



## The Rupee Crunch and India-Bhutan Economic Engagement\*

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### Summary

The rupee-crunch in Bhutan may be a purely domestic issue occasioned by poor fiscal policies and mismanagement of economic affairs. However, there is a strong view gaining ground among the Bhutanese that it is primarily caused by their economic dependence on India, sustained by growing economic ties between the two countries. It is, therefore, important to understand the geographical constraints, the limits of the political economy in Bhutan, and the causes of growing Bhutanese disillusionment about ties with India. While it would be an overstatement to say that such crises could significantly impact India-Bhutan relations, it nevertheless shows that the rupee crunch is an important pointer to the fact that Bhutan's business sector is feeling squeezed by some of the economic policies being pursued by the Indian government. While loans, grants and lines of credit offer a solution to deal with immediate crises, it is important to gauge the long-term impact of such Indian policies on bilateral relations.

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\* The author undertook a field visit to Thimpu, Bhutan in May 2012 and interacted with a cross section of analysts and academics. The author thanks the Institute for Defence Studies and Analyses for providing financial support to undertake the visit as well as the various individuals in Bhutan who graciously met with her and willingly shared their ideas and opinions.

“If one was to scale the impact of the rupee crunch (in Bhutan) on the richter scale, I would rate it at 8.” This response from Tensing Lamsang, Editor of *The Bhutanese*, not only frames the gravity of the rupee crunch issue in the last few months but also brings into focus one of Bhutan’s most debated developments of 2012. What caused the rupee crunch? And what has been its impact on India-Bhutan relations? These are main questions that this Issue Brief attempts to answer. The short answer to the first question is that the rupee crunch is a consequence of domestic economic mismanagement. While Bhutan’s economic links to and the influence of the Indian economy cannot be denied as factors shaping the rupee crunch, it is important to understand Bhutan’s geographical constraints and the limits of its political economy. With its industrial belt predominantly in the South, Bhutan’s land-locked geography means that it needs Indian territory for transit and trade purposes. Flowing from this, India is also Bhutan’s trade and development partner and will therefore remain a key factor in facilitating its economic development.

## The Rupee Crunch

The rupee crunch can best be defined through the classic demand-supply logic – that is, the supply of rupees has not been able to keep pace with the demand for rupees. This is not something new. A liquidity crunch has been haunting Bhutan for the past few years, but it has managed it so far with Indian intervention. For instance, in March 2009, India extended a standby credit facility of Rs. 300 crore to help Bhutan overcome the rupee crunch. In 2011, this limit was increased to Rs. 600 crore. Similarly, in June 2012, in the wake of the rupee crunch crisis, India offered Bhutan a Rs. 10 billion credit line with an interest rate of 5 per cent per annum. This was received with appreciation as the interest rate has been kept low in tune with Bhutan’s insistence. Yet, these credit facilities are proving inadequate to cater for the continuing increase in rupee outflow and the resultant rupee crunch.

The reasons for the rupee outflow have been attributed to factors such as high capital expenditure, growth of Bhutan’s private sector leading to an expansion of private loans, and inappropriate (cross border) trade practices adopted while importing and exporting goods to and from India. At the same time, those from Bhutan’s business community in particular argue that the main reason for the rupee crunch is the nature of India’s economic intervention, which is having the effect of making Bhutan’s an excessively dependent ‘auxiliary economy’.<sup>1</sup> Some of the specific factors (both internal and external) attributed to the rupee crunch issue in Bhutan are discussed below.

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<sup>1</sup> Observations gathered by the author during field trip to Bhutan, May 14-21, 2012.

## Imports over Exports

Some in Bhutan argue that the over-dependence of the Bhutanese economy on imports from India has led to the neglect of an important sector like agriculture, which could have otherwise provided substitutes for many products imported from India. According to the World Bank economic update (September 2011), the share of agriculture in Bhutan's gross domestic product (GDP) has declined from 25 per cent in FY 2002-03 to 14 per cent in FY 2010-11.<sup>2</sup> Some of the main reasons attributed to this decline are low levels of technology adoption, predominance of subsistence agriculture, small domestic market, lack of market access for agricultural products (primarily because it is hard to provide development services to many small villages and thus enable them to raise productivity), and large tracts of fallow land.<sup>3</sup> The *Kuensel* reports that, in 2011, Bhutan spent almost Rs. 4 billion on agricultural imports, which comprised meat items, dairy products, coffee, tea, rice, edible oil and sugar. Some of these products, the *Kuensel* argues, could have been domestically produced if the right focus had been brought to bear upon the agricultural sector.<sup>4</sup>

## The Informal Economy

There is an existing informal structure operational across India-Bhutan border towns for importing and exporting goods. For example, trade practices often use under-invoicing, i.e., quoting a price less than what is actually paid in order to evade tax. This malpractice has had a long term impact, as the coffers of the government were not profiting from specific imports and exports that the business class was undertaking. Also, there were "illegal" bank accounts in Bhutan held by Indian businessmen. While these bank accounts have been closed by the Royal Monetary Authority in May 2012, significantly, there were some voices in Bhutan that alleged "India's invisible hands in the closing of these bank accounts."<sup>5</sup> This, they argued, led to the outflow of crores of rupees from Bhutan, thus contributing to the rupee crunch.<sup>6</sup> From the government's perspective, closing of these accounts was important, as no taxes were being imposed on the money held in these accounts and the revenues were neither going to India nor to Bhutan.

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<sup>2</sup> World Bank, *Bhutan Economic Update*, September 2011, available at <http://siteresources.worldbank.org/BHUTANEXTN/Resources/BhutanEconomicUpdate.pdf>, accessed on April 25, 2012.

<sup>3</sup> Ibid.

<sup>4</sup> "Self-sufficiency Through Commercialization", *The Kuensel*, April 18, 2012, available at <http://www.kuenselonline.com/2011/?p=30114>, accessed on April 18, 2012.

<sup>5</sup> Author's interview with a local resident in Thimphu, May 19, 2012. The interviewee shared some general perceptions about the rupee crunch in Bhutan. Name withheld on request.

<sup>6</sup> Ibid.

## Government Policies

The policies of the ruling Druk Phuensum Tshogpa (DPT) have also been identified as the reason for the rupee crunch. A task force report, authored by the Bhutan Chambers of Commerce and Industry, deliberated on the causes of the rupee crunch and cited the government's expanding expenditure as the main reason for the rupee shortage. The report pointed out that government expenditure increased from Nu 9.8 billion in the 2002-03 budget to Nu 38 billion in the 2011-12 budget. It further noted that 60 per cent of government expenditure directly translated into imports from India. On balance of payments, the report stated that the rupee shortage was due to rising aggregate demand and supply side constraints, and that aggregate demand was triggered by public expenditure, credit market and other private expenditure on health, education, and so on. The report further pointed out that any increase in investment in the economy without a corresponding increase in savings will lead to a current account deficit (negative trade balance).<sup>7</sup> Generation of revenues from national savings is a serious issue, which, thus needs to be addressed by the Bhutanese government.

Another not so direct factor related to the rupee crunch is the increase in the number of private vehicles. Under the DPT regime, a civil servant vehicle quota was given to all government employees. It is estimated that while in 2002 the total number of vehicles imported from India was 1,103 (costing Nu. 309.83 million), it increased to 6,893 (costing Nu. 3.6 billion) in 2011. It is estimated that between 2002 and 2012, there was a total loss of Nu 900 million of potential government revenue because of the import of these vehicles.<sup>8</sup> According to recent available estimates, in 2011 around 9,325 new vehicles were added to the roads, taking the grand total of the number of vehicles in Bhutan to almost 62,707 vehicles.<sup>9</sup> An increase in the number of vehicles also means importing fuel from India, thus causing a further outflow of rupees.

## Auxiliary Economy

According to one local journalist, "[t]here is an auxiliary economy existing in Bhutan, which could be detrimental to Bhutan's sustainable growth in the coming years."<sup>10</sup> This viewpoint hints at certain non-comforting issues in India-Bhutan relations. One major

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<sup>7</sup> Yeshey Tshewang, "Govt and RMA Also Responsible for Rupee Crunch", *The Bhutanese*, May 5, 2012, available at <http://www.thebhutanese.bt/govt-and-rma-also-responsible-for-rupee-crunch/>, accessed on May 5, 2012.

<sup>8</sup> "Civil Servants' Vehicle Quota Drains Govt. Coffers by Nu 900 Million from 2002-2011", *The Bhutanese*, April 28, 2012, available at <http://www.thebhutanese.bt/civil-servants-vehicle-quota-drains-govt-coffers-by-nu-900-mn-from-2002-2011/>, accessed on May 29, 2012.

<sup>9</sup> "An Almost Threefold Increase Over the Last Decade", *The Kuensel*, June 14, 2012, available at <http://www.kuenselonline.com/2011/?p=32421>, accessed on June 12, 2012.

<sup>10</sup> Author's interview with a journalist in Thimpu, Bhutan, May 17, 2012. Name withheld on request.

reservation that some people have about the India-Bhutan economic partnership is with respect to the “monopoly clause” that India gets with business deals.<sup>11</sup> While this is a minority view, there is indeed a growing discomfort with the fact that a lot of money invested and given as credit to Bhutan by India goes back to India. The fact that the money borrowed is not a significant investment in Bhutan is a complaint that needs to be addressed by Indian policy makers. Such a view is not uncommon and could well proliferate uncontrollably in the coming years.

While it can be pointed out that the lack of a domestic technological base and skill based capacity is primarily responsible for the influx of Indian contractors into Bhutan, many in the country hold an alternate view, namely, that India-Bhutan economic relations are not symbolic of a ‘win-win framework’, thus negating the concept of mutual benefit. Tsering Tobgay, the leader of the opposition, has written and commented extensively on this issue. One of personal blog entries of august 2010 reads:

... what I do know for sure is that L & T Gammon India and Hindustan Construction Company have each established stone crushing plants. That is bad. And that is illegal. Stone crushing is a specific business, one that requires a separate industrial license, and one that is not open for foreign direct investment. Added to that, [this] lucrative business is surely outside the scope of the construction contract packages that L&T, Gammon and HCC have with the Punatsangchhu hydropower project...<sup>12</sup>

A similar viewpoint was voiced by an influential Thimpu-based businessman, who stated that the India-Bhutan economic relationship offers little opportunity for local business talent. According to him: “[t]he Government of India has to be a bit sensitive on the way it deals with Bhutan, as Bhutanese are not actively participating in economic activities. Most of the important sectors – like mining and construction – are in Indian hands. Even non-competent sectors, which do not require specific skills, such as that of crushing stones are given to Indian contractors and we perceive this as unfair.”<sup>13</sup> The auxiliary economy created by the hydro power industry is thus perceived as squeezing the space for domestic stakeholders. As is evident in this statement, the fundamentals of the hydro power industry are thus being questioned and problematised by some Bhutanese on account of the massive Indian influence and accompanying economic participation.

Given these varying perceptions, it would be appropriate at this juncture to frame the rupee crisis within the broad contours of India-Bhutan economic relations. The Indian

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<sup>11</sup> Ibid.

<sup>12</sup> ‘Crushing Stones’, August 21, 2010, available at <http://www.tsheringtobgay.com/government/2010/crushing-stone.html>, accessed on June 5, 2012.

<sup>13</sup> Interview with a local businessman in Thimpu, May 20, 2012. Name withheld on request.

factor needs to be underlined due to the geographical imperatives. Given that Bhutan is a landlocked country, and that the Indian financial assistance has played an important role in the evolution of its economy, it is important that a contextual base is added to the discussion on the rupee crunch. A primer to the Bhutanese economy also becomes important in this context.

### **Bhutan's Economy: A Brief Overview**

In 2012, Bhutan has almost reached the status of a lower middle income economy with a GDP per capita of US \$2,277. The real GDP growth rate rose to 11.8 per cent in 2010-11, up from 6.7 per cent in 2009-10. The main reason for this rise in the national output has been the stronger performance of the Bhutanese economy in the secondary and tertiary sectors, specifically in the construction (growth of 20.6 per cent), manufacturing (20.3 per cent), transport (11.1 per cent) and retail and wholesale trade sectors (20 per cent).<sup>14</sup>

Also, given the long-term partnership between India and Bhutan to develop 10,000 MW of power by 2020, it is predicted that growth prospects would be favourable for Bhutan, particularly in the Tenth Five Year Plan period, with the average growth rate for 2012 and 2013 estimated to fall between 9 and 10 per cent per annum.<sup>15</sup> Despite all the optimism, there is also a growing scepticism regarding the pace and sustainability of growth in Bhutan. A major factor for concern in this regard is Bhutan's growing external *debt*, which, in 2011, hit 82.7 per cent of GDP.<sup>16</sup> Moreover, scepticism has also been fuelled by the rupee crunch phenomenon. This has led many analysts to question the economic model of deep integration with India that Bhutan has followed over the last few decades. While apprehensions and criticism are an integral part of a country's democratic responsiveness, an understanding of the broad economic structure under which India-Bhutan economic relations operate is important to generate a better understanding.

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<sup>14</sup> While Bhutan's cement, ferro-alloys and calcium carbide industries have added to the growth of the manufacturing sector, the growth in the construction and transportation sectors has been attributed to the onset of construction works on the 990 MW Punatsangchhu II, 720 Mangdechhu, and 112 MW Dagachhu hydel projects. See 'Bhutan's Medium-Term Outlook-Risks and Challenges Ahead', Press Release of the Royal Monetary Authority of Bhutan, December 2011, available at [http://www.rma.org.bt/forms/GOVERNOR%20STATEMENT%20ANNUAL%20RMA%20MEETING%20WITH%20THE%20FIS\\_2011.pdf](http://www.rma.org.bt/forms/GOVERNOR%20STATEMENT%20ANNUAL%20RMA%20MEETING%20WITH%20THE%20FIS_2011.pdf), accessed on January 5, 2012.

<sup>15</sup> Ibid.

<sup>16</sup> Bhutan exports electricity, base metals and articles, minerals, vegetable fats and oils, alcoholic beverages, chemicals, cement, timber, timber and wood products, cardamom, fruit products, potatoes, mangos, oranges, apples, raw silk, plastic and rubber products. The imports from India include petroleum products, mineral products, base metals and articles, machinery and automobiles and spares, vegetable, nuts, spices, processed food and animal products, chemicals, wood, plastic and rubber. See Ibid.



## India-Bhutan Economic Relations: A Background

India is Bhutan's leading trade and development partner. During 2010, imports from India amounted to Rs. 2,930 crore and constituted 75 per cent of Bhutan's total imports. Its exports to India in 2010 amounted to Rs 2,600 crore and constituted 90 per cent of its total exports.<sup>17</sup> Given the excessive dependence on exports and imports of goods to and from India, Bhutan in 1974 had decided to peg its currency – the Ngultrum – at par with the Indian Rupee. Thus, by following a fixed exchange rate regime, Bhutan aimed to safeguard competitiveness in order to avoid pressures on the net reserves of the country and also nurture, develop and maintain confidence in the local currency.<sup>18</sup> The move to anchor the Ngultrum with the Indian currency, however, also meant exposure to the Indian economy. As has been witnessed in the past few years, Bhutan has been highly vulnerable to economic developments in India. Interest rates and prices in Bhutan, for instance, are influenced greatly by commodity prices in India. This has had extensive implications for domestic prices in Bhutan owing to the fact that most of the country's imports are from India. A manifestation of this was the uncertain inflationary trend in Bhutan since 2011. Inflation in March 2012, for instance, was recorded at 9.4 per cent. These price pressures, it is argued, threaten to erode the strong gains in growth made in Bhutan.<sup>19</sup>

Another incident that highlighted the vulnerability associated with the Bhutanese economy's excessive dependence on India occurred in December 2011, when the country's convertible currency reserves were slashed by 20.4 per cent. While the main reason for this reduction was the sale of \$200 million to finance balance of payment transactions with India,<sup>20</sup> the incident pointed to the lack of an independent monetary policy in Bhutan. In the case of a fluid foreign exchange market, where currencies are not pegged between countries, a current account deficit with a trading partner would lead to upward pressure on the exchange rate of the partner currency making the home country's exports cheaper and more attractive and the partner country's exports more expensive, thus, automatically

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<sup>17</sup> 'India-Bhutan Relations', Ministry of External Affairs, Government of India, March, 2012, available at <http://mea.gov.in/mystart.php?id=50042442>, accessed on April 10, 2012

<sup>18</sup> 'Monetary Policy Statement', Royal Monetary Authority of Bhutan, June 2011, available at <http://www.rma.org.bt/RMA%20Publication/MPS/RMA%20Monetary%20Policy%20Statement%202011.pdf>, accessed on June 20, 2012.

<sup>19</sup> 'Selected Economic Indicators', Royal Monetary Authority of Bhutan, December 2011, available at <http://www.rma.org.bt/RMA%20Publication/SEI/SEI%20DEC2011.pdf>, accessed on June 20, 2012.

<sup>20</sup> Out of the remaining total reserves, as of December 2011, the convertible currency stood at \$719.9, while the remaining equivalent of \$20.2 million (Rs. 1.1 billion), were Indian Rupee reserves. However, this reserve, at the end of December 2011, was sufficient to cover only eight months of merchandise imports, See *ibid.*

restraining imports from the partner country. Under the system of pegged currency, Bhutan is deprived of such an option.<sup>21</sup>

In the long term this also revealed to Bhutan's policy makers the fact that loans, grants and credit lines do not always help. According to official figures, there was a decrease in Bhutan's international reserves from \$930.8 million in 2010 to \$740.4 million in 2011. In this context, it is worth noting that two leading economists – Joseph Stiglitz and Hamid Rashid – have questioned the significance of US Dollar reserves which yield zero returns for a small country like Bhutan. Instead, they have recommended the creation of a “stabilization fund” and a “liquidity management system” to reduce the mismatch between the rupee inflow and outflow.<sup>22</sup>

In the past, the build-up of excess liquidity in Bhutan's banking system was primarily due to consistent balance of payments related surpluses associated with the official flow of aids and grants and loans as well as export earnings largely derived from the hydro power sector. Significantly, these surpluses were highly instrumental in increasing the stock of the Indian rupees in circulation, thus obviating a rupee crunch.<sup>23</sup>

## Remedial Measures

Given that the rupee crunch has been going on for a few years, some remedial measures have been introduced to deal with it. First, since April 2012, the Bhutanese Ngultrum has been made the primary medium of exchange for all buyers and sellers in Bhutan. Earlier, a practice was followed where goods/products were often purchased from bordering towns in India, payment for which was made in Rupee. However, after the rupee crunch all goods have to be bought from suppliers within the country.

Second, a uniform accounting system (Bhutan Automated Customs System or BACS) has been introduced. BACS is a software that records all the import and export exchanges within the country. All payments will now have to be made through the bank. BACS will capture the value of imports and exports as well as the names of traders and banks, and

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<sup>21</sup> “The Rupee Crunch: Reconciling Theory with Reality,” *The Bhutanese*, July 5, 2012, at <http://www.thebhutanese.bt/part-1-the-rupee-crunch-reconciling-theory-with-reality/>, accessed on July 7, 2012.

<sup>22</sup> Minjur Dorji, “Jo Stiglitz and UN-DESA Say USD Reserve Management and Government Deposits in Banks Exacerbated Rupee Crisis”, *The Bhutanese*, May 30, 2012, available at <http://www.thebhutanese.bt/jo-stiglitz-and-un-desa-say-usd-reserve-management-and-government-deposits-in-banks-exacerbated-rupee-crisis/>, accessed on May 30, 2012.

<sup>23</sup> ‘Monetary Policy Statement’, Royal Monetary Authority of Bhutan, June 2011, available at <http://www.rma.org.bt/RMA%20Publication/MPS/RMA%20Monetary%20Policy%20Statement%202011.pdf>, accessed on accessed on June 20, 2012.



this information is automatically relayed to the Central Bank of Bhutan, which is the Royal Monetary Authority (RMA). If the proceeds of a particular export do not reach the (RMA) within 91 days, the Central Bank will be alerted by the system and necessary steps will be undertaken.

The Royal Government of Bhutan has thus taken some corrective measures to contain the financial distortion in the economy. However, some Bhutanese continue to argue that the cause of the rupee crunch does not lie within the country but in fact is a consequence of Bhutan's economic dependence upon India and the unhelpful practices of Indian companies. Let us see how valid this assessment is.

### **The External–Internal Interface: Is the Rupee Crunch Caused by Domestic or External Factors?**

How much is India responsible for the rupee crunch in Bhutan? While this question might seem like an anomaly within the broad discourse on India-Bhutan relations, it continues to be raised because of India's economic presence in Bhutan as a major trade and development partner. Indeed, some Bhutanese contend that the nature of India-Bhutan bilateral trade is the primary causal factor for the rupee crunch. In this regard, it is pointed out that 60 per cent of Bhutan's deficit spending is in India. Many, in fact, narrow it further to the hydel sector and argue that construction activities within Bhutan are too dependent on imported labour and that imported Indian goods (trucks and dozers in particular) has led to the rise in capital expenditure. Commenting on the nature of dependence on India, one local businessman noted that "90 to 95 per cent of what we borrow from India goes back to India." Instead, he argued, "given that Bhutan is a small economy, even if one-fourth of the total investment by India stays in Bhutan, Bhutan in the long term would benefit."<sup>24</sup>

Lam Dorji, a leading Bhutanese environmentalist, asked: "everywhere we see dozers and trucks, but what about other technology?" In his view, one of the major problems with the Bhutan's economic partnership with India is that Bhutan is not upgrading its technological skills, thus perpetuating its dependence on India. He also pointed out that "while construction in the housing sector is happening all over Thimpu, only traditional materials were being used (bamboos, etc.);" He questioned why Bhutan was not using advanced scaffolding material!<sup>25</sup>

Dorji further pointed out that the primary reason for the lack of technological up-gradation was imported labour. If Bhutan were to restrict immigration, such a move could solve

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<sup>24</sup> Author's interview with a local businessman in Thimpu, May 20, 2012. Name withheld on request.

<sup>25</sup> Author's interview with Lam Dorji, Executive Director, RSPN, Thimpu, Bhutan, May 20, 2012.

half the problem, since the use of technology would become the only alternate option. He further added, "right now a low-cost alternative (imported labour) is there, which is always an attractive option. Bhutan should therefore follow a policy of allowing only skilled workers to come from India."<sup>26</sup> But at the same time, he also emphasized that the fault also lies with Bhutanese policy makers and Bhutanese contractors, and that India is not solely responsible for the existing state of affairs. In this regard, Droji pointed to the lack of capacity of Bhutanese contractors, who only seek to profit from contracts by subcontracting the works to Indian companies.<sup>27</sup>

In the overall analysis, it appears that the rupee crunch can trace its causality to Bhutan's domestic policies. The first factor in this regard is the narrow base of domestic revenue, which stood at 23.5 per cent in FY 2011-12. While there was an increase of 11.3 per cent in domestic revenue generation over the previous financial year, with tax revenues increasing by about 49 per cent in the same period, the relative contribution of domestic revenue to overall GDP has remained small.<sup>28</sup>

The second factor is the lack or limited amount of national savings to finance growth, which means over-dependence on lines of credit, loans and grants from India in particular. While it is admitted that Indian investments in the hydro power sector has stimulated growth, the flip side of it was "jobless growth" and an extended "auxiliary economy". Further, most of the growth is based on loans and grants, characterised vendor-financing modalities from India and the steady accumulation of long-term public debt, rather than being financed through savings and revenue generation.<sup>29</sup>

Third, as stated above, there is a growing concern over the dependence of Bhutanese economy on Indian imports and the existence of an informal trade structure across the bordering towns of the two countries. Fourth, while the influx of Indian contractors has also been raised as a cause of concern, it perhaps needs to be reiterated that interventions to rectify such policies need to be initiated within Bhutan. In fact, some respondents stated that policies and the political leadership in Bhutan are primarily responsible for steering the country's path of development. It was also pointed out that much of Bhutan's future development growth will depend on the choices that the current democratic leadership chooses to make.

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<sup>26</sup> Ibid.

<sup>27</sup> Ibid.

<sup>28</sup> 'National Budget, Financial Year, 2011-2012', Minister of Finance, Royal Government of Bhutan, June 2011, available at <http://www.mof.gov.bt/downloads/Budgetreport2012.pdf>, accessed on June 20, 2012.

<sup>29</sup> 'Bhutan's Medium-Term Outlook-Risks and Challenges Ahead', Press Release of the Royal Monetary Authority of Bhutan, December 2011, available at [http://www.rma.org.bt/forms/GOVERNOR%20STATEMENT\\_ANNUAL%20RMA%20MEETING%20WITH%20THE%20FIS\\_2011.pdf](http://www.rma.org.bt/forms/GOVERNOR%20STATEMENT_ANNUAL%20RMA%20MEETING%20WITH%20THE%20FIS_2011.pdf), accessed on January 5, 2012.

For instance, Tsering Tobgay, the opposition leader, pointed out that Bhutan's sustainable growth should depend on how it uses the money it is borrowing from India. If the money borrowed is not used in a constructive manner, Bhutan as a country would lose out in the long term. He emphasized the importance of a responsible, confident and mature leadership that can negotiate with India not from a position of weakness but from a position of strength.<sup>30</sup>

## Impact of the Crisis on India-Bhutan Relations

While it cannot be said that the rupee crunch has had a direct impact on India-Bhutan relations, it nevertheless points to some emerging issues in the India-Bhutan economic engagement. The rupee crunch is an important pointer to the fact that Bhutan's business sector is feeling squeezed by some of the economic policies being adopted by the Indian government. While loans, grants and lines of credit offer a solution to deal with immediate crises, it is important to gauge the long-term impact that Indian policies can have on bilateral relations.

Bhutan is on its way to democratization and, unlike in the past, the number and variety of stakeholders are increasing.<sup>31</sup> Given that India is Bhutan's major development partner, when issues of good governance are discussed in domestic debates, the role played by India will inevitably be touched upon. State funding of political parties was one of the major issues that came up in several interactions. It would be no exaggeration to state that reduced state funding of political parties in the coming years could impact political decisions, as the private sector would gain in importance. They could very well be in the executive boards of political parties, thus impacting key foreign policy decisions in the long term.<sup>32</sup> For Indian decision makers, it is therefore important to be sensitive and responsive towards the sentiment of Bhutan's business community.

## Policy Suggestions

The above narrative throws up the following suggestions for Bhutanese and Indian decision makers to consider.

### For Bhutan

***Adopt a Gradual Approach:*** It is important that economic reforms are undertaken gradually in Bhutan. Any "quick" remedy will not have an effective trickle-down effect. Rather, it

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<sup>30</sup> Interview with Tsering Tobgay, National Assembly, Thimpu, March 15, 2012.

<sup>31</sup> Interview with Pavan K. Verma, Indian Ambassador to Bhutan, Thimpu, May 16, 2012.

<sup>32</sup> Interview with Lily Wangchuk, Executive Director, Bhutan Media Foundation, Thimpu, May 19, 2012.

would be perceived as unpopular by the masses. Also a “liquidity management reserve” should be created in Bhutan to address its domestic needs.

**Focus on the Domestic Sector:** Increasing the domestic revenue base and promoting domestic economic activity should be a major focus for Bhutanese policy makers. While growth should be funded from national savings as much as possible, the manufacturing base in Bhutan should get priority focus in the next five year plan.

### For India

**Interact periodically with the Bhutan Chambers of Commerce and Industry:** It is important that Indian policy makers hold separate meetings with the Bhutan Chambers of Commerce and Industry. Given that Bhutan is on its way to democratization, the number and variety of stakeholders in that country are increasing. The interaction base of Indian policy makers should likewise increase.

**Focus on Technological Up-gradation:** While Indian companies should be mindful of not squeezing the space for their Bhutanese counterparts, technological up-gradation should also be kept in mind as investment progresses in various sectors.

### Conclusion

India is considered a trusted friend and an ally in Bhutan. At present, there is no anti-India lobby in the country and, given the geographical imperatives of Bhutan, India is likely to remain the most important partner in its foreign policy calculus in the coming years. Bhutan also leverages India’s role as its strategic partner. While geopolitics shapes the bilateral relationship in a major way, one needs to take note of the fact that Bhutanese society is changing fast. With the youth constituting almost 50 per cent of the total population, a new generation is emerging in Bhutan. As evident in the India-Bhutan power cooperation, Bhutan is getting increasingly assertive in negotiating various issues with India.<sup>33</sup> India needs to address these growing nuances, which could soon emerge as visible contours in India-Bhutan bilateral relations.

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<sup>33</sup> Medha Bisht, “India-Bhutan Power Cooperation: Between Policy overtures and Local Debates”, IDSA Issue Brief, October 7, 2011, available at [http://www.idsa.in/system/files/IB\\_IndiaBhutanPowerCooperation.pdf](http://www.idsa.in/system/files/IB_IndiaBhutanPowerCooperation.pdf), accessed on June 20, 2012.