Bhutan

Growth slowed for a second year as the authorities continued administrative measures to rein in consumption spending that was putting pressure on the balance of payments and Indian rupee reserves. These measures are evolving into fiscal and monetary mechanisms to strengthen demand management. Growth is expected to pick up on the construction of a series of large hydropower projects that will substantially expand mainstay exports of power to India.

Economic performance

Economic growth continued to moderate from 6.5% to an estimated 5.2% in FY2013 (ended 30 June 2013), well below the average growth of 8.4% over the past decade (Figure 3.16.1). The slowdown largely reflects policy measures adopted in 2012 to alleviate worsening shortages of Indian rupee reserves. The measures entailed credit and import restrictions, particularly in import-heavy activities such as construction and transport that required large rupee payments.

The brunt of the downdraft in FY2013 was felt in services. Expansion in transport and communications halved to 5.2% from 10.3%, while growth in retail trade, hotels and restaurants, and other services moderated mainly to slower domestic spending, especially on vehicles. In addition, finance output fell as lending plummeted. Growth in industry provided a partial offset; the 6.4% expansion in manufacturing and 7.7% in construction remained relatively high, the latter related to hydropower projects rather than to house building.

Inflation decelerated to 5.5% in the fourth quarter of FY2013 from its peak at 13.6% a year earlier as food prices significantly eased (Figure 3.16.2). Local food prices had gone up in the last quarter of FY2012 as supplies tightened and demand rose for consumption goods not subject to the restrictions. Inflation after this slowed as the high base effect dissipated and inflation moderated in India, Bhutan’s major trading partner, which supplies over 90% of food imports. Since June 2013, inflation has rebounded, tracking currency depreciation and price developments in India. Over FY2013, inflation averaged 8.6%, down from 10.1% a year earlier.

Monetary tightening rolled out in March 2012 to fight the rupee liquidity shortage included credit constraints for various imported goods. As the measures took hold, growth in credit to the private sector plunged from high rates averaging about 35% over the past 5 years to 6.8% in FY2013 (Figure 3.16.3). Credit for transport and construction was hardest hit. While growth in the broad money supply recovered...
18.6%, the expansion reflected marked improvement in banking system net foreign assets as the balance of payments turned around.

Following on earlier measures to implement the use of policy rates for more effective monetary management and a base-rate system for financial institutions to strengthen competition, the Royal Monetary Authority in 2013 reviewed in depth its reserve management operations and issued revised policy and operational guidelines.

On the fiscal front, the budget deficit narrowed to 0.9% of GDP in FY2013 from 1.1% the year earlier, below the target of 1.6% (Figure 3.16.4). Substantial grants alongside some increase in tax revenue largely funded spending and helped to rein in the deficit. Preliminary estimates indicate that total expenditure and net lending grew by 14.6%, slightly more quickly than in the previous year.

The trade balance improved as the country's large import bill fell by 6.5%, reflecting the administrative restrictions that curtailed imports of vehicles and construction materials. Hydropower exports continued to be a major source of earnings, accounting for nearly one-third of exports in FY2013, though earnings, which vary with river flow, slipped slightly. Accordingly, the trade deficit narrowed to an estimated $354 million, or 18% of GDP, even as the current account deficit widened from 21.3% to 23.6% of GDP on sharply lower current transfers and increased interest payments.

The deficit was funded by ample capital and financial flows, more than three-quarters of which were earmarked for hydropower construction. The balance of payments moved to a surplus of $167.9 million, or 8.7% of GDP, which marked a sharp turnaround from a deficit of 9.8% of GDP a year earlier (Figure 3.16.5). Reserves increased sharply to $916.9 million, equivalent to 12.6 months of imports (Figure 3.16.6). The $200 million purchase of Indian rupees in June 2013 substantially boosted rupee reserves to about 3 months of imports from India, which should provide a more comfortable cushion for managing cross-border payments.

3.16.3 Monetary indicators growth

3.16.4 Fiscal indicators

3.16.5 Balance of payments

Economic prospects

GDP growth is expected to rebound to 6.0% in FY2014 as hydropower construction projects under the Eleventh Five-Year Plan get under way and improving economic conditions in major tourist source countries boost tourism. Growth is forecast to strengthen further to 6.8% in FY2015 as hydropower construction expands and exports increase with the start of operations at the Dagachhu power plant. Notably, the sale of carbon credits is a potential source revenue for the project, as it was approved under the United Nations Framework Convention on Climate Change.

Total budget spending is planned to moderate in FY2014 in line with the government's policy to rationalize expenditure, but the deficit is nevertheless expected to widen to 3.6% of GDP on lower projected grants. The reduction in spending reflects spending cuts on vehicle purchases, staff quarters construction, and other nonessential operating expenses, as part of austerity measures to address the rupee liquidity problem. Moreover, medium-term macro fiscal projections envisage annual expenditure ceilings to maintain a sustainable fiscal path.
The current account deficit is projected to widen to 28.6% of GDP in FY2014, owing mainly to large imports for power projects, but to narrow again to 26.4% in FY2015 with the mobilization of more development grants.

Inflation is anticipated to rise to average 10.2% in FY2014 as the economy expands and currency depreciation keeps import prices high. Inflation will ease slightly in FY2015 as global price pressures subside and inflation moderates in India.

**Policy challenge—credit availability for inclusive growth**

Bhutan’s economy has grown remarkably in recent years, with GDP tripling over the past decade mostly on the back of capital-intensive hydropower development, which has contributed 20.9% to GDP growth on average over the past 14 years. While the government has harnessed hydropower proceeds to substantially raise the standard of living for many Bhutanese, economic expansion in other sectors has been limited. Productivity gains have been largely confined to industry, which has improved productivity by over threefold in the past 13 years but uses little labor. Productivity increases in the key employment-generating sectors have, by contrast, been negligible. As 62% of the Bhutanese work in agriculture, mainly for subsistence, encouraging private sector development to create more jobs outside of agriculture remains an important macroeconomic priority toward achieving self-sufficient and inclusive growth.

In terms of business development, the greatest constraint identified by small and medium-sized firms is their lack of access to finance, cited by over 30% of all firms (Figure 3.16.7). Accordingly, constraints on domestic credit to the private sector need to be addressed. While deficiency in domestic savings for investment restrains the availability of credit, the distribution of existing credit is hampered by the risk-averse selection of clients in response to limited loan-recovery capacity, little variety in loan products, financial infrastructure shortfalls, and client dispersion over rugged terrain. Further, external borrowing by the private sector remains severely restricted by law in terms of the borrower type as well as regarding the use of funds, effectively eliminating this as a source of funds for potential borrowers who face credit constraints in the domestic market.

Enhancing access to finance should thus be a pillar of government policy to foster private sector development, employment growth, and diversification. The stimulus package that the government will soon start to disburse aims to ease access to credit in priority development sectors such as cottage industries and the informal sector. It is an important measure to address issues of credit distribution. Further development of a credit information system and a better variety of financial products may also help bolster the provision of credit to entrepreneurs.