

Bhutan—Assessment Letter for the World Bank
September 11, 2012

Bhutan’s growth has remained robust, but the current account deficit has widened.

- Bhutan’s economy has expanded at a robust pace driven by the hydropower sector developments. GDP growth is estimated at nearly 8 percent in 2011/12 (from 8.5 percent in 2010/11), and is projected to reach 12.5 percent in 2012/13 due to the acceleration in hydropower-related construction. Inflation has risen, reaching 13.5 percent in 2012Q2, with both food and nonfood components accelerating. Bhutan’s medium-term outlook is favorable, as growth should remain strong at around 8–9 percent over the medium term, driven by developments in the hydropower sector, manufacturing, and domestic services.
- The current account deficit has widened to an estimated 23 percent of GDP in 2011/12 driven in part by strong imports related to the hydropower sector, but the overall balance of payments deficit was 5 percent of GDP due to sizable grants and loan disbursements. Strong growth in domestic demand has fueled the demand for Indian rupees (since about 80 percent of Bhutan’s imports are from India), contributing to a rupee shortage. Convertible currency reserves, however, are broadly adequate (US\$723 million in July 2012).
- Challenges in the banking sector caused by high credit growth have come to the fore. While credit growth has remained high at 26.2 percent year-on-year in June, it has moderated since March—contracting in sequential terms in June—as a result of tight liquidity and policy measures (see below). Loan concentration, particularly in real estate/construction and personal loans, is significant. Interest rates, albeit low, have started to increase. Financial stability indicators are generally adequate, but concerns about a prospective deterioration in asset quality have intensified as nonperforming loans (net) have risen to 5.9 percent from 3.1 percent of total loans a year earlier.

Current policy settings are broadly appropriate, and overheating pressures are being addressed.

- Monetary conditions need *to continue* to be recalibrated to ensure that *prospective* credit growth remains in check and liquidity conditions are appropriate. The Royal Monetary Authority of Bhutan has taken appropriate steps to address high credit growth and improve its ability to manage liquidity, particularly with the introduction of the policy rate and base rate as well as liquidity adjustment facility, though the policy rate has been set at a low level. Financial sector supervision should be strengthened and prudential tools should continue to be used proactively. Greater financial intermediation in recent years may have increased systemic vulnerabilities stemming from rapid credit growth.

- Fiscal policy has generally been prudent, but the widening of the fiscal deficit in 2011/12 has contributed to overheating. The budget deficit, estimated to have reached 4.3 percent of GDP, has led to greater demand for imports, putting pressure on the demand for Indian rupees and exacerbated the rupee shortfall. Strong commitment to the 2012/13 budget deficit target of 1.6 percent of GDP is welcome, as current expenditure declines as a share of GDP on the back of spending restraint and tax revenue is expected to improve slightly. While public debt is sustainable over the long term, the risk of debt distress stems from the possibility of shortfalls in aid-based foreign financing. Public debt has increased significantly since 2009/10 as a result of investments in the hydropower sector and is projected to exceed 93 percent of GDP in 2014/15, putting Bhutan at high risk of debt distress. However, risks are mitigated by the concentration of debt in commercially viable hydropower projects, which account for nearly two-thirds of external debt.
- The rupee shortage reflects a structural imbalance in Bhutan's economy, but overheating has also contributed. The spending on hydropower projects in the pipeline and volatile exports to India (due to the strong seasonality in electricity generation) continue to contribute to volatility in net rupee inflows. While the hydropower projects are financed by rupee loans and grants, ancillary private sector development (particularly construction) and aid inflows have fueled imports. However, loose aggregate demand policies (high credit growth and a widening of the fiscal deficit) have also contributed to the balance of payment pressures. Measures to curb credit growth are expected to alleviate the rupee shortage and fiscal restraint will also help.

The 2011 Article IV consultation was concluded on May 27, 2011. A staff visit took place in July 30–August 7, 2012 and the next Article IV consultation mission is planned for March 2013.

Table 1. Bhutan: Selected Economic and Financial Indicators, 2007/08–2012/13 1/

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
				Est.	Projections	
Nominal GDP (2009): US\$1,265 million						
Population (2009): 0.697 million						
GDP per capita (2009): US\$1,815						
Quota: SDR 6.3 million						
Real sector						
Real GDP at market prices (percent change)	10.8	5.7	9.3	8.4	7.7	11.8
Consumer prices (percent change, period average)	6.3	7.1	4.8	8.6	9.1	8.6
General government				(In percent of GDP)		
Total revenue and grants	34.9	32.8	46.3	36.5	37.0	30.4
Tax revenue	9.0	9.9	13.4	14.1	14.5	14.8
Non-tax revenue	14.6	11.6	16.3	8.8	6.9	5.6
Foreign grants	11.4	11.3	16.6	13.6	15.6	10.0
Total expenditure and net lending	34.7	33.3	44.7	38.6	41.2	31.8
Current expenditure	18.7	19.1	26.0	20.6	19.3	17.9
Capital expenditure	19.2	16.9	19.3	19.1	23.0	14.9
Current balance (excluding grants)	4.9	2.4	3.8	2.3	2.0	2.5
Overall balance	0.3	-0.5	1.6	-2.1	-4.2	-1.4
Public sector debt 2/	66.2	67.7	54.4	71.6	77.2	86.2
Monetary sector 3/				(Percent change, unless otherwise indicated)		
Broad money	2.3	24.6	30.1	21.2	5.4	...
Credit to private sector	39.7	29.3	41.1	31.6	34.4	...
Interest rates (end of period, in percent)						
Deposits (less than 1 year)	4.8	4.8	5.0	5.0	5.0	...
Lending	10–16	10–16	10–16	9.75–16	9.75–16	...
External sector				(In millions of dollars, unless otherwise indicated)		
Current account balance	-28	-26	-142	-323	-386	-534
(In percent of GDP)	-2.2	-2.2	-9.9	-20.8	-23.0	-27.9
Trade balance	-72	-90	-299	-472	-494	-519
Exports (goods)	599	516	544	605	621	681
(Percent change)	4.4	-13.8	5.5	11.0	2.8	9.6
Imports (goods)	671	607	843	1,077	1,116	1,200
(Percent change)	27.4	-9.6	39.0	27.7	3.6	7.6
Grants (current transfer)	161	151	261	231	292	214
Capital account balance	58	109	206	423	291	481
Loans (net)	39	73	108	335	185	328
Overall balance	45	115	107	90	-95	-53
(In percent of GDP)	3.5	9.4	7.4	5.8	-5.7	-2.8
Gross official reserves	646	758	865	952	859	807
(In months of goods and services imports)	11.4	9.7	8.8	9.3	7.8	6.9
External debt (in percent of GDP)	63.5	65.6	52.8	68.9	70.9	80.7
Ngultrum per U.S. dollar (period average)	40.4	47.8	46.7	49.9
Memorandum items:						
Electricity exports (in percent of total goods exports)	41.9	40.1	41.0	34.1	30.6	27.7
Unemployment rate (in percent) 4/	3.7	4.0	3.3

Sources: Data provided by the Bhutanese authorities; and IMF staff estimates and projections.

1/ Fiscal year begins July 1.

2/ Public and publicly guaranteed debt, including loans for hydropower projects and the purchase of one aircraft.

3/ End-March 2012 data for 2011/12.

4/ On a calendar year basis (e.g., the entry for 2007/08 is for 2007).