

ASSESSMENT OF THE STRENGTHENING ECONOMIC MANAGEMENT PROGRAM

I. Objectives of the Program

1. The Strengthening Economic Management Program¹ (SEMP I) was designed against the backdrop of an episode of macroeconomic instability that began with the rupee liquidity crunch in FY2012 in Bhutan, instigated by both structural and cyclical factors. The objective of the program was to strengthen macrofinancial management of the economy and enhance its resistance to shocks.

2. The Asian Development Bank (ADB) approved SEM P I for the equivalent of \$35 million on 21 March 2013. The program had two tranches: (i) the first tranche, a grant of \$20.81 million, was disbursed on the same day as program approval, reflecting full compliance with 10 policy actions; and (ii) the second and final tranche, a loan of SDR9.224 million was disbursed on 24 July 2014, upon full compliance of 15 policy actions.

II. Key Achievements of SEM P I

3. The program comprised four components: (i) budget and debt management, (ii) revenue management, (iii) monetary and liquidity management, and (iv) external and internal audit.

A. Budget and Debt Management

4. The main objective of the budget and debt management component was to improve the effectiveness of public spending and to strengthen debt, reserves, and cash management to synchronize revenue flows with the debt repayments.

5. To strengthen debt programming, monitoring and reporting, Debt Management Division (DMD) was created and staffed. Ministry of Finance (MOF) finalized the Medium-Term Debt Management Strategy and an action plan. DMD prepared an annual debt sustainability analysis. Training of the Treasury staff on the management of reserves, open market operations, and forecasting of government central accounts were supported by technical assistance programs.

6. To develop the government securities market, MOF and the Royal Monetary Authority (RMA) approved a strategy paper, addressing narrow investor base, lack of auction calendar, promotion of price competition, and functional integration of the Treasury Management and Debt Management Divisions. In connection with the strategy, MOF established the primary market's regulatory framework, including auction rules and procedures. Expenditure and revenue forecasting templates were developed and piloted by the Department of Public Accounts to forecast the liquidity needs of the government. Regulations for the establishment of a central depository and clearing house were drafted and circulated.

7. To create the fiscal space needed by subnational governments, multi-year annual budget preparation based on medium-term expenditure framework (MTEF) was completed in Thimphu, Phuentsholing, Samdrup Jongkhar, and Gelephu municipalities.

¹ 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 (Loan 2994/Grant 0338-BHU).

B. Revenue Management

8. The main objectives of the revenue management component were broadening of the tax base to lower dependence on external grants and loans in light of the graduation of Bhutan to middle-income status, and enhanced tax administration to rein in budget deficits and finance a larger share of development outlays from domestic resources.

9. The Department of Revenue and Customs (DRC) approved a new revenue chart of account in line with IMF statistics and the new taxpayer number scheme.

10. DRC completed the pilot implementation of the revenue administration management information system (RAMIS)—including income tax, sales tax at point of sales, and revenue accounting modules. The whole system will provide full integration with customs, excise, and sales tax at point of entry modules. With the RAMIS, DRC establishes a web-based information technology (IT) infrastructure that is critical for making the transformation toward an automated tax system. Full implementation of RAMIS will expand the revenue base through strengthening the effectiveness of tax collection, and help reduce the budget deficits through efficient revenue administration and greater tax compliance achieved by risk-based tax audits.

11. To enhance subnational revenue collection, the Property Valuation Methodology (PVM) based on the objective valuation of land and properties was approved by Ministry of Works and Human Settlement and MOF and new rules and regulations came into effect. The PVM was successfully piloted in Phuentsholing.

C. Monetary and Liquidity Management

12. The main objective of the monetary and liquidity management component was to strengthen the Bhutan's financial system through macroprudential regulations, savings mobilization, and development of national capital markets.

13. The formulation of macroprudential policy paper and the corresponding rules and regulations by the RMA filled an important gap against the risks arising from the procyclicality of bank lending.

14. The new rules and regulations, effective as of May 2014, covered (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 profits; (vii) debt to equity ratio for project financing; and (viii) bank disclosure requirements.

15. The RMA piloted the implementation through (i) notification of the eight rules and regulations to the financial sector, (ii) approval of a timeline for implementation of the regulations starting November 2014, (iii) capacity building of RMA officials and representatives of the Bhutanese financial institutions in stakeholders' workshop, and (iv) training on the stress testing framework.

16. The action plan formulated by RMA for the improvement of the wholesale–retail deposit ratio addressed the structural problem of asset–liability mismatch in the banking sector and laid out actions for savings mobilization. The implementation report showed that banks have started to offer new types of savings products. The RMA made proposals in the 2001 Income Tax Act to link the tax exemption limit for long-term savings accounts to extend the duration of bank

deposits. RMA approved the regulation for branchless mobile banking, but the launch of agencies throughout rural Bhutan is not yet completed. The deposit insurance scheme was partially implemented with the 2011 Financial Services Act, which mandates the RMA to set up a deposit insurance fund up. On the liability side, short-term investment instruments such as T-bills are yet to be introduced once the government securities market develops.

17. RMA formulated the Capital Markets Master Plan for 2014–2024 to diversify away from Bhutan’s predominantly bank-based system to alternative sources of financial intermediation, and improve the financial sector’s resilience. Policies were formulated for the development of an active market for equities and corporate bonds, institutional investors such as pension, mutual and insurance funds, as well as the legal, regulatory, and supervisory framework. RMA licensed a fund management company, based on the approved fund management regulation. SEMP I played a significant role in building a constituency for the Capital Markets Master Plan through the stakeholder seminars.

18. RMA approved and made effective the regulatory and supervisory framework for the domestic credit rating agency (CRA). The services of CRA includes issuance of credit ratings on: (i) debt instruments (equities and bonds), (ii) creditworthiness of small and medium-sized enterprises, (iii) initial public offerings of equity securities, (iv) corporate governance practices of companies listed on the Royal Securities Exchange of Bhutan; and (v) performance of investment funds. The regulation allows for the establishment of joint-ventures with foreign CRAs in Bhutan.

D. External and Internal Audit

19. The objective of the external and internal audit component was to improve the accountability and effective use of public resources amid a growing and complex administration.

20. The Royal Audit Authority (RAA) completed the pilot implementation of Audit Resource Management System (ARMS), which provides the IT infrastructure to efficiently administer audit functions.

21. RAA approved an internal audit manual and completed training of internal audit staff.

III. Technical Assistance

22. Five ADB technical assistance (TA) projects supported the implementation of the program. The preparation of MTEF reports, part of the implementation of RAMIS, and preparation of the PVM took place under the TA for Strengthening Public Management in Bhutan.² The pilot implementation of RAMIS took place under the TA for Developing a Revenue Administration Management Information System.³ Actions related to the development of a government securities market, action plan for improvement of banking sector wholesale-retail deposit ratio, a master plan for capital markets, and formulation of a regulatory framework for CRAs took place under the TA for Capital Market Development.⁴ The preparation of macroprudential rules and regulations took place under the TA for Supporting Financial Stability

² ADB. 2010. *Technical Assistance to the Kingdom of Bhutan for Strengthening Public Management in Bhutan*. Manila (TA 7724 BHU).

³ ADB. 2011. *Technical Assistance to the Kingdom of Bhutan for Developing a Revenue Administration Management Information System*. Manila (TA 7881-BHU).

⁴ ADB. 2012. *Technical Assistance to the Kingdom of Bhutan for Capital Market Development*. Manila (TA 8280-BHU).

in Bhutan and the Maldives.⁵ Finally, the pilot implementation of ARMS took place under the TA for Strengthening Audit Resource Management.⁶ The TA resources were effectively used and the intense training support provided by TA interventions benefited more than 300 participants.

IV. Program Impact

23. Following clear signs of overheating in FY2012, the Government and the RMA slowed down the economy through the restrictions on credit growth on personal, housing, and transport sector loans, and emergency administrative measures such as import ban on vehicles and restrictions on convertibility of ngultrum. These policy and administrative measures successfully led to a soft landing of the economy during the rupee liquidity crunch. As the credit growth was curtailed, inflation was reversed, the economic growth decelerated, and the rupee shortages were systematically eased. The economy has stabilized and been supported by reserve accumulation as balance of payments turned to a surplus.⁷

24. Alongside the short-term measures, SEMP I made a significant impact by strengthening the institutions for macrofinancial management and more effective use of the country's own financial resources, and contributed to the achievement of critical macroeconomic targets. Training provided by the program enhanced sustainability of reforms.

25. The success hinges on the political commitment of the MOF and RMA officials to bring about the essential yet difficult reforms to set the economic recovery on a sustainable trajectory, and the strong partnership, policy dialogue and effective coordination among ADB and government officials.

⁵ ADB. 2012. *Technical Assistance for Supporting Financial Stability in Bhutan and the Maldives*. Manila (TA 8284-REG).

⁶ ADB. 2010. *Technical Assistance to the Kingdom of Bhutan for Strengthening Audit Resource Management*. Manila (TA 7723-BHU).

⁷ Analysis of recent macroeconomic developments during the implementation of SEMP I is provided in Sector Assessment (Summary) (accessible from the list of linked documents in Appendix 2 of the main text).