Export and Foreign Direct Investment Promotion Policies for Mongolia

A Mongolia Japan Joint Symposium and Its Papers
September 16 and 17, 1996

A Result of the Second Year of
Ministry of Finance of Mongolia-JICA Joint Study Project on Economic Reform and Development of Mongolia

Mongolian Economic Reform and Development Study Group
Organized by Ministry of Finance of Mongolia
and
Mongolian Development Policy Support Group of Japan
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September 15, 1996

张邑研究协力

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PREFACE

This is a collection of papers to be presented at the Mongolia-Japan Joint Symposium on Export and Foreign Direct Investment Policies for Mongolia, held in Ulanbaatar, Mongolia on September 16 and 17, 1996. There are six major topics and each one is discussed by two papers except for topic C on interest rate policy, one written by Mongolian expert and another by Japanese expert. Topics are: (a) use of ODA for export promotion, (b) fiscal and financial policies for Export Promotion, (c) interest rate policy, (d) conservation of raw materials for devilment of processing industry, (e) foreign direct investment promotion policies for export, and (f) trade promotion policies. The last paper summarizes recommendations in all the papers and presents a consolidated proposal.

The purpose of the symposium. As a small landlocked country, export promotion is the most important policy for Mongolia only next to its economic transition to a market economy. To achieve this goal and to counter the problems of acute capital and technology shortage, foreign direct investment (FDI) promotion is also one of the most needed policies. At the Symposium, nine reporters will present their policy recommendations on these two issues and participants are expected to discuss the recommendations or present their own views. Based on the discussion and opinions, organizers of the Symposium, Mongolian Economic Reform and Development Study Group (MORES) and Mongolian Development Policy Support Group of Japan (MDPSG-J) intend to produce a consolidated policy proposal to the Government of Mongolia. The last paper of this report could be a base for the proposal. The proposal will be a final result of the second year of the JSP.

Background. The Symposium will be held by the Joint Study Project on Economic Reform and Development of Mongolia (JSP), and is a result of the second year of the JSP. The JSP is a JICA (Japan International Cooperation Agency) research project jointly conducted by the MORES led by the Ministry of Finance and MDPSG-J organized by JICA. The JSP is a three year program from September 1994 through August 1997, each year having different topics to study. The first year topics were industrial policies and human resources development, the second year topics are the export and FDI promotion policies, and the third year topic is tentatively set as strategies for efficient use of official devilment aids (ODAs). Specific topics for the third year, however, will be determined this September.

H.Ueno
September 2, 1996

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Theme A: USE OF ODA FOR EXPORT PROMOTION

A. 1
FOREIGN SAVINGS CAN HELP DEVELOPMENT BUT ARE NOT ESSENTIAL FOR IT

Ts.Enkhbold[1], D.Yanjmaa[2], Ts.Adiya[3],

a. Importance of ODA

For decades utilization of Official Development Assistance (ODA) has been one of the most sensitive issues for developing countries. Proponents and opponents of ODA are numerous and all of them make loyal attempts to prove their points providing success or failure stories.

History shows that countries unable to generate sufficient domestic savings to fuel their economic growth have sought financial resources from other countries. The United States relied heavily on foreign savings, particularly during the period from 1835 to 1860. Japan, which has actively discouraged inflows of foreign savings and investment throughout its history, nevertheless became a prosperous modern nation during the period after the Meiji Restoration of 1868.

Today, foreign aid is conceived as a product of the post World War II era. Under the Marshall plan, the United States transferred $17 billion over four years to help rebuild Europe after the war. That influx of financial capital from the USA and coordinated plans to employ it productively helped Europe to rebuild its devastated physical capital. Asian and African nations, in particular, after gaining their independence from Europe's colonialism, received development assistance which provided the same element-capital-in the form of foreign aid. Early aid programs also recognized that developing countries lacked certain kinds of skills and expertise, so technical assistance programs supplying foreign experts were offered in almost every area of economic development.

As aid flows and number of donors expanded, the economic development rationale for aid changed as well. During the late 1960s and beginning of 1970s, aid programs began to incorporate goals other than promotion of economic growth. Income redistribution, poverty alleviation, supply of basic services, and rural development became motivators for the aid programs of most donors. In the 1980s and beginning of 1990s, the priority areas of donor assistance remained much the same: security, economic leverage, economic health, political evangelism, and humanitarianism. The role of aid aimed at encouraging capacity building in democratic institutions and promoting private-enterprise-based economies has strengthened when transition of ex-socialist countries to a market economy system started. Though this paper covers only one aspect, that is the utilization of ODA for export promotion, it should be kept in mind that the mission of ODA is far broader and much more complex.

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b. Sources of ODA

Another issue which needs mentioning at the beginning of this paper is the confusion and/or misuse of terminology. Foreign savings include both official savings and private savings. Most official savings are provided on concessional (or "soft") terms; that is made available either as outright gifts (grants) or as loans bearing lower interest rates and longer repayment periods compared to those available in private international capital markets. Governments are also granted loans on commercial terms, including export credits, equity investments, and "hard" loans from the World Bank and regional development banks, like the Asian Development Bank. Concessional flows are technically called Official Development Assistance (ODA), but popularly called foreign aid. Aid can further be divided into bilateral aid, provided directly by one government to another, and multilateral aid, in which funds flow to an international agency like the United Nations, the World Bank, and regional development banks, which in turn grant or lend the funds to recipient developing countries. Aid also can be in the form of technical assistance-the provision of skilled individuals to augment national expertise; or capital assistance, the provision of finance or commodities for a variety of purposes. Foreign private savings consist of 4 elements: foreign direct investment, portfolio investment, commercial bank lending and export credits. The afore mentioned points emphasize the diversity of sources of external financing which are broader than the ODA covered in this paper.

c. ODA for Mongolia

The international community supports the transitional policy of the Mongolian Government and renders assistance in overcoming difficulties. The Annual Donors' Consultative meetings held since 1991 served in the creation favorable external environment for receiving and utilizing foreign aid and assistance for Mongolia. Mongolia's foreign economic cooperation considerably activated since the first meeting of donor countries. During this period, the number of donors and volume of aid has increased and aid plays a very important role in the transition of the economy into a market system. Since the first meeting of donor countries total commitments of $1,230.7 million have been made to Mongolia, of which grants make up 40 per cent, soft loans - 60 per cent. 62 per cent of the committed aid has been disbursed so far. Out of the total disbursed aid, 40 per cent went for infrastructure development. If at the beginning aid was used mainly for emergency needs, for the last 2 years the share of long- term development projects has increased. This is explained by the fact that the economy has stabilized and the Government started working on long term policy issues. In this respect a policy aimed at promoting export-oriented enterprises in order to strengthen the country's export capacity is among the priority ones.

The Government's policy as expressed at the Tokyo Donors' Consultative Meeting in February this year is aimed at promoting the exports potential of the country through a multi-fold programs of utilizing firstly natural riches of Mongolia and developing newly organized mining production, secondly, developing the production capacities of animal husbandry based products and achieving world standards, thirdly, development of tourism as an independent sector, fourth, promotion of advertising and services, fifth, encouragement of foreign investment aimed at developing export-oriented production, and lastly, the development of import-substituting industries.

d. Problems Faced by Export-Oriented Enterprises and Possible Options for Export Promotion

The promotion of export oriented enterprises should be done differently in respect of:

- Existing big companies
- Emerging small and medium sized companies.

There are many common problems for these 2 groups, like underdeveloped infrastructure (energy system, water supply, transportation, communication etc.), unreliable and inefficient commercial banking system, lack or poor management capacity to run the enterprises in the new environment, low marketing skills, lack of a reliable information base equally accessible by everybody and others. By stating the many problems it was not intended to describe the situation as totally hopeless. In fact, there are big positive changes in the trade liberalization process.

Further use of ODA in the solution of the above mentioned problems can greatly benefit Mongolia in not only promoting exports but in the development of the whole economy.

Currently running large enterprises have their specific problems. The main issue needing urgent attention at this moment is the successful completion of the privatization process. With shares so widely distributed in small quantities, that is with nobody having the majority of shares, and having mostly outsiders in the Board of Directors, the CEOs are now serving as the Chairmen of the Boards. There is practically no control over their activities from the shareholders. In this situation most CEOs are going for management takeovers thus trying to lower the prices of shares and then buy out the controlling shares themselves. This is a strong subjective negative factor influencing the growth of exports for the last 2 years. Though, at first glance, ODA has no relation to this problem, technical assistance on enterprise management reform is being granted by multilateral donors such as the World Bank under its Banking Restructuring Program and possibly by bilateral donors such as the Government of the Netherlands which would provide for different reform options for management capacity building.

The procurement system of raw materials is jeopardized. On the contrary to the interest of former large companies to acquire supplies of cheap raw materials, the suppliers whose main interest is getting higher earnings from the sale of such materials sell them on neighboring foreign markets. In most cases these primitive trade activities are unsuccessful due to the poor regulation of activities on these markets and lead to the distraction of producers of raw materials from their main economic activities. On the other hand, since the sale of raw materials is somewhat profitable, production of value-added products is not developing.

Emerging small and medium sized companies are mostly involved with merchandising. There are clear reasons behind it. With sky rocketing loan rates the only sphere for survival is trade. Even soft loans from international financial organizations are distributed through commercial banks with very high interest. This high interest rate not only makes it impossible to start any reasonable production activity, but also makes repayment impossible.

For the last few years many organizations have been set up to help private business and promote foreign investment. Unfortunately, they did not succeed much to the lack of the ongoing supply of information and feedback.

Limited access to international markets is the common problem for trading entities. For this reason, the most useful way of utilizing ODA in the promotion of exports would be the creation of a favorable environment of access to international trade activities. Proper advice and consultancy on how to do business avoiding the cumbersome bureaucratic procedures is much needed. Some work has already been started through the use of international trade fairs where Mongolia's products are well advertised on international markets. Specially arranged meetings with business communities and rotary clubs of other countries are organized during which Mongolian businessmen promote the products of their individual companies and Government representatives acknowledge the participants with the laws and regulations that govern foreign investment and other policies related to the development of export production. The International Development Association, the private sector arm of the World Bank, will be conducting a series of foreign investment promotion forums later this year and the year to come. These are intended for both first time and old investors into the country's production capacities. It is hoped that as a result of these forums an influx of foreign investment will be achieved.

Through the use of ODA a reliable foreign private investment climate needs to be created in Mongolia. A challenging proposal for ODA is the idea of establishing an export complex. This proposal, though truly challenging, once implemented could bring tremendous success.

Creation of an Export Complex with a developed infrastructure can serve as a magnet for foreign and domestic export- oriented enterprises. This complex can be set up in Ulaanbaatar, for example, close to Buyant-Ukhaa International Airport. Another possible location is Choibalsan, Dornod province. Choibalsan has good landing facilities for transport planes.

If such complexes prove to be successful, they should be promoted in all economic zones. Some of the committed ODA can be used for the creation of the Export Complex and additional ODA can be further acquired for this purpose on a bilateral and multilateral basis. A special legal framework should secure the necessary foundations for proper functioning and development of such complexes. The local government authorities would be promoted to act as, for instance, Export complex administrators to facilitate promotion of exports to certain countries and regions. Such services from the local governments would also serve as a revenue generating source.

The basic idea is that an Export complex would have different centers, like a product design center, quality control center, technology transfer center as well as a Trade and Investment Support center (TISC). TISC can initially serve as a linkage point for the existing facilities of different small organizations already functioning in Mongolia. But in order to make the TISC a "one-stop center" for exporters and foreign investors, some additional ODA is required. The organizational structure of the TISC could be a matrix, for the purpose of covering different activities, such as market research, technology development, information, advertising, investment etc., and different sectors of economy, like tourism, mining and others, and different regions and countries. At the beginning, it would be desirable to have specialists from different countries in each department through technical assistance type projects.

The experience of many countries, among them Sweden and Italy, shows that incubators for small businesses are successfully used to promote both export- oriented and import- substituting production. Many of you, I am sure, are well acquainted with the notion of business incubators the main target of which is nurturing and realizing ideas for small and medium sized productions until they can independently continue production. Management training and initial investment into business incubators could be generated through the use of ODA.

Another important possibility for using ODA funds is the effective distribution of assistance funds themselves. In addition to the restructured banking system which serves the interests of both the state and private sectors, a development type bank is required to be existent in Mongolia. This type of bank would distribute loans of international organizations on a long and medium term basis to businesses on the basis of them meeting certain criteria. The loans can be made available, for instance, for renovation of old equipment and machinery in export- oriented enterprises. Joint ventures should be able given preferential treatment for acquiring soft loans on a priority basis.

A Government supported Export Promotion Fund would need development. Once this is established, an export insurance system could be fostered together with the Bank of Mongolia. Insurance for Mongolian exports is a vital necessity since exporters are currently boldly plunging into foreign markets, often losing their investments completely. The fact that the country became a member of the World Trade Organization should be used wisely for export promotion purposes.

Another funding direction for ODA is, of course, investment into human capital. Export-oriented businesses should be exposed to business, management and marketing related training. On-site training through internships at similar enterprises and businesses abroad is a fine solution to the many questions that are raised by entrepreneurs. Also, joint studies on defining the comparative and absolute advantages of Mongolian export products on international markets could be conducted using ODA assistance.

Services to export-oriented businesses such as marketing and advertising are good inputs towards promotion of exports. Currently, it seems that most of successful businesses rely a lot on gut feeling. Sooner or later they will, no doubt, experience losses and failures. That is why properly established marketing firms are a necessity. Via doing market research, consulting companies on business opportunities and advertising their products, the marketing firms could very well assist in gaining ground for exporters. ODA funding could be used for establishing the first ever in the country specific, marketing firms. These firms can further grow into becoming Mongolia's trade centers or promotion offices in countries with highest Mongolian exports.

Lastly, it should be stated here that today the utilization of ODA is kept in deep secret. We think it important to change this mentality and system. The destination and use of ODA should be widely publicized, distribution and placement of the funds should be done through Tenders (Bids) after being announced openly in mass media or through TISC type of organisations. Even selection of organizations for the implementation of technical assistance projects/ programs should be made open and the criteria for such selection be individual for each specific project.

It is the hope of the presenters of this paper that through the implementation of both the very few ideas expressed just now and the results of brainstorming of the participants of today's seminar, the export potential of Mongolia will be increased to reach world standards and meet world demands.

Theme B. FISCAL AND FINANCIAL POLICIES FOR EXPORT PROMOTION

B. 1
FINANCIAL AND MONETARY POLICY TO SUPPORT THE MONGOLIAN EXPORT

D. Tserenpil[1]

Summary

This report covers the following basic parts:

(a) Role of export in Mongolian economy
  - *Share of export in the economy and its main structure; and*
  - *Government regulation and its support for export.*

(b) Financial and monetary mechanism for export support
  - *Results from the tight financial and monetary policy;*
  - *Investment (domestic) promotion*
  - *Banking loan and interest rate policy;*
  - *Tax reduction; and*
  - *Exchange rate and its effect.*

a. Role of Export in Mongolian Economy

1. Present Situation

The Mongolian economy can participate in the international division of labour and integrate into the world market only through the developing of export - oriented production.

The development of export potential is the main factor for the substantial growth of Mongolian economy in the future and the most difficult objective in the light of present transition situation to the market economy.

The export affects the national economy and the sector development can be determined by the correlation analysis between the growth of GNP and export. (It will be determined)

The export plays a significant role in the expansion of domestic market. The relative improvement of the supply of both imported consumer and industrial goods over the recent years due to the export growth and the increased ability to import

The principle in foreign trade policy has been a liberalization and development on the basis of the equal and mutual interest. In 1995, Mongolia traded with 56 countries including export to 44 countries and import from 53 countries. The 54.1 % of total exports went to the Central and South East Asian countries and 54.8 % of total imports

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were from the East Europe and Russian Federation, 26.8 % from the East Asian countries.

Table. Turnover of Mongolian Foreign Trade (1990 - 1995)

Indicators (current years price) /mln. US $/	Years					
	1990	1991	1992	1993	1994	1995
Export	660.7	348.0	388.4	383.6	367.8	511.6
Import	924.0	960.9	428.3	379.0	258.4	388.7

The total foreign trade turnover reached 900 mln. US $ in 1995, which was up to 43.8 % against the previous year, including export increase of 39.2 %, and import increase by 1.5 times. The trade balance has had a surplus in the last 3 years.

A big demand and high price for the copper concentrate and cashmere products which are main exports from Mongolia, have had a favorable effects on the income growth from export. But the price decrease for some goods has resulted in the decrease of export income by 8.4 % during the first 5 months of this year in comparison with the same period of the last year. The export strategy of our country is heavily dependent on a particular product's price fluctuation in the world market.

Mongolia still has been facing the substantial difficulties in the foreign market. 1/ price for petroleum products which are main components in our import, has gone up; 2/ our former main trading partner - Russian market has faced difficulties; 3/ the trading countries has tightened their protectionary measures as well as measures against the inflation; 4/ domestic output has fallen down and export has been drastically dropped.

2. Policy and Tendency on Export Development

During the transition to the market economy, the export expansion has become the most important objective. In order to develop Mongolian export, there should be taken comprehensively into account all foreign and domestic factors as well as technical and technological promotion programme for production. This must be an important issue for foreign economic policy.

Measures to be taken shall include the followings :

- The orders from the government shall be given to the entities producing final products;
- To grant soft loans or tax reduction to the exporters when they import equipment and machinery; and
- To provide a tax reduction to the partners cooperating in the investment when they export their products.

The analysis, whether Mongolian products are competitive on the foreign market; whether exports are efficient and profitable or not, is very important. Thus information flow should considerably be improved.

The improvement if export competitiveness is the main engine for Mongolian economy. However, it can be determined by interrelated complex conditions, we can summarize them into 4 groups.

(1) The production structure and quality factors (natural resources, labour resources, capital, scientific and intellectual capability, infrastructure) that influence particular products;
(2) Demand size on the basis of domestic needs, demand structure, its ability to meet export capability; to improve the internationalization of domestic demand, moreover to forecast the world market development, to meet the customer requirements and technical and technological standards in the domestic market;
(3) Competitiveness of similar or joint - venture enterprises in a particular field; and
(4) The have a particular niche market strategy and organizational structure in the company or enterprise.

Here is discussed about the sector with a significant impact on the Mongolian economy (as Erdenet). Therefore, such entity or enterprise should be supported and backed by the government. The criteria determining them are as follows:

(a) Proper combination of the production and high quality factors; "know- how" in the industry, scientific and technical capability, skilled labour resources, information network etc.
(b) Improvement of export-oriented domestic production and demand structure in order to expand own export to the world market;
(c) Significant changes in the domestic production and joint-ventures to attract the foreign investment within the restructuring of enterprises;
(d) Improvement of the competitiveness of mixed and similar production in order to increase the flow of technology and trained staffs from sector to sector; and
(e) Stabilization in the relations of domestic reproduction between all entities and sectors;

In order to improve the export capacity of Mongolia, first of all, the development should receive the mining and agricultural processing industries relying on the natural mineral and raw materials resources. For this purpose :

- Not to decrease the present output of Erdenet concern which contributes about 50 % of total earning from export;
- To restructure the production of mineral resources in related industries in order to switch into a deeper processing and to produce more profitable final products;
- To attract foreign investment into processing and exporting productions not only in the traditional copper, molybdenum and flour spar productions but also petroleum, gold, uranium, rare mineral elements, zinc and lead productions.
- To produce and export of processed raw materials of animal origin. (meat, cashmere, wool, skins and hides etc.) Our country has an annual production capacity to process and produce final products like as 4 mln. pieces of sheepskin, 1 mln. of goatskin, over 400 thousand of cow hides, 18 to 20 tons of sheep wool, over 1800 tons of camel wool and other raw materials of animal origin.

The preferential development of worldwide and regional tourism taking the advantage of wild nature, rare animals and plants, ancient historical and cultural places, nomadic civilization and others, is one of the main resources for export increase. The Mongolian export policy based on the providing of tugruk's real exchange rate, (which is still declining), the liberalization of foreign trade including export liberalization (enhancement for quota and license, change in the present situation of customs).

3. Government Management and Regulation on Export

The process of government management for export can be taken with the following 3 forms.

(1) The government should pay specific attention and encourage considerably the supply of raw materials, machinery and manpower resources which are lacking in the production and necessary to advance in export. In order to develop export - oriented industries, there should be used new scientific achievements and advanced technology, as well as professional personal staff should be trained. As for infrastructure and information network development, a package of measures here should be taken on the encouragement of investment demand, and within this framework the tax loans are to be used efficiently. In case of implementing such programme, there should be involved also private sector savings and foreign capital together with government capital investment.

(2) To provide a vigorous support from the government on the improvement of aggregate demand structure and its quality, to have optional allotment for orders among companies and enterprises in the production of products with quality, up to the international standards and advanced technological level. To provide a financial support and tax reduction to carry out technology renovation and patent policy.

(3) It is very important to directly support from the government the establishment of export structure with a competitive capacity in order to develop infrastructure, attract foreign capital and encourage the profitable activities.

The foreign economic relations should have inevitably a government regulation. A complex economic and financial mechanism will be used in the government regulation. The direct economic incentives in the government regulation should cover the followings:

- the goods designated for export shall be ordered and purchased by the government;
- to grant a loan and to finance the enterprises producing for export products;
- through the implementing of a specific export programme, to promote development of infrastructure, regional industries and social development;
- to finance scientific research and development; and
- to introduce a purpose-oriented project or planning.

Moreover, the tax, depreciation, monetary-credit policies shall be used in the economic regulation.

b. Improvement of Fiscal and Monetary-Credit Mechanizm on Export Promotion

1. Establishment of Export Promotional and Organizational System

The Mongolian export is divided into the following 2 groups:

(a) Direct exports done by the government and private bigger companies on the basis of government permission.
(b) Small - sized exports mainly carried out through the border trade by the local administrative organizations and private merchandisers (with or without licenses).

These trades are not subject to the central monitoring and supervision as well as lack any efficient marketing research and principles. Such situation has brought quite a lot of losses or trouble in the economy. Specially, export of raw materials is disorganized.

The government support on export through the financial policy is related to many issues in the production management and organizational management. There are mainly eight issues as follows.

(1) First of all, to improve export organizational structure and to put control over it. When the export is established with well prepared regulation and control system on the basis of the balance on the production, raw material and financial resources in our country, it will give better results.

(2) In order to increase export, there should be processed raw materials of animal origin, and recovered the current production capacity producing final products, and utilized the full production capacity, and issued the investment policy to renovate technology, and set more incentives in the enterprises with foreign investment.

(3) In order to provide with necessary raw materials the above mentioned factories, the following steps should be taken:

- To put an end to the export of unprocessed meat, wool, cashmere, skins and hides. It is necessary to regulate a very strict custom policy, if necessary the Government should issue a ban decision to the export according to the arrangement with the IMF and World Bank and Asian development Banks. (like as the resolution issued in April, 1994).
- To set a competitive price for above raw materials and products in terms of foreign partners (especially Chinese).
- To establish a relevant preparation and procurement system for livestock raw materials. Here can be the following methods: (i) to have a domestic preparation system where the government orders for main raw materials and purchases at market price, (ii) to establish a direct relation, to send representatives-suppliers to the aimags and sums, (iii) to establish agricultural cooperatives providing trade services to the herdsmen, (iv) to improve vigorously activities of the consumer cooperatives, and (v) to enhance the direct delivery to the factories, and use additional incentives. The important task to be here is to provide cash to the herdsmen.

(4) In order to improve the export organization, payment terms, control over it:

- to enlarge a competitive and reliable performance for companies engaged in the foreign trade under the Ministry of Trade and Industry;
- to establish bigger cooperatives involved in the export servicing for a number of entities in a particular field of industry and agriculture. (such cooperative can formed by contributions from enterprises or entities, and be engaged in the export and import activities as well as have own branches in the local places)

(5) To establish the government investment fund in the development and support for export-oriented manufacturing factories using the following resources:

- specifically designated gratis and loans granted from the supporting and donor countries;
- to allocate concrete investment from the state budget;
- population savings deposited with a fixed period;

(6) To organize annual fair-trade of domestic exported products in our country and take a wide participation in the fairs abroad; for this purpose, to establish a free trade zone at the possible place nearby to the north or south border.

(7) However foreign trade has been liberalized, it is necessary to strengthen the control over the exported products on behalf of Mongolia. Such export control should be executed by private auditors to whom a relevant permission has been granted. A control over the goods, product quality control, packing quality control for exporting products, control over the used raw materials in a particular product's production.

(8) In connection with the urgent need of convertible currencies in Mongolia, the following measures should be taken, including:

- through as much as possible restriction on the domestic demand for goods with high demand abroad, to mobilize additional export resources, full support and promotion of output growth of exported products from the government;
- to produce import-substitutes domestically produced products beginning from spare parts, to implement comprehensive measures on the strengthening of removal measures for great losses occurred in the production and consumer fields;
- to establish an open economic zone, and to provide a long or short term leasing used commonly in the world on the natural mineral recourses, enterprises, other business and cultural objects to foreign businessmen, and to pass the basic legislation (law on establishment for open economic zone etc.)

2. Export Promotion Measures

First of all, the export shall be promoted through the tax system:

(1) Most products exporting from domestic factories are exempted indirectly from (the custom and sales) taxes.

(2) Machinery and equipment necessary for the production which are imported from abroad for the production manufacturing exporting products, are exempted from custom and sales taxes. Such exemptions are as follows:

Reductions and exemption (mln. tug.)	1994	1995
Custom duty reduction on imported goods	570.5	1206.4
Custom and sales tax exemption	1201.1	14564.8

(3) The corporate income tax reduction has been provided on the investment in order to increase the production of export goods. Such reduction worth 2409.7 mln. tugruks in 1995. These reductions will continue further.

(4) Possible ways to be used in the tax reduction are as follows:

- To reduce directly the percentage to be imposed or extend the collecting period;
- To permit to the companies the establishment of a monetary fund without tax in order to promote their export or to deduct the expenses for the development of export from the income before tax;
- to increase the indirect tax percentage for the returned exports; to impose various duties to them;
- to expand export activities to be imposed with tax reduction.

In connection with the requirements needed greater financial expenses in the production of export products except the tax incentives, there can be set a regulation to grant a specific subsidy from the government in order to secure the sales of products from agricultural and industrial sectors.

3. Monetary-Credit Policy

Within the framework of implementing government monetary policy by the Bank of Mongolia, the policy measures have been taken in order to restrict the price increase in conformity with the money supply due to the stabilization requirements in the economy, and to coordinate the credit and deposit rates with the price inflation, and to maintain a stable exchange rate and purchasing power of tugruks.

Out of total credits amounted at 138 bln. tugruks granted by the commercial banks in 1995 the 86.4 % were given for the purpose of support in the production and services investment. From this credit 30.9 % to the industry, 12 % - infrastructure, 5.9 % - agriculture were granted respectively. The credit amounted 58.0 bln. tugruks were provided for the purpose of supporting a privilege industry and private sectors.

There have been taken measures to reduce credit interest rates granted previously, with the purpose of production support and extend its repayment period. Such kind of credit interest rate of 6.1 % is down by 3.1 percentage points from the average credit interest rate granted by commercial banks. Soft credits are given to the export-oriented enterprises to purchase their required raw materials. For instance: the "Eermel" Co. - 700.5 mln. tug., "Gobi" Co., - 1691.0 mln. tug., "Buyan Co. ltd. - 600 mln. tug. have obtained as a credit. Due to the mechanism of the reduction in interest rate and extension of repayment period, it has resulted positively in the strengthening of economic capacity of manufacturing exported products and improvement of competitiveness for exported products abroad.

In other words, the state credit becomes additional strengths in the export financing and enlarges the concluded contracts and agreements to become a secure.

Some proposals needed to be studied:

- To introduce a favorable system in the export credits and production proposed financing in advance with low interest rates for export-oriented enterprises from the central bank through commercial banks. On the basis of the export letter of credit or order or commitment received from a reliable importer, to grant a credit with lower interest rate and to repay it later by the export earrings;
- The central bank should re-estimate the bill of exchange for export allowance granted from commercial banks in the respect of common used commission.
- In case of the usance without letter of credit for export bill of exchange, to grant a credit with lower interests equal to the amount of bill of exchange until the payment is remitted;
- Taking into consideration, besides arranged regulation between central bank and commercial banks, some export credits in special cases can be granted without any affects from the monetary tight policy;
- To apply export credit insurance;
- To set a favorable interest rate to the credits designated to the investment for equipment in the manufacturing enterprises and entities of export products..
- To establish a development bank at the government, and to make research and decision on financing of export-oriented production development, the leasing and forming of credit system with 2 stages through such bank.
- At the first stage, to grant a credit with lower interest rate for the import purpose. To introduce a bill of exchange system for import payment, and to grant a credit for the import of equipment from the bank until the payment is received.

4. Foreign Investment

It is necessary to attract the foreign investment in order to develop the export base of Mongolia. The development programme of the export capacity is closely tightened to the international cooperative development.

It is inevitable to let an enter into Mongolia to the foreign capital. Therefore, the approach to the foreign capital must be changed fundamentally. It is important to switch to more active cooperation with bigger foreign business.

The foreign capital can participate in the Mongolian economy through the following ways:

(1) To establish a traditional joint - venture, but necessary to improve here its way and type, and it should be based on only mutual advantages and maximum efficient activity.

(2) To permit 100 % owned enterprise by foreign owners. But the establishment and running of such enterprise shall be settled according to the public laws.

(3) To let them making investment in the stocks and securities of Mongolian enterprises and entities.

(4) To establish technostocks and technolists. To form technostocks with foreign investment participation.

(5) To establish a concession able to perform the significant role in the utilization of mineral resources.

(6) To establish a free economic zone. It should be settled according to the public legislation.

B. 2
EXPORT PROMOTION STRATEGY: A MONGOLIAN CASE FOR EFFECTIVE FINANCIAL ARRANGEMENTS

Satoshi Sunamura[1]

"Profits are the lifeblood of the economic system, the organic elixir upon which progress and all good things depend ultimately. But one man's life blood is another man's cancer."......Paul Samuelson (1976)

My task today is so much challenging as to prescribe a Mongolian case for effective financial and fiscal arrangements for export promotion. Let me first review the pre-requisites for development strategy as the matters relevant to the subject and to the overall economic as well as financial institutions, then going straight into the cores of export promotion schemes. There are several other related issues which must be addressed in terms of financing conditions, *inter alia,* rates of interest and foreign exchange policy.

a. Pre-requisites for Development Strategy

1. Macroeconomic Stability

Tight monetary policy and hard budgetary constraints should continue to be maintained to keep down the high inflation rate. The large state enterprises may well be privatised as quickly as possible to reduce the fiscal deficits to the level of say, around 3.0% of GDP. The average market rate of interest may has to be kept at least around the inflation rate to avoid financial repression for the time being. Tax collecting system as well as credit allocation mechanism can be improved to make the overall financial and fiscal policy more effective. Exchange rate should be maintained at the realistic level to keep the foreign currency reserves at a comfortable level to make growth sustainable.

2. Economic Restructuring

In order to keep macroeconomic stability as well as potential growth, sustainable economic restucturing must be implemented in priority order, specifically in terms of agricultural productivity, banking system, capital market functions, distribution network, employment, export promotion schemes and foreign direct investment. In addition to the common economic (specifically financial) problems of all developing countries (DCs) (refer to the Table MFD in Attachments to this article) there are specific issues to be resolved by transitional socialist economies (TSEs), such as inherited debts, valuation of corporate assets, property laws, general accounting and auditing practices, changes of production lines as well as management systems of state enterprises to meet with the new market demand, and the like.

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3. Institutional Building

Effective economic institutions can be strategically organized based upon the prevailing social value concept and the appropriate functional elements which should include, inter alia, directives, facilitatives and evaluatives at the macro systems as well as corporate levels (refer to the Table MFD). Specifically a commercial banking system is the basis of efficiency for all economic transactions to facilitate trade and investment in competitive markets. The banks licensed under the Banking Act of Mongolia need to be recapitalized to meet with the prudential banking regulations and to maintain public confidence. Banks are generally instrumental in delivering policy implications as well as market information to their clients, by networking together to operate on the traditional banking principles : accountability in operation, steadiness in profitability, quality in services and diversification in business portfolio by conforming to the financial market development and maturity (refer to the Diagram FSD in Attachment). Governability, accountability as well as credibility criteria must be clearly built into the economic institutions for sustainable economic development.

4. Relevance of East Asian Success

There are lots to be learned from East Asian successful experiences in terms of indirect financing, application of lower interest rates on strategic credits, main bank systems as agents for corporate development and monitoring, industrial financing, control over residents' external portfolio investment, an adjustable peg system to a basket of composite currencies, progressive tax rates at the sources of incomes and the like, in addition to the effective points, as analysed as policy choices and competitive discipline in the World Bank report 1993 (refer to the "East Asian Miracle", page 88) such as high human capital, openess to foreign technology, technocratic insulation, high-quality civil service and high savings.

b. Export Promotion Strategy

1. Facilitating Export by Favourable Financing Terms

The most effective facilitatives for trade and investment activities at the premature market conditions of economic transformation are the provision of financial incentives and competition under the confined but clear rules of the game.

In normal trade transactions, buyers request their suppliers to allow a certain period of time for cash payment (usance for sales). For confirmation of sales of raw materials or products, buyers either issue promissory notes (PNs) to pay on agreed dates, or sellers issue bills of exchange (BEs) addressed to buyers to pay on agreed dates. For example, if a bank's client buys some materials on 30 days usance and sells his/her manufactured products on 90 days' usance, this client usually requires trade financing for 60 days (unless the client has sufficient funding on his/her own). A bank daily engaging in dealing and being familiar with the client's business patterns and behaviour, generally provides the financing for such underlying trade transactions or discounts the buyer's PN or the client's BE (accepted or endorsed by the buyer or his banker) at relatively lower short term interest rates. The bank has no problem with providing trade or bridge financing for underlying payables or receivables. To facilitate such normal trade financing, a central bank's rediscount facility is usually available at a favourable rate for licensed banks and their *qualified* commercial PNs and BEs.

A similar but more strategic and extensive system may be conceived for export financing if this would facilitate competition for export business leading to productive investment in the potential manufacturing industries. The system could include the followings.

(a) Pre-export financing should be put in place, for the exporters gathering products or manufacturers going for production, on the strength of letter of credits (LCs) or letters of commitment or other forms of intent received from overseas buyers. The financing could be for the amount of say, 80% of contracts for the reasonable period of 30 to 120 days by their banks by endorsing the financing amount on the evidencing instruments, at the most favourable rates *close* to Bank of Mongolia (BOM, Central Bank) rates. Repayment shall be made by the subsequent proceeds of negotiated export documents under the relative LCs (with BEs, BLs, insurance, invoices etc.).

(b) *Shippers'* usance bills, drawn under the qualified LCs for 30 to 180 days, shall be bought and discounted by negotiating banks at the most favourable rates at which normally a central bank is willing to provide the rediscount facility for the negotiating bank at the most favourable rates, as are the cases of good domestic trade bills, but more due to the reason that negotiation were made under the overseas bankers' LCs for foreign currency revenues.

(c) *Buyers'* usance bills under overseas bankers' LCs may be negotiable at sight-rates by domestic banks, who immediately send the BEs and documents to the LCs issuing banks for full payment. LC issuing banks upon receipt of the documents, ask the buyers to accept (endorse) the bills (BEs) on the preagreed usance rates to honour on the due dates. As such acceptance bills are not only endorsed by banks but backed by the underlying trade, they are one of the most secured, popular and liquid short term inter-bank market instruments dealt in any international financial centres.

(d) *Documentary* bills without LCs but against *Payment* conditions (D/P) may be reasonably negotiable by the banks who are familiar with the relationship between shippers and buyers, marketability of products as well as current payment positions of the buyers' countries. The *recourse* agreement (for cases of defaults) may be usually put in place. Once negotiated by banks and up until the time of actual payment, such bills may be qualified as collaterals for BOM refinancing for a certain percentage of total amount.

(e) *Documentary* bills against *Acceptance* (D/A) would require more prudent handlings on the part of banks regarding creditworthiness of buyers, knowledges or marketability of products, economic conditions of countries concerned as well as counterparty banks' relationship with buyers. This may look most risky deals among others, but once the notices of buyers' acceptances were informed through their bankers, these D/As could also reasonably be treated as collaterals for BOM refinancing for a certain percentage of the amount.

(f) In either cases of export it is advisable to provide financing incentives, under the climate of credit shortage and economic uncertainty, in any event however with the *recourse* agreement with the commercial banks concerned who can further be protected with the full recourse to shippers in cases of default. To reflect the quality of credits to be extended, more favourable incentives should be given to (a), (b) and (c) than to (d) or (e). It is most advisable not to impose credit ceiling on such export credits, specifically on (a),(b) and (c). Priority for credit rationing may be considered as the essential conditions for encouraging export under the climate of high inflation, capital shortage and high rate of interest. Some realistic suggestion may be made in Section c.

2. Value-Added Export Encouraged

Mongolia's major export items are primary products such as cashmere, wool, camel, leathers, copper, gold, uranium, coals, metal goods and the like, which are readily susceptible to the world commodities market movements. No organization has been successful in containing the price fluctuation of commodities. Some effective measures must be organized to improve the situations, otherwise Mongolia constantly has to expose to the fluctuation of export revenue. This is indeed the classical examples of difficulties in DCs moving towards economic take-off. Some of the measures are as follows.

(a) General policy to improve the *terms of trade* is to add value onto these primary goods by manufacturing which requires fixed investment, technology, marketing and managerial capacity. This is a daunting task for Mongolia today but readily attainable by ways of joint ventures with the *qualified* foreign capitals which eagerly look for such resources in terms of comparative advantage and world logistics. Joint ventures may be conceivable for any manufacturing products. An idea of Free Trade and Investment Zones (FTIZ) in the restricted areas with some tax and financial incentives which I proposed last year may be very instrumental in facilitating foreign direct investment(FDI) including specifically some high-tech industries from U.S., Japan, Korea and Taiwan. Of course, its feasibility must be studied.

(b) Mongolian *cashmere*, however, has unique and valuable features on its own, specifically in terms of quality, scarcity and cost. Comparative advantage is obvious indeed. Hence more values can be easily added by processing and manufacturing, further by appropriate designing and colouring by conforming to the market tastes and preferences willing to pay more money, rather than merely wasting the raw material for cheap and quick cash under the tactful and ad hoc individual border negotiation. Further, even while cashmere factories are suffering from shortage of supply of quality raw cashmere, more expansive modernizing investment may be introduced if there is an assurance of stable supply of raw materials.

(c) An effective collecting system of such important raw materials may be organized by the cooperatives composed of buyers and suppliers, if local cash payment is assured at the reasonable *local* cost plus some relatively handsome margin basis. Such minimum purchasing prices may be informed to the producers upon inquired. Actual day to day purchasing prices may be, however, upper-elastic by reflecting demand and supply in market. Purchasing fund may be readily provided by the cashemere factories, cooperatives, overseas stable buyers (long term contract), revolving fund, counter-part fund, and possibly by a regional development bank, a Mongolian development bank proposed by the author. These funds are easily recoverable or replenishable by the sales proceeds, especially when exported with the value added forms. A caveat due to many failures of other commodities agreements may be that feasible minimum price assurances to the producers shall be made *in the local currency.*

(d) Tourist indusry can be made more value-added in foreign currencies by setting up the comfortable accommodation equipped adequately with modern facilities in the major four areas of scenic beauty where tourists can stay longer period as they wish to pay handsome fees under the strict rules of conducts. Private air services should be upgraded in lieu of motor car conveniences. A chain of good ger services may be also effectively organized for ordinary tourists, surrounding the first class facilities, but near to the trunk road. Some environment preservation tax may be charged onto their accommodation bills.

(e) Fixed investment required for export industries may be facilitated by ODA funds, leasing, foreign investment, deferred or installment payment on imported machineries, bond placement among the financial institutions, syndicated loans by major banks on roll-over basis and by funds from the proposed regional development bank. Any import settlement funds should be refinanciable or rediscountable by BOM corresponding to the cash flows by provision of installment payment notes against collaterals of relative plants or machineries for certain percentage of the initial amount..

(f) At any event competition should be encouraged among foreign capitals, main banks as agents for local corporate development and joint venture companies.

c. Interest Rates Policy
A Case for Favourable Rates of Interest for Strategic Take-off

Short-term credits as well as industrial investment finance should be facilitated for the productive transactions to make economic growth in Mongolia sustainable. Under the acute shortage of capital, lack of credibility and economic uncertainty, at least some framework for the basic financing terms as well as the guidelines or strategic *directives* for productive investment may be clearly given in public *in priority* order.

Even in the developed world there are vast differences in the rates of interest applicable to a similar projects by reflecting, for examples,: (a) amount and terms, (b) cash flows prospect, (c) familiarity of natures of transactions, (d) competition for business, (e) state of relationship, (f) valuation of collaterals, (g) availability of rediscount or refinancing facilities, (h) ranges of business networking, (i) credibility of implementing agencies, (j) modes of commitment, (k) length of experiences, (l) forecast on inflation rate, (m) managerial capacity over market and credit risk as well as organization, (n) management and shareholding structures, (o) monitoring system, (p) strength of B/S and P/L, and the like.

A question of subsidy or price distortion may be argued only *if other things remain equal,* such as price mechanism, financial maturity, accounting standard, levels of disciplines and education, availability of information, demographic mentality, and cultural values, and after all, governability, accountability and credibility established in the systems. Transparencies in the rules of game and procedures should be the points in arguments.

There is nothing wrong to introduce favourable rates for the strategic, preferable and credible deals in business under the premature conditions of economic transition, running however, under the explicit and confined *rules* of the games with a firm social value concept, based upon the objective criteria for govemability, accountability andcredibility. As a matter of fact, price distortion, subsidized cost for state enterprises, cost of social confusion, corruptive practices, rent seeking principal-agents issues, loss of public confidence and equity concept, enlarging disparity of incomes etc. In some countries moving towards market oriented economies may be after all much more costly than preferential but effective and favourable treatment of interest rates for publicly known productive and strategic financing in Mongolia. Differences in economic effects or other distortion sould be objectively assessed say, after five years or so, in terms of effectiveness or in forex reserves extent of implementation of economic restructuring and institutional building as discussed earlier.

Under the circumstances in Mongolia, some preferential treatment of interest rates may be very instrumental in facilitating productive investment, particulary for export. The former may be more prompted by foreign direct investment with the support of a regional development bank, and the latter may be readily facilitated by the rediscount facilities to be provided by BOM. Such cost will be adequately recovered in due course, say within five years or so, in terms of export revenues and activation of economic transactions in general that lead to more tax revenues.

d. A Case for Credit Rationing under High Inflation Rate

Under the climate of high inflation, acute capital shortage and economic uncertainty, productive investment and trade transactions may be facilitated effectively by financial and tax incentives. The objective criteria and the *qualifications* for the favourable treatment must be clearly indicated in public.

(a) The grave question, however, remains as tight monetary policy must be employed over the aggregate amount of monetary supply and the methodology of credit rationing. The former may be effectively advised by IMF and the latter may be objectively judged under the individual circumstances. The rediscount facilities for pre-export and usance bills may be given without credit limits while other export items may be subject to changes in percentages of refinanciable amount or applicable rates, but no restriction at any event on the numbers of application. Refinancing for strategic and productive investment once approved should be continued without restriction.

(b) Some rough idea, however, over the percentages of aggregate credit allocation may be required to work out for the BOM in response to the inflation rates. Generally speaking, the higher the inflation rate, the more preferential treatment may be advisable. As inflation rate comes to be reduced more diversified transactions may be also encouraged.

e. Foreign Exchange Policy During the Development Process

1. A Case for Adjustable Peg System

For a small country with less diversified industries the exchange rate may be effectively pegged to *a basket of composite* currencies (convertibles) of major partners' to reflect the degree of external transactions. Mongolia with large weight on primary industries and susceptible to service income from tourism may require relatively frequent but small adjustment in terms of composite percentage of currencies as well as rates of exchanges. A crawling peg system may be sometimes useful to indicate the direction and extent of changes in rates and to preempt any disruptive market movements with the clear views of economic policy.

However, a relatively stable exchange rate policy may be advisable in the medium term prospect if certain manufacturing industries need to be strategically fostered to make their investment programs as well as treasury accounting manageable.

2. A Need to Control Dual Currency System

(a) The weight of US dollar denomination in the Mongolian banks balance sheets (BSs) looks too large, and cost of deposit may be excessively high to make the investment economically sustainable elsewhere. While the loss may be partly compensated by occasional but small devaluation of Tugrik, it can not be deemed as a sound banking policy, as this is purely a financial speculation and not productive for the transitional economies. Such operation can not be sustainable as deposit rates are more than four times costly than expected returns on US dollar financing or investment overseas.

(b) Foreign exchange positions of banks should be regulated relative to the banks' real capital base under the prudential banking regulations.

(c) Residents' currency transactions should be confined to the licensed domestic banks to make domestic savings available for corporate finance and to keep track of their modes of overseas investment in order to preempt any capital flight *a la* Mexican or Russian residents. A heaver penalty tax may be imposed upon the short-term overseas investment. Any long-term US dollar portfolio investment may be made in the Mongolian National Bond.

3. External Debt Management

A proper and effective, External Debt management may be the most imminent and important policy for Mongolia to maintain its sovereign creditworthiness and integrity in the internetional markets. The matter relates closely to the policy of foreign direct investment (FDI), excange rates, export performances and credibility of the banking system.

Total debt outstanding may well be contained within say, 40% of GNP, Debt Service Ratio (debt service payment against export DSR) under 18% of export, and overseas interest payment may be 12/15% of export.

It is most advisable to negotiate with the creditors at the earliest opportunities to settle the outstanding debt. This appears to be the favourable timing for Mongolia, not entirely in terms of a Brady style, but more effectively in the forms of restoring credit standing in markets to facilitate more foreign direct investment. The most effective and professional advices shall be only be provided by the experienced and qualified consultants.

f. Conclusion

Favourable rediscount facilities may be extended to exporters through the licensed banks on the qualified LCs and export bills. The banks however not observing the banking regulation should not be entitled for BOM's rediscount facilities. Banking restructuring as well as foreign exchange positions are the specific matters of urgenct implementation. Availability of BOM's rediscount facilities may be effectively and strategically used to introduce fair competition in Mongolian economic activities under the climate of high inflation rate and capital shortage.

"I have called this principle, by which each slight variation, if useful, is preserved, by the term of Natural Selection."........Charles Darwin

<u>attachments</u>

(a) Summary
(b) Diagram CDE: Cnallenges for Development Economics
(c) Diagram FSD: Financial System Development
(d) Table MFD: Major Financial Difficulties Common to Developing Countries
(e) Major Attributes of Main Banks

<u>Attachment (a)</u>

<u>SUMMARY</u>

Financial Policy and Fiscal Measures for Promoting Mongolian Export

<u>1. Financial Policy</u>

1-1 Maintain Proper Foreign Exchange Systems.
1-2 Establish the Financial System for Encouraging Export as well as Export Credit Insurance.
1-3 Introduce Favourable Financial System for Export or Imported Goods for Export.

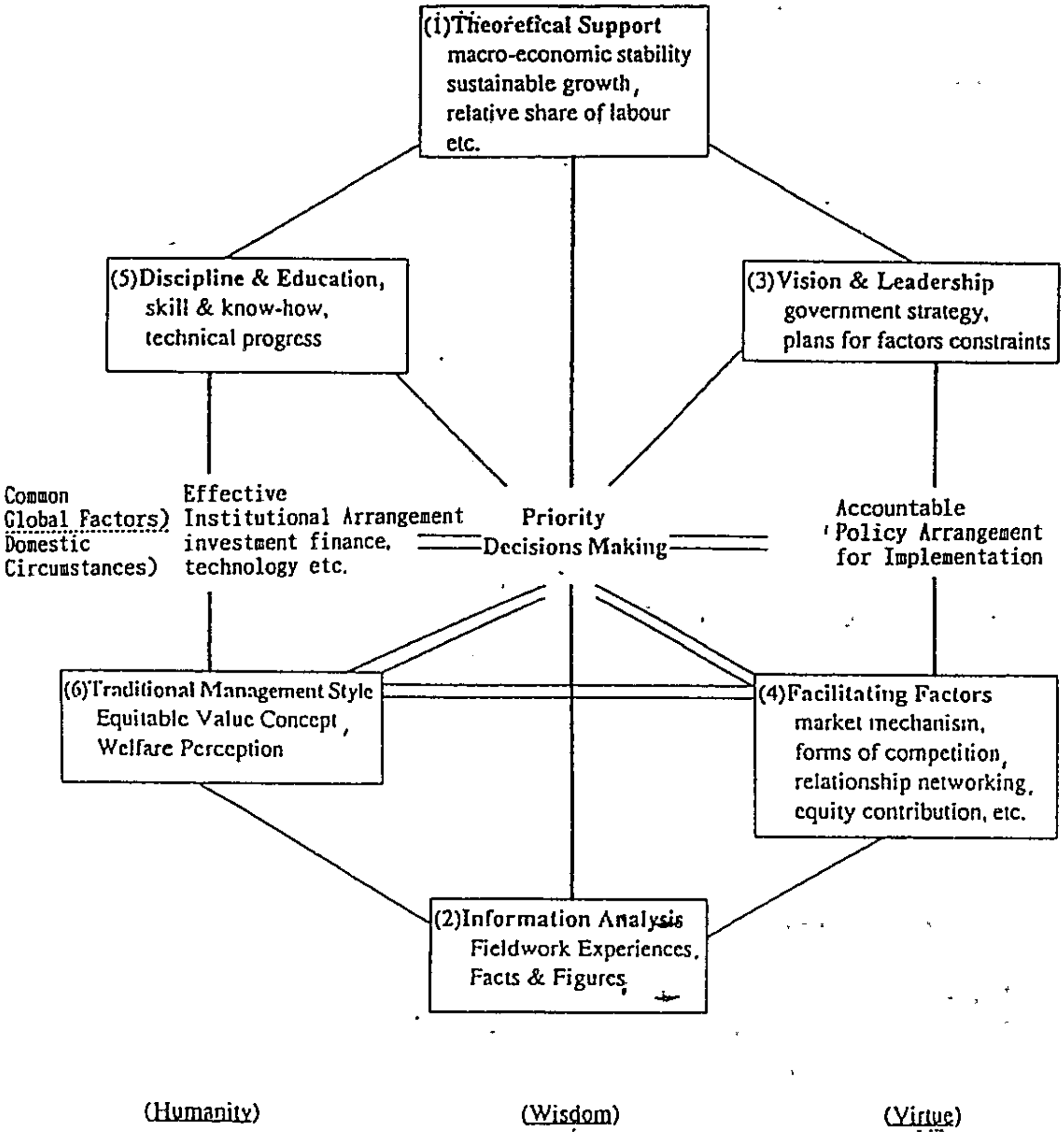
<u>2.Fiscal Measures</u>

2-1 Establish Organizations and Institutions for Export Exhibitions.
2-2. Provide Useful Information and Effective Measures for Export.
2-3. Cooperative Association to Gather Important Raw Materials such as Cashmere for Value-Added Export, may be Organized by the Parties Concerned, and the Local minimum purchases may be assured in line with Market Trend in terms of Local Currency.

Attachment(b)

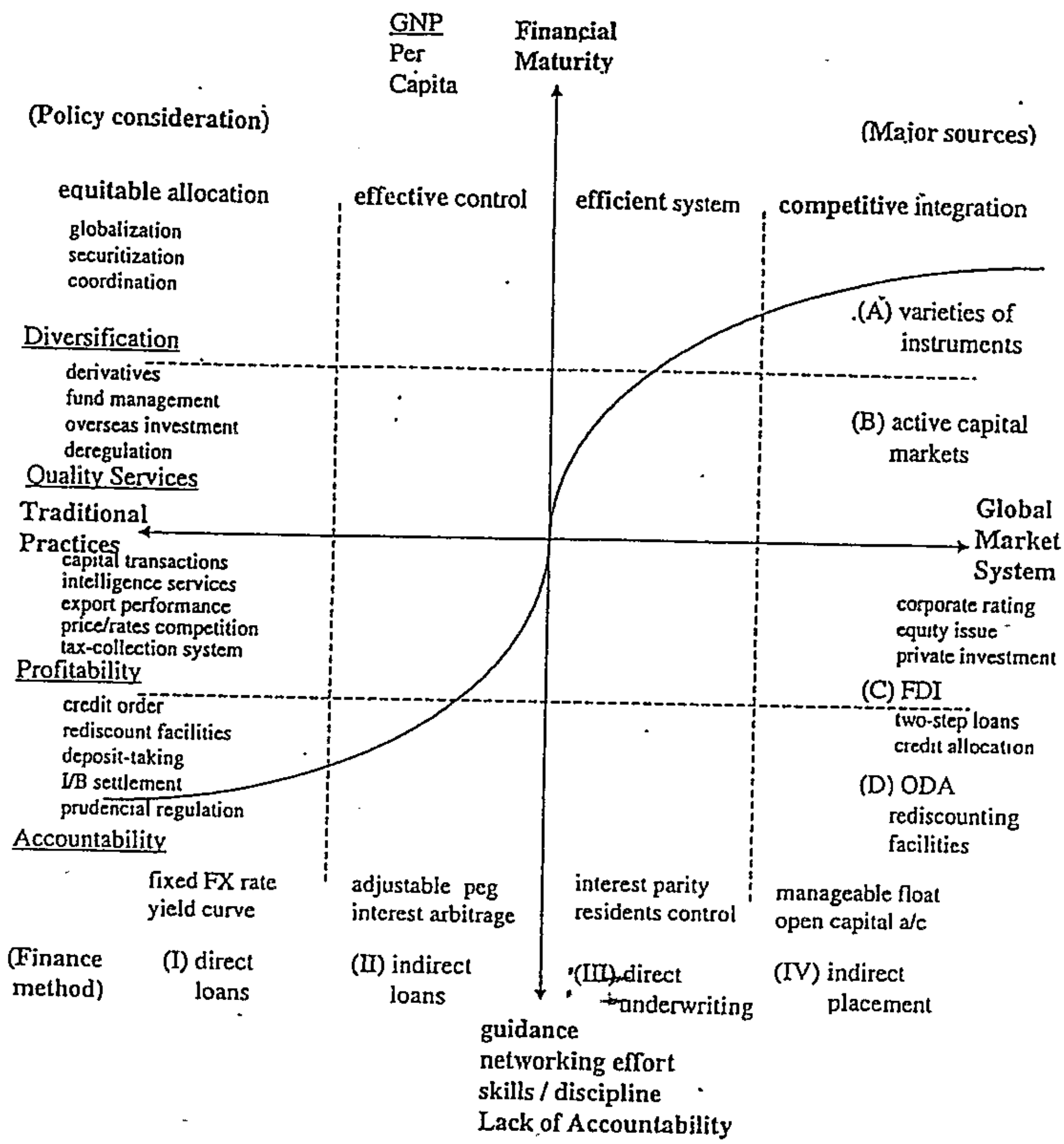
(Diagram CDE) :

Challenges for Development Economics



Attachment (c)

(Diagram FSD):
Financial System Development



(SS 94.3.30 UIBat)

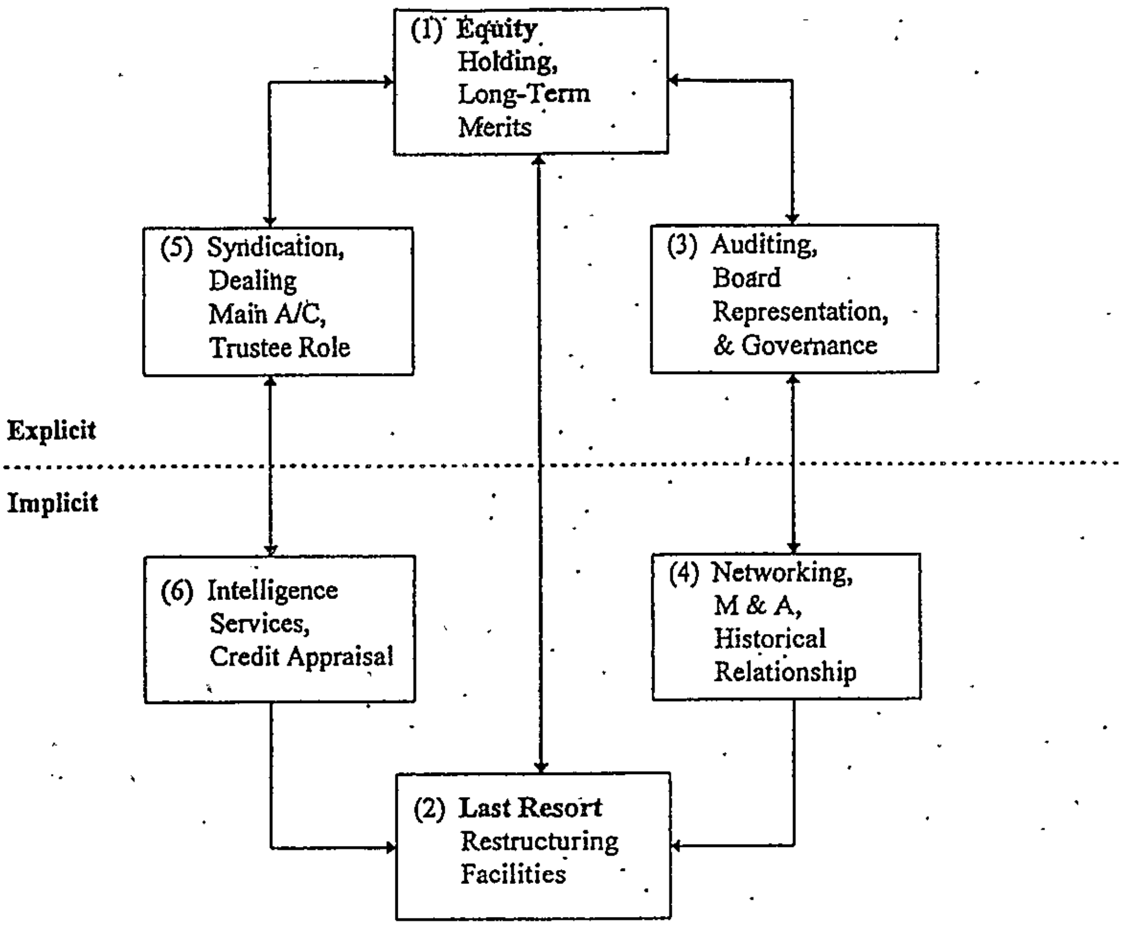
Attachment (d)

(Table HFD) Major Financial Difficulties Common to Developing Countries

Level	m	s	c
Functions			
x:	lower saving rate	credit settlement system	management initiatives
	excessive money supply	rediscount facilities	(privatization programs)
	large budget deficit	long term financial market	
	small currency reserves	residents' external capital	
	(investment environment)		
y:	high interest rate	competition among banks	credit appraisal ability
	(tax collecting system)	(investment incentives)	(human development systems)
	foreign exchange control	market information	
	exchange rate instability		
z:	external debt management	last resort facility	GAAP & prudential regulation
			corporate information
			rating agencies

Attachment (e)

Major Attributes of Main Banks



(a) : Cohesiveness in relationship is stronger in order of numbering.

(b) : Whilst (1) & (2) constitute the backbone of main bank relationship, (4) & (6) can be the channels of changing the position. (1), (2), (3) are the elements at top level, (4), (5), (6) may be developed effectively at working level.

(c) : Those (1), (3), (5) are explicit and the rest three (2), (4), (6) may often be implicit.

(d) : (1) & (2), (3) & (4), (5) & (6) are usually closely interlocked. (5) appears as a major function in growth period. (5)'s role is often related to (1) & (6), and (3)'s position is normally arranged via (1) & (4).

(e) : (1), (4), (5), (6) create *ex-ante* relationship whilst (3), (4), (5), (6) play *interim* roles and (1), (2), (3), (4) may determine *ex-post* position.

(f) : (3) & (4) constitute the basis of accountability. (5) & (6) may determine productivity and (2), (4), (6) set up restructuring ability.

(g) : (2) may be hard to identify on surface unless some critical deals turn up when top decision making is required.

(h) : Managerial capacity may be constantly reviewed or tested at (3), (4), (5) & (6) in competition with other banks for merits, if ever the backbone (1) & (2) appear as ambiguous.

Theme C: INTEREST RATE POLICY

C. 1
MONETARY POLICY OF MONGOLIA: WHY INTEREST RATES SHOULD URGENTLY BE LOWERED AND HOW

Atsushi Fujimoto[1]

Abstract

Mongolia's balance of trade turned black in 1995 after its strenuous effort to control money supply and curtail government expenditures since 1990. The side effects of the high interest rates, however, are salient : primary and secondary industries cannot profitably borrow money for a production increase which is essential for further curbing inflation as well as for improving the low standard of living; those businesses borrowing money find difficulty in repayment; commercial banks suffer from bad debts and lack of good borrowers; and the Mongolian economy is increasingly threatened by capital flight.

Mongolia should now lower lending and deposit interest rates; however, the measures to take should be gradual in order not to upset the economy. The writer suggests : (1) a development bank for priority lending and equity financing with no deposit accepting function be established in joint venture, (2) deposit and lending rates of commercial banks be lowered based on a revised positive real interest rate formula, and (3) the use of central bank monetary policy instruments be differentiated so that the Bank of Mongolia may be able not only to control the economy but to accommodate production increase .

Introduction

Mongolia enjoyed a comfortable standard of living in the 1980s with a per capita income of US$ 1,581 in 1989 under stabilized prices, but at the cost of accumulated debt from the former CMEA countries amounting to approximate 10 billion Convertible Rubles by the end of the same year. Since 1990, Mongolia has endeavored to restore domestic and international equilibria at the cost of standard of living mainly through tightly controlling money and curtailing government expenditures. As a result, the Mongolian economy has been making progress in curbing inflation and rectifying its trade imbalance. The annual CPI hike, which registered 326% in 1992, was reduced to 183% in 1993, to 66% in 1994 and to 53% in 1995. The balance of trade turned black in 1994 after many years of deficits. The exchange rate of the Tugrik has been relatively stable since 1993 with the annual depreciation rate of the Tugrik against the U.S. Dollar being 9.8 % in 1994 and 14.4% in 1995 in spite of the high inflation rate and the absence of foreign exchange control. GDP grew by 2.7% in 1994 and 6.3% in 1995 after a cumulative decline of 22% since 1990 (Table 1).

Interest rates in Mongolia, which have been based on a positive real interest rate formula, have been lowered following the decline in inflation rate; however, the average lending rate and the minimum time deposit rate of commercial banks were still as high as

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8.2% per month and 4.0% per month, respectively, at the end of 1995, while the minimum refinance facility rate and the clearing credit rate of the Bank of Mongolia (BOM, the central bank) to commercial banks were at 11% and 12.5% per month, respectively. The reserve requirements ratio on commercial bank deposits was 17%, regardless of deposit types. In addition, the BOM sets a credit ceiling on lending of each commercial bank (Table 2).

Admitting that the tight money policy of the Bank has greatly contributed to improving domestic and international balances, the writer believes that for a further improvement of the equilibria and a sound development of the Mongolian economy, lowering of the interest rates is imperative. In the following, the writer intends to clarify why it is needed and how to implement it without upsetting the economy.

a. Need for Lowering Lending Interest Rates of Commercial Banks

A further improvement of the equilibria requires a production increase, since inflation in Mongolia is caused by a shortage of production. One of the prerequisites for increasing production is to provide finance at a properly low interest rate. At the interest rates of 60% p.a. or higher, which were prevalent as of end February, 1996, normal businesses in primary and secondary industries cannot profitably borrow money for increasing production. As a Mongolian commercial banker mentioned, only merchants, who can sell their merchandise in a short time, can borrow money.

Agriculture other than livestock raising in Mongolia as in the rest of the world cannot survive, if farmers must borrow money at 60% p.a. Indeed, if the selling price of their products were to be raised to more than offset such a high interest rate, it would be possible. But this would not take place, since it would mean considerably higher food prices for consumers or a substantial budgetary deficit.

Reflecting their predicament, the number of farmers in Mongolia is decreasing, the area of sown land declining, and crop harvest falling. Unless the lending rates to farmers are reduced to, say, 5% p.a., Mongolia will not be able to reverse the trend of declining crop production, not to mention to achieve self-sufficiency of food, which is one of the long-term goals of the economy.

A rational manufacturer will not borrow money unless there is a strong reason to believe that he can sell his products at a price covering all costs including interest. If there is a strong possibility that the prices of his products go up more than interest rates, borrowing at 60% p.a. may be justified. Of 17 items listed in the consumer price statistics, however, the prices of only 5 items, namely, milk-dairy products, fabric, wear, housing goods, and articles of cultural needs went up by more than 60% p.a. in 1995 (Table 3). Judging from the declining trend of prices since 1993 and the current tight monetary and fiscal policies by the Government, it is rational to expect that inflation in 1996 should further decelerate. In addition, the wholesale prices, which better represent the trend of prices of their products, do not rise as fast as consumer prices. Furthermore, the price rises of their products are, after all, possibilities while interest payment, if they borrow money, is a reality.

Under such circumstances, processing and manufacturing industrialists cannot and will not borrow funds for working capital or plant and equipment investment for increasing production, since they know that their profit will decrease, if they borrow at 60% p.a. or higher. Potential entrepreneurs of primary and secondary industries find difficulty in starting business because they cannot profitably borrow money.

Mongolian export industries will find difficulty in competing with foreign competitors in price on the international market, if they have to pay a 60% p.a. interest when their foreign rivals can borrow at 10% p.a. or less and when the Tugrik depreciates against the U.S. Dollar at 20% p.a. or less. Domestic producers will find difficulty in competing with imported goods, when foreign products are financed with low interest loans of 10% p.a. or less. The customs duty of 15% does not offset the high interest rate handicap given to Mongolian domestic producers. Foreign corporations will be discouraged from directly investing in Mongolia, if the local cost of money is so high.

High interest rates not only hinder production from increasing, but hurt commercial banks. They can find too few good borrowers, while many borrowers find it difficult to repay. This is one of the causes for commercial banks to have a significant balance of non-performing loans. Lending interest rates of commercial banks should, therefore, urgently be reduced.

b. Why Deposit Interest Rates Should Be Lowered

While the high lending rates prevent production from increasing, the current high deposit rates and the relatively stable foreign exchange rate are enhancing the potential risk of balance of payments deficits in the future. Time and savings deposits by individuals amounted to Tg. 36.6 billion at the end of 1995, an increase of about 44.7% over the previous year. This increase of time deposits has so far contributed to stabilizing the foreign exchange rate of the Tugrik. However, since Mongolia takes no exchange control policy and since depositors are free to cancel their time deposits for giving up attractive interests, Tg. 36.6 billion deposit could be converted into approximate US$ 77 million at any time. Interest rates on time deposits in the Tugrik up to 1 year ranged typically from 60% p.a. to 79.5% p.a. as of February 29, 1996. This means that the Tg. 36.6 billion deposit will grow to Tg. 58.6 billion or more in a year and to Tg. 93.7 billion or more in two years by only adding its interest to the principal. Assuming that the Tugrik depreciates 15% annually against the U.S. Dollars, Tg. 93.7 billion in February, 1998 will be equivalent to US$ 146 million.

Since there is no foreign exchange control in Mongolia, the Tg. 93.7 billion deposit will be converted into foreign currency deposits equivalent to US Dollar 146 million, as soon as a sign of a drastic depreciation of the Tugrik appears. The foreign currency deposits will flow out as soon as the depositors find better investment opportunities in other countries or as soon as they anticipate an impending restriction on foreign exchange transactions to be imposed by the Mongolian government. A capital outflow of such an amount would cause the Mongolian economy a serious balance of payments problem.

In an open economy without foreign exchange control, deposits by residents and non-residents alike are the same as foreign borrowings or debts. They flow out of a country when it needs them most urgently. That borrowing at a high interest rate destroys the borrower applies to a national economy as well as individuals and business corporations.

In addition to the balance of payments reason, commercial bank deposit interest rates need to be lowered in order to enable commercial banks to lower their lending rates. Deposits constitute more than 60% of the total liabilities in the commercial bank balance sheet (Table 4). Since lending rates should absorb all the cost including deposit interest, commercial banks cannot lower their lending rates, unless deposit interest rates are lowered.

c. Why the Mongolian Economy Performed Well in 1995 Despite High Interest Rates

In 1995, the Mongolian economy is reported to have achieved a GDP growth of 6.3% with a trade surplus of US$ 123 million with exports amounting to US$ 512 million. The reader may wonder why the Mongolian economy performed so brilliantly in 1995 in spite of its very high interest rates. The writer ascribes this mainly to the price hike of copper concentrate and cashmere, Mongolia's two major export commodities on the world market. Mongolia should not count on such price increases in the future.

The average price of copper Grade A on the London Metal Exchange rose by 27% from US$ 2,312.21 per ton in 1994 to US$ 2,935.73 in 1995. Since Mongolian copper concentrate export price rose by 16.8% in 1994, when that on the London Metal Exchange rose by 20.4%, the writer presumes that Mongolian copper concentrate export price rose by 22% in 1995. Since exports accounted for 57.6% of GDP and copper concentrate exports accounted for 51.4% of the total exports in 1994, GDP of Mongolia in 1995 measured in the U.S.dollar would have increased, ceteris paribus, by 6.4%. Incidentally, the quantity of Mongolian copper concentrate exports is also estimated to have increased in 1995, since the exports in the first three quarters were 5% more than those in the corresponding quarters in 1994.

In addition to its direct contribution to GDP and foreign exchange reserves, the export increase must have indirectly contributed to Mongolian overall production increase by supplying the economy with interest-free money (high-powered growth money), which, in turn, must have contributed to the decline of inflation in 1995.

This suggests that, but for the copper concentrate export increase, the Mongolian economy might not have grown in 1995. Since the copper price is expected to fall in 1996, though slightly, and its future price is not predictable, Mongolia should take policy measures for sustainably increasing production. The writer believes that one of these measures is interest rate reduction.

d. Interest Rates in Japan and Other Asian Countries

Throughout the post-War period, Japan succeeded in maintaining a constant exchange rate and a low interest rate policy with the help of a tight foreign exchange control. Because the War severely destroyed its production facilities, there was a keen shortage of the necessities of life in Japan immediately after the War. There was a raging inflation and a great excess demand for money.

Despite that, Japan maintained interest rates lower than 10% p.a., since it believed that increasing the production capacity of key industries, which was deemed a prerequisite for its economic rehabilitation and growth, required low interest rates. The official discount rate applied by the Bank of Japan (the central bank) has often been changed but never exceeded 10% p.a.

The major policy measure used to cool an ebullient economy (inflation and balance of payments crises) was control of money supply by squeezing central bank lending to commercial banks. A raise of official discount rate was a main indication of the intention of the central bank to control the economy more tightly. There was an application of two-tier high penalty lending rates to those banks, whose borrowing from the Bank of Japan exceeded a pre-established limit. Furthermore, "window guidance" (a strong moral suasion by the Bank of Japan for commercial banks to reduce their lending to their clients) was also employed for controlling liquidity. Since Japanese commercial banks were heavily dependent on the Bank of Japan lending, the Banks' control of money supply by pressing commercial banks to reduce their borrowings from the central bank proved to be very effective in cooling an overheated economy.

Two laws in addition to the civil code and the commercial code laid a legal foundation for a low interest rate policy, namely, "The Temporary Interest Rate Adjustment Law of 1947" and "The Law Concerning the Restriction of Interest Rates of 1954", both of which prohibit lending interest rates higher than 15% p.a. Time deposit rates have always been 6% p.a. or lower. Incidentally, Japan, like many other developed countries, maintained a tight foreign exchange control policy until the mid-1960s.

The International Financial Statistics Yearbook (1991) by IMF shows that in all the listed Asian countries, namely, India, Indonesia, Korea, Malaysia, Philippines and Thailand, from 1974 to 1990 for which data are available, the official discount rate and commercial bank deposit rates never exceeded 20% p.a., except in the Philippines in 1984. In all the countries, lending rates were below 20% p.a., except in Indonesia, where the rate ranged from 20% to 23% in late 1980s. The GDP deflator, which is generally lower than CPI, exceeded deposit interest rates in Korea in 1974 through 1981, in the Philippines in 1974 and in 1984, and in other countries occasionally. In short, interest rates in the Asian countries seldom exceeded 20% p.a. and in such cases real interest rates were negative.

e. The Basic Strategy for Lowering Interest Rates and Founding of a Development Bank

While lowering of lending and deposit interest rates of commercial banks is imperative, a drastic departure from the current high interest rate policy might upset the stability of the Mongolian economy. This is particularly true, because Mongolia imposes no restrictions on foreign exchange transactions, which the writer believes should be continued. A step-by-step approach needs to be taken.

The basic strategy for lowering interest rates is to create a low interest world in addition to the existing high interest world and to enlarge the former, while gradually reducing interest rates in the latter.

The writer suggests that in order to create the low interest rate world, a development bank for priority lending and equity financing both for working capital and plant and equipment investment without the function of accepting deposits be established. The development bank should be a joint venture between Mongolian and foreign financing organizations. The priority lending (e.g. at 10% p.a. or lower) should be applied to certain priority transactions/projects of good economic entities. The word, "entity", instead of company is used in order to include farmers and other unincorporated businesses.

Good economic entities are defined here as those entities which are making a good use of resources both for themselves and for the welfare of the nation. In other words, they should be profitable based on a good accounting practice, should be good tax payers, should be efficiently contributing to increasing GDP directly and/or indirectly, should be earning and/or saving foreign exchange, should be increasing employment, and/or should be enhancing the national standard of technical skill. Promising new businesses should also be the objects of the preferential financing. The development bank should be a joint venture with foreign organizations, because foreign assistance will be necessary for fund raising, for financial expertise and for equitable allocation of funds. The bank should have a limited length of life, say, 15 years, because Mongolian commercial banks should become capable of extending low interest loans by that time.

Fund raising will be needed for the low interest rate financing. Counterpart funds of ODA should be fully utilized for this purpose; however, since these funds alone will not be sufficient to meet the need for the bank's financing, additional fund raising by inviting ODA or FDI to participate in the bank will be needed. Furthermore, the Bank of Mongolia should continuously provide an appropriate amount of low interest fund as growth money through the development bank to the economy.

If loans are provided at interest rates of 10% p.a. or lower, there will be a great excess demand for them. Loan applications should be strictly screened so that loans may be extended only to those projects/transactions that will make an effective use of them not only for the entities concerned but for the welfare of the national economy. Extended loans should be strictly monitored and managed from the same viewpoints.

Screening and monitoring on a project/transaction basis rather than on an economic entity basis is necessary for preventing, for example, "important companies" from borrowing only for depositing at, say, 60% p.a. interest rates, without increasing their production. Important companies are important only if they efficiently use resources for enhancing the national economic welfare.

Screening and monitoring of loans require financial expertise. Assistance from foreign financial experts will be necessary. Such foreign personnel should be selected by Mongolian nationals. The writer suggests that a feasibility study of such a development bank be immediately conducted.

f. Lowering of Commercial Bank Rates

The principle of positive real interest rates should continue to be applied to the interest on time deposits and on lending of commercial banks. Interest rates on time deposits should slightly exceed a rationally anticipated inflation rate up to the maturity so that they may encourage domestic savings and to prevent capital flight. A rationally anticipated inflation rate from the time of accepting a time deposit to its maturity rather than an actual inflation rate in the past should be employed because comparison of the two types of rates is meaningful only when they cover the same time span. Time deposit interest rates should be considerably higher than the expected depreciation rate of the

Tugrik against the U.S. Dollar in order to avoid capital outflow. Interest rates on demand deposits should be minimal, as those in other countries.

Lending rates of commercial banks should be the sum of an average cost of funds (including deposit rates adjusted by reserve requirements ratio and the central bank lending rates), operating cost (including personnel and other expenses), risk premium and profit margin. Interest should be paid at maturity, except in case of discounts of commercial bills in which case interest up to the maturity is paid at the time of lending. In the latter case, interest rate should be lowered by the interest to accrue on the prepaid interest up to the maturity. In addition, a legal ceiling of interest rates should be set for commercial bank lending.

g. Need for Differentiating the Use of Instruments for Monetary Policy

As mentioned above, interest charged on credits granted through the Bank of Mongolia refinance facility and that on clearing credits were at a minimum of 11% per month and 12.5% per month, respectively, as of the end of December, 1995, while the average lending rate of commercial banks was 8.2% per month. The reserve requirements ratio as of the same date was a flat 17% on all deposits. Since central bank credits constitute a source of funds of commercial banks (Table 4) and the reserve requirements affect the cost of deposits to commercial banks, lowering of commercial bank lending rates requires a review of the use of the central bank policy instruments.

So far all the instruments have been used for contracting the economy; but now that an international equilibrium has been achieved, some of the instruments should be used for accommodating production increase, while others are used for controlling economy against inflation and/or a balance of payments deficit. The writer suggests that of the two currently dominant forms of central bank credits, refinance credits play the role of supplying the money required for accommodating production increases; therefore, interest rates on them should be substantially lowered. Like official discount rates in other countries, interest rates on refinance credits in Mongolia should lie between prime lending rates and time deposit rates of commercial banks.

As well known, money required for production increase and economic growth can be supplied in the following forms : surplus in the balance of payments, central bank credits to commercial banks, and/or budgetary deficits. While the most desirable form of supplying money for growth to Mongolia is balance of payments surplus, its continuation is very difficult to achieve. Budgetary deficits are not desirable; therefore, a gradual increase of central bank credits is the only sustainable way to supply growth money.

Clearing credits, on the other hand, play the role of controlling the economy by imposing penalty rates on the over-extended portion of commercial bank loans. Their rates need to far exceed commercial bank lending rates in order to force commercial banks to reduce their loans; however, the current rate of 12.5% per month should be lowered to a more reasonable level.

The reserve requirements ratio of a flat 17% on all deposits, which pushes up the cost of commercial bank funds from deposit sources by 20%, should also be differentiated. While reserve requirements ratio is an instrument of the modern monetary policy, its original rationale was that commercial banks should keep a certain portion of deposits in the form of cash or central bank deposit in order to be prepared for withdrawal or cancellation of deposits. The portion of deposits to be held in liquid assets should, therefore, differ by type of deposits. Demand deposits require a higher ratio, while time deposits call for a lower ratio, reflecting the nature of the deposits. This principle is observed in other countries. For example, as of December, 1994, the reserve requirements ratios for demand deposits and time deposits were 10.0% and 0%, respectively, in the U.S.A., 1.3% and 1.2%, respectively, in Japan, and 25.25%and 9.625%, respectively, in Taiwan. The writer suggests that the Bank o f Mongolia apply separate reserve requirement ratios for demand and time deposits and that the latter ratio be lowered to, say, 8%. This arrangement will contribute to reducing the cost of funds of time deposits of commercial banks.

h. To Be Prepared for Potential Risks

When the new interest rates are implemented, demand deposits may be withdrawn for converting the deposits in the Tugrik into those in foreign currencies or into goods, because their interest rates will be substantially lowered. On the other hand, time deposits will not likely be canceled until their maturities as far as the anticipated depreciation rate of the Tugrik against the U.S. Dollar remains substantially lower than time deposit interest rates in Mongolia. Only when there is an impending threat of a substantial Tugrik depreciation, will cancellation of time deposits take place before or at maturity date. A stability of the Tugrik against the Dollar should, therefore, be maintained in implementing new interest rates.

There are two necessary conditions for a successful implementation of the new interest rate policy. They are price stability and the balance of payments equilibrium. In order to fulfill these conditions, a balanced budget, flexible and powerful monetary control measures, export promotion, induction of ODA and FDI, and promotion of domestic savings are needed. Since these conditions and measures will also support growth and development of the Mongolian economy, consistency among economic policies will be smoothly maintained.

In order to be prepared for an unexpected rush of deposit withdrawals or cancellations, the Bank of Mongolia and the Ministry of Finance should first obtain from commercial banks information on their deposits, e.g. by depositor, type of deposit, amount, interest rate, term and maturity date. Similar information on loans is also needed. This will help the monetary authorities anticipate the potential risk of over-liquidity and capital flight over time in implementing low interest rates.

Then, Mongolia should obtain from IMF, other donor organizations and donor countries their consent on the total scheme of its new monetary policy and their commitment to help Mongolia in case of a balance of payments crisis.

i. Conclusion

The tight money policy since 1990 has enabled Mongolia to improve the international and domestic equilibria; however, for further control of inflation, a production increase is needed, which requires lowering of the current high interest rates. From now on, the Bank of Mongolia should play a role not only of maintaining prices and balance of payments stability, but of accommodating production increase and economic growth. This will become possible by differentiating the use of its monetary policy instruments. With the differentiated use, the Bank will remain powerful in controlling economic activities by setting and cutting the lending ceilings of individual commercial banks, by applying punitive clearing credit rates and by raising reserve requirements ratios. At the same time, it will be capable of accommodating production increases and economic growth by financing the development bank, by refinancing commercial banks at lower interest rates and by lowering reserve requirements rati os on time deposits.

Lowered interest rates will help commercial banks improve their profitability, because they will now be able to find good customers. While the currently planned recapitalization of commercial banks (by exchanging non-performing loans of commercial banks with interest bearing treasury bills) will help them solve the bad debts inherited from the monobank (the bank in the planned economy performing both central bank and commercial bank functions), lowering of interest rates on their deposits and loans as well as on central bank credits will enable commercial banks to acquire good customers from various industries and make their loans perform more satisfactorily.

In summary, the writer would like to suggest that Mongolia soon modify its current tight money policy in order to be able not only to control the economy but also to accommodate production increases and economic growth.

Table 1 Macro-economic and Financial Indicators of Mongolia since 1990

	1990	1991	1992	1993	1994	1995	1996	Source #
(% p.a.)								
GDP Growth Rate	-2.5	-9.2	-9.5	-3.0	2.3	6.3	5.3	1
(US$ million)								
GDP	2247	945	1079	587	637	n.a	n.a.	2
Exports f.o.b.	445	347	356	366	367	512	410	2
Imports f o.b.	1024	487	418	375	355	389	459	2
Trade Balance	-579	-140	-62	-9	12	123	-30	2
Net Official Reserves	49	21	5	27	37	n.a	n.a.	2
(1USD=X Tg. Year Average)								
Tg.-USD Ex Rate	4 7	25	40	295	410	450	500	1+3
(%p.a. at Year End)								
Annual CPI Hike Rate	n.a.	205	326	183	66	55	35	1
Annual GDP Deflator	3.	99	176	262	55	n.a	n a.	1

Source: 1. National Development Board: Paper on National Economuc and Social Development: Feb., 1996
2. IMF: IMF Economic Review, Mongolia: Jan., 1996
3. The World Bank: Mongolia, Country Economic Memorandum: Oct., 1996

Table 2 Interest Rate Structure (as of Yerar-end)
(in % per month)

	1995	1994	Note
Central Bank			
Clearing Credits	12.5	-15.0	
Refinancing Facility	11.0	11 0	minimum rate
B.O.M. Bills	5 2	3.9	held by commercial banks
Commercial Bank			
Lending	8 2	10 8	average rate
Deposits	4.0	5 0	minimum rate

Source : The Bank of Mongolia, " Annual Report 1995 "

Table 3 Consumer Price Hike (%) (Year-End Comparison)

	1995	1994
Meat, Meat Products	54	56
Milk, Dairy Products	72	70
Flour, Bakery	60	43
Other Foods	60	71
Soda, Cigarets	4	30
Fabric	82	69
Men's Clothes	15	94
Women's Clothes	50	135
Wear	62	31
Children's Wear	57	51
Shoes	35	89
Rent & Price of Energy	6	49
Housing Goods	83	56
Medicines	0	0
Transport & Communication	44	92
Articles for Cultural Goods	89	105
Other Goods & Services	44	96
Average	53	66

Source : Calculated from "the Bank of Mongolia Monthly Statistical Bulletin, Feb., 1996 "

Table 4 Consolidated Balance Sheet of Deposit Money Banks (as of Year-end)
(in million Tgs.)

	1995	1994		1995	1994
<Assets>			<Liab +Equity>		
Reserves	11,917	10,372	Demand Deposits	17,045	14,104
Central Bank	7,772	7,334	Time & Savings Deposits	59,408	43,906
Cash	4,142	3,038	Time & Savings Deposits	38,529	28,938
B.O.M. Bills	830	2,106	Foreign Currency Deposit	20,879	14,968
Foreign Assets	25,412	17,271	Foreign Liabilities	6,660	4,529
Claims on Gov't	643	734	Long-Term Foreign Liab.	0	398
Claims on Publ. Enterpri	10,883	12,193	Central Gov't Deposits	16,655	8,451
Claims on Priv Sector	51,652	40,631	Credits from B.O.M	7,402	10,152
Claims on non-Banks	61	40,631	Capital Account	16,998	12,784
Securities	124	124	Other Items (net)	-22,646	-10,885
Total	101,522	83,439	Total	101,522	83,439

Source : The Bank of Mongolia, "Monthly Statistical Bulletin, Feb. 1996"

* As for "Reserves" and "Other Items", two trivial modifications have been made:
The original figures habe been changed to the original figures of "Reserves" on the Deposit Money Bank Sheet to the sum of "Central Bank Reserves" and Cash taken from the Monetary Authorities Sheet. "Other Items(net)" is adjusted to have both ends meet.
** Other Items are: Accrued interest both receivable and payable, interbank market loans,fixed assets, interbranch settlement, credits from non-banking sector,provisions for bad loans, etc.

Table 5 The Balance Sheet of the Bank of Mongolia (as of Year- end)

(in million

	1995	1994		1995	1996
< Assets >			< Liab.+Equity >		
Foreign Assets	54,544	42,589	Currency outside Banks	25,591	18,767
Claims on Gov't	434	6,405	Bank Cash	4,142	3,037
Claims on Private Sector	2	7	Bank Deposits	7,775	7,334
Claims on Banks	7,739	10,375	B.O.M. Bills	830	2,106
			Foreign Liabilities	21,587	25,632
			Long-TermForeign Liab.	14,176	7,055
			Gov't Deposits	1,649	2,465
			Capital Account	8,340	3,047
			Others(net)	-21,371	-10,068
Total	62,719	59,376	Total	62,719	59,375

Source: The Bank of Mongolia "Monthly Statistical Bulletin, Feb. 1996"

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Theme D: CONSERVATION OF RAW MATERIALS FOR DEVELOPMENT OF PROCESSING INDUSTRY

D. 1
PRODUCTION, SUPPLY, STORAGE, TRANSPORTATION, PROCESSING AND EXPORT OF DOMESTIC RAW MATERIALS IN MONGOLIA

Tsagaach[1]

a. Current Situation

Production. Mongolia produces annually 210 thousand tons of meat, 320 million litter of milk, 20 thousand tons of wool, 4 thousand tons of camel hair and cashmere, 5 million sheep and goat skin, 470 thousands hides, 340 thousand tons of wheat, which all together meet population's demand in meat and milk, light industry's demand in raw materials and comprise a substantial portion of export revenue.

Supply of raw materials. Raw materials like wool, cashmere, skin, hide produced in agricultural sector are available to provide fully domestic processing plants with raw materials and to export some of them. But factors like lack of working capital as well as saving and increase in prices of raw materials have caused decline in the supply of raw materials. For instance, in 1990 5 million skin, 350 thousands hides, 16.7 thousand tons of wool were produced, but in 1995 these figures dropped to 960 thousands skin, 8 thousands hides, 8.6 thousand tons of wool. Although it is related to the fact that small processing plants have established in rural areas but it is mainly related to financial capacity of the existing plants.

The domestic plants processed over 80 percent of the total skin and hide produced in agriculture in 1990, but in 1995 it was only 17.5 percent. In relation with decreasing purchasing and processing capacity of the existing plants, the agricultural raw materials were exported without any processing and it reached its peak in 1993. But in recent years there is a declining trend in export of raw materials. In 1993 the country exported 4.8 million skin, 466 thousands hides, 23.4 thousand tons of wool, 1.4 thousand tons of cashmere, 2.1 million of skin, 290 thousands hides and 14.3 thousand tons of wool were exported in 1995 and the decline in export volume of the raw materials for the last 2 years shows a positive sign in procurement of raw materials in the domestic processing plants. It might be a positive sign of the further rehabilitation of the processing industry.

b. Policy to Be Pursued and Actions to Be Taken in Relation to Domestic Raw Materials

1. Context of Recommendation

In line with development of priority industries, export oriented industries should be defined and promoted.

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Protection of raw materials of export oriented enterprises by imposing export duties on raw materials of these enterprises for some period of time should be introduced. It means that increase in export duties of raw materials and decline in export duties of finished or processed goods will regulate raw materials flow in and out of the country.

Enhancement of competitiveness of products and goods in international markets
Reduction in domestic transportation costs and establishment of a raw material procurement system.

Strengthening trade companies, conducting market research on international markets and attempt to penetrate to a new market

Make change in people's thinking, co-ordinate policies and activities at all ministries and agencies levels through a unified industrial policy

2. Justification of Recommenations

Mongolia exports 45 percent of the total produced skin and hides and 70 percent of camel hair without any processing. Hence, a policy directed from raw material export to finished/processed goods export must be pursued.(animal products like cashmere, skin, hide, etc. and mining raw materials like gold, copper, rare element, accelerator etc.).

It is essential to further improve competitiveness of traditional export products like cashmere, copper concentrate etc in international markets. In order to promote export of mining products after processing, products of paramount importance must be identified.

Export of raw materials which used in production of finished export goods causes lack of raw materials for Mongolian producers. It should be appropriate to impose customs duties on export of raw cashmere which is one of the competitive products in international markets instead of banning in order to provide an opportunity for working market forces in raw materials markets as well as in others.

Therefore, in order to prevent outflow of raw materials from the country, measures like establishment of relationships between domestic enterprises and herdsmen through setting up profitable buying prices and exchanging raw materials with consumer goods demanded by herdsmen should be implemented. Also measures aimed at improvement of domestic transport conditions and reduction of transportation costs should be taken.

3. Actions to Be Taken

To elaborate and make recommendations on further directions of export-oriented enterprises based on identifying industries which should receive special attention through comprehensive analysis of supply, processing and export of raw materials by each industrial sector.

To determine priority industrial sectors and to seek new possibilities in rural areas. (establishment of an environment for production and processing of national boots, leather goods and souvenir using traditional technology)

To determine priority sectors by entity size. Also to introduce other property types to the economy and provide other supplementary goods and services besides main ones.

To develop other sectors related to the development of industrial sectors and export sector.

To improve the raw material collection/procurement system and to connect it with processing plants

To improve technology of camel hair, meat processing, to upgrade processing and quality of meat and meat products to the international standards/levels, to introduce traditional meat and milk processing technology, to improve the milk collection system and processing of milk products and to develop small scale enterprises which produce souvenir, brush, musical instruments, teeth brush and brush for clothes using special raw materials like horse tail, goat beard, tail and horn, bone, and bone powder.

To expand capacity of and renew tannery plants, improve processing technology and produce high quality skin, leather.

To protect forest, to regenerate forest and to use it efficiently.

To rehabilitate seed and crop production and to process vegetables, fruits and to increase their production

To introduce a technology for production of high quality goods of international level which has competitiveness in neighbour countries markets

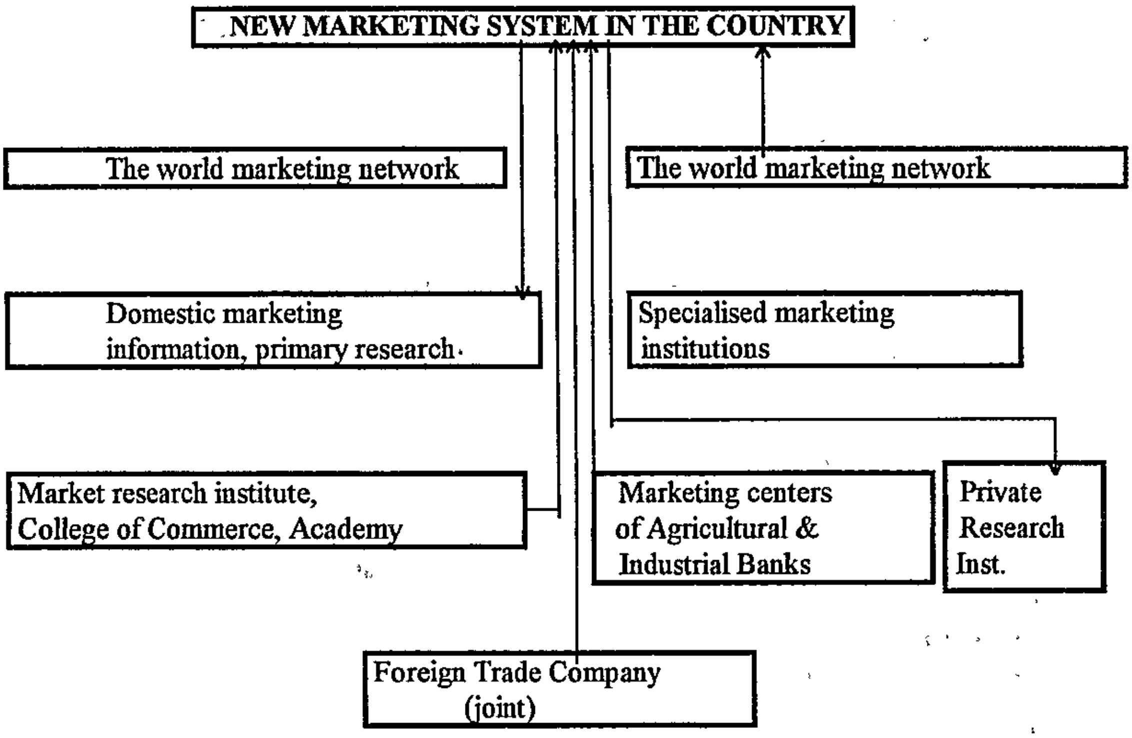
To promote export-oriented processing enterprises through the following mechanisms:

- pursue raw materials/input supply and pricing policies based on market forces but not any legal regulations and conduct market research on raw material trade and routes among Chinese traders/merchants.
- conduct state regulatory mechanisms for raw materials like iron, copper, skin, hide, wool and cashmere etc based economic laws.
- process domestically mineral resources
- improve raw material supply and transportation mechanisms and compete with cheap import raw materials
- establish small scale enterprises near frontier areas: regional development, reduction of transportation costs

- Develop infrastructure: Due to lack and underdevelopment of trade and transport infrastructure systems which connect urban and rural areas, many difficulties have risen. Therefore, it needs to reorganise and rearrange the raw material supply/procurement system in terms of finance and institutions. In other words the following measures might be taken : reduce the domestic transportation costs; to provide herdsmen with opportunities for running their households and trading their output and further to expand households into businesses; as due to remote location from urban areas herdsmen face difficulties in selling produced raw materials and buying consumer goods, thus to provide them with opportunities for cooperation, creating liaison agencies to serve; to promote unions which protect agricultural producers' rights and to further strengthen cooperatives of herdsmen and crop producers as through these cooperatives raw materials should be collected and procured by trade agents/companies.

A group of Japanese researchers has been working on a study for improvement of Mongolian Agricultural Cooperative system. It is expected that some problems will be solved as a result of this study. In addition to supporting the suggestion made by the Japanese group on setting up a joint venture with foreign company and establishing a Development Bank which offer credit at low interest rate, the establishment of a new marketing system in accordance with the main two types of Mongolian lifestyle: urban and nomadic, feature of thinking and the traditional way of running households is an issue which needs an urgent attention.

It is undoubtful that there are many versions on establishing the marketing system. It might be possible to establish the system including the continuous flow of information taking into account real factors like feature of the territory, location of the population and labour force. It means to collect information at central, regional and local levels and provide producers with the collected information and to make arrangements for quality control of raw materials at each stage and for procurement of raw materials. It is considered that the system will establish relationships between consumers and producers, coordinate information networks in the country, regions and particular areas and provide an environment for conducting a unified policy directed to protecting markets and promoting the national industries.



The proposal made by Japanese scholars for establishment of a Development bank is considered to be realised. The bank's activities might be directed to creating a favourable business environment for domestic enterprises and establishment of the marketing system proposed by us. Particularly, if the foreign aid and a fund of the Development Bank are used for establishment and development of regional marketing centers and laboratories for raw material quality control, this kind of investment would be one of the effective and profitable.

It needs to train and re-train specialists; researchers of laboratories, centers and of enterprises and for this purpose a joint project could be developed and implemented with collaboration of international institutions. The project could serve as a step towards creating a favourable business environment in Mongolia.

Exchange of accurate information with "hot ail"(several households/herdsmen) and entities and sale of produced and collected raw materials in reliable markets take an essential place in establishment and development of the proposed marketing system.

Due to the fact that herdsmen and rural producers lack this kind of information and sell their raw materials to odd merchants at cheap prices, this affects negatively on the one hand the living of the herdsmen and on the other hand causes shortage of raw materials to domestic enterprises.

Due to lack of cash herdsmen have to change their produced raw materials with consumer goods(barter trade). As merchants push up artificially prices of consumer goods and buy raw materials at cheap prices, it leads to further poverty among herdsmen.

It is also possible to buy raw materials from herdsmen without liaison agents. For this purpose processing plants should establish relationships with agricultural cooperatives, companies and other raw material producers and collect raw materials through negotiations.

There might be two types here:

(a) Enterprise send their own representatives to sites who in turn check quality of raw materials, negotiate prices and make arrangements for packaging and transportation of raw materials in the sites.

(b) Agricultural cooperatives, companies serve as a liaison agent which collect raw materials from herdsmen and sell them to processing plants.

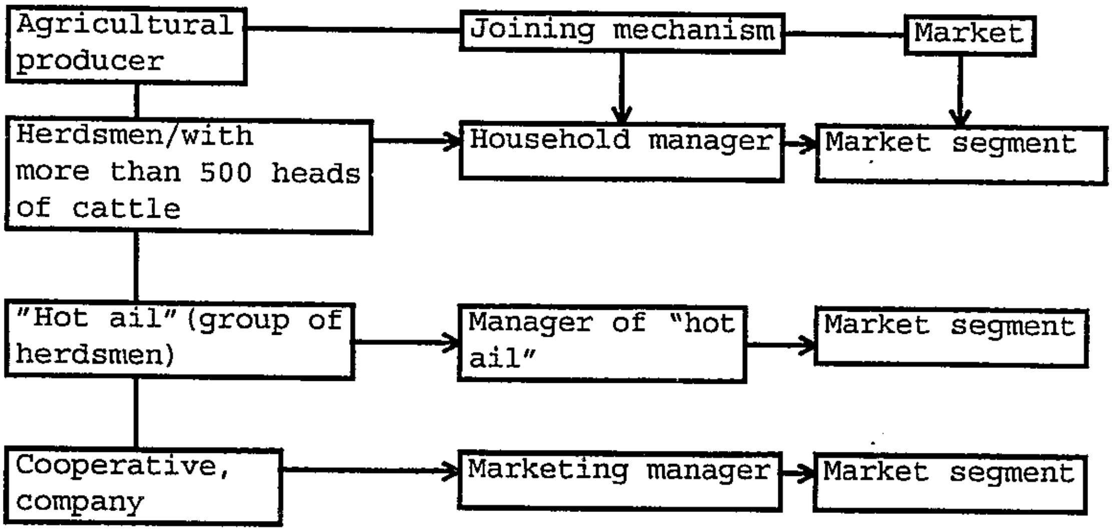
It is also possible that producers who are close to processing plants and markets sell their produced raw materials directly to enterprises or in markets.
Also each sum, bag could have an own trade agent who buys raw materials from herdsmen and sells consumer goods to them

According to the studies the main reason for the above is that there is no market information system which transfers information from local to center and vice versa and no trained people who produce and prepare raw materials for markets and sell them at profitable prices. Based on this we propose the following in order to prepare herdsmen for entering markets. The main idea of the proposal is to make household, 'hot ail' and cooperatives have company managers as well as marketing managers based on number of head of cattle and number of households and entities.

The estimation shows that as several households with up to 500 heads of cattle each forming a 'hot ail' has a marketing manager and households with more than 500 heads of cattle each have own marketing managers, their capabilities to work in markets would improve substantially. Nowadays this matter is being risen as important for agricultural cooperatives and companies.

Within the framework of the proposal local producers of raw materials are provided with an opportunity to sell their goods by the following way:

MARKETING MANAGEMENT IN AGRICULTURAL PRODUCTION



It is important to consider training of marketing managers through gradual programmes as a core issue for the Government.

We propose to establish marketing and research centers in regions and aimags based on Agricultural Economics Institute of the Agricultural University as a component of the marketing system.

Mongolian Trade Promotion Agency and its branches, Mongolian Business Development Agency and branches of Mongolian Marketing Union will serve as a foundation for establishing regional branches of the new marketing system. Therefore, in order to strengthen market relations at micro level and to implement a policy related to production and processing of raw materials and production of high quality goods and export them in long term the following actions should be taken through mobilising domestic capacity and foreign aid, in particular, Japanese:

(a) To expand raw material production, collection laboratory's capacity and transportation capacities in regions, aimags and sums;

(b) To set up schools, training centers to train and re-train regularly marketing specialists.

(c) To cooperate with the neighbour countries in principles based on economic co-operation and Northeast Asia Regional development.

To develop economic and technical co-operation with Inner Mongolia. The area of cooperation might include joint venture, trade, tourism, labour force, transport and energy.

To promote frontier trade and study experiences of Inner Mongolia and Russia.

To transfer technology.

To establish an information exchange system through study on exchange of information between foreign market research institutions and producers.

To take regulatory measures directed to temporary increase in customs duties on export raw materials giving the highest attention to provision of raw materials for export-oriented enterprises.

To reduce relatively high domestic transportation costs and establish an appropriate raw material procurement system
It is important to provide with the most favourable conditions priority industries in terms of taxation, credit, finance, energy supply, transportation and raw material procurement as it happened in Japan after World War II in order to rehabilitate industrial sector.

Based on this the group proposes the following actions related to the development of priority industrial sectors which have export potential:

(a) It is essential to cooperate with foreign companies in order to solve issues related to finance, transportation costs and investment to machinery, technology, thus related legal framework should be developed and enacted.

(b) Considering the fact that as leather goods are in a great demand in American and European markets and foreign investors are interested in production of these kinds of goods and the country has to compete with other developing countries in leather goods market, it needs an urgent attention to develop quality control system at processing level and to renew technology, machinery.

(c) In order to improve the competitiveness of wool in international markets, prices, quality and design of wool products should be improved. To achieve this producers should define certain policies and actions like improvement of raw material procurement system, increase of productivity, renewal of machinery and technology using long term concessional loan.

(d) Production of meat, milk and other foodstuff plays an important role in self provision of the country with foodstuff and substitution of import goods. Particularly, as demand in meat products in the neighbour countries is likely to increase, there is an export opportunity for export of this kind of goods. Therefore, considering the growth potential of these goods measures like environmental protection, procurement system, development of packaging centers should be taken. If procurement of milk and renewal of milk processing technology are solved positively, milk products also have an export potential.

(e) Looking at export of intestine product it seems that market should be expanded as well as export of these goods.

(f) Besides the above goods production of bone, bone powder(raw material for porcelain plant) and horse tail(musical instruments) should be further developed.

To improve competitiveness in international markets.

(a) To introduce and transfer a new technology, know-how which produce low cost high quality goods.

(b) In order to improve quality of wool, cattle should must be developed in terms of kinds and types.

(c) Credit system which offers low interest rate should be established for renewal and replacement of machinery and equipment.

(d) Improvement of management which has no less of importance than renewal and replacement of technology and equipment should be considered as a paramount issue.

(e) Transportation costs should be reduced.

(f) In order to attract foreign investment, an environment for investment should be created and favourable conditions should be offered.

In addition to establishing trade companies, studies on foreign market should be conducted and an attempt to enter new markets should be made.

It is very difficult for Mongolia, which has only 5 years experience of working in the market relations, to enter international markets. Thus, it is more effective to develop export-oriented industries through attracting foreign investment in terms of funds, technology, technique, management and trading skills and establishing joint ventures.

Also the Ministry of Trade and Industry should pursue a policy directed to establishment and development of trade companies and should promote activities like foreign market research, penetration of new market and development and realisation of trade principles.

Furthermore, joint ventures with foreign companies should be promoted and know-how of foreign partners should be introduced and applied.

Coordination of policies between all ministries and agencies should be maintained through a unified industrial policy and change in people's thinking should be made.

D. 2
SECURING MONGOLIA-MADE RAW MATERIALS, PROCESS AND EXPORT

Kubota[1], Kojima[2], Shimazaki[3], Tsuzuku[4],Yoshikawa[5]

Proposal Summary

<u>*Main Proposals*</u>

(1) Specify export-priority industries, and apply preferential measures to them.
(2) Put priority to secure raw materials for priority-export industries (a temporary embargo of raw materials or imposing an export tax on the export of raw materials should not be avoided.)
(3) Reduce costs of processing, transporting and personnel, and strengthen competitiveness in the international market.
(4) Strengthen new "agricultural cooperatives" and other organizations in order to establish raw material collection systems as a means to lower relatively expensive distribution cost within the country.
(5) Develop trading firm functions. In parallel, conduct market research in other countries, explore foreign markets, and emphasize the need of sales promotion efforts.
(6) Formulate a comprehensive industrial development plan that requires a drastic change in consciousness among the people. Implement individual policies, i.e. improvements and adjustments of laws and ordinances, based on the nationwide understanding on the plan and on making policy adjustments among the government departments and local governments. Thus, overcome fundamental problems such as procurement or operating fund.
(7) Establish and develop a central wholesale market, and local wholesale markets. In particular, the evolution of local wholesale markets will help promote small-and-medium-size manufactures (including export-oriented industries) exploiting resources available in the country.

<u>*Supplementary Proposals*</u>

(8) Link export industry policies to poverty reducing policies.
(9) Make export industry policies sustainable.

a. Main Proposals

1. Introduction

Even for long-established export items such as cashmere wool and copper concentrate, efforts should be made to improve the quality as well as manufacturing

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processes in order to strengthen international competitiveness. Recognition on this fact should be the starting point for the country's export promotion. Then, it is necessary to identify export items with strong potential on which priority be placed as a precondition to promote the export of processed primary goods.

It is now the time for Mongolia to make a list of potential export-priority industries even as a provisional one, based on the UNIDO's survey on possible projects for investment and other available sources. In the light of the grave capital restriction, viable export industries should be narrowed down to which the preferential measures should be applied in a concentrated manner.

Export-oriented manufacturing industries using Mongol-made raw materials were faced with a serious shortage of raw materials, because the raw materials were exported as they were. Consequently, cashmere wool which has strong international competitiveness was placed under an embargo for a two years. But it should not be forgotten that the material should be procured, in principle, in accord to market mechanism.

In order to prevent raw cashmere materials from being brought out of the country, trading prices between buyers and herders and other trading practices should be studied, and attractive terms and conditions for selling kashmir should be offered to herders, such as better prices or barter-trading cashmere for much demanded consumer products. Equally essential is the promotion of peripheral policies such as the improvements in inland transport systems and reduced transport costs.

Management consultation should be practised. During our survey, some Mongol managers stressed that the prices of raw materials had been raised as Chinese merchants were buying with higher prices leading to the flux of raw materials outside the country and causing the shortage within the country. Similar explanations were given at several factories (as of April 6, 1996). On the contrary, some fur and leather processing factories denied the problem of material shortage. Detailed management consultation and other surveys are required to determine whether the material shortage is a general problem or it is a problem of individual factories. However, it is true that there are factories making dreadful efforts to buy raw materials. What ever the cause may be, this problem should be solved immediately. Adjustment of foreign exchange rates, imposition of export taxes and procurement of operation funds are effective policies as symptomatic treatments. However, as long-term measures, possibilities of corporate efforts to reduce manufacturing and distribution costs should be considered one by one.

2. Problems Identified

Problem 1. When selecting and nurturing export industries, superannuated production lines and other equipment are not sufficiently taken into consideration. After the democratization began, new plants have been built with foreign aid from various countries. However, efforts to compare efficiency of these plants have not been fully made.

Problem 2. Because of slipshod construction and poor management of plants, the environment of production lines is very poor. Products or raw materials are not being kept under good conditions.

Problem 3. The training system to teach workers basic knowledge on quality control (QC) and QC manual is insufficient, and attitudes for promoting QC on the part of managers are lacking. This is seen not only at production sites but among producers of primary products. There cannot be seen persistent efforts being made to make the idea of QC thoroughly practiced among workers.

Problem 4. During the Communism era, "trade" including export meant barter exchange. Therefore, the concept of gaining income in foreign currency is totally absent in the country. Its legacies are found in the lack of quality control and production management (or achievement of efficiency). Together with the principle of barter economy that nomads used to have, this remains the cause of the setback in the development of the market economy.

Problem 5. Exportable handicraft items, or handicraft souvenirs for tourists have not yet been explored.

Problem 6. Preferential policy schemes for industries making higher contributions to export are not sufficient.

Problem 7. Diversion of export products into illegal channels are rampant at the factory level or at the distributor level.

Problem 8. Production management has not been established, where packaging and designs of export products should be taken into consideration.

Problem 9. Measures to supplement insufficient cash income during off-farming and off-pasturing seasons are not established. The supply and distribution system of daily necessities (flour, tea, clothes and daily necessities) during the seasons is not sufficiently developed. As such, daily necessities are given to farmers/herders in advance by black marketeers on the promise of selling their forthcoming harvest to them. An ill effect of barter trade practices is demonstrated in this "pre-harvest purchase."

Problem 10. There is a big gap between the quality standard of products accepted in Mongolia and in the international markets, which, however, is not recognized by the Mongolian. Low quality leather products which even Mongolian consumers do not buy are still allowed to be processed continuously.

Problem 11. The government has not tried fully to help the nation change their image of the country. Few people understand that the country will not become self-reliant unless the finance is rebuilt by increased foreign currency income. They are led to believe that Mongolia is a country rich in natural beauty and resources with splendid nomad culture with promised future progress.

3. Main Proposals

(a) Proposals (1) and (2)

The proposals are: (1) to specify export-priority industries, and apply preferential measures to them; and (2) to put priority to secure raw materials for priority export-industries, and even a temporary embargo of raw materials should not be avoided.

During the post-war industrial rehabilitation, the Japanese government applied a selective production policy through which major export industries received preferential treatments. In Mongolia at this moment, it is essential that preferential treatments be applied to major export industries treatments being in the fields of tax, finance, public finance, energy supply, transport, raw material supply, and so on. Provisional suggestions of viable export products are as follow.

Copper and gold ore. Considering huge amount of funds involved in necessary transport and equipment investment in this field, forming a joint venture with a foreign investor will be indispensable. In order to promote foreign investment, laws and regulations pertaining to bringing in foreign capital must be reconsidered. As indicated in the "Revised Report on the Introduction of Foreign Investment to Promote Export" by Sumio Kuribayashi, March 13, 1996, there is much to be improved.

Leather products. As leather products from Mongolia are under preferential treatments in the US and EU markets, foreign investors are interested in these products as potential export items from Mongolia. However, competition with other developing countries is anticipated over leather products. To be more competitive, lower prices by reducing costs and enhanced quality and design should be sought. In particular, the thorough quality control in tanning process, the replacement of out-of-date equipment and machinery are urgently required. In addition, in order for manufacturers to secure funds for raw materials, they need to make efforts to reduce production costs. Also, there should be financing services to help them with working capital.

Wool. Prices, upgraded product quality and design are the major elements to gain international competitiveness. Manufacturers and the industry as a whole should have strong determination and policies for better raw material, better collection systems, higher productivity, the replacement of equipment and machinery, and technical development. To support their efforts, there should be long-term, low interest financing schemes.

Meats, dairy products, and other food processing. Food process industry has critical importance to help the country become self-sufficient in food and also as a viable import-substituting industry. Meat demand will likely increase in the neighboring countries, and meats may become an important export product in the near future. Hence, it is necessary to be prepared to respond to future production increase, in the areas of raw material collection systems, packaging-related industries, and consequent environmental preservation. Similarly, by solving the problems of milk collection systems and technical development, dairy products may have potential to be exported.

Surgical catgut. Judging from export records, the export of this item could be further promoted, which will depend on marketing effort.

Others. Processing animal bones and animal bone dust as a catalyst in sugar production, and development of new industries such as processing horsetail hair for bows of musical instruments may be considered.

In addition, the following areas are recommended to be considered for potential export industries.

- Development of Gobi agate: using different melting points of rock and agate, a Gobi specialty may be developed by extracting and processing agate;
- Processing and product development of natural gems and jewels;
- Development of forest products: pine nuts, mushrooms, raspberry, woodwork and woodcarving;
- Sugar beet processing: nurturing sugar manufacturing to substitute sugar import;
- Medicinal herb plantation: Research and collection of herbs growing in cool and cold places;
- Plantation and production of buckwheat noodles for exclusive export to Japan. Spread of farming techniques suitable to cool and cold places;
- Product development using livestock's internal organs and blood;
- Processing furs of wild animals: tarbagan, wolf, fox, etc;
- Development of small-scale milk plants: efficient processing for preservation;
- Meat processing and export: horse, mutton, beef;
- Upgrading cottage industry: handicraft goods; and
- Tourism development: tourism industry allowing tourists to stay at any time of the year to experience Mongolia; horseback riding tour, camelback caravan, grassland life experience, tourism with fishing pleasure, etc.

(b) Proposals (3) and (4)

The proposals are: (3) to reduce costs for processing, transporting and personnel, and strengthen competitiveness in the international market, and (4) to strengthen new "agricultural cooperatives" and other organizations in order to establish raw material collection systems as a means to lower relatively expensive collection cost within the country.

What is imperative is to help people understand the need of strengthening international competitiveness. First of all, competitiveness must be acquired within the country. Availability of working capital will not only the solution to secure raw materials. The key elements for strengthening competitiveness are the same for both domestic and international markets. They are:

(a) transfer of technology and expertise for cost reduction and quality control;
(b) technical support such as improvement of species;
(c) low interest financing schemes to promote equipment and machinery replacement;
(d) creation of cooperative employer-worker relations.
(e) reduction of transport costs;
(f) creation of improved environments and incentives to invite foreign investors; and
(g) for future consideration, research and development of coal liquidation and development of rare earth elements (expertise transfer from South Africa) is recommended. However, this should be considered at a much later time.

For the time being, we expect that the Mongol side will work out concrete plans for (a) through (f).

(c) Proposal (5)

The proposal (5) is to "encourage evelop trading houses, and at the same time, conduct market research in other countries, explore markets, and emphasize the need of sales promotion efforts."

For Mongolia with only five years of experience in export under the market economy system, it is unrealistic to expose itself to international competition all alone. More efficient and realistic means might be to accept foreign corporations with capital, technology, management and sales promotional skills, and nurture export industries in the form of joint ventures with them.

Furthermore, the Ministry of Agriculture and Industry or other relating authorities should support, on the policy level, the growth of "trading houses" of different types in various fields. At the same time, the government authorities should facilitate the formation of joint ventures between local and foreign corporations as a mean to make the most of the latter's expertise.

(d) Proposals (6) and (7)

The proposals are: (6) to formulate a comprehensive industrial development plan that requires a drastic change in conception among the people; to implement individual policies, i.e. improvements and adjustments of laws and ordinances, based on the nationwide understanding on the plan, and on making policy adjustments among the government departments and local governments; thus, to overcome fundamental problems such as acquisition of working capital; and
(7) to establish and develop a central wholesale market, and local wholesale markets; in particular, the evolution of local wholesale markets will help promote small-and-medium-sized manufactures (including export-oriented industries) exploiting resources available in the country.

"Nomadic-industrialized state", the idea which had been too strongly emphasized for the past seven decades proved to be an illusion of the past upon the collapse of the socialist economy. No one can tell if export industries under the market economy may follow the same idealistic path. Policy makers should bear clearly in their minds that they are not drawing an ideal picture but formulating policies to meet realistic necessities. They should try to make the nation understand their intentions, and based on their support, they should coordinate the policies of different governmental departments. It is not too much to say that it is now the time when the Mongolian themselves are tested if they have "the will of the Mongolian" in formulating and implementing detailed policies to put the new government's comprehensive industrial development plan into practice.

b. Some Recommendations to Mongolia

It is the responsibility of Mongolia itself to determine objectively if the country is taking right steps to transfer its economy to market economy. It is only when the country has undergone the experiences that other countries in a similar condition once had that the country can learn how to manage its economy. Most important thing at this moment is to nurture practical attitudes and self-reliant creativity among the people. Too hasty evaluation may result in a loss of confidence or overconfidence in oneself.

For the question of raw material procurement, a feasibility study of Fujimoto Proposal (establishment of new agricultural and pasturing farmers cooperatives, or creation of trading houses) should be carried out by the Mongolian side. With export taxes on raw material exports, domestic manufacturers would have better access to domestic raw material. For reducing transport costs, it is advised several related industrial sectors be set up or material collection systems be improved. It might be useful to analyze the feasibility of applying Japan's agricultural cooperatives' system to Mongolia.

Development of distribution business is urgently required. In other words, trading houses or wholesale houses should be created as soon as possible. Take immediate actions to nurture distribution industries by, for example, organizing existing trading firms, and by creating a central wholesale market. Coal liquidation could be considered at a much later stage.

In order to prevent livestock raw materials from being flown out of the country, (a) export taxes could be imposed, and (b) loans could be made available for working capital.

For improved raw material collection, transport costs should be reduced by establishing new Mongolian-style agricultural cooperatives.

c. Supplementary Proposals

This section considers the ways export industries can prosper using local resources from an alternative point of view: in other words, (1) export industries linking with poverty reducing policies, and (2) export industries with the goal of sustainable development.

1. Proposal (8): Development of Export Industries That Links with Poverty Reduction

Key phrases for this policy are: local/district level, small-and-medium scale enterprises, use of traditional techniques, effective use of high technologies, flexible response to demand in foreign markets through networking of groups, establishment of information centers, international networking to promote direct trade between local communities (without transporting products via large cities), mobilizing women and promotion of networks of women's groups, study groups on the creation of employment opportunities (not for employment expansion), and creation of small groups to study on the use of traditional techniques and the introduction of high technologies.

As generally emphasized, there is no fixed model for this kind of policy mix. Local groups initiate activities to activate their community through people's participation. Local governments should support such initiatives and universities and other research institutes (mostly non-profit organizations) provide their expertise. Such a tripartite structure is effective.

2. One Idea for Proposal (8): Entrepreneur Projects for Small-scale Export Industries

Livestock products. Textile and leather/fur products using traditional skills, high-class, handmade, traditional designs can be one. Or modern high quality products with sophisticated design made in small-quantity production can be another. For example, horsetail hair could be used for bows, calligraphic or painting brushes, and fashionable woven products. For leather, by hand tanning, high class, hand sewn leather products are possible. Glue and medicines can be produced from animal bones and internal organs.

Dairy products and meats (horse milk liquor, dried meat, other food materials for ethnic food, packed food, high-class salami sausage, etc.) would be suitable for small industries.

Mining products. Mining of underground resources such as gold, copper and rare-earth elements and their smelting and processing could be done by small industries. In addition, exploration of unexploited resources such as special substances contained in the sand of Gobi desert could be tried by small industries.

Tourism. Ecological tours (family tours including children, elderly and handicapped people, nature-watching tours, grassland tour on a horseback, natural ecology research tours for researchers), historical/cultural tourism (nomad life experience, historic ruins in Karakorum, playing the Mongolian harp) could be organized by small industries.

In implementing any of the above ideas, empowerment of the people at the local community level is essential, and building the capability to plan and implement ideas should be done through people's participation. Experts can be sent from Japan in the field of academic research, technology, and corporate management. Sending resident workers of trading houses and exchanging women managers' groups will be also effective.

3. Proposal (9): Sustainable Development and Export Industries

Key phrases for this proposal are:

- Make cost-effective investments for multiple years based on comprehensive forecast of such elements as pollution generation, damage, compensation, cost of recovery from damage, etc.
- Calculate cost-effectiveness of incorporating pollution preventive devices in the building of production facilities.
- Consider to build production facilities causing less burdens on the environment by adopting high-tech devices.
- Plan a pilot factory taking into consideration technological progress from traditional techniques, intermediary techniques to near-futuristic technologies.
- Consider setting up small scale industries and disperse them in the country and link them in networks.
- Promote local-based export industries using local resources and linking with the development of near-futuristic technologies.

Researches and plans for investment in equipment/facilities using new technologies are gathering momentum in industrialized countries including Japan. Mongolia may think about requesting assistance from the Japanese government in this regard.

4. Ideas for Proposal (9)

Some of the ideas are:

- Plan a cost-effective plant with pollution preventive devices with forecast effectiveness calculation, and apply to a donor country for its construction.
- Set up a research center within an industrial complex to develop near-future technologies, and to promote the development and application of new technologies to new industries.
- Promote ecologically-considerate products by attaching "Eco-mark" to such export products.
- Develop, under international projects, small-scale production facilities with less economic burdens, and develop products to be produced by such facilities. At the same time, secure foreign markets through such international projects.

Here too, the main driving force must be generated from the linkage of the government, university/research institutes and private corporations in Mongolia. Measures to develop planning and research competence among the nation should be sought. There are much for Japan to be helpful in the field of human resource development.

Attachment (a)

OUTLINE OF AGRICULTURAL COOPERATIVES IN JAPAN

Cooperatives and Members

1. Members: producers (agriculture, dairy farm, fishery, etc). In case of Mongolia, herders and/or farmers.
2. They have multiple functions: (a) banking, (b) trading firm, (c) retail shop, (d) storehous, (e) mutual help (insurance), and (f) technical transfer.
3. They are also food process plants (fruits, milk products, rice, fish,.etc.)
4. Storehouse function is important: it ships in responce to the fluctuation of market prices
5. A cooperative is managed by members themselves. Members must pay their membership contributions, and they have the right to receive services and to participate in the management.
6. They manages sale income of the members by keeping it in deposit. With the deposit funds, a cooperative can serve as a bank.
7. Day-to-day management is carried out by staff members supervised by board members. Determination of buying and selling prices, purchase of farm products, sales of agricultural chemicals, new technologies and machines and seeds, operation of communications and transport services.
8. Management is just like a private enterprise. Efficiency and profit must be sought. Warehouse fee is free.
9. Structure: from unit cooperatives at the village level, federated organizations on the prefectural and finally on the national levels.
10. High interest saving plans to encourage members to save money. The saved money is loaned, or used as a fund for sales on credit.
11. Interest rates are decided on the national level. Fund is operated at the unit level.

Cooperatives and Consumers

1. They facilitate smooth flow of products from processing plants (run by cooperatives) to consumers.
2. Cooperatives serve as distribution agencies to consumers.
3. Cooperatives work on behalf of producers as sales agents by doing promotion and retailing, bid, and make profits. They positively explore markets both in and out of Japan.

Possibilities for Cooperatives in Mongolia

1. A cooperative association can try to gain its own consumers.
2. A cooperative association can create specialty products of its own.
3. A cooperative association can work in cooperation with a local government. Both parties can discusses how to support each other, and a cooperative association can provide consultancy services to the local government.
4. It can organize women, youth and elderly people in a cooperative association.

Theme E: FOREIGN DIRECT INVESTMENT PROMOTION POLICIES FOR EXPORT

E. 1
PROMOTION OF EXPORT-ORIENTED FOREIGN DIRECT INVESTMENT IN MONGOLIA

D.Bayasgalan[1]

This paper will highlight the present situation, Government policies and priorities of foreign and domestic investment, and also means of increasing the efficiency of investment with a view to further increase the Mongolian export potential during the transition period.

Particularly, the following aspects of foreign investment policy shall be considered in order to improve investment decisions and to accelerate the development of the export-oriented industry (EOI) in the country:

- The present situation of investment promotion measures;
- The share of the private investment in the national economy;
- The institutional framework for foreign direct investment (FDI);
- The foreign investment law and international experiences; and
- Infrastructure and natural resource development.

Simultaneously, constraints and difficulties that face foreign investment in Mongolia and the recommendations and suggestions of the mission of the Mongolian Development Policy Support Group of Japan, which visited Mongolia from March 25 to April 6, 1996, will be analysed.

a. Present Situation of Investment Promotion Measures

In this chapter the government policy on foreign and domestic investment and measures to increase the role of the private sector will be briefly described, as well as measures for the enhancement of the business climate for foreign investment and results of this government policy.

The Mongolian government policies to promote private investment have focused on the removal of administrative restrictions that impeded the full functioning of market forces, strengthening of institutional capacities needed for indirect economic management, development of a legal and institutional framework that facilitates equity transactions and property ownership, and encouragement of foreign private direct investment.

The enhanced role of the private sector was initially supported by the decisions to abolish the system of fixed prices, to proceed with the privatisation of state enterprises on a large scale, and to redirect public investment towards infrastructure development. The crucial role of infrastructure development for attracting foreign investment will be discussed below.

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FDI is expected to play an important role in the development of Mongolia's natural resources, especially through the improvement of managerial skills, management know-how, the transfer modern technology, leading to an increase of the export capacity and employment.

Measures that have enhanced the business climate for foreign investment include the implementation of appropriate macro-economic policies and the achievement of political stability, the adoption of a liberal trade and payments system, and the creation of an appropriate legal framework.

Experience shows that the law promulgated in 1990 to codify the procedures for establishing enterprises in the country did not provide a sufficiently liberal framework and contained a number of ambiguities.

The revised Foreign Investment Law, enacted in July 1993, strengthened the climate for investment through more liberal provisions for ownership, especially in the mining and tourism sectors, by abolishing restrictions on profit remittances, granting exemptions from customs duties and sales taxes, and providing possibilities for limited tax holidays.

Since the amendment of this law, the situation of foreign investment has been improving in the country. During the period 1990-1995, around 500 joint ventures have been registered with the Ministry of Trade and Industry (MTI), of which 10 were fully foreign owned. The foreign share in registered capital of these firms was US$ 20.7 million, of them, more than 70 percent belong to private ownership. There are 43 joint venture plants in Mongolia. Most foreign investment comes from the United States of America, the Russian Federation, Japan, China and South Korea.

The largest of these enterprises are to be found in the construction sector. Foreign investment in industrial enterprises accounted for US$ 9.3 million. Three Russian companies in the metal and stone processing industries accounted for almost one-third of this investment.

The textile and garment sector becomes the main focus of foreign investment, with a total of US$ 2.3 million in 17 firms. The larger part of this investment is from Hong Kong. The preferential treatment of the export of Mongolian clothing and garment goods encourages foreign investors to establish a manufacturing plant. The other sectors which attracted a significant share of foreign investment in manufacturing were food processing, with a total of US$ 953 thousand in 11 firms, and wood processing, with a total of US$ 814 thousand in 10 firms.

There was also a considerable foreign presence in industry-related services, including US$ 1.1 million of investment in machinery repair.

The number of projects in the skin processing and electronics assembly has increased to 22 and 9 respectively. There was also a strong growth in the number of machinery repair shops, which reached a total of 34.

The foreign presence also became strong in other activities which are potentially important for industry, such as research, training and information services, and consultancy.

According to recent information from the MTI, the number of companies with foreign investment rose rapidly during the summer of 1994 and reached a total of about 500. This includes a number of investments which are still at the project or approval stage.

As of the end of 1995, over 45 % of economic entities with foreign investment, which have got an official permission (certificate) from MTI during the last 5 years, have started their business activities.

With a respect to economic sectors, the coverage of foreign direct investment has also improved. During 1991-1992, major foreign investments had been noted in trade, public catering, wood and bone processing plants, construction and building repairing sectors, but right now, foreign investors are shifting their attention, and are making investment in the important business areas such as geological research, exploration of gold, petroleum, coal and wool, cashmere, skin processing, finished garment, spin factories as well as high technology sectors such as energy, transportation, telecommunication and information.

In this context, we want to name the following main examples of some joint-venture companies operating in Mongolia: Mongolian-American Inc. "Tamsag-Soca" in geology, Mongolian-Canadian Co., Ltd "Bumbat" and Mongolian-Russian Co., Ltd in gold mining, Mongolian-American Co., Ltd "Bayan-Oil" in the petroleum sector, Mongolian-Japanese Co., Ltd "Mobicom" and Mongolian-Korean Co., Ltd "Mongolian Electrical Communication" in the telecommunication and information areas.

b. Share of the Private Investment in the Economy

Private investment plays an important role in increasing the capacity of the economy. Today, the inflation rate has fallen to approximately 53 percent as compared with 1992, when it was 325.5 percent, and positive macro-economic conditions have been created for increasing the investment in the country.

As a consequence, total investment in 1995 reached MNT 87.8 billion, an increase of more than 40 percent, leading to a share of 22.4 percent of GDP. The absolute volume of investment has increased several times, while the ratio of gross domestic investment to GDP (%) has generally declined. (See Table on page 4).

In order to balance the current account of international payments and to fully cover the investment amount, the sum of domestic savings and FDI should be 25 percent of GDP. This means that the propensity to save in Mongolia should be raised from 7.6 % in 1995 to 25 % in 2010.

Such an increase in the propensity to save in a period of 15 years is not unprecedented in world economic history. For example, while the propensity to save in

Korea was 3 % in 1962, it increased to 27 % in 1977. The propensity to save in Indonesia increased from 0 % in 1967 to 27 % in 1978.[2]

GDP and Total Investment in billion MNT
(at current prices)

	1980	1993	1994	1995
GDP	6.7	166.2	283.3	391.1
Total investment	3.1	45.2	62.2	87.8
Of which:				
Industry	1.2	10.9	16.3	N/A
Agriculture	0.4	1.9	3.3	N/A
Ratio of total investment to GDP (%)	46.2	27.1	21.9	22.4

In Mongolia, almost all commercial banks are facing serious problems with mobilising savings. Apart from comparatively low incomes and savings, the branch network of commercial banks is underdeveloped leaving much of the population out of the banking system. Also, there are several disincentives that keep savings low. Interest rates are only slightly positive, restrictions are imposed and high fees charged on the withdrawal of deposits and no guarantees for depositors exist for the case of bankruptcy of a bank. Cash payment is very common in Mongolia.[3] This means that further efforts have to be made to increase the propensity to save in the country in order to finance an increasing share of private investment.

In 1995, approximately 8 % of finance for total investment has been provided by commercial bank loans, and about 30 % by equity capital finance. In the same year, the share of private investment reached about 36 % and in 1996 it is expected to reach about 37.5 % of total investment (MNT 111.2 billion).

c. Constraints and Institutional Framework for FDI

Foreign investment is important for the country's private sector development as it provides capital which cannot be raised domestically.

We think that first a strong institutional structure for the promotion of FDI has to be developed because everything would depend on it. Some foreign investors said that Mongolian foreign investment registration procedures are still very cumbersome. For instance, all foreign investments require approval, which involves obtaining a certificate from MTI. For some activities, prior approval must be received from other ministries. Before the approval process commences, MTI requires extensive documentation. Not all of the information provided is actually used in the approval process.

Thus, it is not the Foreign Investment Law which creates difficulties for foreign investors, but rather the way this law is implemented.

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2 A. Fujimoto, Suggested Industrial Policy Measures for Accelerating Economic Restructuring beyond the year 2000, Ulaanbaatar, 1995, p.6.

3 E. Koch, "Financial SME Policy: Policy Options", Ulaanbaatar October 1995, p. 15-18.

There are the following two major problems associated with the administration of foreign investment policy:

> **The first** requirement is that the administration needs to be more commercially oriented. The primary objective should be to actively sell the concept of Mongolia's investment opportunities to potential foreign investors, and not to impose regulations on foreign investors.
>
> **The second** major administrative problem is that the administrators have adopted policies which are not included in the Foreign Investment Law.

Apart from this, anorther constraint is the lack of working capital despite sufficient foreign investment.

One of the most other serious difficulties facing foreign investment in the country is the lack of information and its dissemination amongst potential foreign investors. For instance, the IMF noted that "investment inflows are expected to remain modest in the next few years, in part because of the lack of knowledge of available opportunities among potential investors".[4] In order to provide foreign investors with the required information and services, as well as create an unified information policy, the above-mentioned constraints should be taken into consideration and the implementation and service functions should be transferred from Government policy agencies such as the MTI and the MOF to private sector organisations.

With respect to the establishment of a Foreign Investment Board (FIB), which has been suggested by Japanese experts, we generally support this idea. It would mean that the MTI would transfer the implementation and service functions related to foreign investment and it will function as independent Foreign Investment Agency (FIA).

Furthermore, recently the Investment Promotion Association (IPA) was created in the functional structure of the Mongolian Business Development Agency (MBDA). The membership is open to expatriate managers of foreign companies who are resident in Mongolia. This organisation will meet regularly, review problems and share experiences and in the near future hopes to have a comprehensive list of constraints and solutions. This association is located in the MBDA and is provided with a secretariat by MBDA. Since the MBDA is a non-government organisation it is more credible for this activity than a ministry such as MTI.

In order to increase FDI and improve the service quality, we propose to establish a "One stop centre" similar to the structure of the above-mentioned Investment Promotion Association. Taking into account the current institutional situation, FIA may be established on the basis of both the FIA and MBDA.

Gathering of information related to the establishment of joint ventures or fully foreign owned companies as well as their registration, should be done by a "One stop centre". The official permission to operate in the country should however remain in the responsibilities of the relevant Government agency.

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4 IMF, Mongolia, Economic Reviews No. 1, Washington 1996, p. 12.

In spite of that there are many organisations in the institutional structure of FDI. FIA could become a key office, which must have adequate relationship with the MTI, NDB and MOF as well as commercial banks and exporters similar, for instance, to Compromex in Belgium. Compromex involves the provision of financial support for equipment and related services to exporters. It is a form of intermediary agency which examines applications for assistance and advises the Belgian Minister of Foreign Trade as to whether financial aid should be given or not. This measure is further "mediated" through the banks who act as screening agents for Compromex applicants though direct applications may also be made. The banks are the main promotion mechanism for Compromex. The regional networks of export agency offices enhance accessibility by SMEs to export support measures and ease application procedures[5].

FIA has to be the point of contact between the foreign investor and MTI while foreign investment development policy has to remain with MTI.

FIA has to assist the potential investor with information on the economy, pre-feasibility studies for various activities which might be of interest to foreign investors, advice on customs, taxes, legal issues and financial matters (including banking). It should also act as the representative of the foreign investor in dealings with various Government agencies.

Furthermore, it may be advisable to establish Mongolian representative offices abroad, for example, in Tokyo, Beijing, etc. They would study the situation, activities and interests of actual and potential foreign investors.

In order to ensure backward linkages and to consolidate active co-operation between the government and the private sector, we propose to modernise the Government Commission for the Relationship with Representative Organisations of the Private Sector similar to the Joint Public/Private Consultative Committee in Thailand (JPPCC), instead of having separate overlapping organisations such as the Industrial Policy Council or the Export Promotion Council, which were mentioned in the reports of Japanese experts.

Inspection System

Experience confirms, that an inspection system for public investment activities and investments financed by international organisations and donor countries should be separated from investment-making institutions. This has also been proposed by Japanese researchers. Such a system does not yet exist in Mongolia. Cabinet Resolution No.132 of 1993, for example, authorises the National Development Board to inspect, control and co-ordinate donor loans and technical assistance. We consider that the responsibilities for the inspection the public investments should be transferred to the State Audit Board of Mongolia.

At present it is not the right time to separately establish an Inspection Review Committee for the activities of the FIB as has been suggested by Japanese experts. The committee's activities would overlap with those of the Audit Board.

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5 E. Koch, SMEs and SME Policy in the European Union, Ulaanbaatar July 1995, p. 26.

d. Comments on the Foreign Investment Law and International Experiences

1. Tax Preferences

Japanese experts recommended that the time shall be determined when a business entity with foreign investment starts to make profits in order to determine when tax preferences should be granted. But we think that in the current Mongolian situation of transition it is very complicated and not feasible to implement. It is very probable that business people do not want to provide such information.

Therefore, we do not agree with foreign business entities being exempted from income tax for the first 3 years after starting to make profits, and being granted a 12 % income tax reduction for the 4th year as well as a 20 % reduction for the 5th year. Since the 6th year after making profits, economic entities with foreign investment would enjoy similar tax procedure, as national economic entities.

On the other hand, the present Foreign Investment Law has a more preferential treatment in line with income tax holiday, namely:

(a) Power and thermal plants and their transmission network, highways, railways, aircargo and engineering constructions, basic networks of telecommunications shall receive 10 years of tax exemption and a 50 % tax relief in the following 5 years.
(b) Mining and processing of mineral resources (except precious metals), oil and coal, metallurgy, chemical production, machinery, electronics shall receive a tax exemption for 5 years and a 50 % tax relief in the following 5 years.
(c) Should a business entity with foreign investment which is not mentioned in the above-mentioned cases (Paragraph 1 of Article 20), export more than 50 % of its production, then it shall be entitled to a tax exemption for 3 years and a 50 % tax relief in the following 3 years.

This means that the present Mongolian Foreign Investment Law allows foreign investors to be exempted or relieved from taxes for a period of 6 (EOI) to 15 years. The Japanese suggestion refers to a tax exemption for 5 years, with percentages of relief fluctuating between 12% and 100%.

In this context, I want to mention that tax holidays should depend on the level of regional development: less relief should be provided to relatively highly developed areas, and more relief to undeveloped areas or free economic zones.

For example, in Bangladesh tax holiday are allowed for 5, 7, 9 and 12 years respectively for industries set up in the developed, less developed, least developed and special economic zones. The period of such tax holiday is calculated from the commencement of commercial production. This is a much more simpler procedure than taking into consideration the time when first making profits.

In this respect, we propose that small and medium sized enterprises including start-ups in rural areas, independent of the sector they are operating in, shall enjoy a tax holiday for three years.

Comparison of Chinese Experiences

If we consider the tax holidays envisaged in the Mongolian Foreign Investment Law, Japanese experts might find them as not sufficient. They suggested that our facilities have to be more preferential than those of neighbouring countries, especially the People's Republic of China.

For instance, the current level of income tax for Chinese economic entities is 33 percent. The Chinese economic entities with foreign investment are enjoying tax holidays for the 2 first two years, and a 50 % relief for the next 2 years, and additionally a 50 % relief if they are operating in free economic zones. A foreign investor in China shall not be subject to tax payment until the disbursement of initial investment has been made.

Furthermore, in China the economic entities with foreign investment are enjoying a tax holiday in the following areas of activity:

- 50 % relief if more than 70 % of commercial products are sold to the export market, and;
- Tax holiday is allowed to be extended for 3 years after the above-mentioned tax exemptions have expired and relief for that economic entity with foreign investment, which introduces new technology.[6] This is the Chinese version. But the relevant organisations such as MBDA, MTI and MOF should cautiously study these comparisons with China and other neighbouring countries.

The Government of Mongolia should establish legal institutions. An adequate industrial infrastructure should also be provided. The setting-up of industrial zones or export processing zones are an efficient way to provide such infrastructure. In this respect, we must take into account the international experiences including those of China, the Russian Federation and so on.

2. Customs Duty Incentives

Generally, according to the present Foreign Investment Law, economic entities with foreign investment are enjoying 5 years customs duty exemption, starting with the month of their registration in the State Taxation Department.

In other countries, sometimes more preferential treatment is provided to exporters as in Mongolia. For instance, in Bangladesh concessionary duty is allowed on the import of capital machinery and spare parts for setting up EOIs and for existing industries that export part of their production. For 100 % export-oriented industries no import duty is payable. With a view to ensuring backward linkages, EOIs, including ready made garments, that use indigenous raw materials instead of imported ones, are given additional benefits at prescribed rates. Similar incentives are extended to the suppliers of raw materials to EOIs.

[6] "Recipient should bow his thanks", Newspaper "People's Right", No. 215, 1 November 1995.

In Nepal, for example, which is a landlocked country such as Mongolia, goods, imported for re-export are exempted from import duty.

Likewise, the production based on indigenous raw materials, import for re-export and the setting-up of EOIs in Mongolia, should be given additional benefits at preferential rates. Particularly, the businessmen who enjoy Chinese Government loans, are facing serious lack of money to pay their customs duties and sales taxes. Therefore, we propose that above-mentioned three cases should be exempted from sales taxes and customs duties or reimbursed after 2 years.

Taking into account foreign experiences and the present requirements of exporters and producers, in particular small and medium-sized enterprises, we also propose to exempt starting and existing SMEs in rural areas that make export products from customs duties.

3. Legal Guarantees for Foreign Investment and the Right for Purchasing Securities

With respect to foreign investment guarantees, the present Foreign Investment Law says that "Foreign investment within the territory of Mongolia shall not be nationalised or be subjected to unlawful expropriation". But Japanese experts have suggested to include a provision on investment guarantees in the Foreign Investment Law. We think that this is already done.

With regard to the purchase of shares or other securities, Japanese experts, seem to suggest that foreign economic entities should be free to participate in domestic security markets. But, indeed, this is already included in the present Foreign Investment Law as follows: "A foreign investor may, in accordance with the laws of Mongolia, purchase shares or other securities of any business entity operating within the territory of Mongolia" (Article 7, Chapter 1).

4. Free Economic Zone and Land Lease

Although discussions on the issue of establishing Free Economic Zones (FEZs) in Mongolia started in 1991, the Working Committee on FEZs was launched only in 1993. This year, the Government Guidelines on setting-up the FEZs were approved by the State Great Hural. Right now, according to this legislation, the draft law on establishing a FEZ at the Russian border town of Altanbulag (Selenge aimag) was submitted to the Parliament by the MTI.

We will acquire the positive or negative experiences from the Altanbulag FEZ and then we shall be able to solve issues when establishing the second FEZ.e

This FEZ would have to include comprehensive facilities, such as a governing centre, container loading and unloading construction, customs warehouse, export-oriented industrial estates and representative offices for foreign economic entities.

Unfortunately, there are some financial problems required for the creation of above-mentioned infrastructure and facilities. Therefore, it is shall be taken into consideration that provision with adequate preparation, issues of the relevant laws and legislations and selling them to public, including local and overseas businessmen.

According to the recommendation of Japanese experts, the present Foreign Investment Law should be amended, giving the FIB the right to relief foreign economic entities from income tax on a case by case basis.

Economic entities should be relieved from income tax on the condition that they contribute a considerable part to economic growth, to the generation of employment and the introduction of new technologies. Such regulations are made possible as the present law says that "Decisions on the relief from income tax shall be adopted by the State Great Hural on a case by case basis upon the presentation of the Government of Mongolia" (Par.3, Article 20, Chapter 3).

With respect to the right for land lease, the main idea of the suggestions of the Japanese experts, is granting a right to foreign economic entities for land lease of at least 15 years and a maximum of 60 years. This is already reflected in the present Foreign Investment Law. Namely, this law says that the duration of any lease shall be determined by the duration of the operations of the business entities with foreign investment. The initial term of lease shall not exceed 60 years. The lease may be extended once for a period of up to 40 years under the initial conditions of the lease (Paragraph 5, Article 21, Chapter 3). So that land lease is available in Mongolia for a maximum of 100 years.

e. FDI-Infrastructure and Natural Resource Development

The Mongolian Government recognises that on the one hand FDI is of crucial importance to infrastructure development. On the other hand, FDI cannot be developed without adequate infrastructure.

Further development of FDI would heavily depend on how much endowment Mongolia possesses and how this is used. So we will briefly name the primary natural resources, which could attract foreign investors.

1. Infrastructure Needs

The challenge facing Mongolia in 1996 is to sustain growth and rapidly complete the transition process to a market economy. This irreversible shift to a market economy is establishing the basis for economic growth. One of the most important roles of the government will be the provision of an adequate infrastructure to enable the private sector to become more competitive and to expand investment.

Serious problems facing the development of the infrastructure is the deplorable state of the energy sector. For one of the coldest nations in the world, a reliable energy system is of crucial importance to sustainable development.

For a land-locked country like Mongolia, the provision of an efficient transport system is also of crucial importance to support an open economic policy. This requires the development of the infrastructure, a multi-model transport system, transit arrangements and the facilitation of border crossings.

Besides the productive infrastructure, the Government is also paying special attention to the social infrastructure which showed impressive aggregate indicators of achievement.

The sustainable economic development requires large public investments in the infrastructure to support the expansion in mining, tourism and EOI.

The basic objective of the public investment programme (PIP) is to maintain and develop the infrastructure so as to facilitate the expansion of private investment over the medium term. A three year rolling investment programme was initiated in 1995 on the basis of available domestic and foreign resources.

In order to ensure inspection and control over these investment flows and guarantee their efficiency, a draft procedure on the elaboration, financing and inspection of the PIP and central budget investment plan has been worked out by the National Development Board.

2. Mongolian Endowment

In view of the international experiences, it is very important to introduce to national citizens and foreign investors an Industrial Policy Concept for the government priority guidelines, which can attract national population's agreement and acceptance.

Mongolia is endowed with rich natural resources, particularly minerals and livestock. Now, much of Mongolian resources have been subject to geological surveys and more than 6,000 deposits have been discovered, including copper, uranium, gold, fluorospar and coal.

Mongolia has coal deposits of 20 billion tons, a significant portion of which is said to be high quality coal, although only brown coal near population centres is currently hauled. A great deposit of cooking coal has recently been discovered. There is a huge deposit of zinc in the eastern part of Mongolia which has already been researched and a lead deposit of 2 million tonnes. 10,000 tones of silver are available for exploitation along with 2 million tons of tin as well as other metals.[7]

Mongolia possesses a total of 28.6 million heads of pastured cattle, horses, sheep, goats and camels, on which processing industries such as food, leather, wool and cashmere are based. Cashmere is especially important, accounting for one-third of the world production[8] and 13 % of Mongolia's export earnings. Mongolia also has a vast territory and its land is abundant.

These endowments should be reflected in the above-mentioned Industrial Policy Concept for the medium-term development strategy of the country.

MBDA, the Investment Promotion Association, the Mongolian Trade and Industry Promotion Agency (MOTRA) and the Chamber of Commerce and Industry

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7 Kh. Amgalan, "Meeting Mongolia's Infrastructure Challenge, Trade and Investment Opportunities", Brussels, 1995, p.15.

8 A. Fujimoto,"Suggested Industrial Policy Measures for Accelerating Economic Restructuring beyond the year 2000", Ulaanbaatar, 1995, p.2.

shall actively co-operate in disseminating information on the endowment and the exploitation of resources in Mongolia.

E. 2
EXPORT-ORIENTED FDI PROMOTION POLICIES RECONSIDERED
- Comments on the Mongolian Paper -

Sumio Kuribayashi[1]

Introduction

This paper intends to make some comments on the Mongolian paper submitted to the Japanese team in July 1996. Also, it is the third proposal by the Japanese team concerning export oriented foreign direct investment (FDI) promotion policies in Mongolia.[2]

In this paper the Japanese specialists first summarizes the essential points made in their second paper because they believe it necessary for the Mongolian and Japanese experts to have a common understanding of the problems and tasks they are facing. Second, they summarizes major points made by the Mongolian paper, and then summarizes remaining issues and conclusions.

a. Summary of the Second Proposal Paper by the Japanese Team

The second paper by the Japanese team consists of the following six essential issues.

(1) The most important prerequisite to invite foreign investors is to improve administrative efficiency by scrutinizing what dissatisfactions they now have in Mongolia. For this purpose, it is necessary, as the first step, to set up Foreign Investment Committee (FIC) consisting of high ranking officials such as ministers or vice ministers from the ministries related to FDI. FIC is expected to promote coordination functions among foreign business entities and various government organizations.

To facilitate understanding of the FIC functions, let me take the following examples. If a foreign company requests electric power, it can contact FIC responsible

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2 Let me start with a brief review of our project to clarify the present situation of the concerted efforts in Mongolia and Japan for establishing export oriented FDI promotion policies in Mongolia.

By request from the Mongolian team, some specialists from the Japanese team devoted their efforts to complete the first draft of the consultation paper about the subject. After they finished preparing the draft in early January 1996, they made its summary intended for close and quick perusal by the Mongolian team. Specialists from the Mongolian team promptly replied to the summary draft by putting some questions and making some comments.

The Japanese team, in return, by replying to these comments and questions, drafted the second paper by the middle of March. Thanks to Mr.Hiroshi UENO, a JICA expert of economic development policy, stationed in Ulaanbaatar, this paper was translated into Mongolian language. Later, the Japanese mission sent to Mongolia, made explanations about the second paper to the Mongolian team at discussion meetings held in Ulaanbaatar during late March and early April.

On the final day of the mission activities, the Japanese and Mongolian teams concluded that the next meeting should be scheduled in September this year. At the same time, they decided that the Mongolian team should prepare a paper on our subject by the next meeting. The Japanese team should also finish the third revision of the draft paper by that meeting. In mid-July the Mongolian team submitted to Japan the paper for the September seminar.

for the power supply. When the FDI firm needs domestic materials for their production line, it can also contact FIC that can find and introduce related domestic companies supplying them.

The next step is to set up One Stop Service (OSS) office or center. OSS is an organization serving foreign business entities intensively with approvals and other related procedures. Also, this organization operates the intermediary function of contacting by FDI companies with FIC. Unfortunately, there is no system which can secure OSS operation in the present Foreign Investment Law. See Clauses 3-7 in Article 12, Clause 2 in Article 17, Clause 3 in Article 20, Clauses 3-1,2,3 in Article 21, Article 24 and Article 25.

In this regard, the Japanese team proposed that the present function of the Foreign Investment Bureau in Ministry of Trade and Industry (MTI) should also be strengthened to be an OSS organization.

The third step is to set up an inspection committee comprising of, for example, both the Parliament and the Judicial Office to thoroughly examine the operation of the OSS and to secure the intended functions mentioned in the law. Bylaws to clarify following issues an necessary.

(2) There is no clear distinction between the law and the bylaws in the present Foreign Investment Law. So, foreign investors cannot get necessary and enough information from the present text of the Law. Bylaws to clarify following issues are necessary.

For instance, Article 4 states the area in which the activities of foreign investors are prohibited, but the text of the law does not refer the readers to the documents specifying such area. Clauses 5 and 6 in Article 12 state that the investigation of foreign business entities before approval will be done according to the international standards and the government regulations. The investors, however, cannot make sure what the related laws and regulations are. Same kind of problems remain in Clause 1 in Article 22.

Furthermore, Clause 3 in Article 20 mentions the possibility for foreign business entities of tax preferences even in the areas where the Law does not specify. According to the Law, however, the specified areas will be decided by the Parliament each time the government proposes. This means that the Parliament must be opened each time by government's request. No one think that it is plausible and highly efficient. It will be much more effective to set up necessary bylaws stating clearly the procedures to deal with this matter in the government.

(3) There are some items which needs to be supplemented in Articles concerning to investment guarantees and tax preferences in the present Foreign Investment Law.

For instance, the royalties sentence for foreign investors should be added in No. 4, Clause 1, Article 10.

Concerning the tax preferences mentioned in Clause 1, Articles 20, it is better to rewrite the time when foreign investors are admitted for it as "After the foreign business entities begin to produce their products and to make profit."

Clause 2 in Article 20 states that if more than 50% of the products are exported, the foreign business entities will be able to enjoy some kind of tax preferences. Regarding this article, the Japanese team suggests that it is better to give more preferences to foreign investors in accordance with increasing export proportions in their products.

Another important point which the Japanese team suggests is a preferencial treatment to fixed assets of foreign business entities which is not mentioned in the present Foreign Investment Law.

(4) There are inconsistencies or contradictions between the industrial policy and the Foreign Investment Law.

For example, the Law does not specify the tourism industry as an encouraged industry by the government. But government officials sometimes mention that it is one of the important industries and that investments from abroad are welcomed in this section. This is a case of inconsistency.

In other cases, we can see contradictions between the policy and the Law. Concerning the Clause 6 in Article 20, the Mongolian government gives the same preferencial treatments to both domestic and foreign investors when they promote to purchase domestic enterprises. The Japanese team understands what the Mongolian government intends in this regard. It may be very important to promote no discriminatory policies to both domestic and foreign investors. However, when we try to restructure old state-owned companies, for instance, there may be some cases for preferring foreign investors. This is especially true in the absence of any domestic investor to take over a state-owned company, and when the company cannot help bankrupting. On this occasion, we may have a good reason to reconsider the Article and give foreign investors some preferential treatments. If the government finds no reason to do so, however, Article 20 may be maintained as it is.

(5) In both the present Foreign Investment and the Land Laws, what the Mongolian government has introduced is not "the transferable right of land use," but is the right for land use with limited duration. In other word, it has taken "the land lease system." We consider this matter in the following way.

The Japanese team proposed a system of transferable right for land use. In the Mongolian context, it can be translated as the system of transferable right for land occupation with limited duration in the present Land Law.

What the Japanese team intends to suggest is that this system will be effective in joint-ventures between Mongolian entrepreneurs and foreign investors. First, Mongolian domestic investors will be able to use the transferable right for land use as a capital investment. Domestic investors will be encouraged to actually utilize the right when they are in short of money to invest. Second, foreign investors will be able to hold it as the mortgage. Therefore, when a foreign investor draws back their investment, he or she will be able to sell the right and recover a loss. This means that the transferable right for land use can be utilized as a means to decrease investment risks and it can encourage foreign investors.

Seeing from this viewpoint, the Japanese team recommends to reconsider the following clauses.

With regard to Clause 4 in Article 21, i.e., the responsibilities of land use should be shared by the investors according to the proportions of capital investment, it is better to rewrite the text for approving the land use right to be recognized as the capital investment itself.

The clause also states that land lease itself is ended automatically when a foreign investor is dissolved before the end of the duration of land lease. We suggest that this article should be changed to set in the transferable right for land use. We also recommend the same changes in the present Land Law.

In regard to their factory or office location sites, we suggest that an OSS center should deal with necessary procedures in place of local or municipal government offices. At present, when foreign business entities try to find a land for location, they have to get into negotiation with a rural administrative office which is responsible for the rights for land use, occupation or ownership according to the present Land Law. This Articles is often prohibitive in that foreign investors may feel it troublesome or too complicated to negotiate with the local government in the factory or office location area.

(6) As a supplement, we should add that the Mongolian accounting system is still not clear for foreign investors, causing one of the factors for their hesitation to invest into this country.

The preceding comments we have made in regard to the laws reveal that the present laws, especially the Foreign Investment Law, have to be changed with new laws, or supplemented by bylaws. However, if it is difficult to do so in the present situation, it would be all the more important for the government to take an initiative to set up publicly their Guideline for FDI promotion policies by showing directions of changes in the laws and bylaws as soon as possible. For this purpose, the Japanese team has already attached a sample of the Guideline and an Explanation for this sample in the second proposal. We hope that the Mongolian experts make a close examination of our second report and understand what we suggest and recommend for improving the Mongolian laws and setting up bylaws for promoting FDI.

b. The Summary of the Mongolian Paper and Comments on Them

The Mongolian paper consists of the following five sections: (a) the present situation of investment promotion measures; (b) The private investment share in the national economy; (c) The institutional framework for FDI; (d) The Foreign Investment Law and international experiences; and (e) infrastructure and natural resource development.

Among the above five sections, the third and the fourth take up our project tasks, stating what the Mongolian team considers concerning the problems and policies of the export promotion measures through FDI in Mongolia. We understand that the comments by the Mongolian experts in these sections on the Japanese proposal are most important. In this part of our present paper, we will focus upon these two sections.

1. Administrative Efficiency

(a) One Stop Service Functions

First, the experts mention in the Mongolian paper that a strong institutional framework is necessary for receiving FDI. In this regard, they recognize that foreign investors express their dissatisfaction with the investment environment in Mongolia, especially with inefficient approval procedures by the administration. However, they find the main reason for such inefficiency in the MTI's formalities requiring unnecessary documents. Another problem they raise with the MTI is that the institution is often inconsistent with the Law.

Second, the experts basically recognize that they do not find many problems in the present Foreign Investment Law itself. But they see many problems in the practical use of the Law. They insist that the administration should be operated more on a commercial-oriented basis and it should not act against the Law.

Third, they point out the insufficiency of working capital for foreign investors and the lack of information agencies for introducing potential investment opportunities to foreigners. They recommend that some services for FDI promotion should be transferred from government institutions such as ministries to some private organizations.

The Mongolian authors agree to the needs for setting up Foreign Investment Board (FIB) in the near future as is mentioned in the first Japanese proposal. But they insist that this should be a non-governmental institution. They admit, as the first step, that the MTI should devise service functions for foreign investors, but they suggest these functions should be transferred to the private sector in the near future.

Their recommendation is that Foreign Investment Association (FIA) should be established based upon existing Mongolian Business Development Agency (MBDA) and Investment Promotion Association (IPA). MBDA is a newly set-up, non-governmental organization. IPA belongs to MBDA, and aims to promote consultation services between private businesses and the government. It will propose policy recommendations for abolishing the restrictions on private investors. FIA suggested here is expected to maintain close contacts with administrative organizations and banks, and to operate financial intermediary activities for foreign investors like COMPROMEX (whose proper name we think is COPROMEX) in Belgium.

The experts maintain that MBDA, a non-governmental organization, is more reliable than public organizations such as the MTI. They conclude that Mongolia should set up FIA as a private institution to operate One Stop Service functions for foreign investors. But, at the same time, they insist that the government should keep the approval right itself.

Comments by the Japanese team: The Japanese team can not judge whether the MTI promotes policies against the Foreign Investment Law or not, and whether the institution causes the main obstacles on the approval procedure or not. Considering the fact that the final draft of the paper was written by an expert in National Development Board (NDB), we think that the paper puts too much emphases on negative aspects because experts in one government organization tend to be naturally critical to what the other institutions are doing.

Judging from the result of a questionnaire study held by the Japanese team to Japanese businesses which have invested or has a plan to invest in Mongolia, the Japanese team finds the following fact. That is, it is not the MTI, but the present system of Foreign Investment Law that has more problems. That means the lack of OSS function itself is an important obstacle to foreign investment in Mongolia.

This is why the Japanese team emphasizes the importance of setting up Foreign Investment Committee (FIC) comprising of representatives from several related ministries to effectively meet various requests from foreign investors. But, the Japanese team recommends the Mongolian government to carefully decide that FIC should not be the One Stop Service organization itself, but the coordination organization for actual operation. That is, the OSS organization should be organized under the FIC.

Nevertheless, the Mongolian government will have to make their own decision, according to their situation, about whether the foreign investment bureau in MTI should promote OSS functions or not, and whether a newly organized private sector should operate them or not. That is, how to establish OSS function is a proper matter of the Mongolian government.

Concerning the COPROMEX mentioned in the Mongolian paper, we do not understand the intention well. We find that in Belgium the relations among Foreign Trade Committee, Foreign Trade Fund and COPROMEX are important. COPROMEX operates financial support services to the businesses intending to export outside EU. We do not know why this should be a model for OSS function in Mongolia.

Last, we do not understand why the authors judge that private sector is more reliable than government administration. If their judgment is correct, will we be seeing administrative inefficiency in the procedures of foreign investment approval. This is a problem which we cannot ignore.

(b) A Council

Concerning the councils for export promotion policies and for industrial policies recommended in the Japanese report, the authors argue against them by suggesting that a new coordination council comprising of representatives from the private economic sector and the government may function better in the present Mongolian situation.

Comments by the Japanese team: We agree that a council should be set up by taking into account each country's own situation and proper conditions. We do not stick to the names and structures that we proposed in the paper. The real point is that any council should be established to coordinate various interests of different groups in a nation and to reach a consensus for policy decisions. Therefore, it is important to organize a council of any kind so that it could reflect various opinions and interests of different circles and groups in the country. In fact, we could support the council suggested by the Mongolian team if it may consist of the representatives from corporate executives, workers (and farmers), capitalists, government officials and academics. But we could not quite agree to the council if it may be comprised only of private entrepreneurs or capitalists and government officials.

(c) Inspection

The Mongolian experts mention that they should distinguish the inspection by the Board of Audit on public investments from that by the National Development Board (NDB) on official development assistance from donor nations. In regard to the inspection organization on the OSS suggested by the Japanese team, the authors state that it is too early, and that the Board of Audit has enough capacity to do so.

Comments by the Japanese team: As long as the inspection system is secured of its own operations normally and correctly, we will be content with it no matter what organization should be established. When we can not be confident of such a system to operate, we strongly recommend that a new organization should be set up. If the Mongolian government can assure of the normal and correct function of such organization, then it may be able to fully disclose the details of the ODA expenditure directions, say, from Japan. It seems to us that the present situation is far from satisfactory in that the present inspection organizations have problems, and we think it necessary to set up a new one.

2. Problems Related to the Foreign Investment Law

(a) Origin of the Time When Tax Preference Begins

The Mongolian experts are against the Japanese proposal suggesting that it is better to change the time origin of tax preference as "After the foreign investor begins to produce his or her products and to make profit". They do not agree to the Japanese suggestion because they believe it "very complicated and not feasible to implement it under the current Mongolian situation." In addition, they state that "business people do not want to provide such information".

They also mention that the present Foreign Investment Law is better than that recommended in the Japanese proposal with regard to the duration and range of the tax preference. On top of this, they state that the present article in the Law is better than the Japanese proposal which recommends that the preference range should be changed depending upon the export share of the goods produced. What they suggest is that the present Law should be altered to give more preferences to the FDI companies contributing to regional development and Free Economic Zone (FEZ) construction.

In addition, they mention the custom's duty preferences admitted by the present Foreign Investment Law. Under the present law, FDI companies can enjoy preferential treatment for the first five years beginning from their registration. In this regard, the authors state that other countries like Bangladesh give more preferential treatment than Mongolia in that export oriented FDI companies are granted exemptions from tax or duties on imported parts and materials. They suggest that the government should also grant exemptions from sales tax and custom's duty to the following types of companies: those processing Mongolian resources and materials, those producing for re-export, and those using Chinese official loans. They propose such exemptions or two-year tax holidays because these companies tend to fall short of capital fund for paying the taxes or duties.

Next, after the statement about Free Economic Zone (FEZ), the experts turn to the Japanese proposal that government should give tax preferences or exemptions to FDI companies depending upon their contribution to the Mongolian economy. In response to the Japanese proposal, the authors argue that the present Foreign Investment Law can be utilized effectively by having recourse to Clause 3 in Article 20 providing that the Mongolian government could admit tax deductions on FDI companies by a resolution of the Parliament.

Comments by the Japanese team: It is common in foreign investment laws in other countries to take the tax preference system providing that the time origin can be after earning of profit. We would like to know why the Mongolian experts judge that it is infeasible to implement it under the current Mongolian situation.

In a questionnaire survey in Japan, we found that many Japanese investors prefer the above provision. This is contrary to the Mongolian judgment that "business people do not want to provide such information." We would also like to have an explanation for such judgment.

Concerning the duration and the range of tax preferences, the Japanese team have already given a clear explanation in the "Sample" and the "Guide for It." Although we tried our best in preparing our report, we do not mean that our proposal is the best and the most appropriate one by any means in the Mongolian situation. If the Mongolian team has a better proposal than ours, we hope that it should be pursued.

As for the tax preferences to export oriented FDI firms, the Japanese team gave in the proposal, an example or a sample for reconsidering the present export oriented FDI promotion policies in response to the Mongolian government's request. If the Mongolian government believes that the present Articles in the Law would be more appropriate for some time in the future, it may as well maintain them. We find no reason to intervene in the Mongolian decisions from the Japanese side.

The same can be said to the custom's duty policies. If the Mongolian government reached a conclusion that no clause may be added to the policies, it will have to publish bylaws of foreign investment.

Regarding the special preferences given to FDI companies depending upon their contribution to the country, the Mongolian experts maintain that the Foreign Investment Law gives full information and it may not be changed. Here, too, the government will have to call the national assembly each time there is a request by a foreign investor according to the present provision. We believe that it would be very difficult, if not impossible, to keep this procedure. This is why we think it better to set up bylaws which clearly express necessary procedures.

(b) Investment Guarantees and Domestic Fund Raising

The Mongolian authors insist that the present Law may be enough to ascertain the investment guarantee for foreign investors because it expresses clearly that the government will not proclaim a nationalization policy of FDI enterprises. They also maintain that foreign investors are legitimately given enough access to the domestic stock exchange market to raise fund, and they find no necessity to revise the present Law, namely, Clause 1, Article 17.

Comments by the Japanese team: The Mongolian team may provide the ground for maintaining that there is no need to make provisions for investor's right to send royalty fee to the home country and for the government's assertion not to control product prices in the domestic market. The reason why the Japanese experts recommended in the report to formalize such statements in the Law is that it is imperative for promoting foreign direct investment to secure foreign investors' confidence. We would also like to stress that it is necessary to specify the Mongolian law when the Mongolian team asserts that "foreign investors are given access to the stock market."

(c) Free Economic Zone (FEZ)

The Mongolian authors express that the government has a plan to set up a FEZ in Altanbulag as a pilot zone. They mention that the government will learn from experiences in the Altanbulag FEZ to accumulate enough knowledge for setting up other FEZs in different places.

Comments by the Japanese team: We also think that it is important to establish a pilot free economic zone for learning from experiences and accumulating enough knowledge for the first time. We believe that it will mean a great deal for further steps of Mongolian FEZs.

(d) Land Use

The authors insist that there is no need to change the present Foreign Investment Law, especially, Clause 3 in Article 21, because it gives more preferential treatments than the Japanese proposal in that it approves sixty-year land lease which can be extended further.

Comments by the Japanese team: We have explained again and again what we mean in our proposal with regard to this matter. We do not intend, however, to discuss the "duration of lease" itself, but to hold the concept of the transferable right for land use. In the "Sample" and the "Guide for It" mentioned in the Japanese proposal, we have made a detailed explanation for their perusal so that the Mongolian experts could find what we really mean.

Here, again, we do not intend to intervene in the Mongolian government's decisions. If the Mongolian government insists to select the present land lease system for foreign investors, it may as well prefer it. In this case, however, we would like to know why the Mongolian government would not take the transferable land use right.

c. Issues which remain

We have stressed the importance of distinction between laws and bylaws. We have asked the Mongolian team where we can find detailed provisions for, say, the prohibited area to foreign investment stated in Article 4. We have also questioned what the related "Mongolian laws and regulations" are mentioned in Clause 5 in Article 12, Clause 6 in Article 12, and Clause 1 in Article 22. We cannot find any answer to these questions in the Mongolian paper.

There was no reply to our suggestion for clearly expressing the preferential system of fixed asset tax because there is no statement about it in the Foreign Investment Law.

There is no reaction to our recommendation for including the tourism industry in the FDI promotion policies.

The Mongolian authors have made no reference to our proposal for the changes in the Land Law. We recommended that OSS office may be in a better position to deal with the decision procedure for investor's location. We believe that OSS could facilitate the procedure by avoiding direct negotiation or coordination between FDI investors and chiefs of local administrative offices when the investors seek land for their location.

d. Concluding Remarks

Essential standpoint in our proposal is that we intend to transfer the basic ways of thinking with regard to judicial improvement and policy-decision procedures. We believe that we have repeated what we intend in the March paper. We are sure that the Mongolian team may as well decide the expressions of the text of laws and the concrete policy measures for promoting export-oriented FDI. We do not hope that the Mongolian experts may pay too much respect to the text expressed in the Japanese proposal reports. Again, what is important, we stress, is not the expressions, but the basic understanding of the real problems and ideas for policy decisions to solve them.

Such points have been explained in the "Sample" and the "Guide for It" included in the second proposal by the Japanese team. We hope that the Mongolian team will scrutinize the Japanese report again to understand them correctly.

To conclude, we think it necessary to continue discussions on policy matters for mutual understanding between the Mongolian and Japanese teams. We find some differences of opinions regarding particularly the Foreign Investment Law. In fact, we would like to suggest again that the Law needs some alteration or revisions, while the Mongolian experts ascertain that it may not be changed because they do not find problems to be solved in the Law itself. We think it necessary for the Mongolian government to publish a government guideline and to set up related bylaws as soon as possible, if the government can not alter the Law.

Part II: Papers without Presentation

Theme F: TRADE PROMOTION POLICIES

F. 1
INTER-REGIONAL DIVISION OF LABOUR AND MONGOLIAN EXPORT PROMOTION

Sakura Kojima[1]

Introduction

Due to its small internal market together with its low national purchasing power, Mongolia cannot but put an emphasis on more outward-looking or export-oriented strategy. To promote export and to increase the international competitiveness of export commodities, Mongolia needs to strengthen the external economic relations in the fields of research and development (R&D) and transportation cooperation, and joint venture.

According to the Foreign Trade Statistics for the year of 1994, major trading counterparts of Mongolia remain Russia with export and import share of 27.7 percent and 58.7 percent respectively, and China with 19.4 percent and 9.3 percent respectively.

Russia and China also predominate foreign direct investment to Mongolia in terms of registered number of companies, contributing 35.8 percent and 31.6 percent respectively to the total 500 registered companies from 1990 to the middle of 1995. These figures indicate how those two neighbouring countries are influential to Mongolian economy.

One of the formidable problems for land-locked Mongolia to promote export is the high cost of transportation and long distance, hence long time delivery. Russia and China are also absolutely important for Mongolian export in terms of transportation channel. To boost the mineral exports and increase their competitiveness, Mongolian government needs successfully to seek for the way of cost reduction in transportation through negotiating with China and Russia to discount the freight rate, and to find out diversified channels of outlet to seaports. For example, Mongolian government could try to negotiate with China to revitalize the Chinese Eastern Railway with ADB assistance to connect Mongolia and resource-rich Siberia, which would make the route the cheapest and a shortcut to Nahodka and Tumen River free trade zone, hence to the Pacific. In the long run, activating the inter-regional trade and other economic exchanges in North-Eastern Asian region will enhance the gradual construction of transportation facilities there. Although being scattered, the formation of border trade areas will promote such movement, too.

Besides cost, improvement in quality, design and R&D efforts form crucial components of the international competitiveness. In the case of Erdenet copper concentrate, the largest foreign exchange earner, for example, priority must be given to a laboratory and research works. Because of the hardness of the ore, Erdenet ranks among those with the highest cost (grinding cost) in the world. The profit margin will largely disappeared as grinding costs increase over time. Nowadays the Mongolian-Russian joint venture should put much more emphasis on metallurgical research, and strengthen their cooperation in overall R&D effort more. Also in the case of cashmere,

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Mongolian greasy cashmere could get additional export earnings, if it would reach the same level as that produced in Inner Mongolia through improvement of breed and maintaining uniformity of color. Technological cooperation and information exchanges in the field of upgrading Mongolian cashmere between Mongolia and Inner Mongolia will benefit the former greatly. There were so many examples of inter-regional technological cooperation through joint venture especially in the mining sector mainly with the former USSR. It is now proposed to create joint ventures not only in the mining industry but also in the light and food industry, the colored metal, mechanical engineering, electromechanical, chemical and microbiological industries with Russian companies. For Mongolian development, continuous industrial cooperation especially with the Eastern Siberian regions as before will be required. In the light of general lacking of management experiences under the market economy, it would be ideal if Mongolian-Russian joint venture could get a participation from the Asian-Pacific region like Asian NIES, Japan and China.

It is imperative for Mongolia to attract as many foreign direct investment as possible and to enhance the technological cooperation not only with neighbouring countries but also with developed countries, in order to increase its export and its competitiveness. For forming a favorable investment environment for foreign companies, it is required for Mongolian government to try to keep a good relationship with those neighbouring countries and make the best of inter-regional cooperation especially in transportation.

In this paper, focusing on Mongolia's most competitive and the biggest earner of foreign currency, copper concentrate and cashmere, I'll exemplify how inter-regional cooperation will benefit Mongolia. Inter-regional cooperation is to be effectively developed, if it were based on division of labour, reflecting its regional diversity and differences in factor endowments. However, reality sometimes seems to be reverse, because many of the potentially competitive products of Mongolia may compete with those of Inner-Mongolia, China. In the case of fluorspar, one of the major export commodity of Mongolia, China becomes a direct competitor with Mongolia, even though Mongolia being the third largest producer in the world. China's self sufficiency in the fluorspar eliminates China as a potential market for Mongolian fluorspar. Furthermore, Mongolia is at a competitive disadvantage vis-a-vis China in attempting to expand to the European market. But when it comes to copper, China despite producing its own larger copper, is one of major consumers of Mongolian copper. And as for cashmere, thanks to the growing world demand for cashmere finished goods, there is a great scope for cooperation especially in R&D between Mongolia and Inner Mongolia to upgrade the quality of greasy cashmere. The growing demand in the world could allow the inter-regional cooperation, despite producing same commodities among region.

a. The Case of Copper Concentrate

Mongolian mining industry accounts for approximately 20 per cent of GDP and almost 40 per cent of exports (as of 1991). Currently, copper concentrates from the Erdenet earn the largest share of total export earnings, followed by fluorspar, Erdenet molybdenum concentrates, and gold. It was told that the highest increase in GDP in 1995 (5.7%) ever since 1990 could be mainly achieved by the sudden price hike of copper in international market. This fact tells how copper concentrate play a crucial role in Mongolian economy.

Copper is mined in over 50 countries. The larger producing areas are North America (28%), South America (23%), former USSR (15%), Africa (13%), and Oceania (10%). China and Mongolia account for about 4.2% and 1.4% respectively of total world mine production (as of 1991). The international price tends to highly sensitive to the changes in demand for copper. Most of the world's copper are consumed in the industrialized countries. But recently, some rapidly industrialising Asian countries contribute to a major growth in demand. China, despite producing almost 4% of the world copper, needs to import from Mongolia. The economic decline in Russia has caused the Mongolian-Russian copper joint venture, which previously relied on Russian market exclusively, to seek for and exploit unfamiliar markets, either Europe or Asia. There is a possibility that the demand for copper will be increasing in some Asian countries. Thus it will be one way for Mongolian copper company to strengthen its link with North-Eastern Asian region as main market. At present, major overseas market for Erdenet copper concentrate are as follows: Russia, Kazakhstan, China, Japan, Korea, and Czeck. Exploiting new market is one crucial problem for future Mongolian copper.

Erdenet copper concentrate has been supported technologically by former USSR. However, it now faces serious bottlenecks in terms of technology and capital. At the present rate, proven copper reserves at Erdenet are sufficient to sustain operations through 2005. As mining progress, however, copper grades are expected to decrease in the next decade. Therefore, in order to maintain the present production levels, Erdenet needs to expand ore processing capacity. And now government began to implement the 15 Years Plan Toward 2010 to expand the production capacity.

Erdenet copper ranks among those with the highest costs largely because of the hardness of the ore and the high cost of grinding. The profit margin will largely disappear as grinding cost increase overtime. Thus priority must be given to a research especially metallurgical research and laboratory test.

In addition to the high grinding cost, the high transportation charges and smelter cost make Erdenet copper less competitive. Besides negotiating with China to discount the rail charges, the Mongolian-Russian joint venture seeks for the way to add value as much as possible to offset the high transportation cost. This may be a problem of R & D and/or capital investment. The Erdenet joint venture needs to have a plan of smelter/refinery establishment to increase its value-added.

Thus the case of Erdenet copper concentrate which now faces a changing environment, exemplified that for its further development the joint venture company must strengthen its ties with Russia and China and some other Asian countries.

b. The Case of Cashmere

Cashmere is the most competitve export commodity of Mongolia, and it is valued as the finest quality in the world. Mongolia is said to be a good location for the production of high quality greasy cashmere, thanks to its dry and cold climate with substantial grazing areas and herdsmen with long tradition of animal husbandry. About a third of the world's supply of cashmerecomes from Mongolia. Other major producing countries are China, Iran and Afganistan. The best prices are paid for greasy cashmere from the eastern part of Inner Mongolia.

For cashmere export, transportation doesn't annoy Mongolia so much as for the copper export. Rather research and technological aspect will be most required for the further enhancement of its competitiveness in the world. There is much scope to improve the quality of Mongolian greasy cashmere. Mongolian cashmere could be upgraded to the similar quality level as that produced in Inner Mongolia. This can be attained by herd upgrading or improvement of breed, and a greater attention to maintain the uniformity of color in Mongolian cashmere. Thechnological cooperation or information exchanges between Mongolia and Inner Mongolia should be strengthened more in the field of quality improvement of greasy cashmere. A successful quality improvement could provide additional export earnings.

Mongolian cashmere is usually sold without dusting or removing dirt. Herders need to be encouraged to dust and sort cashmere prior to their sale, as the herdsmen in Inner Mongolia do. Mongolian government should take an initiative in assisting herders not only to increase the supply but also to improve the quality. The Australian consultants appointed by the ADB recommend for government to establish purchasing centers where cashmere can be classified by quality and auctioned to users or consumers. Government needs to establish a more sophisticated grading system to give an incentive to herders' efforts in quality improvement.

Thanks to the growing demand for raw cashmere in the world, Mongolian herders have increased their goat numbers since 1991. Greasy cashmere has increased from 1,448 tonnes in 1993 to 1,975 tonnes in 1995, and in 2000, it will be expected to increase to about 3,315. Almost more than 60 percent of greasy cashmere are processed (dehaired) in Mongolia. The remainder are the ones which illegally run out of Mongolia or are held in storages. The biggest bottleneck for cashmere industry in Mongolia is the shortage of raw cashmere because of smuggling to China. The domestic processors including foreign companies struggle for raw cashmere. This is a main background for export ban on raw cashmere by Mongolian government, although it becoming a controversy.

However, there are some grounds for the ban. China and Hong Kong, manufacturing about 75 percent of the world's low grade cashmere knitwear, have increased their final products greatly in the developed countries' market. China could have successfully increased their products through joint venture with developed countries' firms. However, U.S., for example, became restrictive to the Chinese cashmere goods in 1994. The import quotas that imposed on the Chinese cashmere garments to the US through the Multi-Fibre Agreement, provide an opportunity for Mongolian joint ventures to enter the market for finished cashmere products, thanks to non-quotas on Mongolian products. Thus there is a possibility even for Chinese cashmere processors to relocate some parts of their operations and transfer some processing technology to Mongolian firms.

It is true that some foreign cashmere processors like Amicale and Forte have enjoyed the benefits accrued from the export ban. Thus the ban turn to be a good opportunity for the Mongolian cashmere industry to add their value and invite a foreign processors' investments in Mongolia. However, we should bear it in our minds that the export ban must be a transitory measure in its nature and the prices of buying up raw cashmere must be increased to the level of the international market prices. The big gap between domestic and international market prices is the main cause for a smuggling into China.

According to my own view, it is a time for Mongolian cashmere companies to enter the market of finished products. The demands for them seems to be great in the developed countries. However, at this stage of development, technological problems to be solved are immense to Mongolian cashmere processors. Technologically, the most difficult process is to spin cashmere. The technical problems in this fields, i.e., whether they could set up a satisfactory spinning operation or not, may become a key for future breakthrough of Mongolian cashmere industry.

In addition to the technological problems, marketing cashmere products in developed country proved to be extraordinarily difficult. Gobi, for example, needs to improve the design of their products, while Buyan must improve their quality. To meet the consumers' needs in the developed countries, Mongolian companies must try to increase their R&D capacity. To cope with this formidable problems, marketing supports from reputed or established foreign suppliers would be greatly required.

c. Prospects for Further Development of Inter-Regional Cooperation

The above-mentioned cases showed that inter-regional division of labor could take various forms such as transportation and R&D cooperation, information exchanges and joint venture activities. The following three points are some examples of future or potential field of cooperation among regions.

(a) Since rich mineral resources are the most attractive factor for foreign investors, Mongolian government needs to disseminate basic data which have been well accumulated for fifty years to the potential foreign investors, and with financial and technological assistance from overseas especially from Japan, conduct investigation and/or in-depth feasibility studies on a number of attractive mineral prospects which will be accessible to mining companies or mineral investors. Creating a favorable environment for potential foreign mineral investors should be emphasised, besides providing information and data.

(b) While main aim to attract foreign direct investment may lie in promoting export, some import-substitution industries which have been seriously affected by the transition towards market economy and privatization process, need foreign direct investment too. Auto-parts and associated repair services which are suffered severely from economic disorder of the transitional period, may be such a case. The former state company, Auto Repair & MPR Machine Tools Corporation, has almost come to a halt right after privatization. Transportation sector was seriously affected as auto-parts industry. Auto-parts and repair industry is an important basis for the development of machinery industries. And transportation industry is also crucial for economy as a whole. Fortunately, not a few foreign companies mainly came from Russia have begun to invest and operate machinery repair services. These investment may be welcomed.

(c) There is a plan that Irkutsk province will provide natural gas to China via Mongolia. Mongolia will be benefitted from charging transit tolls. And recently, the World Bank and UNDP announced a grand project called Eurasia Natural Gas Pipeline Project (ESMAP) in which a total of 7000 kilometers pipeline will be constructed to supply more than 20 million tonnes (p.a.) of gasfrom Central Asian region to China and Europe. If this grand plan were to be implemented, it would indirectly benefit Mongolia in the future which is suffering from the permanent shortage of energy.

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F. 2

PROMOTION OF BORDER TRADE: NEW DEVELOPMENT STRATEGY FOR LAND-LOCKED BORDER REGIONS

Sakura Kojima[1]

Intoduction

At least until now, most successful economic development models like Asian newly industrialised economies (NIEs) or some ASEAN countries, share a common feature of geographical condition, i.e., located in the coastal areas with easy access to overseas markets. Since success in export is a key for the overall economic development of developing nations, geographical location becomes a decisive precondition.

On the other hand, landlocked regions or countries are often left out of a stream of economic development or industrialization. But recently, after the liberalization of border areas, some inland-border areas in China have gained momentum to develop themselves through activating border trade with neighbouring countries. Many inland local governments came to notice the potentiality of border trade in breaking through their stagnated economies and became earnest to promote border trade.

Although being endowed with rich mineral resources, Mongolia can't attract foreign direct investments mainly because of its location and underdeveloped infrastructure. It is imperative for Mongolia to get an access to the sea through either railway and/or main roads. It is expected that the brisk economic exchanges in the border areas between China and Mongolia will give a stimulus to a gradual build-up of transportation facilities, which will bring in a great advantage to the land-locked Mongolia in the future.

At an early stage of inter-regional economic cooperation, border trade constitutes a major part of the cooperation. Brisk commodity trade in the border areas, will stimulate the trade-related services like insurance, financing, transportation, storage and other distribution, and even foreign direct investment, and so forth. Recently, it is pointed out that labor-export and tourism triggered by the border trade become thriving in Sino-Russian border. And foreign direct investments (FDIs) have flowed into some thriving border areas in order to process local raw materials and to export them through border trade channels, whose activity is defined as "FDI-type of border trade". Mainly Hong Kong and Taiwanese companies actively invest in Russian-Chinese border area. FDI-type of border trade differentiates itself from other ordinary trade and will potentially boost the border economies because they will bring in new infusion of capital, technology and management know-how, and will create local employment opportunity.

In the long run, all of the above-mentioned activities will stimulate the gradual build-up of infrastructure including transportation, hotel, retail shops, and so on, which will in turn attract further foreign direct investment. Although being scattered, border trade areas formed in several places will become a first step for a gradual construction of transportation system in the entire region and substantiate the regional economic zone.

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a. The Present Situation of Border Trade in the Area Surrounding Mongolia

In the north-eastern Asia, Sino-Russian border trade, especially between the Heilungkiang Province and the Far East of Siberia, is most developed in terms of volumes of trade and variety of traded commodities. Comparing with the border trade between China and Russia, Mongolia and China's border trade still accounts for relatively minor share in the region. Main partner with Mongolia is the Inner Mongolia in People's Republic of China.

After 1985, when the two countries officially established border barter trade, their border trade and other economic cooperations have been accelerated. According to Dr. Enkhee, the border barter trade between Mongolia and Inner Mongolia now constitutes about a half of total values of trade between Mongolia and China. But after the rapid development during 1990 to 1993, the bilateral trade has decelerated since 1994 mainly because of immature bank account settlement system, low quality of Chinese products, hence distrust feeling to border trade on the side of Mongolia, and restrictive policies of both governments, etc. Furthermore, brisk development of Sino-Russian border trade seems to have influenced to reduce the total transit trade volume through Mongolia for the moment. Before focusing on Mongolian-Inner Mongolian border trade, we need to pay attention to the present situation of border trade development between Russia and China. And in this section, in the light of China being an initiator in boosting border trade in the region, this paper touch upon an outline of the new regional development strategy for the 1990s in China.

1. China's New Regional Development Strategy in the 1990s

The strategic target in the 1990s China is how to reduce the widening gaps or inequalities between the most dynamic coastal regions and frontier regions. The central government officially recognized the importance of the border trade as a promoter of isolated frontier economies in 1992, and designated some major cities as " liberated frontier cities", where the government gives a preferential treatment. Up until 1992, China opened 21first class trading points.

Before the Sino-Soviet relationships getting worse, there existed small-scale borderers' trade activities in the areas. It had a long tradition at least until 1969 when the border trade was totally banned due to the deterioration of political relationship between the two countries. Upon the cold war regime being collapsed and reconcilliation of Sino-Russian relationship being proceeded, the border trade has gained a momentum and developed dramatically beyond the scope of traditional definition. Recently, local governments, public trade corporations and private companies including foreign ones began to seriously participate in the border trade, while in the traditional trade, people or borderers had played a central role. New form of barter trade, defined as "compensatory barter trade" in which an importer of machinery and equipment is allowed to pay by the finished goods to its exporter, was born. The barter trade constituted a major form of settlement in the former socialist countries. However, China has started to employ the hard currency for the payment to the former Eastern European partners since 1991. Thus, the traditional definition of border trade will need to be renewed in the light of thechanging reality of border trade.

2. The Development of Sino-Russian Border Trade

After the border trade resumed in 1983, Sino-Russian trade has got a momentum especially after 1988 when both central governments decided to decentralize and delegate powers to the local government or to private companies in the border trade business. The total volumes of trade amounted to 2,120 million Swiss franc (SWF) in 1992. For the Far Eastern Region of Siberia, almost 90 per cent of border trade came from China.

Manjuuri, where is the largest center for Sino-Russian border trade, is the earnest promoter of regional economic cooperation in the Inner Mongolia. It started to construct various types of special economic zones like "Economic Cooperation Zone", "Energy Development Zone", "Export-oriented Agro- and Cattle-related Industrial Development Zone", etc. Among them, "Frontier Economic Cooperation Zone", covering 57 square kilometer, in which processing plants, transportation facilities, bonded warehouse were planned to be constructed. There, joint-ventures among Japan, China and Hong Kong is now operating to produce man's shirt for overseas markets.

In spite of the rapid growth of the border trade, there still remain alot of bottlenecks for further development. The biggest constraint is the deficiency in infrastructure, which calls for the aid resources from bi- and multi-lateral donors. The Amur River, for example, needs to be bridged over. Second, there still remains a partial export permission system, which limits the kinds of tradable commodities. So further deregulation will be required in this field. Third, the quality control or check of export goods should be strengthened. The influx of low quality goods will finally reduce the border trade. So the strict screening system needs to be established on the verge of the border.

b. Economic Cooperation Between Mongolia and Inner Mongolia

1. Border Trade

Total amounts of border trade of the Inner Mongolia with neighbouring countries increased from almost US$96 million in 1988 to US$ 257 million in1991. Comparing with other Chinese inland provinces, it has grown most steeply. However, more than 80 percent of border trade of Inner Mongolia was directed to the far eastern region of Russia. It's trade share with Mongolia accounted for only less than 10 percent (in 1991). Thus, for Inner Mongolia, border trade with Mongolia still constitutes relatively small share. But for Mongolian economy, it is never insignificant. For Mongolia, the trade between Mongolia and Inner Mongolia now constitutes about half of total amount of trade betweem China and Mongolia, and more than 90 percent of the total are in the form of barter trade.

The Inner Mongolian government has begun full-fledged open door policy since 1992, designated 13 cities and towns as "liberated zones", and established "technological liberated zones" along the railway lines or "resources development zones", and so forth. It has further deregulated and streamlined the procedures of border trade and delegated powers to subordinate administrations. It has a plan to construct a "Sino-Russia People's Border Trading Zone" covering an area of 210 thousand squaremeters.

As for the trade between Mongolia and China, both parties reached an agreement to strengthen the transhipment capacity of Ulaanbaatar Railway at Ereen in Inner-Mongolia and Zamyn-Uud in Mongolia, and opened the road for passenger traffic. And they will rebuild or expand the joint inspection building, station, and hotel there. With the support from both governments, bilateral border trade increased sharply especially between 1990 to 1993, although since 1994 it has been declined greatly, as Dr. Enkhee's paper mentioned.

However, some forms of economic cooperation between Inner Mongolia and Mongolia other than barter trade have continuously developed. Total numbers of joint-venture between the two have amounted to 132 with total capital invested by Inner Mongolian companies worth of 16 million US dollars during1989 to 1995. And Numbers of projects of economic and technological cooperation have totaled to 126 (see Dr.Enkhee's paper). Peoples' exchanges are activating in Zamyn-Uud, too.

2. Economic Cooperation in Zamyn-Uud and Ereen

Zamyn-Uud is designated as one of the sites proposed for "Free Trade Zone" in Mongolia. Zamyn-Uud and Ereen are the only railway port in each country, and crucial windows to the economic exchanges between the two countries. Both sides become earnest to strengthen and invest a lot on railway to increase their capacities of conveyance. Highway connecting two cities are now under construction with the aid of ADB and construction is contracted to a Chinese company. Once the highway were completed, trade between the two would expand greatly. And Mongolia has reached an agreement with China that Mongolia can use Tianjin port. After the normalization of diplomatic relations between the two countries, trade and transportation cooperation have proceeded actively. Electricity supply is another field of cooperation. Zamyn-Uud which is suffering from chronical shortage of electric power, has contracted with Ereen to be supplied with electricity for almost 60 years. Recently, Chinese company began to investin hotel business in Zamyn-Uud. Potentially, it's said that manyMongolian-Chinese living in Inner Mongolia have desire to visit Mongolia. If the present strict visa system were deregulated, many visitors would come and visit Zamyn-Uud. Sightseeing (border sightseeing) can't be undervalued because peoples' exchanges will be a first step for future development of other forms of economic exchanges like investment.

c. The Formation of a North Eastern Asian Economic Zone and the Mongolian Economy

The development of border trade, among others, between Russia and China, will become one effective factor to substantiate the formation of "North Eastern Asian Economic Zone", covering Japan, Korea, North Korea, Far Eastern Region of Siberia, China and Mongolia. For such land-locked small country like Mongolia, formation of the Zone will bear a great benefit through constructing road, railway and river transportation. Without the regional cooperation, Mongolia can't built up transportation reaching out to the sea. Tumen-River Area Development Project has come to operation as the paper entitled " Opportunities for North East Asia Economic Cooperation: Example of Tumen River Area Development Programme" clarified. Especially, the great development of Hunchun, which is considered to become a key are a for future development of Tumen River Development Project, after the creation of Hunchun Border Economic Cooperation Zone in 1992. And Russia which reluctantly committed herself to the project before, has begun to participate seriously in construction of the railway from Zarubino port to inland border area since May 1995. These movements turn to be strong promoter for the project. If those outside infrastructural development were linked to the domestic economic development zone or so, they would give a great impetus to the Mongolian long-term development.

As Prof. Ah Yan has pointed out, Mongolian-China trade has declined dramatically since the latter half of 1993, because of various reasons: immature bank account settlement systems between two countries, deficiency in credit system, poor quality of Chinese products, and recent restrictive policies of both governments in the period of economic adjustment, etc. It will take a little time to solve those problems and resume to boost the trade between the two. On the other hand, as for other forms of cooperation, i.e., joint venture, technological and economic cooperation, and labor export, there seems to be better prospects in the future.

Annex 1

Program of the Second Mongolia Japan Joint Symposium:
Export and Foreign Direct Investment Promotion for Mongolia

Aug. 31 1996

September 16, 1996, Monday

Chairperson: General Director, Economic Policy Dpt., Minsitry of Finance
Reporter: ?

Opening Speech

09:30~09:40	Opening Speech	Tsagaan, Minister of Finance
09:40~09:50	Opening Speech	Ambassador of Japan

Keynote Address

09:50~10:20	Keynote Address	Hirono

Theme A: Use of ODA for Export Promotion

10:20~11:05	A.1: Foreign Savings Can Help Development but Are not Essential for It	Enkhbold
11:05~11:50	A.2: ---to be announced at the Symposium---	Hirono
	11:50~12:05: Coffer Break	
12:05~13:35	Discussion and Conclusion	

13:35~14:35: Lunch

Theme B: Fiscal and Financial Policies for Export Promotion

14:35~15:20	B.1: Financial and Monetary Policy to Support the MongolianExport	Tserenpil
15:20~16:05	B.2: Effective Financial Policies for Export Promotion	Sunamura
	16:05~16:20: Coffee Break	

Theme C: Interest Rate Policy

16:20~17:05	C.1: Monetary Policy of Mongolia: Why Interest Rates Should Be Lowered and How	Fujimoto
17:05~18:35	Discussion and Conclusion for Themes B and C	

September 17, 1996, Tuesday
Chairperson: Hirono
Reporter: ?

Theme D: Conservation of Raw Materials for Development of Processing Industry

09:30~10:15	D.1: Production, Supply, Storage, Transportation, Processing and Export of Domestic Raw Materials in Mongloia	Tsagaach
10:15~11:00	D.2: Securing Mongol-Made Raw Material, Process and Export	Kubota, Kojima, Shimazaki, Tsuzuki and Yoshikawa
	11:00~11:20: Coffee Break	
11:20~12:50	Discussion and Conclusion	

12:50~13:45: Lunch

Theme E: Foreign Direct Investment Promotion Policies for Export

13:45~14:30	E.1: Promotion of Export Oriented Foreign Direct Investment in Mongolia	Bayasgalan
14:30~15:15	E.2: Export-Oriented FDI Promotion Policies Reconsidered	Kuribayashi
	15:15~15:30: Coffee Break	
15:30~17:00	Discussion and Conclusion	

Overall Discussion and Next Step
17:00~18:00 Discussion and Conclusion

Concluding Remarks

18:00~18:10	Concluding Remarks	Tsagaan, Minister of Finance
18:10~18:20	Concluding Remarks	Hirono

Reception by the JSP (or MDPSG-J)
18:20~20:00

September 18, 1996, Wednesday

9:30~17:00 MORES MDPSG-J Joint Meeting to agree on a proposal to Mongolian Government