Bhutan—Assessment Letter for the Asian Development Bank and the World Bank
April 15, 2020

This letter provides the IMF staff's current assessment of Bhutan's macroeconomic conditions, prospects, and policies.

I. RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

Bhutan has made significant strides in improving per capita income and reducing poverty in the context of the 11th Five-Year Plan (FYP). Poverty has declined significantly from 12 percent in 2012 to 8.3 percent in 2017, with extreme poverty falling to just 1.5 percent, while the Gini coefficient remained roughly unchanged at 0.38.

Before the COVID-19 shock, growth was expected to pick up from new hydropower supply. In recent years growth had moderated, primarily reflecting slowing investment in the hydropower sector and the delayed commissioning of the Mangdechhu hydro project. In FY 2018/19 (FY is July-to-June), the overall fiscal balance improved, reflecting a sharp reduction of capital expenditure in the early years of 12th FYP and the current account deficit further widened, driven by weaker hydro and non-hydro exports and high service imports. Prior to the COVID-shock, private consumption was robust and credit growth had steadily increased (18 percent in December 2019), including from construction-related demand, supporting domestic demand but likely increasing financial vulnerabilities amid rising NPLs (18.4 percent in September 2019) and sectoral concentration risks (tourism, services, and real estate). To strengthen the financial system, the authorities initiated a number of regulatory and supervisory measures, including updating the risk management framework for banks and insurance companies. Inflation had been low, at 2.5 percent in January 2020, aided by relatively moderate inflation in India until recently.

However, the near-term growth outlook for Bhutan is weighed down by the sharp global and domestic slowdown and uncertainties from the COVID-19 pandemic. Growth is now projected to decline to 2.7 percent and 2.9 percent in FY2019/20 and FY2020/21 respectively. This forecast reflects the domestic COVID-19 impact from the unprecedented national lock down (introduced on March 22), decline in tourism receipts and related spending, potential impact on asset quality in tourism sectors, and weak external demand. A gradual recovery is expected in FY2021/22 (6.4 percent growth), supported by greater export of electricity and fiscal support as well as favorable terms of trade from lower oil prices. Headline inflation is projected to be 3.5 percent and the current account deficit is projected to remain around 20 percent of GDP in FY2020/21. At the same time, the overall fiscal deficit is expected to reach 5.1 percent of GDP—with about 2 ppts. deterioration due to the COVID-19 shock—on account of domestic fiscal stimulus, including some reprioritization of expenditure, and the recent increases in public sector wages (the Pay Revision Act of July 2019 represents the first wage revision since 2014 and is expected to increase government spending by around 2 percent).

Against the backdrop of the pandemic, the balance of risks is tilted to the downside. External risks include a sharper-than-expected and a more prolonged global slowdown and/or slowdown in India, and the possibility of a persistent decline in tourism. Domestic risks remain elevated from the uncertainty surrounding the pandemic, even though active reported cases remain limited (five, all imported, no evidence of community transmission). A domestic outbreak would likely increase the length of the lock-down period and could further disrupt the lives of many, especially the vulnerable, strain the health system, and adversely affect unemployment and growth. Furthermore, it could also impact the financial sector by worsening asset quality. Other domestic risks include high debt levels and delays in hydro projects, which would hurt growth and prevent external imbalances from declining rapidly. A crucial mitigating factor is that hydropower production and exports to India remain uninterrupted, bringing in sizable foreign exchange inflows and helping the central bank maintain a reserve buffer. Notably, a new hydropower plant (Mangdechhu) has come online recently, which is expected to further support accumulation of reserves.

II. Assessment and Fund Relations

Responding to the COVID-19 shock remains a near-term priority, including by significantly expanding social insurance and providing support to individuals and businesses. The authorities have taken a number of measures in this regard, including extension of tax filing and deferral of tax payments, provision of working capital at an interest rate of 5 percent for wholesale distributors, expanding access to health delivery services and housing facilities, and ensuring imports of essential commodities from India (including food, fuel, medicines) will continue uninterrupted. In addition, the authorities are working on an Economic Stimulus Plan aimed at helping different sectors of the economy with fiscal and financial measures to protect the vulnerable, support economic activity, and bolster financial stability.

Looking ahead, medium-term challenges of revenue mobilization, macro-financial stability, and targeted structural reforms remain. As and when the COVID-19 shock will ease, attention will need to return to the ongoing reforms, including policies to contain economic and financial vulnerabilities, diversify the economy, and enhance its overall competitiveness to sustain growth. Fiscal policy needs to be anchored within a transparent, rolling, and multiyear budget framework. This can ensure the effective use of fiscal resources towards meeting the nation's goal of creating an inclusive and prosperous state. Such a framework can make capital spending and growth less volatile and improve the efficiency of expenditure. To finance Bhutan's ambitious development goals, mobilizing additional government revenue remains critical, which should be supported by an effective implementation of the recently passed Goods and Services Tax (GST) law. Safeguarding financial stability is necessary to support financial inclusion and development. Recent regulatory and supervisory initiatives, including the publication of the Corporate Governance Rules and Regulation, the Risk Management Guidelines, and the Rules and Regulations for Insurance, are welcome measures but steadfast implementation is needed to ensure financial sector resilience amid the recent increase in nonperforming assets amid rapid credit growth and concentration risks, particularly after the COVID-19 shock. Finally, in the monetary sector, the ngultrum's peg to the rupee has served the economy well, and ongoing reform of the liquidity management framework will further strengthen RMA's capacity to align money market conditions with the monetary policy stance.

The risk of debt distress was assessed as moderate in the last Article IV report published in October 2018. While public and publicly guaranteed (PPG) debt stood at 101 percent of GDP in FY2019, implying that all debt indicators breach the critical thresholds under the baseline projections, there are mitigating circumstances. A large share (over 75 percent) of the debt is linked to hydropower project loans from the government of India (GoI). The GoI covers both financial and construction risks of the projects and buys surplus electricity at a price reflecting cost plus a 15 percent net return. Debt dynamics are set to improve over the medium term driven by a significant increase in electricity exports and decline of imports associated with hydropower construction.

Bhutan's external position is assessed to have been moderately weaker than warranted by fundamentals and desirable policies in FY17/18. The current account deficit is temporarily large due to hydropower-construction-related imports though the overall balance remains positive, supported in part by grant financing. The peg has been an adequate nominal anchor and remains appropriate as India is Bhutan's largest trade and development partner. Reserve coverage remains adequate (13 months of imports in FY18/19). The next external assessment will be conducted in the context of the next Article IV consultation, which had been expected to take place in Summer 2020 before the COVID-19 shock.

Bhutan: Selected Economic and Financial Indicators, 2016/17-2021/22

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
	Act.	Act.		Proj.		
	(In percent of GDP, unless otherwise indicated)					
National Accounts						
Real GDP growth (percent change)	6.3	3.7	5.3	2.7	2.9	6.4
Prices						
Consumer Prices (avg; percent change)	5.4	2.7	2.6	3.1	3.5	3.6
General government accounts						
Overall balance 1/	-3.5	-1.1	0.8	-5.1	-5.5	-1.2
Balance of payments						
Current account balance	-23.6	-19.5	-23.1	-21.3	-20.2	-15.8
Memorandum items:						
Ngultrum per U.S. dollar (eop)	64.5	68.6	68.9	...	...	...

Sources: Bhutanese authorities; and Fund staff projections.

1/ The overall balance takes into account net lending and other advances.