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Bhutan: Strengthening Economic Management Program II (Second Tranche)

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 03 May 2017)

Currency unit	–	ngultrum (Nu) ^a
Nu1.00	=	\$0.0155
\$1.00	=	Nu64.1200

^a The ngultrum is pegged to the Indian rupee at par.

ABBREVIATIONS

ABS	–	asset-backed securities
ADB	–	Asian Development Bank
BDBL	–	Bhutan Development Bank Limited
BNBL	–	Bhutan National Bank Limited
BOBL	–	Bank of Bhutan Limited
CAR	–	capital adequacy ratio
CIB	–	Credit Information Bureau
CIC	–	community information center
DRC	–	Department of Revenue and Customs
FLP	–	financial literacy program
FSR	–	financial stability report
FY	–	fiscal year
GDP	–	gross domestic product
ICT	–	information and communications technology
MMI	–	money market instrument
MOF	–	Ministry of Finance
MPR	–	macroprudential regulation
NPL	–	non-performing loan
NPPF	–	National Pension and Provident Fund
PAVA	–	Property Assessment and Valuation Agency
POS	–	point of sales
PVM	–	property valuation methodology
RENEW	–	Respect, Educate, Nurture, and Empower Women
RAMIS	–	revenue administration management information system
RICBL	–	Royal Insurance Corporation of Bhutan Limited
RMA	–	Royal Monetary Authority
ROC	–	Registrar of Companies
RSEB	–	Royal Stock Exchange of Bhutan
SDR	–	Special Drawing Rights
SEC	–	Securities and Exchange Commission
SEMP	–	Strengthening Economic Management Program
SPV	–	special purpose vehicle
TA	–	technical assistance
T-Bills	–	treasury bills

NOTES

(i) The fiscal year (FY) of the Government of Bhutan and its agencies ends on 30 June. “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY2017 ends on 30 June 2017.

(ii) In this report, "\$" refers to US dollars.

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I. INTRODUCTION

1. The Strengthening Economic Management Program II (SEMP II or the program)¹ was designed as a continuation of SEM P I² to address two critical development constraints. On the cyclical side, the government's macroeconomic management capacity required strengthening to effectively manage macroeconomic shocks and mitigate their impact in the context of the successful contribution of SEM P I to economic stabilization following the rupee liquidity crunch in fiscal year (FY) 2012. Second, on the structural side, distortions related to an overconcentration of bank lending—primarily in real estate development—required creating new areas for expansion of financial intermediation to promote diversification of the economy.

2. In the short run, SEM P II aimed to continue and deepen macroeconomic management reforms to sustain the momentum of recovery and improve the resilience of the economy by strengthening domestic revenue mobilization through improvements in tax administration and taxpayer service delivery, and macroprudential management with enhanced regulatory and supervisory framework and oversight for financial sector stability. Over the medium to long term, the program aimed to promote investment to rebalance growth and reorient and diversify the economic base while strengthening the business climate for private sector. The reforms under the policy-based intervention sought to increase the efficiency of financial intermediation by addressing key bottlenecks, including: (i) lack of diversification and depth; (ii) the high cost of financial intermediation and information asymmetries associated with access to finance; (iii) inadequate outreach to the rural and low-income population; (iv) limited financial literacy; (v) lack of long-term financing instruments, especially for infrastructure; and (vi) low savings mobilization. ADB introduced customized reforms under SEM P II with implementation and capacity building support through a piggybacked technical assistance (TA). The combined SEM P I and SEM P II constituted a programmatic, sequential reform approach towards improving macroeconomic management and financial sector development (Appendix 1).³ The program was fully aligned with the ADB country partnership strategy, 2014–2018 targeting improved public sector management, financial sector development, and private sector promotion in Bhutan.⁴

3. SEM P II was approved and made effective on 16 June 2015. The program has two tranches, providing budgetary support to the Government of Bhutan: (i) the first tranche (a \$16.1 million grant) was fully disbursed following program approval and effectiveness, reflecting full compliance with 8 first tranche policy conditions; and (ii) the second and final tranche (a loan, equivalent of Special Drawing Rights [SDR] 14,443,000), which is scheduled for release by 30 June 2017, subject to full compliance with the 16 policy actions. On 22 November 2016, the original program closure date of 31 December 2016 was extended to 30 June 2017 to accommodate implementation delays due to (i) legislative and administrative issues on formulation of property tax proposal for local governments (paragraph 8); (ii) the corporate takeover of the software vendor, and resulting disruptions in revenue administration management information system (RAMIS) development; (iii) the need to supplement the TA budget to accommodate unexpected cost overruns for the procurement of information and communications

¹ ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Loan, Grant and Technical Assistance Grant to the Kingdom of Bhutan for the Strengthening Economic Management Program II*. Manila.

² ADB. 2013. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Loan and Grant to the Kingdom of Bhutan for the Strengthening Economic Management Program*. Manila. SEM P I introduced reforms that strengthened (i) fiscal management, (ii) debt management, (iii) monetary and liquidity management, and (iv) internal and external audit systems in Bhutan.

³ The linkages between the SEM P I and SEM P II in terms of continuity and complementarity between outputs, policy actions, and TA support are provided in Appendix 1.

⁴ ADB. 2014. *Country Partnership Strategy: Bhutan, 2014–2018*. Manila.

technology (ICT) equipment and software for the taxpayer information call center and the Credit Information Bureau (CIB), and subsequent repetition of the bidding to obtain the lowest price quotes; and (iv) the recruitment of call center agents.

II. RECENT MACROECONOMIC AND POLITICAL DEVELOPMENTS

A. Macroeconomic Developments

4. Following the deceleration that ensued from the rupee liquidity crunch, the economy has successfully stabilized. With the contributions of SEMP I and SEMP II, the economic recovery has been robust while inflation has been kept in check during FY2014—FY2016. Credit to the private sector has gradually increased in FY2015 and FY2016 following the engineering of a soft landing through government measures to cool down an overheated economy. Fiscal management has been prudent. In the external sector, capital inflows for hydropower have been instrumental in countering the current account deficit, and largely account for the increase in foreign exchange reserves. The analysis of macroeconomic developments and key economic indicators are in Appendix 5 and Appendix 6.

B. Political Developments

5. Bhutan held National Assembly elections on 31 May and 13 July 2013. The result was a victory for the opposition People's Democratic Party, which won 32 of the 47 seats. The elections were the second general elections since 2008, when Bhutan successfully completed its political transformation from an absolute to a constitutional monarchy. The current government has been fully supportive of the SEMP II reforms, reinforcing its efforts to promote sustainable and broad-based economic growth in Bhutan.

III. STATUS OF PROGRAM IMPLEMENTATION

6. The release of the second tranche requires compliance with 16 policy actions under two outputs, which target (i) improving macroeconomic management, and (ii) strengthening financial sector development. The policy actions contribute to achieving the outcome of improved macroeconomic stability and the impact of a sustainable growth trajectory. The compliance status of second-tranche policy actions is in Appendix 2. Details are provided below.⁵

I. Output 1. Improved Macroeconomic Management

A. Revenue Management

7. **Tranche 2, policy action 1.** *(i) The property tax rates based on the property valuation methodology shall have been submitted to Parliament (partially complied with), and (ii) the policies, systems and processes, which are necessary to collect property tax using the new rates shall have been completed within the municipality of Thimphu (complied with).* Although municipalities have been authorized to collect property taxes based on the Municipal Finance Policy, land and urban house taxes have been based on unit or area-based fixed rates and have not been revised since 1992, resulting in declining and reduced real rates. The existing property taxation system

⁵ The language of the policy actions in this section reflects the Attachment 3 of Schedule 3 in SEMP II Financing Agreement signed on 15 June 2015 between the Royal Government of Bhutan and ADB.

creates significant undervaluation, leading to sizable revenue losses for municipalities.⁶ To enhance municipal revenues and improve the financial self-sufficiency of local governments by reducing their dependence on central transfers⁷ and to support the fiscal decentralization efforts, property tax rates based on the property valuation methodology (PVM)⁸ were submitted by the Cabinet to Parliament on 15 February 2017. However, the tax rate and methodology approved only apply to Thimphu *thromde* (municipality), and the property tax proposal for the remaining 19 *thromdes* was not introduced as originally intended under the policy action.

8. The Supreme Court writ issued in 15 August 2016 declared the *dzongkhag* (administrative and judicial district) *thromdes* “unconstitutional”, except for Thimphu *thromde*, on the basis that they have only 6 constituencies under the existing delimitations, based on registered voters and size, and thus do not fulfill the criteria under the Local Government Act, requiring having at least 7 and not more than 10 elected constituencies. The Supreme Court thus postponed local government elections until these *thromdes* fulfill the criteria, which has not occurred as of writing of this report. This legal decision, in combination with Cabinet’s earlier requirement that local government-related tax proposals be received only directly from a *thromde* administration, meant property tax rate proposals could not be introduced for the remaining 19 *thromdes*. In addition to the legal issues, the decision to develop the tax proposal solely for Thimphu was guided by (i) the limited implementation capacity and ability to pay in other *thromdes*; (ii) TA, provided only to Thimphu under SEMP II; and (iii) willingness of Thimphu to prepare a property tax proposal (together with the Ministry of Finance [MOF] task force) to boost municipal revenues for better urban service delivery.

9. As the largest city in Bhutan, the introduction of PVM-based property taxation and preparation of the tax collection infrastructure in Thimphu will set an example for other class-A *thromdes*.⁹ When these *thromdes* are fully constituted with elected bodies as per the requirements of the Local Government Act, and adequate preparations are completed for property databases and revenue collection infrastructure, they will be in a position to submit their own tax proposals, depending on local circumstances and the ability of citizens to pay.

10. The proposal for Thimphu introduces (i) a tax rate of 0.2% on the value of land and 0.03% on the value of properties;¹⁰ (ii) vacant land tax at 25% of the land tax value, subject to fulfillment of certain conditions; and (iii) a property transfer tax of 5% of the sales value of the property, subject to exemptions. A fiscal impact analysis was conducted using a representative sample of 1,254 land parcels (out of 8,000) and 1,255 buildings (out of 5,000), selected based on various construction and land characteristics, and residential and commercial use in different municipal zones. Based on the analysis, once the new rates are effective, estimated increase in

⁶ The land tax and urban house tax constituted only about 8% of the total revenue of Thimphu municipality in FY2011 (Ministry of Finance [MOF]. *National Revenue Report 2011–2012*. Thimphu. p. 9).

⁷ Local government allocations made up 44.4% of expenditures in the FY2017 budget (MOF. *National Budget Financial Year 2016–2017*. Thimphu p. 63).

⁸ PVM rules, as prepared by the Property Assessment and Valuation Agency (PAVA), were approved by MOF, came into effect on 21 March 2014, and were piloted in Phuentsholing *thromde* under SEMP I. Preparation of PVM was supported by ADB. 2010. *Technical Assistance to Bhutan for Strengthening Public Management in Bhutan*. Manila.

⁹ *Thromdes* are classified into two types in Bhutan, class-A and class-B, depending on the population, density, area, and non-agrarian activities. There are 4 class-A *thromdes*, which are Thimphu, Phuentsholing, Samdrup Jongkhar, and Gelephu and the remaining 16 *thromdes* are class-B, which are newly established, small, rural municipalities with limited capacity in municipal revenue generation.

¹⁰ The fair economic value of land will be based on PAVA rates, which are objectively determined by market rates from land sellers, capacity of the land to produce monetary income, financial institution rates for insurance and mortgage purposes, official land transaction records of the *thromdes* and National Land Commission. Bhutan Schedule of Rates (based on Phuentsholing *thromde*) will determine the value of buildings based on cost of construction considering cost of materials, labor, transportation costs, age and life of the buildings.

land revenue is 37.6%, from Nu15.2 million in FY2016 to Nu20.91 million. The estimated building tax revenue increase is 27.6%, from Nu1.05 million in FY2016 to Nu1.34 million.

11. Revenues will potentially increase with wider coverage of land and buildings. Under the new PVM-based system, for certain centrally located zones in Thimphu, once the new rates are effective, current property taxes can increase by as much as 300%–450%, reflecting an upward adjustment in taxes that have not been revised since 1992. A more gradual, step-wise increase in taxes has also been considered to improve the affordability to taxpayers. This ad-valorem taxation based on the estimated value of property is more efficient, equitable and progressive, which scores better on the principle of ability-to-pay compared to the unit and area-based fixed rates, because it considers the economic value of the property and the income it generates for the property owners. The PVM-based taxation is also likely to improve prudential assessment of the real estate market. The banking system can more accurately apply prudential indicators—such as standard loan-to-value ratios—that serve to contain asset price buildup by reflecting a property’s true valuation. PVM will also help the municipality generate its own additional resources for improved urban service delivery, which will benefit the poor. Over time higher revenue collection by Thimphu will contribute to the fiscal self-sufficiency of the *thromde*, and reduce transfers from the central budget, thereby improving the government’s fiscal balance.

12. The Department of Revenue and Customs (DRC) submitted a report on 15 March 2017 on the completion of policies, systems and processes necessary to collect property tax within Thimphu using the new rates. With ADB TA support, Thimphu’s ICT-based revenue management system (RMS) was modified and synchronized with the requirements of PVM-based taxation. A pilot study was conducted with 50 properties in Thimphu using PVM and RMS to conduct scenario analysis. A workshop with 22 participants was organized on 22–23 August 2016 for Thimphu *thromde*, DRC, and the Ministry of Works and Human Settlement using the pilot study. Under the existing system, data for 4,501 taxpayers, 215 organizational taxpayers, 6,913 land parcels and 2,909 buildings have been digitized in the RMS. A 10-day seminar was organized with 18 officials from DRC and Thimphu *thromde* (urban planners, building inspectors, ICT officers, and architects) during 23 November–2 December 2016 to digitize and update the building databases and city maps as per the new PVM requirements, and to provide training on the PVM-based property taxation. The land registration records in the RMS were updated using a geographic information system. Based on consultations with technical stakeholders, property tax proposals were developed by Thimphu *thromde* (with estimates for revenue mobilization under various scenarios) for presentation to the Cabinet, to supplement the earlier MOF proposals.

13. **Tranche 2, policy action 2.** *DRC shall have operationalized the direct and sales tax modules of RAMIS (including those for personal income, business income and corporate income taxes) (complied with.)* DRC submitted the report on the operationalization of tax modules of RAMIS on 15 March 2017.¹¹ RAMIS Phase I—including direct tax, revenue accounting, and sales tax modules—¹² were piloted in April 2014 under SEMP I, and the preliminary launch of basic functionalities of direct tax and revenue accounting modules occurred on 1 January 2015, followed by sales tax modules on 2 July 2015.¹³ Under SEMP II, ADB and DRC arranged high-level meeting with the management of the Tata Consultancy Services—the firm developing RAMIS—to seek resolution to the challenges in the system performance, software stabilization,

¹¹ RAMIS was developed under ADB. 2011. *Technical Assistance to Bhutan for Developing a Revenue Administration Management Information System*. Manila.

¹² Major functions under RAMIS include (i) taxpayer registration, (ii) issuance of taxpayer numbers, (iii) creation and monitoring of chart of accounts, (iv) return assessment, (v) electronic filing of returns, (vi) tax payment, (vii) refund processing, and (viii) accounting and management information system for DRC revenue reports.

¹³ Development of RAMIS Phase II (including customs, excise, and sales tax at point of entry modules) is ongoing.

data integrity, and optimal configuration of ICT hardware infrastructure observed during FY2015. Because of the extensive effort by DRC and TCS, the system stabilized, achieving effective use by taxpayers. Combined with the economic recovery, RAMIS helped improve the domestic tax revenue mobilization from Nu16.2 billion in FY2014 (pre-RAMIS) to Nu18.4 billion in FY2015, and Nu19.9 billion in FY2016 (RAMIS implementation period) (details are in Appendix 5 Table 2).

14. RAMIS has increased tax administration and revenue collection efficiency by reducing collection costs.¹⁴ DRC's RAMIS report shows that, due to the strong public awareness using media, number of registered taxpayers increased from 61,251 at the end of 2014 to 159,755 in 2015, and 196,494 in 2016. The number of tax filers showed improvement from 94,690 in 2014 to 102,349 in 2015 and 97,133 in 2016. The number of taxpayers paying taxes electronically increased from 29,615 in 2014 to 41,241 in 2015 and 51,545 in 2016, of which 47,401 were personal income taxpayers. Automation has reduced the average number of DRC staff interacting with taxpayers from 70 in 2014 to 45 in 2016, while the average tax filing time has dropped from 0.5–2 hours in 2014 to under 1 hour in 2016.

15. The transition from the prior manual tax administration system to electronic and simpler tax filing and payment procedures has improved voluntary tax compliance and thus helped expand the revenue base, which reduces fiscal deficits and dependence on external grants and concessional loans, and creates fiscal space for public expenditures. The ICT-based system has also facilitated auditing and monitoring of tax collection, improved coordination and information-sharing within DRC, and helped transform DRC into a modern tax administration agency.

16. **Tranche 2, policy action 3:** *The taxpayer information call center shall have become operational* (complied with). The DRC submitted the report on the operation of the tax payer information call center on 15 March 2017. The call center became operational under DRC with TA support, and was launched on 6 March 2017 by the Finance Minister. Within 1 week of operation, the call center received 500 queries from over 400 callers and most of the queries were related to the use of RAMIS and tax payment or refund status. Over 600 calls per day are expected during the peak tax filing season (April–August). The call center will (i) enable taxpayers to seek clarifications on tax laws and payment processes; (ii) minimize the administration costs for the tax agency; (iii) improve tax compliance and support national tax revenue mobilization, together with automated tax return filing using RAMIS; (iv) simplify tax collection procedures for entrepreneurs and improve the ease of doing business; and (v) help DRC track queries and documents through improved record keeping system. The TA supported (i) project implementation; (ii) development of web-enabled call center software, integrated with RAMIS; (iii) procurement of ICT infrastructure; (iv) development of frequently-asked-questions; and (v) capacity building of DRC staff and six recruited call center agents. A 2-week hands-on training was provided during 31 January 2016–17 February 2017 on (i) call center architecture; (ii) operational guidelines; (iii) Bhutan's direct and indirect tax codes, system and procedures; (iv) RAMIS applications; (v) data mining; and (vi) taxpayer service delivery.

B. Enhancing Financial Stability through Macprudential Management

17. **Tranche 2, policy action 4.** *MOF shall have (i) published a calendar for issuance of government debt securities for FY2017; and (ii) issued government debt securities following the calendar* (complied with). MOF submitted the Treasury Bills (T-Bills) issuance calendar for FY2017 on 12 August 2016, which was approved by the 49th Policy, Planning and Consultative

¹⁴ Bhutan ranks 19th out of 190 economies on the ease of paying taxes based on World Bank. *Doing Business 2017: Equal Opportunity for All*. Washington, DC.

Meeting of MOF on 27 June 2016 and published on the websites of the Royal Monetary Authority (RMA) and MOF, and in Kuensel newspaper on 1 July 2016. On 1 March 2017, MOF submitted detailed information on the auction date, maturity, volume and bidders for the T-Bills issuances conducted during July 2016–February 2017, reaching a total of Nu31.5 billion as of 7 February 2017. Under the TA capacity building, (i) on 17 June 2016, a 1-day workshop with 14 participants from MOF (Department of Public Accounts), DRC, and RMA was organized on development of a T-Bill auction calendar, using econometric analysis of government revenues and expenditures, cash flow patterns, and macroeconomic indicators; and (ii) on 19 August 2016, a 1-day training with 5 participants was held on revenue and cash forecasting methodologies for developing a government debt securities auction calendar.

18. The issuance of T-Bills will constitute an essential part of fiscal and monetary policy. The calendar will minimize volatility in the flow of public funds and ensure accurate prediction of government's cash requirements by using reliable forecasting tools to avoid destabilizing spikes in debt repayments. Publicized T-Bill auctions, conducted on a competitive basis based on an issuance calendar, will increase transparency of public sector borrowing requirements. Auctions will encourage broader investor participation in the primary market from banks, non-bank financial institutions and corporations, minimizing debt service costs associated with domestic borrowing.¹⁵ An active T-Bill market will (i) improve the management of liquidity and monetary policy, and (ii) create a benchmark government yield curve for pricing of other corporate debt.

19. **Tranche 2, policy action 5.** *RMA shall have notified financial institutions of new money market instruments to develop the inter-financial institutions lending market (complied with.)* RMA conducted a stakeholders' workshop on 29 March 2016 with 39 participants from RMA, MOF and financial sector to identify money market instruments (MMIs) that would best suit Bhutan's short-term liquidity management needs. Under the TA five RMA and Royal Stock Exchange of Bhutan (RSEB) officials conducted a visit to Bank of Thailand during 4–6 July 2016 to study the legal, regulatory, institutional, and operational requirements for MMIs.¹⁶ Based on these consultations, RMA submitted the notification on 3 January 2017 on guidelines for the certificates of deposit for commercial banks, which was approved during the 119th RMA Board Meeting on 23 November 2016. To complement the certificates of deposit, the Registrar of Companies (ROC), pursuant to the provisions of the Companies Act 2016, notified guidelines for commercial papers to companies and other business entities on 15 March 2017. The notification came into effect on 1 March 2017, and was published in the Kuensel newspaper on 16 March 2017.¹⁷ The trading and settlement of both certificates of deposit and commercial papers will be managed by the RSEB. The new MMIs will be instrumental in avoiding asset–liability mismatches—a key structural bottleneck for Bhutan's banking system, and developing inter-financial institutions lending market.

20. **Tranche 2, policy action 6.** *RMA shall, as part of the annual onsite inspection, have assessed the compliance with the macroprudential regulations for at least three financial institutions (complied with.)* To strengthen the resilience of the financial system and to contain the credit, default, and sectoral risks arising from the procyclicality of bank lending following the rupee liquidity crunch, a comprehensive set of macroprudential regulations (MPRs) became effective

¹⁵ Ad hoc issuances of short-term T-Bills for 90 days, and use of RMA ways and means advances and the overdraft facility with the Bank of Bhutan have proven to be costly for meeting cash shortages during the rupee liquidity crunch.

¹⁶ The officials looked at laws and regulations on debt issuance, payment and settlement systems for securities, uncollateralized interbank lending and borrowing, and the repo market in Thailand, with a field visit to KBank.

¹⁷ Certificates of deposit are negotiable MMIs issued against funds raised by commercial banks as deposits with a tenor not more than 1 year for meeting the daily liquidity management needs of banks. The commercial papers are issued by companies for a specified amount and are payable on a fixed date, with maturities of 15 days to 1 year.

under the SEMP I, which are in line with the Basel core bank supervision and regulation principles.¹⁸ On 19 January 2017, RMA submitted the assessment report based on annual onsite inspection for the compliance of MPRs by Bank of Bhutan Limited (BOBL), Bhutan National Bank Limited (BNBL) and Royal Insurance Corporation of Bhutan Limited (RICBL) as of December 2015.¹⁹ The report showed that the three financial institutions (i) maintained a minimum leverage ratio above the 5% regulatory requirement (9.9% for BOBL, 17.8% for BNBL, 13.7% for RICBL); (ii) are compliant with the debt–equity ratio (i.e. debt not exceeding 75% and equity at least 25% of project cost); and (iii) complied with the dividend payout ratio requirement to be in the range of 30%–50%, based on a minimum capital adequacy ratio (CAR) of at least 10% for 3 years, and a net NPL ratio not exceeding 7% (various payout ratios applicable for different thresholds of NPLs).

21. As indicated in the report, both BOBL and BNBL are compliant with the maximum loan-to-value limit (70% for loans up to Nu50 million and 50% for loans above Nu50 million) and loan-to-income limit (50% for incomes up to Nu50,000, 60% for incomes of Nu50,000–Nu100,000, and 70% for incomes above Nu100,000), while RICBL was asked to rectify violations in loan appraisals and disposable income calculations by the next onsite inspection. BOBL and BNBL met the annual disclosure requirements while RICBL prepared disclosure reports up to 2015 but has not yet published the 2016 report on its website. The countercyclical capital buffer requirements and sectoral capital requirements are currently not implemented. RMA will determine the effectivity for countercyclical capital buffer requirements if conditions for excessive overall credit growth occur. Similarly, RMA will make the sectoral capital requirements effective during times of economic stress and downturn, when sector-specific exposures turn non-performing. Such scenarios have not occurred in Bhutan. Temporary credit restrictions on housing and vehicle loans—introduced during the rupee liquidity crunch—were removed in September 2014, and the onsite inspection showed that MPRs with strong oversight of sectoral concentration and credit quality were instrumental in moderating excessive inflationary credit growth and import-dependent consumption, lessening the pressure on international reserves.

22. **Tranche 2, policy action 7.** *RMA shall have prepared an assessment report on the implementation of its liquidity management and stress testing framework by the Bank of Bhutan Limited and Bhutan National Bank Limited (complied with.)* RMA submitted the assessment report on 1 March 2017. Development of the conceptual aspects of the liquidity management and stress-testing framework and the templates for stress testing and scenario-analysis with macroeconomic and financial soundness indicators were initiated under SEMP I.²⁰ Stress testing provides important insights into the resilience of the Bhutanese banking system and its balance sheet to ascertain the capacity to absorb losses under extreme stress scenarios using single and multi-factor sensitivity analysis. Stress testing analyzes the vulnerability of the capital adequacy of the Bhutanese banking system and the two largest banks, BOBL and BNBL, to risk scenarios using December 2015 and June 2016 balance sheets. The results show that the entire banking system and the two banks in particular can maintain the minimum regulatory CAR of 10% and above

¹⁸ The MPRs and liquidity management framework were developed under ADB. 2012. *Technical Assistance to the Kingdom of Bhutan for Supporting Financial Stability in Bhutan and the Maldives*. Manila.

¹⁹ MPRs are comprised of (i) countercyclical capital buffer requirements; (ii) loan-to-value and loan-to-income restrictions, applicable to housing, consumer and vehicle loans; (iii) sectoral capital requirements; (iv) minimum ceiling on leverage ratio; (v) time-varying capital provisioning, and minimum margin requirements; (vi) restrictions on distribution of profit; (vii) the debt–equity ratio; and (viii) disclosure requirements, including information on Tier 1 and Tier 2 capital; risk weighted assets; and loans classified by sectoral composition, quality, counter-party, as well as interest and credit risk, among others. The MPRs became effective on 1 November 2014 except for the time-varying capital provisioning and disclosure requirements, which were implemented from 1 January 2016. RMA also complemented the MPRs with the approved Credit Policy, 2015.

²⁰ They were developed under *Technical Assistance to the Kingdom of Bhutan for Supporting Financial Stability in Bhutan and the Maldives* (footnote 18).

under the credit risk scenarios, showing a reasonable degree of resilience. On the other hand, the BOBL's CAR would fall to 9%, below the minimum regulatory ratio, under the concentration risk scenario of default by its top three largest borrowers while BNBL's stronger capital base enables it to withstand the failure of a single largest and/or top three borrowers. The liquidity risk estimates the ability of the banks to carry enough cash or liquid assets to withstand a run for 5 consecutive days. Results from stress testing show that under the June 2016 balance sheet, BOBL and BNBL as well as the banking system as a whole can withstand a deposit run until only day 2; they become illiquid from day 3, and thereby would be unable to fund unexpected withdrawals. This is due to the high risk of asset–liability mismatch (paragraph 23).

23. The liquidity management indicators—such as the cash reserve ratio, which requires banks to hold deposit balances with RMA, and the statutory liquidity requirement ratio, which requires maintaining minimum liquidity in the form of quick or liquid assets—are in place in Bhutan. With the new liquidity management framework, a liquidity coverage ratio is introduced to measure bank's high-quality liquid assets, which can be liquidated without loss of value or used as collateral to obtain funds, relative to cash flow under a 30-day stress scenario. The BOBL's liquidity coverage ratio was 48.4% at the end of June 2016, while BNBL's ratio was 52%. The Basel Committee required this standard to be phased in, commencing at 60% in 2015 and increasing by 10% percentage points each year until it reaches 100% in 2019. Given the difficulty to comply with Basel requirement in the immediate future, RMA will need to develop its own tailored plan for short-term and long-term liquidity monitoring. Regarding the asset–liability mismatch, 61% of BOBL's and 76% of BNBL's total loans have maturity of more than 1 year, while 72% of BOBL and 47% of BNBL deposits have maturity of less than 30 days, suggesting the relatively high risk of asset–liability mismatch. Both banks are facing difficulty in matching their outflows and inflows in the short and medium-term. The RMA assessment report recommends the use of the net stable funding ratio, in effect internationally starting 2018. In summary, the assessments reveal that the scenario analysis and regular implementation of stress testing and liquidity management tools will be essential to proactively monitor the financial sector stability.

24. **Tranche 2, policy action 8.** *RMA shall have published a financial stability report (including an analysis of financial system soundness) in 2016 for FY2015* (complied with). RMA submitted and published the financial stability report (FSR) for 2015 on its website on 1 March 2017. The FSR assesses the stability of the financial sector by looking at the performance indicators, asset quality, and implementation of MPRs for both banks and non-bank financial institutions. The FSR highlights that total banking sector assets increased to Nu102.1 billion (73% of gross domestic product [GDP]) in December 2015, from Nu97.1 billion (78% of GDP) in December 2014. Loans and advances constituted 58% of total bank assets. Banking sector credit growth (from December 2014 to December 2015) increased by 12%, and the credit to GDP ratio increased from 49.8% to 52.1%. RMA judged that no potential leverage-related systemic risk would occur and thus countercyclical capital buffer requirements were not implemented.

25. The banking sector CAR stood at 18.8% of risk-weighted assets at the end of 2015 and the Tier 1 capital ratio was 15%, both of which were above the minimum requirement of 10%. The banking sector leverage ratio was 12.7%, above the minimum requirement of 3%. None of the banks were in violation of the credit concentration limits, loan-to-value and loan-to-income ratios, and loan ceilings for personal loans. The statutory liquidity requirement stood at 32.7%, down from 44.4% in December 2014, but remained above the requirement of 20%. The profitability of banks was strong with high net interest margins.

26. The FSR also conducts stress testing analysis for credit and liquidity risk for the entire banking sector (as discussed in paragraphs 22–23) using December 2015 balance sheets. The

tests reveal that the CAR falls to around 16% from 18.8% due to credit risk shocks, but remains above the minimum 10% requirement if sufficient provisions are maintained to absorb losses from NPLs. However, the concentration stress tests indicate undercapitalization challenges for two banks in the case of default of the top three largest borrowers. Liquidity stress tests indicate that two banks could become illiquid on the 5th day of a bank run scenario, and all banks could maintain up to 70% of the total demand deposits if they liquidate all liquid and/or quick assets collectively. The annual publication of the FSRs, based on this pilot report under SEMP II, will provide a comprehensive and regular mechanism for financial sector oversight in Bhutan.

II. Output 2. Strengthened Financial Sector Development

C. Developing the Capital Markets

27. **Tranche 2, policy action 9.** *(i) The National Pension Policy shall have been approved by the Cabinet, and the National Pension and Provident Fund (NPPF) Board shall have approved the Strategic Plan (together, these documents shall include the membership structure, contributions and benefits and investment guidelines); and (ii) NPPF shall have increased its membership by at least 5% (complied with).* Cabinet approved the NPPF Policy on 21 December 2016 to develop non-bank financial institutions and improve social security coverage in Bhutan. The key objectives of the NPPF Policy are (i) ensuring access to affordable retirement benefit schemes by both formal and informal sector, including the self-employed; and (ii) promoting financially sound and sustainable pension and provident schemes. The policy envisages provision of a (i) defined benefit pension scheme, (ii) defined contribution provident fund scheme, (iii) voluntary defined contribution scheme, and (iv) other schemes in Bhutan. NPPF submitted the Strategic Plan on 1 March 2017, which was endorsed by the NPPF Board during 79th meeting held on 24 December 2014, and subsequently revised and aligned with the approved NPPF Policy of the Cabinet. The Strategic Plan consisted of two strategy papers that extend the defined contribution scheme and improve the sustainability of the defined benefit pension scheme. The NPPF also increased its membership by 5.2% with 2,644 new members (from 51,333 in July 2015 to 53,977 as of 28 February 2017).

28. The current financial security system is limited to coverage of civil servants, armed forces and state-owned enterprises, corresponding to just 15% of the country's labor force. There is also a limited coverage of 17,000 private sector employees (4.9% of the labor force) under RICBL and Bhutan Insurance Limited. A large portion of the population has no social security coverage. The approved NPPF Strategic Plan aims to expand mandatory coverage to all public servants (including elementary and general personnel service and contract employees, totaling 4,112) and local government employees (1,420) and also targets the national workforce (3,502) that are paid the minimum wage and engaged in road maintenance and construction. With the inclusion of these groups, coverage is expected to increase to 17.7% of the labor force by the end of 2017.²¹

29. For capacity building under the TA, a 5-day training was conducted for 38 participants during 15–19 February 2016 on asset valuation methodologies, primarily for real estate in line with the International Financial Reporting Standards. A 1-day workshop for 31 participants was organized on 10 May 2016 on pension funding, actuarial valuation and asset-liability management. Finally, a 10-day training was completed by three NPPF officials during 4–17 June 2016 in Malaysia, on actuarial and financial valuation; actuarial statistics; computerized pension and asset-liability modeling, and application of International and Bhutanese Accounting Standards.

²¹ The average annual growth rate of Bhutan's labor force during 2010–2014 was 1.25% (Ministry of Labor and Human Resources. 2014. *Labor Force Survey Report*. p. 9).

30. **Tranche 2, policy action 10.** *The Prospectus Approval Committee under the Registrar of Companies (comprising, among others, representatives of the Ministry of Economic Affairs and RMA) shall have prepared a report on the legal, regulatory, and institutional requirements for, and feasibility of establishing a separate securities exchange commission (complied with).* To diversify Bhutan's capital markets away from predominantly bank-based system,²² and to complement the RMA's regulatory and supervisory responsibilities, ROC assumed the role of regulating companies and the equity and bond markets with the approval of the Companies Act of Bhutan in November 2016. The ROC submitted the feasibility report on 23 November 2016, laying out the principles for the institutional mandate, organizational structure, and budgetary and staffing requirements to enable Bhutan's new Securities and Exchange Commission (SEC) to operate effectively, autonomously, and independently in line with international best practices. The report also developed the Securities and Companies Authority Act to provide a legal foundation for the new entity as a complement to the RMA's Financial Services Act, 2011 and other regulations.

31. Capacity building under TA included (i) a 1-day workshop for 26 participants, held on 23 October 2015, for RMA and ROC on the International Organization of Securities Commissions principles of securities regulation; (ii) visits—organized for five officials from ROC, RMA and MOF to SECs in the Philippines during 7–11 December 2015, and in Thailand during 14–18 December 2015—to study international best practices in securities market regulation and supervision of listed companies, institutional and operational set up of the regulator, and corporate governance; (iii) attendance by ROC in March 2016 at a conference in Nepal on corporate and business law reforms and good governance; and (iv) a 10-day training program conducted for three officials from ROC at the Bangkok School of Management during 1–10 and 17–23 July 2016 on best practices and standards in (a) corporate law, capital markets and securities law; (b) corporate governance; and (c) applications of technology (e.g. online compliance and supervision systems, and business registry systems) in regulation of corporate entities and capital markets.

32. **Tranche 2, policy action 11.** *Based on its review of international experience, MOF shall have prepared a report on the legal, regulatory, and institutional requirements for, and feasibility of, securitization of Bhutan's hydropower revenues (complied with).* To enhance the government's capacity for using international capital markets for infrastructure financing, a feasibility study was conducted for international bond issuance using securitization of hydropower revenues. A report was submitted by MOF on 12 August 2016, addressing (i) the feasibility of establishing special purpose vehicles (SPVs) and creating asset-backed securities (ABSs) in and outside of Bhutan; (ii) cash-flow projections of the existing hydropower projects to develop financial models for Indian-rupee-based bond issuance; and (iii) other sources of securitization, such as mortgages. The report concluded that, given the limitations of Bhutan's capital market, SPVs need to be established in India (or another jurisdiction with a similar or higher sovereign credit rating as India), where the hydropower receivables are sold by Druk Green Power Corporation to the SPV, which then has the legal right to receive the payments for the sale of the receivables by the issuance of ABSs to investors. The report also (i) analyzed Bhutan's regulations for financial services, corporations, taxation, investment, and foreign ownership, (ii) proposed amendments to the Companies Bill and taxation laws to enable securitization, and (iii) made recommendations for sovereign and corporate ratings. Under the TA, a 2-day workshop was conducted on 7–8 September 2015 with 30 participants (from MOF, RMA, financial sector, Druk Holdings and Investment, and Druk Green Power Corporation) on requirements of securitization in line with best practices in addition to the earlier workshop with 20 participants on principles of securitization.

²² In 2014, Bhutan's banking sector holds over 80% of financial assets while the assets held by non-bank financial institutions corresponded to just 18%, and the market capitalization of RSEB to just 15% of the total (Royal Monetary Authority. 2015. *Annual Report 2013-2014*. Thimphu).

D. Promoting Financial Inclusion

33. **Tranche 2, policy action 12.** *RMA shall have approved a regulatory and supervisory framework to improve financial inclusion, and adopted regulations such as branchless banking and deposit-taking microfinance* (complied with). To strengthen the legal and regulatory framework to facilitate outreach of diversified and affordable financial products and services to low-income households in remote areas,²³ RMA approved the agent banking regulations during 118th Board meeting held on 24 October 2016 and the deposit-taking microfinance regulations during 120th Board meeting held on 29 December 2016. Both regulations enable the use of new branchless banking delivery channels to reduce the cost of financial intermediation using non-traditional means and technology, and promote the inclusion of unbanked and underserved people in rural areas. Agent banking regulations came into effect on 4 November 2016, and outline operational guidelines, due diligence requirements, and permissible activities by agents.²⁴

34. The deposit-taking microfinance institutions regulations came into effect on 3 January 2017 to enable such institutions to receive regular deposits from the public and use these funds for microloans not exceeding Nu500,000, and conduct activities such as money transmission services, insurance services as an agent, and electronic banking. The regulations outlined (i) license application procedures; (ii) minimum capital and ownership requirements; (iii) corporate governance principles; (iv) prudential regulations and permissible investment activities; and (v) consumer protection guidelines. Deposit-taking microfinance institutions will be required to carry out 80% of lending activities in rural areas. As of January 2017, Respect, Educate, Nurture, and Empower Women (RENEW), the Bhutan Association of Women Entrepreneurs, and Rural Enterprise Development Corporation Limited were registered with RMA as microloan institutions. RMA encourages priority sector lending to agro-businesses via microloan institutions.

35. **Tranche 2, policy action 13.** *Bhutan Development Bank Limited shall have substantially implemented Gewog banking services in non-urban areas* (complied with). To overcome the physical difficulties in accessing bank branches, and to promote technology-driven financial services in remote areas for low-income populations,²⁵ Bhutan Development Bank Limited (BDBL) implemented agency and branchless banking project, extending financial services to *gewogs* (groups of villages) in non-urban areas, and submitted the implementation report on 15 March 2017. BDBL launched point of sales (POS)-based agency banking—which enabled enrollment, cash withdrawals and deposits, loan payments, balance inquiries using smart cards, funds transfer, account closure, utility bill payments, and pension disbursement—via community information centers (CICs). A total of 198 POS terminals were deployed in CICs in 20 districts, 2 POS terminals were deployed at merchant outlets, and 5 POS terminals were given to BDBL employees to reach remote villages with no CIC infrastructure. Additionally, 17 POS terminals were deployed at farmer shops and one POS terminal at a school to promote this technology. During August 2014–February 2017, new customer enrollment in agency and branchless banking increased by 10,962, with transactions reaching Nu74 million in deposits, Nu56 million in withdrawals, and Nu80 million in loan repayments, reflecting an increase in savings. Of the 10,425 individuals enrolled in agency banking via POS, 5,436 were women and 4,989 were men.

²³ In 2014, 22.6% of Bhutan's population (and 21.5% of women) above 15 years of age saved in a financial institution, while 4.2% (and 4.1% of women) borrowed from a financial institution in the previous year. (World Bank, G20 Financial Inclusion Indicators, online database accessed on 15 March 2017)

²⁴ Agents include government postal services, telecom operators, registered retail merchants, authorized money changers, and pharmacies and medical stores, which provide services such as cash and check deposits to bank accounts; withdrawals; loan applications; tax, utility and social security premium payments; and balance inquiries.

²⁵ There were 15.5 bank branches and 22.2 ATMs per 100,000 adults in Bhutan in 2014. (World Bank G20 Financial Inclusion Indicators, 2014, online database accessed on 15 March 2017).

36. The ADB TA supported BDBL's procurement of 100 POS machines and a smart card printer. Project management support was also provided. Training sessions were conducted on standard operating procedures on 18 October 2016 and 14 December 2016, involving six BDBL officials using the training-of-trainers approach, whereby participants subsequently trained a larger agent base. Public awareness was carried out under the financial literacy program (FLP) via the CICs. Finally, the TA supported BDBL's legal framework for agent management, and comments were provided to RMA in drafting the agent banking regulations.

37. **Tranche 2, policy action 14.** *RMA shall have developed and implemented a financial literacy program (covering both school-age and adult populations) in consultation with stakeholders with a focus on gender equity (complied with).* An FLP was implemented to create awareness among different socioeconomic, demographic, and gender groups on services offered by banks and capital markets, and to mobilize domestic savings.²⁶ RMA submitted the implementation report on 14 March 2017.²⁷ FLP conducted a financial literacy survey among school-age youth (1,328 respondents) and adult bank customers (388 respondents), and focus group discussions with rural communities (100 farmers, mostly women in farming cooperatives located in four eastern districts).²⁸ A stakeholder workshop was organized on 18 December 2015, chaired by the Governor of RMA and attended by 37 participants from RMA, Ministry of Education, Ministry of Agriculture and the financial sector, in which a financial literacy action plan was developed using survey results. Based on the action plan, print and audio-visual FLP campaign materials were created and disseminated via traditional media and social media using internet to banks, 30 schools, nongovernment organizations, government agencies, and CICs.

38. Starting with Global Money Week celebrations, led by RMA during 4–20 March 2016, financial literacy clubs were established in six pilot schools in five districts across Bhutan, financial literacy outreach session for over 300 girls were conducted, and banks visited pilot schools to provide information on financial services and to open savings accounts for 340 students. During 1–4 September 2016, in collaboration with the Bhutan Scouts Association, RMA and BDBL, bank accounts were opened for 250 scouts, with seed money of Nu100 per student provided by the TA. Media outreach included articles in national newspapers, disseminating FLP materials using the RMA webpage and FLP Facebook page that reached over 9,000 "likes", airing of radio messages and distribution of 3,500 copies of Youth and Finance magazine to schools and college graduates.

39. In conjunction with the BDBL's branchless banking in CICs, financial literacy manuals targeting adults in rural communities were distributed to 205 *gewogs*. Extensive collaboration was achieved with local nongovernment organizations that are active in rural communities and microfinance projects involving women (such as Rural Education and Development Global and RENEW) and in promotion of entrepreneurship among the youth (such as the Loden Foundation) by conducting training with FLP materials. 10,000 copies of the personal budget and record keeping manual were shared with RENEW. A presentation on debt management was made during RENEW's entrepreneurship day celebration on 30 September 2016, where entrepreneurs, who received microfinance loans, shared their experiences with primarily women participants. A training was given to youth at a techno-park during the Entrepreneurship Week (14–18 November

²⁶ The Global Financial Literacy Survey 2014 (accessible at <http://gflec.org/initiatives/sp-global-finlit-survey/>), conducted by Standard and Poor's Ratings Services, found that 54% of Bhutan's adults answered 3 out of 4 questions on risk diversification, inflation, interest rate and interest compounding.

²⁷ A video, showcasing the FLP achievements, was presented at the 5th Asian Youth Forum during 2-7 May 2017, running alongside the 50th ADB Annual Meeting in Yokohama, Japan. <http://www.youthforasia.com/adb-projects/video-documentation/>

²⁸ The surveys indicated gaps in understanding of basic financial and economic terminology such as interest rate, inflation, budgeting, long-term savings, access to banking, and credit and investment products.

2016), and a workshop was held with nine officials from the Bhutan Chamber of Commerce and Industry on 13 January 2017 to promote a culture of entrepreneurship and use of digital finance.

40. RMA set up a Financial Inclusion and Media Unit to carry forward FLPs in the future. It will be essential to engage the Ministry of Education and Ministry of Agriculture to institutionalize financial literacy training in school curriculum and among rural communities for sustainability.

E. Improving the Credit Information Bureau

41. **Tranche 2, policy action 15.** *An oversight unit for the credit reporting system shall have been established* (complied with). RMA submitted a circular dated 1 August 2016 on the establishment of the oversight unit for the CIB under the non-bank unit of the Financial Regulation and Supervision Department. Based on the RMA office order submitted on 28 July 2016 on the composition and terms of reference, there will be a non-bank unit head and four examining officers in the CIB oversight unit, which will (i) review and assess license application and issuance for CIB business; (ii) conduct offsite surveillance and onsite inspection of CIB to ensure compliance with regulations; (iii) carry out inspections when required, and produce a report; and (iv) issue directives and impose penalties. The oversight unit along with the CIB regulations approved under the first tranche will strengthen the credit reporting system, consumer protection, and data security.

42. **Tranche 2, policy action 16.** *CIB shall have substantially implemented the business plan* (complied with). Access to finance was identified as one of the key obstacles for private investment, especially for micro-, small, and medium-sized enterprises in Bhutan.²⁹ A reliable credit information system is critical to overcome information asymmetries and improve the quality and volume of lending, thereby improving the access of entrepreneurs to finance. To realize these objectives, a business plan for CIB was developed under the first tranche, with an implementation report submitted on 16 February 2017. The CIB upgraded its operating software, which was successfully launched on 12 January 2017 by the Finance Minister. Along with the software, the ICT hardware infrastructure was also upgraded under the TA. In addition to the traditional credit reports, the new software allows processing of credit information in real time in larger volumes and under a shorter timeframe, and introduces new products and services such as portfolio monitoring, alert monitoring, and mobile applications.

43. The new system can collect information from telecoms, insurance providers and utility companies and share data with microloan institutions. In addition to project management support, extensive capacity building was provided under the TA to 6 CIB staff on 5–6 September 2016, and 2–3 and 6 November 2016; and to 56 representatives from the Bhutanese financial sector on 10 November 2016 on the technical and functional operations of the new system, customer and financial sector portfolio and risk analysis, and scoring and fraud detection methodologies using case studies. Public awareness under the FLP was also conducted through radio spots, distribution of 5,000 CIB brochures, and social media.

44. With the new ICT-based credit products and services, the transparency and efficiency of processing loans and other financial transactions will improve as the new system introduces (i) a real-time standardized process for effective credibility analysis; (ii) better portfolio monitoring and information sharing among the financial sector institutions; (iii) analysis of borrowers (by sector, client and product) and asset quality, default risk, credit and loan status and payment patterns; and (iv) alert monitoring system for delinquencies for effective banking sector risk management.

²⁹ Based on World Bank Doing Business 2017 (footnote 14), Bhutan is rated 73rd in terms of the ease of doing business, and 82nd in terms of the ease of obtaining credit out of 190 economies.

IV. THE TECHNICAL ASSISTANCE GRANTS

45. The piggybacked TA grant for \$700,000, funded by the ADB Technical Assistance Special Fund (TASF-V), was approved and became effective on 9 July 2015. An additional \$500,000 from the Financial Sector Development Partnership Special Fund was approved on 10 August 2015, and an additional \$110,000 from the TASF-V was approved on 10 June 2016, bringing the total TA resources to \$1.310 million.³⁰ Under the TA, (i) the following experts were recruited under a consultancy firm to support tranche 2, actions 1, 3, 4, 13 and 16: (a) local government finance expert, (b) call center expert and RAMIS functional consultant, (c) public finance expert, (d) mobile financial services expert, and (e) credit information bureau expert; and (ii) an individual national financial literacy and gender expert supported tranche 2, action 14. Using Capital Market Development, an individual capital market expert was recruited for tranche 2, action 10 and a securitization expert for tranche 2, action 11.³¹ Two international firms providing ICT-related software development were recruited for the RMS (tranche 2, action 1); call center (tranche 2, action 3); and CIB (tranche 2, action 16).³² Procurement of ICT equipment and software for the call center, CIB and BDBL (tranche 2, action 13) were also carried out.³³ Training and workshops under TA benefited more than 300 participants, enhancing the sustainability of reforms. While the operationalization of RAMIS (tranche 2, action 2) took place under Developing a Revenue Administration Management Information System (footnote 11), additional software procurement for RAMIS was funded under the TA. The preparation of MPRs (tranche 2, action 6), liquidity management and stress testing framework (tranche 2, action 7) and piloting of FSR (tranche 2, action 8) took place under Supporting Financial Stability in Bhutan and the Maldives (footnote 18).

V. PROGRAM ASSURANCES AND MONITORING FRAMEWORK

46. All program assurances have been complied with (Appendix 4). The executing agency (the Department of Public Accounts and subsequently the Department of Macroeconomic Affairs, following its establishment under MOF) has been responsible for overall program administration, including (i) overseeing timely implementation of policy actions and coordinating across seven implementing agencies, (ii) maintenance of program records, (iii) compliance with reporting requirements, and (iv) disbursement. Program activities were monitored at different levels through (i) seven loan review missions, on 14–18 December 2015, 15–19 February 2016, 4–6 April 2016, 13–17 June 2016, 27 September–1 October 2016, 10–13 January 2017, and 6–7 March 2017; (ii) a steering committee meeting on 11 August 2016; and (iii) aides-mémoires.

VI. ASSESSMENT

47. The Government of Bhutan has complied with the first tranche policy actions, which have continued to remain in effect since program effectiveness, and 15 out of 16 second-tranche policy actions, with one policy action being partially complied. The implementation success critically hinges on (i) the political commitment of the government to bring about essential but difficult reforms; (ii) strong partnership and effective coordination between ADB program management and executing and implementing agencies; (iii) a strong sense of purpose and appreciation of the program benefits across the departments involved in the program, and (iv) a very effective use of

³⁰ Total contract awards under TA stood at 99.8% (\$1.307 million), while total disbursements after final procurement of ICT equipment were at 97.1% (\$1.272) million.

³¹ ADB. 2012. *Technical Assistance to Bhutan for Capital Market Development*. Manila.

³² All individual consultants and consultancy firms were recruited in accordance with ADB's Guidelines on the Use of Consultants, 2013. The firms and individual consultants except for the capital market expert received excellent ratings. The capital market expert received a satisfactory rating.

³³ All procurement was carried out in accordance with ADB Procurement Guidelines, 2015.

targeted TA resources to procure and assimilate know-how and knowledge to increase absorptive capacity in key institutions. The programmatic and sequential approach pursued under SEMP I and SEMP II has ensured that interlinked reforms were implemented in a comprehensive manner.

48. All program performance indicators and targets as laid out in the design and monitoring framework were fully achieved (Appendix 3). With the improved macroeconomic stability, GDP growth trajectory was sustained at over 5%, with a rebound in growth rates to over 6% during FY2015—FY2016 from 3.6% in FY2013, while keeping the average inflation contained at 5% compared to the peak inflation of 10.2% in FY2012 (Appendix 5). The projected GDP growth is 8.2% in FY2017. Gross international reserves improved significantly and reached over \$1,118 billion (13.3 months of import coverage) in FY2016 from \$958.5 million (11.7 months) in FY2015. The fiscal deficit has been brought under control. The fiscal balance was in surplus (3.8% in FY2014 and 1.5% in FY2015) before falling into a deficit of 3% in FY2016, but remained within the program's target level. The gross NPL ratio of banks improved to 9.8% in FY2016, down from 12.1% in FY2014 with stringent credit regulations, achieving the target ratio of less than 10%.

VII. THE PRESIDENT'S RECOMMENDATION

49. In view of the significant progress made in the implementation of the overall program, as evidenced by full compliance with 15 policy actions and partial compliance with 1 policy action for release of the second tranche, the President recommends that the Board approve, on a no-objection basis:

- (i) the waiver of full compliance with one tranche release policy action, which has been partially complied with; and
- (ii) the release of the second tranche in various currencies equivalent to SDR 14,443,000 for the Strengthening Economic Management Program II.

LINKAGES BETWEEN THE STRENGTHENING ECONOMIC MANAGEMENT PROGRAMS I and II

Outputs under SEMP I	TA Support under SEMP I	Policy Actions under SEMP I	Policy Actions under SEMP II	TA Support under SEMP II	Outputs under SEMP II
Output 1: Improved Budget and Debt Management Systems Implemented	TA 7724-BHU Strengthening Public Management in Bhutan	T2-A1: Major municipalities, including Thimphu Phuentsholing, Samdrup Jongkhar and Gelephu, will have prepared a medium-term expenditure framework that is used as the basis for annual budget preparation.			
	Staff consultancy	T1-A1: MOF will have prepared a satisfactory Debt Management Strategy, which includes clear debt management objectives over medium to long-term (3–5 years) and an action plan to implement the strategy. The action plan will also include strengthening of DMD.			
		T2-A2: MOF will have prepared and finalized a report on the implementation of the actions under the debt management strategy covering the period from the date of the loan and grant effectiveness until the review for the 2nd tranche release.			
		T1-A2: DMD will have appointed and filled all nine staff positions in DMD, which will constitute a full complement of DMD organizational chart to carry out the debt management strategy and the action plan to strengthen debt programming, monitoring and reporting.			
	Staff consultancy	T2-A5: DMD will have prepared and submitted an annual debt sustainability analysis to MOF.			
			B. Enhancing Financial Stability through Macroprudential Management		Output 1: Macroeconomic Management Improved
	TA 8280-BHU Capital Market Development	T2-A3: Building on the approved Debt Management Action Plan, MOF, in coordination with RMA, will prepare and approve a strategy paper on development of government securities market to address: (i) narrow investor base, (ii) lack of auction calendar, (iii) limited price competition in	T2-A4: MOF will have (i) published a calendar for issuance of government debt securities for FY2017 and (ii) issued government debt securities following the calendar.	Piggybacked TA 8901-BHU Supporting Implementation of Strengthening Economic	

Outputs under SEMP I	TA Support under SEMP I	Policy Actions under SEMP I	Policy Actions under SEMP II	TA Support under SEMP II	Outputs under SEMP II
		<p>auctioning government securities, and (iv) the functional integration of the Treasury Management Division and DMD for improved cash management.</p> <p>T2-A4: MOF an RMA will have implemented the strategy paper on development of government securities market.</p>		Management Program II	
Output 2: Improved Revenue Effort and Revenue Management System Implemented	TA 7724-BHU Strengthening Public Management in Bhutan	T2-A7: MOF, in coordination with MOWHS, will have approved the rules and regulations on PVM.	A. Strengthening Revenue Management		
		T2-A8: MOWHS will have piloted implementation of PVM in at least one municipality (Phuentsholing).	T2-A1: The property tax rates based on the property valuation methodology will have been submitted to Parliament, and the policies, systems and processes which are necessary to collect property tax using the new rates will have been completed within the municipality of Thimphu.	Piggybacked TA 8901-BHU Supporting Implementation of Strengthening Economic Management Program II	
	TA 7881-BHU Developing a Revenue Administration Management Information System	T1-A3: DRC will have prepared and approved the System Requirement Specification (blueprint) for the internal revenue component of RAMIS.			
		T1-A4: DRC will have revised and approved a new Revenue Chart of Account in line with IMF Government Finance Statistics.			
		T1-A5: DRC will have approved the new TPN scheme.			
		T2-A6: MOF will have piloted implementation of RAMIS within DRC.	T2-A2: DRC will have operationalized the direct and sales tax modules of RAMIS.	TA 7881-BHU Developing a Revenue Administration Management Information System	
			T1-A1: DRC will have approved a plan to establish a taxpayer information call center, including taxpayer services to be provided, and staff, budget, and IT infrastructure requirements.	Piggybacked TA 8901-BHU Supporting Implementation of Strengthening	

Outputs under SEMP I	TA Support under SEMP I	Policy Actions under SEMP I	Policy Actions under SEMP II	TA Support under SEMP II	Outputs under SEMP II	
			T2-A3: The taxpayer information call center will have become operational.	Economic Management Program II		
Output 3: Improved Macprudential Management Framework Implemented	TA 8284-REG Supporting Financial Stability in Bhutan and the Maldives	T1-A7: RMA will have set up a FPC on macroprudential regulations.				
			B. Enhancing Financial Stability through Macroprudential Management			
		T2-A9: The FPC will have prepared and finalized the macroprudential policy paper and its corresponding rules and regulations that will cover, among others, (i) countercyclical capital buffer for banks, (ii) loan-to-value and loan-to-income restrictions, (iii) sectoral capital requirements, (iv) minimum ceiling on leverage ratio of banks, (v) time-varying capital provisioning and margin requirements, (vi) restrictions on distributions of profit, and (vii) debt-to-equity ratio for the policy paper; and the rules will have been approved by RMA.	T1-A2: RMA will have notified the public of the disclosure requirements under its macroprudential regulations.	TA 8284-REG Supporting Financial Stability in Bhutan and the Maldives		
		T2-A10: RMA will have pilot implemented recommendations of the policy paper on macroprudential regulations.	T2-A6: RMA will, as part of the annual onsite inspection, have assessed the compliance with the macroprudential regulations for at least three financial institutions.			
			T2-A7: RMA will have prepared an assessment report on the implementation of its liquidity management and stress testing framework by the Bank of Bhutan Limited and Bhutan National Bank Limited.			
			T1-A3: RMA will have established a committee tasked with monitoring the stability of the financial sector.			
			T2-A8: RMA will have published a financial stability report in 2016 for FY2015.			

Outputs under SEMP I	TA Support under SEMP I	Policy Actions under SEMP I	Policy Actions under SEMP II	TA Support under SEMP II	Outputs under SEMP II
			T2-A5: RMA will have notified financial institutions of new money market instruments to develop the inter-financial institutions lending market.	Piggybacked TA 8901-BHU Supporting Implementation of Strengthening Economic Management Program II and TA 8280-BHU Capital Market Development	
			D. Promoting Financial Inclusion		Output 2: Financial Sector Development Strengthened
	TA 8280-BHU Capital Market Development	T1-A8: RMA will have prepared and approved an action plan for improving the retail to wholesale deposit ratio.	T2-A12: RMA will have approved a regulatory and supervisory framework to improve financial inclusion, and adopted regulations such as branchless banking and deposit-taking microfinance.	Piggybacked TA 8901-BHU Supporting Implementation of Strengthening Economic Management Program II	
		T2-A11: RMA will have implemented the key recommendations of the action plan.	T2-A13: BDBL will have substantially implemented <i>gewog</i> banking services in non-urban areas.		
			T2-A14: RMA will have developed and implemented a financial literacy program in consultation with stakeholders with a focus on gender equity.		
	TA 8280-BHU Capital Market Development	T2-A12: RMA will have completed a Capital Markets Master Plan that charts the strategic development of capital markets over the next 10 years.	C. Developing the Capital Markets		
			T1-A4: The NPPF Board will have approved risk-based investment guidelines.	Piggybacked TA 8901-BHU Supporting	

Outputs under SEMP I	TA Support under SEMP I	Policy Actions under SEMP I	Policy Actions under SEMP II	TA Support under SEMP II	Outputs under SEMP II
			T2-A9: The National Pension Policy will have been approved by the Cabinet, and the NPPF Board will have approved the Strategic Plan; and (ii) NPPF will have increased its membership by at least 5%.	Implementation of Strengthening Economic Management Program II	
			T1-A5: Regulations for the public issue of shares will have become effective.		
			T1-A6: MOF will have approved and started implementation of the BAS and IFRS.		
			T2-A10: The Prospectus Approval Committee under the Registrar of Companies (comprising, among others, representatives of the MoEA and RMA) will have prepared a report on the legal, regulatory, and institutional requirements for, and feasibility of, establishing a separate securities exchange commission.	TA 8280-BHU Capital Market Development	
			T2-A11: Based on its review of international experience, MOF will have prepared a report on the legal, regulatory, and institutional requirements for, and feasibility of, securitization of Bhutan's hydropower revenues.		
		T1-A9: RMA issued fund management license based on approved fund management regulation, and the licensed fund management company is in operation.			
		T2-13: RMA will have established the regulatory and supervisory framework for the domestic credit rating agency.			
			E. Improving the Credit Information Bureau		
			T1-A7: RMA will have approved regulations which will (i) govern the establishment, organization and operation of a credit reporting	Piggybacked TA 8901-BHU Supporting Implementation	

Outputs under SEMP I	TA Support under SEMP I	Policy Actions under SEMP I	Policy Actions under SEMP II	TA Support under SEMP II	Outputs under SEMP II
			system; (ii) establish the conditions for credit reporting; and (iii) specify the roles of participants, and other relevant information.	of Strengthening Economic Management Program II	
			T2-A15: An oversight unit for the credit reporting system will have been established.		
			T1-A8: The CIB will have approved a business plan, including new products and services, projected budget, staffing needs, upgrades of IT infrastructure, and other organizational issues.	Piggybacked TA 8901-BHU Supporting Implementation of Strengthening Economic Management Program II	
			T2-A16: CIB will have substantially implemented the business plan.		
Output 4: Improved External and Internal Audit Operations Implemented	TA 7723-BHU Strengthening Audit Resource Management	T2-A14: Royal Audit Authority will have implemented an ARMS.			
		T1-A10: MOF will have appointed and placed internal audit officials for all major spending departments and large autonomous agencies, including Ministry of Foreign Affairs, Thimphu Municipality, and the National Land Commission.			
		T2-A15: MOF will have prepared and approved an internal audit manual; and completed training of all the staff recruited for internal audit.			

A = action, ARMS = Audit Resource Management System, BAS = Bhutanese Accounting Standards, BDBL = Bhutan Development Bank Limited, BHU = Bhutan, CIB = Credit Information Bureau, DMD = Debt Management Division, DRC = Department of Revenue and Customs, FPC = Financial Policy Committee, FY = fiscal year, IFRS = International Financial Reporting Standards, IMF = International Monetary Fund, MoEA = Ministry of Economic Affairs, MOF = Ministry of Finance, MOWHS = Ministry of Works and Human Settlement, NPPF = National Pension and Provident Fund, PVM = Property Valuation Methodology, RAMIS = revenue administration management information system, RMA = Royal Monetary Authority, SEMP I = Strengthening Economic Management Program I, SEMP II = Strengthening Economic Management Program II, T = tranche, TA = technical assistance, TPN = tax payer number.

Source: Asian Development Bank.

STATUS OF SECOND-TRANCHE POLICY ACTIONS

Objective: To achieve sustainable growth trajectory through improved macroeconomic and financial management.

2nd Tranche Policy Actions (18 months after T1)	Status of Implementation
<p>Output 1: Improved Macroeconomic Management Short-Term Objective: To continue and deepen the macroeconomic management reforms in order to sustain the momentum of recovery and improve the resilience of the economy.</p>	
<p>A. Strengthening Revenue Management</p>	
<p>(1) ** The property tax rates based on the property valuation methodology will have been submitted to Parliament, and the policies, systems and processes which are necessary to collect property tax using the new rates will have been completed within the municipality of Thimphu. (Document required: (i) Letter from National Assembly Secretariat confirming receipt of the property tax rates, and (ii) status report on the completion of property tax policies, systems and processes, certified by the director of DRC)</p>	<p>(i) Partially complied with. The National Assembly Secretariat acknowledged the receipt of the proposal on land and property tax based on PVM in respect of Thimphu <i>thromde</i> (submitted via Cabinet letter No. S-20/259 dated 15 February 2017) on 16 February 2017 through letter No. NAB (SG-42)2016-17/4402.</p> <p>Because of a Supreme Court writ issued on 15 August 2016, only 1 of 20 <i>thromdes</i> has introduced property tax reforms. The writ declared the <i>dzongkhag</i> (administrative and judicial district) <i>thromdes</i> “unconstitutional”, except for Thimphu <i>thromde</i>, on the basis that they have 6 constituencies under the existing delimitations (based on registered voters and size), and do not fulfill the criteria of having 7–10 elected constituencies, as required by the Local Government Act. The Supreme Court postponed local government elections until these <i>thromdes</i> fulfill the criteria as prescribed by law. Considering (i) the legal gridlock on the administrative structure; (ii) Cabinet’s earlier directives to receive local government-related tax proposals directly from the <i>thromdes</i>; (iii) the limited implementation capacity and ability of inhabitants to pay property taxes in other <i>thromdes</i> (including larger class-A <i>thromdes</i>); (iv) limited technical assistance, which was provided only to Thimphu <i>thromde</i> under SEMP II; and (v) willingness of the Thimphu <i>thromde</i> to introduce property taxes to bolster its municipal revenues, the proposal for PVM-based property tax rates was developed only for Thimphu, and could not be introduced for the remaining 19 <i>thromdes</i> as originally intended.</p> <p>(ii) Complied with. The DRC Director certified the status report on the completion of property tax policies, systems and processes within the municipality of Thimphu, which was submitted on 15 March 2017 with letter No. DRC/RAA/Gen(3)/2017/2230.</p>

2nd Tranche Policy Actions (18 months after T1)	Status of Implementation
(2) DRC will have operationalized the direct and sales tax modules of RAMIS. (Document required: Report on the operationalization of the tax modules of RAMIS, certified by the director of DRC)	Complied with. DRC Director certified the report on the operationalization of tax modules of RAMIS, which was submitted on 15 March 2017 with letter No. DRC/RAMIS/2017/2231.
(3) ** The taxpayer information call center will have become operational. (Document required: Status report on the operation of the taxpayer information call center, certified by the director of DRC)	Complied with. DRC Director certified the status report on the operation of the tax payer information call center, which was submitted on 15 March 2017 with letter No. DRC/PIS-ADM/2017/2232.
B. Enhancing Financial Stability through Macprudential Management	
(4) ** MOF will have i) published a calendar for issuance of government debt securities for FY2017 and ii) issued government debt securities following the calendar. (Document required: i) Calendar for FY2017, certified by the secretary of the MOF and ii) Letter from the secretary of MOF that issuances in FY2017 were conducted in accordance with the calendar.)	Complied with. (i) Secretary of MOF certified the T-Bill issuance calendar for FY2017, which was published on RMA and MOF websites and on Kuensel newspaper on 1 July 2016 and submitted with Office Order No. MoF/DPA/DMD/ADB-SEMP II/2016/521 on 12 August 2016. (ii) Secretary of MOF submitted an Office Order No. MoF/DMEA/DMD/ADB-SEMP II/2017/565 on 1 March 2017, detailing information on the issuances of T-Bills conducted as per the calendar during July 2016–February 2017 and stating that the issuances for the remainder of FY2017 will be conducted in accordance with the calendar.
(5) RMA will have notified financial institutions of new money market instruments to develop the inter-financial institutions lending market. (Document required: Notification on the new money market instruments, certified by the governor of RMA)	Complied with. The RMA Governor issued Notification No. RMA/RSD/MMI-2016-17/2731 on 3 January 2017 to BOBL, BNBL, Druk PNB, T-Bank and BDBL, RICBL, Bhutan Insurance Limited, NPPF, Royal Securities Exchange of Bhutan on guidelines for the certificates of deposit, which were approved during 119 th RMA Board Meeting on 23 November 2016. The Registrar of Companies under MoEA in pursuant to the Provisions of the Companies Act, 2016 notified the guidelines for commercial papers on 15 March 2015 to the companies and other business entities via letter No. MOEA/CR-ADB/2017/162. The notification was published on the Kuensel newspaper on 16 March 2017.
(6) RMA will, as part of the annual onsite inspection, have assessed the compliance with the macroprudential regulations for at least three financial institutions. (Document required: Inspection report, certified by the governor of RMA)	Complied with. The RMA Governor certified and submitted the inspection report that assessed the compliance with the macroprudential regulations for BOBL, BNBL and RICBL on 19 January 2017 with letter No. RMA/FRSD/29/2016-17/3007.

2nd Tranche Policy Actions (18 months after T1)	Status of Implementation
(7) RMA will have prepared an assessment report on the implementation of its liquidity management and stress testing framework by the Bank of Bhutan Limited and Bhutan National Bank Limited. (Document required: Assessment report, certified by the Governor of RMA)	Complied with. The RMA Governor certified submitted the assessment report on implementation of RMA's liquidity management and stress testing framework for BOBL and BNBL on 1 March 2017 with letter No. RMA/FRSD/29/2016-17/3616.
(8) RMA will have published a financial stability report in 2016 for FY2015. (Document required: Financial stability report, certified by the governor of RMA)	Complied with. The RMA Governor certified and submitted the Financial Stability Report for FY2015 on 1 March 2017 with letter No. RMA/FRSD/29/2016-17/3615. The report was published on the RMA website at https://www.rma.org.bt/Financial%20stability%20report.jsp .
Output 2: Strengthened Financial Sector Development Medium-Long-Term Objective: To promote investment-driven economy in order to rebalance the growth, and to reorient and diversify the economic base.	
C. Developing the Capital Markets	
(9) (i) The National Pension Policy will have been approved by the Cabinet, and the NPPF Board will have approved the Strategic Plan, and (ii) NPPF will have increased its membership by at least 5%. (Document required: i) National Pension Policy certified by the Cabinet Secretariat as having been approved by the Cabinet, and NPPF Strategic Plan, certified by the chief executive officer of NPPF as having been approved by the NPPF Board, and ii) Letter from the chief executive officer of NPPF certifying the increase in membership)	Complied with. (i) The Cabinet Secretariat submitted a letter No.C-3/120/549 certifying that the government has approved the National Pension and Provident Fund Policy on 21 December 2016, which was previously endorsed by the NPPF Board during its 84 th meeting on 13 October 2015. The NPPF Strategic Plan was approved by the NPPF Board during its 79 th meeting on 24 December 2014. Subsequent revisions were made to the Strategic Plan following the approval of the National Pension and Provident Fund Policy by the Cabinet and the document was certified and submitted by the NPPF chief executive officer with letter No. OD-01/ADB/2017/2350. (ii) The NPPF chief executive officer submitted letter No. OD-01/ADB/2017/2350 certifying the increase in membership of NPPF by 5.15% (2,644 new members) from 51,333 in July 2015 to 53,977 in 28 February 2017.
(10) ** The Prospectus Approval Committee under the Registrar of Companies (comprising, among others, representatives of the MoEA and RMA) will have prepared a report on the legal, regulatory, and institutional requirements for, and feasibility of, establishing a separate securities exchange commission. (Document required: Report certified by the Registrar of Companies)	Complied with. The feasibility report on establishing independent securities regulator, certified by the Prospectus Approval Committee, was submitted by the Registrar of Companies on 23 November 2016 with letter No. MoEA/CR-ADB/2016/862.

2nd Tranche Policy Actions (18 months after T1)	Status of Implementation
(11) ** Based on its review of international experience, MOF will have prepared a report on the legal, regulatory, and institutional requirements for, and feasibility of, securitization of Bhutan's hydropower revenues. (Document required: Report, certified by the Secretary of the MOF)	Complied with. The feasibility report on the enabling environment for the securitization of hydropower receivables, certified by the Secretary of MOF, was submitted on 12 August 2016 with the Office Order No. MoF/DPA/DMD/ADB-SEMP II/2016/520.
D. Promoting Financial Inclusion	
(12) RMA will have approved a regulatory and supervisory framework to improve financial inclusion, and adopted regulations such as branchless banking and deposit-taking microfinance. (Document required: i) Regulations comprising the regulatory and supervisory framework, certified by the Governor of RMA and ii) Letter from the Governor of RMA certifying that the regulations have been adopted.)	Complied with. The agent banking rules and regulations were approved on 24 October 2016. The deposit-taking microfinance regulations were approved during 120 th Board meeting held on 29 December 2016. The adopted rules and regulations, certified by the RMA Governor, were submitted with letter No. RMA/FRSD/29/2016-17/3617 on 24 January 2017.
(13) ** Bhutan Development Bank Limited will have substantially implemented Gewog banking services in non-urban areas. (Document required: Status report on the implementation, certified by the managing director of BDBL)	Complied with. The BDBL managing director (chief executive officer) certified and submitted the implementation report for agent and branchless banking, extending financial services to gewogs in non-urban areas on 15 March 2017 with letter No. BDBL/ITD/42/2017.
(14) ** RMA will have developed and implemented a financial literacy program in consultation with stakeholders with a focus on gender equity. (Document required: Report on the implementation of the financial literacy program, certified by Governor of RMA)	Complied with. The RMA Governor certified and submitted the implementation report of the financial literacy program on 14 March 2017 with letter No. RMA/FRSD/29/2016-2017/3942.
E. Improving the Credit Information Bureau	
(15) An oversight unit for the credit reporting system will have been established. (Document required: i) Circular/order on the establishment of the oversight unit, and ii) Attachment on the composition and terms of reference of the oversight unit, both certified by the Governor of RMA or other relevant regulator)	Complied with. i) The Governor of RMA submitted a circular No. RMA/FRSD/93/2016-2017/420 dated 1 August 2016 on the establishment of the oversight unit for CIB under the non-bank unit of FRSD with letter No. RMA/FRSD/93/2016-2017/419. ii) The Governor of RMA submitted office order No. RMA/FRSD/32/2015-2016/419 dated 28 July 2016 on the composition and terms of reference of the oversight unit with letter No. RMA/FRSD/93/2016-2017/419.

2nd Tranche Policy Actions (18 months after T1)	Status of Implementation
(16) ** CIB will have substantially implemented the business plan. (Document required: Status report on the implementation, certified by the chief executive officer of the CIB)	Complied with. The chief executive officer of CIB certified and submitted the implementation report for the business plan on 16 February 2017 with letter No. CIB/2017/57.

Note: Piggybacked TA support will be provided for policy actions with **.

BDBL = Bhutan Development Bank Limited, BNBL = Bhutan National Bank Limited, BOBL = Bank of Bhutan Limited, CIB = Credit Information Bureau, DRC = Department of Revenue and Customs, FRSD = Financial Regulation and Supervision Department, MoEA = Ministry of Economic Affairs, MOF = Ministry of Finance, NPPF = National Pension and Provident Fund, PVM = property valuation methodology, RAMIS = revenue administration management information system, RICBL = Royal Insurance Corporation of Bhutan Limited, RMA = Royal Monetary Authority, SEMP II = Strengthening Economic Management Program II, T-Bill = Treasury Bill.

Source: Asian Development Bank.

PROGRESS UNDER THE DESIGN AND MONITORING FRAMEWORK

Impact(s) the Project is Aligned with:				
Annual real GDP growth sustained at not less than 5% by end of FY2019 (Defined by the Program) ^a				
Results Chain	Performance Indicators with Targets and Baselines	Achievement Status	Data Sources and Reporting	Risks
Outcome	By end of Q4 2016			
Macroeconomic stability improved.	<p>a. Gross official reserves in months of merchandise import coverage sustained at not less than 13 months (FY2014 baseline: 13 months of import coverage)</p> <p>b. Fiscal deficit within the prescribed level of 3% of GDP achieved (FY2014 baseline: 4%)</p> <p>c. Non-performing loan ratio of banks reached 10% or less (FY2014 baseline: 11.8%)</p>	<p>Achieved. The gross official reserves in months of merchandise import coverage improved from 11.7 months in FY2015 to 13.3 months in FY2016. (Source: RMA Monthly Statistical Bulletin February 2017)</p> <p>Achieved. Fiscal balance was in surplus at 1.5% of GDP in FY2015. The fiscal balance was in deficit at 3% of GDP in FY2016. (Source: Ministry of Finance, National Budget Financial Year 2016-2017)</p> <p>Achieved. The gross non-performing loan ratio of banks improved from 12.1% in FY2014 to 9.7% in FY2015 and 9.8% in FY2016. (Source: RMA Annual Report 2015-2016, p. 34)</p>	<p>a. RMA Monthly Statistical Bulletin</p> <p>b. Ministry of Finance National Budget Report</p> <p>c. RMA Annual Report</p>	Fall in exports and capital flows due to negative shocks to the Indian economy.
Outputs				
1. Macroeconomic management improved.	<p>1a. A calendar for issuance of government debt securities for FY2017 published by MOF by the end of Q2 2016 (2014 Baseline: Calendar not issued)</p> <p>1b. Direct and sales tax modules of the RAMIS launched and fully operational by the end of Q3 2016 (2014 baseline:</p>	<p>Achieved. Treasury Bills issuance calendar for FY2017 was published on RMA and MOF websites and in Kuensel newspaper on 1 July 2016.</p> <p>Achieved. Income tax and revenue accounting modules were launched on 1 January 2015, and sales tax modules on 2 July 2015. System and software enhancements and stabilization of RAMIS were</p>	<p>1a. MOF and RMA website and Kuensel newspaper</p> <p>1b.DRC website</p>	Adequate resources and budget support are not available to the implementing agencies to carry out all program activities.

	<p>RAMIS not operational)</p> <p>1c. An effective liquidity management and stress testing framework for banking sector developed and implemented by the end of Q3 2016 (2014 baseline: liquidity management system is weak)</p>	<p>completed and the direct and sales tax modules were fully operational during the tax filing period January–March 2017 for FY2017.</p> <p>Achieved. RMA implemented the liquidity management and stress testing framework for the entire banking system and for the Bank of Bhutan and Bhutan National Bank, and submitted a report on 1 March 2017 (Letter No. RMA/FRSD/29/2016-17/3616).</p>	<p>1c. RMA report and website</p>	
2. Financial sector development strengthened.	<p>2a. Gender sensitive^b financial literacy program completed by the end of Q3 2016 (2014 baseline: financial literacy program not implemented)</p> <p>2b. <i>Gewog</i> banking services in non-urban areas, targeting the specific needs of low-income women, implemented by the end of Q3 2016 (2014 baseline: <i>gewog</i> banking services not operational)</p> <p>2c. Users of CIB services (disaggregated by gender) increased by 10% by the end of Q3 2016 (2014 baseline: 33,185 men and 18,478 women obtained credit report from CIB)</p>	<p>Achieved. RMA carried out the financial literacy program and submitted a report on 14 March 2017 (Letter No. RMA/FRSD/29/2016-2017/3942).</p> <p>Achieved. BDBL completed the implementation of agent/branchless banking, extending financial services to 205 <i>gewogs</i> (groups of villages), and submitted a report on 15 March 2017 (Letter No. BDBL/ITD/42/2017).</p> <p>Achieved. Male users of CIB services increased by 21% from 30,185 in 2014 to 40,2017 in 2016. Female users of CIB services increased by 9.8% from 18,478 in 2014 to 20,279 in 2016.</p>	<p>2a. RMA financial literacy implementation report.</p> <p>2b. BDBL implementation report for agent/branchless banking services in <i>gewogs</i></p> <p>2c. CIB report on implementation of the business plan.</p>	

Key Activities with Milestones
Not applicable
Inputs
ADB: \$16.1 million (ADF grant) \$20.1 million (concessional OCR loan)
ADB Technical Assistance Special Fund (TASF-V): \$0.81 million (technical assistance)
Financial Sector Development Partnership Special Fund: \$0.5 million (technical assistance)
Government: \$49.3 million
Assumptions for Partner Financing
None

Note: Design and monitoring framework was revised to comply with the new guidelines.

ADB = Asian Development Bank, CIB = Credit Information Bureau, DRC = Department of Revenue and Customs, FRSD = Financial Regulation and Supervision Department, GDP = gross domestic product, FY = fiscal year, MoEA = Ministry of Economic Affairs, MOF = Ministry of Finance, NPPF = National Pension and Provident Fund, PVM = property valuation methodology, Q = quarter, RAMIS = revenue administration management information system, RMA = Royal Monetary Authority.

^a GDP growth was 6.1% in FY2015, 6.4% in FY2016 and is projected at 8.2% in 2017 (Appendix 6).

^b Gender sensitive means the financial literacy campaign materials (i) take into account both women's and men's interests and needs, (ii) are presented in such a way that both women and men can understand the information being communicated, and (iii) are communicated through adequate channels to reach out to both women and men. It also means materials do not contain content or images that reinforce gender stereotypes.

Source: Asian Development Bank.

PROGRAM ASSURANCES AND CONDITIONS

Item	Source	Achievement
<p>Covenants</p> <p>Section 4.02 (b) The Beneficiary shall enable ADB's representatives to inspect any relevant records and documents referred to in paragraph (a) of this Section.</p>	<p>Financing Agreement (FA), Article IV, Particular Covenants</p>	<p>Complied with.</p> <p>The executing agency, DPA of MOF, has cooperated fully with each ADB mission by providing relevant documents as requested by ADB. Following the establishment of DMEA (Public Notification No. MoF/HRD/OD/68/2016/4974 on 21 September 2016 by MOF), DMEA assumed responsibility regarding borrowing, on-lending and grants for the Government of Bhutan. DMEA became the new executing agency of SEMP II. DMEA also fully cooperated with the ADB missions by providing relevant documents.</p>
<p>Section 4.03. (a) As part of the reports and information referred to in Section 6.05 of the Loan Regulations and Sections 6.04 of the Grant Regulations, the Beneficiary shall furnish, or cause to be furnished, to ADB shall reasonably request concerning (i) the Counterpart Funds and the use thereof, and (ii) the implementation of the Program, including the accomplishment of the targets and carrying out of the actions set out in the Policy Letter.</p>	<p>FA, Article IV, Particular Covenants</p>	<p>Complied with.</p> <p>The DPA and the implementing agencies have provided ADB with reports and other information concerning the program.</p>
<p>Section 4.03. (b) Without limiting the generality of the foregoing or Section 6.05 of the Loan Regulations and 6.04 of the Grant Regulations, the Beneficiary shall furnish, or cause to be furnished, to ADB quarterly reports on the carrying out of the Program and on the accomplishment of the targets and carrying out of the actions set out in the Policy Letter.</p>	<p>FA, Article IV, Particular Covenants</p>	<p>Complied with.</p> <p>On 29 September 2016, T. Dorji, chief program officer of the Debt Management Division of DPA, submitted an executing agency progress report on the status of SEMP II policy actions, as agreed with the respective implementing agencies, as part of Bhutan's Tripartite Portfolio Review and Consultation Meeting presentations. The program implementation was discussed with the executing agency and implementing agencies during quarterly ADB review missions.</p>

Item	Source	Achievement
<p>Implementation Arrangements</p> <p>1. The Beneficiary shall be responsible for the coordination and execution of the Program with the Program Implementing Agencies. The Program Executing Agency shall oversee and coordinate the timely implementation of agreed policy, legal, and regulatory actions. The Program Implementing Agencies shall also be responsible for Program administration, disbursements, and maintenance of all Program records. ADB will work through the Beneficiary's Program steering committee mechanism to monitor progress, oversee the implementation of the Program, and guide and direct the activities of the Program Executing Agency.</p>	<p>FA, Schedule 4, Program Implementation and Other Matters</p>	<p>Complied with.</p> <p>The DPA and subsequently DMEA have been responsible for the overall implementation of the program, in coordination with the various implementing agencies. A steering committee meeting was held on 11 August 2016 with 53rd Policy and Planning Coordination Meeting of MOF chaired by the Finance Secretary to review the progress of SEMP II and completion of second-tranche policy actions.</p> <p>The DPA and DMEA have consistently and fully cooperated with the project team and consultants under the piggybacked technical assistance.</p>
<p>Policy Actions and Dialogue</p> <p>2. The Beneficiary shall (a) use its best endeavors to ensure that critical Program staff will remain in their position on a full-time basis for a reasonable duration to ensure continuity in the implementation of the Program; and (b) ensure that all Program Implementing Agencies will be adequately staffed and provided with the necessary financial, technical, and other resources to perform their functions under the Program.</p> <p>3. The Beneficiary shall (a) ensure that all policy actions adopted under the Program, as set out in the Policy Letter and the Policy Matrix, continue to be in effect for the duration of the Program and subsequently; and (b) make submissions to ADB on the completion of actions under the Policy Matrix by reference to the indicators set out therein.</p>	<p>FA, Schedule 4, Program Implementation and Other Matters</p>	<p>Complied with.</p> <p>The DPA and DMEA and implementing agencies have confirmed that all policies adopted and actions taken under the program, as set forth in the Policy Letter and the Policy Matrix, continue to be in effect, and commit to the continuation of the policy actions throughout the program, as recorded in each aide-mémoire following an ADB mission.</p>

Item	Source	Achievement
<p>4. The Beneficiary shall keep ADB informed of policy discussions with other multilateral or bilateral aid agencies that have implications for implementation of the Program, and shall provide ADB with an opportunity to comment on any resulting policy proposals. The Beneficiary shall take into account ADB's views before finalizing and implementing any such proposals.</p>		<p>The DPA and DMEA have informed ADB missions of ongoing and planned activities of other multilateral and bilateral aid agencies and facilitated meetings with the World Bank's resident representative office.</p>
<p>Counterpart Funds</p> <p>5. The Beneficiary shall ensure that the Counterpart Funds are used to finance the implementation of certain programs and activities consistent with the objectives of the Program and provide the necessary budget appropriation to finance the costs relating to the implementation of reforms under the Program.</p>	<p>FA, Schedule 4, Program Implementation and Other Matters</p>	<p>Complied with.</p> <p>The DPA and DMEA have provided information to ADB on the use of counterpart funds as and when needed.</p>
<p>Governance and Anticorruption</p> <p>6. The Beneficiary shall, and cause BDBL, CIB and NPPF to: (a) comply with ADB's Anticorruption Policy (1998, as amended to date) and acknowledge that ADB reserves the right to investigate directly, or through its agents, any alleged corrupt, fraudulent, collusive or coercive practice relating to the Program; and (b) cooperate with any such investigation and extend all necessary assistance for satisfactory completion of such investigation.</p>	<p>FA, Schedule 4, Program Implementation and Other Matters</p>	<p>Complied with.</p> <p>The project team has not received allegations of corrupt, fraudulent, collusive, or coercive practices relating to the program.</p>
<p>Monitoring and Review</p> <p>7. The Beneficiary and ADB shall undertake ongoing monitoring and regular formal review of Program performance. The Beneficiary, through the Program Executing Agency, shall establish and maintain a Program performance monitoring system that will include a database on the compliance status of policy actions.</p> <p>8. The Beneficiary shall monitor the implementation and outcomes of the Program using a set of indicators and targets that has been</p>	<p>FA, Schedule 4, Program Implementation and Other Matters</p>	<p>Complied with.</p> <p>ADB conducted seven review missions in December 2015; February, April, June, September 2016; and January and March 2017.</p> <p>The DPA and DMEA have conducted periodic reviews throughout the program, and provided ADB with the summary of</p>

Item	Source	Achievement
agreed between the Beneficiary and ADB to assess progress towards meeting the objectives of the Program. For each of the agreed indicators, progress shall be measured against the baselines in the design and monitoring framework.		the review meeting held on 11 August 2016.

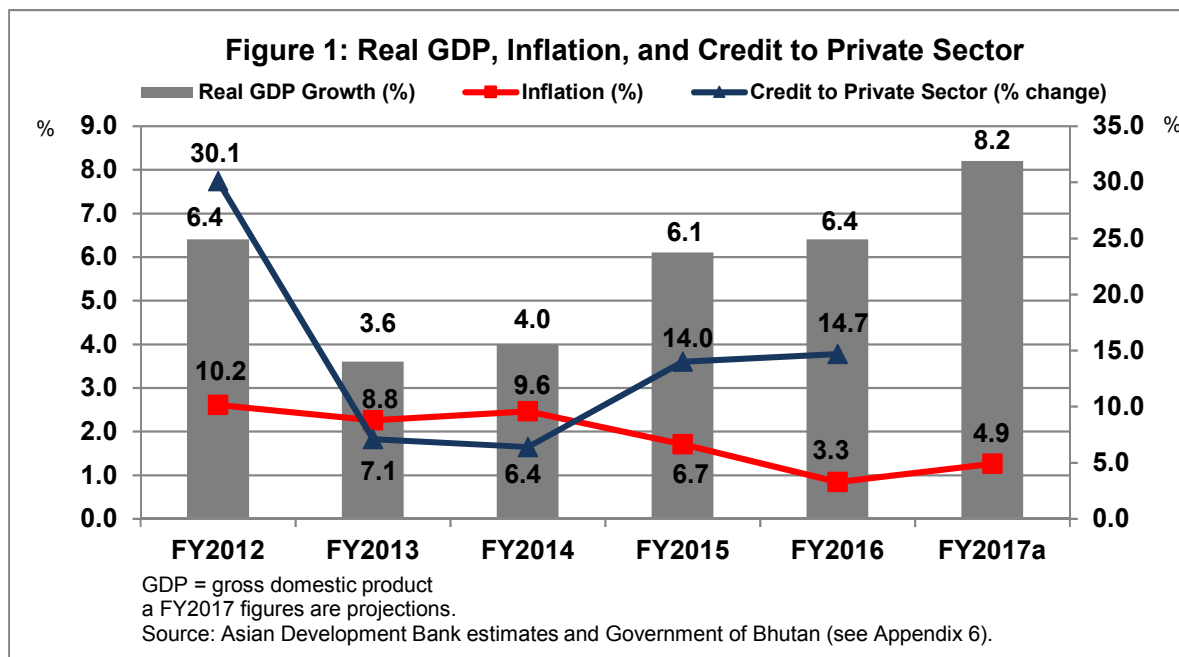
ADB = Asian Development Bank, BDBL = Bhutan Development Bank Limited, CIB = Credit Information Bureau, DMEA = Department of Macroeconomic Affairs, DPA = Department of Public Accounts, FA = Financing Agreement, NPPF = National Pension and Provident Fund, MOF = Ministry of Finance, SEMP II = Strengthening Economic Management Program II.

Source: Asian Development Bank.

ANALYSIS OF MACROECONOMIC DEVELOPMENTS

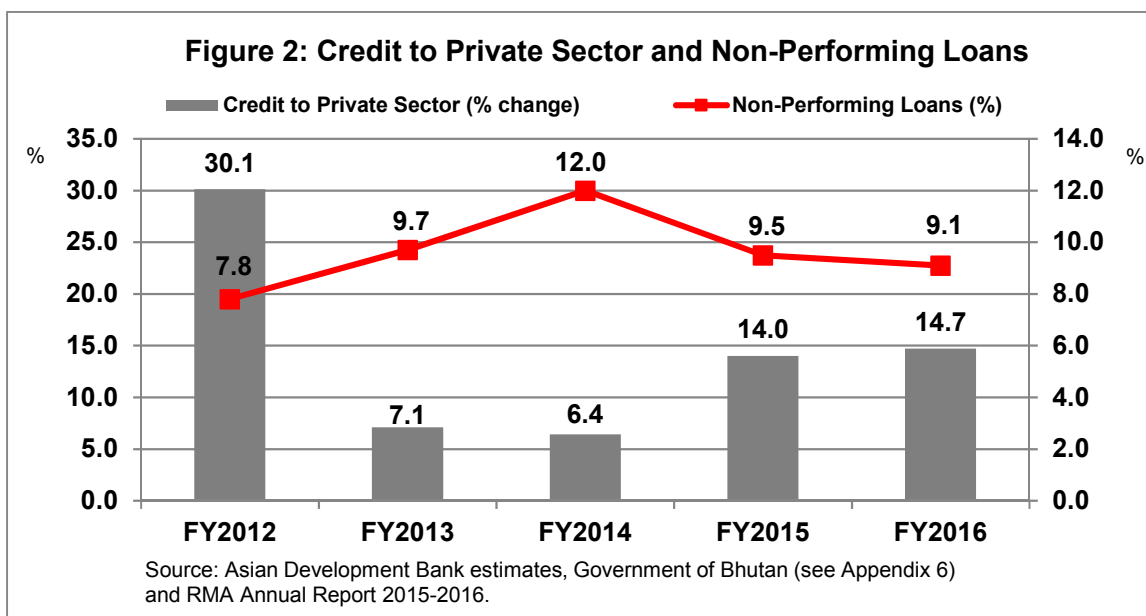
1. The rupee liquidity crunch in Bhutan occurred in fiscal year (FY) 2012 driven by fast credit growth in the banking sector, coupled with a cyclical increase in import demand, reflecting the structural dependence of the Bhutanese economy on lumpy hydropower investment, requiring sporadic and large volumes of spending on construction and equipment as per the needs of the hydropower projects. These two factors led to a liquidity squeeze, hoarding of rupees (required to pay for imports), and downward pressure on rupee reserves. Gross domestic product (GDP) growth slowed from 6.4% in FY2012 to 3.6% in FY2013, well below the average growth rate of over 8% during 2003–2012 (Figure 1). This deceleration was in part engineered by the government—through targeted policy measures—to cool an overheated economy and avoid the risk of a hard landing. The slowdown reflected: (i) credit restrictions in 2012 and an import ban, particularly in import-heavy activities such as construction and transport that required large rupee payments, to alleviate the balance of payment crisis with India and the rupee liquidity shortage; (ii) delays in the construction of new hydropower projects; and (iii) a slowdown in tourist arrivals.

2. Restrictions were gradually relaxed when the currency situation started improving in response to the strict measures by the government and contributions of the ADB's Strengthening Economic Management Program (SEMP) I and II, both of which improved macro-financial management and financial sector development. The economy began its recovery in FY2014, with GDP growth of 4.0% in that year followed by a growth of 6.1% in FY2015 and 6.4% in FY2016. Further, the economy is projected to grow at about 8.2% in FY 2017. The annual growth rate is expected to benefit from various factors, such as the Dagachhu hydropower plant producing in full capacity, and investment in ongoing hydropower projects (e.g., Punatsangchhu 1 & 2, Mangdechhu, Nikachhu and Kholongchhu).



3. The liquidity squeeze reduced private sector credit growth to 7.1% in FY2013, and 6.4% in FY2014, which was expanding at an annual rate exceeding 30% during FY2010–FY2012. While the credit growth increased to 14.7% in FY2016, encouragingly, non-performing loans (NPLs) of financial institutions have remained below 10%, and the ratio has declined to 9.1% in

FY2016 from 12.0% in FY2014 (Figure 2). While a large share of bank lending has been in the housing sector (25%), followed by service and tourism (17%), personal loans (16%), trade and commerce (15%) and manufacturing and industry (14%), the highest proportion of NPLs is in the manufacturing and industry sector.



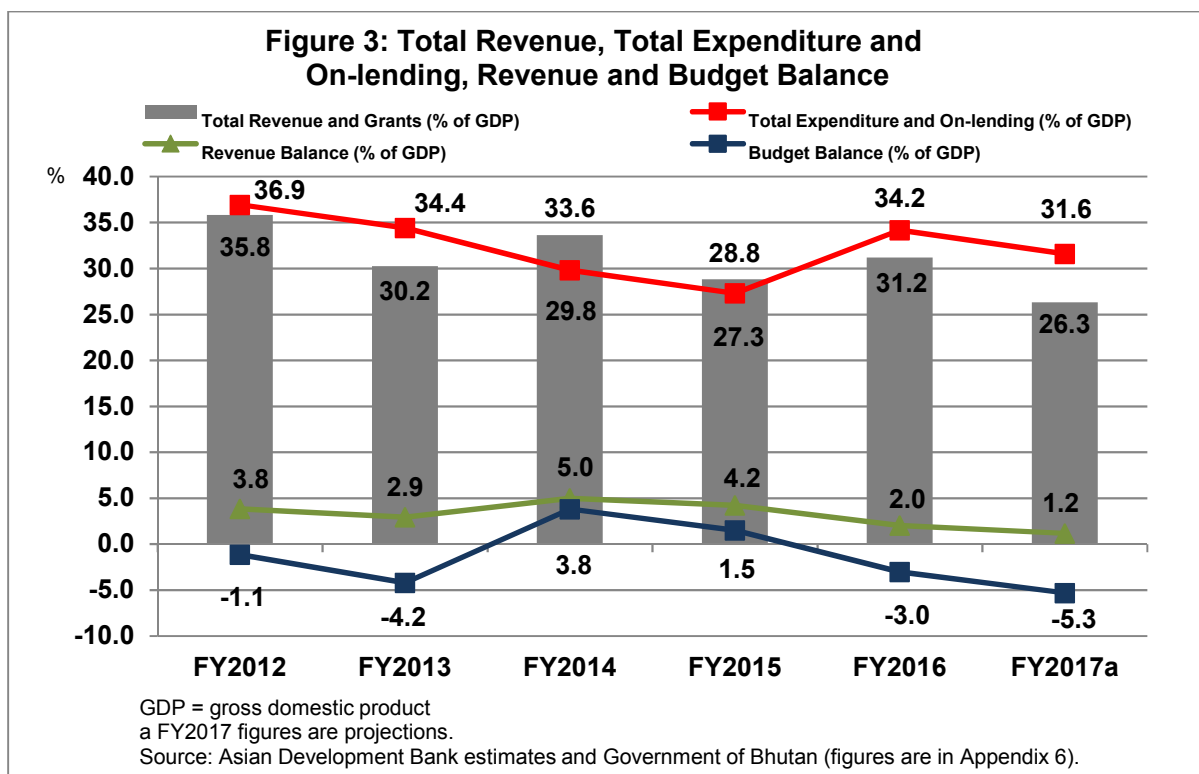
4. Savings mobilization is continuing in Bhutan. Total deposits increased from Nu43.7 billion in FY2012 to Nu73 billion in FY2016. In particular, the share of private sector deposits improved from 71.6% of the total in FY2012 to 84.7% in FY2016. The share of corporate deposits by public and private corporations, commercial banks and non-bank financial institutions declined from 53.2% in FY2012 to 42.5% in FY2016, with a rise of retail deposits (primarily by individuals) from 46.8% in FY2012 to 57.5% in FY2016. Savings deposits grew secularly at an average annual growth rate of 14.7% during FY2012–FY2016.¹

5. Bhutan maintains a currency peg with India. Given the dependence on imports from India, it is not surprising that inflation in Bhutan is highly correlated with Indian inflation. Inflation as measured by the annual percentage change in the consumer price index, peaked in FY2012 at 10.2%. It subsequently moderated to 3.3% in FY2016, in large part because of the decline in crude oil prices over 2 successive years (Figure 1).

6. The constitution of Bhutan mandates that recurrent expenditures be fully financed by domestic revenue. This constitutional provision provides the basic condition for fiscal stability in Bhutan, thus ensuring that any domestic borrowing and aid inflows through grants or loans go entirely towards capital and development projects. In line with this mandate, the revenue balance has consistently been in surplus (exclusive of grants), and averaged 3.7% of GDP during FY2013–FY2016. Prudent fiscal management is also reflected in total expenditures and on-lending, which declined from 36.9% of GDP in FY2012, to 29.8% in FY2014, and 27.3% in FY2015. Total revenue and grants were 33.6% of GDP in FY2014, and 28.8% in FY2015; this resulted in a fiscal surplus of 3.8% in FY2014, and 1.5% in FY2015. However, the expenditure ratio has increased to 34.2% of GDP in FY2016, largely because of a 67% increase in capital expenditure,

¹ Royal Monetary Authority (RMA) of Bhutan. 2016. *Annual Report 2015-2016*. Thimphu.

although revenue and grants increased to 31.2% of GDP in FY2016. Consequently, the budget balance is in deficit (3.0% of GDP) in FY2016 (Figure 3).



7. With the implementation of revenue administration management information system (RAMIS), domestic tax revenue mobilization improved from Nu16.2 billion in FY2014 to Nu18.4 billion in FY2015 and Nu19.9 billion in FY2016, and is expected to reach Nu21.9 billion by FY2019. Domestic revenue continues to exceed current expenditures (Table 1).

Table 1: Domestic Revenues and Expenditures
 Ngultrum (billion)

Item	FY2014	FY2015	FY2016	FY2017 ^a	FY2018 ^b	FY2019 ^b
Domestic Revenue	23.2	25.1	28.0	27.3	28.4	40.15
% of GDP	20.9	20.1	20.0	17.3	15.4	17.9
Tax Revenue	16.2	18.4	19.9	19.6	20.7	21.9
% of GDP	14.5	14.7	14.2	12.4	11.2	9.8
Non-Tax Revenue	7.1	6.8	8.1	7.7	7.8	18.3
% of GDP	6.3	5.4	5.8	4.9	4.2	8.2
Total Expenditure	34.6	36.5	49.7	51.9	47.6	53.2
% of GDP	31.1	29.1	35.5	32.9	25.8	23.7
Current Expenditure	17.9	21	23.9	25.4	26.9	34.8
% of GDP	16.1	16.8	17.1	16.1	14.6	15.5
Capital Expenditure	16.7	15.4	25.8	26.5	20.7	18.4
% of GDP	15	12.3	18.4	16.8	11.2	8.2

FY = fiscal year, GDP = gross domestic product

^a Budgeted

^b Projected

Sources: Ministry of Finance. 2015. *National Budget Financial Year 2015-2016*. Thimphu; Ministry of Finance. 2016. *National Budget Financial Year 2016-2017*. Thimphu; Ministry of Finance, Department of Revenue and Customs. 2016. *National Revenue Report 2015-2016*. Thimphu.

8. In FY2016 corporate income taxes provided 38% of tax revenues, followed by personal income taxes (9%) and business income taxes (6%). Direct tax revenue collection increased from Nu11.1 billion in FY2014 to Nu11.6 billion in FY2015 and Nu12.2 billion in FY2016. Personal income tax collection increased from Nu1.3 billion in FY2014 to Nu1.5 billion in FY2015 and Nu1.8 billion in FY2016. Among indirect taxes, sales tax collection increased from Nu2.2 billion in FY2014 to Nu3.1 billion in FY2015 and Nu3.6 billion in FY2016 (Table 2).

Table 2: Breakdown of Tax Revenues

Ngultrum (billion)

Source of Revenue	FY2014	% GDP	FY2015	% GDP	FY2016	% GDP
Tax Revenue	16.2	14.5	18.4	14.7	19.9	14.2
Direct Tax	11.1	10.0	11.6	9.3	12.2	8.7
Corporate Income Tax	6.1	5.5	6.5	5.2	7.5	5.3
Business Income Tax	1.8	1.6	1.6	1.3	1.2	0.8
Personal Income Tax	1.3	1.1	1.5	1.2	1.8	1.3
Other Tax Revenue	1.9	1.7	2.0	1.6	1.8	1.3
Indirect Tax	5.1	4.5	6.8	5.4	7.7	5.5
Sales Tax	2.2	1.9	3.1	2.4	3.6	2.6
Excise Duty	2.6	2.3	2.7	2.1	2.5	1.8
Customs Duty	0.3	0.3	0.4	0.4	0.6	0.4
Green Tax	1.7	1.5	0.5	0.4	1.0	0.7
Other indirect taxes	0.02	0.02	0.02	0.02	0.02	0.01
Non-Tax Revenue	7.1	6.3	6.8	5.4	8.1	5.8

FY = fiscal year, GDP = gross domestic product

Sources: Ministry of Finance. 2015. *National Budget Financial Year 2015-2016*. Thimphu; Ministry of Finance. 2016. *National Budget Financial Year 2016-2017*. Thimphu; Ministry of Finance, Department of Revenue and Customs. 2015. *National Revenue Report 2014-2015*. Thimphu; Ministry of Finance, Department of Revenue and Customs. 2016. *National Revenue Report 2015-2016*. Thimphu.

9. Most capital investments are financed through external grants and borrowings, and there is minimal recourse to domestic borrowings. The outstanding domestic debt at the end of FY2016 was Nu66.5 million or 0.04% of the total outstanding debt of Nu139,879.3 million. Except for a few instances of bond issuance for specific requirements, most domestic funding has been through treasury bills (T-Bills), which serve the dual purpose of bridging the domestic funding gap and managing temporary cash shortfalls. Coupled with the policy to redeem all T-bills by the end of the year, it has pushed the opening cash balance to negative at the beginning of each year since FY2013 (Table 3). The debt market lacks depth but the government is undertaking various initiatives to strengthen domestic debt management. As a first step, an annual T-Bill issuance calendar has been published, coming into effect from 1 July 2016. It will help financial institutions plan their exposure in advance and thereby encourage their participation in auctions. It will also help Bhutan's Treasury better manage its liquidity position, leading to cost savings.

Table 3: Opening Balance in Government's Consolidated (Fund) Account

Ngultrum (millions)

	FY2012	FY2013	FY2014	FY2015	FY2016
Opening Balance	1327.2	(956.5)	(3005.9)	(1385.9)	(1232.5)

() = negative, FY = fiscal year

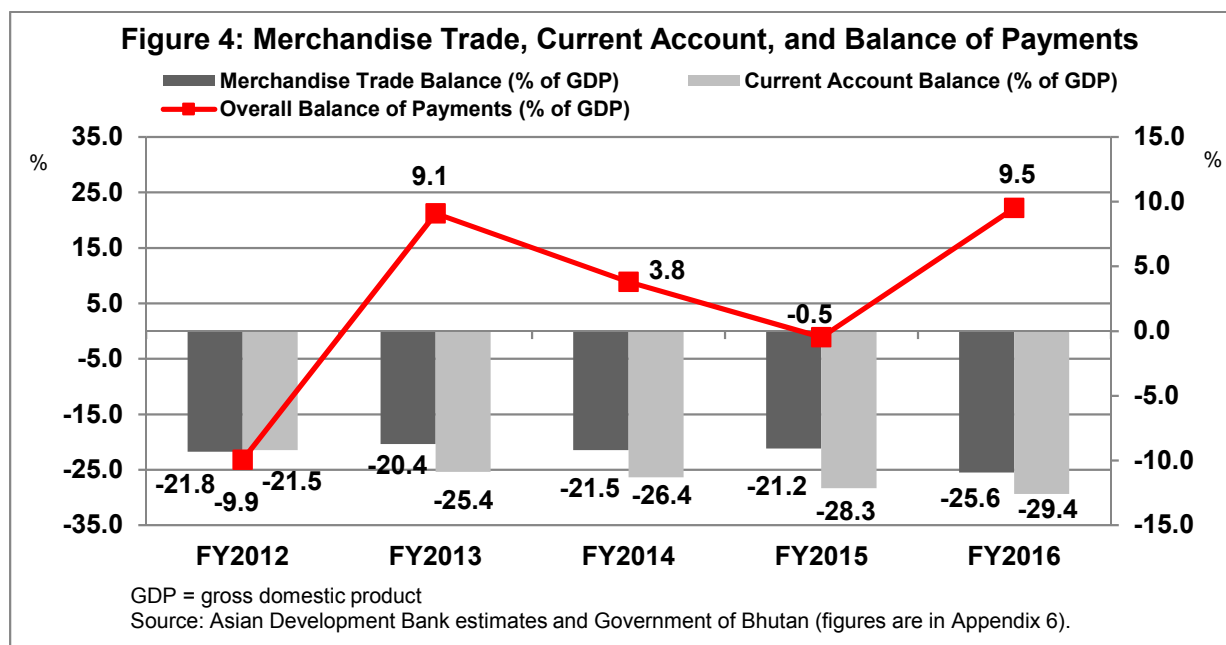
Source: Ministry of Finance.

10. The government's attention to fiscal discipline is also reflected in the introduction of annual performance agreements (APAs) with spending agencies in the FY2015 budget. APAs link the budget of agencies with their outputs and outcomes, thus enabling a results-based management framework. APAs also promote decentralized decision making by giving flexibility to the agencies

and by restricting the roles of the central agencies to policy, planning, monitoring and evaluation. The budget for FY2017 further strengthens performance monitoring by integrating the budgeting system with the Government Performance Management System, and thus linking the agencies' targets and objectives to the budget. The National Technical Committee was formed to review plans, policies, and targets at the beginning of the year, and evaluate year-end achievements.

11. Hydropower-led development supported by the Government of India through loans and grants has been beneficial for Bhutan. Guaranteed electricity exports to India now constitute the largest proportion of total exports (at 34.6% in 2016). With three more mega-hydropower projects commencing operations in 2018 and 2019,² hydropower export earnings are expected to triple. By 2025, five more hydropower projects are expected to be operational. Because India accounted for 90.3% of exports and 79% of imports in FY2016, the hydropower sector provides an automatic currency hedge. Although the ratio of external debt to GDP is high (111.6% in FY2016), because the debt primarily finances capital investment in the hydropower sector, a debt sustainability analysis by the International Monetary Fund (2016)³ indicates moderate risk for Bhutan.

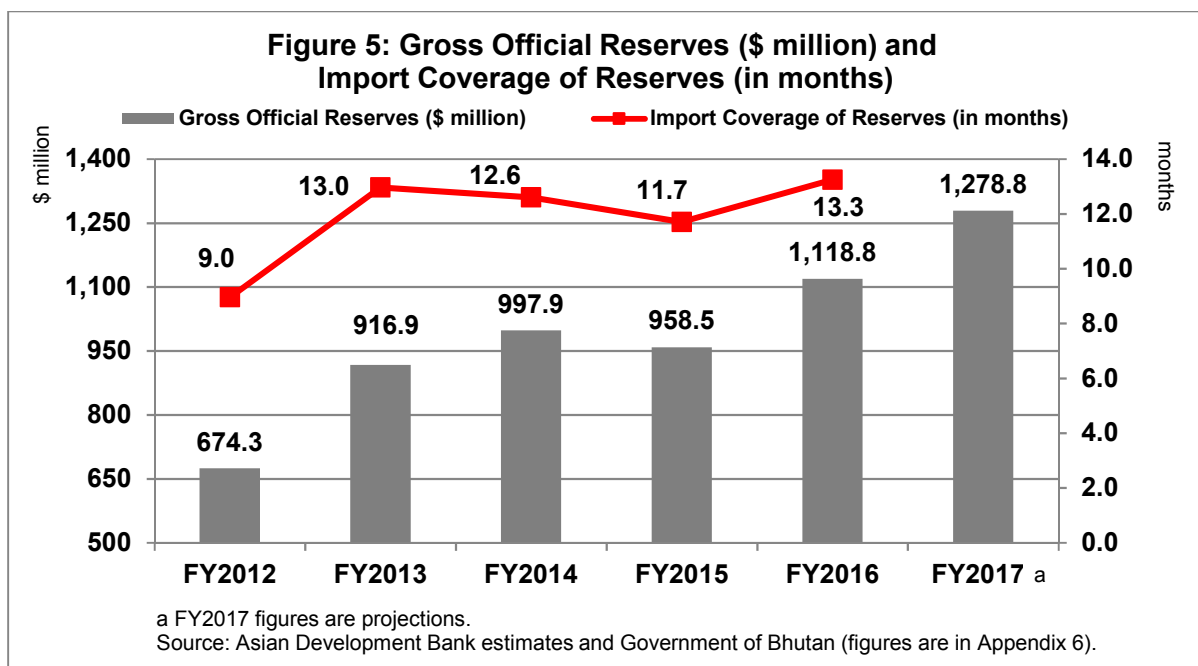
12. With the stabilization measures in place following the rupee liquidity crunch, international reserves increased by 36%—from \$674.3 million in FY2012 to \$917 million in FY2013—while the balance of payments to GDP ratio went from a deficit of 9.9% in FY2012 to a surplus of 9.1% in FY2013. The capital inflows for hydropower have been instrumental in offsetting the current account deficit under the overall balance of payments, and largely account for the surplus in foreign exchange reserves in subsequent fiscal years. Against a current account deficit of \$621 million in FY2016, the capital and financial account surplus was \$831 million, with a consequent increase in reserves by \$189.9 million thus reaching \$1,118.8 million at the close of FY2016.⁴ This was adequate to meet 13.3 months of imports, comfortably above the constitutionally mandated requirement to cover minimum 12 months of essential imports (Figures 4 and 5).



² Punatsangchhu 1 is expected to commence operations in 2019, and Punatsangchhu 2, and Mangdechhu in 2018.

³ International Monetary Fund. Staff Report for the 2016 Article IV Consultation. June 2016. IMF Country Report No. 16/206.

⁴ Royal Monetary Authority of Bhutan. 2017. *Monthly Statistical Bulletin*. XVI (2). February. Values in ngultrum converted to dollars using the corresponding average exchange rate.



13. At the same time, dependence on hydropower sector also exposes Bhutan to risk. Hydropower inflows are seasonal and huge. They need to be regularly monitored to avoid overheating of the economy. For example, the liquidity crisis of 2012 has its roots in the capital inflows from hydropower sector. Banks employed the lag in utilization of hydropower inflows to advance short-term loans that were largely used to finance imports from India. That resulted in a shortage of Indian rupees. Conscious of the risks, the government is contemplating a strategic push into agro-based businesses, small cottage industries and the tourism sector.

14. There is an expected benefit from economic growth contributed largely through the upcoming hydropower projects. The government's focus on diversification beyond hydropower is expected to provide further resilience to the economy. There is also an effort to limit the inflation linkage with India, through measures such as management of buffer stocks and promotion of domestic agricultural production. In the external sector, while there is a current account deficit with India, capital and financial inflows combined provide a surplus. Bhutan has learned from the recent rupee shortage. Most restrictions have now been withdrawn and credit to the private sector has subsequently expanded. Bhutan is well ahead of neighboring countries in terms of its fiscal space. Recurrent expenditures are met entirely from domestic revenue, with a surplus contributing to capital expenditures. Budget deficits, if any, result entirely from investment projects.

15. In summary, while SEMP I contributed to the stabilization of the Bhutanese economy following the rupee liquidity crisis, SEMP II contributed to maintaining the momentum of recovery and further strengthening of fiscal management by improving efficiency in tax administration and taxpayer service delivery, building the capacity of local governments in property tax collections, and better cash management through a pre-determined T-bill issuance schedule. The program also improved macroprudential management, which is critical for a sound financial system; helped develop the capital markets and credit information bureau services; and promoted financial inclusion through a regulatory framework, outreach to rural communities via branchless banking, and financial literacy education. These achievements are expected to help mobilize further savings, deepen the financial system, and improve financial intermediation in Bhutan in support of private sector development.

KEY ECONOMIC INDICATORS

Item	Fiscal Year					
	2012	2013	2014	2015	2016	2017 ^b
A. Income and Growth						
1. GDP per capita (\$, current prices)	2,517	2,522	2,455	2,677	2,751 ^a	...
2. GDP growth (% , constant prices)	6.4	3.6	4.0	6.1	6.4 ^a	8.2
a. Agriculture	2.3	2.3	2.4	3.5	4.0 ^a	...
b. Industry	5.4	5.3	3.8	6.0	7.3 ^a	...
c. Services	6.6	1.1	5.0	8.3	7.1 ^a	...
B. Savings and Investment (% of GDP, current prices)^d						
1. Gross domestic investment	67.8	56.5	49.0	52.9
2. Gross domestic saving	41.2	33.5	27.6	28.7
C. Money and Inflation (annual % change)						
1. Consumer price index	10.2	8.8	9.6	6.7	3.3	4.9
2. Money Supply (M2) - End of Period	(1.02)	18.6	6.6	7.8	15.8	...
3. Credit to private sector	30.1	7.1	6.4	14.0	14.7	...
D. Government Finance (% of GDP)						
1. Revenue and grants	35.8	30.2	33.6	28.8	31.2 ^a	26.3
2. Expenditure and on-lending	36.9	34.4	29.8	27.3	34.2 ^a	31.6
3. Revenue surplus (excluding grants) ^c	4.0	3.1	5.4	4.2	2.0	1.2
4. Overall fiscal surplus (deficit)	(1.1)	(4.2)	3.8	1.5	(3.0) ^a	(5.3)
E. Balance of Payments						
1. Merchandise trade balance (% of GDP)	(21.8)	(20.4)	(21.5)	(21.2)	(25.6) ^a	...
2. Current account balance (% of GDP)	(21.5)	(25.4)	(26.4)	(28.3)	(29.4) ^a	(27.4)
3. Merchandise export (\$) growth (annual % change)	(7.3)	(11.5)	(2.0)	8.4	(15.0)	2.0
4. Merchandise import (\$) growth (annual % change)	(10.0)	(8.8)	0.6	8.8	2.4	6.0
5. Overall balance of payments (% of GDP) ^c	(9.9)	9.1	3.8	(0.5)	9.5	(9.9)
F. External Payments Indicators						
1. Gross official reserves (\$ million)	674.3	916.9	997.9	958.5	1,118.8	1,278.8
(in months of current year's imports of goods)	9.0	13.0	12.6	11.7	13.3	...
2. External debt service	127.1	229.2	27.1	19.9	14.5	...
(% of exports of goods & services)	78.3	94.6	94.0	94.0	111.6 ^a	...
3. External debt (% of GDP)	78.3	94.6	94.0	94.0	111.6 ^a	...
G. Memorandum Items						
1. GDP (current prices, Nu billion)	91.2	101.4	112.5	125.8	140.3 ^a	158.2
2. Exchange rate (Nu/\$, average)	50.3	54.9	61.5	62.1	66.3	...
3. Population (million)	0.7	0.7	0.8	0.8	0.8	0.8

... = not available, () = negative, ADB = Asian Development Bank, GDP = gross domestic product, M2 = money supply, Nu = ngultrum, RMA = Royal Monetary Authority.

Notes:

1. The fiscal year ends on 30 June.

2. GDP data from RMA is on calendar year basis. In ADB staff estimates, it has been converted to financial year basis by taking averages of the corresponding calendar years.

^a Estimate

^b Figures for 2017 are projections from various sources.

^c ADB staff estimates were not available. RMA data series has been adjusted to a financial year basis by taking the corresponding adjustment ratio for other series, for which ADB estimates are available.

^d Unadjusted value from the World Bank. World Development Indicators, accessed from online database on 22 March 2017.

Sources: ADB staff estimates; Government of Bhutan. National Statistics Bureau of Bhutan. 2016. *Statistical Yearbook of Bhutan 2016*. Thimphu; Royal Monetary Authority of Bhutan. 2016. *Annual Report 2015-2016*. Thimphu; Royal Monetary Authority of Bhutan. 2017. *Monthly Statistical Bulletin*. XVI (3). March; National Statistics Bureau of Bhutan. *National Accounts Statistics 2016*. Thimphu; Ministry of Finance. *National Budget Financial Year 2016-2017*. Thimphu.