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# COUNTRY ECONOMIC REVIEW

*BHUTAN*

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*September 2003*

## CURRENCY EQUIVALENTS

(as of 31 August 2003)

Currency Unit	–	ngultrum (Nu)
Nu1.00	=	\$0.021
\$1.00	=	Nu47.63

## ABBREVIATIONS

ADB	–	Asian Development Bank
BEA	–	Bhutan Electricity Authority
BPC	–	Bhutan Power Corporation
CHL	–	Chhukha Power Corporation
CPI	–	consumer price index
DOT	–	Department of Tourism
DYT	–	district development committee
FX	–	foreign exchange
GDP	–	gross domestic product
GYT	–	block development committee
MDG	–	Millennium Development Goals
MW	–	megawatt
NFYP	–	Ninth Five-Year Plan
PIT	–	personal income tax
RMA	–	Royal Monetary Authority
TA	–	technical assistance

## NOTES

- (i) The fiscal year (FY) of the Government ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2002 ends on 30 June 2002.
- (ii) Fiscal year variables are divided by gross domestic product (GDP) at factor cost of the previous calendar year to calculate the variable as a percent of GDP, e.g., a ratio from FY2002 has the GDP of calendar year 2001 as its denominator.
- (iii) In this report, "\$" refers to US dollars.

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## EXECUTIVE SUMMARY

During the past 5 years, Bhutan's real average gross domestic product (GDP) grew by 6.7% per annum. In this period, the agriculture sector grew by 3.7% per annum, industry sector by 9.6%, and services sector by 7.2%. In recent years, the main drivers of GDP growth have been the hydroelectric power, construction, and transport sectors. The hydroelectric sector accounts for some 12% of GDP and 45% of the Government revenues.

The average per annum savings rate over the past 5 years is 17% of GDP, whereas gross domestic investment rate is 42%. Tax revenues, which have exhibited an average annual growth rate of 19%, have not shown corresponding buoyancy. Direct tax collections during 2002 recorded a 7% growth over the previous year and accounted for 61% of tax revenues and 32% of total revenues. The overall budget deficit rose from 3.9% of GDP in FY2000 to 11.1% of GDP in FY2002, before declining to 5.5% of GDP in the following year. As measured by the consumer price index, inflation continued to decline, falling to 2.3% in December 2002 from 2.7% at the end of June 2002. This is the lowest inflation rate in the past 3 years. To enhance the domestic revenue base, effective 1 January 2002, the Government instituted the personal income tax (PIT) applicable on six sources of income.

Over the past 5 years, Bhutan's trade balance has been negative. The composition of Bhutan's merchandise trade shows that India remains its largest trading partner accounting, on average, for some 90% of Bhutan's exports and about 70% of imports. Power exports are the largest export item to India. Bhutan's stock of external debt outstanding increased by 23.2% to \$292 million at the end of FY2002. Corresponding to the growth in total debt, the ratio of outstanding debt to GDP rose to 55% in FY2002, while the debt service ratio rose to 5%. According to Government estimates, over 60% of the soft loans (both convertible currency and rupee) were disbursed to the power sector, while another 25% were shared by the agriculture, education and industry sectors. As of June 2002, India had provided most soft loans to Bhutan, with cumulative gross disbursements totaling \$216 million primarily for the development of the hydropower sector.

During FY2002, growth in commercial bank deposits with the Royal Monetary Authority (RMA) led to an increase in reserve money by 27.9%. Thus, managing excess liquidity remains a key financial sector challenge. Fortunately, the exchange rate policy—which pegs the ngultrum at par with the Indian rupee—and capital controls ensure that excess liquidity does not act as a destabilizing factor for balance of payments, price stability, and monetary policy. RMA has taken steps to reduce excess liquidity by issuing RMA bills and raising the cash reserve ratio. Nonetheless, as of June 2002, commercial banks were holding excess reserves with RMA equivalent to about 40% of their assets.

The cost of financial intermediation in Bhutan appears high, given the prevailing 4-6% spread between the lending and deposit rates (Royal Monetary Authority Annual Report 2001/02, December 2002). At the same time, the financial system has excess liquidity and the banking system continues to hold some 40% of its assets in non-interest earning deposits with RMA. The high intermediation costs and continued excess liquidity (also reflected in the proportion of nonperforming loans, which at end-2002 was some 10%) reflect inefficiencies of the banking system, which are further exacerbated by the lack of competition. The high lending rates and collateral requirements, generally around three times the amount of financing being sought, act as effective barriers for the private sector to access credit from financial institutions.

With a labor force participation rate of 56.5%, the Government estimates the overall open unemployment rate at 1.9% compared with 1.4% in 1998. Within the framework of the Ninth five-Year Plan (NFYP), the Government prepared a Human Resource Development (HRD) Master Plan for Private and Corporate Sectors and assigned 50% of NFYP's HRD allocation for implementing this master plan. To make private sector employment more attractive, the Government drafted labor laws that will be presented to the National Assembly for approval. In addition, an Apprenticeship Act was drafted whereby the Government and the private sector, on a 50:50 cost-sharing basis, will train new entrants in the labor market. However, over the next 5 years, the task of providing employment to about 50,000 school graduates and another 20,000 unskilled workers migrating to urban areas remains challenging.

Under the NFYP's emphasis on devolution and decentralization of planning, the district development committees and block development committees have been granted autonomy to make development plans, allocate resources, and make rules and regulations applicable within their jurisdictions. In 2002, effective measures were undertaken to deepen the decentralization process. District and village development committees were vested with greater administrative and financial powers, including the authority to retain and spend rural taxes for local development. During the implementation of the NFYP, the Government plans to maintain the pro-poor focus of its development objectives. The primary school gross enrollment rate increased from 67% in 1990 to 72% in 2000. Although health care coverage is high—90%—the Government plans to improve delivery of health services. Inflows of external assistance as grants and concessional loans are the primary source of financing for capital expenditures. Given growing pressures on global official development assistance, the quantum of external assistance available to Bhutan may possibly decline in the future. Should this happen, the Government may have to increasingly rely on domestic borrowings or adjust the scope of the NFYP.

The NFYP explicitly acknowledges that the private sector will be the engine of growth and prime source of employment. To promote private sector development, a number of incentives were announced as part of the national budget for 2002/03. They included time-based tax holidays and incentives for establishing businesses in rural areas. Private sector representatives have submitted to the Government recommendations for boosting private sector activity in the country. Almost all pertain to the need for reform of financial institutions existing policies and practices for extending credit to the private sector. Foreign exchange revenues of \$10.5 million from the tourism sector reached their peak value in FY2000. Thereafter, they have been reflecting a declining trend and were \$9million for FY2002. In the NFYP, the Government's objective is to increase tourist arrivals to 15,000 per year by 2007.

Over the past years, domestic resources financed only 15% of the average annual development budget, making Bhutan highly dependent on external assistance to fund its development programs and initiatives. The Bhutanese economy is overly dependent on hydropower (accounting for 11% of GDP in 2003), whose exports account for some 45% of Government revenues. While this is not likely to change in the near term, given the high capital intensity and low employment elasticity of this sector, alternative sources of employment and income generation would have to be explored to reduce the incidence of poverty, increase per capita incomes, and reduce the economy's current high dependence on the one-country-one-export-commodity framework.

## I. RECENT ECONOMIC DEVELOPMENTS

### A. Growth, Employment, Savings, and Investment

#### 1. Economic Growth and the Structure of Production

1. During the past 5 years, Bhutan's real average gross domestic product (GDP) grew by 6.7% per annum (Table 1). In that period, agriculture sector grew by 3.7% per annum, industry by 9.6%, and services sector by 7.2%. Economic growth could have been higher during this period without the floods of 2000, which lowered the growth rate for that year to a below-trend rate of 5.3%. Flooding, which was concentrated in the south of the country, adversely affected industrial production, which was suspended for almost 3 months. Thus, industry's growth rate declined to 2.3% in FY2000, before making a smart recovery in FY2001. In terms of sectoral composition of GDP, during the past 5 years, the average annual shares of agriculture and industry at about 35% each were closely followed by those of the services sector, which posted an average annual share of about 30% (Figure1).

**Table 1: Real Gross Domestic Product Growth by Sector**  
(% change per annum, 1980 prices)

Item	FY1998	FY1999	FY2000	FY2001	FY2002	Average FY1997-FY2001
<b>Gross Domestic Product at Factor Cost</b>	<b>6.4</b>	<b>7.6</b>	<b>5.3</b>	<b>6.5</b>	<b>7.6</b>	<b>6.7</b>
Agriculture	2.8	5.2	4.5	3.2	2.5	3.7
Industry	8.6	11.6	2.3	13.2	12.1	9.6
Services	6.6	5.9	9.5	6.5	7.9	7.2

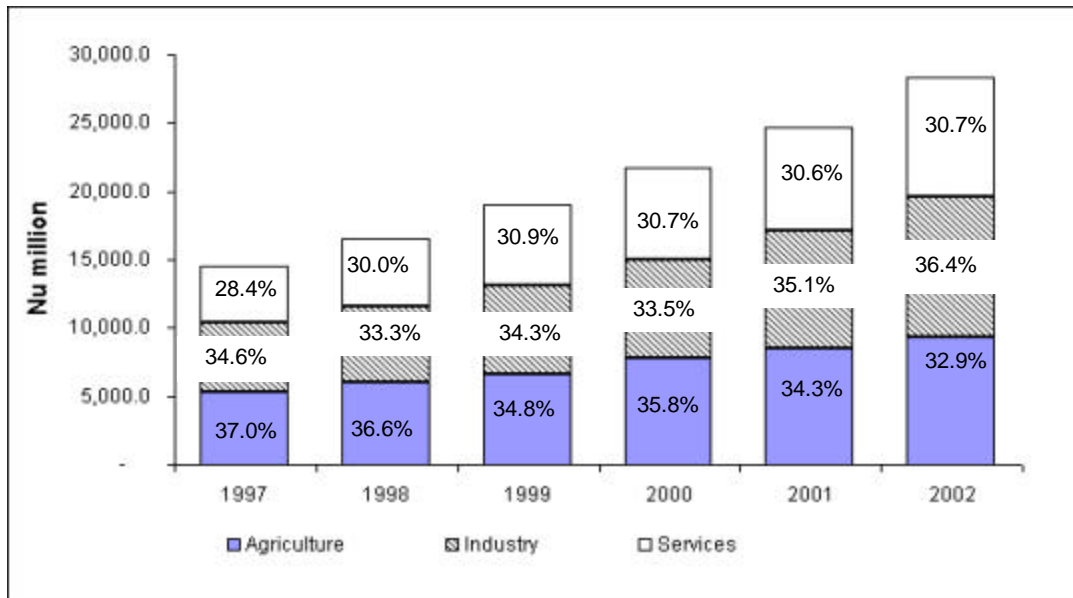
Source: Statistical Appendix, Table A.1.

2. Within the sectors, however, there were variations. For example, the main impetus for growth in agriculture came from the forestry and cash crop subsectors. In industry, growth was mainly on account of the hydropower sector, followed by the construction sector. When viewed over a longer time frame, there is, as expected, a secular decline in the contribution of agriculture to GDP (from over 50% in 1981 to 35% in 2002), and a corresponding rise in the share of industry to GDP (from 17% in 1981 to 36% in 2002).

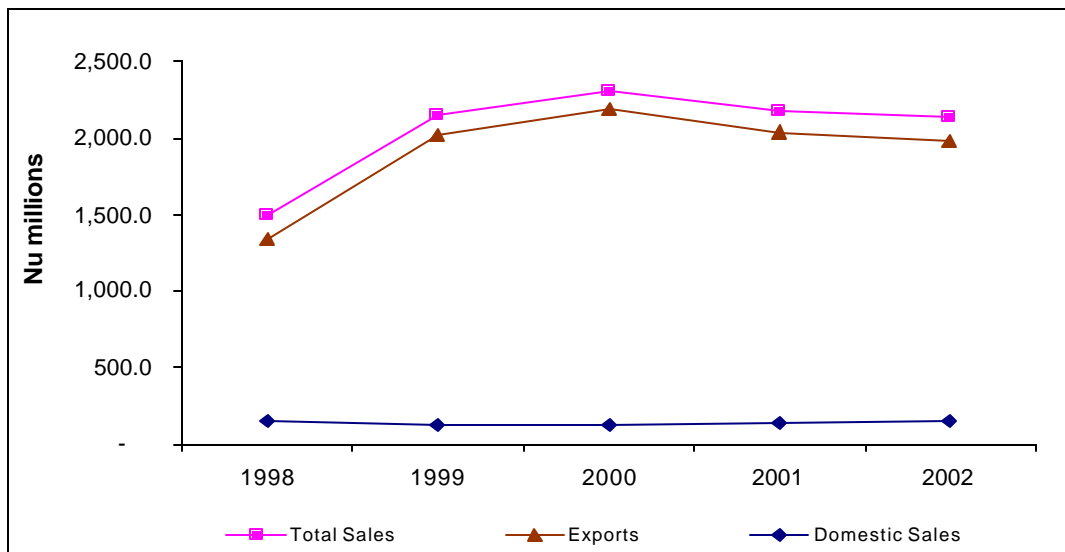
3. In recent years, the main drivers of GDP growth have been hydroelectric power, construction, and transport. Bhutan has a large hydropower potential with an estimated capacity of 30,000 megawatts (MW). The development of the sector began with the commissioning of the first stage of Chhukha plant (336 MW) in 1986 and the initiation of power exports to India. This was followed by the completion of the 60 MW capacity Kurichu plant and then by Basochu (60 MW) in 2004 and the Tala hydropower station (1,020 MW) by end-2005. The hydroelectric sector accounts for some 12% of GDP and 45% of the Government revenues. Within the power sector, the Chhukha Hydropower Corporation (CHC) is the single largest source of revenues for the Government (Figure 2). In FY2002, CHC revenues amounted to 39% of total national revenues. Growth in the construction sector is mainly on account of downstream activities related to the construction of Basochu, Kurichu, and Tala hydroelectric power stations. While construction-related work is gradually tapering off as the first two stations near completion, it is in full swing at the 1,020 MW Tala hydropower plant, which is expected to be completed by end-2005. In the services sector, the transport and communications sectors, as well as the financial

sector have performed somewhat below the annual targets. The contribution of tourism, the largest source of hard currency earning, is not separately identified in the national accounting framework. However, the sector has made important strides and is likely to flourish further under the recently announced incentives for attracting greater foreign direct investment in the country.

**Figure 1: Gross Domestic Product Sector Composition**



**Figure 2: Chhukha Hydropower Corporation Power Sales**



4. The NFYP was launched on 1 July 2002. It envisages an annual average growth rate of 7-9%.<sup>1</sup> The NFYP emphasizes strengthening infrastructure, improving the quality of social

<sup>1</sup> The average annual economic growth rate during the Eighth Five-Year Plan period was 6.7%.

services, ensuring good governance, promoting growth of the private sector, generating employment, and preserving and promoting culture and the environment. Compared with the previous plans, decentralization of development expenditures to the *dzonkhags* (districts) and *gewogs* (village blocks) is an important hallmark of the NFYP. The district development committees (DYT) and block development committees (GYT) have been granted autonomy to make development plans, allocate resources, and make rules and regulations applicable within their jurisdiction. About 25% of the proposed NFYP outlay is earmarked for programs executed by the districts and village clusters.

5. During 2002, effective measures were undertaken to deepen the decentralization process, with special emphasis on devolving local development planning, implementation, and monitoring. To improve the quality and experience of the GYT leadership, a nationwide re-election of gups (leaders of respective GYTs), based on universal suffrage, was held from September to December 2002. Another significant change was that the leadership of DYT, which was formerly a civil servant, became an elected representative. Thus, district administrative and development functions were effectively bifurcated to better respond to the development needs of the respective districts. Through a participatory and consultative process, involving discussions in all 20 DYT and 201 GYT, the National assembly revised and enacted the DYT and GYT Acts in 2002, vesting districts and village blocks with greater administrative and financial powers, including the authority to retain and spend rural taxes for local development. The first draft of the written national constitution was completed in December 2002 and submitted to the King. The constitutional committee is now reviewing the second draft, which is expected to be tabled in the National Assembly for wider discussion.

## **2. Employment and Human Resource Development**

6. With labor force participation rate of 56.5%, the 2001 National Labor Force Survey<sup>2</sup> estimates the overall open unemployment rate at 1.9% compared with 1.4% in 1998. The urban unemployment rate is estimated at 4.1%, and the rate for rural areas at 0.6%. In the urban areas, unemployment is estimated to be 5.3% for females and 3.0% for males (Table 2).<sup>3</sup> In the NFYP, the Government prepared a Human Resource Development Master Plan for Private and Corporate Sectors and allocated Nu3.0 billion, or 50% of NYFP allocation for human resource development, to implement the plan. The master plan aims to achieve the following objectives: (i) enhance the human resource capacities of the corporate and private sectors; (ii) develop a new generation of entrepreneurs; (iii) enhance the competitiveness of Bhutanese products in the domestic and international markets, and (iv) contribute in achieving of the national goals of self-reliance and Gross National Happiness. The NFYP estimates that about 50,000 school graduates will enter the labor market during 2002-2007. Another 20,000 people are expected to come to urban areas in search of gainful employment. Thus, the economy will need to absorb 70,000 new entrants to the labor market over the next 5 years.

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<sup>2</sup> Prepared by the Department of Employment and Labor, and published in 2003.

<sup>3</sup> No statistics are currently available on the extent of underemployment in the economy.

**Table 2: Selected Labor Market Statistics**

<b>Item</b>	<b>Percent</b>
Overall Unemployment Rate	1.9
Urban	4.1
Rural	0.6
Urban Unemployment Rate	
Male	3.0
Female	5.3
Rural Unemployment Rate	
Male	0.6
Female	0.7
Unemployment Rate for 15-19 years old	
Overall	8.4
Urban	10.9
Rural	4.0

Source: Department of Employment and Labor, National Labor Force Survey, 2001.

7. Currently, there is a skills mismatch between the needs of the private sector and the qualification of the school graduates. In addition, there is an aspirations mismatch: school graduates' preference for employment is with the Government first, followed by Government corporations, and, only as a last resort, with the private sector. The Government has taken multiple steps to address the situation. In addition to counseling students on emerging market realities, it is focusing on vocational education to correct the skills mismatch between the needs of the private sector and the qualification of school graduates. To make private sector employment more attractive, the Government has drafted labor laws, which will be presented to the National Assembly for approval. In addition, an apprenticeship act is being drafted whereby the Government and the private sector, on a 50:50 cost-sharing basis, will train new entrants in the labor market. Further, each memorandum of understanding signed in the context of foreign direct investment now specifies the number and skills level of Bhutanese nationals to be employed and trained. These measures are expected to address the issue of shortage of skilled Bhutanese workers<sup>4</sup> as well as provide a sustainable framework for absorbing new entrants to the labor force during the NFYP period.

#### **Box 1: The Power Sector in Bhutan**

Bhutan's hydropower potential is estimated to be over 30,000 megawatts (MW). Of this potential, about 1.5% had been utilized as of end-FY2002. The hydropower sector is the single largest source of domestic revenues, accounting for some 45% of Government revenues and a GDP share of about 12%. Inclusive of hydropower-related construction activity, the power sector is the largest component of Bhutan's industry sector. Of the three in-service hydropower projects, the Chhukha hydropower project (CHP), completed with financial assistance from India with an installed capacity of 336 MW, is the largest, followed by the Kurichu and Basochu hydropower projects. With the commissioning of CHP, Bhutan began exporting power to India, equivalent to about 90% of CHP's generation capacity.

<sup>4</sup> Currently around 54,000 foreign skilled workers are employed in Bhutan.

During FY2002, CHP sales accounted for 39% of total domestic revenues. Over the past 5 years, revenues from CHP have grown at an average annual rate of 11%. With the completion of its final phase, the Kurichu hydropower project is generating 60 MW. The Basochu hydropower project of 62 MW is phased over two stages. The upper stage of Basochu, with Austrian financial assistance, was commissioned in October 2001 with an installed capacity of 22.2 MW. The lower stage also with Austrian financial assistance, and with an installed capacity of 40 MW, is scheduled for completion in March 2005. Following the successful completion of CHP, the Government embarked on the 1,020 MW capacity Tala hydroelectric project (THP). It is the largest hydropower project assisted and undertaken by India in any country; on completion in June 2005, it would surpass CHP and become Bhutan's single largest source of domestic revenues. The revenues from this project would not only help meet the gaps in recurrent expenditure, but also contribute significantly towards meeting a part of capital expenditures. The project would also result in increased exports and thus contribute a reduction of the merchandise trade balance.

It is estimated that annual power consumption in Bhutan grew at an annual average rate of 9.5% over the past 5 years, giving more than 30% of Bhutanese households access to electricity. With the completion of THP and Basochu lower stage, Bhutan will have an installed hydropower capacity of 1,485 MW, equivalent to about 5% of its potential. The industry will then be contributing about 60% of total domestic revenues.

Asian Development Bank (ADB) assistance to the power sector includes support for Government's rural electrification program and institutional and capacity development for sector restructuring. Consistent with its sector restructuring priorities, in July 2002 the Government separated the Department of Power (DOP) into three agencies: the Bhutan Power Corporation (BPC), the Department of Energy (DOE), and the Bhutan Electricity Authority (BEA). With the new framework, BEA will function as the regulatory body for enforcing rules and regulations and the BPC will be responsible for the utility functions. DOE will remain the planning and policy body of the energy sector. Based on the findings of a technical assistance (TA) to be provided by ADB, the Government will consider establishing the Druk Hydropower Corporation (DHPC) to consolidate all Government-owned power stations as profit centers and to facilitate private sector participation in hydropower generation. In support of the Government's sector restructuring initiatives, in 2003, ADB intends to also provide a TA grant for strengthening BEA. Under the NFYP, the Government plans to electrify 15,000 households in 20 districts to achieve 100% electrification by 2020. In support of this, ADB is processing a loan in 2003 to electrify about 8,000 households.

Sources: Department of Power, Ministry of Trade and Industry; Royal Monetary Authority (RMA). 2002. *Annual Report*, and Royal Monetary Authority. 2003. *Selected Economic Indicators*. March. 2003

### **3. Savings and Investment**

8. The average annual savings rate over the past 5 years is 17% of GDP, whereas the gross domestic investment rate is 42%. Gross domestic savings (GDS) comprising mainly of corporate savings has fluctuated from -33% to 47% in the last six years with no clear and consistent trend in its growth. As noted in the RMA's 2002 Annual Report, GDS has consistently fallen short of gross domestic capital formation, requiring an average net inflow of about 13% of GDP in the last 10 years. More recently, the savings-investment gap as a percentage of GDP has risen to over 26%, with the latest figure being 29% for 2001.

#### **B. Fiscal Developments**

9. Domestic revenues, which have shown an average annual growth rate of 10.8% over the past 5 years, have consistently been above 20% of GDP during FY1998 to FY2002 (Table 3), a performance which compares very favorably with that of other South Asian countries. Tax revenues, which have exhibited an average annual growth rate of 19%, have not shown corresponding buoyancy. The average per annum tax-GDP ratio over the past several years has been stagnant at around 10.5% of GDP, with no appreciable upward trend. With the twin objectives of equity and tax buoyancy, the Government introduced, effective from 1 January 2002, a personal income tax (PIT) applicable on six sources: (i) salary, (ii) rental, (iii) dividend, (iv) interest, (v) cash crops, and (vi) others such as income derived from intellectual property rights. All export earnings in convertible currency of licensed manufacturing industries and licensed agriculture produce exporters are exempted from business income tax. The results of

the first year of PIT are encouraging, as actual collections were 85% of the projected target. The Government hopes to collect some Nu120 million for the current calendar year.

10. Direct tax collections in 2002 recorded a 7% growth over the previous year and accounted for 61% of tax revenues and 32% of total revenues. For greater documentation of economic transactions, the Government contemplates requiring the use of letters of credit. Under the present tax structure, dividend income is subject to double taxation, first at the corporate level and again at the personal level. Of the six sources of direct taxation, the largest collection is from the corporate income tax, followed by the business income tax, and royalties. These three tax categories accounted for 94% of direct tax collection and 65% of the total tax revenues in FY2001. While their contribution in the direct taxation category remained at about the previous year's level, their contribution to total revenue dropped to 57% in FY2002 on account of a decline in income from royalties.

**Table 3: Government Finance**  
(% of gross domestic product at market prices)

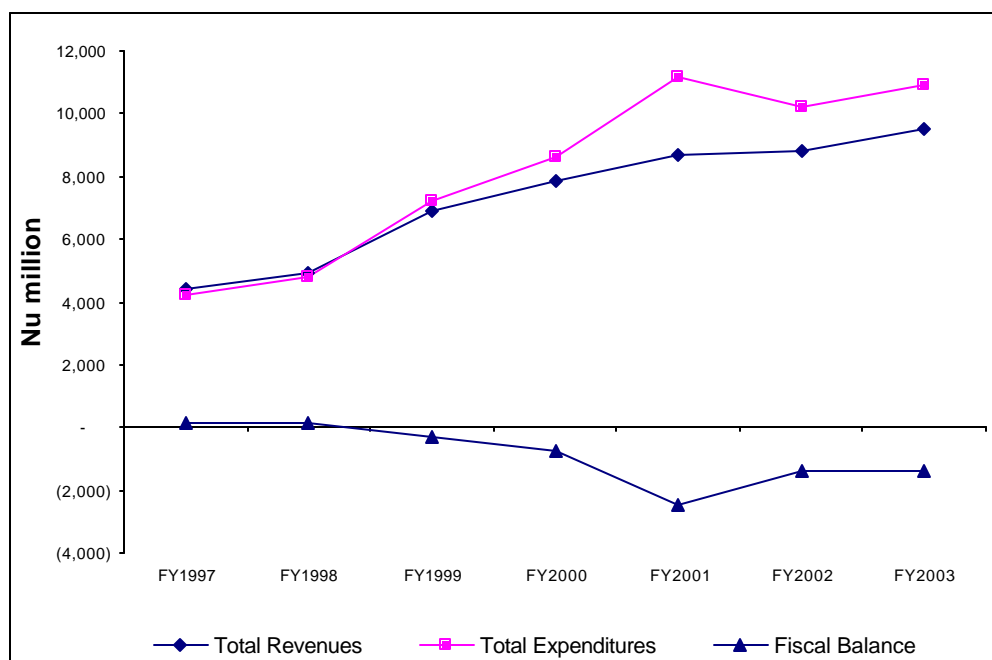
Item	FY1998	FY1999	FY2000	FY2001	FY2002	FY2003 <sup>a</sup>
<b>Revenues and Grants</b>	<b>32.9</b>	<b>40.0</b>	<b>39.6</b>	<b>38.5</b>	<b>34.1</b>	<b>32.5</b>
Domestic Revenues	20.8	21.1	23.1	22.1	21.3	17.5
of which: Tax Revenue	8.3	7.3	10.0	8.5	9.3	9.4
<b>Expenditures and Net Lending</b>	<b>31.9</b>	<b>41.7</b>	<b>43.4</b>	<b>49.6</b>	<b>39.6</b>	<b>37.4</b>
Current Expenditures	17.5	18.3	18.6	19.7	18.1	15.7
Capital Expenditures	13.0	23.7	23.3	27.9	21.2	21.6
Net Lending	1.4	(0.3)	1.5	2.0	0.3	0.1
<b>Overall Balance</b>	<b>1.0</b>	<b>(1.8)</b>	<b>(3.9)</b>	<b>(11.1)</b>	<b>(5.5)</b>	<b>(4.8)</b>
External Financing	2.2	3.2	3.1	4.7	3.1	3.1
Domestic Financing	(3.2)	(1.4)	0.8	6.4	2.4	1.7
Memorandum Item:						
External Funds/Development Expenditure (%)	92.6	79.8	71.0	59.1	61.0	69.8
of which share of India	53.3	47.0	47.2	41.0	29.0	43.8

<sup>a</sup> Estimates.

Source: Statistical Appendix, Table A.5.

11. Over the years, the Government has maintained a prudent macroeconomic stance, resulting in a surplus on the recurrent budget account. However, Bhutan remains heavily dependent on external concessional assistance to finance its capital (development) budget with India providing about half of all external funding to Bhutan. In the past 5 years, the overall fiscal balance has been negative (Figure 3). It rose from 3.9% of GDP in FY2000 to 11.1% of GDP in FY2001, before declining to 5.5% of GDP in FY2002. The increase in the budget deficit for FY2001 was mainly on account of higher than projected expenditures required to cope with the effects of the August 2000 floods and the loss of revenues due to the flood-related shutdown of industrial activity.

**Figure 3: Budgetary Framework**



12. In recent years, the Government has resorted to domestic borrowing to close part of the fiscal deficit. Most recent available data suggest that internal borrowings in FY2001 financed 37% of the fiscal deficit. Internal borrowings are in the form of (i) overdraft facility with the 80% Government-owned Bank of Bhutan at 7% interest per annum, computed on a daily outstanding balance basis; (ii) Nu500 million Government bonds, issued in 2001 and rolled over in 2002, with a yield of 7% per annum; and (iii) Nu250 million, 1-year Government promissory note issued in February 2003, with a yield of 7%.

13. On 2 July 2003, the Government presented the budget for FY2004<sup>5</sup> to the National Assembly. The size of the proposed budgetary outlay represents an overall increase of 3% over the revised estimates for 2003. Compared with the revised estimates, current expenditures are projected to increase by about 3% whereas development expenditures are projected to decline by about 4%. Although during FY2004, domestic revenues are projected to show a modest increase of only 2%, consistent with the past trend, domestic revenues will fully finance recurrent expenditures. As such, there will be a surplus on the budget's recurrent account. The overall fiscal balance would, however, reflect a deficit equivalent to about 5% of the projected GDP. Excluding expenditures for large energy sector projects, the largest shares of FY2004 development expenditures are earmarked for the development of roads (21%) and health and education sectors (17%). A preliminary review of FY2003 fiscal performance<sup>6</sup> indicates a significant drop of external assistance in the first year of the NFYP. Specifically, there was a significant shortfall in external assistance from India, Bhutan's single largest source of grant financing. Overall, grant assistance from India declined by about 50% compared to the budget estimate. Both program and project assistance from India was lower as compared to the budget

<sup>5</sup> 1 July 2003–30 June 2004.

<sup>6</sup> Based on data in the National Budget for FY04, presented in the National Assembly of Bhutan on 2 July 2003

estimate; each declining by 60% and 17%, respectively<sup>7</sup>. The decline in grant assistance from India was partially offset by a 13% increase in grant assistance by other development partners. As a result of the decline in grant assistance, the resource gap increased substantially, and the overall budget deficit rose from the planned 5% of GDP to an estimated 8.6% of the GDP in FY 2003.

### C. Monetary Developments and Prices

14. Monetary conditions remained moderate with broad money supply (M2) accelerating to 17.6% growth from 5.5% in the previous year (Table 4). As in the past, the surplus on the balance of payments and the consequent rise in banking system net foreign assets were the dominant factors in the expansion of M2. During the same period, narrow money supply (M1) exhibited a slower growth of 12.1% compared with the previous year's 21.3%. Among the components of M2, quasi money grew at an annual rate of 22.6% compared with the negative growth of 5.7% in FY2001. A rise in time deposits was largely responsible for the increased growth of quasi money.

**Table 4: Monetary Survey**

Item	FY1998	FY1999	FY2000	FY2001	FY2002
	(% of GDP at market prices)				
<b>Change in Net Foreign Assets</b>	<b>19.0</b>	<b>13.0</b>	<b>9.6</b>	<b>(2.0)</b>	<b>6.1</b>
<b>Change in Net Domestic Credit</b>	<b>(1.9)</b>	<b>(5.0)</b>	<b>1.9</b>	<b>5.6</b>	<b>1.0</b>
to the Public Sector	(2.5)	(4.8)	1.9	2.9	(1.1)
to the Private Sector	0.5	(0.2)	(0.0)	2.7	2.1
<b>Change in Broad Money (M2)</b>	<b>11.9</b>	<b>7.5</b>	<b>7.9</b>	<b>2.2</b>	<b>6.4</b>
<b>Change in Narrow Money (M1)</b>	<b>3.5</b>	<b>2.1</b>	<b>4.1</b>	<b>3.5</b>	<b>2.1</b>
	(% change per annum)				
<b>Broad Money Growth (M2)</b>	<b>41.7</b>	<b>21.4</b>	<b>21.3</b>	<b>5.5</b>	<b>17.6</b>
<b>Narrow Money Growth (M1)</b>	<b>26.7</b>	<b>14.8</b>	<b>28.7</b>	<b>21.3</b>	<b>12.1</b>

Sources: Statistical Appendix, Table A.6.

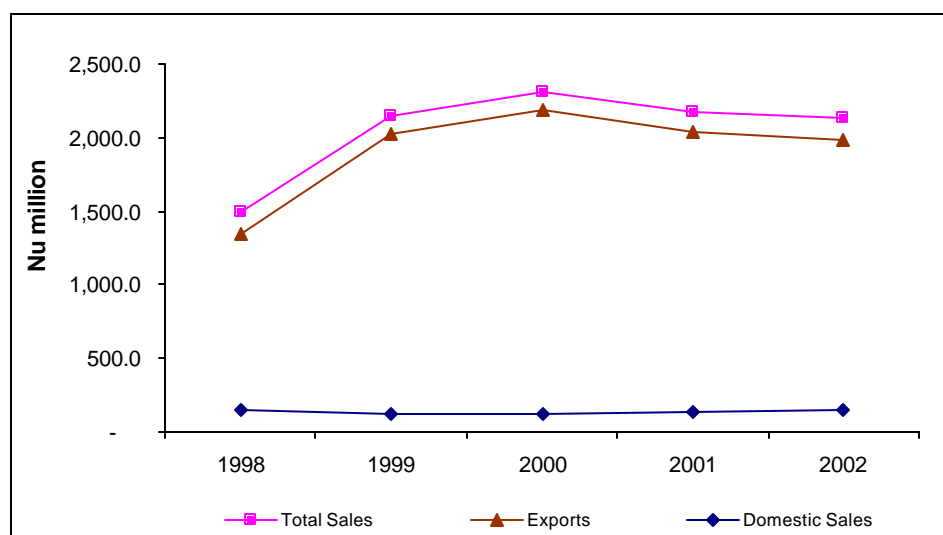
15. During FY2002, growth in commercial bank deposits with the Royal Monetary Authority (RMA) increased reserve money by 27.9%. Thus, managing excess liquidity remains a key financial sector challenge. Fortuitously, the exchange rate policy—which pegs the ngultrum at par with the Indian rupee—and capital controls ensure that excess liquidity does not act as a destabilizing factor for balance of payments, price stability, and monetary policy. RMA has absorbed some excess liquidity by issuing RMA bills, but this carries a 3% per annum cost to RMA. To dampen the growth of excess liquidity in the banking system and to encourage the banking system to employ its excess liquidity domestically, RMA recently issued a directive prohibiting the opening of fresh deposits across the border. To absorb excess liquidity from the banking system, the RMA raised the cash reserve ratio to 20% in July 2002. Nonetheless, despite a 28% increase in lending to the private sector, as of June 2002, the commercial banks were holding excess reserves with RMA equivalent to about 40% of their assets.

<sup>7</sup> The Government is hopeful that once bilateral discussions for financing of the Ninth Five Year Plan are concluded, grant assistance from India could be restored to its historical levels.

16. As noted in RMA's annual report of December 2002, the intermediate target for achieving and maintaining price stability in Bhutan is the one-to-one peg between the Indian rupee and the ngultrum. Targeting the exchange rate, however, implies acceptance of India's monetary policy. As such, an independent monetary policy in Bhutan is more or less precluded. Consequently, monetary policy is confined to the support of the peg, including the following basic measures: (i) ensuring the sustainability of the exchange rate arrangement, i.e., always making available sufficient rupees on demand to exchange for the ngultrum for payments in India and provision of at least 100% reserve backing for all Ngultrum issued (i.e., elements of a Currency Board); (ii) confidence-building measures for the ngultrum; and (iii) sterilizing the persistent growth in liquidity to forestall a possible build up of inflationary pressures, a weakening of the balance of payments, and a contingent effect on the financial market.

17. Latest available data indicate that at the end of 2001, 14 companies were listed on the Royal Securities and Exchange of Bhutan. Their market capitalization of about Nu2.9 billion, reflects an increase of 25% over the previous year. The total shareholder count of 6,610 is low. A key development in the capital market in June 2002 was the floating of shares for the newly opened Bhutan Beverages Company Limited, which was over-subscribed by 2.5 times. In July 2002, an annuity-based, multitiered retirement plan—the National Pension and Provident Fund—was established as an autonomous body governed by the National Pension Board.

**Figure 4: Consumer Price Index**  
(% change over previous year)



18. As measured by the consumer price index (CPI), inflation continued to decline, falling to 2.3% in December 2002 from 2.7% at the end of June 2002 (Figure 4 and Table 5). This is the lowest inflation rate in the past 3 years. As almost all major components in the CPI basket are goods imported from India, the relative low inflation rate prevailing in India has helped maintain a low inflation rate in Bhutan. With respect to the components of the CPI, the annual growth of non-food prices dropped from 4.9% in December 2001 to 3.5% in June 2002, while the annual growth of food prices remained unchanged from December 2001 at 2.2%.

**Table 5: Inflation Rates**  
(% change per annum)

Item	FY1998	FY1999	FY2000	FY2001	FY2002	Average FY1979-2002
<b>Consumer Price Index</b>	<b>12.1</b>	<b>4.5</b>	<b>4.4</b>	<b>3.2</b>	<b>2.3</b>	<b>8.5</b>
Food	12.9	2.6	1.3	2.2	1.9	7.6
Nonfood	10.6	7.9	9.6	4.9	2.8	10.2

Source: Central Statistical Organization of the Planning Commission.

### Box 2: Bhutan's Financial Sector: Issues and Challenges

Financial markets and institutions play an important role in economic growth. The financial system in Bhutan consists of the Royal Monetary Authority (RMA), two commercial banks, two nonbank financial institutions, and one pension and provident fund. RMA regulates and supervises the commercial banks and the lending activities of the nonbank financial institutions.

The lack of effective competition in the Bhutanese financial sector is due mainly to the small size of the market for financial services and has contributed to high intermediation costs with large spreads in lending and deposit rates. A virtuous circle of economic growth and financial sector development has occurred in the public sector in Bhutan, but not in the private sector. Private savings mobilization is low, as is private sector investment. Among the considerable impediments to private sector growth in Bhutan is the lack of risk appetite of commercial banks; another is the lack of institutions for venture capital funds, particularly for small and medium-size businesses with little or no collateral. Dependence on foreign aid and revenues from hydropower has allowed Bhutan to sustain high levels of consumption and low private domestic savings, and has dampened the desire to promote measures to increase domestic private savings. The reasons for sluggish credit activity in Bhutan include high collateral requirements due to the inadequate legal framework for loan recovery and institutional deficiencies in project appraisal.

Emphasis should continue on working with and reducing risks for financial institutions by promoting a sound financial market infrastructure. More needs to be done to enable financial institutions to effectively do their work. This includes (i) promoting a standardized national accounting system; (ii) developing a sound legal system; (iii) improving credit assessment capabilities by creating of a credit information bureau; (iv) changing the ownership structure the banks and nonbank financial institutions and opening up the sector to domestic private banks as well as to both domestic and foreign joint-venture small nonbank financial institutions to bring more competition and diversification to Bhutan's financial sector. Commercial banks also need to develop more expertise to manage risk and their foreign exchange reserves and liquidity and to diversify their portfolios so that they are not so dependent on particular sectors and borrowers. Banks also need to develop skills to do strategic management and to develop their internal prudential criteria.

More needs to be done to link the rural areas in Bhutan with the financial system to help reduce poverty in those areas, and to help fund small and medium-size enterprises. Bringing a large part of Bhutan's population into the formal monetized economy will help reduce rural poverty. A financial infrastructure that can accommodate small savers, such as post office savings accounts, could provide people in rural areas with savings facilities that can be used for local development. Finally, the key to strong financial institutions is strong prudential supervision. In this context, RMA needs more independence in deepening and strengthening its supervision functions.

Source: ADB. 2001. *TA 3687-BHU: Financial Sector Review*. Manila.

## D. External Trade, Balance of Payments, and Foreign Debt

19. Over the past 5 years, Bhutan's exports have decelerated at an average annual rate of 2.4%, while import growth has been 9.4% (Table 6). The result is a negative trade balance for the period (Figure 5). The trade balance with respect to India has been negative during the past 5 years. The composition of Bhutan's merchandise trade shows that India remains its largest trading partner accounting, on average, for some 90% of Bhutan's exports and about 70% of imports. Power is the largest export item to India. In 2001, power accounted for 47% of total

export earnings and 51% of export earnings from India. Besides power, other major export commodities to India are agrobased, chemical, mineral, and base metal products. In 2001, 95% of total export earnings were from India. However, export receipts from India are in rupees and thus are not a source of foreign exchange earnings. Given the one-to-one peg between the Indian rupee and the ngultrum, Bhutanese imports from India are also payable in rupees. Bangladesh is Bhutan's second largest trading partner, and exports to it accounted for 4.5% of export earnings in 2001. Bhutan's leading exports to countries other than India consist of vegetables and fruits, minerals, processed foods, textiles, and handicrafts.

**Table 6: Balance of Payments Indicators**

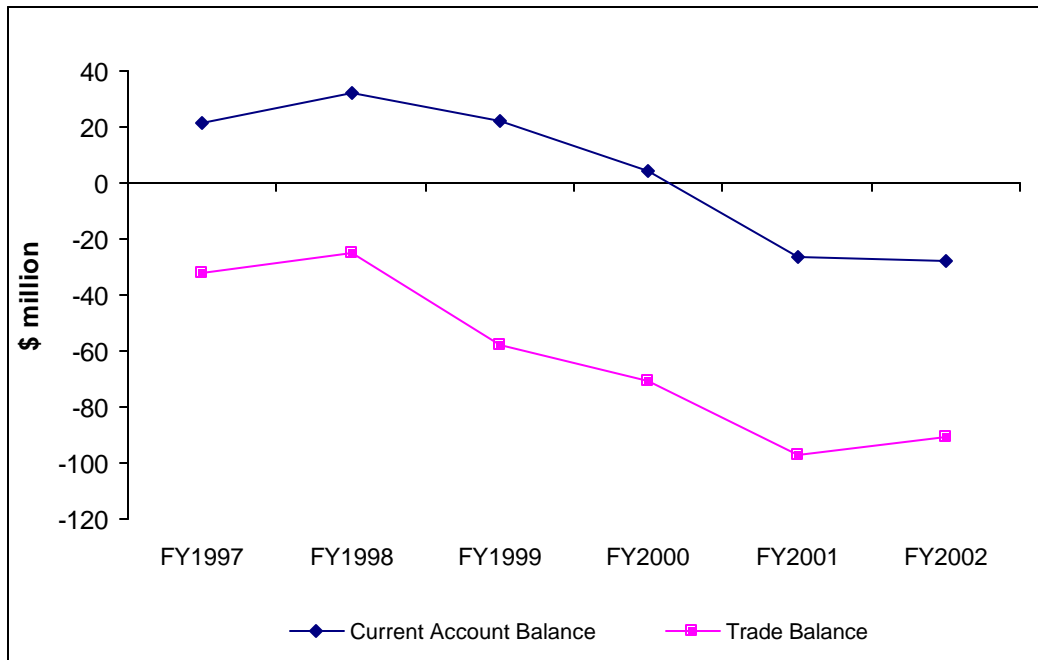
Items	FY1997	FY1998	FY1999	FY2000	FY2001	FY2002 <sup>a</sup>
	(in percent of GDP at factor cost)					
<b>Merchandise Trade Balance</b>	<b>(9.0)</b>	<b>(6.3)</b>	<b>(14.2)</b>	<b>(15.5)</b>	<b>(19.9)</b>	<b>(17.0)</b>
Merchandise Exports	28.0	28.4	25.8	25.1	20.5	18.3
Merchandise Imports	(37.0)	(34.8)	(39.9)	(40.7)	(40.4)	(35.3)
Balance with India	1.2	2.4	(4.3)	(6.8)	(13.7)	(10.1)
<b>Current Account Balance</b>	<b>6.0</b>	<b>8.2</b>	<b>5.4</b>	<b>0.9</b>	<b>(5.5)</b>	<b>(5.3)</b>
Balance with India	7.2	9.9	4.3	0.9	(7.6)	(5.1)
<b>Change in Reserves</b>	<b>5.7</b>	<b>10.8</b>	<b>10.2</b>	<b>7.5</b>	<b>4.7</b>	<b>5.9</b>
	(in percent change per annum)					
<b>Merchandise Exports Growth</b>		<b>12.1</b>	<b>(5.9)</b>	<b>9.2</b>	<b>(13.0)</b>	<b>(1.8)</b>
Exports to India		16.7	(6.7)	10.0	(12.6)	(2.6)
<b>Merchandise Imports Growth</b>		<b>3.7</b>	<b>19.3</b>	<b>14.0</b>	<b>6.1</b>	<b>(4.0)</b>
Imports from India		11.9	20.3	20.3	15.8	(9.3)
Memorandum Items:						
Gross International Reserves (\$ million)	176.1	216.7	259.0	292.6	294.1	316.6
(in months of merchandise imports)	16.1	19.1	19.2	19.0	18.0	20.2
Exchange Rate	35.8	38.4	42.6	43.6	46.4	48.2
(Nu per \$; fiscal year average)						

Source: Statistical Appendix, Table A.7.

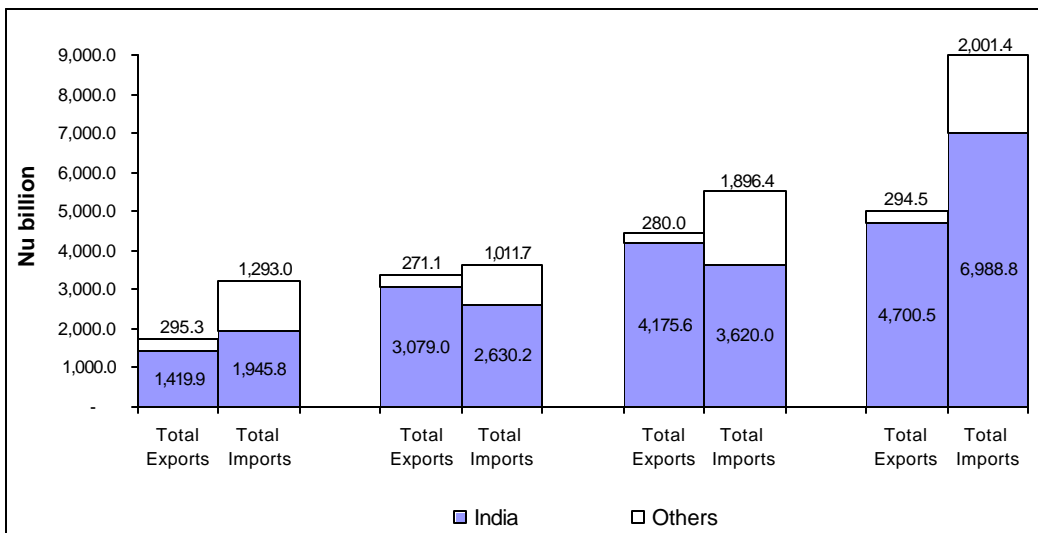
20. The trade account deficit decreased from 19% of GDP in 2001 to 17% of GDP in 2002, reflecting an increase in power exports to India and a decline in imports from India as some major hydropower projects neared completion. However, due mainly to a substantial decrease on account of the lower interest income of financial sector assets held abroad, the current account deficit averaged 5.5% per annum over the past 2 years. Continued inflow of external assistance as grants and concessional loans has contributed to (i) financing the balance of payments current account deficits, (ii) buildup of foreign exchange (FX) reserves, and (iii) a positive balance on the overall balance of payments account. Latest available statistics indicate around 8% increase in gross international reserves, from \$317 million in June 2002 to \$343 million in February 2003. This level of FX reserves was sufficient to provide import cover of

some 22 months. Of the total reserves, 78% were in convertible currencies, and the balance was in Indian rupees.

**Figure 5: Balance of Payments (overall)**



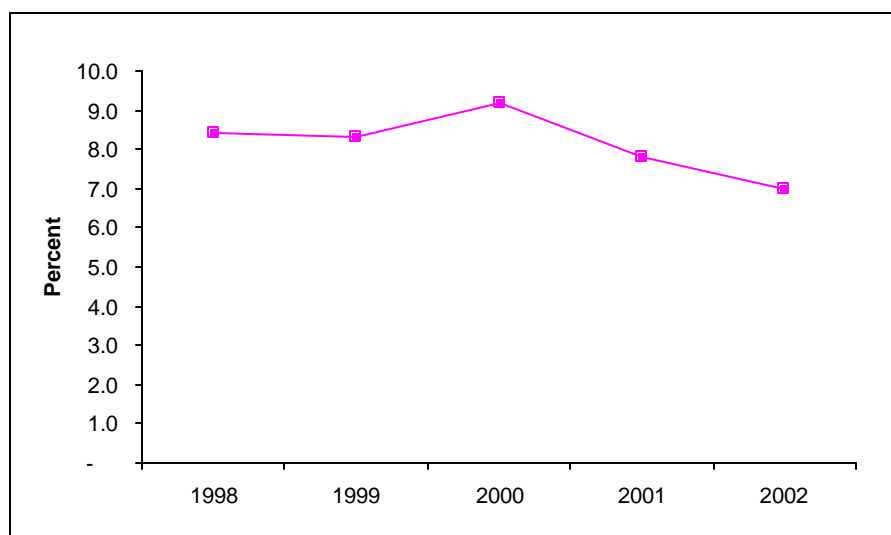
**Figure 6: Direction of Trade**



21. The tourism industry, which is almost exclusively run by the private sector and is the single largest source of foreign exchange earnings, has not recovered from the aftereffects of 11 September 2001. Tourist arrivals reached a peak of 7,600 in 2000, but have been declining at a rate of 12% annually since then. Foreign exchange revenues from the sector (Figure7) declined to \$9 million for 2001/02. With Austrian assistance, the Government is formulating a comprehensive strategy for tourism development. However, the Government's objective is not

to maximize the number of tourist arrivals, but to increase revenue receipts by increasing the average stay of tourists and only secondarily from a gradual increase in the number of tourists. To improve the enabling environment, the Government plans to replace its existing aircraft fleet with larger aircraft and by establishing a hotel and tourism management institute for tour operators and guides. As per current regulations, private sector tour operators have to charge a minimum fee of \$200 per day, per tourist during the high season and \$165 per day, per tourist during the low season. Of this gross receipt, Government's average share over the two seasons is 33%. Currently, two foreign private sector companies are establishing new hotels; these, however, are meant exclusively for high-end market customers. In the NFYP, the Government's objective is to increase the number of tourist arrivals to 15,000 per year by 2007.

**Figure 7: Tourism Revenue**  
(% of domestic revenue)



22. Bhutan's stock of external debt outstanding increased by 23.2% to \$292 million at the end of FY2002 (Figure 8). Of this amount, 45% was in the form of outstanding convertible currency debt, reflecting an increase of 22% over the previous year. The balance of debt outstanding was in the form of nonconvertible currency (rupee) loans, which at end-FY2002 registered an increase of 25% over the previous year. Corresponding to the growth in total debt, the ratio of outstanding debt to GDP rose from 49% in FY2001 to 55% in FY2002,<sup>8</sup> while the debt service ratio rose to 5% (Table 7).

<sup>8</sup> The debt-to-GDP ratio is sensitive to whether the GDP used is calculated on the basis of a calendar or fiscal year. Based on a GDP of 2000/01=2000 classification, the December 2002 Royal Monetary Authority report shows a debt-GDP ratio of 58%. The classification used in this CER is consistent with that used by the International Monetary Fund in its December 2002 Article IV Consultation.

**Table 7: Public External Debt and Debt Service (% of GDP)**

Item	FY1998	FY1999	FY2000	FY2001	FY2002
<b>Total Public External Debt</b>	<b>34.5</b>	<b>39.7</b>	<b>38.2</b>	<b>48.7</b>	<b>54.7</b>
<b>Convertible Currency Debt</b>	<b>23.1</b>	<b>24.2</b>	<b>21.7</b>	<b>22.0</b>	<b>24.3</b>
Concessional	22.8	24.2	21.7	22.0	24.3
Commercial	0.3	0.0	0.0	0.0	0.0
<b>Nonconvertible Currency Debt</b>	<b>11.4</b>	<b>15.5</b>	<b>16.5</b>	<b>26.7</b>	<b>30.3</b>
Memorandum Items:					
Debt Service Ratio (% of merchandise exports)	8.2	11.9	4.9	4.6	5.0
Exchange Rate (Nu per \$, end of period)	38.4	42.6	43.6	46.4	48.2

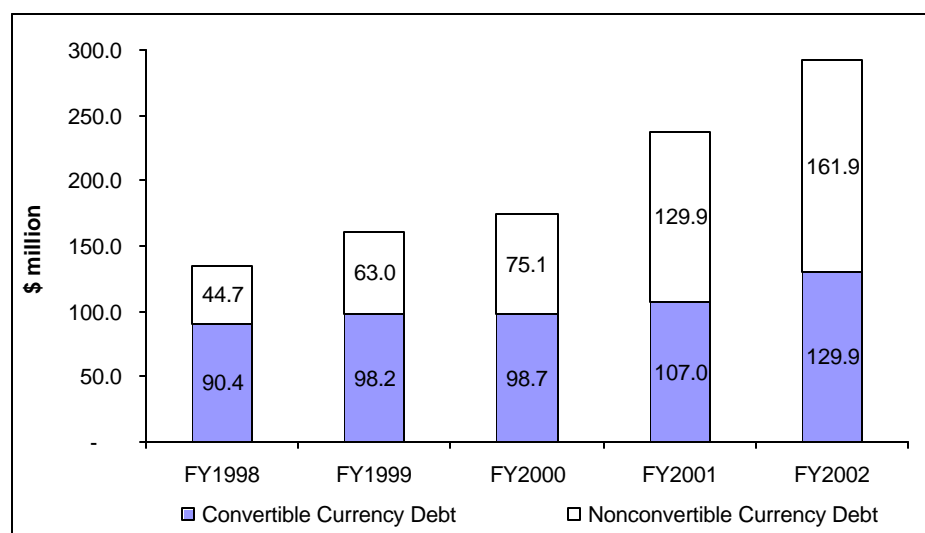
Source: Statistical Appendix, Table A.8.

23. Presently, all external debt of Bhutan is in soft loans or concessional debt. The only commercial loan was procured by the Government in FY1988/99 to purchase an airplane. Repayments on this loan were completed in FY1998/99. According to Government estimates, over 60% of the soft loans (both convertible currency and rupee) have been disbursed to the power sector, and 25% have been shared by agriculture, education, and industry. As of June 2002, India had provided most of the soft loans to Bhutan, with cumulative gross disbursements totaling \$216 million, primarily for developing the hydropower sector. India was followed by ADB, the World Bank, and the Kuwait Fund for Arab Economic Development with gross disbursements of \$63 million, \$36 million, and \$28 million, respectively.

24. In a recent assessment of debt sustainability,<sup>9</sup> Bhutan's public debt dynamics appear sustainable under a number of domestic and external shocks. In the baseline scenario, the Government debt-to-GDP ratio is expected to rise rapidly from 58% in FY2001/02 to 80% by FY2004/05<sup>10</sup> due to external loans from India that are necessary to complete the Tala hydropower project, but would decline to 63% of GDP by FY2009/10. These generally favorable debt dynamics reflect a combination of high-expected growth, low average interest costs, and moderate primary deficits. As these parameters are subject to change over time, existing prudent fiscal stance should continue. The ngultrum is pegged at par with the Indian rupee and therefore reflects changes in the exchange rate development of the rupee. Between FY1995 and FY2002, the ngultrum depreciated against the dollar by an average of 5.9% per annum. Between June 2001 and June 2002, however, it depreciated by 3.8% against the dollar.

<sup>9</sup> International Monetary Fund. 2003. *Bhutan: 2002 Article IV Consultation*, February. Washington DC.

<sup>10</sup> The debt-to-GDP ratio will peak in 2004/05 on completion of the Tala Hydropower Project.

**Figure 8: External Debt Outstanding****Box 3: Tourism Development**

The first official tourists to Bhutan came from the United States (US) after the Royal Coronation in 1974. Thereafter, the Bhutan Tourism Corporation was responsible for all tourist operations till 1991, when the tourism industry was privatized. The Tourism Authority of Bhutan was established in 1991 as a regulatory body. Under the Government restructuring exercise of 2000, the body was reconstituted as the Department of Tourism (DOT).

The policy of "high quality, low volume" has been the guiding principle developing tourism industry in Bhutan to ensure the preservation of its environment, culture and value system. However, the enormous possibilities in the marketing of ecotourism products may alter the overriding principle for the industry from "high quality, low volume" to "high quality, low impact."

In a span of 27 years, tourist arrivals have been steadily increasing: from 5,363 in 1997 to 7,600 in 2000. The sector is the single largest source of hard currency earnings for the country, and accounted for gross receipts of \$10.5 million in 2000. Of this amount, the share of the Government was about 35%. As a percent of domestic revenues, the share from tourism was 7% in 2000. According to a Government publication, by the end of 2012, tourism will constitute 25% of the GDP, with gross revenue receipts projected to increase by 100%. As of September 2001, 94 registered tour operators directly employed over 500 Bhutanese nationals and 2,000 temporary workers.

## Selected Tourism Indicators (1997-2002)

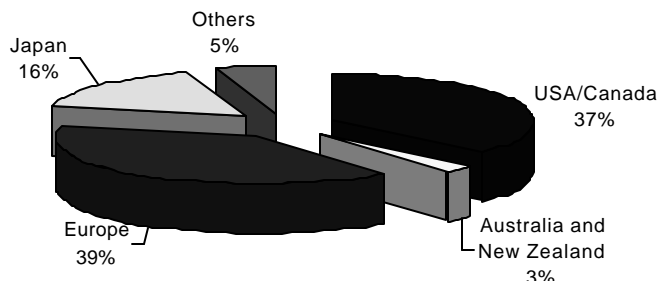
Item	1997	1998	1999	2000	2001	2002
Arrivals (No.)	5,363	6,203	7,158	7,559	6,393	5,249
Gross Receipts (\$ million)	6.6	8.0	8.9	10.5	9.2	7.4
Government Revenue (%)	2.5	3.0	3.5	4.1	3.3	2.8

In 2002, for the second consecutive year, the tourism industry faced negative growth in the number of tourists and associated revenues. Since the peak of 2000, total arrivals and foreign exchange revenue have declined by 44% and 42%, respectively. Reasons for the decline include the repercussions of 9/11 in the US, the Bali blasts of 2002, and the uncertain security situation in neighboring Nepal which serves as an entry point for a large number of tourists intending to visit Bhutan.

In the NFYP, the Government has identified tourism as a priority sector and allocated Nu185 million for tourism development. The plan includes proposals to establish a hotel management and training institute in Thimpu, and develop and promote new tourism products. The Bhutan National Ecotourism Strategy, reflecting collaboration between DOT and members of the Association for Bhutan Tour Operators, was published in November 2001 as a guide for tourism entrepreneurs. The NFYP states that efforts would also be made promote domestic tourism by first examining existing trends and improving public facilities and services at possible places of interest.

Sources: Department of Tourism, Government of Bhutan, Royal Monetary Authority (RMA). 2002.

**Figure 9: Tourism Arrivals**  
(by nationality)



**Box 4: Private Sector Development**  
– A Private Sector View

In the Ninth Five Year-Plan (NFYP) framework, the private sector is envisaged to be the engine of economic growth. However, as noted in the NFYP, the private sector continues to face several constraints arising from the small size of the domestic market, shortage of local skilled labor, underdeveloped infrastructure and disadvantages associated with a landlocked country. In the past 2 years, the Government has taken some steps to improve the overall enabling environment for the private sector (see Box 5). However, the private sector sees some specific hindrances in its development, most of which are related to the financial sector. The Committee for Private Sector Development recently forwarded the following issues for the Government to consider/resolve in reviewing and rationalizing financial sector policies:

- reducing financial charges for banking transactions;
- adopting competitive interest rates, based on market forces;
- introducing customer credit rating system;
- lowering the existing 300% collateral requirement and equating it with the feasibility of a proposed project;
- valuating asset based on market rates;
- developing expertise in financial instruments such as bonds, venture capital and leasing;
- discouraging banks from investing fixed deposits outside the country;
- increasing the limit of consortium funding from Nu20 million to Nu50 million;
- providing foreign exchange for importing raw materials from regional markets; and
- investing more funds in government infrastructure development.

## II. DEVELOPMENT CHALLENGES

25. **Poverty Reduction.** Using the findings of a pilot survey under the ADB-assisted Household Income and Expenditure Survey (HIES) and the benchmark of a minimum caloric intake of 2,124 calories per person per day, a computed absolute poverty line shows 29% of the population of rural areas and 2.4% of the urban population as poor. Although the Government has not adopted an explicit poverty reduction strategy, it is committed to achieving the Millennium Development Goals (MDGs) by signing a Poverty Partnership Agreement with ADB on 23 October 2001 and by adopting an integrated rural development program comprising, among others, agriculture support services, improved rural access, and targeted food aid programs. During implementation of the NFYP, the Government plans to maintain the pro-poor

focus of its development objectives. Toward this end, it plans to further improve the coverage and quality of social services in the rural areas. Decentralization and devolution of development programs are expected to result in improved governance and delivery of social services. To measure progress toward achieving the MDGs, the Government with ADB assistance is strengthening research and diagnostic work and is undertaking the 2003 integrated living standards survey. The survey will provide the first “official” poverty lines for Bhutan. The Planning Commission Secretariat is establishing a poverty monitoring system and is analyzing, on a pilot basis, the impact of rural roads on poverty.

26. **Progress Toward MDGs.** Available data suggest that Bhutan remains on track in its efforts to achieve the MDGs. Bhutan intends to achieve universal primary education MDG by 2007, about 8 years before the target date. The gross enrollment rate for primary school increased from 67% in 1990 to 72% in 2000. Significant improvements have been achieved for such MDGs as decreased infant and maternal mortality rates, lower child malnutrition, and better access to clean drinking water. While health care coverage is high—90%—the Government plans to improve delivery of health services.

27. **External Assistance.** Inflows of external assistance in the form of grants and concessional loans are the primary source of financing for capital expenditures. Given growing pressures on global official development assistance, it is possible that the quantum of external assistance available to Bhutan may decline in the future. In the case of any possible shortfall in external assistance, the Government, which regularly reviews the progress in implementing the NFYP, may opt for domestic borrowing to fill the financing gap, or may phase the implementation of some of the development programs to the first 2 years of the Tenth Five-Year Plan.

28. **Fiscal Decentralization.** Compared with previous plans, decentralization of development expenditures to the districts (dzonkhags) and village clusters (gewogs) is an important hallmark of the NFYP. The DYTS and GYTS have been granted autonomy to make development plans, allocate resources, and make rules and regulations applicable within their jurisdiction. About 25% of the proposed NFYP outlay is earmarked for programs executed by districts and village clusters. It is noteworthy that administrative decentralization has been accompanied by financial decentralization, and detailed financial procedures with appropriate checks and balances have been put in place. These financial procedures form an integral part of the districts and village clusters Development Acts. These Development Acts also specify the level and kind of development activities to be undertaken at those levels, with the balance of activities falling under the realm of federal authorities.

29. **Domestic Resource Mobilization.** While domestic revenues (tax and nontax) have consistently exceeded current expenditures over the past 5 years, their residual contribution to meeting capital (development) expenditures has varied from a high of 26% in FY1998 to a low of 8% in FY2003, with an overall annual average of 15%. Because domestic resources are inadequate to support the development process, Bhutan relies to a very large extent on external assistance for funding its development programs and initiatives.

30. **Finance Sector.** The cost of financial intermediation in Bhutan appears high, given the prevailing 4-6% spread between the lending and deposit rates.<sup>11</sup> At the same time, the financial system has excess liquidity and the banking system continues to hold some 40% of its assets in noninterest earning deposits with RMA. The high intermediation costs and continued excess

<sup>11</sup> Royal Monetary Authority Annual Report 2001/02, December 2002

liquidity reflect inefficiencies of the banking system,<sup>12</sup> which are further exacerbated by the absence of competition. The high lending rates and collateral requirements, generally around three times the amount of financing being sought, act as effective barriers that deny the private sector access to credit from financial institutions. Fortunately, the exchange rate policy—which pegs the ngultrum at par with the Indian rupee—and capital controls ensures that excess liquidity does not act as a destabilizing factor for balance of payments, price stability, and monetary policy. RMA has reduced some excess liquidity by issuing RMA bills, but this carries a 3% per annum cost to RMA. To dampen the growth of excess liquidity in the banking system and to encourage the banking system to employ its excess liquidity domestically, RMA recently issued a directive prohibiting the opening of fresh deposits across the border. To reduce additional excess liquidity from the banking system, RMA has raised the cash reserve ratio to 20%. The Government is considering granting greater autonomy to RMA and also strengthen its supervision of financial institutions.

31. **Private Sector Development.** The NFYP explicitly acknowledges that the private sector will be the engine of growth and the prime source of employment. To facilitate private sector development, some incentives were announced as part of the national budget for FY2002/03. They include tax holidays for (i) 3 years for manufacturing industries; (ii) 3 years for information technology and vocational institutes; (iii) 5 years for hotels, schools, and auto mechanical workshops established in rural areas; and (iv) 7 years for manufacturing industries established in rural areas. To encourage companies to plow back a portion of retained earnings, a reinvestment allowance of 20% will be allowed to incorporated companies. Income earned in convertible currency by manufacturing industries, information technology industry/services, and agricultural produce has been exempted from the corporate income tax and business income tax. The existing export tax on oranges, apples and cardamom exports will be abolished. Private sector representatives have resubmitted to the Government recommendations for boosting private sector activity in the country. They pertain to lowering and rationalizing of the domestic interest rate structure, lowering the existing 300% collateral requirement by commercial banks, enhancing the capacity of the banking system for project appraisal and monitoring, achieving greater coordination among Government ministries and departments, and limited lowering of environmental standards to facilitate the mining of exportable mineral resources such as marble. The Government is cognizant of the concerns of the private sector and has taken a number of steps to improve the enabling environment for private sector development and promotion. At the same time, the private sector also needs to come forward and demonstrate more fully its entrepreneurial abilities.

32. **Employment Generation.** One of the emerging challenges facing Bhutan is the economy's ability to provide employment for the expanding labor force. Given the high capital intensity and low employment elasticity of the hydropower sector, the current mainstay of the economy, there is a need to find alternative ways for generating employment. The presence of a large number of skilled foreign workers suggests opportunities in vocational education and training, which can provide skilled employment to part of the emerging labor force. Moreover, innovative solutions, including support for self-employment and public-private partnerships, need to be explored to provide employment. To minimize the pull/push factors of migration toward the two main cities, the Government is giving high priority to an integrated approach comprising public infrastructure development and private sector employment generation in secondary towns.

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<sup>12</sup> Also reflected in the proportion of nonperforming loans, which at end-2002 was some 10%.

33. **Expansion of the Economic Base.** The Bhutanese economy is overly dependent on hydropower,<sup>13</sup> whose exports account for some 45% of Government revenues. In the near term, the hydropower sector will continue to be the mainstay of the economy. However, given the high capital intensity and low employment elasticity of this sector, the Government is providing incentives for development of other industries and services such as the information technology industry and controlled expansion of tourism and tourism-related services.

#### **Box 5: Improving the Enabling Socio Economic Environment**

Over the past 2 of years, the Government has implemented a number of policy decisions designed to enhance governance and social equity, improve economic efficiency, and provide greater incentives for the private sector. While continuous monitoring of policy decisions would be required to ensure realization of intended benefits, nevertheless, the coverage of the reform programs is comprehensive and would provide a solid foundation for taking Bhutan forward on its chosen path of Gross National Happiness. Some major developments follow.

The process of preparing a written constitution is progressing well. The first draft was completed in December 2002, and the constitutional committee is refining the draft. On finalization, the draft constitution is expected to be presented to the National Assembly for public debate. With the implementation of the Ninth Five Year Plan (NFYP), administrative powers were decentralized and devolved to districts and village clusters, thus making people at the local level responsible for identifying, implementing and monitoring development programs. This step would enhance efficiency, improve governance, and instill greater sense of ownership of development programs, thus ensuring greater sustainability.

A number of legal and policy actions were taken to enhance equity, attract foreign direct investment, and improve the enabling environment for greater private sector participation in economic development. Steps were also undertaken to ensure Bhutan's eventual accession to the World Trade Organization. Some of the major policy actions include the following: adopting a foreign direct investment policy; rationalizing the tariff structure and lowering maximum tariff rate; introducing the personal income tax; eliminating interest rate regulations; streamlining industrial licensing procedures. Improving the enabling environment for the private sector by passing legislation such as the Bankruptcy Act, Movable and Immovable Property Act, Negotiable Instruments Act, Companies Act, Copyright Act, Industrial Property Act, and the Commercial Sales of Goods Act. Strengthening prudential regulations, including risk-weighted capital adequacy requirements, provisioning over time and introduction of limits on maturity mismatches to improve management of financial institutions. In addition, the Government plans to seek private sector participation in infrastructure development on a build-operate-transfer basis. With assistance from the ADB, a dry port and industrial estate is to be established in the near future.

Steps have been undertaken to deregulate the hydropower sector by creating the Bhutan Hydropower Corporation and introducing a multitiered tariff system for the power sector. Creation of Druk Hydropower Corporation is envisaged to encourage private sector participation in hydroelectric projects. Comprehensive rural development supported by emphasis on infrastructure including social infrastructure will be an essential plank of the Government's poverty reduction strategy. Toward this end, the Government will focus on policies such as rapid economic growth, greater vocational skills development, and macroeconomic stability, with the overall objective of enhancing the Gross National Happiness of its populace.

### **III. RISKS AND VULNERABILITIES**

34. The major risk facing Bhutan is its current high dependence on the one-country-one commodity framework. India is Bhutan's largest trading partner and an important source of development financing. Hydroelectric power sales, 90% of these to India, remain Bhutan's single largest source of revenues. Trade and informal currency union with India have many advantages. They have ensured Bhutan a safe and steady stream of revenues from its hydroelectric power exports. At the same time, the one-to-one currency peg between the Indian rupee and Bhutanese ngultrum has enabled Bhutan to benefit from the price stability prevailing

<sup>13</sup> Accounting for 11% of GDP in 2002.

in India over the past few years. However, it also means that Bhutan remains vulnerable to developments across its southern border.

35. Bhutan is faced with two problems that have security implications for the country. One is people in camps in eastern Nepal. To find an early and durable solution to the problem bilateral discussions are continuing between Bhutan and Nepal. This issue is expected to be resolved in the near future. The other issue relates to the presence of armed militant groups from India who have taken shelter in the dense jungles of southern Bhutan. The Government is making efforts to get the militant groups to leave the country peacefully. Until they are resolved, these issues could cast a shadow on Bhutan's development progress.

36. A small and narrow economic base is also a risk factor. Bhutan must use the existing window of opportunity to expand its economic base by focusing on much-needed efficiency improvements in its financial sector and by resolving the existing shortages of a skilled domestic labor force.

37. While Bhutan has made important strides in social development and remains well on track for achieving MDGs, preliminary findings have revealed a 29% poverty rate in rural areas, home to about 80% of Bhutanese. Broad-based equitable economic growth can lead to a decline in the incidence of poverty, but would require that development programs be so structured that the rural population equally benefits. Development of necessary infrastructure for marketing links would be vital for the support of income-generating small and micro enterprises established in rural areas.

38. The NYFP contains a comprehensive framework for Bhutan's development. At the same time, the financing of the NFYP may pose some difficulties, thus necessitating either an increase in domestic borrowings, which in recent years have averaged about 2% of GDP, or scaling back the development program. Currently, the Nu70 billion NFYP has a resource gap equivalent to 19% of the total plan outlay. The closing of this financing gap is based on the assumption that Bhutan would continue to benefit from concessional external assistance for financing the bulk of its development programs. Given the evolving global geopolitical situation and economic slowdown, there is a theoretical chance that the quantum of external funding may decline in the future. Thus, Bhutan needs to rely more on domestic resources to progressively increase the domestic financing share of the development budget.

Table A.1: Key Economic Indicators

Item	FY1997	FY1998	FY1999	FY2000	FY2001	FY2002
<b>Income and Growth</b>						
GNP per Capita	587.0	629.0	683.0	708.0	777.0	855.0
Growth in Real GDP at Factor Cost (1980 prices, % change)	7.2	6.4	7.6	5.3	6.5	7.6
Agriculture	3.0	2.8	5.2	4.5	3.2	2.5
Industry	3.5	8.6	11.6	2.3	13.2	12.1
Services	13.4	6.6	5.9	9.5	6.5	7.9
<b>Savings and Investment (current prices, % of GDP)</b>						
Gross Domestic Investment	33.7	37.6	43.0	46.5	48.1	47.3
Public	15.0	16.6	15.3	16.2	17.4	16.8
Private	18.7	20.9	27.6	30.3	30.6	30.5
Gross National Saving	21.3	12.5	12.9	16.8	20.3	18.5
Public	(4.2)	1.4	0.6	1.2	(0.1)	0.5
Private	25.6	11.0	12.3	15.6	20.5	18.0
Saving-Investment Gap	(12.3)	(25.1)	(30.1)	(29.7)	(27.7)	(28.8)
Public	(19.2)	(15.2)	(14.8)	(15.1)	(17.6)	(12.5)
Private	6.9	(9.9)	(15.3)	(14.7)	(10.2)	(16.3)
<b>Central Government Finance (% of GDP)</b>						
Total Revenues and Grants	<b>38.7</b>	<b>32.9</b>	<b>40.0</b>	<b>39.6</b>	<b>38.5</b>	<b>34.1</b>
Domestic Revenue	17.9	20.8	21.1	23.1	22.1	21.3
Tax Revenue	7.4	8.3	7.3	10.0	8.5	9.3
Nontax Revenue	10.5	12.5	13.8	13.1	13.6	11.9
Grants	20.7	12.1	18.8	16.5	16.5	12.9
Total Expenditures and Net Lending	<b>37.3</b>	<b>32.0</b>	<b>41.7</b>	<b>43.4</b>	<b>49.6</b>	<b>39.6</b>
Current Expenditures	17.3	17.5	18.4	18.6	19.7	18.1
Capital Expenditures	19.2	13.0	23.7	23.3	27.9	21.2
Net Lending	0.9	1.4	(0.3)	1.5	2.0	0.3
Current Balance (excluding Grants)	<b>0.7</b>	<b>3.4</b>	<b>2.8</b>	<b>4.4</b>	<b>2.4</b>	<b>3.1</b>
Overall Balance (including Grants)	<b>1.4</b>	<b>1.0</b>	<b>(1.8)</b>	<b>(3.9)</b>	<b>(11.1)</b>	<b>(5.5)</b>
External	(0.2)	2.2	3.2	3.1	4.7	3.1
Domestic	(1.9)	(3.2)	(1.4)	0.8	6.4	2.4
<b>Money and Inflation (% change)</b>						
Broad Money (M2)	30.9	41.7	21.4	21.3	5.5	17.6
Narrow Money (M1)	50.0	26.7	14.8	28.7	21.3	12.1
Consumer Price Index	12.8	12.1	4.5	4.4	3.2	2.3
<b>Balance of Payments</b>						
Merchandise Trade Balance (% of GDP)	(9.0)	(6.3)	(14.2)	(15.5)	(19.9)	(17.0)
Exports (% of GDP)	28.0	28.4	25.8	25.1	20.5	18.3
Imports (% of GDP)	(37.0)	(34.8)	(39.9)	(40.7)	(40.4)	(35.3)
Balance with India (% of GDP)	1.2	2.4	(4.3)	(6.8)	(13.7)	(10.1)
Current Account Balance (% of GDP)	6.0	8.2	5.4	0.9	(5.5)	(5.3)
Balance with India (% of GDP)	7.2	9.9	4.3	0.9	(7.6)	(5.1)
Export Growth (\$, % change)	-	12.1	(5.9)	9.2	(13.0)	(1.8)
Import Growth (\$, % change)	-	3.7	19.3	14.0	6.1	(4.0)
<b>External Payments Indicators</b>						
International Reserves (\$ million)	176.0	216.7	259.0	292.6	294.2	316.9
(in months of merchandise imports)	16.1	21.0	19.4	19.4	18.2	19.9
Public External Debt (% of GDP)	33.5	34.5	39.7	38.2	48.7	54.7
External Debt Service (% of merchandise exports)	8.2	8.2	11.9	4.9	4.6	5.0
<b>Memorandum Items:</b>						
Gross International Reserves (\$ million)	176.0	216.8	259.1	292.6	294.1	316.6
(in months of merchandise imports)	16.1	19.1	19.2	19.0	18.0	20.2
Exchange Rate (Nu per \$; fiscal year average)	35.8	38.4	42.6	43.6	46.4	48.2
Population (thousand)	600	618	637	656	675	690

- = not available, GDP = growth domestic product; GNP = gross national product.

Note: Fiscal year variables are divided by the calendar year GDP in the period to calculate shares of GDP.

Source: Appendix Tables A.2-A.8.

**Table A. 2: Gross Domestic Product at Factor Cost by Sector of Origin  
(in Constant 1980 Prices)**

Item	1996	1997	1998	1999	2000	2001	2002
	(Nu million)						
<b>Agriculture Sector</b>	<b>1,198</b>	<b>1,234</b>	<b>1,269</b>	<b>1,335</b>	<b>1,395</b>	<b>1,440</b>	<b>1,476</b>
Agriculture	601	625	647	679	712	742	760
Livestock	256	260	263	280	290	294	302
Forestry and Logging	341	349	359	377	394	404	414
<b>Industry Sector</b>	<b>923</b>	<b>956</b>	<b>1,038</b>	<b>1,159</b>	<b>1,185</b>	<b>1,342</b>	<b>1,504</b>
Mining and Quarrying	46	44	51	56	48	57	63
Manufacturing	292	292	298	309	290	311	326
Electricity and Gas	343	354	367	401	398	447	501
Construction	243	267	322	393	449	527	614
<b>Services Sector</b>	<b>1,065</b>	<b>1,208</b>	<b>1,287</b>	<b>1,362</b>	<b>1,492</b>	<b>1,589</b>	<b>1,715</b>
Transport and Communications	271	309	350	382	403	419	468
Trade, Hotels, etc.	203	218	225	232	237	254	265
Finance, Insurance, and Real Estate	256	320	349	339	421	458	497
Community, Social, and Personal Services	335	361	363	410	431	458	485
Less: Imputed Bank Service Charges	(116)	(106)	(90)	(88)	(104)	(143)	(144)
<b>GDP at Factor Cost</b>	<b>3,070</b>	<b>3,291</b>	<b>3,503</b>	<b>3,769</b>	<b>3,968</b>	<b>4,228</b>	<b>4,551</b>
Memorandum Item:							
Implicit GDP Deflator (1980 = 100)	371.5	425.2	459.0	492.0	533.4	566.1	605.0
	(growth rates in percent per annum)						
<b>Agriculture Sector</b>	<b>6.5</b>	<b>3.0</b>	<b>2.8</b>	<b>5.2</b>	<b>4.5</b>	<b>3.2</b>	<b>2.5</b>
Agriculture	2.7	4.0	3.4	4.9	4.9	4.3	2.4
Livestock	5.3	1.4	1.3	6.3	3.6	1.5	2.7
Forestry and Logging	15.0	2.5	2.9	5.0	4.5	2.5	2.5
<b>Industry Sector</b>	<b>5.8</b>	<b>3.5</b>	<b>8.6</b>	<b>11.6</b>	<b>2.3</b>	<b>13.2</b>	<b>12.1</b>
Mining and Quarrying	32.8	(5.4)	16.2	10.6	(14.8)	19.0	10.5
Manufacturing	8.1	0.2	2.0	3.7	(6.1)	7.2	4.8
Electricity and Gas	5.4	3.2	3.9	9.1	(0.6)	12.3	12.1
Construction	0.1	9.6	20.9	22.0	14.2	17.4	16.5
<b>Services Sector</b>	<b>4.7</b>	<b>13.4</b>	<b>6.6</b>	<b>5.9</b>	<b>9.5</b>	<b>6.5</b>	<b>7.9</b>
Transport and Communications	10.4	14.0	13.3	9.0	5.6	4.0	11.7
Trade, Hotels, etc.	14.1	7.4	2.9	3.2	2.3	7.2	4.3
Finance, Insurance, and Real Estate	(2.7)	24.9	9.1	(2.9)	24.2	8.8	8.5
Community, Social, and Personal Services	1.3	7.8	0.7	13.0	5.1	6.3	5.9
<b>GDP at Factor Cost</b>	<b>5.2</b>	<b>7.2</b>	<b>6.4</b>	<b>7.6</b>	<b>5.3</b>	<b>6.5</b>	<b>7.6</b>

GDP = gross domestic product.

Sources: Central Statistical Organization. 2002. *National Accounts Statistics Report*. October; Royal Monetary Authority. 2002. Annual Report. December; Staff estimates.

**Table A.3: Gross Domestic Product at Factor Cost by Sector of Origin  
(in Current Prices)**

Item	1996	1997	1998	1999	2000	2001	2002
	(Nu million)						
<b>Agriculture Sector</b>	<b>4,538</b>	<b>5,369</b>	<b>6,058</b>	<b>6,630</b>	<b>7,773</b>	<b>8,471</b>	<b>9,325</b>
Agriculture	2,254	2,506	2,893	3,175	3,878	4,214	4,593
Livestock	910	1,238	1,374	1,487	1,625	1,770	1,947
Forestry and Logging	1,374	1,625	1,790	1,968	2,270	2,487	2,785
<b>Industry Sector</b>	<b>3,856</b>	<b>5,025</b>	<b>5,512</b>	<b>6,519</b>	<b>7,261</b>	<b>8,658</b>	<b>10,292</b>
Mining and Quarrying	270	309	262	326	341	401	473
Manufacturing	1,444	1,520	1,622	1,762	1,719	1,936	2,226
Electricity and Gas	1,102	1,730	1,941	2,318	2,462	2,601	2,757
Construction	1,040	1,466	1,687	2,113	2,739	3,720	4,836
<b>Services Sector</b>	<b>3,215</b>	<b>4,129</b>	<b>4,970</b>	<b>5,833</b>	<b>6,659</b>	<b>7,542</b>	<b>8,689</b>
Transport and Communications	856	1,023	1,370	1,637	1,881	2,142	2,463
Trade, Hotels, etc.	904	1,014	1,160	1,282	1,465	1,662	1,911
Finance, Insurance, and Real Estate	442	729	1,004	1,042	1,345	1,601	1,922
Community, Social, and Personal Services	1,014	1,363	1,437	1,873	1,968	2,137	2,393
Less: Imputed Bank Service Charges	(203)	(527)	(458)	(442)	(528)	(737)	(773)
<b>GDP at Factor Cost</b>	<b>11,406</b>	<b>13,996</b>	<b>16,081</b>	<b>18,541</b>	<b>21,165</b>	<b>23,934</b>	<b>27,533</b>
	(in percent of GDP at factor cost)						
<b>Agriculture Sector</b>	<b>39.8</b>	<b>38.4</b>	<b>37.7</b>	<b>35.8</b>	<b>36.7</b>	<b>35.4</b>	<b>33.9</b>
Agriculture	19.8	17.9	18.0	17.1	18.3	17.6	16.7
Livestock	8.0	8.8	8.5	8.0	7.7	7.4	7.1
Forestry and Logging	12.0	11.6	11.1	10.6	10.7	10.4	10.1
<b>Industry Sector</b>	<b>33.8</b>	<b>35.9</b>	<b>34.3</b>	<b>35.2</b>	<b>34.3</b>	<b>36.2</b>	<b>37.4</b>
Mining and Quarrying	2.4	2.2	1.6	1.8	1.6	1.7	1.7
Manufacturing	12.7	10.9	10.1	9.5	8.1	8.1	8.1
Electricity and Gas	9.7	12.4	12.1	12.5	11.6	10.9	10.0
Construction	9.1	10.5	10.5	11.4	12.9	15.5	17.6
<b>Services Sector</b>	<b>27.7</b>	<b>28.4</b>	<b>30.0</b>	<b>30.7</b>	<b>30.7</b>	<b>30.6</b>	<b>30.7</b>
Transport and Communications	7.4	7.0	8.3	8.6	8.7	8.7	8.7
Trade, Hotels, etc.	7.8	7.0	7.0	6.8	6.8	6.7	6.8
Finance, Insurance, and Real Estate	3.8	5.0	6.1	5.5	6.2	6.5	6.8
Community, Social, and Personal Services	8.7	9.4	8.7	9.9	9.1	8.7	8.5

GDP = gross domestic product.

Source: Central Statistical Organization. 2002. *National Accounts Statistics Report*. October; Royal Monetary Authority. 2002. *Annual Report*. December; and staff estimates.

**Table A.4: Expenditure on Gross Domestic Product  
(in Current Prices)**

Item	1996	1997	1998	1999	2000	2001
	(Nu million)					
<b>Consumption</b>	<b>7,630</b>	<b>10,975</b>	<b>12,920</b>	<b>14,376</b>	<b>16,159</b>	<b>17,959</b>
Public	2,502	3,651	3,308	4,271	4,422	5,112
Private	5,128	7,324	9,612	10,105	11,737	12,847
<b>Gross Domestic Investment</b>	<b>5,276</b>	<b>4,882</b>	<b>6,245</b>	<b>8,236</b>	<b>10,109</b>	<b>11,963</b>
Gross Fixed Capital Formation	5,276	4,882	6,245	8,236	10,109	11,963
Public	1,797	2,171	2,762	2,940	3,527	4,339
Private	3,479	2,711	3,483	5,296	6,582	7,624
<b>Domestic Demand</b>	<b>12,907</b>	<b>15,857</b>	<b>19,166</b>	<b>22,612</b>	<b>26,268</b>	<b>29,922</b>
<b>Net Exports of Goods and Nonfactor Services</b>	<b>(1,141)</b>	<b>(1,357)</b>	<b>(2,538)</b>	<b>(3,450)</b>	<b>(4,519)</b>	<b>(5,026)</b>
Exports of Goods and NFS	3,979	4,771	5,148	5,714	5,964	5,768
Imports of Goods and NFS	(5,120)	(6,128)	(7,686)	(9,164)	(10,483)	(10,795)
<b>GDP at Market Prices</b>	<b>11,766</b>	<b>14,500</b>	<b>16,628</b>	<b>19,162</b>	<b>21,749</b>	<b>24,896</b>
Plus: Net Factor Income from Abroad	(1,247)	(1,141)	(2,323)	(3,082)	(2,679)	(2,681)
<b>Gross National Product</b>	<b>10,519</b>	<b>13,359</b>	<b>14,305</b>	<b>16,080</b>	<b>19,070</b>	<b>22,215</b>
Plus: Net Transfers from Abroad	376	711	691	772	732	796
<b>Gross National Disposable Income</b>	<b>10,895</b>	<b>14,070</b>	<b>14,995</b>	<b>16,852</b>	<b>19,802</b>	<b>23,022</b>
<b>Gross National Savings</b>	<b>3,264</b>	<b>3,095</b>	<b>2,075</b>	<b>2,476</b>	<b>3,644</b>	<b>5,063</b>
Public Savings	(212)	(615)	239	110	251	(31)
Private Savings	3,477	3,710	1,836	2,366	3,393	5,094
	(in percent of GDP at market prices)					
<b>Consumption</b>	<b>64.9</b>	<b>75.7</b>	<b>77.7</b>	<b>75.0</b>	<b>74.3</b>	<b>72.1</b>
Public	21.3	25.2	19.9	22.3	20.3	20.5
Private	43.6	50.5	57.8	52.7	54.0	51.6
<b>Gross Domestic Investment</b>	<b>44.8</b>	<b>33.7</b>	<b>37.6</b>	<b>43.0</b>	<b>46.5</b>	<b>48.1</b>
Gross Fixed Capital Formation	44.8	33.7	37.6	43.0	46.5	48.1
Public	15.3	15.0	16.6	15.3	16.2	17.4
Private	29.6	18.7	20.9	27.6	30.3	30.6
<b>Net Exports of Goods and Nonfactor Services</b>	<b>(9.7)</b>	<b>(9.4)</b>	<b>(15.3)</b>	<b>(18.0)</b>	<b>(20.8)</b>	<b>(20.2)</b>
Exports of Goods and NFS	33.8	32.9	31.0	29.8	27.4	23.2
Imports of Goods and NFS	(43.5)	(42.3)	(46.2)	(47.8)	(48.2)	(43.4)
<b>GDP at Market Prices</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<b>Gross National Product</b>	<b>89.4</b>	<b>92.1</b>	<b>86.0</b>	<b>83.9</b>	<b>87.7</b>	<b>89.2</b>
<b>Gross National Disposable Income</b>	<b>92.6</b>	<b>97.0</b>	<b>90.2</b>	<b>87.9</b>	<b>91.0</b>	<b>92.5</b>
<b>Gross National Savings</b>	<b>27.7</b>	<b>21.3</b>	<b>12.5</b>	<b>12.9</b>	<b>16.8</b>	<b>20.3</b>
Public Savings	(1.8)	(4.2)	1.4	0.6	1.2	(0.1)
Private Savings	29.5	25.6	11.0	12.3	15.6	20.5

GDP = gross domestic product, NFS = nonfactor services.

Source: Central Statistical Organization. 2002. *National Accounts Statistics Report*. October; and staff estimates.

Table A.5: Summary of Central Government Finances

Item	FY1997	FY1998	FY1999	FY2000	FY2001	FY2002	FY2003 <sup>a</sup>
	(Nu million)						
<b>Total Revenues and Grants</b>	<b>4,410</b>	<b>4,950</b>	<b>6,919</b>	<b>7,859</b>	<b>8,686</b>	<b>8,787</b>	<b>9,531</b>
Domestic Revenues	2,047	3,134	3,656	4,585	4,975	5,470	5,118
Tax Revenue,	844	1,247	1,266	1,977	1,917	2,397	2,762
of which: Chhukha Hydropower	199	364	374	565	304	546	
Nontax Revenue	1,203	1,887	2,390	2,608	3,058	3,073	2,356
of which: Chhukha Hydropower	304	856	871	1,131	1,514	1,148	
Grants	2,364	1,816	3,263	3,274	3,711	3,317	4,413
From India	1,169	1,045	1,929	2,188	2,551	1,565	2,765
From Others	1,195	771	1,334	1,086	1,160	1,752	1,648
<b>Total Expenditures and Net Lending</b>	<b>4,253</b>	<b>4,806</b>	<b>7,224</b>	<b>8,624</b>	<b>11,178</b>	<b>10,184</b>	<b>10,945</b>
Current Expenditures	1,968	2,628	3,178	3,702	4,436	4,664	4,598
Capital Expenditures	2,184	1,961	4,106	4,632	6,281	5,447	6,319
Net Lending	100	218	(60)	290	461	73	28
<b>Current Balance (excluding Grants)</b>	<b>79</b>	<b>506</b>	<b>478</b>	<b>883</b>	<b>539</b>	<b>806</b>	<b>520</b>
<b>Overall Balance (including Grants)</b>	<b>158</b>	<b>144</b>	<b>(306)</b>	<b>(765)</b>	<b>(2,492)</b>	<b>(1,397)</b>	<b>(1,414)</b>
<b>Financing of the Overall Balance</b>	<b>(239)</b>	<b>(144)</b>	<b>305</b>	<b>765</b>	<b>2,493</b>	<b>1,396</b>	<b>1,412</b>
External	(27)	336	554	607	1,059	788	912
Domestic	(212)	(480)	(249)	158	1,434	608	500
	(in percent of GDP at factor cost)						
<b>Total Revenues and Grants</b>	<b>38.7</b>	<b>32.9</b>	<b>40.0</b>	<b>39.6</b>	<b>38.5</b>	<b>34.1</b>	<b>32.5</b>
Domestic Revenue	17.9	20.8	21.1	23.1	22.1	21.3	17.5
Tax Revenue	7.4	8.3	7.3	10.0	8.5	9.3	9.4
Nontax Revenue	10.5	12.5	13.8	13.1	13.6	11.9	8.0
Grants	20.7	12.1	18.8	16.5	16.5	12.9	15.1
<b>Total Expenditures and Net Lending</b>	<b>37.3</b>	<b>32.0</b>	<b>41.7</b>	<b>43.4</b>	<b>49.6</b>	<b>39.6</b>	<b>37.4</b>
Current Expenditures	17.3	17.5	18.4	18.6	19.7	18.1	15.7
Capital Expenditures	19.2	13.0	23.7	23.3	27.9	21.2	21.6
Net Lending	0.9	1.4	(0.3)	1.5	2.0	0.3	0.1
<b>Current Balance (excluding Grants)</b>	<b>0.7</b>	<b>3.4</b>	<b>2.8</b>	<b>4.4</b>	<b>2.4</b>	<b>3.1</b>	<b>1.8</b>
<b>Overall Balance (including Grants)</b>	<b>1.4</b>	<b>1.0</b>	<b>(1.8)</b>	<b>(3.9)</b>	<b>(11.1)</b>	<b>(5.5)</b>	<b>(4.8)</b>
External	(0.2)	2.2	3.2	3.1	4.7	3.1	3.1
Domestic	(1.9)	(3.2)	(1.4)	0.8	6.4	2.4	1.7
Memorandum Item:							
Nominal GDP at factor cost (in millions of ngultrum)	11,406	15,038	17,311	19,853	22,549	25,733	29,282

GDP = gross domestic product.

<sup>a</sup> Budget figures and staff estimates.

Sources: Department of Budget and Accounts, Ministry of Finance, staff estimates; Central Statistics Organization. 2002. *National Accounts Statistics Report*. October; Ministry of Finance. 2001. *Budget Estimate for the Fiscal Year 2001-2002*. July.

**Table A.6: Monetary Survey**

Item	FY1997	FY1998	FY1999	FY2000	FY2001	FY2002
(Nu million; end of period)						
<b>ASSETS</b>						
<b>Net Foreign Assets</b>	<b>6,233</b>	<b>9,088</b>	<b>11,336</b>	<b>13,248</b>	<b>12,789</b>	<b>14,349</b>
<b>Net Domestic Assets</b>	<b>(1,956)</b>	<b>(3,026)</b>	<b>(3,976)</b>	<b>(4,318)</b>	<b>(3,368)</b>	<b>(3,271)</b>
Net Domestic Credit	1,535	1,246	382	752	2,015	2,277
Claims on Government (net)	(278)	(649)	(1,485)	(1,111)	(456)	(744)
Claims on Nongovernment	1,813	1,894	1,867	1,863	2,471	3,021
Public enterprises	497	459	391	354	333	292
Joint Enterprises	219	193	166	146	121	122
Private Sector	1,097	1,242	1,310	1,363	2,017	2,607
Other Items (net)	(3,491)	(4,271)	(4,358)	(5,070)	(5,383)	(5,548)
<b>LIABILITIES</b>						
<b>Broad Money Supply (M2)</b>	<b>4,278</b>	<b>6,063</b>	<b>7,360</b>	<b>8,931</b>	<b>9,420</b>	<b>11,078</b>
Narrow Money (M1)	1,973	2,500	2,869	3,692	4,478	5,020
Currency Outside Banks	617	1,050	853	1,119	1,483	1,600
Demand Deposits	1,332	1,327	1,833	2,475	2,890	3,314
NMFIs Deposits	24	123	183	98	105	106
Quasi Money	2,305	3,563	4,491	5,239	4,942	6,058
(in percent of GDP at market prices)						
<b>Change in Net Foreign Assets</b>	9.6	19.0	13.0	9.6	(2.0)	6.1
<b>Change in Net Domestic Credit</b>	5.8	(1.9)	(5.0)	1.9	5.6	1.0
to the public sector	1.5	(2.5)	(4.8)	1.9	2.9	(1.1)
to the private sector	10.3	0.5	(0.2)	(0.0)	2.7	2.1
<b>Change in Broad Money (M2)</b>	7.9	11.9	7.5	7.9	2.2	6.4
<b>Change in Narrow Money (M1)</b>	5.2	3.5	2.1	4.1	3.5	2.1
(in percent change per annum)						
<b>Broad Money Growth (M2)</b>	30.9	41.7	21.4	21.3	5.5	17.6
<b>Narrow Money Growth (M1)</b>	50.0	26.7	14.8	28.7	21.3	12.1
<b>Consumer Price Index</b>	12.8	12.1	4.5	4.4	3.2	2.3

Sources: Royal Monetary Authority of Bhutan. 2002. *Annual Report*. December; Central Statistical Organization. 2001. *National Accounts Statistics Report*. October; and staff estimates.

Table A.7: Balance of Payments Summary

Items	FY1997	FY1998	FY1999	FY2000	FY2001	FY2002
	(in \$ million)					
<b>With All Countries:</b>						
<b>Current Account Balance <sup>a</sup></b>	<b>21.4</b>	<b>32.2</b>	<b>21.9</b>	<b>4.0</b>	<b>(26.7)</b>	<b>(28.2)</b>
Merchandise Trade Balance	(32.0)	(24.8)	(57.6)	(70.7)	(96.8)	(90.7)
Merchandise Exports, FOB	99.3	111.3	104.7	114.4	99.5	97.7
Merchandise Imports, CIF	(131.3)	(136.1)	(162.3)	(185.0)	(196.3)	(188.4)
Services, Income and Transfers (net) <sup>b</sup>	53.3	57.0	79.5	74.7	70.1	62.5
<b>Capital and Financial Account Balance</b>	<b>5.4</b>	<b>4.5</b>	<b>26.0</b>	<b>42.0</b>	<b>30.8</b>	<b>59.4</b>
Foreign Direct Investment	-	-	1.1	-	-	2.1
Portfolio Investment	-	-	-	-	(19.0)	-
Loans (net)	5.4	4.5	24.9	42.0	49.8	57.3
Errors and Omissions	4.1	5.1	0.4	(12.4)	(28.0)	(10.8)
<b>Change in Reserves</b>	<b>30.9</b>	<b>41.7</b>	<b>48.3</b>	<b>33.6</b>	<b>(24.0)</b>	<b>20.4</b>
<b>With India:</b>						
<b>Current Account Balance <sup>a</sup></b>	<b>25.6</b>	<b>38.6</b>	<b>17.6</b>	<b>4.3</b>	<b>(37.1)</b>	<b>(27.3)</b>
Merchandise Trade Balance	4.4	9.3	(17.3)	(31.0)	(66.5)	(54.1)
Merchandise Exports, FOB	90.2	105.3	98.2	108.0	94.4	91.9
Merchandise Imports, CIF	(85.8)	(96.0)	(115.5)	(139.0)	(160.9)	(146.0)
Services, Income and Transfers (net) <sup>b</sup>	21.2	29.3	34.9	35.3	29.4	26.8
<b>Capital and Financial Account Balance</b>	<b>1.6</b>	<b>-</b>	<b>22.7</b>	<b>37.0</b>	<b>36.8</b>	<b>36.9</b>
Foreign Direct Investment	-	-	-	-	-	-
Portfolio Investment	-	-	-	-	-	-
Loans (net)	1.6	-	22.7	37.0	36.8	36.9
Errors and Omissions	(4.7)	(28.4)	(11.4)	(29.4)	(19.1)	(12.7)
<b>Change in Reserves</b>	<b>22.5</b>	<b>10.2</b>	<b>28.9</b>	<b>11.9</b>	<b>(19.4)</b>	<b>(3.1)</b>
	(in percent of GDP at factor cost)					
<b>Merchandise Trade Balance</b>	<b>(9.0)</b>	<b>(6.3)</b>	<b>(14.2)</b>	<b>(15.5)</b>	<b>(19.9)</b>	<b>(17.0)</b>
Merchandise Exports	28.0	28.4	25.8	25.1	20.5	18.3
Merchandise Imports	(37.0)	(34.8)	(39.9)	(40.7)	(40.4)	(35.3)
Balance with India	1.2	2.4	(4.3)	(6.8)	(13.7)	(10.1)
<b>Current Account Balance</b>	<b>6.0</b>	<b>8.2</b>	<b>5.4</b>	<b>0.9</b>	<b>(5.5)</b>	<b>(5.3)</b>
Balance with India	7.2	9.9	4.3	0.9	(7.6)	(5.1)
<b>Change in Reserves</b>	<b>8.7</b>	<b>10.7</b>	<b>11.9</b>	<b>7.4</b>	<b>(4.9)</b>	<b>3.8</b>
	(in percent change per annum)					
<b>Merchandise Exports Growth</b>		<b>12.1</b>	<b>(5.9)</b>	<b>9.2</b>	<b>(13.0)</b>	<b>(1.8)</b>
Exports to India		16.7	(6.7)	10.0	(12.6)	(2.6)
<b>Merchandise Imports Growth</b>		<b>3.7</b>	<b>19.3</b>	<b>14.0</b>	<b>6.1</b>	<b>(4.0)</b>
Imports from India		11.9	20.3	20.3	15.8	(9.3)
<b>Memorandum Items:</b>						
Gross International Reserves (\$ million)	176.0	216.8	259.1	292.6	294.1	316.6
(in months of merchandise imports)	16.1	19.1	19.2	19.0	18.0	20.2
Exchange Rate (Nu per \$; fiscal year average)	35.8	38.4	42.6	43.6	46.4	48.2

CIF = cost, insurance, and freight; FOB = free on board.

Note: Fiscal year variables are divided by the first calendar year GDP in the period to calculate shares of GDP.

<sup>a</sup> Includes grants.

<sup>b</sup> Grants component includes budgetary and non-budgetary grants, such as power turn-key projects.

Source: International Monetary Fund, *Selected Issues and Statistical Appendix (February 2003)*.

Table A.8: Public External Debt and Debt Service

Item	FY1997	FY1998	FY1999	FY2000	FY2001	FY2002
	(in \$ million)					
<b>Total Public External Debt</b>	<b>118.8</b>	<b>135.1</b>	<b>161.2</b>	<b>173.8</b>	<b>236.9</b>	<b>291.8</b>
<b>Convertible Currency Debt</b>	<b>84.1</b>	<b>90.4</b>	<b>98.2</b>	<b>98.7</b>	<b>107.0</b>	<b>129.9</b>
Concessional Debt	80.7	89.3	98.2	98.7	107.0	129.9
Asian Development Bank	36.3	40.4	43.2	43.2	47.4	55.4
World Bank, IDA	21.3	22.1	24.0	24.0	27.6	33.2
IFAD	11.4	12.2	12.7	12.7	12.5	13.7
Kuwait Fund	10.9	9.6	7.9	7.9	6.5	5.1
Other	0.8	5.0	10.4	10.9	13.0	22.5
Commercial Debt	3.4	1.1	0.0	0.0	0.0	0
<b>Nonconvertible Currency Debt<sup>a</sup></b>	<b>34.7</b>	<b>44.7</b>	<b>63.0</b>	<b>75.1</b>	<b>129.9</b>	<b>161.9</b>
<b>Debt Service Payments</b>	<b>10.4</b>	<b>10.0</b>	<b>14.2</b>	<b>6.6</b>	<b>6.3</b>	<b>6.4</b>
Convertible Currency Debt	6.1	5.9	4.9	3.7	3.7	4.0
Principal	4.4	4.7	3.8	2.6	2.6	2.7
Interest	1.7	1.2	1.1	1.0	1.0	1.3
Nonconvertible Currency Debt <sup>b</sup>	4.2	4.1	9.3	2.9	2.6	2.4
Principal	0.4	2.5	7.9	2.0	1.9	1.8
Interest	3.8	1.7	1.3	0.9	0.7	0.6
	(in percent of GDP)					
<b>Total Public External Debt</b>	<b>33.5</b>	<b>34.5</b>	<b>39.7</b>	<b>38.2</b>	<b>48.7</b>	<b>54.7</b>
<b>Convertible Currency Debt</b>	<b>23.7</b>	<b>23.1</b>	<b>24.2</b>	<b>21.7</b>	<b>22.0</b>	<b>24.3</b>
Concessional	22.7	22.8	24.2	21.7	22.0	24.3
Commercial	1.0	0.3	0.0	0.0	0.0	0.0
<b>Nonconvertible Currency Debt</b>	<b>9.8</b>	<b>11.4</b>	<b>15.5</b>	<b>16.5</b>	<b>26.7</b>	<b>30.3</b>
Memorandum Items:						
Debt Service Ratio (% of merchandise exports)	8.2	8.2	11.9	4.9	4.6	5.0
Exchange Rate (Nu per \$, end of period)	35.8	38.4	42.6	43.6	46.4	48.2

GDP = gross domestic product, IDA = International Development Association, IFAD = International Fund for Agricultural Development.

<sup>a</sup> Converted to dollars using the end of period exchange rate.

<sup>b</sup> Converted to dollars using the fiscal year average exchange rate.

Note: Fiscal year variables are divided by the second year GDP in the period to calculate shares used by other IFIs such as International Monetary Fund. Thus, external debt-to-GDP ratios may vary from these using GDP data on calendar year basis.

Source: Derived from Royal Monetary Authority. 2002. *Annual Report*. December; and staff estimates.