International Labour Review, Vol. 132, 1993, No. 5-6

Initiating transition in a low-income dualistic economy: The case of Mongolia

Eddy LEE *

Mongolia embarked on a programme of transition to a market economy in July 1990, marking the end of seven decades as a centrally planned socialist economy. While the general problems of transition faced by Mongolia are similar to those of other former centrally planned economies in Eastern and Central Europe, it is nevertheless subject to special constraints arising from its level and past pattern of development. These constraints make the transition process more difficult to manage and the social cost higher than in more developed transition economies. The aim of this article is to describe the trauma of the first two years of the transition process in Mongolia, analyse its causes, and draw some lessons for future policies.[1]

In spite of the rapid pace of its industrialization since 1960, Mongolia was still a developing economy when it began its transition to a market economy. In 1989 its per capita GDP was estimated to be US$522.[2] Forty-two per cent of its population lived in rural areas and one-third of the labour force was directly employed in an agricultural sector which is dominated by nomadic pastoralism. The country is vast (half the size of India), remote, land-locked and sparsely populated (population of 2.1 million in 1990) with an underdeveloped transport and communications system. Other characteristics which Mongolia shares with many developing countries include a high rate of population growth, a dualistic economic structure and a high degree of external dependence.

Mongolia has a pro-natalist population policy and its population growth rate, at 2.8 per cent per annum, is one of the highest in Asia. Half the

* International Labour Office.

[1] The article is based on material prepared by the author for the report of an ILO/UNDP advisory mission to Mongolia which he headed. The mission visited Mongolia in September 1992 and the author returned on a follow-up mission early in 1993. The report of the mission, entitled *Mongolia: Policies for equitable transition* (Geneva, ILO, 1992), contains more detailed information and analyses and also deals with other aspects of the transition process not taken up in this article.

[2] International Monetary Fund: *The Mongolian People's Republic: Toward a market economy* (Washington, DC, Apr. 1991).

population is under the age of 20 and labour force growth is about 3 per cent per annum.

The dualistic economic structure is manifested primarily in the co-existence of a modern, capital-intensive industrial structure with traditional nomadic pastoralism where productivity has stagnated for decades.[3] Other axes of dualism are the contrast within the agricultural sector between highly mechanized state farms for crop production and the traditional livestock economy, and the wide gulf in urban housing conditions, between modern, high-rise apartments and crowded encampments of tiny traditional nomadic tents *(gers)*.

This dualism is the result of the development strategy under central planning that emphasized rapid capital-intensive industrialization. By 1989 the industrial sector accounted for one-third of GDP, a share which was substantially higher than in other developing countries at a comparable level of per capita income. Half of industrial output was accounted for by heavy industry and the industrial sector as a whole was characterized by a high degree of concentration, both geographically and in terms of the size-distribution of firms. Large, capital-intensive enterprises dominated most industrial branches and small enterprises did not exist even in activities such as shoe-making and garments.[4] The overwhelming majority of industrial plants were built as turn-key projects by the Soviet Union and Eastern European countries. The technology was capital-intensive and bore little relationship to the factor endowments in Mongolia. Capital-output ratios were high and rising; by the late 1980s they were in the range of 8:1. This indication of the low competitiveness of the industrial structure is reinforced by the fact that the industrial sector was heavily import-dependent and was, overall, a net importer. For many industries value added at world prices was probably negative.[5] This semi-artificial industrialization was largely sustained by Soviet aid but a domestic squeeze on agriculture was also a contributing factor. The inter-sectoral terms of trade were strongly against agriculture, with the result that an over-extended industrial sector was matched by an underdeveloped agricultural sector.

This economic structure was also an extremely dependent one. By the late 1980s Soviet aid was equivalent to between 25 and 30 per cent of GDP. The economy was heavily import-dependent with an import-to-GDP ratio of 52 per cent in 1989. Exports amounted to only 22 per cent of GDP in the same year. This dependence was compounded by the fact that in 1989 trade occurred overwhelmingly with the Soviet Union and CMEA countries (90 per cent of exports and 93 per cent of imports).

---

[3] The size of the livestock herd has stagnated at around 22 to 25 million head of animals since the 1960s. See World Bank: *Mongolia: Country economic memorandum* (Washington, DC, Dec. 1991).

[4] Ibid.

[5] The Boston Consulting Group: *Reconstruction and development of the industrial sector of the Republic of Mongolia*, mimeo. (Aug. 1991).

This brief account of the inherited economic structure indicates that the challenge faced by Mongolia in implementing a transition to a market economy is far greater than that faced by the Eastern and Central European transition economies. At the start of the transition process, Mongolia was at a lower level of development and was far more dependent on the Soviet Union in terms of aid and trade, and was saddled with a more seriously distorted and inefficient economic structure in relation to its factor endowment and comparative advantage.

The impact of external shocks

The initiation of the transition programme in Mongolia coincided with the onset of a serious economic crisis provoked by severe external shocks. These were the termination of external aid from the Soviet Union and the collapse of CMEA markets as a result of developments in Central and Eastern Europe. The extremely heavy dependence of the Mongolian economy on both Soviet aid and CMEA markets meant that the impact of these developments was enormous.

The direct impact of these developments was a 2.1 per cent decline in GDP in 1990 followed by a further decline of 18 per cent in 1991 (see table 1). The fall in output continued through 1992; table 2 on the industrial production index shows that for the 14 main industries for which data are available, output fell in all but one industry (leather coats). Except for bakery goods and flour, output declined very sharply between the end of 1991 and August 1992, ranging from 15 to 50 per cent. These substantial falls in output resulted in domestic shortages and aggravated foreign exchange scarcities.

There are indications that the overall fall in output was greater than that which would have resulted from a fall in demand alone. The strongest indicators were the shortages of food and other domestic goods for which there was excess demand and the inability to meet export demand in certain industries. The explanation for this lay in the severe import compression which generated a vicious circle of falling output beyond the extent of the initial fall in demand. This compression resulted in shortages of essential inputs – fuel (and hence also power), imported inputs and spare parts. Its severity (imports had fallen to one-third of their 1989 level by 1991) and the pre-existing extremely heavy import-dependence of the economy meant that the direct economic impact of compression was very large. This was magnified by the chaotic distribution of the essential inputs mentioned above which resulted in excess capacity even in industries for which there was a demand for outputs, either domestically or externally. These problems were further compounded by the additional disruption caused to the transport system

Table 1. Major economic indicators

	1989	1990	1991
Gross domestic product (% change)	4.2	–2.1	–18.0
Agriculture[1] (% change)	13.8	–0.8	–4.5
Industry[1] (% change)	11.1	–1.9	–30.1
Services[2] (% change)	5.7	3.0	–8.8
Gross domestic investment (% of GDP)	46.0	29.9	12.0
Gross domestic saving (% of GDP)	12.9	2.9	3.5
Resource gap (% of GDP)	–33.1	–27.0	–8.5
Inflation rate (% of change in CPI)	...	...	130.0
Merchandise exports (US$ million)	795.8	444.8	437.0
(% change)	–2.5	–44.1	–1.8
Merchandise imports (US$ million)	1 911.8	1 023.6	574.3
(% change)	7.5	–46.5	–43.9
Trade balance (US$ million)	–1 116.0	–578.8	–137.3
Current account balance (US$ million)	–1 240.4	–644.0	–100.0
(% of GDP)	–34.6	–28.3	–10.1
Total government revenue (% of GDP)	48.9	50.7	62.5
Total government expenditure (% of GDP)	65.3	64.1	76.5
Overall budget deficit (% of GDP)	16.4	13.5	13.8
Sectoral share of GDP			
Agriculture (% of GDP)	20.4	20.2	17.4
Industry (% of GDP)	34.1	33.8	28.5
Services (% of GDP)	45.5	46.0	51.8

[1] Refers to net value of output (Net Material Product basis). [2] Includes material services (net value) and non-material services (gross value).

Sources: Asian Development Bank: *Asian Development Outlook 1992* (Manila); World Bank: *Mongolia: Towards a market economy* (Washington, DC, Dec. 1991).

by import shortages and the partial privatization of transport and other parts of the distribution system.[6]

These additional sources of disruption to the production system over and above the fall in aggregate demand also had negative consequences for the economic and social environment within which the transition programme has to be implemented. The main problem was the disruption in the food distribution system and the consequences for social stability and economic efficiency. This break-down in food distribution was manifested in the inability to ensure regular distribution under the food rationing system and in the haphazard development of the private market for food. The causes of this lay in inefficiencies in the transportation system and in the management

[6] The evidence for this view consisted of the many references to excess capacity being caused by shortages of power and imported inputs during the author's discussions with officials and visits to enterprises; the fact that output in food-processing industries had fallen sharply in spite of the availability of local supplies of raw materials such as meat and milk; and the fact that the production of exports for which Mongolia has a comparative advantage (e.g. carpets, knitted goods, sheepskin coats) had fallen sharply. In addition, the priority now being given by the World Bank to the financing of imports of equipment, spare parts and other essential imports for the transport and mining sectors confirms the critical nature of import compression for the economy.

Table 2. Industrial production index (%) (1990=100)

Year	Month	Electric and mining			Building material industry			Light industry				Food industry			
		Electricity	Coal	Copper concentrates	Cement	Bricks	Sawn wood	Carpet	Knitted goods	Leather coats	Sheepskin coats	Meat, meat products	Milk, dairy products	Flour	Bakery goods
1991		96.5	98.0	...	51.5	71.3	53.2	71.1	66.1	83.2	80.8	87.3	82.0	91.9	99.9
1992	1	...	83.0	...	62.0	...	...	...	...	...	...	...	...	...	
	2	...	97.2	...	41.8	...	35.9	51.4	40.6	...	42.8	58.9	57.4	74.0	86.9
	3	78.8	96.0	76.9	59.8	39.2	31.5	47.2	39.9	98.8	82.4	53.4	52.2	81.9	89.9
	4	...	89.6	...	21.5	...	31.4	43.7	28.8	75.0	77.0	53.2	51.3	84.5	91.3
	5	...	87.9	...	24.7	...	36.1	44.2	30.3	74.7	93.1	55.3	45.9	90.1	91.7
	6	81.6	86.5	...	27.0	39.1	31.8	53.1	35.4	70.4	74.3	46.1	50.8	94.6	95.0
	7	79.9	83.4	83.8	31.4	37.4	31.9	52.4	37.0	86.2	68.2	62.0	50.2	86.7	95.6
	8	82.7	83.2	0,61 ...	29.5	39.0	32.6	50.4	35.9	92.3	63.7	44.5	45.2	87.1	94.6

Source: State Statistical Office (SSO), Government of Mongolia.

of the privatization of procurement and retailing of food. Deficiencies in transportation hampered the delivery of food from producing areas to urban centres.

This problem was compounded by unrealistically low procurement prices for major agricultural products set by the State. For example, the procurement price for grain in September 1992 was 4.2 tughriks per kilogram compared to a free-market producer price of 25 to 30 tughriks per kilogram.[7] For mutton, the procurement price was 36 tughriks per kilogram compared to a free-market price of 80 to 100 tughriks per kilogram. It was thus not surprising that there were significant shortfalls in state procurement, especially when seen in the context of the far-reaching privatization that has been implemented in the agricultural sector. A further complication arose from the privatization of food-processing facilities such as abattoirs and bakeries and of retail shops. These privatized enterprises were still expected to sell part of their output at controlled prices in order to implement the rationing system, when this was in fact at odds with profit maximization.

The breakdown in the food distribution system extracted a high price in terms of the general social demoralization it created and the disproportionate time it diverted into preoccupations with daily provisionment. The shortages also fuelled inflation by creating scarcity margins which could be exploited by private traders. Above all, it was economically irrational in that scarcities existed alongside available supplies which could not be adequately distributed.

The social costs of transition

These severe economic shocks naturally led to a sharp fall in living standards. Rapid inflation and the emergence of unemployment resulted in a significant weakening of the previously adequate social safety net in Mongolia.

In common with other centrally planned economies, Mongolia had hardly any open unemployment in the pre-transition period. However, at the end of 1991, the unemployment rate had risen to 5.8 per cent increasing slightly to 6.1 per cent in January 1992. Thereafter it decreased fractionally during the first eight months of the year. This decline in the unemployment rate may appear surprising in view of the deepening economic crisis and the apparent intensification of the transition process. However, the answer to this apparent paradox is to be found in the way the transition process has been implemented in Mongolia. Privatization was not initially accompanied by significant restructuring of enterprises or lay-offs of surplus workers. This was partly due to the short time that had elapsed but, more importantly, to a lag in changes in the economic environment and in institutions behind

[7] The official exchange rate was then 40 tughriks to US$1.

formal privatization of ownership. It was therefore not surprising that there was not a dramatic rise in unemployment.

This relatively modest level of unemployment during the early phase of transition is no ground for complacency. The fact that retrenchment was limited in 1992 was a negative performance indicator, highlighting the incompleteness and limitations of the transition process that far. Similarly, continued labour-hiring in state enterprises and newly privatized firms indicated that enterprise productivity had not been raised. Since net investment had fallen to negligible levels as a result of the economic crisis there would not have been any significant new employment creation from this source to explain continued recruitment.

The initiation of the transition process and the external shocks also led to a sharp rise in price levels. The consumer price index increased by 130 per cent in 1991 and by 144 per cent during the first eight months of 1992. Increases in money wages for most categories of workers lagged far behind and real wages fell by over 50 per cent between January 1991 and August 1992. Similar falls occurred in the real value of pensions and other welfare payments. This, taken together with reductions in benefit coverage and in the levels of provision in food, education, health and housing subsidies that occurred in this period, undoubtedly led to an increase in poverty.

In the absence of data on the size distribution of incomes no direct estimates can be made of the numbers below the poverty line.[8] However a strong inference can be drawn that a significant level of poverty emerged as a result of wage and price movements. The minimum wage in Mongolia was calculated on the basis of basic consumption requirements of a household of five members with two full-time earners. The minimum wage multiplied by two was taken to be the poverty line for households. The minimum wage was set at 700 tughriks per month in September 1991. However, the consumer price index had risen by at least 150 per cent by September 1992, so the minimum wage should have been 1,750 tughriks per month if its real purchasing power were to have been maintained. The *average* monthly earnings of employees in the civil service and state budget organizations (1,900 tughriks per month) was only slightly above the required minimum.

It can safely be inferred that the majority of these two categories of workers and their households would have been living below the poverty line. Significantly, in 1990 and 1991 the average earnings as a whole had been roughly twice the minimum wage. The virtual disappearance of this differential indicated that a substantial number of income earners must have fallen below the poverty line. In addition, the value of pensions and social welfare benefits by then lagged so far behind the rate of inflation that they no longer provided minimum levels of income support. These developments

[8] The Government cites a figure of 350,000 persons (17 per cent of the population) living in poverty in mid-1992 but it is unclear how this estimate was derived. See Government of Mongolia: *New orientations for national development* (Ulaanbaatar, Oct. 1992).

in real wages and social security payments, together with the very limited level and duration of unemployment benefits, indicated that a serious problem of poverty had arisen in this early phase of the transition process.

It could be argued that the existence of the rationing system provided a buffer against the rise in poverty, but at best the buffer was only partial, the reason being that ration entitlements per capita amounted to less than half per capita consumption levels of most rationed items. For meat, sugar and rice, ration entitlements were only one-third of per capita consumption and for flour it was only 57 per cent. This, coupled with the fact that rationing covered only 11 items, meant that in order to meet basic food requirements people had to rely to a large extent on purchases at free-market prices. The effectiveness of the rationing system was also seriously compromised by endemic food shortages, disruptions in distribution, and leakages to the free market of supplies obtained through the procurement system.

The transition process

In addition to the difficulties arising from its inherited economic structure and the severity of external shocks, the economic problems were compounded by the manner in which the transition process was handled. The imbalance between the pace of privatization and other essential reforms centred on the dismantling of centralized control of the economy was one basic problem. A related problem was the way in which the privatization process was implemented.

While there had been significant progress towards privatization, much less had been achieved in terms of liberalization of prices and the removal of government controls over both domestic and foreign trade. As a consequence, free-market prices and competitive pressures had not emerged to guide the allocation of resources and the behaviour of enterprises. A wide range of domestic prices were still determined administratively. A particularly glaring example of this was the very low procurement price for agricultural products; this reduced the potential gains from the privatization of agricultural production and disrupted the supply of food products. Similarly, domestic real interest rates were strongly negative. With respect to foreign trade, the exchange rate was substantially over-valued and foreign exchange earnings on a substantial part of exports still had to be surrendered to the State at the official exchange rate. This retarded badly needed export growth and blocked adjustments in the production structure in line with Mongolia's comparative advantage. The over-valuation of the exchange rate also provided a significant margin of protection for non-competitive import-substitution industries.

In addition to the absence of price liberalization, the monetary and labour market institutions appropriate to a market economy had not yet been developed. The privatized commercial banks were controlled by state enterprises which pre-empted credit disbursements, hence crowding out borrowing by the private sector. Financial intermediation and the institutional framework for monetary policy still remained underdeveloped. This, coupled with high inflation and negative real interest rates, destroyed incentives to save and to deposit money in the banking system. Direct cash transactions bypassing the banking system had grown significantly. The upshot was a very strong constraint on savings and investment which stunted the potential growth of a dynamic private sector.

As regards the labour market, the institutions for wage determination and labour allocation according to market signals remained to be developed. Administered wage scales from the central planning system still applied in state enterprises and were unlikely to provide sufficient incentives for differential performance and skill acquisition. The evolution of wages in privatized firms was inappropriate. Wages in these firms had risen as a result of collusive agreements between managers and workers both motivated by short-term interest, and the rises were made possible by the monopolistic power enjoyed by these enterprises. The conditions necessary for improving labour productivity and labour allocation did not therefore exist and this constituted a further obstacle to the growth of an efficient private sector.

The serious price distortions and the inadequacies in market institutions described above meant that the significant privatization that had occurred had not begun to yield significant benefits in terms of improved productivity and growth. There was little evidence of enterprise restructuring and related steps to improve economic efficiency. This was not surprising since, apart from the nominal change in ownership, the distorted prices and lack of competitive pressures faced by these enterprises remained unchanged. An important consideration in this regard was that the industrial structure which had developed under central planning was highly concentrated. This conferred oligopolistic power on enterprises and there was insufficient competition to spur increases in productivity. As a consequence, even with privatization there was still a concentration of market power which militated against competitive price determination and allowed protected wage levels to prevail.

The form in which privatization was implemented in Mongolia also contributed to the lack of progress in terms of improved efficiency and growth of the private sector. The voucher system used to transfer ownership ensured a broad-based and egalitarian diffusion of share-holding in privatized firms. But, in contrast to privatization through competitive bidding for the purchase of assets, the free voucher system did not ensure any injection of new capital or entrepreneurship which could lead to enterprise restructuring and improvements in performance. It is not surprising therefore that the change in ownership was not accompanied by changes in the management and control of privatized enterprises. Moreover no effective system of company governance was in place through which the influence of shareholders on company policies and operations could be ensured.

The transition process was thus at a critical juncture. Unless more thoroughgoing and comprehensive reforms were introduced, there was little hope of economic recovery through the growth of a competitive private sector. In such an impasse, few of the gains of a market economy were being realized while many of the benefits of the old economic system – such as economic stability and generous levels of social protection – had been lost. This was the worst of both worlds and the situation needed to be redressed urgently by pressing ahead with further liberalization measures and the development of appropriate market institutions and mechanisms. These steps would, however, have to be accompanied by a more substantive and effective set of active and passive measures to deal with the increased unemployment and poverty which emerge during an intense phase of transition.

Government employment programmes

Although there was growing awareness of the need to reduce the social costs of transition, the Government faced an overwhelming problem in mounting an adequate response. The main response was the creation of an Employment Fund in 1991 to be used for direct employment creation programmes, its chief objective being the provision of subsidized loans and equipment for promoting small enterprises and self-employment. Some subsidies for short-term training courses for the unemployed were also provided, as were funds for the creation of temporary jobs through public works schemes. The basic thrust of this response was sound in that there was a clear need for active programmes of this type to alleviate the emerging unemployment problem in the context of the economic crisis and transition process. However the impact was limited.

Two hundred million tughriks were originally allocated to the Fund by the Government but by mid-1992 only half this amount had actually been transferred to the Ministry of Labour which is responsible for administering it. This highlighted the very limited resources available in relation to the magnitude of the unemployment problem. The funds amounted to an allocation of only 2,000 tughriks per employed person, implying that only a small subset of the unemployed could receive any meaningful assistance through the Fund.

No systematic data were available on how the 100 million tughriks were used or what results were achieved. From discussions and a field visit to Arvahangai Province, it appears that the funds were first used to set up a network of employment exchanges covering all provincial and district population centres. These were essentially single-person operations linked to the local administration. The functions were to set up an unemployment register, provide placement services and assist in the promotion of employment creation activities. Most of the remaining funds were then decentralized to the provincial level, where they were mostly used for providing highly subsidized loans to start up small enterprises and self-employment activities. Smaller amounts were used to fund temporary employment schemes through public works and to subsidize short training courses for the unemployed.

Several problems should be mentioned. Firstly, mechanisms for monitoring and evaluating the use of funds did not exist at either the national or the local level. Neither was there evidence of any guidelines on the identification and *ex-ante* evaluation of the types of activities to be financed. These are prerequisites for any cost-effective use of resources for direct employment creation programmes. The role of the central administrators of the Fund appears to have been confined mainly to the disbursement of funds to the provincial level, where the administrative and technical capacity to design and implement employment schemes is extremely limited. Secondly, the funds seem to have been used almost exclusively for loans, without any significant allocations for other support services to nurture the enterprises and self-employment activities thus financed. Thirdly, no consideration was given to creating even a partly self-sustaining loan fund. Loans were at give-away negative real interest rates and the initial allocation to the Fund was by then exhausted. Finally, the limited resources were probably spread too thinly to be really effective. This was especially true of self-employment activities where it is doubtful whether the minuscule loans could have had any meaningful and durable outcome.

Clearly, in spite of the best intentions of the Government, little effective relief was provided to the unemployed and other categories who fell into poverty during the first two years of the transition process. Passive measures such as unemployment benefits were too limited, while active measures such as direct employment creation schemes were inadequately funded and administered. Apart from the problem of funding such passive and active measures, there was also the (perhaps more serious) problem of the lack of administrative capacity to design and implement the programmes. The unprecedented nature and magnitude of the unemployment and poverty problems meant that no prior knowledge or experience existed on which the administration could draw. Moreover, drastic declines in public sector salaries during this period had weakened the capacity of the administration to handle normal functions, let alone the large new problems engendered by the transition process.

Missed opportunities?

It is clear from the preceding discussion that a major shift in policies was needed for the transition process to succeed. A strategy to reverse the decline in output and to reduce the social costs of transition was urgently required, a key element of which was the maximization of employment growth. This is essential for containing the inevitable rise in unemployment as well as for ensuring an equitable distribution of the benefits from the transition process. Without successful job creation policies, the transition process risks failure as a result of rising social tensions generated by increasing unemployment and poverty.

The maximization of the rate of productive employment growth requires two main lines of action in Mongolia as in most other transition economies. The first lies in ensuring that overall transition policies such as price liberalization and institutional reforms support rather than retard the growth of productive employment. This is essentially a matter of seeing that investment incentives guide production towards industries that are in line with underlying comparative advantage and factor endowments. It is also a matter of ensuring that relative factor prices reflect relative factor scarcities and that labour hiring is not impeded by excessive regulation and other obstacles.

The second line of action lies in the introduction of effective programmes for direct employment creation targeted principally on the unemployed. A variety of instruments can be deployed to this end, including the promotion of self-employment through credit and other assistance, the introduction of public works and other public employment schemes and training and retraining to facilitate the redeployment of redundant workers. It is clear that the main cause of the rise in unemployment was the fall in aggregate output consequent upon the cessation of Soviet aid and the collapse of CMEA export markets. It is also clear that the sharp fall in investment (from 29 per cent of GDP in 1990 to 12 per cent in 1991) meant that this source of job creation was considerably weakened. Over and above these basic causes, however, one can also identify several aspects of the overall transition policies which helped to aggravate the unemployment problem. These were failure to prevent avoidable job losses as well as the pre-empting of opportunities for higher employment growth in the private sector through the adoption of inappropriate policies. These are worth mentioning here for the lessons that can be drawn.

Irrationalities in the distribution of imported inputs and the breakdown of the domestic distribution system caused some unnecessary loss of output which aggravated the unemployment problem. If reduced foreign exchange resources had been focused on meeting the import requirements essential to maintain output in competitive industries (especially in the export sector), then it should have been possible to mitigate the fall in output. By the same token, if scarce imports had also been concentrated on maintaining adequate levels of operation in transportation and power supplies, the second-round falls in output resulting from a general import compression could have been averted. Instead of this, there was an across-the-board cut in imports and a toleration of the growth of luxury imports in the wake of steps to liberalize international trade. It could therefore be argued that some of the observed rise in unemployment would have been averted with alternative import policies. It is also relevant to note that the effects of the import policies extended beyond a rise in open unemployment. They also caused a rise in short-time work as a result of enforced spells of underutilization of productive capacity.

Another weakness in this phase of Mongolia's transition was the lack of consistent policies to promote the growth of private sector employment. As discussed earlier, the growth of the private sector had been hampered by slow progress in the necessary liberalization of prices, procurement systems, foreign exchange markets, capital markets and controls over international trade. As a result, the growth of productive private sector employment had been below its true potential. The lack of a clear disposition for the attraction of direct foreign investment had also dampened an important potential catalyst for the growth of private sector employment. Similarly, the official attitude towards trading and other own-account activities was at best ambivalent and at worst downright hostile. There was a tendency to equate genuine entrepreneurial efforts to exploit possibilities for arbitrage created by the irrationalities of the economic system with illicit or criminal activities. This prevented a rational harnessing of the evident entrepreneurial drive towards an orderly growth of petty trading and other own-account activities which would have boosted employment growth.

Employment growth was also hindered by policies which failed to adjust strong distortions in relative factor prices. The strongly negative real rate of interest and the grossly overvalued exchange rate served as powerful incentives to greater capital intensity than was warranted by Mongolia's factor endowments. Similarly, the new income taxation law did not allow the deduction of labour costs against taxable income. This created a disincentive to labour hiring among existing enterprises and also discouraged the growth of labour-intensive industries. The sharp rise in wages in privatized enterprises unrelated to productivity increases or other market phenomena also tended to discourage labour hiring and the emergence of labour-intensive industries.

Inappropriate policies for the rural sector also resulted in missed opportunities for higher employment growth. Mongolia has a strong comparative advantage in agricultural production, especially in the livestock sector. Nevertheless, under central planning agricultural productivity had remained stagnant over the past few decades as a result of policies which emphasized rapid capital-intensive industrialization and urbanization. Agriculture had been squeezed through the imposition of strongly adverse intersectoral terms of trade – a phenomenon typical of the state socialist model. This inherited situation provided a major opportunity to exploit both output and employment growth through the correction of the urban bias of the past and the promotion of agricultural growth. However, this opportunity was only partially seized. The almost total privatization of livestock ownership and significant privatization of collective and state farms contributed to an observed rise in labour absorption in agriculture, especially in the livestock sector. However, these gains remained modest since, as mentioned earlier, low procurement prices were still in force and substantial control was still maintained over agricultural marketing and distribution. At the same time, the significant potential for employment generation through the promotion of rural small industries, based on the processing of agricultural products and the development of rural non-farm activities in general, remained untapped. Small enterprise promotion programmes, for instance, had been largely confined to urban centres.

For all these reasons it can be argued that an alternative set of transition policies would have led to better employment outcomes. It must, of course, be recognized that better "employment outcomes" are not synonymous with a lower rate of unemployment. This is because of the trade-off faced by economies in transition between gains in efficiency and the loss of non-competitive jobs. The hesitant progress towards the creation of fully liberalized markets in Mongolia undoubtedly retarded the growth of new productive jobs in the private sector. However, this slow pace provided continued shelter for unproductive jobs (redundant labour) in the public sector and in newly privatized firms. Full-blooded transition policies would probably have led to a significantly higher level of unemployment but would have laid firmer foundations for a higher rate of growth in the future. If accompanied by policies to ensure that the potential for productive employment growth was fully exploited, this would also have represented the best employment promotion strategy.

A strategy for an equitable transition

While there can be little doubt that, from a medium-term perspective, the best employment strategy is to move towards efficient job creation as soon as possible, this has to be tempered by a consideration of whether there are adequate means of coping with the higher unemployment that results in the short run. This relationship underscores the importance of having sufficient capacity to implement effective direct employment creation programmes as an essential complement to overall policies to raise the rate of growth of productive employment.

In view of the deficiencies in the implementation of direct employment creation schemes pointed out earlier, it is important for Mongolia to have a central agency capable of coordinating the work of various ministries and mobilizing the contributions of NGOs and the private sector in the implementation of such schemes. Such a body needs the technical capacity to design and carry out *ex-ante* appraisals of activities to be financed, as well as to monitor and evaluate the implementation of programmes. Aspects of this include the capacity to produce guidelines for the use of provincial and lower-level authorities responsible for designing and implementing programmes, and the training of officials at the local level in programme design, implementation and evaluation.

It is also necessary to implement measures to ensure that a significant proportion of the unemployed benefit from employment creation programmes. This involves action on several fronts. Firstly, adequate resources need to be made available to the Employment Fund, complemented by efforts to formulate sound proposals for mobilizing external assistance. Secondly, the Fund should be at least partially self-sustaining. This involves attention to the reimbursement of loans and administering funds used for small enterprise credit through the banking system, at positive real interest rates, to ensure that the Fund is not eroded over time but revolves. Thirdly, the portfolio of activities that are financed need to give adequate attention to public works programmes, which can reach larger numbers and are an effective means of ensuring work and basic incomes to the unemployed who would otherwise face destitution in the absence of adequate welfare support.

It is unlikely that all those adversely affected by the intensification of the transition programme can be catered for by such employment creation programmes. The potential size of such programmes is limited by financial constraints, implementation capacity and the reduced scope for generating economically viable activities under conditions of severe economic crisis. In addition, some proportion of those adversely affected by the transition are not able to participate in such programmes because of family responsibilities or reduced capacity to work. For all these reasons it is imperative to complement employment creation programmes with an effective income support programme targeted on vulnerable groups. This requires either a reform of the existing social welfare system or the creation of a new system of targeted income transfers to vulnerable groups. In either case there needs to be improved information on household income and other characteristics as the basis for estimating needs, defining entitlements and eligibility criteria, and controlling disbursements. In addition, a cost-effective administrative arrangement for implementing the scheme is essential.

In conclusion, the core characteristics of the strategy can be simply reiterated. The transition process needs to be intensified in terms of price liberalization, the removal of other state interventions in markets, and the restructuring of enterprises. This means a swifter move towards allowing market competition to determine resource allocation and would represent a significant improvement over the impasse created by partial and sometimes contradictory steps towards the creation of a market economy. Such an intensification of the transition process is the most effective means for ensuring a revival of growth and efficient employment creation in the medium term. However, the feasibility of doing this depends crucially on developing an adequate social safety net to cope with the sharp rise in unemployment and poverty that invariably occurs. Unemployment will rise significantly as uneconomic enterprises are shut down and retrenchments are implemented in enterprises which need to be restructured. Poverty will rise in the wake of further inflation generated by fuller price liberalization. Installing the essential social safety net necessitates not only financial resources but also the creation of the requisite capacity to implement employment creation and income support programmes. The crux of the transition problem is therefore the feasibility of creating an adequate social safety net within a reasonably short period. This dilemma concerning the advantages of intensified transition and the social costs can be attenuated if significant external financial and technical assistance is made available but it requires a massive mobilization of financial and human resources in Mongolia.