Bhutan

Growth moderated last year as the authorities tightened credit to address a rupee liquidity crunch caused by both cyclical and structural factors. The Royal Monetary Authority implemented significant monetary reforms including the introduction of policy and base rates. Looking ahead, growth is expected to pick up, propelled by exports of hydropower and higher tourist arrivals.

Economic performance

Economic growth moderated to 7.5% in FY2012 (ended 30 June 2012) from 10.0% a year earlier (Figure 3.16.1). The slowdown reflected credit measures taken by the Royal Monetary Authority (RMA) to curb an escalating balance of payments deficit with India and alleviate the rupee liquidity crunch. Both general and specific credit restrictions were implemented to constrain imports that are a large component of consumer and investment spending. Reflecting the measures, growth in consumption, which accounts about three-fifths of GDP, slowed to 7.8% in FY2012 from 10.0% in FY2011.

The measures had their greatest impact on construction and transport and communications services. Construction growth slowed to 9.1% from 17.4% in FY2011, and transport and communications slowed less sharply to 12.7% from 16.6%. Hydropower output, which contributes about 20% of GDP, grew by 7.6% on better water storage after being broadly flat a year earlier. The construction of large ongoing power projects was not subject to tightening.

Consumer price inflation reached an all-time high of 13.6% from a year earlier in the fourth quarter of FY2012 (Figure 3.16.2). Food inflation was 18.7% and nonfood inflation 10.7%. Local prices broadly follow prices in India because the Bhutanese ngultrum is pegged to the Indian rupee. However, scarce supplies appear to have bid local prices to a premium in the second half of FY2012. Average inflation was 10.2% for the fiscal year.

The average annual growth of broad money (M2) slowed to 5.8% in FY2012 from 23.6% in FY2011. Short-term liquidity concerns arising from asset–liability mismatches in the banking sector has led the RMA to create a short-term liquidity adjustment facility and to reduce its cash reserve ratio twice, taking it from 17% to 5%.

The RMA implemented significant reforms by introducing monetary policy rates and a base-rate system for Bhutanese financial institutions. The policy rate, set at 6%, will act as the main monetary policy instrument, supplemented by the cash reserve ratio. The base rate will set the floor for lending by financial institutions and also be the reference rate for floating-rate products. Bank base rates were set between 10.4% and 12.7%, while a uniform base rate of 13% was applied to nonbanking institutions.
Bhutan aims to diversify economic activity and is expanding and upgrading its hotel industry with a target to attract 100,000 tourists by the end of 2013. The total revenues of the tourism sector reached $52 million in October 2012, improving on the $48 million in earnings realized in calendar year 2011.

Labor market conditions have improved with a steady decline in the unemployment rate in recent years. Total unemployment fell to 2.1% of the labor force in FY2012 from 4.0% in FY2009, while the youth unemployment rate was brought down to 7.2% from 9.4% a year earlier, which is much lower than 12.9% recorded in FY2009 (Figure 3.16.3). However, youth unemployment still accounts for about half of total unemployment, and addressing youth unemployment remains a key challenge in Bhutan.

The current account deficit in FY2012 is estimated at 18.9% of GDP, down from 23.5% in FY2011 (Figure 3.16.4). The imposition of credit measures and foreign exchange restrictions caused a slight narrowing of the trade deficit to 26% of GDP from 30%. Exports shrank by 10.6% year on year, while imports fell by 9.5%. India continues to be a major trading partner, receiving over 80% of all exports from Bhutan and providing over 70% of Bhutan’s total imports.

The overall balance of payments recorded a deficit of 5.9% of GDP, down from 5.5% in FY2011 (Figure 3.16.5). This reflected declining capital transfers, foreign direct investment, and government loans. Gross international reserves fell by $136 million to $770 million in FY2012, enough to cover 9.9 months of imports (Figure 3.16.5). External debt reached $1.4 billion (73.4% of GDP), down by 1.8 percentage points from the previous year. About three-fifths of the debt is denominated in Indian rupees. Most borrowings from the Government of India were earmarked for hydropower development.

Economic prospects

Growth is expected to recover in FY2013 and reach 8.6%, driven mainly by hydropower and tourism. The contribution of the service sector to growth is expected to improve as the government develops the country’s tourism potential. As this trend is likely to continue, 8.5% growth is expected in FY2014.

Inflation is expected to moderate to 9.3% in FY2013, as the government has adopted a tight fiscal stance and clamped down on growth in credit, especially for home construction and personal loans, in response to the rupee liquidity crunch. Inflation is expected to ease further to 7.4% in FY2014 as the foreign exchange position relaxes.

Continued shortage of electricity in India will support Bhutan’s hydropower exports. However, a widening of current account deficit is likely to persist at about 20% of GDP in FY2013 and FY2014, driven by strong demand for imports related to hydropower development.

The government aims to limit the fiscal deficit to 1.5% of GDP in FY2013 by cutting capital expenditures, which are expected to contract by 22.9% in FY2013 after expanding by 30.8% in FY2012 (Figure 3.16.6). Current expenditures are expected to expand by 5.3% in FY2013 from 17.7% last year. The cutback in fiscal outlay follows the fiscal rationalization measures announced in the budget.
Policy challenge—sustaining high economic growth

Bhutan has achieved remarkable economic performance and made significant progress in reducing poverty and advancing social development over the past decade. However, sustaining high and inclusive economic growth remains a major challenge. The tight overall balance with India has recently placed great pressure on Indian rupee liquidity in Bhutan. The RMA’s small rupee working balances over the past few years have been maintained by the sale of convertible currencies and borrowing on lines of credit with Indian banks; as of June 2012, outstanding net liabilities on this account were Rs9.6 billion (about $174 million).

The ongoing rupee liquidity problem has been caused by both structural and cyclical factors, which can be attributed to weak economic management. The lumpy nature of hydropower-related imports and the long gestation between construction and operation make managing the trade balance in the medium term a challenge. Lumpy debt payments and high seasonality in hydropower generation and electricity exports contribute to volatility in net rupee inflows. This highlights the need for enhancing capacity to manage debt.

The rupee shortage also reflects the rapid growth of the economy. Rising per capita income has fuelled domestic demand for consumption goods and launched a housing boom, both of which have contributed to the large import bill from India. Limited ability to contain public spending has widened trade deficits and put further pressure on the balance of payments with India. On the financial side, rapid growth in private consumption has been fed by excessive growth in credit. Indeed, loans to the private sector grew by 30.1% in FY2012, greatly outpacing nominal GDP growth of 17.7%. The limited effectiveness of monetary and liquidity management instruments in stabilizing inflation and avoiding asset price buildup has also contributed to the problem.

The Ministry of Finance and the RMA have undertaken a number of measures to address the rupee liquidity issue. For instance, the RMA has clarified that, while the rupee serves to anchor the nominal value of the ngultrum, there should be no presumption of unlimited convertibility. The RMA has made it mandatory to use the banking system to settle Indian rupee transactions, especially for cross-border purchases between India and Bhutan. In addition, it has sought to improve liquidity management by introducing policy rates and the base-rate system, as well as the liquidity adjustment facility. The Ministry of Finance’s tighter fiscal policy, aiming to reduce the fiscal deficit to 1.5% of GDP in FY2013, is a welcome step.

While Bhutan has been the fastest-growing economy in South Asia, the recent rupee shortage has revealed structural imbalance in the economy and Bhutan’s weak economic management. As the large spending on hydropower development is expected to continue in the medium term, Bhutan must strengthen in a timely way its macro-financial management to sustain high growth without exacerbating domestic and external economic imbalances.

### 3.16.1 Selected economic indicators (%)

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
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</thead>
<tbody>
<tr>
<td>GDP growth</td>
<td>8.6</td>
<td>8.5</td>
</tr>
<tr>
<td>Inflation</td>
<td>9.3</td>
<td>7.4</td>
</tr>
<tr>
<td>Current account balance (share of GDP)</td>
<td>–20.0</td>
<td>–20.0</td>
</tr>
</tbody>
</table>

Source: ADB estimates.

### 3.16.6 Fiscal indicators

- Current expenditure
- Capital expenditure
- Total revenue
- Grants
- Overall balance

% of GDP

Click here for figure data