



COUNTRY ECONOMIC REVIEW

BHUTAN

December 2001

CURRENCY EQUIVALENTS

(as of 15 December 2001)

Currency Unit - Ngultrum (Nu)
Nu1.0 = \$0.0209
\$1.00 = Nu47.81

The Bhutanese ngultrum is pegged to the Indian rupee at par.

ABBREVIATIONS

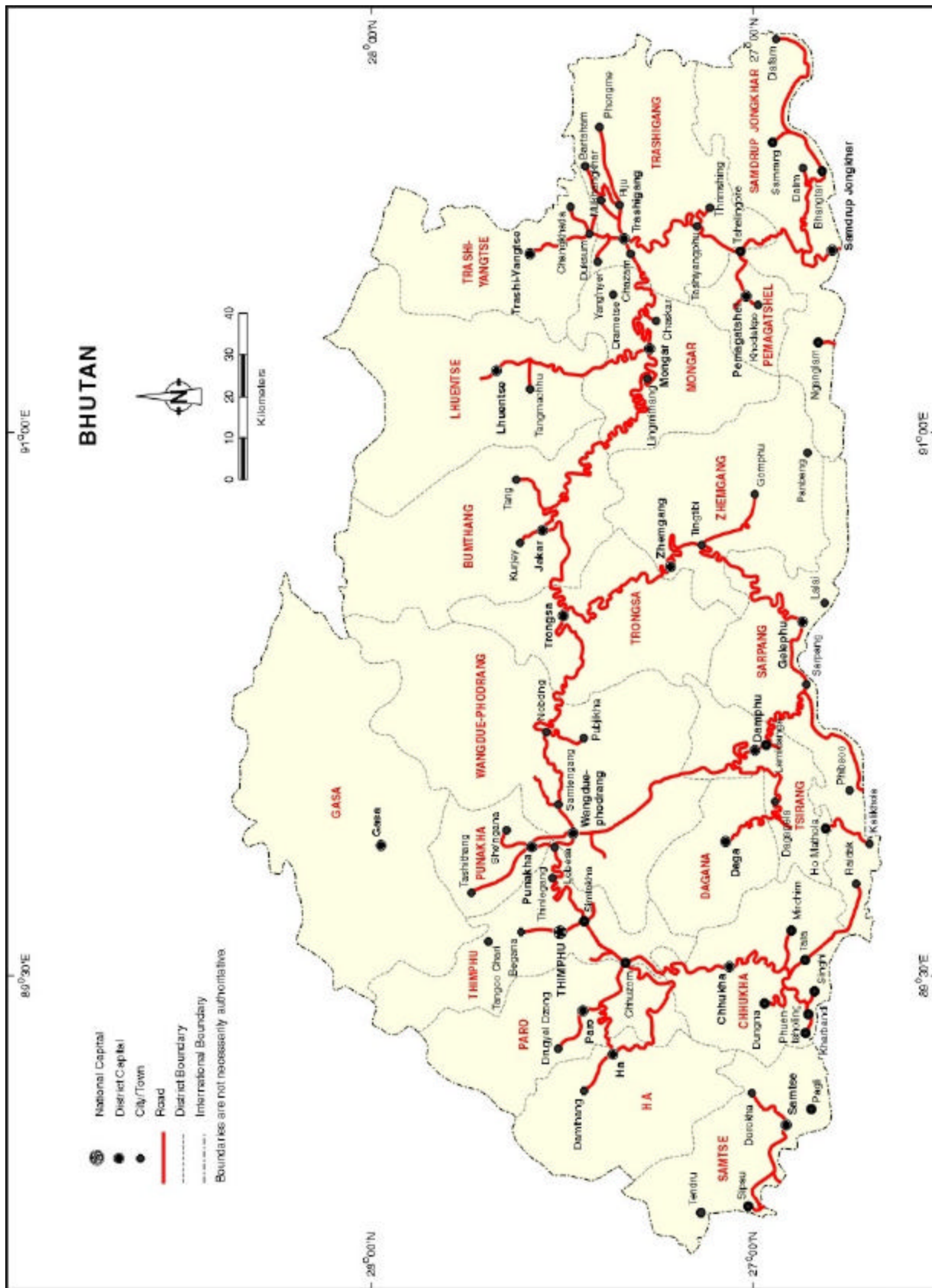
ADB	-	Asian Development Bank
GDP	-	gross domestic product
MW	-	megawatt
RMA	-	Royal Monetary Authority
TA	-	technical assistance

NOTES

- (i) The fiscal year (FY) of the Government ends on 30 June, e.g., 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

Bhutan's Eighth Five-Year Plan is scheduled to end on 30 June 2002 and the Ninth Plan to begin on 1 July 2002. Real gross domestic product (GDP) is estimated to have grown at 6.7 percent per year during the Eighth Plan period, equal to the target and representing an impressive performance. Sector performance, however, has been mixed. Agriculture has grown at 4.3 percent per year, led mainly by forestry and livestock, with cash crop production relatively slow moving. The industry sector has grown at 7.1 percent a year, below the Plan target, especially the mining and manufacturing subsectors; but it has been buoyed by the performance of construction and, to a lesser extent, by electricity generation. With the Kurichu (60 megawatts [MW]) and Basochu (22 MW) hydropower plants coming on stream in the next few months, and the Tala plant (1,021 MW) scheduled possibly for 2006, hydropower development (with related electricity exports to India) has become the main engine of Bhutanese growth. The contribution of the services sector, which has grown at about 8 percent a year during the Eighth Plan, has been erratic, but has been underpinned by growth in transport and communications on the one hand, and in tourism on the other, although the latter has been somewhat depressed in recent months by the slowdown in the world economy.

The Government has traditionally pursued a prudent fiscal policy, one that is guided by conservative financing principles, notably that domestic revenues should at least cover current expenditures, and that capital expenditure should be preferably financed from grants and, only after these, by concessional loans. The first of these principles prevailed during the first four years of the Eighth Plan, although during the current fiscal year it is possible that a small deficit could arise. However, if current expenditures fall short of those budgeted, which they might, this need not arise. A more significant trend has been the recourse to the domestic financing of capital expenditure. This has been the result of accelerated capital investment. It has been financed by the rundown of government deposits with the banking system and by the open market sale of Nu500 million of Treasury Bills.

The existence of the exchange rate peg with the Indian rupee means that there is limited scope for monetary policy in Bhutan. However, the key monetary policy issue continues to be the high level of excess liquidity in the banking system. This is essentially the result of a lack of domestic investment opportunities stemming from the inherent weaknesses of the private sector, which reduce the private sector demand for bank credit that could otherwise be expected to absorb the high levels of liquidity emanating from large balance of payments surpluses. Nevertheless, these factors are also exacerbated by the limitations of the banking system. Even though interest rates have been liberalized, there is still a lack of competition between the banks for business, and little evidence of their pursuing proactive policies to encourage bank lending for private investment purposes.

During the Eighth Plan period, Bhutan's merchandise exports have declined somewhat in proportion to GDP, although they have increased in dollar terms, and imports have increased slightly in proportionate terms and significantly in nominal terms. The trade and current account deficits have each increased in both proportionate and nominal terms, as have the deficits with India, considered separately, but capital inflows, mostly in the form of grants, have continued to exceed by some margin the deficits in trade and current account. The net effect of these trends has boosted Bhutan's foreign exchange reserves significantly over time. By the end of FY2001, they were sufficient to finance over 16 months of merchandise imports at the FY2001 level.

Total public external debt has risen significantly during the Eighth Plan period and currently represents slightly more than 50 percent of GDP. However, convertible currency debt — all of it concessional — has declined as a proportion of GDP but has risen nominally (especially to the Asian Development Bank), but nonconvertible currency debt has risen sharply both nominally and proportionately, largely in response to the loans from India in connection with the new hydropower projects. There is no commercial debt at present, although this is likely to change when Druk Air renews its fleet. The debt service ratio, which has always been manageable, has actually declined during the Eighth Plan period; it stood at 5.6-5.7 percent of merchandise exports in FY2000 and FY 2001.

Perhaps the most impressive achievements of the Government over the past 15-20 years have been the improvements in social indicators, albeit starting from the very poor levels of the 1980s. The long-standing commitment of the Government to improve the human condition is an important feature of Bhutan's development process. In the case of health indicators, for example, life expectancy rose from 35 years in 1961 to about 66 years in 1998. Similarly, between the mid-1980s and 2000, the infant mortality rate was reduced from 142 to 61 per 1,000 live births and the maternal mortality rate from 7.7 to 2.6 per 1,000 live births, while the under-5 mortality rate fell from 162 to 84 per 1,000 live births. Considerable progress has also been made in the field of education over the past 20 or more years. Considering that fewer than 450 children in the whole country attended secular primary schools in the late 1950s, and that the country then had no secondary schools, educational achievements have been impressive. The primary school enrollment ratio had reached 72 percent by 2000 — up from 25 percent as recently as 1990 — which suggests that a 95 percent ratio could be reached in 2002 and universal primary enrollment soon after that. Girls now comprise 46 percent of primary school children. Despite the many improvements and the rise in adult literacy to 54 percent in 1996, the adult literacy rate is only 28 percent for women, and particularly low — even down to 10 percent — in the more remote rural areas.

Unfortunately, however, impressive GDP growth has not led to a commensurate growth in jobs. Private sector performance has been mixed. On the one hand, companies in the tourism business have performed well; several examples of outsourcing (especially public works) and corporatization have taken place; and many farmers, traders, tour operators, and transport firms have reacted positively to the improved marketing opportunities afforded by improved road access and, in many areas, by electrification. On the other hand, many of the key growth subsectors remain capital intensive, and none of the state-owned companies set for possible privatization during the Eighth Plan period have been privatized, although significant divestment of ownership among certain state enterprises has occurred in these years. As such, therefore, promoting private sector growth to absorb the growing number of young people whose better access to education has raised their social aspirations is, perhaps, the Government's major medium-term challenge.

Although it is not yet finalized or published, indications are that the Ninth Plan is well conceived in terms of its strategic objectives, and that it contains some perceptive proposals to tackle the pervasive structural and human impediments to Bhutanese development. Its main objective is to raise living standards, particularly among the rural population, who have often been left behind in the process of development. It has two strategic foci.

The first focus is to expand the rural road network and rural electrification. By expanding the rural road network, the Government hopes to reduce isolation, expand access to essential services, develop markets, moderate the fragmentation of the domestic market, widen personal choice and opportunities, promote the transfer of technology, and lessen vulnerability. Second,

by expanding rural electrification, the Government hopes to raise rural productivity and stimulate the expansion of processing and off-farm employment opportunities in general. Importantly, it also hopes to reduce the use of fuelwood and kerosene for domestic heating and lighting, thereby lessening the incidence of associated respiratory infections, relieving some of the burden of housework and wood-gathering for women and girls, and facilitating home study for school pupils and others.

The second focus is the strengthened emphasis to be placed on upgrading the quality of health and education facilities. This does not mean that efforts to extend the network of schools, clinics, etc. into currently deprived areas will be overlooked, but simply that a greater effort will be made to improve the quality and relevance of health care and teaching.

Implicitly if not explicitly, moreover, government efforts to stimulate private sector activity appear more closely integrated into the overall thrust of the Ninth Plan than with previous plans. This is suggested, first, by the strategy to improve rural infrastructure and to stimulate the small-scale private initiatives of rural people. Given that such a high proportion of the country's population is self-employed and rural, these could collectively become a potent force in private sector development generally. Second, it is also suggested by the Government's intention to improve the quality of public services, notably to strengthen technical and vocational education at the district level; to expand agricultural extension activities; to raise labor productivity; and to continue to address the shortage of business, commercial, and technical skills at higher levels.

Bhutan's medium-term prospects are good, and there is no reason to suggest that a real GDP growth rate of 6-7 percent per year over the medium term is not achievable, perhaps comfortably so if hydropower generation and export plans materialize on schedule. Similarly, the prospects for agriculture at least maintaining recent rates of growth are also good, but, with most implementing responsibilities for Ninth Plan initiatives being transferred to the districts and blocks as part of the decentralization drive, much will depend on how this works out in practice. For the industry sector, the prospects for surpassing Eighth Plan performance are relatively good, given the likely prospects for electricity and construction growth, although prospects for mining and manufacturing are more uncertain and will depend largely on how well the private sector reacts to growth stimuli. For the services sector, the medium-term prospects are also good, although they will depend on how much a revival in the global economy improves tourism.

Fiscal policy will almost certainly continue to be managed prudently, and the overall budget deficit is planned to be confined to about 3 percent of GDP during the Ninth Plan period. This is attainable, but, if external financing falters, the deficit could come under strain. Monetary conditions are likely to remain unchanged, although excess liquidity could fall if private credit demand rises and private sector growth surpasses its recent sluggish performance.

Despite generally good medium-term prospects, however, the Government cannot be complacent, because there are risks that could arise from both external and internal forces. First, it is possible that India's own fiscal situation may not permit it to be as generous with its grant aid as expected, and it may not be able to provide the level of loans for hydropower that is currently being contemplated. Similarly, if the current war on terror begins to use funds that would otherwise have flowed to multilateral organizations and to bilateral aid programs, funds from these sources may fall. Given the importance of external finance, a decline could reduce both Ninth Plan performance and the Government's financial maneuverability. Of more significance, perhaps, are the risks of not achieving rising living standards and adequate job creation. These could lead to growing open unemployment and dissatisfaction, with all the uncertainties to which these might lead.

I. OVERALL PERFORMANCE DURING EIGHTH PLAN PERIOD

A. Growth, Employment, Saving, and Investment

1. Growth and the Structure of Production

1. The Eighth Five-Year Plan began on 1 July 1997 and will end on 30 June 2002. Real gross domestic product (GDP) performance, which is calculated on a calendar year rather than a fiscal year basis, has been vigorous thus far, and an equally robust achievement is expected in the current year. Accordingly, real GDP is estimated to have grown by 6.7 percent a year in 1997-2001 and thus to have attained the annual 6.5-6.7 percent projected in the Eighth Plan (Table 1). This is an impressive performance for a small, landlocked country.

Table 1: Real GDP Growth by Sector, 1997 - 2001
(in percentage change per annum, 1980 prices)

Item	1997	1998	1999	2000	2001 ^a	1997-2001 ^a Average
GDP at Factor Cost	7.6	6.4	7.4	5.7	6.5	6.7
Agriculture	4.0	2.8	5.3	4.7	4.8	4.3
Industry	3.5	8.6	11.6	4.0	8.0	7.1
Services	13.4	6.6	5.2	9.1	6.3	8.1

^a Staff estimates.

Source: Statistical Appendix, Table A.1, and staff estimates.

2. However, within this impressive overall economic performance there has been a marked degree of annual variation exhibited by the sectors. Agriculture, traditionally the slowest moving sector, has performed reasonably well when viewed as a whole (and above target), but this overall sector growth masks uneven trends within it — notably, disappointing crop production and exports (especially fruits and horticulture), stable livestock production, and dynamic forestry output. Moreover, since about 79 percent of a population growing at over 2 percent a year live in the rural areas and are directly or indirectly dependent on agriculture for their livelihoods, agricultural trends have an important bearing on incomes and on the Government's programs for poverty reduction. In particular, the slowdown in the fruit and horticulture subsectors has resulted in a stagnation in some important export items (apples, oranges, vegetables, etc.) over recent years. It might also have slowed the sector's structural diversification in favor of cash crops that took place during the early and mid-1990s and that contributed generally to the higher-than-average incomes earned by the farmers who switched to their cultivation.

3. Growth in the industry and services sectors outstripped growth in the agriculture sector over the Eighth Plan period, thus continuing a 20-year trend. Preliminary estimates indicate that the share of agriculture fell to about 33 percent of GDP in 2000 (from 53 percent in 1981); that of industry — comprising mining, manufacturing, electricity and water, and construction — rose to some 41 percent (from 17 percent in 1981); and that of services fluctuated over time but registered some 26 percent in 2000. Considerable structural diversification of the economy has thus taken place over the past 20 years, but these data disguise the fact that the industry sector is still dominated by a small number of firms producing a restricted number of products, and that exports are dominated by power exports to India.

4. Within the industry sector, the performance of mining and that of manufacturing appear to have been particularly disappointing, with each falling significantly short of their Eighth Plan targets in the first four years of the Plan period. Both subsectors barely expanded at all during 1997-2000, compared with annual real growth targets of 19.4 percent and 12 percent, respectively, during the Eighth Plan period as a whole (see Statistical Appendix, Tables A.2 and A.3). In the case of manufacturing, the poor performance — especially in 2000 — can be attributed to the devastating floods in the south during the year that severely disrupted production, particularly around Phuentsholing.

5. On the other hand, the performance of the electricity and water and the construction subsectors has exceeded Eighth Plan targets, particularly in the case of construction. While the growth of electricity and water seems to have been only moderate during the first two years of the Plan period, accelerated activity associated with the Basochu, Kurichu, and Tala hydro projects caused significant subsectoral growth in 1999-2001. These changes have affirmed the power sector's key contribution to Bhutanese growth. In construction, slow initial growth during the first two years of the Eighth Plan period mirrored that of the electricity and water subsector but, with the gathering expansion in hydropower, the Dungsum cement plant, and externally financed infrastructure projects, subsectoral growth in 1999-2001 has been robust and growing at 10-12 percent in real terms annually.

6. The country has enormous hydropower potential, with an estimated technical capacity of some 16,000 megawatts (MW). The development of hydropower began with the commissioning of the first stage of the Chhukha plant (336 MW) in 1986 and the initiation of sales to India. To this will be added Kurichu (60 MW) by the end of 2001, Basochu (60 MW) in 2004, and Tala (1,020 MW) possibly by 2006, and these extensions to domestic generation capacity should provide major increases to export earnings, government revenue, and the spread of electricity to domestic households and firms.

7. In services, the transport and communications subsector has grown dynamically during the Eighth Plan period (especially during the earlier years), and faster than projected, mainly as a result of the implementation of externally assisted projects and of relatively buoyant internal trade. The contribution of the financial subsector and of government services to GDP has fluctuated, sometimes erratically, but has generally fallen short of Plan projections.

8. The contribution of tourism, not identified separately in the national accounts, is increasingly important. Notwithstanding certain restrictions imposed on tourism to protect the country's unique cultural heritage and the limitations of Druk Air's seating capacity, tourism is a major employer and foreign exchange earner. The number of tourist arrivals¹ rose from 5,363 in 1997 to 7,559 in 2000 (over 40 percent), and to 5,775 in the first ten months of 2001. Although the events of 11 September 2001 in the United States reportedly led to only 315 identifiable tourist cancellations,² the more general global economic slowdown during 2001 is said locally to have been more important in leading to the reduction in tourist numbers during the first 10 months of 2001 by 9 percent (from 6,350 in the first 10 months of 2000 to 5,775 in the first 10 months of 2001). Given that Bhutanese tourism is a relatively expensive product, global economic conditions are an important variable, especially for the major long-haul tourists from United States, Europe, and Japan. Nevertheless, the longer term prospects for tourism appear

¹ These exclude tourist arrivals from India.

² However, while tourist arrivals during September were higher in 2001 than in 2000 (895 compared with 683), tourist arrivals during October were significantly higher in 2000 than in 2001 (2,247 compared with 1,306).

bright, and will be assisted by Druk Air's plans to buy two new, larger airplanes and by a gradual return to normalcy in the global economic situation.

2. Employment and the Private Sector

9. Reliable data on employment trends in Bhutan are not available. Although the National Labour Force Survey, 1998 and 1999, conducted with the assistance of the United Nations Development Programme, provides valuable information on the structure of the labor market at given points of time, it does not provide information on changes over time. Importantly, therefore, it does not provide information on how GDP growth and the changing structure of the economy are affecting the labor market and the employment (and unemployment) situation. It is therefore not possible to assess these effects systematically.

10. However, the Survey indicates that unemployment in 1998 and 1999 stood at about 1.4 percent, mostly concentrated in the 20-24 age group, especially among young men. In a country where such a high proportion of the population live in the rural areas and are dependent on productive activities that are often aimed at little more than subsistence, this low level of open employment is not surprising. A more pressing problem, and certainly one of growing concern for the Government, is that much of the industrial development that has taken place has been capital intensive by nature³ and has not led to a commensurate growth in jobs. Moreover, Indian migrants have taken up many of these jobs, even many of the unskilled ones. In addition, many potential Bhutanese entrants to the labor market are better educated than earlier generations and are less likely than their parents to accept subsistence-level occupations. Given that the Government is also restricting the growth in the number of civil service positions, its main challenge is to absorb a growing number of better educated persons in productive occupations, and to prevent rising unemployment and the social uncertainties it could generate. The Government is thus placing heavy emphasis on private sector growth to absorb new entrants to the labor market and is sponsoring appropriate training programs.

11. Unfortunately, the performance of the private sector and privatization during the Eighth Plan period has been mixed. On the one hand, tourist companies have performed well; several examples of outsourcing (especially of public works) and corporatization and liberalization have taken place; and many farmers, traders, tour operators, and transport firms have reacted positively to the improved marketing opportunities afforded by improved road access and, in many areas, by electrification.⁴ On the other hand, as noted above, many of the key growth subsectors remain capital intensive, and none of the state-owned companies set for possible privatization during the Eighth Plan⁵ have been privatized, although significant divestment of ownership among certain state enterprises has occurred in these years. Indeed, because the number of potential buyers is so limited in Bhutan and because the Government is rightfully concerned about the dangers of concentrating the ownership of state assets in a few private hands, the gradual divestment of ownership of state enterprises might be preferable in a Bhutanese context to outright privatization. Outright privatization in Bhutan runs the risk of changing public monopolies into private ones.

³ That is, hydropower and the production of cement, ferro-alloys, calcium carbide, processed foods, particleboard, etc.

⁴ There has also reportedly been some slight movement out of the civil service to the private sector.

⁵ There were many examples of privatization and partial privatization prior to the Eighth Plan.

12. More generally, the impediments to private sector growth in Bhutan are both numerous and mutually reinforcing.⁶ There are physical constraints caused by topography; location; and the small, widely dispersed population. There is also an acute shortage of skills of all kinds and, paradoxically, given the rapid population increase, even of unskilled labor. Moreover, there is a preference for working in government service rather than in private, paid employment and, in the case of unskilled labor, a reluctance to work in certain occupations. With restrictions now placed on the growth of the civil service, and the economic circumstances of some people becoming difficult, these attitudes are showing signs of change. However, it will take time before attitudinal change and the improvement in training facilities permit a better balance being struck between Bhutanese labor demand and supply. Thus, the domestic shortage of skilled and semiskilled labor continues to pose a constraint. These forces are not amenable to simple correction.

13. Related to these factors, moreover, the private sector's small size and comparatively recent emergence in a business environment traditionally dominated by state capitalism place a limit on the exposure of the general public to business development in a market economy. There has been little history of private commercial development, and little time for private business to become a preferred career for many people. Moreover, considerations of national interest, while legitimate, also serve to limit private sector growth. Concerns about the environment, protection of the country's cultural heritage, and the potential invasiveness of foreign investment have served to limit logging, tourism, foreign direct investment, and the hiring of expatriate labor by domestic companies. Weak financial institutions, inefficient financial intermediation, and many cumbersome official controls and approval procedures also limit private sector development, particularly among potential domestic investors, but also for foreign investment. There still is no comprehensive industrial law or policy, for example, although one is being finalized, and the Government is taking a more liberal attitude towards the extent of foreign ownership allowed.⁷

14. As such, therefore, promoting private sector growth to absorb the growing number of young men and women whose better access to education has raised their social aspirations is, perhaps, the Government's major medium-term challenge. It is not amenable to simple solution, nor can it be corrected by modifying one or two variables. It will require a complex combination of improvements to institutions, policies, attitudes, infrastructure, and business and commercial skills to effect, and it will take time. However, the price of not effecting these improvements would likely be rising unemployment and growing discontent, notwithstanding the otherwise impressive GDP growth and prudent management of the economy.

3. Saving and Investment

15. Saving and investment data as derived from the national accounts in Bhutan are not reliable: There are inconsistencies between the overall investment-saving gap and the balance on the current account of the balance of payments, and there are inconsistencies between the public investment-saving gap and the budget surplus.⁸ Nevertheless, as shown in the Statistical Appendix, Table A.1, gross national saving has declined as a proportion of GDP during the

⁶ For a fuller discussion, see Asian Development Bank, *Bhutan: Country Operational Strategy – Improving the Quality of Life for All*, October 2000.

⁷ Partly as a result of this, three foreign hotel companies (Aman from Indonesia, Four Seasons from Singapore, and Oberoi from India) are nearing the finalization of proposed joint venture investments in three tourist resort complexes catering to the very upper end of the market. Daily full board and inclusive rates are expected to be \$700 upwards. The provision of domestic helicopter services is also being explored with foreign interests.

⁸ For a fuller discussion, see Asian Development Bank, *Bhutan: Country Economic Review*, May 1999.

Eighth Plan period, but remains over 17 percent of GDP in the current year, while gross domestic investment has increased significantly to an estimated 43.8 percent of GDP in the current year. Accordingly, the saving-investment gap (deficit) has risen appreciably.

B. Fiscal Developments

16. The Government has traditionally pursued a prudent fiscal policy, one that is guided by conservative financing principles, notably that domestic revenues should at least cover current expenditures and that capital expenditure should be financed largely from external sources, as far as possible by grants and, after these, by concessional loans. The first of these principles continued to prevail during the first four years of the Eighth Plan, but, during the fifth and current fiscal year, it is possible that a small current deficit of 0.1 percent of GDP could emerge (Table 2). However, this need not in fact eventuate, particularly if, as is common, expenditures fall short of budget. During the Plan, while recurrent expenditures have increased largely as a result of expanded health and education facilities, preparations for the reorganization of the civil service, and salary increases for the civil service, current expenditures have kept remarkably stable as a proportion of GDP (at around 20 percent). On the other hand, current revenues, after rising as a proportion of GDP during the first three years of the Plan, have since fallen. The main reason for this appears to have been the proportionate decline in the tax and nontax revenues emanating from the Chhukha hydropower plant, traditionally amounting to some 40 percent of domestic revenues. While revenues from this increased to 9.2 percent of GDP in FY2000, they are budgeted to decline to 7 percent of GDP in FY2002, a decline that is also registered in nominal terms in the current year (from Nu1,818 million in FY2001 to Nu1,694 million in FY2002).

Table 2: Central Government Finance, FY1998 – FY2002
(in percent of GDP at factor cost)

Item	FY1998	FY1999	FY2000	FY2001	FY2002 ^a
Total Revenues and Grants	35.4	43.0	42.4	39.8	33.2
Current Revenues	21.2	21.5	23.3	21.0	18.8
Tax Revenue	8.9	7.9	10.7	9.6	10.2
Nontax Revenues	12.3	13.7	12.6	11.4	8.6
Capital Revenues	0.5	0.5	0.4	0.3	0.2
Other Receipts	0.7	0.7	1.1	2.9	2.2
Grants	13.0	20.3	17.7	15.7	12.0
From India	7.5	12.0	10.4	7.9	5.5
From Others	5.5	8.3	7.3	7.8	6.5
Total Expenditures and Net Lending	34.3	44.9	46.6	44.9	40.4
Current Expenditures	18.8	19.8	20.0	20.8	19.0
Capital Expenditures	14.0	25.5	25.0	23.8	21.4
Net Lending	1.6	(0.4)	1.6	0.3	0.0
Current Balance (excluding Grants)	2.4	1.8	3.3	0.2	(0.1)
Overall Balance (including Grants)	1.0	(1.9)	(4.1)	(5.1)	(7.2)
External Financing	2.4	3.4	3.3	1.3	2.9
Domestic Financing	(3.4)	(1.5)	0.9	3.8	4.3

^a Budget data and staff estimates of GDP growth and the GDP deflator.

Source: Statistical Appendix, Table A.4.

17. A more significant trend has been the emergence and subsequent increase in recourse to the domestic financing of capital expenditure. This has been the result of accelerated capital investment, including the financing by the Government of a new expressway into the west of Thimphu and a low-income housing estate. Domestic financing of the overall fiscal deficit included the withdrawal of government deposits with the banking system and by the sale of

Nu500 million of Treasury Bills on the open market. While this is a more expensive way of financing capital investment than from external grants and traditional domestic revenue sources, it is by no means unsustainable over the short to medium term. It should be recalled that domestic revenues should increase as the Kurichu and Basochu hydropower plants are commissioned over the coming months, and especially as Tala is commissioned in the longer term, particularly if power tariffs are revised upwards. Similarly, the proposed introduction of personal income tax in 2002 should raise tax revenue, although this may not be substantial during the initial period of its introduction, and there is scope for raising revenue through the introduction on a selective basis of user fees in health and education and for improving tax administration. Ways to do this are being actively explored by the Government.

C. Monetary Developments and Prices

18. Given the existence of the exchange rate peg with the Indian rupee, there is limited scope for the exercise of monetary policy in Bhutan. The rate of growth in broad money supply (M2), which accelerated during the Seventh Plan period as a result of the net inflow of foreign assets derived mainly from external assistance, has slowed during the Eighth Plan period due to the deceleration that has occurred in net foreign asset inflows (Table 3).

Table 3: Monetary Developments, FY1998 – FY2001

Item	FY1998	FY1999	FY2000	FY2001
(in percent of GDP at factor cost)				
Change in Net Foreign Assets	20.4	14.0	10.3	(2.2)
Change in Net Domestic Credit	(2.1)	(5.4)	2.0	6.0
to the Public Sector	(3.1)	(5.8)	1.7	2.9
to the Private Sector	1.0	0.4	0.3	3.1
Change in Broad Money (M2)	12.8	8.1	8.5	2.3
Change in Narrow Money (M1)	3.8	2.3	4.4	3.7
(in percent change per annum)				
Broad Money Growth (M2)	41.7	21.4	21.4	5.5
Narrow Money Growth (M1)	26.7	14.7	28.7	21.3

Source: Statistical Appendix, Table A.5.

19. However, in terms of monetary policy, the key issue continues to be the high level of excess reserves (liquidity) of the banking system, a situation that has persisted for many years. The Royal Monetary Authority (RMA) maintains that this is essentially the result of a lack of domestic investment opportunities stemming largely from the inherent weaknesses of the private sector. These reduce the potential private sector demand for bank loans (credit) that could otherwise be expected to absorb the high levels of liquidity emanating from large balance of payments surpluses. While these weaknesses are the result of the many mutually reinforcing impediments that continue to stifle private investment initiatives, as noted earlier, these tend to be exacerbated by the limitations of the banking system itself. Even though interest rates have been liberalized in recent years, there is still a lack of competition for business between banks and little evidence of their pursuing proactive policies to encourage bank lending for private

investment purposes. Much of what bank lending there is tends to finance the import of cars and the construction or refurbishment of private houses, while the banks' general lending attitude tends to be conservative and based largely on the provision of physical collateral. Moreover, it is also partly colored by nonperforming loans that have been inherited.

20. The overall situation with respect to strengthening the domestic banking system is being addressed, and it has received assistance from both the Asian Development Bank (ADB) and the International Monetary Fund (IMF). In the meantime, some part of the excess liquidity of the banks will have been absorbed by the recent flotation of Treasury Bills to finance part of the capital expenditure of the Government, and will be further absorbed by the purchase of one of two new airplanes planned by Druk Air. Notwithstanding these actions, which are likely to be only temporary, a longer term solution to excess liquidity has to be found because, as noted above, it does aggravate the difficulties of private sector growth even if it is not the sole cause of those difficulties. RMA sees these financial issues to be as much an effect of limited private development as a cause, but it is still a contributory cause.

21. Inflation in Bhutan has traditionally run in parallel with inflationary trends in India, as a result of the overwhelming importance of India as a trading partner, the porous nature of the border with India, and the existence of the ngultrum-rupee peg. For many years, inflation in Bhutan has been in the range of 7-10 percent annually, albeit slightly higher during 1990-1995, but this annual rate fell substantially in FY2000 and FY2001 to 3.6 percent, largely as a result of reductions in some critical food prices and the importance of food in the price index.

D. Balance of Payments and External Debt

22. India receives 90 percent of Bhutan's merchandise exports, mainly electrical energy, and accounts for about 75 percent of Bhutan's total trade. During the Eighth Plan period, Bhutan's merchandise exports in total have declined somewhat in proportion to GDP, although they have increased overall — albeit erratically — in dollar terms (Table 4). On the other hand, imports have increased slightly in proportionate and significantly in nominal terms. The trade and current account deficits have each increased in both proportionate and nominal terms, as have the deficits with India, considered separately.

Table 4: Balance of Payments, FY1998 – FY2001

Item	FY1998	FY1999	FY2000	FY2001
(in percent of GDP at factor cost)				
Merchandise Trade Balance	(6.8)	(15.3)	(16.7)	(22.6)
Merchandise Exports	30.5	27.7	26.9	24.6
Merchandise Imports	(37.3)	(43.0)	(43.6)	(47.3)
Balance with India	2.6	(4.6)	(7.3)	(11.7)
Current Account Balance	(12.8)	(25.9)	(30.6)	(27.5)
Balance with India	(7.0)	(19.1)	(23.6)	(18.7)
Change in Reserves	12.4	11.7	8.6	5.3
(in percent change per annum)				
Merchandise Exports^a	12.0	(5.9)	9.2	(1.8)
Exports to India	16.7	(6.8)	10.0	(1.8)
Merchandise Imports^a	3.7	19.3	14.0	16.3
Imports from India	11.9	20.3	20.3	14.6

^a Growth in the nominal US dollar value.

Source: Statistical Appendix, Table A.6.

23. However, capital inflows, mostly in the form of grants, have continued to exceed by some margin the deficits on trade and current account. The net effect of these trends has boosted Bhutan's foreign exchange reserves significantly over time. By the end of FY2001, for example, they stood at \$294 million, sufficient to finance over 16 months of merchandise imports at the FY2001 level. By comparison, at the start of the Eighth Plan, reserves stood at \$217 million (equivalent to 19 months of that year's merchandise imports). While they increased significantly in FY1998, FY1999, and FY2000, the increase in FY2001 was very much more moderate and in line with the reduction in grant inflows both from India and in total. These represent a comfortable level of foreign exchange reserves.

24. Total public external debt has risen significantly during the Eighth Plan period and currently represents slightly more than 50 percent of GDP (Statistical Appendix, Table A.7). In total, public external debt stood at \$235 million at the end of FY2001 (Table 5). However, convertible currency debt — all of it concessional — has tended to decline as a proportion of GDP, although to rise nominally (especially to the ADB), but nonconvertible currency debt has risen sharply both nominally and proportionately, largely in response to the loans from India in connection with the new hydropower projects. There is no commercial debt at the present time, although this is likely to change when Druk Air renews its fleet.

25. The debt service ratio, which has always been maintained at manageable levels, has actually declined during the Eighth Plan period. Aside from annual fluctuations in earlier years, which tended to reflect principal repayments, the debt service ratio stood at 5.6-5.7 percent of merchandise exports in FY2000 and FY2001.

Table 5: Public External Debt, FY1998 – FY2001
(\$ million)

Item	FY1998	FY1999	FY2000	FY2001
Total Public External Debt	131.9	147.7	171.6	234.8
Convertible Currency Debt	91.2	97.1	98.3	106.6
Concessional Debt	90.1	97.1	98.3	106.6
Asian Development Bank	40.8	45.2	43.2	47.3
World Bank	22.1	23.9	23.8	27.6
International Fund for Agricultural Devt.	12.2	13.2	12.7	12.4
Kuwait Fund	10.0	8.3	7.8	6.4
Other	4.9	6.5	10.8	12.9
Commercial Debt	1.1	0.0	0.0	0.0
Nonconvertible Currency Debt	40.7	50.6	73.3	128.2
Debt Service Ratio (% merchandise exports)	9.0	13.6	5.7	5.6

Source: Statistical Appendix, Table A.7.

E. Human and Social Development

26. One of the most impressive achievements of the Government over the past 15-20 years has been the improvements witnessed in social indicators, albeit from very poor levels of the 1980s and earlier. The long-standing commitment of the Government to improve the human condition is an important feature of Bhutan's development process. However, it is not possible to assess social development specifically during the Eighth Plan period because the periodicity of data collection and publication in this social area is not annual. Nevertheless, improvements over longer periods are plainly evident, and these include those during the Eighth Plan.

27. In the case of health indicators, for example, life expectancy rose from 35 years in 1961 to 46 years in 1977, and to about 66 years in 1998. Similarly, between the mid-1980s and 2000, the infant mortality rate was reduced from 142 to 61 per 1,000 live births and the maternal mortality rate from 7.7 to 2.6 per 1,000 live births, while the under-5 mortality rate fell from 162 to 84 per 1,000 live births. In addition, the crude birth rate was reduced marginally (by 5 percentage points) over the same period, and the crude death rate rather more significantly by 17 percentage points. The population growth rate has fallen to about 2.5 percent per year at present from over 3 percent in earlier years. Moreover, major advances in immunization covering 90 percent of children have virtually eliminated neonatal tetanus, polio, and diphtheria. Malaria and leprosy are now under control, although the former remains a problem in the southern part of the country, while the program to iodize salt has significantly reduced iodine deficiency. The most common causes of morbidity today are acute respiratory infections (mostly associated with the use of wood for cooking and heating in traditional homes having poor ventilation), followed by diarrheal diseases (formerly the most common), skin infections, and tuberculosis.

28. These positive developments have been brought about by providing increased access to health facilities (hospitals, basic health units, dispensaries, and outreach clinics); boosting the number of doctors, nurses, and auxiliary health personnel; and improving access to potable water and sanitation. By 1999, over 90 percent of the population had access to free basic health care (up from 65 percent in 1987); 78 percent of the rural population had access to safe water supplies (a proportion that had increased from 31 percent in 1987 and that is expected to reach 95-100 percent in the next five years); and 88 percent of the rural population had access to sanitary latrines. Moreover, piped sanitation systems have either been completed or are under construction in Thimphu, Phuentsholing, and four other towns.

29. Considerable progress has also been made in the field of education over the past 20 or more years. Considering that fewer than 450 children in total attended secular primary schools in the late 1950s, and that the country then had no secondary schools, educational achievements have been impressive. The education system in 2000 consisted of 261 primary and community schools, 59 junior high schools, and 61 high schools, tertiary and vocational training facilities (including one degree college). Moreover, the number of teachers has trebled, and the number of educational establishments has doubled since 1977 alone.

30. The Government provides free education. The primary school enrollment ratio had reached 72 percent by 2000 — up from 12 percent in 1980 and from 25 percent as recently as 1990 — which suggests that a 95 percent ratio could be reached in 2002, and universal primary enrollment soon after that. Girls now comprise some 46 percent of primary school children. This represents a gross enrollment ratio for girls of over 60 percent, and they tend to have lower dropout rates than primary school boys.

31. Aside from such quantitative improvements, both the quality and the internal efficiency of primary education have improved. A curriculum known as the New Approach to Primary Education, introduced in the mid-1980s and extended to all primary schools in 1993, seeks to provide a curriculum based on Bhutanese values and circumstances and to develop skills that are useful to those who leave school at the end of their primary education. The survival rate at primary school increased from 35 percent in 1987 to 69 percent in 2000. As a result of these improvements and the introduction of nonformal education, the adult literacy rate rose from 17 percent in 1977 to 23 percent in 1980, 38 percent in 1990, and about 54 percent in 1996, although the adult rate is only 28 percent for women, and particularly low — even down to 10

percent — in some of the more remote rural areas. Despite the many improvements, therefore, basic literacy standards remain poor among adults in many areas but have increased rapidly among children.

32. Secondary education has also expanded rapidly, although a persistent shortage of trained, competent teachers at these higher levels remains a major constraint to faster growth. Even so, the Government has built new secondary schools; recruited expatriate teachers; and, importantly, expanded boarding facilities (now covering over 14,000 students) as an inducement to rural students generally and to girls⁹ in particular. The gender balance is about 54:46 in favor of boys in primary schools, the same in junior high schools, 57:43 in high schools, 52:48 in private schools, and 67:33 at the tertiary and vocational levels.

II. IMPROVING QUALITY OF LIFE FOR ALL: THE NINTH PLAN

A Introduction

33. His Majesty the King clearly defined Bhutanese development philosophy in the 1980s, introducing the concept of gross national happiness. This has guided the preparation of the country's five-year plans ever since. In Bhutan, economic growth and material progress must not be seen as being the only way to personal fulfillment, but must be tempered by an equal emphasis on the advancement of an individual's spiritual and emotional security. These societal values stem from a strict Buddhist moral code that permeates personal ethics, government policies, and development philosophy. A part of this is the quest for fairness, equity, and equal treatment for all. Over time, therefore, economic development in the Bhutanese context has come to mean the balancing of material economic progress with the maintenance of Bhutanese cultural and spiritual values, the improvement of social well-being, the preservation of the environment, and the promotion of good governance, all attained as a result of relatively wide participation in decision-making. Resources have been used judiciously and fairly, therefore, and even though vulnerability remains widespread, it is not associated with the abject wretchedness and human suffering so often found elsewhere.

34. These general thrusts are consistent with those on which ADB's Country Strategy¹⁰ is based, and with its institutional approach to poverty reduction, namely that poverty has material and nonmaterial dimensions, each of which has to be addressed. To this end, ADB provided technical assistance (TA) to the Government to help it define the nature and extent of Bhutanese poverty.¹¹ As a result of the participatory process in this exercise, there has been a shift in many areas of government thinking towards a multi-sectoral — or holistic — approach to development and poverty reduction, and a recognition that, despite the Government's traditional quest for fairness, some groups have been left behind in the development process. These groups tend to be those living in the rural areas, where physical access is often poor and the quality of public services inadequate. The Ninth Plan will introduce greater focus on these groups as a key objective.

⁹ In 2000, there were 5,600 girl boarders at secondary schools of a total of 14,400 boarders (almost 40 percent).

¹⁰ Asian Development Bank, *Bhutan: Country Operational Strategy - Improving the Quality of Life for All*, October 2000; and *Poverty Reduction Partnership Agreement* between the Government and ADB, October 2001.

¹¹ Notably, TA2860-BHU: *Strengthening the Central Statistical Organization*, for \$400,000, approved on 9 September 1997, which produced the sample Household Income and Expenditure Survey for 2000; and TA3443-BHU: *Poverty Assessment and Analysis*, for \$100,000, approved on 19 May 2000, which produced a report of the same name.

B. Strategies and Objectives of the Ninth Plan

35. The Ninth Plan is due to begin on 1 July 2002 and to end on 30 June 2007. While the Ninth Plan document has yet to be finalized and published, the Government has announced its basic parameters together with its objectives and general strategies. The planned outlay is to be Nu70 billion (about \$1.5 billion) which in nominal terms is close to double the amount of about Nu40 billion that will have been spent during the Eighth Plan period by the time it ends. Of the Nu70 billion for the Ninth Plan period, about Nu31 billion is expected from domestic revenue sources, about Nu35 billion from external sources (including Nu20 billion being negotiated with India), and the rest from domestic or external borrowing. Moreover, about Nu31 billion is planned as current expenditure, Nu35 billion as capital expenditure, and the remainder as debt servicing. Real GDP growth is targeted at 6.7 percent per year, the same as that achieved under the Eighth Plan.

1. Rural Infrastructure

36. One conclusion of TA3443-BHU (footnote 11) is the close link established between Bhutan's more vulnerable groups and the degree of physical isolation they endure. For a mountainous country, this may seem intuitively obvious, but the closeness of the correlation between the spatial distribution of relative poverty and the existence of transport connections (particularly feeder roads) is conspicuously apparent. While communications between the regions of Bhutan are rarely very easy, the particularly difficult and disadvantaged areas consist of about 100 blocks (*geogs*) (about half the total)¹² which accommodate no less than 25 percent of the population. These areas are spread over at least half the country, especially in the district (*dzongkhag*) of Gasa (where few people live); in large parts of the districts of Lhuentse, Samdrup Jongkhar, Pemagatshel, Mongar, Zhemgang, Trashigang, and Trongsa; and in smaller, mostly remote parts of all other districts with the exception of Bumthang.

37. Moreover, the severe difficulties caused by lack of access to transport facilities are compounded by similar lack of access to electricity in many areas. The most affected households in terms of access to power facilities are those in the rural areas. In terms of access to electricity, TA3443-BHU found that there are 123 blocks covering well over half the country in which virtually no households have any access to electricity at all, a further 15 blocks in which most households have access for less than three days per week, and only 86 blocks in which most households have access for more than three days a week (some of them continuously).

38. Virtually all the most disadvantaged areas are rural and, as part of the concern to improve the quality of rural life and to reduce rural poverty, one of the key strategic foci of the Ninth Plan is to be the development of rural infrastructure, especially rural access roads and rural electrification. This is apparently to be supported by the construction of two major roads to open up two particular areas of poverty concentration, namely, in the east and central south of Bhutan, where the most vulnerable blocks house over 30 percent of all households. Accordingly, the largest sector outlay of the Plan is to be for the Ministry of Communications with 15.2 percent of total Plan outlay (of which the Department of Roads is to receive 9.9 percent of total outlay), and the Ministry of Trade and Industry is to be allocated 12.4 percent of total Plan outlay (of which the Department of Power is to receive 9.1 percent of total outlay).

39. By expanding the rural road network, the Government hopes to reduce isolation, expand access to essential services, develop markets, moderate the fragmentation of the domestic

¹² A block (*or geog*) refers to a local administrative unit comprising a cluster of villages.

market, widen personal choice and opportunities, promote the transfer of information and technology, and lessen vulnerability. This focus on reducing isolation is also to be supported by a gradual extension planned for the telecommunications network and the Internet. Second, by expanding rural electrification, aside from the personal convenience electricity provides, the Government hopes to raise rural productivity and stimulate the expansion of processing or other workshops, and off-farm employment opportunities in general. Importantly, it also hopes to reduce the use of fuelwood and kerosene for domestic heating and lighting, thereby lessening the incidence of associated respiratory infections, relieving some of the burden of housework and wood-gathering for women and girls, and facilitating home study for school pupils and others. Moreover, in parallel with the progress planned for the provision of rural infrastructure under the Ninth Plan, agricultural extension services are to be developed so as to allow those living in rural areas to optimize the potential benefits to be gained from infrastructure expansion. This is to be financed from the 8.6 percent allocated to agriculture, including those to districts and blocks under the Ninth Plan outlay.

2. Upgrading the Quality of Health and Education Facilities

40. A second strategic focus of the Ninth Plan is the strengthened emphasis to be placed on upgrading the quality of health and education facilities. This does not mean that efforts to extend the network of schools, clinics, etc. into currently deprived areas will be overlooked, but simply that a greater effort to improve the quality and relevance of health care and teaching will be made.

41. In terms of health facilities, for example, TA3443-BHU revealed that, while most households are more than three hours' travel from a hospital, over 50 percent of all blocks have a basic health unit and almost all others have a community health unit or outreach clinic. There are no facilities at all in only 13 blocks nationwide, 7 of which are in Paro District within reasonable reach of those in Ha and Thimphu districts. The need to expand the health network quantitatively, therefore, is seen as a lesser priority than improving the quality and sustainability of the health care being provided. Nevertheless, remoteness often militates against prompt referral and backup services, especially during emergency and life-threatening situations, and the general difficulties associated with travel in the Bhutanese countryside are magnified significantly for the sick or for those traveling with the sick or injured. In these overall health circumstances, the difficulties faced by many of those households in the more deprived areas aggravate their susceptibility to illness and missed work-days, and thus to the socioeconomic vulnerability that these can so often manifest.

42. Thus, as health facilities are taken to new areas and the rural road network expands, it is hoped that more people will be able to benefit from improved access to such facilities; and as the upgrading of existing facilities occurs, it is intended that the quality of health care provided by these units will be improved. Since many of those areas currently without easy access to health facilities, or without access to more than rudimentary health care facilities, are in the rural areas, the Government's health thrust during the Ninth Plan is part of its overall attempts to improve rural life and to reduce the nonmaterial causes of poverty evident in the rural areas. Accordingly, the Government plans to allocate 9.1 percent of the Ninth Plan's total outlay to health, including those to districts and blocks.

43. In terms of education facilities, the country's network is not as extensive as in the case of health facilities. TA3443-BHU revealed that, whatever the average national situation might be, there is significant regional disparity in educational access and outcome. Some 38 percent of households can be said to be around the national average, 41 percent to be less than the

national average, and 21 percent to be above it. Those households that face educational circumstances worse than even that represented by the national average must be regarded as being especially disadvantaged. Moreover, this includes especially difficult circumstances for women and girls in many districts, notably in Gasa and Ha and in parts of Wangdue-phodrang, Zhemgang, Pemagatshel, and Tsirang. For the educationally deprived, economic advance on the one hand, or escape from poverty on the other, are inhibited and their vulnerability aggravated. Indeed, when the leaders of the country's 20 districts were asked during implementation of TA3443-BHU to rank the 10 priority needs for their own districts, seven placed educational improvement first, two placed it second, and two placed it third.

44. Thus, the Ninth Plan will still seek to expand facilities into areas that are generally deficient and to expand the enrolment of girls, particularly at the secondary and vocational levels. However, beyond the widened provision of educational facilities themselves, the Government's intention during the Ninth Plan is to place greater emphasis on preparing pupils for the real world. This will require more attention at the district level to technical and vocational education, particularly to studies aimed at introducing more scientific farming methods and at expanding the various artisan trades that are already in demand but that can be expected to be in greater demand as rural activity expands. Again, the intention is to raise rural income potential and, through it, to improve the quality of rural life and thus to provide a realistic alternative for the increasing number of young migrants currently being attracted to the towns.

45. Beyond this, the Ninth Plan seeks to address the acute general shortage of skills at all levels and in a wide array of fields that presently act as a major constraint to development. However, while the training needs implied by the extent of existing shortages have already begun to be addressed during the Eighth Plan (or earlier), the Government intends to expand on these initiatives during the Ninth Plan. For this, it is considering the preparation of a comprehensive strategic plan to guide its approach to long-term human resource needs and development in both the public and private sectors. The planned allocation to the education sector, including those to districts and blocks, as a whole is 15.3 percent of the total outlay.

3. Private Sector Development

46. The developmental role of a vibrant private sector has been increasingly recognized by the Government over recent years and has found expression in previous five-year plans as well as in government policy statements, including the recent creation of the Private Sector Development Committee. Aside from the developmental stimulus it provides, government moves in the general direction of private sector growth have also been part of its attempts to change general attitudes away from a dependence on the Government as the main provider, and thus to encourage greater self-reliance, both individually and nationally.

47. However, implicitly if not explicitly, government efforts to stimulate private sector activity appear more closely integrated into the overall thrust of the Ninth Plan than with previous plans. This is suggested, first, by the strategy to improve rural infrastructure and thus to stimulate the small-scale private initiatives of the rural people. Given that such a high proportion of the country's population is self-employed and rural, these initiatives could collectively become a potent force in private sector development generally if the stimulus is successful. Second, it is also suggested by the Government's intention to improve the quality of public services, notably to strengthen technical and vocational education at the district level; to expand agricultural extension activities; to raise labor productivity; and to continue to address the widespread shortage of business, commercial, and technical skills at higher levels. Indeed, the Government is planning to allocate half of the Ninth Plan's proposed outlay for training to the private sector,

with the other half devoted to public sector training needs and improved governance. It is clear that unleashing private sector initiative is seen as a key element in the Government's poverty reduction strategy, and that government interventions are being used as facilitators for this.

48. As part of the Government's overall intention to create an enabling environment for the private sector, the Department of Industry is planning a number of initiatives for the Ninth Plan period. To address the acute shortage of appropriate land for industrial development, five industrial estates (including basic infrastructure) are to be developed at Pasakha in Chhukha, Chuwabari in Sarpang, Shankhazuli in Samdrup Jongkhar, Bongdyma in Mongar, and Tingtibi in Zhemgang. In parallel with this, service centers are being proposed for all townships, to be established as and when possible. In addition, the delayed industrial legislation is to be finalized; a foreign investment promotion division is to be established in the ministry; feasibility studies on 15 potential industrial projects are to be undertaken; district investment opportunity studies are to be carried out in all districts; the Industrial Master Plan is to be revised; and business development services, business advisory services, and a revolving fund and business incubator are to be started.

49. In addition, the creation of a dry port and export credit finance facilities during the Ninth Plan are being considered by the Department of Trade; the development of new trekking routes, the feasibility of adventure tourism, and the possible establishment of village tourism with direct community participation are being explored by the Department of Tourism; and the extension of private sector participation in the planning, design, construction, and operation and maintenance of the power system is being planned by the Department of Power, and ways to increase greater private involvement in hydropower are being considered. If implemented, these various initiatives should collectively provide significant support to private sector development.

4. Decentralization of Planning and Implementation

50. While the functions of the district development committees and the block development committees have been in the process of refinement and strengthening for over 20 years, it was only with the preparation of the Ninth Plan that a block-based planning model has been used. This has involved the transfer of added responsibility to the local administrations for their own planning and development, and it has allocated 21.4 percent of the anticipated total outlay of the Ninth Plan to the districts and 3.3 percent to the blocks. For these projects, the Government is to provide materials and, along with the district administrations, to provide supervision and TA, while the local communities will be expected to provide the labor. Moreover, these are in addition to the various centrally run programs that are planned for the local areas, such as rural roads, rural electrification, and agricultural extension.

51. In practice, it seems as though the greater involvement of the local administrations in the preparation of the Ninth Plan has worked reasonably well. Inevitably, their restricted technical capacity for planning has often tended to result in the preparation of local "wish lists" of small, largely unrelated projects, but this will improve as experience and training are obtained. What is more important is that the exercise has openly involved local communities more assiduously than in the past and, in allocating almost 25 percent of the Ninth Plan's total outlay to their own perceived needs (around \$370 million), has demonstrated the Government's commitment to open government. It will also serve to reinforce the Government's wider attempts to inculcate an appreciation for heightened individual self-reliance and lesser dependence on the Government.

C. Medium-Term Prospects, Challenges, and Risks

52. Barring major unforeseen disturbances, Bhutan's medium-term prospects are good. For many years, the Government's commitment to economic growth, social equity, environmental preservation, open government, and prudent macroeconomic management has shown its capacity to balance the many potentially disturbing trade-offs associated with development; and its social and economic achievements have demonstrated its ability to deliver sustainable progress in difficult physical circumstances. Other than its tourism sector, its economy is relatively well insulated from the direct effects of global economic disorder, although it would be vulnerable to the effects of major developments in India. In general terms, therefore, there is no reason at the present time to expect Bhutan's socioeconomic trends to falter, and there is no reason to suggest that a real GDP growth rate of 6-7 percent per year over the medium term is not achievable, perhaps comfortably so if hydropower generation and export plans materialize on schedule.

53. The prospects for agriculture at least maintaining recent rates of growth are good, but, with most executing and implementing responsibilities for Ninth Plan initiatives being transferred to the districts and blocks as part of the Government's decentralization drive, much will depend on how this works out in practice. If it works out well, and if headway can be made in the development of domestic and external markets for farm produce, sector performance could well exceed recent growth rates and raise income opportunities for the rural population. For the industry sector as a whole, the prospects for surpassing Eighth Plan performance are relatively good as well, given the likely prospects for electricity and construction growth, although prospects for mining and manufacturing are more uncertain and will depend largely on how well the private sector reacts to growth stimuli. For the services sector, the medium-term prospects are also good, although much will depend on how tourism recovers from its recent downturn.

54. Fiscal policy will almost certainly continue to be managed prudently and conservatively, and the overall budget deficit is planned to be confined to about 3 percent of GDP during the Ninth Plan period. This is attainable, although, for reasons outlined in paras. 56-60, the deficit could come under strain and would come under strain if plans to mobilize domestic revenues were delayed or not fully successful. Monetary conditions seem likely to remain more or less unchanged, although excess liquidity could fall if private sector growth accelerates to surpass its recent sluggish performance. Inflation will continue to reflect Indian more closely than domestic conditions and seems likely to remain moderate.

55. Despite generally good prospects, however, the Government cannot be complacent, because there are several risks that could stem from either external or internal forces.

1. External Risks

56. Bhutan has been, and remains, heavily reliant on foreign sources for financial resources. While there is nothing at present to indicate that there will be a decline in these inflows, the Ninth Plan's execution and Bhutan's wider medium-term prospects are to a greater or lesser degree dependent on whether there will be any decline in foreign financing or any hardening of its terms, and on whether Bhutanese exports of electricity to India continue to increase.

57. India is by far Bhutan's largest source of external funds and its only electricity export market. In the Ninth Plan, assistance from the Government of India is projected to remain a substantial portion of the total external resources. Should this level of assistance not materialize due to various reasons, implementation of the Ninth Plan may be seriously affected, although

the Government of Bhutan could also mobilize additional resources from other sources and/or from its own internal resources to make up any resource gap. Depending on the timing, nature, and extent of any shortfall, it could potentially disturb proposed sector investments, lead to slower growth, and delay poverty reduction programs.

58. No particular problems are foreseen with respect to electricity exports to India. Bhutan supplies less than 0.5 percent of India's electricity demand which, when also considered in terms of India's own power supply shortages, augurs well for a continuation in Indian demand for Bhutanese electricity. Pricing issues have been resolved amicably in the past, and there is no reason to expect anything but a continuation of the same. However, Bhutan's power exports earn nonconvertible currency and, as the grace periods on convertible currency debt expire, loan repayments could begin to exert increasing pressure on convertible currency inflows.

59. In the case of the assistance programs of other external funding sources, whether bilateral or multilateral, the political and/or fiscal implications of the current war on terror may lead to fewer resources being available for foreign assistance and, in particular, for grant or concessional assistance. Already difficulties are being faced by multilateral organizations in their own access to grant resources and concessional loan resources, which has often led to reduced loan and TA programs for their member countries. These difficulties could well become aggravated if heightened global security concerns begin to utilize resources that would otherwise have flowed to multilateral organizations and/or increased support to directly affected countries. If so, this would also likely affect the bilateral agencies' own programs in the respective countries. Moreover, given the high level of Bhutan's exchange reserves, it could conceivably cause some agencies to reallocate a part of their resources to other countries. In Bhutan's case, therefore, in spite of its reputation for using foreign aid resources effectively, and despite aid commitments to future assistance programs, it could find itself in the position of having to accept lower inflows of foreign assistance, or inflows on harder terms — possibly through the blending of grants (or concessional loans) with nonconcessional loans. This could either have a harmful effect on the outcome of the Ninth Plan or could raise external debt.

60. Bhutan's present debt situation is quite manageable and well within its means to sustain. But the level of external public debt is already scheduled to rise over the medium term with a greater recourse to loans than before to finance its hydropower development, and with commercial debt likely to be incurred to finance a new airplane for Druk Air. While these higher levels of debt in no way raise alarm signals, the situation could be exacerbated by falling grant and/or concessional inflows and the unforeseen need to replace these with other foreign or domestic financing sources that would be available only on harder terms. Moreover, it should also be recalled that the domestic financing of capital expenditure has risen over the past 3-4 years and has led to a withdrawal in government deposits and to the reemergence of domestic debt in Bhutan. Again, this is manageable if it is not allowed to rise, and it could well be relatively short-lived anyway, but it might serve to limit financial maneuverability in the event of any abrupt and/or unexpected shortfall in the traditional sources of external financing.

61. However, it should be stressed that, with Bhutan's reputation for fiscal prudence, these risks should be seen as speculative possibilities rather than as likely eventualities. But they are risks nevertheless. Moreover, were they to occur in some form, they could have an impact on domestic sector developments even if they were prevented from becoming major fiscal issues by sound fiscal management. To provide an added cushion against this possibility, therefore, it would seem prudent for the Government to hasten rather than delay its plans for domestic revenue mobilization and user fee collection.

2. Domestic Risks

62. The Ninth Plan is well conceived in terms of its strategic objectives, and it contains some perceptive proposals to tackle the pervasive structural and human impediments to Bhutanese development. However, for whatever reason, there is always the chance that its objectives will not be met in full and that its sector strategies will not generate the results expected. Moreover, the risks of failure or of underperformance — growing unemployment and discontent — are more real than those potentially stemming from external forces.

63. Thus far, the Government has been successful in securing GDP growth and in raising the living standards of its people, but, as a price of this success, it has raised expectations and aspirations and it has generated a conviction that continued progress is assured. But progress is beginning to assume an additional dimension for an increasing proportion of the population, namely that income and job opportunities will rise commensurately with GDP growth and that they will match the progress achieved in health and education. For the Ninth Plan period, whether this transpires will in large measure depend on the performance of the private sector and on how it responds to the stimuli being proposed by the Government for the medium term. Results are inevitably more uncertain.

64. In the past, the Government has transferred to the private sector the management and majority ownership of seven public sector enterprises, it has privatized bus companies, it has corporatized the postal services and telecommunications, and it has abolished the monopoly of the state over petroleum distribution. However, as noted earlier, further advances during the Eighth Plan have largely been limited to divestment and the outsourcing of public works contracts. There has also been the diversification of agricultural production towards the cultivation and export of cash crops, and a growth in private domestic trade and transportation, and it is to be hoped that similar forms of small-scale private initiatives will be encouraged by the attention being given in the Ninth Plan to extending rural infrastructure. The prospects for this do seem to be reasonably good, as do prospects for rising employment in the tourism sector, but the prospects for job creation in what might be called the nontourism formal sector seem more uncertain, especially in terms of job creation in the urban areas. This would require growth in manufacturing, processing, artisan trades, and the service industry, but it is in precisely these areas that growth has been sluggish over recent years. In turn, it would require an increase in private investment, especially among small and medium enterprises, but it is also in these areas that a reluctance to establish new businesses continues to be evident.

65. To complement the initiatives being taken by the Government to address the structural impediments to private sector development (power, communications, roads, industrial estates, etc.) as a means of reducing costs and improving competitiveness, and in parallel to the efforts being made to upgrade technical, business, and commercial skills, it would now seem essential for RMA to further accelerate its attempts to strengthen the banking system and credit appraisal skills in particular. A more aggressive, proactive attitude with respect to fostering growth in bank lending for business rather than consumption purposes needs to be encouraged because, without it, the potential offered by planned government initiatives elsewhere may not be realized. A study of private sector needs is currently being undertaken with the assistance of the World Bank/Foreign Investment Advisory Service, which should help to place the various financial and institutional requirements in context. Job creation and, by implication, private sector development, are the Government's most pressing medium-term challenges.

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