

INTERNATIONAL MONETARY FUND ASSESSMENT LETTER

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Bhutan—Assessment Letter for the Asian Development Bank March 24, 2015

This letter provides the IMF staff's assessment of Bhutan's macroeconomic conditions, prospects and policies. The assessment has been requested in relation to the proposed Development Policy Loan.

Growth has slowed recently due to efforts to moderate aggregate demand and ameliorate overheating pressures, but external imbalances persist.

- Growth has averaged 8 percent during 2008–12, driven by the hydropower sector, but is projected to have slowed to about 5 percent in FY 2013, due to policy efforts to moderate credit growth to contain overheating pressures. Bans imposed on credit for construction and vehicle imports in March 2012 led to a decline in services, mining and construction sector growth. With the removal of these bans in September 2014 and continued development of the hydropower sector, growth is projected to pick up over the medium term.
- Headline inflation declined to 8.6 percent in June 2014 from 11.3 percent in December 2013, mainly due to lower non-food inflation. Inflation is projected to decline over the medium term in line with the moderation in India's inflation and the fall in global commodity prices.
- The current account deficit remains sizable and is financed through substantial aid inflows. The deficit widened to 22.7 percent of GDP in FY 2013 from 15 percent of GDP on average over the 10th Five Year Plan. In addition to hydropower related imports, a consumption and housing boom added to the rapid increase in imports. Robust aid inflows resulted in a positive overall balance of payments position, enabling the continued accumulation of international reserves, which stood at US\$ 1197 million (about 12 months of import cover) in November 2014. However, even though about 60 percent of total external debt is denominated in Indian rupees and more than two thirds of trade is with India, rupee reserves have constituted less than 3 percent of reserves on average during the past 5 years.
- Downside risks to macroeconomic stability stem from high debt levels and possible financial sector vulnerabilities following a prolonged period of rapid credit growth. There is also a risk of renewed external pressures, including on rupee reserves, if macroeconomic policies remain expansionary and credit growth rebounds strongly. Another external risk stems from renewed surges in global financial market volatility, which may adversely affect India, Bhutan's main trade and development partner.

The main near-term policy challenge is to support growth while ensuring that external pressures do not intensify.

- 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 inflows should be fully sterilized and liquidity should be tightened to prevent credit growth from rebounding too strongly. 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 develop a formal interbank market and further develop the government bond market by greater and more regular issuance of T-bills and T-bonds. Interest rate spreads with India need to be narrowed and better reflect market conditions.
- International reserves have to be managed carefully to contain recurrent pressures on Indian rupee reserves, including by aligning the currency composition of reserves with that of the structure of rupee-denominated 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 macro prudential measures.

Bhutan is on a 24-month consultation cycle. The 2014 Article IV consultation was concluded by the Executive Board on June 20, 2014.

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

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
				Prel.	Proj.	
Nominal GDP (2010): US\$1,585.7 million						
Population (2010): 0.725 million						
GDP per capita (2010): US\$2,187						
Quota: SDR 6.3 million						
Real sector						
Real GDP at market prices (percent change)	9.3	10.1	6.4	4.9	6.4	7.7
Consumer prices (percent change, period average)	4.8	8.6	10.1	8.6	9.6	7.2
General government	(in percent of GDP)					
Total revenue and grants	46.3	35.6	35.2	28.9	27.2	22.7
Tax revenue	13.4	13.7	15.8	14.5	12.7	12.6
Non-tax revenue	16.3	8.6	5.9	5.4	5.3	4.9
Foreign grants	16.6	13.3	13.5	9.0	9.2	5.2
Total expenditure and net lending	44.7	37.7	36.5	32.9	31.0	25.1
Current expenditure	26.0	20.2	18.0	17.1	15.8	15.5
Capital expenditure	19.3	18.7	19.6	17.4	16.7	10.8
Current balance (excluding grants)	3.8	2.2	3.9	2.8	2.2	2.0
Overall balance	1.6	-2.1	-1.3	-4.0	-3.8	-2.3
Public sector debt 2/	57.5	68.6	72.2	89.2	107.4	115.7
Monetary sector	(Percent change, unless otherwise indicated)					
Broad money	30.1	21.2	-1.0	18.6	6.6	...
Credit to private sector	22.8	19.2	20.7	6.2	6.4	...
Interest rates (end of period, in percent)						
Deposits (less than 1 year)	5.0	5.0	5.5	5.5	5.8	...
Lending	10-16	9.75-16	10.0-16	11.7-16	10-16	...
External sector	(in millions of dollars, unless otherwise indicated)					
Current account balance	-142	-410	-350	-439	-459	-591
(In percent of GDP)	-9.9	-23.5	-19.0	-22.7	-23.2	-26.8
Trade balance	-299	-519	-477	-459	-517	-571
Exports (goods)	544	665	595	603	641	696
(Percent change)	5.5	22.2	-10.6	1.4	6.3	8.6
Imports (goods)	843	1,185	1,072	1,061	1,158	1,267
(Percent change)	39.0	40.5	-9.5	-1.0	9.1	9.4
Grants (current transfer)	261	254	273	191	199	127
Capital account balance	99	472	261	545	481	620
Loans (net)	108	366	225	342	347	469
Errors and omissions	43	33	-20	0	0	0
Overall balance	-1	96	-109	106	22	29
(In percent of GDP)	-0.1	5.5	-5.9	5.5	1.1	1.3
Gross official reserves	810	907	810	916	938	967
(In months of goods and services imports)	7.5	9.0	8.1	8.5	7.9	7.1
External debt (in percent of GDP)	55.9	65.9	71.0	84.8	100.1	106.7
Ngultrum per U.S. dollar (period average)	46.7	45.3	50.3	54.9	61.5	...
Memorandum items:						
GDP at market prices (in billions of Bhutanese Ngultrum)	66.9	79.2	92.7	106.1	122.0	141.2
GDP at market prices (in millions of U.S. dollars)	1420.8	1714.3	1851.7	1847.3	1978.1	2213.8
Electricity exports (in percent of total goods exports)	42.8	34.3	32.8	29.8	27.1	25.9
Unemployment rate (in percent) 3/	3.3	3.3	3.1	2.1	2.9	...

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).