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The Case of Mongolia

Hongjoo Hahm

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Hongjoo Hahm

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Foreword

The World Bank's economic and sector work program is a very active one ranging over a wide spectrum of topics. We have recently begun to analyze development and reform issues in Mongolia. Each year we publish a handful of our formal studies, but many background papers and informal reports, containing valuable analysis and information, have remained outside the public domain. Through The World Bank Discussion Papers Series, we hope to make available a few of the papers which can contribute to a better understanding of the economic transformation taking place in Mongolia.

This paper by Mr. Hongjoo Hahm provides an analytic description of the private sector in Mongolia. The paper reviews the evolution of the private sector and identifies the major impediments to private sector growth. The data and material were obtained and verified during numerous World Bank missions to Mongolia from February 1992 to August 1993, with invaluable input and comments from Mr. Carlos Elbirt, World Bank Senior Economist working on Mongolia.

We hope this paper proves to be of interest both to those specializing in Mongolian affairs, as well as those with a broader interest in the problems of transition.

Shahid Javed Burki
Director
China and Mongolia Department

CURRENCY EQUIVALENTS

Currency Unit = Tugrik (Tug)

Before November 1991:	$1.00 = Tug 7 (barter rate)
As of June 30, 1992:	$1.00 = Tug 40 (for official transaction)
	$1.00 = Tug 250 (for free market transaction)
As of April 30, 1993:	$1.00 = Tug 150 (for official transaction)
	$1.00 = Tug 420 (for free market transaction)
As of May 31, 1993:	$1.00 = Tug 420 (unified free market exchange rate)

FISCAL YEAR

January 1 - December 31

ABBREVIATIONS AND ACRONYMS

AMPEM	Association of Mongolian Private Enterprises Managers
BOM	Mongol Bank
CCCE	Central Consumer Commodities Exchange
CMEA	Council for Mutual Economic Assistance
CPCU	Central Procurement Cooperatives Union
FTCS	Foreign Trade Corporations
GDP	Gross Domestic Product
IMF	International Monetary Fund
L/C	Letter of Credit
MACE	Mongolian Agricultural Commodities Exchange
MOA	Ministry of Agriculture
MTI	Ministry of Trade and Industry
SBI	State Bank International
SOEs	State-Owned Enterprises
TR	Transferrable Rouble

I. INTRODUCTION

A. BACKGROUND

1.1 Mongolia began to move away from Soviet domination, politically and culturally, with the onset of perestroika in 1984. But it was only three years ago, the first quarter of 1990, that Mongolia began dismantling its centrally planned command economy and introducing a wide range of market-oriented reforms. They included, for example, a doubling of almost all prices, subsidy cuts, devaluation of the exchange rate, banking reforms and the creation of a two-tiered banking system, tax reforms, legal reforms, and a change in the economic role of the state. The scope and comprehensiveness of the reforms envisaged were impressive.

1.2 Mongolia also adopted several important and positive measures to develop its private sector. Legal discrimination against private activities was removed in 1988; restrictions on private ownership of herds were eliminated in 1991; and an extremely ambitious privatization program was launched in 1991. These measures resulted in a rapid expansion of the private sector in Mongolia, through the privatization of state-owned enterprises and through the creation of new privately owned economic entities.

1.3 The country however faced major external shocks in 1991. In early 1991, Soviet financial assistance, which averaged about 30 percent of GDP between 1985 and 1990, was completely cut. Simultaneously, the collapse of the Council for Mutual Economic Assistance (CMEA) resulted in enormous trade disruptions, and exports fell by 17 percent and imports by 51 percent. Mongolia's capacity to respond to these shocks was hampered by the breakdown of the old planning system before new market-oriented institutions and policy instruments were fully in place. The extensive use of imported inputs in most production activities, and extensive reliance on imports of consumer goods, amplified supply shortages in all sectors. GDP fell by over 9 percent in 1991 and by another 7.5 percent in 1992.

1.4 The introduction of market reforms has thus far been accompanied by concomitant reductions in economic activity. Stabilization took precedence over structural adjustment, and the lagged effect of reforms dampened expectations of a quick supply and employment response. This, in an environment of severe supply shortages, heightened public conscience about the reform process. Although the need for reforms is generally accepted and viewed as inevitable, the speed and process of reforms are a hotly debated issue in Mongolia today. The reform process is intricately linked to the development of the private sector, and an early response from the private sector will depend on how well the various reforms are sequenced and implemented. As in the case of Poland, making

privatization consistent with the short and medium stabilization/growth objectives will require clear decisions about the pace and scope of return.

1.5 This paper attempts to identify the overall reform issues affecting the private sector in Mongolia. The paper, first, provides a detailed description of the structure and characteristics of the private sector in Mongolia. That is, an analysis of what constitutes the private sector is made, including an assessment of the number of private sector entities, the type of activities engaged, and the number of employees in the private sector. Further, an assessment of how the private sector evolved is made, focussing on Mongolia's privatization process. The paper, then, examines private sector development issues in Mongolia. It identifies four impediments to private sector growth: (a) managerial and corporate governance issues relating to the privatization process; (b) distortions in the (domestic) distribution process through the use of centralized procurement; (c) lengthy export regulations and licensing requirements that hinders private sector exports; and (d) state control over imports that constrain private sector access to imported raw materials. In this connection, the paper suggests short-term measures to create and/or sustain a supply response from the private sector. The paper, finally, examines the medium and long-term structural and institutional needs of the private sector, including measures that affect private sector access to credit from the commercial banking system.

B. Recent Economic Developments

1.6 Under central planing, the concept of macroeconomic policy was irrelevant to economic decision-making. The decision maker would work with real quantities, with money serving largely as a vehicle for transactions. Shortages translated to longer queues and delivery times, not higher prices. The trade deficit arising from the economy's inability to support the political system's aspirations for a welfare state were compensated by external aid from the former Soviet Union equivalent to almost 30 percent of GDP. The collapse of central planning and temporary disappearance of foreign aid created staggering macroeconomic problems, foremost of which was that the structural trade deficit, and its reflection on the domestic front, the budget deficit, were not sustainable.

1.7 Since 1990, notwithstanding a pickup in activity from the emerging private sector, industrial and agricultural production were constrained, by shortages of intermediate goods and spare parts and, in the case of agriculture, by adverse weather. Domestic investment fell sharply, reflecting in part a curtailment of projects financed by the former Soviet Union. Savings also declined due to a fall in real income, accentuated by a deterioration in the terms of trade that reflected a weakening of world prices for copper and cashmere, the country's main exports. Inflation accelerated to over 300 percent by end-1992, reflecting liberalization of official prices as well as a relaxed monetary and credit policies during the first part of the year. The overall fiscal deficit reached about 10 percent of GDP in 1992, and was mainly financed by nontraditional external sources. New tax measures were introduced during 1991/92, including customs duties and additional excise taxes. Current expenditures were sharply reduced in real terms, primarily through the elimination of most direct budgetary subsidies to state enterprises and through restraint in salary increases. Although budgetary capital expenditures were constrained, substantial

outlays were incurred on a number of large off-budget projects initiated in prior years and financed partly through external commercial borrowing.

1.8 Exports increased in 1992 while imports (including those for turnkey projects) fell by a further 17 percent as the virtual cessation of official medium and long-term assistance from the former Soviet Union was only partly offset by new assistance from new sources. Concomitantly, the deficit on the external current account declined from 22.9 percent of GDP in 1991 to 8.1 percent in 1992. Net official reserves fell from 3 weeks of imports at end-1990 to 1.9 weeks of imports at end-1992. External payments arrears were reduced somewhat to $52 million by end-1992. Mongolia's medium and long-term external debt in convertible currencies rose rapidly to about $340 million (87 percent of gross current account receipts) at end-1992, reflecting new commercial borrowing as well as new aid inflows. Medium and long-term debt to the former CMEA denominated in Transferable Rubles amounted to TR 10.6 billion. This debt is presently under discussion between Mongolia and Russia. Table 1.1 shows the key economic indicators for Mongolia since the initiation of the economic transformation process.

1.9 Mongolia continues to face severe economic difficulties that reflect deep-rooted structural weaknesses, inexperience with new indirect methods of macroeconomic management, and the magnitude of the external shocks since 1990. The Government has been implementing measures to transform the economy since 1990 (i.e., privatization, price liberalization, changes in laws and regulations, etc.). To reduce trade distortions, a series of devaluations in the local currency (the Tugrik) have taken place since 1991. In May 1993, the authorities implemented a unification of the exchange rate at market levels.

Table 1.1: KEY ECONOMIC INDICATORS, 1990-93
(in percent, unless otherwise indicated)

	1990	1991	1992	1993 Est.
Real GDP growth	-2.0	-9.9	-7.6	-1.3
GDP deflator	-0.5	100.6	195.7	330.9
Consumer prices (end period)	-	208.6	321.0	195.5
Gross capital formation/GDP	42.3	28.9	14.5	22.1
Foreign savings/GDP	27.1	16.7	3.5	13.1
National savings/GDP	15.1	12.2	10.9	9.1
Fiscal revenue/GDP	50.6	47.4	22.8	23.4
Current expenditure/GDP	51.9	51.7	21.6	21.2
Current account/GDP (deficit -)	-1.3	-4.3	1.3	2.3
Overall balance/GDP (deficit -)	-13.5	-9.7	-10.0	-23.4
Broad money	10.8	76.0	31.6	168.2
Domestic credit	11.3	68.0	47.8	81.2
Credit to Government (net) /a	29.1	-14.6	-53.9	-58.8
Credit to nonbanks	0.9	58.3	48.6	78.1
Export volume growth	-38.8	-13.0	11.0	2.6
Import volume growth	-41.6	-48.7	-17.3	8.0
Terms of trade	-0.3	-6.2	-4.1	-1.0
External current account ($ mln) /b	-651.4	-160.5	-72.5	-110.7
External current account/GDP	-29.1	-17.0	-5.6	-17.2
Net international reserves ($ mln) /c	49.3	20.5	14.4	16.6
(in weeks of imports)	2.5	2.1	1.9	2.0

/a Excludes bank financing for off-budget projects.
/b Excludes official transfers.
/c Figures after 1992 represent those held by the Bank of Mongolia only.

Source: IMF.

II. THE STRUCTURE OF THE PRIVATE SECTOR

A. Private Sector Entities

2.1 At the beginning of 1990, 96.5 percent of all economic entities were in the public sector. The remaining 3.5 percent were composed of agricultural entities, such as private herders and cooperatives, that were in private hands. Since that time the private sector grew rapidly, largely as a result of Mongolia's privatization program and supplemented by newly created private economic entities, reversing the previous ratios. As of April 1, 1993, there were 26,507 registered economic entities at the Bureau of Taxation in Mongolia, of which 24,985 were classified as private economic entities.

2.2 Under the Bureau of Taxation's classification, private economic entities are either: (a) private companies, either limited liability companies or public shareholding companies 1/ (e.g, small- and medium-sized manufacturing companies engaged in light industry and construction activities of relatively low-capital intensity, and export/import trading companies); (b) cooperatives, composed of limited cooperatives and/or unlimited cooperatives 2/ (e.g., agricultural cooperatives, small businesses under joint ownership, as well as foreign joint ventures); or (c) sole proprietorships 3/ (e.g., small businesses, retail shops, stores, restaurants, bars, beauty and tailor shops, etc.). The remaining entities are either state-run companies with majority state ownership or state-owned enterprises established with state investment and owned fully by the state. Table 2.1 below provides cumulative statistics on the number of registered economic entities in Mongolia for 1991, 1992 and the first quarter of 1993 as compiled by the Ministry of Finance, Bureau of Taxation.

1/ A company with limited liability is an economic entity with a charter fund (capital stock), divided into portions of a certain size and of equal value, and has a contract indicating that each of its members bears the responsibility in proportion to the capital contributed by him. A shareholding company is an entity with a charter fund consisting of certain amount of shares, each with a nominal price, and each shareholder bears responsibility for the total sum of shares that they ordered.

2/ A cooperative with full liability is an economic entity which runs its own business based on the members' joint property and labor, and the liability connected with this business is borne jointly by the members. A cooperative with limited liability also engages in business based on its member's joint property, and the liability connected with the business is borne by at least one member with all his personal property, while the other members are only liable for the share of property they contributed to the cooperative.

3/ A sole proprietorship is an economic entity whose owner alone regularly engages in production or provision of services in order to supply himself with a permanent source of income. The firm is based on the owner's private property.

Table 2.1: NUMBER OF REGISTERED ECONOMIC ENTITIES

	1991	1992	1993/I	1993/I/a
Private Companies	635	2,295	2,513	2,000
Private Co., Ltd.	570	1,891	2,072	-
Mixed Shareholding Co.	65	404	441	-
Cooperatives	1,979	4,134	4,281	1,500
Coop. Limited	751	1,356	1,387	-
Coop. Unlimited	1,228	2,778	2,894	-
Sole Proprietorship	3,135	16,067	18,191	5,500
Total Private Units	5,749	22,496	24,985	9,000
State Companies	31	257	299	
State Enterprises	493	1,170	1,223	
Total Economic Units	6,273	23,923	26,507	

/a Based on Bank Staff estimates.

Source: Bank Staff estimates and Bureau of Taxation, Ministry of Finance.

2.3 By the first quarter of 1993, 94 percent of all economic units were classified as private sector entities, a remarkable reversal of proportions within a three year period. This proportion is not surprising in it of itself, especially when compared with other transition economies. However, in the Mongolian context, this proportion is exaggerated and misleading in three ways. First, the more than fivefold increase in the number of sole proprietorships between 1991/92 is noticeable, since sole proprietorships constitute 73 percent of all private sector units. Of the 15,000 new sole proprietorships that have emerged since 1991, about 3,100 are small private farms. Further, as a result of the privatization process, to date, some 258 private agricultural shareholding companies, 85 private agriculture-based companies and 72 agricultural cooperatives have emerged. The majority of these companies, including the sole proprietorships, were created by breaking up existing state farms into smaller plots, i.e., into private farms. Most of the private agricultural units are thus private only in name and continue to function as part of the state farm and the state agricultural cooperatives network. On the other hand, there has been some genuine grassroots level growth of agriculture-related private enterprises, e.g., milk farms, vegetable plots, and tanneries, including some small shops catering to farmers and herdsmen in the provincial centers. These entities account for less than 4,000 units. Clearly, when the dubious "private" agricultural units are subtracted from the total, the

number of private economic entities is greatly reduced. Table 2.2 shows the breakdown of economic units by aimaks and major city centers. Note the sizable number of proprietorships and cooperatives in remote aimaks, i.e., small-scale private farmers and herdsmen.

Table 2.2: GEOGRAPHIC DISTRIBUTION OF PRIVATE SECTOR ENTITIES IN 1993
(as of April 1)

	Proprie-torships	Coopera-tives	Companies			State enterprise	Total
			Mixed	Private	State		
Arhangai	463	126	15	26	9	43	682
Bayan-Olgii	124	241	31	51	10	29	486
Bayaahongor	365	274	24	18	5	68	754
Bulgan	403	169	0	19	6	56	653
Gobi-Altai	256	142	20	44	4	23	489
Dornogobi	365	79	25	12	1	7	489
Dornod	523	188	5	80	10	71	877
Dundgobi	253	137	11	18	2	76	497
Zavhan	425	151	9	81	11	42	719
Uvorhangai	365	140	10	41	7	64	627
Omnogobi	324	85	1	21	1	0	432
Suhbaatar	196	66	4	21	11	9	307
Selenge	148	36	7	27	5	15	238
Tov	542	164	0	36	78	4	824
Uvs	473	75	11	42	2	53	656
Hovd	479	365	0	79	2	20	945
Hovsgol	456	129	2	59	6	37	689
Hentii	515	165	31	42	12	30	795
Baganuur	124	51	0	10	1	25	211
Choir	92	18	0	5	0	1	116
Darhan	975	233	24	66	10	68	1,376
Erdenet	919	129	0	51	1	47	1,147
Nalaik	171	9	0	1	0	2	183
Partizan	145	3	0	0	0	1	146
Ulaanbaatar	9,090	1,735	211	1,222	105	432	12,166
Bayangol	3419	449	36	341	9	56	4,310
Bayanzurh	1628	205	8	203	5	3	2,052
Chingiltei	262	262	56	113	35	44	523
Congino	389	389	3	12	2	2	417
Han Uul	927	156	22	75	17	56	1,253
MOF	120	20	25	53	5	90	313
Suhbaatar	2,172	230	48	238	20	65	2,773
UB Admin. Unit	173	24	13	187	12	116	525
Total	18,191	4,281	56	2,072	299	1,223	26,507

Source: Privatization Commission.

2.4 Second, the 24,985 private economic entities includes many "phantom" organizations created as a front or for its name value for use in trading activities and/or for social reasons such as employment, stature, etc. Most phantom organizations are

newly created entities. Private economic entities can be classified either as newly "privatized" entities, resulting from a change in ownership (from public to private), or as "created" entities, resulting from a grassroots growth of the private sector. To date, about 4,000 small enterprises and 600 large enterprises have emerged from the privatization process (see paras. 2.17-2.19). The remaining 20,000 or so economic entities are then newly "created" private entities. Of the newly created entities, there are about 5,000 phantom organizations. These entities have not paid any tax and are nonproductive. Eliminating these further reduces the absolute number of "productive" private economic entities as well as the relative share of the private sector firms in the economy.

2.5 Third, for many of the newly privatized entities, the state retains majority ownership (i.e., more than 50 percent) and continues to exercise significant management control. Nine out of the ten privatized entities have kept the original management and personnel that existed prior to privatization; and nine out of ten of those have retained the same management that existed for the past 10 years. Although retention of the pre-privatized management and staff is not a problem in itself, especially given Mongolia's limited labor force, the continued influence of the state on the newly privatized firms is an issue. As long as the state retains majority ownership and/or exerts influence on the day-to-day operations of these entities, it is difficult to categorize these entities as private sector organizations. Until issues of corporate governance, management autonomy, and enterprise independence are addressed, there will be a large gray area of firms that are definitionally private sector, but functionally state-owned enterprises (see para. 3.5).

2.6 Subtracting the above three components, that is, the dubious "private" agricultural units, the phantom organizations, and the state-controlled "privatized" companies, from the total leaves about 9,000 functioning "productive" private sector entities in Mongolia today, of which 1,000 or so are engaged in trading activities.4/ Note the increase in state companies and state enterprises since 1991 in Table 2.1. This reflects the breakup of large state-owned enterprises into smaller ones, and the creation of small companies from branches of larger state-owned enterprises.

B. Private Sector Profile

2.7 According to Ministry of Labor statistics, the private sector employed about 288,340 workers from a national labor force of approximately 665,500 in 1992, i.e., about 44 percent of total employment. Large firms with more than 50 workers accounted for over 80 percent of total private employment; while the majority of private sector entities, i.e., small firms with less than 5 workers, accounted for only 7 percent of total employment. Private employment growth closely mirrors the growth of private sector entities, and a large portion of this growth reflects the transfer of employees resulting from the privatization process.

4/ Based on Bank staff estimates.

2.8 The majority of the productive private sector entities are small businesses, retail shops, trading companies, and a scattering of manufacturing firms producing labor-intensive goods.5/ In terms of production, using the statistics provided by the State Statistical Office that utilizes the official private entities data, production by the private sector accounted for almost 60 percent of total output in 1992. These numbers are overestimated due to overestimations in the number of private sector entities. A clear case in point is the 98.8 percent share of agricultural output by the private sector. Nonetheless Table 2.3 shows the data on the relative share of private sector output vis-à-vis total sectoral output.

2.9 A process of restructuring and corporatizing the state-owned highway carriers was initiated in 1991 in preparation for privatization. The government chose to privatize initially large-scale units (300 trucks or more, with in-house repair facilities), keeping them intact along with their largely exclusive service franchises. As of early 1993, 15 percent of trucking enterprises had been privatized, with a further 50 percent scheduled for privatization by the end of the year. In recent months, though, there is increasing ambiguity over the privatized units' access to as-yet unprivatized sources of inputs, e.g., petroleum from the Petroleum Import Concern; vehicles, spares and tires from the state/distribution/procurement companies; and servicing and repairs from state shops. Devolution of these support functions to the private sector, subject to control of monopolistic practices, will promote the development of a dynamic, competitive freight industry.

2.10 For the industrial sector, large state-owned enterprises still dominate the production process. As shown, state-owned manufacturing enterprises accounted for over 66 percent of total output in 1992.6/ At the subsectoral level (e.g., garments, leather, wool, meat processing, beverages, dairy, etc.), the concentration level of the five largest enterprises, on average, accounted for over 75 percent of production. For example, in the shoe manufacturing subsector, one dominant factory, large even by world standards, satisfies almost all domestic demand. This contrast sharply with successful export-oriented shoe manufacturers in other countries that are characterized by their small size and flexible operations. In this connection, a private sector development strategy in Mongolia must include the promotion of small- and medium-sized private manufacturing enterprises, simultaneously reducing the high level of concentration in many productive manufacturing activities.

5/ For example, members of the Association of Mongolian Private Enterprises Managers (AMPEM) were either privatized shops or restaurants (51 percent), producers of light industrial goods (20 percent), and/or construction companies (13 percent). The others engaged in transportation (5 percent), health and education (3 percent), mineral production (3 percent), and cultural activities (3 percent).

6/ This excludes the Erdenet cooper mine which is the single largest industrial enterprise in Mongolia, generating some $200 million in foreign exchange earnings.

Table 2.3: PRIVATE SECTOR OUTPUT IN 1992
(in millions of Tugrik)

	Total Output (GDP)	Private Sector	% of Private Sector
Industry /a	19,606	8,507	43.4
Agriculture /b	15,641	15,448	98.8
Construction	930	426	45.8
Transport /c	1,294	n.a.	n.a.
Communications	418	0	0.0
Trade /d	7,754	4,932	63.6
Services	5,475	1,859	33.9
Other	546	0	0.0
GDP	51,663	32,027	62.0

/a Data were available, by ownership, on the Gross Value of Industrial Output of about 200 enterprises. Some 50 enterprises were private, i.e., more than 50% share ownership by private individuals or firms GVIO of these enterprises added to Tug 4,870 million out of a total of Tug 11,225 million, yielding a 43.4% share approximation for the private sector.

/b Gross Value of Output of all herdsmen, coops and others add up to 98.8 percent of the total agriculture output.

/c The Ministry of Transportation and Communications estimates Tug 855 as the private sector contribution to output in the transport sector (i.e., 66.1 percent). However, these estimates could not be verified.

/d Based on the total amount of retail turnover.

Source: State Statistical Office.

2.11 Noticeable is the high level of private sector trade activities. A great number of private economic agents engage in trade activities involving exports and imports to Russia and China. This subject is examined in the following section.

C. PRIVATE SECTOR TRADE

2.12 Private sector trade activities prior to 1991 were nonexistent. Mongolia's international trade was conducted exclusively by state foreign trade corporations (FTCs). The FTCs were responsible for all exports and were the sole import purchasing agents. Following the collapse of the CMEA trading arrangements, large numbers of private traders, engaging in small-scale cash and/or barter transactions, began to emerge. In 1991,

total exports amounted to $348 million, of which the private sector contributed over $24 million. Imports exceeded $360 million, of which $33 million were private sector imports. The private sector's contribution to foreign trade has increased to over 17 percent and 20 percent of total exports, and about 8 percent and 39 percent of total imports in 1992 and 1993Q1, respectively. Table 2.4 shows the detailed breakdown of public versus private trade data from 1991 to 1993.7/ Foreign trade statistics up until 1990 were denominated in Transferrable Rouble (TR), the valuation of which is still subject to debate. The collapse of the CMEA trading system in 1991 resulted in a change, from a Rouble-based trading system to US Dollar-denominated hard currency trade.

2.13 Noticeable in Table 2.4 is the large shift toward barter trade on the part of the private sector. Private traders engage predominantly in surface trade, both road and rail, as well as air cargo in the form of checked-in and hand-carried baggage on commercial flights to and from Mongolia. The trade is by and large barter transactions mixed with some hard currency trade. Substantial amounts of Chinese goods, mostly consumer and electronic goods, are imported by private traders into Mongolia for reexport to Russia. To start the cycle, private entrepreneurs would go to China to purchase consumer goods; the goods are then shipped and sold to Russia for hard currency; and the process is repeated. This triangular trade route has been a flourishing base of private sector trade activities; however, its value added to the domestic economy has, by and large, been marginal.

2.14 A more systematic expansion of private trade, to increase domestic value added and to institutionalize private traders, will require a move to a payments-based trading system supported by formal foreign exchange facilities. At present, a lack of institutions to facilitate payments in Mongolia and in its neighbors accounts for the pervasiveness of small-scale cash and/or barter transactions. Mongolian banks, for example, are unable to open accounts with Russian banks, and foreign exchange facilities to convert Tugriks into Rubles and vice versa are virtually nonexistent.8/ It is not the convertability between the two currencies that is important per se, but rather there is a need to enhance the institutional capacity to convert the currencies in each country. For example, official trade-related payments are cleared through the center (e.g., the Buryat central bank clears with Moscow which in turn clears the payments with the Central Bank of Mongolia), which has increased the number of communications necessary for clearing, heightened congestion at the center, and lengthened delays in receiving trade-related

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7/ This data does not entail the overestimation problem depicted in Table 2.1. The private sector entity classification in this case was written by export and importing agents in their customs declaration forms.

8/ In the bordering Republic of Buryat, Russia, an independent bank (The Selenge Bank) was earmarked for operation in both Buryat and Mongolia in 1992 to conduct Tugrik-Ruble transactions and trade-related payments between the two states. However, the opening of the banks was put on hold due to the collapse of the Soviet Union and due to the dissolution of Gosbank, the Soviet central bank which guaranteed trade-related payments through a network of settlement centers. The Selenge Bank was opened in Ulaanbaatar in 1993, but it still does not engage in trade financing, due to poor payments and clearing facilities across the border, and has instead engaged exclusively in domestic banking.

Table 2.4: PUBLIC VERSUS PRIVATE SECTOR TRADE
(in $ million)

	Exports			Imports		
	1991	1992	1993Q1	1991	1992	1993Q1
Total	348.0	355.7	65.0	360.9	400.0	45.4
Public	323.9	294.2	51.4	327.3	368.4	27.6
Private	24.1	61.6	13.6	33.6	31.6	17.8
Total	348.0	355.7	65.0	360.9	400.0	45.4
Barter	6.6	127.3	16.7	4.9	62.6	12.0
Public	6.6	83.1	4.8	4.9	46.8	3.2
Private	0.0	44.2	11.9	0.0	15.8	8.9
Nonbarter	341.4	228.5	48.3	356.0	337.4	33.3
Public	317.3	211.1	46.6	322.4	321.6	24.4
Private	24.1	17.4	1.7	33.6	15.8	8.9
Percentage Shares						
Total	100.0	100.0	100.0	100.0	100.0	100.0
Public	93.1	82.7	79.1	90.7	92.1	60.8
Private	6.9	17.3	20.9	9.3	7.9	39.2
Total	100.0	100.0	100.0	100.0	100.0	100.0
Barter	1.9	35.8	25.7	1.4	15.6	26.5
Nonbarter	98.1	64.2	74.3	98.6	84.4	73.5
Barter	100.0	100.0	100.0	100.0	100.0	100.0
Public	100.0	65.3	28.6	100.0	74.8	26.2
Private	0.0	34.7	71.4	0.0	25.2	73.8
Nonbarter	100.0	100.0	100.0	100.0	100.0	100.0
Public	92.9	92.4	96.5	90.6	95.3	73.3
Private	7.1	7.6	3.5	9.4	4.7	26.7

Source: Ministry of Trade and Industry.

payments. Private sector transactions have therefore occurred on the periphery of the official market, on cash or barter terms. It is imperative to improve Mongolia's payments system so that the private sector can better function within the improved system.

2.15 Tables 2.5a and 2.5b shows total imports and exports, broken down into private and public trade, by country of origin/destination for 1992. Note the high degree of private barter transactions with Russia and China. In the beginning of 1991, when Russia accounted for 78 percent of Mongolia's total imports and 79 percent of its exports, Russia's share has steadily declined to 53 percent and 58 percent, respectively, by the end of 1992. On the other hand, China's share has increased from 2.4 percent to 12.3 percent for imports, and 1.7 percent to 17 percent for exports between 1991 and 1993Q1. Similarly, trade between Mongolia and the former CMEA countries have steadily decreased, while trade of other countries has increased sharply in recent years.

D. PRIVATIZATION

2.16 While in China, indirect methods such as tax reforms and other incentives have been used to move the economic system toward a market economy. Privatization serves as the main vehicle for Mongolia's conversion to a market economy and the main instrument for private sector development. The privatization program was initiated two years ago with the free distribution of share vouchers to every citizen. Each citizen was entitled to three "red" vouchers, (with a nominal face value of Tug 1,000) and one "blue" voucher (with a nominal face value of Tug 7,000). Red vouchers are tradeable on secondary markets; blue vouchers are not, but could be assigned to nominees.

2.17 The program is being implemented in two phases. In the first *small privatization* phase, assets of small businesses, with a total book value of Tug 9.4 billion, including agricultural assets and assets of restaurants, factories, shops and other retail outlets, were auctioned to private individuals. Individuals would bid using their red coupons at auctions organized jointly by local authorities and the Privatization Commission. The highest bidder would win, and the Commission would issue an ownership certificate to the winner. Workers working in the to be privatized establishments were given first rights to form a coalition and bid/acquire their firm. The small privatization process was successful to the extent that by 1993Q1, 100 percent of small urban-based businesses and 90 percent of small businesses nationwide have been privatized. Further, all agricultural cooperatives and over 90 percent of state farms are in private hands. This is contrast to Turkey, where the first attempt at stock sales flopped. The government had not prepared the legal and political base for privatization, it had no clear strategy or concrete program. The assumption that privatization could be treated as an administrative matter was proven wrong.

2.18 As of 1993Q1, Tug 3.5 billion in assets in value terms were privatized through the small privatization process, of which Tug 2.1 billion were agricultural assets and Tug 1.4 billion were assets in services, trade and small businesses. In voucher terms, 4.5 million vouchers, with a face value of Tug 4.5 billion, were used to acquire Tug 3.5 billion in assets, as some assets fetched more than its assessed value through the competitive bidding process. The higher bids, in voucher terms, occurred for assets in

Table 2.5a: IMPORTS BY COUNTRY OF ORIGIN FOR 1992
(in $ million)

Country	Grand Total			Barter trade			Nonbarter trade		
	Public	Private	Total	Public	Private	Total	Public	Private	Total
Afghanistan	0.470	0.000	0.470	0.170	0.000	0.170	0.300	0.000	0.300
Australia	0.001	0.000	0.001	0.000	0.000	0.000	0.001	0.000	0.001
Austria	19.127	0.176	19.303	0.590	0.000	0.590	18.536	0.176	18.713
Bulgaria	0.527	0.000	0.527	0.000	0.000	0.000	0.527	0.000	0.527
China	41.094	7.716	48.810	7.298	4.576	11.874	33.796	3.140	36.936
Taiwan (China)	0.778	0.057	0.835	0.000	0.000	0.000	0.778	0.057	0.835
Czechoslovakia	4.784	0.662	5.446	0.633	0.086	0.719	4.151	0.575	4.727
Denmark	2.231	0.553	2.784	0.000	0.000	0.000	2.231	0.553	2.784
Finland	2.082	0.000	2.082	0.000	0.000	0.000	2.082	0.000	2.082
France	7.304	0.000	7.304	0.000	0.000	0.000	7.304	0.000	7.304
Germany	20.496	1.113	21.608	0.487	0.291	0.778	20.009	0.821	20.830
Hong Kong	7.241	1.804	9.045	0.226	0.000	0.226	7.015	1.804	8.819
Hungary	4.190	0.030	4.220	0.000	0.025	0.025	4.190	0.006	4.196
India	1.725	0.000	1.725	0.000	0.000	0.000	1.725	0.000	1.725
Italy	0.741	0.224	0.966	0.000	0.224	0.224	0.741	0.000	0.741
Japan	39.187	0.730	39.916	0.037	0.182	0.219	39.149	0.548	39.697
DPR Korea	0.210	0.043	0.253	0.014	0.043	0.057	0.196	0.000	0.196
South Korea	7.782	0.228	8.010	0.013	0.009	0.021	7.769	0.219	7.989
Netherlands	0.000	0.075	0.075	0.000	0.032	0.032	0.000	0.043	0.043
Poland	1.150	0.004	1.154	0.000	0.001	0.001	1.150	0.003	1.153
Romania	0.091	0.009	0.100	0.000	0.000	0.000	0.091	0.009	0.100
Singapore	4.578	1.159	5.736	0.015	0.226	0.241	4.563	0.932	5.495
Sweden	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Switzerland	4.125	0.000	4.125	0.000	0.000	0.000	4.125	0.000	4.125
Thailand	0.014	0.091	0.105	0.000	0.000	0.000	0.014	0.091	0.105
Turkey	0.200	0.000	0.200	0.000	0.000	0.000	0.200	0.000	0.200
Russia	193.631	16.004	209.636	37.071	10.103	47.174	156.560	5.902	162.461
Great Britain	1.032	0.434	1.466	0.050	0.000	0.050	0.982	0.434	1.416
USA	1.214	0.508	1.722	0.000	0.002	0.002	1.214	0.506	1.721
Yugoslavia	2.348	0.000	2.348	0.170	0.000	0.170	2.178	0.000	2.178
Total	368.352	31.620	399.972	46.774	15.800	62.574	321.577	15.820	337.397

Source: Ministry of Trade and Industry.

Table 2.5b: EXPORTS BY COUNTRY OF ORIGIN FOR 1992
(in $ million)

Country	Grand Total			Barter trade			Nonbarter trade		
	Public	Private	Total	Public	Private	Total	Public	Private	Total
Afghanistan	0.373	0.297	0.669	0.373	0.000	0.373	0.000	0.297	0.297
Argentina	0.001	0.000	0.001	0.000	0.000	0.000	0.001	0.000	0.001
Australia	0.001	0.000	0.001	0.000	0.000	0.000	0.001	0.000	0.001
Austria	0.045	0.162	0.208	0.000	0.069	0.069	0.045	0.093	0.139
Belgium	3.584	1.110	4.694	0.000	1.110	1.110	3.584	0.000	3.584
Bulgaria	3.144	3.462	6.606	0.000	0.000	0.000	3.144	3.462	6.606
Canada	0.524	0.104	0.628	0.397	0.104	0.501	0.127	0.000	0.127
China	29.521	25.650	55.171	26.300	23.832	50.131	3.222	1.818	5.040
Taiwan (China)	0.048	0.010	0.058	0.000	0.000	0.000	0.048	0.010	0.058
Czechoslovakia	3.445	0.693	4.138	0.481	0.692	1.173	2.964	0.001	2.965
Finland	1.017	0.000	1.017	0.000	0.000	0.000	1.017	0.000	1.017
France	0.768	0.000	0.768	0.173	0.000	0.173	0.595	0.000	0.595
Germany	4.265	6.982	11.247	0.879	3.836	4.715	3.386	3.146	6.532
Hong Kong	0.694	2.928	3.622	0.114	0.637	0.750	0.580	2.291	2.872
Hungary	1.702	0.821	2.523	1.399	0.750	2.149	0.303	0.071	0.374
Iceland	0.000	0.077	0.077	0.000	0.077	0.077	0.000	0.000	0.000
India	0.002	0.000	0.002	0.000	0.000	0.000	0.002	0.000	0.002
Italy	6.730	1.449	8.178	0.000	0.048	0.048	6.730	1.401	8.130
Japan	17.270	1.194	18.464	0.000	0.366	0.366	17.270	0.828	18.098
DPR Korea	0.042	1.143	1.185	0.023	0.091	0.114	0.019	1.053	1.071
South Korea	1.008	0.624	1.632	0.010	0.045	0.055	0.998	0.579	1.577
Laos	0.072	0.000	0.072	0.000	0.000	0.000	0.072	0.000	0.072
Netherlands	1.264	0.346	1.611	0.000	0.293	0.293	1.264	0.053	1.318
New Zealand	1.021	0.000	1.021	0.652	0.000	0.652	0.368	0.000	0.368
Norway	0.003	0.022	0.024	0.000	0.000	0.000	0.003	0.022	0.024
Poland	0.197	0.213	0.410	0.104	0.035	0.139	0.093	0.177	0.271
Romania	0.015	0.000	0.015	0.015	0.000	0.015	0.000	0.000	0.000
Singapore	0.363	0.219	0.582	0.000	0.179	0.179	0.363	0.040	0.403
Sweden	0.000	0.004	0.004	0.000	0.004	0.004	0.000	0.000	0.000
Switzerland	16.428	0.002	16.430	0.000	0.000	0.000	16.428	0.002	16.430
Thailand	0.010	0.080	0.090	0.000	0.080	0.080	0.010	0.000	0.010
Russia	192.965	12.288	205.252	50.414	11.473	61.887	142.551	0.814	143.366
Great Britain	2.670	0.837	3.506	0.174	0.093	0.267	2.496	0.743	3.239
USA	3.172	0.842	4.015	0.006	0.342	0.348	3.166	0.500	3.667
Yugoslavia	1.815	0.000	1.815	1.591	0.000	1.591	0.224	0.000	0.224
Total	294.180	61.559	355.739	83.105	44.157	127.262	211.075	17.402	228.477

Source: Ministry of Trade and Industry.

central areas such as Ulaanbaatar, Bayangore and Darhan. There is an example of 65,000 vouchers being used to purchase a small company valued at Tug 5 million in Darhan. The buyer would amass his needed vouchers through a well-functioning secondary market for red vouchers. The Privatization Commission expects to utilize the remaining unused vouchers for the housing sector in the coming years.9/

2.19 In the second *big privatization* phase, the assets of 450 large enterprises and 300 agricultural companies, with total book values of Tug 10.8 billion and Tug 3.5 billion respectively, are being privatized. The big privatization process begins with enterprises developing privatization plans and seeking approval for its implementation from the Privatization Commission. The enterprises are converted into joint stock companies, while the Commission values the companies' fixed assets, audits their balance sheets, and issues shares on the basis of net assets. Ten percent of the companies' shares are reserved for, and paid in blue voucher by, employees, and the remaining ninety percent are sold in batches at the Mongolian Stock Exchange. Using their blue vouchers, bidders would declare a price or a price range for the shares, and a time period during which their bids remain valid. Brokers in each aimak would, in turn, collect declarations and phone in bids to the Stock Exchange. The broker with the highest bid would win and would register the owners, providing them with ownership/shareholding certificates. However, since secondary trading of blue vouchers is prohibited, ownership of the newly privatized companies has been diffuse. Moreover, the precise time of payment, i.e., when the stock is listed on the exchange, when the privatization commission values the company, when the bid is won, etc., has not been uniform, allowing possibilities for insider trading.

2.20 As of April 28, 1993, 338 large enterprises and 357 agricultural cooperatives have been privatized through the big privatization process. In value terms, Tug 7.7 billion in industrial assets and Tug 5.9 billion in agricultural assets have been privatized to date. Agricultural assets are not offered to the public, and it is basically divided amongst farmers working on the existing state farm/cooperative system. The majority of nonagricultural entities were converted into stock holding companies, of which 82 percent were medium-sized companies with initial assets of Tug 5-25 million and employing about 50 to 300 workers. Of the Tug 7.7 billion in privatized industrial assets, only Tug 5.6 billion have actually been sold in the Stock Exchange to date (i.e., only 259 companies), and the remaining are scheduled for sale in the near future. Hotels, service industries, trading and small manufacturing entities were the first to be privatized, while heavily subsidized state monopolies and/or state-owned enterprises are scheduled for voucher privatization by the

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9/ The Government of Mongolia is discussing the privatization of 48,000 housing units in Ulaanbaatar. There has, however, been some disagreement on (a) the procedures for privatization of units and common areas; (b) the policies for unit and building valuation; and (c) payment policies for individual households. For example, if the housing stock is simply given away in the absence of policies regrading rent, housing vouchers, and the rights and duties of ownership, problems will arise regarding transfer, payment for maintenance and utilities, and management of stock. On the other hand, if incentives for privatization are weak and/or the price prohibitive, the Government may preempt the privatization process. For a detailed discussion on housing privatization issues, see Abt Associates Inc., "Privatization of the Housing Sector in Mongolia: Building the Financial, Legal, Institutional and Economic Framework," Washington DC, December 1992.

end of 1993. The big privatization process, however, has recently begun to stall, owing to the additional time required for asset valuation of the larger state-owned enterprises. They include, for example, Erdenet cooper mine, Gobi cashmere factory, state shoe factory, state carpet factory etc. The Privatization Commission has stated its intent to privatize the state-owned share of these enterprises in the near future.

2.21 The results of the small and big privatization process, by assets and by the number of entities privatized, are shown in Table 2.6a and 2.6b, respectively. The scope and level of privatization are impressive, however, there remains numerous "kinks" in the system, involving corporate governance, capital infusion into the newly privatized entities, etc., that this paper now turns to examine.

Table 2.6a: PRIVATIZATION OF STATE ASSETS
(as of April 28, 1993)
(in Tugrik million)

		Big privatization	Small privatization	Total
1	Industry	4,266.7	189.5	4,456.2
	Energy	-	0.6	0.6
	Fuel	-	-	0.0
	Geology	142.8	7.8	150.6
	Metal processing	16.1	-	16.1
	Chemicals	6.1	-	6.1
	Building materials	470.8	21.9	492.7
	Wood, wood-based	354.1	22.7	376.8
	Light industry	1,989.0	90.1	2,079.1
	Printing	32.5	4.2	36.7
	Food	1,255.3	34.4	1,289.7
	Others	-	7.8	7.8
2	Construction	672.7	77.4	750.1
3	Transport	458.8	117.3	576.1
4	Airways (MIAT)	-	-	0.0
5	Railroads	-	-	0.0
6	Telecommunications	23.7	0.1	23.8
7	Trade, wholesale	370.5	894.8	1,265.3
8	Housing	37.8	66.4	104.2
9	Services	22.0	295.4	317.4
10	Agriculture	5,970.1	2,796.7	8,766.8
	Cooperatives	4,436.9	2,034.4	6,471.3
	State farms	1,533.2	152.7	1,685.9
	Proprietorship (farmers)	-	609.6	609.6
11	Others	770.5	115.9	886.4
12	State-owned entities to be Privatized	286.0	-	286.0
	Total	12,878.8	4,553.5	17,432.3

Source: Privatization Commission.

Table 2.6b: PRIVATIZATION BY ECONOMIC ENTITIES
(as of April 28, 1993)

		Share Holding Company	Limited Company	Limited Partnership/ Cooperative	Unlimited Partnership/ Cooperative	Propriet- -orship	Total
1	Industry	134	65	58	0	15	272
	Energy	-	-	1	-	-	1
	Fuel	-	-	-	-	-	0
	Geology	8	3	11	-	1	23
	Metal processing	1	-	-	-	-	1
	Chemicals	1	-	-	-	-	1
	Building materials	24	14	5	-	1	44
	Wood, wood-based	28	8	14	-	3	53
	Light industry	34	22	12	-	1	69
	Printing	2	7	3	-	-	12
	Food	28	8	9	-	8	53
	Others	8	3	3	-	1	15
2	Construction	44	85	60	-	13	202
3	Transport	27	59	46	-	25	157
4	Airways (MIAT)	-	-	-	-	-	0
5	Railroads	-	-	-	-	-	0
6	Telecommunications	1	-	-	-	-	1
7	Trade, wholesale	23	329	572	1	302	1,227
8	Housing	1	11	12	-	59	83
9	Services	3	135	474	3	274	889
10	Agriculture	326	196	134	0	22	678
	Cooperatives	260	97	91	-	-	448
	State farms	66	99	43	-	22	230
	Proprietorship (farmers)	-	-	-	-	-	0
11	Others	29	93	85	-	44	251
12	State-owned entities to be Privatized	-	-	-	-	-	0
	Total	588	973	1,441	4	754	3,760

Source: Privatization Commission.

III. IMPEDIMENTS TO PRIVATE SECTOR GROWTH

3.1 Given a profile of the private sector in Mongolia, this paper now attempts to identify the major impediments to private sector growth. The impediments are classified in four main categories: (a) managerial and corporate governance issues relating to the privatization process that reduce the independence and autonomy of the private sector; (b) distortions in the (domestic) distribution process through the use of a centralized procurement system that impede the productive and allocative efficiency of the private sector; (c) cumbersome border trade regulations and lengthy export regulations and licensing requirements that hinders private sector exports; and (d) state control over imports that constrain private sector access to imported raw materials. In addition, this paper examines the medium and long-term development needs of the private sector, focusing on some issues in the commercial banking system and related policies that affect private sector access to credit (both Tugrik and foreign exchange).

A. The Privatization Process

3.2 Since the initiation of small privatization in October 1991 and the privatization of large state-owned enterprises in February 1992, the speed and extent of Mongolia's privatization process has been remarkable. Under the small privatization phase, emphasis on speed over substance, yielded mixed results. In a rush to privatize, many small shop owners had to endure some early operational constraints. For example, new owners were not allowed to decide what to sell or who to hire/fire for a year after privatization, with significant government influence on their day-to-day decision-making process. At present, there is no longer any government intervention and no direct operational constraints imposed on small-scale private entrepreneurs. However, with the property law still not passed, there is pending uncertainty about ownership. In this environment, small private entrepreneurs have been unwilling to invest and make capital improvements in their businesses, preferring to focus on short term profit maximization. The merit of the small privatization process was its success in transferring public ownership to private entities, and paving a path for further private sector growth. But to further develop small- and medium-scale enterprises, the authorities must continue to allow these entrepreneurs to operate freely in conjunction with promotion and support programs for small- and medium-scale enterprises. Moreover, legislation on property rights should be resolved immediately so that private owners gain a sense of security and increase their willingness to investments in their firms. As in Russia, since ownership concepts and rights remain unrefined, investors are unwilling to risk personal capital and do not understand the stakes involved.

3.3 The privatization of agricultural economic entities pose the largest problems. Almost all the "privatized" agricultural cooperatives, farms and privatized state plots

continue to operate as they had prior to privatization. They continue to fulfill state production quotas and deal with the same official distributors. In this case, however, it is not the privatization process so much as other factors, such as Mongolia's small market size and limited population, that contribute to the newly "privatized" agricultural entities functioning as they had done so for the past 70 years. There is almost a monopsonistic buying arrangement, and no marketing opportunities for the farmers/herders. Further, there is only a handful of procurement agents limiting possibilities of diversification for the farmer/herders. The process of fully integrating the newly "privatized" agricultural entities into the market will surely take some time to accomplish (see paras. 3.10-3.16).

3.4 With the initial "success" of the small privatization process, in terms of implementation, the Mongolian authorities announced ambitious plans to complete the large privatization phase by the end of 1993. These plans, however, have recently begun to stall due to difficulties in valuating the asset of larger state-owned enterprises. The large-scale privatization process is divided into two stages: the first is geared towards transferring ownership, from the state to private individuals, while the second aims at corporatizing and capitalizing the newly privatized firms. The first stage is well under way. However, much of the managerial and fiscal responsibilities associated with ownership did not follow. Many of the newly privatized companies remain under Government control, and some continue to function as state enterprises with much of the original management and personnel intact. The lack of effective corporate governance reduces the independence and autonomy of the private sector, and further hampers its corporatization and/or capitalization process.

3.5 The creation of effective corporate governance is a three stage process: voucher issue, auctions, and shareholder consolidation through secondary trading. As yet, no company in Mongolia has gone through the entire process. There has been no capital infusion to the newly privatized firms and very little changes in the management structure.1/ The only financial instruments introduced so far have been the vouchers. The privatization process for many of these firms, therefore, represents a change in legal ownership with little or none of the corresponding change in corporate governance that usually accompany a change in ownership. The land that the enterprises are built on is still owned by the state, and many of the enterprises have negative equity unless the Government writes off their nonperforming loans to commercial banks.2/ Under these conditions, shareholders have control in theory, but against a background of zero real ownership. As a first step, the authorities must actively attempt to promote shareholder consolidation. The institution of a secondary market could be an important means of

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1/ A prime example is that of the newly privatized Ulaanbaatar Hotel. The Board of Directors and the management of the Hotel were elected by staff and employees of the Hotel prior to privatization, and a shareholder's meeting after privatization has yet to be held.

2/ The government privatized many of these enterprises with the provision that the newly privatized enterprises are not required to pay back the loans incurred by the former state-owned enterprises. The commercial banks have therefore been left with nonperforming, nonrecoverable loans on their balance sheets. Settlement of the nonperforming loans is a pressing issue affecting the banking and productive sectors.

advancing corporate governance, while promoting capital infusion to the newly privatized enterprises. In this connection, the authorities should allow secondary market transactions for vouchers and/or shares to commence as soon as possible. As a prerequisite, however, the authorities must draft and pass a *securities law* to create a proper regulatory and supervisory environment for capital market transactions and to minimize incidence of fraud and mismanagement.

3.6 On a related note, privatization for cash of government buildings and state owned houses should be examined to augment government revenues and to further develop the private sector. Although some building have been privatized, all sales have been to Mongolians and/or joint ventures. For a foreign firm to acquire a building, a Mongolian company must first purchase the building; the foreign firm would then be the joint venture partner with the Mongolian party and thereby have "ownership rights" to the building. This arrangement must be clarified, and simplified with proper legislative support, in order for the building privatization process to continue in earnest. For instance, without appropriate legislation on property and ownership, titles are subject to reconfirmation, and the definition of property itself becomes contentious. In Pakistan, urbanization has been coupled with relatively low levels of investment in housing and urban infrastructure; privatization of housing, in this environment, may create incentives for increased construction and development.

3.7 The creation of a Special Fund from the sale of government building is being considered in addition to the existing Privatization Fund. Presently, the Privatization Fund is being used to finance the stock exchange (some Tug 80 million in 1993), to support the newly privatized enterprises, for training related to privatization, and to finance the current expenditures of the Privatization Commission. In addition, some Tug 50 million have been used to finance loans to private businessmen by local level privatization commissions. However, the exact amount of the privatization fund and the flow of funds into and out of the fund has not been transparent. In this connection, there is a need for the privatization fund, and any other funds derived from the sale of government-owned assets, to be explicit and connected to government revenues.

B. The Domestic Distribution System

3.8 Historically, under central planning, resources and goods were allocated by the central planning authority to meet the needs of economic plans. Since the planners relied heavily on physical allocation of resources, prices played little or no allocative role and instead was used mainly for accounting and evaluation purposes. Under this system, the Government relied heavily on *state orders* for deliveries of goods from producers. Enterprises and agricultural entities were expected to deliver a predetermined percentage of their output to the state at a state set price that was usually below the market rate. The producers were, in return, given access to subsidized state allocated fertilizers and/or other input requirements. The objectives of the state order system were: (a) to secure domestic supplies for domestic needs, particularly for the ration system and for state-owned enterprises; (b) to centralize exports for key raw materials and manufactured goods; and (c) to utilize earnings from the centralized exports to finance key imports.

3.9 Under the 1990-92 economic reforms, state controls on the distribution of most goods and services in the factor and product markets were relaxed somewhat, and compulsory state orders were changed to "voluntary" deliveries for some goods at "negotiated" prices.3/ In early 1993, state marketing orders were abolished for all goods, and the percentage of goods sold through the state order system fell from 62 percent in 1991 to 47 percent in 1992 and to 37 percent in 1993Q1.4/ State orders persist predominantly in rural areas. For the rural population, the state order system is often the only procurement source and the sole marketing and distribution mechanism.

3.10 Although some private markets have already been established, especially for vegetables and imported consumer goods, they have been slow to develop, as government remains the principal procurement entity. State Orders have been most prevalent for agricultural products. In this connection, and to better understand the current domestic distribution system, the functional and institutional arrangements for state orders up until the end of 1992 are described below.

3.11 State orders for basic agricultural products were principally implemented by the Mongolian Agricultural Commodities Exchange (MACE) 5/ and the Central Procurement Cooperatives Union (CPCU).6/ Agents from MACE and CPCU would visit individual herdsmen and farms regularly, procuring their agricultural products and passing on state orders to the producers. The MACE's direct procurement agent, who reside in the countryside, were teamed up with one or two brokers from the aimak centers and/or from Ulaanbaatar, and together they would purchase goods from producers, supplying the procured goods to buyers. For example, raw wool is purchased and supplied to the wool washing plant; skins are bought and supplied to the tanneries; live animals are procured for the meat processing plants, etc. The procurement agents were also responsible for monitoring herd sizes and production, determining actual quantities of

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3/ "Negotiated" prices, abolished in late 1992, were set at levels lower than market prices. Producer would submit the price of their product to the Price Control Board, usually on the basis of cost plus mark-up. Upon pooling a set of producer prices, the Price Control official would set a price that would become the de facto price for the good in question.

4/ Based on a private sector survey of 100 Mongolian firms conducted by the University of Maryland (mimeo, forthcoming).

5/ The Mongolian Agriculture Commodity Exchange (MACE), formerly the State Agriculture Commodity Exchange, was established in December 1991 by organizing about 150 individual procurement units around Mongolia together as a network of "brokerage firms." Today, MACE is staffed with over 4,000 brokers/agents, and about 500 function as dedicated procurement agents.

6/ The Central Procurement Cooperatives Union in Ulaanbaatar is the central organization linking 20 local procurement cooperative unions throughout the 18 aimaks and 2 cities. CPCU has a membership of over 254 cooperatives and 92 companies, all of which are private entities. Membership is open to all private cooperatives in the countryside engaged in the business of buying raw materials from herdsmen. The central union in Ulaanbaatar is responsible for the governance of all member unions, subject to administrative oversight of MTI, MOA and other Government organizations.

animals and products to be sold to the MACE, negotiating prices and forms of payment (cash or essential consumer goods), and other procurement-related issues.

3.12 The activities of the MACE and the CPCU have been are central to the implementation of the Government's state order plans. A copy of the 1992 state orders were presented by the National Development Board to MACE and CPCU. The head office of the MACE and CPCU would then pass on these state orders to their respective local procurement agents, through their aimak center offices and union, and they in turn would pass the orders down to their local operating units. During this process, aimak-specific state order quantities were broken down into local area-specific procurement requirements, which in turn were broken down into specific procurement orders for individual farms and herdsmen. The local agents would negotiate the quantity, price and terms of payments with the producers. Once agreement is reached, the agents would take possession of the goods on behalf of the state, and these goods were recorded as the actual procurement. The procured goods were then supplied to state enterprises, state trading companies and other Government-designated outlets. Table 3.1 shows the planned and actual amounts procured through the state order system in 1991 and 1992. Except for meat and meat products and grain used for bread (the two main staples of the Mongolian diet), since January 1993, state orders for all goods were formally abolished.

3.13 Though formally abolished, the historic pervasiveness of state orders continues to influence and affect all sectors of the economy, particularly the agricultural sector. For much of the rural population, it continues to be the most important distribution mechanism, although private barter arrangements for meat and skins have been increasing. What is noticeable from Table 3.1 is the dramatic drop in actual procurements as a percentage of the state orders from 1991 to 1992. This reflects, in part, increases in administered prices to more closely reflect true market prices made during 1992. The price adjustments were followed by production and supply decisions from farmers/herdsmen to sell their goods directly to markets, circumventing government procurements whenever possible. Figure 3.1 shows the sharp increase in domestic prices for a select group of livestock products during the latter half of 1992, for example, sheepskin prices increased by about four times in value from July to December 1992.

3.14 For meat and meat products, delayed supply responses to partial increases in meat prices have resulted in some shortages of meat in urban areas. The authorities, in response, have been quick to reintroduce "mandatory" state orders for meat, and issued on March 26, 1993, Government Order no. 43 reinstating state procurement of meat. The objectives of the Order is to require meat be delivered directly to specified state slaughterhouses in order to cover the needs of state reserves, intergovernmental obligations and urban consumer demand. In spite of these stated objectives, Table 3.2 shows that about 50 percent of the 1993 spring meat state procurement (resulting from Order no. 43) went to exports, in most cases to Russia as barter for critical import supplies. The Order specifies direct state procurement for four slaughterhouses instead of through market channels or through the Mongolian Agricultural Commodity Exchange.

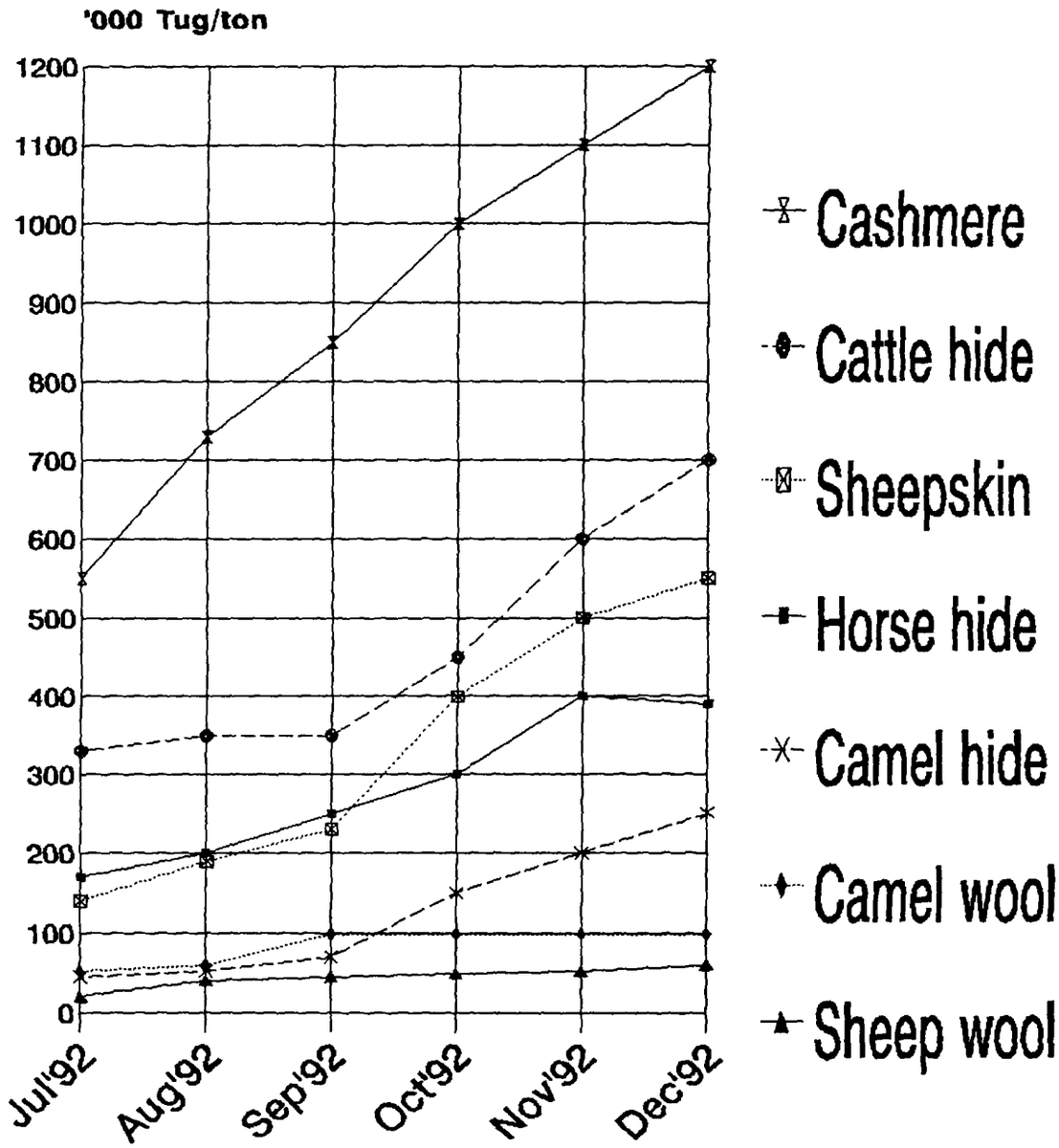
Table 3.1: PLANNED AND ACTUAL STATE ORDER PROCUREMENTS IN 1991 AND 1992

	1991				1992			
	Planned state order (A)	Actual procurement (B)	Production (C)	Actual procurement as % of production (B/C) /a	Planned state order (A)	Actual procurement (B)	Production (C)	Actual procurement as % of production (B/C) /a
Live animals (k tons)	181.5	174	497.7	35.0	173.9	106.6	436.1	24.4
Pork (k tons)	4.8	4.1	6.4	64.1	4.0	0.8	1.9	42.1
Horse (k heads)	53.7	29.1	37.1	78.4	45.3	4.5	-	-
Milk (mil.liters)	52.2	38.3	302.2	12.7	49.5	250	299.1	83.61
Butter (k tons)	3.3	3.1	3.1	100.0	3.0	1.3	1.3	100.0
Poultry (tons)	279.0	234.6	275.3	85.2	279.0	79.1	87.9	90.0
Eggs (mil. pcs)	33.0	24.2	25.5	94.9	33.0	16.8	18.5	90.8
Grain (k tons)	593.6	327.7	595.3	55.0	555.0	256.5	493.9	51.9
Potatoes (k tons)	74.2	56.9	97.5	58.4	70.5	35.3	78.5	45.0
Other Vegetables (k tons)	23.6	16.5	23.3	70.8	24.8	7.3	16.5	44.2
Wool (k tons):								
Sheep wool	19.4	18.7	17.5	106.9	17.3	12.8	21.4	59.8
Cashmere	1.4	1.5	1.2	125.0	1.5	1.4	1.6	87.5
Camel wool	2.3	2.3	2.1	109.5	2.2	2.0	2.2	90.9
Skins (k pcs):								
Camel	-	23.0	13.5	170.4	35.5	17.5	78.7	22.2
Horse	-	88.2	145.1	60.8	191.0	86.0	282.8	30.4
Cow	-	364.6	466.0	78.2	554.8	305.7	605.4	50.5
Sheep	-	2,975.5	3,245.8	91.7	4,386.2	2,641.6	4,686.0	56.4
Goat	-	935.8	953.1	98.2	1,237.8	721.5	1,336.4	54.0

/a For percentages greater than 100%, shortfalls in production were met by government reserve stocks.

Source: Statistical Office of Mongolia.

Figure 3.1: DOMESTIC PRICES (JULY-DECEMBER 1992)



Source: Agricultural Commodity Exchange.

3.15 The effects of state procurements of meat is spilled over into other sectors. It affects trade, as shown in Table 3.2, as well as domestic production and distribution. For example, Table 3.3 shows the range of consumer goods that the state "requested" from various producers for barter trade with herdsmen to ensure the supply of meat under the spring state orders. These requested goods constitute a form of implicit state orders in 1993.

Table 3.2: SPRING MEAT PROCUREMENT BY GOVERNMENT ORDER, 1993

	3 types of animal (live weight in tons)	Horses (head)
Mahimpex		
Ulaanbataar	40,341	1,994
State Reserve	4,654	-
Sausage	4,518	1,400
Exports	12,000	-
Hishig Co.		
Exports	4,580	-
Dornod Co.		
Exports	12,000	-
MonHaa Co.		
Bahahangai	-	14,454
Exports	20,000	10,000
Exports Total	48,580	10,000
Total	98,093	27,848

Source: Agricultural Commodity Exchange.

3.16 The domestic sales of manufactured goods, up until the end of 1992, were subject to a form of state order. A Ministerial Order specified that a minimum percentage of domestic output and imports (between 70 to 100 percent) of 30 state-owned enterprises must be sold through the Central Consumer Commodities Exchange (CCCE). To the extent that these minima are enforced, it limits competition and discourages production. To the extent that many of these enterprises are state-owned entities, it affects their commercialization and corporatization. The percentage of domestic sales required to pass through the CCCE in 1992 is shown in Table 3.4. Prices for goods sold in the CCCE were typically below market prices. Goods sold through the CCCE were auctioned to buyers, but access to the auction process was limited, with state shops receiving priority.

3.17 Since 1993, state orders on all consumer goods and goods produced by state enterprises that had to be sold through the CCCE were abolished. State enterprises are now free to sell their goods directly to retail outlets, although a substantial portion of goods continue to go through the CCCE, by choice and at market determined prices

Table 3.3: CONSUMER GOODS REQUIRED TO FINANCE 1993 SPRING MEAT PROCUREMENTS

Goods	Wholesale company	Wholesale grocery	Razno-impex	State Reserve	Total
Fabrics ('000 m)	1,700	-	810	1,379	3,885
Felt ('000 m)	20	-	-	5	25
Wool carpet ('000 pc)	2	-	-	-	2
Felt boots ('000 pc)	20	-	-	-	20
Boots ('000 pc)	6	-	-	-	6
Teapots ('000 pc)	5	-	-	-	5
Milk cans ('000 pc)	5	-	-	-	5
Household soap (tons)	-	-	-	20	20
Beauty soap (tons)	-	-	-	35	35
Flour (tons)	700	-	-	150	850
Dried milk (tons)	-	-	-	170	170
Sugar (tons)	-	-	-	34	34
Tea (tons)	-	-	300	-	300
Tobacco (tons)	-	-	-	56	56
Candles (tons)	-	-	-	53	53
Matches (mil. boxes)	-	-	10	-	10

Source: Agricultural Commodity Exchange.

through the auction mechanism. The supply chain, from the producer to the ultimate consumer is depicted in Figure 3.2. Areas that represent impediments to a freely functioning market-oriented distribution system are highlighted.

3.18 The domestic distribution system is an area where great improvements are necessary to permit producers to receive appropriate prices to initiate a supply response. Where state orders apply, the development of efficient prices and alternative market channels are impeded and the prospects of supply responses impaired. In this regard, it is imperative that *mandatory* and *implicit* state orders be discontinued immediately. Further, the role of MACE and CPCU, that have served as institution to supply the needs of state agencies, must be reassessed, from a centralized procurement agency to a freely operating commodity market. The exchanges should simply facilitate sales and purchases of buyers and sellers. Private commodity brokers should replace the Government employees of the commodity exchanges, and the brokers should be free to compete with each other on price and services. In addition, there should be no restriction on where producers sell their products. Requirements to sell through specified commodity exchanges should be abolished. Buyers and sellers should be free to exchange products at mutually agreed prices, either through the commodity exchange of their choice or through individual

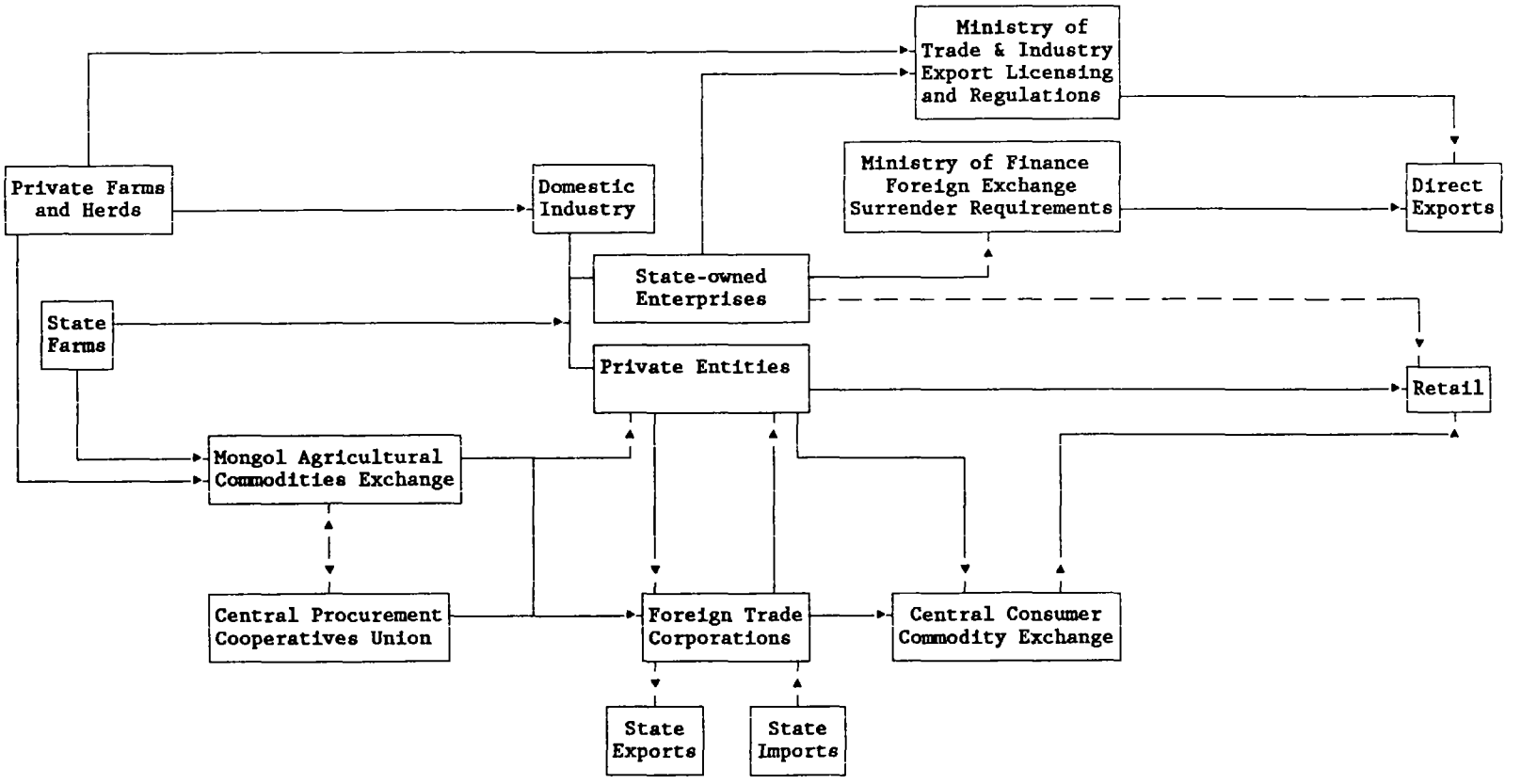
Table 3.4: STATE CONTROL OVER DOMESTIC TRADE IN 1992

Company	% Domestic Sales Required Through State Exchange
1. Meatimpex	70%
2. Vodka, beet factory	70%
3. UB carpet factory	70%
4. Erdenet carpet	70%
5. Dornod carpet	70%
6. Fur wear factory	70%
7. Darkhan sheepskin wear factory	70%
8. Leather wear factory	70%
9. Leather small goods factory	70%
10. Gobi cashmere factory	70%
11. Hunting products factory	90%
12. Coins, jewelry factory	100%
13. Furniture factory	90%
14. UB wood processing plant	90%
15. Household furniture	90%
16. Equipment trade and repair factory	90%
17. Raznoimpex wholesale company	100%
18. Mongolimpex corporation	100%
19. Mongol export corporation	100%
20. Barter and border exchange company	100%
21. Technical import corporation	100%
22. Material import corporation	100%
23. Autoimport corporation	100%
24. Agricultural technical import company	100%
25. Wholesale trading corporation	100%
26. Food products wholesale trading company	100%
27. Trade technic equipment firm	100%
28. UB trade, restaurant general company	100%
29. Hereglee Erin Co. (consumer goods)	100%
30. Other Foreign Trade Organizations	100%

Source: Minister's Decree No. 105 (February 13, 1992), Ministry of Trade and Industry.

sales and purchases outside the exchanges. This should yield market-clearing prices and create a supply response for commodities (e.g., meat) that producers have withheld due to unattractive prices. It would also serve as an incentive for traders to search for new and expanded markets, while requiring domestic manufacturers to compete for raw materials and manufacture more efficiently. In this connection, preferences given to state-owned

Figure 3.2: THE SUPPLY CHAIN



entities in terms of production and distribution should be withdrawn, and for public procurement, a list of Government tenders should be published and all companies made eligible to bid.

C. Export Licensing and Regulations

3.19 Under the centrally planned economy, Mongolia's international trade was conducted exclusively by state foreign trade corporations (FTCs). The FTCs were responsible for all exports and were the sole import purchasing agents. Trade with CMEA trading partners was handled by seven FTCs: *Mongolexport* handled all exports; *Teknikimport* handled machinery and technical equipment; *Materialimpex* handled construction-related trade; *Autoeftimport* handled all imports of vehicles and petroleum products; and *Rasnoimport* handled consumer goods. Further, *Compleximport* supervised the import/export of goods related to turnkey projects from Russia, while trade in convertible currencies was handled exclusively by *Mongolimpex*.

3.20 Following the collapse of CMEA trade and the breakup of the Soviet Union, the institutional function and role of the seven FTCs were drastically altered. As the CMEA countries began to move away from barter trade to a more cash (convertible currency) based trading system, the role of the seven FTCs was further reduced. Mongolimpex, on the other hand, grew in importance as the import/export process was increasing centralized through Mongolimpex under the watchful supervision of the Ministry of Trade and Industry (MTI). The seven FTCs continue to mediate trade transactions with Russia and other former CMEA countries, albeit at lower levels and with less prominence. With the reduced prominence of the seven main FTCs, there has been a proliferation of smaller FTCs, both private and public, in Mongolia. There are now estimated to be over 30 FTCs in Ulaanbaatar alone, and hundreds in the country as a whole with each Ministry and each aimak having their own FTC(s) engaged in specialized procurements from abroad.

3.21 Previously, FTCs obtained their exportables through an export state orders system. A predetermined portion of Mongolia's agricultural and industrial exports were procured and exported through one of the state FTCs. For example, MTI would issue explicit state orders determining a portion of total output to be exported by major manufacturing enterprises. Typically, 20 to 30 percent of the volume of state orders are exported through state FTCs. Since early 1993, however, state export orders have been abolished. While FTCs no longer have a monopoly on trade, their continued share of foreign trade is a manifestation of the Government's ongoing role as the main conduit for external trade. State orders for exports in 1992 for a select group of state-owned enterprises is shown in Table 3.5.

3.22 Private exporters are not subject to centralized state orders on exports, they are, however, required to obtain *export licenses* for items on the state orders list. In 1991, the range of items requiring export licenses was enormous, and the licensing process was a real hinderance to private sector trade. During the latter half of 1992, items requiring export licenses were reduced to thirteen categories of products. As of January 1, 1993,

Table 3.5: STATE CONTROL OVER EXPORTS IN 1992

Enterprise	Planned exports as % of output	Total planned export value ($ mil.)	Centralized export allocation
Erdenet	100%	$220.0	55%
Mongol/Sovtsvetmet Metal Corp.	100%	27.3	55%
Mongol/Czechoslovakian Metal Corp.	100%	1.0	55%
Coal Corp.	2.4%	2.6	80%
Gobi	100%	27.6	80%
Leather Garment Factory	87%	14.6	50%
Fur Factory	56%	3.1	50%
Sheepskin Factory Noosimpex	57%	11.3	50%
Wool Knitwear Factory	23%	0.5	40%
Spinning Factory	11%	1.3	50%
Textiles Factory	70%	5.4	40%
Carpet Factory	68%	19.5	40%
Meat Plant	100%	6.1	0%

Source: Ministry of Trade and Industry; State Statistical Office.

the list was further reduced to 11 items that includes: (a) precious metals and stones; (b) historical and archaeological goods; (c) art work; (d) medical herbs; (e) antlers and other organs of a deer used for medical purposes; (f) different organs of wild animals commonly used in oriental medicines; (g) rare animals, their skins, and horns; (h) game furs; (j) animals used for selective breeding; (k) agricultural animals, meat; and (l) wheat. There is further discussion of reducing export license requirements to two items, i.e., meat and live animals and wheat, by the end of 1993. During 1991, more than 453 enterprises applied for and received 1,153 export licenses, and during 1992, about 2,300 enterprises obtained 4,600 licenses. Large state-owned enterprises, such as the Erdenet copper mine and Gobi cashmere factory are exempt from export license requirements for each shipment and instead obtain a general export license issued once a year.

3.23 Up until late 1992, the export licensing procedures was fraught with bureaucratic hurdles and complicated by different standards applied to different products. To start, a private exporter was only able to access that portion of raw materials in excess of state orders. An exporter wishing to export raw cashmere, for example, would have to compete with other procurers of cashmere, in state commodity exchanges, for the limited amount of cashmere allocated to nonstate entities under the state order system. In this connection, an exporter was required to obtain a license from the state commodity exchange, and a certificate that the products were obtained through the agricultural

commodity exchange. They were also required to pay a broker's commission of 2 percent of the purchase price to the commodity exchange for each transaction. Exporter would then face the Export License Agency,7/ which required the exporter's certificate as an economic entity, an export contract and/or a letter of credit from the foreign buyer, and additional documentation depending upon the product exported. For example, permission of the Ministry of Environment was required for sawn timber; permission of the Ministry of Health was/is required for herbal medicines; permission of the Economic Police Agency 8/ was/is required for scrap and permission of the Ministry of Agriculture was/is required for exports of fodder, meat and wheat, including sanitary and veterinary certificates for foodstuff and live animals. All supporting documents were/are required prior to an export license being issued.

3.24 Upon receiving an export license, the exporter finally undergoes customs clearance. For bulk shipments, the documentation is cumbersome and lengthy, taking up to one week. For surface border crossings, procedures and conditions are prohibiting. For example, at the Russian-Mongolian border, the crossing points are open only from 9:00 a.m. to 5:00 p.m, and there are long queues of trucks often waiting three to four days to cross without food or amenities. Documents and cargo are meticulously checked, on the Mongolian side, and entire cargoes often unloaded to check for contraband items. On entering the Russian side, the focus is on checking engine serial numbers to prevent Mongolian drivers from purchasing new engines in Russia. Border crossings by train are quicker in comparison, but also require lengthy document clearance and customs procedures.

3.25 Throughout this process, private exporters complain of preferential treatment given to state exports, and indeed products with public sector interest face the most bureaucratic hurdles. There is an ongoing dispute regarding whether export licensing, as the authorities contend, are used to ensure domestic manufactures have access to adequate supplies of raw materials or whether, as private traders insist, licensing is a control measure designed for implicit interference by the authorities to meddle in the exporter's export price, contract, and composition. Private exporters cite examples of cases when the Export License Agency established minimum and maximum prices on exports. Some have cited examples of licenses being granted in exchange for their agreement to also export goods of low quality (mostly in raw cashmere and/or cashmere products) that state companies cannot place in foreign markets and to import specified consumer goods.

7/ The Export License Agency is under the jurisdiction of the Ministry of Trade and Industry. However, for agricultural products, a separate Export License Agency exists under the Ministry of Agriculture. Since early 1993, the Export License Agency in MTI has been dismantled and its de facto duties put under the jurisdiction of the Foreign Trade Department of MTI.

8/ The Economic Police Agency was founded in 1991 to stop the flow of illegal exports, in particular, deer horn, timber and scrap metal, from the country. The Export Police Agency checks the legitimacy of the export items and gives the exports its clearance. However, the zeal with which the Agency works is reflected in the lengthy time required for processing. Processing involving the Economic Police Agency can take up to a month.

3.26 The authorities while curtailing export licensing requirements, in late 1992, introduced export registration procedures, on a temporary basis up until the end of 1993. The purported purpose of the registration system is for statistical reasons and to stop the export of inferior goods (i.e., skins, hides, wool, etc.) and government regulated exports (i.e., scrap metal). However, it is unclear how the registration system differs from the licensing one. Private exporters complain of constantly changing regulations that hamper their export activities. The authorities should therefore stipulate transparent and consistent procedures for both export licensing and registration procedures, and clearly disseminate that information to private businessmen. The role and objective of export licenses and regulations must be examined, taking into account licensing requirements imposed on Mongolian exports by the European Community and/or by the US textile market. Further, the authorities should examine ways to facilitate private border trade. The time required by traders for procedural clearance by customs and border police at points of entry/exit should be drastically reduced.

D. Centralized Import Procurement

3.27 Mongolia's imports to GDP ratio was 52 percent in 1989 compared to an average of 30 percent for a number of roughly similar and socialistic economies (i.e., Paraguay, Papua New Guinea, Romania, Bulgaria and Vietnam). This reflects Mongolia's past economic integration with the former Soviet Union, reflecting also misallocations that resulted from large amounts of Soviet assistance to the country. About 1,000 misallocations resulting from enterprises and other installations built with Soviet assistance produce more than half of the national income, about 60 percent of industrial production and 100 percent of energy supply, all of which depend on equipment, spare parts and critical inputs imported from the Soviet Union. These imports have been arranged by state FTCs in consultation with MTI. In this regard, MTI has traditionally been responsible for budgeting, planning and importing all of Mongolia's import needs.

3.28 To finance the import requirements of the country, foreign exchange earnings from exports of copper, agricultural raw materials (such as meat, wool, cashmere and skins), and manufactured products (such as carpets, sweaters and coats) were extracted from state-owned enterprises. Under *foreign exchange surrender requirements*, Mongolian state-owned enterprises are presently required to surrender 55 percent of their foreign exchange earnings to the central bank at the market exchange rate; foreign exchange surrender requirements do not apply to private sector entities. In the past, however, state enterprises faced stiffer foreign exchange surrender requirements. Table 3.6 shows the foreign exchange surrender requirements for state-owned enterprises that existed in 1992.

3.29 The collapse of the CMEA trading system has brought about the need for Mongolia to diversify its source of imports and develop international commercial importing skills. Given Mongolia's isolated position and virtual lack of international commercial contacts, this diversification and development has not been easy. The Ministry of Trade and Industry continues to be the central import procurement agency of the Government and is the only agency involved in large-scale foreign procurement in Mongolia. Private importers are completely excluded from large-scale government procurements.

Table 3.6: FOREIGN EXCHANGE SURRENDER REQUIREMENTS IN 1992

Copper Concentrate	55%
Molybdenum Concentrate	55%
Fluorspar Concentrate	55%
Coal	80%
Unprocessed & semi-processed wool	80%
Unprocessed hides & skins	70%
Semi-processed hides, skins & fur	70%
Live animal and meat	80%
Semi-processed cashmere	80%
Ready-made Garments	
Cashmere products	80%
Camel wool products	80%
Sheep wool products	40%
Leather products	50%
Carpets	40%
Fur, sheepskin products	50%

Source: Ministry of Trade and Industry.

3.30 There is a need to reduce the role of MTI in the import process. The most effective way of dismantling the centralized import mechanism is by curtailing the use of foreign exchange by the state to finance state imports. The import process should be decentralized with the objective of individual importing parties engaging directly in import transactions through payment arrangements involving the financial system. By eliminating state control over imports, and the corresponding need for centralized state imports, the foreign exchange requirements of the Government is limited to meeting payments for debt service, arrears and public projects, and for administrative needs. The authorities should therefore endeavor to reduce the level of foreign exchange surrender requirements to match the Government's nonimport foreign exchange needs at a level that is uniform, equitable and transparent for all enterprises. This should be a stated policy objective of the authorities with a view to total elimination of foreign exchange surrender requirements within a specified period.

3.31 As Mongolia improves its payments system, transforms the role of foreign trade corporations, relaxes restrictions on private exports, and promotes trade through its financial system, the role of the state in the import process will become trivial. However, during the next two to three years, as financial institutions gain experience with international dealings, a proactive policy of assimilating techniques and developing skills in bid evaluations and international purchasing is required. International procurement and trade transaction, now centralized within the Procurement Unit of MTI, should be more and more decentralized to include individuals and/or groups large enough to engage in major international procurement (e.g., tourist industries, cars and durable goods importers,

etc.). Private sector procurement should be encouraged with particular emphasis on procurement through the banking system. The time needed to achieve total elimination of state imports, substituted by direct private imports through the banking system, should coincide with the time needed for the elimination of foreign exchange surrender requirements.

3.32 The role and importance of the financial system in the development of the private sector is increasingly apparent. Even a country like Yugoslavia with solid aggregate savings has had a hard time mobilizing financial resources since economic reforms. Factors that hindered Yugoslavia include: interest rate policy of commercial banks, inflation, and a system of worker self-management that insulated enterprises from financial risk. Further, in Vietnam, a country int he fourth year of its reform, complete price decontrol and a flexible exchange rate policy has been achieved, due in part to the links between private and financial sector development. This paper therefore turns to examine the medium and long-term development needs of the private sector, and in particular examines the role of the financial sector. In addition, the paper outlines the long-term technical and human capital requirements of the country in relation to private sector development.

IV. MEDIUM- AND LONG-TERM DEVELOPMENT NEEDS

4.1 For the medium and long term, Mongolia must address its pressing infrastructural needs to further develop the private sector. For example, Mongolia's remoteness and land locked status makes transportation a major concern for trade expansion. The lack of reliable power supply and an underdeveloped telecommunications system also contribute in dampening private sector growth. These infrastructural needs aside, a sustainable private sector development strategy must advance the development of financial institutions in order to provide the foundation for private savings and investments, and in order to facilitate foreign direct investments. This paper, therefore, focusses on the financial sector issues that affect the private sector in Mongolia. It then discusses some foreign direct investment issues, and addresses the human resource development requirements, necessary to sustain private sector growth.

A. Financial Sector Issues

4.2 The foremost problem faced by private entrepreneurs is limited *access to foreign exchange* to pay for their imports. The shortage in foreign exchange has affected all sectors of the economy, particularly during 1991 and 1992, but its impact on the private sector has been enormous. In an environment of tight monetary policy and limited foreign exchange, private entrepreneurs found it difficult to obtain foreign exchange to finance their import needs. Access to official funds, i.e., funds from the banking system at the official exchange rate, was systematically denied to private entrepreneurs. The official exchange rate was devalued from Tugrik 40 to $1 to Tugrik 150 to $1 in January 1, 1993. Throughout 1992 to 1993, the parallel market rate ranged from Tug 350 to 450 to $1. The authorities have, in May 1993, unified the official and parallel market rates under a floating exchange rate regime. Prior to 1993, however, private entrepreneurs only had access to two very thin alternative foreign exchange markets: a semi-official market and a curb market. The post office was the only semi-official market for foreign exchange, selling foreign exchange at the parallel rate in an equivalent amount to what it purchased that day. In 1992, on average, the post office transacted only $300-500 a day. The only other foreign exchange outlet in 1992 was a private commodity exchange that acted as an auctioning house for foreign exchange transactions. However, its transactions were small, recording only a few foreign exchange transactions. The curb market, on the other hand, operated in open-air markets and on the streets of cities like Darhan and Ulaanbaatar. Small time operators engaged in foreign currency trading, in an atmosphere of illegality, at market exchange rates of about Tug 400 to 450 to $1 throughout this period.

4.3 Since early 1993, private entrepreneurs have been able to obtain foreign exchange from commercial banks at very near market rates, and since the unification of exchange rates in May 1993, at prevailing market rates. There have also been a prolifera-

tion of semi-official foreign exchange transacting agencies, (i.e., in hotels, restaurants, dollar shops, etc.) and these agencies are rapidly replacing the unofficial curb markets. Yet, foreign exchange loan conditions continue to be prohibitive for the majority of private entrepreneurs, ranging anywhere between 10-15 percent per month, and many continue to resort to small-scale barter trade activities to raise their foreign exchange capital.

4.4 Private entrepreneurs face difficulties making payments arrangements through the banking system. A private importer has essentially one foreign exchange transactions bank, State Bank of Mongolia (International), for payment arrangements to facilitate import transactions. Two other commercial banks, the Investment and Technological Innovation Bank and the Mongol Daatgal (Insurance) Bank, have begun operations in financing international trade transactions, but as yet, their operations are small. Aside from State Bank International (SBI), Mongolian banks in general lack experience in opening of letter of credit (L/C), verifying import contracts with the foreign transacting banks, transferring funds to the foreign agent banks, etc. A simple transaction, for example, of transferring existing foreign exchange funds from the savings account of an importer to an exporter's account overseas can take an upward of ten days depending on the size of the transfer, often taking longer for larger sums.

4.5 State Bank International has in the past been predominantly concerned with the payments arrangements for line ministries and state-owned enterprises. Private sector entities were given second priority. Until very recently (i.e., early 1993), SBI was required to finance the foreign exchange trade transactions of all line ministries. For example, SBI would receive a pay order for a public sector import from the Ministry of Trade and Industry, which was responsible for consolidating the import request of all line ministries and processing the procurement and distribution of all imports. SBI was required to finance state imports with its available foreign exchange, without prospects of foreign exchange replenishment by the state agencies concerned. Foreign exchange demand deposits of individuals have frequently been used to finance state imports, and this adversely affected the ability of SBI to quickly facilitate payments arrangements for private individuals. SBI has therefore been unable to function as a commercial entity, constantly lacking foreign exchange to effectively perform its international transactions services.

4.6 The inability of SBI to honor the foreign exchange account of its depositors and to smoothly facilitate foreign exchange transfers has lead to a loss of credibility in the bank and in the banking system. This credibility gap has yet to recover, however, in early 1993, the Mongolian authorities have taken some steps to clarify role of State Bank International, emphasizing its commercial operations and minimizing its role as exchequer of the state. SBI's role as a payment agent for public sector imports has been, by and large, eliminated, and its operations are now conducted under commercial criteria. Moreover, the reserve management responsibility of SBI has been transferred to the central bank, Mongolbank, so that SBI can concentrate solely on international trade financing. However, there is still room for improving the role of SBI as a commercial entity, and to improve its credibility in the eyes of private sector agents. The authorities should also facilitate and support the participation of other commercial banks in foreign exchange transactions. In this connection, a concerted effort to encourage the use financial

institutions (i.e., commercial banks) by private traders must be made. This will have the effect of institutionalizing peripheral private sector trade activities while deepening the financial system.

4.7 To further private sector development, commercial banks should also provide equal *access to Tugrik credit* to public and private enterprises alike based on sound credit analysis. A substantial portion of the private sector loans are based on personal connections and not based on sound credit analysis. In this regard, strengthening the human technical expertise of the financial system could be decisive. Under the command economy, the function of the banks was as a conduit of funds for projects approved by Government ministries, based more on social aspects than credit considerations. Hence, no traditional formal financial analysis of credit applications has been developed on how to evaluate projects or how to calculate loan repayments based on cash flow projections. The commercial banks lack basic skills of credit analysis and have not developed proper credit policies and procedures including loan monitoring techniques and workout situations. In addition, the banks are unfamiliar with how to market bank services, how to develop new products, and what teller services mean. There is therefore an urgent need to support the financial sector and invest in its human capital, particularly in the areas of accounting, auditing and marketing.

4.8 In light of high domestic inflation, the Mongolian authorities must continue to pursue tight monetary policies. However, while pursuing these policies, the monetary authorities must assure that the supply response to the economic reforms and the development of newly budding private sector is not thwarted for lack of sufficient bank financing.1/ But as China's inflationary experience suggests, it is difficult to organize enterprise investment into private risk capital. Therefore, in an environment of tight monetary policy and limited scope for credit expansion, a concentrated effort to minimize the adverse effects of "crowding out" on the private sector is needed. Table 4.1 shows the growing proportion of total loans given to the private sector since 1991. While this effort is commendable, actions must also be taken to reduce direct credit allocations by the government. Further, improving the financial position of the remaining state enterprises would help reduce their claims on the banking sector as a proportion of total credit, allowing greater room for private sector credit use. In addition, reducing the fiscal deficit through expenditure and revenue policies would alleviate the need for substantial bank financing of the deficit, and, correspondingly, allow greater scope for private sector bank financing.

B. Foreign Direct Investment

4.9 In a related field, the opening up of Mongolia and the enactment of the *foreign investment law* have generated 106 joint venture agreements as of December 31, 1992, of which 38 joint venture companies are state-owned, e.g., Erdenet copper mines,

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1/ There is ongoing assistance from the donor community in this regard, including assistance from Asian Development Bank, Germany (KFW), USA (USAID), the World Bank and the International Monetary Fund.

Table 4.1: CONSOLIDATED BALANCE SHEET OF COMMERCIAL BANKS, 1991-93
(in millions of tugriks; end of period)

	1991		1992		1993
	June	Dec.	June	Dec.	Mar.
Domestic credit	4,023	11,739	16,141	17,347	20,150
Net credit to Government	-686	-965	-1,691	-1,538	-2,241
Credit	129	222	315	412	529
Deposits	815	1,186	2,007	1,950	2,770
Loans to nonbanks	4,709	12,703	17,832	18,885	22,391
Public enterprises	3,877	9,631	13,111	11,960	13,004
Private sector	832	3,072	4,721	6,925	9,387
Cooperatives/private companies	(617)	(2,664)	(4,304)	(6,594)	(8,954)
Individuals	(215)	(408)	(418)	(330)	(433)
In domestic currency	4,402	12,425	17,502	18,470	21,056
In convertible foreign currency	307	278	330	415	1,335
Deposits	2,623	8,193	9,926	11,202	14,934
Demand deposits	1,798	5,592	6,810	5,790	6,426
Public enterprises	(1,472)	(4,710)	(5,542)	(4,192)	(4,734)
Private sector	(326)	(882)	(1,267)	(1,598)	(1,693)
Time/savings deposits (domestic currency)	455	1,997	2,421	4,430	4,696
Foreign currency deposits	370	604	695	982	3,812

Source: Bank of Mongolia.

Mongol Railways, etc. Five joint-venture companies have majority foreign equity/ownership, while the other 63 are majority Mongolian equity. The joint ventures are mostly involved in producing commodities such as cashmere, camel wool, horse hair, meat and minerals, but some are in trading and tourism. It is notable that all these ventures utilize Mongolian inputs, and none is an assembly-processing venture, as is frequently found in other Asian countries. The authorities will have to be realistic about the types of foreign enterprises likely to invest in Mongolia and their potential impact. Most foreign investors will probably follow the recent pattern, seeking to add value to Mongolia's natural resources, especially in animal by-products. Transport cost will probably make processing of imported materials expensive, and significant investment in raw material processing will depend on improvements in export transport.

4.10 There is currently less than 30,000 vehicles registered in Mongolia, and only about 1,500 km of paved roads and about 4,000 km of rural roads/tracks. A clear lack of road transport and transportation facilities restrict movement of raw materials and finished goods. There seems to be a lack of coordination of transport organization and control in that while transport pools exist as a function of individual Ministries, mass mobilization of general transport seems to be a problem. The sooner there can be private intervention in this area the better, so that goods can be moved to end users swiftly. Rail transportation is little better. There is a scarcity of rolling stock and the railway gauge are different from that of China through which lies Mongolia's access to the sea. The distribution of essential commodities, such as meat, milk and fuel products, is hampered by a lack of suitable refrigerated tankers/containers and fuel tankers and bulk storage facilities.

4.11 Expectations of immediate benefits from foreign direct investment should be modest. The two areas where immediate action seems most warranted are in strengthening foreign direct investment administration and in selective promotion. In conjunction, foreign investment laws and regulations need to be elaborated upon, in par with foreign investment laws in other comparable countries. It is imperative to have a simple foreign investment process, preferably via a "one-stop" agency where foreign investors can obtain all the necessary permissions as well as information about potential local partners. In addition, such an agency should selectively promote foreign investment, by forging institutional links with overseas agencies that can target potential investors in Mongolia's export industries.

C. Human Resource Development

4.12 Human resource development is necessary to sustain the growth of the private sector. Foremost, there are needs to develop professional accounting, auditing, and marketing skills for all private entrepreneurs. Projects such as the State Economic Enterprises (SEEs) training programs in Turkey have been effective in engendering critical entrepreneurial skills and tools. In this context, entrepreneurship skills for small and medium enterprise owners in Mongolia must also be taught. Within the banking system, practical training in commercial banking, such as in evaluating loan applications, increasing import and export transactions, and strengthening domestic and consumer banking (e.g., check clearing), must be forthcoming. These training needs requires government cooperation and support. However, concerted grass roots level support from individuals and private sector support institutions are also important and necessary. The private sector should be encouraged to organize entities, like the National Business Association or the Association of Mongolian Private Enterprise Managers, to look out for its interests. The organization should be truly independent of government to influence policy, to provide credit and advice to itself, and to work with banks. In this regard, the authorities should help these institutions develop programs that inform and train business owners/entrepreneurs. For example, the authorities could support the development of: (a) sole entrepreneur and the small partnership, by providing credit and advice to microenterprises and supporting for women entrepreneurs; (b) small and medium enterprises, by assisting in their business plan, in their dealing with banks, in their accounting and auditing, and

in dealing with sales and profits tax; and (c) cooperatives, in terms of their legal and organizational framework and in accessing special credit. For all the above, coordination is required, both in terms of donor coordination as well as domestic coordination between Governmental agencies, Nongovernmental Organizations, and the banking system.

V. CONCLUSION AND SUMMARY

5.1 This paper examined the overall reform issues affecting private sector development in Mongolia, characterizing the private sector in Mongolia today while identifying the major impediments to private sector growth. First, the paper identified issues relating to preferential treatment of state enterprises and the lack of corporate governance and autonomy for newly privatized enterprises that prevents an expansion in private sector activities. With respect to the small privatization process, the paper noted that the authorities should continue to allow small scale private entrepreneurs to operate freely, supported by proper legislation (on property rights) so that private owners increase their willingness to invest in their firms. For the large scale privatization process, the paper stressed that the authorities must actively promote shareholder consolidation. The paper noted that a secondary market could be an important means of advancing corporate governance and promoting capital infusion to the newly privatized enterprises. In this connection, the authorities should allow secondary market transactions for vouchers and/or shares to commence as soon as possible. As a prerequisite, however, the paper emphasized the need to draft and pass a *securities law* in order to create a proper regulatory and supervisory environment for capital market transactions and to minimize incidence of fraud and mismanagement.

5.2 Second, the paper observed that distortions in the domestic distribution process should be eliminated by discontinuing *mandatory* and *implicit* state orders immediately. The paper emphasized the need for the authorities to encourage the development of markets (exchanges) that facilitate the sales and purchases of buyers and sellers, abolishing requirements to sell through specified commodity exchanges. Buyers and sellers should be free to exchange products at mutually agreed prices, either through the commodity exchange of their choice or through individual sales and purchases outside the exchange. This should yield market-clearing prices and create a supply response for commodities (e.g., meat) that producers have withheld due to unattractive prices. It would also serve as an incentive for traders to search for new and expanded markets, while requiring domestic manufacturers to compete for raw materials and manufacture more efficiently.

5.3 Third, the paper examined the lengthy export regulations and licensing requirements that hinders private sector exports and recommended its early elimination. The paper noted that private exporters complain of constantly changing regulations that hamper their export activities. The paper therefore suggested that the authorities stipulate transparent and consistent procedures, for both export licensing and registration, and clearly disseminate that information to private businessmen. Further, the paper recommended that the authorities examine ways to facilitate private border trade. The time

required by traders for procedural clearance by customs and border police at points of entry/exit should be drastically reduced.

5.4 Fourth, the paper addressed the issue of centralized imports, supported by foreign exchange surrender requirements, that perpetuates state control over foreign trade in order to ensure a much needed short term supply response from the private sector. The paper suggested the elimination of foreign exchange surrendered for use by the state to finance state imports. Instead, the paper suggested that the import process be decentralized with the objective of individual importing parties engaging directly in import transactions through payment arrangements involving the financial system. The foreign exchange requirements of the Government should be limited to meeting payments for debt service, arrears and public projects, and for administrative needs. The paper therefore recommended that the authorities endeavor to reduce the level of foreign exchange surrender requirements to match the Government's nonimport foreign exchange needs at a level that is uniform, equitable and transparent for all enterprises. This should be a stated policy objective of the authorities with a view to total elimination of foreign exchange surrender requirements within a specified period. Furthermore, the paper stressed that preferences given to state-owned entities in terms of production and distribution should also be withdrawn, and for public procurement, a list of Government tenders should be published and all companies made eligible to bid.

5.5 A positive early response from the private sector greatly depends on how well these issues are addressed and on how well the authorities nurture the environment for private sector development. In this regard, there is a critical need to better coordinate policy-making and policy implementation, and to better disseminate information to private businessmen. This is particularly the case for export licensing and registration procedures. For the medium and long term, Mongolia must examine its pressing infrastructural needs. For example, Mongolia's remoteness makes transportation a major concern for trade expansion; the power and telecommunications sectors should be supported; and, the financial sector should be further developed to facilitate private sector growth. Private sector development must occur in an environment of market reform. In this regard, Mongolia must continue to move forward with its reform process, to ensure the development of the private sector in particular and the growth of the economy in general.

THE COMMERCIAL BANKING SYSTEM

1. Essential to the development of the Private Sector is a well-functioning banking system that is able to provide financing to emerging small- and medium-sized enterprises. In this connection, and in spite of recent progress, the underdeveloped Mongolian financial sector poses a significant constraint to private sector activity.

2. Up until late 1990, Mongolia had only one Bank, the State Bank of Mongolia, which performed both central bank and commercial banking functions. Under the 1991 Banking Law, the State Bank of Mongolia was split into four parts. The central banking functions were consolidated under the **Mongol Bank (BOM)**, focussing on monetary and fiscal policy issues and the monitoring and supervising of commercial banks. Two former departments of the State Bank were turn into separately capitalized state-owned commercial banks—**State Bank International (SBI)** was created to handle foreign trade financing and to conduct foreign exchange operations; and the **Investment and Technological Innovation Bank** was established to finance capital construction projects. And branches of the former State Bank of Mongolia were transferred to two newly formed commercial banks, with the **Agricultural Bank** and the **People's Bank**. As of April, 1993 there were 14 commercial banks operating in Mongolia:

(a) **The People's Bank** was formed from savings banks in Ulaanbataar and handles most of the Government accounts;

(b) **The Investment and Technological Innovation Bank** was formed during the breakup of the State Bank of Mongolia and finances mostly capital construction projects;

(c) **The Agricultural Bank** has the largest branch network in the country (350) and primarily finances agricultural cooperatives;

(d) **The Energy Bank** finances power plants and energy-related projects;

(e) **State Bank International**, also known as the **Trade and Development Bank**, are all Government owned.

(f) **Mongol Daatgal (Insurance) Bank** with 15 branches has a diversified loan portfolio, financing a broad cross-section of businesses;

(g) **Shareholders' Industrial Bank**, which finances industrial projects, have mixed ownership.

(h) **The Transportation Bank** finances road and bridge construction;

(i) **Mongol Horshoo (Cooperative) Bank** has three branches and primarily finances light manufacturing and service cooperative ventures;

(j) **The Central Asian Bank**;

(k) **Rich Bogd Bank**;

(l) **The Selenge Bank**;

(m) **Business Bank**; and

(n) **Post Bank**, which are all privately owned, have recently been established and expect to operate in a variety of sectors including foreign trade financing.

3. Besides the Bank of Mongolia, the state retains full ownership of SBI and the Investment and Technological Innovation Bank. Privately owned financial institution include the newly created Transportation Bank, Mongol Horshoo (Cooperative) Bank, Central Asian Bank, Rich Bogd Bank, Selenge Bank, Business Bank, and Post Bank. The other commercial banks are joint-stock companies, the major shareholders of which are state-owned enterprises. Even though Mongolian law permits foreign banks to establish joint-venture banks and/or engage in wholly owned operations in the banking sector, up to now there has been no foreign banking activity in Mongolia.1/

4. A minimum of Tug 50,000,000 of capital is currently required to start a bank, though there has been discussion about increasing this amount to Tug 150,000,000. Tug 20,000,000 in capital is required to set up a branch, which can be supplied by separate group of shareholders for which the parent bank may not be the majority contributor. Despite this unusual situation, branches do consolidate their finances fully with the "parent" bank, though branches can be either partially owned subsidiaries or separate banks in which the nominal parent has a minority stake.

5. Commercial banks mainly engage in rudimentary banking comprised of simple deposits and loans. Some banks have recently begun to engage in brokerage activities and security transactions; and some licensed foreign exchange banks have begun to finance foreign trade activities. But the scope of these activities are small, and only SBI plays a significant role in foreign trade financing.

1/ There is presently some interest by Lippo Bank to establish a joint-venture bank with either/or Central Asia Bank and Mongol Horshoo Bank.

6. The banks are free to set their own interest rates for deposits and loans,2/ but are forbidden to engage in material production, or to engage in insurance or land transactions. As yet, commercial banks do not offer checking systems. Except for payment orders, there are presently no alternatives to cash, and with physical shortages in bank notes, this has resulted in prolonged delays in withdrawals experienced by most depositors. As the physical shortage of cash grows, economic agents see little virtue in depositing money in banks, only to have that money denied them when they need it. This disincentive to deposit cash is further reinforced by the low (negative real) interest rates offered by banks, and the threat of fiscal authorities using the banks to confiscate taxes via bank accounts. In this connection, commercial banks should begin studying the issue of operating a checking system.

7. The commercial banking system does not have a developed financial infrastructure. Its accounting practices are poor: There is a lack of understanding of the significance of income statements, and therefore no formal income statements exist. Accounting practices for problem loans, for example, is done at the discretion of individual banks, which in practical terms means that nothing is done. Reserve accounting is also done at the discretion of individual banks. Some banks are setting up some reserves, but in the absence of thorough portfolio analyses, including a complete and rigorous accounting for problem loans, these are most likely inadequate.

8. Under the present payments system, BOM maintains clearing accounts for each commercial bank, while individual payment orders are issued by economic entities. Payment orders represent requests by clients to debit their account in a certain amount and transfer same to another party's account at that other party's bank. The process flows through BOM, which transfers money from the payor bank to the payee bank via accounts maintained at BOM for each commercial bank. Smaller banks have found it difficult to maintain sufficient debit balances with BOM, as borrowers empty deposit accounts to pay suppliers, clients, etc. In the absence of sound asset/liability management and lacking specific financial alternatives on the liability side (e.g., short-term interbank loans), and given the difficulty of rapid deposit mobilization, the result is forced loans (at 18-36 percent per month) from BOM to banks in a net credit position. The clearing/payments system clearly needs to be streamlined.

2/ Base interest rates for savings accounts paid to individual depositors are determined by BOM. The current base rate is 5 percent.

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