

Graduation from LDC Status

Towards a Smooth Transition Strategy for Bhutan

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Graduation from LDC Status: Towards a Smooth Transition Strategy for Bhutan

1.0 Introduction

Bhutan is expected to graduate out of least developed country (LDC) status in 2023, following the country's request to the United Nations for the graduation date to coincide with the end of the implementation of Bhutan's 12th Five-Year Plan (12 FYP). The country is scheduled to graduate on 13 December 2023. In granting the five-year preparatory period, the General Assembly asked Bhutan to prepare its national smooth-transition strategy. Given this backdrop, the smooth transition strategy can be expected to cement the gains from the 12 FYP, complement the overall national development strategy and inform the implementation of the 13 FYP.

Considerable uncertainty remains about the extent of the socio-economic damage from the ongoing COVID-19 crisis on economies worldwide. What is immediately evident is that the containment measures, including the nationwide lockdown in Bhutan, brought large parts of the economy to a standstill, decelerating the country's economic growth. The strategy can thus be expected to build on and seek synergies with Bhutan's COVID-19 national response programmes, including the Economic Contingency Plan, Four Point Formula for boosting recovery from the COVID-19 crisis, and the 21st Century Economic Roadmap being developed with the aim of charting the long-term development vision for the country. The latter vision encompasses the leveraging of technology and innovation and empowering all citizens to achieve wellbeing improvements.

This report is intended to propose key elements for consideration by the Royal Government of Bhutan (RGB), its development and trading partners and other interested stakeholders as the country seeks to develop a national smooth-transition strategy. Bhutan's national smooth-transition strategy is expected to accord special consideration to the challenges that pose a potential hindrance to Bhutan reducing its economic and natural vulnerabilities and adjusting to the loss of LDC-associated benefits. It is also expected to consider the support that Bhutan could receive from the United Nations system in cooperation with Bhutan's bilateral, regional and multilateral development and trading partners during the transitional period to enhance the country's ability to adapt to functioning in the global economic and trading landscape post-graduation. The paper thus identifies and discusses LDC-associated benefits that are likely to be vital for Bhutan's continued growth and development and that merit being retained beyond graduation to avoid a roll back on Bhutan's development gains and the disruption of the country's current development trajectory.

2.0 Background: LDC Graduation

The creation of the LDC category in 1971 was underpinned by the recognition of the structural impediments impeding these countries from achieving their development aspirations. LDCs are expected to graduate to developing country status once they have attained a level whereby, they no longer require LDC-specific support from the international community. Graduation from LDC status thus represents a significant milestone for Bhutan.

The United Nations defines LDCs through an assessment of their scores for gross national income (GNI) per capita, the Human Assets Index (HAI) and the Economic and Environmental Vulnerability index (EVI) against graduation thresholds.¹ The GNI threshold for LDC status stands at US\$1,230 as of 2018. The threshold for the Human Assets Index (HAI), which considers the prevalence of

¹ <https://www.un.org/development/desa/dpad/least-developed-country-category/lcd-graduation.html>

undernourishment, maternal mortality ratio, gross secondary school enrolment, adult literacy rate, and (since 2020) gender inequalities, is set at 66 since 2015. The EVI considers share of agricultural production in GDP; remoteness and landlockedness; merchandise export concentration; and instability of exports of goods and services; share of population living in low-lying coastal areas; share of population living in drylands; instability of agricultural production; and victims of disasters. Since 2018, the EVI graduation threshold is set at 10 per cent below the inclusion threshold at 32 (or below). For a country to graduate out of LDC status, it must exceed the graduation threshold for at least two of the above criteria in two consecutive United Nations Committee for Development Policy (CDP) triennial review periods. A country can also be recommended for graduation if its GNI per capita rises to twice the set threshold, regardless how it has performed in the other two criteria.

Special international measures were developed to support countries in the LDC category to meaningfully benefit from the global economy and transform into advanced economies. United Nations General Council Resolution A/RES/59/209² identified the broad range of international support measures (ISMs) for a smooth transition, which can be clustered into official development assistance (ODA), trade-related measures such as LDC-specific preferential market access, and other means such as travel-related benefits. The Resolution also encouraged development partners to aid the transition of graduating LDCs and circumvent immediate disruptions in the assistance given to a graduating country. It also urged trading partners to preserve trade preferences or to phase them out in a gradual manner to allow the graduating country to adapt to preference erosion. Furthermore, World Trade Organisation (WTO) members are encouraged to consider extending special and differential treatment (S&D) and exemptions to graduated countries to help them to participate meaningfully in the multilateral trading system.

In 2011, at the Fourth United Nations Conference on the Least Developed Countries adopted the Istanbul Declaration mandating that the LDC graduation process 'should be coupled with an appropriate package of incentives and support measures so that the development process of the graduated country will not be jeopardised.'³ The United Nations Member states at the Conference also agreed 'to work on the development and implementation of smooth transition strategies for graduating and graduated LDCs.'⁴ Subsequently, with the support of the United Nations system and in cooperation with its development and trading partners, the graduating country may prepare a smooth transition strategy to be implemented after the country has officially graduated⁵. The purpose of the smooth transition strategy is to ensure the full adaptation of the graduating country to the phasing out of LDC-specific support measures as well as to identify practical actions that can be taken by the graduating country, its development and trading partners and other stakeholders such as the United Nations system to ensure successful graduation. Because the Istanbul Declaration restricts incentives and support measures to the development and implementation of smooth transition strategies, the United Nations has increased its focus on supporting graduating countries to adapt to functioning in the post-graduation environment to avoid countries sliding back to LDC status. Effectively, this justifies concern for LDCs to achieve graduation with the necessary development momentum to continue to advance their structural economic transformation to ensure sustainable progress economically and socially (UNCTAD, 2016).

² Resolution adopted by the General Assembly on 20 December 2004, 25 February 2005, A/RES/59/209

³ Draft Istanbul Declaration: Renewed and strengthened global partnership for the development of least developed countries, 12 May 2011, A/CONF.219/L.1

⁴ Ibid.

⁵ Resolution adopted by the General Assembly on 21 December 2012, 26 March 2013, A/RES/67/221

Bhutan's performance under graduation thresholds

Bhutan can be said to have made rapid progress towards graduation. With a spectacular rise from 19% of the graduation threshold in 2000 to 183% in 2015 and 239% in 2020⁶, Bhutan has demonstrated the fastest progress among non-oil exporting LDCs under the GNI per capita criterion. Between 2007 and 2010, the annual income of the country (based on the gross domestic product/GDP) grew at the average rate of 10%, thereby reflecting a diversification pace which remains unique in the economic history of LDCs (UNCTAD, 2018a). The CDP noted in its February 2020 Monitoring report of graduating and graduated LDCs that Bhutan's GNI per capita has been steadily growing and estimated as \$2,941, stood at more than double the LDC graduation threshold. Bhutan's HAI score has also shown rapid improvement and stood at 72.9 at the time of the CDP's triennial review in 2018 and has continued to improve since then. The HAI score exceeded the threshold of 66 in 2013 and increased ever since. For 2020 the HAI is 77.5, which constitutes further improvement by 0.9 score points since 2019. Bhutan has not been able to meet the EVI criterion, giving cause for concern about whether its economic vulnerability can improve after graduation. The EVI stood at 35.4 in 2020, having improved slightly from 2018 (36.2), but remains above the graduation threshold established at 32 or below by the 2018 review. Bhutan has invested considerably in human capital and the provision of free education and health services which has contributed to improved human development. However, given the current fiscal pressures and the geographical disparities that exist, there is a need to explore ways of investing in people's capabilities to enhance productive capacities and simultaneously improve social inclusion and economic growth.

The methodological and statistical lens used by the United Nations to assess performance under graduation thresholds requires complementary analysis to ascertain a more comprehensive picture of Bhutan's vulnerabilities. Like other LDCs, Bhutan has suffered far lighter health-related impacts from the COVID-19 pandemic but is likely to pay a heavy price in terms of lasting economic impacts. Following the official confirmation of Bhutan's first COVID-19 case on 6 March 2020, the Royal Government of Bhutan has executed containment and preventive measures that encompassed the restricted entry of foreign tourists and workers and a 21-day mandatory quarantine requirement as of 31 March 2020. Other measures included the closure of borders, the closure of schools and a prohibition on public gatherings. A three-week national lockdown was instituted from 11 August 2020. ⁷ As of 12 December 2020, the National Situational Update reported zero deaths with a total of 436 confirmed cases, out of which 396 recovered and 40 housed in quarantines facilities.

3.0 Development trajectory

The country's development path is guided by five-year planning (FYP) cycles which lay out the socio-economic development priorities and objectives for each five-year implementation period. The first FYP launched in 1961 focused on infrastructure development to reduce Bhutan's isolation. More recently, the 11 and 12 FYPs have targeted LDC graduation and the Sustainable Development Goals (SDGs), the latter having strong synergies with Bhutan's philosophy of Gross National Happiness (GNH). For example, 16 SDGs were integrated into the 11 FYP (RGB, 2018; Wangmo, 2016). Compared to the 11FYP, the 12 FYP has a focus on the diversification and strengthening of Bhutan's economic base (Box 1) and integrates SDG targets and indicators.

⁶ Data as at 19 February 2020 see <https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/CDP-excerpt-2020-4.pdf>

⁷ At the time of finalizing this report in December 2020 and beginning January 2021, Bhutan had reinstated the national lockdown.

Box 1. Summary of 12 FYP goals

Crafted in the context of the pursuit of GNH, the 12 FYP seeks to enhance citizens' well-being and happiness. The overall objective of the Plan is to achieve a "Just, Harmonious and Sustainable Society through enhanced Decentralisation" anchored on Bhutan's principle of leaving no one behind and narrowing the gap between the rich and poor to ensure equality and justice.

The 12 FYP outlines several strategies which include; (a) creating an investment-enabling environment to attract FDI; (b) promoting and supporting cottage and small industry (CSI) production of high value-added products; (c) diversifying the tourism sector and promoting Bhutan as a high-end tourist destination; (d) diversifying into allied hydropower industries; (e) enhancing, mitigating and adapting to climate change; (f) strengthening preparedness and response to both natural and man-made disasters; (g) promoting entrepreneurship; (h) skills development; and (i) leveraging ICT as an enabler and an industry (RGB, 2019).

With respect to the goal on enhancing economic diversity and productive capacities, emphasis is placed on developing industries other than hydropower, with economic diversity and enhanced productivity and education, and skills quality introduced as new national key result areas (NKRAs). Five priority sectors, namely agriculture, CSI, hydropower, tourism and mining, are identified for the pursuit of expanded domestic production and reduced import dependency.

The priority areas for a sustainable society are:

- (a) Ensuring renewable energy supply
- (b) Ensuring macro-economic stability
- (c) Enhancing economic diversity, and productive capacities
- (d) Securing water, food and nutrition security
- (e) Improving efficiency and effectiveness of public services delivery
- (f) Preserving cultural authenticity
- (g) Ensuring community vitality

Source: RGB (2019) and World Bank (2018).

Bhutan relies on external aid, including bilateral and multilateral assistance, to sustain the country's rising capital expenditure. For example, ODA constituted more than 55 percent and 54 percent of the 11 FYP and 12 FYP total capital expenditure, respectively. External grants accounted for 50 percent of capital spending in 2018. Most grants (50 percent) are extended by India, underlining the role of South-South Cooperation. The EU, Japan, World Bank, Asian Development Bank (ADB) and United Nations agencies are other significant sources of grants. In 2018, the top four sources of development finance were India, the World Bank, the ADB, and the EU (table 1).

Table 1: Main sources of development finance in 2018

Source	Percent share
India	52
World Bank	11
Asian Development Bank	5
European Union	5
Others	6

Source: Bhutan National Budget Financial Year 2019-2020.

Bhutan is a landlocked least developing country (LLDC) facing several challenges and limitations to development. The country faces considerable economic vulnerabilities, including from natural disasters. Characterised by a mountainous topography, small and dispersed population, small domestic market, and an industry in its early stages of development, limited access to international markets and limited range of products that meet international standards, the country embodies most of the characteristics of a small, vulnerable economy.⁸ Having a small domestic market limits Bhutan's growth potential, making it imperative for the country to develop sustainable and stable global markets.

Bhutan has sustained an annual average GDP growth rate of 7.6 percent since 1981—the third highest in the world—driven mainly by the state-led hydropower sector (World Bank, 2019; 2018a; RGB, 2019). Although GDP growth fell to 3 percent in 2018, affected by delays in hydropower construction and a reduction in electricity generation but recovered to 5.5 percent in 2019. The 12 FYP had projected an average annual real growth of 6-7 percent during the plan implementation period. Following the nationwide lockdown in August, GDP growth, previously forecast at 6.9 percent in 2020, was projected to nosedive to -6.1 percent following the August 2020 lockdown⁹, the lowest ever in Bhutan's economic history. Estimates place the economic loss across all sectors at around Nu 3.4 billion in 2020¹⁰. This will have knock-on impacts on tax revenue (compounding revenue losses from diminished trade due to global COVID-19 containment measures implemented globally) and the fiscal space available for the Government's continued ability to provide stimulus packages and social grants for the duration of the pandemic and beyond. Like most LDCs, Bhutan is a price taker for its main commodity exports (table 2), which makes the economy vulnerable to global price fluctuations and other trade shocks. Growth in 2021 is projected to recover to 4.3%, contingent on continued support extended by the Royal Government to productive sectors and to the population.

Bhutan's development success is marked by a dependence on natural resources-based activities such as hydropower generation and tourism (Bhutan's rich biodiversity and cultural heritage being unique assets) with a relatively limited degree of manufacturing. Thus, the rapid rise of per capita income evidenced by the evolution of Bhutan's GNI per capita likely signals a form of quick prosperity that can hide structural impediments to economic diversification. Capital-intensive hydropower generation has been the main area of commercial investment and the mainstay of development, contributing about 30 per cent to Gross Domestic Product (GDP) in 2018 and generating spillover effects in terms of the emergence of energy-intensive industries such as ferrosilicon, iron, steel and chemicals and construction sector growth. Perhaps the biggest concern for Bhutan is the impact of climate change on economic development and the possibility of the impacts therefrom rolling back the gains from developmental progress. Adverse weather events could negatively affect electricity generation from existing plants and, in turn, affect energy-intensive industries, and reduce tourist inflows. However, the link between high energy-intensive manufacturing and the hydropower sector means that much of Bhutan's manufacturing and small export basket is vulnerable to natural shocks on the hydropower sector in the light of increased climate-change impacts. For example, unfavourable weather in 2018 resulted in a 9 percent fall in the export of electricity due to a 3 percent fall in the production of

⁸ LLDCs face greater obstacles to graduation because their geographic remoteness and vulnerability to the economic and political vagaries of transit countries for the movement of goods in and out of their own countries presents additional challenges that make their economies perform considerably less well compared to other LDCs (UNCTAD, 2016).

⁹ June 2020 estimates, *Budget 2020-21, Ministry of Finance*.

¹⁰ Prime Minister's State of the Union address during the 2020 winter session of Parliament.

hydropower compounded by the 66 percent increase in domestic manufacturing demand for energy (World Bank, 2018b).

Table 2: Bhutan's top 5 exports

BTC Heading Description	Commodity Description	% of total exports.
Ferroalloys	Containing by weight more than 55% of silicon	42
Granite, porphyry, basalt, sandstone and other monumental or building stone, whether roughly trimmed or merely cut, by sawing or otherwise, into blocks or slabs of a rectangular (including square) shape	Boulders	6.9
Semi-finished products of iron or non-alloy steel.	Other of rectangular (other than square) cross-section	4.6
Dolomite, whether calcined or sintered, including dolomite roughly trimmed or merely cut, by sawing or otherwise, into blocks or slabs of a rectangular (including square) shape; dolomite ramming mix.	Dolomite, not calcined or sintered, chips	4
Portland cement, aluminous cement, slag cement, super sulphate cement and similar hydraulic cements, whether coloured or in the form of clinkers.	Portland pozzolana cement	3.5

Source: Bhutan Trade Statistics 2018 and the Bhutan Trade Classification and Tariff Schedule 2017.

In 2018, the services (mainly tourism-related activities) sector contribution to GDP was estimated at 42 percent. The share of agriculture in GDP dropped from 43 percent in 1980 to 17 percent in 2017, while the share of industry has increased from 12 percent to 41 percent during the same period as the country embarked on structural transformation and economic diversification. However, there has not been a commensurate shift in the workforce from agriculture to manufacturing (CPD, 2018; GRB, 2019).

The tourism sector projected by the 12 FYP to average 8.3 percent growth during the plan implementation period. Tourism is a key growth driver and a major source of hard currency earnings after the hydropower. Around 16% of the country's working population¹¹ work directly in the sector or in allied activities and the sector represents a major source of employment opportunities for a growing number of youth. Bhutan's long awaited Tourism Policy (awaiting final approval at the

¹¹ As reported by Foreign Minister, who is also the Chairperson of the Tourism Council of Bhutan (TCB), in the December 2020 parliamentary session.

finalization of this paper) is expected to drive the adoption of the ‘high-value low-volume’ approach intended to place the sector on a stronger growth trajectory that focuses on quality and environmental sustainability post COVID-19. Bhutan’s tourism sector is regarded as one of the most exclusive travel destinations in the world and enjoys a reputation of authenticity, remoteness and a well-protected cultural heritage and natural environment. Planned initiatives under the new policy include boosting eco-tourism, operationalising a plan for year-round tourism and diversifying beyond cultural tourism, promoting Bhutan as an exclusive tourism brand, improving tourism sites, and encouraging a regional balance of tourism within the country. The Tourism Levy Act of Bhutan 2020 was passed and became effective in July 2020 with regional tourists required to also pay the Sustainable Development Fee (SDF) of Nu 1,200 per person per night paid by international visitors and enjoy the same level of services and exemptions provided to international tourists.

The sector was immediately and disproportionately affected by the ongoing COVID-19 crisis transmitting multidimensional socio-economic impacts to tourism-related and allied sectors. The sector was brought to a standstill. According to a rapid assessment undertaken by UNDP and the National Statistics Bureau, 32 percent of employees in the sector had lost their job or been sent on leave without pay. For most households surveyed (63%), income from tourism was their only source of livelihood with 74 percent of affected households reporting a significant drop in income (declines of more than 50%) and many having no other source of subsistence or means to carry them through the crisis.

The economic fallout from COVID-19 spread to other key sectors, such as construction and manufacturing, with industrial production suffering severe supply chain disruptions, rising input and transaction costs and labour shortages due to restrictions imposed on the foreign workers on which these sectors are dependent. According to the Ministry of Labour and Human Resources (MoLHR), total demand for foreign workers across the country stood at 35,567, of which 53 percent skilled, in June 2020. As a result of pandemic-related restrictions, the supply of both skilled and unskilled workers fell short by 41 percent. Labour shortages also had negative implications for 12 FYP capital projects and programmes, much of whose activities were frontloaded in 2020/21 fiscal year. Five months into the 2020/21 fiscal year only 6 percent of the capital budget¹² has been used due to prevailing shortages in the supply of workers and inputs. The resultant delays in implementation will likely contribute to foreign labour bottlenecks in the post pandemic period as domestic labour is not able to pick up the slack.

Bhutan’s export market is highly concentrated, with India accounting for about 70 percent of Bhutan’s exports (Table 3) and rendering the country highly vulnerable to exogenous shocks from India. For example, when India introduced its Goods and Services Tax (GST)¹³ in 2016, Bhutan’s cement industry exports to India were adversely affected (CPD, 2018).

¹² As reported in the current parliament session by Finance Minister

¹³ In India, GST is a comprehensive, multi-stage, destination-based tax that is levied on every value addition (value added tax)

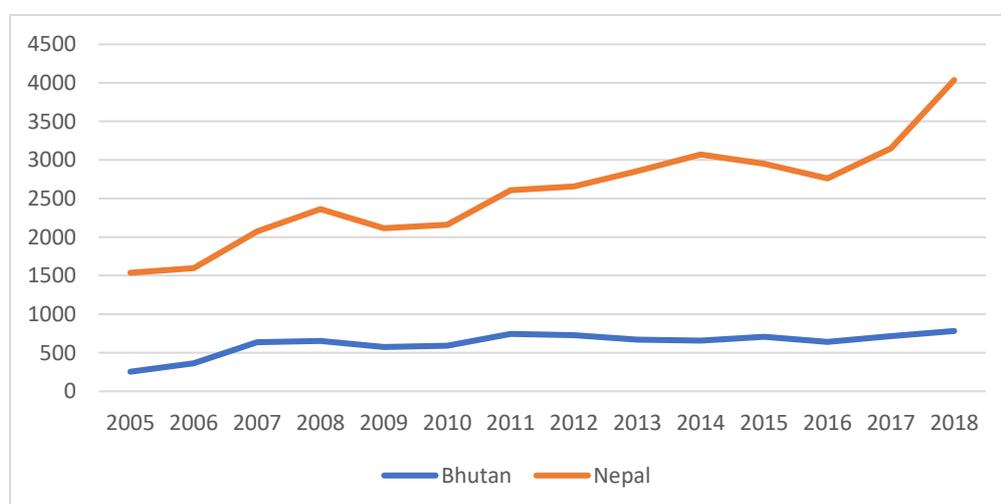
Table 3: Bhutan's Top 10 Export Markets

Country	Export Market share %
India	70
Bangladesh	19
Italy	3
Netherlands	2
Nepal	2
Germany	1
Spain	0.41
Hong Kong	0.34
Turkey	0.33
Singapore	0.32

Source: Bhutan Trade Statistics 2018 (Ministry of Finance, 2018)

Bhutan faces a considerable challenge in large-scale production of goods for export and must rely on niche markets to compete with neighbours such as China and India. The competitiveness of Bhutan's exports on the international markets is further constrained by underdeveloped trade infrastructure and high transport costs owing to Bhutan's unfavourable geographical terrain making it difficult for the country to increase its share of international trade. Figure 1 shows that in the past decade, Bhutan has not been able to significantly increase the value of its total trade in goods and services compared to, for example, other LDCs in the South Asia region such as Nepal. Nepal is one of the country's important trading partners.

Figure 1: Total Trade in Goods and Services (BPM6) (US Dollars at current prices in millions)



Source: UNCTADStat

Over the past decade Bhutan has experienced trade deficits (Table 4), except in 2007, when electricity exports to India increased following the completion of the Tala Hydropower Project. The trade balance for financial year 2018-2019 was expected to be -9.1 percent of GDP (Ministry of Finance, 2019a). The trade deficit has contributed to the country’s current account deficit, which in turn, poses macroeconomic challenges and leads to a shortage of foreign exchange, hampering medium to long term macroeconomic stability.

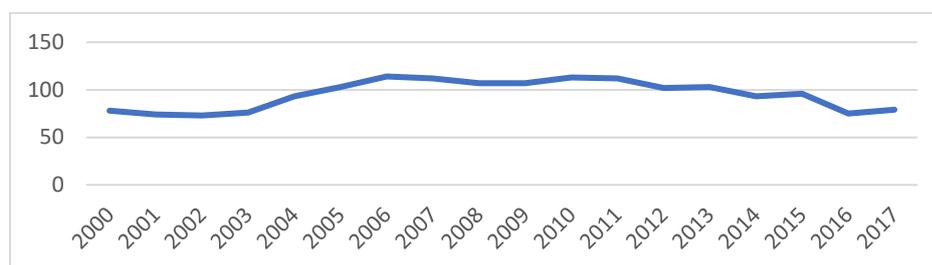
Table 4: Overall balance of trade, Total Trade in Goods and Services (BPM6) (US Dollars at current prices in millions)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Exports	254	364	637	654	574	590	746	729	668	659	707	642	716	782
Imports	543	499	586	766	682	935	1305	1208	1101	1118	1204	1237	1235	1256
Balance	-289	-135	51	-112	-108	-345	-559	-479	-433	-459	-497	-595	-519	-474

Source: UNCTADStat

Despite the constraints on trade, it has played an essential role in the development of Bhutan. Figure 2 shows that since 2012 the trade contribution to GDP has remained above 75 percent and, albeit at a declining trend, has been an important development driver helping to raise living standards and contributing to full employment.

Figure 2: Total Trade (% of GDP)



Source: World Bank World Development Indicators

Amidst the COVID-19 crisis, Bhutan and Bangladesh signed a preferential trade agreement (PTA) adding another 16 products on the duty-free exports list to the 18 products covered by a pre-existing agreement. This initiative is expected to boost bilateral trade between the two countries and potentially incentivize economic diversification and expand non-hydro exports.

India also agreed¹⁴ to open four new trade points at Nagarkata, Agartala, Jogighopa, and Pandu, availing alternative trade routes to India and facilitating trade transit to Bangladesh. Two new riverine ports, Jogighopa and Pandu, both located in Assam on India’s National Waterway 2 along the Brahmaputra River (Dhubri in Assam was the only available port before) opened as additional bilateral and transit routes. These developments potentially enhance logistical efficiency in terms of time and cost and encourage bilateral trade with India and other countries.

¹⁴ Kuensel, December 4, 2020 issue.

Bhutan places increasing importance on the development of cottage and small industries¹⁵ (box 1). In this regard, the 2019 CSI updates the 2012 CSI policy to embody measures intended to improve the policy and regulatory environment to spur the growth of CSI and diversification of the economy. The share of industry (inclusive of electricity generation) in GDP had risen to 40.6 percent by the end of 11 FYP implementation, but within it the share of manufacturing remained very small at just 11 percent of total CSIs with most engaged in the production of low value-added products. Constituting about 95 percent of total industries in Bhutan, the CSI play an essential role in the growth and development of the domestic economy, creating employment, driving innovation, and reducing poverty.

The CSI Policy 2019 aims to realign the sector with the changing business environment, stimulate investment and enhance the growth of the sector (Ministry of Finance 2019b). With cottage and small industries accounting for 90 percent of non-hydro productive activities in 2018, the COVID-19 crisis has dealt a heavy blow on a still nascent productive base and seriously hurt the export of non-hydro goods and services. Smaller firms are by default less resourced and have severely limited ability to withstand shocks. This has negative implications for the 12 FYP goal of expanding and diversifying the country's economic base, diminishing the reliance on imports and narrowing the country's trade deficit.

As part of its policy shift to improving the country's investment climate, Bhutan has undertaken regulatory reforms aimed at improving processes related to starting a business, access to credit, property registration and the enforcement of contracts. As a result, Bhutan outperformed its regional neighbours, such as Bangladesh and Pakistan, in the World Bank's ease of doing business rankings. Ranked at 75 out of 190 countries in 2018, Bhutan was the best-ranked country in the South Asia region and remains among the best-ranked countries in the region (World Bank, 2019a). More recently, Bhutan has eased the payment of taxes and pledged to redouble efforts to further improve the country's business and investment climate through additional reforms such as measures to refine construction permits, strengthen credit bureaus, improve land registration and identifying ways of protecting minority investors.

FDI Rules and Regulation 2019, is the new FDI policy that is expected to attract FDI into and enhance growth of the CSI sector, thereby contribute to building a resilient and diversified economic base, including through encouraging the adoption of new technology, skills acquisition, and enhanced market access by opening the space for FDI joint ventures with local partners in specific small-scale production and manufacturing activities¹⁶. The minimum level of such FDI participation is set at Nu5 million, with maximum foreign investor's equity capped at 49 percent. The new FDI policy also proposes to fast track approval and clearance of FDI in select small-scale production and manufacturing activities once the policy comes into effect.

However, for the past two decades, overall inflows of FDI to Bhutan have been quite limited, averaging about US\$16 million annually since 2000. In 2016 and 2017, FDI inflows turned negative US \$ -7 million and \$ -10 million respectively and recovered in 2018 at US \$ 6 million. FDI inflows to Bhutan are significantly lower than FDI flows to other LDCs in the South Asia region. In 2018, Afghanistan attracted US \$ 189 million, Bangladesh US \$ 3,613 million and Nepal US \$ 161 million. FDI inflows to Bhutan

¹⁵ Cottage industries are those having an investment of less than Nu. 1 million and employing up to 4 people, while small industries are those which employ between 5 to 9 people and with an investment ranging from Nu. 1 million to Nu. 10 million.

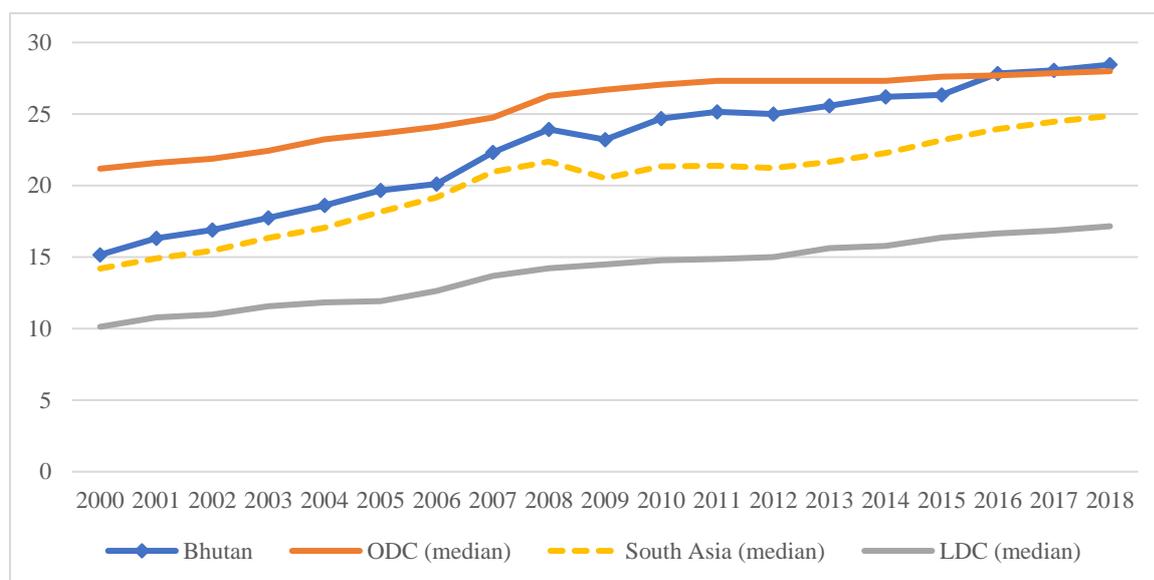
¹⁶ The activities are listed in Schedule III of the FDI Rules and Regulations 2019 and include agro-based value-added processing using locally produced products. The priority lists of manufacturing and services sectors are found in Schedule I and Schedule II of the FDI Rules and Regulations 2019

were also insignificant compared to other LDCs in the Asia region, such as Cambodia (\$ 3,103 million), Lao People’s Democratic Republic (US \$ 1,320 million), and Myanmar (US \$ 3,554 million). The limited inflow of FDI is partly due to Bhutan’s small size and the preponderance of state-owned enterprises.

Productive capacities

Bhutan’s has achieved steady progress in the evolution of the UNCTAD Productive Capacities Index (PCI) score over the last two decades maintaining a trajectory of productive capacities accumulation that outperforms other LDCs and South Asian economies during the period 2000-2018 (figure 3). By 2016, Bhutan had closed the performance gap with other developing countries (ODCs – i.e. non-LDC developing countries).

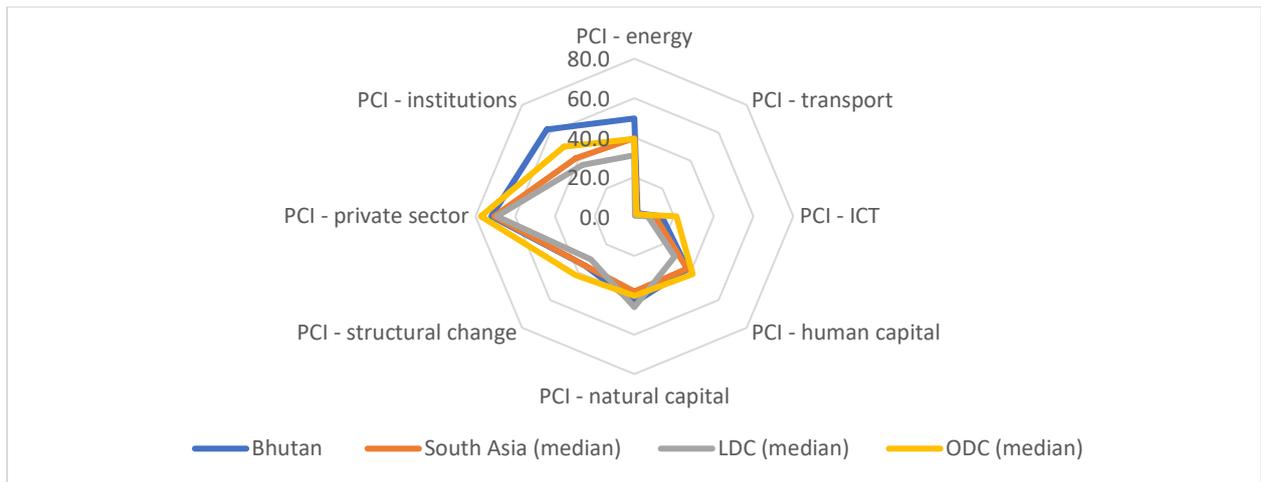
Figure 3: Productive capacity index for Bhutan and related benchmarks (2000-2018)



Source: UNCTAD secretariat calculations, based on data from UNCTAD

A full understanding of the significance of Bhutan’s PCI performance and the material change in productive capacities accumulation requires a deeper analysis of the individual trajectories of the eight components of the PCI (figure 4). Bhutan outperforms other LDCs, countries in South Asia and other developing countries on energy and institutions but the country performs weakest on areas such as private sector. Moreover, the data reveals that regardless of the overall improvement in infrastructural components (ICT, energy and transport) owing to large investments in road and telecommunications networks, deficiencies in links to external and internal markets remain.

Figure 4: Components of the Productive Capacity Index for Bhutan and related benchmarks (2018)



Source: UNCTAD secretariat calculations, based on data from UNCTAD

Significantly, according to the most recent Logistics Performance Index (LPI) published by the World Bank, Bhutan has one of the weakest logistics performance (second lowest after Afghanistan) – scoring particularly low on the quality of trade and transport related infrastructure- among South Asian countries and showing a marked deterioration down from 128 in 2010 to 149 in 2018¹⁷. Deficits in transport and trade logistics, and physical and digital connectivity between major urban centres and remote areas present fundamental bottlenecks for trade and domestic economic activity, and obstruct the development of value chains, including farm-to-market connectivity within the country. As regards ICT and IT-related services, progress has been very slow despite the recognition of telecommunications and broadband Internet connectivity as important contributors and an ICT policy and strategy being in place. For example, while internet use rose from 0.4 percent in 2000 to 48 per cent of the population in 2017¹⁸, Bhutan ranked 121st out of 178 countries in the 2017 ICT Development Index.¹⁹

Addressing trade facilitation challenges is especially important for a landlocked country such as Bhutan. Bhutan has recognized that to attain a higher growth trajectory, there will be greater need for regional air connectivity; better, and safer new roads that are climate proofed and alternative modes of transport to enable people and goods to travel reliably and efficiently²⁰.

Bhutan outperforms the South Asian and LDC median scores on human capital. Fiscal revenues from hydropower have helped finance major investments in human capital and expanded access to basic services²¹, which has significantly improved educational and health outcomes in the country. For example, Bhutan's 2019 HDI score (ranked 129th) is above the average of countries in the medium human development group and for countries in South Asia. The Maldives and Nepal, for example, are ranked 95th and 142nd, respectively.

¹⁷ World Bank. 2018. Logistics Performance Index 2018. Washington, DC.

¹⁸ <https://www.itu.int/net4/ITU-D/idi/2017/index.html#idi2017rank-tab>

¹⁹ <https://data.worldbank.org/indicator/IT.NET.USER.ZS?locations=BT>

²⁰ National Transport Policy of Bhutan 2017.

²¹ Both education and health services are free and are predominantly financed and delivered by the public sector. For example, as of 2017, enrolment in primary education was nearly universal. Net secondary enrolment also expanded rapidly, surpassing 70 per cent in 2018 (from 22 per cent in 2000) (UNESCO UIS).

Dependence on hydropower, however, has resulted in a weak private sector, and despite Government's efforts aimed at developing the private sector, state-owned enterprises (SOEs) remain dominant in viable commercial sectors (such as manufacturing, energy, natural resources, financial, communication, aviation, trading, and real estate sectors).²² Accordingly, the 12th Five Year Plan emphasizes the importance of developing industries other than hydropower, including the Cottage and Small Industries Sector and tourism.

Employment and poverty

The lack of meaningful diversification has serious implications for the creation of decent work and addressing rising unemployment, especially among educated youth. For example, according to a World Bank report, youth with bachelor's degrees constituted 67 percent of total youth unemployment followed by youth with a middle and higher education degree at 21 percent. Bhutan's working age population is set to continue to increase in the 2020s, but youth unemployment has remained consistently high ranging from 7.3 percent to 15.7 percent over the period 2010-2019 (World Bank, 2018b). For example, while overall unemployment stood at 3.4 percent in 2018, youth unemployment was in comparison at a staggering 15.7 percent²³, the highest recorded over the period. In 2019, youth unemployment was estimated at 11.9 percent, a 3.8 percentage point reduction from the previous year²⁴. Rising unemployment among the educated youth poses a major socio-economic challenge for Bhutan pointing to a failure to capitalize on the realised improvements in human capital and underlying deficiencies in the education system that contribute to the weak impact of economic growth on employment in Bhutan as the supply of education has outpaced the growth in quality jobs. In addition, the incidence of queuing²⁵ among educated youth points to a manifest preference for public sector jobs and has broader implications on private sector development and economic diversification.

Agriculture (and allied sectors) is still the largest employer at 57.2 percent of total employment and contributing 16.5 percent to GDP. The imbalance between agriculture's share of employment and share of GDP distinguishes the economy as largely agrarian and requiring further progress on structural economic transformation.

The economic impact of the COVID-19 crisis is hitting the youth the hardest.²⁶ A slow recovery from COVID-19 will have negative implications for the 12 FYP target of 2.5 percent overall unemployment and less than 6.5 percent youth unemployment. It is estimated that more than 5,000 youth laid off in foreign countries returned to Bhutan. Most are beneficiaries of Royal Kidu²⁷. As of December 2020, 27 percent of those registered with the Ministry of Labour and Human Resources as unemployed were laid off due to COVID-19 and about 4 percent were returned migrants. These numbers likely underestimate the real number of unemployed because they account only for registered job seekers and those permanently laid off and not those who are on reduced pay, leave without pay, leave with partial pay and businesses that are only partly operational.

²² <https://blogs.worldbank.org/endpovertyinsouthasia/how-diversify-bhutan-s-economy#:~:text=Diversifying%20the%20economy%20is%20touted,low%20productivity%2C%20and%20macroeconomic%20volatility.&text=The%20main%20driver%20of%20Bhutan's,the%20backbone%20of%20its%20economy.>

²³ 2018 Labour Force Survey Report

²⁴ 2019 Labour Force Survey Report

²⁵ Choosing to remain unemployed while waiting for jobs that match their aspirations or expectations.

²⁶ <https://undp-ric.medium.com/ethnographic-research-on-youth-unemployment-in-bhutan-looking-beyond-statistics-for-stories-2200ae24e694>

²⁷ Druk Gyalpo Relief Kidu, Income support to affected individuals

Bhutan has deemed it vital to apply the Gross National Happiness Index based on the notion Gross National Happiness (GNH)²⁸ conceived by His Majesty the 4th King in 1972 and which is at the centre of Bhutan's development vision, in conjunction with the World Bank poverty line to explain the notion of poverty as much more than a measure of income.²⁹ Most countries define poverty in incomes terms, making low consumption power and poverty synonymous with people having daily real incomes below the World Bank defined US\$1.90 per day poverty line considered poor. However, the conceptualisation of poverty has changed significantly from the basic needs approach of the 1970s and while the content of what constitutes poverty is not specific, today poverty is understood as multi-dimensional deprivation (Green, 2006). There is thus disagreement about the adequacy of the income-based definition of poverty in so far as it fails to quantify conditions such as infectious disease or lack of food or clothing that can help to explain poverty.

While it is difficult to determine a causal link between the benefits derived from LDC status and changes in poverty status, Bhutan has achieved noticeable improvements in education with overall literacy estimated at about 66.0 percent in 2018, almost universal provision of electricity nearing 98 per cent in 2017, and basic access to potable water services at about 97 percent of the population in the same year. Bhutan's Human Development Index score was 0.654 in 2019, above that of other Asian LDCs and its main export partner India (0.645). Growth has led to a dramatic fall in the national poverty rate from 23.2 percent in 2007 to just 8.2 percent in 2017. However, urban-rural disparities remain marked. Rural poverty decreased from 16.7 percent in 2012 to 11.9 percent in 2017. During the same period, urban poverty reduced from 2 percent to 0.7 percent³⁰. At the start of the implementation of the 12 FYP, the average annual household income of the urban population was 172 percent higher than that of rural counterparts, reflecting huge income gaps between urban and rural populations.³¹

Bhutan has a strong track record of reducing poverty, but COVID-19 impacts in 2020 has affected many segments of society, including urban areas through lay-offs, furloughs, leave without pay or reduced wages, and large increases in the cost of basic goods triggering spikes in urban poverty. Bhutan is largely dependent on India for imports of most food items. Agriculture and food accounted for about one-fifth of the deficit of Bhutan's sizable trade imbalance (excluding electricity trade) in 2019.³²

While the impacts of COVID-19 have motivated farmers, laid-off youth and others to venture into commercial production and marketing of agriculture goods, many still depend on income from regular and substantial cash remittances by family members in urban centres. These transfers can be expected to have reduced or dried up because of the crisis. Rural off-farm activities have also been adversely affected. Rural handicrafts, which are a major source of off-farm income, were negatively affected by crisis containment and preventive measures. For example, according to the Bhutan Chamber of Commerce and Industry impact study undertaken in May 2020, 90 percent of handicraft shops were

²⁸ The GNH seeks to strike an appropriate balance between material wellbeing and the spiritual, cultural and emotional needs of the Bhutanese society. It captures socio-economic components such as living standards, health, education and other non-traditional aspects of cultural and psychological wellbeing, time use, community vitality and ecological diversity and resilience to reflect the general wellbeing of Bhutanese people.

²⁹ For instance, to help determine whether economic growth achieved has trickled down, Mozambique has defined a set of minimum needs. Households whose cost of consumption falls short of the cost of the defined minimum basket of needs are deemed poor (Silva, 2019).

³⁰ From the summary of poverty reduction and social strategy written for a project COVID-19 Active Response and Expenditure Support (CARES) Programme.

³¹ Vol-1, 12 FYP

³² COVIT-19 and food security update, April 30,2020 as provided in 'Regional-Annex-Update-Food-Security_4_2020.pdf

affected by the tourism standstill experiencing declines in sales of up to 96 percent. The sector is highly dependent on tourists with domestic buyers accounting for about 40 percent sales. The crisis affected domestic sales impacting thousands of artisans and suppliers in the value chain, including those in rural clusters.

Disruptions to education and learning at all levels from COVID-19 containment and preventive measures may have lasting impact on the ability of many to overcome the challenges of poverty and to capitalise on future opportunities in the job market, while impeding progress on improving human capital and Bhutan's productive capacities. Some estimates suggest that 30 percent of students have missed out on e-learning programmes availed during the crisis due to access or connectivity issues—a figure likely to underestimate the magnitude of the problem given that access to e-learning platforms does not guarantee that students' performance remains at the same level as with face-to-face learning. There are also reports of children dropping out from school due to the pandemic. Some dropout cases were due to parents losing their jobs on account of the crisis.

Environmental vulnerabilities

Bhutan is the only carbon-negative country in the world, but the country is exposed to climate change and natural disaster risks impacting the availability of water, energy and food security. Situated in seismic zones IV and V, Bhutan is susceptible to seismic and hydro-meteorological hazards such as landslides, floods, windstorms, and forest fires. To show its commitment to addressing these hazards in its pursuit of development, the government enacted the Disaster Management Act, 2013, which provides the legal framework for strengthening the institutional capacity for disaster risk management, mainstreaming of disaster risk reduction, and integrated and coordinated approach to disaster management focusing on community participation and managing incidental matters (RGB, 2013).

4.0 Implications of graduating and loss of ISMs

LDC-specific international support measures (ISMs) include measures related to international trade; development cooperation; contributions to the funding of the United Nations System, support for travel to official meetings, scholarships and research grants. Ex ante impact assessments consider the implications of the withdrawal of these support measures granted specifically to LDCs for each country on graduation. The assessments also consider other LDC-specific instruments. While graduation may potentially have benefits, these are not related to specific measures and cannot be assessed ex ante (CDP, 2018c). An ex-ante impact assessment on the likely impact of the withdrawal of LDC-specific measures for Bhutan was undertaken by the United Nations Department of Economic and Social Affairs (UNDESA) in 2018.³³

The United Nations recognises the difficulty of relating LDC graduation to specific ISMs (CDP, 2018b). The limited impact and effectiveness of LDC-specific support measures remains a vexing concern. Their effectiveness in enhancing LDCs exports and promoting integration in the global economic and trading system is limited and most LDC officials polled by UNCTAD in 2016 considered ISMs insufficient to support developing challenges in their countries (Mollerus, 2012; UNCTAD, 2016). International support measures constitute neither a recipe for development, nor offer answers to all the

³³ After a country is found eligible for graduation for the first time, the CDP requests the UNDESA to prepare an ex-ante assessment of the expected impacts for the country of no longer receiving LDC-specific ISMs. UNCTAD is also mandated to prepare a vulnerability profile of the country.

development challenges faced by LDCs, such as smallness, landlocked geographical isolation, justifying a need to reconsider their design (Gay, 2019).

4.1 Trade and development

The main trade-related support measures to LDCs are (i) preferential access to export markets; and (ii) special and differential (S&D) treatment in the implementation of World Trade Organisation (WTO) commitments and in accession to the WTO.

Preferential market access

Bhutan enjoys inclusion in LDC-specific preference schemes granted by developed countries to LDCs under the Generalised System of Preferences (GSP) scheme, which provides for tariff exceptions, duty-free and quota-free (DFQF) market access and greater product coverage. Several developing countries, such as India and China also provide preferential tariffs to LDCs. Accordingly, Bhutan exports to the EU under the Everything But Arms (EBA) programme and exports to India are governed by the Agreement on Trade, Commerce and Transit, a bilateral free trade agreement which provides levels of preferential market access regardless of Bhutan's LDC status. Bhutan also trades with Bangladesh under a Preferential Trade Agreement (PTA), which affords duty-free access to over 90 products. In addition, Bhutan receives market access concessions through the South Asian Free Trade Area (SAFTA) and the South Asian Association of Regional Cooperation (SAARC).

Considering that India is the top destination for almost all the main exports of Bhutan and that other significant trade relations are with Bangladesh, a few European countries and Nepal, the country is unlikely to experience significant trade impacts resulting from graduation. Existing bilateral agreements will continue to govern trade with India, Bangladesh and Nepal. The removal of DFQF market access to the EU might similarly not have a significant adverse effect on the Bhutan economy given Bhutan's current low utilisation of EU preferences. Besides, some of Bhutan's exports such as cardamom and cement will still enter the EU market duty-free under the EU standard GSP afforded to developing countries in general. Moreover, some of Bhutan's exports to the EU such as ferrosilicon are unlikely to face a substantial change in tariff after graduation with the average tariff expected to increase from zero to 2.2 per cent (CDP, 2018a).

However, Bhutan will face a significant increase in tariffs in the EU, Japan and Thailand for dairy products, vegetables and fruit (CDP, 2018d). The increase in tariffs has implications for the competitiveness of some of Bhutan's products, especially in the light of other developing country competitors that have already established distribution networks and supply chains using standard GSPs or MFN access. Since Bhutan relies heavily on the Indian market, losing EU and Japanese market preferences is of concern in so far as it will further concentrate Bhutan's major export destinations, heighten Bhutan's exposure to external trade shocks.

The increase in EU, Japan and Thailand tariffs for dairy products will also have potentially negative implications for Bhutan's efforts to enhance export and economic diversification, particularly in the agriculture sector as EU tariffs on agricultural products are high. Like most LDCs, Bhutan does not have sufficient productive capacities to take advantage of opportunities created in international markets. However, Bhutan has identified export products³⁴ with the potential to become major export sectors in the future but the loss of preferences on these identified sectors, particularly from the EU, Japan

³⁴ Bhutan's potential export products include dairy, apiculture, horticulture, potatoes, apples, mandarins, medicinal plants, cordyceps, mineral water, animal feed, plastic film/sheet, particle board, iron ingots and copper wire (CPD 2018)

and Thailand will make it difficult for Bhutan to develop productive capacities in the same sectors and to diversify its export basket. Besides, failure to diversify the economy and its export basket will mean continued reliance on electricity generation for growth and exports, which will continue to have environmental consequences. Continued reliance on electricity generation would be contrary to Bhutan's 12 FYP which focuses on the diversification of the economy to make the country's economic base stronger and address some of Bhutan's vulnerability challenges in building a resilient and robust economy. Moreover, although FDI is generally not directly associated with a country's LDC status but can establish in an LDC to take advantage of LDC-specific market preferences, graduation might affect decisions by such potential investors impacting the flow of FDI to Bhutan and having implications for Bhutan's strategies of developing productive capacities and diversifying the country's economic base. On the other hand, most countries that provide GSPs such as the EU and US have markets big enough for Bhutan to capture a share as a developing country post-graduation. Access to these markets under GSPs may still constitute incentives for FDI keen on exporting to GSP markets (Kuensel, 2017).

Implementation of World Trade Organization (WTO) commitments

Bhutan is not yet a member of the WTO and does not benefit from most of the WTO S&D provisions nor does the country have WTO obligations to comply with. Nevertheless, as an LDC, Bhutan receives market access to the preferential schemes of WTO developed country members. For example, in 2017, Bhutan benefited from trade-related technical support provided by the EU and from capacity-building resources provided by Japan under the WTO Trade Facilitation Agreement (TFA) technical assistance programmes.

Bhutan is currently negotiating accession, which makes it difficult to ascertain the impact of the loss of benefiting from the implementation of WTO commitments.³⁵ Acceding to the WTO after graduation will entail Bhutan the full costs of assuming WTO obligations³⁶ unlike LDC members that benefit from several S&D provisions and increased flexibilities in the implementation of rules and disciplines governing multilateral trade, such as extended transitional periods and the provision of technical assistance.

However, should Bhutan accede before graduation, the country could negotiate a preferential transition period and would be eligible for LDC-specific technical assistance and capacity-building for accession and post-accession after its graduation and the smooth transition period.³⁷

With regards to trade in services, the WTO Services Waiver adopted in 2011 allows WTO members to provide LDCs market preferences in services.³⁸ The Waiver is relevant to Bhutan's services trade, especially professional services and tourism, which have been identified as potential export sectors. If

³⁵ The Royal Government of Bhutan deferred accession and the situation has not changed to date.

³⁶ For example, LDCs are exempted from implementing the TRIPS Agreement until 1 July 2021. As a graduated country Bhutan would be required to provide intellectual property protection as envisaged under the TRIPS Agreement and the legislative changes required would depend on the country's accession commitments.

³⁷ In 2002, the WTO General Council adopted Guidelines for the Accessions of LDCs, which was intended to facilitate the accession of LDCs. The Guidelines, which were strengthened in 2012, urged WTO Members to exercise restraint in their demand for concessions from acceding LDCs. The Guidelines will not apply of Bhutan accedes after graduation.

³⁸ However, the implementation of the services waiver is still in its early stages, and as of 2018, only 24 WTO members had notified, at the WTO, the sectors and modes of supply to which they would grant preferential treatment to LDCs. In additions, LDCs have requested WTO Members to undertake capacity building measures to make it possible for LDC suppliers to take advantage of preferential treatment notified under the LDC Services Waiver. Further steps are also needed to enhance the operationalisation of the waiver.

Bhutan is to accede to the WTO after graduation, the country will lose the opportunity to benefit from the WTO Services Waiver.

4.2 Development cooperation

ODA

It is unlikely that Bhutan will lose foreign aid after graduation. However, Bhutan has been experiencing a decline in ODA, which in the immediate term poses a challenge for Bhutan's implementation of its 12 FYP (RGB, 2019). Moreover, according to UNCTAD, LDCs stand to lose the most from declining trust in multilateralism in terms of the availability of financing for development in the medium and longer term (UNCTAD 2019). While preferential treatment may apply to LDCs in cases where assistance is given in the form of loans, generally, donors do not necessarily use LDC status to guide their allocations despite that many priority countries identified by donors are LDCs (CDP, 2012). Not only do loans increasingly replace grant funding, but aid remains inadequately directed to economic sectors, requiring LDCs themselves to assume the driver's seat in managing and directing official financial flows to prioritize structural transformation (UNCTAD 2019). The successful implementation of the IPoA plan and strategy was partly contingent on the donors' commitment to allocate between 0.15 and 0.2 percent of their GNI as aid to LDCs, on which most donors have fallen short and recent developments show is waning. However, all donors consulted by UNDESA when undertaking the impact assessment for Bhutan proclaimed their intention to continue to support Bhutan to overcome its specific challenges and meet its development objectives after graduation (CDP, 2018c).

LDC-specific instruments

Aid for Trade

Aid for Trade (AfT) to LDCs is delivered through the Enhanced Integrated Framework (EIF) intended to help LDCs overcome trade-related constraints. Graduation should bring about the phasing out of EIF support provided to Bhutan for analytical work, institutional support, and for developing productive capacities, which are vital if Bhutan is to achieve industrial transformation. The EIF provides an automatic transition period of up to 5 years after graduating, with a possibility of an extension of up to two additional years after that, decided on a country by country basis.³⁹ As a beneficiary of the EIF, Bhutan is thus expected to continue to benefit from EIF programmes for some time yet.

United Nations Capital Development Fund

The United Nations Capital Development Fund (UNCDF) supports LDCs to unlock private and public funds to reduce poverty and support local economic development. Bhutan stands to continue to benefit from the UNCDF as the Fund ensures that programmes are funded for an additional three years after graduation and for a further two years thereafter co-funded with the government on a 50/50 basis.

United Nations Framework Convention on Climate Change

³⁹ Given the United Nations General Assembly Resolution A/RES/59/209 recommendation for the continued implementation of EIF technical assistance programme for a graduated country over a period appropriate to the development situation of that country, the EIF decided to provide an automatic transition period of up to 5 years after graduating,

While graduation will have negative implications for access to the Least Developed Countries Fund (LDCF)⁴⁰ created under the United Nations Framework Convention on Climate Change (UNFCCC), Bhutan will remain eligible for the Green Climate Fund (GCF)⁴¹, Global Environment Facility (GEF) Trust Fund, the Special Climate Fund and the Adaptation Fund. The cessation of access to LDCF – which is vital in Bhutan’s effort to mitigate vulnerabilities and build resilience – will harm the country’s efforts to address the challenges of vulnerability to natural disasters caused by climate change. However, belonging to the LDC category is not a condition for receiving technical assistance. United Nations organisations and agencies such as the OHRLLS, UNCTAD, UNESCAP and the WFP have indicated their commitment to support Bhutan’s smooth transition and to continue support after graduation. Much of this assistance would, however, be technical support.

Technology Bank

The Technology Bank for LDCs⁴² was officially established in January 2017 and operationalized in September 2017. It is still early in the process to assess its effectiveness and therefore the impacts of loss of access. However, Bhutan would continue to enjoy access to the Bank for a period of five years after graduation.

4.3 Contributions to the UN System and Travel Assistance

LDCs benefit from reduced contributions to the United Nations and the WTO and assistance with travel to international meetings. As such, LDC contributions towards the United Nations regular budgets are capped at 0.01% of the budget compared to the maximum contribution for other countries of 22% and contributions to peace-keeping operations and the International Criminal Tribunal are based on the United Nations contribution scale, which is based on gross national income, debt-burden, per capita income, among other criteria, but get 90% discount. Because Bhutan’s contribution of 0.001% is below the LDC ceiling of 0.01%, graduation will not affect Bhutan’s contributions to the United Nations regular budget. However, Bhutan is expected to experience immediate changes to its United Nations Peace Keeping budget and WIPO budget (CDP, 2018c).

LDCs also benefit from travel assistance provided by the United Nations and some of its agencies to participate in official meetings. For instance, the United Nations offers travel assistance for LDC representative to attend the regular sessions of the United Nations General Assembly – support that can be extended for up to three years after graduation. The cessation of the travel assistance might affect Bhutan’s attendance at critical meetings such as meetings to discuss issues of vulnerability and building strong and resilient economies.

4.4 Graduation, vulnerabilities and building resilience

Bhutan has so far qualified for graduation without meeting the EVI graduation criterion. A significant question is whether Bhutan can develop the needed capacity to mitigate economic vulnerability and

⁴⁰ The Least Developed Countries Fund (LDCF) was set up to provide LDCs with climate change financing and it will cease to provide new funds on graduation, although ongoing projects will be financed until up to full implementation.

⁴¹ However, Bhutan will no longer benefit as a member of the Fund’s priority group of countries.

⁴²The Technology Bank was created as a result of the call in the Istanbul Programme of Action (IPOA) for a “supporting mechanism, dedicated to least developed countries which would help improve LDCs’ scientific research and innovation base, promote networking among researchers and research institutions, help LDCs access and utilize critical technologies, and draw together bilateral initiatives and support by multilateral institutions and the private sector, building on the existing international initiatives.”

weather the post-graduation environment to sustain development progress and achieve sustainable development. The above discussion highlights especially the requirement for Bhutan to establish 'graduation with momentum' strategies (UNCTAD, 2016) necessary for the sustainable management of the country's economic vulnerabilities. Table 5 presents a matrix of the implications of situational changes likely to be brought about by graduation for Bhutan on the diversification of both the economy and export basket, building productive capacities, and mitigating natural disasters. Bhutan's limited capacity to address issues of economic and environmental vulnerability will continue to affect Bhutan's ability to address its overall development challenge to deliver greater well-being and happiness its people and realize the SDGs. This lack of capacity provides Bhutan with a compelling reason for requesting a longer phase-out period for specific ISMs to ensure a positive (and sustained) graduation outcome.

Table 5: Bhutan situational changes and vulnerability status

Matrix of Situational Changes and Related Vulnerabilities Implications	
Situation Change	Likely Implications for Bhutan’s vulnerabilities
<p>Trade (a) Loss of LDC-specific preferences</p>	<ul style="list-style-type: none"> • Loss of EBA DFQF preferences will entail export under EU GSP, GSP+ or MFN, impacting on Bhutan products’ competitiveness on EU markets with implications for foreign earnings while exposing Bhutan to heightened economic vulnerability. <ul style="list-style-type: none"> ○ Loss of EU preferences on most agricultural export products would be in the magnitude of more than five percentage points (CDP, 2018c) and will affect the export of products identified as potential candidates for export diversification and building of productive capacities. • Loss of LDC-GSP will mean export under Japan’s standard GSP or MFN impacting on the competitiveness of some of Bhutan’s agricultural products (dairy, honey, vegetables and fruits) on Japanese markets, exposing Bhutan to economic vulnerability. <ul style="list-style-type: none"> ○ Loss of Japanese preferences on most agricultural export products would be in the magnitude of more than five percentage points (CDP, 2018c) and will affect the export of products identified as potential candidates for Bhutan’s export diversification and building of productive capacities. • Loss of EU and Japanese market preferences will further increase reliance on India as Bhutan’s major export destination and thus heighten Bhutan’s exposure to external trade shocks. • Narrowed possibilities for export and economic diversification from preference losses imply correspondingly diminished options for developing productive capacities and heightened reliance on electricity generation for growth and development heightening risks of (continued) negative environmental impacts.
<p>Development Assistance (b) Access to LDCF phased out (c) Exclusion from the GCF priority group</p>	<p>The phasing out of access to the LDCF has potential implications for Bhutan’s capacity and efforts to build resilience and manage vulnerability to natural events.</p> <p>The exclusion will have negative implications as prioritised access to GFC is vital for Bhutan’s continued effort to mitigate vulnerabilities and build resilience to natural events.</p>
<p>Contributions to the UN System and Travel Assistance Bhutan ceases to be eligible for travel assistance for representatives’ travel and participation in international meetings</p>	<p>Cessation of assistance could affect Bhutan's attendance at critical meetings and benefitting from sharing experiences on critical issues such as vulnerability challenges and building strong and resilient economies.</p>

5.0 Planning for a smooth transition and adjustment to post-graduation

The economic vulnerabilities outlined in this section have the potential to disrupt Bhutan's pace of development in the lead up to graduation from LDC status. In this regard, it is critical for the smooth transition strategy to mainstream economic and environmental resilience and recovery in its smooth transition strategy.

The aim is to use the transition period to formal graduation to help Bhutan overcome some of the challenges it faces on its development trajectory as well as to identify and pursue areas for continued international support in accordance with Bhutan's development situation. As such, there is a need to accord special consideration to the challenges that are a potential hindrance to Bhutan adjusting to the loss of LDC associated benefits and continuation of Bhutan's development trajectory.

The crafting of a smooth transition strategy for Bhutan must be situated in the context of Bhutan's unique circumstances, especially related to mitigating Bhutan's economic vulnerabilities and building resilience. In this regard, notable hurdles for continued development include an unstable macroeconomic environment, growing debt burden, lack of technology and human capital, a lack of productive capacities, an insufficiently diversified economic base and export basket that inhibits trade expansion, and marked vulnerability to natural disasters and economic factors – all of which affect Bhutan's capacity to build resilience and weather the post-graduation environment. The strategy must aim to demonstrate how it will achieve a real and sustainable impact on Bhutan's graduation with momentum, build resilience and how it proposes to ensure a graduated Bhutan can adjust to the loss of LDC benefits.

5.1 *Stabilising the macroeconomic environment*

It is vital for Bhutan to ensure that macroeconomic and fiscal instruments help achieve equitable and sustainable growth, job creation and reduction of poverty and inequality. Bhutan's heavy reliance on hydropower for development has created macroeconomic uncertainties and vulnerabilities. Given the country's small economy, large scale hydropower projects have led to large fluctuations in aggregate demand during construction and commissioning phases, and the high import content for the construction projects has contributed to large external balances and high foreign exchange-denominated debt that exceeds 100 percent of GDP (World Bank, 2018a). In addition, the country has experienced pro-cyclical fiscal pressures, including from an expanded public sector, owing to hydro-related contributions to the budget. Currently, the Government cannot collect much tax from the nascent non-hydro private sector, thereby worsening fiscal pressures. Bhutan is also in its early stages of integrating SDGs in its 12 FYP. As a result, revenue collection remains insufficient to address the structural fiscal deficit and debt repayments. Fiscal consolidation thus expected to remain an essential component to reducing economic vulnerability (IMF, 2018).

Domestic resource mobilisation was a major priority for the 11 FYP. While domestic resource mobilisation has improved, it falls short of Bhutan's developmental needs and Bhutan remains reliant on grant aid in the short to medium term. The increasing scarcity of donor funding, which could constrain development spending and negatively affect future growth and development, means Bhutan requires assistance to identify alternative sources of finance (World Bank 201 8b). Table 6 shows that in recent years grants from foreign governments and international organisations have continued to contribute significantly to Bhutan's budgetary requirements, second to tax revenue contributions. In 2016 and 2017 revenue from grants contributed 35 percent and 30 percent of total revenue, respectively. An abrupt reduction in grants will have severe implications for Bhutan budgetary requirements and on the country maintaining its growth path.

Bhutan continues to accord priority to self-reliance in development financing through developing a comprehensive financial strategy, carefully analysing the costs and benefits of several financing options, including introducing a broad-based goods and services tax (GST) in July 2020.⁴³ Such efforts are crucial for the mobilization sufficient resources for the ongoing implementation of Bhutan's 12 FYP, but also for maintaining future development spending. By improving the macroeconomic condition, the RGB will create an environment that is desirable for Bhutan's plans to diversify the economy away from dependence on hydropower (IMF, 2018).

To attract more resources from Bhutanese abroad, Bhutan launched RemitBhutan with the view to promoting national savings and building foreign reserves (World Bank 2018b) to facilitate greater flows of remittances to Bhutan.

Table 6: central government fiscal revenues (Nu millions)

	2013	2014	2015	2016	2017
Total Revenue	30 613.04	37 425.45	35 022.01	42 026.72	42 486.84
Tax Revenue	15 151.18	15 943.70	16 856.03	18 632.08	19 805.06
-Taxes on income, profits, & capital	7 812.79	9 349.71	9 609.95	10 405.24	10 404.51
-Taxes on income, profits, & capital gains: individuals	1257.88	1 438.39	1 536.16	1 770.36	957.31
-Taxes on income, profits, & capital gains: corporations					
-Taxes on property	6 554.91	7 911.32	8 073.80	8 634.88	9 447.20
- Taxes on Goods and Services	0.00	0.00	0.00	0.00	3.59
-Taxes on international trade & transactions	7 051.66	6 285.52	6 828.30	7 658.79	8 817.88
-Other taxes n.e.c.	286.73	308.47	447.40	597.39	562.56
	0.00	0.00	20.18	20.47	16.52
Social Contributions	22.61	24.10	56.38	82.42	-79.92
Grants Revenue	9 562.64	14 236.35	9 955.02	14 889.61	12 986.75
-Grants revenue from foreign governments	6 345.72	12,271.09	6,593.76	10,721.70	12,986.75
- Grants revenue from international Organisations	3 216.91	1 965.27	3 361.26	4 167.91	0.00
Other Revenue	5 876.60	7 221.30	8 154.58	8 422.61	9 774.95

Source: IMF Data: Macroeconomic & Financial Data

The 12 FYP set the target to maintain the average fiscal deficit below 3% of GDP and to fund at least 80 percent of FYP expenditure through domestic revenue. This target looks increasingly uncertain in the light of the elevated expenditure requirements linked to COVID-19 mitigation and recovery⁴⁴ and the downward pressure on non-hydro revenue sources. The 2020/21 fiscal deficit is expected to widen to about 8.4 percent of GDP and to remain elevated for the medium term, likely necessitating recourse to borrowing on foreign markets should access to grant funding be diminished by COVID-19 impacts on donor countries (table 7). The public debt projected for FY2020-2021 is 126.5 percent of GDP, an increase of 8.4 percent from the previous year—as both external and domestic debt are expected to increase mainly on account of loan disbursement for the Kholongchu Hydropower Project, and the borrowings from the domestic market through issuance of T-bills and Government Bonds to meet the resource gap. As of 30 September 2020, total public debt stood at 120.8 percent of GDP. In addition, the local currency suffered a 5.19 percent depreciation against the United States dollar in 2020. All

⁴³ <https://www.mof.gov.bt/wp-content/uploads/2020/07/NotificationGST.pdf>

⁴⁴ <https://www.cabinet.gov.bt/wp-content/uploads/2020/07/PR-Phase-2-fiscal-and-monetary-measured.pdf>

these developments place a premium on the establishment of a robust fiscal management plan and have implications for Bhutan graduating with momentum.

Up to 55.65 percent of the capital budget from front-loading of 12 FYP implementation to the 2020/21 fiscal year as part of the response to COVID-19 impacts is projected to be funded through foreign grants (mostly project-tied assistance). Being unpredictable, external fiscal support represents a source of macroeconomic instability for Bhutan.

Table 7: Trends in external fiscal support

Fiscal Year	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
% of foreign grant to total revenue	35.42	30.43	28.49	19.24	26.03	37.42
% of foreign grant to capital exp	68.28	54.36	51.49	46.90	47.66	55.56

Source: Extracted from Annual Report 2019, RAMA & NB FY 2020/21

On the upside, electricity exports remained a reliable source of trade earnings (also offsetting the reduction in the domestic electricity sales resulting from subdued productive activity, especially energy-intensive industries) and have been boosted by the commissioning of Mangdechhu Hydropower. In addition, subdued imports have been a bonus for macroeconomic health. In the nine months since the start of the COVID crisis, total trade volume dropped by 30 percent with non-hydro exports reduced by 43 percent and imports by 25 percent. The trade deficit declined by 32 percent in the first half of 2020 and the current account deficit is expected to narrow from 15.3 percent of GDP to 7.7 percent of GDP because of COVID-19. Bhutan's foreign exchange reserve was 1,403 million as of December 2020⁴⁵ sufficient to cover more than 21 months of essential imports or more than 15 months of merchandise imports and well within the country's constitutional requirement. However, due to the impact of COVID-19 on the tourism sector, reserves are expected to fall by around 4%.

5.2 Expanding Trade

Bhutan faces numerous exogenous and endogenous challenges to trade, including the changing global trading system, restrictive customs procedures, supply constraints and inadequacies of trade-related infrastructure, loss of preferences in specific key markets due to graduation, undiversified export basket and export markets etc. In a world where big trading countries can resort to international trade tariffs as a lever to promote geopolitical interests, in so far as such tactics can impact opportunities to participate in global supply chains, Bhutan will need to maintain a strategic review of the international trading system with the view to understanding the ramifications of trade wars on key existing and potential trade partners for Bhutan companies and the domestic economy that might be impacted.⁴⁶ Serious ramifications on Bhutan's major trade partners, including India, the EU and Japan, could affect

⁴⁵ This information from the Prime Minister's State of The Union address in the current session of Parliament.

⁴⁶ On 1 June 2018, Bloomberg reported that various members of the WTO were moving forward with intentions to retaliate against the United States (US) tariffs on steel and aluminium imports <https://www.bna.com/countries-mull-wto-n73014476190/>. The report noted that China, the European Union (EU), India, Japan, Russia and Turkey pledged to impose US\$3.45 billion worth of retaliatory tariffs on US goods such as steel and agricultural products – increasing the risk of a global trade war. In addition, on 9 October 2019, India's Economic Times reported that IMF Chief, Kristalina Georgieva stated that emerging markets like India and Brazil were experiencing a downturn in 2019-2020. (<https://economictimes.indiatimes.com/news/economy/indicators/india-slips-10-places-on-global-competitiveness-index-singapore-on-top/articleshow/71498559.cms>)

Bhutan's economic prospects because trade wars contribute to a decline in world trade and disrupt supply networks with knock-on effects on manufacturing output, costs and employment. An understanding of the effects of tariff wars will help options and solutions for mitigating consequences and preserving global markets in the currently uncertain and volatile global trade environment. As such, Bhutan will require to develop capacity in the gathering of accurate data on major trading partners' tariff changes and third-party effects, its use and analysis to determine impacts on domestic producers in the short, medium and long run. Bhutan's limited capacity to collect and use accurate data underlines the need for technical assistance in this area.

Access to international markets by Bhutan's producers is made difficult and costly by inadequate domestic and international transport networks and logistics. Data from Doing Business and the Logistics Index show that the high cost of accessing foreign markets hinders Bhutan's exports. As a landlocked country, trade facilitation is of critical importance to Bhutan. The country needs fluid trade routes to allow for the seamless movement of goods to and from neighbouring countries and the rest of the world. Accordingly, Bhutan is likely to require continued assistance from its trading partners to introduce and implement trade facilitation measures.

To avoid the 'trade shock' from the loss of EU and Japanese LDC-related trade preferences, and increased concentration in export destination, EU and Japan could consider the gradual phasing out of LDC-specific preferences in line with paragraph 8 of the General Assembly Resolution 59/209⁴⁷ and as was agreed in the case of the graduation of Cape Verde, Maldives (CDP, 2012). A gradual phasing out of LDC-specific preferences would help some of Bhutan's export sectors to adjust to the post-graduation environment as well as allow Bhutan's identified potential export growth sectors to flourish. In addition, for Bhutan to effectively benefit from the phasing out of preferences, trading partners could simultaneously consider providing technical assistance programmes and adjustment facility packages to help the country to enhance the competitiveness of export sectors affected by the withdrawal of preferential market access.

Bhutan's continued preferential market access during the smooth transition must also be complemented by other interventions aimed at addressing supply constraints, enhancing capacity to produce at scale and improving product or service quality. A balanced mix of the right domestic policies and international support can help overcome supply-constraints.

To boost trade, sustainable growth and development, it will be vital for Bhutan to continue to take advantage of preferences provided under regional integration initiatives such the SAFTA and SAARC, and its bilateral preferential agreements with India and Bangladesh. Bhutan's regional trade prospects are unlikely to be negatively impacted by graduation. Regional trade can help reduce Bhutan's vulnerability to external shocks. It also offers alternative markets for domestic products affected by the loss of LDC-specific market preferences and can help Bhutan support the growth of nascent export sectors that are critical for Bhutan's export diversification strategy. In addition, they offer additional investment incentives for FDI keen on exporting to the region. However, Bhutan requires effective policies to leverage competitive and comparative advantage to be able to exploit regional markets. In this regard, Bhutan should identify the kind of support it might need to ensure that appropriate policies are developed and implemented during the transition period.

⁴⁷ The gradual phasing out of preferences will also be in line with SDG 17.11 which calls on all countries and all stakeholders to 'significantly increase the exports of developing countries, 'with a view to doubling the least developed countries' share of global exports by 2020.' (Resolution adopted by the General Assembly on 25 September 2015, 21 October 2015, A/RES/70/1). Bhutan can cite SDG 17.11 as justification for trade partners to consider extending market preferences to Bhutan as one way for them to meet their international obligations.

5.3 *Enhancing productive capacities and economic diversification*

UNCTAD maintains that the broadening and full utilization of productive capacities in LDCs remain a central strategy to upgrade economic structure and bridge development gaps vis-à-vis other countries and underline the role of integrated policies, including industrial policies and the development of technological capabilities to support inclusive development in the 21st century (UNCTAD 2020a). As argued by UNCTAD (2016) and reiterated by Kuensel (2017), enhancing productive capacities has strong links to making progress towards graduation having critical links to the HAI through enhancing human capital and the EVI by facilitating economic diversification. To continue its development path, Bhutan must adopt active measures to enhance productive capacities. Enhancing productive capacities will have a positive impact on the achievement of Bhutan's 12FYP and, in the longer term, GNH and sustainable development. However, building productive capacities and competitiveness takes time, and Bhutan requires assistance in this respect. UNCTAD (2018b) and (2020b) outline how by choosing appropriate policies LDC governments can influence the process of structural change, reduce their external vulnerability and provide actionable policy recommendations and instruments on how LDCs can build new productive capacities and enhance the utilization rates of existing capacities, respectively.

The continued development of the CSI sector is of significant importance to Bhutan, and the sector must be cushioned from negative graduation impact by, for example, requesting trading partners for extended phase-out periods for preferences that directly benefit exporting CSIs. COVID-19 impacts led to widespread disruptions of productive activities and may have weakened local industries. Bhutan faces several challenges in raising the quality and capacity of its CSI sector, including the limited size of the domestic market and capacity constraints linked to the development and expansion of domestic productive capacities. For instance, Bhutan's limited supply of skilled labour impedes the development of high value-added products by both CSIs and larger industries. It is equally important for Bhutan to explore ways to support larger industries to ensure balanced industrial development and diversification of the Bhutan economy (UNCTAD, 2018b). Different motivations and sizes mean that the contribution of different enterprises to economic resilience, diversity and structural transformation is differentiated and requires correspondingly differentiated support and entrepreneurship policies (UNCTAD 2018c). The World Bank reported that, as of 2018, there were more than 30, 000 registered CSIs in Bhutan but only a third of them were considered active and operational (World Bank, 2019b). Providing support to CSIs, medium and larger industries will help Bhutan develop a holistic and practical approach to industrialisation and structural transformation – promoting the shift in factors of production from low productivity to higher value-added industries. As such, it is crucial to support medium and larger industries, particularly in export-oriented sectors. In this context, it will also be vital to find the right balance between attracting FDI and growing local entrepreneurship (i.e., promoting both domestic and foreign investment), including the best fit FDI to support the latter goal.

Bhutan revised the FDI Rules and Regulations 2012 (amended December 30, 2014) replacing it with the Foreign Direct Investment Rules and Regulations 2019. The revised FDI policy improves investment requirements in some sectors and opens new sectors to foreign investment. For example, 100 percent FDI equity investment in infrastructure is now allowable and FDI is now also allowed in renewable energy. However, the investment climate in Bhutan remains volatile, coupled with administrative and policy challenges could benefit from further improvements (Ministry of Finance, 2019a). Commercially

oriented state-owned enterprises (SOEs)⁴⁸ involved in the manufacturing, energy, financial and other sectors still dominate and may retard private investment (World Bank, 2018a).

Also necessary will be fostering the development of entrepreneurship ecosystem institutions and strengthening the coordination between public agencies, especially the Royal Monetary Authority (RMA) entrusted with streamlining and improving institutional coordination and policy support by other relevant parties and interested stakeholders to the infant private sector.

5.4 Product space and potential for diversification

Based on Bhutan's current productive capabilities, it is possible to discern the set of upgrading possibilities available to the country.⁴⁹ Based on the International Trade Centre's untapped export potential assessment up until 2023, Bhutan's traded products with greatest export potential growth are ferro-silicon ($\geq 55\%$ of silicon) products, cardamon, and calcium carbides. Ferrosilicon shows the largest absolute difference between potential and actual exports in value terms, leaving room to potentially realize additional exports worth \$91.9 million.

Product selection will be an important aspect of the active promotion of export diversification. Products or industries are identifiable based on the feasibility of production and expected profitability or economic gain. For 2018, Bhutan's Economic Complexity Index score, which is an indicator of available knowledge and a measure of productive capabilities, is zero. This is higher than Lao PDR (-0.63), Myanmar (-0.97) and Bangladesh (-0.88), but lower than Thailand (1.17). The order of complexity of Bhutan's export products reveals that chemical products (hydrides, nitrides, azides, silicides and borides register the highest complexity (1.39), followed by inorganic acids, non-metal inorganics (0.56), plastics and rubber (0.54), aircraft, spacecraft, satellites (0.53) and hydraulic turbines, water wheels, and regulators thereof (0.43). Bhutan's main exports of metals (i.e., ferro-alloys, semi-finished products of iron or non-alloy steel) and mineral products (i.e., dolomite) have on average a complexity index of -0.17 and -2.38, respectively (*Figure 5*, light brown for metals and dark brown for mineral products), associated with lower levels of revenue and economic growth.

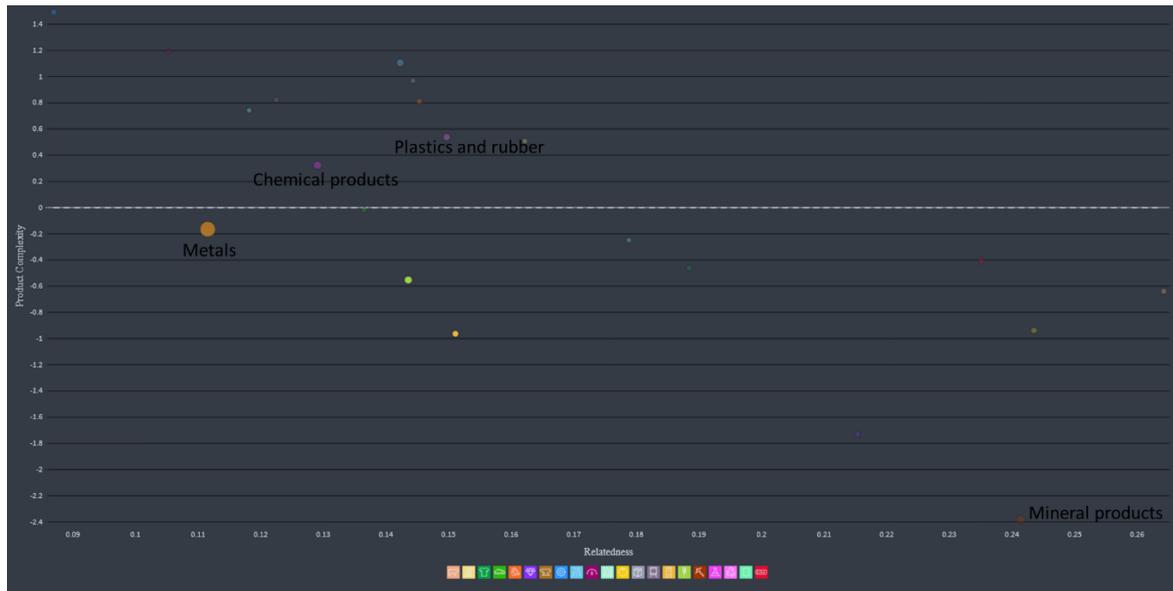
Economic gains in terms of the contributions to economic growth will depend on the level of product sophistication. According to Hidalgo et al. (2007), economic growth is driven by products that are more complex as they provide higher income opportunities. Raising complexity usually occurs in small steps, unless significant investments are mobilized to foster technological progress and build knowledge.⁵⁰ Therefore, it might be worthwhile for Bhutan to place emphasis on diversifying into products that show a larger distance from existing capabilities (with a correspondingly higher investment requirement) but also promise strong economic gains.

⁴⁸ There are 38 SOEs in Bhutan, of which, 19 are directly under the Ministry of Finance, and the remaining 19 SOEs are administered through public owned Druk Holding and Investment (DHI).

⁴⁹ UNCTAD has undertaken this analysis using data and information obtained from the Observatory of Economic Complexity, complemented by the export potential assessment of the International Trade Centre (ITC). According to the chosen methodology, export growth can be realized at the intensive margin (increasing exports of currently exported products) and the extensive margin (introducing new products and diversifying the export basket).

⁵⁰ Countries grow by diversifying into new products of increasing complexity. Strategic new products aim to balance: 1) distance to existing capabilities: lower distance (close to 0) signifies a product is "nearby" to existing knowhow; and 2) complexity: more complex products tend to support higher wages; 3) opportunity gain for future diversification: higher values hold stronger linkages to other high-complexity products, opening more opportunities for continued diversification.

Figure 5: Bhutan exports' diversification frontier, product complexity and relatedness, 2018



Source: <https://oec.world/en/profile/country/btn?depthSelector3=SectionDepth>

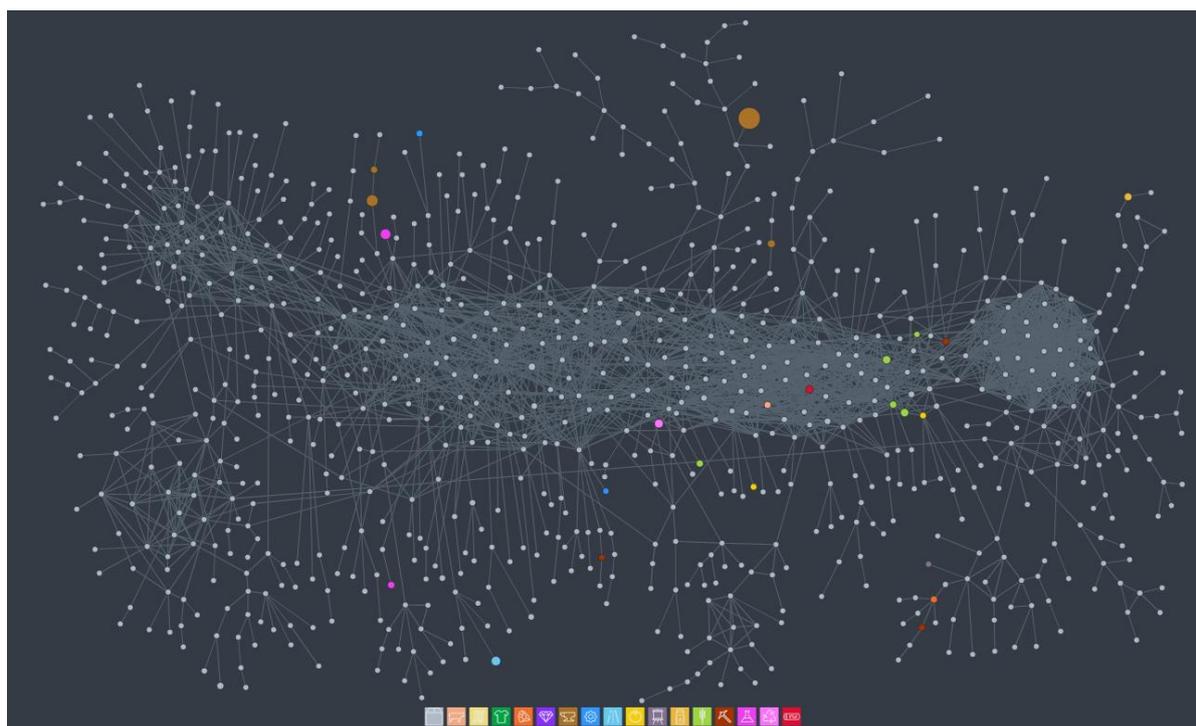
Note: Sections in legend (from left to right): animal products, paper goods, textiles, footwear and headwear, stone and glass, precious metals, metals, machines, transportation, instruments, weapons, vegetable products, Miscellaneous, arts and antiques, animal and vegetable bi-products, foodstuff, mineral products, chemical products, plastics and rubber, animal hides, wood products.

Bhutan's product space⁵¹ shows that the potential for diversification from metals and mineral products is low because it requires specialized knowledge and technology. Many of the recent export products lie at the outer edge of the product space with few direct linkages (figure 6, light brown for metals).

The lowest hanging fruit for export diversification clusters in the sectors such as foodstuff (green) and vegetable products (yellow) due to their high relatedness with current productive capacities and requiring minimal upgrading to produce similar products. Highest relatedness is identified for tropical fruit, wheat flower, spices, and raw sugar. According to the ITC's export potential assessment, the best options for export diversification are raw cane sugar, cut flowers and buds, fresh and wattle extracts while wattle extract is easiest to reach.

⁵¹ Product space is a geometrical representation of products illustrating their proximities based on their production input factors, level of technological sophistication and role of institutions. In other words, two products are related and can be produced in tandem if they require similar institutions, infrastructure, physical factors and technologies.

Figure 6: Product space, 2018



Source: <https://oec.world/en/profile/country/btn?depthSelector3=SectionDepth>

Note: Sections in legend (from left to right): Multiple items, animal products, paper goods, textiles, stone and glass, precious metals, metals, machines, transportation, vegetable products, arts and antiques, animal and vegetable bi-products, foodstuff, mineral products, chemical products, plastics and rubber, wood products.

5.5 Maintaining sustainable levels of debt

Weak productive capacities and limited export diversification result in high import content in domestic consumption and production, and persistent current account deficits, leading to aid dependence and the accumulation of significant levels of foreign debt (UNCTAD, 2016). In March 2018, Bhutan's external debt⁵² was estimated at US\$2.6 billion, about 115 percent of GDP. Though remaining high, it dropped to an estimated 104.4 of GDP by June 2019 but as of 30 September 2020 had risen by 3.7%, mainly due to a loan disbursement for Punatsangchhu-II Hydroelectric Project Authority (RGB, 2020). Total domestic debt also rose in 2020. External debt servicing in FY2020/21 is expected to increase significantly compared to debt servicing in FY2019-20, due to commencement of debt servicing for the Mangdechhu Hydropower Project (MHP) and the liquidation of the Standby Credit Facility (SCF) availed by the Government of India (3.3 percent of the total external debt). The ration of external debt service to exports is thus expected to rise from 6.1% in FY2019-20 to 19.9% in FY2020/21.

Despite the World Bank-IMF joint assessment of Bhutan's risk of debt distress as moderate,^{53 54} Bhutan still needs assistance in deploying risk mitigation measures to avoid exposing the country to

⁵² Linked mainly to hydropower project loans.

⁵³ As of 25 November 2020, and based on the most recently published data. <https://www.imf.org/external/pubs/ft/dsa/dsalist.pdf> accessed 3 January 2021.

⁵⁴ The risk is assessed moderate because of the FDI-like nature of most of the debt. For example, hydropower projects in Bhutan are virtually all financed by India under the Bhutan-India intergovernmental agreement, which obliges India to purchase the electricity generated in Bhutan on a cost-plus-margin price. This decreases

increased debt vulnerabilities, especially in view of the pressures brought about by the COVID-19 pandemic. The measures should depend on a precise diagnosis of potential sources of debt distress. Bhutan might also require assistance in developing sound debt and deficit policies which should be carefully monitored.

5.6 *Fostering technological advancement and enhanced human capital development*

Technology adoption and technological capabilities development contributes to advancing inclusive development (CDP, 2018d; UNCTAD 2020a). Attracting the right investment from abroad could bring not just capital and technologies as discussed above but could, under the right conditions, also inject the necessary skills, knowledge and ideas that can help Bhutan to move beyond hydropower and CSIs, contributing to the diversification and upgrading of the country's economic base and growth and development. Technology transfer can also play an important role in climate change adaptation and mitigation. For example, climate-related technology transferred through the Clean Development Mechanism (CDM), allows developed countries to meet their emission reduction obligations by financing projects in developing countries using technologies not readily available in the host countries (UNCTAD, 2016, 2020).

To stimulate the transfer of new technologies and skills, Bhutan encourages FDI to select small-scale production and manufacturing activities. With the onset of the fourth Industrial Revolution (4IR) and advancements in digital technologies, FDI could be an important source of beneficial 4th Industrial Revolution (4IR) technology and skills for Bhutan. If adequately and strategically leveraged, new and digital technologies could boost Bhutan growth and sustainable development. However, 4IR technologies represent both opportunities and threats to Bhutan's development trajectory because these technologies can rapidly erode the competitiveness of many existing industries while at the same time boosting the prospects and profits of others that are better prepared to absorb them or to develop new business models. Of particular concern are their potential to render certain jobs and skills obsolete. In addition, measures that help tackle concerns around the accessibility, adequacy, affordability and availability of complementary technologies (e.g., electricity, Internet connectivity and related technological capabilities and gender divides) are necessary to fully take advantage of the new technologies. This is of concern as much for the effective implementation of the 12 FYP as it is for Bhutan's future growth and development. It is therefore essential for Bhutan to closely monitor the interface between the opportunities and threats of these new technologies. As such, there is a need to develop enabling and mitigating policies and regulations that will ensure Bhutan benefits from the acquisition of 4IR technologies and skills.

As an LDC, bridging the technology divide has been a significant challenge for Bhutan. Bhutan has made some progress in areas such as strengthening information technology infrastructure, building human capacity on information and communication technology (ICT) and developing appropriate policies and legislation to create an information technology-enabled economy and society guided by the GNH philosophy. However, this progress provides an insufficient for the meaningful leverage of the digital economy. For example, according to World Bank data, Internet use rose from about 13.6 percent of the population in 2010 to about 48.1 percent in 2017 but challenges remain in terms of coverage, quality and reliability of connectivity, with rural services weaker than in urban centres. As a landlocked country, Bhutan's digital and physical connectivity, remains a challenge as evidenced by the country's Logistics Performance Index ranking (see section 5.2). The current inadequacy of skills and expertise in new technologies, particularly as relates to the expansion of productive activities,

the risk associated with the high level of external debt (IMF 2018). Some risk may likely to shift to Bhutan once hydropower projects rely on joint ventures.

compels Bhutan to develop partnerships at the regional and international levels in, for example, skills development, overcoming the constraints in tapping 4IR technology benefits and strengthening the frameworks for attracting the right kind of FDI. Bhutan also requires assistance in boosting technological innovation and enhancing related infrastructure for industrialisation and structural transformation.

5.7 Mitigating vulnerability and building resilience

Bhutan is at high risk from natural disaster and economic vulnerability factors, which pose serious challenges for future growth and development. The Vulnerability Profile of Bhutan (UNCTAD, 2018a) highlights risks from the increased frequency and damaging impacts of natural events experienced by Bhutan over time. Bhutan is especially vulnerable to the effects of climate change because the bulk of the population remains dependent on agriculture and the economy is reliant on hydropower and tourism. While Bhutan has made some progress in the management of natural disasters and the national Constitution requires at least 60 percent of the country to be always maintained under forest cover, the country lacks the needed financial resources and technical expertise to adequately manage frequent disasters.

Bhutan requires financial and technical assistance to enhance its disaster management and resilience-building capacity, especially because climate change is expected to increase the probability and severity of natural disasters. The increase in global temperatures due to the rise in greenhouse gases in the atmospheres is suspected of causing an increased risk of drought and increased intensity of storms and cyclones (Earth Observatory, 2005). Other environmental changes caused by global warming are suspected of making storms deadlier and more severe (Thomas, A. *et al.*, 2017). Examining weather-related natural disasters for 228 countries and territories and their monthly weather patterns over 25 years, Acevedo and Novta (2017) found that temperature and precipitation helped explain most disasters, with higher temperatures associated with wilder and fiercer natural events such as droughts, heatwaves, tropical cyclones and wildfires.

However, in its monitoring of countries that have graduated from the list of LDCs, the United Nations noted that despite high vulnerability to economic and environmental shocks, Samoa continued to achieve slow but steady development progress (CDP, 2018d). Similarly, The Maldives did not experience significant disruption to its development path after graduating in 2011, despite remaining highly vulnerable to economic and environmental shocks. The Maldives experience demonstrates that with tailored support, graduating countries that are highly vulnerable to economic and ecological shocks, such as Bhutan, can still make development progress. In this context, development cooperation directed at building resilience is critical and effective in enhancing disaster management and resilience-building capacity. Bhutan's should similarly focus on its resilience capacity development needs, rather than target isolated interventions. In this regard, Bhutan needs to identify specific support measures, including financial and technical assistance that will help strengthen its disaster management and resilience-building capacity to be able to mitigate natural events that might disrupt Bhutan's growth and development.

6. Conclusion and recommendations

For Bhutan to continue its growth and development trajectory after graduation, there is a need for the country to implement a broad range of complementary policies to address multiple challenges it faces on its development path. For a small, vulnerable landlocked country that relies on a few commodities for export, Bhutan is still susceptible to economic vulnerabilities as well as natural

disasters. In this regard, the prospects of Bhutan to continue its development path post-graduation is strongly influenced by the process leading to graduation, especially in ensuring a smooth transition that enables Bhutan to overcome vulnerability, including economic diversification, developing productive capacities for structural transformation and enhancing disaster management and mitigation and build both economic and natural disaster resilience. Critically, the focus for Bhutan's smooth transition strategy should be on devising measures for mitigating the structural challenges faced by the country to enable Bhutan to effectively implement its 12 FYP and develop the resilience needed to operate in the post-LDC status environment. In this regard, less concessionary support from developing partners potentially poses a challenge for Bhutan, given its lack of financial and human resources to mitigate these shocks and build resilience. Annex 1 provides a summary of some of the challenges faced by Bhutan and suggestions on possible mitigating measures for consideration under Bhutan transition strategy.

Bhutan's 12 FYP outlines several strategies such as infrastructure development, institutional reforms, economic diversification, and human capital development. Considering the key challenges identified, and whose mitigation is critical and vital for the continued growth and development of a graduated Bhutan, several recommendations are put forth for consideration by the RGB and its development and trading partners towards developing Bhutan's smooth transition strategy.

- The experience from graduated countries (such as Cabo Verde) shows the importance of establishing a consultative mechanism to facilitate the development of the smooth transition strategy and to identify related support actions. The establishment of such a consultative mechanism will provide Bhutan with a vital discussion forum where the RGB and its development partners can mount a coordinated and cooperative effort to addressing the challenges and possible effects of graduation.
- National consultations are necessary to create awareness and understanding on the impacts of graduation, as well as gather data and information that would filter into Bhutan's consultative mechanism. In addition, the design of the smooth transition strategy must outline the specific support measures required by Bhutan during the transition period to ensure the determination of the best mix of supporting actions needed. In this regard, Bhutan is advised to conduct national consultations to determine national requirements for support during the transition period.
- Bhutan remains vulnerable to economic and environmental shocks. Vulnerability to natural disasters and to economic shocks are thus, the most critical issues deserving of attention when determining the appropriate length of the transitional period and the range and type of support measures that shall be desirable. The transition strategy needs to highlight the necessary support required by Bhutan to mitigate some of its vulnerabilities and needed to build resilience. Such requirements might include technical assistance and capacity building, advisory services and new forms of development assistance aimed at supporting Bhutan and aimed at furthering the country's development progress in line with Bhutan's overall development strategy and its 12 FYP expected achievements.
- If not mitigated, graduation impacts are likely to exacerbate Bhutan's exposure to economic vulnerability shocks and dilute efforts to diversify the economy and export basket and build productive capacities. It is thus desirable that the manner of phasing down of ISMs in some areas supports rather than hinders the Bhutan's development post-graduation. It will be essential for Bhutan to request specific support measures from its developing and trading

partners, including transitional DFQF market access for products identified as critical for the diversification of the country's economy Bhutan's potential exports.

- The effective implementation of the 12FYP and the sustainability of Bhutan's graduation are contingent on the availability of adequate and timely resources. Bhutan must seek confirmation from donors on the levels of support they will continue to provide to Bhutan after graduation. Bhutan must also identify ongoing projects that will require financial assistance from donors beyond graduation to be able to negotiate a targeted smooth transition strategy with its major development partners. This implies the need for a Financial Needs Assessment (FNA) to facilitate the development of a donor resource mobilisation strategy. The FNA could explore areas that require donor assistance in addressing Bhutan's vulnerability challenges such as climate change and natural disasters that might derail successful graduation and development progress post-graduation.
- The RGB must ensure that there is enough capacity and resources for the successful implementation of the smooth transition strategy. The United Nations General Assembly Resolution 71/243⁵⁵ requested the United Nations Development System to assist graduating countries in formulating and implementing their national transition strategies and take into account country-specific support for the graduating country for a fixed time frame.
- The development of a monitoring mechanism should be a crucial component of the preparation of Bhutan's smooth transition strategy as measuring progress during transition is a critical aspect of addressing vulnerabilities and building resilience.

⁵⁵ Resolution adopted by the General Assembly on 21 December 2016, A/RES/71/243, 1 February 2017

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Annex 1: Summary Table – Guidance on priority elements of a smooth transition strategy

	Challenge to be mitigated	Proposed mitigating measures for consideration under Bhutan smooth transition strategy
Securing macroeconomic stability	Bhutan faces budgetary uncertainties exacerbated by the domestic and global impacts of the COVID-19 crisis and in view of the RGB’s decision to front load 12 FYP implementation spending to the 2020/21 fiscal year and to introduce several programmes aimed at ensuring macroeconomic stability as part of the national response to mitigate COVID-19 impacts. Moreover, Bhutan’s low and dispersed population base, renders the per capita investment cost for public services and infrastructure high. As a result, Bhutan requires more grant aid in the short to medium term. An abrupt reduction in grants and other sources of fiscal revenue could have considerable negative implications for development spending, thus hampering growth and efforts aimed at reducing economic vulnerability with knock-on on the country achieving graduation with momentum.	Bhutan will need to give priority consideration to negotiating with her development partners on continued provision of budgetary grants in short to medium term, including relevant technical assistance in building domestic capacity on the mobilisation of development finance to enable Bhutan to effectively implement the strategies and development programmes envisaged by the 12FYP and for the implementation of the smooth transition strategy.
	Bhutan is currently at moderate levels of debt distress. However, the country intends to borrow from multilateral banks to meet part of its recurrent costs and to increase capital expenditure.	Bhutan needs to maintain vigilance on vulnerabilities that arise from increased debt, there is a need for technical assistance in devising risk mitigation measures.
Developing Productive Capacity	Producers in Bhutan have a shortage of the skills required to engage in value addition.	Consideration should be given to engaging development and trade partners to encourage their constituencies to invest in the beneficiation of Bhutan raw materials. Consideration should also be given to leveraging regional opportunities to develop measures for the joint development and sharing of skills within a competitive, secure and predictable framework.
	The loss of EU and Japanese market preferences, which are essential for the growth of Bhutan’s identified potential export products has implications for	The preservation of LDC-specific trade preferences for a longer period will allow identified potential export sectors to grow, contributing to the diversification of the economic base and export basket, while contributing to reduced economic

	Bhutan's export diversification and building productive capacity strategies	vulnerability. Other interventions aimed at addressing supply constraints and enhancing productive capacities to produce enough to sustain exports must also complement the longer phase-out period.
	Bhutan continues to liberalise and strengthen FDI policy to support the expansion and diversification of the country's economic base.	Bhutan will need to give priority consideration to securing technical assistance and support from development and trading partners on policy reforms, including ensuring synergies and coherence between FDI, industrial and entrepreneurship policies.
	Bhutan is emphasising the development of its still nascent CSI sector to enhance its contribution to sustainable growth and development.	Securing continued support from sources such as the EIF and AfT can be useful in developing business infrastructure and furthering Bhutan's efforts on the development of its four industrial parks.
	The transfer of technology and new skills is crucial to Bhutan to help the country move beyond hydropower and to the diversification of Bhutan's economic base.	For Bhutan to fully take advantage of new technologies and skills, there is need to put in place measures that help tackle concerns around accessibility, affordability and application of technologies, which require technical assistance from Bhutan's development and trading partners. In addition, Bhutan should request its development and trading partners to encourage their constituencies to transfer of technology and technical and management skills.
Trade expansion (Trade in Goods)	Bhutan's trade prospects are subject to a volatile and uncertain global trading environment exacerbated by geopolitical tensions at the global level, and at the national level, export product and export market concentration, and low economic diversification. These sources of trade instability have knock-on effects for fiscal health, domestic growth, job creation and general socio-economic wellbeing. They represent a general threat to achieving graduation with momentum.	Global uncertainty requires Bhutan to adopt a strategic stance informed by analytical capabilities to identify and mitigate threats and leverage opportunities to preserve existing markets or tap new ones as lead producers employ strategies to mitigate risk, build resilience and rebalance global value chains. Bhutan's limited institutional capacity, including in the collection and use of accurate data necessitates the country to secure relevant technical assistance in this area.
	Bhutan's reliance on mainly commodity-based exports heightens exposure the country to revenue and economic shocks	Bhutan must give priority consideration to securing international support measures aimed at accelerating the diversification of the domestic economic base, including

		its export. In this regard, securing an extended phase-out of trade preferences in key existing markets could directly benefit existing CSI exporters and allow for the emergence of new CSI exporters or sectors identified as having the potential to become significant export sectors.
	Some of Bhutan's exports may lose competitiveness due to the phasing out of LDC-specific market preferences.	An extended phase-out period of LDC-specific preferences would help producers to improve or build productive capacities and competitiveness. In addition to securing trade preference prolongation, Bhutan must accord priority consideration to securing complementary assistance, such as technical assistance programmes and adjustment facility packages to help producers to enhance productive capacities, including in the context of industrial policy, technology acquisition, human capital and technological capabilities.
	Like most LDCs, Bhutan has limited productive capacity to take advantage of market access opportunities to increase and diversify its exports	Aid for Trade provided through EIF can be useful in expanding market access, building productive capacity and increase and diversify exports by adding value to raw materials.
	Bhutan experiences deficiencies in trade facilitation, including the problem of inefficient customs procedures, which contributes to high trade costs	<p>Bhutan must consider according priority to securing development finance and technical assistance to improve trade-related infrastructure and enhance trade facilitation to lower the transaction costs faced by domestic economic actors, including through engaging development partners on their WTO trade facilitation commitments and technical assistance that can be availed by UNCTAD.</p> <p>Bhutan benefits from WTO Trade Facilitation Agreement technical assistance and Bhutan can request for continued aid from its trading partners to improve its customs clearance processes.</p>

Trade expansion (Trade in Services)	Sustainable tourism, agriculture and hydropower generation, are priority sectors in Bhutan's drive for economic diversification and are important drivers of development overall, however, these sectors are increasingly at threat from climate change. Climate hazards can be expected to intensify and socio-economic impacts to grow.	Consideration should be given to identifying special interventions towards natural disaster management and resilience, including securing related technical and financial assistance from development partners.
	Bhutan has limited capacity to realise the full potential in trade in services, mainly because of lack of diversification of the services sector.	Assistance in infrastructure development to reach currently inaccessible areas will help create an environment for diversifying services exports.