United Nations
Development Programme

Office for Project Services

World Development

PD-ABS-916
91645

29 May 1992

Dear Mr. Robertson,

Reference: **MON/89/510 - Management Development - Mongolia Grant 438-0001-G-00-1-01**

I am pleased to provide you with this final report of activities and accomplishments produced with the support of the USAID grant to the above referenced project. Please refer to the interim progress reports for more detailed description of activities.

The Government has expressed to UNDP/Mongolia its satisfaction with the overall quality and timeliness of the assistance provided, and only regrets the same or similar assistance could not have been continued for a longer time as the need continues. UNDP/Mongolia has expressed the same judgement on its own.

I am glad we were able to cooperate on this project, and I hope the opportunity will arise for such activities in the future.

Please call me (212-906-6813) if you need any further information.

Sincerely,

Charles Downs

Charles Downs
Senior Project Management Officer

Mr. Denny Robertson
Acting Chief, ASIA/DR/PD
Agency for International Development
Washington, DC 20523

220 East 42nd Street, 14th Floor • New York, NY 10017 • Tel (212) 906-6500 • Cable: UNOPSNEWYORK
FAX: Directorate (212) 906-6501; Purchasing (212) 906-6502 • TELEX: 662293 OPS UNDP; 645495 OPS UNDP; 824608 OPS UNDP

May 8, 1992

The Sachs Team in Mongolia

Final Report

This is the final report on the Sachs team project in Mongolia. The UNDP project (MON/89/010) was funded by a grant from the United States Agency for International Development. The team, headed by Mr. Peter Boone, spent the second half of 1991 in Ulaanbaatar providing policy advice and analysis, conducting policy oriented research projects, and teaching courses on introductory economics and business economics. In carrying out the project, the team collaborated closely with the Mongolian authorities, the UNDP resident representative, and the embassy of the United States. The work of the team was supervised by Professor Jeffrey Sachs of Harvard University.

This report describes the activities and accomplishments of the project. The report does not, however, repeat the detailed descriptions of their activities presented in the interim reports. First, an introductory section describes the emergency circumstances that Mongolia faced when the project was formulated, and the current economic and political environment. Second, recent macroeconomic developments are briefly summarized. Third, the goals and activities of the team during the project period are described in general terms. And a final section describes the specific activities of the team undertaken since the last interim report.

2. Introduction

After decades of central planning and economic domination by the Soviet Union, Mongolia began the arduous process of transforming its econonmy in mid 1991. The challenge Mongolia faced was to rid itself of the vestiges of the old economic system and transform the Mongolian economy to a western-style market-oriented economy. This, in itself, is difficult, but the Mongolian authorities began their economic transformation at a time of extreme economic emergency. The collapse in trade with the Soviet Union, which had been conducted on a barter basis, occasioned by the growing economic chaos in the Soviet Union, led to a balance of payments crisis, a deep industrial depression, and a sharp decline in GDP.

2

The challenges that the Mongolian authorities faced were perhaps as difficult as those facing any national authorities in the world. Unfortunately, years of economic and cultural isolation had left the authorities without the institutional foundation or the trained civil service for coping with the emergency. In mid 1991, the international community began to mount a special bilateral and multilateral effort to help Mongolia. It was in this context that the Sachs team began its project to assist the Mongolian government in its efforts to cope with the emergency and begin the economic transformation.

Now in mid 1992, the Mongolian economic transformation is underway, although the pace of macroeoconomic reform has been slow. The meeting of the Great Khural and the debate over the new constitution have encouraged substantial political manoeuvering on the part of all political parties. This political debate has slowed the macroeconomic and institutional reforms, but progress in particular areas, most importantly in the area of privatization, continues.

Western assistance in the reform program is well underway. The International Monetary Fund, the World Bank, the Asian Development Bank, the United States, Japan, South Korea and others have provided financial assistance approaching US$ 200 million for 1991 and 1992. This emergency assistance is a critical component of the stabilization program as it will be used to finance urgently needed imports. The imports will both help keep key industries operating, and proceeds from their sales will finance a temporary budget deficit until new tax measures are fully introduced, and expenditures are curtailed in line with the loss in Soviet financing. Mongolia remained in good standing with the IMF for much of 1991, but by the end of the year some deviations had resulted from the slow pace of adjustment.

The progress to date in the economic liberalization and stabilization program has been mixed. The reforms have proceeded reasonably quickly in certain key areas, such as restructuring of the central bank, and implementation of new tax policies. Also, there is a rapidly developing private sector, mostly in trade and retail services. But other reforms, particularly in the area of price and trade liberalization, have not proceeded quickly enough.

A key area where rapid progress has been achieved is in the privatization program. Almost all of the state shops, restaurants, and other small enterprises will have been privatized by the end of 1991. Over twenty percent of the large industrial enterprises have been valued for privatization, and they are now ready to be auctioned to private owners in the new stock exchange. If the stock market begins operating, and the sale of large enterprises proceeds as expected, Mongolia will have accomplished the fastest privatization program in the post-communist world.

This privatization program is a critical impetus to the reform program as a whole. If the privatization program is successful, it will create a new class of property owners with vested interests in seeing the reform program succeed. They will provide an impetus to complete the macroeconomic reforms by demanding the right to chose their own prices (both legally and in practice), by avoiding state orders, and by supporting the convertibility of the Tugrik. There are already signs of these changes; some of the newly "commercialized" enterprises have already cut back on state orders, seeking ways to avoid state regulation.

The mixed economonic performance is partly a reflection of the current political environment. As has been mentioned, the economic collapse in Mongolia was probably greater than that experienced in any of the Eastern European countries. After seventy years of central planning, it has been nearly impossible for the population to comprehend either the extent or the cause of their economic decline. In this environment, complicated by a coalition government facing impending elections, it has been politically difficult to make aggressive economic decisions. The privatization program, led and implemented by a group of radical reformists, has so far been untouched by this political debate.

2. Recent macroeconomic developments

The Mongolian economy continues to decline. Trade in the autumn of 1991 continued at low levels, and was disrupted by the August coup in the Soviet Union and the radical changes taking place in Russia. Disruptions are likely to continue for some time, posing a continuing serious threat to macroeconomic stability. Industrial production continues to fall, and there is substantial hidden unemployment. The shortage of spare parts and inputs for the energy industry has resulted in frequent electricity outages, and there is a serious threat that the centralized heating system in Ulaanbaatar could break down.

There are some signs that the monetary and fiscal situation is beginning to stabilize. The structural budget deficit in the latter part of 1991 was sharply reduced compared to previous quarters, and external financial assistance in the fourth quarter of 1991 reduced substantially the need for monetary financing of the deficit. The rate of money and credit creation has been substantially reduced since June of 1991.

But the effects of this tightening of credit and fiscal policy have yet to be shown in inflation. The Tugrik/dollar exchange rate in the parallel market has continued to depreciate, after appreciating in mid 1991. The rate in mid-December was 150 TG/dollar, compared to 40 TG/dollar at the beginning of 1991. Likewise, free market prices continued to rise at a five percent monthly rate in the last quarter; measured inflation in 1991 was about 150 percent.

4

The reduction in money creation and the elimination of the fiscal deficit has occurred in a highly distorted environment; for this reason it remains precarious. The exchange rate has been fixed at a considerably overvalued rate, prices of most food products and many other goods have been effectively (if not legally) fixed, state stores have remained empty, and interest rates have not been set realistically given the present economic environment.

Due in part to these distortions, there has been only modest growth in exports outside of the former USSR. Export growth will be necessary to reduce dependency on the Russian market, and to lessen the need for external financing in the coming years. Moreover, there are few signs that enterprises are actively reforming to meet the new conditions, and the state industrial sector is stagnating.

3. Summary of the activities of the team during the project period

The size of the Sachs team in Mongolia ranged from four to eight members over the course of the last six months. In June, July and August there were a total of eight people teaching, researching, and providing policy analysis. From September to December four people were resident in Mongolia (one team member, Adil Rustomjee, remained until mid-January to assist with the small-scale privatization program).

The team had five main points of contact with the authorities: the Office of the Deputy Prime Minister, the State Bank of Mongolia (the central bank), the Ministry of Trade and Industry, the Privatization Commission, and the Statistics Commission. The team prepared several reports for the Prime Minister's office describing and analyzing the economic situation in Mongolia. In addition, the team established regular contact with the UNDP representative office in Ulaanbaatar, the U.S. embassy, and the Institute for Management Development.

The main policy topics addressed Several key components of policy advice during the six month period have included:

-- assisting in the design and implementation of a macroeconomic stabilization and liberalization program (with the Prime Minister's Office and the Central Bank).

-- assisting in the design and implementation of the privatization program (with the Privatization Commission and the Stock Exchange).

-- advising the Mongolian authorities on their negotiations with the IMF, and monitoring the implementation of the IMF program.

5

-- preparing reports for the Prime Minister's Office for submission to various donor's meetings, documenting the current economic situation in Mongolia, and assessing the financing requirements.

-- assisting the Ministry of Trade and the Market Research Institute in designing programs aimed at the promotion of exports and trade.

-- improving the standard of economic analysis in the Bank of Mongolia and the Ministry of Trade through ongoing advice, and a lecture series on market economics.

-- helping to assess the social safety nets in Mongolia, and advising on the implementation of a foodstamp program with the Statistical Office.

-- teaching a first year university level intensive course in macro and micro-economics to lecturers and students from the Economic College. The Economic College is the first college in Mongolia to provide university level courses in market economics.

-- Teaching a lecture series on capital markets to 300 people and administering oral and written examinations on the course material (the people with the top fifty highest scores were chosen as Mongolia's first brokers). The brokers play a critical role in the privatization program in administering the sale of Mongolian enterprises to citizens.

4. The final interim period

In the period since the third interim report, Peter Boone, Bill Bikales, Aart Kray, and Adil Rustomjee each continued to provide policy analysis. Broadly, their mission was to assist the authorities in the continuing task of developing a strategy to cope with Mongolia's economic emergency. Over the last three months of the project, the team continued to help the authorities prepare steps to set in motion the transformation of the Mongolian economy. In general, their analysis was in the three main policy areas of stabilization, liberalization, and privatization. The team focused increasingly on the subject of privatization, because it received priority from the Mongolian authorities.

The team's activities in the area of policy analysis continued much along the lines described in the third interim report. This report mentions only those activities that took on special importance in the period since that report.

a. Policy analysis

Stabilization and liberalization

-- Monitoring the implementation of the IMF structural adjustment program, and reporting findings to the Office of the Deputy Prime Minister and the Bank of Mongolia.

-- Further reviewing the prospects for macroeconomic stabilization and liberalization of trade and pricing for the Office of the Deputy Prime Minister and the Bank of Mongolia.

-- Helping design a new trade and exchange system to replace the existing state order system some time in 1992, with the Bank of Mongolia.

-- Helping the research department of the Bank of Mongolia improve their economic analysis and economic monitoring; assisting with statistical reporting.

-- Helping outline and document a report from the Ministry of Trade and the Market Research Institute to the government advocating a new trade policy that would both liberalize imports and eliminate export licensing requirements for most goods.

Privatization

-- Monitoring and advising on the implementation of the privatization strategy for small-scale assets, with the Ulaanbaatar Privatization Commission. Mr. Rustomjee played a central role in the design and implementation of small-scale privatization, and stayed in Ulaanbaatar until mid-January to see its completion.

-- Advising on the design and implementation of the privatization strategy for large-scale assets, especially industrial enterprises, with the Privatization Commission.

-- Assisting with the valuation of small and large-scale enterprises, with the Privatization Commission.

-- Helping to train valuation teams and set targets for the privatization process, with the Ulaanbaatar Privatization Commission.

b. Economics lectures

The team also continued to present lectures on economics to various groups in Mongolia.

As previously reported, Peter Boone presented a daily one-hour course on market economics and the important issues in the transition from a centrally-planned economy to a market economy. The course was attended by staff members of the Bank of Mongolia and members of the stock exchange.

Bill Bikales tought a course on basic macro- and micro-economics four times per week. The course was attended by members of the Market Research Institute and staff members from the Ministry of Trade.

c. Research

In addition to their responsibilities as policy analysts and economic lecturers, team members engaged in research activities. These projects were oriented toward gathering information that was helpful to assessing the economic crisis and to formulating policy responses in Mongolia.

Dr. Boone is preparing a detailed macroeconomic analysis of the first year of the Mongolian economic reform program to be submitted to key policy makers in Mongolia. It should serve as one of the first comprehensive assessments of the reform program.

Mr. Bikales is putting together an extensive data set on the state of the industrial sector, with an emphasis on variables that describe industrial structure and export-orientation. He is writing a preliminary assessment aimed at identifying the impact of the Soviet trade shock. Mr. Bikales also wrote case study reports based on a series of visits to state enterprises.

Mr. Kray has written a report on the prospects for privatization of large-scale enterprises.

Mr. Rustomjee has written a study of the Mongolian experience in small-scale privatization. This study was based on his central role in the design and implementation of the small-scale privatization program.