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## Bhutan

*Economic growth in Bhutan has been strong the past two years. If the government remains committed to the objective of the Eighth Five-Year Plan, including social sector improvements and privatization, continued rapid growth can be continued in 2000 and beyond.*

### RECENT TRENDS AND PROSPECTS

**E**conomic growth in Bhutan registered 5.8 percent in 1998 and 6 percent in 1999, respectively. Construction activities expanded because of major hydropower and industrial projects. Per capita income grew more slowly as a result of a rapidly expanding population. With a per capita income of \$480 in 1997, Bhutan is still one of the poorest countries in the world. While life in much of the country's rugged terrain can be harsh, many of the characteristics of poverty such as hunger, malnutrition, and degraded physical environment found in some parts of South Asia and among people of similar income are not evident.

The government continued to conduct a prudent fiscal policy, with current revenues exceeding current expenditures as they have since 1996. The government receives most of its current revenues as profits from public enterprises and service fees from the ministries, and tax revenues are primarily from enterprise and goods taxes. However, inflows of foreign

grants have not been sufficient to cover development expenditures. This led to an overall budget deficit of 2.5 percent of GDP in 1999, in contrast to a 1 percent surplus the previous year. This was due mainly to a major increase in capital expenditures for hydropower projects. Inflation in 1999 was slightly more than the 9 percent recorded the previous year, mainly because food imports from India cost more. Money supply growth slowed from 41.7 percent in 1998 to 21.4 percent because foreign aid slowed and domestic credit declined, particularly to the government. Credit to the private sector increased slightly compared to the previous year.

The dollar value of exports declined 5.9 percent in 1999, compared with a strong growth of 12 percent in 1998, because regional external demand declined. Imports grew 20.5 percent because of import requirements for the large hydropower and industrial projects under construction. The combination of declining exports and rapidly increasing imports resulted in a substantial widening of the trade deficit,

from 6.4 percent of GDP in 1998 to 15 percent in 1999. The current account deficit also widened from 12 percent of GDP to 25.8 percent. The trade balance with India, Bhutan's main trading partner, also turned from a slight surplus to a deficit of 4.8 percent of GDP. The current account deficit with India deteriorated to almost 19 percent of GDP in 1999 compared with 6.6 percent in 1998.

Capital flows, mostly grants for infrastructure investments, were more than sufficient to cover the current account deficit. This resulted in an overall balance-of-payments surplus of more than 26 percent of GDP in 1999. Consequently, international reserves at the end of the year increased to about \$259 million, equivalent to almost 19 months of imports. External debt, all in the form of concessional financing from donor agencies, continued to be small. Total public external debt was less than 30 percent of GDP in 1999 and debt service was about 9 percent of merchandise export earnings. The composition of this debt has been changing, with less nonconvertible currency debt and more convertible currency debt. As the grace periods expire on the concessional debt acquired by Bhutan in the 1980s, the country's external balance will come under increasing pressure because of higher debt-service payments.

Bhutan has concluded two years of its ambitious Eighth Five-Year Plan, and the government has made satisfactory progress in reaching plan targets. It has expanded the physical infrastructure network, including constructing roads and adding to the power supply grid, and has built more schools and added health centers. To fund these projects, the government has relied on international donor support. In the future, there will be greater reliance on domestic resources. In this regard, the preparation for introducing a personal income tax should help broaden the tax base.

Projected GDP growth rate for 2000 is 6 percent, and if the government continues its commitment to the Eighth Plan, Bhutan should continue to experience annual output growth of more than 5.5 percent during 2001 and 2002, the end of the plan period.

### **ISSUES IN ECONOMIC MANAGEMENT**

The government supports the Asian Development Bank's poverty reduction goal, which is consistent

with its own objectives. A large housing scheme has been developed for urban dwellers. However, policymakers need to ensure that the program is financially sustainable. To this end, long-term financial mechanisms need to be put in place. Housing subsidies, if provided at all, should be given only to the lowest income groups. Private sector participation should also be encouraged.

Physical and social infrastructure need to be upgraded in various areas. Despite recent improvements in infrastructure development, road transport and power transmission urgently need improvement. In addition, vocational training needs to be strengthened, particularly in technical and semi-skilled occupations in which workers are in short supply.

### **POLICY AND DEVELOPMENT ISSUES**

A major developmental challenge in the years ahead will be the absorption of the excess liquidity that has built up in the financial system, and the use of these funds to underpin private sector growth. The government is strongly committed to the growth of private sector activity. While several institutional, policy, and labor constraints remain, the government has been active in privatizing state-owned firms, promoting institutional and legislative reform, and upgrading domestic skills.

However, industrial policies, particularly with regard to foreign investment, remain ambiguous. While sectoral diversification and privatization have undoubtedly occurred, the industry sector is heavily concentrated on a narrow range of products. It is highly dependent on expatriate labor and is restricted by the small, fragmented domestic market and a narrow range of readily accessible export markets. It is also limited by inadequate and expensive transportation and constrained by national sensitivities concerning resource exploitation—especially in tourism and logging—and by caution regarding foreign investment and foreign labor. The main challenge facing the government is how to realize its commitment to private sector activity in the face of such constraints.

A series of legal and administrative changes are intended to improve government efficiency and increase administrative capacity. Several important bills were passed during the 77th session of the National

Assembly, including the Telecommunications Act, Road Safety and Transport Act, Bankruptcy Act, Immovable and Movable Property Act, and Municipal Act. These bills will strengthen the legal framework for a market-oriented economy and increase the capacity of the central and local government units to manage development on a sustainable basis. Under a new system, the King remains the head of State, but is no longer the head of government. This position now is rotated annually among the six members of the Cabinet of Ministers.

On 11 November 1999, the government released a report aimed at enhancing good governance by promoting efficiency, transparency, and accountability of government administration. Specific recommendations included measures to prevent corruption and abuse of authority. Reorganization of the government

administration will be fully implemented by 2002. To further enhance efforts to strengthen government administration through decentralization, a two-year rolling budget will be introduced in 2000, and improved systems for budget planning and monitoring will be introduced. Although the overall external debt position is manageable, the new Department of Aid and Debt Management in the Ministry of Finance will consider all new loans cautiously, in the context of debt-servicing capabilities as well as manpower and skill constraints.

After consolidating and evaluating these measures, the government might consider additional actions to strengthen its planning and development framework to prepare for future development challenges, including reducing poverty and developing the private sector.