

CHAPTER IV

ECONOMIC DEVELOPMENT AND FOREIGN TRADE:

A DESCRIPTIVE ANALYSIS

4.1. Economic Development in the light of Foreign Trade

4.1.1. Country Background

The Buddhist Kingdom of Bhutan is a sovereign state and has never been colonized unlike other countries within the sub-region. Bhutan's economy is small by all measures and more so in comparison to the whole of Asia, as well as most individual South Asian countries except Maldives. It has an approximate land area of 38,394 square kilometers bordered by Tibet (China) in the north and India in the south with a population of 0.734 million and per capita GDP of about US\$ 450 in 2003 (one of the highest within the sub region). The 70 percent of land under forest cover is host to a unique flora and fauna and include endangered species, so Bhutan is designated as one of the ten global 'hotspots' for the conservation of biological diversity. This is achieved through a government strategy exceptionally sensitive to the need for environmental protection and considering environmental concerns as an integral part of the development agenda.

The country is often regarded as landlocked because of its formidable mountainous terrain ranging from 100meters to 7500meters height which makes transport and communication difficult limiting a closer relationship with the world trade centers. However, this geographical location has endowed Bhutan with natural resources which constitute major exports. This includes an enormous hydroelectric power potential, substantial deposits of limestone, gypsum, dolomite and graphite. The Tourism industry has also been an important source of hard currency to Bhutan since the country was first opened to tourists in 1974.

For centuries Bhutan's isolation and its self-reliant national character kept the kingdom outside the path of regional economic development. Bhutan cautiously emerged to modern development in 1961, with inception of the first five year plan. Since then, Bhutan has undergone a major transformation and there has been remarkable improvement in many aspects of the lives of Bhutanese people. Now the Himalayan

kingdom of Bhutan, a small country in South Asia is no longer a 'hidden and forbidden land' and its economy is no longer isolated.

By its late development plan, Bhutan has learned from the experiences of other countries and planned its economic development in the best way to achieve sustainable development. The Government has chosen the "middle path" of sustainable development from its initial stage of development, following a development strategy which is holistic in nature guided by the concept of "Gross National Happiness", enunciated by His Majesty the King Jigme Singye Wangchuk in the late 1980s. This unique concept of GNH was articulated by His Majesty to maintain a balance between material progress and spiritual well-being. The concept places the individual at the center of development efforts, and it recognizes that the individual has material, spiritual and emotional needs. Thus it seeks to strike an appropriate balance among social, economic, political, cultural and environmental goals. Under the enlightened and compassionate leadership of His Majesty the King, the country has experienced significant economic and social gains in recent decades.

4.1.2. Macro Economic Performances

Bhutan has achieved rapid progress in overall economic development even though Bhutan began its development plan quite late. In the beginning of the development phase (during the 1960s and 1970s), the focus has been on establishing basic infrastructure to reduce Bhutan's physical isolation and improve internal communications, while also building up the institutions of a modern economy and state, especially through education and training. Accordingly the First and Second Five Year Plans (FYP) allocated 66 and 44 percent respectively of total outlay on the construction of road network, mainly with the help of Indian technical and financial assistance, trying to develop the infrastructure to pave the way for future development. The construction of modern physical and social infrastructure since early 1960s onwards helped set Bhutan on a path of rapid growth and during 1980s growth averaged over 7% per annum. The development of infrastructure not only connected Bhutan to the outside world but also made international trade more feasible.

The annual rate of growth of GDP increased significantly in 1987 with the commission of Chhukha Hydro Power. About 75 percent of the electricity generated by Chukha Hydro Power was exported to India and electricity became the major revenue

generator. The hydropower sector also triggered off the first substantial wave of development in the country which produced ‘spill-over effect’ and promoted investment linkages. Thus it not only provided increased revenues to the government, but also made possible the establishment of a number of manufacturing units producing calcium carbide, ferro alloys, cement etc. This has broadened the country’s economic base and exports base, and the growth in GDP reached nearly 8 percent per annum in the late 1980s. So the electricity is indeed crucial for Bhutanese economy.

However the performance in the 1990s was not as high as in the 1980s. The average growth rate achieved during the 1990s was 6.1% lower than in the 1980s, but more stable and consistent. Figure 3 presents the annual growth rate of real GDP from 1991 to 2003. It can be noted that GDP has increased steadily from 3.5 % in 1991 and reached its peak in 1999 to 7.7% and then dropped to 6.5% in 2003. An examination of figure 3 reveals three distinct periods in growth:

- Slow down between 1990-1992
- Recovery and growth between 1993-1999
- Further slow down in 2000 & Recovery thereafter

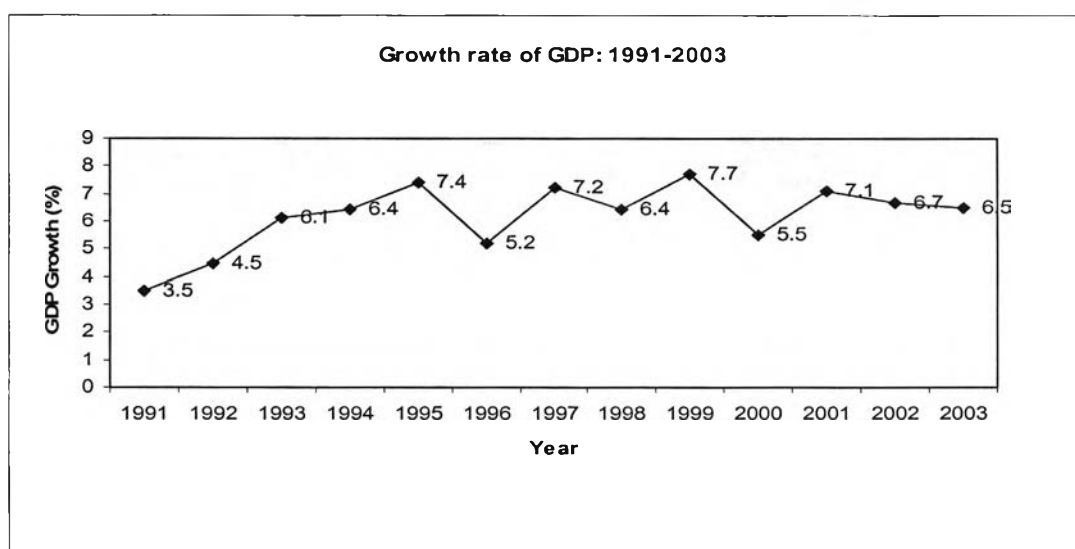


Figure 3 GDP Growth Rate of Bhutan: 1991 to 2003

Source: CSO, National Accounts Statistic Report, 2002

During the period 1991-1992, the growth rate suffered mainly because of the negative growth witnessed in the electricity sector and a slow down in mining and quarrying activities. The real GDP growth picked up between 1993-95, reaching a peak of 7.4 percent in 1995, mainly due to a strong recovery in the electricity and mining sector; with commissioning of manufacturing unit like a ferro-alloy plant and a cement plant. Another important contributory factor was the expansion of the Chukha hydropower project and the enhancement in export tariff from Nu.0.2 to Nu. 1.50/kwh.

Similarly, the growth in 1999 was also significantly influenced by the construction sector, mainly due to the construction of large hydro power projects (such as Tala, Kurichu, Basochu) and manufacturing unit (Dungsam Cement) followed by community, social and personal services. However, in the year 2000 because of slow down in the electricity, mining and manufacturing sectors, real GDP growth averaged to 5.5%. The recovery in the year 2001 is attributable to mining, electricity and construction sectors and also growth rate sustained in the year 2002 by the additional generation of hydropower (from Kurichhu power project), low cost housing project and express highway project in the capital. Slight drop in growth rate in 2003 is mainly attributed to slowdown in growth of the electricity and construction sectors. Thus it appears that the fluctuations in growth rates are driven by the variations in sectors like electricity, manufacturing and construction.

4.1.3. Growth Profile by Major Sectors

The figure 4 and figure 5 illustrates average annual sector wise growth rates and the economic structure of Bhutan from periods 1990 to 2002. Prior to the early 1960s Bhutan's dispersed rural population was entirely dependent upon subsistence agriculture. The above figures illustrate considerable growth in other sectors over the past years. In particular, it is witnessed robust growth in construction sector which is prompted by the major hydropower and industrial projects. It recorded highest growth rate of over 20 percent compared to other sectors and its share in GDP increased from 7 percent in 1990s to 15 percent in 2002. There has been significant increase in share in GDP from other sectors as well; electricity and transport and communication sectors contributed more than 10 percent followed by manufacturing unit with 7 percent and 6 percent by wholesale and trade.

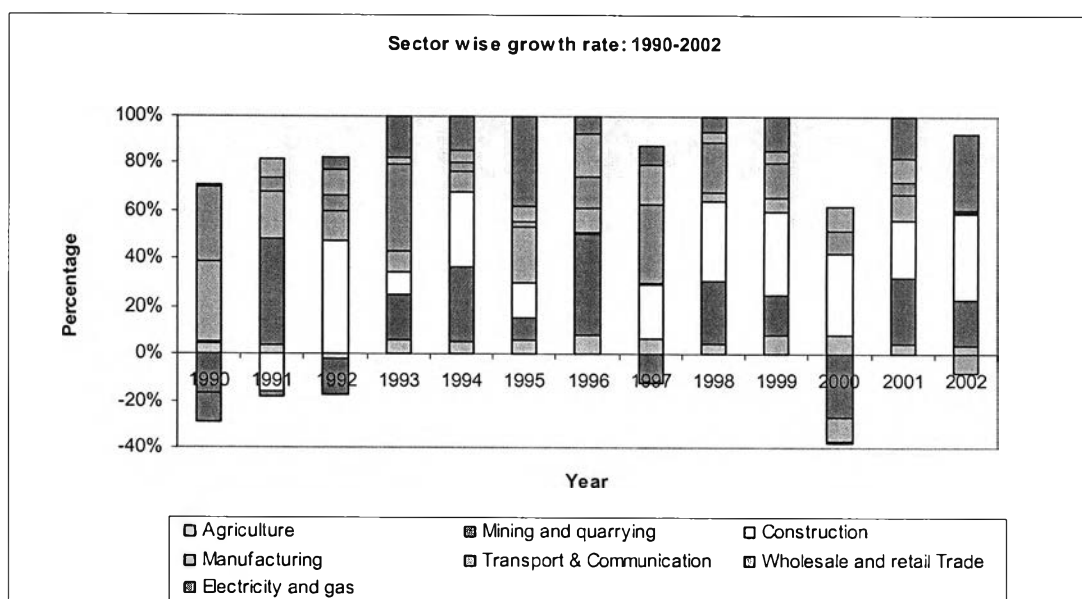


Figure 4: Sector-wise growth rate (%) of Real GDP by Major Sectors of Bhutan at 1980 prices
Source: CSO, National Accounts Statistics Report 2001, 2002.

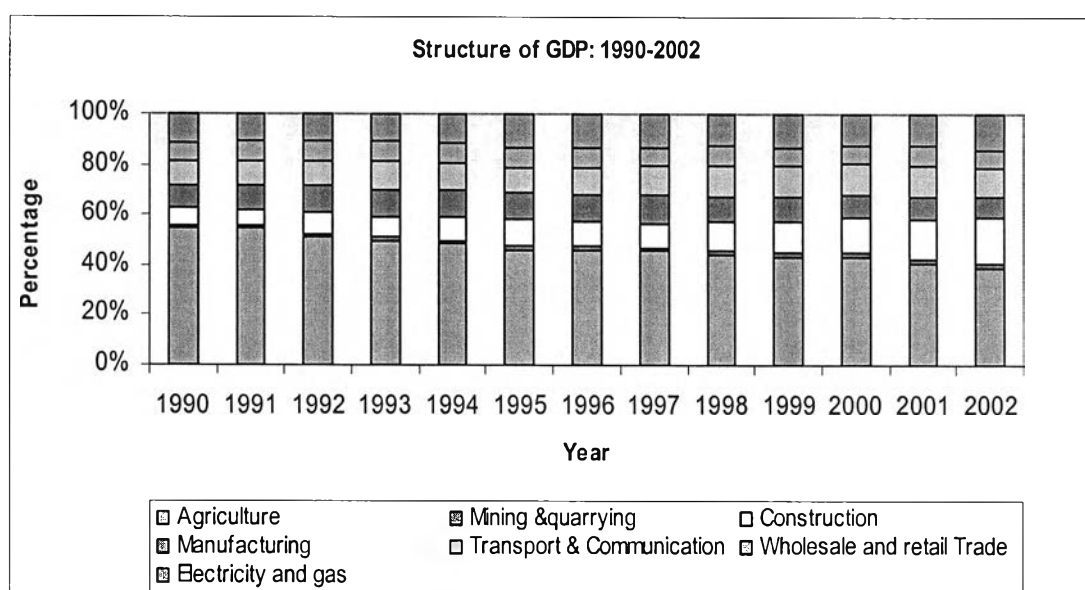


Figure 5: Major Sector-wise contribution to GDP of Bhutan (1980 prices)

Source: CSO, National Accounts Statistics Report 2001, 2002.

On the other hand it is witnessed that agriculture sector is slowest growing sector and its growth continued to weaken and recorded 2.5 percent in 2002. However, agriculture continues to dominate the country's economic structure and remains the most significant sector even though its contribution to GDP has reduced from 44% in 1990s to 32% in 2002. The decrease in contribution from agriculture and mining sector was on account of the increase in the share of electricity and manufacturing. It is quite clear that there has been some structural transformation.

The diagram below indicates the structure of Bhutanese economy in the periods 1980 and 2002.

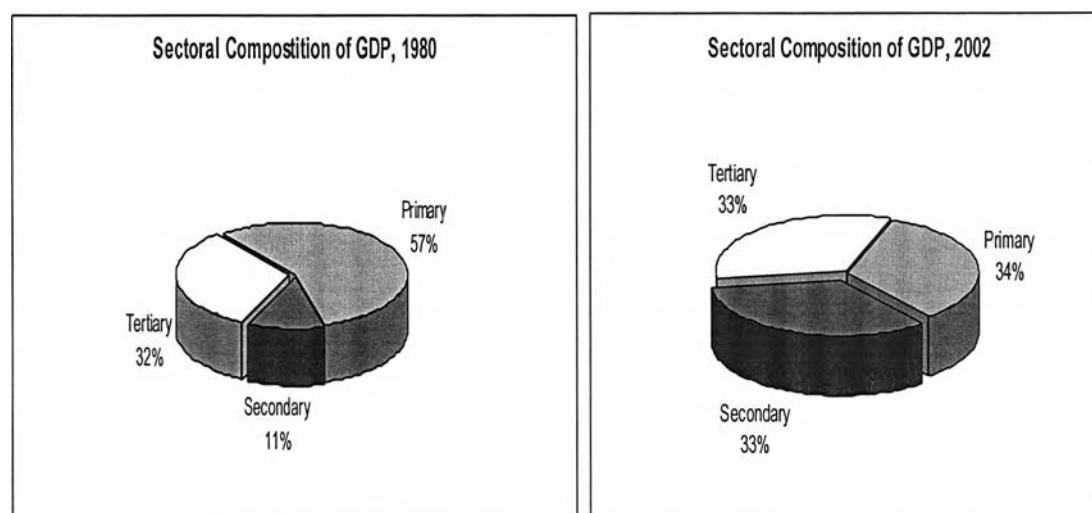


Figure 6 Sectoral Composition of GDP: 1980 & 2002

Source: CSO, National Accounts Statistics Report 2002.

From the above diagram it could be seen that the share of primary sector consisting agriculture and mining has declined from 56.3% in 1980 to 33.1% in 2002. On the other hand the share of secondary sector consisting of manufacturing energy, electricity and construction sectors increased from 11.4% to 33.4% in 2002. There has not been significant change in the share of tertiary sector which is composed of all the service industries (whole sale and retail trade hotels and restaurants transport and communication, financing, insurance real estate and business social and personal services including public administration and defense), so the contribution of tertiary sector to the economy has increased only slightly from 32.3% in 1980 to 33.46% in 2002. Therefore it is evident that the decrease in the share of the primary sector is the direct consequence of the expansion of secondary sector

However, the industrial sectors in Bhutan, has until recently played a relatively small role in the economy of the Kingdom. Industrial development in Bhutan is currently based on four main resources: hydropower, wood, agriculture and minerals. The industrial landscape of Bhutan is dominated by a few large scale industries and a large number of cottage and service enterprises and there are a small number of small-scale industries. According to the industrial classification in 2000, there were 26 large industries, 204 medium industries, 141 small industries, 197 cottage industries and 135 mini industries. About 55 percent of the manufacturing industries were wood based followed by agro

based which formed 20.84 percent. Mineral based industries formed only 8.03 percent. But in terms of the number of people employed in the manufacturing sector in 1997, which were about 12,592 mineral based industries employed the maximum. More than 5,890 people were employed in mineral based industries, compared to 2,226 in forest based industries, 2536 in agro-based and 1,940 in other miscellaneous industrial category (source: 9th FYP document, 2002).

The mining industry in Bhutan is as yet relatively undeveloped and most mining activities are in relatively small operations, though the Kingdom has significant deposits of a number of mineral resources, including limestone, coal, graphite, gypsum, slate and dolomite etc. The manufacturing industry is dominated by a small number of major operations such as the cement plant, wood manufacturing and wood product based industries, the chemical plant (est.1988) and Bhutan Agro Industries, besides there are a number of other small manufacturing plants concentrated in the food processing. Cottage industries also play a prominent role with its good timber resources and favorable agricultural conditions; there is ample scope for expansion of the manufacturing sector especially in these areas.

4.1.4. Growth in Exports and Imports

Trade volume is measured relative to the size of the domestic economy, and can be shown as three values: the value of exports as a percentage of GDP (blue line), the value of imports as a percentage of GDP (pink line) and the combined value of both imports and exports as a percentage of GDP (yellow line). Trade volume shows how much an economy depends on foreign trade. A nation turns abroad for goods and services it needs that cannot be generated domestically. Exports reflect dependence on foreign markets, while imports reflect dependence on foreign-made goods and services. High levels of trade volume reflect vigorous engagement with the global economy.

The figure below indicates that Bhutan has been able to maintain quite a high ratio of exports to its GDP. Bhutan's exports in nominal terms increased consistently and over the decade of the 1990s, Bhutan's exports accounted for an average 28.5 percent of GDP. But the ratio of import to GDP has been much higher compared to export to GDP and on average it accounted for about 40 percent of GDP. With the limitations of production capacity Bhutan depends largely on imports of goods and services and also with a small population the domestic market is limited and therefore seeks foreign market.

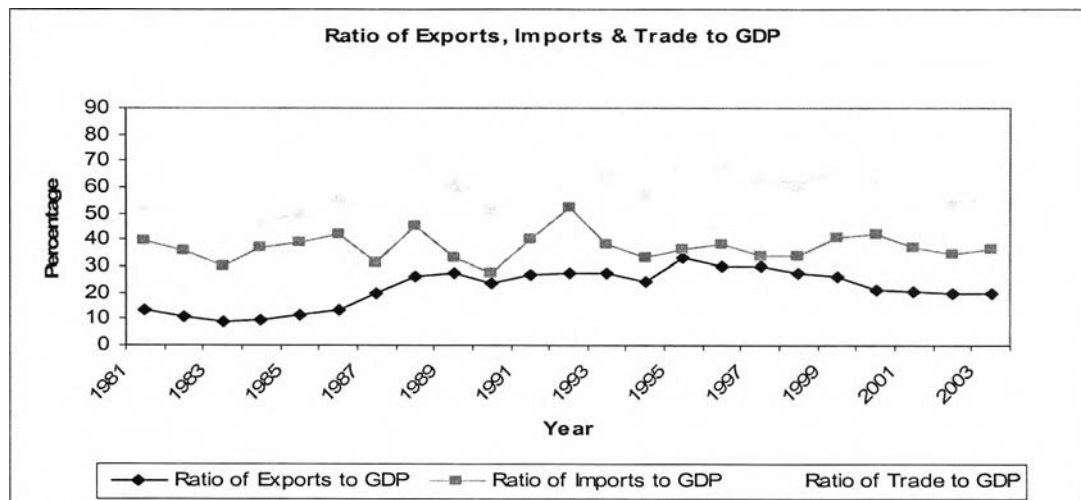


Figure 7 Bhutan's Export, Import & Total Trade as a percentage of GDP

Figure 8 illustrates the pattern of trade of Bhutan beginning in the 1980s to 2003.

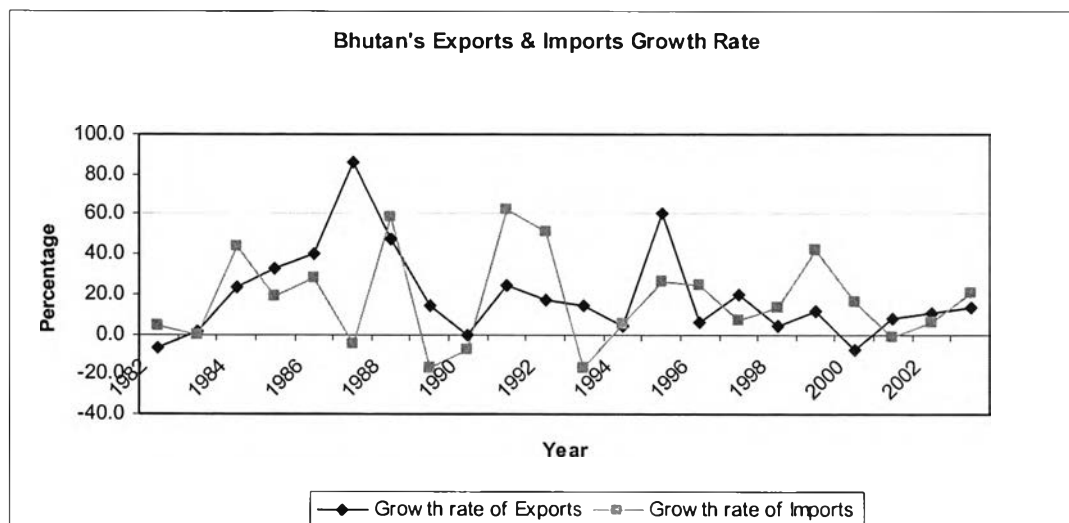


Figure 8 Growth Rate of Exports & Imports of Bhutan: 1981-2003

It can be seen in the above figure that the annual growth rate of exports and imports seem to have fluctuated a great deal. The fluctuation in export growth rates for Bhutan is to be explained on the basis of the nature and composition of exports which is highly lopsided in favor of electricity and few other commodities. Thus exports of electricity, minerals and products such as base metals caused sudden fluctuation on growth rate as and when their exports pick up greatly. Growth of imports in Bhutan is the result of domestic requirements and major fluctuations are mainly caused by import of aircraft, spare parts and heavy machineries, laboratory equipments etc. which are not imported on regular basis. As mentioned earlier huge export growth rate in 1987 is attributable to (commission of Chukha hydro power) export of electricity to India. Also

sharp jump in export growth rate in 1995 is attributable to commencement of major manufacturing units (like Bhutan Ferro Alloys Ltd., capacity expansion of Penden Cement Authority) and upward adjustment of electricity tariff rates on sales to India.

The figure below suggests that South Asian and Indian exports growth rates have followed a close trend with the world trade growth rates and also Bhutan's exports between 1996-98 seems to have followed the world trend.

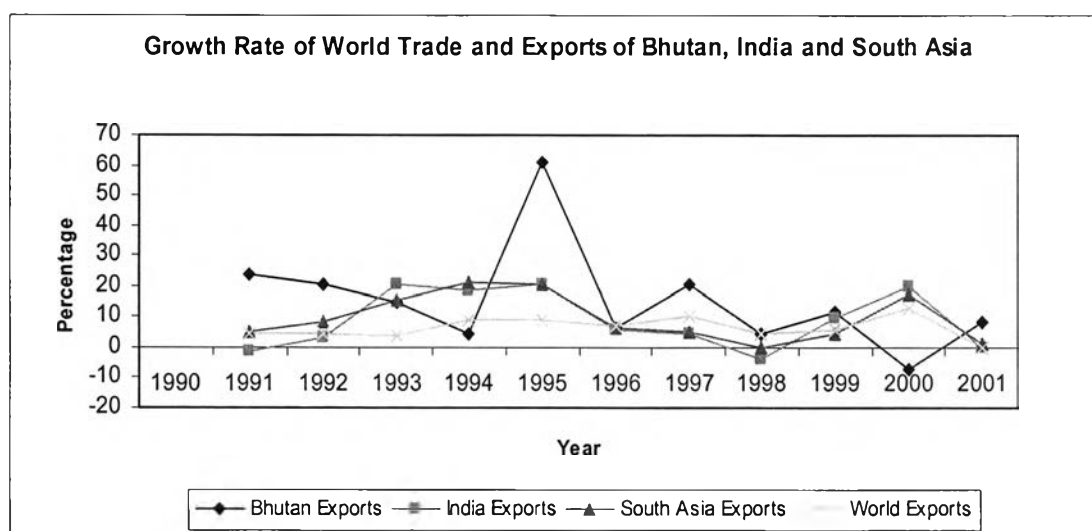


Figure 9 Annual Growth rate of World Trade and Exports of Bhutan, India and South Asia
Source: Source: CBS, IDE/JETRO, 2004

When world trade fell as a result of the East Asian crises, South Asian economies also experienced the spill over of this crisis. However, such a broad impact may not be fully felt in Bhutan, although the possibility of such transmission cannot be ignored. Since Bhutan's trade is largely confined to India and a few other countries, the transmission of trend growth in trade and also the growth of the economy via Indian impact cannot be ruled out.

Table below presents that exports and imports increased simultaneously, while exports increased (more than seventeen fold) over 1981-2003 in value terms, the corresponding rise in imports was much higher (by more than twenty fold), widening the trade deficit.

Table 2 Bhutan's overall Trade Profile in millions of US \$, 1981-2003

Year	Exports	Imports	Balance
1981	20.11	59.63	-39.52
1982	17.16	57.14	-39.98
1983	16.32	53.31	-36.99
1984	17.96	68.09	-50.13
1985	21.95	74.61	-52.66
1986	30.21	93.85	-63.64
1987	54.65	86.44	-31.79
1988	74.84	127.40	-52.57
1989	73.67	90.27	-16.60
1990	68.11	77.52	-9.41
1991	65.03	96.61	-31.59
1992	67.07	127.98	-60.92
1993	65.27	90.03	-24.76
1994	66.38	91.68	-25.30
1995	103.28	112.31	-9.02
1996	100.30	127.71	-27.42
1997	117.70	133.46	-15.76
1998	107.99	133.70	-25.71
1999	115.85	181.97	-66.12
2000	102.65	202.62	-99.97
2001	105.85	190.53	-84.67
2002	113.82	196.28	-82.46
2003	134.42	247.53	-113.11

Source: compiled from Bhutan Trade Statistic Year Book and converted in terms of US\$¹

It can be contented that exports suffered more in the post 1995 period which may be of sluggish demand from Bhutan's major trading partners and in post 2000 can observe steady increase in growth of exports. However, since 1999 the gap of imports over exports increased by a larger margin widening the trade deficit, imports have increased substantially as a result of the implementation of a large number of developmental projects including the construction of hydropower plants (Kurichu, Tala and Basochu) which boosted overall imports level approximately by 18 percent of total imports during 2003/2004. Similarly, the recent purchase of new aircraft for its fleet was one of the major factors which added to the growth in import levels during the years. Furthermore, overall imports can also be attributed to higher food imports, the imports of wood pulp commodities and machinery and mechanical imports. During the same period merchandise export growth increased by 32.4% supported by the combined exports of electricity from (Chukha and Kurichu projects) and also strong growth was also experienced in agricultural and agro based goods, plastic and rubber goods, textiles and

¹To note in 2001 and 2002 fall in export figure is not fall in real value but due to depreciation of national currency against US\$.

base metal and base metal products. However, due to higher imports, the overall trade balance of Bhutan is consistently negative.

Despite of huge trade deficit the rate of growth of the economy has been relatively high; the economy grew on average by about 6.5% according to the estimates. This is because the trade deficits were financed through developmental grants and foreign aid received from donor countries/agencies in convertible currencies which in turn increase the foreign exchange reserves. Exports to third countries continue to be very low against higher imports and have been relying on inflows of aid for the financing of imports.

A majority of capital investments in Bhutan has been financed by India since the launching of planned development (1961) in Bhutan. While the economy links with other countries had been limited, significant amount of aid have also been received since 1990's and this has enabled substantial increases in imports from third countries². Bhutan's external trade with and inflow of foreign aid from third countries has been improving over the past years. In particular, multilateral and bilateral foreign assistance in the social sector has risen significantly. Hence despite of deficits in both the trade and current account balances the country has been able to achieve a significant growth in its gross international reserve position which is enhanced by capital inflows through foreign aid and grants in excess of the current account deficit and enabled to record surplus in its overall balance of payments.

However, to depend on foreign aid as an engine of economic growth in the future would be difficult, therefore in order to reduce hard currency deficit, exports needs to be increase substantially and it is important to look for alternative sources to maintain stable economic growth in the near future. So the increased international trade could be one of the remedies since trade has an immense potential to generate employment and revenue. Many countries not only consider but have also proven international trade as one of the important factors to stimulate growth in their economy. "There has not been a single case of a country that has achieved sustained prosperity under autarky or restricted trade, on the other hand we have many examples of countries that have become rich while trading", John Odling-Smee, IMF.

²

Referred to country other than India.

Thus it is felt utmost importance to study the foreign trade pattern of Bhutan and its future prospects. Of course, trade is not the only factor enabling growth. Structural and institutional reforms aimed at reducing undue government interference and strengthening competition on a level playing field are also considered important components of a strategy to improve the business climate and hence growth. Monetary and fiscal policies to maintain macroeconomic stability are also considered essential (but beyond the scope of the study). However, in next section we have briefly covered the exchange rate regime of Bhutan since exchange rate has great impact on the international trade.

4.1.5. Exchange Rate Regime

Financial development in Bhutan was established very recently. A Secretariat of Finance was established in order to facilitate the flow of cash in the country. In 1982 the government passed an act that established the Royal Monetary Authority as the country's central bank. The mandate of the central bank of Bhutan, the Royal Monetary Authority includes the responsibility to 'regulate the availability of money and its international exchange', to 'promote monetary stability', to 'manage the country's reserves' and to 'be the country's banker and financial adviser to the government.'

Most economic transactions in Bhutan were carried out on the basis of barter arrangements until 1960s. Although some historical documents mention the use of coins in Bhutan during the pre-modern period, studies have shown that apart from the coins minted in Bhutan, Indian and Tibetan coins were in circulation, Galey, (2003). However, barter trade was predominant.

The widespread use of money commenced during 1960s with expansion of trade with India and inflow of development assistance. The Indian Rupee was most commonly used until 1974 (dollarization/ rupeerization system existed for some period) when the government first issued Ngultrum (Nu.) notes, Bhutan's official currency. Since the introduction of the Ngultrum, it is pegged at par with the Indian rupee and is used interchangeably as a medium of exchange. Thus the exchange rate regime in Bhutan is very unique, it has informal currency union with India as the rupee is accepted as legal tender in Bhutan and freely floated alongside ngultrum and there is no special preference to any of the currencies and both are equally preferred by the people.

The arrangement between the two countries does not resemble other monetary unions in terms of symmetry of currency use or agreement on a single institution to formulate monetary policy and there are also some small countries which adopt the currency of some larger country. It shares key characteristics with other fixed exchange rate regimes. Further it also shares some characteristics of dollarization (rupeeization), as dollarization is also used to describe the spontaneous use of U.S dollar alongside country's domestic currency in transactions.

The Indian rupee has been chosen as an anchor currency because of Bhutan's strong economic ties with India and the integrated trade pattern. There are no restrictions on current account transactions but exchange restrictions apply to capital account transactions. Current account controls include: ceilings on amount of foreign exchange that commercial banks can hold; limits on foreign exchange requirements for importers; limits on foreign exchange earnings exporters can retain in foreign currency; and limits on foreign currency that business people or private travelers can take out of the country. Capital account controls include Foreign Direct Investment, and offshore investment and borrowings. In the case of other currencies, convertibility restrictions are followed on both current and capital account.

“The peg to Indian rupee and its free circulation have been beneficial for Bhutan, given its trade pattern which has been directed mainly towards India. Given the absence of trade restrictions on the flow of goods between the two countries, we face an inability to measure the amount of Indian rupees in circulation in Bhutan. The impact of this however should be limited given the confidence in the ngultrum afforded by the policy of unlimited convertibility for current account transactions”. (IMF Director, B.P. Mishra).

But it has no independent exchange rate vis-à-vis other major currencies of the world and the exchange rate is replicated from Indian rupee. Bhutan also has limited seigniorage power since each issue of ngultrum has to be backed by Indian rupee and it doesn't have independent monetary policy. Galey, (2003) in his study has proved that most of the optimum currency criteria holds true for Bhutan and India. He also concluded that the present pegged exchange rate system of Bhutan is optimal despite the apparent disadvantages such as with lack of independent monetary policy suffers some seigniorage losses and its political pride is undermined. Since, if Bhutan floats its currency the cost it has to bear is much more profound and stated that Bhutan's withdrawal from present

regime which is in fact a currency union will result in a decrease in trade, income and output.

If Bhutan establishes a common currency union officially or if it does away with its own currency ngultrum and adopts rupee (rupeeization), then the major implication would be that Bhutan will totally lose the seigniorage revenue and as stated would undermine its political pride, as most countries believe that its currency symbolize its own sovereignty and identity. Therefore, since the present exchange rate system serves the Bhutanese economy well and it fulfills its optimum currency criteria, at this point the need for having any changes in the exchange rate regime is lacking.

Studies have proved that fixing the exchange rate eliminates uncertainty risk and promotes trade since the exchange rate variability discourages international trade and investment. Adopting a neighbor's currency as one's own is a credible commitment to exchange rate stability and has the extra advantage of eliminating transaction costs; both effects promote trade and investment. Studies have shown that belonging to a currency union triples the trade with member countries. So given the high geographic concentration of its international trade it is convenient to use a common currency in transactions with its major trading partners (about 90% of Bhutan's export and 70% of imports occur with India).

Further, much of the literature on exchange rate regimes focuses on the requirements that currency union partner(s) have a stable currency and be subjected to shocks correlated with those of the domestic country. While some studies also suggest that the currency should belong to a country (or set of countries) that is a natural trading partner, by virtue of size, proximity, and/or other linkages. India and Bhutan are to some extent natural trading partners and studies have shown Bhutan and India has face similar shocks. However, though with further integration both the countries benefit but at the same time we need to consider the issue of country's own identity and sovereignty.

4.1.6. International Trade Policy of Bhutan

The output and trade have gained considerable momentum over the years resulting in increase in an annual average of GDP and merchandise exports and importance of international trade for the Bhutanese economy has increased. On the other hand the policies can impact not only a country's trade, but also their development path (i.e.

relative focus on industry versus raw material development can be affected). This in turn has effects on other economic objectives including the distribution of income among the population and between the major sectors of different regions (but this is beyond the scope of this study). If the policy decisions of the importing country have a significant effect on the pattern of exports this may also affect a country's approach to economic development. Thus trade policy analysis and its impact on the trade flow is important to study.

Bhutan has pursued liberal trade policies since it opened up its economy to the rest of the world. The existing openness of Bhutan are one of the highest within the sub-region ranging from 40% to 79% compared to its major trading partners like India ranging from 10% to 20% and other countries within the sub-region, Bangladesh with 20% to 30%. Further Bhutan intends to liberalize with integration into the regional and global trading system as Bhutan's capacity to sustain growth is limited with small internal market and narrow range of exports. In particular diversification of export base is a priority and to produce exportable products is a challenge for Bhutan to promote international trade.

The first policy paper on international trade of the Kingdom of Bhutan was brought out recently and covers a broad policy framework to serve the need of the Bhutanese private sector for policy guidelines. There are no major export promotions and import restriction measures implemented by the Government, only existing trade barrier is tariff which is basically imposed as the source of revenue rather than import restriction.

The tariff was first introduced in 1972 with tariff rates ranging from 0%, 40%, 60% & 100%. Since then there had been series of reduction in rates and increase in product base. With the introduction of Bhutan Customs Rules and Regulations and the Customs Tariffs Schedule in September 1996, duties on almost all commodities have been lowered. Subsequently Sales Tax and Customs and Excise Act of the Kingdom of Bhutan were introduced in 2000 and the prevailing basic customs tariff rates are 0, 10, 20, 30, 50 and 100 percent. Most of the products imported into Bhutan are subject to Bhutan sales tax. Currently it is levied at the entry points in Bhutan and existing rates range from zero percent to 20 percent except for alcoholic beverages and tobacco where 50 percent sales tax is levied and 100 percent customs duty to discourage consumption of socially harmful and non-essential items. The RGoB intends to establish a transparent and liberal

import regime that facilitates economic growth and supports the efficient allocation of its resources. It also intends to autonomously liberalize the import regime through progressive reduction of tariffs.

4.1.6.1 Import Regulations

With regard to rules and procedures for imports from third countries, Bhutan maintains an import licensing system that is clear, simple, quick and transparent. There are no major import controls imposed by the Government, only general hazardous items are prohibited and restricted for the safety of its people and nation at large. Products prohibited for imports and products under quantitative restrictions are regulated by the Sales Tax, Customs and Excise Act, 2000, Bhutan Trade Classification, Custom Tariff and Sales Tax Schedule, 2002 and the Forest and Nature Conservation Act 1995.

There are no major protectionist policies implemented by Government of Bhutan, except some protection is extended to the agriculture sectors based on food security and farm income maintenance concerns. Agriculture is also the major contributor to GDP in spite of production on small subsistence scale.

Currently in Bhutan there are no non-tariff barriers (NTBs) and tariff quotas on imports imposed by the Royal Government and no system of anti-dumping legislation and countervailing duty legislation and procedures are in effect and also there is no safeguard regime in effect. The tariffs are imposed on imports that are not produced domestically; hence they are clearly aimed at raising revenue rather than protecting a domestic industry.

As a member of Codex Alimentarius Commission, International Plant Protection Convention (IPPC) and international Office of Epizootics (IOE) Royal Government intends to introduce standards and improve the quality of goods imported and produced in Bhutan. These standard instruments would be applied non-discriminatorily on both domestic and imported goods. At present the application of standards in Bhutan is limited. Also import inspection procedure for specific commodities was further improved.

4.1.6.2 Export Promotion Measures

One of the main economic issues facing Bhutan is its large trade deficit, so conventional trade policy measures have been implemented to address the problem. Since export promotion is a key feature in export development, the foremost objective with regard to international trade is to stimulate the growth of the export sector and to enhance export earnings. To achieve this objective various strategies are adopted; providing concessional air freight rate, tax and tariff incentives to promote export oriented industries.

Preferential tax incentives include tax holidays and all income earned in convertible currency by manufacturing industries, information technology industries and services and agriculture produce exporters are exempted from corporate and business income tax (CIT/BIT) beginning January 2003. All expenses incurred in earning the convertible currency are also allowed as deductible expenses. Further customs tariffs and Bhutan Sales Tax exemption are given on plant raw materials, machineries and equipment necessary for establishing export oriented industries. However, these incentives are subject to time limitations to discourage businesses relying upon it for their sustenance.

Since the major constraint in Bhutan is the lack of market information and export marketing skills, the Bhutan Export Promotion Centre was established in 1998 to facilitate Bhutan's export sector. It seeks to build an information base, particularly on the trends and opportunities in international markets on goods and services to meet the needs of exporters. So far, the centre has undertaken market studies on horticulture, essential oils, traditional medicine, hand-made paper, and major study on transport constraints to export development. Government also intends to formulate a National Export Development Strategy which will review the performance of the past and define priorities for the future.

Further financial measures adopted to promote export are that banks provide short term export financing which covers pre shipment finance for procurement of materials, packaging, transportation, insurance etc. and post shipment finance since the availability and cost of export finance are often limited and high.

Bhutan has a weak industrial base and limited capacity prohibiting the development of intra-industry trade. But Bhutan is endowed with natural resources and has comparative advantage in goods which uses intensively the factors in which it is relatively abundant, and following Heckscher-Ohlin's factor proportion theory. That is given the opportunity to trade, each country will increase production of the commodity in which it has a comparative advantage, exporting it in exchange for the commodity in which it has a comparative disadvantage. Differences across countries in these factor endowments provide a basis for explaining why opportunity cost ratios differ across countries. These differences in factor endowments allow us to predict patterns of trade across countries.

4.6.1.3 Trade Integration Policy

Bhutan and India signed the Indo Bhutan Treaty in 1949, which envisaged friendship, cooperation and a free trade regime between the two countries, providing the basic framework for bilateral trade and other areas of economic relations between Bhutan and India. The formal negotiations and agreement in trade and commerce was signed in 1972 which is renewed from time to time within the overall framework of this Treaty. The latest one concluded in 1995, valid for a ten-year period up to March 2005. The free trade agreement with India provides free transits of goods from Bhutan to and from third countries that is without the application of tariffs by India. This is the cornerstone of Bhutan's international trade relations. Thus the free trade agreement with India covering all products dates back to 1949 treaty and Bhutan integration with India has began prior to its economy opened up to the rest of the world. Two countries share and enjoy a special relationship that extends far beyond geography to deep-rooted religious, cultural, historical and economic ties.

On the other hand the preferential trade agreement with Bangladesh which existed since 1980 provides concessions of duties on a range of negotiated product lines only. To further facilitate international trade and to have access to new markets, RGOB intends to further improve the existing agreements and also initiate bilateral trade agreements with other countries within the region. Bhutan has already made a proposal for a preferential trade agreement with Nepal. This could help boost the Bhutanese export since Nepal is also one of the major export markets after India and Bangladesh.

The South Asian Association for Regional Cooperation (SAARC) was formed in 1985 and Bhutan joined as a member seeing it as a forum for creating a climate of peace and with hopes of attaining economic development through active collaboration. While Bhutan had bilateral relations with India and Bangladesh much before the SAARC was envisaged, relations with the other member countries followed later. As a member of SAARC, Bhutan has been able to diversify its trade link with South Asian countries while enhancing its status as an independent nation-state. Later SAARC Preferential Agreement was signed and came into force in December 1995 which was initially approved in December 1991 Sixth Summit held in Colombo. The Agreement reflected the desire of the Member States to promote and sustain mutual trade and economic cooperation within the SAARC region through the exchange of concessions. The agreement was based on commodity to commodity approach tariff concessions lines under the HS code system classification of commodities covering all products, manufactures and commodities in their raw, semi processed and processed forms. So far, four rounds of trade negotiations have been concluded under SAPTA covering over 5000 commodities. The rules of origin are applicable under the SAPTA agreement in order to establish whether preferential tariffs should be applied on goods imported from SAARC member states. With regard to imports from third countries, Bhutan does not as yet have rules of origin criteria. Bhutan has actively participated and supported the negotiations of the SAPTA and it continues to push for greater liberalization of tariffs within the region and work towards transition to SAFTA.

Bhutan is also a party to the Growth Quadrangle Initiative within SAARC, comprising Bangladesh, Bhutan, India and Nepal (BBIN-GQ). This was formed to accelerate the pace of economic development in member countries through the identification and implementation of specific projects. The sectors identified for priority attention are multi-modal transportation and communication, energy, optimal sustainable utilization of natural resource endowments, trade and investment facilitation and promotion, and tourism and environment. Although the growth quadrangle pursues objectives beyond trade, very little progress has been made in 28 other areas of cooperation such as poverty eradication, social welfare and improvement in the quality of life.

At the regional level outside of SAARC, Bhutan became the member of BIMSTEC in 2004 along with Nepal, other member countries are Bangladesh, India, Myanmar, Sri Lanka and Thailand. The main purpose of this economic cooperation grouping is to facilitate rapid economic growth, promote active collaboration and mutual assistance on matters of common interest and provide assistance to each other in the form of training & research facilities. The members aim to cooperate mainly in areas of trade and investment, technology, communication and transportation, energy, tourism and fisheries. Bhutan became a member of World Customs Organization (WCO) in 2002 under which it has further revised its tariff.

Regional economic integration has tremendously benefited Bhutan's exports and many other areas of economic development. It has also helped Bhutan in its preparedness towards international integration being sought through WTO membership. And in order to facilitate Bhutan's integration into the regional and global economy the Government intends to accede to the World Trade Organization (WTO). Bhutan has been granted observer status in 24th April 1998 and in 2004 Memorandum of Foreign Trade Regime (MFTR) was formally submitted to WTO and preparations for the accession process are underway. After Bhutan attain membership in WTO, national trade policies would be anchored to the regulatory system of global trade which gives them more transparency and credibility.

4.2. Structure and Direction of Trade Flow

Structure of Trade

Bhutan has very narrow export base but diversified imports. There have not been major changes in the composition of trade, agricultural trade fell and manufactures rose as a share of total trade and those trends have continued at a slower pace. A more recent phenomenon has been the expansion of trade in electricity with construction of more power projects.

4.2.1. Composition of Exports

The diagrams below illustrates composition of exports in the year 1986 and 2003, it clearly indicates increase in the share of electricity exports and also an increase in the export base but decrease in the share of agricultural products in 2003 compared to 1986.

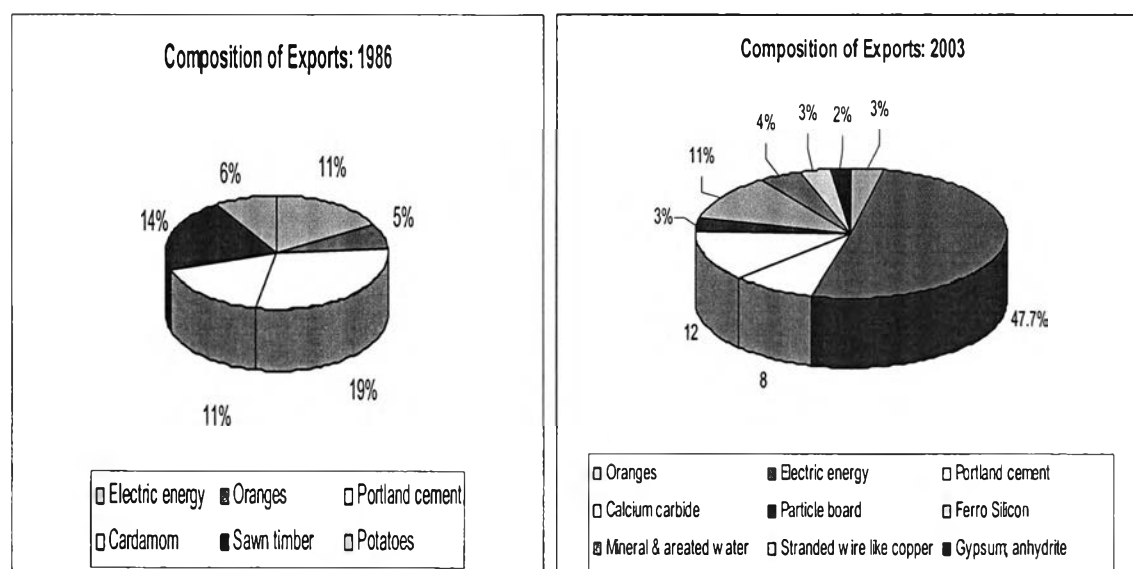


Figure 10 Composition of Exports: 1986 and 2003

Source: RMA, Annual Report.

The electricity sector dominates the diagram in 2003 with 47.7 percent of total exports. The top exported items of Bhutan according to their proportion in total exports are electricity, product of chemical industries, wood products, fruits and non-alcoholic beverage and mineral products. Export of electricity together with other two items calcium carbide and ferro-silicon constituted more than 70 percent of total export earning in 2003 increased from 60 percent in the year 2001. The other items of exports include cereals, vegetables, spices, animal products, prepared food stuff, plastic and rubber products, raw hides and skin, textiles, handicraft products, footwear and clothing accessories, machinery and mechanical appliances, transport equipment, works of art and antique and miscellaneous manufactured items. The detailed list of export is presented in appendix C, table 15c.

The diagram below shows the proportion of exports of Bhutan to India and third countries. Bhutan exports a wide range of items to India and electricity constitutes largest source of export earning.

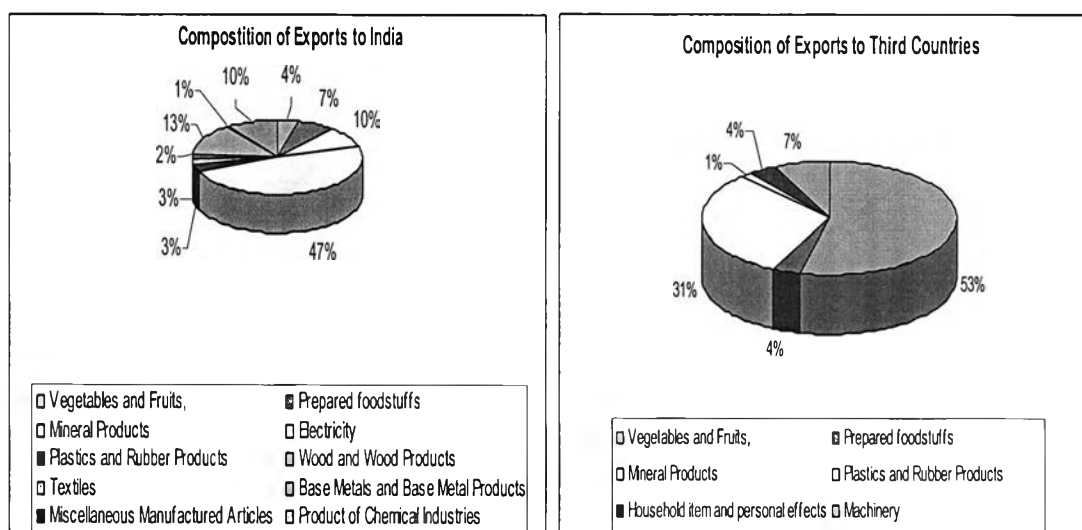


Figure 11 Composition of Exports to India and Third Countries: 2003

Source: RMA, Annual Report.

We can observe that electricity together with mineral products, base metal and base metal products and product of chemical products constitute over 80 percent of total export earnings from India in the year 2003. On the other hand major exports to third countries are vegetables and fruits and mineral products which constitute more than 50 percent and 30 percent respectively in the same year (Bangladesh and Nepal constitute major portion of exports). Other exports are textiles, prepared foodstuffs, machinery, handicrafts, household items and personal effects. The top listed items according to their value in total exports of Bhutan are electricity, mineral products, products of chemical industries, base metals and products and wood & wood products. The detailed list of export to India and third countries are presented in appendix C, table 16c.

The important trend in export seems to be the dominance of manufacturing in total exports. This is the result of changes in domestic production structure which is reflected in trade. Though manufacturing for domestic consumption has not expanded much, export oriented manufacturing based on intensive power use has picked up in a big way. In 1989 there were 168 manufacturing units in the country, which has increased to more than 500 by 2000. Hydropower has generated comparative advantage in natural-resource-based industries. Growth of particle board and agro-based industry are the example of this advantage. This indicates a possible shift from primary commodity exports to manufacturing, which has the potential to generate income and employment. However, an export shift towards manufacturing is confined to only few commodities and hence the

need for diversifying into other manufacturing is essential. Bhutan holds the possibility of diversifying its production into several untouched areas.

4.2.2. Composition of Imports

With rapid industrial development in the sub-region and the industrialization in the other Asian countries provides a variety of manufactures and boosted imports of Bhutan. The import structures have changed rapidly and great varieties of goods are imported based on the preferences of the consumers. Bhutan imports a wide range of products, from intermediary goods to the capital goods. The import structure of Bhutan in general can be seen in terms of gaps between domestic production and demand leading to a large import of food grains, industrial intermediaries, machinery, capital equipment and durable consumer goods.

The diagram, below illustrates the composition of imports (share of principle commodities imported) in the period 1986 and 2003, which clearly indicates that unlike exports, imports do not have a distinct bias in favor of few commodities.

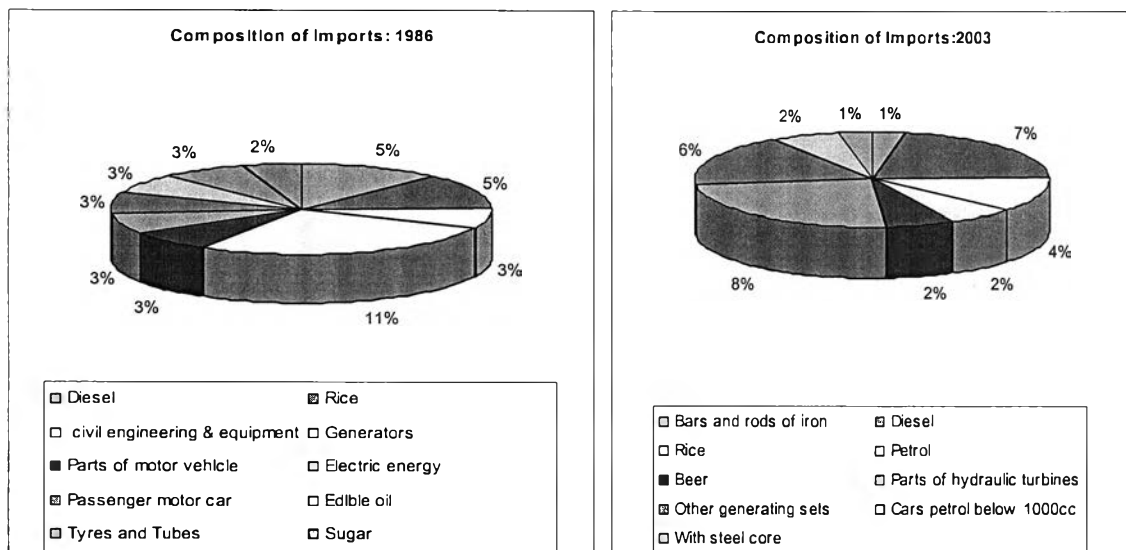


Figure 12: Composition of Imports: 1986 and 2003
Source: RMA, annual report.

The major imports includes transport equipment, machinery, mechanical appliances, electronic items, cereals, beverages, edible oil, fuel, tobacco, mineral products, products of chemical industries, plastics, textiles, pharmaceuticals, parts of aircraft and other manufacturing items. It can be seen that in the year 2003 top imports were parts of hydraulic turbines and water wheels including regulators, diesel, other

generating sets and rice. Rice constituted 4 percent of total import and is fourth highest in the top list. The detailed lists of major imports are presented in appendix C, table 17 c.

There is difference in structure of imports made from the countries within the region and outside the region. Therefore, diagram below is presented to provide proportion of imports made from India and third countries.

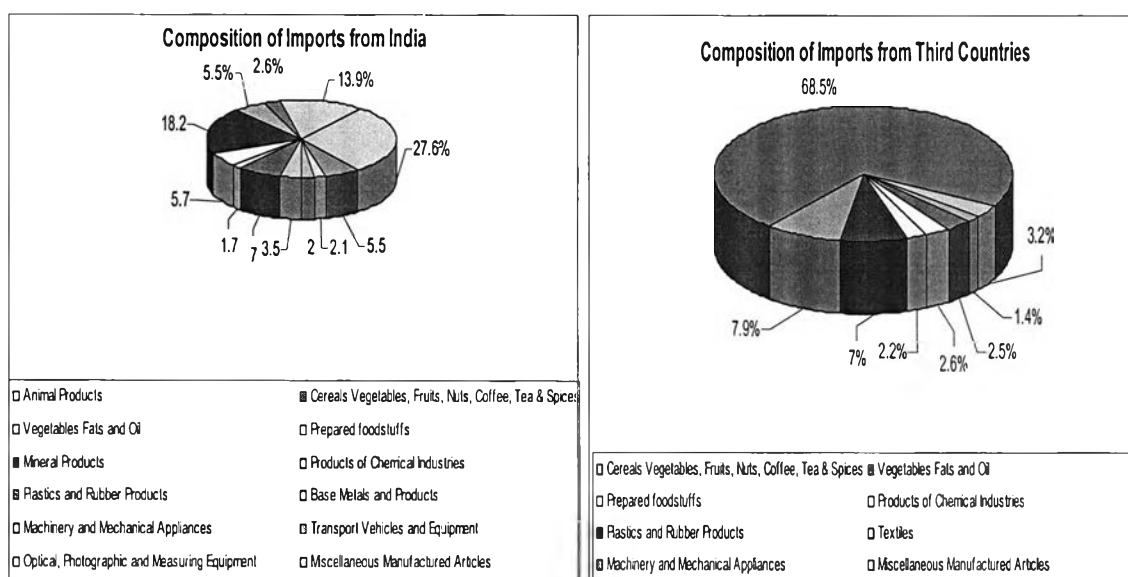


Figure 13: Composition of Imports from India and Third Countries 2003.

Source: RMA, annual report.

It can be seen that imports from India is comprised of a variety of products like machinery appliances, base metal products, product of chemical industries, cereals vegetables, mineral products, transport vehicle and equipment etc. On the other hand, imports from other countries especially outside the sub-region is dominated by machineries and electrical appliances alone accounts for about 83 percent of total imports. Other imports of significance include medicines and pharmaceuticals, product of chemical industries, textiles, goods of personal effects and prepared/processed food (a detailed list of imports from India and Third countries are given in appendix C, table18c).

4.2.3. Direction of Trade Flow

Bhutan's majority of trade takes place within the region. In view of geographical proximity and long standing economic relationship with India over 80 percent of Bhutan's external trade is with India. Also there are no restrictions on the movement of goods and services between the two countries, and the ngultrum is pegged at par with Indian rupee, which circulates freely in the country. Thus Bhutan's trade is largely

directed towards India which account for approximately 95 percent of exports and 80 percent of imports. Electricity is the single most important export to India which account for more than 40 percent of exports. The proportion of electricity in total export to India has consistently increased over time and it is likely to increase further with completion of the Tala Hydropower project. Exports to India has also picked up in areas of manufacturing especially power driven industries. As a consequence of divergent import expansion rates, Bhutan developed sizeable trade deficits with its trading partners, particularly with India.

Figure below shows Bhutan's exports to and imports from India and we can see that Bhutan enjoyed a brief period of favorable balance of trade with India in 1990s due to increase in the earnings from export of electricity. However, by the end of 1990 trade deficit has widened, basically due to significant increase in imports boosted by construction of power plants and implementation of other developmental activities as well as increase in import of passenger cars.

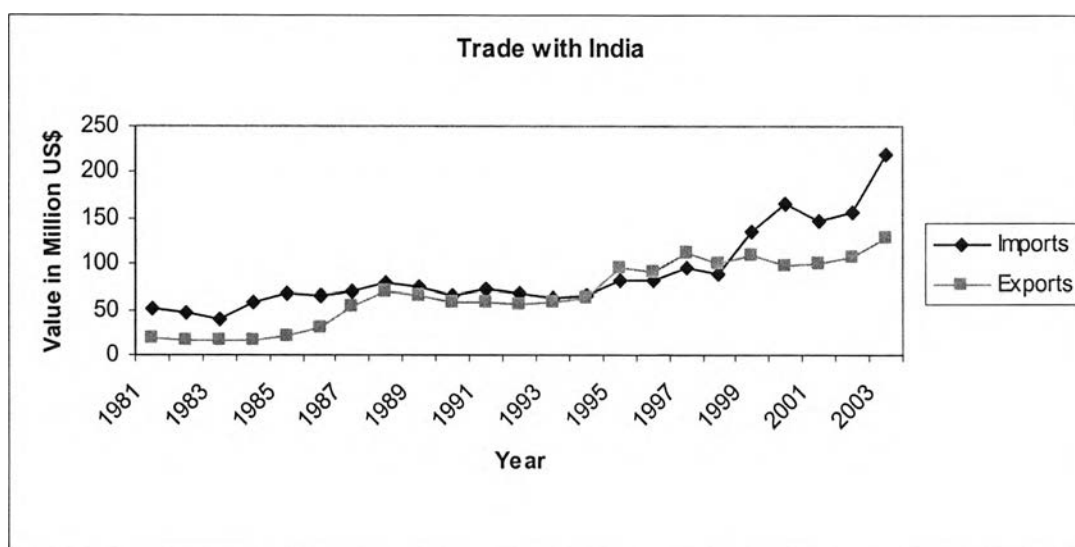


Figure 14: Bhutan's Exports to and Imports from India: 1981-2003
Source: Compiled from Bhutan Trade Statistic Year Book

On the other hand if we exclude electricity from the total exports made to India, then the trade deficit with India is widened as shown in the figure 15. Thus electricity is the major commodity that improves Bhutan's trade balance with India and indicates steady increase in electricity exports since 1987.a

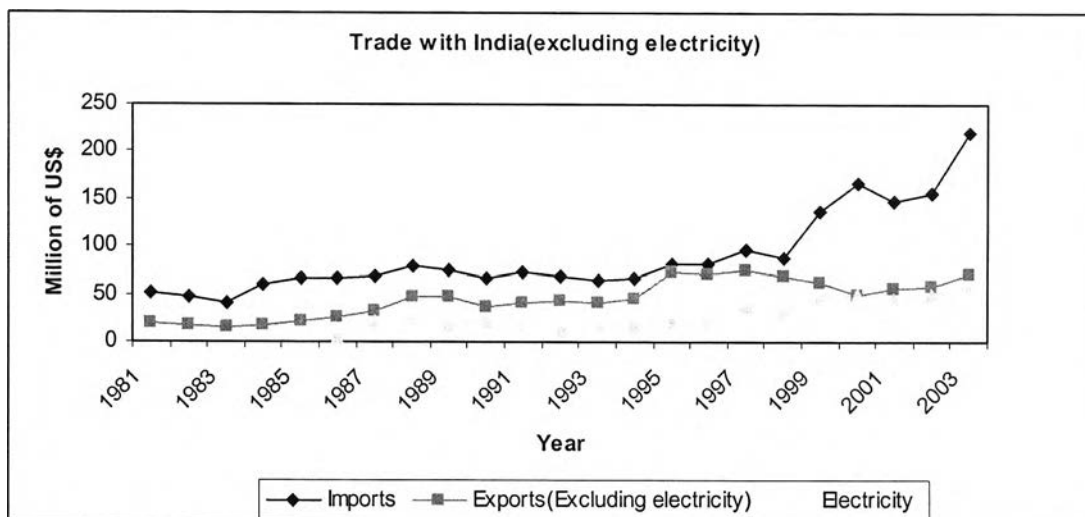


Figure 15 Bhutan's Exports (excluding electricity) to and Imports from India and Electricity Exports to India

Bangladesh and Nepal are the second largest principle markets of Bhutan's exports. With these two countries, Bhutan enjoys trade surplus and it can be seen in figures below that exports to Bangladesh is much higher compared to Nepal and also indicates to be more stable. Trade with Bangladesh has picked up significantly in late 1980s and exports are much higher compared to imports made from Bangladesh. With Nepal trade has increased quite significantly after mid 1990s and both exports and imports seem to fluctuate a great deal.

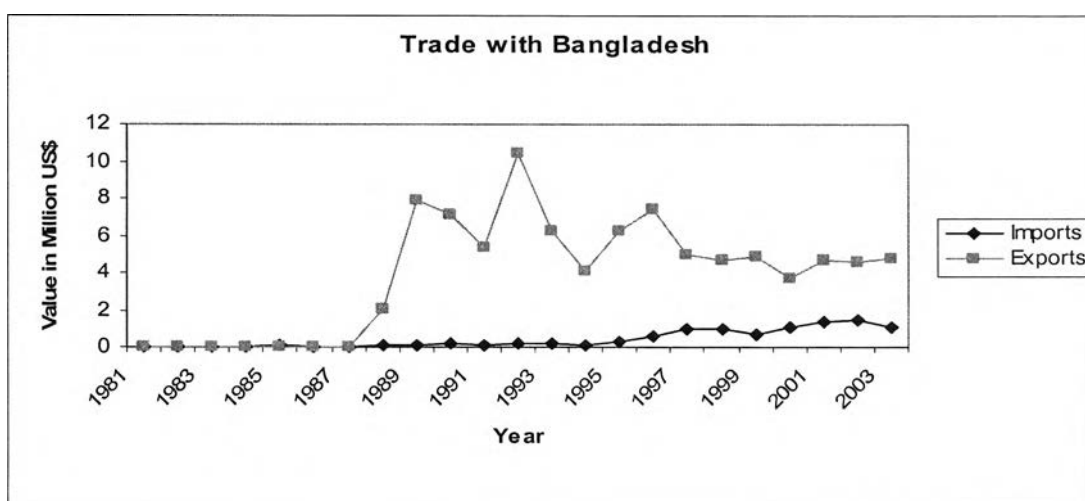


Figure 16: Bhutan's Exports to and Imports from Bangladesh, 1981-2003

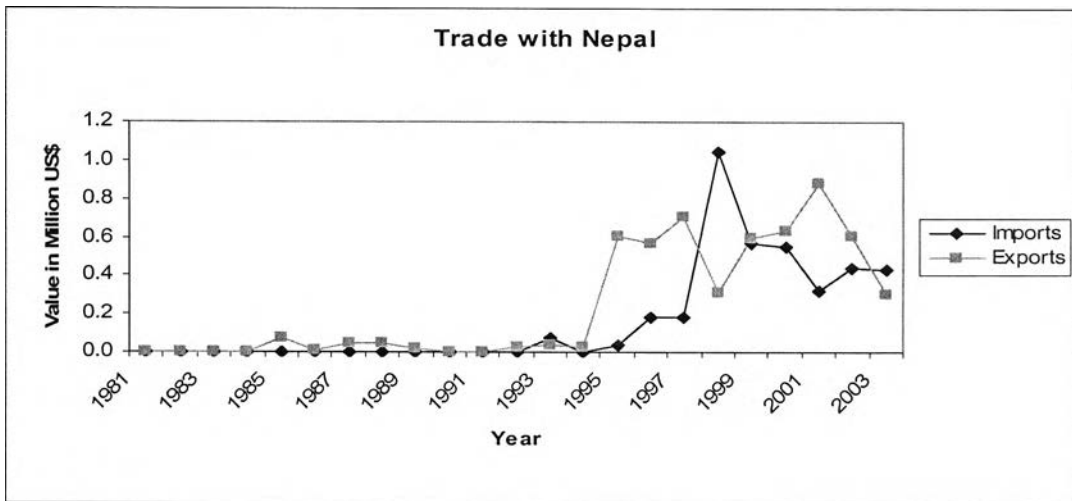


Figure 17: Bhutan's Exports to and Imports from Nepal, 1981-2003

Figure below show Bhutan’s trade with other Asian Countries (within the region) and with Developed countries (out side the region). It can be seen that trade with these countries fluctuate a great deal and exports to these countries are very negligible compared to imports made from these countries. All data for following figures are obtained from Bhutan Trade Statistic Year Book.

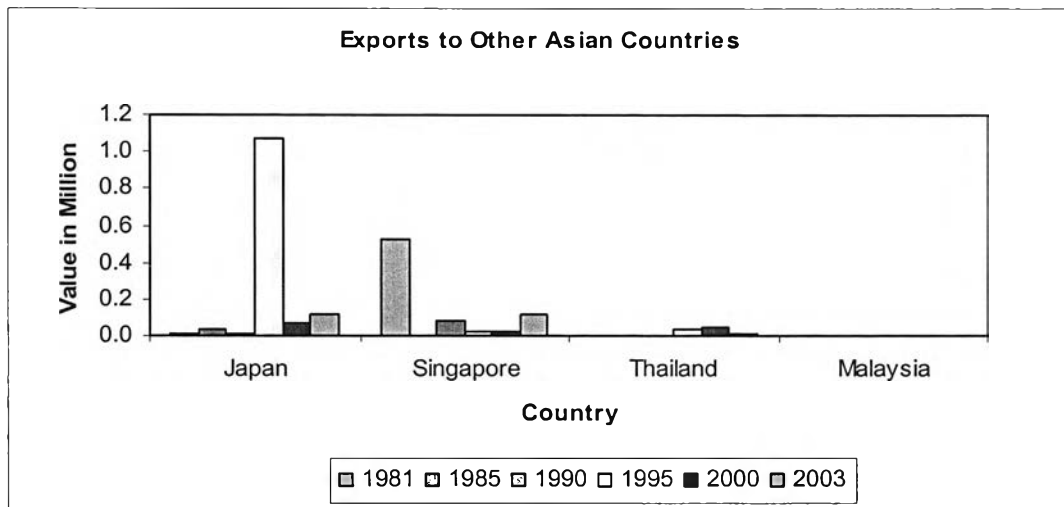


Figure 18 Exports to Other Asian Countries



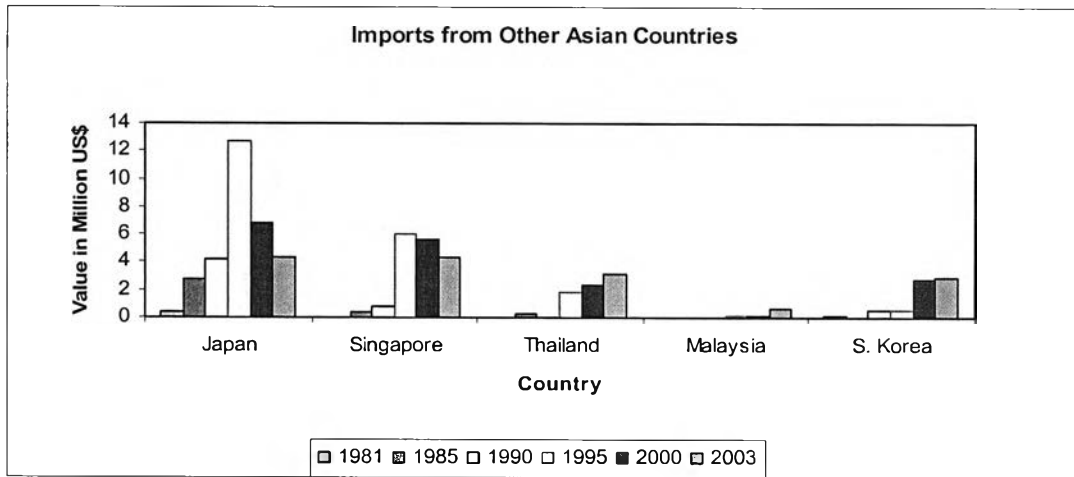


Figure 19 Imports from Other Asian Countries

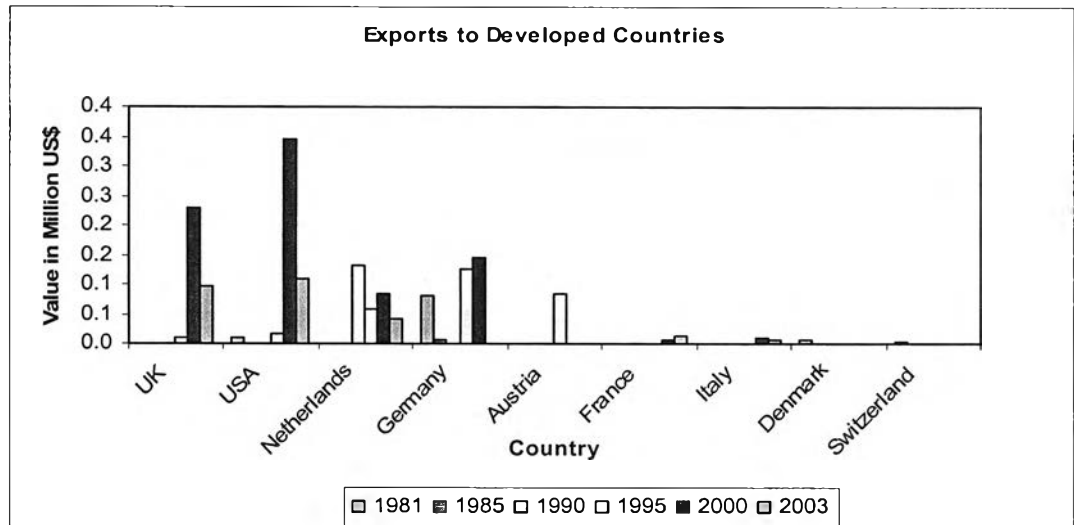


Figure 20 Exports to Developed Countries

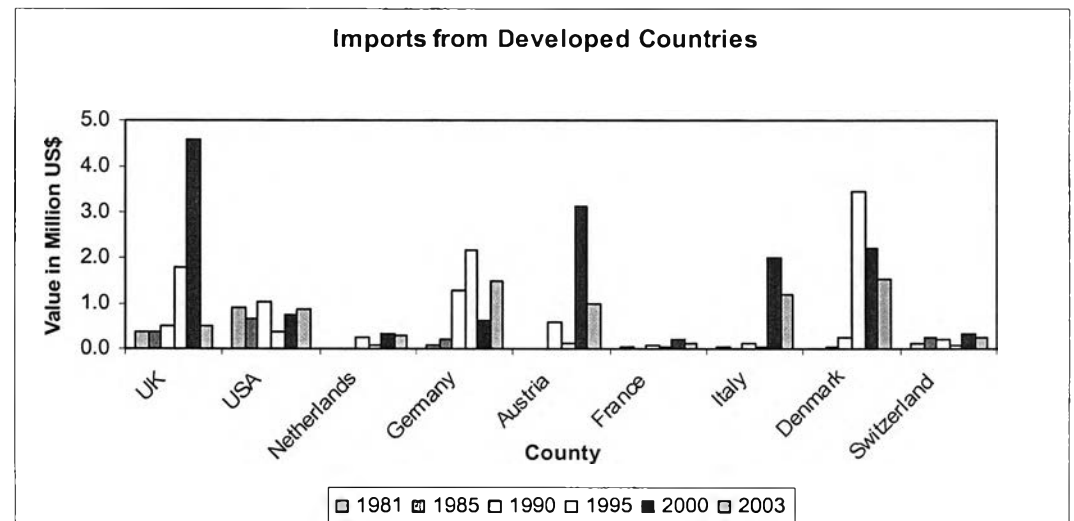


Figure 21 Imports from Developed Countries

Table 3 and 4 present principal market and import sources for selected years from 1981 to 2003. India is the major market accounting for more than 90 percent of total exports followed by Bangladesh with 3 percent of exports and less than a percent to Nepal. The export to Bangladesh reached its peak in 1990 accounting for 10 percent of total exports and has decreased over the period and accounted on average 3 percent of total exports in recent years. It can be seen that the principal export markets of Bhutan's major commodities are India followed by Bangladesh, Nepal, Japan, USA etc. About 99 percent of the export was directed within the sub-region (lopsided to India) and less than a percent of total exports were directed outside the sub-region, mainly to Japan, Thailand, Singapore, United Kingdom, US, Germany, Denmark, Switzerland, Netherlands and other countries like Italy, Austria, France, Norway, Canada, New Zealand and Ireland. To each of these countries very negligible exports are made and in certain years even zero exports are reported. Not a single export to Republic of Korea has been reported since 1981, while huge passenger cars are significant imports made from Korea.

Table 3 Bhutan's principal market, countries & regions (1981-2003) (values in percentage)

Region/country	1981	1985	1990	1995	2000	2003
EU						
UK	0.04			0.01	0.22	0.07
Germany	0.40	0.03		0.12	0.14	
Netherlands			0.20	0.05	0.08	
Switzerland	0.01			0.001	0.0002	
Denmark	0.03			0.0004	0.0001	
US	0.04			0.01	0.34	0.08
Japan	0.05	0.18	0.02	1.03	0.06	0.08
Asia, Developing						
India	94.42	97.66	84.81	91.93	94.88	95.78
Bangladesh		0.09	10.46	6.01	3.57	3.58
Nepal		0.35		0.58	0.62	0.23
Thailand				0.04	0.05	0.01
Singapore	2.61		0.12	0.02	0.02	0.08

With regard to imports, Bhutan has developed significant ties with many countries outside the sub-region. Import partners for major commodities are India followed by Japan, Singapore, Thailand, South Korea, Denmark, Germany, Italy etc. as per 2003. Bhutan's 70 to 90 percent of the imports were from within the sub-region mainly from India and negligible imports of less than a percent from Bangladesh and Nepal. The rest 10 to 20 percent of imports were received from as many as 40 countries from outside the sub-region mainly from Japan, Singapore, Thailand, UK, US, Germany, Italy, France, Denmark, Switzerland and other countries like Sweden, Swaziland etc. Thus Bhutan's

trade is highly concentrated within the region and export diversification is vital, so that it will be less vulnerable to external shock in these few markets.

Table 4 Principal Import Sources, countries & regions (1981–2003) (percentages)

Region/country	1981	1985	1990	1995	2000	2003
EU						
UK	0.63	0.53	0.63	1.58	2.26	0.20
Germany	0.17	0.29	1.69	1.94	0.31	0.60
Italy	0.08	0.02	0.18	0.02	0.99	0.48
France	0.04	0.001	0.12	0.04	0.11	0.05
Denmark		0.06	0.35	3.07	1.10	0.63
Switzerland	0.19	0.35	0.26	0.08	0.17	0.10
US	1.51	0.90	1.34	0.35	0.38	0.35
Japan	0.64	3.61	5.40	11.31	3.35	1.74
Asia, Developing						
India	87.35	89.88	84.22	72.22	81.95	88.71
Bangladesh	0.0002	0.10	0.24	0.24	0.54	0.43
Nepal				0.03	0.27	0.17
Thailand		0.41	0.07	1.67	1.16	1.29
Singapore	0.10	0.54	1.02	5.33	2.76	1.74
S. Korea	0.12	0.07	0.69	0.43	1.36	1.15