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Bhutan Second Green and Resilient Growth Development Policy Credit (P178635)

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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A

PROPOSED CREDIT IN THE AMOUNT OF SDR 28.7 MILLION (US\$38 MILLION EQUIVALENT) AND

A PROPOSED CREDIT ON SHORTER MATURITY LOAN TERMS IN THE AMOUNT OF SDR 9.1
MILLION (US\$12 MILLION EQUIVALENT) TO

THE KINGDOM OF BHUTAN

Bhutan Second Green and Resilient Growth Development Policy Credit
July 19, 2023

Macroeconomics, Trade And Investment Global Practice
South Asia Region

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Kingdom of Bhutan
GOVERNMENT FISCAL YEAR
July 1 – June 30

CURRENCY EQUIVALENTS
 (Exchange Rate Effective as of May 31, 2023)

Currency Unit: Bhutanese Ngultrum

US\$1.00 = BTN82.69

SDR1 = US\$1.33

ABBREVIATIONS AND ACRONYMS

ABS	Access and Benefit Sharing	IT	Information Technology
ADB	Asian Development Bank	IDA	International Development Association
BCF	Bhutan Climate Fund	IMF	International Monetary Fund
BTN	Bhutanese Ngultrum	JICA	Japan International Cooperation Agency
CAD	Current Account Deficit	MoAL	Ministry of Agriculture and Livestock
CPF	Country Partnership Framework	MoF	Ministry of Finance
CPI	Consumer Price Index	MRV	Monitoring, Reporting and Verification
CRR	Cash Reserve Ratio	MSME	Micro-, Small, and Medium-Sized Enterprise
DHI	Druk Holding and Investments	NAP	National Adaptation Plan
DPC	Development Policy Credit	NBC	National Biodiversity Center
DSA	Debt Sustainability Analysis	NDC	Nationally Determined Contribution
ECB	External Commercial Borrowing	NKRA	National Key Result Areas
e-GP	Electronic Government Procurement	NPL	Non-Performing Loan
e-CMS	Electronic Customs Management System	PA	Prior Action
FYP	Five-Year Plan	PPA	Performance and Policy Action
FNS	Food and Nutrition Security	PPG	Public and Publicly Guaranteed
FNC	Forest and Nature Conservation	RGoB	Royal Government of Bhutan
GDP	Gross Domestic Product	RKC	Revised Kyoto Convention on the Simplification and Harmonization of Customs Procedures
GHG	Greenhouse Gas	RMA	Royal Monetary Authority
GoI	Government of India	SOE	State-Owned Enterprise
GRID	Green, Resilient and Inclusive Development	SDF	Sustainable Development Fee
GRS	Grievance Redress Service	WB	World Bank
GST	Goods and Services Tax	WBG	World Bank Group
INR	Indian Rupee		

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KINGDOM OF BHUTAN

BHUTAN SECOND GREEN AND RESILIENT GROWTH DEVELOPMENT POLICY CREDIT

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SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Programmatic	If programmatic, position in series
P178635	Yes	2nd in a series of 2

Proposed Development Objective(s)

The operation aims to (i) strengthen resilient and private sector-led growth through fiscal sustainability and enhanced access to finance and markets, and (ii) foster green growth focused on renewable natural resources.

Organizations

Borrower: THE KINGDOM OF BHUTAN

Implementing Agency: Ministry of Finance

PROJECT FINANCING DATA (US\$, Millions)

SUMMARY

Total Financing	50.00
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DETAILS

International Development Association (IDA)	50.00
IDA Credit	38.00
IDA Shorter Maturity Loan (SML)	12.00

INSTITUTIONAL DATA

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Overall Risk Rating

Substantial



Results

Indicator Name	Baseline [2021]	Target [2024]
Pillar 1: Strengthen resilient and private sector-led growth through fiscal sustainability and enhanced access to finance and markets		
Results Indicator 1: Non-performing loans (NPLs) resolved through out-of-court settlement (number of cases)	330	480
Results Indicator 2: Number of outstanding external commercial borrowing loans	1	8
Results Indicator 3: Score in the World Bank Debt Management Performance Assessment Methodology (DeMPA) on Coordination with Fiscal Policy (DPI 6)	DeMPA sub-indicator: Availability and quality of information on key macro variables and DSA: D	DeMPA sub-indicator: Monitoring fiscal risks: B ¹ DeMPA sub-indicator: Availability of key macro and fiscal variables and DSA: A
Results Indicator 4: E-commerce licenses issued (number of licenses, disaggregated by gender of business owner, cumulative)	Women: 45 Men: 73	Women: 78 Men: 110
Results Indicator 5: Number of digital payment transactions (domestic and international) (thousands)	61,456	73,748
Results Indicator 6: Average tariff on goods imports from countries other than India (percent)	22.4	9.9
Pillar 2: Foster green growth focused on renewable natural resources		
Results Indicator 7: Export value of the agriculture sector (Bhutan Trade Classification Chapters I-IV (excl. 24), VI (33), VIII (41), IX (44), BTN million).	4,630 (2022)	5,500
Results Indicator 8: Share of women/men registered in farmer groups or cooperatives (percent)	Women: 48 Men: 52	Women: 60 Men: 40
Results Indicator 9: Proposals of commercial access to genetic resources that are approved by the National Competent Authority as per Biodiversity Rules and Regulations 2023 (cumulative number)	0	5
Results Indicator 10: Emission reduction credits generated in metric tons (cumulative)	0 TCO ₂ e million	2.5 TCO ₂ e million

¹ This sub-indicator on monitoring fiscal risks was added in the new DeMPA Methodology, 2021 edition.



IDA PROGRAM DOCUMENT FOR A PROPOSED CREDIT TO THE KINGDOM OF BHUTAN

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed operation—the second in a programmatic series of two development policy credits (DPCs)—supports the Royal Government of Bhutan’s (RGoB) efforts toward resilient and green development.** It comprises two pillars: strengthening resilient and private sector-led growth through fiscal sustainability and enhanced access to finance and markets (Pillar 1); and fostering green growth focused on renewable natural resources (Pillar 2). Pillar 1 will improve access to *international finance* for firms; improve monitoring of public debt and fiscal risks from state-owned enterprises (SOEs) to support *fiscal sustainability and SOE oversight*; support e-payments; and improve *access to international markets*. Pillar 2 will promote *green growth* through the sustainable utilization of *renewable natural resources* focusing on commercial agriculture, biotechnology, and monetization of emission reductions from renewable energy. The proposed reforms supported in this operation are aligned with the World Bank Group (WBG)’s approach to Green, Resilient and Inclusive Development (GRID). The proposed credit amount is US\$50 million equivalent, of which US\$38 million equivalent is on IDA small economy terms, and US\$12 million equivalent is on Performance Based Allocations Shorter Maturity Loan (PBA SML) terms.

2. **Rapid economic growth has contributed to substantial poverty reduction over the last two decades, but vulnerability to poverty and spatial inequality remains high.** Bhutan’s economy grew at an average annual rate of 7.2 percent between 2000 and 2019 and its per capita income increased threefold in purchasing power parity terms over the same period. As a result, extreme poverty was almost eliminated in 2017, and the population living below the US\$6.85/day poverty line for upper-middle-income countries decreased from 39.7 to 8.8 percent between 2017 and 2022. The COVID-19 pandemic caused major disruptions to economic activity and had a direct impact on production, livelihoods, and worker earnings, resulting in higher poverty incidence. Poverty is more prevalent in rural areas and there are significant disparities across Dzongkhags (districts). While national inequality is lower than the regional average in the South Asia Region, spatial inequality across districts remains an issue.²

3. **Prior to COVID-19, Bhutan had a relatively strong fiscal position and comfortable external buffers.** The revenue to GDP ratio averaged at around 29 percent of Gross Domestic Product (GDP) in the five fiscal years preceding COVID-19 (FY13/14 to FY18/19), supported by revenue from hydropower projects and sizable external grants, with each accounting for about one third of total revenues. Fiscal deficits averaged 2.3 percent of GDP in the period. While large investments in hydropower resulted in substantial external debt accumulation, risks of debt distress were mitigated by a bilateral agreement with India, the main creditor of the country’s external debt. As a result, non-hydropower public and publicly guaranteed (PPG) debt has remained within the threshold under the government’s Public Debt Policy of 35 percent of GDP, with most owed to external creditors on concessional terms and domestic lenders. External buffers were high with international reserves covering 15.7 months of goods imports in FY20/21, above the IMF reserve adequacy for Bhutan of 6.1 months.³

4. **Bhutan’s economy has been significantly affected by the series of external shocks of the COVID-19 pandemic and the global ramifications of Russia’s invasion of Ukraine, and by a major strategic national investment in crypto mining.** The trade and tourism-dependence of the small landlocked

² The Gini index that measures inequality is recorded at 0.29 in 2022 in Bhutan.

³ Given Bhutan’s classification as a resource rich economy, the fixed exchange rate regime, and the estimated cost of holding reserves of 6.2 percent (based on the marginal product of capital), reserve adequacy is assessed to be around 6.1 months of current imports. IMF 2022 Article IV Consultation Staff Report.



economy have made it susceptible to the pandemic-induced shock. After contracting by 2.3 and 3.3 percent in FY19/20 and FY20/21, respectively, the economy is recovering from the pandemic. COVID-19 relief measures for individuals and businesses and subdued revenue performance have resulted in high fiscal deficits and public debt since FY20/21. Vulnerabilities in the financial sector with high non-performing loan (NPL) levels have increased fiscal risks, given that about 60 percent of assets of the financial sector are controlled by the public sector. Labor shortages during the pandemic resulted in significant delays of hydro projects, constraining the country's ability to strengthen fiscal and external balances in the medium term. The state holding company Druk Holding and Investments (DHI) invested US\$539 million (21 percent of FY21/22 GDP) in crypto mining operations over FY21/22 and FY22/23, financed by loans from the Royal Monetary Authority (RMA), to accelerate the country's digital transformation and diversify the economy. The investment resulted in a significant decline of international reserves in FY21/22 and a widening of the current account deficit (CAD) due to imports of information technology (IT) equipment and related goods for crypto mining.⁴

5. **The lack of economic diversification and promotion of private sector activity poses risks to the long-term sustainability of growth and job creation.** Analysis from the forthcoming Bhutan Country Economic Memorandum (CEM) suggests that GDP growth has been largely driven by the publicly led hydropower sector while structural transformation has been slow. With limited economic diversification and nascent private sector development, jobs remain concentrated in agriculture and the public sector.⁵ Youth unemployment, which was already high before the pandemic, increased to 29 percent in 2022, which contributed to an increase in outward migration. This has raised concerns about significant brain drain from the country. Non-hydropower sector growth has been constrained by the country's geography and challenging investment climate, including high trade costs and a small domestic market. The large SOE sector could crowd out private investments given that commercial SOEs compete against private firms in industries such as air transport, mining, agriculture, communication, information and communication technology, and healthcare. Agriculture—a critical source of employment, rural livelihoods, and food security—remains less productive and is loosely interconnected with other sectors of the economy.

6. **Bhutan is vulnerable to natural hazards and climate change affecting agriculture, water, forests, and biodiversity, with the poorest communities at highest risk of poverty and displacement.** Climate change is expected to increase flooding, runoff, erosion, and water scarcity, leading to decreased crop production and increased invasive species, fire risks, diseases, and pests. Projected increases in the number of days with very heavy precipitation could further increase the risk of flooding and impact runoff, erosion, and rates of river discharge. Changes in precipitation patterns further stress biodiversity, making them more vulnerable to diseases and pests.⁶ The impact of flooding on human health and livelihoods is expected to grow and could cost up to 4 percent of GDP by the 2030s.⁷ Higher temperatures are projected to contribute to increased snowmelt, which could also change patterns of river discharge, water availability and area-specific droughts. Variation in climate and weather patterns greatly affects crop production, while increased temperature leading to an increase in invasive species can also contribute to biodiversity loss across Bhutan's forests and other ecosystems. For example, the continuous rainfall that took place from October 16-21 in 2021 impacted 17 dzongkhags, covered over 2,500 acres, and resulted

⁴ Transactions related to mining and trading related to cryptocurrencies are yet to be adequately reflected in DHI's audited financial statements and annual reports, national accounts, and the external accounts. The Bank's macroeconomic framework reflects the loan repayments from DHI to RMA under the financial account, as a reduction in assets.

⁵ The hydropower sector (including the electricity and construction sector) accounts for about 26 percent of GDP in 2021, and 1 percent of total employed persons in 2022. Agriculture and public sector (including education and health) account for 43 and 19 percent of employed persons in 2022, respectively.

⁶ https://climateknowledgeportal.worldbank.org/sites/default/files/2021-08/15874-WB_Bhutan%20Country%20Profile-WEB.pdf

⁷ WBG and ADB Climate Risk Country Profile: Bhutan (2021).



in the loss of approximately 2,400 MT of crops. Additionally, accelerated glacial melt could lead to water scarcity and catastrophic flooding; such significant alterations to these resources due to climate change could have severe implications for Bhutan's economy. Increased drought conditions combined with increased lightning risks can worsen the risk of forest fires.⁸ Further, significant fluctuations in water availability, glacier retreat, sedimentation, and extreme weather events will impact the hydropower sector,⁹ and disrupted wildlife habitats can impact tourism and biodiversity, increasing the importance of diversifying the country's economy.

7. **This operation supports reforms for a more resilient economy with a green and diverse production base, to enhance resilience to future shocks and support future development.** Reforms to strengthen public debt management and fiscal oversight of SOEs and related fiscal risks are crucial to address short-term macroeconomic vulnerabilities and risks to private investment. Increased access to international finance for firms can support private sector development and firm growth, and free up funds from lending to larger borrowers to smaller companies, thereby enhancing access to credit for smaller companies. Developing a vibrant private sector to generate jobs and diversify the economy, while sustaining Bhutan's natural environment, will be crucial to build resilience and ensure green and inclusive development. In doing so, Bhutan can seize new opportunities, such as the acceleration of digital development and e-trade in goods and services, which can reduce the cost of distance and remoteness. Finally, Bhutan can leverage its renewable natural resources and carbon-negative status for job creation and additional financing for climate adaptation and mitigation.

2. MACROECONOMIC POLICY FRAMEWORK

8. **Bhutan's economy is shaped by hydropower development and its special relationship with India.** Economic growth has been driven by public sector-led hydropower development and the sale of electricity to India. The completed and ongoing hydropower projects are mostly financed through commercial loans and capital grants from India in the ratio of 70:30 on average. The hydropower projects are implemented under a special intergovernmental agreement between Bhutan and India, in which the Government of India (GoI) covers both financial and construction related risks and commits to buying all surplus electricity at a price reflecting cost plus a net return. External debt servicing of hydropower loans is covered by revenues from hydropower exports to India, which offsets the financing needs created by the loans. The GoI also provides grants to help finance investments under Bhutan's Five-Year Plans (FYPs). India is Bhutan's largest trading partner, accounting for 86 and 72 percent of exports and imports in 2022, respectively. Imports from India are not taxed because of a bilateral free trade agreement. Therefore, despite very high imports linked to the construction of hydropower projects, import duty collections are small (0.3 percent of GDP in FY21/22).

2.1. RECENT ECONOMIC DEVELOPMENTS

9. **The economy is expected to grow by 4.5 percent in FY22/23, compared to a real GDP growth of 4.3 percent in FY21/22, supported by the hydropower sector and the reopening of borders in September 2022.** The industry sector is projected to grow by 5.5 percent, reflecting higher electricity production and construction activities. While hydro exports declined, domestic sales increased, reflecting higher demand owing to the (energy-intensive) crypto mining operations. The services sector grew by 4.3 percent, supported by transport- and trade-related services. Tourist arrivals remained below pre-COVID-19 levels

⁸ National Environment Commission (2006). Bhutan National Adaptation Programme of Action. RGoB. https://www.adaptation-undp.org/sites/default/files/downloads/bhutan_napa.pdf

⁹ International Hydropower Association, 2019. Hydropower Sector Climate Resilience Guide. London, United Kingdom.



because of weaker consumer confidence globally and likely due to the new tourism levy act, which tripled the sustainable development fee (SDF) for international tourists.¹⁰ On the demand side, non-hydro goods and services exports and private investment are expected to positively contribute to growth (Tables 1 to 3).

10. **Annual average overall consumer price inflation (CPI) inflation moderated from 5.9 percent in FY21/22 to 4.8 percent in the first ten months of FY22/23, driven by a slowdown in food inflation.** Food inflation declined from 4.7 percent in FY21/22 to 2.8 percent in the first ten months of FY22/23 due to favorable base effects, and lower domestic food inflation. However, non-food inflation remains elevated at 6.5 percent in the first ten months of FY22/23 in line with price movements in India (Bhutan's inflation rate follows India with a time lag since about 70 percent of Bhutan's imports come from India and the BTN is pegged to the Indian Rupee (INR)).

11. **The fiscal deficit is projected to decline significantly from 7.8 percent of GDP in FY21/22 to 5.8 percent in FY22/23, due to lower capital spending.** Revenues are estimated to have declined in FY22/23 as a share of GDP due to lower corporate income taxes. Domestic non-hydro revenues increased, reflecting the gradual recovery of economic activity in the industry and services sectors. Total expenditures declined even further than revenues because of lower capital spending in the last year of the 12th FYP (12th FYP activities were frontloaded in FY20/21 to boost economic activity and support the recovery). The government also rationalized primary recurrent expenditure, including official travel, workshops, office equipment and vehicles, which resulted in a decline in non-wage recurrent expenditure (0.5 percentage points of GDP). The fiscal deficit was financed in equal parts by external borrowing from multilateral and bilateral partners on concessional terms and domestic borrowing.¹¹

12. **Total PPG debt increased marginally from 133.3 percent in FY21/22 to 134.2 percent of GDP in FY22/23.** This reflects an increase in non-hydropower debt due to higher financing needs, which outweighed a decline in hydropower debt due to higher loan repayments. About 88 percent of the PPG debt is external and owed to official bilateral or multilateral creditors, with the GoI the largest creditor, followed by the Asian Development Bank (ADB) and IDA. External PPG debt amounted to 118.3 percent of GDP in FY22/23, of which hydropower debt accounted for about 69 percent. Domestic debt was mostly in the form of treasury bills and 3- to 12-year treasury bonds.

13. **Monetary policy has remained accommodative in FY22/23.** 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 administrative tools to manage liquidity in the financial system and intervenes in the foreign exchange markets to maintain the peg. Monetary policy instruments include the cash reserve ratio (CRR) and a mechanism whereby government accounts held in the commercial banks (including hydro-related project accounts) are swept to the RMA at the end of the day to manage banking sector liquidity. The RMA maintained the CRR at 7 percent in FY21/22 to support credit growth, and increased it to 8 percent in October 2022. The RGoB 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. From July to December 2022, loans in high-risk sectors were eligible for loan restructuring measures.¹² While Phase IV of the COVID-19 support measures ceased in December 2022, the RMA provided loan repayment deferment for high-risk sectors for up to two years until FY24, which was subsequently extended to moderate and low risk sectors in May

¹⁰ The SDF is a daily fee that tourists to Bhutan are required to pay to the government.

¹¹ Budget support in FY22/23 includes US\$37.4 million from ADB, and US\$50 million from JICA.

¹² Including hotels, restaurants, airlines and travel offices and manufacturing sector, which received greater deferment facilities.



2023.

14. **Credit supply to the private sector has expanded in FY22/23 but financial sector vulnerabilities remain substantial.** Private sector credit growth stood at 16.4 percent in December 2022 (y-o-y), reaching pre-COVID growth rates of 15-20 percent (y-o-y). The risk weighted capital adequacy ratio of banks increased marginally from 15.1 percent in March 2022 to 15.7 percent in March 2023. The overall NPL ratio decreased from 9.8 percent in March 2022 to 8.7 percent in March 2023. However, financial sector risks are underreported in official statistics due to the ongoing forbearance measures under Phase IV. The decline in the NPL ratio reflects adjustments in NPL accounting, changes in risk-weights for NPLs, and a writeback of provisions from NPLs as part of the NPL management strategy and resolution framework, 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). The effectiveness of the NPL resolution strategy will be clearer when all forbearance measures are phased out. Two out of five commercial banks and one insurance company are under Prompt Corrective Action (PCA) due to their high NPL ratio. Credit provision to the private sector accelerated in the first half of FY22/23.

15. **The CAD has doubled and reserves halved over two years due to the crypto mining investments.** Exports are expected to increase in FY22/23, reflecting higher tourism receipts (albeit from a low base given near-zero tourism receipts in FY21/22). Goods imports are expected to remain high, reflecting the import of crypto mining equipment and higher commodity prices. As a result, the CAD is expected to remain elevated in FY22/23 at 26.5 percent of GDP. Gross international reserves are expected to decline from US\$833 million (6.6 months of goods and services imports) in June 2022 to US\$585 million (4.5 months) in June 2023 and from US\$1.3 billion and 15.7 months of imports in June 2021. To reduce pressure on international reserves, the government extended two INR standby credit facilities with the GoI in July 2022 and introduced administrative measures in August 2022 to restrict the import of vehicles and a foreign exchange quota for international travel. In June 2023, the RMA imposed a ban on commercial housing and hotel construction loans until end-December 2023 in response to the declining international reserves and the high credit concentration and NPLs in these sectors.

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

16. **The economy is projected to grow by 4.2 percent in FY23/24.** Growth is expected to be supported by the service sector, including higher growth in tourism-related services, and the industry sector due to higher electricity production and a gradual increase in mining (mineral products) and manufacturing activities (base metals). New incentives for longer-staying international tourists are expected to support tourism in FY23/24, however total arrivals are expected to remain below pre-COVID levels.¹³ On the demand side, growth is supported by non-hydro goods and services exports and consumption, reflecting higher government spending. Medium term growth is expected to be supported by a recovery in non-hydro industry and services sectors, and by the commissioning of the Puna II hydropower plant in FY25/26, which will add 1,000 MW to the current hydro generation capacity of 2,300 MW. Non-hydropower sector growth is supported by DPC2 policies that facilitate economic diversification through increased access to finance and markets, including through e-commerce and digitalization, as well as sector-specific policies to promote the sustainable use of natural resources, including agriculture, forests, and biodiversity. Average growth in the 13th FYP (covering FY23/24 to FY27/28) is projected to be 5.2 percent, similar to the pre-COVID growth rate of 5.6 percent from FY14/15 to FY18/19.

¹³ In June 2023, the government lowered fees for international tourists that stay longer than four days.



Table 1. Key Economic Indicators

	FY17/18	FY18/19	FY19/20	FY20/21	FY21/22	FY22/23	FY23/24	FY24/25	FY25/26
	(act)	(act)	(act)	(act)	(est)	(proj)	(proj)	(proj)	(proj)
Real Economy: annual percent change, unless indicated otherwise									
Real GDP	3.8	4.4	(2.3)	(3.3)	4.3	4.5	4.2	4.0	6.3
Supply:									
Agriculture	3.6	2.7	2.9	3.3	2.2	2.9	3.4	3.3	3.1
Industry	(1.3)	(1.6)	(5.5)	(5.9)	3.0	5.5	3.8	5.0	10.7
o/w Electricity, gas & water	(9.2)	(2.5)	19.1	9.2	(1.9)	4.9	6.2	4.8	13.0
Services	7.8	11.1	2.5	(0.5)	5.5	4.3	4.9	3.2	3.6
Demand:									
Private Consumption	9.8	10.9	0.1	(1.1)	(2.9)	0.3	2.8	1.4	6.5
Government Consumption	3.7	7.0	7.3	4.9	5.5	(2.6)	5.6	4.7	(2.3)
Gross Fixed Capital Investment	(3.6)	(11.2)	(16.5)	(3.0)	13.4	1.5	(4.7)	0.1	2.3
Exports, Goods and Services	5.5	9.6	(4.1)	(7.3)	10.3	11.3	5.9	4.1	7.2
Imports, Goods and Services	3.1	(0.0)	(9.2)	0.8	6.2	(2.2)	(3.2)	(2.3)	(0.3)
GDP deflator	3.3	1.3	3.9	6.2	2.0	1.2	3.5	3.3	2.9
CPI inflation (year-average)	3.7	2.8	3.0	8.2	5.9	4.4	3.9	3.5	3.3
Fiscal Account: percent of GDP, unless indicated otherwise									
Total revenue and grants	31.9	24.3	31.1	33.2	28.4	27.6	25.8	27.9	30.2
Tax revenue	16.6	15.7	13.0	11.5	13.5	13.3	14.3	14.7	15.8
Non-Tax Revenue	6.0	4.4	7.7	8.4	6.9	6.9	6.7	6.7	8.2
Other receipts	0.2	(1.8)	1.1	5.0	0.9	-	-	-	-
Grants	9.1	6.1	9.4	8.3	7.1	7.5	4.7	6.6	6.1
Total expenditure	33.5	25.9	33.1	39.3	36.2	33.4	32.2	32.6	33.9
Current expenditure	16.8	16.1	20.3	24.2	17.9	17.8	21.2	20.5	20.0
Capital expenditure	17.6	9.4	12.6	15.3	18.1	15.5	11.0	12.1	13.9
Advance/suspense (net)	(1.0)	0.4	0.2	(0.1)	0.1	-	-	-	-
Overall balance	(1.6)	(1.6)	(1.9)	(6.2)	(7.8)	(5.8)	(6.4)	(4.7)	(3.7)
Primary balance	(0.3)	(0.7)	(1.5)	(5.2)	(6.3)	(3.8)	(4.0)	(2.2)	(0.7)
Total PPG debt 1/	113.4	106.5	122.8	132.4	133.3	134.2	130.2	123.3	133.3
External PPG debt	108.4	103.6	121.6	122.9	118.7	118.3	113.1	106.0	117.2
Hydropower	80.6	79.2	90.8	90.2	85.3	82.2	77.3	70.6	82.8
Non-hydropower	27.8	24.3	30.8	32.8	33.4	36.1	35.8	35.4	34.4
Domestic PPG debt	5.0	2.9	1.1	9.5	14.7	15.9	17.1	17.4	16.1
Balance of Payments: percent of GDP, unless indicated otherwise									
Current account balance	(18.4)	(20.5)	(15.8)	(11.9)	(33.1)	(26.5)	(17.7)	(9.8)	(2.3)
Trade balance (goods and services)	(18.0)	(18.4)	(16.7)	(11.7)	(31.1)	(27.9)	(15.6)	(8.7)	(2.4)
Trade goods	(16.6)	(16.4)	(13.0)	(6.9)	(23.6)	(23.2)	(12.3)	(6.2)	0.2
Goods exports	24.0	24.8	26.7	29.5	30.8	30.4	28.5	28.6	31.4
Hydropower	7.4	6.3	8.6	15.7	12.4	11.7	9.8	9.8	12.8
Non-hydropower	16.6	18.6	18.1	13.8	18.4	18.7	18.7	18.8	18.6
Goods imports	40.6	41.2	39.7	36.4	54.4	53.6	40.8	34.8	31.1
Trade services	(1.4)	(2.1)	(3.8)	(4.8)	(7.5)	(4.7)	(3.3)	(2.5)	(2.6)
Services exports	7.6	6.9	5.5	0.8	0.9	2.2	2.4	3.2	3.0
Services imports	9.0	8.9	9.2	5.6	8.3	6.9	5.7	5.6	5.6
Primary balance	(8.4)	(9.0)	(6.1)	(6.2)	(6.0)	(5.8)	(5.7)	(5.4)	(4.2)
Secondary income	8.1	7.0	7.0	6.0	4.0	7.1	3.6	4.4	4.3
Capital account balance	7.3	5.1	5.9	4.1	5.6	7.4	4.5	4.6	4.2
Financial account balance 2/	(24.3)	(5.6)	(15.5)	(11.3)	(10.8)	(9.2)	(17.1)	(16.8)	(3.3)
Overall balance	3.0	1.3	11.5	(2.3)	(16.9)	(9.9)	3.8	11.6	5.2
Net errors and emissions	(10.2)	11.1	5.8	(5.8)	(0.2)	-	-	-	-
Gross international reserves (USD millions) 2/	1,111	1,065	1,344	1,332	833	585	691	1,028	1,194
Gross international reserves (months of goods and services imports)	11.3	10.1	14.2	15.7	6.6	4.5	6.4	10.3	12.1
Other memo items:									
GDP nominal in LCU (millions)	163,456	172,951	175,428	180,034	191,497	202,478	218,177	234,443	256,294
GDP nominal in USD (millions)	2,509	2,452	2,421	2,442	2,540				
Exchange Rate (Nu/USD), FY Average	65.2	70.5	72.5	73.7	75.4				

1/ PPG debt, including central government debt, central government loans that are on-lent to SOEs, SOE debt (direct debt contracted by SOEs, not routing through the budget) and Central Bank debt (loan/credit facilities for BOP support purposes). 2/ Includes DHI loan repayments to RMA in FY23/24 and FY24/25. The Bank's macroeconomic framework reflects the loan repayments from DHI to RMA under the financial account, as a reduction in assets. This results in an increase in reserves.

Source: Government of Bhutan and WB staff estimates.



Table 2. Fiscal Indicators (in percent of GDP)

	FY17/18	FY18/19	FY19/20	FY20/21	FY21/22	FY22/23	FY23/24	FY24/25	FY25/26
	(act)	(act)	(act)	(act)	(est)	(proj)	(proj)	(proj)	(proj)
Resources	31.9	24.3	31.1	33.2	28.4	27.6	25.8	27.9	30.2
Domestic Revenue	22.6	20.1	20.6	19.9	20.4	20.2	21.1	21.3	24.1
Tax Revenue	16.6	15.7	13.0	11.5	13.5	13.3	14.3	14.7	15.8
Direct Taxes	9.6	9.7	8.7	8.1	9.3	9.3	10.2	10.5	11.5
Hydropower	2.6	2.5	2.8	3.5	3.2	2.8	3.3	3.7	4.4
Non-Hydropower	7.0	7.2	5.9	4.6	6.1	6.5	6.9	6.8	7.1
Indirect Taxes	7.0	6.0	4.3	3.3	4.2	4.0	4.1	4.2	4.3
Non-Hydropower	7.0	6.0	4.3	3.3	4.2	4.0	4.1	4.2	4.3
o/w: Sales Tax	2.6	2.7	2.8	2.3	2.9	2.7	2.6	2.6	2.7
o/w: Excise tax	3.0	2.0	0.5	0.2	0.2	0.2	0.2	0.2	0.2
Non-Tax Revenue	6.0	4.4	7.7	8.4	6.9	6.9	6.7	6.7	8.2
Hydropower	2.5	1.9	4.6	5.8	4.4	4.3	1.7	2.0	4.8
o/w: DHI dividend	2.5	1.9	2.6	1.7	2.1	2.1	1.7	2.0	2.2
o/w: Hydropower profit transfers	0.0	0.0	2.0	4.1	2.3	2.2	0.0	0.0	2.7
Non-Hydropower	3.5	2.4	3.1	2.7	2.5	2.6	5.0	4.7	3.4
o/w: Interest receipts from SOEs	1.1	0.7	0.5	0.9	1.3	1.3	2.3	2.1	2.5
o/w: DHI, 6th pay comission	0.0	0.0	0.0	0.0	0.0	0.0	1.8	1.7	0.0
Other receipts	0.2	-1.8	1.1	5.0	0.9	0.0	0.0	0.0	0.0
Grants	9.1	6.1	9.4	8.3	7.1	7.5	4.7	6.6	6.1
Expenditure and net lending	33.5	25.9	33.1	39.3	36.2	33.4	32.2	32.6	33.9
Current expenditure	16.8	16.1	20.3	24.2	17.9	17.8	21.2	20.5	20.0
Interest payments	1.3	0.9	0.5	1.0	1.6	2.0	2.3	2.5	3.0
Compensation of employees	6.0	6.7	9.3	9.4	9.1	8.8	11.8	11.4	10.7
o/w: 6th pay comission	0.0	0.0	0.0	0.0	0.0	0.0	2.8	2.6	2.4
Goods and services	4.1	4.1	4.2	3.4	3.1	2.6	2.5	2.5	2.4
Social benefits	1.0	1.1	1.4	1.3	1.6	1.5	1.5	1.4	1.3
Subsidies and transfers	4.0	2.7	3.0	2.0	1.9	1.7	1.7	1.6	1.5
Other	0.4	0.5	0.5	0.6	0.6	1.1	1.4	1.1	1.1
NRF 1/	0.0	0.0	1.4	6.5	0.0	0.0	0.0	0.0	0.0
Capital spending	17.6	9.4	12.6	15.3	18.1	15.5	11.0	12.1	13.9
Advance/suspense (net)	-1.0	0.4	0.2	-0.1	0.1	0.0	0.0	0.0	0.0
Overall balance	-1.6	-1.6	-1.9	-6.2	-7.8	-5.8	-6.4	-4.7	-3.7
Overall balance, excl. 6th pay comission	-1.6	-1.6	-1.9	-6.2	-7.8	-5.8	-5.5	-3.8	-1.3
Primary balance	-0.3	-0.7	-1.5	-5.2	-6.3	-3.8	-4.0	-2.2	-0.7
Financing (net)	1.6	1.6	1.9	6.2	7.8	5.8	6.4	4.7	3.7
Net lending 2/	1.3	0.8	0.4	0.4	1.9	3.1	3.0	2.9	4.4
On-lending	0.5	0.1	0.1	0.9	0.1	0.0	0.0	0.0	0.0
Repayments	1.7	0.9	0.5	1.3	2.1	3.1	3.0	2.9	4.4
External borrowing (net) 3/	-0.1	0.6	2.0	0.8	2.1	0.7	1.0	0.3	-0.8
Borrowing	1.7	2.0	3.0	2.9	5.0	3.5	3.7	2.9	2.7
Repayments	1.7	1.3	1.0	2.1	2.8	2.8	2.7	2.6	3.4
Domestic borrowing (net)	0.3	0.2	-0.5	4.9	3.8	2.0	2.4	1.4	0.2
Borrowing	0.0	0.2	-0.5	5.1	4.4	9.7	8.3	3.8	0.9
Repayments	0.0	0.0	0.0	0.0	0.0	7.7	5.9	2.3	0.7
Change in balance	-0.3	0.0	0.0	0.1	0.6	0.0	0.0	0.0	0.0

1/ The National Resilience Fund financed temporary income support to individuals and loan interest payment support to borrowers during the COVID-19 pandemic. 2/ Includes principal repayments from SOEs (for central government loans that are on-lent to SOEs), minus on-lending to SOEs. 3/ Includes central government loans, and central government loans that are on-lent to SOEs.

Source: Government of Bhutan and WB staff estimates.

Table 3. External Financing Requirements and Sources (in US\$ millions)

	FY17/18	FY18/19	FY19/20	FY20/21	FY21/22	FY22/23	FY23/24	FY24/25	FY25/26
	(act)	(act)	(act)	(act)	(est)	(proj)	(proj)	(proj)	(proj)
Financing Needs	505	543	407	342	915	734	557	362	183
Current Account	462	502	382	290	841	665	484	287	73
Debt repayments 1/	43	40	25	51	74	69	73	75	110
Hydropower	21	10	0	19	37	46	47	49	84
Non-hydropower	23	31	25	32	37	24	26	26	26
Financing Sources	505	543	407	342	915	734	557	362	183
Capital Account (grants)	182	124	143	101	142	186	123	135	134
Foreign Direct Investment (net)	7	13	-9	-1	9	4	8	12	12
Disbursements	466	575	675	445	499	287	309	236	202
Hydro, incl. accrued interest 2/	307	227	229	158	173	200	209	151	117
Non-hydropower	159	348	446	287	326	87	100	85	85
Other 3/	279	-214	-72	77	34	9	223	319	1
Change in reserve assets (+ = decrease)	-8	47	-279	11	499	247	-105	-340	-167
Net errors and omissions 2/	-422	-3	-52	-291	-268	0	0	0	0

1/ Includes PPG debt, including central government loans, central government loans that are on-lent to SOEs (routing through the budget), SOE debt (direct debt contracted by SOEs, not routing through the budget) and Central Bank debt (loan/credit facilities for BOP support purposes, not routing through the budget). 2/ Includes accrued interest from hydropower projects (interest during construction). 3/ Includes other financing sources, including loan repayments from DHI to RMA in FY23/24 and FY24/25. The Bank's macroeconomic framework reflects the loan



repayments from DHI to RMA under the financial account, as a reduction in assets. This results in an increase in reserves.

Source: Government of Bhutan and WB staff estimates.

17. Inflation is projected to remain elevated in the short term, owing to higher import prices, before moderating in the medium term. Inflation is projected to remain elevated at 3.9 percent (y-o-y) in FY23/24, reflecting higher commodity prices and extended global supply disruptions resulting from Russia's invasion of Ukraine (imported consumer goods and services carry a 55 percent weight in the CPI basket, of which food products account for 24 percentage points). In the medium term, inflation is projected to be in line with inflation in India, given the Bhutanese Ngultrum's peg to the INR.

18. The fiscal deficit is expected to increase due to a decline in revenues and a major salary increase to address significant staff attritions. The deficit is projected to increase to 6.4 percent of GDP in FY23/24 from 5.8 percent in FY22/23 as revenues decline more than expenditures. Current expenditure is expected to increase due to a major salary hike for public servants between 55 and 74 percent amounting to 2.8 percent of GDP.¹⁴ However, total expenditures are expected to decline because of lower capital expenditures in the first year of the 13th FYP given that capital spending is typically lower in the first two years of the FYP. The hike will be partly financed by proceeds from DHI's crypto mining operations. An increase in tax revenue, driven by higher royalties from tourism and hydropower, will be offset by lower one-off profits from hydropower projects and external grants.

19. The fiscal deficit is expected to decline beyond FY24/25 driven by an increase in hydropower revenues. Primary non-wage recurrent expenditure is expected to moderate in the medium-term, reflecting a normalization in spending after the COVID-19 pandemic and the election year in FY23/24. Domestic revenues are expected to reach 24.1 percent of GDP in FY25/26, reflecting higher hydro revenues in the form of one-off profits and royalties from the commissioning of the Puna II hydropower plant in FY25/26. The government has initiated several reforms to improve public spending efficiencies and increase domestic revenue mobilization through improved tax policy and administrative reforms.¹⁵ However, the impact of these reforms on revenues is difficult to estimate and therefore the macroeconomic framework conservatively assumes minimal impact over the medium term. The baseline does not include the rollout of the Goods and Services Tax (GST), which has been delayed due to delayed development of the IT system.¹⁶

20. Debt is expected to remain sustainable. PPG debt is projected to remain elevated as a share of GDP. Hydro debt is expected to decline (as a share of GDP) due to debt repayments, but non-hydro debt is expected to increase in the short term, reflecting the high fiscal deficit, before moderating in the medium term.¹⁷ According to the 2022 joint IMF-World Bank Debt Sustainability Analysis (DSA), risks of debt distress are assessed as moderate, unchanged from the 2018 joint IMF-World Bank DSA.¹⁸ Although the significant stock of debt would normally point to a high risk of overall and external debt distress, the risk was assessed to be moderate given unique mitigating factors. First, most of the outstanding PPG debt is linked to hydropower project loans from the GoI, which are implemented under an intergovernmental agreement where the GoI covers financial and construction risks and commits to purchase all surplus

¹⁴ The increase is an attempt to curb the high attrition rate of public servants. Voluntary resignations in the Royal Civil Service increased from an annual average of 441 between FY14/15 and FY20/21 to 1,023 in FY21/22 and 1,985 in the first eight months of FY22/23. Royal Civil Service Commission Annual Reports and <https://kuenselonline.com/migration-of-bhutanese/>

¹⁵ Tax reforms include the implementation of the 2022 Property Tax Act, an ongoing review of direct and indirect tax policy, and measures to identify non-tax registrants and reduce compliance costs for taxpayers.

¹⁶ The rollout of the GST has been delayed due to delayed development of the IT system. Once the GST system is deemed ready, the government will have to seek approval from the Parliament for the enforcement of the GST.

¹⁷ While hydropower project loans are mostly on-lent to SOEs by the central government, external debt service payments are done by the MoF on behalf of the SOEs (through the national budget). SOEs reimburse the MoF from their revenues from hydropower exports to India.

¹⁸ The last Bank-Fund Joint DSA was prepared in May 2022. The next update is scheduled for 2024 as part of the IMF Article IV consultations.



electricity at a price reflecting cost plus a margin. Second, the debt dynamics are set to improve over the medium term, driven by a significant increase in electricity exports and a decline in imports associated with hydropower construction. Figure 1 and 2 update the external and public debt indicators based on the World Bank macroeconomic framework, which does not change the conclusion of the assessment.¹⁹ Bhutan’s PPG external debt indicators would exceed the thresholds for several years, before falling below the thresholds in later years. The present value of external PPG debt to GDP ratio would exceed the threshold until FY29/30, and the present of debt to exports would fall below the threshold in FY26/27. The debt service to exports ratio would reach the threshold in FY26/27 and subsequently it would fall below its respective thresholds from FY33/34. Bhutan’s public debt closely follows the dynamics of external debt and does not pose an additional risk to the debt profile. A robust fiscal consolidation underpinned by revenue mobilization, a stable peg with the INR, and reforms to improve productivity and competitiveness of the non-hydropower sector would help strengthen debt sustainability.

Figure 1. External Public Debt Indicators

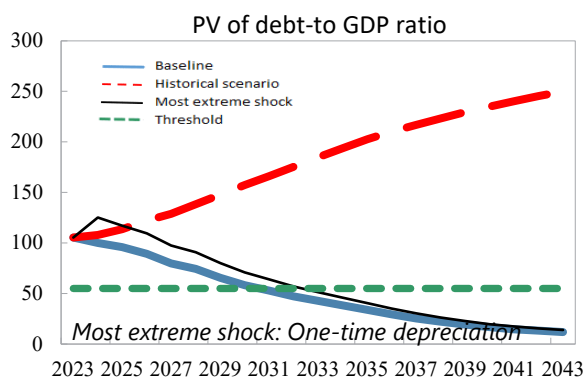
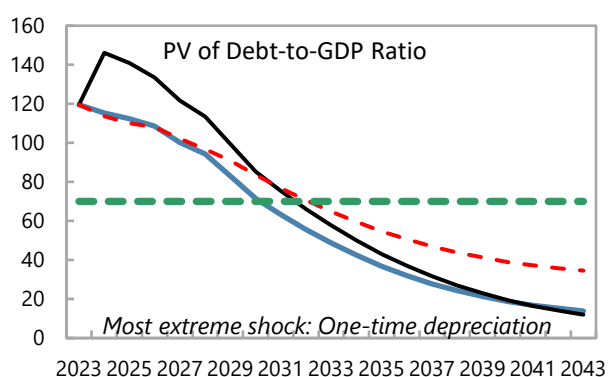


Figure 2. Public Debt Indicators



Source: WB staff estimates

21. **The financial sector is expected to remain weak in the short term due to sluggish recovery of the tourism sector and high stock of NPLs, which may adversely affect credit intermediation.** Financial sector soundness depends largely on the performance of a few sectors including housing, and service and tourism where loan concentration is high (27.6 and 12.6 percent of loans, respectively as of March 2023). Loan recovery and asset quality of the financial sector are likely to remain weak due to the slow recovery of the tourism industry. Subdued tourist arrivals are expected to weaken loan repayment capacities of hotels, restaurants, and travel businesses. Credit to the private sector may also experience crowding out as fiscal deficits are expected to remain elevated in the short term. Given that over 60 percent of financial sector assets are owned by the state, this poses fiscal risks through increased contingent liabilities.

22. **The CAD is projected to fall sharply to pre-COVID levels as lumpy IT equipment imports fall, and to moderate further in the medium term supported by an increase in tourism and electricity exports.** The improvement in the CAD in FY23/24 to 17.7 percent of GDP is driven by a lower trade deficit, led by a significant reduction in goods imports (12.8 percentage points of GDP). This reflects the decline of lumpy imports of crypto IT equipment, which accounted for 6 percent GDP in 2022 (DHI also imported related goods to expand the electricity network).²⁰ The CAD is expected to moderate further in the medium term due to an increase in tourism exports from FY24/25, the on-streaming of the Puna II hydropower project

¹⁹ Further, a ‘delayed fiscal consolidation’ scenario, which assumes a two-year delay in fiscal consolidation, would not affect debt sustainability indicators significantly.

²⁰ As per RGoB, DHI has used all the RMA loan proceeds and there will be no further imports of IT equipment in FY23/24.



in FY25/26, as well as a decline in imports following the completion of the hydropower projects. International reserves are expected to increase to US\$691 million in FY23/24 (6.4 months of imports coverage), due to the narrowing of the CAD and the repayment of the DHI loan to RMA.²¹ Reserves are expected to reach 12.1 months in FY25/26. Without the DHI repayments in FY23/24 and FY24/25, international reserves would decline to US\$467 million in FY23/24 (4.3 months of imports coverage), before increasing to US\$489 million in FY24/25 (4.8 months imports coverage). Although below the IMF reserve adequacy for Bhutan of 6.1 months, it would still be sufficient to cover four months of imports due to the hydropower exports to India. International reserves would then reach US\$655 million in FY25/26 (6.6 months), supported by the coming onstream of the Puna II hydropower plant.

23. The macroeconomic outlook has become more uncertain with the prevailing uncertainties in the global economy, including Russia’s invasion of Ukraine, and is subject to significant downside risks.

Delays of the hydropower projects could constrain the country’s ability to strengthen fiscal and external balances in the short and medium term.²² Delayed fiscal consolidation and the materialization of financial sector contingent liabilities could further erode buffers. External risks include rising and volatile commodity prices due to geopolitical tensions, which could exert further pressure on the external balance and international reserves and weigh on external demand and tourism travel.

24. Bhutan’s macroeconomic policy framework is adequate for the purposes of the development policy financing.

A major salary increase will delay fiscal consolidation in FY23/24 but was a necessary measure to address significant staff attritions. The implementation of reforms to improve public spending efficiencies and increase domestic revenue mobilization, and rising hydropower revenues will support fiscal consolidation efforts going forward. Although external PPG debt is high, the risks are moderate due to the bilateral agreements with India on the hydro project loans which mitigate debt repayment and exchange rate risks. The current account deficit will fall sharply as lumpy IT related imports fall and is expected to narrow further in the medium term with the on-streaming of the Puna II hydropower project. The high initial level of reserves prior to the pandemic also helped the economy absorb the recent CAD deterioration. Delays in DHI’s loan repayment to RMA would slow the recovery of international reserves to the previous high levels. However, international reserves would still be sufficient to cover four months of goods and services imports, before reaching the IMF reserve adequacy of six months import coverage for Bhutan in FY25/26. A stable peg with the INR further underpins macro-financial sustainability. The government remains committed to addressing fiscal sustainability risks from the SOE sector, through DPC-supported reforms to strengthen SOE fiscal risk monitoring and management. To manage risks in the financial sector, the government is implementing a NPL management strategy, which focuses on implementing effective and efficient processes and systems to address the current high level of NPLs and minimize new NPLs. Reforms that promote the non-hydropower sector—supported by the 13th FYP and this DPC series—will be instrumental in facilitating more private sector-led growth and strengthened international competitiveness over the medium term.

2.3. IMF RELATIONS

25. The last Article IV mission took place in February 2022. The Staff Report, including an update of the joint IMF-WB DSA, was presented to the Board on May 13, 2022. The Fund’s July 2023 letter provides an updated assessment (Annex 2). The IMF provides technical assistance to the RGoB, including for macro-

²¹ DHI is expected to repay US\$224 million in FY23/24 and US\$315 million in FY24/25 of the loans from RMA totaling US\$539 million, according to the loan repayment schedules.

²² Delays in hydropower projects are not a concern for debt sustainability as the repayment of loans begins only after the project is commissioned and the price of electricity is set taking into account the actual project costs.



fiscal management, a risk-based supervisory framework, liquidity management, tax reforms, and strengthening of national accounts. The WB and IMF maintain effective collaboration with regular consultations on macroeconomic, debt management, and financial sector issues.

3. GOVERNMENT PROGRAM

26. **The government program is articulated in the 12th FYP, covering FY18/19 to FY22/23.** The focus areas include: (i) a *just society* with equitable access to resources and opportunities through human and institutional development; (ii) a *harmonious society* with a focus on the community, culture, and a healthy eco-system; (iii) a *sustainable society* by focusing on macroeconomic policy, renewable resources, and economic diversity; and (iv) *decentralization*. The 12th FYP includes nine cross-cutting flagship programs that require multisectoral coordination, including growing organic, digitalizing Bhutan, and increasing economic diversification. Progress will be monitored through 17 National Key Result Areas (NKRAs), which are closely aligned with the Sustainable Development Goals (SDGs). The 13th FYP is under formulation with strategic priorities that are broadly aligned with this DPC series. The RGoB is also prioritizing a knowledge-based and technology-driven economy, and civil service reforms to streamline and modernize the public service to improve its efficiency and performance.

4. PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

27. **The proposed operation supports the government's reform agenda and contributes to GRID in Bhutan.** It contributes to the objectives of the 12th FYP, and the government's focus on economic recovery and growth following the COVID-19 pandemic. Measures under Pillars 1 and 2 are aligned with the 12th FYP's objectives of building a *sustainable, just, and harmonious society*. Reforms under Pillar 1 ensure fiscal and financial sector stability through enhanced fiscal risk assessment and SOE oversight, and support better access to finance and markets, as well as digital solutions to boost private sector development. These policy actions are expected to support economic diversification, supporting the objectives of two flagship programs under the 12th FYP (Digitalizing Bhutan, and Increasing Economic Diversification). Measures under Pillar 2 promote the sustainable utilization of Bhutan's renewable natural resources and biodiversity focusing on commercial agriculture, biotechnology, and monetization of emission reductions.

28. **The proposed operation will strengthen resilient and private sector-led growth through fiscal sustainability and enhanced access to finance and markets.** Stronger private sector-led development will hinge on: (i) sound macroeconomic fundamentals and especially fiscal sustainability; (ii) access to finance and lending to productive firms; and (iii) economic diversification through the development of new business areas and markets. Therefore, policy actions under Pillar 1—corresponding to the Country Partnership Framework (CPF) objective of improved economic resilience—are envisaged to: (i) improve transparency and reduce fiscal risks through better monitoring of public debt and SOE performance; (ii) increase access to international finance to support domestic firm growth; (iii) foster the digital economy and digital literacy that will especially benefit women; and (iv) facilitate cross-border trade. These policy actions address structural constraints to potential growth and contribute to the recovery from COVID-19.

29. **The proposed operation will also foster green growth focused on renewable natural resources.** Policy actions under Pillar 2—corresponding to the CPF objective of improved environmental resilience—focus on biotechnology and commercial agriculture to contribute to a shift from conservation to sustainable natural resource management. This will create green and inclusive economic opportunities,



including for the youth, people with disabilities, women and rural communities in remote areas, where many of the poor and vulnerable live.

30. **The program is aligned with the goals of the Paris Agreement.** It is consistent with Bhutan's Second Nationally Determined Contributions (NDC).²³ On mitigation goals, prior actions (PAs) 1, 2, 3, and 4 are not likely to cause a significant increase in GHG emissions or any persistent barriers to transition to low-GHG emissions. PA 5 may increase production of emission intensive commodities, but it will not obstruct the country's low-GHG strategies. PA 6 will strengthen forest and other natural resources management, which will create new engines for carbon sequestration, sustainable livelihoods, and income sources. PA7 supports Bhutan's access to carbon markets to monetize emission reductions from hydropower and other renewable natural resources, and will help ensure that the country's GHG emissions do not exceed the sink capacity of its forests to maximize mitigation co-benefits. The program has also been screened for climate change impacts and disasters. Risks from climate hazards are not likely to have an adverse effect on PAs 1, 2, 3, 4, and 7. PAs 5 and 6 are likely to be at risk from climate hazards. However, their design reduces these risks to an acceptable level. Annex 5 provides additional detail. By incorporating both mitigation and adaptation objectives, the operation aims to ensure carbon neutrality and climate- and disaster-resilient development, in line with one of the NKRA of the 12th FYP.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Strengthen resilient and private sector-led growth through fiscal sustainability and enhanced access to finance and markets

➤ Prior Action 1: To foster international commercial borrowing, the Ministry of Finance has approved the 2023 External Commercial Borrowing guidelines.

31. ***Access to finance PA1 will improve access to international finance for domestic firms, thereby supporting private sector development and firm growth.*** External borrowing opportunities for banks and companies under Bhutan's External Commercial Borrowing (ECB) framework (non-equity capital flows) are currently significantly restricted, including regarding the foreign exchange amount, maturity and end use, and the approval process is cumbersome. External borrowing is reserved only for larger export-oriented companies, and there have been only five instances where Bhutanese companies have been permitted to borrow from external sources in the recent decade. ECB is relatively closely regulated in South and Southeast Asia and is less prevalent elsewhere.²⁴ Other countries usually restrict the outflow of capital but not the inflow. Expanded access to foreign financing can significantly strengthen the private sector by facilitating technology transfer and improving corporate governance. Expanded external borrowing for the larger companies could free up access to domestic financing for the smaller companies and thereby enhance financial inclusion. It could also reduce domestic banks' maturity mismatches (banks are financing long-term assets with very short-term funding, i.e., deposits) and concentration risks (banks are relatively small, therefore taking larger export-oriented projects could create industry concentration risks in their balance sheets) by taking some loans off the banking sector balance sheet.

32. **The 2023 ECB Guidelines will ease ECB restrictions for the corporate sector, without jeopardizing macro-financial stability.** The guidelines shorten the minimum required loan maturity, broaden the allowable end-use (utilization) of ECB proceeds including working capital, liberalize refinancing options, and increase the maximum allowed interest rates. The guidelines also introduce an automatic approval process for loans that meet eligibility criteria (amount, end-use of the funds, minimum

²³ Bhutan NDC. (Updated). June 2021. <https://unfccc.int/sites/default/files/NDC/2022-06/Second%20NDC%20Bhutan.pdf>

²⁴ The current ECB framework in Bhutan is largely built on criteria used in other countries in the region, including India, Nepal, Bangladesh.



maturity period). Capital account liberalization needs to be carefully sequenced in countries with weaker institutions and fragile financial sectors. The liberalization of the ECB framework needs complementary reforms and institutional strengthening, including risk-based supervision, RMA's liquidity management framework, strengthening of fiscal planning, and mechanism for monitoring short and medium-term borrowing. Given that the ECB and foreign direct investment inflows to Bhutan are currently very small, a gradual liberalization of ECB rules is unlikely to impact macroeconomic stability. Given weaknesses in the financial sector, ECB option will be available only to the corporate sector (including SOEs), as is currently the case. The banking sector could be opened to ECB in the medium term, subject to strict supervisory oversight and regulations. The Bank is providing technical assistance for the ECB framework revision.

33. **Expected results:** The NPL resolution through Out-of-Court settlements, supported by DPC1, is expected to support financial sector stability by reducing NPLs, which will also enable fresh domestic lending. Together with the ease in ECB restrictions, this will increase access to domestic and international finance for domestic firms, thereby supporting growth in the private sector.

➤ Prior Action 2: To strengthen risk assessment and monitoring of public debt and SOE oversight, the Ministry of Finance has mandated: (a) the annual publication of the SOE report, which includes all SOEs under the Ministry of Finance and Druk Holding and Investments; and (b) the inclusion of guaranteed and nonguaranteed debt of non-financial SOEs under Druk Holding and Investments in the Debt Sustainability Analysis.

34. ***Fiscal sustainability and SOE oversight.* PA2 will support the annual publication of the SOE report, which will strengthen fiscal oversight of SOEs and related fiscal risks.** Energy sector SOEs overall have consistently reported profits, but SOEs in other sectors have seen a mixed performance. Analysis from the forthcoming Public Expenditure Review (PER) suggests that SOE-related fiscal risks, estimated at 225 percent of GDP in FY20/21, are significant and could become a burden on the budget in the future. The SOE notification mandates the annual publication of the SOE report. It specifies that the report covers all SOEs in Bhutan, is prepared within 15 months after the end of the concerned fiscal year, and provides guidance on the content in line with international best practices, by requiring a portfolio analysis and an analysis of trends and drivers of financial and non-financial performance. This will provide a full overview of the SOE portfolio and related fiscal risks, including SOEs under the Ministry of Finance (MoF) and DHI. The publication of the 2020 and 2021 annual SOE reports are FY22 and FY23 Performance and Policy Action (PPA) under the IDA Sustainable Development Finance Policy for Bhutan. In line with PA2, the 2021 SOE report expands the SOE coverage, by including SOEs managed under the MoF and DHI. Bhutan Agro Industries has been delinked from the MoF in 2020, and the MoF has confirmed that there are no budgetary links with this SOE. Regular SOE monitoring will help assess the performance of SOEs, and—combined with the implementation of the 2020 Competition Policy and annual performance compacts—help improve performance of the SOE portfolio. Enhanced SOE monitoring will also generate awareness of SOE dominance in the economy and enable collection of data to inform future SOE reforms. The Bank team has been providing technical assistance on the preparation of the SOE report, including the development of a SOE monitoring dashboard (SOE database).

35. **PA2 will also support a more comprehensive debt coverage by the government's annual DSA to strengthen the institutional capacity for risk assessment and monitoring of public debt and improve the coordination with fiscal policy.** The annual publication of the DSA was supported by DPC1 and was also a FY22 PPA. The first national DSA, published in March 2022, followed the Debt Sustainability Framework for Low-Income Countries (LIC DSF) developed jointly by the IMF and the WB. The national DSA extended the public debt coverage by including guaranteed and non-guaranteed debt of nonfinancial SOEs under the MoF. DPC2 expands the public debt coverage in the DSA by including domestic non-guaranteed debt of non-financial SOEs under DHI. SOEs under DHI include the hydropower SOEs and account for almost 90



percent of total SOE assets in 2020. As of June 2022, external and domestic debt contracted directly by SOEs accounted for 29.2 percent of GDP. A broader public debt coverage will reduce the likelihood of unexpected increases in SOE debt and improve the assessment of risk of debt distress. The Bank has been providing technical assistance for the preparation of the DSA report and the medium- to long-term macroeconomic framework.

36. **Expected results:** The regular analysis and publication of the sustainability of public debt and performance of the SOE portfolio is expected to support more informed fiscal and borrowing decisions and increase transparency, thereby enhancing fiscal sustainability and accountability.

➤ Prior action 3: To support the digital economy and e-trade, the RMA has amended the 2018 Payment and Settlement Systems Rules and Regulations.

37. ***Access to markets.* PA3 will strengthen the e-payments framework by amending the 2018 Payment and Settlement Systems Rules and Regulations, which will facilitate e-commerce and the digital economy.** In addition to connectivity infrastructure, advancement of e-payments requires security of transactions and protection of personal data. Therefore, e-payments systems require a legal and regulatory basis to address privacy and identity theft. The existing 2018 Payment and Settlement Systems Rules and Regulations will be amended by incorporating guidance on requirements of account holders and financial institutions, liability for losses arising from unauthorized transactions, and specific requirements for erroneous transactions. They aim to establish a baseline protection offered by financial institutions to individuals or sole proprietors from losses arising from unauthorized or erroneous transactions. An e-payments system exhibiting integrity, confidentiality, reliability, and availability is expected to facilitate domestic and international digital payment transactions including for ecommerce. PA3 includes the adoption of strong data protection policies that are already in place in Bhutan and meet the Bank's data protection standards.

38. **Improved and safer e-payments systems is crucial to support women to enter e-commerce and start online businesses.** This is particularly important in Bhutan where fewer women compared to men are involved in Micro, Small, and Medium-Sized Enterprises (MSMEs) and digital solutions.²⁵ 63 percent of registered MSMEs were owned by men and 36 percent by women.²⁶ Moreover gender gaps exist in financial inclusion especially for digital financial services, for instance, only 8.8 percent of women compared to 29.5 percent of men use eMoney, a form of e-payment.²⁷ While data for Bhutan is scarce, global data shows that women are more vulnerable to digital financial services risks. The amendment, with focus on improving security and reliability, will expand options for digital financial services for women. Together with the e-commerce policy's focus on digital literacy, it will reduce gender gaps in digital financial inclusion and enable women to engage in the digital economy. The Bank is providing technical assistance for the amendment of the e-payments framework.

39. **Expected results:** PA3 is expected to facilitate domestic and international digital payment transactions, including for small businesses and individuals. This is expected to support the digital economy and uptake of e-commerce activities, which was supported through the e-commerce policy under DPC1. E-trade in both goods and services can reduce the costs of connecting Bhutanese buyers and suppliers with external markets, and thus support expansion of access to markets.

²⁵ Women are 58 percent less likely than men to utilize digital solutions for their businesses, such as digital payment systems. Source: UNDP (2020). Diagnostic Trade Integration Strategy Update.

²⁶ Department of Cottage and Small Industry (2016).

²⁷ Financial Inclusion report 2021



➤ Prior action 4: To streamline customs procedures and facilitate cross-border trade, the Ministry of Finance has approved the 2023 Customs Rules and Regulations: Revised Edition.

40. **PA4 will support the introduction of the 2023 Customs Rules and Regulations to facilitate cross-border trade and increase access to international markets.** The 2023 Customs Rules and Regulations will simplify and harmonize customs procedures, in line with the *Revised Kyoto Convention on the Simplification and Harmonization of Customs Procedures* (RKC). The rules are crucial for the operationalization of the Electronic Customs Management System (eCMS), which will support the automation of import and export clearance procedures and reduce the time and costs for cross-border trade across all goods. The eCMS is expected to be rolled out in mid-2023. The amended rules will allow the use of digital documentation for customs procedures and simplify the use of customs forms and annexes, in tandem with the roll out of the eCMS, update the authority environment ruling customs operations, adjust the scope of duties and taxes conferred to customs responsibility accordingly to the Customs Act of Bhutan 2017, and introduce a new valuation method. The Bank has been providing technical assistance for the drafting of the Customs Rules and Regulations. The revisions are part of the GST reform, which has been supported through the last two DPC operations.²⁸

41. **Expected results:** Together with the 2021 Customs Duty Act from DPC1, which reduced the average customs duty rates from countries other than India, PA4 is expected to facilitate cross-border trade and increase access to international markets.

Pillar 2: Foster green growth focused on renewable natural resources

➤ Prior Action 5: To increase the economic benefits of agri-food production and enhance the security and sustainability of the food and nutrition system, the Cabinet has approved the National Food and Nutrition Security Policy.

42. ***Growth of sustainable and resilient agriculture.* PA5 will support the National Food and Nutrition Security (FNS) Policy to facilitate the transition towards a commercially sustainable, climate-smart, and resilient agricultural sector that does not undermine food and nutrition security.** The agriculture sector remains the main employer in the economy, especially in rural areas, but the sector is constrained by low on-farm productivity, lack of sufficient public and private investment undermining value addition and competitiveness, and vulnerability to climate change. The objectives of the FNS policy are two-pronged. First, it aims to enhance the sector's contribution to economic growth by promoting diversification toward high-value agriculture products, strengthening agricultural value-chains, and promoting commercial and export-oriented farming (including organic farming). Second, it promotes sustainable levels of food and nutrition security by promoting sustainable agriculture and livestock, the productive use of land and water, and the safe and nutritious consumption of food. The policy has a particular focus on building a sustainable and resilient agri-food system by introducing climate smart and resilient technologies – including climate-smart irrigation, climate-resilient crop varieties, improved feeding practices, disease control, and disaster risk management practices –to ensure that agricultural growth contributes to green and resilient economic growth, aligned with Bhutan's NDC. The implementation of the FNS policy will be guided by a policy action plan outlined in the 2023 Renewable Natural Resources Strategy and the 13th FYP to clarify implementation arrangements, roles and responsibilities, and a robust monitoring and evaluation framework. The Bank provided technical assistance in the drafting of the FNS Policy.

²⁸ The GST Act was supported by the third Strengthening Fiscal Management and Private Sector Employment Opportunities DPC (FY20) and the GST Rules and Regulations have been supported by the COVID-19 Crisis Response DPC (FY21).



43. **Despite women’s significant presence in the agriculture sector, they have limited access to information and agricultural services, climate-smart and labor-saving technologies, and are under-represented in farmer groups and cooperatives.**²⁹ To improve collective action and the quality of support provided to farmers, the Department of Agricultural Marketing and Cooperatives initiated the formal registration of farmer groups and cooperatives in 2010.³⁰ Members of farmer groups and cooperatives can access trainings (e.g. post-harvest, marketing, accounting), platforms for product promotion, and equipment for value addition and packaging. Although women represent 58 percent of the agricultural workforce, they were underrepresented in formal organizations.³¹ The FNS policy includes a specific strategic policy intervention area to promote gender equality and social inclusion by helping female farmers gain better access to economic opportunities, labor-saving technologies, and representation in the agricultural sector. This involves encouraging greater female participation and empowerment in farmer groups, which is expected to enhance their access to socially and environmentally sustainable agricultural technologies, training programs, connections to markets, and support for business growth.

44. **Expected results:** PA5 is expected to support the sustainable and resilient production and commercialization of high value export crops, thereby increasing the export value of agricultural products. This is expected to create green jobs and contributing to economic diversification. Further, the policy is expected to enhance women’s participation in farmer groups, which is expected to enhance their access to agricultural technologies, training programs, connections to markets, and support for business growth.

➤ Prior Action 6: To increase the country’s attractiveness for biotechnology development and investment, while strengthening biodiversity conservation and benefit sharing from genetic resources, (i) the Parliament has adopted the Biodiversity Act and (ii) the Competent National Authority has approved the Biodiversity Rules and Regulations.

45. ***Sustainable and equitable commercialization of genetic resources.* PA6 supports the Biodiversity Act and Rules to promote the conservation and sustainable use of Bhutan’s biodiversity, while ensuring equitable access and benefit sharing (ABS) from the use of those resources.** Bhutan has abundant biological resources which are crucial for rural livelihoods (addressing 80 percent of the needs of the poor), through food production, timber, textiles, medicines, breeding stocks and population reservoirs, fresh water, and fertile soils. To ensure conservation and sustainable use of those resources, the Biodiversity Act and Rules set forth and regulate the mandates and procedures for protecting and accessing genetic resources and traditional knowledge associated with biological resources, for research or commercial use. The Rules also prioritize the preservation of local crop varieties and animal breeds, contributing to climate resilience by protecting Bhutan's agricultural heritage and contributing critical genetic materials for the development of climate-resilient, disease-resistant crops and livestock. The Rules detail how the benefits are shared between users and providers of genetic resources or holders of associated traditional knowledge (e.g., individuals, institutions, communities),³² with procedures for the National Biodiversity Center (NBC) to (i) process access proposals and negotiate ABS agreements (on behalf of providers such as local communities); (ii) create public awareness; and (iii) manage the Bhutan ABS Fund to finance initiatives for conservation and sustainable use of biodiversity and traditional

²⁹ The Labor Force Survey Report (2021) shows more women are involved in the agricultural sector (58 compared to 41 percent men) and represent a higher proportion of unpaid family workers in rural areas (48 compared to 25 percent). There is a significant gap in gender-disaggregated data on access and participation in the agriculture value chain. This affects adequate assessment, prioritizing and planning.

³⁰ Farmer groups and cooperatives focus on livestock, agriculture, forest, savings and credit. Department of Agricultural Marketing and Cooperatives. 2022. Annual Report 2021-2022.

³¹ In 2021-2022, a total of 1,111 membered were registered in farmer groups and cooperatives of which 48 percent were female and 51 percent were male. Department of Agricultural Marketing and Cooperatives Annual Report 2021-2022.

³² These two instruments incorporate the provisions of Nagoya Protocol on Access to Genetic Resources and the Fair and Equitable Sharing of Benefits arising from their Utilization in Bhutan’s legal framework.



knowledge, and enhancement of rural livelihoods. Women are strongly engaged in community forestry, are holders of traditional knowledge, and use biodiversity differently than men. The focus on equitable benefit sharing will therefore facilitate women to engage in forest-based enterprise. The Bank is providing technical assistance to support implementation of key provisions, such as the ABS Fund.

46. **The Biodiversity Act and Rules complement the Forest and Nature Conservation (FNC) Bill supported under DPC1.** The FNC Bill is key to biodiversity protection within forest areas, and the Biodiversity Act will promote sustainable use of forest-related genetic resources and traditional knowledge. In case of genetic resources from forests, potential users are required to comply with the FNC Bill, particularly its permit requirements.

47. **Expected results:** PA6 is expected to attract domestic and international commercial proposals for accessing genetic resources, which in turn can create new engines for green growth, secure livelihoods and income sources, and promote co-benefits such as increased resilience and climate change mitigation.

➤ Prior Action 7. To monetize emission offsets from hydropower and other renewable natural resources, the National Environment Commission has adopted rules for Article 6 of the Paris Agreement, which includes the framework for the national monitoring, reporting and verification (MRV) system and the emissions reductions credit registry.

48. ***Monetizing emission reductions from renewable energy generation. PA7 on the adoption of Article 6 of the Paris Agreement will support Bhutan's access to carbon markets to monetize emission reductions from hydropower and other renewable natural resources.*** DPC2 will support the establishment of the rules and procedures for approval and authorization of projects and programs for participation in carbon markets (i.e., Carbon Market Rules). The Carbon Market Rules will allow the RGoB to monetize emission reduction credits from hydropower and other renewable natural resources. They provide guidance for participation in international voluntary or compliance carbon markets for all activities within Bhutan's jurisdiction, and include institutional arrangements related to the process of generating emission reduction credits, the operationalization of a monitoring, reporting and verification (MRV) system, the designation and maintenance of a national registry, and the level of government involvement envisioned in the case of voluntary market participation. It is expected that this will provide a valuable additional source of revenue for Bhutan.

49. **The Carbon Market Rules serve as the first step for the establishment of the Bhutan Climate Fund (BCF), which was approved by the Cabinet in 2019.** If credits receive authorization for corresponding adjustment (whether for use under voluntary or compliance carbon markets),³³ Bhutan will need to undertake additional mitigation action to demonstrate achievement of its NDC. Therefore, the price paid for such credits should be reflective of the opportunity cost of additional climate action, and such payment for opportunity cost is expected to be directed toward the BCF, which will then channel these payments toward additional climate investments, thereby contributing to additional climate mitigation and adaptation in the country. The Carbon Market Rules will help create a streamlined authorization process, ensure that the country's NDC commitments are met, and that carbon revenues are reflective of the opportunity cost of implementing additional mitigation action. The process for generating emission reductions under the carbon market rules could also enable access to results-based climate finance, i.e., payments for emission reduction results without transfer of ownership of the credits. Such finance would count toward climate finance flows under Article 9 of the Paris Agreement.

³³ A corresponding adjustment under Article 6 of the Paris Agreement sets out the requirement to adjust the country's emission targets when a credit is transferred to ensure there is no double counting.



50. **Expected results:** PA7 is expected to promote green growth by generating emission offsets (carbon credits) from hydropower and other renewable natural resources for their monetization. The hydropower sector alone is expected to generate about 2.5 million tons of emission reduction credits per annum. The revenue from the sale of emission reductions will depend on the portion of credits that Bhutan chooses to sell and the type of market in which it sells them.

51. **In response to the evolving policy environment some PAs and results were modified (Table 4) but the strength of the overall program has been maintained.**

Table 4. Changes to the Policy and Results Matrix

Original	Revised	Reason
Prior Actions (PAs) DPC-1		
Trigger 3: To support the digital economy and e-trade, the Cabinet has approved the e-payment guidelines.	PA3: To support the digital economy and e-trade, the RMA has amended the 2018 Payment and Settlement Systems Rules and Regulations.	Instead of issuing new e-payment guidelines, the RMA suggested to amend the existing Payment and Settlement Systems Rules and Regulations (2018), which is the overarching framework for all payment systems, and thereby more suitable to reflect elements regarding e-payments.
Trigger 5: To increase the economic benefits of renewable natural resources, the Ministry of Agriculture and Forests has approved the National Organic Policy.	PA5: To increase the economic benefits of agri-food production and enhance the security and sustainability of the food and nutrition system, the Cabinet has approved the National Food and Nutrition Security Policy.	The Ministry of Agriculture and Forests (MoAF) decided to include the organic policy as a strategic policy intervention in the more comprehensive FNS Policy. FNS Policy will update elements on (i) food security and nutrition, (ii) sustainable management of renewable natural resources, and (iii) increased commercialization of agricultural production.
Trigger 6: To improve sustainable forest management, the Ministry of Agriculture and Forests has approved the Forests and Nature Conservation Rules.	PA6: To increase the country’s attractiveness for biotechnology development and investment, while strengthening biodiversity conservation and benefit sharing from genetic resources, (i) the Parliament has adopted the Biodiversity Act and (ii) the Competent National Authority has approved the Biodiversity Rules and Regulations.	The FNC bill was not passed in the Winter Session of the Parliament as expected and will be deliberated in the Summer Session in July 2023. As such, the FNC Rules cannot be included in the DPC matrix. The FNC Rules have been replaced with the Biodiversity Act and Rules, which promote the conservation and sustainable use of the country’s biodiversity, and thereby contribute to green growth.
Trigger 7: To monetize emission offsets from hydropower and other renewable natural resources, the National Environment Commission has adopted rules for Article 6 of the Paris Agreement, including a national MRV system and the establishment of an emission reductions credit registry consistent with the requirements of Article 13 of the Agreement.	PA7: To monetize emission offsets from hydropower and other renewable natural resources, the National Environment Commission has adopted rules for Article 6 of the Paris Agreement, which includes the framework for the national monitoring, reporting and verification (MRV) system and the emissions reductions credit registry.	The Bank is providing technical assistance for the establishment of the emission reduction credit registry. While the establishment of the credit registry has progressed, it was not ready within the DPC2 timeframe. However, the Carbon Market Rules include a framework for carrying out MRV and maintaining an emission reduction credit registry by clearly allocating responsibility for these functions and rules for their operationalization.



Results Indicators (RIs) DPC-1		
RI2: External commercial borrowing (US\$)	RI2: Number of outstanding external commercial borrowing loans	Changed to reflect the number of ECBs outstanding, rather than the value, which will also capture uptake of smaller ECB.
RI4: E-commerce licenses issued (number of licenses, disaggregated by gender of business owner, cumulative)	RI4: E-commerce licenses issued (number of licenses, disaggregated by gender of business owner, cumulative)	The target value for women was increased, to reflect the closing of the gender gap.
	RI5: Number of digital payment transactions (domestic and international) (thousands)	Added to reflect the PA on the payments system.
RI6: Production of organic produce (metric tons)	RI7: Export value of the agriculture sector (Bhutan Trade Classification Chapters I-IV (excl. 24), VI (33), VIII (41), IX (44), BTN million).	Changed to reflect the revision of the PA to focus on the FNS policy, which includes more components than organic farming. The export target indicator and value is aligned with the targets and objectives of the FNS policy.
	RI8: Share of women/men registered in farmer groups or cooperatives (percent)	Added to reflect the gender results chain as part of the FNS policy.
RI7: Business licenses issued for forest-based industries (number of licenses, disaggregated by gender of business owner, cumulative)	RI9: Proposals of commercial access to genetic resources that are approved by the National Competent Authority as per Biodiversity Rules and Regulations 2023 (cumulative number)	Replaced to reflect the change in the PA.
RI8: Monetized emission reduction credits in metric tons (cumulative)	RI10: Emission reduction credits generated in metric tons (cumulative)	Revised to reflect the achievable milestone by the project's closing date and the latest projections of generation capacity given delays in hydropower projects.

Table 5. DPF Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
Operation Pillar 1: Strengthen resilient and private sector-led growth through fiscal sustainability and enhanced access to finance and markets	
Prior action #1. To foster international commercial borrowing, the Ministry of Finance has approved the 2023 External Commercial Borrowing guidelines.	ECB Assessment Report (WB, 2022). Findings: The report reviews the framework for the existing ECB policies in Bhutan, draws on relevant international experience, and provides recommendations for amending the framework and guidelines. While there are multiple benefits associated with foreign capital inflows for the corporate sector and the economy (increased access to finance, facilitation of technology transfer and improvement of corporate governance), capital account liberalization in countries with weaker institutions and fragile financial sectors should be gradual and carefully sequenced. The ECB framework should be based on well-defined policy-goals and be clear about the risks as well as market failures and negative externalities it is intended to address, so that foreign capital could still play a catalytical role in the economy.
Prior action #2. To strengthen risk assessment and monitoring of public debt and SOE oversight, the Ministry of	Technical assistance by the WB on SOE reforms and debt management (funded by the Debt Management Facility Trust Fund) as part of the PPA implementation.



<p>Finance has mandated: (a) the annual publication of the SOE report, which includes all SOEs under the Ministry of Finance and Druk Holding and Investments; and (b) the inclusion of guaranteed and nonguaranteed debt of non-financial SOEs under Druk Holding and Investments in the Debt Sustainability Analysis.</p>	<p>Findings: The regular publication of the SOE report will strengthen the oversight of SOE performance and related fiscal risks. The regular preparation and publication of the DSA is expected to strengthen the institutional capacity for risk assessment and monitoring of public debt and improve the coordination with fiscal policy.</p>
<p>Prior action #3. To support the digital economy and e-trade, the RMA has amended the 2018 Payment and Settlement Systems Rules and Regulations.</p>	<p>Technical assistance by the WB; Bhutan Development Update: Ramping up e-trade for a Resilient Recovery (WB, 2021); South Asia’s Digital Opportunity - Accelerating Growth, Transforming Lives (WB, 2022).</p> <p>Findings: Stakeholder consultations have highlighted several challenges with e-payment gateways in Bhutan, including frequent failures of domestic payment transactions, and limited access to international payment processing networks. Bhutan needs to address cross-cutting bottlenecks to develop its digital economy by (i) ensuring that the digital economy is inclusive for all regardless of age, gender, and socio-demographic status, and (ii) building a trusted digital ecosystem, with a population that has basic digital literacy skills to take advantage of digital services and a regulatory framework to protect data and privacy with adequate cybersecurity measures.</p>
<p>Prior action #4. To streamline customs procedures and facilitate cross-border trade, the Ministry of Finance has approved the 2023 Customs Rules and Regulations: Revised Edition.</p>	<p>Technical assistance by the WB as part of the GST introduction. Diagnostic Trade Integration Update (DTISU), 2020.</p> <p>Findings: The revision of customs laws and regulations in accordance with the RKC will simplify and harmonize customs procedures, and help improve trade procedures involved in the import, export, and transit of goods, and increase transparency in trade administration.</p>
<p>Operation Pillar 2: Foster green growth focused on renewable natural resources</p>	
<p>Prior action #5. To increase the economic benefits of agri-food production and enhance the security and sustainability of the food and nutrition system, the Cabinet has approved the National Food and Nutrition Security Policy.</p>	<p>Technical assistance by the WB; Increasing Agribusiness Growth in Bhutan (WB, 2017); Climate-Smart Agriculture in Bhutan (CIAT; World Bank. 2017); Bhutan Policy Note: Harnessing Spatial Opportunities in Agriculture for Economic Transformation (WB, 2019); Commercial Agriculture Assessment Bhutan (WB, forthcoming); Bhutan CEM (WB, forthcoming).</p> <p>Findings: The agri-food sector can improve food and nutrition security, increase export earning, and foster inclusive rural economic growth. However, current agricultural practices deteriorate the natural resources base, yields are low, and value addition is limited. The sector’s dominance by smallholder farmers and monsoon-fed production makes it highly vulnerable to the impacts of climate change. At the same time, the agricultural sector is increasingly responding to market incentives, as production factors are reallocated towards high-value production within specialized strategic geographic centers. Realizing this potential of the sector therefore requires a new agricultural growth policy that recognizes the nexus between agriculture, climate change, and natural resource management over space and time.</p>
<p>Prior action #6. To increase the country’s attractiveness for biotechnology development and investment, while strengthening</p>	<p>Technical assistance by the WB; World Bank reports: Bhutan Forest Note: Pathways for Sustainable Forest Management and Socio-equitable Economic Development; The Economic Case for Nature: A Global Earth-Economy Model to Assess Development Policy Pathways; and Bhutan Country Environmental Analysis</p>



<p>biodiversity conservation and benefit sharing from genetic resources, (i) the Parliament has adopted the Biodiversity Act and (ii) the Competent National Authority has approved the Biodiversity Rules and Regulations.</p>	<p>(forthcoming). UNDP, 2021. Assessment of climate risks on forests and biodiversity for National Adaptation Plan (NAP) formulation process in Bhutan. Findings: Bhutan can continue preserving its biodiversity, while creating jobs and economic opportunities. Biodiversity regulations must consider climate risks, and make sure that economic benefits from biodiversity (especially from genetic resources) are shared with local communities. An adequate and transparent ABS system must be in place, based on international good practices.</p>
<p>Prior action #7. To monetize emission offsets from hydropower and other renewable natural resources, the National Environment Commission has adopted rules for Article 6 of the Paris Agreement, which includes the framework for the national monitoring, reporting and verification (MRV) system and the emissions reductions credit registry.</p>	<p>World Bank report and related technical assistance: Bhutan Climate Fund Concept Note (2018); Bhutan Climate Fund: Feasibility Report (2019); Bhutan Climate Mitigation Financing and Disaster Resilience. Findings: Bhutan’s NDC commits to remaining carbon neutral. Revenues from carbon markets can provide a valuable source of additional funding for Bhutan, which can be invested in low carbon development for ecologically balanced growth for the country. A climate fund that aggregates and monetizes emission reductions generated by Bhutan can help reduce transaction costs and access carbon markets in a streamlined manner.</p>

4.3. LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

52. **This DPC series is consistent with the WBG CPF FY21-24 discussed by the Board on January 14, 2021 (Report No. 154927-BT).** Policy actions included in this operation are directly related to the first two CPF development challenges, a lack of job opportunities and macroeconomic vulnerability. The CPF prioritizes macro-fiscal stability through reforms that increase transparency in fiscal and debt management (PA2). It also identifies better access to finance (PA1) and digital solutions (PA3) as priorities to boost private sector development. The CPF further envisions a shift from conservation to sustainable natural resource management with a focus on agriculture and biodiversity (PA5, PA6). The proposed DPC is complemented by the Bank’s technical assistance and analytical work, including a CEM, a Public Expenditure Review, a Country Environmental Assessment, and a Climate Change and Development Report (forthcoming in FY24). This operation builds on the reform program supported under the “Strengthening Fiscal Management and Private Sector Employment Opportunities” DPC series (P164290, P168166, P171780), and the “COVID-19 Crisis Response DPC” completed in FY21 (P175758).

4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

53. **The reforms supported by the DPC went through an extensive consultation process.** The RGoB has a well-established approach to stakeholder consultation for any major policy instrument. These involve public meetings with stakeholders including from the private sector, civil society, and development partners. For relevant policies, consultations are also held at the sub-national level across the country, and the results are recorded. The ECB Guidelines, the Payment and Settlement Systems Rules and Regulations, and the Custom Rules and Regulations included consultations with the private sector and financial institutions. The FNS Policy and the Biodiversity Act and Rules were broadly consulted with relevant stakeholders, which include in-situ, multi-day consultations at the sub-national and central levels and a period open for public comments. The Bank supported the consultations and staff joined as a relevant stakeholder. Further, the regular reporting on public debt and SOEs is expected to continue during the implementation of the DPC. The feedback received from this process will be incorporated in the implementation mechanism that will promote public transparency and accountability, a prerequisite condition for effective citizen and stakeholder engagement.



54. **The WB is coordinating closely with development partners in Bhutan.** This operation has been prepared in close collaboration with the IMF and other multilateral and bilateral development partners, including the ADB and the Japan International Cooperation Agency (JICA). ADB has been supporting institutional and policy reforms to expand domestic resource mobilization, including through reforms in the areas of customs administration, promote private sector development, and introduce climate change adaptation and mitigation measures. JICA has used PAs from the First Bhutan Green and Resilient Growth DPC operation (FY23) in its budget support operation in FY23.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

55. **The proposed DPC is expected to have positive poverty and social impacts.** Direct poverty and social effects are mainly from PAs that support the digital economy and e-trade (PA3) and facilitate cross-border trade (PA4). PA3 will pave the way for the creation of new economic opportunities for small scale entrepreneurs (including women) and improve digital access and skills among the underserved. It will also strengthen the institutional framework for the adoption of strong data protection, cyber security, and consumer protection measures to safeguard citizens, especially the less digital fluent. PA4 is expected to have indirect poverty effects. Improved trade procedures and transparency in trade administration might help reduce costs of cross-border trade and result in reduced cost of imported commodities for Bhutanese consumers, especially the poor. Other PAs under Pillar 1 are expected to have overall positive poverty and social effects in the medium to long term. PA1 to foster ECB and boost private sector access to finance and markets (PA1) is critical for the long-term sustainability of growth and job creation by accelerating private sector development. While the DSA and SOE reporting (PA2) has a neutral poverty impact, it could improve macro stability and help prevent economic crisis-induced increases in poverty.

56. **PAs under Pillar 2 are generally expected to have positive poverty and social impacts.** PA5 enhances food sustainability and security and promotes job creation, contributing to the reduction of malnutrition, and promotes a diversified, balanced, and healthy diet with positive impacts on the health and wellbeing of the population. The action to enhance production of organic produce will further strengthen food sustainability and security, as well as promote new job creation, with positive social and distributional impacts. The challenge for Bhutan is feeding its population with safe, healthy, and nutritious food (consumption is concentrated on cereals and rice while the consumption of vegetables and fruits is low). Malnutrition prevalence (e.g., stunting, wasting and low birth weight) is high. Therefore, increasing production of organic food can help to promote diversified, balanced, and healthy diets, with positive impacts on the health and wellbeing of the population. PA6 on the Biodiversity Act and Rules is expected to recognize and protect farmers rights, who are more likely to be poor and rely on forests and forest products for their livelihoods.³⁴ Together with other reforms to harness the economic benefits of sustainable private forestry and forest-based industries, these measures are likely to have positive poverty impacts. PA7 can have a positive impact on poverty if the revenues from the sale of carbon credits are invested in a pro-poor manner given that the poor are also the most impacted by climate change.

5.2. ENVIRONMENTAL, FORESTS, AND OTHER NATURAL RESOURCE ASPECTS

57. **The DPC-supported policies under Pillar 1 are expected to have either positive or no effect on Bhutan's environment, forests, and other natural resources.** PAs 1, 2 and 3 are not expected to have any

³⁴ According to 2022 BLSS, about 11 percent of Bhutanese households use solid fuels for cooking and these are almost exclusively in rural areas. Solid fuels include coal and wood biomass, charcoal, crop residues, and animal dung.



significant environmental effects. PA4 on customs procedures is expected to have positive effects on the environment. While this reform aims to facilitate cross-border trade, it will also contribute to strengthen border control of restricted and prohibited goods, such as (i) live animals; (ii) plant materials, (iii) forestry products (fauna and flora); (iv) industrial and toxic wastes and residues, scraps, used or secondhand goods, vehicles, machinery and equipment that may contain hazardous substances; (v) chemicals and fertilizers, (vi) plastic packing materials, and (vii) animals and plants classified as endangered species and their parts and products. The import of restricted goods requires a license from the relevant government agency, such as from the National Environmental Commission for industrial and toxic waste. The individual or company must also comply with Bhutan's environmental clearance regulations for the commercial activities involving those items.

58. Under Pillar 2, PAs are expected to generate significant positive effects on the environment.

PA5 on the FNS Policy will contribute to (i) improve sustainability and efficiency of agriculture and livestock input system and land management, leading to higher resource use efficiency, savings in crops, water, and energy losses, and better soil conditions; (ii) incentivize organic farming and improve biosecurity and food safety – key elements of the “One Health” approach –, with interventions such as increasing animal disease surveillance; (iii) promote climate-smart farming that will reduce the carbon emissions from current production practices in line with Bhutan's Low Emission Development Strategy; (iv) promote adaptive and sustainable use of agrobiodiversity and non-wood forestry products, in line with the Biodiversity Act and Rules. For example, the FNS Policy envisages support to biogas plants in livestock farms, promoting a 3R concept (Reduce, Recycle and Reuse) of livestock waste and cater the basic household energy requirements of farmers. All activities under the FNS Policy shall comply with environmental legislation, including requirements for environmental clearance and the forthcoming FNC Bill. Through PA6, the RGoB will strengthen environmental and natural resources management, particularly for biodiversity conservation and ABS of genetic resources and associated traditional knowledge, creating new engines for green jobs from Bhutan's natural capital. PA7 on the Carbon Market Rules will support the country in maintaining its carbon neutral status, while generating revenues from those mitigation efforts. Depending on the projects participating in the carbon markets, this PA may also contribute to other environmental priorities, such as reduced household air pollution through projects that promote clean energy and reduction of fuelwood in households.

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

59. While challenges remain, the core elements of a basic PFM system are in place, including the publication of a comprehensive budget on the MoF website.³⁵ The positive trajectory of improvements in financial management stems from the recent PFM reforms which include launch of country-wide electronic government payment system and electronic procurement system which was particularly helpful during the COVID-19 pandemic, issuance of quarterly budget execution reports, integration of various PFM and non-PFM systems to achieve an Integrated financial management information systems (IFMIS) system and implementation of Cluster Finance Services offices in Dzongkhags to enhance internal controls and bring efficiency at the national and sub-national levels. The challenges include an absence of a sound public investment management system, the lack of integration of payroll and personnel records and a lack of data on expenditure arrears. The early indicators from the ongoing Public Expenditure and Financial Accountability (PEFA) assessment confirms that the Bhutan's PFM systems continue to be sound. The Bank continues to provide technical assistance through the ongoing PFM Multi-Donor Trust Fund,

³⁵ It includes an analysis of the previous year's financial statements, the budget for the coming year by economic classification, tax measures, a macro-fiscal economic outlook, a report on SOEs and government shareholdings, a report on the RMA, and a report on the pension fund.



which include implementation of International Public Sector Accounting Standards (IPSAS) expected to be implemented from FY22/23, the development of a roadmap for a modern Integrated Financial Management Information Systems (IFMIS), reforms in property tax and the development of the Bhutan Integrated Revenue Management System (BIRMS).

60. Bhutan’s public procurement is being modernized through the Electronic Government Procurement (e-GP) system. As part of continued reforms over the years, Phase 2 of the e-GP system was launched in July 2020, supporting government-wide procurement through an online platform. Government agencies are already using the e-GP system, which has facilitated the procurement during the COVID-19 pandemic. Further enhancements are currently being developed in Phase 3. The government also introduced flexibilities in the Procurement Rules and Regulations in March 2020 to address emergency needs and expedite the implementation of the COVID-19 response. In addition, it issued Simplified Procurement Rules and Regulations (SPRR) in November 2021, applicable to all public procurement, to streamline procurement processes, including reduced time for advertising and increased thresholds for the use of simplified procurement methods. A comprehensive assessment of the public procurement system using the universally recognized Methodology for Assessing Procurement Systems (MAPS) tool is currently underway which aims to identify the strengths and remaining gaps, provide recommendations for reforms, and enables effective monitoring and evaluation of procurement performance going forward.

61. Bhutan has a reasonably well-functioning government external audit system. The Royal Audit Authority (RAA), the Supreme Audit Institution in Bhutan conducts financial audits at two tiers: (i) the consolidated annual financial statements of the RGoB at the national level; and (ii) at the individual agency level. The report contains the result of the audit of the annual financial statements of the government and recommendations to improve the economy and efficiency and effectiveness of the government. The latest RAA audit report is unqualified, and the RAA also conducts the financial audits of the donor-assisted projects and performance audits.

62. There are risks associated with the foreign exchange control environment of the RMA, which requires mitigation measures. As a risk mitigation measure, a dedicated U.S. Dollar bank account shall be shared by the MoF for the receipt of the DPC proceeds. The borrower shall furnish to the Bank as soon as possible, but in any case, not later than six months after the end of the borrower’s fiscal year, a certified copy of the report of such audit, of such scope and in such detail as the Bank shall reasonably request, by independent auditors acceptable to the Bank and make such report publicly available in a timely manner and a manner acceptable to the Bank. In addition, the Borrower shall furnish to the Bank such other information concerning the said account and their audit as the Bank shall reasonably request. There has been no recent IMF Safeguards Assessment of the RMA’s internal controls. The World Bank committed to provide technical support to the RMA to conduct a review of the foreign exchange management internal control systems by a firm acceptable to the World Bank, in accordance with terms of reference acceptable to the World Bank, to help RMA further strengthen its internal control framework. The RMA accepted the technical support and agreed to share its assessment report with the World Bank by February 29, 2024, given the timely support from the World Bank. Also, the RAA will select an international audit firm from its list of empaneled audit firms to conduct future financial audits of the RMA’s annual financial statements jointly with a local audit firm, in accordance with relevant international standards.

63. The credit proceeds will be made available to the government upon approval of credit effectiveness and meeting of the standard withdrawal tranche release conditions. At the request of the MoF and upon submission of withdrawal application, the disbursement in U.S. dollars will be made into the dedicated foreign currency account of the government maintained at the RMA, which will later be transferred into BTN equivalent of the government’s consolidated fund. Within 30 days the government will confirm to



the WB the receipt of the proceeds and its credit in the dedicated U.S. Dollar bank account and consolidated fund, including the date of receipt, and the exchange rate applied to convert the credit proceeds into BTN and accounting in the budget management system.

5.4. MONITORING, EVALUATION AND ACCOUNTABILITY

64. **The MoF leads the effort in coordinating the overall implementation of the DPC.** The MoF has experience and is conversant with WB policies and procedures through lending and technical assistance operations and has a dedicated focal point for the DPC who supports the coordination with line ministries. The WB team will continue to provide support in monitoring the reform progress and results. This will be facilitated by regular engagement of the teams implementing technical assistance and investment operations in support of the reforms in all the areas covered by this DPC. During preparation, responsibility for data collection, sources, and reporting have been agreed.

65. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as Prior Actions or tranche release conditions under a World Bank Development Policy Financing may submit complaints to the responsible country authorities, appropriate local/national grievance mechanisms, or the Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Project affected communities and individuals may submit their complaint to the Bank's independent Accountability Mechanism (AM). The AM houses the Inspection Panel, which determines whether harm occurred, or could occur, as a result of Bank non-compliance with its policies and procedures, and the Dispute Resolution Service, which provides communities and borrowers with the opportunity to address complaints through dispute resolution. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit <http://www.worldbank.org/GRS>. For information on how to submit complaints to the Bank's Accountability Mechanism, please visit <https://accountability.worldbank.org>.

6. SUMMARY OF RISKS AND MITIGATION

66. **The overall risk rating is substantial.** *The fiduciary risk is substantial* due to the risks associated with the foreign exchange control environment of the RMA, as highlighted in Section 5.3. Mitigation measures include a dedicated bank account for the DPC disbursements and its audit, technical assistance from the Bank and other development partners including a review of foreign exchange management internal control at RMA, and future financial audits of the RMA's annual financial statements jointly by an international and a local audit firm from RAA's list of empaneled audit firms. *Macroeconomic risks are substantial* due to the materialization of financial sector contingent liabilities, additional delays in hydro projects and the repayment of the DHI loans to RMA, as well as external risks including high commodity prices and lower tourism demand. Short-term macroeconomic risks are partially mitigated by the government's commitment to ensure macro-financial sustainability, including through improved fiscal risk monitoring and the implementation of the NPL management strategy. *Stakeholder risks are substantial* as some reforms may face resistance from interest groups. ECB reforms (PA1) could face resistance from domestic lenders which are benefitting from current restrictions. Greater SOE oversight (PA2) could be opposed by SOEs currently benefitting from lax oversight and those rejecting a need for SOE reform. These are mitigated by continuous joint government and World Bank engagement and consultation on ECB with domestic banks, and technical workshops for SOEs. *Technical design and institutional capacity risks are*



substantial. The implementation of the carbon market rules (PA7), including the development of the credit registry and the MRV system, could be technically challenging, and are mitigated by ongoing and planned technical assistance from the Bank. *Political risks are substantial* and include the upcoming national elections in January 2024, which could impact the government’s commitment to the reform program. The ongoing civil service reform, which resulted in institutional changes and high staff turnover, may slow down the implementation of the reform program. These are mitigated by strong government ownership of the proposed reforms, and full alignment with government priorities.

Table 6: Summary Risk Ratings

Risk Categories	Rating
1. Political and Governance	● Substantial
2. Macroeconomic	● Substantial
3. Sector Strategies and Policies	● Moderate
4. Technical Design of Project or Program	● Substantial
5. Institutional Capacity for Implementation and Sustainability	● Substantial
6. Fiduciary	● Substantial
7. Environment and Social	● Moderate
8. Stakeholders	● Substantial
9. Other	
Overall	● Substantial



ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions		Results		
Prior Actions under DPC1	Prior Actions under DPC2	Indicator Name	Baseline [2021]	Target [2024]
<i>Pillar 1--- Strengthen resilient and private sector-led growth through fiscal sustainability and enhanced access to finance and markets</i>				
Prior Action 1. To expedite the resolution of non-performing loans, the RMA has approved the standard operating procedure for out-of-court settlement of non-performing loans.	Prior action 1: To foster international commercial borrowing, the Ministry of Finance has approved the 2023 External Commercial Borrowing guidelines.	Results Indicator 1: Non-performing loans (NPLs) resolved through out-of-court settlement (number of cases)	330	480
		Results Indicator 2: Number of outstanding external commercial borrowing loans	1	8
Prior Action 2. To strengthen risk assessment and monitoring of public debt and SOE oversight, the Ministry of Finance has mandated the annual publication of the Debt Sustainability Analysis, including guaranteed and non-guaranteed debt of non-financial SOEs under the Ministry of Finance.	Prior Action 2. To strengthen risk assessment and monitoring of public debt and SOE oversight, the Ministry of Finance has mandated: (a) the annual publication of the SOE report, which includes all SOEs under the Ministry of Finance and Druk Holding and Investments; and (b) the inclusion of guaranteed and nonguaranteed debt of non-financial SOEs under Druk Holding and Investments in the Debt Sustainability Analysis.	Results Indicator 3: Score in the World Bank Debt Management Performance Assessment Methodology (DeMPA) on Coordination with Fiscal Policy (DPI 6)	<i>DeMPA sub-indicator: Availability and quality of information on key macro variables and DSA: D</i>	<i>DeMPA sub-indicator: Monitoring fiscal risks: B³⁶ DeMPA sub-indicator: Availability of key macro and fiscal variables and DSA: A</i>
Prior Action 3. To support the digital economy and e-trade, the Cabinet has approved the e-commerce policy.	Prior action 3: To support the digital economy and e-trade, the RMA has amended the 2018 Payment and Settlement Systems Rules and Regulations.	Results Indicator 4: E-commerce licenses issued (number of licenses, disaggregated by gender of business owner, cumulative)	Women: 45 Men: 73	Women: 78 Men: 110
		Results indicator 5: Number of digital payment transactions (domestic and international) (thousands)	61,456	73,748

³⁶ This sub-indicator on monitoring fiscal risks was added in the new DeMPA Methodology, 2021 edition.



Prior actions		Results		
Prior Action 4. To reduce and streamline duties on imports, the Recipient has issued the 2021 Customs Duty Act.	Prior action 4: To streamline customs procedures and facilitate cross-border trade, the Ministry of Finance has approved the 2023 Customs Rules and Regulations: Revised Edition.	Results Indicator 6: Average tariff on goods imports from countries other than India (percent)	22.4	9.9
Pillar 2--- Foster green growth focused on renewable natural resources				
	Prior Action 5: To increase the economic benefits of agri-food production and enhance the security and sustainability of the food and nutrition system, the Cabinet has approved the National Food and Nutrition Security Policy.	Results Indicator 7: Export value of the agriculture sector (Bhutan Trade Classification Chapters I-IV (excl. 24), VI (33), VIII (41), IX (44), BTN million).	4,630 (2022)	5,500
		Results Indicator 8: Share of women/men registered in farmer groups or cooperatives (percent)	Women: 48 Men: 52	Women: 60 Men: 40
Prior Action 5. To improve sustainable forest management and regulate the development of sustainable private forestry and forest-based industries, the Cabinet has submitted the Forest and Nature Conservation Bill to the Parliament.	Prior Action 6: To increase the country's attractiveness for biotechnology development and investment, while strengthening biodiversity conservation and benefit sharing from genetic resources, (i) the Parliament has adopted the Biodiversity Act and (ii) the Competent National Authority has approved the Biodiversity Rules and Regulations.	Results Indicator 9: Proposals of commercial access to genetic resources that are approved by the National Competent Authority as per Biodiversity Rules and Regulations 2023 (cumulative number)	0	5
	Prior Action 7. To monetize emission offsets from hydropower and other renewable natural resources, the National Environment Commission has adopted rules for Article 6 of the Paris Agreement, which includes the framework for the national monitoring, reporting and verification (MRV) system and the emissions reductions credit registry.	Results Indicator 10: Emission reduction credits generated in metric tons (cumulative)	0 TCO2e million	2.5 TCO2e million



ANNEX 2: FUND RELATIONS ANNEX

Bhutan—Assessment Letter for the World Bank

July 5, 2023

This letter provides the IMF staff's assessment of Bhutan's recent economic developments, outlook, and economic policies based on available information as of June 23, 2023. The assessment was requested by the World Bank in connection with the Second Green and Resilient Development Policy Credit.

Recent Developments, Outlook, and Risks

1. **Bhutan achieved remarkable socio-economic progress in the past decade, together with a track record of sound macroeconomic management.** Between 2003 and 2022, poverty declined from 31.7 to 12.4 percent, while enrollment in higher secondary education increased from 13 to 85.7 percent. Access to electricity is now almost universal, from about 43 percent in 2003. Bhutan is set to graduate from the Least Developing Country (LDC) status in 2023. In the decade preceding the pandemic, on average, output growth and inflation were 6.2 percent, the fiscal deficit was 1.7 percent of GDP, while the current account deficit was 25 percent of GDP.

2. **The prolonged effects of external shocks, as well as domestic developments, led to a substantial deterioration of the macroeconomic situation since the 2022 Article IV Consultation.** Tax revenues—which started falling pre-pandemic due to the end of excise duty refunds from India—declined further due to a weaker economy, hydropower delays, and tourism shutdown. Combined with pandemic support to households and firms, the fiscal deficit rose to around 7 percent of GDP on average in FY2020/21¹ and FY2021/22. Public debt rose to over 127 percent of GDP by end June 2022, with non-hydro external debt reaching 33 percent of GDP. The current account (CA) deficit widened to 32 percent of GDP in FY2022, and reserves fell from US\$1,332 million (18 months of imports of goods and services) at end-June 2021 to US\$662 million (5½ months of imports) as of mid-April 2023.

3. **Several domestic policies contributed to further worsen the economic situation.** The Royal Monetary Authority (RMA) purchased foreign-currency securities issued by a state-owned enterprise (DHI)—depleting RMA reserves by almost US\$540 million (20.3 percent of GDP). The authorities indicate that these securities mature between mid-2024 and mid-2025 and that they are expecting on-schedule repayments, though staff considers that there are significant risks given the limited quantitative information on the underlying investments.² Moreover, the authorities decided to postpone the implementation of the Goods and Services Tax (GST) as the vendor failed to deliver the underlying IT system, in a significant setback to revenue mobilization efforts (representing a loss of around 2 percent of GDP in tax revenues over the medium term). The increase in the Sustainable Development Fee from US\$65 to US\$200 per tourist/day raised tourism cost by an estimated

¹ In Bhutan the fiscal year runs from July to June.

² DHI has disclosed that they used the funding to invest in crypto mining operations, but information on balance sheet and the income generated from these investments is not available.



30 percent and might slowdown the pickup in international tourist inflows after the reopening in September 2022.³

4. The authorities are taking steps to address the fiscal and external imbalances, but macroeconomic pressures are expected to continue absent a more ambitious policy package. Tax incentives and customs, sales, and green tax bills were amended to address inefficiencies, and a new property tax was passed by Parliament, although the yields from these measures may be limited in the short term.⁴ The government is also restricting its spending on goods and services, particularly travel expenses and vehicle purchases. To help contain the rapid loss in reserves, the authorities enacted temporary restrictions on non-essential imports and drew on the swap agreement with the Reserve Bank of India.⁵ Nonetheless, under current policies, the fiscal deficit is expected to remain elevated at 6.4 percent of GDP and the CA deficit will remain large at 29 percent of GDP for FY 2022/23. A large uncertainty surrounds these projections, given the weight of one-off factors.

5. Growth is expected to moderate in FY2023/24. The slowdown in public investment associated with the 5-year planning cycle will contribute to a slowdown in growth to about 3 percent. Inflation will increase due to pressures from wage increases, but it is expected to slow down gradually towards 4 percent afterwards, while—in the absence of large one-off investments—the current account deficit will decline sharply to about 12 percent, albeit still at an elevated level. Non-hydro debt will keep increasing rapidly, edging closer to 60 percent of GDP.

6. Uncertainty around the economic outlook is elevated, with the balance of risks tilted to the downside. Key downside risks include a global slowdown and/or a slowdown in India, including from a sharp tightening in global financial conditions. Intensifying spillovers from Russia's war in Ukraine, particularly on commodity prices, could put pressure on inflation. Delays in hydropower investments and tourism could weigh on growth. Moreover, limitations on the transparency and timeliness of data represent additional risks. On the upside, a coordinated policy package of fiscal consolidation and monetary tightening would help address macroeconomic imbalances. With upcoming general elections, achieving such a macroeconomic adjustment could however prove challenging.

Policy Framework and Settings

7. Macroeconomic policy settings need to be revisited to restore macroeconomic stability. Over the medium term, there is a need to strengthen policy frameworks and rebuild reserve buffers. This is crucial to put non-hydro debt on a declining path as well as to support sustained, job-rich, and inclusive growth by leveraging Bhutan's green, intangible, and digital assets.

³ Even though the government enacted some temporary rebates on the SDF for tourist with longer stays.

⁴ The reform to the property tax could yield 0.25 percent of GDP per year once implemented. The reduction in custom duties would be revenue-reducing but would be offset by increases in sales tax rates.

⁵ Imports of vehicles (excl. electric vehicles) are not allowed at this juncture and the amount of foreign exchange (cash) available for travelers has been reduced.



8. A revenue-based fiscal consolidation would be key to addressing macroeconomic imbalances. On the tax policy side, a prompt implementation of the GST would boost revenues, and complement measures already introduced to raise property and sales tax revenues. On the revenue administration side, a shift to risk-based enforcement—including by designing and implementing a tax debt management framework and establishing a Large Taxpayer Office— could yield some gains. Spending prioritization would also help restrain aggregate demand. Stronger public financial management would improve the efficiency of spending, including by adopting a new unified chart of accounts. However, the FY2023/24 budget does not envisage a consolidation, as it includes a large increase in public sector wages at a cost of 2.5 percent of GDP which will worsen permanently the fiscal position; albeit for two years the authorities expect to compensate two-thirds of the increase through extraordinary dividends from DHI—related to their crypto mining operations.

9. Monetary policy should also play a role in addressing the imbalances. The monetary policy tightening in October 2022 is welcome, but additional tightening would be needed to complement the fiscal consolidation and ease balance of payment pressures. Strengthening the RMA toolkit by developing effective monetary policy instruments would go a long way to support the peg, manage domestic liquidity conditions, and maintain financial stability. In the medium term, the focus should be on reforming the domestic liquidity management framework so that it can support RMA's monetary policy objectives.

10. Financial sector balance sheets have improved, but vulnerabilities remain. As the financial sector recovery becomes entrenched, the RMA should continue to take steps to rebuild buffers, address remaining vulnerabilities and ensure that banks comply with lending directives (e.g., regarding minimum loan-to-value ratios) to help prevent an increase in NPLs. Improving credit origination would help prevent recourse to broad moratoriums; in June the RMA placed a moratorium on new loans for housing and hotel construction until end-2023. The RMA should continue to closely monitor the existing exposure of banks to risks from sectors such as tourism and housing, which make up the bulk of the loan portfolio, and are under pressure from the slowdown in international visitors and affordability issues, respectively.

11. In the June 2022 joint Bank-Fund DSA, Bhutan's risk of overall and external debt distress was assessed to be moderate, prior to the recent sharp fall in reserves. Total public and publicly guaranteed debt stood at 127 percent of GDP at the end of FY2021/22. Most of the outstanding public and publicly guaranteed debt is linked to hydropower project loans from the government of India, which covers both financial and construction risks of the projects and commits to buy all surplus electricity at a price reflecting cost plus margin, and so, it is akin to FDI. Worsening of the fiscal and external position since the last DSA was published, including a large drop in reserves, poses additional risks to debt sustainability and further emphasizes the need to implement corrective macroeconomic policies.

12. The external position of Bhutan is substantially weaker than the level implied by fundamentals and desirable policies, a change from the 2022 AIV. The current account deficit widened significantly in FY21/22, due to accommodative fiscal and monetary policies and large one-off imports. The current account deficit is expected to remain large in FY22/23, with similar



factors at play. As a result, and despite sizable grant financing, international reserves, historically ample, are now somewhat below the IMF adequacy metrics (6.2 months of import coverage, as of the 2022 Article IV). While part of the sizable current account deficit should reduce mechanically once one-off effects dissipate and electricity exports and tourism pick up, a credible fiscal consolidation plan and a tighter monetary policy stance are needed to limit the pressure on reserves and stabilize non-hydro debt over the medium term, while helping to rebuild reserve buffers and supporting Bhutan's development needs. Bhutan's peg has been an adequate nominal anchor and remains appropriate, as India is Bhutan's largest trade and development partner.

13. The next phase of Bhutan's development will require diversification away from hydropower and a greater focus on private sector development. Several initiatives are underway to address impediments to private sector development. Digitalization efforts are ongoing and can help overcome Bhutan's geographic disadvantage. The focus on education programs to address skills mismatch continues with reforms to technical and vocation education, supported by development partners. These initiatives can be complemented with a streamlining of regulatory processes to encourage FDI inflows and domestic entrepreneurship.

14. Bhutan has made significant progress in climate mitigation and adaptation. Bhutan is one of the few carbon-neutral countries in the World, and it is committed to maintain carbon neutrality. This objective is reflected in the government's vision and strategy, as evident in the 12th Five Year Plan, REDD+ Strategy Action Plan 2020, Climate Change Policy 2020, and sustainable Hydropower Development Policy 2021. To remain carbon neutral and contribute to contain emissions beyond its borders, renewable energy production should be expanded to address seasonality in hydropower energy supply, satisfy growing local demand, and expand clean energy exports.

15. Bhutan is a large recipient of IMF technical assistance, including from the South Asia Regional Training and Technical Assistance Center (SARTTAC) and has no outstanding financial arrangement with the IMF. Bhutan is on a 24-month consultation cycle. The 2022 Article IV consultation was concluded on May 13, 2022. A staff visit took place on May 11 to 17, 2023.



Bhutan: Selected Economic and Financial Indicators, 2017/24							
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
	Act.	Act.	Act.	Act.	Proj.	Proj.	Proj.
(In percent of GDP, unless otherwise indicated)							
National Accounts							
Real GDP growth (percent change)	3.8	4.4	-2.3	-3.3	4.8	5.0	3.1
Prices							
Consumer Prices (EoP; percent change)	2.5	2.7	4.5	7.4	6.5	4.3	5.0
GDP deflator (percent change)	3.3	1.3	3.9	6.2	6.1	4.5	4.6
General government accounts							
Total revenue and grants	31.9	24.3	31.1	33.2	27.2	26.1	24.4
Total expenditure /1	33.5	25.9	33.1	39.3	34.7	32.5	31.3
Current expenditure	16.8	16.1	20.3	24.2	17.2	16.6	19.7
Capital expenditure	17.6	9.4	12.6	15.3	17.4	15.9	11.6
Primary expenditure /1	32.2	25.0	32.6	38.3	33.2	30.9	29.2
Primary balance	-0.3	-0.7	-1.5	-5.2	-6.0	-4.9	-4.8
Overall balance	-1.6	-1.6	-1.9	-6.2	-7.5	-6.4	-6.9
General government debt 2/	113	106	123	132	127	130	130
Domestic	5	3	1	9	12	15	20
External	108	104	122	123	115	115	110
Monetary sector							
Broad money (M2) growth (percent change)	10.4	5.6	19.3	24.4	9.4	11.3	2.7
Private credit growth (percent change)	15.7	20.5	13.3	6.5	10.8	14.8	7.8
Balance of payments							
Current account balance	-18.4	-20.5	-15.8	-12.0	-31.9	-29.3	-12.0
Goods balance	-16.6	-16.4	-13.0	-6.9	-23.1	-24.2	-8.0
Hydropower exports	6.8	6.4	12.9	14.5	11.9	11.8	10.9
Non-hydropower exports	17.2	18.5	13.8	15.0	17.1	17.8	25.7
Imports of goods	40.6	41.2	39.7	36.4	52.1	53.7	44.6
Services balance	-1.4	-2.1	-3.8	-4.7	-7.1	-4.3	-2.3
Primary balance	-8.4	-9.0	-6.1	-6.2	-6.0	-5.4	-5.2
Secondary balance	8.1	7.0	7.0	5.8	4.2	4.6	3.5
Capital account balance	11.8	8.5	7.6	4.1	5.2	4.6	3.0
Financial account balance	-21.9	-4.8	-16.2	-9.8	-8.9	-10.3	-6.9
Net errors and emissions	-10.2	11.1	5.8	-5.1	1.6	5.4	0.0
Overall balance	5.2	3.9	13.8	-3.2	-16.3	-9.0	-2.2
Gross official reserves (in USD millions)	1111	1065	1344	1332	840	559	491
(In months of goods and services imports)	11.3	10.1	14.2	15.6	6.6	4.1	4.0

Sources: Bhutanese authorities; and Fund staff projections.

1/ The expenditure for FY2020/21 and FY2021/22 includes an estimated amount for income support provided to individuals and loan interest payment support to borrowers financed by the National Resilience Fund.

2/ Public and publicly guaranteed debt, including loans for hydropower projects.



ANNEX 3: LETTER OF DEVELOPMENT POLICY



MINISTER

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Ministry of Finance
Royal Government of Bhutan

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MoF/D MDF/DCDMD/WB/DPC2/2023/2951

June 29, 2023

Mr. Ajay Banga
President
The World Bank Group
Washington DC 20433
USA

Dear Mr. Banga,

This letter of Development Policy outlines the main elements of the Royal Government of Bhutan's (RGoB) proposed reform program for the Bhutan Second Green and Resilient Growth Development Policy Credit (DPC2). The RGoB requests the assistance of the World Bank Group in the form of Development Policy Financing (DPF) for US\$50 million. This financing will be used to support the RGoB's efforts for resilient and green development by strengthening resilient and private sector-led growth through fiscal sustainability and enhanced access to finance and markets; and by fostering green growth focused on renewable natural resources. The proposed operation is aligned with the government's reform program outlined in the 12th Five Year Plan (FYP) and the RGoB's focus on economic recovery and growth following the COVID-19 pandemic.

The proposed operation follows a long series of successful DPC engagements supported by the International Development Association (IDA), for which the RGoB would like to express its sincere appreciation. Since FY2006, our country benefitted from US\$354.2 million in financing in the form of 13 DPC operations, including 3 Development Policy Grants (DPG), that helped strengthen our country's reform agenda and contributed to boosting growth and reducing poverty. As a result, extreme poverty was almost eliminated in 2017, and the population living below the \$6.85/day poverty line for upper-middle-income countries decreased from 39.7 percent to 8.8 percent between 2017 and 2022. The proposed operation builds on reforms and lessons learned from these previous engagements, including fiscal and financial sector stability, sustainable and productive use of natural resources, digitization of the economy, and increasing economic diversification.

The RGoB remains highly committed to a sound macroeconomic policy framework, which is underpinned by gradual fiscal consolidation to bring down non-hydropower debt and maintain debt sustainability. In this regard, our government will pursue fiscal management reforms, including the planned operationalization of the Goods and Services Tax (GST) and fiscal stabilization measures. The GST is an important step toward increasing revenue collection, contributing to the diversification of revenues away from hydropower and reducing their volatility. To manage the fiscal volatility associated with future hydropower projects, the RGoB will operationalize the fiscal stabilization measures that regulate contributions to and uses of the Bhutan Economic Stabilization Fund (BESF).

The RGoB welcomes the World Bank's continued support to implement reforms that aim to: (a) strengthen resilient and private sector-led growth through fiscal sustainability and enhanced access to finance and markets; and (b) foster green growth focused on renewable natural resources.

Strengthening resilient and private sector-led growth through fiscal sustainability and enhanced access to finance and markets

Our government is committed to deepening the reform areas supported by this operation which are reflected in the 12th FYP. The first pillar of the reform program is aligned with the 12th FYP's National

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Key Result Areas of “Macroeconomic Stability Ensured,” “Economic diversity and productivity enhanced,” and “Productive and gainful employment.”

First, to increase access to financing opportunities in support of enhanced economic diversity and productivity, we have approved the 2023 External Commercial Borrowing guidelines. The measures included in the updated guidelines such as shorter minimum loan maturity requirements, expanded end uses of ECB proceeds, and automatic approval routes for low-risk loans, are expected to lead to a significant increase in access to international finance for domestic firms.

Second, in support of our ongoing commitment to debt management and transparency, we have mandated the annual publication of the State-owned Enterprise (SOE) report, which includes all SOEs owned directly and indirectly by the government, and the inclusion of guaranteed and nonguaranteed debt of non-financial SOEs in the Debt Sustainability Analysis (DSA). Further, the latest SOE report and DSA have been completed and publicly disclosed.

Third, to improve the ease of doing business in today’s digital economy, we have continued the series of reforms started in this area. After last year’s approval of the e-commerce policy, we have now amended the 2018 Payment and Settlements Systems Rules and Regulations which will improve the safety and reliability of electronic payment transactions. This will not only lead to an increase of the volume of e-commerce, but also to the expansion of possible businesses leading to gainful employment, and the reduction of gender gaps in financial inclusion.

Fourth, we have approved the 2022 Customs Rules and Regulations to facilitate and increase cross-border trade. This reform is part of a larger initiative of the government to reduce the barriers for trade, automate clearance procedures, adjust the scope of duties and taxes, and introduce new valuation methods. These reforms will lead to lowering of import tariffs to increase the volume of transactions.

Fostering green and private sector-led growth through policies focusing on renewable natural resources, the digital economy, and access to finance

The second pillar reforms are aligned with the 12th FYP’s National Key Result Areas of “Water, food, and nutrition security ensured,” “Economic diversity and productivity enhanced,” and “Carbon neutral, climate and disaster resilient development enhanced.”

First, the government approved a comprehensive Food and Nutrition Security Policy to increase agriculture productivity, food and nutrition security, climate-resilience, gender and social inclusion, and commercialized agribusiness. The key strategic focus of the policy is to focus on enhancing agriculture and livestock contribution to GDP and ensuring sustainable food security. Emphasis will be on value chain, marketing, certification, and exports to ensure farmers get good returns for their products.

Second, the 2022 Biodiversity Act the Biodiversity rules were approved to promote conservation and sustainable use of biological resources, to regulate access to genetic resources and associated traditional knowledge for research and commercial utilization, and to ensure fair and equitable sharing of benefits derived from their use. The Act and Rules will improve the process and therefore increase the commercial utilization of Bhutan’s vast biological resources, unlocking opportunities for high-value ventures, and ensuring the benefits are equitably shared.

Third, we have adopted the Carbon Market Rules for the Kingdom of Bhutan 2023 as a foundation for robust, transparent, and effective participation in carbon markets. This is a significant first step towards the generation of a new source of revenue for the government from the monetization of carbon credits.

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This will allow for the capitalization of the Bhutan Climate Fund which is intended to invest in climate adaptation and mitigation. As one of the only carbon-negative countries in the world, we see this as a key element in our commitment to long-term carbon neutrality, and to sustainable development to achieve environmental, social, and economic benefits.

We also remain fully committed to building institutional capacity and enhancing transparency in public sector operations. In this regard, the Royal Audit Authority (RAA) will select an international audit firm from its list of empaneled audit firms to conduct future financial audits of the Royal Monetary Authority (RMA)'s annual financial statements jointly with a local audit firm, in accordance with relevant international standards. We will use the dedicated U.S. dollar account held at the RMA only for the purposes of the DPC2. The above auditors shall also audit the dedicated account used solely for the DPC2 proceeds as per the agreed terms of reference and the audit report will be shared with the World Bank within six months from the end of the fiscal year and made publicly available.

Conclusion

The RGoB remains highly committed to our reform progress supported by this programmatic DPC series. We would like to express our appreciation for the support and assistance extended by the World Bank Group to Bhutan's socio-economic development. We look forward to continued support and fruitful collaboration in the years to come.

Best regards,

[Namgay Tshering]



ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
Operation Pillar 1: Strengthen resilient and private sector-led growth through fiscal sustainability and enhanced access to finance and markets		
Prior action #1. To foster international commercial borrowing, the Ministry of Finance has approved the 2023 External Commercial Borrowing guidelines.	No significant effect	Yes, overall positive poverty and social effects in the medium to long term
Prior action #2. To strengthen risk assessment and monitoring of public debt and SOE oversight, the Ministry of Finance has mandated: (a) the annual publication of the SOE report, which includes all SOEs under the Ministry of Finance and Druk Holding and Investments; and (b) the inclusion of guaranteed and nonguaranteed debt of non-financial SOEs under Druk Holding and Investments in the Debt Sustainability Analysis.	No significant effect	No significant poverty and distributional impacts
Prior action #3. To support the digital economy and e-trade, the RMA has amended the 2018 Payment and Settlement Systems Rules and Regulations.	No significant effect	Positive social and distributional impacts
Prior action #4. To streamline customs procedures and facilitate cross-border trade, the Ministry of Finance has approved the 2023 Customs Rules and Regulations: Revised Edition.	Positive effects. New customs procedures are expected to strengthen border control of restricted and prohibited goods, such as (i) live animals; (ii) plant materials, (iii) forestry products (fauna and flora); (iv) industrial and toxic wastes and residues, scraps, used or secondhand goods, vehicles, machinery and equipment that may contain hazardous substances; (v) chemicals and fertilizers, (vi) plastic packing	Positive and indirect poverty impact



	<p>materials, and (vii) animals and plants classified as endangered species and their parts and products. The import of restricted goods requires a license from the relevant government agency, such as from the National Environmental Commission for industrial and toxic waste. The individual or company must also comply with Bhutan’s environmental clearance regulations for the commercial activities involving those items.</p>	
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Operation Pillar 2: Foster green growth focused on renewable natural resources

<p>Prior action #5. To increase the economic benefits of agri-food production and enhance the security and sustainability of the food and nutrition system, the Cabinet has approved the National Food and Nutrition Security Policy.</p>	<p>Significant positive effects. PA 5 will contribute to (i) improve sustainability and efficiency of agriculture and livestock input system and land management, leading to higher resource use efficiency, savings in crops, water, and energy losses, and better soil conditions; (ii) incentivize organic farming and improve biosecurity and food safety – key elements of the “One Health” approach –, with interventions such as increasing animal disease surveillance; (iii) promote climate-smart farming that will reduce the carbon emissions from current production practices in line with Bhutan’s Low Emission Development Strategy; (iv) in line with the Biodiversity Act and Biodiversity Rules and Regulations, promote adaptive and sustainable use of agrobiodiversity and non-wood forestry products. For example, the FNS Policy envisages support to biogas plants in livestock farms, promoting a 3R concept (Reduce, Recycle and Reuse) of livestock waste and cater the basic household energy</p>	<p>Significant poverty and distributional effects</p>
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	requirements of farmers. All activities under the FNS shall comply with environmental legislation, including requirements for environmental clearance and the Forest and Natural Conservation Act.	
Prior action #6. To increase the country’s attractiveness for biotechnology development and investment, while strengthening biodiversity conservation and benefit sharing from genetic resources, (i) the Parliament has adopted the Biodiversity Act and (ii) the Competent National Authority has approved the Biodiversity Rules and Regulations.	Significant positive effects. The PA aims to promote a sustainable use of Bhutan’s biodiversity, while enabling job creation, stimulating economic opportunities, and sharing their benefits with local communities.	Significant poverty and distributional effects
Prior action #7. To monetize emission offsets from hydropower and other renewable natural resources, the National Environment Commission has adopted rules for Article 6 of the Paris Agreement, which includes the framework for the national monitoring, reporting and verification (MRV) system and the emissions reductions credit registry.	Significant positive effects. The PA will stimulate the country to maintain its carbon neutral status, while generating revenues from those mitigation efforts. Depending on the projects participating in the carbon markets, this PA may also contribute to other environmental priorities, such as reduced household air pollution through projects that promote clean energy and reduction of fuelwood at households.	Potential positive impact on poverty. Remains to be seen



ANNEX 5: PARIS ALIGNMENT ASSESSMENT

Program Development Objective: The operation aims to (i) strengthen resilient and private sector-led growth through fiscal sustainability and enhanced access to finance and markets, and (ii) foster green growth focused on renewable natural resources.	
Step 1: Taking into account our climate analysis, is the operation consistent with the country’s climate commitments, including the NDC, NAP, LTS, and other relevant strategies?	Answer: Yes Explanation: Regarding NDCs, the DPC supports (i) Bhutan’s commitment to remain carbon neutral by supporting access to carbon markets, to monetize emission reductions from hydropower and other renewable natural resources; and (ii) mitigation actions of the NDC target for the agriculture and livestock sector through the FNS policy such as organic farming, the establishment of biogas plants in livestock farms and centers, as well as climate-smart agriculture (including better animal feeding practices, more efficient irrigation systems, and the use of organic fertilizer).
Mitigation Goals: Assessing and reducing the risks	
The following prior actions are not expected to lead to an increase in GHG emission nor are they expected to reduce carbon sinks (PAs 1, 2, 3, and 4). PAs 6 and 7 are not likely to cause a significant increase in GHG emissions, and both include measures to support emission reductions aligned with the NDC.	
Prior Action 5: To increase the economic benefits of agri-food production and enhance the security and sustainability of the food and nutrition system, the Cabinet has approved the National Food and Nutrition Security Policy.	
Step M2.1: Is the prior action likely to cause a significant increase in GHG emissions?	Answer: Yes Explanation: This prior action may foster the production of emissive intensive commodities. However, emissions from agriculture sector have not historically been increasing significantly and neither is it expected to increase significantly soon in Bhutan ³⁷ . Moreover, the FNS policy aims to promote climate smart activities in crop (climate smart agriculture technologies, on farm water saving) and livestock production (improved breeds and feeding activities) which is expected to lead to higher resource efficiency and thus reducing emissions from current production practices. In addition, the policy promotes the

³⁷ Bhutan NDC. (Updated). June 2021. <https://unfccc.int/sites/default/files/NDC/2022-06/Second%20NDC%20Bhutan.pdf>



	<p>diversification away from staple crops (which are typically land and water consuming) towards high value crops that offer better sustainability (e.g. perennial crops) or nutrition (e.g., buckwheat or Quinoa) outcomes and promotes specific carbon reducing technologies, such as biogas installations to reduce, re-use and recycle livestock waste. Therefore, it is likely that some changes in GHG emission from changes in production systems will be counterbalanced (or offset) by the adoption of more climate smart technologies, crop varieties, and livestock breeds.</p>
<p>Step M2.2: Is the prior action likely to introduce or reinforce significant and persistent barriers to transition to the country’s low-GHG emissions development pathways?</p>	<p>Answer: No Explanation: This prior action will not impede low-GHG emissions development pathways. In fact, it supports Bhutan's NDC commitment to the agriculture and livestock sector by promoting organic farming, establishing biogas plants in livestock farms and centers, and climate-smart agriculture. It is also aligned with Bhutan’s Low Emission Development Strategy that proposes mitigation actions to cope with GHG emissions from transforming the agriculture and livestock sectors. These strategies demonstrate Bhutan’s commitment to remain carbon neutral.</p>
<p>Step M3: Is the risk of the prior action introducing or reinforcing significant and persistent barriers being reduced to low after mitigation measures have been implemented?</p>	<p>Answer: No Explanation: There is no risk of introducing or reinforcing significant and persistent barriers to transition to the country’s low-GHG emissions development pathways. This prior action is in line with Bhutan's 2030 NDC's prioritized mitigation goals and promotes mitigation actions such as organic farming and the establishment of biogas plants in livestock farms and centers, as well as climate-smart agriculture, which are also universally aligned with the Paris Agreement's mitigation goals.</p>
<p>Conclusion for PA5: [ALIGNED]</p>	
<p>Adaptation and resilience goals: assessing and managing the risks</p>	
<p>The following prior actions’ contribution to the PDO is not expected to be significantly impacted by current or future physical climate risk (PAs 1,2,3,4, and 7). The following prior actions warrant a more detailed assessment (PAs 5 and 6).</p>	
<p>Prior Action 5: To increase the economic benefits of agri-food production and enhance the security and sustainability of the food and nutrition system, the Cabinet has approved the National Food and Nutrition Security Policy.</p>	



<p>Step A2: Are risks from climate hazards likely to have an adverse effect on the prior action’s contribution to the Development Objective(s)?</p>	<p>Answer: Yes Explanation: The sector is highly vulnerable to the impact of climate change and other natural calamities. For instance, the incessant rainfall from October 16-21 in 2021 has affected 17 dzongkhags, more than 2,500 acres and caused crop loss of about 2,400 metric tons.³⁸ In other years, Bhutan faced localized and seasonal water shortages because agriculture is mostly monsoon rainfed.</p>
<p>Step A3: Does the design of the prior action reduce the risk from climate hazards to an acceptable level, considering climate adaptation good practices applicable to the country context?</p>	<p>Answer: Yes Explanation: By developing a climate smart agriculture and livestock input system and promoting the productive use of land, and introducing climate and disaster risk management practices, risks from climate hazards will be reduced to an acceptable level.</p>
<p>Conclusion for PA5: [ALIGNED]</p>	
<p>Prior Action 6: To increase the country’s attractiveness for biotechnology development and investment, while strengthening biodiversity conservation and benefit sharing from genetic resources, (i) the Parliament has adopted the Biodiversity Act and (ii) the Competent National Authority has approved the Biodiversity Rules and Regulations.</p>	
<p>Step A2: Are risks from climate hazards likely to have an adverse effect on the prior action’s contribution to the Development Objective(s)?</p>	<p>Answer: Yes Explanation: Climate change is expected to increase flooding, runoff, erosion, and water scarcity, leading to decreased crop production and increased invasive species, fire risks, diseases, and pests. Higher temperatures are projected to contribute to increased snowmelt, which could also change patterns of river discharge, water availability and area-specific droughts. Variation in climate and weather patterns greatly affects crop production, while increased temperature leading to an increase in invasive species can also contribute to biodiversity loss across Bhutan’s forests and other ecosystems. Increased drought conditions combined with increased lightning risks can worsen the risk of forest fires. Further, significant fluctuations in water availability, glacier retreat, sedimentation, and extreme weather events will impact the hydropower sector, stressing the importance to diversify the country’s economy.</p>

³⁸ Ministry of Agriculture and Livestock, 2021.



Step A3: Does the design of the prior action reduce the risk from climate hazards to an acceptable level, considering climate adaptation good practices applicable to the country context?	Answer: Yes Explanation: By protecting biological resources from extreme weather events, the susceptibility of Bhutan's biodiversity to climate change will be reduced to an acceptable level.
Conclusion for PA 6: [ALIGNED]	
Overall Conclusion of Paris Alignment Assessment: All prior actions of the proposed program are aligned with the mitigation, adaptation and resilience goals of the Paris Agreement.	