

Chapter 5: RECOMMENDATIONS FOR PRIVATE SECTOR DEVELOPMENT STRATEGY IN MONGOLIA

A. Strategic Approach

259. ADB has identified PSD as a basic requirement for achieving sustainable poverty reduction.¹⁷⁰ Mongolia cannot continue to depend on the levels of IFI investment support it has received over the past 12 years, regardless of the concessionary nature of such support. Levels of private investment must increase while the Government ensures that its revenue is used wisely to maintain and to enhance provision of essential social services.

260. ADB has developed a PSD strategic framework designed to provide its DMCs with a guide to private sector support programs. The PSD strategic framework consists of three components: (i) supporting DMC governments in creating enabling conditions for the private sector; (ii) generating business opportunities through ADB-financed public-sector projects; and (iii) catalyzing private investment through direct financing and credit enhancements that mitigate political and credit risks. Elements of the proposed ADB PSD strategy were discussed with key government bodies, representatives of the private sector, and IFIs in a workshop held in Ulaanbaatar in January 2004.

B. Potential Areas for ADB, Donor Assistance

261. **Governance.** ADB is financing the Second Governance Reform Program Loan,¹⁷¹ which emphasizes output-based budgeting in an attempt to improve central government performance and efficiency. Associated with this loan is a series of TA grants that have focused on improving management in the central Government.¹⁷² Good governance needs to be extended rapidly from the central Government to government executing agencies, and especially to key agencies interfacing with the private sector (e.g., GDNT, CGA, and other inspection agencies). The private sector will benefit directly from a more efficient and focused government sector.

262. **Build in Governance and Performance Measures to Project Designs.** Where projects address issues within one productive, social, or infrastructural sector, measures to improve the governance and performance of regulatory and licensing bodies that interact with the private sector should be introduced into project design. The establishment of such regulatory bodies is, in itself, insufficient. Transparent and consistent rules shared with those being accredited or regulated must be drawn up and embedded in the organizations.

¹⁷⁰ ADB. 1999. *Fighting Poverty in Asia and the Pacific: The Poverty Reduction Strategy of the Asian Development Bank*. Manila.

¹⁷¹ ADB. 2003. *Report and Recommendation of the President to the Board of Directors on a Proposed Program Cluster of Loans and a Technical Assistance Loan to Mongolia for the Second Phase of the Governance Reform Program*. Manila.

¹⁷² For example, ADB. 1999. *Technical Assistance to Mongolia for Initial Phase of Public Administration Reform*. Manila; ADB. 1999. *Technical Assistance to Mongolia for Public Expenditure Management*. Manila; and ADB. 1999. *Technical Assistance to Mongolia for Study of Central-Local Government Aspects of Reform Implementation*. Manila, all approved at the end of 1999. ADB. 2001. *Technical Assistance to Mongolia for Establishment of a Central Procurement Monitoring Office*. Manila; and ADB. 2001. *Technical Assistance to Mongolia for Improving Social Statistics*. Manila, all approved in 2001. ADB. 2002. *Technical Assistance to Mongolia for Improving Aid Coordination and Management*. Manila; and ADB. 2002. *Technical Assistance to Mongolia for Strengthening Public Sector Administration and Financial Management*. Manila, approved in 2002. will provide continued support for the budgetary reform process through 2005.

263. **Competition Policy.** Although a competition law has been enacted and although USAID has provided assistance in designing a structure for the new competition regulator, no new regulatory body has been established nor has an overall framework for competition policy been developed. On first blush, creation of a multisector regulatory body for competition might seem a welcome donor intervention. In light of widely recognized governmental capacity constraints, however, a competition watchdog agency is at present a luxury best deferred until more fundamental reforms are carried out. There are many greater constraints to PSD than lack of competition, e.g., corruption, poorly developed legal framework, flawed taxation regime.

264. **Legal System Reforms.** Lacking an effective and transparent legal system, the private sector has no effective recourse when disputes arise. The interests of foreign investors are likewise in need of legal protection. Over the past few years, international investors have lost a number of high-profile cases related to nonpayment for goods and services, and these outcomes add to the general perception of country risk. Even the straightforward task of firing a worker typically ends up in the courts, which frequently force firms to reinstate employees and pay substantial damages.

265. While USAID has provided assistance in developing a system for public consultation on draft laws and amendments, this system must be institutionalized and deepened. GTZ is working on harmonizing proposed laws with the new Commercial Code, but is doing so more on a case-by-case basis than according to a systemwide approach. Though World Bank and USAID are providing legal training and though GTZ provides limited assistance with respect to training legal practitioners in commercial law, training needs to be more widespread to promote compliance and effective monitoring of regulatory requirements. Although a new arbitration law has been adopted, new arbitration bodies have not yet been established, nor have qualified independent arbitrators been identified and trained. ADB might therefore consider further TA in support of targeted programs in the newly established Legal Retraining Center.

266. **Agriculture.** To a great extent, progress in this sector depends on improving (i) access to capital, (ii) education and extension to promote effective grazing and cultural practices, (iii) breeding programs for livestock and seed crops, and (iv) new agro-processing businesses. ADB is engaged in policy dialogue on developing and upgrading irrigation systems/water supply and is in close consultation with the Government regarding its role vis-à-vis the role of the private sector in crop production. The Government may require additional assistance in quantifying the costs of the new Food and Agriculture Policy and the Livestock Intensification Program. Both these undertakings envisage strong government intervention and assume commercial viability, but the question of why the private sector has been lukewarm about investing in certain targeted agricultural subsectors is not being addressed directly. Agricultural activities outside the livestock subsector are subject to tremendous natural risks, which the private financial sector is not properly equipped to mitigate. Risk-mitigation tools, including crop insurance and interest-rate pricing mechanisms (e.g., subsidies), are either inadequate or ill suited. Fundamentally, crop production has not yet demonstrated itself to be a profitable long-term activity; and the inherent natural risks make this an unattractive avenue for donor intervention. A TA is planned for 2004 to help the Government identify constraints to private sector investment in agriculture and to analyze its own role in sector promotion. This proposed TA will also identify appropriate areas for future ADB investment, focusing on small- and medium-scale entrepreneurs, import substitution based on comparative advantage, and phytosanitary improvements.

267. **Tourism.** To help develop a long-term strategy for the tourism sector, ADB could build on its work in the aviation and road sector and on its experience in advising other DMCs with

similar development constraints. However, JICA and the EU each have carried out a tourism development master plan recently, neither of which has been put into action. This fact indicates that similar interventions in the tourism sector, especially ones that directly engage official government tourist bodies, may not bring sufficient returns to warrant the effort. It may be advisable for ADB to build on its strengths and experiences in other sectors.

268. **Infrastructure.** ADB is an important player in the building of key transport routes. ADB is engaged in an ongoing dialogue with the Government regarding the need to allocate additional resources to road maintenance and to increase the involvement of the private sector in such maintenance. ADB is financing the completion of the north-south road corridor connecting Russia to China through Ulaanbaatar. A second corridor has been proposed to link Novosibirsk in Siberia to Urumqi in China, through western Mongolia. This corridor could divert substantial transit trade currently running through Kazakhstan. ADB may wish to conduct preliminary assessment of the economic viability of this corridor. With respect to the railway sector, the Government should consider contracting out certain current business activities to the private sector. There is scope for a donor intervention bringing in external management to upgrade the system and to promote Mongolia as a major transit route. ADB was active in the aviation sector, most recently in proposing substantial policy reform to promote private sector participation. A number of important areas require further assistance, including the sustainability of domestic air transport, MIAT privatization, domestic airport improvement, and outsourcing or privatization of airport services. Before ADB commits to investments in these areas, the Government should respond to the policy issues and proposals made in the most recent TA covering competition policy, tariffs and subsidies, regulation, and essential air services.

269. **Financial Sector.** ADB has made significant contributions to financial sector development, as have both World Bank and USAID. The financial sector represents a set of subsectors requiring both careful nurturing and close regulation. Lack of access to financial services clearly is a key constraint to PSD, so successful interventions in the financial sector can have a great impact on the growth and development of private businesses. The need for efficient government regulation and the substantial leverage effect from financial market deepening make the financial sector an attractive area of opportunity for ADB and for other donors. For most Mongolian financial institutions, the “nurturing” should now come from investors, foreign and domestic, who can bring, along with capital, innovations in product development, management and organizational design, accounting, internal control, and risk management, as well as improved corporate governance. ADB’s Private Sector Operations Division functions effectively as a private investor when it lends and invests equity, as in the present case with TDB. Certainly in subsectors of the financial sector, such as the SCC, donors can provide capital along with needed technical expertise.

270. Donor institutions, working through their public-sector divisions, have perhaps a more likely role to play in assisting policymakers and regulators to develop systems supporting the appropriate functioning of financial markets. ADB is working to develop a more robust NBF1 subsector through a streamlined and improved NBF1 supervisory and regulatory regime. ADB should continue to take a leadership role in this area and should coordinate efforts with other donors to ensure that resources are available to develop adequate regulatory structures. Work being carried out under the Rural Finance Project, which directly supports efforts to develop the regulatory and supervisory framework for SCCs, complements the PPTA. Lack of indigenous investment banking skills and scarcity of equity capital have been highlighted as critical PSD constraints. Mongolian businesses could benefit greatly by more corporate finance, management, and marketing expertise, along with greater access to efficiently priced risk

capital. In addition to addressing regulation, the ongoing ADB PPTA will help the Government develop a sectorwide vision for NBFIs and explore modalities for developing the investment/pension-fund industry.

271. **Capacity Building in Accounting.** ADB has played, and will continue to play, a leading role in creation and development of the accounting and the auditing professions. These are the bedrock upon which an efficient, transparent, market-based economy is built, and their development is vital for PSD.

272. **Social Sectors.** ADB has taken the lead in helping promote private sector participation in both health and education sectors, through the development of new enterprises, such as FGPs, that are better funded and promote higher service standards. Also in the health sector, substantial rationalization of public hospitals in Ulaanbaatar remains a daunting task while private investors have expressed interest in establishing a first-class private hospital in the capital. ADB is implementing the second phase of investments and policy reforms in both health and education sectors and likely will remain involved in the medium term.

C. Towards a Private Sector Strategy for ADB

273. This report provides an overview of the private sector in Mongolia and a host of recommendations to address constraints to PSD. Which of these recommendations fits into a realistic, achievable PSD support strategy for ADB? Such a strategy must consider the lessons and achievements of ADB's work in Mongolia and avoid overlap with other effective programs and projects. The purpose of this document is not to develop a specific PSD program, but rather to outline a strategy to guide thinking about PSD as ADB develops its Country Strategy and Program. The following then is a list of suggested activities in support of PSD that respond to the reality of the Mongolian context, are consistent with ADB's principals, build on ADB's project experience and strengths, and are mutually supportive.

1. Creating Enabling Conditions for the Private Sector

274. Leadership and technical expertise are needed to help the Government regulate, supervise, and promote financial innovation and deepening by means of NBFIs. On the regulatory and supervisory side, ADB should continue to provide leadership in creating a risk-based system for regulating SCCs, and in fact this work is well under way. There is more work to do, especially regarding insurance and pension funds. Support of sound SCCs, insurance companies, and pension funds will benefit individuals, microenterprises, and SMEs by providing continual access to capital and other essential financial services. Such support will help strengthen the social safety net and alleviate poverty.

275. The professions of accounting and auditing are crucial elements of a market economy, and the lack of qualified accountants, auditors, and auditing firms is a significant impediment to PSD. It is important now to increase substantially the numbers of fully qualified accountants, auditors, and auditing firms. Wherever ADB works, proper accounting and auditing must be a requirement. Proper accounting is the foundation for transparency, and improved corporate governance rests on qualified independent auditing.

2. Generating Business Opportunities through Public-Sector Projects

276. ADB's current work in public governance reform supports improved efficiency in government operations. Practical results of this work must include (i) greater participation by the

private sector and by private sector interest groups in the making of laws, policies, and regulations related to business and (ii) greater business opportunities in terms of outsourcing for the private sector. To the extent that the fiscal burden is reasonable and taxes are used effectively, the private sector benefits from improved government efficiency.

277. ADB infrastructure activities can promote real business opportunities in public works and open avenues for new business. In such an immense and isolated country, a road is (literally) a concrete development vector benefiting all, but especially the poor who benefit directly from decreased transportation costs, and, among other things, greater access to social and other services. Roads pave the way for tourism, an industry with immense potential for Mongolia. ADB's Third Road Project clearly will have a positive effect on trade, tourism, and local businesses along its route. Further reform of civil aviation would provide similar benefits. In agriculture, future TA investments might point the way to new private sector investment strategies and limit the Government's role in propping up uncompetitive subsectors.

3. Catalyzing Private Investment

278. ADB has made the decision to invest in the equity of a large financial institution, TDB. This provides ADB with the direct responsibility to help establish and maintain good corporate governance and management practices. TDB is the largest bank in Mongolia. Thus, while earning a market rate of return, ADB's active board participation can help make TDB a positive example of a transparent, well-governed private firm. This initial foray into direct ownership in a Mongolian private enterprise could facilitate private investment. Future investments by ADB's Private Sector Operations Division cannot be dictated by policy, but must stand alone as attractive commercial propositions. The market intelligence and comfort level gained through the TDB transaction, however, likely will prove valuable in the analysis of future deals. ADB has been approached directly by Mongolian businessmen eager to see a professional investment-fund industry begin. Promising areas for investment in the medium term include private participation in the infrastructure sector, either to introduce private sector finance and management into existing companies where full privatization is not feasible, or to stimulate new private sector investment. Indirect investments, such as trade facilitation through the banking sector, or equity and mezzanine financing and advisory mechanisms for SMEs, might bring wider benefits for relatively little expenditure. Opportunities may also present themselves in due course in the social sectors, particularly in the health sector, where private provision of publicly supported services is expanding.