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Bhutan Development Update

*Macroeconomics and Fiscal
Management*

The World Bank

Growth rebounded in 2014 along with the lift of restrictions over credit and imports, tourism expansion, and the resumption of hydropower investment. Bhutan's significant dissaving is illustrated by a large current account deficit. Priority will have to be given to private sector development and asset diversification if Bhutan wants to reduce its vulnerability to donor finance and address rising youth unemployment

Recent developments

Growth

With the lift of administrative restrictions on foreign exchange access and credit, GDP growth in 2014 is estimated to have rebounded to 5.7 percent, after reaching a bottom low 2.05 percent in 2013. Restrictions on credit, foreign exchange and imports, put in place in 2013 to address the shortage of Indian rupees, were removed in July and August 2014 and replaced by more market friendly macro-prudential measures on credit and higher taxes on vehicle and fuel imports to curb domestic demand for Indian rupees.

The mains drivers of growth in 2014 included: (i) hydropower construction back on track after the 2013 delays due to geological disruptions (three major hydropower projects are underway--Punatsangchhu I and II, and Mangdichhu, all developed under an inter-governmental arrangement model between India and Bhutan (see Box 1 and Table 1)—and these projects have significantly boosted the construction and services sectors); (ii) five-year plan implementation, now in full swing ; and (iii) a record level of tourists visiting the country following a special offer to Thailand over the low season of June-August.

Figure 1: Growth drivers (%)

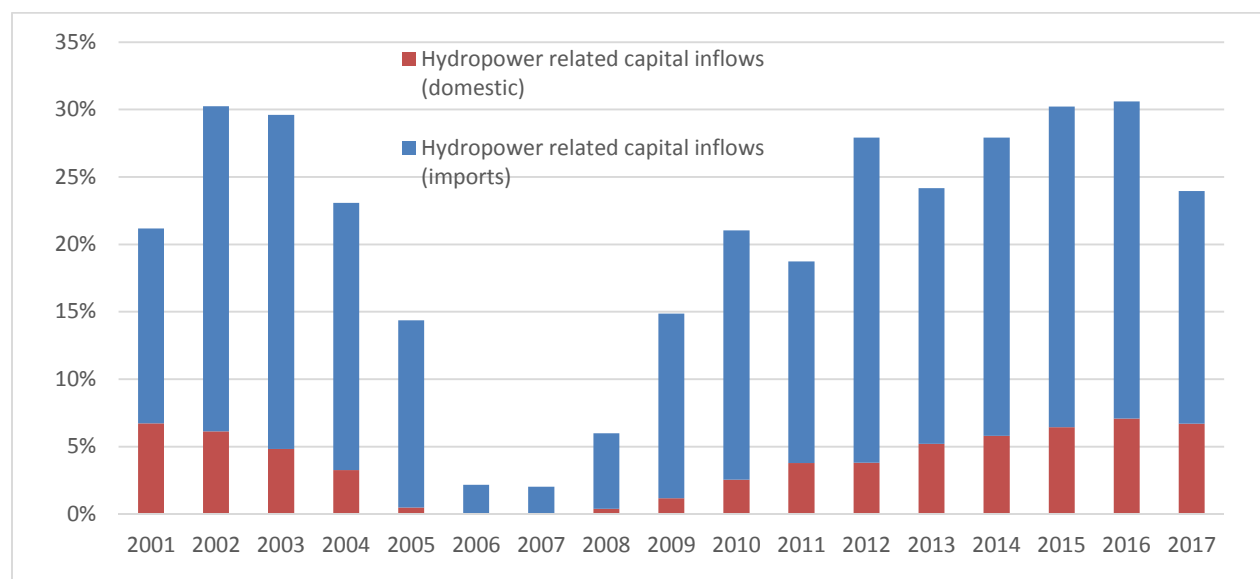


Source: National Bureau of Statistics and World Bank estimates

On the demand side, private consumption, supported by an increase in wages, is estimated to have grown by 6.6 percent. Growth of gross capital fixed investment is estimated to 22.4 percent, masking an even larger increment in the hydropower sector. The construction phase of these

projects results in significant financial inflows into the economy outside the budget, because at that time these projects are not yet the property of Government. The associated financial inflows as forecasted could reach as much as Nu 50 billion, equivalent to a third of GDP in 2016. Since these projects are highly capital intensive, most of the spending translates into imports. Still, the local spending, albeit smaller, is still high, picking up at Nu11 billion, or 6% of GDP in 2016.

Figure 2: Hydropower related capital inflows (% GDP)



Source: Ministry of Economic Affairs

Box 1: Hydropower in Bhutan

Bhutan is blessed with a massive potential for hydropower generation (30,000MW), which the Bhutanese government has started to tap, with 1,606MW of installed capacity and an additional 3,153MW coming on line in 2018. Another 2,170 MW have reached agreement and are expected to start construction in 2015. Lastly, there is an additional 8,068 MW which has been identified in the longer-term pipeline. Surrounded by energy-hungry India, the long term management of its potential hydropower generation is critical to meet the country development goals.

Projects have been carried out in partnership between the Government of Bhutan and the Government of India under three different development models:

- The *Inter-Governmental* (IG) model (67 percent of identified generation capacity): The Government of India is responsible for mobilizing the project's funding and implementing the project until the time of commissioning. Project ownership is then transferred to the Government of Bhutan, with an agreed amount of debt repayment to the Government of India. The Government of India buys all the electricity generated in surplus of domestic consumption, at a price determined on a cost-plus basis, guaranteeing a net return of 15 percent to the Bhutanese government above debt repayment and the project's operating cost.
- The *Joint-Venture* (JV) model (14 percent of identified generation capacity): Projects are developed and commissioned under a joint venture of Bhutan and India Public Sector Undertakings (PSUs) under a 50/50% ownership, with 70 percent being financed by loans raised by the PSUs, and 30 percent

equity participation, of which the Bhutanese share is financed out of grants provided by the Government of India.

- The *Public-Private Partnership* (PPP) model (13 percent of identified generation capacity): So far, two PPP projects have been developed with the support of ADB and the Government of Austria.

Table 1: Bhutan: list of hydropower projects

Project name	Cons Date	Com Date	Capacity (MW)	Development model
Commissioned				
Tala	1997	2007	1,020	IG
Chhukha	1974	1988	336	IG
Dagachhu	2009	2015	126	PPP
Basochu	1997	2001	64	Austria
Kurichhu	1995	2001	60	IG
Under Construction				
Punatsangchhu I	2008	2019	1,200	IG
Punatsangchhu II	2011	2018	1,020	IG
Mangdichhu	2011	2018	720	IG
Nikachu	2015	2022	118	PPP
Near-Term Pipeline (agreed with India, April 2014)				
Kholungchhu	2015	2021	650	JV
Bunakha	2015	2021	180	JV
Chamkharchhu	2016	2025	770	JV
Wangchhu	2016	2022	570	JV
Planned (Long Term Pipeline)				
Sankosh Storage			2,560	IG
Kuri-gongri			2,800	IG
Rotpashong			1,230	PPP
Amochhu storage			540	IG
Nyera Amari			473	
Khomachhu			363	PPP
Gamrichhu			102	PPP

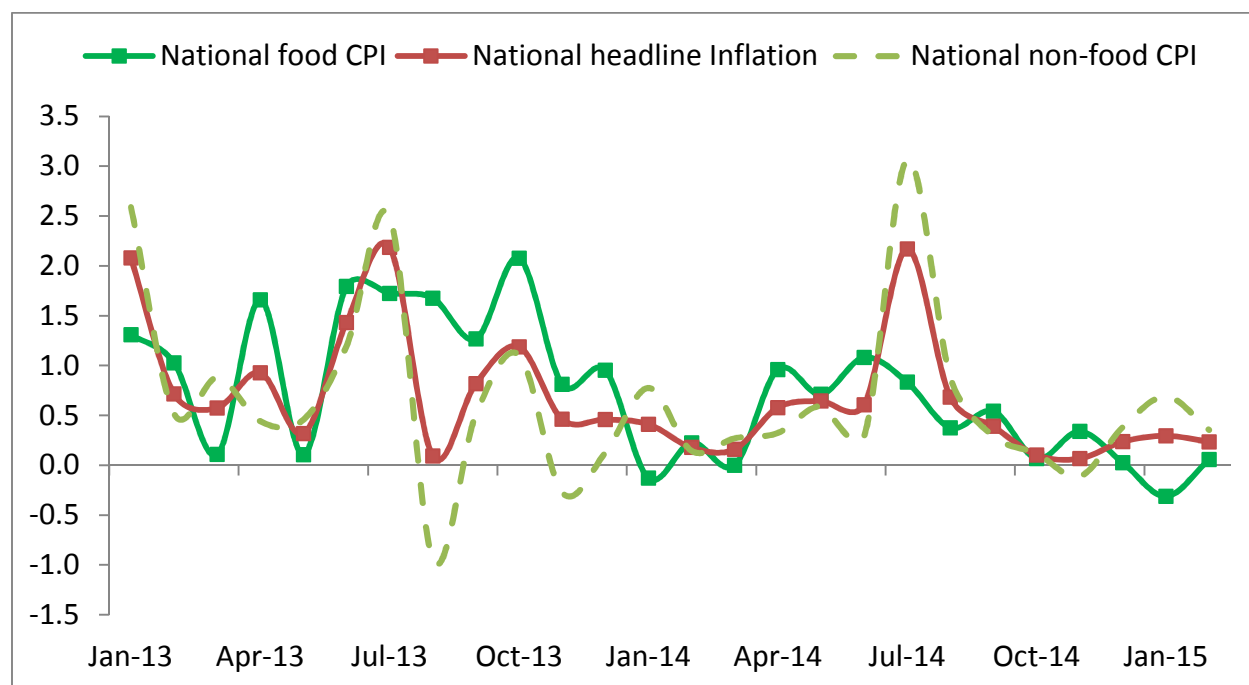
Source: Ministry of Economic Affairs

Private investment elsewhere has contracted in real terms, against the background of lagging investment climate reforms, while public investment share in GDP, funded mostly by donor resources, has remained the same. Export earnings grew at 12.9 percent, supported by tourism expansion.

Inflation

Consumer price inflation in Bhutan has slowed to 6.3 percent in January 2015 from 11.3 percent at the end of 2013. This decline was mainly driven by the decline in oil prices and India's easing of inflation (Bhutan has a fixed exchange rate with India from which it imports the majority of its consumption). Food inflation (year-on-year) was 5.0 percent and non-food 7.1 percent while imported inflation was 6.0 percent year-on-year in January 2015.

Figure 3: Inflation (monthly change - %)



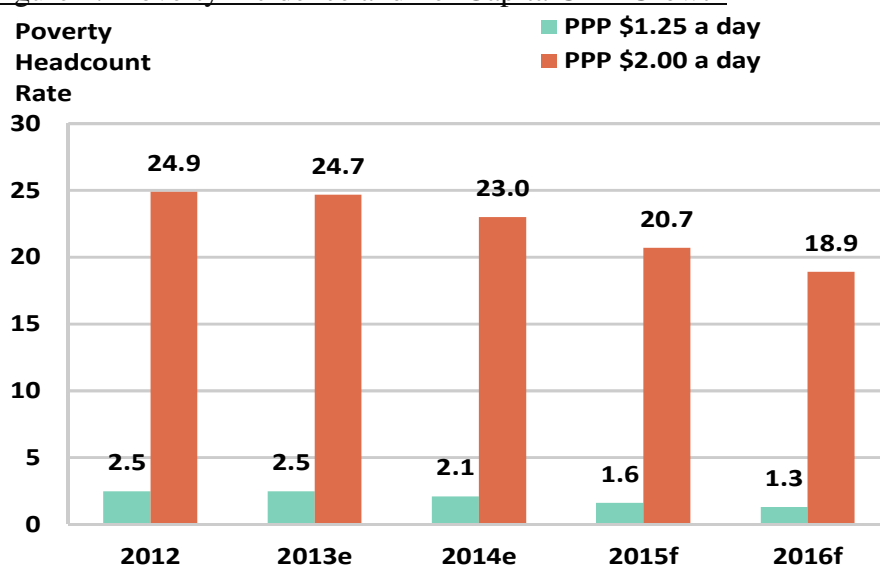
Source: National Bureau of Statistics

Employment and Poverty

Increasing youth unemployment, queuing for public-sector jobs, widespread informality, underemployment and high reservation wages point to significant mismatches in the labor market. Whereas in 2013 the overall unemployment rate stood at 2.9 percent, unemployment was more prevalent among urban, female, and relatively well-educated individuals, and youth unemployment reached 9.9 percent. Informality is highly prevalent, and public sector jobs are more valued than private. Per capita income is estimated at \$2,418 at end-2014, well into the lower middle income category, under the World Bank classification.

The projected poverty rate in 2014 indicates that the pace of poverty reduction has slowed since 2012, the last year for which an official poverty estimate is available. From 2007 to 2012, poverty measured at PPP \$2.50/day decreased from 42.8% to 24.9%, or 2.6 percentage points per year. Since then, projections based on GDP elasticity estimate poverty to have decreased at 0.9 percentage points per year, with a headcount rate of 23.0% by 2014. Inequality, measured by the Gini coefficient of consumption, has barely changed, from 0.381 in 2007 to 0.387 in 2012, and is not expected to change in the near future.

Figure 4: Poverty Incidence and Per Capita GDP Growth



Source: 2014 projections, World Bank staff estimates based on GDP growth elasticity approach

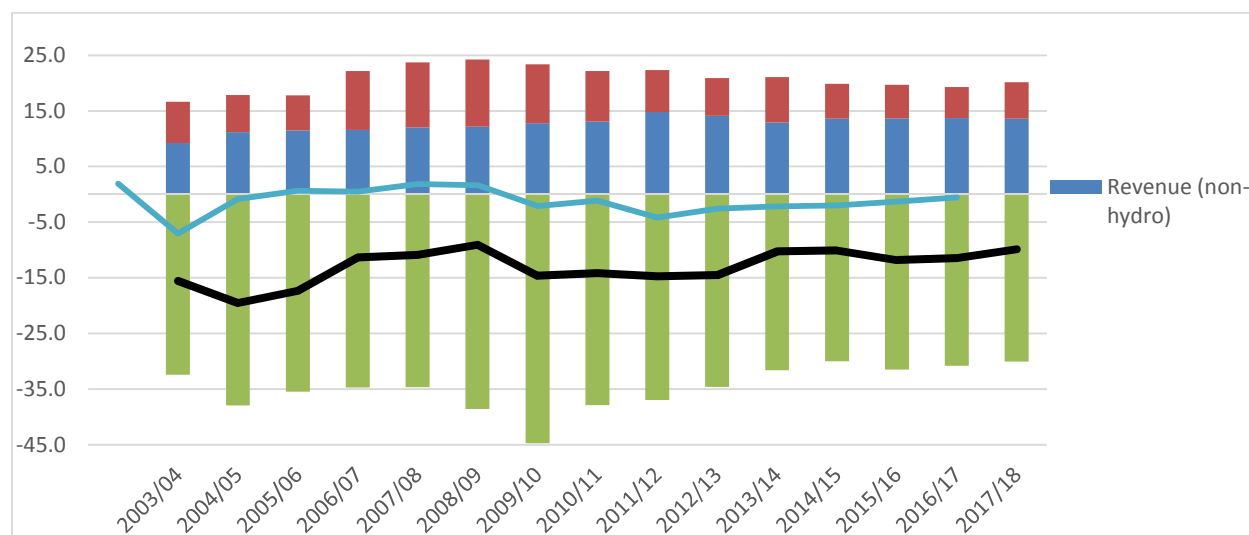
Fiscal Balance

In spite of an upward revision of public compensation in 2014/15, the fiscal deficit in FY14/15 is projected at 2.2 percent of GDP (the absence of publicly-available budget execution reports does not allow to gauge actuals for the ongoing fiscal year). Civil service wages and allowances were increased in FY14/15 by 19 to 23 percent respectively, but the impact on spending is expected to be offset by a reduction in other current and capital expenditures. Public wages had not been revised since November 2010. The increase corresponds to a catching up of purchasing power of civil servants. In fact, taking into account the increase in prices since November 2010 (+35 percent), the purchasing power of the median civil servant has actually declined by more than 8 percent.

Domestic revenues as a share of GDP have declined over the last three years, from 22 percent to an estimate of 19.9 percent in FY14/15, while grants finance about 27 percent of total spending, 70 percent of which is from India. This decline comes mostly from a relative decline of public revenue from hydropower as a share of GDP, while the tax effort elsewhere has remained about the same. The reason for this is that hydropower generation has remained about the same over recent years, awaiting new projects to come on stream, and that electricity tariffs do not keep up with the rate of nominal GDP growth. As a result, the share of hydro revenues in GDP mechanically declines over time.

Bhutan's fiscal coverage of public spending by domestic revenues is forecasted at 63 percent in FY2014/15, against a background of a 85 percent target by the end of the Five-Year Plan.

Figure 5: Fiscal developments



Source: Ministry of Finance and World Bank estimates

Public Debt

Bhutan's public and publicly-guaranteed external debt stood at 95 percent of GDP at end-2014. The rise in external public debt is primarily due to disbursements to on-going hydropower projects (59.1 percent of GDP), which are financed primarily by India with a mix of loans (70 percent) and grants (30 percent). External debt is largely denominated in Indian rupees (and related to hydropower sector debt), which accounts for 64.4 percent of total external debt, with convertible currency debt accounting for only 35.6 percent of GDP. Domestic debt is due entirely to a loan to purchase aircraft for the national carrier Druk Air in FY09/10.

Bhutan's rapid hydropower development is projected to lead to a substantial buildup of external debt in the medium-term, with debt ratios breaching most of the country-specific indicative thresholds. Bhutan's debt situation is expected to improve over the long run, reflecting significantly higher electricity exports when hydropower projects come on stream.

Bhutan's risk of external debt distress continues to be moderate, based on the latest 2014 Joint Bank-Fund Sustainability Assessment. This is because of the commercial viability of the hydropower projects, the risk-sharing agreement with India for hydropower loans, Bhutan's strong track record of project implementation, rapid growth in energy demand in India, committed donor support, and Bhutan's high level of international reserves. Bhutan's concentrated export base, its trade structure, and its rupee-reserves mismatch with external debt leave it vulnerable to exports and any shortfalls in aid inflows. Additional risks stem from bulky hydropower-related debt service payments requiring provisioning of rupee reserves. Bulky debt service payments may have contributed to creating a shortage of rupees in the past, hence the need for good cash/reserves management and projections.

Hydropower projects bring strong economic dividends in the long term, boosting average real GDP growth and exports. Moreover, despite the large increase in the stock of debt resulting from these projects, their addition does not actually create substantial vulnerabilities in debt servicing over the long term. The commercial viability of the new hydropower projects and the close economic

and political ties that Bhutan has with India are all factors that mitigate the commercial risks of these projects. India has been both the main financier of hydropower projects and the purchaser of the projects' generated electricity.

External Accounts

Bhutan runs a large current account deficit (estimated at about 29 percent of GDP in 2014/15), to which the hydropower sector contributes about a third. Export revenues from sales of electricity declined slightly, by 5 percent year-on-year, in step with less than expected rainfalls in 2014. Since no new hydropower projects have become operational since 2006, the fluctuation in export revenues reflects the vagaries of hydrological flows. The monsoon rains in the first half of 2014 were below those of 2013, explaining the decline of 4 percent in export revenues (year-on-year) from sales of electricity in 2014 compared to 2013.

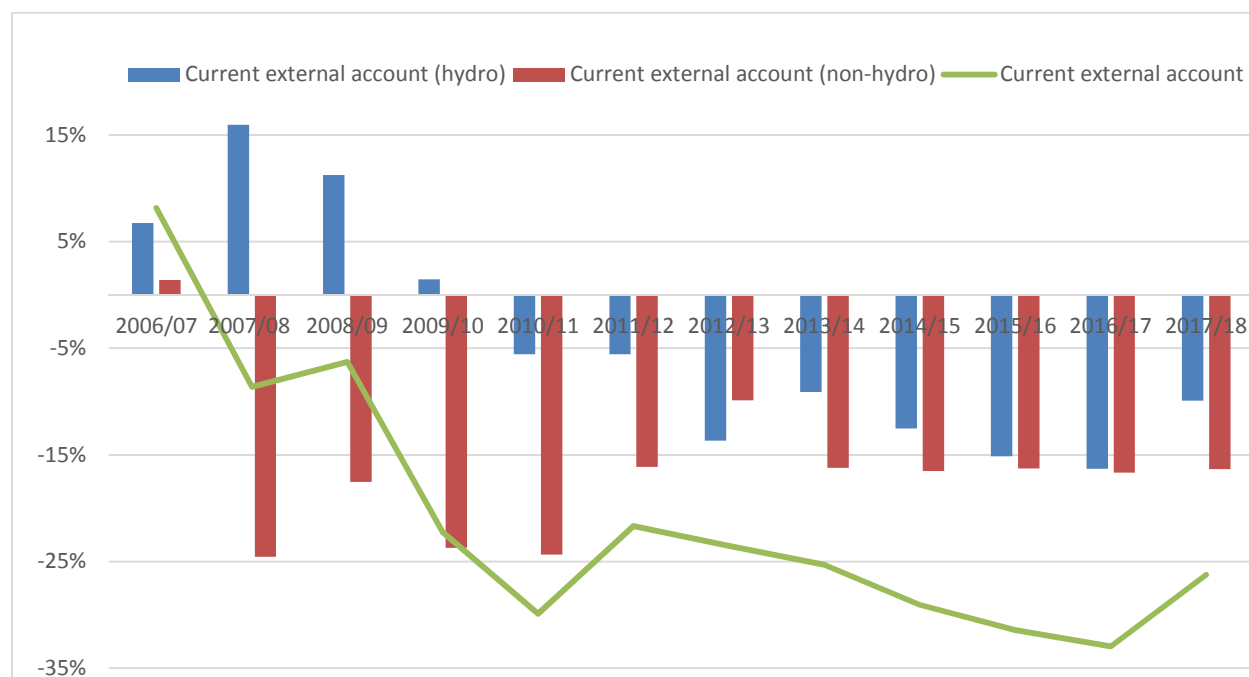
The potential for future increases remain strong, with the three projects coming on line in 2018 and 2019 expected to triple export earnings from hydropower from Nu 17 billion in 2017 to Nu 49 billion in 2021. Exports of minerals and mineral-based products account for more than half of total exports, with hydropower exports comprising a further 45 percent, and manufactured products a tiny 5 percent. India receives almost 90 percent of Bhutanese electricity production.

The tourism sector has turned into an important contributor of export revenues in recent years. Tourist arrivals and revenues (from convertible currency-paying tourists) expanded at an average of 15 percent per year in the five years to 2013. In 2014, a record level of 58,000 convertible-currency tourists came to Bhutan, a jump of 31 percent year-on-year, earning the country US\$ 73.2 million in convertible currency, a 15 percent increase year-on-year. Special new promotional measures to attract tourists from Thailand have contributed to this growth. A similar number of tourists came overland, mainly from India with light travel requirements, but the statistics are not up-to-date for this segment.

The current account is essentially financed by donor resources, of which India contributes the most through loans and grants to finance hydropower development. Foreign direct investment finances a low 8 percent of the capital account (about US\$ 20m). The recent amendment of the FDI policy should help to attract more foreign investment into the country. In particular, foreign investors are now allowed to repatriate their profits in the currency of their choice.

International reserves had built up to US\$ 1,184 million by end-2014, reflecting prudent management by the RMA. Reserves amount to 13.3 months of goods and services imports (the Constitution requires that foreign exchange reserves should be maintained at 12 months of essential imports). There has been a mismatch in the composition of Bhutan's reserves and the structure of its international transactions, as the country primarily needs Indian rupees for trade settlement and debt service. Responding to this issue, the RMA has been implementing, since August 2014, new reserve policy measures allowing the conversion of convertible currency reserves into Indian Rupees above a threshold of US\$ 700 million. As a result, the share of reserves held in convertible currencies has declined to 72 percent at end 2014, down from 83 percent in mid-2014, with the rest in Indian rupees.

Figure 6: Current account hydropower related and non-hydropower (% GDP)



Source: Royal Monetary Authority, Ministry of Economic Affairs and World Bank estimates

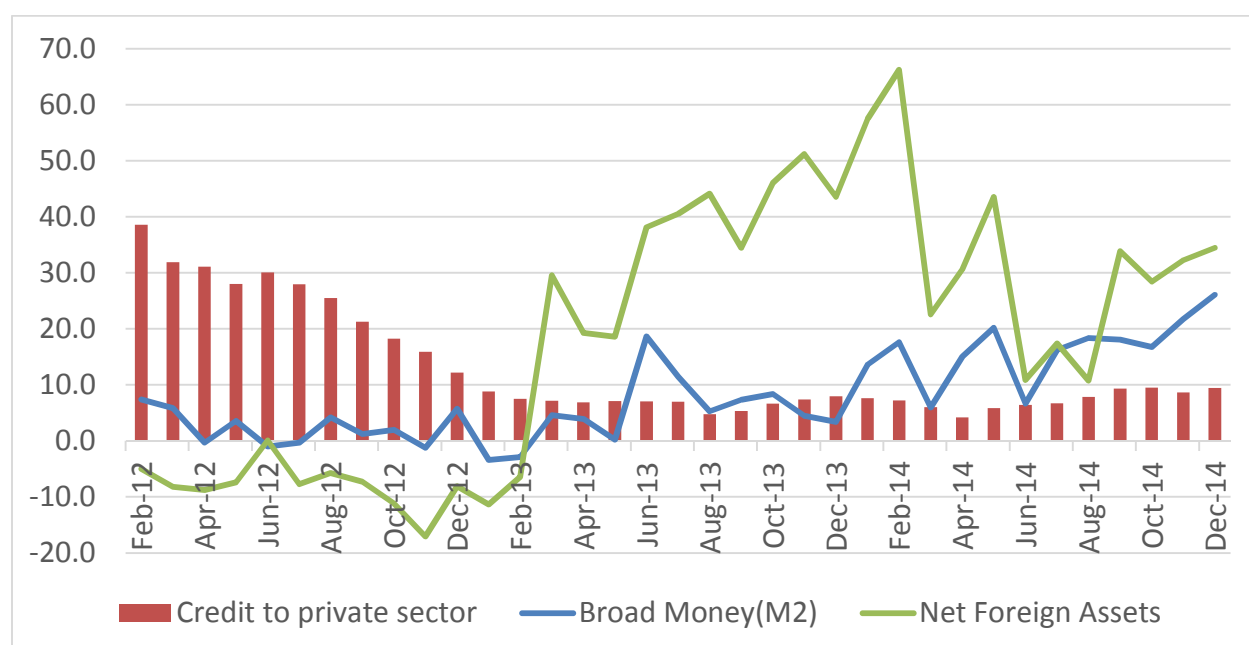
Monetary and Financial Management

Simultaneously with the lift of credit restrictions, the RMA put in place strengthened prudential measures in replacement and is closely monitoring credit expansion, to avoid another rupee shortage. These measures so far appear to be regulating credit to the private sector successfully: in 2014, private credit growth grew at a moderate 9.4 percent, a stark decline compared to the annual growth rates of 30-50 percent year-on-year during 2010-2011. From July 2014, credit has not picked up, growing only by a low 1 percent.

Interest rates show little movement. The present base interest rate system, which establishes individual bank maximum and minimum interest rates based on individual cost of funds and administration, creates an unequal playing field and significantly undermines banks' ability to compete on price because individual bank cost structures vary a lot. There is inadequate competition in price for lending to priority sectors, for the best customers, for government deposits and for long-term deposits. Replacing the existing system by a uniform system-wide base rate for the individual bank base rate could significantly increase price competition and allow more innovation in the sector.

Strengthening supervision is critical. In the short-to-medium term, financial sector vulnerabilities have likely accumulated. Banks appear to be well capitalized, with the risk-weighted capital adequacy ratio rising to 19 percent in September 2014 compared to 17.7 percent in 2013. Non-performing loans amounted to 11.6 percent in September 2014, compared to 12.3 percent a year before. The decrease is mostly due to an increase in the loan portfolio (denominator) following the relaxation of credit restrictions.

Figure 7: Credit, broad money and foreign assets growth (percentage points)



Source: Royal Monetary Authority

Lending remains concentrated in personal and real estate loans, which raises concerns. More than a quarter of the financial sector's portfolio consists of building and construction loans, followed by personal loans that constitute around 16 percent of overall credit outstanding. Over the last four years, credit in the economy has almost doubled, but only 39 percent of the new credit went to productive sectors (tourism, agriculture, manufacturing, transport) while the rest was directed to consumption. By institutions, the Bank of Bhutan continues to dominate the sector, holding 43 percent of market share.

Box 2: Bhutan's Business Opportunity and Information Center

The Business Opportunity and Information Center (BOIC), established in 2014 in association with MoEA, is mandated to stimulate the growth of cottage and small manufacturing industries and the non-formal commercial sector by providing financial and back-up support. It is a time-bound autonomous agency, with a Nu 1.9 billion (US\$ 31 million) revolving fund, as part of an Economic Stimulus Package that was intended to kick start lending – particularly to SMEs. A Nu 1.5 billion component of the revolving fund is available for lending to SMEs and CSIs engaged in manufacturing and production, in amounts up to a maximum of Nu 8 million per borrower. A second Nu 0.4 billion component is available for loans of up to Nu 100,000 per borrower for informal rural activities. To date, BOIC has approved more than 300 loans, with a total value of Nu 82 million as of December 2014.

BOIC efforts to help SMEs access credit can potentially affect negatively the financial market development. The substantial funding available at very low interest rates is likely sharply to reduce the level of commercial bank SME lending. It may also be difficult to find sufficient attractive lending opportunities to utilize the entire SME fund within its five year period.

Efforts to deepen the financial sector in a sustainable manner are underway. A comprehensive Financial Sector Development Strategy is being prepared with a careful sequencing of reforms within a medium-term plan.

Outlook

In 2015, economic activity is expected to gain momentum, with real GDP growing at 6.9 percent, driven by new hydropower construction and innovative tourism measures (“Visit Bhutan 2015”)-though agriculture is projected to grow at its low historic rate of about 2 percent. This projected higher growth rate could risk a resumption of overheating and macroeconomic imbalances. GDP growth is likely to vary between 3.6 and 7.6 percent the years after, before new hydropower projects starting generation boost GDP growth from late 2018. Domestic demand will be driven by hydropower investment and, to a lesser extent, government consumption. Consumer inflation will closely follow India’s tracks.

The current account deficit is expected to continue growing over the next few years, driven by hydropower projects in their construction phase. The current account deficit outside the hydropower sector is forecasted to remain stable, supported by robust growth in the tourism sector and donor grants. The fiscal accounts are assumed to remain in balance, supported by donor grants, with current spending contained, and capital spending following the patterns of the five-year plan disbursements. The revenue effort should weaken slightly, unless new measures to strengthen the tax base and limit the many exemptions and holidays are introduced. With moderate growth, poverty is expected to decline further, slowly shifting from rural to urban, along with migration.

The risk of Bhutan’s external debt distress continues to be moderate. This is based on the commercial viability of its hydropower projects, the risk-sharing agreement with India for hydropower loans, a strong track record of project implementation, rapid growth in energy demand from India, committed donor support, and Bhutan’s high level of international reserves.

With faster GDP growth, poverty reduction is projected to pick up between 2014 and 2016 to an average 2.1 percentage points per year. The poverty headcount rate based on PPP \$2.5 day is expected to be 18.9 percent in 2016.

Challenges

While Bhutan’s outlook is positive, macroeconomic pressures on domestic demand will have to be managed. Hydropower-driven growth results in fluctuations not only in government revenue, but also in aggregate demand. Some of the impact is through the public sector: as government revenue from electricity exports increases, public sector expenditures go up. But the biggest impact happens outside the government budget during the construction phase of major hydropower dams, as this construction is associated with huge capital inflows. While inflows are partially offset by imports of equipment and construction materials, they also translate into significant additional domestic demand, through direct domestic spending and indirect spillover effects. This calls for rethinking aggregate demand management in the context of lumpy capital inflows, through a combination of countercyclical fiscal and monetary policies.

Hydropower projects coming on line in 2018 and 2019 will provide the much-needed domestic resources to finance the twin deficits in the fiscal and external current accounts. That said, the

extent to which this relief will be lasting depends on whether hydropower rents will be used to diversify the country's economic assets and raise the tax base to ensure that the government-set goals of fiscal, external and economic self-reliance are met.

Similarly, shared prosperity will depend on the ability of the economy to provide jobs to educated youth, whose aspirations increasingly differ from existing employment opportunities, to address the large informality in the labor market, and the large bias towards public sector jobs.

While debt risk is still moderate, the rapid-build-up over recent years cautions against any additional non-concessional borrowing, given that Bhutan's debt carrying-capacity will only improve in the long run, reflecting significantly higher electricity exports when hydropower projects come on stream. Efforts to deepen the financial sector will need to be sustained to provide the country the basis for financing sound and sustainable development and diversification

Poor households also face new risks and vulnerabilities requiring new strategies. Limited land for agriculture, higher exposure to international commodity prices and changing social structures can increase poor households' vulnerability to shocks and reduce their ability to deal with unexpected situations. The government of Bhutan plays an important role in the development of new social protection strategies to help cope with unexpected events, especially for the poor and vulnerable.

Annex: Bhutan Main Macroeconomic Indicators

Indicator	2013	Est. 2014	Proj. 2015	Proj. 2016	Proj. 2017	Proj. 2018
Gross domestic product (US\$ million at current prices)	1,781	1,828	1,965	2,106	2,246	2,321
Consumer price index (% change)	11.8	6.4	n.a.	n.a	n.a	n.a
Real annual growth rate	2.0	5.7	6.9	6.8	7.6	3.6
Balance of Payments (% GDP)	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Exports	31%	29%	29%	29%	27%	29%
<i>o.w. Hydropower exports</i>	11%	11%	10%	10%	9%	11%
Imports	49%	49%	51%	52%	53%	49%
<i>o.w. Hydropower associated imports</i>	14%	13%	15%	16%	17%	13%
Trade balance	-18%	-20%	-22%	-24%	-25%	-21%
Current account balance	-24%	-25%	-29%	-31%	-33%	-26%
<i>o.w. Hydropower</i>	-14%	-9%	-13%	-15%	-16%	-10%
FDI (US\$m)	49	8	23	31	39	48
Reserves (US\$)	917	980	1,031	1,177	1,273	1,355
Public finance (as % of GDP at market prices) ^c	2012/13	Est. 2013/14	Proj. 2014/15	Proj. 2015/16	Proj. 2016/17	Proj. 2017/18
Expenditures	36.2	32.6	31.3	32.9	32.0	31.2
Revenues	20.9	21.1	19.9	19.7	19.3	20.2
<i>o.w. Hydropower</i>	6.8	8.2	6.3	6.0	5.6	6.5
Grants	9.5	12.9	7.8	9.8	10.2	9.3
Fiscal Balance	-4.2	-2.6	-2.2	-2.0	-1.3	-0.6
Domestic Revenues - Expenditures (% GDP)	-14.6	-10.3	-10.1	-11.8	-11.5	-9.9
Monetary indicators	2013	2014	2015	2016	2017	2018
M2/GDP (%)	58	63	n.a	n.a	n.a	n.a
Growth of M2 (%)	18.6	26	n.a	n.a	n.a	n.a
Private sector credit growth (%)	7.1	9.4	n.a	n.a	n.a	n.a
Total credit growth (%)	12.8	7.2	n.a	n.a	n.a	n.a
External PPG debt/GDP (%)	90.9	91.2	106.3	117.3	122.5	122.5
<i>o. w hydro publicly guaranteed</i>	51.7	58.1	72.9	83.8	91.4	91.4
Exchange rate (BTNu/US\$)	59	61	n.a	n.a	n.a	n.a