

BHUTAN

DEVELOPMENT UPDATE

Special section: Recent trends in poverty and shared prosperity: progress and challenges

Macroeconomics, Trade, and Investment Global Practice

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Government Fiscal Year:	July 1–June 30
Currency Equivalent:	Exchange Rate Effective as of January 21, 2020 Currency Unit = Ngultrum (Nu) US\$1 = Nu 71.2
Weights and Measures:	Metric System

Abbreviations and Acronyms

BEFIT	Bhutan Economic Forum for Innovative Transformation
BESF	Bhutan Economic Stabilization Fund
BLSS	Bhutan Living Standards Survey
CAD	Current Account Deficit
CIT	Corporate Income Tax
CPI	Consumer Price Index
CRR	Cash Reserve Ratio
CSI	Cottage and Small Industry
DSA	Debt Sustainability Analysis
ECoB	Economic Census of Bhutan
FDI	Foreign Direct Investment
FYP	Five-Year Plan
GDP	Gross Domestic Product
GNHC	Gross National Happiness Commission
GST	Goods and Services Tax
ICT	Information and Communications Technology
IMF	International Monetary Fund
INR	Indian Rupee
IRC	Interest Rate Corridor
MoF	Ministry of Finance
LDC	Least Developed Countries
NCD	Non-Communicable Diseases
NFA	Net Foreign Assets
NPL	Nonperforming Loan
NSB	National Statistics Bureau
PSL	Priority Sector Lending
PPP	Purchasing Power Parity
REER	Real Effective Exchange Rate
RMA	Royal Monetary Authority
RWCAR	Risk-Weighted Capital Adequacy Ratio
THPP	Targeted Household Poverty Program

Acknowledgments

The Bhutan Development Update is a World Bank report series produced twice a year. It assesses recent economic and social developments, prospects, and policies in Bhutan. 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 update was prepared by the Macroeconomics, Trade, and Investment Global Practice and the Poverty and Equity Global Practice and included: Yoichiro Ishihara (Resident Representative and Senior Economist), Melanie Trost (Junior Professional Officer) and Tenzin Lhaden (Operations Officer and Economist). The focus section on poverty was prepared by Yeon Soo Kim (Poverty Economist).

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Overview

Recent Developments

Growth is estimated to have remained subdued in 2018/19 as hydropower production declined further. After slowing to 3.8 percent in 2017/18 as a result of reduced hydropower production, growth is expected to have remained subdued at 3.9 percent in 2018/19. The hydropower sector, which currently accounts for around 30 percent of GDP, experienced a further decline in production in 2018/19 due to prolonged maintenance work at the Tala hydropower plant, lower than expected rainfall, and delays in the commissioning of the Mangdechhu hydropower project. The other main growth driver, tourism, showed mixed results. While tourist arrivals increased, tourism receipts declined significantly from 3.7 percent of GDP in 2017/18 to 2.9 percent in 2018/19, reflecting lower average spending by tourists. Output expansion during the year was primarily driven by the services sector, including retail trade, transport and communication.

Inflation decelerated to its lowest level in 2018/19 since 2003, reflecting a rapid decline in food prices. The annual consumer price index decreased by almost one percentage point from 3.7 percent in 2017/18 to 2.8 percent in 2018/19 and stood at 2.3 percent in November 2019. The deceleration reflects a decrease in food prices, which in turn was the result of a base effect due to unusually high vegetable prices in 2017. More recently, food prices are on the upswing again given the increase in food prices in India.

Growth in bank lending to the private sector remained strong in 2018/19 (16.7 percent, YoY) but risks to the financial sector are on the increase. The stock of credit outstanding to the private sector as a share of GDP more than doubled since 2007 and reached 65 percent at the end of 2018. The Non-Performing Loan (NPL) ratio, however, increased to 18.4 percent in September 2019, vis-à-vis 10.4 percent in December 2018, mainly due to an accumulation of NPLs in the non-banking sector. While this reflects mid-year cyclical factors, the NPL ratio has been on an upward trend in recent years. The financial sector overall has adequate cushion to absorb potential losses given its capital adequacy. However, there is variance among institutions with weaknesses particularly concentrated in the non-banking sector.¹ The overall risks in the financial sector are on the increase and the sector's resilience needs to be further strengthened.

The current account deficit (CAD) widened in 2018/19 on the back of lower electricity and tourism receipts. Total exports decreased on the back of lower hydropower exports and a drop in tourism receipts. Falling merchandise imports - reflecting slowing hydropower construction and fuel imports - could not offset the decline in exports. As a result, the CAD increased from 19.6 percent of GDP in 2017/18 to 23.9 percent in 2018/19. Gross international reserves, however, remain at comfortable levels, standing at US\$1,093 million in August 2019, which is equivalent to 11.6 months of imports of goods and services.

The fiscal balance improved in 2018/19 due to a sharp decline in capital spending. The fiscal balance improved from a deficit of 3.3 percent of GDP in 2017/18 to a surplus of 0.8 percent of GDP in 2018/19 due to a large decline in capital expenditure, which more than offset a decrease in revenues. Hydropower revenues decreased as a result of lower hydropower production, and one-off factors - including the discontinuation of

¹ Given the limited investment opportunities in Bhutan, non-banks are notably permitted to undertake retail lending activities.

the excise duty refunds from India – had a negative impact on non-hydro revenues. While capital expenditure decreased significantly in the run-up to parliamentary elections in 2018, the control on current expenditure remained tight. Public debt as a share of GDP remained high, estimated at 105.4 percent of GDP at the end of 2018/19, but risks of debt distress are moderate as most of the debt is linked to hydropower projects financed by India.

Outlook and Risks

The medium-term economic outlook remains positive, driven by the on-streaming of two large hydropower projects. Growth is expected to rebound in 2019/20 to 5.5 percent following the operationalization of the Mangdechhu hydropower project, although the plant is expected to reach full potential only in 2020/21. In the medium term, growth is projected to average around 6 percent, supported by an increase in hydropower production (with the expected on-streaming of Puna II in 2022/23) and good growth in the services sector. Tourism activities, including hotel and restaurant, transport, and retail trade, are expected to boost growth in the services sector.

Inflation is expected to accelerate in the near term due to rising food prices in India. Inflationary pressures should ease over the medium term as RMA steps up efforts to strengthen monetary management.

The external accounts are expected to improve over the medium term, supported by higher hydropower exports. Current account deficits are likely to persist due to imports associated with the hydropower sector. The CAD is however projected to narrow over the medium term, boosted by an increase in electricity exports with the on-streaming of the Mangdechhu and Punatsangchhu II projects in 2019/20 and 2022/23, respectively. However, the ongoing construction of Punatsangchhu II and I and higher public capital spending are expected to raise imports associated with hydropower construction and infrastructure projects.

The fiscal deficit is expected to widen compared to 2018/19 but remain below 3 percent of GDP. Hydropower revenue is projected to increase over the medium term in line with higher production levels and one-off profit transfer revenues in 2019/20 and 2020/21 (from Mangdechhu). Non-hydro revenues are expected to increase with improvements in tax policy and administration, including the implementation of the goods and services tax (GST) in 2020. Current expenditures are projected to remain tight while capital expenditures are expected to decrease after an initial pick up in 2019/20 – in line with the reduced grant inflows for the 12th FYP from India. As a result, the overall deficit is projected to increase in 2019/20 with the pickup in capital spending and in 2021/22 due to the absence of profit transfers. The government is in the process of approving fiscal stabilization measures which will smoothen spending over the medium to long term, especially after the remaining two large hydro projects are commissioned. Total public debt is expected to decline gradually over the medium term as debt servicing starts with the on-streaming of hydropower projects.

Risks to the outlook arise primarily from delays in the completion of the remaining large hydro projects, volatile hydropower revenues and slippages in the implementation of non-hydro revenue measures. Further delays in hydro project completion and/or adverse weather events would negatively impact growth, reduce exports and government revenues. Delays in the implementation of non-hydro revenue measures like the implementation of the GST constitute a risk to the government's fiscal stance. This is especially so because of the discontinuation of excise duty refunds from India and lower levels of grant financing from India (as evidenced in the 12th FYP cycle). This risk is mitigated, in part, by the government's commitment to introduce the GST and the implementation of the fiscal stabilization measures (currently being finalized), which will help smoothen expenditures in later years when no new large hydro projects are likely to be commissioned.

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

Table: Main macroeconomic indicators	2015/16 (actual)	2016/17 (actual)	2017/18 (actual)	2018/19 (estimate)	2019/20 (forecast)	2020/21 (forecast)	2021/22 (forecast)
Real GDP growth	7.4	6.3	3.8	3.9	5.5	7.3	5.7
Private Consumption	3.9	0.0	10.1	12.0	4.0	6.8	7.0
Government Consumption	7.3	4.3	3.7	4.5	18.6	7.0	4.6
Gross Capital Investment	14.1	4.5	-3.8	-4.7	1.4	6.6	0.6
Exports	-4.2	0.4	5.5	-3.7	6.4	3.1	6.4
Imports	8.6	2.9	-5.3	3.6	0.9	4.8	3.6
Real GDP growth	7.4	6.3	3.8	3.9	5.5	7.3	5.7
Agriculture	4.4	3.6	3.7	4.2	4.2	4.3	4.3
Industry	7.6	4.7	-1.2	-0.5	5.6	8.8	3.3
Non-manufacturing (incl. hydro)	8.6	4.7	-2.7	-2.3	5.5	9.6	2.5
Manufacturing	3.4	4.5	5.0	6.0	6.1	6.2	6.0
Services	9.2	8.2	7.9	8.4	8.6	8.7	8.3
Inflation (CPI)	3.3	4.3	3.7	2.8	3.0	3.6	2.7
Current Account Balance (% GDP)	-31.7	-23.6	-19.6	-23.9	-15.4	-17.3	-16.6
Fiscal Balance (% GDP)	-1.9	-4.8	-3.3	0.8	-1.9	-1.5	-2.7
Revenue	30.7	28.0	31.9	26.1	29.3	29.3	27.6
Hydropower revenue	3.5	4.4	5.1	4.4	6.4	6.5	5.3
Non-hydro revenue	16.4	15.1	17.7	15.6	15.1	15.6	15.7
Grants	10.9	8.5	9.1	6.2	7.8	7.2	6.6
Expenditure	32.7	32.8	35.2	25.3	31.2	30.8	30.3
Current expenditure	16.7	15.8	16.8	15.9	18.1	18.2	18.1
Interest Payments	1.5	1.3	1.3	0.9	1.2	1.3	1.4
Salary and Allowances	6.9	6.2	6.0	6.7	8.7	8.6	8.5

Table: Main macroeconomic indicators	2015/16 (actual)	2016/17 (actual)	2017/18 (actual)	2018/19 (estimate)	2019/20 (forecast)	2020/21 (forecast)	2021/22 (forecast)
Goods and Services	4.5	4.3	4.2	4.2	4.1	4.1	3.9
Subsidies and Transfers	2.3	2.7	4.0	2.7	2.7	2.7	2.7
Other	1.5	1.4	1.4	1.5	1.5	1.5	1.5
Capital expenditure	15.9	17.0	18.3	9.3	13.1	12.6	12.2
Debt (% GDP)	112.4	111.5	110.1	105.4	99.9	92.2	88.5
<i>Memo items:</i>							
Hydropower production	7,747	7,747	7,265	7,098	7,978	9,741	10,120
Tourist arrivals, international and regional	180,006	245,206	253,356	298,502	338,216	441,379	591,281

Source: WB staff estimates

In the medium term, Bhutan faces two key challenges: making growth more inclusive and less reliant on hydropower. Although hydropower has contributed significantly to economic growth, going forward, there are greater uncertainties in the rapidly evolving regional electricity markets. In addition, the capital intensive hydro sector accounts for less than 1 percent of total jobs. Therefore, Bhutan needs to facilitate more private-sector-led growth to increase employment opportunities and domestic revenues. While Bhutan achieved great strides in poverty alleviation, the pace of progress in shared prosperity has slowed in recent years. Also, disparities in poverty and other development outcomes across districts persist, as discussed below.

Recent Trends in Poverty and Shared Prosperity: Progress and Challenges

Bhutan has made remarkable progress in reducing poverty and providing access to services, but progress was uneven and disparities across the country persist. The poverty headcount measured by the US\$3.20 poverty line (in 2011 purchasing power parity (PPP) terms) decreased from 36.4 percent in 2007 to 17.8 percent in 2012 and further to 12.1 percent in 2017. Poverty in rural areas declined significantly throughout the decade, from 48.1 percent in 2007 to 17.4 percent in 2017. However, progress was uneven and differences in poverty rates between districts are large, with 96 percent of the poor residing in rural areas. While educational outcomes and access to health care saw large improvements, there are disparities in the access and quality of services across the country. Similarly, the quality of other basic services (electricity, water, sanitation) is also highly variable across the country.

Poverty reduction in rural areas was likely driven by improvements in agricultural productivity and better prices of cash crops, but vulnerability of households remains high. Working in agriculture is highly correlated with being poor: about two thirds of heads of poor households work in agriculture, whereas only about a third of non-poor households do. With agriculture being the largest employer (accounting for nearly 60 percent of employment), the presence of uninsured risks from price and weather shocks contributes to high vulnerability

of households. Simulations show that a 20 percent increase in the 2017 poverty line would almost double the poverty headcount rate, from 12.1 percent to 20.1 percent. This suggests that while welfare improved and poverty declined, a large share of households is tightly clustered around the lower end of the welfare distribution and vulnerable to falling back into poverty.

The creation of productive jobs is key to achieving long-term welfare improvements. While the public sector-led development model has boosted economic growth and directed large investments in human capital, private sector development has been lackluster and job creation sluggish. Bhutan's ability to further reduce poverty and enhance welfare will critically depend on its capacity to identify alternative sources of growth beyond hydropower and generate private sector employment. In the short- to medium-term, progress will be difficult to achieve without raising agricultural productivity. Addressing the constraints to growth in the commercial agriculture sector could go a long way towards increasing rural incomes: this would include broad-based support to increase productivity, combined with efforts to develop market systems and integration into larger value chains. A stronger social protection system that focuses on targeted poverty reduction and offers an appropriate package of benefits could further help mitigate the impact of income shocks.

Spatial trade-offs in development need to be better understood and reflected in the prioritization and sequencing of policies. Given the need to continue to invest in human capital and other services, an important trade-off may be needed between expanding access to services and improving the quality of services. Low urbanization rates mean that most people live dispersed across the countryside and Bhutan's unique geographic features – characterized by a rugged terrain of deep valleys and steep mountains – make service provision very difficult, costly, and inefficient. Reliance on technological innovations and diversifying modes of service delivery (such as mobile clinics for providing health care in remote areas) could help contain the cost and address quality-related concerns. At the same time, a shift in policies away from a focus on spatially balanced development and towards improving efficiency and promoting the benefits of urban agglomeration could be considered.



I. Recent Economic Developments

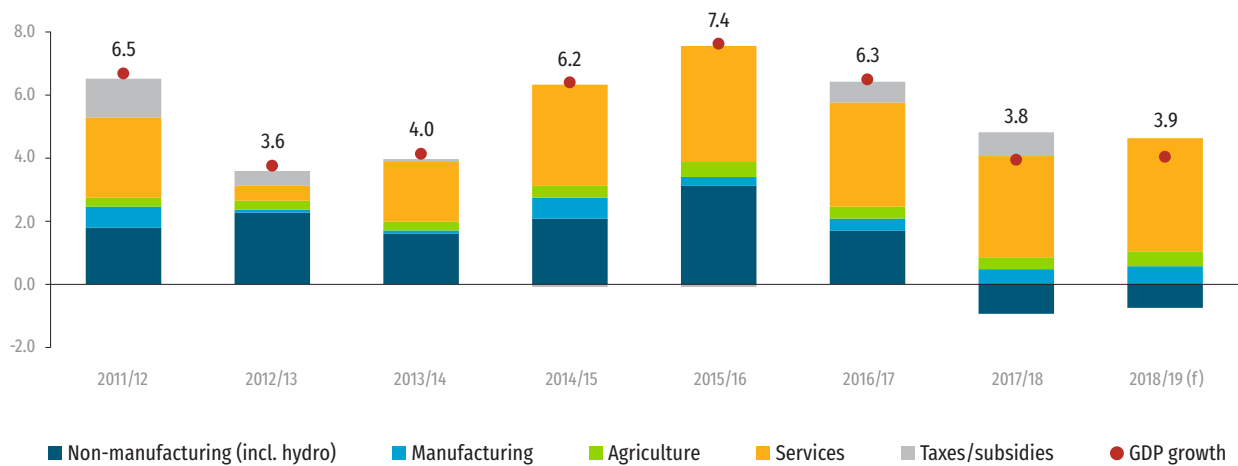
1. Growth

Bhutan's economy is largely driven by hydropower, which contributed to rapid economic growth in the past two decades through investments, export earnings, and contributions to the budget. The state-led hydropower sector currently accounts for around 30 percent of GDP,² and 20 percent of export receipts and domestic revenues. Bhutan's hydropower potential is estimated at around 30,000 MW, of which a total

of 2,326 MW of hydropower capacity has been installed. Hydropower projects drive economic growth through boosts in aggregate demand, both during the construction phase and when projects are commissioned. On the supply side, growth is supported by the services sector, mainly transport and communication, retail, and hotels and restaurants (**figure 1**). The expansion in tourism has been a key driver for these activities, with the annual number of tourists doubling in the past five years to 300,000.

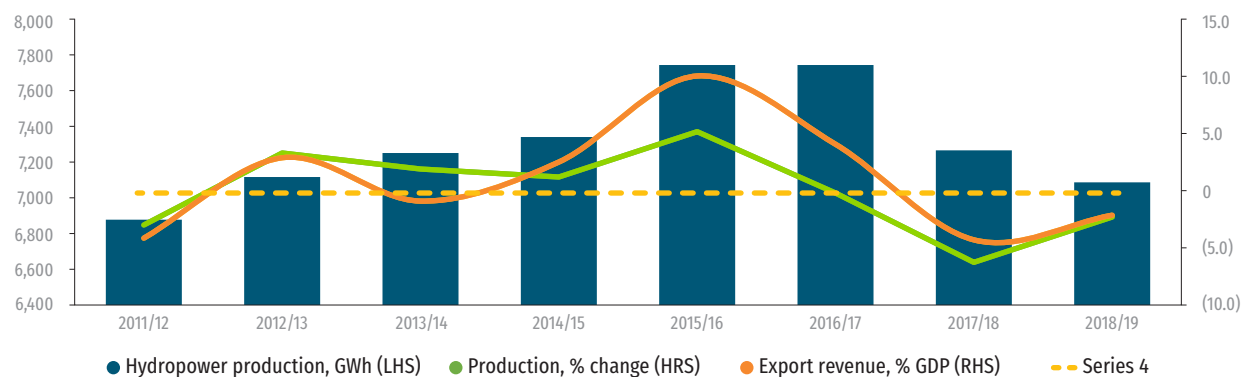
² The share of non-manufacturing industry—most of which is hydropower—stood at 30 percent in 2018/19.

Figure 1. Sources of growth (percent)



Source: NBS, WB staff estimates

Figure 2. Hydropower production (GWh) and export revenue (percent of GDP)

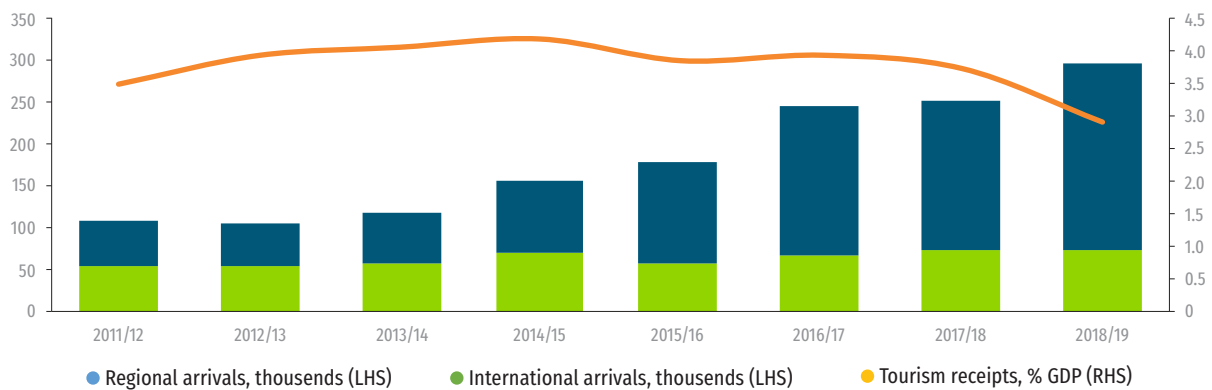


Source: MOF

Growth is estimated to have remained subdued in 2018/19 as hydropower production contracted further. After slowing to 3.8 percent in 2017/18 as a result of lower hydropower production, growth is estimated to remain subdued at 3.9 percent in 2018/19. Hydropower production declined further from 7,265 GWh in 2017/18 to 7,098 GWh in 2018/19 reflecting a combination of factors, including maintenance work in the largest hydro project Tala (1,020MW, accounting for 60 percent of total production) over the last two fiscal years, lower than expected rainfall - hydro production is heavily dependent on weather patterns -, and delays in the commissioning of the Mangdechhu

hydropower project (720MW). The latter was inaugurated in August 2019, four months behind schedule (**figure 2**). As a result, the industry sector, which includes hydropower, is estimated to have contracted by 0.5 percent in 2018/19.

The main driver of growth in 2018/19 was the services sector. The services sector showed robust growth in 2018/19 at 8.4 percent, supported by retail trade, transport and communication. The tourism sector however showed mixed results. Tourist arrivals increased by 17.8 percent in 2018/19, supporting growth in the services sector. Most of this increase came from regional tourists from India and

Figure 3. Tourist arrivals (thousands) and export revenue (percent of GDP)

Source: MOF

Bangladesh who are not subject to a minimum package fee.³ Their numbers increased by 24.8 percent in 2018/19 while the number of higher value non-regional tourist arrivals grew only by 0.4 percent. While total tourist arrivals increased, tourism receipts decreased from 3.7 percent of GDP in 2017/18 to 2.9 percent in 2018/19, mainly due to lower average spending (figure 3). To regulate the rising influx of regional tourists, the Tourism Council of Bhutan (TCB) has prepared a new Tourism Bill, which will be discussed in parliament in January 2020.

Despite efforts by the government, Bhutan still has some way to go in the creation of a competitive, job-creating private sector. The key constraints faced by the private sector include limited connectivity, lack of skilled manpower, low access to finance and regulatory bottlenecks in the business environment. The government is undertaking measures on all these fronts and the first economic census (discussed below) was a stock taking exercise in this direction.

2. Bhutan's First Economic Census

The Economic Census of Bhutan (ECoB) 2018/19—the first economic census conducted in the country—provides essential information on the real sectors of the economy. The census, conducted by the National Statistics Bureau (NSB), provides firm-level data for 13,997 economic establishments⁴ on parameters such as geographic location, legal status, ownership characteristics, as well as economic activities and employment. The census also provides information on the main business constraints. The key findings include the following:

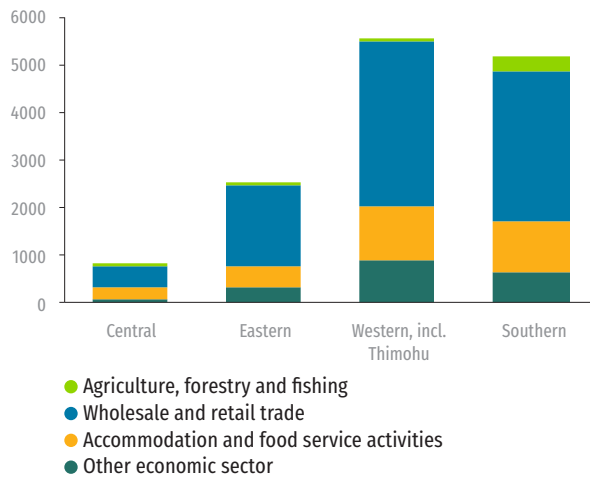
- (i) **Firms are geographically concentrated in the Thimphu dzongkhag and in urban areas.**⁵ Almost 60 percent of the firms are concentrated in 6 out of 20 dzongkhags, with Thimphu dzongkhag accounting for around 25 percent of the total. Almost two-thirds (64 percent) of the firms are located in urban areas, and Thimphu *thromde* alone represents 22 percent of the total. Almost two-thirds of firms (63 percent) are operating in the trade sector, mostly in retail trade (figure 4). This is followed by accommodation and food services

³ According to Bhutan's tourism policy, international visitors need an entry permit to visit the country and have to subscribe to a package costing a minimum of US\$250 per person per day. Regional visitors from India, Bangladesh and the Maldives do not require an entry permit.

⁴ The ECoB covers state-owned enterprises, NGOs, project authorities, farmer's groups and other legal forms. It does not cover general government offices, household-based businesses, household-based subsistence growing of crops and rearing of livestock, defense services and religious institutions.

⁵ Bhutan is geographically divided into 20 administrative districts referred to as *dzongkhags*, and four urban centers, called *thromdes* (Gelephu, Phuentsholing, Thimphu, and Samdrup Jongkhar). The definition of rural or urban is defined at the *Gewog* or town level.

Figure 4. Number of establishments by economic sector and region, 2017

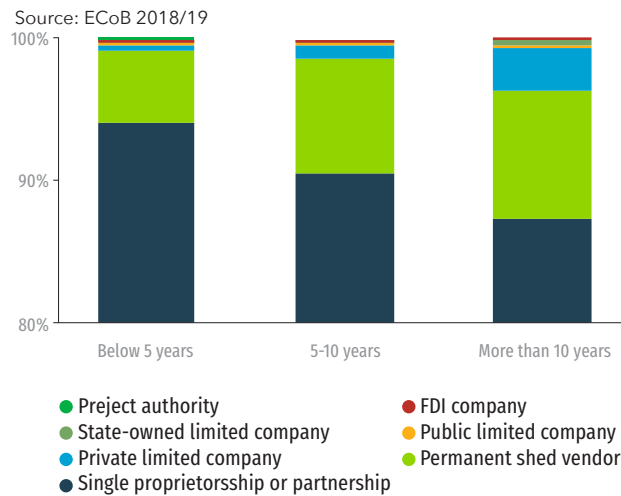


Source: ECoB 2018/19, and WB staff estimates

(21 percent) – mainly food and beverage service providers – and the manufacturing sector (5 percent). The agriculture sector accounts for 3 percent of total firms and is mainly present in the Southern region.

- (ii) **Bhutan’s real sector is dominated by young firms—about 55 percent of firms are less than 5 years old, and 34 percent of firms are 1-2 years old.** Almost all young firms operate as single proprietorships, partnership or permanent shed vendor (99 percent of firms less than 10 years old, **figure 5**). 56 percent of owners of single proprietorship and partnership firms are women, concentrated in the age bracket of 30–39 years of age. Private limited companies, public limited companies, and state-owned companies have been in operation significantly longer (on average between 13 and 16 years). The share of FDI related companies is relatively small in Bhutan (0.2 percent or 31 firms), with the majority being from India.
- (iii) **Employment is concentrated in a few large firms.** While large firms with 100 employees or more account for less than one percent of total firms, they employ 45 percent of

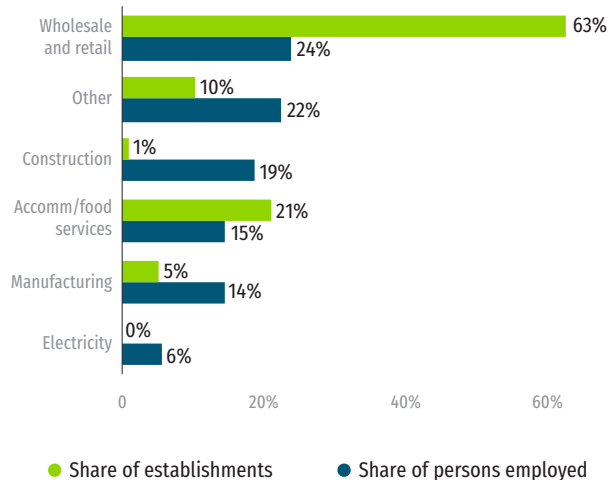
Figure 5. Establishments by legal status and duration of operation, 2017



the total workforce. Wholesale and retail, accommodation and food services (which account for 63 and 21 percent of total firms) employ only around 39 percent of workers. In contrast, construction and manufacturing (accounting for 1 and 5 percent of total firms) employ 19 and 14 percent of the labor force (**figure 6**).

- (iv) **The main business constraints include payment of rent, competition with the informal sector, access to finance, and electricity supply.** Access to finance and electricity are among the top six constraints in all economic sectors (ranked in terms of prevalence and severity). This is reflected in Bhutan’s ease of doing business (**figure 7**).⁶ While Bhutan scores better in most sub-indices and overall compared to the South Asian regional average (66 vis-à-vis 58.2), *getting credit* is at par with the regional average. Furthermore, *getting electricity* is the only sub-index with a lower score in 2020 vis-à-vis 2016. Compared across sectors, the lack of access to finance is more pronounced in the primary sector, followed by access to water and transport. Skill shortages and

⁶ WB Doing Business 2020.

Figure 6. Share of establishments and employment by economic sector, 2017

Source: ECoB 2018/19

elevated tax rates are the main constraints in the secondary sector, whereas firms in the tertiary sector listed the competition from the informal sector and payment of rent as the main obstacles to doing business.

3. Inflation and Monetary Policy

Monetary policy is anchored by the peg to the Indian Rupee (INR). The Bhutanese Ngultrum is pegged to the INR at par. The peg, introduced in 1974, served Bhutan well for macroeconomic stability, as India is Bhutan's largest trading partner. The peg remains an appropriate nominal anchor even though the real effective exchange rate has recently been moderately overvalued.⁷

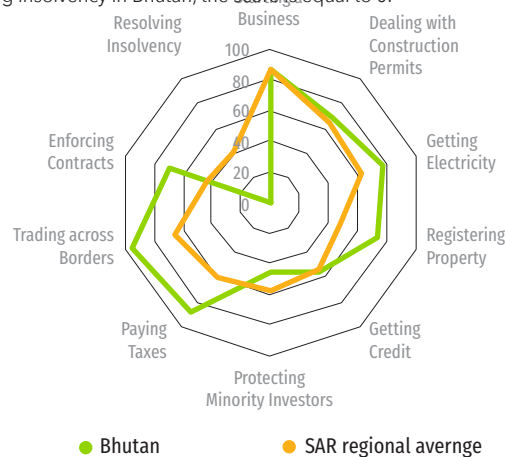
In 2018/19, average annual inflation decreased to its lowest level since 2003, reflecting a rapid decline in food prices. With 85 percent of Bhutan's imports coming from India and with the exchange rate pegged to the INR, Bhutan's inflation rate is closely linked to that of India, albeit with a time lag.⁸

⁷ IMF (October 2018). 2018 Article IV Consultation. External Sector Assessment. The ngultrum has been moderately appreciating in real effective terms. During the first quarter of 2018 the REER appreciated by 0.4 percent and the NEER depreciated by 2.5 percent. Movements in both the REER and NEER are heavily influenced by the rupee.

⁸ WB (November 2018). Bhutan Development Update. The time-lagged correlation coefficient between India's Wholesale Price Index (WPI) and Bhutan's CPI is statistically significant and suggests that Bhutan's CPI lags India's WPI by six months.

Figure 7. Bhutan's ease of doing business 2020, (score 0 center, score 100 outer edge)

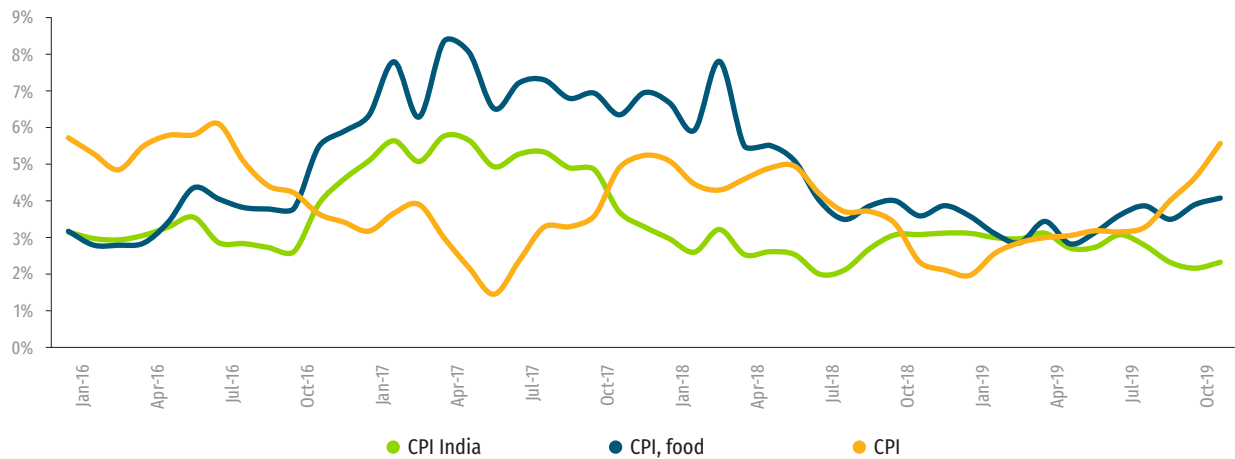
Source: WB Doing Business 2020. Since there is no practice regarding resolving insolvency in Bhutan, the score is equal to 0.



The annual inflation rate decreased by almost one percentage point from 3.7 percent in 2017/18 to 2.8 percent in 2018/19. The deceleration was largely driven by food prices, which account for about 40 percent of the Consumer Price Index (CPI) basket. Growth of food prices decelerated from 6.5 percent to 3.5 percent during the period. In November 2019, inflation was still moderate at 2.3 percent; however food prices have been increasing since mid-year (4.1 percent in November 2019), in line with the increase in food prices in India (figure 8).

The growth of money supply slowed down further in 2018/19 because of a decline in net foreign assets. Broad money increased by 5.6 percent in 2018/19 vis-à-vis 10.4 percent in 2017/18, the lowest growth in 7 years (figure 9). This was due to a continued decrease in net foreign assets (NFA), reflecting lower capital and financial flows including grants and Foreign Direct Investment (FDI)-related investments. The government continues with its efforts to enhance monetary management through the introduction of a new policy framework and a

Figure 8. CPI, Bhutan and India (percent change YoY)



Source: NSB

Figure 9. Money supply (percent change YoY)



Source: RMA

broadening of monetary policy instruments.⁹ This includes improved liquidity management and forecasting capabilities, establishing an interest rate corridor and supporting the development of the interbank market. Currently, the Royal Monetary Authority (RMA) relies on administrative instruments for managing liquidity and market conditions.¹⁰

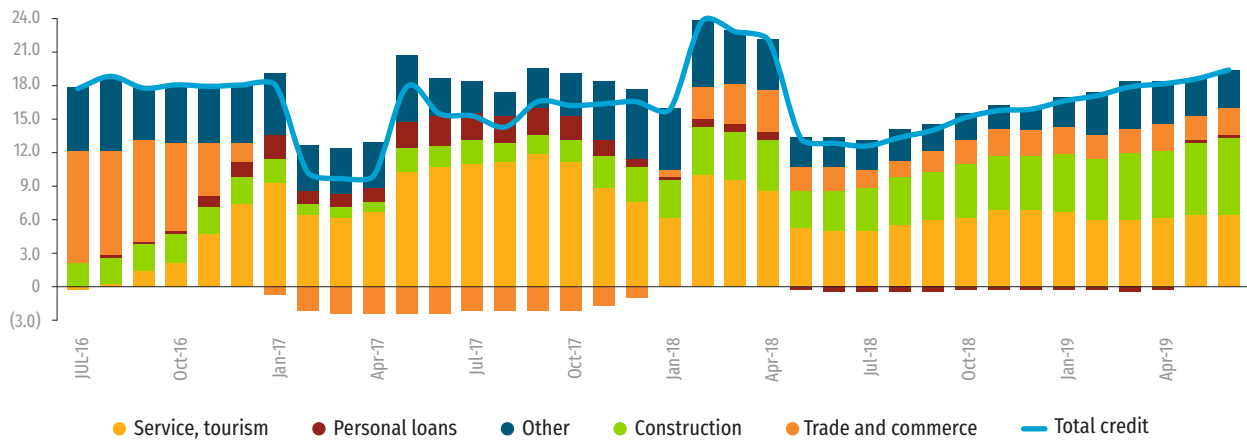
4. Financial Sector

Credit growth to the private sector remained strong in 2018/19 (16.7 percent, YoY), similar to the past three years. The stock of credit outstanding to the private sector as a share of GDP more than doubled since 2007 (standing at 65 percent at the end of 2018). Most of the credit is concentrated in construction, services and tourism, and trade sectors,

⁹ WB (July 2019). Bhutan Development Update.

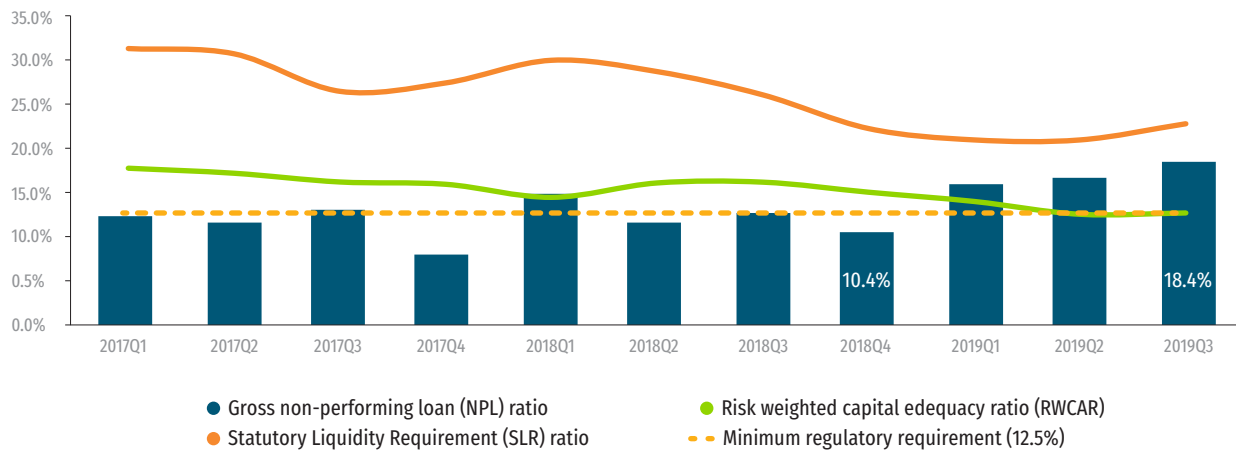
¹⁰ RMA has relied on the Cash Reserve Ratio CRR and statutory liquidity ratio (SLR) for monetary policy management. To guide banks' lending rates, the RMA relies on the Minimum Lending Rate (MLR) since August 2016. The move was intended to introduce a forward-looking and interest rate policy mechanism expected to enhance transparency in the bank credit market, and encourage competition and professionalism among banks. The MLR is a single reference rate for all financial institutions calculated using cost parameters across all banks, including certain regulations (such as CRR or SLR), overhead costs, and profitability.

Figure 10. Credit growth and contribution (percent change YoY, 3-months moving average)



Source: RMA

Figure 11. Financial sector soundness indicators (percent)



Source: RMA

while credit to the agriculture sector remained flat at around 5 percent of the total portfolio. Medium-sized enterprises are the largest recipients of loans, while the cottage and small industries (CSI) sector—the focus of the Priority Sector Lending (PSL) initiative¹¹—accounted for 5 percent of the total loan portfolio. The sectoral composition of credit has changed in recent years. While the share of the services and tourism sector increased from 17 percent in the beginning of 2016/17 to 24 percent by end-2018/19, trade and commerce declined from

21 to 14 percent in the same period (**figure 10**). This change primarily reflects a pick up in tourism in the past two years.

The gross NPL ratio stood at 18.4 percent in September 2019, adversely affecting the profitability of financial institutions. The banking sector is nascent. The profitability of the financial sector is low, with some institutions having large NPLs. The NPL ratio increased to 18.4 percent in September 2019, vis-à-vis 10.4 percent in December 2018 (**figure 11**).¹²

11 RMA has launched a PSL program to improve access to credit for the CSI sector in 2018. RMA decided to forgo enforcement of the envisaged priority sector lending targets for the commercial banks at the early stages of implementation.

12 The NPL ratio also increased YoY, from 12.4 percent in September 2018, to 18.4 percent in September 2019.

At the same time, provisions for NPLs decreased by 11.7 percentage points to 56.9 percent. While these movements reflect mid-year cyclical factors, the NPL and provisioning ratios have overall been negatively impacted in recent years.¹³ The increase in NPLs was largely attributable to the non-banking sector, which also has a lower loss absorption tolerance.¹⁴ Earnings of the financial sector decreased, mainly due to an increase in interest and operating expenses (commercial banks) along with an increase in NPLs and subsequent increase in provisions for the bad loans (in the non-banking sector).¹⁵

While financial soundness indicators remain comfortable in the banking sector, the risks for the financial sector are on the increase, and the sector's resilience needs to be further strengthened. The banking sector has adequate cushion to absorb potential losses given its capital adequacy (risk weighted capital adequacy ratio (RWCAR) at 12.8 percent in September 2019 and 15.1 in December 2018, with the minimum regulatory requirement at 12.5 percent). There are, however, concerns with regards to the non-banking sector. The financial sector's resilience needs to be further strengthened and the regulatory regime needs to be modernized to avoid a build-up of risks. There is a need to bolster prudential oversight, especially for non-banks, and the insurance sector in particular. It is equally important to develop a medium to long-term strategy for the non-banking sector, including options to diversify investment opportunities and improve asset-liability management.

5. External Sector

Bhutan has the third largest trade deficit (as a share of GDP) among South-Asian countries and trades heavily with India.¹⁶ The trade deficit is structural, reflecting hydropower investment, which requires large capital goods imports along with other

equipment and fuel. As a landlocked, mountainous country, Bhutan also largely depends on imports for its consumption needs. India is Bhutan's main trading partner, accounting for 80 and 85 percent of exports and imports, respectively. Bhutan's major exports in goods—in addition to electricity (accounting for 33 percent of exports)—are base metal (31 percent) and minerals (19 percent), most of which are low value-added. Tourism is the second-largest source of foreign-exchange earnings after hydropower.

The current account deficit (CAD) widened in 2018/19 on the back of lower electricity and tourism receipts. The CAD increased from 19.6 percent of GDP in 2017/18 to 23.9 percent in 2018/19 (figure 12). Falling imports—reflecting slowing construction activity of hydropower projects and fuel imports—could not offset a decline in electricity exports. The latter was a result of a combination of factors, including maintenance work in existing power plants, lower than expected rainfall, and delays in the construction of the Mangdechhu hydropower project. Exports in services dropped significantly from 7.2 percent of GDP in 2017/18 to 5 percent of GDP in 2018/19 due to a decrease in tourism receipts. The CAD was mainly financed by capital flows from India.¹⁷

International reserves, however, remain at comfortable levels. International reserves have grown steadily over the recent years and reserve adequacy measures are met by a wide margin. Gross international reserves stood at US\$1,093 million in August 2019, which is equivalent to 11.6 months of imports of goods and services (figure 13). The composition of reserves also improved after the rupee crisis in 2012-13, when overheating pressures led to a shortage of INR reserves. The share of INR has increased since and is better aligned with the country's external liabilities and trade structure.

13 The financial sector experiences significant fluctuations in its NPL ratio for the following reasons (i) NPLs are written off periodically; (ii) financial instruments are not well aligned with borrowers' expected cash flow distribution; and (iii) there are seasonal repayments based on the borrowers' activities. The NPL ratio to total loans stood at 12.3 percent for banks, and 48.7 percent for non-banks by end-September 2019.

14 A systemic insurance company, in particular, is experiencing significant balance sheet pressures.

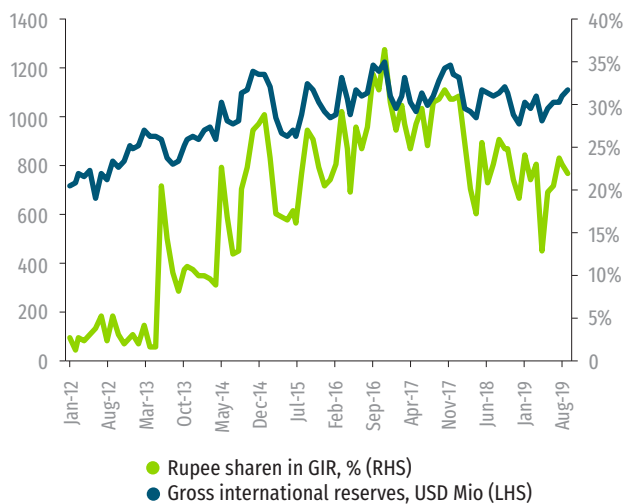
15 RMA (June 2019). Financial Sector Performance Review Report.

16 WB WDI (2019). Using trade balance as a share of GDP, average 2015-17, Bhutan has the third largest trade deficit after Afghanistan and Nepal.

17 The CA has been financed by surpluses in capital and financial accounts.

Figure 12. Current account, components (percent of GDP)

Source: RMA

Figure 13. Gross international reserves (US\$ Mio, LHS) and percent share of Rupee reserves in total reserves (RHS)

Source: RMA

Table 2. Balance of Payments, contributions, 2015/16-2018/19

Table: BOP, % of GDP	2015/16 (actual)	2016/17 (actual)	2017/18 (actual)	2018/19 (estimate)
Export	31.0	31.1	31.0	27.1
Goods	24.0	24.2	23.8	22.1
Services	7.1	6.9	7.2	5.0
Tourism	3.9	4.0	3.7	2.9
Import	(61.4)	(53.8)	(50.3)	(49.0)
Goods	(51.4)	(44.7)	(40.6)	(38.9)
Services	(10.0)	(9.2)	(9.6)	(10.0)
Primary income	(8.3)	(8.6)	(8.4)	(8.9)
Secondary income	7.0	7.7	8.1	6.9
Current Account	(31.7)	(23.6)	(19.6)	(23.9)

Source: RMA, WB staff estimates



6. Fiscal Performance

Fiscal outcomes have been largely dependent on hydropower revenues and grant inflows from India. Revenue volatility reflects heavy reliance on hydro-related revenues, a narrow tax base, and the dependence on grants. Domestic revenues are highly dependent on hydropower revenues, which accounted for around 20 percent of the total in the past five years. The tax-to-GDP ratio is low by international standards, standing at 15.6 percent in 2018/19, due to a narrow tax base, widespread exemptions and a nascent private sector. Bhutan is dependent on foreign resources for its capital

expenditure. Nearly 30 to 35 percent of total capital expenditure is financed through external grants and borrowings, mostly from India.¹⁸ Expenditure fluctuates due to FYP cycles (see **box 1** on fiscal policy under Bhutan's Five-Year Plans).

The fiscal balance improved further in 2018/19 due to a sharp decline in capital expenditure.¹⁹ The fiscal balance improved from a deficit of 3.3 percent of GDP in 2017/18 to an estimated surplus of 0.8 percent in 2018/19. This was primarily due to the decline in expenditures, which more than offset the decrease in revenues (**figure 14**). Grants as a share of GDP declined from 9.1 percent in 2017/18

¹⁸ Development assistance in the form of grants has played a significant role in the budget, accounting for 8.5 percent of GDP in 2015-2018. India accounted for 6 percent of GDP.

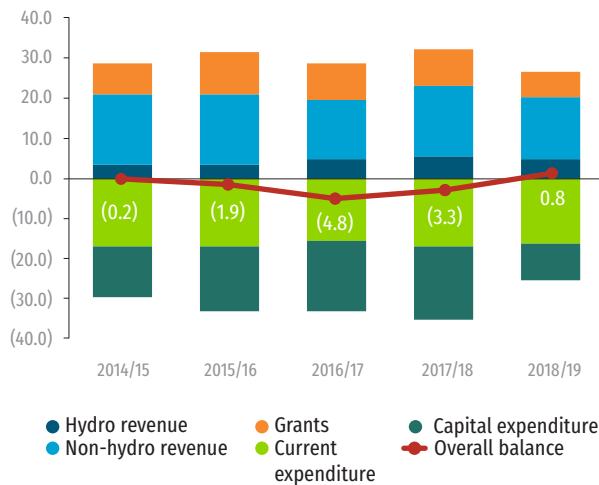
¹⁹ Capital expenditure on hydropower projects are not included in the budget, they are however part of the public debt stock. Maintenance and operational cost of past investments in infrastructure are included in the current expenditure.

Table 3. Fiscal accounts, 2015/16-2018/19

Table: Fiscal accounts	2015/16 (actual)	2016/17 (actual)	2017/18 (actual)	2018/19 (estimate)
Overall balance	(1.9)	(4.8)	(3.3)	0.8
Primary balance	(0.4)	(3.5)	(2.0)	1.8
Revenue	30.7	28.0	31.9	26.1
Hydropower revenue	3.5	4.4	5.1	4.4
DHI	1.9	1.6	1.4	1.2
Others	0.1	0.1	1.2	1.3
PIT	1.4	2.7	2.5	1.9
Taxes on Goods and Services	-	-	-	-
Non-hydro revenue	16.4	15.1	17.7	15.6
Excise Duty Refund from India	5.6	5.2	5.9	5.8
Royalties	6.9	7.3	8.1	7.4
Hydropower	3.9	2.6	3.8	2.4
Grants	10.9	8.5	9.1	6.2
Expenditure	32.7	32.8	35.2	25.3
Current expenditure	16.7	15.8	16.8	15.9
Compensation of employees	6.9	6.2	6.0	6.7
G/S	4.5	4.3	4.2	4.2
Interest payments	1.5	1.3	1.3	0.9
Transfers and subsidies	2.3	2.7	4.0	2.7
Other	1.5	1.4	1.4	1.5
Capital expenditure	15.9	17.0	18.3	9.3

Source: MoF

Figure 14. Fiscal accounts, components (percent of GDP)



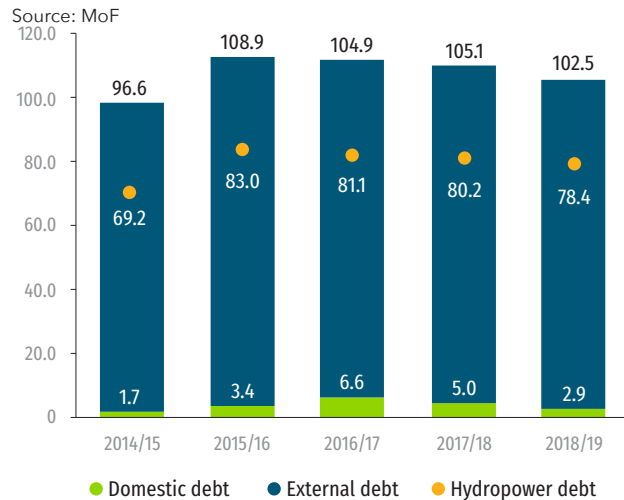
Source: MoF

to 6.2 percent in 2018/19 as capital expenditures remained subdued. At the same time, hydropower revenues²⁰ decreased from 5.1 percent of GDP in 2017/18 to 4.4 percent of GDP in 2018/19, reflecting lower hydropower production. Non-hydro revenues declined as a result of one-off factors, including the discontinuation of the excise duty refunds from India²¹ (indirect tax revenue) and a decrease in profit transfer from RMA (non-tax revenue).

The decrease in revenues was surpassed by an even larger contraction in fiscal spending. Capital expenditure decreased significantly, from 18.3 percent of GDP 2017/18 to 9.3 percent in 2018/19 as a result of the 2018 elections. While the interim budget did not include new investment projects, the new budget was only approved in January 2019, delaying the initiation of new investment projects. The control on current expenditure remained tight.

Public debt levels remain high, but risks are moderate as most of the external debt is linked

Figure 15. Public debt (percent of GDP)



to hydropower project loans from India. External debt increased significantly over the past two decades, driven by disbursements for hydropower projects. Public debt as a share of GDP remains high, estimated at 105.4 percent of GDP at the end of 2018/19 (figure 15). Hydropower debt accounted for 74.4 percent of the total debt stock. According to the 2018 Debt Sustainability Analysis (DSA), the risk of debt distress however remains moderate. Around 95 percent of total debt is external with a long-term maturity, of which the majority is linked to hydropower project loans from the government of India (74.3 percent of GDP). This debt is denominated in INR and electricity export receipts are also in INR. The loans from India are under an intergovernmental agreement in which the government of India covers both financial and construction risks of the hydropower projects and buys surplus electricity at a price reflecting cost plus a 15 percent net return. Domestic debt remains a small share of GDP (2.9 percent).

20 Hydropower revenue includes corporate income taxes (CIT), royalties, one-time profit transfers (when a project is handed over to the government of Bhutan), and dividends.

21 The government of India collected excise duties on alcohol and other excisable products that were exported to Bhutan, and transferred them to the government of Bhutan. With the introduction of GST in India, this arrangement has come to an end because of removal of excises on exports from India. Since these revenues are transferred with a delay of one year, the impact is evident in the current year.

Box 1. Fiscal policy under Bhutan’s Five-Year Plans

Fiscal outcomes have been largely dependent on five-year planning cycles in the past. Bhutan’s development strategy has been guided by five-year plans (FYPs), a series of national development plans initiated in 1961. While current expenditures have remained largely constant as a share of GDP, capital expenditures tend to increase toward the end of the FYP cycle. This results in a deterioration of the fiscal balance as the plan progresses and leads to a significant increase in aggregate demand (figure 16). Fiscal policy is further complicated by volatile hydropower revenues, which leads to procyclical fiscal policy. For example, the commissioning of the Tala hydropower project in 2007 resulted in a doubling of government revenues, leading to higher government spending—highlighting the need to ensure the sustainability of spending trajectories.

The government is implementing measures to reduce volatility in fiscal revenue and expenditure. The government established a stabilization fund in 2017—the Bhutan Economic Stabilization Fund (BESF)—to manage hydropower revenues and business cycle fluctuations, and operating rules are currently being designed. The adoption of fiscal stabilization measures will help the government to implement counter-cyclical fiscal policies and ensure even distribution of expenditure, thereby reducing fluctuations in aggregate demand and building fiscal space.

The 12th FYP ‘Just, Harmonious and Sustainable Society through enhanced Decentralization’ lays out the national economic development plan for 2018-23. The 12th FYP, led by the Gross National Happiness Commission, was finalized in January 2019. The plan’s overall objective is to increase well-being and happiness for the people of Bhutan, focusing on 17 National Key Result Areas, including, among other, macroeconomic stability, economic diversification, and job creation. The fiscal framework for the 12th FYP (figure 17) projects a total financing gap of Nu 29.2 billion (US\$450 million).

Measures to increase domestic revenue and develop domestic capital markets are crucial for the implementation of the 12th FYP. Efforts are needed to increase the domestic (non-hydro) revenue base, including through the introduction of the GST regime in 2020 and reforms in tax administration. As Bhutan is expected to graduate from the United Nations’ least developed country status in 2023 and concessional financing is likely to decrease, the authorities need to develop the domestic public debt market and increase public-private partnerships.

Figure 16. Fiscal outcomes over FYP cycles (percent of GDP)

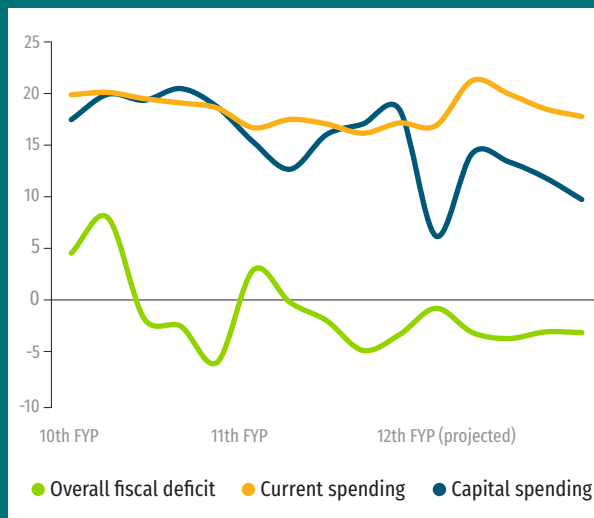
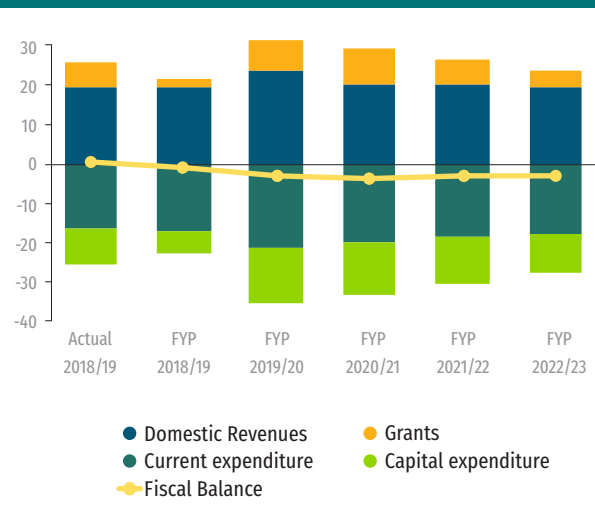


Figure 17. Fiscal framework, as per 12th FYP (percent of GDP)



Source: Gross National Happiness Commission (GNHC)



II. Outlook and Risks

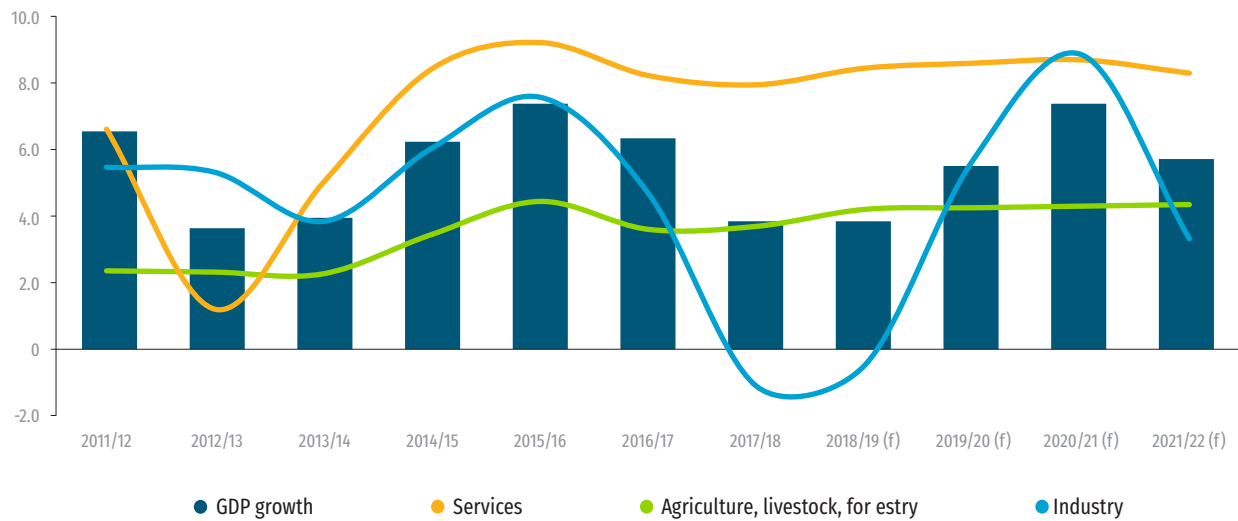
Economic growth is expected to average at around 6 percent a year over the medium term, supported by an increase in hydropower production and good growth in the services sector (figure 18). Growth is projected to rebound in 2019/20 to 5.5 percent following the operationalization of the Mangdechhu hydropower project, although the plant is only expected to reach full potential in 2020/21 (figure 19).²² The services sector is projected to retain its growth momentum, with the key drivers in the hotel and restaurant, transport, and retail trade

sub-sectors, buoyed by tourism demand. Growth in agriculture and manufacturing is gradually strengthening, supported by improvements in the business environment, such as the implementation of the 2019 FDI policy.

Inflation is expected to pick up in the near future due to the increase in food prices in India (figure 8). It is however expected to decline over the medium term as RMA steps up efforts to strengthen monetary management.

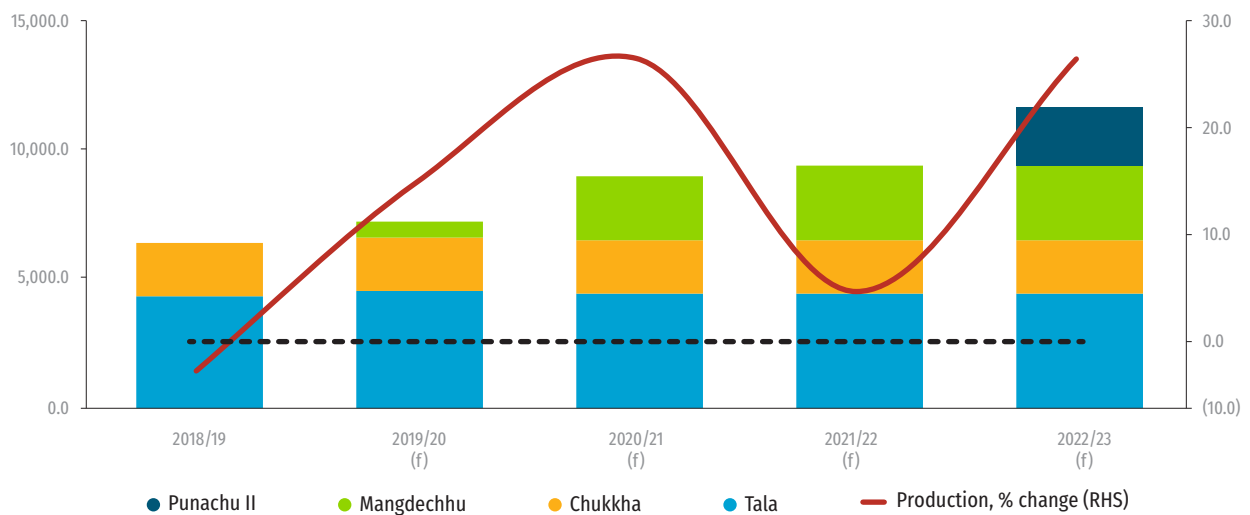
²² Bhutanese (November 2019, Vol 08 issue 42). After the commissioning of the Mangdechhu hydropower project in August 2019, the plant was suspended the following month due to computer and mechanical issues that affected all four turbines.

Figure 18. Growth projections 2018/19-2021/22 (percent change)



Source: MoF, WB staff estimates

Figure 19. Hydropower production, estimated capacity (GWh, LHS)



Source: MOF, WB staff estimates

External accounts are expected to improve over the medium term. The CAD is projected to narrow over the medium term, driven by an increase in electricity exports with the on-streaming of the Mangdechhu and Punatsangchhu II projects in 2019/20 and 2022/23, respectively. Imports are expected to increase due to the ongoing construction of Punatsangchhu II and I and higher public capital spending, thus increasing imports associated with hydropower construction and infrastructure

projects. Although current account deficits are likely to persist due to imports associated with the hydropower sector, they will continue to be financed by capital inflows from India.

The adoption of fiscal stabilization measures is expected to reduce revenue and expenditure volatility in the medium term. Hydropower revenue is projected to increase in the medium term as production levels increase, boosted by the one-off profit transfer

from the commissioning of the Mangdechhu power plant in 2019/20 and 2020/21.²³ Grants, as a share of GDP, are expected to decrease in the medium term, in line with reduced grant financing from India over the 12th FYP cycle. The planned introduction of the green tax on fuel in 2019 and the GST in 2020, as well as a gradual improvement in tax administration are expected to support non-hydro revenues and partly offset the decline in grants.²⁴ After an expansionary fiscal stance in 2019/20 due to a pick up in capital spending, the overall deficit is expected to remain moderate with a slight increase in 2021/22 because of the absence of profit transfer revenues. Capital expenditure—constrained by the reduced grant inflows for the 12th FYP from India—is expected to decrease in the medium term in line with the 12th FYP. Current expenditure is projected to remain tight despite the expected salary increase in 2019/20 (which is largely financed by the one-off profit transfer from the Mangdechhu hydropower project),²⁵ supported by public financial management measures to increase expenditure efficiency and the adoption of fiscal stabilization measures (**box 1**).

Public debt is projected to gradually decline over the medium-term. According to the 2018 DSA, jointly conducted by the World Bank and the IMF, the risk of debt distress remains moderate despite breaches in all five indicators under the baseline scenario. This is because of the intergovernmental arrangement on hydropower projects between India and Bhutan which ensures that financial and construction risks of the projects are covered by India, which buys surplus electricity at a price reflecting cost plus a 15 percent net return. Total public debt is expected to decline gradually over the medium term as debt servicing starts with the on-streaming of hydropower projects.

The main downside risk to growth is volatile hydropower production due to further delays in project

completion and/or adverse weather events. Lower hydropower production results in lower electricity exports and a deterioration in fiscal accounts. The construction of Punatsangchhu I and II projects has been delayed for several years due to geological problems. A one-year delay in project implementation is estimated to lower growth by 3-4 percentage points (through lower production levels), reduce annual export revenue by US\$250-300 million and government revenue by 0.5 to 1 percent of GDP.²⁶ Electricity production also strongly depends on water availability and weather patterns, and the frequency and intensity of extreme events is expected to increase with climate change. Weather related events could also impact tourist arrivals.

Delays in the implementation of the GST and other revenue measures constitute another risk. External grant financing as a share of GDP declined significantly from an average of 11.6 percent during the last two FYP cycles (2008/09-2017/18) to 6.2 percent in 2018/19, based on the bilateral discussions with India. In addition, excise duty refunds from India have also been discontinued. The introduction of the GST in 2020 and other revenue measures are critical to offset the decline in excise duties and grant financing in the medium to long term. Delays in the implementation of these revenue measures could lower the resource envelope available to the government. This risk is partly mitigated by the implementation of fiscal stabilization measures (under discussion), which will help smoothen spending over the medium to long term, especially after the completion of the existing mega hydropower projects.

In the medium term, Bhutan faces two key challenges: making growth more inclusive, and less reliant on hydropower activities. Bhutan needs to facilitate more private-sector-led growth to increase employment opportunities and domestic revenues and

23 The peak in hydropower revenue in 2019/20 and 2020/21 is due to one-off profit transfer revenues associated with the commissioning of new hydropower plants. Profit transfers are expected to resume in 2023/24 with the commissioning of Punatsangchhu II and I in 2022/23 and 2023/24, respectively.

24 The parliamentary session in January 2020 will discuss the GST bill and various revisions to the income tax act, property tax, and financial incentives act.

25 The government formulated the Fourth Pay Commission in January 2019. The report was prepared based on three principles: (a) protecting erosion of income from past-unadjusted inflation, (b) linking salary to performance, and (c) enhancing the post-retirement benefits. Also, to improve effectiveness and efficiency, the report recommends introducing performance-based incentives (PBI).

26 WB (July 2019). Bhutan Development Update.

lessen the country's dependence on foreign grant financing. While the hydropower sector has contributed significantly to economic growth, electricity export markets in South Asia are rapidly changing, and the recently adopted framework for cross-border trade of electricity in India has added to the uncertainty in accessing foreign electricity markets. Despite efforts by the government to improve the business environment, the private sector remains underdeveloped and is dominated by small and micro firms, with a majority operating in services and retail trade, as illustrated in Bhutan's first economic census (see section A.2).

Bhutan achieved great strides in poverty alleviation but the pace of progress in shared prosperity has slowed in recent years. The share of Bhutan's population living on less than US\$3.20 (in 2011 PPP terms) decreased from 36.4 percent in 2007 to 12.1 percent in 2017. Disparities between urban and rural areas remain, with 96 percent of the poor living in rural areas. Gender disparities in economic opportunities persist and the quality of jobs is lower among women as they are more likely to work in low-paying sectors including subsistence agriculture.²⁷ The special section in this economic update outlines recent trends in poverty and shared prosperity.

²⁷ WB (2019). Forthcoming Systematic Country Diagnostic (SCD) for Bhutan.



III. SPECIAL SECTION. Recent Trends in Poverty and Shared Prosperity: Progress and Challenges

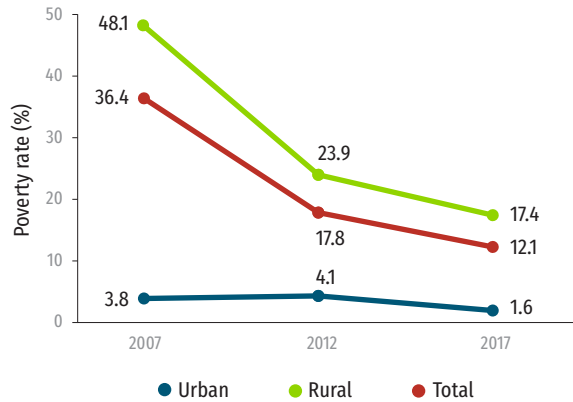
1. Recent progress in poverty reduction and welfare

Poverty declined in recent years with rural areas making significant strides. At \$3.20 per person per day (in 2011 PPP terms), the poverty headcount decreased from 36.4 percent in 2007 to 17.8 percent in

2012 and then further to 12.1 percent in 2017.²⁸ The \$3.20 poverty line is the World Bank's poverty line for lower-middle-income countries such as Bhutan. Urban poverty has been low and decreased further from 4.1 percent in 2012 to 1.6 percent in 2017. Poverty in rural areas declined significantly throughout the decade, from 48.1 percent in 2007 to 17.4

²⁸ The poverty trend presented in this section differs from the official poverty trend for two reasons: (a) the consumption aggregate was harmonized across years to ensure consistency; (b) the World Bank's \$3.20 poverty line (in 2011 PPP terms) is used as a threshold to identify the poor. For more details on the methodology, see WB (2019) "Bhutan Poverty, Vulnerability and Welfare".

Figure 20. Poverty rates according to World Bank’s international poverty line of \$3.20 per day (in 2011 PPP terms)



Source: Calculations using Bhutan Living Standards Survey (BLSS) for 2007, 2012, and 2017.

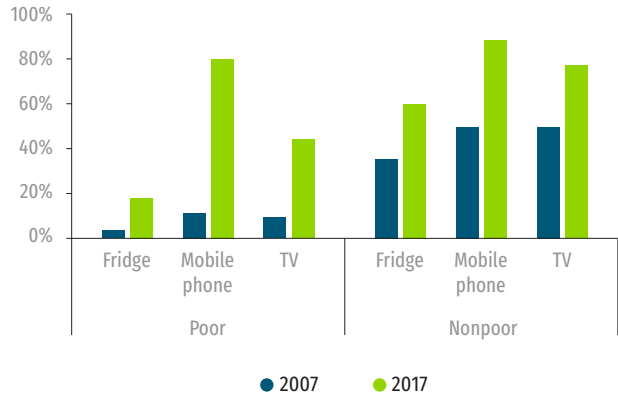
percent in 2017 (**figure 20**). As almost all of the poor reside in rural areas, the large improvements in rural areas drove progress at the national level.

In line with reduction in monetary poverty, asset ownership also improved significantly, for the poor as well as the nonpoor. Among poor households, the ownership of refrigerators rose from 3 percent in 2007 to 17 percent in 2017, while that of mobile phones increased from 10 percent to 79 percent over the same period. Nevertheless, the gap between the poor and nonpoor remains wide as the latter group experienced significant improvements as well (**figure 21**). The ownership of large assets such as cars remains particularly low among the poor (2 percent) compared to the nonpoor (25 percent).

However, progress was uneven and differences in poverty rates between Dzongkhags are large. As of 2017, poverty varies widely across districts (**Figure 22**) and remains almost exclusively a rural phenomenon, with 96 percent of the poor residing in rural areas. Most districts experienced steady progress in poverty reduction between 2007 and 2017: for example, the poverty headcount in Chukha, the second-most populous district, decreased from 32.2 percent in 2007 to 16.1 percent in 2012 and further to 7.4 percent in 2017. The poverty headcount in Samtse, which accounts for the largest number of

Figure 21. Selected asset ownership of poor and nonpoor, 2007-2017

Source: Calculations using BLSS for 2007, 2012, and 2017. Note: No data on mobile phone ownership in 2012.



poor people, declined from 53.2 percent in 2007 to 32.3 percent in 2012 and to 17.5 percent in 2017. In contrast, the poverty headcount rates in Dagana and Zhemgang, the two districts with the highest incidence of poverty, declined strongly between 2007 and 2012 but increased again afterwards. As of 2017, the poverty rate was 42.8 percent in Dagana and 36.5 percent in Zhemgang. Both are remote districts located in the central part of Bhutan. Just three districts – Dagana, Monggar, and Samtse – accounted for more than a third of the total number of poor due in part to their large populations.

While educational outcomes saw large improvements, disparities across districts persist. Educational attainment increased tremendously in the last decades: while the share of 15-29 year-olds with no education was 17.4 percent in 2017; the same figure was 57.2 percent for 30-49 year-olds and 84.4 percent for 50-64 year-olds. Progress continued in recent years, with net secondary enrollment expanding rapidly and surpassing 70 percent in 2017. Enrollment rates are higher among women at all levels, which is a significant progress considering that literacy rates and educational achievements are lower among women in older cohorts. Non-formal education programs have helped improve basic literacy and numeracy skills. However, there are large disparities across the country: only 20 percent of

Figure 22. Dzongkhag-level poverty rates in 2017



Source: Calculations using Bhutan Living standards Survey (BLSS) for 2017.

individuals aged 15–29 in Zhemgang have obtained upper-secondary education, which is one-third the rate for Thimphu (59 percent).

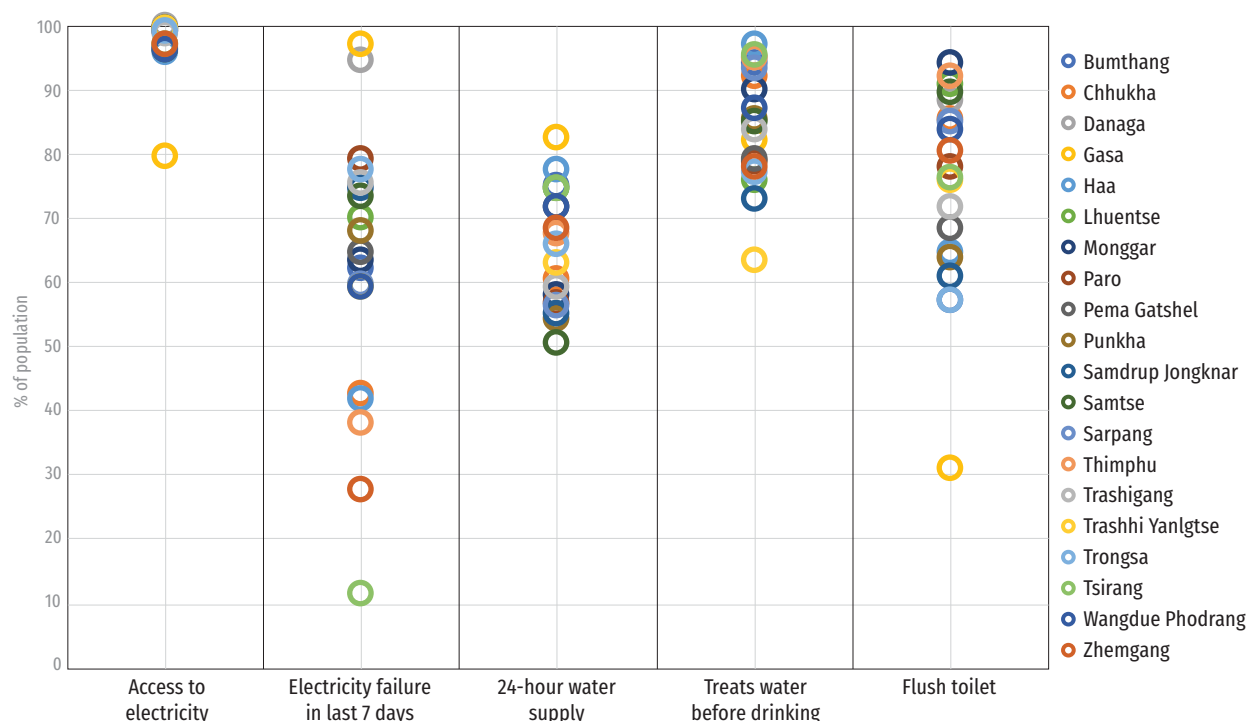
Bhutan’s health system performs well in terms of coverage, affordability and availability of care; however, quality of care and equitable access require attention as changes in the population health profile place an increasing burden on the system. Access to health care improved, especially at lower levels of care. Coverage is almost universal because public health services are free. As of 2017, 99 percent of the urban and 86 percent of the rural population live within an hour of a health care facility (outreach clinic, basic health unit, or district hospital). However, it still takes significantly longer to reach a health care facility in rural areas than in urban areas. Out-of-pocket expenditure remains low, at 12 percent in 2014, as access to government health facilities is high, providing financial protection to households. A large share of this expenditure is related to transport costs, which may lead to inequitable access to services. The incidence of non-communicable diseases (NCDs) is increasing rapidly, while the burden of communicable diseases remains significant; the existing system is however not well equipped to meet the challenges of the ongoing epidemiological transition. While the government has continued

to invest in health infrastructure, with just 3.7 doctors (300 total) and 15.1 nurses per 10,000 population in 2017, there is an acute shortage of health professionals, especially among specialists.

Similarly, the quality of other basic services is also highly variable across the country. With a rapid expansion, almost every Bhutanese has access to electricity, but the quality of service varies substantially: the share of households that experienced a power outage in the last seven days ranges from 11 percent in Tsirang to 95 percent in Dagana. The overall average is just below 60 percent. Access to water has improved, but almost 90 percent of the population treats water before drinking it. Across districts, the share of households with 24-hour water supply varies from 51 percent to 83 percent. 81 percent of households have a flush toilet at home but in three districts this figure is less than 60 percent (figure 23). The lack of safe drinking water and basic sanitation could contribute to high levels of stunting among children under five, estimated at 21.2 percent. Waterborne diseases such as diarrhea and dysentery are among the diseases with the highest incidence in Bhutan.

The share of households that “feels poor” declined significantly, but the monetary poor are less likely to be happy. The share of households that felt “not

Figure 23. Quality of various basic services across districts



Source: Calculations using BLSS for 2017.

Table 4. Monetary poverty vs subjective poverty **Table 5. Monetary poverty vs happiness**

Indicator of poverty	Monetary poverty measure		
	Not poor	Poor	Total
No	21.3	11.8	20.2
Neither poor nor unpoor	63.6	56.8	62.8
Poor	11.8	24.7	13.3
Very poor	1.3	5.4	1.8
Don't know	2.1	1.3	2.0
Total	100.0	100.0	100.0

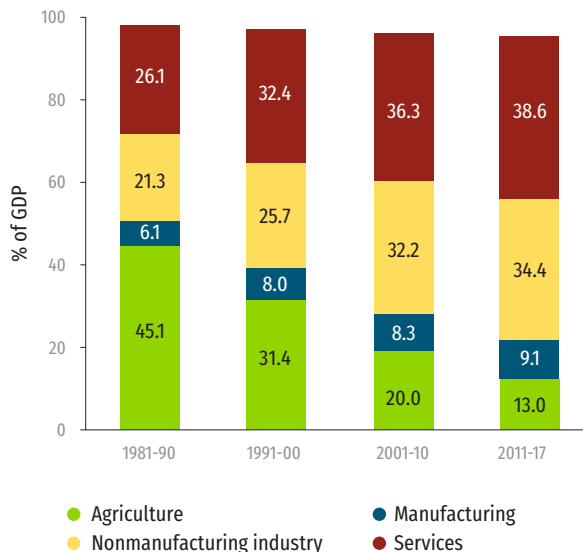
Source: Calculations using BLSS for 2017.

Indicator of happiness	Monetary poverty measure		
	Not poor	Poor	total
Very unhappy	2.2	3.7	2.4
Moderately unhappy	3.0	7.1	3.5
Neither happy nor unhappy	17.1	25.9	18.1
Moderately happy	39.3	37.8	39.1
Very happy	38.5	25.5	36.9
Total	100.0	100.0	100.0

poor” almost doubled from 10.7 percent in 2012 to 20.2 percent in 2017. The share of households that felt either “poor” or “very poor” fell significantly from 25.7 percent in 2012 to 15.3 percent in 2017. However, poverty was felt differently according to monetary poverty status: 3 out of 10 households that

are considered monetary poor also felt poor or very poor, whereas only about 13 percent of the nonpoor felt the same (table 4). In terms of the perception of happiness, the poor are significantly less likely to be happy and more likely to be unhappy than the nonpoor (table 5).

Figure 24. Contribution to GDP (value added), by sector



Source: World Development Indicators.

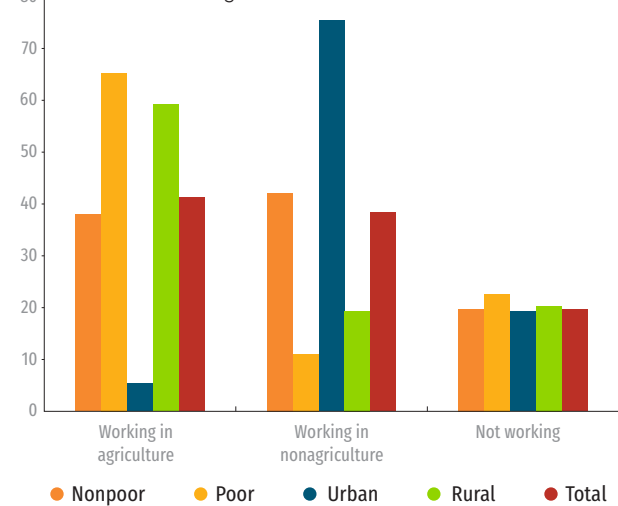
2. Drivers of poverty reduction

Economic growth was strong, driven by hydropower development, but it was not accompanied by job creation. The hydropower sector contributed to strong economic growth, which led to an increase in the share of industry and services in GDP (figure 24). While hydropower receipts helped finance large investments in education and health, labor market outcomes did not improve substantially because the capital-intensive hydropower sector has not significantly contributed to job creation, accounting for less than one percent of total jobs.²⁹ Meanwhile, hydropower construction relies extensively on foreign labor.

The working-age population expanded rapidly but labor force participation declined, particularly among women. Between 2013 and 2016, more than 41,000 persons entered the labor market. However, only around 11,000 net jobs were added over the same period. The increase in inactivity occurred mainly among younger cohorts (ages 15-29) and among women. Unemployment rates are low, hovering around 2-3 percent in recent years and are only slightly higher in

Figure 25. Share of population whose household head is working in agriculture, working in non-agriculture or not working (%)

Source: Calculations using BLSS for 2017.



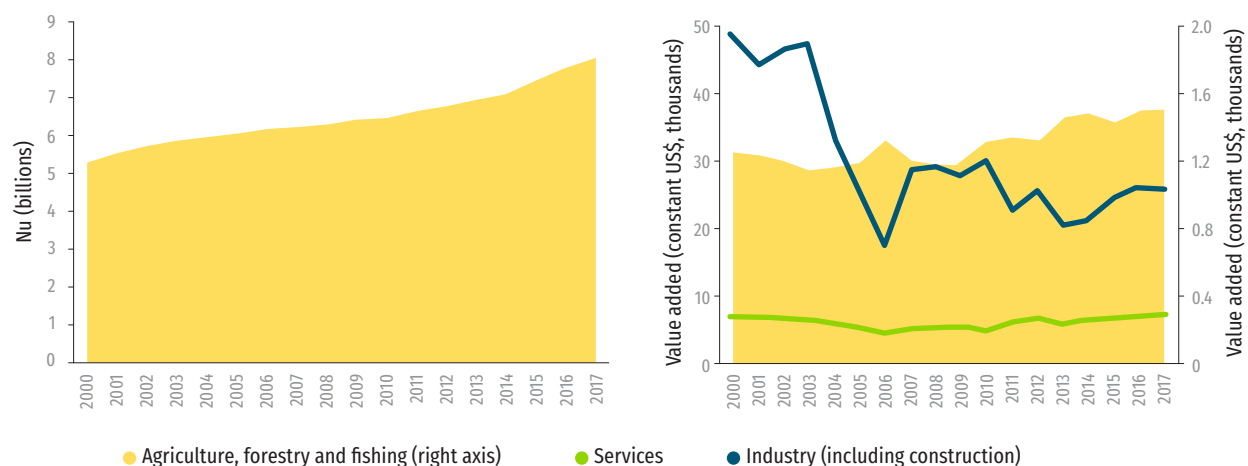
urban areas. Most job search is conducted by better educated youth living in urban areas.

Poverty is highly correlated with being engaged in agriculture. Nearly 60 percent of the employed were engaged in agriculture in 2016. In rural areas, the share amounted to 78.1 percent, compared with only 5.9 percent in urban areas. Working in agriculture is highly correlated with being poor, as 66 percent of the poor live in households where the head is engaged in agricultural activities (figure 25). This is much higher than the estimate for nonpoor households (38 percent). 11 percent of the poor and 42 percent of nonpoor live in a household where the household head works in the non-agricultural sector. Wage employment remains low and concentrated in urban areas: 70 percent of urban households and only 21 percent of rural households rely on wages for their primary source of income.

Poverty reduction was likely driven by improvements in agricultural productivity and better prices of cash crops. A critical data gap - i.e., limited information on agricultural activities at the household

²⁹ Labor Force Survey (LFS) Report Bhutan 2018.

Figure 26. Total output (L) and value added per worker (R) in agriculture, forestry and fishery increased



Source: World Development Indicators.

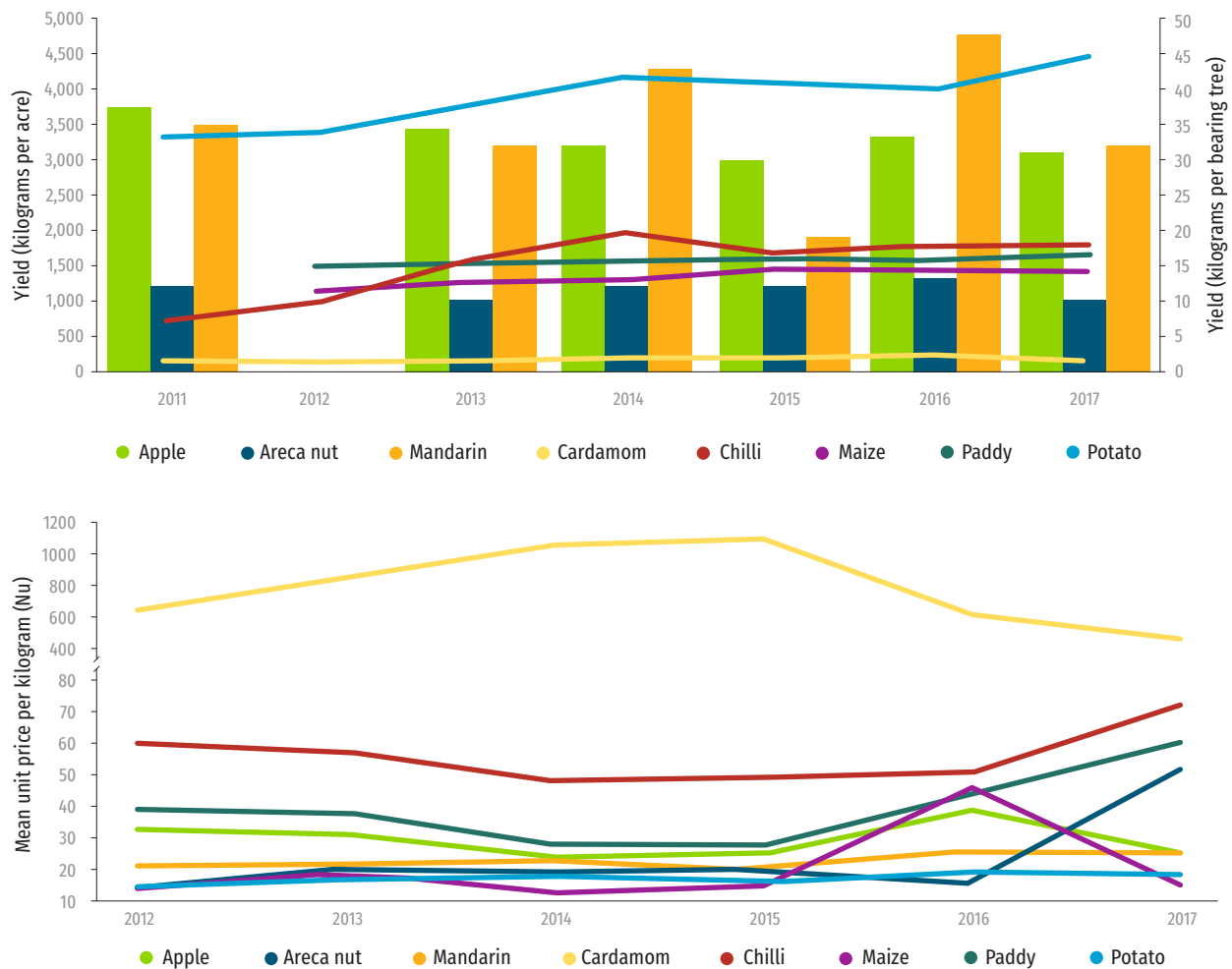
level –, makes it difficult to make direct linkages between agricultural activities and poverty reduction. However, aggregate data shows that the output in the primary sector increased steadily, with a small acceleration in recent years (figure 26, left). Value added per worker also improved accordingly (figure 26, right). Most gains were observed in the crop subsector where output growth increased steadily through 2016. The livestock subsector also grew, mainly due to increased demand for dairy products.

Increased cash crop farming and generally higher returns contributed to higher earnings. A handful of fruits and crops account for most earnings in the crop sub-sector: specifically, apples, areca nuts and mandarin account for more than 90 percent of earnings from fruits, and high-value crops such as cardamom, chili and potato make up more than 80 percent of earnings from crops. Total earnings from these key fruits and crops have generally improved, but there has been a lot of volatility in average yields and prices (figure 26, figure 27). On the other hand, a large share of harvest land is devoted to maize and paddy (57 percent in 2017) but their contribution to national crop earnings is negligible at 2 percent. These are the main staple crops which are of low value and a large share of which is produced by farm households for their own consumption.

Price and yield trends were generally favorable and led to higher earnings but have also been volatile, which raises concern over the sustainability of these improvements. Yields remained largely stagnant for fruit crops but showed marked improvements for potato and chili (figure 27, left). However, prices exhibited large fluctuations in the 2012-2017 period, particularly for cardamom and chili, the crops with the highest unit price (figure 27, right). Higher prices can lead to higher earnings if agricultural households are net producers.

Vulnerability is high in the population, partly because farmers' exposure to uninsured risks leads to volatility in earnings. Higher prices can increase earnings during good times, but subsequent price drops can have the opposite effect if farmers are not insured against negative price shocks – that is, exposure to frequent shocks can contribute to high levels of vulnerability. There are several sources of risks in Bhutan that could lead to such shocks: for example, agricultural production is heavily reliant on irrigation and thus rainfall. Bhutan's location in the Himalayan mountains places the population at substantial risk of climate change and potentially extreme weather variations are expected to increasingly affect agricultural production. In addition to weather variability, wildlife predation is a widespread concern which further increases vulnerability. More broadly, external

Figure 27. Average yields (L) and prices (R) of key fruits and crops



Source: Agriculture Statistics for each year (NSB, various years). Note: Yield is measured as kilograms per bearing tree for apple, areca nut, and mandarin (right axis); and as kilograms per acre for cardamom, chilli, maize, paddy, and potato (left axis). No yield data for fruits in 2012. Prices are measured as the mean unit price (Nu per kilogram) of main fruits and crops. Prices are deflated using food consumer price index (December 2012 = 100).

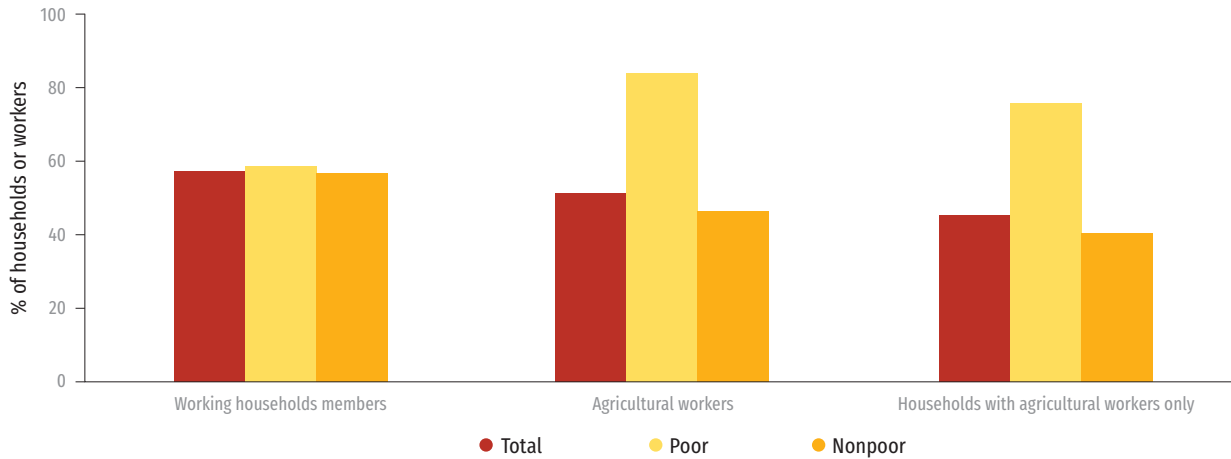
food price shocks are likely to have wide-ranging effects on consumption because Bhutan imports 34 percent of its cereal needs. Meat consumption is also mostly met by imports.

Although poverty declined, vulnerability remains high with many households remaining just a small shock away from poverty. The extent of vulnerability is illustrated with a simple simulation that shows how the poverty rate changes with a small increase in the poverty line. For example, a 20 percent increase in the 2017 poverty line (US\$3.20 in 2011 PPP terms) would almost double the poverty headcount rate, from 12.1 percent to 20.1 percent. A larger shock

equivalent to a 50 percent shock almost triples the headcount to 31.7 percent. Alternatively, if the poverty line in 2017 had been just 15 percent (or Nu 354 per month) higher - equivalent to about US\$14 (in 2011 PPP terms) per person per month, or less than half a dollar per day - the poverty headcount rate in 2017 would have been unchanged from 2012.

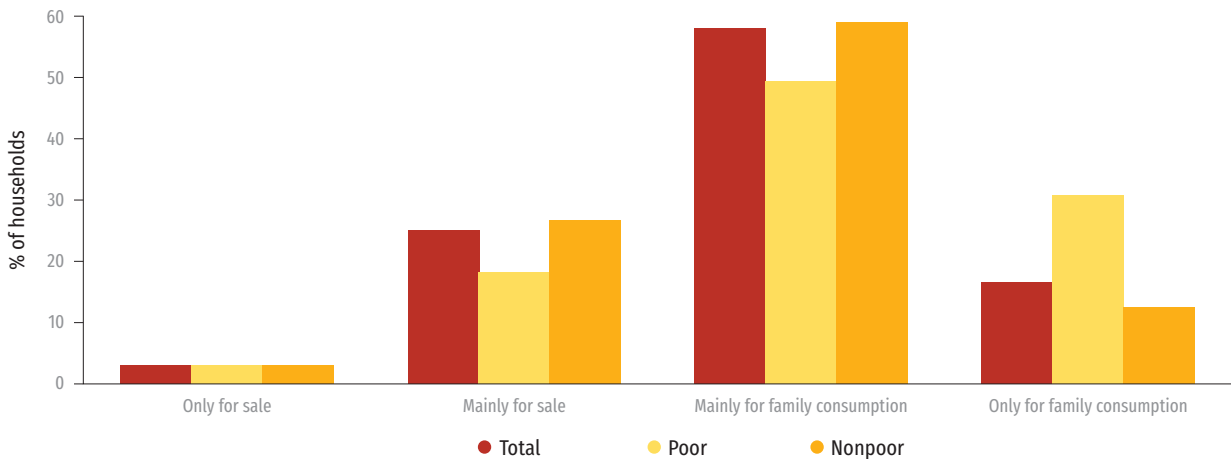
Off-farm employment could help households diversify their income sources but there are few such opportunities. While the likelihood of working is similar between the poor and nonpoor, almost 80 percent of poor households have all of their working household members engaged in agriculture,

Figure 28. Share of household members that are working (L) and share of households with at least one agricultural worker (M) and agricultural workers only (R)



Source: Calculations using BLSS for 2017.

Figure 29. Share of agricultural households that produce only or mainly for sale, or mainly or only for family consumption



Source: Calculations using BLSS for 2017.

which indicates that there are not enough non-farm employment opportunities (**figure 28**). Most farm production is conducted mainly or solely for family consumption, and relatively little for income generation (**figure 29**).

To summarize, poverty reduction was helped by improved earnings in the agriculture sector, but vulnerability is high and most farming activities are of subsistence nature. Aggregate trends suggest that households that engaged in commercial farming

would have benefited from positive albeit volatile trends in prices and yields, particularly of cardamom, potato and chili. These crops also account for an increasingly larger share of agricultural exports.

3. Priorities for sustainable poverty reduction and welfare improvement

A few priorities emerge from the analysis. First, the creation of productive jobs is key to achieving long-term welfare improvements. Bhutan’s public



sector-led development model has boosted economic growth and directed large investments in human capital. Private sector development has been lackluster and job creation sluggish. Bhutan's ability to further reduce poverty and enhance welfare will critically depend on its capacity to identify alternative sources of growth beyond hydropower and generate private sector employment. With a dependency ratio that is projected to decline until 2040, the next two decades offer an opportunity for Bhutan to reap its demographic dividend if the expanding

workforce can be absorbed by more productive jobs. The labor force is increasingly educated, and urbanization is likely to continue as a result of steady rural to urban migration. This trend, combined with rising aspirations and increased access to information, will generate growing pressure to create jobs outside the agriculture sector—the latter is particularly important to sustain poverty reduction and promote broad-based shared prosperity in the long run. At the same time, it is important to address the low and declining female labor force participation.

In this context, the trade-off resulting from Bhutan's spatial characteristics need to be better understood and reflected in policy formulation and prioritization—especially given the need to continue investing in human capital. While urbanization has progressed relatively rapidly, most people still live dispersed across the countryside and in remote areas. The mountainous terrain and large rural population make service provision costly and inefficient. Coverage of services has expanded rapidly but quality is increasingly a concern. Given the need to continue to invest in human capital and other services, an important trade-off may be needed between expanding access to services everywhere and improving the quality of services. Reliance on technological innovations and diversifying modes of service delivery (such as mobile clinics for providing health care in remote areas) could help contain the cost and address quality-related concerns. At the same time, a shift in policies away from a focus on spatially balanced development and towards improving efficiency and promoting the benefits of urban agglomeration could be considered.

In the short- to medium-term, progress will be difficult to achieve without raising agricultural productivity. Addressing the constraints to growth in the commercial agriculture sector could go a long way towards increasing rural incomes: this would include broad-based support to increase productivity (through greater input use, irrigation facilities, agricultural extension services), combined with efforts to develop market systems and integration into larger value chains. Market infrastructure and wholesale systems are largely absent, and marketing activities continue to rely heavily on public agencies.

A stronger social protection system could further help mitigate the impact of income shocks. Spending on social assistance accounts for about 0.9 percent of GDP through a combination of universally provided and targeted programs. With the

exception of universal programs (such as free electricity, health care and education), government-financed programs reach only a small proportion of households. Moreover, this support is mainly intended as hardship relief rather than poverty alleviation. For example, the *Kidu* program, Bhutan's main social assistance program and royal prerogative, grants assistance in various forms including land endowments, scholarships, and support for people living in destitution, the elderly and the disabled. However, beneficiaries may not necessarily belong to the poorest households. On the other hand, the Targeted Household Poverty Program (THPP) is a household-level intervention program that provides support for housing improvements, supply of agricultural equipment, and income-generating activities such as dairy farming and cash crop cultivation. However, an assessment conducted in 2017 found that the program's criteria could result in high exclusion and inclusion errors.³⁰

Finally, further efforts are needed to strengthen statistical capacity, improve data quality, and fill data gaps. Much progress has been achieved but important gaps remain. For example, there is very little information on production activities of agricultural households that would allow for a better understanding of drivers of welfare and poverty in rural areas. Also, there is a lack of information on household income. The following areas were identified to improve the quality of data: (i) ensure consistent measurement of poverty over time; (ii) improve the quality of data collected and improve sampling to enhance the precision of estimates derived from household surveys; and (iii) ensure regular collection of essential socioeconomic data – for example, there is no recent data available on population health. Finally, given that the official poverty line is relatively low, it should be updated in the next round of the Bhutan Living Standards Survey Report (BLSS) based on the latest consumption patterns.

³⁰ The assessment was part of a World Bank Technical Assessment to evaluate the targeting performance of the THPP.





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