Bhutan

Bhutan ended its self-imposed isolation in the 1960s, and consequently development activities date back only a few decades. Nonetheless, it has established a record of sustained solid growth based on its vast hydropower resources for export, on sound policies, and on strong support from international partners. The country has fashioned a unique, far-reaching strategy based on the goal of boosting “gross national happiness”—a holistic concept combining material, spiritual, emotional, and cultural well-being. The outlook for continued strong development is bright, though generating greater employment remains a challenge.

Economic performance

In 2005, economic growth was again strong, posting a rate of 8.8%. This performance compares favorably with the medium-term trend growth of 8.2%. While hydropower remains the mainstay of the economy, the 19.0% growth rate of construction (part of the industry sector) accounted for one half of the growth in gross domestic product (GDP) (Figure 2.15.1).

Construction’s strong performance was based on the physical works associated with the 1,020 megawatt (MW) Tala hydropower project, and the increased construction of houses and other establishments in the private sector.

Despite steady economic progress, Bhutan remains a poor country with a national poverty rate of 32%. Since some of the population are still involved in traditional subsistence activities, inequality is high with the top quintile having eight times greater income than the lowest. The economic base remains narrow, despite development of manufacturing, and largely depends on hydropower, which accounts for some 12% of the country’s GDP and 45% of national revenues. However, hydropower and its related industries have a low employment elasticity, and since some 50,000 young people are expected to enter the labor market and another 20,000 to migrate from rural to urban areas, over 2002–2007, the Government would like to see greater private sector activity.

Fiscal policy was expansionary with the overall budget deficit in FY2005 (ended 30 June 2005) increasing to 11.3% of GDP from 6.7% a year earlier. The larger deficit is mainly attributable to a substantial increase in capital spending that raised total government expenditure by 25%, with the higher capital spending linked to the purchase of two Airbus A-319 aircraft for state-owned Druk Air Corporation. For the year, capital expenditure amounted to 29.2% of GDP. Current spending grew by nearly 17%, largely reflecting salary increases for civil servants and interest payments for Druk Air bonds. Total revenue growth for the year was 14.2%. Nontax revenue made a large jump (mainly dividends from public sector corporations) but the increase in tax revenue was small (2.9%), stemming from tax reductions of previous years made to
promote development in the private sector. The tax-to-GDP ratio declined slightly to 12.0% from 12.7% in FY2004, though it is not unusually low in the South Asian context. About 35% of the overall deficit was financed through external borrowing, and the balance through domestic sources.

Monetary expansion (M2) accelerated by 10.7%, a rate below its 5-year average of about 15%, though annual changes in the monetary aggregates have been variable. About equal nominal increases in domestic credit and net foreign assets drove M2 growth. Approximately half of the increase in domestic credit was on account of the Government drawing down its deposit balances as part of the financing of the budget deficit. Credit to the private sector grew by 26%, and despite similar increases in recent years, outstanding private sector credit stands at only about 18% of GDP. With limited investment opportunities in the country, about 35% of commercial bank assets are lying as deposits with the Royal Monetary Authority, signifying substantial excess liquidity. Lending rates stayed unchanged during FY2005, in the range of 10–16%; interest paid on 1-year deposits had been reduced from 6.0% to 4.5% in FY2004. The overall financial sector nonperforming loan ratio improved from 16% to 12%.

With the local currency, the ngultrum, pegged at par to the Indian rupee, monetary developments have a limited impact on prices, as inflation is influenced heavily by price movements in India. The inflation rate in Bhutan was therefore 5.5% at end-FY2005 (Figure 2.15.2). Tracking the Indian rupee, the local currency appreciated by 4.4% against the dollar between June 2004 and June 2005.

The global increase in prices of petroleum had only a limited impact on the country’s consumer price index since it has a weight of only 3.2%. Moreover, given the availability of cheap hydropower, imports of petroleum products are used essentially to power motor vehicles. However, since Bhutan is an import-reliant country, and as most items in the consumer price basket are imported, the indirect effect of the global oil price increase does have some impact. A Reserve Bank of India analysis has estimated that every $1 increase in crude oil prices adds 15 basis points to India’s wholesale price index as a direct effect, and another 15 basis points as an indirect effect, in the absence of any countervailing policy intervention. A similar impact might be expected in Bhutan.

Bhutan’s balance-of-payments position in FY2005 was characterized by a 68% increase in imports (Figure 2.15.3), though the abnormal jump was in large part driven by the purchase of two aircraft by Druk Air. Import growth (excluding aircraft) was about 30%. Fast import growth in the past 2 years has been associated with the construction of Tala. Export growth was robust at 18% and, in a welcome development, was almost entirely due to strong gains in nonpower exports, such as minerals, manufactures, and agricultural products. While tourist arrivals increased by 67% and tourism’s foreign exchange earnings (about one third of services sector receipts) rose by 66% to $15.3 million (Figure 2.15.4), higher services payments (partly reflecting better recording) meant there was only a small gain in net invisible receipts during the year. The current account deficit amounted to $187.5 million (about 27% of GDP), with the Airbus purchases accounting for about half of the total.

As in the past, net inflows on the capital and financial account were greater than the current account deficit and in FY2005 provided an overall
balance-of-payments surplus of $32.7 million, bringing official reserves to $420 million (Figure 2.15). At this level, the reserves could finance about 13 months of imports of goods (excluding aircraft) and nonfactor services—a very strong position. About 80% of reserves are held in convertible currencies and the balance in Indian rupees. Capital transfers and official inflows accounted for most capital and financial account financing. Foreign direct investment increased sharply to $9 million, mainly reflecting ongoing development of high-end hotel resorts.

External debt outstanding grew by 15% in FY2005 to $608 million (at end-June 2005). Of this figure, 39% ($237 million) consisted of convertible currency debt, representing a 9% increase from the previous year, and the balance rupee debt, a 17% increase. The ratio of outstanding debt to GDP remained essentially unchanged at 88%. The service ratio was only 7.0% in FY2005, since virtually all debt has soft or concessional terms.

**Economic outlook**

The Tala hydroelectric project is by far Bhutan’s largest hydropower project. Its phased coming-online from March through June this year is expected to double the country’s annual power exports, generating about $1 million a day. GDP growth is therefore expected to spike up from about 8% in 2005 by about 2 percentage points each year to 10% in 2006 and 12% in 2007 (Figure 2.15.6). Over the full year, Tala’s operations should raise the share of hydropower dividend revenues to total budget revenues from the current 45% to 60%. With substantially larger exports, the current account deficit should decline to about 9% in 2006 and then move into surplus in 2007 (Figure 2.15.7). Inflation will likely stay broadly in line with that in India.

The country’s medium-term economic prospects will remain anchored to further development of the hydropower sector to generate export revenues. In this regard, three memorandums of understanding have been signed between Bhutan and India for the preparation of detailed project reports on the 870 MW Punatsangchu, the 992 MW Punatsangchu (Stage II), and the 670 MW Mangdechu hydroelectric projects. India has informed the Government of Bhutan that it intends to proceed with the financing of this last project.

The following issues present challenges as well as opportunities: the narrow base of the economy; the low employment elasticity of the hydropower sector; the weak involvement of the private sector in economic development; administrative limitations on the expansion of the private sector; and the rapidly growing number of educated, unemployed young people.

Major economic uncertainty pertains to the size of bilateral grant inflows. With Tala coming online, many bilateral development partners seem to believe that Bhutan does not need as much financial support as in the past. The Government objects, as it plans to use its revenues from Tala for expanding the social services network.