MONGOLIA QUARTERLY

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The World Bank's *Mongolia Quarterly* provides an update on recent economic and social developments and policies in Mongolia. It also presents findings of ongoing World Bank work in Mongolia. The Mongolia Quarterly is produced by a team from the World Bank's Poverty Reduction and Economic Management (PREM) Sector Unit in the East Asia and Pacific Regional Vice-Presidency, with key inputs from other members of the Mongolia Country Team. Questions and feedback can be addressed to Sunjidmaa Jamba (SJAMBA@WORLDBANK.ORG)

RECENT ECONOMIC DEVELOPMENTS

1. ***In 2007 Mongolia achieved high economic growth.*** Real GDP growth rate was 9.9 percent in 2007 (Figure 1a and 1b). Economic growth has been primarily driven by agriculture (which contributed 3.4 percentage points to economic growth), and services (which contributed 4.3 percentage points). In the agriculture sector, the December 2007 annual livestock census reported an increase of 15 percent of livestock from 34.8 to 40.3 mln livestock, with the number of goats, sheep and cattle increasing by 18, 15 and 14 percent respectively. While most of the foreign direct investment (FDI) coming into Mongolia continues to go to mining, its value-added only grew by only 1.7 percent this year (mainly came from coal extraction). The services sector continues to show a strong growth, driven in particular by transports anmd trade (2.1 and 1.3 points of economic growth respectively.

2. ***Inflation has picked up to reach 15.1 percent in 2007, the highest level in the decade (Figure 1a)***. This marked increase in inflation is due to rapid monetary growth, public sector wage increases and increases in the price of some main imports (c.f. Mongolia Quarterly, November 2007).

Figure 1a – In 2007, economic growth accelerated and so did consumer prices…

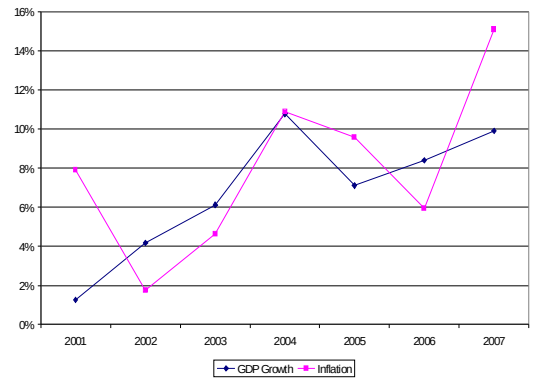
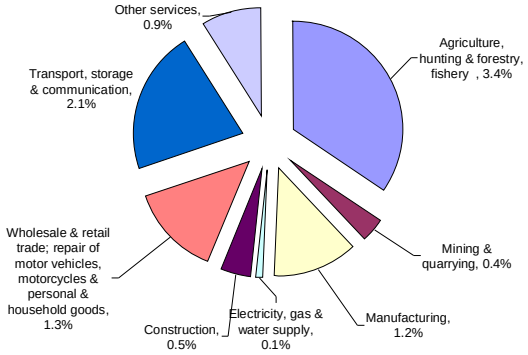


Figure 1b – … and was driven primarily by agriculture, transport and trade.



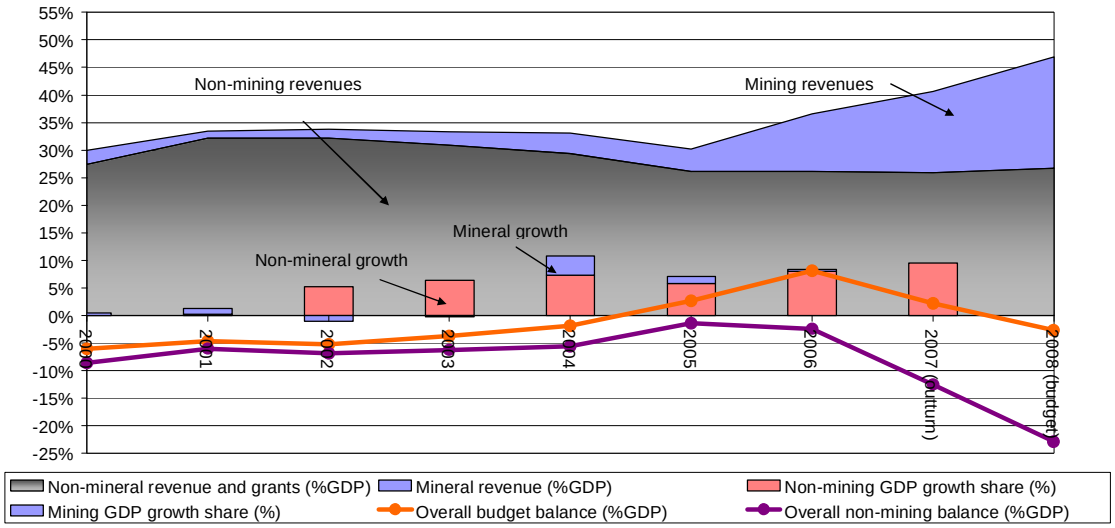
3. ***Rapid monetary expansion continues***. In 2007, money supply (M2) increased by 56.3% and currency issued in circulation by 48.5%. Total loans outstanding increased by 68.1% of which loans to private sector increased by 83.3%. Some monetization of the economy is still at work. Compared with other similar developing countries, the level of monetization in Mongolia is low. In 2006 for instance, low income countries have on average a ratio of M2 to GDP of 52 percent.

4. ***Declining gold exports (officially recorded) combined with robust import growth have led to a trade deficit in 2007***. Since the imposition of the windfall tax on gold and copper exports, officially recorder gold exports have started to decline as more and more gold is now allegedly being smuggled out of the country. These exports outside formal trade networks are typically undertaken in order to avoid paying the windfall tax. For the first year, the (positive) price impact of high international prices for copper and gold on export earnings has been outweighed by the (negative) impact of the windfall tax on recorded gold exports. Meanwhile, import growth has remained robust in 2007, led by strong economic growth which translated into sustained demand for consumption and investment goods. As a result, the total external trade balance turned to a

deficit of $228.3 million. Compared to a year ago, exports grew by 22.5% (reaching $1,888.9 million) and imports rose by 42.5% (reaching $2,117.3 million).

5. ***The impact of the mining sector in the economy is by and large due to a price effect linked to high international prices, as opposed to expansion of production***. For instance, while the volume of copper concentrate exports only increased by 1.4%, its value increased by 27.7% in 2007 compared to 2006. The average price of copper concentrate increased by 26% from was $1,059.9 per ton in 2006 to $1,335.2 per ton in 2007. As shown in Figure 2, Mongolia's recent economic growth has not been directly driven by the mining sector but by agriculture and services sector value added (see Figure 1b and Figure 2 below). However, looking ahead, Mongolia is becoming increasingly vulnerable to fluctuations in world mineral prices. This has important implications in terms of policy response, especially to insulate the associated risks from the poor. Indeed, mining revenues are contributing to an increasing share of the budget, while expenditures are on the rise (see Figures 2 and 4). If one believes that the current price level of mineral prices will eventually come down in the medium-term, policies are recommended which aim at smoothing the revenue stream over time by, for instance, directly saving some of it or prudently investing the proceeds in renewable assets.

Figure 2 – How much does Mongolia rely on Mining?



6. ***China is Mongolia's main trading partner, while Russia remains an important strategic trading partner***. Mongolia's trade with China represents 51.9% of total external trade turnover. Mongolia's trade with Russia is declining and represents 19.7% of total external trade in 2007. Although declining, trade with Russia is strategically significant, as Mongolia is almost totally dependent on Russian oil. In 2007, a total of 769.6 thousands tons of oil products (equivalent to USD 533.5 million) were imported mostly from Russia. Similarly, it imports most of its wheat and wheat–related products from Russia (see also the next section on impact of world oil and food prices increase on the Mongolian economy).

7. ***Mongolia's exchange rate has been recently reclassified in the IMF's de facto classification of exchange rate arrangements from floating to a (fixed) conventional peg***. At end-2007, the Mongolia's net international reserves (NIR) reached $972.4 million, which is equivalent to about 24 weeks of imports. They have increased by 41.5% compared to the previous year. But at the same time, the nominal togrog exchange rate against the US dollar was stable at 1,169.97 togrogs/$. This implies only a slight 0.4% depreciation of the currency compared to a year ago. This has led the IMF to re-classify Mongolia's exchange rate arrangement to a conventional peg, which acknowledges the *de facto* peg of the Mongolian togrog within margins

of ±1 percent or less vis-à-vis the US dollar. There is no commitment to keep the parity irrevocably. With such an arrangement, flexibility of monetary policy is more limited compared to using a floating exchange rate regime. As a result, the main central banking function becomes one of accommodating net demand for foreign currency, while maintaining the fixed parity between the togrog and the US dollar. Thus, any of its interventions to regulate monetary growth will be ineffective and it becomes more difficult for the monetary authorities to regulate domestic inflation.

8. ***For the third consecutive year and despite an initially planned budget deficit of 3.9 percent of GDP, the government's fiscal balance recorded a surplus again, for the third consecutive year.*** Preliminary outturns suggest a 2.2 percent fiscal surplus in 2007, with revenues reaching 40.6 percent of GDP and expenditures 39.4 percent of GDP. Reasons for this surplus are (i) higher than expected revenues in particular coming from the windfall and value-added tax; (ii) under-spent expenditures and in particular capital expenditures (see Table 1) This enabled the Government to build reserves at the Bank of Mongolia of about 169 millions togrogs.

Figure 3 - The Government's budget is in surplus again

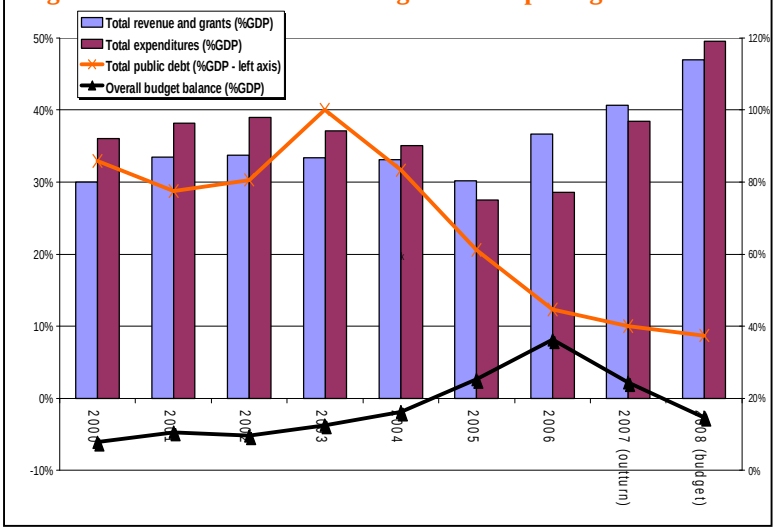


Table 1a- Actual government revenues in 2007 mostly exceeded budget targets.

(Millions of togrogs)	Budget	Actual	Contribution to variance (percentage points)	% of GDP
TOTAL REVENUE AND GRANTS	**1,703,981.5**	**1,851,189.8**	**8.6%**	**40.6%**
Current Revenue	1,698,081.8	1,843,669.4	8.5%	40.4%
Tax Revenue	1,348,149.1	1,500,720.3	9.0%	32.9%
Income Tax	304,851.3	294,142.4	-0.6%	6.5%
Windfall tax	269,180.8	353,700.0	5.0%	7.8%
Social security contributions	139,601.6	158,442.8	1.1%	3.5%
Taxes on domestic goods and services	351,250.7	409,964.0	3.4%	9.0%
VAT	229,949.1	263,222.2	2.0%	5.8%
Excise taxes	108,395.9	133,757.8	1.5%	2.9%
Taxes on foreign trade	94,137.8	102,480.8	0.5%	2.2%
Other taxes	202,032.5	186,841.0	-0.9%	4.1%
NonTax Revenues	349,932.7	351,082.5	0.1%	7.7%
Capital Revenue	1,799.7	2,512.7	0.0%	0.1%
Grants and Transfers	4,100.0	5,007.7	0.1%	0.1%

9. ***Tax revenue performance has remained strong across all taxes***. Cumulatively, total government revenues (including grants) have over-performed against the budget 2007 projections (by 9 percent). The key reasons for this strong revenue performance were: (i) higher than

anticipated commodity prices; (ii) robust economic growth rate; and (iii) improved revenue administration. Table 1 shows the revenue performance by major tax category.

10. ***On the expenditure side, total expenditures were contained at 96.3 percent of the 2007 amended budget target***. Wages and salaries were significantly increased in 2007, and average salaries reached US$300 for civil servants. The execution rate for capital expenditures was much lower than budgeted. This was mainly due to absorptive capacity constraints at line ministries to execute their respective capital budgets. Table 1b shows expenditures by main categories.

Table 1b. Planned and actual public expenditures, 2007

(Millions of togrogs)	Budget	Actual	Contribution to variance (percentage points)	% of GDP
TOTAL EXPENDITURES AND NET LENDING	**1,849,000.0**	**1,751,586.6**	**-3.7%**	**38.4%**
Current expenditure	1,229,618.5	1,202,110.0	-1.1%	29.9%
Good and Services	680,084.8	675,914.5	-0.2%	14.6%
Interest payment	24,035.4	18,320.2	-0.3%	0.4%
Subsidies and transfers	525,498.2	507,875.2	-0.6%	14.9%
Capital expenditures	516,946.5	448,750.9	-2.5%	**6.3%**
From domestic sources	481,431.3	432,222.7	-1.4%	5.9%
Foreign financed	35,515.3	16,528.3	-1.0%	0.4%
Net Lending	102,435.0	100,725.7	-0.1%	2.2%
OVERALL BALANCE	**-145,018.5**	**99,603.2**		**2.2%**

11. ***Fiscal policy in 2007 was significantly expansionary, and so is the planned 2008 fiscal stance.*** GDP growth rate for FY2008 is projected at 8.7 percent of GDP, while the inflation rate is estimated to be 5 percent. The fiscal stance as assessed from the 2008 budget is expansionary, albeit ensuring that overall budget deficit remains contained at 2.5 percent of GDP. The expansion in expenditures is driven by increased revenue collection, rather than resorting to deficit financing. The budget plans for a net domestic repayment of 27 billion togrogs. Public expenditure is budgeted to increase by 44 percent, in real terms, due to another announced public sector wage increase, and renewed spending on social welfare and public investment programs (Figure 4).

12. ***In 2008, revenue policy is planned to be by-and-large unchanged, with most of the focus to be directed towards improving tax administration***. Total revenue collection is projected at 44 percent of GDP. High commodity prices and continued economic growth is expected to result in 48 percent increase in corporation income tax and value added tax.

13. ***On the spending side of the 2008 Budget***, expenditures are budgeted at 47 percent of GDP, an increase of about 8 percent of GDP, year-on-year. Domestic investment expenditures have been increased by 53 percent, from 449 billion togrogs in FY2007 to 689 billion in FY2008 – 13 percent of GDP. Expenditures on wages and salaries will be raised by 90 percent – to 10 percent of GDP; Subsidies and transfers have been increased by 30 percent from their 2007 levels, reflecting mostly the increase in pensions and to a lesser extent social welfare. Although capital maintenance expenditures have been increased by 75 percent they still represent only 4.7 percent of total capital investment budget – low by international standards of 10 percent.

14. ***From 2008 onwards, the Development Fund will be explicitly included in the Government's Budget***. This is a commendable step towards fiscal transparency and accountability. Total resources for the development fund have been forecasted to reach Tg 363

billion. According to the Development Fund Law, tabled together with the Budget Law for 2008, these resources have been programmed for: (i) investment and capital repairs (235 billion togrogs); and (ii) cash allowance of 100,000 togrogs per child via the child money program (105 billion togrogs). The remaining amount of 13 billion togrogs is to be retained in the Development Fund account itself.

15. ***So far, Mongolia is at moderate risk of debt distress over the medium term***. A Debt Sustainability Analysis was jointly conducted by the IMF and the World Bank in early 2007. Another one is now underway jointly between the Government, ADB, IMF and the WB. Debt indicators are prudent as of end-2007. Specifically, Mongolia's public external debt as a percentage of GDP has decreased significantly over the last seven years, from 76 percent in 2000 to an estimated 37.5 percent in 2007 (US$1438 million, preliminary estimates, see Figure 3). The NPV debt to GDP ratio is now below the 40 percent debt sustainability threshold that is applied to countries, at equivalent levels of policy performance. The joint DSA concluded that Mongolia is at a moderate risk of debt distress over the medium term, its category unchanged from last year. Under the baseline scenario of sustained economic growth, and a fiscal deficit in the 3 percent range that would be financed solely by concessional loans, Mongolia's external debt ratios would decline substantially over the long term. However, stress tests also suggest that the debt situation could become unsustainable if there were severe negative terms of trade shocks. Moreover, this scenario does not allow for large scale non-concessional borrowing during this period. A medium-term debt management strategy document was drafted by the Government at the end-2005 for further discussion and approval by the Cabinet. This Strategy document is still to be sent to Parliament.

16. ***Official unemployment continues to decrease***: As of December, 2007, the number of registered unemployed was 29.9 thousand people, which was 9.1% lower than a year ago. According to the survey by the NSO, around 50 thousand new jobs were created in 2007. Employment in the industry increased by 1.2 percent in 2007, and most of this increase came from manufacturing. Given that only industrial employment statistics are available, it is difficult to identify the specific sectors which are creating jobs in the economy. It is however likely that services are the most dynamic sector in terms of job creation, given its dynamic expansion and that it is typically a labor-intensive sector in the economy. New poverty numbers are planned to be released in autumn 2008.

17. ***Turning to the financial sector, the Mongolian banking system assets have grown at a very fast pace over the past 3 years***. In 2007 the banking system loan growth over a 1 year period ending September 2007 was 65.9 percent, with a few banks accounting for most of this growth. Based on reported data, the system appears to be liquid and profitable and most of the banks are reported meet the capital adequacy requirements. However, financial performance varies significantly among banks and thus in the overall banking system numbers portfolio quality and financial position of some of the banks is compensated by significantly better performance by some of the larger banks which have doubled their portfolios and profits in 2007. The systems Non-Performing Loan ratio has declined significantly (3.7 percent as end September 2007) but this can be attributed primarily due to the rapid credit growth. Given an environment where risk management capacity and internal control mechanisms of most banks need strengthening, rapid increase in loans could lead to additional deterioration in portfolio asset quality in the near future. This would adversely impact the ability of some of the banks to deal with financial problems in the future and impact the capital adequacy of the banking system.

18. ***Real lending rates have declined over the past few years, albeit slowly***. In the absence of alternatives, financial institutions compete for savings and deposits and the deposit rates have remained relatively high and rigid. Over the past year, there has been a downward pressure on lending rates due to competition which has squeezed the profitability of banks. To maintain their

profit margins, some banks have now started to reduce deposit rates which have remained rigid over the past few years. Going forward, banks would need to compete on the basis of the new financial products and services they can offer rather than only on interest rate differentials.

19. ***On the non-bank side, the Financial Regulatory Commission has been making efforts to improve the legal and regulatory framework***, however, its weak institutional capacity and resource constraints continue to be a major impediment in effective supervision. Several key laws relating to the financial sector need to be finalized. Efforts have been made towards resolving immediate issues relating to the closed savings and credit cooperatives, developing the insurance industry and developing a framework and institutions to develop the mortgage market. However, several laws and enabling regulation still need to put in place before benefits of increase in financial sector efficiency (lower cost of financing) can be fully realized. The securities market has been dormant with no change in number of companies or listed stocks. Though market capitalization has shown some signs of increasing over the past year, trading and capitalization continue to be dominated by a handful of companies. An Anti Money Laundering (AML) Law was passed in July 2006, however, the establishment of an adequately staffed Financial Intelligence Unit has been delayed and, thus, it may take some more time before this law can be effectively implemented.

IMPACT OF IMPACT OF INCREASES IN WORLD FOOD AND OIL PRICES ON ECONOMIC GROWTH AND CONSUMPTION

20. ***Unlike previous years, food prices did not come down in the last quarter of 2007.*** The 15.1 percent of inflation rate which Mongolia experienced in 2007 was the highest in the decade, and was mostly driven by food items. Typically, inflation is highly seasonal in Mongolia. Food prices tend to go up starting in April and go down again from August. This year, however, such a seasonal pattern was not observed and the increase in prices of consumption goods (including food) has continued into September and following months in 2007. Since then, however, meat prices have started to decline somewhat (by 4 percent). Figure 4 shows that the typical cyclical pattern that one saw in previous years was notably absent in 2007.

2007 inflation is the highest in the decade and food was the main driver

Figure 4 – Annual inflation rates by month

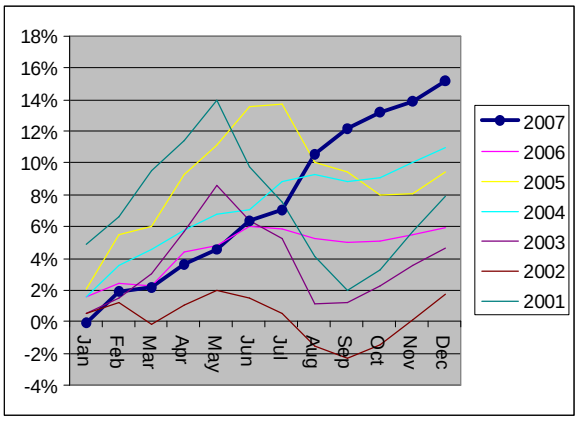
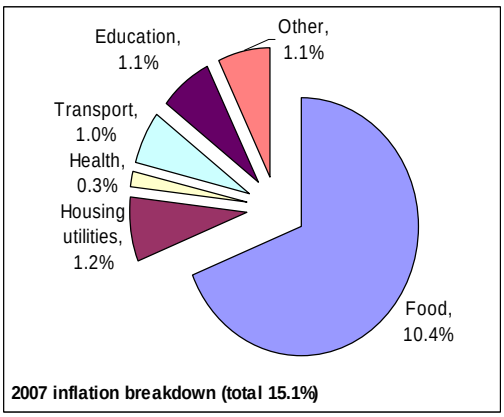


Figure 5 – 2007 inflation breakdown



21. ***More than two-third of 2007 inflation in Mongolia can be explained by food item, while oil prices contributed only a negligible portion (0.4 percentage point of inflation)***. Food items and oil have a 41 and 1.6 percent weight respectively in the CPI consumption basket. In particular, the price increase of domestically-produced meat accounted for more than 2.6 percentage points in the observed inflation rate in 2007. Given the absence of any adverse supply shock that one saw in Mongolia in previous years (such as a *dzud*) that may have caused a decrease in meat supply, the increase in meat prices now is mostly due to increased demand. Bread and cereals, mostly imported from Russia, contributed to 4.4 percentage points of the 2007 inflation rate. [1] While oil is also mostly imported from Russia, its direct contribution to inflation in 2007 is limited.

22. ***Unlike other low-income countries where the consumption basket consists of primarily***

Table 2: Per capita monthly consumption by poverty status and urban-rural divide

	Total		Urban		Rural	
	Non-poor	Poor	Non-poor	Poor	Non-poor	Poor
Consumption						
Food	20,504	9,002	18,636	7,912	23,366	9,949
Alcohol and tobacco	1,767	557	1,851	531	1,637	579
Education	3,284	1,166	3,986	1,400	2,209	962
Health	2,561	782	2,813	801	2,176	765
Durable goods 1/	574	120	709	132	369	110
Rent 2/	2,722	586	4,060	832	671	372
Heating 3/	1,349	934	1,739	1,429	751	504
Utilities 4/	2,730	927	3,748	1,196	1,171	695
Clothing	6,206	1,684	6,308	1,460	6,049	1,878
Transportation and communication	2,659	534	2,945	602	2,220	476
Others 5/	3,434	921	3,591	929	3,194	915
Total	47,790	17,214	50,386	17,224	43,813	17,205
Shares						
Food	43	52	37	46	53	58
Alcohol and tobacco	4	3	4	3	4	3
Education	7	7	8	8	5	6
Health	5	5	6	5	5	4
Durable goods 1/	1	1	1	1	1	1
Rent 2/	6	3	8	5	2	2
Heating 3/	3	5	3	8	2	3
Utilities 4/	6	5	7	7	3	4
Clothing	13	10	13	8	14	11
Transportation and communication	6	3	6	3	5	3
Others 5/	7	5	7	5	7	5
Total	100	100	100	100	100	100

1/ Estimation of the monetary value of the consumption derived from the use of durable goods.
2/ Estimation of the monetary value of the consumption derived from occupying the dwelling. If the household rents its dwelling, the actual rent will be included instead of the imputed rent.
3/ Includes central and local heating, firewood, coal and dung. *4/ Includes electricity and lighting, water and telephone.*
5/ Includes recreation, entertaiment, beauty and toilet articles, and household utensils.
Source: 2002/03 HIES/LSMS.

[1] It should be noted that wheat crop domestic production declined in fall 2007 due to drought in the agricultural provinces such as Khentii, Selenge, and Tuv aimags, thereby contributing to reducing aggregate supply and putting further upward pressure in prices.

food, Mongolian households typically devote only half of their consumption basket to food. The impact of food price increases is hard on poor consumers – and among them, the urban poor bear most of the shock. In Mongolia, the impact is likely to be more limited than in other countries with comparable income levels since the poor households in rural areas devote the highest share of their consumption basket on food (58 percent), while in Ulaanbaatar the share in the non-poor household's is the lowest (35 percent). Typically, the household surveys undertaken for the World Bank's Poverty Assessment in Mongolia show that the urban poor dedicate 46 percent of their consumption to food products.[2] The study also found that in the Ulaanbaatar "Ger" districts, households spend on average 6.7% of their total expenditure for heating. These costs skyrocket over the winter months (reaching 18% of total expenditure for poor households).

23. ***Within food consumption, domestically produced meat accounts for a significant share. So, fluctuations in the worldwide food prices have had only a moderate impact so far.*** Meat products account for 36 percent of the food consumption and are primarily domestically produced. Wheat and cereals account for 28 percent. Meat prices in Mongolia are thus more dependent on domestic rather than external factors. These include: number of livestock, weather conditions, the overall consumer demand that is driven by income levels, and the domestic meat procurement practices.

24. ***In addition, Mongolia imports most of the non-meat food products (among which bread and cereals come from Russia and fruits and vegetables from China).*** Overall, the imported inflation for these items is estimated to 5 percentage points of the Mongolia September yoy 13.1 inflation.

25. ***The adverse impact on growth of high oil prices is likely to be more than offset by high mineral prices which the Mongolia economy is taking advantage of, while the overall impact on consumption is limited.*** On the one hand, Mongolia is highly dependent on petroleum products imports from Russia. About 95 percent of its total oil supply is obtained from one Russian State-owned oil company. This makes Mongolia vulnerable to Russian oil export policies towards Mongolia. In 2007, the Russian authorities raised their export tax on this oil several times. Another consequence of this dependence is that the political economy dimension of oil imports from Russia becomes significant.[3]

26. ***Notwithstanding this unique relationship, the observed price of oil in the pumps in Mongolia has so far been somewhat limited.*** It currently accounts for less than 1 percent of the total CPI inflation in Mongolia. In addition, Mongolia's high rate of economic growth is being fueled by the current high level of international copper and gold prices that has, in turn, resulted in higher foreign exchange inflows. One is also seeing higher FDI inflows due to increased mineral exploration, and fast expansion in the construction and services sectors. Over the last 5 years, Mongolia has enjoyed an average GDP growth rate of 8 percent. This is expected to continue at a similar level in the short and medium term.

27. ***The inherent mitigating factors described above have so far limited the aggregate impact of these price hikes on growth***. Yet the food price increase will surely hurt the poor, even though in Mongolia food imports contributed a lower share to the consumption basket. As a result one may see increasing disparities between the poor and non-poor if this situation of increasing food prices continues.

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[2] Source: Mongolia LSMS, 2002/3.

[3] A recent example is the use of the tax which Russia collects on its oil exports as a bargaining instrument in mining-related and other business negotiation ns between Russia with Mongolia.

28. ***The Government Policy response so far has been to*** create a price stabilization program and set up a Council in charge of overseeing the program. [4]Measures include:

- closely monitor inflation and analyze its impact;
- submit a proposal to exempt wheat imports from VAT and customs taxes;
- re-negotiate the imported oil price with the Russian oil company;
- conduct financial audits of petrol importing companies; and
- continue to subsidize domestic wheat producing farms.

29. The following recommendations can be considered to mitigate the global food and oil price increases: (i) More *targeted policies* to help alleviate the effect of price increases on the poorest households. These could include: targeted consumption subsidies to poor households; (ii) Possibilities for *diversifying its fuel sources*, as well as developing Mongolia's own oil and natural gas resources, should be pursued over the medium term. This should include the use of renewable fuels, including solar and wind energy which are already in limited use in Mongolia today; (iii) The authorities should compile and regularly monitor and publish Mongolia's Producer/wholesale price index (PPI), consumer price index (CPI) and GDP deflator. In order to undertake a more thorough analysis of the impact of imported inflation on Mongolia's growth and poverty, one needs to examine trends in consumer and producer price indexes. The latter is currently not available; (iv) At a policy level, a freely floating exchange rate would typically help curb monetary growth and the associated inflationary pressures. In the Mongolian circumstances, with commercial gold market operations by the Central Bank, the monetary policy transmission mechanism is somewhat blurred.

RECENT POLICY DEVELOPMENTS

30. ***In the mining sector, the Oyu Tolgoi draft Investment Agreement was withdrawn in December 2007 from the Parliament discussion***. The new Cabinet is considering increasing the state participation limit in this mine from 34 to 51 percent. Meanwhile, many have called for a review of Mongolia's mining tax legislation.

31. ***The Government is also considering to increase the Tavan Tolgoi coal deposits to the 100 percent of state ownership***. Significant public debates took place in recent weeks regarding full state ownership of the Tavan Tolgoi mine. Negotiations between the Government and the "Energy resources" consortium are ongoing. More recently, in January 2008, a new joint Parliamentary and Government Working Group has been set up to re-visit the investment agreements for Oyu Tolgoi, Tavan Tolgoi, and the Asgat silver deposit; to review proposed amendments in mineral law. They have been asked by Government to provide suggestions and recommendations on these issues before 05 February 2008.

32. ***The Government is developing a Private Sector Development Strategy for Mongolia*** (see special focus). The strategy design and implementation will need to be well coordinated with the private sector and Mongolia's other development partners.

33. ***Mongolia adopted the SME Law in July 2007.*** The SME Law provides for the first time a clear definition of SMEs which should help to improve the consistency and effectiveness of government support programs. The Law provides eligibility criteria for the participation of SMEs

[4] The Council is chaired by the Finance Minister and composed of the Tax office, various line Ministries, Customs Authority, Bank of Mongolia, the Unfair Competition Agency, Consumer associations, Minerals and Petroleum Authority, Employer's federation, Federation of Trade unions, General Police Department.

in government programs and financial assistance to SMEs in terms of soft loans, loan guarantees, insurance schemes and preferential tax treatment. As the Government implements the law, it should be kept in mind that international experience has shown that government programs that use market mechanisms to support SME development have a much higher rate of success. Direct interventions, such as provision of funds at below market rates to SMEs, can often lead to weaker financial discipline by SMEs and distorted credit risk assessment of these SME's by their creditors.

34. ***The Mongolian Government has designated this year to be the "Year for Food Supply and Safety".*** The three objectives of the program are (i) to promote domestic food production by reducing the country's dependence on imported goods for main consumer food products; (ii) to raise public awareness and information on quality of food products, and (iii) to ensure hygienic and safe food production and processing. The program was created in response to several recent deadly food poisoning and contamination accidents which led to the resignation of the Head of the State Specialized Inspection Agency (SSIA). The program is also responding to concerns that prices of food imports are increasing worldwide (see above section). On the latter, while promoting domestic products may be a reasonable objective to support, one should be careful to rely on market mechanisms in doing so.

35. ***On the social sector side, as per new amendments to the Social Insurance Law the employer's contribution rate to social insurance has been decreased from 19% to 10%***. This decrease is applicable both for pension and health insurance programs. The minimum pension amount has been increased (full pension – MNT 81 thousand for 293.7 thousand pensioners and partial pension – MNT 54 thousand for 96.7 thousand pensioners).[5] In the 2008 budget, pension fund revenue and expenditures were presented separately from the state budget in order to report with more transparency the fund financial status. The parliament separately approved both the pension fund revenue and expenditures by new amendments to Social Insurance Law. Other recent social policy measures include the implementation in January 2008 of the one laptop per child program. In addition, the minimum wage was increased to MNT 108,000 per month in January 1, 2008 from 53,000.

36. ***The Independent Authority Against Corruption (IAAC) is showing significant progress,*** as it pursues its mission of prevention and investigation of corruption. The Criminal Code was amended in September 2007, allowing the Agency conduct investigations.[6] In December, the agency had more than 70 investigations underway, of which 21 had been referred to the prosecutor and 8 are going to trial. A Public Awareness was launched in November and within a month the IAAC had received more than 275 calls and close to 50 walk-ins. The IACC appropriation in the 2008 Budget is 2.7 billion togrogs, which represents a 43 percent increase compared to 2007.

[5] Government Resolution No. 335 dated on December 16, 2007

[6] The other investigative bodies authorized to conduct investigations under the Criminal Procedures Code are the Criminal Policy, the Central Intelligence Agency, and the Special Investigative Unit under the Attorney General's Office.

SPECIAL FOCUS: PRIVATE SECTOR DEVELOPMENT

This section of the Quarterly examines the main issues and prospects for private sector development in Mongolia, and highlights areas for improvement.

Background - Mongolia is a land of opportunities with many challenges

37. ***Mongolia has a rich endowment of natural, social, and cultural resources, but has a large and landlocked territory, with a high and growing urbanization and concentration rate, and faces harsh weather conditions***. Mongolia benefit in particular from world class mineral reserves, a living nomadic culture, and a large territory with intact examples of Eurasia's forest, steppe, and Gobi desert ecosystems, and associated species that are rare or endangered in the rest of the world. It is well known that Mongolia faces a unique set of physical characteristics - a landlocked country, relatively isolated by two large neighbors, challenges of large internal distances, a widely dispersed population, and a very cold climate. The share of its total population living in its capital city is one of the highest in the world, while the population density in the rest of the country is one of the lowest in the world (Figure1 and Table 1). This is good news. Ulaanbaatar represents a growing critical viable market. However, the high cost water provision (Figure 2), transport, heating, and communication costs give Mongolian firms a disadvantage compared to their peers in other countries. For example, Mongolia's rail transport unit costs are relative much higher than select comparator countries in Central Asia even though the nearest port is much closed than for the other land locked comparator countries (see Table 2). On the other hand, Mongolian firms benefit from a educated population (Table 3), demonstrated entrepreneurship in terms of new products being exported each year (but not able to sustain them), and a location that is adjacent to two of the world's largest and rapidly growing economies.

Figure 1. Income density is low (2005).

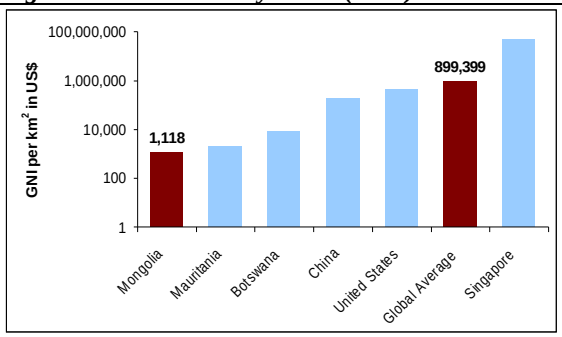


Figure 2. Relative water provision costs are high.

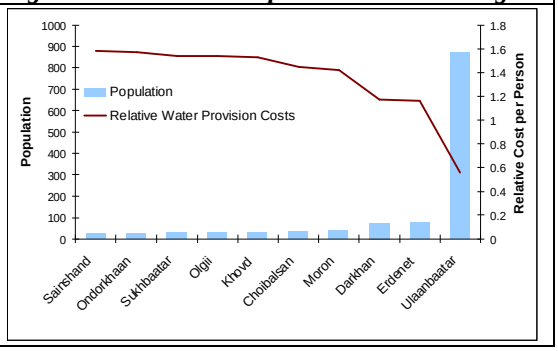


Table 1: Mongolia's educated population and its large concentration in Ulaanbaatar offers ample opportunities for private sector development

Selected Indicators, Mongolia and some Comparators, 2005

	GNI per capita	----------Population ----------			Literacy Rate/a	Land Area
	(US$)	in millions	growth rate-%	% in largest city	(%)	(million km^2)
Azerbaijan	1,240	8.4	1.0	43.7	98.8	0.1
Cambodia	380	14.1	2.0	..	73.6	0.2
Ghana	450	22.1	2.0	19.2	57.9	0.2
Kazakhstan	2,930	15.1	0.9	13.0	99.5	2.7
Kyrgyz Republic	440	5.2	1.2	47.6	98.7	0.2
Mongolia	690	2.6	1.6	37.6	97.8	1.6
Uruguay	4,360	3.5	0.7	42.0	96.5	0.2
Uzbekistan	510	26.6	1.5	22.3	98.7	0.4
Vietnam	620	83.0	1.0	22.7	90.3	0.3
Memo:						
East Asia and Pacific	1,627	1,885.3	0.8	7.4	90.7	15.9
Low Income	580	2,353.0	1.8	17.1	61.5	28.2

Note: a/ latest available year, in most cases 2004.
Source: World Development Indicators database, World Bank and Bank staff estimates.

Table 2: Mongolia's Rail Transport Unit Costs are high relative to comparator countries in Central Asia

	Kazakhstan	Uzbekistan	Tajikistan	Kyrgyz Rep.	Mongolia	
	Almaty	Tashkent	Dushanbe	Bishkek	Ulaan Baator	
	Trade	Trade	Trade	Trade	Exports	Imports
Distance to nearest port* (km)	3380	2720	2040	3100	1700	1700
Cost ($/TEU/km)	0.37	0.35	0.59	0.34	0.61	0.87

Source: staff estimates based on data for Kazakhstan, Uzbekistan, Tajikistan, Kyrgyz Republic from Chapter 5 in Broadman (2005) and data on Mongolia from World Bank (2006b).
** Karachi for Kazakhstan, Uzbekistan, Tajikistan, Kyrgyz Republic; Tianjin for Mongolia.*

Table 3: Mongolia's education indicators compare well to other mineral rich low-income countries.

School Indicators 2004

	Secondary school enrollment rates (gross) (%)	Tertiary school enrollment rates (gross) (%)
Mongolia	89.5	38.9
Cambodia	29.4	2.9
Vietnam	73.5	10.2
Azerbaijan	83.1	14.8
Kazakhstan	98.1	48.0
Kyrgyz republic	88.0	39.7
Uzbekistan	94.6	15.3
Ghana	41.8	3.1
Uruguay	108.0	39.3

East Asia & Pacific	70.9	19.4
Low income	45.1	9.1
Low & middle income	61.4	18.6
Middle income	75.3	26.5
High income	99.5	68.8

Source: World Bank, SIMA.

Table 4: Mongolia's business environment compares well to other mineral rich low-income countries
Selected Parameters of the Business Environment

	Cost of starting a business	Cost of closing a business	Total tax payable	Procedures for enforcing contracts	Cost of enforcing contracts	Time for enforcing contracts
	(% of GNI per capita)	(% of estate)	(% of gross profit)	number	% of debt	Days
Mongolia	5.1	8.0	32.2	29	17.6	314
Cambodia	236.4	No practice	22.3	31	121	401
Vietnam	44.5	14.5	41.6	37	31.0	295
Azerbaijan	9.5	8.0	44.9	27	19.8	267
Kazakhstan	7.0	18.0	45.0	37	11.5	183
Kyrgyz republic	9.8	14.5	67.4	44	12.0	140
Uzbekistan	14.1	10.0	122.3	35	13.5	195
Ghana	49.6	22.0	32.3	29	13.0	552
Uruguay	44.2	7.0	27.6	39	15.9	655
East Asia & Pacific	42.8	23.2	42.2	31.5	52.7	477
Europe & Central Asia	14.1	14.3	56.0	31.5	15.0	409
L. America & Caribbean	48.1	13.6	49.1	39.3	23.4	642
Middle East & N. Africa	74.5	12.1	40.8	41.6	17.7	606
OECD	5.3	7.1	47.8	22.2	11.2	351
South Asia	46.6	6.3	45.1	38.7	26.4	969
Sub-Saharan Africa	162.8	16.0	71.2	38.1	42.2	581

Source: Doing Business Data, World Bank (2006).

Achievements - Economic transition is over and focus has switched to private sector development

38. ***Mongolia has managed the transition from a planned economy to a market economy quite well***. It has made good progress in undertaking fundamental economic reforms centered on price liberalization, privatization and the establishment of market institutions in the past 15 years. The benefits of these efforts can be seen in the growth performance of the Mongolian economy and the accompanying structural changes in the economy, and the progress towards reduction of the incidence of poverty.

39. ***The draft National Development Strategy (NDS) sets an overarching vision for Mongolia to become a middle-income country*** (within the next decade), and reiterates the urgent need to strengthen the country's human capacity and to promote a private sector-led economic growth

path. In pursuit of this objective, the draft NDS places high priority on export-oriented, private sector-led, high technology-driven manufacturing and services sectors, including a modern processing industry. It also aims to strategically tap its mineral deposits and build national savings. It aims to encourage private sector activities by eliminating corruption in the public sector and reduce bureaucratic red tape. (Table 4 provides World Bank Doing Business Indicators for selected countries). In a recent speech, Prime Minister Bayar, has echoed these sentiments as well by calling for improving the utility of natural resources by focusing on exploitation of strategic deposits in the mining sector, reducing bureaucracy, and refining the distribution of wealth in society.

Challenges – Constraints to economic growth need to be addressed

40. ***For sustained growth and development, Mongolia will need to address the binding constraints to growth***. Despite robust growth in recent years, the Mongolian economy remains dependent on a narrow band of exports and is vulnerable to external shocks. A recent World Bank Study, Mongolia's Sources of Growth (the 2007 Country Economic Memorandum), identifies the following constraints to economic growth:

- ***Low returns from economic activities*** (including in mining, where the price effect has predominated) rather than the high cost of capital explains the low levels of private investment one sees in Mongolia today. à *Efforts are needed to increase returns.*
- ***Infrastructure bottlenecks*** have led to a costly transportation system with complex logistics and long transit times. à *These bottlenecks need to be removed.*
- ***Product market distortions***, such as distortionary taxes (including lately in the mining sector activities) and complex customs and trade rules, have increased the implicit cost of doing business in Mongolia. à *These distortions need to be eliminated.*
- ***Poor Financial Intermediation*** has resulted partly from the vicious competition among commercial banks to attract depositors and make loans in an environment where assessment of creditworthiness of borrowers and bankruptcy collections are limited. à *Improve financial intermediation and efficiency in the financial sector.*
- ***Need for better coordination*** of: (i) laws and regulations, (ii) trade and logistics (iii) sector strategies and implementation plans, (iv) resource use and environmental degradation. These have together led to inability of exporters to comply with international quality standards, and environmental degradation has occurred in the production processes. à *Improve coordination of policies and actions.*
- Finally, ***growing corruption and crime***—symptoms of rising inequalities—are partly stemming from perceptions of lack of transparent and accountability in policy decision making and public sector governance. à *Lower crime and corruption.*

Looking Ahead

41. Based on the analyses undertaken in the recent World Bank studies (Investment Climate Assessment and the Country Economic Memorandum and other sector-specific reports and policy notes to Government), the following key issues have been identified as areas where policy making should focus in order to achieve sustained and broad-based growth going forward:

- Improving the ***Investment Climate*** (IC) and ***Competitiveness***
- ***Economic Diversification*** with particular focus on areas of comparative advantage with growth and employment generation potential
- Addressing ***infrastructure bottlenecks*** and enhancing ***global supply chains***
- Addressing ***Labor Market*** constraints

In designing a private sector strategy, the government of Mongolia - in partnership with the private sector and the international donor community – could decide on concrete steps it can take to promote private-sector activity and greater integration with the global economy in a way that leads to job creation, broad-based growth and most importantly, poverty reduction.

42. ***In implementing the strategy, structuring a formal arrangement for dialogue between the public and private sector stakeholders, domestic and foreign, in Mongolia.*** An arrangement for private public dialogue would foster communication and trust between government and businesses and provide a mechanism through which the private and public sectors could jointly identify, prioritize, implement and monitor progress of initiatives to advance PSD.

Improving the Investment Climate (IC) and Competitiveness

43. With the aim towards improving the investment climate and global firm competitiveness in Mongolia's private sector, the following key issues may be considered:

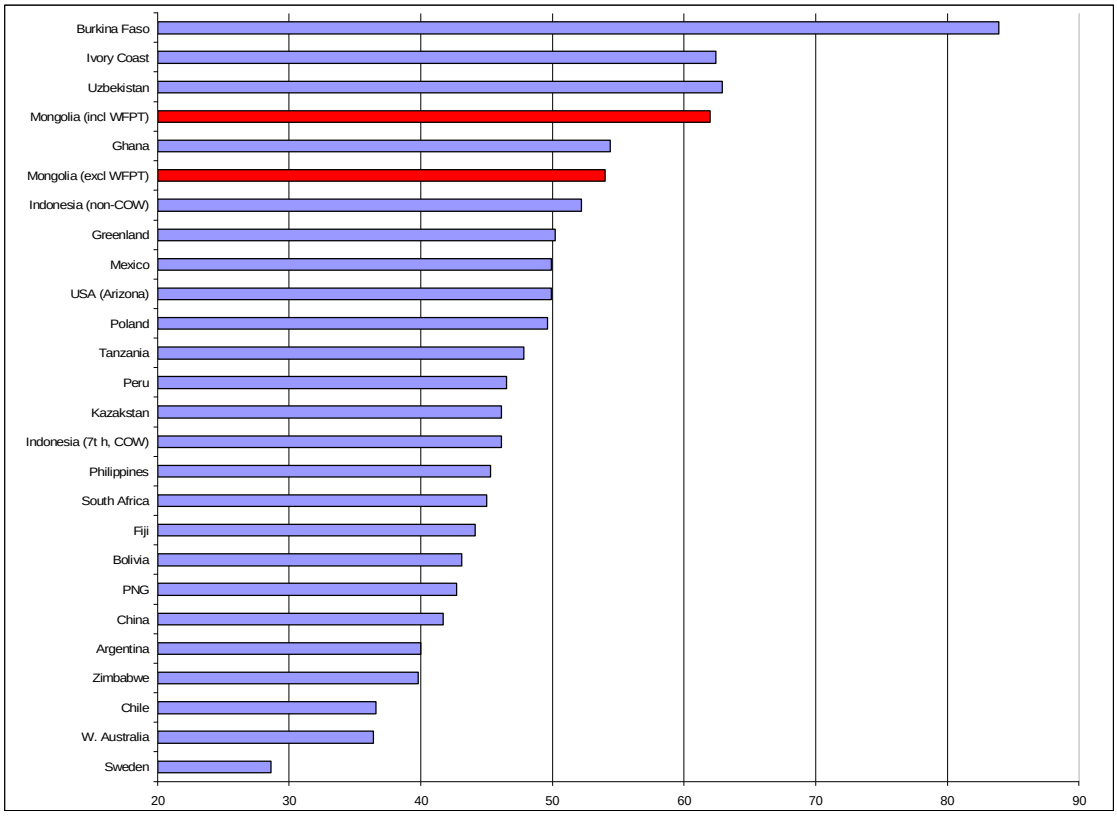
- ***Tax system and administration reforms need to continue:*** Distortionary taxes (including lately in mining sector activities) and complex customs and trade rules have increased the implicit cost of doing business in Mongolia. IC surveys suggested that tax evasion and under-reporting by firms of their labor costs are also widespread. In the cashmere industry, the export tax on raw cashmere has provided incentives to processors to offer herders the same price regardless of quality. This has, however, allegedly led to increased smuggling of raw high-grade cashmere into China thereby depriving domestic processing firms of high quality raw materials to produce Mongolian finished/semi-finished cashmere goods. On the corporate income tax side, the law that became effective from January 1, 2007 appears to have moved Mongolia's corporate tax law closer to international best practices.

- ***The mining tax regime*** is of late moving away from international sound practices. Mongolia currently has one of the highest effective tax rates in mining in the world (Figure 5). In addition, the Government is currently contemplating a state equity participation in the mining sector that will further lower mining investors' returns and increase government risk. Hence, it is imperative to provide a balanced mining taxation regime and appropriate levels of equity participation by private sector mining firms, that allows for efficient mining operations, encourages value-added processing, encourages exploration, research and development (R&D) and, at the same time, generate revenues for the government to spend prudently. In addition, the adoption of a stable, competitive and transparent legal, regulatory and fiscal regime for the mining sector will be essential for its continued growth and development.

  International experience suggests that almost all governments of mineral resource-rich countries choose to have some specific provisions for mining, and some governments have entirely separate but transparent mining fiscal codes. In analyzing mining tax systems, it is essential to look at the complete system of <u>all</u> taxes and fees rather than at individual rates in isolation. The total effective

tax rate (ETR) should be used as a first step in comparing mining tax packages. Common incentives that other countries have given to mining operators include: accelerated depreciation, loss carry forward, no-ring-fencing rules (i.e. level of consolidation of tax base. Ring-fencing favors existing operators and is complex to implement.), carry forward and amortization of exploration, feasibility and development costs, deductible environmental and closure costs, and deductible community and public infrastructure costs. Although less common, another important incentive is fiscal stabilization. Tax holidays or initially reduced rates, depletion allowances and loss carry back are uncommon and not recommended. Meanwhile, it would be very important to build the capacity of the tax agency, especially to collect the mineral taxes owed to Government under the existing tax laws.

Figure 4. Countries typically compete for mineral sector investment and generally offer Effective Tax Tate (ETR) between 40 to 50%.



Source: IMF staff estimates.

International experience also suggests that mining sector investment will flow globally to areas where the geology is attractive, the regulatory systems are workable, and taxation is reasonable and predictable. Tax systems are converging, there is a need for countries to be competitive without sacrificing too much revenue – provide incentives for exploration and increasing the net present value of investor without changing the ETR. Tax systems should be responsive to periods of low and high prices – many are currently slightly regressive. A well designed tax system can provide a fair contribution to the treasury whilst still promoting new investment.

- ***State Participation in Mining.*** With few exceptions, fully state-owned mining companies have not been successful mining operations, both in terms of the efficiency of their

operations, risk exposure and the costs it poses for state coffers. Hence, investment agreements in the mining sector need to be structured to primarily define the basic rights and obligations of both the government and investors and to stabilize the fiscal provisions upon which investment decisions are based. It is important to ensure that such agreements remain subordinate to existing legislation and apply to the sector as a whole, rather than provisions which result in discriminatory treatment of individual firms. The recent changes to the fiscal and policy regime in Mongolia undermine its competitiveness and could impact negatively on the investor confidence that has been built over the period 2001-2005. (Table 6)

In this regard, the authorities may wish to reconsider/re-evaluate the prevailing mining royalty rates, the windfall profits tax, and the share of equity participation by the State in mining projects. An increased Government role in mining and high effective tax rate could lead to an increase in the perception or risk and cost, which could pose a significant deterrent to private participation. In developing a PSD strategy, the Government could articulate a clear policy regime for private investment in mining and give a clear signal to the private sector to invest and participate. *A substantial deterioration in perception due to mixed messages may be difficult to reverse if the policy and fiscal regime can not be substantially improved and could adversely investment climate.*

Table 6. Typical Components of a Mining Tax System.

Tax Type	Good Practice	Mongolia
Income tax	25-35%	25%
Dividend withholding tax	15%	20%
Royalties (ad valorem)	2-4%	5%
Windfall Tax	None	68%
Import duty on equipment	None	None
Export duty on minerals	None	None
VAT	negated (refundable)	Refundable
Depreciation	accelerated & pooled	straight line
Depletion	None	None
Ring fencing	None	None
Exploration	amortized (5 yr)	5 yrs
Environmental costs	Expensed	?
Closure costs	deductible closure fund	None
Tax holidays	none	None
Loss carry forward	7 year or unlimited	2 years

Source: World Bank.

- ***Enhanced Transparency and Management of Fiscal Revenues are key to Sustained Growth.*** Enhanced revenue transparency and the effective policy response/s to significant increases in fiscal revenues from the minerals sector will be key in avoiding the negative impacts of the "resource curse" experienced by so many other resource rich countries and translating Mongolia's mineral endowment into lasting economic growth. Lessons, both good and bad, abound in other mineral dependent economies.

- ***Corruption needs to be addressed***: The recent passage of the Anti-Corruption legislation, the implementation of the Asset and Income Declaration requirements for senior Government officials and Parliamentarians, and the adoption of the Extractive Industries Transparency Initiative (EITI) is a commendable step by the Government in the right direction. Much remains to be done however, and the current Government has also stated its intention to continue to strengthen its public sector governance capacity and implement the anti-corruption law effectively, and promote transparency in Government-business interactions.

  World Bank Investment Climate Survey (2006) results suggest that the prevailing perceptions of corruption in Mongolia's public sector may be a symptom of rising inequalities, and partly stemming from perceptions of lack of transparency and accountability in policy decision making and public sector governance. These survey results (World Bank 2006) indicate that unofficial payments, required for obtaining licenses, and the average bribe for different types of licenses, were high-estimated at around 40 percent of the official fees. Firms paying bribes to obtain access to electricity, water, communication infrastructure (Table 7). According to Transparency International and the World Bank's Governance Indicators, perception of corruption in Mongolia has worsened substantially since 2001, and perceptions of corruption as an obstacle to growth are more widespread in Mongolia than in a number of comparator countries. Mongolia's ranking in the latest *World Bank Governance Indicators* (2008) has also fallen relative to other countries as compared to last year's rankings.

Table 7 : Corruption pervades every sphere of business activity

% of firms that view corruption as a major or severe obstacle	56.5	% of firms paying bribes for electricity connection	26.0
Value of gift expected to secure government contract (% of contract)	4.3	% of firms paying bribes for telephone line	23.0
% of firms indicating that political ties are important for business	47.1	% of firms paying bribes for water connection	15.0
% of cases where unofficial payments needed for registration	15.2	% of exporters paying bribes for customs clearance of exports	25.0
% of cases where unofficial payments needed to obtain licenses and permits	22.2	% of importers paying bribes for customs clearance of imports	22.6

Source: Mongolia Productivity and Investment Climate Survey, 2004.

- ***Access and efficiency (cost) of financial services needs to be improved:*** Access to financial services and cost of financing continue to be constraints, especially in rural areas. The relatively higher cost of financing in Mongolia (as reflected by high interest rates) is a result of various factors -- high competition for relatively scare deposits (low cost funds) among banks pushes up the deposit and, thus, the lending rates; high credit risks in the economy (including, weak risk management practices at banks and limitation of existing credit bureau) implies that banks need to balance these with higher margins; limited alternatives to bank financial services (including an underdeveloped securities market) also contributes to high cost of financing (in particular the weaker banks are unable to seek funds from alternative sources). Weak corporate governance and accounting practices coupled with limited /weak liquidation and bankruptcy procedures also contribute to a environment with higher risk and thus higher cost of finance. To this end, especially given fast credit growth in the last couple of years, both non-banks and banks should be supervised proactively to ensure a stable financing environment where new financial services can develop to address the emerging needs of the private sector. In particular, supervision and regulation on the non-bank financial intermediaries and saving and credit cooperatives need to be improved. Consolidation in the financial sector could also help better align the financial system structure with the economies needs. The authorities should also

improve credit reporting. Cross-ownership of financial and non-financial enterprises should be closely monitored. In addition, the private sector accounting practices need to be brought up to par with International Standards. Governance at the central bank and corporate sector should also be strengthened.

- ***Government-Business interface should be improved and bureaucracy and red tape reduced.*** In addition to the impediments discussed above, firm level surveys have also identified non-transparent processes for urban land registration, licensing and permits, customs, and procurement as key constraints to business and private sector development. The Prime Minister of Mongolia has recently indicated the Government's intent to reduce bureaucracy and red tape. With feedback and in consultation with the business community, the Government could also consider measures and actions to realign and restructure operations of key Government agencies that directly interact with business community in key areas**.** This could future improve the Business-Government interface and help alleviate some of the impediments faced by businesses when dealing with the Government agencies.

Economic Diversification

44. It was already mentioned that economic development in Mongolia in future will continue to depend on sustaining and enhancing traditional sectors, particularly mining and livestock, while nurturing new sources of growth and export earnings. Diversification of Mongolia's economy depends on business and investment climate reforms, investment in needed public goods (see sections below) and careful use of Mongolia's mineral wealth to facilitate development of the non-traditional sector. In a perfect world, improving the overall investment climate for private businesses (foreign and domestic) to enter and flourish in Mongolia would eliminate the need for the Government to directly support new or specific areas and sectors for diversifying the manufacturing and economic base. However, due to the presence of market, product and information imperfections, improving investment climate can be slow and in itself may not always encourage entrepreneurship and investment in new areas of comparative advantage by the private sector. In such situations, the Government can play a facilitating role (and not an interventionist role) to help address some of the market imperfections and failures and encourage diversification. In designing a PSD strategy, the Government, with the help of the other stakeholders, could identify new areas which have may hold potential to support sustainable growth and development for Mongolia so that it can focus scarce economic and financial resources effectively.

45. Over the past few years, the Government of Mongolia has considered giving priority to various sectors: mining, meat, carpets and wool, cashmere, skins and hides, textiles, tourism, forestry and wood, petroleum, metallurgy, and information technology. *However, priority for some of these sectors is questionable since the market forces suggest otherwise.* For example, the textile and wood industries face several structural limitations which leave them at a disadvantage with other global competitors. In developing a PSD strategy the following specific areas and reforms should be considered. In developing a PSD strategy at the sectoral level, the authorities may wish to consider the following areas and issues:

- ***Mining Support Services:*** While mining is inevitably the most dominant sector in Mongolia in terms of future expected value added, more attention should be paid to opportunities for horizontal diversification into mining support and knowledge management activities. Large mining operations require many supporting goods and services, including catering, trucking, equipment repair, chemicals supply, and utilities. Knowledge management opportunities include geological and environmental management

services. Potential for related value added industries such as smelting could also be explored.

- ***Livestock supporting services:*** Development of supporting services for livestock would reduce livestock sector vulnerabilities, while raising and diversifying rural incomes. Future growth will depend on increasing productivity and value adding activities, rather than increasing livestock numbers, which are already at the limits of sustainability. Additional income-producing and diversification opportunities lie in such livestock support activities as fodder production, well maintenance, animal health surveillance, animal husbandry extension services, veterinary medicine (also an export possibility), and quality control.

- ***Meat Production***: Both bulk and specialty meat products offer potential given international demand. However, efforts to restore the quality (and pricing) for bulk meats are needed. The linkages between now-private veterinary services and public agencies need to be strengthened. While nationwide control of animal diseases is a good medium-term objective, short-term efforts to create disease-free zones would help. The large pet food marker and opportunities for higher-value meat exports (e.g., horsemeat for Japan) should be explored.

- ***Offshore Engineering***: Mongolia has some potential for offshore engineering. With appropriate labor market developments, software development for foreign clients could be a future diversification possibility that may hold potential since requirements for physical shipment of goods are minimal. However, this will require significant human resource and skills development that are geared to market demands. Notwithstanding, Mongolia's already high share of educated youth, efforts at fostering an efficient and globally competitive labor force to meet these emerging demands will require a more strategic targeting of possible twinning arrangements with foreign universities, vocational training institutions that are closely linked to private sector conglomerates and global research entities.

- ***Small and Medium Enterprise (SME) Development*** **:** For broad based growth in Mongolia, development of a strong SME sector is critical, especially given the need for diversification and development of new products and services in the future. Most of the 30,000 registered and operational business entities in Mongolia fall in the Micro-business and SME category per the definitions provided in the new SME Law. SMEs could provide much useful support, for example, in water well development/ maintenance, fodder production, product quality control, product development, animal breeding and health, and at the same time generate employment. However, until recently, the special needs of SMEs seem to have been ignored in the development debate in Mongolia. They also face a number of impediments, including high cost of financing, corruption and red tape and ineffective support systems. They have weak capacity for individually conducting market research and business planning, low skills development for their staff, and face a domestic banking system that lacks the capacity or skills to assess their creditworthiness, and hence, are unable to lend much to SMEs. Building the capacity of banks to evaluate risk of lending to SMEs would not only facilitate lending to this sector but also help banks enhance their risk management practices in general.

  The new SME law provides for direct interventions, such as provision of funds at below market rates to SMEs. However, international experience suggests that this measure can often lead to weaker financial discipline by SMEs and further distorted credit risk assessments of these SME's by their creditors, who in turn, expect the Government to bail them out in case these loans become non-performing. *Thus, the Government may wish to*

develop programs that use market mechanisms to support SME development since these have a much higher rate of success (as witnessed in other countries).

- ***Specialty Tourism:*** General tourism creates its own sustainability issues - waste deposits and water pollution around tourist accommodations; steppe erosion, from cross-country vehicles; and poaching of rare and endangered species. For environmental as well as economic reasons, Mongolia should probably focus more on tourism yield and less on tourism numbers. In this regard, greater appeal to high-end/ specialty tourism may help. Specialties could include eco-tourism, cultural or historical tourism, or geological-interest/ mining tourism. However, to encourage high-end / specialty tourism, it will be important to address some of the negative concerns - roads and travel conditions; service standards and quality of accommodations; quality and variety of food; general hygiene; language barriers; sporadic environmental degradation; and crime.

Addressing infrastructure bottlenecks and encouraging global supply chains

46. Fostering new sources of export earnings in Mongolia through renewed private sector-led activities will need to work around existing trade logistics and transport bottlenecks, at least over the medium term. Rail transport will likely remain useful for bulk cargo, while the gestation lags involved with infrastructure development imply that truck transport will be problematic in the next few years for anything except low-value products. Investments in non-sector specific investments and policies focusing on infrastructure and human capital are the preferable options. But it should be noted that in Mongolia it takes significantly more capital investment to produce one unit of output in manufacturing (i.e. the capital-output ratio, Table 8) than in other countries in the region. Thus, productive investment projects with large spillover effects should be encouraged with appropriate monitoring and evaluation mechanisms to be put in place to track public procurement and expected outcomes of these projects.

Table 8: Capital-Output Ratios for Selected Countries and Country Groups (2006)

Country/Region	Capital output ratio
Philippines	2.7
Indonesia	3.0
China	3.1
Low income (all regions)	**3.1**
East Asia and Pacific region	**3.2**
Malaysia	3.4
Thailand	3.8
Mongolia	**5.8**

Source: World Bank Mongolia: Country Economic Memorandum 2007, Table 6.2.

47. The ongoing endeavor of the Government to finalize a medium-term infrastructure development strategy is an essential step in the right direction. This has important linkages with any Private Sector Development strategy that the Government develops. For instance, the government's position on public-private partnerships in infrastructure provision (whatever it may be) needs to be consistent in these two strategy documents. The Government may then want to issue corresponding regulations to guide public-private partnerships in infrastructure construction and service delivery. Measures could be considered to better align pricing with costs of provision

of energy, water and sanitation services, improving efficiency and governance in these sectors and better planning of infrastructure investments. A comprehensive regional development planning with regard to infrastructure could also help better manage the tradeoffs between competing demands. This will help to reap allocative efficiency, high economic returns and greater poverty alleviation impacts. The recent World Bank Poverty Assessment found that the poor pay disproportionately higher tariffs for heating and energy in Mongolia.

48. Looking at global supply chains in today's world, Mongolia may also wish to consider taking greater advantage of its unique location between Russia and China by exploiting more systematically its position of a transit corridor for trade between its two neighboring economic giants and beyond. Policies could, therefore, focus on facilitating trade on the China-Russia corridor, both internally by improving internal infrastructure and by streamlining regulations and bureaucratic procedures, and externally by looking at possible trade facilitation agreements and regulations harmonization. Internally, one cannot escape but see the increasing migration of people into the Ulaanbaatar area and its environs (especially, the Ger-areas) that is occurring today. This may provide the agglomeration effects to foster growth if appropriate infrastructure and public/private services are provided. Appropriate investments in infrastructure and associated policy measures to promote its efficient development and use may go a long way in facilitating trade-routes, cross-country commerce and foreign direct investment. It would help strengthen supply chains and thus improve the investment climate. Better coordination efforts should be supplemented by carefully selected prudent public investments in infrastructure, could have large beneficial impacts to deepen and diversify supply chains within Mongolia and generate growth, including in its mining and livestock sectors—the two sectors that will continue to be an integral part of Mongolia's future growth story.

Private sector development and labor market issues

49. Broad-based growth in Mongolia and the development of a vibrant private sector will also require addressing the binding constraint of skills mismatches that exist today in the labor market, i.e., the mismatch of the skills set produced by the education and training systems in Mongolia and the needs of the labor market. Today one also sees the underutilization of human capital—particularly the high incidence of idleness among the working-age population. To this end, policies that focus on human development need to be instituted with a view towards removing existing skills mismatches and bringing about flexibility in the labor market. These skill enhancement efforts must be also directed to the migrating population, who are mainly coming from rural areas, as well as the urban youth, and congregating to the largest economic center in Mongolia – Ulaanbaatar and its environs (the *Ger* areas).