Chapter 1: MACROECONOMIC ENVIRONMENT

A. Background

1. Mongolia is unique in many ways. A remote nation of 1.6 million square km, with a population of 2.5 million, it is one of the most sparsely populated countries in the world.[1] Its natural environment has remained largely intact due to the low population density and traditional nomadism that has changed little in rural areas over time.[2] Mongolia is one of the highest and coolest countries in the world, with an average annual temperature below the freezing point. Although being landlocked between the People's Republic of China (PRC) and the Russian Federation (Russia) provides Mongolia easy access to large and fast-growing markets, it is dependent on these countries for overland transport. Mongolia's significant mineral resources and unspoiled natural beauty, attractive to tourists, are viewed as key resources.

2. Mongolia has achieved a reasonable degree of macroeconomic stability a decade after the fall of the Soviet Union and the demise of the Council for Mutual Economic Assistance (COMECON). Mongolia has weathered the inflationary impact of price liberalization at the early stage of the transition to a market economy, the impact of the Asian and Russian crises in 1997 and 1998, respectively, and two exceptionally severe winters in 2000 and 2001, during which 10% of Mongolia's total herd of livestock perished. In September 2001, the International Monetary Fund (IMF) approved a 3-year arrangement under its Poverty Reduction and Growth Facility to provide $37 million to help finance the Government Action Program. The strategy requires fiscal measures to restrain public expenditure growth in 2002–2004 and implementation of a privatization program. IMF's criteria for success in the project include (i) achieving 6% annual real gross domestic product (GDP) growth by 2004, (ii) decreasing inflation to 5% by 2004, (iii) containing the budget deficit within 5.5% of GDP, and (iv) building gross official foreign exchange reserves equivalent to 4 months of import cover.

B. Critical Issues and Trends

3. **Overview.** Compared with other transition economies in the region, Mongolia seems to have the second highest per capita GDP, the highest savings rate, and the lowest inflation rate. Its external debt burden and budget deficit are among the highest in the region, and its real GDP growth rate is one of the lowest, however (Table 1).

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1 Population density is very low, at 1.5 persons per square km. Economist Intelligence Unit (EIU). 2003. *EIU Country Profile*. 1.4 million persons (56% of the population) live in urban areas, of which 1 million live in the capital, Ulaanbaatar. The remaining 40% live in provincial capitals with an average population of 25,000.

2 Mongolia's increasing urbanization, active mining industry, overgrazing and pasture degradation, growing competition for water resources, deteriorating air and water quality, deforestation, and increased frequency of droughts and harsh winter conditions are providing environmental challenges.

Table 1: Comparative Macro-Indicators, 2002

Item	Mongolia	Kyrgyz Republic	Kazakhstan	Tajikistan	Uzbekistan
GDP ($ billion)	1.1	1.6	24.4	1.2	9.7
GDP/capita ($)	448.0	321.0	1645.0	185.0	382.6
Real GDP Growth Rate	4.0	-0.5	9.5	9.1	4.2
Inflation rate (%)	1.6	2.0	5.9	14.5	27.6
Budget Deficit (% GDP)	5.6	5.9	0.0	(0.2)	0.8
Private Sector (% of GDP) [a]	75.0	60.0	65.0	30.0[a]	
External Debt (% of GDP)	88.3	117.1	74.0	87.0	56.0
Savings Rate (% GDP)	23.7	16.5[a]	22.2		20.0[a]

[a] 2001 data.
Sources: Asian Development Bank Basic Statistics, May 2003; *Asian Development Outlook 2003*; *Economist Intelligence Unit Country Reports*.

4. **Gross Domestic Product Growth.** Official GDP figures since 1990 show a typical pattern for a transition economy (Table 2). GDP declined rapidly from 1990–1993 (by 20% in 1995 MNT), followed by a relatively strong recovery from 1994–1999 (39.1% in 1995 MNT). Growth rates in 2000 and 2001 were low but positive, and revised figures for 2002 show a GDP growth rate of 4.0%. But GDP may be higher than recorded. First, although contributions of the informal sector are included in official figures, at 13% of GDP, indications are strong that the real figure is significantly higher, possibly around 35%. Second, there is a very significant discrepancy in National Statistics Office (NSO) publications between production figures for key commodities (most notably, copper concentrate and textile/garment production) and export statistics.[3] Finally, underreporting of production and profitability figures, resulting in lower tax revenues and in underestimated GDP, is believed to be widespread.

5. The structure of GDP changed significantly during the transition period. Wholesale and retail trade (including miscellaneous services) has become the most important contributor to GDP, with agriculture in second place and mining and manufacturing together in third. Mining and manufacturing are, however, disproportionately important to tax revenues and to foreign exchange earnings. Official GDP per capita figures remain very low at $453 for 2002, up from $373 in 1999.

6. **Inflation, Budget Deficits, and Exchange Rates.** Inflation figures were very high in the early 1990s, stabilized at around 10.0% per annum during the late 1990s, and dropped to 8.2% in 2001 and to a reported 1.6% in 2002. In 2003, inflation reportedly picked up to 4.7%. The recent rapid expansion in commercial bank lending, allied to decreased net sales of Bank of Mongolia (BOM) bonds in 2002 and depreciating exchange rate (except against the US dollar)

[3] Production figures and values, rather than export figures, are used to calculate value added and, therefore, GDP. Re-exports, stock movements, or weight gain during transit do not seem to explain the differences. Companies provide production figures, either through a questionnaire (for the 600 largest companies) or through sample surveys for another 500 whereas the Customs General Administration (CGA) extracts export data from export documentation. Cumulative discrepancy from 1992–2002 in the case of copper concentrate, for example, is 1,045,000 metric tons (current value of approximately $260 million).

since mid-2002, helped fuel higher inflation in 2003. The onset of severe acute respiratory syndrome (SARS) also affected consumer prices negatively. According to NSO, prices of foodstuff increased sharply in April 2003, leading to a 5.7% inflation rate in the first 4 months of the year.

7. The budget deficit declined steadily from 14.3% of GDP in 1998 to revised figures of 4.5% in 2001 and 5.8% (MNT72 million) in 2002. During 2003, the deficit increased to 5.9% of GDP, or MNT80.7 million. The decrease registered between 1998 and 2001 was due to a significantly improved tax generation and collection system (partly a result of the successful implementation of the Treasury Single Account) and an increase in value-added tax (VAT) from 13%–15%, which resulted in tax revenues rising from 19.6% of GDP in 1999 to 28.0% in 2002 (Appendix 1).[4] Such rates of increase, of course, are not sustainable. Public expenditure control continues to cause concern, and pressure to increase civil service wages and pensions without offsetting staff reductions has been ongoing; consistent cost over-runs occurred in 2000–2001.[5] Moreover, because tax revenues are volatile and depend significantly on world market prices of copper and gold, the budget deficit is vulnerable. Foreign lending grants and privatization receipts largely finance the fiscal gap.

8. The MNT/US$ exchange rate has been stable since 1999, at a little under (1999–2000) or a little over (2001–2003) MNT1,100 to the dollar. The appreciation of the dollar in mid-2002 led to a decline in international competitiveness of the Mongolian economy, which may have fuelled deterioration in the trade balance over that period. Appreciation has been offset to some extent by the decline of the dollar since mid–2002.[6]

9. **Savings, Debt, and Reserves.** Although higher than in comparable regional economies (Table 1), the savings rate in Mongolia is low, at 23.7% of GDP. A significant proportion of investment is accounted for by government grants and loans (37.1% in 2001) and foreign direct investment (FDI) (21.5% in 2001). One of the challenges in the coming years is to increase local and foreign private investment while decreasing dependency on government financing. Government external debt grew to exceed an estimated $960 million in 2002[7] although this figure represents largely concessionary debt that is being serviced regularly. According to IMF criteria, Mongolia does not yet qualify as a highly indebted country. Post-1991 foreign debt shows signs of levelling off, and the debt-service ratio has remained manageable. Net international reserves (NIR) grew strongly in 2001 and 2002 (e.g., 39.4% in 2002) to reach $225.9 million, enough to cover 18 weeks' imports at the 2002 rate.

10. After 10 years of negotiations, the pre-1991 Russian debt has been settled. Following Paris Club practices, the 11.4 billion transferable rouble debt was agreed to be the equivalent of $11.4 billion. Negotiations concluded in December 2003 between the Mongolians and the Russians resulted in the latter's agreeing to write off 98% of the debt in exchange for an immediate cash payment of the balance ($250 million). On 31 December 2003, the Government of Mongolia repaid the agreed-upon amount, which represents approximately 20% of Mongolian GDP. For that purpose, $100 million from the NIR were utilized. This has resulted in a drop of NIR from $280 million to $180 million, equivalent to a decrease from 19 to 9 weeks of imports.

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4 This compares to figures for tax revenue as a percentage of GDP of 11.7% in the Kyrgyz Republic, 9.5% in Kazakhstan, and 10.5% in Tajikistan. Note that in 2003, taxes comprised 77% of Government revenues, an increase of 3% from 2001. Taxes on goods and services comprised 50% of such revenues, of which VAT comprised 66%.

5 IMF. 2002. *IMF Country Report*. No. 02/252, November.

6 ADB. 2003. *Asian Development Outlook*. Manila.

7 Excluding transferable rouble claims and disputed debts.

Total external debt stands now at $1,097 million, which is equivalent to about 91% of GDP. Most debt consists of loans from multilateral or bilateral sources on concessional terms, and the debt situation has remained manageable with a debt-service ratio equivalent to 5.4% of exports.

11. **External Trade.** In 2003, total trade turnover reached an estimated $1.4 billion, which was roughly equal to GDP and the highest rate since 1990. The trade gap widened from $116.2 million in 2001 to $187.1 million in 2003. In 2003, exports increased 14.5% by value helped by a 12.4% rise in copper prices. Mining, jewelry, and textile exports all rose. At the same time, imports increased 14% by value. Mineral exports amounted to 34.6% of the total, with Erdenet Mining Corporation (Erdenet) alone accounting for 29.5% of exports by value. Exports of textiles and textile products accounted for 26.9% of exports, and gold accounted for 23.3%. Machinery and electrical appliances accounted for 20.9% of imports; foodstuffs, for 7.63%; and mineral products, for 20.5%.

12. Mongolia's dominant trade partners, the PRC and the US, accounted for approximately 70% of Mongolia's total trade in 2003 (Appendix 2). In 2002, private transfers ($25 million in remittances) and official capital transfers offset the trade deficit and produced a balance of payments surplus of $42.6 million.

13. **Interest Rates.** Nominal commercial bank lending rates in 2003 remained high (12–30%) for dollar-denominated loans, and 12–42% for MNT loans, with an inflation rate of 4.7%. Interest rates, however, seem to be trending downward as deposits flow into the banking system and competition triggered by the proliferation of nonbank financial institutions (NBFIs) increases. Despite high rates, the demand for credit remains strong and commercial bank credit volumes expanded vigorously from 2001–2003, with fresh deposits boosting bank liquidity.

14. The macroeconomic picture has improved substantially, with most indicators moving in the appropriate direction. Attention to government expenditure is required, for the budget deficit (5.8%) remains too high; as a result, excessive government borrowing and interest rates are necessary. The improving macroeconomic situation enables the private sector increasingly to plan investments with confidence and to take a medium- to longer-term view (Table 2).

Table 2: Selected Macroeconomic Indicators

Item	1998	1999	2000	2001	2002	2003	2004[a]
Real GDP Growth Rate (% in Constant Prices)	3.5	3.2	1.1	1.1	3.9	5.0	5.2
Agriculture	6.4	4.2	(16.8)	(18.5)	(10.5)	—	—
Industry	3.8	1.1	7.4	11.9	4.7	—	—
Services	0.3	3.5	17.0	10.0	12.0	—	—
Gross Domestic Investment (% of GDP)			26.1	28.3	26.7	—	—
Gross Domestic Savings (% GDP)			32.4	26.0	23.7	—	—
Current Account Balance/GDP (%)	(7.7)	(5.7)	(16.2)	(16.6)	(16.0)	(13.4)	(12.1)
Fiscal Balance/GDP (%)	(14.3)	(12.2)	(6.8)	(5.4)	(5.6)	(6.0)	(6.0)
International Reserve (Gross, $ million)	124.7	156.8	187.7	205.6	349.6		
Consumer Price Index	9.4	7.6	8.1	8.0	1.6	5.0	5.0
Money Supply (M2) Growth (%)	8.8	31.7	17.6	27.9	42.0	25.0	20.0
Debt-Service Ratio (% of export)	7.3	9.3	4.5	5.3	4.9	4.2	4.1
Exchange Rate (MNT/$, average)	902.0	1072.4	1097.0	1102.0	1,125	—	—
GDP Per Capita ($ current)	405.0	382.0	398.7	421.9	453.0	—	—
Official Unemployment Rate (%)	5.9	4.7	4.6	4.6	3.4	—	—

— not available.
[a]2004 figures are projections.
Sources: International Monetary Fund, *Asian Development Outlook*, various issues, *Asian Development Bank Key Indicators 2002.*

C. Private Sector Profile

15. The *private sector*, defined as businesses majority-owned by private investors, has grown rapidly in Mongolia since the dissolution of COMECON. In terms of GDP contribution, the private sector accounted for 57% in 1996, 71.8% in 1999, and 75% in 2001. Following recent privatizations, private sector share of GDP may now be 80%. Certain caveats apply, however. First, although the state holds minority equity stakes in only a small number of privatized companies,[8] it continues to influence the operations of a number of privatized companies (e.g., by selecting companies to deliver food products and animal feed in rural areas, and by offering selected companies soft loans). Second, GDP measures the value added by economic entities in the economy. Third, companies with state share holdings contributed 29% of corporate tax receipts in 2001 even though their level of net profitability seemed lower than that of the private sector. Business surveys also show that the informal sector is quite strong.[9]

16. In terms of contribution to the country's GDP in 2001, the private sector dominated the following sectors: agriculture (98%), manufacturing (95%), construction (90%), trade (90%), and mining (75%). State-owned enterprises (SOEs) accounted for 42% of total output in transport and communications and for 69% of total output in the financial sector[10] (Appendix 3).

17. Growth in the number of enterprises registered with the State Registration Department of the General Department of National Taxation (GDNT) has been dramatic. But growth has been

8 The State Property Committee (SPC) recognizes only two minority state-owned companies in its list of 108 companies monitored—Shijir Alt, a mining company, and Mongol Amicale, a cashmere processing company.
9 USAID. 2000*. The Mongolian Informal Sector: Survey Results and Analysis* (USAID 2000 Survey).
10 Private banks accounted for 94% of total commercial loans outstanding in 2002 (Appendix 8).

influenced by applicable legal requirements, including the need, before 1997, to register sole-trader businesses, and the perverse incentive offered by the dual corporate tax rate (15% for profits up to MNT100 million and 40%, recently decreased by Parliament to 30%, for profits above that figure) to split a business into a number of similarly operating companies. Registration also has been encouraged by the reduction of minimum capital levels to MNT10 million ($9,091) for joint stock companies (JSCs) and MNT 1 million ($910) for limited liability companies and by relatively simple and inexpensive registration procedures for businesses engaged in general activities.[11] Table 3 shows the number of enterprise registrations to 2003.

Table 3: Enterprise Registrations, 1995–2003

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Individual Traders [a]	27,816	22,357	19,087	8,843	4,931	4,395	4,148	2,800	0
Cooperatives	3,599	2,111	2,711	2,626	2,033	1,872	1,708	2,047	2,360
Shareholder Cos.	498	423	447	443	398	396	401	399	402
Ltd. Liability Cos.	5,598	5,955	7,516	8,652	9,935	12,047	13,702	17,072	20,787
SOEs[b]	1,236	1,153	1,006	904	617	474	376	373	371
Total	**38,747**	**31,999**	**30,767**	**21,468**	**21,468**	**17,916**	**19,184**	**22,691**	**23,920**

[a] Since 1997, individual traders have not been required to register with the General Department of National Taxation. They are still required to register with local authorities, however.

[b] Although 371 SOEs are registered, SPC monitors only 108 that are fully owned by the national Government. The remaining SOEs are fully or partly owned by local authorities.

Source: General Department of National Taxation.

18. The Ministry of Industry and Trade (MIT) records company activity at the time of initial registration with GDNT. As reflected in Table 4, the large number of trading companies registered is a reflection of both the small size of many of these companies and the fact that many newly established enterprises start as trading companies.[12] 2001 and 2003 data show that the number of companies in some activities has changed dramatically. Real estate and rentals has grown by a factor of 21, raw materials processing by a factor of 4, and health and education by a factor of 3. The number of financial service companies has been cut in half, as has the number of firms engaged in agriculture, forestry, and hunting. The figures for remaining companies have not changed significantly. The decrease in the number of financial service companies can be explained by consolidation in the banking and the NBFI sectors. The growing number of companies involved in real estate indicates a positive trend toward long-term investment in the property sector.[13]

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[11] To register, the applicant (i) selects the form of ownership for an entity, the form of initial capital, the name of the entity, and the entity's location and bank and (ii) pays a registration fee of MNT10,000 (less than $10) and minor charges to check the availability of the chosen name, obtain copies of the application forms, etc. Processing of an application can be slow. Registration of businesses engaged in areas where special permits or licenses are required is more complicated (Box 3).

[12] This is true of a number of very large companies whose management was interviewed.

[13] The rapid increase in bank lending, combined with the explosion in real estate firms may represent a gathering storm. Frenetic construction activity in Ulaanbaatar, by any measure a small market, may result in a glut of new buildings. To the extent (unknown) that banks are financing property and construction, the seeds of a nonperforming-loan crisis may be in the planting.

Table 4: Principal Company Activity, 2001 and 2003[a]

Category of Activity	**Number of Companies: Primary Activity**		**Authorized Share Capital** (MNT Million)	**Number of Companies: Secondary Activity**
Agriculture, Forestry, Hunting	3,567	(1,928)	134,381	7,969
Energy, Gas, Water Supply	241	(209)	298,500	360
Construction	811	(888)	50,682	1,919
Mining	332	(297)	62,627	594
Raw-Materials Processing	710	(2,684)	143,241	1,528
Wholesale and Retail Trade	14,793	(13,339)	668,294	26,192
Tourism, Hotels, Restaurants	855	(946)	46,620	2,889
Transport, Storage, Comms.	610	(625)	290,189	1,724
Real Estate and Rentals	98	(2,184)	27,064	287
Health and Education	1,240	(3,574)	22,619	2,164
Financial Services	1,427	(736)	176,616	2,376
Other	1,328	(4,068)	555,013	3,503
Total	**26,012**	**(31,478)**	**2,475,846**	**51,505**

Notes: Authorized shares may not necessarily be issued and paid up.
[a] 2003 figures are in parentheses. Other figures are for 2001.
Source: Ministry of Industry and Trade.

19. Data are scarce on employment levels, productivity, and profitability within the private sector. In 2002, the average value added per employee across all industries was $2,467/year. Because this figure ranges from $27,893 in furniture manufacturing to $509 in the treatment and manufacture of fur garments, the reliability of the data is in doubt.[14]

20. The Mongolian Stock Exchange (MSE) reports financial performance indicators from the annual reports of the top 20 listed companies (MSE 20), all of which are private. Returns on turnover and assets are presented in Table 5. Caution is necessary in interpreting the data. First, turnover, assets, and profits are those declared in annual reports, which may be understated to decrease tax liability. Thus, it is not clear whether the reported decline in returns is a result of lower trading margins or increased underreporting. Second, data are not necessarily fully representative of the 403 companies listed on MSE in 2001 although MSE 20 accounted for 62% of market capitalization. Also presented in the table are limited data on the performance of SOEs and of private small and medium enterprises (SMEs) in 2001 (figures derived from State Property Committee (SPC) and GDNT data, respectively).

[14] *Mongolia Statistical Yearbook*. 2002. Ulaanbaatar.

Table 5: Comparative Company Performance Data

Item	1999		2000		2001	
	Profit Margin %	Return on Assets %	Profit Margin %	Return on Assets %	Profit Margin %	Return on Assets %
SOE 1					(0.2)	
SOE 2					(0.1)	
MSE 20	14.75	12.79	12.05	9.64	9.33	6.42
SME					6.4	

Notes: *SOE 1* refers to all state-owned enterprises, and *SOE 2* refers to results for industrial companies in State Property Committee categories A–D.
Returns are after tax, but before payment of any dividend; income is net of value-added tax.
SME is defined as registered companies with revenue of MNT10,000,000/100,000,000/year.[15]
Source: Mongolian Stock Exchange, State Property Committee.

21. In the case of SOEs, after-tax profit margins for all entities, as well as for the major industrial companies, are negative. Despite this, and despite the fact that SOEs accounted for less than 1% of reporting companies in 2001, they provided 29% of all corporate income tax receipts, a fact reflecting the relatively large scale of their operations. Post-tax, however, many SOEs are left with few resources to invest in the business. Of the 25 SOEs in the A–D industrial categories, only 15 emerge with positive balances. Erdenet alone accounted for 7% of all corporate income tax revenues in 2001, but was left with only $3 million of after-tax profits on revenue of around $150 million.

22. SMEs, including 14% of reporting SMEs that declared losses in 2001, seem to have an average after-tax profit margin of 6.4%. Thus, the same caveats in respect to reliability of data apply.

23. **Large Enterprises.** Many large enterprises in Mongolia were or are SOEs. The lack of truly private large enterprises is striking and is the likely result of the tiered corporate tax rates in Mongolia, which encourage business owners to establish new companies to stay within the lower tax bracket. The Tax Law does not require business owners to consolidate earnings across wholly owned enterprises in the same business sector. In addition, the small size of Mongolia's internal market represents a significant barrier to enterprise growth.

24. Notwithstanding, a number of large indigenous companies have emerged since 1991, many in the form of holding companies with diversified operations, including banking. For example, Nomin Holdings, which began importing home appliances and electronic goods in the early 1990s, now has 60% of this market. Nomin Holdings bought and relaunched the dormant state-owned electronics assembly company Monelcom JSC, bought 75% of the Erdenet Carpet factory from the state and invested substantially in it, owns 75% of the former state-owned State Department Store and 50% of Interbank, recently established Nomin Insurance Company Ltd., and is involved in tourism and general trading.

25. **Small and Medium Enterprises.** According to reported company data, there are approximately 3,400 SMEs. Almost all were formed in the 1990s although 26 of the 108 SOEs

[15] SMEs are also defined as legal entities having an income of less than MNT100 million (see discussion below). Note, however, that NSO classifies business entities with fewer than 50 employees as SMEs.

monitored by SPC constitute SMEs by revenue.[16] The balance of companies reporting consists either of large companies (2,361 reporting in 2002) or of microenterprises.[17] But if underreporting of revenue and profit is as widespread as it seems, then the number of SMEs operating may be greater and the number of microenterprises smaller. Moreover, a number of companies currently reporting as SMEs may in fact be large companies that have split operations to minimize tax liability.

26. If the definition of SME is broadened to include all registered companies reporting a turnover of less than MNT100 million, then the number rises from 3,400 to around 15,000.[18] Some 7,939 of these additional companies, however, report a turnover of less than MNT1 million.

27. **Informal Sector.** Mongolia's informal sector, which consists of individual traders and enterprises engaged in such diverse activities as taxi driving, retailing through pavement kiosks, meal preparation and sale, and the offering of pavement-based mobile phone services, plays a crucial role in the economy. Although non-incorporated, such enterprises and traders are required to register with local authorities and to pay a flat tax in lieu of calculated income tax.[19] Most are believed to comply with these requirements.

28. The World Bank and the United States Agency for International Development (USAID) have conducted two major surveys of the informal sector.[20] World Bank's 1997 survey estimated the informal sector contribution to GDP at 30–35% and to employment at 105,000 to 130,000 in Ulaanbaatar alone. The USAID 2000 survey calculated that the informal contribution to GDP was 13.3%, but acknowledged that this certainly was an underestimate.[21] The USAID 2000 survey also estimated that 80% of all informal activity occurs in Ulaanbaatar and that informal incomes were two to three times those of average government employees in 1999. Apart from income levels, the attraction of the informal sector is the relative lack of bureaucracy and petty corruption and the voluntary contribution to social funds, which adds more than 19% to the formal sector's wage bill. The Soros Foundation is undertaking a comprehensive study of the informal sector, with results likely to be available before the end of 2004.

29. **Herders.** Herders are not included within the formal or informal private sector but play an important role in the private economy, especially in rural areas where herding of livestock is often the only source of income. In 2002, 24% of GDP (1995 prices) was contributed by herders through the sale of raw materials (meat, animal skins, cashmere, wool, etc.). At the end of 2002, approximately 175,911 herder households owned approximately 136 livestock each (total of 23.9 million) (Box 6).

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16 SPC.

17 A *microenterprise* has a revenue of less than MNT10 million ($9,000–10,000).

18 However, under NSO definition, there were 18,000 private SMEs at the end of 2002.

19 The informal sector is subject to the Income Tax Law of the Citizens Who Engage Individually in Business and Services Whose Income Can Not Be Determined.

20 The Size, Origins and Character of Mongolia's Informal Sector. James Anderson, 1997. World Bank. *World Bank 1997 Informal Sector Survey*. Chicago; USAID 2000 Survey; See also Morris, Elizabeth. 2001. ILO/UNDP. *The Informal Sector in Mongolia*.

21 Nevertheless, it was this percentage that was included by NSO in GDP figures from 1999, leading to the view that for this, and other reasons, official GDP may be underestimated.

D. Private Sector Role in Poverty Reduction

30. Measurements of the extent and depth of poverty in Mongolia come from surveys undertaken in 1995, 1998, and 2000[22] and arise from the adoption of the National Poverty Alleviation Program in 1994. Although these measurements indicate a fairly stable incidence of poverty at around 36% of the population, they also indicate a gradual deterioration in depth and severity of poverty and a modest increase in inequality, as measured in terms of the Gini-coefficient (0.35 in 1998). The "very poor" are considered to constitute around 20% of the population, and the "poor" 16%. Unusually, poverty is associated more with urban than with rural areas, and particularly with regional urban centers. Urban unemployment has risen based on the decline of employment in former SOEs and migration from rural to urban areas. Household head unemployment is the most important determinant of poverty, and family size, household head marital status, and alcohol dependency are other important determinants.

31. Estimates of recent private sector employment generation are speculative. Very crudely, total registered employment increased by 103,200 between 1995 and 2002, when the private sector share of GDP was approximately 50% and 75%, respectively. Net increase during the period (20,000) was overwhelmingly of public employees (e.g., in public administration, defense, education, and health and social security sectors), and if this amount is deducted, then only 83,200 additional jobs were created. These jobs probably were created in the private sector. It is also likely that SOEs released staff over this period, some of whom surely were absorbed by private companies. Whatever the number, the private sector clearly has employed a large number of additional staff over the past 5–7 years and has alleviated the increase in poverty. Although the informal sector is dynamic and has, according to World Bank's 1997 survey, lifted 15% of the population of Ulaanbaatar above the poverty line, the formal private sector has the long-term challenge of creating viable and stable employment.

E. Investment and Sources of Finance

1. Investment in Relation to Gross Domestic Product

32. Since 1995, overall investment rates in Mongolia have increased gradually as a percentage of GDP (Table 6). Investment remains dominated by the Government, which continues to provide more than half of all investment, and to a significant extent by international financial institutions (IFIs). Proportion of investment financed by retained earnings has shrunk while bank lending has remained roughly constant in percentage terms over the period but grew strongly in 2000 and 2001 while FDI doubled during this period.

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[22] Summarized in Living Standards Measurement Surveys in UNDP. 2000. *Human Development Report:* Mongolia.

Table 6: Savings and Investment, 1995–2001

	1995	1996	1997	1998	1999	2000	2001
Investment as % of GDP, of Which:	16.6	16.4	18.0	18.0	18.2	19.4	20.6
Earnings	29.1	29.1	22.2	33.6	29.5	19.9	19.5
Bank Borrowing	9.8	3.7	4.4	6.3	4.3	8.0	8.1
FDI[a]			11.1	7.7	16.5	20.9	21.5
Govt. Budget, Loans and Grants			62.3	52.4	49.7	51.2	50.9

[a] Figures are lower than those reported by the Foreign Investment and Foreign Trade Agency.
Source: National Statistics Office Yearbook.

2. Local Debt and Equity Finance

33. A chronic impediment to private sector growth in Mongolia is the limited amount of financing available. Capital has been constrained not only by the limited capacity of borrowers and by the shortage of pledgable assets,[23] but by the preference of commercial banks to issue short-term loans, and in light of the nonfunctioning capital market, the absence of formal or informal mechanisms and institutions capable of providing risk capital. Lending is expanding at an accelerating rate, however, and is being overseen by a handful of experienced and skilled bank management teams that are succeeding in winning ever more public trust. As a result of the growing base of core deposits at certain of the larger commercial banks, conditions are favorable for term lending, which, indeed, is beginning to occur. Equity finance, however, remains an extremely scarce and valuable commodity.

34. **Bank Lending.** The volume of private sector credit provided through commercial banks since 2000 has expanded rapidly. In 2001, lending to the private sector increased by 250% compared with lending to the public sector, which grew by 68%. Expansion is due to a number of factors, including modifications to legislation permitting banks and NBFIs to repossess collateral immediately upon default so long as the sale is explicitly permitted in the loan agreement,[24] a dramatic increase in commercial bank deposits,[25] and significant reductions in interest rates.[26]

35. Although BOM carries out annual sample surveys of commercial bank borrowers, only indicative structural information is available. Of the 2,035 company respondents in the February 2002 survey, 45.9% were trading companies and 17.7% were service companies. Manufacturing, mining, and other industrial companies were more prominent among very large

[23] In the February 2002 Bank Lenders' Survey prepared by the Research Department of BOM, 18.5% of company borrowers reported that they had insufficient assets to provide adequate collateral while 29.2% stated that their greatest challenge was onerous loan documentation.

[24] 2001 amendments to section 6 of Article 368 of the Civil Code and Article 29.1 of the Law on Deposit Taking, Payment Services and Lending Activities permit banks and NBFIs to foreclose on immovable and movable property outside the court system. But subsequent amendments to the Civil Code in 2002 require a mandatory court order and bailiff's auction procedure to enable banks and NBFIs to foreclose on immovable collateral. The Civil Code also prohibits foreclosure of real property during the winter months (between 1 October and 30 April).

[25] Demand deposit accounts in 2002 grew by MNT43.7 billion ($39 million), and savings accounts grew by MNT83.8 billion ($74.5 million). *Bank of Mongolia Annual Report*. 2002. Ulaanbaatar.

[26] Interest rates in commercial banking declined considerably from 30–40% per annum in the late 1990s to 12–18% for loans denominated in US dollars and down to 15–30% for MNT debt by the end of 2003.

borrowers, a fact indicating that the majority of loan volume may have been concentrated in these industries. This survey showed that 69.1% of companies borrowed for working capital, 16.0% for investment capital, and 8.3% for real estate purposes. Small companies borrowed more for working capital purposes (71%) than for investment purposes (13.9%) whereas the converse was true for the largest companies (58.8% and 26.3%, respectively). No information is available on borrower rate of return on investment.

36. **Nonbank Financial Institutions and Savings and Credit Cooperatives.** NBFIs, which are supervised by BOM and are prohibited from receiving deposits, currently comprise less than 3% of total banking system assets.[27] Most licensed NBFIs are located in urban areas and engage in short-term lending for working capital purposes. Lombards, a form of pawnbroker regulated as an NBFI, are believed to service very few, if any, business activities and carry the highest rate of interest (approximately 9%/month).

37. There are approximately 400 savings and credit cooperatives (SCCs), which are community-based lending organizations permitted to receive only members' deposits. SCCs finance both individual consumption and small businesses, predominantly in rural areas. Interest rates are higher than in commercial banks, and business financing is exclusively for working capital.[28] A regulatory framework for SCCs is being developed.

38. **Equity Finance.** The equity market in Mongolia is barely functional. By and large, equity investment is arranged privately among a small group of wealthy individuals for larger companies; networks of relatives and close acquaintances often pool funds to invest in smaller businesses.

39. **Retained Earnings.** The volume of retained earnings within the private sector and available for investment is difficult to quantify. MSE data for MSE 20 show 2001 retained earnings (after tax and dividend payments) averaging 6.4% on assets and 9.3% on sales. In absolute terms, these 20 companies retained earnings of $5.5 million in 2001, down from $7.9 million in 1999. Figures compare with a total commercial bank loan portfolio of around $200 million at the end of 2002, indicating that bank borrowing, at least among large listed companies, is a far more important financing tool than retained earnings.

3. Foreign Direct Investment

40. Foreign investment is defined in Mongolia as an investment from a source external to Mongolia of at least 25% of equity into a wholly foreign-owned company, a new joint venture (JV), or an existing company. Such investment must take the form of foreign currency or reinvested MNT profits. Registration of the investment with FIFTA—the government agency responsible for attracting and regulating foreign investment—is necessary to claim tax concessions. Based on these concessions, it is assumed that foreign-invested companies provide the vast bulk of FDI. Although FIFTA was created in1996, debate continues over the exact extent of FDI in Mongolia.

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[27] Vogel, Robert and Robert Hefner. 2003. Improving Regulation and Supervision of Nonbank Financial Institutions and Savings and Credit Cooperatives. Final Report on *Technical Assistance to Mongolia for Strengthening Restructuring the Mongolian Banking System*. ADB, Manila.

[28] On average, SCCs charge 4.8–5.3% per month on loans.

41. Between 1990 and 2001, accumulated FDI commitments amounted to $481 million from more than 2,000 foreign-invested companies (Appendix 4).[29] FIFTA has not released figures for FDI disbursements. Work carried out by NSO and BOM values FDI disbursement at $63 million in 2001 compared with commitments made in that year of $125 million, a difference indicating that foreign-invested companies are not yet ready to fully disburse amounts committed.

42. Principal investors in Mongolia come from the PRC and the Republic of Korea (Korea) and are largely responsible for the increase in foreign interest in the garment industry. The mining industry accounted for 37% of commitments in 2002, followed by industry (16%) and animal-related raw-materials processing (10%) (Appendix 4). World Bank's Business and Investment Report estimates that FDI has created 67,000 new jobs for the domestic workforce,[30] and foreign invested companies account for 39.4% of total tax revenue and for 51.7% of all exports.

4. International Financial Institutions

43. IFIs contribute to private sector development (PSD) in a number of ways. First, they assist with the modification of macro-economic, business, and commercial environments and reinforce financial, social, and infrastructural supports to PSD. IFIs also provide dedicated credit lines through commercial banks for private sector borrowing and direct private sector loans and equity investments, which can help improve governance from the inside and act as a "seal of approval" for other potential investors. With respect to the equity investments, the International Finance Corporation (IFC) has made one investment in Mongolia to date: G & M Industrial Co. Ltd., a local garment manufacturer that was owned by a Mongolian company and a foreign investor and became insolvent. A proposal to invest in Trade and Development Bank (TDB) (jointly with IFC) will be presented to the ADB Board of Directors in the first quarter of 2004 with the completion of the transaction subject to successful negotiations on price for ADB's equity share in TDB. IFC is also investing in the Agricultural Bank of Mongolia.

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[29] On an actual basis, $77.8 million was invested in 2002.

[30] World Bank. 2002. *Business and Investment Guide for Mongolia*. Ulaanbaatar, July. Methodology for the calculation of the job creation figure was not included.