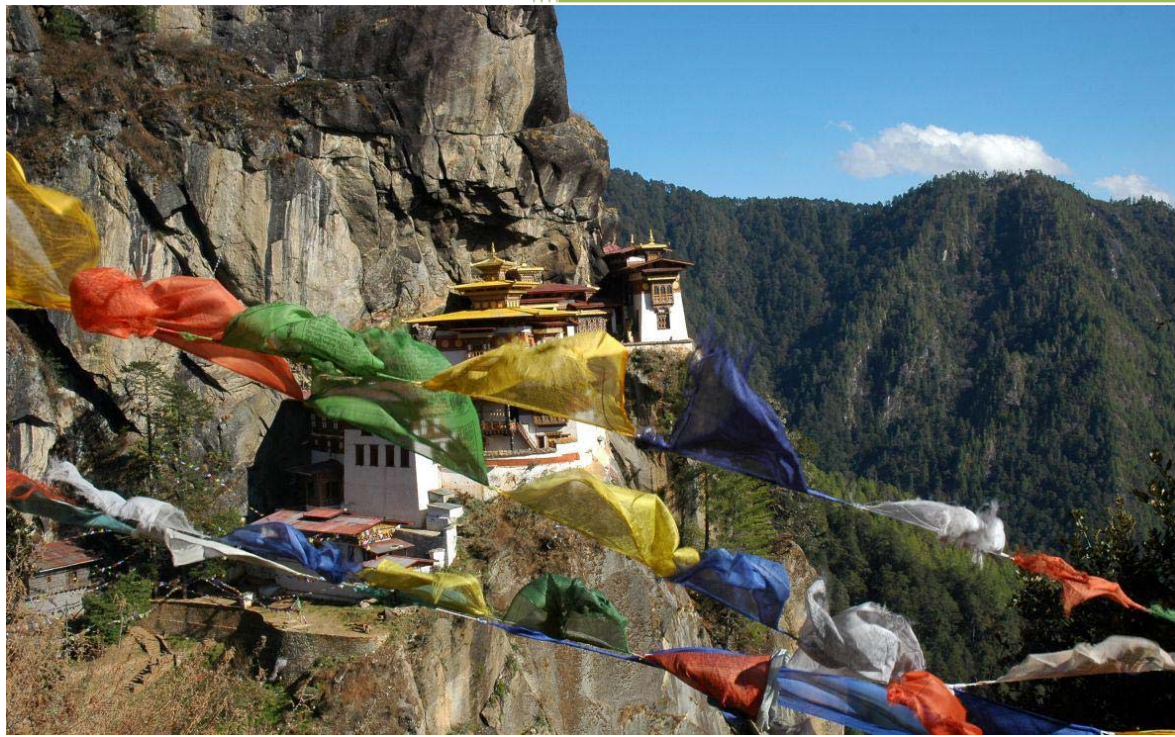


September, 2009

Bhutan Economic Update



*Economic Policy and Poverty Team
South Asia Region*

The World Bank

Summary

- *The Royal Government of Bhutan (RGoB) recently presented its budget for 2009/10, supporting the Tenth Five-Year Plan (10FYP)'s objective of poverty reduction within a sound macroeconomic framework.*
- *Growth is expected to slow from 9 percent during the Ninth Five-Year Plan (9FYP) to below 8 percent during the 10FYP (2008/09-2012/13), but ambitious plans for hydropower development are expected to yield dividends in growth and revenue beyond the 10FYP period.*
- *The fiscal deficit is expected to average less than 5 percent during the 10FYP, but this depends critically on hydropower revenues and external assistance, leaving the economy vulnerable to macroeconomic volatility.*
- *Bhutan's debt is projected to increase significantly during the 10FYP, due largely to hydropower development loans that are expected to be serviced through hydropower receipts in the long run.*
- *The current account is expected to weaken during the 10FYP due to worsening trade balance and interest payments on hydropower loans, although capital transfers from India, foreign direct investment and loans and grants from development partners are expected to finance this.*
- *Cautious monetary policies have helped to lower inflation and domestic credit growth, and, even though growth in credit to the private sector is high, access to finance is cited as the main investment climate barrier for private sector development.*
- *Growing youth unemployment and shortage of skilled workers for the industries and services sectors are important policy concerns.*
- *The Bhutanese economy was largely insulated from the global financial and economic crisis, and is showing signs of recovering from limited declines in tourism and the steel industry.*

¹ This report was prepared by Ananya Basu.

Recent Developments

Headline Events

The National Assembly finalized the 10FYP (2008/09–2012/13) in January 2009 and publicly disclosed it in March. The Plan aims to bring down poverty from a headcount rate of 23.2 percent in 2007 to 15 percent by the end of 2012/13. The strategic priorities identified for the 10FYP are to: (i) revitalize industry; (ii) strengthen national spatial planning; (iii) synergize rural-urban development; (iv) expand strategic infrastructure; (v) invest in human capital; and (vi) foster an enabling environment through good governance.

The RGoB bases its development vision on a unique concept of maximizing Gross National Happiness (GNH). The RGoB adopted the GNH Index with the coronation of the fifth King of Bhutan, His Majesty Jigme Khesar Namgyel Wangchuck, in November 2008. The purpose of this index is to assign values to national happiness, set benchmarks and track policies and performances of the country. The index is based on 72 measurable indicators grouped under nine principal domains. Following the established formula, Bhutan's GNH Index, based on a survey of 950 respondents from 12 *dzongkhags* conducted between December 2007 and March 2008, is estimated to be 0.812. This serves to establish a baseline, and future surveys will examine trends in GNH. The Fifth International Conference on GNH is scheduled to be held in Brazil in November 2009.

The Prime Minister's first State of the Nation address to the Parliament in June highlighted some of the key socio-economic achievements in the newly-created democracy over the preceding year. While citing good socio-economic performance during the global economic crisis, the address recognized the need to further strengthen the fundamentals of the Bhutanese economy. It reaffirmed the RGoB's commitment to maximizing GNH for its citizens.

The RGoB unveiled its budget for financial year 2009/10 in July 2009. The new budget supports the 10FYP and aims to achieve the core objective of poverty reduction by pursuing focused socio-economic development strategies within a sound macroeconomic framework.

Floods resulting from Cyclone Aila in May cost the kingdom an estimated Nu719 million (about USD14.8 million) in damages. This includes damage to roads, bridges, government and private buildings, machinery, vehicles, sawmills, drinking and irrigation water supplies, and land and crops. The flood also claimed the lives of twelve people. The RGoB said the damage jeopardized the achievement of some infrastructure goals under the 10FYP.

The Indian government recently reaffirmed its external aid commitments to Bhutan. India's commitment to Bhutan's 10FYP is almost double what it was under the 9FYP. Additional commitments by the Indian government during the 10FYP period amount to Nu227.9 billion (about USD4.6 million), of which 95 percent will be for the development of hydropower projects. In June-July 2009, the Indian government approved a grant of Nu100 million to restore and rehabilitate damage caused by Cyclone Aila in Bhutan, and agreed to provide Nu7 million to assist Bhutan's efforts to transform the Kingdom into an Information Technology (IT)-enabled knowledge society.

A recent study by Bhutan's Royal Education Council forecast that the shortage of skilled workers in the Kingdom will intensify. Bhutan faces a dual challenge of providing employment to its educated population and ensuring that industries are not constrained by a shortage of skilled manpower. The study found that, as Bhutanese companies rely increasingly on IT, they are likely to face a 40 percent shortage of skilled IT professionals by 2020. The hotel industry is expected to face a 70 percent shortage of professionals, with the luxury sector being worst affected. The construction and power generation

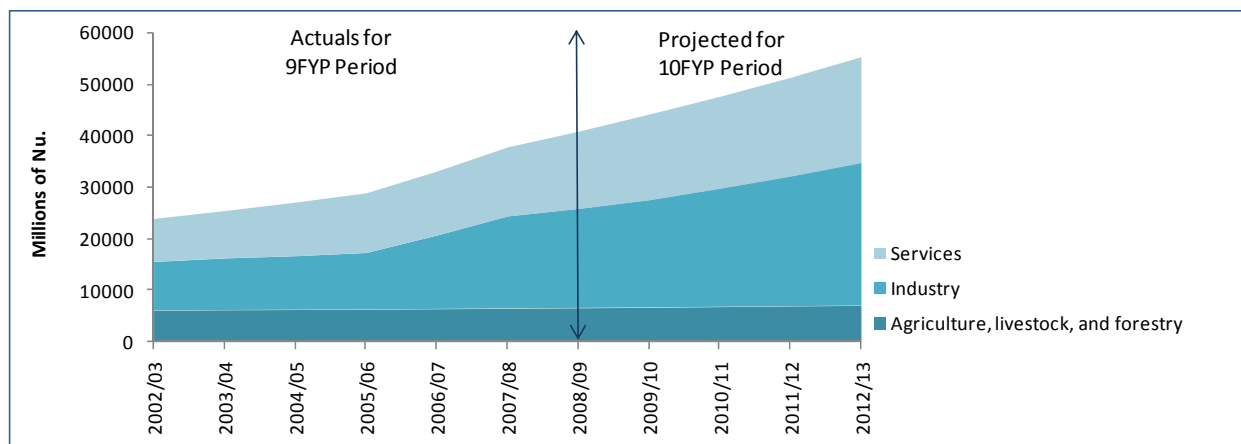
industries may face a 15 percent shortage of vocationally trained technicians, while the shortage of healthcare professionals — doctors, nurses and paramedics — is expected to be about 30 percent by 2020.

An earthquake measuring 6.3 on the Richter scale struck eastern Bhutan on September 21st. Initial reports put the death toll at 12. Over a thousand structures — including roads, houses, schools, historical monuments, and government offices — were reportedly damaged, mainly in the Mongar and Trashigang districts. The cost of damages had not been estimated at the time this report was issued.

Real Sector

Bhutan averaged about 9 percent annual economic growth during 9FYP, but this is expected to slow slightly during the 10FYP. During the 9FYP (2002/03–2007/08, extended by one year), economic growth averaged about 9 percent per annum. This was driven largely by growth of over 14 percent in 2006/07 and 2007/08, as the Tala hydropower project came onstream, trebling Bhutan’s power generation capacity (Figure 1). The economy grew by 8.1 percent in 2008/09. The per capita Gross National Income was estimated to be US\$1,900 in mid-2008 — higher than those of other South Asia Region countries, except the Maldives. To sustain a target real growth rate of almost 8 percent during the 10FYP, the RGoB intends to focus on electricity, and construction of hydropower projects as its main sources of growth. However, World Bank and International Monetary Fund estimates suggest that growth during the 10FYP may be 1.0-1.5 percentage points lower than the RGoB’s target. This is largely because the RGoB’s target growth rate is predicated on an agricultural growth rate of around 4 percent, which is more than double the growth achieved during 9FYP, and may be difficult to achieve.

Figure 1: Trends in Real Sectoral Gross Domestic Product (2000 Prices at Factor Cost)



Source: Royal Government of Bhutan, National Statistics Bureau. 2008/09 figure is a revised estimate.

Hydropower could be a major engine of growth and public revenue during and beyond the 10FYP, and the RGoB has ambitious plans for the sector. Bhutan has limited domestic demand, and surplus power is exported to India. The Kingdom has the potential to develop 23,760 MW of capacity, of which only 5 percent has been tapped so far. Under the 10FYP, the installed hydropower generation capacity is targeted to go up from 1,488 MW in 2007 to 1,602 MW in 2013, with the planned commissioning of the 114 MW Dagachu hydropower project. In addition, the RGoB proposes to add 10,000 MW capacity by 2020. To this end, Bhutan and India have agreed on a list of 10 hydropower projects to be developed — six under an ‘intergovernmental model’ of 30 percent grant and 70 percent loan, and four under the joint

venture model whereby public sector companies from both countries will implement the project. The Tala hydropower project was officially handed over to the commercial management of Druk Holding and Investment (DHI) and Druk Green Power Corporation (DGPC) on April 8.

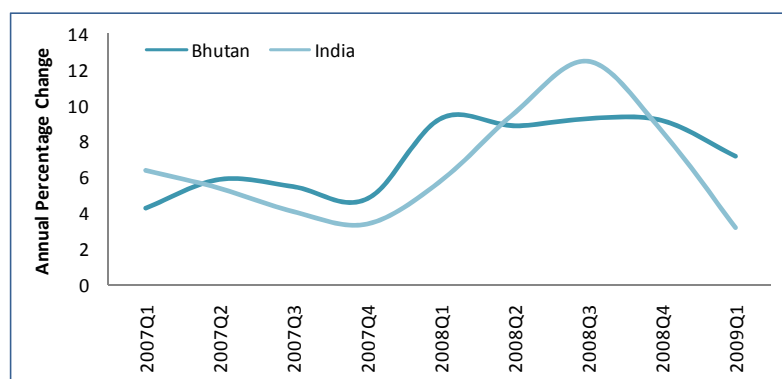
Social development indicators are generally good, although unemployment among the youth is rising. Bhutan received a score of 0.579 on the UNDP’s Human Development Index in 2005, placing it in the medium range, along with most of its neighboring South Asian countries. Supportive government policies have ensured that Bhutan is on track to achieve most of its Millennium Development Goals (MDGs) for which data are available. However, youth unemployment is a growing concern. The overall unemployment rate has risen to 4 percent, from 3.7 percent in 2007. This jump translates to about 13,000 unemployed Bhutanese, of which 81 percent are 15-24 years old, raising the youth unemployment rate to 13 percent (from 9.9 percent in 2007, and 2.2 percent in 1998). Despite its low share of GDP, the primary sector still provides employment for around 65 percent of the Bhutanese labor force.

Financial Sector

There are signs that inflationary pressures are easing, after having risen to elevated levels in late-2007. Since the Bhutanese ngultrum is pegged to the Indian rupee, price developments have tracked India’s inflation closely (Figure 2). When India’s inflation peaked in the summer of 2008 due to high oil prices, Bhutan’s inflation was in the 8-9 percent range.

Currently, with the easing of inflationary pressure in India due to a sharp drop in global oil and commodity prices, Bhutan’s headline inflation rate has dropped to 7.2 percent in the first quarter of 2009, from 9.2 percent in the preceding quarter.

Figure 2: Inflation trends



Source: National Statistics Bureau of Bhutan, Consumer Price Index (2003 = 100), and Reserve Bank of India, Wholesale Price Index of All Commodities (1993/94 = 100)

Domestic credit growth has been curtailed due to cautious monetary policy, although growth of credit to the private sector remains high. Domestic credit growth stood at about 10 percent in May 2009 (y-o-y), after having declined substantially to 1.2 percent in December 2008 (y-o-y) from 41.8 percent in August 2008 (y-o-y). This was due to the increase in government deposits in Bhutan’s Royal Monetary Authority (RMA). Growth in credit to the private sector remained high at 32.7 percent in May 2009 (y-o-y), even though this represents a decline from end-2008 figures.

Inadequate access to credit continues to be a major barrier to private sector development. The International Finance Corporation-World Bank’s Doing Business Report 2010, ranks Bhutan 177th out of 183 countries on the ease of getting credit. The share of credit to the private sector remains well below regional averages, as shown by the fact that the domestic credit to GDP ratio in Bhutan in 2007 stood at around 25 percent, compared with the regional average of 44.8 percent. The relatively low domestic credit share persists despite Bhutan’s rapid growth. Bhutan’s RMA has taken steps to foster competition in the financial sector by issuing, in early 2009, in-principle approval for three new bank licenses and one additional insurance license (with criteria fulfillments expected by the end of 2009).

Box 1: Enabling Environment for the Private Sector

The Royal Government of Bhutan embarked on private sector development reforms in FY09, with the drafting of three new investor-friendly policies. The Economic Development Policy (EDP) is intended to: (i) achieve economic self-reliance; (ii) generate employment; (iii) harness and add value to natural resources in a sustainable manner; (iv) realize import substitution; (v) promote entrepreneurship; (vi) diversify the economic base; and (vii) increase and diversify exports. The Foreign Direct Investment (FDI) Policy aims to encourage more FDIs to broaden the employment and revenue base, to benefit from technology transfer, and to increase foreign exchange earnings. Both policies have been presented to Cabinet and are expected to be approved by end-2009. A draft Mineral Development Policy is expected to be presented to the Cabinet by end-2009. The EDP has been complemented by a review of all rules and regulations to improve the business environment. There will be further steps, in FY10, to draft new rules and regulations to operationalize these new policies. The signing, in September 2009, of the first public private partnership in Bhutan, to develop an IT Park, also marks the government's commitment to leverage foreign private investment flows into Bhutan.

Fiscal Sector

The National Budget for 2009/10, presented to the Assembly in July 2009, shows a marginal increase in total expenditure over 2008/09. It estimates a total expenditure of Nu27.4 billion (about USD550 million), more than a quarter of which goes to social services, health and education. Of the total expenditure, Nu13.6 billion is to be allocated to current expenditure, and the remaining Nu13.8 billion to capital expenditure (Table 1). Current expenditure estimated for 2009/10 is about 18 percent higher than the revised estimates for 2008/09. This reflects the salary revision that became effective when the National Assembly approved a uniform 35 percent salary hike to civil servants; salaries and wages account for 43 percent of current expenditure for 2009/10, compared to 23 percent in 2008/09. This is balanced somewhat by capital expenditure estimates for 2009/10 that are about 8 percent lower than the 2008/09 revised estimates.

Table 1: Major Fiscal Indicators

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	Actual	Actual	Actual	Revised	Proj.	Proj.	Proj.	Proj.
	<i>(in millions of ngultrum)</i>							
Total Revenue & Grants	13,595	16,673	18,317	23,926	21,498	23,342	24,741	26,455
Domestic Revenue	7,046	10,224	12,346	13,848	14,109	14,256	15,119	16,216
<i>Electricity Sector</i>	2,170	4,604	4,656	6,145	6,716	7,771	8,259	9,160
Grants	6,425	6,393	5,935	9,485	7,354	9,085	9,622	10,239
<i>From India</i>	3,417	3,466	4,671	5,833	4,373	6,816	7,267	7,719
Expenditure + Net Lending	13,531	15,292	17,913	25,520	26,304	26,754	28,788	31,186
Total Expenditure	13,357	15,166	19,693	26,958	27,421	27,665	30,310	32,708
<i>Current expenditure</i>	6,672	7,636	9,726	11,911	13,594	13,664	14,215	15,265
<i>Capital expenditure</i>	6,684	7,530	9,967	15,048	13,827	14,001	16,095	17,443
Net lending	49	126	-1,805	-1,439	-1,117	-910	-1,522	-1,522
Fiscal Balance (including all grants)	64	1,381	404	-1,594	-4,806	-3,413	-4,047	-4,731
Fiscal Balance (share of GDP)	0.2	3.0	0.7	-2.6	-6.9	-4.4	-4.6	-4.7

Source: Royal Government of Bhutan, Macroeconomic Framework Coordination Committee.

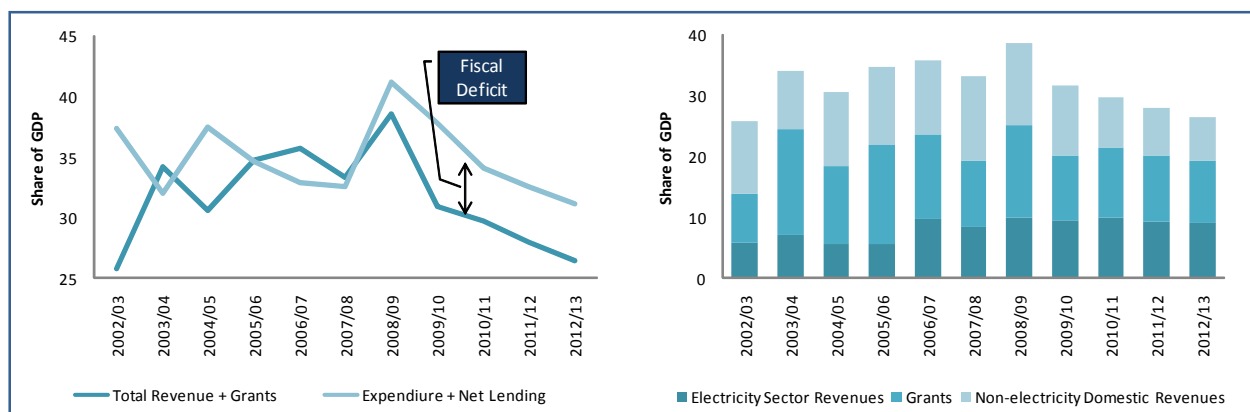
The 2008/09 revised estimates show significantly lower fiscal deficits than originally projected — largely on account of higher grants and domestic revenues. For 2008/09, against a budget estimate of

over 10 percent of GDP, the revised fiscal deficit is only about 2.6 percent — reflecting grant inflows (chiefly from India) that were almost three times as high as originally projected, as well as higher domestic revenues which include higher personal income tax due to the salary revisions, business income tax, and import and excise duties. The lower fiscal deficit was achieved in spite of total budgetary outlays being about 18 percent higher than originally planned.

The RGoB seeks to maintain sound macroeconomic performance over the medium term, and targets limiting the overall deficit (including grants) to less than 5 percent of GDP. The fiscal deficit is expected to average about 4.6 percent during the 10FYP (Table 1 and Figure 3). However, in 2009/10, the projected fiscal deficit is about 6.9 percent of GDP, reflecting: (i) an 18 percent increase in current expenditure over 2008/09 revised estimates, largely due to increased civil servant salaries, balanced somewhat by lower capital spending, and (ii) a projected decrease in grants (particularly those from India). The RGoB faces an estimated resource gap of Nu4.5 billion (about USD90 million) for 2009/10, and plans to introduce T-bills later this year to finance this. Going forward, grants are projected to pick up again from 2010/11, and, combined with slow growth in projected expenditures, are expected to contribute to fiscal deficits lower than 5 percent in the remaining years of the 10FYP.

Electricity and budgetary grants are the main projected sources of domestic revenue during the 10FYP, and attainment of fiscal goals depends critically on timely availability of these revenues. Budgetary grants account for almost 40 percent of Bhutan’s aggregate revenues during the 10FYP. About 80 percent of these budgetary grants during the 10FYP are expected to be tied to specific projects, while the remainder is classified as programmatic support. India alone accounts for almost 70 percent of budgetary grants during the 10FYP. At the same time, the share of electricity (taxes plus dividends) in aggregate revenue is estimated to rise from about a quarter in 2008/09 to over a third by the end of the 10FYP (Table 1 and Figure 3). Revenues from personal income tax and business income tax are projected to show modest increases, growing at between 6 and 10 percent annually during the 10FYP. As a share of aggregate revenues, however, non-electricity domestic revenues decline in importance from about a third in 2008/09 to about a quarter by 2012/13.

Figure 3: Key Fiscal Variables as Percentage Shares of GDP



Source: Royal Government of Bhutan, Macroeconomic Framework Coordination Committee. 2002/03 to 2007/08 are actual, 2008/09 is revised, remaining are projections. Grants denote on-budget grants only.

The country’s debt is projected to increase during the 10FYP, driven largely by borrowing for hydropower development. The debt-to-GDP ratio is projected to rise from about 56 percent of GDP in 2008/09 to over two-thirds of GDP by the end of the 10FYP (Table 2). However, this is less of a problem than the numbers might indicate; much of the country’s debts are external (accounting for almost 98 percent of total debt), owed to India and serviced automatically by hydropower receipts. The scheduled

debt-service payment as a share of exports of goods and services is projected to fall from over 13 percent to about 5.4 percent over the same period.

Table 2: Evolution in Key Indicators of Debt

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	<i>Actual</i>	<i>Actual</i>	<i>Actual</i>	<i>Revised</i>	<i>Proj.</i>	<i>Proj.</i>	<i>Proj.</i>	<i>Proj.</i>
Total government debt (% of GDP)	87.1	73.6	60.2	56.7	59.3	59.4	63.8	67.4
Foreign debt (% of GDP)	76.6	70.2	57.6	54.7	57.8	58.2	63.0	66.9
Hydropower debt (% of GDP)	53.7	45.0	36.3	32.4	32.7	36.3	45.2	55.1
Domestic debt (% of GDP)	10.5	3.4	2.6	2.0	1.5	1.1	0.8	0.5
External debt service (% of exports of G&S)	5.1	3.3	17.0	13.8	9.2	8.0	6.8	5.4

Source: Royal Government of Bhutan, Macroeconomic Framework Coordination Committee.

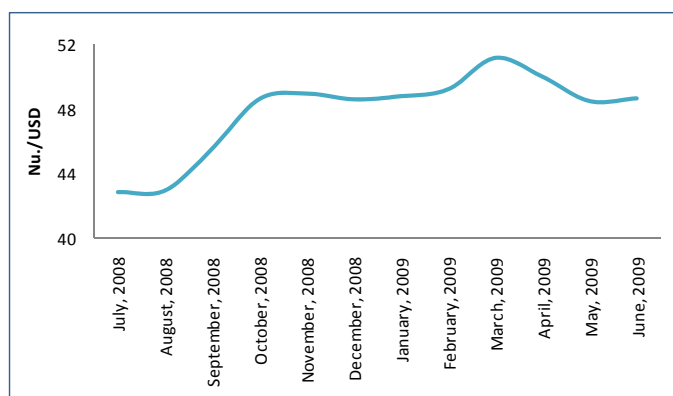
External Sector

The nominal exchange rate has depreciated during the last fiscal year. Overall, the ngultrum depreciated by almost 14 percent against the dollar between June 2008/09 and 2009/10, even though there has been appreciation in the second quarter of 2009 (Figure 4). This has put some pressure on the fiscal situation, through its effect on the repayment of convertible currency loans.

The current account balance is projected to worsen during the 10FYP, due to a deteriorating trade balance and increased interest payments.

The current account balance showed a surplus for the first time in many years in 2006/07, but is likely to go from a surplus 14.3 percent of GDP in 2006/07 to 3.9 percent of GDP in 2007/08, and further to a deficit of 10.1 percent in 2008/09 (Table 3). This is largely due to an increase in the trade deficit, particularly with India, and the start of interest payments for the Tala hydropower scheme. More than 80 percent of trade is with India, with electricity and base metals accounting for almost 75 percent of exports to that country. Trade in services constitutes less than 5 percent of aggregate external trade. There is a small deficit on the services account, contributing about 1.5-2.0 percent of the aggregate current account deficit during the 10FYP. Current account deficits are projected to average about 15-16 percent of GDP from 2008/09 to 2012/13, as domestic demand grows rapidly.

Figure 4: Trends in Nominal Exchange Rate



Source: International Financial Statistics, IMF.

The overall balance will continue to show a surplus during the 10FYP period, due to capital inflows. Robust capital inflows in the form of capital transfers from India, foreign direct investment (FDI), as well as loans and grants from development partners are expected to finance the current account deficit and enable a modest increase in gross international reserves. Bhutan had reserves equivalent to 17.8 months of import cover in May, 2009. FDI inflows are projected to increase at about 25 percent per annum during the 10FYP (Table 3), as the RGoB seeks to encourage partnerships with foreign companies, and adopts measures recommended under the FDI Policy (see Box 1 above).

Table 3: Key Indicators for the External Sector

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	Act.	Act.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account (millions of Nu)	-1695.7	6417.0	2089.4	-5961.5	-7999.5	-12239.6	-15083.5	-19586.6
Trade balance (millions of Nu)	-5496.7	2061.9	-3086.1	-10396.7	-11403.4	-13120.3	-14063.7	-16294.1
Exports, f.o.b.	13959.8	25333.8	18934.6	34512.3	38604.9	46588.9	58773.6	75208.3
Imports, c.i.f.	-19456.5	-23271.9	-22020.7	-44909.0	-50008.4	-59709.2	-72837.3	-91502.4
Current account balance (% of GDP)	-4.3	14.3	3.9	-10.1	-12.3	-16.9	-18.6	-21.6
Overall balance (millions of Nu)	5209.1	5184.4	2035.3	208.5	5251.4	5459.1	8947.4	4386.8
Overall balance (% of GDP)	13.2	11.6	3.8	0.4	8.1	7.5	11.0	4.8
Gross international reserves (millions of USD)	478.8	599.0	649.4	654.3	761.3	876.0	1063.2	1154.5
Exchange rate (Nu per USD) - FY avg	44.7	44.2	40.4	42.8	49.1	47.6	47.8	48.1

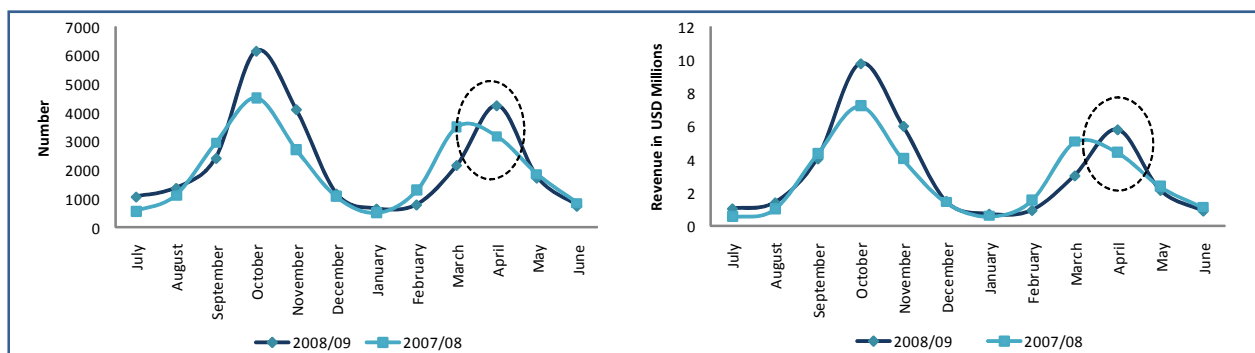
Source: Royal Monetary Authority

Vulnerabilities and Risks

The Bhutanese economy has not been seriously affected by the global economic crisis, even though there were limited impacts on the tourist and steel industries, from which the economy is gradually showing signs of recovery.

- Tourist arrivals and revenues declined by almost a third between the first quarter of 2008 and the first quarter of 2009. Comparing the second quarters of the two years, tourist arrivals are 15 percent higher and revenues 11 percent higher, indicating a sector recovery. However, this recovery is driven largely by tourist inflows in April; arrivals and revenues for May and June of 2009 are still marginally lower than in 2008 (Figure 5). Overall, compared to tourism revenues of USD33.6 million in 2007/08, the sector brought in USD37.3 million more in 2008/09. The current account deficit in 2008/09 would have been about 25 percent higher in the absence of tourism revenues amounting to about USD37.3 million. Going forward, tourism revenues are projected to grow at around 5-6 percent annually.

Figure 5: Trends in Tourist Arrivals and Tourism Revenues (Year-on-Year)



Source: Department of Tourism. Convertible currency paying tourists

- As commodity trading from India fell, there were reports of steel plant closures and job lay-offs in Bhutan in late 2008. In order to provide support, the RGoB introduced measures, including the reduction of penalties for late payment of power bills, deferral of bank loan repayments by six months and waiver of import duties on raw material. Latest reports show the steel industry has increased production from 3,500 MT to 4,200 MT per month due to an increase in demand for

steel from the Indian market, which absorbs about 60 percent of Bhutanese steel production. The revival is also reflected in the recent increase in steel prices of about 4-5 percent.

At the same time, the RGoB continues to face several macroeconomic risks. As a small country, Bhutan faces macroeconomic challenges that increase fiscal volatility. For example, as discussed above, the country's revenue stream is heavily dependent on the timing of hydropower projects coming onstream, and on external assistance materializing on schedule. Despite the global financial crisis, donors have not indicated a decline in their commitments to Bhutan. Against this backdrop, the RGoB has adopted a Budget Policy and Fiscal Framework Statement (BPFSS) in its policy analysis, to try to ensure and maintain prudent macroeconomic policies which will help mitigate such volatility.

Prudent monetary policies have helped maintain financial stability. Bhutan's financial sector appears stable, as indicated by a high Capital Adequacy Ratio (16.55 percent). The relative insulation of Bhutan's financial sector from the global financial system has helped protect it from a direct systemic banking failure due to the global financial crisis. Non-Performing Loans (NPLs) in the financial sector have remained mostly unaffected by the global financial turmoil.

World Bank Assistance to Bhutan in FY10

With the objective of assisting the RGoB to improve its policies, the World Bank Group is involved in two important pieces of analytical work in the country.

1. Investment Climate Assessment

Following an Investment Climate Assessment for Bhutan, undertaken in 2002, the Bank group is currently engaged in a follow-up. A survey of 248 firms — covering Thimphu, Phuentsholing, Gelephu, and Samdrup — was completed in June 2009. The survey encompasses firms of various sizes in the industry and services sectors. Preliminary results have been discussed in a workshop in Thimphu in June. They suggest that the private sector finds insufficient access to finance, inadequately educated labor force, labor regulations, tax rates, and transportation to be major obstacles to business development in Bhutan. Results from the enterprise survey, ranking access to credit as the leading investment climate constraint, thus confirms the low rank of Bhutan's credit accessibility in the Doing Business Report 2010, referred to above. Small firms in particular cite limited access to finance as a constraint, while the larger firms are more affected by inadequate education of the labor force. In contrast, key positive factors that confer a regional comparative advantage to Bhutan include political stability, very low crime rates, and the availability of electricity — reflective of the country's hydropower assets. It is expected that the assessment will provide a platform for further discussion between the RGoB and the Bank group on reforms to improve the investment climate.

2. Poverty Mapping

Under the 10FYP, the RGoB seeks to introduce a formula-based resource allocation mechanism for block transfers from the central government to *gewog* (sub-district) governments. The formula includes poverty estimates at the *gewog* level, which were not available. The Gross National Happiness Commission (GNHC) and National Statistical Bureau (NSB) requested the World Bank to provide technical assistance in producing statistically-reliable poverty estimates at the *gewog* level, and in building capacity at the NSB for the estimation method. The "small area estimation" methodology, which produces statistically reliable poverty estimates for small areas by exploiting the strengths of both the Population Census 2005 and the Bhutan Living Standard Survey 2007, has been adopted for this purpose. The preliminary results from this exercise were shared with a Technical Committee in June, and training sessions have been organized for NSB and GNHC staff. The final results of this exercise were presented in September 2009, and will be used to strengthen the resource allocation framework.

Conclusion

The RGoB recently announced its budget for 2009/10, supporting the 10FYP objective of achieving poverty reduction within a sound macroeconomic framework. The 10FYP projects somewhat slower growth than the 9FYP, but ambitious hydropower development plans are expected to yield future dividends in growth and revenue.

While the fiscal deficit is expected to average under 5 percent during the 10FYP, the deficit is expected to widen in 2009/10. Bhutan's debt is projected to increase during the 10FYP, but this is largely on account of hydropower development loans, expected to be serviced automatically by hydropower receipts. The current account is expected to deteriorate due to a worsening trade balance and interest payments on hydropower loans, although capital transfers from India, foreign direct investments, and loans and grants from development partners are expected to finance this, and enable a modest increase in gross international reserves. Cautious monetary policies have helped to lower inflation and domestic credit growth, and, even though growth in credit to the private sector is high, access to finance remains a major barrier to private sector investment.

The Bhutanese economy was largely isolated from the global economic crisis, and is showing signs of recovering from limited negative impacts on tourism and the steel industry. However, the country remains vulnerable to macroeconomic volatility on account of its dependence on hydropower revenues and external assistance.

Against this backdrop, the Bank group is involved in two key pieces of analytical work. The Investment Climate Assessment will help identify critical constraints for the private sector, and provide a platform for further dialogue with the RGoB on private sector development reforms (including for reforms to be supported under the Development Policy Operation now in preparation). This is in line with the RGoB's 10FYP objectives for promoting employment opportunities and fostering an enabling environment for industrial development. The poverty mapping work will help produce statistically reliable estimates of poverty at the *gewog* level, and help improve the resource allocation framework, in line with the RGoB's 10FYP goals for improving national spatial planning, and strengthening decentralized governance. ■