

NEO-LIBERAL “SHOCK THERAPY” POLICY  
DURING THE MONGOLIAN ECONOMIC  
TRANSITION

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# NEO-LIBERAL “SHOCK THERAPY” POLICY DURING THE MONGOLIAN ECONOMIC TRANSITION<sup>1</sup>

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## 1. Introduction

After 70 years of power being concentrated in the hands of one political party, Mongolia held its first free election in 1990 and the first democratic constitution was approved in 1992. The Constitution declared the people’s ultimate goal to be the building of civil democratic society. These democratic changes in the political environment were crucial turning points in Mongolia’s recent history. The country embarked upon an irreversible path towards a market economy in 1990 and today continues to implement political and economic reforms with the aim of becoming a democratic society with a free market economy.

Following the decline of the Soviet Union’s influence on the country’s political and economic policies, Mongolia found itself embraced by the international community and, in shaping its key economic policy agenda, eagerly followed the measures recommended by multilateral development banks and international financial institutions, such as the International Monetary Fund (IMF), the World Bank<sup>2</sup> and the Asian Development Bank (ADB). Mongolia became a member of the IMF, World Bank and the ADB in 1991 and joined the WTO in 1997. The economic policy implemented in Mongolia during this transformation can be described as a classic example of the ‘neo-liberal’ policy package, which is characterized by price and trade liberalization, financial liberalization, privatization, deregulation and small government.

At the beginning of the economic reforms, the country’s immediate priority was to establish the basis of a market economy and the government adopted a policy of ‘shock therapy’ that quickly removed many regulations and controls while trying to hand as many activities over to the private sector as possible. The initial transformation included two sets of policies to be implemented simultaneously. The first set included measures for achieving a macroeconomic balance and the *liberalization of prices and trade*, the introduction of a unified *floating exchange rate*, strict wage and credit controls and the *abolition of subsidies*, and the development of a social safety net. The second set of policies was oriented towards structural changes, including the *privatization of state sector assets*, a guarantee of property rights, *enterprise restructuring*, the *reform of fiscal and financial systems*, the introduction of a legal framework for reform, control over monopolies, the encouragement of foreign investment, and the reform of the education and healthcare sectors. Securing macroeconomic stabilization, increasing investment and

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<sup>1</sup> An earlier version of this paper was published in English in ERINA REPORT Vol.54.

<sup>2</sup> E.g. policies prescribed under the World Bank’s ‘Stand-by’, ESAF (Enhanced Structural Adjustment Facility), PRGF (Poverty Reduction and Growth Facility) and PRSP (Poverty Reduction Strategy Paper) programs.

savings, developing economic and social infrastructure, promoting exports, boosting the competitiveness of Mongolia and ensuring economic growth have been defined as priority objectives of the transition phase. It should be noted here that the most praiseworthy feature of Mongolia's economic reform was the country's unwavering political stability throughout the transition process.

However, the implementation of such policies has often resulted in undesirable outcomes. Policy making was often fragmented and confused. Mongolia experienced economic contraction, slow growth, unemployment, poverty and inequality as a result. After passage of more than a decade in transition, the country is still struggling to put the economy on a sustainable growth path.

This paper investigates some features of these neo-liberal policy proceedings in Mongolia in the course of its transition towards a free-market economy.

## **2. Neo-liberalism in Economic Policy**

### *2.1. Price Liberalization and Inflation*

The reform programs launched by the first democratic government in 1990-1992, including price and trade liberalization, the establishment of new banking and financial systems, and privatization, laid the foundation for the development of a private sector-based, market-oriented economy in Mongolia.

Prior to 1991, the prices of all products were set directly by the government by means of decrees issued by the State Committee for Price and Standardization, with the difference between world prices and domestic production costs being subsidized from the state budget. Government Resolution No. 20, which was passed on January 15, 1991 and concerned measures relating to the transition to a market economy, was the first, radical step in the price liberalization process in Mongolia; as a result of this, the prices of 60% of all products were liberalized, with the prices of the remainder being doubled. The number of directly controlled retail prices was reduced from 220 categories to 35, along with 10 categories of imported goods. At the same time, pensions, scholarships and the wages and salaries of workers and employees of governmental organizations and state-owned enterprises doubled, while taxes and tariffs were also doubled. The authorities called these measures a change in the money scale, although in fact it was a twofold devaluation of the Mongolian national currency: the Mongolian Togrog (MNT). As a consequence of this resolution, the purchasing power of all cash deposits at banks and cash money held in private hands halved, except private savings deposited at banks. In order to protect private savings, the amounts of private savings deposits in banks were doubled. Although the public was somewhat prepared for the reforms and a new economic system, this sudden change without prior explanation was a shock for most citizens.

Furthermore, the prices of petroleum products were quadrupled in June 1991, with the list of controlled retail prices being cut from 35 to 17 categories in September 1991. This process recommenced in March 1992, when the government officially liberalized almost all prices except for a few rationed goods (e.g. petroleum products, housing, electricity and other public services). By February 1994, price controls on more than 90% of all goods and services in Mongolia had been removed. Between October 1992 and 1996 there were several increases in the

price of petroleum products and the national currency was devalued a number of times (Box 2.1).

As a result, the prices of all goods and services began to escalate and the Mongolian economy experienced high inflation during the early 1990s. Annual inflation rose to 325.5% in 1992, with the highest rise being seen in the foodstuffs category, at 476.6%. Such high inflation was mainly caused by the extensive liberalization of prices and periodic devaluations of the national currency, as the import dependence of the Mongolian economy was very high. Most of the basket of consumer goods that defines the Consumer Price Index<sup>3</sup> (CPI), 70-90% of intermediate goods, and 100% of petroleum products were imported; this is still the case, even today.

**Box 2.1** Chronology of Devaluation (Rates in MNT per US\$1)

1988	Non-commercial exchange rate introduced at MNT20
Till June 1990	Exchange rate fixed at MNT3
July 1990	Devaluation to MNT5.63 and rate pegged to the US\$
May 1991	Devaluation to MNT7.10
June 10, 1991	Devaluation of commercial rate to MNT40 For barter trade – MNT7.10 Free market rate – MNT100-150
August 1991	All commercial banks and the Central Bank (Bank of Mongolia) allowed to buy and sell hard currencies
October 1991	Devalued to MNT100
October 18, 1991	Currency exchange center opened in Ulaanbaatar, with rates of MNT125-135
May 1992	Unification of commercial and barter rates at MNT40 Free market rate ranged around MNT250
January 8, 1993	Devaluation to MNT150
May 28, 1993	Floating exchange rate introduced, ranging around MNT400

*Source: Amarjargal, 2002.*

The highest price escalations were in the fields of cultural goods and recreation services, followed by transport and communications. The prices of these items in

<sup>3</sup> The National Statistical Office of Mongolia began to estimate CPI using the IMF's methodology in September 1991. The Laspeyres Standard Index was used as the basic index for the compilation of the CPI. The base period was January 16, 1991, when Government Resolution No.20 became effective. The CPI estimate basket included 123 goods and services until 1995. During the period 1996-2000, the number of items in the basket increased to 205 and the base period was changed to December 1995.

Starting from 2001, the number of items in the basket increased further to 239 and the base period was changed to December 2000. The Modified Laspeyres Index began to be used in CPI calculations.

2004 increased by 330.6 times and 187.6 times respectively, whereas the overall index increased by 131.2 times (Figure 2.1).

Nevertheless, owing to a tight monetary policy, annual inflation dropped to 6% in 1998 and further to 1.6% in 2002, but rose again to 11% in 2004. In particular, the consumer price index for household goods and foodstuffs and for housing, heating and electricity declined respectively by 2.9% and 1.9% in 2003 compared with the previous year (Table 2.1). On the other hand, one may suspect that these lower inflation rates were achieved at the cost of a high rate of hidden unemployment.

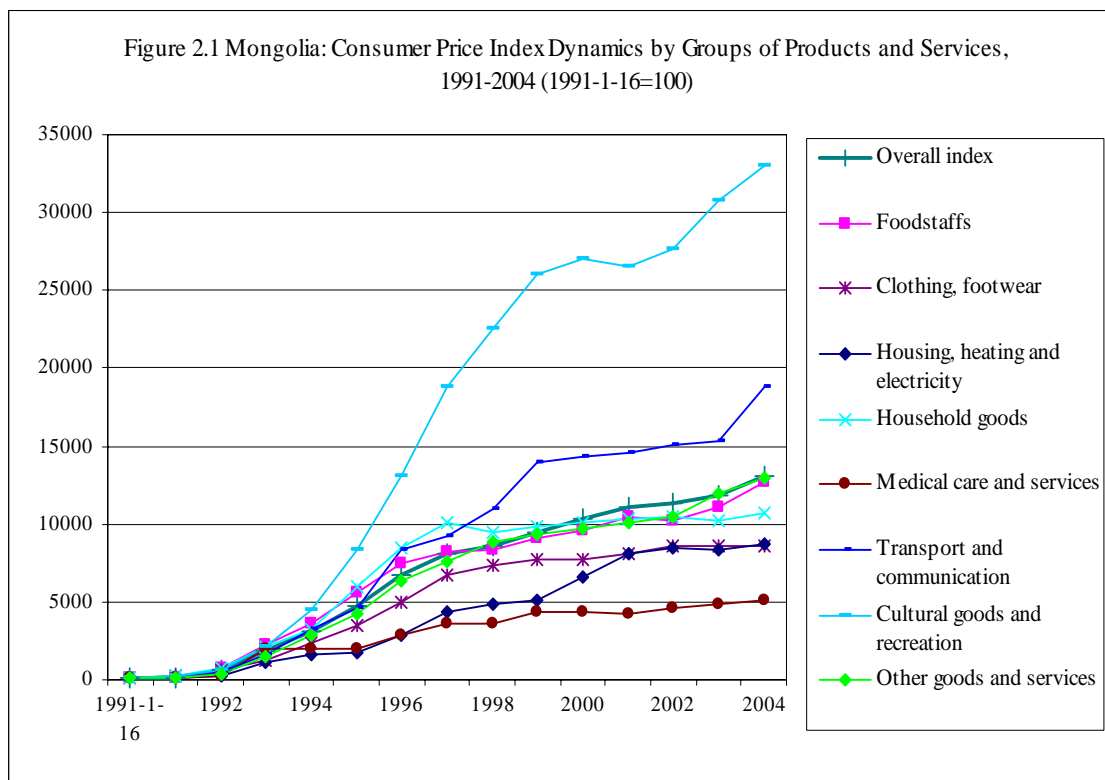


Table 2.1 Mongolia: Annual Consumer Price Index Changes for Selected Groups of Commodities 1991-2004 (%)

Group	Overall index	Foodstuffs	Clothing, footwear	Housing, heating and electricity	Household goods	Medical care and services	Transport and communications	Cultural goods and recreation	Other goods and services
1991*	52.7	31.0	92.4	15.5	109.6	0.0	37.3	177.3	52.3
1992	325.5	476.6	253.0	112.8	279.7	96.7	289.9	109.5	182.5
1993	183.0	197.5	92.1	334.6	162.3	883.2	212.6	270.9	244.9
1994	66.3	58.7	81.2	49.4	55.6	0.0	92.5	105.5	95.7
1995	53.1	56.0	46.2	6.0	82.7	0.0	43.7	89.4	44.0
1996	44.6	33.7	46.0	72.7	42.3	47.7	79.5	56.6	51.8
1997	20.5	11.3	32.5	50.6	19.9	24.7	10.7	43.1	20.3
1998	6.0	0.9	10.5	9.2	-6.8	2.6	18.7	19.7	16.0
1999	10.0	9.1	5.0	5.0	4.7	17.8	27.4	15.4	6.0

2000	8.1	5.2	-0.3	32.0	2.7	0.0	3.3	3.9	3.9
2001	8.0	8.8	4.6	21.8	1.4	-0.6	1.0	-1.7	3.4
2002	1.7	-1.8	5.6	4.8	2.2	9.0	3.8	4.1	4.3
2003	4.7	7.7	0.0	-1.9	-2.9	5.0	2.0	11.3	13.5
2004	11.0	15.4	1.2	4.2	5.0	3.4	22.0	7.5	8.1

Note: \*Change from the base period, i.e. from January 16, 1991.

Source: Estimated from Mongolian Statistical Yearbook, various issues.

## 2.2. Trade Liberalization

Mongolian trade prior to 1990 was characterized by a state monopoly on trade, a centrally planned pricing system, and limited export markets in the former CMEA<sup>4</sup> countries, in which the Soviet Union occupied the dominant share. During that time, only seven state-run foreign trade corporations were allowed to engage in foreign trade transactions under the state order system. Each of these corporations specialized in a particular form of foreign trade transaction and specific types of product<sup>5</sup>. However, the country lost its traditional trading partners with the collapse of the CMEA, along with the discontinuation of the flow of finance from the Soviet Union due to its internal difficulties and subsequent collapse in 1990. The financial flow from the Soviet Union was equal to 35% of the country's GDP (Amarjargal, 2002). Moreover, trade transactions began to be made in hard currency, thus ending the transactions in transferable rubles that had been used between CMEA countries.

At that time many enterprises had to halt production due to such difficulties as power cuts and shortages of spare parts, raw materials and fuel. Among others, the aforementioned shift to hard currency transactions in foreign trade became one of the major hurdles that enterprises had to face; this was a problem not only for companies in Mongolia, but also for its trading partners in former CMEA countries, as these also suffered from a shortage of hard currency. Many of them tried to cope with such circumstances by shifting to barter trade transactions.

Under these conditions, it was necessary to undertake trade reforms aimed at integration with international trade. Consequently, along with removing the state monopoly, the government abolished all quantitative restrictions on exports and imports, along with the export/import state order system. Under the Law of Mongolia on Economic Entities passed in May 1991, all forms of economic entity, including sole proprietorships, and individuals were allowed to engage freely in independent foreign trade activities. As a result, Mongolia's trade has diversified in terms of export destinations and the sources of its imports.

Another step towards its goal of integrating with international trade was Mongolia's accession to the World Trade Organization (WTO) on 29 January 1997. Then, on May 1, 1997, the government began unilaterally to abolish the uniform customs duty of 15% and excise taxes on all imported goods, apart from those levied on a few items, such as alcohol, tobacco, petroleum products and motor vehicles.

<sup>4</sup> Council for Mutual Economic Assistance

<sup>5</sup> Namely, Mongolexport (all exports); Technikimport (machinery and equipment imports); Materialimpex (trade in construction materials); Avtoneftimport (all imports of vehicles and petroleum products); Raznoimport (consumer goods imports); Compleximport (imports and exports of goods associated with turn-key projects from the former Soviet Union); and Mongolimpex (all trade made in convertible currencies).

However, due to a growing need to increase budget revenues, the government increased value-added tax (VAT) from 10% to 13% in September 1998. The following year, in 1999, a 5% uniform import tariff was reintroduced, and an excise tax on beer followed soon after. From November 2000, the customs tariff underwent a further hike from 5% to 7%, with VAT rising to 15%.

Until 2004, Mongolia had bilateral trade and economic cooperation agreements with more than 30 countries, such as Russia, China, the USA, the EU, Canada, Indonesia, Malaysia and the ROK. In addition, Mongolia is included in the GSP (Generalized System of Preferences) schemes of the USA, Canada, the EU and Japan, under which duty-free entry is provided for certain goods and products originated from a developing country, with the aim of assisting its economic development, based on an agreement reached at UNCTAD.

A further step taken by the Mongolian government, with the aim of enhancing international trade and attracting foreign direct investment into the country, was the enactment of the Mongolian Law on Free Zones in June 2002. Currently, three locations in the north, south and western border areas – Altanbulag, Zamyn-Uud<sup>6</sup> and Tsagaan Nuur, respectively – have been designated as free trade zones (FTZ); preparations for their becoming fully operational are currently underway.

### *2.3. Privatization*

A dominant private sector is considered to be the basis for strong economic development, and the role of the private sector in Mongolia has been increasing with the ongoing privatization of state assets, which started in 1991. In May 1991, the Law of Mongolia on Privatization was adopted, setting out the legal basis for the privatization of state properties. The initial stage of the privatization process began with the equitable distribution of equally valued vouchers to all Mongolian citizens, to enable them to invest in a variety of enterprises, cooperatives and state-owned farm equities, based on individual choice. Every citizen of Mongolia born on or before the day on which this law took effect received a voucher worth MNT 10,000. It was estimated that about MNT 20 billion of the MNT 55 billion worth of fixed assets owned by the state as of 1991 would be privatized under this scheme, with shares being held by 2.2 million citizens (Namjim, 2000b). In 1991-1994, more than 4500 entities were privatized through this voucher system. The Securities Law of Mongolia was approved in September 1994 and the second stage of privatization began with the stock market in 1995, but its role in the economy continued to be weak in terms of both market capitalization and market liquidity<sup>7</sup>. Market capitalization (market value) was equal to 5.2% of GDP in 1997, but fell to 1.5% in 2004. Market liquidity (i.e. the total value of traded stocks divided by GDP) was equal to only 3.7% in 2002, but dropped to 1.8% and 0.8% in 2003 and 2004 respectively.

Furthermore, the State Property Committee was established in 1996 and a census of state property was carried out in 1997. Based on this, the government

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<sup>6</sup> The designated location in Zamyn-Uud has FEZ (Free Economic Zone) status.

<sup>7</sup> With regard to market capitalization, the global total was equal to 89.7% of the world's GDP in 2003, while it was 37.3% in low-income countries and 53.5% in the Asia-Pacific region. At the same time, with regard to market liquidity, the global total was 83.4%, while the figures for low-income countries and the Asia-Pacific region were 42.5% and 32.8%, respectively.

adopted the Privatization Program for 1997-2000 and the Privatization Guidelines for 2001-2004; the former program focused on the sale of small and medium-sized enterprises and assets, while the latter focused on the privatization of Mongolia's largest or most valuable ones. The Guidelines serve as an official statement of the government's privatization policies and define enterprise- and sector-specific objectives and priorities. The government adopted an annual action plan specifying the enterprises and assets to be privatized by the State Property Committee and their privatization methods. Starting from 1997, state-owned enterprises and state shares in joint stock companies began to be privatized through public auctions, competitive tenders and management contracts, and they became available for purchase by foreigners as well.

The Guidelines of 2001-2004 defined sector-specific plans and approaches for reform and privatization of the country's major infrastructure, such as energy, telecommunications, roads, coal, and railways. A phased approach has been adopted for privatizing the energy sector by restructuring the Energy Authority into separate generation, transmission, and distribution companies, along with an independent regulatory authority (GOM, 2001).

However, the consequences of privatization often resulted in undesirable outcomes. Unsuitable methods of privatization and the mismanagement of transitional reforms had a negative impact on domestic production capacity and conspired to bring about the failure of light industry, with the only exception being in the cashmere processing industry. Mongolian light industry had developed significant capacity for processing raw materials of livestock origin and manufacturing finished goods that were capable of competing in international markets. For example, in 1988, a new leather garment and leather haberdashery plant – the 'Uyan' factory – was started up in cooperation with Yugoslavia, using investment of more than \$11 million, 70% of which was loan financing. As all the machinery and equipment installed in this plant was purchased from Western manufacturers and used the best technology available at the time, Mongolia was able to export more than 90% of the factory's products to a diverse range of markets, including the most sensitive western markets. The factory employed more than 1,500 workers and continued operating successfully until the end of 1993. The factory managed to repay its initial loan within three years and planned to sell a significant amount of its products in US markets, with talks about this being initiated. However, following privatization and subsequent management changes, this plan failed to be realized; production then declined, ceasing completely by 1997. It is now under new ownership, with space in the plant being rented out to textile sewing companies.

Nevertheless, as a result of privatization and the emergence of new private assets, the private sector became the prevailing sector in the economy in 1995 and produced 76% of GDP in 2004. In 2004, the private sector's share of the agriculture, hunting and forestry sector totaled 95.9%, while its share of the mining and manufacturing sectors was 69% and 86.4% respectively. The private sector's share of financial mediation has increased as well, accounting for 77.8% in 2004. Work is underway to commercialize the energy and communications sectors, and a legal framework for incorporating land into economic turnover has been constructed. In 2002, Parliament passed the Law on Allocation of Land to Mongolian Citizens. The total area of land to be allocated to citizens for private ownership is 1.2463 million ha, which



constitutes 0.9% of the 156.4 million ha of land that Mongolia covers in total. The process began on May 1, 2003, with land being allocated to households and businesses. Privatization in the social and education sectors had also started, with the private sector share in these fields amounting to 12.1% and 14.5% respectively in 2004. The share accounted for by the private sector in each industry is shown in Table 2.2.

Table 2.2 Mongolia: Private Sector Share by Industry 1999-2004, at current prices (%)

Sectors	1999	2000	2001	2002	2003	2004
Agriculture, hunting and forestry	96.4	98.0	98.3	98.4	91.1	95.9
Mining and quarrying	56.0	56.6	74.9	64.2	61.7	69.0
Manufacturing	75.0	78.7	94.9	87.8	86.2	86.4
Electricity, gas and water supply				3.1	3.2	3.2
Construction	89.1	89.2	89.5	93.1	94.2	94.0
Wholesale and retail trade, repair of motor vehicles, motorcycles, personal and household goods	80.3	88.8	90.0	98.2	99.9	99.9
Hotels and restaurants	84.3	91.7	94.6	100.0	100.0	100.0
Transport, storage and communications	41.1	57.7	58.0	60.1	59.7	62.9
Financial intermediation	28.0	31.4	30.6	59.9	77.7	77.8
Real estate, renting & business activities	77.6	82.6	78.5	86.0	91.0	91.4
Education	12.9	11.0	8.2	9.5	11.9	14.5
Health and social work	5.5	6.3	6.5	9.0	11.4	12.1
Other community, social & personal service activities	41.1	45.9	48.4	48.5	40.7	40.6
Total private sector share of GDP	70.3	72.2	75.0	74.5	73.0	76.0

Sources: NSO, 2003a; NSO, 2005.

#### 2.4. Financial Liberalization and Banking Sector Performance

In line with the restructuring and liberalization taking place in real sectors, the same process took place in the financial sector, with the aim of transforming it into a sector that supports the country's economic development. Prior to 1991, the banking sector was the only dominant type of financial mediation in the economy, apart from a few insurance organizations. During this period, the exchange rate and interest rates were under state control, and priority sectors were subsidized through government-directed credit programs. However, in October 1990, under its free market economic reforms, the Mongolian government dissolved the state bank. In 1991, Mongolia enacted a new banking law and the banking system was reorganized into a two-tier structure, with the Bank of Mongolia acting as the central bank implementing monetary policy, and 16 other banks providing commercial services. However, the banking and financial sectors were still weak and fragile, and not entirely capable of playing a proper role in supporting and promoting economic growth.

At the same time, exchange rate liberalization was considered to be an integral part of financial and trade liberalization, and this process took place progressively over the course of several devaluations and the establishment of foreign exchange markets. On May 28, 1993, Mongolia switched to a floating exchange rate system (Box 2.1). Individuals and enterprises had been allowed freely to exchange the national currency into foreign currencies at the prevailing exchange rates since July 1, 1991. However, all foreign exchange centers were required to be licensed. On August 30, 1990, the first foreign currency auction was held for state enterprises and state and private cooperatives, under the brokerage of the State Bank<sup>8</sup>. Although the amount of foreign currency available was tiny, this was a landmark event in the move towards a market economy (Amarjargal, 2002).

The first commercial banks commenced operating at the end of 1989 and the beginning of 1990, and the first commercial banks, the Trade and Development Bank and the Investment and the Technological Innovation (ITI) Bank, began their lending operations before the Banking Law came into effect. At the same time, the absence until July 1992 of both the necessary legislative regulatory environment for bank operations to take place in the new market-oriented system and an inter-bank clearing and settlement system, along with a lack of specialists and professionals capable of working in this new system, prevented the banking system developing properly. The commercial banks issued loans without any control, and the outstanding loans at banks exceeded gross money by 45.6% in 1990, by 29.6% in 1991, and by 46.5% in 1992 (BOM, 2002).

The Bank of Mongolia failed to maintain monetary management during 1991-1992 due to a lack of regulatory mechanisms; substantial losses of the state reserves were subsequently incurred in speculative currency dealings. Consequently, the reputation of the central bank fell among the public and banks, resulting in a substantial increase in the gross money supply, of 76% in 1991 and a further 31.6% in 1992. Accordingly, the CPI increased to 325% in 1992 and 183% in 1993. At the same time, due to the absence of a legal framework for governing and regulating the relationship between the government and banks, a number of loans were provided as a result of government decisions (BOM, 2002). All of these initial shortcomings later led to increases in the number of non-performing loans and insolvencies of major banks. According to the BOM, non-performing loans increased twelve-fold by 1995 from the 1992 level, accounting for 20% of total outstanding loans.

Nevertheless, starting from October 1992, the BOM began to use direct, simple monetary instruments imposing lending limits and reserve requirements for the commercial banks. In addition, a minimum interest rate for savings was set and controlled by the central bank in order to keep the real interest rate at a positive level and protect savings from depreciation. Furthermore, the clearing loans provided directly to the commercial banks by the central bank to meet their capital shortages ceased completely in 1996. Then, in order to enforce the Central Bank Law and switch to a market-determined interest rate, the system under which the BOM fixed the minimum interest rate was changed to a system that allowed free inter-bank competition from the end of 1996. However, prior to 1995, when the new Civil Code was enacted, the legislative framework for regulating loan-related dealings was

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<sup>8</sup> Currently the Bank of Mongolia

merely ruled by guidelines and decisions issued either by the BOM or the commercial banks themselves (BOM, 1997).

In 1995, the Government of Mongolia and the BOM started to implement a program aimed at strengthening and restructuring the banking system with the support of international financial institutions. The objectives were the improvement of the legal environment, an increase in the effectiveness of the monetary policy, the enhancement of bank liquidity, improved management and operational structures, improved loan management and cooperation among banks, and reduced government intervention in bank operations. Accordingly, a number of laws that regulate the banking sector were enacted in compliance with the new Civil Code, such as the Law of the Central Bank (BOM), the Banking Law, and the Law on Savings, Settlements and Bank Loan Operations (BOM, 2002).

Mongolia's banking sector suffered three crises, in 1994, 1996 and 1998. The cost of the 1994 restructuring exercise was estimated at over 2% of GDP. In December 1996, the Mongolian financial system underwent major restructuring, aimed at eliminating insolvency in the banking system and restoring confidence by addressing nonperforming loans, inadequate management, and weak supervision. Two large insolvent banks, which together accounted for nearly 50% of banking system assets, were closed, while two new government-owned banks, namely the Reconstruction Bank and the Savings Bank, were created. In addition, a debt recovery agency, the Mongolian Asset Recovery Agency (MARA) was established. This restructuring project was supported by a \$35 million Financial Sector Program Loan (FSPL) from the ADB, the IMF and the World Bank. Both the newly created banks were initially set up as narrow banks with limited functions, but the Reconstruction Bank was allowed to evolve into a full lending institution offering universal banking services, with the Savings Bank making limited loans secured by deposits held in the bank itself. The other large problem banks, the Agriculture Bank and the ITI Bank, underwent rehabilitation by means of Memoranda of Understanding (MOU) between the banks and the Bank of Mongolia (IMF, 1999).

The cost of restructuring rose to 7.8% of GDP in 1996, measured solely by the issue of government reconstruction bonds and exceptional liquidity support of about MNT 5.0 billion provided by the BOM to these three troubled state-owned banks (the Reconstruction Bank, the Agricultural Bank and ITI Bank). In 1998, these three banks, which held 21.4% of Mongolia's total bank assets, once again became illiquid and insolvent. The direct costs of the 1996-1998 banking crises continued to impose a burden on the budget and the direct cost to the budget was estimated at over 0.6% of GDP in 2001 (World Bank, 2002a). The BOM liquidated both the ITI and Reconstruction Banks on December 24<sup>th</sup>, 1999, due to their insolvency (BOM, 1999).

From 1999, individuals and economic entities were allowed to engage in some banking activities and non-bank financial institutions (NBFIs) emerged as a new form of financial intermediary. The number of NBFIs increased from two in 1999 to seven in 2000, 28 in 2001 and further to 66 in 2002. An improvement in the banking and financial services sector has been observed since 2000, with banks recovering public trust and significantly increasing their lending operations. There were 17 banks and 88 non-bank financial institutions operating in Mongolia at the end of 2003, with a total of 635 offices, about 75.3% of which served rural areas. Of these, only one bank was state-owned, while two others had state participation in their

equity funds. In other words, banking and financial services in Mongolia were almost exclusively handled by privately owned financial institutions (BOM, various issues). As of 2004, 77.8% of all financial intermediation activities in Mongolia were handled by the private sector (Table 2.2).

Two major Mongolian banks – the Trade and Development Bank and the Agricultural Bank – were sold to foreign investors in 2002 and 2003 following international tenders. This opened up the banking sector to further international investment and management.

In 2002, 76% of the Trade and Development Bank (TDBM), which was owned by the government of Mongolia, was sold to Global Investment and Development Inc., a joint consortium of Banco Lugano Commerciale of Switzerland and Gerald Metals Inc. of the US. In December 2004, the International Finance Corporation (IFC)<sup>9</sup> and the Asian Development Bank (ADB) invested in the TDBM. As of 2005, Global Investment and Development Inc. owned 61.51% and the IFC and the ADB respectively owned 9.08% and 9.08% of the TDBM's equity, while the remaining 20.32% belonged to the TDBM's employees and other shareholders. Since 2003, ING Advisory<sup>10</sup> has been providing management advice and technical assistance to the TDBM (TDBM, 2005).

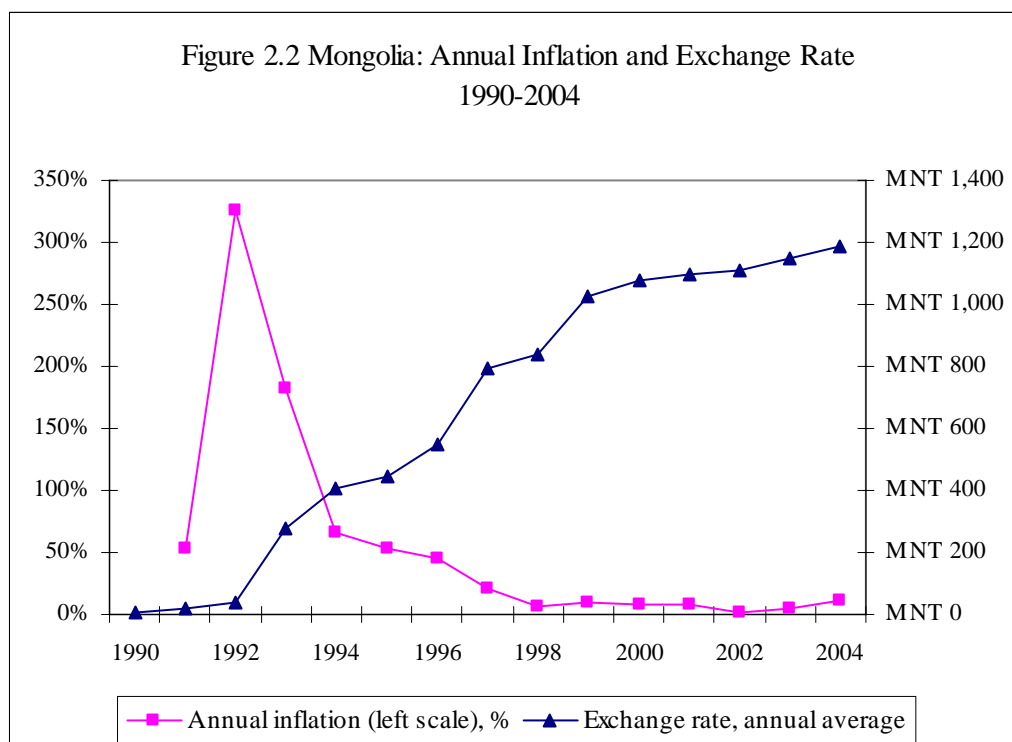
In 2003, one of the state-owned banks – the Agricultural Bank of Mongolia (KHAN Bank) – which is a major provider of financial services in rural areas of Mongolia, was privatized through an international competitive tender, with the Japanese company HIS Securities, part of Hideo Sawada's group of companies, becoming the new owner. The IFC and Development Alternatives, Inc. (DAI), an American company, invested in the KHAN Bank in 2004 through the issue of new common stock. As of December 2004, the IFC and DAI respectively had approximately 10% and 2% ownership interests in the bank's equity (KHAN Bank, 2005).

Due to the high inflation spiral in the early 1990s, the annual interest rate on loans issued by commercial banks rose to 213.1% per annum, making it impossible to use such costly financing to conduct any industrial activity. Consequently, bank loans were used only for wholesale and retail trade in imported goods. Interest on loans gradually decreased to an average of 30% in 2004 (Figure 2.2).

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<sup>9</sup> Part of the World Bank Group, founded in 1956, which promotes growth in developing countries by providing support to the private sector through loans and equity financing. The IFC's activities also play a catalytic role in stimulating and mobilizing private investment in the developing world.

<sup>10</sup> ING Advisory is an independent advisory unit of ING Group, with its headquarters in Amsterdam and representative offices in Asia and Latin America. Since 1989 ING Advisory has been providing advisory services to financial sector clients and governments, particularly in emerging markets and transitional countries. ING Advisory has successfully completed more than 100 projects in some 40 countries spanning Asia, Latin America, Africa, and Europe. (Source: <http://www.ingfi.com/ingfi/ingadvisory/overiga/index.html>, October 21, 2005)



Sources: Mongolian Statistical Yearbook, various issues; BOM, 2003.

Owing to the monetary policy implemented over the past years, financial mediation in the economy by the banking sector is increasing as public confidence in the banks rises. Individual deposits at banks reached a total of MNT 348.6 billion in 2003, 2.8 times greater than the 2001 level, while outstanding loans increased to MNT 442.2 billion, 3.3 times higher than previously. At the same time, the percentage of non-performing loans decreased to 8.3% of the total in 2003 from 9.8% in 2001 (Table 2.3).

Despite the lower inflation rate, interest on commercial bank loans remains relatively high. Although the annual average interest rate on loans declined to 30% in 2004 from 45.8% in 1998, this rate is still rather high for financing long-term investments and manufacturing activities. Accordingly, most bank loans were provided to non-manufacturing sectors. For example, 70% of new loans issued by banks were utilized by non-manufacturing sectors in 2003, with 61.4% being issued to the wholesale, retail trade and repair of household goods sector. Domestic manufacturers merely use trade intermediary services for marketing their products, so bank loans were mainly used to finance wholesale and retail trade activities relating to imported goods (Table 2.3).

Nevertheless, state intervention in directing bank loans and financial recourses were kept to minimal levels, along with reorganization and privatization in the banking and financial sectors since the early 1990s. However, commercial banks and other financial institutions, constrained by their limited resources and high interest rates, preferred to finance short-term activities, such as trade and services, rather than financing large investments. Nevertheless, this helped to keep the share of bad loans at manageable levels, at least per customer, as well as preventing widespread loan default.

Table 2.3 Sectoral Composition of Bank Loans in 2003, MNT 1 billion

Sectors	Outstanding loans, beginning of the year	Loan issuance	Loan repayment	Outstanding loans, end of the year
Total	281.9 (100)	714.7 (100)	560.0 (100)	441.2 (100)
<i>Manufacturing</i>	147.0 (52.1)	214.2 (30.0)	171.0 (30.5)	194.9 (44.2)
Agriculture, hunting, forestry	13.8 (9.4)	24.5 (11.4)	16.7 (9.8)	24.2 (12.4)
Electricity and water supply	3.6 (2.4)	14.0 (6.5)	8.2 (4.8)	9.4 (4.8)
Construction	14.3 (9.7)	44.6 (20.8)	27.6 (16.1)	31.3 (16.1)
Mining and quarrying	35.6 (24.2)	47.9 (22.4)	46.9 (27.4)	37.5 (19.2)
Processing	79.7 (54.2)	83.2 (38.8)	71.6 (41.9)	92.5 (47.5)
<i>Non -manufacturing</i>	134.9 (47.9)	500.5 (70.0)	389.0 (69.5)	246.3 (55.8)
Wholesale and retail trade, repair of household goods	80.7 (59.8)	307.2 (61.4)	236.6 (60.8)	150.4 (61.1)
Tourism, hotels and restaurants	7.2 (5.3)	5.7 (1.1)	5.8 (1.5)	7.2 (2.9)
Transport, storage and communications	6.5 (4.8)	19.3 (3.9)	12.4 (3.2)	13.6 (5.5)
Real estate, rental and other business services	3.0 (2.2)	9.3 (1.9)	5.2 (1.3)	7.6 (1.8)
Health and education	1.3 (1.0)	2.9 (0.6)	2.2 (0.6)	2.1 (0.9)
Financial intermediary services	4.0 (3.0)	5.2 (1.0)	4.9 (1.3)	4.4 (1.8)
Others	32.2 (23.9)	150.9 (30.1)	121.9 (31.3)	61.0 (24.8)

Note: Numbers in parentheses show shares as a percentage.

Source: BOM, 2004.

### 3. Conclusion

Mongolia rapidly transformed its economy from a centrally planned command economy to a market-oriented one, and followed a neo-liberal shock therapy transition policy in its transition course. The main outcome to have emerged so far from the period of transition to the new social system is intensive political and economic reform within a short period of time, as well as Mongolia's opening up to the world, the liberalization of the economy and its irrevocable metamorphosis into a market economy, and Mongolia's transformation into a democratic country respecting multiple opinions. However, the implementation of this policy has often resulted in undesirable outcomes, with Mongolia experiencing economic contraction, slow growth, unemployment, poverty and inequality as a result. Policy making during the early part of the transition was fragmented and confused, and many of the reforms were unduly hasty and poorly sequenced.

The country is still struggling to bring the **one-third** of its citizens out of poverty and put the economy on a sustainable growth path. In describing Mongolia's post-1990s economy, Dr. Namjim states that, although rapid social and economic

changes occurred during transition, an efficient market economic mechanism has not been formed yet and the economy is in crisis. There are many troubling social problems and the majority of the population is trapped in poverty (Namjim, 2000a).

In particular, a properly thought-out program for economic transition and reform was lacking, and policy measures were often introduced without prior explanation or public debate, leading to low levels of public understanding and support. In addition, the new policymakers often failed to recognize the value and support of their predecessors, and neglected almost everything built and developed under the economic system that had prevailed in Mongolia for 70 years. Such actions may be attributed to policymakers' inexperience and lack of knowledge with regard to the functioning of market economic mechanisms. Accordingly, policymakers had few policy options, other than to follow the proposals of external advisors, who often lacked a thorough knowledge of the workings of the Mongolian economy.

Nevertheless, Mongolia could counter that it has achieved certain positive outcomes in a decade of transition, in terms of the diversification of its economic foundations, its integration into the global economy, and, most importantly, public perceptions of the free market economy. However, if it continues without a proper strategy for economic development, this may lead to more profound socioeconomic problems and social unease.

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