

Chapter 3: SECTOR PROFILES

A. Overview

133. This chapter summarizes the situation in respect to key productive sectors (agriculture, natural resources, tourism, manufacturing) and the supportive sectors of infrastructure, finance, and social services. The systemic constraints presented in Chapter 2 affect each of the individual sectors presented, in unique ways (Table 11).

Table 11: Mongolia GDP by Sector, 1999–2002
(% of GDP)

Sector	1999	2000	2001	2002
Agriculture	40.3	34.2	27.8	20.7
Industry	22.3	22.6	24.9	21.4
Transport and Communications	7.5	9.3	10.4	14.0
Construction	1.5	1.3	1.4	2.1
Trade	17.2	21.4	23.7	27.6
Other services	11.2	11.3	11.8	14.3

Sources: *World Bank Business and Investment Guide for Mongolia, 2002*; *Mongolia Statistical Yearbook 2002*.

B. Agriculture

134. The private sector accounts for 98% of the agricultural sector (Appendix 3), which is dominated by animal production.⁹² This sector contributed 20.7% to GDP in 2002 and employed almost 45% of the total labor force in rural areas.

135. **Livestock.** Cashmere and meat are the main export products in this subsector. Following privatization of livestock (Box 6), the production of raw cashmere more than doubled from 1,500 tons in 1990 to 3,288 tons in 2000, but production declined in 2001 and 2002 to 3,100 and 2,900 tons, respectively. The rapid increase from 1990–2000 had been tied to an increase in animal numbers and to the receipt by herders of a higher percentage of value based on increasing buyer competition—which, in turn, had been based on the entry of buyers from the PRC into the local market and on a growing number of local traders and manufacturers.⁹³

136. The export of raw cashmere from Mongolia has been the subject of fierce debate since the early 1990s. To protect local spinners and manufacturers, an export ban was in place from 1991–1996 despite pressure from ADB and others for its removal. This ban was replaced in 1997 by a flat export tax of MNT4,000/kg. Although declining in real terms, this tax still represents a significant percentage of herder prices.

137. To promote the competitiveness of Mongolian cashmere, the government, with USAID assistance, recently developed an internationally recognized certification trademark to

⁹² Production of animals (sheep, goats, cattle, horses, and camels) accounts for approximately 79% of sector GDP.

⁹³ Although producers have received a higher percentage of value since privatization, cashmere world prices have fluctuated since 1989. In that year, prices for Mongolian dehaired (semi-finished) cashmere reached \$60/kg, only to fall to \$14/kg in 1993. Current prices are \$51–\$53/kg, cif Europe. See *Wool Record Weekly Market Report*, quotes for 13 February 2002.

distinguish high-quality Mongolian cashmere (which generally is 15% longer than cashmere from the PRC, pills less, and is softer) from lower-quality cashmere products. A new Fiber Certification Board will be established to certify such products.⁹⁴

138. With respect to meat production, export growth is limited by current slaughter and by veterinary and meat packing standards, which are in the process of being improved with assistance from ADB and other donors.⁹⁵ Although exports to Russia of largely unprocessed meat products have averaged nearly 20,000 tons annually, the PRC has banned Mongolian meat and dairy exports since an outbreak of foot and mouth disease in 2001.

Box 6: Sustainability of Livestock Production

Before privatization, herders were employees of state farms, which provided necessary support services, controlling the number of livestock produced and the quality of livestock, and maintaining the delicate ecological balance. After privatization, support to the livestock industry collapsed. Number of herders increased due to the lack of other employment options. Based on the limited number of livestock owned by individual herders, livestock production moved to more of a household-based subsistence system.

As number of herders increased and quality of livestock decreased as a result of inadequate breeding methods and veterinary care, herders began to increase the size of their herds beyond the optimal herd size (nationwide, this is considered to be around 22 million), which led to overgrazing and degradation of pastures. Fodder (hay) production also decreased as a result of inadequate irrigation, which no longer was maintained. Three consecutive years of severe weather (2000–2002) resulted in the loss of 11 million livestock. As of 2003, there were approximately 25.3 million livestock, a slight decrease from the 1994 stock numbers following privatization (26 million). Herds rapidly increased to 33.6 m head in 1999, followed by sharp decreases to 26.1 million, a figure reflecting harsh climatic conditions in 2001 and 2002.

Herders who live far from Ulaanbaatar lack access to the central market, in which higher prices are paid for cashmere. Thus, they barter and sell their cashmere for lower prices, often to traders from the PRC, a practice that decreases the amount of raw cashmere available to local producers.

With donor assistance, the Government is adopting a number of policies (e.g., regarding livestock health, fodder production, infectious disease control, water supply improvement) to address these constraints, and continues to work to develop a more effective long-term strategy for the subsector.

Sources: *Rural Development Strategy for Mongolia*, Centre for Policy Research, October 2002; World Bank; Food and Agriculture Organization; Department for International Development; United Nations Development Programme; Economist Intelligence Unit Country Report, May 2003.

⁹⁴ USAID Competitive Initiative. 2002. *Discussion Paper on Fiber Certification Mark—Promoting Mongolian Cashmere*, April.

⁹⁵ ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Agricultural Sector Development Program*. Manila. This loan supports improvement of veterinary standards through the Ministry of Agriculture and training of veterinary inspectors of meat hygiene through the Veterinary Inspection Agency.

139. **Crops.** Inadequate rainfall, limited access to finance, high cost of irrigation, lack of adequate management, low-quality seed material, outdated equipment and technology, brief growing season, and availability of inexpensive imports from the PRC are factors affecting crop production in Mongolia. The sustainability of wide-scale production of cereals, principally wheat, the main food staple in Mongolia, is highly questionable. In the 1980s, the Government dedicated significant resources to wheat production, which grew to approximately 600,000 tons in 1991. During 1990–1996, all state-owned crop farms were corporatized in an effort to promote private ownership. Investors avoided this industry, and production dropped steadily to 139,000 tons in 2000 and 2001, a figure that appears, in light of the factors listed above, to represent a rational resource allocation. The remaining domestic wheat production is supported by Government subsidies. Russia, although not self sufficient in wheat, and Kazakhstan periodically provide Mongolia with wheat priced to compete with or to undercut domestic wheat prices.

140. Horticulture production, which includes potatoes and vegetables, increasingly is carried out on small family-plots and small commercial greenhouses. Private investment in vegetable growing (excluding potatoes), where the Government does not intervene and capital requirements are relatively modest, has grown strongly. This area of crop production grew throughout the 1990s, reaching a peak of 5,600 ha and 45,000 tons in 2001. Production fell to 39,700 tons in 2002 but rebounded to 59,600 tons in 2003.

141. **Agro-processing.** Mongolia's small and medium-scale agro-processing industries are not competitive domestically, let alone in the position to export. Although Mongolia had a few large agro-processing industries, a combination of factors including outdated equipment and technology and lack of financial capacity caused their collapse. According to a 2002 survey conducted by NSO, 407 agricultural raw material and processing industries operate in Mongolia, primarily in urban areas. Approximately 30% produce meat, meat products, and casings; 27%, milk and milk products; 7%, skins and hides; 1%, animal and plant oils; 31%, flour and flour products; 2%, fruit and vegetables; and 2%, livestock feed and starches. Most industries use only 50% of their total operating capacity.

142. With the exception of Darkhan Meat Export Company, which is 50% owned by the State, all meat slaughter, packing, and processing facilities are owned by the private sector. Three major vertically integrated cashmere producers currently operate in Mongolia. One is financed privately, one is in the process of being privatized (Gobi JSC), and one remains state owned. Overall, the level of raw-material utilization and processing remains low and the finished-goods industry is based mainly on imported raw materials.

143. **Initiatives Required.** The future of Mongolian agriculture lies in the exploitation of its extensive grazing lands and in the selling of animal products into local industries and foreign markets, principally, although not exclusively, those of neighboring countries. Animal production must be complemented by niche arable production in areas where season length, product value, and product enable effective competition with imports. Arable production is likely to be concentrated in vegetables rather than in cereals although the latter likely are still viable in certain geographic zones.

144. ADB has provided considerable resources to agricultural policy reform, capacity building, and technical analysis (Appendixes 6 and 7). A number of fundamental reforms have been carried out under these programs—and with additional assistance provided by UNDP, USAID, European Union Technical Assistance for the Commonwealth of Independent States (EU

TACIS), and GTZ; but structural reforms seem not to have led to significant improvements in production or quality.

145. A viable model for crop production (wheat and potatoes) in Mongolia has not yet appeared, and no policy or other intervention may be able to overcome the formidable nexus of natural barriers to such production. With respect to wheat, future assistance should be conditioned on ongoing policy dialogue with the Government regarding the long-term viability of the subsector. Further technical and financial assistance is required for the livestock industry. One of the most important constraints facing it concerns veterinary care, which is necessary to ensure not only the survival of animals but also the quality of their skin, meat, and milk. Comprehensive programs should include continued strengthening of private veterinary services; improvement of private feedstock management; improved health monitoring and slaughter control; implementation of meat hygiene codes under the Codex Alimentarius; introduction of more compelling incentives for clean meat, skins, and hides; and improved management of pastureland. In relation to the foregoing, there remains broad scope for large-scale public-sector support. Strengthened supply-chain management links with processing industries and exporters also should be introduced, and Mongolian produce should be promoted actively in neighboring countries. (With respect to agro-processing, see initiatives proposed under the Manufacturing Sector, discussed below.)

C. Natural Resources

146. Mongolia has significant mineral resources, including gold, copper, coal, and oil. In 2003, the mining sector accounted for approximately 8.5% of GDP and for 34.58% (down from 57% in 2002) of foreign exchange earnings (of which gold production comprised 24%) and employed approximately 3% of the national labor force.

147. **Coal.** Mongolia has coal reserves estimated at 150 billion tons, of which 25% has been confirmed by geological survey. Over the last 5 to 7 years, production has been relatively constant at 5m–5.2m ton/annually.⁹⁶ The State continues to own majority interests in Baganuur JSC, Sharyn Gol JSC, and Shivee Ovoo JSC (75, 80, and 90% state owned, respectively); all other coal-mining companies are privately owned. Both Baganuur JSC and Shivee Ovoo JSC are benefiting from rehabilitation and development with World Bank and Japan International Cooperation Agency (JICA) assistance. Newly discovered coal deposits in the South Gobi are generating a great deal of interest from the PRC, where demand for coal is high.

148. **Gold and Copper.** Geological surveys carried out in the 1960s reveal substantial mineral resources, especially gold and copper. More recent and advanced searches during the 1990s by international mining groups including Ivanhoe Mines (Ivanhoe) and Cameco Mines (Cameco), Canadian exploration companies, confirmed more extensive and richer deposits.⁹⁷ These companies have invested extensively in further exploration.⁹⁸

⁹⁶ 80–85% of production is used by thermal power stations.

⁹⁷ This year, drilling at the Ivanhoe concessions at Oyu Tolgoi, a mine in Omnogov *aimag* in southern Mongolia, indicates that deposits of copper and gold are 50% and 20% larger, respectively, than expected. This is good news for the Government, which will receive 2% royalties from Ivanhoe when the project is in full production.

⁹⁸ For example, Boroo Gold Mine received a \$50m investment in resource verification and construction by Cameco, which owns a controlling interest in the mine. Ivanhoe announced major and rich deposits in the South Gobi and raised around \$47m in equity and loan finance in 2002 to continue exploration and quantification of deposits. At a presentation in London in September 2002, the Deputy Chairman of Ivanhoe estimated that the initial concept of an open pit development at Oyu Tolgoi (Turquoise Hill) and an underground development at S.W. Oyu would require \$450 million–\$550 million and \$230 million–\$270 million in investment respectively although it is unclear to what extent these figures include the development of essential infrastructure.

149. Most domestic mining companies are owned by the private sector although the domestic share of two Mongolian-Russian JVs (Monrosvetmet LLC and Erdenet) remain state-owned,⁹⁹ Berk-Uul JSC remains 100% state owned; Mongol Bulgar Geo and Mongolia CzechMetall are JVs each 50% state owned; and Mongol Gazaar, Altandornod Mongolia, and Shijir Alt are each 20% state owned. As well as formal mining companies, a significant amount of informal gold mining takes place, which may involve as many as 100,000 persons or more.¹⁰⁰

150. Mineral licenses are managed by the Mineral Resource Authority of Mongolia under the 1997 Minerals Law (Box 2), under which the number of licenses granted private operators expanded rapidly. For example, in the past 2 years, the number of prospecting licenses tripled to 3,000 while mining production licenses increased from a few dozen to 650.¹⁰¹ This law requires mining license holders to pay royalties equal to 2.5% to central and local governments on the sale of minerals extracted; 7.5% is charged on gold.

151. **Oil.** Since the late 1990s, Mongolia has produced crude oil, the production of which had reached 71,000 barrels from the Tamsag Basin field by June 2002.¹⁰² All this oil is exported in crude form because no domestic refining capacity exists.¹⁰³

152. The Petroleum Law of 1991 allows for production sharing contracts (PSCs) with private operators. In the event that a find is exploited, the PSC determines the respective revenue shares of the state and the contractor and requires the latter to carry out exploration using its own finances. Through the use of PSCs, domestic oil production has been developed with little or no operational input from the Government. SOCO,¹⁰⁴ an American owned company, holds 85% of the interest in the Tamsag Basin, along with Hubei Oilfield Services, a company from the PRC that provides drilling services, and Petrovietnam, the Vietnamese national oil company. Tamsag Basin reserve estimates range from 300 million–1.5 billion barrels.

153. **Initiatives Required.** The IFIs have not been much involved in the mining sector, where substantial private sector investment has stimulated mineral and precious metal production. One exception is the mining sector study launched in April 2003 by the World Bank. Generally, Mongolian firms lack the financial resources to carry out large scale mining operations. The Government is aware that Mongolia must remain an attractive market for exploration and extraction by foreign mining firms. This is ensured by creating a taxation and licensing regime that offsets exploration costs, which are elevated by geographical isolation and harsh climate.

D. Tourism

154. Mongolia's enormous unfenced open spaces, stunning scenery, centuries-old nomadic culture that has survived relatively unchanged, and extensive opportunities for leisure and sport,

⁹⁹ Although Erdenet remains profitable and physical quantities of ore mined have increased modestly in recent years, resource quality has declined. It is unclear what the remaining economic life of the mine will be under present technological, market, or management conditions and what its life might be if sufficient investment is made available to upgrade facilities. EBRD is providing an external adviser to introduce better management to Erdenet and to assess the scope for technical improvements and investments.

¹⁰⁰ Cameco reports individuals' accessing old workings on the site to mine small amounts of gold bearing rock. The physical danger is significant, but company safety warnings and local police patrolling have done little to halt incursions by these "ninja miners."

¹⁰¹ *International Herald Tribune*. 2003. Mining Booms in Mongolia. 4–5 October.

¹⁰² Mongolia's Mining and Oil Sector Profile. Prepared for IFC for *Mongolia Investors Forum 2002*.

¹⁰³ Crude oil in Mongolia is not of commercial quality, and refinement is costly.

¹⁰⁴ Soco found reserves of 500 million barrels of oil in Dornod (EIU. 2003. Country Report, November).

create opportunities for the development of tourism. Notwithstanding this huge potential, official foreign investment in the sector is estimated at only \$10 million since 1990.

155. The size of the tourism industry is unknown, and estimates differ greatly. For example, the EIU estimated that nearly 78,800 tourists entered the country in the first 7 months of 2003. In contrast, the government-managed Mongolian Tourism Board (MTB) estimated the figure at around 130,000; the Mongolia Tourism Association, an NGO, placed the figure at 10,000–11,000; and the *2003 Statistical Yearbook* included a figure of 21,890. The discrepancies may depend in part on the definition of *tourist* and *tourism activity*. For example, the Mongolia Tourism Association considers a *tourist* a foreign visitor entering Mongolia for the “sole” purpose of tourism. It does not consider local residents tourists when they visit other areas of the country, nor does it consider a business visitor a tourist when spending the weekend in a countryside camp. Based on this narrow definition, the figure 10,000–11,000 may be accurate. Further attention to definitions and monitoring are needed.

156. Company registration data for 2001 (Table 3) indicate that 855 companies declared their principal business as tourism, hotels, and restaurants whereas 2,889 specified these activities as subsidiary or secondary activities. Of these latter, however, most probably are restaurant rather than tourism operators. Four-hundred-and-fifteen companies are licensed with MSE as tour operators, and a further one-hundred-and-eight are licensed as tourist camp operators. In 2002, income from the tourism sector was estimated at \$130.1 million (9.8% of GDP), and employment comprised 1.0% of total employment.¹⁰⁵

157. The tourism industry enjoys a number of benefits, introduced in the 2000 Tourism Law, including an exemption from charging VAT for hotels accommodating tourists booked through a tourist operator.

158. A number of factors, in addition to those identified in Chapter 2, impede development of this sector (Box 7). Based on harsh weather conditions, the tourism season in Mongolia is very short, and tourism companies are required to diversify or to develop new year-round tourism products. This sector has not been promoted effectively overseas, nor have adequate tour packages been developed. Many tourists discover Mongolia through personal references and make their own arrangements. Furthermore, Mongolia is a relatively expensive tourist destination: only those persons in the bordering areas of Russia¹⁰⁶ and of the PRC can realistically travel overland to Mongolia, and air travel is expensive. Within Mongolia, overland travel involves long and uncomfortable journeys, and internal air travel options are limited and raise safety concerns.

159. Moreover, no international hotel chains operate in Mongolia although more than 100 hotels (with a total of 5,000 beds) are registered in Ulaanbaatar, 81 hotels are registered at the *aimag* level, and an estimated 118 tourist camps, of which approximately one third provide traditional *gher*-type accommodations, exist in 16 *aimags*. All facilities are majority owned or fully owned by private interests.

¹⁰⁵ MTB estimates.

¹⁰⁶ Mongolia and Russia have agreed to develop a tourist area encompassing Lake Baikal in eastern Siberia and Lake Khovsgol, 250 km away in northwestern Mongolia. The project completion date, originally planned for 2009, has been advanced to 2004–2005. Because they must now travel via Ulaanbaatar, it is quite difficult for foreign visitors who are neither Mongolian nor Russian to visit both lakes in one trip. The border station at Khankh Mond, a four-hour journey from Irkutsk, in Siberia, is to be granted international status and this will facilitate traffic between the lakes. The Mongolian government will invest MNT400 million (\$355,000) in the project.

160. MTB, the government agency in charge of tourism development and regulation, has not been viewed as effective either in promoting Mongolia as an international tourist destination or in ensuring high standards of quality for the industry.

Box 7: Tourists' Perceptions of Mongolia

To better understand the type of tourists visiting Mongolia and their perceptions of it as a tourist destination, the Mongolian Tourism Association conducted, with the assistance of USAID, a survey in 2002 of 3,700 persons who had traveled to Mongolia by air. The survey found the following:

- More than half of all foreign tourists visit Mongolia on vacation while one third of all tourists are business travelers. Vacation tourists choose Mongolia over its competitors (primarily the PRC) because of the landscape, culture, history, religion, adventure opportunities, open spaces, nomadic lifestyle, and festivals. Many tourists visit Mongolia based on recommendations from friends and relatives and view Mongolia as an exotic and relatively new and unspoiled destination.
- More than half the vacation tourists were from Western Europe while one third of business travelers were from Japan or Korea. Most tourists were male (65%), and more than half were more than 40 years of age. Approximately 72% were first-time visitors; only 14% had traveled to Mongolia before. Sixty percent made independent travel arrangements to Mongolia, and only half used tour operators. Tourists stayed on average 12.74 nights, and spent approximately \$1,137/person, or \$87/day. Tourists traveling on package tours spent \$2,133/person, or \$181/day whereas independent travelers spent on average \$832/person, or \$60/day. Japanese tourists spent the most per day (\$126), followed by American (\$98) and Korean tourists (\$69).
- The most pleasant memories of tourists relate to nature, landscape, people, and hospitality; the least pleasant memories, to infrastructure, sanitary facilities, service standards, and environmental issues.

Source: Mongolian Tourism Association & USAID Competitiveness Initiative, International Tourism Survey 2002 Report of Results.

161. **Initiatives Required.** Tourism development provides a way (i) to promote and to manage Mongolia's significant ecological, environmental, and cultural assets; (ii) to raise the demand for goods and services through increased tourist arrivals and higher spending; and (iii) to decrease poverty by generating employment in tourism and related services. Unlikely ever to be a mass market, except possibly for neighboring countries, adventure and ecological tourism nevertheless offers real opportunities. To develop the industry, the Government and the private sector need to collaborate on a comprehensive strategy incorporating the following activities: (i) upgrading tourism infrastructure and facilities to create higher-quality accommodations and more cost-effective transport services (an area that ADB has been significantly involved with through its work in the aviation sector and its financing of major roads); (ii) expanding and upgrading variety and type of tourism products; (iii) developing and implementing higher product and service standards; and (iv) promoting overseas the opportunities for tourists in Mongolia.

162. MTB has been ineffectual in promoting this industry and in addressing tourist concerns; and the private sector, which is fragmented in this area, lacks adequate funding and expertise. To pool limited resources effectively, a collaborative relationship between government and industry should be developed. The public-private interface may be served better by an autonomous Tourism Board that is comprised of government and private sector representatives and is responsible for coordinating sector development, including project planning, funding, and implementation. Such a board certainly would benefit from a twinning arrangement in a similar organization in a non-competitive tourist destination. A Tourism Promotion Fund, along with adequate sector regulation, also could be developed in line with international best practice standards.

E. Manufacturing

163. The manufacturing sector is largely privately owned. Gobi Cashmere JSC, which is in the process of being privatized (Table 7), dominates in terms of size, with a turnover of MNT12.3 billion (\$11 million).

164. Analysis of this sector has been assisted by the preparation of a November 2002 United Nations Industrial Development Organization (UNIDO)/United Nations Development Programme (UNDP) study.¹⁰⁷ From 1989–2002, the manufacturing sector index declined significantly, from 100 in 1989 to 35 in 1994, and to 27 in 1999, but increased to 36 in 2001 and to 46 in 2002. The latter increase occurred when the MNT was appreciating against many currencies and thus may have been linked to the concentration of share ownership and direction, the increase in credit availability, and the effect of three SME-oriented development projects.¹⁰⁸ Increased activity also led to a change in the composition of manufacturing production. Food and beverage production increased from 33%–46%, and textile production from 18%–30% of manufacturing value added from 1990–2001 while the leather and footwear industries declined from 12% to almost 0%.

165. In parallel, employment in manufacturing declined from 27%–7% of all employment despite the growth of small businesses and microenterprises in the 1990s. The garment industry accounted for 35% of manufacturing employment in 2001 (this industry is expected to collapse after the December 2004 expiry of the WTO quota agreement unless a special status can be negotiated with major markets). Food and beverages, and textiles were ranked second and third in terms of employment. Together the three industries providing the greatest employment accounted for 78% of all manufacturing jobs.

166. The UNIDO study calculates a declining trend in labor productivity from 1993–1999, with an average value added of \$1,669 against a wage rate of \$549 annually. Interestingly, the study calculates that wage rates in the Mongolian manufacturing sector were just half those in the PRC and Indonesia in 1999, but the data may not include social security contributions, which are believed to be higher in Mongolia (19%) than in the other two countries.¹⁰⁹

167. **Initiatives Required.** The manufacturing sector has suffered from difficulties at the public-private interface and especially from difficulties with taxation, import and export, and business inspections. Moreover, within the manufacturing sector, management, marketing, and

¹⁰⁷ UNDP/UNIDO. 2002. *Mongolia: Industrial and Trade Development Policy Review*, November.

¹⁰⁸ The Dutch-funded Enterprise Restructuring Project, the EBRD Turn Around Management Project, and the GTZ SME Promotion Project.

¹⁰⁹ As of 1999. See World Development Indicators 2003.

technological changes are required urgently. Progress has been achieved when consolidation of ownership in entrepreneurial hands has led to improvements in management, finance, marketing, design, and technology. Although managing to stay in business, many manufacturing companies make scant progress towards international competitiveness.

168. A number of initiatives are required to ensure that entrepreneurs have increased access to equity capital. Measures are needed to improve the stock market's performance and to promote venture capital. Development of other financial services (innovative loan products, investment banking, leasing, and insurance) also would benefit this sector significantly, which in turn would affect the broader economy positively.

169. Some local consulting companies are beginning to emerge, but these are concerned primarily with providing financial advice. The Chamber of Commerce structure has a limited membership and is able to provide limited assistance with respect to exposure to international manufacturing trends and norms. Exposing developing SMEs to international fairs and matchmaking events, encouraging investment in new technology, and stimulating practical research and development might benefit certain businesses and industries.

170. Of more general benefit, however, would be stimulation of the investment environment through decreasing effective tax rates, improving import and export procedures, and lightening the inspection burden in a real sense.

F. Infrastructure

1. General

171. Private sector financing for infrastructure decreases the fiscal burden on the Government, lowers the cost of providing infrastructure services by introducing competition and providing market-based incentives to encourage efficiency improvements, and helps allocate and mitigate investment risks between public and private sectors. The private sector brings capital, managerial experience, and technological innovation, thereby facilitating infrastructure and capital market development.

172. In the past two decades, significant funding has been channelled by the Government into infrastructure. In very limited areas, the Government is supporting private investment in this sector although inadequate pricing reforms may render private investment in certain subsectors, e.g., power, unattractive. Moreover, the Government has adopted no overall legal and regulatory framework for private participation in infrastructure.

2. Transport

173. Because Mongolia occupies a remote geographical position and is sparsely populated, the state-maintained road network is limited, rail infrastructure serves only areas of significant economic production and external trade routes, and air transport depends on internal and external commerce.

174. **Roads.** Of a nominal network of 49,250 km of roads, only 5,517 km has been engineered.¹¹⁰ Although many roads are impassable in bad weather, this network provides the

¹¹⁰ 1,711 km is paved, 1,877 km is gravel, and 1,924 km is improved earth roads. See Mongolia's Investor's Forum 2002: Infrastructure Sector.

only surface transport link to 16 of the 21 *aimags*. Ground transport from provincial centers to the capital can take up to one week and in winter is, for most purposes, impossible. Although 95.5% of passenger journeys were carried out by road in 2001, road transport provided only 18.8% of passenger km traveled and 2.4% of all freight moved as measured in kilometer tons.¹¹¹

175. Since 1991, road improvements to link Mongolia to its two largest neighbors have been financed by a number of IFIs, including ADB.¹¹² The road north from Ulaanbaatar, through Darkhan to Altanbulag on the Russian border, and its spur to Erdenet, passes through the economic heartland of Mongolia, where an estimated 60% of GDP is generated. Upgrading and reconstructing this road led, over the period 1997–2000, to a 67% increase in traffic between Ulaanbaatar and Darkhan and to a 17% increase between Darkhan and Altanbulag.¹¹³ Resulting in improved access and decreased journey times, such improvements have led to a higher rate of business development in the Darkhan–Uul *aimag*.¹¹⁴

176. The road from east of Ulaanbaatar running southeast to the PRC border is being improved with ADB loans.¹¹⁵ The Government and ADB are discussing upgrading a second Russia–PRC road link through western Mongolia, part of a network expected to link Novosibirsk in Russia to Urumchi in northwestern PRC and to pass through some of the most disadvantaged areas of Mongolia. The Government of Mongolia is preparing a third road project from Choir to Zamyn Uud.

177. The Road Authority of Mongolia, under the Department of Roads and Transport at MOI, manages the road network. Reform of this department in the mid-1990s, carried out under the ADB's First Roads Project, achieved the separation of government functions (policy formulation, planning, regulation, and licensing) from road building, maintenance, and transport operations, which were transferred to a number of newly-formed JSCs into which private capital was in many instances injected. Ten such JSCs remain in the SPC portfolio, of which at least five have minority private sector participation.¹¹⁶

178. Financing of road maintenance is done through the Road Fund, which receives revenue from the levy of a fixed sum per liter of gasoline and diesel imported. But increased import volume has failed to compensate for the declining real value of the levy, which has been fixed for a number of years and is inadequate to fund road maintenance. For example, Road Fund expenditure in 2001 amounted to MNT4,746 million (\$4.27 million) compared with total taxes on petrol and diesel imports of MNT16,626 million (\$15.1 million). Road maintenance support thus has become increasingly dependent on growing central budget support. Even with this support, however, maintenance continues at inadequate levels. The Department of Roads and Transport focuses on contracting maintenance for roads reconstructed using donor finance and for which maintenance covenants exist; as a result, many other roads are under-maintained.¹¹⁷

¹¹¹ In 2002, road transport provided 18% and 2% of passenger km traveled and freight turnover, respectively. National Statistics Office.

¹¹² ADB. 1995. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Roads Development Project*. Manila.

¹¹³ Data from surveys carried out by the Roads Department of MOI, quoted in the ADB Mongolia CAPE, 2002.

¹¹⁴ The rate of increase of limited liability company formation in Darkhan–Uul in 2001 was 30.6%, compared with 13.2% for the country as a whole.

¹¹⁵ ADB. 1999. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Second Roads Development*. Manila.

¹¹⁶ Seven of the 10 reported profits in 2001. The Government intends to sell packages of state-owned shares of these companies through MSE before the end of 2004.

¹¹⁷ Moreover, currently only a fraction of the Road Fund is used for road maintenance. Much of the fund is used for financing new road development under ADB and World Bank projects.

179. Road transport is managed largely by the private sector. All urban taxi services and urban and inter-urban bus services are private. Most freight is hauled by private sector operators although the four state-owned trading companies have their own transport fleets.

a. Rail

180. The only rail operator in Mongolia, MNR, is a 50/50 JV of the Mongolian and Russian Governments. MNR manages the spurs to Erdenet and links Sukhbaatar on the Russian border with Zamiin Uud on the PRC border, passing through Darkhan and Ulaanbaatar and through the eastern city of Choibalsan to the Russian trans-Siberian line at Borzya. MNR transports most imports and exports and transit cargo, as well as a large portion of domestic and international passengers,¹¹⁸ and dominates freight turnover, accounting for 97.4% as measured in kilometer tons.¹¹⁹ MNR turned over MNT95.1 billion (approximately \$86.5 million) in 2001 and made a profit of MNT1.5 billion (\$1.37 million).

181. There are no plans to privatize MNR. The possibility of leasing rolling stock to train operating companies is being left open, and the Mongolian Railway Administration, the government agency responsible for managing the railway system, plans to allow other train operating companies to provide services using their own rolling stock.

182. Development of this subsector is constrained by the state monopoly and by the (i) limited or irregular access to services by most Mongolian companies,¹²⁰ (ii) use of a single railway track; (iii) use of the wide Soviet rail gauge of 1520 mm, which causes significant border delays when the wheels on passenger and freight cars are changed to accommodate the standard narrow gauge of 1435mm used by the PRC; and (iv) lack of spare parts due to obsolete equipment.

b. Civil Aviation

183. Two ADB-financed projects during the mid to late 1990s have facilitated division of air traffic regulation and infrastructure provision from airline operations, spinning off the 100% state-owned airline company MIAT¹²¹ and establishing the Civil Aviation Authority (CAA) under MOI. MIAT is the only Mongolian international airline linking Mongolia to Korea, Japan, Russia, the PRC, and Germany on a year-round basis. MIAT's market share in international flights has

¹¹⁸ The system handles just 4.2% of passenger journeys but 53.9% of passenger turnover measured in passenger km. *American Business Guide to Mongolia*, 2003. Third Edition.

¹¹⁹ Of total rail freight turnover, local freight transport has risen only moderately since 1995 while international trade, driven by a 16-fold explosion in transit traffic between Russia and the PRC between 1995 and 2001, has expanded rapidly and now comprises 68.8% of total turnover. The expansion of international freight has led to significant opportunities for local private-owned freight forwarders such as Tuushin Freight Forwarders and for international companies such as Maersk Sealand, which has a representative office in Ulaanbaatar but is not registered locally.

¹²⁰ Given the domination of railway transit traffic between Russia and the PRC, schedules are arranged primarily to suit large traders and freight forwarders. Mongolian companies on the route, with the exception of Erdenet, complain that they have irregular or no access to services.

¹²¹ ADB. 1993. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for the Ulaanbaatar Airport*. Manila; and ADB. 1993. *Technical Assistance to Mongolia for Institutional Strengthening of the Civil Aviation Sector and National Air Safety Master Plan*. Manila. ADB. 1995. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for the National Air Navigation Development Project*. Manila; ADB. 1995. *Technical Assistance to Mongolia for Phase II Institutional Strengthening of the Civil Aviation Sector*. Manila.

shrunk, however, as a result of the increased competition provided by international airlines such as Aeroflot, Korean Airlines, Japan Airlines, and Air China. Passenger air transport is highly seasonal and some airlines (e.g., Japan Airlines) operate only during peak summer season.

184. MIAT also runs a network of national routes linking Ulaanbaatar with 21 *aimag* centers, only four of which have paved runways with basic lighting systems. MIAT's domestic airplane fleet averages nearly 30 years' service (the mandatory retirement age imposed by CAA) and are not fuel-efficient. MIAT lacks funds to replace its domestic fleet, and the cost—and cash flow—strain is aggravated by the CAA requirement that MIAT serve low-volume routes even at a loss. Restrictions on domestic tariffs mean that the value of ticket prices on these routes have fallen by 40% since 1994.¹²²

185. In 2001, MIAT reported revenues of MNT45 billion (\$40.9 million), reflecting an increase of 15.7% in international passenger numbers since 2000 and of 72.4% since 1995, and declared a profit of MNT1.0 billion (approximately \$0.91 million). In 2002, MIAT reported revenues of MNT52.9 billion (\$447 million) and declared a pretax profit of MNT1.01 billion (\$898 million), figures based largely on international airline revenues.¹²³ Lower-than-expected tourist arrivals in 2003, a result of the SARS outbreak,¹²⁴ have affected MIAT's bottomline adversely.

186. In 2003, a new domestic airline, Aero Mongolia, a private, foreign-Mongolian JV, commenced operations with two Fokker aircrafts. Aero Mongolia received permission to increase tariffs by 15% this year, and subsequent increases are promised annually. By operating flights among the five busiest domestic airports, Aero Mongolia is competing directly with MIAT, which has not been permitted to increase its tariff.

187. In addition to regulating airlines (entry, safety), CAA provides airport and support services (ground handling, maintaining aircraft, catering, fuel supply,¹²⁵ airport management, and air traffic control) and has benefited greatly from improvements to the national Buyant Ukha airport and associated air traffic control systems financed by ADB between 1994 and 2000.¹²⁶ As a result of improved air traffic control systems, which now meet international standards, revenues from overflying rights have increased dramatically. Further substantial investment is required if regional airports are to be improved, the fleet upgraded, and booking systems brought up to international standards. It is unlikely that such investment can be mobilized from state operators and the central budget. This is especially the case insofar as international agreements on overflying rights are due to be renegotiated shortly, possibly leading to a drop in CAA revenue. In 2001, CAA had lower operational revenues than the prior year (MNT23.8 billion, or approximately \$21.6 million) and declared profits of MNT3.9 billion (approximately \$3.5 million).

188. ADB is providing TA to CAA in developing a forward-looking aviation policy, including a regulatory framework and new private sector management and finance. ADB is working closely

¹²² Mongolian travellers obtain a 79% discount on published domestic tariffs whereas foreign travellers pay the full-published fare.

¹²³ In 2002, domestic airline services lost approximately MNT2.8 billion. See Phase I report of ADB. 2002. *Technical Assistance to Mongolia for Civil Aviation Policy Development*. Manila.

¹²⁴ In the first seven months of 2003, the number of foreign visitors fell by 21% year on year, to 78,800, and tourist income declined by 26%, to \$16 million (EIU Country Report. 2003, November).

¹²⁵ Fuel supply has been partly privatized. Privately owned A Jet JSC handles certain activities in this area. See Phase II report of ADB. 2002. *Technical Assistance to Mongolia for Civil Aviation Policy Development*. Manila, 25 August 2003.

¹²⁶ See Phase I report of ADB. 2002. *Technical Assistance to Mongolia for Civil Aviation Policy Development*. Manila, Nathan Associates, 30 May 2003.

with EBRD, which recently prepared a roadmap for the sector and began financing a foreign management team for MIAT¹²⁷ for 1 year, to advance the possibility of sale.

c. Initiatives Required

189. Generally speaking, reform within the transport sector has been significant. A number of key roads have been upgraded, public road transport services have been privatized, and the private sector is involved in road construction and maintenance. The extent of this reform, however, is limited by the Government's reluctance to finance the Road Fund to a level sufficient to maintain the existing road network fully. Rail transport has grown impressively while technical and managerial improvements made within the civil aviation subsector have permitted rapid revenue growth. Major challenges remain, however.

190. State reluctance to challenge the rail monopoly has, arguably, limited both service innovation within the railways and user choice. If the rail network is to expand, then the private sector will need to be involved in both its finance and operation. Within the civil aviation subsector, the possible abolition of overflying fees will require strategic planning on the part of the Government. Assistance in this area will help safeguard the technical and financial advances already made. Orderly development of the aviation sector depends on the future of the loss making domestic market, an issue that will need to be resolved before MIAT is privatized. Additional attention to institutional reform and to regional infrastructure would be economically beneficial given that surface transport in Mongolia will never be able to provide comprehensive geographical coverage.

3. Power

191. The private sector has not played a major role in power generation.¹²⁸ During the last decade, the Government has concentrated on rehabilitating aging infrastructure, extending the working lives of power plants, and extracting short-term supplies. MOI remains focused on new power generation through hydropower projects, but the sustainability of these plans is doubtful.

192. Mongolia has a central power system consisting of five coal-fired cogeneration power plants, which serve a majority of electricity needs. Smaller electricity and heating systems, including the Western system, are connected to Russia's Siberian grid and to the Eastern system and serve remote *aimags* and towns. Diesel generators provide power in urban centers. One third of the population receives no electricity and must rely on renewable energy equipment (e.g., solar and wind generators).

193. Significant foreign-donor (approximately \$409 million)¹²⁹ and Government funding has been committed to this sector—most to the coal-fired generation plants in Ulaanbaatar. This assistance has resulted in significant improvements in technical performance over the last

¹²⁷ The team has not been allowed to increase domestic tariffs. In order to run their profitable ground handling service, CAA wants to take back equipment, purchased with ADB funds, that they are leasing.

¹²⁸ The only exception remains the import and sale of private solar power units used by certain nomadic herders.

¹²⁹ EBRD is financing a long-term privatization advisor. Darkhan Selenge network was privatized in November. The next major target for privatization, Ulaanbaatar Distribution Company, is obtaining assistance for financial management under a World Bank credit.

decade.¹³⁰ Supply losses due to shutdowns were decreased to around 5% of levels seen in 1992, and power imports from Russia were decreased from 381 giga-watt hours in 1995 to 196 giga-watt hours in 2001. The system remains quite inefficient, however. Losses have increased and most generating, transmission, and delivery companies do not break even. Current tariffs, combined with such inefficiencies, do not cover cost. Only small firms can make a profit under current circumstances.

194. A new Energy Law was adopted in 2001 to enable reform of this sector through the processes of unbundling, commercializing, and privatizing. The process, supported principally by World Bank and USAID, resulted in 2001 in the break-up of the energy complex, previously under the sole control of the Energy Authority, into a regulatory body (the Energy Regulatory Authority) and 18 independent entities that have been corporatized.¹³¹ The Energy Regulatory Authority is responsible for supervising commercialization and privatization of the industry and for collecting the debt accrued to date, including systemwide financial issues such as tariffs and return on capital employed.

195. Initiatives Required. A comprehensive government strategy supported by a number of IFIs and bilateral donors is in place to develop this sector, which may lead to the possible involvement of private capital and management within the next few years. Whether private capital will be attracted remains to be seen, but currently new donor initiatives, like activities already planned, are not required to attract private sector involvement or to service private sector users more effectively.

4. Water

196. Public water-intake and treatment facilities in Mongolia have a capacity of greater than 550,000 cubic meters/day and serve 81% of the urban population, but only 3% of *soum* populations. More than 100 piped-water systems drawing on deep well supplies serve the latter; water tankers often serve peri-urban consumers.

197. Most cities and towns are served by sewage systems with a treatment capacity of 400,000 cu.m. Most urban areas have solid-waste collection and disposal systems although funding shortages often prevent full compliance with environmental standards. At the end of 2000, only 37% of the urban population had access to waste disposal services.

198. The private sector has no role in the provision of water and sanitation services. Construction, urban development, and public utility agencies, which report to the provincial government and are responsible for tariff setting, delivery, and system management, are facing considerable technical and financial difficulties in providing services. The ADB-financed Second Urban Services project, now working with eight towns in the eastern part of Mongolia to upgrade

¹³⁰ In 1991, this sector not only suffered from lack of generation investment, but was also impeded by systematic inabilities to measure output, transmission, and distribution volumes, as a result of the absence of meters at substations and end-users. Users could not be charged according to use, but only according to their size or type. Although the situation is now much more equitably managed, metering is far from universal.

¹³¹ The 18 companies include 8 generating companies, 4 electricity distribution companies, 2 heat distribution companies, the central electricity transmission network, the national dispatch center, the eastern electricity center (a stand-alone power system), and the western electricity transmission network (also a stand-alone center). See USAID. *USAID 2003–2010 Report: Contributions to Mongolia's Sustainable Energy Strategy*.

municipal services, envisages the development of a strategy for private sector involvement in such services during 2004.¹³²

5. Communications

199. **Telecommunications.** Structural reform in the telecommunications sector, which began in 1994, separated telecommunication operations from postal services and from regulation now overseen by the Communications Regulatory Commission under the Telecommunications Law.¹³³ These reforms led to significant improvements in telecommunications infrastructure.¹³⁴ The Government sold 40% of Mongol Telecom (MT) to Korea Telecom in 1995, but continued to own and to manage network and housing facilities, which it leased to other telecom providers.

200. Several JVs with private foreign mobile phone operators began to enter the market in 1995. Mobicom, a JV between private Japanese and Mongolian investors, was the first and continues to hold the largest market share, followed by the entry of Skytel, a JV between Mongolian and Korean investors, and most recently by MT in January 2003. At the end of 2002, there were 256,000 cellular phone users, compared with 48,200 in 1999. Entry of private telecom operators resulted in the significant lowering of international tariffs. For example, international tariffs were in the range of \$1.40–\$1.80/min in 2001 compared with \$2.20–\$6.00/min in 1996.

201. The Government is restructuring MT with a view toward preparing it for full privatization in the near term, but debate continues regarding the extent to which government-owned infrastructure should be privatized.

202. **Information and Communications Technology.** Rapid improvements in telecommunications infrastructure and pricing led to an equally rapid expansion in the information and communications technology (ICT) industry. In 1996, the first Internet link was established. Currently, 11 companies are licensed as Internet service providers. MagicNet seems to dominate the industry. Private Internet cafes and noncommercial Internet centers, financed by UNDP and the Open Society Foundation, offer inexpensive access to the general public and to small businesses in the capital and Darkhan; outside these cities access is more limited.

203. Approximately 60 private companies and 60 developers are involved in software development.¹³⁵ Annual revenue for the industry is estimated at \$3 million. The industry is highly fragmented, however; its workers have limited specialization, management, and marketing skills; and most of its large projects are outsourced to Russia or to India.

¹³² ADB. 2001. *Technical Assistance to Mongolia for Preparing the Integrated Development of Basic Urban Services in Secondary Towns*. Manila.

¹³³ ADB assisted in restructuring this sector. ADB. 1992. *Technical Assistance to Mongolia for Telecommunications Development Plan*. Manila; ADB. 1994. *Technical Assistance to Mongolia for Sector Reform*. Manila; ADB. 1994. *Technical Assistance to Mongolia for Accounting and Management Systems and Tariff Reform*. Manila; and ADB. 1994. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Telecommunications*. Manila.

¹³⁴ In the late 1990s, new exchange lines, external lines, and digital links were installed that resulted in enormous growth in the volume of traffic that could be handled by MT and the speed at which it could be handled. The number of landline calls made in the five *aimags* covered by the first phase of modernization grew by a factor of 4.1 over the 1997–2001 period at the same time as time-based tariffs for local calls were introduced. A second phase of development in the last 2–3 years has seen the benefits of modernization extended to a number of *aimag* centers.

¹³⁵ Information drawn from a Profile of the ICT sector in Mongolia. IFC. 2002, August.

204. Through establishment of a National ICT Committee headed by the prime minister, and through publication of ICT Vision 2010, an initiative to improve and expand ICT in Mongolia, which was endorsed by Parliament in 2000, the Government has underlined the importance of ICT. Although the private sector is driving the industry, the Government plans to upgrade ICT capacity within schools and CGA.¹³⁶ These initiatives are supported by and executed in part through the Mongolian Development Gateway, which aims to promote technology to facilitate governance and management in public and private sectors. Infodev and World Bank are cofinancing the gateway. World Bank also is providing assistance in the drafting of the new E-Commerce Law.

205. **Initiatives Required.** Progress made in the telecommunications sector, supported by the ADB in the mid-1990s, has been impressive. Technical improvements and liberalization encouraged foreign capital, tariffs dropped, and usage soared. Subsequent improvements in the regions spread modern telecommunications more widely. But the Government's reluctance to privatize core assets, and weak and unpredictable regulation (e.g., tariffs), constrain further development. Consideration of alternative strategies is required if the private sector is to keep pace with international developments in this area.

206. Information technology has yet to have a noteworthy effect on the efficiency of public services. Improved systems within GDNT and CGA could aid in effectiveness and efficiency of revenue collection while improving transparency and allowing more sophisticated analyses of the revenue base. Within the private sector, further technical and personnel development will enable the industry to capture an increasing share of the local market for software development, but it is unlikely that Mongolia will be able to compete for the IT outsourcing business of international companies.

G. Finance

207. In 2002, the financial sector was relatively small in terms of its contribution to GDP (3.2%) and total employment (1.1%). In recent years, the informal financial sector has expanded rapidly while the commercial banking sector has undergone significant restructuring.¹³⁷ Capital markets, insurance, and leasing remain underdeveloped.

1. Commercial Banks

208. **Banking.** Accounting for 81% of total financial assets of \$439 million in 2002, and reaching 40% of GDP (an increase of 48% from 2001 figures [MNT332.7 billion, or \$302.4 million]), commercial banks dominate the financial system.¹³⁸ At the end of 2002, 16 commercial banks operated in Mongolia. The top five banks, all privately owned, included TDB (which is foreign owned), Golomt, Anod Bank, Agricultural Bank (Ag Bank, also foreign owned), and Zoos Bank. TDB had the largest asset base (33% total in March 2002) and loan portfolio,

¹³⁶ ICT in schools will be assisted under the ADB-financed loan. ADB. 2002. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Second Education Development Project*. Manila.

¹³⁷ For a more extensive discussion of this sector, see ADB. 2000. *Technical Assistance to Mongolia for Strengthening Financial Sector Development*. Manila, and the annex to the 2002 ADB Country Assistance Programme Evaluation (CAPE), which deals with financial system development.

¹³⁸ Reforms during the early 1990s, supported extensively by IFIs, saw the original state bank broken up into five commercial banks, only one of which, Trade and Development Bank, remains. Starting in 1996, the insolvency and failure of the state-owned banks dramatically reduced public confidence in the banking sector. That confidence (as measured by growing deposit levels) has been restored and strengthened considerably.

the majority of which was denominated in foreign currency. ADB's board has been presented with a proposal for ADB to acquire a \$10 million ownership stake in TDB. The state-owned Savings Bank has the largest amount of retail deposits although its asset base, equal to 14% of total commercial bank assets, is composed largely of nontradable government bonds.¹³⁹ Ag Bank has the largest number of branch networks (371) and extends into rural areas; it also has the largest portfolio of individual borrowers.

209. **Background.** Reforms during the 1990s, supported extensively by IFIs, witnessed the subdivision of the original state bank into five commercial banks, only one of which, TDB, remains (Appendix 5). Liquidation of insolvent state banks in the 1990s, and the physical shortage of bank notes that limited withdrawals, diminished public confidence in the banking sector. Liquidation left a number of large borrowers with capital that has been difficult to reclaim.¹⁴⁰ It is only in the last 2–3 years that confidence has been restored.

210. **Regulation.** Banks in Mongolia are regulated primarily under the Banking Law of Mongolia and by BOM. BOM has received significant assistance from ADB, World Bank, and other donors to upgrade, inter alia, legal and regulatory frameworks, and onsite examination and offsite surveillance tools and techniques. Much of this donor assistance was provided in the context of bank restructuring/liquidation. BOM has been able to maintain a core staff of qualified individuals, many of whom have studied finance and economics in Western countries and received advanced degrees. As of April 2003, the Supervision Department of BOM employed 40 staff overseeing 16 commercial banks and 66 NBFIs.

211. **Lending.** In 2002, loans to the private sector grew by 78%, from MNT114.7 billion (\$104.3 million) in 2001 to MNT203.6 billion (\$180.9 million), and represented 88% of total outstanding loans (MNT231 billion, or \$205.7 million)¹⁴¹ (Appendix 8). As of March 2002, 97% of all outstanding loans were given by privately owned banks, and 84% of loans went to the private sector. More than 70% of commercial bank lending was made to finance working capital activities, typically short-term inventory financing followed by raw-material processing (e.g., animal skins) and mining (Appendix 9).

212. Because borrower financial statements regarding cash flow are often unreliable, lending decisions generally are based on personal references, physical evidence, and the availability of collateral, which is generally more than 1.5 times the loan amount. The BOM requires banks to register basic borrower information with all loans with its Credit Information Bureau.¹⁴² The most recent reliable year-end rate for nonperforming loans is quite low, but the rapid expansion of lending (60% annual growth rate in banking assets since 2000) may have been accompanied by more lax credit underwriting standards.¹⁴³ Commercial banks clearly have improved the level of service to consumers and to the private sector dramatically; in turn, confidence in banks as depository institutions has grown. Improved confidence in the sector is due to the strong leadership of BOM, the dramatic turnaround of Ag Bank, the emergence of Xac Bank, and the

¹³⁹ Annex to the 2002 CAPE on Financial System Development.

¹⁴⁰ Approximately MNT48 billion (\$43.6 million) of assets were transferred to the Mongolian Asset Restructuring Agency, an SOE, from five insolvent banks. As of September 2002, only MNT7 billion (\$6.4 million) had been realized although court judgments had been obtained for repayment of a further MNT19.7 million (\$17,900).

¹⁴¹ In 2002, a total of MNT469.9 billion of loans were granted.

¹⁴² With World Bank assistance, BOM credit information bureau's software system is being upgraded.

¹⁴³ In 2002, the rate of nonperforming loans stood at 7.2%, down 0.8% from 2001. This rate may have risen above 10% at the end of 2003, according to a very concerned CEO of one of the country's largest banks, who reported this possibility to ADB staff. Fears of deteriorating credit quality were shared widely by other bankers with whom ADB staff held detailed conversations in early 2004.

continued solid performance of TDB and Golomt Bank. Improved public perception of commercial banks is a signal achievement, but the recent rapid credit expansion, fueled by a rise in deposits, is cause for alarm. Noteworthy consolidation and strengthening of the banking sector over the past 5 years could be undone if bank loan portfolios are not being soundly managed. BOM is duly alarmed and has taken measures to slow lending growth; it will impose higher minimum capital requirements (\$6 million) on banks before the close of 2004.

2. Capital Market

213. The stock market in Mongolia does not play a meaningful role in the economy. The MSE, founded in 1991 as a government agency reporting to Parliament, has facilitated reallocation of property rights but has never provided a venue to raise capital.¹⁴⁴ Based on its limited role, MSE has operated at a loss for several years and requires support of the state budget to maintain solvency.¹⁴⁵

214. Although approximately 1.3 million persons (86% of the population) became shareholders as a result of privatization, some years passed before share ownership became consolidated. Consolidation of ownership has, in some cases, led to an increase in shareholder pressure on management, changes in management, and an upturn in company performance. Currently 2,400 shareholders own 83% of the shares of MSE-listed companies, and companies owned by three to eight large shareholders constitute a majority of MSE-listed companies. The concentration of share ownership has not led to improved transparency of better corporate governance.

215. At the end of 2002, 403 companies that had been privatized through the mass voucher privatization scheme were listed on MSE, of which 61 remained state owned.¹⁴⁶ Many are not operating, most remain unprofitable,¹⁴⁷ and fewer than 20 pay dividends or are traded regularly. No newly formed private companies have been listed on MSE.

216. Since 1995, there have been approximately 34 issues of equity by listed companies, raising some MNT4 billion (\$3.6 million), and 50 commercial bond issues, raising almost MNT30 billion (\$26.7 million). In 2002, there were three issues of corporate bonds valued at \$1.9 million, all issued to finance apartment construction. Although sales were carried out through MSE, they were preplaced and not offered to the public at large. Trading in listed shares has declined steadily from its peak value in 1997 (MNT12.2 billion) and from its peak volume in 2000 (35.4 million shares). Currently, liquidity in the market is low to nonexistent. Between 2001 and 2002, trading volume declined nearly 40%, to just 9.2 million shares valued at MNT1.4 billion. In 2002, trade in the top 30 stocks accounted for 97.1% of all trades.

217. Since BOM stopped issuing debt directly to banks in November 2000, short-term government securities have been auctioned on MSE through securities company members and

¹⁴⁴ Secondary trading did not begin until 1995.

¹⁴⁵ The ADB-financed Financial Sector Improvement Project report discusses options for improving MSE's structure and management.

¹⁴⁶ Listed companies are categorized by MSE according to performance: Class A shares are required to generate greater than a 5% return on assets, to have a minimum market capitalization of MNT30 million, to have no fewer than 200 shareholders, and to have been in business for at least five years. The A category shares comprise Spirt Bal Buram, MT, Ulaanbaatar Hotel, and Bayangol Hotel; the B category shares comprise APU, Atar Urguu, Darkhan MakhExpo, and Tahi Company.

¹⁴⁷ Approximately 60 listed companies are insolvent but have not yet been delisted. Interview with MSEC and MSE Chairmen.

have been placed primarily with commercial banks. These auctions have succeeded in increasing competition on the primary market and now dominate MSE business, representing 91.3% of all business by value (MNT86.26 billion, or \$76.6 million) in 2002, a 76% increase in value from 2001 levels.¹⁴⁸

218. At the end of 2002, MSE trades had been executed through 34 registered securities companies, down from 42 in 2001. Based on new net capital requirements under the recently amended Securities Law (increased from MNT10 million to 50 million), only eight brokers, all of which are private, are currently registered with MSEC and qualify for MSE membership. There is one investment fund member of MSE, down from sixteen in 2001.¹⁴⁹

219. MSE is regulated by MSEC, which does not have the capacity to carry out fully its functions stipulated under the Law on Securities Markets, which was enacted in December 2002. Currently MSEC has 20 staff, including 4 lawyers and 13 accountants. It is viewed as an ineffective market regulator partly as a result of the lack of transparency in company reporting. This lack of transparency is the result of poorly developed accounting, auditing, and corporate governance standards, combined with a corporate culture that would avoid the responsibilities of regulation and taxation. The current tax structure, with higher taxes levied on larger companies, may encourage firms to split their businesses into smaller units. This practice undermines transparency insofar as smaller firms actually are operating as a coordinated unit.¹⁵⁰

220. As companies grow and new opportunities arise, enterprises require risk capital in the form of equity financing. Given the state of MSE, large companies may look at issuing capital on foreign stock markets (at best, an unlikely avenue) or employ a tactic that has gained wide currency, namely, finding a foreign investment partner. There may be ways to expand the role of MSE, but the lack of strong corporate governance, accounting, and auditing standards represent substantial impediments to the development of a public stock exchange. Upgrading of skills within the accounting and auditing professions, leading to increased transparency, and widespread adoption of good governance practices, are necessary preconditions for MSE to develop as a venue for raising equity capital. It would be worthwhile to develop alternative mechanisms, e.g., investment or pension funds, for channeling risk capital to deserving companies. Furthermore, in such a small market and in the absence of other investment vehicles, universal banking may be a more appropriate model than a stock exchange for developing equity finance. Mongolia's commercial banks are demonstrating increasing mastery of basic front and back office functions and these same banks might be able to develop, slowly and carefully, corporate finance and equity-related businesses. Well-run commercial banks have advantages in terms of market and client information, can build on evolving risk management systems, and may be able to deepen staff capacities in finance.

¹⁴⁸ The short maturity of the bonds means that there has been no secondary trading and no government debt yield curve, important for guiding commercial lending beyond the very short term.

¹⁴⁹ Investment funds were established in each *aimag* at the time of mass privatization in order to allow voucher holders to invest in a broad selection of shares, rather than to invest in individual companies. Currently there is little or no demand for broad-based investment funds.

¹⁵⁰ Though this feature of the tax code and its ill effects are often commented upon, there are no figures available to show either how many firms have split to avoid taxation or the extent of the negative impact on tax collections. Certain government observers believe that the tax code is an excuse used to justify simple tax evasion.

3. Insurance and Pension

221. The insurance industry in Mongolia remains underdeveloped despite the existence of 18 licensed insurance companies.¹⁵¹ Annual premium income for 2002 amounted to MNT6.1 billion (\$5.5 million) (0.5% of GDP), of which the largest insurance company, Mongol Daatgal Insurance Company, accounted for 79.3%. The industry does not enjoy a good reputation, for claims often go unpaid and most if not all companies offering insurance products are unable to manage significant risks. Although the Insurance Law, originally adopted in 2001 and recently amended,¹⁵² allows insurance companies to use up to 30% of their required reserves (60% of their premiums) to invest in government securities and other reliable long-term securities, including company shares, most insurance companies keep their money in various bank accounts and cash. Alternative long-term, low-risk liquid securities are not available to them.

222. A unit of the Professional Supervision Service within the Prime Minister's Office plays the role of insurance regulator. The regulator has very limited capability and currently has only six full-time staff, none of whom are trained insurance professionals. To date, little attention has been paid this subsector by international donors. Although the draft law on insurance prepared under ADB's Second Financial Sector Program Loan incorporates solvency and prudential requirements in line with international standards, further assistance is required to develop the regulatory framework and to ensure compliance.

223. The national pension scheme is a government budget supported, pay-as-you-go system open to private-company employees. The fund is severely underfinanced due to large contribution arrears and to the narrow base of pension contributions relative to the coverage of pension recipients. In view of the important role that institutional investors can play in catalyzing capital market development, the promotion of insurance and pension funds should be an integral part of the medium-term financial development strategy. The present system, like most pay-as-you-go systems in other transitional economies, is not viable and ultimately must be replaced. Defined contribution schemes are unknown in the country, and no enabling legislation exists to allow for their formation, as in the case of Kazakhstan, where the legal framework for pension reform was laid in 1996–1997 and private pension funds are now operating. A dearth of life insurance products, combined with a lack of commercial pension schemes means that citizens of Mongolia have practically no long-term savings option other than that of maintaining savings accounts at banks.

4. Microfinance

224. Mongolia's microfinance sector is fairly robust. Both Ag Bank and Xac Bank serve a large and growing micro-enterprise clientele. In addition to these large, profitable financial institutions, SCCs have expanded rapidly in recent years, in a largely unregulated environment,

¹⁵¹ After the sale of Mongol Daatgal insurance Company to Russian interests in alliance with Chinggis Khan Bank in December 2003 (\$5.8 million purchase price), the insurance firm Tushig Daatgal, which underwrites only agricultural risks, alone remained state owned. The other 16 insurers are private companies.

¹⁵² Under this law, prudential guidelines do not exist though basic licensing criteria do. Barriers to entry are low. To promote development of this market, MOFE initially prepared a new draft Insurance Law that was rejected by MOJ. With USAID assistance, MOJ subsequently developed a new draft framework incorporating international best practice standards. See Carpenter, Richard. 2003. Mongolia Insurance Law Review. Draft Final Report. Development Alternatives, Inc., USAID, 19 February 2003. ADB provided additional assistance, which resulted in preparation of a new draft that was submitted to Parliament for approval by the Cabinet of Ministers in September 2003. See TA 3459-MON (footnote 137). The revised insurance law was approved in April 2004.

to fill a void in the provision of credit in rural areas. Some NGOs also are active providers of microcredit, particularly in more isolated rural areas where commercial opportunities are fewer.

225. NBFIs, which are prohibited from accepting deposits, are regulated by BOM under the 2002 Law on Non Bank Financial Activities, which imposes related accounting and prudential standards (e.g., minimum capital of \$100,000). Under this law, each NBFIs is licensed for specific activities. At the end of 2002, there were 66 NBFIs, of which 64 were licensed to engage in lending. Of these 64, 60 are located in Ulaanbaatar, reflecting the urban nature of such institutions. The largest, Chinggis Khan, which has recently applied for a banking license, accounts for \$30 million of the total asset size (\$40 million) of NBFIs. Apart from Chinggis Khaan, most NBFIs have little more than the required minimum capital, are incorporated as limited liability companies, and are owned by a single individual, family, or group of closely related individuals. Lending consists of small, short-term loans to SMEs, mainly for working capital. Loans are collateralized heavily.

226. SCCs began to develop in 1996, with assistance from ADB's Employment Generation Project.¹⁵³ Five-hundred-and-seventy SCCs, up from 6 in 1996 and 98 in 2000, have been registered in Mongolia, though only 282 are believed to be operating. Of these 282 functioning SCCs, 166 are located in Ulaanbaatar; the remaining 116 operate outside the capital. Fourteen of the SCCs have total assets of greater than MNT500 million (\$425,000), and another 24 have assets between MNT100 million and MNT500 million. This group of SCCs accounts for more than 87% of total SCC assets, and all 38 SCCs are located in Ulaanbaatar. Average asset size of the rural SCCs is quite small, at MNT22 million (\$19,000). In terms of membership, there are 22,200 SCC members nationwide, of which 6,800 are in rural areas and 15,400 are in Ulaanbaatar. Total loans and deposits within the SCC system have increased three times since 2002, and the total assets of Mongolian SCCs now amount to more than 6% of total banking sector assets.¹⁵⁴

227. Netmon, a licensed NBFIs owned by Xac Bank, lends to 51 SCCs (comprised of 4,780 members) through its wholesale lending program.¹⁵⁵ Applicants are screened through an evaluation system based on World Council of Credit Unions principles. Netmon charges 2–3%/month on wholesale loans, depending on loan conditions. At the end of 2002, Netmon had \$118,000 of loans outstanding to SCCs, of which 13.5% were considered at risk. Netmon has disbursed a cumulative \$515,000 since start-up, of which 52% has been lent to rural SCCs. Xac Bank's management is interested in developing this business model further, with SCC clients serving as de facto retail "affiliates" serviced by Xac Bank. At the same time, Netmon has been absorbed into Xac, with its activities fully integrated into Xac Bank's.

228. Although no data are available on the use of loan proceeds by SCC clients, it is assumed that demand is primarily for consumption, MSE working capital, and agriculture-related purposes. As such, SCCs play a useful role in bridging the gap between commercial banks, on the one hand, and Lombards, on the other—the former requiring travel to a branch facility, a formal application, security and preferably a credit history; the latter requiring collateral deposits and demanding a very high rate of interest.

¹⁵³ ADB. 1993. *Technical Assistance to Mongolia for Employment Generation*. Manila. See also Moyes, R. T. and Ira Singh. 2000. *Mongolia Microfinance Market Assessment: Towards an Efficient and Private Sector Led Microfinance Market*. Abridged Version. Prepared for IFC, Market Study, July (DAI).

¹⁵⁴ Data from an unpublished May 2004 draft of a country diagnostic report on rural finance in Mongolia, sponsored under a regional TA, REG-6078: Rural Finance in Central Asian Republics. Robert Vogel.

¹⁵⁵ Netmon, which was established in 2000 with a grant of \$12,000 from UNDP, is responsible for wholesale financing of SCCs.

229. The ADB-financed Rural Finance Project¹⁵⁶ is assisting in the development of a regulatory and supervisory environment for SCCs. MOJ is currently drafting a new law to govern SCCs, which are now covered under the Cooperative Law.¹⁵⁷ The project team provided a model SCC law to MOJ in May 2004. BOM has been given the mandate to regulate SCCs by Parliament until new legislation is in place; SCCs have been operating essentially in regulatory vacuum since the first SCCs were set up in 1995 under the ADB Employment Generation Project. The recently enacted Insurance Law (April 2004) calls for the creation of a Financial Regulatory Commission that would assume responsibility for regulation and supervision of all NBFIs, including SCCs. Arguably, even after the Financial Regulatory Commission begins operations, it may be advisable that BOM retain responsibility for the SCCs because SCCs operate essentially like small banks. In any event, the ADB Rural Finance Project to date has been helpful in providing a conceptually sound draft law and an appropriate set of regulations, and is engaged in creating some practical supervisory systems. The project is also delivering capacity building and training to rural SCCs in 4 pilot *aimags*.

5. Leasing

230. One licensed leasing company currently operates in Mongolia. This private company leases office equipment, vehicles, and other assets and competes with large but unlicensed machinery and vehicle sales companies. IFC is planning to provide assistance to this subsector, following an earlier study of leasing operations and collaboration with the Government on a draft leasing legislation. IFC plans to link the project with the successful IFC-supported Russia Leasing Development Group, operational since 1997.¹⁵⁸

6. Initiatives Required

231. Recognizing the importance of the financial sector to the development of the economy as a whole, the Government has placed considerable emphasis on development of this sector. BOM is enforcing higher commercial-bank capital requirements, which are expected to lead to further industry consolidation; the State has largely divested itself of its bank interests; and foreign capital and expertise have entered the sector. Banks need to strengthen lending procedures, develop their corporate cultures, and introduce new loan products. Foreign investor involvement and competitive pressures should lead to improved financial services. Certainly, there is now less scope for government or donor intervention in the commercial banking sector, except to enforce prudential regulations and to provide strong supervision.

232. Most of the external assistance provided has been concentrated on commercial banks, and their performance indeed improved dramatically from 1999 through the end of 2002. Solvency is high, lending has expanded dramatically, and bank profitability has permitted further investment in, for example, ATMs, computerization, and ameliorated employee conditions.

233. Although the financial sector, mainly banks, has developed dramatically in recent years, reform momentum must be sustained and financial markets broadened and deepened. Now that commercial banks are providing basic financial services, it may be time to pay closer attention to development of NBFIs. Mongolian enterprises need equity and venture capital. A lack of

¹⁵⁶ ADB. 2001. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Rural Finance Project*. Manila.

¹⁵⁷ The Cooperative Law sets out registration and other legal requirements governing SCCs and is overseen by GDNT, an administrative unit under MOFE.

¹⁵⁸ The proposed Mongolia Leasing Development Project is a 2-year TA initiative based on an earlier IFC study of the Mongolian situation carried out by S. Amembal and S. Gilyeart.

equity finance is a critical and chronic constraint to business development and negatively affects both employment growth and poverty alleviation. Improved financial reporting within private companies is essential to the creation of an investment culture. Financial skills, transparency, and governance must be improved to create an environment that can attract institutional, strategic, and portfolio investors. Equity markets can be developed through commercial bank subsidiaries, investment and pension funds, legal and management improvements to the stock exchange, and insurance companies.

234. Focused almost exclusively on property and casualty coverage, and failing to tap its leasing potential, the insurance industry is in an early stage of development. That insurance and leasing products often are sourced internationally highlights the inefficiency of local providers. Leasing and insurance companies need assistance in product development and management whereas potential customers need more accurate and comprehensive information about the features and benefits of these products. Like commercial banking, insurance is a sector to which foreign investors can contribute technical, financial, and marketing know-how.

235. The microfinance sector has expanded rapidly, and there are clear indications that credit is increasingly available in poor rural areas, where SCCs play a potentially important role. To promote development of SCCs in a safe and sound manner, the Government is adopting a legal and regulatory framework to be implemented by BOM through a framework supported by the ADB's Rural Finance Project.¹⁵⁹

236. ADB approved a TA in December 2003 to assist the Government of Mongolia in strengthening NBFIs. This \$589,000 Project Preparatory TA (PPTA) supports development of a follow-on program loan for 2005. In addition to creating a long-term strategy, the TA will produce governance and regulatory and supervisory standards for NBFIs and will streamline the regulatory and supervisory framework.¹⁶⁰

¹⁵⁹ SCCs are required to register with GDNT. Under the project, GDNT and BOM undertook a census of the exact number of SCCs that are (i) registered and (ii) actually operating, resulting in the numbers reported in para. 226.

¹⁶⁰ ADB. 2003. *Technical Assistance to Mongolia for Preparing the Third Financial Sector Program Loan*. Manila. There is substantial rationale for streamlining and improving the regulatory and supervisory regimes related to different parts of the financial sector. Capacity constraints of individual regulatory agencies, and small market size, particularly of the nonbank financial sector, provide a strong rationale for consolidating regulation and supervision of NBFIs and capital markets. Based on concerns regarding lack of information about this subsector, the rapid growth of SCCs and the potential for abuse, in April the Ikh Hural resolved to create a Financial Regulatory Committee (FRC). ADB, through this PPTA, is working with parliamentarians to develop the framework law to govern FRC activities. At present, FRC would encompass regulation of all NBFIs, including SCCs. Commercial bank supervision has been the traditional preserve of BOM, but, arguably, supervision of commercial banks might be improved significantly by removing it from the central bank's jurisdiction. Some countries, notably, the UK and Kazakhstan, have unified all financial sector regulation within one agency. Mongolia might consider establishing one financial regulatory authority, which would combine FRC with BOM's supervision department. BOM has succeeded in developing a strong supervision capacity for Mongolia, a uniquely firm foundation upon which to build other, specialized supervisory structures. In a very small country, where individual and organizational capacity constraints are prevalent, it is particularly useful to build on success. Despite the success of BOM's supervisory efforts, these activities may still be subject to undue political pressure. Placing supervision within an institution dedicated only to such activities may provide more insulation from political pressure in dealing with vested interests. Finally, it is sensible to move SCC regulation under BOM, as SCCs are similar in nature to commercial banks, rather than to have SCC regulation carried out within FRC, which would be dealing with quite different types of nonbank financial institutions.

H. Social Services

237. **Education.** The Education Law of 1995 anticipated greater private sector involvement in the education sector, particularly in the tertiary sector. This law paved the way for the ADB-financed Education Sector Development Program and Project (ESDP) in 1996,¹⁶¹ under which an Education Sector Strategy 2000–2005 was drawn up by the Ministry of Education, Culture and Science in 1999. The Second ESDP “supports initiatives to explore contracting out to the private sector, but advises caution on the extent of privatization, especially in poor, rural areas” (footnote 136). The ESDP sees opportunities for private sector involvement at all levels of the educational system (e.g., publication and provision of textbooks, ICT provision, teacher training, and facilities maintenance and rehabilitation).

238. Private sector involvement has increased at the tertiary level. The Institute of Finance and Economics reports 178 tertiary institutions in which there was private involvement in the 2001–2002 academic year, 160 of which were located in Ulaanbaatar. Of this number, which excludes technical and vocational training institutes (32 in 2001), 76 were registered as “private universities” and had 29,893 students enrolled in the prior academic year. At an average tuition fee of MNT320,000 (\$291), the turnover of “private universities” was estimated at MNT9.6 billion (\$8.7 million). The Government subsidizes private institutes and universities by financing the fees of students accepted to licensed education providers. Removal of a license by the authorities is, therefore, a substantial business blow; four educational establishments are reported to have had their licenses rescinded in March 2003.

239. Tertiary institutions cover a range of disciplines from law to textile technology, but their rapid expansion has raised questions about quality and accreditation. In a sample survey carried out during the Mongolian CAPE in 2002 among both public and private tertiary institutions, 70.2% of previous year’s graduates reported being employed, 12.9% reported being unemployed, and 16.9% could not be contacted. In a parallel survey of 57 businesses in Ulaanbaatar and Darkhan, however, employers expressed dissatisfaction with new school and university entrants, indicating that 41% of employees recently graduating from secondary school were “not very suitable” or “not at all suitable” compared with 26% of employees graduating from technical and vocational training and 12% graduating with a higher education degree. Moreover, higher-education graduates were said to suffer from a lack of business experience (33% of business respondents) and poor technical knowledge (24%). In conclusion, privatization of tertiary educational institutions as a goal in and of itself does not seem to have a positive effect on PSD.

240. **Health.** There has been significant investment in recent years in the establishment of private clinics. According to the government-financed Directorate of Medical Services (Directorate), an implementing agency established in December 2002 to provide quality assurance services for health organizations, there were 536 private clinics and hospitals operating in 2002,¹⁶² which provided dental, gynecological, and traditional medical care. Of these, 375 were in Ulaanbaatar. In the first 3 months of the Directorate’s activities, 20 private clinics and hospitals were accredited.

¹⁶¹ ADB. 1996. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan for Education Sector Development Program*, and ADB. 1996. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan for Education Sector Development Project*. Manila.

¹⁶² Local terminology differentiates between clinics (361) with no beds, and hospitals with beds (122). Average number of beds in private hospitals was 6.8 in 1999.

241. Progress in facilitating private involvement at the level of hospital services has been slow. Management contracts were entered into in 1997–1998 with a number of private sector operators at the *soum* level but were unsuccessful because they were entered into with inappropriate organizations and/or with insufficient specification of outputs. Reportedly, although financial performance has improved, clinical standards have dropped and all but one contract, the management of Bayanzurkh District Hospital in Ulaanbaatar, has been rescinded. The Health Sector Development Program (HSDP) also envisaged that public buildings would be sold and leased back and that support services such as catering and laundry would be tendered to the private sector. There has been no sale and leaseback to date, but a Ministerial Order of 2000 allows for the subcontracting of nonmedical services and has led to trials in Ulaanbaatar and in the regions.

242. Private hospitals are free to set patient fees and may bill the health insurance fund (HIF) for patients covered by the service (approximately 87% of the population) although no budget funds are used to support private hospitals. Full privatization of *soum* and *aimag* hospitals is considered infeasible at present; for both types would lose budgetary support, and co-payment charges to patients would have to rise dramatically to supplement HIF payments, where available. Such changes would hit the poor particularly hard. Prospects for asset sale and leaseback (possibly following renovation), subcontracting of nonclinical services, management contracts, and placement of private doctors in public facilities are all plausible strategies for maintaining or improving services while lowering costs.

243. The Ministry of Health estimates that \$30 million–\$35 million is spent annually by Mongolians seeking treatment from top-flight medical facilities abroad. Thus, there exists the potential for Mongolian entrepreneurs to attract foreign investment to set up a center of excellence in the country to attract those currently traveling overseas.

244. During the first ADB-financed HSDP, primary-care facilities at the local level were reorganized into family group practices (FGPs), which are privately owned but receive financial support from government funds.¹⁶³ As of September 2002, there were throughout Mongolia¹⁶⁴ 238 FGPs providing primary health care for 45–55% of the total population.¹⁶⁵

245. Drug availability is a difficulty for most FGPs, especially in rural areas, for 85% of all drugs are imported and only 7% of drugs are on the Ministry of Health essential drugs list. There are now 40 companies licensed to import pharmaceuticals, up from 20 in 1998, and 28, mostly small, drug manufacturing companies. Government involvement in the sector continues through the ownership of Mongolemimpex, a pharmaceutical trading company with MNT3.4 billion (\$3.1 million) in annual sales, and Emiin Uildver, a pharmaceutical manufacturing company with MNT515.7 million (\$468,000) in annual sales.

246. **Initiatives Required.** The results of reforms being introduced in the social sectors are not yet completely clear. Private operators play a very significant role in the independent provision of tertiary education and health services in Ulaanbaatar in particular, but efforts to

¹⁶³ ADB. 1997. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Health Sector Development Program*. Manila, and ADB. 1997. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Health Sector Development Project*. Manila.

¹⁶⁴ *HSDP Quarterly Progress Report*. 2002, October.

¹⁶⁵ From January 2003, FGPs are financed through capitation fees funded 60% from the HIF and 40% from the state budget, following approval in 2002 to appropriate modifications to the Citizens' Health Insurance Law and the Health Law.

subcontract functions in both sectors have been hampered by a lack of guidelines, training, and contract standardization.

247. In the education sector, the explosion of tertiary institutions as a result of liberalization has led to a plethora of degree or diploma courses for which there is limited demand within the Mongolian economy. Businesses continue to find it difficult to recruit experienced and capable technicians and managers. The business and the education sectors need to collaborate more closely to ensure that appropriate signals are sent to tertiary establishments with respect to qualifications in demand, and to develop forms of attachment and sponsorship favoring both parties. Clearly, it is too early to ascribe a leading role to private sector institutions, particularly in tertiary education. Indeed, it seems evident that the Government must play a stronger role in concentrating resources to improve the quality of tertiary education. At present, it is likely that only the Government of Mongolia has the wherewithal to develop a technical institute or a business school based upon international standards.

248. In the health sector, there are indications that, with appropriate improvements, private provision may allow government budgetary contributions to be concentrated increasingly on facilities serving the poor. A parallel, fully private system of clinics and hospitals would likely have a positive effect on all health care professions and prevent bright medical professionals from seeking employment outside the country, or outside the medical profession. It would be important to ensure that public funding was not diverted to inadvertently subsidize new for-profit ventures. Given the recent introduction of the Directorate to supervise quality standards within the sector, reforms need to be given time to have a real impact, and contractual conditions between state and provider need to be improved, where necessary.