

this work will initially help identify the extent of applicability of the country systems to Bank-financed projects, and the steps needed to ensure this applicability.

### C. Monitoring Implementation and Results

117. The results matrix described in Section IV-A and Attachment 8 indicate a set of priority outcome objectives that the Bank expects to influence during the CAS period, outcome indicators to measure impact, and intermediate indicators / milestones that will be used to assess progress toward these outcomes.

118. Gender will continue to be mainstreamed through the project design of IDA-financed operations in Bhutan, as it was done recently in the HIV/AIDS Prevention Project and the Decentralized Rural Development Project. The gender-specific impact of Bank assistance will be monitored whenever feasible.

119. Implementation of the 9FYP will finish in June 2007, and the 10FYP/PRSP will cover FY07 to FY11. As such, the CAS Progress Report, which should be prepared towards the end of FY07, will be a critical instrument to assess progress in CAS implementation, and adjust the strategy to address any changes in priorities and/or country conditions.

## VI. MANAGING RISKS

120. **Key Economic Assumptions.** The successful implementation of the 9FYP/PRSP, which the proposed CAS supports, is predicated on several assumptions. If these do not materialize, the development progress of Bhutan would be seriously imperiled. Given the dependence on hydropower (expected to account for about 25 percent of GDP and about 50 percent of total government revenues once Tala comes on stream), a key assumption is that the strong commercial ties with India will continue, involving both the sale of electricity and the financing of new hydropower projects. Development prospects will also hinge on continued donor support, especially from India, which has agreed to provide program grants through the last year of the 9FYP/PRSP, though at lower levels. Finally, the macro-framework assumes that macroeconomic management will continue to be sound in the years ahead, maintaining the fixed exchange rate, containing inflation, and managing fiscal imbalances and debt stocks. These risks are mitigated by the historically strong ties between Bhutan and India, and the GoI's recent agreement to increase the power tariff paid on electricity sales from Chukha. The Royal Government is also endeavoring to strengthen its macro/fiscal management capacity, and these efforts will be supported during CAS implementation. Moreover, the country continues to maintain a high level of reserves to ensure the sustainability of the exchange rate parity with the Indian rupee.

121. **Political Reform.** As noted above, a new Constitution is being finalized, which in the medium term is to herald a democratically elected national government. The impact of this on the political process is difficult to forecast. The democratic machinery, in terms of forming political parties, managing the electoral process, and ensuring adequate advisory support for the National Council, may face capacity constraints. However, the process being followed is highly participatory and being paced to allow national capacity building to implement the required changes in the political system. Policy makers have shown strong commitment to implementing the reform agenda underpinning the country's 9FYP/PRSP.

122. **Natural / External Hazards.** The mountains in Bhutan are comparatively young in geological terms, and monsoon-induced landslides are a significant risk, damaging roads and leading to the phenomenon of glacial lake outburst flooding. Bhutan is also vulnerable to other potential

hazards outside of its control, such as epidemics like SARS and avian influenza or terrorism in other parts of the world hurting tourism. Following the September 11 attacks in the United States and epidemic outbreaks in Asia, tourist arrivals to Bhutan fell sharply, and it has taken three years for the number of tourist arrivals to return to previous levels. Improving land management, using environmentally friendly road construction methods, providing adequate resources for operations and maintenance, and monitoring glacial lakes prone to bursting, are some of the relevant mitigating factors. An additional risk is the possible re-emergence of disturbances in border areas with India, which could impinge the movement of goods and people in Bhutan and harm trade with India. Bhutan and India, however, continue to collaborate closely to maintain the situation under control.

123. **Capacity Issues Related to Ambitious Targets and Increased Revenue.** The implementation of government programs and initiatives, especially in the area of decentralization, faces capacity constraints. In general, managing donors active in Bhutan is challenging at the various government levels. Capacity is particularly weak at the local level, and at times local officials find it difficult to implement donor-financed projects. In addition, governance institutions for ensuring transparency and accountability will need to be strengthened as the revenues from Tala accrue, if these are to have maximum development impact. These risks are mitigated by strong leadership, ongoing efforts to steadily build capacity, and growing efforts to improve donor coordination and harmonization, and to use country systems as these are strengthened. There is also a good precedent in the case of Bhutan that despite capacity constraints, increased revenues from hydropower development have been used efficiently to promote country priorities regarding human development and infrastructure. Historically, RGoB has spent heavily on services aimed at helping the poor, such as primary education, primary health, and rural access. To help the government in this endeavor, it was agreed to make strengthening the management of public resources a pillar of this CAS.

124. **Development Policy-Based Financial Support.** As noted above, the proposed Development Policy Grant (FY06) is the first policy-based operation in Bhutan. There is a risk that the preparation of the operation may not proceed at the needed pace, and it may take longer to define the components of the reform program to be supported by the Bank or to implement some of the agreed actions. A delay in the DPG would heighten the need for domestic financing. Nevertheless, RGoB has demonstrated its commitment to the reform agenda, and the deepening of the policy and reform dialogue should help mitigate this risk.