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# TRANSITIONAL ECONOMICS: THE MONGOLIAN PATTERN AND COMPARATIVE ANALYSIS

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## 1. THE MONGOLIAN PATTERN OF TRANSITION

**Mongolia has entered a era of transition from a centrally planned to a market economy.** Human history confirms that markets are tested means for solving the question how of and what can be done to match limited resources with measurable needs existing in any society.

Like other peoples, Mongols have experienced rise and fall, fragmentation and unification. The Mongolian Empire of the twelfth and thirteenth centuries, founded by Chinggis Khan is well known to the whole world. Mongolia then lost its independence, and for over 200 years (1691-1911), it had been under the Manchu rule.

Present-day Mongolia attained its independence as a result of the national liberation movement of 1911 and the People's Revolution of 1921, and embarked on the road of free, independent development. **After that, a centrally planned economy was established as the only acceptable path of development.**

1. However, the general picture of the development of Mongolia's economy from 1911 to 1940 was in many respects, similar to the current process of transition to a market economy rather than a centrally planned one. The main difference today is that the former path of economic development was not oriented to market development, but to a centrally planned economy. So, that earlier period is regarded as a stage which laid the foundations for a centrally planned economy.

As part of the new economic structure, new economic sectors emerged, such as trade, industry, transport, and communications. Retail trade turnover increased 21.1 per cent. In 1940, the state accounted for 30.8 per cent, of trade, while cooperatives contributed 59.5 and the private sector 9.5 per cent. Where in 1924, Mongolia produced industrial output of 0.3 million tugrugs and by in 1940 it had reached 124.7 million tug. Freight turnover of road transportation increased from 0.3 mln t/km to 13.3 mln t/km. In the same year, the country had twenty-five post offices, twenty telephone stations, 2,400 telephones, sixteen radio stations, 4.4 mln wired-radio outlets and 10.9 mln km telephone and telegraph lines.

In the course of cultural change, there has developed a new non-material sphere, which did not exist

in the pre-revolutionary Mongolia, centered on education, culture, sciences, art, health-care, physical culture and sport. This was a real "cultural revolution".

The fact that the state had a the monopoly on foreign trade can be noted in history as an important phenomenon which strengthened the "political independence" of the country by adding economic independence and ensuring the prerequisites for a non-capitalist development path. History remains, but a new approach should be applied to historical writing. Based on international trade theory and Mongolia's experience of transition to a market economy, are can conclude that establishment of a monopoly on all import and export goods and non-recognition of any trade partners but one, constituted an historical mistake linked to creation of a centrally planned economy and a Soviet-style socialist system. However, by creating new economic sectors, national trade and a financial system, it immeasurably aided the newly attained independence. This is the truth.

2. At the initial stage of the centrally planned economy, there were various forms of property. In the end, state enterprises and farms, state or public sector cooperatives dominated. With the exception of the last few years of Communist rule, Mongolia practically had trade and economic relations with only one state, the former Soviet Union.

From 1941 to the 1960s, the Gross National Product increased 3.7 times and national income 3.8 times. In 1959, cooperation (collectivization) of individual households was completed. Along with this, an equally important development was the cultivation of virgin lands. As a result, the country could meet domestic needs with its own grain harvests, and land cultivation became an independent branch of agriculture.

The Mongolian economy industrialized, and so the share of industry and other industrialized sectors increased sharply. Whereas industry accounted for just ten per cent of the national income in 1940, it had increased to thirty percent by 1960, and where state and cooperative sectors accounted for 29.5 per cent of national income in 1950, they generated almost 100 percent in 1960. This meant that formation of the centrally planned economy had been completed.

3. From 1961 to the 1990s, the country had a centrally planned economy dominated by state property. On the basis of the state-written plan, economic management was so centralized that it led to severe limitations on market relations. Production cooperatives were brought into state forms in 1972, individual households could not sell products they had produced, and members of agricultural cooperatives were restricted in sales of part of production of cooperative farms or individual farms at free market prices. During this period, the GNP increased almost five times and national income 3.9 times. This was the outcome of rapid growth of industrialized sectors, and indicates the dominating position of industrial production. Thus, the centrally planned economy centered on state-selected products of nationalized units, and planned relations among them served as enforcing mechanism.

For instance, the Mongolian economy was closed within the Council of Mutual Economic Assistance (CMEA), and was protected by means of a foreign trade monopoly. This monopoly not only protected national production from foreign competition, but used its newly unlimited power to isolate it. The foreign trade monopoly protected the centrally planned economy, and such a power was ensured only through a centrally planned economy.

The four main economic features of central planning were as follows:

**A. The macroeconomic balance by direct control.** Nominal prices and wages were almost always fixed in socialist economies. Interfirm financial flows became the passive outcome of central directives. Since only wages were paid in cash, they determined household purchasing power, and the level of wages was a critical factor for balancing supply and demand. Before the collapse of the



old regime, wage increases often exceeded the upward adjustment in prices and the ability of the economy to provide consumer goods. As a result, consumer goods were rationed, and households were left with an involuntary accumulation of financial assets or a monetary overhang associated with repressed inflation.

**B. Coordination through plans.** Economic activity was based on a central plan, with quantitative output targets specified in physical units. Heavy industry was accorded priority over consumer goods production, and service sectors were repressed and accorded low priority in the allocation of resources.

**C. Little private ownership.** With few exceptions, all property belonged to the state, and private ownership was not allowed. A lack of a profit motive, arising from the absence of private ownership, hurt efficiency. So did the concentration of activity in large firms, which were more compatible with a system of planned allocations.

**D. Distorted relative prices.** Prices played an accounting role and were set in accordance with the central plan. Implicit prices of essentials, including housing, energy, transportation, education, and medical care were kept low, and land prices were essentially zero. Implicit trade margins were low, and prices of final goods did not reflect differences in distribution costs.

The specific features of Mongolia transition to a market economy concern the transition from a centrally planned to a market system, entering normal capitalist development through an unusual way; new creation of market products and units, as well as determination of their relations and mechanisms; simultaneous confrontation with two large strategic tasks: accomplishing this complicated historical transition and restoring a declining economy.

Depending on development issues, the market in Mongolia is generally regulated by the state. Throughout history, there has been no market without the involvement of states. Especially in developing countries involvement of the state is needed, particularly in the initial stages of development, transition from a centrally planned to a market economy requires special attention and caution. I would call this process of conscious transition "an unnatural transition to the natural way of development". However, Mongolia got lost in trying to follow "the natural way". Therefore, the national economy broke down society faced a mass of problems.

An already developed market faces an entirely different set of problems. A market in its initial stages has to be developed consciously. Transition to a market economy is a common problem, but how to accomplish it is nation-specific. Even in developed countries, the state must fulfil the role of regulator. For instance, while the monetarist school would restrict the role of a state to creation of stable conditions for economic development through effective monetary policy, the Keynesian school emphasizes a stronger state role in economic regulation. In reality, any state participates in the market activities through varying means. For instance, scholars call the American economy a mixed economy with a dominating market.

In Mongolia, **state regulation** has the following directions which are common for all states:

- (1) Creation of a favorable legal and social environment, in order to stimulate active market operations;
- (2) Support of market competition, i.e., to keep economic actors on a "proper" level and protect them;
- (3) Distribution of income through direct participation in market activities, operation of a taxation system and disbursement of welfare free payments;
- (4) Solution of matters relating to transfer of resources in large quantities to other sector affected by nonmarket factors, according to law and regulations and by special taxation;
- (5) Production and financing by the public sector of some goods and services affecting social welfare;

(6) Policies to combat unemployment and inflation;

(7) Redistribution of aggregate income, and stabilization of the national economy:

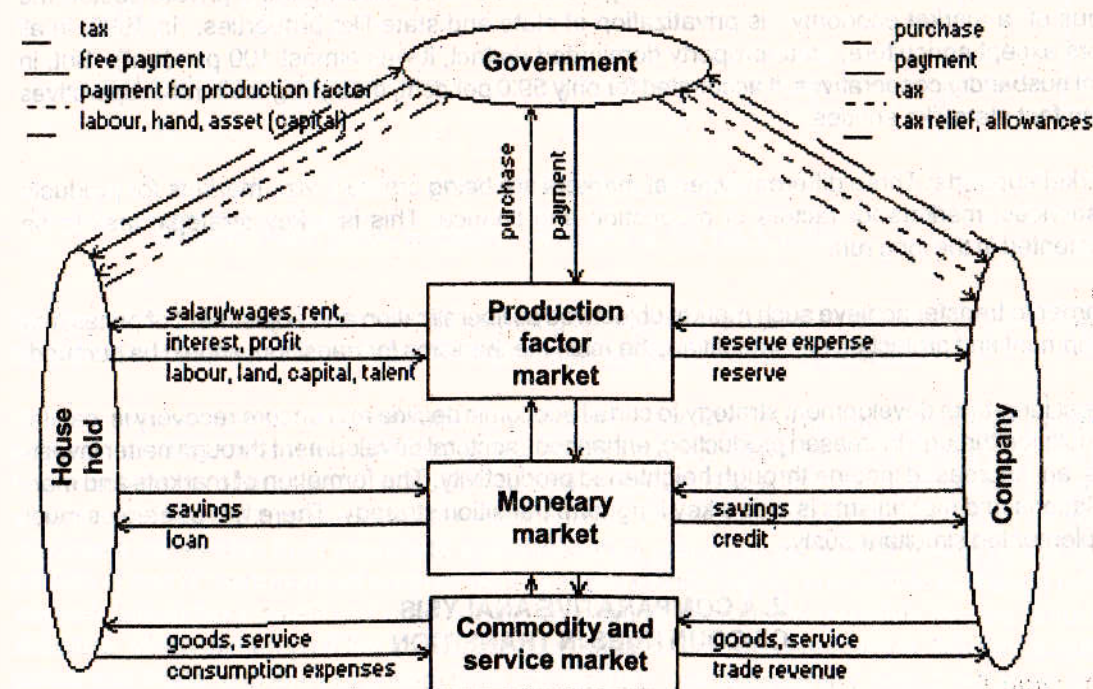
Like other developing countries, the Mongolian state plays an active role in "selecting winners". The winners are relatively advantageous branches with future which are entitled to receive all-round assistance from the state.

The experiences of the Newly industrialized Countries share the efficacy of strong states involvement in developing economies at initial stages. In these countries, it was impossible to generate the large investments necessary to develop new industries as to implement costly scientific and technical development projects without state assistance. These nations would not have reached their current positions in the world economy and market if their governments had not helped them.

A key characteristic of developing countries is the major role of agriculture in their economies. Small scattered households have to sell their products to large buyers at low prices, and buy from them at high prices, and thus incur double losses. The same happens in Mongolian rural areas. State regulation is necessary to alleviate such adverse effects of market relations. Likewise, there is alternative to filling some gaps in the early market relations with state regulation. For instance, the state selects the sectors to be included in a market economy through the process of privatization. The state regulates the process of liberalizing price, the main mechanism of market relations. The state also lays the legal foundations for regulation of market relations.

Besides, there are many areas such as the environment, the non-renewable resources, public health, education, culture, science, and national defence, which are not covered by the market regulations. These are public goods that must be developed by the state. **Therefore, formation of a market system with state regulation in Mongolia is founded in theory and proved in practice.**

Figure 1. Revenue and expenditure flow among the market subjects





The above illustration compares the selection of economic objectives and transition to a market economy to the wood frame structure of a Mongolian ger (yurt). The drawing further indicates key market, sectors:

1) household business, companies and the state;  
2) economic units, i.e., factors of production, finance and service sectors (in the initial stage), and  
3) the inadequacy of overall economic relations and weak economic institutional mechanism. In the absence of fundamental market relations, how can other economic relations be formed? In particular, in the absence of basic market relations and institutions, monetary, fiscal budget, tax and other policies will not yield results, and the transition process and economic recovery may slow down. In the end, economic decline presents an obstacle to the development of markets. Thus, some experts suggest the need for simultaneous implementation of two strategies: to promote markets as generators of development, and development as ground for the formation of markets.

1. It is clear that markets can develop, if there are economic activities. In a macro sense, these sectors are households, companies and state. Creation of such sectors anew is a long-term strategic task, and in order to do this, the following should be done:

(1) To be considered an economic unit, a household should consist of one or more people, decide its own matters independently, own its own means of production, strive to satisfy its own needs to the utmost and most productively uses available resources. Households include consumers, employees, small and large owners of capital, land and means of production; therefore, it is necessary to improve their composition, efficiency and ability to do business.

(2) It is necessary to support companies, and economic units which use productive factors for manufacturing and selling goods to other companies, households and state-all of which seek to maximize profits.

(3) To attain social objectives, the scope of the state should cover competent economic units and government agencies, both legal and political, that supervise market operations.

All three sectors have mutual relations in the market, but differ in their structure, developmental level and in scope of activities. The main way to create and development the private sector, the nucleus of a market economy, is privatization of state and state-like properties. In 1990, in all sectors except agriculture, state property dominated (in fact, it was almost 100 per cent). But, in animal husbandry cooperatives, it accounted for only 59.0 per cent, though agricultural cooperatives were in fact state-like entities.

2. Market supports: Three different types of markets are being created, viz., markets for products and services, markets for factors of production and finance. This is a key strategic task to be implemented in the long run.

3. In order to transfer achieve such market objectives as liberalization and adjustment of prices, the development and protection of competition, the main mechanisms for transition, should be pursued.

The best long-term development strategy to curtail economic decline and ensure recovery is: capital accumulation through increased production, enhanced, sectoral development through better investments, and increased income through heightened productivity. The formation of markets and market relations and mechanisms is also a key long term transition strategy. These two strategies must be implemented simultaneously.

## 2. A COMPARATIVE ANALYSIS OF COUNTRIES IN TRANSITION

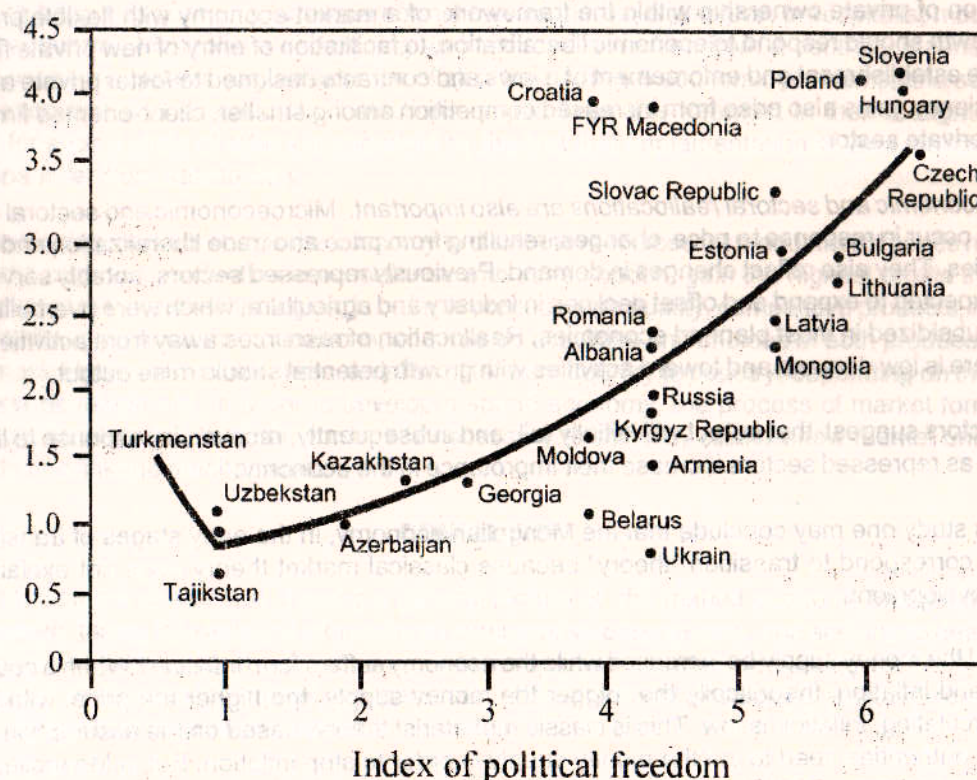
Economic transition and comparative economic play very important roles in modern economics.

This is because many countries are transiting to market economies through both economic development and command-to capitalist transition. Many post-socialist countries, in particular Mongolia, are changing through such a transition process.

Comparative research shows that the Mongolian democratization process is successfully developing. M. de Melo, C. Denizer, and A. Gelb, using World Bank data on economic transformation, Mongolia places in the second group of four (twenty-six countries total).

Figure 2. Political Freedom and Degree of Economic Liberalization in Twenty-Six Countries in Transition, 1989-94

### Cumulative Liberization Index



Source: World Bank. Economic Review vol. 10, No 3, p.420.

Comparative Experience is shows that following changes have occurred because of the disintegration of the old regime, and in response to the aggressive economic liberalization:

1. *Initial macroeconomic destabilization is generally followed by re-stabilization.* When prices and wages are initially liberalized, stability is lost. Prices typically increase, especially if they are freed under conditions of repressed inflation. The immediate challenge for macroeconomic policy is to slow the rate of price increases, and reverse inflationary expectations and capital flight. This change requires a conversion from passive to active monetary policy, characterized initially by the reintroduction of one or more nominal anchors (an expanded money supply, convertible exchange rates, or wages). Inflationary pressures may persist because of attempts to maintain the old production structure, which centered on the granting of large subsidies to state enterprises. But liberalization of prices and trade, and entry of private firms can facilitate restructuring and hence reduction of such subsidies. This, in turn, allows inflation to fall.



2. *Output declines, due to disruptions in industrial coordination, because the sudden abolition of planning in a complex, highly interdependent economy can impede state economic control.* This disruption affects both useful and unwanted production, until an efficient system of market coordination evolves. Short-term increases in transaction costs can be considered a negative supply shock to economywide production functions, which includes coordination activities (such as for trade and payments, including those between newly independent states) as an intermediate sector. The fall in output and the delay in recovery - will be greater the higher the initial reliance on central planning, the more the planning system is disrupted, and the slower the development of a new, market-based coordinating system in response to liberalization.

3. *Output rises, due to private ownership and private sector growth.* Efficiency gains come from legalization of private ownership within the framework of a market economy with flexible prices. Thus, growth should respond to economic liberalization, to facilitation of entry of new private firms, and to the establishment and enforcement of a laws and contracts designed to foster private activities. Efficiency gains also arise from increased competition among smaller, client-oriented firms in the new private sector.

4. *Microeconomic and sectoral reallocations are also important.* Microeconomic and sectoral reallocations occur in response to price changes, resulting from price and trade liberalization and cuts in subsidies. They also reflect changes in demand. Previously repressed sectors, notably services, can be expected to expand and offset declines in industry and agriculture, which were overbuilt and heavily subsidized in most planned economies. Reallocation of resources away from activities for which there is low demand and toward activities with growth potential should raise output.

These factors suggest that output will initially fall, and subsequently, recover, in response to liberalization, as repressed sectors increase their importance in the economy.

From this study one may conclude that the Mongolian economy, in the early stages of transition, does not correspond to transition "theory" because classical market theory does not explain its current development.

(1) Should the money supply be increased while the economy suffers from inflation? When a country has demand inflation, theoretically the bigger the money supply, the higher the price; with less money circulating, inflation is low. This is classic monetarist theory, based on the assumption that monetary authorities need to cut the money supply in order to stop inflation. But in Mongolia, the money supply dropped 5900 percent, commodity supplies decreased by half, and while inflation reached worrying levels, currency is in shortage. The real need to raise the prices of agricultural products and finance land cultivation necessitated increasing money in circulation. This was not so dangerous because the inflation was caused by spending and not demand. Demand inflation can be fought by reducing the currency in circulation, but to halt expenditure inflation support for production and greater supply of goods is more suitable.

(2) Should prices be raised, while production is decreasing? Decreasing production through reduction of prices conforms exactly to the law of supply and demand. Similarly, according to the law of supply and demand, production should increase with rising prices. However, while the price of goods and services increased about 6,000%, the volume of national production decreased by thirty to forty percent. This also does not accord with theory.

(3) So, if the economy does not accord with "theory", does a country have to pursue the policies usually prescribed for that situation? According to directives on economic and social development issued by the government, incomes were supposed to increase by eight per cent in 1992, but this

did not happen. It is an indication that it is impossible to pursue an "abnormal" policy in an "abnormal" economy.

(4) Is it right to pursue a policy in accordance with "theory" when the economy fails to conform to theory? We are now pursuing a tight monetary policy. Such a policy is important to increase interest rates, attract foreign capital, and reduce and eliminate balance deficits of payments. Nevertheless, high interest does not serve the purpose of supporting newly emerging private business. Again, it is impossible to copy and use "normal" economic policy in an "abnormal" economic environment, and policy should be made according to the conditions of the economy in transition.

First, one should realize that the economy is truly "abnormal", and then seek proper ways and means to bring it to normalcy. Unlike a normal transition from a primitive, precapitalist mode to a market economy, Mongolia is undergoing an intentional transition from a centrally planned to a market economy. Herein lies the essence of all of the country's economic problems, and so legislative, executive and bureaucratic institutions should keep this foremost in their thoughts. The reason for such a state of affairs is underlain by the fact that implementation of laws, policies and decisions is far from satisfactory.

Well-functioning markets enable the economy to distribute resources for production of goods needed in society, organize production in accordance with consumption, gain the highest profits through application of the latest technologies, in order to produce high quality, competitive products, flexibly adapt to changing economic conditions, and free up activities and choices of both producers and consumers. However, market characteristics differ from country to country, depending on the level of market development. In order to develop a sound economy, the process of market formation should be accelerated. In other words, it is necessary to speedily create anew market units and supports and linkage mechanisms.

## CONCLUSION

1. Our studies are directed at framing a general picture of the market economy being formed in Mongolia, taking into account international comparative experiences, and seeking to determine strategic objectives for the formation of major component parts; in so doing we have a dual purpose: to develop the market as a generator of development and accelerate development as the soil in which to grow the market.
2. Comparative experience has shown that the success of economic reform depends mostly on political reform. This is confirmed in the case of Mongolia, which is conducting simultaneous political and economic reforms.
3. As the historical analysis shows the centrally planned economy was centered on state control, state-owned economic units, planned economic relations and command mechanisms.
4. Marketization can lead to the strategic objective of creating a highly productive economy capable of absorbing new scientific and technological achievements and meeting demands of consumers. In this sense, Mongolia has made a historic choice to pursue transition to a market economy.
5. Specifics of Mongolia's transition to a market economy center on its shift from a centrally planned to a market system. This is an abnormal jump to the "normal" path and necessitates formation of new, market units and supports, as well as their mutual relations and operations. It also has to solve two major strategic problems at the same time carrying out a complex, historic transition and lifting the national economy from its depression.



6. Depending on specifics of development, the market in Mongolia will probably be regulated by the state.
7. This study shows, that market units are household husbandry, companies and the state, objects while supports consist of factors of production, finance and services which are in the initial stages of development. The process of creating national market relations and complex economic mechanisms is far from satisfactory. In the absence of basic market relations and mechanisms, regulations carried out by monetary, fiscal, taxation and other policies will not yield results, and the processes of transition and economic recovery will be slowed. Economic decline also becomes an obstacle to the process of market formation.
8. A long-term development strategy that will halt the economic decline and ensure recovery must concentrate on accumulation of capital through increased production, support for development through heightened investments, and raising incomes due to better productivity. The formation of market units and supports, as well as their mutual relations and mechanisms is a long-term strategy for transition to a market economy. Simultaneous implementation of these two strategies is a strategy best suited to specific of the Mongolian transitional economy.

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