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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A PROPOSED PROGRAMMATIC DEVELOPMENT POLICY SERIES

IN THE AMOUNT OF US$20 MILLION
(SDR14.5 MILLION EQUIVALENT)

TO THE KINGDOM OF BHUTAN

FOR A

FIRST FISCAL SUSTAINABILITY AND INVESTMENT CLIMATE DEVELOPMENT POLICY CREDIT

May 15, 2015

Macroeconomics & Fiscal Management and Finance and Markets
South-Asia Region

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GOVERNMENT OF THE KINGDOM OF BHUTAN FISCAL YEAR
July 1-June 30

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of May 15, 2015)

Currency Unit
US$1.00=BTN 63.66

ABBREVIATIONS AND ACRONYMS

ADB	Asia Development Bank
BBS	Better Business Summit
BTN	Bhutanese ngultrum
CAS	Country Assistance Strategy
CFAA	Country Financial Accountability Assessment
CIB	Credit Information Bureau
CPS	Country Partnership Strategy
CRR	Cash Reserve Ratio
CRST	Central Registry Secured Transaction
DANIDA	Danish Development Cooperation
DB	Doing Business
DPC	Development Policy Credit
EDP	Economic Development Plan
EU	European Union
FAD	Fiscal Affairs Department (IMF)
FDI	Foreign Direct Investment
FSA	Financial Services Act
FY	Fiscal Year
GDP	Gross Domestic Product
GNH	Gross National Happiness
GNP	Gross National Product
HIPC	Heavily Indebted Poor Countries
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
INR	Indian rupee
IT Park	Information Technology Park
JICA	Japan International Cooperation Agency
JV	Joint-Venture
JSAN	Joint Staff Advisory Note
KPI	Key Performance Indicator
LDP	Letter of Development Policy
MDGs	Millennium Development Goals
MIC	Middle Income Country
MOE	Ministry of Education
MOF	Ministry of Finance
MOH	Ministry of Health

MSME	Micro Small and Medium Enterprise
MW	Mega Watts
NBFI	Non-Bank Financial Institution
NEPA	National Environment Protection Act
NKRA	National Key Result Area
NPFF	National Pension and Provident Fund
NPL	Non-Performing Loan
PEFA	Public Financial Management Accountability
PER	Public Expenditure Review
PFM	Public Financial Management
PHRD	Japan Policy and Human Resources Development Trust Fund
PPG	Public and Publicly Guaranteed
PPP	Public Private Partnership
PSD	Private Sector Development
RGOB	Royal Government of Bhutan
RMA	Royal Monetary Authority (Central Bank)
ROSC	Report on the Observance of Standards and Codes
RSEBL	Royal Securities Exchange of Bhutan Limited
SAR	South Asia Region
SDC	Swiss Development Cooperation
SDR	Special Drawing Rights
TA	Technical Assistance
UNDESA	United Nations Department of Economics and Social Affairs
UNDP	United Nations Development Program
WBG	World Bank Group

The first Development Policy Credit "Improving fiscal sustainability and Investment Climate" was prepared by an IDA team comprising Geneviève Boyreau (Senior country economist, GMFDR), Korotoumou Ouattara (Senior financial economist, GFMDR), Sabin Raj Shrestha (Senior financial specialist, GFMDR), Massimiliano Santini (Economist, GTCDR), Om Bhandari (IFC Bhutan coordinator), and Tenzin Lhaden (Operation officer/Economist).

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KINGDOM OF BHUTAN

A PROGRAMMATIC DEVELOPMENT POLICY SERIES FOR A FIRST FISCAL SUSTAINABILTY AND INVESTMENT CLIMATE DEVELOPMENT POLICY CREDIT

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SUMMARY OF PROPOSED CREDIT AND PROGRAM

KINGDOM OF BHUTAN

FIRST FISCAL SUSTAINABILITY AND INVESTMENT CLIMATE DEVELOPMENT POLICY CREDIT

Borrower	Kingdom of Bhutan
Implementation Agency	Ministry of Finance
Financing Data	IDA Credit. Terms: 5 years grace period, 25 years of repayment, 1.25% interest rate, 0.75% service charge, commitment charges up to 0.50%, principal repayable at 3.3% and 6.7% per year for 6-15 and 16-25 years respectively. Amount: US$20 million (SDR14.5 million equivalent).
Operation Type	Programmatic (1st of 2), single-tranche.
Pillars of the Operation And Program Development Objective(s)	The proposed DPC aims to promote fiscal discipline, contribute to enhancing access to finance to enterprises, and to improve the climate for business entry and investment in Bhutan. It is articulated around three pillars: (i) Strengthen fiscal discipline and self-reliance; (ii) Increase access to finance; (iii) Improve the business climate and increase domestic/foreign investment.
Result Indicators	By 2017: 1. Fiscal deficit is reduced below 3 percent of GDP. 2. The number of days to start a business is reduced from 32 days to 15 days. 3. Two new Public Private Partnership (PPP) operations are approved. 4. Cumulative Foreign Direct Investment (FDI) increase from US$100 million to US$150 million.
Overall risk rating	Moderate
Climate and disaster risks	Are there short and long-term climate and disaster risks relevant to the operation? No
Operation ID	P147806

PROGRAM DOCUMENT FOR A
PROPOSED IDA CREDIT
TO THE KINGDOM OF BHUTAN

1. INTRODUCTION AND COUNTRY CONTEXT (INCLUDING POVERTY DEVELOPMENTS)

1. **The proposed IDA Development Policy Credit (DPC) of US$20 million is the first of a programmatic series of two that aim to promote fiscal discipline and improve investment climate in Bhutan.** The series focuses on: (i) improving fiscal sustainability after a two-year episode of rupee shortage and bans over imports and credit; and (ii) improving the investment climate to support the development of Bhutan's private sector and job creation. The DPC series is designed to support Bhutan's 11th Five-Year Plan (2013–2018) objective of green socio-economic development and self-reliance. This supports the government's efforts to strengthen its fiscal sustainability and improve investment climate for private sector development as well as its *Doing Business* ranking.

2. **Bhutan's economy is on the rise.** It is a lower middle income country with an impressive poverty reduction record and well on track towards achieving the Millennium Development Goals (MDGs). Bhutan has peacefully transitioned to a democracy, cut poverty down to low levels, and reaped positive results from sustained investment in rural infrastructure such as roads, schools, telecommunications, power, and health centers across a difficult terrain. Its per capita gross domestic product (GDP) is US$2,400, the economy has grown on average between 7 and 8 percent for the past five years, and this performance is likely to continue. Hydropower development, better tourism performance and services lead the country's economic growth. Such a record from a small, mountainous, landlocked country situated between two economic giants (China and India) is remarkable.

3. **Bhutan is subject to step-wise increases in foreign exchange inflows as major hydropower plants begin exporting electricity and new plants are built with external finance**. These rapid inflows have posed a challenge, with shocks leading to boom and bust cycles of aggregate demand. Looking forward, hydropower revenues as a share of GDP will increase substantially, as more hydropower projects start construction and generation. Because hydropower projects are government-owned, these revenues flow to the budget and Bhutan could, as a result, face increasing pressures to expand public sector employment and increase public sector wages. In addition, hydropower-led growth has left little room for private sector enterprises to develop, expand, and generate jobs. One reason for this is the expected real appreciation of the currency, which makes it harder for private firms to compete internationally. That brings two challenges forward:

4. **First, while poised in the long run to receive an increasing amount of hydropower revenue, the country faces, in the short to medium run, large macroeconomic imbalances**. Bhutan's large current account deficit stands at about 21 percent of GDP. This external deficit is reflected in the financing by domestic revenues of only 65 percent of government spending, the rest being financed by donors' resources. Over the coming four to five years, monetary and fiscal consolidation will be needed to contain domestic demand and avoid a new episode of rupee shortage in the financial system. Undertaking these measures would also limit real currency

appreciation pressures and provide for a more stable financial sector, better equipped to provide financial services to micro-, small-, and medium-sized enterprises (MSMEs), which make up more than 90 percent of enterprises in Bhutan.

5. **Second, while the public sector has been, in the past, the preferred employer, there is a need now to turn increasingly to the private sector for sustainable growth and job creation.** As more young people enter the labor market every year, the government's ability to absorb new workers has reached a saturation point. While total unemployment remains low at 2.9 percent, youth unemployment was 9.6 percent in 2013 and is on the rise. The private sector plays a limited role in the economy. With nascent entrepreneurship, several factors affect the competitiveness of firms operating in Bhutan. These include a challenging terrain, limited access to finance and markets, a difficult investment climate, and low productivity levels. Investment climate reforms are needed to allow the private sector to contribute to economic diversification and job creation.

6. **Bhutan's record of poverty reduction, shared prosperity and gender equality is strong**. Poverty reduction in Bhutan has been rapid and broad-based and other social indicators have improved. Both consumption-based poverty measures and multi-dimensional poverty indicators show that the percentage of poverty was cut by nearly half in five years—from 23 percent in 2007 to 12 percent in 2012. On average, per capita consumption of the bottom 40 percent has grown faster than for the rest of the population. Bhutan has almost eliminated extreme poverty (US$1.25 purchasing power parity terms, per day per person) within the living memory of a generation. Primary drivers of rapid poverty reduction and shared prosperity are agriculture commercialization, rural infrastructure, and spillovers from the construction of hydroelectric projects. Meanwhile, Bhutan has attained or is on track to achieve most of the MDGs. Bhutan has also made considerable strides in closing gaps in gender equality, making it comparable to higher middle income or OECD countries. Areas where gender gaps persist are: (i) agricultural land holding and inheritance practices, and (ii) gender gaps in labor markets and job quality.

7. **That said, the reduction in poverty has been accompanied in rural areas by rising vulnerabilities and, in urban areas, rising youth unemployment, magnified by rural-urban migration**. The chronically poor constituted two-thirds of all poor people in 2012. The absence of formal social protection institutions and targeting mechanisms for the chronically poor could be shackling them in a poverty trap. Urbanization is on the rise, with the capital, Thimphu, attracting most rural migrants. The proposed DPC operation, by supporting investment climate reforms for private sector development to generate jobs, aims to contribute to absorbing new labor market entrants in urban areas.

8. **Risks in this operation include:** (i) *Macroeconomic risks*. The main risk is that aggregate demand pressures re-emerge and lead to another episode of rupee shortage. This risk is mitigated by policy measures that the government is pro-actively taking and which are supported by this operation. (ii) *Implementation risks*. Technical capacity constraints and lack of inter-agency coordination call for the provision of appropriate technical assistance to support the government in implementing reforms. The proposed series is backed-up by technical assistance. (iii) *Political economy risks*. While political will at the highest level is strong, pressures to spend as elections get closer might compromise the reform momentum. This risk is mitigated by the timing of this operation at the beginning of the political cycle and strong government ownership and commitment.

2. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

9. **Growth in Bhutan has been volatile, dependent on the hydropower sector and disbursements from India.** Macroeconomic cycles follow closely developments in the hydropower sector, given the magnitude of these projects compared to the size of the economy. The economy is estimated to have grown at 6 percent in FY2013/14, constrained by various administrative restrictions. These restrictions were put in place in FY2012/13 on credit, foreign exchange and imports, limiting the expansion of aggregate demand to respond to the rupee shortage.[1] This led to a sudden halt in construction and service growth, which, combined with a poor record in agriculture, contracted growth to 5.6 percent, the lowest level since 2008.

10. For the first half of 2014, hydropower generation declined by 2 percent year-on-year (annualized) compared to 2013, due to reduced rainfall (hydropower projects are run-of-the river, so generation depends on the amount of rainfall). Meanwhile, tourism recorded a marked expansion, following the introduction of new measures aimed at boosting tourism during the low season months of June to August.[2] Tourist arrivals more than doubled in June and July, and grew by 12 percent year-on-year as of July 2014. Construction in hydropower has been sustained by four projects built at an average annual investment of 28 percent of GDP. Domestic sales of cement, a good proxy for construction-sector activities, slowed markedly in the first half of 2014, despite the BTN10.9 billion (about US$180 million) Dungsam Cement mega-project starting production—but at less than 50 percent capacity.

Figure 1: Economic Growth

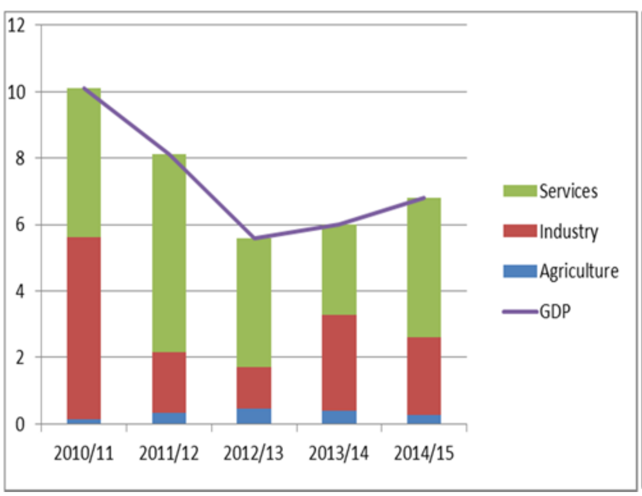
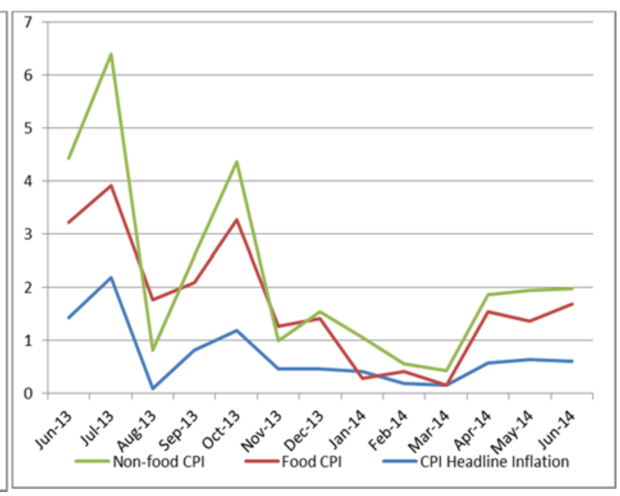


Figure 2: Monthly inflation



Sources: National Statistical Bureau and Macroeconomic Framework Coordination Committee

[1] At the end of 2011, a combination of loose macroeconomic policies, a public sector pay increase, rapid credit growth, and a consumption boom led to a shortage of Indian rupees to pay for imports.
[2] Under the Bhutan-Thailand friendship initiative, Thai residents were offered a special package during the low season, including a 50 percent discount in airfare and hotel, and did not have to pay the mandatory minimum daily rate of US$200 a day for the lean season. Instead, they would be only levied the daily royalty of US$ 65.

11. **With 75 percent of Bhutan's imports coming from India and an exchange rate at par with the Indian rupee, Bhutan's consumer inflation is intimately linked to India's.** Food and beverages have the heaviest weighting in Bhutan's consumer price index, at 36.9 percentage points, and since most are imported from India, they will continue to have the strongest impact on overall inflation. Consumer price inflation in Bhutan has slowed to 8.1 percent in June 2014 year-on-year, from 11.3 percent at the end of 2013. This decline was mainly driven by inflation easing in India.

12. **Tighter public spending has kept the fiscal deficit below 5 percent of GDP, despite a decline in revenues.** Overall, the fiscal deficit is estimated at 4 percent of GDP in FY2013/14, about the same as in FY2012/13**.** Total spending in FY2013/14 contracted by almost one percentage point of GDP. Given the risk of shortage of rupees, the government has tightened expenditures to bring them in line with available resources.

13. **Domestic revenues declined to 28.5 percent of GDP in FY2013/14 from 29.3 percent of GDP in FY2012/13 due to lower non-hydropower revenues, following the slowdown of economic activities, which led to lower income tax excise duties and non-tax revenue**.[3] Hydro revenue remained stable at 3.7 percent in FY2013/14, with no new projects starting generation.

14. **The new FY2014/15 budget, approved in July 2014, features an upward revision of public compensation**. Civil service wages and allowances have been increased by 21 percent. That increase corresponds to a 0.7 percentage point increase of GDP and has been partly offset by a reduction in other current expenditures. Because public wages had not been revised since November 2010, the increase corresponds to a catching up of purchasing power of civil servants. Another important feature of the FY2014/15 budget is the introduction of new taxation measures on vehicle imports to replace the ban on vehicle imports. Following the move, the Royal Monetary Authority (RMA, Bhutan's central bank) also lifted other restrictions on access to foreign exchange and credit, while introducing strengthened macro-prudential measures in banks. New taxes included a fuel tax of 5 percent, an increase in tax on vehicle imports (other than from India) between 100 to 180 percent, and a sales tax on Indian vehicles of 55 percent. Nevertheless, it will be important to tighten fiscal policy and to sterilize hydropower-associated financial inflows through monetary policy.

15. **Overall, the approved budget's fiscal deficit for FY2014/15 is a low 2.7 percent of GDP, reflecting the prudent approach of the government**. Revenues and grants are estimated at a conservative 24.6 percent of GDP (down by 4 percentage points) and public spending is tightened, despite the increase in public wages.[4]

Table 1. Wage Bill revision (aggregate)

Wage Bill breakdown (Nu million)	Before	After
Salary	4,855	6,009
Lumpsum salary allowance	643	
Allowance	969	2,084
Total	7,485	9,283
% GDP	6.4%	7.2%

Source: MOF and Royal Civil Service Commission

[3] From 2013/14 onwards, the excise tax retroceded from India to Bhutan will cover one year, instead of two.
[4] The drop of the capital budget from 17.5 to 11.7 percent of GDP does not reflect the actual projections of capital spending, but provide merely a very conservative estimate of committed donor resources for the year, hence the drop in revenue and grants.

16. **Bhutan runs a large current account deficit due to an increasing demand for imports**. In June 2014, the current account deficit was estimated at about 21 percent of GDP, of which around 10 percent was (self-financed) hydropower imports: the remainder was split between fuel and consumption goods—both private and public imports. Since the rupee exchange rate is fixed, the market price signal is not provided adequately to consumers importing goods from India. Signaling the market foreign exchange scarcity is left to the RMA through ad-hoc monetary policy measures or interventions. To curb the two most important consumer durables, the government has imposed credit restrictions on housing construction and higher taxes on imported automobiles.

Figure 3: Balance of payments (% GDP)

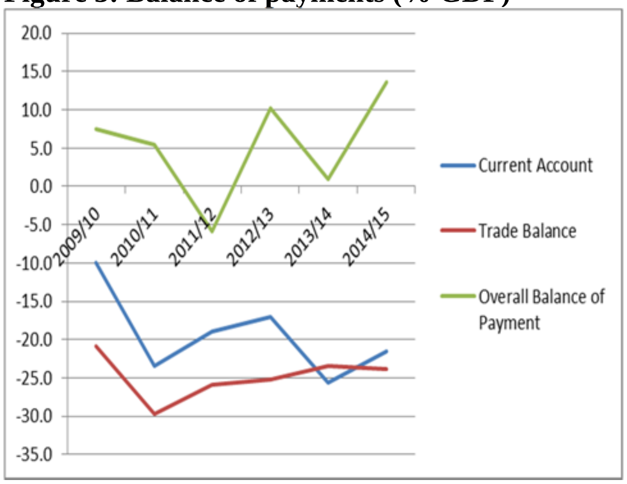
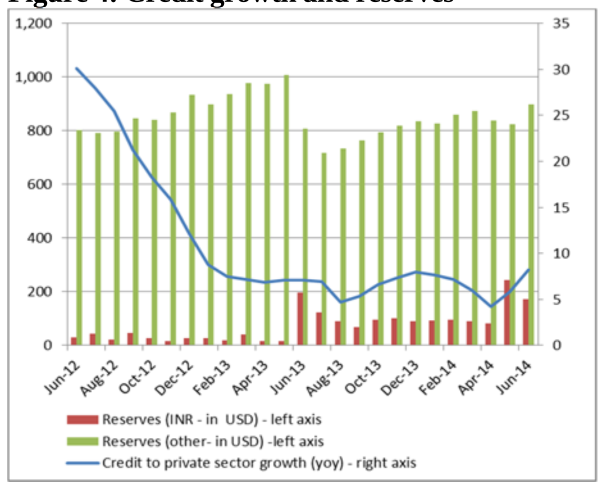


Figure 4: Credit growth and reserves



Source: Royal Monetary Authority

17. **Export earnings come primarily from sales of electricity, mining-related activities, and tourism.** Since no new hydropower projects have become operational since 2006, the fluctuation in export revenues reflects the vagaries of hydrological flows. The potential for future increases remains strong: India receives almost 90 percent of Bhutanese electricity exports, and continued power shortages in India will ensure strong demand for electricity. Exports of minerals and mineral-based products account for about a half of exports of goods and services; hydropower exports comprise about one third, and manufacturing a tiny 4 percent.[5] The tourism sector has turned into an important contributor of export revenues in recent years, amounting to 13 percent of exports of goods and services**.** Tourism revenues (from convertible currency-paying tourists) expanded at an average of 15 percent per year between 2008 and 2013. New measures to attract tourists have contributed to this growth and will continue.

18. **The current account deficit is essentially financed by donor resources, to which India contributes the most** through loans and grants to finance hydropower development. That results in a significant national dissaving coming from the trade deficit and the need for the country to borrow to finance consumption. This cannot be sustained over the long-term. Foreign Direct Investment (FDI) finances a low 8 percent of the capital account (about US$ 20 million). The

[5] Ferro-silicon, steel and silicon industries accounted for about BTN11 billion of exports earning in 2013, about the same as hydropower earnings (BTN 11 billion). This energy-capital intensive industry, located for the most part in Pasaka, an industrial zone at the bordering India, benefits from the relatively low cost of electricity in Bhutan and proximity of the Indian market.

recent revision of the FDI policy, supported by this operation, should contribute to attracting more foreign investment into the country.

19. **Gross international reserves are currently equal to 17 months of goods and service imports.** At the end of June 2014, international reserves were US$ 997.9 million, 83 percent of which was in convertible currency and the rest in Indian rupees.[6] There is a continuing mismatch in the composition of Bhutan's reserves and the structure of its international transactions, as the country primarily needs Indian rupees for trade settlement and debt service. To start addressing this issue, the RMA has implemented new reserve policy measures that allow the conversion of convertible currency reserves into Indian rupees above a threshold of US$ 700 million.

20. **Bhutan's external public and publicly-guaranteed (PPG) debt stands at a high 100 percent of GDP at end 2014, but about two thirds come from self-sustaining export-oriented hydropower projects**. These hydropower projects carry their own creditworthiness by promising to produce–after covering their debt obligations–substantial earnings, with very limited risks for the Government of Bhutan (see section 2.2 below). The Government of India is the main financier and buyer of the electricity generated by these projects – in Indian rupees. As a result, a large portion of external debt–58 percent–is denominated in Indian rupees. External convertible currency PPG debt outside hydropower projects stands at a 32.2 percent of GDP and comes from concessional loans from multilateral financial institutions and bilateral donors (Austria, Denmark and Japan). Domestic debt is a low 2.5 percent of GDP.

21. **Vulnerabilities in the financial sector have accumulated after the shortage of rupees which led to a liquidity constraint and tightening of lending**. From early 2013 to June 2014, private credit growth slowed markedly from 30 percent to an average of 7-8 percent annually, due to the strict tightening of credit and foreign exchange availability (see Table 3). Credit growth is expected to rebound with the lifting of restrictions.[7] Non-performing loans are on the rise—up to 12.1 percent as of June 2014 from 10.1 percent a year before, following the sudden halt of rapid credit growth. Even so, the financial sector remains adequately capitalized, with a capital adequacy ratio of 18.9 percent in June 2014, which is above the institutional requirement. Yet vulnerabilities arise from asset-liability mismatches, with a significant proportion of the deposit base being corporate deposits, whereas bank credit is concentrated in loans with longer time horizons to finance projects. More than a quarter of the financial sector's portfolio consists of building and construction loans, followed by 16 percent for personal loans. Little goes to the productive MSME sector.

22. **Efforts to deepen the financial sector in a sustainable manner are underway.** A comprehensive Financial Sector Development and Implementation Strategy is being prepared with a careful sequencing of reforms within a medium-term plan. It will emphasize the importance of balancing further deepening with maintaining financial stability. It will promote alternatives to bank financing for the private sector firms, especially MSMEs including improving information and market infrastructure such as broadening coverage of the credit bureau and enhancing the collateral registry. The proposed DPC operation supports these efforts.

[6] The Constitution requires that foreign exchange reserves should be maintained at 12 months of essential imports.

[7] On September 1, 2014, RMA lifted the ban that had been imposed on housing and vehicle loans in March 2012. Consumer loans guidelines have also been issued as a pre-emptive measure by the RMA to mitigate systemic risk that could arise from potential build-up of risks particularly in these sectors.

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

23. **The macroeconomic outlook is positive, but macroeconomic pressures on domestic demand will have to be managed.** Economic growth is projected to be 6.8 percent in FY2014/15, 7.3 percent in FY2015/16 and about 7 percent thereafter. Growth drivers are a combination of: (i) on-going hydropower developments and construction; (ii) macroeconomic stability and the lifting of restrictions; and (iii) good performance of the tourism sector, with innovative measures. Aggregate demand is likely to regain momentum in the next 12 months. Consumption will rebound following the lifting of administrative restrictions and the increase in civil service salaries in July 2014. Investment will be sustained with continued inflows into the hydropower sector. Donor resources, in particular from India, are expected to continue funding an important part of the government budget, while reform efforts should improve government self-reliance and private sector development.

24. **Bhutan's inflation is expected to rebound to 10 percent in FY2014/15**. Structural drivers of inflation in India, including rising food prices, are expected to persist. Domestic factors will push up prices, including the civil servant wage increase, the introduction of a 5 percent fuel tax and a scheduled increase in electricity tariffs by up to 15 percent.

25. **The fiscal accounts are projected to remain in check.** This is assuming prudent management of current spending, projected to remain stable as a share of GDP (above 16 percent), and conservative assumptions on capital spending funded out of foreign aid. There is need in the short- to medium-term to improve tax collection, by limiting exemptions and improving tax administration and policies. The Bhutan tax ratio over GDP stands at a low 13 percent of GDP. Keeping spending under check and improving spending efficiency will also be important. The proposed DPC is supporting efforts to strengthen fiscal sustainability.

26. **Over the short- to medium-term, the current account deficit should decline slightly, following efforts to contain demand for imports.** The latter include fiscal measures through prudent public spending, new taxation measures on imports of vehicles and fuels, and prudent debt policy to finance capital spending that is borrowing targeted to productive capital spending. Export earnings are expected to increase, starting by the end of 2017 with the commissioning of the Punasangtshhu 2 hydropower project (1,200 MW).

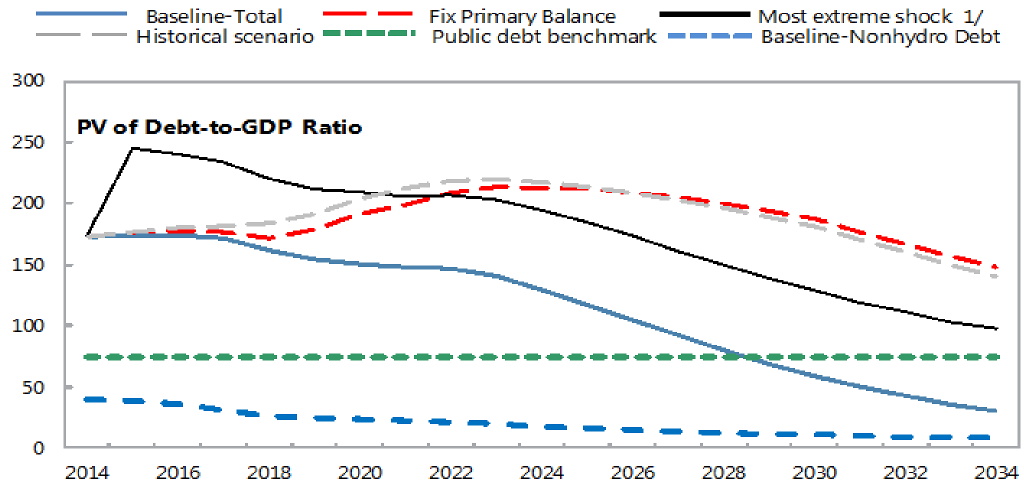
27. **Based on the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries, Bhutan's risk of external debt distress is moderate.** Bhutan's rapid hydropower development is projected to lead to a substantial buildup of external debt in the medium-term, with debt ratios breaching most of the country-specific indicative thresholds for protracted periods of time. But Bhutan's debt situation is expected to improve over the long run, reflecting significantly higher electricity exports when more hydropower projects come on stream.[8]

28. **The assessment is primarily based on unique mitigating factors, namely explicit guarantees from India that cover financial and construction risks for the hydropower projects, thus allowing for the exceptional treatment of hydropower loans from India as similar to FDI—i.e., non-debt creating**. Other mitigating factors include Bhutan's strong track record of project implementation, rapid growth in energy demand from India, committed donor support, and Bhutan's high level of international reserves. Notwithstanding these mitigating

[8] Joint Bank-Fund Debt Sustainability Assessment, 2014.

factors, any new non-concessional borrowing should be carefully considered, as the level of debt has increased substantially compared to previous assessments. Stress tests to public sector debt dynamics reveal the need for fiscal consolidation and the importance of sustaining rapid economic growth going forward. The proposed DPC aims at improving the sustainability of public finances.

Figure 5: Projected present value of public debt to GDP ratio - various scenarios



Source: Bhutan Joint Bank-Fund Debt Sustainability Assessment, 2014

29. **The macroeconomic framework is appropriate for the proposed Fiscal Sustainability and Investment Climate DPC operation.** Foreign exchange reserves have been rebuilt following the rupee shortage and have reached 17 months of imports. Hydropower projects under construction or in the pipeline provide a strong basis for increased exports earnings and revenues. It is not anticipated that this IDA credit will have any adverse impact on debt sustainability, given that terms are concessional and that this operation will support better fiscal sustainability and private sector development, which will generate more public revenues through taxes.

30. **Against the background of a positive outlook, downside risks need to be managed:**

- On the *external front*, the current account deficit is large. While international reserves are at comfortable levels, there is a mismatch in the composition of Bhutan's reserves—88 percent of which was in convertible foreign exchange—and the structure of its international transactions, as the country primarily needs Indian rupees for external payments. Moreover, these reserves have been accumulated over years from external assistance, tourism earning and hydropower.[9] They could rapidly drop unless an appropriate policy stance is in place.
- Although the *fiscal deficit* has remained below 5 percent of GDP, domestic revenues and tax efforts are low (19 percent and 13 percent of GDP, respectively) and only cover about 65 percent of total expenditures. The expected boost in economic activity could risk a resumption of overheating and macro imbalances. It will be important for monetary policy to sterilize hydropower related inflows and for fiscal policy to be tightened in light of: (i) disbursements under the economic stimulus; (ii) increases in the public service wage bill; and (iii) relaxation of restrictions over foreign exchange, vehicle imports, and housing loans.
- These *risks are mitigated* by policy measures and monitoring put in place by the government. The

[9] The Constitution requires that foreign exchange reserves should be maintained at 12 months of essential imports.

RMA has issued a revised reserve management policy and strengthened macro-prudential regulations for banks. The Parliament has approved taxation measures on vehicles and fuel imports, which have been the two main sources of demand for rupees. The proposed DPC operation supports fiscal sustainability and the government's objective of fiscal self-reliance.

2.3. IMF RELATIONS

31. **Bhutan is on a two-year Article IV cycle.** A review took place in February 2014 with a joint Debt Sustainability Assessment presented to the IMF Board in July 2014. In addition, the IMF provides technical assistance, which focuses on macro-fiscal, budget, cash management, and e-payments. A long-term IMF advisor on budget management is based in Thimphu. The proposed DPC operation is consistent with and reinforces the IMF Article IV recommendations on the fiscal side and on financial deepening. It also complements the macro-fiscal support provided by the IMF, and brings additional depth to key structural efforts over the medium term in investment climate and private sector development.

Table 2: Fiscal developments and outlook

Fiscal Sector	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
	Actual	Actual	Actual	Revised	Budget	Proj.	Proj.
Revenue & Grants	**35.6%**	**35.2%**	**29.3%**	**28.5%**	**24.6%**	**28.9%**	**27.8%**
Domestic Revenue	**22.0%**	**22.0%**	**20.2%**	**18.8%**	**18.9%**	**17.7%**	**17.5%**
Tax revenue	14.6%	15.8%	14.7%	13.2%	13.6%	13.1%	13.1%
Non-tax revenue	7.4%	6.1%	5.5%	5.6%	5.4%	4.7%	4.4%
Grants	**13.3%**	**13.5%**	**9.2%**	**9.6%**	**5.7%**	**11.1%**	**10.3%**
GoI	10.0%	9.7%	4.5%	6.5%	3.7%	7.3%	7.4%
Others	3.3%	3.8%	4.7%	3.1%	2.0%	3.8%	2.9%
Other receipts	0.3%	-0.2%	0.0%	0.1%	0.0%	0.0%	0.0%
Outlay	**37.7%**	**36.3%**	**33.4%**	**32.5%**	**27.3%**	**28.7%**	**27.5%**
Total Expenditure	37.3%	37.6%	35.0%	34.1%	28.6%	30.2%	28.7%
Current	18.6%	18.0%	17.3%	16.6%	16.9%	16.4%	16.1%
o/w interest payment	2.3%	2.0%	2.5%	1.8%	1.6%	1.5%	1.3%
Capital	18.7%	19.6%	17.6%	17.5%	11.7%	13.8%	12.6%
Net lending (NL)	-1.1%	-1.1%	-0.7%	-1.6%	-1.3%	-1.5%	-1.3%
Fiscal Balance	**-2.1%**	**-1.1%**	**-4.1%**	**-4.0%**	**-2.7%**	**0.1%**	**0.4%**
Net Borrowings	0.4%	-1.5%	0.5%	0.1%	-1.0%	0.0%	0.0%
Borrowings external	-0.2%	-0.2%	-0.2%	-0.2%	-0.1%	n.a.	n.a.
Borrowings internal	0.6%	-1.3%	0.6%	0.2%	-0.9%	n.a.	n.a.

Table 3: Key Macroeconomic indicators and outlook

Indicator	Actual 2011/12	Actual 2012/13	Estimate 2013/14	Projected 2014/15	Projected 2015/16	Projected 2016/17
Gross domestic product (US$ million at current prices)	1,815	1,975	2,298	2,460	2,772	3,114
Consumer price index (% change)	13.5	5.5	8.0	8.0	n.a	n.a
Real annual growth rate	8.1	5.6	6.0	6.8	7.3	7.0
Balance of Payments (% GDP)	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
Exports	56%	48%	41%	41%	40%	38%
Imports	34%	30%	25%	25%	23%	22%
Trade balance	-22%	-18%	-16%	-17%	-17%	-17%
Current account balance	-22%	-23%	-21%	-24%	-23%	-22%
FDI (US$)	24	21	20	25	27	30
Reserves (US$)	674	917	895	1,177	1,311	1,294
Public finance (as % of GDP at market prices)[c]	actual	actual	estimate	(budget)	2015/16	2016/17
Expenditures	36.3	33.4	32.5	27.3	28.7	27.5
Revenues	35.2	29.3	28.5	24.6	28.9	27.8
Fiscal Balance	-1.1	-4.1	-4.0	-2.7	0.1	0.4
Monetary indicators	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
M2/GDP	58.8	58.2	58	n.a	n.a	n.a
Growth of M2 (%)	-1	18.6	6.6	n.a	n.a	n.a
Private sector credit growth	30.1	7.1	8.2	n.a	n.a	n.a
Total credit growth (%)	51.3	12.8	0	n.a	n.a	n.a
External PPG debt (% GDP)	75	91	91	106	117	122
o. w hydro publicy guaranteed	*45*	*52*	*58*	*73*	*84*	*91*
Exchange rate (BTNu/US$)	47	49	56	60	60	60
Statistics follow Bhutan's fiscal year (July to June), except blance of payment and debt data (calendar year)						
source: Government medium-term fiscal framework and Staff estimates						

3. THE GOVERNMENT'S PROGRAM

32. **"Self-reliance and inclusive green socio-economic development" are the overarching objectives of Bhutan's 11th Five-Year Plan**.[10] A notable paradigm shift of the 11th Plan is the adoption of a results-based planning framework that articulates clear outcomes and outputs to realize the objectives. The government has identified 16 National Key Result Areas (NKRAs), national outcomes and outputs, to be achieved over the next five years. The 16 NKRAs are described under the four pillars of Gross National Happiness (GNH), the philosophy and framework which guides Bhutan's development:

- **Sustainable and Equitable Socio-economic Development**: Sustained Economic Growth; Poverty Reduced and MDG Plus achieved; Food Secure and Sustained; and Full Employment. The achievement of these four NKRAs are measured by corresponding Key Performance

[10] The 11th Five-Year Plan is the second five year plan to be implemented since the introduction of democratic constitutional monarchy in 2008. It was approved by Parliament in October 2013. Self-reliance is defined as being able to meet national development needs as articulated through the Five Year Plans by 2020. Inclusive Social Development requires reducing poverty and inequality by enhancing the standard of living and the quality of life of the most vulnerable sections of the society. Green Development means ensuring carbon neutral development at all times.

Indicators (KPIs) such as the annual GDP growth rates, inflation, poverty, enrollment, mortality, employment, the cereal sufficiency target, and so on.

- **Preservation and Promotion of Culture**: Strengthened Bhutanese Identity, Social Cohesion and Harmony; and Indigenous Wisdom, Arts and Crafts Promoted for Sustainable Livelihood. The corresponding KPIs to measure progress include the GNH Index, rural households engaged in cultural industries, and jobs created.
- **Conservation and Sustainable Utilization and Management of the Environment**: Carbon Neutral/Green and Climate Resilient Development; Sustainable Utilization and Management of Natural Resources; Water Security; and Improved Disaster Resilience and Management Mainstreamed. The NKRAs have corresponding KPIs to measure performance.
- **Promotion of Good Governance**: Improved Public Service Delivery; Democracy and Governance Strengthened; Gender Friendly Environment for Women's Participation; Corruption Reduced; Safe Society; and Needs of Vulnerable Group Addressed. KPIs such as reducing the turnaround time for Government to Citizen, Government-to-Business and Government-to-Government services; monitoring government performance; drafting legislation to ensure quota for women in elected offices; reducing female unemployment; implementation of national anti-corruption strategy; and reducing crime per 1,000 population is the basis for tracking progress towards these NKRAs.

4. THE PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

33. The proposed operation is the first single-tranche credit under a two-phase framework aimed at supporting the 11th Five-Year Plan's pillar of sustainable and equitable socio-economic development. It supports the macro-fiscal and investment climate components of the government's program, which are focused on: (i) macroeconomic sustainability and fiscal governance; (ii) reduced volatility in liquidity and credit; (iii) government's ability to support counter-cyclical interventions to sustain the desired level of growth in the economy; (iv) priority areas identified for investment and private sector development; and (v) investment in foreign government bonds. The 11th Five-Year Plan includes specific objectives in terms of macro-fiscal stability, *Doing Business* indicators, and FDI increase. The DPCs' support to improving the investment climate also contributes to the development of key sectors for economic growth such as agriculture, tourism, trade, industries, and mining.

34. **The Program Development Objective is to promote fiscal discipline, contribute to enhancing access to finance to enterprises and to improve the climate for business entry and investment in Bhutan.** The proposed operations are structured around three pillars. The first pillar focuses on actions that strengthen fiscal sustainability and self-reliance. This will also contribute to a more stable financial sector that is better able to achieve the objective of the second pillar, which seeks to increase access to finance, in particular for MSMEs. The third pillar supports reforms to improve the business climate and increase domestic and foreign investment. The first operation in the proposed two-operation program consists of nine prior actions. This operation also identifies 10 indicative triggers, to be achieved by December 2016, which will form the basis for the second operation. However, these triggers will be reviewed and revised as appropriate at the

time of DPC2 preparation in alignment with findings of analytical work underway (public finance piece and investment climate programmatic TA). Both the prior actions and triggers are summarized in Annex 1 and discussed in Section 4.2 below.

35. **The design of this operation includes country-specific lessons from past operations**. The 2014 Country Partnership Strategy Completion Report notes that: "Programmatic approaches will have unique advantages for Bhutan's future lending. Budget support operations provided an important forum for dialogue especially on issues related to structural reform. The programmatic policy lending series helps to sustain the momentum of reforms while enabling the WBG to remain engaged with the government in supporting the implementation of policy reforms. This approach helps build a constituency for the reform program in a well-sequenced and incremental way. The full integration of analytical work, technical assistance and policy financing is important to maximize results and impact."

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

4.2.1. Macroeconomic and Fiscal Sustainability

36. **Managing aggregate demand is crucial for macroeconomic stability in Bhutan**. The government and RMA acknowledge the need to tame consumption expenditure, particularly imports, to sustain the peg of the Bhutanese ngultrum with the Indian rupee. As explained in the macroeconomic section above, at the end of 2011 the government imposed several administrative measures that included a ban on imports of vehicles (one of the main items responsible for the spike in rupee demand and subsequent shortage) and restriction on foreign exchange accessed by banks, in particular for personal and constructions loans. These administrative restrictions were lifted in July 2014, with the introduction of taxes on vehicles and fuel, thereby reducing the demand for rupees and increasing government revenues while minimizing market distortions **(prior action 1).** These fiscal measures were followed by monetary policy interventions (i.e., strengthened macro-prudential rules) to enhance scrutiny over credit.

Prior Action 1: The Recipient: (a) through RMA, has issued the RMA Official Communication that lifts the policy ban of March 2012 imposed on the provision of housing and vehicle loans by financial institutions; and (b) through MoF, has issued the Tax Public Notification that raises custom duties, sales taxes and green taxes of selected goods.

37. **Improved fiscal responsibility will supplement the efforts for smoothing consumption**. A fiscal rule, with debt ceilings and limits on deficits, is being considered. The World Bank is providing advice on the policy, which is scheduled to be discussed by Cabinet by the end of 2014 **(trigger 1).**[11]

Trigger 1: Cabinet approves a debt policy setting debt limits to improve fiscal sustainability.

38. **Enhancing tax collection is an integral component of achieving fiscal self-reliance.** The tax-to-GDP ratio stands at a low 13 percent, and on a declining trend. Numerous tax exemptions and holidays have weakened the tax base, without clear evidence of contribution to private sector

[11] See Annex 1 for a combined list of prior actions and triggers.

development. A review of these exemptions and holidays is warranted, and will inform tax rationalization measures (**trigger 2**).[12]

Trigger 2: MoF approves tax rationalization measures to improve efficiency and broaden the tax base.

39. **Expected Results**: A prudent debt policy, higher taxation on vehicles, and a reduction of tax exemptions will contribute to keeping the fiscal deficit below 3 percent of GDP, and raise tax revenues from 13 percent of GDP to 15 percent.

4.2.2. Fostering Financial Sector Development

40. **There are several reasons why firms and especially SMEs have limited access to financial services in Bhutan**. As revealed by the World Bank Enterprise Survey (2009), the top constraint that firms face was and remains access to finance. The procedures for acquiring a loan are complex, collateral requirements are high and the regulations governing their use are restrictive. Implementation of the proposed legal reforms described below (Movable and Immovable Property Act, Bankruptcy Act) to improve financial infrastructure (collateral registry, credit information bureau, and land registry) and strengthen the legal rights of creditors and borrowers go a long way in addressing the constraints to finance.

Improving the Use of Collateral Registry for Credit Access by MSMEs

41. **In Bhutan, small firms do not have access to land to use as collateral**. However, they have moveable assets—such as machinery, inventory, accounts receivables, and equipment. The legal and institutional framework plays an important role in facilitating the use of such movable assets as collateral to secure a loan without having to give up possession of those assets while running a business. Improving the use of collateral registry in Bhutan to increase access to credit by MSMEs calls for amendments of several laws including: the Movable and Immovable Property Act (prior action 2) and the Bankruptcy Act (trigger 3). These actions are necessary to make the Central Collateral Registry function according to international best practice (prior action 3).

Movable and Immovable Property Act

42. **The Movable and Immovable Property Act (MIPA) of 1999 provides the legal framework for secured transactions in Bhutan**. However, some provisions are in conflict with the Companies Act of 2000, which introduced secured transactions elements of common law as well as the collateral registry regulations by the RMA. An improved MIPA has the potential to: (i) increase the level of credit; (ii) decrease the cost of credit; and (iii) increase access to finance (**prior action 2**).

Prior Action 2: The Recipient, through its Cabinet, has approved for submission to its Parliament a bill that amends the Movable and Immovable Property Act (MIPA) in order to facilitate the effective usage of movable assets as collaterals.

[12] Trigger #2 will be clarified and appropriately formulated at the time of DPC2.

Resolving Insolvency and the Bankruptcy Act

43. **In Bhutan, *Doing Business* reports "no practice" of insolvency, and no formal or informal guidelines to facilitate rehabilitation and cooperation among banks**. Where insolvency regimes are most effective, creditors—confident that they will be able to collect on loans—are more likely to lend, including to borrowers with whom they have not had a long-standing relationship. The authorities are reviewing the Bankruptcy Act (1999) and the Companies Act (2000) to evaluate the existing insolvency provisions and where new provisions should be introduced for effective implementation **(trigger 3).** Both laws regulate the winding up of a company (although the Bankruptcy Act generally covers non-incorporated entities, in specific situations it also applies to corporations—though this needs to be made explicit). Overall, the insolvency system needs to be simplified.

Trigger 3: Cabinet approves the amendment of the Bankruptcy Act to provide for a framework for businesses to resolve insolvency and strengthen the rights of secured creditors.

Collateral Registry

44. **A good collateral registry helps increase access to finance, especially for small firms.** Its operation would need to take into account international good practices such as: (i) flat and reasonable fees for registrations and searches; (ii) non-cash payments (debit/credit cards, electronic transfers, or pre-paid accounts); (iii) secured and protected registry data, with established disaster recovery sites; and (iv) a priority scheme that ensures that secured creditors are ranked as high as possible. In August 2013, the RMA launched the Central Registry for Secured Transaction (CRST), a collateral registry for movable and immovable goods. The registry has been operating since July 1, 2014, but is currently limited to collection of data of existing loans and registering liens only in case of new collaterals. Data related to vehicles and inventory/stock were put into the system in December 2014. The Central Bank (RMA) has plans to make the registry fully functional by the first quarter of 2015, and strengthen legal rights for secured creditors as well (**prior action 3**).

Prior Action 3: The Recipient, through RMA, has issued the CRST Public Notification that improves access to credit by, *inter alia*, small and medium enterprises through the usage of movable assets as collaterals by requiring the registry of them in the Central Registry for Secured Transaction (CRST).

45. **<u>Expected Results</u>:** An improved legal framework for collateral and a fully functional collateral registry following international best practice will contribute by 2017 to:

- Increasing access to credit: The number of MSME loans in collateral registry increases by at least 40 percent.
- Strengthening the legal rights of secured creditors: The *Doing Business* "strength of legal rights" index[13] increases from 4 to 6 (out of 12).

[13] Measures compiled in the "strength of legal rights" index focus on whether collateral and bankruptcy laws include certain features that facilitate lending. The higher the index, the stronger the legal rights of borrowers and lenders. The legal rights index which was measured on a scale of 10 in DB 2013 is now measured on a scale of 12 after two new points were added to the data collected in 2014 to assess the overall legal framework for secured transactions and the functioning of the collateral registry.

Land Registry and Registering Property

46. **Currently, all records in the land registry and in the cadaster are paper-based, and the two databases are not connected**. Registered property rights play an important role in supporting investment, productivity, and growth. With land and buildings accounting for between one-half and three-quarters of the wealth in most countries, having an up-to-date land information system matters. When multiple sources need to be consulted to obtain relevant information on the property to be transferred, the procedure is time consuming and potentially subject to errors and corruption. By creating an electronic system of land-related information and matching records across agencies, Bhutan will maintain accurate land information and limit potential land conflicts. Digitizing land records is also a precondition to offering the end user the option of a full-fledged electronic registration. Completing the full digitization of records will facilitate the creation of a unified registry, where the status of a land title, the existing encumbrances, and their relative priorities can easily be determined by consulting the single registry. After completing the digitization of all the property titles, the next step for Thimphu District Municipality would be to implement a fully operational electronic registry, with electronic input and search capabilities (**trigger 4**).

Trigger4: The National Land Commission enhances the electronic property and land registration system in Thimphu with electronic input and search capabilities.

47. **Expected Results:** An enhanced electronic property registry is expected to shorten the time to register property as measured by the *Doing Business* indicator from 92 days in 2013 to 47 days in 2017.

Credit Information Bureau

48. **Increased credit information reduces the risk of lending and the cost of giving loans by providing accurate information about borrowers.** The Bhutan Credit Information Bureau (CIB) was established in 2010. CIB collects and distributes information from commercial banks, the pension fund, and insurance companies. Because the bureau only allows for the distribution of credit information from financial institutions, its usefulness is limited. To align with good practices, CIB plans to include collection and distribution of credit information from utility companies. That would require an agreement to be reached between the CIB and the utilities to share information and to establish interoperability (**prior action 4 and trigger 5**).

49. The CIB coverage will be further enhanced by adding data for payment of utility services to the system. This could help lenders with a better KYC (know your customer) process through knowing the history of an applicant's utility payments history. While most of the post-paid mobile subscribers are likely to be existing borrowers, there is good potential to increase the CIB coverage by adding rural household clients of the Bhutan Power Company (BPC) who could be potential borrowers at the MSME level. This would help to achieve a higher access to finance (as a percentage of the adult population). Between the two mobile companies currently operating in Bhutan, there are more than 400,000 subscribers, out of whom around 10 percent are active post-paid subscribers. BPC has 127,942 households as clients, the majority (80 percent) of whom are in rural areas.

Prior Action 4: The Recipient, through RMA, has issued the CIB Regulations that sets forth, *inter alia*, the obligation of Data Providers to provide credit information of utility companies to the Credit Information Bureau (CIB). .
Trigger 5: Utility regulators (BICMA and BEA) issue a directive instructing utility companies (Tashi Cell, Bhutan Telecom and Bhutan Power Co) to share credit information with CIB, and RMA introduces inter-operability system between CIB and the utility companies.

50. **Expected Results:** Bringing a small portion of utility company subscribers and households into CIB could enable the bureau to achieve a target of 30 percent of adult population coverage by 2017.

Financial Sector Strategy and Implementation Plan

51. **Against a background of limited coordination of financial reforms, and existing vulnerabilities, a coherent vision and strategy for development of an integrated and sound financial sector is needed**. The RMA's adoption in 2012 of emergency and macro-prudential measures illustrated the need for a more proactive strategy to manage the sector, and address any new emerging threat of overheating and liquidity shortage. A Financial Sector Strategy and Action Plan for Implementation will provide the vision and actions to be undertaken to deepen the financial sector and improve its soundness, efficiency and inclusiveness (**trigger 6**). The development of a Financial Sector Strategy is being led by the RMA with the support of the World Bank. It follows a stock-taking exercise in FY2013/14. One of the key areas of focus of the action plan will be to identify ways to expand MSME access to finance.

Trigger 6: RMA adopts the Financial Sector and Implementation Strategy.

52. **Expected Results**: The adoption of the Strategy and its action plan will lead to the establishment of an oversight committee and coordination mechanism. The oversight committee will monitor implementation of an action plan of reforms to deepen the financial sector and ensure increased access to finance for MSMEs.

4.2.3. Investment climate

53. **The government recognizes that a credible and predictable policy environment that minimizes the cost of doing business, expedites business start-ups, and facilitates FDI is vital to achieving the objectives envisaged in the 11th Five Year Plan.** Over the past five years, through a combination of technical assistance, investment and development policy lending, the World Bank Group has supported the government in its reform efforts. The 11th Five year Plan aims at creating 82,000 new jobs through the Rapid Investment in Selected Enterprises (RISE) program for the private sector. To spur private sector development, in the past five years, the government has formulated and approved a number of policies and laws. They include: (i) the Economic Development Policy (EDP); (ii) the FDI policy and rules and regulations; (iii) the Renewable Energy Policy; (iv) the Micro Small and Medium Enterprises (MSME) policy; and (iv) the Consumer Protection Bill. Forthcoming policy reforms will include industrial infrastructure development (governing economic zones), public private partnerships (PPPs), licensing, mineral development, and enterprise registration. The reforms identified for the DPC are based on those judged critical by the government to help private sector firms get established and invest to create

jobs. Implementation of the proposed reforms is expected to impact directly and positively the ability of firms to start a business and may increase FDI and job creation.

Making it Easier to Start a Business

54. **Despite recent progress, starting a business in Bhutan remains a difficult endeavor**.[14] Currently, an entrepreneur who wants to open a business in Bhutan must physically go to Thimphu to register his firm at the Thimphu Thromde (i.e., municipality) in addition to complying with many cumbersome regulations. During the life of a firm, officials from the Registrar of Companies will conduct annual on-site inspections to review and monitor the status of each company and its compliance with the Companies Act, such as whether or not it conducts board meetings, holds shareholders meetings, has a designated CEO, occupies the registered office, and submits annual returns. Other countries have tackled these cumbersome requirements through systematic and ongoing reviews of the burdens imposed by licenses. Revision of the Companies Act, and other policy measures and reforms (**prior actions 5, 6 and trigger 7**) should lead to reduced burdens for businesses and a more predictable and transparent investment climate, as has occurred in other countries adopting such reforms.

The Companies Act

55. **The amendments to the Companies Act remain critical** to harmonize with the other acts and regulations that are being revised, such as the Movable and Immovable Property Act and the Bankruptcy Act. The amendments include a number of items aimed at making it easier for a company to get established by, among several other things, eliminating the requirement for a company seal. The amendment strengthening the protections for minority shareholders enhances a company's ability to raise the capital needed to grow, innovate, diversify, and compete. Globally, Bhutan ranks 104th out of 189 economies on the index of strengthening minority investor protection. A revised Companies Act which strengthens the protection of minority shareholders has been submitted to Parliament (**prior action 5**).

Prior Action 5: The Recipient, through its Cabinet, has submitted to its Parliament a bill that amends the Companies Act in order to strengthen the protection of minority shareholders of companies regulated by such act.

56. **<u>Expected Results</u>:** Reduction of the time and cost to start a business (see above) and improvement of the *Doing Business* indicator "Extent of director liability" from 3 to 4 (out of 10)[15] by 2017.

The Enterprise Registration Bill

57. **Registering an enterprise today in Bhutan takes time.** It requires eight procedures, 32 days and visits to several different government institutions. For Bhutan to align business registration to best practices, this process should become easier and less costly. The Enterprise Registration Bill introduces the legal form and the registration procedures for Partnerships and

[14] Doing Business 2015 report ranked Bhutan 125 out of 189 economies and 92th for starting a business indicator.

[15] A higher ranking indicates that an economy's regulations offer stronger investor protections.

Sole Proprietorships. As a result, firms will have an easier time registering their enterprises. The Bill: (i) eliminates the need for an operating license; (ii) allows for the establishment of a single business identification number for all businesses; and (iii) develops the legal framework for a one-stop-shop for business creation and online registration for new companies. The bill has already been approved by the Cabinet **(prior action 6**).

Prior Action 6: The Recipient, through its Cabinet, has submitted to its Parliament an enterprise registration bill that regulates the usage of a single business identification number and one-stop-shop enterprise registration processes.

58. **The effective creation of a single window for business registration will follow approval of the Enterprise Registration Bill.** The Minister of Economic Affairs will issue the rules and regulations that allow its implementation, including a set of regulations for the single window for business registration (**trigger 7**). The Registrar of Companies will move towards offering a single window for business registration, where the procedures to start a business are performed in the same office after the delivery of one application.

Trigger 7: MoEA introduces a single window for on-line business registration.

59. **Expected Results:** The time taken to register a business (as measured by *Doing Business*) is expected to decline from 32 to 15 days by 2017, while the associated cost is expected to decrease from 5 percent to 4 percent of income per capita, and the number of procedures to be reduced from 8 to 4.

Licensing Policy

60. **Although much progress has been made, businesses in Bhutan are still hampered by many inefficient and ineffective regulatory requirements.** These do not achieve policy objectives and adversely affect the growth of the private sector. Bhutan has already taken important steps to improve the regulatory system and the interface between government and businesses. To complement these efforts, the government, with the support of the International Finance Corporation (IFC), has formulated a Licensing Policy (**prior action 7**). With the new Licensing Policy, Bhutan has an important instrument to improve the regulatory environment.

Prior Action 7: The Recipient, through its Cabinet, has approved the Licensing Policy that creates a level playing field for companies and encourages them to participate in the formal economy.

FDI Policy

61. Bhutan's FDI inflows have been around US$100 million over the last 10 years, and the government is keen to improve on this performance.[16] It is widely acknowledged that some FDI has been lost due to relatively high minimum investment thresholds. The current FDI policy and regulations have been in implementation since 2010. However, there have been issues related to the minimum level of investment required and the treatment of foreign investment profits that have prevented some operations. Following comments and feedback provided by various stakeholders,

[16] FDI do not include financial flows in the hydropower sector, which are accounted as loans and grants.

including the IFC, the FDI policy was amended in September 2014 to revise the minimum threshold of investment, and to authorize profit repatriation in foreign currency (**prior action 8**).

Prior Action 8: The Recipient, through MoEA, has approved the Revised Foreign Direct Investment (FDI) Rules and Regulations to lower threshold values for allowing foreign institutional investors and repatriations of profits.

62. **Expected Results**: FDI policy amendments will contribute to increasing FDI cumulated inflows from US$100 million to US$150 million by 2017.

Public Private Partnership (PPP) Policy

63. **The government plans to develop an appropriate policy framework to allow PPPs in infrastructure projects.** Infrastructure contributes significantly to a country's social development strategies. During the last decade, PPPs have become an important way to leverage private sector resources for infrastructure projects. In addition to providing the framework for future PPP operations for sustainable infrastructure and other development, a PPP policy would provide adequate security for private sector investment. It would at the same time ensure that adequate checks and balances are maintained through transparency, competition and regulation. Since 2010, the World Bank has been providing support to strengthen PPP capacity within the government, formulate the PPP policy, and develop PPP rules and regulations **(trigger 8).**

Trigger 8: Cabinet approves PPP Policy, and policy rules and regulations are approved by MoEA.

Expected Results: At least two PPP projects approved by 2017. It is expected that the new PPP policy, rules and regulations will attract PPP projects outside of the traditional hydropower sector.

Dealing with Construction Permits

64. **Bhutan ranked 131 out of 189 countries in the ease of obtaining a construction permit, ranking the country as one of the worst in South Asia.** The Thimphu Thromde is working on creating an e-based platform where building permit applicants can apply for all initial clearances simultaneously by submitting one online form along with the final drawing (**trigger 9**). This form, the drawings and the other required documentation, would then be accessed by the various agencies, which could review the technical information by their own requirements and approve the designs electronically. In parallel, a risk assessment of the stock of buildings, and a review of existing construction regulations should also be conducted, to differentiate areas that warrant more attention and direct controls from the building authorities, from those that warrant less. As a result, the time for obtaining a construction permit could be significantly reduced.

Trigger 9: Thimphu Thromde introduces an electronic registry of building permits

65. **Expected Results**: The time for a business to acquire a construction permit is expected to decrease from 150 to 129 days by 2017.

Paying Taxes

66. **Reforms in the areas of business tax processes, and improvement of the tax environment by rationalizing tax incentives, can help reduce financial costs and time to comply with taxes**. They also reduce revenue leakages from ineffective tax incentives. The *Doing Business* "paying taxes" indicator records the taxes and mandatory contributions that a medium-size company must pay in a given year, as well as the time it takes to meet these obligations. Bhutan ranks 104th globally out of 189 economies on the "ease of paying taxes" indicator. Companies make 19 payments a year to meet their tax obligations. To make it easier to pay taxes, the Government of Bhutan plans to reduce the number of times a company has to pay taxes. In addition, Bhutan's Department of Revenue and Customs has been developing a platform for electronic filing and payment of personal, business, and corporate income taxes. This platform is part of RAMIS, a comprehensive electronic data interchange system. The new system includes a custom module, which will ensure better internal workflows and improve the processing of tax payments and customs forms (**prior action 9**).

Prior Action 9: The Recipient, through MoF, has issued the Filing of Tax Return Notification that enhances the tax module of its revenue administration management information system by allowing electronic tax filing and payments.

67. **Expected Results**: A tax return notification by the Government of Bhutan allowing electronic tax filing and payment is also expected to contain provisions decreasing the number of tax payments by businesses from 19 to 6 per year by 2017.

Trading across borders

68. **The government with the support of the ADB has been working to reduce the cost and time it takes to import and export goods.** Bhutan ranks 172nd globally on the trading across borders indicator and sixth in the South Asia region**.** Goods take, on average, 38 days to export and 38 days to import. **Nine documents are required for exports and twelve documents are required for imports.** Following the roll out of the tax module (see above), the Department of Revenue and Taxes will complete the operationalization of RAMIS's customs module, which will allow for the complete automation of handling of the customs forms (**trigger 10**). Electronic transmission of documents not only speeds the clearance of goods, it often reduces the incidents of corruption.

Trigger 10: MoF enhances the custom module of RAMIS to allow electronic submission of custom forms.

69. **Expected Results:** The migration to RAMIS is expected to be completed in the first quarter of 2015. As a consequence, by 2017, time for businesses to export as well as import is expected to be reduced from 38 to 22 days.

4.2.4. Analytical underpinnings

70. **The proposed operation is systematically underpinned by analytical work.** The Implementation Completion and Results Report for the last DPC series underscored the importance of analytics to inform the policy dialogue**.** This is especially true in development policy lending operations which address more than one reform area. Policy-based lending, when combined with hands-on capacity support seems to yield the strongest response to advance key reforms. The proposed operation backs up proposed policy actions with analytical work, in particular, the Bhutan semi-annual economic updates, the 2014 joint debt sustainability analysis, the poverty assessment (2014), the financial sector stock-taking (2014), the doing business reform memorandum (2013) and the investment climate assessment (2010).

Table 4: DPO Prior Actions and Analytical Underpinnings

Prior actions	**Analytical Underpinnings**
Pillar 1 – Fiscal Measures: Strengthening fiscal sustainability and self-reliance	
Prior action 1: The Recipient: (a) through RMA, has issued the RMA Official Communication that lifts the policy ban of March 2012 imposed on the provision of housing and vehicle loans by financial institutions; and (b) through MoF, has issued the Tax Public Notification that raises custom duties, sales taxes and green taxes of selected goods.	IMF Article IV and government analysis recommended that fiscal measures replace administrative restrictions on rupee demand
Pillar 2 – Fostering Financial Sector Development: Increasing access to finance	
Prior action 2: The Recipient, through its Cabinet, has approved for submission to its Parliament a bill that amends the Movable and Immovable Property Act (MIPA) in order to facilitate the effective usage of movable assets as collaterals.	World Bank Group Doing Business reform 2013 memorandum identified the most critical reforms to improve the investment climate
Prior action 3: The Recipient, through RMA, has issued the CRST Public Notification that improves access to credit by, *inter alia*, small and medium enterprises through the usage of movable assets as collaterals by requiring the registry of them in the Central Registry for Secured Transaction (CRST).	World Bank Group Doing Business reform 2013 memorandum identified the most critical reforms to improve the investment climate
Prior action 4: The Recipient, through RMA, has issued the CIB Regulations that sets forth, *inter alia*, the obligation of Data Providers to provide credit information of utility companies to the Credit Information Bureau (CIB).	World Bank Group Doing Business reform 2013 memorandum identified the most critical reforms to improve the investment climate
Pillar 3 – Private Sector Development: Improving the investment climate and increasing domestic and foreign investment	
Prior action 5: The Recipient, through its Cabinet, has submitted to its Parliament a bill that amends the Companies Act in order to strengthen the protection of minority shareholders of companies regulated by such act.	World Bank Group Doing Business reform 2013 memorandum identified the most critical reforms to

Prior actions	Analytical Underpinnings
	improve the investment climate
Prior action 6: The Recipient, through its Cabinet, has submitted to its Parliament an enterprise registration bill that regulates the usage of a single business identification number and one-stop-shop enterprise registration processes.	World Bank Group Doing Business reform 2013 memorandum identified the most critical reforms to improve the investment climate
Prior action 7: The Recipient, through its Cabinet, has approved the Licensing Policy that creates a level playing field for companies and encourages them to participate in the formal economy.	Licensing policy based on international best practice was drafted with support from ADB and IFC
Prior action 8: The Recipient, through MoEA, has approved the Revised Foreign Direct Investment (FDI) Rules and Regulations to lower threshold values for allowing foreign institutional investors and repatriations of profits.	IFC review of cross country experience
Prior action 9: The Recipient, through MoF, has issued the Filing of Tax Return Notification that enhances the tax module of its revenue administration management information system by allowing electronic tax filing and payments.	Doing Business 2013 memorandum recommendations on the ease of paying taxes

4.3. LINK TO CPS AND OTHER BANK OPERATIONS

71. **This DPC series underpins two objectives of the new Country Partnership Strategy (CPS) FY15-19 (IDA/R2014-0280; IFC/R2014-0290) discussed by the Board on September 23, 2014.** The CPS focused on: (i) improving fiscal efficiency and (ii) promoting private sector development. The DPC is designed to have a strong impact on economic growth through a renewed focus on private sector development through actions that focus on improved business environment, access to finance and restoring macroeconomic imbalances —three well-identified challenges to Bhutan's harmonious development.

72. **Other Bank operations/activities complementing the proposed DPC series include:** (i) an investment climate programmatic technical assistance, including the preparation of a *Doing Business* reform memorandum, a time-bound action plan, regular video-conferences with the *Doing Business* team, and implementation of the plan; (ii) general policy dialogue on macro-fiscal and the preparation of a public finance think piece as an input to a fiscal strategy; (ii) support to public-private sector dialogue (e.g., the Better Business Summit organized by the government and the creation of the *Doing Business* Steering Committee); (iv) financial sector technical assistance (FIRST); and (v) technical assistance on implementing the PPP policy (PPIAF).

4.4. CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

73. **Consultations with stakeholders have shown a broad based support for the proposed reforms.** With a new government and parliament in place for more than a year, the timing is right for reforms to take place, backed-up by solid political and stakeholder buy-in. Macro-fiscal reforms are well supported by most, given the rupee shortage faced in the recent past. *Doing Business* reforms have met with strong collective support, with the 11th Five-Year Plan referring explicitly to them and fixing a target related to them. The Prime Minister with his Cabinet has

publicly committed to Bhutan being part of the top 100 countries of the *Doing Business* ranking within two years. The private sector, represented by the Bhutan Chamber of Commerce and Industry, is supportive.

74. **Coordination with development partners.** Collaboration between the IMF and the World Bank staff is effective with regular consultations on macroeconomic, debt management, and financial issues. The World Bank teams actively participate and contribute to the IMF Article IV reviews and coordinate closely with a number of technical assistance initiatives. Other development partners engaged in macro-fiscal technical assistance dialogue include the ADB and the UN Department of Economic and Social Affairs. The ADB is an important partner in the areas of public sector management, financial sector development and private sector development. It provides a variety of technical assistance services and budget support operations, in particular through the ongoing Strengthening Economic Management Program II, where the teams coordinate closely. Many donors are involved in supporting governance, including Austria, the European Union, the Swiss Development Cooperation (SDC), the Japan International Cooperation Agency (JICA), and Danish Development Cooperation (DANIDA). The World Bank Group is working with the European Union on a Public Financial Management (PFM) Trust Fund for FY2014/15.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

75. **The policies supported by this DPC are expected to have a positive poverty and social impact over the medium- and long-term.** The reforms supported under this operation contribute to achieving the Bank's twin goals of poverty reduction and shared prosperity by: (i) improving fiscal sustainability and macroeconomic stability, which are necessary conditions for a sustainable growth and thus for poverty reduction and shared prosperity; and (ii) improving access to finance and the investment climate for the private sector, which will contribute to growth diversification and job creation (particularly for the poor and disadvantaged groups). By enhancing growth and providing jobs, these reforms contribute to reducing poverty and further expanding shared prosperity. The reforms are expected to have neutral impact on Bhutan's good record of gender equality.

76. **The introduction of taxes on imports of vehicles and subsequent elimination of restrictions on credit and imports will assist in restoring macroeconomic stability and stable growth, which are important prerequisites for shared prosperity.** The 2012 introduction of bans on some imports and other administrative measures had led to a sudden stop of economic activities, in particular in the construction sector, with significant spillovers to the rest of the economy. With market friendly taxation and strengthened macro-prudential measures, policymakers have given themselves the necessary policy tools to adjust and react to emerging imbalances. High taxes on vehicle imports will not hurt the poorest segment of the population, since the poor tend to use public transportation, to which the new taxation does not apply.

77. **Improving access to finance is expected to benefit the bottom 40 percent of the population.** Access to finance has been limited, especially for MSMEs, which create private sector

jobs in Bhutan. Access to finance is also more limited for women-headed households.[17] Allowing the use of utility bill payments to create a credit history and movable collateral to access credit will benefit the poorest segments of the population who do not currently have a credit record or immovable assets to use as collateral.

78. **Enhancing the business environment is also expected to have a beneficial impact on poverty reduction and shared prosperity**. Addressing the major constraints to business, in terms of simplifying business procedures (licensing, starting a business, importing and exporting) is expected to boost job creation, in particular for small and medium enterprises that are key to the economic opportunities for the bottom 40 percent. Similarly, making it easier for foreign investors to repatriate profits and lowering the minimum threshold for investment will impact favorably the decision to invest in Bhutan, and as a result contribute to private sector development, economic diversification and job creation. Altogether, these reforms will aim to enhance Bhutan's long-term growth prospects.

5.2. ENVIRONMENTAL ASPECTS

79. **The proposed DPC series is not expected to have any adverse environmental impact**. Measures to promote fiscal sustainability and financial sector development are expected to be environmentally neutral—and so is a better investment climate. The RGoB's capability to manage any environmental risks arising from private sector development is good, as reflected in the country's consistently high CPIA score for environment. Bhutan has adequate legislative cover, policy guidelines, and institutional mechanisms in place to manage the environment. Bhutan has accorded a high priority to environmental conservation and sustainable development. Bhutan's constitution, the 20 year perspective plan (Bhutan 2020), the 10th Five-Year Plan, and the National Environment Strategy, all enshrine the concept of sustainable development. Projects and developmental activities are not permitted in protected areas. All development proposals are subject to environmental assessment as required by the Environmental Assessment Act (2000) and Regulation for the Environmental Clearance of Projects and Regulation on Strategic Environmental Assessment (2002). The government has made progress in strengthening environmental considerations by enacting the National Environment Protection Act of Bhutan (NEPA 2007), an umbrella environmental act. Building on experience, Bhutan is also in the process of revising the Environmental Act and Regulations, the Application for Environmental Clearance Guidelines, and also the Environmental Codes of Practices.

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

80. **The overall fiduciary risk from Bhutan's public financial management system (PFM) and the use of budget resources is moderate.** While challenges remain, the core elements of an adequate financial management system are in place, including publication of the budget. The positive trajectory of improvements in financial management stems from the government's commitment to: (a) strengthen the legal framework; (b) enhance institutional capacity and the internal control framework; (c) improve the financial management information system, and (d) strengthen the oversight of public finances. Together, these actions are aimed at increasing accountability and improving the timeliness, quality, transparency and reliability of the

[17] Bhutan Gender Policy note 2013, "Connecting the disconnected" report (2012)

government’s accounting and reporting functions. The World Bank team has been engaged in supporting public financial management through TA/capacity building programs and supervision activities on investment projects.

81. **The Ministry of Finance discloses the National Budget to be discussed and approved by parliament during the June session on the Ministry’s website.** The budget document is comprehensive: it includes an analysis of the previous year financial statements, the budget for the coming year by economic and administrative classification, tax measures, a macro-fiscal economic outlook, a report on state-owned enterprises and government share-holdings, on the RMA and the pension fund**.** Quarterly and monthly execution reports are produced, but not disclosed, to date. Financial statements of the previous year are disclosed after being audited.

82. **In the area of external audit, Bhutan has a reasonably well-functioning public financial accountability.** The Royal Audit Authority conducts financial audits at two tiers, one at the national level, the consolidated annual financial statements of the Royal Government, and the other at the individual agency level. The Auditor General submits the annual audit report during the fourth quarter of the fiscal year on the audits carried out during the previous fiscal year. The report contains the result of the audit of the annual financial statements of the government, the overall financial condition and recommendations to improve the economy, efficiency and effectiveness of the government. Besides, the Royal Audit Authority also conducts the financial audits of the donor assisted projects and performance audits.

83. **Although there is no IMF Safeguards Assessment of the RMA, the foreign exchange control environment of the central bank is satisfactory.** The auditors have issued an unqualified report for the fiscal year 2012/2013 and the auditors are the Royal Audit Authority. The accounts and audits were compiled and conducted in accordance with generally accepted accounting and auditing standards. Based on the audit reports and the satisfactory track record in the operation of special (designated) accounts in several IDA-financed investment operations in the past, which have been held in the RMA, it was concluded that the Bank has reasonable assurance that the control environment for foreign exchange at the RMA is satisfactory.

84. **Once the credit is approved by the Board and becomes effective, the government will submit to IDA an application for withdrawal of the proceeds, provided that IDA is satisfied with the progress achieved by the government in carrying out the Program and with the adequacy of the country's macroeconomic policy**. IDA will disburse the US dollar proceeds of the credit in one tranche to the Government Consolidated Fund Account maintained by the RMA, after which the disbursed foreign currency will be converted within five business days to local currency and made available to finance the government’s budgeted expenditures. Transactions and balances of the account will be incorporated into the government’s accounting records and financial statements. The government will confirm to the Bank within 30 days of disbursement the receipt of these funds and its credit into the Government Consolidated Account of the country (including the date of receipt, exchange rate applied to convert the Credit proceeds into Bhutanese ngultrum and name/number of the government’s bank account in which the funds have been deposited).

85. **Disbursement of the credit proceeds will not be linked to specific purchases**. However, the government would not use the credit proceeds to pay for expenditures included in the Bank’s standard negative list, which includes expenditures on military hardware and environmentally hazardous goods. If any portion of the credit is used to finance ineligible expenditures as so

defined in the Financing Agreement, IDA shall require the government to refund the amount. Money refunded to IDA in respect of payments made for ineligible expenditures would be cancelled. If required, the Bank may request an audit of the borrower's dedicated bank accounts where proceeds of Bank credit are deposited.

5.4. MONITORING AND EVALUATION

86. **The World Bank works closely with the Prime Minister's office, Ministry of Finance, Ministry of Economic Affairs, Gross National Happiness Commission, Royal Monetary Authority, Land Management Authority, and Thimphu Thromde to monitor and assess the reform progress and impacts during the course of operation and in the context of the implementation of the 11th Five-Year Plan**. The Doing Business Reform Steering Committee – established in April 2014 by executive order of the Prime Minister, and chaired by him-- monitors the progress made in the *Doing Business* reforms, together with the World Bank team. The Ministry of Finance monitors progress of fiscal indicators both through their annual budget report and their performance agreement signed with the Prime Minister.

87. Grievance Redress Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit www.worldbank.org/grs. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

88. **The overall risk rating level of the Program Development Objective of this operation is moderate**. There are some risks that can affect implementation progress, but mitigation measures are in place.

- *Macroeconomic risks.* Aggregate demand pressures could re-emerge and lead to another rupee shortage following the lift of foreign exchange restrictions combined with the increase in civil servant salaries. Mitigating factors include monetary sterilization and fiscal tightening, including taxation measures, learning from the lessons of the previous rupee shortage. Secondly, rapid credit growth in recent years has increased financial sector vulnerabilities. Mitigating factors include actions taken by the RMA to adjust prudential regulations and the development of a financial sector strategy. Thirdly, the Debt Sustainability Analysis (2014) shows Bhutan to be at a moderate risk of debt distress. The first pillar of the proposed DPC helps mitigate these risks.

- *Implementation risks.* Technical capacity constraints and a lack of inter-agency coordination call for the provision of appropriate technical assistance to support the government in implementing the ambitious reforms. To some extent, familiarity with World Bank procedures and continuity of counterparts mitigate this risk. The operation's design accounts for capacity constraints through selectivity and limiting the number of prior actions. It also seeks to leverage technical assistance resources.
- *Political economy risks.* While political will at the highest level is strong, fiscal restraint (better taxation, less spending) might face increasing resistance when the country approaches elections in 2018. These risks are mitigated by the timing of the operation (during the first half of the 5-year political cycle). It is also helped by government's ownership of the reform program.

Table 5: Systematic Operation Risk-rating Tool (SORT) Table

Risk Categories	**Rating (H, S, M or L)**
1. Political and governance	M
2. Macroeconomic	M
3. Sector strategies and policies	M
4. Technical design of project or program	S
5. Institutional capacity for implementation and sustainability	S
6. Fiduciary	M
7. Environment and social	L
8. Stakeholders	M
9. Other	
Overall	M

ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions by December 15, 2014	Indicative Triggers by December 2016	Results (by 2017)
Pillar 1 - FISCAL MEASURES: Strengthening Fiscal sustainability and self-reliance		
Prior action 1: The Recipient: (a) through RMA, has issued the RMA Official Communication that lifts the policy ban of March 2012 imposed on the provision of housing and vehicle loans by financial institutions; and (b) through MoF, has issued the Tax Public Notification that raises custom duties, sales taxes and green taxes of selected goods.	Trigger 1: Cabinet approves a debt policy setting debt limits to improve fiscal sustainability. Trigger 2: MOF approves tax rationalization measures to improve its efficiency and broaden the tax base	Fiscal deficit (% GDP) Baseline (FY13/14): 4 percent Target (FY16/17): 3 percent or less Tax revenue (%GDP): Baseline (FY13/14): 13 percent Target (FY16/17): 15 percent
Pillar 2 - FOSTERING FINANCIAL SECTOR DEVELOPMENT: Increasing access to finance		
Prior action 2: The Recipient, through its Cabinet, has approved for submission to its Parliament a bill that amends the Movable and Immovable Property Act (MIPA) in order to facilitate the effective usage of movable assets as collaterals	Trigger 3: Cabinet approves the amendments of the Bankruptcy Act to provide a framework for businesses to resolve insolvency and strengthen the rights of secured creditors.	Share of MSME credit in collateral registry Baseline (2014) : Number of MSME loans in collateral registry: 348 Target (2017): Number of MSME loans in collateral registry increases by at least 40% Legal rights of creditors and borrowers in secured transactions as measured by DB index are strengthened. Baseline (2014) : Strength of Legal Rights Index is 4/12 Target (2017): Index increases to 6/12
Prior action 3: The Recipient, through RMA, has issued the CRST Public Notification that improves access to credit by, *inter alia*, small and medium enterprises through the usage of movable assets as collaterals by requiring the registry of them in the Central Registry for Secured Transaction (CRST).		
	Trigger 4: National Land Commission improves the electronic property and land registration system in Thimphu with electronic input and search capabilities.	Doing Business "Registering Property" Time to register Property: Baseline (2013) : 92 days Target (2017) : 47 days
Prior action 4: The Recipient, through RMA, has issued the CIB Regulations that sets forth, *inter alia*, the obligation of Data Providers to provide credit information of utility companies to the Credit Information Bureau (CIB).	Trigger 5: Utility regulators (BICMA and BEA) issue a directive for utility companies to share credit information with CIB. RMA introduces inter-operability system between CIB and utility companies.	CIB coverage -individuals and firms (% of adult population) Baseline (2014): 15.9% Target (2017): 30%
	Trigger 6: RMA adopts the Financial Sector Development & Implementation Strategy.	Establishment of a coordination mechanism to oversee/monitor implementation of reforms.

Prior Actions by December 15, 2014	**Indicative Triggers by December 2016**	**Results**
Pillar 3 – PRIVATE SECTOR DEVELOPMENT : Improving the Investment climate and increasing domestic/foreign investment		
Prior action 5: The Recipient, through its Cabinet, has submitted to its Parliament a bill that amends the Companies Act in order to strengthen the protection of minority shareholders of companies regulated by such act.		Doing Business "Protecting Investors" Extent of Director Liability Index Baseline (2013): 3 Target (2017): 4
Prior action 6: The Recipient, through its Cabinet, has submitted to its Parliament an enterprise registration bill that regulates the usage of a single business identification number and one-stop-shop enterprise registration processes	Trigger 7: MoEA introduces a single window for online business registration	Doing Business "Starting a business" (i) Time Baseline (2013) 32 days Target (2017): 15 days (ii) Number of Procedures Baseline (2013): 8 Target (2017): 4 (iii) Cost Baseline (2013): 5% Target (2017): 4% of income per capita
Prior action 7: The Recipient, through its Cabinet, has approved the Licensing Policy that creates a level playing field for companies and encourages them to participate in the formal economy.		
Prior action 8: The Recipient, through MoEA, has approved the Revised Foreign Direct Investment (FDI) Rules and Regulations to lower threshold values for allowing foreign institutional investors and repatriations of profits		Cumulative level of FDI inflows: Baseline (2013): US$100 million Target (2017): US$150 million
	Trigger 8: Cabinet approves PPP policy and MoEA approves PPP policy rules and regulation.	Number of PPPs in operation: Baseline (2013): one - Target (2017): Two new PPP projects (o.w. one non-hydro)
	Trigger 9: Thimphu Thromde in consultation with MoWHS introduces an electronic registry of building permits.	Doing Business "Dealing with construction permits" (i) Time: Baseline (2013): 150 days - Target (2017): 129 days
Prior action 9: The Recipient, through MoF, has issued the Filing of Tax Return Notification that enhances the tax module of its revenue administration management information system by allowing electronic tax filing and payments	Trigger 10: MoF enhances the custom module of RAMIS to allow the electronic submission of custom forms.	Doing Business "Paying Taxes" (i) Number of Payments per year Baseline (2013): 19 - Target (2017): 6 Doing Business "Trading across borders indicator": (i) Time to export: Baseline (2013): 38 days - Target (2017): 22 days (ii) Time to import: Baseline (2013): 38 days - Target (2017): 22 days

ANNEX 2: LETTER OF DEVELOPMENT POLICY

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MoF/IDA/DPFIS/
MAY 8, 2015

Mr. Jim Yong Kim
President
The World Bank
1818 H Street, N.W.
Washington, DC, 20433
USA

Re: Letter of Development Policy for First Development Policy Credit

Dear Mr. Kim,

1. This Letter of Development Policy lays out the key elements of the Royal Government of Bhutan's proposed policy and institutional reform program over the next few years. The Royal Government has requested World Bank support to this reform agenda through the First Development Policy Credit (DPC1) and the Second Development Policy Credit (DPC2). The Royal Government further request that the assistance be provided in the form of a programmatic series to support the 11th Five Year Plan (2013-18) objective of green socio-economic development and self-reliance. This will support the Royal Government's effort to strengthen its fiscal sustainability and improve investment climate for private sector development as well as its Doing Business ranking.

2. The Royal Government of Bhutan (RGoB) would like to thank the International Development Association for providing the Second Development Policy Credit (DPC2) of US$ 36.84 million in 2012 and First Development Policy Credit (DPC1) of US$ 24.75 million in 2010. This is followed by the Development Policy Financing for Institutional Strengthening (DPFIS) for US$ 20.22 million in FY09 and the two Development Policy Grants of US$ 12 million in FY07 and US$ 15 in FY06 to Bhutan. These operations have supported key components of the RGoB's program under the Ninth and Tenth Five-Year Plans, to help meet its development goals. An evaluation of the major political, economic, physical and social indicators and developments over the Tenth Plan period provides a picture of significant and tangible achievements. During the 10FYP, the country maintained sustained rapid economic growth and this performance is likely to continue. More importantly, this has been accomplished in a sustainable manner with minimal impact on the physical, social and cultural environments. There has been remarkable progress made in advancing social and human development conditions in the country on the basis of the Royal Government's strong social redistributive policies and investments made over the plan. As a result, Bhutan is well on track to achieve the MDGs and remains firm on realizing its long-term Vision 2020 social goals. Bhutan has successfully elected its second government since the transition to Democratic Constitutional Monarchy in 2008, reaped positive results from sustained investment in rural infrastructure such as roads, schools, telecommunications, power, and health care centers across a difficult terrain.

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3. The Eleventh Plan (2013–2018) espouses to achieve national objectives of "Self Reliance and Inclusive Green Socio-Economic Development". One of the notable changes in the Eleventh Plan is the adoption of Results Based Planning (RBP) framework that articulates clear outcomes and outputs to be achieved in the plan period. 16 National Key Result Areas (NKRAs) are identified and more than 300 Sector Key Result Areas (SKRAs) and *Dzongkhag* or District Key Results Areas (DKRAs) are identified that will support the achievement of 16 NKRAs. The 16 NKRAs are identified based on the pillars of the Gross National Happiness principle. Continuing the effort on poverty reduction, the 11th FYP plans to bring down income poverty from 12% to 5% by the end of the plan period.

4. The Royal Government has requested continuing Bank support through a new series of operations to support institutional strengthening measures in some key areas, largely continuing the momentum of reform programs undertaken under the DPFIS by building on lessons learnt, including the usefulness of the instrument in facilitating development in Bhutan. The Royal Government requests that DPCs selectively support Eleventh Plan goals and strategies, and the RGoB is committed to implement the institutional and policy reforms described in the Policy Program Matrix as part of its effort to foster development and achieve its objectives of Self Reliance and Inclusive Green Socio-Economic Development. The following three broad thematic areas will be addressed under this DPC series: (A) strengthening Fiscal sustainability and Self-reliance; (B) fostering financial sector development to increase access to finance; and (C) developing the private sector to improve investment climate and increase domestic/foreign investment.

(A) Strengthening Fiscal sustainability and Self-reliance

5. Strengthening fiscal sustainability and Self-reliance is overarching objective of the Eleventh Plan. Despite sustained economic growth, Bhutan was exposed to macroeconomic vulnerabilities during the last several years. At the end of 2011, the Government had to impose several administrative measures that included ban on imports of vehicles and restriction on foreign exchange access, in particular for personal and construction loans. These administrative restrictions were lifted in July 2014, with the introduction of new taxes on vehicles and fuel.

6. While the country is expected to generate additional revenue in the long-run, it faces large macroeconomic imbalances in the short to medium term. Our current account deficit remains constantly high which is largely financed through external grants.

7. The RGoB is taking important steps towards strengthening fiscal sustainability and self-reliance. Since the start of the Eleventh Plan, Government has embarked on various tasks to address the economic situation faced by the country. The administrative measures that were in place were lifted with reforms in the taxation policy to address the shortage of Indian Rupees and to increase government revenues.

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8. For enhancing public financial management, a web based tax module of RAMIS has been operationalized providing online and real time tax payers' services. The RGoB also initiating development of e-procurement as part of the performance reform.

9. To improve fiscal responsibility and supplement efforts to smoothen consumption, the government has taken additional measures to control ballooning public debt. A public debt policy, with debt ceilings and limits on deficits is being considered by the Government. The expenditure rationalization is being seriously considered and government agencies are mandated to improve their efficiency to effectively utilize the available resources and minimize waste in the public sector. In order to broaden tax base and improve tax administration, government is initiating efforts to improve tax administration agency and rationalize exemptions and holidays. Given our situation, while exemptions and holidays are important to encourage investments in economically productive sectors, their contribution to economic development and private sector development needs to be studied objectively. Therefore, the Government is committed to review exemptions and holidays provided to our private sector.

10. At the end of the Eleventh Plane, government has committed that more than 85 percent of the total expenditure will be financed through domestic revenue. This entails improving revenue generation and balance of payment situation. In order to achieve this, the Eleventh Plan aspires to achieve more than 10 percent of average annual GDP growth during the plan period.

(B) Fostering financial sector development to increase access to finance

11. Access to finance remains a big constraint in the country. The small economic base and geo-topographical situation limit the Financial Institutions' venture in a significant way to improve access to finance by the SMEs and individual entrepreneurs and farmers. The Government has committed to improve the access to finance by taking the facilities to all the areas in the country. Laws and procedural mechanism will be made simpler in consultation with relevant authorities such as the Royal Monetary Authority of Bhutan and other relevant organizations. Further, relevant organizations have been newly established to cater to the non-formal and small businesses around the country.

12. The Eleventh Plan has ambitious targets to improve and simplify the procedures for business start-ups, prevent business malpractices, promote fair competition in the market and promote international best practices in the business environment. The Plan also envisions to promote Cottage and Small Industries (CSIs) through following objectives:

i. Strengthened policy environment and institutional framework
ii. Strengthened legislative framework and enterprise environment
iii. Improved access to finance and incentives
iv. Enhanced competitiveness and innovation
v. Enhanced employment and develop a culture of entrepreneurship
vi. Improved market access

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13. In order to scale up Private Public Partnership (PPP) in strategic infrastructure sector, the government has drafted PPP policy which will govern institutional arrangements for government facilitation of PPPs.

(C) Developing the private sector to improve investment climate and increase domestic/foreign investment

14. The Government continues to play the role of "provider" rather than "enabler" due to small and underdeveloped private sector. Therefore, under the "Thrust Area"; Green Accelerated Economic Development of the Eleventh Plan, greater emphasis has been given to economic diversification with the focus on development of non-hydropower sectors and fostering growth of a dynamic private sector that catalyzes a transition to a green economy. Key attributes of a green economy include low carbon emissions, efficient and sustainable resource use, and socially inclusive economic growth and investments, which are closely aligned with our development planning framework.

15. The main programmes under the thrust areas include: (i) economic stimulus programme (ii) Rapid Investment in Selected Enterprise (RISE) Programme under which, focus has been given to: (a) Tourism Sector, (b) Agro-processing industries, (c) Construction Sector, (d) Small and Cottage Industries including Cultural industries and (e) manufacturing and mining sector; (iii) Optimizing Opportunities of Accelerated Hydropower Development; and (iv) Enabling environment which includes improvement and simplification of procedures, enhancing efficiency in reviewing, streamlining and enforcing legislation, policies, rules and regulations; and facilitating infrastructure investments.

16. To promote the necessary framework for economic development, to create an enabling environment for private sector development and to facilitate expediting identified thrust areas, the government is revising EDP 2010 and Fiscal Incentives 2012. The better Business Council has been constituted and it is expected to facilitate and develop regular dialogues with private sector.

17. To achieve the objectives mentioned above, the Government has committed to enhance the rank of the country for the ease of doing business. Concerted efforts are being made by the entire government machinery to bring improvement on all the 10 indicators of the ease of doing business.

Summing up

18. The RGoB remains highly committed to our reform process through the DPC series in the areas described above. Attached to this letter is RGoB's Policy Program matrix for DPC2. It will serve as a framework to analyze and evaluate the reform program over time.

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MINISTRY OF FINANCE
TASHICHHO DZONG

19. Finally, we wish to express our appreciation for the support and assistance extended by the World Bank to Bhutan's socio-economic development. We look forward for the Bank's continued support and fruitful collaboration in the years to come.

Yours sincerely,

(Namgay Dorji)
Minister of Finance

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ANNEX 3: FUND RELATIONS ANNEX

DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

FOR INFORMATION

FO/DIS/15/9

January 21, 2015

To:	Members of the Executive Board
From:	The Acting Secretary
Subject:	**Bhutan—Assessment Letter for the World Bank**

Board Action:	Executive Directors' **information**
Publication:	Not yet decided*
Questions:	Mr. Jonas, APD (ext. 38674)

***If the authorities consent to the publication of this assessment, it may be published by the World Bank.**

Bhutan—Assessment Letter for the World Bank
January 20, 2015

This letter provides the IMF staff's assessment of Bhutan's macroeconomic conditions, prospects and policies. The assessment has been requested in relation to the proposed Development Policy Loan.

Growth has slowed recently due to efforts to moderate aggregate demand and ameliorate overheating pressures, but external imbalances persist.

- Growth has averaged 8 percent during 2008–12, driven by the hydropower sector, but is projected to have slowed to 5 percent in FY 2013, due to policy efforts to moderate credit growth to contain overheating pressures. Bans imposed on credit for construction and vehicle imports in March 2012 led to a decline in services, mining and construction sector growth. With the removal of these bans in September 2014 and continued development of the hydropower sector, growth is projected to pick up over the medium term.
- Headline inflation declined to 8.5 percent in June 2014 from 11.3 percent in December 2013, mainly due to lower non-food inflation. Inflation is projected to remain elevated, gradually declining over the medium term in line with the moderation in India's inflation.
- The current account deficit remains sizable and is financed through substantial aid inflows. The deficit widened to 22.7 percent of GDP in FY 2013 from 15 percent of GDP on average over the 10th Five Year Plan. In addition to hydropower related imports, a consumption and housing boom added to the rapid increase in imports. Robust aid inflows resulted in a positive overall balance of payments position, enabling the continued accumulation of international reserves, which stood at US$ 992 million (over 9½ months of import cover) in August 2014. However, even though about 60 percent of total external debt is denominated in Indian rupees and more than two thirds of trade is with India, rupee reserves have constituted less than 3 percent of reserves on average during the past 5 years.
- Downside risks to macroeconomic stability stem from high debt levels and possible financial sector vulnerabilities following a prolonged period of rapid credit growth. There is also a risk of renewed external pressures, including on rupee reserves, if macroeconomic policies remain expansionary and credit growth rebounds strongly. The main external vulnerability stems from a slowdown in India, Bhutan's main trade and development partner.

The main near-term policy challenge is to support growth while ensuring that external pressures do not intensify.

- Fiscal policy should be tightened while preserving social and productive expenditure. Revenue reforms, including broadening the tax base by reducing the number of zero-sales tax-rated goods and taxing domestic value added more extensively, would help in the near term. Over the medium term, consideration should be given to introducing a value-added tax.

- On monetary policy, external inflows should be fully sterilized and liquidity should be tightened to prevent credit growth from rebounding too strongly. Over the medium-term, there is a need to further improve the monetary transmission mechanism and deepen the financial system. In particular, it is essential to develop a formal interbank market and further develop the government bond market by greater and more regular issuance of T-bills and T-bonds. Interest rate spreads with India need to be narrowed and better reflect market conditions.

- International reserves have to be managed carefully to contain recurrent pressures on Indian rupee reserves, including by aligning the currency composition of reserves with that of the structure of rupee-denominated external liabilities and trade.

- Further financial deepening should be balanced with maintaining financial stability. Risks to stability necessitate continued vigilance, given past rapid private credit growth. Supervision and regulation need to be strengthened to monitor and safeguard banks' asset quality and limit systemic risk, including by use of macro prudential measures.

Bhutan is on a 24-month consultation cycle. The 2014 Article IV consultation was concluded by the Executive Board on June 20, 2014.

Table 1. Bhutan: Selected Economic Indicators, 2009/10–2014/15 1/

Nominal GDP (2010): US$1,585.7 million
Population (2010): 0.725 million
GDP per capita (2010): US$2,187
Quota: SDR 6.3 million

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
				Est.	Proj.	
Real sector						
Real GDP at market prices (percent change)	9.3	10.1	6.5	5.0	6.4	7.6
Consumer prices (percent change, period average)	4.8	8.6	10.1	8.7	10.2	8.8
General government				(In percent of GDP)		
Total revenue and grants	46.3	35.6	35.2	28.9	27.2	22.7
Tax revenue	13.4	13.7	15.8	14.5	12.7	12.6
Non-tax revenue	16.3	8.6	5.9	5.4	5.3	5.0
Foreign grants	16.6	13.3	13.5	9.0	9.2	5.2
Total expenditure and net lending	44.7	37.7	36.5	32.9	31.0	25.1
Current expenditure	26.0	20.2	18.0	17.1	15.8	15.5
Capital expenditure	19.3	18.7	19.6	17.4	16.7	10.8
Current balance (excluding grants)	3.8	2.2	3.9	2.8	2.2	2.0
Overall balance	1.6	-2.1	-1.3	-4.0	-3.8	-2.4
Public sector debt 2/	57.5	68.6	72.2	89.2	108.1	117.7
Monetary sector				(Percent change, unless otherwise indicated)		
Broad money	30.1	21.2	-1.0	18.6	…	…
Credit to private sector	22.8	19.2	20.7	6.2	…	…
Interest rates (end of period, in percent)						
Deposits (less than 1 year)	5.0	5.0	5.5	5.5	…	…
Lending	10–16	9.75–16	10.0–16	11.7–16	…	…
External sector				(In millions of dollars, unless otherwise indicated)		
Current account balance	-142	-410	-350	-439	-456	-581
(In percent of GDP)	-9.9	-23.5	-19.0	-22.7	-23.2	-26.7
Trade balance	-299	-519	-477	-459	-514	-562
Exports (goods)	544	665	595	603	637	684
(Percent change)	5.5	22.2	-10.6	1.4	5.7	7.4
Imports (goods)	843	1,185	1,072	1,062	1,151	1,246
(Percent change)	39.0	40.5	-9.5	-0.9	8.4	8.2
Grants (current transfer)	261	254	273	191	198	125
Capital account balance	99	472	261	545	478	611
Loans (net)	108	366	225	342	345	463
Errors and omissions	43	33	-20	0	0	0
Overall balance	-1	96	-109	106	22	30
(In percent of GDP)	-0.1	5.5	-5.9	5.5	1.1	1.4
Gross official reserves	810	907	810	916	938	968
(In months of goods and services imports)	7.5	9.0	8.1	8.5	8.1	7.1
External debt (in percent of GDP)	55.9	65.9	71.0	84.8	100.7	108.4
Ngultrum per U.S. dollar (period average)	46.7	45.3	50.3	…	…	…
Memorandum items:						
GDP at market prices (in billions of Bhutanese Ngultrum)	66.9	79.2	92.7	106.1	121.9	140.9
GDP at market prices (in millions of U.S. dollars)	1420.8	1714.3	1851.7	1846.4	1976.1	2209.3
Electricity exports (in percent of total goods exports)	42.8	34.3	32.8	29.8	27.1	25.9
Unemployment rate (in percent) 3/	3.3	3.3	3.1	2.1	…	…

Sources: Bhutanese authorities; and IMF staff estimates and projections.

1/ Fiscal year begins July 1.

2/ Public and publicly guaranteed debt, including loans for hydropower projects and the purchase of one aircraft.

3/ On a calendar year basis (e.g., the entry for 2009/10 is for 2009).

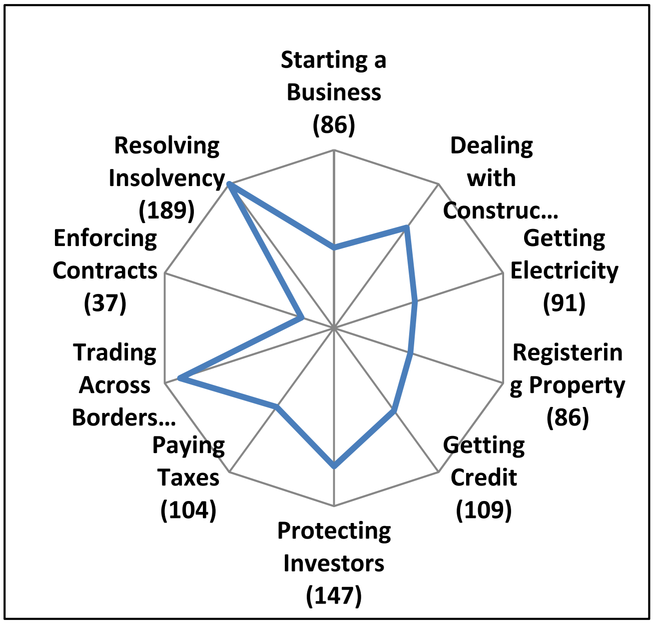
ANNEX 4: Improving the Investment Climate in Bhutan: WBG Doing Business Reforms

1. **Firms' competitiveness in Bhutan has been hampered by difficult investment climate and low productivity levels.** The geography of the country (difficult to access and mountainous terrain) remains a major constraint to access to finance although some progress has been achieved. Moreover, while Bhutan outperforms its South Asian neighbors on Transparency International's Corruption Perception Index (ranked first), Bhutan ranks the worst among the same group of countries on the Regulatory Quality Indicator.

2. **The World Bank has been supporting the government's efforts to improve its investment climate with key investment climate policies enacted during 2011-13.** The World Bank reviewed and helped the government formulate a number of policies and laws, to implement the Economic Development Policy (EDP), vetted in May 2010 and governing the country's industrial development and 11th Five-Year Plan.

3. **Despite these achievements, Bhutan's Doing Business ranking still lags behind its peers.** In the *Doing Business* 2014 report, Bhutan ranked 141 out of 189 countries in the ease of doing business. [18] In the South Asia Region, Bhutan ranked last in 2013 and just second to last in 2014. Its weakest areas included construction permits, protecting investors and trading across borders, while it performed the best in the area of enforcing contracts (see figure 1).

Figure 1: Ranking of selected countries in 2014Doing business report and Bhutan performance in all Doing Business indicators



[18] Bhutan's ranking was revised to 125th after application of a new methodology

4. **The government's commitment towards a better business environment is, however, strong**. The World Bank received a technical assistance (TA) request in April 2013 and in November of the same year, the newly elected Prime Minister communicated to his Minister of Economic Affairs and the World Bank his objective to raise Bhutan's ranking in the Doing Business report to the top 100 in about two years.

5. **As a result, the objective of the joint World Bank and IFC Non Lending TA (NLTA) was to improve the business environment in Bhutan along the areas captured in the Doing Business report, measured by the number of reforms by one year post-project completion.** A complementary objective was to get the facts well translated in Doing Business indicators or "measurement" gains. Box 1 summarizes achievements, with World Bank assistance.

Box 1 – Achievements through WBG NLTA Doing Business Reforms

(1) Formulation of a time-bound actionable plan of reforms in the short and medium term based on the recommendations from the "Investment climate reform memorandum (memo)" which was drafted by the WBG and submitted to the government in December 2013. The memo highlights the areas of reforms in order to improve the business environment in Bhutan. The memo and the Action plan were formulated following consultations of various stakeholders from the public and private sectors and various agencies of the government involved in the regulatory process. Two workshops were organized in Bhutan: (i) in September 2013 with Doing Business respondents (from government agencies and the private sector) to discuss the Doing Business surveys and in preparation of the memo; (ii) and in March 2014 with various government agencies to discuss the draft action plan formulated by the government with assistance from the World Bank. The workshop was used to get agencies' feedback about the feasibility and timeline for each action and ensure ownership of the action plan of reforms.

(2) Institutional set-up to drive the reform agenda. Building on cross-country experiences, the WBG shared international best practices of institutional setups to implement an investment climate reform agenda and commented on government proposals. An Executive Order was signed by the Prime Minister on April 2, 2014 which set up two committees: (i) a Doing Business Steering Committee chaired by the Prime Minister and comprising all Ministers including the Joint Secretary of the MOEA to oversee reform initiatives, (ii) and a Doing business task force chaired by the Minister of Economic Affairs to review, recommend and implement reforms across the government. It comprises senior officials concerned by Doing Business indicators and private sector representatives. As of end May 2014, the task force met twice to finalize how each Ministry/Agency would carry the reforms forward.

(3) Dissemination and discussion of the action plan of reforms with the public including the private sector and other stakeholders such as donors, international organizations, academia and renowned experts. The discussion took place during the Better Business Summit (March 26-28, 2014) organized by the government with the help of the WBG. The WBG project team discussed the organization of the "making business easy" workshop planned during the summit and the external side-event hosted by the World Bank country office, with high level implementers of the reform agenda, representatives of the private sector and a World Bank expert on Doing Business and global indicators: Mr. Augusto Lopez Claros (Director, Global Indicators Group).

(4) Clarification of the Doing Business methodology and dialogue to update results of the Doing Business surveys through series of Video conferences held with relevant government agencies of the government and the Doing Business measurement team. Throughout April 2014 video conferences were held to explain the methodology for six selected indicators of the Doing Business report. In the past, discussions also took place on the "getting electricity indicator" (which estimate has been challenged by the government). Following the data updates received by the Doing Business measurement team after each video conference with the government, Bhutan's ranking in this indicator improved from 134 to 93 (out of 185 countries) in the 2013 report and by an additional two positions in the 2014 report (91 out of 189). Nonetheless, this ranking remains unrepresentative of Bhutan's major comparative advantage on access to electricity.

6. **With World Bank assistance, Bhutan has made a lot of progress; however, more needs to be done to improve the business environment, notably, by implementing the action plan of reforms.** The World Bank is striving to support the government's efforts in that light, but, rather than aiming at specific advancements in the rankings, emphasis would be placed on the implementation of the key reforms to improve the investment climate to ensure that the absolute quality of the regulatory environment improves over time.[19]

7. The implementation of some of the reforms outlined in the action plan would be relevant for the next Development Policy Credit in preparation for Bhutan and some reforms could also benefit from a WBG project with IFC Advisory services.

8. **Among the policy and institutional reforms that are aimed to be achieved by the end of the CPS program** two regulatory reforms which would contribute to making the process of business registration easier, more efficient, and in line with international best practices:

- The "Enterprise Registration Bill," which will introduce the legal form for Partnerships and Sole Proprietorship. This law also contains the provision of eliminating the need for an operating license, and will introduce the legal framework for online registration for new companies.
- The amendment to the existing Companies Act (2000), which regulates the Limited liability Companies and will eliminate the requirement for a company seal among other things.

9. In the medium-term, three important improvements are needed and include:

- Making electronic both the Companies Registry and the Property Registry, which now are still paper-based.
- Legislative reviews in the areas of secured transactions and resolving insolvency.
- For the areas of tax administration and trade logistics, the implementation of the new electronic data interchange system, called RAMIS, will insure better internal workflows and an improvement in the processes of export and tax payments.

10. Finally, many recommendations to ease doing business are related to improvements in e-government and e-services, for instance by developing the Information and Communication Technology (ICT) infrastructure and internet connectivity.

[19] For instance on monitoring the change in the distance-to-frontier indicator which shows how far on average an economy is from the best performance achieved by any economy on each Doing Business indicator since 2005, except for the getting electricity indicators, which were introduced in 2009.

INTERNATIONAL MONETARY FUND

May 30, 2014

BHUTAN

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITYANALYSIS

Approved By

Paul Cashin and Ranil Salgado (IMF) and Jeffrey Lewis and Ernesto May (IDA)

The Debt Sustainability Analysis (DSA) has been prepared jointly by IMF and World Bank staff, in consultation with the authorities, using the debt sustainability framework for low-income countries approved by the Boards of both institutions.

Based on the Joint Fund-Bank Debt Sustainability Framework for Low-Income Countries (LIC DSA), Bhutan's risk of external debt distress is moderate. Bhutan's rapid hydropower development is projected to lead to a substantial buildup of external debt in the medium-term, with debt ratios breaching most of the country-specific indicative thresholds for protracted periods of time. Also risk stem from volatile hydro-related debt service payments. Bhutan's debt situation is only expected to improve over the long run, reflecting significantly higher electricity exports when more hydropower projects come on stream. The staff's assessment is primarily based on unique mitigating factors, namely explicit guarantees from India that cover financial and construction risks for the hydropower projects, thus allowing for the exceptional treatment of hydropower loans from India as similar to FDI—i.e., non-debt creating. Other mitigating factors include Bhutan's strong track record of project implementation, rapid growth in energy demand from India, committed donor support, and Bhutan's high level of international reserves.[20] *Notwithstanding these mitigating factors, staff cautions against further new non-concessional borrowing as the level of debt has increased substantially compared to previous DSAs. Stress tests to public sector debt dynamics reveal the need for fiscal consolidation and the importance of sustaining rapid economic growth going forward.*

[20] Bhutan, with an average Country Policy and Institutional Assessment (CPIA) index of 3.85, is currently classified as a strong performer with regard to its policies and institutions.

Background

1. **Bhutan's public and publicly guaranteed (PPG) external debt increased to 85 percent of GDP at end 2012/13 adding 14 percentage points of GDP to the previous year.** The rise in the external public debt was, in large part, driven by hydro sector related external borrowing (with an outstanding stock of 48 percent of GDP). Hydropower projects are primarily financed by India with a mix of loans (70 percent) and grants (30 percent). A large portion of external debt continues to be denominated in Indian rupees (and related to hydropower sector debt), which accounts for 61 percent of total external debt, with convertible currency debt accounting only 29 percent. Domestic debt was entirely due to the loan to purchase aircraft for Druk Air in 2009/10, and the increased domestic debt-to-GDP ratio at about 6 percent of GDP in 2012/13 reflects the fiscal outturns in the following three years.

Bhutan: Structure of Public Sector Debt

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Total Public Sector Debt (percent of GDP)	59	71	57	69	72	90
External	56	69	56	66	71	85
Hydropower sector debt	36	39	32	40	42	48
Non-hydropower sector debt	20	30	24	26	29	37
Domestic	3	2	2	3	1	6

Underlying Debt Sustainability Analysis Assumptions

2. **Under the baseline scenario, Bhutan is expected to pursue expansion in its power generation capacity to about 10,000 MW by 2020.** The hydropower development policy of Bhutan consists of eleven new hydropower projects (see text table), which would quintuple Bhutan's power generation capacity. External financing for non-hydropower sector activities continues to remain predominantly from multilateral and bilateral donors at concessional terms. In addition, the government has a stand-by facility with the Government of India to relieve temporary BOP pressures, as well as a swap line with the Reserve Bank of India and overdrafts with Indian commercial banks. These also add to the external debt stock when availed.

Table. Summary of Hydropower Projects in the Pipeline

Project	Capacity (MW)	DPR Schedule	Construction Schedule	Development Model
Punatsangchhu I	1200	Under construction	2008-2017	Intergovernment
Punatsangchhu II	1020	Under construction	2010-2017	Intergovernment
Mangdecchu	720	Under construction	2010-2017	Intergovernment
Sankosh Storage	2650	DPR yet to be cleared	2015-2023	Intergovernment
Kuri Gongri	2640	DPR to be prepared in 11FYP	2017-2026	Intergovernment
Amochhu Storage	540	DPR cleared by CEA	2015-2023	Intergovernment
Wangchhu	570	DPR yet to cleared by CEA, GoI	2015-2023	Joint Venture
Bunakha Storage	180	DPR cleared by CEA	2014-2020	Joint Venture
Kholongchhu	600	DPR approved by two Governments	2014-2021	Joint Venture
Chamkarchhu I	770	DPR yet to be cleared	2015-2024	Joint Venture
Dagachhu	126	Completed	2009-2014	PPP
Total	**11066**			

Source: Annual Report 2012/13, Royal Monetary Authority of Bhutan

Note: CEA: Central Electricity Authority, Government of India.

3. **The hydropower sector developments will govern the rest of the economy as summarized by the following key baseline macroeconomic assumptions**.

- ***Real sector***: Similar to the spike in real GDP when Tala hydropower project was commissioned in 2006/07, Puna I, Puna II and Mangdechu hydropower projects will continue to boost economic growth during the construction phase and as they come on stream in 2017/18. Real growth in the medium-term is projected to remain at around 8½ percent, close to its 10-year historical average of 8 percent. As construction of hydro projects phases out, growth will gradually return to around 6¾ percent in the long-term.
- ***Fiscal sector***: Upon completion, the hydropower projects will boost the domestic revenue-to-GDP ratio, similar to when Tala hydropower project came on line. External budgetary aid is projected to decline as a share of GDP as Bhutan's per capita income rises. On average, the overall fiscal deficit remains broadly balanced over the long term.
- ***External sector***: The current account deficit is projected to deteriorate over the medium term because of strong growth in import demand associated with the construction phase of the hydropower projects, as well as hydro debt service. Upon the completion of hydropower projects, however, electricity exports are likely to more than triple from current levels, and the current account deficit should decline over the longer term, leading to balance of payment surpluses from 2020 onwards.

Key Macroeconomic Assumptions

	10 year Historical Average	Baseline Average	
		2013–2018	2019–2033
Current transfers, net total (in percent of GDP)	11.3	5.2	0.3
Real GDP growth (percent)	8.0	8.4	6.6
Growth of exports of goods and services (US dollar terms)	21.4	17.6	8.6
Non-interest current account deficit (in percent of GDP)	10.0	15.6	-16.5
Primary deficit (in percent of GDP)	-1.2	-7.1	-11.7

External Debt Sustainability Analysis

A. Baseline

4. **Bhutan's external debt closely traces hydropower cycles**. External debt as a share of GDP is projected to rise to 121 percent of GDP in 2016/17 in line with disbursements for hydropower-sector projects, before declining slightly to 116 percent of GDP in 2017/18 with the completion of the first phase of hydro construction (Table 1). The stock of external public and publicly guaranteed (PPG) debt is expected to gradually decline in the long term to about 29 percent in 2034 once construction of most of the hydropower projects is completed and debt service commences to pay down the debt stock. As a result, the present value (PV) of PPG external debt-to-GDP gradually declines to 25 percent only over the long term. The PV of debt-to-exports ratio falls below the threshold of 200 percent also only in the long run and remains

above the threshold for most of the projection period. The PV of PPG external debt to revenue is also on a downward trend from a peak of 750 percent in 2014/15 and is projected to fall below the threshold of 300 percent only in the long run.[21] However, all the debt ratios remain above the LIC-DSA indicative thresholds for a significant part of the projection period under the baseline. The commissioning of the hydropower projects (in 2017/18), which also marks the start of the debt repayment, puts the debt ratios on a steady downward trajectory.

5. **Debt service-to-export ratio is expected to remain below the indicative thresholds for most of the entire projection period.** However, debt service-to-revenue ratio breaches the indicative threshold as Puna II and Mangdechu's debt service begin in 2018/19; however, it is expected to fall below the threshold over the long run.[22] The protracted breaches of the thresholds over the medium term would indicate a high risk of debt distress, although strong mitigating factors exist for hydropower debt.

6. **Excluding hydropower debt from the total (i.e., treating these loans like FDI), breaches of baseline debt-ratios are temporary and/or marginal**. The assumptions in the scenario are the same as the previous one outlined in paragraph 3. All hydropower loans are excluded to assess debt dynamics of non-hydro debt. The results of this scenario are that non-hydro debt ratios are well below the threshold in case of PV of debt to GDP, exports and revenues. There are temporary breaches in the case of the debt service indicators.

B. Sensitivity Analysis

7. **The PV of debt-to-exports and debt-to-revenue ratios (which are two of the external debt sustainability thresholds) are breached under stress tests** (exports shock, exchange rate depreciation, growth shock and unfavorable financing terms). The standard sensitivity analysis points to a moderate risk of debt distress (Figure 1 and Table 2), as all debt burden indicators (PV of debt-to-exports, debt-to-revenue, and debt-to-GDP ratios) breach their respective thresholds after the shocks in 2014 and only come down in the long run (except under the historical scenario). Based on the bound tests, the most extreme stress for the PV of debt-to-exports or revenue ratios is a one-standard deviation shock to the exchange rate in 2013–14. However, this shock overestimates Bhutan's debt vulnerability since a large share of Bhutan's external income is in Indian rupees, which act as a natural hedge to the rupee-denominated debt.

[21] The PV indicators exceed ratios in nominal terms due to non-concessional nature of outstanding debt (hydropower-project loans, Dungsam-cement-company borrowing, stand-by-credit-facility with government of India, SWAP arrangement with RMA, and borrowing from Indian commercial banks).

[22] Revenues used to pay for amortization are accounted in the budget as repayable in net lending. The DSA template adds these numbers to revenues to better reflect the capacity of the government to service the debt.

8. **Debt service ratios also breach their respective thresholds for parts of the projection period.** The debt service-to-export ratio breaches the threshold under a growth shock and the debt service-to-revenue ratio breaches the indicative threshold continuously under the shock scenarios.

PUBLIC DEBT SUSTAINABILITY ANALYSIS

C. Baseline

9. **The baseline public debt dynamics trace closely the path of external debt**. The public debt-to-GDP ratio is expected to rise to 129 percent in 2016/17 and then decline gradually until it reaches 35 percent of GDP by end 2033/34. External financing is projected to shrink as a share of GDP, making room for domestic financial markets to play a larger role in the financing of the development agenda.

D. Sensitivity Analysis

10. **The public debt ratios are projected to be on a declining path over the long term under various stress tests**. A one-time depreciation results in an upward shift in the various public debt indicators without affecting the shape of the debt indicators' path. However, the sensitivity analysis suggests that the debt service ratios are susceptible to extreme shocks, given the bunching of repayments in the outer years. This scenario underscores the importance of containing fiscal deficits to ensure the sustainability of public debt.

STAFF ASSESSMENT

11. **Despite worsening of debt ratios compared to the 2011 DSA, staff maintains the assessment that Bhutan's risk of external debt distress is moderate due to the presence of unique and strong mitigating factors. These factors are primarily the explicit guarantees from India that cover financial and construction risks for the hydropower projects (Box 1). This unique arrangement allows for an exceptional treatment of hydropower loans from India as similar to FDI—i.e., non-debt creating.**

- The addition of new hydropower projects leads to a substantial build-up in external debt, relative to the analysis in the 2011 DSA. The policy-related LIC-DSA thresholds are breached for most of the indicators and remain breached for a longer period compared to the previous analysis. As Bhutan's debt carrying capacity only improves in the long run, staff cautions against any additional non-concessional borrowing. Also, Bhutan's (i) concentrated export base, (ii) rupee-reserves mismatch with external debt and the trade structure of the country (and the consequent buildup of debt related to the overdrafts)—see Selected Issues paper on reserve adequacy and reserve management, and (iii) its fiscal stance, leave it vulnerable to export and constant primary-deficit shocks and any shortfalls in aid inflows. These vulnerabilities are confirmed by the stress tests in the DSA which reveals potential vulnerabilities in Bhutan's external debt situation. Additional risks stem from volatile hydro related debt service payments requiring provisioning of rupee reserves. Two episodes of rupee shortage in 2006/2007 and as recently as 2011/12 are partly explained by lumpy debt service payments.

- However, the guarantees from India mitigate risks related hydropower loans, with debt and debt-service ratios significantly lower and breaches of indicative thresholds temporary and/or marginal, once these loans are excluded. These additional projects also confer strong economic dividends in the long-term, boosting real GDP growth and exports.

12. **Furthermore, mitigating factors that were also highlighted in previous assessments remain valid, namely:**

- Bhutan has a strong track record of project implementation.
- Bhutan maintains close economic and political ties with India, which mitigate the commercial risks of these projects. India has been both the main provider of financing for hydropower projects and the main consumer of the projects' electricity output. Going forward, India's sizeable power deficit will continue to support the demand for Bhutan's hydropower.

Box 1. Institutional and Legal Arrangements of Inter-Governmental Hydropower Projects in Bhutan

Intergovernmental hydropower projects in Bhutan are being undertaken under a unique arrangement between India and Bhutan, reflecting close links between the two countries. Under the "10,000 MW by 2020" bilateral cooperation agreement signed on 26th July 2006 and the protocol to the agreement signed on 16th March 2009, the Royal Government of Bhutan (RGoB) and the Government of India (GoI) agreed to develop 5 intergovernmental projects (Chhuka, Kurichhu, Tala which have been commissioned, and Punatsangchhu I, Punatsangchhu II, Mangdechhu which are under construction).

Under the intergovernmental agreement, a detailed project report (DPR) is prepared by a GoI undertaking. The report reviews all technical and financial aspects of the project. After the DPR is final and endorsed by the 2 countries, a Project Agreement between Bhutan (Ministry of Foreign Affairs) and India (Ministry of External Affairs) is signed, which establishes:

- Sole ownership of the project by the RGoB;
- Estimated cost of project, and establishes GoI's sole responsibility for funding (including additional costs);
- Terms of financing (share of grant versus loan financing from India, simple - non capitalized interest rate, amortization period, with the first repayment starting one year from the mean date of commercial operation)
- Setting-up of a project authority for the construction, operation, maintenance and evacuation of the surplus power, with a chairperson appointed by RGoB;
- Handing over of the project by the project authority to the RGoB within 2 years of completion of the project and dissolution of the project authority at the time;
- That the GoI will purchase all the surplus power from the project (over and above domestic use);
- Principle of a "cost plus" approach for the determination of the power rate at the time of commissioning the project. Cost plus includes the costs of the project, financing costs, operation and maintenance charges, (accelerated) depreciation and market conditions and a net return of 15 percent.
- The principle of reviewing the rate every 3 years.

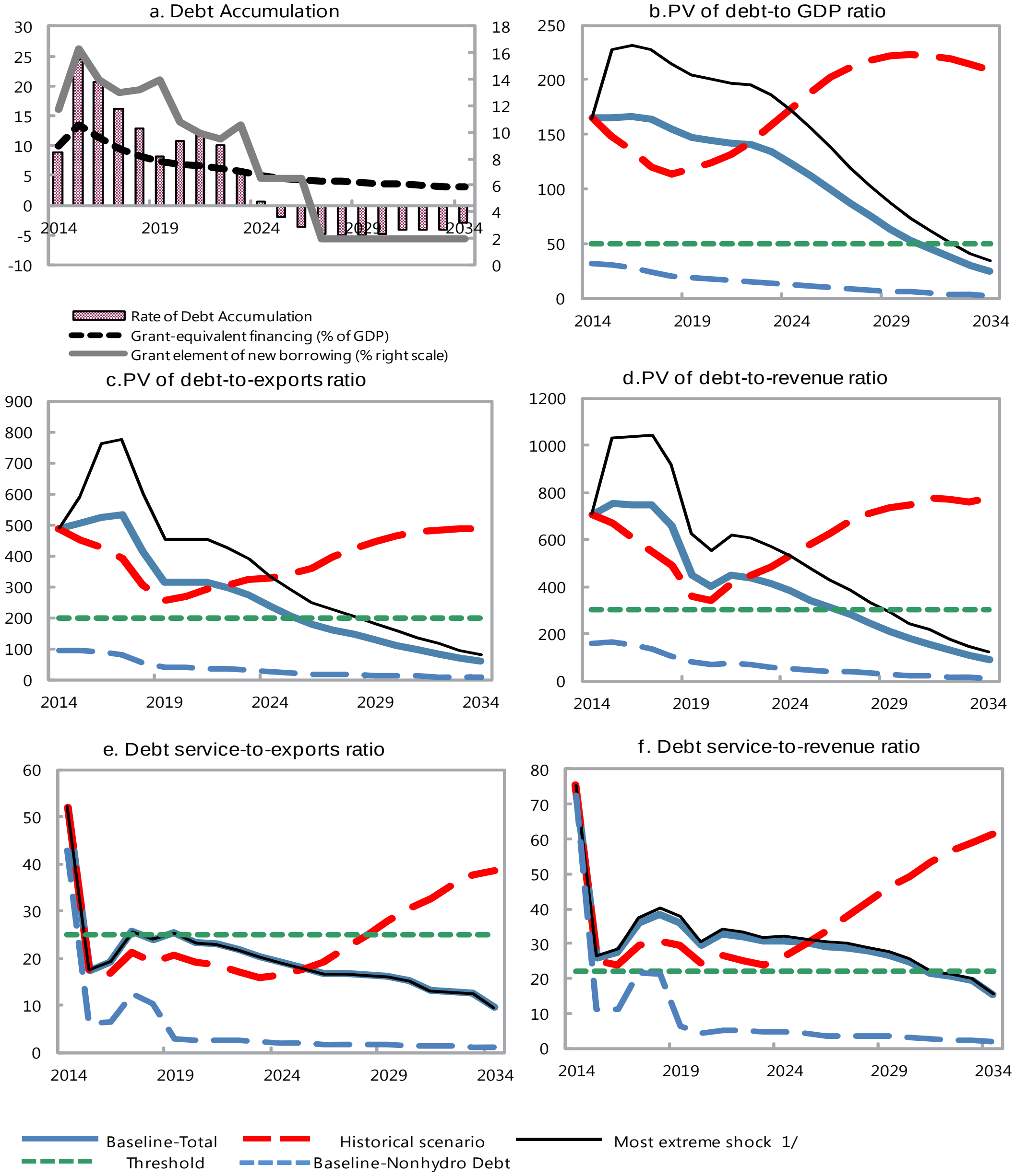
Once the project has finished construction and is commissioned:

- a protocol to the Project Agreement is signed between RGoB (Ministry of Economic Affairs) and GoI (Bhutan Embassy), which establishes the rate at which the surplus power will be sold to GoI, authorizes the designated nodal agencies to enter into a Power Purchasing Agreement (PPA) following the principles established in the Protocol;
- a protocol to the Project Agreement is signed between RGoB (Ministry of Finance) and GoI (Bhutan Embassy), which establishes the principal to be repaid, repayment schedule and interest.
- a subsidiary loan agreement between the Government of Bhutan and Druk Green Power Corporation (DGPC), a Public Holding company part of Druk Holding Investments (DHI), treating the MoF loan as on-lending to DGPC. The agreement follows the same terms as the umbrella agreement, DGPC payments to MoF treasury having to be made a week before the due date to GoI.

<u>Assessment of Debt Sustainability risks of Intergovernmental hydropower projects</u>

Debt sustainability risks are minimal: (i) construction risks are born by GoI, (ii) power rates are determined at the time of the project commissioning, when the actual project cost is known, and are set to allow revenues to service debt and a financial return; (iii) hydropower project are insured (and re-insured) for natural disaster. The only risk is hydrological after commissioning of the project, if electricity, once the project is commissioned, could not be generated.

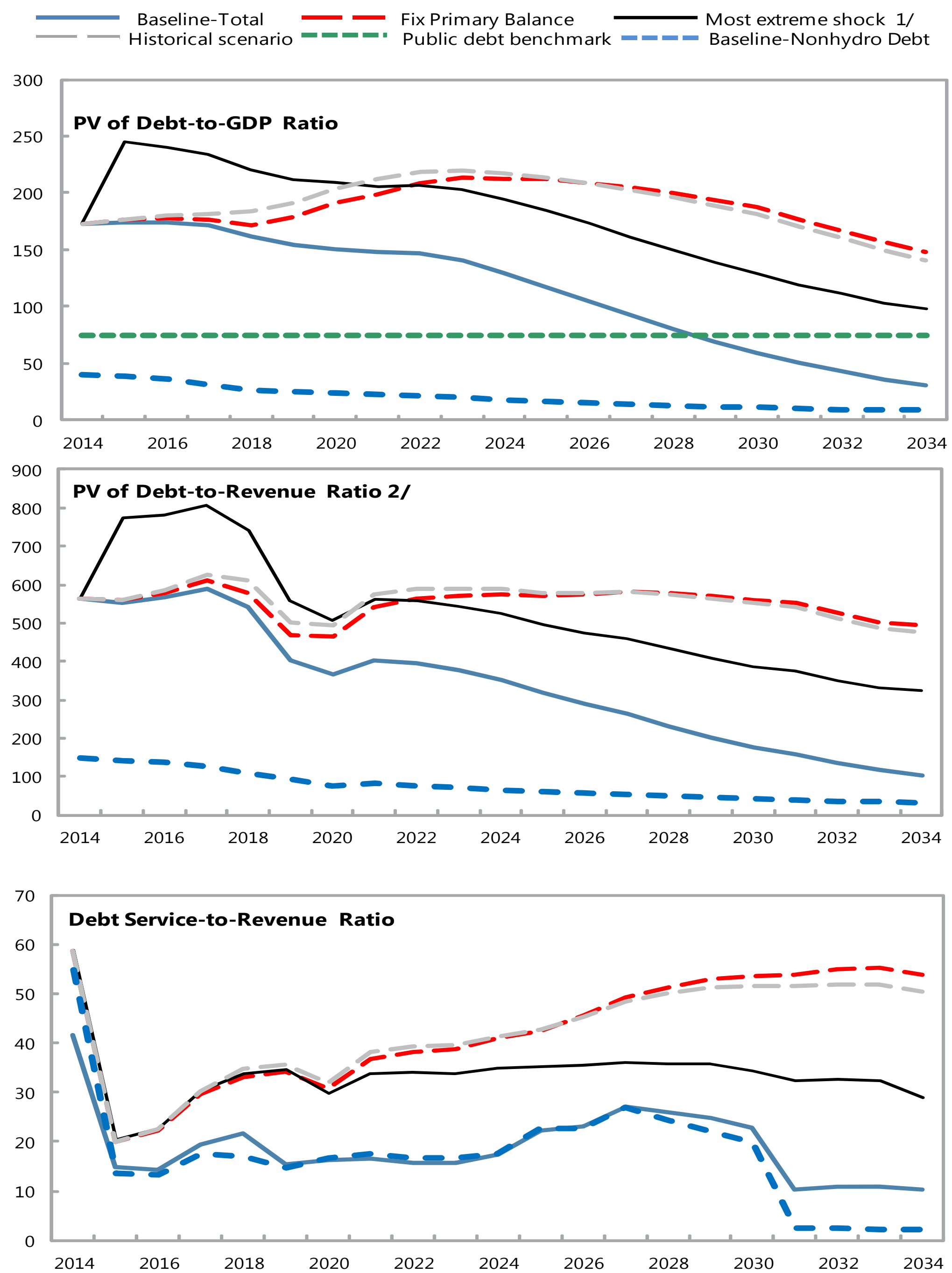
Figure 1. Bhutan: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2014–2034 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Growth shock and in figure f. to a Growth shock

Figure 2. Bhutan: Indicators of Public Debt Under Alternative Scenarios, 2014–2034 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024.

2/ Revenues are defined inclusive of grants.

Table 1. Bhutan: External Debt Sustainability Framework, Baseline Scenario, 2011–2034 1/

	Actual			Historical Average 6/	Standard Deviation 6/	Projections									
	2011	2012	2013			2014	2015	2016	2017	2018	2019	2014-2019 Average	2024	2034	2020-2034 Average
External debt (nominal) 1/	**65.9**	**71.0**	**84.8**			**105.2**	**114.4**	**120.0**	**120.8**	**115.9**	**116.8**		**117.5**	**29.4**	
of which: public and publicly guaranteed (PPG)	65.9	71.0	84.8			105.2	114.4	120.0	120.8	115.9	116.8		117.5	29.4	
Change in external debt	10.0	5.1	13.8			20.4	9.2	5.6	0.8	-4.9	0.9		-7.5	-5.9	
Identified net debt-creating flows	11.9	15.0	18.4			17.9	17.1	16.5	16.8	1.7	-2.9		-22.3	-13.9	
Non-interest current account deficit	**21.0**	**16.9**	**20.1**	**10.0**	**13.5**	**16.8**	**22.1**	**22.3**	**23.4**	**11.2**	**-2.4**		**-21.7**	**-11.7**	-16.5
Deficit in balance of goods and services	29.7	25.9	23.8			24.8	28.5	29.3	29.2	17.0	7.6		-9.1	-1.9	
Exports	38.1	32.2	31.1			33.8	32.9	31.7	30.6	37.4	46.8		52.4	43.0	
Imports	67.8	58.1	54.9			58.6	61.4	61.0	59.8	54.4	54.4		43.3	41.1	
Net current transfers (negative = inflow)	-12.8	-13.2	-14.1	-11.3	2.9	-4.4	-7.6	-6.7	-5.1	-4.2	-3.0		-1.3	1.8	-0.3
of which: official	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other current account flows (negative = net inflow)	4.1	4.2	10.4			-3.5	1.1	-0.3	-0.7	-1.6	-7.0		-11.2	-11.6	
Net FDI (negative = inflow)	**-1.5**	**-0.5**	**-1.3**	**-1.5**	**2.1**	**-1.3**	**-1.3**	**-1.3**	**-1.3**	**-1.3**	**-1.3**		**-1.3**	**-1.3**	-1.3
Endogenous debt dynamics 2/	**-7.7**	**-1.4**	**-0.4**			**2.4**	**-3.7**	**-4.5**	**-5.3**	**-8.2**	**0.8**		**0.8**	**-0.9**	
Contribution from nominal interest rate	2.4	2.1	2.9			7.9	3.6	3.9	4.0	4.0	9.2		7.9	1.2	
Contribution from real GDP growth	-4.6	-4.1	-3.4			-5.5	-7.3	-8.4	-9.3	-12.1	-8.4		-7.2	-2.1	
Contribution from price and exchange rate changes	-5.4	0.6	0.0			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**-1.8**	**-9.9**	**-4.6**			**2.6**	**-7.9**	**-10.9**	**-16.1**	**-6.7**	**3.8**		**14.8**	**8.0**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	142.5			164.8	165.5	166.1	163.2	154.1	147.0		124.0	24.9	
In percent of exports	...	...	458.3			487.1	503.7	524.6	533.9	411.7	314.1		236.6	57.9	
PV of PPG external debt	**...**	**...**	**142.5**			**164.8**	**165.5**	**166.1**	**163.2**	**154.1**	**147.0**		**124.0**	**24.9**	
In percent of exports	**...**	**...**	**458.3**			**487.1**	**503.7**	**524.6**	**533.9**	**411.7**	**314.1**		**236.6**	**57.9**	
In percent of government revenues	**...**	**...**	**588.2**			**706.9**	**749.4**	**746.4**	**747.5**	**659.0**	**447.9**		**381.7**	**92.5**	
Debt service-to-exports ratio (in percent)	**13.6**	**13.2**	**17.7**			**52.0**	**17.4**	**19.2**	**25.6**	**24.0**	**25.3**		**19.1**	**9.6**	
PPG debt service-to-exports ratio (in percent)	**13.6**	**13.2**	**17.7**			**52.0**	**17.4**	**19.2**	**25.6**	**24.0**	**25.3**		**19.1**	**9.6**	
PPG debt service-to-revenue ratio (in percent)	**23.4**	**18.2**	**22.7**			**75.5**	**25.8**	**27.3**	**35.9**	**38.4**	**36.0**		**30.8**	**15.3**	
Total gross financing need (Billions of U.S. dollars)	0.4	0.4	0.5			0.7	0.5	0.6	0.8	0.6	0.3		-0.6	-1.1	
Non-interest current account deficit that stabilizes debt ratio	11.0	11.8	6.3			-3.6	12.9	16.7	22.6	16.1	-3.3		-14.2	-5.8	
Key macroeconomic assumptions															
Real GDP growth (in percent)	10.1	6.5	5.0	8.0	2.5	6.4	7.6	8.2	8.6	11.5	8.0	8.4	6.2	6.6	6.6
GDP deflator in US dollar terms (change in percent)	10.7	-0.9	0.0	4.8	7.2	-8.6	1.8	2.9	2.8	2.6	2.3	0.6	2.4	2.4	2.4
Effective interest rate (percent) 5/	5.1	3.3	4.3	3.2	1.9	9.1	3.7	3.8	3.7	3.7	8.8	5.5	6.9	3.9	6.8
Growth of exports of G&S (US dollar terms, in percent)	22.2	-10.6	1.2	21.4	30.3	5.7	6.4	7.3	7.8	40.0	38.2	17.6	15.8	6.5	8.6
Growth of imports of G&S (US dollar terms, in percent)	40.5	-9.5	-0.9	20.5	27.5	3.7	14.8	10.6	9.5	4.1	10.5	8.9	3.8	9.1	7.2
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	11.7	16.3	14.0	13.0	13.2	14.0	13.7	6.5	2.0	5.1
Government revenues (excluding grants, in percent of GDP)	22.1	23.4	24.2			23.3	22.1	22.3	21.8	23.4	32.8		32.5	26.9	30.9
Aid flows (in Billions of US dollars) 7/	0.9	1.4	0.6			0.2	0.3	0.3	0.3	0.3	0.3		0.2	0.4	
of which: Grants	0.2	0.3	0.2			0.1	0.2	0.2	0.2	0.2	0.2		0.2	0.4	
of which: Concessional loans	0.7	1.1	0.4			0.0	0.1	0.1	0.1	0.1	0.1		0.0	0.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			9.9	13.5	11.4	9.4	8.4	7.3		4.9	3.0	4.5
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			33.8	39.1	39.6	38.5	38.9	37.2		52.1	100.0	75.7
Memorandum items:															
Nominal GDP (Billions of US dollars)	1.7	1.8	1.9			1.9	2.1	2.3	2.6	2.9	3.2		5.0	12.0	
Nominal dollar GDP growth	21.9	5.5	4.9			-2.8	9.5	11.3	11.6	14.3	10.5	9.1	8.8	9.2	9.1
PV of PPG external debt (in Billions of US dollars)			2.7			2.9	3.3	3.7	4.1	4.4	4.7		6.1	2.9	
(PVt-PVt-1)/GDPt-1 (in percent)						8.9	24.4	20.6	16.1	12.8	8.2	15.2	0.6	-3.0	-0.2
Gross workers' remittances (Billions of US dollars)	...	...	...			...	...	...	...	...	...		...	...	
PV of PPG external debt (in percent of GDP + remittances)	...	...	142.5			164.8	165.5	166.1	163.2	154.1	147.0		124.0	24.9	
PV of PPG external debt (in percent of exports + remittances)	...	...	458.3			487.1	503.7	524.6	533.9	411.7	314.1		236.6	57.9	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	17.7			52.0	17.4	19.2	25.6	24.0	25.3		19.1	9.6	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes. Sizable capital grants are part of residuals.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 2. Bhutan: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–2034

	Projections							
	2014	2015	2016	2017	2018	2019	**2024**	2034
PV of debt-to GDP ratio								
Baseline	165	165	166	163	154	147	**124**	25
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	165	148	136	120	114	118	**173**	209
A2. New public sector loans on less favorable terms in 2014-2034 2	165	168	174	175	169	164	**151**	47
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	165	164	170	167	158	151	**127**	25
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	165	165	175	172	162	154	**128**	25
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	165	168	179	176	167	159	**133**	26
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	165	162	164	161	152	145	**122**	24
B5. Combination of B1-B4 using one-half standard deviation shocks	165	162	167	165	156	148	**125**	25
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	165	228	231	227	214	204	**172**	34
PV of debt-to-exports ratio								
Baseline	487	504	525	534	412	314	**237**	58
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	487	451	428	391	304	252	**329**	485
A2. New public sector loans on less favorable terms in 2014-2034 2	487	512	551	573	450	351	**289**	108
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	487	490	514	524	404	308	**231**	55
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	487	588	762	774	596	454	**336**	80
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	487	490	514	524	404	308	**231**	55
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	487	493	518	528	407	310	**232**	55
B5. Combination of B1-B4 using one-half standard deviation shocks	487	487	512	522	403	307	**231**	55
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	487	490	514	524	404	308	**231**	55
PV of debt-to-revenue ratio								
Baseline	707	749	746	748	659	448	**382**	93
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	707	672	609	548	487	360	**531**	775
A2. New public sector loans on less favorable terms in 2014-2034 2	707	762	784	802	721	501	**466**	173
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	707	743	765	767	676	459	**390**	92
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	707	749	788	788	693	471	**393**	93
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	707	760	806	808	712	484	**410**	97
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	707	733	737	739	651	442	**375**	89
B5. Combination of B1-B4 using one-half standard deviation shocks	707	733	753	755	666	452	**385**	91
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	707	1033	1038	1040	917	623	**529**	125

Table 2. Bhutan: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–2034 (continued)

Debt service-to-exports ratio								
Baseline	52	17	19	26	24	25	**19**	10
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	52	17	17	21	19	21	**16**	38
A2. New public sector loans on less favorable terms in 2014-2034 2	52	17	17	25	24	26	**23**	16
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	52	17	19	26	24	25	**19**	9
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	52	20	27	38	35	36	**28**	14
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	52	17	19	26	24	25	**19**	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	52	17	19	26	24	25	**19**	9
B5. Combination of B1-B4 using one-half standard deviation shocks	52	17	19	26	24	25	**19**	9
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	52	17	19	26	24	25	**19**	9
Debt service-to-revenue ratio								
Baseline	76	26	27	36	38	36	**31**	15
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	76	25	24	29	31	29	**26**	61
A2. New public sector loans on less favorable terms in 2014-2034 2	76	26	25	35	39	37	**37**	25
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	76	26	29	37	40	38	**32**	16
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	76	26	28	38	40	37	**33**	16
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	76	27	30	39	42	40	**34**	17
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	76	26	27	36	39	36	**31**	15
B5. Combination of B1-B4 using one-half standard deviation shocks	76	26	28	37	40	37	**31**	15
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	76	37	39	51	54	51	**43**	21
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	4	4	4	4	4	4	**4**	4

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly a an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 3. Bhutan: Public Sector Debt Sustainability Framework, Baseline Scenario, 2011–2034

	Actual					Estimate	Projections								
	2011	2012	2013	Average 5/	Standard Deviation 5/	2014	2015	2016	2017	2018	2019	2014-19 Average	2024	2034	2020-34 Average
Public sector debt 1/	68.5	72.3	90.4			113.5	123.3	128.6	128.7	123.1	123.7		123.4	35.3	
of which: foreign-currency denominated	65.9	71.0	84.8			105.2	114.4	120.0	120.8	115.9	116.8		117.5	29.4	
Change in public sector debt	11.1	3.8	18.0			23.1	9.8	5.3	0.2	-5.6	0.6		-7.6	-5.8	
Identified debt-creating flows	-6.6	2.9	-6.6			13.5	-16.4	-14.4	-14.5	-19.8	-20.3		-17.2	-4.7	
Primary deficit	-0.2	-1.2	-2.8	-1.2	2.9	-2.8	-4.5	-4.7	-5.0	-7.7	-18.0	-7.1	-14.6	-2.6	-11.7
Revenue and grants	35.3	37.9	33.5			30.7	31.5	30.8	29.0	29.8	38.1		37.1	30.0	
of which: grants	13.1	14.5	9.3			7.4	9.4	8.5	7.1	6.4	5.3		4.6	3.0	
Primary (noninterest) expenditure	35.1	36.7	30.7			27.9	27.0	26.1	24.0	22.1	20.2		22.5	27.4	
Automatic debt dynamics	-6.4	4.1	-3.9			16.3	-11.9	-9.7	-9.5	-12.2	-2.3		-2.6	-2.2	
Contribution from interest rate/growth differential	-2.8	-7.6	-5.5			-2.5	-8.7	-9.4	-10.1	-13.1	-3.7		-3.9	-2.5	
of which: contribution from average real interest rate	2.5	-3.4	-2.1			2.9	-0.8	-0.1	0.1	0.2	5.4		3.8	0.0	
of which: contribution from real GDP growth	-5.3	-4.2	-3.4			-5.4	-8.0	-9.3	-10.2	-13.3	-9.1		-7.7	-2.6	
Contribution from real exchange rate depreciation	-3.7	11.7	1.6			18.8	-3.2	-0.2	0.6	0.9	1.4		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	17.7	0.9	24.7			9.6	26.2	19.7	14.7	14.2	20.9		9.6	-1.1	
Other Sustainability Indicators															
PV of public sector debt	...	...	148.1			173.0	174.3	174.6	171.1	161.3	153.9		130.0	30.9	
of which: foreign-currency denominated	...	...	142.5			164.8	165.5	166.1	163.2	154.1	147.0		124.0	24.9	
of which: external	...	...	142.5			164.8	165.5	166.1	163.2	154.1	147.0		124.0	24.9	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	5.0	3.7	3.2			14.9	0.2	-0.3	0.6	-1.2	-12.0		-8.1	0.6	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	442.3			563.9	553.0	567.1	590.5	541.9	403.6		350.8	103.0	
PV of public sector debt-to-revenue ratio (in percent)	...	...	611.2			742.2	789.5	784.8	783.7	689.9	468.9		400.0	114.7	
of which: external 3/	...	...	588.2			706.9	749.4	746.4	747.5	659.0	447.9		381.7	92.5	
Debt service-to-revenue and grants ratio (in percent) 4/	14.7	13.1	17.9			41.6	15.0	14.4	19.4	21.8	15.6		17.3	10.4	
Debt service-to-revenue ratio (in percent) 4/	23.5	21.2	24.7			54.8	21.4	19.9	25.7	27.7	18.1		19.8	11.6	
Primary deficit that stabilizes the debt-to-GDP ratio	-11.3	-5.0	-20.8			-25.9	-14.3	-10.0	-5.1	-2.0	-18.5		-6.9	3.3	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	10.1	6.5	5.0	8.0	2.5	6.4	7.6	8.2	8.6	11.5	8.0	8.4	6.2	6.6	6.6
Average nominal interest rate on forex debt (in percent)	5.1	3.3	4.3	3.2	1.9	12.6	6.0	5.4	5.0	4.8	9.7	7.3	7.3	4.0	7.1
Average real interest rate on domestic debt (in percent)	1.0	3.5	-6.1	1.5	7.4	-44.1	-34.5	-23.5	-19.6	-17.6	-15.8	-25.9	-9.4	-2.3	-6.8
Real exchange rate depreciation (in percent, + indicates depreciation)	-6.9	20.0	2.5	3.3	14.7	...	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	4.6	1.1	14.5	5.8	7.3	2.3	13.4	7.6	6.3	5.9	5.5	6.8	5.7	5.7	5.7
Growth of real primary spending (deflated by GDP deflator, in percent)	-4.7	11.4	-12.2	-0.5	5.7	-3.4	4.1	4.4	-0.1	2.8	-1.3	1.1	5.9	7.0	8.9
Grant element of new external borrowing (in percent)	...	...	...	...	...	11.7	16.3	14.0	13.0	13.2	14.0	13.7	6.5	2.0	...

Sources: Country authorities; and staff estimates and projections.
1/ Gross government debt including hydro-related liabilities.
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues excluding grants.
4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 4. Bhutan: Sensitivity Analysis for Key Indicators of Public Debt 2014–2034

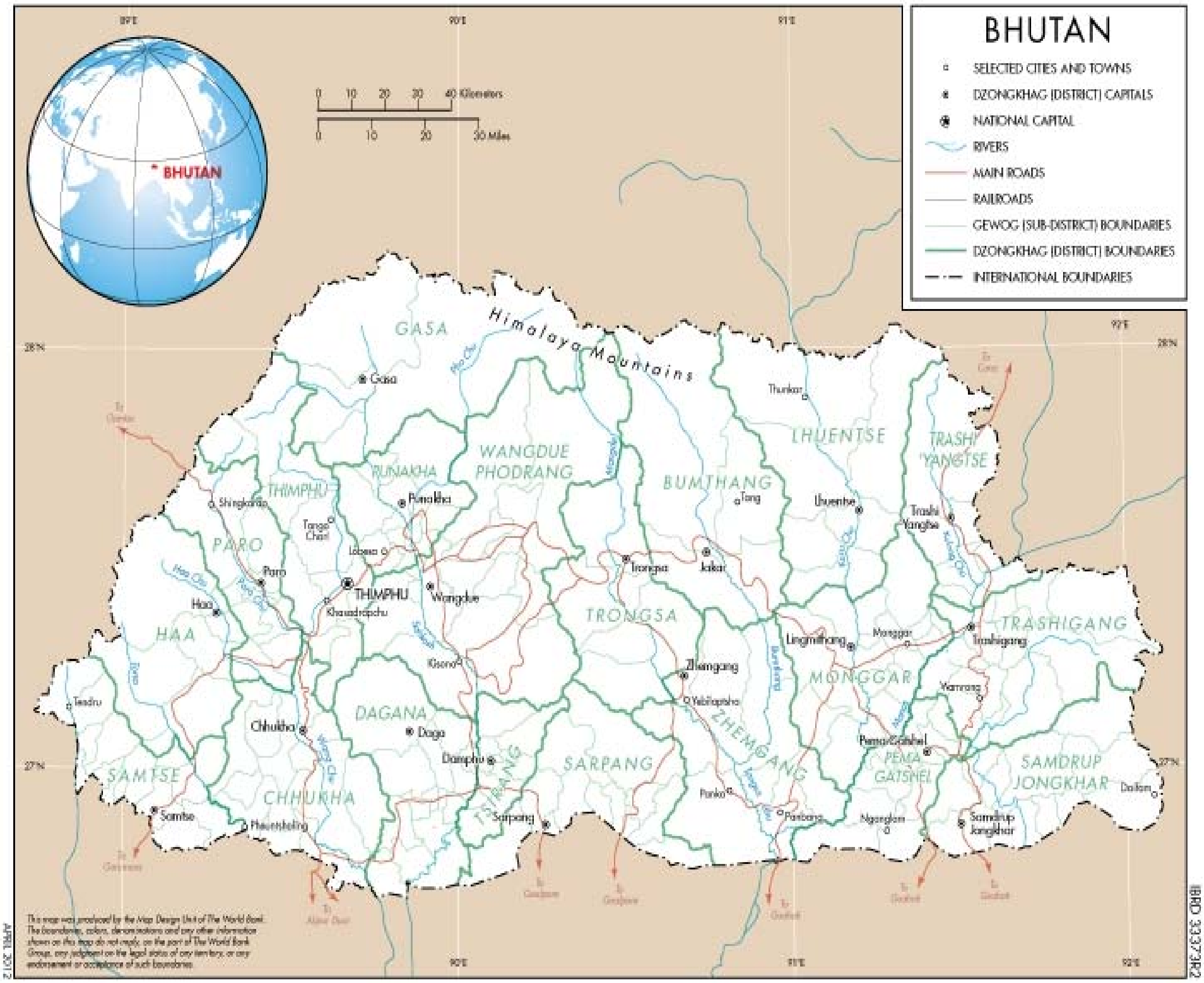
	Projections							
	2014	2015	2016	2017	2018	2019	2024	2034
PV of Debt-to-GDP Ratio								
Baseline	173	174	175	171	161	154	130	31
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	173	177	181	182	183	192	217	140
A2. Primary balance is unchanged from 2014	173	176	178	177	172	179	213	147
A3. Permanently lower GDP growth 1/	173	175	177	175	167	161	152	76
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	173	178	184	182	173	167	153	65
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	173	180	186	183	172	165	145	51
B3. Combination of B1-B2 using one half standard deviation shocks	173	180	188	184	174	167	150	58
B4. One-time 30 percent real depreciation in 2015	173	244	241	234	221	212	194	98
B5. 10 percent of GDP increase in other debt-creating flows in 2015	173	184	184	180	170	163	143	50
PV of Debt-to-Revenue Ratio 2/								
Baseline	564	553	567	591	542	404	351	103
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	564	561	587	627	611	501	588	476
A2. Primary balance is unchanged from 2014	564	558	579	611	577	469	575	492
A3. Permanently lower GDP growth 1/	564	555	573	602	557	421	407	251
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	564	562	591	620	575	434	411	216
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	564	571	605	630	579	432	390	170
B3. Combination of B1-B2 using one half standard deviation shocks	564	570	606	633	583	438	404	194
B4. One-time 30 percent real depreciation in 2015	564	776	781	808	742	556	525	326
B5. 10 percent of GDP increase in other debt-creating flows in 2015	564	583	597	622	571	426	386	166
Debt Service-to-Revenue Ratio 2/								
Baseline	42	15	14	19	22	16	17	10
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	59	20	22	30	35	36	41	50
A2. Primary balance is unchanged from 2014	59	20	22	30	33	34	41	54
A3. Permanently lower GDP growth 1/	59	20	22	30	33	34	35	31
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	59	20	23	30	34	35	35	29
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	59	20	23	31	34	34	34	26
B3. Combination of B1-B2 using one half standard deviation shocks	59	20	23	31	34	35	35	28
B4. One-time 30 percent real depreciation in 2015	59	26	34	45	50	50	51	45
B5. 10 percent of GDP increase in other debt-creating flows in 2015	59	20	23	31	34	34	34	25

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

ANNEX 6: Map


BHUTAN
SELECTED CITIES AND TOWNS
DZONGKHAG (DISTRICT) CAPITALS
NATIONAL CAPITAL
RIVERS
MAIN ROADS
RAILROADS
GEWOG (SUB-DISTRICT) BOUNDARIES
DZONGKHAG (DISTRICT) BOUNDARIES
INTERNATIONAL BOUNDARIES
BHUTAN
Himalaya Mountains
GASA
WANGDUE PHODRANG
PUNAKHA
THIMPHU
PARO
HAA
BUMTHANG
LHUENTSE
TRASHI YANGTSE
TRONGSA
MONGGAR
TRASHIGANG
DAGANA
SAMTSE
CHHUKHA
SARPANG
TSIRANG
ZHEMGANG
PEMA GATSHEL
SAMDRUP JONGKHAR
Gasa
Punakha
Thunkar
Tang
Lhuentse
Trashi Yangtse
Shingkarap
Tango Chari
Lobesa
Paro
THIMPHU
Wangdue
Trongsa
Jakar
Haa
Khasadrapchu
Mongar
Trashigang
Lingmithang
Zhemgang
Wamrang
Tesdru
Chhukha
Daga
Yebilaptsha
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