

BHUTAN DEVELOPMENT UPDATE

November 2018

Accelerating Reform Momentum



Macroeconomics, Trade, and Investment
Global Practice



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Government Fiscal Year: July 1–June 30
Currency Equivalent: Exchange Rate Effective as of November 2, 2018
Currency Unit = Ngultrum (Nu)
US\$1 = Nu 73
Weights and Measures: Metric System

Abbreviations and Acronyms

CAR	Capital Adequacy Ratio
CPI	Consumer Price Index
CSI	Cottage and Small Industry
DHI	Druk Holding and Investments
DNT	Druk Nyamrup Tshogpa
DPT	Druk Phuensum Tshogpa
DSA	Debt Sustainability Analysis
FDI	Foreign Direct Investment
FY	Fiscal Year
FYP	Five-Year Plan
GDP	Gross Domestic Product
GNHC	Gross National Happiness Commission
IMF	International Monetary Fund
MoF	Ministry of Finance
NKRA	National Key Results Area
NPL	Nonperforming Loan
NSB	National Statistics Bureau
PPP	Purchasing Power Parity
PSL	Priority Sector Lending
REER	Real Effective Exchange Rate
RMA	Royal Monetary Authority
ROA	Return on Asset
RWCAR	Risk-Weighted Capital Adequacy Ratio
SDG	Sustainable Development Goal
SOEs	State-Owned Enterprises
VNR	Voluntary National Review
WPI	Wholesale Price Index

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ACKNOWLEDGMENTS

The Bhutan Development Update reports on recent economic developments and places them in medium-term and regional and global contexts. 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 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 and Economist) 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

Economic performance remains strong. Accelerating reform momentum after the 2018 general elections will be key to consolidating and furthering Bhutan's development. Efforts aimed at enabling a vibrant and job-creating private sector will need to be prioritized. The hydropower sector has served Bhutan well, but it has not created enough jobs for the country's educated youth. In addition, the sector has also witnessed construction delays in the past few years, which have adversely impacted growth, revenues, and exports.

Recent Developments

Bhutan successfully conducted their third Parliamentary elections in 2018. The upper house election was held in April 2018, followed by the lower house elections in September and October 2018. The new government was formed in early November and its first tasks are to revise the FY2018/19 budget (an interim budget is currently in place) and endorse the 12th Five-Year Plan (FYP).

Economic growth in FY2017/18 is estimated at 5.8 percent. Delays in hydropower construction and decline in electricity generation hampered growth. However, services growth remained buoyant, primarily driven by financial services, hotels and restaurants. Macroeconomic stability has been maintained. Prices remained stable, the fiscal deficit was contained, and despite a large current account deficit, international reserves remain comfortable at 11 months of imports of goods and services. External debt remains high, but is not on an increasing trajectory and the risk of debt distress is deemed moderate.

Outlook

Economic growth is projected to average 6 percent a year over the medium term, largely supported by ongoing hydropower projects and the services sector, especially tourism. With the completion of the Mangdechhu hydropower project in late 2018, exports are likely to increase in FY2019/20, while imports are expected to decline because of lower capital goods imports for hydropower projects, as well as overall lower public investment, narrowing the current account deficit to 12 percent of gross domestic product (GDP) by FY2020/21. In addition, external debt as a share of GDP is expected to decline to 88 percent due to elevated repayments and faster GDP growth. With lower public capital spending during the first few years of the new 12th FYP, the fiscal deficit is likely to remain below 2 percent of GDP during the forecast period. As hydropower projects contribute little to job creation, the direct impact of growth on poverty reduction is expected to be modest. Due to low-productivity growth in agricultural activities (which still accounts for nearly 60 percent of employment) and limited private sector development, the transition out of farming into more productive jobs will likely happen at a slow pace.

Risks and Challenges

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) donor financing is getting scarce while domestic debt markets are not yet developed (limited financing sources could constrain development spending and negatively affect future growth and development); (c) policy uncertainty after the 2018 general election could affect growth and investment; and (d) adverse weather events could negatively affect the economy through lower electricity generation from existing hydropower plants and moderating tourist inflows. Ensuring a vibrant, job-creating private sector remains a longer-term challenge.

Table 1. Macro poverty outlook (annual percentage change unless indicated otherwise)

	2016/17 e	2017/18 f	2018/19 f	2019/20 f	2020/21 f
Real GDP growth	7.4	5.8	4.6	7.6	6.4
Private Consumption	3.7	-2.0	0.8	10.8	9.6
Government Consumption	5.1	6.0	6.1	6.0	4.9
Gross Capital Investment	7.2	2.3	-1.3	4.2	-0.1
Exports, Goods and Services	-2.0	-1.4	-2.0	0.2	4.4
Imports, Goods and Services	-2.4	-10.3	-10.5	1.7	0.4
Real GDP growth	7.4	5.8	4.6	7.6	6.4
Agriculture	3.9	4.5	3.7	2.7	2.7
Industry	5.7	5.4	5.1	4.4	2.1
Services	10.7	6.7	5.1	11.9	11.0
Inflation (CPI)	4.3	5.0	5.0	5.0	5.0
Current Account Balance (% GDP)	-24.7	-21.7	-17.8	-13.3	-12.2
Fiscal Balance (% GDP)	-3.3	-2.4	-0.7	-1.9	-2.6
Debt (% GDP)	106.6	94.7	92.3	87.9	87.5
Primary Balance (% GDP)	-2.1	-1.2	0.1	-0.4	-0.8
Poverty Rate (US\$1.9 per day in 2011 PPP)	-	1.5	1.3	1.0	0.8
Poverty Rate (US\$3.2 per day in 2011 PPP)	-	12.0	11.2	9.6	8.5
Poverty Rate (US\$5.5 per day in 2011 PPP)	-	38.6	37.3	34.8	32.5

Source. World Bank staff estimates.

Note: e = Estimate; f = Forecast; CPI = Consumer Price Index; PPP = Purchasing Power Parity.

A. SOCIOECONOMIC DEVELOPMENTS

1. Political Update

Bhutan shifted from absolute monarchy to constitutional monarchy in 2008. The country has held two national elections for Parliament, in 2008 and 2013, and has just completed the third one. The Parliament consists of the 47-member National Assembly (lower house) and the 25-member National Council (non-partisan upper house). Of the 25 National Council members, 20 are elected and 5 are appointed by His Majesty as Eminent Members.

Bhutan's new government is likely to be in place by early November 2018. The upper house election was conducted in April 2018, and the lower-house election was held in two stages: the primary poll took place in mid-September, and general elections were held in mid-October. During the primary poll, the incumbent party did not gain enough votes to contest the run-off. The Druk Nyamrup Tshogpa (DNT) party won the general election and will form the new government.

The first two major tasks of the new government will be the endorsement of the 12th FYP and the revision of the FY2018/19 state budget. The 11th FYP for 2008–13 was completed in June 2018. The Royal Government of Bhutan (RGoB), led by the Gross National Happiness Commission (GNHC), drafted the 12th FYP, but it was decided that the new government should finalize the plan. Similarly, Parliament approved an interim budget for FY2018/19, including recurrent expenditures and ongoing capital expenditures, but not including new capital expenditures. The party manifesto points to expansionary fiscal policies, committing to an increase in the salaries of civil servants and higher grants to subnational governments (districts and sub-districts). Domestic revenue mobilization is also emphasized in the manifesto, and maintaining fiscal sustainability/financing for development will be critical.

2. Growth and Inflation

Economic growth in FY2017/18 is estimated at 5.8 percent. Although the national accounts for 2017 was not published when this update was written (box 1), available statistics suggest that economic growth in FY2017/18 decelerated from the 7.4 percent growth rate registered in FY2016/17. Delays in hydropower construction and a decline in electricity production, combined with international tourist arrivals negatively affected growth.

Hydropower production in FY2017/18 was below the FY2016/17 level. Electricity generation in FY2017/18 was 3 percent lower than in FY2016/17 (figure 1), due to less favorable weather. Domestic electricity sales increased by 66 percent due to strong demand by the manufacturing sector (primarily food processing). As a result, electricity exports fell by 9 percent. The performance of hydropower production negatively affected the growth rate. As the electricity and water sector account for 13 percent of Bhutan's GDP, and the decline in hydropower production in FY2017/18 may have reduced GDP growth rate by 0.4 percentage points.

No growth in the number of international tourists in FY2017/18. The number of international tourists (excluding regional tourists) in FY2017/18 was 59,000, almost the same as in FY2016/17 (figure 2). In late FY2016/17, Bhutan offered a special package for Koreans,¹ which raised the number of Korean tourist arrivals. Overall, the number of international tourists in FY2017/18 was almost the same as in the previous year, as the decline in Korean tourist approvals was offset by the increase in tourist arrivals from other countries.

Figure 1. Hydropower electricity production fell in FY2017/18 (annual growth rate, %)



Source. Royal Monetary Authority (RMA).

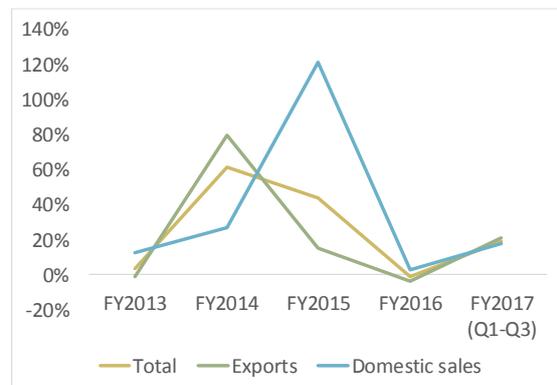
Figure 2. The number of international tourists remained the same in FY2017/18 (annual growth rate, %)



Source. RMA.

On the other hand, the performance of the manufacturing sector remained solid. During the first three quarters of FY2017/18, the total sales values of major manufacturing companies, such as food processing and carbide, increased by 19 percent compared with the same period in FY2016/17. Domestic sales increased by 17 percent, and exports rose by 21 percent (figure 3). Although inventory data is not available, the significant increase in the sales values indicates that manufacturing production increased.

Figure 3. Sales values of major manufacturing companies were strong in FY2017/18 (annual change, %)



Source. RMA.

¹ All international tourists to Bhutan must pay the minimum daily package rate of US\$250 per person per night during high season. The minimum package rate includes a royalty of US\$65 for the government. The remaining US\$185 covers accommodation, food, transportation, among others. Although Korean tourists had to pay the royalty, other expenses were based on markets.

Box 1. Improving statistics and data is critical

Bhutan has room to improve the quality of its statistics and capacity of statistics' office. Bhutan's score in the World Bank's 2017 Statistical Capacity Indicator was 66 (0=lowest, 100=highest), lower than the average score in South Asia (74) and neighboring countries (Bangladesh=70, Nepal=73, and India=91). Among three sub-indicators (methodology, source data, and periodicity), Bhutan's score is especially low in methodology, including the national accounts base year.

The National Statistics Bureau (NSB) publishes the national accounts once a year with 9–10 months lag. The frequency and timing make it difficult to monitor economic developments on a timely basis. The technical report on national accounts from the International Monetary Fund (IMF) notes ongoing efforts to rebase the national accounts and develop quarterly GDP. Also, the World Bank has been providing technical assistance on the economic census to improve the quality of the national accounts. Beside the national accounts, other key statistics, such as budget, are only available on an annual basis through the budget document. This limits the usefulness of statistics in monitoring the economy.

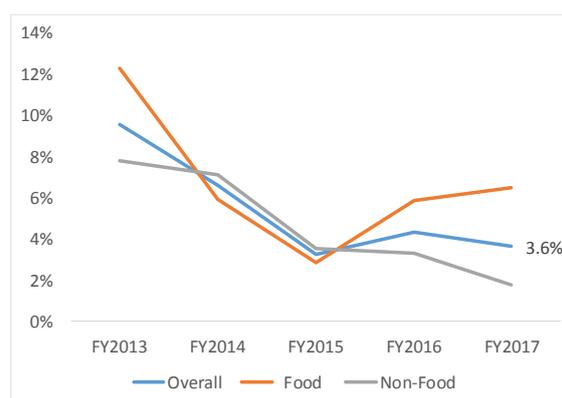
The 11th FYP Final Report (see section on economic and structural issues) was not able to include the most updated information. Although the 11th FYP set the target for exports in 2017–18, the most recent data cited was as of 2016.

The government recognizes the need to improve data and statistics management. In Bhutan's Voluntary National Review (VNR) Report on the Implementation of the 2030 Agenda for Sustainable Development, improving data and statistics management is listed as one of the priorities.

Prices were stable in FY2017/18, with the overall CPI rising by 3.6 percent, slightly lower than the 4.3 percent in the previous year. While food prices increased by 6.5 percent mainly due to fruits and vegetables, non-food prices increased by merely 1.8 percent. Among non-food prices, transportation prices fell by 1.5 percent because of a slight drop in vehicle prices, and communication prices were unchanged.

Price stability has continued in 2018. As of June 2018, the overall CPI increased by 2.5 percent from the same month in 2017. The stability was driven mainly by non-food prices. India accounts for 80–90 percent of Bhutan's international trade, and the ngultrum is pegged to the Indian rupee. Therefore, price developments in Bhutan and India are highly correlated. The time-lagged correlation coefficient between India's Wholesale Price Index (WPI) and Bhutan's CPI suggests that Bhutan's CPI lags India's WPI by six months.² India's WPI in the first five months of 2018 increased by 3.1 percent, indicating continued price stability in Bhutan in the near future.

Figure 4. Price stability was maintained in FY2017/18 (annual change, %)



Source. NSB

² The time-lagged correlation coefficient between India's WPI and Bhutan's CPI is 0.8, which is statistically significant.

3. External Sector

The current account deficit remained the same in the first three quarters of FY2017/18 as in the same period in FY2016/17, reaching Nu 25.6 billion (table 2). However, as a percentage of GDP, the current account deficit narrowed.

This is mainly due to higher receipts from service exports, driven by tourism, especially regional tourists. The trade deficit declined by 6 percent. Exports of

goods increased by 3 percent and service exports by 19 percent. Exports to markets other than India increased by 63 percent, only partially offset by a 5 percent decline in exports to India, reflecting a fall in electricity production and exports. Imports of goods declined by 1 percent because of lower capital goods imports for hydropower construction with the completion of Mangdechhu (one of three mega-hydropower projects under construction).

Though small, officially recorded remittances from non-resident Bhutanese have increased significantly. To attract more resources, the RGoB launched RemitBhutan in late 2016, a platform enabling non-resident Bhutanese to open foreign currency accounts with commercial banks in Bhutan.³ RemitBhutan is aimed at promoting national savings and building foreign reserves. Since the launch two years ago, remittances have almost doubled from Nu 1.3 billion in FY2015/16 to Nu 2.5 billion in FY2017/18. In FY2016/17, remittances were equivalent to about 5 percent of the current account deficit.

Bhutan's gross international reserves are sufficient to absorb potential future external shocks. With elevated imports driven by hydropower construction that is also financed by India, the large current account deficit is adequately financed, enabling the maintenance of gross international reserves at US\$1.1 billion, equivalent to 10.9 months of imports of goods and services, as of June 2018, broadly unchanged from a year earlier. The IMF's Article IV report deems Bhutan's reserve coverage adequate.

Foreign direct investment (FDI). Despite recognition of the importance of FDI by the RGoB and various initiatives to encourage more inflows, FDI has been limited and volatile. In the first three quarters of FY2017/18, net direct investment was Nu 0.2 billion, a significant increase compared to net outflows of Nu 0.8 billion during the same period in the previous year (box 2).

Table 2. Current account deficit remained unchanged during Q1–Q3 FY2017/18

	FY2016/17 Q1–Q3 (Nu, billions)	FY2017/18 Q1–Q3 (Nu, billions)	Percentage Change
Credit	46.0	47.9	4.1
Goods	28.2	29.0	2.8
Services	7.6	9.0	18.6
Primary and Secondary Income	10.2	9.9	-3.2
Debit	71.6	73.4	2.5
Goods	48.9	48.5	-0.7
Services	10.5	11.5	9.5
Primary and Secondary Income	12.3	13.5	9.5
Current Account	-25.6	-25.6	-0.2

Source: RMA.

³<https://www.remitbhutan.bt/>

Box 2. Snapshot of Bhutan's FDI

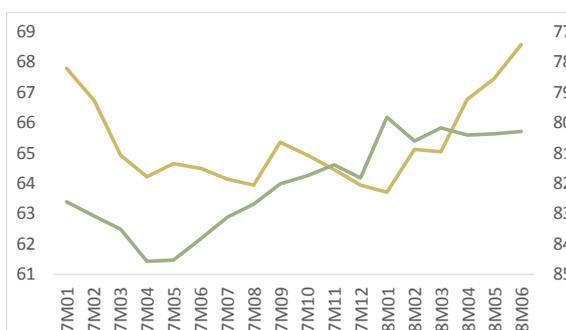
There were 57 active FDI projects (of which 17 are under construction) as of December 2017, and the total stock of FDI inflows amounted to US\$117 million as of June 2017. Half of all projects are in hotels (22), followed by manufacturing (14), and agribusiness (including beverage projects, 8). About 70 percent of investments are from Asia, mostly from India. Despite RGoB efforts to attract FDI, progress is limited. Between FY2013/14 and FY2016/17, the total stock of FDI inflows increased by only US\$11 million. On job creation, FDI companies employed 5,285 people, about 1.4 percent of total employment. Total employment in FDI companies increased from 2,341 in 2011 to 5,285 in 2017, more than double in 6 years but from a small base.

Source. Ministry of Finance (MoF).

Despite the depreciation of the nominal exchange rate, the real effective exchange rate (REER) remained stable (figure 5).

Starting in early 2018, the nominal exchange rate started to depreciate and reached Nu 72 per U.S. dollar in mid-September 2018. Currently, the RMA maintains a peg with the Indian rupee for price stability. Thus, the depreciation of the Bhutanese ngultrum is due to the depreciation of the Indian rupee. India accounts for 80–90 percent of Bhutan's international trade and price developments of these two countries are mostly parallel. Therefore, the REER of Bhutan has been stable.

Figure 5. REER of the Bhutanese ngultrum has been stable.



Source. RMA, Bruengel database.

Note. Higher REER means appreciation.

4. Financial Sector

There has been a rapid increase in loans outstanding. In FY2017/18, loans outstanding grew by 15.0 percent, almost the same as the growth rates in the previous two years (16.9 percent in both FY2015/16 and FY2016/17). Loans outstanding to the services and tourism sectors increased by 39 percent. Loans to the transport sector rose by 22 percent, and to manufacturing by 12 percent.

The increase in nonperforming loans (NPLs) is a concern. The rapid increase in outstanding loans means that the quality of assets has become even more important. As of March 2018, the gross NPL ratio was 14.6 percent, 2 percentage points higher than a year ago. The increase in NPLs adversely affected the profitability of financial institutions. For example, return on assets (ROA) declined from -0.6 percent in March 2017 to -0.9 percent in March 2018. NPLs are concentrated in trade and commerce (25 percent of the total), service and tourism (23 percent), and housing (17 percent).

Nevertheless, the financial institutions have a strong capital base. The risk-weighted capital adequacy ratio (RWCAR) stood at 14.5 percent in March 2018, well above the minimum regulatory requirement of 12.5 percent, although the RWCAR fell from 17.8 percent registered a year earlier. The overall liquidity position of the financial sector was adequate. Against the minimum requirement of Nu 26.15 billion, the actual liquidity was Nu 41.9 billion, indicating sufficient buffers to meet payment obligations.

B. ECONOMIC AND STRUCTURAL POLICIES

1. Fiscal Policy and Debt Sustainability

(a) Fiscal Policy

The fiscal outturn for FY2016/17 was better than expected. The fiscal deficit as a share of GDP was 3.3 percent (table 3). On revenues and grants, actual tax revenues at 13.6 percent of GDP exceeded the earlier estimate of 13.2 percent of GDP. In absolute values, tax revenues increased by 9.2 percent from the previous year. Among major items, taxes on goods and services (including sales tax) increased by 17.3 percent followed by corporate income tax, which rose by 9.5 percent. The increase in corporate income tax came from manufacturing and services. On the other hand, personal income tax fell by 46 percent reflecting the change in the basic exemption limit from Nu 100,000 to Nu 200,000 per year. Current expenditures were equivalent to 15.1 percent of GDP and were fully met with domestic revenues as required by the Constitution.⁴

The revised estimates for FY2017/18 indicate a lower fiscal deficit than envisaged in the budget. The fiscal deficit as a share of GDP is expected to be 1.0 percent in FY2017/18 compared to 2.5 percent in the approved budget. Total revenues and grants are expected to be higher by 1.4 percentage points due to higher corporate income tax receipts and excise duty refunds from India. Capital expenditures were revised upward by 1.3 percentage points of GDP, as there was a push to implement planned projects in FY2017/18, the final year of the 11th FYP, and complete projected activities in the 11th FYP.

Table 3. The fiscal outturns in FY2016/17 and revised projection in FY2017/18 are better than expected (% GDP)

	FY2015/16	FY2016/17		FY2017/18			FY2018/19	
	Actual	Revised	Actual	Difference	Budget	Revised	Difference	Interim Budget
Revenue and grants	29.9	29.9	26.7	-3.2	28.6	29.9	1.4	19.8
Tax	14.2	13.2	13.6	0.4	13.6	14.3	0.7	12.7
Nontax	5.8	5.1	5.0	0.0	5.7	5.5	-0.2	4.7
Grants	10.6	11.2	8.1	-3.1	9.3	9.5	0.3	2.2
Outlay	31.1	34.0	30.1	-3.9	31.0	32.1	1.0	19.3
Current	16.3	16.1	15.1	-0.9	15.9	15.7	-0.2	14.1
Capital	14.8	18.0	16.2	-1.8	15.2	16.4	1.3	5.2
Fiscal balance	-1.1	-4.1	-3.3	0.7	-2.5	-1.0	1.5	0.4

Source: MoF.

Note: FY2016/17–FY2018/19 figures are based on estimated/projected GDP.

The interim budget for FY2018/19 only includes current expenditures and ongoing capital expenditures. As the term of the previous government was completed in August 2018, only an interim budget was formulated for FY2018/19. The main objective of the budget is to

⁴ Article 14 of the Constitution states that “the Government shall ensure that the cost of recurrent expenditures are met from internal resources of the country.”

ensure economic stability by allocating budget for spillover activities of the 11th FYP and critical regular activities. Accordingly, the current budget has been allocated for maintaining continuity of public service delivery, and the capital budget includes existing projects. Therefore, the size of the interim budget, especially capital expenditures, is smaller than the previous years.

The state-owned enterprises (SOEs) continue to contribute to public coffers, mainly through the management of hydropower. SOEs in Bhutan have played a significant role in providing infrastructure and public services. There are 38 SOEs, of which, 19 are directly under the MoF, while the remaining 19 are through Druk Holding and Investments (DHI), 100 percent owned by the RGoB. The combined asset value of SOEs is equivalent to 143 percent of GDP. SOEs contribute to the budget through corporate income tax and dividend transfer (table 4). In FY2016/17, SOEs contributed Nu 11.2 billion to the budget, equivalent to 38 percent of total revenues and grants. At the same time, the government spent Nu 2.4 billion on subsidies to SOEs, mainly for Bhutan Power Cooperation for the domestic power tariff.⁵ Thus, the net contribution to the budget amounted to Nu 8.8 billion.

Table 4. Contributions of SOEs to the budget

	2013	2014	2015	2016	2017
SOEs' contribution to revenues (Nu, billions)	8.9	9.7	10.0	11.1	11.2
% of total revenues	43	42	40	40	38

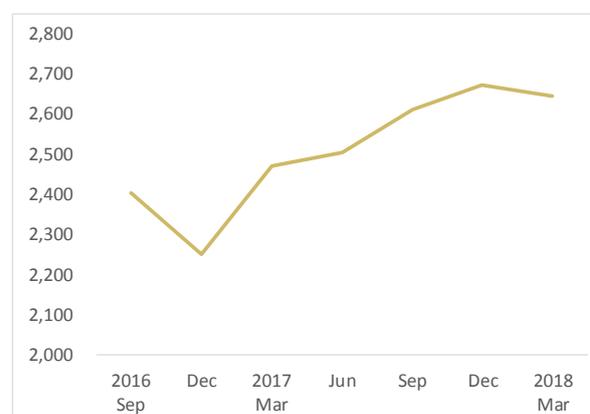
Source. MoF

(b) Debt Sustainability

External debt declined slightly to reach US\$2.6 billion in March 2018, or about 115 percent of estimated GDP (figure 6). This is mainly because repayments of past hydropower debt started.

Majority of external debt is related to hydropower denominated in Indian rupees. Of the total debt, about 70 percent of debt relates to hydropower and about 75 percent is denominated in Indian rupees. Hydropower projects are implemented under an intergovernmental agreement in which the Government of India covers both financial and construction risk, and buys surplus electricity at a price reflecting cost plus a 15 percent net return.

Figure 6. External debt outstanding slightly fell in March 2018 (US\$, millions)



Source. RMA.

⁵ To help improve rural lives, as earning capacity is generally lower in the villages, 92,000 rural households are being provided 100 units of free electricity each month.

The 2018 World Bank-IMF joint Debt Sustainability Analysis (DSA) deemed the risk of debt distress as moderate⁶. With the unique risk mitigation measure on a majority of Bhutan's external debt, the 2018 DSA maintained the assessment of the risk of debt distress as moderate, the same as in the 2014 and 2016.

2. Monetary and Exchange Rate Policies

The RMA's monetary policy stance continues to support economic growth and employment generation. The RMA aims to channel credit to productive sectors of the economy, while managing consumption credit in a context of price stability.⁷

The RMA will introduce a new market-based monetary policy operating framework in late 2018. Currently, the RMA's pursues policy objectives through the cash reserve ratio and interest rates to influence credit and monetary aggregates, as well as prudent management of international reserves to support the exchange rate peg. To strengthen the conduct of monetary policy, the RMA will be introducing new market-based instruments (such as open market operations based on the issuance of Treasury bills and collateralized loans) and standing facilities, including both marginal lending and deposit facilities. The main objectives are to: (a) signal the monetary policy stance to the market, (b) maintain an adequate level of liquidity in the banking system, (c) allow banks to enhance their treasury function, leading to reduced liquidity costs and settlement risks, and (d) support the development of the domestic money market.

The RMA introduced the National Financial Inclusion Strategy 2018–23.⁸ Bhutan has placed much emphasis on financial inclusion as the key to sustainable and inclusive socioeconomic development. The main building blocks of the strategy are ensuring the provision of appropriate financial products and services, boosting access to finance, facilitating economic growth through financing of cottage and small industries (CSIs), and increasing financial literacy and consumer protection. To implement the strategy, a National Financial Inclusion Strategy Committee, Working Group, and Financial Inclusion Secretariat will be established. As one of the next steps, a detailed and comprehensive action plan with targets is being formulated.

Boosting priority sector lending is a key RGoB policy objective. Access to finance is one the most binding constraints to private sector development, especially for CSIs which Bhutan wishes to harness for job creation and economic diversification.⁹ To address this constraint, the RMA initiated Priority Sector Lending (PSL) on a pilot basis in January 2018, providing loans to CSIs with preferential interest rates of 8 or 8.5 percent. PSL is not merely a lending

⁶ <https://www.imf.org/en/Publications/CR/Issues/2018/10/30/Bhutan-2018-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-46319>

⁷ RMA, Monetary Policy Statement. July 2018.

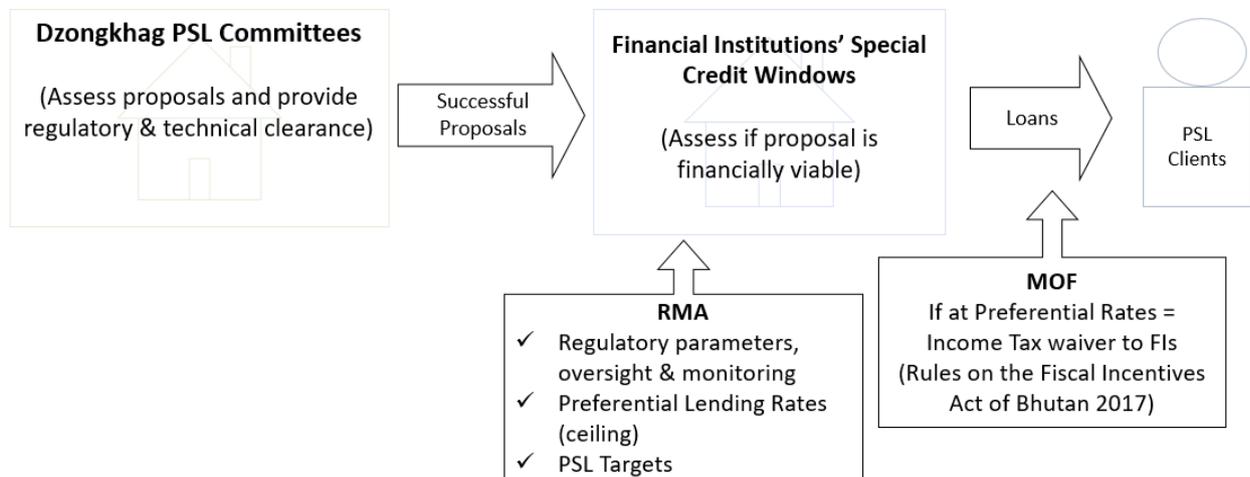
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<https://www.rma.org.bt/RMA%20Publication/papers/National%20Financial%20Inclusion%20Strategy%202018-2023.pdf>

⁹ World Bank, 2017, "Investment Climate Assessment of Bhutan."

instrument, but an integrated platform of partnership to leverage the expertise of key stakeholders (figure 7). District PSL committees assess a proposal and provide regulatory and technical clearance. A successful proposal goes to a special credit window of a financial institution to assess viability. If the preferential interest rates are applied, the MoF provides a waiver for income tax based on the 2017 Fiscal Incentive Act. During the first half of 2018, District PSL committees reviewed 681 applications and approved 513 projects. Then, commercial banks approved 127 projects.¹⁰ CSI accounting capacity (such as proper recording of profits and losses) and ability to make long-term projections are key considerations constraining borrowing. Hence, the Department of Cottage and Small Industry under the Ministry of Economic Affairs spearheads various schemes such as skill development trainings, business advocacy workshops, and a rural industries development schemes to support the purchase of machinery.¹¹

Figure 7. PSL provides an integrated platform for stakeholders



Source. RMA.

The RMA issued rules and regulations for CSI banks.¹² To complement PSL, the RMA issued rules and regulations for CSI banks that became effective in July 2018. The rules and regulations define licensing requirements (including the minimum capital requirements) and prudential measures, including a minimum risk weighted capital adequacy ratio (CAR) of 15 percent. The CAR is higher than the minimum ratio of 12.5 percent that is applicable to other financial institutions. Preferential lending to CSIs are subject to a waiver of income tax on interest income of the CSI banks based on the Fiscal Incentive Act.

¹⁰ RMA, Priority Sector Lending Quarterly Report, Q2 2018.

¹¹ Annual Report 2018 of the Department of Cottage and Small Industry, Ministry of Economic Affairs.

¹² Rules and Regulations for Cottage and Small Industries (CSI) Banks in Bhutan 2018.

3. 11th FYP Performance

Bhutan completed the 11th FYP in June 2018. The 11th FYP included quantitative targets in its National Key Results Areas (NKRAs). The GNHC, Bhutan’s planning agency, published the country’s development performance against the quantitative targets in June 2018 (table 5).¹³

Progress towards the goals of the 11th FYP was mixed, despite relatively high growth in 2014–16.¹⁴ The ratio of domestic revenues to total expenditures—Bhutan’s key indicator for economic self-sufficiency—remains broadly unchanged. Key labor statistics such as the youth unemployment rate (including the rate for females) deteriorated. The 11th FYP envisaged that economic diversification through private sector development would contribute to quality job creation and domestic revenue mobilization. However, private sector development was slow.

Table 5. Selected NKRAs

Indicator	Baseline	Target	Actual	Remarks
Economy				
Annual average GDP growth	8–9%	>10%	6.7% (2014–16)	Not achieved
% of domestic finance to total expenditure	65%	>85%	62.1%	Not achieved.
Annual average fiscal deficit over plan period	0.3%	<3%	0.8%	Achieved
Consumer price index	8.37%	7–8%	5.0%	Achieved
Priority sector lending	TBD	TBD		Achieved; launched in Jan 2018
Exports (without electricity) (Nu, Billions)	15 (2012)	>28 (2017–18)	25.3 (2016)	Not achieved
Inclusive Social Development				
Income poverty reduced	12% (2012)	<5%	8.2% (2017)	Not achieved
Multidimensional poverty reduced	25.8% (2012)	<10%	5.8% (2017)	Achieved
Gini coefficient reduced	0.36 (2012)	<0.3	0.38 (2017)	Not achieved
Gender				
Ratio of female to male in tertiary education	71%	>90%	83%	Not achieved
Female youth unemployment	7.2%	<2.5%	11.7% (2016)	Not achieved
Agencies with gender sensitive policies/gender mainstreaming strategies	n.a.	>20%	100%	Achieved; all agencies have under Annual Performance Agreements
Employment				
Full employment	97.9%	>97.5%	97.9% (2016)	Achieved
Youth unemployment reduced	7.3%	<2.5%	13.2% (2016)	Not achieved
% of regular paid employee	23.9%	>40%	23.9% (2016)	Not achieved

Source. GNHC and World Bank.

¹³ GNHC, “Eleventh Five Year Plan 2013–2018 Final Report”

¹⁴ Among about 200 countries where data is available, Bhutan’s growth rate ranked 19th.

4. Bhutan's Voluntary National Review Report

Bhutan's VNR report describes the country's medium-term priorities.¹⁵ VNRs aim to facilitate the sharing of experiences, including successes, challenges, and lessons learned, with a view to accelerating the implementation of the 2030 Agenda. Bhutan is one of 47 countries participating in the 2018 VNR. Bhutan presented the country's review report to the United Nation's high-level political forum in July 2018.¹⁶ Although the final draft of the 12th FYP is not publicly available and is to be endorsed by the new government, the VNR report describes strategic issues in the medium term to achieve the Sustainable Development Goals (SDGs).

Bhutan's VNR states that (a) enhancing productive capacity of the economy, (b) rethinking human capital development, and (c) mobilizing resources for environmental vulnerabilities are priority actions. Enhancing productive capacity (for example, infrastructure development including industrial parks, and expansion of national highways and information and communication technology) is critical to diversifying the economy. The RGoB recognizes that economic diversification will enhance resilience. Rethinking human capital development, the RGoB is committed to improving quality in health, education, and skills development, in line with the principles of the World Bank's Human Capital Project. Bhutan is the only carbon negative country in the world, but is exposed to climate change and natural disaster risks for water, energy, and food production.

The RGoB has identified priority policies through the VNR. Implementation requires an improvement of the governance framework and mobilizing financing. The RGoB has identified the following priority actions in the VNR: (a) harmonizing policies, (b) improving data and statistics management, (c) enhancing awareness on SDGs and ownership, (d) developing financing strategies, and (e) improving stakeholder coordination. These actions are all essential to progress towards the SDGs. For example, the lack of quality of data and statistics limits the review of the 11th FYP. Also, a lack of a comprehensive financing strategy negatively affects mobilizing financing for critical infrastructure and human capital investments.

¹⁵ The VNRs also seek to strengthen policies and institutions of governments and to mobilize multi-stakeholder support and partnerships for achievement of the SDGs (<https://sustainabledevelopment.un.org/vnrs/>).

¹⁶ The Royal Government of Bhutan. 2018. "Sustainable Development and Happiness: Bhutan's Voluntary National Review Report on the Implementation of the 2030 Agenda for Sustainable Development."

C. OUTLOOK AND RISKS

1. Outlook

Economic growth is projected to average 6 percent a year over the medium term supported by ongoing hydropower projects and the services sector, especially tourism. On the supply side, services including financial services and tourism will remain the main drivers of growth. With the completion of the Mangdechhu hydropower project in late 2018, the growth rate of industry, especially construction, is likely to moderate. On the demand side, private and public consumption will be the main drivers of growth. With the completion of the Mangdechhu hydropower project, while the growth rate of gross fixed capital formation will decelerate, exports are likely to gradually increase after FY2019/20, and imports will decline because of lower capital goods imports for hydropower. This improvement in the trade balance will help narrow the current account deficit to 12 percent of GDP by FY2020/21. As the pace of external debt accumulation to finance the current account moderates, the external debt to GDP ratio will decline to 88 percent. Lower capital spending, especially in the first year of the 12th FYP, will narrow the fiscal deficit to below 2 percent of GDP during the forecast period. As hydropower projects contribute little to job creation, the direct impact of growth on poverty reduction is expected to be modest. Low-productivity agricultural activities still account for nearly 60 percent of employment and with limited private sector development, the transition out of farming into more productive jobs will likely happen at a slow pace. As a result, the poverty headcount ratio using the US\$3.20 per day poverty line is projected to fall from 11.2 percent in 2018 to 8.5 percent in 2020.

2. Risks to the Baseline

There are four key risks facing the Bhutanese economy: (a) any further delays in hydropower construction will lower exports and revenues; (b) limited financing sources, including donor financing, could constrain government spending and negatively affect future growth and development; (c) policy uncertainty after the 2018 general election could impact growth and investment; and (d) adverse weather events could negatively affect the economy through hydropower and agriculture. Ensuring a vibrant, job-creating private sector remains a longer-term challenge.

The hydropower sector continues to 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 GDP in FY2017/18. During 2018–2022, the government plans to start operating three new hydropower projects with a total capacity of about 3,000 MW, compared with the current capacity of 1,600 MW. However, the schedule of the completion of Punatsangchhu I and II was delayed several times (table 6). In the FY2018/19 interim budget, the schedule was delayed by another year. Assuming there is no escalation of costs, a one-year delay may reduce GDP growth by 3–4 percentage points, lower exports by US\$250–300 million (about 50 percent of the current exports), and lessen revenues by 0.5–1.0 percent of GDP.

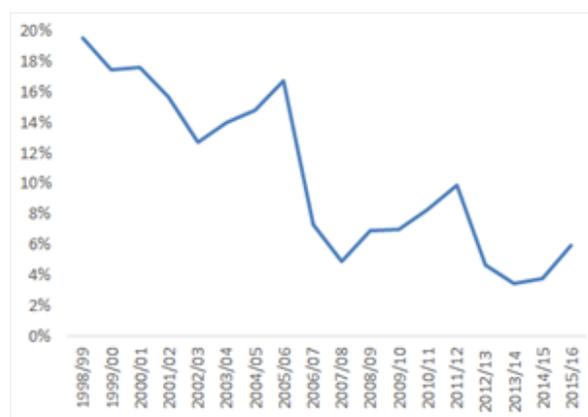
Table 6. Delay in hydropower construction

Project	MW	Planned completion year			
		In 2015/16 budget	In 2016/17 budget	In 2017/18 budget	In 2018/19 budget
Punatsangchhu I	1,200	2019	2019	2021	2022/23
Punatsangchhu II	1,020	2018	2018	2019	2020/21
Mangdechhu	720	2018	2018	2018	2018

Source. MoF.

Financing for development remains challenging. Unlike a regular budget document, the 2018/19 budget document does not include a medium-term macroeconomic framework. Nevertheless, the decline in budget grants (figure 8) suggests that Bhutan needs to identify alternative sources of financing. Bhutan’s own commitment to develop a comprehensive financial strategy, as described in the VNR report, is a commendable step. In formulating the financing strategy, costs and benefits of different financing options need to be carefully analyzed.

Figure 8. Budgetary grants have been declining (% GDP)

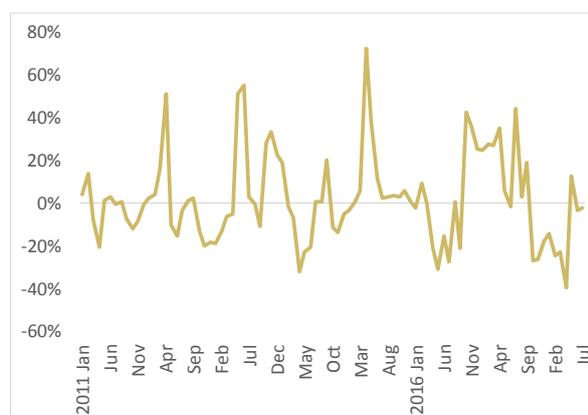


Source. World Development Indicators.

Maintaining reform momentum after the 2018 general election will be crucial. Bhutan’s reform momentum slowed in mid-2018. For example, during the interim government between August and October 2018, few strategic decisions are made. If the formulation of the FY2018/19 budget and endorsement of the 12th FYP are delayed, there would be a negative impact on growth is expected.

Bhutan remains at risk of adverse weather events and natural disasters. Bhutan’s development has benefited from its renewable natural resources. About 60 percent of the labor force is in agriculture and hydropower is the backbone of Bhutan’s economy. However, the majority of agricultural land is rain fed, and irrigated areas are limited. In the past several years, hydropower production fluctuated significantly, which outside the periodic coming onstream of new projects is largely the result of weather (figure 9).

Figure 9. Hydropower production fluctuates (year-on-year growth rate)



Source. RMA.