

## INTERNATIONAL MONETARY FUND ASSESSMENT LETTER

**Bhutan—Assessment Letter for the Asian Development Bank  
February 28, 2018**

*This letter provides the IMF staff's current assessment of Bhutan's macroeconomic conditions, prospects, and policies. The assessment has been requested in relation to the proposed Health Sector Development Program.*

**Growth remains stable, supported by hydropower construction and services.  
External imbalances persist but are expected to improve over the near term.**

- Growth has averaged 6.2 percent during FY2015–16, driven by the hydropower sector, and is estimated to be at 6 percent in FY2017, with robust growth in services and manufacturing offsetting to some extent a tapering in hydropower-related construction. Growth is projected to rise to just over 7 percent in FY2018, supported by expanding hydropower construction.
- Headline inflation has risen slightly from a historic low of 3.2 percent in December 2016 to 4.0 percent in December 2017, with both food and non-food inflation rising. Over the medium term, inflation is projected to remain in line with price developments in India, Bhutan's key trade partner and import source, and given the ngultrum's peg to the rupee.
- Fiscal policy in FY2017 was expansionary. Although lower than budgeted (at 5.3 percent of GDP), the deficit widened to 4.1 percent in FY2017 from 1.1 percent in FY2016, driven largely by a sizable expansion of capital expenditures. Deficits are projected to decline as expenditures return to pre-FY2017 levels.
- The current account (CA) developments largely reflect investments in the hydropower sector financed through a combination of official loans and grants, most from the Government of India. The CA deficit has averaged 26 percent of GDP during FY2012-16; is estimated to have narrowed to 20.5 percent in FY2017 (due to lower hydropower imports and increased exports of electricity); and is projected to improve to 16 percent of GDP in FY2019. International reserves stood at US\$1.17 billion (over 12 months of import cover) in September 2017. About 70 percent of public external debt is denominated in Indian rupees, and both exports and imports are predominantly with India (between 70–90 percent). In the past, a low share of rupee reserves in total reserves resulted in a drying up of rupee liquidity. This has improved recently, with rupee reserves constituting 36 percent of total reserves (five months of imports) in September 2017, up from 30 percent in December 2016 and 16 percent in July 2015. Withdrawal of old Indian rupee banknotes from circulation in Bhutan and their replacement with new ones following the November 2016 currency exchange initiative in India was concluded without much disruption.
- Downside risks to macroeconomic stability stem from high debt levels (public sector debt is 109 percent of GDP) and possible financial sector vulnerabilities (due to quality of lending and weak profitability). Risks of overheating due to large step increases in hydropower activity in the medium term and subsequent potential rapid

credit expansion remain sizable. External risks stem from renewed surges in global financial market volatility, which may adversely affect India, Bhutan's main trading and development partner.

**The main near-term policy challenges are to implement carefully policy priorities and to adapt to recent policy changes in India.**

- Regarding fiscal policy, timely implementation of the good and services tax (GST) is important and measures are needed to make up for the impending revenue shortfall from India's withdrawal of excise duty refunds, following its adoption of a national GST in July 2017. Bhutan is targeting a July 2020 implementation of GST, which is challenging given the resource constraints. However, the authorities have developed an implementation plan and will receive technical assistance from the Fund to pursue it. The withdrawal of excise duty refunds by India is expected to have a sizable revenue impact (nearly 2 percent of FY2017 GDP), which will gradually decline before ceasing in FY2020. The compensatory tax measures that have been identified by the authorities (including a higher GST rate, streamlined sales tax structure, and excise tax increase on items such as fuel, vehicles, and imported alcohol) should be implemented expeditiously. Together with spending restraint, such measures would help contain fiscal deficits and debt and related vulnerabilities.
- With increased deposits related to hydropower construction, Bhutan's banking sector has ample liquidity. To avoid a repeat of the excess liquidity-fueled external imbalances faced in 2011–12, the Royal Monetary Authority (RMA) has been sterilizing large portions of this liquidity. The authorities should continue to enhance and modernize their monetary policy framework, including by developing government securities and interbank markets, establishing an interest rate corridor, and enhancing RMA's liquidity management and forecasting capabilities.
- The system-wide non-performing loan ratio was at 6.3 percent in December 2016, requiring supervisory vigilance. The move toward IFRS in the course of 2018 (for both the RMA and banks) and related loan-loss provisioning standards should improve the quality of financial reporting.
- Further financial inclusion efforts should be balanced with maintaining financial stability. The authorities have issued guidelines for Priority Sector Lending (PSL) to extend more credit to agriculture and small industries, sectors that typically lack access to credit, as part of the broader financial inclusion strategy. Three micro-finance institutions have been registered to participate in this program, and others are in the pipeline. Measures to enhance financial inclusion are welcome, although care should be taken to keep PSL-associated distortions to a minimum. Financial inclusion measures should be well complemented by supervisory and regulatory policies to prevent the build-up of financial stability risks including outside the banking sector.

**Bhutan is on a 24-month consultation cycle. The 2016 Article IV consultation was concluded by the Executive Board on June 22, 2016. The next Article IV consultation is expected to take place in June-July 2018.**

Table 1. Bhutan: Selected Economic Indicators, 2012/13–2018/19 1/

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
					Est.	Proj.	
<b>Real sector</b>							
Real GDP at market prices (percent change)	3.6	4.0	6.1	6.3	6.0	7.1	7.6
Consumer prices (percent change, period average)	11.3	10.0	6.4	3.9	3.4	4.1	4.6
<b>General government</b>							
	(In percent of GDP)						
Total revenue and grants	30.2	33.6	28.8	29.7	30.1	29.0	24.4
Tax revenue	15.2	14.4	14.6	14.0	13.2	13.8	13.3
Non-tax revenue	5.6	6.3	5.4	5.7	5.1	5.8	8.1
Foreign grants	9.4	12.7	7.9	10.5	11.2	9.4	3.0
Total expenditure and net lending	34.4	29.8	27.3	30.8	34.2	31.7	25.3
Current expenditure	17.8	16.0	16.7	16.1	16.1	16.1	18.6
Capital expenditure	18.2	14.8	12.3	15.4	19.2	16.5	8.4
Current balance (excluding grants)	3.0	4.7	3.3	3.6	2.2	3.5	2.9
Overall balance	-4.2	3.8	1.5	-1.1	-4.1	-2.7	-0.8
Public sector debt 2/	99.9	96.4	96.0	113.3	108.7	109.0	105.0
<b>Monetary sector</b>							
	(Percent change, unless otherwise indicated)						
Broad money	18.6	6.7	8.2	15.9	31.5	...	...
Credit to private sector	7.1	6.4	14.0	0.0	...	...	...
<b>External sector</b>							
	(In millions of dollars, unless otherwise indicated)						
Current account balance	-470	-483	-574	-618	-479	-499	-446
(In percent of GDP)	-25.4	-26.4	-28.3	-29.1	-20.5	-19.6	-15.9
Trade balance	-377	-393	-430	-538	-341	-518	-379
Exports (goods)	546	535	580	491	524	583	677
(Percent change)	-11.5	-2.0	8.4	-15.4	6.8	11.3	16.1
Of which: Electricity	188	167	182	159	184	232	312
Imports (goods)	-923	-928	-1,009	-1,028	-865	-1,102	-1,056
(Percent change)	-8.8	0.5	8.8	1.9	-15.9	27.4	-4.1
Grants (current transfer)	86	63	77	126	18	106	37
Capital and financial account balance	578	516	586	827	535	526	359
Loans (net)	294	212	350	629	229	161	170
Errors and omissions	60	37	-20	-20	0	0	0
Overall balance	168	70	-9	189	56	26	-87
(In percent of GDP)	9.1	3.8	-0.5	8.9	2.4	1.0	-3.1
Gross official reserves	917	998	959	1,119	1,174	1,201	1,114
(In months of goods and services imports)	11.9	11.9	11.2	15.5	12.8	13.6	11.5
External debt (in percent of GDP)	94.1	93.6	94.0	108.1	108.6	110.7	106.8
Debt service ratio (in percent of G&S exports)	10.9	14.2	11.8	18.5	23.2	12.6	13.6
Ngultrum per U.S. dollar (period average)	54.9	61.5	62.1	66.7	68.2	...	...
<b>Memorandum items:</b>							
GDP at market prices (in billions of Bhutanese Ngultrum)	101.4	112.5	125.8	141.7	159.1	177.4	199.0
GDP at market prices (in millions of U.S. dollars)	1848.7	1829.6	2026.7	2126.6	2334.1	2547.2	2800.2
Electricity exports (in percent of total goods exports)	34.5	31.2	31.4	32.4	35.1	39.7	46.1
Unemployment rate (in percent) 3/	2.1	2.9	2.6	2.5	...	...	...

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.

3/ On a calendar year basis (e.g., the entry for 2012/13 is for 2012).