



Bhutan

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RECENT TRENDS AND PROSPECTS

Bhutan initiated a cautious policy of modernization in the mid-1960s, but remains a predominantly agriculture-based economy. Growth in 1996 was 6.1 percent, partly because of the construction of a ferro-alloy plant and expenditures to increase the capacity of the power and cement industries. In 1997, however, despite the absence of such new projects, growth was slightly higher at around 6.6 percent.

Fiscal policy has been prudent during the last few years. Recently commissioned power projects, together with adjustments in electricity tariffs to India, increased fiscal revenues. These have helped the government cover its increasing recurrent expenditures brought about by a 25 percent increase in civil service pay at the beginning of 1996 and another 20 percent raise in early 1997. These wage increases were intended to help reverse the erosion of real wages that has occurred since the last general wage increase in 1988. Development expenditures also increased significantly in 1997, and these were mainly financed by foreign grants and loans. Tax revenues have increased gradually because of

improved administration. Nevertheless, the tax ratio of 8 percent of GDP caused by an extremely narrow tax base remains low compared with other countries at similar income levels. The government is continuing its tax reform policy introduced earlier, and is also attempting to strengthen nontax revenues by expanding user fees and improving cost recovery. However, despite these measures and a strong inflow of grants, Bhutan recorded an overall budget deficit of 5 percent of GDP in 1997. With gross domestic savings at 30 percent of GDP and gross domestic investment at 47 percent, the resource gap was 17 percentage points.

In 1997 the money supply (M2) grew by 20 percent and inflation was kept to 7 percent. The government has implemented policies to increase the efficiency of the financial sector. These include liberalizing rates for deposits above Nu5 million, introducing a government securities auction, and converting the Unit Trust of Bhutan into a second commercial bank.

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1997 refers to fiscal year 1996/97, ending 30 June.

sector still plays a dominant role in the economy, the government is committed to reducing its presence in certain areas while still concentrating on the provision of infrastructure. Bhutan must maintain its efforts to diversify the economy and reduce poverty, which is still high. The external balance deteriorated in 1997: while exports grew at 8.5 percent, this was more than offset by a 25 percent increase in imports. As a result, the current account deficit, which in 1996 amounted to \$48 million (or 14 percent of GDP), increased to \$79 million (22 percent of GDP) in 1997. At the same time the country's external debt increased from 35 to 45 percent of GDP. However, the debt-service ratio halved from 24 percent in 1996 to 12 percent in 1997. At the end of 1997 Bhutan's reserves stood at \$180 million, enough to cover imports for 17 months.

The short- and medium-term economic prospects for Bhutan are favorable. Assuming that the reform measures and investment projects announced for the Eighth Plan (1997/98-2001/02) will be realized, GDP growth is projected at 5 percent for 1998 and some 7 percent for 1999. To improve revenue prospects, the government should focus on broadening the tax base; introducing user fees; improving cost recovery; and preventing any deterioration in the fiscal situation, while safeguarding such expenditures as those on social services and operations and maintenance.

Projections indicate that the agriculture sector, which contributes 40 percent of GDP and employs 90 percent of the workforce, will grow about 2.5 percent in 1998, mainly because of productivity gains and horticultural development. Higher growth of around 12 percent is projected for manufacturing in 1998, while the figure for energy is 7 percent.

Although external assistance will continue to finance capital investments, domestic revenues will cover recurrent costs completely. The upward trend in the budget deficit is expected to continue during 1998 and 1999, with deficits reaching 9 and 12 percent of GDP, respectively, because of the implementation of a number of major projects.

The growth rate of exports is expected to decline slightly to around 6 percent in 1998, while in 1999 it will be around 9 percent. The growth rate of imports during the same period will be around 7 to 9 percent. Projections indicate that the current account deficit will reach 30 percent of GDP by 1999. Reserves will continue increasing to reach a level

that could finance 18 months worth of imports. The debt-service ratio is expected to stay at around 15 to 16 percent during 1998 and 1999, while the country's external debt will continue to increase to more than 65 percent of GDP. Inflation will remain at around 8 percent, and the resource gap will continue at around 17 percentage points.

CRITICAL ISSUES IN SHORT-TERM ECONOMIC MANAGEMENT

Bhutan's growth and development prospects for the next five years depend largely on the success with which the government implements the Eighth Five-Year Plan. This plan retains the overall objectives of earlier plans, namely, accelerated growth and improved living standards, and is also committed to preserving Bhutan's environment and cultural heritage.

While the public sector continues to dominate the economy, the Eighth Plan emphasizes strengthening the private sector's contribution to economic activity. Thus the government is committed to reducing the state's role in the commercial sectors of the economy through such means as privatizing public sector enterprises, which should improve telecommunications and transportation; allowing the state to focus on providing infrastructure, including addressing the various structural and institutional constraints; strengthening the legal framework; introducing tariff reform; implementing financial, industrial, and trade liberalization; helping small businesses, including cottage enterprises; and decentralizing government decisionmaking. If these measures are implemented successfully, they will lay the foundations for future sustained growth.

Bhutan needs to increase the amount of domestic resources mobilized for investment. Finally, if plans to establish a free trade zone among the seven members of the South Asian Association for Regional Cooperation between 2000 and 2005 materialize, this could provide a major boost to Bhutan's development.

POLICY AND DEVELOPMENT ISSUES

Bhutan continues to be a poor country, with one of the lowest per capita incomes in the world. Some 80 percent of the population live in rural areas. Adult illiteracy remains high. The fertility rate is high, with

an average of 5.6 births per woman. The maternal mortality rate has decreased to 380 deaths per 100,000 live births.

Since Bhutan began opening its borders to the world in the 1960s, it has established a series of long-term development objectives. These include promoting self-reliance, encouraging sustainability, preserving the country's culture and traditions, ensuring balanced development as well as national security, promoting industrialization, developing institutional and human resources, and focusing on integrated rural development. The country needs to continue its efforts to escape from the poverty trap and to achieve sustainable growth. To this end,

Bhutan has rapidly expanded its expenditure on primary education and health services during the past few years. These policies will greatly enhance its development potential, as such investments have a high rate of return in countries at low levels of development. Bhutan also needs to improve its transportation network. In a country of such breathtaking beauty, tourism could play an important role in generating foreign exchange. At present, however, road access is extremely difficult and air connections are limited. As access expands, a delicate balance will have to be maintained between preserving cultural heritage and enjoying the benefits of globalization.