SECTOR ASSESSMENT (SUMMARY): PUBLIC SECTOR MANAGEMENT

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. With hydropower sector as the engine of growth, Bhutan achieved an average gross domestic product (GDP) growth rate of 8% during fiscal years (FYs) 2001–2011 and almost doubled GDP per capita, measured in 2005 constant dollars, from $1,042 in 2001 to $1,905 in 2011.[1] Despite limited domestic savings, using hydropower revenues and external assistance in the form of grants and highly concessional borrowing, the government has embarked on an ambitious buildup of public spending, prioritizing infrastructure development, poverty reduction, and investment in health and education.

2. Despite the high growth performance, the rupee liquidity crunch in FY2012 exposed the critical structural and cyclical imbalances of the Bhutanese economic model. On the structural side, Bhutan has a narrow economic base and relies heavily on export of hydroelectricity to India, which requires large imports of construction materials for hydropower plants before the ensuing export revenue flows are generated. On the cyclical side, the mismatches between revenue flows and demand for rupees associated with the large imports of construction materials and debt repayments for hydropower development have worsened the balance of payments position. To complicate matters, reflecting Bhutan's rapid increase in income per capita, consumption patterns have been changing, resulting in an increase in import demand for consumption goods from India, instigated by rapid credit growth in the banking system. During the liquidity crunch, coupled with weaknesses in liquidity management, the peak of the cycle coincided with rising import demand, leading to depletion of Indian rupee reserves.

3. The government and the Royal Monetary Authority (RMA) responded to the rupee liquidity crunch with monetary, banking, and administrative measures, and managed to engineer a soft landing of the economy. Alongside these short-term measures, reforms under the Asian Development Bank (ADB) financed Strengthening Economic Management Program (SEMP I)[2] improved systems and institutions for (i) budget and debt management, (ii) revenue collection and administration, (iii) macroprudential management of the financial sector, and (iv) external and internal audit operations.

4. GDP growth slowed from 6.4% in FY2012 to 3.5% in FY2013 as a result of restrictions on credit growth and imports, and subsequent declines in manufacturing, construction, and government sectors (Table 1).[3] Inflation declined to 8.8% in FY2013 from 10.2% in FY2012, due in particular to price developments in India and domestic monetary tightening. With measures to reduce shortages of Indian rupee reserves in place, in FY2014, gross reserves reached $997.9

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[1] World Bank. 2015. *World Development Indicators, 2015.* Washington, DC.

[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 Strengthening Economic Management Program.* Manila (Loan 2994 /Grant 0338-BHU)

[3] Targeted measures such as administrative restrictions on imports of vehicles and construction materials; growth of credit; and convertibility of ngultrum to foreign currencies have lowered import-dependent consumption, and moderated demand for Indian rupees. Due to restrictions, import growth shrank by 10% in FY2012 and further by 6.4% in FY2013 from a growth rate of 41.7% in FY2011. Credit growth declined to 7.1% in FY2013 from 30.1% in FY2012.

million, of which 83.1% were held in convertible currency and 16.9% as Indian rupee reserves.[4]

Table 1: Macroeconomic Indicators

Item	FY2010	FY2011	FY2012	FY2013	FY2014
Real GDP growth (%)	9.3	9.7	6.4	3.5	4.0
Inflation (%)	4.8	8.6	10.2	8.8	9.6
Merchandise import ($) growth (%)	36.1	41.7	(10.0)	(6.4)	(5.0)
Credit to private sector growth (%)	40.7	29.4	30.1	7.1	6.4
Gross official reserves ($ million)	759.4	796.2	674.3	916.9	997.9
in months of current year's imports of goods	11.5	8.4	9.0	12.6	13.0

( ) = negative, FY = fiscal year, GDP = gross domestic product.
Source: Country Economic Indicators (accessible from the list of linked documents in Appendix 2 of the main text).

5. Although Bhutan's fiscal policy has remained prudent, Table 2 shows that the fiscal deficit increased to 4% of GDP in FY2013 and FY2014 from 1.2% in FY2012 due to the decline in grants and lower tax revenues. The fiscal deficit is projected to stay below 3% with austerity measures in FY2015. The fiscal deficit is expected to decline further to 0.9% in FY2016, and turn to a modest surplus of 0.1% in FY2017, reflecting the projected increase in grants in FY2016, accrual of the impact from revenue reforms under the Strengthening Economic Management Program II from FY2016 onwards, and the start of operation of new hydropower projects in FY2017. Bhutan's total public debt to GDP is projected to increase to 122.5% by FY2017 from 98.4% in FY2013 due to the targeted construction of 10 hydropower projects by 2020. However debt sustainability analysis indicates that public debt poses only moderate risk because of the favorable financing arrangements with India and strong economic returns from the hydropower projects. Non-hydropower debt stabilizes at 33% of GDP in FY2014.

Table 2: Fiscal and Debt Indicators
(% of gross domestic product)

Item	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015 Budget	FY2016 Proj.	FY2017 Proj.
Fiscal balance	1.8	(2.3)	(1.2)	(4.1)	(4.0)	(2.7)	(0.9)	0.1
Total public debt	66.6	79.5	87.4	98.4	101.3	106.5	117.3	122.5
Non-hydro debt	…	…	…	39.2	33.0	33.4	33.6	31.1

… = data not available, ( ) = negative, FY = fiscal year, Proj. = projection.
Sources: Royal Monetary Authority. 2014. *Monthly Statistical Bulletin*. June. Thimphu; Government of Bhutan, Ministry of Finance. 2014. *National Budget Financial Year 2014/2015*. June. Thimphu; Royal Monetary Authority. 2015. *Annual Report 2013/14.* January. Thimphu. Fiscal balance for FY2016 and FY2017 is Asian Development Bank projection from Economic and Financial Analysis (accessible from the list of linked documents in Appendix 2 of the main text).

6. The hydropower-related trade continued to drive the external sector, accounting for nearly one-third of exports. While trade deficit narrowed to 22.6% of GDP in FY2013 from 23.4% in FY2012 with import restrictions, current account deficit widened to 28.2% of GDP from 23.3% on lower current transfers and increased interest payments on overdraft and swap facilities with the Reserve Bank of India. (Table 3) Capital transfers, foreign direct investment, and foreign loans (including hydropower) funded the large current account deficit. The balance of payments moved to a surplus of 9.5% of GDP in FY2013 and 5.8% in FY2014, marking a sharp turnaround from a deficit of 10.7% of GDP in FY2012 and is projected to be in surplus with favorable capital and financial accounts.

[4] For short-term liquidity support, RMA entered into a bilateral swap agreement of Rs5.4 billion with the Reserve Bank of India; utilized the Government of India's standby facility for Rs4 billion; sold $200 million into Indian rupees to liquidate the overdraft facility with the State Bank of India. The government issued Treasury bills and used its overdraft facility with RMA to finance cash shortages and rupee requirements. For reserve management, RMA developed minimum reserve thresholds and management guidelines for operations based on import, debt service, and expenditure requirements. To avoid destabilizing spikes, debt repayments were decreased to twice a year.

Table 3: Merchandise Trade Balance
(% of gross domestic product)

Item	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015 Proj.	FY2016 Proj.
Merchandise trade balance	(20.5)	(28.7)	(23.4)	(22.6)	(21.5)	(20.3)	(22.3)
Current account balance	(24.3)	(32.6)	(23.3)	(28.2)	(27.3)	(29.9)	(30.6)
Balance of payments	7.2	1.1	(10.7)	9.5	5.8	16.1	8.9

( ) = negative, FY = fiscal year, Proj. = projection.
Sources: Country Economic Indicators (accessible from the list of linked documents in Appendix 2 of the main text) and Royal Monetary Authority. 2014. *Monetary Policy Statement.* June. Thimphu.

7. In terms of economic prospects, GDP growth is expected to reach 6.8% in FY2015, 5.2% in FY2016, and 5.1% in FY2017 as hydropower construction expands under the Eleventh Five-Year Plan (2013–2018) and exports increase with the start of operations at the Dagachhu power plant.[5] Tourism is predicted to expand as the economies of major tourist source countries improve. Growth will receive further boost from the government's Economic Stimulus Plan.

8. In summary, the measures by the government and reforms under SEMP I reduced the severity of the liquidity crunch and stabilized the economy. The key challenge ahead is to focus on reviving growth following the removal of temporary restrictions, particularly on credit,[6] and putting in place more permanent, structural, and corrective measures to rebalance and reorient the economy. Thus, the following shortcomings have to be corrected for a sustainable growth trajectory and a more inclusive and balanced growth model in Bhutan.

9. First, to sustain the recovery in the short term, institutions for macrofinancial management need to be strengthened by deepening reforms to effectively manage the potential fiscal, monetary, financial, and balance of payments shocks to the economy. Second, to rebalance the economy by promoting investment in the medium term, financial intermediation must be enhanced by (i) developing a banking system with strong macroprudential regulations, (ii) deepening capital markets with increased participation of nonbank financial institutions, (iii) increasing financial inclusion, and (iv) mobilizing savings. Strengthening the financial sector will help reorient and diversify the economy in the long term by improving the business climate for private sector development,[7] which is critical for poverty reduction and employment generation.

2. Government's Sector Strategy

10. The government has initiated several policy reforms to address these challenges. In the public sector, debt and cash management capabilities have been strengthened. In the financial sector, strong supervisory oversight by RMA, in combination with macroprudential regulations, helped the banking system remain resilient to the rupee liquidity crunch. The government has been committed to the Capital Markets Master Plan through strengthening the legal, regulatory, and institutional framework for bond and equity markets and nonbank financial institutions such as pension, mutual, and insurance funds. For private sector development, the government formulated the Economic Development Policy (2010) and the Cottage, Small and Medium

[5] Government of Bhutan, Ministry of Finance. 2014. *National Budget Financial Year 2014/2015*. June. Thimphu.
[6] As of 1 September 2014, RMA reintroduced housing and vehicle loans. To encourage responsible lending and counter any prospective overheating and pressure on rupee reserves, RMA kept a loan-to-value cap in place for home and vehicle loans, and imposed a total loan-to-income cap of 70% for consumer loans.
[7] A diagnostic report on Bhutan's development constraints cited (i) limited access to finance, (ii) inadequate infrastructure, particularly in transport and (iii) shortage of workers with appropriate skills and extensive mismatching in the labor market among the key impediments to private sector development. ADB. 2013. *Country Diagnostic Studies. Bhutan: Critical Development Constraints*. Manila.

Industry Development Strategy (2012–2020). The government has also been working to improve the business climate through the Doing Business Steering Committee, chaired by the Prime Minister, and the 2014 Improving the Investment Climate in Bhutan Action Plan.[8] Under the Economic Stimulus Plan, a grant of Nu5 billion from India (4.4% of GDP in FY2014) will be provided to banks to facilitate access to funds for firms with potential to increase exports, and generate employment in sectors such as tourism, agro-processing, and manufacturing. The Business Opportunity and Information Center was created to administer these funds.

3. ADB Sector Experience and Assistance Program

11. ADB's engagement in Bhutan through SEMP I and five ADB technical assistance (TA) projects complements the government's strategies in public sector management. SEMP I enhanced the government's capabilities for fiscal and monetary management. With the TAs, the government (i) enhanced the capacity of local governments to prepare budgets based on the medium-term expenditure framework and pilot a property valuation methodology; (ii) modernized the revenue collection system; (iii) enhanced Bhutan's audit systems; (iv) developed a strategy for the government securities market, an action plan for deposit mobilization, a master plan for the capital markets, and a regulatory framework for credit rating agencies; and (v) prepared the macroprudential regulations to enhance financial sector stability.[9]

12. In the area of finance, the Financial Sector Development Program enhanced RMA's regulatory and supervisory capacity and corporate governance of financial institutions through key regulations, such as the Financial Services Act (2011) and the Corporate Governance Regulations (2011).[10] TA was also provided for the development of nonbank financial institutions.[11] For private sector development, ADB has been providing assistance for infrastructure development, cross-border connectivity and trade facilitation, trade finance, skills development, and advisory services to attract private investment. ADB also encouraged growth of micro, small, and medium-sized enterprises by enhancing access to market-based finance.[12]

13. ADB country partnership strategy for Bhutan, 2014–2018 places greater emphasis on financial and private sector development.[13] The Strengthening Economic Management Program II will coordinate with the World Bank's 2014 development policy credit for improving access to finance and the business climate in Bhutan. In addition, ADB will provide support for the establishment of the Better Business Council.[14]

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[8] In 2015, Bhutan ranked 125th of 189 countries in the World Bank's Ease of Doing Business ranking.

[9] (i) ADB. 2010. *Technical Assistance to the Kingdom of Bhutan for Strengthening Public Management in Bhutan.* Manila (TA 7724-BHU); (ii) ADB. 2011. *Technical Assistance to the Kingdom of Bhutan for Developing a Revenue Administration Management Information System.* Manila. (TA 7881-BHU); (iii) ADB. 2010. *Technical Assistance to the Kingdom of Bhutan for Strengthening Audit Resource Management.* Manila. (TA 7723-BHU); (iv) ADB. 2012. *Technical Assistance to the Kingdom of Bhutan for Capital Market Development*. Manila. (TA 8280-BHU); and (v) ADB. 2012. *Technical Assistance to the Kingdom of Bhutan for Supporting Financial Stability in Bhutan and the Maldives.* Manila. (TA 8284-REG).

[10] ADB. 2006. *Report and Recommendation of the President to the Board of Directors: Proposed Loans and Technical Assistance Grants to the Kingdom of Bhutan for the Financial Sector Development Program.* Manila. (Loan 2279/ 2280-BHU and TA 4885-BHU).

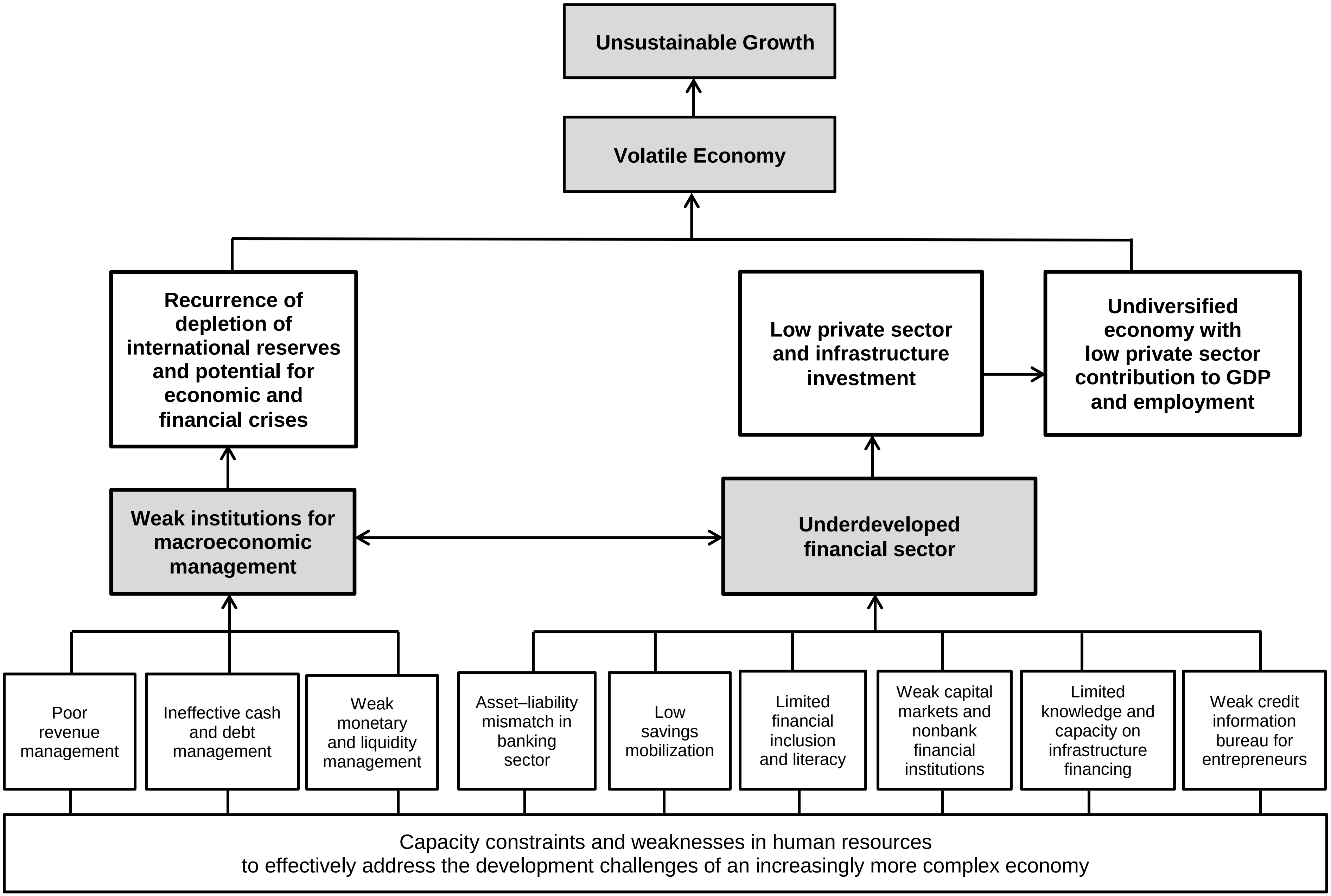
[11] ADB. 2012 *Technical Assistance to the Kingdom of Bhutan for Strengthening Royal Monetary Authority's Regulatory Capacity for Nonbank Financial Institutions*. Manila. (TA 8076-BHU).

[12] ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Grant to the Kingdom of Bhutan for the Micro, Small, and Medium-Sized Enterprise Sector Development Program*. Manila. (Grant 0088/0089-BHU).

[13] ADB. 2014. *Country Partnership Strategy: Bhutan, 2014–2018*. Manila.

[14] ADB. 2012. *Technical Assistance to the Kingdom of Bhutan for Enhancing Development Management for Sustainable and Inclusive Growth.* Manila (TA 8229-BHU).

PROBLEM TREE



Sector Results Framework (Public Sector Management and Finance, 2014–2018)

Country Sector Outcome		Country Sector Outputs		ADB Sector Operations	
Outcomes with ADB Contributions	**Indicators with Targets and Baselines**	**Outputs with ADB Contributions**	**Indicators with Incremental Targets**	**Planned and Ongoing ADB Interventions**	**Main Outputs Expected from ADB Contributions**
More stable macrofinancial environment, and efficient financial intermediation	Balance of payments maintained in surplus (FY2013 baseline: 9.5% of GDP) Gross international reserves maintained at greater than $900 million (FY2013 baseline: $917 million) Interest rate spread maintained at less than 9% (2012 baseline: 9%) Average growth of domestic credit contained below nominal GDP growth (FY2013 baseline: 12.8%) Credit from domestic source maintained at greater than 50% of GDP (FY2012 baseline: 54%) NPL ratio of banks maintained at less than10% (FY2012 baseline: 8.2%) Stock market capitalization growth maintained at greater than 5% (2012 baseline: 23%)	Finance sector infrastructure (enabling environment), including regulatory, governance, and market infrastructure, improved to support private sector development	Banking sector performance improved, e.g., capital adequacy and asset quality maintained at a CAR greater than 10% and SLR greater than 20% (2012 baselines: CAR = 19.1%, SLR = 27.5%) Nonbanking sector performance improved, e.g., asset quality maintained at SLR greater than 10% (2012 baseline: 19.1%) Permanent financial sector training institute established by the end of 2014 (2013 baseline: none) Mutual funds, credit rating agencies, registrar of properties licensed and operationalized by 2018 (2013 baseline: none) Macroprudential regulations approved and being enforced by 2018 (2013 baseline: none)	**Planned key activity areas** Money markets: 2% of funds Microfinance institutional development: 20% of funds Long-term debt, such as export credits: 16% of funds Pensions: 1% of funds Finance sector policies and strategies: 61% of funds **Pipeline projects** 1. Strengthening Economic Management Program II ($36.2 million) 2. Rupee Financing for Infrastructure Development (amount TBD) **Ongoing projects** 1. Loan and Grant for Strengthening Economic Management Program ($35 million), closed 2. TA for Supporting Financial Stability in Bhutan and the Maldives ($500,000) 3. TA for Strengthening Royal Monetary Authority's Regulatory Capacity for Nonbank Financial Institutions ($525,000), closed 4. Loan and Grant for SASEC Subregional Trade Facilitation Program ($11.66 million) 5. TA for Capital Market Development ($1.25 million) 6. TA for Strengthening Public Management ($850,000), closed 7. TA for Strengthening Audit Resource Management ($675,000), closed	**Planned key activity areas, pipeline projects** 1. A capital markets master plan to be formulated by Q1 2014 under the TA for Capital Market Development to facilitate the generation of capital market-related pipeline projects (achieved) 2. Indian rupee resources to be raised in India's capital market for Bhutan infrastructure development **Ongoing projects** 1. Capacity to manage short-term liquidity and institutional development for money markets, microfinance, long-term debt such as export credits, pensions 2. Trade system and capacity improved 3. Capital markets master plan adopted by government 4. Customs administration modernized and made efficient 5. Trade regulations and procedures streamlined and made transparent 6. Transit and transshipment times made faster 7. Services and information for traders and investors improved

CAR = capital adequacy ratio, GDP = gross domestic product, NPL = non-performing loan, SLR = statutory liquidity requirement, SASEC = South Asia Subregional Economic Cooperation, TA = technical assistance, TBD = to be determined.

Source: Country Economic Indicators (accessible from the list of linked documents in Appendix 2 of the main text); Royal Monetary Authority. 2015. *Annual Report 2013/14.* January. Thimphu; and Asian Development Bank. 2014. *Country Partnership Strategy: Bhutan, 2014–2018.* Manila.