BHUTAN

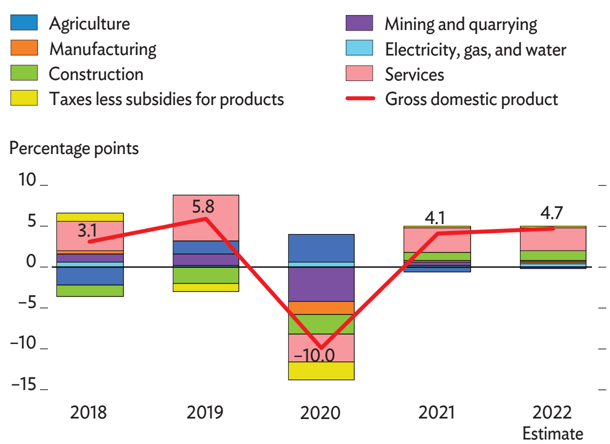
Growth accelerated in 2022. Inflation eased, but the current account deficit widened sharply, drawing down official reserves. The outlook is for moderate slowing of growth as impetus from recovery in production and the commissioning of new hydropower projects is offset by low investment during the transition to the 13th Five Year Plan covering the period 2024-2028. Current account deficits are expected to remain elevated, placing further pressure on foreign exchange reserves. Bhutan needs a more vibrant private sector to achieve its development goals.

Economic Performance

Provisional estimates show growth increasing from 4.1% in 2021 to 4.7% in 2022 (Figure 2.16.1). All sectors are estimated to have grown in 2022 on strong domestic demand supported by government's monetary relief measures and the easing of COVID-19 restrictions. Services were the largest contributor, with growth estimated at 5.6% and underpinned by strong expansion in accommodation and food services and in transport, storage, and communication. Industry output is estimated to have increased by 4.4% on a 10.0% expansion in construction as capital spending surged and restrictions limiting expatriate labor imports were relaxed. New policies requiring value addition to minerals before export caused minerals, mining, and quarrying to contract by 1.5%. Agriculture grew by 2.2%.

Figure 2.16.1 Supply-Side Contributions to Growth

All sectors registered moderate growth in 2022.



Sources: National Statistics Bureau ; Haver Analytics; Asian Development Bank estimates.

On the demand side, growth was driven by continued revival in gross fixed capital formation and consumption expenditure (Figure 2.16.2). Growth in gross fixed investment is estimated to have increased to 15.0% on double-digit growth on both the public and the private side, and with a marked buildup in inventory. Private consumption expenditure expanded by 4.8% and public by 5.3%. Net exports became a larger drag on growth with sharp expansion in imports.

Inflation moderated from 7.3% in 2021 to 5.6% in 2022 (Figure 2.16.3). Inflation slowed in 2022 in tandem with food price inflation, which fell from 12.8% in 2021 to 5.0%. Nonfood inflation averaged 9.0%, driven mainly by transport costs that increased by nearly 13.0% with a large rise in global oil prices following the Russian invasion of Ukraine. One-third of overall inflation came from this category.

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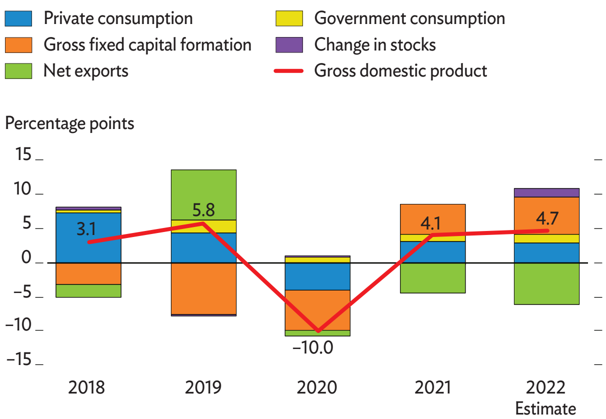
Figure 2.16.2 Demand-Side Contributions to Growth

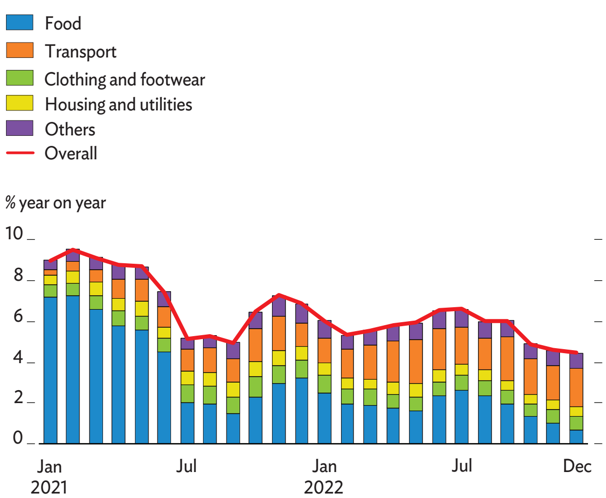
Demand-side drivers highlight continued reliance on public spending.



Sources: National Statistics Bureau ; Haver Analytics; Asian Development Bank estimates.

Figure 2.16.3 Inflation

Inflation moderated in 2022 as food price inflation slowed.

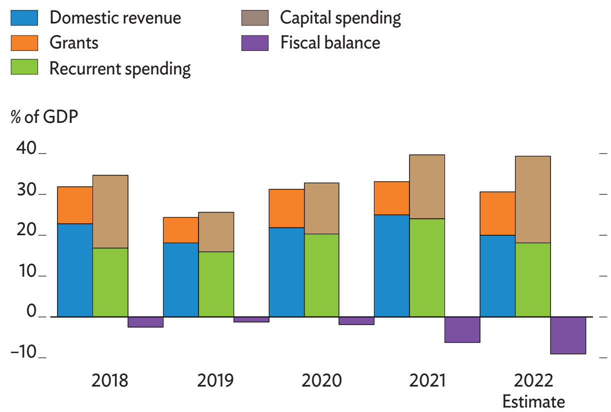


Sources: National Statistics Bureau ; Haver Analytics.

The budget deficit widened in fiscal year 2022 (FY2022, ended 30 June 2022) from 6.2% a year earlier to 8.8%. There were marked changes in the composition of both expenditure and revenue (Figure 2.16.4). Government spending was marginally lower, down from 39.5% of GDP in FY2021 to 39.3% in FY2022 despite a 25.8% increase in capital expenditure to 21.4% of GDP. However, the increase in capital expenditure was offset by a decline in current expenditure, which fell from 24.2% of GDP to 18.0% mainly with the scaling back of economic relief

Figure 2.16.4 Fiscal Indicators

As revenue fell, a widening fiscal deficit helped to sustain growth.



GDP = gross domestic product.
Note: Years are fiscal years ending on 30 June of that year.
Sources: Ministry of Finance; Asian Development Bank estimates.

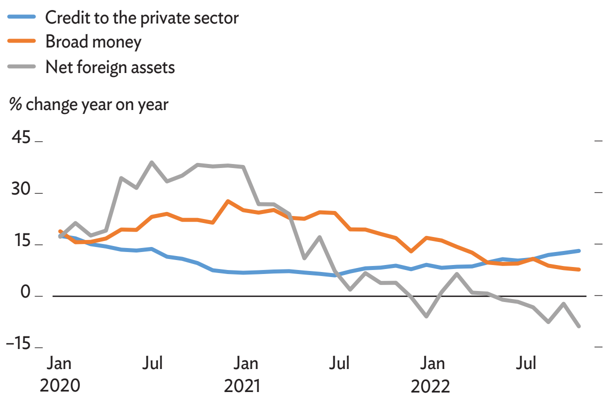
measures provided during the height of COVID-19 lockdowns. Despite a modest increase in growth, domestic revenue declined sharply from 24.9% of GDP in FY2021 to 20.1%. Even with an increase in grants to 10.4% of GDP, revenue and grants together amounted to only 30.5% of GDP, or 2.7 percentage points less than in FY2021. With a slight decline in expenditure, the increase in the deficit was held to 2.5 percentage points, equal to 8.8% of GDP.

Monetary policy remained accommodative to revive the economy. Monetary policy continued to promote economic growth and ensure adequate and uninterrupted flow of credit. Domestic credit grew in 2022 by an estimated 18.7%, with a 13.2% increase to the private sector and a near doubling of net credit to the government. Money supply is estimated to have grown by only 7.7%, however, as net foreign assets fell steeply along with official reserves as a result of marked deterioration in the balance of payments (Figure 2.16.5).

The current account deficit widened considerably from the equivalent of 21.9% of GDP in 2021 to an estimated 34.3% (Figure 2.16.6). The trade deficit grew as imports increased by 35.2% from a year earlier, largely because of price rises for fuel and steel and a dramatic rise in the imports of information technology equipment, while exports increased by only 2.4%. The current account deficit was financed

Figure 2.16.5 Monetary Indicators

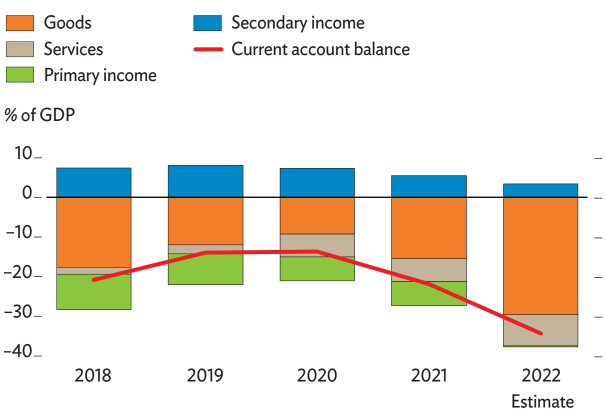
Accommodative monetary policy contributed to economic growth.



Source: Royal Monetary Authority.

Figure 2.16.6 Components of the Current Account

The current account deficit widened on strong growth in imports.



GDP = gross domestic product.

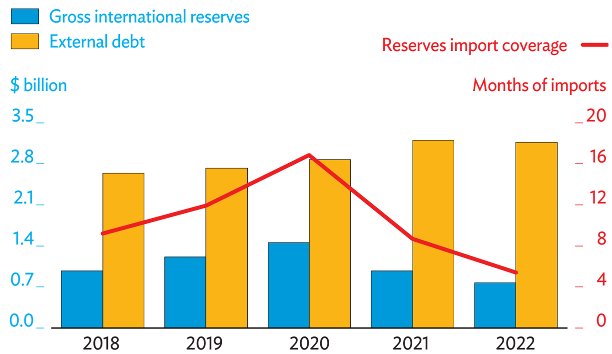
Sources: Royal Monetary Authority; Asian Development Bank estimates.

by a large net financial account inflow, if errors and omissions are included, and by drawing down gross foreign exchange reserves by $215.0 million.

Despite falling by 20% in 2022, gross international reserves at $755.0 million provided cover for 4.7 months of merchandise and service imports (Figure 2.16.7). Public external debt fell from the equivalent of 117.7% of GDP in 2021 to 115.8% in 2022 largely because of GDP growth. Though the ratio of debt to GDP ratio is high, 69.2% of public external debt is hydropower debt owed to India, which the IMF points out is self-liquidating, given Bhutan's power purchase agreements with India. Hence, Bhutan's risk of debt distress is moderate.

Figure 2.16.7 External Debt and Gross International Reserves

An import surge diminished gross international reserves.



Source: Royal Monetary Authority.

Economic Prospects

Growth will slow slightly in 2023 and 2024 (Table 2.16.1). A return to normal hydropower production after 2 years of decline will underpin growth in 2023, while expected production from two newly commissioned hydropower plants will help sustain growth in 2024. At conservatively projected capacity for that year, these plants are expected to raise GDP by 3 percentage points. As India is Bhutan's main trade partner, its robust economic growth prospects in 2023 and 2024 will boost exports and growth. However, growth prospects are tempered this year and next by a marked decline in investment caused by emerging domestic macroeconomic issues, national elections in December 2023, and a transition to a new government five year plan. On balance, growth is projected to slow from 4.7% in 2022 to 4.6% in 2023 and 4.2% in 2024.

Table 2.16.1 Selected Economic Indicators, %

Growth and inflation are expected to moderate in 2023 and 2024.

	2021	2022	2023	2024
GDP growth	4.1	4.7	4.6	4.2
Inflation	7.3	5.6	5.5	5.1

GDP = gross domestic product.

Sources: Ministry of Finance; National Statistical Bureau; Asian Development Bank estimates.

Greater hydropower generation in 2023 and 2024 will sustain growth. Bhutan opened up its economy to tourism on 23 September 2022. While the recovery in tourist arrivals has been slow due to the increase in the sustainable development fee, total tourist arrivals in 2023 will be considerably higher than in 2022 and boost foreign reserves and services. While tourism is expected to remain well below its 2019 level, accommodation and food services will grow by 4.3%. Wholesale and retail trade, however, is forecast to contract as import restrictions are sustained to reduce pressure on foreign exchange reserves. Growth in agriculture is forecast at 3.2% in 2023 and 2.6% in 2024 as the government continues to invest in agricultural infrastructure, value chain creation, and contingency measures to address the rising issue of human–wildlife conflict. Industry growth at 5.0% will be strengthened by increased electricity output in 2023, reaching the 2020 level on expected better hydrological flow and less maintenance downtime—two factors that held back generation in 2021 and 2022. However, mining and quarrying will be hampered by changes in export policy. Moreover, growth in the large construction industry will slow as work winds down and nears completion on the 1,020 megawatt Puna-2 hydropower plant and the smaller Nikachhu plant. In 2024, growth in electricity output from the commissioning of these two plants will underpin 5.4% expansion in industry growth. Services are expected to continue to grow in 2024, but with accommodation and food services remaining below their 2019 level as tourist arrivals continue to lag, in part because the sustainable development fee charged to international tourists has risen steeply.

On the demand side, aggregate consumption expenditure will drive growth. It is forecast to expand by 25.4% in 2023 and 12.3% in 2024, mainly on strong private consumption, as is consistent with the experience of past government election cycles. Public consumption is expected to grow by 5.6% in 2023 and 5.0% in 2024. Fixed investment is projected to contract by 8.1% in 2023 and 1.6% in 2024, with the FY2024 capital allocation shrinking by almost 20%—the largest decrease in the Twelfth Five-Year Plan, 2018–2023. Transition to a new government and 5-year plan will slow growth in fixed investment as arrangements are made for newly selected projects and financing. On balance, the budget deficit is projected to widen marginally in FY2023 as grants and other revenue shrink and then narrow in FY2024 as expenditure declines.

A widening fiscal deficit and declining foreign exchange reserves will remain key concerns for the government. If reserves continue to decline at the 2022 rate, they will likely breach the constitutionally mandated requirement that they be sufficient to cover 12 months of essential imports. As a small and import-dependent economy, Bhutan could face challenging tradeoffs if this problem persists. In the near term, higher hydropower output will likely sustain Bhutan's exports and finances. Moreover, the expected cessation of large information technology imports by mid-2023 is expected to keep the reserve position from deteriorating at such a rapid clip. At the same time, it is important that Bhutan continue to implement its medium-term strategy for debt management and the latest International Monetary Fund Article IV recommendations to reduce its debt: gradual fiscal consolidation, revenue mobilization, normalization of an accommodative monetary policy introduced in response to COVID-19, and addressing risks to banks, especially from a possible rise in nonperforming loans when pandemic relief measures expire.

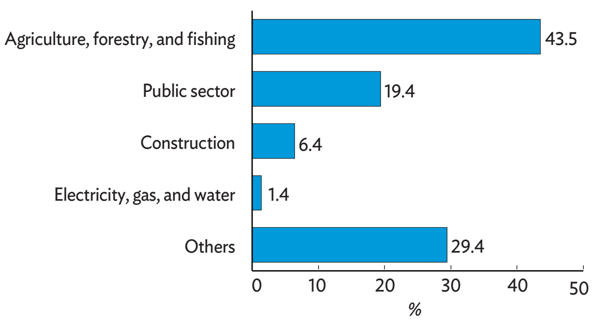
Headline inflation is projected to remain elevated at 5.5% in 2023, driven mainly by moderating but still relatively high global prices for petroleum, food, and other commodities caused by the Russian invasion of Ukraine. Given the government's food security drive, domestic food prices are expected to remain low, offsetting some imported inflation. Moderation of inflation in India, to 5.0% in 2023 and 4.5% in 2024, will help contain inflation in Bhutan as imports from India constitute about half of the consumer price index. The rule of thumb is that a 1.0 percentage point change in India induces a 0.5 point change in Bhutan. With improvements to the global supply chain and the geopolitical situation, and with moderation of inflation in India, average inflation in Bhutan is forecast at 5.1% in 2024.

Policy Challenge—Strengthening the Private Sector as a Partner in Economic Development

Private sector development in Bhutan has stalled despite it being envisioned as an engine of growth. Aside from hydropower, the economy is largely stagnant. This is an obstacle to equitable growth because hydropower and related sectors use little labor. While the public sector and agriculture collectively provide about 63% of employment and a quarter of GDP, construction, electricity, water, and gas provide another quarter of GDP with only 8% of employment (Figure 2.16.8). Meanwhile, the GDP share of manufacturing has slowly fallen since 2009 while its employment share held steady, indicating a lack of productivity growth. The absence of a dynamic private sector constrains the creation of productive employment for Bhutanese, which is reflected in rising youth unemployment over the past 3 years to a high rate of 29% in 2022.

Figure 2.16.8 Employment by Sector, 2022

Hydropower and related pursuits create relatively few jobs.



Note: The public sector includes public administration, defense, compulsory social security, education, health care, and social work.
Source: National Statistical Bureau. 2022. *Labour Force Survey Report*.

The private sector is constrained by a regulatory burden and factor market constraints. Bhutan's business environment is held back by burdensome business compliance processes, a shortage of skilled workers, low digitization, crowding out by state-owned enterprises, and poor access to finance. In an economic census in 2018, businesses cited customs procedures, business licensing, workforce skills, timely clearances, tax administration, and access to finance as factors affecting operations. Without a conducive business environment, private firms struggle to grow and exploit economies of scale.

The government is undertaking reform to improve the business and investment climate. Administrative approval processes are being simplified and digitized through the Government to Citizen initiative. Public services are progressively being integrated and placed online. Ongoing civil service reform has at its core, improved coordination between public agencies and easy access to public services.

The private sector needs to grow to achieve the government's ambitious target of a $10 billion economy by 2034. This will require additional reforms. It is imperative to create an environment of policy certainty, promote the private sector through public–private partnerships, privatize loss-making state-owned enterprises, and support skill development, product innovation, and process innovation. Foreign direct investment will be essential, given the large and growing gap between savings and investment. As competition for such inflows is highly competitive, a favorable policy framework is required to induce entry, smoothen the operations of foreign companies, and improve access to credit. An environment of trust and policy certainty needs to be established.

The urgency of private sector development is greater than ever given ongoing mass emigration. Thousands of Bhutanese have emigrated for economic reasons in the past year. Unless the private sector is empowered to create jobs that match the aspirations of Bhutanese youth, the exodus of human capital will continue, hampering the country's long-term development efforts.