

Bhutan: Selected Economic and Financial Indicators, 2003/04–2007/08 1/

	2003/04	2004/05	2005/06 Est.	2006/07 Est.	2007/08 Proj.
Real sector					
Real GDP at market prices (percent change)	7.2	6.9	9.1	17.0	14.4
Consumer prices (percent change, period average)	4.3	4.8	4.9	5.0	4.8
Nominal GDP (at market prices; billions of ngultrum)	30.7	34.5	39.3	48.0	57.7
General government (In percent of GDP)					
Total revenue and grants	33.9	30.3	33.9	35.1	30.7
<i>Of which: foreign grants</i>	17.5	12.7	16.3	14.0	11.1
Total expenditure and net lending	32.1	37.4	35.0	38.2	36.5
<i>Of which: capital expenditure</i>	17.1	19.8	17.3	21.0	18.4
Current balance (excluding grants)	-0.3	-0.3	0.6	4.0	0.9
Overall balance (excluding grants)	-15.7	-19.8	-17.5	-17.1	-16.8
Overall balance (including grants)	1.8	-7.1	-1.1	-3.1	-5.8
Public sector debt 2/	84.7	86.3	81.9	71.3	73.5
Monetary sector 3/ (Percent change, unless otherwise indicated)					
Broad money	4.0	10.7	24.8	7.6	...
Credit to private sector	35.9	29.3	33.3	31.8	...
Interest rates (end of period, in percent)					
Deposits (less than 1 year)	6.0	4.5	4.5	4.5	...
Lending	10–16	10–16	10–16	10–15	...
External sector (In millions of U.S. dollars, unless otherwise indicated)					
Current account balance	-73	-217	-29	116	141
(In percent of GDP) 4/	-10.8	-28.2	-3.3	10.6	10.1
Trade balance	-105	-249	-123	12	88
Exports (goods)	158	212	312	521	687
(percent change)	39.7	34.5	47.2	66.9	31.8
Imports (goods)	263	461	435	509	598
(percent change)	27.3	75.5	-5.6	17.0	17.6
Grants (current transfer)	94	120	176	158	188
Loans (net)	103	78	78	16	-13
Overall balance	8	-21	111	45	165
(In percent of GDP)	1.2	-2.7	12.6	4.2	11.8
Gross official reserves	383	367	479	524	689
(In months of goods and services imports)	8.9	8.9	9.8	9.2	9.8
External debt (in percent of GDP)	78.2	78.7	77.5	64.8	64.0
<i>Of which: power sector debt</i>	53.8	55.7	53.6	44.0	45.8
Debt service ratio (in percent of G&S exports)	4.2	7.2	5.8	4.0	14.2
Ngultrum per US\$ (period average)	45.4	44.6	44.7	44.2	...
Memorandum items:					
Electricity exports (in percent of total goods exports)	40.3	31.0	25.1	26.6	34.7
Unemployment rate (in percent) 5/	1.8	2.5	3.1

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

1/ Fiscal year begins July 1.

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

Including interest during construction for Tala from 2007/08 onwards.

3/ 12-month percent change in June. 2006/07 monetary data are IMF projection, and interest rate data are actual as of April 2007.

4/ In 2004/05, includes the import of two aircraft amounting to US\$78 million.

5/ On a calendar year basis, e.g., the entry for 2005/06 is for 2005.

**Statement by Adarsh Kishore, Executive Director for Bhutan
and Saranyan Krishnan, Advisor to Executive Director
October 5, 2007**

1. On behalf of my authorities, I thank staff for the constructive policy discussions and the comprehensive and analytical set of reports. My authorities agree with the thrust of the staff appraisal and welcome the policy recommendations. Bhutan's macroeconomic performance in the period since the last Article IV consultation has strengthened even further. Aided by prudent policy making and strong support from donors, GDP growth targets have been exceeded. Our authorities have achieved this performance with no dilution in their commitment to preserving the environment and the local culture and in a manner that enhances the pursuit of individual all round happiness. Remarkable progress has been made in improving social indicators and Bhutan is set to meet many of its Millennium Development Goals. The ambitious growth targets of the 9th Plan have been by and large achieved, with external assistance flowing in as anticipated.
2. Bhutan is at the cusp of a historic transformation that will accompany the adoption of the Constitution and the introduction of parliamentary democracy in 2008. This transition is progressing in a completely peaceful and orderly manner. Bhutan's international integration is growing and accession to the WTO is planned to take place during 2008. Bhutan has already joined the BIMSTEC, the IFC, SAFTA and the World Customs Organization. The direction of Bhutan's trade is also gradually diversifying and the share of newer trade partners like Hong Kong grew since the last review. Bhutan's geographical location and close links with India continue to offer immense opportunities. At the same time, it is recognized that strong economic links with one country could pose some risks.
3. Bhutan's real GDP growth during 2006-07 is projected to almost double to 17 percent from 9 percent in the year before. Growth is driven by the Tala Hydropower Project going on-stream and government spending on infrastructure and private investment in housing. Annual inflation in 2006-07 at 5 percent remains in line with price developments in India, with the one to one exchange rate peg to the Indian rupee. The Ngultrum has appreciated marginally against the US dollar. This, however, has not had any significant bearing on the country's competitiveness. With electricity exports from Tala commencing in 2006-07, the current account balance has shifted to a sizeable surplus of 10.6 percent of GDP. Bhutan's foreign reserves presently cover 9 months of goods and services imports. However, the rupee reserve ratio has declined to under one month, although this appears to be a cyclical issue.
4. My authorities recognize that despite an improvement in the overall budgetary position of the country and developmental activities progressing without major problems, challenges remain. Given the dependency on external aid, there is little room for fiscal complacency.

Fiscal Policy

5. The overarching challenge of fiscal policy is to strengthen fiscal prudence and to limit domestically financed deficits while continuing to finance ambitious infrastructure projects beyond the current plan period into the 10th Plan period. With generous grant assistance from development partners and rigorous expenditure control the government has managed to keep overall deficits on an average at 4 percent of GDP, below the policy ceiling of 5 percent. While the Royal Government would like to finance all capital expenditures of the Plans through grant financing, the overall grants available are likely to be somewhat below the requirement and would be partially compensated by external and domestic borrowing. My authorities agree with staff assessment for the medium term fiscal framework that revenue receipts to GDP ratio should be maintained at about 18.5 percent, expenditure contained to about 31 percent, divided equally between capital and current expenditure, and that domestically financed deficits should be moderated to 1 - 2 percent of GDP. This would involve ensuring that the Tala project is fully commissioned by 2008 and commences yielding the expected revenues, negotiating grant financing from India and preparing contingency plans to meet any shortfalls.
6. Reviewing the 2006 - 07 budget, the domestically financed fiscal deficit target of 1.5 percent is expected to be exceeded somewhat leaving a deficit of about 2 percent of GDP. This is mainly on account of the higher spending associated with the celebration on the centenary of the establishment of the monarchy in Bhutan and for the new constitutional bodies to be set up in 2008.
7. The Tenth Plan is being prepared in the context of momentous socio-political change, but the governing development philosophy of maximizing Gross National Happiness will continue to hold true. The four pillars of GNH - promotion of equitable and sustainable socioeconomic development; preservation and promotion of cultural values; conservation of the national environment; and good governance - will form the core values of the Tenth Plan. Poverty reduction will be the main development goal of the Tenth Plan and programmes in all sectors will be prepared to target the poor and vulnerable.
8. The budget for 2007-08 was endorsed by the National Assembly in 11 June 2007. As a result of a combination of slightly higher levels of projected expenditure and the expectation that slightly higher revenues being offset by a projected decline in grants, my Bhutanese authorities anticipate the fiscal deficit to be 4 percent of GDP in the budget estimates for the year 2007 - 08, with 2.75 percent being the domestically financed deficit. In keeping with the longstanding government priority for the social infrastructure, 22 percent of the budget has been allocated to the education and health sectors, with emphasis on construction of outreach clinics, basic health units and expansion of educational infrastructure. Domestic revenues are expected to increase, due to higher contributions from the Tala project. While my authorities are committed to seeking external financing, should such aid not materialize the Royal Government may have to rely on domestic finances to meet the expenditure plans.

9. My Bhutanese authorities are aware that there are risks and vulnerabilities on the debt sustainability front. However, there are also strong mitigating factors. Most of the contracted debt is intended for implementation of hydro-electric projects. The record of such implementation starting with Chukha (336 MW), Kurichhu (60 MW) and now Tala (1020 MW) has been very encouraging. The Punatsangchhu and Dagchhu projects are being undertaken in this back-drop. A further element contributing to sustainability of the debt is Bhutan's relationship with India which has found new meaning and been further strengthened with the signing of the new India-Bhutan Friendship Treaty in February 2007. Since India has also committed to purchase at least 5000 MW of power from Bhutan by 2020, no difficulty is expected on sustainability of debt for the hydro-electric sector. Regular plan assistance is received as a grant and the Indian and Bhutanese authorities are in regular touch on this issue.

Monetary Policy and Financial Sector

10. The exchange rate peg of the Ngultrum to the Indian rupee has served Bhutan well and the exchange rate peg and its level remain appropriate. However, the immediate challenge is to tighten monetary conditions to support the exchange rate peg. The RMA is maintaining a close watch on the liquidity conditions and is prepared to take appropriate measures to absorb excess liquidity. My RMA authorities concur with staff advice on this issue and are contemplating a stepped up issuance of RMA Bills and an increase of the Cash Reserve Ratio.
11. In 2007-08, with the commissioning of the Tala project, the current account is likely to remain in a surplus of about 10 percent of GDP. Reserves are expected to grow even further beyond the present level of about 9 months of goods and services imports.
12. An immediate issue is the temporary shortage in rupee liquidity, with rupee reserves having dropped to less than one month's imports in July 2007. This is a temporary and cyclical phenomenon which can be overcome by appropriate measures to monitor, manage and forecast rupee liquidity. In case the situation persists, the Royal authorities are contemplating negotiating a concessional rupee credit line with India.
13. My RMA authorities find it difficult to eliminate the remaining restrictions under Article XIV and to accept the obligations under Article VIII given the currency composition of the balance of payments and their concerns over hard currency outflows. Given the limited and unpredictable sources of convertible currency inflows liberalization of the remaining restrictions would need to be taken cautiously with further diversification of export earnings and the developments in greater convertibility of the Indian rupee. I would seek support of my colleagues for an extension to the arrangement.

Financial Sector Issues:

14. The financial sector has performed well and private sector growth has been robust, exceeding 30 percent. The RMA is conscious of the risks of the rapid private sector credit growth, specifically the vulnerability of banks' balance sheets to concentration

of credit growth in the housing sector. The RMA is closely monitoring the situation and is prepared to take further prudential measures.

15. My authorities are aware of the need to provide more investment opportunities for the commercial banks. Maturity mismatches in the financial institution balance sheets are sought to be addressed through developing the government bonds market. The development of financial markets will require a further strengthening of the institutional capacity in the RMA, given the lack of adequate technical expertise. The RMA authorities are keen on a long-term technical assistance on central banking from the Fund. Since the central banking functions of the RMA are modeled on the Reserve Bank of India, their preference is for an expert familiar with RBI operations.

Structural Issues

16. Hydropower is the engine of economic growth and it is planned that this sector will account for an even larger proportion of the economy at the conclusion of the Tenth Plan period. Tala project is expected to generate electricity up to its installed capacity of 1020 MW by 2008. In July 2007 an agreement was signed for the implementation of the 1095 MW Punatsangchhu -I hydro-electric power project which is expected to be completed by 2014. The Dagachu power project is being implemented with Austrian assistance. India has committed to import a minimum of 5000 MW of electricity from Bhutan by 2020, assuring evacuation of the electricity generated.
17. My Bhutanese authorities recognize the significant potential of Bhutan's tourism sector with the main focus on promoting and maintaining Bhutan as a high quality destination. The goal is to increase annual tourist arrivals from about 13,000 in 2005 to about 30,000 by the end of the Tenth Plan period. The sector has attracted the largest FDI in recent years and some hotel chains have also started investing.
18. Bhutan faces the challenge of providing employment to rapidly growing labor force. The authorities are making efforts to match supply by generating demand and by improving employability. Promotion of small scale industries, horticulture, floriculture and handicrafts will increase avenues for self employment. The Royal Bhutan Vocational and Qualifications Authority is expected to bring a greater focus to improved vocational training facilities including job-oriented skill upgradation to reduce the skill mismatch and conduct of job fairs to promote employment in private sector companies.
19. Bhutan's close trade links with India means that further trade liberalization would broadly follow developments in India. The regional trade agreements and accession commitments to WTO will help streamline the regulatory environment to international standards. My Bhutanese authorities are seeking technical assistance from the IMF to enable them to meet the commitments of accession to WTO by 2008.

Statistical Issues

20. My authorities are continuing their efforts to improve the statistical data base through a variety of interventions. The periodicity of CPI has increased from half yearly to