Bhutan

The economy, which has vast hydropower potential, is driven by the cycle of hydropower building and output. Two hydropower stations are being built and two other projects started preconstruction work in May 2010, ensuring strong growth for the medium term. The main challenges for the government are to try and diversify the economy and create job opportunities.

Economic performance

Growth is estimated to have accelerated to 7.0% in FY2010 (ended 30 June 2010) from 5.7% in FY2009 (Figure 3.16.1). Construction revived with work on the Punatsangchhu I (1,200 megawatts [MW]) and Dagachhu (114 MW) hydropower stations. Services, accounting for nearly two-fifths of GDP, contributed the bulk of the GDP gain, mainly construction related. Agriculture's growth was solid. Despite generating only about 16% of GDP, it engages over 65% of the labor force.

The electricity and water sector—nearly a quarter of GDP—did not contribute to the expansion, as no additional generation capacity has been added since Tala hydropower station came online in FY2007. Tourism was also a drag on growth due to the global downturn: visitor arrivals dropped by 9.3% and foreign exchange earnings by 12.4%.

As Bhutan is linked with India through trade (93.5% of exports and 77.7% of imports) and a currency peg, rising consumer prices in India tend to spill over. Year-on-year inflation rose to 6.1% in the fourth quarter of FY2010 from 3.0% a year earlier (Figure 3.16.2).

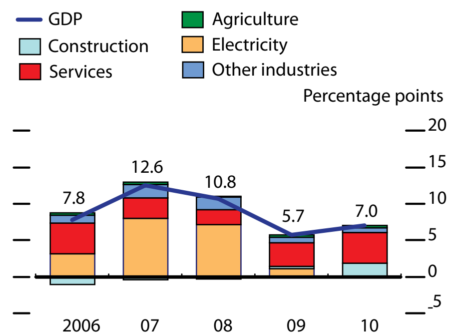
With a pickup in economic activity, growth in broad money accelerated to 30.1% from 24.6%, as domestic assets expanded. Domestic credit, primarily to the private sector, grew by 38.6% in FY2010 from 31.1% in the previous year, reflecting surging personal loans and credit to manufacturing. The sectorwide distribution of credit remained mostly to housing (about one-quarter of the loan portfolio), followed by manufacturing, personal loans, and services (including tourism).

Credit quality improved as nonperforming loans as a share of the total narrowed to 10.1% in June 2010 from 18.3% the previous year, reflecting a fall in such loans in manufacturing, where several export-oriented firms saw an upswing in sales. Banks are well capitalized with a capital-adequacy ratio of 17.1% at end-FY2010.

The budget deficit in FY2010 is estimated at around 6% of GDP, reflecting revisions that sharply raised capital expenditure despite a fall in nontax revenue (Figure 3.16.3). These adjustments stemmed from additional construction spending, including a monastery and other public buildings.

Nontax revenue declined because of a 1-year gap in dividend receipts. (Druk Holding and Investments was set up to own all major state-owned

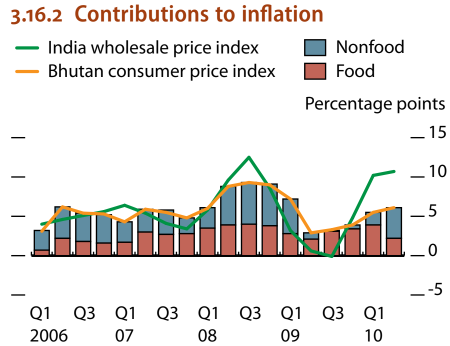
3.16.1 Contributions to growth (supply)



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

Click here for figure data

3.16.2 Contributions to inflation



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

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3.16.1 Selected economic indicators (%)

	2011	2012
GDP growth	7.5	8.0
Inflation	8.0	7.5
Current account balance (share of GDP)	-20.0	-20.0

Source: ADB estimates.

This chapter was written by Tadateru Hayashi of the South Asia Department, ADB, Manila.

enterprises, including Tala Hydroelectric Project Authority, such that dividends were not immediately passed through to the budget.) The final figure of the fiscal deficit in FY2010, may, however, be substantially lower due to underimplementation of capital investment projects. The fiscal deficit in FY2011 is estimated at 4.4% of GDP. A civil service wage hike effective January 2011 will increase current spending in FY2011 and FY2012.

The government has announced tax incentives to stimulate private investment. Foreign direct investment (FDI) projects in FY2010 with an estimated investment of Nu1.1 billion (equivalent to $23.6 million) included an IT park and an agro-industry project.

The trade deficit is estimated to have worsened to 21.5% of GDP in FY2010 from 7.5%, as growth in merchandise imports accelerated markedly (Figure 3.16.4). Imports climbed by 39.0%, mainly because of heavy needs for machinery, transport vehicles, and base metals for the hydropower projects and housing.

Exports rose by only 5.5% as sales of hydropower to India (about two-fifths of total exports) were pretty flat as capacity production has been reached. A jump in budgetary grants, mainly from India, held the current account deficit to 13.5% of GDP in FY2010 from 1.6% the previous year.

The capital and financial account surplus—about half in capital grants and half in borrowing and FDI—nearly offset the current account deficit. The overall balance of payments was in surplus by $94 million, giving an unusually large positive errors and omissions item. Gross international reserves rose to the equivalent of $868.1 million at end-FY2010, equivalent to about 12 months of merchandise imports.

Economic prospects

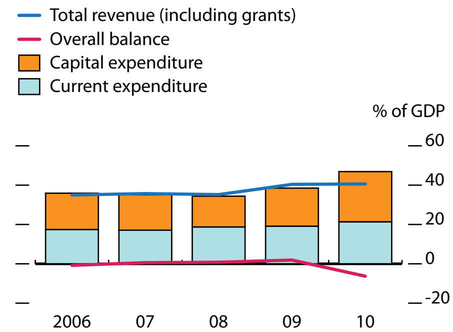
In addition to the construction of two hydropower stations, preconstruction works for Punatsangchhu II (990 MW) and Mangdechhu (720 MW) projects started in May 2010. Hydropower construction will therefore fuel GDP growth for the next 5 years, even as additional power production capacity and exports come online. Indeed, the government plans by 2020 to see new power stations increase generation capacity to 10,000 MW, about seven times the present level. Accordingly, GDP is estimated to grow by 7.5% in FY2011 and 8.0% in FY2012.

High inflation in India, especially of food, is a concern. Projected higher global commodity price hikes will indirectly affect Bhutan, where inflation is expected to reach 8.0% in FY2011 and moderate to 7.5% in FY2012.

The current account deficit will deteriorate, mainly owing to imports of construction materials for power stations, as well as higher import prices of fuel. Export growth will likely be limited in the next couple of years. Expansion will need to come mainly from manufactured and commodity exports, as no additional power generation capacity will come online.

Although tourism revenue will grow, soaring imports are expected to push the current deficit out to around 20% of GDP in both years. As with past projects, capital inflows from India to finance power plant construction, combined with development assistance, FDI, and some other borrowing, will likely suffice to finance the current account deficit.

3.16.3 Fiscal indicators



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

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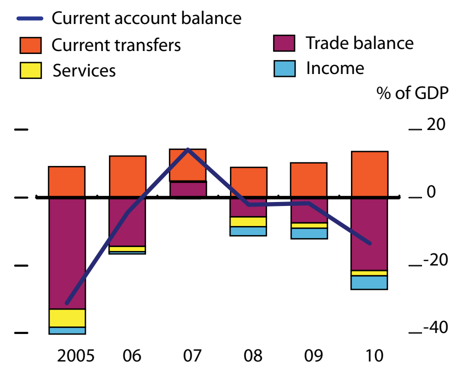
3.16.4 Current account indicators



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

Click here for figure data

3.16.1 Development challenges

The slowdown in economic growth in FY2009, when neither new construction or new production in the power sector were strong, indicates that growth is not being led by productivity improvements or new business ventures. The government's decision to undertake the Thimphu Technology Park and Education City projects are attempts to foster economic diversification by moving toward a knowledge-driven economy.

Generating jobs is hard, as hydropower has small backward linkages and is capital intensive. Speeding up private sector development is therefore crucial to expand job opportunities and diversify the economy.

The government has announced Fiscal Incentives 2010—a broad array of general and sector-specific tax incentives—as well as Foreign Direct Investment Policy 2010, to promote private sector investment.