



Bhutan

Bhutan's economic performance in recent years has been encouraging. The economy has been growing steadily due to high investment rates financed mainly by concessional external resources. The economy is dependent largely on agriculture, forestry, and livestock, although in recent years, with the development of hydropower and some allied industries, the share of manufacturing in GDP has increased. The manufacturing sector is nevertheless narrow in its range of industries, most of which are owned by the state.

Bhutan has close economic and political links with India. The local currency, the ngultrum (Nu), is fixed to the Indian rupee; external trade is predominantly with India; and Bhutan receives substantial budgetary support as well as grants to finance major investment projects from India. With acceleration of growth in India and liberalization of its economic policies, the Bhutan economy is likely to benefit. Much will depend, however, on Bhutan maintaining macroeconomic stability and on much-needed social sector investment being undertaken.

Recent Trends and Prospects

After experiencing somewhat low rates of growth in the early 1990s, Bhutan's GDP growth has accelerated in recent years and is estimated at 5.5 percent for 1995. The domestic investment rate tends to fluctuate considerably from year to year depending on whether a major investment project has been commissioned. In recent years, the investment/GDP ratio has fluctuated between 30 percent and 55 percent. Gross national saving is estimated

to be about 10 percent of GDP which means that Bhutan's external resource requirement for financing domestic investment has been large. The resource gap, however, has been easily financed by inflows of concessional assistance and grants (Figure 2.18).

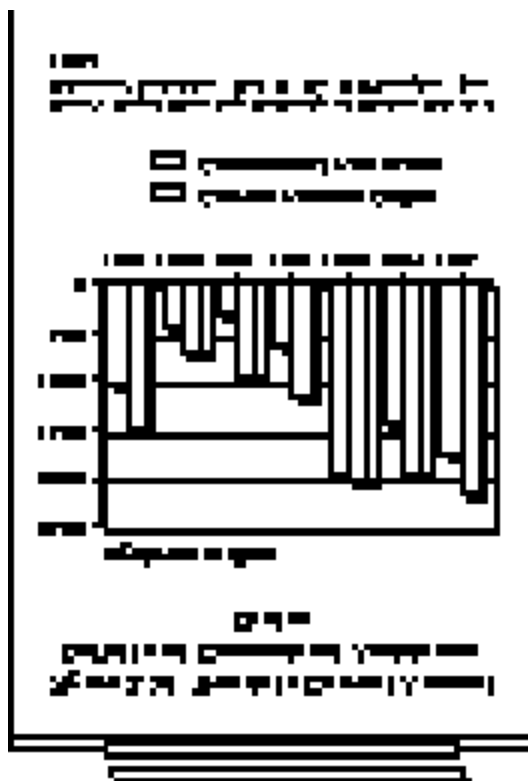
Because of the structure of the economy, Bhutan has an extremely narrow tax base with tax revenue usually being 6–7 percent of GDP. Government revenue consists largely of foreign grants of approximately 30 percent of GDP and profits from public enterprises. Since 1990, the Bhutan authorities have ensured that domestic revenues finance all recurrent expenditure, while foreign grants and concessional loans finance capital expenditure. Revenue and grants amounted to 50 percent of GDP in 1995 (1994/95, ending 30 June) while total expenditure was 52.2 percent of GDP. The overall fiscal deficit was thus about 2 percent of GDP which was financed by foreign resources equal to 1.4 percent of GDP and domestic borrowing at 0.3 percent of GDP. The overall budgetary balance was in surplus in fiscal years 1993 and 1994 but was in deficit in fiscal year 1995 because of a sharp increase in expenditure. In recent years, the Government's current expenditure has risen to meet growing demands for education and health care. On the revenue side, returns from hydropower investment have been somewhat constrained because of subsidized domestic tariffs.

Broad money supply (M2) expanded rapidly in 1995 at close to 30 percent. Much of the increase in money supply reflected the increase in foreign exchange reserves as a result of large inflows of foreign aid. Given the openness

of Bhutan's economy with India, inflation has remained close to that in India and in 1995 is estimated to have been about 8.6 percent. The monetary authorities have recently taken steps to develop new instruments of monetary policy, strengthen prudential norms and supervision, and enhance competition in the financial system. More notable among the policy measures are the introduction of regular auctions of Central Bank bills and the creation of a government securities market.

Exports in 1995 increased by 6 percent to \$71 million. About 93 percent of exports were destined for India. Due to commissioning of new foreign-financed industrial projects, imports increased sharply by 16 percent in 1995 to \$102 million. The invisibles account of the balance of payments was also in deficit with the result that the current account deficit in 1995 reached an estimated \$45 million or 16 percent of GDP. Net external resource inflows from abroad, mainly concessional official loans and grants, were larger than the current account deficit and thus the overall balance of payments was in surplus. Bhutan added \$18.8 million to its foreign exchange reserves in 1995. Reserves in 1995 were estimated at \$126 million, equivalent to 13 months of import cover.

With the recent commissioning of ferro-alloy and cement projects, which are predominantly export oriented, GDP growth in 1996 is likely to improve to 7 percent. Inflation is likely to moderate somewhat in 1996 because, with the recent projects having been commissioned, expansion of money supply should slow down. Over the medium term, however, the Government will need to exercise greater fiscal prudence, especially since the revenue base is both narrow and inelastic. Exports are projected to increase in 1996 and 1997 by about 15 percent per annum as the output of recently commissioned projects is exported. Import growth should moderate somewhat; however, the current account deficit is expected to be substantial at about 18 percent of GDP. With inflows of external grants and concessional assistance more than covering the current account deficit, the foreign exchange reserve position is likely to improve further over the next two years. Bhutan's external debt position will remain comfortable and the debt-service ratio is likely to range between 15 percent and 18 percent of exports of goods and services.



Policy and Development Issues

The main industry in Bhutan is hydropower and related activities in which the Government has invested heavily in the past. Recently, however, there have been significant efforts towards reducing state holdings in several public sector companies. While the Government is keen to promote privatization, the results have been somewhat modest because of a lack of entrepreneurial talent in conjunction with a primitive financial system. To promote the role of the private sector, the Government will need to strengthen the legal framework, legislate to protect private property rights, liberalize regulations on imports from countries other than India, and dilute the extant exchange controls. Financial sector reforms are also required, especially the deregulation of interest rates and the liberalization of the regulations governing foreign direct investment.

Over the medium term, Bhutan will have to pay more attention to fiscal issues as demands on both recurrent and capital expenditure are expected to increase. If the Government is to meet these demands while maintaining macroeconomic stability, it needs to take steps to broaden the tax base and to ensure improved tax compliance.