INTERNATIONAL MONETARY FUND

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BHUTAN

July 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR BHUTAN

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV consultation with Bhutan, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 20, 2014, following discussions that ended on March 7, 2014, with the officials of Bhutan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 30, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A supplement on **Enhancing Financial Sector Surveillance** prepared by the IMF and the World Bank.
- A **Staff Statement** of June 20, 2014 updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board as expressed during its June 20, 2014 consideration of the staff report that concluded the Article IV consultation with Bhutan.
- A **Statement by the Executive Director** for Bhutan.

The following document has been or will be separately released.

Selected Issues Paper

The publication policy for staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

BHUTAN

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

May 30, 2014

KEY ISSUES

Outlook and Risks: Growth in Bhutan was robust during the last Five-Year Plan (2008/09 to 2012/13), driven by the development of the hydropower sector. However, growth has slowed recently due to policy efforts to moderate aggregate demand to ameliorate overheating pressures. Downside risks remain due to high public debt, potential financial sector vulnerabilities, and the need to manage recurrent pressures on Indian rupee reserves. The main external vulnerability stems from a prolongation of the slowdown in India, Bhutan's main trade and development partner.

Main Policy Recommendations: The main near-term policy challenge is to revive growth while ensuring that external pressures do not reemerge. The key policy recommendations are:

- Fiscal policy should be tightened while preserving social and productive expenditure. Revenue reforms, including broadening the tax base by reducing the number of zero-sales tax-rated goods and taxing domestic value added more extensively, would help in the near term. Over the medium term, consideration should be given to introducing a value-added tax.

- On monetary policy, external flows should be fully sterilized and liquidity should be tightened to prevent credit growth from rebounding too strongly. Interest rate spreads need to be narrowed and better reflect market conditions. Over the medium-term, there is a need to further improve the monetary transmission mechanism and deepen the financial system. In particular, it is essential to further develop the government bond market by greater and more regular issuance.

- Reserves have to be managed carefully to contain recurrent pressures on rupee reserves, including by aligning the currency composition of reserves with that of the structure of external liabilities and trade.

- Further financial deepening should be balanced with maintaining financial stability. Risks to stability necessitate continued vigilance, given past rapid private credit growth. Supervision and regulation need to be strengthened to monitor and safeguard banks' asset quality and limit systemic risk, including by use of macroprudential measures.

Approved By
Paul Cashin and Ranil Salgado

Discussions took place in Thimpu during February 24–March 7, 2014. The staff team comprised S. Jain-Chandra (head), A. Mohommad, and M. Raissi (all APD). Mr. Mohan and Mr. Kapur (OED) participated in key policy meetings. The mission met with Finance Minister Dorji, Governor Tenzin, Finance Secretary Dorji and other senior officials and representatives of the business community. May Inoue and Qianqian Zhang (all APD) assisted in the preparation of this report.

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INTRODUCTION

1. **Significant economic and social gains have been realized during the Tenth Five Year Plan** (spanning 2008/09–2012/13). Against the background of strong implementation, robust donor support, and increased hydropower generation capacity over the 10th Five Year Plan (FYP), there has been a steady increase in per capita incomes to middle-income levels and substantial reduction in poverty, along with marked improvement in social indicators. Bhutan has attained or is on track to achieve most of the MDGs. Additionally, Bhutan has pioneered a unique development approach based on the concept of Gross National Happiness (Box 1). Bhutan has also enjoyed political stability, with elections and a smooth political transition taking place in mid 2013.

Table. Poverty and Social Indicators, Bhutan

	2000	2007	2012
Population below poverty line (%)	36.3	23.2	12.0 [1]
GNI per capita, Atlas method US$	780	1,640 (2008)	2,420
Gross primary enrolment (%) [2]	72	106	110
Human development index	0.58 (2003)	0.61 (2006)	0.54 [3]
Infant mortality (per 1,000 live births) (‰)	68.4	56.2	43.7 (2010)

Source: UN Publications, UNDP, World Bank, Bhutan National Statistics Bureau

[1] Bhutan Poverty Analysis, 2012

[2] Percent of school age population

[3] World Human development index: 0.69; Global ranking: 140

2. **Notwithstanding these successes, Bhutan faces growing external imbalances.** Rapid growthwas accompanied by overheating pressures which resulted in a sharp widening of the current account deficit, in part due to substantial hydro-power related imports. External pressures have led to a recurrent shortfall in Indian rupee reserves. A comprehensive set of policies should be put in place to ensure that such pressures are minimized in future as Bhutan continues on its quest to raise growth and living standards through expansion of hydropower capacity.

3. **The authorities' macroeconomic policies and past Fund advice have been broadly aligned, but progress on fiscal consolidation and structural reforms have been slow**. Consistent with Fund advice, important steps have been taken to improve the monetary transmission mechanism, to introduce macroprudential rules, and to actively manage reserves. However, the stance of fiscal policy has been looser than staff recommended in 2011 Article IV Consultation and is budgeted to remain high in FY2014. Also, progress on structural reforms has been limited.

RECENT ECONOMIC DEVELOPMENTS

4. **GDP growth in Bhutan has been strong over the Tenth FYP, driven by the hydropower sector.** However, growth is projected to have slowed to 5 percent in FY 2013[1] from over 10 percent in FY2011, due to policy efforts to moderate credit growth to contain overheating pressures.

[1] The fiscal year (FY) begins July 1.

Restrictions on credit for construction and vehicle imports led to a decline in services sector growth, particularly in transport and financial services, as well as a decline in construction sector growth.

5. Inflation remains elevated above double digits, mostly reflecting price developments in India, given the peg to the Indian rupee[2]. Headline inflation reached 11.3 percent in December 2013, accelerating from 9.5 percent in December 2012. Inflation is projected to average above 10 percent in FY 2014, but should decline over the medium term in line with moderation in India's inflation. Staff analysis has found that inflation in Bhutan is closely related to Indian inflation (see Box 2).

6. The current account (CA) deficit remains sizable and is financed through substantial aid inflows. The CA deficit, reflecting large hydropower-related imports, widened to 22.8 percent of GDP in FY 2013 from 15 percent of GDP on average over the 10th FYP. In addition, hydro-related auxiliary activities and a consumption and housing boom added to the rapid increase in non-hydropower imports. Nonetheless, robust aid inflows have led to a positive overall balance of payments position, enabling the continued accumulation of international reserves, which stood at US$ 933 million (over 10 months of import cover) in December 2013.

OUTLOOK AND RISKS

7. Growth momentum is expected to pick up in the near term. Growth is projected to recover to 6½ percent in FY2014, rising to about 7½ percent in FY2015, driven mainly by a pick-up in hydropower-related construction and domestic services. In addition, policy measures to revive the economy, including a capital infusion in banks as part of an Economic Stimulus Package (ESP), are likely to exert a modest positive impact on growth. The CA deficit is projected to widen further to around 25 percent in FY 2014 due to stronger hydro-related imports.

8. The expansion of hydropower capacity over the medium-term poses challenges for macroeconomic management (see Box 3). Growth is projected to average 8½ percent over the course of the Eleventh FYP, boosted initially by the construction of hydropower facilities and then by electricity generation in later years. As a result, the CA deficit is projected to widen to more than 27 percent of GDP by FY2017. External financing should be monitored closely so that pressures on the overall balance of payments position remain contained. However, if this transition is well managed, per-capita incomes could double to around US$5,000 by FY2019.

9. Risks are firmly tilted to the downside. Risks stem from high debt levels and the possible surfacing of financial sector vulnerabilities following a prolonged period of rapid credit growth. There is also a risk of renewed external pressures, including pressures on rupee reserves, if macroeconomic policies remain expansionary and credit growth rebounds strongly. Additionally, risks emanate from a potential slower-than-expected recovery in India—including due to financial market volatility—

[2] The rupee refers to the Indian rupee in this report.

though these risks are mitigated by the concentration of exports in the hydropower sector, which enjoys healthy demand from power-constrained India (see Box 4 for spillovers from India)[3].

POLICY THEME #1—MAINTAINING MACRO-ECONOMIC STABILITY

The near-term challenge is to support growth while ensuring that macroeconomic stability is maintained and external pressures remain contained. Fiscal and monetary policies should be tightened and reserve management strengthened in the face of recurrent pressures on rupee reserves.

A. Fiscal Policy

Background

10. The fiscal deficit worsened sharply in FY2013 due to a shortfall in grants, and is budgeted to remain high in FY2014. The FY2013 fiscal deficit was revised to 4 percent of GDP, compared with the previous estimate of 1 percent, driven primarily by a shortfall in grants. The budget for FY2014 aims for a deficit of 3.6 percent, mainly on account of lower projected revenues and grants. In addition, an off-budget economic stimulus plan, financed by official grants from India, has been prepared in the amount of ngultrum 5 billion (about 4 percent of GDP) to be spent over 5 years, of which ngultrum 4 billion will be provided to banks in the form of subordinated debt and revolving funds to reinvigorate credit growth. Furthermore, the stimulus plan proposes subsidies of ngultrum 1 billion for education, free electricity, financial support for senior citizens, and unemployment benefits.

11. Over the medium term (corresponding to the Eleventh FYP), donor financing is projected to fall as per capita incomes rise. Accordingly, grants are expected to decline from 9 percent of GDP in 2012/13 to 6 percent by 2017/18. The impact of declining grants is expected to be mitigated by the increase in hydropower revenues as major projects currently under construction come on-stream in the outer years of the plan. The fiscal deficit is projected to be around 1 percent of GDP (on average) during the plan period[4]. The programs and financing of the Eleventh FYP were negotiated with the Government of India, which will provide Nu. 45 billion (or 21 percent of plan outlay) in the form of grants.

[3] For a discussion of risks to India's economic outlook, see *India: 2014 Article IV Consultation* (IMF Country Report No. 14/57).

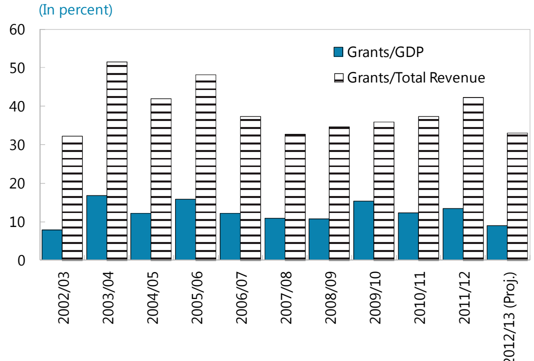
[4] The authorities' fiscal anchor in the past has restricted current expenditure to domestic revenues, and has been tightened to include part of capital expenditure in the FY2014 Budget. By the end of the medium term, the aim is to cover an increasing share of expenditure from domestic revenues.

Staff Views

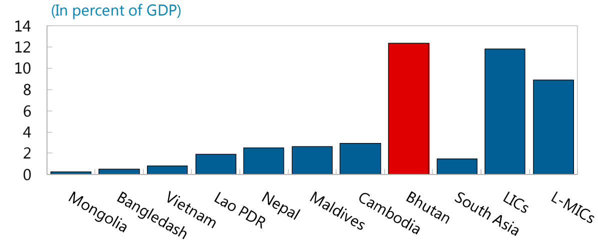
12. In the near term, fiscal policy should aim for consolidation to ensure that overheating pressures do not reemerge. Fiscal policy has generally been prudent in the past, but more recently, the fiscal stance has turned much more expansionary. Persistent large deficits, financed by domestic borrowing, risk crowding out the private sector and contributing to a buildup of public debt. Revenue reforms are essential, including reducing the number of zero-rated goods, simplifying the indirect tax rate structure, widening taxation of domestic activity, and improving tax administration (see Selected Issues Paper on "Options for Tax Reform"). Such reforms will reduce dependence on hydropower and on external aid, and will ameliorate revenue volatility. In addition, if there are further grant shortfalls, restraining spending while preserving social and productivity-enhancing expenditure will be appropriate. Further civil service wage hikes, unaccompanied by complementary revenue measures, would lead to deterioration of fiscal balances[5]. As well, the ESP risks stoking overheating pressures which could translate into external pressures.

12. Over the medium term, reforms should aim to place public finances on a more solid footing. As noted, over the span of the Eleventh FYP, donor financing is projected to fall as incomes rise. Caution is needed in the event of further delays in grant inflows and in the commissioning of the ongoing hydropower projects (which would lead to large revenue shortfalls in the outer years of plan). Given such potential eventualities, spending restraint and prioritization would be prudent to create the fiscal space for necessary development-related expenditure (on health and education) while avoiding a build-up of public debt. Consideration should be given to introducing a value-added tax to replace the existing system of indirect taxes, to boost revenue collection through a wider base and better enforcement.

Grants (Aid Flows)
(In percent)



Grants 2003-2013: South Asia, Other Asian LICs and L-MICs 1/
(In percent of GDP)



1/ South Asia: Bangladesh, Bhutan, Maldives, Myanmar and Nepal.
LICs (Least-Income Countries) in Asia: Myanmar,Mongolia, Bangladesh, Lao PDR, Nepal , Maldives, Cambodia, Papua New Guinea, Bhutan, Timon-Leste, Kiribati, Micronesia, Mashall Island, Palau, Samoa, Solomon Islands, Tonga and Vanuatu .
L-MICs (Middle-and-Least Income Countries) in Asia: the LICs above and India, Vietnam, Indonesia, Philippines, Thailand and Malaysia

Sources: IMF, International Financial Statistics, Royal Monetary Authority of Bhutan, and IMF staff calculations.

[5] The government has instituted a new Pay Commission to recommend wage adjustments in the public sector, which will issue its recommendations in the near future.

13. There is a need to improve fiscal management, including strengthening cash management (on which Fund TA is being provided). Government cash balances are prone to sharp fluctuations due to erratic and volatile inflows, particularly grants, necessitating the maintenance of large precautionary balances. Moreover, domestic financial markets are shallow and underdeveloped, and treasury bills are not issued regularly enough to handle fiscal volatility. Thus, cash flow is both complicated to forecast and difficult to smooth with existing instruments. The issuance of treasury bills should be planned and based on a cash forecasting framework, as opposed to ad-hoc short-term borrowing. Over the medium term, the multi-year budget framework could be enhanced to enable the government to better mobilize donor support, along with coordinated development of a treasury bill market to both facilitate issuance and develop demand for treasury bills.

Authorities' Views

14. The authorities broadly agreed with the need to maintain fiscal restraint, including through additional revenue-raising measures. The next Budget is expected to include a number of near-term tax measures to boost revenues, and a broader review of tax policy is envisaged in the medium term. Fiscal measures will also likely replace administrative measures restricting imports of vehicles and construction-related items. The authorities also recognized that fiscal room to implement pay hikes is limited, even as expectations of a pay hike have arisen with the appointment of the Pay Commission.

15. On the larger-than-expected fiscal deficit in FY2013, the authorities noted that larger domestic borrowing resulted from cash management needs as grants were delayed. They clarified that the ESP will be implemented to minimize risks to banks and the possible generation of excess aggregate demand. They clarified that banks will only serve as a conduit for financing, and will be free to advance loans on purely commercial basis as long as the loans meet the criteria of import substitution, export promotion, or employment promotion.

B. Monetary Policy

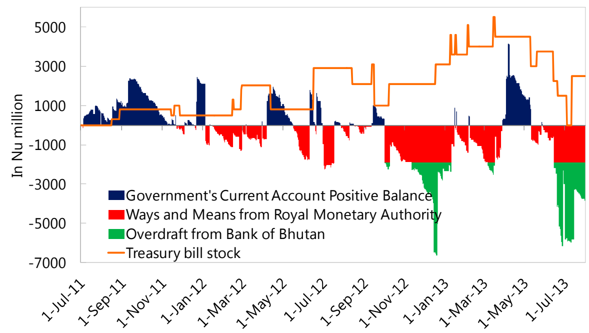
Background

16. The tight liquidity condition faced by the banking system in 2011 and 2012 have eased recently. Excess bank liquidity characterized the financial system from 2008 to early-2011 due to the accumulation of hydropower and non-hydro inflows (which were only partially sterilized). Tight liquidity conditions emerged in June 2011 (shortfall of Nu 1.1 bn or 1.5 percent of GDP) as a result of persistent growth in rupee imports with an equivalent drain on local currency liquidity; a reduction in retail deposits; over-dependence on more volatile and seasonal corporate and government deposits as a source of funding; and bank financing of large investment projects (e.g. Dungsam cement project). Responding to tight liquidity conditions, the Royal Monetary Authority (RMA) cut the cash reserve ratio (CRR) twice, banned construction and vehicle loans, relaxed the provisioning requirements, and suspended overnight sweeping of government accounts from the banks to the RMA, which eased liquidity. At present, banking sector liquidity is ample at around 10 percent of GDP .

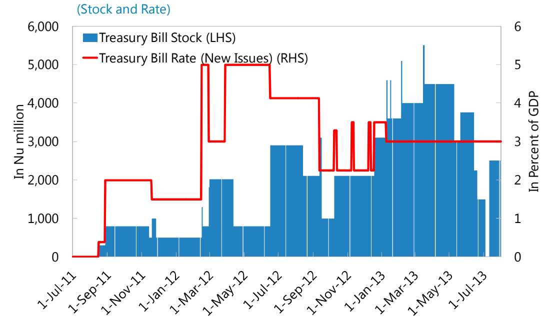
17. The authorities have made some progress towards improving the monetary transmission mechanism. In March 2012, the RMA introduced a Short-Term Liquidity Adjustment Window (RSTLAW) for securitized RMA lending to banks at a newly-introduced policy rate which is linked to the RSTLAW facility. To further strengthen the transmission mechanism, a base rate system (below which lending is not viable for financial institutions) was introduced in order to influence credit growth, increase transparency of loan pricing, and foster lending discipline. The base rate could also serve as a reference benchmark for floating-rate loans. There remains a persistent negative interest rate differential with India.

18. Despite substantial financing requirements recently, the government has continued to rely on bank financing rather than Treasury bill issuance. First, the Ways and Means (W&M) account is available at the RMA up to a limit of 10 percent of average revenues over the last two years. Second, the overdraft facility with the largest commercial bank could be overdrawn without limit. As shown in the text figure, the government first utilizes the cheaper W&M account before making use of the overdraft. The issuance of Treasury bills (T-bills) has to a large extent been detached from financing requirements. Since December 2009, T- bills have rarely been issued for monetary policy purposes, nor are they being issued at market-determined interest rates. Since February 2013, the interest rate has been fixed at about 3 percent which is far below deposit rates and the policy rate.

Bhutan: Government Borrowing from the Banking System



Bhutan: Government Issuance of Treasury Bills
(Stock and Rate)



Staff Views

19. Monetary conditions should be tightened to ward off prospective overheating and better manage pressures on rupee reserves. Liquidity conditions should be closely monitored and promptly adjusted to prevent excessive credit growth in future. Specifically, the CRR should be adjusted upward, and with further market development, regular and increased issuance of T-bills should be used to mop up excess liquidity. Hydropower-related inflows and aid flows should be fully sterilized to dampen inflation pressures and credit growth, thereby obviating the need for import compression. Tighter macropolicy stances should also help to address competitiveness concerns.

20. Despite progress, considerable enhancements to the monetary transmission mechanism are needed. Interest rates need to be higher and be more closely aligned with those prevailing in India. Notwithstanding the introduction of a new policy rate (which is not yet operationally effective), the framework for monetary operations is underdeveloped, constrained by the limited range of government securities and the lack of money and securities markets. Over the medium term, the development of a formal interbank market and increased and regular issuance of

T-bills and bonds are the most critical elements for making monetary policy more effective, for enhancing financial markets, for improving banking system health, and for ensuring overall macro financial stability. While it would entail some costs, introduction of a well-functioning government securities market is critical, and would provide a risk-free benchmark for the financial system (and eventually a yield curve), an investment vehicle for financial institutions, and a tool for open market operations.

Authorities' Views

21. The authorities agreed on the need to monitor bank liquidity and credit conditions more closely. They acknowledged that external flows should be fully sterilized and that the use of current tools (including the overnight sweeping facility) are insufficient, and are therefore exploring other instruments to manage liquidity. They noted that while credit growth has been reduced, such administrative restrictions are not optimal and will be rolled back once the macroeconomic policy stance is sufficiently tight.

C. External Sector Issues

Background

22. The large current account deficit and the currency composition of reserves have contributed to a recurring shortfall of Indian rupees. Convertible currency reserves are much larger than rupee reserves, which have constituted less than 3 percent of reserves on average during the past 5 years. Rapid credit growth, which led to higher non-hydropower imports, as well as large hydropower-related imports resulted in strong demand for rupees. These pressures culminated in pronounced rupee shortages and prompted two reserves sales of US$200 million each by the RMA in December 2011 and June 2013.[6] The RMA also utilized foreign exchange overdrafts with Indian commercial banks and the line of credit with the Government of India. Additionally, a bilateral swap agreement of US$100 million with the Reserve Bank of India was agreed upon in March 2013 and was subsequently used (though it was reversed in September 2013). While these financing instruments helped to relieve immediate reserve pressures, they are expensive and cannot address the ongoing structural need to mobilize rupee reserves.

Staff Views

23. The exchange rate peg with India has served Bhutan well, though the real effective exchange rate is assessed to be above levels suggested by underlying fundamentals. The peg to the Indian rupee remains appropriate and provides Bhutan with an appropriate nominal anchor, given that India is Bhutan's largest trade and development partner. The ngultrum is currently

[6] Continued rupee shortages led to the adoption of a number of measures— including the restriction on the availability of Indian rupee for making payments for imports of vehicles and construction material from India— in March 2012.

assessed to be overvalued by between 8–21 percent, though once additional hydropower revenues materialize over the medium term, this overvaluation is projected to dissipate (see Box 5). Bhutan has also ample reserves, as its reserve cover exceeds the standard measures of reserve adequacy and is much higher than peer countries[7].

24. Notwithstanding an adequate level of reserves, they have to be managed carefully to contain recurrent pressures. Risks stem from the fact that hydropower-related rupee debt service payments are lumpy and there are timing mis-matches between hydropower-related rupee inflows and outflows. These features require careful management and provisioning in advance for necessary rupees. Also, the currency composition of reserves should be more closely aligned with the structure of Bhutan's external liabilities and trade (sources of rupee-currency liquidity needs)[8]. As noted in the 2013 IMF technical assistance on reserve management, consideration should be given to gradually increasing the share of rupee reserves and to adopting reserve management and investment guidelines. Furthermore, once the policy stance is tightened sufficiently and revenue reforms instituted, the import restrictions should be gradually withdrawn, in line with the authorities' plans.

25. External debt is projected to rise significantly over the medium term. Bhutan's debt dynamics are subject to moderate risk of distress, as indicated by the Low-Income Country (LIC)-Debt Sustainability Analysis (DSA)—see Supplement I. The construction of new hydropower projects is expected to lead to a substantial build-up of external debt, relative to levels projected during the previous 2011 Article IV consultation. In particular, the LIC-DSA thresholds are breached for several indicators for prolonged periods of time. However, these additional projects are expected to confer strong future economic dividends, boosting future GDP growth and exports. The mitigating factors that were highlighted in the previous DSA remain valid, namely a strong track record of project implementation, commercial viability, and close economic and political ties with India, Bhutan's main provider of financing for hydropower projects and the key consumer of its electricity exports. Notwithstanding these mitigating factors, additional non-concessional borrowing should be avoided as the level of debt has increased substantially compared to previous DSAs.

26. Recent changes to Bhutan's foreign exchange framework, including the regulatory responses to the Indian rupee shortage, have given rise to new exchange restrictions subject to Fund approval under Article VIII, Section 2(a). These include: (i) banning residents who do not comply with the requirement to repatriate export proceeds from accessing foreign exchange for unrelated imports; (ii) requiring foreign direct investment businesses to pay for their establishment and operational expenses from their own convertible currency resources; (iii) requiring Bhutanese companies to pay the interest on and amortization of external loans from their own convertible currency resources; (iv) restricting the availability of Indian rupees for making payments and transfers

[7] See selected issues paper "Reserve adequacy and reserve management in Bhutan".

[8] Rupee debt constitutes 61 percent of total external debt in Bhutan, with convertible currency debt accounting for 29 percent. India is the largest trading partner for Bhutan (about 80 percent of Bhutan's commodity exports are destined for India and about 70 percent of Bhutan's imports are from India).

to India in the following current international transactions: personal travel, study-abroad living arrangement, family and salary remittances, advance payments for import from India and to recruit Indian workers, and imports of certain construction materials and vehicles from India; and (v) banning the access to Indian rupees for unrelated current international transactions for those who contravene the RMA's 2012 guidelines on Indian rupee transactions. The authorities should eliminate the restrictions upon establishing the necessary macroeconomic and structural conditions.

Authorities' Views

27. The authorities noted that while Bhutan's reserves exceed most standard reserve adequacy thresholds, reserves have been largely built up through aid flows and not through export earnings. The RMA, with technical assistance from the Fund, has revised its Reserve Management Policy (RMP) and is drafting Investment Guidelines. In line with the new RMP, the RMA has developed a reserve adequacy framework with a threshold based on essential imports and other payments, beyond which the RMA shall convert its convertible currency reserves and increase rupee reserves to meet external obligations. Nevertheless, the authorities noted that since the Indian rupee is not a convertible currency, the RMA will need to calibrate its reserve composition between convertible currencies and rupees cautiously. Also, they underscored that any conversion of convertible currencies to rupees should take into account the Bhutanese Constitutional requirement that the RMA hold 12 months of essential imports cover, as well as third country imports and debt servicing requirements. The authorities considered the maintenance of most exchange restrictions under Article XIV, and those inconsistent with the Article VIII obligations, as necessary given that Bhutan's reserves are built on aid and external borrowing, and the continuing pressure on Bhutan's Indian rupee reserves.

POLICY THEME #2—SAFEGUARDING FINANCIAL SECTOR STABILITY AND FOSTERING DEEPENING

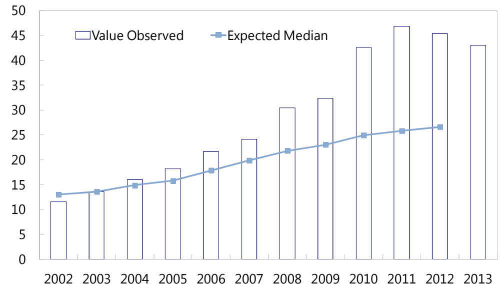
Vigilance on the risks to financial stability is warranted, against the backdrop of rapid credit growth for a number of years. Supervision needs to be strengthened to safeguard asset quality. Over the medium term, further financial deepening will require a comprehensive financial sector strategy that balances the twin objectives of development and financial stability.[9]

[9] Bhutan is a pilot case in the Enhancing Financial Sector Surveillance (EFSS) in Low-Income Countries initiative (see supplement III). The findings of an MCM-World Bank mission in September 2013 are included as a supplement to this report. The main recommendations of the mission are included in Annex 1.

Background

28. Growth in bank credit to the private sector has been rapid, though it has decelerated recently. Private sector credit grew at an average annual rate of 30 percent during 2002–11, increasing credit from 11 to 47 percent of GDP. This compares with a median of 32 percent for lower middle-income countries, and an "expected norm" of 27 percent based upon a regression controlling for relevant country-specific characteristics. This expansion stemmed from an initially-low credit base, ample wholesale liquidity (mostly deposits from the government and government corporations as shown in the chart), growth in civil service wages, the entry of three new banks in 2010, and loose monetary conditions. Additionally, non-bank financial institutions have also engaged in lending. Responding to the shortage of rupees, administrative measures (banning housing and vehicle loans) to slow down credit have resulted in growth of private credit decelerating to 7.4 percent year-on-year in November 2013 and the credit-to-GDP ratio falling to 43 percent in 2013.

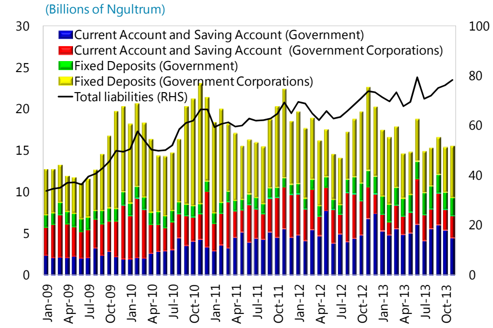
Private Credit / GDP
(In percent)



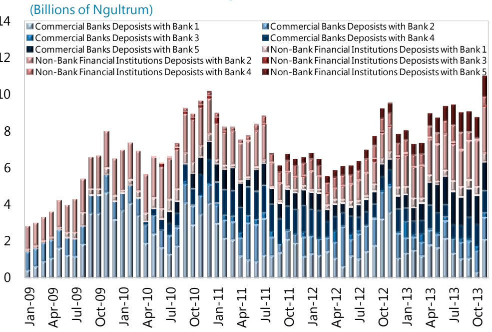
Source: World Bank FinStat database

29. Financial stability indicators are generally sound, though NPLs have increased recently. For the system as a whole, the Capital Adequacy Ratio remained high (at 18 percent in September 2013), though there is considerable variation across banks. The Statutory Liquidity Requirement (SLR) was also comfortably met at 36 percent in September 2013 (compared with the regulatory minimum of 20 percent), though the SLR includes unsecured longer-term bank deposits with other banks and non-banks, which heightens systemic risk (see chart). Reflecting the economic slowdown, there has been a deterioration in banks' asset quality, with non-performing loans (NPLs) rising from 8 percent in June 2012 to 12 percent in September 2013. Some sectors are seeing a much sharper increase in NPLs, in particular trade and commerce and personal loans. The bank credit-to-deposit ratio has eased somewhat to 86 percent in September 2013 from over 105 percent in June 2012, as credit has been curtailed.

Bank Deposits of Public Sector
(Billions of Ngultrum)

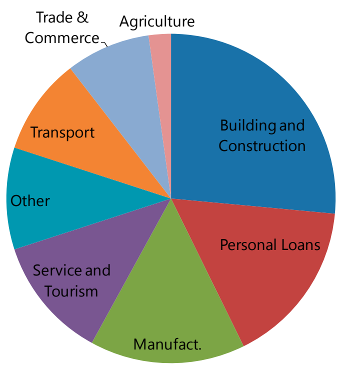


Financial Institutions Deposits with Other Banks
(Billions of Ngultrum)

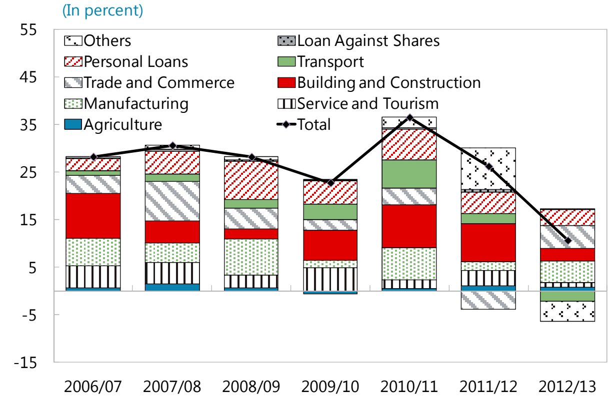


30. Financial sector vulnerabilities arise from growing asset-liability mismatches and concentrated lending. A significant proportion of the deposit base is corporate deposits, which tend to be short-term, seasonal, and volatile, whereas bank credit is concentrated in loans with longer time horizons. The concentration of lending in personal and real estate loans raises particular concerns. More than a quarter of the financial sector's portfolio consists of building and construction loans, followed by personal loans which constitute around 16 percent of credit outstanding. The prolonged credit boom has been associated with a run-up in real estate prices, and their recent decline may expose weaknesses in asset quality. Stress tests indicate that the banking system would be hardest hit under scenarios involving (i) a large increase in NPLs, which will reduce the banking system's CAR by 7 percentage points, and (ii) a souring of large exposures which has a particularly sizeable impact on one of the large state owned banks and the private bank with the most significant large exposures (for details please see EFSS supplement).

Bank Lending, End-June 2012



Bhutan: Sectoral Contributions to Credit Growth
(In percent)



Staff Views

31. Notwithstanding progress, financial sector regulation and supervision need to be strengthened. It is important to monitor vulnerabilities that may have accumulated in the wake of sustained rapid credit growth for a number of years, including sectorally-concentrated lending, asset-liability mismatches, the recent fall in asset values, and increased lending by non-banks. Measures to strengthen regulation and supervision should include closing gaps in regulation, regular stress-testing by the RMA to monitor risks, encouraging banks to conduct their own stress tests, and putting in place crisis management and deposit insurance arrangements.

32. Macroprudential policies should play an active role in containing the buildup of financial sector risks. The RMA should continue to use macroprudential policies but reduce its reliance on a single tool, namely the adjustment of risk weightings, and should undertake a regular review of sector-wide risks. The authorities' plans to further contain risks by using additional macroprudential tools—including credit-to-deposit, loan-to-value, and debt-to-income limits—are welcome. However, care needs to be taken to sequence these measures appropriately and to provide financial institutions with sufficient time to comply. Instituting investment guidelines for non-banks would be a welcome step, however requirements to limit lending activities should be complemented by measures to enhance investment opportunities (such as encouraging the development of long-dated government securities).

33. Efforts to deepen the financial sector should continue, along with initiatives to make it more inclusive. The preparation of a comprehensive Financial Sector Development Strategy (now under way with World Bank assistance) will provide a careful sequencing of reforms within a medium-term plan. As well, promoting alternatives to bank financing for the private sector, including developing the commercial bond market and private equity markets over the medium term, would be welcome. Floating minority shares of public enterprises would broaden the range of investment opportunities. Efforts to promote financial literacy are valuable and should continue.

Authorities' Views

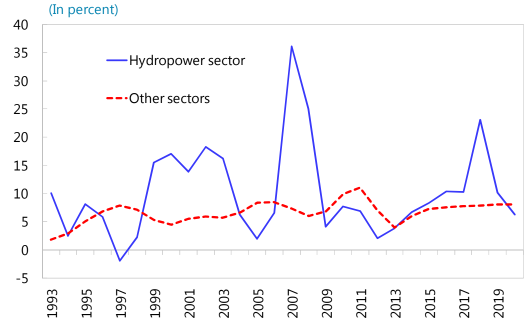
34. The authorities highlighted that they are closely monitoring financial sector risks and are planning regular bank stress testing. They acknowledged that short-term deposits dominate the banks' funding base, and hence, there are asset-liability mismatches. They recognized the need to use varied macroprudential policies and instruments and plan to roll out measures gradually in the coming months to deal with the significant build up in financial sector liquidity, asset-liability mismatches and other sector-wide risks and vulnerabilities. They agreed that further engaging the banks by conducting periodic stress tests would allow for a better understanding of risks.

POLICY THEME #3— DIVERSIFYING THE SOURCES OF GROWTH AND ENHANCING INCLUSIVENESS

The key medium-term challenge is to diversify the economy to make growth more sustainable and less volatile, while also reducing the reliance on hydropower. Greater private sector development and job creation would also pave the way for more sustainable and inclusive growth.

Background

Hydro vs. Non-hydro GDP Growth
(In percent)



Source: Staff estimates.

35. Diversifying sources of growth is an appropriate and important policy priority for Bhutan. Cross-country research suggests a positive link between trade and real sector diversification and macroeconomic outcomes, including lower output volatility.[10] While the expansion of hydropower over the past decade has boosted growth, it has also led to higher growth volatility. In addition, the hydropower sector provides limited employment opportunities. As well, exports have become more concentrated over the last decade (see Selected Issues Paper on Prospects for Economic Diversification).

[10] It is estimated that diversification episodes are associated with a 17 percent reduction in output growth volatility; among LICs, the reduction in volatility is as high as 40 percent. The evidence also suggests that diversification episodes and growth accelerations are correlated. See "Economic Diversification in LICs: Stylized Facts and Macroeconomic Implications", IMF Staff Discussion Note SDN 12/13.

36. The development of new sectors, export diversification and job creation are central goals of government policy. The government's Economic Development Policy, as represented in various Five Year Plans and its "Vision 2020" statement, underscore the importance of leveraging hydropower development to achieve broad-based growth, including through encouraging tourism and related services and the development of certain niche products and activities such as organic foods, horticulture, cash cropping, forestry and related activities, and ICT-related industries. Consistent with Bhutan's emphasis on environmental conservation and sustainable development, the policy promotes green growth. The government has ambitious plans to develop tourism, with the aim of increasing tourist arrivals to 200,000 by 2018 (a fourfold increase from 2012).

Staff Views

37. Economic diversification will ease pressures on external balances, lower output volatility and promote employment creation. Even though hydropower exports are expected to dominate export receipts in the medium term as large projects come on-stream, revenues from this sector should be leveraged to encourage development of a wider range of private sector activity (such as addressing the skills mismatch and investing in infrastructure). As noted in the government's policy, some sectors in which efforts may be focused include tourism, education and other green services and niche agricultural products (such as organic products), as well as power-intensive manufacturing industries. Efforts should also be made to further improve connectivity and enhance FDI including to facilitate technology transfer, though tax incentives need to be monitored closely and should include sunset clauses.

38. Improvements in the investment climate and access to finance, as well as addressing skills mis-matches in the labor market, would support economic diversification and boost competitiveness. Government policies should seek to address Bhutan's relatively weak performance on various business climate indicators. Lack of adequate finance for micro and small/medium scale enterprises and skills mis-matches in the labor market are impediments to private sector development. Measures to enhance training (including encouraging vocational training and expanding technical education) programs and improve access to job-related information will be needed to upgrade the skills of the labor force and promote employment creation. In addition, access to finance should be enhanced by encouraging the development of capital markets for large corporates and increased bank finance for micro and small and medium-sized enterprises (such as enhanced credit information).

Authorities' Views

39. The authorities agreed that diversification is critical for Bhutan's long-term development prospects. However, options for raising competitiveness may be limited to niche sectors, particularly agricultural products, which may then also boost employment, given the limited employment potential of the hydropower sector. In the tourism sector, traditionally a growth area for Bhutan, infrastructure development (including improved connectivity) will be key to reducing seasonality and the relative concentration of tourism in western Bhutan.

STAFF APPRAISAL

40. While Bhutan has made important economic and social gains, it faces growing external imbalances and associated challenges. Rapid growth, which paved the way for rising income levels and much-improved social indicators, has led to overheating and has placed pressure on the country's external position. Demand management policies have engendered a slowdown in growth, as the authorities have stepped in to contain overheating. As Bhutan seeks to continue to augment its hydropower capacity and meet future development goals, care has to be taken to prevent overheating from resurfacing and external imbalances from widening further.

41. Bhutan's growth momentum is expected to recover in the near term. Growth is projected to recover modestly in the current fiscal year, driven by a pick-up in hydropower-related construction and policy measures to revive the economy. Over the medium term (corresponding to the Eleventh Five-Year Plan), growth is expected to pick up more robustly, boosted initially by hydro-related construction and then by electricity generation in later years. Inflation is expected to remain elevated, closely tracking Indian inflation. At the same time, the current account deficit is projected to widen considerably due to stronger hydro-related imports. Risks are tilted to the downside due to high public debt, potential financial sector vulnerabilities, and the need to manage recurrent pressures on Indian rupee reserves. The possible negative spillovers to Bhutan from slower Indian growth are mitigated by the concentration of exports in the hydropower sector, which enjoys healthy demand from India, and on long-term India-financed investment projects and electricity purchase agreements.

42. It is critical that the fiscal stance be tightened in the near term to ensure that overheating pressures do not reemerge and public debt remain contained. Revenue reforms are essential, including reducing the number of zero-rated goods, widening taxation of domestic activity, and improving tax administration. In addition, if there are further shortfalls in grants, restraining expenditure while prioritizing social and productivity-enhancing capital spending will be appropriate. Any civil service wage hike should be accompanied by complementary revenue measures, otherwise they could lead to further deterioration of fiscal balances and a resurgence of overheating pressures. Over the medium-term, consideration should be given to introducing a value added tax to boost revenue collection.

43. Monetary conditions should be tightened to ward off prospective overheating and manage pressures on rupee reserves. Liquidity conditions should be closely monitored and promptly adjusted to prevent excessive credit growth in future. Specifically, the CRR should be adjusted upward, and with further market development, more regular and increased issuance of treasury bills should be used to mop up excess liquidity. Inflows related to hydropower projects and aid flows should be fully sterilized. Interest rate spreads need to be narrowed and reflect market conditions. Over the medium-term, it is essential that the monetary transmission mechanism be further improved, and that initiatives be undertaken to further deepen the financial system.

44. The exchange rate peg with India has served Bhutan well, though the real effective exchange rate is assessed to be above levels suggested by underlying fundamentals. The ngultrum is currently assessed to be overvalued. Tighter macropolicy stances and structural reform to enhance the business climate should also help to address competitiveness concerns. Over the medium term, once hydropower revenues materialize, this overvaluation is projected to dissipate.

45. External reserves have to be managed carefully to contain recurrent pressures. Timing mis-matches in hydropower-related rupee inflows and outflows require careful management and provisioning for the necessary rupees in advance. Also, the currency composition of reserves should be more closely aligned with the structure of Bhutan's external liabilities and trade. Furthermore, once the policy stance is tightened sufficiently and revenue reforms are instituted, there should be a gradual withdrawal of import restrictions.

46. Growing risks to financial stability necessitate continued vigilance and action, given past rapid private credit growth, sectorally-concentrated lending, growing asset-liability mismatches, and lending by non-banks. Supervision and regulation need to be strengthened to monitor and safeguard banks' asset quality and limit systemic risk, including by use of macroprudential measures. Measures to strengthen regulation and supervision should include closing gaps in regulation, regular use of stress-testing by the RMA to monitor risks, encouraging financial institutions to conduct their own stress tests, and putting in place crisis management and deposit insurance arrangements. Also, further financial deepening should be balanced with the need to maintain financial stability.

47. Efforts to diversify the economy to make growth more sustainable and less volatile should be stepped up. Diversification will ease external pressures, lower output volatility and promote employment creation. Measures to improve the investment climate, broaden access to finance and address skills mis-matches in the labor market would help economic diversification and boost competitiveness.

48. The authorities did not request and staff does not recommend approval of the exchange restrictions maintained inconsistent with Article VIII obligations. Bhutan continues to maintain exchange restrictions under the transitional arrangements of Article XIV, Section 2. Given the limited and unpredictable sources of convertible currency inflows and justifiable concerns over outflows, staff encourages the authorities to gradually ease the exchange restrictions towards their eventual elimination including restrictions that have been maintained under Article XIV, Section 2, which should be eliminated as soon as Bhutan's balance of payments position permits. Staff also recommends that the authorities eliminate the exchange restrictions, which result from inconsistencies in the applicable legal framework or where the practice is more liberal than the legal framework, early in the process. The authorities are encouraged to consider accepting the obligations under Article VIII, Sections 2(a), 3 and 4, of the IMF's Articles of Agreement in due course.

49. It is recommended that the next Article IV consultation take place on a 24-month cycle in accordance with the Decision on Article IV Consultation Cycles (Decision No. 14747-(10/96) (9/28/2010)).

Box 1. Gross National Happiness[1]

Gross National Happiness (GNH) is a unique approach to development that has been pioneered by Bhutan. Developed in the 1970s, this approach to development, which measures well-being of its citizens not based on GDP but on the principles of GNH, which considers the spiritual, physical, social and environmental health of its citizens and the natural environment. Since 2008, precise metrics to measure GNH have been developed based on equitable social development, cultural preservation, conservation of the environment and promotion of good governance. The GNH Index provides an overview of performance across 9 domains, which include psychological well-being, time use, community vitality, cultural diversity, ecological resilience, living standard, health, education, good governance. According to the 2010 GNH Survey, 40.9 percent of Bhutanese are "happy." In March 2012, the United Nations hosted a major conference on GNH and adopted UN Resolution 65/309 which recognized the pursuit of happiness as a fundamental human goal. Since then, Bhutan has convened a high-level panel of international experts to make recommendations to the UN General Assembly.

[1] Prepared by Sonali Jain-Chandra.

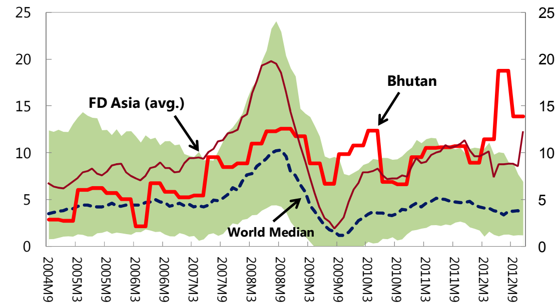
Box 2. Inflation in Bhutan[1]

Historically, headline inflation tracked close to the world median, but started to diverge upward from mid-2009. Currently, Bhutan is in the top decile of world inflation, and is tracking its peers in frontier and developing (FD) Asia more closely as compared to the pre-2009 period. Much of the rising inflationary trend of the recent past is explained by greater non-food inflation. This coincides with the expansion of domestic demand driven by rapid credit growth, in the aftermath of the commissioning of the large Tala hydropower project. The increase in government wages and salaries may also have contributed to inflationary pressures. However, in the absence of detailed data on inflation in traded and non-traded goods and services, and the high degree of import dependence, it is difficult to assess the role of domestic drivers of inflation.

Given that the bulk of Bhutan's imports are sourced from India (about three quarters on average), a strong relationship can be observed between Indian and Bhutanese inflation over a fairly long time series.[2] The growth rate of Bhutan's CPI and India's CPI (industrial workers) appear to track very closely, and given the close economic ties between the two countries, suggests an equilibrium or co-integrating relationship in which Bhutan's inflation converges to that of India. Indeed, Granger causality tests confirm that lags of India's inflation help to explain Bhutan's inflation (and not vice versa). A vector error correction model shows that inflation in both countries is cointegrated, and that Bhutan's inflation converges to that of India fairly rapidly within two periods (which is equivalent to one year, based on semi-annual data).

CPI Inflation: Bhutan vis-a-vis World

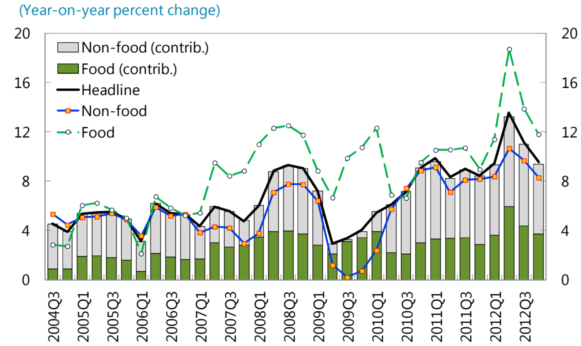
(In percentage, year-on-year)



Note: Shaded area represents World's 90th and 10th percentiles.
Source: *IFS* database; and IMF staff estimates.

Bhutan Headline, Food and Non-food Inflation

(Year-on-year percent change)

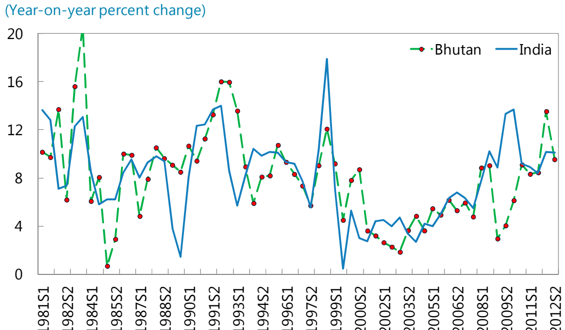


Sources: Royal Monetary Authority of Bhutan; various reports.

Based on this statistical relationship, a simple inflation forecasting model for Bhutan—where the change in Bhutanese inflation depends on contemporary and lagged change in India's inflation, lagged change in Bhutan's inflation, and the lagged difference between Bhutan and India's inflation rates—shows that about 40 percent of the change in inflation is due to the contemporary change in India's inflation, and 60 percent due to the lagged difference between India and Bhutan's inflation, thereby showing strong convergence properties. Given this dynamic and forecasts of India's inflation (see *India: 2014 Article IV Consultation* (IMF Country Report No. 14/57), Bhutan's inflation is expected moderate, but remain high, at an average of over 9 percent in the near-to-medium term.

CPI Inflation in Bhutan and India

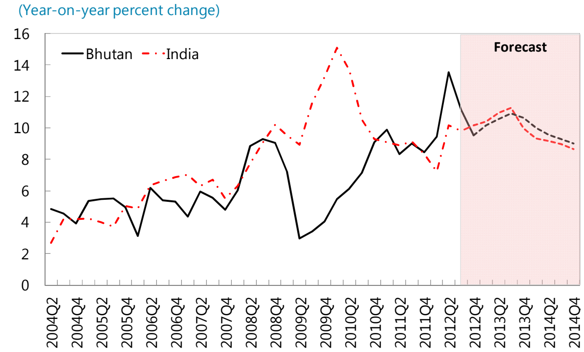
(Year-on-year percent change)



Source: IMF staff calculations.

Bhutan vs. India: CPI Inflation

(Year-on-year percent change)



Source: IMF staff calculations.

[1] Prepared by Adil Mohommad.

[2] Quarterly inflation data are available only from 2003 onward, and semi-annual data series stretch back from 1980.

Box 3. The Macroeconomic Effects of Hydropower Development in Bhutan[1]

Bhutan plans to expand its power generation capacity to 10,000 megawatts (MW) by 2020, considerably larger than its current level of 1,480 MW. There are currently four major hydroelectric facilities in operation (i.e. Chukha, Basochhu, Kurichhu and Tala) and further projects are being developed (see Table). The development of these hydropower plants (exporting electricity to India) are mostly financed by a combination of loans and grants from the Government of India. Other sovereign and multinational contributors, including the Government of Austria and the Asian Development Bank, have also funded and developed some hydroelectric projects. In the early 2010s, Bhutan began to shift its focus to joint ventures and public-private partnerships for future hydropower development.

Table. Summary of Hydropower Projects in the Pipeline

Project	Capacity (MW)	Detailed Project Report (DPR) Schedule	Construction Schedule	Development Model
Punatsangchhu I	1200	Under construction	2008-2017	Intergovernment
Punatsangchhu II	1020	Under construction	2010-2017	Intergovernment
Mangdecchu	720	Under construction	2010-2017	Intergovernment
Sankosh Storage	2650	DPR yet to be cleared	2015-2023	Intergovernment
Kuri Gongri	2640	DPR to be prepared in 11FYP	2017-2026	Intergovernment
Amochhu Storage	540	DPR cleared by CEA	2015-2023	Intergovernment
Wangchhu	570	DPR yet to cleared by CEA, GoI	2015-2023	Joint Venture
Bunakha Storage	180	DPR cleared by CEA	2014-2020	Joint Venture
Kholongchhu	600	DPR approved by two Governments	2014-2021	Joint Venture
Chamkarchhu I	770	DPR yet to be cleared	2015-2024	Joint Venture
Dagachhu	126	Completed	2009-2014	PPP
Total	**11066**			

Source: Annual Report 2012/13, Royal Monetary Authority of Bhutan
Note: CEA: Central Electricity Authority, Government of India.

GDP growth, the fiscal and external positions, monetary conditions, and public debt are driven largely by developments in the hydropower sector. Hydropower generation is the key source of national income in Bhutan (about one-fifth of Bhutan's GDP) and an important source of government revenues (about 30 percent of total revenues). Hydropower projects and credit-fuelled private consumption have propelled a decade of high growth and improving living standards in Bhutan. While hydropower projects have boosted government revenues, they have also given rise to recurring balance of payments pressures. External debt also increased to 85 percent of GDP at end 2012/13, in large part due to hydropower-related borrowing. Looking ahead, during the Eleventh Five Year Plan, Puna I, Puna II and Mangdechu hydro plants are projected to boost economic growth during the construction phase and the commissioning stage (as they come on stream in 2017/18). The current account deficit is projected to deteriorate over the medium term due to strong import growth associated with the construction phase, as well as hydro debt service. Upon the completion of hydropower projects, however, revenues and electricity exports are likely to increase significantly, and the trade balance should improve. Bhutan's rapid hydropower development is also projected to lead to a substantial buildup of external debt in the medium-term.

Hydropower sector development poses challenges for macroeconomic management in Bhutan. Following the commissioning of the Tala in 2006/07, the installed power capacity of Bhutan increased three fold and there was a surge in power exports and government revenues, a build-up of reserves, a credit boom and significant overheating pressures (especially due to housing and vehicle loans), all of which eventually resulted in a sharp widening of the current account deficit. A pronounced rupee shortage arose from loose macroeconomic policies, rapid credit growth, withdrawal of short-term government and government corporation deposits (for investment in projects), and timing mis-matches in bulky hydro-related transactions. As a result, the RMA had to resort to recurrent short-term borrowing of rupees from India at considerable cost and selling of some of its U.S. dollar reserves. Rupee borrowing then resulted in a contraction of the monetary base, creating tight liquidity in the market.

Going forward, it will be important to be mindful of spillovers from hydropower-related inflows. The above challenges may arise again as Bhutan is expected to attract more inflows (grants, loans and export revenues) for hydropower projects. If there is a surplus on the balance of payments, there could be an expansion of the monetary base, which, if allowed to result in high credit growth, could lead to an excess demand for Indian rupees. Nonetheless, if the non-hydropower sector of the economy is carefully calibrated so that growth rate of imports does not exceed those of exports and other rupee obligations, then the medium-term risks can be managed. To be successful, this calibrated response will require coordinated fiscal and monetary policies.

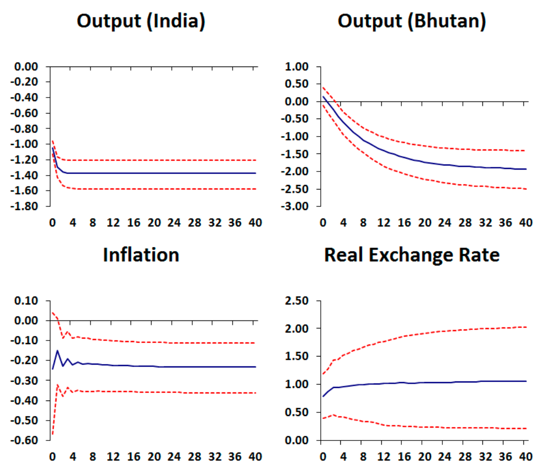
[1]Prepared by Mehdi Raissi.

Box 4. Spillovers from India to Bhutan[1]

The macroeconomic situation in Bhutan is closely tied to that of India. India is the largest trading partner for Bhutan (about 80 percent of Bhutan's commodity exports are destined for India and about 70 percent of Bhutan's imports are from India). India is the primary destination for Bhutan's electricity exports and in turn supplies most of the financing for hydropower development in the form of grants and loans—of the total rupee debt, 85 percent is outstanding public debt on hydropower projects while the remaining 15 percent represented overdrafts from Indian commercial banks and the Government of India line of credit. Furthermore, about 35,000 Indian tourists visit Bhutan annually and there is a strong long-run relationship between India and Bhutan's inflation rates (see Box 1).

This Box develops a long-run structural macro-econometric model for Bhutan to evaluate the nature and strength of its economic linkages with India, and to study inward spillovers to Bhutan from output shocks in India. Using quarterly data between 1981Q2 and 2011Q2 on core macroeconomic variables for Bhutan and a number of key Indian variables, two long-run relationships are identified: an augmented Purchasing Power Parity (PPP) relationship which specifies the link between "India and Bhutan's output differential" and "real exchange rate", and an equation linking Indian and Bhutanese inflation rates.[2] The hypothesis that a large share of Bhutan's output volatility can be associated with fluctuations in India's growth is confirmed empirically. Specifically, any slowdown in India can bring about negative spillovers to Bhutan. A one percent decline in the GDP of India generates significant output losses in Bhutan, corresponding to around 0.18 percent after one year. Figure 1 shows the estimated median impulse responses (for up to 40 quarters) of the key macroeconomic variables of Bhutan to a one-percent GDP shock in India, together with the 16th and 84th percentile error bands. The results indicate that a growth slowdown in India decreases inflation in Bhutan (as output gap widens in India) and causes a real-exchange-rate depreciation.

Figure 1. Impact of negative output shocks in India



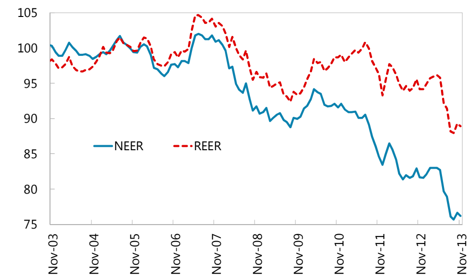
The growth slowdown in Bhutan can be explained both by domestic factors and, to a lesser extent, external conditions (i.e. in India). Risk aversion on the part of global investors, in mid-2013, resulted in a moderation in capital inflows to India, a rise in long-term bond yields, and exchange rate depreciation. Investor concerns were amplified by India's persistently-high inflation, worsening growth prospects, large external current account and fiscal deficits. Bhutan, with its peg to the Indian rupee, has been only moderately affected. Considering that growth in Bhutan is driven by hydropower exports to India; electricity generation and exports are dependent on long-term India-financed investment projects and electricity purchase agreements; and that Indian demand for electricity is inelastic, the negative spillover effects to Bhutan were dampened (they could have been much larger otherwise).[3] Most of the slowdown in Bhutan is attributable to demand side measures put in place by the authorities.

[1] Prepared by Mehdi Raissi.

[2] The model has the following variables: real GDP, inflation, interest rate differential between Bhutan and India, real exchange rate, the price of oil, real GDP of India and Indian CPI inflation. Annual data were linearly interpolated backward when quarterly observations were missing for Bhutan.

[3] *India Selected Issues* (IMF Country Report 14/58) shows that a one-percent decline in the GDP of India generates larger output losses in Nepal.

Box 5. Real Exchange Rate Assesment[1]



This Box assesses real exchange rate in Bhutan using three model-based approaches, suitably adjusted to capture the relevant features of the Bhutanese economy and data constraints.[2] These methods include the external sustainability (ES) approach; the macroeconomic balance (MB) method; and a (reduced form) equilibrium real exchange rate (ERER) technique.

Several adjustments are made to the standard framework to overcome the conceptual and methodological challenges inherent in assessing the real exchange rate in low-income countries and renewable-resource-rich economies. First, a large sample of countries (including those with characteristics similar to Bhutan) is used to calculate the CA norm and the equilibrium exchange rate misalignment, using data over the period 1973–2012 and correcting for structural breaks in the data series. This large dataset helps to alleviate the multilateral inconsistency problem, sample selection bias and statistical over fitting. Second, the determinants of the CA are augmented with aid flows and remittances, to better reflect the specific characteristics of LICs. Third, an econometric technique is used that mitigates the potential endogeneity of the variables and exploits the panel nature of the data. Finally, the CA is stripped of Bhutan-specific temporary factors (over importation that will be accompanied by higher hydro-exports in the long run) to arrive at a more reasonable underlying CA.

These model-based approaches indicate a real exchange rate overvaluation in the range of 8.5 to 21 percent. The macrobalance approach suggests a CA norm of -12 percent of GDP, about 4 percentage points less than the underlying CA in the medium-term. Based on an elasticity of the CA to the real effective exchange rate of -0.25 percent, as referenced by Vitek (2009), this would imply an exchange rate misalignment of about 16 percent (this result also involves a multilateral consistency adjustment). The external sustainability approach estimates a CA norm for Bhutan which stabilizes the NFA/GDP of the country around its norm (which is estimated from a panel data model). Comparing this CA norm with its underlying value, while using the above elasticity, implies a REER overvaluation of 21 percent. Finally, the reduced form equilibrium real exchange rate approach suggests an overvaluation of around 8.5 percent.

These methodologies are subject to limitations and are sensitive to assumptions, and so should be viewed with some caution. The assessment of real exchange rate misalignment in countries with foreign exchange rationing (which are therefore persistently on the supply curve for foreign exchange and off their demand curve) is especially difficult, because the equilibrium is not found within the data. In addition, using estimated coefficients from a panel of countries that are in different stages of development (when compared to Bhutan) may also bias the results. Furthermore, Bhutan is currently going though an important transition by building up its hydropower generation capacity, where such capacity is mainly financed by bilateral aid from India. Given this structural characteristic, results using the standard exchange rate assessment toolkit may suggest overvaluation, but some of the required adjustment in the external position will happen naturally as the current scale-up in import-intensive investments leads to a permanent boost in hydropower-related exports in the long run.

Over the medium term, further structural reforms are central to strengthening competitiveness. Bhutan's exports have shown a lack of diversification and its export basket has a falling share in world exports. Required policy measures include addressing key structural deficiencies such as shortage of skilled labor and access to finance, as well as encouragement of niche sectors such as tourism, agri-business, and energy intensive activities that could take advantage of access to cheap and clean power (Selected Issues Paper III). Efforts to enhance the business climate (Figure 4) and achieve productivity gains will help offset any potential real exchange appreciation that may follow from rapid growth and resulting implications for the demand for nontradables.

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[1] Prepared by Mehdi Raissi.

[2] See Vitek, F., 2009, "Exchange Rate Assessment Tools for Advanced, Emerging, and Developing Economies (Washington: International Monetary Fund) and Chen, S., Dwight, L., Nkusu, M., Raissi, M., Ter-Martirosyan, A., Vitek, F., and A. Watson, 2014, "External Assessments in Special Cases", Strategy Policy and Review Departmental Paper, (Washington: International Monetary Fund) for details about the CGER-type methodologies.

Bhutan. Risk Assessment Matrix

Nature/Source of Threat	Likelihood	Impact	Policies to Minimize Impact
Domestic Risks			
Mis-matches in rupee inflows and outflows	***H***	***H*:** Mis-matches in rupee inflows and outflows, and prospective bulky debt service payments could lead to renewed pressure on Bhutan's Indian rupee reserves and thereby tighten the liquidity conditions.	Build rupee buffers by holding a larger share of reserves in rupees to meet obligations. Develop a foreign exchange cash-flow forecasting framework to anticipate pressures and build buffers.
Delayed project implementation	***M***	***H:*** Delays in projected completion of hydropower projects could lead to lower electricity exports and larger-than-expected budget deficits over the Eleventh FYP.	Curtail non-essential spending, while accelerating revenue administration reforms and broadening the tax base.
Bank balance sheet risks	***M***	***M*:** Banks' asset quality could deteriorate further in the wake of very rapid credit growth for many years, especially in sectors such as personal loans and construction.	Strengthen and intensify supervision and tighten prudential regulations. Take early action as signs of deteriorating asset quality emerge.
External Risks			
Protracted period of slower growth in EMs	***H***	***H*:** A longer-than-expected growth slowdown in India, which could lead to delayed or reduced aid and hydropower construction disbursements to Bhutan.	Scale back non-essential spending plans while mobilizing domestic revenues.
Surges in global financial market volatility	***H***	***M*:** Any resulting financial and economic stress in India could spill over to Bhutan, mainly from higher inflation and somewhat lower Indian financial assistance. REER depreciation would be a mitigating factor.	Spending reorientation and revenue mobilization.
Continued high inflation in India	***M***	***M*:** Higher imported inflation from India would hurt the poor.	Tighten monetary conditions and reduce bank liquidity to prevent second-round effects from building.

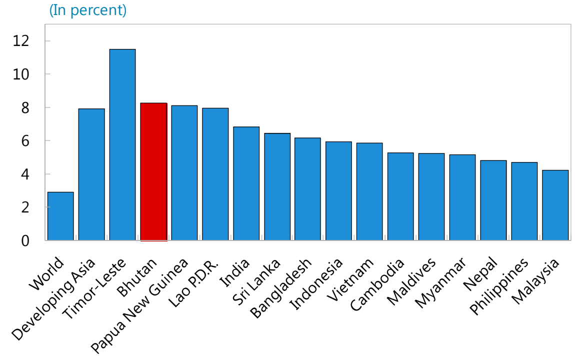
"L"=Low; "M"=Medium; "H"=High.

The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Figure 1. Bhutan: Recent Macroeconomic Developments

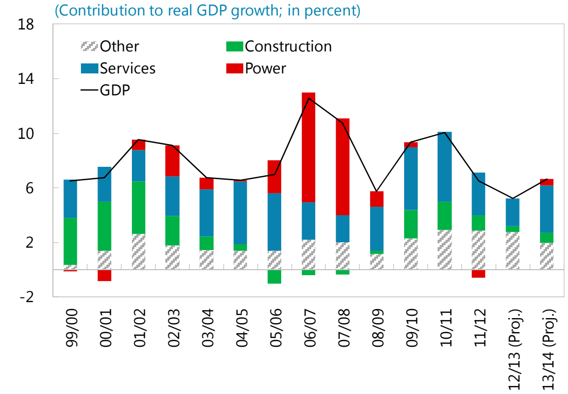
Bhutan is among the world's fastest-growing economies, supported by hydropower and services…

Real GDP Growth 2008–2012: World, Developing Asia and Selective Countries
(In percent)



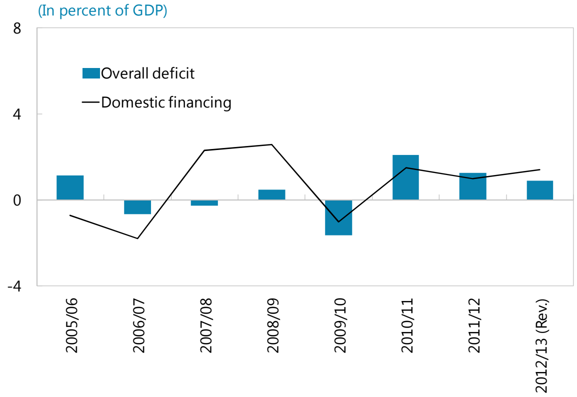
…though growth has slowed in the recent past…

Sources of Growth
(Contribution to real GDP growth; in percent)



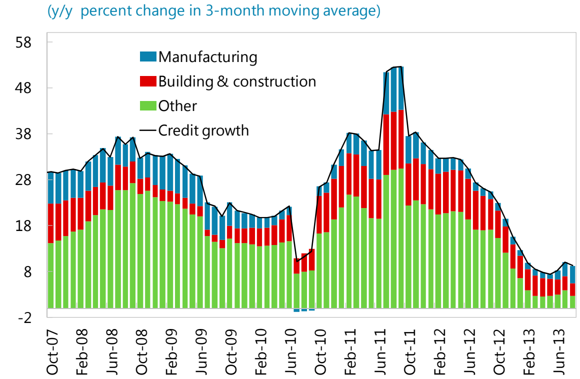
… as the fiscal stance tightened…

Fiscal Deficit and Financing
(In percent of GDP)



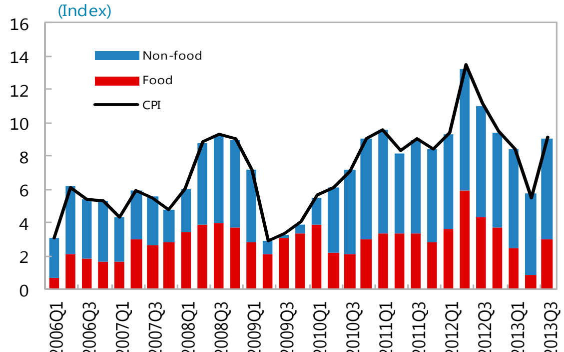
… and measures to contain previously-high credit growth have taken effect.

Credit Growth and Contributions
(y/y percent change in 3-month moving average)



However, inflationary pressures appear to be resurfacing …

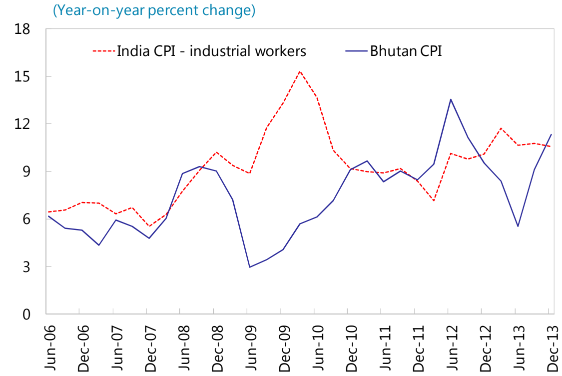
CPI Inflation
(Index)



Note: As of 2013Q2, the National Statistics Bureau has increased the weight of food in the CPI from 31.67% to 39.92%.

…closely tracking developments in India.

Inflation Relative to India
(Year-on-year percent change)



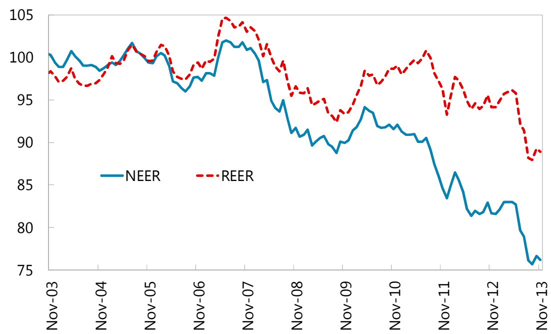
Sources: IMF, International Financial Statistics, Royal Monetary Authority of Bhutan, and IMF staff calculations.

Figure 2. Bhutan: External Developments

The Bhutanese REER has depreciated recently, in line with the Indian rupee's depreciation.

Nominal and Real Effective Exchange Rates

(Index, 2005=100)

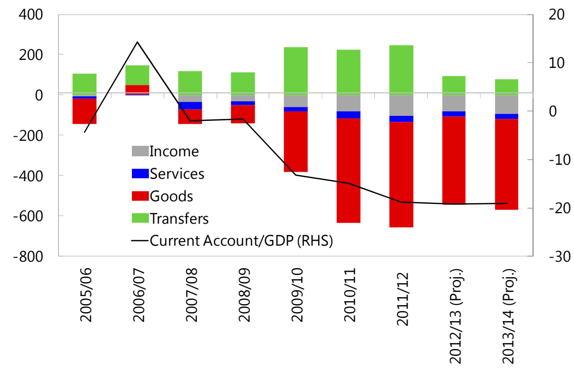


Sources: IMF, *Information Notice System*.

Even so, large current account deficits have persisted as hydro-related imports from India have increased.

Current Account and Components

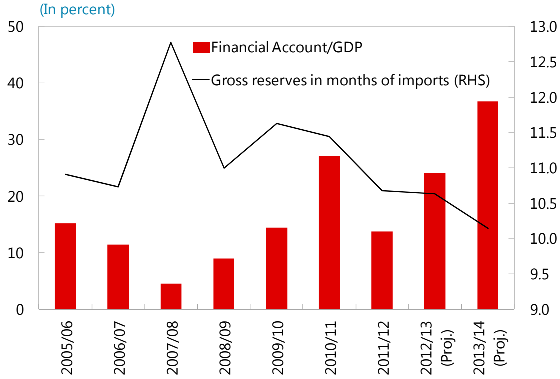
(In millions of U.S.dollars; in percent)



As a result, reserve cover, though adequate, has declined, despite inflows on the capital and financial account.

Financial Account and Gross Reserves

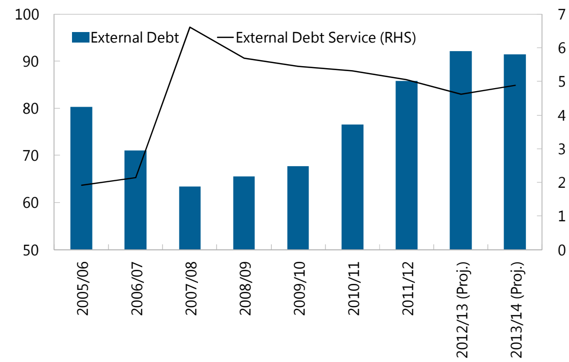
(In percent)



The stock of external debt has risen with hydropower project disbursements.

External Debt and External Debt Service

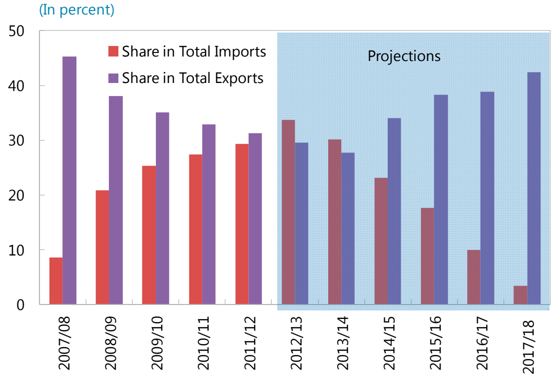
(In percent of GDP)



With major projects coming on-stream in the medium term, electricity exports are projected to rise …

Hydropower Imports and Exports

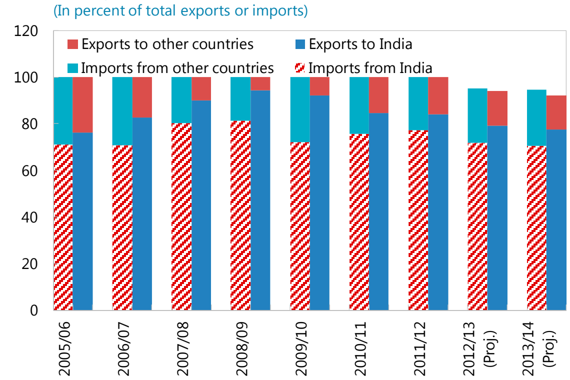
(In percent)



…headed mostly for the Indian market, which remains Bhutan's dominant trade partner.

Foreign Trade

(In percent of total exports or imports)

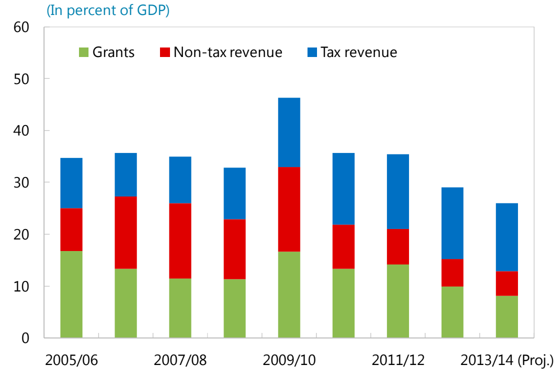


Sources: IMF, International Financial Statistics, Royal Monetary Authority of Bhutan, and IMF staff calculations.

Figure 3. Bhutan: Fiscal and Monetary Developments

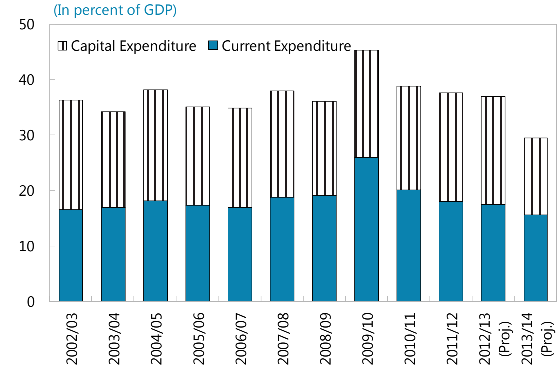
Revenues (as a share of GDP) have been declining as electricity export prices are fixed in nominal terms, and external grants fall with rising income levels...

Total Revenue and Grants
(In percent of GDP)



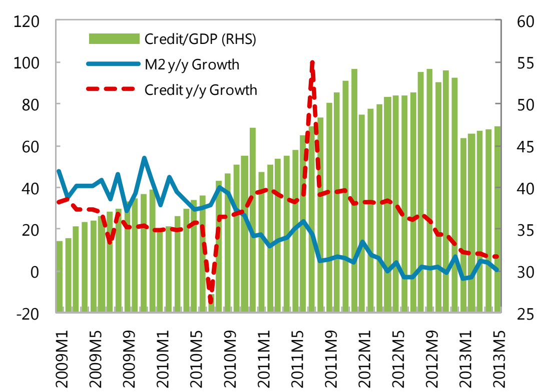
...and while expenditures have also declined somewhat, the deficit is expected to increase in 2013/14.

Current and Capital Expenditure
(In percent of GDP)



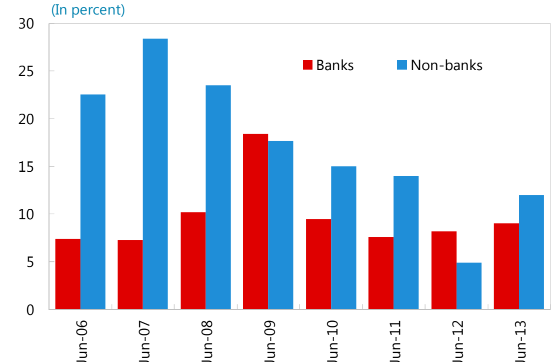
High credit growth accompanied financial deepening, but has eased with recent measures to cool lending...

M2 and Credit
(In percent)



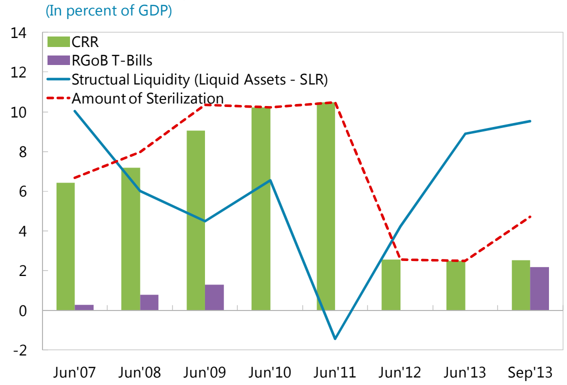
... and NPLs among banks and nonbanks have risen modestly.

Gross NPL ratio 1/
(In percent)



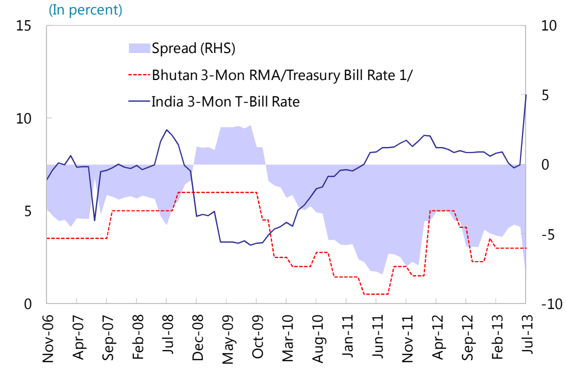
Liquidity shortages appears to have eased...

Excess Liquidity
(In percent of GDP)



... while the interest differential with India remains negative and has widened recently

Bhutan-India Policy Rates
(In percent)

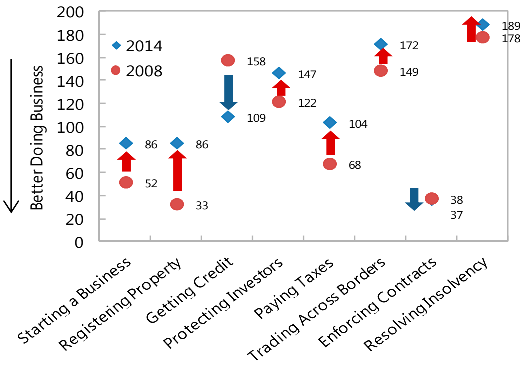


Sources: IMF, *International Financial Statistics*; Royal Monetary Authority of Bhutan; and IMF staff calculations.

Figure 4. Bhutan: Business Environment and Governance

Along most dimensions, the ease of doing business ranking for Bhutan has worsened, though access to credit and contract enforcement have improved.

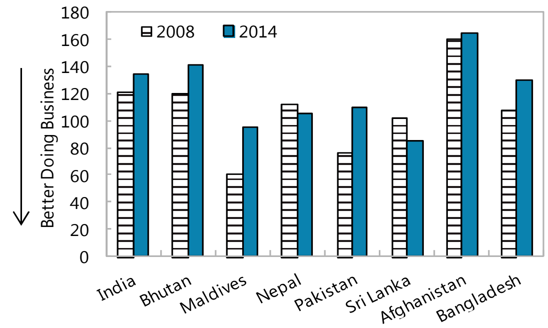
Evolution of Doing Business Indicators Ranking: Bhutan



Sources: World Bank, Doing Business Report (2014 and 2008)

The overall doing business ranking has slipped somewhat, and is lower than most of its regional peers.

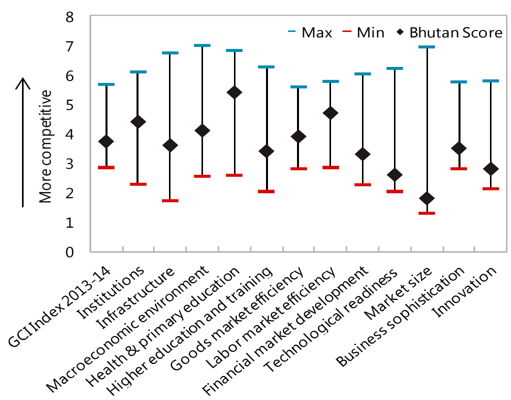
Ease of Doing Business Ranking: South Asia



Sources: World Bank, Doing Business Report (2014 and 2008)

Institutional quality, health and education are strengths of the economy.

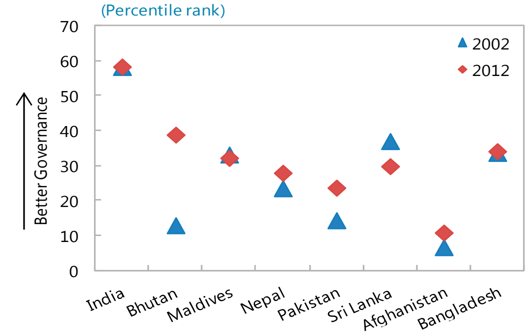
2013-14 Bhutan Scores in Global Competitiveness Index and Pillars



Sources: World Economic Forum Global Competitiveness Report (2013-14)

Bhutan has demonstrated a significant improvement in voice and accountability.

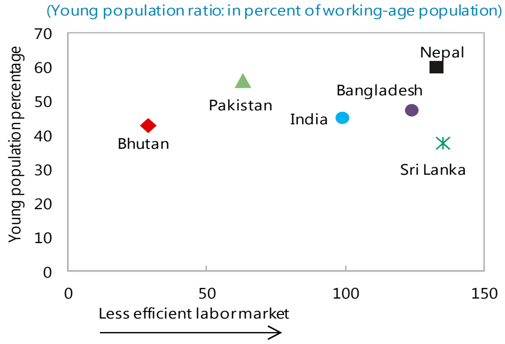
Voice and Accountability: South Asia
(Percentile rank)



Sources: Worldwide Governance Indicators 2013
Note: Voice and Accountability reflects perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom.

Labor markets appear more efficient than regional peers…

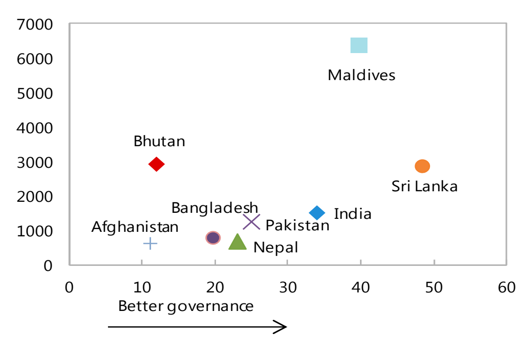
Labor Market Efficiency Ranking and Young Population Ratio: South Asia
(Young population ratio: in percent of working-age population)



Sources: World Development Indicators (2012) and World Economic Forum Global Competitiveness Report (2013)
Note: Young, defined as people younger than 15; working-age population as 15-64.

…though regulatory quality shows room for improvement.

Regulatory Quality and GDP Per Capita: South Asia 2012
(Percentile rank; in US Dollars)



Sources: Worldwide Governance Indicators 2013; IMF
Note: Regulatory quality eflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector.

Note: As pointed out in an independent evaluation of the Doing Business survey (see www.worldbank.org/ieg/doingbusiness), care should be exercised when interpreting these indicators given subjective interpretation, limited coverage of business constraints, and a small number of informants, which tend to overstate the indicators' coverage and explanatory power.

Table 1. Bhutan: Selected Economic Indicators, 2009/10–2014/15 1/

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
			Est.		Proj.	
Real sector						
Real GDP at market prices (percent change)	9.3	10.1	6.5	5.0	6.4	7.6
Consumer prices (percent change, period average)	4.8	8.6	10.1	8.7	10.2	8.8
General government	(In percent of GDP)					
Total revenue and grants	46.3	35.6	35.2	28.9	25.2	27.0
Tax revenue	13.4	13.7	15.8	14.5	13.0	13.0
Non-tax revenue	16.3	8.6	5.9	5.4	5.4	4.9
Foreign grants	16.6	13.3	13.5	9.0	6.8	9.2
Total expenditure and net lending	44.7	37.7	36.5	32.9	28.3	28.5
Current expenditure	26.0	20.2	18.0	17.1	15.8	16.5
Capital expenditure	19.3	18.7	19.6	17.4	14.0	12.6
Current balance (excluding grants)	3.8	2.2	3.9	2.8	2.6	1.3
Overall balance	1.6	-2.1	-1.3	-4.0	-3.0	-1.4
Public sector debt 2/	67.5	73.7	86.0	110.7	122.0	128.7
Monetary sector	(Percent change, unless otherwise indicated)					
Broad money	30.1	21.2	-1.0	18.6	…	…
Credit to private sector	22.8	19.2	20.7	6.2	…	…
Interest rates (end of period, in percent)						
Deposits (less than 1 year)	5.0	5.0	5.5	5.5	…	…
Lending	10–16	9.75–16	10.0–16	11.7-16	…	…
External sector	(In millions of dollars, unless otherwise indicated)					
Current account balance	-142	-410	-350	-441	-461	-522
(In percent of GDP)	-9.9	-23.5	-19.0	-22.8	-24.5	-25.4
Trade balance	-299	-519	-477	-460	-465	-588
Exports (goods)	544	665	595	601	636	677
(Percent change)	5.5	22.2	-10.6	1.2	5.7	6.4
Imports (goods)	843	1,185	1,072	1,062	1,101	1,264
(Percent change)	39.0	40.5	-9.5	-0.9	3.7	14.8
Grants (current transfer)	261	254	273	191	140	208
Capital account balance	99	472	261	545	458	584
Loans (net)	108	366	225	342	331	444
Errors and omissions	43	33	-20	0	0	0
Overall balance	-1	96	-109	104	-2	62
(In percent of GDP)	-0.1	5.5	-5.9	5.4	-0.1	3.0
Gross official reserves	813	904	800	904	902	964
(In months of goods and services imports)	7.5	8.9	8.0	8.8	7.6	7.4
External debt (in percent of GDP)	65.9	71.0	84.8	105.2	114.4	120.0
Ngultrum per U.S. dollar (period average)	46.7	45.3	50.3	…	…	…
Memorandum items:						
GDP at market prices (in billions of Bhutanese Ngultrum)	66.9	79.2	92.7	106.1	121.9	140.9
GDP at market prices (in millions of U.S. dollars)	1420.8	1714.3	1851.7	1814.9	1879.7	2059.1
Electricity exports (in percent of total goods exports)	42.8	34.3	32.8	29.8	26.0	24.8
Unemployment rate (in percent) 3/	3.3	3.3	3.1	2.1	…	…

Sources: 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/ On a calendar year basis (e.g., the entry for 2009/10 is for 2009).

Table 2. Bhutan: Government Budget Summary, 2009/10–2013/14 1/

	2009/10	2010/11 Est.	2011/12 Proj.	2012/13 Proj.	2013/14 Budget	2013/14 Proj.
			(In millions of ngultrum)			
Revenue and grants	30,990	28,172	32,646	30,664	31,600	30,733
Domestic revenue	19,871	17,674	20,354	21,102	22,391	22,445
Tax revenue	8,975	10,882	14,677	15,393	15,866	15,904
Nontax revenue	10,896	6,792	5,677	5,709	6,525	6,541
Foreign grants	11,119	10,498	12,502	9,563	9,209	8,288
From India	7,306	7,883	9,003	6,887	5,589	5,030
Other	3,813	2,615	3,498	2,676	3,621	3,259
Expenditure and net lending	29,889	29,842	33,806	34,902	35,931	34,443
Current expenditure	17,360	15,962	16,706	18,097	19,229	19,229
Capital expenditure	12,929	14,787	18,137	18,431	18,600	17,112
Net lending	-400	-907	-1,037	-739	-1,898	-1,898
Current balance (excl. grants)	2,511	1,712	3,648	3,005	3,162	3,216
Overall balance	1,101	-1,671	-1,160	-4,238	-4,331	-3,710
Foreign financing	-416	469	257	-598	654	653
Disbursement	2,320	2,611	2,403	1,614	3,236	3,236
Amortization	2,736	2,141	2,146	2,213	2,583	2,584
Domestic financing	-685	1,201	903	4,836	3,677	3,057
			(In percent of GDP, unless otherwise indicated)			
Revenue and grants	46.3	35.6	35.2	28.9	25.9	25.2
Domestic revenue	29.7	22.3	22.0	19.9	18.4	18.4
Tax revenue	13.4	13.7	15.8	14.5	13.0	13.0
Nontax revenue	16.3	8.6	6.1	5.4	5.4	5.4
Foreign grants	16.6	13.3	13.5	9.0	7.6	6.8
From India	10.9	10.0	9.7	6.5	4.6	4.1
Other	5.7	3.3	3.8	2.5	3.0	2.7
Expenditure and net lending	44.7	37.7	36.5	32.9	29.5	28.3
Current expenditure	26.0	20.2	18.0	17.1	15.8	15.8
Capital expenditure	19.3	18.7	19.6	17.4	15.3	14.0
Net lending	-0.6	-1.1	-1.1	-0.7	-1.6	-1.6
Current balance (excl. grants)	3.8	2.2	3.9	2.8	2.6	2.6
Overall balance	1.6	-2.1	-1.3	-4.0	-3.6	-3.0
Foreign financing	-0.6	0.6	0.3	-0.6	…	…
Domestic financing	-1.0	1.5	1.0	4.6	…	…
Nominal GDP at market prices						
(In millions of ngultrum)	66,869	79,196	92,684	106,086	121,888	121,888

Sources: Data provided by the Royal Government of Bhutan; and Fund staff estimates and projections.

1/ Revenues (including interest receipts), interest payments, and foreign financing include flows related to hydropower projects.

Table 3. Bhutan: Balance of Payments, 2009/10–2017/18

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
			Act.			Proj.			
				(In millions of U.S. dollars)					
Current account	-142	-410	-350	-441	-461	-522	-598	-700	-441
Trade balance	-299	-519	-477	-460	-465	-588	-672	-747	-498
Exports, f.o.b.	544	665	595	601	636	677	726	782	1,095
Of which: Electricity	233	228	195	179	165	168	164	158	401
Imports, c.i.f.	-843	-1,185	-1,072	-1,062	-1,101	-1,264	-1,398	-1,530	-1,593
Of which: Hydropower-related	-90	-181	-146	-268	-325	-386	-420	-460	-488
Services	-22	-34	-39	-32	-29	-40	-44	-45	-37
Credit	69	82	102	108	105	114	127	141	158
Debit	-90	-116	-141	-140	-134	-154	-171	-187	-194
Income	-61	-81	-77	-91	-57	-51	-36	-37	-31
Credit	16	17	17	25	38	39	52	47	35
Debit	-77	-97	-94	-116	-95	-90	-88	-85	-66
Of which: Interest payments 1/	-39	-42	-42	-56	-43	-38	-38	-35	-32
Current transfers	239	224	243	143	91	156	153	131	124
Credit	276	276	286	200	147	217	221	207	211
Of which: Grants 2/	261	254	273	191	140	208	211	197	202
Debit	-37	-52	-42	-58	-56	-61	-68	-76	-87
Capital and financial account	99	472	261	545	458	584	496	463	484
Capital transfer 3/	80	81	26	178	103	114	101	76	44
Foreign direct investment	19	26	10	25	25	27	30	33	37
Portfolio investment	0	0	0	0	0	0	0	0	0
Loans (net)	108	366	225	342	331	444	366	353	403
Other flows 4/	0	0	0	0	0	0	0	0	0
Errors and omissions	43	33	-20	0	0	0	0	0	0
Overall balance	-1	96	-109	104	-2	62	-102	-237	43
Memorandum items:			(In percent of GDP, unless otherwise indicated)						
Current account balance	-9.9	-23.5	-19.0	-22.8	-24.5	-25.4	-26.1	-27.3	-15.1
Trade balance	-20.8	-29.7	-25.9	-23.8	-24.8	-28.5	-29.3	-29.2	-17.0
Merchandise exports (percent change)	5.5	22.2	-10.6	1.2	5.7	6.4	7.3	7.8	40.0
Merchandise imports (percent change)	39.0	40.5	-9.5	-0.9	3.7	14.8	10.6	9.5	4.1
Capital and financial account	6.9	27.0	14.2	28.2	24.4	28.4	21.6	18.1	16.6
Overall balance	-0.1	5.5	-5.9	5.4	-0.1	3.0	-4.4	-9.3	1.5
External debt	55.9	65.9	71.0	84.8	105.2	114.4	120.0	120.8	115.9
(In millions of U.S. dollars)	801	1,152	1,310	1,640	1,978	2,356	2,752	3,092	3,391
(In percent of exports of goods and services)	130.7	154.2	187.9	231.2	267.0	298.0	322.7	334.8	270.7
Debt service (in percent of exports of goods and services)	23.5	20.0	28.6	35.8	31.0	16.9	15.6	22.5	28.2
(In millions of U.S. dollars)	144	149	199	254	230	134	133	208	354
Gross official reserves (in millions of U.S. dollars)	813	904	800	904	902	964	862	625	668
(In months of imports of goods)	8.2	10.1	9.0	9.9	8.6	8.3	6.8	4.7	4.6
(In months of imports of goods and services)	7.5	8.9	8.0	8.8	7.6	7.4	6.0	4.2	4.1
Ngultrum per U.S. dollars (fiscal year average)	46.7	45.3	50.3	...	...	...	...	...	...
Nominal GDP (in millions of U.S. dollars)	1,433	1,747	1,844	1,934	1,880	2,059	2,293	2,559	2,926

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

1/ Debt service for Tala hydropower project starts in 2007/08.
2/ Including budgetary and off-budgetary grants.
3/ Including grants for Tala, Puna I, Puna II and Mangdechu hydropower projects.
4/ Including trade credit, rupee credit lines, short-term capital flows and IMF SDR allocation in 2009.

Table 4. Bhutan: Medium-Term Macroeconomic Framework, 2009/10–2018/19

	Tenth Plan Period									
	2009/10	2010/11	2011/12 Budget	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Real sector (percent change)										
Real GDP at market prices	9.3	10.1	6.5	5.0	6.4	7.6	8.2	8.6	11.5	8.0
Consumer prices (period average)	4.8	8.6	10.1	8.7	10.2	8.8	7.7	6.9	6.7	6.7
Fiscal sector (in percent of GDP)										
Revenue and grants	46.3	35.6	35.2	28.9	25.2	27.0	26.2	24.5	24.2	27.1
Domestic revenue	29.7	22.3	22.0	19.9	18.4	17.8	17.8	17.5	17.9	21.8
Of which : tax revenue	13.4	13.7	15.8	14.5	13.0	13.0	13.1	13.2	13.3	14.0
Grants	16.6	13.3	13.5	9.0	6.8	9.2	8.4	7.0	6.3	5.2
Expenditure and net lending	44.7	37.7	36.5	32.9	28.3	28.5	27.6	25.3	23.1	23.1
Current expenditure	26.0	20.2	18.0	17.1	15.8	16.5	16.0	16.0	16.0	16.0
Of which : interest	2.6	2.3	2.4	3.0	2.5	2.1	2.0	1.7	1.4	3.2
Capital expenditure	19.3	18.7	19.6	17.4	14.0	12.6	12.3	9.9	7.8	7.7
Net lending	-0.6	-1.1	-1.1	-0.7	-1.6	-0.7	-0.7	-0.7	-0.7	-0.7
Current balance (excl. grants)	3.8	2.2	3.9	2.8	2.6	1.3	1.8	1.4	1.9	5.8
Overall balance	1.6	-2.1	-1.3	-4.0	-3.0	-1.4	-1.4	-0.8	1.0	4.0
External financing	-0.6	0.6	0.3	-0.6	0.5	0.2	0.8	0.1	-1.7	-4.6
Domestic financing	-1.0	1.5	1.0	4.6	2.5	1.2	0.6	0.6	0.6	0.6
Monetary Sector (percent change)										
Broad money	30.1	21.2	-1.0	18.6	...	...	...	...	...	...
Credit to private sector	22.8	19.2	20.7	6.2	...	...	...	...	...	...
External sector (in millions of U.S. dollars)										
Current account balance (including grants)	-142	-410	-350	-441	-461	-522	-598	-700	-441	-216
(In percent of GDP)	-9.9	-23.5	-19.0	-22.8	-24.5	-25.4	-26.1	-27.3	-15.1	-6.7
Trade balance	-299	-519	-477	-460	-465	-588	-672	-747	-498	-246
Exports	544	665	595	601	636	677	726	782	1095	1513
Imports	843	1185	1072	1062	1101	1264	1398	1530	1593	1760
Services, income, and transfers (net)	157	109	127	158	11	88	95	-5	-9	-34
Of which : grants	261	254	273	191	140	208	211	197	202	186
Capital and financial account balance	99	472	261	545	458	584	496	463	484	467
Of which : foreign direct investment	19	26	10	25	25	27	30	33	37	43
Of which : loans (net)	108	366	225	342	331	444	366	353	403	422
Overall balance	-1	96	-109	104	-2	62	-102	-237	43	251
(In percent of GDP)	-0.1	5.5	-5.9	5.4	-0.1	3.0	-4.4	-9.3	1.5	7.8
Gross foreign reserves (in millions of U.S. dollars)	813	904	800	904	902	964	862	625	668	919
(In months of goods and services imports)	7.5	8.9	8.0	8.8	7.6	7.4	6.0	4.2	4.1	5.1
External debt (public and private, in percent of GDP)	65.9	71.0	84.8	105.2	114.4	120.0	120.8	115.9	116.8	120.2
Of which : Power sector debt	35.9	40.4	41.1	4.5	51.1	60.3	70.5	81.0	84.9	86.4
External debt service										
(In percent of exports of goods and services)	23.5	20.0	28.6	35.8	31.0	16.9	15.6	22.5	28.2	28.3

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

1/ Revenues (including interest receipts), interest payments, and foreign financing include flows related to hydropower projects.

Table 5. Bhutan: Monetary Survey, 2008/09–2012/13

	2008/09	2009/10	2010/11	2011/12	2012/13
Monetary survey			(In millions of ngultrum)		
Net foreign assets	33,074	35,236	35,145	35,532	48,566
Indian rupee	-3,259	-3,071	-7,113	-9,551	1,493
Other	36,333	38,307	42,258	45,083	47,073
Net domestic assets	-961	6,542	15,495	14,591	10,885
Net claims on government 1/	-4,204	-4,047	-5,074	-784	-7,508
Claims on nongovernment	19,937	27,184	34,576	45,220	49,109
Public enterprises 2/	1,111	612	555	1,486	2,285
Private sector 3/	17,861	25,196	33,235	43,735	46,825
Other items (net) 4/	-16,693	-16,594	-14,006	-29,846	-30,717
Broad money	32,114	41,779	50,640	50,123	59,451
Narrow money	18,374	22,538	30,270	31,960	37,794
Currency	4,541	5,387	6,894	6,391	5,681
Demand deposits	13,833	17,151	23,377	25,570	32,113
Quasi-money 5/	13,740	19,241	20,370	18,163	23,548
Royal Monetary Authority					
Net foreign assets	31,318	32,777	32,636	32,723	45,633
Indian rupee	-3,799	-4,363	-7,824	-10,943	674
Other	35,116	37,140	40,459	43,666	44,959
Net domestic assets	-16,621	-12,202	-12,908	-15,980	-21,636
Net claims on government	-4,204	-4,047	-5,074	173	1,163
Claims	0	0	0	957	1,900
Minus: deposits	4,204	4,047	5,074	784	737
Claims on deposit money banks	44	633	112.7	182.2	2243.6
Claims on private sector	17	18	19	19	14
Minus: RMA bills	2,000	21	20.7	26	0
Other items (net)	-10,478	-8,785	-7,945	-16,328	-25,056
Reserve money	14,697	20,575	19727.6	16743.1	23997.4
Memorandum items:					
			(Change in percent of initial stock of broad money)		
Broad money	24.6	30.1	21.2	-1.0	18.6
Net foreign assets	27.7	6.7	-0.2	0.8	26.0
Net domestic assets	-3.2	23.4	21.4	-1.8	-7.4
Net claims on government	-7.5	0.5	-2.5	8.5	-13.4
Claims on private sector	15.7	22.8	19.2	20.7	6.2
Other items (net)	-12.4	0.3	6.2	-31.3	-1.7
			(Change in percent of initial stock of reserve money)		
Reserve money	14.2	40.0	-4.1	-15.1	43.3
Net foreign assets	52.4	9.9	-0.7	0.4	77.1
Net domestic assets	-38.2	30.1	-3.4	-15.6	-33.8
Money multiplier	2.2	2.0	2.6	3.0	2.5
Velocity of money	1.8	1.6	1.5	1.7	1.7
Broad money/GDP	0.55	0.63	0.67	0.59	0.59
Broad money growth (12-month percent change)	24.6	30.1	21.2	-1.0	18.6
Reserve money growth (12-month percent change)	14.2	40.0	-4.1	-15.1	43.3
Credit to private sector (12-month percent change)	29.3	41.1	31.9	31.6	7.1

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

1/ Includes deposits of some public enterprises and off-budgetary entities; as such, data differ from bank financing data reported in the fiscal accounts.

2/ From 2011/12 onward, public enterprises include government corporations and other public corporations as in the previous definition.

3/ From 2011/12 onward, private sector credit includes joint corpoerations, NBFIs and private sector as in the previous definition.

4/ Includes foreign exchange valuation adjustments and capital accounts.

5/ Includes time and foreign currency deposits.

Table 6. Bhutan: Financial Soundness Indicators, 2006/07–2012/13 1/

(In percent, unless otherwise specified)

	2006/07 June	2007/08 June	2008/09 June	2009/10 June	2010/11 June	2011/12 June	2012/13 June	2013 Sep
Risk weighted capital adequacy ratio								
Financial sector	19.9	18.6	17.3	17.1	14.4	18.4	18.2	17.7
Banks	16.9	15.9	16.5	17.1	14.2	19.1	18.2	18.2
Nonbanks	31.7	28.1	23.6	17.2	16.0	19.4	15.8	14.9
NPL ratio								
Financial sector	12.4	13.4	18.3	10.1	8.5	8.2	9.5	12.2
Banks	7.3	10.2	18.4	9.5	7.6	8.2	9.5	12.7
Nonbanks	28.4	23.5	17.7	15.2	14.1	4.9	11.9	8.8
Return on assets								
Financial sector	0.6	0.3	0.1	1.0	0.6	0.9	0.7	0.6
Banks	...	0.3	-0.1	0.9	0.4	0.9	0.7	0.6
Nonbanks	...	0.3	2.4	2.1	2.2	3.6	4.2	4.1
Credit to deposit ratio (banks only)	...	70.5	74.2	74.6	81.7	105.8	84.9	86.0
Statutory liquidity requirement (SLR)								
Banks	38.3	32.0	27.9	35.5	18.0	27.5	34.4	36.3
Nonbanks	20.1	14.0	10.6	20.9	13.9	19.1	23.8	21.7

Source: Royal Monetary Authority of Bhutan.
1/ Data are for July–June fiscal years.

Table 7. Bhutan: Millennium Development Goals

Targets	Indicators	2000	2010	2012	2015 (Goal)	Status of Progress
Eradicate extreme poverty and hunger						
Target 1: Halve between 1990 and 2015, the proportion of people living below the poverty line	Proportion of population below the national poverty line (percent) 1/	36.3	N/A	12	20	**Achieved**
Target 2: Halve by 2015, the proportion of people who suffer from hunger	Proportion of population below minimum level of dietary energy consumption (percent)	3.8 2/	N/A	2.8	1.9	***On Track***
Achieve universal primary education						
Target 3: Ensuring that by 2015, children everywhere will be able to complete a full course of primary schooling	Gross primary enrollment ratio (percent) 3/	72	117	N/A	100	**Achieved**
	Net primary enrollment ratio (percent)	62	93.1	96	100	***On Track***
Promote gender equality and empower women						
Target 4: Eliminate gender disparity in primary and secondary education preferably by 2005, and to all levels of education by 2015	Ratio of girls to boys in primary education (percent)	82	99.4	99	100	**Achieved**
	Ratio of girls to boys in secondary education (percent)	78	103.5	107	100	**Achieved**
	Ratio of females to males in tertiary institutes (percent)	41	61	71	100	***On Track***
Reduce child morality						
Target 5: Reduce by two-thirds between 1990 and 2015, the under-five mortality rate	Under-five mortality rate (per 1,000 births)	N/A	61.5	69	41	***On Track***
	Infant mortality rate (per 1,000 live births)	N/A	40.1	47	30	***On Track***
Improve maternal health						
Target 6: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio	Maternal mortality ratio (per 100,000 live births)	255	180	155	140	***On Track***
	Births attended by skilled health personnel (percent)	24	67.4	69	100	***On Track***
Combat HIV/AIDS, malaria, and other diseases						
Target 7: Halt and begin to reverse the spread of HIV/AIDS	HIV prevalence among population aged 15-24 years	38	217	297	N/A	***Needs Attention***
Target 8: Halt and begin to reverse the spread of malaria and other major diseases	Contraceptive prevalence rate (percent)	30.7	35	65.6	60	**Achieved**
	Number of malaria cases per 100,000 population at risk	0.875	N/A	194	N/A	***On Track***
	Number of tuberculosis cases per 100,000 population at risk	168	1250 4/	N/A	N/A	***On Track***
Ensure environmental sustainability						
Target 9: Integrate the principles of sustainable development into country policies and programmes and reverse the loss of environmental resources	Proportion of population without access to an improved drinking water source	22	N/A	2	27.5	**Achieved**
Target 10: Halve between 1990 and 2015, the proportion of people without sustainable access to safe drinking water and sanitation	Proportion of population without access to improved sanitation (percent)	12	N/A	5	17.5	**Achieved**
Develop a global partnership for development						
Target 14: In cooperation with developing countries, develop and implement strategies for decent and productive work for youth	Youth unemployment rate (percent)	2.6	12.9 5/	N/A	N/A	***Needs Attention***

Source: World Bank; *MDGs: Where Are We?* BO Focus, Millennium Development Goal/Vol. III, Issue IX, Friday, September 10–17, 2010, UNDP.
1/ Data from the Poverty Analysis Report (PAR).
2/ As of 2003.
3/ Global primary school enrolment is at 88 per cent.
4/ As of 2007
5/ As of 2009.

Annex I. Key Recommendations on Enhancing Financial Sector Surveillance in Low-Income Countries

Recommendation	Timing	Priority
Develop a comprehensive Financial Sector Development Strategy, with a careful sequencing of reforms while balancing any tradeoffs between financial stability and deepening	Medium Term	High
Float minority stakes in state-owned enterprises. Draft private equity regulations. Review options for providing corporate bond credit ratings	Medium Term	High
Enable secured transactions by expanding the collateral registry	Short Term	High
Review and approve the Financial Inclusion Policy, in light of need to extend outreach while maintaining a sound financial system	Short Term	High
Provide technical assistance to MFIs to support new product development	Short Term	High
Establish a "Code of Conduct" on disclosure of bank products, prices, and procedures (as per Financial Services Act 2011)	Short Term	High
Continue expanding financial literacy campaigns among underserved groups, on financial products and services including mobile banking	Short Term	High
Resume onsite supervision, within the framework of an annual supervisory plan for risk-based supervisory work	Short Term	High
Develop mismatch approach to liquidity risk regulation, moving to a stress-based framework once high quality liquid assets are available	Short Term	High
Formulate short statement of regulatory approach to making and changing regulation addressing consultation and impact assessment	Short Term	High
Create a regulatory policy function	Short Term	Medium
Introduce occasional stress testing exercises, requiring banks to run simple adverse scenarios and report results	Short Term	High
Develop policy on selection and use of macroprudential tools	Short Term	High
Review latest capital risk weightings after six months to reflect development of risks; extend requirements to off balance sheet credit risk	Short Term	Medium
Complete regulations on insurance and reinsurance solvency requirements based potentially on EU Solvency I or equivalent framework	Short Term	High
Publish an issuance calendar for Treasury bills and commit to float meaningful amounts even when there is no financing need	Short Term	High
Utilize regular meetings of the Treasury Bill Management Committee to share information and coordinate public debt management and liquidity management	Short Term	Medium
Reduce gradually use of the government's overdraft facility in a commercial bank and restrict use of the overdraft facility at the RMA	Short Term	High
Agree on a Memorandum of Understanding specifying how RMA could be reimbursed for the cost of monetary policy	Short Term	High

Establish an automated depository for registering treasury bills at the RMA	Medium Term	High
Initiate systematic work on strengthening the market infrastructure for securities trading	Short Term	Medium
Merge reserve requirement and current accounts and allow reserve averaging	Short Term	High
Establish a liquidity management framework in which monetary instruments ensure market rates are determined close to the policy rate	Medium Term	High
Limit the use of the sweeping arrangement to clearly eligible accounts, selected in cooperation with commercial banks, and refrain from using sweeping to manage normal liquidity flows	Short Term	Medium

INTERNATIONAL MONETARY FUND

BHUTAN

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

May 30, 2014

Prepared By

Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of April 30, 2014)

Membership Status:

Joined: September 28, 1981; Article XIV.

General Resources Account

	SDR Million	% Quota
Quota	6.30	100.00
Fund Holdings of Currency (Exchange Rate)	5.28	83.81
Reserve Tranche Position	1.02	16.20
Lending to the Fund		

SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	5.99	100.00
Holdings	6.43	107.35

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund [1/]
(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2014	2015	2016	2017	2018
Principal					
Charges/interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

[1/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Implementation of HIPC Initiative: Not Applicable

Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable

Implementation of Post-Catastrophe Debt Relief (PCDR): Not Applicable

Exchange System

Since its introduction in 1974, the ngultrum has been pegged to the Indian rupee at par. Bhutan continues to avail itself of transitional arrangements under Article XIV, Section 2, pursuant to which it maintains exchange restrictions in connection with: (i) the availability of foreign exchange for travel, except for medical travel abroad by Bhutanese citizens[1], invisibles[2], and private transfers[3]; (ii) foreign exchange balancing requirement on remittances of income in convertible currencies or other foreign currencies from FDI; and (iii) the availability of foreign exchange for importers who are not able to provide the identity of the seller.

Bhutan also maintains exchange restrictions subject to Fund approval under Article VIII, Section 2(a) in connection with: (i) the FX balancing requirements for imports of capital goods (for projects involving FDI) and primary raw materials (for certain industrial projects); (ii) banning residents who do not comply with the requirement to repatriate export proceeds from accessing foreign exchange for unrelated imports; (iii) requiring foreign direct investment businesses to pay for their establishment and operational expenses from their own convertible currency resources; (iv) requiring Bhutanese companies to pay the interest on and amortization of external loans from their own convertible currency resources; (v) restricting the availability of Indian rupee for making payments and transfers to India in the following current international transactions: personal and business travel and study-abroad living arrangement[4], family[5] and salary remittances[6], advance

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[1] For Bhutanese citizens, the annual private travel FX allowance is set at $3,000 (plus $1,000 per each credit or debit card), the annual FX allowance for living expenses and stipend for education-related travel are set at $1,500 and $900, respectively, and the daily FX allowance for business travel is limited to the amount imposed by the Ministry of Finance on government officials. The RMA may provide access to FX above the private and education-related travel limits on a case-by-case basis, but does not publish any guidance on it. For medical travel by Bhutanese citizens, the exchange restriction has been removed since FX is made available upon provision of supporting documents. Resident non-citizens, however, must use their own foreign currency sources for all types of travel.

[2] Resident non-citizens must use their own foreign currency sources for subscriptions, application and testing fees and professional membership fees. Resident Bhutanese citizens may access FX exceeding the limits (currently US$300 without documentation and US$3,000 upon providing documentary evidence) with RMA approval. While such approval is granted based on documentary evidence, this is not specified in any RMA guidance. Thus, the limits create a "chilling effect" with respect to potential customers, since in the absence of any published guidance, they do not know that the limits are indicative.

[3] Restrictions are maintained on residents' family remittances in convertible currency. Residents who are not Bhutanese citizens may transfer only 50 percent of their monthly salaries and the rest of the funds at the end of the employment. While such approval is granted based on documentary evidence, this is not specified in any RMA guidance. Thus, the limits create a "chilling effect" with respect to potential customers, since in the absence of any published guidance, they do not know that the limits are indicative. Nonresidents may remit their salary only after deduction of estimated living expenses.

[4] Limits are imposed on the purchase of Indian rupee amounts for personal and business travels to India by residents (up to 10,000 Indian rupee per day and 50,000 Indian rupee per month for personal travel, while the access to pay for business travel daily expenses in Indian rupee is limited to the amount equal to the daily allowance imposed by the Ministry of Finance on government officials), and living expenses of citizen students studying in India (in forms of limits on maximum 20,000 Indian rupee stipend and 20,000 Indian rupee living allowances/incidental expenses per month). The RMA may provide access above these limits on case-by-case review, but does not publish any guidance on it. Thus, the limits create a "chilling effect" with respect to potential customers, since in the absence of any published guidance, they do not know that the limits are indicative.

payments for imports from India[7] and to recruit Indian workers[8], imports of certain construction materials and vehicles from India[9]; and (vi) banning the access to Indian rupee for unrelated current international transactions for those who contravene RMA 's 2012 guidelines on Indian rupee transactions.[10]

Staff is in the process of assessing other measures imposed by the authorities with respect to their consistency with Bhutan's obligations under Art VIII, Section 2(a) and 3.

Article IV Consultation

Bhutan is on a 24-month consultation cycle. The 2011 Article IV consultation was concluded by the Executive Board on May 27, 2011.

[5] Limits are imposed on family remittances by Indian expatriates, who are Bhutanese residents, to pay for their children's certain education expenses in India (in forms of limits on maximum 20,000 Indian rupee stipend and 20,000 Indian rupee living allowances/incidental expenses per month). The RMA may provide access above these limits on case-by-case review, but does not publish any guidance on it. Thus, the limits create a "chilling effect" with respect to potential customers, since in the absence of any published guidance, they do not know that the limits are indicative. Workers in specified industries are allowed to make family remittances, but with respect to workers on private housing projects, the RMA's 2012 guidelines on Indian rupee transactions only allow access to Indian rupee for remittances by Indian expatriate workers on housing projects approved by March 8, 2012. There is no provision for family remittances by resident Bhutanese citizens to India.

[6] Current regulations only allow residents in Bhutan to make limited salary remittances, and there is no provision for salary remittances in Indian rupee by nonresidents.

[7] Importers making advance payments for imports in Indian rupee must submit evidence that the relevant goods entered Bhutan within 91 days. The RMA states that advance payments can be contracted for a longer period of time, but this is not reflected in any published guidelines or documents. Thus, the requirement creates a "chilling effect" with respect to potential customers, since in the absence of any published guidance, they do not know that the limit is indicative.

[8] The RMA's 2012 guidelines on Indian rupee transactions limit amounts for making advance payments to recruit Indian expatriate workers (up to 8,000 or 1,000 Indian rupee, depending on the type of employers). Moreover, these 2012 guidelines only specify certain employers who can purchase Indian rupee for making such advance payments, although the RMA states that in practice other employers may purchase India rupee for such purposes as well. The specific provision of the 2012 guidelines create a "chilling effect", since in the absence of any published guidance, other employers do not know that they would be entitled to make advance payments. With respect to private housing projects, the guidelines allow access to Indian rupee for advance recruitment payments only to Indian expatriate workers on housing projects approved by March 8, 2012.

[9] Pursuant to a circular issued by the RMA in 2012, no access to Indian rupee is allowed for the import of construction materials from India for housing projects approved after March 8, 2012, or for the import of vehicles from India. The RMA intends to remove these measures by July, 2014.

[10] The RMA's 2012 guidelines on Indian rupee transactions impose an immediate ban to access Indian rupee for unrelated transactions by any person violating any provision of the guidelines. There are also some specific provisions in these guidelines that state, for example, that failure to submit medical expense documentation (with respect to both citizens and residents), or personal travel documentation (with respect to residents only) would deprive the relevant person from accessing Indian rupee in the future. The authorities have stated that they are willing to modify these penalties into fines, so as to remove the exchange restriction.

Technical Assistance

Fiscal (FAD):

1982, 1983	-	Tax policy, budgeting, and accounting
1984	-	Tax legislation
1984–86, 1988–89	-	Technical experts assigned as General Fiscal Advisor to the Ministry of Finance
1987, 1989	-	Tax system and public enterprises
1992, 2003	-	Income taxation
2003	-	Workshop on tax auditing and revenue forecast
2004	-	Accounting (with MFD)
2009	-	Indirect tax system, scope for VAT introduction
2009	-	Sales tax/VAT
2012	-	Diagnostic mission on budget preparation
2012, 2013	-	Assistance for cash flow forecasting and cash management
2013	-	Capacity building on budget analysis through structured management review
2013	-	Treasury management
2013	-	Treasury diagnostic
2013, 2014	-	Macrofiscal capacity building
2013, 2014	-	Budget planning and analysis

Legal (LEG):

1982–84	-	Tax legislation
2004, 2005	-	Central banking and financial services legislation and foreign exchange regulations (with MFD)
2011	-	TA in Payments Law

Monetary and Financial (CBD/MAE/MFD/MCM):

1983	-	Set-up the Royal Monetary Authority (RMA)
1980–92	-	Technical experts assigned as General Advisors to RMA
1989	-	Financial system review
1991	-	Financial sector legislation/development of supervisory capabilities
	-	Technical experts assigned as Advisor for Bank Supervision
1992	-	Issuance of government securities
1993–96	-	Implementation of issuance of government securities
2003	-	Monetary and exchange operations / financial systems
2004	-	Accounting

2004, 2005	-	Central banking and financial services legislation and foreign exchange regulations
2005, 2007	-	Risk based internal audit policies and practices
2006, 2007	-	Implementation of accounting reforms
	-	Debt management and financial markets development
2007	-	Follow-up on excess liquidity issues
	-	Follow-up on reserve management
2008	-	Foreign exchange issues
2013	-	Enhancing financial sector surveillance
2013	-	Treasury and reserve management

Statistics (STA):

1988	-	Trade statistics
1990	-	Statistics database
2004	-	Multisector statistics/GDDS mission
2005, 2009, 2011, 2013	-	Balance of payments statistics
2010	-	GDDS: Metadata Development
2011, 2012	-	JSA ICP: Producer Price Index
2012	-	Module management/oversight
2012	-	National Accounts - Quarterly
2011, 2013	-	JSA ICP-SNA: Quarterly National Accounts
2013	-	Government Finance Statistics
2013	-	Consumer Price Index
2013	-	Assessment/Evaluation

Resident Representative/Advisor: None.

RELATIONS WITH THE WORLD BANK GROUP

(As of March 2014)

The National Assembly finalized the Eleventh Five-Year Plan (11FYP) (2013–2018) in October 2013. The government shall focus on Self Reliance and Inclusive Green Socio-economic Development in the Eleventh Five year Plan. Self-Reliance is interpreted as "ability to meet all national development needs as articulated through 5 year plans by 2020" and Inclusive development refers to "reducing poverty and inequality by enhancing the standard of living and the quality of life of the most vulnerable sections of the society".

World Bank Group's Country Partnership Strategy

The current joint World Bank/IFC-Bhutan Country Partnership Strategy (CPS) covers the period FY11–14. It is aligned with three key strategic frameworks – the Principles of Gross National Happiness (GNH); Bhutan 2020 Vision and the Tenth Five-Year Plan (2008–2013). The CPS has two areas of engagement: (i) Economic Diversification, Job Creation and Financial Inclusion and (ii) Spatial Planning and Public Services, with two cross-cutting themes: capacity building and environmental sustainability.

The next CPS is scheduled to begin in FY 2015. It is anticipated that many of the themes of the current CPS will continue to resonate. The bulk of IDA financing is expected to continue in the form of development policy lending, supplemented by a limited number of specific investments in key areas, particularly where IDA resources may be leveraged, and a robust knowledge program. The next CPS probably will also reflect a shift toward IDA-IBRD blend status for Bhutan, in keeping with Bhutan's emerging middle-income country (MIC) status.

International Development Association (IDA)

Lending Program

The World Bank provides around $15–20 million of new IDA resources per year. There are four ongoing specific investment operations for a net commitment of $82 million of IDA resources. These include three country specific IDA operations – Decentralized Rural Development, Urban Development II, Remote Rural Communities Development – one regional IDA project – Regional Cooperation on Wildlife Protection – and one GEF grant operation – Sustainable Financing for Biodiversity Conservation. An additional financial project for the Urban Development II is being prepared. In addition, the WB manages several grants for Bhutan on Disaster Management, Public Private Partnerships, Corporate Governance, Public Financial Management and inter-governmental fiscal relations, Urban Budget Processes, social protection.

The World Bank has extended three development policy operations over the last six years. The most recent, Development Policy Credit-2 (DPC-2) was approved by the World Bank's Board of Executive Directors in November 2012 for a total of $36 million. This operation has focused on

(i) Promoting government efficiency and effectiveness through sound fiscal and public financial management and procurement, and strong public administration;

(ii) Fostering private-sector development by improving the policy environment and facilitating productive employment opportunities; and

(iii) Expanding access to infrastructure in a sustainable manner.

Non- lending Program

The World Bank provides support on knowledge through analytical work and technical assistance. Recent analytic work includes Gender Policy Note, a Nutrition Assessment, a Poverty and Social Impact Analysis of the proposed Bill on Cultural Heritage, a Human Development Public Expenditure Review, a review of higher education, and an Investment Climate Assessment which served to underpin the most recent budget support operation (DPC-2) to improve the policy framework governing private sector development. A poverty assessment, Financial Sector Assessment and a green growth study are underway, as well as a financial sector technical assistance to support the design of a financial sector strategy.

International Finance Corporation (IFC)

The IFC has a total committed investment portfolio in Bhutan of over $31 million. The portfolio consists predominantly of IFC's recent equity participation in Bhutan National Bank. The advisory portfolio includes advice in structuring Public Private Partnerships (PPPs), improving Bhutan's investment climate and enhancing access to financial services. IFC continues to explore areas of assistance in hydropower, tourism, manufacturing, agribusiness, health and education sectors among others. IFC's advisory support on investment climate reforms, PPP development and the financial sector is expected to continue.

Multilateral Investment Guarantee Agency (MIGA)

In January 2013, Bhutan took the first step to becoming a member of MIGA by signing the MIGA Convention. The Convention has been ratified by the National Assembly and the National Council. Bhutan is currently in the process of completing the other requirements for membership. Upon completion of the membership process, MIGA will be able to support investments in Bhutan by providing guarantees.

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Bhutan became a member in 1982 and ADB began its lending operations to the country in 1983. Bhutan is classified as a Group A country and is eligible for the Asian Development Fund (ADF) resources. Classified as moderately debt stressed, Bhutan has been receiving a 50:50 mix of ADF loan and ADF grant assistance since 2011. Cost-sharing ceiling has been set at 99 percent for loans, technical assistance, and other grants.

ADB assistance has followed closely Bhutan's Five Year Plans (FYP) and been guided by ADB's country partnership strategies (CPS) and country operations business plans (COBP). ADB is currently preparing a new CPS for the period 2014-2018, in line with the government's Eleventh FYP (2013–2018) and Strategy 2020—ADB's Long-Term Strategic Framework, 2008-2020. The overarching goal of the previous CPS, 2006–2010 and interim CPS, 2012-2013 was poverty reduction through economic diversification, and the core sectors of ADB operations were energy (including rural electrification and renewable energy), finance, transport, and urban development. The country assistance program evaluation, conducted in 2010, rated ADB country operations and programs in Bhutan *successful*, which were found to be well aligned with country development needs, government development priorities, and Strategy 2020.

ADB has been closely coordinating with other development partners in key sectors to avoid duplication. It provided parallel financing for urban development in Thimphu with the World Bank, and for rural electrification with the Japan International Cooperation Agency and the Austrian Development Agency. ADB also collaborated with SNV on renewable energy, and is currently supporting a pilot biogas project in southern Bhutan, which builds on the experience of SNV to create a viable biogas sector. Other examples of effective partnerships include ADB's rural electrification loans following the Rural Electrification Master Plan, which was developed with assistance from the Government of Japan. Similarly, development partners are using the Road Sector Master Plan, which was developed with ADB assistance. ADB's new resident mission in Thimphu will help further strengthen its partnership and coordination with development partners.

The current COBP covers the period 2014–2016. The indicative cumulative ADF allocation for this period in aggregate is $147 million. The 2014-2016 lending program will help develop the Nicachhu hydropower project (Green Power Development Project II), enhance transport connectivity and trade facilitation (South Asia Subregional Economic Cooperation (SASEC) Road Connectivity Project and SASEC Transport, Trade Facilitation and Logistics Project), improve urban infrastructure (Improved Urban Environmental Infrastructure Project), and provide additional financing to improve infrastructure at three domestic airports (Additional Financing for Air Transport Connectivity Enhancement Project). A nonlending program of $14.253 million has been programmed for 2014−2016.

Bhutan: Ongoing Loans and Grants
(As of 31 March 2014)

Project	Year of Approval	Project Amount ($ million)	Disbursements ($ million)
LOANS			
Urban Infrastructure Development Project	2006	25.5	20.8
Green Power Development Project (OCR Loan)	2008	51.0	51.0
Green Power Development Project	2008	29.4	29.4
Urban Infrastructure Project	2011	19.7	2.1
SASEC Trade Facilitation Program	2012	8.3	3.1
Strengthening Economic Management Program	2013	14.3	0.0
Additional Financing for Green Power Development Project	2013	39.6	19.5
GRANTS			
Micro, Small, and Medium-sized Enterprise Sector Development Project	2007	8.3	8.3
SASEC Information Highway Project	2007	4.7	2.1
Green Power Development Project	2008	25.3	23.9
Road Network Project II	2009	38.8	21.1
Rural Renewable Energy Development Project	2010	21.6	10.2
Air Transport Connectivity Enhancement Project	2012	6.9	1.5
SASEC Trade Facilitation Program	2012	3.3	3.3
Strengthening Economic Management Program	2013	20.8	20.8

OCR = Ordinary Capital Resources, SASEC = South Asia Subregional Economic Cooperation

Notes: Loans and grants include those funded by ADF and OCR. The first tranche of both the SASEC Trade Facilitation Program and the Strengthening Economic Management Program was released in 2013, and the second/final tranche is expected to be released in 2014.

STATISTICAL ISSUES

<table>
<tr><th colspan="2">BHUTAN—STATISTICAL ISSUES APPENDIX
As of April 30, 2014</th></tr>
<tr><th colspan="2">I. Assessment of Data Adequacy for Surveillance</th></tr>
<tr><td colspan="2">General: Data provision has some shortcomings, but is broadly adequate for surveillance. Most affected areas are: national accounts, balance of payments, and fiscal data.</td></tr>
<tr><td colspan="2">Real sector: As part of a Japan-funded technical assistance project for the Implementation of the System of National Accounts and the International Comparison Project that will take place over the next three years, the Statistics Department of the IMF (STA) will provide technical assistance to improve the national accounts and develop a producer price index.

National Accounts: The accuracy and reliability of the data are affected by inadequate source data. Key shortcomings include heavy reliance on production data collected by line ministries, which often lack quality control, long lags in providing estimates, large revisions of historical data and, in certain cases, ad hoc estimation procedures. Lack of reliable data on expenditure components hampers estimation of national savings and domestic investment. The key factors contributing to the data deficiency are the shortage of qualified personnel and facilities. The National Statistical Bureau (NSB) is also constrained by the absence of a Statistics Act.

Price statistics: Starting in 2004, the consumer price index (CPI) is compiled on a quarterly basis, the number of commodity prices has been greatly expanded, and the geographical scope broadened. Quarterly CPI series are available from March 2008 onwards. Monthly CPI series for domestic and imported goods starting from January 2013 have recently been released, but as yet the series are too short to aid in surveillance. NSB released the first monthly PPI series starting Q2 of 2012.</td></tr>
<tr><td colspan="2">Government finance statistics: Despite recent improvements in the quality of government finance statistics (GFS), the fiscal data are subject to frequent and substantial revisions, particularly in the expenditure area. The compilation and dissemination of budget execution data and GFS are very limited. Only annual budget execution data are compiled and disseminated, but with a long lag. No GFS are disseminated nationally. Quarterly data are now produced and made available internally. There are inconsistencies between the fiscal and monetary data with regard to bank financing, stemming from differences in the definition of government.</td></tr>
<tr><td colspan="2">Monetary statistics: While monetary statistics are generally consistent with the Fund’s guidelines, there is room for improvement in a number of areas, specifically: (i) the valuation of financial assets is based on purchase price while market or market-price equivalents would be preferable; (ii) to avoid misclassifications, a list of government units and nonfinancial public enterprises should be prepared and shared with the reporting financial institutions; During the technical assistance mission on Monetary and Financial Statistics (MFS) in March 2010, the authorities and STA improved the timeliness of data reporting to STA to be in line with national publications. As part of the mission objectives, the Royal Monetary Authority (RMA) has also submitted to STA the Financial Soundness Indicators (FSI) for Bhutan on a quarterly basis, which have been published on the IMF’s FSI website: http://fsi.imf.org/.</td></tr>
<tr><td colspan="2">Balance of payments: Despite significant improvements, external statistics continue to be affected by shortcomings. These include: (i) limited coverage of services’ transactions in the current account, (ii) long lags in dissemination.
Building on the technical assistance mission in June 2009, a mission in March 2011, in conjunction with the RMA, developed the International Investment Position for Bhutan and a plan for improvement in balance of payments statistics. It includes a quarterly business survey, improved estimation methods, and increased timeliness. The mission was able to identify and correct some measurement problems, significantly lowering net errors and omissions in the BOP. The RMA currently compiles and disseminates quarterly balance of payments data. Bhutan began supplying balance of payments data for publication in IFS in November 2010 and currently submits the BOP data in BPM6 format to the Fund. Authorities have also been participating in IMF’s Coordinated Direct Investment Survey from 2011.</td></tr>
<tr><th colspan="2">II. Data Standards and Quality</th></tr>
<tr><td>Bhutan participates in the General Data Dissemination System (GDDS), and posted metadata for the first time on the Fund’s Dissemination Standard Bulletin Board (DSBB) in May 2010.</td><td>No data ROSC is available.</td></tr>
</table>

BHUTAN—TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF MARCH 18, 2014

	Date of Latest Observation	Date Received	Frequency of Data[8]	Frequency of Reporting[8]	Frequency of Publication[8]
Exchange rates	03/2014	03/2014	D	D	D
International reserve assets and reserve liabilities of the Monetary Authorities[1]	11/2013	02/2014	M	M	M
Reserve/base money	11/2013	02/2014	M	M	M
Broad money	11/2013	02/2014	M	M	M
Central bank balance sheet	11/2013	02/2014	M	M	M
Consolidated balance sheet of the banking system	11/2010	3/2011	M	M	M
Interest rates[2]	09/2009	10/2009	M	M	M
Consumer price index[3]	06/2013	06/2013	Q/M	M	M
Revenue, expenditure, balance and composition of financing[4] – general government[5]	2012/13	01/2014	A	A	A
Revenue, expenditure, balance and composition of financing – central government	2012/13	01/2013	A	A	A
Stocks of central government and central government-guaranteed debt[6]	2012/13	01/2013	A	A	A
External current account balance	2013	01/2014	A	A	A
Exports and imports of goods and services	2013	01/2014	A	A	A
GDP/GNP	2013	01/2014	A	A	A
Gross external debt	06/2013	01/2014	Q	Q	Q
International investment position[7]	06/2009	10/2009	Q	Q	Q

[1] Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Monthly CPI data for domestic and imported goods is available from April 2013 onward.
[4] Foreign, domestic bank, and domestic nonbank financing.
[5] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[6] Including currency and maturity composition.
[7] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[8] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

INTERNATIONAL MONETARY FUND

BHUTAN

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

May 30, 2014

Approved By
Paul Cashin and Ranil Salgado (IMF) and Jeffrey Lewis and Ernesto May (IDA)

The Debt Sustainability Analysis (DSA) has been prepared jointly by IMF and World Bank staff, in consultation with the authorities, using the debt sustainability framework for low-income countries approved by the Boards of both institutions.

Based on the Joint Fund-Bank Debt Sustainability Framework for Low-Income Countries (LIC DSA), Bhutan's risk of external debt distress is moderate. Bhutan's rapid hydropower development is projected to lead to a substantial buildup of external debt in the medium-term, with debt ratios breaching most of the country-specific indicative thresholds for protracted periods of time. Also risks stem from volatile hydro-related debt service payments. Bhutan's debt situation is only expected to improve over the long run, reflecting significantly higher electricity exports when more hydropower projects come on stream. The staff's assessment is primarily based on unique mitigating factors, namely explicit guarantees from India that cover financial and construction risks for the hydropower projects, thus allowing for the exceptional treatment of hydropower loans from India as similar to FDI—i.e., non-debt creating. As well, India buys the surplus output (after domestic use) with the price based on a cost-plus basis (building in a net return of 15 percent). Other mitigating factors include Bhutan's strong track record of project implementation, rapid growth in energy demand from India, committed donor support, and Bhutan's high level of international reserves.[1] Notwithstanding these mitigating factors, staff cautions against further new non-concessional borrowing as the level of debt has increased substantially compared to previous DSAs. Stress tests to public sector debt dynamics reveal the need for fiscal consolidation and the importance of sustaining rapid economic growth going forward.

[1] Bhutan, with an average Country Policy and Institutional Assessment (CPIA) index of 3.85, is currently classified as a strong performer with regard to its policies and institutions.

BACKGROUND

1. **Bhutan's public and publicly guaranteed (PPG) external debt increased to 85 percent of GDP at end 2012/13 adding 14 percentage points of GDP to the previous year.** The rise in the external public debt was, in large part, driven by hydro sector related external borrowing (with an outstanding stock of 48 percent of GDP). Hydropower projects are primarily financed by India with a mix of loans (70 percent) and grants (30 percent). A large portion of external debt continues to be denominated in Indian rupees (and related to hydropower sector debt), which accounts for 61 percent of total external debt, with convertible currency debt accounting only 29 percent. Domestic debt was entirely due to the loan to purchase aircraft for Druk Air in 2009/10, and the increased domestic debt-to-GDP ratio at about 6 percent of GDP in 2012/13 reflects the fiscal outturns in the following three years.

Bhutan: Structure of Public Sector Debt

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Total Public Sector Debt (percent of GDP)	59	71	57	69	72	90
External	56	69	56	66	71	85
Hydropower sector debt	36	39	32	40	42	48
Non-hydropower sector debt	20	30	24	26	29	37
Domestic	3	2	2	3	1	6

UNDERLYING DEBT SUSTAINABILITY ANALYSIS ASSUMPTIONS

2. **Under the baseline scenario, Bhutan is expected to pursue expansion in its power generation capacity to about 10,000 MW by 2020.** The hydropower development policy of Bhutan consists of eleven new hydropower projects (see text table), which would quintuple Bhutan's power generation capacity. External financing for non-hydropower sector activities continues to remain predominantly from multilateral and bilateral donors at concessional terms. In addition, the government has a stand-by facility with the Government of India to relieve temporary BOP pressures, as well as a swap line with the Reserve Bank of India and overdrafts with Indian commercial banks. These also add to the external debt stock when availed.

Table. Summary of Hydropower Projects in the Pipeline

Project	Capacity (MW)	DPR Schedule	Construction Schedule	Development Model
Punatsangchhu I	1200	Under construction	2008-2017	Intergovernment
Punatsangchhu II	1020	Under construction	2010-2017	Intergovernment
Mangdecchu	720	Under construction	2010-2017	Intergovernment
Sankosh Storage	2650	DPR yet to be cleared	2015-2023	Intergovernment
Kuri Gongri	2640	DPR to be prepared in 11FYP	2017-2026	Intergovernment
Amochhu Storage	540	DPR cleared by CEA	2015-2023	Intergovernment
Wangchhu	570	DPR yet to cleared by CEA, GoI	2015-2023	Joint Venture
Bunakha Storage	180	DPR cleared by CEA	2014-2020	Joint Venture
Kholongchhu	600	DPR approved by two Governments	2014-2021	Joint Venture
Chamkarchhu I	770	DPR yet to be cleared	2015-2024	Joint Venture
Dagachhu	126	Completed	2009-2014	PPP
Total	**11066**			

Source: Annual Report 2012/13, Royal Monetary Authority of Bhutan
Note: CEA: Central Electricity Authority, Government of India.

3. **The hydropower sector developments will govern the rest of the economy as summarized by the following key baseline macroeconomic assumptions**.

- ***Real sector***: Similar to the spike in real GDP when Tala hydropower project was commissioned in 2006/07, Puna I, Puna II and Mangdechu hydropower projects will continue to boost economic growth during the construction phase and as they come on stream in 2017/18. Real growth in the medium-term is projected to remain at around 8½ percent, close to its 10-year historical average of 8 percent. As construction of hydro projects phases out, growth will gradually return to around 6¾ percent in the long-term.
- ***Fiscal sector***: Upon completion, the hydropower projects will boost the domestic revenue-to-GDP ratio, similar to when Tala hydropower project came on line. External budgetary aid is projected to decline as a share of GDP as Bhutan's per capita income rises. On average, the overall fiscal deficit remains broadly balanced over the long term.
- ***External sector***: The current account deficit is projected to deteriorate over the medium term because of strong growth in import demand associated with the construction phase of the hydropower projects, as well as hydro debt service. Upon the completion of hydropower projects, however, electricity exports are likely to more than triple from current levels, and the current account deficit should decline over the longer term, leading to balance of payment surpluses from 2020 onwards.

Key Macroeconomic Assumptions

	10 year Historical Average	Baseline Average	
		2013–2018	2019–2033
Current transfers, net total (in percent of GDP)	11.3	5.2	0.3
Real GDP growth (percent)	8.0	8.4	6.6
Growth of exports of goods and services (US dollar terms)	21.4	17.6	8.6
Non-interest current account deficit (in percent of GDP)	10.0	15.6	-16.5
Primary deficit (in percent of GDP)	-1.2	-7.1	-11.7

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

A. Baseline

4. **Bhutan's external debt closely traces hydropower cycles**. External debt as a share of GDP is projected to rise to 121 percent of GDP in 2016/17 in line with disbursements for hydropower-sector projects, before declining slightly to 116 percent of GDP in 2017/18 with the completion of the first phase of hydro construction (Table 1). The stock of external public and publicly guaranteed (PPG) debt is expected to gradually decline in the long term to about 29 percent in 2034 once construction of most of the hydropower projects is completed and debt service commences to pay down the debt stock. As a result, the present value (PV) of PPG external debt-to-GDP gradually declines to 25 percent only over the long term. The PV of debt-to-exports ratio falls below the threshold of 200 percent also only in the long run and remains above the threshold for most of the projection period. The PV of PPG external

debt to revenue is also on a downward trend from a peak of 750 percent in 2014/15 and is projected to fall below the threshold of 300 percent only in the long run.[2] However, all the debt ratios remain above the LIC-DSA indicative thresholds for a significant part of the projection period under the baseline. The commissioning of the hydropower projects (in 2017/18), which also marks the start of the debt repayment, puts the debt ratios on a steady downward trajectory.

5. **Debt service-to-export ratio is expected to remain below the indicative thresholds for most of the entire projection period.** However, debt service-to-revenue ratio breaches the indicative threshold as Puna II and Mangdechu's debt service begin in 2018/19; however, it is expected to fall below the threshold over the long run.[3] The protracted breaches of the thresholds over the medium term would indicate a high risk of debt distress, although strong mitigating factors exist for hydropower debt.

6. **Excluding hydropower debt from the total (i.e., treating these loans like FDI), breaches of baseline debt-ratios are temporary and/or marginal**. The assumptions in the scenario are the same as the previous one outlined in paragraph 3. All hydropower loans are excluded to assess debt dynamics of non-hydro debt. The results of this scenario are that non-hydro debt ratios are well below the threshold in case of PV of debt to GDP, exports and revenues. There are temporary breaches in the case of the debt service indicators.

B. Sensitivity Analysis

7. **The PV of debt-to-exports and debt-to-revenue ratios (which are two of the external debt sustainability thresholds) are breached under stress tests** (exports shock, exchange rate depreciation, growth shock and unfavorable financing terms). The standard sensitivity analysis points to a moderate risk of debt distress (Figure 1 and Table 2), as all debt burden indicators (PV of debt-to-exports, debt-to-revenue, and debt-to-GDP ratios) breach their respective thresholds after the shocks in 2014 and only come down in the long run (except under the historical scenario). Based on the bound tests, the most extreme stress for the PV of debt-to-exports or revenue ratios is a one-standard deviation shock to the exchange rate in 2013–14. However, this shock overestimates Bhutan's debt vulnerability since a large share of Bhutan's external income is in Indian rupees, which act as a natural hedge to the rupee-denominated debt.

8. **Debt service ratios also breach their respective thresholds for parts of the projection period.** The debt service-to-export ratio breaches the threshold under a growth shock and the debt service-to-revenue ratio breaches the indicative threshold continuously under the shock scenarios.

[2] The PV indicators exceed ratios in nominal terms due to non-concessional nature of outstanding debt (hydropower-project loans, Dungsam-cement-company borrowing, stand-by-credit-facility with government of India, SWAP arrangement with RMA, and borrowing from Indian commercial banks).

[3] Revenues used to pay for amortization are accounted in the budget as repayable in net lending. The DSA template adds these numbers to revenues to better reflect the capacity of the government to service the debt.

PUBLIC DEBT SUSTAINABILITY ANALYSIS

A. Baseline

9. **The baseline public debt dynamics trace closely the path of external debt**. The public debt-to-GDP ratio is expected to rise to 129 percent in 2016/17 and then decline gradually until it reaches 35 percent of GDP by end 2033/34. External financing is projected to shrink as a share of GDP, making room for domestic financial markets to play a larger role in the financing of the development agenda.

B. Sensitivity Analysis

10. **The public debt ratios are projected to be on a declining path over the long term under various stress tests**. A one-time depreciation results in an upward shift in the various public debt indicators without affecting the shape of the debt indicators' path. However, the sensitivity analysis suggests that the debt service ratios are susceptible to extreme shocks, given the bunching of repayments in the outer years. This scenario underscores the importance of containing fiscal deficits to ensure the sustainability of public debt.

STAFF ASSESSMENT

11. **Despite worsening of debt ratios compared to the 2011 DSA, staff maintains the assessment that Bhutan's risk of external debt distress is moderate due to the presence of unique and strong mitigating factors.** These factors are primarily the explicit guarantees from India that cover financial and construction risks for the hydropower projects (Box 1). As well, India buys the surplus output (after domestic use) with the price based on a cost-plus basis (building in a net return of 15 percent). This unique arrangement allows for an exceptional treatment of hydropower loans from India as similar to FDI—i.e., non-debt creating.

- The addition of new hydropower projects leads to a substantial build-up in external debt, relative to the analysis in the 2011 DSA. The policy-related LIC-DSA thresholds are breached for most of the indicators and remain breached for a longer period compared to the previous analysis. As Bhutan's debt carrying capacity only improves in the long run, staff cautions against any additional non-concessional borrowing. Also, Bhutan's (i) concentrated export base, (ii) rupee-reserves mismatch with external debt and the trade structure of the country (and the consequent buildup of debt related to the overdrafts)—see Selected Issues paper on reserve adequacy and reserve management, and (iii) its fiscal stance, leave it vulnerable to export and constant primary-deficit shocks and any shortfalls in aid inflows. These vulnerabilities are confirmed by the stress tests in the DSA which reveals potential vulnerabilities in Bhutan's external debt situation. Additional risks stem from volatile hydro related debt service payments requiring provisioning of rupee reserves. Two episodes of rupee shortage in 2006/2007 and as recently as 2011/12 are partly explained by lumpy debt service payments.

- However, the guarantees from India mitigate risks related hydropower loans, with debt and debt-service ratios significantly lower and breaches of indicative thresholds temporary and/or marginal, once these loans are excluded. These additional projects also confer strong economic dividends in the long-term, boosting real GDP growth and exports.

12. **Furthermore, mitigating factors that were also highlighted in previous assessments remain valid, namely:**

- Bhutan has a strong track record of project implementation.
- Bhutan maintains close economic and political ties with India, which mitigate the commercial risks of these projects. India has been both the main provider of financing for hydropower projects and the main consumer of the projects' electricity output. Going forward, India's sizeable power deficit will continue to support the demand for Bhutan's hydropower.

Box 1. Institutional and Legal Arrangements of Inter-Governmental Hydropower Projects in Bhutan

Intergovernmental hydropower projects in Bhutan are being undertaken under a unique arrangement between India and Bhutan, reflecting close links between the two countries. Under the "10,000 MW by 2020" bilateral cooperation agreement signed on 26th July 2006 and the protocol to the agreement signed on 16th March 2009, the Royal Government of Bhutan (RGoB) and the Government of India (GoI) agreed to develop 5 intergovernmental projects (Chhuka, Kurichhu, Tala which have been commissioned, and Punatsangchhu I, Punatsangchhu II, Mangdechhu which are under construction).

Under the intergovernmental agreement, a detailed project report (DPR) is prepared by a GoI undertaking. The report reviews all technical and financial aspects of the project. After the DPR is final and endorsed by the 2 countries, a Project Agreement between Bhutan (Ministry of Foreign Affairs) and India (Ministry of External Affairs) is signed, which establishes:

- Sole ownership of the project by the RGoB;
- Estimated cost of project, and establishes GoI's sole responsibility for funding (including additional costs);
- Terms of financing (share of grant versus loan financing from India, simple - non capitalized interest rate, amortization period, with the first repayment starting one year from the mean date of commercial operation)
- Setting-up of a project authority for the construction, operation, maintenance and evacuation of the surplus power, with a chairperson appointed by RGoB;
- Handing over of the project by the project authority to the RGoB within 2 years of completion of the project and dissolution of the project authority at the time;
- That the GoI will purchase all the surplus power from the project (over and above domestic use);
- Principle of a "cost plus" approach for the determination of the power rate at the time of commissioning the project. Cost plus includes the costs of the project, financing costs, operation and maintenance charges, (accelerated) depreciation and market conditions and a net return of 15 percent.
- The principle of reviewing the rate every 3 years.

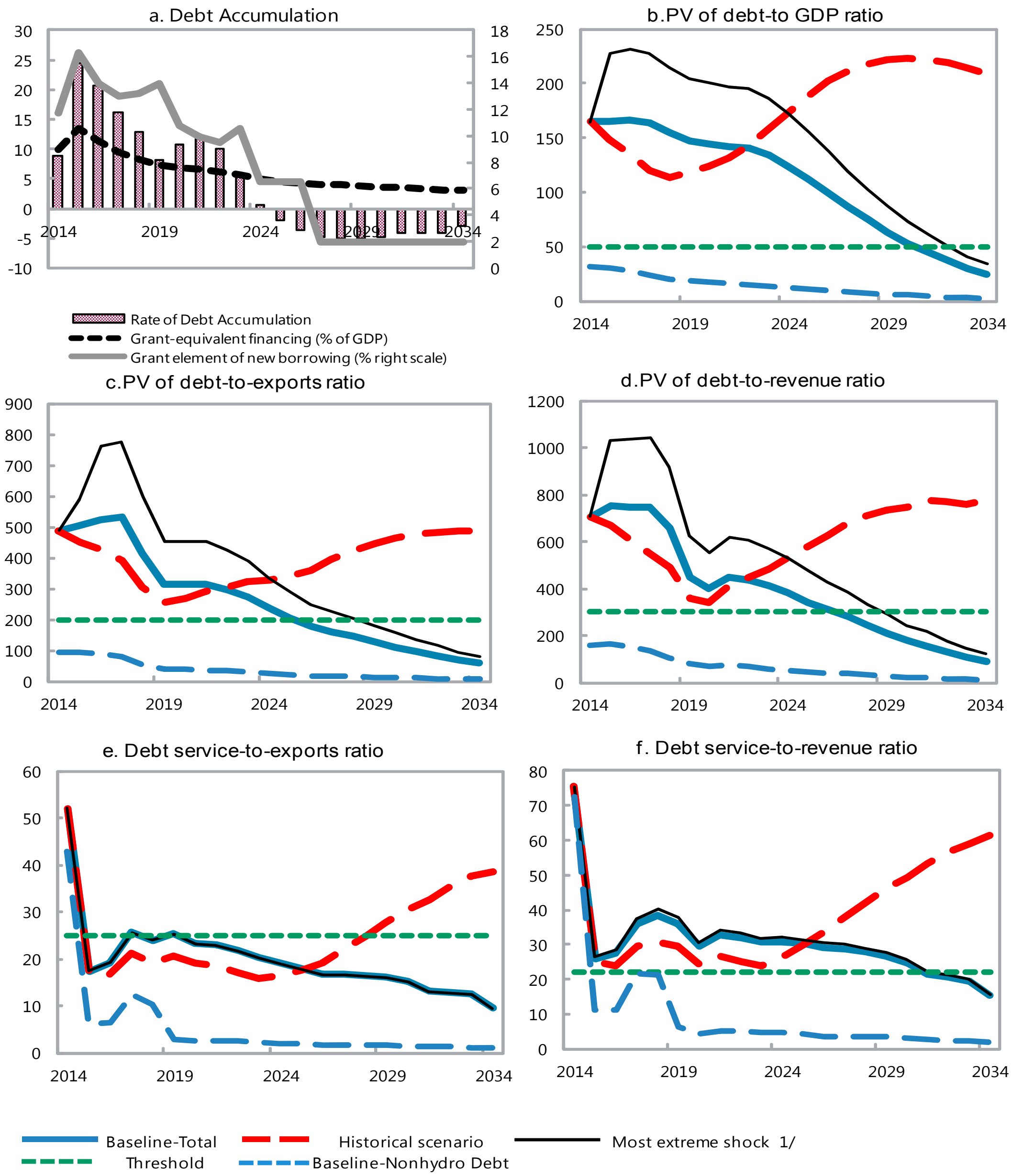
Once the project has finished construction and is commissioned:

- a protocol to the Project Agreement is signed between RGoB (Ministry of Economic Affairs) and GoI (Bhutan Embassy), which establishes the rate at which the surplus power will be sold to GoI, authorizes the designated nodal agencies to enter into a Power Purchasing Agreement (PPA) following the principles established in the Protocol;
- a protocol to the Project Agreement is signed between RGoB (Ministry of Finance) and GoI (Bhutan Embassy), which establishes the principal to be repaid, repayment schedule and interest.
- a subsidiary loan agreement between the Government of Bhutan and Druk Green Power Corporation (DGPC), a Public Holding company part of Druk Holding Investments (DHI), treating the MoF loan as on-lending to DGPC. The agreement follows the same terms as the umbrella agreement, DGPC payments to MoF treasury having to be made a week before the due date to GoI.

<u>Assessment of Debt Sustainability risks of Intergovernmental hydropower projects</u>

Debt sustainability risks are minimal: (i) construction risks are born by GoI, (ii) power rates are determined at the time of the project commissioning, when the actual project cost is known, and are set to allow revenues to service debt and a financial return; (iii) hydropower project are insured (and re-insured) for natural disaster. The only risk is hydrological after commissioning of the project, if electricity, once the project is commissioned, could not be generated.

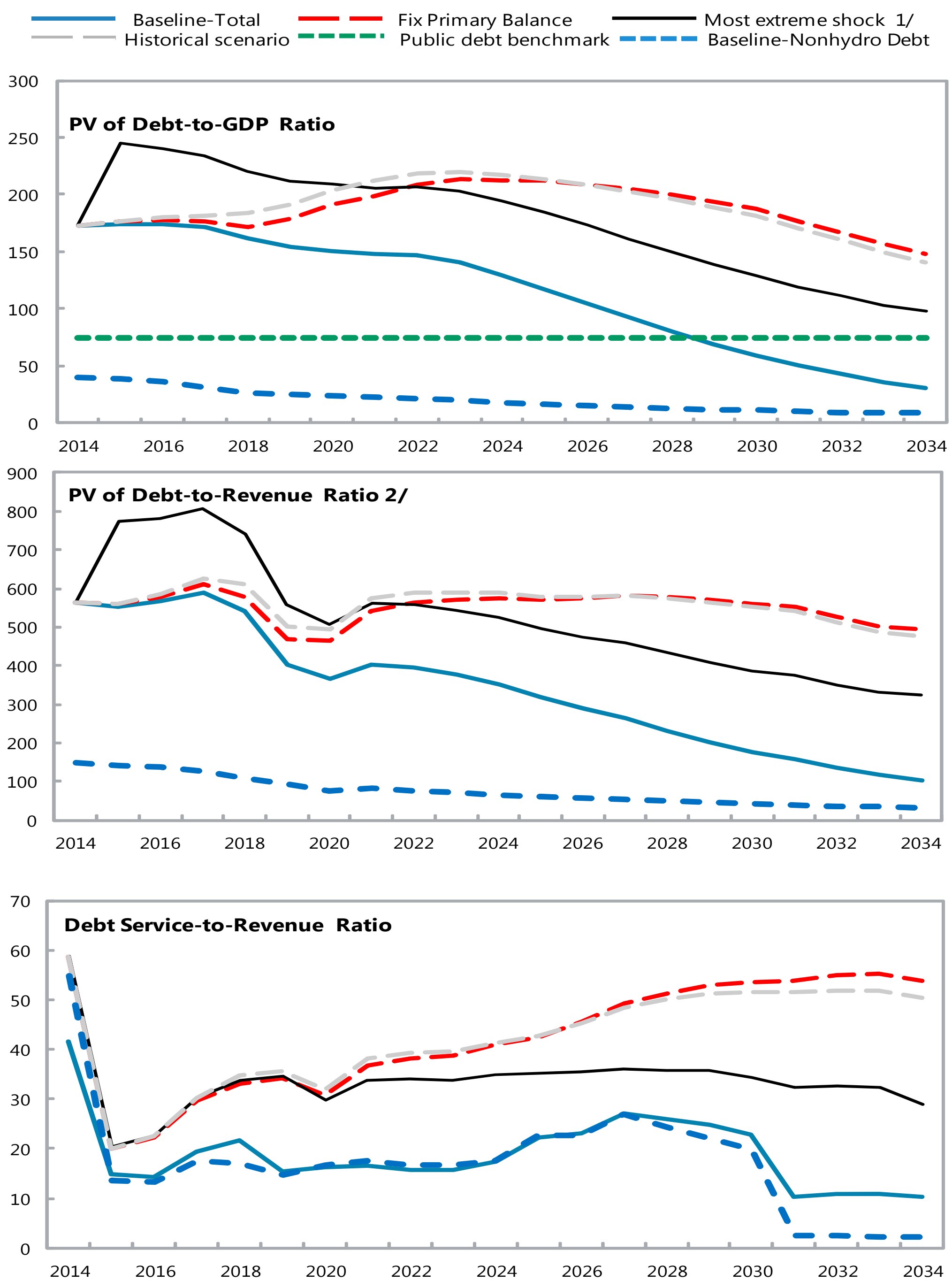
Figure 1. Bhutan: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2014–2034 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Growth shock and in figure f. to a Growth shock

Figure 2. Bhutan: Indicators of Public Debt Under Alternative Scenarios, 2014–2034 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio on or before 2024.
2/ Revenues are defined inclusive of grants.

Table 1. Bhutan: External Debt Sustainability Framework, Baseline Scenario, 2011–2034 1/

	Actual			Historical Average 6/	Standard Deviation 6/	Projections									
	2011	2012	2013			2014	2015	2016	2017	2018	2019	2014-2019 Average	2024	2034	2020-2034 Average
External debt (nominal) 1/	**65.9**	**71.0**	**84.8**			**105.2**	**114.4**	**120.0**	**120.8**	**115.9**	**116.8**		**117.5**	**29.4**	
of which: public and publicly guaranteed (PPG)	65.9	71.0	84.8			105.2	114.4	120.0	120.8	115.9	116.8		117.5	29.4	
Change in external debt	10.0	5.1	13.8			20.4	9.2	5.6	0.8	-4.9	0.9		-7.5	-5.9	
Identified net debt-creating flows	11.9	15.0	18.4			17.9	17.1	16.5	16.8	1.7	-2.9		-22.3	-13.9	
Non-interest current account deficit	**21.0**	**16.9**	**20.1**	**10.0**	**13.5**	**16.8**	**22.1**	**22.3**	**23.4**	**11.2**	**-2.4**		**-21.7**	**-11.7**	-16.5
Deficit in balance of goods and services	29.7	25.9	23.8			24.8	28.5	29.3	29.2	17.0	7.6		-9.1	-1.9	
Exports	38.1	32.2	31.1			33.8	32.9	31.7	30.6	37.4	46.8		52.4	43.0	
Imports	67.8	58.1	54.9			58.6	61.4	61.0	59.8	54.4	54.4		43.3	41.1	
Net current transfers (negative = inflow)	-12.8	-13.2	-14.1	-11.3	2.9	-4.4	-7.6	-6.7	-5.1	-4.2	-3.0		-1.3	1.8	-0.3
of which: official	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other current account flows (negative = net inflow)	4.1	4.2	10.4			-3.5	1.1	-0.3	-0.7	-1.6	-7.0		-11.2	-11.6	
Net FDI (negative = inflow)	**-1.5**	**-0.5**	**-1.3**	**-1.5**	**2.1**	**-1.3**	**-1.3**	**-1.3**	**-1.3**	**-1.3**	**-1.3**		**-1.3**	**-1.3**	-1.3
Endogenous debt dynamics 2/	**-7.7**	**-1.4**	**-0.4**			**2.4**	**-3.7**	**-4.5**	**-5.3**	**-8.2**	**0.8**		**0.8**	**-0.9**	
Contribution from nominal interest rate	2.4	2.1	2.9			7.9	3.6	3.9	4.0	4.0	9.2		7.9	1.2	
Contribution from real GDP growth	-4.6	-4.1	-3.4			-5.5	-7.3	-8.4	-9.3	-12.1	-8.4		-7.2	-2.1	
Contribution from price and exchange rate changes	-5.4	0.6	0.0			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**-1.8**	**-9.9**	**-4.6**			**2.6**	**-7.9**	**-10.9**	**-16.1**	**-6.7**	**3.8**		**14.8**	**8.0**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	142.5			164.8	165.5	166.1	163.2	154.1	147.0		124.0	24.9	
In percent of exports	...	...	458.3			487.1	503.7	524.6	533.9	411.7	314.1		236.6	57.9	
PV of PPG external debt	**...**	**...**	**142.5**			**164.8**	**165.5**	**166.1**	**163.2**	**154.1**	**147.0**		**124.0**	**24.9**	
In percent of exports	**...**	**...**	**458.3**			**487.1**	**503.7**	**524.6**	**533.9**	**411.7**	**314.1**		**236.6**	**57.9**	
In percent of government revenues	**...**	**...**	**588.2**			**706.9**	**749.4**	**746.4**	**747.5**	**659.0**	**447.9**		**381.7**	**92.5**	
Debt service-to-exports ratio (in percent)	**13.6**	**13.2**	**17.7**			**52.0**	**17.4**	**19.2**	**25.6**	**24.0**	**25.3**		**19.1**	**9.6**	
PPG debt service-to-exports ratio (in percent)	**13.6**	**13.2**	**17.7**			**52.0**	**17.4**	**19.2**	**25.6**	**24.0**	**25.3**		**19.1**	**9.6**	
PPG debt service-to-revenue ratio (in percent)	**23.4**	**18.2**	**22.7**			**75.5**	**25.8**	**27.3**	**35.9**	**38.4**	**36.0**		**30.8**	**15.3**	
Total gross financing need (Billions of U.S. dollars)	0.4	0.4	0.5			0.7	0.5	0.6	0.8	0.6	0.3		-0.6	-1.1	
Non-interest current account deficit that stabilizes debt ratio	11.0	11.8	6.3			-3.6	12.9	16.7	22.6	16.1	-3.3		-14.2	-5.8	
Key macroeconomic assumptions															
Real GDP growth (in percent)	10.1	6.5	5.0	8.0	2.5	6.4	7.6	8.2	8.6	11.5	8.0	8.4	6.2	6.6	6.6
GDP deflator in US dollar terms (change in percent)	10.7	-0.9	0.0	4.8	7.2	-8.6	1.8	2.9	2.8	2.6	2.3	0.6	2.4	2.4	2.4
Effective interest rate (percent) 5/	5.1	3.3	4.3	3.2	1.9	9.1	3.7	3.8	3.7	3.7	8.8	5.5	6.9	3.9	6.8
Growth of exports of G&S (US dollar terms, in percent)	22.2	-10.6	1.2	21.4	30.3	5.7	6.4	7.3	7.8	40.0	38.2	17.6	15.8	6.5	8.6
Growth of imports of G&S (US dollar terms, in percent)	40.5	-9.5	-0.9	20.5	27.5	3.7	14.8	10.6	9.5	4.1	10.5	8.9	3.8	9.1	7.2
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	11.7	16.3	14.0	13.0	13.2	14.0	13.7	6.5	2.0	5.1
Government revenues (excluding grants, in percent of GDP)	22.1	23.4	24.2			23.3	22.1	22.3	21.8	23.4	32.8		32.5	26.9	30.9
Aid flows (in Billions of US dollars) 7/	0.9	1.4	0.6			0.2	0.3	0.3	0.3	0.3	0.3		0.2	0.4	
of which: Grants	0.2	0.3	0.2			0.1	0.2	0.2	0.2	0.2	0.2		0.2	0.4	
of which: Concessional loans	0.7	1.1	0.4			0.0	0.1	0.1	0.1	0.1	0.1		0.0	0.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			9.9	13.5	11.4	9.4	8.4	7.3		4.9	3.0	4.5
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			33.8	39.1	39.6	38.5	38.9	37.2		52.1	100.0	75.7
Memorandum items:															
Nominal GDP (Billions of US dollars)	1.7	1.8	1.9			1.9	2.1	2.3	2.6	2.9	3.2		5.0	12.0	
Nominal dollar GDP growth	21.9	5.5	4.9			-2.8	9.5	11.3	11.6	14.3	10.5	9.1	8.8	9.2	9.1
PV of PPG external debt (in Billions of US dollars)			2.7			2.9	3.3	3.7	4.1	4.4	4.7		6.1	2.9	
(PVt-PVt-1)/GDPt-1 (in percent)						8.9	24.4	20.6	16.1	12.8	8.2	15.2	0.6	-3.0	-0.2
Gross workers' remittances (Billions of US dollars)	...	...	...			...	...	...	...	...	...		...	...	
PV of PPG external debt (in percent of GDP + remittances)	...	...	142.5			164.8	165.5	166.1	163.2	154.1	147.0		124.0	24.9	
PV of PPG external debt (in percent of exports + remittances)	...	...	458.3			487.1	503.7	524.6	533.9	411.7	314.1		236.6	57.9	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	17.7			52.0	17.4	19.2	25.6	24.0	25.3		19.1	9.6	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes. Sizable capital grants are part of residuals.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 2. Bhutan: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–2034

	Projections							
	2014	2015	2016	2017	2018	2019	**2024**	2034
PV of debt-to GDP ratio								
Baseline	165	165	166	163	154	147	**124**	25
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	165	148	136	120	114	118	**173**	209
A2. New public sector loans on less favorable terms in 2014-2034 2	165	168	174	175	169	164	**151**	47
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	165	164	170	167	158	151	**127**	25
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	165	165	175	172	162	154	**128**	25
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	165	168	179	176	167	159	**133**	26
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	165	162	164	161	152	145	**122**	24
B5. Combination of B1-B4 using one-half standard deviation shocks	165	162	167	165	156	148	**125**	25
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	165	228	231	227	214	204	**172**	34
PV of debt-to-exports ratio								
Baseline	487	504	525	534	412	314	**237**	58
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	487	451	428	391	304	252	**329**	485
A2. New public sector loans on less favorable terms in 2014-2034 2	487	512	551	573	450	351	**289**	108
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	487	490	514	524	404	308	**231**	55
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	487	588	762	774	596	454	**336**	80
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	487	490	514	524	404	308	**231**	55
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	487	493	518	528	407	310	**232**	55
B5. Combination of B1-B4 using one-half standard deviation shocks	487	487	512	522	403	307	**231**	55
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	487	490	514	524	404	308	**231**	55
PV of debt-to-revenue ratio								
Baseline	707	749	746	748	659	448	**382**	93
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	707	672	609	548	487	360	**531**	775
A2. New public sector loans on less favorable terms in 2014-2034 2	707	762	784	802	721	501	**466**	173
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	707	743	765	767	676	459	**390**	92
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	707	749	788	788	693	471	**393**	93
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	707	760	806	808	712	484	**410**	97
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	707	733	737	739	651	442	**375**	89
B5. Combination of B1-B4 using one-half standard deviation shocks	707	733	753	755	666	452	**385**	91
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	707	1033	1038	1040	917	623	**529**	125

Table 2. Bhutan: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–2034 (continued)

				Debt service-to-exports ratio				
Baseline	52	17	19	26	24	25	**19**	10
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	52	17	17	21	19	21	**16**	38
A2. New public sector loans on less favorable terms in 2014-2034 2	52	17	17	25	24	26	**23**	16
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	52	17	19	26	24	25	**19**	9
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	52	20	27	38	35	36	**28**	14
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	52	17	19	26	24	25	**19**	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	52	17	19	26	24	25	**19**	9
B5. Combination of B1-B4 using one-half standard deviation shocks	52	17	19	26	24	25	**19**	9
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	52	17	19	26	24	25	**19**	9
				Debt service-to-revenue ratio				
Baseline	76	26	27	36	38	36	**31**	15
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	76	25	24	29	31	29	**26**	61
A2. New public sector loans on less favorable terms in 2014-2034 2	76	26	25	35	39	37	**37**	25
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	76	26	29	37	40	38	**32**	16
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	76	26	28	38	40	37	**33**	16
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	76	27	30	39	42	40	**34**	17
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	76	26	27	36	39	36	**31**	15
B5. Combination of B1-B4 using one-half standard deviation shocks	76	26	28	37	40	37	**31**	15
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	76	37	39	51	54	51	**43**	21
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	4	4	4	4	4	4	**4**	4

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly a
an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 3. Bhutan: Public Sector Debt Sustainability Framework, Baseline Scenario, 2011–2034

	Actual					Estimate	Projections								
	2011	2012	2013	Average 5/	Standard Deviation 5/	2014	2015	2016	2017	2018	2019	2014-19 Average	2024	2034	2020-34 Average
Public sector debt 1/	68.5	72.3	90.4			113.5	123.3	128.6	128.7	123.1	123.7		123.4	35.3	
of which: foreign-currency denominated	65.9	71.0	84.8			105.2	114.4	120.0	120.8	115.9	116.8		117.5	29.4	
Change in public sector debt	11.1	3.8	18.0			23.1	9.8	5.3	0.2	-5.6	0.6		-7.6	-5.8	
Identified debt-creating flows	-6.6	2.9	-6.6			13.5	-16.4	-14.4	-14.5	-19.8	-20.3		-17.2	-4.7	
Primary deficit	-0.2	-1.2	-2.8	-1.2	2.9	-2.8	-4.5	-4.7	-5.0	-7.7	-18.0	-7.1	-14.6	-2.6	-11.7
Revenue and grants	35.3	37.9	33.5			30.7	31.5	30.8	29.0	29.8	38.1		37.1	30.0	
of which: grants	13.1	14.5	9.3			7.4	9.4	8.5	7.1	6.4	5.3		4.6	3.0	
Primary (noninterest) expenditure	35.1	36.7	30.7			27.9	27.0	26.1	24.0	22.1	20.2		22.5	27.4	
Automatic debt dynamics	-6.4	4.1	-3.9			16.3	-11.9	-9.7	-9.5	-12.2	-2.3		-2.6	-2.2	
Contribution from interest rate/growth differential	-2.8	-7.6	-5.5			-2.5	-8.7	-9.4	-10.1	-13.1	-3.7		-3.9	-2.5	
of which: contribution from average real interest rate	2.5	-3.4	-2.1			2.9	-0.8	-0.1	0.1	0.2	5.4		3.8	0.0	
of which: contribution from real GDP growth	-5.3	-4.2	-3.4			-5.4	-8.0	-9.3	-10.2	-13.3	-9.1		-7.7	-2.6	
Contribution from real exchange rate depreciation	-3.7	11.7	1.6			18.8	-3.2	-0.2	0.6	0.9	1.4		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	17.7	0.9	24.7			9.6	26.2	19.7	14.7	14.2	20.9		9.6	-1.1	
Other Sustainability Indicators															
PV of public sector debt	...	...	148.1			173.0	174.3	174.6	171.1	161.3	153.9		130.0	30.9	
of which: foreign-currency denominated	...	...	142.5			164.8	165.5	166.1	163.2	154.1	147.0		124.0	24.9	
of which: external	...	...	142.5			164.8	165.5	166.1	163.2	154.1	147.0		124.0	24.9	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	5.0	3.7	3.2			14.9	0.2	-0.3	0.6	-1.2	-12.0		-8.1	0.6	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	442.3			563.9	553.0	567.1	590.5	541.9	403.6		350.8	103.0	
PV of public sector debt-to-revenue ratio (in percent)	...	...	611.2			742.2	789.5	784.8	783.7	689.9	468.9		400.0	114.7	
of which: external 3/	...	...	588.2			706.9	749.4	746.4	747.5	659.0	447.9		381.7	92.5	
Debt service-to-revenue and grants ratio (in percent) 4/	14.7	13.1	17.9			41.6	15.0	14.4	19.4	21.8	15.6		17.3	10.4	
Debt service-to-revenue ratio (in percent) 4/	23.5	21.2	24.7			54.8	21.4	19.9	25.7	27.7	18.1		19.8	11.6	
Primary deficit that stabilizes the debt-to-GDP ratio	-11.3	-5.0	-20.8			-25.9	-14.3	-10.0	-5.1	-2.0	-18.5		-6.9	3.3	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	10.1	6.5	5.0	8.0	2.5	6.4	7.6	8.2	8.6	11.5	8.0	8.4	6.2	6.6	6.6
Average nominal interest rate on forex debt (in percent)	5.1	3.3	4.3	3.2	1.9	12.6	6.0	5.4	5.0	4.8	9.7	7.3	7.3	4.0	7.1
Average real interest rate on domestic debt (in percent)	1.0	3.5	-6.1	1.5	7.4	-44.1	-34.5	-23.5	-19.6	-17.6	-15.8	-25.9	-9.4	-2.3	-6.8
Real exchange rate depreciation (in percent, + indicates depreciation)	-6.9	20.0	2.5	3.3	14.7	...	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	4.6	1.1	14.5	5.8	7.3	2.3	13.4	7.6	6.3	5.9	5.5	6.8	5.7	5.7	5.7
Growth of real primary spending (deflated by GDP deflator, in percent)	-4.7	11.4	-12.2	-0.5	5.7	-3.4	4.1	4.4	-0.1	2.8	-1.3	1.1	5.9	7.0	8.9
Grant element of new external borrowing (in percent)	...	...	...	...	...	11.7	16.3	14.0	13.0	13.2	14.0	13.7	6.5	2.0	...

Sources: Country authorities; and staff estimates and projections.

1/ Gross government debt including hydro-related liabilities.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 4. Bhutan: Sensitivity Analysis for Key Indicators of Public Debt 2014–2034

	Projections							
	2014	2015	2016	2017	2018	2019	2024	2034
PV of Debt-to-GDP Ratio								
Baseline	173	174	175	171	161	154	130	31
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	173	177	181	182	183	192	217	140
A2. Primary balance is unchanged from 2014	173	176	178	177	172	179	213	147
A3. Permanently lower GDP growth 1/	173	175	177	175	167	161	152	76
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	173	178	184	182	173	167	153	65
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	173	180	186	183	172	165	145	51
B3. Combination of B1-B2 using one half standard deviation shocks	173	180	188	184	174	167	150	58
B4. One-time 30 percent real depreciation in 2015	173	244	241	234	221	212	194	98
B5. 10 percent of GDP increase in other debt-creating flows in 2015	173	184	184	180	170	163	143	50
PV of Debt-to-Revenue Ratio 2/								
Baseline	564	553	567	591	542	404	351	103
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	564	561	587	627	611	501	588	476
A2. Primary balance is unchanged from 2014	564	558	579	611	577	469	575	492
A3. Permanently lower GDP growth 1/	564	555	573	602	557	421	407	251
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	564	562	591	620	575	434	411	216
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	564	571	605	630	579	432	390	170
B3. Combination of B1-B2 using one half standard deviation shocks	564	570	606	633	583	438	404	194
B4. One-time 30 percent real depreciation in 2015	564	776	781	808	742	556	525	326
B5. 10 percent of GDP increase in other debt-creating flows in 2015	564	583	597	622	571	426	386	166
Debt Service-to-Revenue Ratio 2/								
Baseline	42	15	14	19	22	16	17	10
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	59	20	22	30	35	36	41	50
A2. Primary balance is unchanged from 2014	59	20	22	30	33	34	41	54
A3. Permanently lower GDP growth 1/	59	20	22	30	33	34	35	31
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	59	20	23	30	34	35	35	29
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	59	20	23	31	34	34	34	26
B3. Combination of B1-B2 using one half standard deviation shocks	59	20	23	31	34	35	35	28
B4. One-time 30 percent real depreciation in 2015	59	26	34	45	50	50	51	45
B5. 10 percent of GDP increase in other debt-creating flows in 2015	59	20	23	31	34	34	34	25

Sources: Country authorities; and staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND

BHUTAN

May 30, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—ENHANCING FINANCIAL SECTOR SURVEILLANCE

KEY ISSUES

Bhutan's financial sector has substantially deepened in recent years through high credit growth and entry by new banks. However, rapid credit expansion has had negative side effects by contributing to overheating and the buildup of financial sector risks. Financial institutions' risk management has not kept pace, and sufficient assets are not available for liquidity management or investment diversification. Growing liquidity and interest rate mismatches need to be addressed by the regulatory framework.

Bhutan should aim to develop a comprehensive Financial Sector Development Strategy (now underway with World Bank assistance). This should entail a careful sequencing of reforms within a medium term plan while balancing any trade-offs between financial stability and deepening. The strategy might include measures such as floating minority shares in public enterprises; encouraging private bond issuance; and creating an enabling environment for private equity including by relaxing constraints on foreign involvement in venture capital funding. It should also encompass improved access to financing by individuals and by small- and medium-sized enterprises under the authorities' Financial Inclusion Policy.

Improving banks' ability to manage financial risks is essential for further sustained financial deepening. Development of financial instruments and markets, including through increased and regular Treasury bill issuance, will allow financial institutions to manage risk better themselves, while facilitating effective transmission of monetary policy. This would be supported by an improved liquidity management framework for the RMA.

Regulation and supervision should be further developed. There are immediate needs to fill gaps in regulation, including putting in place effective bank liquidity requirements; increasing use of stress testing to monitor risks associated for instance with large exposures and with rising funding costs; and implementing crisis management and deposit insurance arrangements. The RMA should continue with work on broadening the range of macroprudential tools.

Prepared by

This paper was prepared by the Monetary and Capital Markets Department and the World Bank. The authors are Hunter Monroe (MCM), Cecile Niang (World Bank), Ian Tower, and Bryn Vollan (MCM experts). The Enhancing Financial Sector Surveillance mission to Bhutan took place during August 26-September 12, 2013.

CONTENTS

TABLES

GLOSSARY

BDBL	Bhutan Development Bank Limited
BDFC	Bhutan Development Finance Corporation
BIL	Bhutan Insurance Limited
BNB	Bhutan National Bank Limited
BOBL	Bank of Bhutan
BOP	Balance of Payments
RSEBL	Royal Securities Exchange of Bhutan Limited
CIB	Credit Information Bureau
CRR	Cash Reserve Ratio
DHI	Druk Holdings and Investments
Druk PNB	Druk Punjab National Bank Limited
FED	Foreign Exchange Department
FIP	Financial Inclusion Policy
IMF	International Monetary Fund
LIC	Low Income Country
LoLR	Lender of Last Resort
MCM	Monetary and Capital Markets Department
MOD	Monetary Operations Department of the RMA
MoU	Memorandum of Understanding
MoF	Ministry of Finance
NBFI	Nonbank financial institution
NPPF	National Pension and Provident Fund
Nu	Bhutanese Ngultrum
OD	Overdraft Facility
RBI	Reserve Bank of India
RICBL	Royal Insurance Corporation of Bhutan Limited
RGOB	Royal Government of Bhutan
RMA	Royal Monetary Authority
RSTLAW	RMA Short-Term Liquidity Adjustment Window
SLR	Statutory Liquidity Ratio
TA	Technical Assistance
W&M	Ways and Means Account
WB	World Bank

INTRODUCTION

1. **Bhutan was selected as pilot case for the initiative on Enhancing Financial Sector Surveillance called for by Executive Board in May 2012 (FO/DIS/12/66).**[1,2] As an input to the Article IV consultation, this supplement assesses the extent to which a shallow and undiversified financial sector in Bhutan has created macro-financial vulnerabilities that impact the economy, and its ability to sustain growth and reduce poverty, how the country can generate financial deepening that will provide greater access to credit and financial services, and whether the process of deepening itself has increased risks in the financial sector. It also explores how the state of development of the financial system may have constrained monetary policy implementation and the efficacy of the transmission mechanism.

2. **Bhutan is a small, fast-growing, lower middle-income country with deep economic ties to India and a peg to the Indian rupee.** Hydropower projects exporting electricity to India and credit-fuelled private consumption have driven a decade of high growth, which in turn has led to improving living standards and appears to have been a key driver of a rapid expansion of the banking system. However, the country is vulnerable given the rapidly growing (until recently) borrowing from banks against the backdrop of weak regulation and supervision. A key challenge is mediating large expected flows from hydropower development into productive uses for the economy, while coping with volatility in the associated external financing and proceeds.

3. **The country faces recurring balance of payments pressures stemming from a combination of factors.** These include loose macroeconomic policies, rapid credit growth (which has led to higher imports), and time-inconsistency in bulky hydro-related transactions in particular, rupee debt repayments in January and hydro-related export receipts during the rainy season in July–September. As a result, the authorities have had to resort to recurrent short-term borrowing of rupees from Indian commercial banks (now refinanced by the Indian government and Reserve Bank of India (RBI)) at considerable cost. A pronounced rupee shortage in 2011–resulting from excessive credit growth, house price appreciation, and a consumption boom–led the Royal Monetary Authority (RMA) to sell 20 percent of its U.S. dollar reserves in December 2011, with a subsequent sale in June 2013.[3] Continued shortages led to the adoption in 2012, at the recommendation of a government Task Force, of corrective measures including banning of imports of vehicles and construction materials. Reserve requirements were relaxed to ease the liquidity stress on commercial banks, as were provisioning requirements, and lending for construction and vehicle imports was banned, while planned macroprudential measures that would have strengthened capital standards

[1] Pilot cases thus far have included Benin, Ghana, Haiti, Senegal, and the West African Economic and Monetary Union, and Haiti.

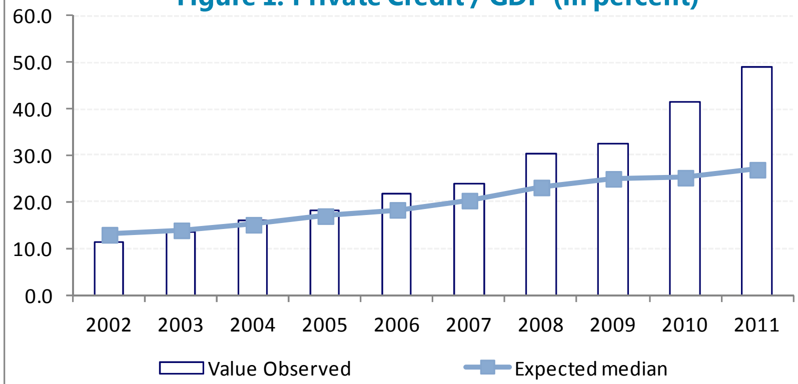
[2] This document reflects information available as of the September 2013 mission, except where noted.

[3] Although Bhutan primarily needs Indian rupees for trade settlement and debt service, with de facto full convertibility for rupee (but not convertible currency) current and capital transactions, the Constitution of Bhutan stipulates that foreign currency reserves of at least one year's "essential imports" must be maintained.

were not implemented. In 2013, the newly elected government has proposed an Economic Stimulus Plan that would inject funds equivalent to 4 percent of GDP into the financial system "to restart lending to productive and priority sectors".

4. The banking system has grown rapidly and competition has intensified with the entry of new domestic private banks. Credit growth averaged above 30 percent over the past 10 years, increasing credit from 11 percent to 49 percent of GDP.[4] This compares with a median of 32 percent for lower middle-income countries (16 percent for low-income countries), and an "expected norm" of 27 percent based upon a regression controlling for relevant country-specific characteristics,[5] while coinciding with the median of 49 percent for South Asia. The rapid expansion stemmed from the initially low penetration, ample liquidity from large government deposits tied in part to concessional loans and grants, growth in civil services wages, a more liberal land use policy, and in recent years, spillovers from large hydropower projects and the entry of three new banks in 2010. Other factors have included loose monetary conditions (including low and often negative interest rates), the establishment of a state pension fund, and growth in corporate borrowing particularly in special economic zones. In addition, non banks such as the pension fund and insurance companies have also engaged in lending in the absence of alternative investment opportunities.[6]

Figure 1. Private Credit / GDP (in percent)



Source: World Bank FinStat database

5. The next sections provide background on the financial sector and present recommendations on deepening the financial system, enhancing regulation and supervision, and strengthening monetary operations. A concluding section summarized the detailed recommendations of the report.

[4] Data exclude lending by insurance companies and the state pension fund.

[5] These characteristics are GDP per capita, population size and density, young and old age dependency ratios.

[6] See "Bhutan: Selected Issues", Chapter II on "Rapid Private Sector Credit Growth, Macroeconomic Risks, and Financial Sector Soundness", IMF Country Report 07/349.

BACKGROUND ON THE FINANCIAL SECTOR

6. **Financial service providers in Bhutan can be broadly categorized as formal financial institutions (banks and nonbank financial institutions), informal moneylenders, and semiformal providers such as NGOs and cooperatives.** In addition, Bhutan Post provides remittance services. The formal financial sector has recently undergone significant transformation and modernization but remains bank led. The financial sector remains shallow, with the banking sector accounting for over 80 percent of total financial sector assets (excluding the stock exchange).

Table 1. Structure of the Financial System

	Number	Total Assets in Billions Nu.	Percent of total assets
Total Financial System	8	88.8	100.0
Commercial Banks	5	73.2	82.5
Nonbank Financial Institutions			
Insurance Companies[1]	2	8.8	9.9
Pension Fund	1	6.7	7.5
GDP (current US$)		1.8 billion	
GDP (current Nu)		94.9 billion	
Total financial sector assets/GDP		94 percent	

Source: Royal Monetary Authority - Bhutan Financial Sector Performance Overview (March 2012-13)

[1] Excludes a reinsurance company licensed in 2013.

A. Formal Financial Service Providers

7. **Bhutan's financial sector has undergone rapid changes since 2009, notably with the entry of three new banks and one private insurance company.**[7] Five banks operate in Bhutan: two incumbents—Bank of Bhutan Limited (BOB) and Bhutan National Bank Limited (BNB)—and the three new banks—Druk Punjab National Bank Limited (Druk PNB), T Bank, and Bhutan Development Bank Limited (BDBL). Banks offer credit facilities, savings or deposit services, insurance, remittance services, foreign exchange services, and other financial services such as ATM services, mobile (SMS) banking, and internet banking. BDBL is mandated by the Royal Government of Bhutan, which owns 94 percent of its capital, to operate in rural regions of the country. BDBL grants around 99 percent of the formal loans going to the agricultural sector. Commercial financial institutions remain mostly concentrated in urban areas, viewing rural operations as unprofitable because of high costs and low

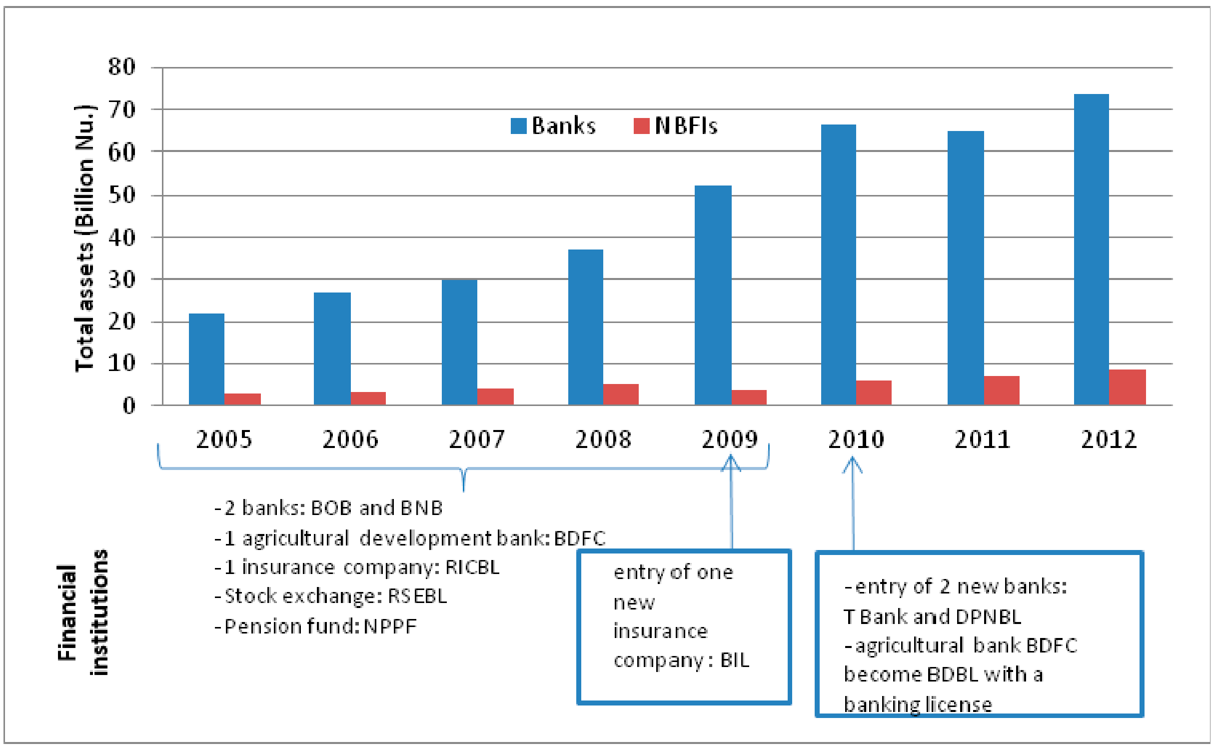
[7] Two new banks were licensed, one a subsidiary of an Indian state-owned bank and the other owned by private Bhutanese investors. Both have been listed and issued shares on the Royal Securities Exchange of Bhutan (RSEB), meeting a legislative requirement that any new financial institution is at least 40 percent public. The established development finance company has also been licensed as a bank.

profits. The predominance of lending based on collateral further reduces the demand for services in rural areas, since rural clients often lack sufficient collateral or large savings in a bank.

8. Three nonbank financial institutions (NBFIs) provide insurance and pension services. These are the Royal Insurance Corporation of Bhutan Limited (RICBL), the newly licensed Bhutan Insurance Limited (BIL), and the National Pension and Provident Fund (NPPF). RICBL is the dominant insurance provider, though BIL has quickly captured a large share of the market in its three years of operation. Nonbank financial institutions in Bhutan—insurance companies as well as pension boards—have been allowed to engage in retail lending activities. These institutions were initially allowed to lend because of the small market size and limited avenues for investment. A reinsurance company has also been licensed.

9. The Royal Securities Exchange of Bhutan Limited (RSEBL) is at an early stage of development. It has 21 listed companies. While liquidity remains low, the RSEBL has been automated, leading to a 230 percent increase of the total value traded in the secondary market between 2011 and 2012.

Figure 2. Financial Sector Assets, 2005–12



Source: World Bank analysis based on RMA data.
Note: Data exclude RSEBL. BDFC = Bhutan Development Finance Corporation.

B. Informal and Semi-formal Financial Service Providers

10. There is no formal microfinance sector in Bhutan, although several civil society organizations or intermediaries provide financial services. A number of regulations aimed at increasing financial access have been finalized, including for non deposit-taking and deposit-taking microfinance institutions. In addition, a Financial Inclusion Policy has been drafted (see below) and is awaiting Cabinet approval. There is growing interest among the Bhutanese in forming cooperatives and self-help groups for saving and lending, especially in rural communities. The existing ones provide only group savings, though many are considering expanding to lending services in the future.

11. Informal creditors dominate the market in communities where financial institutions have little presence. Recent research found that that, unlike formal financial service providers, informal providers typically only offer loans, though anecdotal evidence suggests that a few informal lenders may also accept deposits. Informal providers can be broadly categorized into two groups: moneylenders (individuals or businesses) and family members, relatives, friends, or neighbors. Bhutan is a cash-based economy where households have a vibrant, if informal, savings and lending culture. Basic access indicators in Bhutan compare favorably with benchmark countries, although segments of the population (rural areas, women) remain underserved.[8]

Table 2. Bank Outreach in Bhutan and Peer Countries, 2011

	Bank Branches per 100,000 adults	Bank Branches per 1,000 km^2	ATMs per 100,000 adults
Bangladesh	7.8	61.6	3.6
Bhutan	16.4	2.2	14.1
Cambodia	4.3	7.2	
Lao PDR*	2.5	0.4	8.5
Mongolia	66.4	0.9	31.8
Myanmar	1.7	0.9	0.0
Nepal	6.7	8.9	6.7
Vietnam	3.6		20.0

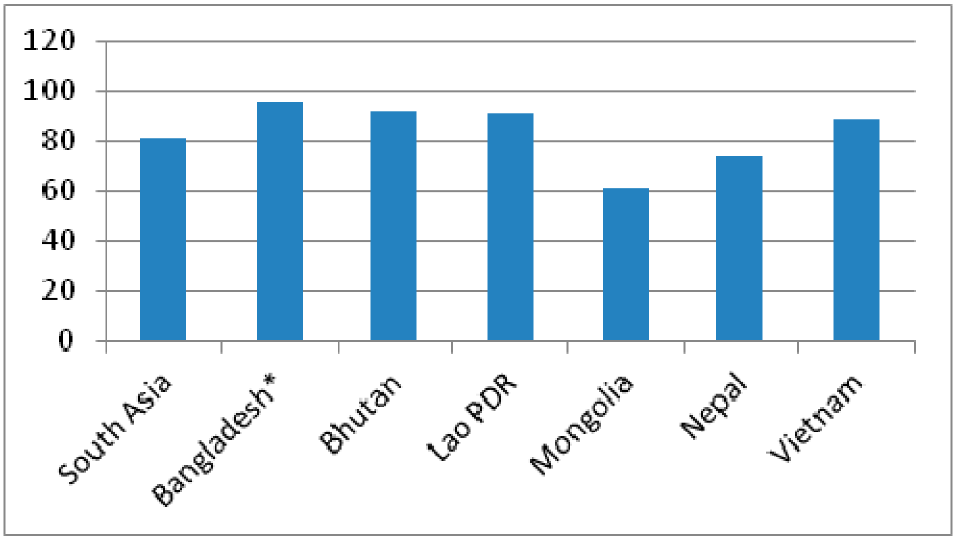
Source: Financial Access Survey, IMF *2010

12. From the perspective of the private sector, access to basic banking and savings is good, but firms have few financing options besides credit. The World Bank Enterprise Survey has noted the need to improve accounting, cumbersome bank procedures, difficult collateral recovery,

[8] See World Bank, Connecting the Disconnected: Coping Strategies of the Financial Excluded in Bhutan, 2013.

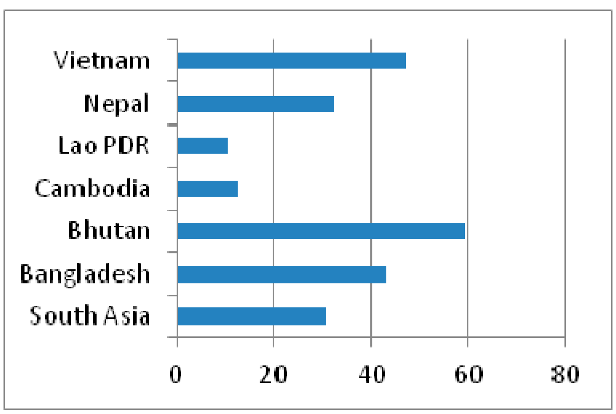
and limited financing instruments beyond bank credit. The difficult mountain terrain and scattered settlements in rural areas are important constraints on financial inclusion.

Figure 3. Share of Firms with a Checking or Savings Account



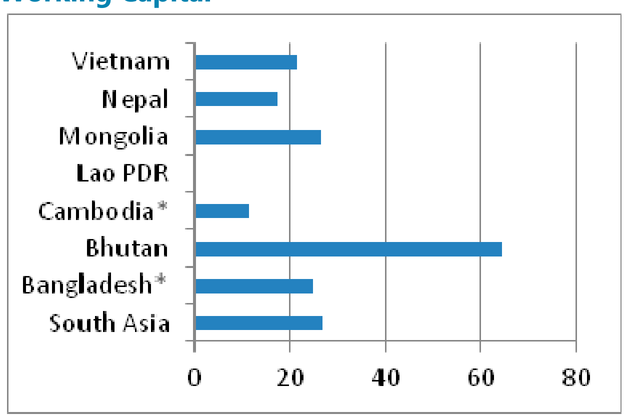
Source: World Bank Group Surveys 2009 (*2007).

Figure 4. Share of Firms Using Banks to Finance Investments



Source: World Bank Group Surveys, 2009 (*2007)

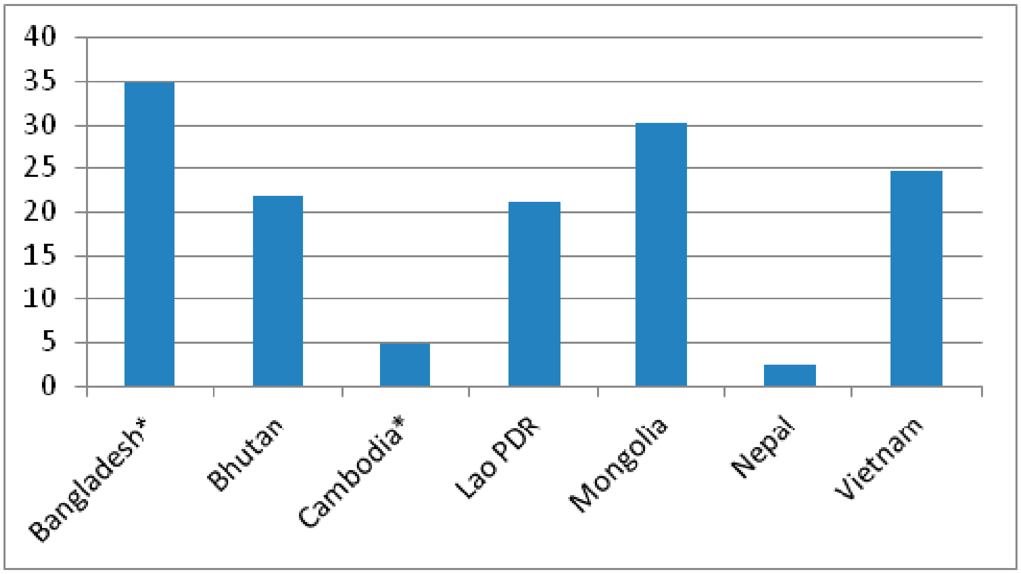
Figure 5. Share of Firms Using Banks to Finance Working Capital



13. **Uneven access to bank credit and lack of access to other financial services are possible explanations of the private sector's perception that access to finance remains a problem in Bhutan.** According to a series of nationally representative World Bank enterprise surveys, when asked to rank the severity of access to finance as a constraint, the percentage of firms responding that access to finance is a major obstacle more than doubled from 14 percent to 30 percent between 2001 and 2009. The 2009 survey also indicated that that 22 percent of surveyed firms identified access to finance as their biggest obstacle to doing business, more than all other

investment climate obstacles in the enterprise survey. Similarly, Bhutan ranks low among countries worldwide in the Doing Business survey on access to credit—which does not appear to reflect recent improvements in credit infrastructure.

Figure 6. Share of Firms with Access to Finance as Biggest Obstacle



Source: World Bank Group Surveys 2009 (*2007)

14. The range of financial instruments offered by banks has expanded. Banks have increasingly been using cash flow based lending in lieu of collateral for enterprises. Non-loan financial products such as letters of credit and products similar to factoring are now being offered.[9] Most loans to individuals continue to be collateralized.

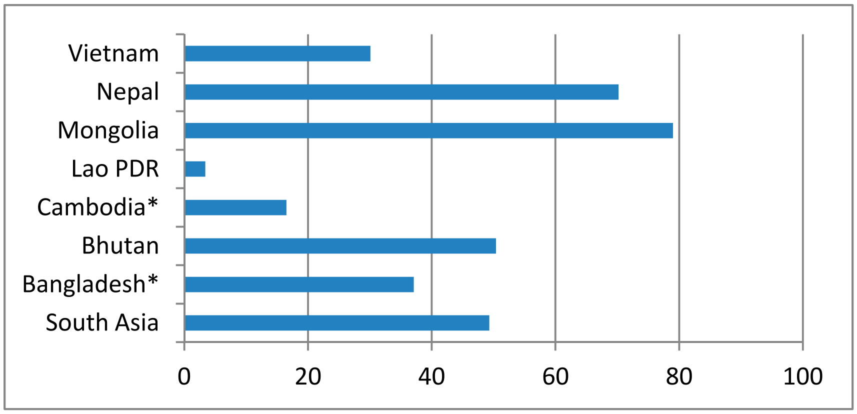
15. The limited availability of financial statements for borrowers makes it difficult for the commercial banks to carry out a proper loan appraisal for the borrowers' credit worthiness. As a result, they require more collateral from the borrowers.[10] Overall, only half of firms in Bhutan prepare certified financial statements.[11] This is low compared to regional averages and comparator countries.

[9] Factoring is a financial transaction in which a business sells its accounts receivable to a third party (called a factor) at a discount.

[10] The January 2010 follow on survey included interviews with banks which corroborated banks' difficulty in evaluating creditworthiness of borrowers in the absence of financial statements and requiring the use of collateral.

[11] Bhutan Enterprise Survey, World Bank Group, 2009.

Figure 7. Share of Firms with Financial Statements Reviewed by External Auditors



Source: World Bank Group Surveys 2009 (*2007)

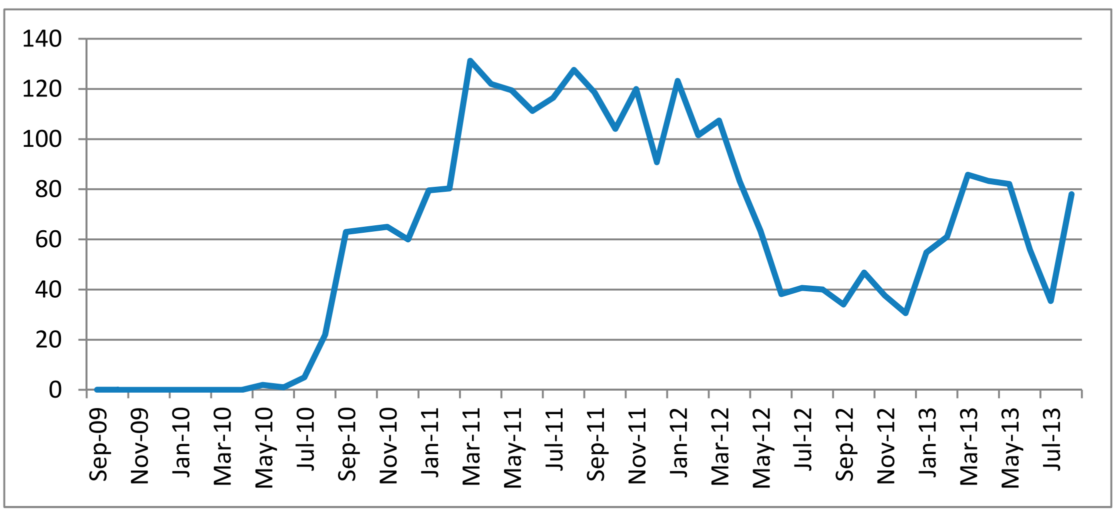
16. **Commercial banks are also facing a lack of skilled workers in their efforts to expand the range of financial products they offer.** The need for capacity building of financial sector staff has become increasingly important to provide efficient and transparent banking services, particularly in an environment of increased competition among banks, due to the new entrants.

17. **From the perspective of the private sector, firms see loan procedures as complex and lacking in transparency.** In Bhutan, 37 percent of surveyed firms responded that they had not applied for any loan in 2008, although they needed a loan for their businesses. Of these firms, 17 percent also indicated that they did not apply for a loan because application procedures for loans or lines of credit are complex and difficult to understand.

DEEPENING THE FINANCIAL SYSTEM

18. Bhutan has taken recent steps to modernize financial sector infrastructure, including the establishment of a credit bureau, a collateral registry, and an improved payments system. The Credit Information Bureau (CIB), established in 2009, is now an independent institution and is used by all financial institutions. Coverage is now complete except for microfinance loans. It incorporates information on 97 percent of individuals and 50 percent of corporate borrowers as of May 2013 (see Figure 8). A collateral registry for moveable collateral was launched in August 2013 and may be an important enabler to diversify sources of collateral. An electronic funds transfer and clearing system was inaugurated in June 2010. The system's functionalities include credits (such as salaries and dividends) and debits (such as utility bill payments). The RMA plans to draft a Payment and Settlement Systems Act with technical assistance from the Reserve Bank of India. To allow for the interoperability of ATMs and bank point-of-sale terminals, the Royal Monetary Authority launched Bhutan Financial Switch, a national card switch system, in December 2011. The RMA has also made the National Electronic Funds Transfer System available to the public since December 2011. This system is a nationwide inter-bank fund transfer system that facilitates transfer of funds among individuals and institutions. The CIB could be expanded to include microfinance clients and supporting secured transactions including by movable collateral by expanding the collateral registry.

Figure 8. Average of Daily Reports Generated in Credit Information Bureau



Source: Credit Information Bureau of Bhutan

Note: Lower daily volumes in 2012 can be explained by the rupee shortage and the ensuing credit contraction in the banking sector.

19. Sectoral initiatives could also be taken within the framework of a wider development strategy. In the banking sector, there is a need to break out of current practices that limit the range and types of loan available to borrowers while adding complexity to asset and liability management. The CIB could continue to develop its services to include a credit scoring or credit assessment capacity so as to equip banks to make more credit decisions based on underlying creditworthiness.

In insurance, divestment of banking business from insurance company balance sheets would provide an impetus for widening and deepening the range of insurance services. Implementation of the divestment requirements would need to be managed by the authorities in conjunction with efforts to stimulate a wide range of investment securities.

20. The formulation of a Financial Sector Development Strategy would provide a framework for considering any trade-offs between effective regulation and supervision and financial sector development. Analysis could be undertaken of the areas where regulatory requirements are unnecessarily prescriptive or create obstacles to financial sector development disproportionate to the regulatory benefit. This could be undertaken in the context of changes in supervisory approach recommended in this paper including more risk-based supervision, increased focus on holding management responsible and more impact assessment of regulatory changes. While participating fully in such a review and resulting decisions, the RMA would clearly retain the final responsibility for any changes in its approach, taking into account its statutory objectives.

21. Extending the range and maturity of marketable government securities would deliver many benefits. These include more effective monetary policy implementation (as discussed below), increased bank prudential liquidity, the creation of a yield curve to underpin a corporate bond market and support for better loan pricing as well as the long term investments required by insurance and the NPPF as they exit lending. These benefits would have to be set against the cost implications of government issuance given the low costs of current borrowing.

22. Similarly, floating minority shares in public enterprises would broaden the range of investment channels while enhancing corporate governance. The government benefits at present from dividend income streams from these companies via its investment vehicle Druk Holdings and Investments (DHI). Divestment of minority shares in public enterprises through an RSEBL flotation would boost both demand and supply of marketable securities—extending the range of shares available for investment and releasing resources for DHI to invest in a wider range of assets. In particular, it would broaden the range of assets available to the NPPF, whose liabilities are a state responsibility. The companies divested could include the Bank of Bhutan, which would put it on the same basis as financial institutions required under the Financial Services Act to float at least 40 percent of their equity.

23. The wider share ownership that could result would also make it appropriate for the government to reconsider the taxation of corporate dividends. At present, dividends are subject to income tax on the recipients (i.e., there is double taxation of company profits). Relief in this area would raise returns on holdings of equities and create more options for corporate structures, including holding companies. At present, the large share of corporate equity held by government itself creates limited incentives for reform. Again, there would need to be a consideration of the benefits of reform against the costs in tax income foregone.

24. A Financial Inclusion Policy (FIP) has been drafted to facilitate access to finance for all as a means to improving livelihoods, raising income levels and reducing vulnerability. Financial inclusion has improved significantly, but the geography of the country remains a major constraint to access to finance. Many rural communities are half a day's walk or more from the nearest farm road and are one or two days travel away from the nearest bank. The FIP was drafted through an extensive consultation process and includes "guiding principles" used to formulate its strategies. The authorities should consider:

- The need to formulate proportionate regulation which will consider risk management, while avoiding stifling innovation and making evidence-based analysis, is a key principle.
- In cases where market failures call for Government support, subsidies should be carefully targeted to improve the supply of financial services to underserved individuals, time bound, and not impact the overall soundness of the financial sector.
- Directed lending, to rural areas or to the agriculture sector, should be avoided, given the high risk based on international experience that directed loans are likely to become nonperforming.
- The government should facilitate access to funding for microfinance institutions (MFIs), support the creation of a microfinance association possibly with a shared technology infrastructure, and provide technical assistance to MFIs, help them expand their businesses, assist in their coordination.
- Proportionate increased supervisory controls and oversight mechanisms will be needed. These controls are important to ensure that the consumer protection regulatory environment and dispute resolution mechanisms work as intended.

25. As highlighted in the draft FIP, support to financial literacy and to a consumer protection regulatory environment will be a key enabler of financial outreach. Savings strategies and attitudes suggest that Bhutanese households could benefit from financial literacy education, as they display poor financial management skills. The research undertaken established that savings are an afterthought as opposed to the first step in financial management. Efforts to increase financial management skills among the Bhutanese would also likely improve their ability to access formal financial services. In addition, no regulation on financial consumer protection exists in Bhutan, although the Companies Act 2000 and Consumer Protection Bill of Bhutan 2010 broadly address some consumer protection rights.[12] One key client protection measure includes establishing mechanisms and processes that ensure clients have an affordable, independent, fair, accountable, and timely access. A clear and direct pathway for dispute resolution that is easily accessed will greatly increase trust in the financial sector.

26. Lenders need technical assistance to develop capacity to work with small- and medium-sized enterprise (SME) borrowers. The Government has established an Accounting and

[12] Other acts that address financial consumer protections through increased competition and an enabling environment in the financial sector include the RMA Act 2010, Prudential Regulations 2002, Financial Services Act of Bhutan 2011, Corporate Governance Regulations 2011, and Moveable and Immovable Property Act of the Kingdom of Bhutan 1999, among others.

Auditing Standards Board of Bhutan (AASBB), and has started adopting standards aligned to IAS/IFRS. This should help increase the reliability of financial information and reduce collateral requirements. In addition, technical assistance to financial institutions and enterprises should help financial institutions build their capacity to provide financing instruments to micro, small and medium enterprises and ensure that the private sector has the capacity to effectively utilize finance.

27. Development of a private equity market is a priority. There have been some positive developments, including the licensing of Nubri Capital, a local fund management company. The International Finance Corporation (IFC) has been exploring supporting the launch of a private equity fund in Bhutan, in collaboration with Druk Holding and Investment and an international private equity fund. These encouraging developments would however benefit from a better enabling policy and regulatory environment:

- The restriction to 100 percent domestic ownership rules out knowledge transfer from experienced foreign firms. The clause requiring ownership and management to be 100 percent domestic may be difficult to reconcile with requirements such as a minimum of 10 years experience of the CEO in the investment and finance-related business.

- The regulations seem to rule out venture capital funds, since the total investment in venture capital cannot exceed Nu 5 million, whereas minimum capital requirements are of Nu 50 Million. Given the nascent risk capital market and given Bhutan's small private sector, venture capital will be critical to boost access to finance for Bhutanese firms. Private equity regulations should ensure venture capital can develop in Bhutan.

28. Development of corporate bonds market would provide an alternative to bank financing. Only Nu 4.2 billion of corporate bonds are outstanding, all four issuers being financial institutions or state-owned companies. Several private sector firms have shown interest in issuing bonds. A key question is whether financial institutions should be allowed to guarantee bonds, which would jumpstart the market but could carry prudential risks and potential overleveraging of financial institutions. The RMA is exploring how to encourage the availability of credit ratings to support development of a corporate bond market.

ENHANCING REGULATION AND SUPERVISION

A. Recent Developments in the Financial Sector

29. Notwithstanding entry by new banks, the dominance of existing institutions remains mostly unchallenged. The largest institutions remain the two established banks, with 75 percent of total bank assets of Nu 80 billion as well as the most extensive branch networks, and the long-established insurance company (life and general), with 75 percent of total gross premium income of Nu 1.1 billion. The NPPF, which provides pensions for government and public sector employees, remains Bhutan's largest institutional investor, with the assets of its various funds totaling Nu 15 billion.

30. Recent institutional diversification has not been matched by broadening of the sector. Finance in Bhutan is dominated by traditional banking products and credit continues to account for most financial assets:

- Loans and advances, mostly medium and longer term and at fixed rates, represent 65 percent of banking sector assets and off-balance sheet business of Nu 6.5 billion is mostly in the form of credit substitutes—guarantees, letters of credit and performance bonds.

- The insurance companies and NPPF offer their customers loans and advances, which for the insurers represent 70 percent of assets and which are partly funded by borrowing from banks (insurers may not take deposits). NPFF is more restricted in the loans it can make.

- Insurance penetration is limited to 1.3 percent of GDP and density to US$25 per capita; only limited life insurance products are available.

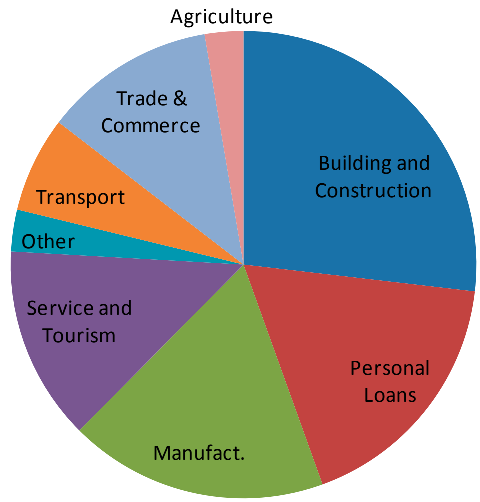
- The government does not generally finance itself (or major projects) by issuing marketable securities. Nu 2.5 billion of Treasury bills are outstanding and there are no longer term bonds.

- Banks' earnings derive mostly from net interest margins, with limited fees and commissions.

31. Rapid credit growth has taken place without significant growth in reported loan losses until recently. Banking sector capital has also been growing strongly, supported by high returns and capital-raising by the new and existing private sector banks. However, the economic slowdown increased NPLs from 8 percent at end-June 2012 to 12 percent at end-September 2013 (Table 4), potentially indicating latent problems that have not yet emerged.

32. There have been costs to the economy and banks themselves from rapid credit growth. Import demand has been stoked by activity supported by bank lending, especially for housing and construction (over 25 percent of the total), personal loans (18 percent) and transport (7 percent). The banks face greatly increased challenges in asset and liability management from balance sheets comprising traditional forms of lending (fixed rate, medium and long term) and increasingly short term, mobile and individually large deposits. Corporate deposits are now 60 percent of the total, while retail deposits are hard to mobilize, given interest rates of 5 to 7 percent up to two years against inflation of over 8 percent. Given the fixed rate, long-term basis of much lending, there is limited scope for banks to raise deposit rates without cutting into their net interest margin. There has also been a shift from term to demand deposits (now 55 percent of the total). The resulting mismatches have given risen to significant liquidity and interest rate risks in the banking system.

Figure 9. Bank Lending, End-June 2013



Source: RMA and staff calculations

33. These reforms have not, however, yet contributed to a broadening of the range of banking products, while the infrastructure falls short in other respects. The CIB has yet to stimulate wider availability of unsecured credit or lending practices (and loan pricing) based on the credit assessment of the individual borrower rather than on the sector, maturity, and availability of security. Most lending in Bhutan is collateralized, with loans typically an initial 75 percent of the security value. However, increasing numbers of borrowers in public and private sector employment have access to unsecured credit serviced directly from their salary payments. Other aspects of financial infrastructure have to be sourced outside Bhutan, including professional services such as accounting, audit, and actuarial. The financial statements of all Bhutanese companies are heavily reliant in practice on Indian accounting standards and audit practices.

34. The regulatory framework has been strengthened:

- A new Financial Services Act was passed in 2011, updating previous legislation, strengthening the RMA's independence from government and making provision for RMA to issue regulations (those issued include comprehensive corporate governance standards).[13]

- Capital requirements applying to banks and insurance companies have been substantially increased since 2012 through changes to risk weightings.

[13] Also issued were Regulations for Fund Management Companies in 2011; Investment Advisors Regulations, 2011; Insurance Brokers Regulations, 2011; and Securities Brokers Regulations, 2011.

- Banks are now subject to base rate regulation that prescribes how rates are to be calculated, based on funding and other costs, subject to RMA approval. Publication of base rates is required, which is helping to improve transparency.

35. **There remain significant gaps in regulation, however.** The RMA has not yet issued all regulations mandated by law, including insurance risk requirements (i.e., basic requirements on valuation of liabilities, acceptable investments and a solvency margin).[14] Limits on maturity mismatches between bank assets and liabilities, although provided for in the Prudential Regulations 2002, have not yet been set in practice owing to lack of readiness at banks and to skills and resourcing constraints at the RMA.[15] Even allowing for the significance of lending, the RMA's prudential requirements remain overly focused on credit risk, while other risks faced by financial institutions, including liquidity, interest rate, insurance, operational and foreign exchange risks, as well as risks in off balance sheet business, are addressed incompletely or not at all, in both regulation and supervision. Stress testing is not routinely undertaken and is not used by financial institutions, although the RMA has provided input to stress tests undertaken by the IMF. Pressure on resources in the supervision function contributed to a severe curtailment of onsite supervision work, although this is being reversed.

36. **The RMA has been taking a more macroprudential approach to supervision and is working on its policy approach**. The RMA responded to escalating current account pressures from 2011 with a series of monetary, foreign exchange, and supervisory measures. Capital requirements were increased significantly from end-2012, targeting sectors where banks had the largest exposure as a result of loan growth, and were increased further from the end of 2013. At the same time (November 2012), provisioning requirements and maximum gestation periods (the time over which loans must be disbursed) were eased. A new RMA Financial Policy Committee is coordinating macroprudential policy and has developed a policy framework for its approach, to be implemented through RMA Board-approved regulations from November 2014. There are limited specific crisis management arrangements in place. Deposit insurance arrangements are also now planned.

37. **Some recent policy changes should have a positive impact on financial sector development.**

- A major project has been started by government to develop local accounting standards based on IFRS with a view to full IFRS implementation by 2021. For financial institutions, listed and large public sector companies, an initial 18 Bhutan Accounting Standards, likely to be complemented by International Auditing Standards, take effect for audits in 2014.

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[14] Draft regulations have been prepared by a consultant and a revised version was in preparation at the time of the EFSS mission, drawing on consultancy services funded by the Asian Development Bank.

[15] The RMA is actively working with consultants funded by the Asian Development Bank on a reporting format for banks to use (only one bank has been able to make reports under the existing format) and on developing supervisory expertise in the area of asset and liability management.

- There are plans to develop a local accounting professional body with training accredited by one or more foreign institutes. These developments should over time increase the extent and quality of disclosures by financial institutions and other companies and address risks associated with reliance on foreign standards and practices.

38. Other policy initiatives may be hard to implement without some adverse impacts.

- The licensing in 2013 of a new (Indian-owned) reinsurance company will create capacity within Bhutan (insurance companies currently cede large shares of premium income to foreign reinsurance companies); however, the RMA's requirement that insurers cede to the new company a minimum of 20 percent of premiums across all lines may unduly favor that company over foreign competition and could lead to distortions in insurers' risk management decisions, while raising costs.

- The RMA's April 2012 directive to insurance companies and the NPPF to plan for the discontinuance of existing and past lending activities by January 2015 rightly sought to address risks associated with the current combination of banking with insurance business. However, it does not by itself tackle the underlying lack of appropriate investments for companies seeking to invest premiums and manage significant insurance risks, including, in life insurance, some exposure to interest rate changes arising from long-term guaranteed savings products.[16]

- The new RMA base rate system could stimulate improved loan pricing by banks and more lending at floating rates of interest (i.e., base rate plus a margin), but at the cost of reducing the flexibility for banks to compete on the basis of lending rates determined by themselves.

B. Developments in Financial Soundness

39. Financial soundness indicators for banks remain positive despite the shocks of 2012. Bank capital ratios vary but averaged 18.2 percent for the Capital Adequacy Ratio (CAR, minimum 10 percent) at June 2013. The Statutory Liquidity Requirement was also comfortably met (34 percent compared with a minimum 20 percent). Capital quality appears high. Most is in the form of equity and the average Tier 1 CAR was 14.9 percent at June 2013. The large share of loans in the balance sheet and high risk weights for some loans and for concentrated sectors results in high ratios of risk-weighted assets to total assets (90 percent) and low leverage ratios (6 times on average and as low as 4 times for one bank). Loan books are relatively concentrated, with individual exposures up to 25 percent of capital (the limit is 30 percent).

40. The capital position of banks needs careful monitoring, however, given gaps in the capital framework and the uncertain impact of recent risk weighting changes. Capital requirements are based on the Basel I framework, covering only credit risk and using a definition of

[16] The directive was lifted subsequent to the mission, and the authorities are now developing investment guidelines for non-banks to encourage them to gradually lend less.

capital that excludes all the deductions required under the latest international standards. The RMA has used changes in risk weighting percentages to fine tune overall requirements for macroprudential purposes. From end-2013, these will range from 300 percent for personal loans to 50 percent for agriculture.[17] The impact of these changes will vary by bank but banks have argued that they could result in CARs falling by 3 to 4 percentage points. The new framework of risk weights does not, however, apply to off balance sheet business (most are 100 percent risk weighted), reducing the risk sensitivity of the new requirements and potentially creating opportunities for regulatory arbitrage.

41. **There are uncertainties over bank asset quality given macroeconomic developments, and NPLs have already begun increasing as noted above.** The recent depreciation of the Indian rupee may affect the quality of loans to borrowers with convertible currency liabilities. Provisioning levels are lower than they were in 2012 (averaging around 50 percent of NPLs) as a result of the relaxation in provisioning requirements in late 2012, which should be reversed.

42. **Overall loan growth is already increasing again and would be boosted by government plans to ease bank liquidity, and credit standards need careful monitoring.** Loan growth has continued, although at a lower rate since the RMA measures in 2012. Notwithstanding the RMA's decision to cease making Indian rupees available for imports of vehicles and construction materials, bank lending for housing continues to rise, as disbursements continue under existing facilities, although lending to the transport sector has fallen. In recent months, total lending has been rising at a more rapid rate than in 2012.[18] The government is proposing measures to support the availability of liquidity for bank lending to sectors which generate low demand for imports. It will be important to ensure that credit standards are not relaxed as banking sector liquidity eases. Banks have indicated that demand for loans remains high.

43. **Collateral values are a key driver of loan loss and may be under pressure.** Collateral values are reported to have fallen, including land prices in parts of the country where there was a surge in prices in the run-up to March 2012, which may lead to higher write-offs (loan losses have been limited owing to the prevalence of collateralized forms of lending). Revaluation practices appear to vary by bank, there are no generally accepted or widely-used price indices, and supervisory oversight of banks' approaches to revaluation is limited.

44. **Bank liquidity remains constrained and the Statutory Liquidity Ratio (SLR) does not take into account balance sheet mismatches and vulnerability to stress.** Genuine high quality liquid assets that could meet prudential liquidity standards are limited given the low issuance of marketable government securities. In the circumstances, banks are rightly permitted to meet SLR using claims on other banks, but these may include interbank claims up to one year and real

[17] The RMA has made clear that this new framework is an interim measure and will be reviewed after six months, taking into account how financial institutions respond.

[18] Lending by banks grew at a rate of nearly 5 percent in the second quarter of 2013 compared with rates of less than 2 percent per quarter since the measures introduced in March 2012.

liquidity is dependent on RMA balances. Few banks meet the minimum SLR, when liquid assets (known as "quick assets") are redefined to exclude such assets. In addition to extensive maturity mismatching (on which no supervisory information is collected), banks' deposit books are concentrated, i.e. large deposits account for a significant share, mirroring the concentration of lending. Credit demand drives balance sheet management, leading to some high Credit to Deposit ratios, exceeding 100 percent for one bank at June 2013.

45. Stress tests of the banks based on end-2012 data conducted by the mission highlighted some vulnerabilities, varying by bank (Box 1). Tests based on end 2012 data (see Box) measured the adverse impact on banks of a number of credit risk and one liquidity shocks. The results highlighted a concentration of lending, and susceptibility to increased NPLs, whether a proportionate increase in current NPLs or increases in particular sectors. Under all the credit risk scenarios, a number of banks' CARs fell below the 10 percent minimum and one bank's ratio was below 10 percent on all three tests.

46. The financial soundness of the insurance sector is harder to judge in the absence of full prudential standards.[19] The CAR and SLR requirements, although designed for banks, have some relevance to Bhutanese insurers given their significant credit risk. The minimum standards are met by both companies. Claims ratios are healthy. Insurance risk is limited on account of the extensive use of reinsurance, including for catastrophe risk (particularly earthquake in Bhutan). The RMA needs to monitor exposures to reinsurers and how these are managed. Life business has been written with high guaranteed returns, but amounts remain low.

47. The insurance sector faces significant challenges, including divestment of banking business. A priority for supervisors will be to monitor the impact of reduced premium income due to the slowdown in activity in some sectors (e.g., importers and purchasers of cars) and to continue to plan for the implications of insurance companies ceasing to act also as banks. Whether they divest their banking business into subsidiaries or cease operations altogether, a long transitional period may be required if the companies are to diversify from loans into a wider range of investments.

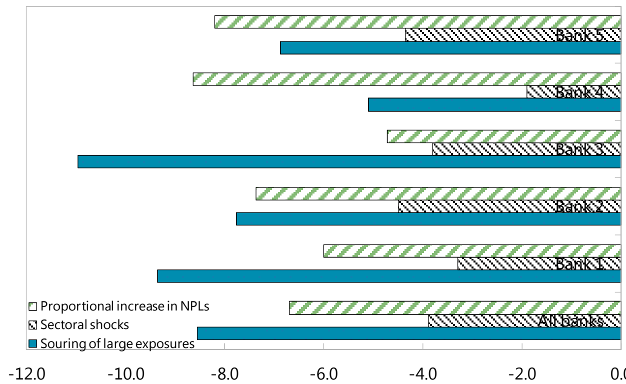
[19] Regulations have been drafted but implementation has been delayed by conflicting technical assistance recommendations.

Box 1. Stress Testing of the Banking Sector

Rapid credit growth in the previous 10 years, the run up in real estate prices, and entry by new banks highlight the need to closely monitor vulnerabilities in bank balance sheets. Stress testing provides a tool for quantifying vulnerabilities under specific macro-financial shocks, and bank-by-bank analysis is particularly important given the concentration of loans in the two large state-owned banks and the rapid growth by three new domestic private banks that began taking deposits in 2010. By 2012, the new banks already represented 18 percent of deposits and 24 percent of loans.

As of December 2012—the baseline for the stress tests—the banking system capital adequacy ratio (CAR) was 19.1 percent, with non performing loans (NPLs) of 8.2 percent and provisioning as a ratio of NPLs of 81 percent. Stress tests are described below in three scenarios involving credit risks and one involving liquidity risks:[1]

Fall in the Capital Adequacy Ratio under Different Shocks



Source: RMA and IMF staff estimates.

A proportional increase in NPLs scenario, in which NPLs increase from 8.2 percent to 18.4 percent—the level reached in 2008/09;

- A sectoral shocks scenario, in which a certain percentage of loans become nonperforming in three sectors: construction and personal loans (50 percent become nonperforming), trade (10 percent), and tourism (20 percent);
- A scenario entailing a souring of large exposures, in which a bank's five largest loans need to be fully written off;
- A liquidity shock scenario, in which 15 percent of baseline demand deposits are withdrawn each day for five days, and 95 percent of liquid assets are available for immediate sale.

The findings of the stress tests are:

- A souring of large exposures, which account for 13½ percent of total loans, lowers system-wide CAR by 8.6 percentage points, with a decline of 12.6 percentage points for one bank;
- Sectoral shocks lower banking system CAR by 3.9 percentage points for all banks, and by 4.5 percentage points for private banks;
- A proportionate increase in NPLs to 18.4 percent reduces the banking system's CAR by 6.7 percentage points;
- In the liquidity shocks scenario, all five banks remain liquid after five days despite the hypothetical deposit run, given the initial high level of liquid assets relative to demand deposits.

The results highlight a concentration of lending and susceptibility to increased NPLs in particular sectors. Under all the credit risk scenarios, a number of banks' CARs fell below the 10 percent minimum and one bank's ratio was below 10 percent on all three tests. Overall, the assessment is that the financial system is vulnerable to shocks, and close monitoring is warranted.

[1] The analysis does not focus on other types of risks for the following reasons: for interest rate risks, because banks' holdings of long-term government bonds are not significant; for foreign exchange risks, because banks do not have significant open foreign exchange positions; and for interbank exposure risks, because these exposures are small.

48. Looking ahead, there are vulnerabilities and financial institutions and the authorities need to adopt a more forward-looking approach. Balance sheets have been bolstered against potentially worsening credit losses, and economic indicators such as unemployment are relatively benign. However, the financial strength of individual institutions varies significantly. Moreover, for all the banks, recent liquidity pressures have highlighted serious asset and liability mismatches—preexisting but growing—as well as exposure to the sudden and severe measures (those of March 2012 in particular) to which the authorities had to resort to address financial imbalances in the absence of developed financial markets and functioning fiscal and monetary policy tools. Financial institutions are vulnerable to adverse impacts of future such measures. Given balance sheet mismatches, they would also face significant challenges in case of financial sector reform that exposed them to more volatile and particularly to rising funding costs.

C. Policy Recommendations

Regulation and Supervision

49. There are a number of areas where RMA should develop its approach, both in substance and supervisory process. The RMA's approach has a number of strengths, including intensive offsite supervision, based on extensive and frequent reporting by financial institutions; oversight of the banks' preparation of their annual accounts, including meetings with auditors and bank management; and a readiness to hold financial institutions to its standards (i.e., not granting waivers and exemptions) and to say "No" when necessary. However, regulatory gaps should be filled over time, and the RMA should consider how it can move from a relatively prescriptive approach in some areas (for example, bank base rates, requirements to purchase reinsurance, restrictions on guaranteeing corporate bond issues) towards one based more on holding management responsible for how they run the business, the supervisory role being to assess whether they are meeting that responsibility and to respond where they are not. All of these changes will require RMA to rebuild supervisory capacity through recruitment and training.

50. Priorities should include:

- Ensuring that supervisors have a view of the full range of risks in financial institutions. This will require starting to use scenario and stress testing, for example requiring banks to quantify their key risks including credit, interest rate, liquidity and foreign exchange risks on the basis of certain assumptions or insurance companies to evaluate the impact of catastrophic events. In addition, the resumption of onsite work subsequent to the mission will be essential to monitor financial system soundness and to evaluate systems and controls, developments in credit standards and the adequacy of management and governance.

- Developing a policy framework and issuing regulations in key areas where there are gaps, including prudential standards applicable to insurance and reinsurance, and bank liquidity. The latter needs careful consideration given the lack of high quality liquid instruments that would normally be at the core of any requirement for stock liquidity. The alternative is to develop a mismatch limit approach as envisaged in Section 7 of the Prudential Regulations, and it is recommended that the RMA begin with such an approach.

- Developing a strategy for updating the bank capital adequacy framework in areas such as the definition of capital (introducing a minimum Core Tier 1 Equity concept from the Basel III framework), capturing operational risk (using the non-advanced approaches) and interest rate in the banking book (taking into account the results of stress tests that would help establish the extent of the risks); and developing a Pillar 2 framework to relate the capital adequacy of financial institutions to the supervisory assessment of risks in individual companies.

- Using the results of the results of the deeper risk assessment of individual financial institutions to develop supervisory strategies in relation to each company, which would include challenging on business strategy, controls and financial strength; in particular, any weak banks should be identified and challenged to develop remedial action plans. With a small number of financial institutions, RMA is well placed to take a more bank specific approach to its supervisory work, which would also address the variable financial conditions of the individual institutions.

- Developing a crisis management framework in case of a future bank failure. This should start with the authorities evaluating what additional information they may need in case of a crisis (for example, on immediately maturing liabilities) and ensuring that this information would be available at short notice, and making sure that practical preparations are in place, including updated contact details of key officials etc. In due course the work could extend to consideration of potential changes to the Bankruptcy Act to create a bank insolvency framework. In this context, it is important that planning for the introduction of deposit insurance resumes, as the availability of insurance can help support retail depositor confidence in case of crisis.

- Developing a policy framework on its approach to setting new standards and regulations, covering consultation with financial institutions and preparation of impact assessments. A number of regulatory changes have been introduced at short notice without consultation or reference to RMA's objectives, triggering pushback from financial institutions which it has sometimes been hard for the RMA to resist in the absence of its own impact analysis.

- Strengthening its capacity in the framing of regulations and standards through the creation of a function within the Financial Regulation and Supervision Department dedicated to the preparation and promulgation of new standards.

51. The RMA should also build on its existing readiness to take macroprudential policy measures with:

- A regular review of sector-wide risks, extending the analysis in the Financial Sector Performance Review; and

- An internal policy statement on future choice and use of macroprudential tools.

The objectives should be to move away from the current reliance on one tool, the adjustment of risk weightings, and, in the current context, to ensure that supervisors seek to identify and address what may be the next source of stress rather than focusing only on present stresses related to current account pressures.[20] It must be emphasized that macroprudential tools cannot substitute for an appropriate monetary and fiscal stance in addressing overheating pressures.

52. Debt-to-income limits should in particular be considered, in conjunction with the development of monetary policy tools. Some macroprudential tools used in other countries appear to have limited relevance at present. Loan-to-value ratio limits would have limited impact given that high levels of collateralization are part of established lending practice. Limiting credit to deposit ratios could be introduced if and when money and capital markets develop, at which point banks would have the scope to manage balance sheets to meet such minimums. Making monetary policy implementation more effective should be the starting point and priority. However, the RMA could also consider setting debt-to-income ratio limits, which have been effective in other countries, and may also support increased focus on individual credit assessment. Limits on overall credit growth could be considered but would be hard to calibrate.

53. The authorities also need better to distinguish macroprudential measures from those designed to encourage lending to particular sectors and to take action preemptively. Recent changes to risk weighting have been driven mainly by analysis of risks in bank lending, but are also designed to encourage lending to targeted sectors such as agriculture—reflecting the wider government objective to stimulate sectors with lower demand for imports. The adequacy of overall capital requirements resulting from recent changes is hard to assess, and the RMA's recent increases are consistent with a higher risk environment, but increasing the requirements at an earlier stage (for instance as proposed in early 2012) might have helped moderate the rapid build-up in credit.

Developing the Financial Sector

54. A number of obstacles have frustrated the development of Bhutan's financial markets, notwithstanding the significant expansion of the banking sector. The challenges include:

- The absence of fully market-determined interest rates and the development of a yield curve to support pricing in financial markets generally.
- Inflexibility in credit provision—entrenched approaches to banking products and services, partly reflecting the absence of any alternatives to bank finance, limited openness to foreign participation and low penetration of technology.

[20] Subsequent to the mission, the authorities issued proposed regulations to introduce a range of new tools, including countercyclical capital buffers, loan-to-value and debt-to-income limits, sectoral capital requirements, restrictions on profit distributions, and dynamic provisioning. The MCM department has offered to provide a desk review of the proposed framework which is now being revised.

- Limited availability of risk management instruments—in insurance (i.e. limited scope of products, especially for life insurance and low penetration generally) and no scope for hedging of risks through financial transactions.

- Still limited infrastructure and business services, with no ratings agency, other sources of independent evaluations of risk in financial assets or local accounting, auditing and actuarial services; and limited expertise in modern finance.

- Government ownership and control of large parts of the economy, limiting the scope for broader participation in ownership of financial assets. (The government is committed to retaining its most significant interests.)

- Limited understanding of finance amongst investing public.

- The difficulty of achieving scale in a country of only 700,000 people.

55. Equally, Bhutan has a number of advantages that could be exploited:

- Institutional and high net worth investors including the NPPF, life insurance, the funds of the new fund management company, and DHI which manages the government's investments and investor interest from abroad.

- A number of large public and private sector companies with a need for longer term finance and a government with a deficit to finance.

- A legal framework that is broadly understanding of and ready to support the enforcement of financial contracts.

- High quality infrastructure in payments and settlement.

- Policy-makers ready to take a strategic approach as evidenced, for example, by the government project on accounting and auditing standards.

56. While a number of initiatives have been taken, and improvements in supervision and regulation will contribute, more is needed. The recent expansion of the financial sector has contributed to financial development by bringing in foreign capital and expertise and adding to listings on the RSEB. Developing regulation and supervision will have the same effect. Strong supervision that, for example, addresses weak banks and requires all banks to recognize full costs of their lending decisions (for example, by addressing the risks in maturity mismatches), will support the better allocation of resources through bank intermediation as well as promoting confidence and helping to safeguard financial stability. Good supervisory process enables institutions to plan for the development of their business. However, more is required.

STRENGTHENING MONETARY OPERATIONS

A. Overview

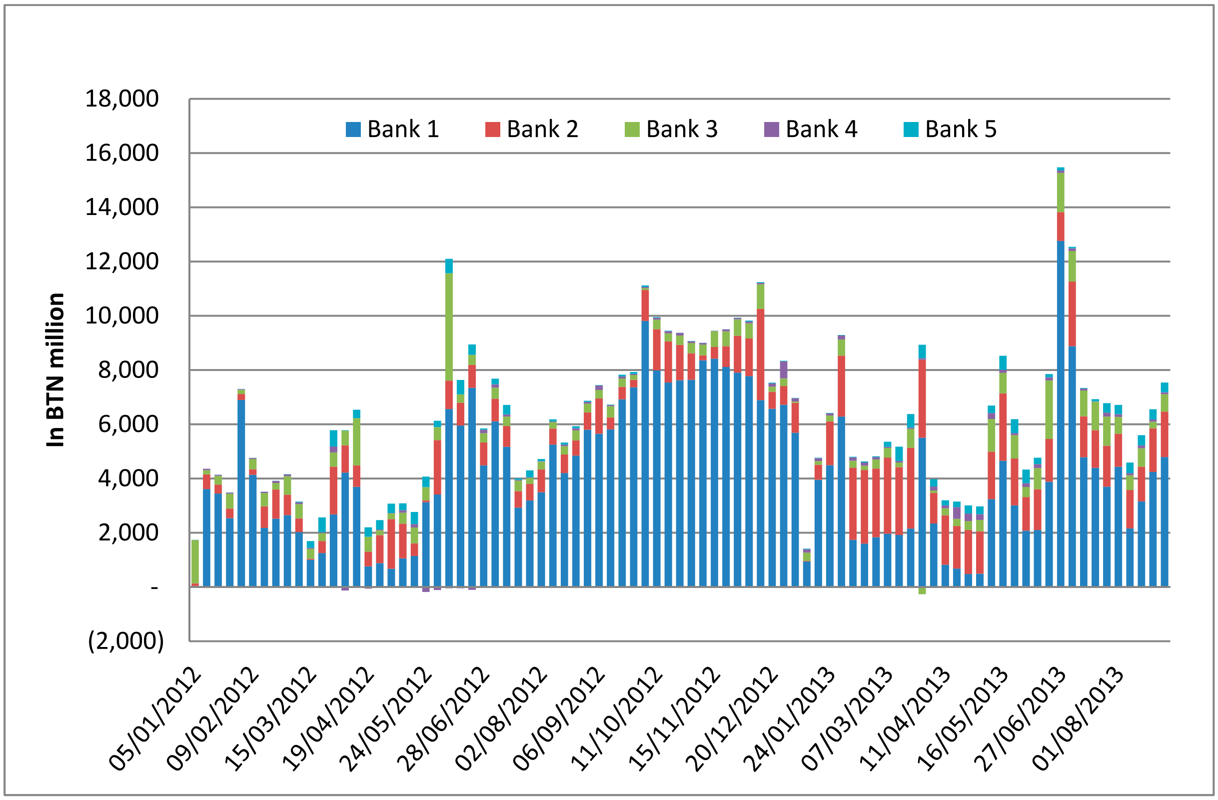
57. **Bhutan has a potential to make monetary policy contribute more effectively to macroeconomic stability and financial sector deepening, despite a number of constraints.** Due to the peg to the Indian rupee, exchange rate changes cannot be used for macroeconomic adjustment. As monetary transmission through interest rates also is weak (or non-existent), there is a need to deepen financial markets, starting with an interbank market and short-term securities market and continuing with to government and corporate bond markets. The room for an independent monetary policy is limited due to the exchange rate regime, but there should be sufficient scope to build a meaningful interest rate transmission channel.

58. **The RMA has until recently neither had the mandate nor the instruments to develop a monetary regime to address the challenges of operating under the fixed exchange rate regime.** The new RMA Act of 2010 has given a clear mandate to pursue price stability as the primary objective while secondary objectives include regulation and supervision of the financial system. As a central bank, the RMA now has the independence to formulate and implement a monetary policy adequate to meet its objectives. However, to a large extent, the monetary policy function has since becoming a full-fledged central bank had a focus on dealing with a shortage of Indian rupees in the context of limited rupee reserves. Although this is a complex problem which has been building up over a long period, part of the unsustainable expansion of credit has been caused by high levels of excess liquidity in the banking system over several years. Also for this reason, it is important to establish a liquidity management system with effective market-based instruments which can contribute to macro stability in the future and prevent recurrence of the rupee problem.

59. **Active liquidity management is the starting point for improving monetary transmission.** This is important under a fixed exchange rate arrangement as in other monetary regimes. A strong focus on balancing and controlling short-term developments in bank reserves is a precondition for establishing an interbank market. Although the distribution of liquidity across banks is uneven and bank reserves are displaying large swings, a banking system which now consists of five banks should accommodate interbank trading of short-term funds (see Figure 10). As discussed below, the liquidity management framework has to provide stable and predictable incentives to induce individual banks to plan and take responsibility for their own liquidity, as described in Section C below. By giving commercial banks the right incentives to manage their liquidity, the resulting interest rate from the transactions in the interbank market will in turn affect other money market interest rates and influence the term structure of interest rates.

60. **More active and deeper money and credit markets will absorb and smooth out erratic fluctuations and provide more stability through market determination of interest rates.** From this basis, the interest channel for the transmission of monetary policy impulses will evolve, which will improve the central bank's potential to implement an effective monetary policy in the future.

Figure 10. Banks' Current Accounts with RMA (Excess Reserves), January 2012 – August 2013 (weekly)



Source: RMA.

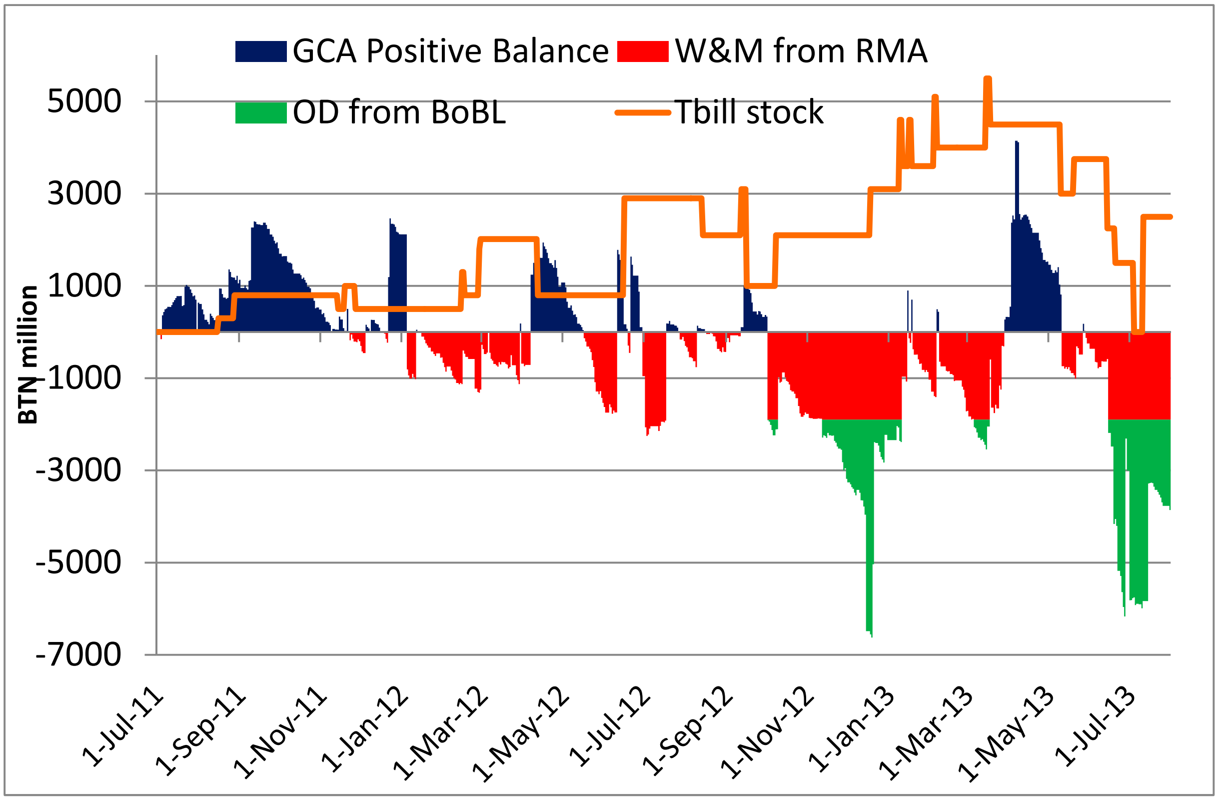
B. Government Securities Market

Present Situation

61. Treasury bills were introduced in December 2009 to replace RMA bills with the objectives of improving government cash management, allowing the use of market-based instruments of monetary policy, and providing a benchmark for short term interest rates. These objectives have not been met because of erratic issuance, unpredictable and insufficient amounts, small market size, limited market participation, and the lack of other financial instruments (see Figure 11).[21]

[21] See RMA Annual Report 2011-2012.

Figure 11. Government Financing, July 2011-July 2013



Sources: RMA and MoF

62. **Treasury bills are also not being issued at market-determined interest rates.** The issuance of Treasury bills started out as a conventional market auctions, but the MoF found it difficult to accept the interest rate outcome. Since February 2013, the interest rate has been fixed at 3 percent which is far below deposit interest rates and RMA's policy rate. A so-call "tap-sale" mechanism has been used in which the MoF determines the interest rate and the amount. On redemption, Treasury bills are often rolled over and the same holders keep the security at unchanged interest rates. Maturities have varied from 14 to 90 days, with issuance primarily at 30 days.

63. **Despite a substantial financing requirement in recent months, the government has continued to rely on bank financing rather than T-bill issuance.** First, an overdraft facility (OD) is available at the RMA up to a limit determined as 10 percent of average revenue over the last two years. This limit was recently raised from Nu 1.9 billion to Nu 2.1 billion reflecting this guideline. The RMA charges an interest rate, currently 4 percent, at 1 percentage point above the rate for the most recent Treasury bill issuance. Second, the Ways and Means (W&M) account with the largest commercial bank (BOBL) can be overdrawn without a limit. The interest rate charged is currently 5.5 percent. As shown in Figure 11, the government will first utilize the cheaper overdraft in RMA before making use of Ways and Means. It is also noticeable that the issuance of Treasury bills has to a large

extent been detached from the financing requirement. In the period under review, Treasury bills have not been issued for monetary policy purposes.

Discussion and Recommendations

64. Developing a government securities market is the most critical element for making monetary policy more effective and for enhancing financial markets in Bhutan. The availability of sufficient amounts of government securities at market-determined rates will provide a range of benefits. First, financial institutions will be given an investment alternative which at present is lacking for necessary portfolio adjustments and liquidity management, including meeting prudential liquidity requirement. Second, the central bank will directly and indirectly have a basis for effectively managing banking sector liquidity. Third, the government will have access to market financing necessary for efficient cash management. Finally, building a (risk-free) benchmark yield curve will have a number of positive externalities for financial sector development.

65. The current arrangements for financing the government hamper the development of a Treasury bill market and money markets more generally. The main sources for financing of government should be gradually shifted from bank to market financing as the government cash management improves and the financing requirement can be covered through an operational issuance program of Treasury bills. At that point, the Ways and Means account with a commercial bank should not be allowed to be overdrawn and the use of the overdraft facility in RMA should be made more restrictive. Even though drawings stay within the legal limits, this arrangement weakens incentives to strengthen government cash management.[22] Consideration should be given to limiting direct access to financing from the central bank to emergency situations in which access to other funding sources is difficult. Moreover, overdraft drawings should have a limited maturity and not generally be rolled over. This would put additional pressure on the Department of Public Accounts to impose strict discipline on budgetary agencies to follow their cash plans and give incentives to an active management of public debt.

66. Although the main responsibility for a meaningful Treasury bill issuance program rests with the MoF, the central bank has also an obligation to persistently promote the development of a short-term securities market. Without such a market, the implementation of monetary policy will be less effective and the transmission of interest rates more limited. It must therefore be a joint responsibility of the MoF and RMA to establish a reliable issuance calendar for Treasury bill and to ensure that meaningful amounts are issued also when there are no immediate financing needs of the Government. Establishing an issuance calendar of Treasury bills (used for fiscal and monetary policy purposes) will require a proven capacity at the central bank to forecast liquidity and at the Ministry of Finance to forecast government cash flows.

[22] TA is currently being provided to MoF by the IMF Fiscal Affairs Department on developing cash planning and cash management.

67. The arrangement in place for using Treasury bills both for government financing and monetary policy purpose should be fully utilized.[23] This is a progressive and forward-looking decision by the authorities which could have important advantages for market development and the use of RMA bills should not be resumed. A combined issuance program using Treasury bills for both fiscal and monetary purposes would broaden the basis for establishing reference rates for the pricing of financial assets. On its part, the RMA should for liquidity management purposes preferably issue Treasury bills with shortest maturities, with maturities and amounts being determined by the expected liquidity management needs. Issuance of Treasury bills for both fiscal and monetary purposes will necessitate robust arrangements to prevent the government from utilizing the liquidity that has drained from the system for monetary policy purposes, as well as an appropriate communication strategy with market players to communicate the policy direction.

68. Market financing of government cash requirements and liquidity absorption at market rates will imply increased costs to the budget and to the RMA. These costs are outweighed by the benefits of having a more developed financial sector and better tools for achieving stability in the economy. It is also not obvious that the cost of Treasury bill issuance for monetary purposes should be born exclusively by the RMA. The present arrangement as specified in the November 2009 Memorandum of Understanding (MoU) clearly states that the cost of Treasury bills issued for monetary policy purposes should be borne by the RMA. In general, providing liquidity to the banking system generates interest earnings for the central bank while draining liquidity using market-based instruments carries costs. Too much focus by a central bank on the profit position may defer necessary market operations.

69. It is important to establish an acceptance that the cost of monetary policy ultimately—directly or indirectly—must be borne by the budget. This is because the finances of the government and the RMA must in the final analysis be considered on a consolidated basis. Taking sterilization costs directly into the budget—for example through the issuance of Treasury bills for monetary policy purpose—may be a better alternative than having to repeatedly recapitalize the central bank.[24] In order to provide certainty to the institutional arrangement safeguarding RMA's financial position and its ability to conduct monetary policy, the RMA and the MoF could consider adjusting the existing MOU on this point. A binding cost-sharing arrangement should be established in which the government's willingness to protect the central bank for taking on these costs as part of implementing monetary policy is clearly stated. The revised MOU should specify how the RMA could be reimbursed for the costs that cannot be absorbed on its own balance sheet in connection with issuing Treasury bills for sterilizing liquidity. This would support to the independence and autonomy of the RMA. Public knowledge of such an arrangement will strengthen confidence in the RMA, as it would not be constrained by profit considerations when it needs to tighten monetary

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[23] An MOU between MoF and RMA of November 2009 gives the RMA the authority to issue Treasury bills for monetary policy purposes; this arrangement replaces the earlier use of RMA bills.

[24] Proceeds from issuances of government securities for monetary policy purposes would be placed in a blocked account where they would not be available for financing government expenditures.

policy. Although the Treasury bills issued for different purposes are identical for the investors, there should be full transparency as to the distribution of issued amounts between the MoF and RMA.

70. Apart from cost sharing, cooperation and coordination between the MoF and the RMA on debt and liquidity management should be strengthened. While the management of public debt is clearly the responsibility of the MoF, the RMA should be given the opportunity to comment on the debt strategy before final decisions are taken. The choice of instruments, maturities, and amounts may have implications for monetary policy implementation and should therefore be factored in, if possible. The existing Treasury Bills Management Committee should meet regularly (e.g. weekly)[25] and be fully used as a platform for sharing all relevant information in relation to the implementation of fiscal and monetary developments between the two institutions on an ongoing basis. Furthermore, in determining the short-term borrowing requirement of the government, there should be some flexibility to take into account factors which can influence RMA's liquidity management.

71. The technical infrastructure supporting a Treasury bill program needs to be strengthened. At present, the ownership records are maintained in an Excel spreadsheet at the RMA. An automated depository system should be developed to facilitate transfer of ownership resulting from secondary market trades and allow for temporary transfers in connection with the use of securities as collateral and in repurchase transactions. Ideally, the depository should be integrated with the payment system to ensure delivery versus payment. As the payments system recently adopted by the RMA is based on the RBI system, the RBI could be approached for support in extending this system to include a depository.[26]

72. Along with the technical infrastructure, a viable Treasury bill program should also be supported by market infrastructure. This should include regulations and market practices, and clear guidelines for trading and settlement. The RMA should assume the main responsibility for this task, in close collaboration with MoF.[27] It would be useful if the traders themselves established a Code of Conduct. For example, under the umbrella of the Financial Institutions' Association of Bhutan (FIAB), a forum of bank treasurers should be set up. One of the first tasks of this group should be to discuss and adopt a Code of Conduct for trading in the domestic money market and,

[25] The present arrangement specifies that meetings should take place as and when necessary but not less than once a quarter. In a dynamic market environment, with an active Treasury bill issuance program, the frequency of meetings should be considered.

[26] The Royal Securities Exchange of Bhutan (RSEB) has a depository in place for debt instruments. While multi-year government bonds may be listed and traded at the RSEB, it is generally advisable to start the infrastructural development with a separate depository—most often in the central bank—for Treasury bills (and other money market instruments). In addition to fast and secure settlements, this will allow for Over the Counter (OTC) trading which has proven to be the most effective way for developing a secondary market for these instruments.

[27] This is also the recommendation of aFiscal Affairs Department mission.

perhaps, foreign exchange market. This activity should be utilized as a vehicle for training and increasing trading skills among bank treasurers.

C. Enhancing Monetary Operations

Present Situation

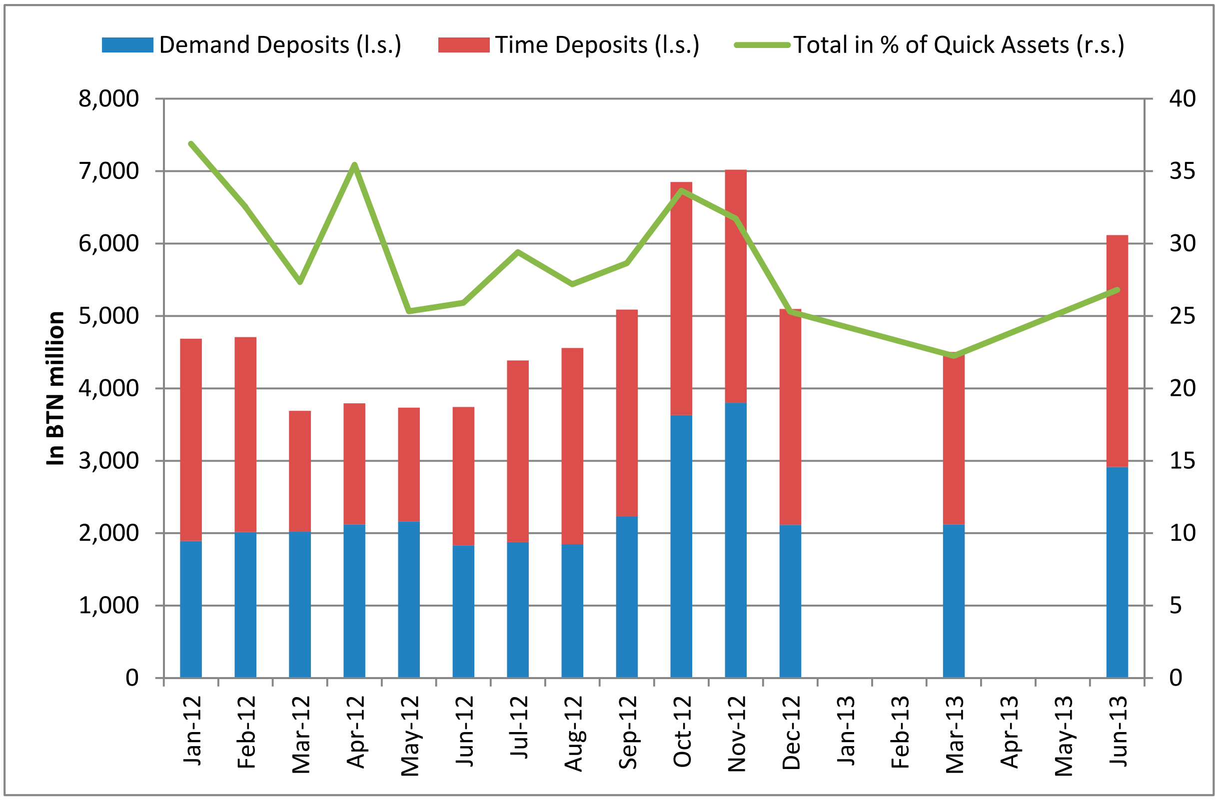
73. **The RMA continues to rely heavily on direct instruments and administrative intervention to implement monetary policy.** As such, the use of the reserve requirement (cash reserve ratio (CRR)) and liquidity regulations (SLR) have been central tools. Banks have separate CRR accounts, and there is not a provision for banks to meet the requirement on average during a maintenance period. Efforts have been made to move in the direction of more market based instruments, but the use of RMA bills and, more recently Treasury bills, has not achieved the intended objectives. In connection with the rupee stabilization measures introduced in March 2012, a number of new monetary policy instruments were announced with the intention to make monetary policy more effective. This included a "lender of last resort" facility (RMA Short-Term Liquidity Adjustment Window (RSTLAW)) which would provide funds up to 90 days. This facility was priced 1 percentage point above the Policy Rate which also was introduced. It is currently set at 6 percent. The facility has been used only once, mainly because banks lack collateral but also reflecting excess liquidity. The intention was also that the Policy Rate should set the price for central bank funds in ordinary market operations, but as such operations have not yet taken place the Policy Rate has so far had no practical purpose. Base rate regulation was also introduced (see above) with the aim of increasing transparency and improving the transmission of monetary policy. While there may have been some positive effects in meeting the first objective, it does not appear that transmission has been improved by the introduction of base rates.

74. **A fairly recent administrative measure to influence banking system liquidity is to sweep balances of selected accounts in commercial banks to the RMA overnight.** This is a normal practice in connection with the management of Treasury Single Accounts (TSA) in central banks where funds collected by commercial banks or any unused balances on settlement accounts are swept overnight to the central bank. In Bhutan, sweeping has been used to manage liquidity, and the practice has been extended to a number of large accounts (currently 8), including mostly, but not only, hydropower project accounts. The daily amounts involved vary between Nu 500 million - Nu 1.2 billion. The sweeping was discontinued at the end of May 2012 when liquidity became tight, but was resumed in the beginning of July 2013. This indicates that although the stated objective is to sterilize volatile hydropower related funds, the measure has also been used as a general liquidity management tools (see discussion below).

75. **There is a limited interbank market in Bhutan, with banks and other financial institutions making unsecured placements with each other on a regular basis.** These placements are almost never short-term, and normal maturities range from 90 days to one year. The interest rates are said not to fluctuate much (according to a "gentlemen's agreement"), but follows the interest rates for corporate deposits. An indication of this activity is shown in the Figure 12

below. Both demand and time deposits with other banks qualify as Quick Assets in relation to the SLR, and bank placements make up about one-third of all Quick Assets.

Figure 12. Banks' Placements with Other Domestic Banks, January 2012-June 2013 1/



Source: RMA.

1/ Only quarterly data is available for 2013.

76. There are no foreign exchange transactions between banks, and banks are only allowed to deal in foreign exchange with their customers at rates fixed by the RMA. The RMA fixes buying and selling rates daily based on the US$/INR closing rate the day before. Banks are obliged to use these rates in their retail transactions and they are not allowed to make transactions within this margin. (Under a similar system in India, banks are allowed to trade within this margin). Banks can at any time sell convertible currencies to the RMA when they are approaching a fixed limit (US$10 million for larger banks and US$5 million for smaller banks). All sales and purchases of foreign exchange with the RMA take place at the mid-rate. This arrangement gives no incentives to interbank trading.

Discussion and Recommendations

77. An operational liquidity framework will be an important mechanism to develop the capacities for formulating monetary policy and analyzing financial stability. By monitoring the factors influencing liquidity developments and banks' behaviors, the central bank can develop a better understanding of current and future trends affecting liquidity developments in the banking sector. The standard approach for most central banks is to make forecasts in order to observe banks' reserves and calibrate open market operations to deal with disrupting fluctuations. Technical assistance has been given in the past to set up a liquidity monitoring framework, but availability of data to the RMA has made the updating very difficult. As the most difficult and important data input is government cash flows, the ongoing TA to the Department of Public Accounts on cash management and the introduction of a TSA should improve the basis for liquidity forecasts. It is important that the RMA becomes involved in this work so that the cash flow projections can be directly entered into the liquidity forecasts. Cash flow forecasts would also need to reflect information about large hydropower related flows. It is important to note that not all cash flows have immediate liquidity effects, such as foreign exchange transactions and other transactions between the government and RMA. Under a fixed exchange rate arrangement, the RMA should develop its capacity to offset domestic sources of volatility in bank reserves to avoid corresponding adverse fluctuations in interest rates.

78. The reserve requirement system (CRR) should be redesigned to enable reserve requirements to be more effective as a supplement to other monetary instruments. In particular, the practice that required reserves are kept in separate CRR accounts should be changed. Banks should have only one account with the RMA which should be used to meet the reserve requirements as well as serving as an ordinary settlement account. Having one current account in RMA would also make it possible to allow banks to meet the reserve requirement on average over the maintenance period. The averaging mechanism would provide more flexibility in banks' liquidity management and reduce the demand for excess reserves. In an averaging system, individual banks may draw on their reserve account in case of unexpected liquidity needs, but they would then have to overfulfill later in order to meet the requirement. This gives the banks more responsibility and incentive to manage their own liquidity more actively, which in itself is a precondition for improving the monetary transmission mechanism. The current practice that the RMA makes the posting on the banks' reserve account will become unnecessary. At the present relatively low level of the reserve ratio (5 per cent), this is now a good opportunity to make the change. Should the ratio increase in the future, the averaging provision could be combined with a minimum daily requirement in order to limit the potential for a large reserve drawdown on any given day. This floor could be lowered as experience with the new system increases. At the end of the maintenance period, non-fulfillment should be penalized.

79. Reserve requirements are an effective but a blunt instrument which should be used with care. The RMA has (understandably) actively used changes in the reserve ratio in response to tight liquidity resulting from the measures taken in March 2012 to deal with the rupee shortage.[28] The RMA should in the future avoid frequent and large changes in the cash reserve ratio, as this can be disruptive for financial intermediation. Changes in the reserve ratio have a direct impact on the money multiplier and reserve requirements generally serve as a tax on financial intermediation, which may result in wider spreads between retail deposit and lending rates. As the reliance on

[28] The reserve ratio was reduced from 17 percent to 10 percent in March 2012 and further to 5 percent in June 2012.

market-based instruments in liquidity management increases, large and frequent changes in the reserve requirement should not be necessary.

80. The application of sweeping is an administrative tool for direct regulation of liquidity and should not be used as a general liquidity instrument as alternative tools are developed. Future use of this arrangement should be analyzed and clarified in cooperation with commercial banks. Although the arrangement can serve a useful purpose, namely to sterilize huge, very short-term and potential destabilizing funds in connection with the hydro-power projects, the selection of accounts could be reviewed.

81. With a stronger focus on short-term liquidity management, the RMA should consider introducing a short-term standing lending facility. The RSTLAW is much too long term, and banks need to become more active and responsive in their short-term liquidity management. Many central banks have introduced an overnight standing facility, which allows banks to borrow funds overnight. The arrangement should normally not be extended beyond overnight, to give banks incentive to repay any outstanding balances in the morning when the interbank market opens. As it will take time to develop an interbank market in Bhutan, the short-term facility could be extended to, say, one week. To encourage banks to first try to find the funds needed from other banks before making use of the central bank facility, the short-term loan facility should be offered at a reasonably penal interest rate relative to the cost of borrowing in the interbank market. This interest rate on the facility should be determined by the RMA, and it will normally form the ceiling for the interbank market rate. The purpose of the facility is therefore to induce banks to take a reasonable risk in their liquidity management which will help to increase activity in the short-term money market and reduce interest rate volatility. Access to the RMA standing loan facility would be at the discretion of the banks that have appropriate collateral. It is important that occasional use of this facility should be considered as a normal part of a bank's liquidity management, and no stigma should be attached to frequent drawings.

82. It should be emphasized that the standing lending facilities are meant only to provide very short-term liquidity support. Banks with longer-term liquidity problems or structural liquidity needs in the banking system should be addressed through other measures. The RMA should consider the need for introducing a properly designed Lender-of-Last-Resort (LoLR) facility for banks that are faced with longer-term liquidity problems. The already existing RSTLAW, which can extend credit up to 90 days in the form of an overdraft, could perhaps serve such purpose in the meantime should the need arise.[29] LoLR support should not be considered as part of monetary policy implementation, although the liquidity effects of longer-term support have to be taken into account.

[29] To grant commercial banks an overdraft facility in the central bank, for any period, is unusual. Standing facilities should be available for covering unexpected short-term liquidity needs; 90 days are in the context of short-term liquidity management much too long.

83. Many central banks have also introduced a standing deposit facility to provide an interest rate floor in the interbank market. As a standing facility, banks can deposit any excess funds overnight at their discretion. Similar to the overnight lending facility, the interest rate on the deposit facility should have a penalty element in the form of a low rate and be lower than the deposit rates offered in the interbank market. This should discourage its use and provide incentive to first try to place available funds in the interbank market. The need for a standing deposit facility is not pressing in Bhutan, but such a facility would in due course assist monetary policy in case of a sudden capital inflow by preventing interest rates from falling significantly (and in this respect be an alternative to sweeping). The cost of these operations has to be kept in mind, as the RMA would need to pay interest on all excess reserves. A standing deposit facility will only become relevant when the RMA is able to manage the banking system liquidity in such a way that the use of the standing facilities would be for marginal funds only. The RMA should consider introduction of these tools in the context of a broader package aimed at fostering market development and effective monetary policy implementation.

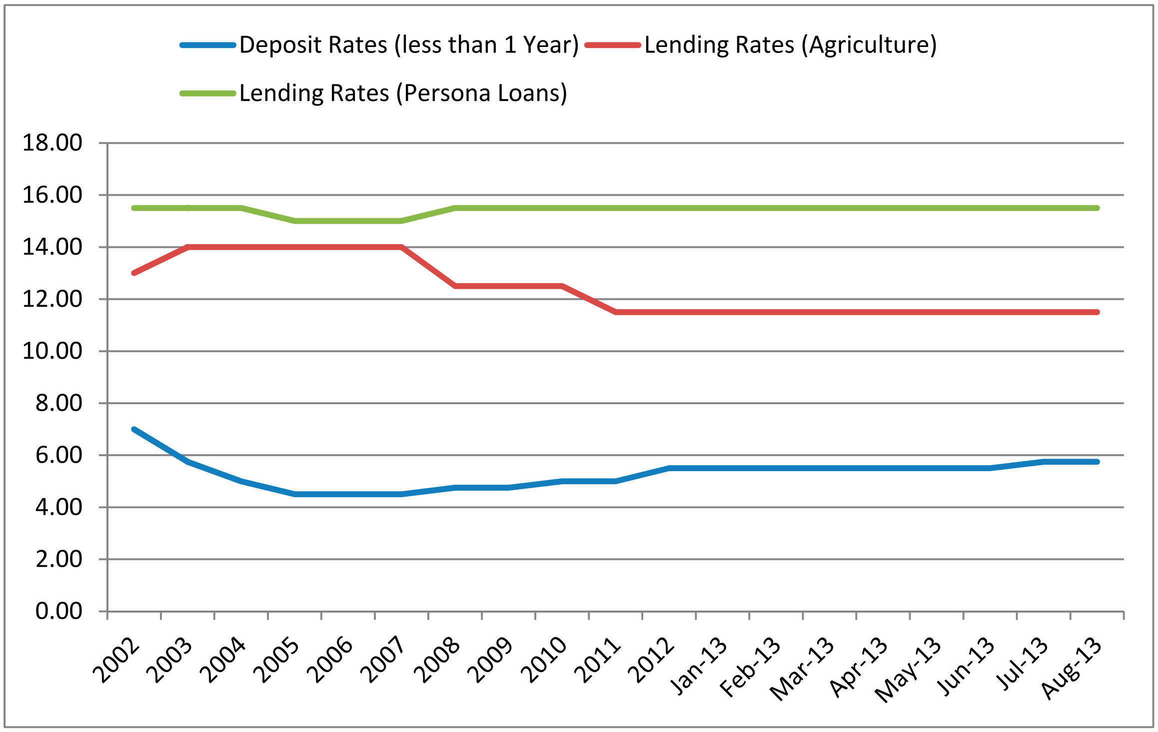
84. As part of a more market-based monetary policy framework, some increased flexibility also in the foreign exchange market should be considered. Banks could—as in India—be allowed to determine the exchange rate for transactions with their retail customers within the margin prescribed by the RMA. Allowing banks to compete on price for attracting foreign currency transactions is necessary to create a more competitive environment. Banks should also be allowed to sell foreign exchange a bit cheaper as part of their overall banking relations with their customers. Also, the foreign exchange transactions between the RMA and the commercial banks should not be at mid-rate and available at all times. As a start, the RMA should provide a daily window (at a fixed time) with a buy and sell rate around a parity rate of the USD/Nu rate determined on the basis of the US$/INR market rate. This would give banks an incentive to obtain a better price from each other. At a later stage, the RMA should only open the window on a few predetermined days during the week. A functioning inter-bank market is internationally the main mechanism for facilitating an efficient distribution of foreign exchange from institutions with a surplus to institutions with a deficit. Giving banks incentives to become more responsive and active also in this area will support the orientation toward a more effective implementation of monetary policy. This established practice of stable interest rates appears to have contributed to the build-up of substantial maturity and interest rate mismatches on banks' balance sheets.

D. Strengthening Monetary Transmission

Present Situation

85. The transmission of interest rates is currently weak in Bhutan. Despite large swings in banking system liquidity and macro-economic developments, banks' retail deposit and lending rates have remain remarkable stable (see Figure 13). Although banks are in principle free to determine their interest rates, there appears to have been limited attempts to make adjustments in their portfolios by changing their interest rates.[30] As discussed earlier, there has also been very limited impact on bank funding costs coming from monetary policy instruments, such as Treasury bills (see Figure 14).

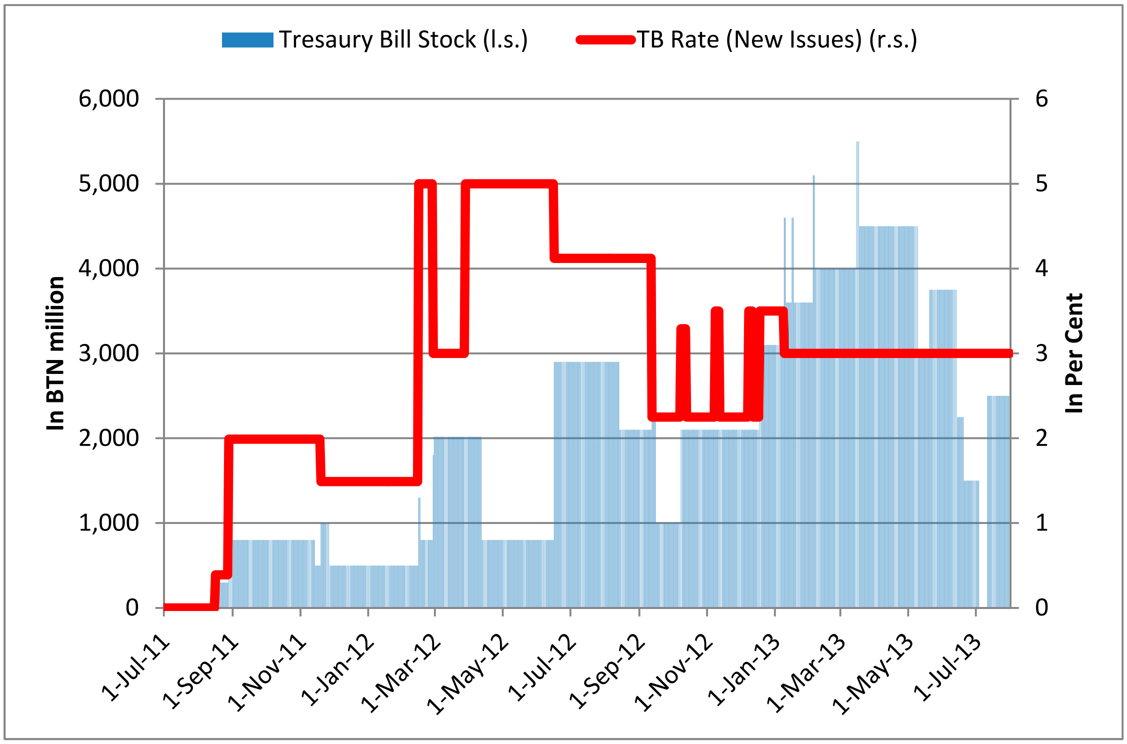
Figure 13. Banks' Deposit and Lending Rates (mid-rate), 2002-Aug 2013



Source: RMA.

[30] Data on interest rates are limited and only ranges of interest rates in various categories of deposit and lending are available.

Figure 14. Treasury Bill Activities, July 2011-July 2013



Source: RMA.

Discussion and Recommendations

86. Liquidity management should aim at influencing the functioning of money and securities markets. This would strengthen the transmission channel through interest rates and pave the way for changes in the rates determined by the central bank (policy rates) having an effect on the economy through changes in bank retail interest rates and asset prices. A reasonably competitive and responsive banking sector is necessary in order for interest rates to respond to changing market conditions so that the allocation of funds from savers to debtors in the retail market is influenced in the desired direction. Usually, there are two important interest rate transmission mechanisms. The first goes from the policy rate to the interest rates in the wholesale interbank and Treasury bill markets. As these interest rate changes are influencing the banks' cost of funds, the second channel will lead to adjustments in banks' retail deposit and lending rates. By integrating the two channels, the transmission of monetary policy decisions would become significantly stronger. The challenge for most central banks trying to influence interest rate transmission through changes in the policy rate is to have a liquidity management framework that ensures short-term market interest rates are determined close to the policy rate. It is also important in a fixed exchange rate regime that changes in the policy rate can be used to correct market interest rates from diverting too much from the interest rate of the anchor currency.

87. Developing these transmission channels in Bhutan will take some time, particularly as banks' current lending practices should be changed. Because banks mostly lend medium to long term at fixed interest rates, a tightening of monetary policy with corresponding increase in funding costs will have a first-round effect of declining profits and perhaps capital depletion. The effect on bank lending and on overall demand would be stronger if interest rates on existing loans could be adjusted, and not only the interest rate on new loans.

88. In practical terms, liquidity management should attempt to ensure stability in bank reserves in order to establish a link between quantities (bank reserves) and the price of reserves (market interest rates). Large volatility in banks' reserves makes liquidity planning by banks difficult and without a consistent framework to absorb large swings in liquidity flows, it will be difficult to establish an interbank market. In addition to monitoring and forecasting the supply of reserves, the approach must also be to determine banks' demand for reserves and "true" excess reserves (or surplus reserves).

89. For Bhutan, the demand for bank reserves is primarily linked to the banks' need to meet the reserve requirement (CRR) and the liquidity requirements (SLR). The latter is unusual as banks normally will meet prudential liquidity requirements with other interest bearing assets rather than unremunerated current accounts at the central bank. A credible Treasury bill program, as discussed earlier, should provide more appropriate assets for meeting the SLR in the future. In any event, banks often may want to hold additional reserves over the legally required minimum (CRR or SLR) for clearing purposes and other contingencies. This portion of banks' reserves is often referred to as banks' "own demand" for reserves. Banks' own demand cannot be directly observed, but has to be estimated or critically assessed in some manner. Surveys can be used as a starting point to capture banks' expressed preferences, but they should be supplemented by frequent contacts with individual banks. In a liquidity framework with a focus on bank reserves, it will be necessary to manage "true" excess reserves (also referred to as surplus reserves), which is the residual portion above statutory requirement and banks' own demand.

90. In order for the link between banks' reserves and market interest rates to work efficiently, the market for bank reserves should be in approximate balance. Any "surplus reserves" held beyond the demand for reserves will then become particularly important for liquidity management. A rise (decline) in surplus reserves will normally induce banks to expand (reduce) their balance sheets and to lend more (less) on the interbank market, putting downward (upward) pressure on short-term interest rates. An analysis of the interrelationship between the level of surplus reserves and interest rates will become important in a monetary regime with interest rates as the operating variable.

CONCLUSION

91. Notwithstanding substantial progress with key financial reforms, recent experience has shown that Bhutan needs a comprehensive strategy for deepening and broadening the financial sector. Accomplishments have included new entry into banking and insurance, amendment of the Royal Monetary Authority (RMA) Act and passage of the Financial Services Act, and improved financial infrastructure including a new payments system, credit bureau, and collateral registry. However, financial institutions' risk management has not kept pace with the five-fold increase in credit/GDP in the last decade, and assets are not available for liquidity management or investment diversification. Growing liquidity and interest rate mismatches need to be addressed by the regulatory framework. Furthermore, there is a risk that ad hoc measures may create uncertainty, increase vulnerabilities, and impede financial sector development.

92. A comprehensive Financial Sector Development Strategy (FSDS) is needed aimed at improving the ability of the financial system to contribute to long-term economic growth by channeling savings efficiently to productive investments in a sound and stable financial environment and by providing opportunities to smooth consumption and manage risk. A broader range of financial assets is needed, most importantly government debt with a range of maturities to provide a benchmark yield curve, but also public and private equity, corporate bonds, and micro-finance. Monetary policy could be made more effective by developing financial markets, starting with an interbank market and short-term securities market and continuing with government and corporate bond markets. It must be a joint responsibility of the MoF and RMA to promote the development of a short-term securities market. The strategy would also strengthen regulation and supervision while broadening access to the financial system of excluded groups. It would encompass a detailed, prioritized, and sequenced action plan to address gaps and vulnerabilities while deepening and broadening in the financial system and would benefit from consultation with relevant stakeholders. It is recommended that the strategy forms part of a masterplan that would also include a financial sector review and diagnostic covering both the bank and non-bank financial sectors and the establishment of a mechanism to monitor the implementation of the strategy and coordinate technical assistance.

93. There are also opportunities for enhancing affordable access to financial services, in the context of the authorities' Financial Inclusion Policy; identified priority areas for strengthening of regulation and supervision of banks and non-banks; recommended measures to enhance monetary operations and monetary transmission; and suggested areas for future technical assistance.

Table 3. Detailed Recommendations
DEEPENING THE FINANCIAL SYSTEM
Draft private equity regulations, float minority shares of state owned enterprises, consider removing the double taxation of dividends
Support non registered firms in maintaining accounting and auditing standards
Enable secured transactions by expanding the collateral registry
Continue the expansion of the Credit Information Bureau to include microfinance clients
Review and approve Financial Inclusion Policy
Build capacity for bank downscaling through training
Provide credit lines to registered MFIs at market rates and offer competition and innovation grants
Provide business development services to SMEs
Provide technical assistance to MFIs and other financial providers to support new product development such as microsavings and microinsurance
Encourage financial institutions to establish and strengthen "Customer Help Desks" and increase the awareness of the Central Bank's "Grievance Cell" to handle consumer complaints
Continue and expand financial literacy campaigns
SUPERVISION AND REGULATION
Regulation
Complete project to make regulations on insurance and reinsurance solvency requirements based on EU Solvency I or equivalent simple framework and covering valuation, investment and solvency
Review latest capital risk weightings after six months to reflect development of risks; extend requirements to off balance sheet credit risk
Select elements of new international capital standards that can be implemented in Bhutan, including Common Equity Tier 1 capital definition, operational risk capital, Pillar II
Develop mismatch approach to liquidity risk regulation, with longer term objective of a simplified stress-based framework when there is increased availability of high quality liquid assets
Reduce large exposure limits over time in line with Basel Committee Core Principle 19 and extend limits to exposures to other financial institutions
Formulate short statement of regulatory approach to making and changing regulation, e.g., approach to consultation, impact assessment
Prioritize creation of a regulatory policy function, taking into account overall resources needs and availability
Supervision
Introduce occasional stress testing exercises, requiring banks to run simple adverse scenarios and report results: use to assess extent of liquidity, interest rate and foreign exchange rate risk
Develop supervisory strategies for each financial institution, based on offsite analysis and onsite assessment of governance, risk management etc
Resume onsite supervision as a high priority in line with expected increased resourcing, within the framework of an annual supervisory plan for risk-based supervisory work (this recommendation was implemented subsequent to the mission)
Develop framework for regular contacts with the Reserve Bank of India in respect of supervisory

cooperation and information-sharing on the Indian-owned Bhutanese bank
Macroprudential Supervision
Set policy on selection and use of tools, including risk weights, debt-to-income ratios, credit limits
Develop template for reports to Financial Policy Committee on main risks and emerging issues
Other
Finalize crisis management plan, prioritizing information requirements, contact lists and procedures
Update benchmarking of current approach against Basel and IAIS Core Principles and IOSCO
MONETARY POLICY FORMULATION AND IMPLEMENTATION
Government Securities Market
Start systematic work toward establishing an issuance calendar for Treasury bills and commit to float meaningful amounts on a regular basis even when there is no financing need
Reduce gradually use of the government's overdraft facility in a commercial bank and agree on more restrictive use of the overdraft facility at the RMA
Agree on a MoU specifying how RMA could be reimbursed for the cost of monetary policy
Utilize regular meetings of the Treasury Bill Management Committee to share information and coordinate public debt management and liquidity management
Establish an automated depository for registering treasury bills at the central bank
Initiate systematic work on strengthening the market infrastructure for securities trading and establish a Code of Conduct by treasurers in financial institutions
Monetary Operations
Reactivate the liquidity monitoring framework by in particular ensuring that the government cash flow projections can serve as direct input to the liquidity framework
Redesign the reserve requirement system (CRR) by merging the CRR account and the current account into one account and allow for averaging over the maintenance period
Limit the use of the sweeping arrangement to clearly eligible accounts, selected in cooperation with commercial banks, and refrain from using sweeping to manage normal liquidity flows
Use Treasury bills on a regular basis with maturities and amounts determined by expected liquidity flows to stabilize as much as possible bank reserves
Introduce a short-term standing lending facility (one week) and redesign the RSTLAW as a Lender-of-last resort facility to assist banks with longer-term liquidity problems
Allow banks to trade foreign exchange with their retail customers at rates within the prescribed margin and redesign the trading of convertible currencies between banks and RMA to give incentives to interbank trading
Monetary Transmission
Establish a liquidity management framework in which monetary instruments are available that can ensure that market interest rates are determined close to the policy rate
Start work to analyze and identify the various components of banks' demand for reserves in order to determine the level of "true" excess reserves or surplus reserves

Statement by the Staff Representative on Bhutan
Executive Board Meeting
June 20, 2014

1. **This supplement to the staff report summarizes the main developments since the staff report was issued on June 2, 2014.** Staff projections and the thrust of the staff appraisal remain unchanged.

- Credit growth increased slightly to 8.3 percent (year on year) in March 2014 from 7.5 percent in December 2013. Private sector credit grew at an average annual rate of 30 percent during 2002–11. However, administrative measures to slow credit growth had resulted in a deceleration of private sector credit growth before its recent slight increase (March 2014).

- International reserves increased from US$ 931 million in December 2013 to US$ 965 million in March 2014. Reserve cover remains at over 10 months of imports, suggesting an overall adequate level of reserves.

- Inflation in Bhutan is projected to remain elevated given the recent reading of inflation in India (CPI inflation rose by 8.3 percent in May in India) and the findings of staff analysis that inflation in Bhutan is closely related to Indian inflation (see Box 2 in the Bhutan staff report).

- Indian Prime Minister Narendra Modi reaffirmed India's commitment to extensive development cooperation with Bhutan (both hydropower-related and non-hydro aid) during his June 14–15 visit and committed to further enhancing the economic ties between the two countries (via expanding bilateral trade, for example).

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with Bhutan

On June 20, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Bhutan.

GDP growth in Bhutan has slowed from around 10 percent in Fiscal Year (FY) 2011(July 1-June 30) to 5 percent in FY2013. Slower growth reflects policy efforts to contain overheating pressures in the form of restrictions on credit for construction and vehicle. Inflation has remained elevated, tracking closely that of India (Bhutan's main trading partner). Social development indicators have improved steadily, and Bhutan is on track or has achieved most of its Millennium Development Goals. The fiscal deficit worsened sharply in FY2013 due to a shortfall in grants. The current account deficit has widened due to hydropower-related imports, as well as a consumption and housing boom. Nonetheless, robust aid inflows (loans and grants) have led to a positive overall balance of payments position, enabling the continued accumulation of international reserves. External pressures have led to a recurrent shortfall in Indian rupee reserves.

Growth is projected to recover to 6½ percent in FY2014, driven mainly by a pick-up in hydropower-related construction activities and domestic services. In addition, policy measures to revive the economy, including a capital infusion as a part of an Economic Stimulus Package,

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

are likely to exert a modest positive impact on growth. The current account deficit is projected to widen further to around 25 percent in 2013/14 due to stronger hydro-related imports but financing from India and other development partners in the forms of loans and grants is expected to be adequate. The fiscal deficit is budgeted to remain high in 2013/14.

Risks stem from high debt levels and the possible surfacing of financial sector vulnerabilities following a prolonged period of rapid credit growth. There is also a risk of renewed external pressures, including pressures on rupee reserves, if macro policies remain expansionary and credit growth rebounds strongly. Additionally, risks emanate from slower growth in India—including due to financial market volatility—though these risks are mitigated by the concentration of exports in the hydropower sector, which enjoys healthy demand from India.

Executive Board Assessment[2]

Executive Directors welcomed Bhutan's continuing progress driven by hydropower development, which has led to robust economic growth and much improved social indicators. However, they noted that rapid economic growth and credit expansion had led to overheating pressures in the past and to continued deterioration in the current account balance. While the expansion of hydropower capacity offers good medium-term economic growth prospects, Directors encouraged the authorities to carefully manage macroeconomic pressures and to continue to diversify the economy to reduce economic volatility, create more jobs, and enhance inclusiveness.

Directors recommended tightening fiscal policy to preserve macroeconomic stability and contain public debt. They considered that revenue reforms are essential to achieve greater fiscal self-reliance over the medium term and support critical social and infrastructure spending. They noted the need for measures to widen the tax net in the near term and to consider introducing a value-added tax over the medium term. Improved fiscal management and public spending efficiency, including prioritizing expenditures to mitigate the risk of grant shortfalls, and better cash forecasting will also be crucial.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors considered that monetary policy should complement a tighter fiscal stance by curbing the build-up of excess liquidity and sterilizing large capital inflows. They noted that more regular and increased issuance of treasury bills would help liquidity management, deepen financial markets, and improve monetary transmission.

Directors recommended strengthening bank supervision and regulation, including by regular stress testing and closing regulatory gaps, and putting in place institutional arrangements including crisis management and deposit insurance. Directors looked forward to the preparation of Bhutan's Financial Sector Development Strategy.

Given Bhutan's close economic relationship with India, Directors agreed that the peg to the Indian rupee has served Bhutan well and remains an appropriate nominal anchor. They saw merit in closer alignment of reserve currency composition with the structure of external liabilities through a gradual increase in the share of Indian rupees in overall reserves. A few Directors noted that the authorities' reserves adequacy framework has a threshold for changing convertible currencies to rupees when conditions are favorable.

Directors took note of the staff's assessment that the real exchange rate is overvalued. They encouraged the authorities to make progress on structural reforms, including reducing skills mismatches in the labor market and increasing access to finance particularly for small and medium enterprises, to boost competitiveness, create jobs, and help diversify the economy.

Directors encouraged elimination of exchange restrictions subject to approval under Article VIII and the restrictions maintained under Article XIV as soon as macroeconomic conditions allow.

Bhutan: Selected Economic Indicators, 2009/10–2014/15 1/

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
			Est.		Proj.	
Real sector						
Real GDP at market prices (percent change)	9.3	10.1	6.5	5.0	6.4	7.6
Consumer prices (percent change, period average)	4.8	8.6	10.1	8.7	10.2	8.8
General government			(In percent of GDP)			
Total revenue and grants	46.3	35.6	35.2	28.9	25.2	27.0
Tax revenue	13.4	13.7	15.8	14.5	13.0	13.0
Non-tax revenue	16.3	8.6	5.9	5.4	5.4	4.9
Foreign grants	16.6	13.3	13.5	9.0	6.8	9.2
Total expenditure and net lending	44.7	37.7	36.5	32.9	28.3	28.5
Current expenditure	26.0	20.2	18.0	17.1	15.8	16.5
Capital expenditure	19.3	18.7	19.6	17.4	14.0	12.6
Current balance (excluding grants)	3.8	2.2	3.9	2.8	2.6	1.3
Overall balance	1.6	-2.1	-1.3	-4.0	-3.0	-1.4
Public sector debt 2/	67.5	73.7	86.0	110.7	122.0	128.7
Monetary sector			(Percent change, unless otherwise indicated)			
Broad money	30.1	21.2	-1.0	18.6	…	…
Credit to private sector	22.8	19.2	20.7	6.2	…	…
Interest rates (end of period, in percent)						
Deposits (less than 1 year)	5.0	5.0	5.5	5.5	...	...
Lending	10–16	9.75–16	10.0–16	11.7-16	...	...
External sector			(In millions of dollars, unless otherwise indicated)			
Current account balance	-142	-410	-350	-441	-461	-522
(In percent of GDP)	-9.9	-23.5	-19.0	-22.8	-24.5	-25.4
Trade balance	-299	-519	-477	-460	-465	-588
Exports (goods)	544	665	595	601	636	677
(Percent change)	5.5	22.2	-10.6	1.2	5.7	6.4
Imports (goods)	843	1,185	1,072	1,062	1,101	1,264
(Percent change)	39.0	40.5	-9.5	-0.9	3.7	14.8
Grants (current transfer)	261	254	273	191	140	208
Capital account balance	99	472	261	545	458	584
Loans (net)	108	366	225	342	331	444
Errors and omissions	43	33	-20	0	0	0
Overall balance	-1	96	-109	104	-2	62
(In percent of GDP)	-0.1	5.5	-5.9	5.4	-0.1	3.0
Gross official reserves	813	904	800	904	902	964
(In months of goods and services imports)	7.5	8.9	8.0	8.8	7.6	7.4
External debt (in percent of GDP)	65.9	71.0	84.8	105.2	114.4	120.0
Ngultrum per U.S. dollar (period average)	46.7	45.3	50.3	…	…	…
Memorandum items:						
GDP at market prices (in billions of Bhutanese Ngultrum)	66.9	79.2	92.7	106.1	121.9	140.9
GDP at market prices (in millions of U.S. dollars)	1420.8	1714.3	1851.7	1814.9	1879.7	2059.1
Electricity exports (in percent of total goods exports)	42.8	34.3	32.8	29.8	26.0	24.8
Unemployment rate (in percent) 3/	3.3	3.3	3.1	2.1	...	...

Sources: 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/ On a calendar year basis (e.g., the entry for 2009/10 is for 2009).

Statement by Mr. Rakesh Mohan, Executive Director for Bhutan and Mr. Muneesh Kapur, Advisor to Executive Director June 20, 2014

1. On behalf of our authorities, we thank the staff for a comprehensive and well-written report, which reflects a strong understanding of the economic dynamics and macroeconomic challenges faced by Bhutan. Our authorities appreciate the Mission's hard work and diligence in discussing the issues with Bhutanese authorities in a collaborative manner, for their efforts to include and cover issues of importance to the authorities, and for providing assistance with requests for technical assistance and in institutional capacity building. Our authorities broadly share the staff's assessment.

Recent Economic Developments

2. The Bhutanese economy recorded strong growth during the 10th Plan (2008-13). Real GDP growth averaged 8 percent during this period, buoyed by electricity, construction and services activity. Strong growth, along with other inclusive policies, pushed down poverty from 23 percent in 2007 to 12 percent in 2012. The unemployment rate dropped from 3.1 percent in 2011 to 2.1 percent in 2012.

3. Strong growth over the 10th Plan period, however, also led to external imbalances and was accompanied by high credit growth. In response to some signs of overheating, the authorities implemented monetary policy and prudential measures to rein in aggregate demand. Accordingly, real GDP growth in Bhutan slowed during 2012 to 4.6 percent from 8.6 percent during the previous year.

4. The hydropower sector remains a key sector of economic activity – construction and electricity sub-sectors constitute almost one-fourth of GDP. Hydropower sector and related growth has, however, slowed down in recent years due to the plateauing of production, which has also contributed to the deceleration in growth in the recent years. Electricity and related growth can be expected to pick-up in 2016-17, when the next project starts production. This will lead to a spike in the growth rate in 2016-17; given the bulky nature of these projects, such spikes have occurred in the past and can be expected to occur in the future as well. Efforts are underway to increase the power generation capacity from the current level of 1500 MW to 10,000 MW by 2020, predominantly with support from India. The hydropower sector is expected to start adding to growth momentum, as the new capacity starts production.

5. The power generated from the existing and the prospective hydropower plants will be largely sold to India. Concomitantly, the import requirements associated with these power plants are expected to maintain pressure on the current account deficit during the construction stage of these projects; however, financing of such deficits is not an issue. The current account position is expected to move from deficit to surplus, once these projects start production. Similarly, the public debt as well as external debt position will improve significantly, as the various hydropower projects start generation.

6. Continued expansion in the hydropower sector is critical for socio-economic development; however, given the strong possibility of further harnessing of hydropower potential beyond the 10,000 MW target by 2020, sequencing of these investments and negotiation of project modalities is critical.

7. Consumer price inflation moderated from 13.5 percent in 2012:Q2 to 5.5 percent in 2013:Q2, reflecting easing in both food and non-food inflation; it has since then, however, edged again up to 11.3 percent in 2013:Q4, largely due to upward pressures in food-related prices. The RMA continues to maintain a tight monetary policy stance and has launched new initiatives and macro prudential policies to strengthen financial sector regulation and supervision under the scope of a Financial Sector Development Strategy.

8. The fiscal deficit remained modest and decreased slightly from 1.2 percent of GDP in 2011-12 to 1 percent of GDP in 2012-13.

External Sector Management

9. As noted earlier, strong growth during the 10th Plan period was, inter alia, mirrored in widening current account deficits. In response, the authorities put in place demand management measures as also some temporary restrictions on selected imports in 2011-2012. Accordingly, there was a modest reduction in the merchandise trade deficit. Nevertheless, the current account deficit widened to 25 percent of GDP in 2012-13 from 23 percent of GDP in 2011-12 due to reduced inflows in budgetary grants. As of March 2014, Bhutan's international reserves were USD 965 million, providing a cover for 22 months of merchandise imports.

10. While the overall balance of payments (BoP) position has recorded modest deficits or surpluses in recent years, the BoP position with India has recorded persistent deficits. This reflects the heavy dependence of the economy on India to meet its import requirements amidst high domestic demand. Thus, while there is a deficit BoP position with regard to India, there is a surplus BoP position with respect to other countries. This has created challenges for the authorities to raise Indian rupee (INR) resources, even though overall foreign exchange reserves are equivalent to 22 months of merchandise imports.

11. During 2012 and 2013, the Royal Monetary Authority (RMA) also took steps to address volatility in the external sector and pressures on Rupee reserves. The RMA entered into an INR Swap arrangement with the Reserve Bank of India (RBI) and raised INR 5.4 billion in March 2013 for 6 months; the Swap was liquidated in September 2013. In addition, USD 200 million was sold against INR in June 2013 to raise INR resources, in light of a comfortable convertible currency reserve position and favorable exchange rate conditions. The authorities continue to be vigilant on external sector developments. Overall, given strong trade and economic ties with India, the currency peg to the INR has served Bhutan well.

Reserve Adequacy Issues

12. On reserve adequacy and management [Selected Issues - Chapter 2], staff estimates that if Bhutan had invested on average 30 percent of its reserves in INR denominated government bonds, it would have earned net interest of INR 4 billion in 2005-12 period. Second, staff notes that the actual interest cost of INR overdraft facilities to which the RMA resorted to periodically has added to the cost of holding convertible currency reserves. Finally, staff recommends that the currency composition of reserves should be more aligned with the structure of Bhutan's external liabilities and trade, with consideration being given to a gradual increase in the share of INR reserves. To begin with, staff recommends any excess of convertible currency reserves a certain nominal threshold should be converted into rupees and managed in a liquidity portfolio.

13. In this context, we may note that staff's estimates of interest earnings foregone are unlikely to be realized, since INR funds would need to be maintained in the most liquid form (under the reserve management policy) to meet daily payment obligations which are very unpredictable in nature. Moreover, the currency composition of reserves reflects the fact that (i) reserves build up is largely due to aid inflows; (ii) Bhutan has sizable convertible currency payment obligations largely denominated in USD; (iii) since INR is a non-convertible currency, it is more efficient to keep reserves in USD terms and convert them into rupees as and when needed. Besides, as staff acknowledge, Bhutan is also bound by the Constitutional requirement of an import cover of 12 months in foreign currency.

14. The RMA has a Reserve Management Policy and is developing guidelines. This process has benefited from the Fund TA on Reserves Management. The RMA has developed and is implementing its Reserve Adequacy Framework with a threshold limit, beyond which RMA shall convert its convertible currency reserves and increase Rupee reserves as and when conditions are favorable. The value of the threshold can be expected to change from time to time in line with economic conditions and pattern of financial flows. It should, therefore, be treated as an element of RMA's internal operational framework and it would be inappropriate to mention a specific nominal threshold.

15. Bhutan has prudential restrictions on the foreign exchange usage and the authorities avail of the transitional arrangements under Article XIV, section 2. Our authorities have followed prudent foreign exchange policies so as to safeguard international reserves which serve as the foundation of Bhutan's macroeconomic and exchange rate policy and to support sustainable development. Bhutan's reserves have been accumulated over the past 5 decades through gradual inflows of aid and debt as opposed to export performance. Until such time Bhutan's macroeconomic fundamentals do not improve, removing exchange measures would not be prudent. The current INR exchange restrictions related to the import of vehicles and construction materials (in line with credit controls) since 2012 are temporary and the RMA has plans to remove these restrictions this year in line with the introduction of fiscal measures by the Royal Government.

16. During the year, Bhutan started disseminating BoP and international investment position (IIP) statistics, including quarterly statistics, compiled under IMF's Balance of Payments Manual 6th Edition (BPM6). Successful migration of Bhutan's BOP to BPM6 was carried out under the IMF TA and Japan Subaccount (JSA) Project on the Improvement of External Sector Statistics (ESS) in the Asia and Pacific Region. This makes Bhutan one of the first Asian countries and IMF Member nations to implement the BPM6 framework on a quarterly basis and ensures international comparability of Bhutan's BOP statistics.

Financial Sector

17. Financial soundness indicators for Bhutan remain generally comfortable, with capital adequacy and liquidity well above the required prudential norms, although the proportion of non-performing loans has increased in the recent period. In order to strengthen the regulatory system, the central bank has recently supplemented its micro-prudential regulations with a macro-prudential system to make the Bhutanese financial system more resilient. Macro-prudential regulations covering counter-cyclical capital buffers, sectoral capital requirements, leverage ratio, loan to value and loan to income ratios, debt to equity ratio, time-varying capital provisioning and margin requirement and profit distribution are being put in place. These macro-prudential regulations, in conjunction with the existing micro-prudential regulations, are expected to foster financial stability in an environment of continued financial deepening amidst high growth.

18. To promote lending to productive and priority economic sectors, the Government is implementing an Economic Stimulus Plan (ESP) from 2014. Under the ESP, INR 5 billion secured by the Government as grant support outside of the 11th Five Year Plan (FYP) (2013-18) from the government of India (GoI) is being injected into the financial institutions to improve financial sector liquidity levels and lending.

19. A Central Registry for Movable Property was established in September 2013, which has helped the RMA facilitate smooth credit appraisal. As part of its strategy to contain over-exposure of financial institutions towards select credit portfolios and to regulate rapid credit expansion, the RMA adjusted prudential provisions pertaining to loan provisioning, risk weight limits during 2012 and 2013.

Capacity Development and Small States

20. Our authorities are highly appreciative of the Fund for providing opportunities for enhancing human resource capacities through training and technical assistance (TA). During 2013, Bhutan benefitted tremendously from TAs in the areas of National Accounts Statistics, Treasury Management, Financial Sector Surveillance, Balance of Payments (External Sector Statistics), and Foreign Exchange and Reserve Management. Notably, as noted earlier, Bhutan has become one of the success stories in enhancing compilation and quality of BoP and IIP statistics.

21. Our authorities would like to request the Fund to explicitly support Bhutan in its need for continued external resource support and assistance when pursuing these reforms. As the staff projections indicate, Bhutan's level of official development assistance is expected to decline gradually in line with improvements in per capita income. However, as the staff assessment shows, growth in Bhutan has been driven primarily on the back of a single sector (hydropower development) which generates limited employment. Bhutan continues to remain an import and aid-dependent country. To strengthen economic fundamentals, and to pursue economic diversification, Bhutan will continue to rely on the goodwill and assistance from its key multilateral development partners including the IMF, World Bank and ADB.

Outlook

22. Bhutan has achieved noteworthy progress in recent years. The poverty rate has been reduced from 32 percent in 2003 to 12 percent in 2012. The authorities are working towards self reliance and reducing dependence on external assistance by 2020. Notwithstanding the creditable progress achieved in social indicators and robust growth performance during the 10th FYP period (2008-13), the authorities recognize that Bhutan faces numerous structural weaknesses and challenges that need close attention to ensure long term sustainability. The economy can no longer be sustained on the back of a single economic sector, although hydropower development remains a vital catalyst for socio-economic development.

23. The 11th Five Year Plan, covering the period 2013-14 to 2017-18, envisages average annual growth of 12 percent as compared with that of 8 percent in the 10th Plan. As the 11th Plan notes, the macroeconomic challenges of recent years underscore the need to prudently address various issues in the real, external and monetary sectors. In this regard, the prudent management and use of hydropower inflows will be critical in the long-run; in the short-to-medium-term, our authorities recognize that managing the spillovers from the hydropower sector and related activities during the gestation period of these projects on INR reserves will be important for macroeconomic and financial stability.