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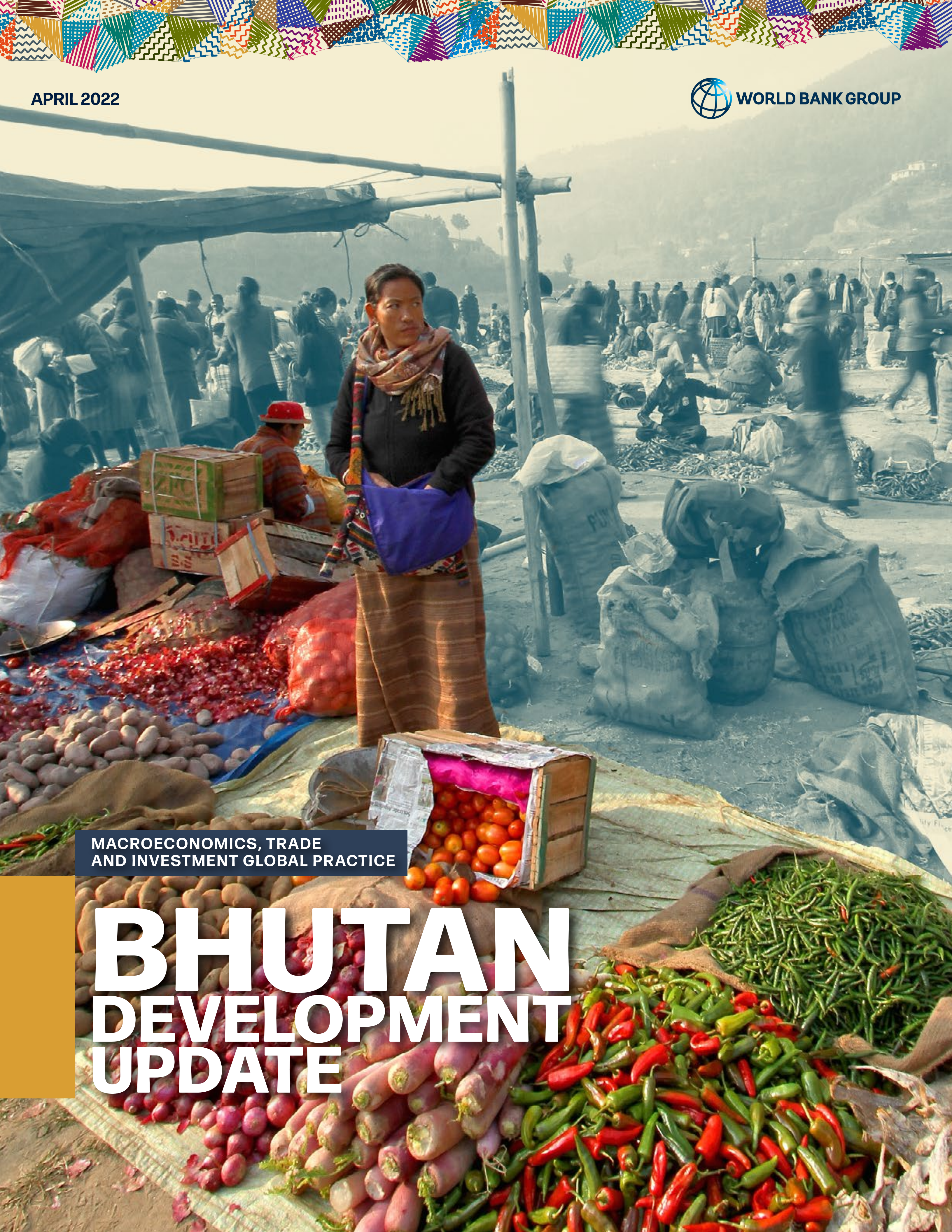

MACROECONOMICS, TRADE AND INVESTMENT GLOBAL PRACTICE

BHUTAN DEVELOPMENT UPDATE

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ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
CAR	Capital Adequacy Ratio
CRR	Cash Reserve Ratio
CSI	Cottage and Small Industries
CAD	Current Account Deficit
CPI	Consumer Price Index
DSA	Debt Sustainability Analysis
DGRK	Druk Gyalpo Relief Kidu
ECP	Economic Contingency Plan
FYP	Five Year Plan
GST	Goods and Services Tax
GoI	Government of India
IDA	International Development Association
INR	Indian Rupee
LCU	Local Currency Unit
MoF	Ministry of Finance
MSMEs	Micro, Small, and Medium Sized Enterprises
NBFIs	Non-Banking Financial Institutions
NCGS	National Credit Guarantee Scheme
NDAs	Net Domestic Assets
NPLs	Non-Performing Loans
NRF	National Resilience Fund
NSB	National Statistics Bureau
PPG debt	Public and Publicly Guaranteed Debt
RGoB	Royal Government of Bhutan
RMA	Royal Monetary Authority
SLR	Statutory Liquidity Ratio
SOEs	State-Owned Enterprises
y-o-y	Year-on-Year

PREFACE AND ACKNOWLEDGMENTS

The Bhutan Development Update (BDU) is published annually. It assesses recent economic and social developments, prospects, and policies in Bhutan. The report is intended for a wide audience, including policy makers, business leaders, researchers and academics, the community of analysts monitoring Bhutan's economy, and the general public.

The update was prepared by the *Macroeconomics, Trade, and Investment* (MTI) Global Practice of the World Bank by a team consisting of Melanie Trost (Economist), Abigail LNU (Consultant), Sailesh Tiwari (Senior Economist), and Sabin Raj Shrestha (Senior Financial Sector Specialist).

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The report was prepared based on published data available on or before March 31, 2022. The BDU draws on data reported by the government, as well as information collected through the World Bank Group's regular economic monitoring and policy dialogue. Data sources include the World Bank, International Monetary Fund, Royal Monetary Authority, Ministry of Finance, National Statistics Bureau, and press reports.

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EXECUTIVE SUMMARY

Overall, Bhutan has successfully contained the pandemic thanks to strong control measures and rapid vaccination, although there was a surge in COVID-cases due to the Omicron variant early 2022. Bhutan has achieved mass vaccination (almost 90 percent of its adult total population has received a booster dose by early March 2022), and successfully managed to contain the virus. As of mid-March, the county has only recorded 7 deaths. However, the government's strict zero-COVID policy has significantly constrained livelihoods and economic activity in the non-hydro industrial and services sectors, as social and mobility restrictions – including for inbound tourism and foreign workers – remained in place.

The pandemic has caused the economy to contract by 3.7 percent in FY20/21 (July 2020 to July 2021), after a negative growth rate of 2.4 percent in FY19/20. The industry sector contracted by 5.5 percent, despite positive growth in the hydropower sector, supported by the on-streaming of the Mangdechhu plant. Construction, manufacturing, and mining sectors were adversely affected by foreign labor shortages and supply chain disruptions. Services sector output fell by 2.2 percent, as the tourism industry remained largely inactive in FY20/21. On the demand side, private investment and consumption contracted sharply due to domestic COVID-19 containment measures and lower incomes. Average inflation increased to 8.2 in FY20/21, driven by food prices, and remained elevated in the first half of FY21/22. Poverty is estimated to have increased, with the $3.20 poverty rate going up from 11.0 percent in 2019 to 12.6 percent in 2021.

The current account deficit (CAD) remained low in FY20/21 relative to pre-COVID levels. Goods exports (as a share of GDP) increased, supported by an increase in hydro exports and trade facilitation measures for non-hydro goods, mainly mineral products, and base metals. Goods imports also increased compared to FY19/20, but to a lesser extent, as private investment projects, including hydro construction, remained subdued. As a result, the current account deficit improved to 11.8 percent of GDP in FY20/21.

The fiscal deficit widened to 6.3 percent in FY20/21 largely due to pandemic-related expenditures and subdued revenue performance. Total expenditures increased, driven by COVID-19 relief measures, which included a partial interest rate waiver and temporary income support, as well as an increase in capital expenditures to support the economic recovery. Total revenues also increased, though to a lesser extent, driven by hydro profit transfers from the on-streaming of Mangdechhu. Tax revenues and external grants declined relative to FY19/20. Public and publicly guaranteed (PPG) debt increased to 134.9 percent of GDP in FY20/21 but risks to debt sustainability remain moderate as the majority of the debt is linked to hydro project loans from India with low refinancing and exchange rate risks.

Growth is expected to recover to 4.4 percent in FY21/22, supported by Bhutan's rapid vaccination campaign, the easing of mobility restrictions, and ongoing fiscal support. Output is expected to return to pre-pandemic levels in FY22/23 with a gradual recovery in tourism and a pick up in services sector growth. In the medium term, growth will be driven by the new hydro plants coming on stream, and a recovery in non-hydro industries and the services sector. Inflation is projected to remain elevated in the short to medium term, owing to continued supply disruptions and higher energy and food prices. The CAD is expected to remain low relative to pre-COVID levels, and to moderate further in the medium term due to an increase in electricity exports from the new hydro plants and a gradual decline in hydro-related imports with the completion of construction of those plants.

The fiscal deficit and PPG debt are expected to remain elevated in the short term. The fiscal deficit is expected to increase to 10.1 percent of GDP in FY21/22 due to the scale up in capital expenditures and subdued revenue performance, before gradually declining to 7.4 percent of GDP in FY22/23 as pandemic-related fiscal measures are gradually phased out. PPG debt is projected to remain elevated in the short term due to higher fiscal deficits.

The outlook is subject to significant downside risks. The pace of the recovery will depend on the return to economic normalcy, and the efficacy of fiscal support, both through COVID-19 relief measures and the scale up of capital expenditures. Pandemic-related uncertainties include an intensification of the current surge in cases, resulting in prolonged mobility restrictions. Other risks include delays in hydro projects as the generation capacity is expected to double in the medium term, and the materialization of financial sector contingent liabilities. The economic impact from the the war in Ukraine on Bhutan will likely be felt through higher energy and food prices, as direct trade with Russia and Ukraine is negligible.

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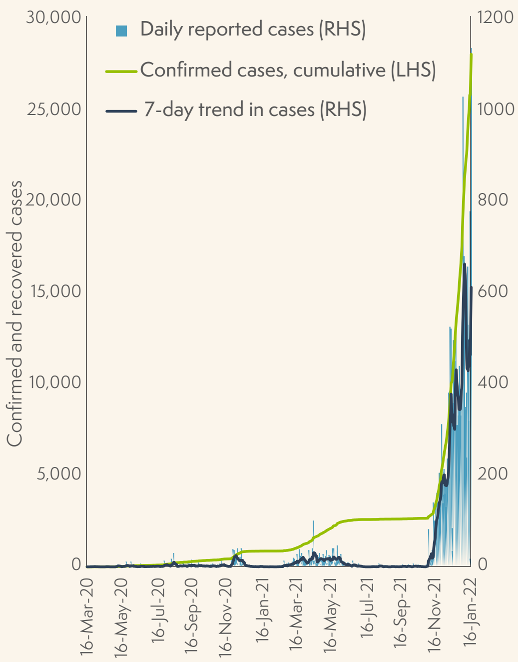
A RECENT ECONOMIC DEVELOPMENTS

1. Context

Bhutan has recorded a surge in confirmed COVID-19 cases since early January 2022, despite stringent restrictions. Bhutan has been highly successful in containing the pandemic until end-2021, recording less than 3,000 cases (**Figure 1**). Despite a recent surge in cases due to the highly transmissible Omicron variant (cases increased eight-fold since January 2022), Bhutan has kept COVID-19 at bay, with only 10 recorded deaths as of March 31, 2022. Stringent social and mobility restrictions remained in place since March 2020, when the first known case was discovered. Borders remained closed for inbound tourism and foreign workers as of March 2022. All incoming travelers are obligated to undertake a 14-day quarantine in a government assigned facility. Domestic movement restrictions between high-risk areas (southern districts and areas adjacent to international borders) and low-risk areas remained in place, including a 7-day mandatory quarantine. Domestic outbreaks have been contained through several regional lockdowns in 2021, followed by mass-testing and phase-wise relaxation.[1]

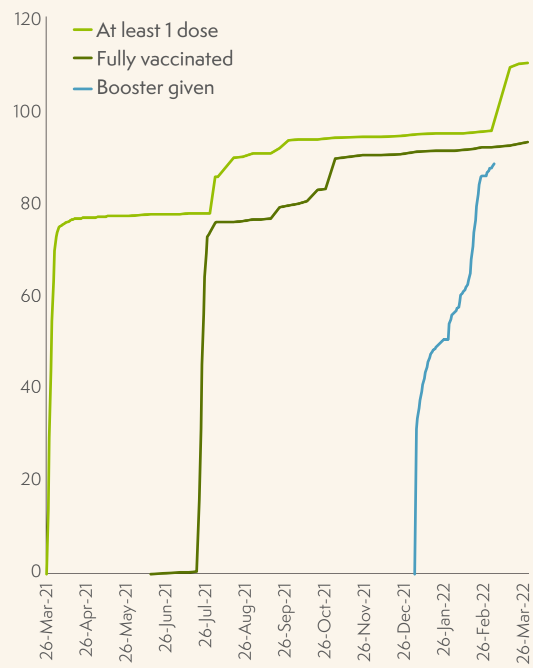
The Royal Government of Bhutan (RGoB) announced a shift in its zero-COVID policy, supported by the successful vaccination and booster rollout. The RGoB has rolled out a successful vaccination campaign in March 2021. As of end-March 2022, about 79 percent of the total population has received two vaccine doses, and 89 percent of its adult total population has received a booster dose (**Figure 2**). The RGoB announced on March 12, 2022, that it would start easing COVID-restrictions in April 2022, including a reduction in the quarantine period for international travelers. While some domestic movement restrictions are expected to remain in place, regional lockdowns will only be imposed if the health situation deteriorates.

Figure 1. Number of confirmed and recovered cases (daily reported cases)



Source: Ministry of Health (as of March 31, 2022), WB staff estimates

Figure 2. Adult population who has been vaccinated (percent)



Source: Our World in Data and Ministry of Health, WB staff estimates (as of March 27, 2022)

1 Lockdowns have been more targeted in 2021 and 2022 compared to 2020, which saw two nationwide lockdowns in December and April. The government announced a lockdown in southern districts in April 2021, and a smart lockdown in January 2022 in select districts, based on the presence of community cases.

2. Real Sector

Growth

After a negative growth rate of 2.4 percent in FY19/20, the economy is projected to have further contracted by 3.7 percent in FY20/21, reflecting broad-based disruptions from the pandemic across the non-hydro industrial and services sectors (**Figure 3**).[2] Economic growth had been strong prior to the COVID-19 pandemic, fueled by the public sector-led hydropower sector and strong performance in the services sector, including tourism. Annual real GDP growth averaged 5.6 percent from FY14/15 to FY18/19. The agriculture sector grew at 5.7 percent in FY20/21, supported by government measures to boost domestic food production, including through infrastructure development, technical support, and youth employment programs.[3] However, output in the industry and services sector dropped significantly.

The industry sector contracted by 5.5 percent in FY20/21, despite positive growth in the hydropower sector. Hydropower production and exports to India increased in FY20/21 (y-o-y). Higher production in the recently commissioned Mangdechhu hydro plant offset lower hydrological flows and disruptions at the Tala plant, the country's largest hydropower project. As a result, the electricity (and water) sector grew by 8.2 percent in FY20/21. In contrast, the construction, manufacturing (cement Industry, food industry, chemical, metal) and mining sectors contracted sharply, reflecing trade-related disruptions and shortages of foreign labor. While there have been limited formal restrictions on the movement of goods across the Indian border, supply side disruptions have been reported due to high transport and logistics costs. Labor shortages continued through FY20/21 as the entry of foreign workers was mostly suspended.

Services sector output fell by 2.2 percent in FY20/21. The contraction was most accentuated in tourism-related services, including the transport sector (mainly air transport, travel agencies, but also land transport), and hotels and restaurants, in line with a drop in international and regional tourist arrivals. Total tourist arrivals declined by 91 percent, from 173,000 in FY19/20 to 15,000 in FY20/21. Retail, and finance, insurance and real estate services have also contracted, reflecting supply chain disruptions at the border for imported goods and poor performance of the banking sector.

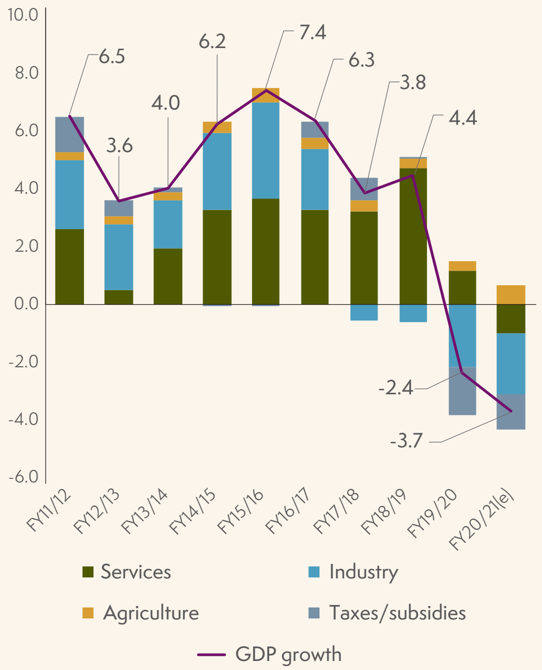
On the demand side, private investment and consumption contracted sharply in FY20/21 due to COVID-19 containment measures and lower incomes (Figure 4). The fall in private investment mostly reflects disruptions in the construction sector, which covers hydropower projects from state-owned enterprises (SOEs). In contrast, government investment and consumption expanded. Net exports also grew, as imports declined by more than exports.

Anecdotal evidence suggests that economic activity in non-hydro industries has normalized in the first three quarters of FY21/22. While COVID restrictions remained in place, lockdowns were regionally targeted, and containment modes for businesses helped normalize activities in the non-hydro industry, including mining and construction. Industries in Pasakha, a major industrial town in southern Bhutan, were allowed to operate and export goods to India under strict health protocols during lockdowns.[4] In contrast, hydropower production declined by 3.2 percent in the first half

2 A per the latest National Accounts Report, the economy contracted by 10.1 percent in 2020. This translates into a negative growth rate of 2.4 and 3.7 percent in fiscal years FY19/20 and FY20/21, respectively.
3 Government measures include the Economic Contingency Plan (ECP), which focused on agriculture and farm roads, including the acceleration of winter vegetable production in southern districts, agriculture enterprise development, and youth engagement programs.
4 A few southern districts were under a prolonged lockdown from April 16 to August 10, 2021. See https://businessbhutan.bt/industries-operate-in-containment-mode-in-pasakha/

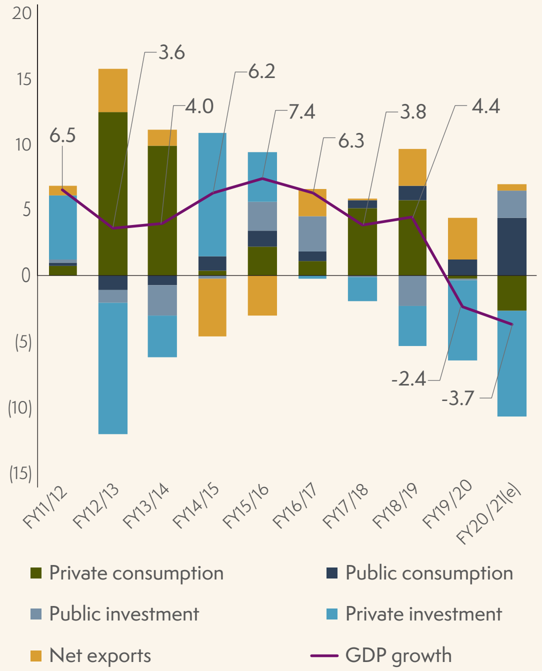
of FY21/22 (y-o-y), mainly due to adverse weather patterns and the maintenance of the Tala and Mangdechhu plants.[5] Growth in the services sector has likely remained subdued, weighted down by pandemic lockdowns and international travel restrictions.

Figure 3. Contribution to GDP growth, supply side (percentage points)



Source: NBS, WB staff estimates

Figure 4. Contribution to GDP growth, demand side (percentage points)



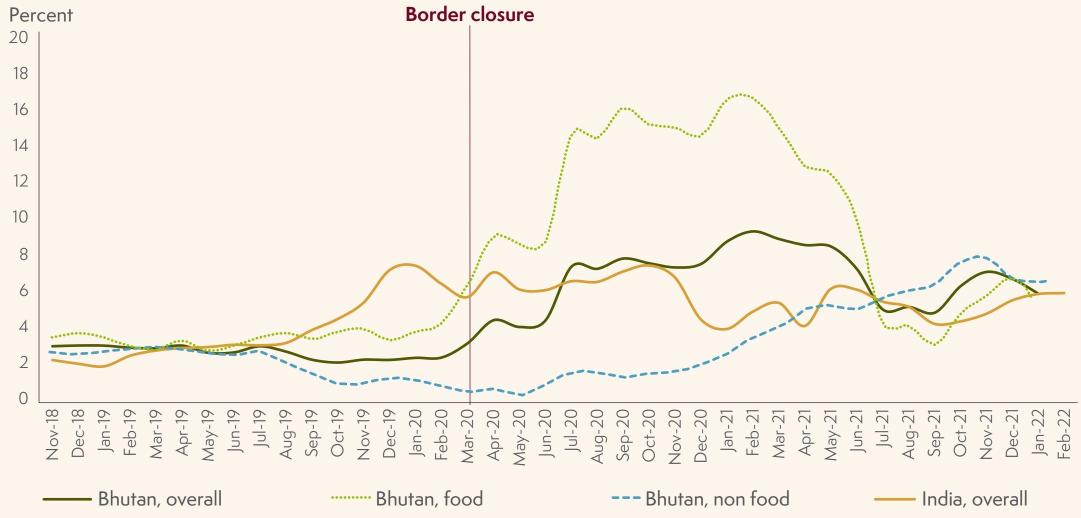
Source: NBS, WB staff estimates

Inflation

Average inflation increased from 3.0 percent in FY19/20 to 8.2 percent in FY20/21, driven by an increase in food prices. Food inflation averaged 14.7 percent in FY20/21 (**Figure 5**). Food items together carry a 46 percent weight in the consumer price index (CPI) basket, of which imported and domestic food products account for 24 and 22 percent, respectively. Since about 80 percent of Bhutan's imports come from India and the Bhutanese Ngultrum is pegged to the Indian Rupee (INR), Bhutan's inflation rate co-moves with that of India with a time lag. Average inflation moderated to 6.0 percent in the first seven months of FY21/22, driven by a slowdown in food inflation (primarily vegetables, meat, and seafood). However, non-food inflation remains elevated, reflecting higher fuel and transport prices (**Figure 6**). To contain inflation, the government has streamlined and reduced the customs duty rate for imports from countries other than India,[6] and fixed prices of vegetables and fruits in Thimphu district during the lockdown in early 2022. The price controls, which have been in place since January 20, remain in place as of end-March.[7]

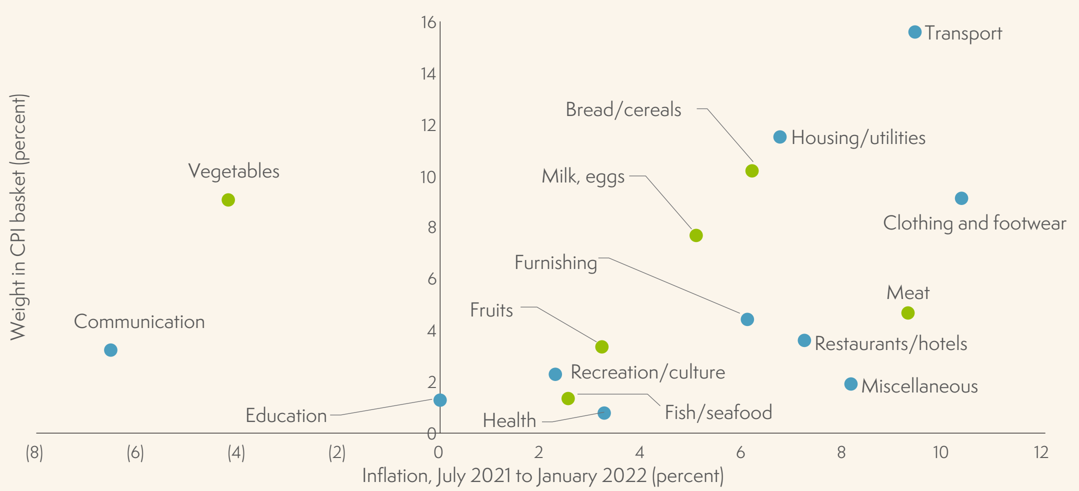
5 See https://kuenselonline.com/tala-expected-to-resume-to-full-capacity-today/ and https://kuenselonline.com/mhpas-unit-iii-to-resume-by-next-week/
6 No customs duty is levied on imports from India due to the bilateral free trade agreement between Bhutan and India.
7 Notification from January 10, 2022: https://www.gov.bt/covid19/21-01-22-selling-price-of-vegetables-and-fruits-during-current-lockdown-situation-ocpmoea/ and notification from February 23, 2022: https://www.moea.gov.bt/?p=11766.

Figure 5. Inflation, Bhutan and India (percent)



Source: NSB, MoSPI India.

Figure 6. CPI categories and inflation drivers in the first seven months of FY21/22 (percent)



Source: NSB

Poverty

Reduced worker earnings, sustained high food prices, and the decline in aggregate consumption is likely to have affected living standards and wellbeing, especially for those at the bottom of the distribution. Poverty is estimated to have increased, with the $3.20 poverty rate going up from 11.0 percent in 2019 to 12.6 percent in 2021. The second round of the phone-based COVID-19 impact monitoring survey showed that about 29 percent of households are still worried about running out of food. Of these, almost half curtailed food consumption as a precautionary measure. Households who ate fewer meals or skipped meals were more prevalent in rural areas. Social assistance coverage declined slightly from 20 percent of households receiving any form of assistance in September 2020 (first round of the survey) to about 17 percent in April 2021. Encouragingly, coverage has increased for groups that are more adversely affected by the pandemic, including service sector workers and workers who have lost jobs. In terms of type of assistance, the temporary income support from the *Druk Gyalpo's Relief Kidu* (DGRK) remain by far the most dominant form of assistance (78 percent).[8]

3. Monetary Policy and Financial Sector

Overall money supply growth accelerated further in FY20/21, driven by an increase in aggregate deposits and net domestic assets (NDAs). Monetary policy is anchored by the exchange rate peg to the INR. The RMA does not have an explicit inflation target. It uses the cash reserve ratio (CRR) and the statutory liquidity ratio (SLR) to manage liquidity in the financial system and interventions in the foreign exchange markets to maintain the peg. The acceleration in broad money (M2) supply growth in FY20/21 was driven by an increase in aggregate (longer term) deposits as spending and investment activities in the economy remained subdued. Together with the reduction in the CRR at the start of the pandemic (by 300 basis points), this led to a significant buildup of liquidity. This was reflected in an increase in NDAs on the money sources side, driven by higher domestic borrowing of the government, while private sector credit growth decelerated further in FY20/21.

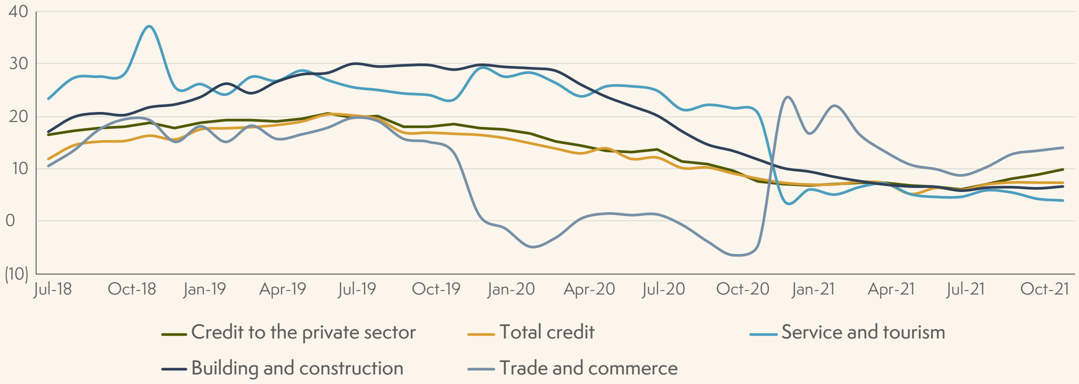
The growth of credit to the private sector fell to a seven-year low in FY2020/21, reflecting subdued demand and risk-averse behavior of financial institutions. Credit growth slowed from 13.3 percent (y-o-y) in FY19/20 to 6.5 percent in FY20/21 despite monetary policy measures to ensure financial sector liquidity (**Figure 7**). The slowdown was most accentuated in the services sector (including tourism) and the construction and housing sector, reflecting the adverse impact of the pandemic on these sectors, including delays in government spending on capital projects. In contrast, credit growth to trade and commerce increased, reflecting COVID-19 support measures for wholesalers to ensure uninterrupted supply of essential goods. Credit growth accelerated in the first half of FY21/22, reaching 8.9 percent in November 2021 (y-o-y). To support lending to micro, small and medium sized enterprises (MSMEs), specifically the cottage and small industry (CSI) sector, the *National Credit Guarantee Scheme* (NCGS) approved 168 projects in the amount of Nu643 million (US$8.4 million) in 2021, of which Nu400 million is guaranteed by the government (equivalent to 0.2 percent of FY20/21 GDP).[9] To further unlock financing for MSMEs, the authorities are considering extending credit guarantee services undert the NCGS to private sector banks, mobilizing additional capital funding, and establishing a robust NCGS structure for sustainable operation.

Financial vulnerabilities are elevated, with pressures on asset quality yet to be reflected in reported asset quality indicators. The government has extended borrower relief measures until June 2022, including a partial interest waiver to all loan account holders (funded through the *National Resilience Fund*, NRF) and the deferment of loan repayments. While the reported non-performing loan (NPL) ratio decreased to 14.1 percent in September 2021 (from 16.3 percent in September 2020), Bhutan's financial sector was already weak before the pandemic. The gradual withdrawal of the interest moratorium and forbearance measures is expected to exacerbate the long-standing asset quality problems associated with poor underwriting standards and weak supervision (**Figure 8**). The risk weighted Capital Adequacy Ratio (CAR) stood at 13.6 percent in September 2021 (above the

8 This is based on data from round 1 and round 2 of the Rapid Phone Survey in Bhutan, conducted in September to October 2020 and April to May 2021.
9 The FY21/22 budget allocated US$50 million for the NCGS, to cover for expected losses under the scheme. Public Debt Report, December 2021. https://www.mof.gov.bt/wp-content/uploads/2021/05/BUDGET-REPORT-FY-2021-22_ENGLISH.pdf; and https://www.mof.gov.bt/wp-content/uploads/2022/02/PublicDebtSituation-Report14022022.pdf.

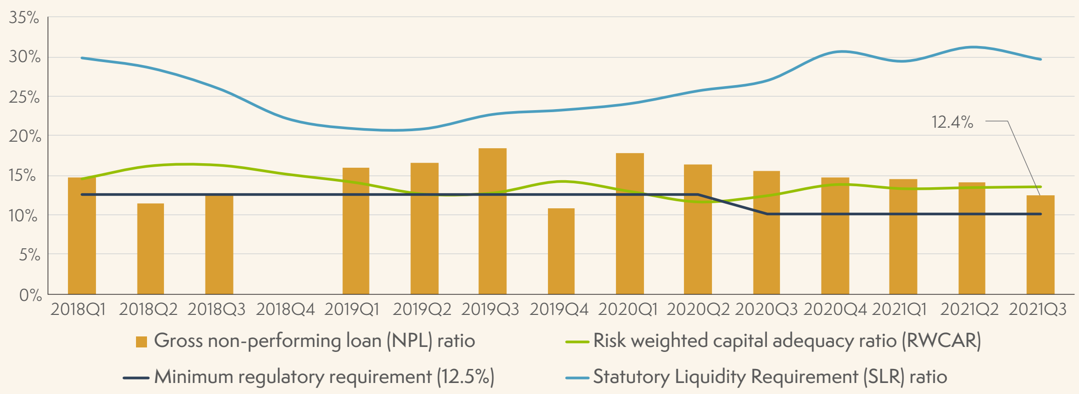
minimum 10 percent requirement) and provisions for NPLs are high (59 percent as of September 2021, estimated on a conservative gross basis). However, NPLs are concentrated in two systemically important financial institutions and a few economic sectors, including tourism, trade and commerce, manufacturing, and housing.[10] The government and the RMA have conducted a comprehensive asset quality review in 2021 and announced an NPL resolution framework to facilitate rehabilitation and foreclosures of NPLs.

Figure 7. Credit growth to select sectors (y-o-y growth, percent)



Source: RMA

Figure 8. Financial sector soundness indicators (percent)



Source: RMA

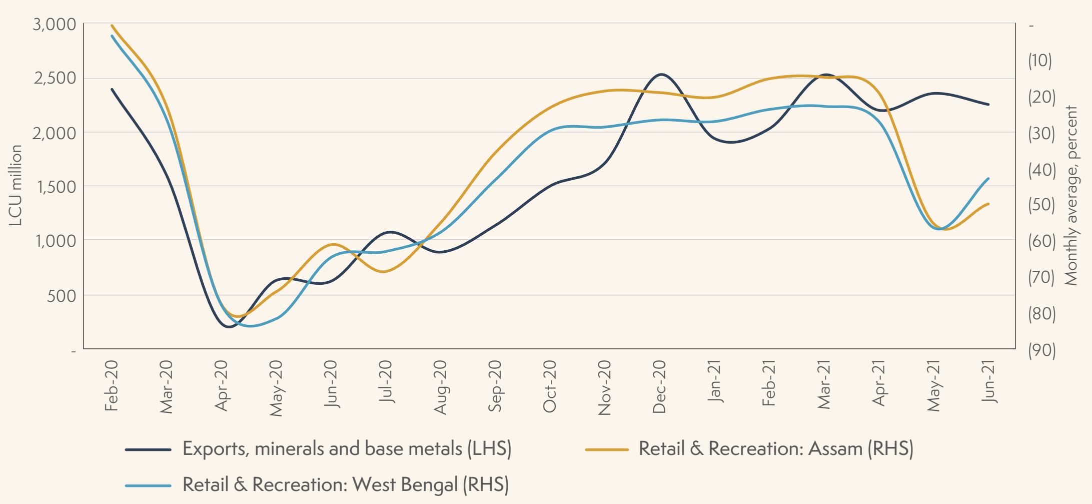
10 A state-owned insurance company and a state-owned bank are experiencing significant balance sheet pressures. Non-bank financial institutions (NBFIs) are permitted to undertake retail lending activities in Bhutan although, relative to commercial banks, they are more prone to maturity mismatches.

4. External Sector

The CAD has narrowed further in FY20/21, driven by a smaller trade deficit than in FY19/20. Goods exports (as a share of GDP) increased, supported by an increase in hydro exports and trade facilitation measures for non-hydro goods, mainly mineral products (boulders) and base metals (ferro-silicon). Goods imports also increased compared to FY19/20, but to a lesser extent, as private investment projects, including hydropower construction, remained subdued. The services deficit deteriorated further, reflecting the standstill in tourism-related services (**Figure 9**). As a result, the CAD improved from 12.4 percent of GDP in FY19/20 to 11.8 percent in FY20/21. The CAD is mainly financed by capital flows from India for hydropower projects through a combination of grants and loans. While capital and financial accounts have continued to register net inflows in FY20/21, budgetary grants for hydropower projects (registered under the capital account) declined. Gross international reserves increased in FY20/21, to US$1.6 billion (which is equivalent to [20.3] months of imports of goods and services).

Exports of non-hydro goods have been supported by trade facilitation measures, and a pickup in demand from India. Trade of non-hydropower goods was heavily impacted by cross-border movement restrictions after the border closure in March 2020. Exports of mineral products and base metals—which accounted for 80 percent of total non-hydro goods exports in 2020—reached pre-pandemic levels (in local currency unit, LCU) in the second half of FY20/21. This has been supported by measures to enhance the capacity and the efficiency in customs, such as additional land customs stations and the rollout of automation and electronic procedures, as well as containment modes for industries during lockdowns. The recovery in non-hydro exports has also been driven by a pickup in external demand from neighboring states; exports of mineral products and base metals are strongly correlated with mobility patterns in Assam and West Bengal (**Figure 10**).[11]

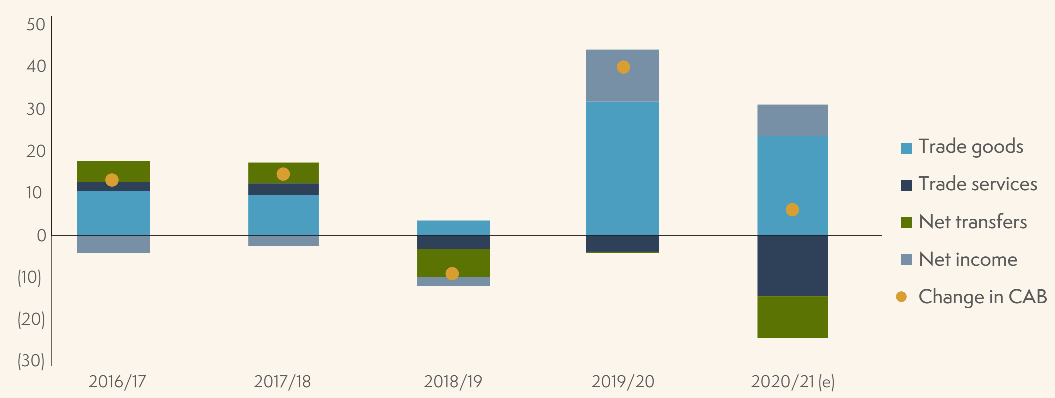
Figure 9. Contribution to changes in current account balance (percentage points)



Source: RMA

11 The correlation coefficient between monthly exports of base metals and mineral products, and monthly mobility data from Assam and West Bengal is 0.7.

Figure 9. Contribution to changes in current account balance (percentage points)



Source: RMA

5. Fiscal Sector and Debt Sustainability

The fiscal deficit widened in FY20/21 due to an increase in COVID-19-related expenditure and subdued revenue performance. Total expenditure is estimated to have grown by 22.2 percent in FY20/21 in nominal terms y-o-y, from 33.1 percent of GDP in FY19/20 to 40.1 percent in FY20/21 (**Table 1**). The increase in spending was primarily driven by COVID-19 relief measures, which include the partial interest rate waiver (5.1 percent of GDP) and temporary income support (1.5 percent of GDP), as well as an increase in capital expenditures (largely covered by external grants). In contrast, other current non-interest expenses have declined, as the government strove to rationalize non-essential expenditures (**Figure 11**). Total revenues also increased, as a share of GDP, but to a lesser extent. This increase was driven by hydro profit transfers from the on-streaming of Mangdechhu (4.2 percent of GDP), and a decline in external grants.[12] Tax revenues declined further, from 13.0 percent of GDP in FY19/20 to 11.7 percent in FY20/21, reflecting the slowdown in the non-hydro economy. As a result, the fiscal deficit increased from 1.9 percent of GDP in FY19/20 to 6.3 percent in FY20/21 (**Figure 12**). Financing needs in FY20/21 have been covered by domestic borrowing and concessional external borrowing.

Capital expenditures increased in the first half of FY21/22, reflecting the targeted scale up of public investment. According to preliminary data for the first six months of FY21/22, the fiscal balance deteriorated, driven by lower revenues and a sharp increase in expenditures. Total revenues contracted by 5.5 percent (y-o-y). While tax revenues increased slightly, non-tax revenues and external grants declined. Total expenditures have grown by 36 percent (excluding COVID-19 relief measures), driven by an increase in capital expenditure.[13] To support economic recovery, the FY21/22 budget targeted the frontloading of the 12th Five Year Plan (FYP) capital outlay, steered toward critical and impactful public infrastructure projects. While capital spending is still lower than expected (25 percent of the annual estimate), it increased by 72 percent compared to the first half of FY20/21, which saw COVID-19-related disruptions and labor shortages.

12 Profit transfers from SOEs fluctuate year-to-year depending on the commissioning of new hydropower projects.
13 Total expenditure does not include expenses from the NRF.

Table 1. Fiscal accounts (percent of GDP)

	FY17/18 (act)	FY18/19 (act)	FY19/20 (act)	FY20/21 (est)
Resources	**31.9**	**24.3**	**31.2**	**33.8**
Tax revenue	16.6	15.7	13.0	11.7
Non-tax revenue	6.0	4.4	7.7	8.6
o/w hydropower profit transfers	0.0	0.0	2.0	4.2
Other receipts 1/	0.2	(1.8)	1.1	5.1
Grants	9.1	6.1	9.4	8.4
Expenditure	**33.5**	**25.9**	**33.1**	**40.1**
Current expenditure	16.8	16.1	20.3	24.6
o/w National Resilience Fund 2/	0.0	0.0	1.4	6.6
Capital expenditure	17.6	9.4	12.6	15.6
Advance/suspense (net)	(1.0)	0.4	0.2	(0.1)
Fiscal Balance	**(1.6)**	**(1.6)**	**(1.9)**	**(6.3)**
Primary balance	(0.3)	(0.7)	(1.5)	(5.3)

1/ Other receipts include the redemption of T-Bills and overall transactions from cash balances. This line item has been negative in some years, driven by adjustment for prior year's advances. In FY19/20 and FY20/21, other receipts cover transfers from the National Resilience Fund (NRF) to cover COVID-19 relief measures.
2/ Includes temporary income support provided to individuals and loan interest payment support to borrowers (DGRK) financed by the National Resilience Fund (NRF).
Source: MoF, WB staff estimates

Total PPG increased further in FY20/21, but risks are moderate as the majority of external debt is linked to hydro project loans and tied to future proceeds.14 Total PPG debt increased to 134.9 percent of GDP in FY20/21 (vis-à-vis 123 percent in FY19/20), reflecting loan disbursements for ongoing hydropower projects and higher gross financing needs, partly reflecting the COVID-19 shock. External PPG debt amounted to 125.3 percent of GDP in FY20/21, of which hydropower debt accounted for about 73 percent. Domestic debt amounts to 9.7 precent of GDP, and is mostly in the form of treasury bills (5.5 percent) and 3-year and 10-year treasury bonds (1.6 percent). The 2021 *Debt Sustainability Analysis* (DSA) assessed Bhutan to be at moderate risk of debt distress. Around 95 percent of PPG debt is external with a long-term maturity.[15] The majority is on account of hydropower project loans from the Government of India (GoI) based on intergovernmental contracts, with low refinancing and exchange rate risks. Risks stemming from non-hydro debt are low, owed mostly to the Asian Development Bank (ADB) and the International Development Association (IDA), and contracted on concessional terms. The authorities have published the first national DSA in March 2022 to strengthen the institutional capacity for risk assessment and monitoring of public debt debt management.

14 External PPG debt covers central government loans, central government loans which are on-lent to SOEs, direct debt contracted by SOEs, and central bank debt.
15 The last Bank-Fund Joint DSA was prepared in October 2018. The World Bank team has updated the Bhutan DSA in May 2021. The next update of the Joint DSA will be published in the first half of 2022 as part of the IMF Article IV consultations.

Figure 11. Expenditure components (percent of GDP)

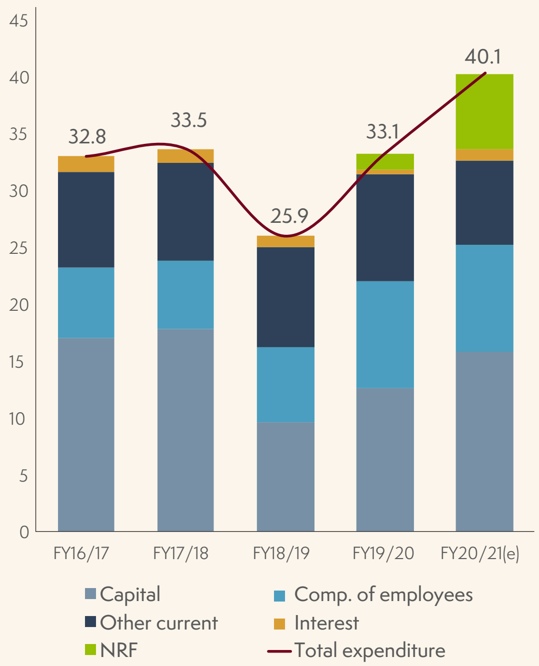
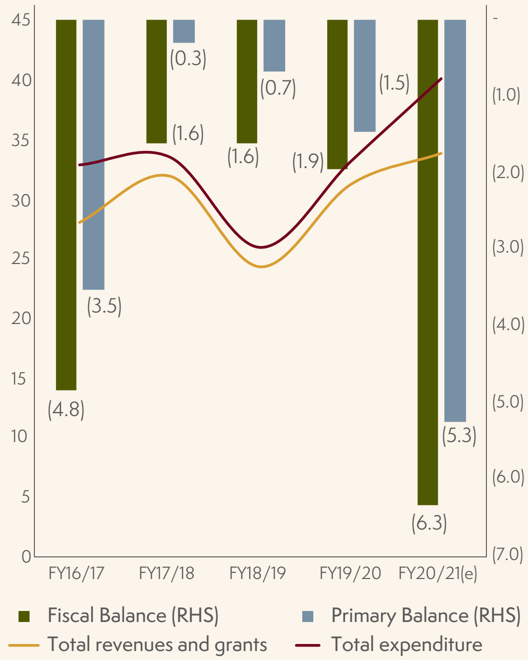


Figure 12. Fiscal accounts components (percent of GDP)



Source: MoF

B OUTLOOK AND MEDIUM-TERM PROSPECTS

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1. Medium-term Outlook

The economy is expected to grow by 4.4 percent in FY21/22, supported by Bhutan's rapid vaccination campaign, the easing of mobility restrictions, and ongoing fiscal support. The baseline scenario assumes that the RGoB starts easing COVID-19 restrictions in the fourth quarter of FY21/22, and that international travel restrictions will be further relaxed in in early FY22/23. Non-hydro industrial activities are driving growth in FY21/22, while services sector growth remains subdued due to pandemic lockdowns. On the demand side, public investment and a recovery in domestic and external demand (in particular from India) underpin growth.[16] Output is expected to return to pre-pandemic levels in FY22/23 with a pick up in services sector growth, reflecting a gradual recovery in tourism and a normalization in domestic activity patterns (**Table 2**). The $3.20 poverty rate is expected to decline from 2022 onwards, although a full recovery to poverty headcount rates estimated before the pandemic is not likely to be achieved until 2023.

In the medium term, growth will be driven by new hydro plants coming on stream, and a recovery in the services sector and non-hydro industries. The hydro generation capacity is expected to double between 2023 and 2026 with the completion of four projects, which will support industry sector growth and result in a sharp increase in electricity exports.[17] Services sector growth will be supported by a pick up in tourism activities in the medium term, underpinned by the new tourism policy, which is focusing on increasing the quality, sustainability and seasonal as well as geographic distribution of tourism. Reforms to boost economic diversification, digitalization, and private-sector-led growth are expected to support non-hydro growth in the medium term.

Elevated inflation is expected to persist in the short to medium term, owing to continued supply disruptions and higher commodity prices. Inflation is projected to average 7.3 percent (y-o-y) in FY21/22 and to remain elevated at 5.5 percent in FY22/23, reflecting higher global energy and commodity prices (globally and in India), as well as extended global supply disruptions resulting from the war in Ukraine (imported consumer goods and services carry a 55 percent weight in the CPI basket, of which food products account for 24 percent). In the medium term, inflation is projected to be in line with the inflation path in India, given the Bhutanese Ngultrum's peg to the INR.

The CAD is expected to remain low relative to pre-COVID levels, and to moderate further in the medium term due to a sharp increase in electricity exports. The CAD is expected to narrow slightly in FY21/22, driven by an increase in budgetary grants (reflected under secondary income). The trade balance deteriorates in FY21/22, due to lower hydro exports (reflecting scheduled maintenance works at Tala hydro plant) and higher imports, reflecting higher capital imports for public infrastructure projects and higher oil prices. From FY22/23, the CAD is expected to moderate further. Hydropower exports are expected to increase with the commissioning of the new hydro plants, while hydro-related imports are expected to decline gradually after the completion of projects. The overall balance of payments, which has been supported by grant financing, is expected to remain positive over the medium term.

16 Economic growth in India is estimated to grow by 8.3 in FY2021/22 (April 2021 to March, 2022). Forthcoming World Bank South Asia Economic Focus, April 2022.
17 Four hydropower projects—Nikachhu (118 MW), Punatshangchhu 2 (1,020 MW), Kholongchhu (600 MW), and Punatshangchhu 1 (1,200 MW)—will significantly expand the installed generation capacity between 2023 and 2026, from 2,334 MW to 5,273 MW.

Table 2. Main macroeconomic indicators

	FY17/18 (act)	FY18/19 (act)	FY19/20 (act)	FY20/21 (est)	FY21/22 (proj)	FY22/23 (proj)	FY23/24 (proj)
Real Economy: annual percent change							
Real GDP growth, at constant factor prices	3.2	4.6	(0.8)	(2.6)	4.4	4.7	6.7
Agriculture	3.6	2.7	2.9	5.7	3.5	3.5	3.5
Industry	(1.3)	(1.6)	(5.6)	(5.5)	7.5	5.4	11.9
Services	7.8	11.1	2.6	(2.2)	2.3	4.3	3.2
Real GDP growth, at constant market prices	3.8	4.4	(2.4)	(3.7)	4.4	4.7	6.7
Private consumption	9.8	10.3	(0.5)	(3.5)	4.0	2.5	2.0
Government consumption	3.7	7.0	7.3	24.0	(5.6)	(11.4)	1.2
Gross fixed capital investment	(3.8)	(11.2)	(15.2)	(18.6)	19.1	3.0	(6.2)
Exports, goods and services	5.5	9.6	(4.1)	(1.2)	5.2	20.7	20.8
Imports, goods and services	3.1	(0.0)	(9.2)	(2.1)	8.9	3.8	6.7
GDP deflator	3.3	1.3	3.7	4.8	4.7	4.4	3.5
CPI inflation (year-average)	3.7	2.8	3.0	8.2	7.3	5.5	3.9
Fiscal Account: percent of GDP							
Overall balance 1/	(1.6)	(1.6)	(1.9)	(6.3)	(10.1)	(7.4)	(4.5)
Primary balance	(0.3)	(0.7)	(1.5)	(5.3)	(8.3)	(5.8)	(2.2)
Total PPG debt 2/	113.4	106.5	123.0	134.9	134.6	131.4	128.1
External PPG debt	108.4	103.6	121.9	125.3	123.2	120.1	116.6
Hydropower	80.6	79.2	91.0	91.9	88.9	85.1	84.6
Non-hydropower	28.0	24.3	30.9	33.4	34.3	34.9	31.9
o/w Central Bank	8.4	4.0	4.0	4.0	1.6	-	-
Domestic PPG debt	5.0	2.9	1.1	9.7	11.4	11.3	11.5

	FY17/18 (act)	FY18/19 (act)	FY19/20 (act)	FY20/21 (est)	FY21/22 (proj)	FY22/23 (proj)	FY23/24 (proj)
Balance of Payments: percent of GDP							
Current account balance	(18.4)	(20.5)	(12.4)	(11.8)	(11.4)	(9.5)	(5.2)
Trade balance (goods and services)	(18.0)	(18.4)	(12.9)	(11.9)	(13.6)	(8.4)	(3.7)
Goods exports	24.0	24.8	26.9	30.1	29.2	30.7	35.1
Hydropower	6.8	6.4	13.0	14.8	13.0	14.0	18.3
Non-hydropower	17.2	18.5	13.9	15.3	16.3	16.7	16.8
Goods imports	40.6	41.2	36.9	37.2	38.6	38.3	38.3

1/ Includes an estimated amount for FY21/22 and FY22/23 for temporary income support provided to individuals and loan interest payment support to borrowers (DGRK) financed by the National Resilience Fund (NRF).
2/ PPG debt, including central government debt, central government loans that are on-lent to SOEs, SOE debt (direct debt contracted by SOEs, not routing trough the budget) and Central Bank debt (loan/credit facilities for BOP support purposes)
Source: MoF, WB staff estimates

The fiscal deficit is expected to peak at 10.1 percent of GDP in FY21/22, and to narrow gradually in the medium term. The deterioration in the fiscal balance in FY21/22 reflects the scale up in capital expenditures and subdued revenue performance, including a decline in hydro profit transfers. The fiscal deficit is expected to decline to 7.4 percent of GDP in FY22/23 as COVID-relief measures are gradually phased out amid an improvement in economic conditions. Domestic revenues are expected to increase over the medium term, supported by hydro revenues and policies aimed at mobilizing non-hydro revenues, including the introduction of the Goods and Services Tax (GST) in FY22/23. PPG debt is projected to remain elevated as a share of GDP in the short term due to high fiscal deficits.

This outlook assumes that the economic impact from the war in Ukraine on Bhutan is likely to be moderate in the short term. The economic impact will likely be felt through the commodity price channels, as direct trade with Ukraine and Russia is negligible. The external balance deteriorates with higher energy and agricultural prices, as Bhutan is a net importer of fuel and food products. Higher commodity prices also drive-up inflation, both directly and indirectly through pass-through of import prices from India. The impact on the fiscal balance is expected to be limited since there are no direct fuel subsidies in Bhutan.[18] However, subsidies to state-owned enterprises for agricultural inputs including fertilizer and public transport could increase.

18 Bhutan imports fuels from India at market prices, and revises retail fuel prices (linked to the India fuel import price) twice a month. The country also imports 700 metric tons of LPG from India every month at a subsidized rate. The amount and rate is at the discretion of the Government of India.

2. Risks, Challenges, and Opportunities

The outlook is subject to significant downside risks and uncertainty. The short term outlook is largely dependent on the speed of return to economic normalcy, and the efficacy of fiscal support, both through COVID-19 relief measures and the scale up of capital expenditures. The current surge in cases could be followed by another wave once domestic mobility restrictions are eased, prompting the government to lengthen the duration of the restrictions. This would be reflected in lower service and industry sector growth on the supply side, and dampen domestic demand. Other domestic risks include delays in hydro projects and lower-than-expected hydropower production (due to adverse weather patterns), which would have significant impacts on growth, fiscal revenues, and exports, and the materialization of financial sector contingent liabilities. External risks include lower external demand, in particular from India (given significant tourism and trade linkages), and higher global energy and commodity prices due to pandemic and geopolitical tensions.

Reforms to strengthen financial sector stability and gradual fiscal consolidation would help reduce short-term macro vulnerabilities. Addressing vulnerabilities in the financial sector is crucial, as pressures on asset quality are likely to increase once the forbearance measures and the partial interest waiver are phased out, necessitating rescheduling and restructuring of distressed loans. The implementation of the NPL strategy, including regulatory and institutional framework for NPL resolution and foreclosure, will be critical to manage risks in the financial sector. Gradual fiscal consolidation, through more targeted COVID-support measures and revenue mobilization, including the timely implementation of the GST and a gradual phasing out of fiscal incentives, would support fiscal and debt sustainability.[19] Going forward, the government will need to shift its attention from relief efforts to supporting the economic recovery and resilience.

A more resilient economy with a green and diverse production base can support the COVID-19 recovery and future development in Bhutan. Much of recent growth has been driven by public sector-led hydropower development. Non-hydro sectors, facing constraints related to the country's challenging investment climate including high trade costs and a small domestic market, remain less competitive. As a result, job creation outside of the public sector and agriculture has been limited. Bhutan is also highly susceptible to the adverse impacts of climate change. For instance, climate-induced changes to glacial-fed rivers will reduce hydropower production and government revenues. Developing a vibrant private sector to generate jobs and diversify the economy, while sustaining Bhutan's natural environment, will be crucial to build further resilience and sustain inclusive development. As a carbon-negative country, climate change also creates an opportunity to monetize emission offsets through voluntary carbon markets, which can in turn support climate-relevant investment needs.

19 The government has adopted the 2021 Fiscal Incentives Act in December 2021 to attract new investment and support the economic recovery. Tax holidays and tax exemptions have generated significant tax expenditures equivalent to 2.6 percent of GDP annually between FY14/15 and FY18/19.


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