Bhutan

Economic growth is dominated by the hydropower project cycle. While growth decelerated last year from very high levels as the effect of newly installed power production faded, construction of new power plants will sustain solid expansion over the next few years. Bhutan has a record of relatively strong growth that has cut poverty and advanced social development. It is based on prudent economic management and well-targeted donor support. Anchored by power, the medium-term outlook is bright, though rising unemployment, especially among young people, remains an economic and social concern.

Economic performance

Bhutan was well insulated from the global meltdown as the economy is driven largely by construction of hydropower stations and the export of electricity to power-hungry India. Electricity is the single largest sector of the economy, with a 22% share of GDP (its exports to India amount to half total exports), followed by construction at 12%, agriculture at 17%, and manufacturing at about 9%. (Services as a group account for around 36%.)

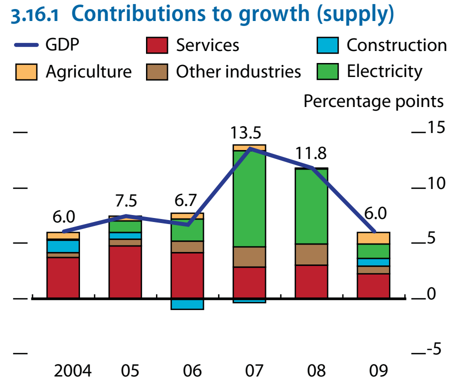
GDP growth in FY2009 (ended 30 June 2009) decelerated to an estimated 6.0% from 11.8% in FY2008 (Figure 3.16.1) reflecting the leveling-off of power output gains after the 2007 commissioning and phase-in of the huge Tala hydropower station (Figure 3.16.2). There were no stimulus measures introduced given the limited impact of the global crisis.

Though its impact was not as severe as elsewhere in the region, the global recession affected tourism and manufacturing. Tourism, though small in relation to GDP, is important for employment creation and is the largest source of hard currency earnings. While it benefited from the one-time centenary and royal coronation celebrations held in June–July 2008, arrivals dropped by 7.3% in January–June 2009, year on year (Figure 3.16.3). Major manufacturing companies, most of which produce raw materials, saw sales fall by 13.1% in FY2009, reflecting a drop in exports to India. In the labor market, unemployment is estimated to have increased to 4.0% in FY2009 from 3.7% in FY2008.

With strong economic and financial ties to India, and its currency (the Ngultrum) pegged at par with the Indian rupee, Bhutan's inflation is highly influenced by that in India, and averaged 7.1% in FY2009. It decelerated to 3.0% in the fourth quarter of FY2009 from a peak of 8.8% in FY2008, as nonfood price inflation (including transport) tumbled (Figure 3.16.4).

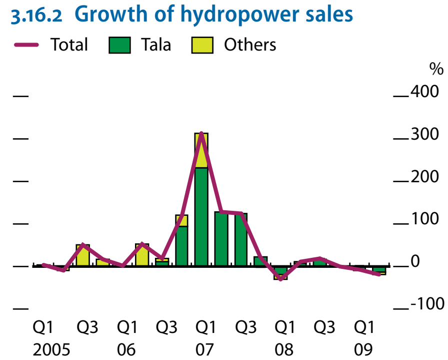
Money supply (M2) rebounded, to 24.6% growth in FY2009 from 2.3% a year earlier, primarily due to growth in net foreign assets. Credit to the private sector grew by 31.1%, reflecting continued significant expansion in

3.16.1 Contributions to growth (supply)



Source: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January. http://www.rma.org.bt

3.16.2 Growth of hydropower sales



Note: Sales based on cost in Ngultrum.

Source: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January. http://www.rma.org.bt

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

personal and housing loans and lending to manufacturers. Credit to the private sector has grown rapidly by an average of 35% in the past 3 years despite efforts by the Royal Monetary Authority, the central bank, to rein in banks' excess liquidly.

Credit quality deteriorated in FY2009 as nonperforming loans increased from 13.3% to 18.3% of the total. Such loans in manufacturing more than doubled, largely owing to lower prices and export sales in metal and other processing industries, which benefit from low-cost electricity. While the outlook for manufacturing is positive (largely due to India's rapid recovery), the central bank has raised provisioning requirements of substandard and doubtful loans to 30% and 60%, respectively, to minimize any potential adverse impact on banks.

Otherwise, developments in the finance sector have generally been positive. It is expected that the entry of two commercial banks, one specialized bank, and an insurance company will stimulate greater competition in the sector.

Budget revenue for FY2009 is estimated to be up by 30.6% from FY2008, attributable to increases in personal income tax receipts, business income tax receipts, excise duty, and profit transfer from Tala. Total expenditure rose by 42.5%, reflecting a surge in capital expenditure (50.3%) due primarily to the inclusion of additional budget allocations for agriculture-related infrastructure, rural electrification, and project funds for a cement project. The estimated fiscal deficit of Nu1.6 billion is equivalent to 2.8% of GDP (Figure 3.16.5).

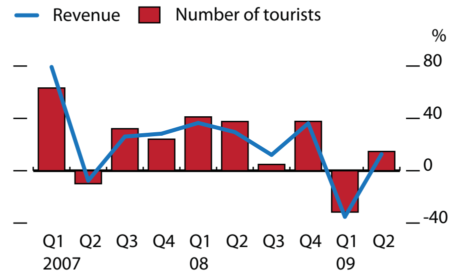
The FY2010 budget plan projects an increase in the deficit to Nu4.8 billion, or about 9.0% of projected GDP. The larger deficit reflects a 10.1% decline in budget revenue, mainly due to a fall in grant receipts, which are volatile from year to year. Domestic revenue declined slightly as weaker profit transfers from Tala are not expected to be offset by continued strong growth in domestic tax revenue. Total outlays are projected at Nu26.3 billion (up 3.1%), with current expenditure rising by about 14% (largely on a 23% increase in salaries and wages), and capital spending falling (after the large increase in FY2009).

The overall trade balance is estimated to have deteriorated to a deficit of 12.1% of GDP in 2009 from 5.0% in 2008 (Figure 3.16.6), attributable to easing commodity exports and increased imports. Manufactured exports, particularly textile- and mineral-based products, contributed to weaker export performance, but their impact was mitigated by moderate growth in hydropower exports. In the other direction, intermediate imports surged on burgeoning construction-related activity.

Despite the much higher current account deficit (9.4% of GDP), the overall balance remained in surplus due to large inflows associated with capital grants received from the Government of India. At end-September 2009, gross international reserves (convertible currency and Indian rupee combined) climbed to $849 million, equivalent to 17.1 months of import cover.

External debt as a share of GDP was high at 65.0% as of end-FY2009, with loans from India for hydropower development constituting more than half. The government recently started borrowing in rupees from the Indian government's standby credit facility and the State Bank of India's overdraft facility to meet shortfalls in rupees required for

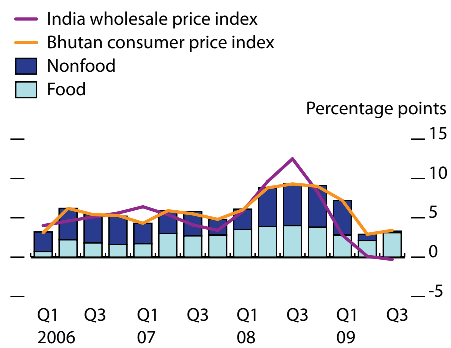
3.16.3 Tourism growth



Note: Revenue changes calculated in US dollars.

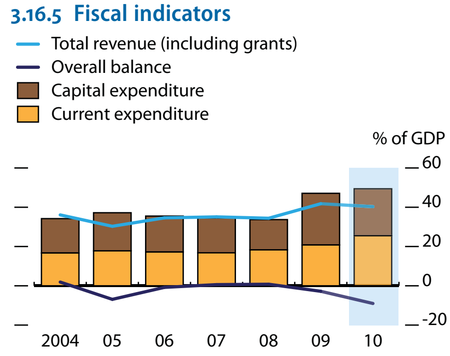
Source: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January. http://www.rma.org.bt

3.16.4 Contributions to inflation



Sources: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January; 2009. *Monthly Statistical Bulletin*. September. http://www.rma.org.bt

3.16.5 Fiscal indicators



Sources: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January. http://www.rma.org.bt; ADB estimates.

import payments. Still, Bhutan's debt level is largely self-sustaining, as a steady stream of earnings from power exports to India generate the necessary service payments. Convertible currency debt is mostly on highly concessional terms involving modest debt servicing. The external debt service ratio increased to 39.6% in FY2009 from 18.5% a year earlier, reflecting repayments to the State Bank of India (Figure 3.16.7).

Economic prospects

It is expected that during the 10th five-year plan (FY2009–FY2013), growth will continue to be strong, mainly driven by new hydropower developments including 10 hydropower projects, with three of the projects expected to start this year. Construction of these new power stations will sustain high economic growth.

On these factors, GDP growth is projected to be 6.0% in FY2010 and 6.5% FY2011. With close trade links and the currency peg to the Indian rupee, inflation is projected at 5.0% for FY2010 and FY2011, largely following Indian inflation. While power exports to India will remain stable due to strong demand and long-term contracts, commodity exports will likely improve in view of that country's expected strong expansion in the forecast period.

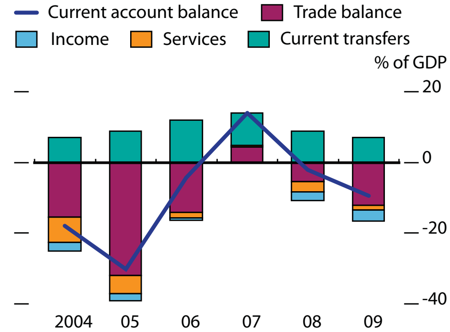
Recovery of service exports (mainly tourism) may take time, reflecting the economic recovery in industrial countries. The assumed relatively stable fuel import prices will, however, help restrain import growth. The current account is projected to be in balance in both FY2010 and FY2011.

Development challenges

Rising unemployment is a concern, as hydropower-led development employs few people and has small backward linkages. Labor-intensive activities need to be developed. Tourism is one area where the private sector can expand. Depending on the development of tourism infrastructure and new tourism products, a more steady inflow of tourists throughout the year could be better promoted.

Private sector development will be a key focus in diversifying economic activity. Bottlenecks such as lack of skilled labor, difficult access to land, inadequate infrastructure, and limited financial sector outreach need to be addressed to facilitate economic diversification and growth.

3.16.6 Current account indicators



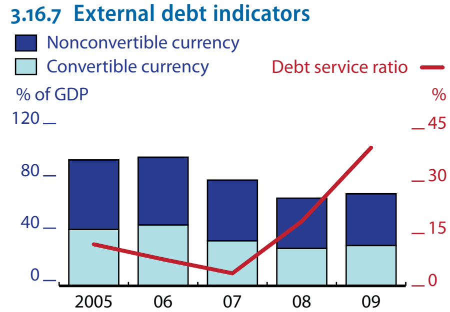
Source: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January. http://www.rma.org.bt

3.16.1 Selected economic indicators (%)

	2010	2011
GDP growth	6.0	6.5
Inflation	5.0	5.0
Current account balance (share of GDP)	0.0	0.0

Source: ADB estimates.

3.16.7 External debt indicators



Source: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January. http://www.rma.org.bt