

Bhutan

The economy is driven by hydropower project cycles. Significant new hydropower investment and output have contributed to rapid GDP growth in the past few years. For the next few years, the growth rate will slow before construction of new power plants lifts it again. Most power is exported to India under long-term contracts. Because of this, and the dominance of the power sector, the global economic slowdown is likely to have relatively little impact. However, the close trade and foreign exchange links to India, as well as a possible downturn in tourism, may still have an effect.

Economic performance

GDP growth in FY2008 (ended 30 June 2008) is estimated at 11.5%, down from 14.1% in the previous fiscal year (Figure 3.16.1). The phased commissioning of the 1,020 megawatt (MW) Tala hydropower station since July 2006 has tripled Bhutan's total power generation capacity to 1,480 MW (from 460 MW produced by three older power stations), boosting GDP growth sharply in FY2007 and slightly less in FY2008, due to the high base effect. Most hydropower is exported to India.

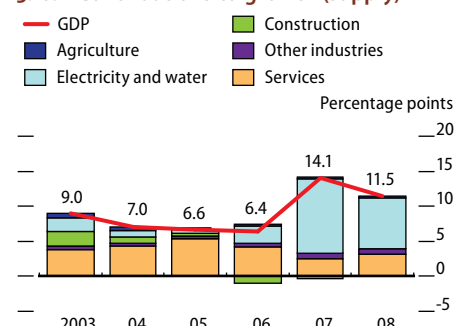
With its currency, the ngultrum, pegged to the Indian rupee (helping anchor inflation), and the country's close trade relationship with India (the source of 70% of imports), Bhutan's inflation moves along with India's. Mainly reflecting the increase in global commodity prices, the consumer price index in Bhutan escalated to 8.9% in the fourth quarter of FY2008, averaging 6.4% for all FY2008 (Figure 3.16.2). With the fall-off in global prices since mid-2008, inflation has likely peaked.

Money supply (M2) recorded modest growth of 2.3% in FY2008, compared with a 8.6% increase a year earlier. Credit to private sector, which dominates domestic credit, grew rapidly once more, at near 40%. The housing sector continued to have the highest share in bank loans (about 30%) reflecting the recent housing boom, followed by manufacturing (19%) and trade and commerce (18%).

Revised fiscal estimates for FY2008 show that nontax revenue was high, mainly from transfers of profits, tax, and dividends related to the Tala project, helping push total revenue to 37.8% of GDP (Figure 3.16.3). External borrowing (net of principal repayments) has been in a decreasing trend and turned negative in FY2008. Bhutan is taking pro-poor fiscal policy measures, according to which a third of expenditure is to be used for health and education (30% was achieved in FY2006 and FY2007). The Government has committed to maintaining its pro-poor policy in the use of additional resources.

The FY2009 budget set plans for greater expenditure (48.8% of GDP), which, however, does not include the additional costs of a 35% salary hike

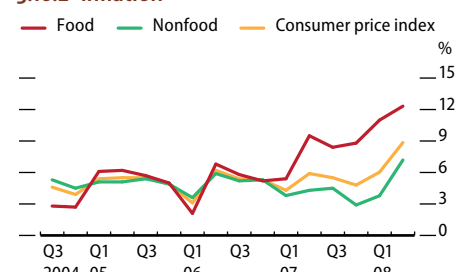
3.16.1 Contributions to growth (supply)



Sources: Royal Monetary Authority, *Selected Economic Indicators*, Vol. 22, No. 2, June 2008; staff estimates.

[Click here for figure data](#)

3.16.2 Inflation



Source: Royal Monetary Authority, *Selected Economic Indicators*, Vol. 22, No. 2, June 2008.

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that was endorsed by the National Assembly in January 2009. With larger grants from India and increased receipts from hydropower projects, the government-budgeted deficit was projected to be 2.8% of GDP.

Total exports in the balance of payment are estimated to have decreased by 8.5% in FY2008, resulting in an unexpected trade deficit. The fall in exports appears to have resulted from a sharp drop in exports in January–June 2008. However, the latest available detailed customs data show a large increase in 2007 exports. Sales of electricity to India, which doubled in 2007, dominate Bhutan's total exports, with a share of 36% in 2007. Other major items are base metals (steel) exported to India (23% of total exports) and magnetic discs and cards sold to countries other than India (16%).

Tourism, an important source of hard currency, grew strongly up to June 2008 with visitor numbers rising by 32.4% and revenue by 29.8%. Because of the large current transfer inflow of budgetary grants from India (among others), the current account maintained a surplus, but one that declined to 3.9% of GDP (Figure 3.16.4). The overall balance of payments also stayed in surplus with a foreign direct investment inflow of \$30 million (equivalent to 3.0% of GDP), including Tata Power's investment in a new hydropower project (Dagachhu). Gross international reserves stood at \$646 million, equal to about 15 months of merchandise imports at end-FY2008.

Bhutan has a large external debt (relative both to other countries' and its own GDP), contracted mainly to finance hydropower projects. It stood at \$780 million, or 58% of GDP, as of end-FY2008 (Figure 3.16.5). About 55% of debt is rupee-denominated borrowing from the Indian Government to support hydropower construction. The overall debt service ratio increased to 18% of total exports of goods and services in FY2008, reflecting the start of repayment for Tala. The bulk of Bhutan's external debt is self-sustaining, serviced by long-term power contracts with India, and with no foreign exchange risk. In addition, much of the remaining debt has been contracted on concessional terms. Thus the overall debt situation appears to be sustainable.

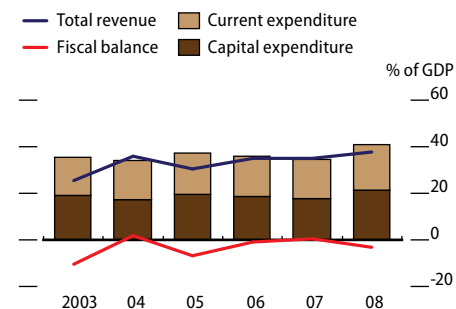
In the political sphere, Bhutan completed the transition from a monarchy to a two-party democracy. Elections were held for the National Council (the upper house) in December 2007 and for the first National Assembly (the lower house) in March 2008. The first written constitution was adopted in July 2008. The political situation under the new democratic system is expected to remain stable.

Economic prospects

Located in the Himalayas and close to India with its burgeoning demand for power, Bhutan is capitalizing on its huge untapped hydropower potential. The Government is planning four hydropower projects (Figure 3.16.6) with an aggregate generation capacity of about 2,900 MW for implementation during the 10th and 11th five-year plans (from FY2009 to FY2018).

Economic growth is therefore dominated by the hydropower project cycle. In FY2007 and FY2008, high growth was led by new electricity production from Tala. With Tala now at full output, GDP growth will

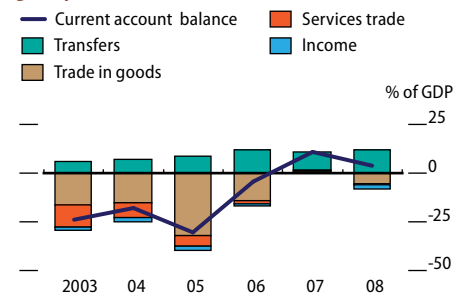
3.16.3 Fiscal indicators



Source: Royal Monetary Authority, *Selected Economic Indicators*, Vol. 22, No. 2, June 2008.

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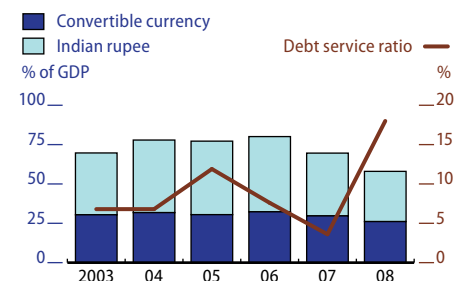
3.16.4 Current account indicators



Sources: Royal Monetary Authority, *Selected Economic Indicators*, Vol. 22, No. 2, June 2008; staff estimates.

[Click here for figure data](#)

3.16.5 External debt indicators



Source: Royal Monetary Authority, *Annual Report 2007/08*, January 2009, available: <http://www.rma.org.bt>, downloaded 16 March 2009.

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come back to its normal path. Construction of new hydropower stations will gradually take over as drivers of growth.

Although these hydropower projects are unlikely to be directly affected by the global economic slowdown, some sectors have felt the chill wind. An early recovery cannot be expected for the steel industry, which benefits from cheap electricity, given the outlook for growth in India. Tourism is another sector that will likely suffer from the global slowdown. Moreover, some companies now face a lack of working capital because banks are reluctant to provide additional loans so as to avoid concentrating their lending among a few borrowers. Considering these factors, GDP growth is projected to be 5.5% and 6.5% in FY2009 and FY2010, respectively.

Inflation is projected at 3.5% and 4.0% for FY2009 and FY2010, respectively, similar to India's. A pay rise for Bhutan's civil servants could add to inflation pressures.

Although power exports to India will remain stable due to strong demand, exports of other products are expected to see only limited growth given the economic outlook in trade partner countries. Exports of services will also moderate as tourism weakens. The drop in international oil and other commodity prices will however help reduce imports. The current account surplus is projected at 5.5% of GDP for FY2009 and will further improve to 9.0% in FY2010.

Development challenges

The 10th five-year plan targets full employment, particularly among educated youth, and emphasizes economic diversification, since hydropower employs few people and has few backward linkages. The unemployment rate rose to 3.7% in 2007 from 1.8% in 2003, and to help counter this, labor-intensive activities would be preferred—and tourism is one area where the private sector can expand. Private sector development will be a key focus, which would also diversify economic activity. The Government also needs to tackle some bottlenecks to investment activity, such as lack of skilled labor and limited financial sector outreach.

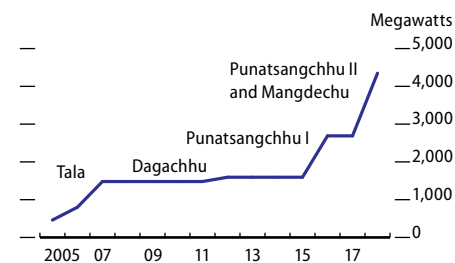
Bhutan is preparing to join the World Trade Organization this year. In the process, it has already agreed to open 54 out of 155 services. The 10th five-year plan committed to addressing the issue of skills shortages by providing vocational education and training. The Government has recently decided to approve new bank and insurance business licenses.

3.16.1 Selected economic indicators (%)

	2009	2010
GDP growth	5.5	6.5
Inflation	3.5	4.0
Current account balance (share of GDP)	5.5	9.0

Source: Staff estimates.

3.16.6 Generation capacity



Sources: Gross National Happiness Commission, Royal Government of Bhutan, *Draft Tenth Five-Year Plan (2009–2013)*; staff estimates.

[Click here for figure data](#)