ROYAL GOVERNMENT OF BHUTAN

# Workshops on Supporting Asia-Pacific LLDCs and Bhutan in Mobilizing Resources for the SDGs

11 December 2018 – National workshop for Bhutanese participants
12-13 December 2018 - Regional workshop for all participants
14 December 2018 - Field trip for international participants

Namgay Heritage Hotel, Thimphu, Bhutan

## Day 1: National Workshop

**Session summary**

### Session 1: The macroeconomic context and role of the financial sector in Bhutan

The session provided an overview of the macroeconomic setting in Bhutan as well as an outlook for important parameters such as the output growth, inflation, money supply and credit complemented by a discussion of a more specific macroeconomic challenge confronting Bhutan. The Royal Monetary Authority of Bhutan presented an assessment of the economy's macroeconomic situation and a brief discussion of the role of the financial sector. This was followed by a presentation on a specific macroeconomic challenge labelled as the Dutch disease.

Key messages:

- Bhutan continues to rely heavily on the hydropower sector with multiple implications on the real, fiscal, external and monetary sector.
- The financial sector plays a critical role in mobilizing savings, transferring risk and generating employment directly and indirectly.
    - The share of credit to agriculture is persistently low and lending to housing and service and tourism constitute the highest share.
    - The monetary sector is also characterized by volatile liquidity, lack of long term investment avenues.
- Ensuring external stability will require addressing the concentration of credit.
- The development of the capital market will be critical for mobilizing and channelling resources.

- Symptoms of the Dutch disease as assessed through the three channels of the spending effect, resource movement effect and the monetary disequilibrium can be observed. However, it is challenging to categorically link them to hydropower exports.
- The role of a stabilization fund was highlighted which is now under implementation by the government.

**Session 2: Financing needs and gaps in Bhutan**

The session began with a general discussion of the characteristics and challenges faced by LLDCs. This was followed by a more focused discussion of Bhutan's position relative to other LLDCs in areas such as international trade, logistics performance, corruption, doing business, etc. Priority areas for financing such as infrastructure and the various sources were highlighted. The session also presented an estimation of financing needs from the government's fiscal position. In particular, the session identified the opportunities and challenges in mobilizing the resources required to finance the investment plans as per NKRAs of the 12$^{th}$ FYP, which is aligned with the SDGs, and the financing needs to maintain external balance.

Key messages:

- LLDCs face challenges related to geographic distance from seaports that result in high transportation costs exacerbated by poor infrastructure, low levels of integration with GVCs, low FDI, lack of diversification, etc.
- The MSME financing gap in Bhutan is the lowest among LLDCs at 5% of GDP. Nevertheless, fostering FDI-MSME linkages, enhancing financial literacy and engaging the private sector in infrastructure provision are important policy actions.
- The 12$^{th}$ FYP's ambitious objectives require significant investments to the tune of Nu. 310 billion. This period coincides with the expected withdrawal of numerous donors as well as Bhutan's graduation from LDC category.
- The financial sector continues to be bank dominated with a limited range of products although numerous reform initiatives are underway. Recent regulatory reforms include the replacement of the rigid base rate lending regime with the minimum lending rate system leading to an instantaneous drop in lending rates through a more transparent and competitive framework.
- While both Banks and NBFIs remain well capitalized and above the statutory requirement, RWCAR has declined in FY 2018 for both the cases.
- Liquidity management thus far has been undertaken through administrative tools as opposed to sharper monetary instruments.
- Overall a financing need of Nu. 29 billion is projected.
    - Given the high levels of external debt, emphasis needs to be placed on fostering the underexplored domestic market.

**Session 3: Development of Capital Markets in Bhutan**

The session presented a vibrant discussion with several practitioners from Bhutan's fledgling but ambitious financial sector. Presentations included both the demand side dimensions as well the

supply side requirements to foster a thriving domestic capital market. For instance, the Ministry of Finance highlighted the benefits of a bond market to mobilize low cost finances whereas the pension fund emphasized the need for long term investment avenues given their portfolio requirements. The Royal Securities Exchange of Bhutan Limited also presented a brief status of the capital market and the four positive outcomes from deepening markets.

Key messages:

- A stark feature of Bhutan's capital market is the very low level of trading, especially trading in the secondary market. With a market capitalization of 17 percent of GDP, the capital market lacks the critical mass required to catalyse the benefits that can be reaped from an organized financial sector.
- Regulatory reforms necessary to support the growth of the capital markets include actions like the restructuring of the RSEBL and initiatives to unleash the unharnessed benefits of agricultural commercialization.
- Some of the indirect but tangible benefits of capital market development extend to the building of institutions conducive to growth, increasing the opportunities for broad-based ownership, the spreading of transparency and minimum standards besides the mobilization and channelling of capital towards purposes that ensures efficient formation.
- Due to the absence of an effective and institutionalized market for government debt, the absence of a yield curve makes the pricing of financial instruments difficult thereby hampering the emergence of new products. A sovereign bond at this stage is the appropriate step to provide an alternative channel of long-term finance besides leveraging the other catalytic benefits in terms of providing a benchmark for financial instruments.
- Primary decisions regarding sovereign bond financing requires choosing between local currency or foreign currency denominations. The former involves forgoing the risks of exchange rate risks as well as access to deeper liquid markets while the latter would require more institutional reforms in addition to ensuring a reliable credit rating.
- The existence of an appetite for long term institutional investors is apparent from the maturity structure of their liabilities and the dearth of reliable long-term financial products, which is why the National Pension Fund engages in areas that are traditionally the domain of commercial retail banks.
- Furthermore, given the country's green image and the growing popularity of Green Bonds as a low-cost option, the modality offers huge potential.

## Session 4: Going forward: Filing financing gaps in Bhutan

The session provided an appropriate conclusion with a discussion of alternative modalities for financing development as envisaged by the recently established PPP Unit of the Ministry of finance and the Druk Holdings and Investment- the investment arm of the Government which also provides a significant share of the government's dividend revenue and corporate income tax.

Key messages:

- Sources of financing for the DHI can be categorized into short term, medium-term and long-term alternatives.
    - Short term options include commercial papers or inter-corporate loans
    - Medium-term options include conventional loans and less tested instruments such as preference shares, debentures, corporate bonds and external commercial borrowing
    - Longer term and untapped sources include divestment of shares in non-strategic enterprises
- For the Ministry of Finance, PPP is being explored to support the government's implementation of larger capital investments for the 12th FYP.
    - Enabling regulations such as the PPP Policy, PPP rules and regulations, have been enacted and list of 12 potential projects have been identified
- Challenges in adopting PPP include an underdeveloped market, institutional capabilities and access to finance

# Day 2: Regional Workshop

**Session summary**

## Session 1: Macroeconomic conditions and the financial sector in LLDCs

The session set the context for the more specific thematic discussions that followed. The first presentation provided a general overview of various macroeconomic parameters and the financial sector in the LLDCs, which was complemented by the specific case of Mongolia that highlights some of the symptoms of deeper structural issues. Given the recurring characteristic of low levels of diversification and productive capacities, the second presentation on the theme of structural economic transformation was an appropriate complement to initiate discourse on required policy actions.

Key messages:

- The LLDCs are characterized by high levels of dependence on a narrow range of sectors and sources, high current account deficits; with central Asian LLDCs reliant on remittances and commodities.
    - For instance, in Mongolia minerals constitute nearly 90% of exports
    - The decline in commodity prices sent shockwaves through the Mongolian economy as international reserves, BoP, fiscal deficit and FDI inflows deteriorated dramatically. However, the economy is set to rebound with improvements registered across various parameters.
- Such symptoms also indicate that in many of these economies the pace and pattern of structural transformation is slower and less dynamic than successful Asia-Pacific countries where manufacturing had significant positive externalities.

- The potential gains from structural transformation are significant considering the productivity gaps across sectors and the concentration of resources in the least productive sectors
- Besides Kazakhstan and Uzbekistan, the levels of industrialization are still very low and where economies have made the move out of agriculture the destination has been in low productivity or informal services and no the dynamic manufacturing sector.
- An enabling macroeconomic environment and an efficient financial sector are important determinants for dynamic structural transformation.

## Session 2: Assessing financing needs and gaps in LLDCs

The session convened an interesting mix of practitioners engaged in areas of innovative financing from the region. A general overview of the needs in LLDCs was followed by a sharing of insights on flagship initiatives such as the AIFC's Green Finance Centre in Kazakhstan and UNDP Bhutan's Biofin Programme. An intervention from Nepal highlighting the needs of an LDC that is also an LLDC was also presented.

Key messages:

- LLDCs in general score poorly in areas of infrastructure, corruption (although Bhutan is an outlier), and in ease of doing business.
    - The low ranking in most indices related to competitiveness relates to poor access to infrastructure.
    - Infrastructure financing needs range from a modest 3% of GDP in Armenia to a colossal 29% if GDP in Afghanistan for the period 2018-2030.
- Traditional sources of development finance such as the state budget, ODA, concessional borrowing will have to be increasingly complemented by private sources which among other initiatives requires a more vibrant financial sector.
    - LLDCs on average have a low financial development score of .21.
- Specific measures include development of supportive business services, crowdfunding, harnessing fintech, strengthening FDI-SME linkages.
- Green finance is assuming an increasingly important role with one third of green investments in Kazakhstan financed through such channels. 50% of respondents in a recent survey identified green bonds as the most attractive instrument. However, barriers to green bonds include immature financial markets, regulatory risk, insufficient incentives and lack of expertise.
- An appropriate framework for pursuing green objectives is the Biofin programme which provides an innovative methodology enabling countries to measure their current biodiversity expenditures, assess their financial needs in the medium term and identify the most suitable finance solutions to bridge their national biodiversity finance gaps.
    - In Mongolia this has involved development of a new mechanism to calculate pasture fees
    - In Kyrgyzstan new budgeting formalities to reflect environmental priorities have been implemented

    - Estimates imply that Bhutan's natural areas could generate a capital investment of USD150 million cumulative PPP fees of USD 5.2 million per year; the impact on the local economy is estimated at 1400 new jobs, with USD 19.8 million in wages and benefits to staff annually, and local procurement value of USD 3.3 million per year.
- In Nepal, while the bulk of financing still comes from the government amounting to 54%, strengthening partnership with local governments, private and NGO sector as well as South-south cooperation are seen as important priorities.

**Session 3: Capital market development in LLDCs**

The session started with some general characteristics and benefits of promoting deeper capital markets such as connecting investors seeking for higher yield investments to infrastructure projects in emerging countries in addition to concepts such as impact investing. This was followed by country specific discussion relating to market development in Bhutan and the experience of Tajikistan and Uzbekistan in issuing their first sovereign bonds.

Key messages:

- Capital markets offer numerous opportunities for infrastructure development
    - They can better align private sector financing with longer term infrastructure assets. Bank loans to infrastructure projects often need refinancing after 10-15 years, imposing a risk on the developer.
    - Vibrant markets provide liquidity for investors enabling the trade of the underlying security facilitating transfers before maturity.
    - Credit limits constrain investment from banks that often impose lending limits on single counterparties. Bonds on the other hand spread risk over a larger diverse pool of investors.
    - Hybrid instruments may de-risk institutional risk appetite through government underwriting a portion of the loan to encourage greater investment and stimulate investment.
- Impact investing involves incentivization based on outcomes and/or objectives met rather than service delivery, enabling service providers to be nimble and reactive to opportunities aligned with meeting pre-determined policy targets rather than restrictive in the delivery of service models.
- A domestic government debt market can provide a source of long term predictable funding, for budget deficits thereby reducing recourse by the government to monetary financing.
    - Assessing the liquidity situation is one of the key preparatory actions when launching the market.
    - Issues for consideration include the value of the unit bond, underwriter of the bond, creation of a redemption fund.
- For a foreign currency bond issuance exchange rate risks, nature of funds and the credit rating of the country needs to be addressed.
- Green bonds also offer significant advantages such as:

- A cheaper way of raising significant volume of funds that are relatively long term;
- They are attractive to institutional investors such as pensions and other funds;
- The term and relative cash-flow certainty which matches the long-term liabilities of such investors; and
- ADB as issued 600 million euros at a coupon rate of .35%.

**Session 4: Challenges and opportunities in SME financing**

The session highlighted the central role of SMEs in LLDCs and the challenges they face in modernizing. A conceptual overview of the issues faced by SMEs was then substantiated by practitioners engaged in promoting SMEs in Bhutan through micro-credit institutions and other forms of targeted support. The experience of Laos PDR also provided further insights on promoting SMEs through moves such as value chain integration, improving SME accounting practices and streamlining SME registration and operational processes.

Key messages:

- The issues faced by SMEs can be conceptualized into 8 components
  - Time lag between payment and income, different stages of business growth and the corresponding cash flows, various points in the trade cycle and available instruments for financing, terms of trade payment depending on whether one is an exporter or importer, the gap between those that have access to commercial loans and those that rely on micro-finance, PPP, leveraging fintech.
  - The methods of financing can then vary depending on the creditor's perception of risk, level of financial sophistication.
- SMEs are a powerful platform for growth and development at the local grassroots level comprising 90% of the private sector but face significant financing constraints at the start up and expansion stage. 70% of borrowers are required to collateralize double the loan amount.
  - MFIs such as Bhutan Care Credit seeks to provide common people the ability to borrow, save and earn a living through income generating activities while cultivating a financially sound and financially empowered population.
- Micro-credit institutions such as the Rural Enterprise Development Corporation and the Bhutan Development Finance Corporation face numerous hurdles in expanding financial inclusion.
  - The geography and scattered client base make outreach and loan recovery extremely challenging leading to high operational costs.
  - Farmers have small and uneconomic land holdings and lower economies of scale and therefore lower returns on investment.
  - The diversion of funds disbursed for entrepreneurial purposes is a common issue.
  - Informal financial structure and inadequate financial information amplifying information asymmetry.

**Session 5: Role and challenges of development assistance**

The final session provided a platform for highlighting the continued importance of ODA given the high dependence by the LLDCs on grants and concessional finance, particularly bilateral assistance. The perspectives of the aid coordinating agencies of the government were complemented by the supply side perspectives of a very important donor in the form of the World Bank and JICA, which highlighted some of the misalignments between donor expectations and recipient standards.

Key messages:

- ODA continues to form the cornerstone of the government's financing source for development with commercial borrowing the last resort with strict conditions of financial sustainability.
- The level of external borrowing, its cost and terms are expected to increase with Bhutan's improving parameters.
- The absence of a medium-term debt management strategy must be addressed to ensure a coherent approach to development financing.
- Climate financing presents a huge untapped potential but requires capacity enhancement of policy makers and practitioners to access these windows.
- Donor's also face significant challenges in ensuring aid effectiveness
    - For Technical Assistance this includes financial mismanagement, limited fiscal space and high staff attrition rates that diminish institutional memory.
    - For Grant Finance this includes the greater emphasis on social dimensions leaving limited room for economic infrastructure and limited room for detailed project proposals.
    - For concessional loans this includes the limited room for debt financing of non-hydropower undertakings based on the nation's public debt policy.
- ODA should be increasingly leveraged as a catalyst for other private financial flows although challenges related to engaging private players such as information gaps need to be addressed.

# Day 3: Regional Workshop

**Session summary**

Interactive sessions

The sessions provided a forum for participants to exchange some of the more country specific nuances and experiences based on the technical discussions of the earlier sessions. To streamline discussion a set of guiding questions were circulated based on which participants coalesced their thoughts.

1. What are the priority areas for domestic resource mobilization in your country?
    a. What untapped opportunities exist?

   b. What are the policy reforms are needed to mobilize them?
2. How can financial institutions be incentivized to provide financial services to households and firms (SMEs) that have no access to such services (i.e. Financial inclusion)?
3. What can private sector in LLDCs do to develop deeper and more liquid domestic financial markets and what kind of supportive measures would they require from governments and international organization?

Key messages:

- The key priority area for Bhutan is **capital market development**, specifically developing a **sovereign bond market** for the various reasons discussed during the workshop.
    - In addition to serving as a reliable source of competitively priced financing, it would also open the door for the emergence of numerous financial instruments.
- The key priority areas for LLDCs are leveraging private finance especially capital market for infrastructure investment and enhancing **access to finance for SMEs**.
    - Currently LLDCs are characterized by shallow and illiquid financial markets, limiting the use of financial instruments.
    - Some possible **innovative financial instruments** include remittance bonds, citizen bonds, etc.
    - International organizations can play a role in capacity building in areas like **PPP, fintech, financial literacy**, etc.
    - Necessary reforms to attract financing through alternative sources include **revision of FDI regulations, formalization of informal sectors, and bond market governance**.