

EXECUTIVE SUMMARY

The Mongolian private sector has grown considerably since 1991. From generating virtually 0% of gross domestic product, the private sector now generates 75–80%. More than 90% of all enterprises are privately owned. This achievement is the result of a decade-long program of privatization and creation of an enabling environment generally supportive of new private enterprise. Although emphases and priorities of successive governments have differed, policy to open the economy to private sector entrepreneurship has been consistent. Substantial challenges remain, nonetheless, if Mongolia is to build on its achievements, to integrate fully with world markets, and to increase gross domestic product to rates permitting significant levels of poverty reduction. Although substantial concerns persist regarding course and conduct of fiscal and monetary policy, most challenges are institutional.

Mongolia has significant mineral resources, as well as enormous herds of livestock. Additionally, the country offers a unique destination for tourists. Although agriculture— primarily livestock production—continues to account for the largest share of employment (approximately 45%) and is the most important source of income in rural areas, the sector is extremely vulnerable to harsh climatic conditions. A key feature of the transition to a market economy is the rapid development of wholesale and retail trade, which have become greater contributors to GDP than agriculture, mining, and manufacturing.

Mongolia has achieved a reasonable degree of macroeconomic stability, which has facilitated trade and investment and enabled development of the private sector. Public expenditure control continues to be of concern, however; and tax revenue collection, dependent to a great extent on world commodity prices for copper, gold, and cashmere, remains volatile.

An institutional framework based on the rule of law has been adopted along with policies liberalizing trade, promoting competition, and encouraging foreign direct investment. Mass privatization, particularly of small enterprises and livestock, has proceeded more rapidly than in many other former communist countries, the number of private small and medium enterprises (SMEs) has grown significantly, conglomerates have sprouted and grown to have a significant economic impact, and the informal sector is flourishing. Recently, the Government has begun to privatize its most valuable enterprises. It has thus largely exited from productive activity, with a number of key exceptions, and has made efforts to transform ministries into policymaking and regulatory, rather than productive, organizations. Many regulatory responsibilities of the Government have been transferred to state-controlled executive agencies, each with a great degree of autonomy.

Most basic laws and institutions necessary in a market economy have been created. A commercial law framework has been adopted although it may not yet protect private-property rights adequately. Commercial laws, modelled after laws in developed markets that may exist within legal systems distinct from Mongolia's, have not been harmonized. Mongolia's laws generally provide a basic structure and lack accompanying definitions, thereby allowing excessive discretion to those charged with implementation. This situation has created a growing problem of corruption, specifically with regard to the acceptance of bribery by the private sector as a means of resolving/avoiding disputes. Absence of a reliable judiciary, limited familiarity with court adjudication, and longstanding custom lead citizens to look outside the legal system for solutions to business problems.

The inconsistent interpretation of commercial laws and the weak judicial system diminish business confidence and heighten sense of investment risk. Recent developments, however, including adoption of a new arbitration law and establishment of a new administrative court system, reflect the Government's willingness and ability to address such concerns.

A number of internal constraints to private sector development (PSD) still must be removed if the private sector is to take full advantage of the improving business environment. Although Mongolia has a highly literate workforce, employees often lack adequate practical skills and do not always demonstrate a work ethic. Poor technology undercuts the ability of Mongolia to compete internationally and to engage in "downstream" production. Although a number of business advocacy groups and associations have emerged in Mongolia, few have succeeded in presenting the concerns of their members to the Government. Actions to improve PSD need to target core and systemic causes of underachievement.

Situations inside companies differ greatly. Where there is dynamic and visionary leadership and where this is accompanied by high-level links with the Government, business has flourished. Many emerging SMEs, however, find the demands of the business environment onerous. Some succeed while many go out of business or remain informal in order to avoid the pressures and scrutinies that formality entails. Private sector standards related to financial disclosure, environmental consciousness, and investor relations are poor.

A rapid evolution in business culture is a feature of the economic transition. A "culture of repayment" of bank loans by private businesses is fully evident. Strengthened links with other countries and foreign businesses have provided a rich source of business information and creative ideas. Although lacking familiarity with the latest international currents in marketing and having carried out only rudimentary investment analyses, many bright young entrepreneurs have opened new businesses. At the same time, many business owners are oriented to production rather than to customer requirements and have a lamentably bureaucratic approach to management and business development.

With the notable exception of infrastructure, most key productive sectors (agriculture, tourism, manufacturing) and supporting sectors (finance, social services) are dominated by private interests. Within the agricultural sector, cashmere production is pre-eminent, and cashmere is a commodity subject to world market prices that have fluctuated widely in recent years. Meat production also is important, but meat exports are limited by inadequate slaughter, veterinary inspection, and meatpacking standards. Partly because of a "world class" mining law, the mining sector attracts the greatest percentage of foreign investment. The garment industry accounts for 35% of the manufacturing sector but may not survive the expiration of favorable quota agreements in 2004. The tourism sector presents significant potential, realization of which will depend on improved infrastructure, facilities, and promotion.

The banking sector is dominated by private interests as a result of the privatization of two large state-owned commercial banks in 2002 and 2003. In rural areas, microfinance institutions have expanded rapidly and continue to grow in a largely unregulated environment. Capital market, insurance, and leasing subsectors do not yet play meaningful roles in the economy. Introduction of private sector capital and skills into education and health sectors has resulted in significant expansion of the number of private tertiary institutions and private clinics and hospitals. Quality of service remains an issue, however.

Access to capital, especially by SMEs, is limited. Although the amount of credit provided by commercial banks has expanded significantly in recent years, most lending still is conducted on a short-term basis and is fully asset based. The situation is improving, however, in regards to term lending. But equity finance is more limited: the capital market is barely functional, and there are no formal sources of venture capital. Leasing is undeveloped. Foreign investment is constrained by the small domestic market, inadequate infrastructure, high transportation costs, a high corporate tax rate, and weak implementation of the rule of law. Although the amount of foreign direct investment has increased recently, disbursed amounts seem to account for less than 50% of funds committed, and investments are concentrated heavily in the mining sector and the garment industry.

With a few exceptions, the Government has neither promoted nor adopted a framework for private participation in infrastructure. The state continues to dominate the transport sector, in which the road network is limited; rail infrastructure continues to serve only areas of significant economic production; and international airfares, which must subsidize costly domestic operations, are very high. The private sector does not yet take a meaningful role in power generation although this sector has been unbundled and is being commercialized and prepared for privatization. The private sector plays no role in the provision of water or sanitation services. Having privatized 40% of the former state telecommunications monopoly, the Government continues to own and to manage network and housing facilities. A number of private joint-venture mobile phone operators have entered the market, and as a result international tariffs have been lowered significantly. Information and communications technology has expanded rapidly.

In general, the main institutional and/or systemic constraints affecting PSD in Mongolia include lax enforcement of laws by a judiciary inadequately trained and equipped to support a burgeoning market economy; an overly engineered tax regime; a widespread lack of both accounting literacy and auditing skills; a reliance on outdated technology; slow absorption of modern management and organizational development principles; and a financial sector until recently incapable of assessing risks and able to provide only minimal services. To understand the full extent of the challenge to PSD in Mongolia, these constraints must be set against the background of an isolated location, a harsh climate, a severely limited internal market, and a traditional economic dependence on livestock and minerals.

In light of Mongolia's many challenges and constraints, it is remarkable that over the past decade so much progress has been made in transforming a state-run command economy into a vibrant, growing market economy dominated by the private sector. The progress is due to steady and consistent efforts by successive governments to build the legal superstructure for a market economy; strong support from a very committed donor community; fundamental public intolerance of the kind of massive, high-level corruption that has plagued formerly Soviet transition economies and resulted in the creation of dictatorships supported by crony capitalism; recent accelerated growth of China and the world economy, trends that have boosted demand and prices for Mongolia's primary exports; and increasing sophistication, confidence, and capacity among Mongolia's new entrepreneurs.

The most obvious risks to PSD in Mongolia include external price shocks transmitted through the economy's overdependence on a few commodities subject to volatile world prices; poor fiscal and monetary management, which would waste public resources, unleash inflation, or fail to control the currency or money supply; increasing corruption, which would undermine already weak transparency and governance standards and further undermine the credibility of various official revenue collection regimes; a repeat of the mid-1990s banking collapses, which

would destroy public confidence, imperil household savings, and constrain firms' already limited access to financial services (which in turn would affect in particular the more dynamic small and medium-sized firms and microenterprises); and delay in the reform of the judiciary and the development of a more responsive and competent legal system which would undermine transparency and good governance. Put positively, PSD depends on ethical entrepreneurs armed with skill, capital, and courage enough to take advantage of and to create new business opportunities within a fair, efficient legal environment that rewards industry and punishes corruption.

Assistance from international financial institutions and bilateral donors has supported Mongolia's transition to a market economy. The initial focus was on emergency relief, fundamental policy reforms, and physical rehabilitation of vital infrastructure. In the mid-1990s, assistance began to focus on promotion and attraction of private sector capital and management. Little work has been focused directly or systematically on the business environment and the public/private interface, where many constraints to PSD arise. Most official assistance for the private sector has addressed enterprise-level issues before improving the business environment.

From 1991 to June 2003, the Asian Development Bank (ADB), through its public-sector concessional lending window, approved 32 loans worth \$553.2 million for 28 projects in the transportation, agriculture, education, energy, finance, health, and telecommunications sectors, and \$53.9 million in technical assistance grants. Significant private sector components were included in ADB's overall program.

In 2000, ADB adopted a PSD strategy with three strategic thrusts: (i) creating enabling conditions for business; (ii) generating business opportunities for the private sector; and (iii) catalyzing private investment. The challenge of ADB, like that of other donors, is to build on institutional strengths and programming experience in Mongolia and other transitional economies to provide targeted interventions addressing key PSD constraints.

ADB has actively assisted Mongolia in strengthening the financial sector. The Government of Mongolia faces the tasks of regulating and of supervising the financial sector and of promoting financial innovation and deepening. ADB will continue to provide leadership in creating a risk-based system for regulating savings and credit cooperatives and will support the development of insurance and pension funds. Supporting sound savings and credit cooperatives, insurance companies, and pension funds will benefit individuals, microenterprises, and SMEs by providing continuous access to capital and needed financial services. Such support also will strengthen the social safety net and alleviate poverty.

ADB is working to build strong accounting and auditing professions. ADB should continue to provide leadership in this regard and to work with the nascent organizations representing these professions, so as to increase the numbers of accountants, auditors, and auditing firms in Mongolia. Wherever ADB works, proper accounting and auditing must be a requirement: they are the foundation for transparency, and improved corporate governance rests on qualified independent auditing.

ADB's current work in public governance reform promotes efficiency in government operations. Practical results of this work must include (i) greater participation by both the private sector and its interest groups in the making of laws, policies, and regulations related to business and (ii) increased business opportunities for the private sector, through outsourcing. To the

extent that the fiscal burden is reasonable and taxes are used effectively, the private sector also benefits from improved government efficiency. Furthermore, it is crucial to develop a civil service within whose ranks corruption is not tolerated. ADB is supporting, and will continue to support, reform promoting a competent, ethical, and professional civil service.

Activities sponsored by ADB in the area of infrastructure development create substantial opportunities for private business in public works contracting. Infrastructure development, especially improvement of the transportation network linking Mongolia with the outside world, is essential for PSD, and ADB's Third Road Project clearly will have a positive effect on trade, tourism, and local businesses.

ADB is investing in the equity of the country's largest commercial bank, the Trade and Development Bank (TDB). Through board participation, ADB is given the opportunity to demand enhanced transparency and improved corporate governance and thus to help create a model enterprise owned by foreign private interests, managed by Mongolians for Mongolian customers, and run according to international best practices. Other such direct investments may follow. Conditions for the creation of an investment banking industry, which might include investment or venture capital funds, seem increasingly favorable. This is an interesting avenue for further exploration by ADB, both on the public-sector (policy) side and for the Private Sector Operations Division of ADB. The Mongolian economy would benefit greatly from increased provision of equity capital by institutional investors with both strategic and financial objectives.