Royal Government of Bhutan

Ministry of Finance

Annual Macroeconomic Performance and Outlook:

Structural Transition Towards the "Diamond Strategy"

2026

Department of Macro-Fiscal and Development Finance

DISCLAIMER

The views shared and the errors made in this report are that of the authors.

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Abbreviations

AI	Artificial Intelligence	IMF	International Monetary Fund
AKP	Average Capital Productivity	INR	Indian Rupee
ALP	Average Labour Productivity	LFPR	Labour Force Participation Rate
BIRT	Bhutan Interbank Real Time	MoF	Ministry of Finance
BSI	Bhutan Stock Index	MoICE	Ministry of Industry, Commerce and Employment
BTN	Bhutanese Ngultrum	MTFF	Medium Term Fiscal Framework
BTPA	Bhutan Productivity Account	NPL	Non-Performing Loan
CAD	Current Account Deficit	NQRC	Bhutan QR Code
CGE	Computable General Equilibrium	OCASC	Office of Cabinet Affairs and Strategic Coordination
CIT	Corporate Income Tax	OECD	Organization for Economic Cooperation and Development
COTI	Countries Other Than India	OLG	Overlapping Generation Model
CRR	Cash Reserve Ratio	PHPA-I	Punatsangchhu Hydropower Project Authority-I
CSI	Cottage and Small Industries	PHPA-II	Punatsangchhu Hydropower Project Authority-II
CY	Calendar Year	PIMS	Public Investment Management System
DDK	Druk Dungkar Model	PIT	Personal Income Tax
DHI	Druk Holding and Investment	PLB	Precautionary Liquidity Buffer
EAP	East Asia and the Pacific	POS	Point of Sale
FY	Fiscal Year	RCA	Revealed Comparative Advantage
FYP	Five-Year Plan	RER	Real Exchange Rate
GDP	Gross Domestic Product	RMA	Royal Monetary Authority
GFS	Government Finance Statistics	RSEBL	Royal Securities Exchange of Bhutan Limited
GMC	Gelephu Mindfulness City	SOE	State-Owned Enterprises
GNH	Gross National Happiness	TFP	Total Factor Productivity
GO	Gross Output	TOT	Terms of Trade
GST	Goods and Services Tax	USD	United States Dollar
IIP	International Investment Position	VA	Value Added
ILO	International Labour Organization	WB	World Bank

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Executive Summary

Bhutan's economic growth is expected to moderate after a strong post-hydropower expansion, while remaining above its medium-term potential. Real GDP growth is projected to moderate from 8.71 percent in 2025 to 6.86 percent in 2026 as the impact of the commissioning of PHPA-II tapers off, while the construction of new hydropower projects slowly picks up pace. Near-term growth is expected to be driven primarily by construction activity associated with ongoing hydropower projects and increased public capital expenditure. Over the medium term, growth is projected to remain above 6 percent on average, with volatility driven by hydropower investment cycles. The outlook is reinforced by resilient regional conditions, particularly India's strong domestic demand and investment momentum. However, growth prospects remain highly sensitive to domestic factors, including the execution capacity of hydropower projects, the effectiveness of government expenditure, and climate-related shocks. On the external front, ever-changing geopolitics, supply chain disruption, continued protectionism through tariffs, and depreciating INR create significant uncertainties.

Fiscal policy aims to promote economic growth while ensuring sustainability, targeting a fiscal deficit close to 3 percent of GDP during the 13th FYP. The projected fiscal deficit for FY 2025-26 is 3.23 percent of GDP, an improvement over previous estimates, broadly aligned with the medium-term objective. While the government adopts an expansionary fiscal policy, effective implementation depends on agencies' implementation capacity, which has been affected by attrition among civil service professionals. As a result, the fiscal deficit, despite being projected at a higher level in the budget appropriation bill for the same fiscal year, is in line with the medium-term fiscal anchor. Further, the quarterly fiscal framework reveals pronounced seasonality, with revenue collection and capital spending concentrated in later quarters, which could tighten implementation timelines and affect value for money if not properly managed. Public debt remains elevated at Nu. 382,095 million, about 110.47 percent of GDP in Q2 of FY 2025-26, mainly linked to hydropower projects. This situation underscores the importance of improving the efficiency of public investment to ensure that capital accumulation boosts output and expands fiscal space over time.

Inflation and monetary conditions remain broadly stable under the currency peg, but domestic reforms and liquidity dynamics are becoming more policy-relevant. Inflation averaged about 3.51 percent in 2025 while temporary pressures are expected in 2026 following the introduction of the 5 percent GST. However, this impact is expected to be short-lived as a result of tax-pass through for old stock. Broad money supply (M2) for FY 2025-26 is projected at about Nu. 296,187.212 million, growth of around 19 percent, driven mainly by higher government spending and credit expansion. Credit growth remains moderate, while non-performing loans are contained at around 3.14 percent. Excess liquidity in the banking system rose to over Nu. 12 billion, supporting continued credit flow. Nevertheless, increased liquidity in the market on account of increased government activity, coupled with increased investment in hydropower projects, could result in external imbalances towards the end of the 13th FYP, should the

expansionary fiscal policy fail to increase the domestic supply within the economy, pointing to overall system instability alongside the need to manage sectoral credit concentration and liquidity swings.

External balances continue to face structural pressures due to substantial capital import requirements, despite an anticipated temporary improvement in the trade deficit as one-time import surges subside. The current account deficit is projected to narrow from 19.47 percent of GDP in FY 2025-26 to 16.40 percent of GDP in FY 2026-27 driven by a reduced effect of one-time surge in imports. However, it is expected to widen sharply to about 27 percent of GDP in the coming years, driven by a surge in capital-goods imports for hydropower projects and government investments, alongside a narrow export base. These pressures have been partially offset by improvements in services exports, rising inward remittances, and strong financial account inflows, including a one-time surge in FDI equity. Capital and financial account inflows, mainly driven by government activities, continue to play a critical role in financing the external imbalance, while foreign exchange reserves have gradually rebounded from recent lows but remain vulnerable over the medium term as import demand accelerates. Overall, the external sector outlook underscores the need for structural transformation toward export diversification, productivity-enhancing investment, and services-led growth, aligned with the 10X Economic Vision and Diamond Strategy, to strengthen external sustainability and reduce reliance on grants and borrowing over time.

Labour market indicators point to slight overall improvements, but ongoing structural challenges persist among youths. Although the overall unemployment rate has reached 3.38 percent in 2025, youth unemployment remained high at around 18.20 percent, significantly above the global average of 12.40 percent. Medium-term forecasts suggest youth unemployment will hover between 19 and 21 percent from 2026 to 2028. While the economy is generating new jobs—21,396 vacancies in 2025 compared to 12,410 job seekers—this is a reversal from 2023, when 7,355 vacancies were available for 22,012 applicants. The coexistence of a vacancy surplus and high youth unemployment highlights fundamental structural issues in the labour market, as meaningful job creation is not keeping pace with human development. This is largely due to capital-intensive government-led growth and a weak private sector. Despite a low Labour Force Participation Rate (LFPR) of just around 65 percent, these challenges persist. Persistent high youth unemployment, combined with Bhutan nearing the final stage of demographic transition and continued out-migration, presents significant long-term economic and security risks.

Despite renewed investment increase and a growing number of industrial establishments, Bhutan's industrial sector has yet to translate activity into meaningful structural transformation. As the industrial sector remains dominated by the high-performing metals sector, there is a lack of industrial deepening and limited integration across domestic supply and value chains. While global and regional trends point to a shift towards higher-value, technology-driven manufacturing, Bhutan's industrial base continues to face structural constraints that hamper industrialization. Industrial exports remain highly concentrated, domestic supply responses remain

weak, and value added has remained largely unchanged despite broader economic recovery. Addressing these constraints will require strategic supply chain development, horizontal linkages to address scale issues, and a strategic shift towards diversified industrial growth for sustained gains and resilience.

State-Owned Enterprises (SOE) play a central role in Bhutan's economy and strategic planning, yet divergent performance and dual mandates present governance and efficiency challenges. SOEs held approximately Nu. 398 billion in assets in 2025, equivalent to about 142 percent of GDP, and contributed roughly 23 percent to national output. SOE employment is projected at 11,291 by 2026, representing about 2.9 percent of total employment, with industry accounting for over half of SOE jobs. Financial indicators reveal a K-shaped trajectory, with mining and electricity sectors achieving high profit ratios, while other sectors lag behind. Dividend data show non-hydropower contributions rising, though hydropower still accounts for more than half. The output and benefit maximization objective of SOEs is constantly overwritten by a weak corporate governance framework and soft budget constraints, wherein the expectation of government bailouts weakens incentives for productive efficiency and shields loss-making operations from competitive pressure.

Growth accounting analysis indicates a capital-intensive economy with decreasing efficiency, highlighting the need for reforms to boost productivity. From 1990 to 2023, average output growth was around 6.3 percent, mainly driven by a 9.2 percent increase in capital input and a 5.2 percent rise in labour productivity. However, capital productivity declined by about 2.9 percent annually, and Total Factor Productivity contributed negatively, averaging -0.3 percentage points annually. In 2023, labour productivity growth fell from 5.5 percent in 2022 to nearly zero, while the labour income share increased to 53.49 percent. The nominal capital stock reached roughly Nu. 965,784 million, nearly 3.9 times the GDP, indicating high capital-output needs and the importance of improving investment efficiency. Sector-level productivity shows some rebound but persistent stress in capital-heavy sectors, reinforcing concerns about diminishing returns. Mining and quarrying experienced strong labour productivity growth of about 29.97 percent in 2023, and tourism-related hotels and restaurants rebounded sharply with about 37.89 percent growth. Conversely, manufacturing productivity declined from 15.80 percent in 2022 to -0.87 percent in 2023, and electricity labour productivity fell to around -10.56 percent. Manufacturing's capital productivity improved to approximately 5.28 percent in 2023 from 3.98 percent in 2022, but electricity capital productivity worsened to about -9.79 percent, with TFP in electricity plunging to around -13.80 percent, indicating that simply scaling capital is insufficient without better utilization and efficiency.

Five thematic research studies on Bhutan provide evidence-based guidance on prioritizing diversification, stabilization policies, and building climate resilience. First, the Revealed Comparative Advantage analysis shows that Bhutan's comparative advantage is now concentrated in mineral products, iron/steel, and few agriculture products, highlighting the reliance on resource-based and low-processing manufacturing exports. This underscores the need for targeted

interventions to link the domestic supply chain and improved value chain within the firm. Second, a study on money supply from 1992 to 2023 finds that monetary policy can help stabilize the economy in the short run, particularly during shocks, but it cannot drive long-term growth. Excessive monetary expansion could undermine external stability and threaten the exchange rate peg. Therefore, fiscal policy, structural reforms, and productivity-enhancing investments should be the main drivers of long-term growth, with monetary policy playing a complementary role. Third, using the Dynamic Computable General Equilibrium model to simulate a climate shock—a 2 percent decrease in electricity output and a 5 percent loss in infrastructure capital—projects a 0.6 percent reduction in GDP in 2025 compared to the baseline, with recovery expected after reconstruction. Fourth, Druk Dungkar Model, a 55-generation dynamic Overlapping Generations Models for Bhutan, shows that an expansionary fiscal policy that does not yield a desired result of expanding the economy could have negative unintended consequences on intergenerational inequality expanding over 20 years. Fifth, the IS-LM-BP model evaluates shocks such as a 30 percent drop in exports and a 20 percent rise in import prices, examining their effects on output, liquidity, and inflation. These analytical tools support the report's conclusion that policy design must carefully consider trade-offs, especially in a small, open, import-dependent economy with a fixed exchange rate.

Bhutan's constraints are manageable but require a deliberate shift from government-led capital-intensive expansion toward productivity-led, private-sector-enabled, and climate-resilient growth. Core challenges are framed as K-shaped sectoral performance, persistent youth unemployment, demographic headwind, fiscal seasonality and increased size of government crowding out the private sector, credit concentration with liquidity management needs, and persistent external imbalances driven by imports of both consumption and investment goods. Going forward, leveraging strong leadership and clear national strategies, adequate human development foundations, institutional strength and strict rule of law, bolstered by green growth positioning, can overcome the core challenges. A strategic shift towards a diversified, productivity-driven private-sector-led growth path will be essential to deliver inclusive and dynamic economic growth, along with sustainable prosperity aligned with GNH principles, towards the path of convergence with the Diamond Strategy.

Leading Economic Indicators: Bhutan

Table 0.1: Leading Economic Indicators

Indicators	Units	2023/24	2024/25	2025/26	2026/27	2027/28
		2023	2024	2025	2026	2027
		Actual		Projection		
Real Sector[1]						
Real GDP growth	% (CY)	4.63	7.50	8.71	6.86	7.40
Nominal GDP	Million Nu. (CY)	248,863	280,008	325,363	366,415	411,165
Agriculture Sector Growth	% (CY)	1.37	3.73	1.94	1.56	1.63
Industry Sector Growth	%(CY)	-0.79	6.96	16.69	12.20	13.92
Services Sector Growth	%(CY)	7.92	8.80	5.82	4.38	4.06
GDP per Capita	US$ (CY)	3,965	4,347	4,855	5,149	5,743
Fiscal Sector						
Domestic Revenue	Million Nu. (FY)	56,014	62,208	78,592	77,406	80,218
Tax Revenue, in percent of GDP	*% (FY)*	13.25	14.54	13.25	10.87	10.44
Grants and Other Receipts	Million Nu. (FY)	14,180	19,258	31,960	31,881	29,162
Current Expenditure	Million Nu. (FY)	43,424	45,872	58,545	59,753	60,557
Capital Expenditure	Million Nu. (FY)	31,098	43,519	63,548	70,857	62,008
Fiscal deficit, in percent of GDP	*% (FY)*	1.79	2.64	3.23	5.48	3.04
Total Public Debt	Million Nu. (FY)	287,487	303,571	382,095	401,807	419,065
o.w Domestic Debt	Million Nu. (FY)	21,477	24,646	31,115	33,835	31,413
o.w External Debt	Million Nu. (FY)	266,010	278,924	350,979	367,971	387,651
External Sector						
Current Account Balance (CAB)	Million Nu. (FY)	-55,321	-45,522	-58,921	-56,712	-106,151
o.w Trade balance (Goods)	Million Nu. (FY)	-51,933	-67,697	-88,574	-84,660	-135,335
CAB, in percent of GDP	*% (FY)*	-23.20	-17.20	-19.47	-16.40	-27.30
Total International Reserves	Million US$ (FY)	625	800	1,319	1,640	1,437
Monetary Sector						
Inflation	% (CY)	4.23	2.78	3.51	n.a	n.a
Money Supply	Million Nu. (FY)	220,405	248,930	296,187	328,763	365,090
Credit growth	% (FY)	5.10	17.02	8.07	6.90	7.68
Pure Excess Liquidity	Million Nu. (FY)	11,193	11,498	11,998	12,466	14,855
NPL	% (CY)	3.33	3.04	3.14	n.a	n.a
Labour and Household Sector						
Unemployment	% (CY)	3.50	3.49	3.38	3.30	3.11
Youth Unemployment Rate	% (CY)	15.9	19.07	18.20	19.05	19.95

[1] Real sector indicators are presented on a Calendar Year (CY) basis. Fiscal, External and Monetary sector indicators are reported on a Fiscal Year (FY) basis. This reporting convention applies throughout the report unless otherwise specified.

Chapter 1 Macroeconomic Outlook

1.1. Introduction

The global economy is projected to grow at 3.3 percent in 2026, before moderating to 3.2 percent in 2027 (IMF, 2026). This relatively resilient outlook is supported by continued investment in artificial intelligence, renewable energy, and energy efficiency, which has helped offset downside risks arising from elevated policy uncertainty and trade-related tensions. Growth in emerging markets and developing economies is expected to remain slightly above 4 percent, while South Asia is projected to expand by 5.6 percent, led by strong growth momentum in India. India's economy is expected to grow in the 6–7 percent range over the near to medium term, reflecting robust domestic demand, sustained public investment, and improving export diversification, although growth is anticipated to moderate gradually as cyclical factors ease (IMF, 2026).

On the domestic front, economic growth is projected to moderate to 6.86 percent in 2026, following a strong expansion of 8.71 percent in 2025. This moderation reflects an expected slowdown in electricity sector growth as the one-off impact of the commissioning of Punatsangchhu Hydropower Project Authority-II (PHPA-II) in 2025 tapers off, partly offset by stronger performance in the construction sector. Growth in 2026 is expected to be driven primarily by construction activity, supported by the development of Dorjilung, Khorlochu, and Punatsangchhu Hydropower Project Authority-I (PHPA-I) hydropower projects, alongside a ramp-up in government capital expenditure. The industrial sector is projected to remain a key engine of growth over the medium term, with overall growth expected to hover above 6 percent. Nevertheless, the outlook remains subject to downside risks from the implementation capacity of the hydropower projects and heightened vulnerability to extreme weather events resulting from climate change.

1.2. Global Economic Outlook

The year 2025 was marked with a series of speculations stemming from sweeping tariff hikes, dynamic reactions and supply chain diversification, resulting in policy uncertainty. Amidst the noise, the IMF in its World Economic Outlook (WEO) states that the global economy grew resiliently, still on track with earlier estimations of 3.3 percent growth in 2025 and is expected to grow optimistically at a rate of 3.8 percent in 2026, gradually slowing to 3.2 percent in 2027 (IMF, 2026). The WEO attributes the positive outlook to policy uncertainties that have been offset by surging investments in Artificial Intelligence (AI), investments in renewable energy and energy efficiency, a softer-than-anticipated international trade situation, and fiscal and monetary support (Lacina & North, 2025).

The United Nations Trade and Development (UNCTAD) and Organisation for Economic Co-operation and Development (OECD) take a much more cautious approach to global economic growth prospects, estimating global growth at 2.6 percent and 2.9 percent for 2026, respectively.

This is expected to improve slightly in 2027, to 2.7 percent (UNCTAD, 2026). Softer growth is expected as higher effective tariff rates work their way through the economy, dampening investment and trade and later strengthen as tariff effects diminish and financial conditions ease.

The lower-than-anticipated effective tariff imposed by the United States, combined with tightening immigration policies and absorption of tariff shock by domestic importers, resulted in lower-than-anticipated inflation. Global headline inflation is expected to decline from an estimated 4.1 percent in 2025 to 3.8 percent in 2026 and further to 3.4 percent in 2027 (IMF, 2026). This disinflationary trend is expected to create additional room for cautious monetary easing, though the pace will vary across countries depending on inflation dynamics and financial stability considerations. Fiscal policy in several major economies is expected to remain supportive in the near term, but elevated public debt levels underscore the need for credible medium-term consolidation strategies.

The WEO projects the Emerging Markets and Developing Economies' growth to continue to hover just above 4.0 percent in 2026 and 2027. China is expected to grow faster, at a rate of 4.5 percent in 2026, owing to lower effective tariffs on Chinese exports as a result of the year-long trade truce reached in November and fiscal stimulus measures that are assumed to be implemented over a two-year period. In India, growth is revised upward by 0.7 percentage points to 7.3 percent for 2025, reflecting the better-than-expected outturn in the third quarter of the year and strong momentum in the fourth quarter. Growth is projected to moderate to 6.4 percent in 2026 and 2027 as cyclical and temporary factors wane.

Risks remain tilted to the downside, with technology-associated risks surrounding AI-driven productivity gains, which could lead to volatility and pullback in investments. AI saw massive investment growth with data centers accounting for more than one-fifth of global greenfield project values (UNCTAD, 2026). Although industry experts cite different views, trade and geopolitical tensions are expected to remain elevated. High public debt and increased reliance on market-based financing raise the risk of tighter financial conditions and volatility.

1.3. Regional Economic Prospect

Growth in East Asia and the Pacific (EAP) is projected to moderate to 4.4 percent in 2026 and 4.3 percent in 2027, mainly owing to a deceleration in China as a result of subdued consumer confidence, property sector slump, and a softer labour market. The Asia-Pacific region continues to be one of the fastest-growing and most dynamic parts of the global economy, underpinned by robust domestic demand, strong export performance in technology-related sectors, and continued investment in infrastructure and innovation. Despite these strengths, the near-term outlook reflects a moderation in momentum relative to the rapid post-pandemic recovery.

According to the IMF, EAP economies are expected to experience dampened growth as a result of higher effective tariffs and rising protectionism in the West, which is a major market for EAP

exports. Nevertheless, Asia is projected to continue to contribute around 60 percent of global growth in 2025 and 2026. Inflation is expected to move closer to targets in 2026.

South Asia is forecasted to grow 5.6 percent in 2026, easing from 5.9 percent, led by India's 6.6 percent expansion, driven by resilient consumption and substantial public investment, according to the Global Economic Outlook (The World Bank Group (WB), 2026). Growth in India is projected to slow to 6.5 percent in FY 2026-27. Even so, India is expected to maintain the fastest growth rate among the world's largest economies. Despite higher tariffs on certain exports to the United States, the adverse impacts of higher tariffs will be offset by stronger momentum in domestic demand and more resilient exports than previously anticipated. India has also been making strides in diversifying export partners, announcing that it has finalized a "mother of all deals" free trade agreement with the EU (Ellis-Petersen & Rankin, 2026). Growth is set to inch up to 6.6 percent in FY 2027-28, underpinned by robust services activity, as well as a recovery in exports and a pickup in investment.

Recovering from political turmoil, Bangladesh is expected to grow at 4.6 percent in FY 2025-26 and 6.1 percent in the following fiscal year, with private consumption strengthening alongside easing inflationary pressures. Expected structural reforms are anticipated to lead to faster public spending and investment growth than previously projected (WB, 2026). Growth in Sri Lanka and Nepal is expected to decelerate to 3.5 percent and 2.1 percent, respectively, reflecting structural impediments to growth and policy uncertainty.

Inflation across the South Asian economies is expected to converge towards central bank targets, while the Maldives may experience price pressures due to rising demand and tight food supplies. Job creation, particularly in the nonagricultural sector, is anticipated to remain subdued in the region, likely insufficient for the youth who are expected to reach working age over the forecast horizon. In several economies, including Bhutan and Sri Lanka, emigration pressures are projected to remain heightened, especially among the young and highly skilled population. Risks to the regional outlook are skewed to the downside, reflecting the potential for tighter trade restrictions, elevated trade policy uncertainty, tighter financial conditions, social unrest, political instability, and more frequent climate-related shocks to weigh on growth, especially in economies with greater exposure to the United States or higher debt vulnerabilities. However, upside risks include a partial rollback of tariffs, faster productivity gains from new technologies such as AI (particularly in India), and improved political stability that could unlock growth-enhancing structural reforms and stronger investment and confidence.

1.4. Domestic Economic Outlook Prospect

Bhutan's economy is expected to moderate to 6.86 percent in 2026, down from a growth of 8.71 percent in 2025. The moderation is primarily due to a slowdown expected in the industry sector as growth in the electricity subsector tapers off in 2026, following the one-off boost from the commissioning of PHPA-II. Strong growth in the construction sector, driven by hydropower-

related works and increased capital spending, is expected to offset the normalization in electricity growth.

The 2026 growth estimates in the current update are revised downwards by 1.39 percentage points from the last quarter estimate, reflecting an adjustment in anticipated hydropower disbursements and constraints related to the economy's implementation and absorption capacity, particularly in construction. Nevertheless, the industry sector is expected to remain the primary driver of growth in 2026, contributing 3.98 percentage points to growth, followed by the service sector.

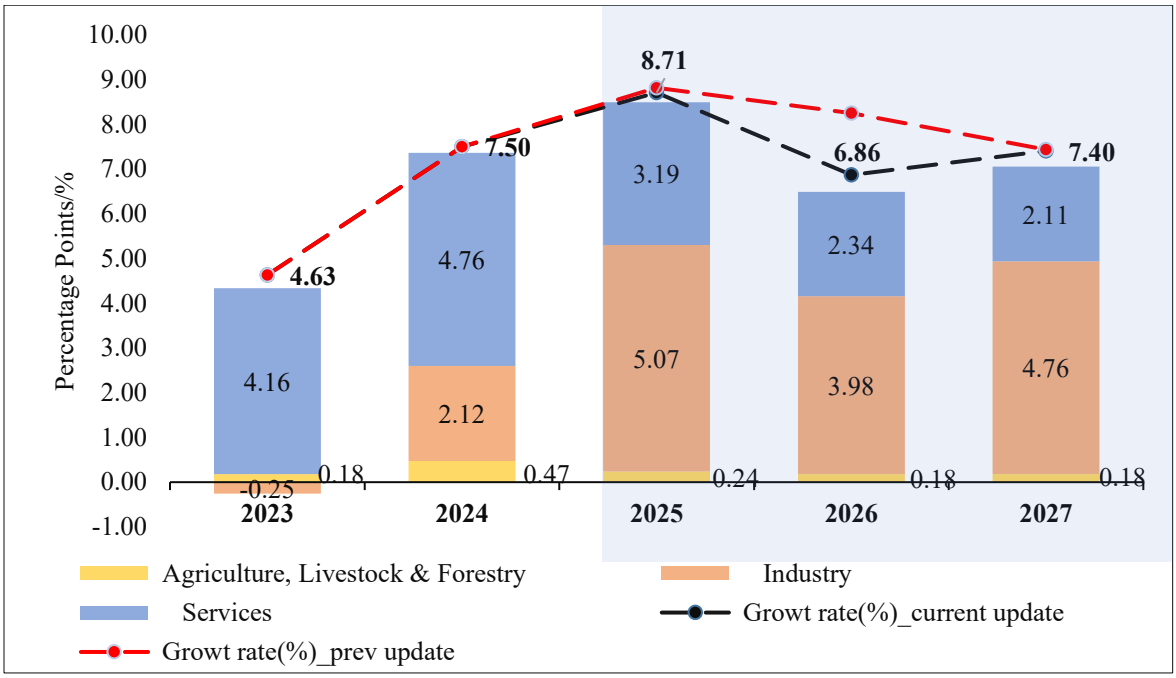


Figure 1.1:GDP Growth and its Drivers

Economic growth in 2025 is estimated at 8.71 percent, revised downward by 0.11 percentage points from the previous quarter estimate, reflecting a lower projected contribution from the service sector. The service sector growth was revised downwards, with tourist arrivals being lower than what was projected in the previous quarter. This downward pressure is partly offset by stronger-than-expected electricity generation during the year.

Looking ahead, GDP growth is projected at 7.40 percent in 2027, with the economy expected to grow above an average rate of 6 percent in the medium term. Growth will continue to be driven primarily by the industry sector, underpinned by the implementation of major hydropower projects, while a gradual recovery in tourism and related services is also expected to support overall economic performance. Nevertheless, the growth outlook remains highly sensitive to hydropower sector developments, with delays in project implementation being a downside risk to medium-term growth prospects.

1.4.1. Agriculture Sector

The agriculture sector is projected to grow by 1.94 percent in 2026, unchanged from the previous quarter's estimate as high-frequency agriculture data gets stabilized. Livestock production is expected to grow by 2.41 percent in 2026, contributing 0.92 percentage points to overall agricultural growth. The forestry and logging subsector is projected to expand by 4.24 percent in 2026, contributing 0.77 percentage points higher than the 0.70 percentage points projected for 2025. Among agricultural subsectors, forestry and logging are expected to sustain the growth recorded in 2024, supported by rising timber demand as the construction sector gains momentum. Nevertheless, overall growth in the agriculture sector remains vulnerable to climate-related risks and extreme weather events.

1.4.2. Industry Sector

The industry sector growth is projected to slow down to 12.20 percent in 2026 from 16.69 percent in 2025, largely reflecting a normalization in the electricity subsector growth, which is partially offset by strong growth in construction.

The growth in the electricity sector is expected to slow down from 25.71 percent in 2025 to 2.19 percent in 2026, as the one-off boost in 2025 from the commissioning of PHPA-II resulted in a level jump in electricity generation capacity. Electricity generation rose by 36.20 percent in 2025 from the recorded generation of 11,650.237 MU in 2024 as a result of the PHPA-II commissioning. Of the 36.20 percent increase in 2025 generation, PHPA-II is responsible for more than 80 percent of the increase, alongside a smaller capacity addition from the commissioning of the first small hydropower project, Suchhu.

The electricity subsector growth projection in 2026 is expected to be 0.16 percentage points lower than the previous quarter estimate, mainly due to the extension of the Dagachhu Power Plant shutdown period from 6 to 12 months. Over the medium term, the subsector's contribution to industry growth is expected to remain moderate, hovering around 1.00 percentage point, before increasing in 2029 in anticipation of the commissioning of the Khorlochhu and other small hydropower projects.

The construction sector is expected to grow at 32.02 percent, accelerating from a growth of 13.26 percent in 2025 in anticipation of construction activities of major hydropower projects: Khorlochhu, Dorjilung and PHPA-I, alongside a ramp-up in government investment. However, this is a downward revision from the previous quarter estimate of 41.50 percent growth, on account of a shift in Khorlochhu's project disbursements and considerations around the implementation and absorption capacity of the economy. In the medium-term, the construction sector growth is expected to sustain through 2027 and 2028, driven by continued hydropower-related works, making the construction sector a key driver of industry growth. This also means higher imports of

labour inputs and construction materials, making the growth outlook vulnerable to external economic fluctuations and increasing external sector vulnerabilities.

The manufacturing, mining and quarrying sectors are expected to grow by 5.56 percent and 3.35 percent in 2026, respectively. The commencement of operations at the Norbugang Industrial Park is expected to partially support a recovery in manufacturing activity and contribute to the sectoral growth in 2026. Nevertheless, as discussed in section 1.6, a sectoral analysis of post-pandemic recovery shows that the manufacturing sector remains on the lower arm of the K-shaped recovery with a heightened risk of being left behind. Despite its strong potential to generate gainful employment and its significant backward and forward linkages within the economy, the sector has not fully capitalized on Bhutan's availability of low-cost and clean electricity, reflecting persistent structural and policy constraints.

Over time, the growth contribution of the industry sector is expected to broaden beyond construction and electricity toward higher-value manufacturing and energy-intensive activities alongside the development of strategic sectors as Bhutan moves to achieve its 10X Economic Vision.

1.4.3. Service Sector

While the service sectors continue to perform strongly, the sector's performance is expected to moderate to 5.82 percent, down from the earlier projections of 6.21 percent for 2025. The downward revision is mainly driven by the hotels and restaurants subsector, which is projected to perform 13.01 percentage points lower than the previous quarter's estimates. This reflects the continued challenges facing Bhutan's tourism ecosystem, which has not yet rebounded despite the full reopening of Bhutan's borders. Many establishments report operations with excess capacity relative to actual occupancy levels, with facilities remaining underutilized outside the traditional tourism period, dampening revenue recovery and containing broader service growth.

A similar trend is expected in 2026, with overall service sector growth being dampened by the performance of the hotel and restaurant sector, as economic actors adjust to persistent structural constraints. Despite increased marketing activities and promotional efforts undertaken by the private and public sectors in 2025, the impact of these initiatives is expected to take time to translate into tangible gains. Over the long term, service sector growth is envisaged to move into higher-value segments such as wellness, professional services, creative industries, ICT and digital activities, reflecting a gradual convergence with the 5 core areas identified for the Gelephu Mindfulness City (GMC).

The pace and quality of tourism recovery will increasingly depend on targeted policy interventions aligned with Bhutan's strategy of 'High Value, Low Volume' tourism. Tourism arrival data for 2025 reveal that Bhutan has recovered to 66.34 percent of pre-pandemic arrival levels (2019). This is a 33.82 percent increase from 2024's arrivals of 156,463 tourists. While the sector's recovery remains gradual, it signals steady progress toward normalization.

However, the rebound has been uneven across visitor segments. In particular, arrivals under the Countries other Than India (COTI) segment have already surpassed pre-pandemic levels, suggesting a stronger recovery among higher spending and less price-sensitive tourists. In contrast, more price-sensitive segments have yet to return to pre-pandemic levels, underscoring the importance of differentiated targeting and pricing strategies. Going forward, the tourism sector is expected to grow at an average rate of 12.39 percent between 2026 and 2029 based on recovery trends and calibrated to remain in line with Bhutan's carrying capacity.

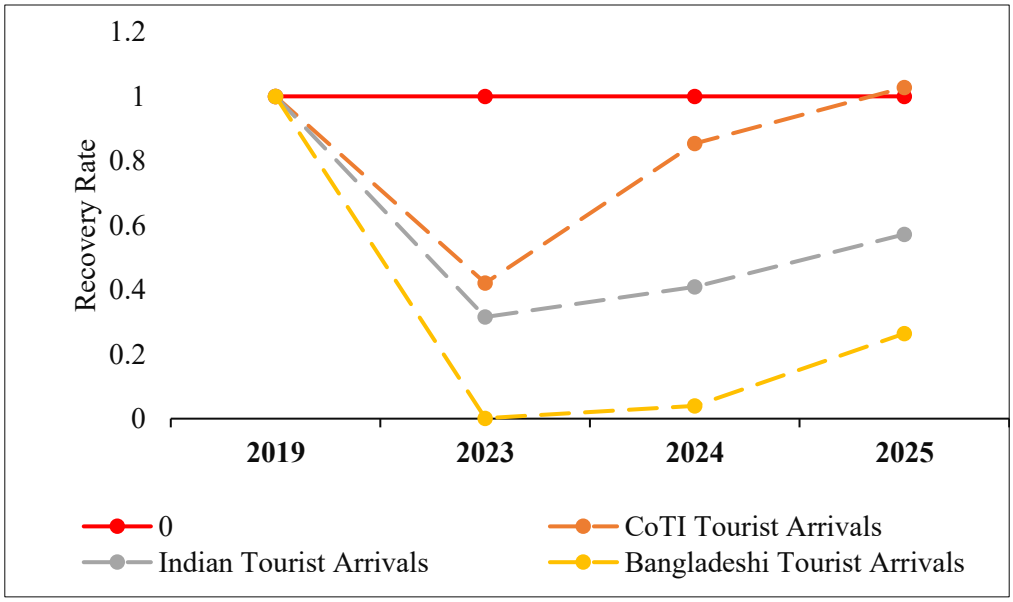


Figure 1.2: Tourism Recovery Relative to Pre-Pandemic Levels (2019 = 1)

1.5. Domestic Economic Outlook: Demand Side Dynamics

Aggregate demand growth in 2026 is projected to be driven primarily by public investment, followed by private investment. Capital expenditure in FY 2025-26 is expected to increase significantly compared to FY 2024-25, while private investment is projected to grow by 5.72 percent, supported by rising expenditure related to hydropower construction activities.

Reflecting the expected deterioration in the Current Account Balance (CAB) during FY 2025-26 and FY 2026-27, the contribution of net exports to growth is projected to decline to 0.27 percentage points, compared to the projection of 1.19 percentage points in the previous quarter. Over the medium term, as the trade deficit widens further due to higher import demand associated with large infrastructure projects, net exports are expected to exert an increasing drag on aggregate growth.

Over the medium term, as capital expenditure gradually winds down, its contribution to growth is expected to decline, while private investment is projected to remain relatively stable. Government consumption is expected to grow at 4.28 percent in 2026 and, on average, is expected to grow at 4.11 percent, reflecting a stable growth in recurrent expenditure. On the other hand, private consumption is projected to contract by 2.93 percent while its contribution to growth declines to -1.40 percentage points, down from a positive growth contribution of 1.24 percentage points estimated in the previous quarter. This is likely reflecting the impact of higher inflation expectations as a result of GST implementation, and ultimately leading to a decline in real wage growth. Nevertheless, private consumption is expected to recover and strengthen over time in the medium-term.

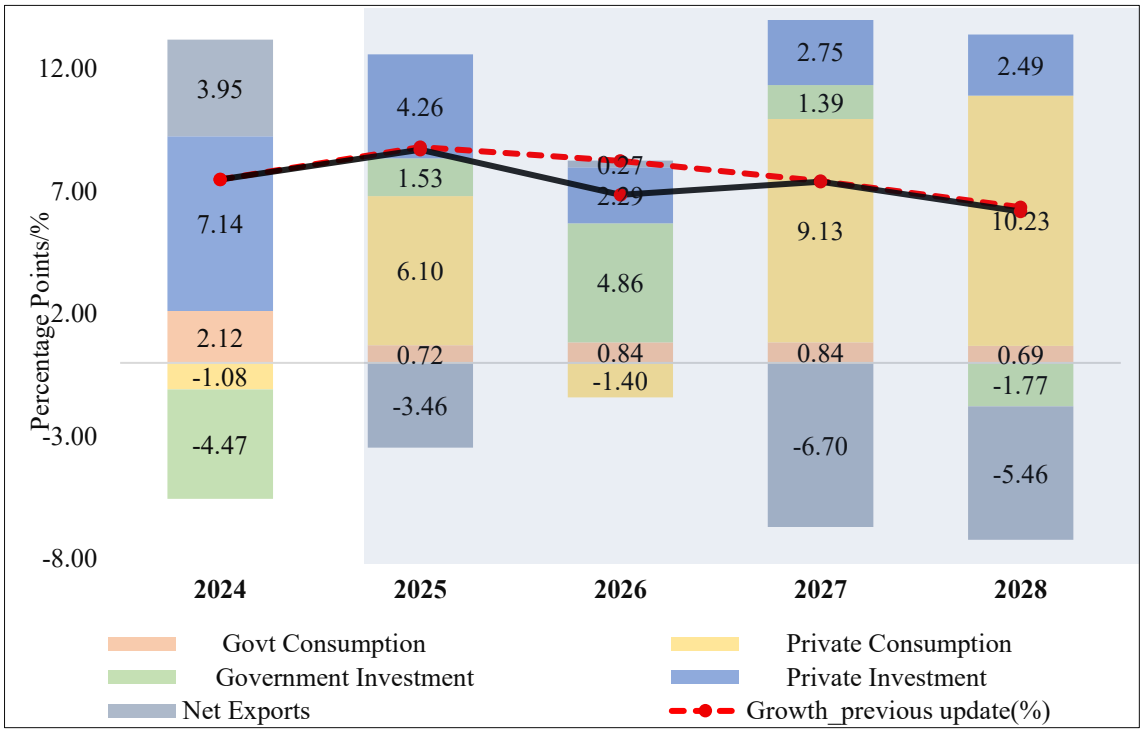


Figure 3: GDP growth and expenditure components contribution

1.6. Growth Diagnostics

The economy is gradually recovering from the COVID-19 pandemic. Following the onset of the pandemic, the actual GDP lingered below its potential between 2020 and 2024 with a significant negative output gap in 2023, as illustrated in Figure 1.4. With the economic growth of 7.50 percent in 2024, close to the long-run average growth, the output gap between the actual and the potential GDP narrowed. As the output gap continues to close, it signals a gradual recovery at the aggregate level. As growth is projected to remain above 6 percent in the medium term, overall economic conditions are expected to improve further. However, this recovery path remains vulnerable to persistent weaknesses in several sectors, which continue to dampen the overall momentum and partially offset the strong performance of key growth drivers, particularly stemming from hydropower and government investments.

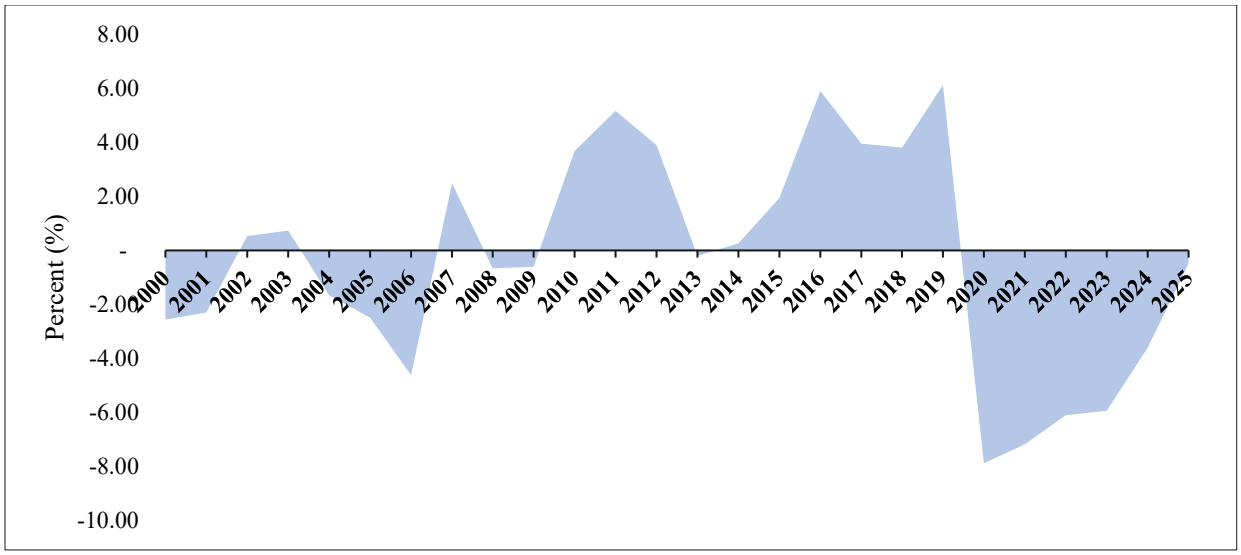


Figure 1.4: Output Gap

This underlying vulnerability is further reflected in Bhutan's recent recovery through a "K-shaped" lens to move beyond headline GDP and examine whether growth is becoming increasingly uneven across sectors. A K-shaped recovery is defined as a situation where, after a common shock, some sectors rebound strongly (the upper arm of the "K") while others stagnate or decline (the lower arm), such that the GDP average can appear healthy even as gaps within the economy widen.

To diagnose whether K-shaped dynamics are present, the analysis applies a structured set of complementary lenses. First, the macro lens compares broad sector performance (agriculture, industry, and services) and highlights that while total GDP has recovered, sectors are moving at different speeds and the distance between them has widened. Second, the micro lens drills down into sub-sectors and explicitly identifies a split between upper-arm and lower-arm activities: Electricity, trade, and communications are presented as sectors pulling ahead, while hotels and restaurants, transport, manufacturing, and entertainment are identified as lagging, illustrating that a few sub-sectors are driving the rebound while others remain behind. Third, the fiscal lens uses tax performance to corroborate real-economy divergence, noting that revenue growth is concentrated in upper-arm sectors reinforcing the conclusion that the recovery is not evenly distributed. Fourth, the credit lens introduces a credit-GDP quadrant crosswalk to assess whether credit allocation is aligned with sector performance and whether financing patterns may be reinforcing divergence. Finally, the study consolidates these signals into a verdict and scorecard, concluding that K-shaped growth is present, supported by evidence across GDP, taxes, and credit, alongside a key risk: increasing concentration of revenue and credit.

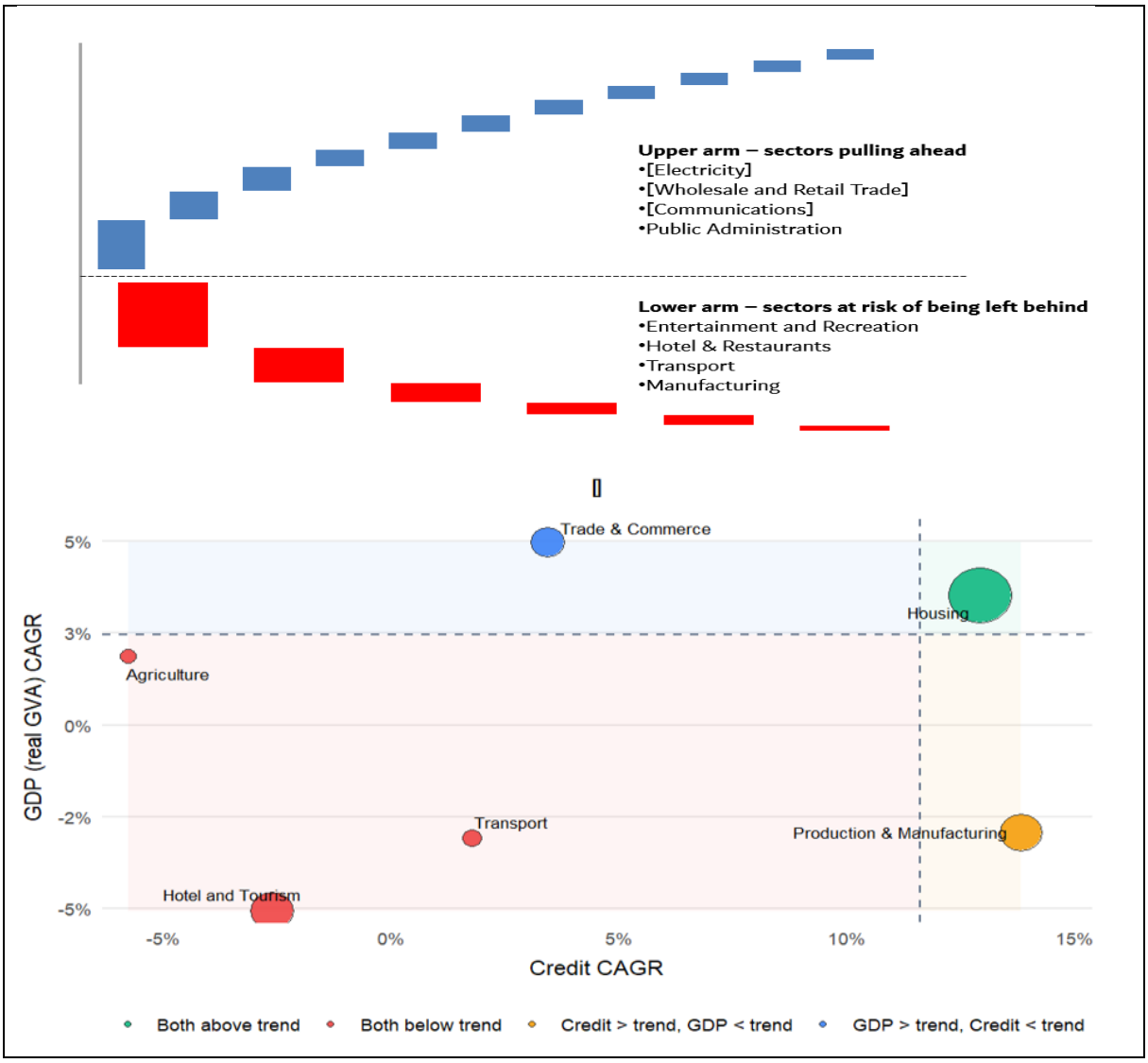


Figure 1.5: K-shaped recovery growth

At a more detailed sectoral level, agriculture continues to register steady but largely flat growth, reflecting long-standing structural constraints and limited productivity gains. The industrial sector has strengthened, driven mainly by electricity generation and construction activity. Within the services sector, wholesale and retail trade has emerged as the primary driver of growth, while tourism-related activities, particularly hotels and restaurants, remain sluggish. As a result, although aggregated growth has returned to near-trend levels, sectoral expansion is occurring at markedly different speeds, with the gap between leading and lagging sectors continuing to widen.

This divergence has important fiscal implications. Revenue buoyancy is increasingly reliant on a limited set of high-performing sectors, leaving public finances more exposed to sector-specific shocks and reducing the resilience of the revenue base. Overall, the combined evidence from GDP, taxes and credit points to a clear K-shaped recovery in Bhutan. Safeguarding and strengthening

key growth engines are essential to sustain and prevent widening structural gaps and to ensure that the recovery remains inclusive, balanced, and resilient over the medium term.

As Bhutan advances toward its 10X Economic Vision, there is a pressing need to strengthen policy focus and strategic emphasis on manufacturing and services sectors—particularly those linked to tourism—to ensure they become key drivers of productivity-led and inclusive growth. While hydropower will continue to underpin the industrial sector and overall growth dynamics, a dynamic and diversified manufacturing base must take a more central role in Bhutan's structural transformation. Expanding manufacturing across resource-based and innovation-driven industries provides a clear pathway to move up global value chains, diversify the economic base, and generate quality employment.

At the same time, a renewed focus on the tourism-related services sector will be critical to uplifting the lower arm of the K-shaped recovery by strengthening linkages with local production, SMEs, and value-added activities. As the GMC evolves into a hub for innovation, services, and global integration, a robust manufacturing sector will be essential to translate investments into gains for the achievement of 10X Economic Vision and the Diamond Strategy.

1.7. Conclusion

Economic growth is projected to moderate to 6.86 percent in 2026, down from 8.71 percent in 2025. This slowdown is primarily attributed to the tapering off of electricity sector growth following the commissioning of PHPA-II in 2025. The moderation is expected to be partially offset by stronger growth in the construction sector, driven by the commencement of major hydropower projects and a ramp-up in government capital expenditure. Construction activity linked to hydropower development is therefore expected to remain a key driver of growth over the medium term, supported by steady growth in the tourism sector.

The industry sector is projected to continue expanding in 2026, growing by 12.20 percent, albeit at a slower pace than in 2025. Subsector analysis indicates that this performance is largely driven by construction related to hydropower projects, while manufacturing growth is expected to remain moderate at around 3.35 percent. Given the strong forward and backward linkages associated with manufacturing, its relatively subdued performance, particularly in the post-pandemic recovery phase, suggests that the sector remains on the lower end of the K-shaped recovery, weighing heavily on overall growth dynamics.

However, a stronger focus on key sectors such as manufacturing, which has significant potential to generate gainful employment, alongside a sustained recovery in the tourism sector, will remain critical to achieving the 10X Economic Vision and converging toward the Diamond Strategy. While traditional growth drivers such as hydropower will continue to underpin the economy, moving beyond a predominantly capital-intensive growth model is essential to foster productivity-led, inclusive, and resilient growth across the economy.

Chapter 2 Fiscal Situation and Outlook

2.1. Introduction

Fiscal policy remains the primary macroeconomic stabilization instrument in Bhutan's post-pandemic recovery, navigating the complex trade-off between growth support and fiscal sustainability. The projected fiscal deficit of 3.23 percent of GDP for FY 2025-26 represents a significant improvement from earlier estimates and demonstrates disciplined adherence to the medium-term target of 3 percent under the 13th FYP. This consolidation has been achieved despite rising expenditure pressures, driven primarily by enhanced revenue mobilization from hydropower profit transfers and improved tax revenues. However, structural challenges remain, notably elevated public debt at 110.47 percent of GDP, pronounced revenue and expenditure seasonality that tightens project implementation, and a continued dependence on external financing that limits fiscal policy autonomy.

This chapter provides a comprehensive assessment of fiscal position and medium-term trajectory, analyzing the alignment of fiscal policy with the ambitious 10X Economic Vision and Diamond Strategy while evaluating sustainability risks and policy effectiveness. The analysis employs both conventional fiscal metrics and the Government Finance Statistics (GFS) 2014 framework. Moreover, evaluation of fiscal multipliers and counter-cyclical indicators demonstrate that while current expenditure delivers strong short-term stimulus, capital spending effectiveness remains constrained by implementation inefficiencies, highlighting the imperative for execution reforms alongside strategic resource allocation.

The medium-term outlook hinges on successful implementation of structural reforms particularly Goods and Services Tax (GST) rollout, income tax modernization, and Public Investment Management System (PIMS) deployment to strengthen revenue buoyancy, reduce seasonality, and improve expenditure quality. As Bhutan pursues transformative economic growth, fiscal policy must evolve from reactive budget management to strategic enabler of structural transformation, balancing immediate stabilization needs with long-term productivity-enhancing investments while maintaining unwavering commitment to debt sustainability and macroeconomic stability.

2.2. Fiscal Policy

Fiscal policy remains a key instrument for supporting economic recovery, employment generation, and macroeconomic stability. In line with the priorities of the 13th FYP, the Government will maintain an expansionary yet disciplined fiscal stance, balancing growth objectives with fiscal sustainability. While constrained domestic resources necessitate continued reliance on external financing, fiscal policy is anchored on maintaining debt sustainability and preserving fiscal space. To this end, the Government is committed to containing the fiscal deficit at an average of 3.00 percent of GDP over the 13th FYP, with budgetary agencies prioritizing high-impact, results-

oriented expenditures aligned with annual work plans and key performance indicators to enhance spending efficiency and remain within the economy's absorptive capacity.

For FY 2025-26, fiscal policy is guided by a strong commitment to sustainable and inclusive development, underpinned by fiscal discipline and structural reforms. Revenue-side measures, including the implementation of the GST, modernization of the Income Tax system, enhanced digitalization, and improved compliance, are expected to strengthen domestic revenue mobilization and reduce reliance on external financing. Public expenditure will be strategically directed toward priority sectors such as infrastructure, hydropower, tourism, agriculture, and digital services, supported by a results-based approach and prudent financial controls.

2.3. Fiscal Policy alignment with 10X Economic Vision and Diamond Strategy[2]

Bhutan's ambition to achieve the 10X Economic Vision, by 2050, together with the Diamond Strategy for convergence between the rest of Bhutan and GMC, requires a fiscal framework that is both growth-enabling and sustainable. Fiscal policy must, therefore, move beyond short-term budget management toward a strategic role in financing structural transformation. This demands a shift from reliance on narrow and concentrated revenue bases such as hydropower, trade taxes and grants toward a broad, modern and growth-responsive tax system anchored in GST, and Personal Income Tax (PIT). As the economy grows, these taxes will ensure that public revenue scales automatically with consumption, wages and profits, allowing it to finance rising development needs without resorting to debt financing or distortionary tax increases.

On the expenditure side, the fiscal framework must increasingly prioritize growth-enhancing investment while maintaining debt sustainability. Public spending should be reoriented toward research and development, innovation, human capital, digitalization and strategic infrastructure, as these generate lasting productivity gains and expand future revenue capacity. At the same time, controlling low-impact recurrent spending is essential to create space for such investments. The convergence of stronger revenue mobilization and more productive expenditure will allow Bhutan to maintain its fiscal deficit around the 3.00 percent of GDP anchor, even as the economy grows tenfold in size. In this way, growth itself becomes the main engine of fiscal sustainability, ensuring that Bhutan's long-term development vision is financed in a stable, credible and self-reinforcing manner.

2.4. Medium-Term Fiscal Framework (MTFF)

The fiscal deficit for FY 2025-26 is estimated at 3.23 percent of GDP, representing an improvement from 4.44 percent estimated in the previous quarter update. This improvement is

[2] The 10X Economic Vision Strategy is currently under development and, therefore, is not incorporated into the present fiscal framework. The framework will be updated to reflect the strategy once it is finalized and formally adopted.

primarily driven by a higher-than-expected profit transfer from PHPA-II, as shown in Table 2.1. Moreover, relative to the approved budget, the fiscal deficit has improved by 2.98 percentage points. This stronger fiscal outturn is mainly attributable to enhanced revenue mobilization, particularly from higher profit transfers from the Royal Monetary Authority (RMA), a revised upward profit transfer from PHPA-II, and the receipt of deferred dividends from Druk Holding and Investments (DHI) in the current fiscal year. Compared to the previous quarter, there is a slight increase in external grants on account of project-tied assistance from the Government of India; however, this has no impact on the fiscal deficit as the corresponding expenditure has already been incorporated.

Table 2.1: Medium Term Fiscal Framework (Nu. in Million)

Sl. No.	Particular	2023-24 *Actual*	2024-25 *Actual*	2025-26		2026-27 *Projection*	2027-28 *Projection*
				Approved	Revised Estimate		
A	**Total Resources**	**70,195.195**	**81,466.220**	**97,772.618**	**110,912.571**	**109,287.803**	**109,380.370**
1	**Internal Resources**	**59,579.628**	**64,193.651**	**72,357.400**	**81,449.228**	**79,283.255**	**82,180.858**
1.1	***Domestic Revenue***	***56,014.461***	***62,208.397***	***70,462.134***	***78,952.498***	***77,406.065***	***80,218.449***
a	*Tax*	*35,037.732*	*44,008.072*	*46,939.248*	*46,905.191*	*42,253.083*	*45,261.046*
b	*Non-tax*	*20,976.728*	*18,200.324*	*23,522.886*	*32,047.307*	*35,152.982*	*34,957.403*
1.2	***Other receipts***	***3,565.167***	***1,985.254***	***1,895.266***	***2,496.730***	***1,877.190***	***1,962.409***
2	**External Grants**	**10,615.567**	**17,272.569**	**25,415.218**	**29,463.343**	**30,004.548**	**27,199.512**
2.1	*GoI*	*6,773.255*	*13,008.711*	*19,885.874*	*21,615.908*	*18,167.206*	*16,807.222*
2.2	*Others*	*3,842.312*	*4,263.858*	*5,529.344*	*7,847.435*	*11,837.342*	*10,392.290*
B	**Total Expenditure/ Outlay**	**74,926.000**	**89,466.857**	**119,162.302**	**122,094.723**	**130,610.797**	**122,566.418**
1	**Current**	**43,424.604**	**45,872.259**	**58,432.217**	**58,545.784**	**59,753.349**	**60,557.617**
1.1	*Primary Current (Regular)*	*38,301.726*	*40,331.142*	*47,524.285*	*47,637.852*	*49,801.473*	*50,719.387*
1.2	*Interest payments*	*5,122.879*	*5,541.117*	*10,907.932*	*10,907.932*	*9,951.876*	*9,838.230*
2	**Capital**	**31,098.396**	**43,519.443**	**60,730.085**	**63,548.939**	**70,857.448**	**62,008.801**
C	**Fiscal Balance**	**(4,730.805)**	**(8,000.637)**	**(21,389.684)**	**(11,182.152)**	**(21,322.994)**	**(13,186.049)**
	In percent of GDP	*(0.16)*	*(2.64)*	*(6.21)*	*(3.23)*	*(5.48)*	*(3.04)*

In the medium term, total expenditure is projected to increase, mainly driven by the upward revision of education stipends, higher transfers to the local governments, incorporation of donor-funded projects, and the re-classification of capital expenditure, which together raise the expenditure baseline over the planning horizon. At the same time, revenue performance is expected to strengthen, supported by the implementation of GST, which broadens the tax base and improves revenue buoyancy, alongside higher non-tax revenue from profit transfers from PHPA-II. The combined effect of these expenditure pressures and revenue-enhancing measures is expected to keep the fiscal deficit contained, allowing the fiscal deficit under the 13th FYP to be maintained within the 3.00 percent of GDP threshold in line with the medium-term fiscal deficit target.

2.5. Quarterly Fiscal Framework for FY 2025-26

The quarterly fiscal framework presented in Table 2.2 reveals a seasonal pattern in both revenue collection and expenditure execution, shaped by tax payment schedules, project implementation cycles, and institutional budget processes. Total fiscal resources are unevenly distributed across the year, with relatively weak inflows in the first half of the fiscal year and a sharp build-up in the latter quarters, particularly in Q4. This is largely explained by the timing of domestic revenue

collections, especially CIT and PIT, as well as non-tax revenues, together with the concentration of external grant disbursements toward the end of the fiscal year.

Table 2.2: Quarterly Fiscal Framework (Nu. in Million)

Sl. No.	Particular	2023-24	2024-25	2025-26				
		Q2 (actual)	Q2 (actual)	Q1 (actual)	Q2 (actual)	Q3 (Proj.)	Q4 (Proj.)	Total (estimate)
A	**Total Resources**	**12,162.990**	**11,980.678**	**21,130.850**	**16,545.684**	**26,730.797**	**46,505.240**	**110,912.571**
1	**Internal Resources**	**10,213.850**	**10,345.417**	**18,948.503**	**13,756.275**	**15,385.079**	**33,359.371**	**81,449.228**
1.1	***Domestic Revenue***	***9,495.050***	***9,972.462***	***18,328.680***	***13,321.705***	***14,782.873***	***32,519.240***	***78,952.498***
a	Tax	6,818.520	8,257.171	11,975.477	10,684.098	6,402.182	17,843.435	46,905.191
b	Non-tax	2,676.530	1,715.290	6,353.203	2,637.607	7,795.532	15,260.964	32,047.307
1.2	***Other receipts***	***718.800***	***372.955***	***619.823***	***434.570***	***378.493***	***1,063.844***	***2,496.730***
2	**External Grants**	**1,949.140**	**1,635.261**	**2,182.348**	**2,789.409**	**10,993.745**	**13,497.842**	**29,463.343**
2.1	GoI	1,012.850	546.777	554.479	6,861.079	2,723.397	11,476.953	21,615.908
2.2	Others	936.280	1,088.485	1,740.492	2,003.307	1,959.272	2,144.365	7,847.435
B	**Total Expenditure/ Outlay**	**14,794.150**	**16,953.004**	**18,131.606**	**19,719.781**	**39,050.984**	**45,192.352**	**122,094.723**
1	**Current**	**10,153.620**	**10,749.206**	**11,082.166**	**11,679.940**	**19,331.488**	**16,452.190**	**58,545.784**
1.1	Primary Current (Regular)	9,298.690	9,594.876	9,484.151	10,437.017	13,954.278	13,762.406	47,637.852
1.2	*Interest payments*	*854.930*	*1,154.330*	*1,598.015*	*1,242.923*	*5,635.983*	*2,431.011*	*10,907.932*
2	Capital	4,640.530	6,203.798	7,049.440	9,282.764	27,381.458	19,835.278	63,548.939
C	**Fiscal Balance**	**(2,832.860)**	**(4,972.326)**	**2,999.245**	**(3,174.097)**	**(12,320.187)**	**1,312.887**	**(11,182.152)**
	In percent of GDP	(1.07)	(1.64)	0.87	(0.92)	(3.56)	0.38	(3.23)

A similar back-loaded pattern is observed on the expenditure side. Total spending rises significantly in the second half of the year, driven primarily by capital expenditure, which accelerates in Q3 and Q4 in line with project implementation schedules, procurement timelines, and payment milestones. In contrast, current expenditure remains relatively stable throughout the year, although a moderate increase in Q3 reflects higher operational and administrative outlays as project activities intensify.

Figure 2.1 shows clear quarter-to-quarter fluctuations and seasonal patterns in fiscal operations, reflecting the uneven timing of revenue collection and expenditure execution during the fiscal year. These intra-year movements highlight the continued back-loading of expenditure, particularly capital spending and the reliance on revenue inflows in the latter quarters. Such patterns can affect the efficiency and quality of budget execution by compressing implementation timelines and limiting flexibility for adjustments during the year. Going forward, the implementation of GST and the rollout of the PIMS are expected to help reduce revenue seasonality, improve predictability, and strengthen the overall quality of fiscal management, in line with the medium-term fiscal objectives under the MTFF.

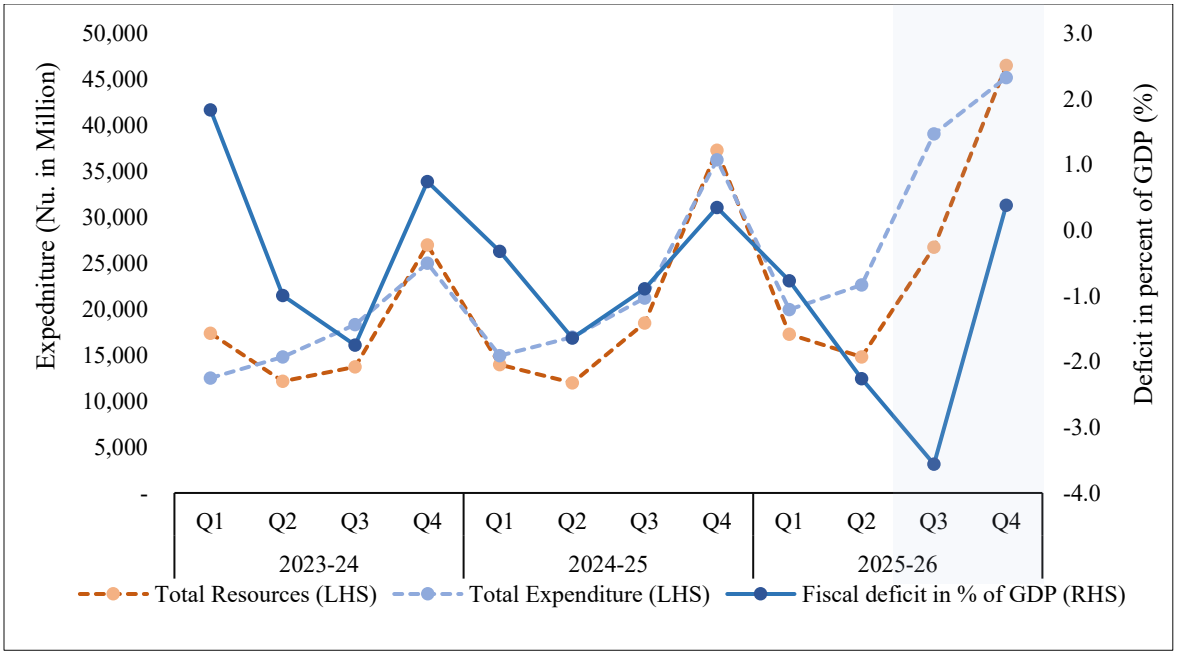


Figure 2.1: Quarterly fiscal performance trends

2.6. Fiscal framework as per GFS 2014

The MoF also compiles a fiscal framework as per the GFS 2014, which is discussed in this section. A key distinction between Bhutan's conventional fiscal framework and the GFS 2014 framework, as reflected in Table 2.1, lies in the classification and economic interpretation of revenue. In the fiscal framework, royalties and other natural resource receipts are generally recorded as tax revenue, consistent with their treatment for budget appropriation, cash management, and policy execution. Under GFS 2014, however, these inflows are classified as rent (property income) and recorded as non-tax revenue, reflecting the economic reality that they arise from the exploitation of government-owned natural assets rather than from compulsory taxation. Similar reclassifications apply to other revenue items under GFS, which systematically distinguishes tax-based inflows from income derived from economic ownership or service provision. This approach allows for a clearer assessment of the government's underlying revenue capacity and the sustainability of its income sources.

Differences are also evident in the treatment of expenditure. In the fiscal framework, spending is broadly categorized into current and capital expenditure, where current spending includes compensation of employees, goods and services, interest payments, subsidies, and transfers, while capital expenditure captures investment in physical infrastructure and other fixed assets. Under GFS 2014, current spending is classified as expense, encompassing all transactions that reduce government net worth during the accounting period. Capital spending, by contrast, is treated as net acquisition of non-financial assets, which represents an exchange of one form of wealth (cash or financial assets) for another and therefore does not directly affect net worth. As a result, asset

acquisition does not enter the operating statement under GFS, but is instead reflected on the balance sheet.

This conceptual distinction is central to the GFS analytical framework and is captured through key fiscal indicators such as the Gross Operating Balance and Net Lending/Borrowing. While the fiscal framework focuses on the overall cash deficit or surplus for budget execution, the GFS indicators provide a more economically meaningful measure of fiscal performance by separating operating sustainability from investment-driven financing needs. The integrated GFS balance sheet further strengthens fiscal analysis by comprehensively recording financial assets and liabilities, including hydro and non-hydro loans, debt securities, equity holdings, and other financial instruments. While Bhutan's fiscal framework reports outstanding debt and annual borrowing primarily for debt management and compliance with fiscal rules, the GFS 2014 links changes in assets and liabilities to transactions, other economic flows, and valuation effects thereby providing a more comprehensive and analytically more robust assessment of the government's fiscal position and sustainability.. This enables the calculation of net financial worth, offering a fuller picture of the government's fiscal position. However, it is important to note that the current compilation is still at its preliminary stage and requires further refinement of classification and cleaning of data.

Table 2.3: Integrated Balance Sheet (Nu. in Million)

Particular	2023-24					2024-25				
	Transactions	Other economic flows			Closing balance	Transactions	Other economic flows			Closing balance
		Holding Gains and Losses	Other volume changes	Residual			Holding Gains and Losses	Other volume changes	Residual	
1 REVENUE	70,628.382					82,545.773				
Taxes	**30,052.033**					**38,555.370**				
Taxes on income, profits, and capital gains	*16,480.380*					*20,682.420*				
Taxes on property	*695.861*					*570.820*				
Taxes on goods and services	*9,882.286*					*12,871.120*				
Taxes on international trade and transactions	*2,972.223*					*4,414.560*				
Grants	**11,495.771**					**18,082.760**				
Other revenue	**28,698.224**					**25,460.063**				
2 EXPENSE	53,698.601					70,116.971				
Compensation of employees	26,239.577					27,134.479				
Use of goods and services	10,944.022					15,096.068				
Interest	5,122.878					5,541.117				
To nonresidents	3,510.114					4,246.348				
To residents other than general government	1,612.764					1,294.769				
To other general government units	-					-				
Subsidies	1,025.208					1,279.453				
Grants	493.291					583.825				
Social benefits	3,793.825					3,826.936				
Other expense	6,079.800					16,655.093				
GOB Gross Operating Balance (1 minus 2)	***16,929.781***					***12,428.802***				
31 Nonfinancial assets	**20,087.811**	-	-	**(20,087.811)**	-	**19,092.853**	-	-	**(19,092.853)**	-
Fixed assets	20,353.985	-	-	(20,353.985)	-	19,032.256	-	-	(19,032.256)	-
Nonproduced assets	(266.174)	-	-	266.174	-	60.597	-	-	(60.597)	-
2M Expenditure (=2+31)	**73,786.412**					**89,209.824**				
Net lending (+) / Net borrowing (-)	***(3,158.030)***					***(6,664.051)***				
Statistical discrepancy / financing gap	6,976.063					2,682.869				
Net Financial Worth (and changes in)	(10,134.093)	-	402.243	1,611.285	(59,209.684)	(9,346.920)	-	13,395.129	(4,056.253)	(59,217.728)
Financial assets	**(1,953.771)**	-	**402.243**	**1,633.429**	**225,969.734**	**388.737**	-	**13,395.129**	**4,993.900**	**244,747.500**
Currency and deposits	(16.020)	-	-	-	26.743	24.606	-	-	-	51.349
Debt Securities	-	-	-	-	-	-	-	-	-	-
Loans	(2,227.358)	-	-	1,633.429	171,542.218	(87.109)	-	-	4,993.900	176,449.009
o.w Hydro Loans	*(2,733.290)*	-	-	*1,206.971*	*163,879.977*	*(852.429)*	-	-	*2,084.655*	*165,112.203*
o.w Non-Hydro Loans	*505.932*	-	-	*426.459*	*7,662.241*	*765.320*	-	-	*2,909.245*	*11,336.806*
Equity and Investment Fund Shares	289.607	-	402.243	-	54,400.773	451.240	-	13,395.129	-	68,247.142
Liabilities	**8,180.322**	-	-	**22.145**	**285,179.418**	**9,735.657**	-	-	**9,050.153**	**303,965.228**
Currency and deposits	-	-	-	-	-	-	-	-	-	-
Debt Securities	(6,755.586)	-	-	0.016	21,098.050	-	-	-	0.002	21,098.052
Loans	14,935.908	-	-	22.129	264,081.368	9,735.657	-	-	9,050.151	282,867.176
o.w Hydro Loans	(1,087.884)	-	-	(365.925)	167,194.627	1,459.841	-	-	1,433.180	170,087.648
o.w Non-Hydro Loans	20,581.490	-	-	388.048	96,507.432	5,106.258	-	-	7,616.978	109,230.668
o.w Overdraft	(4,557.698)	-	-	0.006	379.309	3,169.557	-	-	(0.006)	3,548.860

The integrated balance sheet in Table 2.3 shows that total revenue under the GFS 2014 framework is estimated at Nu. 82,555.773 million, slightly higher than Nu. 81,466.220 million reported under the conventional fiscal framework. This difference mainly reflects variations in consolidation treatment, particularly the classification of certain receipts that are recorded as internal grants in the conventional framework but retained as revenue under GFS based on their economic nature. On the expenditure side, total expense under GFS 2014 amounts to Nu. 70,116.971 million,

compared to the current expenditure of Nu. 45,872.259 million in the conventional framework. The gap largely arises from the treatment of capital grants not elsewhere classified (Nu. 16,148.494 million), which are recorded as expenses under GFS as they reduce government net worth.

As a result, the Gross Operating Balance under GFS 2014 is estimated at about Nu. 12,428.802 million. Given that the compilation of non-financial asset stock positions is still ongoing, only transaction-level data are reflected at this stage, and the difference between revenue and total expenditure is captured as Net Lending/Borrowing, estimated at Nu. 6,664.051 million. This deficit is financed through the incurrence of financial liabilities, resulting in a negative net financial worth of Nu. 59,217.728 million, equivalent to around 20 percent of GDP, providing a more comprehensive assessment of the government's fiscal position than the conventional fiscal indicators.

Contrary to the commonly cited narrative that Bhutan has a high public debt-to-GDP ratio (100.3 percent in FY 2024-25), the integrated balance sheet analysis shows that the government also holds significant financial claims. As a result, the government's actual level of indebtedness is substantially lower than what is suggested by the gross debt figure, which should provide greater confidence to lenders. Moreover, a large share of these financial claims is concentrated in the hydropower sector, which has consistently proven to be a reliable and resilient investment over time.

2.7. Public Debt Dynamics

Public debt has historically served as an important financing instrument for governments to expand fiscal space and support investments that generate positive social and economic outcomes. However, in more recent years, excessive accumulation of debt beyond the economy's carrying capacity has led to increasingly negative perceptions of public borrowing.

Nonetheless, no country in the early stages of development has been able to expand its economic base without mobilising substantial financial resources through debt, whether through concessional borrowing, commercial loans, or capital market instruments. Public debt has therefore played, and continues to play, a critical role in bridging financing gaps and accelerating economic development. In this context, effective public debt management remains essential to ensuring fiscal sustainability and safeguarding macroeconomic stability.

Table 2.4: Medium-Term Public Debt Projections (Nu. in Million)

Sl. No	Particular	2023-24	2024-25	2025-26	2026-27	2028-29
		Actual	*Actual*	*Estimate*	*Projection*	
1	Total Public Debt	287,487.440	303,571.007	382,095.000	401,807.187	419,065.355
	External	*266,010.077*	*278,924.094*	*350,979.603*	*367,971.946*	*387,651.433*
	Domestic	*21,477.362*	*24,646.913*	*31,115.396*	*33,835.241*	*31,413.922*
2	Hydropower	167,194.676	170,086.965	235,152.714	244,514.691	254,968.427
3	Non-Hydropower	120,292.764	133,484.042	146,942.286	157,292.495	164,096.928
	Non-Hydro Budgetary	*99,658.791*	*111,591.064*	*124,435.392*	*140,903.537*	*147,195.846*
	Non-Hydro Commercial	*10,633.973*	*11,892.978*	*12,506.894*	*13,388.958*	*13,901.083*
	Non-Hydro Central Bank	*10,000.000*	*10,000.000*	*10,000.000*	*3,000.000*	*3,000.000*
	In Percent of GDP (%)					
4	Total Public Debt	*108.72*	*100.29*	*110.47*	*103.35*	*96.69*
	External	*100.60*	*92.15*	*101.47*	*94.65*	*89.45*
	Domestic	*8.12*	*8.14*	*9.00*	*8.70*	*7.25*
5	Hydropower	*63.23*	*56.19*	*67.99*	*62.89*	*58.83*
6	Non-Hydropower	*45.49*	*44.10*	*42.48*	*40.46*	*37.86*
	Non-Hydro Budgetary	*37.69*	*36.87*	*35.98*	*36.24*	*33.96*
	Non-Hydro Central Bank	3.78	3.30	2.89	0.77	0.69
	Non-Hydro Commercial	4.02	3.93	3.62	3.44	3.21

Public debt peaked at 124.50 percent of GDP in FY 2020-21 during the COVID-19 pandemic and subsequently declined to 100.29 percent of GDP in FY 2024-25, mainly driven by strong fiscal outturns and robust GDP growth in recent years. As of Q2 FY 2025-26, public debt is estimated at 110.47 percent of GDP, representing a 1.29 percentage point increase from the previous quarter update, primarily due to external debt disbursements for hydropower project development.

Notably, almost all non-hydropower-related debt remains highly concessional, largely sourced from multilateral development banks. Looking ahead, public debt is expected to remain elevated, mainly reflecting continued borrowing for renewable energy projects (hydropower and solar) as well as other priority social sector development projects.

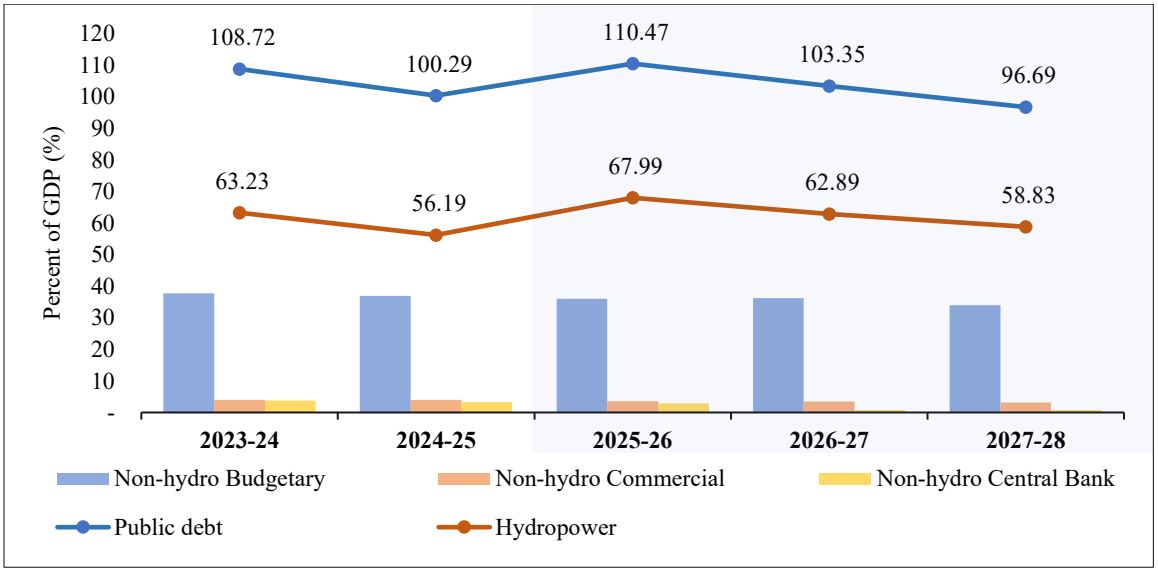


Figure 2.2: Public Debt (In percent of GDP)

The central government debt, commonly referred to as Non-Hydro Budgetary Debt, is projected at Nu. 124,435.392 million as of Q2 FY 2025-26, accounting for 35.98 percent of the estimated GDP. This reflects a marginal decline of 0.7 percentage points from Q1, when the debt stock was estimated at Nu. 127,770.022 million (36.7 percent of estimated GDP). Going forward, central government debt is expected to rise, mainly due to increased deficit financing requirements and the non-confirmation of resource commitments from official development partners at this stage. Nonetheless, despite the projected upward trend, central government debt is expected to remain well below the 55 percent of GDP threshold prescribed under the Public Debt Management Policy 2023.

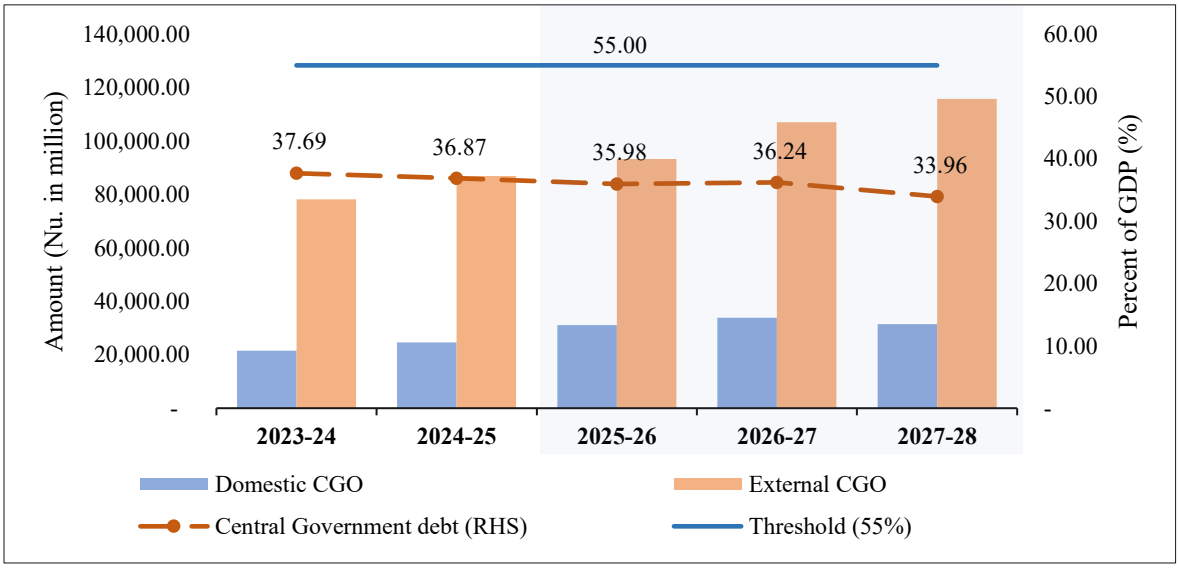


Figure 2.3: Central Government Debt Composition and in percent of GDP

At the present juncture, given Bhutan's relatively closed economy, the country remains heavily dependent on concessional borrowing from multilateral development banks and bilateral partners, as well as commercial loans for self-liquidating renewable energy projects, particularly in hydropower and solar.

Going forward, to enhance the economy's public debt carrying capacity, the Government should place stronger emphasis on the development of productive and export-oriented sectors, while ensuring that limited financing resources are utilised efficiently and strategically, without crowding out private sector development.

2.8. Efficacy of Fiscal Spending

2.8.1. Fiscal Multiplier

The fiscal multipliers for FY 2024-25 provide important insights into the differential effectiveness of government spending across expenditure categories. The current expenditure multiplier of 1.42 demonstrates that operational spending on wages, subsidies, transfers, and essential services

delivers substantial stimulus to the economy by directly supporting household consumption and driving immediate economic activity. Wage payments to civil servants and social transfers translate quickly into demand for goods and services, creating ripple effects as businesses expand production in response. In contrast, the capital expenditure multiplier of 0.17 reflects the delayed and diminished short-term impact of public investment, attributable to extended procurement and construction timelines, high import content of capital projects that results in expenditure leakages, and the pronounced back-loading of capital spending in the latter quarters that compresses implementation periods. Taken together, the overall expenditure multiplier of 0.54 indicates that public spending contributes positively to GDP, but the moderate short-term effects underscore the critical importance of both the composition and execution efficiency of fiscal interventions, not merely their aggregate magnitude.

Table 2.5: Fiscal Multiplier for FY 2024-25

Sl. No.	Particulars	Fiscal multiplier
1	Current Expenditure	1.42
2	Capital Expenditure	0.17
3	Total expenditure	0.54

Building on these insights, fiscal policy can be more strategically calibrated to maximize developmental impact. While the low capital multiplier reflects short-term measurement constraints rather than fundamental ineffectiveness, the government should prioritize high-return infrastructure projects while strengthening execution and monitoring frameworks through enhanced PIMS to ensure investments generate sustainable productivity gains. At the same time, maintaining strategically targeted current expenditure particularly on social transfers and essential services can support consumption and provide immediate economic relief during periods of slack. Efforts to increase domestic content of spending, develop local construction capacity, and address seasonal expenditure patterns can further enhance multiplier effects by reducing import leakages and improving implementation efficiency. By balancing investment and operational spending in line with multiplier evidence and economic conditions, policymakers can ensure that fiscal policy remains both responsive in the short term and transformative over the long term.

2.8.2. Counter-cyclical Fiscal Policy (Fiscal Stance and Impulse)

The fiscal stance and fiscal impulse indicators over the period FY 2023-24 and FY 2027-28 suggest a measured and broadly counter-cyclical fiscal policy, with alternating phases of mild consolidation and targeted expansion. The contractionary stance and negative impulse in FY 2023-24 reflect a withdrawal of fiscal support as post-pandemic recovery took hold. This was followed by a modest expansion in FY 2024-25, indicating renewed fiscal support for economic activity. While the fiscal stance remains mildly expansionary in FY 2025-26, the negative fiscal impulse points to a slowdown in the pace of expansion, consistent with efforts to balance growth support

with fiscal discipline. A stronger expansionary impulse is observed in FY 2026-27, before moderating again in FY 2027-28 as fiscal support is gradually withdrawn.

Table 2.6: Fiscal Stance and Impulse

Fiscal Year	Fiscal Stance	Fiscal Impulse
2023-24	-0.01	-0.03
2024-25	0.01	0.02
2025-26	0.01	-0.01
2026-27	0.03	0.03
2027-28	0.01	-0.02

Overall, the relatively small magnitude of fiscal stance and impulse values reflects a prudent fiscal approach aimed at supporting growth while safeguarding macroeconomic stability and debt sustainability. Going forward, fiscal policy should continue to prioritize high-quality, growth-enhancing expenditure, particularly capital investment, while gradually consolidating through improved revenue mobilization and expenditure efficiency. Strengthening the timing and composition of fiscal impulses within the medium-term fiscal framework will be critical to enhancing fiscal effectiveness and ensuring sustainable economic growth.

2.9. Conclusion

The fiscal outlook for FY 2025-26 reflects steady progress toward sustainable fiscal management, with the deficit contained at 3.23 percent of GDP, remaining close to the medium-term target of 3.00 percent and marking a notable improvement from earlier projections. Stronger-than-expected revenue mobilization is supported by higher hydropower profit transfers from PHPA-II and the RMA, alongside disciplined expenditure management, which has strengthened fiscal buffers and preserved macroeconomic stability. The adoption of the GFS 2014 framework also provides a more comprehensive view of the government's fiscal position and indicates a net financial worth of approximately 20 percent of GDP when substantial financial assets, particularly in the hydropower sector, are fully recognized. This perspective significantly moderates the fiscal risks implied by the headline gross debt ratio of 110.47 percent of GDP, while central government debt remains well within the prudential ceiling under the Public Debt Management Policy 2023, at 36.0 percent of GDP.

Notwithstanding the positive fiscal outlook, the quarterly fiscal framework reveals persistent seasonality in revenue collection and capital expenditure execution, with spending heavily concentrated in the latter half of the FY. Such back-loaded patterns compress implementation timelines, heighten execution risks, and may undermine value for money in public investment. At the same time, fiscal multiplier analysis suggests a carefully calibrated policy stance. The current

expenditure multiplier of 1.42 confirms the effectiveness of operational spending in supporting household consumption and near-term demand, while the relatively low capital expenditure multiplier of 0.17 reflects implementation constraints, import leakages, and execution delays that limit the short-term growth impact of public investment.

Looking ahead, enhancing the growth impact and sustainability of fiscal policy will require sustained improvements in the quality and timing of capital spending through strengthened PIMS, better procurement planning, and smoother budget execution across the fiscal year. Accelerating revenue-enhancing reforms, including the rollout of GST and modernization of income tax systems, will be critical to broadening the tax base and reducing reliance on concentrated revenue sources. Complemented by prudent debt management and measures to increase domestic content in public procurement, these reforms will help ensure that fiscal policy effectively supports structural transformation, inclusive growth, and economic diversification in line with Bhutan's long-term development objectives.

Chapter 3 Monetary and Financial Market: Situation and Outlook

3.1. Introduction

A stable and well-performing monetary and financial sector is pivotal for maintaining macroeconomic stability and supporting economic growth. Key indicators such as inflation, money supply, liquidity conditions, credit growth, and financial market performance influence broader economic outcomes through their impact on investment, consumption, and financial intermediation. In Bhutan, the monetary policy environment is shaped by the pegged exchange rate regime with the Indian Rupee (INR) and strong capital controls, which limit the scope for independent monetary policy actions. Consequently, a significant portion of the RMA's policy focus is directed toward maintaining the exchange rate regime through effective foreign reserve management and ensuring overall financial stability.

The monetary and financial sector therefore plays a critical role in facilitating investment, supporting financial intermediation, and ensuring the smooth functioning of the financial system. Monetary conditions in Bhutan are strongly influenced by external developments due to the Ngultrum's (BTN) peg to the INR and the country's high dependence on imports from India. As a result, domestic inflation dynamics and liquidity conditions often mirror inflationary trends and monetary developments in India, while also reflecting domestic policy measures and structural changes in the economy. At the same time, Bhutan's financial sector continues to evolve, supported by expanding credit activity, increasing adoption of digital payment systems, and the gradual development of the capital market.

Maintaining price stability, adequate liquidity in the banking system, and sound financial intermediation remains essential for sustaining economic growth and preserving financial sector stability. Recent developments in money supply, sectoral credit distribution, and payment systems highlight both opportunities for financial deepening and emerging risks related to liquidity management and credit concentration.

This section reviews key monetary and financial sector indicators, including inflation trends, money supply growth, liquidity conditions, sectoral credit developments, non-performing loans, capital market performance, and digital payment transactions, to provide a comprehensive overview of the sector's recent performance and outlook.

3.2. Inflation

Headline inflation remained broadly stable at 3.51 percent for the year 2025, given the currency peg to the INR and heavy reliance on Indian imports, which anchors the price dynamics to India's inflation trends. As a result, Bhutan's inflation trends closely follow India's, reflecting the close economic linkage between the two countries. In contrast to the usual inflation co-movement with India, Bhutan recorded an increase while inflation in India declined, indicating the influence of stronger domestic pressures. This pattern is evident in the month-on-month inflation movements and reflects the influence of differing domestic policy developments. In particular, GST rate reductions and a general disinflationary trend in food and fuel prices in India are expected to ease the price pressures once old stock clears out, while in the immediate future, the implementation of GST in Bhutan is expected to put some inflationary pressure, resulting in upward adjustments in prices.

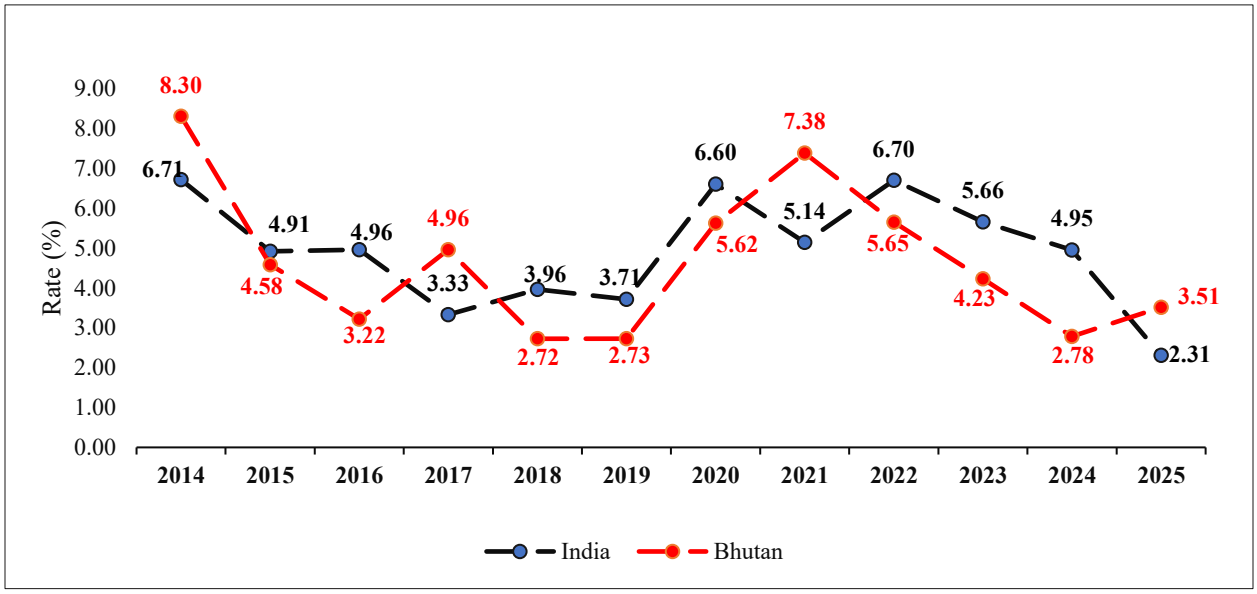


Figure 3.1: Annual Inflation rates of Bhutan and India

As shown in Figure 3.1, India's inflation has generally declined over the period, from 6.71 percent in 2014 to a projected 2.31 percent in 2025. After peaking in 2014, it moderated sharply during 2015-2017, with temporary increases in 2020 and 2022 due to pandemic-related disruptions. Bhutan's inflation has been more volatile, starting at 8.30 percent in 2014, falling to 2.72 percent in 2018, and rising again to 7.38 percent in 2021. Overall, Bhutan experienced higher inflation than India, particularly in 2014 and 2021, highlighting the sensitivity of its import-dependent small economy to external shocks.

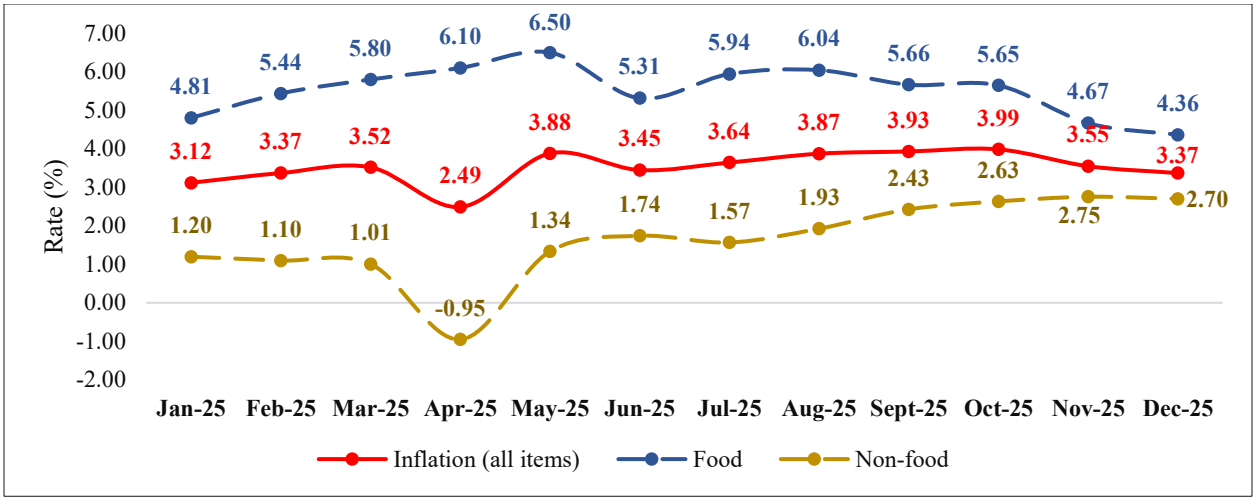


Figure 3.2: Year-on-Year Inflation

Average inflation for the year 2025 is recorded at 3.51 percent, with the rise in inflation primarily driven by increases in both the food and the non-food prices, as illustrated in Figure 3.2. Annual averages indicate that overall price indices increased across all categories; however, within the non-food category, declines were observed in housing and utilities, health, transport, education, and miscellaneous goods and services. Looking ahead, inflation is expected to face temporary upward pressure following the introduction of the 5 percent GST, particularly during the earlier months of the year, as prices adjust to the new tax structure.

3.3. Money supply

As illustrated in Figure 3.3, the money supply for FY 2025-26 is projected at Nu. 296,187.212 million, expected to grow by 18.98 percent, revised upward from the previous quarter's projection of 11.43 percent (Nu. 277,391.206 million). The expansion in the money supply can be explained from both the asset and liability sides of the banking system.

On the assets side, the upward revision in the money supply reflects higher-than-expected convertible currency inflows from remittances and hydro-related proceeds, which led to an increase in the net foreign assets to Nu. 190,017.360 million, which is an increase of around 38.24 percent compared to the previous quarter's projection. Although there was an increase in INR liabilities during the period, its impact was outweighed by the strengthening of convertible currency holdings, providing a stronger base for monetary expansion relative to the previous fiscal year. Similarly, in FY 2026-27, money supply is projected to increase from the asset side, driven by an expansion in net foreign assets, particularly from higher convertible currency inflows alongside a rise in net domestic assets, mainly reflecting increased claims on the government and the private sector.

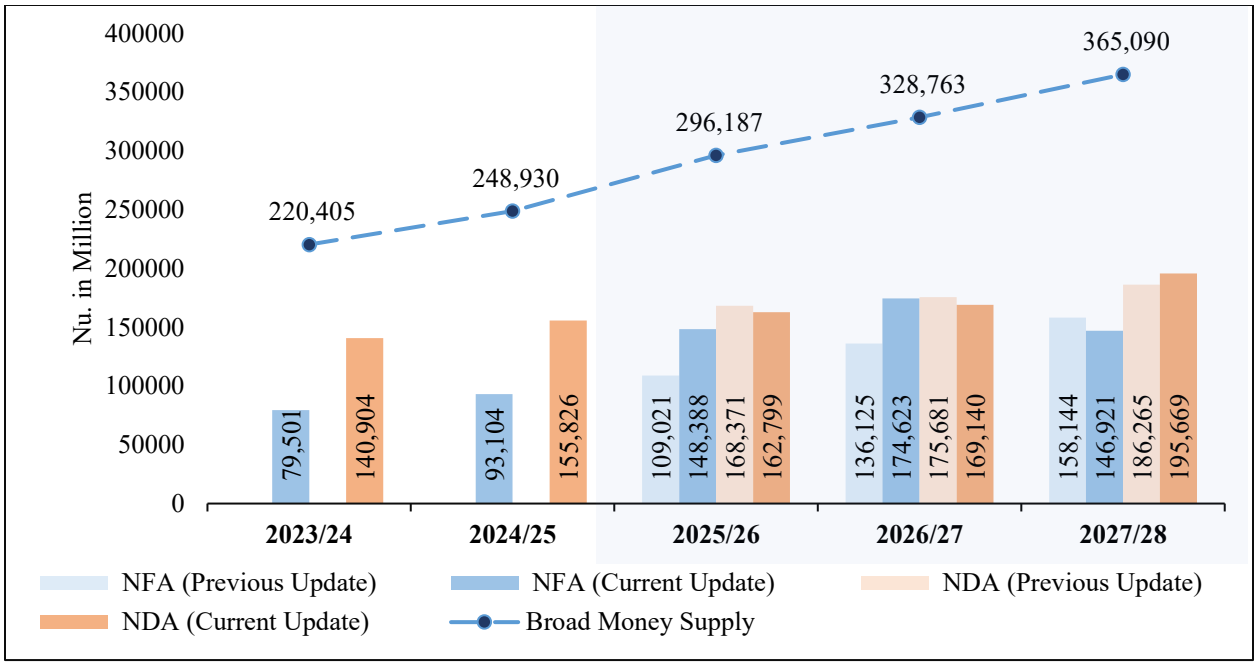


Figure 3.3: Monetary Aggregates

From the liability side, the composition of broad money shows that the liquidity is predominantly held in deposit form. Demand deposits (current and savings) account for 51.88 percent of the total money supply, followed by time deposits at 43.21 percent, indicating the absorption of money supply is largely through bank deposits. In contrast, currency outside banks and foreign currency deposits account for around 5.00 percent of the total money supply, reflecting their limited role in the overall liquidity. Overall, the liability side composition highlights the absorption of money supply through demand and time deposits.

3.4. Liquidity

The liquidity position for FY 2025-26 is projected at Nu. 11,998.445 million as shown in Figure 3.4, revised downward from Nu. 12,801.200 million in the previous quarter projection. Despite the downward revision in available liquidity, total net autonomous factors increased to Nu. 43,830.441 million, registering a 14.13 percent increase from Nu. 38,403.318 million projected in the previous quarter. The improvement in NFA contributed significantly to the overall growth of liquidity in the banking sector and provided a stable foundation for monetary expansion.

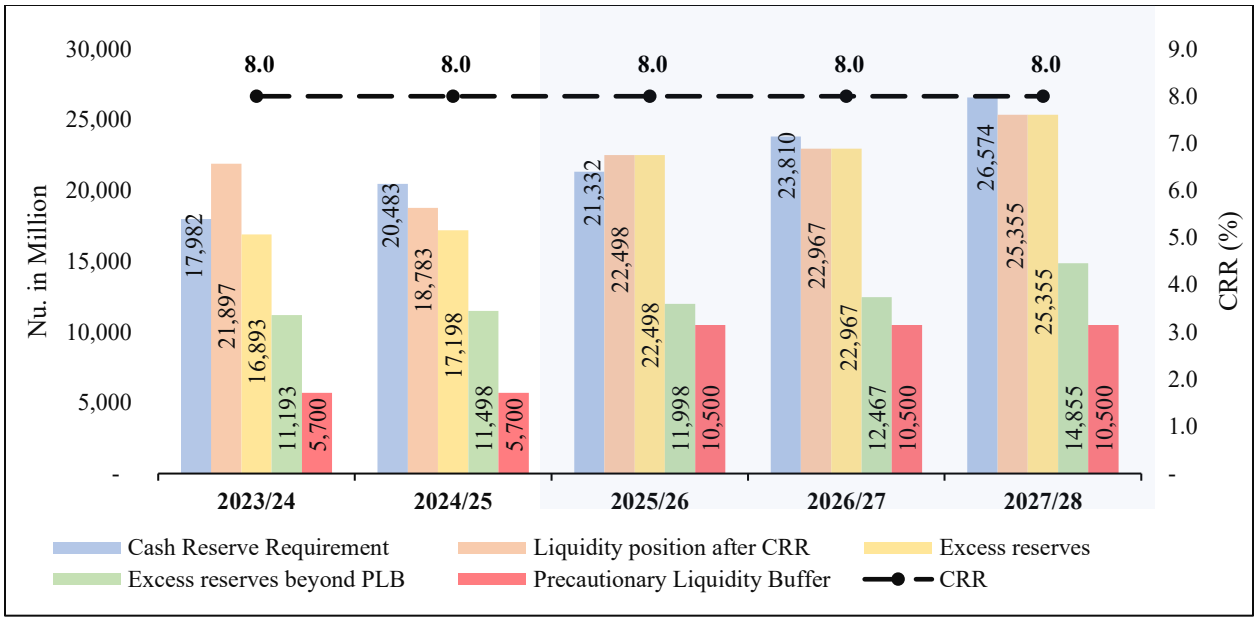


Figure 3.4: Liquidity

The cash reserve ratio (CRR), which remains the primary monetary tool for monitoring liquidity and credit growth in the banking sector, has been maintained at 8 percent, subject to revision based on market and macroeconomic conditions. At this level, for FY 2025-26, the CRR translates into a reserve requirement of Nu. 21,331.996 million. After accounting for the CRR, the sector records excess reserves of Nu. 22,498.445 million. The Precautionary Liquidity Buffer (PLB) has been revised upward to Nu. 10,500.00 million from Nu. 5,700.00 million in the previous projection. This upward revision reflects the need to accommodate increased digital payment transactions, higher credit sanctions, and smooth day-to-day banking operations.

After deducting the required reserves and maintaining the PLB, the net available liquidity stands at Nu. 11,998.445 million (Figure 3.4). The decline in the liquidity projection relative to the previous quarter is therefore largely attributable to the higher PLB and on account of sweeping arrangement, rather than a weakening of autonomous liquidity conditions. Going forward, liquidity conditions are expected to remain lower than previous quarter projections, mainly due to the requirement for a higher PLB and an increase in liquidity absorption through sweeping operations undertaken for effective liquidity management.

3.5. Credit Situation

3.5.1. Sectoral Credit

As of November 2025, total sectoral credit amounted to Nu. 269,130.873 million, registering a year-on-year growth of 15.54 percent. As shown in Figure 3.5, credit expansion was broad-based across most sectors; however, loans against shares and securities and loans to financial service providers recorded contractions of 3.77 percent and 56.88 percent, respectively, reflecting a net decline in outstanding credit in these segments during the period. Among the major sectors, credit

extended to mining and quarrying recorded the strongest growth at 62.09 percent, increasing from Nu. 5,773.715 million to Nu. 9,358.362 million, reflecting increased interest in the sector and increased financing requirements associated with the sector's recovery and expansion. Staff incentive loans also grew significantly by 37.68 percent compared to the same period last year.

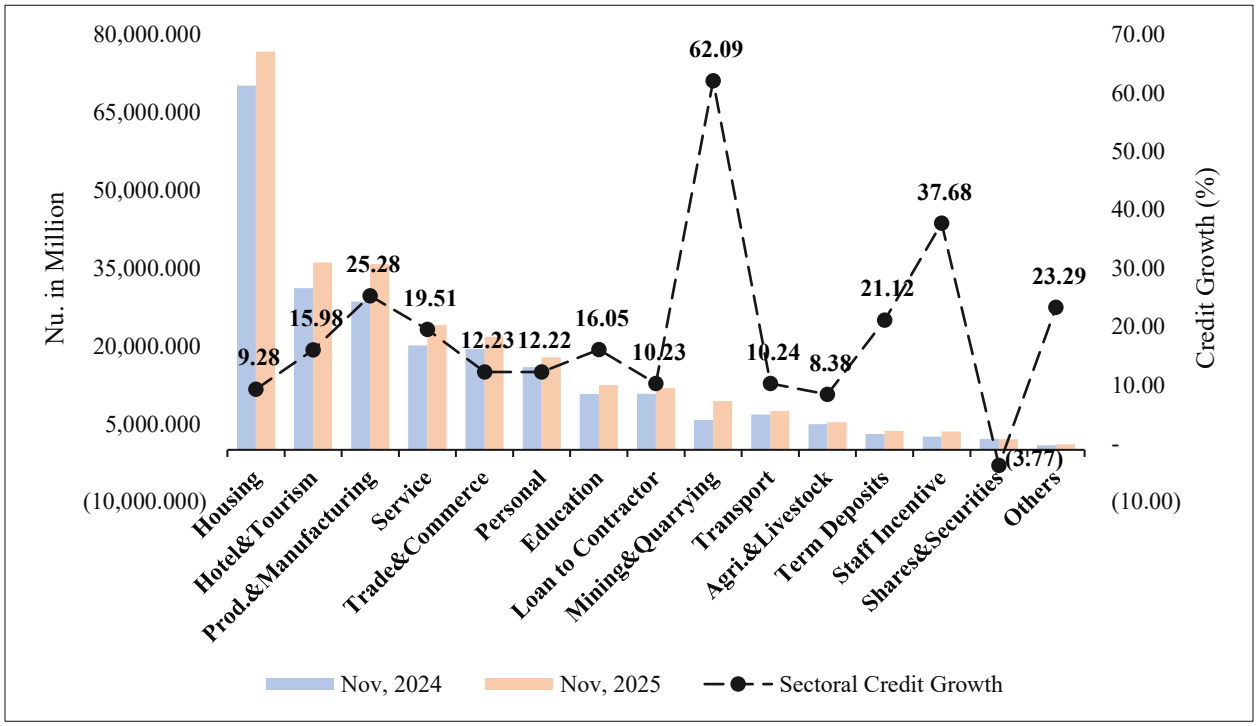


Figure 3.5: Total Sectoral Credit

In terms of sectoral distribution, the housing sector continues to hold the largest share of the total loan portfolio, amounting to Nu. 76,702.645 million, or 28.50 percent of total sectoral credit, as evident in Figure 3.5. This is followed by the hotel and tourism sector and the production and manufacturing sector, accounting for 13.42 percent and 13.29 percent of total credit, respectively. The sectoral composition of credit indicates sustained demand for financing in housing and key productive sectors, consistent with ongoing economic recovery and investment activity.

For FY 2025-26, total sectoral credit is projected to reach Nu. 278,712.375 million, representing a growth of 8.07 percent compared to the previous year's growth of 17.02 percent, as shown in Figure 3.6. The sharp increase in credit growth during FY 2024-25 was largely driven by the easing of the moratorium on vehicle loans as well as housing and construction loans, which led to a surge in borrowing in these sectors.

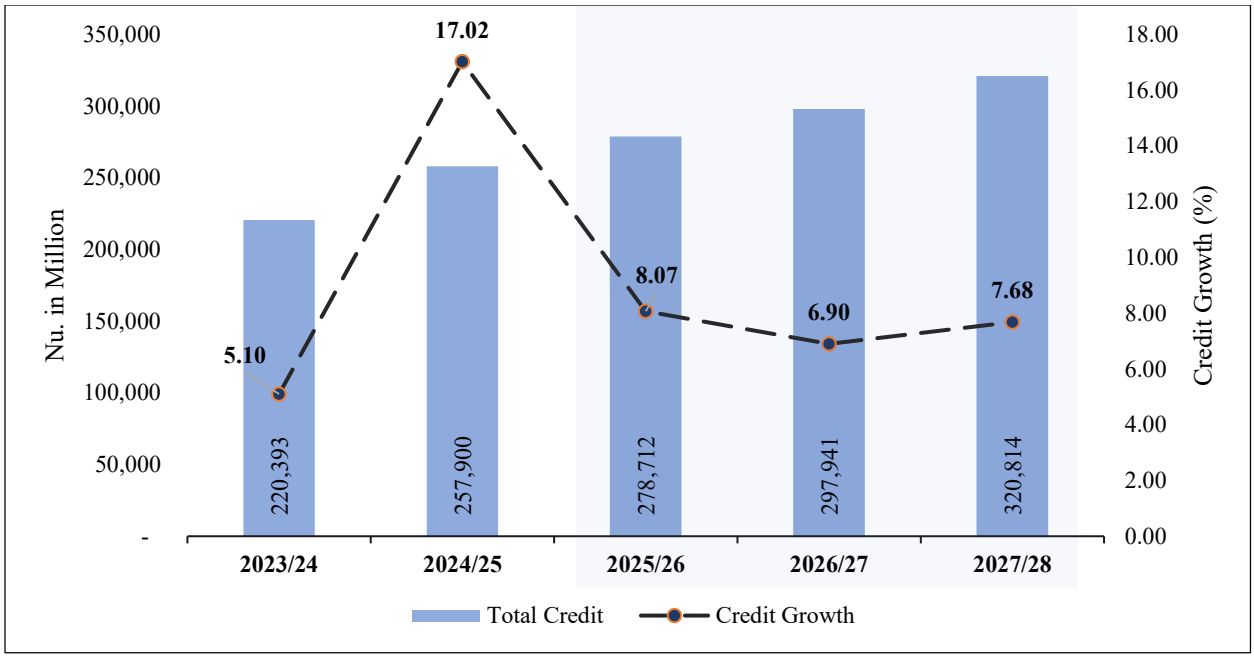


Figure 3.6: Total Credit and Credit Growth

While credit growth is expected to remain positive, the pace of expansion is projected to moderate going forward due to the base effect and the anticipated slowdown in GDP growth over the medium term. As economic activity expands at a more gradual pace, demand for credit is also expected to stabilize, resulting in steady but slower credit growth compared to the previous year.

3.5.2. Non-Performing Loans

Non-Performing Loan (NPL) ratio as of November 2025 stood at 3.14 percent of total credit extended, equivalent to Nu. 8,445.917 million, marking an increase of around 7.88 percent month-on-month, as depicted in Figure 3.7. The housing sector accounts for the largest share of sectoral NPLs, representing about 25.68 percent of the total, reflecting its dominant share in overall credit exposure. However, its NPL ratio remains well below the NPL threshold of 5.00 percent. Following the housing sector, trade and commerce, and production and manufacturing account for 19.47 percent and 10.33 percent of total sectoral NPLs, respectively. The concentration of NPLs in these sectors corresponds to their higher share in total sectoral credit, indicating elevated concentration risk. Such concentration increases vulnerability to sector-specific shocks, which may lead to higher default rates and, consequently, elevated NPL levels in these sectors.

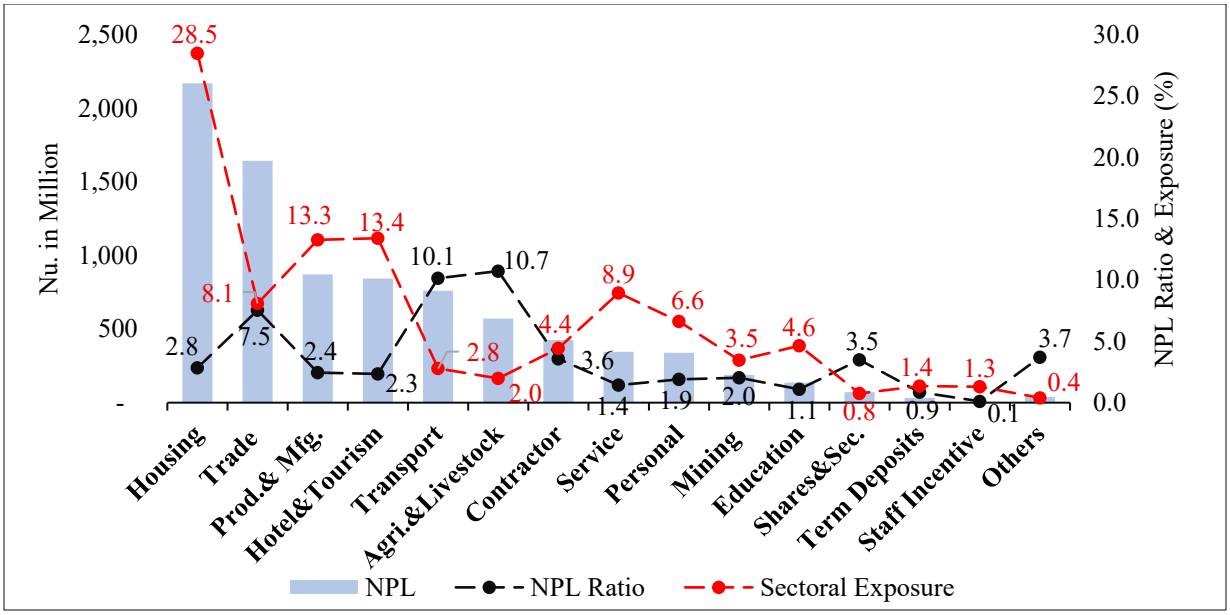


Figure 3.7: Sectoral Non-performing Loans

A potential increase in NPL is anticipated across sectors with high loan exposure, which highlights the need for targeted interventions. The consistently high NPL levels in housing, trade and commerce point to significant credit exposure and repayment challenges, which require closer monitoring. RMA generally considers an NPL ratio above 5.00 percent as the threshold for concern. They issue cautionary notices if the gross NPL ratios approach tolerance levels, and written notices follow if ratios exceed the thresholds of 5.00 percent for the gross NPLs. As of November 2025, the NPL ratio exceeded the threshold of 5.00 percent in these four sectors: trade and commerce, transport, agriculture and livestock, and the credit cards category. Monitoring and managing NPLs remain a priority for the central bank to promote financial stability.

Although the overall level of NPLs increased compared to the previous month, a sector-wise assessment indicates a decline in NPLs in the transport and personal loans segment, the services sector, and loans to contractors. The decline in the gross NPL ratio indicates improved financial soundness, and continued monitoring and risk management will be key to sustaining credit growth while maintaining financial sector stability.

3.6. Capital Market

Bhutan's capital market, though still at a nascent stage, has been gradually evolving as part of the country's broader financial sector development agenda. Well-functioning capital markets play an increasingly important role in providing companies with access to long-term financing for investment and innovation, while also mobilizing domestic savings and offering liquidity to shareholders. The Royal Securities Exchange of Bhutan Limited (RSEBL), as the country's sole stock exchange, was established to promote wider share ownership and support economic diversification beyond the banking sector.

Recognizing its importance, capital market development remains a priority under the 10X Economic Vision, which aims to strengthen the capital market as a key component of financial sector reforms. A deeper and more vibrant capital market is expected to contribute to financial stability and expand investment opportunities within the economy. In line with this objective, the strategy targets doubling market capitalization within the 10X strategy period and listing at least three state-owned enterprises on the stock exchange to deepen the market further.

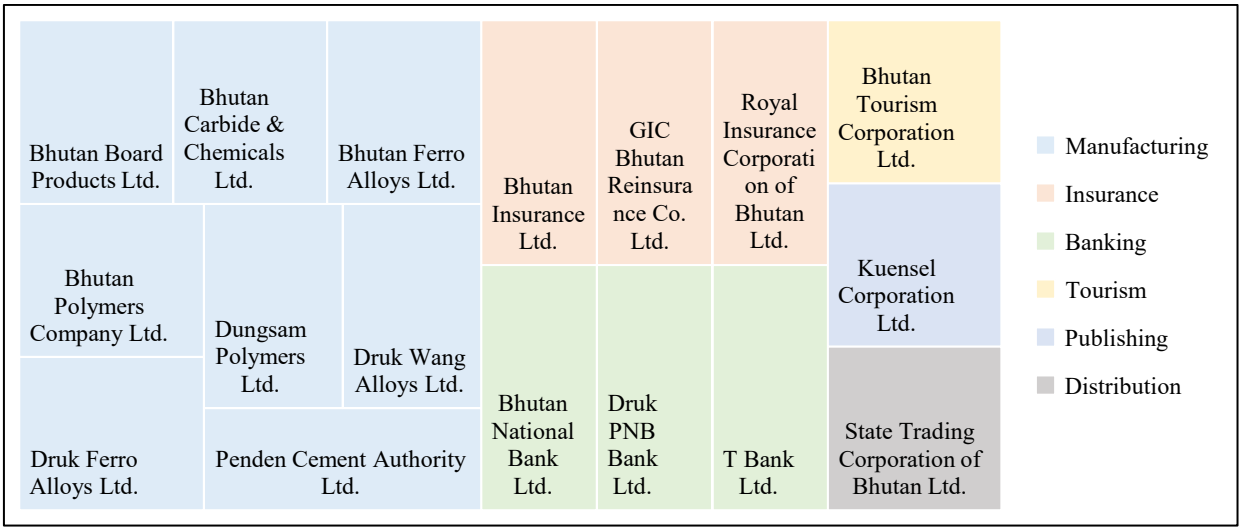


Figure 3.8: Listed Companies on RSEBL

As of February 2026, market capitalization stood at Nu. 53.3 billion, with 18 listed companies and 9 licensed brokerage firms operating under RSEBL, equivalent to 23.34 percent of GDP. This marks a decline from Nu. 60.02 billion in January 2025, reflecting a reduction in the overall value of the listed companies over the period. While the market remains relatively small, this highlights the sensitivity and volatility of Bhutan's capital market.

The listed companies on the stock exchange are concentrated across a few key sectors, with manufacturing accounting for the largest number of listed entities. As evident from Figure 3.8, the manufacturing sector comprises eight listed companies, a majority concentrated in heavy materials and chemicals categories, reflecting Bhutan's narrow industrial base. This is followed by the financial sector, with three listed banking institutions and three insurance companies. The remaining sectors, tourism, publishing and distribution, are represented by one listed company each. Overall, the sectoral composition of listed companies indicates a strong presence of manufacturing and financial institutions, while other sectors remain thinly represented on the stock exchange.

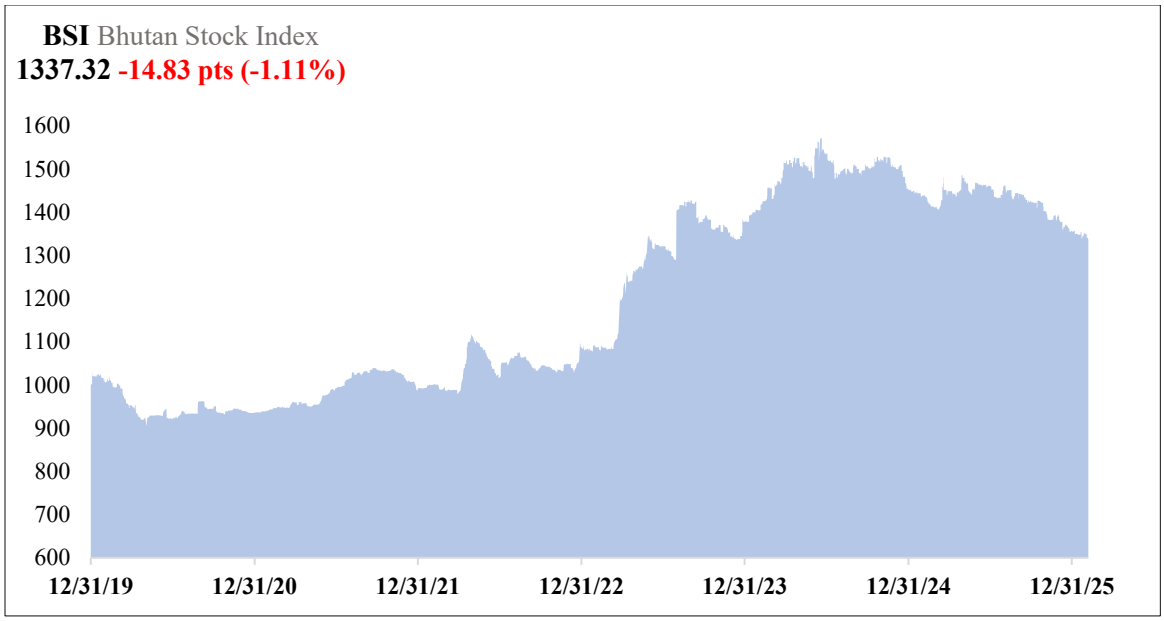


Figure 3.9: Bhutan Stock Index

Source: RSEBL

Bhutan Stock Index (BSI), as shown in Figure 3.9, provides an overview of overall market trends and sector-specific dynamics. It serves as a benchmark for assessing macroeconomic conditions and evaluating the impact of policy changes on the secondary market. The index also facilitates historical performance analysis and market forecasting, providing insights into sectoral performance, where the higher values indicate stronger market performance, while lower values suggest otherwise. The BSI of 1,000 points on 31st December, 2019, has increased to 1,337.32 points as of 6th February, 2026 which indicates an increase of around 33.37 percent in the value since the end of 2019. The BSI of 1,337.32 points, as presented in Figure 3.9 represents the current level of the index, which tracks the overall performance of companies listed on the RSEBL. The decline of 14.83 points is equivalent to a 1.11 percent decrease. As of 6th February, 2026, the BSI stands at 1,337.32 points compared to 1,340.93 as on 5th February, 2026.

3.7. Digital Payment Transactions

Digital payment transactions provide an overview of the performance of various payment channels in terms of transaction volume, value and usage over time.

3.7.1. By volume

In 2025, a total of 345.81 million payment transactions were recorded across all payment channels, with transaction volumes peaking towards the end of the year, as shown in Figure 3.10. Transaction activity was highest in the fourth quarter of 2025, accounting for nearly 30.00 percent of total payment transactions for the year, indicating a notable increase in payment activity towards the end of the year. These transactions were conducted through multiple payment instruments, including mobile banking, Bhutan QR Code (NQRC), internet banking, digital wallets,

international payment gateways, Bhutan Interbank Real-Time (BIRT), ATMs, point-of-sale (POS) terminals and paper cheques.

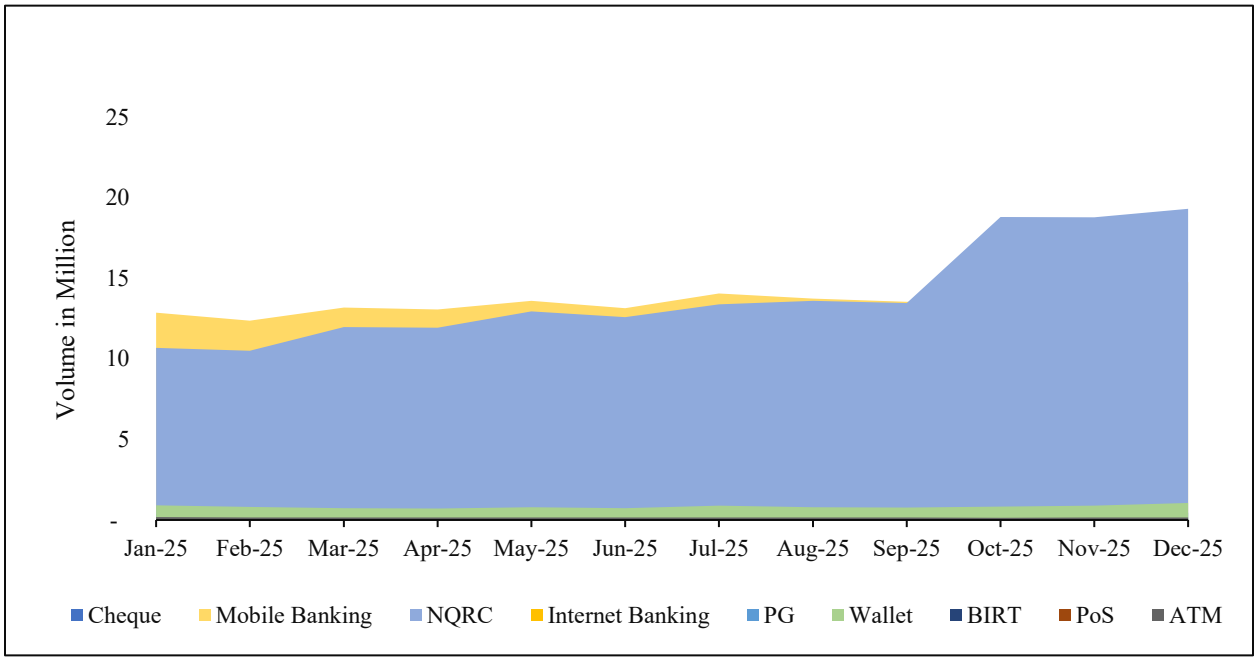


Figure 3.10: Domestic Payment Transactions (By Volume)

Among the various payment channels, mobile banking and NQRC emerged as the most widely used instruments. Mobile banking facilitates financial transactions through mobile devices, including fund transfers and bill payments, while NQRC enables payments through QR code-based transactions. Combined, mobile banking and NQRC accounted for the majority of transaction volumes during the year, representing the growing adoption of digital and cashless payment methods.

3.7.2. By Value

In terms of value, total payment transactions amounted to Nu. 1,257,587.68 million in 2025, equivalent to around 386 percent of GDP. Among the various payment channels, mobile banking accounted for the largest share of transaction value at Nu. 683,273.955 million, followed by cheques (Nu. 186,865.071 million), NQRC (Nu. 159,249.890 million) and BIRT (Nu. 42,279.586 million). As observed in the transaction by volume, mobile banking and NQRC recorded the highest number of transactions, which correspondingly translated into higher transaction values for these channels. In contrast, cheque-based transactions, while limited in volume, accounted for a relatively large share of total transaction value, indicating their continued use for high-value payments. Consistent with the trend in transaction volumes, payment transaction values increased notably during the fourth quarter of the year. This notable rise in payment transactions in the last quarter of 2025 coincided with major events, which are likely to have contributed to increased transaction activity through higher visitor spending and related economic activities. The surge in

domestic payments is likely fueled by higher-than-expected inward remittances and opportunities to invest in TER.

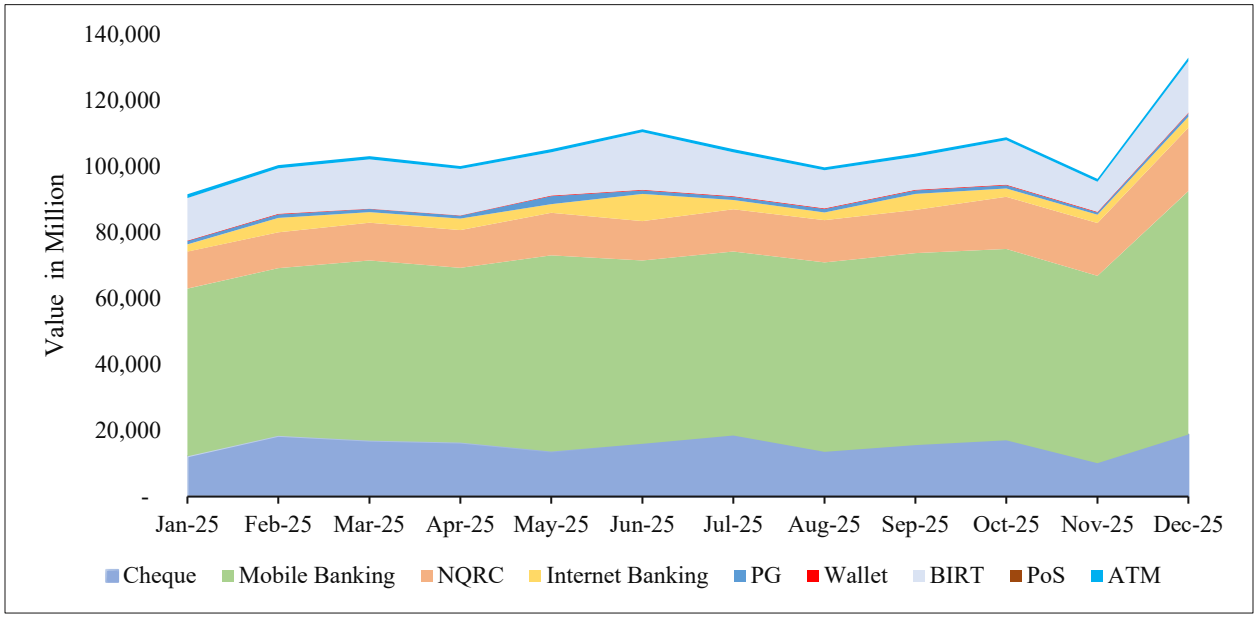


Figure 3.11: Domestic Payment Transaction (By Value)

3.8. Conclusion

In summary, the monetary and financial sector continues to support economic activity through stable inflation, expanding money supply, and sustained credit growth across key sectors of the economy. Inflation remained broadly stable during 2025, although some price movements created temporary deviations from India's inflation trends. Growth in money supply has been largely supported by improvements in net foreign assets, particularly from remittance inflows and hydropower-related earnings, providing a strong foundation for monetary expansion.

The banking system remains stable, with credit growth continuing at a more moderate but sustainable pace following the strong expansion observed in the previous year. While the overall NPL ratio remains below the regulatory threshold, the concentration of credit exposure and NPLs in a few sectors highlights the importance of continued monitoring and prudent risk management. Bhutan's capital market, though still at a nascent stage, is gradually evolving, as reflected in the steady growth of market capitalization over the years. The introduction of the BSI has further enhanced the assessment and evaluation of policy impacts on the secondary market. Meanwhile, digital payment transactions continue to expand in both volume and value, signaling increasing adoption of digital financial services by individuals and businesses. This trend not only streamlines transactions but also enhances transparency, reduces reliance on cash, and supports broader economic digitization. However, liquidity management is emerging as an important policy concern. Although autonomous liquidity conditions have improved, the projected decline in net available liquidity driven by higher precautionary liquidity requirements and liquidity absorption through sweeping operations suggests tighter liquidity conditions in the near term. Going forward,

balancing liquidity support with monetary discipline, while strengthening financial sector resilience, will remain a key priority for sustaining macroeconomic stability and supporting long-term economic growth.

Looking ahead, maintaining financial sector resilience will remain a priority. Continued monitoring of credit quality, managing sectoral concentration risks, deepening the capital market, and promoting the adoption of digital financial services will be central to supporting sustainable economic growth and ensuring the stability of Bhutan's financial system.

Chapter 4 External Sector: Situation and Outlook

4.1. Introduction

While global trade in 2025 has been marked by heightened policy uncertainty and geopolitical tensions, it has shown greater-than-expected resilience, supported by strong growth in services trade, lower effective tariff rates and front-loaded merchandise flows ahead of anticipated tariff increases. However, the global trade outlook for 2026 points to weaker momentum as higher U.S. tariffs begin to take full effect. Rising trade policy uncertainty is contributing to an evolving global trade landscape, characterized by shifts in product composition, supply chain reconfiguration, and a strengthening of South-to-South trade.

Bhutan's external sector continues to show structural weaknesses with a persistent Current Account Deficit (CAD) fueled by continuous import of both consumption and capital goods, combined with a narrow export base. The CAD in FY 2025-26 is projected to reach 19.47 percent of GDP and 16.40 percent in FY 2026-27. The CAD remains financed by inflows in the capital and financial account. In FY 2025-26, the financial account inflows were driven by direct investment for the equity transfer of machinery for the establishment of data centers, besides the grants and borrowings. However, this is a one-off surge with FDI projected to grow at a stable rate in the financial account, and borrowings remain a key source.

In the medium-term, the CAD is projected to worsen to 27.30 percent of GDP, driven by increased imports of capital goods for hydropower projects, while export growth is expected to remain moderate. At the same time, the capital account surplus is projected to decline as grant inflows taper off with the winding down of the 13th FYP. Financial account inflows are projected to remain moderate. Consequently, foreign exchange reserves are projected to decline to USD 1,436.918 million by FY 2027-28, reflecting heightened external financial pressures.

4.2. Global Trade Dynamics

Despite expectations of a slowdown in global trade amid intensified protectionist policies, heightened economic policy uncertainty, and geopolitical tensions, global trade proved more resilient than expected in 2025. Global trade is expected to have expanded by 3.8 percent, supported by continued strength in merchandise trade and solid momentum in services trade, supported in part by accelerated imports into the United States ahead of anticipated tariff increases. However, global trade growth is projected to slow to 2.2 percent in 2026 as the higher tariffs move their way through the economy (UN World Economic Situation and Prospects, 2026).

With the United States raising its average effective tariff rate from 2.5 percent in 2024 to about 15 percent by November 2025, global value chains are reconfiguring operations as firms diversify suppliers, relocate production closer to key markets and expand South-South trade, which now accounts for over half of developing country exports (The Budget Lab, 2025; UNCTAD, 2026).

Services trade (digitally deliverable services) outpaces goods trade while environmental regulations, critical mineral dynamics, and tighter trade-related regulations are increasingly shaping competitiveness. Together, these trends suggest that the global trading system is becoming more fragmented, regulated, and technology-driven, creating heightened risks but also new opportunities for developing countries.

For Bhutan, whose exports are bolstered by mineral trade, global trade dynamics such as mineral markets entering a phase of high volatility and combined with trade dumping, translate to high exposure to cyclical downturns such as that experienced by the ferrosilicon industries since 2020 (Chuki, 2025). India remains Bhutan's primary trading partner, with 78.25 percent of exports going to India and 57.16 percent of imports coming from India in 2025, limiting Bhutan's exposure to other markets. However, key exports such as iron and steel and mineral products remain highly susceptible to market changes and are also exposed to policy uncertainties as the United States and Korea remain key export destinations besides India for ferro-alloys.

4.3. Balance of Payment

The balance of payment is projected to reach Nu. 50,355.735 million, an upward revision from 45,946.178 million in the previous quarter update. This is mainly driven by the increase in inflows in the financial account compared to the last quarter update.

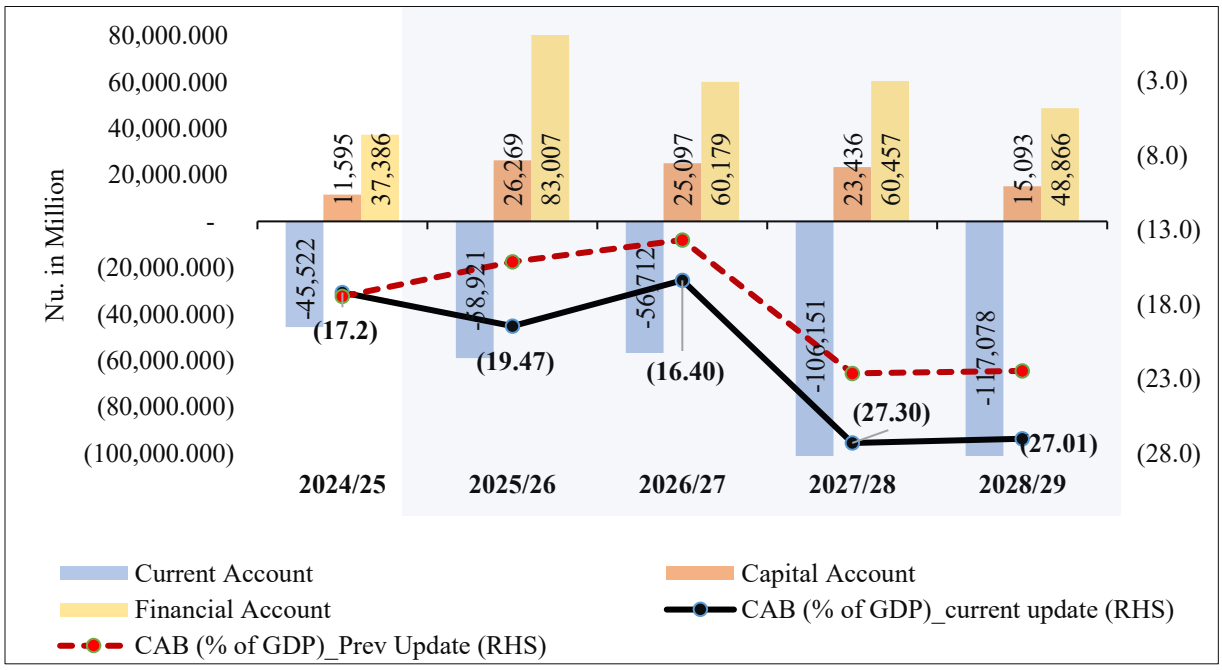


Figure 4.1: Balance of Payment Projections

4.3.1. Current Account Balance

The CAD is projected to reach 19.47 percent of GDP in FY 2025-26, a deterioration of 11.51 percent from the last quarter update. The deterioration is driven by the trade deficit in goods, which is projected to worsen by 24.37 percent compared to the last quarter's projection. The worsening trade deficit is due to elevated levels of high-value machinery imports from COTI observed in the first two quarters of FY 2025-26 for establishing data centers, exceeding previous projections.

On the other hand, the service account is projected to improve significantly in FY 2025-26, more than fourfold from previous estimates. This is primarily driven by exports of computer services, which were previously not accounted for due to data limitations. As data availability stabilizes, the inclusion of these data in the medium-term projections will be reviewed and gradually incorporated. In the medium term, consistent with historical trends, the services account is expected to remain in surplus.

The primary income deficit is projected to widen to Nu. 19,782.417 million in FY 2025-26, a 23.43 percent deterioration compared to the previous update. This revision reflects the inclusion of new outflows related to the Khorlochhu project, as well as more comprehensive coverage of external commercial borrowings that were previously not captured. Meanwhile, the secondary income balance is expected to improve to Nu. 34,956.300 million in FY 2025-26, an upward revision of 11.85 percent from the last quarter update. This is driven by upward revisions to inward remittance flows based on the high level of inflows observed in the first two quarters of FY 2025-26.

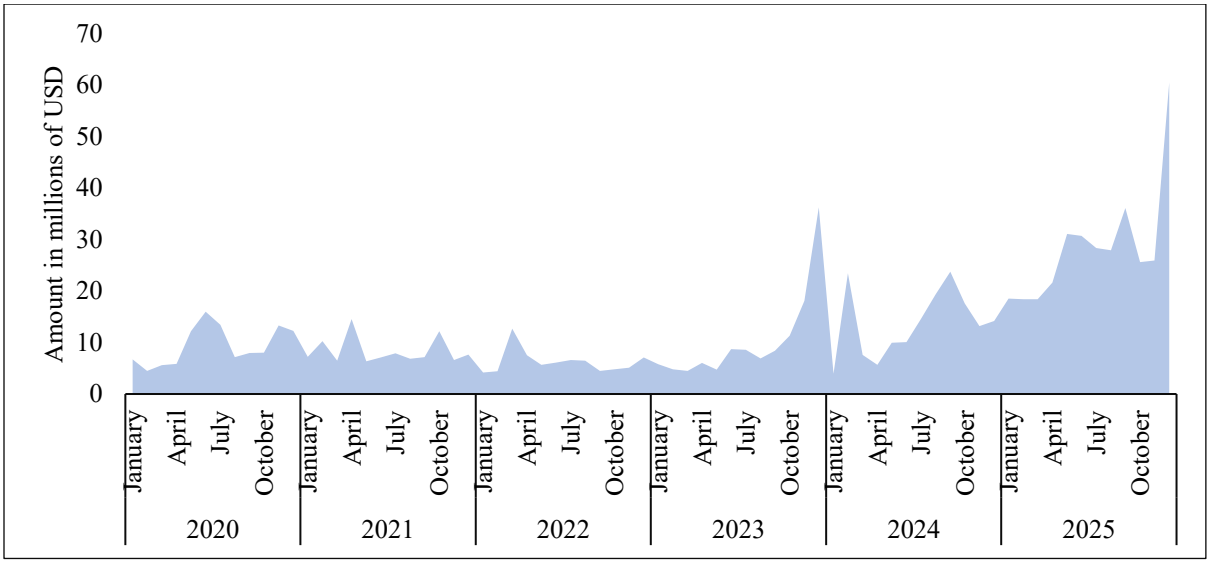


Figure 4.2: Trends in inward remittances

Inward remittances from Bhutanese living abroad have increased substantially between 2020 and 2025, recording a three-fold increase and gaining traction as an important source of foreign reserves. This sharp increase could be partly attributable to transfers made to family members to

support their investments related to the GMC through subscriptions to the Nation Building Bond and TER.

In the medium-term, the CAD is projected to improve in FY 2026-27, before worsening from FY 2027-28 onward, reaching 27.30 percent of GDP. This indicates the structural challenges within the economy, which have not been able to improve the CAD as Bhutan continues to remain an import-dependent economy.

4.3.1.1. Merchandise Trade[3]

The trade deficit excluding electricity is projected to widen to Nu. 145,808.231 million in FY 2025-26, an increase of 18.51 percent from the previous quarter's projection. This is mainly driven by a sharp rise in merchandise imports from COTI, which are now projected at Nu. 68,844.465 million, 61.33 percent higher than earlier estimates. The increase reflects elevated imports of data-center-related goods in the final quarter of CY 2025, following the operationalization of Bitdeer Jigmeling. As a result, a higher trade deficit is expected in FY 2025-26.

Looking ahead, the trade deficit in FY 2026-27 is expected to improve significantly, by about 360 percent relative to FY 2025-26, as COTI-related imports are projected to taper off, with no further data center expansions currently planned.

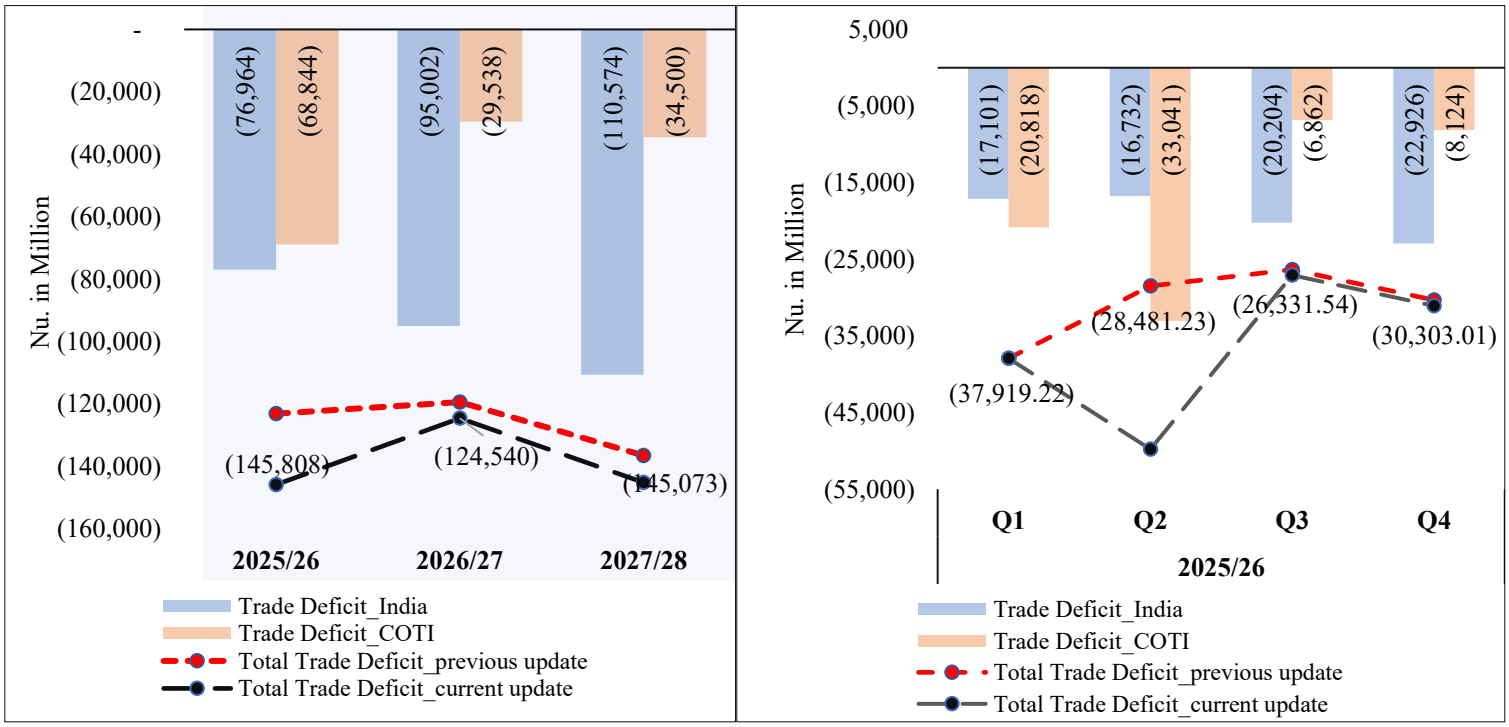


Figure 4.3: Quarterly and Annual Merchandise Trade Projection

[3] The merchandise trade deficit is based on the Bhutan Trade Statistics and excludes electricity. Further, treatment differs from the BoP framework, resulting in different trade balances.

Over the medium term, while merchandise exports are expected to remain stable, imports are projected to rise due to increased capital-goods imports for the construction of Khorlochhu, Dorjilung, and PHPA-I.

India continues to be Bhutan's top export destination, with its share of total exports rising to 78.45 percent in 2025 from 72.20 percent in 2024, followed by Bangladesh. [4] Although Bhutan's exports to the United States remain modest, the export share to the United States increased to 2.45 percent in 2025 from 0.85 percent in 2024, despite ongoing trade restrictions and uncertainties. The key merchandise exports remain iron and steel (ferro-alloys), mineral products (dolomite, gypsum, boulders) and a few niche agricultural products.

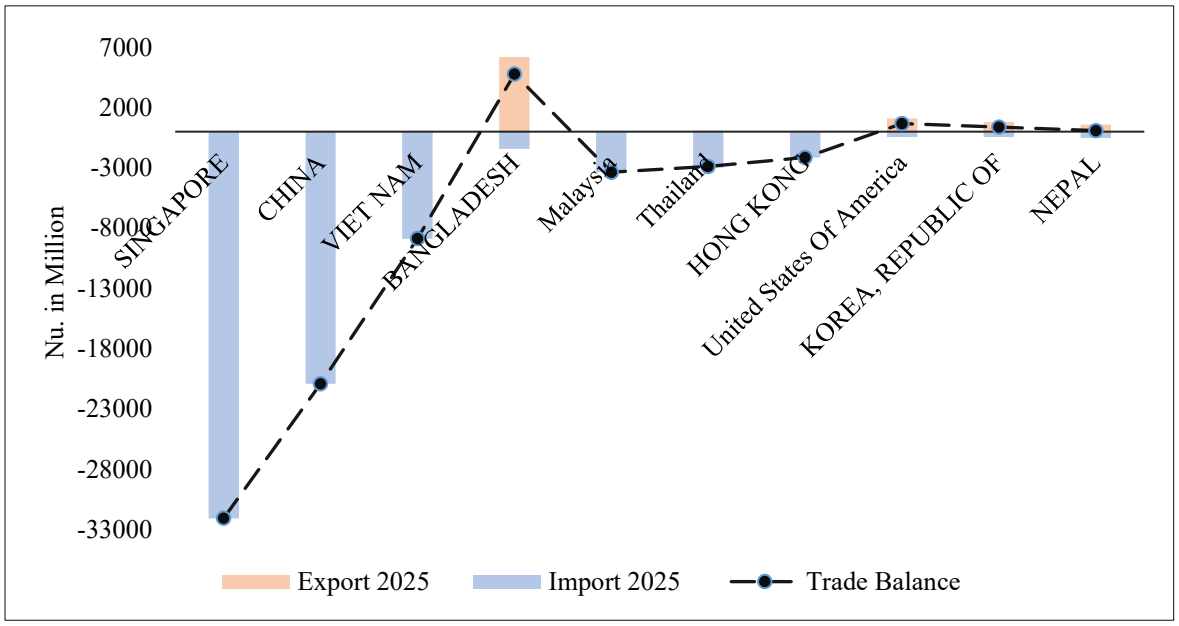


Figure 4.4: Trade with key COTI partners

In terms of imports, India's share declined to 57.16 percent in 2025 from 82.79 percent in 2024, while Singapore and China accounted for 17.31 percent and 11.29 percent of total imports, respectively. The decline in India's import share does not indicate a structural shift in the economy; rather, it reflects the volatility of imports from COTI, largely driven by the purchases of high-value machinery for establishing data centers. In 2024, Bhutan continued to maintain trade surpluses with Bangladesh (Nu. 4,785 million), the United States (Nu. 661.528 million), Korea (Nu. 375.017 million), and Nepal (Nu. 87.256 million). However, in absolute terms, these surpluses have declined compared to the previous year, except for that with the United States.

[4] The 2025 trade statistics is a provisional figure as December 2025, and may defer slightly from the published Bhutan Trade Statistics 2025 as data has not been reconciled yet.

4.3.1.2. Terms of Trade

Bhutan's Terms of Trade (TOT) is marked by volatility due to its dependence on metals, mineral products, cement, and electricity for both exports and imports. From 2016 to 2018, the TOT index rose above 100, indicating a strengthening in export prices for its commodities. As a result, the country's capacity to import more for a given volume of exports increased. This trend reversed in 2019, when export contribution weakened across most sectors due to higher export prices and rising import prices. During and after the pandemic, the TOT rebounded slightly, mainly driven by strong export contributions from metals. This was again reversed in 2022 and 2023, marking the sharpest decline since 2016, mainly attributed to low export prices for metals and metal articles.

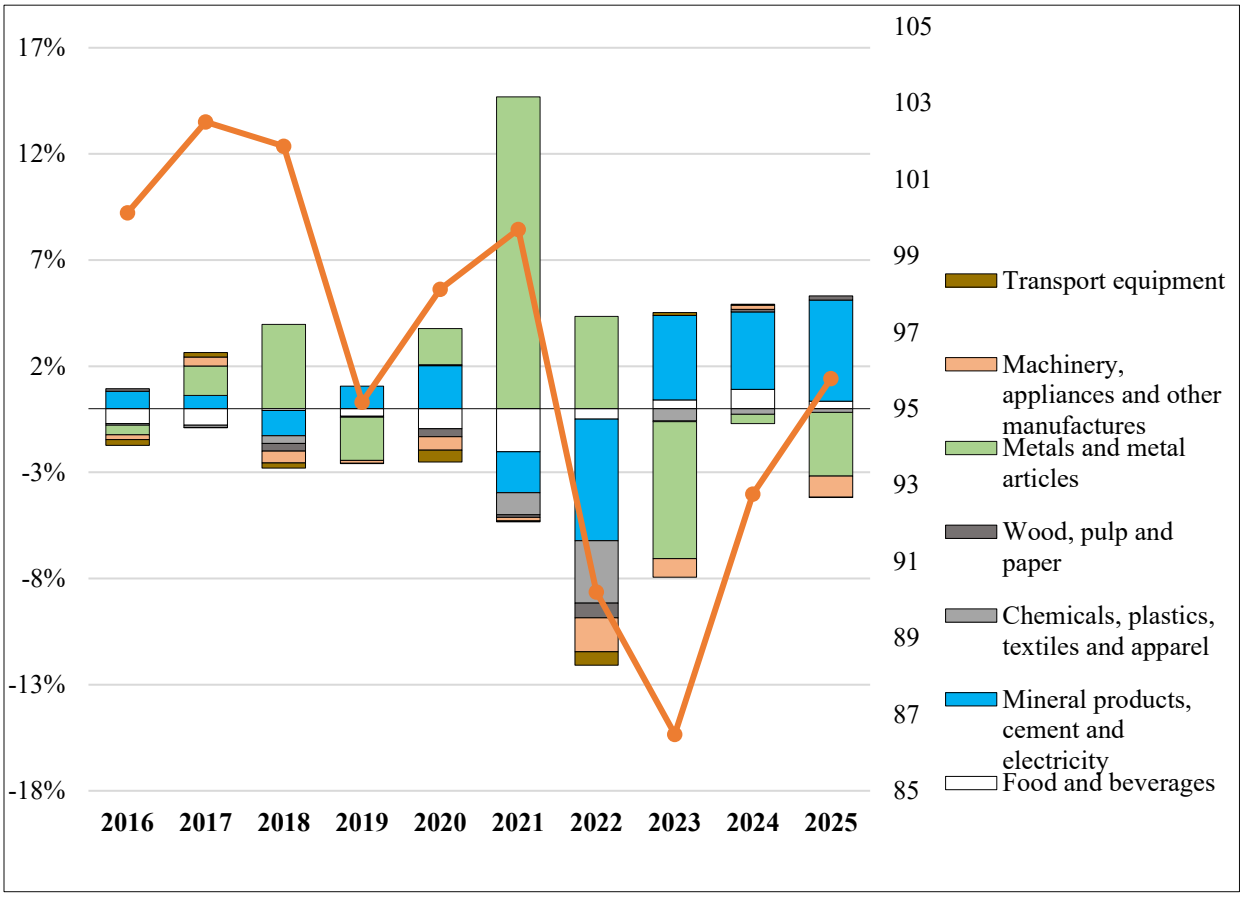


Figure 4.5: Terms of Trade

In 2025, the TOT increased slightly to 95.795, up from 92.768. [5] This was primarily driven by improvements in the export prices of minerals, cement, electricity and agricultural products. However, the export price for metals and metal articles has declined. The TOT remain below 100, indicating that export earnings are insufficient to fund imports in 2025. While the TOT is showing

[5] The terms of trade for 2025, is average of the first three quarters of 2025.

signs of recovery, the vulnerability still persists, indicating the need to diversify and strengthen the export base.

4.3.2. Capital Account Balance

The capital account surplus for FY 2025-26 is projected to reach Nu. 26,268.923 million, 16.32 percent improvement from the previous quarter estimates. A marginal increase of around 1.15 percent reflects the higher inflows from COTI, driven mainly by exchange rate movements. The bulk of the upward revision, however, arises from revised assumptions regarding the classification of grants as investment-related activities rather than non-investment grants. Taking into account the composition of project-tied and program grants within the overall grant inflows, the share of grants earmarked for investment has been increased in the forward projections.

Net inflows in the capital account in FY 2025-26 are significantly higher than in FY 2024-25, increasing by 126.55 percent, reflecting an anticipated acceleration in the implementation of the 13th FYP activities, including the ESP and other priority programs. Over the medium-term, capital account inflows are expected to gradually decline from FY 2026-27 to FY 2028-29, as budgetary grants from development partners decline with the winding down of 13th FYP-related activities and programs.

Overall, the capital account continues to play a critical role in financing the current account deficit and supporting the balance of payments. In FY 2025-26, the capital account surplus is projected to finance approximately 44.58 percent of the CAD. While capital inflows have historically been a key source of external financing and continue to play an important role in the near to medium-term, reducing reliance on such inflows is essential for Bhutan's transition toward a high-income economy. Strengthening the supply side to improve the current account position and support sustained accumulation of foreign exchange reserves, therefore, remains a key policy priority.

4.3.3. Financial Account Balance

Net financial inflows in FY 2025-26 are projected to reach Nu. 83,007.318 million, representing an 8.93 percent increase from the previous quarter's estimate. This upward revision primarily reflects higher-than-expected FDI equity inflows, driven by the transfer of high-value machinery for data center projects, which exceeded earlier projections.

Over the medium term, net financial inflows are expected to moderate, declining to Nu. 60,178.957 million in FY 2026-27 and further to Nu. 48,866.426 million by FY 2028-29. The sharp reduction projected for FY 2026-27 is mainly attributable to the unwinding of the one-off surge in equity inflows recorded in FY 2025-26, driven by data centers.

Within the financial account, liabilities are expected to increase as disbursements commence for major hydropower projects such as Dorjilung and Khorlochhu, reflecting the gradual scaling up of external financing as these projects move into their implementation phases.

4.3.3.1. Foreign Direct Investment

The net direct investment flow is projected to reach Nu. 47,605.388 million in FY 2025-26, an increase by more than fivefold compared to FY 2024-25. The sharp increase is driven primarily by Foreign Direct Investment (FDI) equity inflows from the one-time surge in investment to establish the Bitdeer Jigmeling. As this tapers off, net direct investment inflows are projected to stabilize, with growth averaging 10 percent in the medium term. However, as greater clarity emerges on equity inflows for FDI hydropower projects, particularly during implementation, direct investment inflows could be higher than currently projected.

In 2025, a total of 14 FDI projects with an aggregate investment value of Nu. 73.76 billion were registered, while an additional 18 projects received in-principle approval (MoICE, 2025). Overall, the hotels and restaurants sector accounted for the largest share of FDI projects (30.4 percent), followed by the IT/ITES sector (26.7 percent), with most projects currently in operation or under construction. As a result, FDI inflows remain dominated by high-end tourism, a relatively mature sector.

Looking ahead, however, hydropower projects, particularly Khorlochu, Dorjilung, and Wangchhu, are expected to dominate FDI in investment values, reflecting the scale and capital intensity of these investments. A positive shift is also evident in the composition of in-principle approved projects, with a majority concentrated in production and manufacturing, likely supported by the commissioning of the Norbugang Industrial Park. This shift is encouraging, as manufacturing-oriented FDI has greater potential to strengthen domestic value chains and enhance productivity. However, it is important that this trend continues, as FDI plays a key role in improving efficiency and technology transfer, ultimately enhancing capital and Total Factor Productivity (TFP), which has declined since the 1990s. This will play a critical role in attracting investment to fuel growth toward achieving the 10X Economic Vision and ultimately aligning with the sectors identified in GMC.

The approval of the revised FDI Rules and Regulations in 2025 represents a key step toward strengthening Bhutan's investment climate by streamlining procedures and relaxing control measures. These policy improvements are expected to support a more conducive FDI environment and enhance the sustainability and quality of FDI inflows over the medium term.

4.4. Foreign Reserves

Bhutan's foreign reserve is projected to improve to USD 1,319.943 million at the end of FY 2025-26, a downward revision of 7.85 percent from previous quarter estimates mainly on account of worsening CAD. This is enough to finance 34 months of essential imports during a critical period. As of December 2025, the external reserves amounted to USD 1,116.292 million (RMA, 2026).

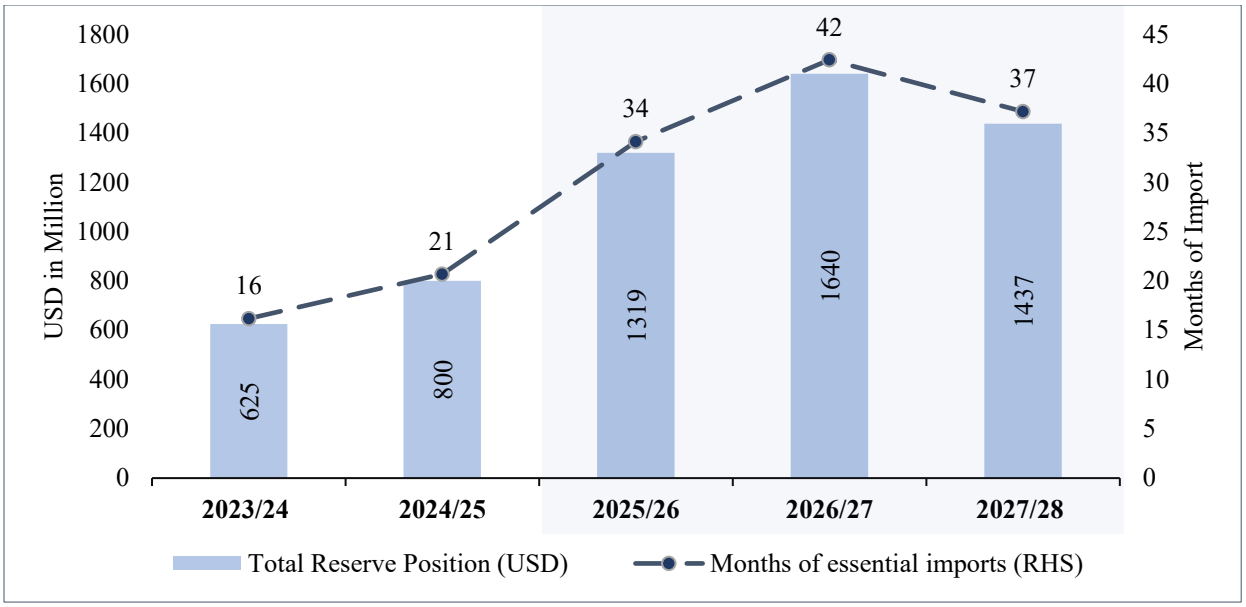


Figure 4.6: Foreign Reserves Projection

The overall improvement trend in FY 2025-26 and FY 2026-27 is also attributed to the bond redemption. From FY 2027-28, without any significant improvement in the supply side, the reserves from FY 2027-28 will be affected as imports of capital goods for major hydropower plants accelerate.

Foreign exchange reserves have gradually built up from the lows recorded in FY 2022–23, but remain exposed to external sector vulnerabilities, particularly as the current account deficit is projected to widen over the medium term. As Bhutan advances toward its 10X Economic Vision, strengthening reserve adequacy will require a greater emphasis on export and productivity-driven sectors, rather than continued reliance on grants and external borrowing to finance the CAD. The medium-term objective should be to build reserves through sustainable current account improvements, supported by structural transformation and diversification. This approach would also enable a gradual and well-sequenced relaxation of capital controls, consistent with practices in high-income economies, and anchor the Diamond strategy aligned with the evolving financial and investment ecosystem envisaged under the GMC.

4.5. Exchange Rate

The USD/BTN exchange rate recorded an upward trend in both the short and the medium term, indicating a depreciation of the BTN against the USD. Over the past year, the exchange rate increased by 7.98 percent, rising by Nu. 6.84 to reach Nu. 92.56 per USD as of February 1, 2026. While short-term fluctuations were observed during the year, the overall movement reflects the strengthening of the US dollar. Over the five-year period, the USD/BTN exchange rate rose by 28.57 percent, equivalent to an increase of Nu. 20.57, pointing to a sustained medium-term depreciation of the BTN against the USD.

Figure 4.7: Nominal Exchange Rate

Source: Google Finance

Given BTN's peg to the INR, these movements largely follow the developments in the INR-USD exchange rate and global United States dollar dynamics. Exchange rate movements serve as one of the channels of external adjustment. Pegged exchange rate arrangement with the INR has served well in terms of building confidence in the domestic currency, reducing trade uncertainty, anchoring price stability and also cushioning the impact of exchange rate shocks. However, depreciation of the INR against the USD also exposes Bhutan to external risks, as sustained INR weakness can heighten uncertainty

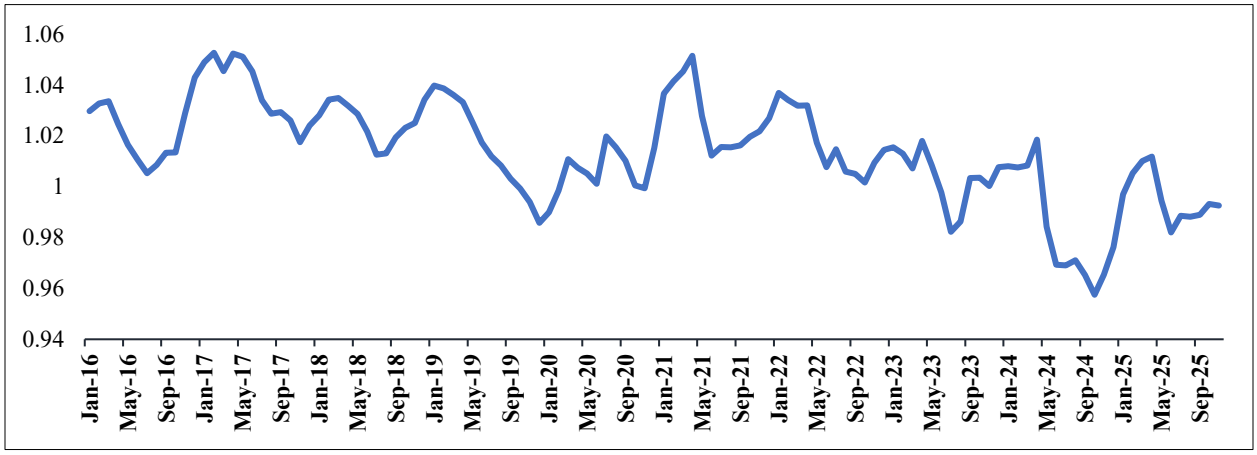


Figure 4.8: Real Exchange Rate (Nu. /INR)

The Real Exchange Rate (RER) is the ratio of the price level abroad and the domestic price level, where the foreign price level is converted into domestic currency units via the current nominal exchange rate. The real exchange rate between BTN and INR between January 2016 and November shows moderate fluctuations around the parity level. Between 2016 and 2017, the BTN appreciated in real terms, making Bhutanese goods relatively more expensive than Indian goods. From 2018 to 2020, the RER declined, reflecting a real depreciation of the BTN post-2021. The RER stabilized around 1.0 with minor fluctuations, indicating relative stability in Bhutan's

purchasing power in relation to India. The recent trend in the real exchange rate since 2024 is estimated to remain slightly below parity, indicating a mild undervaluation of the BTN, in contrast to the historical pattern, which points to periods of overvaluation. This shift may be partly attributable to the rebasing of the CPI in 2024, the effects of which have not yet been estimated backwards. Nevertheless, the real exchange rate in 2025 rose to 0.996 from 0.98 in 2023, indicating a partial reversal of earlier undervaluation. These movements are consistent with Bhutan's currency peg to the INR, which anchors the nominal exchange rate while allowing moderate real adjustments driven by inflation differentials between Bhutan and India.

4.6. International Investment Position

Bhutan's international investment position stood at USD -4,009.491 million at the end of June 2025, reflecting a modest improvement from USD 4,104.175 million in June 2024. Total financial assets amounted to USD 1,094.736 million, representing a 32.64 percent increase from the previous year.

Reserve assets constituted the largest share of total assets (75.93 percent) and increased by 46.50 percent year-on-year. This reflects a gradual rebuilding of gross international reserves from the lows recorded in FY 2022-23, strengthening Bhutan's external buffer and enhancing its capacity to absorb external shocks. On the liabilities side, total financial liabilities increased by 3.54 percent, a significantly slower pace than asset accumulation. Liabilities growth continued to be driven mainly by loans, which rose by 3.18 percent over the year.

Table 4.1: International Investment Position

	Jun-23	Jun-24	Jun-25
Net IIP	**-4,133.8**	**-4,104.175**	**-4,009.491**
Assets	**709.1**	**825.335**	**1,094.736**
Currency and deposits	63.603	68.896	77.906
Trade credits	91.717	189.052	185.587
Reserve assets	553.778	567.387	831.243
Others	0.000	0.000	0.000
Liabilities	**4,842.859**	**4,929.510**	**5,104.227**
Direct investment in Bhutan	343.426	138.279	137.166
o.w. Equity	305.591	121.137	103.632
o.w. Intercompany debt	37.835	17.142	33.534
Currency and deposits	72.308	80.983	83.874
Loans	4,360.826	4,649.372	4,797.305
Trade credits	32.327	26.703	59.728
SDR allocations	33.973	34.173	26.155

Source: Monthly Statistical Bulletin, RMA

4.7. Conclusion

The external sector continues to show vulnerabilities with the persistent CAD, which remains largely financed by grants and borrowings. In FY 2025-26 and FY 2026-27, the CAD is projected to improve mainly on account of non-hydropower exports associated with bond redemption.

Over the medium term, the CAD is expected to improve temporarily in FY 2026-27, before deteriorating again from FY 2027-28 as imports rise sharply with the acceleration of hydropower construction. Merchandise export growth, while stable, remains narrowly concentrated in mineral products, ferro-alloys, and a limited range of agricultural commodities, leaving Bhutan exposed to commodity price volatility and external demand shocks. This underscores the need to move beyond a growth model reliant on capital-intensive projects and episodic inflows toward one anchored in diversified, productivity-driven exports.

Ultimately, ensuring external sustainability will require a shift from financing growth through grants and borrowing toward building reserves through durable current account improvements. This will depend on successful structural transformation, targeted FDI that enhances technology and productivity, and export diversification to achieve the 10X Economic Vision.

Chapter 5 Household and Labour Market

5.1. Introduction

This chapter examines the recent developments in Bhutan's labour market and household welfare, highlighting the evolving relationship between employment outcomes, demographic change, and consumption patterns. Labour market performance improved modestly in 2025, supported by the continued economic recovery and gradual expansion of job opportunities. The employment rate remained high, and unemployment declined slightly on average, indicating some progress in labour absorption. However, underlying structural challenges persist, particularly in the form of high youth unemployment, gender disparities in labour force participation, and limited diversification of employment away from agriculture and the public sector.

Bhutan's recovery displays features of a K-shaped growth trajectory, where gains are concentrated in a narrow set of high-performing sectors, while labour-intensive industries like tourism, manufacturing, and transport are lagging behind. This uneven recovery has important implications for job quality, inclusiveness, and the ability of the economy to generate productive employment for new labour market entrants.

At the same time, Bhutan is undergoing a rapid demographic transition marked by declining fertility, rising life expectancy, outward migration, and a gradually aging population. These demographic changes are expected to tighten labour supply over the medium to long term, raising the urgency of improving labour productivity and increasing labour force participation, especially among women and youth.

Household consumption patterns highlight the rising cost of living pressures and disparities between urban and rural households. Labour market structure, employment quality, and income generation are closely linked to household welfare outcomes as these factors determine security, stability of income, and the ability of households to meet basic needs. Strengthening private sector job creation, reducing labour market mismatches, and supporting inclusive growth will therefore be critical as Bhutan navigates both economic recovery and demographic change.

5.2. Labour Market Dynamics

5.2.1. Employment

The overall employment rate reached 96.63 percent in 2025, slightly higher than 96.50 percent in 2024. Although the increase is marginal, it reflects a gradual strengthening of labour market outcomes alongside ongoing economic recovery and development progress. The employment peaked at 97.10 percent in the second quarter of 2025, followed by a steady decline in the subsequent quarters.

As seen in Figure 5.1, male employment continues to exceed female employment, partly due to constraints on women's labour force participation. These disparities may be partly linked to the

higher burden of household and family work undertaken by women. According to the International Labour Organization (ILO), women globally face significant barriers to employment, as women are engaged more in contributing to family work than men by about 8.30 percentage points. In 2025, women accounted for only two-fifths of global employment, indicating that they are less likely than men to enter or remain in the labour force (ILO, 2026).

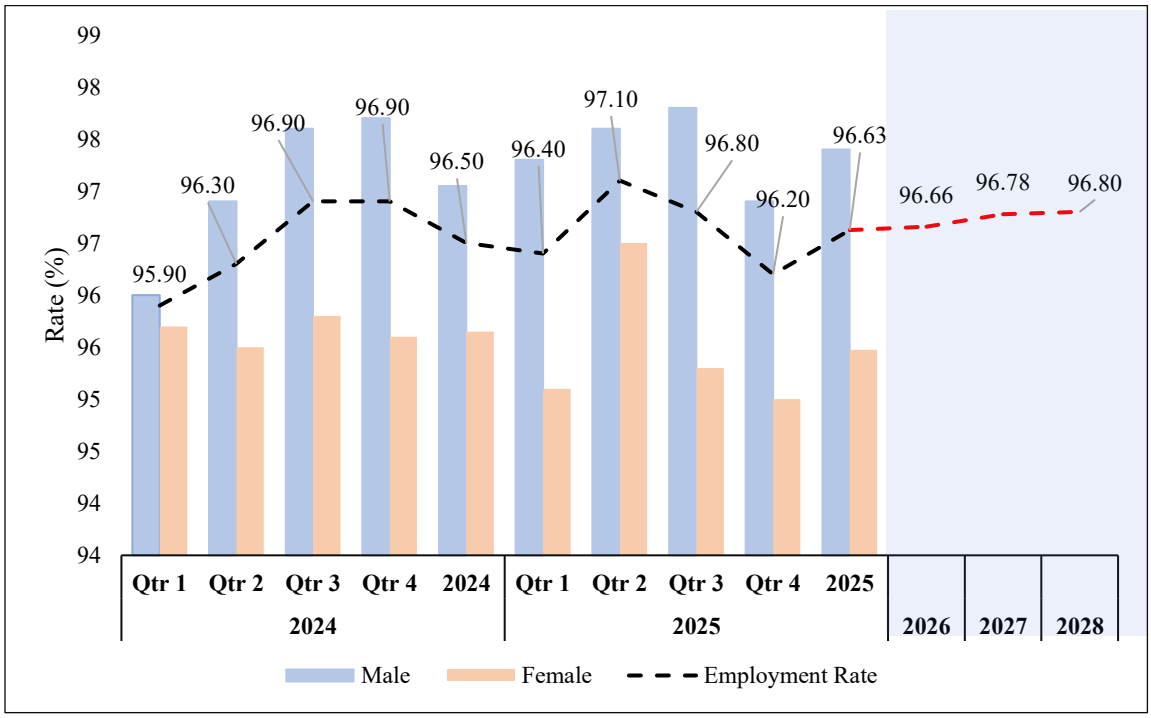


Figure 5.1: Employment Rate (in percent)

This pattern is also evident in Bhutan, where female participation is limited by structural factors such as informal employment, agricultural dependence, and social norms. In the medium term, employment is expected to increase steadily as economic activity expands further. However, the benefits of recovery may not be evenly distributed across sectors. Bhutan's K-shaped growth pattern suggests that labour-intensive industries such as tourism, transport, manufacturing, and entertainment are lagging behind, limiting broad-based employment generation.

5.2.2. Sectoral Labour Share

The sectoral employment projections indicate a gradual increase in total employment from about 360,000 workers in 2023 to nearly 400,000 workers by 2028. Despite this growth, Bhutan's employment structure remains heavily concentrated in a few key sectors, highlighting the slow pace of structural transformation. In 2025, total employment across all sectors was estimated at 380,261 workers, with agriculture, forestry and livestock remaining the largest employers, accounting for 43.52 percent of total employment. Although its relative share is projected to decline slightly over time, the agriculture sector continues to serve as a residual employer, a

common feature in developing economies where labour shifts gradually from low-productivity sectors (ILO, 2026).

The second largest employer continues to be public administration and defense, accounting for 18.84 percent of total employment. This underscores the continued central role of government in absorbing labour, particularly in the absence of a sufficiently large and dynamic private sector. Other sectors such as construction, wholesale and retail trade, and service-related industries are projected to record moderate employment gains, supported by infrastructure development, consumption growth, and tourism-related activities. Employment gains in hotels and restaurants, transport and communications, and private social services suggest a gradual shift towards services. In contrast, manufacturing, mining, and utilities remain small contributors, indicating limited industrial diversification.

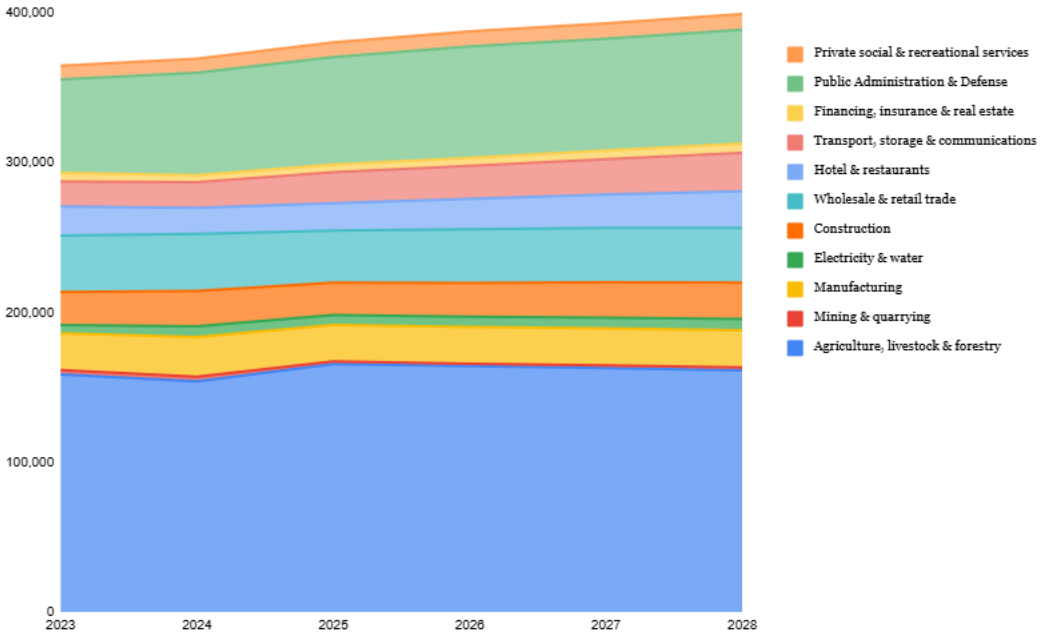


Figure 5.2: Employment by Sectors

Overall employment growth is projected at 1.92 percent in 2026, 1.40 percent in 2027, and 1.57 percent in 2028, highlighting the need to accelerate private-sector job creation and productivity-enhancing transformation. Continued recovery of the tourism industry and emerging industrial development are expected to strengthen employment opportunities in the medium term.

5.2.3. Unemployment

The unemployment conditions remained broadly stable in 2025. The unemployment rate increased slightly in the last quarter of 2025 to 3.80 percent, up from 3.20 percent in the previous quarter, partly reflecting seasonal labour market fluctuations. On average, unemployment in 2025 stood at 3.38 percent, marginally lower than 3.50 percent in 2024, suggesting a modest improvement in labour absorption.

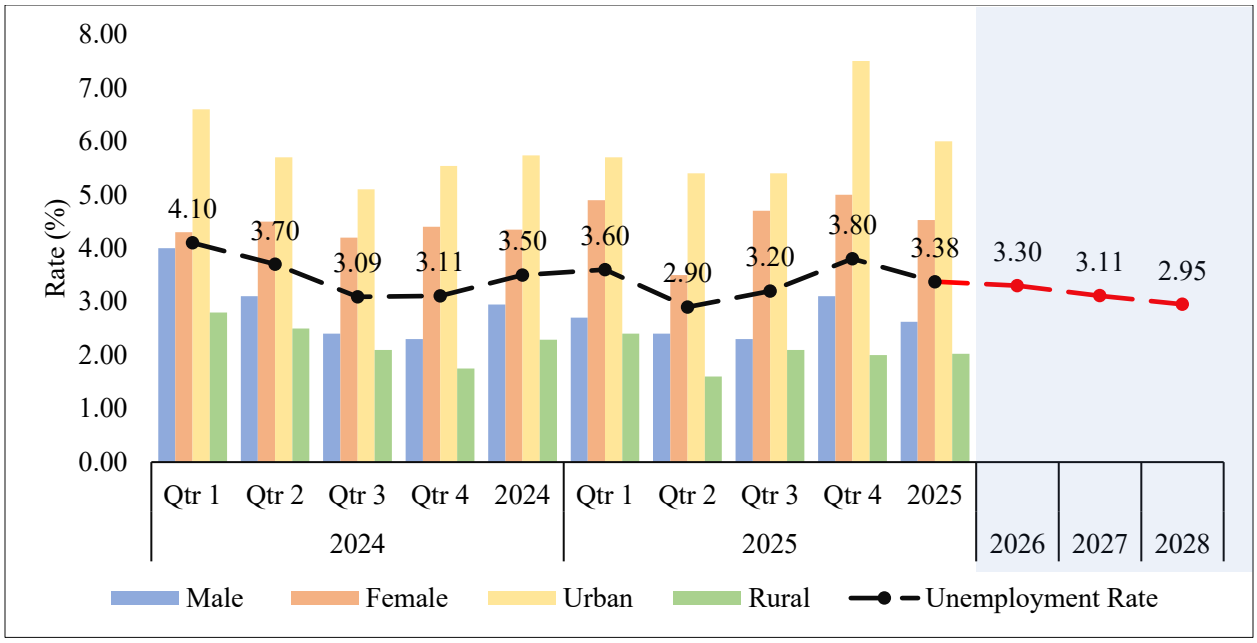


Figure 5.3: Unemployment Rate (in percent)

Unemployment continues to be higher in urban than rural areas, reflecting greater labour concentration and more competitive job markets in urban centers. Female unemployment also remains consistently above male unemployment, pointing to persistent structural challenges such as labour market access, occupational segregation and household responsibilities. This mirrors global patterns where social norms strongly shape women's access to employment opportunities (ILO, 2026).

Urban unemployment is also partly explained by the K-shaped recovery. Growth has been stronger in upper-performing sectors such as electricity, communications, and wholesale trade, which tend to be less labour-intensive and absorb fewer job seekers. Meanwhile, a slower recovery in labour-intensive private sector industries continues to constrain employment opportunities for urban youth and new entrants into the labour market.

In the medium term, unemployment is estimated to decline gradually, reaching 3.30 percent in 2026 and 3.11 percent in 2027, and 2.95 percent in 2028, supported by the expansion of economic activities with the acceleration of the 13th FYP implementation.

5.2.4. Youth Unemployment

Youth unemployment remains one of Bhutan's most pressing labour market challenges. In 2025, the average youth unemployment rate declined to 18.20 percent, down from 19.10 percent in 2024. This improvement may partly reflect increased job creation associated with large infrastructure projects, including the commencement of GMC airport construction.

Despite this improvement, Bhutan's youth unemployment is still higher than the global average of 12.40 percent in 2025 (ILO, 2026). Moreover, youth unemployment increased consistently over

the quarters in 2025, reaching 20.60 percent in the fourth quarter, indicating continued vulnerability among young labour market entrants. Urban youth unemployment remains significantly higher than rural youth unemployment, reflecting the concentration of educated job seekers in towns and cities. Female youth unemployment also exceeds male youth unemployment, indicating a gender gap within youth labour market outcomes.

From the ILO perspective, high youth unemployment, especially in the presence of hiring difficulties, signals structural labour market inefficiencies. The ILO also emphasizes that employment quality, not just the employment rate, is critical. High youth unemployment often coexists with underutilization of skills and a mismatch between education and market needs.

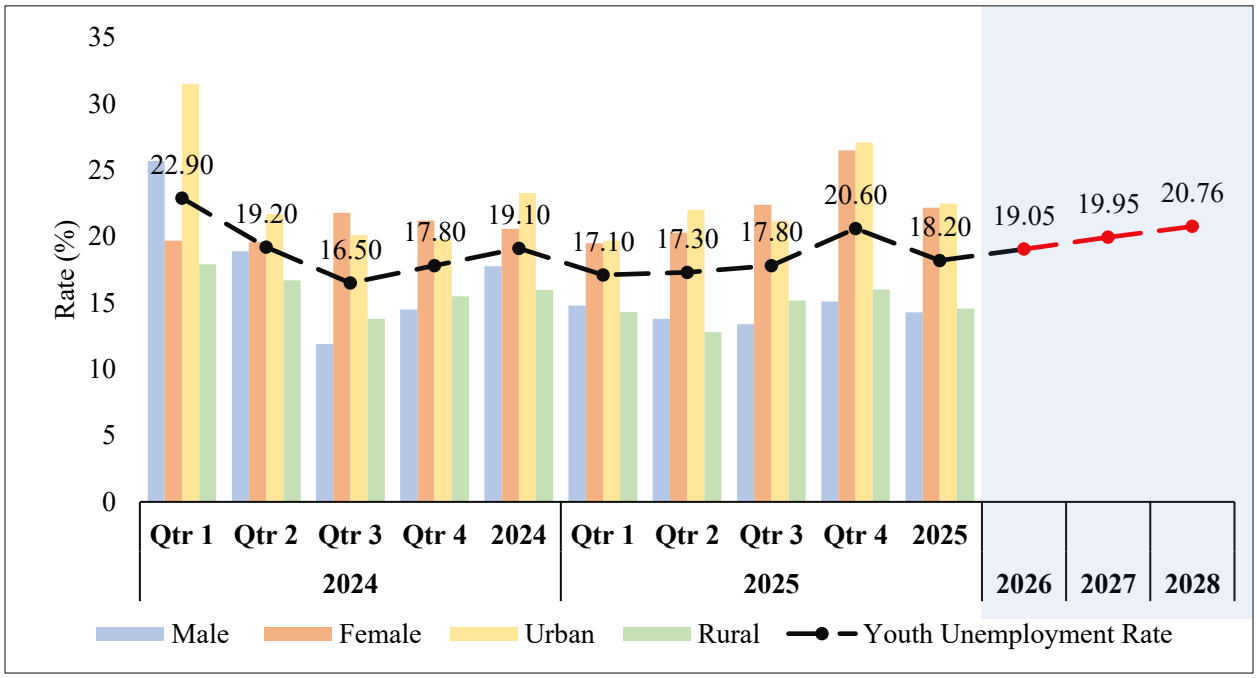


Figure 5.4: Youth Unemployment Rate (in percent)

Looking ahead, youth unemployment is estimated to rise again to 19.05 percent in 2026, 19.95 percent in 2027, and further to 20.76 percent in 2028, underscoring persistent structural constraints, which are further highlighted by the K-shaped growth pattern. Moreover, the challenges in the labour market may include skills mismatches, wage expectations, and strong preferences for public sector employment. Many young job seekers may delay entry into private employment while considering overseas opportunities. These structural constraints highlight the need for targeted interventions to enhance employability, expand job opportunities, and align skills development with evolving market requirements.

5.2.5. Employment Generation

Labour market vacancy data from the Bhutan Labour Market Information System highlights a striking shift in labour market dynamics in 2025. During the year, a total of 21,396 vacancies were

created (including 3,110 overseas jobs), compared to only 12,410 job seekers.[6] Since 2023, the number of vacancies has steadily increased, while the number of job seekers consistently decreased. In 2023, there were 7,355 vacancies against 22,012 job seekers. In 2024, vacancies rose to 9,745, while job seekers declined to 16,017. By 2025, vacancies exceeded job seekers for the first time, suggesting that the economy generated more employment opportunities than available applicants.

However, this emerging vacancy surplus reflects a growing mismatch between labour supply and employer demand. Many vacancies are concentrated in clerical and support staff positions, which are often perceived as unattractive due to low wages, job location, and limited career progression. Differences between job seeker expectations and labour market realities, particularly among youth, contribute to persistent unemployment despite available openings.

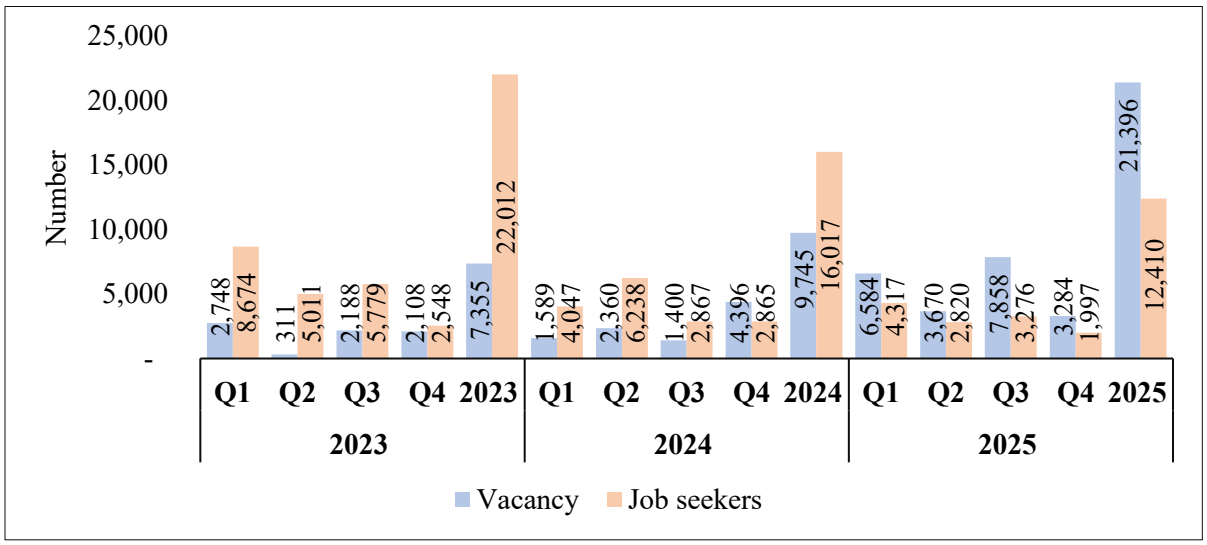


Figure 5.5: Number of Vacancies and Job Seekers

Therefore, unemployment, particularly youth unemployment, remains elevated, which is further reinforced by K-shaped growth where growing upper arm sectors may generate vacancies requiring specialized skills, while weaker lower arm sectors wouldn't absorb large numbers of job seekers. Addressing these challenges will require long-term reforms in education, training, stronger private sector dynamism, and targeted support for lagging sectors to ensure more job creation.

5.2.6. Labour Force Participation

The labour force participation increased to 393,607 persons in 2025, up from 382,636 in 2024, representing an increase of 10,971 individuals. Projections indicate continued growth, with the labour force expected to reach nearly 400,000 in 2026 and exceed that level in 2027 and 2028,

[6] The job seeker number only reflects registered job seekers with the Bhutan Labour Market Information System portal. The actual number of job seekers is expected to be larger.

supported by demographic factors and improving labour market engagement. The Labour Force Participation Rate (LFPR) rose to 64.91 percent in 2025, up by 1 percentage point, from 63.91 percent in 2024, reflecting improved confidence and stronger job prospects. Over the medium term, from 2026 to 2028, LFPR is projected to remain broadly stable around 65.39 percent on average, which is much below the average LFPR of 76.60 percent of high-income countries.

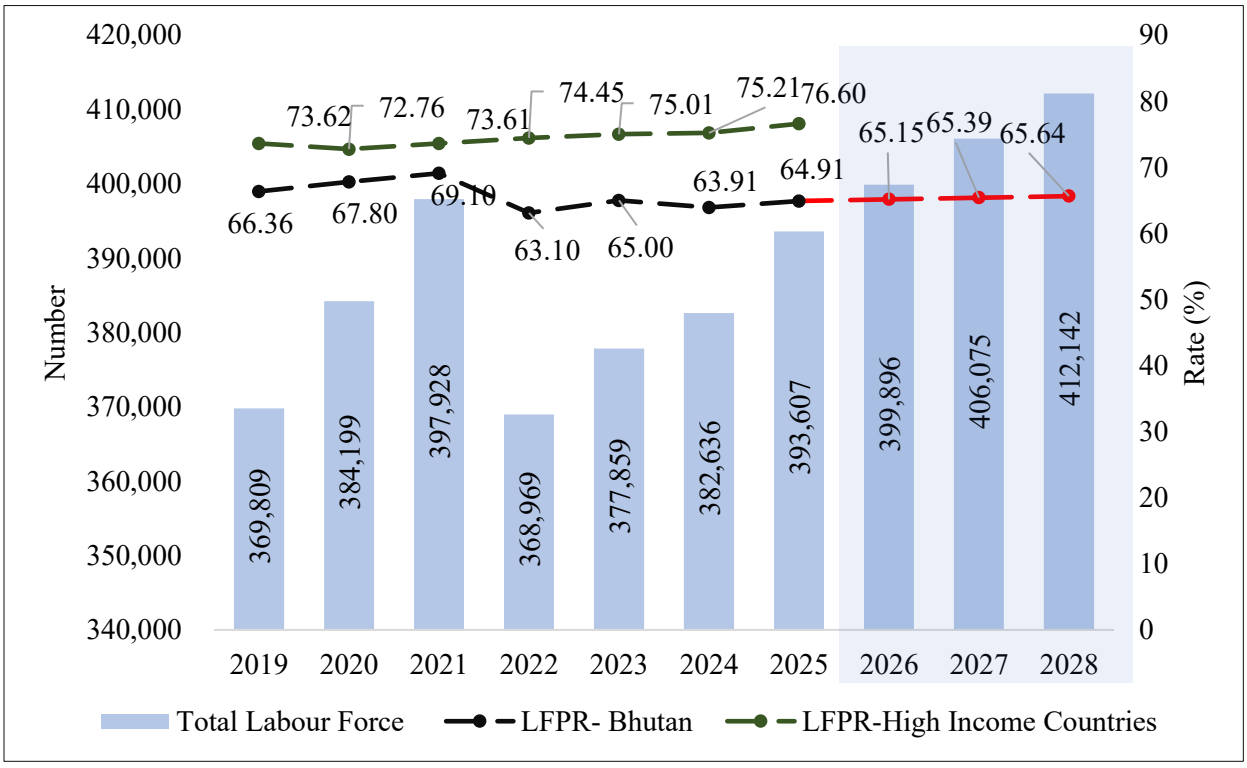


Figure 5.6: Labour Force Participation Rate (in percent)

Historically, over the past seven years from 2019 to 2025, Bhutan's LFPR has remained relatively stagnant at 65.74 percent on average, which is below international benchmarks. According to ILO data, LFPRs in upper-middle and high-income economies are often above 70 percent, with many transitioning economies striving toward achieving an LFPR of 75 percent. As seen in Figure 5.6, for high-income countries, the average LFPR was around 74.46 percent between 2019 and 2025. Therefore, for Bhutan to transition toward a high-income GNH economy, LFPR would need to increase significantly at a rate similar to the LFPR of developed countries, or productivity improvements must compensate for limited labour supply growth.

From a labour market efficiency perspective, increasing LFPR, particularly among women and youth, is critical for enhancing labour supply, broadening productive capacity, and supporting higher economic growth. In the context of Bhutan's demographic transition and aging population, expanding labour force participation is essential to sustain economic momentum and mitigate the impact of a shrinking working-age population.

5.3. Demographic Transitions and Labour Market Implications

5.3.1. Demographic change

Bhutan is undergoing a rapid demographic transition marked by declining fertility rates and rising life expectancy. As shown in Figure 5.7, the total fertility rate has fallen sharply from 5.6 births per woman in 2000 to about 1.7 by 2025, well below replacement level. At the same time, life expectancy has increased from 66 years in 2000 to around 73 years in 2025, reflecting improvements in healthcare, living standards, and human development.

According to the National Population and Housing Census 2017, Bhutan is expected to become an aging society in the upcoming decades, with the fertility rate declining and life expectancy increasing to mid-70s. As a result, the proportion of older persons in the population is increasing steadily, and this trend is expected to accelerate over time.

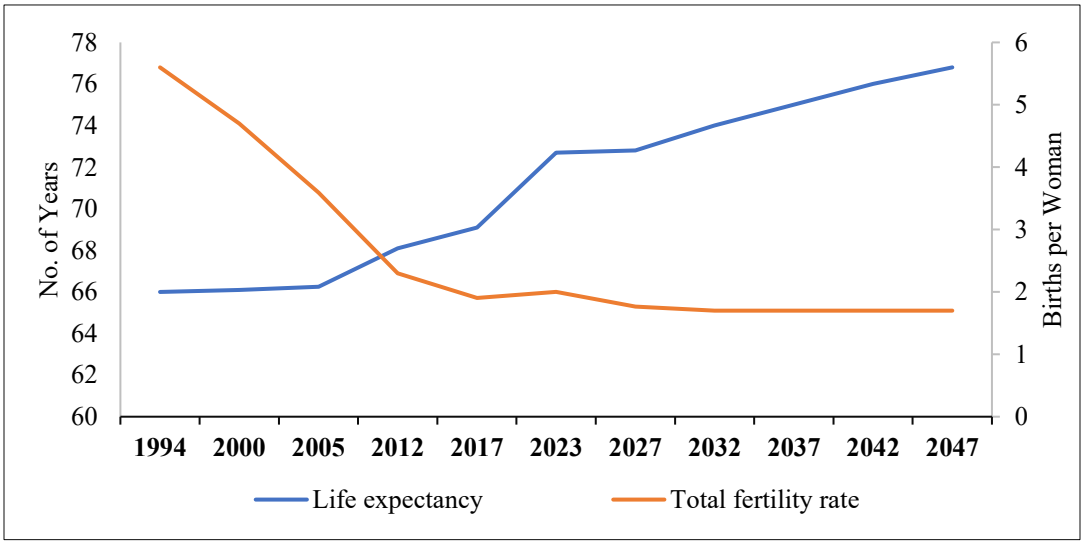


Figure 5.7: Total Fertility Rate and Life Expectancy

This demographic shift has far-reaching implications for Bhutan's labour market and long-term growth prospects. A declining fertility rate implies that fewer young people will enter the labour force in the future, leading to a gradual slowdown in the labour force growth. At the same time, rising longevity will increase the share of retirees relative to the working-age population. Together, these demographic trends suggest that Bhutan may face a tightening labour supply over the medium to long term, which could constrain economic growth unless productivity improves significantly and labour market reforms offset the decline in workforce growth.

In addition, Bhutan's demographic transition is occurring alongside increasing out-migration, approximately over 65,000 as of 2025, particularly among young and educated workers seeking employment opportunities abroad (State of the Nation, 2025). This outward flow reduces the domestic labour pool further and may intensify labour shortages in key sectors, while also contributing to skills gaps within the economy. Although migration can generate remittance

inflows, sustained emigration of productive youth may weaken Bhutan's long-term labour market potential and reduce the country's capacity for private sector-led transformation.

Therefore, Bhutan's demographic transition underscores the urgency of policies aimed at retaining talent, improving domestic working conditions, and expanding productive employment opportunities at home, especially for youth. Strengthening private sector job creation, enhancing skills development, and aligning education with labour market needs will be crucial to sustain growth as demographic conditions evolve.

5.3.2. Age Dependency Ratio

Figure 5.8 illustrates the decade averages of youth and old-age dependency ratios. Over the past three decades (1991-2020), the youth dependency ratio has decreased from 74.17 percent to 38.96 percent, indicating a significant decline of around 47.47 percent, reflecting falling fertility and a shrinking share of children in the population.[7] On the other hand, the old-age dependency ratio has increased from 5.84 percent to 8.31 percent during the same period, an increase of over 40 percent.[8]

Going forward, demographic projections suggest that the youth dependency ratio will decline further from 27.59 percent to 21.66 percent between 2021 and 2050, which is a drop of 21.49 percent. However, old-age dependency is expected to rise sharply from 9.21 percent to 18.49 percent over the same period, an increase of more than 100 percent. This indicates a growing burden on the working-age population as Bhutan moves toward an aging society.

These dependency trends have important macroeconomic implications as a lower youth dependency reduces pressure on education and health spending, while rising old-age dependency increases fiscal obligations related to pensions, healthcare services, and elderly care. This shift could place additional strain on public finances, especially for Bhutan's economy, which continues to rely heavily on government expenditure and public sector employment.

Moreover, a rising old-age dependency ratio implies a smaller share of economically active workers supporting a larger dependent population. This may reduce national savings, weaken labour productivity, and limit the economy's long-term growth potential. It also highlights the importance of increasing labour force participation, especially among women and older workers, and extending productive working lives through skills upgrading, lifelong learning, and flexible employment opportunities.

[7] Youth Dependency Ratio is computed as the population below 15 years divided by the working-age population (15-64).

[8] Old-age Dependency Ratio is computed as the population above 64 years divided by the working-age population (15-64).

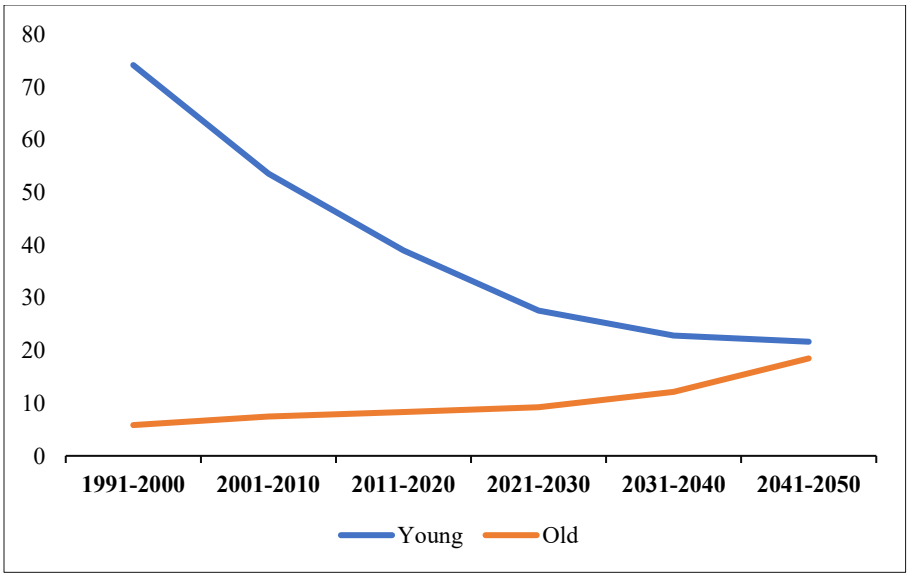


Figure 5.8: Youth and Old-age Dependency Ratio

Bhutan's demographic transition suggests that the country may age before achieving a high-income GNH country status. While aging reflects positive development outcomes, it also presents significant economic and social challenges. Early and coordinated policy responses will be essential to manage fiscal risks, like increasing social spending pressure, strengthening social protection systems, and ensuring an inclusive transition, to avoid crises in the future.

5.3.3. Median Age

The median age is a key demographic indicator that reflects the age distribution of a population and provides insights into a country's economic and social dynamics. A higher median age is associated with lower birth rates, rising health care and pension burdens, and greater demand for elderly care services. In contrast, a lower median age indicates a younger population, which can support a growing workforce but may also create challenges in education and job opportunities.

As seen in Figure 5.9, Bhutan's median age was estimated at around 29 years in 2022, indicating that the country still has a relatively young population. With declining fertility and falling youth dependency, Bhutan remains in its demographic dividend phase, which is expected to continue until around 2032. This presents a critical window of opportunity for accelerating growth, provided that the right policies are in place to support education, health investment, and productive employment creation.

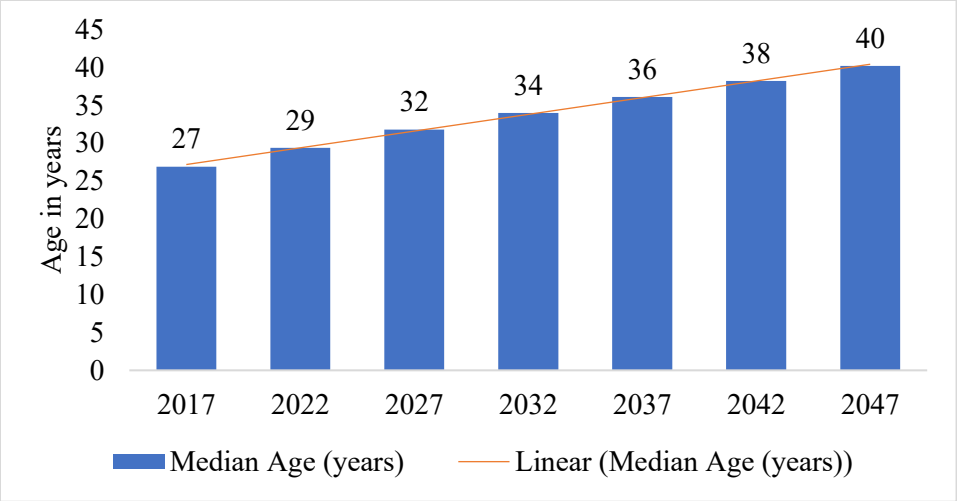


Figure 5.9: Median Age

However, this dividend window will close soon. Projections indicate that Bhutan's median age will rise from 32 to 38 between 2027 and 2042, reaching around 40 by 2047. This reflects the steady increase in the older population and rising old-age dependency, implying a shrinking workforce over time.

To maximize the remaining demographic dividend and prepare for aging, Bhutan must strengthen labour productivity, expand private sector employment, invest in human capital, and implement forward-looking reforms in pension sustainability, healthcare financing, and active labour market policies. Without timely action, demographic change could become a constraint on growth rather than a development advantage.

5.4. Household Consumption and Expenditure

Household consumption expenditure provides important insights into living standards, purchasing power, and the broader interaction between labour market outcomes and household welfare. The National Statistics Bureau's Household Consumption and Expenditure Survey 2025 highlight the notable differences in spending patterns across food and non-food items, as well as between urban and rural households.

Figure 5.10 represents the nationwide mean monthly household expenditure on major food items. The national average monthly household food consumption expenditure is estimated at Nu. 21,991 with a per capita expenditure of Nu. 7,069. Urban households spend significantly more on food, averaging Nu. 23,738 per month, compared to Nu. 17,194 for rural households. This implies that urban food expenditure exceeds rural levels by about 38.06 percent, reflecting differences in income levels, consumption choices, and access to markets.

Food expenditure is largely concentrated in essential staples. Cereals and cereal products account for the largest share (21.40 percent) of total food spending, followed by milk and dairy products

(19.50 percent), vegetables (15.50 percent), and meat and fish (12.90 percent). The dominance of basic food items suggests that household consumption remains heavily oriented toward necessities, particularly among rural households, where dietary expenditure is more constrained. Overall, the higher urban food expenditure may also reflect greater reliance on purchased food items, while rural households continue to depend partly on subsistence agricultural production.

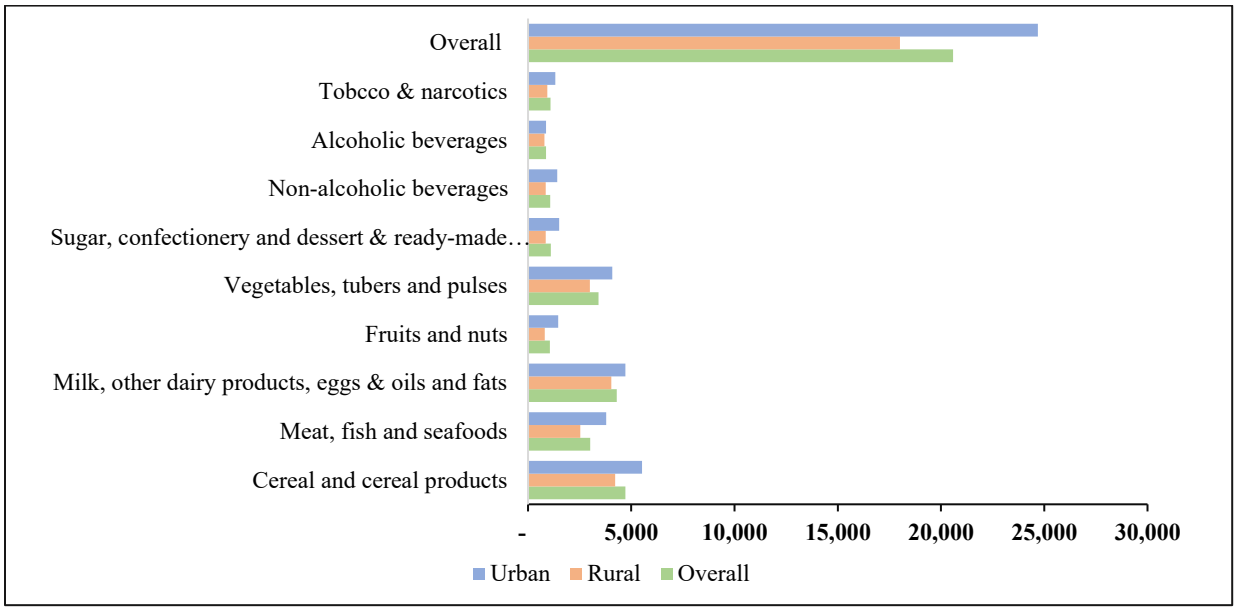


Figure 5.10: Mean Monthly Household Expenditure on Major Food Items

Figure 5.11 illustrates household expenditure on major non-food items. Mean monthly household spending on non-food items stands at approximately Nu. 33,245, substantially higher than spending on food. The largest components of non-food expenditure are housing, utilities, fuel and transport, which together account for over 47 percent of total non-food expenditure. This highlights the growing burden of essential service-related costs on Bhutanese households.

Other significant spending categories include insurance and financial services (11.77 percent) and information and communication (9.04 percent), reflecting the rising importance of financial inclusion and connectivity. Conversely, expenditure on discretionary categories such as footwear, recreation, sports, and cultural activities remains low (around 2 percent each), indicating limited room for non-essential consumption. Similar to food expenditure, urban households' spending on non-food items is considerably higher than that of rural households, suggesting higher disposable incomes, but also higher living costs in urban centers.

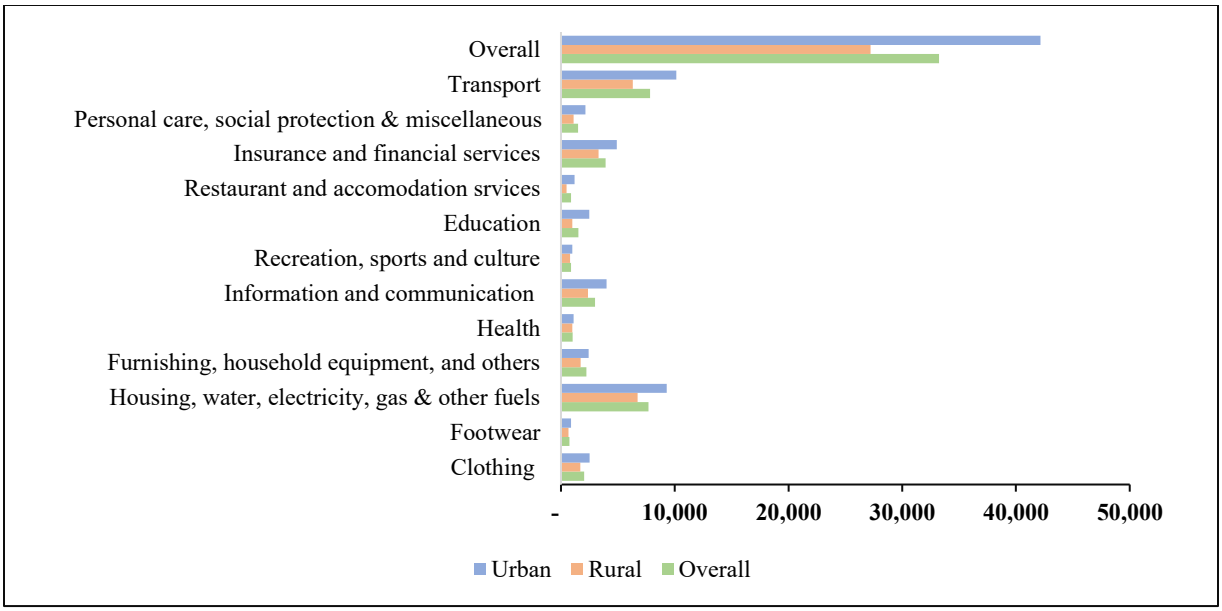


Figure 5.11: Mean Monthly Household Expenditure on Non-food Items

Households in Bhutan spend around Nu. 53,832 per month on average when combining food and non-food expenditures. However, according to the Bhutan Living Standard Survey 2022, the average monthly household income was only Nu. 33,845; significantly lower than reported expenditure levels. This gap points to a potential financial stress among households, which may be bridged through savings drawdowns, informal borrowing, remittances, or non-reported income sources. The widening income-expenditure disparity highlights concerns about cost-of-living pressures and the vulnerability of households, particularly those dependent on low-productivity employment. Strengthening job creation, especially in lower arm sectors of the K-shaped recovery, will therefore be essential to ensure that economic recovery translates into improved household welfare and sustainable consumption growth.

5.4.1. Household Expenditure and Labour Market Linkage

Household consumption behavior is closely linked with Bhutan's labour market structure and employment quality. While Bhutan reports a high employment rate, over 96 percent, a large share of employment remains concentrated in agriculture and informal activities, which tend to generate lower and less stable incomes. This, to some extent, helps explain why consumption expenditure is still dominated by basic necessities and why many households face limited discretionary spending capacity.

Urban households, which are more reliant on wage employment and formal sector jobs, exhibit higher expenditure levels, consistent with greater cash income opportunities. However, urban unemployment remains higher than rural unemployment, particularly among youth, which may contribute to uneven household welfare outcomes and rising inequality across regions within Bhutan.

Furthermore, the persistence of youth unemployment alongside increasing vacancies reflects labour market mismatches, where households may continue to support unemployed young members even as employers struggle to fill positions requiring specific skills. This dynamic may increase household dependency burdens and constrain consumption growth. Additionally, outward migration of working-age Bhutanese in search of better employment opportunities abroad has implications for household expenditure patterns. Remittances may help sustain consumption for some households, but the loss of young workers also reduces productive capacity and may intensify labour shortages in key sectors.

Overall, strengthening labour market efficiency through higher productivity job creation, private sector expansion, and improved skill matching is crucial not only for employment outcomes but also for enhancing household welfare, reducing financial vulnerability, and supporting inclusive economic growth.

5.5. Conclusion

Bhutan's labour market showed gradual improvement in 2025, reflecting the broader economic recovery and expansion in employment opportunities. However, the labour market outcomes continue to be shaped by consistent structural challenges, including sectoral concentration, limited industrial diversification, and elevated youth unemployment.

The uneven nature of the K-shaped recovery remains a central concern. While some sectors in the upper arm have expanded, many labour-intensive industries that are critical for broad-based job creation lag behind. As a result, the employment generation has not translated fully into inclusive opportunities, particularly for young and urban job seekers. The increasing mismatch between vacancies and job seekers points to challenges in skills alignment, wage expectations, and job attractiveness within the domestic labour market.

Demographic shift adds another layer of complexity to the labour market. Declining fertility, increasing longevity, and increasing outward migration are expected to tighten Bhutan's labour supply over time and raise dependency burden. Without timely reforms, Bhutan risks aging before achieving high-income GNH country status. Expanding labour force participation, improving human capital, and retaining skilled workers will therefore be essential to sustaining economic momentum.

Household expenditure patterns also reflect these labour market dynamics. Consumption remains heavily oriented toward necessities, and rising non-food costs such as housing, utilities, and transport suggest increasing financial pressure on households. The gap between reported income and expenditure highlights vulnerabilities, particularly among households dependent on low-productivity employment or affected by unemployment and underemployment.

Overall, the chapter emphasizes that strengthening labour market efficiency through private sector development, productivity-enhancing transformation, targeted youth employment strategies, and

improved skill matching will be crucial not only for better employment outcomes but also for improving household welfare and ensuring inclusive and sustainable growth.

Chapter 6 Industrial Development

6.1. Introduction

As the boundaries between the physical and digital worlds are rapidly dissolving, Industry 4.0 is redefining the very essence of industrial revolutions with economies integrating the Internet of Things, data analytics, and AI into manufacturing processes. Economies around the world are venturing into high-tech manufacturing, with these trends catching up to traditional manufacturing units in South Asia, as Bangladesh experiences restructuring in the textile manufacturing sector, which is one of its core industries. Elsewhere, countries like China are rapidly advancing in niche sectors and high-tech.

In Bhutan, industrial development is concentrated in a few key areas: ferrosilicon, wood-based products, traditional handicrafts, and agro-processing. Much of this is localized in the southern belt, where industries benefit from proximity to raw materials and export markets. However, stagnancy in the manufacturing sector has become increasingly concerning as the sector plays a decisive role in global economic performance due to its strong multiplier, generating additional output, income, and employment across the economy. Expansion and deepening of the industrial base into higher-value industrial activities will be crucial for translating Bhutan's development vision into durable and tangible economic outcomes.

Tourism is playing an increasingly influential role in shaping the industrial scene in Bhutan, where the manufacturing sector is evolving with small-scale players in high-value, traditionally embedded handicraft manufacturing, such as traditional textiles, by expanding markets and facilitating market access. As Bhutan pursues its goal of achieving high-income GNH country status, industrialization and private sector development are being prioritized, contributing to renewed interest in industry growth. However, the extent to which this renewed activity is translating into structural transformation, efficiency and productivity gains remains to be monitored.

6.2. Global and Regional Industrial Development

Industrial activity in the EAP remains a critical driver of regional economic performance, but growth has become increasingly uneven across subsectors. A clear divide has emerged between technology and scale-intensive manufacturing, which are experiencing growth. One of the most striking developments in 2025 has been the continued rapid expansion of China's electric vehicle (EV) manufacturing industry, which now accounts for over 70 percent of global EV production (International Energy Agency, 2025).

On the other hand, more traditional manufacturing segments have softened amid weaker external demand and tighter financial conditions. The S&P Global Purchasing Managers' Index data indicates that basic materials manufacturing (chemicals, forestry and paper products, metals and mining) has been the weakest performing manufacturing grouping since mid-2024, with the index

reporting declines in production across all three component sectors and chemicals output falling back into contraction in March 2025 (S&P Global, 2025). Looking ahead, globalization is expected to give way to more fragmented, regionally anchored economic blocs, prompting global supply chains to diversify and invest in agility. As efficiency is increasingly traded off against security amid geopolitical policy and climate uncertainty, growth is likely to remain uneven, with competitive advantage driven by flexibility and agility.

In South Asia, industrial growth has strengthened in recent years, supported by both traditional manufacturing sectors and emerging industrial clusters. Expansion in manufacturing activity across electronics, automotive components, pharmaceuticals and textiles reflects a confluence of external and internal factors. Global supply-chain reconfiguration driven by heightened trade restrictions, stricter transshipment enforcement, and rising geopolitical uncertainty has encouraged firms to diversify production locations, which India has benefited from. Schemes such as Production Linked Incentive have drawn companies like Foxconn, which now produces 15 percent of Apple's phones in India, directly contributing to growth in mobile phone exports (Lam, et al., 2025; Jha, 2025). Supportive policy measures and the changing supply chain landscape have helped expand factory activities such as electronics manufacturing clusters in Pune to laptop assembly industrial diversification and expansion into higher-value sectors.

The Ministry of Electronics and Information Technology reported that electronics manufacturing rose sixfold and exports increased eightfold over the last 11 years, while electronics value addition has jumped from 30 to 70 percent, with targets to reach 90 percent by FY 2027-28. Similarly, exponential expansion in mobile production capacity is improving self-sufficiency with the country now meeting its domestic demand (imports have decreased from 75 percent in FY 2014-15 to .02 percent in FY 2024-25). Overall, these numbers highlight India's transition from being a large importer to becoming a global hub of electronics, and India is now the world's second-largest mobile manufacturer (Press Information Bureau, 2025).

However, regional dynamics also point to stress and restructuring in several long-established manufacturing segments. Recent economic developments in Bangladesh illustrate this pattern: between January 2024 and March 2025, around 113 small and medium-sized garments factories closed, while 128 new factories were established. These new factories are either replacements or expansions made by existing industry players with investment in state-of-the-art machinery, digital production systems and automation. A net loss of 22,000 jobs is reported, with closures linked to price pressures, uncompetitiveness, and shrinking global orders (Uddin, 2025).

This points to a manufacturing upgrade across South Asia, with automation and higher-value manufacturing reshaping labour demand, marking a shift towards higher-skilled industrial jobs, contributing to rising labour demand in technical and engineering roles, while lower-skilled jobs are phased out due to automation.

6.3. Industrial Development and Value Chain Integration in Bhutan

Bhutan's industrial development is shaped by a small domestic market, a highly skewed firm-size distribution, and persistent gaps in value-chain integration. While the economy has grown in recent years, industrial activity, net of hydropower developments, remains marginal and concentrated in a narrow set of capital and energy-intensive sectors. Cottage and Small Industries (CSI) is the major category, dominating the number of establishments, yet large-scale firms continue to account for the overwhelming share of industrial turnover and export earnings.

Market structure analysis indicates a dualistic system with a highly concentrated upper tier of large manufacturing firms operating behind significant entry barriers, alongside a crowded lower tier of CSIs facing intense competition, thin margins, and limited capacity to scale. As a result, CSIs remain reliant on traditional technologies and domestic demand, while export-oriented growth is confined to a few established industries (MoF, 2025). This structure becomes a binding constraint because linkages between large, medium and small industries remain underdeveloped and missing. Larger firms internalize production and are mostly dependent on imported inputs, while smaller firms operate largely as standalone units, competing for the same domestic market. The absence of concentration, subcontracting, supplier development, and functional specialization limits economies of scale and spillovers across firm sizes.

These structural features are reflected in Bhutan's industrial licensing demography, which provides informative signals about entry, survival, scaling and exit of industries from the market. Licensing trends of production and manufacturing industries show that licensing across all groups has picked up from 2024 levels. Cottage industries have low barriers to entry, as levels of CSI in the specific sector show that production and manufacturing require relatively heavier investment and know-how; however, stable production and market cannot be guaranteed for these cottage industries. A similar trend is observed in small industries, with a growth of 19.02 percent, rebounding from the dip in 2024, reflecting fragile survival in a high-cost environment. In Bhutan's small domestic market, tourism functions as an extension of the industrial market, particularly for cottage and small-scale manufacturing engaged in handicrafts and niche agro-processing. However, these linkages remain shallow and seasonal, limiting opportunities for upgrading or integration into broader value chains.

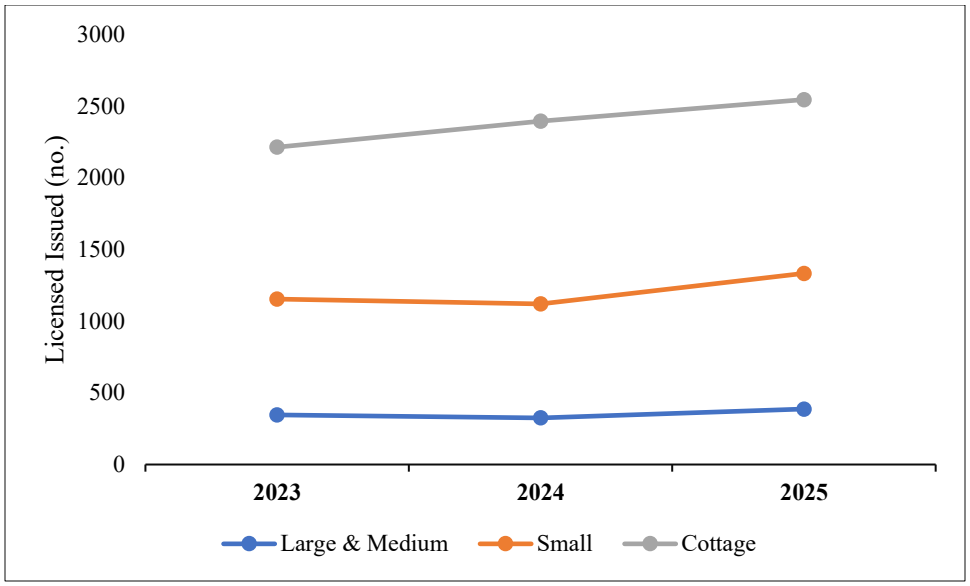


Figure 6.1: Licensing trend for Production and Manufacturing Industries, 2023-2025

While medium and large industries constitute the smallest share of establishments within production and manufacturing, they are more sensitive to policy uncertainty, power tariffs, logistics, credit and market access. Licensing in these categories contracted by 6.07 percent in 2024, but has recorded a jump in 2025, which notes the expansion of medium and large industries, with increasing interest in wood-based industries and increased uptake of industrial park allotments (MoICE, 2025). While these trends indicate a macro-level recovery and an appetite for industrial investment, the current level of information does not allow for detailed sectoral analysis of whether new investments are strengthening domestic supply chains or reinforcing isolated, in-house production structures.

The consequences of weak value-chain integration are most visible in Bhutan's export structure. Despite a rising number of industrial establishments, exports remain dominated by a narrow group of large-scale industries. Excluding electricity, industrial exports are heavily concentrated in heavy material and ferro industries. Between 2023 and 2025, overall export values increased, but with limited structural change in composition. Growth has been driven primarily by ferrosilicon, steel, metals, and mining-related products; all industries characterized by high capital intensity and limited backward linkages to domestic SMEs.

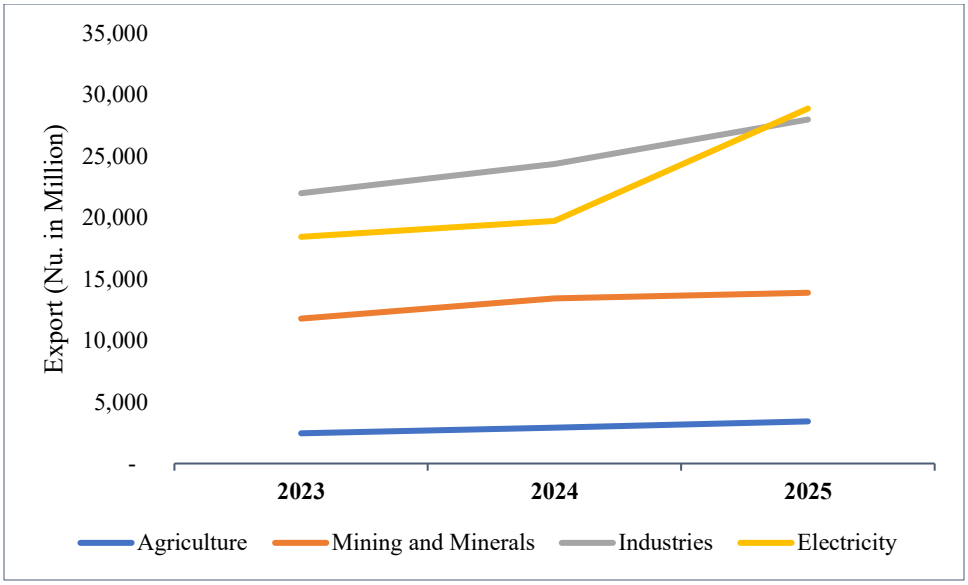


Figure 6.2: Export Growth

Industries engaged in value-added agricultural products stand out as an emerging industry, recording strong growth in exports year-on-year (estimated at approximately 19.70 percent in 2024 and 3.44 percent in 2025). This shows movement towards processing and development in the agricultural value chain, though their scale remains modest relative to mineral-based industries. Similarly, wood and paper products are another emerging sector, with exports rising sharply from 2023 to 2025, reflecting Bhutan's sustainable forest management commitment and increased activity in the forestry and logging sector. Demand from the GMC and domestic markets further highlights the potential for forest-based value chains. In contrast, light manufacturing segments such as garments, plastics and handicrafts remain negligible and volatile, reflecting persistent constraints related to scale, costs, and competitiveness.

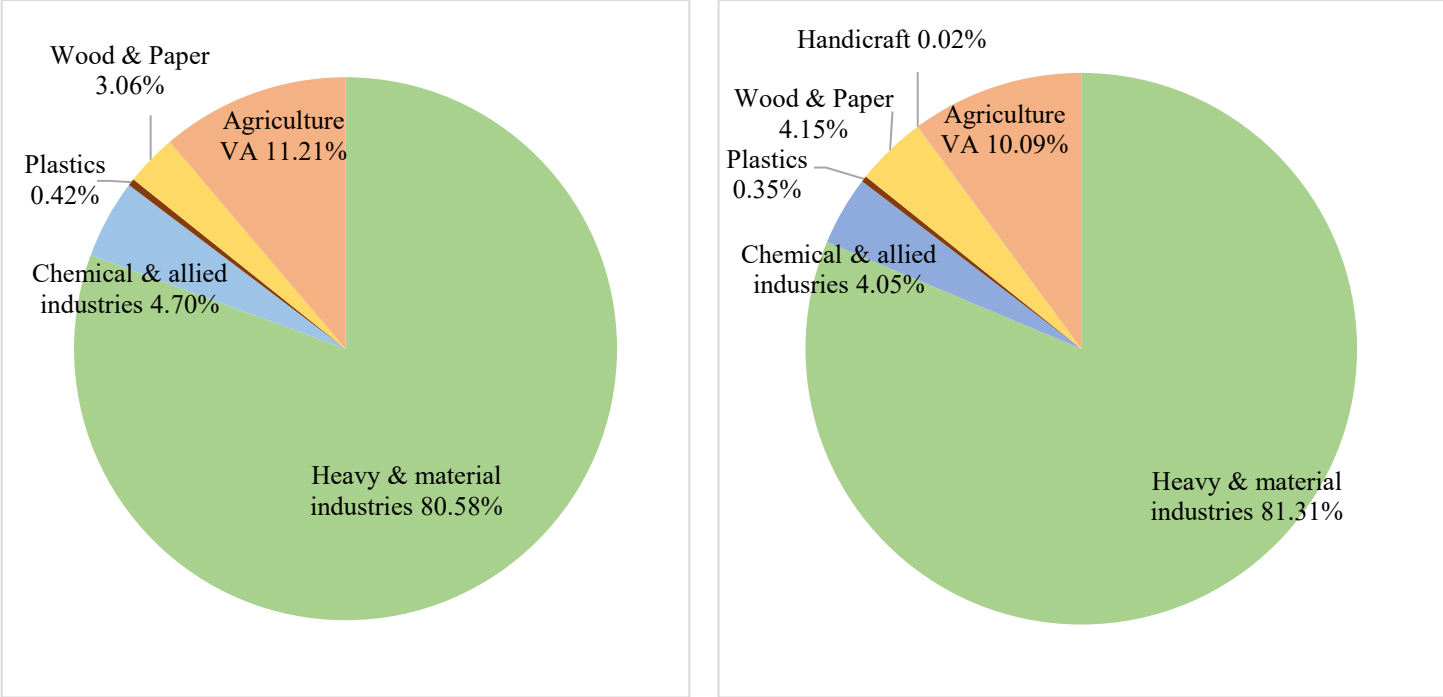


Figure 6.3: Composition of Exports by Industrial Group, 2023 on LHS and 2025 on RHS

Overall, Bhutan's export profile continues to reflect concentration in raw-material, capital and energy-intensive industries that typically operate with limited domestic subcontracting and supplier development. Broader diversification and meaningful participation of CSIs and medium enterprises remain constrained by weak vertical integration and the absence of coordinated value-chain development. Strengthening horizontal linkages among CSIs, by consolidating individual abilities to achieve scale, could improve productivity and competitiveness. At the same time, a mapping of domestic industrial supply and value chain may provide important insight into the development of supporting industries through the viability of strategic vertical de-linking, enabling firms to specialize in core functions while building up supporting supply chains, which could improve industrial linkages while allowing firms to enhance profitability.

Structural weaknesses are further reinforced by domestic market constraints, such as a small domestic market and the nature of consumption, which is mainly towards cheaper imports. While Bhutan’s total market size is estimated to have increased to Nu. 325.363 billion in 2025, demand for products remains limited and shrinking for some sectors, such as Bhutanese textiles, which face heavy competition from cheaper machine-made counterparts. Similarly, contractors have indicated a clear preference for imported construction materials such as HDPE pipes due to concerns related to quality and prices (Kuensel, 2025).

Private consumption is largely met through imports that benefit from scale, quality consistency, and price competitiveness, while government and public sector demand tends to be project-based,

episodic and concentrated in a narrow range of products.[9] As a result, increases in aggregate demand do not transmit into stable demand conditions for domestic producers. This limits the ability of industries to make sound investments, which, paired with limited production scale, heavy upfront investment requirements, and high operational costs, increases the perceived risk of entrepreneurship in the economy. For domestic industries, this translates into difficult market access and heightened competitive pressures.

6.4. Industrial Gross Output and Value Added

While licensing trends show growth in the number of establishments, this has not translated into industrial output or value added. While this is expected to materialize with a lagged effect, it remains critical to review gross output, which is the total production, and value addition by industries as this can provide an indication of whether industries are operating in low-value addition areas or shifting to higher-value addition. Within industry sectors, manufacturing and mining maintained a relatively small and largely stagnant share of value added, indicating limited industrial deepening despite broader economic recovery. As illustrated by Figure 6.4, showing industry share of value added from 1990 to 2023, changes to the structure as a result of emerging industries are yet to be seen.

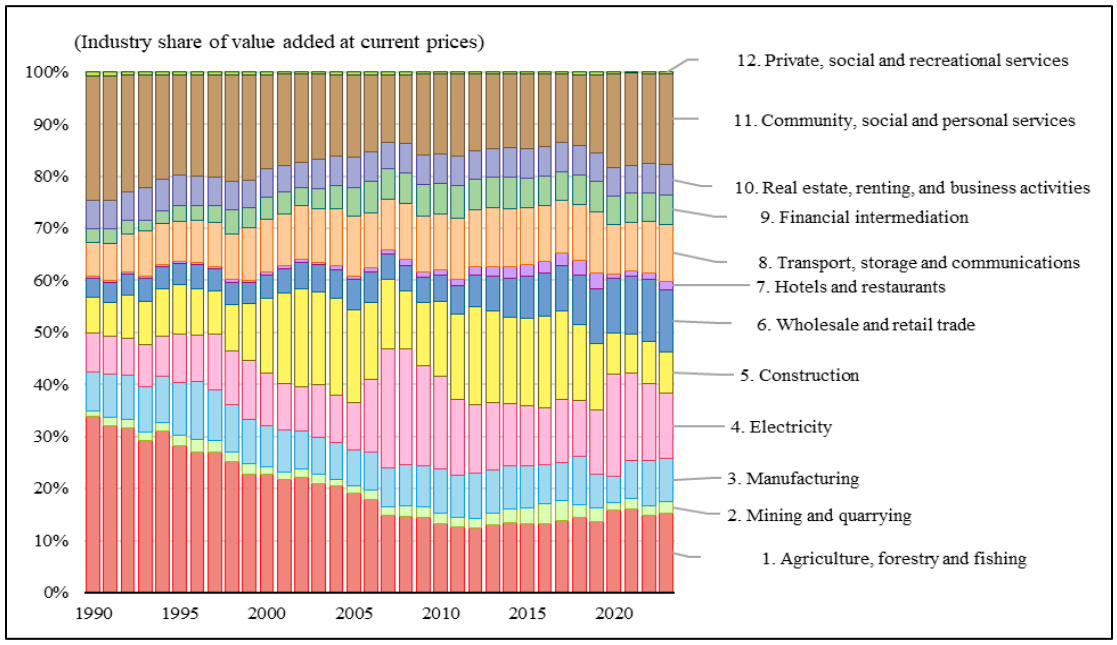


Figure 6.4: Industry Share of Value Added at Current Prices, 1990 - 2023

Based on the Bhutan Productivity Account (BTPA), during 2020-2023, growth in Bhutan's industry sector remained uneven across subsectors. Illustrated in Figure 6.5, the manufacturing sector exhibits a divergence between gross output and value added, with value added rising more sharply than output pre-pandemic but becoming volatile thereafter. The pre-pandemic period is

[9] Public sector demand here refers to organisations run by the government that exist to provide a service for the population and communities.

marked by stagnancy, with output growth softening post-pandemic. This suggests limited scale expansion and reinforces the sector's vulnerability to demand shocks.

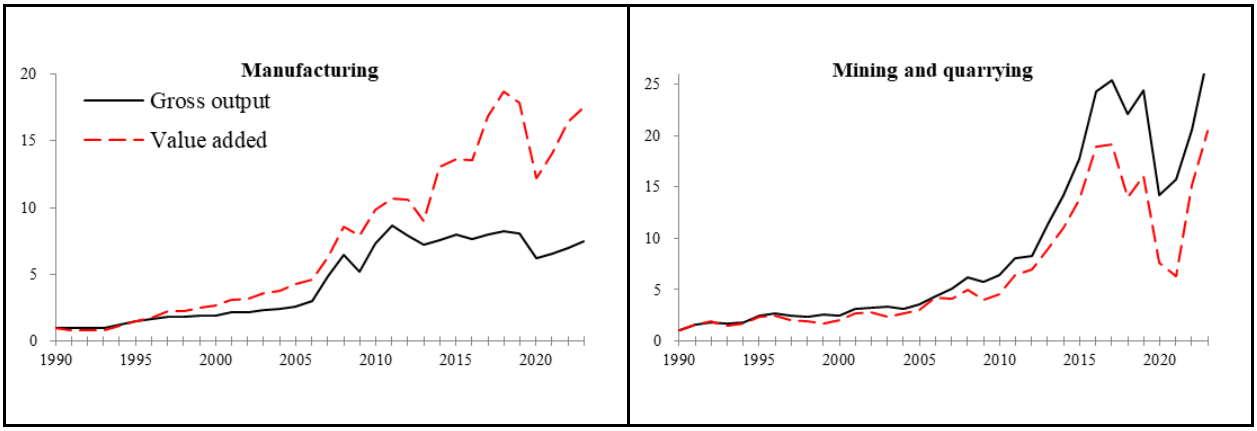


Figure 6.5: Growth in Industry Gross Output and Value Added, 1990 - 2023

Gross output and value added for mining and quarrying display high volatility between 2020 and 2023, with improvements in gross output noted from 2022 onward. The lower level of value added indicates the nature of the final output, which is mostly raw materials. Diversification into higher value-added manufacturing is expected to result in faster growth of value added relative to gross output, with more visible impacts anticipated from the BTPA's update in FY 2027-28.

6.5. Conclusion

Bhutan's industrial sector is at a crucial juncture. While progress in industry uptake and renewed investment interest suggest a recovery in industry activity, deeper structural constraints continue to limit industrial deepening and transformation. These include the missing industrial middle as a result of limited supply and value chain development, logistical costs, scale impediments, and a weak standardization climate. This reduces incentives for firm specialization and subcontracting, preventing the development of production networks and ancillary industries that could support productive growth and industrial upgrading.

In the absence of a robust system of backward linkages and supply chain, disparities between high performing sectors and CSIs are likely to widen. Internalization of production and reliance on imported inputs are expected to constrain positive spillovers, leaving smaller firms constrained to lower-scale production with higher per unit costs, limiting learning opportunities and weak integration into supply chains. Over time, this structure constrains industrial diversification, suppresses gainful employment generation and increases vulnerability to external shocks.

Global and regional trends point toward higher-value, technology-intensive and environmentally aligned industrial growth, exposing the need for Bhutan to strengthen value chain integration, particularly through the building of intermediate industries, standards strengthening, and logistics. These will be central to improving competitiveness and resilience. The Industrial Development Roadmap 2025 provides a strategic framework to address these structural constraints by targeting

ecosystem-level gaps alongside sector-specific bottlenecks, including measures to improve access to affordable finance, facilitate investment and attract FDI, as reflected in the recent FDI policy liberalization in 2025.

Deepening linkages across agriculture, forestry, energy and manufacturing while leveraging Bhutan's clean and cheap energy will be crucial to aligning industrial expansion with sustained productivity growth, employment generation, and export diversification towards successfully achieving the 10X Economic Vision and the Diamond Strategy.

Chapter 7 State-Owned Enterprises

7.1. Introduction

State-Owned Enterprises (SOEs) in Bhutan hold a pivotal position in realizing the Bhutan 10X Economic Vision for economic transformation. With about Nu. 398 billion in assets in 2025, equivalent to 142 percent of GDP, and contributing about 23 percent to national output, SOEs serve as indispensable instruments for achieving the ambitious target of tenfold GDP growth by 2050 (OCASC, 2025). In developing economies, SOEs often function as catalysts for structural transformation, particularly where private sector capacity remains nascent (World Bank, 2020). Research demonstrates that well-governed SOEs can significantly accelerate infrastructure development and enhance service delivery in emerging markets (IMF, 2019). However, realizing their full potential requires robust governance frameworks and performance-oriented management systems (Asian Development Bank, 2021).

Globally, SOEs account for around 20 percent of investment, 5 percent of employment and up to 40 percent of domestic output (International Finance Corporation, 2018). According to recent Fortune Global 500 rankings, in 2024, state-affiliated enterprises account for approximately one-quarter of the world's largest multinational corporations (Fortune, 2024). In developing economies, SOEs continue to play a key role in economic development by ensuring the implementation of government schemes and initiatives and enhancing geo-strategic reach by acquiring strategic assets through targeted investment.

7.2. SOEs in Bhutan

As Bhutan navigates its transformative journey toward achieving a high-income GNH economy, SOEs stand at the nexus of national economic transformation. The 21st Century Economic Roadmap envisions SOEs evolving beyond their traditional role as service providers to become strategic capital catalysts that accelerate Bhutan's economic advancement. This evolution requires a fundamental reconceptualization of SOE mandates – from passive operators to dynamic agents of structural transformation. International experience demonstrates that successful economic transitions in developing nations have been underpinned by strategically deployed state enterprises that create enabling conditions for broader market development (World Bank, 2020).

To fulfill this transformed mandate, Bhutan's SOEs must assume four interconnected strategic roles. First, as capital catalysts, they must deploy infrastructure investments that crowd-in private sector participation, addressing the persistent challenge of limited domestic entrepreneurial capacity (Asian Development Bank, 2022). Second, functioning as market builders, SOEs should establish nascent industries and value chains before strategically transitioning mature operations to private operators, a model successfully employed in Singapore and Malaysia during their developmental phases (Musacchio & Lazzarini, 2014). Third, as innovation anchors, state enterprises must pioneer high-risk ventures aligned with knowledge economy priorities, areas

where private capital remains reluctant to venture, given Bhutan's small market size and geographical constraints (OECD, 2023). Fourth, and perhaps most distinctively, SOEs must serve as sustainability champions, demonstrating empirically that GNH principles and commercial excellence are mutually reinforcing rather than contradictory objectives, thereby positioning Bhutan as a global exemplar of values-based economic development.

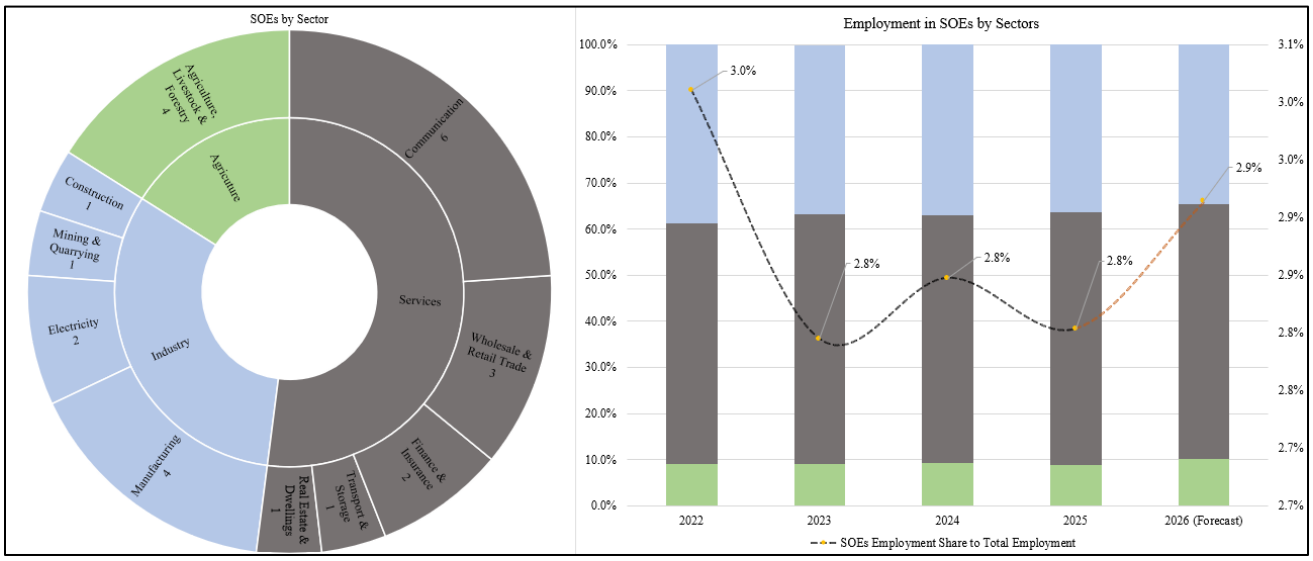


Figure 7.1: Number of SOEs with major shareholding and Employee Composition by sectors

This report covers the 25 SOEs directly under the purview of the MoF and DHI-owned and controlled companies with a direct shareholding of more than 50 percent. SOE employment is projected to reach 11,291 employees by 2026, representing 2.9 percent of national employment, with the employment share highest in the industry sector (more than 50 percent).

7.3. Outlook for 2026

The performance trajectory in 2026 is projected to exhibit characteristics consistent with the "K-shaped" recovery pattern. This phenomenon, extensively documented in recent economic literature, describes an economic environment where different sectors and economic segments experience markedly divergent outcomes; some experiencing robust growth while others face continued stagnation or decline (Dalton et al., 2021; Caliendo et al., 2018). The performance of SOE in various sectors demonstrates this dynamic clearly, with performance variation likely to widen rather than converge. Capital-intensive sectors such as mining, electricity, and finance occupy the ascending trajectory, benefiting from established infrastructure, regulatory stability, and access to capital markets. These advantages compound over time, creating self-reinforcing cycles of growth (Berlingieri et al., 2017). Labour-intensive sectors, including agriculture, construction, and retail trade, are on a downward trajectory, facing structural headwinds of lower capital intensity, fragmented markets, and exposure to external shocks.

Table 7.1: Financial Indicators of SOEs (SOEs with major shareholding) by Sector[10]

Sectors	Year	Efficiency		Productivity			Profitability		
		Fixed Asset Turnover Ratio	Total Assets Turnover Ratio	Gross Income per employee (Nu. in million)	Gross Profit per employee	Labor's Share of Gross Profit (%)	Gross Profit Ratio (%)	Employee Cost / Gross Income (%)	Net Profit Ratio (%)
Agriculture, Livestock & Forestry	2024	1.03	0.46	1.18	0.81	99.63	965.14	33.88	-9.18
	2025	1.46	0.78	2.05	0.82	82.34	48.95	22.41	-1.73
	2026	1.94	1.04	2.77	0.90	46.17	39.57	16.02	1.65
Communication	2024	2.12	0.52	3.26	2.54	58.24	82.30	41.34	13.97
	2025	2.28	0.59	3.50	2.90	52.48	93.26	40.30	8.43
	2026	2.32	0.57	3.35	2.74	51.31	91.49	40.17	10.20
Construction	2024	2.09	0.88	5.06	1.75	46.75	37.58	16.20	3.70
	2025	1.64	0.93	5.21	1.34	62.14	27.88	16.00	-1.92
	2026	2.12	1.21	6.75	2.23	37.53	33.31	12.37	2.99
Electricity	2024	11.48	0.36	11.92	8.02	14.29	65.88	6.61	21.92
	2025	13.03	0.32	11.80	8.37	12.16	66.60	5.98	25.00
	2026	13.02	0.36	11.92	7.95	11.91	66.37	5.83	22.07
Finance & Insurance	2024	10.51	0.07	8.03	3.80	27.99	48.93	10.60	13.33
	2025	13.99	0.07	8.98	4.50	20.70	57.97	9.59	16.21
	2026	12.00	0.07	9.58	4.83	20.69	58.69	9.93	19.38
Manufacturing	2024	1.78	0.84	3.44	1.79	42.63	53.92	22.68	0.11
	2025	1.85	0.92	4.00	1.98	39.35	53.52	20.91	6.74
	2026	2.29	1.15	4.58	2.39	32.91	54.49	18.33	8.66
Mining & Quarrying	2024	8.01	1.33	12.95	9.33	6.60	72.62	4.76	34.85
	2025	7.74	1.51	14.10	9.84	5.87	69.96	4.10	35.38
	2026	8.02	1.57	13.99	10.02	6.49	71.64	4.65	39.74
Real Estate & Dwellings	2024	1.27	0.06	1.71	1.61	37.90	134.13	35.70	14.12
	2025	1.39	0.06	1.84	1.77	38.37	133.40	37.09	13.10
	2026	1.61	0.07	2.41	2.21	46.87	168.52	43.06	10.63
Transport & Storage	2024	0.88	0.59	10.60	6.48	19.98	64.98	12.21	3.66
	2025	1.10	0.64	12.77	7.67	17.98	61.58	10.80	11.67
	2026	1.16	0.67	13.36	7.66	18.00	58.59	10.32	8.99
Wholesale & Retail Trade	2024	9.84	3.04	15.79	1.21	40.26	8.19	3.23	0.91
	2025	11.16	4.11	22.19	1.78	32.71	8.49	2.76	1.12
	2026	12.46	4.61	22.48	1.81	28.75	8.43	2.42	1.18

The mining and quarrying sector is expected to maintain strong performance, with a net profit ratio of 39.94 percent and improved productivity. The electricity sector will continue robust performance, with a gross profit ratio of 66.37 percent while keeping labour's share of gross profit at 11.91 percent, reflecting high capital efficiency. The finance and insurance sector shows a fixed asset turnover of 12.00 with a labour share of gross profit at 20.69 percent, indicating moderate productivity gains driven by digital transformation. The communication sector will recover to a net profit ratio of 10.20 percent in 2026, up from 8.43 percent in 2025. The manufacturing sector is expected to improve, with a net profit ratio of 8.66 percent and a fixed asset turnover ratio of 2.29, reflecting enhanced capital efficiency. The transport and storage sector projects a net profit ratio of 8.99 percent, with marginally higher gross income per employee. The construction sector will achieve modest recovery with a net profit ratio of 2.99 percent, improving from negative profitability in 2025.

[10] Financial data for 2024 is sourced from the audited report, while data for 2025 is unaudited and for 2026 is derived from the business plans submitted by SOEs.

The primary sector, particularly agriculture, livestock and forestry, is projected to achieve a positive net profit ratio of 1.65 percent and improved fixed asset turnover to 1.94, indicating progress through business process re-engineering. The agriculture sector's movement to positive profitability represents a critical inflection point requiring sustained support for mechanization, value chain development, and market access. Wholesale and retail trade will maintain minimal profitability at 1.18 percent despite high asset turnover ratios of 4.61 for total assets. Real estate and dwellings are projected to show a net profit ratio of 10.63 percent.

Across industries, the labour share of gross profit is either declining or remains stable at relatively low levels. This indicates that output growth is primarily driven by capital injection and capital-intensive activities rather than labour productivity gains. The pattern is evident across sectors, with mining and quarrying showing labour's share at only 6.49 percent, electricity at 11.91 percent, and finance at 20.69 percent. Even in labour-intensive sectors, the share remains constrained, with agriculture at 46.17 percent and construction at 37.53 percent. This capital-driven growth model raises sustainability concerns, particularly as capital productivity in the economy has been declining. The divergence in productivity metrics reveals a fundamental structural challenge.

High-performing sectors generate higher gross profit per employee, while challenged sectors produce significantly lower returns. The ten-fold differential reflects deep structural variations in capital intensity, technology adoption, and market dynamics. Research suggests that such productivity gaps tend to widen without targeted interventions, as high-productivity sectors reinvest surpluses in further improvements while low-productivity sectors struggle with resource constraints (Berlingieri et al., 2017). Sectoral productivity differentials amplify through inter-sectoral linkages, extending beyond direct effects to influence broader economic structures (Caliendo et al., 2018). Moreover, persistent structural constraints, especially transport bottlenecks, inefficient SOEs, and insufficient job creation, will continue to impede economic activity.

7.4. Evolution of Dividend Share

The evolution of dividend contributions from SOEs over the past two decades reveals a fundamental structural transformation in the nation's economic base. During the initial period from 2008 to 2016, the hydropower sector dominated dividend generation, averaging 87.77 percent of total SOE dividends and peaking at 95.65 percent in 2009, reflecting the economy's overwhelming reliance on electricity exports as the primary revenue source. However, recognizing that hydropower's capital-intensive nature limits job creation and employs less than 1 percent of the labour force, Bhutan has embarked on an intentional diversification strategy to expand non-hydro industries and private sector participation. This strategic reorientation manifested tangibly in dividend patterns from 2017 onwards, with the non-hydropower sector's share rising significantly from 12.23 percent (2008-2016 average) to 32.73 percent (2017-2024 average), eventually achieving parity with the hydropower sector. This marks a positive shift towards mitigating

sectoral concentration risk. However, the hydro sector is still projected to contribute over half of total dividends, underscoring the need for continued diversification efforts.

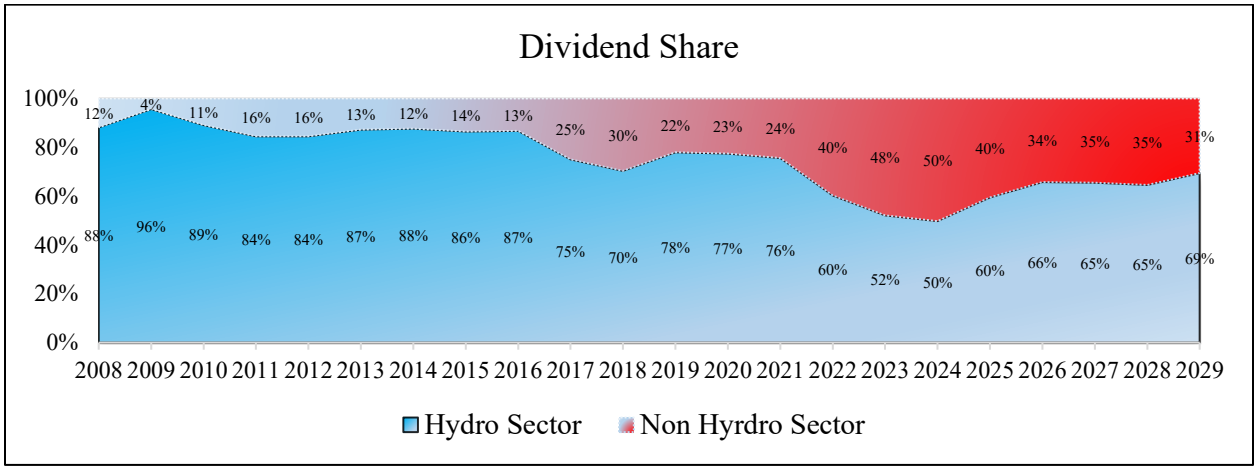


Figure 7.2: Dividend share by Hydro and Non-Hydro Sectors

The diversification of the dividend base reflects broader sectoral maturation across Bhutan's SOE landscape, driven by strategic investments in telecommunications, financial services, mining, manufacturing, and emerging industries. This diversification is critical given that over-reliance on hydropower has hampered economic resilience and job creation, with the sector's capital expenditure generating minimal direct spillover effects on the non-hydro economy. The trajectory toward balanced dividend generation aligns with international practices, emphasizing that economic diversification is crucial to increase resilience, generate quality employment opportunities, and sustain long-term growth in small economies vulnerable to external shocks. Sustaining this diversification momentum will require continued reforms to governance frameworks, operational efficiency improvements, and the strategic allocation of hydropower rents to long-term investments in productive non-hydro sectors rather than current consumption.

7.5. The Dual Mandate Challenge

The imposition of multiple non-commercial objectives on state enterprises, ranging from employment maintenance in politically sensitive regions to ensuring affordable access to essential services, creates inherent friction between developmental imperatives and commercial viability, tensions that scholars argue represent the central governance challenge in mobilizing public enterprise capacity for both economic efficiency and broader societal transformation (Chang, 2007). Unlike in the private sector, where market discipline imposes hard budget constraints that compel firms to adjust to unfavorable circumstances through cost reduction, quality improvement and entrepreneurial innovation, SOEs often operate under soft budget constraints wherein the expectation of government bailouts weakens incentives for productive efficiency and shields loss-making operations from competitive pressure (Kornai et al., 2003). The cumulative effect is that many SOEs struggle to meet the dual imperatives of commercial sustainability and social mandate fulfillment, creating what Kornai describes as a fundamental tension where "the soft budget

constraint protects the old production line, the inefficient firm against constructive destruction and thus impedes innovation and development." (Kornai, 1986, p. 17).

The governance asymmetry manifests in operational inefficiencies across multiple dimensions: weak implementation of best management practices leading to lower productivity and project delays, accountability gaps in employee and project monitoring, insufficient investment in research and development and technology adoption, manpower imbalances characterized by simultaneous overstaffing and critical skill shortages, and limited competitive orientation as evidenced by preference for nominated projects over competitive bidding processes (OECD, 2024). However, these efficiency challenges do not negate the potential catalytic role that well-governed SOEs can play in economic transformation, particularly where capital markets remain underdeveloped, and infrastructure gaps constrain private investment (Chang, 2007). The challenge is not whether to maintain state enterprise but rather how to structure governance frameworks that harness SOE capacity as catalysts for broader economic transformation through strategic investment in sectors with positive spillovers, coordination of complementary investments that private actors would undervalue and provision of patient capital for high-risk ventures with long gestation period while simultaneously ensuring commercial discipline prevents the accumulation of contingent fiscal liabilities that could undermine macroeconomic stability (Megginson & Netter, 2001).

7.6. Conclusion

The productivity differential in SOEs underscores structural divergence, reinforcing K-shaped performance observed across sectors that transcend cyclical variation as a result of systematic differences in capital intensity, market structure and the distribution of soft budget constraint vulnerabilities. High-performing capital-intensive sectors like mining, electricity and finance demonstrate self-reinforcing growth dynamics driven by established infrastructure and regulatory stability, while labour-intensive enterprises face compounding challenges of fragmented markets, skill mismatches, and exposure to external shocks. This bifurcation creates a paradox: the sectors generating the highest fiscal returns contribute minimally to employment and inclusive development, while those bearing the greatest social mandate struggle with commercial viability despite their centrality to equitable growth objectives.

The sustainability of this divergent trajectory depends critically on policy interventions. Without corrective measures, the gap risks becoming entrenched, with high-performing sectors pulling further ahead while challenged sectors fall further behind. The challenge is not merely improving the aggregate SOE performance but fundamentally restructuring the relationship between capital deployment, labour productivity and value creation to align with GNH principles. The dual mandate dilemma of balancing commercial viability with development obligations manifests differently across the portfolio in ways that demand differentiated governance responses rather than uniform reform. Moving forward, Bhutan's SOE reform must transcend the incremental improvements in profitability and operational efficiency to address foundational institutional deficits. The challenge is managing the diverging trend to harness high-performing sector

dynamism while preventing marginalization of those facing difficulties, ensuring that various sectoral SOEs contribute effectively to national development goals.

Chapter 8 Sources of Growth

8.1. Introduction

Productivity performance in 2023 provides critical insights into the evolving structure and resilience of Bhutan's economy as it emerges from the post-pandemic period. This chapter examines the drivers of economic growth, situating recent outcomes within the longer-term productivity trends observed over 1990-2023 using the BTPA.[11]

While Bhutan has achieved relatively strong long-term labour productivity growth, recent developments indicate increasing sectoral divergence. In 2023, the economy experienced a marked slowdown in labour productivity growth, alongside continued declines in capital productivity and a sharp contraction in TFP in several capital-intensive sectors. At the same time, selected sectors – particularly mining and quarrying, tourism-productivity gains, reflecting post-pandemic normalization and cyclical recovery effects. By highlighting recent sectoral dynamics, the chapter aims to identify both emerging opportunities and persistent structural constraints that will shape Bhutan's medium-to-long-term growth trajectory.

8.2. Growth Drivers

Over the period 1990-2023, total output growth, as estimated by the BTPA, averaged 6.3 percent. This growth has been largely capital-intensive, with capital input growing at 9.2 percent while accounting for only 6.6 percentage points of national aggregate growth. Of the three main drivers of economic growth, the Average Labour Productivity (ALP) grew at 5.2 percent per year between 1990 and 2023. On the other hand, the Average Capital Productivity (AKP) declined at 2.9 percent annually. The total factor productivity has been stagnating, averaging -0.3 percentage points per year in terms of its contribution to the national aggregate, as illustrated in Figure 8.1.

[11] The BTPA 2025 spanning 1990 to 2023 is developed in collaboration with Keio University, Japan and is updated annually.

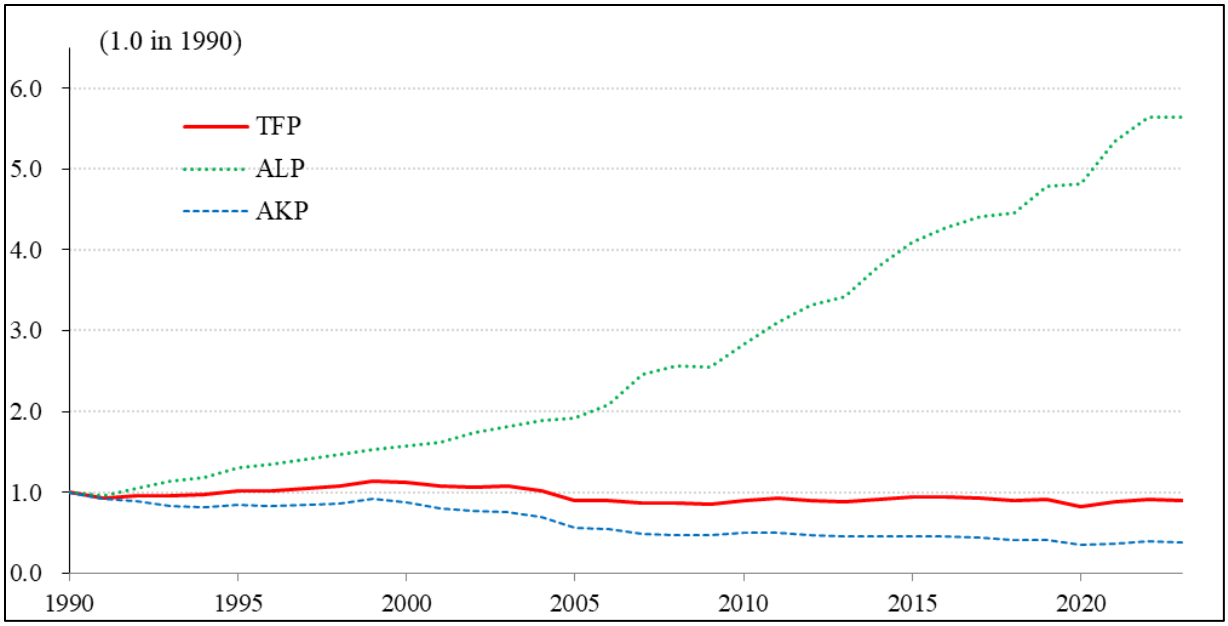


Figure 8.1: Aggregate Productivity, 1990-2023

Looking at the industry origins of growth across different sectors, as illustrated in Figure 8.2, most sectors exhibit increasing average labour productivity (ALP) between 1990 and 2023, with the exception of hotels and restaurants. Nevertheless, labour productivity growth in the tourism sector showed a marked improvement in 2023, recording an ALP growth of 37.89 percent. Despite this improvement, the sector displays relatively high volatility in both ALP and AKP compared to other sectors, largely reflecting the effects of the capital cycle.

In the electricity sector, AKP has been on a declining trend, and ALP also registered a decline in 2023. The BTPA currently measures electricity capital stock on an installed-capacity basis, and it is anticipated that in future updates, with the full commissioning of PHPA-II and other delayed hydropower projects, may lead to a further decline in capital productivity, given their high capital costs.

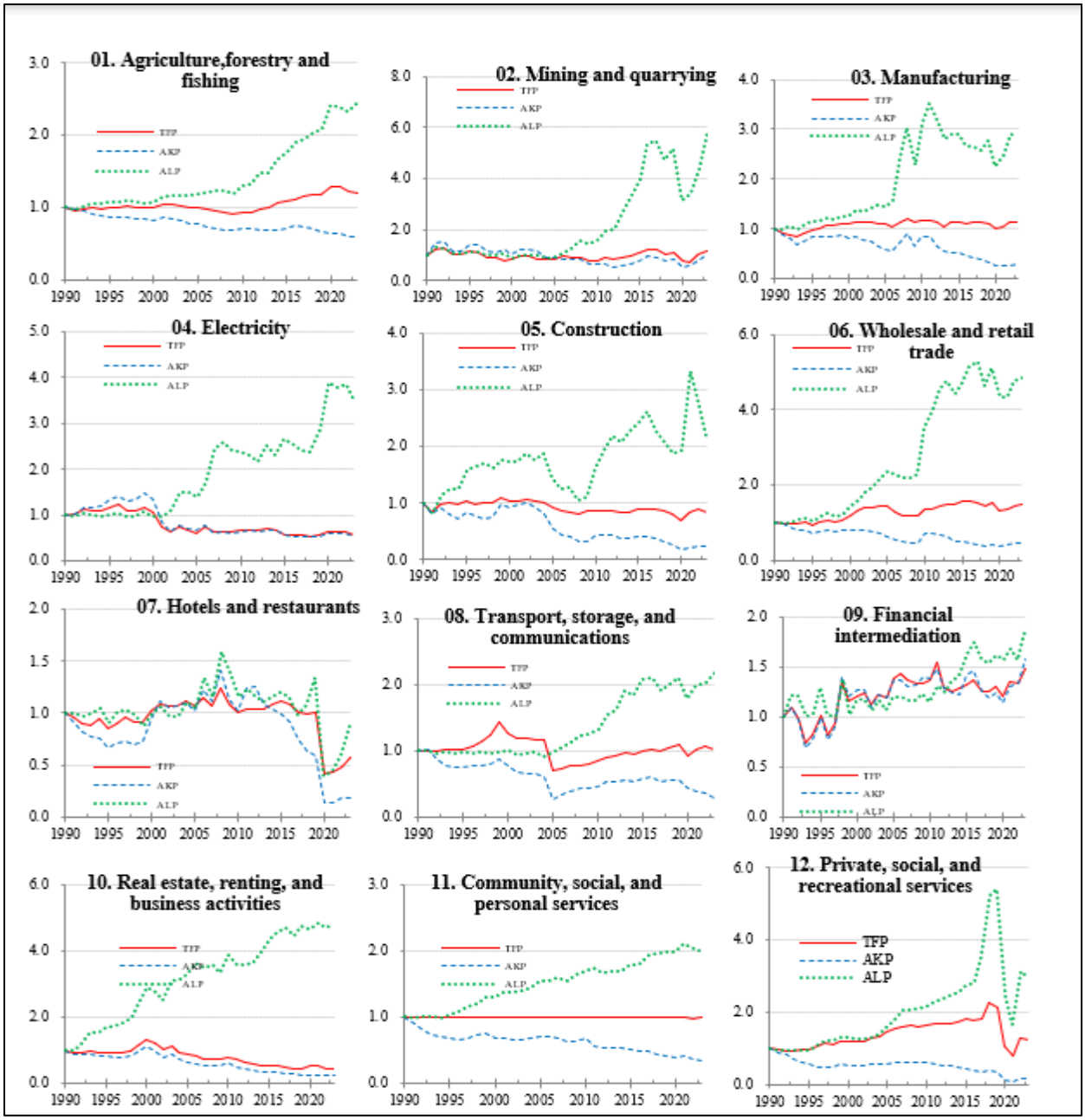


Figure 8.2: Industry-level productivity, 1990-2023

8.3. Labour Productivity

Labour productivity growth is defined as the amount of real production (GDP) per hour worked. ALP grew at 5.2 percent annually between 1990 and 2023. In line with the slowdown in the economy recorded in 2023, the labour productivity growth fell from 5.5 percent in 2022 to virtually zero in 2023.

Table 8.1: Average Labour Productivity Growth by Sector[12]

	Unit: Percent (Average annual growth rate based on natural logarithm)	1990-2008	2009-2019	2020-2023	2021	2022	2023	1990-2023
1	Agriculture, livestock, and forestry	1.12	4.81	4.08	-1.12	-2.01	4.53	2.71
2	Mining and quarrying	2.47	10.89	3.24	8.06	24.32	29.97	5.37
3	Manufacturing	6.17	-0.86	0.93	8.54	15.80	-0.87	3.19
4	Electricity	5.27	0.97	4.73	-2.39	1.46	-10.56	3.77
5	Construction	0.29	5.29	3.73	54.64	-16.42	-25.69	2.38
6	Wholesale and retail trade	4.38	7.70	-1.29	0.35	8.95	2.15	4.80
7	Hotels and restaurants	2.56	-1.50	-10.77	10.19	30.90	37.89	-0.41
8	Transportation and communication	1.11	4.99	0.62	10.33	2.15	6.63	2.34
9	Finance and insurance	0.88	2.89	3.40	7.54	-7.32	16.29	1.86
10	Real estate, renting, and business activities	7.08	2.54	0.37	4.00	-2.12	1.67	4.75
11	Community, social, and personal services	2.44	2.18	0.08	5.66	-3.24	-2.45	2.07
12	Private, social, and recreational services	4.08	8.71	-15.29	-37.97	63.78	-5.73	3.27

In the electricity sector, labour productivity grew at an average annual rate of 3.77 percent over the period 1990–2023. Among non-electricity sectors, the strongest labour productivity growth was recorded in mining and quarrying (5.37 percent), wholesale and retail trade (4.80 percent), and real estate, renting, and business activities (4.75 percent), as shown in Table 8.1. Manufacturing also recorded moderate productivity growth, averaging 3.19 percent over the same period. In contrast, hotels and restaurants were the only sector to record a decline in ALP over the long term, contracting by 0.41 percent annually, with losses intensifying during 2020–2023 when productivity declined sharply by 10.77 percent, reflecting the severe impact of the pandemic.

Year-on-year productivity growth shows a mixed and uneven recovery across sectors. In 2023, a strong ALP was observed in the mining and quarrying (29.97 percent) from 24.23 percent in 2022. While the ALP in the hotels and restaurants between 1990 and 2023 remains negative, an improvement is recorded on a year-on-year comparison, with labour productivity growth of 37.89 percent in 2023 compared to 30.90 percent in 2022, as tourism makes a gradual recovery towards a pre-pandemic level, indicating a sustained post-pandemic rebound in tourism-related activities. Agriculture, livestock, and forestry saw a turnaround, shifting from a contraction of 2.01 percent in 2022 to growth of 4.53 percent in 2023, likely reflecting the targeted investment going towards the agriculture sector. Transportation and communication similarly strengthened, with productivity growth increasing from 2.15 percent to 6.63 percent over the same period.

[12] The industry-level ALP is defined as constant-price gross output per hour worked

In contrast, several sectors experienced a deterioration in labour productivity performance in 2023. Manufacturing slipped into contraction, declining from 15.80 percent growth in 2022 to -0.87 percent in 2023, while electricity productivity fell sharply from 1.46 percent to -10.56 percent, reflecting operational and capacity-related constraints. Construction recorded a deeper contraction in 2023 (-25.69 percent) compared to 2022 (-16.42 percent), highlighting ongoing volatility in the sector.

Overall, the comparison between 2022 and 2023 highlights a divergence across sectors, with resource-based and tourism-related activities driving productivity gains, while capital-intensive and construction-related sectors continued to face headwinds.

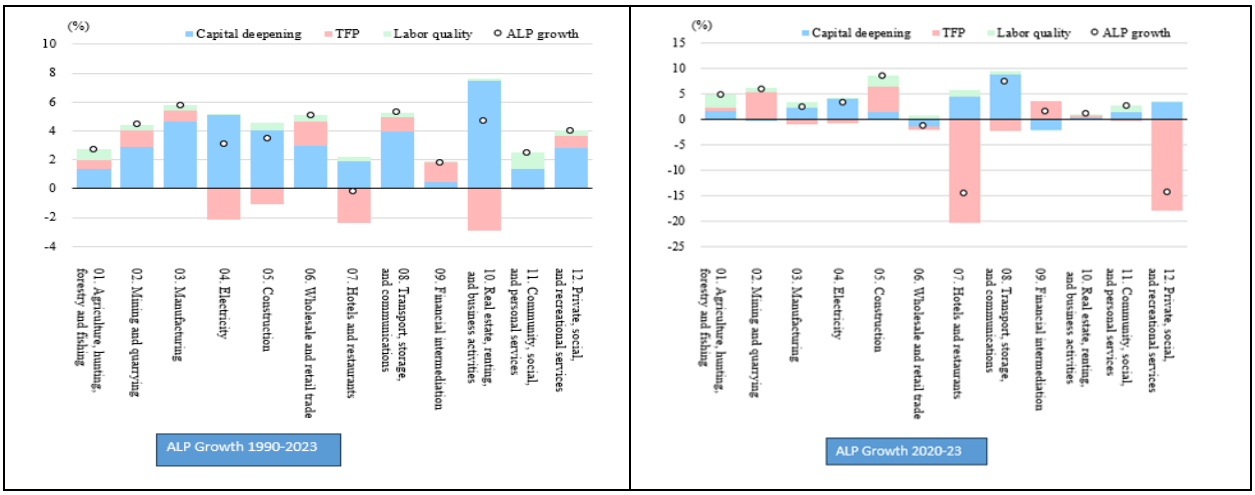


Figure 8.3: Sources of labour productivity growth by industry

The decomposition of labour productivity growth indicates that, over the period 1990–2023, productivity gains across all sectors have been driven primarily by capital deepening, while the contribution of Total Factor Productivity (TFP) has remained limited. During 2020–2023, this pattern largely persisted across most sectors, except for wholesale and retail trade and financial intermediation. In this latter period, labour productivity growth in mining and quarrying, construction, and financial intermediation was supported by positive TFP growth. In particular, the mining and quarrying sector recorded an improvement in the TFP contribution to labour productivity in 2023 compared to 2022.

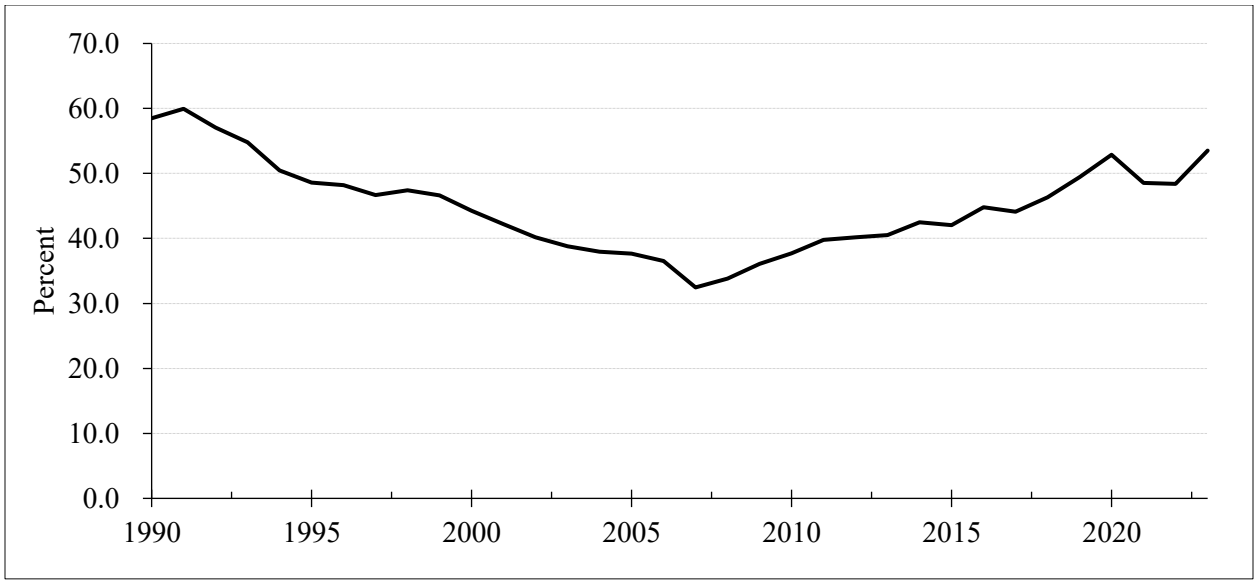


Figure 8.4: Trends in Labour Income Share

The labour income share improved from 48.38 percent in 2022 to 53.49 percent in 2023, as illustrated in Figure 8.4, indicating gains in labour incomes. Nonetheless, the labour share remains well below its historical peak of 60 percent in 1990 and continues to lag behind levels observed in advanced economies.

8.4. Capital Productivity

The declining capital productivity remains a challenge for Bhutan, which declined at 2.9 percent annually between 1990 and 2023. During the period, the capital input growth of 9.2 percent exceeded the output growth of 6.3 percent. Capital contributed 6.6 percentage points to growth. The declining capital productivity is also attributed to a high level of Capital Output Ratio (COR). The nominal capital stock in 2023 stood at Nu. 965,784.242 million as detailed in Annexure II. The nominal capital stock in 2023 is equivalent to 3.9 times the GDP in current prices. This implies a requirement of 3.9 units of investment to generate one unit of output in 2023. The ratio remains high, reflecting the inefficiencies in the investment structure.

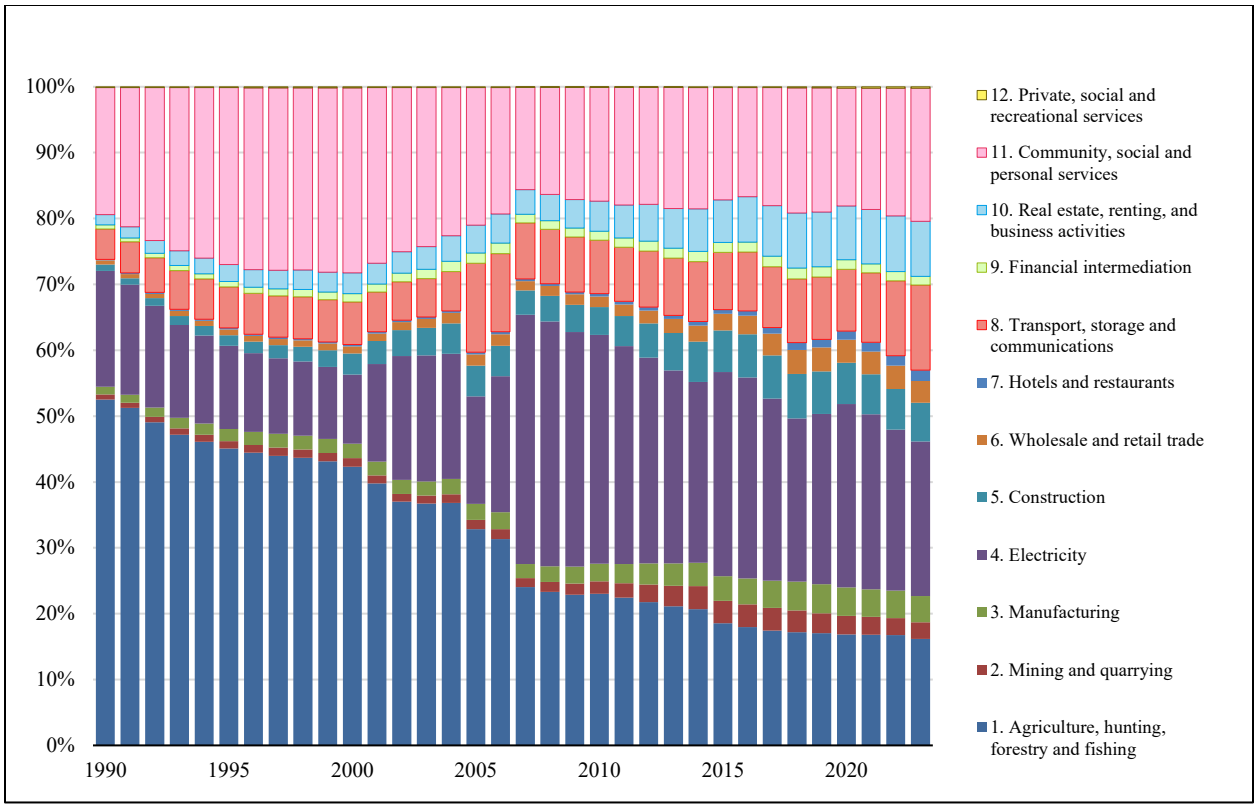


Figure 8.5: Share of capital stock by sector

The declining trend in agriculture's share of the capital stock continues, falling slightly to 16.19 percent in 2023 from 16.75 percent in 2022. In contrast, the share of capital allocated to hotels and restaurants, transport and communication and community, social and personal services indicate a gradual reallocation of investment toward service-oriented activities.

Capital productivity declined across all sectors of the economy over the period 1990-2023 except for positive growth in finance and insurance (1.38 percent) and a marginal growth in mining and quarrying (0.06 percent). The steepest declines were observed in hotels and restaurants (-5.18 percent), private, social, and recreational services (-5.59 percent), construction (-4.43 percent), and manufacturing (-3.74 percent). While the manufacturing sector continues to exhibit declining long-run AKP, raising concerns given its strategic importance, recent trends show some improvement. Capital productivity in the manufacturing sector strengthened, with capital productivity growing at 5.28 percent in 2023 compared to 3.98 percent in 2022, indicating the need for this to be sustained given its potential to generate gainful employment.

Table 8.2: Capital Productivity Growth by Sectors[13]

	Unit: Percent (Average annual growth rate based on natural logarithm)	1990-2008	2009-2019	2020-2023	2021	2022	2023	1990-2023
1	Agriculture, livestock, and forestry	-2.05	-0.00	-2.58	-1.74	-7.43	1.89	-1.55
2	Mining and quarrying	-0.90	0.00	4.10	13.25	26.36	29.25	0.06
3	Manufacturing	-0.62	-0.09	-3.72	4.99	3.98	5.28	-3.74
4	Electricity	-2.54	-0.02	0.42	-2.46	-0.14	-9.79	-1.87
5	Construction	-6.26	-0.02	-3.01	10.20	16.33	-7.60	-4.43
6	Wholesale and retail trade	-4.29	-0.01	2.71	8.11	10.65	4.56	-2.35
7	Hotels and restaurants	1.92	-0.08	-29.26	-3.52	27.31	1.40	-5.18
8	Transportation and communication	-4.65	0.02	-15.86	-9.40	-5.75	-22.45	-3.63
9	Finance and insurance	1.52	-0.01	6.09	12.75	2.33	16.72	1.38
10	Real estate, renting, and business activities	-3.48	-0.06	-0.06	3.82	-1.05	4.23	-3.95
11	Community, social, and personal services	-2.53	-0.04	-5.86	0.63	-7.66	-11.85	-3.33
12	Private, social, and recreational services	-2.71	-0.05	-20.95	-39.64	54.40	-0.39	-5.59

The performance in 2023 vis-à-vis 2022 indicates a mixed performance across sectors, with notable improvements in resource-based and service-oriented activities, while several capital-intensive and transport-related sectors experienced renewed contractions. The electricity sector showed a further decline in capital productivity, from a declining growth of -0.14 percent in 2022 to -9.79 percent. Construction sector capital productivity contracted sharply, from a positive growth of 16.33 percent to -7.60 percent in 2022.

8.5. Total Factor Productivity

The TFP, typically calculated as a ratio of aggregate output to aggregate input, measures the efficiency in the economy. TFP growth, estimated as a residual, is output growth that is not explained by growth in labour and capital inputs. Its growth implies efficiency gains in the economy and improved resource allocation, while stagnation signifies inefficiencies and reliance on input-driven growth.

[13] Industry-level AKP is defined as real gross output per capital service

Table 8.3: TFP Growth by Sectors

	Unit: Percent (Average annual growth rate based on natural logarithm)	1990-2008	2009-2019	2020-2023	2021	2022	2023	1990-2023
1	Agriculture, livestock, and forestry	-0.42	2.19	0.56	-0.28	-5.72	-0.78	0.57
2	Mining and quarrying	-0.37	1.28	2.33	-8.02	35.87	13.06	0.51
3	Manufacturing	0.95	-0.55	0.37	5.23	7.08	0.97	0.38
4	Electricity	-2.37	-1.30	-0.55	0.02	-0.71	-13.80	-1.79
5	Construction	-1.12	-0.11	1.07	16.80	5.80	-4.53	-0.52
6	Wholesale and retail trade	0.90	2.29	-0.56	2.26	7.89	2.10	1.19
7	Hotels and restaurants	1.21	-1.86	-14.34	3.07	11.13	17.02	-1.70
8	Transportation and communication	-1.32	2.94	-1.33	9.07	5.32	-4.56	0.10
9	Finance and insurance	1.62	-0.22	3.15	10.14	-0.70	10.44	1.19
10	Real estate, renting, and business activities	-1.63	-4.70	0.43	1.81	-15.89	-0.68	-2.40
11	Community, social, and personal services	0.00	-0.01	-0.01	-0.03	-0.05	0.02	-0.00
12	Private, social, and recreational services	2.69	2.56	-13.76	-29.74	47.29	-2.22	0.65

Industry-level TFP continues to reveal stagnating TFP growth in both electricity and non-electricity sectors. Sectors such as electricity (-1.79 percent), construction (-0.52 percent), hotels and restaurants (-1.70 percent) and real estate (-2.40 percent) continue to experience negative TFP growth. Some of the sectors, like construction, hotels and restaurants, have potential for job creation, but the result in TFP decline raises concerns about driving growth in the long run. On the other hand, another high-potential sector, manufacturing, has seen some TFP growth but remains minimal at 0.38 percent.

The performance in 2023 vis-à-vis 2022 indicates a similar performance in capital productivity. The TFP growth in the electricity sector fell sharply from -0.71 percent in 2022 to -13.80 percent in 2023, while the construction sector saw a decline of -4.53 percent. On the other hand, hotels and restaurants saw a positive growth of 17.02 percent as tourism gradually recovers.

Regional comparisons indicate that TFP growth in Bhutan remains below that of most South Asian economies and is on par with Nepal and Bangladesh in 2023. The average TFP growth gap relative to India narrowed slightly to about 2.3 percentage points per year over the period 1990–2023, compared to 2.7 percentage points over 1990–2022. Despite this modest improvement, the persistent productivity gap remains a concern for Bhutan's price competitiveness in export markets, particularly in the manufacturing and agriculture sectors, with the gap remaining above 2 percentage points.

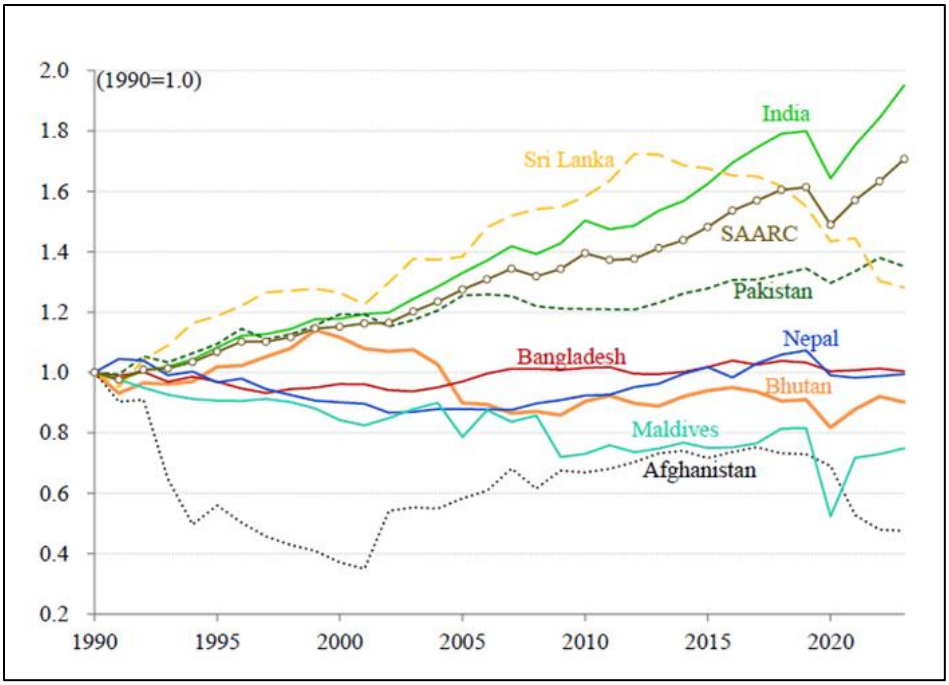


Figure 8.6: TFP In South Asian Economies

Source: Nomura (2025)

While Bhutan records the lowest average growth in capital productivity in the region, it exhibits the highest labour productivity growth. Closing the overall productivity gap is therefore imperative to enhance competitiveness and sustain long-term growth.

8.6. Conclusion

The productivity outcomes observed in 2023 underscore both the strengths and vulnerabilities of Bhutan's growth model. While overall labour productivity growth weakened sharply in line with the broader economic slowdown, significant improvements were recorded in mining and quarrying and tourism-related sectors, reflecting a recovery in external demand and normalization of activity following the pandemic. The rise in labour income share in 2023 further suggests a partial rebalancing toward labour, with positive implications for household incomes and inclusiveness.

However, the year also exposed persistent challenges. The AKP deteriorated further in key capital-intensive sectors, notably electricity, construction, and transport and communication, reflecting high capital costs, underutilized capacity, and investment inefficiencies. Most critically, TFP declined sharply in 2023, particularly in the electricity and construction sectors, indicating worsening efficiency and weak technological or organizational improvements. These developments reinforce concerns that recent growth remains heavily input-driven and vulnerable to diminishing returns on capital.

Overall, the 2023 experience highlights the urgency of shifting toward a more productivity-led growth path. Strengthening investment efficiency, improving project sequencing and capacity

utilization, enhancing skills and firm-level capabilities, and fostering innovation and competition—particularly in manufacturing and tradable services related to tourism supplies—will be essential to reverse the decline in capital productivity and revive TFP growth. Without such reforms, the country's ability to sustain growth, improve competitiveness, and narrow productivity gaps with regional peers will remain constrained. The need to align productivity with the diamond strategy calls for accelerated implementation of productivity-enhancing policies.

Chapter 9 Thematic Research Outcome Summary

In addition to the function of surveillance, forecasting and simulation of the economy, the Macro-Fiscal Policy Division also conducts various research and policy reviews for facilitating evidence-based decision making to keep the economy on track to achieve the Diamond strategy and 10X Economic Vision. This chapter presents the following research on the following five topics:

1. Bhutan's comparative advantage: insights from revealed comparative advantage indices
2. Empirical analysis on the relationship between money supply and economic growth in Bhutan
3. October 4th rainfall impact on the economy
4. Development of the overlapping generations model – Druk Dungkhar Model.
5. IS-LM-BP model for Bhutan

The summary of the above papers is presented in the following section:

9.1. Bhutan's Revealed Comparative Advantage

Author: Chimi Dema and Pema Wangdi
Year: 2025
Summary

Bhutan's trade competitiveness was computed using the export-based Revealed Comparative Advantage (RCA) and net-export-based RCA index based on the framework of Balassa and Noland (1985). It computes the export-based RCA and net export-based RCA index over the period 2016 to 2023 using the HS 2-digit and 4-digit level data from UN Comtrade Database to identify the sectors and products that exhibit comparative advantage.[14] By using two RCA measures and a disaggregated product classification, the study provides a systematic and transparent assessment of Bhutan's trade structure, while acknowledging the limitations of the RCA as a post-trade and descriptive indicator. The study's central contribution lies in narrowing the focus for priority sectors in drafting strategies.

The RCA analysis indicates that Bhutan's export competitiveness remains highly concentrated in a narrow range of products, with a gradual erosion in the breadth of sectors exhibiting comparative advantage between 2016 and 2023. Both export-based RCA (RCA 1) and net export RCA (RCA 2) show a decline in the number of HS chapters with comparative advantage over time, reflecting increasing concentration and limited diversification. Persistent comparative advantage is observed in a small group of sectors, most notably HS Chapter 25 (mineral products), HS Chapter 72 (iron and steel), HS Chapter 28 (inorganic chemicals), and HS Chapter 09 (coffee, tea, mate, and spices), highlighting Bhutan's continued reliance on resource-based and low-processing manufacturing

[14] The analysis only includes the merchandise trade goods and excludes electricity.

exports. While these sectors benefit from natural resource endowments and low-cost electricity, they remain vulnerable to commodity price volatility and offer limited scope for downstream value addition.

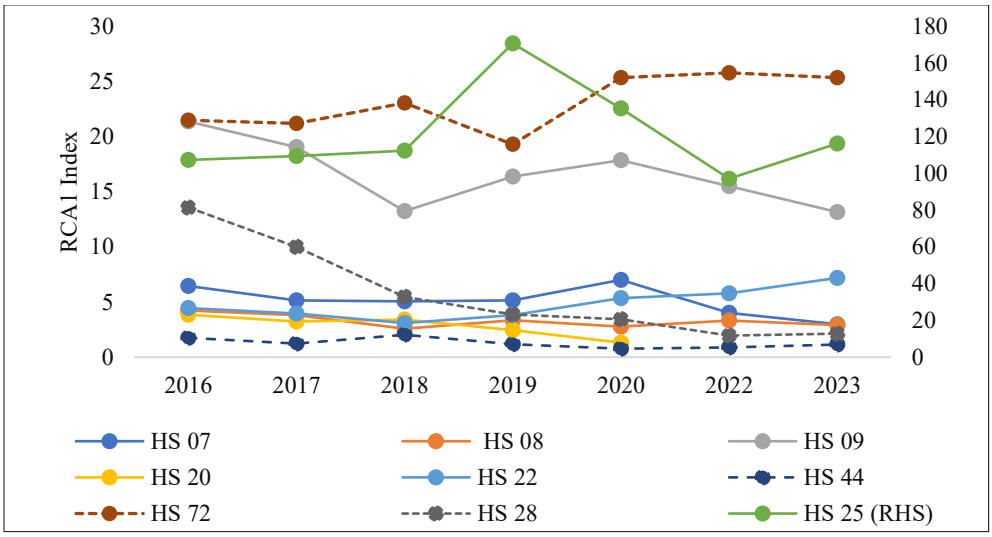


Figure 9.1: RCA Index greater than 1 at HS 2-digit code

Agriculture and agro-processing products, including vegetables, fruits, and beverages, continue to exhibit a comparative advantage under the export-based RCA, but declining trends and negative net export RCA in recent years point to waning international competitiveness and rising import dependence. Further disaggregation of agriculture and agro-processing products reveals a comparative advantage in a few products, such as cardamom, potatoes, citrus fruits, mineral water, beer, and spirits, suggesting limited product diversification within sectors. Overall, the findings underscore structural constraints in Bhutan's export basket, characterized by limited penetration into higher value-added manufacturing and downstream processing, reinforcing the need for targeted policies to deepen value chains, enhance productivity, and strengthen competitiveness in priority sectors.

In manufacturing, the analysis shows that Bhutan's comparative advantage is largely confined to upstream, electricity-intensive activities, notably ferro-alloys and semi-finished steel products. This reflects Bhutan's access to low-cost hydropower, which has supported some degree of industrial activity. However, the absence of comparative advantage in downstream or higher value-added manufacturing highlights a critical structural weakness. From a policy perspective, this finding underscores the need to strengthen linkages between existing upstream industries and downstream processing, rather than attempting to develop entirely new manufacturing sectors without a competitive base.

The research highlights a strong dependence on raw and semi-processed mineral exports, with extremely high RCA values. While these products contribute significantly to Bhutan's export competitiveness, they also expose the economy to commodity market volatility and resource

depletion risks. For policymakers, this underscores the importance of balancing short-term export gains with long-term sustainability by promoting value addition, process improvements, and diversification within resource-based sectors. Furthermore, it highlights the shortcomings of the industrial development policies undertaken to date, noting low technological know-how transfer and limited supply and value chain development, resulting in dependence on the lower end of the industrial chain.

Overall, the paper offers several important insights for policy formulation in Bhutan. First, it provides an evidence-based framework for prioritizing sectors and products, enabling policymakers to focus on areas where Bhutan already has a comparative advantage rather than spreading resources too thinly across multiple sectors. Second, it emphasizes that the core challenge is not the absence of comparative advantage but the limited upgrading of existing advantages into higher-value-added activities. Third, it highlights the need for closer alignment between trade and industrial policy, particularly in guiding export promotion, leveraging foreign direct investment, and benefiting from improved product-level trade negotiations.

9.2. Money Supply and Economic Growth in Bhutan: An Empirical Analysis

Author: Rinchen Dolkar and Karma M P Dorji
Year: 2025
Summary

The study examines the dynamic relationship between the broad money supply (M2) and real economic growth, using annual data from 1992 to 2023. Motivated by limited empirical evidence on Bhutan's monetary policy transmission mechanism, the study assesses whether money supply influences economic growth in the short run and long run, while controlling for inflation and government expenditure.

As shown in Figure 9.2, both GDP and M2 in Bhutan exhibit a consistent upward trend over the period, suggesting a certain degree of correlation between the two indicators. While GDP has grown gradually and steadily, M2, which initially remained well below GDP levels, began accelerating more rapidly in recent years. On the other hand, the second graph shows that the GDP growth has remained relatively stable over the period, while M2 growth exhibited significant volatility, marked by sharp drops and spikes. This suggests that the steady increase in M2 seen in the earlier chart was driven by short-term fluctuations rather than consistent year-on-year growth. In comparison, GDP followed a more gradual and stable trajectory.

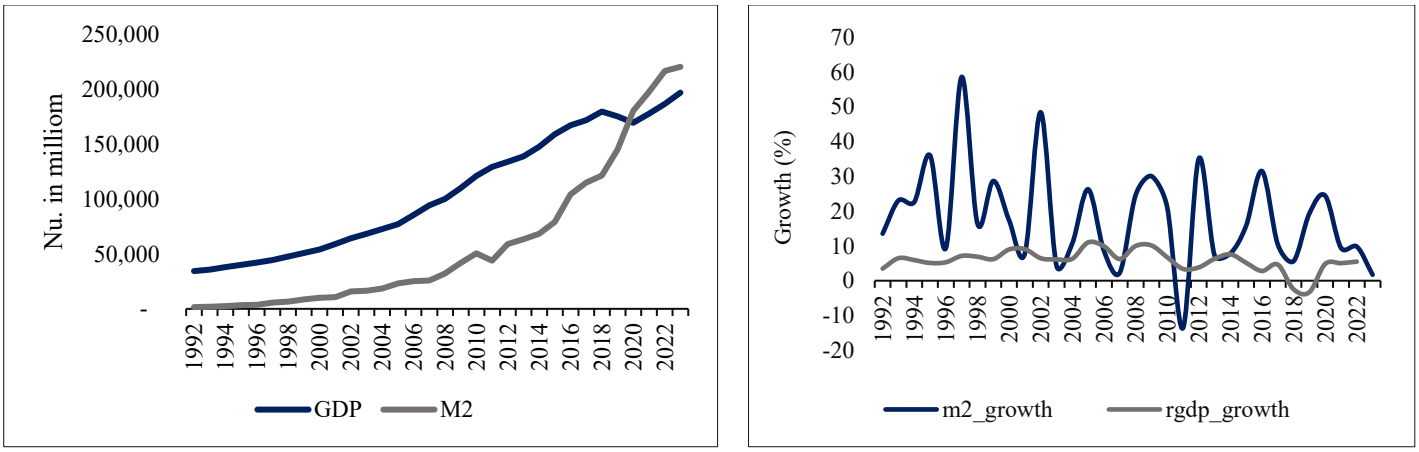


Figure 9.2: Trend and Growth Rates of GDP and M2

Using standard time series econometric techniques, it was established that real GDP, money supply, inflation, and government expenditure are non-stationary in levels but stationary in first differences. Standard econometric tests confirm the existence of a stable long-run equilibrium relationship among these variables. This indicates that although money supply and GDP may deviate from each other in the short run, they tend to move together over time, suggesting a meaningful long-run economic linkage within Bhutan's economy.

The Vector Error Correction Model results reveal an important asymmetry in adjustment dynamics. Real GDP adjusts to restore long-run equilibrium following shocks, while money supply is found to be weakly exogenous. This finding is consistent with operational realities of a fixed exchange rate regime, where money supply is largely policy-driven and influenced by external factors such as capital flows and balance-of-payments pressures, rather than automatically responding to domestic economic activity. The adjustment burden, therefore, falls on real output rather than on monetary expansion. In the short run, increases in the money supply have a positive and statistically significant effect on real GDP growth. Granger causality tests reinforce these findings by showing unidirectional causality from money supply to GDP, with no evidence of reverse causality. Within a pegged exchange rate framework, this indicates that RMA retains limited but effective policy space to use liquidity management and credit conditions to support short-run economic activity, even though long-run monetary independence is constrained by the need to maintain the currency peg.

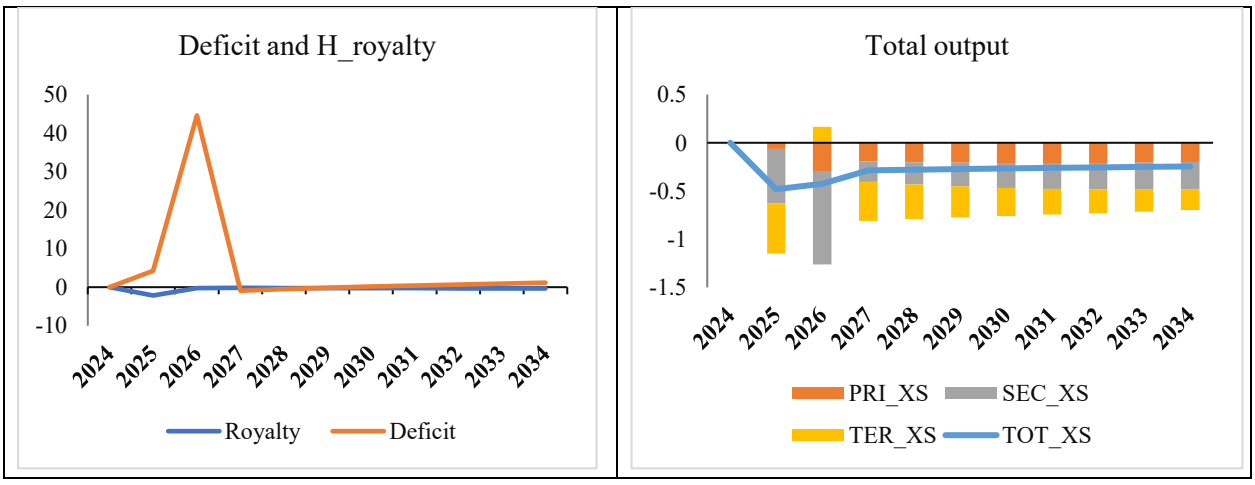
These findings have important implications for policy formulation in Bhutan. Monetary policy can play a meaningful role as a short-run stabilization tool, particularly during economic slowdowns or external shocks, but it cannot serve as the primary engine of long-term growth. Excessive monetary expansion could undermine external stability and threaten the exchange rate peg. As a result, fiscal policy, structural reforms, and productivity-enhancing investments must bear the primary burden of sustaining long-term growth, with monetary policy playing a complementary role.

9.3. October 4th Rainfall Impact on the Economy

Author: Chimi Dema, Karma M.P. Dorji, Lungten Tshewang, Phurpa Gyeltshen, Sejal Chhetri, Rinchen Dolkar and Pema Dorji.
Year: 2025
Summary

Bhutan's economy is highly exposed to climate risks due to its geography and reliance on climate-sensitive sectors, including hydropower and agriculture. Using a dynamic Computable General Equilibrium model, a preliminary assessment simulated the macroeconomic impacts of climate shocks based on the October 4th rainfall event's damages. The analysis applied a combined shock of a 2 percent decline in electricity and a 5 percent loss in infrastructure capital; each measured against their respective capacities. As a result, value added in the electricity and land transport sectors declines by about 2 percent and 5 percent, respectively, relative to a no-damage reference scenario in 2025. While the electricity sector has been simulated to show a quick rebound, its value added remains below the reference path, whereas the transportation sector recovers more gradually due to the time required to rebuild damaged infrastructure.

The contraction in value added in these key sectors transmits to the broader economy through strong intersectoral linkages, resulting in a sharp decline in total output in 2025. The reduction in electricity supply and transport services disrupts production across the economy, with the largest output losses observed in the secondary and services sectors, which are particularly dependent on reliable energy and transport infrastructure. As reconstruction efforts begin and productive capacity is gradually restored, total output starts to converge back towards the reference scenario in the subsequent years, as illustrated in the figures. Nevertheless, the short-term shock is significant, with real GDP estimated to decline by around 0.6 percent in 2025 compared to the reference scenario, with normalization occurring in the outer years as reconstruction progresses.



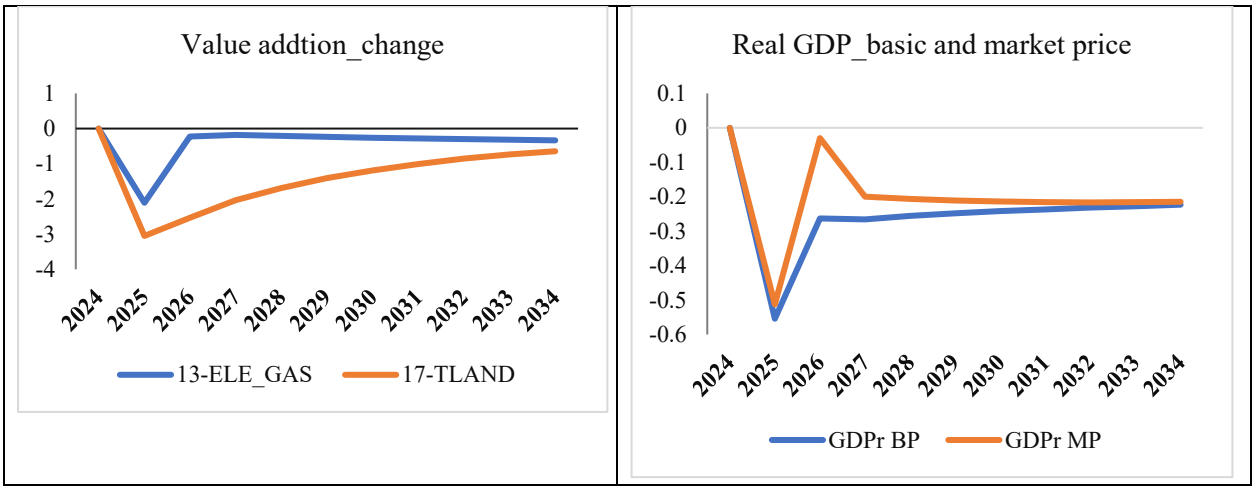


Figure 9.3: Impact of loss and damage on revenue, output and value addition

The macroeconomic effects of the climate shock are also reflected in the fiscal accounts. On the revenue side, lower electricity generation will reduce hydropower royalty revenues in 2025, directly weakening government revenues and contributing to a wider fiscal deficit. On the expenditure side, the government faces additional pressure as capital spending increases from 2026 onwards to finance the reconstruction and replacement of damaged infrastructure. While this rise in capital outlays supports the recovery of productive capacity and helps restore economic activity, it also places short-term strain on fiscal balances. Similar to the output, the macroeconomic impact gradually normalizes as infrastructure investment boosts growth and revenue streams return close to their reference levels.

9.4. Development of the Overlapping Generations Model – Druk Dungkhar Model

Author: Pema Dorji, Karma M P Dorji, Lungten Tshewang, Phurpa Gyeltshen, Sejal Chhetri, Rinchen Dolkar and Chimi Dema

Year: 2025

Summary

The Druk Dungkar Model (DDK) is Bhutan's first large-scale Overlapping Generations (OLG) macro-fiscal model, developed to strengthen evidence-based policy making in the face of long-term fiscal, demographic and sustainability challenges. Drawing inspiration from international OLG frameworks such as Denmark's DREAM model and Australia's OLGA, the DDK is tailored to Bhutan's unique economic structure and institutional context, covering 55 generations spanning working life (age 21-60) and retirement (age 61-75). Its central objective is to provide a coherent framework for assessing the macroeconomic, fiscal, external, and welfare implications of policy choices over time.

At its core, the model integrates households, firms, government and the rest of the world within a unified general equilibrium structure. Households are disaggregated by age and employment group, allowing the model to capture life-cycle behaviour in consumption, savings, taxation and

pension outcomes. Firms operate under a single production function with exogenous productivity, while ages and returns to capital are determined endogenously by marginal productivity. The government sector is modeled in detail, incorporating multiple tax instruments such as income tax, business tax, and consumption tax, while expenditure covers current and capital expenditure, transfers, and explicit public debt dynamics. Furthermore, the government sector is constrained by the debt threshold rule set by the country's public debt policy. Finally, the external sector captures trade balances, hydropower exports, remittances, capital flows, and reserve accumulation, reflecting Bhutan's pegged exchange rate regime and dependence on external financing for both government investment and maintaining the balance of payments.

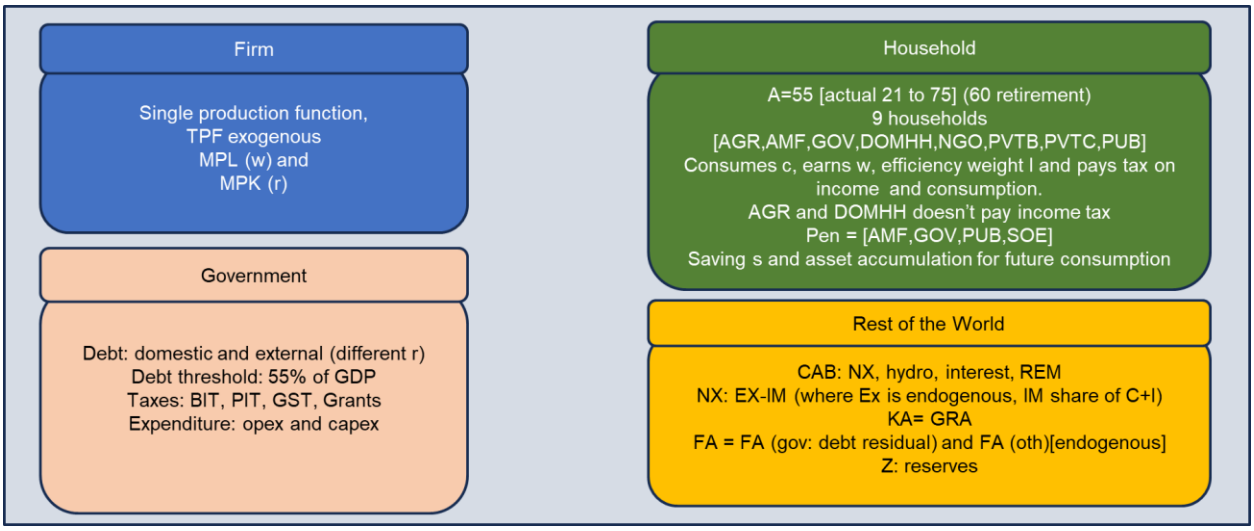


Figure 9.4: Model specification summary

The policy relevance of the DDK lies in its ability to simulate medium-to-long term impacts of fiscal policy decisions rather than focusing solely on short-run macroeconomic effects. Simulation results presented in the paper illustrate how increases in current and capital expenditure affect GDP, consumption, investment, public debt and the current account balance and foreign reserves over time. Importantly the model highlights trade-offs between growth, fiscal sustainability and external stability – trade-offs that are particularly salient for a small, relatively closed and one-sector dependent economy like Bhutan. The distinctive contribution of such a model is its explicit focus on economic welfare and intergenerational equity. By tracking welfare outcomes across age cohorts and employment groups, the model reveals how fiscal expansions or consolidations can generate uneven welfare effects across generations and occupations. This feature is especially valuable in Bhutan's context, where demographic transition, pension liabilities, and youth employment are group policy concerns. The results demonstrate that policies which appear growth-enhancing in aggregate terms may still impose welfare costs on specific groups or future generations.

Overall, the DDK represents a significant advancement in Bhutan's macro-fiscal analytical capacity. It provides policymakers with a forward-looking tool to evaluate the sustainability and

distributional consequences of fiscal and development strategies supporting more informed decisions aligned with Bhutan's long-term economic and social objectives to achieve a high-income GNH economy vision.

9.5. IS-LM-BP model for Bhutan

Author: Karma M.P Dorji
Year: 2025
Summary

The model on Bhutan's IS-LM-BP Tariff-shock simulation represents a pioneering attempt to construct a Bhutan-specific macroeconomic framework capable of assessing the transmission of external trade shocks in a small, open and highly import-dependent economy. By adapting the IS-LM-BP and AD-AS analytical structures to Bhutan's institutional and structural characteristics, the model provides an empirically grounded tool for evaluating macroeconomic vulnerabilities and policy response options in the context of tariff-war-type disturbances.

The primary purpose of the model is to strengthen evidence-based macroeconomic analysis by simulating adverse tariff shocks and quantifying their effects on output, liquidity conditions, external balance, and inflation dynamics. Specifically, the framework links the goods market, money market, and external sector within a coherent system, while extending the analysis to aggregate demand and short-run aggregate supply to capture inflationary dynamics. Two realistic shock scenarios—a 30 percent decline in exports and a 20 percent increase in import prices—are embedded in the model to trace how external disturbances propagate through Bhutan's economy.

Methodologically, the model adopts a semi-dynamic structure, relying on cross-sectional relationships among key macroeconomic variables rather than explicit lagged dynamics in the core IS-LM-BP block. Output in the IS equation is driven by consumption, investment, government spending, and the trade balance, while the LM equation links broad money (M2) to output and interest rates, reflecting liquidity behavior in Bhutan's financial system. The BP equation captures external equilibrium by relating the trade balance to monetary conditions, interest rates, investment, and foreign exchange factors. These relationships are complemented by an AD-SRAS (short-run aggregate supply) extension that allows for explicit analysis of demand drivers and inflation responses under both normal and shock conditions.

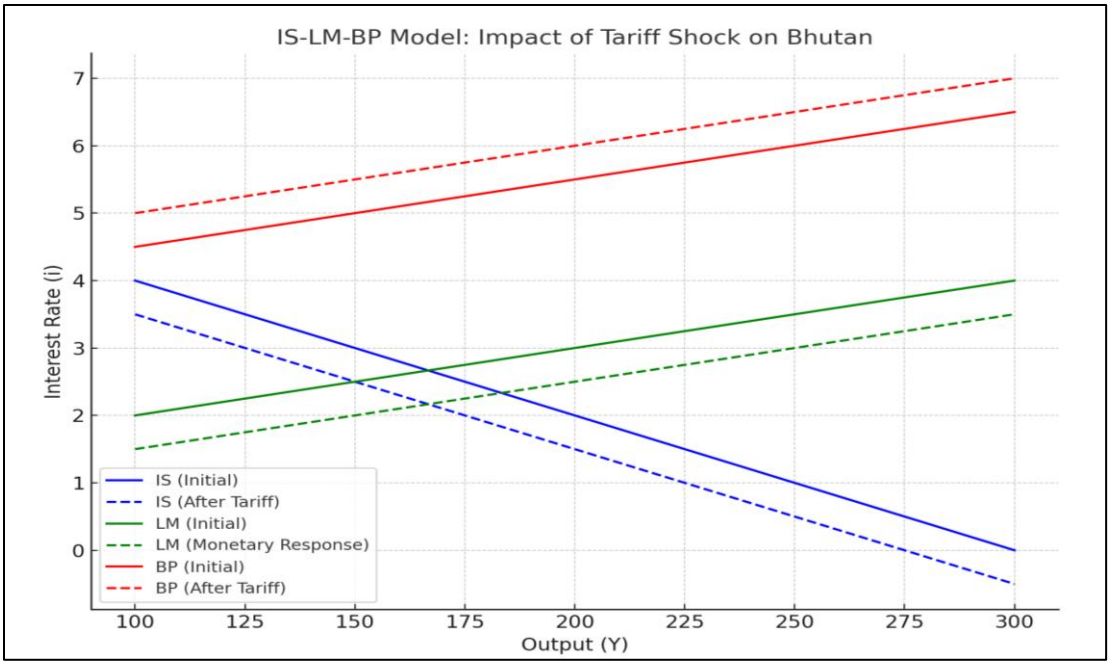


Figure 9.5: IS-LM-BP Model

The simulation results yield several important policy-relevant insights. Domestic demand emerges as the dominant driver of output, indicating that consumption, investment, and government expenditure play a central stabilizing role when external conditions deteriorate. Interest-rate transmission to money demand appears weak, suggesting that conventional monetary policy channels may be limited, while output-linked liquidity responses are more influential. The external sector is found to be sensitive to monetary and foreign exchange conditions, underscoring the importance of macroeconomic and financial policies. Tariff shocks have pronounced effects on the money market and inflation dynamics. Liquidity responses are sizable during adverse external episodes, with output contractions translating into significant reductions in broad money. Moreover, import-cost shocks generate strong and persistent inflationary pressures, highlighting substantial pass-through effects and reinforcing the trade-off between stabilization support and price stability.

Overall, the IS-LM-BP tariff-shock model provides Bhutan with a practical and structured analytical platform to assess external vulnerabilities and evaluate coordinated fiscal and monetary responses. By demonstrating how external trade shocks interact with domestic demand, liquidity conditions, and inflation, the model contributes meaningfully to strengthening Bhutan's macroeconomic preparedness and policy formulation capacity.

Chapter 10 Challenges and Opportunities

10.1. Introduction

The preceding analysis of Bhutan's macroeconomic performance and productivity dynamics highlights a critical transition in the country's development path. While economic growth has recovered following the pandemic and remains supported by expansionary fiscal policy and hydropower project investments, the underlying structure of growth reveals increasing vulnerabilities. Output expansion has remained largely capital-intensive, with declining capital productivity, weak TFP and uneven labour productivity gains across sectors. These patterns have important implications for employment creation, fiscal sustainability, financial stability, and external resilience.

This chapter brings together insights from across the report to assess the key challenges and opportunities shaping Bhutan's future growth prospects. It examines how the post-pandemic recovery has taken on a K-shaped recovery path where government-led capital-intensive sectors are advancing while labour-intensive and productivity-enhancing sectors lag behind, limiting inclusiveness and amplifying exposures to sector-specific shocks. It further explores how structural labour market mismatches, demographic transitions, outward migrations and persistently high youth unemployment interact with fiscal rigidities, financial sector concentration, inflationary pressures, and external imbalances to constrain the economy's ability to generate sustained and broad-based growth.

At the same time, the chapter underscores that Bhutan's constraints are accompanied by significant strengths and untapped potential. High levels of human capital development, strong public institutions, strong leadership, and a coherent long-term vision provide a solid foundation for reform. Opportunities lie in leveraging green growth advantages, deepening industrial value chains, attracting productivity-enhancing foreign direct investment, and better aligning credit allocation with priority growth sectors. By presenting a balanced assessment of risks and opportunities, this chapter sets the stage for identifying policy directions needed to transition from an input-driven growth model towards one that is more diversified, productivity-led and resilient.

10.2. Challenges

10.2.1. Uneven K-Shaped Growth and Hydropower Vulnerability

Bhutan's growth performance masks underlying structural weaknesses. The post-pandemic recovery has been uneven, with strong expansion in capital-intensive sectors (hydropower-related construction and electricity) while labour-intensive and productivity-enhancing sectors such as manufacturing, transport, and hotel and restaurant continue to lag. This divergence has resulted in a K-shaped recovery where high-performing sectors pull ahead while weaker sectors are left behind. Such uneven growth undermines the sustainability and inclusiveness of recovery as key

sectors remain unevolved, increasing vulnerability to sector-specific shocks and could drag down the growth outlook.

At the same time, Bhutan's growth trajectory remains highly dependent on the hydropower sector, which is increasing macroeconomic volatility. The projected moderation in growth in 2026 highlights the one-off nature of large hydropower commissioning effects, after robust growth in 2025, and the sensitivity of aggregate output to project timelines. Delays or implementation challenges in ongoing projects, including PHPA-I, Dorjilung, and Khorlochhu, pose a key downside risk to medium-term growth, fiscal revenues, and export earnings. These risks are compounded by constraints in implementation and absorption capacity, particularly in the construction sector. Heavy reliance on hydropower also exposes the economy to climate-related and hydrological risks, which could affect generation and revenue outcomes. Without stronger progress in economic diversification and private sector-led growth, Bhutan's medium-term outlook is likely to remain vulnerable to episodic volatility and limited job creation

10.2.2. Youth Unemployment and Skills Mismatch in a K-Shaped Recovery

Despite a high aggregate employment rate and a vacancy surplus, youth unemployment remains structurally elevated and is projected to rise again over the medium term. The coexistence of vacancies and unemployment points to deep labour market mismatches between education outcomes and labour market needs. The K-shaped recovery reinforces these mismatches, as labour-intensive industries are growing at a slow rate. As a result, employment gains have not translated into sufficient opportunities for urban and educated youth, who face higher unemployment and longer job search durations.

Structural rigidities further constrain youth absorption as employment remains heavily concentrated in agriculture and public administration, reflecting slow structural transformation. At the same time, private sector vacancies are largely in low-wage clerical and support roles, misaligned with youth skills, expectations, and career aspirations.

10.2.3. Demographic transition, Aging and Outward Migration

Bhutan's labour market challenges are compounded by a rapid demographic transition that will tighten labour supply over the medium to long term. As such, Bhutan is already approaching its last phase of demographic transition, after which the population decline becomes inevitable. Declining fertility rate and rising life expectancy imply that labour force growth will slow over time, while old-age dependency burdens will increase. At the same time, outward migration of young and educated individuals reduces the domestic labour pool further, intensifying potential labour shortages and skills gaps.

A rising dependency burden will increase fiscal pressures on pensions, healthcare, and social protection systems, while a smaller workforce will constrain potential growth unless productivity rises substantially. Persistently low LFPR (around 65 percent), particularly among women and

youth, limits the economy's ability to offset demographic challenges. Furthermore, it is projected that the median age is going to increase to 40 years by 2050, which is going to result in an older workforce before yielding the demographic dividend.

Without productivity improvements and stronger domestic job opportunities, demographic change is likely to amplify existing structural weaknesses rather than support long-term growth.

10.2.4. Fiscal Challenges

The pronounced back-loading of both revenue collection and expenditure execution poses significant challenges to fiscal management. Revenue inflows remain weak in the first half of the fiscal year, with sharp concentration in Q3 and Q4, driven by the timing of corporate and personal income tax collections and delayed external grant disbursements. Similarly, capital expenditure accelerates heavily in Q3 and Q4, compressing implementation timelines and limiting flexibility for mid-year adjustments. This seasonal pattern affects the efficiency and quality of budget execution, potentially compromising project outcomes and value for money. Addressing these inefficiencies requires improving the predictability of resource flows and strengthening expenditure planning and monitoring systems throughout the year.

Compounding these challenges, public debt remains elevated at 110.47 percent of GDP in FY 2025-26, primarily driven by borrowings for renewable energy projects, particularly hydropower development. While much of this debt is on concessional terms and self-liquidating through export revenues, the debt outlook remains sensitive to economic growth, as the country's ability to carry debt depends largely on sustained economic growth.

10.2.5. Output vs. Outcome: A challenge of budget maximization

In Bhutan's context, as a small landlocked developing country, there are various limitations due to which government interventions become inevitable, including managing capital flows. As the size of government increases over the period, the efficacy and efficiency of government spending become critical. Equally important is the consideration towards the market economy, such that the government interventions should only be to the extent of facilitating the market economy through infrastructure development, addressing market failures and creating conducive policies. Especially, the increased size of government and its activities should not crowd out or increase the compliance costs on the private sector.

A key fiscal challenge arises from the disconnect between public spending outputs and on-the-ground outcomes, reflecting a tendency toward budget maximization rather than benefit maximization. While capital outlay remains strong, the translation into productivity gains, gainful employment creation, and household welfare improvements is weak. Additionally, the compliance burden on the private sector has been on the rise, therefore necessitating strong process reforms.

10.2.6. Non-Performing Loan

One of the key challenges in the monetary and financial sector is the high concentration of credit in a limited number of sectors. Credit is predominantly concentrated in the housing sector, followed by the hotel and tourism and the manufacturing sector. Such concentration increases vulnerability to sector-specific shocks and can lead to higher loan defaults, thereby raising NPLs. A sustained rise in NPLs could undermine the financial soundness, liquidity and credibility of financial institutions. The financial sector must gradually reduce concentration in a limited set of sectors and diversify credit allocation in line with the sectoral economic importance and growth potential.

10.2.7. Liquidity Management

Strengthening liquidity management will require improving liquidity forecasting while also developing and actively using market-based instruments, such as the open market operations, to manage the short-term liquidity fluctuations. The CRR, maintained at 8 percent since FY 2022-23, remains the primary tool for managing liquidity. With the major hydropower projects taking off alongside the accelerated implementation of activities under the 13th FYP, liquidity conditions in the banking system are expected to become more dynamic, making proactive and market-based liquidity management increasingly important. In the past, periods of excess liquidity were often followed by administrative tightening measures, which subsequently led to tight liquidity conditions in the financial system. Amid increased government expenditure as a result of the expansionary fiscal policy, weak transmission in improving domestic productive capacity can increase the risk of pronounced liquidity swings.

10.2.8. Inflation Concerns

Recent divergence between inflation trends in Bhutan and India points to rising domestic price pressures, suggesting inflation dynamics may become more complex going forward. Managing temporary inflationary pressures while preserving price stability will require careful coordination between fiscal and monetary policy, particularly as liquidity is expected to expand while credit demand remains on the rise. Rapid money supply growth, driven by foreign inflows and government-related claims, raises the risk of excess liquidity, which limits the transmission potential of monetary policy.

10.2.9. Structural Weaknesses in the External Sector

The external sector continues to exhibit structural weakness with a persistent current account deficit, as the trade deficit in goods continues to widen, driven by imports of capital goods for investments. Towards this, the country continues to rely on capital and financial account inflows in the form of grants and borrowings to finance the current account deficit. The current account position is projected to remain under increasing pressure from the widening of the trade deficit, driven by capital imports related to ongoing investments. While some imports are one-off and expected to taper off, the medium-term outlook remains characterized by structurally high import

demand for hydropower-related construction. At the same time, exports remain heavily concentrated in a few mineral-based products and markets and are expected to grow at a stable rate. This concentration exposes Bhutan to commodity price volatility, cyclical downturns in mineral markets, and shifts in regional demand, which weakens external resilience.

10.2.10. Slow Industrialization: Narrow Industrial Base and Limited Value Chain

Bhutan's industrial development remains narrow, fragmented, and weakly integrated, limiting its contribution to productivity growth, employment, and export diversification. Industrial activity outside hydropower is concentrated in a small number of capital and energy-intensive sectors, while CSIs dominate in number but operate at a low scale with limited capacity to upgrade. Weak vertical and horizontal linkages across firm sizes constrain value-chain integration, resulting in limited spillovers, shallow industrial deepening, and minimal growth in value added despite rising industrial licensing.

These structural constraints are reinforced by demand-side and competitiveness challenges. A small domestic market, strong preference for low-cost imports, and high operating costs prevent firms from achieving scale and discourage long-term investment. Export growth remains concentrated in low-value, mineral-based products with limited backward linkages, leaving emerging sectors such as agro-processing and wood-based industries insufficient to drive structural transformation. Without targeted value-chain development, firm upgrading, and stronger market integration, Bhutan's industrial sector risks remaining high-cost, low-scale, and peripheral to the country's broader growth and diversification objectives.

10.2.11. Balancing Commercial and Developmental Objectives in SOEs

Bhutan's SOEs operate under a dual mandate that combines commercial objectives with wide-ranging social and developmental responsibilities, creating persistent tension in operational decision-making. Requirements to maintain employment, ensure affordability of essential services, and support regional development often conflict with output maximization and efficiency goals. In particular, the absence of clearly defined and transparently financed mechanisms for non-commercial obligations can complicate performance assessment and weaken incentives for efficiency, cost control, innovation, and productivity enhancement.

These challenges are compounded by soft budget constraints, where the expectation of government support reduces exposure to market discipline. The implicit assurance of bailouts or policy protection shields underperforming SOEs from exit or restructuring, allowing inefficiencies to persist. Strengthening the effectiveness of SOEs will therefore require continued efforts to clarify and separate commercial and non-commercial mandates, enhance transparency around public service obligations, and reinforce performance-based accountability frameworks.

10.3. Opportunities

10.3.1. High Level of Social Progress and Human Capital Development

Bhutan's high level of social progress provides a strong foundation for sustaining long-term economic transformation. Decades of investment in health, education, and social protection have resulted in high literacy rates and improved life expectancy. These outcomes translate into a healthy and adaptable workforce, forming a basis for productivity-led and knowledge-based growth.

Increasingly, human capital development in skills, innovation, and service delivery is being prioritized. At the moment, Bhutan's relatively young population and rising educational attainment allow scope for the expansion of higher value-added sectors driven by innovation and digitization. Realizing this potential, however, will depend on the alignment of education and training systems with labour market needs, the development of relevant technical and digital skills, and the creation of sufficient employment opportunities to absorb skilled workers productively.

10.3.2. Strong Public institution with a Small Economy

While a strong government presence in a market economy has its own demerits, it also has advantages in a small economy like Bhutan. Bhutan's institutional strengths, rule of law, and corruption index are ranked alongside those of advanced economies in Scandinavian countries. However, from a macroeconomic fundamentals' perspective, it remains a lower-middle-income country. Therefore, there is an opportunity for the country to channel these strengths towards fostering a strong private sector, grounded not in aggressive rent-seeking behaviour for profit maximization but rather in market-conforming, socially beneficial, profit-maximizing firms in line with the country's development philosophy of GNH.

Furthermore, while its smallness—both in size and population—is seen as a binding constraint for a dynamic market economy development, it also presents opportunities in the form of unity and cohesiveness, such that any intervention designed to strengthen the market economy that is socially desirable could be implemented at record speed. Past experiences also highlight the strength of our smallness, along with strong leadership that resulted in the efficient and effective implementation of programs, including privatization and vaccination, as was evident during the pandemic.

Such characteristics are essential for the mobilization of human capital and resources in the most productive way to harness the benefits of a market economy in an environmentally sustainable and socially desirable way.

10.3.3. Strong Leadership

Bhutan's clear national vision, articulated through the 21st Century Economic Roadmap's 10X Economic Vision, the Diamond Strategy for alignment with the GMC, and the 13th FYP, provides a strong foundation for aligning public and private actions around a shared long-term development

trajectory. Strong leadership from the highest level, His Majesty the King, anchors the nation's expectations and provides strategic direction in an increasingly volatile global environment.

The translation of strategic vision into implementation is being supported by renewed efforts to strengthen public sector capacity and institutional effectiveness following the period of significant civil service attrition. These efforts are essential to ensure that ambitious strategic objectives are translated into concrete policy actions and measurable outcomes. For a small economy with limited administrative and fiscal space, such leadership-driven coordination is particularly important. It allows Bhutan to prioritize reforms, sequence interventions effectively, and mobilize public and private actors around shared objectives. By strengthening the link between vision and implementation, strong leadership enhances policy credibility and supports the conditions necessary for private investment, productivity growth, and sustained economic transformation.

10.3.4. Advancing Data-Driven Macroeconomic Policymaking

A key opportunity for Bhutan lies in the expanding use of macroeconomic analysis and econometric tools to support data-driven policymaking and strengthen macroeconomic surveillance. Recent advances in empirical modeling, simulation frameworks, surveillance capabilities and structural macro-fiscal tools enhance the capacity to assess policy trade-offs, quantify transmission channels, and evaluate the short and long-term impacts of fiscal, monetary, climate, and external shocks. For a small, open, and structurally concentrated economy, such tools are essential for moving beyond descriptive analysis toward forward-looking, scenario-based policy assessment. Institutionalizing these analytical frameworks, alongside continued improvements in data quality and technical capacity, can improve policy credibility, coordination, and responsiveness, helping to better align efforts with Bhutan's long-term development objectives under the 10X Economic Vision.

10.3.5. Green Growth and Climate-Aligned Development

Bhutan's carbon-negative status, clean energy base, and sustainable forestry create opportunities to position the country as a green investment destination. Expanding forest-based value chains, climate-resilient agriculture, renewable energy diversification (solar), and green finance instruments can attract climate-aligned FDI while strengthening resilience to climate and hydrological risks.

10.3.6. Industrial Growth through Value Chains and FDI Linkages

Industrial growth presents a critical opportunity for Bhutan to transition from a narrow, capital-intensive production structure to a more diversified, resilient, and employment-generating economy. Existing industries have created a foundation for deeper supply chains and auxiliary industries, including accessories, components, packaging, maintenance, and logistics. Targeted development of such auxiliary industries, such as fittings and accessories for HDPE pipes, other construction inputs and packaging materials, can raise domestic value added, reduce import dependence, and support labour-intensive industrial activity. There is an opportunity for the

government to become either a financier or consumer and shift the role of producer to the private sector providing consistent demand for their products.

Recent surges in FDI expose key opportunities for industry development in sectors such as wood and furniture, construction and manufacturing, education, energy-linked industries, and digital infrastructure, leveraging Bhutan's access to reliable, low-cost energy. For Bhutan, embedding foreign anchors within domestic production networks can facilitate technology transfer, diversification of foreign-currency inflows, and productivity gains.

10.3.7. Aligning Credit Allocation with Productive Sectors

An important opportunity for the financial sector is to align its credit flows with the priorities of Bhutan's 10X Economic Vision. While credit growth has remained broad-based, lending continues to be concentrated in a few sectors, particularly housing, trade and commerce. Redirecting and expanding the credit towards productive sectors identified under the 10X strategy can support economic diversification and enhance sectoral productivity. A balanced sectoral productivity would not only reduce concentration risks in the financial system but also improve the effectiveness of the financial intermediation in supporting long-term economic transformation.

10.4. Conclusion

Bhutan's recent development journey reflects significant achievements and a pivotal transition. This report highlights a growth model that has delivered steady expansion, improved living standards, and strong social outcomes, driven by public investment, hydropower, and robust institutions. However, it also identifies the limitations of a government-led investment approach and the need to shift toward a more diversified, productivity-driven, and private-sector-led growth path.

The analysis demonstrates that Bhutan has established a strong foundation. Higher labour productivity, advances in human development, effective governance, strong rule of law, low corruption, and social cohesion position the country well for accelerated growth. Despite recent global shocks, the economy has remained resilient, with recovery evident in key sectors. Gradual increases in labour income share also indicate progress toward more inclusive growth. These achievements reflect efforts that few countries can match.

The analysis also identifies structural challenges that must be addressed to maintain progress. Growth is uneven and concentrated, with capital-intensive sectors outpacing labour-intensive and productivity-enhancing activities. Capital productivity has declined, TFP remains weak, and job creation (especially for youth and the broader workforce) lags behind expectations. Demographic shifts, outward migration, fiscal constraints, financial-sector concentration, and external imbalances highlight the need for reform. These challenges are natural pressures that arise as the economy matures.

Bhutan enters this phase with significant opportunities. Strong institutions, visionary leadership, and a clear national direction, as outlined in the 10X Economic Vision and the Diamond Strategy, provide a solid framework for coordinated action. Bhutan's environmental stewardship, carbon-negative status, and clean energy base uniquely position it to pursue green, climate-aligned growth as the global economy transitions. Increasing foreign investment, especially in services and energy-related industries, reflects confidence in Bhutan's long-term prospects.

To move forward, Bhutan must convert its strengths into tangible outcomes. This requires improving the efficiency of public investment, ensuring higher returns on capital, and encouraging private-sector participation by deregulating the domestic market. Empowering small and medium enterprises to innovate, scale, and integrate into broader supply and value chains is essential. Aligning credit, skills development, and industrial policy with productive sectors and emerging technologies, as well as strengthening TFP through technology adoption, skills matching, and more effective institutional spending, will be key to sustaining growth and avoiding the middle-income trap.

Bhutan's small size, often viewed as a constraint, is a strategic advantage. When managed efficiently, it allows for policy coherence, rapid implementation, and close coordination among economic agents, conditions essential for successful structural transformation. Coupled with the GNH development philosophy, Bhutan is well-positioned to demonstrate that economic transformation can align with social, cultural, and environmental values.

In summary, Bhutan is at the nexus of opportunities drawn out by the challenges that it faces. The challenge is not whether the country can grow, but how it chooses to grow. By adopting a productivity-led, diversified, and inclusive growth strategy anchored in strong institutions, visionary leadership, and GNH principles, Bhutan can advance confidently into its next stage of development, delivering lasting prosperity, meaningful employment, and resilience for future generations.

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Annexure I: SOE Classification by Sectors

Sector	State Owned Enterprise
Agriculture, Livestock & Forestry	Bhutan Livestock and Development Corporation Limited
	Farm Machinery Corporation Limited
	Green Bhutan Corporation Limited
	Natural Resources Development Corporation Limited
Communication	Bhutan Broadcasting Services Corporation Limited
	Bhutan National Digital Identity Limited
	Bhutan Postal Corporation Limited
	Bhutan Telecom Limited
	Kuensel Corporation Limited
	Thimphu Teck Park Limited
Construction	Construction Development Corporation Limited
Electricity	Bhutan Power Corporation Limited
	Druk Green Power Corporation Limited
Finance & Insurance	Bank Of Bhutan Limited
	Bhutan Development Bank Limited
Manufacturing	Dungsam Cement Corporation Limited
	Dungsam Polymers Limited
	Kofuku International Limited
	Menjong Sorig Pharmaceuticals Corporation Limited
Mining & Quarrying	State Mining Corporation Limited
Real Estate & Dwellings	National Housing Development Corporation Limited
Transport & Storage	Druk Air Corporation Limited
Wholesale & Retail Trade	Crawfish Himalayan Limited
	Food Corporation of Bhutan Limited
	State Trading Corporation of Bhutan Limited

Annexure II: Nominal Capital Stock (Nu in Million)

Industry	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	
1. Agriculture, forestry and fishing	8,805	10,761	11,039	12,029	14,171	14,714	16,518	17,935	18,955	19,544	21,103	
2. Mining and quarrying	128	166	194	246	322	365	444	514	559	586	656	
3. Manufacturing	198	254	316	410	529	614	730	846	911	963	1,095	
4. Electricity	2,941	3,507	3,474	3,605	4,106	4,123	4,458	4,686	4,887	4,965	5,225	
5. Construction	169	211	261	344	443	521	645	808	966	1,143	1,599	
6. Wholesale and retail trade	99	125	151	193	244	276	324	375	414	448	545	
7. Hotels and restaurants	30	41	47	59	74	82	96	110	119	126	143	
8. Transport, storage and communications	774	992	1,189	1,511	1,872	2,036	2,303	2,574	2,768	2,900	3,225	
9. Financial intermediation	103	127	150	190	237	276	353	428	481	519	618	
10. Real estate, renting, and business activities	265	355	437	571	732	827	989	1,154	1,275	1,367	1,590	
11. Community, social and personal services	3,230	4,438	5,227	6,321	7,960	8,773	10,266	11,298	12,018	12,701	14,016	
12. Private, social and recreational services	18	23	25	31	38	42	52	59	62	63	69	
	16,761	20,999	22,511	25,511	30,727	32,649	37,178	40,787	43,415	45,325	49,884	
Industry	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	
1. Agriculture, forestry and fishing	23,806	24,964	27,269	31,465	35,215	40,728	46,473	49,482	51,993	58,471	66,941	
2. Mining and quarrying	738	787	881	1,091	1,480	1,975	2,601	3,181	3,819	4,761	6,548	
3. Manufacturing	1,264	1,419	1,595	2,010	2,619	3,335	4,174	5,013	5,904	6,820	8,688	
4. Electricity	8,852	12,676	14,212	16,243	17,480	26,836	73,086	78,946	80,921	88,285	98,720	
5. Construction	2,096	2,647	3,106	3,929	5,019	6,046	7,096	8,174	9,406	10,708	13,714	
6. Wholesale and retail trade	676	839	1,023	1,357	1,811	2,281	2,775	3,211	3,640	4,108	5,204	
7. Hotels and restaurants	167	186	215	275	381	497	627	734	854	1,038	1,373	
8. Transport, storage and communications	3,608	3,938	4,328	5,090	14,458	15,379	16,477	17,505	18,925	20,662	24,536	
9. Financial intermediation	746	888	1,040	1,316	1,681	2,086	2,519	2,871	3,174	3,458	4,238	
10. Real estate, renting, and business activities	1,878	2,184	2,566	3,356	4,509	5,772	7,172	8,457	9,827	11,520	14,924	
11. Community, social and personal services	15,970	16,796	17,927	19,200	22,403	24,976	30,047	34,467	38,694	43,941	53,310	
12. Private, social and recreation	76	81	86	99	117	134	153	167	180	198	236	
	59,877	67,406	74,249	85,431	107,175	130,046	193,200	212,208	227,339	253,972	298,433	-
Industry	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
1. Agriculture, forestry and fishing	75,278	80,788	82,859	85,940	92,817	98,784	108,168	119,583	130,571	140,472	153,294	156,372
2. Mining and quarrying	9,141	11,849	13,888	15,704	17,888	19,476	20,661	21,129	21,726	22,491	23,658	23,961
3. Manufacturing	11,103	13,072	14,337	17,220	20,471	23,382	27,587	30,713	33,637	34,878	38,152	38,749
4. Electricity	108,077	112,220	109,793	143,587	157,801	156,416	155,911	181,458	215,762	222,184	223,388	226,434
5. Construction	17,912	21,608	24,598	29,088	33,834	37,299	42,460	45,300	48,691	50,688	56,851	56,773
6. Wholesale and retail trade	6,741	8,163	9,563	11,630	14,535	18,537	22,841	25,237	27,048	29,085	32,136	32,164
7. Hotels and restaurants	1,814	2,194	2,521	2,992	3,825	5,174	6,913	8,549	10,273	11,731	13,853	15,825
8. Transport, storage and communications	29,503	33,219	36,429	40,333	46,343	52,418	60,820	66,561	72,621	87,788	104,159	125,064
9. Financial intermediation	5,184	5,834	6,268	6,961	7,767	8,939	10,294	10,829	11,341	11,695	12,638	12,596
10. Real estate, renting, and business activities	19,315	22,949	25,792	29,862	35,538	43,442	52,554	58,213	63,138	68,778	77,718	80,424
11. Community, social and personal services	61,402	70,410	73,850	79,027	85,832	101,532	119,593	132,054	138,949	154,132	177,353	195,627
12. Private, social and recreational services	285	321	354	424	543	737	1,029	1,256	1,441	1,550	1,758	1,795
	345,755	382,626	400,254	462,770	517,193	566,136	628,832	700,882	775,199	835,473	914,958	965,784