

Bhutan: Poverty Reduction Strategy Paper—Joint Staff Advisory Note

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BHUTAN

Joint Staff Advisory Note on the Poverty Reduction Strategy Paper

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I.	Introduction.....	2
II.	Macroeconomic Performance and Policies.....	3
III.	Policies to Support Growth.....	5
IV.	Social Sector Issues.....	7
V.	Monitoring and Evaluation Framework.....	8
VI.	Conclusion and Issues for Discussion.....	9

I. INTRODUCTION

1. **Bhutan has made substantial socio-economic progress in recent years, supported by major improvements in governance arrangements.** Economic growth has been robust, while inflation remained moderate. The poverty headcount ratio fell dramatically, from 36 percent in 2000 to 23 percent in 2007.¹ Other social indicators have also registered appreciable improvement, and Bhutan is on track to meet (or has already met) most of its Millennium Development Goals (MDGs). This impressive progress has been achieved against the backdrop of Bhutan's momentous transition to democracy.

2. **The overarching objective of Bhutan's Tenth Five-Year Plan (10FYP)—which is also the Royal Government of Bhutan's Poverty Reduction Strategy Paper (PRSP)—is to sustain this trajectory and reduce poverty further.** The PRSP aims to lower the poverty headcount ratio to 15 percent by 2012/13. The strategic objectives identified by the Royal Government of Bhutan (RGoB) for achieving this goal are: (i) revitalizing industry; (ii) strengthening national spatial planning; (iii) synergizing rural-urban development; (iv) expanding strategic infrastructure; (v) investing in human capital; and (vi) fostering an enabling environment through good governance. The core principles of Bhutan's development planning are reflected in its distinctive vision of Gross National Happiness (GNH). These have focused on achieving broad based and sustainable growth, improving the quality of life, ensuring the conservation of the natural environment, preserving the country's rich culture, and strengthening good governance.

3. **Bhutan's PRSP reflects the country's long tradition of participatory planning.** The 10FYP (2008/09 to 2012/13) is based on a consultative process that started soon after the completion of the Mid-Term Review (MTR) of the 9FYP in 2005. The preparation process involved extensive consultations with stakeholders, including the private sector and local government bodies (dzongkhags and gewogs), and reflected the recommendations of the MTR and the Good Governance Plus Report of 2005. The resulting Plan is based on a consolidation of individual dzongkhag plans, and was approved by Parliament in January 2009.

4. **Staffs commend the strong development progress achieved to date, and concur with the strategic areas of reform identified in the PRSP.** Sustaining momentum would be helped by continuing to focus on (i) maintaining a sound macroeconomic and fiscal framework; (ii) ensuring an enabling environment for further robust growth; (iii) improving access and quality of education and health services and (iv) enhancing institutional capacity

¹ Poverty data for 2000 and 2007 are not strictly comparable. Data for 2000 come from the pilot Household Income and Expenditure Survey (HIES), which was the first attempt to quantify poverty in Bhutan at the household level. Data for 2007 come from the Bhutan Living Standard Survey (BLSS).

for monitoring and evaluation, essential for informing key policy decisions that will arise as the PRSP is implemented.

II. Macroeconomic Performance and Policies

5. **Political stability, prudent economic management, and development of the hydropower sector delivered robust economic growth during the 9FYP.** Real GDP growth averaged about 9 percent during this period, raising per capita GDP to around US\$1800 in mid-2008, compared to only \$835 in 2002.² Growth was supported in particular by the Tala hydropower project coming on-stream, trebling Bhutan's electricity generation capacity and expanding the services sector. Inflation has broadly tracked price developments in India, and has averaged about 5½ percent since 2004 (when the CPI was rebased). On the external front, buoyant aid flows offset large current account deficits, thus allowing foreign reserves to remain at comfortable levels, covering about 9-12 months of imports.

6. **Favorable economic performance was underpinned by sound macroeconomic policies.** Monetary policy was successful in delivering low and stable inflation, with the exchange rate peg to the Indian rupee helping to anchor inflation expectations. Fiscal policy has coped adequately with volatile revenue and expenditure (related to the hydropower construction and production cycle), with the current fiscal balance remaining near balance or in surplus, as targeted by the RGoB. Although public debt registered a sharp increase reflecting large borrowing for hydropower development, debt sustainability risks have been mitigated by Bhutan's solid record of project implementation, the commercial viability of the projects, and strong donor support.

7. **The outlook for Bhutan remains positive.** The 10FYP forecasts an average growth rate of 7¾ percent, with the main drivers being construction, especially for new hydropower projects, and services. So far, Bhutan's relatively limited financial and trade integration with other countries (with the exception of India) has insulated it from the global financial and economic crisis. While the current account deficit is projected to widen during the 10FYP, reflecting higher imports as a new hydropower construction cycle begins, adequate external financing (primarily from official sources) should limit the decline in the international reserves cover to 7 months of imports. This would continue to provide ample cushion for external shocks.

8. **Staffs note several risks to the macroeconomic outlook.** Domestic risks relate primarily to the potential for overheating, with the recent large increase in civil service wages and low real interest rates representing the principal risk factors. External risks relate primarily to potential spillovers from the global crisis, in particular as they affect India,

² The increase reflects in part the large downward revision in the estimated population of Bhutan, following the first formal census in 2005.

which is Bhutan's largest trading partner and the source of most FDI and official financing flows, critical for the development of the hydropower sector. Tourism and commodity-related industries could also be at risk. In addition, possible shortfalls in aid flows could present external financing risks. Preparing contingency plans would enhance the flexibility of the PRSP, and help the RGoB manage these and other potential downside risks.

9. **Given the uncertain macroeconomic outlook, fiscal policy will need to be managed carefully in the period ahead to safeguard macroeconomic stability and sustain rapid growth.** The 10FYP forecasts an average fiscal deficit of about 3 percent of GDP, the same as in the 9FYP and in line with the RGoB's strategic fiscal policy goals.³ Staffs encourage the RGoB to monitor closely the impact of fiscal policy on the economy and to ensure good coordination with monetary policy. Budget implementation will be guided by the Ministry of Finance's Budget Policy and Fiscal Framework Statement (BPFSS), which includes budget targets for three years that are updated several times a year as a part of the budget preparation process. Staffs also encourage the authorities to continue deepening their public financial management reform program. This would include implementing the multi-year rolling budget framework (which will enable closer monitoring of budget execution), strengthening public finance oversight institutions, and bolstering public procurement systems.

10. **Staffs note several downside risks to the budget outlook.** With regards to revenue, foreign grants are targeted to nearly double during the 10FYP. Given budgetary constraints in donor countries, as well as possible reductions in grants as Bhutan's per capita income rises, this assumption may prove too optimistic. On the expenditure side, the projected rapid slowing in non-interest current spending may not materialize. Because domestic financing needs are forecast to remain substantial, there are risks of crowding out the private sector, especially given Bhutan's limited scope for non-bank financing. In this regard, efforts to further improve revenue generation, by broadening the tax base and improving tax administration, are required. The long-term debt sustainability warrants close monitoring.

³ The 10FYP fiscal deficit projection shown in the PRSP—6¾ percent of GDP on average—differs from this number for two reasons. First, a significant increase in dividends from the electricity sector since the PRSP was finalized has boosted the revenue forecast for the plan period. Second, the fiscal deficit concept used in the PRSP (which was prepared by the Gross National Happiness Commission) differs from that used by the Ministry of Finance, because it excludes negative net lending associated with external debt repayments by the Tala hydropower company (which are channeled through the budget). Staffs agree with the fiscal deficit concept used by the Ministry of Finance, which is in accordance with the Public Finance Act and the IMF's Government Finance Statistics (1986). Since Tala repayments are projected at about 2 percent of GDP during the plan period, achieving Bhutan's long-term fiscal target of keeping the deficit below 5 percent of GDP would mean setting the overall budget deficit target at around 3 percent of GDP.

Government efforts to develop a debt management strategy and the related institution and processes are therefore needed to ensure debt is on a sustainable path.

11. **With respect to monetary policy, staffs note that a cautious stance will be essential for maintaining macroeconomic and financial stability.** Monetary conditions need to be such that credit creation, which has been running at a very high pace of about 35-40 percent per year, does not stoke excess demand and a rising trade deficit. Monetary policy will also need to ensure consistency with the exchange rate peg.⁴ Further strengthening of bank supervision and enforcement of prudential regulations remain essential to safeguard financial stability and prevent the emergence of a real estate bubble.

III. Policies to Support Growth

12. **Staffs underscore the importance of implementing significant productivity-enhancing reforms in order to achieve the 10FYP growth objective.** The 7¾ percent average annual growth target, while below the average achieved during the 9FYP, is about 1-1½ percentage points above staffs' estimate for the medium term. Moreover, Bhutan's heavy reliance on hydropower for its growth prospects makes it particularly vulnerable to economic volatility. Raising productivity in agriculture is of particular importance for meeting the poverty reduction target, which is predicated on agriculture growing at an average annual rate of 4 percent, more than twice the baseline projection.

A. Private Sector Environment

13. **Private sector growth needs to accelerate if Bhutan is to achieve its growth targets, as well as generate adequate employment for growing cohorts of school leavers.** The PRSP sets out important measures to improve the overall business environment, promoting financial sector deepening, trade liberalization, regulatory reform, industrial development, and foreign direct investment. Staffs also welcome the importance given in the PRSP to raising agricultural productivity, in order to generate income earning opportunities in rural areas where most of the poor live. Finally, the PRSP places appropriate emphasis on the linkage between private sector development and employment.

14. **The 10FYP appropriately identifies further deepening of the financial sector as a critical element of fostering private sector development.** In this regard, staffs support in particular the reforms set out in the PRSP to strengthen prudential supervision, develop non-bank financial markets, and modernize the infrastructure of the financial system. Strengthened supervision is needed to address asset-liability mismatches, stemming from

⁴ A large negative interest rate differential with India during the recent period may have resulted in large capital outflows (as reflected in a large negative errors and omissions in the balance of payments). The interest rate differential with India is now positive, and with inflationary pressures on a downward path, staffs do not see a need for further tightening of monetary policy at this time.

several years of rapid credit growth (especially to housing), and a possible increase in non-performing loans, should spillovers from the global financial crisis materialize. The planned introduction of government T-bills represents an especially important step forward, as in addition to kick-starting Bhutan's securities market it will help the government regularize its domestic borrowing, while also serving as an important liquidity management instrument for monetary policy. Staffs also encourage the authorities to press ahead with passage of pending financial legislation, including the Royal Monetary Authority (RMA) Act and Financial Services Act. The entrance of several new financial institutions presents the possibility of improving the reach of financial services, while also increasing competition in the banking sector. However, it could also accelerate credit growth further, at a time when its pace has already raised financial stability concerns.

15. **The PRSP recognizes that private sector development is essential to generating employment opportunities.** Rising unemployment, particularly for educated youth, reflects the important role of hydropower, which creates few jobs directly, and the limited scope for more employment in manufacturing and agriculture. At the same time, school enrolment has increased considerably—resulting in better educated youths, but often lacking the specific employable technical or vocational skills demanded by the labor market. During PRSP implementation, it will be crucial to scale up efforts to improve the skills match—especially in expanding services sectors. The PRSP points to the need for collaboration across sectors, but there could be more specificity on initiatives to strengthen ties between the education sector, and entities that support private sector development.

B. Sustainable Development of Infrastructure

16. **The PRSP articulates ambitious infrastructure development targets, and implementation capacity will be a major challenge.** Private sector involvement will be important to meeting the stated goals, and will depend on developing the capacity of local contractors, as well as ensuring an enabling legal framework for development modalities like public-private partnerships (PPPs). This must be accompanied by the development of an adequate framework for PPPs. In this context, staff recommends that a legal framework governing the PPPs should be the first step to ensure proper risk management and good governance. The RGoB is also right to focus on ensuring that appropriate policy, planning, and monitoring institutions are in place, especially related to procurement, financial management, and environment. With large amounts of financing flowing through government systems to develop infrastructure, further capacity building in the institutions responsible for oversight, including the Royal Audit Authority, the Parliamentary Accounts Committee, and the Anti-Corruption Commission will be important. Similarly, strengthening public procurement systems and the capacity of relevant staff will be essential to enhance transparency, accountability, and the efficiency of public resource use. Finally, the proposed infrastructure expansions may pose considerable environmental risks. While the RGoB has a reasonably sound policy and legislative framework for environmental safeguards, mitigation,

and management, the RGoB is encouraged to ensure adequate capacity in relevant sectors, as well as in the National Environment Commission.

17. **Hydropower will remain a major engine of growth for Bhutan, catalyzing the economy as a whole, and the PRSP seeks to accelerate the development of the sector.** Of Bhutan's 23,760 MW estimated potential capacity, only 5 percent has been tapped so far, and the PRSP proposes to add 10,000 MW of capacity by 2020—double the original target for this time frame. The PRSP also aims to expand rural electrification from the present 57 percent to 100 percent by 2013 (against the earlier target of 2017). This will be challenging, given capacity and financing constraints.⁵ Staffs support the measures proposed by the RGoB to bolster energy sector institutions, including the ongoing restructuring and upgrading of the Department of Energy, and the capacity building for assessing and managing environmental and social impacts. On environmental aspects in particular, the RGoB could consider establishing regulations for the safe operation of dams as future investments in hydropower include the use of containment structures.

18. **Staffs endorse the PRSP's emphasis on road construction to expand access and support economic development.** Ambitious 10FYP targets will see a three-fold increase in the workload of the concerned departments, again with significant pressures on existing capacity likely. Staffs encourage the RGoB to enhance coordination and clarification of responsibilities between various entities engaged in the construction and maintenance of roads. Specific measures could include formulating a national road policy, reviewing the existing sectoral master plan, and preparing a detailed sector investment plan for new construction and maintenance. The other important challenge for the RGoB will be to introduce asset management practices and build the capacity of road sector agencies to ensure that they can meet plan targets.

C. Agriculture

19. **The PRSP provides a balanced and well-reasoned argument on the plans for the agricultural and natural resources sectors.** While these sectors account for only one-fifth of GDP, they continue to employ almost half the labor force. Boosting their performance is therefore critical for reducing poverty, which is concentrated in rural areas. Accordingly, the RGoB rightly focuses on broad measures to improve productivity through better research, management, and farm mechanization. Other specific issues that warrant attention include reducing post-harvest losses, improving access, developing some basic branding for Bhutan, expediting transportation, developing linkages to potential export markets, and creating a more transparent interface between international demand and rural suppliers.

⁵ Most labor employed in Bhutan's hydropower sector is from India, and the development of new projects is almost entirely financed externally.

IV. Social Sector Issues

20. **Staffs support the PRSP's emphasis on universal access to basic health services as a key element of an effective poverty reduction strategy.** The RGoB continues to focus on improving coverage and quality of services, by expanding health infrastructure, strengthening human resources, and enhancing technology. Even though health services are provided free, health care costs are rising sharply with the expansion of service delivery to secondary and tertiary care, the increase in use of technology, and the growth in prevalence of non-communicable diseases. In order to address this, the PRSP supports sustainability and equity in the delivery of health care, and notes the positive contribution that can be made by greater private sector participation. Staffs recommend that the RGoB carefully assess and monitor the sustainability and equity implications of private sector participation in health, especially to ensure that benefits do not elude the poorest and remotest communities. An understanding of who benefits from existing health expenditures would be useful, in order to improve or protect equity. The RGoB is also encouraged to pay more attention to demand factors that may be limiting the utilization of existing health services.

21. **The RGoB continues to accord high priority to increasing both access to and the quality of education in Bhutan.** Significant curriculum reforms and learning support programs have been initiated, particularly in the three core subjects of Dzongkha, English, and Mathematics. In light of sharply increased enrolment at the primary, lower and middle secondary education levels over recent years, along with the RGoB's decision to raise the basic education norm to Grade 10, there has been a dramatic increase in the number of students continuing their education to the higher grades. The challenge of providing further education and employment opportunities to school leavers is of paramount concern. A number of useful initiatives are underway and planned during the PRSP period, including the establishment of the Royal Education Council, a think-tank charged with seeking innovative approaches to education sector reform, and increased harmonization efforts on the part of Bhutan's development partners supporting education system development.

V. Monitoring and Evaluation Framework

22. **There has been significant progress in poverty measurement and diagnostic work.** The RGoB has already completed three rounds of household surveys, namely the Household Income and Expenditure Survey 2000 and the Bhutan Living Standards Survey (BLSS) 2003 and 2007. The data from these household surveys provided not only poverty estimates but also poverty profiles, which were used for broadly informing the PRSP. The PRSP usefully documents the main characteristics of poverty, such as the dominance of rural poverty and steady decline in the headcount rate since 2000, as well as the progress on other human development indicators. Furthermore, the RGoB's ongoing initiative of poverty mapping which can produce reliable poverty estimates at the dzongkhag and gewog levels is encouraging because it will help to identify poorer areas in the country for devising poverty alleviation programs. An outstanding challenge is establishing comparable poverty estimates

over time, which is critical to track outcomes of the PRSP. Deepening the link between analysis and policy through more determinants of poverty and sectoral decomposition of growth will further enhance the RGoB's ability to fine-tune and prioritize reforms, and assess the growth and distributional impacts of policies and programs to realize the goal of poverty reduction.

23. **The staffs commend the RGoB's commitment to adopting the new results-based planning approach.** The 10FYP lays out some very specific social and economic quantitative targets, which are largely consistent with the articulated policy priorities. This framework has been incorporated to ensure that the national development planning and the budgeting processes are more dynamic, efficient, responsive, and better able to anticipate emerging challenges. The new approach enables the RGoB to implement more need-based and objective resource allocations for local governments. The PRSP also introduces formula-based resource allocations to local governments, which will make them more accountable for planning outcomes. The PRSP describes an institutional framework for the results-based planning approach, and staffs encourage the RGoB to further elaborate the responsibilities for monitoring and evaluation (M&E). In particular, the National Statistical Bureau (NSB) could play a critical role in this area. Furthermore, the PRSP rightly recognizes that improving the M&E system requires better coordination between local and national government.

24. **Statistical capacity building is key for implementation of the new results-based planning approach.** High quality and more user-friendly databases form the foundations needed for the effective implementation of the results-based planning approach. The National Statistical Bureau (NSB) recently prepared a National Statistics Development Strategy (NSDS), which is intended to be implemented over the 10FYP period. The successful implementation of the NSDS will enhance results-based planning by building capacity and producing comprehensive and reliable databases. Staffs urge the RGoB to secure funding, and accelerate its implementation. Furthermore, improvements that support decentralized data systems will also be critical to support local level planning that is introduced in the PRSP.

VI. Conclusion and Issues for Discussion

25. **Bhutan has enjoyed rapid economic growth in recent years, through a combination of sound macroeconomic management, good governance, and hydropower development.** The authorities have focused on growth and poverty reduction, balanced with the preservation of cultural heritage and the promotion of environmental sustainability. The planning process has been highly inclusive, and the transition in governance arrangements has been underpinned by a process of extensive consultations. The RGoB continues with this development vision under the new PRSP.

26. **Staffs commend the strong development performance achieved to date, as well as the institutional changes implemented through the democratic transition.** The achievement of the ambitious goals set out in the PRSP will be helped by continuing to deepen policy and institutional reforms, and addressing capacity constraints. In particular, maintaining a good macroeconomic environment, promoting private sector led growth, and ensuring the effective use of public resources in expanding infrastructure, will be essential to mitigating risks and continuing on the present favorable trajectory of poverty reduction.

27. **The PRSP focuses on the broad priorities that are part of the RGoB's development vision, but would benefit from greater attention in key areas.** These include: (i) calibrating macroeconomic policies to support sustainable, rapid economic growth, and managing downside macroeconomic risks; (ii) improving the enabling environment for growth across sectors to facilitate achievement of PRSP goals; and (iii) further strengthening monitoring and evaluation of the PRSP.

28. **Do Executive Directors concur with the broad directions of Bhutan's PRSP (as described in Paragraphs 2 and 4), and the staff's recommendations for strengthening the PRSP over the coming years?**