1,992 Kcal in urban areas. People with income 40 percent below this minimum living level were classified as ultrapoor. The poverty line was at various times amended downwards. In early 1997, the National Statistical Office (NSO) proposed a poverty line of Tug 14,000 per month, but the Cabinet reduced it to Tug 10,400. By this definition, poverty increased from 15 percent in 1991 to 28.9 percent at the end of 1998.

29. In mid-1995, the World Bank undertook a Living Standard Measurement Survey (LSMS) and introduced an expenditure-based poverty line for an intake of 2,100 Kcal, which is comparable with the norm in other developing countries. On this basis, the World Bank estimated that more than 800,000 people (36.3 percent of the population) in Mongolia were poor. This compares with 547,000 people (23.3 percent of the population in mid-1996) as estimated by the NSO, and 406,000 (19.7 percent in mid-1997) as estimated by the Ministry of Health, Labor, and Social Welfare.

30. The NSO replicated the LSMS in 1998, based on a consumption food basket that was substantially similar to the one used in 1995 by the World Bank, to obtain the calorie intake of 2100. The very poor were defined as those consuming up to 75 percent of this poverty line. On this basis, the NSO found that the incidence of poverty remained stable at 36.3 percent of the households in 1995 and 35.6 percent in 1998. The reduction in the incidence of poverty was due mainly to a faster rate of national population growth compared with the increase in the poor population. Table A1.4 below shows the per capita equivalents for these levels of consumption in Tugrik.

**Table A1.4: Tugrik Equivalents of Consumption of the Poor (1998)**

	Consumption per Capita (Tug) <sup>a</sup>	Population (%)	Households (%)
Very poor	-- - 11,005	19.7	16.2
Poor	11,005 - 14,674	15.9	13.7
Nonpoor (low income)	14,674 - 22,012	27.0	25.9
Nonpoor (middle income)	22,012 - 33,018	21.9	23.7
Nonpoor (high income)	33,018 - --	15.5	20.6

<sup>a</sup> Using an exchange rate of Tug1,030 per \$, the poverty line is set at about \$0.47 cents per day per person; the international definition of the poverty line is \$1 per day per person. The highest category of Tug33,018 translates into a consumption of \$32 per month.

Source: National Statistical Office.

## 2. Profile of the Poor

31. The government has identified the orphans, the physically handicapped, single household pensioners, female-headed households, households with more than four children, the unemployed, and small herders in remote areas to be particularly vulnerable to poverty. While poverty remains a multidimensional and complex issue, this study and the strategy developed on the basis of the study remain focused on the type of poverty that is due mostly to lack of viable employment and income opportunities. The poor under this category are predominantly economically mobile, literate, and basically healthy. However, they are gradually falling deeper into poverty and are raising a future generation of the poor who may be deprived of the basic health and education opportunities that the present generation of the poor had access to.

32. In 1998, a higher portion of the poor lived in urban areas (57.2 percent of the poor in 1998; unchanged from 1995) than in rural areas (42.8 percent). Ulaanbaatar, with 27 percent of the country's population, had 26 percent of the poor, and the incidence of poverty was slightly lower than the national average (34 percent, compared with 35 percent in 1995). Poverty was more concentrated in the provincial urban areas, which accounted for 25 percent of the country's total population, but 31.5 percent of the poor (raising the incidence of poverty to 45 percent, up from 42 percent in 1995). Rural areas together accounted for 47.5

percent of the population, but only 43 percent of the poor (lowering their poverty incidence to 32.6 percent, slightly lower than that of 1995).

33. Poverty is particularly severe among female-headed households but the situation is improving. In 1995, 63 percent of households headed by women were poor. This ratio has decreased to 47 percent. In 1998, some 24.6 percent of the very poor, and 18.3 percent of the poor households were headed by women. These households are mostly in urban areas (44 percent of Ulaanbaatar's poor households, and 53 percent of the provincial centers' poor households), rather than in the rural areas (24 percent of the poor households).

34. Unemployment is strongly correlated with poverty in the urban areas, where 52 percent of the poor are unemployed (compared with 20 percent of the rural poor). The national average for the unemployed poor is 30 percent. This high correlation of unemployment and poverty in the urban areas can be explained for the most part, by the breakdown of the pre-1990 economic structure in which major industries were concentrated in the urban areas; their closure after the transition left most of the workers without many alternatives for employment.

35. A better general education is a strong factor in increasing employment opportunities in urban areas. About 67.5 percent of the urban labor force with tertiary education are employed, compared with 26.7 percent of those without formal education. However, education as a tool for increased employment opportunities has its limitations. A full one third of the educated urban labor force remain without employment. In the rural areas, 68.3 percent of those without education are employed, meaning that job opportunities there do not correspond with education.

36. In the rural areas, some 90 percent of the poor are employed in agriculture activities, which, however, does not provide year-round employment. Another 6 percent are health, education, and government workers. In the urban areas, the distribution of the poor is less skewed. Some 24 percent are in agriculture-related activities; 26 percent in health, education, and the civil service; and 19 percent in hotel, restaurants, and other services. Only 9 percent of the poor are in manufacturing industries.

37. Some 61 percent of the urban poor's income is in the form of monetary receipts (salary, pension, and social benefits), with another 13 percent in the form of gifts, and 11 percent from nonfarm businesses. The rural poor receive 26 percent of their income from monetary receipts, 41 percent from own-products consumption, 16 percent from livestock, and 15 percent from gifts. Therefore, the rural poor have more evenly distributed sources of income, which can cushion the shock of losing one.

### **3. Depth of Poverty**

38. In 1998, 35.6 percent of the population were below the poverty line compared with 36.3 percent in 1995. However, the average consumption of the poor in 1998 went down by 11.7 percent below the poverty line, compared with 10.9 percent in 1995, indicating that the poor were poorer in 1998 than in 1995. In 1998, 5.6 percent of the poor were consuming less than 75 percent of the 2,100 Kcal marking the poverty line (definition of the very poor), compared with 4.8 percent in 1995.

39. The phenomenon of increasing depth of poverty is the result of a complex interaction between social and economic issues. People in most income categories in Mongolia,

including the poor, have family-owned small herds to supplement their daily food consumption. With poverty, however, the poor may resort to depleting their stock, thereby depriving themselves of future supplementary food. With poverty, changes also occur in the social structure of the poor families, which push them deeper into poverty. While some of the changes (e.g., increased breakup of marriages) are captured by average statistics, others (e.g., increasingly unhealthy lifestyles) are not.

#### **4. Identified Causes of Poverty**

40. In the urban areas, a real wage decline and loss of employment were the main reasons for persistent poverty. By 1996, real average wage was 40 percent lower than in 1991 and 20 percent lower than in 1994. Only agriculture showed a wage increase due to massive lay-offs from the privatized farms. Most negatively affected were the public servants, with wages for highly specialized health workers and doctors as well as those in public administration being 10-30 percent below the average formal sector wage.<sup>6</sup>

41. In education and health, transition and privatization brought other forms of poverty, as access to services became more difficult for those who could not pay for them. The number of street children increased. Families coped by allowing girls to pursue higher education, while boys increasingly entered the labor market at a younger age.<sup>7</sup>

42. Poverty is found mainly in small towns, where SOEs lay off workers and public servants are sliding into poverty because no social expenditure funds are released. In rural areas, the main cause of poverty is the temporariness of employment. In the absence of agroprocessing industries, agricultural employment remains confined to the crop season.

#### **5. Poverty-Reduction Efforts**

##### **a. National Poverty Alleviation Program**

43. To address poverty, in 1994, the Government introduced a comprehensive, six-year multisectoral National Poverty Alleviation Program (NPAP). The main goal of the NPAP is to reverse the trends of increasing human deprivation and human capital erosion on a sustainable basis and to substantially reduce poverty level from 26 percent in 1994 to 10 percent by the year 2000. The program has six components: (i) reducing poverty through economic growth and employment promotion; (ii) protecting human capital through improved delivery of education, health services; (iii) addressing poverty among women; (iv) strengthening the social safety net through targeted assistance for the poor who cannot benefit from new employment opportunities in the short term; (v) reducing rural poverty, especially among the herders; and (vi) developing and strengthening suitable institutional structures required to organize, implement, and manage the program activities. The NPAP is financed through external sources and a special poverty alleviation fund (PAF).

44. Overall responsibility for the program lies with the National Poverty Alleviation Committee, comprising the state secretariats of relevant line and oversight ministries and chaired by the Cabinet Secretariat. The Poverty Alleviation Program Office (PAPO) is responsible for the overall management of the program. PAPO is a small and very efficient

<sup>6</sup> Due to well-placed political pressures, teachers could maintain their real income.

<sup>7</sup> Male labor force participation of 10 to 14 year-olds has more than doubled from 0.25 percent in 1989 to 0.56 percent in 1994. These figures do not yet reflect increasing child labor as a result of privatization and concentration of livestock.

organization with 18 staff at headquarters and 62 staff assigned to province and district levels. At the local level, Poverty Alleviation Councils comprising local governments and nongovernment organizations (NGOs) assist the NPAP.

45. The NPAP has four major program components: (i) income generation and microfinance, (ii) public works, (iii) targeted assistance, and (iv) capacity and institution building (Table A1.5). For 1994-2000, the PAF allocated \$15.3 million for the implementation of the NPAP. Most of the money came from the World Bank, Swedish International Development Cooperation Agency (SIDA), United Nations Development Programme (UNDP), United Kingdom, and New Zealand. The World Bank allocated \$10 million mainly for labor intensive rehabilitation of social infrastructure at the local level, whereas UNDP supports mainly capacity- and institution-building activities.<sup>8</sup>

**Table A1.5: The National Poverty Alleviation Program, 1994-2000**

<b>Program Component</b>	<b>Committed Funds (\$ million)</b>	<b>Disbursed as of 31/12/98 (\$ million)</b>	<b>Major Source</b>
Employment Promotion Fund (income generation for vulnerable groups)	4.4	1.2	UK, SIDA
Women's Development Fund (income generation activities and microfinance for women)	1.4	0.6	UNDP, New Zealand
Local Development Fund (community-based public work schemes for social infrastructure and environment protection)	9.1	3.8	World Bank, Dutch Government, Aus-AID
Social Assistance Fund (targeted assistance for very poor households)	0.4	0.4	UNDP, New Zealand
Capacity- and Institution-Building			UNDP, ADB

Source: Poverty Alleviation Program Office (PAPO).

46. The basic purpose of the PAF is to allow aid agencies to channel their contributions toward specific poverty reducing activities. The PAF has four component funds: (i) Local Development Fund (LDF), designed to implement the human capital protection component and, to a small degree, the economic growth and employment components of the NPAP, it provides grants to finance locally identified projects in public works, basic education, preschool, rural health, and support for the disabled; (ii) Women's Development Fund (WDF), designed to address the women's poverty reduction component of the NPAP by providing loans and grants for employment generation for women, rehabilitation of maternity and child care centers, food assistance to households headed by women, and NGOs active in employment generation for women; (iii) Income Generation Fund (IGF), designed to provide loans to vulnerable groups for income- and employment-generating small-scale enterprises and for livestock restocking; and (iv) Targeted Assistance Fund (TAF), designed to supplement the Government-run Social Assistance Fund (SAF) by giving in-kind assistance to families in the form of fuel, basic food, and clothes and school materials for children from single-parent families.

47. Income-generating activities mostly use microfinance schemes averaging \$320 per activity. However, disbursements have been slow in the initial phase due to the absence of support structure at the local level, and the nonavailability of cash in the rural areas because

<sup>8</sup> ADB plans to support the PAF through its Social Protection Project, proposed for 2000.

of the insolvent commercial banks (Agricultural Bank of Mongolia) at the province and district levels. However, implementation has improved substantially since early 1998, as local institutions, community activists, and NGOs have been successfully trained, and the program (since early 1999) is using the post office for distributing the money.<sup>9</sup>

48. In addition to the NPAP, various governments at the central and local levels and line agencies have initiated other poverty reduction programs such as the unemployment reduction project (1995), the women's welfare program (1996), the children's development program, a pre-school program, and poverty alleviation projects at the local level. There is no clear picture of the success of these programs, as implementation and flow of funds are not transparent and there are problems with accountability.

49. An evaluation of NPAP performance shows that this mechanism has made some measurable difference in arresting the increasing trend of poverty in Mongolia. Some new 42,000 jobs were created, of which about 22,000 were permanent. Of the permanent jobs, more than 63 percent were allotted to women. The total number of beneficiaries of income-generating projects is estimated at 99,000. In addition, 308 basic education projects were implemented to renovate schools and install low-cost heating systems; 18 training projects for preschool teachers and 331 kindergarten projects were also undertaken. It is estimated that some 870,000 people in rural areas benefit directly or indirectly from the 441 rural health projects implemented under LDF and WDF.

50. Substantial capacity building and participatory process development have been achieved through the NPAP. Sixty-four NGOs were involved in the implementation of 454 PAF projects, of which, 374 were NGO-facilitated income-generating projects and 80 were NGO-implemented training projects. The overall institutional framework for project implementation was substantially strengthened. The number of projects implemented and managed rose from 599 in 1996 to 6,415 by mid-1999. The amount disbursed increased from \$0.6 million to \$8 million.

51. Poverty reduction programs within the NPAP have suffered mainly from lack of coordination and policy guidance. Various components are implemented by a variety of Government departments, international agencies, and NGOs with no apparent central coordination and guidance. The NPAP will need to be maintained and improved in terms of efficiency of service delivery and targeting. A broadening of the scope of poverty reduction programs will be a priority, with closer linkages between microenterprise development, rural works programs, gender-based programs, and vocational training as elements of the poverty reduction strategy. Phase II of the NPAP will be launched in 2000.

#### **b. Social Insurance**

52. Mongolia's social insurance system consists of the Pension Insurance Fund, Benefits Insurance Fund, Work Injury Fund, Unemployment Insurance Fund, and Health Insurance Fund. Under the 1995 Social Insurance Law, employers and employees under formal labor contracts are required to contribute to these funds, with a total contribution rate of 29-31 percent of employee wages. The Pension Fund, the largest component of the social insurance system, is of the pay-as-you-go type, with contribution rates of 13.5 percent for

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<sup>9</sup> An evaluation of the NPAP is envisaged for autumn 1999. ADB has been asked to participate in this joint government-aid agency evaluation.

employers and 5.5 percent for employees in the private sector.<sup>10</sup> Participation in the pension system for the self-employed is voluntary, and the contribution rate is 9.5 percent. Currently, the minimum pension is Tug12,000 per month (equivalent to the minimum wage).<sup>11</sup> After the 1995 pension reform, the average replacement rate increased from 20 percent in 1994 to about 39 percent in 1997; but it is still significantly lower than the 1991 level (nearly 50 percent). The high and erratic inflation rates plus the absence of automatic adjustments of pension benefits for changes in prices or average wage rates make the link between contributions and benefits tenuous, and limit the incentive to contribute.

53. There are several problems with the pension system. First, it is not self-financing. In 1997, the Pension Fund ran a deficit of 0.75 percent of GDP and transfers from the budget were necessary to cover the deficit. Without reform, this system is likely to be unsustainable unless inflation is allowed to erode benefits. Second, contribution arrears to the Pension Fund remain large, reaching Tug55 billion in September 1998. Third, the base for pension contributions is narrow relative to the coverage of pension recipients. This is a legacy of the former system, which provided universal coverage, resulting in a relatively high number of beneficiaries.

54. To reform the current pension system, the government plans to introduce nationally defined individual accounts in the near future. This plan is in the draft Law on Individual Pension Accounts, currently being reviewed by Parliament. The reform's main objectives are to (i) establish a closer link between paid contributions and benefit accruals so as to improve the incentives for compliance by existing contributors and increase the voluntary participation of the self-employed, (ii) improve the benefit structure for controlling future pension costs, and (iii) create a basis for the transition to a partially funded system.<sup>12</sup>

55. The formal social safety net includes targeted consumer subsidies particularly for shelter and heating, targeted allowances (unemployment and child allowances), and social insurance (pensions). In addition, public works programs, emergency assistance, retraining of the unemployed, and enterprise promotion (including microfinance schemes) have been introduced through the NPAP and other projects.

56. Social assistance comprises allowances for vulnerable people as identified by the Government, as well as assistance to the disabled, single parents of large families, the very poor (defined as receiving less than 40 percent of the statutory minimum income), and for maternity and funeral benefits. Faltering social assistance spending, neglected reform needs in the sector, and lack of government commitment to address social development made social assistance inadequate to address the pressing needs of the poor. For example, in June 1995 the poorest households received Tug11,000 per annum in total of social transfers compared with a minimum required income of Tug50,000-80,000 per capita per month. Poverty remained stable; for example, family allowance in 1994 was given to only 180,000 persons, compared with 700,000 in 1992. Similarly social assistance payments for clothes, subsidized milk for children, and fuel and housing for the elderly were reduced during the same period from Tug550 million to Tug254 million. The World Bank reported that in 1995

<sup>10</sup> Government employees' contributions to the Pension Fund are 1.1 percent of wages and the government contributes 17.9 percent on their behalf.

<sup>11</sup> Nonparticipants in the pension system who live under minimum living standards fall under the Social Assistance Law, and receive 50 percent of the minimum living standard as social pension. Minimum living standards differ among provinces. At end-September, the minimum living standard in Ulaanbaatar was Tug10,400 per month.

<sup>12</sup> The government recognizes that a transition to a fully funded system is not feasible in the short run, given the inability of the budget to finance the large transition costs and the underdevelopment of the financial market.

only 16.4 percent of the very poor received any form of assistance, and only 10 percent of the official poor received any kind of social assistance. Most of the social assistance payments were concentrated in Ulaanbaatar. In 1995, the country's capital received 31 percent of the total social assistance spending, but had only 14 percent of the ultrapoor.

57. The most important safety net is the informal family support, which is very strong particularly in rural areas. Household statistics derived in 1997 show that only 42 percent of the monetary household income was through wages, 8 percent through pensions, 21 percent through other income (informal sector), and 29 percent through informal transfers. Private transfers supported 19 percent of the poor's expenditures and was an important source for financing schooling, durable consumer expenditures, start-up loans for businesses, and health and emergency care. Without private transfers, poverty incidence would be 46 percent.

## 6. Necessary Components of Comprehensive Poverty Reduction Strategy

58. A survey of literature conducted by J.W. Mellor<sup>13</sup> on the empirical relation between the structure of growth and poverty shows that statistically

- ?? manufacturing growth has little or no effect in reducing poverty;
- ?? urban growth has a modest effect on urban poverty, but no effect on rural poverty;
- ?? agricultural growth has an immense effect on poverty;
- ?? rural growth sharply reduces rural poverty, and reduces urban poverty more than urban growth does;
- ?? there is a 2-3 year lag between agricultural growth and its poverty reduction impact, showing that the effect is indirect (the impact comes mostly in the form of employment generation); and
- ?? although agricultural growth benefits substantially from free trade, it is more inward-looking than export-led growth, thus remaining more stable through large changes in international demand and prices.

59. The poverty reduction strategy for Mongolia will focus mainly on the reduction of income (employment) poverty through employment-generating interventions in the urban and rural areas. Its generation of propoor (labor-intensive) growth is designed through means that facilitate income and employment generation for the population in general, and the poor in particular. The strategy will further use governance as a means toward poverty reduction.

60. The various groups of the poor in the different income groups (urban and rural) will require different strategies to lift themselves up from poverty: (i) for people above the poverty line but likely to become poor, it is advisable to concentrate on development of small enterprises, microfinance, skills development/labor advisory programs, livestock and agriculture activities; (ii) the poor (below but close to the poverty line) can benefit from microfinance, skills development/labor advisory programs, sustainable access to social services, livestock and agriculture, development of social infrastructure; (iii) the very poor, on the other hand, will need income-generation activities, training/labor advisory programs, sustainable access to social services, and development of social infrastructure. Of the last group, those with ability to work can benefit from public works, while the disabled, aged,

<sup>13</sup> Mellor, John W. 1999. The Structure of Growth and Poverty Reduction. In Poverty Reduction – Sequences and Priorities, presented at the World Bank's Stiglitz Summer Research Workshop on Poverty, Washington, D.C., 6-8 July 1999. The study was financed by the United States Agency for International Development (USAID).

orphans, multichildren households, etc., will need targeted social assistance on an expanded basis.

61. The strategy will therefore address the following issues:

- (i) Employment and income generation.
  - (a) The need to remove barriers to increased economic activity within the private sector and to create an environment conducive to private-sector-led growth. These include, among others, restructuring and reform of the financial sector to broaden and deepen financial intermediation and reorienting the public sector to support private sector growth by acting more as a supervisory and regulatory entity operating within a framework of good governance, and improving its service delivery by devolving responsibility for provision of these services to lower levels of Government in a phased and organized manner.
  - (b) The need to generate employment on a wide scale by using microfinance combined with labor market-related training to generate viable self-employment in urban areas (where the unemployment is high); and agroprocessing industries in the rural areas to transform the nature of employment opportunities from temporary (dependent on the crop season) to year-round.
- (ii) Social and human living standards. There is need to maintain standards of human development and improve access, where needed, by providing interventions in the social sectors. The strategy acknowledges that inaction on the part of the Government and the aid agencies to make affordable forms of social services widely accessible to the poor means that the present, relatively healthy and educated poor will give way to those that may lack basic education, have lower standards of health, or may not as easily benefit from self-help opportunities (such as employment generation) that will enable them to get out of poverty on their own efforts.
- (iii) Social protection. The need to reach the severely poor and those unable to get out of poverty on their own efforts, by strengthening and reforming the social protection system.
- (iv) Improved governance. The need to improve service delivery by improving transparency and efficiency in resource allocation to social public expenditure, increasing wages and income of civil servants, and enhancing participation in decision making on local and social affairs.
  - (a) The need to improve efficiency in the private sector through actions to reduce and eliminate wastage of resources. Resources could include financial, as well as human, environmental, or other categories, including the concept of time.
  - (b) The need to improve transparency in both public and private sector decision making by taking action to enhance the clarity and availability

of information, financial and otherwise, on the issues that can affect actions taken by stakeholders. This would lead to reduced wastage of resources.

- (c) The need to improve predictability (rule and stability of the law), which can lead to better economic planning and investment decision making in the private sector.

## **7. Perseverance in Reforms**

62. For a successful poverty reduction strategy, reforms must be implemented as planned. Of the reforms planned under the new strategy, those for public sector governance may have short-term negative social impact, while their full positive impact on delivery of social services and poverty reduction will follow after a period of unrelenting implementation. These are explained below.

63. Public sector reforms will contribute to improvements in the labor market, services delivery, social public expenditure allocations, and participation dimensions. This will improve human development, and create a better environment for increased growth perspectives, leading to growing income and reduced poverty in the long run. The governance reforms, meant to make the public decision-making process more transparent and participatory, will provide major democratization gains for every individual in Mongolian society. In the medium term, the main impact of governance reforms will be in making the public sector more focused on core activities, efficient, and receptive to the development of private sector activities.

64. In more specific ways, the public sector reforms are expected to impact poverty through the following measures: (i) by emphasizing the need for reducing the budget deficit, the program will help reduce the frequency of wage arrears occurring in the public sector and will free resources for better allocation to areas in the social sectors; (ii) by improving and strengthening public expenditure management, the program will ensure that misallocation of resources (which now occurs for various reasons, including political) does not continue at the expense of the poor provinces and other disadvantaged recipients; and (iii) emphasizing medium-term strategic budgetary planning will allow better master plans to be designed for medium-term development of the social sectors. However, public sector reforms also mean a reduction in the size of a large bureaucracy, and could result in job losses, particularly for the civil servants in the overstuffed social sectors. Recognizing this impact, the new strategy has designed the implementation of the public sector reforms in stages so that the job losses will not come about until the later years of the strategy (2004-2005). It is expected that, by that time, the capacity of the private sector to absorb these civil servants will be sufficiently enhanced.

## GENDER STRATEGY

### A. Key Issues and Constraints

1. Mongolia has a history of substantial gender equality due to the nomadic lifestyle and its former socialist tradition. Life expectancy at birth for both males and females is 64 year. Generally, health indicators for both male and female population have been reasonable. However, with the transition to market economy, the maternal mortality ratio radically rose from 130 per 100,000 live births in 1991 to 240 in 1994 with particular adverse impacts on the population in rural and other less developed areas. There is no indication that this trend has improved during the last five years.

2. Literacy is at about 98% for both male and female population (expressed in percentages of school age population). While the percentage of population attending school decreases for both genders by the time they reach secondary school, the ratio of female to male increases substantially, with 65 percent of females and 48 percent of males attending school. In higher education, 70-80 percent of the students is females. The privatization of livestock during the transition period has contributed to an increasing demand for male child labor, and consequently, more boys are dropping out of school.

3. In Mongolia female-headed households comprise nearly one fifth of all households, and 18.4 percent of all poor households are headed by women. The potential for increased risk of poverty among female-headed household include: lower educational attainments of female heads compared to male heads which contribute to lower earning capacity, ownership of few herding animals per capita, making them dependent on limited social assistance and private transfers. This indicates that social factors are at work which are leading to gender inequality (limited job opportunities compared to men, and limited social support system to enable working women to seek better employment opportunities).

4. Since changes in the restructuring of the economy during the transition period, unemployment among both men and women has increased significantly. At the national level, the rate of unemployment appears to be the same between the two genders, although slightly increasing for females. The share of women in the registered unemployment was 53 percent in 1998. Even though national statistics indicate that the rate of registered unemployment appears to be the same between the two genders, the figures do not include unregistered unemployment. This is of particular importance for measuring the unemployment rate of women, because many women are employed in the informal sector.

5. Deteriorating social services have a negative impact on women particularly in terms of increased workload within the household. Rationalization of the health system has meant that elderly parents and grandparents, even when they are not living with their children, increasingly become the responsibility of younger female members of the family, placing further pressures on women. And due to high treatment cost there is a trend towards increasing maternal mortality rate. Lack of adequate childcare facilities also increase women's workload significantly, which will have an impact on women's employment opportunities.

6. A further trend that could worsen gender equality against women, is the expected labor impact of sector governance reforms. The majority of personnel (close to 80 percent) in health and education sectors are females. These are the two most overstaffed sections of the public sector, and they are expected to undergo labor retrenchments. Although it is

anticipated that most of the retrenched labor will find new jobs in the private or NGO sectors, these jobs may not be as secure, in terms of such things as social benefits and labor contracts. Many women react to the shortage of jobs by entering the household economy and the informal sector.

7. Women's representation in all levels of decision-making is very low, which can be seen by the present gender structure in the highest ranks of the government's legislative and executive bodies. At the middle level of decision-making women are represented in few numbers as well: there are only 9 female governors out of 373 provinces, city, soum, district governors. The trend towards disempowerment of women is very damaging with respect to ensuring women's long-term interests. In addition, lack of women's presentation at all levels of decision-making may undermine promotion of good governance in Mongolia.

## **B. ADB's Gender Strategy and Operations in Mongolia**

8. In line with the thrust of ADB's gender and development policy, the gender strategy for Mongolia will encompass the following elements: (i) focus on women's and children's health, in urban development projects; (ii) strengthening the social protection system; and (iii) ensure that education is not gender biased, and direct education of women towards the labor market, e.g., by providing vocational training.

9. To minimize the social costs of privatization, ADB will, on a limited scale and as a targeted approach, consider social assistance for the very poor, including female-headed households. In addition, ADB will focus on improving women's and children's health. The goal will be to reduce by half the mortality rates for infants and children less than 5 years of age, and by two-thirds the maternal mortality rates by 2005. In addition, the strategy aims to increase access with the objective of providing universal access to reproductive health services for all females of appropriate age by 2015.

10. Good governance reforms included in the COS will create positive opportunities for women within government structures and for the institutionalization of gender issues. To support this, the strategy will support clear and transparent promotion policies, and will encourage resources to be directed to departments which prioritize gender issues. Strengthening organizational procedures represents an opportunity to firmly establish procedures which take gender issues into account at all levels in the public sector. Also, ADB will cooperate with women's NGOs to promote and facilitate increased participation of women in local (aimag, soum) decision-making levels.

11. A special study of gender and development has been initiated as part of the new strategy, the results of which will be published in due course.

## GOVERNANCE

1. In addition to policies that aim at increased employment generation in the private sector to reduce poverty, the new Asian Development Bank (ADB) strategy can also benefit from policies that focus on reduction of poverty through improved design of interventions. The existing problems of lack of access and/or poor delivery of social services for some segments of society, and ineffective interventions for those with the potential to move out of poverty through self-help are basically problems of bad governance within sectors.

2. Governance in the public sector is defined as the “manner in which power is exercised in the management of a country’s economic and social resources.”<sup>1</sup> Good governance thus implies good government: the government allocates and uses resources to promote the general welfare of society. However, good governance is not limited to the public sector. Four features define the quality of governance in any sector: efficiency, transparency, accountability, and predictability.<sup>2</sup>

3. Efficiency refers to actions to reduce and eliminate wastage of resources defined in a broad sense. Resources could include financial, as well as human, environmental, or other categories, including the concept of time. In the case of Mongolia, a clear example of the need for improved governance through improved efficiency is in the case of the public sector’s way of allocating public expenditure resources. Other examples are the education system’s way of spending the time and efforts of the country’s labor force (existing and potential) on nonmarket-related education, and operation of financially hard-pressed overstuffed hospitals. In the latter two examples, poor governance leads to poor social service delivery.

4. Transparency refers to the clarity and availability of information, financial and otherwise, on the issues that can affect the actions taken by the stakeholders. In the case of Mongolia, the absence of information on rules for obtaining business licenses, inconsistencies in accounting practices across government agencies, ambiguity in the rules governing promotion of civil servants, absence or limited coverage of publications accessible to the public on financial transactions of a business unit, all reflect lack of transparency. Lack of transparency can lead to wastage of resources, the most common example being corruption. It can also lead to substantial economic problems affecting the country’s growth and development, as did the nontransparent ways of commercial banks during 1996-1997, when they hid their bad loans by recapitalizing the unpaid interest and rolling over the unpaid principals.

5. Accountability refers to the extent to which decision makers are held responsible for their actions. For example, there is less accountability when officials do not have to report to the public (or their representatives) on the use of taxes paid by the public. In Mongolia, the existence of long lags before audit reports of government agencies were completed, and the ability of the Government to conveniently divert public finances into extrabudgetary funds are examples of lack of accountability in the past.

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<sup>1</sup> ADB Annual Report. 1998. Note that corporate governance refers to the implicit checks and balances within a business enterprise. Public sector governance refers to checks and balances in the exercise of political power. The distinction is unambiguous, so one should not imply the other.

<sup>2</sup> Note that this definition is different from the four pillars of good governance in the public sector, namely: participatory, transparency, accountability, and predictability.

6. Predictability pertains to clarity and uniformity in the enforcement of laws, as well as policies and regulations. Where the judiciary is weak, laws can be interpreted in different ways to favor some parties over others. In this instance, there is a high degree of unpredictability. Where the police is corruptible, enforceability of even traffic regulations is highly unpredictable. Predictability can lead to better economic planning in the private sector. A positive example of such action is when the Bank of Mongolia adopted, under guidance from Parliament, a predictable exchange rate policy during 1997-1998, which led to the substantial stability of the tugrik. A negative example of lack of predictability is the way the central Government has been allocating tax revenues among the provinces mainly on an ad hoc basis.

7. Each of the above features is influenced by the degree to which participation is allowed in the decision-making processes. There is greater transparency, accountability, and predictability in the government's decision-making process when information on the government's activities can and are systematically monitored by citizen watchdog organizations. The same is true about the activities of private sector units.

8. The degree and nature of corruption are the flip side of governance. Corruption is a manifestation of and results from bad governance. Where there is lack of transparency, accountability, and predictability in government decision making, corruption in the public sector will thrive naturally. Hence, combating corruption effectively requires promoting better governance. Better governance stems from institutional reforms that promote greater transparency, accountability, and predictability.

#### **A. Governance Dimensions of ADB Operations**

9. ADB has played an active part in improving governance through policy reforms and capacity building in several key sectors such as banking, agriculture, telecommunications, civil aviation, transport, power, housing, education, and health. It has provided substantial technical assistance to develop accounting and financial management systems in key infrastructure sectors and to improve the legal and regulatory frameworks. Among the laws that were drafted with ADB assistance are the Telecommunications Law, Energy Law, Education Law, Environment Law and Regulations, Housing Policy Law, Housing Privatization Law, Condominium Law, Audit Law, Civil Aviation Regulations, Law on Private Land Ownership, Land Settlement Act, Land Registration Act, and Cadastral Survey Regulations. Technical assistance has also been provided to strengthen taxation, improve accounting and audit systems, develop local procurement capacities, strengthen local governments and support decentralization efforts, enhance the state statistical system, and retrain legal professionals. To assist the Government in implementing far-reaching public administration reforms, substantial policy advice and technical assistance have been provided in the civil service reforms and in drafting the comprehensive Public Sector Management and Finance Act.

10. At the request of the Government, further ADB assistance is contemplated to enhance governance in the public sector and to adopt a comprehensive public administration reforms program largely patterned on models of best international practice. The program will cover the key areas of (i) civil service reforms, (ii) privatization, (iii) local government reforms, and (vi) legal reforms. In the housing sector, technical assistance is proposed to enhance the transparency of restructuring housing finance institutions through support for the creation of a housing development fund. The Parliament has also established an anticorruption working

group with the objective of strengthening legislation in this area. ADB is liaising closely with the working group with a view to assisting in its work.

## **B. Increasing Efficiency to Accelerate Growth**

11. Evaluating the impact of governance reforms is much more difficult than doing the same for an infrastructure project, e.g., a power plant. Improvements in the management of a sector or a production unit within a sector contribute in a number of ways to better economic performance. First, they reduce the costs of doing business and thus facilitate the flow of investment and enhance the efficiency with which capital is used. Second, they lead to better provision of infrastructure services and thus to lower production costs for firms, e.g., relatively cheaper transport costs. Third, they result in better delivery of services, including social services, and hence in higher human capital. However, these effects are either indirect or much less tangible. Consequently, it is harder to estimate the impact of this type of reform.

12. Recent developments in economic research suggest, however, that rough estimates can be made in some areas of governance. For example, it has been demonstrated econometrically that bureaucratic inefficiency in the public sector, which is a manifestation of bad governance, retards investment and economic growth. One analysis indicates that “a one standard deviation improvement in bureaucratic efficiency is significantly associated with an increase in the average investment rate by 4.3 percent of GDP and with a 1.3 percentage point increase in the annual growth rate of GDP per capita”.<sup>3</sup> Another analysis indicates that improving the quality of governance in the public sector in developing countries to levels that are more similar to those in developed countries reduces the gap in income per capita between the two.<sup>4</sup> Still another has shown that an increase in corruption from a level akin to Singapore’s (which is very low) to one more akin to Mexico’s is “equivalent to a thirty-two percentage point increase in the tax rate on multinational firms,” and “a one percent increase in a host country’s tax rate on multinationals is associated with a five percent reduction in that country’s inward foreign direct investment.”<sup>5</sup> So the indications are that governance reforms are likely to lead to higher levels of investment and faster economic growth.

13. Through improved economic growth, better governance will indirectly contribute to poverty reduction. But governance reforms have a direct impact on poverty reduction as well. Greater transparency and accountability encourage more efficient and greater value for money in the delivery of social services.

## **C. Governance Improvements for Various Sectors**

14. Strong elements of governance reforms can be included in the action plan for reforms in any sector. The nature of these governance reforms will depend on the particular circumstances of a sector. A list of areas in need of governance reforms can be very long. The following are some specific examples:

- ?? Change the system of tax exemptions and upgrade the General Department of National Taxation to improve tax administration.

<sup>3</sup> Mauro, Paolo. 1995. Corruption and Growth. *Quarterly Journal of Economics*, August: 681-712.

<sup>4</sup> Knack, Stephen and Philip Keefer. 1995. Institutions and Economic Performance: Cross Country Tests Using Alternative Institutional Measures. *Economics and Politics* 7(3): 202-227.

<sup>5</sup> Wei, Shang-Jin. 1997. How Taxing Is Corruption on International Investors. Working Paper 6030, National Bureau of Economic Research.

- ?? Improve public expenditure management processes and systems to produce higher returns to public expenditure.
- ?? Implement performance-based management in the public sector.
- ?? Focus on core priorities and asset management requirements of the aid-financed infrastructure rather than increase the size of the aid portfolio beyond what can be financed.
- ?? Transfer to the private sector the generation and distribution of assets of the Energy Authority and sell a large proportion of a restructured Mongolian Telecom.
- ?? Rationalize and improve the scope and performance of the regulatory framework and institutional arrangements of the infrastructure utilities to allow them to change into divested and contracted asset management agencies.
- ?? Consolidate regulatory processes and systems into single entities covering segments of the utilities area. A single regulator for all transport operations could be developed. In the same way, energy and telecommunications regulators can be established with the sole function of regulation. Further rationalization of regulatory functions for utilities into a single entity should be considered.
- ?? In dealing with an increasingly complex legal and regulatory framework, improve the performance of the courts and the quality of the judiciary.
- ?? Develop the capacity of Bank of Mongolia in managing the new commercial bank accounting system and interbank, government securities, and foreign exchange markets.
- ?? Streamline systems of business registration for foreign investors and joint ventures.
- ?? Develop and expand formal exchange programs with universities, business organizations abroad, and local government agencies to allow business people to become better informed on the laws and regulations that govern business in adjacent countries and regions.

15. Below are further general examples of actions that can be taken within sectors and as part of ADB interventions.

#### **1. Improving Efficiency (beyond policy reforms)**

- ?? Improve the incentive-structure and personnel management within the administration of the operating units in the sectors.
- ?? Bring management practices closer to private sector practices.
- ?? Implement performance-based budgeting and remuneration systems.

**2. Improving Accountability**

- ?? Conduct financial audits.
- ?? Strengthen program evaluation and audit.
- ?? Conduct better judicial and financial surveillance.
- ?? Improve management of revenues.
- ?? Reduce the possibilities for misuse of power (nepotism, corruption).

**3. Improving Predictability**

- ?? Strengthening the rule of law.
- ?? Ensure independence and effectiveness of the regulatory body in each sector.

**4. Improving Transparency**

- ?? Improve the availability of information.
- ?? Increase participation.
- ?? Improve, simplify, and adhere to guidelines known by the public.
- ?? Encourage competition in procurement.

## **MONITORING INDICATORS**

1. Effective medium-term development planning by the Asian Development Bank (ADB) will require that experience and lessons learned from past efforts be utilized in developing future plans. However, to leave clear lessons behind for future generations of development strategies, on-going strategies will need to be “measurable.” Measurability is defined on the basis of a strategy’s ability to achieve its objectives; therefore it is essential that the objectives of a strategy be well defined. In cases of strategies with multiple objectives, a priority ranking of the objectives will need to be established.

2. Well-defined objectives, however, are not sufficient to determine the success of a strategy. Exogenous factors that can affect the outcomes also need to be identified and (at least the direction of) their impact determined. Alternatively, indicators of the input (measures taken) can be used to demonstrate efforts made irrespective of the outcomes.

3. With its overarching objective of fostering economic growth and combating poverty, the success of the new strategy can be defined and measured as follows.

### **A. Defining Success: Pareto Optimality**

4. In an environment with multiple variables, achieving an outcome in which at least one variable is improved while all other variables have, at least, not worsened, is considered to be Pareto optimal. For Mongolia, this means that if (i) economic growth has been achieved (“acceptable” level for a successful rate of growth will be defined as the average rate of growth in real gross domestic product [GDP] in the preceding four years) while poverty has not increased, or (ii) poverty has been reduced while the economic growth rate has not diminished, then ADB’s strategy may be considered to have achieved Pareto optimal results.

5. All Pareto optimal outcomes, however, may not be considered desirable or indicate a successful outcome—as demonstrated by outcome (i) in para. 4. Outcome (ii), however, can demonstrate success if achieved—i.e., poverty must be reduced.

6. While accepting outcome (ii) as the definition of success, its components will need to be carefully defined. New patterns may develop in the course of the implementation of the strategy that may render the reduction in absolute numbers of the poor less meaningful. An example of this possibility would be an observed further deepening of poverty, while absolute poverty could be declining. Another example would be the deterioration of human development standards, or reduced accessibility of social services, while income-based poverty is declining. Under both scenarios, ADB could consider having achieved success in its strategy, only to face new forms of poverty and deprivation.

### **B. Monitoring Success**

7. The success of the strategy is to be evaluated based on achievements in the two areas of economic growth and poverty reduction. Various indicators of poverty, human development, economic development and stabilization, and contributions of various sectors to the achievement of the overall objective of poverty reduction will have to be monitored. Adjustments will also have to be made for the impact of exogenous factors. The following variables can be used as monitoring indicators:

## 1. Poverty

8. The particular type of poverty in Mongolia—being income-based—may be more amenable to measurement than other forms of poverty. The strategy calls for poverty reduction through employment generation (as opposed to, for example, increased production efficiency leading to higher wages) through the private sector (as opposed to the public sector).

- (i) Changes in the total number of persons below the poverty line. Care should be taken to define this index in terms of absolute number of persons rather than as a percentage of the total population, so that definition of success does not become dependent on rate of population growth. The definition of the poverty line should also remain unchanged.
- (ii) Changes in the relative number of persons close to the poverty line and the very poor.
- (iii) Variations in the shape of the income distribution line (the Lorenz curve) toward a more equitable distribution.

## 2. Human Development

- (i) Developments in the school enrollment ratios at primary, secondary, and tertiary levels, segregated by male and female.
- (ii) Changes in the literacy rates for the male and the female population.
- (iii) Infant mortality rates and mortality rates for mothers.

## 3. Economic Conditions

- (i) Rate of growth in GDP at constant prices.
- (ii) Changes in GDP per capita in current and constant prices.
- (iii) Number of new jobs created in the private sector.
- (iv) Variations in real wages in the private sector.
- (v) Indicators of financial intermediation (private deposits in banks, rates of interest on deposits, loan rates).
- (vi) Size of the civil service in total, and ratio of civil servants in core public sector functions to those in noncore functions.
- (vii) Number of new small and medium-size enterprises and industrial units.
- (viii) Changes in number of housing units (gers, apartments, houses) with urban facilities (heating, sanitary water, and waste disposal system).

#### 4. Sector Contribution

9. An important component of any evaluation of the success of the strategy will be to determine which sectors, and through what strategies, contributed best to the overall achievements of the strategy. Table A4 summarizes what is expected of each sector's contribution to the overall strategy.

#### C. Main Poverty Reduction and Human Development Targets

10. The main goal of the strategy is to assist Mongolia to achieve and surpass international targets for poverty reduction and human development as established by "Strategy 21."<sup>1</sup> On this basis, the targets are:

- (i) Reducing by at least 25 percent the proportion of people in extreme poverty by 2005, and by half by 2015.
- (ii) Reducing by at least half the proportion of people below the Government's officially defined poverty line by 2005, and by a further 25 percent by 2015.
- (iii) Achieving universal primary education by 2005.
- (iv) Reducing by half the mortality rates for infants and children under 5 years of age, and by two thirds the mortality rates for mothers by 2005.
- (v) Increasing access with the objective of providing universal access to reproductive health services for all females of appropriate age by 2015.

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<sup>1</sup> International targets for poverty reduction and human development were established by the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD) in 1996 and are known as "Strategy 21". See ADB's policy paper, R179-99: *Fighting Poverty in Asia and the Pacific: the Poverty Reduction Strategy of the Asian Development Bank*, 19 October.

Table A4: Sector Composition of Reforms

Reform Area	Key Issue	ADB Strategy for Poverty Reduction	ADB Strategy for Governance
Poverty	Increasing depth of poverty while incidence of poverty is stable. Poverty is income based, and not caused by weakening living standards.	Need for income generation type of projects for those close to the poverty line, linked to microfinance and small business development.	Stabilize social safety net (part of governance reform loan)
Governance	Rationalization, prioritization, aid agency coordination		Mainstreaming governance through sectors.
Finance and Banking	Establishing new banking system, microfinance.	Establishing new bank together with the private sector. Microfinance and credit lines to small business. Training of bankers	Accelerating reforms in banking and finance. Improve regulatory framework for private sector involvement and public-private partnership (part of governance loan).
Agriculture, Rural Development, and Small Industry Promotion	Diversify from livestock toward agroprocessing	Livestock processing industry, vegetable production, labor-intensive rural transport, and small transport rehabilitation (bridges)	Public-private interface Employment potentials (TA)
Education	Focus on labor market relevant education	School heating Basic education infrastructure	Education management, strategic planning, reproductive health education, Reform vocational training
Health	Management reform and training	Preventive and primary health care education	Governance aspects of health: decentralization, privatization, management, civil service reform, retraining (part of governance loan)
Urban Development	Regionalization, urbanization, and migration urban transport	Water and heating infrastructure in selected cities Urban transport	Tariff reforms
Transport	Viability	In the context of urban and rural development	Privatization
Energy	Decentralizing the heating system Heating as a major cost in education and health	No major investment at this stage, except possibly in the context of school heating	Tariff reforms

## **D. Risk Factors**

11. Exogenous factors that could work against the achievement of successful results for the strategy should be identified. However, in the case of failure to achieve the desired results for the strategy, simple identification of the impact of exogenous factors that prevented ADB's successful implementation of its strategy would not absolve the Bank and its strategy. Instead, it could mean that having identified these exogenous factors in advance, ADB failed to fine-tune or direct its implementation efforts away from them to minimize their impact.

12. A realistic example of the responsibility of ADB to take exogenous risk factors into account in its implementation strategy is the case of the Parliament's role. Although reform-minded and dedicated to the principles of democracy, the Mongolian Parliament operates under a different set of priorities and deadlines than what is needed for the Government's reform agenda. As a result, legislative support for the reform projects may not be delivered in time to meet the implementation schedule for ADB strategy. In this environment, ADB's foresight to delink its reforms from legislative requirements could spell the difference between success and failure.

13. The possibility of a resurgence of political instability in Mongolia's young democracy cannot be ruled out. However, the important role of foreign assistance in Mongolia's development efforts would probably ensure that any such pause in Mongolia's progress toward development would be short-lived.

14. Another risk factor that could undermine ADB's efforts at achieving the expected results is the possibility of reduced availability of concessional Asian Development Fund (ADF) resources in general, and for Mongolia in particular.

15. On the economic side, Mongolia's dependence on international market prices for primary commodities, and its nondiversified industrial base will continue to subject the economy to highly variable economic growth. The new strategy has in it the seeds of resolving this problem by encouraging small-scale industries and by reducing the impact of primary commodity prices on the fiscal budget.

## COORDINATION OF EXTERNAL ASSISTANCE

### A. Introduction

1. Access to concessional external resources is essential for economic development and sustained growth in Mongolia. With a large fiscal deficit and the need to build up adequate foreign exchange reserves, substantial net capital inflows are required. While foreign direct investment (FDI) will meet some of these needs, the amount of FDI is expected to be modest and concentrated in a few sectors (e.g., minerals). Since 1991, the International Monetary Fund (IMF), Asian Development Bank (ADB) and World Bank have worked closely together to support the Government's macroeconomic stabilization and reform program. Concessional assistance from bilateral sources has also been instrumental in assisting Mongolia in its efforts at development and growth. Cumulative loan and credit commitments from various sources of multilateral and bilateral assistance during 1994-1998 added up to \$535.6 million, of which \$436.5 million was from multilateral sources (with ADB providing \$274.7 million of this sum). During the same period, aid agencies provided \$145.5 million in technical assistance. At the Seventh Assistance Group Meeting in June 1999, about \$320 million in external assistance (loans, credit, and technical assistance) was pledged for the next 18 months (July 1999–December 2000), with Japan (\$115 million), ADB (\$76 million) and the World Bank (\$52 million) as the three largest sources.

### B. Past Focus of Aid Agencies

2. In the past nine years, ADB has taken a lead role in providing assistance in several key sectors (education, health, finance, roads, telecommunications, power, air navigation, and housing). Among its activities, ADB has financed the preparation of several sector master plans that provide frameworks within which to coordinate external assistance. ADB has provided assistance to strengthen the Government's capability to prioritize and coordinate projects proposed for external aid and also sought grant or soft cofinancing for all its projects included in the operational program. ADB has been active in arranging cofinancing which, by the end of 1999, amounted to \$91.5 million (about 21.4 percent of total ADB lending to Mongolia) for projects in the telecommunications and energy sectors. Major sources of cofinancing included Kreditanstalt fur Wiederaufbau, Nordic Development Fund, Norway, Danish International Development Authority, and Spain.

3. The World Bank has provided assistance to the transport, coal and mining sectors, poverty reduction, privatization, and State-owned enterprise reform. Japan, the largest bilateral source, has financed critical imports and provided assistance for the rehabilitation of power plants, railways, urban transportation, and water supply sectors; it has also provided assistance for health equipment, human development, and environmental issues. The United Nations Development Programme (UNDP) and other United Nations (UN) agencies are playing an important role in the areas of health and population, poverty reduction, and human development and management capacities. UNDP is also active in facilitating local aid agency coordination.

### C. Strategies of Major Aid Agencies

#### 1. World Bank

4. The main objective of the World Bank Group's International Development Association (IDA) is to support the Government of Mongolia in completing the transition to a market-led

economy, improving living standards, and reducing poverty. To this end, IDA is assisting the Government to create an environment conducive to private-sector-led growth, to tackle transitional and structural poverty, and to manage the country's resources strategically to improve long-term growth. Specifically, IDA is working to

- ?? promote equity in development through direct poverty reduction assistance to ensure continued support for the most vulnerable groups;
- ?? support medium-term macroeconomic stabilization and thus lay the foundation for broad-based economic growth and improved living standards;
- ?? facilitate private sector development and associated employment and income-generation opportunities; and
- ?? develop infrastructure to support private sector growth and market development, contribute to increased foreign investment and global integration; improve the living conditions of the poor by improving access to services and increasing efficiency gains, particularly in energy and water supply.

## **2. Japan**

5. The priority areas of Official Development Assistance (ODA) to Mongolia are as follows:

- ?? improvement of economic infrastructures and conditions for the promotion of industries;
- ?? intellectual support and human resources development for the introduction of a market-oriented economy;
- ?? further support for developing appropriate agriculture plans from a long-term perspective, improvement of administrative systems and circulation of agroproducts, and technical cooperation to transfer agricultural technologies;
- ?? assistance on basic human needs with focus on education, health and medical services, and water system.

## **3. United States Agency for International Development**

6. The operational strategy focuses on accelerating and broadening environmentally sound private sector growth and assisting in consolidating Mongolia's democratic transition. Specifically the assistance program is geared towards:

- ?? private sector growth: transfer productive assets to the private sector, increase the efficiency of financial markets, improve the business environment, improve management of natural resources.
- ?? consolidation of the democratic transition: develop and strengthen new and existing market-oriented civil society associations, local governments, and

private sector businesses and support organizations able to address issues important to the economic growth of Mongolia; and improve the effectiveness of the Parliament and the judiciary.

**Table A5: Sector Focus of Major Aid Agencies  
(a) Multilateral Agencies**

Sector	ADB	World Bank	IMF	UNDP & Other UN Agencies	European Union/TACIS
Agriculture and Natural Resources	Policy and sector-based reforms	Community environment, LIL (grazing associations)		Rehabilitation of forest areas, biodiversity and environmental protection, elite seeds distribution, community forestry IFAD: small holder credit FAO: irrigation Microcredit	Agroprocessing Crop production Veterinary services
Finance and Industry	Policy and sector-based reforms	Banking and enterprise sector assistance, banking enterprise & legal TA	ESAF, ADB restructuring, fiscal reforms		SME microcredit
Infrastructure	Energy, transport, and communications	Coal project Transport rehabilitation Electricity distribution including 2 <sup>nd</sup> Transport and Energy Project		Energy conservation and efficiency	Energy conservation, renewable energy, capacity building & institutional strengthening of tourism sector, transport rehabilitation
Urban Development & Housing	Urban sector development & housing sector finance	Including UB services improvement (water supply) in ger areas		Water sanitation in rural areas	
Education	Sector development			Preschool education strengthening	Curriculum development
Health	Sector development			Hygiene awareness HIV/AIDS/STD prevention and awareness	Rehabilitation of the blind and prevention of blindness
Social Protection	Proposed	Poverty reduction incl. 2 <sup>nd</sup> Poverty Project		Poverty reduction	Strengthening of participatory democracy
Governance	Program loan (approved 1999)	Fiscal TA (Public expenditure management, VAT)		Decentralization, good governance and the building capacity of government institutions	

**(b) Bilateral Agencies**

Sector	Japan	UK	USA	France	Germany	Other Bilateral Sources
Agriculture and Natural Resources	Water resources		Crop production Seed production Veterinary health Livestock breeding		Veterinary services, nature protection and forest management cooperatives	
Finance and Industry	Coal mine development		Privatization of SOEs Bank privatization Restructuring		Legal reforms (civil code), banking & enterprise sector development	
Infrastructure	Rehabilitation of thermal power station, meat plant Construction of grain storage Railway, roads, public transportation		Energy sector projects, restructuring	Rehabilitation of telephone network and water treatment plant	Telecommunications, training of power station employees	Republic of Korea: Energy development Assessment of infrastructure needs and financing Kuwait: Hydropower projects
Urban Development & Housing	Improvement of water supply & sanitation in UB, Globaltai, & Mandalgobi			Rehabilitation of sewer treatment system in Orkon Province		
Education		Preschool education	Training in economic management	Training in remote sensing		
Health		Reproductive health care	Reproductive health care	Rehabilitation of trauma hospital		
Social Protection		Social work/welfare projects				
Governance	Grassroots projects		Strengthening rule of law, democracy and governance		Organized self-help in rural areas	
Others	Food aid, emergency relief				Legal advice and auditing	

ADB = Asian Development Bank, ESAF = Enhanced Structural Adjustment Facility, FAO = Food and Agriculture Organization, HIV/AIDS/STD = Human Immunodeficiency virus/Acquired immune deficiency syndrome/Sexually transmitted diseases, IFAD = International Fund for Agricultural Development, IMF = International Monetary Fund, SME = Small and medium-sized enterprise, SOE = State-owned enterprise, TA = Technical assistance, TACIS = Technical Assistance for the Countries of Independent States, UB = Ulaanbaatar, UN = United Nations, UNDP = United Nations Development Programme, UK = United Kingdom, USA = United States of America, VAT = Value-added tax.

## **IMPLICATIONS OF THE NEW COUNTRY OPERATIONAL STRATEGY FOR LENDING OPERATIONS OF ADB**

### **A. Lending**

1. ADB was active in nine sectors in Mongolia during the first Country Operational Strategy (COS). With the reduction in Mongolia's indicative planning figure (IPF) from an average of \$60 million-\$65 million during 1994-1997 to \$40 million for 1998-2000, however, it has become clear that remaining active in the same number of areas in a continuous way (i.e., to be able to revisit the sector with loan assistance at least every three years to follow up the reforms) would push the loan sizes down to small, suboptimal levels. Therefore, the new strategy, which proposes ADB activities be limited to five sectors, will have some significant implications for the current ADB project pipeline in Mongolia.

#### **1. Poverty Reduction**

2. The key impact will be the adoption of poverty reduction as the strategy's overarching objective. This will require redesign or significant strengthening of a number of projects already in the pipeline and the inclusion of new loan projects with employment generation objectives.

3. With poverty reduction as the overarching objective of the program, ADB must be prepared to devote significant effort and resources to monitor the poverty situation in Mongolia. This work should be carefully coordinated with other aid agencies (notably United Nations Development Programme, World Bank). The 1999 assessment of the National Poverty Alleviation Program (in which ADB participated) and the forthcoming national census in 2000 will help to provide benchmarks. Both TA and staff consultancy resources will be required both to guide poverty interventions and to measure impacts.

4. Emphasizing direct poverty impacts also suggests that the balance between project and program lending should shift significantly toward projects. This should not be difficult as program lending will be conducted largely in the context of the sector development program (SDP) lending modality, giving flexibility between the policy-based and investment components.

#### **2. Governance**

5. The formal adoption of governance as a key objective of the strategy will add coherence to ADB's already strong program in this area. A second Public Sector Governance Reform is planned for 2003. Work to strengthen the legal system and audit and accounting capacity will also continue. Within infrastructure sectors, governance themes will be pursued with emphasis on promoting sustainable infrastructure development through improvements in sector institutional reform, regulation, and financing rather than investments in physical infrastructure. The focus here will be on the institutions providing urban infrastructure services.

#### **3. Infrastructure**

6. In the current pipeline, ADB's involvement in physical investments in infrastructure sectors has been considerably reduced. The new strategy envisages the interventions planned in urban services to be oriented as much as possible towards poverty reduction. In

the urban sector this will have implications for sustainable service delivery and cost recovery. No further lending operation is envisaged for the road sector.

#### 4. Financial Sector

7. The strategy envisages that support for restructuring of the financial sector will continue to be a cornerstone of the program. The possibilities for microfinance project components will be examined in the context of Financial Sector Program Loan II (FSPL II) and planned sectoral lending. While FSPL II will be the centerpiece of Bank's assistance, it will also provide a framework to pursue the (i) promotion of bank privatization through a potential equity investment, (ii) rural finance project and the (iii) housing sector finance project.

8. From the preceding discussion, the pipeline of assistance will need to be revised along the lines shown in Table A6.

**Table A6: Implications of the New Strategy for ADB's Lending Pipeline**

<b>Project</b>
<b>1. Projects that will remain in the pipeline</b>
?? Agriculture Sector Development Program
?? Rural Finance
?? Education Development II
?? Social Safety Net
?? Financial Sector II
?? Provincial Towns Urban Services II
?? Health Sector Development II
?? Housing Sector Finance
?? Public Sector Governance Reform II
?? Urban Services
<b>2. Projects to be taken out of the pipeline</b>
?? Road Sector Development III
<b>3. Possible projects that could be added to the pipeline</b>
?? Small and Medium-Size Enterprise Development
?? Skills-Development Project
?? Social Sector Development and Governance Reform
?? Decentralization and Local Governments

**B. Sector Interlinkages**

9. Sector interlinkages have been discussed in the context of sector strategies. To repeat some, (i) a link could be established between education, health, and agriculture by including health, hygiene, and food education in the curriculum; (ii) in education, there is a strong need to make better linkages with private sector development, the financial sector, and agriculture in providing more labor market relevant training; (iii) in urban development, more emphasis is needed on the health dimensions (epidemic diseases can easily arise when nomadic people are shifting to urbanized life); and on urban transport, alternative energy and heating, employment promotion, and good governance and participation under the new decentralization structures; (iv) the rural development sector provides a good area for multisectoral project designs in microfinance, education attainment and school dropouts, integrative road and bridge network, agricultural marketing, decentralization of agroprocessing industries, and promoting regionalization; (v) support for water supply and road maintenance, can be part of urban sector development; and (vi) within the intended reforms of the public sector, particular attention should be made to mainstreaming governance reforms through all sectors.

10. ADB will need to consider openly procedural (intra-ADB) requirements for adopting methods of project processing and implementation that will allow interlinkages between sector reforms as a means of providing better chances for success in the overall reforms.