

April, 2010

Bhutan Economic Update



*Economic Policy and Poverty, and
Finance and Private Sector Team
South Asia Region*

The World Bank

Summary

- *Real economic growth exceeded 6 percent in 2008/09, but was below the 11-14 percent of the two previous years. However, ambitious plans for hydropower development are expected to yield dividends in growth and revenue in the coming years.*
- *The past year saw a decline of US\$7 million in annual tourism revenues from the levels of 2008, and an estimated loss of US\$67 million due to earthquake and cyclone damage.*
- *A fiscal deficit of more than 4.5 percent is projected for 2009/10, though this is expected to reduce over the next few years.*
- *Bhutan's debt is projected to increase significantly, but the risk of debt distress in the medium term is 'moderate', since the debt build-up is due largely to hydropower development loans that can be serviced with hydropower receipts.*
- *The current account is projected to weaken in the next few years due to a 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.*
- *The authorities are taking important steps to promote private sector development by improving the policy environment and liberalizing the financial sector.*
- *While the outlook for Bhutan remains bright, the authorities should guard against overheating and economic volatility.*

¹ Prepared by Ananya Basu, with inputs from Cecile Niang, Nobuo Yoshida, and Apichoke Kotikula.

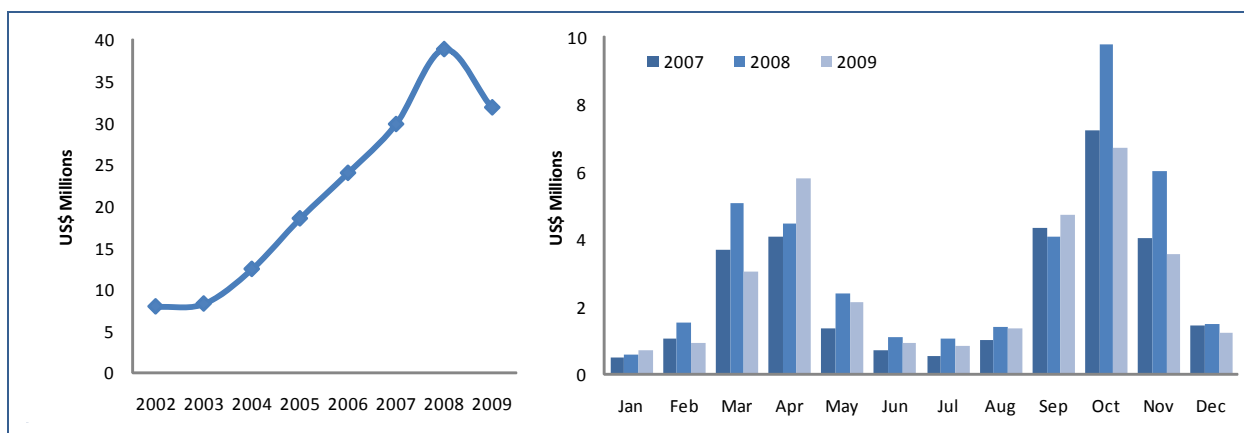
Recent Developments

Real Sector

Real economic growth was above 6 percent in 2008/09, lower than that of the past couple of years. Bhutan averaged about 9 percent annual economic growth during the Ninth Five-Year Plan (9FYP: 2002/03–2007/08, extended by one year), but this is projected to slow slightly during the Tenth Five-Year Plan (10FYP: 2008/09–2012/13). During the 9FYP, the economy was driven largely by growth of 11–14 percent in 2006/07 and 2007/08, as the Tala hydropower project came onstream, trebling Bhutan’s power generation capacity. Growth slowed to about 6.2 percent in 2008/09. The per capita Gross National Income was estimated to be over US\$2,000 in 2009 — higher than that of other South Asia Region countries, except the Maldives. To sustain a targeted real growth rate of almost 8 percent during the 10FYP, the Royal Government of Bhutan (RGoB) intends to focus on electricity and construction of hydropower projects as its main sources of growth.

Updated annual data shows that tourism revenues have fallen in 2009. The Bhutanese economy was not seriously affected by the global economic crisis. However, figures for the final months of 2009 reveal a decline of US\$7 million in annual revenues from convertible currency tourism compared to 2008 figures of approximately US\$39 million. Earnings in the last quarter of 2009 are 33 percent below the corresponding 2008 figures, indicating that sector recovery is still some distance away.

Figure 1: Trends in Tourist Revenues



Source: Tourism Council of Bhutan. Convertible currency paying tourists.

Damage from natural disasters cost Bhutan about US\$67 million in 2009. An earthquake measuring 6.1 on the Richter scale struck eastern Bhutan on September 21, 2009. Over one thousand structures — including roads, houses, schools, historical monuments, and government offices — were reportedly damaged, mainly in the Mongar and Trashigang districts. The cost of the damage is estimated to be US\$52 million. In addition, damage from Cyclone Aila in May is reported to be around US\$15 million.

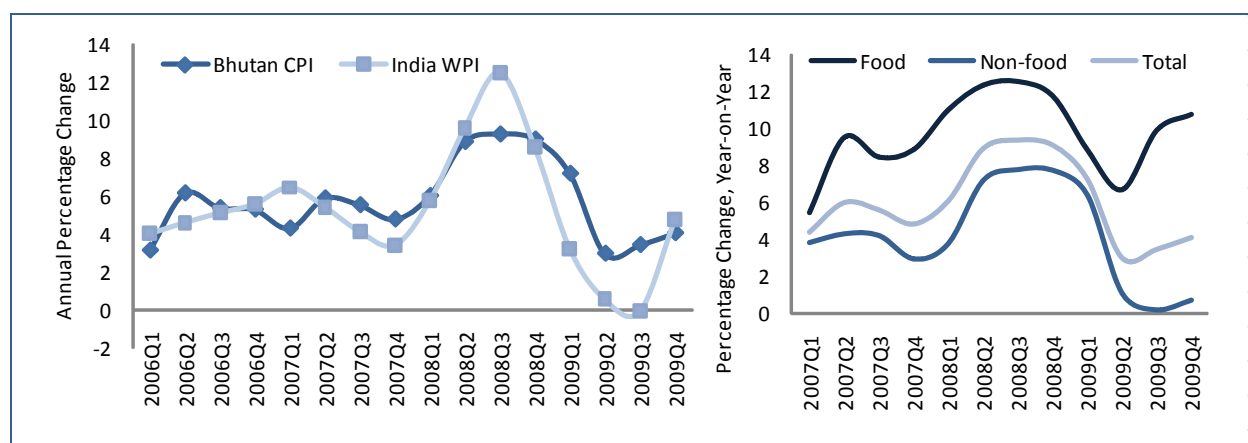
Hydropower is a major engine of growth and public revenue in the medium term, and the RGoB has ambitious plans for the sector. The kingdom has the potential to develop capacity of 23,760 MW, of which only 5 percent has been tapped so far. Under the 10FYP, the installed hydropower generation capacity is projected to rise 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 to develop 10 hydropower projects — six under an ‘intergovernmental model’ of 30 percent grant and 70 percent loan from India,

and four under a joint venture model whereby public sector companies from both countries will implement the projects. Construction work on Punatsangchhu I hydropower project is under way, and construction on Punatsangchhu II and Mangdechhu hydropower projects is due to commence shortly.

Financial Sector

After some easing of inflationary pressure from the elevated levels of late-2008, there are signs that food inflation is resurging. 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. With the easing of inflationary pressure in India due to a sharp drop in global oil and commodity prices, Bhutan's headline inflation rate dropped to 3 percent in the second quarter of 2009, from over 9 percent in the third quarter of 2008. However, the last half of 2009 has seen a slight increase in overall inflation due to higher prices of rice, meat, and vegetables on account of supply shocks from India, from where three-quarters of commodities are imported. Food inflation (which accounts for close to 32 percent of the Consumer Price Index basket) went up by 4.1 percentage points from the second quarter.

Figure 2: Inflation Trends and Components



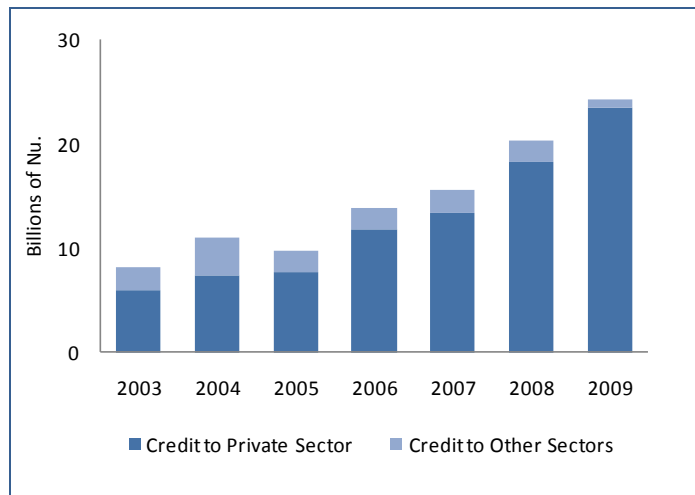
Source: National Statistics Bureau of Bhutan, Consumer Price Index (2003 = 100), and Reserve Bank of India, Wholesale Price Index of All Commodities (1993/94 = 100).

Domestic credit growth has been curtailed due to cautious monetary policy, although growth of credit to the private sector remains high. The total volume of credit provided by four financial institutions has increased from Nu8.15 billion to Nu24.25 billion between June 2003 and June 2009 (Figure 3). Credit to the private sector accounted for about 97 percent of the total outstanding credit in June 2009, showing a 28.7 percent increase from 2008. The building and construction sector constituted the highest share with 25 percent, followed by trade & commerce with 17 percent, and services & tourism with 13 percent.

An Investment Climate Assessment (ICA) for Bhutan reveals some key constraints to private sector development. The World Bank Group is currently engaged in an ICA follow-up to the one undertaken in 2002. For the current one, 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. They suggest that the private sector finds insufficient access to finance, inadequately educated labor force, labor regulations, transportation, and regulatory procedures to be major obstacles to business development in Bhutan (Figure 4). Results from the enterprise survey, ranking access to credit as the leading investment climate constraint, thus confirms the low rank of

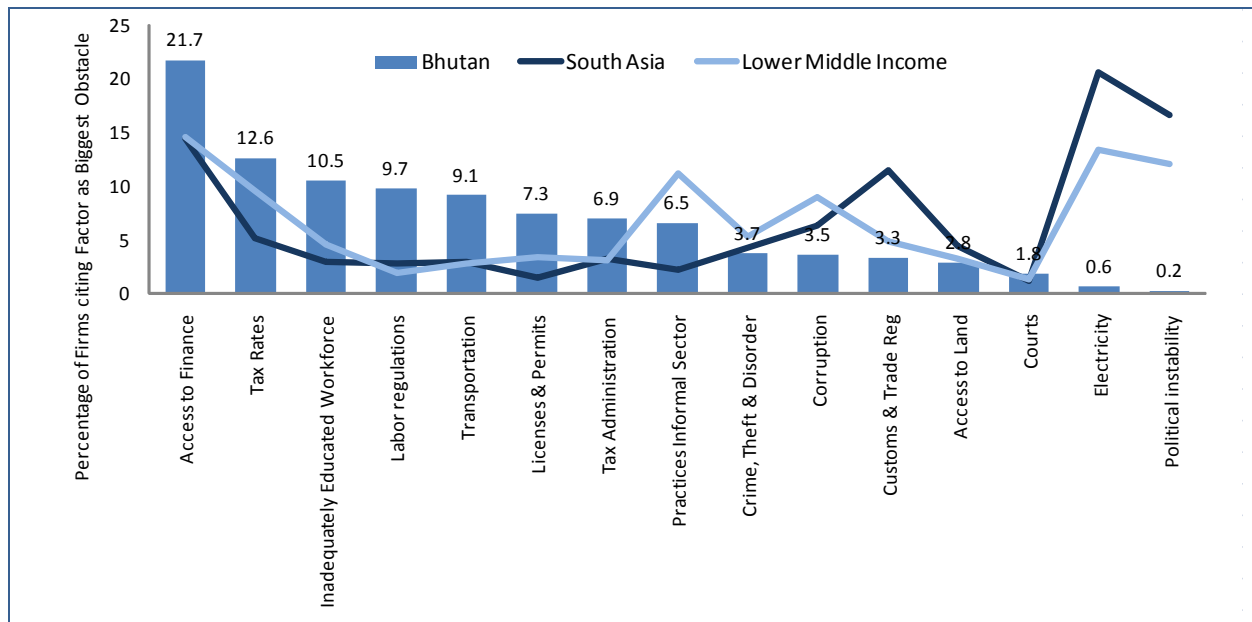
Bhutan's credit accessibility in the Doing Business Report 2010, which places it 177th out of 183 countries. Small firms in particular cite limited access to finance as a constraint, while larger firms are more affected by inadequate education of the labor force. In contrast, key positive factors that 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. Productivity analysis reveals that, while labor costs are higher than in other parts of the region, labor productivity is high in Bhutan, and suggests that the country should be able to compete in niche services sectors. The assessment will provide a platform for further discussion between the RGoB and the World Bank Group on short and medium term reforms to improve the investment climate.

Figure 3: Trends in Credit Growth



Source: Royal Monetary Authority.

Figure 4: Biggest Obstacles to Private Sector Development in Bhutan



Source: Investment Climate Enterprise Survey, 2009. The 248 firms surveyed were asked which of the fifteen factors above they considered obstacles, and to rate them in importance.

Financial sector liberalization is well underway and should help to effectively meet the financial needs of the private sector. Bhutan's Central Bank, the Royal Monetary Authority (RMA), has taken steps to foster competition in the financial sector by issuing three new bank licenses and one additional insurance license. As a result, the number of financial institutions more than doubled in the first quarter of 2010. The two new private banks, Druk Punjab National Bank and Tashi Bank, are rapidly rolling out their operations in Bhutan. Bhutan Development Bank has also received a specialized bank license, and a

new insurance company, Bhutan Insurance Limited, launched operations in August 2009. Regulations accompanying these new licenses require these financial institutions to float at least 30 percent of their paid-up capital to the public. Increased financial sector liberalization, combined with positive financial sector reforms during 2009 — notably the launch of a Credit Information Bureau and the revised Royal Monetary Authority Act — are expected to increase the efficiency and depth of the financial sector. In April 2010, the RGoB has also issued guidelines permitting External Commercial Borrowing by companies incorporated under the Companies Act.

The RGoB embarked on important private sector development reforms in 2009, with the drafting of three new investor-friendly policies. The Economic Development Policy (EDP), released in April, 2010, 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, currently being finalized, aims to encourage more FDIs to broaden the employment and revenue base, to benefit from technology transfer, and to increase foreign exchange earnings. In addition a Mineral Development Policy was approved in 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 2010/11, to draft new rules and regulations to operationalize these policies. The signing, in September 2009, of the first public-private partnership in Bhutan, to develop an Information Technology Park, also marked the government's commitment to leverage foreign private investment flows into Bhutan. A Framework for Private Partnership in Infrastructure was approved by a Cabinet meeting in March, 2010. This will form the basis for a Public-Private Partnership Policy.

Fiscal Sector

The currently projected fiscal deficit for 2009/10 is above 4.5 percent, following surpluses of the past four years. This reflects total expenditures that are about one-third higher than 2008/09 revised estimates, due largely to increased civil servant salaries, and higher development spending, balanced partly by a projected increase in grants (particularly those from India). 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 3.5 percent during the remaining years of the 10FYP (Table 1). The RGoB faces an estimated resource gap of Nu4.3 billion (about US\$90 million) for 2009/10, and has introduced T-bills from earlier this year to finance the same. Grants are projected to increase and, combined with slower growth in forecasted expenditures, are expected to contribute to fiscal deficits lower than 5 percent in the remaining years of the 10FYP.

The 2008/09 revised estimates show significantly better fiscal outcomes than originally projected — largely on account of higher grants and domestic revenues. For 2008/09, against an estimated fiscal deficit of over 10 percent of GDP, the revised fiscal surplus is about 2.3 percent — reflecting grant inflows (chiefly from India) which were higher than originally projected, increased domestic revenues which include higher personal income tax due to recent salary revisions, business income tax, and import and excise duties. This accrued in spite of total budgetary outlays being higher than originally planned.

Electricity and budgetary grants are the main projected sources of domestic revenue during the 10FYP, and attainment of fiscal goals depends critically on timely inflow of these revenues. Budgetary grants account for almost 40 percent of Bhutan's aggregate revenues during the 10FYP (Figure 5). More than 80 percent of these budgetary grants during the 10FYP is expected to be tied to specific projects, with the remainder classified as programmatic support. India alone accounts for more than 70 percent of budgetary grants during the 10FYP. At the same time, the share of electricity (taxes plus dividends) in domestic revenue is expected to rise from about 43 percent in 2008/09 to over 53 percent by

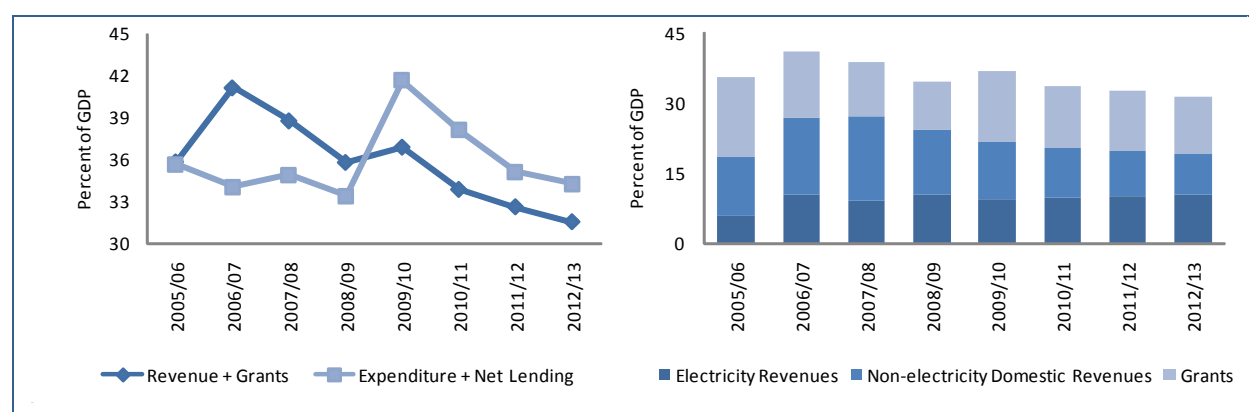
the end of the 10FYP (Table 1). Revenues from personal income tax and business income tax are projected to show modest increases, growing at between 6 and 10 percent annually during the 10FYP. As a share of aggregate revenues, however, non-electricity domestic revenues decline in importance from about a third in 2008/09 to about a quarter by 2012/13.

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 | Estimated | Projected | Projected | Projected |
| | (in millions of ngultrum) | | | | | | | |
| Total Revenue + Grants | 13,595 | 18,473 | 20,067 | 20,742 | 24,281 | 24,949 | 26,716 | 28,674 |
| Domestic Revenue | 7,046 | 12,024 | 14,096 | 13,993 | 14,364 | 15,065 | 16,229 | 17,503 |
| <i>Electricity Sector</i> | 2,170 | 4,604 | 4,656 | 5,976 | 6,107 | 7,149 | 8,278 | 9,345 |
| Grants | 6,425 | 6,393 | 5,935 | 6,157 | 9,881 | 9,884 | 10,487 | 11,171 |
| <i>From India</i> | 3,417 | 3,466 | 4,671 | 2,505 | 6,900 | 7,615 | 8,133 | 8,651 |
| Expenditure + Net Lending | 13,531 | 15,292 | 18,065 | 19,386 | 27,399 | 28,082 | 28,788 | 31,186 |
| Total Expenditure | 13,357 | 15,166 | 19,693 | 20,824 | 28,345 | 28,948 | 30,515 | 32,913 |
| <i>Current Expenditure</i> | 6,672 | 7,636 | 9,726 | 11,060 | 13,738 | 14,225 | 14,773 | 15,852 |
| <i>Capital Expenditure</i> | 6,684 | 7,530 | 9,967 | 9,764 | 14,607 | 14,722 | 15,742 | 17,061 |
| Net Lending | 49 | 126 | -1,654 | -1,439 | -946 | -866 | -1,727 | -1,727 |
| Fiscal Balance (including all grants) | 64 | 3,181 | 2,002 | 1,356 | -3,118 | -3,133 | -2,072 | -2,512 |
| Fiscal Balance (share of GDP) | 0.2 | 7.1 | 3.9 | 2.3 | -4.7 | -4.2 | -2.5 | -2.8 |

Source: Royal Government of Bhutan, Macroeconomic Framework Coordination Committee. December 2009.

Figure 5: Key Fiscal Variables as Percentage Share of GDP



Source: Royal Government of Bhutan, Macroeconomic Framework Coordination Committee. December 2009. 2002/03 to 2007/08 are actual, 2008/09 is revised, and the remaining are projections. Grants are on-budget 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 54 percent in 2008/09 to about 80 percent by the end of the 10FYP (Table 2). This is less of a problem than the numbers might indicate. Almost 98 percent of the country's debts are external, owed to India and serviced automatically by hydropower receipts. Hydropower projects bring strong growth dividends, boosting the average real GDP growth and exports. The external debt service ratio as a share of exports of goods and services is expected to decline from more than 14 percent to below 13 percent during the 10FYP. A joint IMF / World Bank Debt Sustainability Analysis (DSA) suggests moderate risk of debt distress over 2008/09–2028/29, supported by: (i) Bhutan's strong track record of project implementation; (ii) commercial viability of new hydropower projects; and (iii) Bhutan's close economic and political ties with India

which render minimal the commercial risks of these projects, as India is both the main provider of financing for hydropower projects and the main consumer of the projects' output.

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>Projected</i> | <i>Projected</i> | <i>Projected</i> | <i>Projected</i> |
| Total Government Debt (% of GDP) | 89.6 | 76.3 | 62.3 | 54.2 | 59.5 | 65.3 | 74.3 | 80.3 |
| Foreign Debt (% of GDP) | 78.8 | 72.7 | 59.6 | 52.1 | 57.9 | 64.1 | 73.4 | 79.8 |
| Of which Hydropower Debt (% of GDP) | 53.7 | 46.7 | 38.3 | 33.9 | 40.5 | 46.3 | 56.0 | 64.0 |
| Domestic Debt (% of GDP) | 10.8 | 3.5 | 2.7 | 2.1 | 1.6 | 1.2 | 0.9 | 0.6 |
| External Debt Service (% of exports of G&S) | 5.1 | 3.3 | 13.7 | 14.3 | 14.2 | 13.9 | 13.3 | 12.7 |

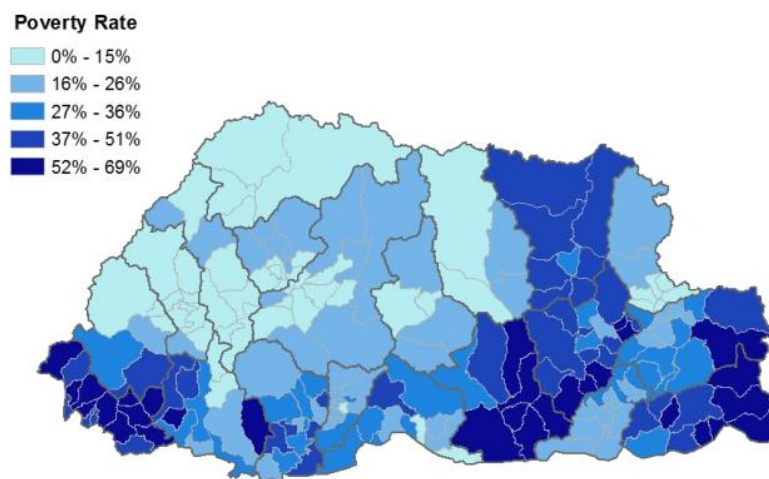
Source: Royal Government of Bhutan, Macroeconomic Framework Coordination Committee. December 2009.

The RGoB is taking important steps to enhance equity in resource allocation. Under the 10FYP, the RGoB seeks to introduce a formula-based resource allocation mechanism for block transfers from the central government to *dzongkhag* (district) and *gewog* (sub-district) governments. The formula includes poverty estimates at the *gewog* level. Towards this end, the RGoB has worked to produce poverty estimates at the *gewog* level, which were not available earlier. It is expected that these estimates will be used to strengthen the resource allocation framework in the upcoming budget year.

Box 1: Poverty Mapping in Bhutan

In order to produce *gewog* level poverty estimates to enhance the formula-based resource allocation mechanism for block transfers from the central government to *dzongkhag* (district) and *gewog* (sub-district) governments, the Gross National Happiness Commission (GNHC) and National Statistical Bureau (NSB) requested the World Bank to provide technical assistance. The Bank worked with the GNHC and NSB to produce statistically-reliable poverty estimates at the *gewog* level, and to build 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 at a workshop in Thimphu in September 2009 (Figure A).

Figure A: Rural Poverty Map of Bhutan: Gewog Level



Source: Bhutan Living Standards Survey 2007, and Population Household Census 2005.

External Sector

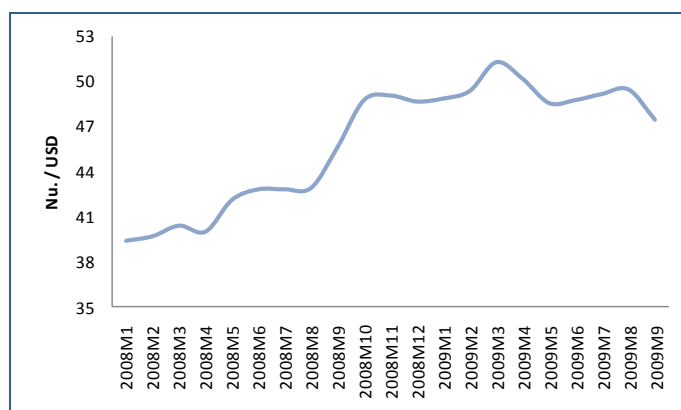
The nominal exchange rate depreciated over the last year. Overall, the ngultrum depreciated by about 11 percent against the US dollar between 2008 and 2009, even though there has been appreciation in the second and third quarters of 2009 (Figure 6).

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 in 2006/07, for the first time in many years, but is likely to go from a surplus of 14.3 percent of GDP in 2006/07 to a deficit of 2.1 percent of GDP in 2007/08, and further to a deficit of 4.5 percent in 2008/09 (Table 3). This is due largely 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 10 percent of GDP from 2009/10 to 2012/13, as domestic demand grows rapidly.

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, 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 more than 12 months of import cover in 2009.

Figure 6: Trends in Nominal Exchange Rate



Source: National Statistical Bureau.

Table 3: Key Indicators for the External Sector

| | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 | 2012/13 |
|--|----------|----------|----------|----------|-----------|-----------|-----------|-----------|
| | Actual | Actual | Actual | Revised | Projected | Projected | Projected | Projected |
| Current account (millions of Nu.) | -1695.7 | 6417.0 | -1080.4 | -2626.9 | -7576.4 | -8639.1 | -8719.9 | -6281.3 |
| Trade balance (millions of Nu.) | -5496.7 | 2061.9 | -2921.7 | -7573.0 | -9222.5 | -9386.1 | -9085.9 | -7640.4 |
| Exports, f.o.b. | 13959.8 | 25333.8 | 24170.8 | 21833.7 | 23460.9 | 25484.8 | 27645.1 | 30559.2 |
| Imports, c.i.f. | -19456.5 | -23271.9 | -27092.4 | -29406.7 | -32683.3 | -34870.8 | -36731.1 | -38199.6 |
| Current account balance (% of GDP) | -4.3 | 14.3 | -2.1 | -4.5 | -11.5 | -11.7 | -10.5 | -6.7 |
| Overall balance (millions of Nu.) | 5209.1 | 5054.7 | 1957.0 | 5057.8 | 643.7 | 2561.8 | 8436.1 | 13366.6 |
| Gross international reserves (millions of USD) | 478.8 | 600.4 | 645.7 | 758.2 | 791.5 | 844.6 | 1019.5 | 1295.8 |
| (In months of imports of GNFS) | 11.8 | 11.4 | 10.1 | 13.5 | 12.2 | 12.2 | 14.0 | 17.2 |

Source: Royal Government of Bhutan, Macroeconomic Framework Coordination Committee. December 2009.

Foreign Direct Investment (FDI) is likely to increase during the 10FYP. FDI inflows are projected to increase at about 25 percent per annum during the 10FYP, as the RGoB seeks to encourage partnerships with foreign companies. A Public-Private Partnership (PPP) contract was signed between the RGoB, and a joint venture between the Singapore holding of the global developer, Assetz Property Group, and

Bhutan's national holding company, Druk Holding and Investments, for the construction of the first Information Technology (IT) Park in Bhutan. The Oberoi Group has also indicated its plan to build a 75-room luxury resort in Bhutan with a projected cost of US\$10.5 million. This resort is expected to employ 150 people, of which 90 percent will be Bhutanese.

Vulnerabilities and Risks

While the overall macroeconomic outlook remains bright, implementation of Bhutan's development agenda is subject to several constraints. These include: (i) economic constraints associated with debt sustainability, potential overheating due to spillovers from the hydropower and development spending, financial sector vulnerabilities, and gaps in reserve management; (ii) resource constraints from uncertain donor support, especially in the aftermath of the financial crisis; and (iii) implementation capacity constraints within Bhutan.

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. 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. With the sharp rise in the 2009/10 budget deficit, spending prioritization with a near-term tightening bias is needed to avoid stoking excess demand. In the medium term, revenue expansion and prudent expenditure planning are needed to limit domestic debt buildup.

With rapid credit growth, financial sector vulnerabilities are on the rise. Credit growth averaged about 30 percent over the last decade, and there are signs of deteriorating asset quality. Banks' non-performing loans (NPLs) more than doubled to 18 percent of total loans between December 2008 and June 2009. Banks also have maturity mismatches due to the long term-structure of these loans and the short-term corporate deposits that dominate the funding base. Strengthening the supervision function of the RMA will be helpful in the context of NPLs and entry of new financial institutions in the sector.

Conclusion

The outlook for Bhutan remains bright. At the same time, the country remains vulnerable to macroeconomic volatility on account of its dependence on hydropower revenues and external assistance, and potential overheating from higher development spending and credit growth.

The 10FYP projects somewhat slower growth than the 9FYP, but ambitious hydropower development plans are expected to yield future dividends in growth and revenue. The Bhutanese economy was largely isolated from the global economic crisis, but has been affected by natural disasters and declining tourism revenues in the past year.

While the fiscal deficit is expected to average less than 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 will likely finance this, and enable a modest increase in gross international reserves. The authorities are taking important steps to promote private sector development, by improving the policy environment and liberalizing the financial sector.