

# BHUTAN DEVELOPMENT UPDATE

June 2018

Youth unemployment rate increased under high  
growth

Macroeconomics, Trade, and Investment  
Global Practice



Government Fiscal Year: July 1–June 30  
Currency Equivalent: Exchange Rate Effective as of April 3, 2018  
Currency Unit = Ngultrum (BTN)  
US\$1 = BTN 65  
Weights and Measures: Metric System

### **Abbreviations and Acronyms**

CPI	Consumer Price Index
DSA	Debt Sustainability Analysis
FYP	Five-Year Plan
GDP	Gross Domestic Product
GNH	Gross National Happiness
GNHC	Gross National Happiness Commission
GST	Goods and Services Tax
MoF	Ministry of Finance
MoLHR	Ministry of Labor and Human Resources
NKRA	National Key Results Area
NPL	Nonperforming Loan
NSB	National Statistics Bureau
PPP	Purchasing Power Parity
REER	Real Effective Exchange Rate
RMA	Royal Monetary Authority
WPI	Wholesale Price Index

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## Acknowledgments

The Bhutan Development Update reports on recent economic developments and places them in a medium-term and regional and global context. It analyzes the implications of these developments and policies for the outlook of Bhutan's economy. It attempts to make an analytical contribution to the implementation of Bhutan's Economic Development Policy and the 11th Five-Year Plan. The report is intended for a wide audience, including policy makers, business leaders, researchers and academics, and the community of analysts monitoring Bhutan's economy. The Macroeconomics, Trade, and Investment Global Practice at the World Bank has prepared this update. Yoichiro Ishihara (Resident Representative and Senior Economist) and Tenzin Lhaden (Operations Officer) led the task. Mona Prasad (Lead Economist) provided useful comments. Qimiao Fan (Country Director) and Manuela Francisco (Practice Manager) provided overall guidance. The World Bank team appreciates the valuable contributions of the Ministry of Finance, Royal Monetary Authority, and the National Statistics Bureau.

## Overview

*Bhutan maintained solid growth and macroeconomic stability during 2016/17. The national poverty headcount rate fell from 12 percent in 2012 to 8 percent in 2017. However, the job challenges remained unaddressed. the youth unemployment rate increased from 10.7 percent in 2015 to 13.2 percent in 2016 indicating that high growth was not able to generate enough jobs for youth.*

### Recent developments

The gross domestic product (GDP) growth in 2016/17 is estimated at 7.4 percent. Growth was driven by the hydropower sector, a good agricultural harvest, and the services sector (especially financial services, hotels and restaurants, and transportation). To support the last year of the implementation of the 11th Five-Year Plan (FYP), the government boosted spending, raising the fiscal deficit from 1.1 percent of GDP in 2015/16 to an estimated 3.3 percent in 2016/17. Helped by stable non-food prices and nominal effective exchange rate appreciation, inflation decelerated from 5.8 percent in April 2017 to 3.3 percent in December. The financial sector remained sound with a risk-weighted capital adequacy ratio of 16.3 percent in September 2017. With sustained growth, the national poverty headcount rate declined from 12 percent in 2012 to 8 percent in 2017. The overall unemployment rate declined for three straight years from 2.9 percent in 2013 to 2.1 percent in 2016. However, the youth unemployment rate increased from 10.7 percent in 2015 to 13.2 percent in 2016. Youth unemployment was especially high among educated youth. The youth unemployment rate with a bachelor's degree was 67 percent.

### Outlook

Economic growth is projected to average 6 percent a year over the medium term largely supported by the ongoing hydropower projects and the services sector, especially, tourism. Lower capital spending during the first few years of the new 12th FYP will also affect growth. It will, however, help reduce the fiscal balance to -0.9 percent by 2019/20. With the completion of the Mangdechhu hydro project, exports are likely to increase while imports will decline because of lower public capital spending. This will help narrow the current account deficit to 12 percent of GDP by 2019/20 and reduce external debt to 89 percent. With sustained growth, the poverty headcount rate (US\$1.90 per day in 2011 PPP) is projected to decline further from 1.6 percent in 2015/16 to 1.0 percent in 2019/20.

### Risks and Challenges

There are four key risks facing the Bhutanese economy: (a) further delays in hydropower construction; (b) Limited financing sources; (c) the upcoming 2018 general election and policy uncertainty; and (d) adverse weather events.

**Table 1: Macro poverty outlook indicators (annual percent change unless indicated otherwise)**

	2014/15 (actual)	2015/16 (actual)	2016/17 (estimated)	2017/18 (forecast)	2018/19 (forecast)	2019/20 (forecast)
<b>Real GDP growth, at constant market prices</b>	6.2	7.3	7.4	5.8	5.4	6.0
Private consumption	1.5	3.4	3.7	-2.0	0.8	7.0
Government consumption	6.6	7.3	5.1	6.0	6.0	6.0
Gross capital investment	20.0	14.1	7.2	2.3	-0.6	3.5
Exports, goods and services	-4.7	-2.7	-2.0	-1.4	-2.0	6.3
Imports, goods and services	5.0	3.4	-2.4	-10.3	-11.5	1.7
<b>Real GDP growth, at constant factor market prices</b>	6.6	7.8	7.5	5.9	5.4	6.0
Agriculture	3.7	4.3	3.9	4.5	3.7	2.8
Industry	6.0	7.5	5.7	5.4	5.0	4.8
Services	8.3	9.2	10.7	6.7	6.3	8.1
<b>Inflation (CPI)</b>	6.6	3.3	4.3	5.0	5.0	5.0
<b>Current account balance (% GDP)</b>	-28.3	-29.8	-24.7	-21.7	-17.5	-11.7
<b>Fiscal balance (% GDP)</b>	1.5	-1.1	-3.3	-2.4	-0.7	-0.9
<b>Debt (% GDP)</b>	96.0	114.4	106.6	94.7	92.3	88.9
<b>Primary balance (% GDP)</b>	3.1	0.4	-2.1	-1.2	0.1	0.7
<b>International poverty rate (US\$1.9 in 2011 PPP)<sup>a,b</sup></b>	1.9	1.6	1.4	1.2	1.2	1.0
<b>Lower-middle-income poverty rate (US\$3.2 in 2011 PPP)<sup>a,b</sup></b>	12.8	11.1	10.0	9.1	8.7	7.0
<b>Lower-middle-income poverty rate (US\$5.5 in 2011 PPP)<sup>a,b</sup></b>	41.1	38.7	36.5	34.7	33.5	30.1

Source: World Bank projection.

Note: PPP = Purchasing power parity;

(a) Calculations based on SAR-POV harmonization, using 2012 Bhutan Living Standard Survey. Nowcast: 2015–2017. Forecasts are from 2018 to 2020;

(b) Projection using neutral distribution (2012) with pass-through = 0.7 based on GDP per capita in constant LCU.

## A. SOCIOECONOMIC DEVELOPMENTS

### 1. Growth and Inflation

**Annual GDP growth rate in 2015/16 accelerated to 7.3 percent from 6.2 percent in 2014/15.**

The 2015/16 growth rate is almost the same as the average growth rate of last three decades at 7.6 percent. The GDP growth rate improved for three straight years since 2012/13 when growth rate hit the bottom at 3.6 percent due to the shortages in Indian rupees. The 2015/16 growth was driven by services and hydropower. Bhutan's growth was the sixth highest in the world and exceeded the average growth rate of South Asia at 6.8 percent.<sup>1</sup>

**The production account shows that the services sector contributed to about half of the growth** (3.6 percent) followed by the non-manufacturing sector (3.0 percent) including the hydropower subsector (figure 1). The contributions from the agriculture (0.6 percent) and manufacturing sectors (0.3 percent) remained small. In the services sector, the transport, storage, and communication subsector contributed most (1.0 percent) followed by the wholesale and retail subsector (0.9 percent) and the financial subsector (0.7 percent). In the nonmanufacturing sector, the construction subsector (1.8 percent)—related to hydropower construction—made the major contribution.

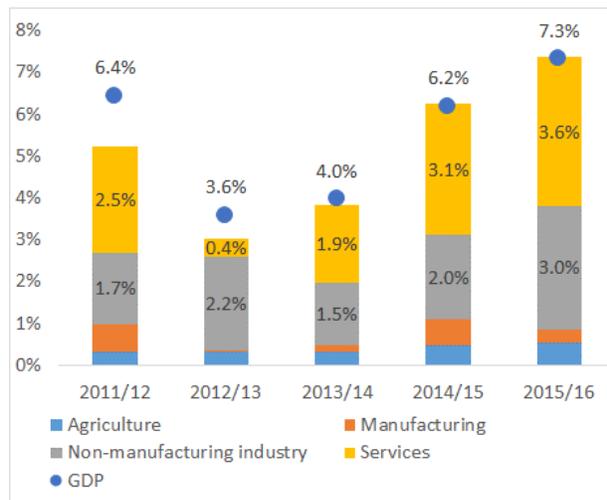
**On the demand side, investments have supported growth.** In 2015/16, gross fixed capital formation contributed 6.9 percent to the overall growth of 7.3 percent (figure 2). The construction of three mega-hydropower projects, (Punatsangchhu I [1,200 MW], II [1,020 MW], and Mangdechhu [720 MW]), contributed to gross fixed capital formation. Consumption also contributed positively to growth (3.2 percent). However, private consumption growth is likely to decelerate in 2016/17 due to the demonetization that happened in India in November 2016.<sup>2</sup> Net exports contributed negatively to growth (–2.8 percent). Goods exports fell by 5.1 percent. Trade statistics show that exports of base metals, the second-largest export item, fell by 10 percent in 2015/16.

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<sup>1</sup> For international comparison, the 2016 growth rate at 8.0 percent was used.

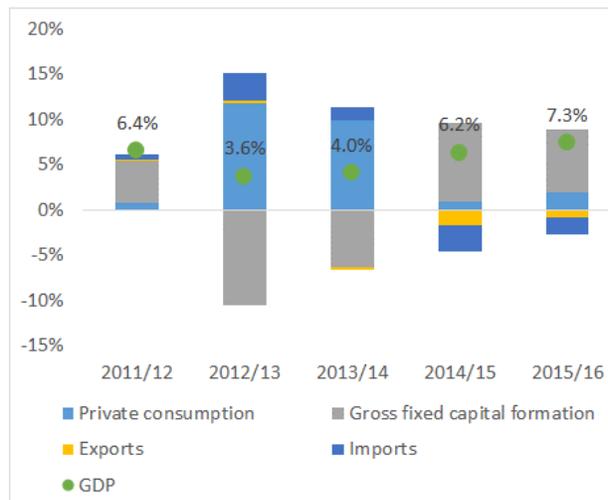
<sup>2</sup> The growth rate of private consumption in 2016 turned negative at –2.6 percent.

**Figure 1: Services and non-manufacturing drove growth (contribution to growth, %)**



Source: NSB, World Bank calculation.

**Figure 2: Gross fixed capital formation was the main growth driver (contribution to growth, %)**



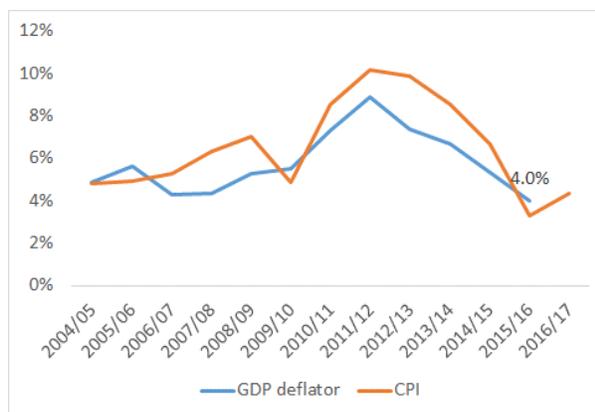
Source: NSB, World Bank calculation.

**Bhutan’s economy has a strong relationship with India.** India accounts for about 90 percent of Bhutan’s international trade and the Bhutanese ngultrum is pegged to the Indian rupee. The demonetization in India seems to have had a negative impact on private consumption in 2016/17. Anecdotal evidence shows that Bhutanese holding Indian rupees faced difficulties in converting the old notes to new ones, especially those living outside Thimphu. The impact of the introduction of the GST in India in July 2017 on growth and trade is yet to be known.

**GDP deflator is closely correlated with CPI.**<sup>3</sup> GDP deflator shows that inflation rates were 4.0 percent in 2015/16. In Bhutan, GDP deflator and CPI are highly correlated (figure 3).

**The Consumer Price Index has been stable.** CPI inflation rate gradually decelerated to 3.3 percent in December 2017 (figure 4). While food price increases remained high at 7–9 percent, non-food items, especially transport costs, led the slowing of the overall inflation rate. India accounts for 80–90 percent of Bhutan’s international trade. Therefore, price developments in Bhutan and India are highly correlated (figure 5). The time-lagged correlation

**Figure 3: GDP deflator and CPI are highly correlated (annual change, %)**

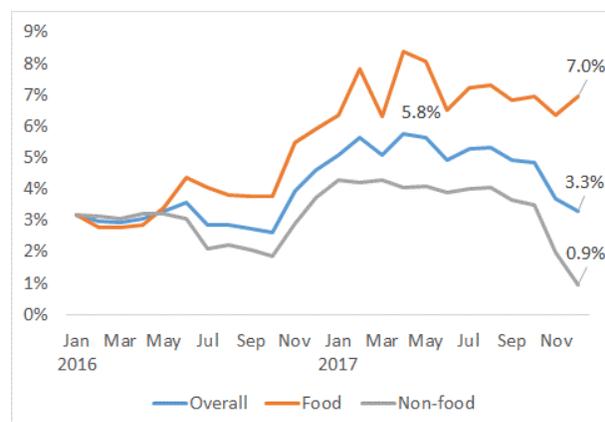


Source: NSB and World Bank staff calculation.

<sup>3</sup> GDP deflator is more comprehensive indicator than CPI to measure inflation.

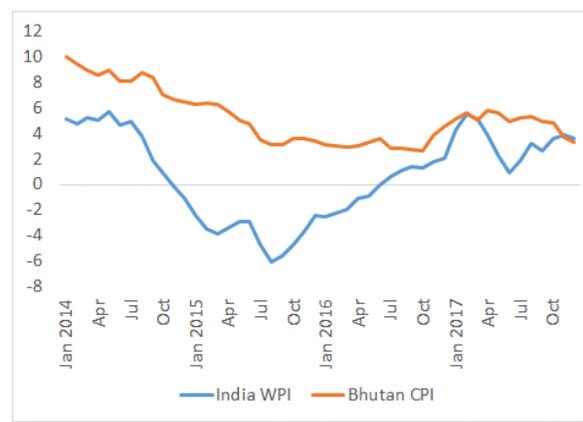
coefficient between India’s Wholesale Price Index (WPI) and Bhutan’s CPI suggests that Bhutan’s CPI lags India’s WPI by six months.<sup>4</sup>

**Figure 4: Non-food items brought down CPI inflation rate to 3 percent (year-on-year change, %)**



Source: NSB and World Bank staff calculation.

**Figure 5: Bhutan’s CPI and India’s WPI are highly correlated (year-on-year change, %)**



Source: NSB, Royal Monetary Authority (RMA), World Bank staff calculation.

**Youth unemployment rate kept increasing.** The overall unemployment rate declined for three straight years from 2.9 percent in 2013 to 2.1 percent in 2016. Despite the decline in the overall unemployment rate, the gaps between different groups widened. Most notably, the youth unemployment rate increased from 10.7 percent in 2015 to 13.2 percent in 2016 (figure 6). Youth unemployment was especially high among educated youth. The youth unemployment rate with a bachelor’s degree was 67 percent followed by youth with a middle and higher education degree at 21 percent. The increase in youth unemployment, especially among educated youth, suggests that the high economic growth in the recent few years was not able to create enough job opportunities for youth.

**The imbalance between the public and private sectors exacerbates the youth unemployment situation with tertiary education.**<sup>5</sup> The issue of public/private imbalance and subsequent queuing for public sector jobs not only contributes to growing youth unemployment, but also has broader implications on private sector development.

**The continued decline in the labor force participation rate also indicates a weakening of the labor market.** The labor force participation rate declined from 69 percent in 2010 to 62 percent in 2016. Although the level remains above 60 percent, some people may have given up seeking jobs.<sup>6</sup> If the labor force participation rate had remained at 69 percent in 2016, and assuming that

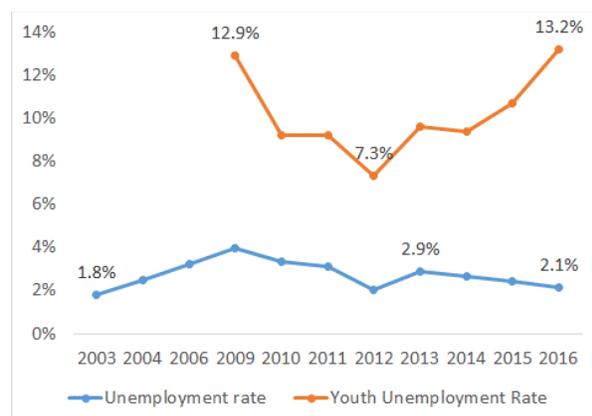
<sup>4</sup> The time-lagged correlation coefficient between India’s WPI and Bhutan’s CPI is 0.8 which is statistically significant.

<sup>5</sup> <http://www.worldbank.org/en/news/press-release/2016/11/17/addressing-labor-market-challenges-unlocking-private-sector-growth>

<sup>6</sup> The increase in school attainment could be part of the reason for the decline in the labor participation rate. However, the sharp decline in the last several years suggest this has a minor impact.

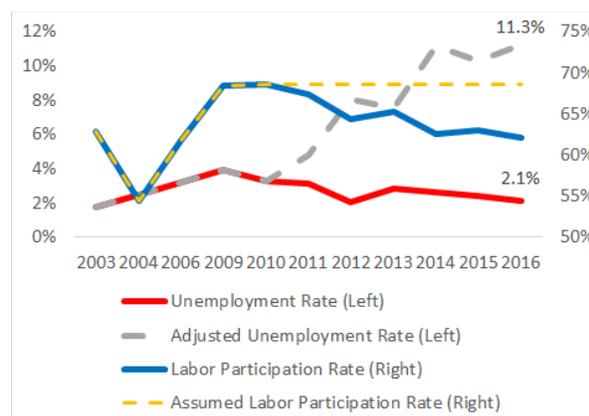
the gap between the actual (62 percent) and assumed participation rates (70 percent) represents the unemployed, the estimated overall unemployment rate would have been 11.3 percent rather than the recorded 2.1 percent in 2016 (figure 7).

**Figure 6: The youth unemployment rate kept increasing**



Source: Ministry of Labor and Human Resources (MoLHR).

**Figure 7: The decline in the labor participation rate masks**



Source: MoLHR.

## 2. External sector

The current account deficit narrowed from 29.3 percent of GDP in 2015/16 to 24.5 percent in 2016/17 due to the decline in imports as a share of GDP (table 2). The decline in goods imports by 5.8 percent of GDP contributed most to the improvement of the current account. The 2016 trade statistics show that imports of intermediate goods declined by 15 percent, and imports of consumer goods grew by only 3.3 percent. On exports, electricity exports as a

**Table 2: Current account deficit narrowed in 2016/17 (% GDP)**

	2015/16	2016/17	Change	Cont. (%)
<b>Credit</b>	<b>39.5</b>	<b>37.5</b>	<b>-2.0</b>	<b>-41</b>
Goods	23.4	23.3	-0.1	-2
Services	6.9	6.5	-0.4	-9
Primary & Secondary Income	9.2	7.8	-1.5	-31
<b>Debit</b>	<b>68.7</b>	<b>62.0</b>	<b>-6.7</b>	<b>-141</b>
Goods	48.7	42.9	-5.8	-122
Services	9.3	8.8	-0.5	-10
Primary & Secondary Income	10.8	10.4	-0.5	-10
<b>Current Account</b>	<b>-29.3</b>	<b>-24.5</b>	<b>4.7</b>	<b>100</b>

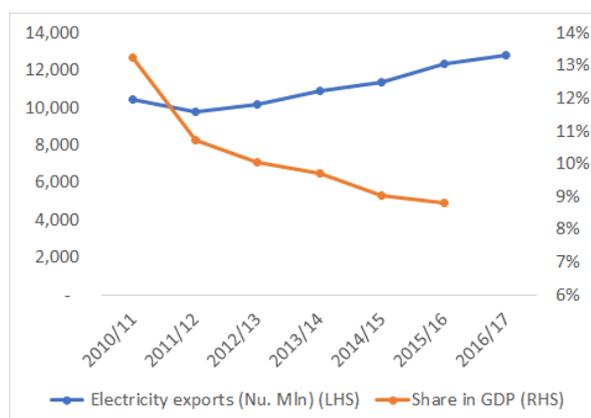
Source: RMA.

share of GDP fell from 9.0 percent in 2014/15 to 8.8 percent in 2015/16, although electricity exports remained almost unchanged in absolute values. In recent years, no major hydropower project has been operationalized. Therefore, while hydropower construction contributes to growth, the contribution of hydropower exports as a share of relative to GDP continued to fall (figure 8). Services exports (% GDP) declined by 0.4 percent between 2015/16 and 2016/17. The number of international tourists<sup>7</sup> increased by 19 percent to about 57,000 and revenues

<sup>7</sup> Excluding regional tourists mainly from India and Bangladesh.

increased by 9 percent to US\$76 million (figure 9). However, the increase in revenues was lower than the nominal GDP growth rate,<sup>8</sup> hence a decline in the share of GDP. To strengthen the balance of payments, the government introduced ‘Remit Bhutan’ in 2016<sup>9</sup>—a platform to facilitate nonresident Bhutanese to open foreign currency accounts with authorized banks in Bhutan. Remit Bhutan aims to promote national savings and enhance foreign exchange reserves through preferential interest on deposit. As a result, gross workers’ remittance inflows increased by 33 percent to BTN 2.5 billion between 2015/16 and 2016/17.

**Figure 8: Contribution of hydropower exports kept declining**



Source: RMA.

**Figure 9: Tourism sector recovered in 2016 and 2017 (growth rate, %)**



Source: RMA.

**Despite high current account deficit, international reserves remained high** (figure 10). In recent years, the sum of the capital and financial accounts exceeded the current account deficit. In other words, the overall balance of payments, was positive and thus, international reserves kept increasing since mid-2017. As of November 2017, international reserves reached US\$1.2 billion, equivalent to 11.3 months of imports of goods and services. The high level of international reserves combined with convertibility between Indian rupee and hard currencies ensures macroeconomic stability.<sup>10</sup>

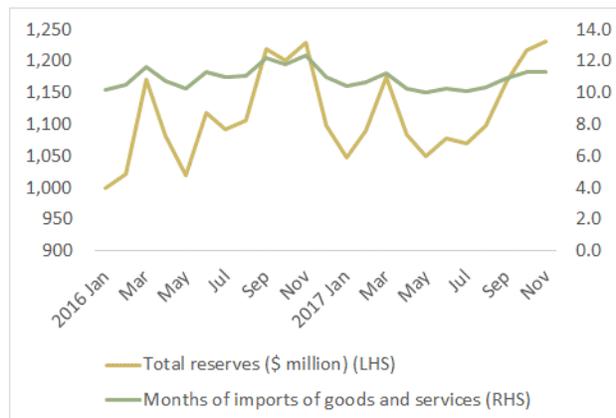
**Both the nominal and real effective exchange rate (REER) continue to appreciate** (figure 11). The Bhutanese ngultrum is pegged to the Indian rupee. Therefore, ngultrum exchange rates against the U.S. dollar fully reflect Indian rupee exchange rates. Starting in early 2017, Bhutanese ngultrum appreciated from BTN 68 per U.S. dollar and reached BTN 64 per U.S. dollar in January 2018 due to the appreciation of the Indian rupee against the U.S. dollar.

<sup>8</sup> Nominal GDP growth rate in 2015/16 was 11.5 percent.

<sup>9</sup> <https://www.remitbhutan.bt/>

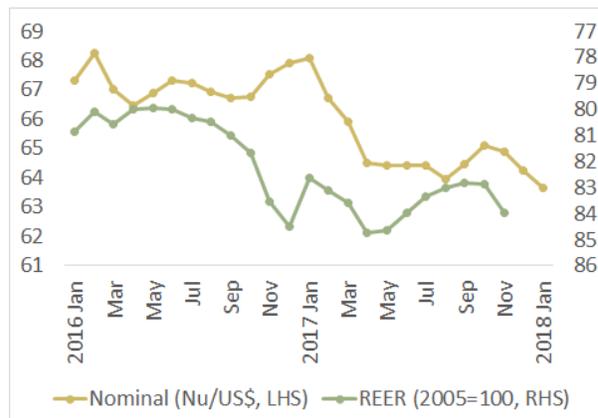
<sup>10</sup> One of the causes of rupee shortage in the early 2010s was that the convertibility between Indian rupee and hard currencies was not allowed (for example, Karma Ura. 2015. “Bhutan’s Indian Rupee Shortage: Macroeconomic Causes and Cures”). As of November 2017, reserves in convertible currencies were US\$0.8 billion, while reserves in the Indian rupee were US\$0.4 billion.

**Figure 10: Gross international reserves keep increasing**



Source: RMA.

**Figure 11: Bhutan’s currency has been appreciating**



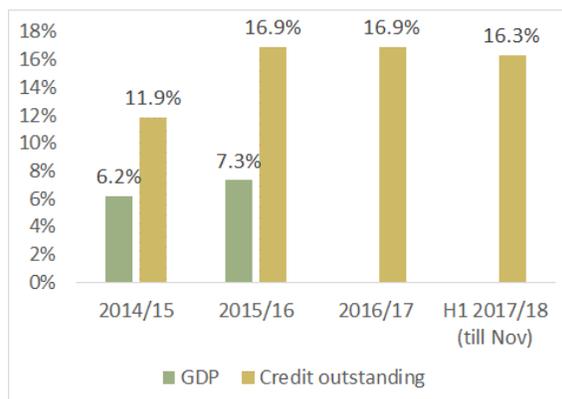
Note: Higher REER means appreciation.

Source: RMA, Bruengel database.

### 3. Financial sector

**Bhutan’s economic activities have been supported by strong growth in credit outstanding in 2016/17 and 2017/18.** Credit outstanding grew by 16.9 percent in 2016/17 and 16.3 percent in the first half of 2017/18 (till November). The strongest increase was in services and tourism (47 percent) and transport (38 percent) in 2016/17, reflecting strong private consumption including on vehicles. The correlation between GDP and credit outstanding growth rates suggests that economic activities were solid in 2016/17 and 2017/18 (figure 12). At the same time, higher credit outstanding than GDP growth rates also signal progress on financial deepening. Credit outstanding as a share of GDP (nominal) has, indeed, increased from 58 percent in 2013/14 to 61 percent in 2015/16, albeit remains at relatively low levels.

**Figure 12: Strong credit outstanding growth suggest solid economic in 2016/17 (annual change, %)**



Source: RMA, NSB.

**The financial sector maintained an adequate capital level, but the level of NPLs is of concern.** As of September 2017, the total Risk Weighted Capital Adequacy Ratio was 16.3 percent. Although the ratio was higher than the minimum requirement (12.5 percent), it fell from 17.8 percent in September 2016. The decline was mainly due to the increase in risk weighted assets. On asset quality, the NPL ratio decreased slightly from 13.2 percent in September 2016 to 12.9 percent in September 2017. The NPL ratios were especially high in trade/commerce (13.9

percent), services/tourism (21.2 percent), and housing (22.8 percent) where credit outstanding is mostly concentrated.

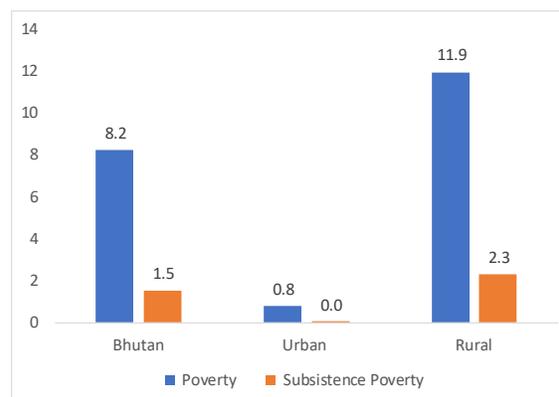
#### 4. Social sector

**With sustained growth, the national poverty headcount rate declined in 2017.**<sup>11</sup> The poverty headcount rate declined from 23.2 percent in 2007 to 12.0 percent in 2012 and 8.2 percent in 2017. The headcount rate for subsistence poverty<sup>12</sup> declined from 5.9 percent in 2007 to 2.8 percent in 2012 and 1.6 percent in 2017. In other words, Bhutan has been successful in eradicating extreme poverty.

**Inequality has been mostly unchanged between 2012 and 2017.** In 2017, a person in the top 10 percent consumed 1.6 times more than a person in the bottom 40 percent. The Gini index, which measures inequality,<sup>13</sup> was almost unchanged between 2012 (0.36) and 2017 (0.38).

**Despite poverty reduction, the gap between urban and rural remained substantial.** Although the poverty headcount rates declined in both urban and rural areas, most of the poor reside in rural areas (figure 13). For example, while there was almost no subsistence poor in urban areas, about 2.3 percent of rural population was subsistence poor. Likewise, there were significant disparities among 20 *dzongkhags* (districts). The poverty headcount rate in Thimphu, the capital, was 0.6 percent in 2017. However, the rate in Dagana *dzongkhag*—located in Southern Bhutan—stood at 33.3 percent followed by Zhemgang—located in Southern Bhutan—at 25.1 percent.

**Figure 13: Poverty rates in rural areas are higher than urban areas in 2017**



Source: NSB.

## B. ECONOMIC AND STRUCTURAL POLICIES

### 1. Medium-term strategy

**Bhutan’s development management is guided by the principles of Gross National Happiness (GNH).** The Five-Year Plan, Bhutan’s medium-term strategy, is the main policy document. The preparation of the 12th FYP for 2018–23 has been under way. Almost all stakeholders including key political party members have been engaged in the preparation

<sup>11</sup> Based on the 2017 Bhutan Living Standard Survey. The national poverty line is BTN 2,196 (about US\$34) per person per month.

<sup>12</sup> Those with per capita real consumption below the food poverty line (BTN 1,473 per person per month).

<sup>13</sup> Zero is perfect equality and 1 is perfect inequality.

process. The 12th FYP will be endorsed officially by the new government upon taking office in late 2018.

**The objective of the 12th FYP is “Just, Harmonious and Sustainable Society through enhanced Decentralization.”**<sup>14</sup> Although the number of National Key Results Areas (NKRAs) is the same as the 11th FYP, the contents of NKRAs show adjustment in direction in the 12th FYP (table 3), especially on decentralization and private sector development through economic diversification.

**Decentralization will be a new focus area.** In the 11th FYP, NKRAs are grouped by the four pillars of GNH. On the contrary, in the 12th FYP, the NKRAs are grouped by the four objectives. Most notably, the 12th FYP places explicit focus on decentralization including improvement of public service delivery. This is consistent with the direction of the fiscal policy. Starting in 2018/19, subnational governments (districts and sub-districts) will receive 50 percent of the national budget rather than 30 percent.

**Economic diversification is identified as a means for private sector development.** Although economic diversification is referred numerous times in the 11th FYP, it was not part of the NKRAs. However, key foundations for economic diversification (for example, infrastructure, quality education, and improved skills) are also included in NKRAs.

**Table 3: Comparison of NKRAs between the 11th FYP and 12th FYP<sup>a</sup>**

11th FYP	12th FYP	Remarks
<b>Pillar 1. Sustainable and Equitable Socioeconomic Development</b>	<b>Pillar 1. Sustainable Society</b>	
1. Sustained Economic Growth	1. Ensuring macroeconomic stability	
2. Poverty Reduced and MDG Plus Achieved	2. Economic diversity and productivity enhanced	New NKRA
3. Food Secure and Sustained	3. Water, food, and nutrition security ensured	Integrate NKRAs 3 and 9 in the 11th FYP
4. Full Employment	4. Infrastructure, communication, and public service delivery improved	
<b>Pillar 2. Preservation and Promotion of Culture</b>	<b>Pillar 2. Harmonious Society</b>	
5. Strengthened Bhutan Identity, Social Cohesion and Harmony	5. Culture and traditions preserved and promoted	
6. Indigenous Wisdom, Arts, and Crafts Promoted for Sustainable Livelihoods	6. Healthy ecosystem services maintained	
<b>Pillar 3. Conservation and Sustainable Utilization of Environment</b>	7. Healthy and caring society enhanced	
7. Carbon Neutral/Green and Climate Resilient Development	8. Livability, safety, and sustainability of human settlements improved	
8. Sustainable Utilization and Management of Natural Resources	9. Carbon neutral, climate, and disaster resilient development enhanced	

<sup>14</sup> The 12th Five-Year Plan Guideline.

11th FYP	12th FYP	Remarks
9. Water Security	<b>Pillar 3. Just Society</b>	
10. Improved Disaster Resilience and Management Mainstreamed	10. Poverty eradicated and inequality reduced	
<b>Pillar 4. Good Governance</b>	11. Productive and gainful employment created	
11. Improved Public Service Delivery	12. Quality of education and skills improved	Education and skills not referred in NKRA in the 11th FYP.
12. Democracy and Governance Strengthened	13. Justice service and institutions strengthened	
13. Gender Friendly Environment for Women's Participation	14. Gender equality promoted, women, and girls empowered	
14. Corruption Reduced	15. Corruption reduced	
15. Safe Society	<b>Pillar 4. Decentralization</b>	
16. Needs of Vulnerable Group Addressed	16. Democracy and decentralization strengthened	Decentralization not referred in NKRA in the 11th FYP
	17. Infrastructure, communication, and public service delivery improved	Appears twice in pillars 1 and 4

Source: Gross National Happiness Commission (GNHC).

Note: a. Based on the 12th FYP Guidance Paper. MDG = Millennium Development Goal.

## 2. Fiscal policy and debt sustainability

### (a) Fiscal Policy

**Fiscal outturn of FY2015/16 was better than expected.** Fiscal outturn of 2015/16 (-1.1 percent of GDP) turned out to be better than the one in the revised budget (-3.6 percent of GDP). Both current and capital expenditures were lower than the revised budget.

Table 4: Selected fiscal indicators (% GDP)

	2014/15	2015/16	2016/17	2017/18
	Actual	Actual	Revised	Budget
<b>Revenue and grants</b>	<b>28.8</b>	<b>29.9</b>	<b>29.9</b>	<b>28.6</b>
Tax	14.6	14.2	13.2	13.6
Grants	7.9	10.6	11.2	9.3
<b>Outlay</b>	<b>27.3</b>	<b>31.1</b>	<b>34.0</b>	<b>31.0</b>
Current	16.7	16.3	16.1	15.9
Capital	10.6	14.8	18.0	15.2
<b>Fiscal balance</b>	<b>1.5</b>	<b>-1.1</b>	<b>-4.1</b>	<b>-2.5</b>

Source. Ministry of Finance (MoF).

**The fiscal policies in FY2016/17 and FY2017/18 were expansionary** (that is, increase in budget deficits) to complete the remaining activities of the 11th FYP ending in 2017/18. The fiscal deficit for 2016/17 is expected to narrow to 4.1 percent of GDP from the original estimate of 4.9 percent mainly due to the increase in the domestic revenue and a program grant. The domestic revenue in 2015/16 increased by 3.3 percent due to growth in both tax and non-tax revenues. The total external grants constituted 35 percent of the overall government resources in 2015/16, almost the average of the last eight years. Budget deficits are largely financed by concessional

financing from development partners. Therefore, there is a low risk of public financing crowding out the private sector.

**On the budget allocation, the government strikes a good balance between provision of public services and economic development.** In the 2017/18 budget, health and education account for 26 percent of the total expenditures, while economic and public services (including agriculture, infrastructure development, and energy) account for 34 percent. To ensure the quality of public goods provision, all expenditures are built on the FYP and medium-term expenditure framework. Further, the Government Performance Management System, defines targets and objectives and serves as the basis for budget allocation among agencies. Moreover, to empower the local government and from the positive impact brought about by the previously introduced Gewog Development Grant, the new budget includes a new system of Dzongkhag Development Grants of BTN 7 million for each *dzongkhag*.

**Fiscal policy supports macroeconomic stability.** As stipulated in Paragraph 57 of the 2007 Public Finance Act, the budget can be revised in the event of shocks affecting macro-fiscal sustainability. Furthermore, to react to a shock quickly, the MoF can issue a public notification. For example, to react to the introduction of India's GST, which was expected to bring a negative impact on revenues, the MoF issued a public notification changing the Rules on Valuation, Collection, and Deposit of Sales Tax on Vehicles.

In 2017, the following new fiscal policies were introduced to further strengthen the fiscal policy:

- (a) **Measures in response to India's GST:** The MoF issued a public notification in August 2017. With this notification, sales tax on vehicles is collected at the point of sale rather than at the point of entry. As sales prices include profits and other costs in addition to import prices, this notification has revenue generation impact.
- (b) **Fiscal incentive act:** Parliament passed the Rules on the Fiscal Incentive Act of Bhutan 2017. The act streamlines all the previous incentives and aims to implement the 2016 Economic Development Policy for private sector development. The act enables the government to allocate fiscal incentives toward productive sectors of the economy.
- (c) **Introduction of Bhutan's GST:** In August 2017, the Cabinet issued a directive to the MoF to proceed with the preparation of GST.
- (d) **Establishment of the stabilization fund:** Parliament approved the establishment of the stabilization fund with an initial allocation of BTN 100 million (US\$1.4 million). The stabilization fund aims to sterilize inflows from hydropower exports and enable the government to support counter-cyclical interventions for macroeconomic stability.

## (b) Debt Sustainability

To assess debt sustainability, Bhutan's special situation (that is, debt related to hydropower projects) should be considered, as hydropower debt is fully financed by India and revenues from hydropower projects are calculated on a cost-plus basis, underpinning debt sustainability. The debt indicators on non-hydropower debt have been improving in recent years. Also, the 2016 debt sustainability analysis (DSA) projects significant improvement of debt indicators in the future.<sup>15</sup>

**The stock of public debt remains high.** However, about 80 percent of the debt is related to hydropower. The debt indicators on non-hydropower debt have been improving. The non-hydropower external debt-to-GDP ratio improved/decreased from 26.7 percent in 2014/15 to 22.7 percent in 2016/17 (as of December 2017).

**The 2016 DSA concluded that Bhutan's risk of external debt distress is moderate, unchanged from the assessment in 2014.** The DSA observes that Bhutan's rapid hydropower development has led to a substantial buildup of external debt, with ratios breaching all indicative thresholds and projected to continue doing so for several more years. At the same time, the DSA recognizes key factors mitigating risk. For example, a large share of external debt is linked to hydropower project loans from the Government of India, which covers both financial and construction risks of these projects and buys the surplus electricity output at a price reflecting costs plus a 15 percent net return. As a result, Bhutan's debt situation is expected to improve in the medium and long term, reflecting significantly higher electricity exports once the additional hydropower projects come on stream. For example, the debt-to-GDP ratio is projected to improve to 34.1 percent in 2025/26 assuming no new hydropower projects construction in the pipeline from 2017/18 onward.

**Table 5: Selected debt indicators (in percent of GDP unless otherwise mentioned)**

	2014/15	2015/16	2016/17 <sup>a</sup>
Total debt	96.5	99.9	106.6
External debt	94.8	99.9	100.3
Hydro	67.9	76.1	77.6
Non-hydro (% of non-hydro GDP)	26.7	23.7	22.7
External debt service payments (% of exports)	19.3	14.7	11.0
Hydro	8.4	9.0	7.2
Non-hydro (% of non-hydro exports)	10.9	5.7	3.8
Government debt service (% of revenue)	31.2	21.6	17.0
Hydro	13.2	12.7	10.1
Non-hydro (% of non-hydro revenue)	19.0	8.7	6.1

Source: MoF.

<sup>15</sup> Please see the World Bank note on Bhutan's debt (<http://www.worldbank.org/en/country/bhutan/brief/should-bhutan-worry-about-public-debt>)

Note: a. As of December 2017.

**On debt management, the approval of the Debt Policy in August 2016 is a major step to ensure debt sustainability.** The debt policy imposed the ceiling of non-hydro debt of 35 percent of GDP on average in a five-year period. The Debt Policy also mandates the formulation of a Medium-Term Debt Management Strategy and regular DSAs. To support the implementation of the debt management policy, the Debt Management Unit (Division of Debt Management) was formally transferred to the Department of Macroeconomic Affairs (newly formed department that will coordinate all policies relating to macroeconomics) that will help consolidate and strengthen the functions related to the public debt management.

**A quarterly debt report is produced, though the report is not publicly available.** Debt reports are generated at least quarterly for submission to the Cabinet and MoF, and quarterly debt statistics are shared to the RMA, NSB, and other relevant agencies. The debt reports are used for the preparation of Annual Budget and Annual Financial Statements that are tabled in the Parliament every summer session. To enhance understanding of the public debt situation among senior policy makers, in the short term, the quarterly debt report also includes cost and risk indicators of the debt portfolio along with a brief explanation of these indicators. This will also help initiate the process of preparing and publishing an annual debt statistical bulletin (with coverage of total debt). For the medium term, the aim would be to prepare an annual report on debt management activities including evaluation of strategy implementation.

### 3. Monetary and exchange rate policies

**Based on the Financial Sector Development Action Plan, the RMA (the central bank) introduced new initiatives in 2017 to further strengthen monetary policy.** Access to finance is the most binding constraint for private sector development as confirmed in the 2017 Investment Climate Assessment. To address this, the RMA launched the Priority Sector Lending Guidelines in December 2017. For the same purpose, the RMA amended the Credit Information Bureau Rules and Regulations. The amendment ensures reporting of entities (utilities, insurance companies) in addition to banks. Thus, the creditworthiness of customers is now more readily assessed. Also, the 2017 e-money issuer rules and regulations provided the legal framework for mobile banking and payments services.

**The exchange rate is pegged to the Indian rupee.** The peg anchors confidence in the ngultrum and has facilitated Bhutan's trade relations with India (India accounts for 80–90 percent of Bhutan's international trade). The pegged exchange rate system has contributed to macroeconomic stability.

## C. OUTLOOK AND RISKS

### 1. Outlook

**Economic growth is projected to average 6 percent a year over the medium term, largely supported by the ongoing hydropower projects and the services sector, especially tourism.**

However, downside risks to growth remain, particularly from the delay in the completion of two mega-hydropower projects and the general elections scheduled for the summer of 2018. In addition, lower capital spending during the first few years of the new 12th FYP will also affect growth. It will, however, help reduce the fiscal deficit to –0.9 percent by 2019/20. With the completion of the Mangdechhu hydro project, exports are likely to increase while imports will decline because of lower public capital spending. This will help narrow the current account deficit to 12 percent of GDP by 2019/20 and reduce external debt to 89 percent. With sustained growth, the poverty headcount rate (US\$1.90 per day in 2011 PPP) is projected to decline further from 1.6 percent in 2015/16 to 1.0 percent in 2019/20.

## 2. Risks to the baseline

**There are four key risks facing the Bhutanese economy:** (a) given the size of hydropower projects relative to the size of the economy, any further delays in hydropower construction will negatively affect the economy through lower exports and revenues; (b) with sustained growth, donor financing in Bhutan is getting scarce, while domestic debt markets are not yet developed. Limited financing sources could constrain government spending and negatively affect growth and development; (c) the upcoming 2018 general election could lead to policy uncertainty that could affect growth and investments; and (d) adverse weather events could negatively affect the economy through lower electricity generation from existing hydropower plants and lesser tourist traffic. In terms of longer-term challenges, the country needs a vibrant job-creating private sector.

**Hydropower development is likely to have significant impact on the economy.** The large hydropower projects have a sizeable impact on the economy (for example, the construction cost of Punatsangchhu I is estimated at US\$1.5 billion, about 55 percent of the projected GDP in 2017/18). In 2018–2021, the government plans to start operating three new hydropower projects (with a total capacity of about 3,000 MW against the current capacity of 1,600 MW). However, the completion of Punatsangchhu I and II is likely to be delayed by one to two years (Table 66), which will affect the economy in the following way (assuming there is no escalation of costs): a one-year delay in completion may reduce GDP growth by 3–4 percentage points, exports by US\$250–300 million (about 50 percent of the current exports), and revenues by 0.5–1.0 percent of GDP (Table 7).

**Table 6: Delay in hydropower construction**

Project	MW	Planned completion year		
		In 2015/16 budget	In 2016/17 budget	In 2017/18 budget
Punatsangchhu I	1,200	2019	<b>2019</b>	<b>2021</b>
Punatsangchhu II	1,020	2018	<b>2018</b>	<b>2019</b>
Mangdechhu	720	2018	2018	2018

Source: MoF.

**Table 7: Impact of a delay in hydropower construction (one-year delay in Puna I or II project)**

Subject	Source of impact	Net impact	Remarks
GDP (production account)	Decline in forecast electricity subsector growth	About 3–4 percentage points of GDP growth	Increase in the construction subsector could partly offset the impact
Exports	Decline in forecast export growth	About US\$250–300 million a year (about 50 percent of actual exports in 2015)	—
Government revenues	Decline in forecast corporate tax, dividend, and royalty	About 0.5–1 percent of GDP	Sum of corporate tax, dividend, and royalty

Source: World Bank staff estimates.

**Financing for development remains challenging.**

The medium-term expenditure framework shows a resource gap in FY2017/18–2019/20 (table 8). The resource gap will have to be filled by: (a) an **increase in borrowing** (either external and/or domestic): domestic borrowing through Treasury

Bill issuance, in theory, crowds out the private sector; (b) a **drawdown of government deposits**; and/or (c) a **cut in expenditures**: such a cut, especially in capital expenditures, has a negative impact on infrastructure development and growth.

**Table 8: Budget has resource gap in 2017/18 and 2019/20 (% GDP)**

	2017/18 budget	2018/19 projection	2019/20 projection
Fiscal balance	-2.5	-0.4	-3.7
Net borrowing	-0.2	0.9	0.0
<b>Resource gap</b>	<b>-2.9</b>	<b>0.4</b>	<b>-3.7</b>

Source: MoF.

**The impact of the 2018 general election on reforms needs to be monitored.** Bhutan will hold the third national election in 2018. National Council election (upper house) will be held on April 20, 2018, followed by National Assembly election in the second half of the year. The next parliamentary session in June 2018 will be held with the existing government and new National Council members, mainly to discuss 2018/19 budget. As Bhutan’s development management is guided by GNH and the 12th FYP has been prepared through consultative process, the overall development direction is unlikely to change significantly with the coming into office of a new government. However, the policy reform process—especially new policies and acts—are likely to be delayed or left to the new government.<sup>16</sup>

**Bhutan is prone to various types of natural disasters.** In the 1990s and 2000s, more than 10 percent of the population was affected by either floods, storms, or earthquakes. About 60 percent of Bhutanese are in the agriculture sector, and hydropower electricity exports account for 30–40 percent of the total. These sectors tend to be affected by natural disasters. During monsoon season, frequent landslides disrupt domestic connectivity.

<sup>16</sup> A new policy requires the following steps: (a) Cabinet approval of a concept note, (b) GNH screening by both GNHC and initiating ministry/agency, (c) secretaries meeting, (d) GNH committee meeting chaired by the Prime Minister, and (e) the Cabinet meeting for decision.