PROGRAM ECONOMIC ASSESSMENT

Introduction

1. The Financial Market Development Program (FMDP) of the Government of Bhutan is a programmatic assistance provided by Asian Development Bank with the objectives of strengthening the resource mobilization of finance sector to improve its allocative efficiency and to enhance stability, and inclusiveness. The program began with a policy-based loan of $30 million and a TA grant of $0.5 million for the FMDP in 2019. Two subprograms were proposed under the loan together with a post program engagement framework. The Subprogram 3 is proposed to support incremental financial reforms to continue the reform momentum and to sustain progress of reforms, as requested by the government.

A. Macroeconomic Context

2. Bhutan's economy grew at an annual average rate of 6.7%[1] during the last 3 decades ending fiscal year 2019 reflecting its sound macroeconomic management. The country experienced a strong growth in pre-coronavirus disease (COVID-19), the economy grew by 5.5% in 2019, an increase of 2.4 percentage points from 2018. The national poverty rate declined from 23.0% in 2007 to 8.2% in 2017. The unemployment rate stood at 2.7% with high youth unemployment rate at 11.9% at the end of 2019. In addition, the country's fiscal deficit had been consistently maintained at less than 3.0% of GDP since FY1993. However, with the introduction of preventive measures to mitigate COVID-19 outbreak including two nationwide lockdowns, the economy entered a brief recession in FY2020 and the growth is now estimated at 0.9%. The annual inflation in FY2020 increased to 5.6 % from 2.7 % in 2019. The pandemic resulted into loss of jobs, according to the 2020 Labour Force Survey Report[2], the overall unemployment rate increased to 5% in 2020 from 2.7% in 2019. There was also significant rise in the overall youth unemployment rate to 22.6% in 2020 from 11.9% in 2019.

3. The economy is anticipated to rebound in FY2021 with the successful vaccination program, higher capital investment and government consumption, and ongoing fiscal support. The economy is expected to grow to 4.2% in FY2021 and moderate to 3.9% in FY2022. Likewise, post COVID-19 fiscal deficits are projected to be 7.3% and 8.6% of GDP during FY2021 and FY2022, respectively, Table 1 depicts the outlook of the government fiscal position in FY2021 and 2022. The annual inflation rate in 2021 is estimated to remain high at around 6.8%.

Table 1: Government Fiscal Position Following COVID-19 as of 30th April 2021 ($ million)

Indicators	FY2021	FY2022
Total revenues	775.55	772.43
Total expenditure	959.99	1,005.84
Fiscal deficit	(184.42)	(233.42)
Fiscal deficit (% to GDP)	(7.3)	(8.6)
Financing		
Financing need	184.42	233.42
External borrowing[a]	55.29	60.59
Internal borrowing	129.13	172.83

( ) negative, FY = fiscal year, GDP = gross domestic product.
[a] Includes borrowings from multilateral development banks such as Asian Development Bank and the World Bank.
Source: Government of Bhutan, Ministry of Finance. 2021. *National Budget Financial Year 2021-22.* Thimphu.

[1] Government of Bhutan. Ministry of Finance. GDP data from the Macroeconomic Framework Coordination. Thimphu.
[2] Government of Bhutan. National Statistics Bureau. Labor Force Survey Report 2020. Thimphu.

B. Sector Context

4. **Bhutan's financial sector is limited.** Comprising of five commercial banks and non-banking segment composed of three insurance companies, one Pension and Provident Fund, one Cottage and Small Industries (CSI) bank, and five microfinance institutions (MFIs), one fund management company, one credit information bureau (CIB), one securities exchange, one loss adjuster, and nine brokers with seven securities and two insurance brokers.[3] The financial sector is regulated by the Royal Monetary Authority, the central bank, which concurrently houses the electronic clearing house, financial inclusion secretariat, consumer protection cell and central registry. Capital markets are regulated by the Royal Stock Exchange of Bhutan (RSEB) and transactions are facilitated through a central depository. RSEB is under the purview of the RMA. Market intermediaries include seven registered brokerage firms,[4] four brokers owned by the financial institutions and three are the private brokerage firms. There are 20 listed companies as of December 2020 with a market capitalization of Nu47,450 million (26.4% of GDP). The market capitalization declined from 2019 due to the fluctuation of share prices and delisting of two companies in 2020. More specifically, private sector development has been hampered mainly due to limited access to finance and high cost of borrowing.

5. **COVID-19's impact on Bhutan's Finance Sector.** The government's preventive measures to contain the spread of COVID-19 have severely affected the economy, reducing the previously expected GDP growth in FY2020 of 6.0% to just 0.9%, the lowest in 3 decades. Asset quality of both bank and non-bank financial sectors have been negatively affected with the economic slowdown. The NPLs of the financial sector stood at Nu24,397 million, 15% of the total loans and advances, and the Capital Adequacy Ratio decreased from 15% in 2019 to 14 % in December 2020. The general insurance sector has also been severely affected in construction, vehicles, and equipment imports, while gross premium has increased by 26% in 2020 from 2019 with people purchasing more life insurance and property insurance related to fire and motor portfolio.[5] Growth seen in the secondary trading in the capital markets over the few years are expected to decrease significantly, the total market capitalization declined in 2020. Similarly, stock prices are expected to dive with the fall in dividend pay-outs in corporates along with lower demand for new capital and fund raising.

6. These problems have magnified the importance of reforms in the financial market to aid in mitigating the severe impact of the pandemic to the economy, and to strengthen the country's long-term resource mobilization to improve its allocative efficiency and to enhance stability and inclusiveness. The government recognizes the importance of the finance sector in domestic resource mobilisation and has identified three binding constraints: (i) underdeveloped nonbank financial institutions; (ii) deficient financial infrastructure, and (iii) the combined effects of low financial literacy and inadequate financial inclusion.

7. **Underdeveloped nonbank financial institutions with inadequate housing finance.** Nonbank financial institutions are with very limited investment options. Insurance companies have resorted to creating loan assets like banks under RMA regulations. There is no dedicated housing finance institution. The demand for housing credit is largely unmet. Middle-income and lower-income urban households spend an estimated 40.0%–60.0% of disposable income on rent because of lack of affordable housing. Currently banks and insurance companies give housing loans (26.1% of total finance sector credit is on housing as of March 2021) with significant nonperforming loans and concentration risks. Subprogram 1

---

[3] Government of Bhutan. RMA. 2019. *Financial Sector Performance Review Report*. Thimphu.
[4] Government of Bhutan. RSEB. 2019. *Annual Report 2019*. Thimphu.
[5] Government of Bhutan. RMA. 2020. *State of the Financial Inclusion Report 2020*. Thimphu.

included a policy development on National Housing while subprogram 2 included a housing strategy which include supply side and demand side recommendations with gender inclusions.

8. **Deficient financial infrastructure.** Absence of underwriting agencies and credit rating agencies prevent the development of the capital markets. Further, regulatory capacity of the RMA in nonbank financing areas needs to be addressed as regulation is a crucial soft financial infrastructure. The Prospectus Approval Committee should be developed into a Securities and Exchange Commission which will independently regulate capital markets.

9. **Limited financial inclusion.** As of December 2020, 76.1% of adults had savings accounts while just 21.6%[6] of adults had access to credit, and 25.3% of adults owned an insurance policy. Low access to credit attributed to Bhutanese banks' lending practices that still require collateral in providing loans instead of assessment of credit worthiness or borrowers' ability to pay in line with international practice. The country's payment system is still dominated by cash although modern electronic and online payments have picked up especially during the COVID-19 pandemic. RMA implemented the Payment System Strategy in 2020, which aims to create an ecosystem conducive for digital payment in promoting it as the most preferred choice of people within 2020–2022.[7] In terms of gender difference in access to financial services, disaggregated data shows no significant gap in terms of saving account holding but higher gender gap for credit and ownership of insurance. Men have higher access to credit by 3.8% and ownership of insurance by 6.9%. The RMA's focus now is working towards further enabling and unlocking financial inclusion and reforms are to focus around the following areas: (i) Creating more relevant products and platforms such as inclusive green finance, collateral replacements schemes, credit guarantee and e-commerce;(ii) Fintech development to bridge offline customers to online merchants, digital identity and enabling person to person (P2P), and business to person (B2P) initiatives (footnote 6). Feasibility for a digital currency was completed.

C. Rationale for Reform

10. The underdeveloped financial market is now further weakened by the COVID-19 pandemic. In addition, Bhutan is preparing to graduate from LDC in 2023, therefore, a sound capital market is imperative to access long term finances and provide fiscal space for promoting sustainable growth. It is also important for ensuring that the financial sector meets demand from the private sector to facilitate economic diversification, promote financial inclusion and achieve stability and integrity of the system. Considering the slow progress of capital market development in the country, financial sector reforms that caters to address the constraints are pivotal. The reforms can ensure that the financial system is operating within a well-regulated framework with functioning financial markets. This include strong institutions, transparent legal structures and rules that are equipped to meet the requirements of electronic commerce. The evidence show that the strength of the enabling environment is an important driver for capital market development.[8] The enabling environment includes low and stable inflation and sustainable fiscal management, market autonomy, supportive legal environment, independent regulations including well developed disclosure regimes.

D. Policy reforms achieved

11. Full compliance of the 9 policy actions under subprogram 1 was achieved in November 2019. Incremental and additional reforms were built with 15 policy actions under subprogram 2, were completed by October 2020. Both subprograms supported increased access to finance to the private sector, strengthening the stability and integrity of the financial sector and

[6] Government of Bhutan. RMA. 2021. *State of the Financial Inclusion 2020*. Thimphu.
[7] Government of Bhutan. RMA. 2019. *Annual Payment System Report 2020*. Thimphu.
[8] Bank for International Settlements. 2019. *Establishing viable capital markets, CGFS papers no. 62.*

improving financial inclusion to enable economic diversification efforts in the country over the medium and long term. The Government of Bhutan had requested for a subprogram 3 including 13 policy actions planned for completion by October 2021.

12. Discussing with the government revealed the need to develop capital markets further and rapidly. Bhutan is currently in transition from LDC to DC. When it completes the transitioning phase, the access to concessional financing will no longer be available. Therefore, the need to assist the regulatory authorities with capacity building and guidance in areas under the selected reform categories including reforms in development of financial technology to facilitate financial inclusion have been recommended. Subprogram 3 entails continuing development of financial market under 3 reform areas. These are reform area 1 will include (i) secondary market development and insurance industry strategy, reform area 2 incudes (ii) implementing the IFRS 9, revised rules on anti-money laundering, and full alignment with Basel III, and reform area 3 focuses on (iii) financial inclusive green finance and financial technology.

E. Transmission Mechanism

13. The 14 policy actions under 3 reforms areas, targeting financial market development, stability and inclusiveness are expected to generate significant contribution in promoting economic growth and productivity in the long run. There is abundant evidence that show that greater financial development leads to higher economic growth for which formal banking sector play a vital role. However, the development of nonbanking financial sector plays equally important role in promoting an inclusive growth. A well-developed domestic capital market allows government and companies to access long-term finance in local currency, increase investments directed towards innovation, and promoted sustainable growth with greater employment opportunities.

14. Given the adverse impact of COVID-19, there is a pronounced need to ensure that available resources are used effectively, and additional financing is accessed from the private sector. Evidence shows that the linkage between nonbanking financial sector and economic growth could both be direct and indirect.[9] It can directly promote savings, investments, risk allocation and total factor productivity, thereby, enhancing economic growth. Its indirect linkage and their impact on economic growth can be captured through the influence of nonbanking sector on the development of formal banks and capital markets. A cross-country study based in developing Asian countries provides evidence that sound and efficient financial systems are important for sustaining developing Asia's growth.[10] Hence, the efficiency of financial institutions plays an important role in resource allocation which in turn spur growth. The study also substantiates that the primary role of financial sector development in economic growth is expected to move away from conventional function of mobilising savings to augmenting the quantity of investment towards improving the efficiency and contributing to higher economy wide productivity. Therefore, in context of fostering growth, an integral component of developing Asia's financial development must be to build up robust and resilient financial system capable of withstanding even large socks.

15. Improved financial inclusion for the poor and disadvantaged provides potential to improve financial literacy, facilitate investment in human capital for poor households and communities, enable people to take economic risks to pursue income-generation opportunities, and to strengthen resilience and social cohesion thereby reducing poverty.

---

[9] P. Haiss & K. Sumegi. 2008, The relationship between insurance and economic growth in Europe: A theorical and empirical analysis. Empirica 35, 405-431.

[10] G. Estrada, D. Park, A. Ramayandi, 2010, Financial Development and Economic Growth in Developing Asia. *ADB Economics Working Paper Series*. No. 233. Manila: Asian Development Bank.

F. Economic Benefits

16. The benefits of the program are being assessed in terms of (i) development of the nonbanking sector, (ii) strengthening the stability and integrity of the financial sector, and (iii) financial inclusion promotion. The analysis follows the approach recommended for PBL by ADB.[11]

17. **Development of the nonbanking sector.** Policy actions includes capital markets, related policies, regulations and strategies and systems. Creating an enabling environment for the government to raise long term bonds will help stimulate its demand, which in turn help increase domestic resource mobilization and establish a long-term yield curve with risk premia. This in time reduces the cost of government borrowing. The reform action will result in secondary market activities on government bonds, which helps developing, expanding, and deepening the market for corporate bonds leading to increased access to funds by the private sector. Housing finance providers will be able to price loans correctly and improve their asset and liability risk management. In addition, the availability of medium to long term bonds will widen the investment scope of the pension and provident funds and insurance companies leading to increased product range, returns and diversification of risk. Empirical evidence confirms the potential benefits of capital markets to economic growth and further deepening of the market.12 The evidence further links capital markets and innovation, as well-developed capital markets play key role in financing of technology and risker projects and enterprises, which are not financed via bank lending.

18. The housing strategy included supply side and financing strategy recommendations including gender focus, which will lead to availability of better planning of building and obtaining finance. It is expected to enhance the standard of living and reduction in poverty incidence with the provision of safe and affordable housing benefiting disadvantaged groups including women. Pension and provident fund reforms will benefit the currently excluded segments of the population like the private sector and self-employed workforce providing a social safety net leveraging on the current demographic dividend in Bhutan.

19. The main outcome of the benefits of the reform is seen in terms of volume of bonds traded in the economy. The success of the reform is expected to increase the volume of bonds traded. Table 2 presents the baseline and the end line statistics. This was addressed through policy actions on revision of listing rules and regulations on corporate bonds, listing rules of government bonds and issuance of government bonds. These actions led to the increase of instruments and issuances in the market helping to increase the bonds outstanding. The targets were established based on past trends. Bonds outstanding include bonds issued by both private sector issuers and state owned enterprises. 2020 includes government bonds. Some state-owned bonds have been redeemed by 2018 onwards. The target had been set based on the slow growth rate of the market.

Table 2: Bond Market Statistics

Year	2015	2016	2017	2018 (Baseline)	2019	2020	2023 (Target)
Volume of bonds outstanding in Nu. Billion	11.83	10.97	11.04	8.76	8.45	8.65	9.30
Year on year Growth rate	NA	(7.2)%	0.64%	(20.65)%	(3.54)%	2.37%	Expected growth rate over base year 6.16%

( ) = negative

[11] ADB. 2020. *Guidance Note for the Economic Assessment of Policy-Based Lending*. Manila.
[12] World Bank. 2019. *Capital market development causes, effects, and sequencing*. Washington DC.

20. **Strengthening the stability and integrity of the financial sector.** Impact of RMA's move to risk-based from compliance-based supervision and gradual adoption of Basel III framework will significantly improve stability and the integrity of the financial system. The impact will be felt through better compliance on loan provision and impairment of loans rules by Bhutan Accounting Standards with eventual alignment with international standards. RMA will increase the frequency of risk profiling and assessment of banks which will improve the banking sector metrics like the capital adequacy ratios, asset quality and liquidity. Reforms in the cyber security framework will increase the resilience of the banking system and protect both customer and the banks from risk of cyber threats and business continuity planning. Evidence suggests the importance of effective regulation for sustained capital market growth (footnote 8). Effective and efficient regulatory regime play important role in enforcing laws and regulations that protect investors, ensuring that markets operate fairly, and well-developed disclosure practices.

21. The outcome of the policy actions under these reforms is expected to see in terms of year-to-year growth of private sector credit by commercial banks. With the successful implementation of the policy actions under the reform area, the year-to-year growth of private sector credit by commercial banks is targeted to increase at least to 17% during 2019-2023 from baseline data of 14.7% from 2014-2018. Target increase is in line with past trends and potential acceleration of growth in credit. Policy actions in gradual compliance with international market standards and capacity building would enable commercial banks as well as other financial institutions to grow credit portfolios to the private sector with better governance and risk management.

Table 3: Credit to Private Sector

Year	**2015**	**2016**	**2017**	**2018 (Baseline)**	**2019**	**2020**	**2023 (Target)**
Credit to Private Sector by GDP (%)	14	14.7	15.4	15.7	20.5	13.3	17

22. **Financial inclusion promotion.** Adoption of National Financial Literacy inclusion and National strategy to extend the finance sector outreach to the underserved will impact the extension of financial services to the unbanked releasing capital for economic growth. Benefits will accrue largely to those at the fringes of the financial system who take up the service offering, and the share of benefits also accrues to service providers. Initiatives on financial technology developments and digital banking will impact currently unbanked but users of mobile payment systems to access financial services. The digital currency feasibility study by RMA, central bank is expected to benefit in improving payment system, access to credit reaching out to poor in terms of access to finance.

23. The economic benefit emanating from financial inclusion can be wide ranging and help improve people's income earning potential and thereby reduce poverty. An access to financial services to marginalized groups can particularly be instrumental in promoting savings and spending on necessities including human capital of poor households and communities. Empirical evidence suggests that access to finance induced women-headed households in Nepal to spend 15% more on nutritious foods, 20% more on education and higher ability to cope with shocks.[13] Considering the fact, the proposed interventions aiming at enhancing financial literacy are important specifically to improve access to finance for women who are in less-favourable conditions. Likewise, evidence from Malawi propose that farmer who had their earnings deposited into savings accounts spent 13% more on farming equipment resulting in increased crop values by about 15%.[14] While it is important to improve financial inclusion, the

[13] Prina, Silvia. 2015. Banking the Poor via Savings Accounts: Evidence from a Field Experiment. *Journal of Development Economics* 115. pp. 16–31.

[14] L. Brune et al. 2015. Facilitating Savings for Agriculture: Field Experimental Evidence from Malawi. *Economic Development and Cultural Change*. 64(2). pp 187–220.

government and policymakers must ensure that the gains from reforms are equally distributed among different segments of population.

24. Improving financial literacy is an important driver of development of capital market, which require investors to be financially literate to participate meaningly in the market. Improved access to finance is also beneficial for promoting SMEs' business and private sector growth in the country. Facilitating SMEs can help stimulate domestic demand and help economic recovery in the post-COVID-19 environment. Adequate access to finance is crucial for SMEs to survive and eventually grow. Prioritizing small business is, therefore, critical for promoting inclusive economic growth. Bhutan being a small economy, the small businesses have a crucial role in economic recovery of the current pandemic. Cross country evidence using firm-level data from the World Bank Enterprise Surveys, substantiate that the expected gains are economically significant, and indeed much larger for SMEs than for large firms. For example, giving access to finance to SMEs and small business, can lead to a 2.1% increase in the rate of employment growth and about 1.2% increase in labour productivity growth. The findings of the study on SME financial inclusion for sustained growth[15] also suggest that policymakers should pay attention to the distribution of credit across firm size, and to various structural constraints on SME access to finance.

25. One of the outcomes of the policy action under this reform area is expected in terms of increasing the share of adults' access to credit. A national financial literacy survey, A national financial inclusion policy and consumer protection principles adopted by RMA was targeted to increase financial inclusion. The benefits of the reforms are expected to translate into increase in share of adults who have access to credit at least to 20% by 2023 from the baseline of 16% in 2018. The past trends were used to project the target of 20%. The increase in FY2020 is due to the monetary measures during COVID-19, especially to cottage and small industrial and microfinance institutions and the start of the National Credit Guarantee scheme which enhanced loan growth (Soft Term Micro Loans with interest rate at 2 percent per annum).

Table 4: Credit to Private Sector
(%)

Year	2015	2016	2017	2018 (Baseline)	2019	2020	2023 (Target)
Credit to private sector by GDP	14	14.7	15.4	15.7	20.5	13.3	17
Share of adult population with access to credit			16	16.8	19.7	21.8	20

G. Reform Challenges

26. The cost associated to implement the reforms is substantial, which Bhutan currently do not have the fiscal space to implement the necessary reforms. The country will need substantial and continued supports from overseas development assistance. The non-financial barrier to reforms is expected to be minimum as the sub-program is the spill over of the previous sub-programs under the FMDP. The FMDP has undergone vigorous reviews by both the Government of Bhutan and ADB, therefore the risks of non-financial barriers are expected to be low.

[15] M. Ghassibe et al. 2019. SME Financial Inclusion for Sustained Growth in the Middle East and Central Asia. *IMF Working Paper.* 19/209.

H. Effects and Sustainability of the Reforms

27. The reforms are expected to improve overall financial market system and inclusiveness, and economic welfare, especially women. The reforms will improve financial literacy, enhanced access to finance and enable people to take economic risks to pursue income-generation opportunities, business development of the private sector, and improved efficiencies of financial intermediation, which is expected to meet government's requirement to strengthen domestic resource mobilization. These reforms are vital in post-COVID-19 economic recovery and in achieving sustained and inclusive growth in the medium to long run. ADB's programmatic approach continuing to the subprogram 3 and post-program partnership framework have been set-up to ensure sustainability of the program, providing a structured dialogue from the medium term leading on to long lasting and effective reforms in the financial markets. This represents ADB's commitment in supporting the government's reform program for increased access to finance to the private sector and improve financial inclusion to enable economic diversification in the country.