DEBT SUSTAINABILITY ANALYSIS

1. **Bhutan's public and publicly guaranteed debt stood at 117.0% of GDP in fiscal year (FY) 2019 (ended in June 2019).**[1] The most recent Article IV staff report published by the International Monetary Fund (IMF) in October 2018 assessed that the risk of debt distress remained moderate despite breaches in all five indicators under the baseline. Domestic debt is only 8.9% of GDP in FY2019 and does not pose an additional risk. The bulk of Bhutan's public and publicly guaranteed (PPG) debt is comprised of hydropower projects (74.4%) of which mostly is financed by the Government of India with debt dominated in Indian rupees. The stock of non-hydropower debt-to-GDP is modest and owed mostly to the Asian Development Bank (ADB) and World Bank contracted on highly concessional terms. The primary risk to debt sustainability stemmed from weaker growth and higher inflation in India, Bhutan's main trading and development partner, and increases in global oil prices. Domestic risks include delays in completing hydropower projects and lower electricity exports.

2. **Hydropower debt financed by the Government of India is closer in nature to foreign direct investment.** All existing debt from India financing for hydropower projects are under an intergovernmental agreement in which construction and financial risks are borne by the Government of India and surplus electricity is sold to India at cost plus a 15% net return. The price of electricity is negotiated and finalized after the completion of the project when the final cost of the project is known, and the rate is agreed to be revisited every 3 years to incorporate changes in costs.[2] The unique nature does not preclude risks to the debt stock from an overvaluation of the ngultrum as it is pegged to the Indian rupee.

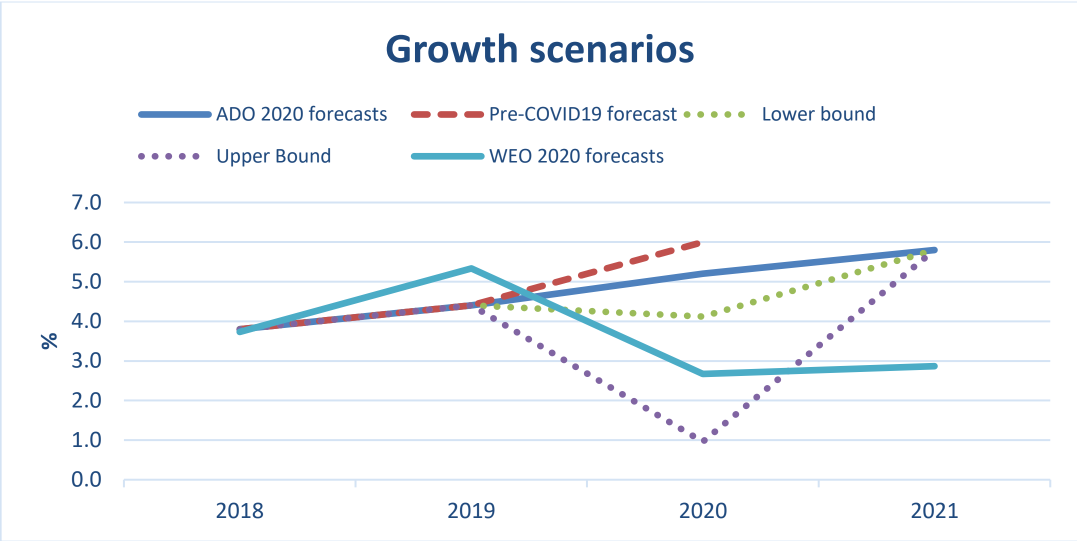
3. **The COVID-19 pandemic has impacted on the economy.** ADB estimates that Bhutan's economy grew sluggishly at 4.4% in FY2019 due to a substantial decline in construction activities as hydropower production suffered a marked fall. Before the pandemic struck, GDP growth in FY2020 had been expected to pick up to 6.0% on increased hydropower capacity (Figure 1). With the pandemic starting to affect all neighboring countries and Bhutan closed air links with other countries, the Asian Development Outlook (ADO) 2020 published on 3 April projected a growth of 5.2% for FY2020 and 5.8% in FY2021, assuming only global spillovers.[3] ADO 2020 also estimated that a domestic outbreak of the pandemic would push growth in FY2021 down to 4.1% with shorter containment measures and further to 1.0% if containment measures prolong. Borders were closed on 23 March. IMF's latest World Economic Outlook (WEO) on 14 April projects GDP growth to fall to 2.7% in FY2020 with a slight uptick to 2.9% in FY2021. The fiscal deficit is estimated to increase to 5.8% of GDP in FY2020 and 9.7% in FY2021, higher than those projected by WEO 2020, as the government increases spending to fight the pandemic and support recovery.

[1] This assessment uses the estimate of public debt in FY2019 from the World Economic Outlook October 2019 database. The government estimate was 102.1%, due to different classification of domestic debt.

[2] IMF. 2018. IMF Article IV staff report. October 2018.

[3] Asian Development Bank, Asian Development Outlook 2020, Manila, April 2020.

Figure 1: Growth projections



Note: Pre-COVID19 forecasts correspond to Asian Development Outlook Supplement, December 2019 forecast. ADO 2020 forecasts assumed only global spill-overs. ADO shorter and longer containment estimates are from ADO 2020.
Source: Asian Development Outlook 2020; World Economic Outlook, April 2020 and ADB estimates.

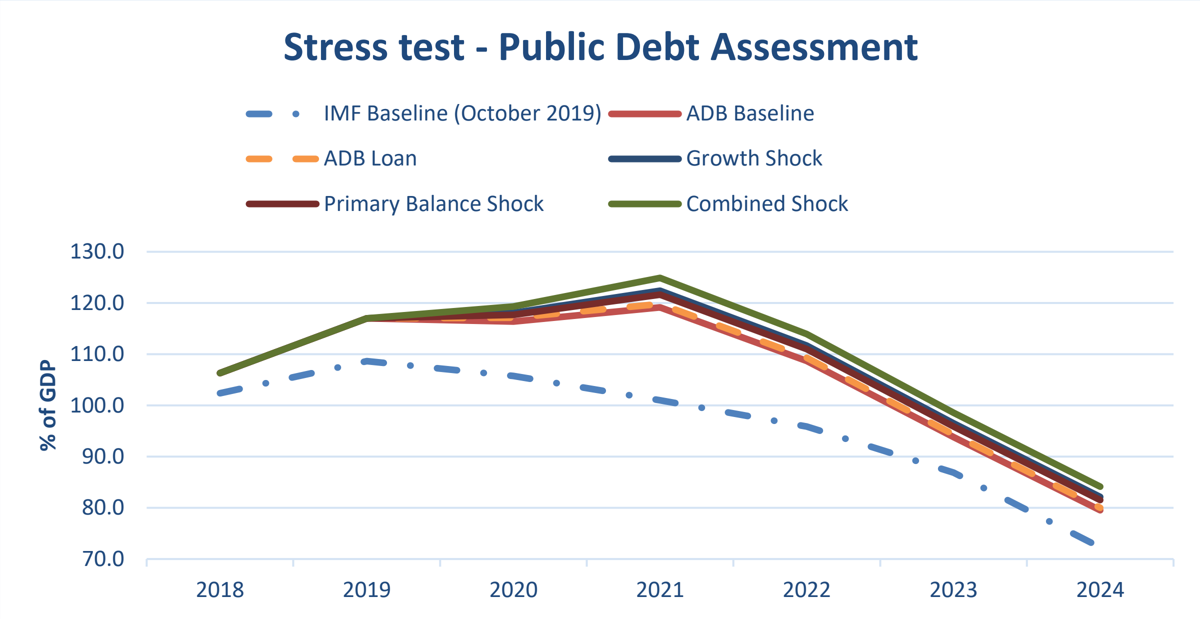
4. **Public and publicly guaranteed debt is expected to rise in FY2021 before falling gradually in the medium term.** The ADB baseline (Table 1) follows the latest WEO growth projections for FY2020 and FY2021 and assumes growth to pick up to an average of 6.8% in the medium-term as the pandemic dissipates and production in the new hydropower projects commences. The primary deficit is assumed at 4.7% in FY2020 and 8.2% in FY2021. In the medium-term, the primary balance is assumed to turn into a surplus. With these assumptions, PPG debt, after falling to 116.4% of GDP in FY2020, will increase to 119.1% in FY2021 as nominal GDP growth falls and the primary deficit rises due to the pandemic. The debt-to-GDP ratio is likely to fall going forward as the economic conditions improve and primary balance turns a surplus and reaches 79.5% in FY2024. The debt path under the baseline is about 11 percentage points on average above the IMF projections from the WEO October 2019 database (with more complete data than WEO 2020), because of data revisions and the adverse impact of COVID-19 on growth and the primary balance.

Table 1: Key Macroeconomic Assumptions

IMF October 2019	***FY2019***	***FY2020***	***FY2021***	***FY2022***	***FY2023***	***FY2024***
Real GDP Growth	5.5	7.2	5.9	6.9	7.2	6.4
GDP Deflator	5.4	4.8	5.2	3.6	4.0	4.3
Effective interest rates	0.9	1.0	1.3	1.2	1.4	6.8
Primary balance % of GDP	-0.5	-0.9	-1.1	0.2	5.1	10.7
Nominal GDP Growth	11.2	12.4	11.4	10.8	11.5	11.0
ADB Baseline						
Real GDP Growth	4.4	2.7	2.9	6.9	7.2	6.4
GDP Deflator	2.7	3.0	3.4	3.6	4.0	4.3
Effective interest rates	1.1	1.0	1.3	1.2	1.4	6.8
Primary balance of GDP	-1.8	-4.7	-8.2	0.2	5.1	10.7
Nominal GDP Growth	7.2	5.7	6.3	10.8	11.5	11.0

Source: World Economic Outlook Database, October 2019 and April 2020; IMF Article IV report, October 2018 and ADB estimate.

Figure 2: Debt Sustainability Assessment Stress Tests



Note: IMF Baseline: based on World Economic Outlook, October 2019; ADB Baseline incorporates the impact of COVID-19; ADB's assistance comprises a loan of $20 million under ADB's countercyclical support facility COVID-19 pandemic response option.
Source: World Economic Outlook Database, October 2019 and April 2020 and ADB estimates.

5. **Risks to the debt-to-GDP ratio arise primarily from delay in commencement of hydropower plants and subdued growth.** Delays and disruptions in hydropower plants will cause the primary balance to remain in deficit. A primary balance shock, assuming the primary balance as a percent of GDP one half standard deviation (1.3 percentage points) below the ADB baseline in FY2020 and FY2021 to be 6.0% and 9.5%, respectively (Table 2), would raise the debt path to peak at 121.6% of GDP in FY2021 before falling more slowly to 81.5% in FY2024 (Figure 2). A prolonged pandemic will have much bigger impact on the economy. A negative real GDP growth shock with growth at 0.5% in FY2021 and 1.8% in FY2021[4] will raise the debt path higher to peak at 123.6% in FY2021 before falling to 83.1% in FY2024. The two shocks combined together will result in a further elevated, yet similarly declining, debt path compared to the baseline.

6. **The impact of an ADB countercyclical facility loan on the public debt path is marginal.** The assistance includes a $20 million under the COVID-19 Pandemic Response Option of the Countercyclical Support Facility. The loan would initially raise the debt-to-GDP ratio to 119.8% in FY2021, 0.7% above the baseline. The debt path would then gradually converge to the baseline due to slow amortization. Under the ADB loan scenario, the debt-to-GDP ratio would fall to 80.0% by FY2024.

[4] Real GDP Growth is one Standard Deviation (2.2 percentage points) below the baseline in FY2021 and one-half standard deviation (1.1 percentage points) in FY2022, along with corresponding falls in growth of the GDP deflator.

Table 2: Underlying Assumptions for Stress Tests

	FY2020	*FY2021*	*FY2022*	*FY2023*	*FY2024*
Real GDP Growth Shock					
Real GDP Growth	0.5	1.8	6.9	7.2	6.4
GDP Deflator	2.6	3.0	3.6	4.0	4.3
Primary Balance shock					
Primary balance % of GDP	-6.0	-9.5	0.2	5.1	10.7
Combined Shock					
Real GDP Growth	0.5	1.8	6.9	7.2	6.4
GDP Deflator	2.6	3.0	3.6	4.0	4.3
Primary Balance % of GDP	-6.0	-9.5	0.2	5.1	10.7

Source: ADB estimates.