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Economic and Political Relations
Between Bhutan and Neighbouring Countries

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Contents

INTRODUCTION	3
CHAPTER 1: OVERVIEW OF THE ECONOMY.....	5
1.1 NATURE AND SIZE OF THE ECONOMY	5
1.2 BHUTAN'S ECONOMIC INTEGRATION AND INTERDEPENDENCE.....	6
1.3 MACROECONOMIC PERFORMANCES AND FUTURE OUTLOOK.....	7
CHAPTER 2. ECONOMIC DEVELOPMENT POLICY.....	19
2.1 DEVELOPMENT STRATEGY	19
2.2 ECONOMIC REFORMS AND APPROACH	20
CHAPTER 3. ECONOMIC RELATIONS WITH THE NEIGHBOURING COUNTRIES AND AREAS.....	24
3.1 REGIONAL ECONOMIC COOPERATION	24
3.2 BHUTAN'S ADVANTAGEOUS AREAS	31
CHAPTER 4. ECONOMIC AND POLITICAL RELATIONS BETWEEN BHUTAN AND INDIA	37
4.1 A HISTORICAL BACKGROUND ON INDO-BHUTAN RELATIONS	37
4.3 INDO-BHUTAN COOPERATION	40
CHAPTER 5. BHUTAN'S PERSPECTIVES ON REGIONAL COOPERATION.....	62
5.1 BHUTAN AND SAARC.....	62
5.2 BHUTAN'S RELATIONS WITH ITS REGIONAL NEIGHBOURS	68
CONCLUSION.....	80
ANNEXURE 1.....	81
TREATY BETWEEN INDIA AND BHUTAN, 1949.....	82
ANNEXURE 3.....	85
THE SOUTHERN BHUTAN PROBLEM AND PEOPLE IN THE REFUGEE CAMPS IN NEPAL	85
ANNEXURE 4.....	89
AGREEMENT BETWEEN THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA AND THE GOVERNMENT OF THE KINGDOM OF BHUTAN ON THE MAINTENANCE OF PEACE AND TRANQUILITY ALONG THE SINO-BHUTANESE BORDER AREAS	89
BIBLIOGRAPHY	91

INTRODUCTION

Bhutan is a Himalayan Buddhist Kingdom that is physically small with limited economic dimensions and military might. Unlike its neighbours in the region, it was never colonized; while two world wars and the cold war ushered the world into an atmosphere of instability and alignments, Bhutan was spared such direct impact. Nevertheless, Bhutanese society has traditionally been sensitive to issues of security, and preserving its sovereign independence and territorial integrity has historically been a constant challenge. With the launch of planned development in the 1960s, socioeconomic development and gradual political reforms have been additional and main issues of priority.

While Bhutan had historical ties with Tibet, its less definite dealings with China and the shedding of an isolationist policy gradually led Bhutan to develop political orientation towards India. Since the 1950s, Bhutan's foreign policy focused on building a close relationship with its southern neighbour, thereby enhancing its territorial security and prospects for socioeconomic development. At the same time, the Himalayas to the Indians were natural barriers that could enhance India's security vis-à-vis China. The first visit of India's Prime Minister Jawaharlal Nehru to Paro Bhutan in 1958 was the initiation of a "special relationship" between the two countries. Looking back over the decades since then, it is the expansion of Indian assistance in every field of Bhutan's development that has facilitated Bhutan's socioeconomic growth. Among all other donors today, India continues to provide the largest economic assistance to Bhutan.

The diversification of Bhutan's relations began with its entry into the United Nations in 1971, and while external relations continued to be largely confined to India, the establishment of its relations in other areas and at various levels gained momentum over time. This has enhanced the recognition of Bhutan as a sovereign and independent nation, and resulted in the facilitation of economic and development cooperation. As of now, Bhutan has diplomatic bilateral relations with 22 countries.¹

Realizing the need for economic diversification in achieving self-sufficiency and to remove constraints inhibiting its expansion, Bhutan's interactions at the bilateral and multilateral levels have increased substantively. Today, Bhutan not only looks toward building up a strong export-oriented economy to compete in the regional market, it also awaits accession to the WTO in the near future. Given the realities of its economy, however, Bhutan's trade and other economic relations are confined to only a few countries in the sub-region, mainly India, Bangladesh and Nepal, and a few countries outside the sub-region. And while most analysts agree that the pattern of Bhutan's economic growth is highly people-oriented, the pace of growth resulting in necessary diversification of domestic economy is yet to come about. However, the adoption of the unique development philosophy of Gross National Happiness has brought about a distinct position for Bhutan in the region and beyond, and it is this principle that is meant to serve as the guiding philosophy in Bhutan's socioeconomic development initiatives.

The subsequent chapters mainly reflect on the various facets of Bhutan's political economy in relation to neighbouring countries in the region. Chapter one provides an

¹ South Asian nations, Japan, Korea, Kuwait, Bahrain, Switzerland, Denmark, Austria, Netherlands, Sweden, Norway, Finland, Australia, Canada, Singapore, and EU.

Overview of Bhutan's Economy discussing its size and nature, its gradual economic integration, macroeconomic performance and future outlook, as well as its growth profile over the last four decades. These elements have substantively been presented by drawing comparisons with other countries in the South Asian region.

Chapter two looks at Bhutan's *Economic Development Policy* with consideration of various economic reforms that have taken place over the years including development strategy and Bhutan's cautious move towards economic liberalization with its proposed accession to the WTO.

Bhutan's Economic Relations with the Neighbouring Countries and Areas is explored in chapter three by looking at various levels of Bhutan's involvement in regional integration, and its future outlook in such setting is considered by examining some of Bhutan's advantageous areas in production and policy coordination.

The prominence of Indian involvement in Bhutan's economic and political affairs is highlighted in chapter four, which covers *Economic and Political Relations between Bhutan and India*. This section shows that even within regional cooperation and amidst processes of diversification, India remains the most important development partner for Bhutan. It also covers various areas of concern with special emphasis on the issue of militant insurgents from India and their illicit penetration into Bhutanese territory.

In Chapter five, *Bhutan's Perspectives on Regional Cooperation* is mainly focused on SAARC and briefs on bilateral relations between Bhutan and the member countries (with the exception of India since this section has been covered abundantly in chapter four). With regard to Bhutan-Nepal relations, the main issue of concern hovering over the verification of people in the camps in eastern Nepal has been attached in the annexes as a backgrounder. In light of the fact that China figures considerably in Bhutan's regional outlook, some attention has been given to relations with this neighbour in the north.

Chapter 1: OVERVIEW OF THE ECONOMY

1.1 Nature and Size of the Economy

Bhutan is a landlocked country located between the Tibetan autonomous region of China in the north and India in the south, with formidable mountainous terrain ranging from 100 meters to 7,500 meters in height. It is a predominantly rural economy with more than 79 percent of its population living in rural areas (Planning Commission: *Ninth Five Year Plan 2002-07*, p.3). The population of the country is estimated at 658,000 in 2000 with as large as 39.1 percent below 15 years of age. According to the World Bank classification of countries Bhutan is a low-income country (*World Development Report 2004*). The adoption of the holistic philosophy of Gross National Happiness as a development tool nurtures the view that “Gross National Happiness is more important than Gross National Product”. It also reflects the symbiotic relationship that exists between people and the environment, and many other symbioses found in various facets of life in Bhutan. It stands to shed light on the religious nature of the country that has traditionally developed a culture relatively free from western influence. (Royal Government of Bhutan 2000: *Development Towards Gross National Happiness*, pp.15-23).

Bhutan’s economy is small by all measures and more so in comparison to the whole of South Asia, as well as most individual South Asian countries except Maldives. Table 1 suggests that the population of Bhutan is just 0.05 percent of the whole of South Asia, whereas its area is slightly higher and comes to 0.75 percent of the total. Bhutan is little more than one fourth of Nepal in area and about 2.7 percent in its population. Bhutan’s natural setting in terms of mountainous environment is better as compared to Nepal. The size of Bhutan’s gross national income is about 0.8 percent of the whole of South Asia and about 9 percent of Nepal. However, the per capita income of Bhutan is much higher in comparison to almost all South Asian countries, except for Sri Lanka (US \$ 840 in 2002). It is perhaps due to its small population that Bhutan enjoys a per capita income that comes in more than double of Nepal and almost 23 percent more than India.

Table 1: Bhutan in South Asia, 2002: Size of the Economy

Country	Population (million)	Population Density (people per sq. km. of land area)	Surface Area (1000 sq. km.)	Gross National Income (US \$ billion)	Per Capita Income (US \$)
Bhutan	0.658	17	38.394	0.505	590
India	1048	353	3287	501.5	480
Bangladesh	136	1042	144	48.5	360
Nepal	24	169	147	5.6	230
South Asia	1401	293	5140	640.5	460

Note: The World Bank’s reporting of South Asia figures include seven countries of the sub-region—Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

Source: i. *World Development Report 2004*, World Bank; ii. *Ninth Five Year Plan 2002-07*, Royal Government of Bhutan.

1.2 Bhutan's economic integration and interdependence

During the 1990s, the economies of the sub-region underwent extensive reforms towards more permissive and open policies resulting in a quantum jump in the proportion of trade in their national incomes from 22 percent to nearly 30 percent over the 1990s (RIS 2002, p.1). Bhutan's benefit from trade during this period has been moderate. In 1999, Bhutan accounted for roughly 3.5 percent of the total Intra-SAARC exports, mostly directed towards India, Bangladesh and Nepal. This may be understood taking into account the small size of the economy and limited trade opportunities in absence of diversified production base and specialization. Nevertheless, Bhutan is able to maintain a high ratio of exports to its Gross Domestic Product (GDP). Over the decade Bhutan's exports accounted for an average 28.5 percent of its GDP. This shows that trade is extremely important for Bhutan seeing that it constitutes one of the largest sources of earning for the country. Further, this suggests that Bhutan's economy is much more integrated with the rest of the world today than in the past.

Table 2 suggests that the ratio of exports to GDP for Bhutan consistently increased and peaked around the mid-90s and thereafter started sliding. During the second half of 1990s, as the rest of South Asia witnessed a decline in exports, Bhutan too seemed to have experienced a decline in the ratio of exports to GDP and in the growth of export.

However, the export growth rates for Bhutan witnessed volatile fluctuations between some years around the mid-90s. Figure 1 suggests that South Asian and Indian exports growth rates have followed a close trend with the world trade growth rates. Bhutan's export growth rates seem to follow the world trade graph with a higher quantum growth and Indian exports graph with a time lag of one year. This is more evident in the second half of the '90s. For example, Indian exports growth rate peaked in 1994 before sliding, while Bhutan's exports growth rate peaked one year later in 1995 and then started declining. The recovery of exports growth rates for India and Bhutan followed over a period after 1998. Between 1996-98, Bhutan seems to have followed the world trend, and unlike Indian exports growth rates it did not present a stretched recession of several years. This once again suggests that Bhutan's economy is much more integrated today with the rest of South Asia and the world than ever before.

South Asia reaps the benefits of intensified integration through the absorption of international specialization, spillover of knowledge and technological developments. However, this has also resulted in the transmission of external trends to these economies, and the world economic trends are more likely to affect the economies of South Asia today. This can be seen in the broad correspondence between world growth of trade and South Asian exports growth. When world trade plummeted due to the East Asian crisis, South Asian economies also felt the spillover of this crisis (see Table 2). However, such a broad correspondence may not be fully felt in Bhutan, although the possibility of such transmission cannot be ignored. Since Bhutan's trade is largely confined to India and a few other countries, the transmission of trend growth in trade and also the growth of the economy via Indian impact cannot be ruled out. Thus, not only is the economy more integrated, there is also greater reason for influence by the global trend. However, it would be premature to say that the transmission of the external trend to Bhutan's economy is direct and visible. Bhutan's economy would continue to be affected more by

the regional economy of northeast India, more precisely economic trends in Assam and Bengal.

Figure 1

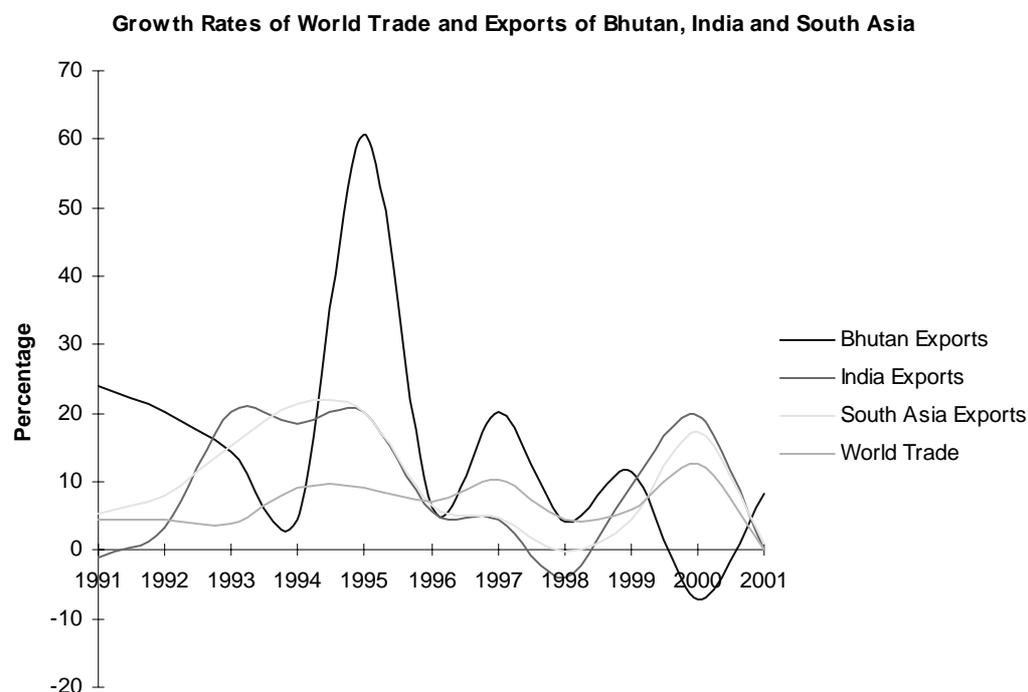


Table 2: Growth of Exports: World, South Asia, India and Bhutan during 1990s

	Bhutan				India	South Asia	World
	GDP (in million Nu.)	Exports (in million Nu.)	Ratio of exports to GDP (%)	Annual growth rate of exports (%)	Annual growth rate of exports (%)	Annual growth rate of exports (%)	Annual growth rate of trade (%)
1990	4848	1192.4	24.6				
1991	5342	1478.9	27.7	24.0	-1.1	5.2	4.5
1992	6178	1738.2	28.1	20.2	3.3	8.0	4.5
1993	7008	1990.4	28.4	14.5	20.2	15.3	3.8
1994	8151	2082.7	25.5	4.6	18.4	21.3	9.0
1995	9611	3349.1	34.8	60.8	20.3	20.2	9.0
1996	11406	3553.8	31.1	6.1	5.6	6.5	7.0
1997	13994	4274.1	30.5	20.3	4.5	4.8	10.4
1998	16081	4455.6	27.7	4.2	-3.9	-0.1	4.4
1999	18541	4967.9	26.8	11.5	9.5	4.4	5.8
2000	21166	4615.8	21.8	-7.1	19.6	17.2	12.6
2001	23933	4994.7	20.9	8.2	0.1	1.1	0.1

Note: figures in bracket are percentage growth for total volume of trade.

Source: i. Asian Development Bank and International Monetary Fund data; ii. National Accounts Reports, Various Issues, CSO, Thimphu; iii. Statistical Year Book of Bhutan (1999), CSO, Thimphu.

1.3 Macroeconomic Performances and Future Outlook

1.3.a. Growth profile by major sectors

Construction, Electricity, Manufacturing and Mining

Over the 1960s and 1970s, the focus of planning was basically on removing the major hurdles in terms of infrastructure and on creating conditions for future growth.

Accordingly, the First and Second Five Year Plans (FYP) allocated 66 and 44 percent of total outlay on the construction of road network, mainly with the help of Indian technical and financial assistance. The formulation of initial plans in Bhutan was constrained by the unavailability of information and data on the country's potential and resources. The Second FYP (1966-71) made it clear in the very beginning—"As no census has been taken nor has any detailed statistical information been collected so far it is difficult to assess the resources and potential of the country and to formulate a coordinated development plan" (p.1). The 1960s, covering the first two plans (1961-71), may be seen as preparatory plans as they basically tried to create the building blocks of infrastructure to pave the way for future development. The first priority was assigned to the construction of road network. Pommaret (1994, pp.69-72) looks at the first plan as little more than an agreement between India and Bhutan to focus on infrastructure development. Similarly, UNDP's Joint Donor Database Report (2000, p.VII) mentions that the first plan provided a framework for the allocation of Indian assistance, mainly in the form of road construction as a way of linking Bhutan internally as well as to India. The allocation on the establishment of road network continued to increase up until the third FYP (1971-76). With the commissioning of the Chhukha Hydropower Project, the real GDP experienced a major increase of 18 percent between 1986-87. This resulted in good economic performance that has been consistent over the second half of the 1980s, producing a strong growth average of 8 percent for the whole decade.

The performance over the 1990s, however, could not match that of the 1980s. The average real GDP growth of 6.1 percent achieved during the 1990s is much lower in comparison to 8 percent in the 1980s. However, the growth performance over the 1990s has been much more stable and consistent, and appears to have consolidated a great deal in the second-half of the decade. Table 3 presents the average annual growth rate of real GDP and some major sectors during the 1990s and also for 2000-01. It suggests that growth rate of real GDP has been affected mainly because of the variations witnessed in sectors like electricity, manufacturing and construction (see Figure 2). An examination of Table 3 reveals three periods in growth, recovery and slow down –

- Slow down between 1990-92
- Recovery and growth between 1993-99
- Further slow down in 2000

During the period 1990-92, growth rate suffered mainly because of the negative growth witnessed in the electricity sector and a slowdown in mining and quarrying activities. The real GDP growth picked up between 1993-99, reaching a peak of 7.4 percent in 1995, mainly due to strong recovery in the electricity and mining sector; this came about with the commissioning of a ferro-alloy plant and a cement plant. An important contributory factor was the capacity expansion of the Chhukha hydropower project and the enhancement in export tariff from Nu. 0.20 to Nu. 1.50/kwh. Once again in the year 2000 due to a slowdown in the electricity, mining and manufacturing sectors, real GDP growth suffered and averaged 5.3 percent in comparison to the peak of 7.6 percent observed in the previous year. The recovery of growth in 2001 is clearly attributed to a strong growth in the mining (19.4 percent), electricity (12.3 percent) and construction (17.5 percent) sectors. Besides initiating development waves in the country, hydropower generation has also caused the simultaneous growth of manufacturing, trade and other sectors, demonstrating

a strong linkage-effect of investment. The construction sector, for example, has been largely affected by the pre-commissioning stage of hydropower projects. This is why it has demonstrated average growth trends of slowing down between 1993-97 (the post-commissioning stage of Chukha project) and a strong recovery between 1998-99 with the massive construction work taken up towards the installation of Tala hydropower project in 1997-98 and other projects at Kurichu and Basochu.

Figure 2

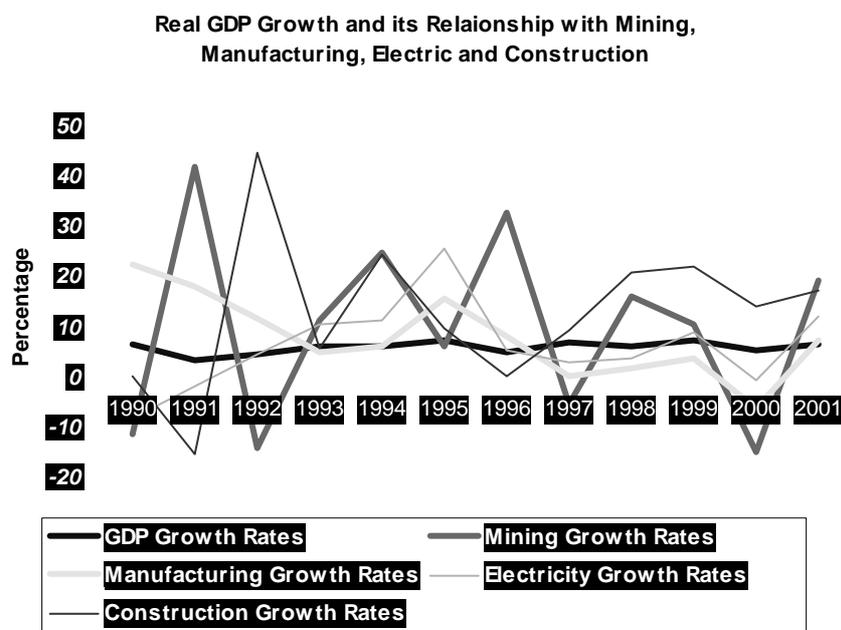


Table 3: Average Annual Growth Rate (%) of Real GDP by Major Sectors of Bhutan (at 1980 prices)

Year	GDP	Agriculture	Mining & quarrying	Manufacturing	Electricity & gas	Construction	Wholesale & retail trade	Transport & communication
1990	6.6	3.1	(-) 11.1	22.4	(-) 8.2	0.4	0.8	20.9
1991	3.5	3.2	42.0	18.1	(-) 1.8	(-) 15.1	7.7	5.8
1992	4.5	(-) 2.0	(-) 14.2	11.8	4.8	45.0	10.8	5.7
1993	6.1	3.6	11.5	4.9	10.5	5.7	1.9	22.0
1994	6.4	3.9	24.8	6.4	11.6	24.4	3.9	2.9
1995	7.4	4.0	6.4	15.8	25.6	9.7	4.6	1.6
1996	5.2	6.5	32.8	8.1	5.4	0.1	14.1	10.4
1997	7.2	3.0	(-) 5.4	0.2	3.2	9.6	7.4	14.0
1998	6.4	2.8	16.2	2.0	3.9	20.9	2.9	13.3
1999	7.6	5.2	10.6	3.7	9.1	22.0	3.2	9.0
2000	5.3	4.5	(-) 14.8	(-) 6.2	(-) 0.7	14.1	2.1	5.5
2001	6.6	3.2	19.4	7.3	12.3	17.5	7.2	4.0
1980s	8.0	-	-	-	-	-	-	-
1990s	6.1	3.3	11.4	9.3	6.4	12.2	5.7	10.6
2000-01	5.9	3.8	2.3	0.5	5.8	15.8	4.6	4.7
1990-1992	4.9	1.4	5.6	17.4	(-) 1.7	10.1	6.4	10.8
1993-1999	6.6	4.1	13.8	5.9	9.9	13.2	5.4	10.4
2000-2001	5.9	3.8	2.3	0.5	5.8	15.8	4.6	4.7

Source: i. *National Accounts Statistics Report 2001*, CSO, Planning Commission, Royal Government of Bhutan; ii. *Selected Economic Indicators*, June and September 2001, Royal Monetary Authority, Royal Government of Bhutan.

Agriculture, Animal Husbandry and Forestry

The agriculture sector consists of the agriculture sector proper, forestry and logging, and livestock production. Estimates² suggest that arable and horticultural production together account for about 53 percent of sector output, with rice, maize and wheat being the main food crops, and major cash crops being apples, oranges, potatoes, ginger, and cardamom. Forest products consisting of timber and firewood supplied to the domestic markets and the export of swan timber and unsawn logs to India account for about 26 percent of sector output. Exports of wood and wood products to India were valued at Nu. 271 million in 1993, although a downward trend in recent years reflect the government's concern to ensure sustainable practices in forest utilization. Livestock production is estimated to account for around 21 percent of sector output, with cattle providing draught and manpower being owned by 90 percent of households. With meat and livestock products mostly retained for home consumption, the marketed amounts are small.

Although the livestock production grew at an annual rate of 3 percent in 2002 from 1.3 percent in the previous period, a significant slowdown in the agriculture proper sector from 4.3 percent in 2001 to 2.4 percent in 2002 resulted in a lower overall growth in the sector.

Estimates indicate that the output growth of the agriculture sector continued to weaken to 2.5 percent in 2002. Although the contribution of the agriculture sector to the GDP is estimated to have fallen further to about 33 percent in 2002, after rising from 35 percent in 1999 to almost 36 percent in 2000, it still remains the most significant sector. Agriculture is a source of livelihood for almost 4/5th the population who largely practice subsistence farming although rough terrain, poor soil quality and limited arable land (approximately 7%) pose limitations to its growth. It is nevertheless anticipated that the sector will benefit from the increasing emphasis being given to rural development activities, and expected to result in improved access to inputs, services and markets during the 9th FYP period (2002-2007).

Table 4: Share of Agriculture, livestock and forestry to GDP (at factor cost)

Year	At current Prices in Millions of Ngultrum				
	Agriculture, livestock & forestry	(a) Agriculture proper	(b) Livestock production	(c) Forestry & logging	GDP
1980	621.4	309.9	139.2	172.3	1095.5
1993	2801.9	1526.6	545.9	729.4	7007.5
1994	3427.1	1814.6	703.5	909.0	8150.5
1995	3897.7	2043.2	805.5	1048.9	9610.6
1996	4538.0	2253.7	910.2	1374.1	11405.6
1997	5368.9	2506.4	1237.5	1625.0	13995.6
1998	6057.5	2893.4	1374.1	1790.0	16080.9
1999	6630.0	3175.1	1486.9	1968.0	18540.5
2000	7772.5	3877.5	1625.0	2270.0	21165.6
2001	8470.8	4213.5	1770.3	2487.0	23933.0
2002 (e)	9325.5	4592.7	1947.3	2785.4	27532.7
(%) Share of GDP in 2002	32.9	16.2	6.9	9.8	100.0

Source: RMA Annual Report 2002/2003, Royal Monetary Authority.

² (i) 8th Plan Main Document 1997-2002 (ii) 9th Plan Main Document 2002-2007, Planning Commission, Royal Government of Bhutan.

1.3.b The decadal growth profile

The decade of 1960s: Foundation for development

The 1960s witnessed the execution of the first two five year plans in the country over the period of 1961-71. The 1st FYP (1961-66) of Bhutan was prepared by the Planning Commission of India with a total outlay of Nu. 175 million fully funded by the Government of India (GOI). The road networking accounted for Nu. 62 million of total expenditure, which was about 35 percent of total outlay. Education received second priority with an allocation of Nu. 10 million (5.7 percent of the total outlay), followed by transport (Nu. 7.5 million), health (Nu. 3.2 million), forests (Nu. 3.2 million), agriculture (Nu. 2 million), power (Nu. 1.6 million), animal husbandry (Nu. 1.5 million) and industries (Nu. 1.1 million). An expenditure of Nu.9.1 million was incurred on miscellaneous pursuits. The First Plan resulted in the construction of 1770 kilometers of roads in Bhutan, including the 208 km highway connecting Phuntsholing to Thimphu and Paro. Other roads constructed were from Paro to Ha, Trashigang to Samdrup Jongkhar and from Sarbhang to Gelephu. The 2nd FYP (1966-71) envisaged a total outlay of Nu. 200 million with top priority given to road, water supply and power accounting for an allocation of Nu. 78 million or 39.5 percent of the total outlay. This time agriculture received second priority in terms of allocation and accounted for 17.5 percent of the total outlay, followed by education (12.5 percent), transport (7.6 percent), and health (6.4 percent).

The resultant expansion of road network in the country generated two parallel impacts. One, there was a diversion of manpower towards development activities, mainly towards construction, which resulted in labour shortage in agriculture. This affected agricultural output, at least in the short period. However, with further influx of a large number of workers connected to construction activities, food supply was counter balanced partially on account of the quota of 200 tonnes of grain a month provided by the Government of India, enough to fulfill the cereal need of 7,000 workers at a time (*Second Five Year Plan 1966-71*, pp.1-3). The creation of wage-employment increased the cash inflow and thereby the demand for petty consumer goods. The prices of such goods tended to increase several times.

Two, before the closure of the Tibetan border in 1951, Bhutan was supposedly self-sufficient in cereal production. It also enjoyed a small surplus that was exported to Tibet. The decline in demand for food-grain in the post-1951 period was compensated by a rise in domestic demand resulting from increased construction activities. The post-second plan period witnessed a further rise in domestic production of food gains. This was also the time when informal trade inflow from India, especially in food and other consumer items, started picking up. The increased road network brought about a tremendous rise in trade, providing farmers an opportunity to opt for specialized production. The construction of education and health infrastructure also started coming up in a big way.

The second impact ultimately proved stronger than the first one and the economy was in a position to consolidate the gains of the past.

The decade of 1970s: Consolidation of gains

The 2nd FYP (1971-76) envisaged an outlay of Nu. 355 million and laid emphasis on improving agricultural production, setting up cooperative marketing societies and improving local livestock. In this Plan, an overarching stress was put on transport and communication with an allocation of Nu. 90.7 million, which was one-fourth of the total outlay. Bhutan quickly realized the significance of the social sector and the need for investment in health and education. The allocation on social services was about 31 percent of the total outlay of the plan. The most important feature of the third plan was reflected in the country's ability to generate revenue from domestic sources. The Royal Government of Bhutan (RGOB) was able to finance about 70 percent of the total outlay of Nu. 355 million, while the rest came from the GOI. This was partly the result of heavy investment incurred in power and the resultant spillover in other sectors such as direct productive activities. The 4th FYP (1976-81) continued to lay emphasis on education, health and forestry. As a result of the concerted efforts of the RGOB the country was able to lay down the foundations of socio-economic development by the end of the 1970s.

The beginning of the 1970s was also a period of grief for Bhutan due to the untimely demise of the 3rd King Jigme Dorji Wangchuck. However, the void was quickly filled in by the enthronement of the fourth king of Bhutan Druk Gyalpo Jigme Singye Wangchuck in 1972. Under the able and farsighted leadership of the young King Jigme Singye Wangchuck, Bhutan embarked upon a path of sustained growth. The 1970s was a significant period for Bhutan as it acquired a new face in the world on joining several international bodies, including the United Nations. In August 1975, Bhutan attended the Non-Aligned Foreign Ministers Conference at Lima, Peru and began participating in the World Food Programme (WFP), the Colombo Plan, the United Nations Development Programme (UNDP), and International Labour Organisation (ILO). Here again, the bonds of friendship with India proved strong and Indian assistance in strengthening international recognition for Bhutan was unfaltering.

The decade of 1980s: On a sustained growth path

The process of modern economic development in the country took on greater strength by the 5th FYP period (1981-87). The period witnessed the initiation of industrial development in the country. Hydropower development was rightly identified as the main source of revenue generation and an initiator of growth impulses. By the beginning of the 6th FYP (1987-92), Bhutan was able to meet two-thirds of its development budget from internal revenue generation. Although India's assistance to Bhutan increased in nominal terms, it reduced relatively in the funding of the Five-Year plans. This was an indication of the growing strength of the Bhutanese economy. The decade of the 1980s put the economy on a higher growth path with real GDP experiencing a quantum jump of 18 percent over 1986-87. The commissioning of the Chukha Hydropower Project proved to be a real boon for the economy as it produced a strong growth average of 8 percent for the whole decade.

The decade of 1990s: Period of fluctuating fortune

The goal of self-sufficiency and less dependency on foreign capital and labour was further emphasized in the 7th FYP (1992-97). The 1990s also witnessed concerted efforts towards the process of decentralization. The 8th FYP (1997-2002) crystallized the idea of sustainable development. At the same time, the need for expanding the public sector has been felt and

measures initiated for its development. The growth of hydropower projects resulted in a strong growth of the industrial sector in the country. However, as has been already explained, the average annual growth rate of the economy during the 1990s could not match that of 1980s. The economy suffered during the beginning of the decade due to political turbulence in the south.³ A recovery was witnessed only at the end of the decade. Growth fluctuated a great deal over the period of 1990s, once again to decelerate in the post-2000 period.

1.3.c. Budgetary position

Table 6 reports the overall budget surplus/deficit as percentage of GDP for Bhutan and also internal revenue generation position of the country. These percentages have been calculated from the actual figures presented in table 5 containing a summary of budgetary operations. Bhutan maintained a relatively low deficit ratio till recently, and it was only during 1999-2000 that the ratio climbed slightly and crossed 5 percent in 2000. The explanation appears to lie in the relative position of total revenue and expenditure of the government. The ratio of total revenue including grants saw a decline during 1999-2000. On the positive side, the tax revenue to GDP percentage improved considerably over time and during 1999-2000, it crossed 10 percent for the first time indicating the growing strength of the economy.

Table 5: Summary of Budgetary Operations

Item	Millions of Ngultrum							
	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01(r)
Revenue	1,666.3	1,877.4	2,127.7	2,424.4	3,133.0	3,656.9	4,585.4	5,097.6
Tax	503.3	649.8	844.2	868.9	1,246.4	1,265.8	1,977.1	2,200.6
Non-tax	1,064.9	1,032.1	1,086.9	1,204.1	1,743.4	2,220.0	2,355.5	2,470.9
Others	98.1	195.5	196.6	351.4	143.2	171.1	252.8	426.1
Grants	1,456.3	1,773.2	2,363.6	2,232.1	1816.3	3,262.6	3,274.1	3,310.7
From India	607.5	728.0	1,168.9	947.6	1,045.1	1,928.5	1,927.1	1,663.4
Others	848.8	1,045.2	1,194.7	1,284.5	771.2	1,334.1	1,347.1	1,647.3
Total Revenue and Grants	3,122.6	3,650.6	4,491.3	4,656.5	4,949.3	6,919.5	7,859.5	8,408.3
Expenditure	3,167.5	3,642.7	4,252.7	4,957.2	4,806.0	7,224.4	8,624.1	9,704.9
Current	1,550.9	1,906.7	1,968.2	2,341.2	2,627.8	3,178.3	3,702.1	4,397.6
Capital	1,616.6	1,736.0	2,284.5	2,616.0	2,178.2	4,046.1	4,921.9	5,307.4
Budget Surplus/Deficit	-44.9	7.9	238.6	-300.7	143.3	-304.9	-764.5	-1,296.6
Financing Transactions	45.0	-7.8	-238.7	300.8	-143.3	304.9	764.5	1,296.6
External borrowings (Net of principal repayments)	24.0	-6.7	-26.8	124.2	336.3	553.6	606.6	496.6
Internal resource gap	21.0	-1.1	-211.9	176.6	-479.6	-248.7	158.0	800.0
Internal borrowings (Net of principal repayments)	22.5	2.5	37.2	-100.0	-1.8	-	-	
Cash and bank balances	-1.5	-3.6	-249.1	276.6	-477.8	-248.7	158.0	
Others	-	-	-	-	-	-	-	

Source: *Selected Economic Indicators*, June 2001, Royal Monetary Authority.

³ Background provided in the annexes.

Table 6: Budget surplus/deficit, total revenue and tax revenue as percentage of GDP of Bhutan

	Budget surplus/deficit as % of GDP	Total revenue (including grants) as % of GDP	Tax revenue as % of GDP
1993	- 0.6	44.6	7.2
1994	0.1	44.8	8.0
1995	2.5	46.7	8.8
1996	- 2.6	40.8	7.6
1997	1.0	35.4	8.9
1998	- 1.9	43.0	7.9
1999	-4.1	42.4	10.7
2000	- 6.1	39.8	10.4

Source: Calculated from data provided in *Selected Economic Indicators*, June 2001, Royal Monetary Authority.

However the percentage increase in total revenue including grants show a consistent decline (Table 7). Data on total revenue of the government indicate that it increased by 40 percent in 1998-99 over the previous year, declined to 14 percent in 1999-00, further down to 7 percent in 2000-01, and was then estimated to decrease further by 4 percent in 2001-02. The expenditure side suggests that percentage rise in total expenditure, both current and capital, has tended to decline over time and is kept within prudent limit. It is basically the grant factor that has resulted in a large budget deficit that recently occurred. On the grant side, the most important factor seems to be the recent decline in the proportion of Indian grants in total grants received by Bhutan (Table 6). Indian grants in proportion to total grants to Bhutan has declined from 59 percent in 1998-99 to 50 percent in 2000-01 and is estimated to go down further to 46 percent in 2001-02. Even the absolute amount of grants from India in the post-1999 period seems to have gone down from Nu.1927.1 million in 1999-00 to Nu.1663.4 million in 2000-01, and the amount is expected to go decrease further to Nu.1340.3 in 2001-02. Table 8 presents a summary of Individual grant donors including India since 1993/1994 – 2002/2003.

Table 7: Revenue and Expenditure Position of Bhutan

	Percentage rise in total revenue including grants	Percentage rise in total expenditure		Percentage of Indian grants in total grants received by Bhutan
		Current	Capital	
1998-99	40	21	86	59.1
1999-00	14	16	22	58.8
2000-01	7	19	8	50.2
2001-02 ^e	-4	5	2	45.9

Note: e is estimated.

Source: *Selected Economic Indicators*, September 2001, Royal Monetary Authority.

Table 8: Individual Grant Donors (1993/1994 – 2002/2003)

In Millions of Ngultrum

Agency	1993/93	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03
Govt. of India	607.5	721.4	1168.9	947.6	1045.1	1928.5	2187.9	2551.2	945.3	2631.8
DANIDA	141.3	173.0	155.3	218.2	135.6	385.2	318.7	394.8	534.8	525.8
JICA	225.8	313.4	0.0	475.0	0.0	0.0	7.1	0.0	4.2	0.0
Netherlands	14.9	60.6	253.6	84.0	66.8	88.8	74.4	147.6	274.5	201.0
UNDP	47.2	18.5	21.9	44.5	100.3	122.1	140.8	51.4	132.7	85.6
Austria	26.1	45.8	1.9	22.0	85.3	170.7	143.0	174.2	44.2	68.7
HELVETAS	80.9	26.1	106.0	18.1	15.0	147.2	75.8	94.3	0.0	0.0
Swiss Dev. Coop.	27.7	42.0	29.9	62.2	49.5	200.6	106.2	66.8	62.6	103.5
EU	45.0	60.4	107.8	33.5	57.1	35.1	29.9	18.0	112.5	130.8
UNCDF	30.7	85.0	43.9	118.2	88.4	37.4	10.6	27.2	26.9	26.6
Others	209.1	198.5	464.9	208.7	173.1	146.9	179.7	185.4	559.3	707.9
Total	1456.2	1744.7	2354.0	2232.1	1816.3	3262.6	3274.1	3711.0	2696.9	4481.7
Percentage change on the Previous Year										
Total	18.4	19.8	34.9	-5.2	-18.6	79.6	0.4	13.3	-27.3	66.2

Source: RMA Annual Report 2002/2003, Royal Monetary Authority.

1.3.d Money supply and inflation

The annual average growth rates of money supply, measured in terms of broad money excluding term deposits M_2 , have fluctuated a great deal (see Table 9). The M_2 supply has fluctuated the maximum around the mid-1990s. However, the post-1997 period has seen a consistent decline in M_2 supply, and this has presumably affected inflation rates over time. The average inflation rate over the 1990s has consistently gone down for Bhutan and in 2001 it was just 1.1, one of the lowest in the sub-region. Food prices seem to have fluctuated a great deal, while changes in non-food prices have been sharper and higher than that of food prices. Table 6 suggests that both food and non-food prices have tended to stabilize on the lower side since 1999.

Figure 3 provides a plotting of money supply growth rates along with the inflation rates in Bhutan. The plotting lends support to the notion that inflation has moderately, if not closely, followed the growth of money supply in the country.

Table 9: Money Supply and Inflation in Bhutan

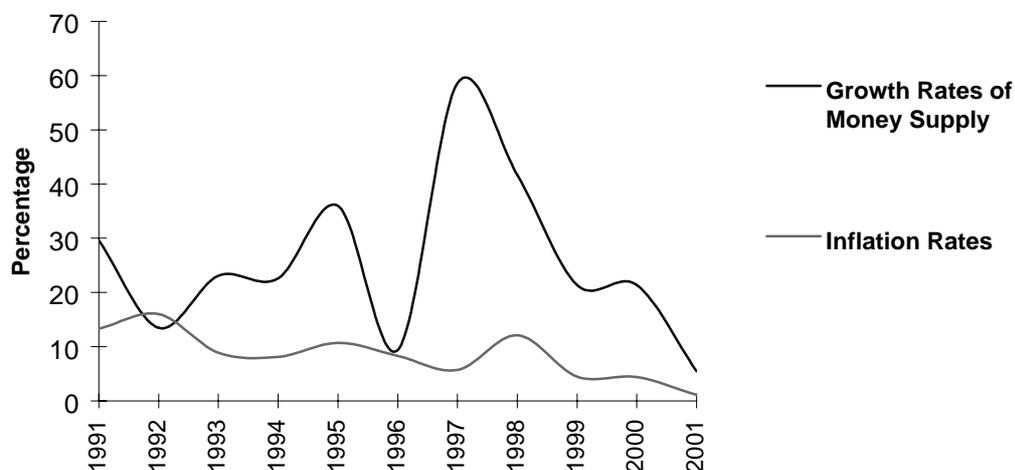
Year ending	Changes in money supply (M_2) (%)	CPI (December 1979=100)	Changes in CPI (%)	Changes in food prices	Changes in non-food prices (%)	Purchasing Power of Ngultrum (December 1979=Nu.1)
1990	--	--	--	--	--	--
1991	29.6	289.5	13.3	15.1	9.7	0.34
1992	13.5	335.7	16.0	16.3	15.2	0.30
1993	23.1	365.7	8.9	6.3	14.5	0.27
1994	22.6	395.3	8.1	3.5	17.1	0.25
1995	36.0	437.7	10.7	12.7	7.2	0.23
1996	9.4	474.1	8.3	7.8	9.2	0.21
1997	58.6	501.2	5.7	3.6	9.6	0.20
1998	41.7	561.7	12.1	12.9	10.6	0.18
1999	21.4	587.0	4.5	2.6	7.9	0.17
2000	21.4	612.9	4.4	1.3	9.6	0.16
2001	5.5	619.5 ^a	1.1	0.3	2.3	0.16

Note: a. Figure pertains to June

Source: Various issues of *Selected Economic Indicators*, Royal Monetary Authority, RGOB.

Figure 3

Growth Rates of Money Supply and Inflation in Bhutan



1.3.e International reserves and foreign capital

Bhutan's international reserves include convertible currency reserves and rupee reserves. An important point to be noted here is that Bhutan's requirement for convertible currency reserve has increased gradually. This is due to economic diversification and growing ties with countries other than India, though the proportion of convertible currency reserves in total reserves has gone down recently, from almost 85 percent in 1997 to 77 percent in 2001. This might have its implications, especially in trade. For example, 20 percent of import is paid for in convertible currencies whereas export proceeds fetch a mere 5 percent of earnings in convertible currencies (Wangyel 2003). However, the building up of rupee reserve has provided a stable basis and easy flow of trade with India.

Bhutan joined the IMF on September 28, 1981 and since then its SDR quota increased consistently from US \$ 1.7 million in 1981 to US \$ 6.3 million in 1999. Bhutan's reserves position at IMF has increased from US \$ 0.57 million in 184 to US \$ 1.02 million by September 30, 2003, reflecting the growing strength of the Bhutanese economy.

1.3.f Future Outlook: IMF's Projection

The IMF's World Economic Outlook (WEO) 2003 provides future outlook for 2003-04 for the growth of the economy. The data pertaining to Bhutan and its neighbouring countries as reported in this report is presented in Table 10 below.

The decadal comparison points out that except for Nepal, other countries have shown improved performance in the average growth rate of GDP during 1995-2004 in comparison to 1985-94. However, the average growth rate difference between the decades has not been very significant for any of the countries, the highest being demonstrated by Bangladesh (by 1.2 percent point). The trend growth suggests a downward movement during the close of the 1990s and a probable recovery by the beginning of 2001-02. For Bhutan, however, growth rate seems to have fluctuated a great deal between the periods with a projected recovery by 2004.

Table 10: Growth Outlook of Bhutan and Neighbouring Countries as Projected by IMF's World Economic Outlook 2003 (%)

	Bhutan	Bangladesh	India	Nepal
1985-94	6.4	4.0	5.4	5.7
1995-04	6.8	5.2	5.8	3.8
1995	7.4	4.8	7.6	3.3
1996	5.2	5.0	7.5	5.3
1997	7.2	5.3	5.0	5.3
1998	6.4	5.0	5.8	2.9
1999	7.6	5.4	6.7	4.5
2000	5.3	5.6	5.4	6.1
2001	6.6	4.8	4.2	4.8
2002	7.7	4.9	4.7	-0.5
2003p	7.3	5.4	5.6	2.3
2004p	7.6	5.8	5.9	4.0

Source: *World Economic Outlook 2003*, IMF.

Overall, the performance of the Bhutanese economy indicates its macroeconomic stability, while at the same time highlighting its dependency on other countries, especially India, in several crucial areas. This increases the vulnerability of the economy. It has also been pointed out that in the absence of diversification in production and trade, the Bhutanese economy may become more dependent on imports with every enlargement in 'hydro-Ngultrum' earnings. For example, the commissioning of the Tala hydropower project of 1020 MW by 2004-05 is expected to increase the GDP growth by 18.1 percent by 2006-07, which is likely to induce the GDP per capita further by 40 percent with an expected population base of 0.792 million. Since the share of manufacturing is expected to reach 30 percent of GDP only by 2012, this newly generated 'hydro-Ngultrum' will further increase the demand for imports. This may be explained as *dependency amidst plenty syndrome* (Pankaj 2003). Further, the limited growth of the private sector poses constraints on the desired diversification of the economy. Perpetuated, this can undermine Bhutan's capacity to reap advantages from the multilateral trading system when it joins the WTO.

Chapter 2. ECONOMIC DEVELOPMENT POLICY

2.1 Development Strategy

The development strategy of Bhutan seeks to strike an appropriate balance among social, economic, political, cultural and environmental goals. While mapping the future development course, *Bhutan 2020: A Vision for Peace, Prosperity and Happiness* (Planning Commission 1999, RGOB) clearly brings out these goals in the 'Normative Architecture for Change and Development' (p.49). The various elements of this 'architecture' are put under the following broad categories: **Social** - Human Development; **Economic** - Self-Reliance, Sustainability, Flexibility, Balanced and Equitable Development; **Political** - Independence, Sovereignty and Security of the Nation- State and Governance; **Cultural** - Identity, Unity and Harmony, Preserving and Promoting Culture and Heritage; **Environmental** - Preservation through Environmentally Sustainable Development.

The development strategy places human development at the center-stage. A holistic approach to development has been designed to take care of material as well as spiritual needs of individuals. Health and education are considered priority areas for basic capacity development towards the generation of human capital. This is to be achieved within the framework of traditional values and ethics so that the "society in transformation" continues to draw inspiration from the nation's cultural heritage (Planning Commission 1999: *Bhutan 2020*, pp.47-48). It is crucial that sustainability be observed because an untenable proposition in any field is likely to have a negative impact on the sovereignty and security of the nation (Ibid: *Bhutan 2020*, p.45).

The national development vision accords Gross National Happiness (GNH)⁴ as the central development concept, one that encompasses goals, principles, objectives and direction of development. His Majesty King Jigme Singye Wangchuck propounded the philosophy of GNH, emphasizing that Gross National Happiness is more important than Gross National Product. This vision of GNH has been articulated and groomed into the overall guiding principles for the development of Bhutanese society and economy. The expression GNH is essentially a summarization of the basic tenets of Vajrayana Buddhism, the state religion of Bhutan, which spreads the culture of harmony and compassion.

The GNH does not essentially reject material progress, but takes it as a precondition for enlarging self-reliance, opportunities and choices (Ibid: *Bhutan 2020*, p.47). At the operational level, the theory of GNH would mean that every policy and every project is to be planned and evaluated not simply in terms of the enhancement it makes to GNP and the material basis of society but also by its contribution to the total well-being of individuals and society (RGOB 2000: *Development Towards Gross National Happiness*, p.22), including the impact it will have on the environment. The GNH is, therefore, "Bhutan's bridge over the gap between values and development" (Ibid: *DTGNH 2000*, p.23). The doctrine of GNH has not only allowed the development process to emanate from the cultural roots; it has also provides a cautious and rational defense against the impoverishing and detrimental impact of global changes. This places Bhutan on a better footing, where it can exercise options and obtain judicious benefits from the process of liberalization.

⁴ More information on GNH can be accessed at <http://www.bhutanstudies.org.bt>: *Gross National Happiness - Discussion Papers*, The Centre for Bhutan Studies, Thimphu, 1999.

2.2 Economic Reforms and Approach

Bhutan's pursuit of development is intended to be holistic in nature to ensure flexibility and sustainability. While flexibility is explained in terms of the country's ability to adapt and respond effectively to changes, sustainability has to be taken into account in the social, financial, economic, cultural and environmental fields. The process of economic reforms in Bhutan is essentially set against this backdrop.

Nevertheless, over the last four decades of planned economic development Bhutan's interactions at the bilateral and multilateral levels have increased considerably. Bhutan's development strategy has gradually started moving towards incorporating the benefits of globalization and increasing participation in international trade, through structural changes geared at ensuring faster growth and economic diversification. However, the process of economic reforms in Bhutan has not emanated from any serious economic crisis and therefore differs from 'conditionality driven' reforms. For Bhutan, it has been more a process of self-adjustment based on the changing needs of its society and economy. Such changes are driven by domestic needs as well as influence from external developments, especially those occurring in the neighbouring countries. In light of this, the process of economic reforms in Bhutan can be described as an attempt to make up for discrepancies in policies with regard to its major economic development partners. Another way of looking at the process of economic reforms in Bhutan is from the participatory requirement point of view. Bhutan's perceived need to join international communities and share the benefits of liberalization has propelled its active commitment under several forums and treaties within and outside the sub-region. Today Bhutan is committed to join the WTO, and a constant perusal of policy is required to fulfill the requirements of WTO and to benefit from the new regime.

2.2.a The External Sector

The external sector is extremely important for Bhutan as it provides two most important sources of growth—exports earnings and foreign aid. The top listed items of exports are electricity, mineral products, products of chemical industries, base metals and products, wood & wood products and processed foodstuff. Bhutan is dependent on imports for its requirements of capital goods, raw materials, basic consumer goods and medicine and pharmaceuticals. Bhutan has bound its tariff structure at a moderately low level that is relatively lower than India and other South Asian countries. Bhutan sales tax rates for most commodities range up to 15 percent with a high of 50 percent for alcohol and tobacco products. Custom duties range between 10 to 30 percent for most items and 50 percent for non-alcoholic beverages and beer. For alcoholic beverages and tobacco products the custom duty is fixed at 100 percent (Department of Revenue and Customs, RGOB 2002). In the absence of a well-diversified domestic economy, Bhutan depends heavily on imports; consequently, import duties on most items are low and well within the applied range of 20-40 percent (GATT 1994).

Foreign capital in Bhutan flows mostly in the form of official development assistance (ODA) and concessional debt. Very little has been received so far in the form of foreign direct investment (FDI). The ODA to Bhutan is mostly donor-funded in the form of grants, directed chiefly towards development projects. The country has been dependent on foreign aid for most of its massive development projects with huge capital requirements.

The aid inflow in Bhutan mostly comes from bilateral donors, who are also its development partners with India being the most important one.

While such bilateral aid flows averaged about 62 percent of the total during the 1990s, about 15 percent on average had been received by the UN systems (UN 2001: *UN: Country Presentation for Bhutan 2001*, p.53). The sector-wise inflow of foreign aid over the 1990s suggests that on average the Renewable Natural Resources sector received the maximum of 19 percent, followed by Transport and Communication (16 percent), Human Resource Development (14 percent), Health (11 percent), Development Administration (11 percent), Energy (8 percent), Industries (4 percent) and social development (7 percent).

Bhutan follows the principle of achieving self-reliance in the course of economic progress and sustainability in each aspect of its development process. This underscores the idea that development should not be financially unsustainable with indulgence in investments that can be ill afforded. More precisely, untenable increases in debt service obligations in blind pursuit of development, is strongly discouraged (Planning Commission 1999: *Bhutan 2020*, pp.44-45). Such guidelines have helped the country in utilizing foreign aid resources quite efficiently and effectively, with most of the aid being well directed and in the form of technical co-operation, project assistance and investment related technical assistance.

Bhutan's cautious policy towards foreign capital has resulted in its acceptance of loans strictly on concessional terms. Even though the volume of such debt has increased over time, the overall situation seems comfortable. However, debt-volume is expected to go up slightly by 1999-2000 in the wake of increased borrowings for the construction of power projects. The overall debt portfolio suggests that the maximum outstanding commitment of US \$ 194.86 million (more than 50 percent of total loan commitment) falls in the energy sector, with 90 percent from India as Rupee loans. An outstanding loan commitment of about US \$ 73.37 million stands towards ADB, World Bank and other international institutions, basically being utilized in the Renewal Natural Resources sector (UN 2001: *UN: Country Presentation for Bhutan 2001*, p.36).

2.2.b Foreign Exchange Regime

The Bhutanese Ngultrum is pegged to the Indian rupee, which is accepted as legal tender in Bhutan. However, this is confined to current account transactions only and restrictions apply in dealing with capital account transactions. Current account controls include: ceilings on amount of foreign exchange that commercial banks can hold; limits on foreign exchange requirements for importers; limits on foreign exchange earnings exporters can retain in foreign in foreign currency; and limits on foreign currency that business people or private travelers can take out of the country. Capital account controls include Foreign Direct Investment, and offshore investment and borrowings. In the case of other currencies, convertibility restrictions are followed on both current and capital account.

2.2.c Private Sector Development

While the total investment in the economy has increased tremendously, the share of private investment has not picked as up much. Private investment in manufacturing is quite low with investments largely directed towards residential dwellings. The Royal Government has taken a host of measures to encourage private sector development in the

country (for details see RGOB 2000: *Development Toward Gross National Happiness*, pp.83-86 and Planning Commission 2002: *Ninth Five Year Plan 2002-07*, pp.61-65). The Bhutanese government is following an active divestiture program towards privatizing many major public sector enterprises. The postal services, road maintenance, forestry services and agricultural machinery are on the list of future privatization in the country. However, views have been expressed that this should await further growth in the private sector, especially in consideration of a small population of local labour, small capital market, shortage of skills and insufficient infrastructure and the extremely small presence of foreign capital (World Bank 1996, p.8).

2.2.d Foreign Direct Investment Policy

Bhutan has pursued a conservative and restrictive foreign investment policy until very recent times. This has been in keeping with concerns over the undesirable impact that FDI could have on Bhutanese tradition and culture, as well as in the interests of a relatively weak private sector that could face undue pressure from the competitiveness of foreign investors. Considered on a "case by case basis" foreign investment up to date has been limited as shown in table 11.

Table 11

	Year	Local Partner	%	Foreign Partner	%	Public
1.	1971	Bank of Bhutan	80	State Bank of India	20	0
2.	1990	Bhutan Ferro Alloys Ltd.	40.12	Marubeni Corp (Japan)	20	39.88%
3.	1996	Bhutan National Bank*	27.2	Asian Development Bank	20.1	52.77%
4.	2001	Bhutan Tourism Co. Ltd.	30	Aman Resorts (Singapore)	60	10%
5.	2001	Bhutan International Company ⁵	30	Hotel Property Ltd. (Singapore)	60	10%

Source: *Monthly Statistical Bulletin January 2003*, Royal Monetary Authority, Thimphu, Bhutan.

Following the entry of the State Bank of India as the first foreign investor in Bhutan, there was a long gap before the Marubeni Corporation made investments into the Bhutan Ferro Alloys Ltd., and the Asian Development Bank facilitated the transformation of the Unit Trust of Bhutan into the Bhutan National Bank. Now, with the coming of the two international hotel chains to the country, Bhutan has for the first time allowed foreign investors a majority shareholding.

The government's approval of the Foreign Direct Investment (FDI) Policy in December 2002 is a significant landmark in Bhutan's gradual process towards economic liberalization. With its broad objectives to support private sector development, generate employment, facilitate transfer of capital, technology and skills, and broaden the revenue base, a number of areas in the manufacturing and service sectors where foreign investors can hold up to 70% equity have been identified⁶. However, it is observed that the FDI Policy is still somewhat conservative (Wangyel 2003), presenting several constraints to

⁶ With a minimum investment of US\$ 1 million, the areas open to FDI under the manufacturing sector include mineral processing, forestry and wood based industries, agriculture and agro processing, livestock based industries, light industries, electronics, engineering and power intensive industries. The areas under the service sector, with a minimum investment of US\$ 500,000, are tourism including hotels, transport, roads and bridges, education, business infrastructure, information technology, financial services and housing.

potential foreign investors, as it has been developed along cautious lines. The need to relax the ceiling on foreign equity participation investment and a further simplification of the regulatory framework for private investment, particularly industrial licensing has been considered an essential element of future reforms (World Bank 1996, pp.7-8 and 2002).

2.2.e Bhutan's proposed accession to WTO: Are we going to ride the tiger?

Bhutan has decided to join WTO and hopes to complete the process of accession by 2007. The necessary preparations in terms of fulfilling the requirements, creating regulatory frameworks and safeguards are being put in place (Ministry of Finance 2001: *Action Programme for the Development of Bhutan 2001-2010*). Joining the rule based trade regime is seen as a major step forward, which will necessitate a great deal of liberalization of domestic economic policies. Such assimilation will have its own benefits as well as costs. Weighing the benefits and costs of this move has been a matter of intense debate in the country. As a small, landlocked country, Bhutan faces limiting factors that can undermine its capacity to benefit fully from the multilateral trading system (see Wangyel 2003 and Pankaj 2001; 2002; 2003). The bottom line is that the economy should be in a position to take advantage of expanding opportunities, and based on experiences elsewhere, the following parameters can be delineated:

1. Countries with a sizeable and matured private sector that can play a lead role in promoting trade and function as 'organized private sector' are likely to benefit more.
2. Countries with a sizeable manufacturing sector capable of producing quality products at least cost-effectively are likely to benefit more.
3. Countries with a well-diversified industrial structure within the economy capable of producing a wide range of products are likely to benefit more.
4. Countries with a good size of domestic market enough to generate sufficient demand for products are likely to benefit more.
5. Countries with sound macro parameters are likely to reap more benefits.
6. Countries, which initiated reforms with better record in human capital development in terms of health and education, are likely to gain more.
7. Countries with better environmental situation are likely to benefit more.
8. Countries with better record in institutional building, sound and stable government, less corruption and good law and order are likely to benefit more.

Of these eight parameters, Bhutan's record in the last four is extremely good while it lags behind in the first four. Therefore, by simple logic it can be deduced that the chances of gain and loss stand on equal footing in Bhutan's accession to WTO. Bhutan demonstrates particular strength in those parameters related to policy and priorities in contrast to those in the growth related areas. This, once again, is indicative of the choice that Bhutan opted for over the years i.e. pattern over growth. Bhutan may draw inspiration from experiences elsewhere, which suggest that countries with better pattern of growth (achieved through more investment in human capital) have, in the long run, been able to accelerate the pace of growth as they started getting higher returns on physical capital. Therefore, the question is that of managing change wherein the pre-requisites of change are more-or-less put in place.

Chapter 3. ECONOMIC RELATIONS WITH THE NEIGHBOURING COUNTRIES AND AREAS

3.1 Regional Economic Cooperation

Regional economic cooperation is extremely important for Bhutan. Bhutan and India share special bilateral relations in trade and development by virtue of the Indo-Bhutan Treaty of 1949. Bhutan is also a party to the Growth Quadrangle Initiative within SAARC, comprising Bangladesh, Bhutan, India and Nepal (BBIN-GQ). These initiatives have tremendously benefited Bhutan's exports and many other areas of economic development. Regional economic integration has also helped Bhutan in its preparedness towards international integration being sought through WTO membership. However, apprehensions are raised over constraints posed by factors that include being a small and landlocked country, and the question if Bhutan can really benefit much from regional integration or for that matter from international integration is a valid one. In this regard, there are a few arguments that can be considered.

First, apart from Bhutan's official trade with India, the volume of unofficial/informal/border trade has been estimated to be quite large (Rao and Das 1997; Taneja 2001). This is an indication of the strong complementarities that exist between Bhutan and India. This seems to hold true for various other pairs of countries as well in the South Asia region. Therefore, with the actual volume of transaction being much higher than what is apparent, there is always a case for gaining more by bringing unrecorded transactions to record. Border trade links have also served as a means of transforming the border economy. Such unrecorded transactions have been found influencing the variability of prices of essential items in Bhutan a great deal (Pankaj 1998). This also leads to price distortion and a diversion of trade, which can be removed by strengthening regional cooperation.

Second, studies have confirmed rich potential in enhancing intra-South Asian trade flows, if the region's trade flows are kept in tune with trends in the global trade flows of the intra-industry variety (Panchmukhi 1992). This can be facilitated by identifying similar areas in production and promoting intra-industry trade flows. Bhutan can look into such possibilities for future trade diversification. Textile, readymade garments and fusion designs production are some examples among several other possibilities.

Third, it has been argued that Bhutan's benefits from a liberalized trade regime would depend upon its own domestic production capabilities, industrial diversification and private sector initiatives. Regional cooperation can augment the process of domestic production diversification through investment and technological linkages. Bhutan can follow a policy of "export-oriented production, based on import-substitution" taking advantage of the huge Indian market under free trade arrangements. It can also help substitute garments import from Bangladesh, Nepal and Thailand. Regional integration can effectively help Bhutan deal with the domestic market size constraint on development.

Fourth, among several other areas of comparative advantage, environment is Bhutan's distinct advantage. It has been argued that the option of 'green trading' would be

extremely crucial for Bhutan. This is one option that can enable Bhutan to enter in the global trade with confidence (for details see Pankaj 2003).

Finally, however, the future benefits will all depend on Bhutan's preparedness, foresight and necessary policy adjustments. The benefits will be gradual, and definitely not over night.

3.1.a Bhutan's involvements in regional cooperation

Indo-Bhutan Treaty

Much before the SAARC forum came into being, Bhutan and India signed the Indo-Bhutan Treaty in 1949, which envisaged friendship, cooperation and a free trade regime between the two countries. Providing the basic framework for bilateral trade and other areas of economic relations between Bhutan and India, negotiations and agreements in trade and commerce have been worked out from time to time within the overall framework of this Treaty. The latest one concluded in 1995, is valid for a ten-year period up to March 2005.

Under this treaty, India is an Ngultrum payment area for Bhutan and the transactions with Indian Rupees is pegged on a one-to-one basis (GOI: Ministry of External Affairs 2000). The Indian Rupee is legal tender in Bhutan, while Bhutanese Ngultrum is informally transacted freely in the bordering towns. This transaction is mostly confined in the immediate border areas within a maximum 30-40 km lateral distance, validated basically by small businessmen, traders and others involved in transactions with their Bhutanese counterparts.

Since 1949, Indian assistance to Bhutan has covered a wide range of areas representing an intensification of bilateral relations over time. To date, the areas of cooperation have been infrastructure, communication, hydel-projects, road network, skilled manpower under technical assistance program and many others. Some of the major projects launched in Bhutan with assistance from India have been the Tala, Kurichu, and Chhukha hydropower projects; the Dungsum and Penden cement plants; Paro Airport; Bhutan Broadcasting Station; Indo-Bhutan Microwave Link; building major highways; and exploration of mineral resources, etc. (GOI: Ministry of External affairs 2000).

SAPTA and Bhutan

The South Asian countries formed the South Asian Association for Regional Cooperation (SAARC) almost two decades ago in 1985. During the initial period of its foundation not much progress could be seen, until recently when in 1991 it was decided that a South Asian Preferential Trading Arrangement (SAPTA) would be established. SAPTA is based on a commodity-to-commodity approach and in its first two rounds of negotiations, 2,094 commodities were offered for concessions at the HS 6-digit level. By the third round of negotiations concluded in 1998, a total of 3456 tariff lines were included for concessions. Table 9 and 10 provide the break-up of the number of products included for concessions by Bhutan and other member countries during the last three rounds of negotiations, as well as the depth of tariff concessions that have ranged between 5 to 100 percent. Bhutan agreed to provide concessions ranging from 10 to 20 percent on a wide range of commodities. While these concessions are far less than what India has provided, they are

more than the concession range of 10 to 15 percent that Bangladesh and Nepal have agreed to. The detailed lists of products on which concessions have been extended by Bhutan are provided in the annexes.

Table 12: Number of Products on which Tariff Concessions have been extended by Bhutan and its Neighbouring Countries in the Three Rounds of Trade Negotiations (1996-98) under SAPTA

	First Round			Second Round			Third Round		
	<i>For LDCs</i>	<i>For All</i>	<i>Total</i>	<i>For LDCs</i>	<i>For All</i>	<i>Total</i>	<i>For LDCs</i>	<i>For All</i>	<i>Total</i>
Bhutan	7	4	11	10	37	47	101	23	124
India	62	44	106	514	390	904	1874	43	1917
Bangladesh	1	11	12	11	215	226	143	338	481
Nepal	4	10	14	67	166	233	137	52	189

Source: SAARC Secretariat, taken from RIS (2001-02, p.173).

Table 13: Depth of Tariff Concessions agreed by Bhutan and its Neighbouring Countries in the Three Rounds of Negotiations (1996-98) under SAPTA

	First Round		Second Round		Third Round	
	<i>For LDCs</i>	<i>For All</i>	<i>For LDCs</i>	<i>For All</i>	<i>For LDCs</i>	<i>For All</i>
Bhutan	10,13 and 15 percent	15 percent	15 percent	10 percent	10,18 and 20 percent	10 percent
India	50 and 100 percent	10,25,30,50, and 90 percent	25 and 50 percent	10,15,25 and 40 percent	50 percent	10 and 20 percent
Bangladesh	10 percent	10 percent	10 percent	10 percent	10 and 15 percent	10 percent
Nepal	10 percent	10 percent	15 percent	10 percent	10 and 15 percent	10 percent

Source: SAARC Secretariat, taken from RIS (2001-02, p.173).

Rules of origin are about the domestic content requirement of exportable products. In order to qualify for SAPTA tariff preferences, rules of origin stipulate certain percentage of domestic content in exportable products. This has been viewed by some as a possible obstruction to trade flows among South Asian countries. Since South Asian exports are highly import-dependent, such a qualification for domestic content requirements would be a hurdle in trade. Contrary to this is the argument that excessive dilution of the rules of origin would perpetuate the tendencies of high import dependence on extra-SAARC countries and may result in trade deflection. Arguably, rules of origin may to some extent be export restrictive, but in turn they check trade deflection and serve as instruments of development (Panchmukhi and Das 1998). A downward revision in the domestic content requirements of exportable products from member countries was considered, eventually reducing it to 40 percent in 1999 from the previously existing 50 percent. For LDCs within the regional group, this has been reduced from 40 to 30 percent.

The issue of trade between Bhutan and India is guided by the Trade and Commerce Agreement of 1995 which provides free trade between the two countries. However, the Bhutanese government may/can impose non-tariff restrictions on the entry of Indian goods if deemed necessary to protect its industries in Bhutan. Further, both governments can impose non-tariff restrictions on the entry of goods of third-country origin into their territory. There are no explicit guidelines with regard to domestic content requirements of exports between the two countries.

After three rounds of negotiations, SAPTA envisaged the formulation of a South Asian Free Trading Arrangements (SAFTA), which was recently signed at the 12th SAARC Summit held in Islamabad, Pakistan in January 2004. SAFTA has been formulated to broaden trade relations within the region and to lower import tariffs among the member countries, and this is meant to come into force in a few years. The main aims of this arrangement include liberalizing trade and removing tariffs in intra-trade & for promoting welfare of people in South Asia; broadening economic cooperation and ensuring equitable distribution of trade and cater to the special needs of small & least developed members by providing them special & differential treatment. Member rates have been accorded different durations to lower their customs tariffs between 0% and 5%: 7 years for India and Pakistan; 8 years for Sri Lanka; and 10 years for (LDCs) Nepal, Bhutan, Bangladesh and Maldives.

Various levels of integration

There are various levels of integration within SAARC, basically at the unilateral, bilateral, sub-regional level and regional level. At the unilateral level, some initiatives pertaining to trade and investment liberalization have been taken by India on its own. For example, India offered to dismantle import restrictions on around 2307 import products from the SAARC countries in 1998 (RIS 2001-02, p.162). As expected, this unilateral decision to remove QRs increased India's demand for imports by 7.3 percent (Mehta 2000), and subsequently increased the exports of other SAARC countries. Further, India has also enhanced investment limits for Indian investors investing in SAARC countries. It was increased from US \$ 15 million in 1998 to US \$ 30 million in 1999 for SAARC countries, and from Indian Rs. 60 crore in 1998 to Indian Rs. 120 crore in 1999 for investments in Nepal and Bhutan (RIS 2001-02, p.162).

At the bilateral level, there are arrangements worked out between India-Bhutan, India-Nepal and India-Sri Lanka. Between India and Sri Lanka, an agreement on free trade area was signed recently. While Indo-Bhutan bilateral trade is fundamentally guided by the Treaty of 1949, Indo-Nepal economic relations are governed by the bilateral Treaties on Trade and Transit, and Agreement for Cooperation to Control Unauthorized Trade.

There are two important initiatives taken at the sub-regional level—one, Bangladesh-Bhutan-India-Nepal Quadrilateral Growth Initiative (BBIN-GQ) and two, Bangladesh-India-Myanmar-Sri Lanka-Thailand Economic Cooperation (BIMST-EC). While the former is pursued under SAARC, the later involves two countries belonging to the ASEAN. Studies have shown that such Growth Zone Approach to development can help in achieving higher levels of regional integration by providing necessary flexibilities to exploit economic complementarities existing within a specific sub-region (Panchmukhi 1995; Rao 1997; Panchmukhi and Das 1997; RIS 1999).

The BBIN-GQ was formed to accelerate the pace of economic development in member countries through the identification and implementation of specific projects. The sectors identified for priority attention are multi-modal transportation and communication, energy, optimal sustainable utilization of natural resource endowments, trade and investment facilitation and promotion, and tourism and environment. Although the growth quadrangle pursues objectives beyond trade, very little progress has been made in

other areas of cooperation such as poverty eradication, social welfare and improvement in the quality of life.

At the sub-regional level outside of SAARC, Bhutan and Nepal are soon to join BIMST-EC, an economic cooperation grouping whose main purpose is to facilitate rapid economic growth, promote active collaboration and mutual assistance on matters of common interests, and provide assistance to each other in the form of training & research facilities. Members aim to cooperate mainly in areas of trade and investment, technology, communication and transportation, energy, tourism and fisheries.

3.1.b Trade profile with the neighbouring countries

Table 11 presents Bhutan's overall trade profile. It suggests that over the period 1990-01, there has been a more than four-fold increase in Bhutan's exports in value terms. It increased from Nu. 1221.5 million in 1990 to Nu. 4994.7 million in 2001. However, corresponding to this there has also been an enhancement in the total value of imports. The rise in import is much higher by more than six-fold during 1990-01. The value of import was Nu. 1424.5 million in 1990, which increased to Nu. 8990.2 million in 2001. A faster rise in imports has resulted in a consistently negative balance of trade. The ratio of trade balance to real GDP increased from a low of 4.2 percent in 1990 to 16.7 percent in 2001. In fact, the ratio of trade balance to GDP started rising from 1998 and entered into double digit, whereas between 1994-1997 it remained in single digit with a low of 3 percent in 1995. The ratio of exports to GDP also started sliding from 1998.

Bhutan's trade is mostly directed towards India. In 2001, about 94 percent of exports and 78 percent of imports took place with India. Within the sub-region, Bhutan has developed some trade links with Bangladesh and Nepal as well. While Bangladesh constitutes about 5 percent of Bhutan's total trade, including both exports and imports, Nepal accounts for 1 percent of total trade. Table 15 reports Bhutan's trade with India, Bangladesh, Nepal and the rest of the world in 2001. Bhutan enjoys a positive balance of trade with Bangladesh and Nepal, and a negative balance of trade with India. The value of imports from the rest of the world also far exceeds the value of exports to countries outside the sub-continent. Even though the volume of trade with Bangladesh and Nepal is small, it is still significant from the bilateral-trade relationship point of view.

Is Bhutan's inflation a stepped up version of Indian inflation?

Given its dependence on Indian economy in terms of trade, both formal and informal, Bhutan's inflation can be seen as a replica of Indian inflation. One plausible hypothesis can be that Bhutanese inflation is a stepped up version of Indian inflation. The source of this hypothesis is the observation that Bhutanese inflation has been found somewhat higher or very close to Indian inflation; it scarcely lies on the lower side. When examined for the analytics of inflation, it has been found that the seemingly greater fluctuation in food prices over 1990s was better explained on account of—I) the structural constraint in the domestic supply of food, and II) the 'informal inflow' of essential items from neighbouring regions of India, at times able to balance the demand with supply and sometimes not (Pankaj 1998). A better hypothesis seems to be that Assam and West Bengal prices have more perceptible influence on Bhutanese prices rather than all India prices. The regional rice prices in India would be a crucial determinant in this regard. The received indications pointed to the fact that domestic output change is perhaps failing to influence prices as much as the 'informal inflow' would have been able. However, raising domestic output would still be a better strategy for containing the level of and fluctuations in the prices in Bhutan (Ibid., pp.48-50). Controlling the level and fluctuation of the prices of essential items was also found crucial in addressing the problem of poverty in the country (Pankaj and Pelgen 2003a).

Table 14: Bhutan's Overall Trade Profile (in millions of Ngultrum)

	Exports	Imports	Balance	Ratio of Exports to GDP	Ratio of Trade Balance to GDP
1990	1221.5	1424.5	-203.0	24.6	4.2
1991	1437.2	1889.7	-452.5	27.7	8.5
1992	1715.2	3238.8	-1523.6	28.1	24.7
1993	1991.7	2745.3	-753.6	28.4	10.7
1994	2082.7	2876.4	-793.7	25.5	9.7
1995	3350.1	3641.9	-291.8	34.8	3.0
1996	3553.8	4525.2	-966.4	31.1	8.5
1997	4274.2	4977.9	-703.7	30.5	5.0
1998	4455.6	5516.4	-1060.8	27.7	6.6
1999	4988.0	7834.9	-2846.9	26.8	15.3
2000	4615.8	7875.0	-3259.2	21.8	15.4
2001	4994.7	8990.2	-3995.4	20.9	16.7

Source: i. *Selected Economic Indicators*, Royal Monetary Authority, various issues; ii. *Bhutan Trade Statistics, March 2003*, Ministry of Finance.

Table 15: Bhutan's Trade (in millions of Ngultrum) with its Neighbouring Countries and Rest of the World in 2001

	India		Bangladesh		Nepal		Rest of the World	
	Total value	% of total	Total value	% of total	Total value	% of total	Total value	% of total
Export	4700.5	94.1	222.4	4.4	41.5	0.8	30.3	0.6
Import	6988.8	77.7	64.7	0.7	15.0	0.2	1921.7	21.4
Trade Balance	-2288.3		157.7		26.5		-1891.4	

Source: i. *Selected Economic Indicators*, Royal Monetary Authority, various issues; ii. *Bhutan Trade Statistics, March 2003*, Ministry of Finance.

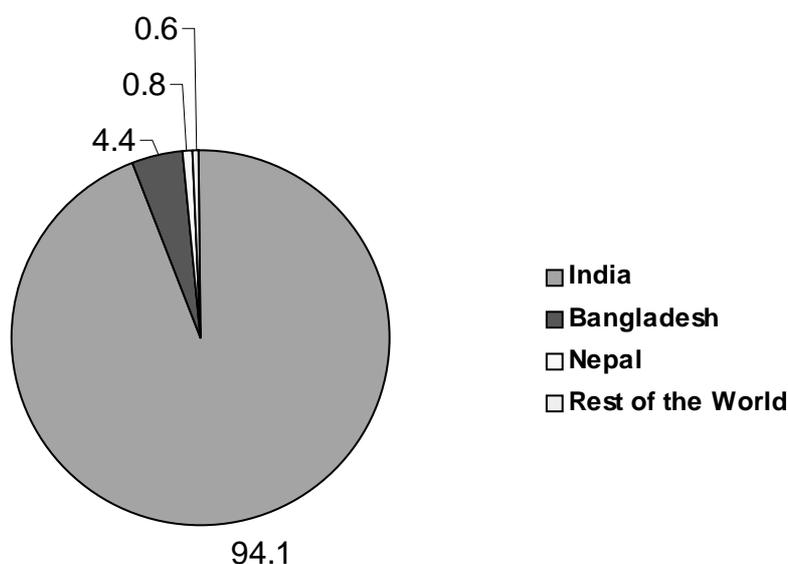
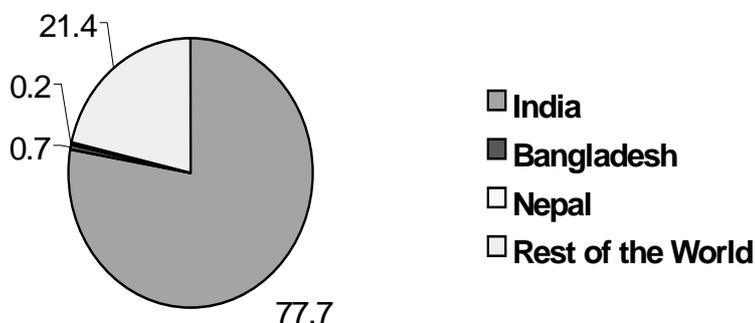
Figure 4**Bhutan's Exports in 2001 (%)**

Figure 5

Bhutan's Imports in 2001 (%)



Bhutan's trade with India

Bhutan exports a wide range of items to India. The top listed items according to their value in total exports are electricity, mineral products, products of chemical industries, base metals and products and wood & wood products. Import items from India include machinery, mechanical appliances, base metals, electronic items and a wide range of food items. A detailed description of Bhutan's trade with India is presented separately in Chapter 4.

Bhutan's trade with Bangladesh

Bhutan's total value of exports to Bangladesh in 2001 stood at Nu. 222.4 million, out of which orange exports alone accounted for Nu. 137.5 million (about 62 percent of total exports). The next most important item of export according to total value is apple (Nu.21.7 million). Orange and apple together constitute 72.5 percent of total exports to Bangladesh. Bangladesh provides a very good market for Bhutan's fruits, processed and packed food such as jams, jellies, pickles, puree and juice etc. Other important items of exports to Bangladesh include plaster of Paris, quartzite, dolomite powder, lime powder, soap stone powder, calcium, particle board, coal and bituminous, etc.

Bhutan imports a wide range of products from Bangladesh. In 2001, garment imports alone accounted for about 40 percent of total imports. Melamine, tableware and kitchenware items constitute about 17 percent of total imports. Next import item of significance is computers worth an approximate Nu. 4.8 million (about 7 percent of total imports). Medicine worth Nu.0.9 million was also imported in 2001. Other items include processed food, soya bean oil, furniture and items of personal effects.

Bhutan's trade with Nepal

Bhutan exports only limited items to Nepal, worth Nu. 41.5 million in 2001. Out of the total exports, coal alone constituted about 97 percent. Other items include gypsum, hand-made paper and paperboard. On the other hand, the list of imported items from Nepal is quite long. Out of a total value of Nu. 15 million imports in 2001, majority items were processed food, toiletries and garments. The import of washing soap alone was worth Nu.

2.1 million (about 14 percent of the total). Another important item of import from Nepal is copper wire, valued at 2.6 million in 2001.

Bhutan's trade with rest of the world

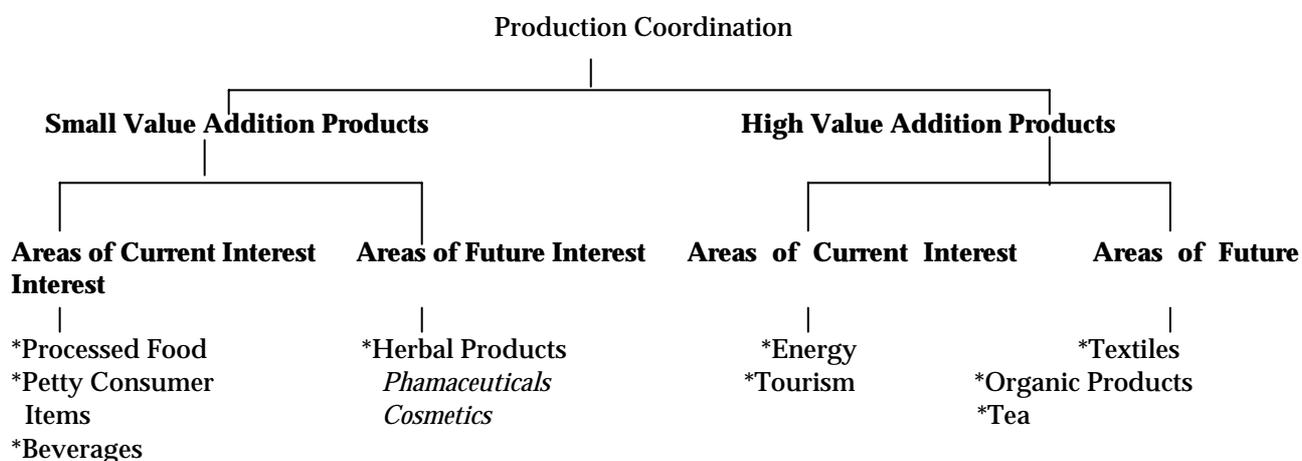
Bhutan's exports outside the sub-region basically comprise vegetable fats and oil (about 63 percent of the total exports) and mineral products (about 23 percent). Other items include wood and wood products, textiles, and prepared and processed food. Imports from outside the sub-region are mostly machinery, appliances and electronic items, constituting about 84 percent of total imports. Other imports of significance include textiles, medicines and pharmaceuticals, goods of personal effects and prepared/processed food.

Outside of the South Asian Region, Bhutan has developed trade ties with Japan, Germany, United States, United Kingdom, Thailand, the Netherlands and Singapore. Trade has also taken place with Italy, South Korea, Belgium, Austria, Taiwan, Greece, France, Canada, New Zealand, Ireland and China, but not on a regular basis; it takes place on an 'as and when required' basis.

3.2 Bhutan's advantageous areas

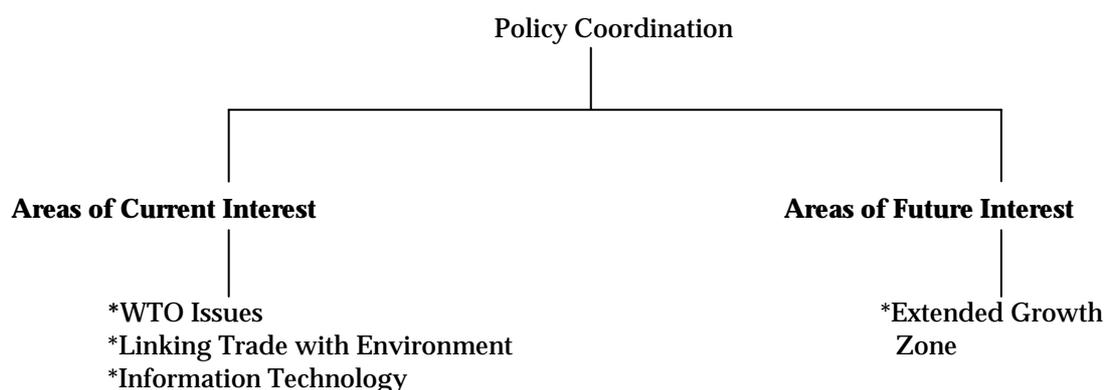
Bhutan has comparative advantage in certain areas like hydropower, tourism potential, textiles and herb-based pharmaceuticals among others. However, Bhutan lacks capital, technical expertise and technology in addition to the hurdle posed by its small domestic market. It can be contended that Bhutan explores the possibility of removing such hurdles through regional cooperation. For example, as mentioned earlier, the hurdle related to the size of market may be removed as regional integration intensifies. The readily available huge market in the neighbourhood also ensures a timely and reliable delivery of goods with minimum transit loss. Some of the areas of comparative advantage can be explored for market outside the sub-region, as they may not attract a big market within the region, e.g., organic agricultural products. The possible coordination areas for Bhutan are outlined in the following Charts 1 and 2.

Chart 1: Bhutan's Advantageous Production Areas for Future Coordination



Source: Charted out from *Bhutan 2020: A Vision for Peace, Prosperity and Happiness*, Planning Commission, Royal Government of Bhutan, Thimphu, 1999.

Chart 2: Bhutan's Advantageous Policy Areas for Future Coordination



Source: Charted out from *Bhutan 2020: A Vision for Peace, Prosperity and Happiness*, Planning Commission, Royal Government of Bhutan, Thimphu, 1999.

3.2.a Production Coordination

Processed food, petty consumer items and beverages

In the production of processed food, petty consumer items and beverages, Bhutan can establish inter-industry linkages with India. With further coordination on investment, technology and skilled manpower exchanges, production units can be established in the country. This will have the dual effect of reduced dependence on import, and enhanced export earnings. Production can be directed towards regional markets under free trade agreements. Bhutan's experience shows that a major new resource-based industry could be established within 24 months of cheap power becoming available (Planning Commission 1999: *Bhutan 2020*, p.57). This suggests that once a niche market is identified for such products, export is less likely to be affected by 'production-lag' resulting from long gestation period. This is a distinct advantage for Bhutan.

Herbal products

In the long run, Bhutan can explore the possibilities of herbal-based products. Such products can be cosmetics and pharmaceuticals. Several types of useful herbs grow in the Himalayan environment and the potential for trade in such herbs does exist (Aryal, 1993). Eastern Himalaya of Bhutan holds enormous possibilities in the export of medicinal and other herbs. It may be noted that Bhutan has an indigenous medicinal system, known as *So-Wa-Rigpa*, which is being promoted actively by the government. The service is offered through the indigenous hospital in Thimphu and 11 indigenous dispensaries spread all over the country (Planning Commission 2000: *Bhutan NHDR 2000*, p.27). This traditional medical system uses Himalayan herbs and flora of medicinal value. Such products can be standardized and explored for export possibilities. Similarly, herbal cosmetics have tremendous market in the sub-region and also in the west. With coordination on technical and financial issues, herbal products can bring about a prosperity-breakthrough for Bhutan.

Hydroelectricity

Among high-value addition products, Bhutan's market in hydroelectricity is already expanding. The demand for electricity in South Asia has been estimated to grow at the

rate of 6.7 percent per annum with increasing income and rural electrification (TERI 1997). As per Government of India estimates, the peak demand shortfall of electricity is nearly 30 percent, the most affected being the Northern region at 38.5 percent (Lama 1999). Therefore, electricity will continue to be the major area of advantage for Bhutan. Apprehensions over 'excessive' production of electricity in Bhutan and the resultant lack of demand in the future may be addressed by ensured demand from India, and the idea of commissioning a SAARC Grid that could expand the market into other neighbouring countries. The export through SAARC Grid can be deemed as direct export to third country, and such an idea if brought to reality will prove extremely beneficial for Bhutan. The United States Agency for International Development (USAID) recently started an energy program called the "South Asia Regional Initiatives/Energy" aimed at improving cross-boarder cooperation for energy, building up institutional capacity to promote energy development as well as encourage private sector participation in energy development (Wickramasinghe 2001).

Tourism

Of late, the discussion on ecotourism has come into sharp focus in Bhutan. Since 1974 tourism in Bhutan has followed a policy of cautious growth. The principle of "high value, low impact" tourism has enabled the country to earn a revenue totaling US\$10.5 million in 2000 as compared to US\$2 million received in 1990. The flow of international tourists increased from 1538 in 1990 to 7559 in 2000 (Department of Tourism 2002: *Bhutan National Ecotourism Strategy*, p.27).

The Royal Government has always been aware of the consequences of uncontrolled inflow of tourists in the country. In order to limit the number of tourists averaging roughly 3000 tourists every year by late 1980s, the tourist tariff was increased substantially in 1989. This resulted in a considerable decline in the tourists inflow (by almost 50 percent), though the total revenue suffered a set back of only 0.05 million. Three years later the inflow of tourists returned to the old level with revenue scaling high, amounting to 15-20 percent of the value of Bhutan's exports (Department of Tourism 2002: *BNES*, p.22). This is perhaps a reflection of the combined effects of increased promotion and facilities as well as a higher willingness-to-pay on the part of the tourists.

Today the tourism sector stands as the third largest revenue earner in the country. Its potential as a major source of revenue earnings for the government, employment provision, private sector growth and as a tool for development is very high. Such a perception of tourism has developed over a considerable period of time. While the Seventh Five Year Plan (1991-1997) discussed tourism in a limited fashion, the focus during the Eighth Five Year Plan (1997-2002) has been more on 'high value-low impact' tourism, and necessary reviews and changes in the tourism tariff structure. The Ninth Five Year Plan (2002-2007) has fully recognized tourism as major sector of the economy:

The potential of tourism as a high growth sector and as a revenue earner and employer is well recognized. Gross earnings and revenue is targeted to increase by 15 percent per year. By the end of 2006, tourist arrivals should reach the 15,000 mark and the gross earnings should be in excess of US\$21 million and revenue from royalties should cross US\$8 million (p.151).

It is projected in the vision document *Bhutan 2020* that by the end of the 10th FYP (2012), tourism must constitute 25 percent of the country's GDP. Bhutan has chosen to build a

more substantial eco-tourism industry and increase economic gains from this. Under the “quantity vs. quality” issue, Bhutan has adopted the approach of setting a fee (a percent of the daily \$200 per person fee - currently \$65 during peak seasons or \$55 during low season), that raises the total cost curve in an effort to achieve what has been described as “equilibrium” number of tourists. However, this has been fixed only on an experimental basis to see whether the cost is great enough to limit tourism to the socially optimum level. It is clearly recognized that a market-study of the tourism potential to obtain better estimates of “willingness to pay” to visit Bhutan would be in the country’s best interests (Ministry of Agriculture 2002: *Biodiversity Action Plan for Bhutan*, p.208).

Tourists from SAARC countries visiting Bhutan are exempted the daily US \$200 per person charge. Tourists from the region are mostly holidaymakers from India with a few arrivals from Bangladesh and Nepal. A steady flow of tourists from SAARC countries can be a great source of private sector sustenance in Bhutan.

Textiles, organic products and tea

Estimates suggest that beyond 2005, the world trade will increase by about US \$200-300 billion per year solely on account of what the Uruguay Round has achieved through tariff reductions and liberalizing trade in agriculture and textiles and garments. About 90 percent of this increase is due to agriculture, the remaining 10 percent to textiles and garments (*The Economic Times*, 8 August 1994). Bhutan can explore possibilities in the field of Organic Agricultural Products (OAPs) for which the international market has expanded tremendously, especially in the developed countries (UN 2001). With chemical-intensive commercial farming yet to gain ground, Bhutan’s natural soil conditions provide enormous opportunity to use the heritage of ancient wisdom towards the production of OAPs.

Textile and garments production can be a possible area of advantage for Bhutan. However, Bhutan has very little experience in textiles and garments production especially oriented towards exports. With the withdrawal of the MFA quota system, India and other countries in the sub-region are likely to see tremendous boom in textiles and garments production. Bhutan can try and establish inter-industry linkages in textiles and garments production for exports with ethnic and fusion designs.

So far, tea production in Bhutan has hardly been given serious thought. Presumably however, Bhutan would have very conducive climatic and geographical conditions for the production of good quality tea. The eastern boarder areas adjoining Bhutan, Assam, West Bengal and other parts of northeast India produce tremendous amount of tea. With similar agro-climatic conditions in many parts of Bhutan, tea production can be a source of high value addition in the country.

3.2.b Policy coordination

WTO issues and linking trade with environment

Coordinating with other SAARC countries on WTO issues would be beneficial for Bhutan by following guidelines towards preparation for WTO membership. With the emergence of the G-21 plus group at the WTO meeting in Cancun, it is all the more important for

South Asian countries to work together on issues of common interest. This will increase Bhutan's negotiating capability in the WTO when such needs arise.

Bhutan's experience suggests that an adaptation to achieve 'green goals' like sustainable development has not proved incompatible with the objective of attaining a high standard of living through trade. Nevertheless, a lot of ground is yet to be covered, especially towards self-sufficiency, economic diversification, modernization, social sector and equity. In its pursuit to achieve these goals, trade will continue to play a vital role. With environmental concerns becoming more pressing and gradually gaining ground, the issue of linking trade with environment will be of utmost significance for Bhutan. It can serve the twin objectives of raising exports earning and facilitating effective environmental management (for details see Pankaj 2002 and 2003). Bhutan can seek expertise in its own development of eco-labeling and initiate the process of producing SPS compliant products. Since Bhutan has already obtained *codex* membership, it can closely follow the developments and make arrangements for its compliance. In the beginning, a minimum possible compliance can be followed and then be strengthened gradually. For example, the latest 26th meeting of *Codex Alimentarius* has adopted 50 new safety measures and quality standards related to the risks to consumers from foods derived from biotechnology, including GMFs and irradiated products. This covers an assessment of DNA-modified plants such as maize, soya, potatoes and DNA-modified micro-organisms, including cheese, yoghurt and beer. Most of these products bear significance for Bhutan from the point of view of exports under the new possibilities. A close look at the outcome and the method suggested at this meeting should help in developing a compliance process in the country.

Information technology

The development of information technology is extremely crucial for Bhutan. Limited as it is, this has already helped overcome some of the geographical constraints in the country, resulting in considerable integration of the whole nation. Bhutanese economy recently witnessed the introduction of computers and the Internet, and has developed an IT master plan in its efforts to modernize. Bhutanese society is well on its way in experiencing tremendous benefits such as better productivity and income enhancement. However, at the same time, the impacts have also been felt on the changing facets of everyday life with cultural implications. Related issues like 'digital divide' (see RGOB 2000: *Development Towards Gross National Happiness*, pp.72-73; *Kuensel*, Editorial 9 June 2001) and 'exclusion' (Pankaj 2001) are being discussed and considered. Today, Bhutan finds itself at the crossroads of technological advancement cultural integrity. However, as a society with minimum initial differences in technological sophistication and social pattern, Bhutan stands a better chance at coping with the transition. Still, a proper 'management of transition' will be a task ahead. The bottom line is that Bhutan must take advantage of the information technology boom in the sub-region through intensive cooperation and integration.

Extended growth zone

Bhutan is already extending its growth zone to include Thailand and Myanmar by joining the Bangladesh-India-Myanmar-Sri Lanka-Thailand Economic Cooperation (BIMST-EC). Bhutan's trade relationship with Thailand is well established. For Bhutanese people,

Thailand is also a sort of gateway to the west. As part of future strategy, it would not be a bad idea for Bhutan to establish an extended growth zone and seek freer trade.

China's accession to WTO

One of the important events resulting from the Fourth Ministerial Meeting of WTO at Doha in November 2001 was China's accession to the WTO. This news evoked discussion on whether Chinese accession would affect the export competitiveness of South Asian countries. Amidst the expression of mixed opinions, some claim that it would definitely be tough for South Asian countries to compete with China in the international market once it receives the MFN status. The competition is likely to be centered over labour intensive and matured technology goods such as textiles and garments, leather goods, light engineering products, chemicals and pharmaceuticals and many more. Even before its accession, China had always presented tough competition to South Asian countries. Therefore, China joining the WTO would further strengthen Chinese competitiveness and possibly affect South Asian exports adversely. However, with China becoming a new source of growth in terms of exports possibility, better investment prospects and ideas cannot be ruled out (Agarwal 2001).

With Bhutan's own accession to WTO and subsequent extension of MFN with China, the door for new avenues in investment and trade could open up for Bhutan. The establishment of trade relations with China will have tremendous economic and social impact if direct routes are opened through the Himalayan passes. Trade via Nepal and India might result in increased competition, especially for Indian exporters to Bhutan; on the other hand, such arrangements may not manifest if the payment for Chinese imports is to be made in convertible currencies (Wangyel 2003).

Nepal's accession to WTO

Nepal's accession to WTO is of particular significance to Bhutan. The two countries enjoy similar geographical entities such as being mountainous and forested with abundant water resources. Both are mountainous and full of forests and water resources. With many areas of common and interests and concerns, Nepal can serve as a good example and provide guidelines for Bhutan to consider while preparing for accession. These common concerns can relate to issues in agriculture, farmers' rights, bio-diversity conservation, trade and environment, trade negotiations, tariff binding, investment and other development related issues.

Further, Bhutan is a net exporter to Nepal. Bhutan's average annual export of goods to Nepal comes to about Nu. 25-30 million. With MFN treatment, it might go up further. Bhutan will have the opportunity to explore new areas of cooperation, investment and trade with Nepal. Within the SAARC forum, this ideal development can contribute towards a definite move from SAPTA to SAFTA and strengthen the regional grouping.

Chapter 4. ECONOMIC AND POLITICAL RELATIONS BETWEEN BHUTAN AND INDIA

4.1 A Historical Background on Indo-Bhutan Relations

Bhutan's closest friend is its southern neighbour India. The two countries enjoy a special relation that extends far beyond geography to deep-rooted religious, cultural, historical and economic ties. Friendship encompasses these wide range of areas and issues of common interests. Viewed in the broader context of many changes transforming the world, the Bhutan-India relationship is a model of partnership and cooperation worthy of emulation. The foundation of this unique relation was laid by the Late King His Majesty Jigme Dorji Wangchuck and Indian Prime Minister Pandit Jawaharlal Nehru on the basis of mutual trust, friendship and neighbourly cooperation. This personal relation between the two leaders has fostered strong ties of friendship between the two countries and its people. Over twelve hundred years ago in 747 AD, the great India saint Padmasambhava came to Central Bhutan to make a truce between Bhutanese and Indian warring kings; more than bringing peace, Padmasambhava brought Buddhism to Bhutan. The state visit by the Late King to India in 1954 and consequent visit to Bhutan by Jawaharlal Nehru four years later were no less important events in the kingdom's history, for these visits are landmark events in Bhutan-India friendship and co-operation, and in building a durable foundation of friendship on the basis of trust and confidence, which continues to be nurtured and strengthened by successive leaders of the two countries.

4.1.a Bhutan's relations with British India

Bhutan's first contact with India in the realm of political relations was through the British East India Company in 1773. British interference in what Bhutan considered as political right on Cooch Behar affairs shaped its relation with the British, and later with independent India. The first Anglo-Bhutanese war of 1773 resulted in the Treaty of Peace between the Honourable English East India Company and the "Deb Raja" of Bhutan on 25 April 1774. The Company began to take interest in Bhutan as a gateway for British trade with Tibet, and consequently sent many missions to extend and explore frontiers of knowledge and trade routes to Central Asia. The period of hostility between 1837-64 with the Company and later with the British Empire started after Bhutan came into direct contact with the British after its annexation of Assam in 1829. The hostility led to the Duar War in 1865, and its direct result was the Treaty of Sinchula, 1965 where Article 2 "agreed that the whole of the tract known as the Eighteen Doars ...is ceded by the Bhootan Government to the British Government forever." Article 4 provides that "In consideration of the cession by the Bhootan Government of the territories specified in Article 2 of this Treaty...the British Government agreed to make an annual allowance to the Government of Bhootan of a sum not exceeding fifty-thousand rupees." This treaty institutionalized the relation between the two countries for the first time, and provided a basis for future relations. British India was set as an arbitrator for Bhutan's relations with Sikkim and Cooch Behar.

The events surrounding the Younghusband Mission to Tibet in 1903-05 and the signing of the Treaty of Punakha, 1910 set the main principle for Bhutan's foreign relations at that time. While Bhutan maintained a policy of isolation, geopolitical factors drew the influence of British India in the conduct of Bhutan's foreign policy. China's invasion of Tibet (1910-12) and subsequent claims made on Bhutan resulted in the signing of the

Treaty of Punakha in 1910. It was in fact a revision of the Treaty of Sinchula, meant to deter any Chinese interest in Bhutan. Article 4 provided for an increase in the annual allowance to one hundred thousand rupees, and Article 8 was revised as, "The British Government undertakes to exercise no interference in the internal administration of Bhutan. On its part, the Bhutanese Government agrees to be guided by the advice of the British Government in regards to its external relations." Although Bhutan has always been an independent country, at that time it remained a kind of a loose British dependency for practical and political purposes. While the Treaty of Sinchula was considered an unequal and forced treaty, the Treaty of Punakha was more balanced in spite of according the British as its advisor on external matters. Relations with British India were at its best following the Younghusband Expedition in which the first king, then the Trongsa Penlop, Ugyen Wangchuck played an important role. Following the establishment of the monarchy in 1907 however, British India became the "only potentially complicating factor" in the conduct of its external affairs.

4.1.b Relations with Independent India

As the Treaty of Punakha did not define Bhutan's status technically or legally, and the British did not realize the necessity for Bhutan's external relations so long as the country remained isolated and inward-looking, there was some uncertainty over Bhutan's relation with India during the time that British rule in India was coming to an end. However, Bhutan's separate identity was affirmed after it submitted a memorandum to the British Cabinet Mission in 1946.

Following its independence in 1947, the Government of India signed 'standstill agreement' with Sikkim, Nepal and Tibet to continue existing relations until new agreements were signed. Bhutan's own status became clearer when Nehru invited Bhutan to participate in the Asian Relations Conference in 1947 – the first international conference that Bhutan participated in. The Bhutanese delegation went to India in as far as 1948 to negotiate a fresh treaty although the negotiation for a new Indo-Bhutan Treaty started only in the summer of 1949. Bhutan's main objectives were to reaffirm India's recognition of its independence and for the restoration of Dewangiri in south-eastern Bhutan ceded to British India under the Treaty of Sinchula; on India's part, it surrendered the 32 km territory of Dewangiri (Deothang) to remove any fear of India's alleged imperialistic designs, and to prevent Bhutan from looking north. Bhutan did not sign the 1949 treaty under any diplomatic or political compulsion.

The Indo-Bhutan Treaty of 1949 forms the basis for formal relations between the two countries. The ten-article treaty provides for, among others, "peace and friendship", "free trade and commerce", between the two countries and "the government of India agrees to grant the Government of Bhutan every facility for the carriage, by land and water, of its produce throughout the territory of the Government of India, ..." Article 2 states that, "The Government of India undertakes to exercise no interference in the internal administration of Bhutan. On its part the Government of Bhutan agrees to be guided by the advice of the Government of India in regard to its external relations." The article is significant in providing the main framework for Indo-Bhutan relation and in conducting Bhutan's foreign relations. It requires Bhutan (in theory or principle) to seek India's advice in external matters, while India pledges non-interference in Bhutan's internal affairs. Another important provision is Article 3 where "the Government of India agrees to make

an annual payment of Rupees five lakhs to the Government of Bhutan" "in place of the compensation granted" by the British Government "under Article 4 of the Treaty of Sinchula, and enhanced by the treaty of Punakha (1910) and a temporary subsidy of Rupees one lakh per annum granted in 1942". This was in acknowledgment of the Bhutanese territories forcefully occupied by British India. The Indian word *Maharaja* was substituted with the Bhutanese word *Druk Gyalpo* to distinguish Bhutan from the princely Indian states.

Two months after the signing of the Indo-Bhutan Treaty, the People's Republic of China was proclaimed on 1 October 1949. A year later in 1950, the People's Liberation Army (PLA) entered Tibet to what it called 'liberate' Tibet and defend China's frontiers; China disputed the McMahon border line with India. This development changed the geo-political scene not only in Bhutan but also in the entire Himalayan region and Indian sub-continent. Tibet's fate was a warning to Bhutan that an isolationist policy could cost it its independence. The country was forced to re-evaluate this traditional policy of isolation, and the need to develop its lines of communications with India became an urgent necessity. As a consequence Bhutan moved closer to India and the process of modernization began with the acceptance of India's assistance in its development programmes.

From India's perspective, its own security required stability in the entire Himalayan neighbourhood comprising Nepal, Sikkim, Bhutan and its north-eastern states. India being in a defensive position vis-à-vis China on the Himalayan states, it was important that areas within its strategic interest did not fall under foreign powers.

4.2 Diversification of Bhutan's Foreign Relations

Following Prime Minister Nehru's visit to Bhutan in 1958 and the late king His Majesty Jigme Dorji Wangchuck's visit to India in 1961, Indo-Bhutan relations began to take on concrete form. In Nehru's public statement in Paro, India recognized Bhutan's independence and sovereignty. For India, Bhutan was an increasingly important element in India's strategic interests. Border tensions between India and China escalated into military conflict in 1962, and India could not afford Bhutan to be a weak buffer state or "extended frontier" with China. For Bhutan, the event of 1959 in Tibet, presence of Chinese troops near Bhutan's border, annexation of Bhutanese enclaves in Tibet and continuous Chinese claims on Bhutan all led to serious concern over its state of self-imposed isolation. Economic development assistance was the main topic of the discussion with Prime Minister Nehru in 1958. After a visit to India by Bhutan's Prime Minister Jigme Palden Dorji, an agreement was reached for giving both technical and financial assistance to Bhutan.

The Late King first discussed Bhutan's UN membership with the Indian External Affairs Minister Dinesh Singh in July 1966, and asked India to sponsor its membership. The discussions on Bhutan's UN membership were also held in the National Assembly in 1966 and 1967. After the signing of the 1949 treaty, Bhutan wanted to project its independence and sovereignty to the global community, and UN membership was seen as the best means to achieve this important national goal. In 1971 India sponsored Bhutan's application for UN membership for consideration before the Security Council and General Assembly session. Bhutan had initial worries over Article 2 of the 1949 treaty, which

theoretically gave India control over Bhutan's external relations; however, India lobbied for clearance and Bhutan's official position was that India's advice and guidance was not mandatory, and that any decision would fully in its own hands. Discussions in Bhutan's National Assembly maintained that Bhutan had a right to establish direct relations with other countries while conducting these relations with India's guidance. With the sponsorship of Bhutan as a sovereign independent nation to the UN membership, India and Bhutan demonstrated that Article 2 was neither a restricting factor in the exercise of Bhutan's foreign policy nor a source of consternation to either side.

Meanwhile, formal bilateral relations between India and Bhutan had been established in January 1968 with the appointment of a special officer of GOI to Bhutan. The India House was inaugurated on May 14, 1968 and Resident representatives were exchanged on 17 May 1971. Ambassadorial level relations began with the upgrading of the residents to embassies on 8 August 1978.

Bhutan slowly adopted a policy of a cautious expansion of its relation with the outside world while simultaneously accommodating India's regional and security interests. After the integration of Tibet with China (1950) and Sikkim with India (1976), Bhutan explored multilateralism and international bilateralism. Bhutan became a member of the Colombo Plan in 1962 and the Universal Postal Union in 1966. The establishment of missions in UN Mission in New York and India, and the contacts with increasing number of countries led to the formation of a Ministry of Foreign Affairs in 1972. As a Least Developed Country, Bhutan's foreign policy centered on exploring diversification of development assistance and promotion of her independence and sovereignty. In addition to Indian assistance, aid flowed from Australia, New Zealand and Japan through the Colombo Plan, and some bilateral assistance from Switzerland and UNDP in 1973. In 1980s, Bhutan diversified its relations with other countries including Switzerland, Denmark, EEC, Norway, Netherlands (1985), Kuwait, Japan, and Finland (1986), South Korea (1987), Austria (1989), Thailand (1991), Bahrain (1992), consulate in Hong Kong and Singapore (1982), consulate in Macaw (1985). Bhutan's membership in various UN agencies like FAO, IDA, and IMF in 1981 was ensued by its membership in the UN, followed by regional association in SAARC in 1985. To date, Bhutan has bilateral relations with 22 countries.

4.3 Indo-Bhutan Cooperation

4.3.a Development Assistance and Projects

With the inception of Bhutan's planned development in 1961, Indian assistance began to flow into the country and the volume has increased steadily over the years from Rs. 107 million in the First FYP to Rs. 9000 million in the Eight FYP. India wholly financed the first two FYP, during which the Indian Border Roads Organization started road construction in the first FYP (1962-66); public works, education, agriculture and health were the main focus of the second plan (1966-71). Although Bhutan's source of foreign aid has significantly diversified since it joined the UN, Indian assistance accounted for about 41 percent of total external outlay during the 8th FYP period (1997-2002) and India continues to be the major donor of external aid to Bhutan today. Over the last four decades, Indian assistance has been mainly in the social sectors such as education and human resource development, health, hydropower development, agriculture, and roads. Besides such planned assistance, Bhutan has been receiving partial or full grant assistance from the

Indian government and economic relations have gradually evolved with cooperation extending towards mutually beneficial projects such as in hydropower development and industrial projects.

These projects continue to be taken up outside of the Five-Year Plan programmes, and the construction of these projects are carried out by awarding major works to Indian companies, and smaller works to Bhutanese contractors. Some of the important projects invested in under GOI-RGOB cooperation are the Chhukha (336 MW), Kurichhu (60MW) and Tala (1020MW) Hydro Power Projects; the Penden, and Dungsam Cement Projects; and the Paro Airport Project.

Chhukha hydropower project, which was commissioned in 1988, was the first mega-project undertaken with a 60 percent grant and 40 percent loan of the total completion cost of Nu.2470 million; during 2001/2002 an interest of NU 29.6 million was paid along with principal repayments of Nu 87.6 million, bringing down the Rupee debt service ratio marginally from 2.3 to 2.2 for the period under review⁷. Currently more than 70 percent of power generated is exported to India and the Chhukha Hydro Power Corporation earns about Nu. 1400 million each year from power sales to India.

Following the success of this project, work on the Tala Project began in 1997 with 60 percent grant and 40 percent loan at an estimated cost of Nu. 14080 million which is now envisaged at a revised amount of Nu. 37250; its expected date of completion is June 30, 2005. It is by far the largest project under GOI assistance. This project has contributed towards the generation of business and employment for the people in the towns of Gedu, Wangkha, Tala and Sinchekha; the project itself has financed many public services such as roads, hospitals, schools and water treatment facilities.

Meanwhile, the Kurichhu project has been commissioned in two phases following construction that began in 1995 with 60 percent grant and 40 percent loan; of a total cost of Nu. 5600 million, Nu. 5263 million was awarded to the main contractor, National Hydro Power Corporation of India. Since November 2001 with the start of commercial operations on phase I, the project has been exporting power at a per unit tariff of Nu. 1.75 to the Damodar Valley Project in West Bengal, the West Bengal Electricity Board, and the State of Jarkhand.

Most recently in September 2003, a Memorandum of Understanding regarding the preparation of a detailed project report for the proposed 870 MW Puna Tsangchhu hydropower project has been signed between the governments of Bhutan and India. Under this MOU, a detailed feasibility study of the project will be carried out by a Government of India undertaking, M/s WAPCOS (Water and Power Consultancy Services). Currently, the Indian market for electricity is huge and faces domestic supply difficulties. With almost 90 percent of electricity presently generated in Bhutan being exported to India, Bhutan supplies less than 0.5 % of its total demand⁸. While all hydropower projects in Bhutan are fully government-owned, it is apparent that for as long as construction of these plants continue the manufacturing industry, Bhutanese and

⁷ RMA Annual Report 2001/2002.

⁸ Bhutan Private Sector Survey, June 14 2002.

Indian contractors and other businesses will thrive on the opportunities created by the projects.

Similarly, the Paro Airport Project was completed at a cost of Nu. 23 crores with grant assistance from the Government of India. This included the renovation of the airport complex and construction of a new terminal building; the latter was inaugurated on 10th April 1999 by the External Affairs Minister of India Mr. Jaswant Singh. In the cases of the Penden and Dungsum Cement Projects, the Indian government committed 100 percent grant financing. The Penden Cement project was constructed at a cost of Nu.. 142 million and began production in 1982 with a capacity of 300 tonnes a day. Besides meeting the domestic demand for cement, it exports surplus to neighbouring states in India. The Dungsum Cement Project is projected to produce 500,000 tonnes per year and estimated to cost Nu. 4000 million including infrastructure works on the Indian side. However, security risks in the area have stalled the implementation of the Project.

4.3.b Economic Relations

Until 1958 Bhutan's major trade link was with Tibet. In the absence of proper transportation infrastructure like road links, fixed routes via passes and valleys were used. For example, Paro's trade followed the low pass of Termo La, while the merchants of Punakha travelled up the valley of the Mo Chu to Lingshi La on their journey to Gyantse and Shigatse (Karan 1990, p.110). Traders of eastern Bhutan mostly followed the Lhodrak River. The exports of Bhutanese merchants were mainly rice, silk fabrics, vegetable dyes and brass utensils, while the items of imports from Tibet were salt, wool and precious metals.

The first recorded Indo-Bhutanese trade link was established in the post-turmoil period of Cooch Behar annexation by Bhutan and the subsequent peace initiatives, which culminated into the Anglo-Bhutanese Treaty of 1774. This Treaty made it possible for the Bhutanese traders to visit Bengal to sell and buy goods; this can be considered a rudimentary form of export-import reported between Bhutan and India. The main items sold by Bhutanese traders in Bengal included china silk, cowtails, tungun ponies, wax, walnuts, musk, lac, madder, coarse blankets, silver, and stripped woolen cloth. From Bengal, Bhutanese back took indigo, cloves, cardamom, nukher, camphor, sugar, broadcloth, copper, goat-skins, endy and coarse cloth, sandalwood, dried fish and tobacco back home (Hasrat 1980, p.83). However, for this trade to take place Bhutanese traders had to pay Rs. 2000 at Rangpur. This can be read as a case of lump sum excise on trade.

The British also established trade relations with Bhutan through the 19th century treaty with Tibet, which opened the Indian trade post at Yatung and it was through Chumbi valley in Tibet that the traders from India could approach western Bhutan. However, the trade routes between Bhutan and Tibet were finally closed in 1960, as mentioned earlier, and by this time Bhutan had already entered into development partnership with India by virtue of the Treaty of 1949. This helped in redirecting Bhutan's trade towards India. With the construction of lateral roads linking the Bengal-Assam plains to Phuentsholing, and Phuentsholing to Thimphu and Paro in 1962, a new era in Bhutan's foreign trade commenced.

Trade Flow and Composition

As presented in Table 16 Bhutan's trade with India is extremely important. Over the period of 1981-2001, Bhutan's exports to India accounted for on average 86.5 percent of its exports, while imports from India accounted for an average 79 percent of the total imports. The significance of trade with India seems to have increased over time. The sub-period averages indicate that while exports to India accounted for an average 74.3 percent of total exports during the 1980s, the ratio increased to 91 percent during the 1990s and 94.4 percent during 2000-01. However, the average proportion of imports from India to total imports seems to have gone down from 87 percent during the 1980s to 71.5 percent during the 1990s, and then increased to 78.4 percent during 2000-01.

The growth rates of exports to India and imports from India seem to have fluctuated a great deal (Figure 6). On average, during 1981-2001, the growth rates of exports (13.8) seem slightly higher than the growth rates of imports (11.3). This is true for the two sub-periods of the 1980s and 1990s. During the 1980s, the average growth rate of exports of 23.3 was much higher than the average growth of 10.1 perceived for imports. Similarly for the 1990s, the average growth rate of exports was recorded at 18 percent while imports grew at an average rate of 14.5 percent. It was in the year 2000 that a deceleration in exports was reported, to be recovered once again in 2001. During 2000-01, import growth rate has been consistently higher than the export growth rate.

Figure 6



Table 16: Volume and Growth Rates of Trade Flow between Bhutan and India
(In Nu. Million)

Year	Exports to India			Imports from India		
	Total Value	% of Total Exports	Annual Growth Rate (%)	Total Value	% of Total Import	Annual Growth Rate (%)
1981	166.2	95.5	--	520.60	100.0	--
1982	157.0	96.8	5.5	546.5	100.0	5.0
1983	157.2	95.4	0.1	600.6	100.0	9.9
1984	200.0	98.0	2.7	725.0	100.0	20.7
1985	270.0	99.4	35.0	800.0	86.7	10.3
1986	380.1	99.8	40.8	814.0	68.8	1.7
1987	702.4	99.2	84.8	899.7	80.3	10.5
1988	989.8	95.0	40.9	1,108.9	62.5	23.2
1989	985.9	87.1	-0.04	1,214.8	82.9	9.5
1981-89	445.4	74.3	23.3	803.3	86.8	10.1
1990	1011.3	84.8	2.6	1,143.0	100.0	-5.9
1991	1338.0	90.5	32.3	1,651.5	75.2	4.4
1992	1455.8	83.7	8.8	1,745.4	52.6	5.7
1993	1786.0	89.7	22.7	1,930.3	70.3	10.6
1994	1945.8	93.4	8.9	2,051.3	71.3	6.3
1995	3078.9	91.9	58.2	2,630.2	72.2	28.2
1996	3227.0	90.8	4.8	2,896.2	64.0	10.1
1997	4041.9	94.6	25.2	3,453.6	69.4	19.2
1998	4175.6	93.7	3.3	3620.9	65.6	4.8
1999	4711.2	94.4	12.8	5845.3	74.6	61.4
1990-99	2677.1	90.7	18.0	2696.8	71.5	14.5
2000	4376.9	94.8	-7.1	6231.3	79.1	6.6
2001	4700.5	94.1	7.4	6988.8	77.7	12.1
2000-01	4538.7	94.4	0.1	6610.0	78.4	9.3
1981-01	2553.7	86.5	13.8	3370.0	78.9	11.3

Source: i. *Statistical Yearbook*, CSO, Ministry of Planning, Thimphu, various issues. ii. *Foreign Trade Statistics of Bhutan*, various issues.

An examination of Table 17 suggests that Bhutan's exports are no longer confined to traditional, agricultural and forest based products. According to the value of items in 1999 and 2001 and their percentage share in total exports to India, the top listed items are electricity, mineral products, product of chemical industries, base metals and products and wood & wood products. Table 18 shows Bhutan's electricity exports to India and its proportion to the rest of the exports. Though the share of electricity exports in total exports comes to about 43 percent, its ratio to rest of exports seems to have gone up. The ratio of electricity exports to other exports to India has gone up from about 23 percent in 1996 to 43 percent in 1999. This shows that hydropower generation is still the most important area of comparative advantage, and with the existing bilateral ties with India on its production and sales, Bhutan will continue to depend largely on this source of export earnings.

However, it can also be seen that there has been significant improvements in the field of manufacturing and mining. The linkage effect of investment in hydropower has been able to generate comparative advantage in the development of natural resource based industries, basically directed towards India and other countries in the neighbourhood.

Bhutan imports a wide range of products from India. According to the percentage share of items in total imports to India, machinery, mechanical appliances, base metals and electronic items top the list. Import of foodstuff and other petty consumer items from India is quite significant.

Table 17: Trade Composition of Bhutan with India

(Value in Nu. Million)

Sl. No	Items	1993		2001		Percentage share to total in 2001	
		Export	Import	Export	Import	Export	Import
1.	Cereals, live animals and animal products	0.01	54.16	0.02	270.61	0.0	3.9
2.	Vegetables, fruits, nuts, coffee, tea & spices	139.72	254.96	279.93	555.63	5.9	7.9
3.	Vegetable fats & oil	0.01	78.49	0.00	200.99	0.0	2.9
4.	Alcoholic bev., prepared/processed food stuffs	135.78	154.59	218.49	503.80	4.6	7.2
5.	Mineral product	267.67	283.46	2682.43	1512.67	57.1	21.6
6.	Electricity	537.3	0.00	--	0.00	--	0.0
7.	Plastic and rubber product	6.17	83.37	55.50	157.65	1.2	2.2
8.	Raw hide & skin	1.74	3.23	2.52	5.19	0.0	0.1
9.	Wood and wood product	328.68	40.98	241.36	148.47	5.1	2.1
10.	Wood pulp products	0.17	59.80	0.96	151.40	0.0	2.2
11.	Textiles	0.16	80.58	0.98	168.67	0.0	2.4
12.	Footwear, headgear & clothing accessories	0.01	28.91	0.00	49.73	0.0	0.7
13.	Stone plaster, cement and asbestos products	1.70	83.79	14.17	145.44	0.3	2.1
14.	Base metal & products	0.88	0.1	595.11	969.20	12.7	13.9
15.	Machinery & Mechanical appliances	0.29	406.74	0.09	1014.02	0.0	14.5
16.	Transporting equipment	0.02	132.41	0.42	454.93	0.0	6.5
17.	Optical, photographic and measuring equipment	0.00	14.67	0.00	87.88	0.0	1.2
18.	Misc. manufactures articles, others	0.13	22.04	19.44	77.66	0.4	1.1
19.	Products of chemical industries	365.55	147.91	589.01	514.80	12.5	7.4
Total		1785.98	1930.33	4700.47	6988.78	100.0	100.0

Source: i. *Selected Economic Indicators*, September 2001, Royal Monetary Authority; ii. *Bhutan Trade Statistics*, March 2003, Ministry of Finance.

Table 18: Ratio of Bhutan's Electricity Export to Total Export to India

	Export of Electricity (Nu. Million)	Export of Rest of Items (Nu. Million)	Ratio of Electricity Export to Total Exports
1996	747.6	3227.0	0.2317
1997	1288.1	4041.9	0.3187
1998	1338.8	4175.6	0.3206
1999	2019.1	4711.2	0.4286

Source: *Selected Economic Indicators*, September 2001, Royal Monetary Authority.

Investment Relations and informal trade

Although not typically considered investment but rather as assistance in the form of concessional grants and loans, the Government of India's increasing contribution towards the afore-mentioned projects in Bhutan's hydropower and industrial projects is

fundamental to the growth of investment opportunities in the country. As seen already, Indian involvement extends into many areas of Bhutan's private and public sector activities. In the area of Foreign Direct Investment, Bhutan has so far pursued a conservative policy. In fact, the first and only foreign investor in Bhutan for almost two decades since 1971 was the State Bank of India in collaboration with the Bank of Bhutan.

(i) Bank of Bhutan and State Bank of India²

The Bank of Bhutan is the oldest and largest financial institution in the country, established on May 28 in 1986. As the desired level of its development was initially hindered owing to the non-convertibility of Bhutan's local currency, "Tikchung," a team of banking experts from India and representatives from RGOB studied the situation and recommended collaboration between the State Bank of India and the Bank of Bhutan in 1971. Based on the banking expertise available, presence of vast branch network within India and overseas, tax-free earnings on Rupee Investments, at par remittance facilities, and access to well-established in-house training facilities for BOB staff, the SBI was identified as partner in management and share holding in the capital of BOB. As such, the bank was reconstituted under the Royal Charter of Bank of Bhutan 1972 inducting the State Bank of India as a partner in the capital and management of BOB (SBI held 40% of the bank's shares, while the RGOB held 60%). A new agreement on June 27, 1997 extended the collaboration period to December 31, 2001 after which date, the management of the bank was handed over to the Bhutanese. As of December 2000, the bank's capital stood at Nu. 100 million, and its reserve fund at Nu. 407.4 million.

Based on this relationship between the State Bank of India and the Bank of Bhutan, BOB has invested Rupee deposits of 1.167 billion in Term deposits with the branches of SBI at Kolkata, Alipur Duar and Hasimara. BOB also maintains current accounts with the following branches of SBI for realizing their collection proceeds from various places in India: Hasimara - Main Account; Kolkata; Alipur Duar; Birpara; Bongaigaon; and Rangiya. The balances held in these accounts are minimum. BOB monitors Rupee drawings and payments through the SBI Hasimara branch for reconciliation purposes. Further, for the conveniences of its clients, BOB maintains small balances in current accounts with the Siliguri branch of Centurion Bank Ltd., Siliguri branch of Unit Trust of India Bank, Kolkata branch of Standard Chartered Bank, and Kolkata branch of American Express Bank. BOB's collaboration with SBI was last renewed on January 1, 2002 for a period of up to December 31, 2006. The current share holding stands at 80:20. Presently, the bank has 25 branches and two extension-counters covering 20 *dzongkhag* within Bhutan.

(ii) The Private Sector

The private sector in Bhutan is dominated by small enterprises, small-scale production and service industries including trading. By the end of year 2000, the government had issued over 9000 industrial licenses, 12,000 trading licenses, and 124 registered companies operating in power intensive industries, light manufacturing industries, mining & processing, sawmill & wood processing, and service industries. Indian nationals are especially active traders and service providers throughout the Himalayan region; in Bhutan too, a sizeable number of licenses have been issued to them by the Ministry of

² Appreciation and acknowledgment are due to Ms. Bimla Gurung, Dy. Manager at BOB Phuentsholing for providing the information in this section.

Trade and Industry. As of date, there are 347 business licenses held by Indians operating a range of small-scale trading activities.

Table 19

Region	Indians holding Trade License in Bhutan
Thimphu	3
Chhukha/Phuentsholing	141
Samtse	18
Sarpang/Gelephug	127
Samdrup Jongkhar	58
Total	347

Source: Ministry of Trade and Industry, November 2003

These businesses include shops trading in a variety of products ranging from grocery to auto parts, furniture, and scrap dealing as well as distribution/dealership agencies. Of these, grocery shops, general shops, cloth shops, hardware and electrical shops, and *pan* shops (small shops especially selling betel nut, cigarettes, and other small consumer items) show dominance in the market, catering to daily and basic needs of customers.

Table 20: Industrial Licenses Issued to Indian Nationals

#	Categories of Activity	Th	Pa	Ha	PL	Sm	GP	Ts	TG	SJ	Total by category
1	Bakery					1	1				2
2	Bar/Restaurant/Hotel				7		4			3	15
3	Hotel						9			2	11
4	Restaurant	1				3	5			4	13
5	Cloth/Tailoring			1	11	2	9			4	27
6	Cobbler	6	1		7		2		1		17
7	Contract						2				2
8	Electrical contract; sales & services	2					1				3
9	Goldsmith				2	1	1				4
10	Goods transport				4					1	5
11	Laundry				1	1	4			1	7
12	Photo studio				1		2			2	5
13	Photo studio; radio/watch sales & services				2						2
14	Quilt Making	1					1				2
15	Radio/electrical/watch sales & services				1						1
16	Rice mill						1				1
17	Saloon	6	2		9	3	7	1	1	2	31
18	Umbrella repairs				2						2
19	Watch repair/sales & services				2		1				3
Total no. of license		16	3	1	49	11	50	1	2	19	152

Source: Ministry of Trade and Industry, November 2003.

Abbreviations - Th: Thimphu; Pa: Paro; Ha: Haa; PL: Phuentsholing/Chhukha; Sm: Samtse; GP: Gelephug/Sarbang; Ts: Tsirang; TG: Tashigang; SJ: Samdrup Jongkhar

Since 1960, a total of 152 industrial licenses have been issued to Indians with most of these having being issued between 1970 and 1990. The table below shows the number of licenses issued in various *dzongkhag* according to their broad categories of activity. As

evident from this data, Indians in Bhutan have focused on the provision of services with the bulk of it being in hotels/restaurants, saloons, tailoring and cobbler services. As will be explained shortly, these establishments are concentrated in the southern border towns.

In addition to the above, Indian investment in Bhutan also exists in the form of more noted companies which are either solely Indian or in partnership with Bhutanese counterparts. The list of companies provided in Table 21 represents Indian engagement in manufacturing and processing, construction, service, engineering, steel and electronic industries, and consultancy.

Table 21: Indian Companies/Joint Venture in Bhutan

#	Company
1.	AFCONS Infrastructure Ltd.
2.	Bhutan Engineering & Builders Ltd.
3.	B.H.E.L.
4.	B.S.E.S. Ltd.
5.	Bhutan Beverages Company Ltd.
6.	Bhutan Information Institute Tech.
7.	Bhattacharjee Mech. Engineering
8.	Conveyor & Ropeway Services
9.	Damodar Ropeways & Construction
10.	Drangchu Beverages
11.	Druk Hotel
12.	Encardio-Rite Electronics
13.	Gammon India Ltd.
14.	Hindustan Construction Company
15.	Jaiprakash Industries Ltd.
16.	Johnson Controls
17.	Larsen & Tourbro Ltd.
18.	M/S Development Consultant Pvt. Ltd.
19.	M/S Kolli Construction
20.	M/S Rites
21.	National Hydro Power Corporation
22.	Om Metal & Minerals Ltd.
23.	Prem Power Construction
24.	RPG Transmission Ltd.
25.	Steel Works & Power Engineer
26.	Steelage Industries Ltd.
27.	Technico India Pvt. Ltd.
28.	Techno Trade Ltd.
29.	Texmaco Ltd.
30.	W.A.P.C.O.S.

Source: Ministry of Home and Cultural Affairs, August 2002.

Companies such as the Jaiprakash industries and the NHPC have come into Bhutan to carry out major works for the Tala and Kurichhu Power Projects respectively. Similarly, many other Indian as well as Bhutanese companies (or joint ventures) stand to benefit from the requirements of massive power projects and manufacturing industries.

In light of an already thriving trade and investment relation between the two countries, as well as the proximity, one may anticipate that since the coming of the FDI policy, the major investors in Bhutan could well be Indian companies. India's role figures into the FDI-related proposal for *export processing of imported agricultural raw materials* under the agriculture-processing sector. This proposal is "firmly focused on the Indian market",

meaning that the companies most likely to profit from such activities will be those already established in the Indian market and see investment in Bhutan as a lower-cost alternative for servicing their existing market.⁹ As for information technology and profitable ventures related to it, it is essential that FDI take place in this area; while Indian skills will always present competition in the region, India itself can be a major contributor to this sector in Bhutan.

(iii) Informal trade

Much of the informal trade between India and Bhutan are not illegal economic activities (i.e. those unregulated by the government) but more of extra-legal trading. Such extra-legal trading is tolerated in practice although illegal in the letter of the law. Informal trading enterprises would be those that are unregistered and unlicensed, and not recorded by the government. Such trade is tolerated partly because of the difficult terrain and geographical location of the country, where there are areas that are virtually difficult to approach. There is no in-depth study available on the level of informal trade between the two countries; however, one suggestion is that informal trade is mostly in the form of exports from India to Bhutan (Rao, Baruah and Das 1997). It is estimated that in 1993-94, India's informal exports to Bhutan was to the tune of US \$ 31.3 million, while it imported goods through informal channels worth US \$ 1.2 million. Therefore, informal trade balance was exceedingly in favour of India, with exports exceeding imports by a margin of US \$ 30.1 million. It can be seen that while India had a trade surplus with Bhutan on the official account it had a trade surplus of a much larger magnitude on the unofficial trade account. Unofficial exports to Bhutan consist mainly of yarn, rice, sugar and aluminum goods (Taneja 2001, p.961).

It is common knowledge that there are a number of disguised Indian investments through indigenous fronts, using the licenses of Bhutanese nationals. The following table presents the number of business licenses suspected of fronting under different regions; however, this is only an estimate and the actual figures could be much more since such practices are supposed to be discouraged by regulation.

Table 22: Licenses Suspected of Fronting

Region	No. of Licenses
Gelephu	21
Phuentsholing	101
Samdrup Jongkhar	27
Total	149

Source: Ministry of Trade and Industry compilation, November 2003.

The prevalence of small-scale Indian investment as well as business fronting is understandably concentrated in southern Bhutan owing to proximity of bordering Indian towns. In the case of Phuentsholing, which appears to harbour the largest number of "fronts", there is a greater degree of stability as compared to the security-affected areas of the Gelephu and Samdrup Jongkhar areas. Phuentsholing is also the centre of commercial hub in the country from where the exit and entry of goods as well as travelers largely takes place; the Indian town Jaigon under Jaipalguri district is "just across the fence" where tailor-made goods suited to Bhutanese needs are especially stocked. Although

⁹ MTI, BCCI, UNDP & World Bank's collaborative report on *Bhutan Private Sector Survey*, June 14 2002. pp 82.

statistics are not available, it is apparent that the business community in Jaigon has prospered, most probably in large part owing to the level of trading activities with Bhutanese businessmen and other customers.

Without any systematic study on the flow, pattern and factors governing such informal trade between the two countries, it would be premature to come to any kind of conclusion. However, *prima facie*, the existence of a large flow of such trade, especially in mass consumer goods, cannot be ruled out. Even fluctuations in the prices of essential food items in Bhutan seem to hold some explanation in terms of informal inflow of commodities (Pankaj 1998), sometimes able to balance the internal demand and sometimes not. The question here is—what factors govern informal trade between India and Bhutan? Further, what policy changes can bring informal trade flow into the formal domain? While it would be difficult to answer these questions without a proper study, it can be presumed that factors related to high tariffs, non-tariff barriers, rules of origin, domestic policies related to taxes etc., transaction costs arising from multiplicity of rules, regulations, stringent administrative procedure, poor infrastructure facilities, lack of institutional support, and high transportation costs resulting from inadequate transport and transit system etc., could be held responsible for the existence of informal trade. Presumably, even the Bodo-Ulfa-KLO militancy influx in Bhutan may have had its impact on the volume and pattern of informal trade between India and Bhutan. A careful consideration of this issue can benefit Bhutan as well as India by bringing informal trade into the formal channel. This calls for a well-researched study on this issue.

Labour Relations

Bhutan is a labour deficit country and has to depend on other countries, particularly India, for its requirement of semi-skilled and unskilled labour especially in mining, agro-based industries and hydro power projects. This traditional dependence on Indian labour and the recent growth of Bhutanese labour have cultural, economic and political implications on Indo-Bhutan relations.

The dependence on Indian labour began soon after economic modernization plans began with the assistance of Government of India in 1960-61. Works on the first road connecting Phuntsholing near the Indian border in southern Bhutan to Thimphu and Paro began in January 1960. In 15 months, 10, 000 people working at one time constructed 145 kms road.

The road construction project definitely required diversion of Bhutanese labour force from their farms. The Bhutanese state devised an ingenious system of labour contribution where able Bhutanese were grouped in numbers of 6 and later 12 locally known as *drudom* and *chunidom* respectively. From the group, one person went to work for a certain period of time and was then replaced by another member after six months or so. Sometimes, the same person would continue to work without being replaced, in which case, his provision would have to be supplied by the person for whom he was working.

While these arrangements ensured steady supply of Bhutanese labour force, the lack of experience and skills in road construction as well as technical skills and equipment brought in Indian laborers and personnel in large numbers. They were mainly recruited from the neighbouring Indian states of Assam and West Bengal. This was a mutually beneficial undertaking. While Indian labourers found employment on Bhutanese roads,

Bhutanese labourers were spared the sole brunt of undertaking the construction works. Thus, the Indian labourers first came to Bhutan to assist in road constructions.

Public road maintenance was entrusted mainly to Project Dantak, undertaken by GREF, an organization of the Indian Border Roads Organization. These two organizations have retained many Indian labourers on Bhutanese roads and even today, Dantak recruits its labourers directly without having to consult with the Division of Immigration; it only submits a monthly report. At any given time, Dantak has today, on average, 2000 Indian labourers working on roads in different parts of Bhutan¹⁰. The number of these labourers would have been more were it not for the establishment of a National Work Force in the later half of 1980s when landless Bhutanese were recruited to work on roads and other government construction sites.

After the fourth five-year plan (1976-81), priorities shifted particularly towards sectors in trade and industry. As mining, agro-based and other industries were being set up, labour forces moved away from the agriculture sector by various pull and push factors. The Labour Force Survey of 1998 and 1999 conducted by the Central Statistical Organization of the Planning Commission indicates labour force distribution in different sectors as indicated in the following table.

Table 23: Labour Force Distribution in Different Sectors

Sectors	1998 (%)	1999 (%)
Agriculture	76.0	74.9
Mfg. Industry	5.5	4.6
Service	9.4	11.7
Trade and Commerce	5.6	3.9
Transport	1.2	1.1
Others	2.2	3.8

Source: *Labour Force Survey*, Central Statistical Organization, 2000.

The figure shows that the size of the farming community has declined approximately by 20% since modernization began. A decrease of almost 1.1% in a year, i.e. from 1998-1999 suggests the sudden and increasing trend of decline in agriculture labour force. By 2000, in the country as a whole, there were 12,592 people employed in the manufacturing and mining industry, which is approximately 2% of the population. Some 5,127 people or 0.08% of the population were employed in the private sector by 1999. (Kinga: 2002)

But the actual number of labourers in these sectors is more. Bhutanese labourers working in these sectors are a recent phenomenon. In the initial period, Indian labourers were recruited owing to their availability especially since most of the industries were located in border towns. The number of Indian labourers in most manufacturing and mining industries is considerable.

For example, the Bhutan Carbide and Chemicals Ltd. (BCCL) in Phuntsholing employs 37 Indians of which 22 are in managerial positions including the top post of General Manager. The rest includes skilled blue-collar workers such as plumbers, foremen and welders. Then there are 78 seasonal workers employed for calcium carbide breaking,

¹⁰ Rinzin Dorji, Joint Director, Immigration Division, Interview, November 21, 2003.

packing, staking, loading and unloading of raw materials. Again, there are additional 26 Indians employed on muster roll basis. The Indians employed in this company thus totals 141.

In 2002, the Druk Satair Corporation Ltd. employed 311 Indian day workers of which 246 were women in the stone crusher at its dump yard. At the Bhutan Fruit Products Ltd. based in Samtse, there are eight permanent workers including a chief executive and four managers for different units. In addition, day workers are also employed in numbers differing for different units. In addition, day workers are also employed in numbers differing between peak and off-seasons; the approximate number of workers is as follows:

Table 24: Day Workers in Bhutan Fruit Products Ltd.

	Peak season	Off season
Male	45-50	20-25
Female	130-150	100-110

Source: Bhutan Fruit Products Ltd., November 2003.

The construction of major hydropower projects beginning with Chukha Hydro Power Corporation (CHPC) brought on a significant increase in the number of Indian labourers in Bhutan. The construction of Kurichhu Power Project employed hundreds of Indians in various capacities. The project encompasses several Indian agencies such as National Hydroelectric Power Corporation Ltd. (NHPC), Water and Power Consultancy Services (W.A.P.C.O.S.) and Bharat Heavy Electricals Ltd. (BHE). A total of 13 major agencies and many smaller contractors were employed. Categorized into executives, non-executives, skilled and semi-skilled labourers, the project employed 1354 Indians in 1998, 3048 in 1999, 8024 in 2000, 7355 in 2001, 1418 in 2002 and only 129 in 2003. The number of Indians in 1999, 2000 and 2001 was much higher since most of the agencies were active during these years with construction activities at their peak. Most skilled and semi-skilled workers left after the commissioning of the Kurichhu Hydropower Project in 2002. As of 2003, only four agencies are operating.

Although lack of data makes it difficult to ascertain the number of Indian labourers recruited during the construction of Chukha Hydro Power Corporation, it can be estimated that the figure would have been much more than that of the Kuricchu project considering the differences in their size and capacity. It is known, however, that CHPC employed only 155 Indians in 2001, 89 in 2002 and 68 in 2003, excluding contract employees and muster roll employees totaling less than 20.

The development of a formal education system in Bhutan was initiated after 1955, and by 1959, there were only 440 students studying in about 11 primary schools. It was a few decades before the first generation of Bhutanese educated in modern schools entered the civil service. As such, when modernization first began, many Indians were recruited to man administrative and development programmes. There were many Indian teachers, administrators, accounts personnel, and engineers in different sectors. While Bhutanese trained in modern education system in various fields increasingly replaced Indian expatriates, many continue to serve in both public corporations and civil service today.

Table 25: Non-nationals Working in Public Corporations, Bhutan, 2002

Agency	Non-national			
	Regular	Contract	Deputation	Total
Bhutan Agro Industries Ltd.	0	0	0	0
Bank of Bhutan	53	0	0	53
Bhutan Development Finance corporation	0	0	0	0
Bhutan National Bank	0	0	0	0
Bhutan Post	2	4	0	6
Bhutan Telecom	0	2	0	2
Chukha Hydro Power Corporation	97	3	0	100
Druk Air	11	34	0	45
Druk Seed Corporation	0	1	0	1
Food Corporation of Bhutan	2	2	0	4
Forestry Development Corporation	1	5	0	6
Handicrafts Development Corporation	0	1	0	1
Kuensel Corporation	0	1	0	1
Kurichu Hydro Power Corporation	3	3	19	25
National Pension & Provident Fund	2	1	0	3
Penden Cement Authority Ltd.	48	21	0	69
Royal Insurance Corporation of Bhutan	4	5	0	9
Royal Monetary Authority of Bhutan	1	0	0	1
State Trading Corporation of Bhutan	10	2	0	12
Tala Hydroelectric Project Authority	31	227	89	347
Army Welfare Project	14	2	0	16
Bhutan Broadcasting Service	2	1	0	3
Wood Craft Center		1	0	1
Bhutan Ferro Alloys Ltd.	1	28	0	29
Total	282	344	108	734

Source: Ministry of Labour and Human Resources, 2002.

In 2002, there were a total of 11,499 Indians working in 30 Indian companies undertaking joint ventures in Bhutan. There were also 734 Indians working in 24 different public corporations. Tala Hydroelectric Project Authority (THPA) employs the highest with 347 persons followed by Chukha Hydro Power Corporation (CHPC) and Penden Cement Authority Ltd. (PCAL). The details of these workers are reflected in the table above.

In the civil service, Indians number 871 of which 128 are regular employees and 743 contract employees. Nearly 84% of them are teachers in Bhutanese schools. In 2001, the total number of Indians working in different capacities exceeded 69,000 people of which 37,587 are regular employees:

There are currently 37,587 non-Bhutanese workers in the country with regular work permits, about 10,000 to 20,000 non-national day-workers and 1,900 seasonal workers granted permits for mining and other work during the winter months in southern Bhutan. (Kinga: 2002)

By August 2002, the total number of regular Indian employees was 35,607 with 15,119 skilled workers heading the list. In May 2003, the number was down to 32,776. They are of course not concentrated in any one place but spread out in all the *dzongkhag*. They work for government, semi-government, private, international and military organizations.

Table 26: Non-nationals in the Civil service, Bhutan, 2002

Occupation	Total	Regular	Contract
Engineer	14	12	2
Doctor	14	2	12
Teacher	730	24	706
Officer Manager	14	9	5
Finance Officer	5	3	2
Accountant	24	16	8
Nurse	7	5	2
Technician	4	4	
Electrician	8	8	
Clerk	7	7	
Office Assistant	11	10	1
Mechanic	3	3	
Driver	13	12	1
Welder	1	1	
Machine Operator	3	2	1
Carpenter	3	2	1
Mason	6	5	1
Plumber	2	2	
Cook	1	1	
Cleaner	1		1
Total	871	128	743

Source: Ministry of Labour and Human Resources, 2002.

As shown in the following table, Chhukha Dzongkhag has the maximum Indian labourers owing to two major power projects, especially Tala Hydroelectric Project and industries located in and around the commercial town of Phuntsholing and Pasakha. A large number also work in Thimphu, mostly in private organizations.

On average, the number of Indians in any *dzongkhag* is 1617. But this does not hold true for Gasa, which has a minimum of 42 Indians because there are no major projects of any kind owing to its remoteness and inaccessibility.

In all the *dzongkhag*, Indians number highest in private organizations followed by semi-government and governmental organizations. Again, there are approximately 200 illegal Indians working as maids, servants and performing other manual jobs in Thimphu.

Table 27: Details of Indian Employees, Dependents, Drivers and Labourers, May 2003

ORGANISATIONS	DRIVERS										Total	
	Dzongkhag	Govt.	Semi Govt.	Pvt.	Inter	Army	Govt.	Semi Govt.	Pvt.	Inter		Army
Bumthang	26	0	361	2	0	0	0	0	0	0	0	389
Chukha	180	1001	14163	2	0	19	11	334	0	0	0	15710
Dagana	14	0	93	0	0	0	0	0	0	0	0	107
Gasa	0	0	42	0	0	0	0	0	0	0	0	42
Haa	24	1	214	0	0	0	0	1	0	0	0	240
Lhuntse	20	0	219	0	0	0	0	0	0	0	0	239
Monggar	240	146	450	0	0	2	6	6	0	0	0	850
Paro	56	2	1840	5	0	0	0	0	0	0	0	1903
Pema Gatshel	35	0	74	0	0	0	0	0	0	0	0	109
Punakha	45	0	518	0	0	0	0	1	0	0	0	564
S/Jongkhar	92	4	441	0	7	2	0	1	0	0	0	547
Samtse	70	481	417	0	12	1	4	1	0	0	0	986
Sarpang	105	0	304	0	3	2	0	1	0	0	0	415
Thimphu	278	63	6165	84	65	3	0	13	0	0	0	6671
Trashigang	174	0	292	0	1	2	0	0	0	0	0	469
Trashi Yangste	22	0	119	0	0	0	0	0	0	0	0	141
Trongsa	25	0	442	0	0	0	0	0	0	0	0	467
Tsirang	21	0	89	0	0	0	0	0	0	0	0	110
Wangdue	41	1	1893	0	11	0	0	0	0	0	0	1946
Zhemgang	119	0	308	0	0	2	0	0	0	0	0	429
Sub Total	1587	1699	28444	93	99	33	21	358	0	0	0	32334
CWC												213
GSI												229
Grand Total	1587	1699	28444	93	99	33	21	358	0	0	0	32776

Source: Ministry of Labour and Human Resources, 2002.

It was the official policy of the Royal Government from 1994 to 2000 that at any given time the ceiling of Indian labourers in Bhutan would be 30,000 including day workers. In 2000, this ceiling was raised by 15,000 so that major power projects like Tala, Kurichhu and Basochhu would be able to recruit labourers to their requirement. Upon completion of the major projects, the ceiling is due to fall back to 30,000.

The general ceiling for private dwelling construction is five labourers; for other construction and for mining, it is set at 25% of the total workforce required; there is no ceiling for the civil service. Besides, an auto workshop is given four skilled workers; a sawmill is given two sawyers; and a furniture workshop is given two carpenters.

From road-workers to teachers, medical personnel, engineers, accountants, and administrators, India's labour contribution to Bhutan has been invaluable. However, the mutual benefit conferred by the presence of Indian labourers in Bhutanese economy is reaching a turning point. The introduction of modern education and its successes have helped to gradually replace Indian expatriates in various professions. With more than 4000 students graduate from educational institutions every year, and the annual outflow of students projected to increase to 14,000 by 2010, it is estimated that more than 90,000 students would enter the labour market in the first decade of the 21st century. Although

unemployment rate in 1999 was a negligible 1.4%, this enormous estimate of students entering the labour market has direct bearing upon Indian labourers in the country. Where formal sector employment is about 60,000 and Indians account for 50%, the compulsions to provide employment to graduating Bhutanese students have made it necessary for measures to be taken to make these jobs available to Bhutanese:

The Council of Ministers had decided to reduce the number of non-Bhutanese labourers by 50% in 2000 and by 75% on December 31, 2001. ...For example, mining firms will be allowed 75% of the labour requirement for the 2001-2002 season, 50% for 2002-2003 and 25% for 2003-2004. (Kinga: 2002)

The former Minister of Health and Education, and the present Minister of Labour and Employment have signed memorandums of understanding with major private companies in the country to employ Bhutanese. The government has also instructed firms to reduce the level of non-national employment.

Initially, replacement of Indians began in higher echelons of administration, management and technical expertise. Of late, with employment opportunities in the public sector approaching a saturation point, coupled with a large number of school graduates and dropouts seeking employment, their gradual replacement of Indians even at the lower levels of labour hierarchy can be anticipated.

Replacing Indian workers imply higher costs for Bhutanese employers and even lower productivity. According to the private sector survey, one of the biggest problems faced by Bhutanese private firms is the lack of skilled labour. While Bhutanese school graduates are increasingly available, they do not match the skill requirements of the firms. Therefore, it might prove to be disadvantageous in terms of cost for Bhutanese firms not to access the low-cost and highly skilled workers for the time being. But pressures of youth unemployment may require compromises at certain point. Although the Royal Government decided that it would recruit only skilled workers and technicians, and employers employing such workers are also required to employ Bhutanese as counterparts and train them, around 90% of foreign workers recruited for constructions and industries are unskilled.

In the final analysis, it can be inferred that the recruitment of Indian labourers to work in different aspects of Bhutanese economy has so far been mutually beneficial. The development activities and growth of Bhutanese economy is a source of direct employment for people in the Indian states of West Bengal and Assam particularly. At the same time, their availability spurred the growth of industries in Bhutan's border towns. This is advantageous in another way. Since the domestic market in terms of consumer is relatively small, the Indian market provides ready and closer access to Bhutanese products. This mutually beneficial arrangement has been a success so far. In the changing context of Bhutanese economy and global free trade, the benefits could still be mustered but it is difficult to think if it would be along similar lines.

4.3.c Other Areas of Cooperation

In addition to Indo-Bhutan cooperation in Bhutan's socio-economic development and other related sectors, there are several other areas of cooperation that continue to strengthen Indo-Bhutan relations. This includes bilateral civil aviation that dates back to 1983 when Druk Air, Bhutan's national airline, began commercial operations to India with flights from Paro to Calcutta and later from Paro to Delhi in 1988. Druk Air was granted Fifth Freedom Rights by India with the signing of an Air Services Agreement in September 1991, and these Rights were provided on concessional terms after the signing of a new commercial agreement in May 1998. In the same year, a GOI notification qualified Druk Air to avail of fuel at bonded rates, and the Indian Oil Company continues to provide its fuel supply. By 2000, Druk Air was granted permission to use Bagdogra as a diversionary airport for refueling, technical halts and during bad weather conditions. Recently, on 11th November 2003, Druk Air inaugurated flights on the Paro-Bodhgaya sector with permission from the Indian government's Department of Civil Aviation.

In the fields of education and culture too, India and Bhutan share a high level of interaction. Besides the availability of scholarships to Bhutanese students under GOI assistance for higher studies in India, there are significant numbers of Indian teachers many of whom are posted to teach in remote areas in Bhutan. Support from the Indian government and its affiliation to the Delhi University has helped Sherubtse College in Kanglung to develop into a premier institution for tertiary education in Bhutan.

Under the bilateral cultural exchange programme, there have been regular exchanges of cultural troupes and artists between the two countries. The government of India hosted a cultural exhibition on Bhutan titled "The Living Religious and Cultural Traditions of Bhutan" at New Delhi and Kolkata in October and December 2001. In response to this, and with the greater purpose of strengthening the ties of friendship and creating awareness among the people about the many areas of commonalities between the two countries, a six-month Festival of India was held in Bhutan from June to November 2003.

Besides everyday people-to-people contact at the informal level, there is a strong tradition of official visits between the two countries during which views are exchanged and often areas of cooperation are enhanced. Since 1971, His Majesty King Jigme Singye Wangchuck himself has made fourteen visits to India with the most recent one being in September 2003. Ministers and other officials make regular visits, and efforts continue to be made to boost exchange visits at various levels including parliamentarians.

In the international fora, Bhutan has not always voted a hundred percent in line with India but it has consistently supported India's position on most occasions and

significant issues. Some of these include issues of the CTBT, the establishment of Nuclear Weapons Free Zone in South Asia, India's aspirations to be a permanent member of the UN Security Council, India's candidature to various international bodies, negotiations in the WTO, and the importance of India in the success of SAARC.

4.3.d Issues of Concern

Although Bhutan and India share an extraordinary friendship, there are some issues that are of concern to both countries. These are mainly centered on the illegal presence of militants in Bhutan rebelling against the Indian government, the state of relations with China, and (more exclusively for Bhutan) the liberalization policies in India.

Illegal Presence of Militants

The illicit establishment of camps by groups of armed militants in the dense jungles of South-east Bhutan has been a matter of great security concern for Bhutan over the last decade. Their unwanted but continued presence on Bhutanese soil has not only posed potential threat to the friendly relations between Bhutan and India, but has also created problems for commercial activities of the business sector and affected implementation of development programmes in the country. The United Liberation Front of Assam (ULFA) militants are fighting for the independence of Assam, while the National Democratic Front of Bodos (NDFB) militants are fighting for an independent state of Bodoland. Recently, the Kamtapuri Liberation Organization (KLO), a tribal group spread across the state of West Bengal fighting for an independent state of Kamtapur, also established camps on Bhutanese territory.

It is observed by some that the militants started infiltrating into Bhutanese forests after the Indian army launched operations against the ULFA militants in 1990-91. It was easy for the militants to take advantage of the 266-kilometer porous, open Assam-Bhutan border since military posts at that time were mainly concentrated along the north bordering China, and the Bhutanese government was largely occupied with the rise of the problem in southern Bhutan. The presence of the militants inside the country came to the government's attention only in the mid '90s; by 1997, the gravity of the situation was realized and has since then been discussed extensively in the National Assembly.

The need for a peaceful resolution has been stressed repeatedly by the government in keeping with the fact that in spite of their actions, the militants are nonetheless citizens of India from the neighbouring states of Assam and West Bengal; besides consideration of the close ties between India and Bhutan, it is of special concern to the Bhutanese that this matter be solved peacefully without claim on precious lives, and without affecting Indo-Bhutan relations. The RGOB has always been aware of the consequences and after-effects of military action. The government issued that

besides the expected bloodshed and serious impediments to the socioeconomic development of the country, there would be direct consequences on the people in ten of the twenty *dzongkhag* in Bhutan since the militants either had camps or traveled through these areas. Also, trade and travel routes to these districts pass through the Indian territory of Assam; over the years, the concern has lingered that armed conflict with the militants posed every possibility of retaliation from their supporters in Assam. There had been several incidences of attack on Bhutanese civilians and army personnel in the recent past, and although those responsible for the acts have not been brought to light, the association of these events to the militant situation has been obvious.

In his report to the 81st session of the National Assembly in 2003, the home minister recalled that the Bhutanese government had held four rounds of talks with the ULFA; the third round of talks in June 2001 resulted in an agreement signed between the government and the militants, stipulating that the ULFA remove four of nine camps within December 2001 and reduce their cadres in the remaining five camps. By 31st December 2001, the ULFA had closed down four camps and the Bhutan army burnt down the vacated camps. However, these camps had all been relocated and by mid 2003, the ULFA had thirteen camps in Bhutan and an estimated 1560 militants.

The NDFB had twelve camps with an estimated 740 or more militants. Although the government held two rounds of meetings with NDFB leaders in October 2000 and May 2001, they did not make any commitments to leave Bhutan, and in the last two years had refused to come for talks.

The KLO was reported to have five camps in Bhutan with over 430 militants. In spite of the home ministry having sent correspondences to the KLO leaders twice, in June and September 2002, asking them to close down their camps and inviting a high-level delegation for discussions, talks could be held only with mid-level leaders of KLO with the RGOB having to send a delegation near their base.

While it had become increasingly apparent that the militants intended to stay on in Bhutanese territory until they achieved their own objectives, the Bhutanese government held one last round of talks with the militants in December 2003 as mandated by the 81st session of the National Assembly to urge them to leave peacefully. The Bhutanese government had hoped that it would not be pushed into exercising the military option, which it persevered to keep at bay by initiating attempts at peaceful solutions over the last six to seven years.

Given the lack of positive response and cooperation from the militants, it became necessary for the country to make all necessary preparations in the event of conflict. People all over the country were briefed in public meetings about the situation and

the king himself made frequent visits to the affected areas to meet the people personally. As recorded in the home minister's report to the National Assembly, "service facilities and installations were protected, a number of actions had been taken after three rounds of security coordination meetings in Gelephu, Samdrup Jongkhar and Gedu, the council of ministers had approved a contingency budget up to NU 2,000 million, two refugee camps and 12 transit camps were being prepared, 150 *risoop* had been appointed".

In addition, and important to the Bhutanese psyche, the clergy continued performing *kurim* for the well-being of the nation and people. The business community initially raised NU 103 million as contribution from the private sector, of which NU 8.8 million had been spent on *kurim* in all the *dzongkhag* for peace and stability in the country, and NU 94.92 million was offered to the king towards strengthening the country's security. Over weeks, many more initiatives were taken as a community by groups of people and organizations. In spite of a shortage of troops and officers, more than 4,800 soldiers and 161 officers of the security forces¹¹ were stationed from Diafam in the east to Samtse in the west¹². A nation-wide militia force of officers and troops totaling over 700 volunteers, were trained in two batches by September and December to support the armed forces and defend the security of the nation.

In December, with the talks with the ULFA and NDFB having failed, and the KLO not even responding, the Bhutanese government's repeated attempts at a peaceful solution to the situation came to an end.

On the morning of 15th December 2003, the Bhutanese army finally launched operations to flush out the militants. Even as security forces took over all thirty of the militants' camps into the second day of offensive, the combing process and the implications of the operations have brought forth the reality, that the long spell of peace and tranquility that has been the proud inheritance of the present Bhutanese generation can no longer be taken for granted.

Relations with China

As discussed earlier, Bhutan figures into India's security interests owing to its strategic location and the contentious state of Indo-China relations. As such, there may be implications brought on to Indo-Bhutan relations by future trends in Indo-China relations. Although it would be unrealistic to expect immediate normalization of Indo-China relations, the effort made towards this end is apparent in the confidence building measures that continue to be taken by both sides. These include meetings of the Joint Working Group (JWG) on the boundary issue, regular

¹¹ The Armed Forces are the Royal Bhutan Army, Royal Bhutan Police, and Royal Body Guards.

¹² Kuensel, May 17 2003. *The People must defend their country*.

exchange of high level visits, and agreements towards enhancing cooperation in areas of culture, trade, science and technology. It is highly probable that Indo-China relations could eventually normalize; consequently the degree to which strategic considerations influence India's policy towards Bhutan may diminish. These are possibilities that Bhutan needs to consider in its course of relations with the two giant neighbours. Bhutan has to consider the reality of China even as geo-political and geo-economic realities ensure that India will continue to be one of the most critical elements in Bhutan's foreign relations. Clearly, it will be a challenge for Bhutan to maintain friendly relations with China without undermining its own relations with India.

India's liberalization policies

Since the 1990s, economic liberalization in India has been on the rise. Consequently, Bhutan has suffered a gradual loss of its protected status in relation to trade with India. The downward movement in India's tariff structure indicates that Bhutanese industries could lose their market share in the increasingly open market in India unless they are able to remain competitive. As evident from the delay in disbursements in GOI project-tied assistance, Bhutan has already felt the impact of the reform in India's subsidy policies, which has resulted in a gradual phasing out of subsidies and a decrease in its budget for assistance to Bhutan. And as India gradually moves toward privatizing its power, petroleum and other traditional public sectors, Bhutan will have to take steps to be fully prepared for subsequent effects.

Chapter 5. BHUTAN'S PERSPECTIVES ON REGIONAL COOPERATION

5.1 Bhutan and SAARC

The South Asian Association for Regional Cooperation was formed in 1985. It is comprised of seven countries: Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. This association was formed with abiding objectives to create and enhance strong meaningful ties between the member countries to work towards promoting peace, economic prosperity, freedom and social justice in the region based on the principles of sovereign equality, territorial integrity, non-interference in internal affairs and political independence. His majesty the king of Bhutan welcomed the formation of SAARC as an epoch making event in the history of the South Asia.

Joining SAARC was politically significant for a small nation-state like Bhutan. Situated between two giant neighbours, Bhutan was compelled to extend its relations with countries other than India to consolidate its status as the sovereign nation that it has been historically. Opening itself to the rest of the world in the 1950's was another epoch making era of adopting new policies to strengthen Bhutan's relations with its neighbouring countries. It became members of several global and regional forums in addition to establishing diplomatic relationships with its neighbours. While Bhutan had bilateral relations with India and Bangladesh much before the SAARC was envisaged, relations with the other member countries followed later. As a member of SAARC, Bhutan has been able to diversify its trade link with South Asian countries while enhancing its status as an independent nation-state.

5.1.a A Historical Perspective: Bhutan's Accession to SAARC

The late 1950s witnessed Bhutan's growing suspicion of China; added to this the conflict between India and Pakistan exposed this small nation-state to an unsettling environment where the threats of territorial integration, internal destabilization and political crisis loomed large. When Sikkim was merged as a state of the Indian Union in 1974, Bhutan's desire to protect its identity as a sovereign Himalayan Buddhist Kingdom intensified. One of the steps that Bhutan took towards fulfilling this objective was to become a member of SAARC. Bhutan was convinced that joining this forum would counteract external threats while expanding its relation with neighbouring South Asian countries. Induced by its relatively low level of economic development, Bhutan saw immense prospect in expansion of its trade within the region and economic cooperation with the neighbouring countries.

The Soviet Union's intervention in Afghanistan in December 1979 and Mrs. Indira Gandhi's accession to power in 1980 caused concern and anxiety in the region. It caused even more concern to the United States, which immediately responded by sending its high level emissaries to India and Pakistan to convince the leaders to initiate regional approach to this new situation. The Bangladesh president Zia-ur

Raman took the bold initiative and addressed the formal letters to the heads of states of all seven countries on 2nd May 1980. He addressed in his letter the immediate need for regional cooperation to cope up with the changing situation in the region. Being a small nation with limited military strength and economic capacity, Bhutan welcomed the idea and gave a positive response. By some accounts, the concept of SAARC had also originated in the mind of the third king just prior to the 1971 Indo-Pak war, though in limited form. He visualized a triangular alliance of India, Bangladesh and Bhutan as starting point for regional cooperation extending to other countries in the coming years.¹³

The proposal to set up a regional organization came at a period of doubt and apprehension in the region, and Bhutan endorsed this proposal although India and Pakistan had initial reservations at the outset.

5.1.b Significance of SAARC to Bhutan

Bhutan joined SAARC seeing it as a forum for creating a climate of peace and cooperation in the region based on mutual understanding, trust and goodwill. Divergence in political and security perceptions, and sizes and economic situations of member countries presented some difficulties in achieving regional peace and cooperation right from the beginning. However, Bhutan has always anticipated that SAARC would serve its purpose to a certain extent because of the geographical homogeneity of its member countries.

The intensification of nuclear armament in the region is a concern to Bhutan and as a member country it proposed that SAARC should work on achieving nuclear disarmament in the region. Bhutan sees SAARC as a forum for smaller nations to stand in firm union to support various international bodies devoted to disarmament. For this country, good political relations between mighty and smaller nations and people to people contacts are vital to embark upon any redemption of the common problems.

Bhutan views regional economic cooperation as a viable alternative strategy to bring about collective economic self-reliance and mutual prosperity to uplift the poorer nations. As a landlocked country, Bhutan proposed the immense need to develop air links and telecommunication between the member states, to facilitate increased trade and joint economic ventures in harnessing the rich natural resources and manpower. The changing economic situation in the world has made Bhutan realize new challenges posed by major economies on smaller developing nations. SAARC is seen as a forum to enhance economic cooperation and bring about greater liberalization and privatization in nations with smaller economies.

¹³ Extracted from "From Dependency to Independence: A Study of Indo-Bhutan Relations", Manorama Kohli

As home to one fifth of mankind with nearly half of them living under poverty, environmental destruction has been another issue of great concern. High population density and abject poverty pose serious threat to the environment. Due to its small population and traditional outlook of nature, Bhutan has been able to preserve its environment better than some of its neighbouring countries. Attaching high importance to balance between development and conservation, Bhutan strongly maintains that nature conservation should not be specific to each country but extend beyond its borders. Apart from harnessing fast flowing Himalayan rivers as a source of energy and income through export of hydro electricity, it has committed to conserve these rivers. Keeping Bhutan's water free of pollution is considered important for countries like India and Bangladesh as well.

In the early 1990's, Bhutan was plagued with problems in its southern region. Although, it is an issue to be solved at the bilateral level, the leaders of the countries shared it at the SAARC forum keeping in view that challenges posed by poverty and economic migration, as well as acts of terrorism, in the region can be addressed only through collective efforts. As a regional organization, Bhutan relies on SAARC to create an atmosphere of mutual trust and understanding and appreciation of one another's problem to reduce the regional tension and enhance security and stability. It was for this reason that Bhutan ratified an agreement on collectively combating terrorism in the region.

Bhutan joined SAARC with hopes of attaining economic development through active collaboration and mutual assistance in unanimously chosen areas of economic, environmental, scientific and cultural fields. Functional approach of Bhutan to regional cooperation was based on the realization that national development objectives can be attained through collective regional efforts. The ultimate goal was however more political and strategic in nature. Bhutan realized that it was more important to enhance its internal stability while at the same time projecting itself as sovereign and independent nation.

The timely formation of SAARC was an additional thrust to Bhutan's gradual diversification of foreign policies and quest to consolidate its status as a sovereign nation. SAARC, with its principles to advocate non-interference in both internal and international affairs of the member nations enabled Bhutan to maintain multilateral diplomacy in the region.

As a small developing country, Bhutan has aimed at harmonising its economic policies at the regional level through SAARC. Bhutan used SAARC to fulfill its objective to promote trade balance with India and expand trade relations with other SAARC countries. Bhutan stressed to attain mutually beneficial economic co-operation in solving the problems of trade deficit, and debt management from the International Funding Institutions. In various SAARC forums, Bhutan encouraged

practical economic cooperation in the region. Recent dramatic changes in global economic and political environment gave Bhutan more impetus to support the launching of SAPTA. During the Ninth SAARC Summit held in Maldives in 1997, His majesty the king stated, "It took us almost a decade to sign the Agreement on SAPTA and take the first concrete step towards regional cooperation in the core economic areas. While other economic and regional groupings have seen expanded growth in their trading activities, South Asia has been lagging woefully behind the rest of the world". He stated, "... at a time when all SAARC countries are opening their markets to the outside world there is no justification that we should restrict trade and economic interactions among countries of our region". He encouraged the leaders to make commitment towards accelerating and establishing a free trade agreement in South Asia in order to enhance the well being of the South Asian people. Bhutan's support to establish SAPTA represents its willingness to integrate its economy with the region and derive maximum benefit to gear up its own economic development.

As one of the Least Developed Countries (LDCs) along with Maldives, Nepal and Bangladesh, Bhutan receives special preferences in the form of deeper tariff cuts. The guiding principles of SAPTA, which provides LDC members the special concessions and additional measures to train and enhance export capabilities are facilitators to Bhutan in its trade with India, Bangladesh and Nepal. In line with the principles, India has offered tariff concessions over 106 products in 1995, with even higher cuts to LDCs. Other supplementary measures such as upgrading and modernizing the region's infrastructure like seaports, airports, railways, roads, custom clearances and import trade financing facilities should prove useful to Bhutan to expand intra-SAARC trade. Expansion of Asian Clearing Union to Asian Payments Union, creation of export-import Banks and export trade risk insurance under the aegis of SAARC has helped Bhutan to alleviate bilateral balance of trade.

SAARC countries cooperate in aviation related areas like training personnel, airline security, improvement of communication facilities, and marketing and technical services. This can be beneficial for Bhutan's small airline, particularly in terms of use of regional training facilities and maintenance infrastructure belonging to larger airlines in the region.

Under the SAARC scholarship scheme, the Government of India offers one fellowship and two scholarships for meritorious Bhutanese nationals. Several educational institutes in Bhutan like Sherubtse College and the Royal Institute of Management are the members of the Association for Management Development Institutions (AMDISA), which is responsible for promotion of management education and training fostering management development activities in the South Asian Region.

5.1.c Bhutan's Role in SAARC

In the area of development, SAARC continued to make some progress. Bhutan played an active role in both socio-economic and cultural spheres. At the beginning, three meetings of foreign secretaries resulted in identification of some key areas of cooperation and preparation of the Integrated Programme of Action (IPA) in nine fields of nation building activities, namely postal services, telecommunications, rural development, transport, science and technology, health and population, agriculture, meteorology, and sports, arts and culture. While IPA was being launched, Bhutan signed the programme that aimed to promote national and regional self-reliance. It committed to contribute towards bettering the equality of life in the region. While identifying nine areas of cooperation, Bhutan was appointed the country coordinator for the working group of postal services. It also coordinated table tennis coaching training as a part of activities amenable to short-term cooperation. Bhutan was an enthusiastic participant in various SAARC cultural programmes and South Asian federation games. Bhutan Broadcasting Service has worked closely with SAVE (SAARC Audio Visual Exchange Programme) and organized a few radio programmes on various themes such as non-formal education, nature conservation and cultural preservation. In addition to regular exhibitions of handicrafts, Bhutan also organized mobile photographic exhibitions of monuments and natural heritage. Through such participation, Bhutan was able to come out of its self-imposed isolation and come into social contact with people of other member countries.

In one of the preparatory talks held in Thimphu in 1985 between all the foreign ministers of SAARC countries, the king pointed out that the region needed harmonious cooperation among its members. He urged the seven nations to forget their past differences and look into shaping the future on the basis of mutual trust and confidence on each other. During this meeting, the date for the first SAARC Summit in Dhaka was fixed and the draft of the first SAARC Charter was approved. It was during this meeting in Thimphu that SAARC was envisioned as a 'Regional Association'.

The creation of SAARC helped in mitigating and minimizing regional conflicts. Following nationwide riots and clashes between Tamils and Sinhalese, the LTTE or Liberation Tigers of Tamil Elam began its guerrilla campaign against the Sri Lankan government in 1983. In its quest to establish an independent Tamil state, the LTTE resorted to terrorist attacks against the government, military personnel and public infrastructure. There were differences between India and Sri Lanka over the issue of Tamil, somewhat obstructing the creation of SAARC. Bhutan offered a venue for peace talks between leaders of Sri Lanka and Tamil rebels in Thimphu in 1985. Although, this meeting did not solve ethnic issues in Sri Lanka, it gave Bhutan a sense of confidence in handling issues at the multilateral diplomacy level and generated goodwill.

Bhutan hosted the first SAARC seminar on forestry in 1987. The seminar recommended various fields of cooperation in research related to forestry. It also organized a seminar on wood-based handicrafts in 1995 where all the participants from the SAARC countries agreed on regional cooperation to promote the standard of living arts and craftsmanship in the region. Bhutan also organized several seminars and workshops related to agriculture. It always stressed on regional exchange of programmes to improve transfer of technology, human resources development and harnessing natural resources while also arguing that there should be food available for the poor countries in the region at reasonable prices.

In spite of a controlled tourist policy, Bhutan has looked favourably towards increasing the number of tourists from India and tour packages from other SAARC countries to promote regional tourism under SAARC. Bhutan Tourism Corporation provides special discounts and concessions to children and students under twenty-five from within the region. Travel agents in Bhutan allow regional tourists the use of their own currencies in Bhutan. There is also a special arrangement for travel vouchers through the Bank of Bhutan. Under the SAARC agreement, Druk Air provides a twenty-five percent discount to a group of ten or more tourists organized by Bhutan Tourism Corporation on round trips covering a minimum of two SAARC countries.

Bhutan served as the chairman of the Technical Committee on Rural Development and organized several meetings related to this field. It supported the SAFSR (South Asia Food Security Reserve), and following natural calamities and food crisis in the region, Bhutan contributed money and food grains to the affected countries. Bhutan has also been actively involved in programmes related to improving the condition of women in the region. It organized exhibitions on handicrafts involving SAARC participants, mainly to share the skills of rural women in the region. Bhutan proposed the South Asian Economic Order for SAARC and ratified the formation of SAPTA in 1994 fully appreciating it as positive move to solve economic challenges in the region. In order to advertise its products and strengthen economic ties with the member countries, Bhutan participated in various regional trade fairs. Bhutan proposed setting up a South Asian Development Fund to mobilize global surpluses towards developing South Asian countries. It strongly supported poverty alleviation programmes and decentralized approach to national programmes in SAARC countries.

5.1.d Overview of Bhutan in SAARC Today

While some may say that SAARC was a success story in one way, today a strong conviction holds that mutual cooperation among the SAARC countries is theoretical. South Asia has a greater desire for cooperation outside the region than within. Constant bilateral differences and conflicts between India and Pakistan continue to affect the regional cooperation within the context of SAARC. Smaller nations' quest

for peace is marred when the big powers are in constant strife. India is often seen as being dominant in the SAARC region.

Although SAARC has been able to bring about a regional identity, it has not been as effective in developing strong economic linkages among the member countries nor be of much influence in addressing political discord. For Bhutan, SAARC has been looked at for strategic and security objectives as well as socio-economic development. However, Bhutan still conducts its major trade with India alone. While Bhutan has presented the issue of its southern problem and the people in the refugee camps at the regional level, SAARC as a regional forum has not had much of a role in it. And although Bhutan supported the SAARC convention on the suppression of terrorism, the ways to address threats posed by Indian militants on Bhutanese soil is taken up as the responsibility of the Bhutanese alone.

Keeping aside some problems that remain unaddressed, Bhutan has been an active member of SAARC. It has strengthened Bhutan's national identity, spirit of regional friendship and economic development. It is not Bhutan's motive to align with any nation in the region but to broaden its relations in the spirit of trust and mutual benefit. Even as a small nation, Bhutan has many things to offer as well as gain from being a member of SAARC.

5.2 Bhutan's Relations With its Regional Neighbours

5.2.a Bangladesh

Bhutan has a long history of interactions with Bengal and other southern border areas. Annual caravan to Bengal formed the main trade with the south where Bhutanese bartered their goods. At the religious level, Bengal continues to inspire the Bhutanese through Drukpa Kagyu hierarchs like Tilopa and Naropa.

Bhutan was very sympathetic to Bangladesh's movement for independence. The Late King was very outspoken in his support, and he personally visited the refugee camp in Calcutta, and conveyed his sympathy to the helpless refugees in the camps. Immediately upon his return to the country, the king mobilized funds and donated Nu.7 lakhs toward relief funds for refugees. That sympathy was reflected on 7 December 1971 when Bhutan gave recognition to an independent Bangladesh and its government a day after India recognized it. This emergence of an independent country close to its border was a positive development for Bhutan.

Soon after, the Bhutanese foreign minister visited Bangladesh in 1972, and issued a communiqué announcing the establishment of diplomatic relations at embassy levels to concretize the similar views that the two countries shared. The heads of both countries' missions in New Delhi were accredited and designated as

ambassadors in 1973. His Majesty visited Dhaka in 1974 and discussed trade and economic co-operation for mutual benefits.

However, the missions could be upgraded to a full-fledged resident mission only in December 1979 because of the political instability following the assassination of Sheikh Mujibur Rahman. Besides India, Bangladesh is the only other country that Bhutan has diplomatic relations with at resident ambassadorial level.

In September 1980, a bilateral trade agreement was signed between Bhutan and Bangladesh. India agreed to the use of its transit facilities (rail and road) within India for trade between Bhutan and Bangladesh. Trade volume increased after Bhutan started exporting its surplus export to Bangladesh and other third countries, following a more liberal trade agreement with India in 1988. Additional trade exit points include Chittagong port from Bangladesh providing an important link for Bhutan's overseas trade. Trade agreement between the two countries allows concessions on duties on a wide range of products, under which all products from Bangladesh are granted duty free access in Bhutan, while Bhutanese exports are imposed 50% of normal duty in Bangladesh. Bangladesh became an alternative market for Bhutanese traders, and the largest export market for Bhutanese goods in terms of hard currency. Bhutanese fruits and primary products export to Bangladesh are worth an average of US \$ 5 million annually. Bhutan's major imports from Bangladesh include food items, medicine, urea fertilizers, newsprint, dry fish, cellophane, household utensils, ready-made garment and automobile and machine parts. Bhutanese exports constitute fresh fruits and dolomite.

In the late 1980s Bhutan started weekly air services to Dhaka. Dhaka granted the Royal Bhutan Airlines, Druk Air, Fifth Freedom Rights and 50% concession on handling charges. Bhutan has benefited in the field of human resource development through Bangladesh government scholarships in medicine, engineering and agriculture. His Majesty visited Bangladesh in 1984 and signed trade protocol agreements, and economic and cultural co-operation. During the visit of the Bangladesh President General Ershad to Thimphu in October 1988, the two countries agreed to co-operate in identifying and implementing appropriate flood control measures.

With Bhutanese students already pursuing higher studies in medicine, engineering and agriculture in Bangladesh following the visit made by a Bhutanese education delegation in 1980, the Agreement on Economic and Technical Co-operation was signed between the two governments in February 1984; subsequently the two countries agreed to promote a programme of development co-operation consisting of exchange of expert missions for co-operation projects and provide training facilities in institutions. Between 1980 and 1994, 34 Bhutanese students were accepted to study in Bangladesh; so far, about 25 students have completed their

studies in Bangladesh with scholarships from the Bangladeshi government. As of March 2003, there are 12 medical students - 4 on RGOB scholarship, 6 on WHO scholarship and 2 financed by DANIDA. Bhutanese students are allowed a waiver of US\$ 2000 for admission fee payable by foreign students.

Summing up, bilateral agreements signed between the two countries include the 1) Trade Agreement of 1980 and Protocol to the Trade Agreement in 1984. 2) Agreement of Economic and Technical Co-operation in 1984. 3) Air Services Agreement. 4) Agreement on Cultural Co-operation.

Besides these formal ties, relations between the two countries have benefited from, among others, Bhutan's enthusiastic response to the formation of SAARC as proposed by Bangladesh's former President Zia; the support extended to Bangladesh's candidatures in several international bodies; the provision of material support to Bangladesh in the aftermath of natural disasters, etc. Besides geographical proximity, there are economic and other reasons for Bhutan establishing bilateral relations with Bangladesh. For Bhutan, Bangladesh provides an alternative market, and a source as well as outlet for Bhutanese goods through its major seaports. Over the years, its relation with Bangladesh has reduced exclusive dependence on India and helped Bhutan diversify its trade and political relations.

5.2.b Maldives

Maldives is an island country with an area of 1,566,500 sq km. Its 1190 coral islands span over 90,000 sq km in the Indian Ocean. It became a Republic in 1968 and the incumbent President Gayoom became President in 1978.

Formal diplomatic relations between Bhutan and the Republic of Maldives was established on 20th July 1984, with the Bhutanese Ambassador in Bangladesh accredited to the Maldives and the Maldivian Ambassador in Sri Lanka accredited to Bhutan. An Agreement on Cultural Cooperation was signed during President Gayoom's visit to Bhutan in 1987. Notes agreeing on visa free travel have also been exchanged between the two countries.

Under technical cooperation, seven Maldivian nurses were trained at the Royal Institute of Health Sciences in Bhutan under WHO sponsorship between 1986 and 1997; additional nurses sponsored by the Maldivian government were enrolled as well. Such an arrangement came about after the Bhutanese government agreed to facilitate Maldives' request through the WHO, to offer seats to the Maldives for training in the health sector. Subsequently, an offer to train Bhutanese in hotel and catering services was made by the Maldivian government.

Since 1987, there has been a steady stream of visits made by Bhutanese and Maldivian officials between the two countries. His Majesty the King Jigme Singye

Wangchuck attended the 5th and 9th SAARC Summits held in Male, and H.E. President Maumoon Abdul Gayoom made a state visit to Bhutan to 1987 in addition to visits in 1991 and 1998 in his capacity as the SAARC Chairman. Back in 1987, the representative of the king in the Ministry of Finance, Her Royal Highness Ashi Sonam Choden Wangchuck, visited Male as Special Envoy of His Majesty to present a contribution of Nu. 1 million towards relief operations in the aftermath of a tidal wave disaster in Maldives.

5.2.c Nepal

As two kingdoms in the Himalayas, Bhutan and Nepal share many commonalities, one of which was to form a buffer between India and China following the Chinese takeover of Tibet. Although non-resident relations between the two countries were established in 1983, it has been the issue of the people in the refugee camps in Nepal that has overridden bilateral relations since the '90s (The background to this issue is provided in the annexes). Nonetheless, there is potential to develop and enhance cooperation in many areas of common interests. Up until now, some areas of cooperation between the two countries include trade and services, sports, technical and cultural cooperation, among others.

On 7th August 1990, Bhutan and Nepal signed an Air Services Agreement, and Druk Air currently operates two flights a week to Kathmandu.

Over the years, Bhutanese nationals have availed of fellowships offered by Nepal in the field of animal husbandry, as well as several trainings and workshops under UN, SAARC and other regional and international organizations.

In sports, several exchanges and interactions have taken place and considering that Nepal is more advanced than Bhutan in many sports, the latter acknowledges the usefulness of receiving technical help in this field. Sports of interest include football, table tennis, rifle shooting and taekwondo.

As of date trade and economic relations between the two have not been particularly substantive although initiatives continue to be taken since Bhutan made some efforts to build up trade links with Nepal, following the establishment of SAARC. Bhutan's major exports to Nepal were coal and gypsum until 1997 when these were replaced by cheaper Indian products. The steady increase in imports from Nepal includes consumer goods like instant noodles, soaps, beer, camping equipment, footwear and clothing. There is no official framework within which Bhutan and Nepal conduct trade procedures, and these are currently governed by the Trade and Transit Agreements that each one has signed with India. On 14th March 2003, the Bhutan Chamber of Commerce and Industry (BCCI) and the Federation of Nepalese Chamber of Commerce and Industry (FNCCI) signed a Memorandum of Understanding geared toward enhancing mutually beneficial trade and economic

cooperation.¹⁴ Similarly, the Construction Association of Bhutan (CAB) is in the process of signing an MOU with the Federation of Contractors Association of Nepal (FCAN) to promote cooperation and understanding between the private sectors of the two countries.

In order to promote tourism in the two countries, a Memorandum of Understanding (MOU) was signed on May 3rd 2003 between the Association of Bhutanese Tour Operators (ABTO) and the Nepal Association of Travel Agents (NATA). Among others, the MOU aims at establishing clear understanding and professionalism, integrated promotion of tourism in the Himalayan region, strengthening tourism alliance, organizing exchange programmes and establishing Kathmandu and Paro as “sister destinations”.

Nepal continues to be an important destination for many Bhutanese pilgrimages as it has many sacred Buddhist sites such as the birthplace of Lord Buddha in Lumbini. The two countries possess great potential in enhancing bilateral relations through cultural cooperation, considering that Buddhism continues to flourish in Nepal and permeates all aspects of life in Bhutan. Already, Bhutan is a member of the Lumbini Development Advisory Committee entrusted with several responsibilities and plans underway to construct a Bhutanese monastery in Lumbini.

Imperative to the establishment and maintenance of strong ties of friendship and cooperation, state and official visits between the two nations have taken place since the first royal visits from Nepal in the 1970s. The exchange of visits continue to take place at all levels of government with the most recent being those of Her Majesty the Queen Ashi Tshering Pem Wangchuck’s in June 2003 (as President of the Youth Development Fund to visit relevant youth programmes in Nepal), and Ambassador-at-large H.E. Dr. Bekh Bahdur Thapa’s visit to Thimphu for the 15th Ministerial Joint Committee in October 2003.

5.2.d Pakistan

With non-resident diplomatic relations established in 1988, Pakistan was the last SAARC member country with which Bhutan established ambassadorial level diplomatic relations. After 1994, the Ambassador of Bhutan to Bangladesh has been accredited as non-residential Ambassador to Pakistan, prior to which the Ambassador to New Delhi had been accredited to Pakistan.

¹⁴ The MOU provides for the exchange of information on trade and commerce, and the promotion of trade and economic linkages between the two countries particularly for the development of small and medium-sized enterprises. A Joint Economic Council (JEC) was formed with five members from each side (with one co-chairman from BCCI and the other from FNCCI) to, among other objectives, identify new areas of cooperation between the two chambers, and to prepare concrete suggestions of policy and procedural measures for suggestions to the governments of the two countries.

While there is not a high degree of bilateral cooperation between the two countries, interactions take place in activities taken up by SAARC and International Organizations; Bhutanese nationals have attended various programs, trainings and courses in Pakistan. In addition to funding programs of the SAARC and the Pakistani Government, various funding schemes such as UNDP, UNICEF, UNESCO, World Bank, and Helvetas, have made it possible for Bhutan to avail of about 65 trainings, seminars and workshops in Pakistan till date.

Over the years, various levels of official visits have taken place between the two countries with accredited ambassadors presenting their respective credentials, and in relation to SAARC agendas as well as meetings arranged by UN agencies.

5.2.e Sri Lanka

Bhutan and Sri Lanka share common concerns as members of SAARC and also as two countries rich in the Buddhist tradition. Non-resident diplomatic relations between the two were established in 1987 with the Sri Lankan Ambassador in New Delhi accredited to Bhutan and the Bhutanese Ambassador in Dhaka accredited to Sri Lanka. The two countries have enjoyed an array of modest interaction and cooperation since 1985 when Thimphu served as the venue for talks between representatives of the Sri Lankan Government and six Tamil groups including the Tamil United Liberation Front.

Under SAPTA, Sri Lanka has agreed to grant Bhutan a special tariff import rate (15% of the 20% SAARC rate as an LDC) for apples, as well as concessions for oranges, processed fruits, and wood products. Likewise, Bhutan has agreed to grant concessions on the import of tyres, chocolates and semi-precious stones from Sri Lanka.

Close to 200 Bhutanese have availed of short-term (and a few long-term) training and study opportunities in Sri Lanka offered with financing by multilateral agencies as well as the Bhutanese and Sri Lankan governments since 1982. Government of Sri Lanka sponsorship of Bhutanese nationals for training includes areas such as Planning and Management, Broadcasting, Social Statistics, Management of Schools, Human Resource Management, and Post Graduate Medicine. The Royal Civil Service Commission (RCSC) of Bhutan and the Post-Graduate Institute of Medicine (PGCIM) under the University of Colombo also signed a Memorandum of Understanding (MOU) in October 2000 in order to strengthen collaboration in the HRD sector. The MOU presents the RCSC with opportunities to avail training facilities at the PGIM particularly in the field of medicine, as well as concessional rates of fees at one-third of the rate of foreign students.

Besides a steady flow of high level visits at the state and government level between the two countries, renowned Pakistani individuals from the world of cricket

conducted coaching camps and workshops on two occasions for cricket enthusiasts in Bhutan in 2001 and 2002; an exhibition match was also organized in 2002.

5.2.f China

Out of 25 countries sharing common borders with China, Bhutan is the only one that has not established diplomatic relations with this neighbour. This fact can be understood only in the larger context of Chinese suzerainty claims on Bhutan till the recent past, border conflicts ranging from cartographic to geographical intrusion, integration of Tibet to the 'motherland', and the China-India relation factor. The two countries have longstanding differences on the delineation of their common border, which follows the watershed of the Chumbi Valley in the northwest, and the crest of the Great Himalayan range in the north. To understand Bhutan-China relations, it is important to first understand Bhutan's relations with Tibet and China right up to the latter's integration in 1950.

Bhutan has a long history of both war and interactions in religious and cultural fields with Tibet in the 17th and 18th centuries¹⁵. In spite of these wars and invasions, people to people contact especially in spiritual matters have continued between the peoples of Tibet and Bhutan.

Chinese Claims on Bhutanese Territories

The specter of a vague Chinese claim of 'suzerainty' over Bhutan had a great impact on shaping the relation between the two countries. China was involved in Tibetan affairs since the time that Chinese *Ambans* (residents) were stationed in Lhasa in the 1720s under the Ching dynasty, and it was through this involvement that Bhutan and China had their first informal contact. The Bhutanese delegation to the Dalai Lama came into contact with the Chinese representatives in Lhasa although there was no evidence of any tributary relation with Beijing whatsoever. Relations with Tibet itself, was never better but it was severely strained after Bhutan supported the British during the 1904 Younghusband Expedition. The only contact with China was the occasional, informal meeting of a Bhutanese representative in Lhasa with the Chinese officials. Unlike Nepal, Bhutan never sent tributary missions to China. The Bhutanese agents only went to meet the Dalai Lama, and when they met Chinese officials, no gift or letter was forwarded to the Chinese emperor in Beijing. A Chinese historian Tieh-tsung, wrote that China assumed suzerainty over Bhutan

¹⁵ Some scant sources mention incursion into an area (what is now Bhutan) by Tibetans in the sixth century. These new settlements were believed to have integrated with the locals through inter-marriages. Bhutan was then afflicted with strife and conflict amongst different petty local rulers. Conflicts among different Buddhist traditions (sects) in Tibet resulted in an exodus of Tibetan lamas and monks seeking sanctuary in Bhutan until the 16th century. Slowly the rule of local chiefs weakened, and lamas began to carve a niche both in spiritual and secular affairs. The man who consolidated Bhutan as a geographical-political entity was Ngawang Namgyal, who came to Bhutan from Tibet in 1616 as a refugee. This landmark event was ensued by a series of invasions from Tibet, and later the Mongol empire.

beginning 1931, after Tibet's ruler Polhane misinformed Tibet's overlord of Ching dynasty in China that Bhutan was under him.

China made several efforts to exercise what it called 'historic' rights over Bhutan between 1865 when the Treaty of Sinchula was signed, and the signing of the Treaty of Punakha¹⁶ in 1910 - a direct outcome of the claim the Manchu Government of China made on Nepal, Sikkim and Bhutan after its invasion of Tibet in 1910-12. China continued to make feudatory claim on Bhutan even after the 1910 Treaty of Punakha. It made a vague suzerainty claim over Bhutan during years just before the Chinese Revolution of 1911 to secure its southeastern border against increasing foreign aggression. The new Republic of China slowly let the claim die down, only for it to resurface later time and again.

In the original version of *The Chinese Revolution and the Communist Party*, Chairman Mao in 1930 openly declared that, "the correct boundaries of China would include Burma, Bhutan, Nepal..." although the later edition left out these claims. By then China was working on forming a 'Himalayan federation" comprising Tibet, Ladakh, Nepal, Sikkim, Bhutan and the North-East Frontier Agency (NEFA) of India to extend its influence in the southern Himalayas.

The first Chinese claim over Bhutan after the communist revolution, and subsequent integration of Tibet was in 1954 when it published a map in *A Brief History of China* where a considerable portion of Bhutan, including other countries, was included as a pre-historical realm of China. This was in fact the beginning of Bhutan-China conflict. Another map published in 1958 claimed a large tract of Bhutanese land; later in the year, China occupied about 300 square miles of Bhutanese territory in North and North-eastern Bhutan. Chinese claim on Bhutan resurfaced in 1960 when it openly declared that, "Bhutanese, Sikkimese and Ladakhis form a united family in Tibet. They have always been subject to Tibet and to the great motherland of China. They must once again be united and taught the communist doctrine."

Integration of Tibet and Closure of Northern Border

Tension in Bhutan-China relations following the Chinese takeover of Tibet in 1950 subsided two years later. The Sino-Tibetan Treaty of 1951 promised autonomy, and the 1952 agreement with India allowed New Delhi to maintain a consul-general in Lhasa. The signing of a treaty with India based on five principles (*panchshila*) of peaceful co-existence in 1954 demonstrated Chinese positive attitude towards its neighbours. Bhutan's mission in Lhasa carried on as before, and trade continued. But developments in subsequent years in Tibet and along the Himalayan borders proved that motives remained unsettled. The relation worsened after the brutal

¹⁶ The main objective of the treaty was to contain all foreign influences, particularly that of the Chinese south of the Himalayas. This treaty was important in regulating Bhutan's foreign relations and stopping Chinese influence by allying itself with the powerful British.

crushing of anti-Chinese revolts first in eastern Tibet between 1954 and 1955, and later in central Tibet in 1958. The massive Tibetan uprising in 1959 and the flight of the Dalai Lama to India, and the increasing presence of Chinese troops on the ill-defined frontier alerted Bhutan of a threat to its security from the north. Moreover, China stationed troops near un-demarcated border areas, and there were reports of incursion by Chinese troops into Bhutanese territory. For centuries Tibet has been considered a Buddhist heartland in the Himalayan regions, and as Bhutan's closest neighbour, Tibet had influenced the country's religion, art, culture and politics, and the loss of an independent neighbour had great strategic and security implications for Bhutan. It became apprehensive of its own independent status.

After Tibet's integration, China was keen on developing good relations with Bhutan. It even dropped China's historical claim over Bhutan, soon to be followed by an offer of conciliation in form of economic assistance and assurance of independence. In 1955, Chinese officers in Lhasa decided to issue visas directly to Bhutanese citizens. However, in 1959 the People's Liberation Army occupied eight Bhutanese enclaves in western Tibet¹⁷; added to this, the Dalai Lama's flight to India and Chinese misconduct completely changed Bhutanese attitude toward China, consequently shaping Bhutanese policy. The exodus of Tibetan refugee in large numbers across the border presented Bhutan with a serious problem vis-à-vis China.

In 1960 Bhutan closed its northern border and withdrew its representatives in Lhasa and officers in western Tibet. With its traditional northern trade route closed, Bhutan was forced to turn south. As Indian aid began to flow and the first road connected western Bhutan and India in 1961, China started to follow the carrot and stick policy – with an offer to resolve the border issue through bilateral talks without India's involvement, unconditional economic assistance to the country, and at the same time continuing to make claims on Bhutan.

The border problem between China and India erupted into a full-scale but short border war in October 1962. Though China adopted a conciliatory attitude towards Bhutan in the aftermath of the Sino-Indian border war, the event alarmed the Bhutanese. Five additional maps were published in November 1962 showing parts of Bhutan within Tibet¹⁸. Bhutan gave serious thought to its defense; discussions

¹⁷ There are eight villages in Tibet over which Bhutan had been exercising administrative jurisdiction after they were given to Bhutan by a Ladakhi king Singye Namgyal in the 17th century. The eight enclaves were Khangri, Tarcheng, Checkar, Jangtong, Tussu, Janghi, Dirafoo, Chakop and Kachan, and they were never subject to Tibetan law, nor did they pay any Tibetan taxes. China seized all arms, ammunition and ponies belonging to the officers of Bhutan who were in charge of these enclaves at Tarcheng. This was a violation of traditional Bhutanese rights and authority. When India intervened with Beijing on Bhutan's behalf, China refused to discuss with India on a matter that it considered a bilateral issue between China and Bhutan.

¹⁸ The Kameng district in the North East Frontier Agency - the scene of the largest and most decisive battle - borders eastern Bhutan.

were held in the National Assembly in May 1963 and one of the direct results of China-India border war was Bhutan's decision to have a standing army.

Annual Border Talks and Improving Relations

Bhutan shares a 470 kilometer border with China to its northeast and northwest. Bhutanese and Tibetans continued their interactions and trade regardless of the fact that the border remained undefined and un-demarcated, until the Chinese takeover of Tibet. Bhutan was exposed to the Chinese threat after it contested that Tibet, being the palm of a hand, was liberated, and the five fingers, Ladakh, Nepal, Sikkim, Bhutan and NEFA must follow suit. The un-demarcated northern border started to become a source of insecurity and threat to Bhutan territorial integrity. Since the border has not been properly demarcated there were claims and counterclaims. In 1959, Chinese Premier Chou En-Lai wrote to Indian Prime Minister Nehru expressing China's desire for direct bilateral border talks with Bhutan. However, the country's border issues were incorporated with the Sino-Indian border discussion until 1970s.

The border problems through incursion on grazing lands culminated in 1979 when a larger than usual intrusion by Tibetan herders into Bhutanese territory was reported in September 1979. When Bhutan and India protested, China ignored India's protest, but responded to Bhutan. This large-scale Chinese intrusion was instrumental to the start of direct official talks on border disputes between Bhutan and China. That same year, the National Assembly deliberated on the need for normalizing relations with China and initiating direct talks with China to resolve the problem. In 1981 a process was started to initiate a dialogue with China, and the Boundary Commission of Bhutan was established for this purpose. By then China followed a policy of improving its image in the third world, particularly its neighbours in South Asia and South East Asia; in 1977 when India elected the Janata Government which promoted its policy of "beneficial bilateralism", there was an improvement in the bilateral relations between India and China.

The preliminary talks over border issues began in 1981 through their UN Missions in New York and embassies in India. In 1983, the Chinese State Councilor and Foreign Minister, and the Bhutanese Foreign Minister met in New York to consult on developing bilateral relations. However, it was not until 1984 that the first formal meeting took place in Beijing from 17-20 April, and the talks have been held annually alternatively in Thimphu and Beijing since then. During Bhutan's National Day in 1984, the Chinese Premier conveyed that China attached great importance to developing friendly and neighbourly relations with Bhutan, and urged Bhutan to assert its independence.

While progress has been slow, a lot of differences were narrowed and consensus reached on basic guiding principles on boundary settlement. It became evident from

the very start that China was more interested in developing direct relations with Bhutan than resolving border issues. At the second round of talks in 1985, China talked about expanding contact. Till the third round, the talks were restricted to generalities.

Differences on boundary demarcation surfaced when Bhutan insisted on the 'watershed' and 'traditional practices' of grazing rights and collection of local taxes as guiding principles, while China was interested in adding to this the principle of 'existing reality', thus justifying the Chinese occupation of the Bhutanese enclaves in 1959. However, the negotiations on border issues have generally been proceeding well. The disputed territory has been reduced from 1,128 to 269 square kilometers in three areas in the Northwestern part of Bhutan. Bhutan's ambassador to India led the first five rounds of talks, and the Vice Foreign Minister led the Chinese delegation. From the sixth round the delegation level was upgraded with Bhutan sending its Foreign Minister and China deputing its Senior Vice Foreign Minister.

During the first ten rounds of talks (1984-1993) a consensus was reached on the guiding principles for resolving the border issue. In 1996, the Survey of Bhutan discovered Chinese logging and road construction activities in the disputed territory, and when the issue was brought up in the 11th round, China proposed to sign an agreement on friendship between the two countries. The signing was postponed to the 12th round since the Bhutanese delegation was not vested with the authority to make such a decision. So in the 12th round an "Agreement of Maintenance of Peace and Tranquility in Bhutan-China Border Areas" was signed on 8 December 1998. This agreement is very important for border talks and relations between the two countries. In this first ever inter-governmental agreement, China reaffirmed that it "completely respects the independence, sovereignty and territorial integrity of Bhutan". This is significant since it is the 'first legal document signed between the two countries' providing written acknowledgement of Bhutan's sovereignty by China.

As in its approach towards resolving its border issue with Nepal through a 'package deal' rather than a sector-by-sector settlement, China made a similar offer to Bhutan. During the 11th round of talks held in Beijing, China proposed to exchange 495 square kilometers area of Pasamlung and Jarkarlung valleys in the northern borders of central Bhutan for Sinchulumba, Dramana and Shakhtoe with an area of 269 square kilometers in North-west Bhutan. Sinchulumba shares borders with Sikkim and is very close to Chumbi valley. Such a settlement would bring the Bhutan-China border down to the south.

By the 14th round of talks in 2000 Bhutan extended the claims beyond what China had offered in three sectors, Doglam, Sinchulumba and Dramana areas. After the 15th round in 2001 Chinese Vice Foreign Minister Wang Yi described that the

“boundary issue had, by and large, been resolved”, and the Bhutanese side mentioned “considerable progress”. During the 16th round, Bhutan expressed concern over some aspects of border issues. It was not only a question of technical delimitation, but also the issue of security. Concerns were also raised in the National Assembly about the presence of Chinese military camps in disputed territory in western part of the country, and a regular encroachment into Bhutanese pasture land by Tibetan herdsmen. Both sides agreed to hold discussions at the technical level to reach a decision on Chinese and Bhutanese territories on map. In June 2002, the technical team met in Beijing.

Bilateral Visits and Interaction

Bhutan-China interactions have not been confined to annual border consultations. There have been many bilateral exchange visits at various levels in recent decades. The most notable was in 1974 when Bhutan invited China to attend the coronation of King His Majesty Jigme Singye Wangchuck. This was significant since Chinese officials were visiting Bhutan for the first time since Bhutan closed its northern border. China described it as a "new page in the friendly contacts between the two countries", and the Chinese congratulatory message stressed "desire of the Bhutanese government in developing its economy and safeguarding its national independence". Bhutanese table tennis teams visited China in 1977 and 1979. Bhutan has shown some support to China since 1995, for example, in defeating anti-China drafts at the UNHCR conference, maintaining the one-China policy by voting in favour of restoring China's seat in the United Nations in 1971, voting against the draft on Taiwan's participation in the UN, and opposing Taiwan's bid to host the 2002 Asian Games. The Chinese ambassador to India has visited Bhutan on a regular basis since 1994, and the Bhutanese ambassador in India went to China in 2000. These visits opened up new channels of interaction and contacts, besides boundary talks, for exchanging opinions on different issues.

The Bhutanese sports delegation to the Asian Games in Beijing in 1990 was followed by the 4th World Women Conference held in Beijing in 1995, which was attended by HRH Sonam Choden Wangchuck. The two governments decided to keep a Bhutanese honorary consulate in China's Macao Special Administrative Region in 2000. At the political level, a Bhutanese delegation led by the Foreign Secretary visited Beijing and other places in China in July 2001, and this was followed by the visit of Bhutan's National Assembly Speaker who attended the Conference for Peace of Asian Parliament held in Beijing and Chongqing in 2002. Similarly, there have been many other official visits taken up to attend seminars and meetings on security, development of hydropower, tourism and health.

CONCLUSION

Bhutan's development strategy reflects its recognition of the benefits of globalization and increased participation in international trade while taking the cautionary path against impulsive liberalization – it demonstrates that the move towards opening up its economy has been gradual and weighed against unwarranted corruption of its own cultural heritage. Over the past 40 years, Bhutan's interactions at the bilateral and multilateral levels have increased significantly. While Bhutan has nurtured a consistent and progressive relation with India, its trade relations with Bangladesh and Nepal see gradual expansion and can be expected to gain ground in the years to come. Importantly, Bhutan's trade outside the sub-region has also been picking up. It may be in Bhutan's interest to consider formalizing its trade relations with Thailand and enter into extended growth zone facilitation.

The external sector continues to be crucial for Bhutan, seeing as its socio-economic development has been largely dependent on contributions from this sector. With the deepening and widening of trade relations within the sub-region and beyond, Bhutan can look to consolidate the gains in the future. However, at the same time, the two major sources of development and growth - foreign aid and export earnings from hydropower production - point to the excessive dependence of the national economy on these sources and its resultant vulnerability. At this juncture, Bhutan cannot afford to ignore the possibilities of trade expansion and diversification that the deepening of bilateral and multilateral trading relationship is likely to bring about. There are, however, limiting factors that can continue to undermine Bhutan's capacity to reap the full benefits of such moves. These factors are related to manpower development, technical knowledge acquisition, fund mobilization, database creation and inventories, furthering cooperation in trade, etc. These are also areas where the role of international organizations in assisting Bhutan has high potential.

Bhutan's economy has come quite a way since the initiation of planned development in 1961, and efforts continue to be geared towards balancing liberalization through social and cultural integrity. Bhutan has long put emphasis on improving the qualitative and holistic dimension in the lives of its people, and towards this end there has been considerable progress. Granted, there is still a long way to go before the task reaches anywhere near completion, and a lot remains to be done, but in general, events seem to be following a positive course. As Bhutan comes of age in the regional and international community, however, the spillovers of regional phenomena such as poverty, economic migration and militancy have found their way into the traditional confines of Bhutanese society, requiring Bhutan to face the "other" realities of being part of the region and making the necessary adjustments.

ANNEXURE 1

SAARC PREFERENTIAL TRADING ARRANGEMENT (SAPTA) Consolidated National Schedule of Concessions Granted by Bhutan under First, Second and Third Rounds of Trade Negotiations under SAPTA



BHUTAN-merged-CNS.pdf

ANNEXURE 2

Treaty between India and Bhutan, 1949

August 8, 1949

The Government of India on the one part, and His Highness the Druk Gyalpo's Government on the other part, equally animated by the desire to regulate in a friendly manner upon a solid and durable basis the state of affairs caused by the termination of the British Government's authority in India, and to promote and foster the relations of friendship and neighbourliness so necessary for the well-being of their peoples, have resolved to conclude the following treaty, and have, for this purpose named their representatives, that is to say Sri Harishwar Dayal representing the Government of India, who has full powers to agree to the said treaty on behalf of the Government of India, and Deb Zimpon Sonam Tobgye Dorji, Yang-Lop Sonam, Chho-Zim Thondup, Rin-Zim Tandin and Ha Drung Jigmie Palden Dorji, representing the Government of His Highness the Druk Gyalpo, Maharaja of Bhutan, who have full powers to agree to the same on behalf of the Government of Bhutan.

Article 1

There shall be perpetual peace and friendship between the Government of India and the Government of Bhutan.

Article 2

The Government of India undertakes to exercise no interference in the internal administration of Bhutan. On its part the Government of Bhutan agrees to be guided by the advice of the Government of India in regard to its external relations.

Article 3

In place of the compensation granted to the Government of Bhutan under Article 4 of the Treaty of Sinchula and enhanced by the treaty of the eight day of January 1910 and the temporary subsidy of Rupees one lakh per annum granted in 1942, the Government of India agrees to make an annual payment of Rupees five lakhs to the Government of Bhutan. And it is further hereby agreed that the said annual payment of shall be made on the tenth day of January 1950. This payment shall continue so long as this treaty remains in force and its terms are duly observed.

Article 4

Further to mark the friendship existing and continuing between the said Governments, the Government of India shall, within one year from the date of signature of this treaty, return the Government of Bhutan about thirty two square miles of territory in the area known as Dewangiri. The Government of India shall

appoint a competent officer or officers to mark out the area so returned to the Government of Bhutan.

Article 5

There shall, as heretofore, be free trade and commerce between the territories of the Government of India and of the Government of Bhutan; and the Government of India agrees to grant the Government of Bhutan every facility for the carriage, by land and water, of its produce throughout the territory of the Government of India, including the right to use such forest roads as may be specified by mutual agreement from time to time.

Article 6

The Government of India agrees that the government of Bhutan shall be free to import with the assistance and approval of the Government of India, from or through India into Bhutan, whatever arms, ammunitions, machinery, warlike materials or stores may be required or desired for the strength and welfare of Bhutan, and that this arrangement shall hold good for all time as long as the Government of India is satisfied that the intentions of the Government of Bhutan are friendly and that there is no danger to India from such importations. The Government of Bhutan, on the other hand, agrees that there shall be no export of such arms, ammunition, etc., across the frontier of Bhutan either by the Government of Bhutan or by private individuals.

Article 7

The Government of India and the Government of Bhutan agree that Bhutanese subjects residing in Indian territories shall have equal justice with Indian subjects, and that Indian subjects residing in Bhutan shall have equal justice with the subjects of the government of Bhutan.

Article 8

The Government of India shall, on demand being duly made in writing by the Government of Bhutan, Vide letter No. 1(2) MHA/69 dated 13/3/1969 from Home Minister, Government of Bhutan to the Political Officer, Sikkim, and Ministry of External Affairs Order (G.S.R. 2093) published in the Gazette of India Extraordinary Part II – Sec. 3 Sub Section (i) dated 26/8/1969 (F.No. EI/103/5/63-BH) take proceedings in accordance with the provisions of the Indian Extradition Act 1962 (of which a copy shall be furnished to the Government of Bhutan), for the surrender of all Bhutanese subjects accused of any of the crimes specified in the first schedule of the said Act who may take refuge in Indian territory.

The Government of Bhutan shall, on requisition being duly made by the Government of India, or by any officer authorized by the Government of India in this behalf, surrender any Indian subjects, or subjects of a foreign power, whose

extradition may be required in pursuance of any agreement or arrangements made by the Government of India with the said power, accused of any of the crimes, specified in the second schedule of Indian Extradition Act 1962, who may take refuge in the territory under the jurisdiction of the Government of Bhutan and also any Bhutanese subjects who, after committing any of the crimes referred to in Indian territory, shall flee into Bhutan, on such evidence of their guilt being produced as shall satisfy the local court of the district in which the offence may have been committed.

Article 9

Any differences and disputes arising in the application interpretation of this treaty shall in the first instance be settled by negotiation. If within three months of the start of negotiations, no settlement is arrived at, then the matter shall be referred to the Arbitration of three arbitrators, who shall be nationals of either India or Bhutan, chosen in the following manner:

One person nominated by the Government of India;

One person nominated by the Government of Bhutan;

A Judge of the Federal Court, or of High Court in India, to be chosen by the Government of Bhutan, who shall be Chairman.

The judgment of this Tribunal shall be final and executed without delay by either party.

Article 10

This treaty shall continue in force in perpetuity unless terminated or modified by mutual consent.

Done in duplicate at Darjeeling this eight day of August one thousand nine hundred and forty-nine, corresponding with the Bhutanese date the fifteenth day of the sixth month of the Earth-Bull year.

ANNEXURE 3

The Southern Bhutan Problem and People in the Refugee Camps in Nepal

As a migratory race, the Nepalis dominate the neighbouring Indian regions of West Bengal, Assam, Sikkim, Darjeeling and Kalimpong, a result of which the indigenous people of these areas have been reduced into minorities¹⁹. Bhutan presents an attractive alternative for economic migrants since it is a small country with a small population and favourable conditions such as high land-to-population ratio, employment opportunities, free education and free health services– as such, it is of concern to the Bhutanese that undesirable developments similar to those in the neighbouring states of India will replicate in Bhutan.

The first time that the Nepalis came to Bhutan was in the early 1900s. They had been recruited by Bhutanese authorities for the purpose of extracting timber from the dense forests in the southern foothills. They were allowed to stay on as tenant farmers in the areas that had been cleared, and when the Nationality Law was enacted in 1958 these groups of people were granted Bhutanese citizenship by the National Assembly.

The entry of illegal immigrants into Bhutan gained momentum at the time when the government was engrossed with the start of planned socioeconomic development in 1961. Alongside the import of Nepali labourers for development works, illegal Nepali immigrants easily accessed the country's open and porous border bypassing a relatively weak administration in the south. The extent to which illegal immigrants had infiltrated and settled in the five southern districts was revealed only after the conduct of detailed census in 1988-90. It was found that illegal settlers made up a large portion of the immigrant population; over 13,000 of the immigrant population in the district of Samtse alone was reported to be illicit²⁰. Around this time, a number of these people began to stir dissent and political agitation, accusing the government of "ethnic cleansing" and spreading negative propaganda. The sense of insecurity felt by the southern Bhutanese increased as the policy of strengthening national integration through the promotion of a national dress and language came into place, and with the removal of Nepalese as a third language in primary schools. Playing upon the fears of the southern Bhutanese and stirring up sentiment, violent demonstrations and destructive activities took place. Between 1988 and 1993, there were frequent raids, kidnapping, killing, extortion and the destruction of infrastructure (schools, bridges, etc) carried out by the dissidents. In spite of these many acts of terrorism, the Bhutanese government deliberately avoided military retaliation. It did, however, provide training for voluntary militia recruits to assist

¹⁹ Ministry of Home Affairs. 1993. *The Southern Bhutan Problem. Threat to a Nation's Survival*. Thimphu, Bhutan.

²⁰ Ura, Karma. 2002. "Perceptions of Security" pp 59-79, in Dipankar Banerjee ed., *South Asian Security: Futures*. Colombo: Regional Centre for Strategic Studies, Sri Lanka.

the armed forces in dealing with mob attacks and demonstrations, and to guard important infrastructure.

The dissidents initially set up their camps in the Jalpaiguri district of West Bengal across the border when they left Bhutan. Soon after, they moved to Nepal and formed several organizations such as the Bhutan People's Party, Bhutan Student's Union, People's Forum for Human Rights, Bhutan National Democratic Party and United People's Front. In an effort to win international sympathy, ethnic Nepalis from southern Bhutan and elsewhere were gathered and set up in refugee camps in eastern Nepal and declared as Bhutanese refugees. Through demonstrations held in Kathmandu and with claims that the Bhutanese government had tortured and forcefully evicted them, they made attempts to have the Nepalese government and international organizations pressure Bhutan into taking back the "Bhutanese refugees. Under the guise of "peace marches", several attempts at mass infiltration into the country were also made.

Although there are presently close to 100,000 people in the seven camps in Nepal claiming to be Bhutanese refugees, not all of these are true Bhutanese citizens; a declared objective of the dissidents is to change the citizenship laws of Bhutan. The number of people claiming to be Bhutanese refugees in eastern Nepal in January 1991 was 234. This number grew at a multiple rate with the provision of UNHCR humanitarian assistance upon the request of the Nepalese government six months later; the number of people in the camps had reached 6000 by the year's end.

During the sixth SAARC summit held at Colombo in December 1991, talks between Bhutan and Nepal on the issue of the people in the camps began when the King of Bhutan met with Prime Minister Koirala of Nepal. It was the request of the King that Nepal stop ethnic Nepalis claiming to be Bhutanese refugees from coming to Nepal since this was providing an opportunity for poor and destitute people of Nepalese ethnicity to take advantage of free food and facilities in the camps with false claims of being refugees from Bhutan. However, the Nepalese Prime Minister said that such a stance on his part would hurt the sentiments of the Nepalese people and invite political criticism.

The establishment of camps by the UNHCR in Jhapa, Nepal was immediately followed by an increase in the number of people in the camps, which continued to grow rapidly. Before the UNHCR and the Nepalese government managed to establish a screening system to register people as "Bhutanese refugees" at the Nepal border in July 1993, the number of people in the camps had already crossed 80,000. Ministerial level talks between Bhutan and Nepal on this issue first took place between the home ministers of the two countries in July 1993, and a Ministerial Joint Committee (MJC) was established to find a solution to the problem. In its third meeting held in Kathmandu in April 1994, the MJC established four categories of

people in the camps on which the two sides would harmonize their positions after the completion of joint verification in each camp. The four categories are:

1. Bonafide Bhutanese if they have been evicted forcefully – Bhutan has agreed to take full responsibility for any Bhutanese national who has been forcefully evicted; those responsible for this act would be punished according to the law of the country.
2. Bhutanese who have emigrated – people in this category would be treated according to the citizenship and immigration laws of Bhutan and Nepal. Following the 12th MJC in February 2003, the agreement states that these emigrants will be given the option to apply for either Bhutanese or Nepalese citizenship according to the laws of the two countries.
3. Non-Bhutanese people – these people would have to return to their respective countries.
4. Bhutanese who have committed criminal acts – the repatriation of people in this category would be done in keeping with the laws of Bhutan and Nepal.

The Joint Verification Team (JVT) comprising 10 officials representing the two governments began the verification process on March 26, 2001 in the first camp, with the understanding that the process of verification and the harmonization of positions on each category would be done simultaneously and not separately. The results for the first camp, (Khudunbari) was announced in June 2003. Of the total 12,183 people in this camp, 293 were identified as belonging to category I, 8595 in category II, 2948 in category III, and 347 in category IV. As per the decision reached during the 14th MJC at Kathmandu in May 2003, the people in the camp would given two weeks to appeal against the current JVT decision; appeals would be considered on presentation of new evidence or if there had been errors in the process²¹. During the 15th meeting of the MJC held in Thimphu in October 2003, it was decided that the JVT of the two governments would implement the outcome of its work in Khudunbari camp and start work on the second camp Sanischare²². The MJC also agreed that the JVT would review appeals of the people in category III by the end of January 2004, and in keeping with the laws of Bhutan the family members of individuals with criminal records would not be charged or prosecuted on their return to the country.

In Bhutan's view, the root of this problem is related to population growth in the region that is unmatched by economic growth. The displacement of huge populations has led to the economic migration of a single ethnic group in large numbers over the years from neighbouring areas into its territory, which has porous

²¹ Kuensel June 21, 2002. *JVT announces results of categorization.*

²² Kuensel October 24, 2003. *MJC moves from talks to action.*

borders and holds out alternative incentives of livelihood. It can be said with a measure of certainty that, as in other similar situations, a huge portion of the people in the camps claiming to be Bhutanese refugees are in fact using internal problems and security issues to their advantage in their search for better living conditions. Evidently, people in the camps in Nepal receive up to US\$ 20 to 22 million each year from the UNHCR²³.

Elected members of the National Assembly have made it abundantly clear that they do not want to accept the return of a single person from the camps in eastern Nepal. However, the government continues to stand by its decision to come to a solution to this issue by working in mutual understanding and effort with the Nepalese government. Although only one camp has been categorized and there is still a long way ahead before a lasting solution to the issue can be established, progress has been made slowly but steadily over the years. As declared by both sides, the 15th meeting of the MJC was a “resounding success”, and Nepal’s ambassador-at-large Dr. Thapa has been quoted as saying that “the foundations of friendship have been established in the relations between the two countries”.

²³ Deputy Minister of NEC’s comment in National Assembly discussions on the verification process.

ANNEXURE 4

Agreement between the Government of the People's Republic of China and the Government of the Kingdom of Bhutan on the Maintenance of Peace and Tranquillity Along the Sino-Bhutanese Border Areas

(December 8, 1998)

The Government of the People's Republic of China and the Government of the Kingdom of Bhutan (hereafter known as “Both sides”), in accordance with the five principles of mutual respect for each other's sovereignty and territorial integrity, mutual non-aggression, mutual non-interference in each other's internal affairs and peaceful co-existence and for the purpose of maintaining peace and tranquillity along the Sino-Bhutanese border, have reached the following agreements:

Article 1

Both sides hold the view that all countries big or small, strong or weak are equal and should respect one another. The Chinese side reaffirmed that it completely respects the independence, sovereignty and territorial integrity of Bhutan. Both sides stand ready to develop their good-neighborly and friendly cooperative relations on the basis of the Five Principles of Peaceful Co-Existence.

Article 2

Both sides are of the view that during the ten rounds of talks that have been held so far, they have reached consensus on the guiding principles on the settlement of the boundary issues and narrowed their differences on the boundary issues in the spirit of mutual accommodation, mutual trust and cooperation and through friendly consultations. The mutual understanding and traditional friendship between the two countries have been deepened. Both sides stand ready to adhere to the above-mentioned spirit and make joint efforts for an early and fair solution of the boundary issues between the two countries.

Article 3

Both sides agreed that prior to the ultimate solution of the boundary issues, peace and tranquillity along the border should be maintained and the status quo of the boundary prior to March 1959 should be upheld, and not to resort to unilateral action to alter the status quo of the border.

Article 4

Both sides reviewed the progress made after ten rounds of border talks. As both sides have already expounded each other's stand on the disputed areas, both sides agreed to settle this issue through friendly consultations.

Article 5

This agreement will come into force on the date of signing.

This agreement was signed on December 8, 1998 in Beijing, done in two copies in the Chinese, Bhutanese and English languages, all three languages are authentic. If differences arise, the English text will be the standard text.

Representative of the Government
of the People 's Republic of China

Representative of the Government
of the Kingdom of Bhutan

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