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Bhutan Development Update

SPECIAL SECTION: TURNING BHUTAN'S STATE ENTERPRISES INTO A DEVELOPMENT ASSET

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Abbreviations and Acronyms

APC	Annual Performance Compact
BESF	Bhutan Economic Stabilization Fund
BNBL	Bhutan National Bank Limited
BTN	Bhutanese Ngultrum
DSA	Debt Sustainability Analysis
CAR	Capital Adequacy Ratio
CEO	Chief Executive Officer
CRR	Cash Reserve Ratio
CSI	Cottage and Small Industries
CAD	Current Account Deficit
CFS	Clustering of Finance Services
CGCSRC	Corporate Governance and Corporate Social Responsibility Code
CPI	Consumer Price Index
CRA	Corporate Regulatory Authority
DHI	Druk Holdings and Investments
DGRK	Druk Gyalpo's Relief Kidu
eGP	Electronic Government Procurement
FY	Fiscal Year
FYP	Five Year Plan
GoI	Government of India
ICGD	Investment and Corporate Governance Division, Ministry of Finance
IDA	International Development Association
IMF	International Monetary Fund
INR	Indian Rupee
ICT	Information and Communication Technology
IT	Information Technology
MoF	Ministry of Finance
MSME	Micro, Small, and Medium Sized Enterprise
NBFI	Non-Banking Financial Institution
NDA	Net Domestic Asset
NPL	Non-Performing Loan
NPPF	National Pension and Provident Fund
NRF	National Resilience Fund
NSB	National Statistics Bureau
PIM	Public Investment Management
PFA	Bhutan Public Finance Act
PPG	Public and Publicly Guaranteed
QPO	Queen's Project Office
RGoB	Royal Government of Bhutan
RMA	Royal Monetary Authority
SCF	Standby Credit Facility
SE	State Enterprise


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Preface and Acknowledgments

The Bhutan Development Update (BDU) is published annually. It assesses recent economic and social developments, prospects, and policies in Bhutan. The BDU also provides an in-depth analysis of selected economic and policy issues. In this edition, the special section focuses on state enterprises (SEs) in Bhutan given their significant role in the economy. The section provides an overview of the current SE landscape, its fiscal impact, and potential risks for the central government, and discuss recent developments in corporate governance. The report is intended for a wide audience, including policy makers, business leaders, researchers and academics, the community of analysts monitoring Bhutan's economy, and the general public.

The update was prepared by the Macroeconomics, Trade, and Investment (MTI) and Public Sector staff of the World Bank by a team consisting of Melanie Trost (Economist), Michel Mallberg (Senior Public Sector Specialist), Abigail (Consultant), Martin Brownbridge (Consultant), Savinay Grover (Senior Financial Management Specialist), Aman Mangrio (Consultant), Alvin Etang Ndip (Senior Economist), Sabin Raj Shrestha (Senior Financial Sector Specialist), and Venkat Bhargav Sreedhara (Financial Sector Specialist).

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The report was prepared based on published data available on September 20, 2022. The BDU draws on data reported by the government and information collected through the World Bank Group's regular economic monitoring and policy dialogue. Data sources include the World Bank, International Monetary Fund, Royal Monetary Authority, Ministry of Finance, National Statistics Bureau, and press reports.

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For information about the World Bank and its activities in Bhutan, please visit: www.worldbank.org/en/country/bhutan

Executive Summary

The global ramifications from the war in Ukraine and heightened macroeconomic vulnerabilities threaten Bhutan's gradual recovery from the COVID-19 shock. Bhutan was highly successful with its pandemic response, and started easing COVID-19 pandemic restrictions in April 2022. This was followed by a gradual recovery of economic activity in FY21/22, after two consecutive fiscal years of economic contraction. At the same time, macroeconomic vulnerabilities have increased for several reasons. First, COVID-19 relief measures for individuals and businesses and subdued revenue performance have resulted in high fiscal deficits and public debt, with limited fiscal space to absorb additional shocks. Second, as a net importer, Bhutan has been significantly impacted by higher global commodity prices, which are weighing on the balance of payments, with declining international reserves. Third, vulnerabilities from a weak financial sector with elevated non-performing loans (NPLs) have increased fiscal risks, given that over 90 percent of assets of the financial sector are controlled by the public sector.

Output is estimated to have grown by 4.6 percent in FY21/22, after two years of economic contraction. Strong growth in the non-hydro industry and the services sectors supported growth, while the electricity sector contracted due to a temporary suspension of operation at the Tala hydropower plant due to maintenance in early FY21/22, resulting in lower hydro exports and revenues. The tourism industry remained largely inactive in FY21/22. On the demand side, public and private investment and private consumption supported growth.

Annual average headline inflation moderated to 5.9 percent in FY21/22, driven by a slowdown in food inflation due to favorable base effects. While non-food inflation has increased to 7.0 percent, reflecting higher fuel and transport prices, overall inflation decelerated since food items together carry a 46 percent weight in the consumer price index (CPI) basket. The moderation in prices has led to an increase in consumption and a slight decrease in poverty to 8.7 percent in 2022 based on the lower-middle-income international poverty rate of $3.65/day.

Partly affected by the global commodity price increase, the current account deficit (CAD) has more than doubled since FY20/21 to 27.4 percent of GDP in FY21/22. Exports remained subdued (as a share of GDP) due to near-zero tourism-related services exports. Higher non-hydro goods exports, mainly base metals, were offset by a decline in hydro exports. Imports surged, both due to a volume increase in Information and Communication Technology (ICT) equipment and capital goods for hydropower projects and a value increase from higher import prices, particularly fuel and food prices. As a result, gross international reserves declined rapidly in FY21/22, reaching US$840 million in June 2022 (a 37 percent decline, y-o-y), equivalent to 7.1 months of imports of goods and services (and 8 months of prospective FY22/23 imports). To reduce pressure on international reserves, the government introduced administrative measures in August 2022 including the import restrictions on vehicles.

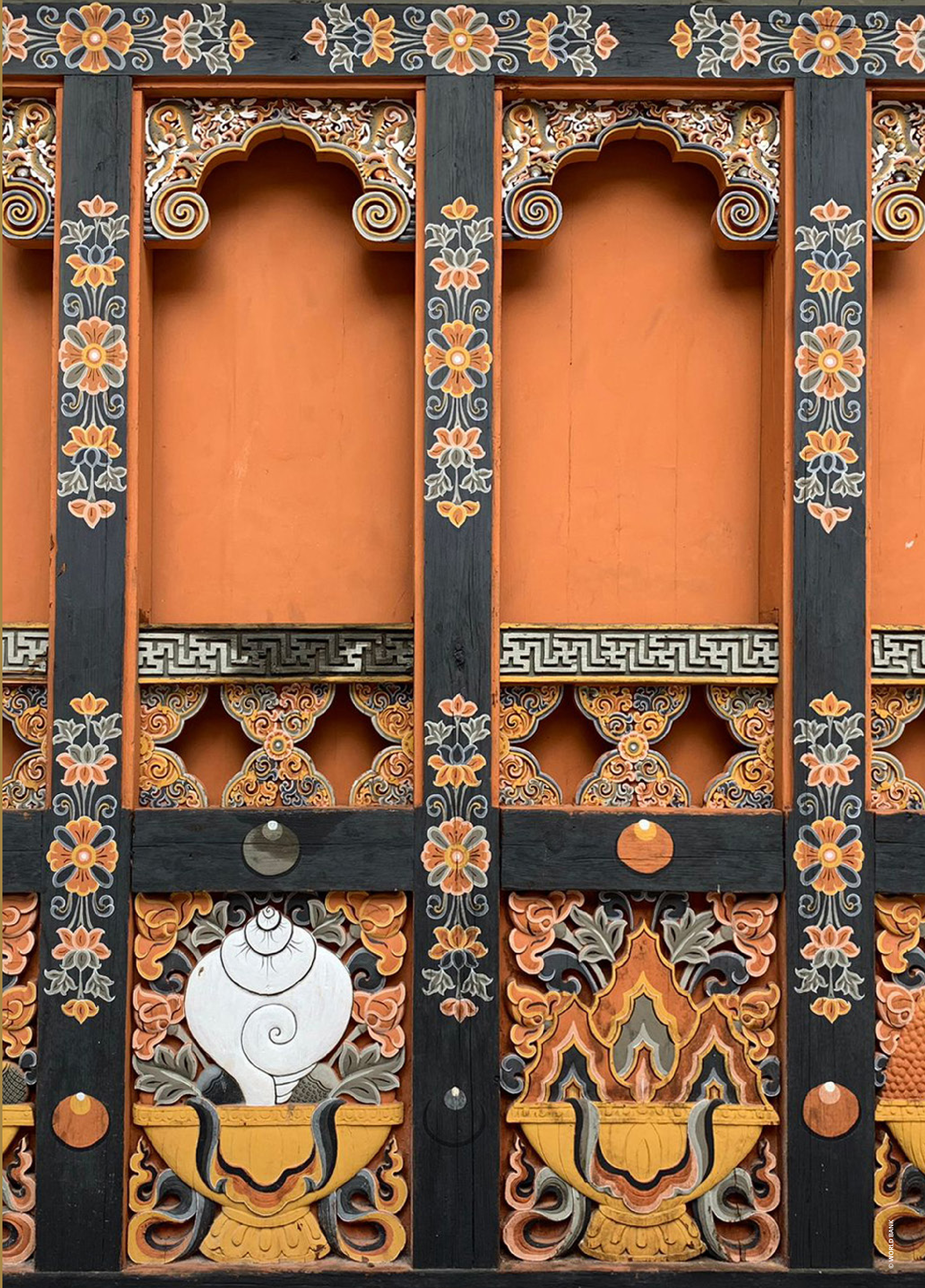
The fiscal deficit widened further to 8.9 percent of GDP in FY21/22. Total expenditures declined (as a share of GDP) as COVID-19 relief measures have been financed by the King and the Sungchob Fund in FY21/22 outside of the budget. Capital expenditures increased, reflecting continued fiscal support to boost economic activity through accelerated implementation of the Twelfth Five Year Plan (FYP). Total revenues declined even more because of lower hydro revenues and external grants. Public and publicly guaranteed (PPG) debt declined from 132.4 percent in FY20/21 to 130.9 percent of GDP in FY21/22 due to a decline in hydropower debt. While debt levels remain high (as a share of GDP), risks to debt sustainability remain moderate as the majority of the debt is linked to hydro project loans from the Government of India (GoI) with low refinancing and exchange rate risks.

The macroeconomic outlook has become more uncertain with the prevailing uncertainties in the global economy, including the war in Ukraine. The economy is expected to grow by 4.1 percent in FY22/23, supported by the broader reopening of borders in September 2022 with positive spillovers on the non-hydro industry and services sector. While output is returning to pre-pandemic levels, slower domestic demand recovery due to high inflation and lower hydro investments are expected to decelerate growth in FY22/23. Medium term growth is expected to remain below pre-COVID growth due to delays in hydropower projects, which otherwise would help strengthen fiscal and external balances in the medium term. As a result, the current account and fiscal deficit are expected to moderate only gradually over the medium term, supported by a lower trade deficit and expenditure rationalization. The outlook is subject to significant downside risks. Higher commodity prices due to the pandemic and geopolitical tensions could exert further pressure on the country's external balance and international reserves, and weigh on external demand and tourism travel, globally and in India (given significant tourism and trade linkages).

Fiscal consolidation and ensuring financial sector stability are crucial to restore fiscal space and prevent the materialization of contingent liabilities. In addition to continued global uncertainties, downside risks to the country's growth outlook also include delays in fiscal consolidation and financial sector vulnerabilities, which would constrain the government's ability to support a robust recovery. Reforms to enhance domestic resource mobilization and improve spending efficiency are important to restore fiscal space and sustain public debt. In addition, monetary conditions could be gradually tightened in light of inflationary pressures. The successful implementation of the NPL resolution framework to address high NPL levels, standing at 9.8 percent as of March 2022, will be critical to manage risks in the financial sector.

The special section of the BDU 'Turning Bhutan's State Enterprises into a Development Asset' discusses the performance and governance of the large state enterprise (SE) sector and the significant fiscal risk it poses. SEs in Bhutan are concentrated in strategic sectors including electricity, manufacturing, and the financial sector. They employ over 13,000 persons or 4.1 percent of the total labor force. SEs also make substantial contributions to budget revenues. While SEs overall have consistently reported profits, driven by the electricity sector, SEs in other sectors have shown a mixed performance. Both financial and non-financial SE performance SEs have deteriorated in the past years. SE-related fiscal risks, estimated at 245 percent of GDP in FY20/21, are significant and could become a burden on the budget in the future. While the Royal Government of Bhutan (RGoB) has implemented significant reforms over the past decades, there is room to further improve the legal and institutional framework, oversight, and corporate governance of SEs. For instance, the Corporate Governance and Corporate Social Responsibility Code (CGCSRC) is yet to be issued and the Corporate Regulatory Authority (CRA) is yet to be fully autonomous. The majority of SE Board members are from the civil service and three is limited training of Board members. Although required by the legal and regulatory framework, disclosure and transparency remains limited and lacks timeliness.

The special section outlines options to improve the SE legal and regulatory framework, corporate governance, performance, and minimize fiscal risks. Short term measures to minimize fiscal risks include: (i) having a comprehensive assessment of all fiscal risks in the annual budget; (ii) strengthen the SE investment framework; (iii) operationalize the Bhutan Economic Stabilization Fund (BESF) governance framework and fiscal rules; (iv) establish rules for calculating quasi-fiscal activities and compensate these explicitly; (v) identify and compensate SEs with non-commercial activities; and (vi) analyze the National Pension and Provident Fund Limited (NPPF)'s long-term liabilities. To enhance the corporate governance of the SE sector, the following short-term measures could be implemented: (i) further centralize the ownership model and strengthen the Ministry of Finance (MoF)'s oversight role; (ii) issue the CGCSRC and strengthen the CRA; (iii) review the SE performance management framework; and (iv) enhance SE transparency and disclosure. The forthcoming Bhutan Public Expenditure Review will analyze the SE sector with greater detail.



1. Recent Economic Developments

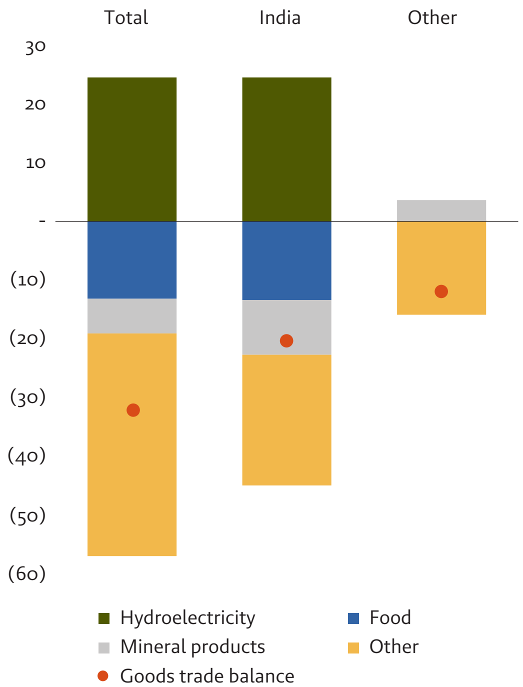
1. Context

Bhutan is still recovering from the pandemic and faces strong headwinds from global uncertainties and the ramifications of the war in Ukraine. Bhutan is a net importer of most non-hydro products and relies heavily on products from abroad, in particular for food and fuel (**Figure 1**). The economic impact from the war in Ukraine has been mainly felt through the commodity price channel, as direct trade with Ukraine and Russia is negligible, and indirectly through its close relationship with India.[1] More than 90 percent of trade is with India, and the Bhutanese Ngultrum (BTN) is pegged to the Indian Rupee (INR). Higher global energy and commodity prices have put significant pressure on the country's external balance, and the depreciation of the INR to the U.S. dollar has further increased import costs. The surge in energy and commodity prices has also resulted in higher domestic inflation, both directly and indirectly due to the pass-through of import prices from India.

The government started easing COVID-19 restrictions in the fourth quarter of FY21/22 after successfully managing the health impact of the pandemic and timely vaccinating its population (Figure 2). Bhutan has achieved high vaccination rates (as of mid-September 2022; 87 percent of the population has received two vaccine doses, and 72 percent of its adult total population has received a booster dose); and only 21 COVID-related deaths were recorded as of mid-September 2022 despite a surge in cases due to the Omicron variant in early 2022. The government started relaxing strict COVID-19 restrictions in April 2022, starting with the discontinuation of domestic movement restrictions and the reduction of the mandatory quarantine period for Bhutanese travelers from 14 to 5 days. The government has reopened international and regional tourism, starting from September 23, 2022, including the removal of COVID-19 testing requirements.

1 Direct goods trade with Russia and Ukraine is negligible, and inbound tourists from both countries accounted for only 1 percent of total international tourist arrivals in 2019 and 2020. In 2020, Bhutan exported goods in the amount of US$27,000 to Russia (cordyceps) and imported US$16,000 from Ukraine (machines). There are no inward Foreign Direct Investment (FDI) from Russia or Ukraine to Bhutan.

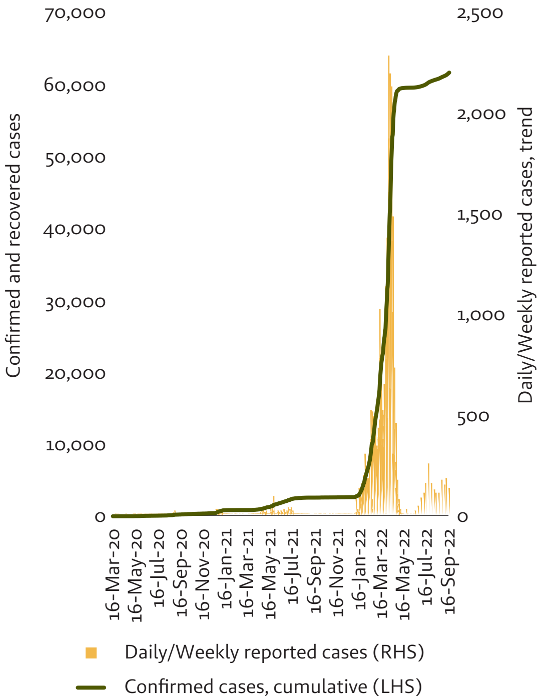
Figure 1. Goods trade balance, by source country (BTN billion)



Source: National Statistics Bureau (NSB), WB staff estimates.

Note: Mineral products include fuel products (import) and base metals and minerals (export)

Figure 2. Number of confirmed and recovered cases (daily reported cases)



Source: Ministry of Health (as of 19 September, 2022), WB staff estimates.

Note: MoF moved from daily to weekly reporting from May 16, 2022

2. Real Sector

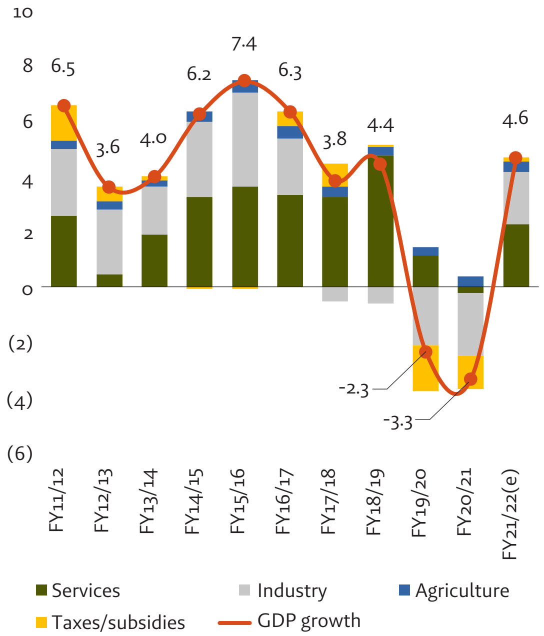
Growth

After contracting for two consecutive fiscal years, economic activity has gradually recovered in FY21/22, supported by the easing of strict social and domestic mobility restrictions, high vaccination rates, and continued fiscal support to boost economic activity.[2] The economy is estimated to have grown by 4.6 percent in FY21/22. While economic activity in the services and non-hydro industry sector has picked up, lower output in the electricity sector and the largely inactive tourism industry has dampened growth (**Figure 3**). On the demand side, investment and private consumption supported growth (**Figure 4**). After contracting since FY17/18, public and private investment increased in real terms, reflecting higher public investments through the acceleration of the Twelfth FYP and resumption of hydropower construction. Private consumption bounced back as consumer confidence recovered. Net exports contributed negatively to the overall GDP growth, as imports grew more than exports.

Despite lower electricity output, the industry sector grew by 5.0 percent in FY21/22, supported by a recovery in the construction, mining and manufacturing sector. After strong growth in FY19/20 and FY20/21 with the on-streaming of Mangdechhu hydropower plant, hydropower production contracted by 1.6 percent in FY21/22 due to a temporary suspension of operation at the Tala hydropower plant due to maintenance. Together with an increase in domestic electricity consumption, this resulted in lower electricity output, hydropower exports and revenues (**Figure 5**). Output in the non-hydro industry sector grew by 11.4 percent after two large contractions in FY19/20 and FY20/21 of 17.7 and 16.8 percent. This was driven by the construction and manufacturing sectors, which benefitted from improved labor supply and access to raw material with the easing of COVID-19 restrictions and trade facilitation measures, including additional land customs stations and the rollout of automation and

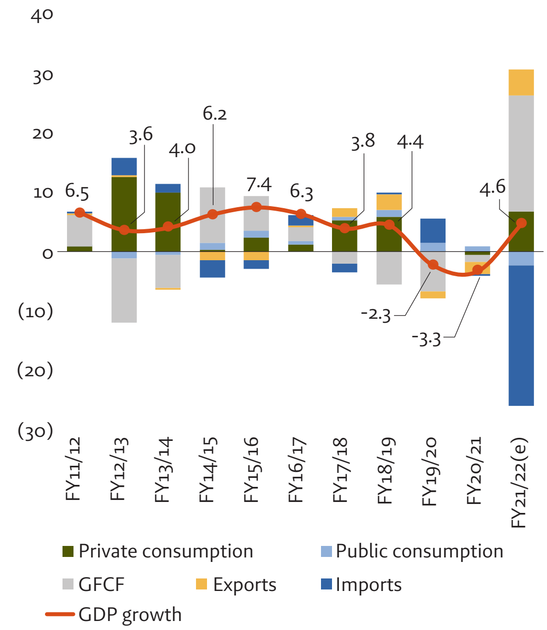
2 The fiscal year is from July to June. The latest national accounts estimates are available for calendar year 2021. The growth forecast for FY21/22 is aligned with MoF estimates (4.5 percent of GDP). However, the nominal GDP in current prices in FY21/22 is different from the MoF as the WB has a different assumption for the GDP deflator.

Figure 3. Contribution to GDP growth, supply side (percentage points)



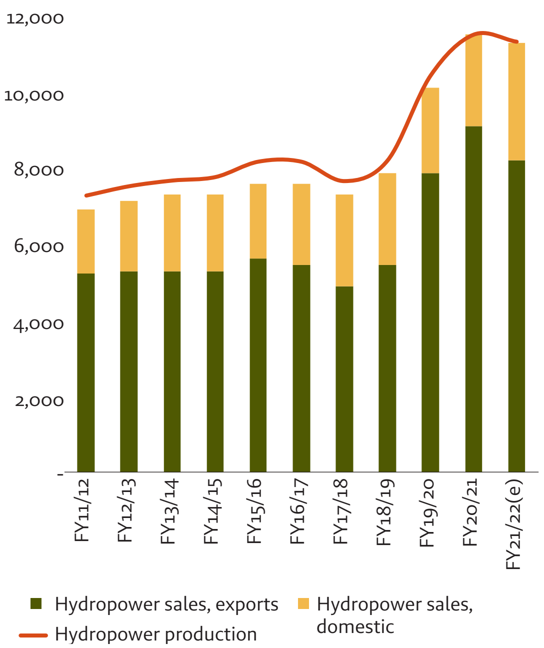
Source: NSB, WB staff estimates.

Figure 4. Contribution to GDP growth, demand side (percentage points)



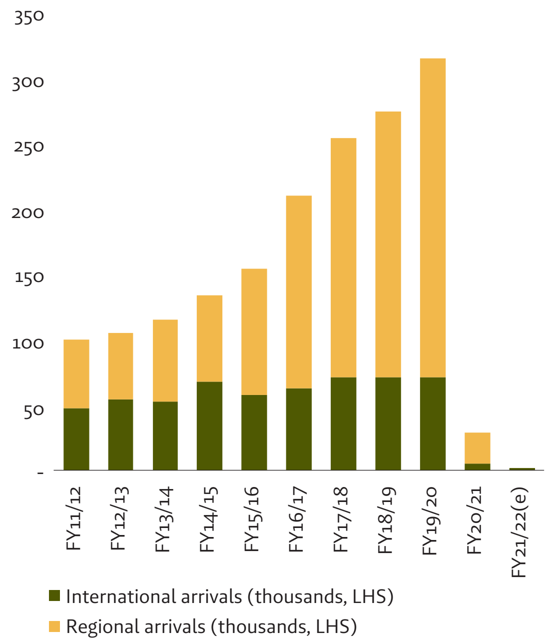
Source: NSB, WB staff estimates.

Figure 5. Hydropower production and sales (GWh)



Source: NSB, WB staff estimates.

Figure 6. Tourist arrivals and services exports



Source: NSB, WB staff estimates.

electronic procedures. The mining sector also grew strongly, albeit from a low base in FY20/21. Base metal exports grew by 60 percent (y-o-y) in FY21/22, supported by higher commodity prices.

The services sector grew by 4.6 percent in FY21/22, driven by transport, communication, and trade activities. Transport, communication and trade services were the largest contributors to services growth, reflecting the normalization of economic activity after the pandemic. Output in the hospitality sector, which accounted for about 6 percent of GDP prior to the pandemic, stagnated as tourism did not resume. Total international and regional tourist arrivals have declined from 29,812 in FY20/21 to 1 in FY21/22 (**Figure 6**).

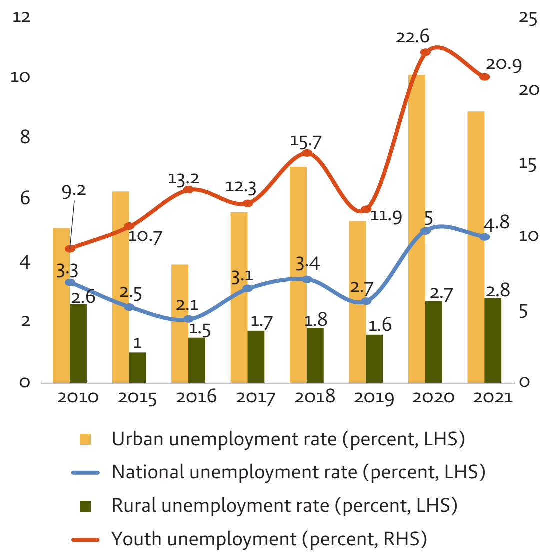
The agriculture sector has grown moderately at 3.5 percent in FY21/22. The agriculture and livestock sectors saw positive growth, reflecting continued government support to boost domestic food production through infrastructure development including farm roads, input support for seeds and fertilizers, and a continuation of the public buyback schemes for domestic produce. In contrast, the forestry sector showed a small contraction.

Employment

The labor market has not yet recovered, with high unemployment rates for the youth and females. The unemployment rate remained elevated at 4.8 percent in 2021, much higher than the 2015-2019 average of 2.8 percent (**Figure 7**). It was significantly higher among females (6.1 percent) than males (3.6 percent) and appeared more of an urban phenomenon (8.9 percent in urban areas compared to 2.8 percent in rural areas) with Thimphu district having the highest unemployment rate (10.1 percent), followed by Paro (7.7 percent). The youth unemployment rate[3], which was already high before the COVID-19 pandemic, almost doubled between 2019 and 2020 from 11.9 percent to 22.6 percent and remained elevated at 20.9 percent in 2021. The majority of unemployed youth were females (61.4 percent). Recent studies suggest that skills mismatch, a lack of employment opportunities in the private sector, and youth not being keen on taking blue collar jobs are among the main reasons behind the high youth unemployment rate.[4] Anecdotal evidence suggests that a large number Bhutanese have migrated to Australia to find better work opportunities.[5]

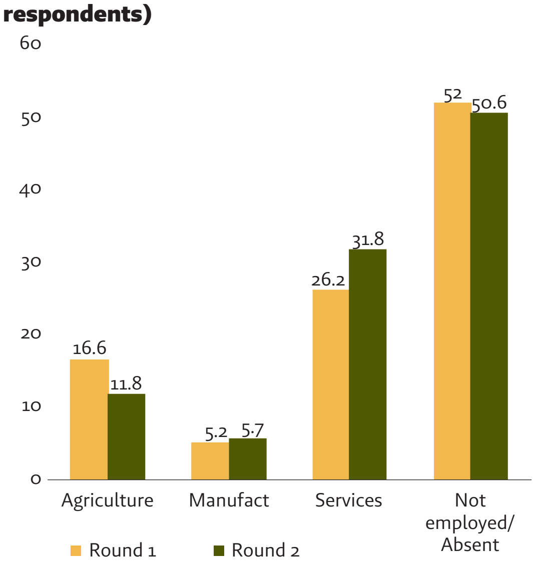
Bhutanese workers experienced a high rate of job transition across sectors. Results from the COVID-19 High-Frequency Monitoring Survey suggest that a substantial portion of Bhutanese workers changed jobs across sectors between September 2020 and 2021, the first and the second round of the survey.[6] In line with economic activity, the share of respondents working in the services and manufacturing sector increased from 2020 to 2021 (**Figure 8**). Employment gains in the service sector were attributable to respondents who had not been employed for pay or absent from work in September 2020. In contrast, those working for pay in agriculture dropped from 17 percent to 12 percent during the same period.

Figure 7. Unemployment rate (percent), 2010-21



Source: NSB, WB staff estimates.

Figure 8. Job transition by sector (percent of respondents)



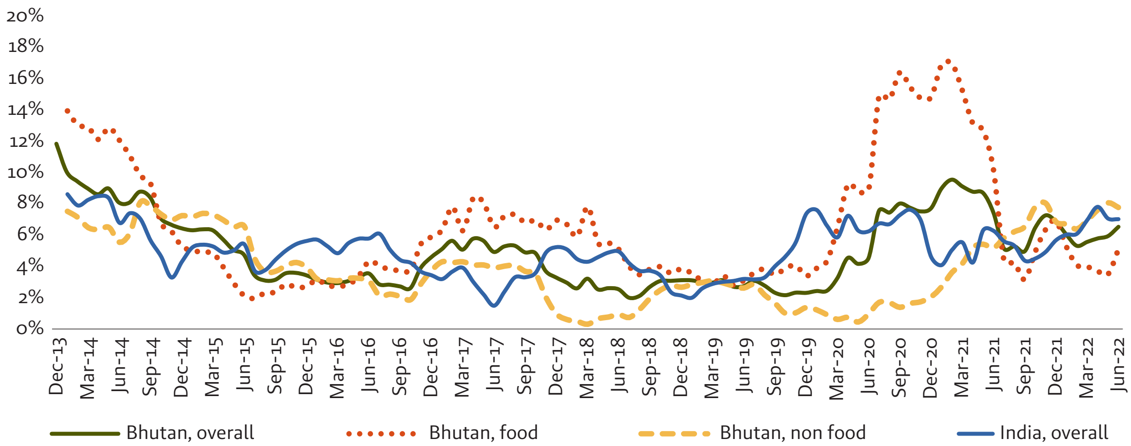
Source: SAR COVID-19 High-Frequency Monitoring panel survey, WB staff estimates.

3 Youth unemployment rate is defined as the percentage of unemployed persons in the age group 15-24 years to the labor force (also known as economically active population) in the same age group (NSB, 2021 Labor Force Survey Report).
4 Addressing the Youth Unemployment Challenge in Bhutan Through a Systemic Portfolio-Based Approach. UNDP (2022).
5 https://thebhutanese.bt/the-growing-risks-of-the-australia-rush-and-the-push-and-pull-factors-behind-the-rush/
6 The World Bank conducted a rapid phone survey across eight South Asian countries to track the impacts of the pandemic, including the impact on the labor market and food security situation. In Bhutan, two rounds of COVID-19 Rapid Phone surveys were conducted in September-October 2020 (Round 1) and in September-October 2021 (Round 2). Data on the 1,083 panel individuals who were interviewed in both rounds allows to examine how the how the labor market and food security situations evolved between the two rounds.

Inflation

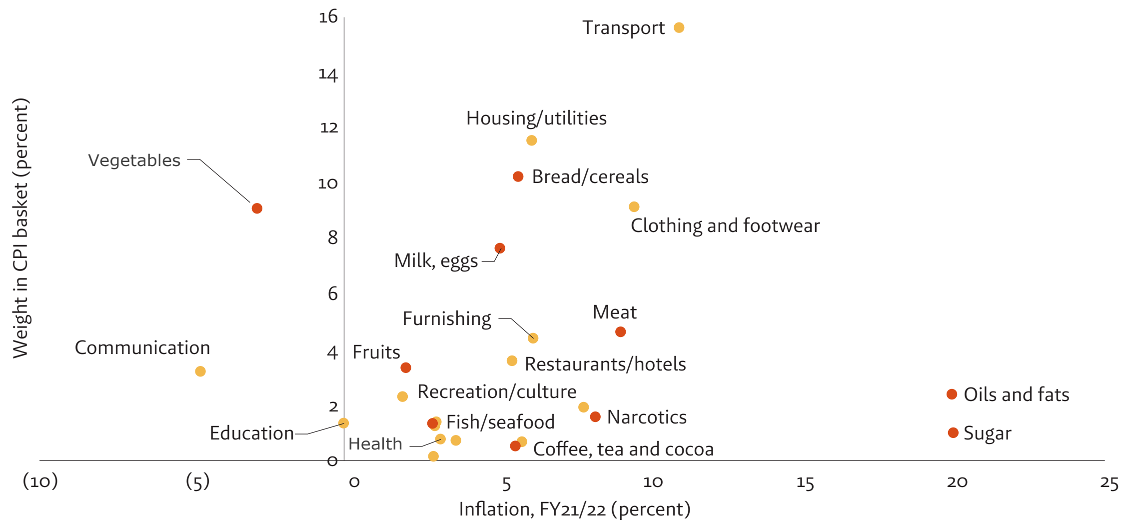
Annual average overall CPI inflation moderated from 8.2 percent in FY20/21 to 5.9 percent in FY21/22, driven by a slowdown in food inflation. Food inflation declined from 14.7 percent in FY20/21 to 4.7 percent in FY21/22 due to favorable base effects, and lower domestic food inflation (**Figure 9**). While imported food inflation remained elevated at 7 percent in FY21/22, in line with price movements in India (Bhutan's inflation rate co-moves with that of India with a time lag since about 80 percent of Bhutan's imports come from India and the BTN is pegged to the INR), domestic food inflation eased to 2.1 percent year-on-year (y-o-y), below the 5-year pre-COVID average of 5.3 percent from FY14/15 to FY18/19. The lower domestic food prices partly reflect government measures to boost domestic food production. In addition, the government fixed the prices of vegetables and fruits in the beginning of 2022 (they together carry a 12-percent weight in the CPI basket), which could have supported the decline in domestic food prices.[7] While non-food inflation accelerated from 3 percent to 7 percent, reflecting higher fuel and transport prices, the overall inflation declined since food items together carry a 46 percent weight in the CPI basket (**Figure 10**).[8]

Figure 9. Inflation, Bhutan and India (percent)



Source: NSB, MoSPI India.

Figure 10. CPI categories and inflation drivers in FY21/22 (percent)



Source: NSB.

7 MoAF Notification DAMC/MoAF/MIR-01/66, 23 February 2022 https://www.moea.gov.bt/wp-content/uploads/2022/02/Price-notification-of-vegetables-and-fruits.pdf

8 In a recent study, the Royal Monetary Authority (RMA) analyzed the impact of fuel prices on inflation. While first-round impact of higher oil prices is limited (the total weight of fuels in the CPI is relatively small at 4.4 percent) secondary effects are substantial: a 10 percent increase in fuel prices translates into a 4.9 percentage points increase in inflation within 3 months, accounting for direct and indirect effects (including transport). RMA Annual Report 2021.

Poverty

The government provided temporary income support to the most vulnerable up to September 2022, targeting the severely affected by the pandemic. The government extended temporary income support through the Druk Gyalpo's Relief Kidu (DGRK) until September 2022.[9] Results from the COVID-19 High-Frequency Monitoring Survey suggest that social assistance coverage declined slightly from 20 percent of households receiving any form of assistance in September 2020 (first round of the survey) to about 17 percent in April 2021. Encouragingly, coverage increased for groups that were more adversely affected by the pandemic, including service sector workers and workers who lost jobs. Temporary income support from the DGRK remained by far the most dominant form of assistance (78 percent).

Poverty increased in 2020 and 2021 as the economic contraction translated into lower household incomes. The share of the Bhutanese population living on less than the lower-middle-income international poverty line of US$3.65 per day fell from 11.9 percent in 2012 to 9.4 percent in 2017.[10] While poverty rate is estimated to have further declined until 2019 (to 8.3 percent based on US$3.65 per day), the COVID-19 pandemic reversed the progress. Reduced worker earnings and sustained high food prices and the resulting decline in aggregate consumption is likely to have affected living standards and wellbeing, especially for those at the bottom of the distribution. As a result, poverty based on US$3.65 is estimated to have increased to 8.8 percent in 2020 and 9.4 percent in 2021. However, the moderation in prices in 2021 has led to an increase in consumption and a slight decrease in poverty to 8.7 percent in 2022 based on US$3.65 per day.

3. Monetary Policy and Financial Sector

Monetary policy remained accommodative in FY21/22. Monetary policy is anchored by the exchange rate peg to the INR, which limits RMA's ability to use monetary policy for macroeconomic adjustments. The RMA does not have an explicit inflation target. It uses the cash reserve ratio (CRR) and the statutory liquidity ratio (SLR) to manage liquidity in the financial system and intervenes in the foreign exchange markets to maintain the peg. The RMA maintained the CRR at 7 percent in FY21/22, and lowered the minimum lending rate from 7.14 to 6.92 percent in June 2022 to support liquidity and credit. The RMA also provided broad-based support to businesses and individuals from April 2020 to June 2022, including interest payment support, loan deferment, and a credit guarantee scheme.[11] After strong growth in FY20/21, broad money supply decelerated from 24.4 percent (y-o-y) at end-June 2021 to 9.4 percent at end-June 2022, due to a slowdown in deposit growth.

Despite the RMA's support and various initiatives, credit provision to the private sector remained subdued in FY21/22. While private sector credit growth accelerated from 6.5 percent in June 2021 to 8.6 percent (y-o-y) in June 2022, it is well below pre-COVID growth rates (**Figure 11**). In particular, credit flows to the services and construction sector, which constitute more than half of the lending portfolio, remained weak post-pandemic, reflecting the continued impact of the pandemic on these sectors. Credit growth turned negative in the agriculture sector in the second half of FY21/22, despite measures to facilitate collateral-free lending to small-holder borrowers, owing to supply disruptions. In contrast, credit growth was strong in the transport and trade and commerce sectors. The RMA introduced more targeted support measures for performing loans in August 2022, whereby eligibility for loan restructuring measures is based on the overall risk level of the sector.[12] NPLs will be covered under the

9 DGRK was launched in April 2020 and provided support to more than 50,000 Bhutanese whose livelihoods have been impacted.

10 Poverty data are now expressed in 2017 Purchasing Power Parity (PPP) prices, versus 2011 PPP in the previous BDU from April 2022. As price levels across the world evolve, global poverty lines have to be periodically updated to reflect the increase of the value of the lines in nominal terms. The new global poverty lines of $2.15, $3.65, and $6.85 reflect the typical national poverty lines of low-income, lower-middle-income, and upper-middle-income countries in 2017 prices. See https://pip.worldbank.org/home

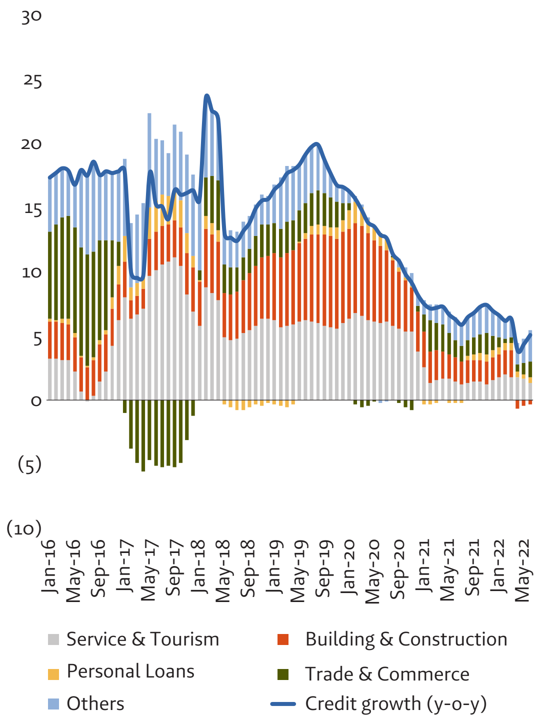
11 Monetary measures for Phase I to III (April 2020 to June 2022) included the following: (i) partial interest waiver on loans, deferred monthly loan instalment repayment, loans for the tourism, manufacturing and wholesale trade sectors at concessional terms, and micro loans for cottage and small industries (CSI). In October 2020, the government also launched the National Credit Guarantee Scheme (NCGS) to support lending to CSIs. See https://www.rma.org.bt/notificationdirectives.jsp?id=8

12 See https://www.rma.org.bt/assets/MM/MMPIV/2.pdf. Sectors are classified into 3 different risk level: high (tourism), moderate (construction, manufacturing, and transport), and low (ICT, hydropower, and agriculture). Among other, performing loans under the high-risk category may qualify for loan repayments up to 2 years, and a partial repayment (50 percent) for up to 2 years. Performing loans in the low-risk category may extend the gestation period up to 2 years.

government's NPL resolution framework to facilitate rehabilitation and foreclosures of NPLs.[13] The NPL framework is part of a comprehensive NPL strategy, which focuses on (i) preventing a loan from becoming an NPL (flow) by implementing effective and efficient processes and systems, and (ii) resolving the current NPLs (stock).

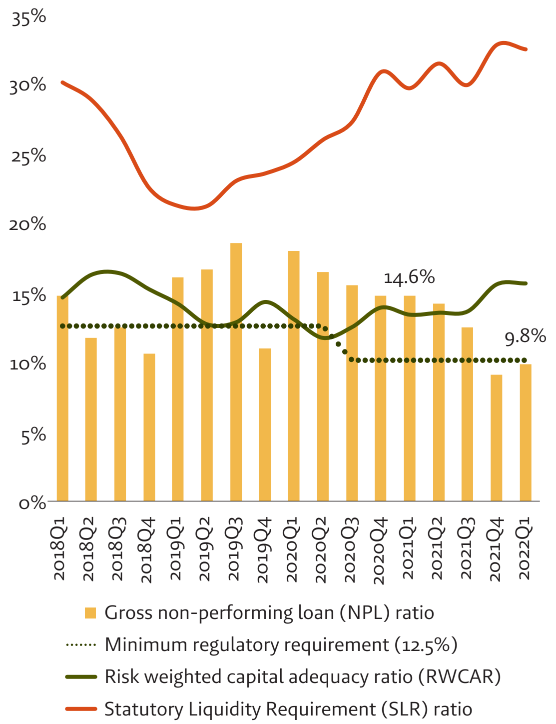
Financial sector vulnerabilities remain elevated, particularly in the non-banking financial sector. The NPL ratio declined from 14.6 percent in March 2021 to 9.8 percent as of March 2022 (latest available date, **Figure 12**). However, the reported NPL ratio does not reflect actual asset quality as borrower relief measures were provided until June 2022. NPLs are concentrated in two systemically important financial institutions and a few economic sectors, including tourism, trade and commerce, manufacturing, and housing.[14] In May 2022, the RMA instructed three financial institutions to suspend new lending because of the high level of NPLs, suggesting that loan performance of those institutions has deteriorated with potentially adverse impacts on capital adequacy.[15] Overall, capital buffers increased in FY21/22. The aggregate risk weighted capital adequacy ratio of the banks increased to 15.6 percent at end-March 2022, against a statutory minimum of 10 percent and a capital conservation buffer of 2.5 percent. Return indicators (return on equity and assets) improved in the first three quarter of FY21/22.

Figure 11. Credit growth and sectoral contribution (y-o-y growth, percent, 3-month moving average)



Source: RMA.

Figure 12. Financial sector soundness indicators (percent)



Source: RMA.

13 The NPL resolution framework includes: (i) an NPL asset transfer framework where eligible NPLs will be temporarily parked by the financial institutions with subsequent freezing of interest to provide relief to borrowers; (ii) a segregation of NPLs into viable and non-viable loans for rehabilitation.

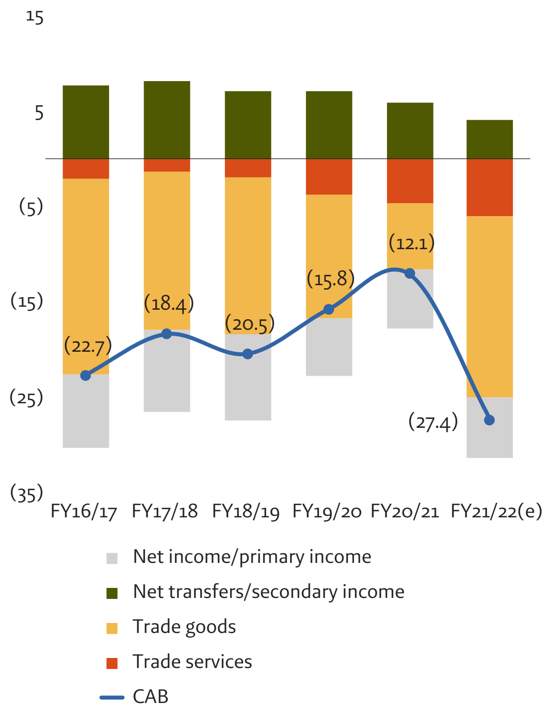
14 The NPL ratio is highest in small and cottage enterprises (29 percent of the respective portfolios) and medium-sized enterprises (24 percent) as of March 2022.

15 The suspension currently affects three institutions, the Bhutan Development Bank Limited (BDBL), the Royal Insurance Corporation of Bhutan (RICBL), and the National Cottage and Small Industry Development Bank (NCSIDBL).

4. External Sector

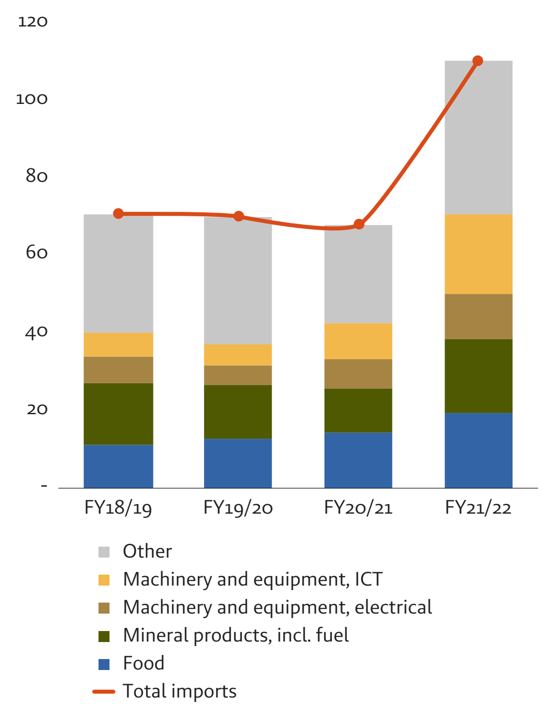
The trade balance deteriorated significantly in FY21/22 due to an increase in goods imports, in part due to higher commodity prices. The CAD more than doubled from 12.1 percent of GDP in FY20/21 to 27.4 percent in FY21/22, driven by the deterioration in the trade balance (**Figure 13**). Goods imports increased from 36.4 percent of GDP in FY20/21 to 49.1 percent in FY21/22 (**Table 1**), above the pre-COVID average of 45.6 percent between FY14/15 and FY18/19. This was due to a volume increase in Information and Communication Technology (ICT) equipment (accounting for 25 percent of the total increase) and capital goods for hydro projects, as well as a value increase from higher import prices, particularly fuel and food prices (**Figure 14**). The appreciation of the U.S. dollar to Indian Rupee has put further pressure on import costs. Goods exports remained constant as a share of GDP (**Figure 15**). While non-hydro exports increased, supported by higher prices for base metals, hydropower exports declined in line with lower hydropower production as a result of maintenance works and an increase in domestic consumption. Services exports, mainly comprising tourism and transport services, declined further to 0.8 percent of GDP in FY21/22 as tourism did not resume. Services imports increased with a pick up in personal travel and transport services. On balance, therefore, the services trade deficit deteriorated further in FY21/22. The secondary income balance also deteriorated, reflecting lower budgetary grants and remittances (**Figure 16**).

Figure 13. Current account and components (percent of GDP)



Source: RMA.

Figure 14. Goods import (BTN billion)

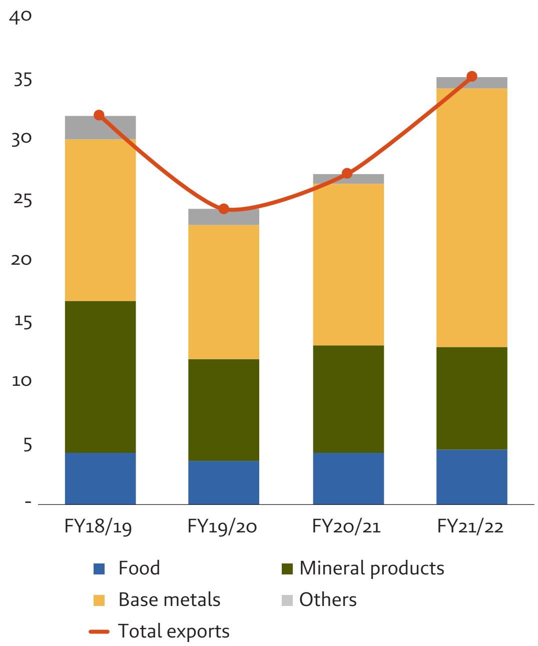


Source: MoF.

The sharp widening of the CAD resulted in a rapid decline in international reserves. The CAD has been financed by budgetary grants for investment and grants for hydropower development grants (capital account) and loans (financial account), with a negative overall balance in FY21/22 (**Figure 17**). As a result, gross international reserves declined by 37 percent (y-o-y) in FY21/22 (**Figure 18**), to US$840 million, which is equivalent to 7.1 months of imports of goods and services (8 months of prospective FY22/23 imports). In addition, the level of international reserves was revised retrospectively in July 2022, which led to a further reduction in the level of reserves, compared to the level previously estimated.[16] The RMA sold convertible currency reserves in FY21/22 to ensure availability of

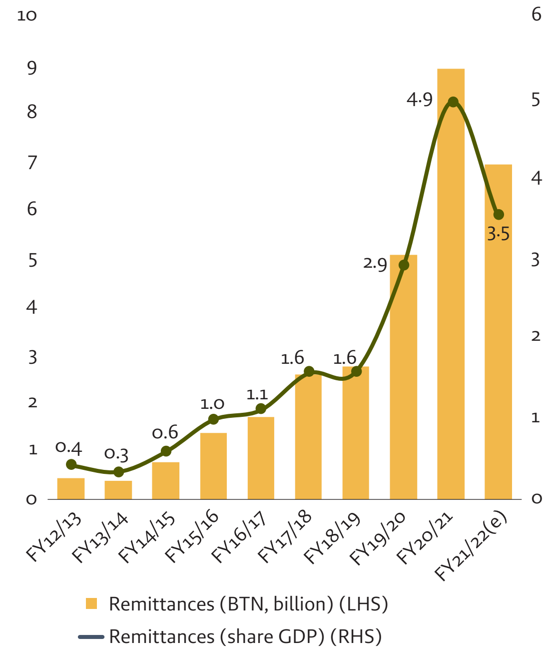
16 The RMA revised gross international reserves retrospectively in July 2022, which resulted in lower international reserves from September 2020 to December 2021 (i.e., FY20/21 and the first half of FY21/22). With the revision, international reserves stood at US$970 million in December 2021, compared to US$1.4 billion in the old series.

Figure 15. Non-hydropower goods exports (BTN billion)



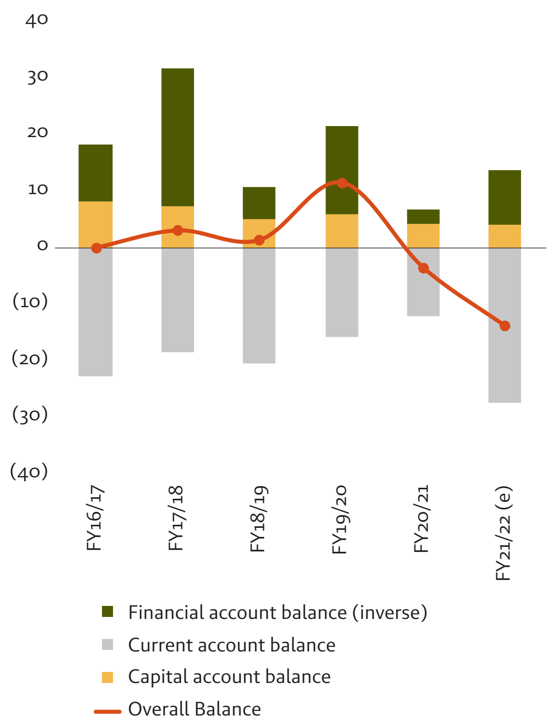
Source: MoF.

Figure 16. Remittances (BTN million and percent of GDP)



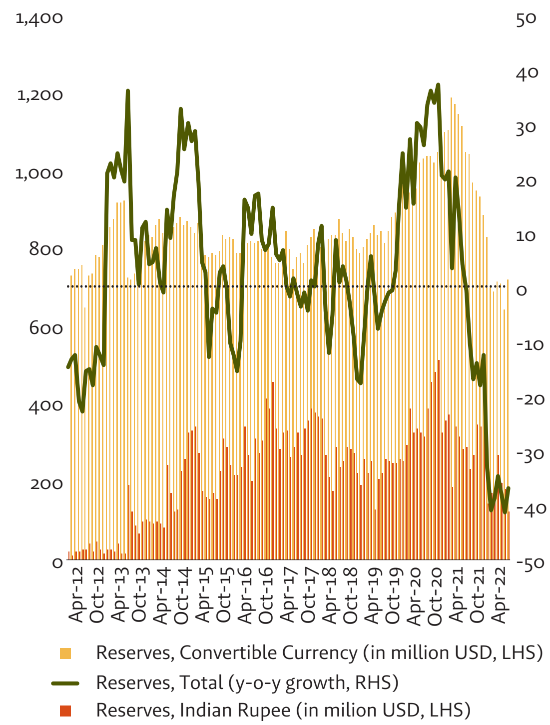
Source: RMA.

Figure 17. Balance of payments (percent GDP)



Source: MoF.

Figure 18. Gross international reserves (in million US$ and y-o-y growth)



Source: RMA.

INR reserves given that India is the main trading partner, and the majority of PPG external debt is denominated in INR. The share of INR reserves declined from about 25 percent in FY20/21 to 22 percent in FY21/22.

The government introduced administrative measures to address external pressures. To maintain the peg with the INR, the Constitution mandates that a minimum foreign currency reserve adequate to cover 12 months of essential goods imports. In response to the decline in international reserves, the government has extended two Rupee standby credit facilities (SCF) with the GoI in July 2022 in case of an INR shortage,[17] and introduced administrative measures in August restricting the import of vehicles except utility ones and agriculture machinery.[18] Additional measures, including restricting non-essential imports, may be imposed if reserves decline further. The RMA also extended and enhanced the incentives scheme on inward remittance from 1 percent to 2 percent.[19] Import restrictions were last imposed in March 2012 when the RGoB experienced pressures on INR reserves due to an increase in imports, fueled by rapid credit growth.

Table 1. External accounts (percent of GDP)

	FY17/18 (act)	FY18/19 (act)	FY19/20 (act)	FY20/21 (act)	FY21/22 (est)
Current account balance	(18.4)	(20.5)	(15.8)	(12.1)	(27.4)
Goods balance	(16.6)	(16.4)	(13.0)	(6.7)	(18.9)
Exports	24.0	24.8	26.7	29.7	30.2
Hydropower exports	7.4	6.3	8.6	15.7	12.0
Non-hydropower exports	16.6	18.6	18.1	14.0	18.2
Imports	(40.6)	(41.2)	(39.7)	(36.4)	(49.1)
Services balance	(1.4)	(2.1)	(3.8)	(4.7)	(6.1)
Exports	7.6	6.9	5.5	0.9	0.8
Imports	(9.0)	(8.9)	(9.2)	(5.6)	(6.9)
Primary income	(8.4)	(9.0)	(6.1)	(6.3)	(6.4)
Secondary income	8.1	7.0	7.0	5.8	4.0

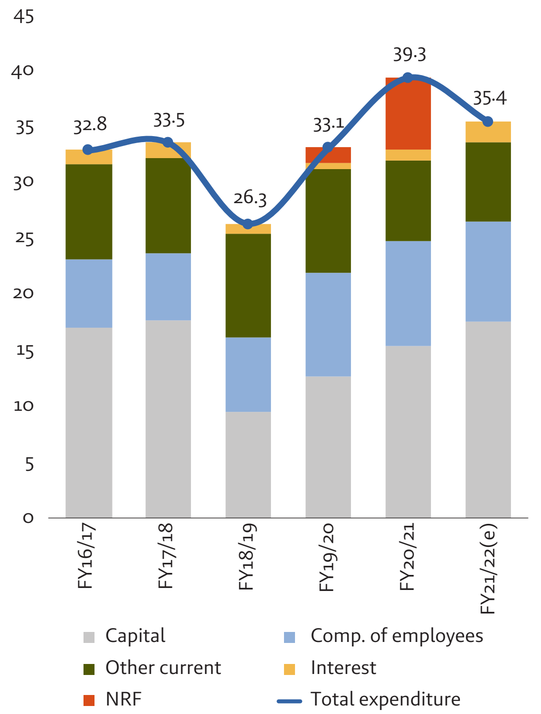
Source: MoF and WB staff estimates.

17 The settlement period of the SCF was extended by five more years with a reduced interest rate from 5 percent to 2.5 percent starting July 2022.
18 See https://www.mof.gov.bt/wp-content/uploads/2022/08/Final-Notification-on-the-moratorium-on-import-of-vehicles.pdf. The share of vehicles in total goods imports in FY21/22 was 6 percent. Vehicle imports increased by 76 percent (y-o-y) in FY21/22, after contracting by 63 percent in FY20/21.
19 See https://www.rma.org.bt/what_news.jsp?newId=365

5. Fiscal Sector and Debt Sustainability

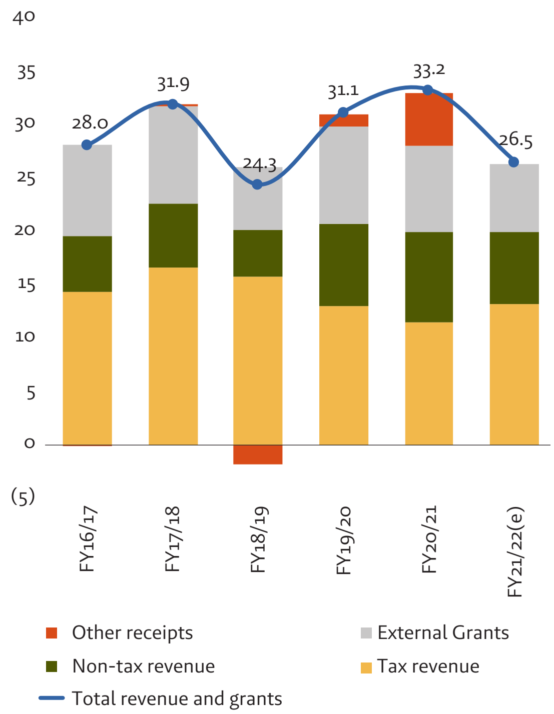
The fiscal deficit widened further in FY21/22, on account of higher capital expenditures and subdued revenue performance. Total expenditures declined as COVID-19 relief measures (6.5 percent of GDP in FY20/21) have been financed by the King in FY21/22 and the Sungchob Fund outside of the budget (**Figure 19, Table 2**).[20] Other current primary expenditures have also declined as the government strove to rationalize recurrent expenditure. Capital expenditures increased, reflecting continued fiscal support to boost economic activity through the frontloading of some Twelfth FYP activities. Total revenues declined, mainly driven by a decline in other receipts, which have covered the COVID-19 relief measures through transfers from the National Resilience Fund (NRF) (**Figure 20**). Other revenues also declined due to lower hydro revenues in the form of non-tax revenue (with the discontinuation of profit transfers from Mangdechhu),[21] as well as external grants. Tax revenues increased but remained below pre-COVID levels at 13.1 percent of GDP. As a result, the fiscal deficit widened from 6.2 percent of GDP in FY20/21 to 8.9 percent in FY21/22 (**Figure 21**). The financing needs have been covered in equal parts by external borrowing from multilateral and bilateral partners on concessional terms and domestic borrowing. Domestic borrowing increased in FY20/21 an FY21/22 due to growing financing needs, as well as the government's objective to develop the domestic debt market through the issuance of government bonds.[22]

Figure 19. Expenditure components (percent of GDP)



Source: MoF. Note: NRF expenses in FY19/20 and FY20/21 include COVID-19 relief measures in the form of a temporary income support provided to individuals and loan interest payment support to borrowers. Starting from FY21/22, COVID-19 relief measures were financed by the King and Sungchob Fund outside of the budget.

Figure 20. Revenue components (percent of GDP)



Source: MoF. Note: In FY19/20 and FY20/21, other receipts cover transfers from the NRF to cover COVID-19 relief measures.

20 See FY22/23 Annual Budget Report. The King sold shares of the Royal Insurance Corporation of Bhutan Limited (RICBL) and the Bhutan National Bank Limited (BNBL), both listed on the Royal Securities Exchange of Bhutan Limited (RSEBL) to replenish the National Resilience Fund (NRF), which funded temporary income support and the partial interest waiver through the DGRK program. See https://thebhutanese.bt/nu-2-2-bn-from-auction-of-bnb-ricb-shares/

21 A profit transfer modality is applied when a hydro plant has begun operating and generating revenue but has yet to begin servicing its debt

22 A gradual shift from short-term treasury bills to medium- and longer-term bonds is expected to support the development of a domestic bond market. Ministry of Finance, Medium term debt management strategy FY20/21 to FY22/23.

Table 2. Fiscal accounts (percent of GDP)

	FY17/18 (act)	FY18/19 (act)	FY19/20 (act)	FY20/21 (act)	FY21/22 (est)
Resources	**31.9**	**24.3**	**31.1**	**33.2**	**26.5**
Tax revenue	16.6	15.7	13.0	11.5	13.1
Non-tax revenue	6.0	4.4	7.7	8.4	6.7
o/w hydropower profit transfers	0.0	0.0	2.0	4.1	2.2
Other receipts 1/	0.2	(1.8)	1.1	5.0	0.0
Grants	9.1	6.1	9.4	8.3	6.6
Expenditure	**33.5**	**26.3**	**33.1**	**39.3**	**35.4**
Current expenditure	16.8	16.5	20.3	24.4	17.8
o/w National Resilience Fund 2/	0.0	0.0	1.4	6.5	0.0
Capital expenditure	17.6	9.4	12.6	15.3	17.5
Advance/suspense (net)	(1.0)	0.4	0.2	(0.1)	0.0
Fiscal Balance	**(1.6)**	**(2.0)**	**(1.9)**	**(6.2)**	**(8.9)**
Primary balance	(0.3)	(1.1)	(1.5)	(5.2)	(7.0)
Financing (net)	**1.6**	**2.1**	**2.0**	**6.3**	**8.9**
Net lending 3/	1.3	0.8	0.4	0.4	1.9
External borrowing (net) 4/	0.3	0.6	2.0	0.8	2.7
Domestic borrowing (net)	0.0	0.7	-0.4	5.0	4.3

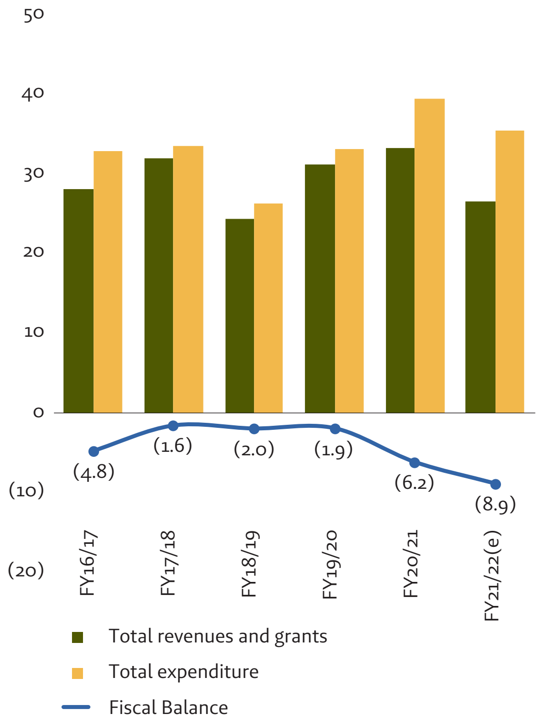
1/ Other receipts include the redemption of T-Bills and overall transactions from cash balances. This line item has been negative in some years, driven by adjustment for prior year's advances. In FY19/20 and FY20/21, other receipts cover transfers from the NRF to cover COVID-19 relief measures.
2/ Includes temporary income support provided to individuals and loan interest payment support to borrowers (DGRK) financed by the NRF.
3/ Includes principal repayments from SEs (for central government loans that are on-lent to SEs), minus on-lending to SEs
4/ Includes central government loans, and central government loans that are on-lent to SEs
Source: MoF and WB staff estimates.

Total PPG debt declined in FY21/22, reflecting a decline in hydropower debt.[23] Total PPG debt declined from 132.4 percent of GDP in FY20/21 to 130.9 percent in FY21/22 (**Figure 22**). External debt amounted to 116.6 percent of GDP in FY21/22, of which hydropower debt accounted for about 71 percent. Hydropower debt declined with higher loan repayments. In contrast, external non-hydropower debt and domestic debt increased, reflecting higher financing needs. Domestic debt is mostly in the form of treasury bills (7.9 percent of GDP) and 3-12-year treasury bonds (5.8 percent). According to the 2022 joint International Monetary Fund (IMF)-World Bank (WB) Debt Sustainability Analysis (DSA), risks to debt sustainability remain moderate as the bulk of the debt is linked to hydropower project loans from India, the export revenues from which should be more than sufficient to fund their debt service payments.[24]

23 The total PPG debt level in FY21/22 is aligned with the MoF. However, the WB has a lower PPG debt to GDP ratio in FY21/22 than the MoF (133.6 percent) because the nominal GDP in current prices is different.
24 See https://www.imf.org/en/Publications/CR/Issues/2022/05/24/Bhutan-2022-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-518275

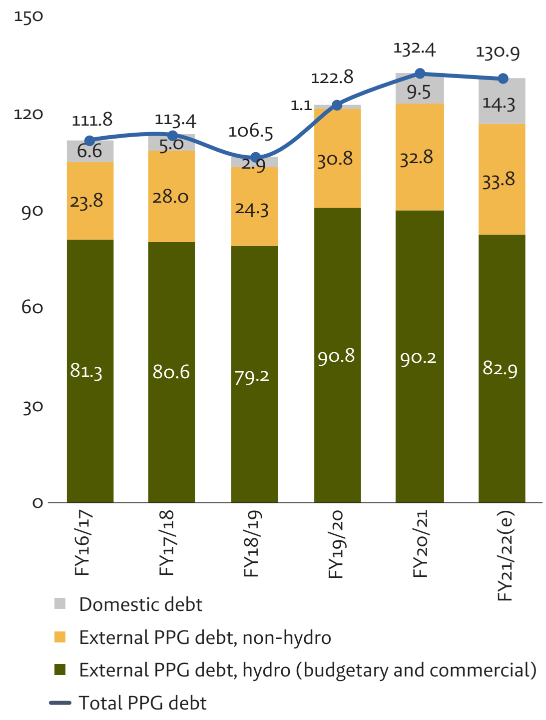
The government extended fiscal support to businesses despite limited fiscal space, while measures to improve domestic revenues have been postponed. Fiscal measures to support businesses have been extended from July 1 to end-December 2022, including (i) the deferment of the business income and corporate income tax for the tourism sector for the income year 2019; (ii) a waiver of rental charges for tourism-related business entities leasing government properties; and (iii) a deferral of payment of electricity charges for medium and high voltage industries. The government has also issued guidelines to further cut recurrent expenditures and relaxed procurement rules and regulation (recent public financial management (PFM) reforms are highlighted in **Box 1**).[25] Meanwhile, the introduction of the Goods and Services Tax (GST), which is part of a broader tax reform agenda to generate sustainable government revenue by moving toward a simple and broad-based tax system, has been delayed.

Figure 21. Fiscal accounts components (percent of GDP)



Source: MoF.

Figure 22. Public debt (percent of GDP)



Source: MoF.

25 The government committed to rationalize recurrent expenditure, including printing, official travel, meeting refreshments, and other procurements. See https://www.mof.gov.bt/wp-content/uploads/2022/09/Notification.pdf

Box 1. Recent PFM reforms

The government has implemented several PFM reforms in FY21/22, reinforcing its commitment to Good Governance, which is one of the four pillars of the country's Gross National Happiness (GNH) Index. Reforms focused on strengthening finance and accounting at the subnational level, modernizing public procurement, and including climate in the budget reporting.

Clustering of Finance Services (CFS): CFS bring together all finance personnel of a district under one office to strengthen efficiency, internal controls, and transparency at the subnational level. Since July 2022, 22 CFS were rolled out across 14 Dzongkhags, 5 ministries and in the judiciary.

Electronic Government Procurement (eGP) system and simplified procurement rules and regulations: The eGP system supports government-wide procurement trough an online platform. Phase II, which linked the tool with various government agencies and procuring agencies, facilitated the procurement during the COVID-19 pandemic. Phase III is ongoing, including reverse auction, e-catalogue, handling procurement-related grievances, contract management, data analytics and reporting. The government issued simplified Procurement Rules and Regulations in 2021 to simplify and streamline procurement processes, and introduced further relaxations in 2022 to ease the financial burden on bidders and contractors.

Climate budget tagging: Government officials from four pilot agencies were trained for climate budget tagging in FY21/22. The FY22/23 annual budget report introduced a section on climate co-benefits.

The government has also initiated several diagnostics in the PFM domain including (i) the third Public Expenditure and Financial Accountability (PEFA) Assessment, including a separate assessment focusing on climate and gender; (ii) the Tax Administration Diagnostic Assessment Tool (TADAT); (iii) the Methodology for Assessing Procurement Systems (MAPS); and a public investment management (PIM) diagnostic using the World Bank PIM Framework. These diagnostics will inform the forthcoming PFM reform strategy.

2. Outlook and Medium-Term Prospects

1. Medium-term Outlook

The economy is projected to grow by 4.1 percent in FY22/23. The broader reopening of borders in September 2022 is expected to support growth in the industry and services sector. Tourist arrivals are expected to remain subdued because of weaker consumer confidence globally and the new tourism levy act, which tripled the sustainable development fee for international tourists. While output is expected to recover to its pre-crisis level, slower domestic demand recovery due to high inflation and lower hydro investments are expected to decelerate growth in FY22/23.

Medium term growth is expected to remain below pre-COVID growth due to delays in hydropower projects. Growth is expected to remain subdued in FY23/24 at 3.7 percent (**Table 3**). This is due to lower public investments in the first year of the Thirteen FYP and delays in the commissioning of hydropower projects. Labor shortages during the pandemic resulted in delays of hydro projects and hence expected delays in additional hydro revenue flows, constraining the country's ability to strengthen fiscal and external balances in the medium term. As a result, the growth projection for FY23/24 was revised down by 3 percentage points vis-à-vis the April 2022 forecast (**Figure 23**).[26]

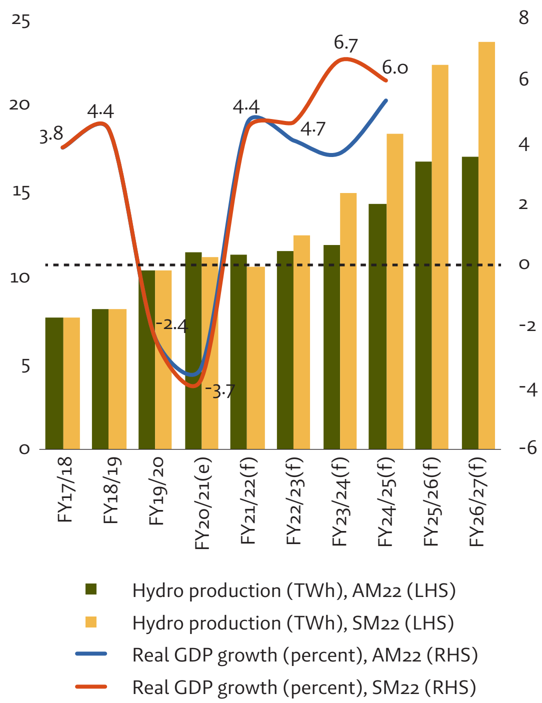
Inflation is projected to remain elevated for in FY22/23, owing to continued supply disruptions and higher energy and commodity prices. Food export restrictions on basic commodities imposed by India may add further pressure on prices in Bhutan.[27] As a result, inflation is expected to remain elevated at 5.9 percent in FY22/23 before moderating to 5 percent in FY23/24, in line with projections for India and the projected fall of energy prices.[28] Although the US$3.65/day poverty rate is expected to decline from 2022 onwards, a full recovery to poverty headcount rates estimated before the COVID-19 pandemic is not likely to be achieved until 2023 given elevated consumer prices.

26 World Bank Bhutan Development Update, April 2022. The Puna II hydropower project commissioning has been delayed from FY22/23 to FY24/25, and the Kholongchhu hydro plant has been delayed indefinitely due to the discontinuation of the first joint venture modality between the Druk Green Power Corporation (DGPC) and Satluj Jal Vidyut Nigam Limited (SJVNL), an Indian SE.
27 The GoI has imposed several export restrictions, including on sugar, wheat, and rice. While the GoI has given Bhutan special concessions for sugar and wheat, anecdotal evidence suggests that manufacturers have already experienced some shortages.
28 Inflation in India is projected to peak at 7.1 percent in FY22/23 (April 2022 to March 2023), before moderating to 5.2 percent in FY23/24. Forthcoming World Bank South Asia Economic Focus, April 2022.

Asset quality deterioration in the financial sector is expected to surface once forbearance measures are phased out. Targeted monetary relief measures are expected to be gradually phased out to curtail inflationary expectations. This is likely to expose the long-standing asset quality problems associated with poor underwriting standards and weak supervision. As a result, NPL levels are expected to increase in FY22/23. The successful implementation of the NPL management strategy, including the NPL resolution framework, will be critical to manage risks in the financial sector.

The CAD is expected to moderate from FY22/23 due to a lower trade deficit. Higher non-hydro goods and tourism-related services exports are expected to offset lower hydro exports amid an increase in domestic electricity demand. Food and fuel imports will remain elevated due to higher globally commodity prices, but demand for other goods imports is projected to ease from FY22/23 on investment moderation. Recently imposed import restrictions for vehicles are also expected to dampen goods imports in the short term. Given the elevated CAD, international reserves are expected to decline until FY22/23, to around 6-7 months of goods and services imports.

Figure 23. Projected hydropower capacity and real GDP growth (BDU SM22, AM22)



Source: MoF and WB staff estimates.

The fiscal deficit is expected to remain elevated in the short and medium term. The fiscal deficit is expected to decrease slightly with recurrent expenditure rationalization, although it will remain elevated at 8.2 percent of GDP in FY22/23 due to continued fiscal support though capital expenditures and subdued revenue performance.[29] The deficit would decline to 5.5 percent of GDP in FY23/24 due to lower public investments in the first year of the Thirteen FYP and measures to improve spending efficiency. Financing needs are projected to be covered mainly by concessional external borrowing from multilateral and bilateral partners and domestic financing, in line with market absorption capacity of the domestic financial system. Despite a decline in hydropower debt, public debt is projected to remain elevated as a share of GDP in the short to medium term due to high fiscal deficits.

29 The fiscal deficit in FY22/23 deviates from the FY22/23 budget report, which projected a higher deficit of 11.3 percent. This is due to different underlying assumptions for capital expenditures and GDP growth. The latest MoF projections expect a fiscal deficit of 9 percent for FY22/23 due to higher domestic revenue, as well as lower current expenditures compared to the budget report.

Table 3. Key macroeconomic Indicators

	FY18/19 (act)	FY19/20 (act)	FY20/21 (act)	FY21/22 (est)	FY22/23 (proj)	FY23/24 (proj)
Real Economy: annual percent change						
Real GDP growth, at constant factor prices	4.4	(2.3)	(3.3)	4.6	4.1	3.7
Agriculture	2.7	2.9	3.3	3.5	3.5	3.5
Industry	(1.6)	(5.5)	(5.9)	5.0	4.9	3.9
Services	11.1	2.5	(0.5)	4.6	3.6	3.5
Real GDP growth, at constant market prices	4.4	(2.3)	(3.3)	4.6	4.1	3.7
Private consumption	10.4	0.1	(1.2)	11.0	4.0	2.0
Government consumption	7.0	7.3	4.9	(12.4)	0.3	(1.5)
Gross fixed capital investment	(11.2)	(16.5)	(3.0)	54.9	(18.9)	(4.6)
Exports, goods and services	9.6	(4.1)	(7.3)	15.6	7.4	7.7
Imports, goods and services	3.1	(0.0)	(9.2)	0.8	51.4	(13.5)
GDP deflator	1.3	3.9	6.2	4.5	4.4	3.8
CPI inflation (year-average)	2.8	3.0	8.2	5.9	5.9	5.0
Fiscal Account: percent of GDP						
Overall balance 1/	(2.0)	(1.9)	(6.2)	(8.9)	(8.2)	(5.5)
Primary balance	(1.1)	(1.5)	(5.2)	(7.0)	(6.4)	(3.8)
Total PPG debt 2/	106.5	122.8	132.4	130.9	129.2	126.5
External PPG debt	103.6	121.6	122.9	116.6	113.6	110.7
Hydropower	79.2	90.8	90.2	82.9	78.2	74.2
Non-hydropower	24.3	30.8	32.8	33.8	35.4	36.5
o/w Central Bank	4.0	4.0	3.9	3.6	3.3	3.0
Domestic PPG debt	2.9	1.1	9.5	14.3	15.6	15.8
Balance of Payments: percent of GDP						
Current account balance	(20.5)	(15.8)	(12.1)	(27.4)	(17.1)	(13.4)
Trade balance (goods and services)	(18.4)	(16.7)	(11.6)	(25.0)	(14.6)	(10.1)
Goods exports	24.8	26.7	29.5	30.2	29.7	28.5
Hydropower	6.3	8.6	15.7	12.0	11.3	10.0
Non-hydropower	18.6	18.1	14.0	18.2	18.4	18.5
Goods imports	41.2	39.7	36.4	49.1	40.6	37.5
Gross international reserves (USD million) 3/	1,345	1,340	1.332	840	733	680
Gross international reserves (months of goods and services imports)	12.8	14.2	15.6	7.1	6.9	6.4
Gross international reserves (months of prospective goods and services imports)	13.0	16.1	10.7	7.9	6.9	6.4

1/ Includes an estimated amount for FY21/22 and FY22/23 for temporary income support provided to individuals and loan interest payment support to borrowers (DGRK) financed by the NRF.

2/ PPG debt, including central government debt, central government loans that are on-lent to SEs, SE debt (direct debt contracted by SEs, not routing trough the budget) and Central Bank debt (loan/credit facilities for BOP support purposes).

3/ The RMA revised gross international reserves retrospectively in July 2022, which resulted in lower international reserves from September 2020 to December 2021. With the revision, international reserves stood at US$970 million in December 2021, compared to US$1.4 billion in the old series.

2. Risks, Challenges, and Opportunities

The outlook has become more uncertain with global uncertainties and increased domestic macroeconomic vulnerabilities. Macroeconomic vulnerabilities have increased amid the pandemic and global ramifications of the war in Ukraine. COVID-19 relief measures for individuals and businesses and subdued revenue performance have resulted in high fiscal deficits from FY20/21. International reserves have declined rapidly in FY21/22, limiting external buffers. Fiscal risks increased due to vulnerabilities in an already weak financial sector with elevated non-performing loans, given that over 90 percent of assets are controlled by the public sector. Delays in fiscal consolidation and the materialization of financial sector contingent liabilities could further erode buffers, thereby constraining the government's ability to support a robust recovery. External risks include rising and volatile commodity prices due to the pandemic and geopolitical tensions, which could exert further pressure on the country's external balance and international reserves, and weigh on external demand and tourism travel, globally and in India (given significant tourism and trade linkages).[30]

The immediate priority is to restore fiscal space to continue supporting the economic recovery while keeping inflation under control. The expansionary fiscal policy during the pandemic was appropriate to support the immediate response and economic recovery. The government has outlined ambitious reforms to support economic diversification and green and inclusive development, including through the upcoming Thirteen FYP. However, limited fiscal space and high debt levels limit the government's ability to support the economic recovery during global economic uncertainties. In this context, it is important to accelerate reforms to enhance domestic resource mobilization and improve spending efficiency to restore fiscal space and sustain public debt. Furthermore, monetary conditions could be gradually tightened in light of inflationary pressures.

There are tangible fiscal risks from a large SE sector, which need to be carefully monitored and managed, especially because the small size and lack of diversity of the economy limits its capacity to absorb additional fiscal shocks. The recently announced delay in several hydropower projects highlights the risks of the heavy dependence of government revenues on the hydropower sector, which accounts for about half of all budget revenues. Vulnerabilities also increased in the financial sector, which is dominated by state owned financial institution, with over 90 percent of assets controlled by the public sector. The special section of this BDU will provide an overview of the current SE landscape in Bhutan, outline the links between SEs and public finances, and provide recommendations how fiscal risks can be mitigated.

30 The baseline projection assumes that the Indian economy will have robust growth in the fiscal year ending in March 2023.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SPECIAL SECTION:

3. Turning Bhutan's State Enterprises into a Development Asset

State enterprises (SEs) in Bhutan play a significant role in the economy and are dominant in multiple strategic sectors. They are also very large contributors of government revenues and generate significant employment. Over the past years, SEs have grown in number and are implementing multiple large projects impacting the development of Bhutan. Both financial and non-financial performance of SEs have been deteriorating in the past years and SEs are a significant source of fiscal risk. The government has implemented several reforms to enhance the institutional and regulatory environment, oversight and transparency, performance management and corporate governance. Meanwhile, significant room for improvement remains in these areas and, if addressed could contribute to improve SE performance, minimize fiscal risks, and turn Bhutan's SEs to a development asset. The below section outlines the role of SEs in the economy in terms of their fiscal implications on the government budget and potential fiscal risks. It also gives an overview of recent developments in corporate governance and ends with a set of recommendations.[31] Due to the lack of firm-level data in Bhutan, this study does not assess the impact of the SE sector on market dynamics and potential implications for the viability and profitability of private companies.

1. Role of SEs in the Economy

The SE sector makes up the backbone of the country and is responsible for providing essential services and infrastructure. The number of SEs increased significantly over the last 15 years, from from 18 companies in 2005 to 39 in 2020, and their combined assets increased to 171 percent of GDP in 2020, up from 142 percent of GDP in 2017. The increase in the number of SEs was driven by the RGoB's dual strategy to (i) harness the hydropower potential by developing new hydropower plants and associated services, and (ii) promote economic diversification and job creation through investments in multiple SEs including in the manufacturing (base metals, textiles, food products, healthcare), agriculture, and ICT sector. The SEs make substantial contributions to budget revenues, ranging between 32 percent and 58 percent of total revenues per annum in the last five years. They employed almost 13,000

31 The special section draws from background papers from the forthcoming World Bank Public Expenditure Review for Bhutan.

persons as of 2020, or 4.1 percent of the total labor force, compared to 30,000 employees in the civil service.[32] SEs are concentrated in strategically important sectors including electricity (primarily in hydropower generation and electricity distribution), manufacturing, and the financial sector. Other sectors in which they operate include air transport, mining, agriculture, communication, IT, and healthcare. The largest SEs by assets and employment are shown in 2020 are shown in **Table 4**.

The 39 SEs are divided between three different shareholders under the umbrella of the MoF with commercial and non-commercial objectives. MoF holds the government's share of all SEs and is responsible for monitoring and reporting the performance of SEs as a whole. A large share of the SE portfolio is managed by a holding company, Druk Holdings and Investments (DHI), which is fully owned by the MoF. According to the MoF 2020 annual SE report, two SEs (Army Welfare Project and Bhutan Agro Industries Ltd) have been transferred to the Queen's Project Office.[33] The King's Kidu Fund and the Sungchob Fund also hold shares in companies.[34] Companies under DHI are profit oriented SEs in the manufacturing, electricity, and communication sectors, while SEs under MoF undertake non-commercial objectives as well. The quasi-fiscal activities for SEs under the MoF include offtake of agriculture products from small farmers (buyback schemes), concessional finance for housing, and public service broadcasts among various other activities. The non-commercial mandates are given to these SEs as direct instructions from the shareholder, yet they are also expected to function as a for-profit organization as there is no legal distinction under the Companies Act of Bhutan between for-profit and non-profit companies.

Table 4. Largest SEs by assets and their employment in 2020

	Entity	Shareholder	Sector	Total Assets (BTN billion)	Employees
1	Bank of Bhutan Limited (BOBL)	DHI Owned or Controlled	Financial and Insurance Activities	87.2	820
2	Druk Holding and Investments (DHI) (Standalone)	MoF	Financial and Insurance Activities	66.1	62
3	Druk Green Power Corporation (DGPC)	DHI Owned or Controlled	Electricity, Gas, Steam and Air Conditioning Supply	56	1,700+
4	National Pension and Provident Fund Limited (NPPF)	MoF	Financial and Insurance Activities	41	183
5	Bhutan Power Corporation Limited (BPC)	DHI Owned or Controlled	Electricity, Gas, Steam and Air Conditioning Supply	35	2,326
6	Bhutan Development Bank Limited (BDBL)	MoF	Financial and Insurance Activities	27.9	622
7	Dungsam Cement Corportion Limited (DCCL)	DHI Owned or Controlled	Manufacturing	9.7	no data
8	Druk Air Corporation Limited (DACL)	DHI Owned or Controlled	Transportation and Storage	9.6	495
9	Bhutan Telecom Limited	MoF	Information and Communication	7.2	656
10	National Housing Development Corporation Limited	MoF	Construction	4.2	171

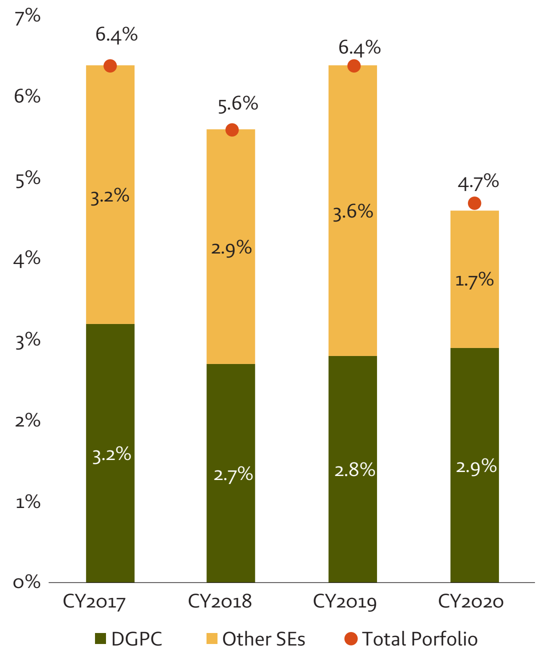
Source: SEs annual reports.

32 Table 4.1, Statistical Yearbook 2020, NSB
33 https://www.mof.gov.bt/wp-content/uploads/2022/02/SOEannualReport2020.pdf
34 See https://royalkidu.bt/wp-content/uploads/2021/04/Press-Release-22-April-2021.pdf; https://businessbhutan.bt/rsebl-offers-sale-of-shares-of-sungchob-fund-and-kidu-fund/

2. Financial performance of the SE portfolio

The SEs overall have consistently reported profits, driven by the electricity sector, but SEs in other sectors have shown a mixed performance. Overall profitability declined by over 25 percent since 2017, from 6.4 percent of GDP to 4.7 percent of GDP in 2020 **(Figure 24).** The electricity sector, more specifically the utility company that operates and maintains hydropower assets Druk Green Power Corporation (DGPC), is the major contributor to overall profitability, generating profits averaging around 3 percent of GDP annually for the past four years **(Figure 24).** The profitability of the remaining SE portfolio is more volatile due to the deteriorating operational performance of some SEs, including Druk Air Corporation Limited (DACL), Dungsam Cement Corporation Limited (DCCL), and Construction Development Corporation Limited (CDCL), as well as the COVID-19 impact in 2020.

Figure 24. Overall profitability of the SE portfolio (percent of GDP)



Source: SEs annual reports.

The return on assets (ROA) is relatively low in most sectors and negative in some. The mining sector, represented by the State Mining Corporation Limited (SMCL), registered the highest ROA at 27 percent, with a significant increase in profits of 268 percent after the acquisition of Khothakpa Gypsum Mines in 2019.[35] The electricity and financial sectors, the largest SE sectors in terms of assets and employees, have low ROAs (**Table 5**). The ROA is a result of many factors such as demand and supply dynamics as well as exogenous shocks. SE specific factors such as corporate governance and SE management also have a significant impact on the ROA through investment, human resource and operational decisions, which in turn can affect cost and revenues, equity and liability as well as profitability.

Table 5. Average return on assets (ROA) of SEs by sector, 2020

	Assets (BTN billion)	RoA (percent)
Agriculture, forestry and fishing	1.7	1.0
Arts, entertainment and recreation	0.1	10.0
Construction	6.7	(0.2)
Electricity	91.1	6.2
Financial and insurance activities	157.6	1.3
Information and communication	8.7	18.1
Manufacturing	12.6	(4.6)
Mining and quarrying	1.4	26.7
Transportation and storage	10.1	(8.9)
Wholesale and retail trade	3.5	(2.7)
Total	**293.5**	**2.7**

Source: World Bank staff calculation based on SEs annual reports.

35 State Mining Corporation Limited, Annual Report 2019

3. Assessment of fiscal costs and risks from SEs for the central government

The SE sector is a major source of budget revenues, greatly exceeding budget expenditures on SEs which include subsidies provided to the SEs. There are several channels through which budget resources are transferred to SEs and received from SEs (**Table 6**). Contributions to budget revenues comprise corporate income tax and dividends, hydropower royalties, profit transfers from hydropower projects, and interest payments on loans on-lent to SEs. They totaled between 32 percent and 58 percent of total revenues per annum in the last five years, equivalent to between 6.5 percent and 11.5 percent of GDP.[36] In contrast, in the same time period SEs received relatively modest amounts of subsidy from the budget, totaling between 1.3 percent and 2.5 percent of GDP per annum. The largest component of which, accounting for more than half of total subsidies to SEs, was a rural electricity tariff subsidy paid to Bhutan Power Corporation (BPC), equivalent to around one percent of GDP per annum during FY18/19-FY20/21. There were also operational subsidies for the SEs under the MoF.[37] Expenditures on SEs, including interest on SE related debt which is fully funded by interest payments received from SEs, amounted to an average of 6 percent of total budget expenditures over the last five years.[38]

Table 6. Budget transactions with SEs (BTN million)

	FY16/17	FY17/18	FY18/19	FY19/20	FY20/21
Revenues from SEs (percent of total revenues)	**10,046 (33.8)**	**12,378 (33.5)**	**11,254 (32.3)**	**16,510 (45.4)**	**20,649 (57.5)**
Corporate income tax	3,973	4,980	4,372	4,679	4,930
Hydropower royalty	142	1,991	2,234	2,833	4,097
Dividends	4,037	4,060	3,405	4,606	3,039
Profit transfer from hydropower projects				3,504	7,376
Interest received from SEs	1,895	1,846	1,243	887	1,571
Expenditures on SEs (percent of total expenditures)	**2,026 (4.1)**	**4,116 (7.3)**	**3,371 (7.7)**	**3,900 (6.8)**	**2,975 (4.2)**
Subsidies	463	2,551	2,396	2,408	2,122
o/w BPC, rural electricity tariff subsidy[39]	0	1,995	1,773	1,829	1,508
Equity and grants				1,171	
Interest payments on SE related debt	1,563	1,565	975	328	853
Below the line transactions					
Net lending	-2,037	-2,112	-1,353	-729	-746
Disbursements	42	49	198	147	1,659
Recoveries of principal	2,079	2,161	1,551	876	2,405
Amortization of SE related debt	1,552	1,538	911	247	1,676
Revenues from SEs as percent of GDP	6.6	7.5	6.5	9.4	11.5
Expenditures on SEs as percent of GDP	1.3	2.5	1.9	2.2	1.7

Source: MoF and World Bank.

36 There is only one corporate income tax included in the table because this is the only tax for which the economic burden is borne by the SE and not its employees (payroll taxes) or its customers (indirect taxes).
37 In 2019/20 SEs also received grants, mainly for the National Food Security Reserve and equity injections, but these were one off expenditures.
38 There are also below the line budget transactions related to the SEs. These involve the disbursements and repayments of loans to and by SEs, mostly of on-lent donor loans. Hence these are mostly neutral in terms of their overall net impact on the budget, e.g., repayments of SE related external loans are funded with repayments of the on-lent loan from the SEs.
39 The Domestic Electricity Tariff Policy 2016 requested that the MoF implement an improved accounting system for the subsidy payment to BPC. The rural electricity tariff subsidy was implicit before.

Table 7 shows a fiscal risk matrix, which includes liabilities of the SEs which may become a future burden on the budget. The fiscal risk matrix divides the risks between those emanating from the operating statement, which are those related to budget transactions, and various forms of direct and contingent fiscal liabilities. Direct risks are certain to materialize, while contingent liabilities are contingent on uncertain future events, such as an SE defaulting on its debt liabilities. Explicit fiscal risks are the government's legal obligation to honor the liability if the SE cannot do so. For implicit risks, the government only has a moral, political or social obligation but is likely to have to honor the liability. The aggregate nominal value of all SE-related fiscal liabilities is large, about 245 percent of GDP in FY20/21 (**Table 7**), and has increased since FY17/18. There are also compounded fiscal risks as some of the liabilities of SEs are owed to financial sector SEs.[40]

Table 7. Fiscal risk matrix covering for real and financial sector SEs (percent of GDP for FY17/18 and FY20/21 in parenthesis)

	Operating Statement		Balance Sheet	
	Revenues	Expenditures	Direct Liabilities	Contingent Liabilities
Direct	-Tax payments: 2.7 (2.5) -Dividends: 2.5 (1.7) -Hydro royalty: 1.2 (2.3) -Profit transfer: 0.0 (4.1) -Interest receipts: 1.1 (0.9)[41] **Total:** 7.6 (11.5)	-Interest paid: 1.2 (0.8) -Subsidies: 1.1 (0.9) **Total:** 2.3 (1.7)		
Explicit Obligations			-External debt on-lent for hydro projects: 79.5 (86.8) -External debt on-lent to non-hydro SEs: n.a. (3.7) - Domestic debt on-lent to non-hydro SEs: n.a. (2.1) **Total:** n.a. (92.6)	-External SE debt - hydro and guaranteed by RGoB: 1.1 (3.4) -External SE debt - non-hydro and guaranteed by RGoB: 3.8 (4.1) -Domestic SE debt guaranteed by RGoB: 0.9 (2.9) -Defined benefit scheme of NPPF: 12.6 (16.2) **Total:** 18.3 (26.6)
Implicit Obligations				-SE debt to domestic commercial and development banks: 5.1 (5.5) -Debts owed to NBFIs: 4.5 (6.2) -Bail out costs of distressed state-owned banks and NBFIs (total financial sector liabilities: n.a. (113.9) **Total:** n.a. (125.6)

Source: World Bank.

There are four distinct types of fiscal risk in relation to the SE sector in Bhutan: (i) the dependence of the budget on SE revenues, most of which are potentially volatile hydro revenues; (ii) the requirements to subsidize the quasi-fiscal activities of BPC; (iii) the risks emanating from loss making real sector SEs; and (iv) the risks posed by financial sector SEs. In addition, fiscal risks also emanate from the SE investment management system. SEs implements and plan to implement several major investments, many of which are funded by government

40 Financial sector SEs hold around BTN 20 billion of the domestic debts of real sector SEs. In addition, the NPPF holds claims of BTN 17.4 billion on other financial sector SEs (e.g., deposits in state owned banks). The RICB also holds claims on banks (e.g., BTN 3.5 billion in bank deposits) but its financial statements do not specify which financial institutions these claims apply to. Given the dominance of SEs in the financial system, most of RICB's claims on other financial institutions are likely claims on SEs. There are also inter-company loans of SEs within DHI of BTN 0.9 billion. This suggests that about BTN 40-42 billion of the total SE liabilities are assets of other SEs; i.e., around 10 percent of the total liabilities of the SEs.

41 This reflects interest receipts from SEs to reimburse the MoF for the debt servicing of the on-lent loans.

guaranteed loans. Given that several recent projects implemented by SEs are encountering delays and cost overruns, there is a fiscal risk related to these projects. Meanwhile, little is known on the SE investment management system.

i. **Dependence of the budget on SE revenues, most of which are volatile hydro revenues:** A high share of the combined SE fiscal revenues is derived directly through profit transfers and hydropower royalties and indirectly via tax and dividend payments from DHI,[42] which account for around 90 percent of total fiscal revenues from SEs in FY20/21. Hydro revenues have been volatile, mainly because these revenues spike when new hydropower plants come into operation. A second source of volatility is that budget revenues are very vulnerable to fluctuations in the volume of power generated by the hydropower plants.[43] Over the period 2001-2021, the standard deviation of the real annual value of total hydro budget revenues, excluding the profit transfer from the newly commissioned Mangdechhu hydropower plant, was 17 percent or 1.9 percent of GDP. On average, a one percent change in annual real hydropower output (GWh) translated into 1.4 percent change in the real value of budget revenues. Although Bhutan's budget revenue volatility is not especially high in comparison to other countries which are dependent on natural resource revenues, that does not lessen the problems posed by this volatility for fiscal management. The RGoB has established the BESF in 2018 and defined fiscal stabilization measures that regulate contributions to and uses of the fund in 2020. However, the fiscal rules for the stabilization fund have not been utilized to date.

ii. **Budget subsidies are required to fund the quasi-fiscal activities of BPC.** Fiscal risks related to BPC include the provision of power to rural consumers at prices which are much less than the full cost of supply. As the number of rural consumers expands because of rural electrification, a larger budget subsidy will be required to offset the losses incurred by BPC in serving this segment of the market. Second, BPC's profitability is already marginal, and therefore any further deterioration in financial performance will likely mean it will incur losses which will have to be funded out of the government budget. Also, BPC may have substantial capital investment requirements to maintain the quality of its assets and expand its coverage. If it cannot fund investments from retained earnings, it will have to borrow money for this purpose, which will entail explicit or implicit government contingent liabilities. While the probability of these fiscal risks materializing is very high, their magnitude is relatively small (rural power subsidies currently amount to around one percent of GDP) and hence they can be absorbed within the budget.

iii. **Losses being incurred by several of the real sector SEs**, a few of which have substantial liabilities (around 11 percent of GDP in total at end-2020). Unless the financial performance of these SEs can be improved, it is likely that they will require finance either from the budget or from DHI to honor their liabilities, and if they are bailed out by DHI, its capacity to make dividend payments will be reduced (in effect these SEs will be cross subsidized by profitable SEs within the DHI structure).

iv. **Financial sector SEs, which dominate the financial sector in Bhutan**. The financial sector is dominated by SEs, which at end-2020 accounted for 85 percent of the assets of the the non-banking financial institutions (NBFIs), including the NPPF. Also, existing bank-level data suggests that the state-owned Bank of Bhutan Limited (BOB) tends to a have lower cost of fund than other banks due to its large base with the government and SEs, which maintain their main accounts with the bank. The financial performance of both state-owned banks and NBFIs has been poor over the last few years (in particular RICBL and BDBL) and it is likely that the economic disruptions caused by the COVID-19 pandemic will have furthered weakened their balance sheets (see section 3). The specific fiscal risk in the short to medium term is that some of the financial sector SEs may need capital injections to restore capital adequacy because of loan losses. These capital injections will have to be funded directly, or indirectly through DHI, from the budget. In the long term, the liabilities of the defined benefit scheme of the NPPF may also require to be funded from fiscal resources. A significant share of SE borrowing is from the financial sector SEs and thus an additional source of fiscal risk.

42 DGPC (which owns most of the hydropower plants) contributed 65 percent and 71 percent of the dividend income of DHI in 2019 and 2020 respectively (National Budget, FY 2021-22, p91).

43 This is because budget revenue is determined by two sets of residuals; i) the surplus power, after domestic demand is met, which is exported, and ii) the financial surplus after total costs of generation, including financing costs, have been deducted. Both domestic power demand and the total costs of generation are relatively stable and independent of the total power generated. Consequently, fluctuations in total power generated have an amplified impact, firstly on the surplus available for export and, secondly on the financial surplus, after costs are deducted from export revenues, which is available to be paid as budget revenue.

4. Corporate Governance

Corporate governance impacts on SE performance and fiscal risk. As noted above, SE performance deteriorated over the past years and fiscal risks are high. While Bhutan has implemented multiple reforms to strengthen its legal and institutional framework, performance monitoring, and transparency and disclosure, the SE sector continues to face multiple challenges in terms of corporate governance.

Legal and Institutional Framework

Overall, Bhutan has a comprehensive legal and regulatory framework governing SE but it is yet to be completed. The Bhutan Companies Act (2016) governing corporatization and corporate governance of all companies in Bhutan treats public and private companies equally. Additional rules governing SEs are set forth in the Bhutan Public Finance Act (PFA) (2007, amended in 2012). A Royal Charter[44] established DHI and its governance framework. As per the 2016 Companies Act, a draft CGCSRC has been prepared by the CRA. The new code, aligned with the OECD's six principles of corporate governance, will be applied to all companies other than licensed financial institutions regulated by the RMA. When finalized and issued, the code will be a major step forward to improve the regulatory environment and the corporate governance of companies, including SEs in Bhutan.[45]

Bhutan's SE ownership model is a centralized one with exceptions and elements of a dual model. MoF, through its Investment and Corporate Governance Division (ICGD) assumes oversight of SEs not held by DHI, and is responsible for oversight and reporting on SE performance management. Furthermore, ICGD responsibilities include formulating recommendations on SE capital structure, divestment and investment, privatization, capital expenditures and foreign equity participation in SEs. The division also issues corporate assessment guidelines with line ministries, including the corporate governance guidelines in 2019. The commercial arm of the RGoB, DHI is a holding company centralizing ownership of commercially oriented SEs. Its main mandate is "to hold and manage the existing and future investments of the RGoB for the long-term benefit of its shareholders, the people of Bhutan, represented by the MoF".

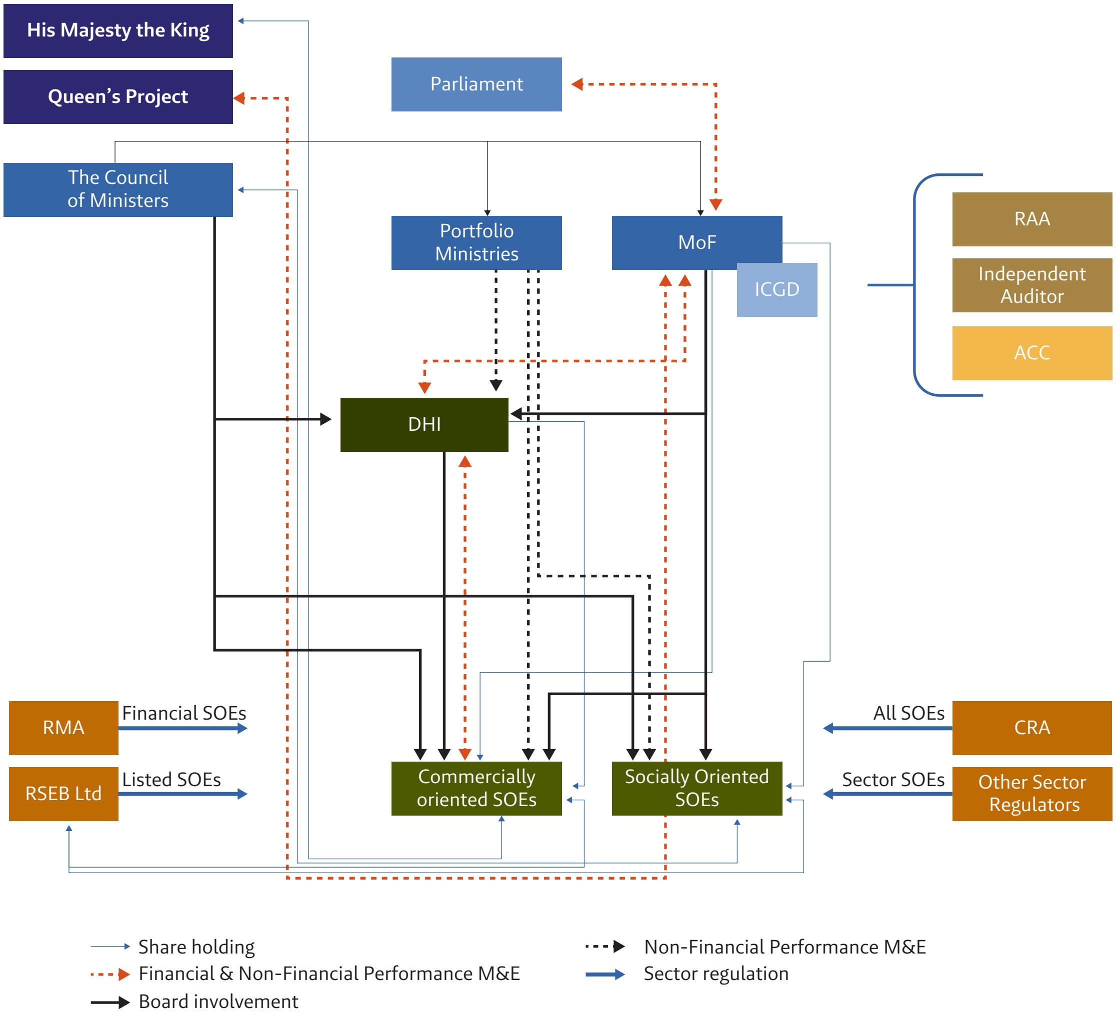
Multiple other government entities are part of the SE institutional framework. The CRA, yet to be fully delinked from the Ministry of Economic Affairs (MoEA), is responsible for the incorporation or registration of corporate entities. The Royal Audit Authority (RAA) is the ex-officio auditor of all SEs and it approves private auditors that conduct SE audits. The Anti-Corruption Commission is also covering SE in its work. Finally, SEs are subject to sector specific regulators, including the National Environment Commission, Bhutan Electricity Authority, Bhutan Information Communications and Media Authority.

The current ownership model adds complexity and reduces the oversight function (Figure 25). The current ownership model in Bhutan has multiple actors and is complex. MoF, in addition to holding shares in socially oriented SEs, holds shares directly and indirectly in commercially oriented companies, including companies where DHI holds shares. For instance, the National Pension and Provident Fund Limited (NPPF), a SE under MoF ownership, holds 6 percent of shares in Penden Cement, a DHI controlled company. the largest shareholder of the Bhutan National Bank Limited (BNBL), a DHI-linked company. The QPO holds shares in both commercially and socially oriented companies. DHI holds shares in commercially oriented companies. Also, state-owned financial institutions are shareholders of the Royal Securities Exchange Bhutan (RSEB), which has an important regulatory role of listed companies. Furthermore, the PFA of Bhutan also gives portfolio ministries the responsibly for monitoring and reporting the performance of assigned SEs. The MoF has a responsibility to prepare an annual report on SE performance but has limited access to SE information beyond SEs it holds shares in. This in turn blurs reporting lines, dilutes accountability and reduces the efficiency of SE oversight.

44 Royal Charter of Druk Holding and Investments, 2007, amended in 2008.

45 The draft CGCSR include more detailed requirements on transparency and reporting than current CG of DHI or MOF, enhance the role of independent directors, establishes a maximum tenure (six years) and number of companies in which the independent director can serve on (three), establishes training requirements of directors and requirement regarding board committees as SEs will have to establish audit, nomination and remuneration committees compared to the current minimum requirement of an audit committee. Furthermore, the CRA will have a monitoring and compliance function.

Figure 25. Ownership and oversight function of SEs in Bhutan



Source: World Bank staff compilation.

Performance Monitoring

Both DHI and MoF have a corporate performance management system linked to compensation of SE management and staff. DHI, following discussions with MoF, signs Annual Performance Compacts (APCs) with SEs it owns, consisting of both financial and non-financial indicators. MoF has also an APC system. Performance is subsequently monitored and evaluated on an annual basis and achievement of targets affects both Chief Executive Officer (CEO) and staff compensation (through the performance based variable incentive). CEO's contract renewals are also subject to satisfactory performance. According to the DHI 2020 Annual Report, 26 Board Committee for Performance Management were held in 2020 including compact negotiations and reviews.

The outcome of the APC system in 2020 revealed potential for improving the methodology as APCs do not seem to be consistently linked to SE performance. Three SEs had an APC scored above 75 although they did not meet revenue targets and the NPPF, with a score of 97 did not meet the revenue target (Table 8). Six SEs scored APCs above 75 although they had negative profitability and return on asset, two of which also did not meet the revenue target. Although performance across SEs varied substantially, all SEs received a 15 percent performance based variable incentive due to COVID-19.

Table 8. APC score and key performance indicators

SE	Profitability (BTN million)	Return on asset (percent)	APC Score 1/	Revenue target met (Y/N)
KUENSEL Corporation Limited	-11	-3.8	n.a.	n.a.
Druk Holding and Investments Limited	3,656	1.6	97	Y
National Pension and Provident Fund Limited	2,102	5.1	97	N
Bhutan Development Bank Limited	-140	-0.5	93	Y
Green Bhutan Corporation Limited	-1	-1.8	92	Y
Farm Machinery Corporation Limited	-13	-2.9	89	N
Bhutan Broadcasting Service Corporation Limited	-16	-3	88	Y
Bhutan Duty Free Limited	40	20.8	86	Y
Royal Bhutan Helicopter Services Limited	-63	n.a.	78	N
Food Corporation of Bhutan Limited	-112	-7.3	75	Y
Bhutan Livestock Development Corporation Limited	6	0.9	69	Y
National CSI Development Bank Limited	-27	-2.5	63	Y
National Housing Development Corporation Limited	-27	-0.6	63	N
Bhutan Lottery Limited	13	10	53	N
Bhutan Postal Corporation Limited	-24	-5.2	47	N

1/ For all companies but DHI financial and non-financial targets are weighted 50. For DHI, financial targets are weighted 30 and non-financial targets are weighted 70

Source: MoF 2020 SE annual reports.

SE Boards

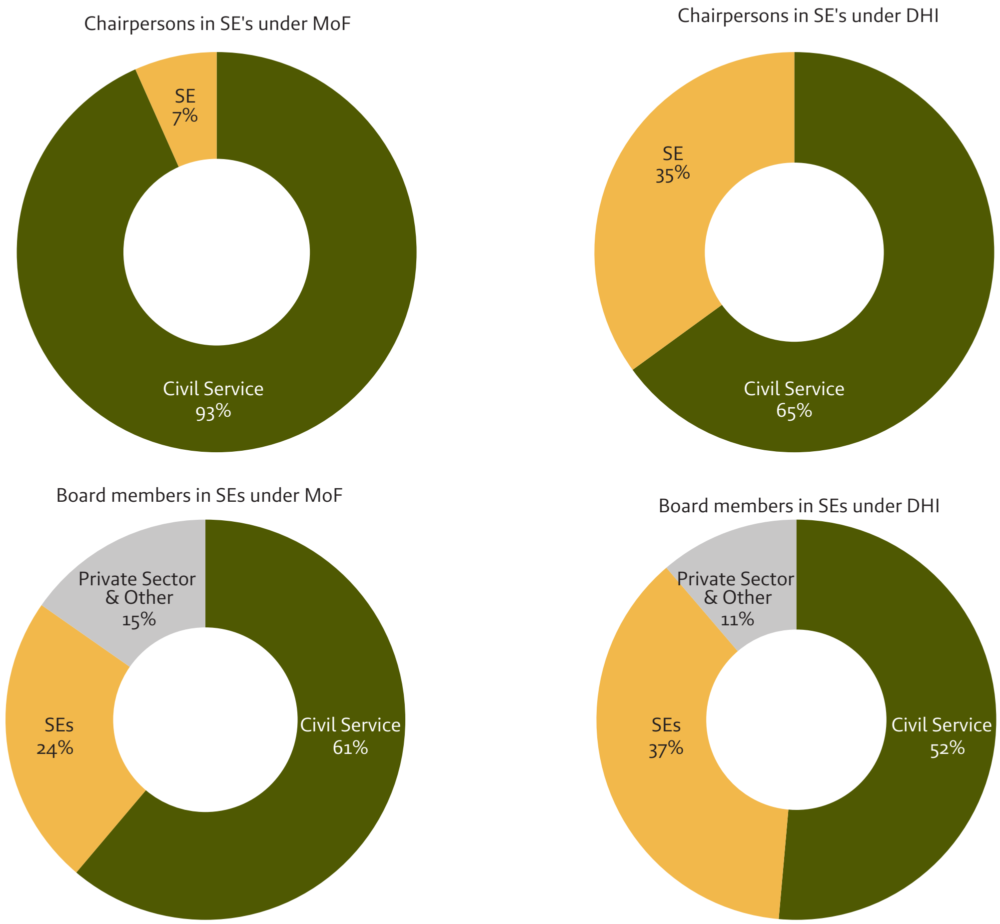
The Majority of SE Board members are male with a background in Civil Service and other SEs. The DHI Board, MoF and Cabinet have an important role in appointment of Board Directors and CEOs and corporate governance codes provide some guidance on recruitments.[46] The chairpersons of SEs owned by DHI are selected by the DHI Board. For SEs under MoF, Board members and CEO are identified by MoF and relevant portfolio ministries and approved by Cabinet. While SE Board members are required by regulation to have a diverse background, the majority of Board members are senior Civil Servants and CEOs in other SEs (**Figure 26**). There are no requirements on gender and women represented on average 10 percent and 13 percent in MoF and DHI Boards respectively. Out

46 Boards are regulated by provisions in the Companies Act, the PFM act, the Financial Services Act (2011), corporate governance codes and other regulations. SE Boards have similar mandates across the different regulation and corporate governance codes.

of 39 SEs, one had a woman as Chairperson. Training of Board members and the role of the Company Secretary is limited. Given the role of SEs and the importance of the Board, increasing the share of Board members with private sector background is likely to be beneficial for SE performance. While corporate governance codes provide some requirements of Board members and CEOs, only the MoF corporate governance code provides minimum education and experience requirements and only for the CEO.

SE Boards and corporate governance are critical for SE performance, but there is limited data on them. SE Boards make major investments of SEs, including on investments and divestment. Corporate governance codes provide rather detailed reporting requirements and data provided in Annual Reports and aggregated reports by the MoF and DHI include some information on Boards and corporate governance. Meanwhile, for most SEs this information is sparse and not in line with corporate governance codes requirements.

Figure 26. Chairpersons and Board members' backgrounds



Source: World Bank staff calculation based on SEs annual reports.

Transparency and Disclosure

The legal framework and regulatory framework establish information disclosure requirements. The Companies Act requires companies to prepare annual financial statements no later than six months after the end of the fiscal year (no later than May for listed companies). SEs must comply with Bhutan accounting standards and DHI is transitioning towards International Financial Reporting Standards. Both the DHI and MoF corporate governance codes require SEs to prepare annual reports and the MoF code requires SEs to publish the annual report no later than one month after the annual general meeting. The DHI code encourages SEs to maximize use of webpages to communicate with stakeholders. Both codes provide some information on the content of the annual report, including on financial and non-financial performance, audited financial statements, corporate social responsibilities and Board and CEO performance.

The share of SEs with published annual reports and audited financial statements and timeliness of publishing is limited. As of September 2022, the total share of SEs with audited and published financial statements for 2020 was 62 percent (59 percent and 64 percent for SEs under DHI and MoF, respectively). The total share of SEs with published audited financial statements and annual reports for 2021 was even lower, at 39 percent and 26 percent respectively. SEs under the MoF performed worse than SEs under DHI (**Table 9**).

The MoF published a consolidated annual SE report in 2018 and 2020. The ICGD of the MoF prepared and published a consolidated annual report on financial and non-financial SEs including DHI in 2018. A second report was published in 2020, covering SEs under the MoF and consolidated results from DHI. While the quality of the 2020 consolidated annual SE report improved from the 2018 report, it did not include SEs under DHI and the QPO and had limited information on corporate governance and SE investment management.

Table 9. SE reporting (as of September 2022)

Reporting line

	Annual Report 2020	Audited Financial Statements 2020	Annual Report 2021	Audited Financial Statements 2021
SE’s under MoF + Queen’s Project	53%	59%	18%	24%
SE’s under DHI	55%	64%	33%	52%
All SE’s	54%	62%	26%	39%

Source: Company webpages, Royal Stock Exchange Bhutan and World Bank staff calculations.

5. Recommendations

Table 10 outlines policy recommendations to mitigate fiscal risks and improve corporate governance in the SE sector. While some of these policy recommendations can be implemented in the short term, more challenging ones would require more time to implement. Recommendations that can be implemented in the short term include strengthening the fiscal risk assessment in the annual budget documents, formalizing a mechanism for calculating the costs of the policy based objectives implemented by BPC (such as providing subsidized power to rural consumers) and funding these fully from the budget and undertaking the actuarial evaluation of NPPF’s defined benefit pension scheme. More difficult reforms pertain to the loss-making real sector SEs and the financial sector SEs. In the medium to long term, the government could further improve the performance of these SEs (and reduce fiscal risks) through better SE oversight, reporting and performance management, professionalization and diversification of SE Boards, and improved SE investment management. The RGoB could rapidly undertake an assessment of the investment management using international standards and outline measures to improve the investment management framework.

Table 10. Policy recommendations for the SE sector

Challenges	Policy measure to mitigate challenge	Timeline
Fiscal Risk		
All types of fiscal risk	Include a comprehensive assessment of all risks in the annual budget report, including an estimate of all SE related liabilities.	Short term
All types of fiscal risk	Undertake an assessment of SE investment management using international standards and strengthen the SE investment management framework.[47]	Short term
Volatility of hydro budget revenues	Operationalize the BESF governance framework and fiscal rules.	Short term
Quasi fiscal activities of BPC	Establish and publish clear criteria for calculating the magnitude of policy-based objectives of BPC and compensate these explicitly from the budget. Ensure that BPC can finance all its other operations from its revenue.	Short term
Losses of real sector SEs	Identify SEs with non-commercial objectives to implement, establish and publish clear criteria for compensation of such activities and explicitly compensate them from the budget. Undertake a sustainability analysis and impact analysis of such compensation.	Short term
Long term liabilities of NPPF's defined benefit pension scheme	Undertake an actuarial evaluation of the defined benefit scheme with recommendations to strengthen its financial sustainability.	Short term
Losses of real sector SEs	Monitor more closely financial and non-financial performance of loss-making SEs, set targets and establish an action plan to restore loss-making SEs to profitability. Establish a framework to determine what to do with commercially oriented SEs that cannot be made profitable.	Medium term
Potential financial distress in financial sector SEs	Encourage gradual privatization for weaker state-owned banks and NBFIs, with the private investors taking responsibility for managing these institutions on purely commercial lines. Given the shocks from COVID-19 and impact of balance sheets of state-owned financial institutions, the government might have to recapitalize these institutions and resolve NPLs before they become attractive for private investors. Financial institutions which are mandated to implement social objectives and which therefore cannot be run on purely commercial lines should not take deposits, but instead be funded from equity, loans or transfers from the budget and concessional loans from international financial institutions.	Medium term

47 https://openknowledge.worldbank.org/bitstream/handle/10986/36002/Assessing-Public-Investment-Management-Functions-and-Institutional-Arrangements-for-State-Owned-Enterprises-A-Diagnostic-Framework.pdf?sequence=1&isAllowed=y

Challenges	Policy measure to mitigate challenge	Timeline
Corporate Governance		
Oversight	Strengthen the institutional and regulatory framework by: (i) introducing a more centralized ownership model with clear reporting lines and responsibilities for enhanced accountability and oversight; (ii) strengthening MoF oversight role of all SEs and its capacity for SE oversight; (ii) issue the corporate governance code as required by the Companies Act and harmonize existing codes; (iii) strengthen the CRA.	Short term
Performance management	(i) Review and assess DHI and MoF's compact system and performance-based compensation; (ii) ensure consistency between SE results and compact performance and across DHI and MoF performance management systems; (iii) revise compact targets annually to include productivity gains.	Short term
Transparency and disclosure	(i) MoF to publish annually an expanded SE report including SE financial and non-financial performance, SE investment management, fiscal risk and corporate governance analysis and covering all SEs, including DHI and QPO SEs; (ii) expand SE database to include more information on corporate governance, SE human resources and non-financial performance; (iii) establish a monitoring and evaluation system of SE investments; (iv) establish annual report standards and improve their quality and timeliness of publication; (v) publish performance results of Board, CEO and performance compact of all SEs.	Short term
Board professionalization and diversity	(i) Scale-up training and establish clear appointment criteria of Board members and CEOs consistent across SEs; (ii) increase the share of private sector representatives and women in Boards; iii) professionalize the role of the company secretary and review their compensation.	Medium term

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