

# Bhutan

After a solid year, the outlook remains favorable with growth staying robust, in part driven by the construction of large hydropower projects. Current account deficits will remain high, though, reflecting the projects' import requirements—but associated capital inflows are expected to keep the overall balance of payments in surplus. A main challenge for government is to implement policies that would rapidly expand private sector activity to boost job opportunities and broaden the country's economic base.

## Economic performance

Growth is estimated to have moderated slightly to 8.3% in FY2011 (ended 30 June 2011) from 9.3% a year earlier (Figure 3.16.1). Reflecting the country's hydropower project cycle, the construction phase is under way on four large projects that would more than double power capacity, thus construction and manufacturing (cement mainly) are the main drivers of expansion. Electricity generation capacity has not risen since 2007, so power production provided little impetus to growth—sales to India rose by only about 4% during the year. Expansion in services eased solely on community services while the rest of the components remained robust.

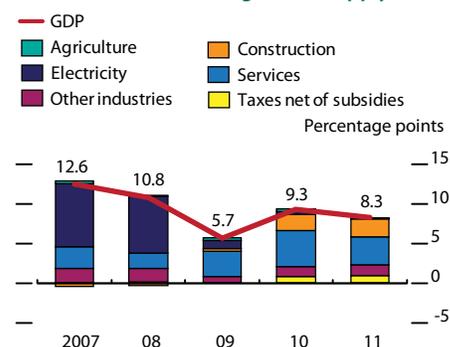
Agriculture has been unable to record significant growth in the past 7 fiscal years, and is gradually losing its overall share of output, because it is hard to provide development services to raise productivity to the many small villages in the remote mountainous parts of the country.

Broad money (M2) growth moderated—along with the economy—to 21.2% in FY2011, mainly due to small expansion in net foreign assets. Private sector credit grew 31.9% in FY2011, broadly in line with its long-term average of 32%, concentrated in housing and construction and in personal loans. The ratio of nonperforming loans declined to 8.5% at end-FY2011 from 10.2% a year earlier.

Local price movements continue to follow India's because Bhutan's currency is pegged to India's and because the country keeps strong trading ties with its giant neighbor (taking about 90% of exports and providing 75% of imports). Bhutan's average inflation, therefore, rose to 8.6% in FY2011, almost twice the FY2010 rate. (Food prices rose by 9.3% and nonfood prices by 8.0%—Figure 3.16.2.)

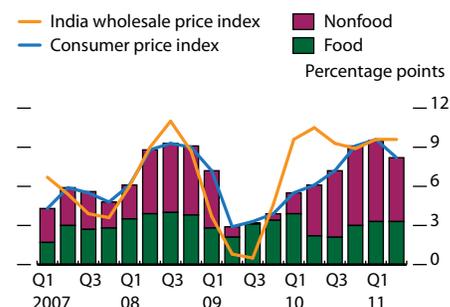
The government revenue-to-GDP ratio fell to 39.1% in FY2011 from 46.4% a year earlier as nontax revenue growth slowed (Figure 3.16.3). Expenditures (43.8% of GDP) rose by 14.4% in FY2011 on the back of rising capital expenditures reflecting hydropower construction and a pay hike for public servants from January 2011. The fiscal deficit was 4.7% of GDP in FY2011 (from a surplus equivalent to 1.6% of GDP in FY2010) and was financed mostly from domestic borrowing.

3.16.1 Contributions to growth (supply)



Source: National Statistics Bureau, 2011. *National Accounts Statistics 2010*. <http://www.nsb.gov.bt>

3.16.2 Contributions to inflation



Source: Royal Monetary Authority of Bhutan, 2011. *Selected Economic Indicators*. June. <http://www.rma.org.bt>

According to the Royal Monetary Authority (RMA), public external debt amounted to 76.2% of GDP at end-FY2011. By currency, nearly three-fifths was in Indian rupees; by use, just over two-fifths of the total had been allotted for hydropower loans and the balance for development projects.

Even though the overall current account deficit widened from 9.9% of GDP in FY2010 to about 20.6% in FY2011 as trade deficit widened from 20.9% of GDP to 30.2%, the overall balance of payments recorded a sizable surplus equivalent to 5.7% of GDP as loans and capital grants more than compensated for the current account deficit (Figure 3.16.4). However, Bhutan's external position with India has weakened greatly because export growth to it has slowed, given that power sales have reached generation capacity and that import demand has accelerated because of the power construction program and strong economic growth. At end-FY2011 Bhutan's rupee reserves amounted to about one week of imports, although convertible currency reserves were high at nearly \$890 million, equivalent to about 9 months of total (essential and inessential) imports (Figure 3.16.5).

## Economic prospects

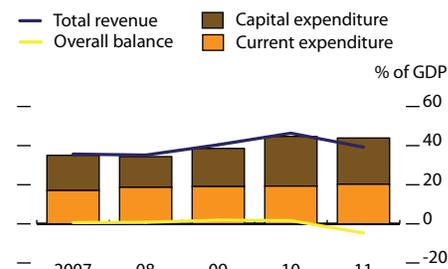
Growth is forecast at 8.0% for FY2012 and 8.5% for FY2013 largely on the account of continued hydropower construction. The FY2012 budget will continue to support high growth with total planned expenditure to increase by about 11%. More than half the budget is allocated to capital expenditure, which rises by about 13%, with about two-thirds of it financed by grants. Current expenditure is slated to grow by 9%, mainly on account of public servants' salary revisions and higher operations and maintenance expenses. The overall deficit is projected to rise to 6% of GDP.

Inflation is expected to moderate to 7.3% in FY2012 and 6.5% in FY2013, broadly in line with assumed price developments in India. The *Asian Development Outlook* baseline forecast of relative stable global oil and food prices underpins a favorable outlook.

The current account deficit is projected to stay high at 20% and 22% of GDP in FY2012 and FY2013, mainly owing to continued high imports for power plant construction. The overall balance of payments is expected to remain in surplus reflecting continued substantial project loans and capital grants. The tight overall balance with India is not expected to improve and pressures on rupee liquidity will persist.

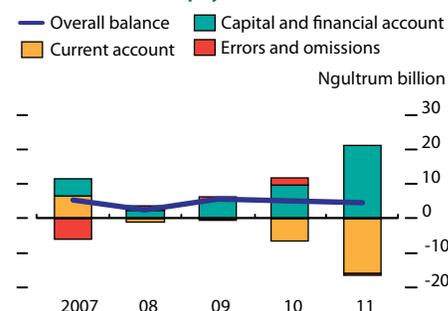
In recent years the RMA has borrowed through an overdraft facility (at relatively steep rates) with the State Bank of India and through a credit line with the government of India to keep an adequate working balance. Its borrowing from the overdraft exceeded Rs8 billion as well as reaching the Rs3 billion credit line limit with the government before end-2011. The RMA sold \$200 million of its convertible currency reserves in November 2011 to eliminate this expensive overdraft and to partly pay other rupee debt. However, liquidity pressures caused the RMA in March 2012 to clamp down on import spending and to restrict the use of reserves to importing priority items, including fuel. Because Bhutan's constitution requires foreign reserves to provide 12 months of cover for essential imports and they are about at this level, there is limited scope to sell additional reserves. To avoid disrupting the economy, the RMA is, therefore, expected by

### 3.16.3 Fiscal indicators



Source: Royal Monetary Authority. 2012. *Annual Report FY2011*. <http://www.rma.org.bt>

### 3.16.4 Balance of payments



Source: Royal Monetary Authority. 2012. *Annual Report FY2011*. <http://www.rma.org.bt>

### 3.16.5 Gross international reserves



Source: Royal Monetary Authority. 2012. *Annual Report FY2011*. <http://www.rma.org.bt>

April 2012 to negotiate a higher ceiling on the credit line with the Indian government and, possibly, carry out a currency swap arrangement through the facilitation of the SAARC FINANCE. Power exports from the plants under construction will, of course, provide an enduring solution.

The RMA and the Reserve Bank of India are working to establish guidelines to create a base-rate system for Bhutanese financial institutions, expected to come in this fiscal year, which would make loan pricing more transparent and foster competition in the sector. This is a precursor to the RMA's carrying out monetary policy by setting policy rates, a change that would be a more effective mechanism for monetary policy.

## Policy challenge—broadening the economic base

The private sector needs to expand to tackle rising unemployment. The unemployment rate has averaged 3.5% in the last 3 years, well above the government target of 2.5% set for 2013. Unemployment is an especially serious problem among those aged 15 to 24 years—over 45% of the unemployed, this group has a 9.4% jobless rate (Figure 3.16.6). This stems from limited job openings and deficiencies in labor skills necessary for employability in various sectors. The government is the employer of choice especially among the young but the absorptive capacity of the public sector to hire more staff is nearing saturation. Hydropower—the industrial mainstay—offers very few jobs.

The government recognizes the problem. Its Economic Development Policy, issued in 2010, specified fiscal incentives to attract foreign direct investment (FDI). It has, therefore, drafted new FDI regulations that include clearer provisions for owning land as well as liberalizing other features of current regulations. The policy also identified niche business opportunities for cottage and small industries and tourism, where the government believes it can promote local entrepreneurship.

The government has identified the information and communications technology industry as a promising niche sector. The country's first park for this, the Thimpu Techpark, was inaugurated in 2011 and is expected to attract FDI and provide some high-skilled jobs. The industry is, however, still at a very early stage.

According to World Bank's 2010 Bhutan Investment Climate Assessment Report, the top constraint for small firms is access to finance. In an effort to ease it, the government has recently adopted expanded microfinance policies, including subsidized interest rates, new credit products suitable for small firms, and incentives for socially and environmentally friendly lending.

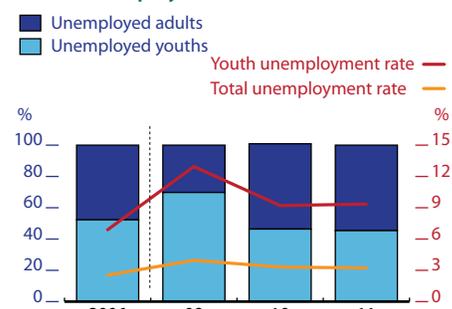
The same report notes that the major constraint for large firms is inadequate education. The 2011 Labor Force Survey Report noted that only 6% of the work force has received higher secondary education (and 3% has tertiary education) (Figure 3.16.7). The government has introduced competency-based training programs for five trades, namely auto-mechanics, construction carpentry, plumbing, masonry, and industrial electrical. It has also launched a grant program to train tertiary graduates working in the private sector. Other constraints faced by large firms include the difficulty in hiring foreign workers, transport difficulties, high tax rates, and restrictive labor regulations.

### 3.16.1 Selected economic indicators (%)

	2012	2013
GDP growth	8.0	8.5
Inflation	7.3	6.5
Current account balance (share of GDP)	-20.0	-22.2

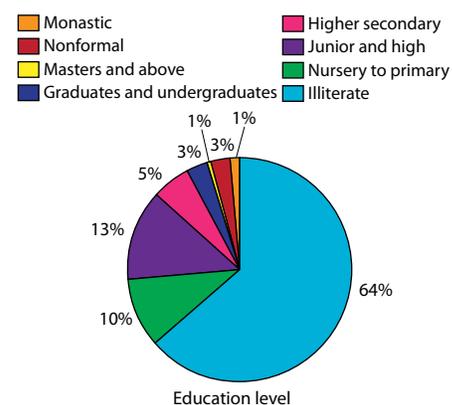
Source: ADB estimates.

### 3.16.6 Unemployment



Source: Ministry of Labour and Human Resources. 2011. *Labour Force Survey Report*. <http://www.molhr.gov.bt>

### 3.16.7 Education level of employed persons, 2011



Source: Ministry of Labour and Human Resources. 2011. *Labour Force Survey Report*. <http://www.molhr.gov.bt>