

## EXECUTIVE SUMMARY

**Context:** Bhutan's rapid growth has been underpinned by hydropower sector development with donor support, and its strong ties with India. Since 2008/09, however, the fiscal position has deteriorated because of higher spending and sluggish revenue, and inflation has risen. The medium-term outlook remains favorable provided the near-term challenges are addressed and structural reforms implemented.

### **Policy messages:**

- Tighten fiscal policy in the near term by controlling current spending. The current balance should remain in surplus to limit domestic financing, which will shore up macroeconomic stability.
- Broaden the revenue base and improve public financial management by adopting a multi-year rolling budget to help ensure debt sustainability.
- Improve monetary operations and liquidity management. The policy rate should be better aligned with India's money market rates to ensure the sustainability of the exchange rate peg. A more active management of convertible currencies reserves would help address rupee shortages.
- Strengthen regulatory and supervision capacity of the Royal Monetary Authority (RMA) to safeguard financial stability in an environment of rapid credit growth.
- Advance the implementation of structural reforms to facilitate private sector investment and boost competitiveness, as envisaged in the authorities' new Economic Development Policy (EDP).

## I. CONTEXT

1. **Following its transition into a parliamentary democracy in 2008, Bhutan has enjoyed political stability.** Local elections were held in January 2011 and the process of transition to a full participatory democracy has proceeded steadily. The government has implemented its economic policies to improve Gross National Happiness (GNH) and ensure sustainable development. The 10<sup>th</sup> five-year plan (FYP) encompasses ambitious socio-economic goals.

2. **Bhutan's economic performance in recent years has been strong, driven by hydropower sector development and donor support.** Growth averaged 8 percent in the last decade benefiting from the country's strong ties to India, which currently absorbs about 95 percent of Bhutan's exports (about half of which is hydroelectricity) and supplies three-fourths of its imports. Inflation has been historically low, but has risen, reflecting trends in India and the ngultrum's peg to the Indian rupee.<sup>1</sup>

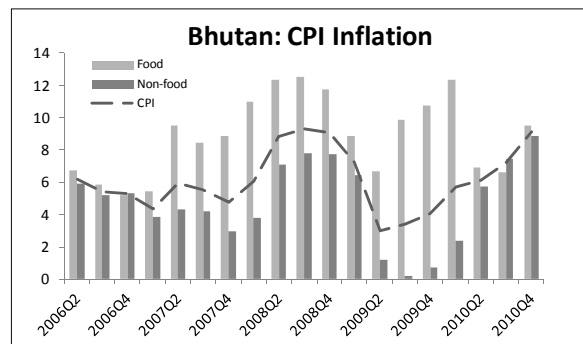


3. **Bhutan's progress on social indicators has been steady.** Primary school enrollment ratio has risen significantly over the fifteen years. Gender equality has also improved, as have health indicators such as infant mortality, which has been nearly halved since 1995. Progress has also been made on poverty reduction. Overall, Bhutan is on track or has achieved most of the Millennium Development Goals.

## II. MACROECONOMIC OUTLOOK AND RISKS

### *Recent Developments*

4. **Growth has been strong, but inflation has risen.** GDP growth accelerated to an estimated 7.5 percent in 2009/10, underpinned by services, construction, and the hydropower sector. However, inflation rose sharply, doubling to 9 percent at end-2010 from the year before. While initially food prices were the main culprit, price pressures have become generalized, as in India.



<sup>1</sup> For the whole document, rupee refers to Indian rupee.

5. **The external position has deteriorated, but remains manageable.** The current account deficit has increased to about 13 percent of GDP due to strong imports related to the construction of hydropower plants, but the overall balance of payments has remained in surplus due to sizable grants and loans disbursements. The reserve position has remained comfortable. Despite some recent appreciation, the real effective exchange rate has been stable and close to its ten-year average.

### *Outlook and Risks*

6. **Bhutan's near-term outlook is favorable, but overheating risks loom.** Growth is expected to remain at around 8 percent. The current account deficit will remain high due to hydropower-related imports, but financing from India and other development partners is expected to be adequate. As a result, the overall balance of payment is projected to remain in surplus. Inflation is expected to decline while remaining somewhat elevated (at around 6 percent), in line with developments in India. In light of high commodity prices and increased pass-through from global prices to prices in India, inflation risks are to the upside.

7. **Despite challenges, the medium-term outlook is also positive.** Growth is projected to remain robust at 8–9 percent over the remainder of the 10<sup>th</sup> Five Year Plan (FYP; 2011–13), in part driven by the construction of new hydropower projects. The current account deficit is expected to widen as the construction of the Puna and other hydropower projects pick up steam. Pressure on the overall balance of payments, however, is expected to remain manageable as associated loan disbursements from India are also projected to increase.

8. **The risks to this outlook are broadly balanced.** In the near term, growth in India should continue to boost Bhutan's exports, but on the downside, rapid credit growth and overheating could increase vulnerabilities. Over the medium term, implementing key structural reforms is critical to sustaining rapid growth. On the upside, if the development spending crowds in more private sector investment, higher productivity could provide a boost to the economy. Strong growth in India should also continue to underpin export growth. At the same time, private sector development could slow down if implementation capacity constraints are not eased and the provision of infrastructure by the public sector falls short of envisaged levels. Aid inflows — particularly current grants — are expected to decline, as Bhutan's per capita income has risen rapidly over the last decade.<sup>2</sup> Medium term prospects would also suffer if public investment financing needs are not met by domestic revenue.

---

<sup>2</sup> Current grants in the form of budgetary support are projected to decline by 7 percentage points to about 10 percent of GDP over the next couple of years as developing partners scale down their operations. Capital transfers, on the other hand, are tied to hydropower projects and are envisaged to remain high.

*Authorities' views*

9. **The authorities broadly share this assessment.** They forecast similar growth rates in the near term, but expect slightly stronger growth over the longer term. As in staff's baseline scenario, they also project a widening current account deficit (in relation to GDP) as the construction of hydropower projects advances further, followed by a correction from 2018.

10. **The authorities share the staff's view that risks are balanced.** They view them stemming mainly from India's economic situation. Unlike staff, the authorities do not see an immediate risk of overheating, but are monitoring credit growth closely. They agree with the staff that the medium-term challenges revolve around the need to create fiscal space to finance investment as aid inflows decline and the need to implement structural reforms that will boost private sector growth and competitiveness.

### Box 1. Hydropower Sector Issues

Bhutan's hydropower development has been an important driver of its rapid growth since the first major hydropower plant (Chhukha, 336MW) was commissioned in 1988. In 2006, when the 1,020 MW Tala plant came on stream, GDP growth jumped by 5½ percentage points. Currently, the hydropower sector alone constitutes around 20 percent of Bhutan's economy, and growth in electricity production and related construction accounts for about one third of GDP growth.

Bhutan currently harnesses a little over 1,480 MW of hydropower electricity, about 5 percent of its estimated potential. The government aims to achieve a total installed capacity of 10,000 MW by 2020. Construction work of three new projects (Puna-I with a capacity of 1,200 MW, Puna-II with a capacity of 990 MW, and Mangdechhu with a capacity of 720 MW) has commenced, and is expected to be completed by around 2017.

Domestic consumption accounts for only about 20 percent of Bhutan's electricity generation, and low domestic electricity tariffs have been a major contributor to the country's competitiveness. Hydropower exports to India accounts for almost 40 percent of Bhutan's total goods exports in 2009/10, or about 15 percent of GDP. So far, all the major hydropower projects are financed by the Government of India through a combination of loans and grants. Four future projects will be developed as joint ventures with Indian public sector companies with a debt-to-equity ratio of 70:30 and the Indian partner allowed 51 percent equity stake.

The hydropower sector is an important contributor to fiscal revenue, with earnings from the hydropower sector (corporate income tax and transfers of dividends) accounting for 23 percent of total revenue in 2009/10. However, hydro-related revenue as a share of GDP is projected to decline until the new projects come on stream, as the electricity export price is fixed and the construction of the new hydropower plants is exempt from taxes.

Bhutan's hydropower revenue is also subject to strong seasonality due to the seasonal changes in water levels and the lack of water storage capacity. More than 50 percent of the annual revenue is generated in the third quarter. This in turn poses challenges to the government to manage its outflows throughout the fiscal year with volatile resources. Against this background, the government has continued to assess alternatives to develop a strong cash management system based on accurate and timely forecasting of government's cash inflows and outflows to help mitigate the impact of revenue fluctuations and smooth public sector outlays.

When electricity generation shrinks in the dry winter months (January–March), there is a shortage of power for domestic consumers and the country has to import electricity from India at a relatively high cost. As the economy continues to grow rapidly, increasing domestic electricity demand will intensify the seasonal power shortage problem until the new projects are commissioned. Several strategies, including load shedding for power-intensive industries, are being considered by the government to address this issue.

Public debt incurred by the hydropower projects accounts for about half of Bhutan's total debt, which currently stands at around 80 percent of GDP and is projected to exceed 110 percent in 2014/15. The risks of large public and external debt are mitigated by the commercial viability of the hydropower projects, which benefit from India's strong energy demand.

Hydropower Projects in the Pipeline

Project	Capacity (MW)	Construction Schedule	Development Model
Puna-I	1200	2008-2015	IG 1/
Puna-II	990	2010-2016	IG
Mangdechhu	720	2010-2016	IG
Sankosh Storage	4060	2011-2020	IG
Kuri-Gongri	1800	2012-2019	IG
Amochhu Storage	620	2012-2018	IG
Wangchhu Storage	600	2012-2020	JV 2/
Bunakha Storage	180	2012-2018	JV
Kholongchu	650	2012-2018	JV
Chamkharchhu-I	670	2012-2018	JV

Source: Royal Monetary Authority of Bhutan Annual Report 2009/10

1/ Inter-governmental undertakings with the Government of India

2/ Joint venture undertakings with Indian public sector companies

## **Box 2. Dealing with Revenue Volatility**

Fiscal revenue generated by the hydropower sector has been a key contributor to higher public investment in Bhutan. However, due to the nature of the projects execution and financing, hydropower revenue and foreign grants have been highly volatile. For instance, nontax revenue rose from 8.5 percent of GDP in 2005/06 to 17.9 percent in 2008/09 when the Tala project came on stream and paid profit transfers, but declined to 10 percent in 2009/10 when Tala became a corporation and its revenue contribution appeared in corporate tax and dividends instead.

At the macro level, the volatility in revenue reflects in part a narrow tax base and little economic diversification. The share of electricity in aggregate revenue is estimated to average 27 percent during the 10<sup>th</sup> Five Year Plan period (2008/09–2012/13). Grants amount for 37 percent of total revenue, with 80 percent of them tied to specific projects. Other taxable activities raise relatively little revenue: for instance, sales tax was 1.5 percent of GDP in 2008/09, less than half in the average of Asian LICs.

Hydropower revenue is also subject to strong seasonality due to the seasonal changes in water levels. More than 50 percent of the annual revenue is generated in the third quarter of the year. This in turn poses challenges to the government to manage its outflows throughout the fiscal year with volatile resources.

Volatile revenue and grants have often been reflected in volatile public spending, and have had a negative impact on the level of public investment. A medium-term fiscal framework is needed to ensure a sustainable fiscal position while minimizing the impact of volatility on the budget and delivering a more counter-cyclical fiscal policy. In this connection, a smoothing mechanism could be considered that requires the budget to run surpluses in good times and enables fiscal policy to offset the decline in hydro-related revenue and grants.

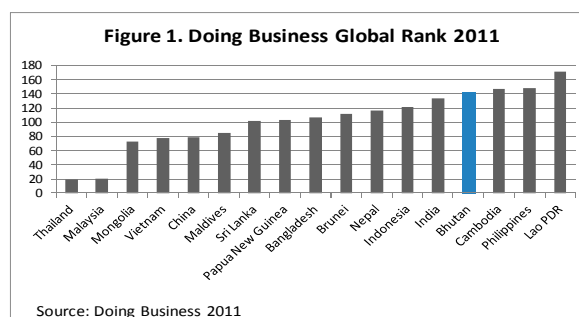
A cash management system based on accurate and timely forecasting of government's cash inflows and outflows can also help mitigate the impact of temporary cash shortfalls and smooth public sector outlays. On this front, the introduction of the T-bills in 2009 is a welcome step.

Efforts are also needed to increase non-hydropower sector revenue to offset the decline in hydropower related revenue as both income tax and dividend payments from hydropower projects are set in nominal terms and thus would decline as a share of GDP. Moreover, the only new power sector project expected to come on stream during the 10<sup>th</sup> Plan is the Dagachu project (114 MW). Options that have received consideration include replacing the existing sales tax with a broader-based value-added tax and unifying the business income tax and personal income tax.

Finally, country experiences show that only those resource-producing countries with a sound institutional framework and a robust Public Financial Management system have managed to effectively deal with the “resource curse”.

### Box 3. Ease of Doing Business in Bhutan

Bhutan's economy is dominated by the hydropower sector, but other economic activities are underdeveloped, partly because it lags behind most emerging economies in Asia on ease of doing business. In *Doing Business 2011*, Bhutan ranks 142<sup>nd</sup> among the 183 economies, and its performance is particularly weak in categories of getting credit, protecting investors, trading across borders, and closing a business.



The “getting credit” indicator reflects credit information registries and the effectiveness of collateral and bankruptcy laws in facilitating lending. Even though credit to the private sector is growing fast in Bhutan, access to finance is considered a major constraint to private sector development. The time firms spend to comply with government regulations and the associated costs are higher compared to regional and international averages. Given the country's landlocked geography, the cost of transportation and trading across borders is high.

For countries that rely heavily on exports, improving the ease of doing business can facilitate the growth in non-tradable sectors through better allocation of capital and labor. This is particularly relevant for Bhutan as it attempts to diversify non-hydropower sectors. The experience of other small LIC economies can be useful. Zambia, a major copper producer, was named among the top ten economies that have improved the ease of doing business by the World Bank's *Doing Business 2011*. The Zambian government made significant progress in implementing its private sector development reform program (PSDRP). Cost of doing business was reduced by eliminating the minimum capital requirement, computerizing customs declarations and introducing an electronic case management system in courts. Although the economy will continue to rely on copper production and export, development in the domestic sectors such as construction is widely expected to play a more important role in the country's growth prospect. It is hard to disentangle the boom in non-exporting sectors from the benefits accrued in the export sectors, especially when the country is experiencing a terms of trade led boom. Nonetheless, the experience of Zambia shows that it is possible to achieve fast gains in Doing Business indicators by implementing economic reforms. Empirical study also suggests that improving from the worst quartile of business regulations to the best implies a 2.3 percentage point increase in annual growth.

Bhutan's Vision 2020 pictures that while the country's economic future will be driven by hydropower investments, the economy will also be well balanced and sufficiently diversified as a thriving high-value added agriculture sector, a clean manufacturing base, and a burgeoning hospitality industry start growing rapidly. These non-hydro power sectors are also expected to contribute in very significant ways towards generating productive employment for the growing numbers of youth entering the labor market. Improving the ease of doing business will support diversifying the resources of growth and help achieve these goals. In particular, resources need to be allocated to human capital investment, especially in tertiary education and vocational training, to create a skilled domestic labor force.

### III. POLICY DISCUSSIONS: PRESERVING MACROECONOMIC STABILITY AND SUSTAINING STRONG GROWTH

*A recalibration of policy settings is desirable to ensure that the forward momentum continues. The RMA should adjust monetary settings to help curb credit growth and step up its monitoring of financial institutions. The fiscal framework could be bolstered by the introduction of a spending ceiling that would increase the predictability of current expenditure over the near and medium term. The authorities' goals of diversifying the economic base as outlined in the new Economic Development Policy (EDP) are appropriate, but tax incentives should be carefully evaluated.*

#### A. Fiscal Policy

##### **Background**

**11. Fiscal policy has been accommodative, which has contributed to the risk of overheating.** In 2009/10, the current balance declined to an estimated surplus of 4 percent of GDP and is anticipated to fall further to 2 percent of GDP in 2010/11. The overall balance is estimated at about 2½ percent of GDP in 2009/10 (compared with a deficit of 6 percent envisaged in the revised budget), but is also expected to drop sharply to *minus* 4.5 percent of GDP in 2010/11. The deterioration in the overall balance reflects: (i) a decline in non-tax revenue; (ii) sluggishness in tax revenue; (iii) higher current spending following a 35 percent hike in civil servant wages in January 2009 and 20 percent in early 2011; and (iv) an increase in capital spending.<sup>3,4</sup>

**12. The overall balance excluding the hydropower sector (mostly corporate income tax and profit transfers) is also projected to deteriorate in the near term** due to higher public investment and the decline in grants. In the medium and longer term, buoyancy of non-hydropower tax revenue (due to base broadening) and the planned decline in spending will bring down the non-hydropower deficit from 10 percent of GDP to 6 percent of GDP.

**13. Public debt has risen owing to new hydropower projects.** After declining by nearly 20 percentage points to 68 percent of GDP between 2005 and 2009, public debt has increased in 2009/10 due to the start of new hydropower projects. Public debt is expected to rise further to

---

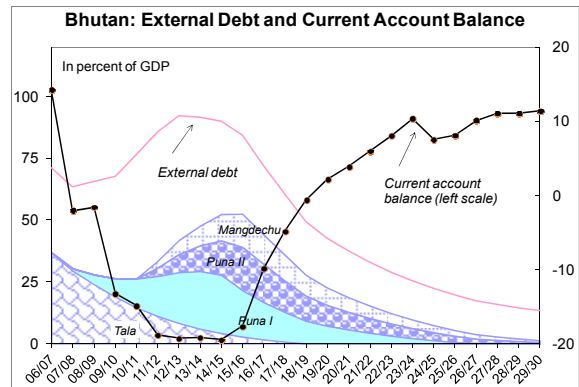
<sup>3</sup> Before 2009, nontax revenue included profit transfers and interest payments from the Tala project. When Tala becomes a corporation, its revenue contribution appears in corporate income tax instead. Since operating profits are still increasing, tax revenue has not offset the drop in nontax receipts.

<sup>4</sup> Data revisions have been sizable. Generally, they have been due to under-execution of capital spending.



81 percent of GDP by the end of the current fiscal year as a result of investments in the hydropower sector and rising current spending.

14. **The debt sustainability analysis (DSA) shows a moderate but still significant risk of distress as most indicative debt thresholds are temporarily breached.** Based on the DSA, public debt is projected to exceed 110 percent of GDP in 2014/15. As in previous consultations, based on the LIC-DSA thresholds, these levels put Bhutan at risk of debt distress. However, in the staff's assessment, the risks are mitigated by the concentration of debt in commercially viable hydropower projects, which account for about half of total debt and benefit from India's strong energy demand. Other mitigating factors are important, including Bhutan's strong project implementation record and good governance, as well as a comfortable reserve position. Also, operational risks for specific projects (including those related to natural disasters) are significantly reduced as debt repayments are stopped if electricity cannot be delivered to India.



### *Staff Advice*

15. **While fiscal policy has been generally prudent, the current fiscal settings pose challenges from both a near-term and a longer-term perspective.**

- *In the near term, fiscal policy should be tightened to address overheating.* This can be achieved by cutting non-priority current spending and saving any revenue overperformance. A fiscal tightening of about 2 percent of GDP (combined) in 2011 and 2012 would be desirable to help cool growth in aggregate demand. The proposed fiscal adjustment would encompass primarily current spending and could entail spending reallocation toward capital projects and other projects with high social returns, especially in case of grant shortfalls.<sup>5</sup> Tax administration should be improved to help reverse the sluggishness in tax revenue.
- *To bolster the fiscal framework, the Royal Government of Bhutan (RGB) could consider introducing a nominal ceiling on current spending (excluding interest).* The spending ceiling would increase the predictability of fiscal policy and at the same time reduce its procyclicality (e.g., the ceiling would link wage adjustments to inflation forecasts). Over time, this ceiling would also help create fiscal space, which could be used to: (i) finance

<sup>5</sup> Broadly, the proposed tightening would amount to a negative fiscal impulse over the next two years.

capital spending as aid inflows are projected to decline, and (ii) increase social spending should food and energy prices rise significantly from current levels.<sup>6</sup> The classification of spending would have to be monitored closely, as the proposed ceiling would not encompass capital spending, which is financed mostly with capital grants. The spending ceiling is based on debt sustainability considerations, and aims to maintain domestic financing contained. Escape clauses could address tail risks such as natural disasters, while the fiscal space would provide flexibility in the reallocation of spending. The proposed ceiling could take the form of an amendment to the existing fiscal rule that stipulates that current spending should be covered by domestic revenue.

- *In the medium term, domestic financing should remain limited to ensure sustainable debt dynamics, which requires both revenue and expenditure reforms.* The revenue base should be broadened to reduce revenue volatility and the dependence on the hydropower sector and external financing (see Box 2). Introducing the VAT and improving tax administration should remain key priorities. Implementation of multi-year rolling budgets, including by specifying three-year rolling ceilings on current spending consistent with medium term revenue, could better align spending plans with policy priorities and revenues.<sup>7</sup>

### *Authorities' views*

16. **While the authorities view fiscal policy as having been generally prudent, they concurred that at the moment fiscal settings pose challenges.** They underscored that fiscal measures will be aimed at ensuring that domestic revenue continues to finance current spending. They also noted that while the wage hikes will need to be financed with higher tax revenues, non-priority spending should be cut to help create fiscal space.

17. **Regarding medium term fiscal risks, the authorities underscored that there is a need to boost revenue to address the envisaged decline in foreign aid flows.** They were receptive to the staff's proposal to create a nominal current spending ceiling to help with the implementation of medium-term budgets, but added that any such measure would not address the need for more revenue over the medium term. The authorities also highlighted that revenue measures, including broadening the tax base and improving tax administration, must be implemented as tax incentives will likely have an impact on tax buoyancy going forward. Finally, the authorities broadly agreed with the medium- and long-term debt projections underlying the staff's DSA.

---

<sup>6</sup> Creating fiscal space will also be important to address declining hydropower-related revenue (in relation to GDP) during the construction of new plants.

<sup>7</sup> Over time, the multi-year budget framework would also help reduce prospective fiscal revisions, as the revised budget would better reflect interim spending in relation to the overall multi-year envelope.

Nonetheless, they reiterated that the commercial viability of the projects, implementation capacity, and donor support, should allay any concerns about the rapid debt buildup.

## B. Monetary and Financial Sector Policies

### *Background*

18. **Recently inflation has accelerated and become more volatile, reflecting price developments in India, but also accommodative domestic policies.** Monetary policy has been hampered by a weak transmission mechanism, as evidenced by persistent excess liquidity in the banking system, averaging 40 percent of reserve money in 2010. Short-term interest rates have declined since end-2009 to 2 percent in early 2011 (negative in real terms), and the spread with Indian money market rates is currently at *minus* 500 basis points (compared with a historical average of *minus* 250-300 basis points, see Figure 2).

19. **Financial stability indicators have remained stable.** With limited financial linkages to advanced economies, Bhutan's financial sector has weathered the global financial crisis largely unscathed. Private sector credit growth, however, has accelerated to nearly 45 percent yoy, driven by housing and construction sectors as well as personal loans.<sup>8</sup> Banks' CAR was 17 percent in September 2010. While remaining volatile due to seasonality, the gross NPL ratio of the financial system fell to 8.6 percent as of September 2010 from 15.6 percent at end-September 2009. While the decline in NPLs reflects rapid credit growth, it is also driven by loan recoveries. Loan provisions (as a percent of NPL) increased by 4 percentage points to 43.6 percent.

### *Staff advice*

20. **Monetary conditions need to be tightened to lower excess liquidity and credit growth.** In the near term, the RMA should raise interest rates to help cool down aggregate demand. This would reduce imports and consequently the demand for Indian rupees. Over the medium term, the RMA should continue to take steps to improve liquidity management, including by promoting the development of the interbank market in conjunction with the Ministry of Finance.

21. **Rapid credit growth also warrants close monitoring.** The RMA should stand ready to adjust existing prudential regulations and norms, such as general provisioning, to help curb large exposures to specific sectors. These steps would bolster the capacity of Bhutan's financial system to withstand a potential deterioration in asset quality and strains in funding, especially for the new banks.

---

<sup>8</sup> Private sector credit to GDP has nearly doubled since 2006, reaching 40 percent at end-June 2010.

22. **Financial sector supervision should be strengthened, especially in light of greater competition in the banking sector.** While the entry of new banks should improve financial intermediation, it may also increase credit risk and other systemic vulnerabilities stemming from rapid credit growth. The RMA should ensure that major commercial banks and other financial institutions conduct stress tests on a periodic (quarterly) basis and report their findings to the RMA.

### *Authorities' views*

23. **While the authorities agreed on the need to monitor credit growth closely, they did not see the need for higher interest rates at this juncture.** In addition, they noted that while higher interest rates would help keep *prospective* credit growth in check, they would reduce the RMA's profitability as the monetary authority would have to bear the interest cost of mopping up the excess liquidity. The authorities also added that further fiscal tightening would alleviate the need for monetary measures to address the high credit growth situation.

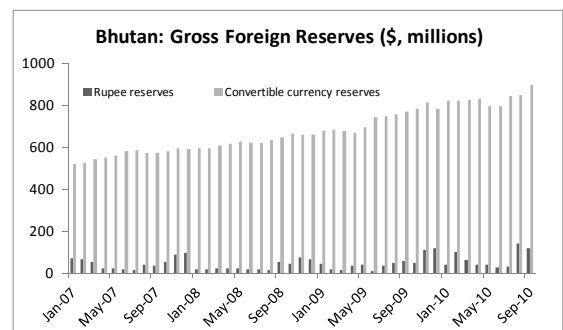
24. **The authorities highlighted that they are closely monitoring financial sector risks and that banks have been properly assessing risks, as evidenced by the level of NPLs.** They also noted that the high credit growth environment has been a feature of a low-income economy such as Bhutan. The authorities have agreed, however, that further engaging the banks by conducting periodic stress tests would help the strong credit culture and allow a better understanding of the underlying financial system risks.

## C. External Sector and Structural Issues

### *Background*

25. **The real effective exchange rate (REER) has been stable and close to its ten-year average (Figure 1).** There has been some recent appreciation of the REER in 2010 as inflation accelerated, but the REER is estimated to be only 5 percent above its historical average. Despite the somewhat sluggish performance of exports, debt service has remained stable in relation to exports of goods and services. While wages in the public sector have risen significantly due to hikes in the last two years, anecdotal evidence indicates that wage inflation in the private sector (formal and informal) remains contained.

26. **Despite large trade deficits arising from hydropower-related imports, aid inflows have led to balance of payments surpluses over the past 5 years.** The current account deficit is increasingly due to the construction of the Puna hydropower project (Phase I). Pressure on the overall balance of



payments, however, is expected to remain contained as associated loan disbursements from India are also projected to increase. The reserve position is comfortable, with import coverage at about 10½ months. The convertible currency reserves (currently about 90 percent of the total) have been rising steadily, in part due to strong donor inflows. Though rising sharply in 2010, rupee reserves have remained volatile and cover only about 2¼ months of rupee denominated imports.

27. **Government policies envisage economic diversification over the medium term.** While Bhutan has enjoyed robust growth driven by the hydropower sector, the new EDP launched in early 2010 envisages diversification of the economy. The EDP's goals encompass rapid growth in merchandise exports and a boost to the service sector through a combination of various tax incentives. The initiatives in the EDP also include “green” sectors, consistent with Bhutan's emphasis on sustainable development.

### *Staff Advice*

28. **Being close to its historical average, the ngultrum remains broadly in line with its medium-term equilibrium level and its parity with the Indian rupee is appropriate.** Given Bhutan's strong ties with India, the peg to the rupee is deemed appropriate and has contributed to trade integration between the two countries. Nevertheless, fiscal and monetary tightening would help contain appreciation pressures that have appeared recently. Over the medium term, productivity improvements can help offset the impact of any real exchange rate appreciation.

29. **The large number of hydropower projects in the pipeline and volatile hydropower exports to India will likely contribute to volatility in rupee reserves, requiring a more active reserve management.** The authorities could consider revisiting the import coverage floor for convertible currencies to reduce the costs of drawing on the rupee credit lines. While the rupee credit lines play a useful role in addressing short-term mismatches in rupee inflows and outflows, they have become relatively costly given the low yield on convertible currencies. Over the medium term, export diversification beyond the hydropower sector (e.g., tourism), as highlighted in the EDP, would also help. The authorities should also carefully assess the cost of tax incentives provided under the EDP. In this regard, the authorities could consider reforms that could lower the cost of doing business as a more effective way to develop new sectors (see Box 3).

### *Authorities' views*

30. **The authorities agreed with the staff's assessment of the exchange rate level.** They also agreed that tightening aggregate demand policies, including by containing credit growth would help contain balance of payment pressures and the demand for Indian rupees. They underscored that the level of convertible currencies reserves is important for the credibility of the peg, but recognized that more flexibility in reserve management can be obtained by lowering the convertible currencies import coverage floor to prudent levels, based on balance of payments

stress tests. They stressed that while they have not experienced signs of Dutch disease, they monitor the level of the real exchange rate closely and are actively taking measures to improve competitiveness by providing incentives for private sector development.

31. **The authorities reiterated that existing exchange rate restrictions on current account transactions were needed since Bhutan's international reserves have been built largely on aid flows.** They recognized that such restrictions could be eased gradually as exports strengthen.

#### IV. STAFF APPRAISAL

32. **Bhutan's growth has remained robust and its medium-term prospects are favorable, but implementing structural reforms is critical to ensuring sustainable growth.** The economy is expected to grow at 8 percent this year and to continue growing strongly over the medium term, underpinned by the hydropower sector (including associated construction), manufacturing, and services. Risks to growth seem broadly balanced but medium term prospects depend on addressing overheating and implementing critical reforms. Inflation is expected to remain high, reflecting price developments in India.

33. **With rapid growth and elevated inflation, monetary and fiscal policies should be tightened to reduce the risk of overheating.** The near-term fiscal objectives are likely to be met, but saving any revenue overperformance and cutting non-priority spending would help contain aggregate demand. Monetary tightening by raising interest rates would also help cool credit growth, and prevent balance of payment pressures.

34. **In light of rapid credit growth, financial sector supervision should be strengthened.** While the financial sector is benefiting from rapid growth so far, enhancing the monitoring of financial institutions is important to better assess system wide risks that could be masked by high credit growth and spurred by greater competition in the banking system.

35. **Fiscal policy should be tightened in the near term to address overheating, and spending and revenue reforms are needed to bolster the fiscal framework.** Over the medium term, the sluggishness in tax revenues should be reversed and fiscal space needs to be created to address declining foreign aid inflows and finance much-needed public infrastructure. Also, establishing a nominal ceiling on current spending would help create fiscal space over time and would make fiscal policy more countercyclical. The revenue base should be broadened to increase tax buoyancy. Multi-year rolling budgets should also be implemented to better align spending plans with fiscal resources and policy priorities.

36. **Bhutan's exchange rate peg against the India rupee has served the country well by helping deliver macroeconomic stability.** The real effective ngultrum has appreciated only modestly and has been close to its long-term average. There are no obvious signs of Dutch

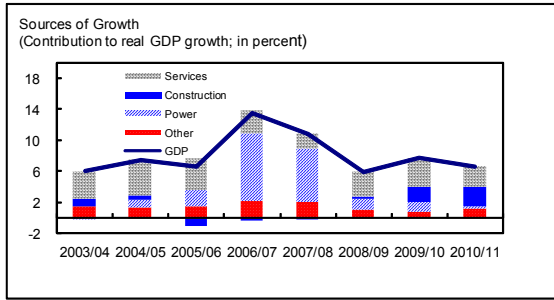
disease so far and the authorities are taking measures to ensure that competitiveness is sustained over the medium term mainly by promoting the diversification of the economy. Bhutan will continue to enjoy robust growth driven by the hydropower sector, but job creation in that sector is unlikely to be sufficient to absorb Bhutan's prospective labor force. The comprehensive strategy embedded in the EDP identifies activities that have strong job-generating potential and promotes foreign direct investment and private sector development. Moreover, the thrust of the EDP is in harmony with Bhutan's sustainable development strategy and its focus on GNH.

37. **Bhutan maintains restrictions under Article XIV.** A careful and gradual easing of these exchange restrictions would facilitate Bhutan's acceptance of the obligations under Article VIII of the IMF's Articles of Agreement with minimal impact on the balance of payments. Bhutan also maintains an exchange restriction subject to Fund approval under Article VIII, Section 2(a). Staff does not recommend approval of this restriction as the authorities have not provided a timeframe for its removal.

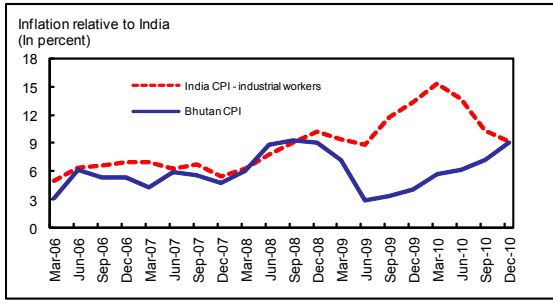
38. It is recommended that the next Article IV consultation take place on the 24-month cycle in accordance with the *Decision on Article IV Consultation Cycles* (Decision No. 14747-(10/96) (9/28/2010)).

Figure 1. Bhutan: Real and External Sector Developments

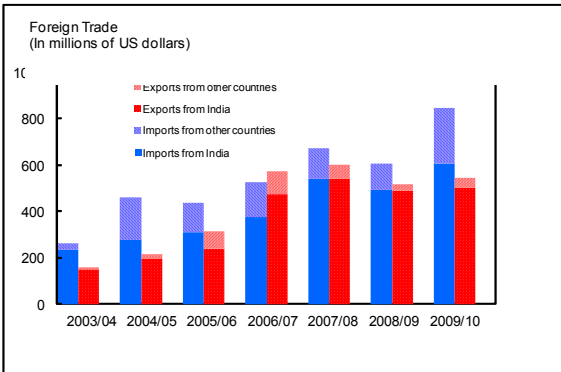
After the commission of the Tala hydropower project in 2007, growth has moderated though remains strong.



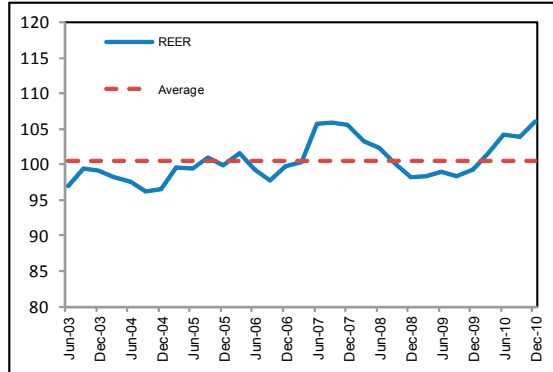
Inflation has risen, following price developments in India,...



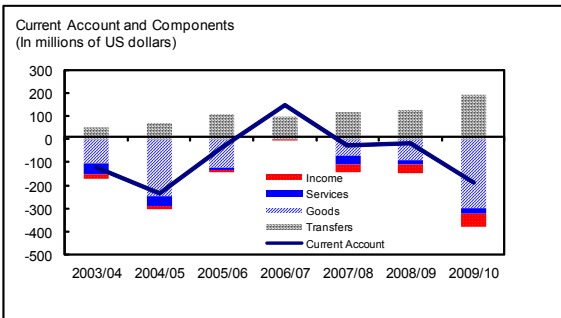
...which remains Bhutan's most important trading partner.



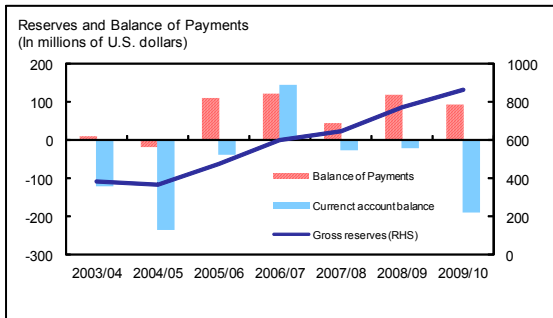
The real exchange rate has appreciated in 2010, but is broadly in line with the historical average.



The current account swung into deficit as debt service of the Tala hydropower project began and the construction of the Puna I project started.



However, with adequate foreign inflows, overall reserves rose.

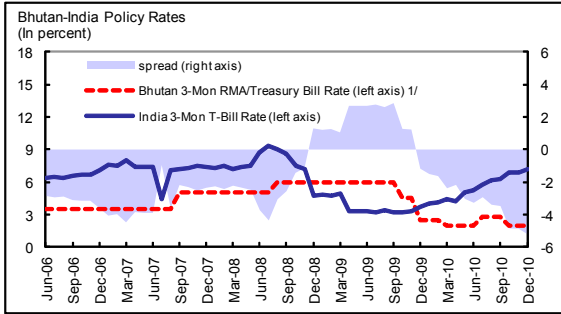


Sources: IMF, International Financial Statistics; Royal Monetary Authority of Bhutan; and IMF staff calculations.

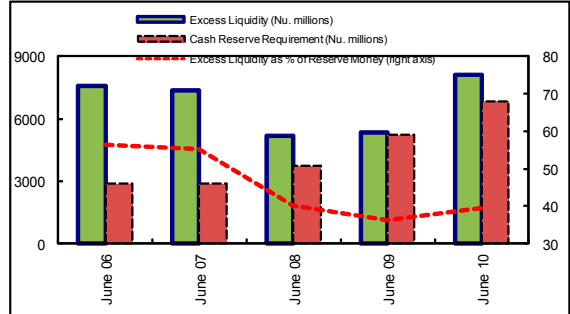


Figure 2. Bhutan: Monetary, Financial and Fiscal Developments

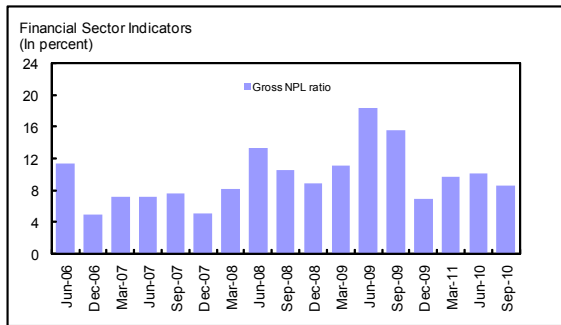
The policy rate spread with India has turned negative...



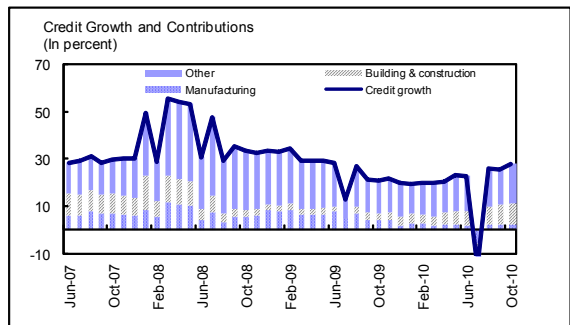
...and while excess liquidity has come down, it has remained large.



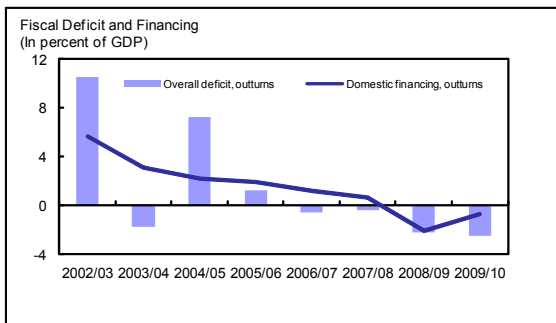
Although the NPL ratio has improved ...



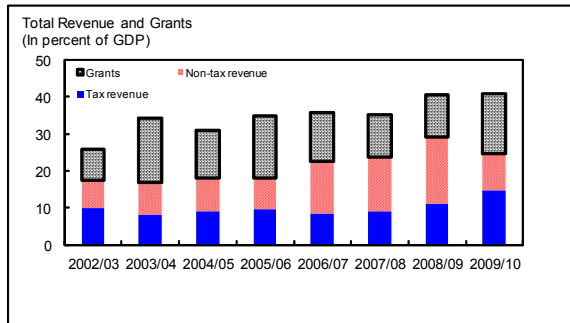
...credit growth has been strong, particularly in construction.



Fiscal performance has deteriorated somewhat since 2008/09...



...reflecting sluggish non-tax revenue and volatile foreign grants.



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

1/ RMA bill was replaced by treasury bill in December 2009.

**Table 1. Bhutan: Selected Economic and Financial Indicators, 2007/08–2011/12 1/**

Nominal GDP (2009): US\$1,265 million

Population (2009): 0.697 million

GDP per capita (2009): US\$1,815

Quota: SDR 6.3 million

	2007/08	2008/09	2009/10 Est.	2010/11 Proj.	2011/12 Proj.
<b>Real sector</b>					
Real GDP at market prices (percent change)	10.8	5.7	7.5	8.2	8.3
Consumer prices (percent change, period average)	6.3	7.1	4.8	6.8	5.8
Nominal GDP (at market prices; billions of ngultrum)	52.1	58.0	66.2	76.4	87.8
<b>General government</b> (In percent of GDP)					
Total revenue and grants	35.1	35.6	41.0	39.5	30.9
Tax revenue	9.0	9.9	13.6	13.5	12.9
Non-tax revenue	14.7	14.4	10.1	8.7	7.9
Foreign grants	11.4	11.3	17.3	17.3	10.1
Total expenditure and net lending	34.7	33.3	38.4	44.1	37.7
Current expenditure	18.7	19.1	19.5	20.1	19.4
Capital expenditure	19.2	16.9	19.5	25.2	19.6
Current balance (excluding grants)	5.0	5.2	4.1	2.1	1.4
Overall balance	0.4	2.3	2.5	-4.6	-6.8
Public sector debt 2/	66.2	67.7	70.9	81.3	95.3
<b>Monetary sector 3/</b> (Percent change, unless otherwise indicated)					
Broad money	2.3	24.6	30.1	26.7	...
Credit to private sector	39.7	29.3	41.1	45.5	...
<b>Interest rates (end of period, in percent)</b>					
Deposits (less than 1 year)	4.8	4.8	5.0	5.0	...
Lending	10-16	10-16	10-16	10-16	...
<b>External sector</b> (In millions of dollars, unless otherwise indicated)					
Current account balance	-27	-20	-188	-224	-313
(In percent of GDP)	-2.1	-1.6	-13.2	-14.9	-18.8
Trade balance	-72	-90	-299	-347	-347
Exports (goods)	599	516	544	549	583
(percent change)	4.4	-13.8	5.5	0.8	6.3
Imports (goods)	671	607	843	896	930
(percent change)	27.4	-9.6	39.0	6.3	3.9
Grants (current transfer)	161	151	270	291	188
Capital account balance	140	106	150	243	335
Loans (net)	25	88	47	136	160
Overall balance	45	119	94	19	22
(In percent of GDP)	3.5	9.8	6.7	1.3	1.3
Gross official reserves	646	773	868	887	909
(In months of goods and services imports)	11.4	9.9	10.5	10.3	9.6
External debt (in percent of GDP)	63.5	65.6	67.7	76.5	85.8
Of which: power sector debt	38.9	35.5	34.7	37.4	45.9
Debt service ratio (in percent of G&S exports)	14.2	13.4	14.3	13.9	14.2
<b>Memorandum items:</b>					
Electricity exports (in percent of total goods exports)	41.9	42.3	39.2	36.1	31.0
Unemployment rate (in percent) 4/	3.7	4.0	3.3	...	...

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

1/ Fiscal year begins July 1.

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

3/ End-November 2010 data for 2010/11.

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

**Table 2. Bhutan: Government Budget Summary, 2007/08–2011/12**

	2007/08	2008/09	2009/10 Est.	2010/11 Proj.	2011/12 Proj.
(In millions of ngultrum)					
Revenue and grants	18,282	20,624	27,107	30,173	27,132
Domestic revenue	12,346	14,049	15,638	16,963	18,278
Tax revenue	4,666	5,725	8,975	10,282	11,337
Nontax revenue	7,681	8,324	6,663	6,680	6,941
Foreign grants	5,935	6,575	11,469	13,211	8,854
From India	4,671	4,395	7,306	9,082	7,129
Other	1,264	2,180	4,163	4,129	1,725
Expenditure and net lending	18,065	19,310	25,431	33,683	33,139
Current expenditure	9,726	11,061	12,903	15,342	17,045
Wages and salaries	3,525	4,560	5,599	6,247	6,904
Goods and services	3,928	4,160	4,919	6,288	6,965
Subsidies and transfers	554	607	641	740	850
Interest	1,719	1,734	1,743	2,067	2,326
Capital expenditure	9,993	9,829	12,929	19,217	17,244
Net lending	-1,654	-1,580	-400	-876	-1,150
Current balance (excl. grants)	2,620	2,988	2,736	1,621	1,232
Overall balance	216	1,314	1,676	-3,509	-6,007
Foreign financing	-1,319	-1,219	-483	785	1,039
Disbursement	758	833	2,252	3,015	3,658
Amortization	2,077	2,052	2,736	2,229	2,619
Domestic financing	1,103	-95	-1,193	2,724	4,968
(In percent of GDP, unless otherwise indicated)					
Revenue and grants	35.1	35.6	41.0	39.5	30.9
Domestic revenue	23.7	24.2	23.6	22.2	20.8
Tax revenue	9.0	9.9	13.6	13.5	12.9
Nontax revenue	14.7	14.4	10.1	8.7	7.9
Foreign grants	11.4	11.3	17.3	17.3	10.1
From India	9.0	7.6	11.0	11.9	8.1
Other	2.4	3.8	6.3	5.4	2.0
Expenditure and net lending	34.7	33.3	38.4	44.1	37.7
Current expenditure	18.7	19.1	19.5	20.1	19.4
Capital expenditure	19.2	16.9	19.5	25.2	19.6
Net lending	-3.2	-2.7	-0.6	-1.1	-1.3
Current balance (excl. grants)	5.0	5.2	4.1	2.1	1.4
Overall balance	0.4	2.3	2.5	-4.6	-6.8
Foreign financing	-2.5	-2.1	-0.7	1.0	1.2
Disbursement	1.5	1.4	3.4	3.9	4.2
Amortization	4.0	3.5	4.1	2.9	3.0
Domestic financing	2.1	-0.2	-1.8	3.6	5.7

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

Table 3. Bhutan: Balance of Payments, 2007/08–2014/15

	2007/08	2008/09	2009/10 Prov.	2010/11	2011/12	2012/13 Proj.	2013/14	2014/15
(In millions of U.S. dollars)								
Current account	-27	-20	-188	-228	-316	-361	-404	-456
Trade balance	-72	-90	-299	-347	-347	-398	-461	-535
Exports, f.o.b.	599	516	544	549	583	623	665	721
Of which: electricity	251	218	213	198	181	174	191	192
Imports, c.i.f.	-671	-607	-843	-896	-930	-1,022	-1,126	-1,256
Services	-39	-19	-22	-22	-16	-12	-8	-4
Credit	55	57	69	74	84	97	112	130
Debit	-93	-75	-90	-96	-100	-109	-120	-134
Income	-32	-37	-57	-60	-66	-76	-78	-74
Credit	35	21	16	17	18	18	20	21
Debit	-68	-58	-73	-77	-84	-94	-97	-95
Of which: interest payments 1/	-43	-35	-43	-43	-45	-46	-46	-48
Current transfers	117	126	190	201	113	126	142	158
Credit	168	162	223	236	152	170	191	212
Of which: grants 2/	161	151	270	286	184	205	231	257
Debit	-51	-36	-34	-36	-39	-44	-49	-55
Capital and financial account	140	106	150	243	335	446	466	627
Capital transfer 3/	16	30	80	87	135	179	228	349
Foreign direct investment	30	15	11	21	41	66	71	73
Portfolio investment	0	0	0	0	0	0	0	0
Loans (net)	25	88	47	136	160	202	166	205
Disbursements	36	129	91	180	210	253	235	279
Amortization 1/	11	41	44	44	50	51	68	74
Other flows 4/	69	-26	12	0	0	0	0	0
Errors and omissions	-68	33	132	0	0	0	0	0
Overall balance	45	119	94	14	19	86	62	171
(In percent of GDP, unless otherwise indicated)								
Memorandum items:								
Current account balance	-2.1	-1.6	-13.2	-15.2	-19.0	-19.4	-19.3	-19.6
Trade balance	-5.6	-7.5	-21.1	-23.1	-20.9	-21.5	-22.0	-23.1
Merchandise exports (percent change)	4.4	-13.8	5.5	0.8	6.3	6.9	6.7	8.4
Merchandise imports (percent change)	27.4	-9.6	39.0	6.3	3.9	9.8	10.2	11.6
External debt	63.5	65.6	67.7	76.5	85.8	92.1	91.5	90.1
(In millions of U.S. dollars)	819	796	961	1,152	1,428	1,709	1,913	2,089
(In percent of exports of goods and services)	125.4	139.1	156.7	185.2	214.0	237.2	246.2	245.5
Debt service (in percent of exports of goods and services)	14.2	13.4	14.3	13.9	14.2	13.5	14.7	14.3
(In millions of U.S. dollars)	93	77	88	87	94	97	114	122
Gross official reserves (in millions of U.S. dollars)	646	773	868	883	902	987	1,048	1,219
(In months of imports of goods)	12.8	11.0	11.6	11.4	10.6	10.5	10.0	10.5
(In months of imports of goods and services)	11.4	9.9	10.5	10.3	9.6	9.5	9.0	9.5
Ngultrum per U.S. dollars (fiscal year average)	40.4	47.8	46.7	...	...	...	...	...
Nominal GDP (in millions of U.S. dollars)	1,291	1,214	1,419	1,506	1,665	1,854	2,091	2,320

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

1/ Debt service for Tala 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: Monetary Survey, 2006/07–2010/11

	2006/07	2007/08	2008/09	2009/10	2010/11 1/
Monetary survey	(In millions of ngultrum)				
Net foreign assets	24,459	25,923	33,074	35,236	41,994
Indian rupee	795	-835	-3,259	-3,071	2,794
Other	23,664	26,757	36,333	38,307	39,200
Net domestic assets	750	-142	-961	6,542	12,868
Net claims on government 2/	-2,010	-2,265	-4,204	-4,047	-431
Claims on nongovernment	12,073	15,627	19,937	27,184	28,751
Public enterprises	1,243	1,168	1,111	612	613
Joint enterprises	228	78	355	51	...
Non bank financial institutions	718	568	610	1,325	...
Private sector	9,884	13,812	17,861	25,196	28,138
Other items (net) 3/	-9,313	-13,504	-16,693	-16,594	-15,452
Broad money	25,209	25,781	32,114	41,779	54,862
Narrow money	13,542	14,392	18,374	22,538	27,706
Currency	3,166	3,641	4,541	5,387	5,587
Demand deposits	10,376	10,752	13,833	17,151	22,119
Quasi-money 4/	11,666	11,388	13,740	19,241	27,156
Royal Monetary Authority					
Net foreign assets	20,988	24,571	31,318	32,777	41,770
Indian rupee	136	-1,609	-3,799	-4,363	4,388
Other	20,852	26,180	35,116	37,140	37,382
Net domestic assets	-7,669	-11,700	-16,621	-12,202	-13,637
Net claims on government	-2,010	-2,265	-4,204	-4,047	...
Claims	0	0	0	0	...
Minus: deposits	2,010	2,265	4,204	4,047	...
Claims on deposit money banks	22	147	44	633	...
Claims on private sector	12	15	17	18	...
Minus: RMA bills	200	2,000	2,000	21	...
Other items (net)	-5,492	-7,597	-10,478	-8,785	...
Reserve money	13,319	12,871	14,697	20,575	28,133
Memorandum items:					
	(Change in percent of initial stock of broad)				
Broad money	8.6	2.3	24.6	30.1	26.7
Net foreign assets	10.1	5.8	27.7	6.7	3.9
Net domestic assets	-1.5	-3.5	-3.2	23.4	22.8
Net claims on government	-5.9	-1.0	-7.5	0.5	7.9
Claims on private sector	11.0	15.6	15.7	22.8	20.3
Other items (net)	-7.6	-16.6	-12.4	0.3	-1.8
	(Change in percent of initial stock of reserve money)				
Reserve money	-1.2	-3.4	14.2	40.0	23.6
Net foreign assets	17.0	26.9	52.4	9.9	24.9
Net domestic assets	-18.1	-30.3	-38.2	30.1	-1.3
Money multiplier	1.9	2.0	2.2	2.0	2.0
Velocity of money	1.8	2.0	1.8	1.6	1.4
Broad money/GDP	0.56	0.49	0.55	0.63	0.72
Broad money growth (12-month percent change)	8.6	2.3	24.6	30.1	26.7
Reserve money growth (12-month percent change)	-1.2	-3.4	14.2	40.0	23.6
Credit to private sector (12-month percent change)	34.6	39.7	29.3	41.1	45.5

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

1/ Provisional data as of end-November 2010.

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

3/ Includes foreign exchange valuation adjustments and capital accounts.

4/ Includes time and foreign currency deposits.

**Table 5. Bhutan: Medium-Term Macroeconomic Framework, 2007/08–2014/15**

	2007/08	Tenth Plan Period					2013/14	2014/15
		2008/09	2009/10	2010/11	2011/12	2012/13		
			Est.			Proj.		
<b>Real sector (percent change)</b>								
Real GDP at market prices	10.8	5.7	7.5	8.2	8.3	8.2	9.7	8.6
Consumer prices (period average)	6.3	7.1	4.8	6.8	5.8	4.8	4.3	4.0
<b>Fiscal sector (in percent of GDP)</b>								
Revenue and grants	35.1	35.6	41.0	39.5	30.9	30.4	29.3	29.2
Domestic revenue 1/	23.7	24.2	23.6	22.2	20.8	20.3	19.3	19.1
<i>Of which</i> : tax revenue	9.0	9.9	13.6	13.5	12.9	12.8	12.3	12.3
Grants	11.4	11.3	17.3	17.3	10.1	10.1	10.1	10.1
Expenditure and net lending	34.7	33.3	38.4	44.1	37.7	35.8	33.7	33.2
Current expenditure	18.7	19.1	19.5	20.1	19.4	18.6	17.5	16.8
<i>Of which</i> : interest 2/	3.3	3.0	2.6	2.7	2.6	2.6	2.4	2.5
Capital expenditure	19.2	16.9	19.5	25.2	19.6	18.7	17.8	17.8
Net lending 3/	-3.2	-2.7	-0.6	-1.1	-1.3	-1.6	-1.6	-1.4
Current balance (excl. grants)	5.0	5.2	4.1	2.1	1.4	1.7	1.8	2.3
Overall balance	0.4	2.3	2.5	-4.6	-6.8	-5.3	-4.3	-4.0
External financing 3/	-2.5	-2.1	-0.7	1.0	1.2	2.1	-1.9	-2.7
Domestic financing	2.1	-0.2	-1.8	3.6	5.7	3.2	6.2	6.7
<b>External sector (in millions of U.S. dollars)</b>								
Current account balance (including grants)	-27	-20	-188	-224	-313	-357	-400	-451
(In percent of GDP)	-2.1	-1.6	-13.2	-14.9	-18.8	-19.3	-19.1	-19.5
Trade balance	-72	-90	-299	-347	-347	-398	-461	-535
Exports	599	516	544	549	583	623	665	721
Imports	671	607	843	896	930	1022	1126	1256
Services, income, and transfers (net)	46	71	111	123	34	41	60	84
<i>Of which</i> : grants	161	151	270	291	188	209	236	261
Capital and financial account balance 4/	140	106	150	243	335	446	466	627
<i>Of which</i> : foreign direct investment	30	15	11	21	41	66	71	73
<i>Of which</i> : loans (net)	25	88	47	136	160	202	166	205
Overall balance	45	119	94	19	22	89	66	176
(In percent of GDP)	3.5	9.8	6.7	1.3	1.3	4.8	3.1	7.6
Gross foreign reserves (in millions of U.S. dollars)	646	773	868	887	909	997	1062	1238
(In months of goods and services imports)	11.4	9.9	10.5	10.3	9.6	9.6	9.2	9.7
External debt (public and private, in percent of GDP)	63.5	65.6	67.7	76.5	85.8	92.1	91.5	90.1
<i>Of which</i> : Power sector debt	38.9	35.5	34.7	37.4	45.9	54.0	58.2	61.0
External debt service								
(In percent of exports of goods and services)	14.2	13.4	14.3	13.9	14.2	13.5	14.7	14.3

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

1/ Including payment receipts from Tala for its interest payment to the government of India.

2/ Including Tala interest payment.

3/ Including Tala's amortization payment.

4/ Including grant inflows for hydropower projects.