

# CHAPTER I

## INTRODUCTION



### 1.1. Background of the Study

The trade is considered as an integral part of the development effort and national growth of an economy. This is in fact a crucial instrument for industrialization while access to foreign exchange is essential for sustained economic development. Trade openness is widely recognized as a cornerstone of economic development and growth, and ultimately poverty reduction. As a result there has been intensified interest in the relationship between trade policy and trade performance and between trade performance and overall economic development. “Developing countries are increasingly realizing that trade is not a zero-sum game, but a win-win proposition for both the trading partners” (IMF, Executive Director B.P. Mishra).

The volume of international trade has increased markedly across the world during the past 40 years. Trade as a share of world GDP has increased from 24 percent in 1960 to 47 percent in 2002. Similarly, for low income countries, the ratio has risen from 19 to 46 percent during the same time period (World Development Indicators, 2004). This reflects deeper international specialization, which has probably led to an increased in the number of international transactions per dollar of GDP. The rise in the flow of trade has led to an increase in the number of studies investigating the sources of trade.

It is also witnessed considerable increase in the international trade of Bhutan. Over the decade considerably higher exports to GDP ratio is achieved despite of small size of the economy and limited trade opportunities in absence of diversified production base and specialization. Bhutan’s exports accounted for an average 28.5 percent of its GDP over the decade. In 1999, Bhutan accounted for roughly 3.5 percent of the total Intra-SAARC exports, mostly directed towards India, Bangladesh and Nepal (CBS & IDE/JETRO, 2004).

Trade has been extremely significant for the Bhutanese economy as well, as it has provided the basic impetus for economic development and it has gained considerable importance seeing that it constitutes one of the largest sources of earning for the country.

Hence with the recognition of the benefits of globalization and increased participation in international trade, Bhutan has opened up its economy under different levels of regional cooperation and Bhutan's interaction with the outside world at the bilateral and multilateral levels has increased intensively.

On a bilateral basis, Bhutan has developed free trade relationship with India and has preferential trade agreement with Bangladesh. In the future, the Royal Government of Bhutan intends to negotiate a preferential trade agreement at bilateral level with Nepal and Thailand and also intends to promote trade liberalization with existing and potential trading partners through negotiations on mutual reduction of tariffs and non-tariffs barriers on international trade. Further, Government's approval of the foreign direct investment policy in December 2002 is a significant landmark in Bhutan's gradual process towards economic liberalization and recently new foreign investments have been seen in the tourism sector.

On the regional basis, Bhutan is a signatory to SAPTA negotiations and has taken initiatives in binding tariffs at lower rates. With SAPTA (South Asian Preferential Trading Arrangement) progressing to SAFTA (South Asian Free Trade Areas), Bhutan is expecting to gain trade much beyond the current level. Bhutan is also a member of sub regional growth quadrangle along with India, Bangladesh and Nepal. These four countries are natural trade partners and share a special relationship based on past history. Outside the sub-region Bhutan became a member of BIMSTEC in 2004.

Today not only does the country aim to build up a strong export oriented economy to compete in the regional market but also aspires to join the World Trade Organization (WTO) in the near future. Joining the rule based trade regime is seen as a major step forward, which will necessitate a great deal of further liberalization of domestic economic policies. Such assimilation will have its own benefits as well as costs. Under the WTO membership when Bhutan gets MFN status elsewhere and in turn will award this to others. This might have impact on the direction of trade flow.

The liberalization and globalization has resulted in increased integration of Bhutanese economy with the rest of the world and has brought about a situation where Bhutanese economy today will be more sensitive to the changing economic trends outside than ever before. For example, the ratio of Bhutan's export to GDP accounted for 25% in

1990 and it reached its peak to 35% in 1995 however, it started declining from mid 1990s. During the same period the rest of South Asia also witnessed a decline in exports and Bhutan too seemed to have experienced a decline in the ratio of exports to GDP and in the growth of exports. This indicates that while the increased economic integration of Bhutan brought benefits in terms of enhanced trade opportunity, it also made the economy susceptible to global trends. So the Bhutan's economy is much more integrated with the rest of the world today than in the past.

Although it is certain that the benefits from joining the multilateral trading system will be many however it also depends on country's capacity and preparedness to take advantage from it. As a small landlocked country Bhutan faces limiting factors of absence of a sizeable private sector, limited production lines, shortage not only of technical capabilities but also of skilled and unskilled manpower and over all the small size of domestic market undermines its capacity to benefit fully from multilateral trading system. But keeping in mind, the fact that Bhutan is endowed with natural resources in terms of water, forests and minerals, Bhutan should be able to take advantage of expanding opportunities and long term dynamic benefits of increased trade through participation in multilateral trading environment cannot be undermined.

Further Bhutan has a very unique economic structure which typifies and distinguishes it from other developing economies. The economic activity is predominantly agricultural in nature and it depend on single commodity and single market for both exports and imports; And the industrial sector largely owned by government and semi-government enterprises as the private sector continues to be relatively weak and underdeveloped and *finally* unlike other developing economy, Bhutan face a shortage of unskilled labor and a substantial number of workers are imported from neighboring country India.

It has more than 79 percent of population still living in rural areas deriving sustenance mostly from agriculture, livestock and other traditional activities in the rural sector (9<sup>th</sup> FYP document, 2002). The unemployment has not been a major problem but now there is growing concern about the potential of rising unemployment among youth which is exacerbated by the mismatch between supply and demand and the reluctance of the school leavers to take up blue-collar jobs in the private sector. Employment in the modern sectors of the economy is limited, apart from public services of various kinds and

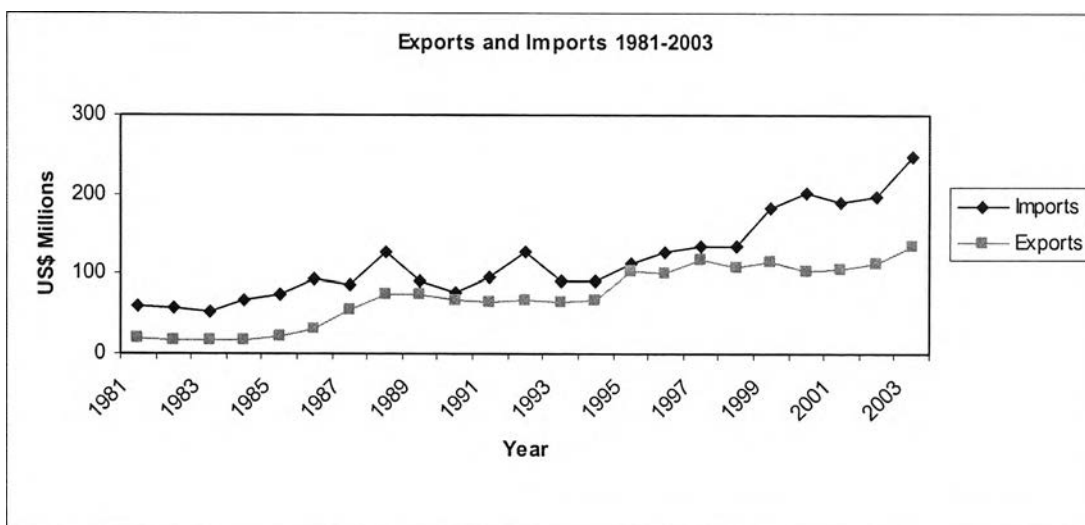
small-scale trade in the urban areas. Industrial development is as yet limited and does not provide significant employment. The lack of managerial and technological skills is the major cause for the slow development plan of the private sector. To address shortage of skilled and unskilled labor, RGoB has adopted various policy measures like skills development program to equip the new generation of labor force with the skills demanded by the labor market. Also the increased interna

tional trade could be one of the remedies since trade has an immense potential to generate employment and revenue.

## **1.2. Brief Picture of Foreign Trade Flow of Bhutan**

Prior to 1960's there existed negligible or limited barter system of trade link across the borders with Tibet in the north and India in the south. Accordance with study by CBS&IDE/JETRO, 2004 before the closure of the Tibetan border, Bhutan was supposedly self sufficient in cereal production and also enjoyed a small surplus that was exported to Tibet and imported salt and other products from Tibet. After the closure of Tibetan boarder, India was the only trading partner of Bhutan. Since then, the country focused on building a close relationship with its southern neighbors, thereby enhancing its territorial security and prospects for socioeconomic development and opened up its economy to the rest of the world. Today it has trading link with over 50 countries and total trade has increased significantly over the decade; however India still remains the major trading partner.

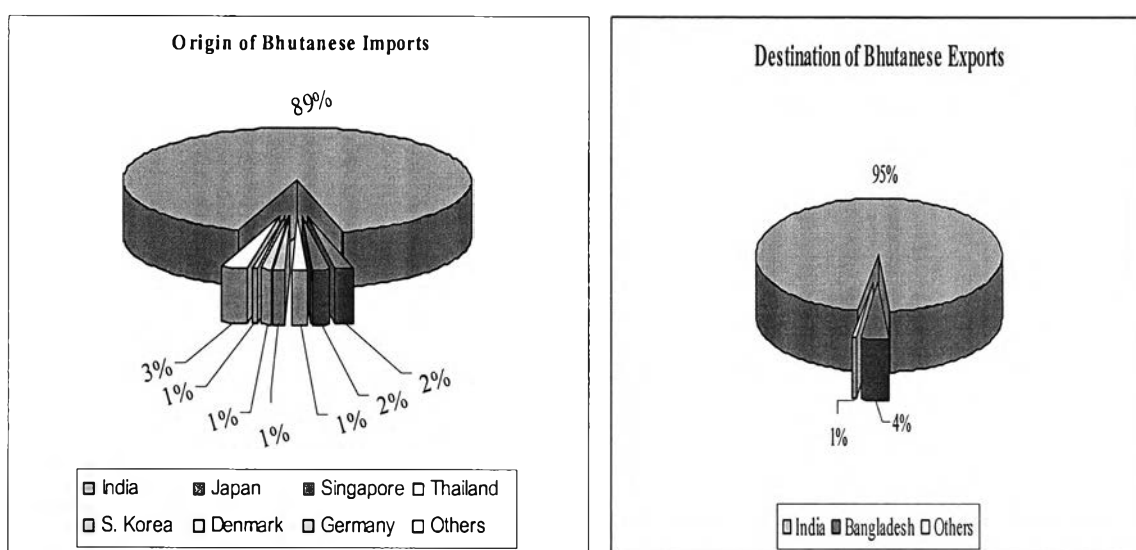
The diagram below illustrates the pattern of trade from 1981 to 2003 and it can be seen that exports and imports have increased over the period, but the imports have increased more than the exports, widening the trade deficit. In 1999 the gap of imports over exports increased substantially, especially as a result of the implementation of a large number of developmental projects. On average more than 90 percent of total exports and 70 percent of total imports of Bhutan are with India. So, Bhutan's trade is largely directed towards India, it is not only the major source of imports but also a major market for Bhutan's exports. Electricity is the single most important export to India, representing more than 40 percent of total export to India and is the main source of revenue for the country.



**Figure 1 Total Exports and Imports of Bhutan: 1981 to 2003**

Source compiled from Trade Statistic Year Book

The diagram below illustrates the major trading partners of Bhutan in the year 2003. It can be seen that India constituted (89%) of total imports and (93%) of total exports indicating strong dependence of Bhutan's trade on the performance of one economy, which is uncommon for other countries of the region. The significant increase in imports compared to 2001 of 78% was mainly boosted by power plant and industrial development activities in the country. Bhutan has huge trade deficit with India of US\$48.495 million as of 2001.



**Figure 2 Geography of foreign trade, 2003**

Bangladesh is Bhutan's second largest trade partner after India in the sub region accounting for more than 5% of total trade of Bhutan in 2001. Bhutan enjoys trade surplus with Bangladesh and it constitute 3.6% of total exports in 2003, and it provides a

promising market of fruits, processed and packed food, quartzite, boulders etc. Import from Bangladesh is mainly composed of garment and kitchenware. Followed by Nepal, which is the third export market of Bhutan within the region. Bhutan exports limited items to Nepal, coal (constituted roughly 97% of total exports in 2001) followed by gypsum and handmade paper and paperboard. There are long list of items which Bhutan imports from Nepal in small quantities like cheese, garlic, electrical parts, garments etc. As per 2001 Bhutan enjoyed trade surplus with Nepal as well however, in 2003 there is trade deficit with significant increase in imports and decrease in exports to Nepal.

Outside the South Asian Region Bhutan's trade with Japan constituted a major proportion of total trade. It is observed increase in trade with Thailand since 1995 and in 2001 Thailand became Bhutan's third largest import source constituting about 3.2 % of share of the total imports source displacing Singapore, first two being India and Japan. However, in 2003 imports from Thailand decreased to 1% and also imports from Japan and Singapore has decreased and there is increase in imports from Denmark, Germany and S. Korea (Figure 2). But trades with countries outside the region are not on a regular basis; it takes place on an 'as and when required' basis.

Thus Bhutan's 99.5 % of total exports were directed within the sub-region to India, Bangladesh and Nepal and less than 0.5% of exports are directed outside the sub region, mainly to Japan, Thailand, Singapore, and United Kingdom, USA. Further, only about 10% of imports are made from out side the sub-region indicating lopsided trade pattern and imports from outside the sub-region is dominated by machinery, appliances and electronic items accounting for roughly 85% of total imports.

Bhutan displays a very diverse import structure. It depends on imports for a wide range of products, from consumer items to intermediate goods and to the capital goods. On the other hand Bhutan has very narrow export base and enjoys uneven export structure, dominated by one commodity that is electricity and followed by minerals products, product of chemical industries, base metals and products, wood and wood products, vegetable fats and oil, textiles and processed foodstuff. Country depends on export of electricity for the major source of revenue which depends on single market. Bhutan's export to the rest of the world basically comprised of vegetable fats and oil, mineral products, textiles, processed food, wood product and handicrafts. Due to higher imports, the overall trade balance of Bhutan is consistently negative. Thus one of the

main objectives during the ninth plan period is to stimulate the export sector and to enhance exports earnings.

Table below represents all trading partners of Bhutan for the year 2003. Bhutan has developed trade ties with over 45 countries of the world outside the South Asian Region. This increase in number of trading partners are extremely significant for Bhutan however, it can be noted that to most of these countries no exports are made. In future such trade ties can be strengthened with identification of market for advantageous products.

**Table 1: The Trading Partners of Bhutan 2003, Unit in million US \$**

Country	Imports	Exports
India	219.5856	128.7499
Japan	4.297805	0.110983
Singapore	4.270308	0.021359
Thailand	3.194112	0.014640
S. Korea	2.843639	0.000000
Denmark	1.555172	0.000000
Germany	1.494214	0.000000
Italy	1.187963	0.005989
Sweden	1.105282	0.000000
Bangladesh	1.054228	4.807503
Austria	0.983975	0.000002
United Kingdom	0.861749	0.097436
Saudi Arabia	0.796205	0.000000
China	0.623999	0.000000
Malaysia	0.605982	0.000572
Nepal	0.429080	0.304778
Indonesia	0.398737	0.000000
Taiwan	0.358208	0.000000
Netherlands	0.308953	0.043110
Belgium	0.287149	0.000000
Switzerland	0.240536	0.000000
Norway	0.155028	0.000000
Australia	0.145305	0.000000
France	0.119494	0.014106
United Arab Emirates (UAE)	0.112718	0.000000
Ethiopia	0.095794	0.000000
Hungary	0.088364	0.000000
Israel	0.069657	0.000000
Hong Kong	0.057617	0.001106
Ukraine	0.052001	0.000000
Spain	0.046244	0.000000
Philippines	0.038841	0.000000
Pakistan	0.022990	0.000000
Canada	0.020038	0.021017
Sudan	0.011586	0.000000

New Zealand	0.007335	0.000000
Turkey	0.006031	0.000000
Vietnam	0.005125	0.000000
Ireland	0.004255	0.000000
Finland	0.004098	0.000000
North Korea	0.000000	0.003569
Swaziland	0.000000	0.117199
USA	0.000000	0.109088
<b>Total</b>	<b>247.5454</b>	<b>134.4224</b>

### 1.3. Rationale for the study

To date there are no empirical studies on determinants of trade flow and trade potential of Bhutan which can serve as a basis for this study and to compare the degree of trade shifts. However, there are number of studies carried out on the trade flow and trade potential with application of gravity model approach for many other small open economies in transition and have also been applied to India and Bangladesh, countries within the sub-region. Such empirical studies have become a standard tool for international trade economists and policymakers for the assessment and formulation of trade policy measures and formation of FTA.

Bhutan has been excluded from most of the regional studies mainly due to lack of data and also because its size represents a negligible share of the world market which have negligible or no impact on the economy of its trading partners or world at large. However, any changes in the economy of its trading partners and world at large would have huge impact on Bhutan's economy and its future prospects.

Further economic activity is predominantly agricultural in nature and it depends on single commodity and single market for both exports and imports; and private sector continues to be relatively weak and underdeveloped. Thus it has very uneven export structure and has strong trade dependence on the performance of one economy. On the other hand displays very diverse import structure. Thus might distort estimation due to very narrow export base and small size of Bhutan's economy (GDP) compared to its trading partners.

With these limitations, in this thesis an attempt is made to conduct empirical research and develop an econometric gravity model to find out the crucial factors for enhancing Bhutan's trade and specifically for analyzing the trade potential of Bhutan as a



whole. Thus the Gravity model applied in this paper hope to shed some light on the actual trade patterns, characteristics and the expected future trade potentials of Bhutan.

#### **1.4. Objectives of the study**

According to the background of the research it would be interesting to examine determinants of the trade flow of Bhutan and to find trade potential of Bhutan. To draw conclusion and to suggest policy advices quantitative method is adopted to ascertain the trade pattern and the trade potential. The objectives of the study are presented as follows:

- i. To describe the development of economy of Bhutan in the light of international trade growth and trade policy.
- ii. To find structure and the direction of trade flows of Bhutan.
- iii. To find major factors which contribute to the trade flows and analyze trade pattern and trade relation of Bhutan with the major trading partners.
- iv. Examine regional differences that emerge from the analysis that is between the two trading blocs (Asian countries and other developed countries) and briefly comment on the implications of results obtained from the study.
- v. Finally to find trade potential of Bhutan and analyze actual and potential exports and imports of Bhutan to determine priority markets, currently marked by underperformance in trade potential.

#### **1.5. Scope of the study**

This study focuses on investigating the determinants of trade flow of Bhutan and the trade potential taking in to account 17 main trading partners from total of about fifty countries. The study also examines the role of trade to the economic development and analyzes the trade policy.

With the panel framework designed to cover trade variation between a set of 17 of Bhutan's main trading partners for the period of 23 years, the total number of observation is 391. These countries are selected based on their trading volume and availability of data and also selection of variables is based largely on the availability of data. In this study we

have employed unbalanced panel data because Bhutan's trade with countries outside the region is not on regular basis and in certain years no exports and imports were recorded.

The variables employed in the study are export and import as a dependent variables and GDP, GDP per capita, GDP per capita differential, distance, trade openness and dummy variables as independent variables. The dummy variables like common border, bilateral free trade agreement with India and preferential trade agreement with Bangladesh and the regional blocs arrangements considered in the analysis is SAPTA. Exchange rate is additional variables incorporated in the export and import model as an independent variable.

### **1.6. Structure of the study**

The following section of this thesis is structured as follows. a). In chapter two theoretical background of the gravity model is discussed and also literature review on using gravity approach for modeling international trade flows is presented. That is, it provides highlights on theoretical foundation of gravity model and draws relationship between various existing studies to show how these theories and empirical evidence relates to this study. b). The third chapter covers the model and panel gravity model methodology of the study and the data sample. c). The descriptive analysis is presented in chapter four to provide brief overview on economic development of Bhutan in the light of international trade growth and assessment of trade policies. It also presents the structure and direction of trade flow. d). The fifth chapter presents analysis with bilateral gravity model and covers the empirical study and interpretation of the results obtained from the estimation of parameters. It also covers briefly on the evidence of 'natural trading partners' hypotheses between Bhutan and India. e). Finally, the conclusion is presented in chapter six, it includes summary of the study, policy implications and also highlights on the limitation of this study and prospects for future research.