

Bhutan

The huge Tala hydropower project started commercial production in July 2006. In the medium term, Tala is forecast to double electricity export capacity, boosting GDP and government revenues significantly. Yet it makes Bhutan even more reliant on export of one commodity to India. Also, hydropower employment elasticity is low, and cannot cope with the many tens of thousands of young people entering the labor market or migrating to urban areas. The Government needs to stimulate greater private sector activity and to diversify the economy.

Economic performance

Economic growth is estimated to have accelerated to 9.0% in 2006 from 6.5% in 2005 (Figure 2.15.1). The pickup in growth was largely due to commissioning of the 1,020 megawatt (MW) Tala project in July, with the commercial operation of the first of six turbines in July and the second in October. Nearly all output is exported to India. Production of power from all the four power projects (Basochu, Chukha, Kurichhu, and Tala) increased by 30% year on year, and Tala was responsible for all this rise. Total export sales of power grew by 54% to Nu4.9 billion (about \$109 million).

In other sectors, agriculture is estimated to have grown by 1.5% and services 10.4%. Construction, which declined by about 3% in 2005, recovered on the back of increased private residential and commercial property building.

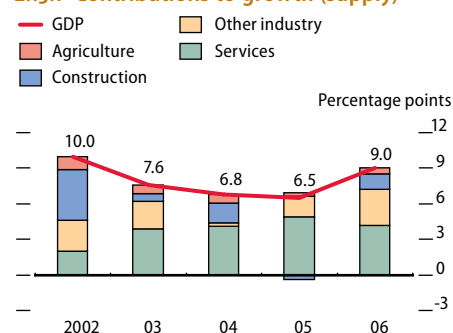
Revised budget estimates for FY2006 (ended 30 June 2006) indicate that the Government's fiscal position improved, with the overall budget deficit narrowing to Nu2.6 billion (or 7.1% of GDP) from 11.0% the previous year (Figure 2.15.2). A small decline in capital spending and an increase in foreign grants were largely responsible.

Capital spending was shaved by 2%, mostly reflecting the high FY2005 base when the Government purchased two Airbus aircraft. Current spending rose by 11%, which included outlays for draft constitution meetings and establishment costs for new institutions, such as the anticorruption and election commissions. Total expenditures, including capital spending of 24% of GDP, came to 44% of GDP.

Revenues and grants increased by 12%, with a robust increase in tax revenues and disbursement of project-tied grants as a result of faster implementation. Total budget receipts depend heavily on grants, and the tax-to-GDP ratio is low at 10.2% of GDP. Of the overall fiscal deficit, about two thirds was financed from domestic sources.

The budget for FY2007 anticipates a further reduction of the deficit to Nu1.5 billion (3.3% of estimated GDP), largely on account of much stronger domestic revenues (up 42%) associated with Tala. With grants estimated at a similar large amount as in the previous fiscal year, total receipts are projected to increase by 21%. Expenditures—both current

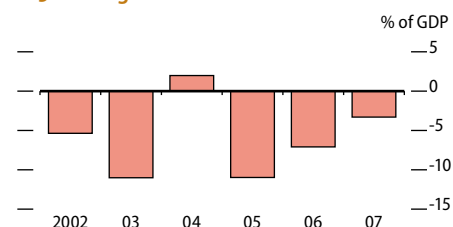
2.15.1 Contributions to growth (supply)



Sources: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007; staff estimates.

[Click here for figure data](#)

2.15.2 Budget balance



Source: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007.

[Click here for figure data](#)

and capital—are each budgeted to increase by about 11%, due to a higher salaries and wages bill, preparations for the introduction of a constitution in 2008, construction of a Supreme Court building, road projects, hospital construction, and preconstruction work for Punatsangchu I and Dagachhu hydropower projects.

Broad money (M2) grew by 25% in FY2006, more than doubling from 11% in FY2005 (Figure 2.15.3). This was entirely due to an increase in the net foreign assets in the banking system. Credit to the private sector rose by 33%, but a very large build up in net deposits of the government more than offset this, and total domestic credit declined over the year. The bulk of the increase in private sector credit was for building and construction, manufacturing, and trade and commerce.

As the ngultrum is pegged to the Indian rupee, monetary developments have limited impact on prices, and inflation in Bhutan is heavily influenced by price developments in India. Consumer price inflation peaked at 6.2% in the second quarter of calendar 2006 (Figure 2.15.4). This gave an average of 4.9% for FY2006, slightly higher than India's 4.3% for the period.

The current account improved markedly, as the deficit narrowed (Figure 2.15.5) to \$30 million (3.6% of GDP) from \$211 million (29.7%). This is mainly attributable to tremendous growth in exports (up \$114 million), small reductions (of about \$15 million each) in both imports and the combined services and income accounts deficit, as well as somewhat larger net transfers receipts (up \$37 million). The 61% expansion in export earnings was about equally split between India (largely electricity) and other countries (mainly fruit and manufactured commodities).

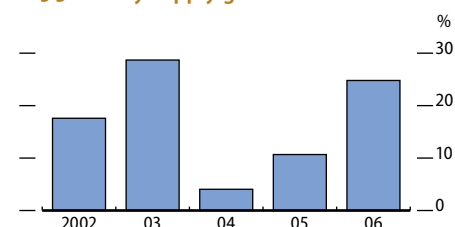
Since imports in FY2005 were buoyed by the purchase of two Airbus aircraft, the relatively small size of their drop in FY2006 of only 3.5% may be partly explained by imports for the Tala project. However, there appears to have been brisk demand for imported goods from both India and other countries. Tourism also continued strong, near-40% growth, with revenues estimated at \$21 million.

As the inflows in the capital account (including grants for Tala) and the financial account (mainly foreign aid loans) together amounted to \$144 million and were much greater than the current account deficit, the overall balance of payments registered a large surplus. Gross international reserves increased to \$479 million at end-FY2006, a very comfortable level equivalent to about 14 months of imports. External debt outstanding at end-FY2006 was \$681 million, or 82.5% of GDP. The debt service ratio for the year was only 5.3%, as almost all debt has been contracted on concessional terms.

Economic prospects

With the start of commercial operations, Tala will be the main driver of economic expansion in the next 2 years, with growth expected to accelerate further to 18% in 2007 and then moderate to 10% in 2008. Growth in other sectors together is expected to average 6–8%, while inflation should stay around 5%. Tala is expected to generate Nu40 million (approximately \$1 million) in daily revenues, and raise hydropower's share of total government revenues from 45% to about 60%.

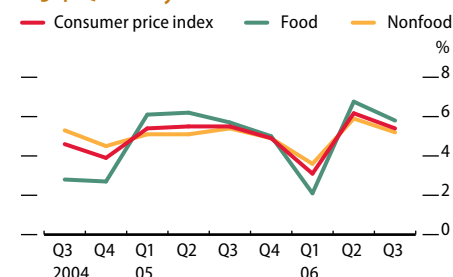
2.15.3 Money supply growth



Source: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007.

[Click here for figure data](#)

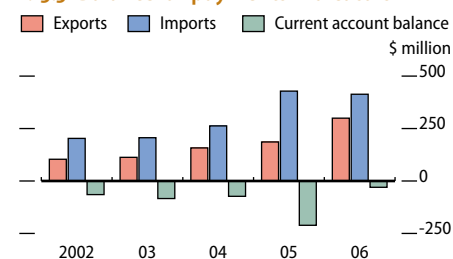
2.15.4 Quarterly inflation



Source: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007.

[Click here for figure data](#)

2.15.5 Balance-of-payments indicators



Source: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007.

[Click here for figure data](#)

Export income from the additional power sales is expected to turn the trade balance to a surplus, and with current transfers likely maintained at about the present level, the current account balance is also projected to switch to a surplus, of 3% of GDP.

Further growth in the medium term will benefit from continued international cooperation in the hydropower sector. Memorandums of understanding have been signed between Bhutan and India for preparing detailed project reports on the 1,095 MW Punatsangchu I, the 992 MW Punatsangchu II, and the 670 MW Mangdechu hydropower projects. The full feasibility report of the Punatsangchu I project is complete and India has agreed to finance it with 60% loan and 40% grant components. Construction is expected to start this year.

2.15.1 Selected economic indicators		
	2007	2008
GDP growth	18.0	10.0
Inflation	5.0	5.0
Current account balance (% of GDP)	3.0	3.0
Source: Staff estimates.		

Development challenges

The main challenge is that hydropower employment elasticity is low. With more people entering the labor market each year, the Government must stimulate greater private sector activity and diversify the economy to boost employment, in line with the Government's poverty reduction strategy. The Government might aim to do this by improving transportation and communications infrastructure for better integration of the national economy, strengthening the private sector enabling environment (particularly for tourism and high-value agriculture), and enhancing the efficiency of the financial sector.

In preparation for its planned transition from a monarchy to a two-party democratic system in 2008, the Government has established institutions to ensure high standards of governance and transparency. An autonomous Anticorruption Commission has been established, and autonomous status is envisaged for the existing Auditor General's Office. The National Assembly has set up a public accounts committee, and a fiscal responsibility bill is expected to be presented for passing. The actual transformation and workings of a two-party democracy may lead to some initial uncertainty, but the transition is unlikely to result in any significant economic policy changes.

Bhutan is trying to integrate itself with regional and international economic groupings. It is currently negotiating to become a member of the World Trade Organization; the third meeting of the working party was held in October 2006.