INTERNATIONAL MONETARY FUND

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BHUTAN

October 2018

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR BHUTAN

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with Bhutan, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its October 26, 2018 consideration of the staff report that concluded the Article IV consultation with Bhutan.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on October 26, 2018, following discussions that ended on July 4, 2018, with the officials of Bhutan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 7, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the International Development Association (IDA).
- A **Statement by the Executive Director** for Bhutan.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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October 30, 2018

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IMF Executive Board Concludes 2018 Article IV Consultation with Bhutan

On October 26, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Bhutan.[1]

Bhutan continued to make strides in raising per capita incomes and reducing poverty as it concluded the 11th Five Year Plan in 2018. Notably, poverty declined from 12 percent in 2012 to 8.2 percent, and extreme poverty fell to just 1.5 percent. The country is poised to transition to middle-income status, with per capita incomes at nearly $3,600 in 2018, up from $1,100 in 2004.

Growth has remained robust, averaging 6 percent over the 11th Plan. In FY2018, growth is expected to slow to 5.8 percent from 7.4 percent in FY2017, reflecting slowing construction activity of hydropower projects set to come on stream in 2018 and beyond. Inflation remains low at around 4¼ percent in December 2017. With lower hydropower-related imports and higher electricity export revenue, the current account deficit narrowed from an average of 26 percent of GDP over FY2012-16 to 22.8 percent in FY2017, and reserve cover at 13 months of imports remains at robust levels. Growth is likely to slow further in FY2019 (to 4.8 percent), due to a contraction in fiscal spending driven by the timing of the new government's transition to power. Over the medium term, coming on stream of three new hydropower projects is expected to boost growth to around 7 – 7½, along with improvements in the current account, reserves, and the fiscal position. Improving macroeconomic conditions will provide a desirable backdrop for the authorities' plans to diversify the economy away from dependence on hydropower generation, with access to finance and labor market reforms being core issues.

Nevertheless, risks are skewed to the downside. Domestic risks include delays in implementing the goods and services tax (GST) and completing hydropower projects and lower electricity exports. Higher fiscal spending in FY2019 and more gradual fiscal consolidation in the medium term could lift growth above the baseline forecast. External risks stem from weaker growth and higher inflation in India, Bhutan's main trading and development partner, and increases in global oil prices. Key policy challenges relate to avoiding the sharp reduction in capital spending, timely implementation of the GST, and prudent management of anticipated hydropower revenues.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[2]

Executive Directors welcomed the significant improvements in per capita income and poverty indicators, with strong economic growth and low inflation. They also welcomed progress made on structural reforms, especially in access to finance and economic diversification. However, Directors observed that while external imbalances are declining, they are still large. In addition, key medium-term policy challenges remain, including domestic revenue mobilization and prudent management of hydropower revenues, while maintaining macroeconomic stability, enhancing competitiveness and further diversifying the sources of growth.

Directors noted that the FY2019 interim budget implies a sharp fiscal withdrawal and may impact growth. Given Bhutan's infrastructure needs, Directors called for higher capital expenditure supported by additional domestic revenue and a modest increase in domestic financing. They welco0-med the authorities' commitment to implement a broad-based GST by July 2020 and called for a rationalization and gradual curtailment of tax exemptions. Directors encouraged the authorities to develop a domestic public debt market and further strengthen public financial management. They commended the steps taken to establish a macroeconomic stabilization fund to manage hydropower revenues and business fluctuations and noted the importance of transparent and rule-based principles for the fund's operations.

Directors considered the current monetary policy stance to be broadly appropriate. They welcomed efforts by the Royal Monetary Authority (RMA) to modernize the monetary policy framework by enhancing its liquidity management and forecasting capabilities. Directors also encouraged the establishment of an interest rate corridor and steps to develop the interbank market. This framework would help support the ngultrum's peg with the Indian rupee. Once this framework is fully operational, the minimum lending rate could be abolished.
While the risk of systemic distress remains low, the nascent banking sector needs to be strengthened.

Directors underlined the need to further improve the prudential framework for the financial sector and strengthen oversight to avoid a build-up of risks. They welcomed the priority sector lending program which is expected to improve access to finance for cottage and small industries but emphasized the need to monitor its performance.

Directors agreed that the exchange rate peg to the Indian rupee has served Bhutan well and remains an appropriate nominal anchor. Bhutan's reserve cover remains adequate but its composition may benefit from a higher share in rupees.

Directors encouraged elimination of exchange rate restrictions as soon as macroeconomic conditions allow.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

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.	
Real sector							
Real GDP at market prices (percent change)	3.6	4.0	6.2	7.3	7.4	5.8	4.8
Consumer prices (percent change, period average)	11.3	9.6	7.6	7.6	5.8	4.6	4.9
General government			(In percent of GDP)				
Total revenue and grants	30.2	33.6	28.8	29.9	26.7	31.1	22.1
Tax revenue	15.2	14.4	14.6	14.2	13.6	14.9	14.4
Non-tax revenue	5.6	6.3	5.4	5.8	5.0	5.8	5.0
Foreign grants	9.4	12.7	7.9	10.6	8.1	9.9	2.6
Total expenditure and net lending	34.4	29.8	27.3	31.1	30.1	32.1	19.9
Current expenditure	17.8	16.0	16.7	16.3	15.1	16.2	15.1
Capital expenditure	18.2	14.8	12.3	15.5	16.2	17.0	5.6
Current balance (excluding grants)	3.0	5.0	4.2	3.0	3.5	5.0	4.4
Overall balance	-4.2	3.8	1.5	-1.1	-3.3	-1.0	2.2
Public sector debt 2/	99.9	96.2	95.7	114.2	106.3	102.7	103.9
Monetary sector			(Percent change, unless otherwise indicated)				
Broad money	18.6	6.6	7.8	15.8	31.5	...	...
Credit to private sector	7.1	6.4	14.0	14.7	15.4	...	...
External sector			(In millions of dollars, unless otherwise indicated)				
Current account balance	-470	-483	-574	-621	-547	-597	-426
(In percent of GDP)	-25.4	-26.4	-28.3	-29.4	-22.8	-22.8	-15.0
Trade balance	-377	-393	-430	-540	-469	-460	-226
Exports (goods)	546	535	580	493	555	572	716
(Percent change)	-11.5	-2.0	8.4	-15.0	12.6	3.0	25.2
Imports (goods)	-923	-928	-1,010	-1,033	-1,024	-1,031	-942
(Percent change)	-8.8	0.5	8.8	2.4	-0.9	0.8	-8.7
Grants (current transfer)	174	232	160	225	195	260	74
Capital and financial account balance	578	516	586	831	551	645	510
Loans (net)	294	212	350	632	377	283	315
Errors and omissions	60	37	-20	-20	-28	-19	0
Overall balance	168	70	-9	189	-24	29	84
(In percent of GDP)	9.1	3.8	-0.5	9.0	-1.0	1.1	3.0
Gross official reserves	917	998	959	1,115	1,226	1,243	1,327
(In months of goods and services imports)	11.9	11.9	11.1	13.1	14.3	15.8	16.6
External debt (in percent of GDP)	94.1	93.6	94.0	108.6	105.4	107.4	105.4
Debt service ratio (in percent of G&S exports)	10.9	33.6	22.8	18.7	33.3	38.0	9.9
Ngultrum per U.S. dollar (period average)	54.9	61.5	62.1	66.3	66.4	...	...
Memorandum items:							
GDP at market prices (in billions of Bhutanese Ngultrum)	101.4	112.5	125.8	140.4	159.7	176.2	192.6
GDP at market prices (in millions of U.S. dollars)	1848.7	1829.5	2027.6	2116.7	2404.6	2623.6	2838.6
Electricity exports (in percent of total goods exports)	34.5	31.2	31.4	32.4	32.3	34.3	40.7
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).

BHUTAN

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

August 7, 2018

KEY ISSUES

Context: Bhutan has made significant strides in improving per capita incomes and reducing poverty, with growth strong and inflation in single digits. While still large, external imbalances are declining. Welcome progress has also been made on structural reforms. Key medium-term policy challenges include the mobilization of domestic revenues and prudent management of hydropower revenues to support adequate levels of public spending, while maintaining macroeconomic stability, and enhancing competitiveness and diversifying the sources of growth.

Outlook and Risks: Risks to the outlook are skewed to the downside, but active policies could lead to higher growth outcomes. On the *domestic* side, delays in implementing the goods and services tax (GST) and completing hydropower projects could lead to lower electricity exports and larger fiscal deficits. However, a more gradual fiscal consolidation could lift growth above the baseline forecast. *External* risks stem from weaker growth and higher inflation in India and increases in global oil prices.

Key Policy Recommendations:

- Fiscal consolidation is appropriate to reduce vulnerabilities. However, a more gradual pace than envisaged in the draft 12th Five-Year Plan would help lessen the planned sharp fall in capital spending and better support growth. Resources should be secured for timely implementation of the GST project. Public financial management should be further strengthened, including by replacing the current five-year planning cycles with a rolling multiyear budget framework and enhancing fiscal transparency. Comprehensive medium-term debt management and public debt market development strategies are needed.
- Plans to modernize the monetary policy framework and establish an interest rate corridor should continue. Once this framework is in place, a review of the Minimum Lending Rate is advised with an eye of evaluating its benefits against the costs of potential distortions.
- The loan loss classification requirements for banks should be tightened and risk-based provisioning mandated as a supplementary measure. A gradual reduction of banks' liquidity requirements should be pursued, once the RMA's liquidity facility is in place. The credit assessment of priority sector lending proposals should be kept at par with those for market-based lending and progress evaluated regularly.
- The business climate and access to finance should be further improved. More targeted training for Bhutanese workers should be undertaken and barriers for skilled immigration reduced. The authorities should revisit the relatively high minimum threshold for foreign direct investment (FDI) and, in some cottage and small industries, remove the FDI restrictions.

Approved By
Ranil Salgado (APD) and Kevin Fletcher (SPR)

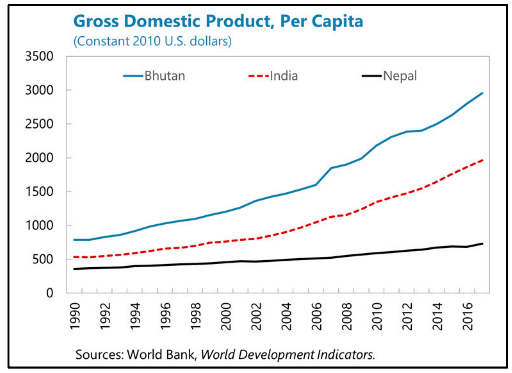
Discussions took place in Thimphu during June 25–July 4, 2018. The team comprised Mr. Grigorian (head), Mr. Mohommad, Ms. Moussa (all APD), and Mr. Bauer (Senior Resident Representative). The mission met with Prime Minister Tshering Tobgay, Minister Namgay Dorji, Governor Dasho Penjore, and other senior government officials. Ms. Dhillon (OED) attended all meetings, and Mr. Gokarn (OED) attended the meeting with the Prime Minister and the concluding meeting. Staff from the World Bank and Asian Development Bank joined the meetings. Ms. Inoue and Mr. Singh (both APD) assisted in the preparation of this report.

CONTENTS

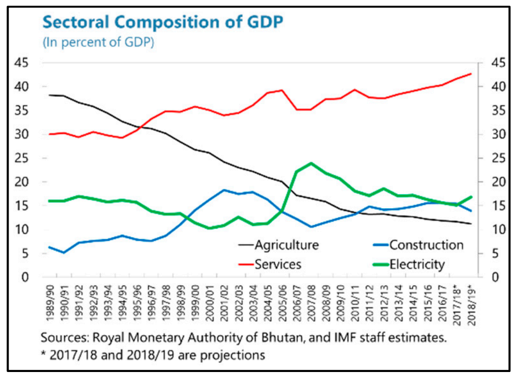
APPENDICES

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

1. **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 8.2 percent in 2017, with extreme poverty falling to just 1.5 percent, while the Gini coefficient remained roughly unchanged at 0.38 (Box 1). With the country now transitioning to middle-income status, continuous reforms and prudent policies are needed to contain economic and financial vulnerabilities, diversify the economy and enhance its overall competitiveness to sustain growth, and further improve gross national happiness.



2. **Growth remains robust** (Figures 1–3, Tables 1–6). GDP grew at 7.3 percent during FY2015–16, driven by the hydropower sector, and is estimated to have maintained momentum at 7.4 percent in FY2017, with strong growth in services and manufacturing offsetting a tapering in hydropower construction. Headline inflation increased from a historic low of 3.2 percent in December 2016 to 4.3 percent in December 2017, with both food and non-food inflation rising.



3. **External imbalances are large but beginning to decline.** The current account deficit (CAD) averaged 26 percent of GDP during FY2012–16 reflecting investments in the hydropower sector and is estimated to have narrowed to 22.8 percent in FY2017 due to lower hydropower-related imports and increased electricity exports. Reserve coverage is adequate at nearly 13 months of imports of goods and services.[1]

4. **The financial performance of the banking sector remains weak but risks appear contained overall.** Profitability is low and some banks have high rates of non-performing assets. At the same time, liquidity and provision coverages are high and interest rate risks are contained due to adjustable rate lending. Recently, four microfinance institutions have been licensed. Progress is being made on modernizing the payment system and financial inclusion. The Royal Monetary Authority (RMA) has recently launched a Priority Sector Lending (PSL) program (Appendix I) as part of a holistic effort to improve access to credit for cottage and small industries (CSI) sector.

5. **Work on formulating the 12th FYP is underway.** The draft 12th FYP intends to deepen decentralization by increasing the share of capital expenditure by local governments (from 30 to 50

[1] The Constitution mandates a reserve coverage of 12 months of "essential imports", defined by the government. The reserves currently cover around 23 months of "essential imports."

percent); further reduce poverty and create jobs; enhance the quality of education and health; and improve institutions and the justice system. The current draft will have to be endorsed by the incoming government (which will take over in October) to become final. The Gross National Happiness Commission recently began work on articulating a new long-term vision (the current 20-year vision expires in 2020).

6. **Medium-term growth will be driven by new hydropower plants coming on stream, services, and manufacturing**. On current policies, real GDP growth is projected to decelerate to 4.8 percent in FY2019, reflecting a sharp decline in public investment in the transition to the 12th FYP and continued tapering of hydropower construction, but moderated by the coming on stream of the large Mangdechhu hydropower plant. Subsequently, growth is expected to recover to about 6 percent in FY2019-20, with a further acceleration in FY2021–22 due largely to the expected coming on stream of two other hydropower projects. Inflation is projected to remain broadly in line with that in India, given the ngultrum's peg to the rupee. The current account balance and reserve coverage are expected to improve due to a decline in hydropower-related imports and a sharp increase in hydropower exports.

7. **Risks to the outlook are skewed to the downside in the baseline, but active policies could lead to higher growth outcomes (Appendix II).** On the *domestic* side, delays in implementing the GST and completing hydropower projects could lead to lower electricity exports and larger fiscal deficits. Vulnerabilities exist in the financial sector due to the quality of banks' lending and weak profitability. However, avoidance of a sharp spending cliff in FY2019 and more gradual fiscal consolidation in the medium term, coupled with higher domestic revenue mobilization, could lift growth above the baseline forecast. *External* risks stem from the possibility that Indian growth, Indian inflation, or global oil prices could deviate from baseline assumptions as these variables have substantial effects on the Bhutanese economy.

8. **Policies have been largely in line with past Fund advice.** Weaknesses in the domestic revenue base will be addressed by the impending introduction of the GST, while volatility in fiscal revenues and expenditures will be reduced through the Bhutan Economic Stabilization Fund (BESF) (Appendix III). In addition, efforts are underway to strengthen the fiscal institutional framework. Monetary management is being enhanced by the introduction of the new policy framework, and reserve management has been improved, inter alia, by the increased share of Indian rupees in total reserves. Finally, the prudential regulatory framework for banks has been bolstered, and regulatory gaps in other areas (e.g., insurance regulation and risk management) are being addressed.

Authorities' Views

9. **The authorities broadly agreed with the outlook and risks for the economy, but they were more optimistic about the short-term growth prospects.** They stressed the importance of having a risk-mitigating framework underpinned *inter alia* by the BESF, which is currently being established. While acknowledging the potential fiscal drag on GDP growth from low capital expenditures in FY2019, they were hopeful that the coming on stream of the Mangdechhu plant would keep the growth in line with previous years, surprising on the upside.

MACROECONOMIC AND FINANCIAL POLICIES

10. Bhutan's transition from the 11th to the 12th FYP, its forthcoming graduation from Least Developed Country status, and the growing importance of hydropower raise important policy issues. The most immediate concern is avoiding a sharp reduction in public investment budgeted for FY2019 that would hurt growth. Key medium-term policy challenges include the mobilization of domestic revenues and prudent management of hydropower revenues to support adequate levels of public spending against the background of declining foreign grants, while maintaining macroeconomic stability. Plans to upgrade the monetary policy framework and to establish a stabilization fund for hydropower revenues will support these goals. On the structural front, the key challenge is to enhance competitiveness and diversify the sources of growth.

A. Fiscal Policy

11. While prudent on average over each FYP cycle, fiscal policy in Bhutan is characterized by large swings in expenditures and deficits within these cycles. After recording overall surpluses in the first two years of the 11th FYP, fiscal policy became expansionary in FY2016-17. Although lower than budgeted (at 5.3 percent of GDP), the deficit widened to 3.3 percent in FY2017 from 1.1 percent in FY2016, driven largely by a sizable expansion of capital expenditure, while domestic direct tax revenues declined, in part due to weaker hydropower-related revenues. The estimated FY2018 budget outcome is a deficit of 1 percent of GDP, with the improvement driven by higher hydropower revenues and excise duty refunds from India.

12. Staff assess Bhutan's risk of debt distress as moderate (see 2018 Debt Sustainability Analysis). Outstanding hydropower debt makes up 77 percent of Bhutan's external public and publicly-guaranteed debt.[2] All hydropower projects but one are financed by India under the intergovernmental agreement wherein India is contractually obligated to purchase the electricity at tariffs based on cost-plus-margin pricing, decreasing risks associated with the high level of external debt. Plants and equipment are insured for replacement value against calamities, and Bhutan only carries the production risks.

13. The budget for FY2019—proposed by the outgoing government and adopted by the parliament on an interim basis—implies a sharp fiscal withdrawal.[3] The overall balance would swing to a 2.2 percent of GDP surplus, owing mainly to a massive decline in capital expenditure from 17 percent of GDP in FY2018 to 5.6 percent in FY2019. Moreover, current spending is set to remain flat in nominal terms, implying a 1.2 percent of GDP decline relative to FY2018. Revenues and grants are set to decline by 9 percent of GDP, reflecting mainly lower foreign grants and a decline in excise

[2] The present value of non-Indian debt is well below the high-risk threshold.

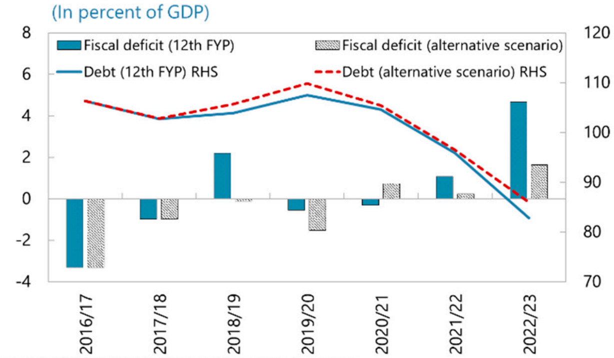
[3] According to the current budgetary framework, each government has a jurisdiction over its own FYP and can only provide for critical current expenditures, loan repayments, and 6 months' worth of capital expenditures in the first year of the following FYP.

duty refunds from India, which will fall in the next year and cease after FY2020, following the introduction of India's GST in July 2017.[4]

14. The draft 12th FYP implies an average overall budget surplus of 1.4 percent of GDP for the period FY2019–23.[5] Under this plan, capital expenditures would amount to around 9½ percent of GDP annually on average, well below the 15½ percent of GDP recorded on average during the 11th FYP. While capital spending is partly constrained by the expectation of declining foreign grants (projected to reach 5¼ percent of GDP annually on average, as compared to 9½ percent of GDP under the 11th FYP) and the loss of excise duty refunds from India of about 1¾–2 percent of GDP, the lower spending envelope also appears to be a policy choice.

15. Staff proposed higher fiscal spending in FY2019 and a more gradual fiscal consolidation over the medium term. The programmed investment cliff will negatively affect growth in FY2019. While implementation lags limit the possible increase in capital spending in the short term, expenditures on maintenance can be frontloaded to limit the fiscal withdrawal in FY2019. Moreover, given Bhutan's significant infrastructure needs (see Structural Issues section), staff saw scope to raise capital spending by about 2 percent of GDP annually on average over the medium term and recommends a more even spending path than implied in the draft 12th FYP. Higher capital spending could be supported by additional domestic tax revenue mobilization as well as a modest amount (about 1 percent of GDP annually on average) in domestic financing. This alternative fiscal path would allow the continued expansion of much needed productive infrastructure and support higher growth.

Medium-term Fiscal Outlook
(In percent of GDP)



Source: Draft 12th Five Year Plan fiscal projections, and staff projections.
In the alternative scenario, it is assumed that authorities will implement a GST by July 2020, that will make up for the loss of excise duty refunds from India, and the current sales tax, with modest buoyancy over the medium term. The additional capital spending is financed partly by the higher revenue mobilization and partly by increased domestic debt.

16. To boost the domestic revenue base, the authorities should implement their plans for a broad-based GST without delay (Box 2). While currently not in the baseline projections, the authorities have begun planning for GST implementation scheduled for July 2020, supported by Fund technical assistance (TA). Early endorsement of the project by the incoming government and passage of the associated legislation will be critical to meet the implementation timeline. In terms of design, the GST should be broad-based (to include services) and have a simple rate structure (preferably a single tax rate). Some additional domestic revenue could be collected in the short term by updating the bases of user charges and land/property taxes, which have been eroded by inflation.

[4] Prior to this (which resulted in elimination of most excise duties in India), the excise refunds have been transferred on a calendar year basis with a lag of about two years.

[5] If the (hydropower-related) Net Lending were to be presented below-the-line (as recommended by a recent IMF technical assistance mission), the budget for 12th FYP would be in balance.

Finally, the authorities should seek to rationalize and gradually curtail the use of tax exemptions (mainly indirect taxes), which were estimated to amount to 2¾ percent of GDP in FY2017.

17. Staff encouraged the authorities to develop a domestic public debt market in Bhutan. At present, domestic financing is based on a small Treasury bill market, which is subject to high rollover risk. With concessional financing decreasing, the authorities need to develop a source of stable and inexpensive domestic funding. To function properly and without undue risk, this needs to be based on a medium-term debt strategy and a comprehensive market development strategy.

18. The ongoing initiatives to strengthen public financial management (PFM) are commendable and should be deepened further. The authorities are currently in the process of implementing a fully electronic system for government payments. It will be advisable to replace the current five-year planning cycle, which creates large and undesirable aggregate demand shocks, with a rolling multi-year budget framework that will enable greater stability. Staff encouraged the authorities to further improve fiscal transparency by enhancing the scope and content of budget documents and more frequent reporting.

19. The authorities have embarked on an effort to establish a stabilization fund to manage hydropower revenues and business cycle fluctuations. The draft Royal Charter is under review and the Rules and Regulations are expected to be issued shortly, with seed money (in the amount of Nu 100 million) allocated to be invested in Indian rupee assets. Staff noted the importance of transparent and rules-based principles for the fund's operations. In addition, it viewed the proposed floor for transfers to the fund (5 percent of hydropower royalties) to be insufficient and urged the authorities to set a more ambitious target to ensure meaningful (countercyclical) contributions from the fund to the expenditure envelope.

Authorities' Views

20. The authorities agreed with staff's assessment of the fiscal stance under the 11th FYP, noting that it had been prudent, achieving on average a balanced budget for the five-year period. They also agreed that a projected sharp contraction in capital spending in FY2019 was of concern, but that it was constrained by the electoral cycle, limiting expenditures to essential activities and spillovers from the 11th FYP. They noted that—while desirable—higher spending in FY2019 will not be feasible as the new Cabinet, which would need to approve the spending, will only be appointed in October. Overall, the authorities assessed positively the staff's alternative scenario for the medium-term, noting that it provides somewhat higher and stable investment, but stated that it will be subject to the approval of the final 12th FYP.

21. The authorities expressed concern about the risks of the tax-to-GDP ratio declining in coming years and agreed on the need to undertake revenue reforms. While reaffirming their commitment to GST implementation, including mobilization of the required project funding, they noted that the project is subject to final approval by the new Cabinet. The authorities also agreed that the proposed 5 percent minimum on royalties from hydropower to be transferred to the BESF was low, but noted that the rate of transfer can be raised, if necessary. The authorities acknowledged that the public debt level remains high but agreed that the debt-related risk is moderate due to the foreign direct investment (FDI)-like nature of most of Bhutan's debt. Finally, on PFM reforms, they expressed interest in a medium-term rolling budgetary framework, as a way of reducing the cyclicality of budgetary spending and avoiding unnecessary volatility in the fiscal stance, and stated their commitment to improving budget transparency and more frequent fiscal reporting.

B. Monetary Policy

22. Monetary conditions have remained stable in recent years. Credit growth has slowed from 35 percent on average in 2005–11 to a more manageable 15 percent in 2012–17 including due to the use of macroprudential instruments. To avoid a repeat of the excess liquidity-fueled external imbalances of 2011–12, the RMA is sterilizing hydropower-related liquidity through a daily sweeping of related bank balances. Staff analysis shows that only a small positive credit gap has emerged in recent quarters, much lower than in the run-up to the rupee crisis in 2012 (Appendix IV).

23. The authorities are in the process of modernizing their monetary policy framework, supported by TA from the South Asia Regional Training and Technical Assistance Center (SARTTAC). The RMA's liquidity management and forecasting capabilities are being enhanced, along with the establishment of an interest rate corridor (IRC) and development of the interbank market. The new monetary policy framework—including standing marginal lending and deposit facilities to support the IRC—is expected to become operational shortly.

24. Staff welcomed the ongoing reforms, which will enhance the policy toolkit to maintain macroeconomic stability. Once fully operational, the liquidity management framework will allow the RMA to align money market conditions with the monetary policy stance that is needed to support the currency peg. Because of the uncertainties about inflation dynamics and the need to gain experience in the operation of the IRC while preserving credibility, the RMA should start with a relatively wide corridor (e.g., +/- 200 bps) and then reduce it gradually over time to allow for better interest-rate control and market development. Once the framework is in place, staff recommended a review of the Minimum Lending Rate (MLR), which is only remotely related to RMA's monetary policy stance and appears to create distortions in the credit market.[6]

Authorities' Views

25. The authorities acknowledged the challenges of moving from a quantity to interest rate signaling of the policy stance but reaffirmed their commitment to putting the new monetary policy framework in place soon. They welcomed the capacity development provided by the Fund and agreed with the need to further strengthen the capacity to analyze macroeconomic and monetary developments. They concurred on the need to have the benchmark interest rate aligned with that in India and to have market-based interest rate signals from a properly functioning

[6] The MLR is a single reference rate for all financial institutions calculated using three cost parameters across all banks: (i) marginal cost of funds, (ii) negative carry charges on cash reserve ratio, and (iii) operating costs.

domestic debt market, which would also make more instruments available for banks to access short-term funds through the liquidity facility.

C. Financial Sector

26. The banking sector is nascent and suffers from low profitability. The return on assets dropped from 1.8 percent in 2016 to just 0.7 percent in 2017, while the return on equity declined from 11.3 percent to 4.8 percent. The system-wide non-performing loan (NPL) ratio was at 8.4 percent in December 2017, up from 7.2 percent in December 2016. NPLs continue to show a strong seasonal pattern, with sharp declines in December (end of the banking financial year). Adjustment in risk weights and provisioning requirements resulted in a fall in the capital adequacy ratio (CAR) from 19 percent in 2016 to 16 percent in 2017. On the positive side, provisions are high and required provisions are calculated on a (conservative) gross basis. The sector's liquidity levels are high (above the already demanding regulatory requirements of 10 percent of the cash reserve ratio (CRR), kept with the RMA, and an additional 20 percent statutory liquidity ratio (SLR), kept in liquid assets).[7] The risks of financial contagion appear to be contained by the relatively small size of gross exposures between banks, corporations, households, and the budget.

27. While the prudential framework of the financial sector needs continued improvement, progress has been made in some key areas aided by SARTTAC. Corporate governance regulations for financial institutions and a new regulatory framework for the insurance sector are being implemented; a review of the macroprudential framework is underway; the collateral credit registry has recently moved to the RMA; risk management regulations and guidelines are under preparation; and the pension fund guidelines and regulatory strategy are under review. However, bank supervision remains largely compliance-based, and only a subset of the main prudential rules is monitored on a quarterly basis (the rest being enforced at year-end), with no penalties for non-compliance before year-end. While loan loss provisioning rules appear reasonably stringent, the rules and the practical application of loan classification remain somewhat lax.[8]

28. The financial sector's resilience should be further strengthened and the regulatory regime modernized to avoid a build-up of risks. Staff urged the authorities to tighten loan classification requirements for banks (including by enforcing and extending the period of satisfactory performance before an impaired loan can be reclassified as performing, which will help address the sharp seasonal NPL swings) and mandate the banks to supplement the current rules with risk-based provisioning (which some banks practice already). With the coming on stream of RMA's new liquidity facility, the authorities should gradually reduce the current liquidity requirements for banks, since high liquidity buffers affect profitability and may increase, rather than reduce, financial risk. On PSL, staff recommended maintaining the credit assessment of proposals under the program at par with those for market-based lending and evaluating program outcomes on a regular basis to avoid

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[7] RMA has relied on the CRR and SLR for monetary policy management.

[8] They require 20, 50, and 100 percent provisioning on the gross value of the loan after 90, 180, and 350 days past due, respectively. NPLs can be reclassified as performing as soon as arrears have been cleared.

creating market distortions. Finally, staff urged continued vigilance in the face of potential financial stability risks, adjusting macroprudential policies when needed.

Authorities' Views

29. The authorities were encouraged by recent improvements in regulatory compliance of some banks but nonetheless agreed with staff on the need to further tighten financial sector regulation and supervision. They pointed to several key financial sector-related policy changes taking place now and stressed the role they will play in broadening and deepening access to finance. They noted that the financial inclusion strategy (to be issued by December 2018) is expected to be the cornerstone of their efforts in this direction. Finally, the authorities agreed that there might be scope to review and possible reduce liquidity requirements once the new monetary framework, with the supporting liquidity facility, is operational.

D. External Sector and Exchange Rate Policy

30. The ngultrum's peg to the rupee has served the economy well. It has important implications for debt and reserve management due to the economy's exposure to the rupee. About three-quarters of public external debt is denominated in Indian rupees, and both exports and imports are predominantly with India (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, with rupee reserves constituting 36 percent of total reserves in September 2017, up from 16 percent in July 2015. This, along with access to a swap line with The Reserve Bank of India (RBI, for US$100 million) and a rupee facility with the Government of India (GoI, with an outstanding amount of 7 billion Indian rupees), improves financial buffers. However, staff continued to advise the authorities to further increase the share of rupee reserves (to above 50 percent), based on trade patterns and the structure of the RMA's balance sheet.

31. Staff assesses Bhutan's external position to be moderately weaker than warranted by fundamentals and desirable policies (Appendix V). Vulnerabilities relate to India's recent GST implementation (which makes Indian exports zero-rated and therefore cheaper in Bhutan) and an increase in oil prices (which will increase the current account deficit). Bhutan's reserve coverage remains adequate.

Authorities' Views

32. The authorities agreed that the peg continues to be the appropriate exchange rate regime for Bhutan. They noted that the share of Indian rupees (INR) has exceeded 30 percent of total reserves in recent months and rupee liquidity is further bolstered by the facilities available to them via RBI and GoI. As in the past, maintaining an adequate buffer of INR has been a critical part of overall reserve management system. Although, currently, the RMA has been managing the INR using the RBI and GoI facilities, it would be important to institute a more formal INR management system to meet the day-to-day INR demand of the economy. While a proposal to increase the rupee share of reserves to 40 percent was recently rejected by the RMA Board, the authorities noted that, based on the projections, electricity exports due to the commissioning of three hydroelectric plants by FY2023 are expected to turn the current account positive in the medium term, which would structurally improve rupee liquidity. However, any delays in the hydropower projects would entail challenges in managing the external sector.

E. Structural Issues

33. While the development of the hydropower sector has contributed significantly to progress, associated risks and the need to generate high-quality jobs for Bhutan's youth have heightened the need for diversification. The guideline for the 12th FYP emphasized the importance of developing industries other than hydropower including the CSI. The authorities have identified five sectors—agriculture, CSI, hydropower, tourism, and mining—to help expand domestic production and reduce import dependency.

34. Improving the business environment will aid private sector development.[9] Bhutan is ranked 75th in Doing Business 2018, and the World Bank's Investment Climate Assessment in 2016 identified access to finance, access to skilled labor, and access to external markets as three binding constraints. The authorities have taken measures to address some of these bottlenecks in recent months.

35. Further progress with improving access to finance is important. On the *supply side*, the recent expansion of the Credit Information Bureau coverage (to include information on utilities' payments and borrowing from micro-finance institutions) will facilitate better risk assessment of borrowers and the PSL policy is expected to improve access to finance for the CSI sector, previously largely underserved by the financial sector. An insolvency bill is currently awaiting parliamentary approval. The authorities also should open more specialized courts to adjudicate commercial (specifically, credit-related) disputes and initiate a review of procedures for out-of-court restructuring of impaired loans to reduce delays in loan recoveries and the transaction cost for bank lending.[10] Related to this, the RMA should issue guidelines to encourage banks to write off legacy bad loans (e.g., classified as loss for more than three years) to free up their balance sheet. Legislation should be amended to allow secondary purchases of impaired loans. On the *demand side*, the ongoing review of the Movable and Immovable Properties Act—which has served the financial sector well by facilitating impaired loan resolutions—should not weaken creditor rights. Finally, improving the registration and validation of land would improve the availability of collateral, especially for farmers. Additional efforts are underway to improve financial literacy and inclusion.

36. Skilled labor is in short supply and skill mismatches are an ongoing concern. While school enrollment has improved in recent years, Bhutan's gross tertiary enrollment remains at around

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[9] Indicators cited hereafter should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints and information availability.

[10] At present, there is only one specialized court/bench to address commercial disputes, resulting in lengthy delays (often years) to secure court verdicts.

10 percent, lower than in the neighboring countries.[11] To meet short-term labor needs, more training and lower barriers for skilled immigration would be needed. A recent World Bank report found that the public sector is the choice for educated youth due in large part to a significant wage and compensation gap.[12] To make private sector employment more attractive, the authorities could promote voluntary private-sector pension schemes.

37. Further improvements are also needed in infrastructure development. Bhutan is ranked 135th among 160 economies in the World Bank's 2016 Logistics Performance Index, suggesting a continued need for public investment in infrastructure. Information and Communication Technology connectivity also needs to be improved, with potentially significant implications for private sector development in the services sector. In this regard, the minimum threshold for FDI—a key channel for investment in technology and employment generation—is high (currently at US$20 million). There is also a case for liberalizing access of foreign investors to select CSI activities that are presently on the negative list for FDI.[13]

Authorities' Views

38. The authorities stated their strong commitment to diversifying the economy and providing high-paying jobs for the population, especially the youth. They noted that deep-rooted reforms are needed in the education system, in addition to improvements in access to finance. While they acknowledged the existence of skills' mismatch and a strong preference by youth for public sector jobs, large-scale donor-funded training programs are being provided and that a review of the education system is underway. While they agreed to undertake a review of the FDI thresholds (with an eye on providing employment opportunities and enhancing technology transfer), they indicated that in some sectors (e.g., retail trade) FDI is likely to reduce aggregate employment. They also said that second annual event of the Bhutan Economic Forum for Innovative Transformation, to be held in July 2019, will be on issues of economic diversification. On access to finance, the authorities agreed with staff recommendations and pledged to work with the judicial branch to expedite the implementation of the proposed measures. They also reaffirmed their commitment to limiting market distortions from the recently launched PSL program and to undertake a review of its progress on a regular basis.

STAFF APPRAISAL

39. Bhutan's growth has been strong and poverty has declined significantly. Growth has been driven by the hydropower and services sectors, while inflation has been and is expected to

[11] World Bank's World Development Indicators.

[12] "Bhutan's Labor Market: Toward Gainful Quality Employment for All," The World Bank Group, 2016.

[13] Activities included in the negative list are media and broadcasting, distribution services (including wholesale), retail and micro trade, mining for sale of minerals in primary or raw form, hotels (3 stars and lower), and general health services.

remain in single digits, underpinned by price developments in India due to the currency peg. While still large, external imbalances are beginning to decline. The most immediate policy challenge is to limit the sharp fiscal withdrawal programmed for FY19. Medium-term challenges include mobilizing domestic revenues and prudently managing rising hydro revenues against the background of declining grants, and enhancing competitiveness to diversify the sources of growth and employment.

40. Staff supports fiscal consolidation over the medium term, which will strengthen the fiscal position and reduce external imbalances. However, a more gradual consolidation path (in line with staff's illustrative alternative scenario) would be more appropriate for growth while still maintaining macroeconomic stability. This path should be supported by measures to enhance the domestic revenue base, of which the GST project remains a key ingredient. Staff urged the authorities to secure the required resources for the GST project to avoid delays. PFM should be strengthened and the current five-year planning cycle replaced by a rolling multiyear budget framework. The establishment of a stabilization fund for hydro revenues is welcome and rules governing its operation should be completed soon. Finally, staff noted that measures to develop a public debt market would bring economic benefits far outweighing the financial cost of market-based interest on outstanding debt securities required to support the market.

41. Staff views monetary conditions to be broadly appropriate. Credit growth rates have declined, and the credit gap has been negative until recently. Following the rupee crisis in 2012, the share of rupees in total reserves has been markedly increased. Staff welcomed the authorities' efforts to revamp the monetary policy framework, which will help align the monetary conditions with a policy stance required for the ngultrum's peg to the rupee.

42. To better safeguard financial stability and provide a solid foundation for the private sector's access to finance, continuous efforts to modernize the regulatory framework would be needed. The banking sector has adequate buffers to absorb potential losses, but bank profitability is low and maintaining liquidity comes at a cost. These conditions require continued supervisory vigilance and calibration of both micro- and macro-prudential frameworks to contain financial risks and minimize the potential economic costs of a crisis.

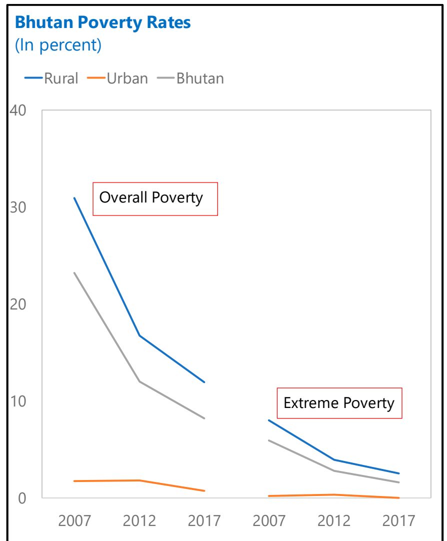
43. The authorities' emphasis on diversification of the economy is appropriate and should prioritize further improving access to finance and educational and labor market outcomes. A holistic approach to making credit available for sectors that have been previously underserved by the financial sector is welcome, but caution should be exercised to limit potential distortions. To reduce unemployment, especially among the youth, and enhance labor productivity, efforts should focus on targeted training of workers and improved tertiary educational enrollment. Relaxing rules for foreign direct investment, at least in select areas where the spillovers for both the upstream and downstream sectors could be significant, should also be pursued.

44. Staff supports the ngultrum's peg to the rupee, which—given the degree of interconnectedness with India—has served the economy well. Developments in 2017 suggest that Bhutan's external position remains moderately weaker than warranted by fundamentals and desirable policies.

45. The authorities did not request and staff does not recommend approval of the exchange restrictions that are inconsistent with Article VIII obligations. Bhutan continues to maintain exchange restrictions under the transitional arrangements of Article XIV, Section 2. Staff encouraged the authorities to gradually ease the exchange restrictions towards their eventual elimination, which should be eliminated as soon as Bhutan's balance of payments positions permits. Staff is encouraged by the authorities' use of Fund TA to explore options for the removal of these restrictions.

46. The staff recommends that the Article IV consultation with Bhutan remain on a 24-month cycle.

Box 1. Poverty Trends



Source: Bhutan Poverty Analysis Report (2017); Royal Government of Bhutan, and World Bank.

Bhutan continues to make inroads into reducing poverty at an appreciable pace. Backed by average GDP growth of 7.5 percent over the decade to 2017, driven in large part by hydropower construction and exports, the poverty rate in Bhutan has declined from 23.2 percent in 2007, to 12 percent in 2012, and further to 8.2 percent in 2017. Poverty reduction was a key focus of the 10th FYP, the period corresponding to the steepest decline in poverty, with further reduction in poverty and improved social outcomes observed during the 11th FYP.

Poverty in Bhutan is largely a rural phenomenon. Even so, impressive gains have been in reducing rural poverty from nearly 31 percent in 2007 to 12 percent in 2017, whereas urban poverty has also declined from very low initial levels (1.7 percent in 2007) to 0.7 percent in 2017.[1] Subsistence (or extreme) poverty is even lower, about 1.5 percent in aggregate, and just over 2¼ percent in rural areas. The depth of poverty, measured as the average gap in per-capita consumption of the poor from the poverty line (assumed to be zero for the non-poor, expressed in percent of the poverty line) too is greater in rural areas, but, at 2.4 percent on average, it does not appear to be particularly severe.

The statistics on access to public services and information are encouraging. The overwhelming majority (99.9 percent) of the population is reported to have access to improved water sources, with no significant differences across income groups. At least 92 percent of households have access to improved sanitation, with only an eight percent difference between poor and non-poor households. 67 percent of non-poor households have at least one smart phone, compared to 29 percent in poor households. Going forward, most surveyed poor households in rural areas specified public transport as a priority concern, while those in urban areas mentioned employment generation as an area for improvement.

An analysis of the change in poverty suggests that the main driver has been an increase in non-food consumption, with no appreciable change in food consumption patterns. Further understanding the drivers of poverty reduction would require more research, which the authorities are planning to conduct in the near future, supported by the World Bank and other donors.

[1] *Bhutan Poverty Analysis Report (2017)*, Royal Government of Bhutan and World Bank.

Box 2. Goods and Services Tax

With India's implementation of the GST in July 2017, the adoption of a GST in Bhutan has become a high priority. This box outlines some of the key considerations in adopting a GST in Bhutan, including the benefits and important milestones to be accomplished to meet the July 2020 deadline for its implementation.

At present, Bhutan raises around 5½ percent of GDP in indirect tax revenues. Sales taxes account for 2½ percent of GDP, while around 2 percent of GDP is raised from the excise duty refund (EDR), which reflects excises levied by India on exports to Bhutan. The remainder is raised from domestic excises, a green tax, and customs duties.

With India's adoption of the GST (and removal of excises on exports), the EDR will effectively cease in FY2020, leaving a large revenue gap to be filled. While the authorities have identified a set of primarily sales tax-related measures that could potentially make up for the loss of EDR revenue, a broad-based GST will help to cover the revenue gap in a sustainable and more efficient manner. Moreover, a GST is likely to be buoyant; in a sample of nearly 70 countries compiled by staff, the average increase in VAT revenue as a percent of GDP was about ½ percent of GDP over a five-year period.[1]

Furthermore, the potential to increase indirect tax revenues from other sources, such as raising customs duties, is severely limited by Bhutan's free trade agreement with India (which covers 90 percent of imports), as well as South Asian Association for Regional Cooperation preferences and the preferential trade agreement with Bangladesh. Thus, indirect tax revenues will rely heavily on GST implementation.

While the benefits of a broad-based GST are well understood, the key challenge from a tax policy perspective will be to design and implement a GST that does not "resemble" the existing sales tax. This requires: (i) a broad base, (ii) effective input tax credit/refund management, and (iii) administrative simplicity (e.g., few rates), in particular given capacity constraints. The GST under consideration presently in Bhutan resembles a standard VAT with input tax crediting, a mandatory turnover-based registration threshold, and adherence to the destination principle (with zero-rated exports and taxed imports, including service imports).

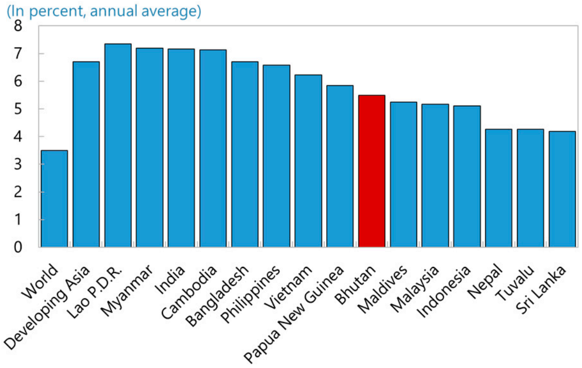
Bhutan is receiving extensive IMF support for implementing the GST. Bhutan created a project office and prepared a GST implementation plan, consisting of a detailed timeline, in line with IMF recommendations. IMF TA has provided further recommendations in key areas including: (i) legislation and rules including to draft the GST law; (ii) establishing and guiding business processes related to the GST; (iii) selection of the appropriate information technology (IT) system; (iv) taxpayer outreach; and (v) capacity building. TA on the GST law is currently on-going. The draft law is being reviewed by the GST Working Group at the Department of Revenues and Customs. In terms of challenges, the ability of the revenue authority to develop and implement an IT system that can underpin GST processing is considered one of the potential stumbling blocks that could delay the adoption of the GST.

[1] There is substantial variation over the sample, however, and this does not control for tax policy changes.

Figure 1. Bhutan: Recent Macroeconomic Developments

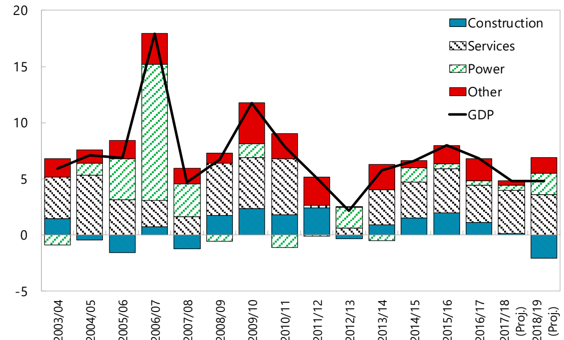
Bhutan's growth is relatively high…

Real GDP Growth 2013–2017: World, Developing Asia and Selected Countries
(In percent, annual average)



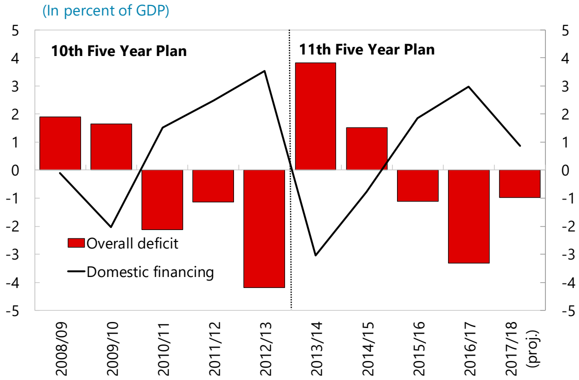
…and remains robust thanks to hydropower development and services…

Sources of Growth
(Contribution to real GDP growth, in percent)



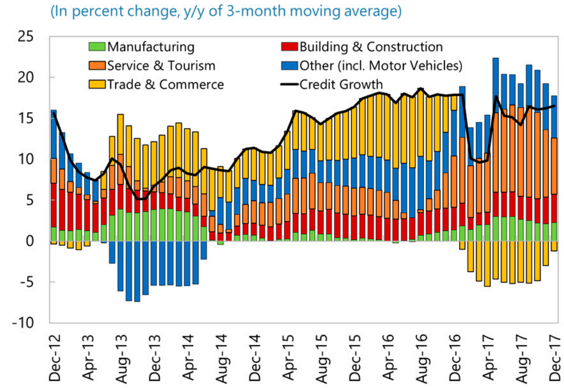
…with some support from fiscal policy, though this has reversed in FY2018…

Fiscal Deficit and Financing
(In percent of GDP)



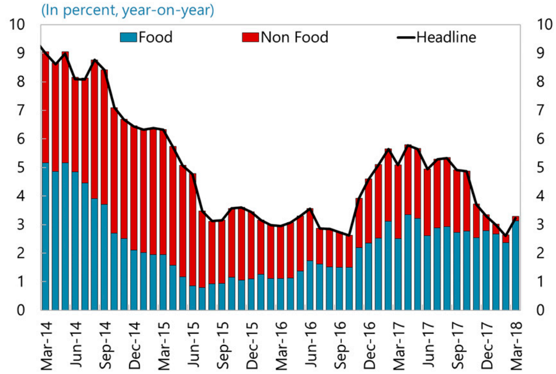
…and strong credit growth.

Credit Growth and Contributions
(In percent change, y/y of 3-month moving average)



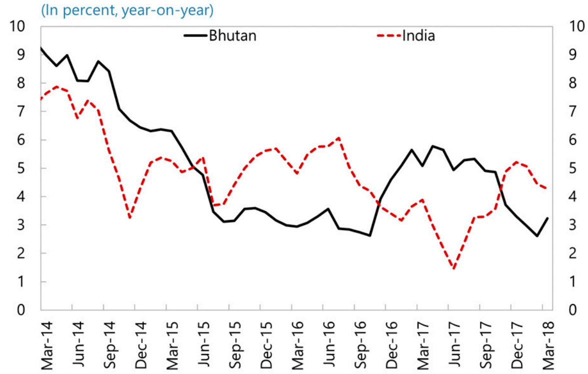
Inflation has declined, mainly due to lower food inflation…

Contributions to CPI
(In percent, year-on-year)



…and has fallen below inflation in India.

Inflation Relative to India
(In percent, year-on-year)

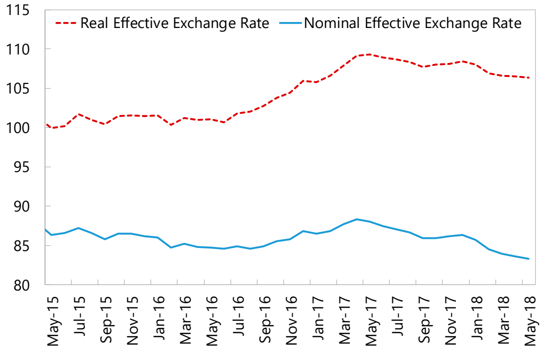


Sources: IMF International Financial Statistics, IMF World Economic Outlook, Royal Monetary Authority of Bhutan, CEIC, and IMF staff calculations.

Figure 2. Bhutan: External Developments

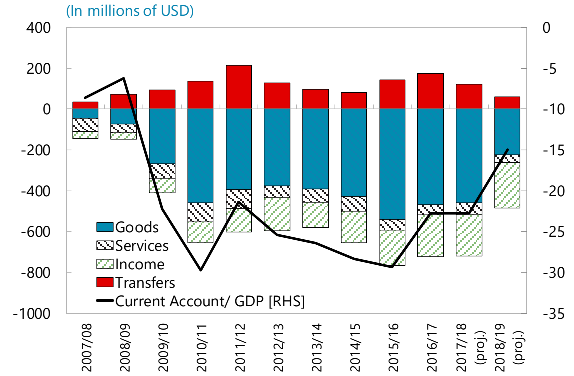
The Bhutanese NEER has depreciated recently, following the previous appreciation, while the REER appreciation moderated….

Nominal and Real Effective Exchange Rates
(Index, 2010=100)



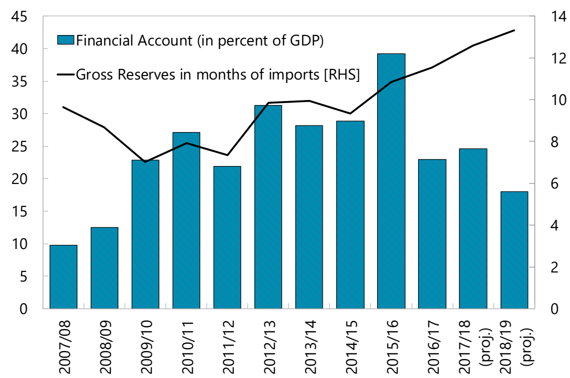
…and large current account deficits, reflecting large hydro-related imports, have begun to moderate.

Current Account and Components
(In millions of USD)



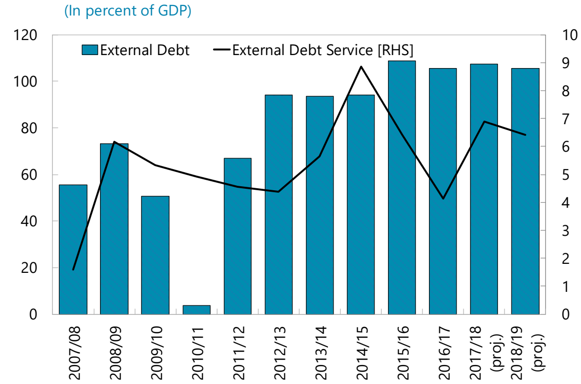
Though the financial account is declining, the overall balance remains positive and reserve import coverage remains adequate…

Financial Account and Gross Reserves



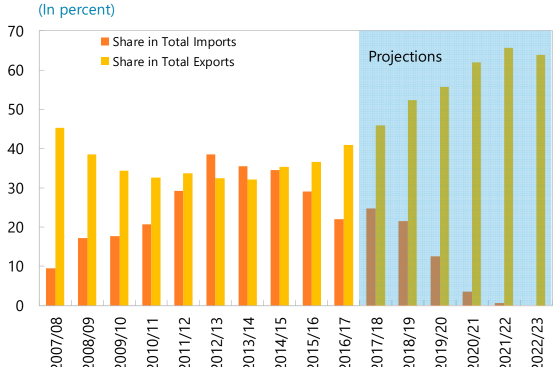
…and the increase in external debt driven by hydropower disbursement has stabilized.

External Debt and External Debt Service
(In percent of GDP)



Electricity exports are projected to rise rapidly with major projects coming on-stream…

Hydropower Imports and Exports
(In percent)



…destined mainly for India which is Bhutan's dominant trade partner.

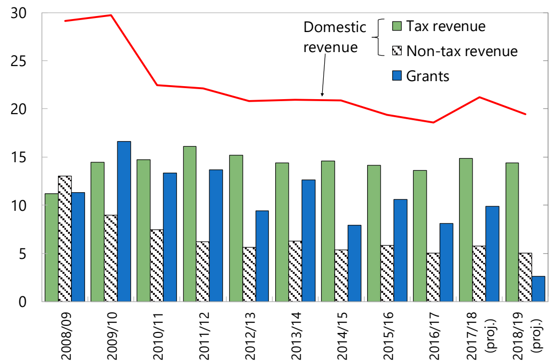
Foreign Trade
(In percent of total exports or imports)

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

Figure 3. Bhutan: Fiscal, Monetary, and Financial Developments

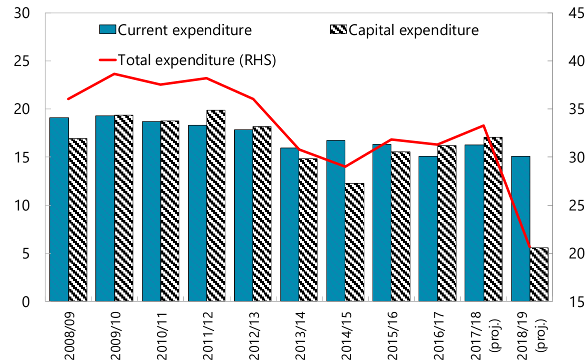
Higher hydropower tariffs are expected to boost declining tax revenues, but grants are set to fall sharply this year…

Total Revenue and Grants
(In percent of GDP)



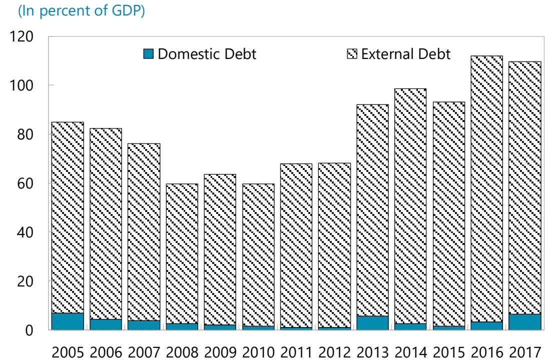
…with a corresponding decline in capital spending, as Bhutan negotiates the transition to the new 12th Plan.

Current and Capital Expenditure
(In percent of GDP)



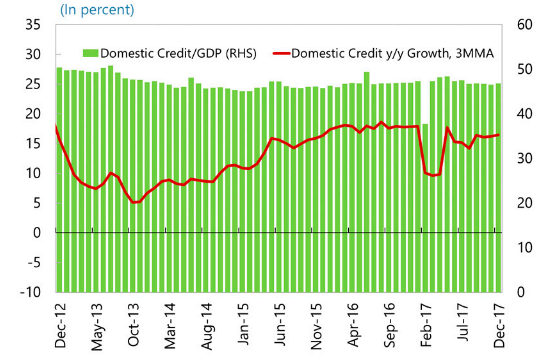
Domestic debt remains a small share of GDP.

Public Debt Profile
(In percent of GDP)



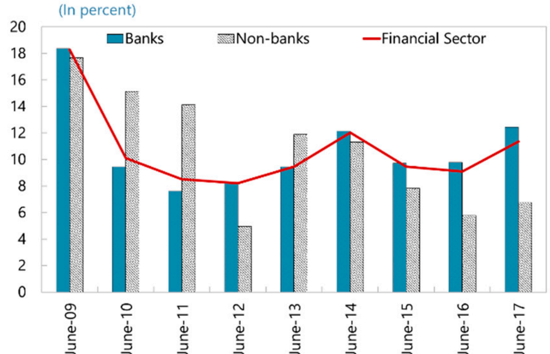
Money supply growth slowed down and credit growth picked up.

Bank Credit
(In percent)



The NPL ratio for banks has picked up recently.

Gross NPL Ratio
(In percent)



Key Policy Indicators

Policy Indicators	Bhutan	India[1]
Minimum Lending Rate	6.52 [2]	8.70-9.45
Cash Reserve Ratio	10.00	4.00
Statutory Liquidity Ratio	20.00	19.50
Savings Deposit Rates	5.00-5.55	3.50-4.00
Term Deposit Rates	3.00-9.50	6.25-6.75
Government T-Bills rates (91 days)	2.57 [3]	6.11

As of May 2018.

1) Rates are revised as per latest information available from the RBI website.

2) The Base Rates of Financial Institutions have been

3) The rate reflected here pertains to RGOB T-Bills (R293) worth Nu. 4.0 billion

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

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.	
Real sector							
Real GDP at market prices (percent change)	3.6	4.0	6.2	7.3	7.4	5.8	4.8
Consumer prices (percent change, period average)	11.3	9.6	7.6	7.6	5.8	4.6	4.9
General government				(In percent of GDP)			
Total revenue and grants	30.2	33.6	28.8	29.9	26.7	31.1	22.1
Tax revenue	15.2	14.4	14.6	14.2	13.6	14.9	14.4
Non-tax revenue	5.6	6.3	5.4	5.8	5.0	5.8	5.0
Foreign grants	9.4	12.7	7.9	10.6	8.1	9.9	2.6
Total expenditure and net lending	34.4	29.8	27.3	31.1	30.1	32.1	19.9
Current expenditure	17.8	16.0	16.7	16.3	15.1	16.2	15.1
Capital expenditure	18.2	14.8	12.3	15.5	16.2	17.0	5.6
Current balance (excluding grants)	3.0	5.0	4.2	3.0	3.5	5.0	4.4
Overall balance	-4.2	3.8	1.5	-1.1	-3.3	-1.0	2.2
Public sector debt 2/	99.9	96.2	95.7	114.2	106.3	102.7	103.9
Monetary sector				(Percent change, unless otherwise indicated)			
Broad money	18.6	6.6	7.8	15.8	31.5	…	…
Credit to private sector	7.1	6.4	14.0	14.7	15.4	…	…
External sector				(In millions of dollars, unless otherwise indicated)			
Current account balance	-470	-483	-574	-621	-547	-597	-426
(In percent of GDP)	-25.4	-26.4	-28.3	-29.4	-22.8	-22.8	-15.0
Trade balance	-377	-393	-430	-540	-469	-460	-226
Exports (goods)	546	535	580	493	555	572	716
(Percent change)	-11.5	-2.0	8.4	-15.0	12.6	3.0	25.2
Imports (goods)	-923	-928	-1,010	-1,033	-1,024	-1,031	-942
(Percent change)	-8.8	0.5	8.8	2.4	-0.9	0.8	-8.7
Grants (current transfer)	174	232	160	225	195	260	74
Capital and financial account balance	578	516	586	831	551	645	510
Loans (net)	294	212	350	632	377	283	315
Errors and omissions	60	37	-20	-20	-28	-19	0
Overall balance	168	70	-9	189	-24	29	84
(In percent of GDP)	9.1	3.8	-0.5	9.0	-1.0	1.1	3.0
Gross official reserves	917	998	959	1,115	1,226	1,243	1,327
(In months of goods and services imports)	11.9	11.9	11.1	13.1	14.3	15.8	16.6
External debt (in percent of GDP)	94.1	93.6	94.0	108.6	105.4	107.4	105.4
Debt service ratio (in percent of G&S exports)	10.9	33.6	22.8	18.7	33.3	38.0	9.9
Ngultrum per U.S. dollar (period average)	54.9	61.5	62.1	66.3	66.4	…	…
Memorandum items:							
GDP at market prices (in billions of Bhutanese Ngultrum)	101.4	112.5	125.8	140.4	159.7	176.2	192.6
GDP at market prices (in millions of U.S. dollars)	1848.7	1829.5	2027.6	2116.7	2404.6	2623.6	2838.6
Electricity exports (in percent of total goods exports)	34.5	31.2	31.4	32.4	32.3	34.3	40.7
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).

Table 2. Bhutan: Government Budget Summary, 2012/13–2022/23

	2012/13	2013/14	2014/15	2015/16	2016/17 Rev.	2017/18 Budget	2018/19 Proj.	2019/20 Proj.	2020/21 Proj.	2021/22 Proj.	2022/23 Proj.
	(In percent of GDP, unless otherwise indicated)										
Revenue and grants	30.2	33.6	28.8	29.9	26.7	31.1	22.1	28.1	28.0	26.3	26.6
Domestic revenue	20.8	21.0	20.9	19.3	18.6	21.2	19.5	21.2	20.2	20.3	23.8
Tax revenue	15.2	14.4	14.6	14.2	13.6	14.9	14.4	13.1	13.5	13.5	13.9
Direct tax	9.3	9.9	9.2	8.7	8.1	9.2	9.8	9.9	10.3	10.3	10.7
Indirect tax	5.9	4.5	5.4	5.5	5.5	5.6	4.7	3.3	3.2	3.2	3.2
Nontax revenue	5.6	6.3	5.4	5.8	5.0	5.8	5.0	8.1	6.7	6.7	9.9
Of which: DHI dividend 1/	1.5	1.6	1.4	1.3	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Of which: Hydropower dividend and profit transfers 2/	1.5	1.8	1.5	1.4	1.3	1.2	1.9	4.7	3.0	3.3	5.9
Other receipts	0.0	0.3	0.9	-0.6	0.0	0.6	0.0	0.0	0.0	0.0	0.0
Foreign grants	9.4	12.7	7.9	10.6	8.1	9.9	2.6	6.9	7.8	6.0	2.8
From India	4.6	9.5	5.2	7.6	6.2	7.8	1.1	5.4	5.6	4.3	1.9
Other	4.8	3.2	2.7	3.0	1.9	2.1	1.4	1.3	2.1	1.6	0.8
Expenditure and net lending	34.4	29.8	27.3	31.1	30.1	32.1	19.9	28.6	28.3	25.2	21.9
Current expenditure	17.8	16.0	16.7	16.3	15.1	16.2	15.1	18.4	17.4	15.6	16.2
Interest expenditure	2.6	1.9	1.6	1.5	1.3	1.2	0.8	1.6	1.6	1.5	3.0
Capital expenditure	18.2	14.8	12.3	15.5	16.2	17.0	5.6	11.5	12.2	10.7	7.9
Net lending	-0.7	-1.2	-2.0	-1.3	-1.3	-1.2	-0.8	-1.3	-1.2	-1.1	-2.2
Primary balance	-1.6	5.7	3.1	-1.8	-2.1	0.2	3.0	1.1	1.2	2.5	7.7
Overall balance	-4.2	3.8	1.5	-1.1	-3.3	-1.0	2.2	-0.5	-0.3	1.1	4.6
Foreign financing	0.7	-0.8	-0.7	-0.7	0.3	0.1	-0.4	0.1	-1.6	-1.6	-2.7
Disbursement	3.5	1.4	1.3	1.3	2.0	1.7	0.6	1.9	0.2	0.2	0.0
Amortization	2.9	2.1	2.1	2.0	1.7	1.6	1.0	1.8	1.8	1.7	2.8
Government of India	2.2	1.4	1.2	1.1	0.8	0.8	0.3	1.0	0.9	0.8	1.9
Domestic financing	3.5	-3.0	-0.8	1.8	3.0	0.9	-1.8	0.4	2.0	0.5	-1.9
Nominal GDP at market prices (in millions of Ngultrum)	101,416	112,462	125,813	140,380	159,743	176,178	192,608	213,231	234,665	262,404	294,122
Overall balance (excl net lending)	-4.9	2.6	-0.5	-2.5	-4.6	-2.2	1.4	-1.9	-1.5	-0.1	2.4

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

1/ Excluding DGPC dividends.

2/ Includes dividend from DGPC, new power projects and BPC, and profits transfer from Tala Hydroelectric Project Authority (THPA).

Table 3. Bhutan: Balance of Payments, 2013/14–2022/23

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(In millions of U.S. dollars)									
Current account	**-483**	**-574**	**-621**	**-547**	**-597**	**-426**	**-325**	**-244**	**-123**	**115**
Trade balance	-393	-430	-540	-469	-460	-226	-157	-121	-30	209
Exports, f.o.b.	535	580	493	555	572	716	804	849	984	1,269
Of which: Electricity	167	182	160	179	196	291	364	388	501	764
Imports, c.i.f.	-928	-1,010	-1,033	-1,024	-1,031	-942	-961	-971	-1,013	-1,060
Of which: Hydropower-related	-344	-357	-351	-290	-215	-312	-258	-151	-45	-6
Services	-65	-69	-53	-51	-55	-37	-19	27	70	71
Credit	124	125	144	158	189	205	217	232	248	266
Debit	-189	-195	-197	-209	-245	-242	-236	-205	-179	-195
Of which: Electricity	-109	-118	-138	-80	-67	-103	-85	-49	-11	-4
Income	-121	-157	-172	-203	-204	-223	-227	-234	-245	-239
Credit	19	27	24	30	32	23	24	33	36	41
Debit	-140	-184	-196	-233	-236	-245	-251	-267	-281	-280
Current transfers	96	81	144	175	121	60	77	84	82	75
Credit	119	111	171	200	139	80	100	108	108	104
Of which: Grants 1/	232	160	225	195	260	74	209	257	215	108
Debit	-23	-30	-27	-25	-18	-20	-22	-24	-26	-29
Capital and financial account	**516**	**586**	**831**	**551**	**645**	**510**	**584**	**331**	**192**	**6**
Capital transfer 2/	275	225	191	187	332	160	288	269	193	99
Foreign direct investment	29	11	8	-12	30	35	45	32	15	16
Portfolio investment	0	0	0	0	0	0	0	0	0	0
Other Investment	212	350	632	377	283	315	251	31	-16	-109
Other flows 3/	0	0	0	0	0	0	0	0	0	0
Errors and omissions	37	-20	-20	-28	-19	0	0	0	0	0
Overall balance	70	-9	189	-24	29	84	260	87	69	121
Memorandum items:	(In percent of GDP, unless otherwise indicated)									
Current account balance	-26.4	-28.3	-29.4	-22.8	-22.8	-15.0	-10.7	-7.4	-3.4	2.9
Trade balance	-21.5	-21.2	-25.5	-19.5	-17.5	-8.0	-5.2	-3.7	-0.8	5.3
Merchandise exports (percent change)	-2.0	8.4	-15.0	12.6	3.0	25.2	12.3	5.6	15.9	29.0
Merchandise imports (percent change)	0.5	8.8	2.4	-0.9	0.8	-8.7	2.0	1.1	4.4	4.6
Capital and financial account	28.2	28.9	39.3	22.9	24.6	18.0	19.2	10.1	5.4	0.1
FDI	1.6	0.5	0.4	-0.5	1.1	1.2	1.5	1.0	0.4	0.4
Overall balance	3.8	-0.5	9.0	-1.0	1.1	3.0	8.5	2.7	1.9	3.1
External debt	93.6	94.0	110.9	100.0	96.2	99.7	103.2	98.8	90.1	79.6
(In millions of U.S. dollars)	1,753	1,855	2,302	2,478	2,600	2,916	3,167	3,197	3,182	3,073
Debt service (in percent of exports of goods and services	33.6	22.8	18.7	33.3	38.0	9.9	18.0	26.6	17.5	22.7
(In millions of U.S. dollars)	179	132	92	185	217	71	145	226	172	288
Gross official reserves (in millions of U.S. dollars)	998	959	1,115	1,226	1,243	1,327	1,587	1,674	1,744	1,864
(In months of imports of goods)	11.9	11.1	13.1	14.3	15.8	16.6	19.6	19.8	19.7	20.3
(In months of imports of goods and services)	9.9	9.3	10.9	11.5	12.6	13.3	16.2	16.9	16.7	17.0
Nominal GDP (in millions of U.S. dollars)	1,830	2,028	2,117	2,405	2,624	2,839	3,041	3,277	3,575	3,909

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

1/ Includes budgetary grants only.

2/ Including grants for hydropower projects (Tala, Puna I, Puna II, Mangdechhu, Kholongchhu, Bunakha, Chamkarchhu, and Wangchhu).

3/ Including trade credit, rupee credit lines, short-term capital flows and IMF SDR allocation in 2009.

Table 4. Bhutan: Medium-Term Macroeconomic Framework, 2012/13–2022/23

		Eleventh Plan Period					Twelfth Plan Period				
	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Real sector (percent change)											
Real GDP at market prices	3.6	4.0	6.2	7.3	7.4	5.8	4.8	6.3	6.0	7.2	7.5
Consumer prices (period average)	11.3	9.6	7.6	7.6	5.8	4.6	4.9	4.8	4.7	4.7	4.7
Fiscal sector (in percent of GDP) 1/											
Revenue and grants	30.2	33.6	28.8	29.9	26.7	31.1	22.1	28.1	28.0	26.3	26.6
Domestic revenue 2/	20.8	21.0	20.9	19.3	18.6	21.2	19.5	21.2	20.2	20.3	23.8
Of which : tax revenue	15.2	14.4	14.6	14.2	13.6	14.9	14.4	13.1	13.5	13.5	13.9
Grants	9.4	12.7	7.9	10.6	8.1	9.9	2.6	6.9	7.8	6.0	2.8
Expenditure and net lending	34.4	29.8	27.3	31.1	30.1	32.1	19.9	28.6	28.3	25.2	21.9
Current expenditure	17.8	16.0	16.7	16.3	15.1	16.2	15.1	18.4	17.4	15.6	16.2
Of which : interest	2.6	1.9	1.6	1.5	1.3	1.2	0.8	1.6	1.6	1.5	3.0
Capital expenditure	18.2	14.8	12.3	15.5	16.2	17.0	5.6	11.5	12.2	10.7	7.9
Net lending	-0.7	-1.2	-2.0	-1.3	-1.3	-1.2	-0.8	-1.3	-1.2	-1.1	-2.2
Overall balance	-4.2	3.8	1.5	-1.1	-3.3	-1.0	2.2	-0.5	-0.3	1.1	4.6
External financing	0.7	-0.8	-0.7	-0.7	0.3	0.1	-0.4	0.1	-1.6	-1.6	-2.7
Domestic financing	3.5	-3.0	-0.8	1.8	3.0	0.9	-1.8	0.4	2.0	0.5	-1.9
Public sector debt (in percent of GDP)	100.3	96.2	95.7	114.2	106.3	102.7	103.9	107.4	104.6	95.8	82.8
Monetary Sector (percent change)											
Broad money	18.6	6.6	7.8	15.8	31.5	…	…	…	…	…	…
Credit to private sector	7.1	6.4	14.0	14.7	15.4	…	…	…	…	…	…
External sector (in millions of U.S. dollars)											
Current account balance (including grants)	-470	-483	-574	-621	-547	-597	-426	-325	-244	-123	115
(In percent of GDP)	-25.4	-26.4	-28.3	-29.4	-22.8	-22.8	-15.0	-10.7	-7.4	-3.4	2.9
Trade balance	-377	-393	-430	-540	-469	-460	-226	-157	-121	-30	209
Exports	546	535	580	493	555	572	716	804	849	984	1,269
Of which: Electricity exports	188	167	182	160	179	196	291	364	388	501	764
Imports	-923	-928	-1,010	-1,033	-1,024	-1,031	-942	-961	-971	-1,013	-1,060
Of which: Hydropower-related	-280	-344	-357	-351	-290	-215	-312	-258	-151	-45	-6
Services, income, and transfers (net)	-92	-90	-145	-81	-78	-138	-200	-168	-123	-93	-94
Of which : grants 3/	128	96	81	144	175	121	60	77	84	82	75
Capital and financial account balance	578	516	586	831	551	645	510	584	331	192	6
Of which : foreign direct investment	20	29	11	8	-12	30	35	45	32	15	16
Of which : loans (net)	294	212	350	632	377	283	315	251	31	-16	-109
Overall balance	168	70	-9	189	-24	29	84	260	87	69	121
(In percent of GDP)	9.1	3.8	-0.5	9.0	-1.0	1.1	3.0	8.5	2.7	1.9	3.1
Gross foreign reserves (in millions of U.S. dollars)	917	998	959	1,115	1,226	1,243	1,327	1,587	1,674	1,744	1,864
(In months of goods and services imports)	11.9	11.9	11.1	13.1	14.3	15.8	16.6	19.6	19.8	19.7	20.3
External debt (PPG, in percent of GDP)	94.1	93.6	94.0	110.9	100.0	96.2	99.7	103.2	98.8	90.1	79.6
Of which: Power sector debt	49.1	62.4	65.6	79.4	79.7	75.7	78.5	78.9	75.8	68.9	59.9
External debt service											
(In percent of exports of goods and services)	19.5	33.6	22.8	18.7	33.3	38.0	9.9	18.0	26.6	17.5	22.7
Nominal GDP (in millions of ngultrum)	101,416	112,462	125,813	140,380	159,743	176,178	192,608	213,231	234,665	262,404	294,122
Nominal GDP (in millions of US$)	1,849	1,830	2,028	2,117	2,405	2,624	2,839	3,041	3,277	3,575	3,909

Sources: Data provided by the Bhutanese authorities; and Fund staff estimates and projections.
1/ Government budgetary accounts. Revenues, interest payments, and foreign financing include flows related to hydropower projects.
2/ GST is not included in the baseline.
3/ Includes budgetary grants only.

Table 5. Bhutan: Monetary Survey, 2013/14–2017/18

	2013/14 June	2014/15 June	2015/16 June	2016/17 June	2017/18 Dec
Monetary survey	(In millions of ngultrum)				
Net foreign assets	53,887	58,249	67,816	68,476	72,879
Indian rupee	265	4,034	7,317	18,237	…
Other	53,621	54,214	60,499	50,239	…
Net domestic assets	9,501	10,096	11,347	35,927	37,122
Net claims on government 1/	-1,978	-7,740	-5,570	2,853	2,499
Claims on nongovernment	54,277	63,995	71,263	82,232	87,857
Public enterprises 2/	4,438	7,174	6,106	7,047	5,702
Private sector 3/	49,839	56,821	65,157	75,185	82,155
Other items (net) 4/	-42,798	-46,160	-54,346	-49,158	-53,234
Broad money	63,388	68,344	79,163	104,114	110,001
Narrow money	39,702	41,676	44,934	60,723	63,486
Currency	5,705	5,946	6,102	8,788	8,767
Demand deposits	33,997	35,729	38,832	51,936	54,719
Quasi-money 5/	23,686	26,669	34,229	43,390	46,515
Royal Monetary Authority					
Net foreign assets	50,575	55,113	64,173	64,821	69,440
Indian rupee	-507	2,827	5,214	16,496	19,571
Other	51,082	52,286	58,959	48,325	49,869
Net domestic assets	-23,937	-28,864	-36,370	-30,493	-36,728
Net claims on government	-3,855	-7,780	-10,200	-7,152	-9,503
Claims	0	0	0	0	28
Minus: deposits	3,855	7,780	10,200	7,152	9,531
Claims on deposit money banks	281.6	1696.9	266.6	578.4	1427.7
Claims on private sector	14	28	33	36	34
Minus: RMA bills	0	0	0	0	0
Other items (net)	-20,378	-22,809	-26,470	-23,955	-28,686
Reserve money	26638.2	26248.8	27802.9	34327.9	32712.2
Memorandum items:					
	(Change in percent of initial stock of broad money)				
Broad money	6.6	7.8	15.8	31.5	5.7
Net foreign assets	8.9	6.9	14.0	0.8	4.2
Net domestic assets	-2.3	0.9	1.8	31.0	1.1
Net claims on government	9.3	-9.1	3.2	10.6	-0.3
Claims on private sector	5.1	11.0	12.2	12.7	6.7
Other items (net)	-20.3	-5.3	-12.0	6.6	-3.9
	(Change in percent of initial stock of reserve money)				
Reserve money	11.0	-1.5	5.9	23.5	-4.7
Net foreign assets	20.6	17.0	34.5	2.3	13.5
Net domestic assets	-9.6	-18.5	-28.6	21.1	-18.2
Money multiplier	2.4	2.6	2.8	3.0	3.4
Velocity of money	1.7	1.7	1.7	1.4	…
Broad money/GDP	0.6	0.6	0.6	0.7	…
Broad money growth (12-month percent change)	6.6	7.8	15.8	31.5	5.7
Reserve money growth (12-month percent change)	11.0	-1.5	5.9	23.5	-4.7
Credit to private sector (12-month percent change)	6.4	14.0	14.7	15.4	9.3

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

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

2/ From 2011/12 onward, public enterprises include government corporations and other public corporations as in the previous definition.

3/ From 2011/12 onward, private sector credit includes joint corpoerations, NBFIs and private sector as in the previous definition.

4/ Includes foreign exchange valuation adjustments and capital accounts.

5/ Includes time and foreign currency deposits.

Table 6. Bhutan: Financial Soundness Indicators, 2008/09–2017/18 1/

(In percent, unless otherwise specified)

	2008/09 June	2009/10 June	2010/11 June	2011/12 June	2012/13 June	2013/14 June	2014/15 June	2015/16 June	2016/17 Dec-16	2016/17 June	2017/18 Dec-17
Risk weighted capital adequacy ratio											
Financial sector	17.3	17.1	14.4	18.4	18.2	18.9	17.2	16.9	19.0	17.3	16.0
Banks	16.5	17.1	14.2	19.1	18.2	20.0	17.5	17.9	20.2	17.2	16.5
Nonbanks	23.6	17.2	16.0	19.4	15.8	14.0	15.7	13.0	14.2	17.4	14.0
NPL ratio											
Financial sector	18.3	10.1	8.5	8.2	9.5	12.0	9.5	9.1	6.5	11.4	8.0
Banks	18.4	9.5	7.6	8.2	9.5	12.1	9.7	9.8	7.2	12.5	8.4
Nonbanks	17.7	15.2	14.1	4.9	11.9	11.3	7.9	5.8	3.4	6.8	6.0
Return on assets											
Financial sector	0.1	1.0	0.6	0.9	0.7	0.7	0.5	0.2	1.8	-0.5	0.7
Banks	-0.1	0.9	0.4	0.9	0.7	...	0.4	...	1.5	-0.7	0.5
Nonbanks	2.4	2.1	2.2	3.6	4.2	...	1.8	...	3.6	0.7	2.5
Credit to deposit ratio (banks only)	74.2	74.6	81.7	105.8	84.9	82.9	86.4	86.6	77.2	73.4	77.0
Statutory liquidity requirement (SLR)											
Banks	27.9	35.5	18.0	27.5	34.4	38.8	29.6	26.0	32.0	33.8	29.3
Nonbanks	10.6	20.9	13.9	19.1	23.8	31.2	23.5	12.8	13.3	10.4	15.4

Source: Royal Monetary Authority of Bhutan.

1/ Data are for July–June fiscal years.

Appendix I. Priority Sector Lending Guidelines

1. **Bhutan began implementing Priority Sector Lending (PSL) Guidelines in January 2018.** The Guidelines form an integrated platform to coordinate interventions from several government agencies to stimulate the cottage and small industries (CSI) sector. It was developed based on consultations with several government agencies, commercial banks, and insurance companies. A PSL Council has been formed to monitor and evaluate implementation. It is chaired by the RMA and comprises representatives from all relevant government and financial sector entities.

2. **The Guidelines recognize the CSI sector as the largest source of domestic production and employment** as critical for addressing challenges facing the agriculture sector and stemming from rural-urban migration, which has risen markedly. In consultation with financial institutions, the RMA has prescribed lending targets (a function of their outstanding loan portfolio in priority sectors), and ceiling preferential lending rates for lending to the agricultural (8 percent) and non-agricultural (8.5 percent) CSI sectors. Financial institutions having any shortfalls in meeting their priority sector targets may allocate their funds for on-lending to a microfinance institution or Bhutan Development Bank. Notably, financial institutions lending to the CSI sector at preferential interest rates are exempt from paying taxes on the income from such lending as per the Fiscal Incentives Act of 2017. In addition, the Guidelines prescribe mandatory insurance coverage to accompany loans to agricultural projects, with insurance to substitute for collateral. Finally, the Guidelines provide for training at the RMA's Financial Institutions Training Institute (FITI).

3. **The Guidelines set an important coordination platform to address key challenges in Bhutan.** Based on lessons learned and good practices from other countries, the following recommendations may help achieve PSL's objectives and reduce risks associated with the plan:

- *First, the rigor of credit assessments under the CSI program should be kept at par with those for market-based lending.* In addition, the experience and progress under the program should be evaluated frequently to avoid a build-up of risks and contingent liabilities.
- *Second, incentives rather than quantitative targets should be used to encourage lending.*[1] Commercial banks may face barriers and risks given the lack of relevant expertise, reach, and operational efficiency.[2]
- *Third, interest rate caps need to be frequently reviewed.* Global experience suggests that the effectiveness and any unintended side-effects will depend on the type and specification of the cap. Calibrating interest caps at the "right" level to achieve operational efficiency is

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[1] Such incentives may include partial credit risk guarantees or the provision of financial infrastructure to mitigate risks and reduce costs (e.g., reverse factoring platforms for value chains, broader and better credit and collateral information, efficient payment systems, and digital financial channels).

[2] The Guidelines recognize this and allow for any shortfall amounts to be transferred to more appropriate financial institutions.

difficult, while binding caps set below market levels can affect not only profitability and risk in financial institutions, but also the overall credit supply.

- *Fourth, any deviations from market conditions should be fully compensated.* Tax benefits can be perceived as an offset to below-market pricing. This may, however, not be enough to compensate for the full difference between preferential and commercial rates, as well as for the losses of targeting a potentially riskier market segment.

- *Finally, technical capacity and coordination among all relevant parties should be strengthened.* PSL loan proposals are routed through Special Technical Window Services that involve coordination with multiple agencies, including regional and local administration officials. Given the complexity of the undertaking and the moral hazard involved, capacity building and inter-agency coordination are critical. FITI is the designated institution to provide training, but its effectiveness is yet to be tested.

Appendix II. Risk Assessment Matrix

Nature/Source of Threat	Likelihood	Impact	Policies to Minimize Impact
Domestic Risks			
Delays in adopting revenue measures to offset loss of excise duty refunds from India and implementing the GST	***H***	***H:*** There is a risk that offsetting tax measures may not be implemented in time to make up for the loss in revenue (expected to kick in from FY2019). In addition, the authorities are aiming for a July 2020 implementation of the GST, which is ambitious. While key milestones have been met, challenges remain (e.g., timely adoption of an IT system) that may delay the process.	Ensure timely implementation of the GST related actions in line with IMF recommendations.
Delayed project implementation	***M***	***H:*** Delays in projected completion of hydropower projects could lead to lower electricity exports and larger fiscal deficits.	Implement measures to broaden the tax base and improve tax administration.
Debt sustainability	***M***	***M:*** So far, hydropower projects have been government-to-government. The next generation of hydropower projects will rely on joint ventures, with some risks shifting to the Government of Bhutan.	Strengthen the capacity to evaluate and manage the risks from joint venture hydropower projects.
Bank balance sheet risks	***L***	***M:*** Banks are weak and suffer from low profitability; NPLs are high and growing. While provisioning standards are adequate, classification remains lax, potentially masking solvency problems at least in some banks.	Strengthen supervision and tighten prudential regulations. Take early action as signs of deteriorating asset quality emerge.
External Risks			
Weaker growth in India	***M***	***M:*** Slowing structural reform could weaken growth in India, which could adversely affect Bhutan's non-hydropower exports, aid, and hydropower construction disbursements to Bhutan.	Contingency planning to prioritize expenditure and mobilize domestic revenues, including through timely GST implementation.
Higher inflation in India	***M***	***M:*** The recent pickup in India's inflation would push up imported inflation from India, which would hurt the poor.	Tighten monetary conditions and reduce bank liquidity to prevent second-round effects from building.
Sizeable deviations from baseline energy prices	***M***	***M***: Oil price deviations from baseline assumptions could have significant effects on the current account and fiscal deficit.	Reserve buffers can be used to smooth adjustment to oil price shocks.

"L"=Low; "M"=Medium; "H"=High.

The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("L" indicates a probability below 10 percent, "M" indicates a probability between 10 and 30 percent, and "H" indicates a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and the overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Appendix III. Guiding Principles for the Stabilization Fund Management

1. Bhutan's Sovereign Wealth Fund (SWF), known as the Bhutan Economic Stabilization Fund, gained ground following the Indian Rupee shortage in 2012. Initial considerations included addressing volatile liquidity conditions, economic stabilization through countercyclical fiscal policies, and intergeneration equity and economic diversification through investment of surplus revenues. Subsequently, the stabilization objective has gained primacy, in line with IMF recommendations. A draft Royal Charter and a Concept Note have been drafted, and a seed capital allocation of Ng 100 million has been made available through the FY2018 budget.

2. SWF assets—and the returns they generate—can have a significant effect on public finances, monetary conditions, external accounts, and balance sheet linkages with the rest of the world. In particular (i) fiscal policy might be affected by SWF funding and withdrawal rules (usually derived from a fiscal rule), (ii) monetary policy may be impacted by wide fluctuations in fiscal revenues and procyclical implications for aggregate demand that typically affect inflation and the real exchange rate; and (iii) exchange rate variations could be mitigated by investing the SWF's resources abroad.

3. The 24 Generally Accepted Principles and Practices for SWFs, usually referred to as the "Santiago Principles", are typically the cornerstone of setting up and managing SWFs. The Principles are designed to promote good governance, prudent investment practices, accountability, and transparency, whilst encouraging a more open dialogue and deeper understanding of SWF activities.[1] The remainder of this appendix lists recommendations and considerations for setting up a well-functioning SWF in Bhutan's context.

- **The draft Charter and the Concept Note can be improved in terms of defining objectives for governance and investment mandates.** The establishment and management of the SWF should be based on sound foundations and reaching consensus around such foundations is essential. The objectives and investment decisions/portfolio allocations of SWFs need to be closely linked, as well as the stated investment objectives and governance structure.

- **The authorities must decide on a fiscal (responsibility) law that is consistent with the macroeconomic setting.** The Constitutional fiscal rule that constrains current expenditure to be met from domestic revenues, and deficit caps as articulated under the FYP, are not countercyclical by design. A new law would have to be designed to reflect the countercyclical role envisaged for the SWF and its operations included into the medium-term fiscal framework.

- **A legal framework is required to promote sound institutional and governance arrangements for the effective management of SWFs.** The legal framework should among other things: (i) provide clearly for the legal form and structure of the SWF and its relationship with other state bodies (including the ministry of finance and the central bank); (ii) be consistent

[1] See http://www.ifswf.org/santiago-principles

with the broader legal framework governing government's budgetary processes; (iii) ensure legal soundness of the SWF and its transactions; (iv) support its effective operation and the achievement of its stated policy objectives, which should be economic and financial in nature; and (v) promote effective governance, accountability, and transparency.

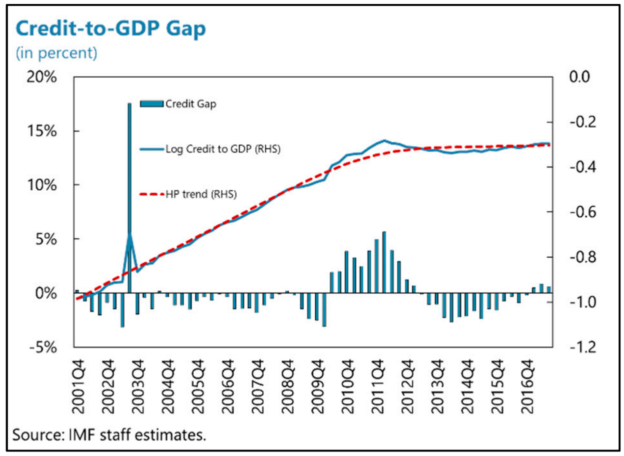
- **The institutional frameworks of SWFs differ across countries, and a framework suitable for Bhutan should be pursued.** Regardless of the governance framework, the operational management of the SWF should be conducted on an independent basis to minimize potential political influence or interference that can affect the achievement of the SWF's objectives. The governance structure must be commensurate with the risks and complexities of the investment strategy.

- **Suitable SWF funding and withdrawal rules are found to be critical components of an effective governance structure.** Also, a strong institutional development and risk management framework is typically required to ensure an appropriate timing and frequency of asset allocation changes, especially in periods of high or intensifying market volatility. As an example, only once a stabilization fund reaches an adequate size to address anticipated deficits, then excess assets can be placed in a savings fund, provided that the country's public debt is sustainable.

- **Framing the SWF in the context of the overall sovereign balance sheet would be particularly important to Bhutan given its large hydropower assets and liabilities.** A sovereign-asset liability management (SALM) approach can help detect and monitor sovereign risk exposures from a consolidated public-sector portfolio perspective. In this context, the interaction between the public debt management strategy and SALM would be clear and helps communicate logical and detailed explanations of policy decisions, ex ante.

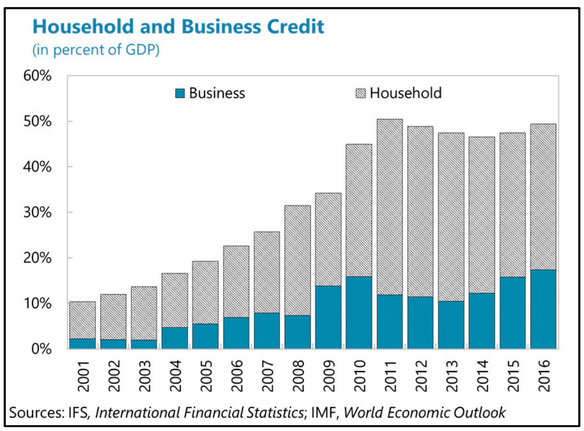
Appendix IV. Composition of Credit and Economic Activity

1. The credit gap has been negative until recent quarters. A small positive credit gap has emerged but it remains significantly smaller compared to values witnessed in the run-up to the rupee crisis. The credit gap measures the extent to which the credit-to-GDP ratio exceeds its (HP-filtered) trend and is reported in percent of the trend value. The credit gap has been positive in recent quarters, but remains small at below 1 percent.

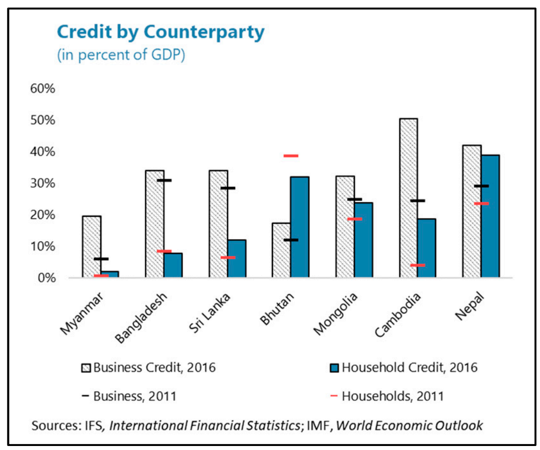


Credit-to-GDP Gap
(in percent)
Source: IMF staff estimates.

2. The composition of credit-to-GDP has changed in recent years. Credit to businesses has been growing faster than credit to households in recent years, resulting in the stock of credit to business regaining its share to GDP following the end of the household credit boom in 2011. Nonetheless, household credit as a share of GDP remains high and business credit low compared to frontier and developing Asian economies.

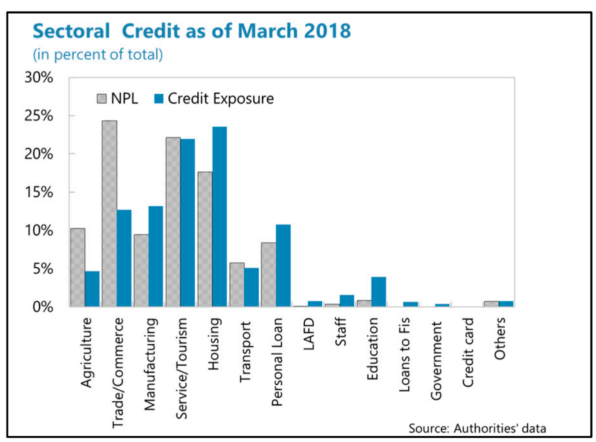


Household and Business Credit
(in percent of GDP)
Sources: IFS, *International Financial Statistics*; IMF, *World Economic Outlook*



Credit by Counterparty
(in percent of GDP)
Sources: IFS, *International Financial Statistics*; IMF, *World Economic Outlook*

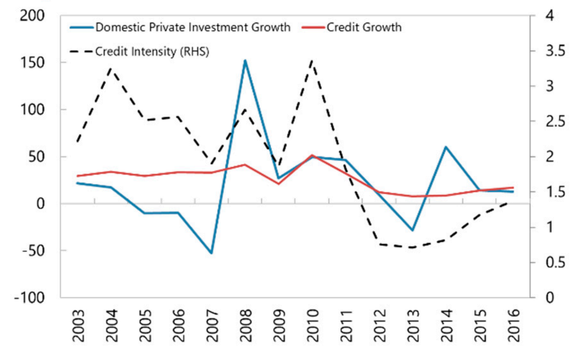
3. Data on the sectoral composition of credit and NPLs provide interesting insights into the relative riskiness of activities. While the stock of outstanding credit to trade and commerce sector is only 13 percent of total credit, NPLs in the sector are 24 percent of total. In contrast, personal loans, comprising 11 percent of total credit, generate 8 percent of NPLs. Similarly, tourism and housing make up 45 percent of credit exposure and 40 percent of NPLs.



Sectoral Credit as of March 2018
(in percent of total)
Source: Authorities' data

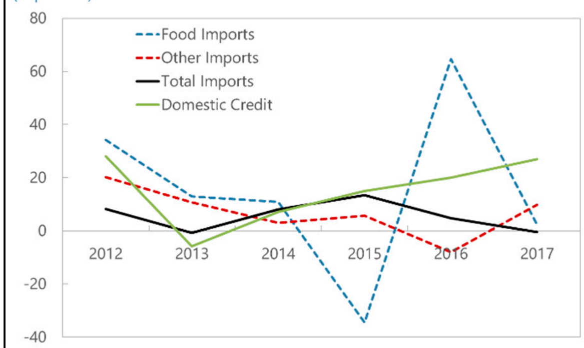
4. Credit intensity has been at historic lows since the end of the last credit boom and aggregate data on credit utilization provide mixed signals. Credit intensity, measured as the ratio of credit growth to nominal GDP growth, averaged 2.4 between 2002 and 2011. Since then, credit intensity has remained low, although on an increasing trend, reaching 1.4 in 2016. A similar story of credit utilization emerges upon an examination of domestic investment vs. credit. It appears that domestic private investment-to-GDP growth is more volatile than credit growth, suggesting a low credit intensity of domestic investment. However, the aggregate data does not provide enough evidence of the impact of credit on imports. While there is an uptick in other imports (i.e., other than food and hydro-related goods) in 2017, the correlation between domestic credit growth and the growth of other imports is low (at 0.13), casting doubts on the hypothesis that credit mostly funds imports.[1] More granular data would be required to assess the role private credit plays in promoting domestic activity vs. contributing to imports.

Credit Growth and Domestic Private Investment
(in percent)



Sources: IFS, *International Financial Statistics*; IMF, *World Economic Outlook*

Import Growth and Domestic Credit
(in percent)



Sources: Bhutan Trade Statistics

[1] Other imports include categories under sections VI to XIV as defined in Bhutan Trade Statistics.

Appendix V. External Sector Assessment

Bhutan's external position is moderately weaker than warranted by fundamentals and desirable policies. The current account deficit is temporarily large due to hydropower imports though the overall balance remains positive supported in part by grant financing. The volatile nature of revenue and debt flows related to hydropower along with the peg to the Indian rupee warrants careful policy planning. The peg has been an adequate nominal anchor and remains appropriate as India is Bhutan's largest trade and development partner.

1. The adjusted EBA-lite current account (CA) methodology suggests that the external position is weaker than fundamentals and desirable policies. The adjustment strips hydropower-related imports from the current account as these are temporary and exhibit large variations depending on the number of hydropower projects under construction. This adjustment results in an estimated CA gap of -3.5 percent of GDP. Positive policy contributions to the CA gap from world policy gaps and staff's advice to keep reserves-to-GDP constant (given adequate levels of reserves—see discussion below), are offset by a negative fiscal policy gap[1] and a negative unexplained residual, which may capture underlying competitiveness issues. The elasticity for calculating the implied REER gap is calculated as the sum of the template-suggested elasticity of imports and exports weighted by the share to GDP of imports excluding hydropower and exports.

EBA-Lite CA Methodology	
CA-Actual	**-22.8%**
Cyclical Contributions (from model)	0.9%
additional temporary/statistical factors	-15.4%
Cyclically adjusted CA	**-8.3%**
CA-Norm	**-3.9%**
additional adjustments to the norm	0.00%
Cyclically adjusted CA Norm	**-4.8%**
CA-Gap	-3.5%
o/w Policy gap	1.7%
Elasticity	-0.19
REER Gap	18.7%

2. The external sustainability (ES) methodology suggests a moderately stronger external position. The ES methodology is anchored on longer- term current account dynamics which are favorable in Bhutan's case due to the projected take-off of hydropower exports. As Bhutan is not part of the EBA-lite sample, data are not adequate to use the REER model.

EBA—Lite Methodology	CA norm 1/	CA 1/	CA gap	REER gap
CA	-4.8	-23.7	-18.0	95.6
CA adjusted for hydropower imports	-4.8	-8.3	-3.5	18.7
ES	1.4 2/	2.9 3/	1.5	-6.6

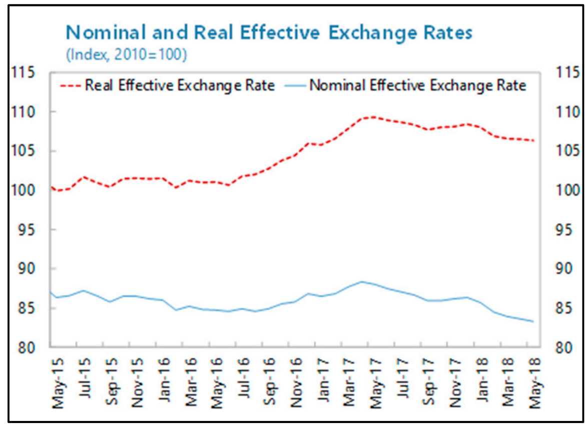
Note: all values are in percent
1/ Cyclically adjusted.
2/ The ES CA norm is assuming an IIP position of 30 percent of GDP to be reached in 30 years.
3/ The ES CA is anchored on the CA at the end of the projection period.

3. On balance, staff assesses the external position to be moderately weaker than warranted by fundamentals and desirable policies. The results of the ES model suggest that the external position may not be as weak as the CA model suggests. At the same time, the ES model should be interpreted with some caution, given uncertainties about the future path of the CA. Taking such uncertainties into account, staff assesses

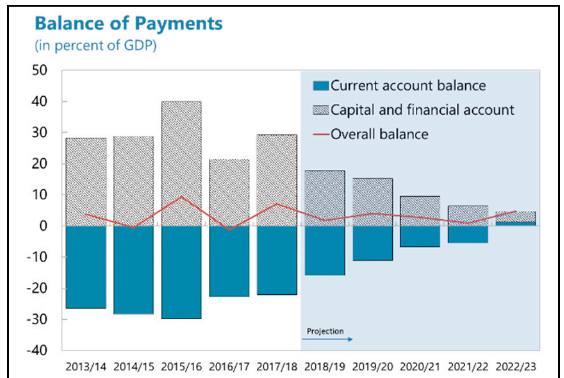
[1] The negative policy gap is relative to the cyclically adjusted fiscal balance in FY2017.

that, on balance, the CA gap is around 0 to -3 percent of GDP and the REER gap is around 0–16 percent.

4. The ngultrum is pegged to the rupee at par and has been moderately appreciating in real effective terms. During the first quarter of 2018 the REER appreciated by 0.4 percent and the NEER depreciated by 2.5 percent. Movements in both the REER and NEER are heavily influenced by the rupee. The peg has been an adequate nominal anchor and remains appropriate as India is Bhutan's largest trade and development partner.

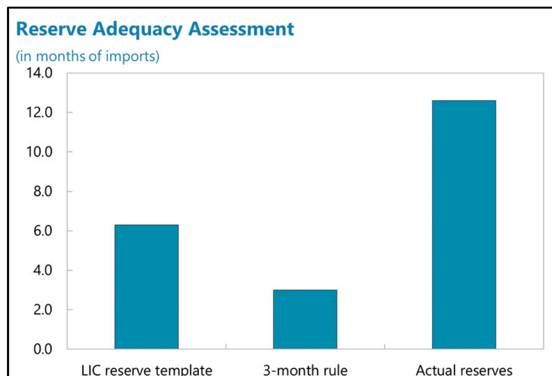


5. The financial account is projected to decline over the medium term though the overall balance continues to be positive. The current account deficit is covered by large inflows related to the hydropower sector including grant financing. As debt disbursements and grants related to hydropower projects decline, electricity exports will boost the current account helping maintain a positive overall balance. The net international investment position stood at -60 percent of GDP in 2016, and is driven by debt flows associated with hydropower projects causing a deterioration as disbursements begin around the time of construction. Assets are dominated by foreign reserves though debt assets exist but have been small. Portfolio flows are not an important source of assets or liabilities.



Sources: Authorities' data and staff estimates

6. Bhutan has adequate reserve buffers. Reserve adequacy is assessed to be around 6 months of imports using a cost of reserves equal to the marginal product of capital estimated to be 6.2 percent.[2] Other measures of cost suggest a range between 4 to 9 months of imports. Bhutan currently holds nearly 13 months of imports in reserves. In recent years, the share of rupee reserves has increased to 36 percent of total reserves, which along with a 100 million USD swap line with the Reserve Bank of India, improves buffers with Bhutan's largest trading partner.



Sources: Royal Monetary Authority and staff estimates

[2] http://www.imf.org/external/np/pp/eng/2013/111313d.pdf

INTERNATIONAL MONETARY FUND

BHUTAN

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

August 7, 2018

Prepared By | Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of July 31, 2018)

Membership Status:

Joined: September 28, 1981; Article XIV.

General Resources Account

	SDR Million	% Quota
Quota	20.40	100.00
Fund Holdings of Currency (Exchange Rate)	15.85	77.72
Reserve Tranche Position	4.55	22.29
Lending to the Fund		

SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	5.99	100.00
Holdings	6.03	100.65

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund 1/
(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2018	2019	2020	2021	2022
Principal					
Charges/interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

1/ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Implementation of HIPC Initiative: Not Applicable

Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable

Implementation of Post-Catastrophe Debt Relief (PCDR): Not Applicable

Exchange System

Since its introduction in 1974, the ngultrum has been pegged to the Indian rupee at par. Bhutan continues to avail itself of transitional arrangements under Article XIV, Section 2, pursuant to which it maintains exchange restrictions in connection with: (i) the availability of foreign exchange for travel, except for medical travel abroad by Bhutanese citizens, invisibles, and private transfers; (ii) foreign exchange balancing requirement on remittances of income in convertible currencies or other foreign currencies from FDI; and (iii) on the availability of FX for importers who have not provided evidence that goods for which payments have been made were actually imported.[1]

Bhutan also maintains exchange restrictions subject to Fund approval under Article VIII, Section 2(a) in connection with: (i) the foreign exchange balancing requirements for imports of capital goods (for projects involving FDI) and primary raw materials (for certain industrial projects); (ii) banning residents who do not comply with the requirement to repatriate export proceeds from accessing foreign exchange for unrelated imports; (iii) requiring foreign direct investment companies to pay for their establishment and operational expenses from their own convertible currency resources; (iv) requiring Bhutanese companies to pay the interest on and amortization of external loans from their own convertible currency resources; (v) restricting the availability of Indian rupees for making payments and transfers to India for certain current international transactions[2] and banning the access to Indian rupees for unrelated current international transactions for those who contravene RMA 's 2012 guidelines on Indian rupee transactions.[3]

Article IV Consultation

Bhutan is on a 24-month consultation cycle. The 2018 Article IV consultation was concluded by the Executive Board on September 17, 2018.

[1] Revisions to the description of the exchange restrictions maintained by Bhutan under the transitional arrangements of Article XIV are reflected in this section, which result from findings made by IMF staff following a TA mission in 2016. These refer to: (i) the elimination of a previously identified restriction on the availability of FX for importers who are not able to provide the identity of the seller, because staff confirmed that to obtain an import license the importer indeed has to disclose the identity of the seller; and (ii) the reintroduction in the list of a restriction arising from a 2002 measure restricting the availability of FX for importers who have not provided evidence that goods for which payments have been made were actually imported, as the information that staff had about the removal of this measure at the time of the 2009 Article IV consultation was incorrect given that the measure continues to be present in the 2002 Rules and Procedures on Imports from Third Countries, at Section C.12(v)."

[2] The current international transactions for which access to Indian rupees is limited are: personal and business travel and study-abroad living arrangement, moderate family remittances, advance payments for imports from India, and advance salary payments to recruit Indian workers.

[3] On September 1, 2014, the RMA reintroduced housing and vehicle loans (after temporary suspension of access to Indian rupees to finance imports of personal vehicles and housing construction materials in March 2012). This measure removed the previous exchange restrictions found on the access to Indian rupees for imports of certain construction materials and vehicles from India. Staff also found that the exchange restriction on access to Indian rupees for salary remittances by non-residents has been removed. For a description of the measures which lead to the remaining findings of exchange restrictions outlined above, please see IMF Country Report No. 14/179 (Informational Annex).

Technical Assistance

Over the past five years Bhutan has received technical assistance in the areas of: macro-fiscal capacity building, budget planning, treasury and cash management, strengthening the AML/CFT framework, drafting new foreign exchange regulations and removing exchange restrictions, reserve management, foreign exchange operations, national accounts statistics, balance of payments statistics, e-GDDS, producer price index, and the consumer price index. Bhutan has also received technical assistance and training from the South Asia Regional Training and Technical Assistance Center (SARTTAC) covering most recently liquidity management and forecasting, money and foreign exchange market operations, revamping the monetary policy statement, regulation and supervision of insurance and financial institutions, implementation of the goods and services tax, tax administration, national accounts and BOP statistics.

The term of the resident treasury advisor at Ministry of Finance has been extended until end-August 2018, and a Resident Goods and Services Tax Advisor was installed in July 2018 with a term of one year.

Resident Representative

Mr. Andreas Bauer has been the Senior Resident Representative since June 15, 2016. He is based in New Delhi.

INFORMATION ON THE ACTIVITIES OF OTHER IFIS

Information on the activities of other IFIs in Bhutan can be found at:

- World Bank: http://www.worldbank.org/en/country/bhutan/overview
- Asian Development Bank: https://www.adb.org/sites/default/files/publication/27755/bhu-2017.pdf

STATISTICAL ISSUES

(as of June 24, 2018)	
I. Assessment of Data Adequacy for Surveillance	
General: Data provision—particularly with regards to timeliness—has some shortcomings, but is broadly adequate for surveillance. Most affected areas are: national accounts, balance of payments, and fiscal data.	
Real sector: The Statistics Department of the IMF (STA) has been actively providing technical assistance (TA) to improve the national accounts and develop a producer price index. Since 2017, TA is being provided through the South Asia Training and Technical Assistance Center. **National Accounts:** The current benchmark year of the national accounts is 2000. Besides benchmarking to an old economic structure of the economy, the accuracy and reliability of the GDP estimates are affected by inadequate source data and by some poor compilation methods. Key shortcomings include lack of source data quality control and long lags in gaining access to some source data. The key factors contributing to the data deficiency are the shortage of qualified personnel and facilities. The National Statistical Bureau (NSB) is also constrained by the absence of a Statistics Act. Thus far, Bhutan does not produce quarterly national accounts data. The NSB is currently carrying out a project to estimate a new benchmark for the national accounts and to rebase the current series and produce quarterly national accounts. **Price statistics:** Starting in January 2013, the consumer price index (CPI) is compiled on a monthly basis. More current household surveys should be used to update the current CPI weights (2012). A Producer Price Index is compiled monthly but disseminated quarterly. It covers manufacturing, mining, utilities, transport, information, and communication activities.	
Government finance statistics: Despite recent improvements in the quality of government finance statistics (GFS), the fiscal data are subject to frequent and substantial revisions, particularly in the expenditure area. The compilation and dissemination of budget execution data and GFS are very limited. Only annual budget execution data are compiled and disseminated, and with a long lag. No GFS are disseminated nationally. The authorities were planning to start producing and distributing internally quarterly data, but thus far there has been little progress. There are inconsistencies between the fiscal and monetary data with regard to bank financing, stemming from differences in the definition of government. Further improvements in GFS are expected under the new SARTTAC GFS/public sector debt statistics program.	
Monetary statistics: Monetary and financial statistics are compiled broadly in line with the *Monetary and Financial Statistics Manual*. The Royal Monetary Authority (RMA) reports monetary and financial statistics monthly, using Standardized Report Forms (SRFs) for the central bank, other depository corporations, and other financial corporations, and monetary data based on these SRFs are published in the *International Financial Statistics*. However, some data shortcomings include the valuation of financial assets which are recorded at acquisition cost rather than at market price or fair value. **Financial Sector Surveillance:** The RMA reports to STA the Financial Soundness Indicators (FSI) on a quarterly basis which include 12 core and 7 encouraged indicators for deposit takers. The FSIs are published on the IMF's FSI webpage.	
Balance of payments: External sector statistics have improved in recent years. The RMA compiles and disseminates quarterly balance of payments (BOP) and international investment position (IIP) data and participates in the Coordinated Direct Investment Survey (CDIS). RMA is expected soon to start reporting external debt statistics to the World Bank's Quarterly External Debt Statistics Database. Coverage, accuracy, and timeliness of ESS data has improved. Despite recent improvements, external statistics continue to be affected by shortcomings. These include: (i) limited coverage of services' transactions in the current account; (ii) long lags in dissemination; and (iii) some inconsistencies between the BOP and the IIP data. As recommended by the last TA mission, conducted in April 2018, currently the RMA is developing a new survey to collect additional data from the hydropower projects and expanding the FDI survey frame to improve the coverage of FDI data.	
II. Data Standards and Quality	
Bhutan participates in the enhanced General Data Dissemination System and maintains a regularly updated National Summary Data Page.	No data ROSC is available.

Table of Common Indicators Required for Surveillance

(as of June 24, 2018)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[8]	Frequency of Publication[8]
Exchange rates	04/2018	06/2018	D	D	D
International reserve assets and reserve liabilities of the Monetary Authorities[1]	03/2018	06/2018	M	M	M
Reserve/base money	11/2017	04/2018	M	M	M
Broad money	11/2017	04/2018	M	M	M
Central bank balance sheet	03/2018	06 2018	M	M	M
Consolidated balance sheet of the banking system	03/2018	06/2018	M	M	M
Interest rates[2]	03/2018	06/2018	M	M	M
Consumer price index[3]	04/2018	06/2018	Q/M	M	M
Revenue, expenditure, balance and composition of financing[4] – general government[5]	2017	06/2018	A	A	A
Revenue, expenditure, balance and composition of financing[3]– central government	2017	06/2018	A	A	A
Stocks of central government and central government-guaranteed debt[6]	2017	06/2018	Q	Q	Q
External current account balance	2017	01/2018	Q	Q	Q
Exports and imports of goods and services	2017	05/2018	Q	Q	Q
Gross external debt	12/2017	06/2018	Q	Q	Q
International investment position[7]	09/2015	05/2016	Q	Q	Q

[1] Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, and rates on treasury bills, notes, and bonds.
[3] Monthly CPI data for domestic and imported goods are available from April 2013 onward.
[4] Foreign, domestic bank, and domestic nonbank financing.
[5] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[6] Including currency and maturity composition.
[7] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[8] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

INTERNATIONAL MONETARY FUND

BHUTAN

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

August 7, 2018

Approved By
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Prepared by the staffs of the International Monetary Fund (IMF) and the International Development Association (IDA)[1]

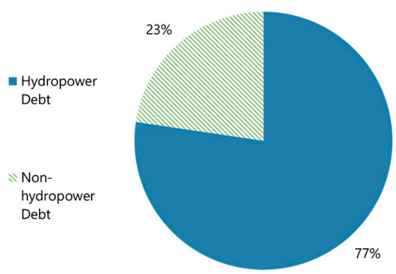
The assessment of Bhutan's external risk has not changed materially from the 2016 DSA. Given the unique nature of the bulk of Bhutan's debt stock, as spelled out in the 2014 and 2016 DSAs, the risk of debt distress is assessed to remain moderate despite breaches in all five indicators under the baseline. The unique mitigating circumstances are as follows. A large share of outstanding public and publicly guaranteed debt external debt is linked to hydropower project loans from the government of India (GoI). These projects are implemented under an intergovernmental agreement in which 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. While India's political commitment to increase its reliance on clean energy continues to provide reliable demand, India's recent power surplus and financing models for new projects where the construction risk is not guaranteed by India (e.g., joint ventures and public-private partnerships) are sources of risk.

[1] The DSA was prepared jointly by IMF and International Development Association staff in collaboration with the Asian Development Bank and Bhutanese authorities. The analysis updates the previous Joint DSA dated June 8, 2016 (IMF Country Report No. 16/206). The DSA follows the IMF and World Bank Staff Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-Income Countries (November 7, 2013). The data underlying the analysis are from the Bhutanese authorities, IMF, and World Bank staff estimates.

BACKGROUND

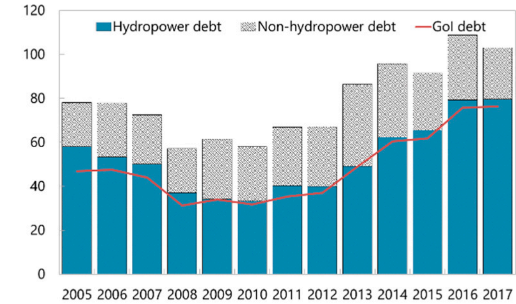
1. **Public and publicly guaranteed (PPG) debt stood at 107 percent of GDP in FY2017.** Bhutan borrows almost exclusively from official creditors, most of which is used to develop its hydropower sector.

Outstanding PPG External Debt by Purpose, 2016/17
(in percent of outstanding debt)



Sources: Royal Monetary Authority

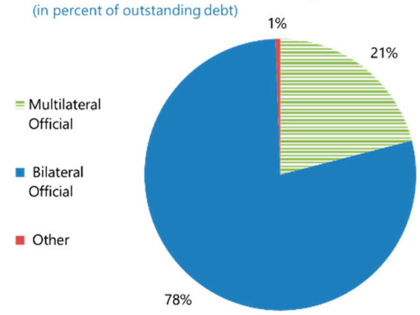
Hydropower
(in percent of GDP)



Source: Royal Monetary Authority

Hydropower projects comprised 77 percent of the PPG external debt stock in FY2017. These projects are mostly financed by India with debt denominated in Indian rupees. More than 99 percent of public and publicly guaranteed debt was from official creditors with India lending the largest share, 74 percent, followed by the Asian Development Bank (ADB), 11 percent, and the World Bank (IDA), 9 percent.

Outstanding PPG External Debt by Creditor, 2016/17
(in percent of outstanding debt)

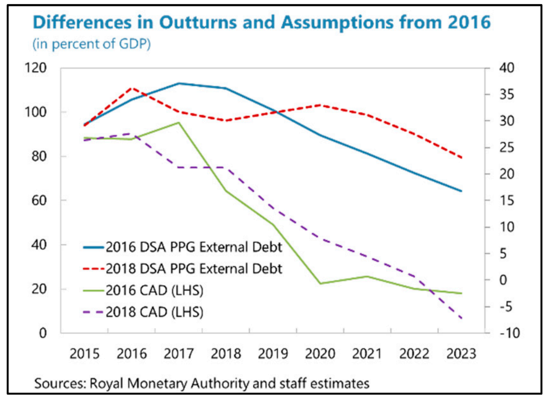


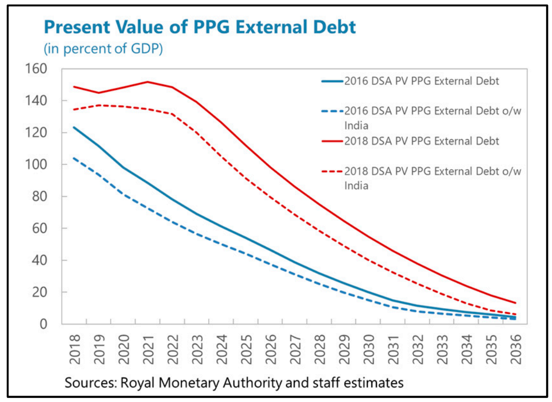
Source: Royal Monetary Authority

2. **Debt from the Government of India (GoI) to finance hydropower projects is closer in nature to foreign direct investment (FDI) as emphasized in the last two DSAs.** All existing debt from India provides financing for projects under an intergovernmental agreement in which construction and financial risks are borne by the GoI and surplus electricity is sold to India at cost plus a 15 percent net return. The price of electricity is set at the time of construction, when costs are known, and the rate is agreed to be revisited every 3 years to incorporate changes in costs.[2]

[2] See Box 1 in the 2014 DSA for more detail.

UNDERLYING ASSUMPTIONS





3. **Delays in the completion of major hydropower plants have hampered the expected acceleration in growth and consolidation of the current account deficit (CAD).** Project delays have also shifted associated disbursements causing the nominal debt path to be lower than was anticipated in the 2016 DSA. These delays come with associated costs, for example, delayed and higher debt service costs, which have led to a deterioration in the present value (PV) of debt indicators.[3] Nonetheless, at its highest level, the PV of non-Indian debt-to-GDP is 21 percent and remains well below Bhutan's threshold for a high-risk rating (40 percent of GDP). Over the medium term, the current account is still expected to improve sharply, with construction imports falling and electricity exports doubling as a percent of GDP and hovering around 60 percent of exports.

4. **The main baseline macroeconomic assumptions are as follows:**

- **Real sector.** Historical growth estimates for FY2016 and FY2017 have been revised up by around one percentage point each year. Over the medium term, with production commencing in new large hydropower projects, growth is projected to remain strong, averaging around 6 percent, close to its average during the eleventh five-year plan. Long-term growth is projected to be around 6 percent.

- **Fiscal sector.** When hydropower projects are completed, government revenues increase through both tax and non-tax revenues. As the completion of major projects has been delayed, these revenues will accrue mainly towards the end of the medium term. The fiscal deficit remains broadly balanced over the medium term, exhibiting a surplus towards the end of the five-year planning cycle as hydropower revenues from the newly commissioned projects are received.

- **External sector.** The current account deficit (CAD) is expected to narrow sharply over the medium term, reaching a surplus in FY2023. CAD dynamics are driven by an increase in electricity exports from around 7 percent of GDP to around 20 percent of GDP and a decline in imports for the hydropower sector to nearly nil over the medium term.[4] The overall balance of payments, which has been supported by grant financing, is set to remain positive over the

[3] These increased costs are covered by the government of India for projects under the intergovernmental agreement.

[4] The completion of three hydropower plants is incorporated in the baseline microframework: Mangdechhu (with capacity of 720 MW in FY2019), Puna II (with capacity of 1,020 MW in FY2021), and Puna I (with capacity of 1,200 MW in FY2023).

medium term, supporting reserve accumulation. As grant financing declines over the long run, the current account surplus will support the overall balance. Bhutan's borrowing from IDA is set to remain on concessional terms, as the country is eligible for credit financing under IDA's small economy terms.

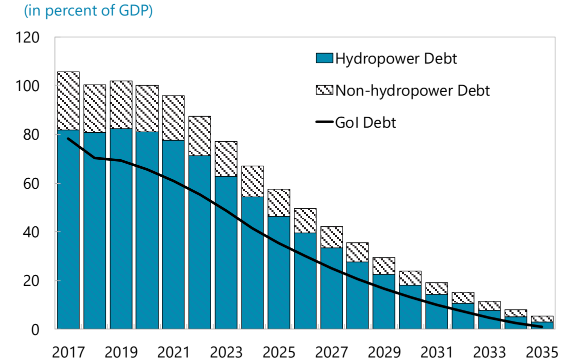
Text Table 1. Key Macroeconomic Assumptions, 2018–2036

	2016 DSA	2018 DSA
Real GDP growth (in percent)	6.4	6.1
GDP deflator in US dollar terms (change in percent)	2.0	1.8
Growth of exports of G&S (US dollar terms, in percent)	9.7	6.7
Growth of imports of G&S (US dollar terms, in percent)	5.7	1.9
Grant element of new public sector borrowing (in percent)	27.3	30.4
Government revenues (excluding grants, in percent of GDP)	21.6	22.2
Aid flows (in Billions of US dollars)	0.1	0.1
of which: Grants	0.1	0.1
of which: Concessional loans	0.0	0.0
Grant-equivalent financing (in percent of GDP)	2.6	2.9
Non-interest current account deficit	1.1	-3.3
Net FDI (negative = inflow)	-1.5	-0.6
Public sector balance	-1.8	-1.7

EXTERNAL DSA

5. The composition of hydropower debt is projected to remain dominated by debt contracted with India under the intergovernmental agreement. Other hydropower projects will be constructed under joint venture agreements and public-private partnerships (PPPs), where guarantees from the GoI are not available. Since the stock of debt will remain dominated by projects constructed under the intergovernmental agreement, which is more like FDI, vulnerabilities are contained. The government's liabilities under projects already financed through PPPs are reflected in the DSA. Other contingent liabilities, for example from the banking sector, and external borrowing outside of hydropower are not a source of immediate risk.

Composition of External Debt Projections
(in percent of GDP)



Sources: Royal Monetary Authority and staff estimates.

6. Under the baseline scenario, each debt indicator breaches its indicative threshold. The breaches are large and will be sustained into the long run. It is important to note that the PV of debt indicators are higher than their nominal values because the loan portion of hydropower projects financed by India are not concessional. The total package—loan and grant—has a positive grant element.[5] For example, the PV of debt-to-GDP ratio falls below threshold only after 2031 whereas the nominal debt-to-GDP ratio goes below the threshold in 2028. The profile of debt service indicators has worsened relative to the previous DSA, due to both higher debt service, and in the case of exports, a more moderate rate of growth.[6]

7. Volatility in the debt service indicators is due to a lumpy amortization schedule. Breaches in debt service indicators occur beyond the medium term and do not return to the threshold until the end of the projection horizon. This is in line with the repayment schedule for hydropower debt.

8. All five indicators breach their indicative threshold under stress tests. It is worth noting that although the ngultrum is pegged to the rupee, and nearly 80 percent of the debt stock is denominated in rupees, this does not preclude risks to the debt stock from an overvaluation of the ngultrum. As it stands, the ngultrum is only moderately overvalued (see External Sector Assessment in accompanying staff report), and risks remain contained given the projected improvement of the current account. Notwithstanding, efforts must remain vigilant to contain inflation near that of India.

PUBLIC DSA

9. Domestic debt is 6 percent of the debt stock in FY2017 and does not pose an additional risk to the debt profile. Movements in the public debt profile mirror those for external debt. As Bhutan relies less on grant financing and external concessional borrowing over the medium term, developing a deep and liquid domestic debt market will be important to meet financing needs going forward. To further this, the debt management office is preparing a Medium-Term Debt Strategy for FY2019–2023 and studying the possibility of issuance of longer term domestic instruments.

CONCLUSION

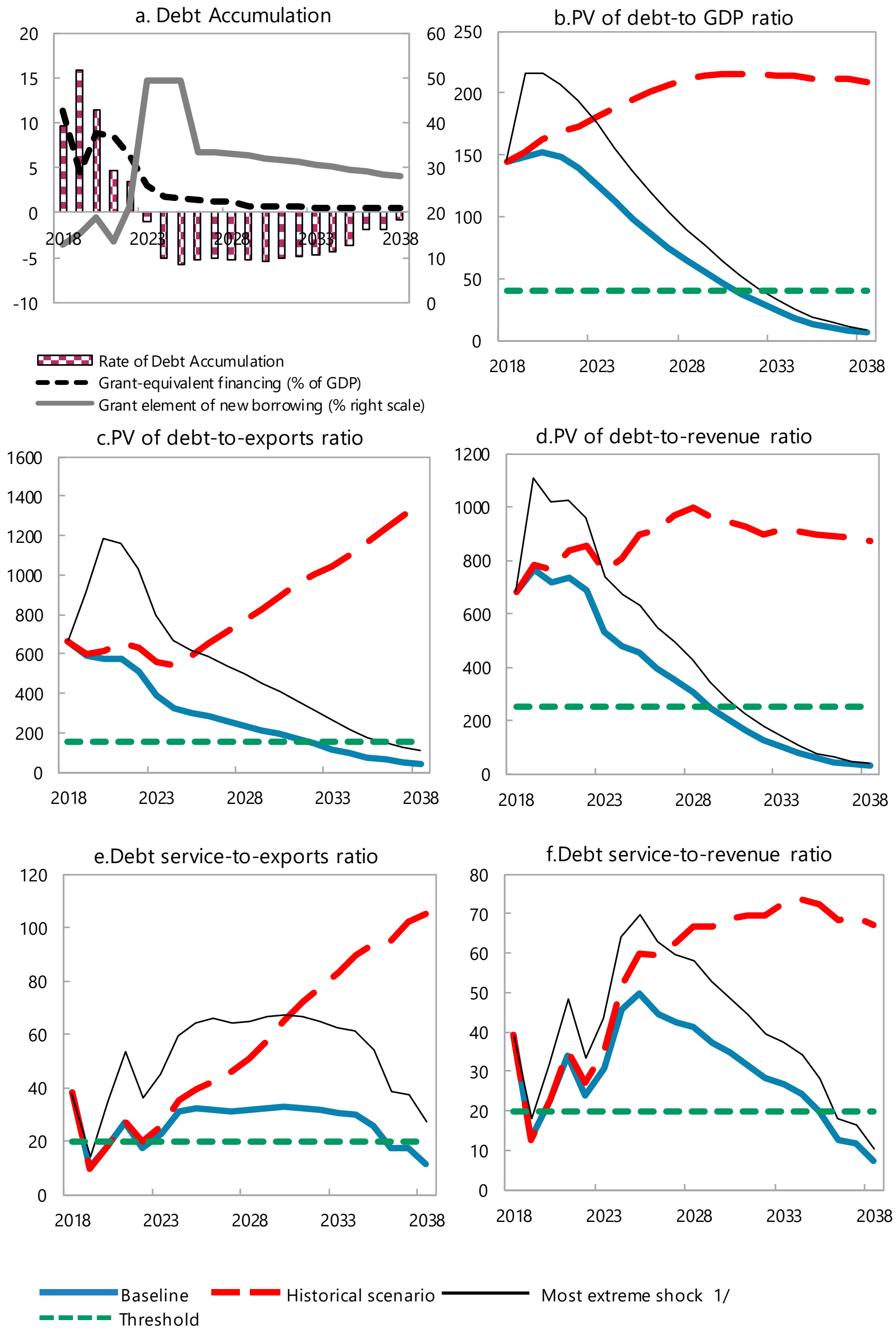
10. The current assessment remains broadly the same as the assessments made in the 2014 and 2016 Article IV DSAs, which assessed Bhutan's debt at a moderate risk of debt distress. Even though under the baseline each indicator breaches its threshold, the unique mitigating factors discussed in detail in the last two DSAs remain valid and underpin our assessment. 77 percent of Bhutan's external PPG debt is hydropower related, and most are hydropower projects constructed under the intergovernmental agreement in which the GoI covers both the financial and construction risks of these projects and buys surplus electricity at a price reflecting cost plus a 15 percent net return. Debt flows from these projects are projected to remain the bulk of the debt stock going forward. Risks stemming from non-hydropower debt are low, as the stock of non-hydropower debt-to-GDP is modest and owed mostly to the ADB and World Bank contracted on highly concessional terms.

[5] Note that the grant element in the total package is generally below the 35 percent threshold for concessionality as defined by the IMF's debt limits policy.

[6] Bhutan's CPIA rating, which determined the thresholds for each indicator, is assessed to remain medium as in the 2016 DSA.

11. The authorities agreed with staff's assessment of a moderate risk of debt distress. They expect the electricity exports resulting from the commissioning of Mangdechhu (in FY2019), Puna II (in FY2021), and Puna I (in FY2023) will reverse the current account deficit by the end of the medium term. The authorities acknowledged that debt levels are high but that debt vulnerabilities are contained as financing is secured through the intergovernmental agreement with the GoI.

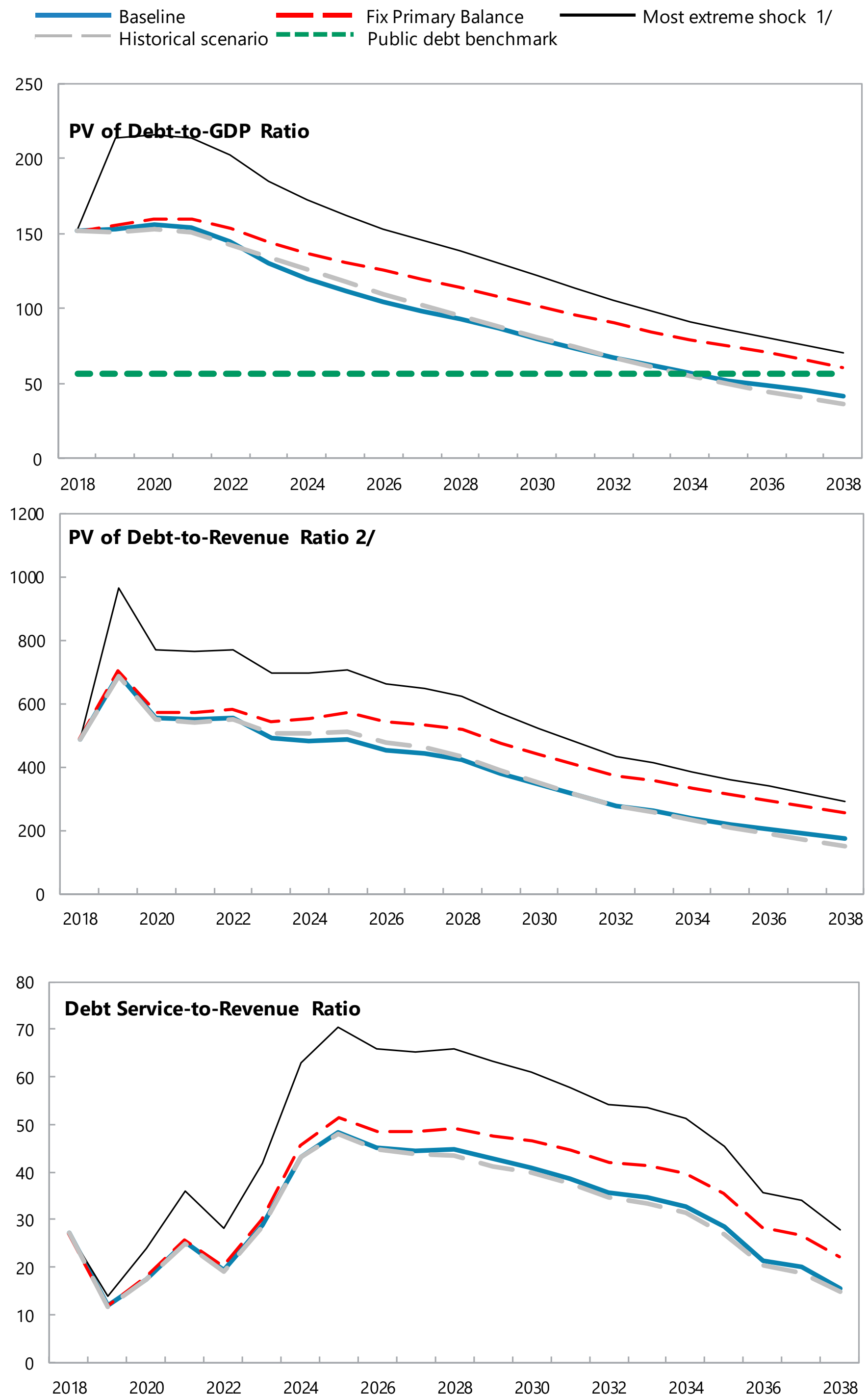
Figure 1. Bhutan: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2018–2038 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2028. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock

Figure 2. Bhutan: Indicators of Public Debt Under Alternative Scenarios, 2018–2038 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio on or before 2028.
2/ Revenues are defined inclusive of grants.

Table 1. Bhutan: External Debt Sustainability Framework, Baseline Scenario, 2015–2038 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/	Standard 6/	Projections									
				Average	Deviation							2018-2023			2024-2038
	2015	2016	2017			2018	2019	2020	2021	2022	2023	Average	2028	2038	Average
External debt (nominal) 1/	**94.0**	**110.9**	**100.0**			**96.2**	**99.7**	**103.2**	**98.8**	**90.1**	**79.6**		**38.4**	**3.9**	
of which: public and publicly guaranteed (PPG)	94.0	110.9	100.0			96.2	99.7	103.2	98.8	90.1	79.6		38.4	3.9	
Change in external debt	0.4	16.9	-10.9			-3.9	3.5	3.5	-4.4	-8.7	-10.5		-6.6	-0.8	
Identified net debt-creating flows	18.6	25.1	10.0			16.3	9.4	3.2	0.7	-3.5	-9.4		-7.6	-4.6	
Non-interest current account deficit	**26.3**	**27.7**	**21.2**	**19.7**	**8.6**	**21.2**	**13.6**	**7.8**	**4.5**	**0.7**	**-7.1**		**-9.5**	**-4.3**	-7.4
Deficit in balance of goods and services	21.2	25.5	19.5			17.5	8.0	5.2	3.7	0.8	-5.3		-6.0	-3.9	
Exports	28.6	23.3	23.1			21.8	25.2	26.4	25.9	27.5	32.5		27.6	15.3	
Imports	49.8	48.8	42.6			39.3	33.2	31.6	29.6	28.4	27.1		21.5	11.5	
Net current transfers (negative = inflow)	-4.0	-6.8	-7.3	-6.5	2.4	-4.6	-2.1	-2.5	-2.6	-2.3	-1.9		-1.5	-1.1	-1.4
of which: official	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other current account flows (negative = net inflow)	9.2	8.9	9.0			8.3	7.7	5.2	3.3	2.2	0.1		-1.9	0.7	
Net FDI (negative = inflow)	**-0.5**	**-0.4**	**0.5**	**-1.3**	**1.5**	**-1.1**	**-1.2**	**-1.5**	**-1.0**	**-0.4**	**-0.4**		**-0.4**	**-0.5**	-0.4
Endogenous debt dynamics 2/	**-7.2**	**-2.2**	**-11.7**			**-3.8**	**-2.9**	**-3.1**	**-2.8**	**-3.8**	**-1.9**		**2.3**	**0.2**	
Contribution from nominal interest rate	1.9	1.7	1.6			1.5	1.4	2.8	2.9	2.8	4.3		4.8	0.5	
Contribution from real GDP growth	-5.2	-6.6	-7.2			-5.3	-4.3	-5.9	-5.8	-6.5	-6.2		-2.5	-0.3	
Contribution from price and exchange rate changes	-3.9	2.6	-6.1			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**-18.3**	**-8.2**	**-20.9**			**-20.1**	**-5.9**	**0.3**	**-5.1**	**-5.2**	**-1.1**		**1.0**	**3.8**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	148.7			144.9	148.2	151.8	148.4	139.3	126.5		64.8	6.5	
In percent of exports	...	...	644.4			664.5	587.6	574.1	572.6	506.0	389.6		234.9	42.6	
PV of PPG external debt	**...**	**...**	**148.7**			**144.9**	**148.2**	**151.8**	**148.4**	**139.3**	**126.5**		**64.8**	**6.5**	
In percent of exports	**...**	**...**	**644.4**			**664.5**	**587.6**	**574.1**	**572.6**	**506.0**	**389.6**		**234.9**	**42.6**	
In percent of government revenues	**...**	**...**	**799.0**			**683.1**	**761.6**	**716.8**	**734.7**	**687.3**	**531.0**		**307.5**	**27.2**	
Debt service-to-exports ratio (in percent)	**22.8**	**18.7**	**33.3**			**38.0**	**9.9**	**18.0**	**26.6**	**17.5**	**22.7**		**31.4**	**11.5**	
PPG debt service-to-exports ratio (in percent)	**22.8**	**18.7**	**33.3**			**38.0**	**9.9**	**18.0**	**26.6**	**17.5**	**22.7**		**31.4**	**11.5**	
PPG debt service-to-revenue ratio (in percent)	**31.2**	**22.6**	**41.3**			**39.1**	**12.8**	**22.5**	**34.1**	**23.7**	**30.9**		**41.1**	**7.4**	
Total gross financing need (Billions of U.S. dollars)	0.7	0.7	0.8			0.7	0.4	0.3	0.3	0.2	0.0		-0.1	-0.4	
Non-interest current account deficit that stabilizes debt ratio	26.0	10.8	32.1			25.0	10.0	4.3	8.9	9.4	3.4		-2.9	-3.5	
Key macroeconomic assumptions															
Real GDP growth (in percent)	6.2	7.3	7.4	7.0	2.4	5.8	4.8	6.3	6.0	7.2	7.5	6.3	6.0	7.3	6.2
GDP deflator in US dollar terms (change in percent)	4.4	-2.7	5.8	2.1	7.8	3.1	3.2	0.7	1.6	1.8	1.8	2.0	1.8	1.8	1.8
Effective interest rate (percent) 5/	2.3	1.9	1.6	3.7	1.4	1.7	1.6	3.0	3.1	3.1	5.2	2.9	11.6	11.5	14.6
Growth of exports of G&S (US dollar terms, in percent)	8.4	-15.0	12.6	0.5	13.4	3.0	25.2	12.3	5.6	15.9	29.0	15.2	2.5	3.3	2.9
Growth of imports of G&S (US dollar terms, in percent)	8.8	2.4	-0.9	9.0	19.7	0.8	-8.7	2.0	1.1	4.4	4.6	0.7	2.7	-1.2	2.1
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	13.0	15.4	18.8	13.5	21.6	49.4	22.0	33.1	28.1	33.6
Government revenues (excluding grants, in percent of GDP)	20.9	19.3	18.6			21.2	19.5	21.2	20.2	20.3	23.8	21.0	21.1	24.0	22.9
Aid flows (in Billions of US dollars) 7/	2.0	2.4	2.7			0.3	0.2	0.3	0.3	0.2	0.1	0.2	0.1	0.1	0.1
of which: Grants	0.2	0.2	0.2			0.3	0.1	0.2	0.3	0.2	0.1	0.2	0.1	0.0	0.0
of which: Concessional loans	1.9	2.2	2.5			0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			11.4	4.5	8.8	8.5	6.4	2.9	7.1	1.2	0.5	0.9
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			53.5	30.3	51.6	66.9	83.2	93.8	63.2	73.9	41.9	61.9
Memorandum items:															
Nominal GDP (Billions of US dollars)	2.0	2.1	2.4			2.6	2.8	3.0	3.3	3.6	3.9		5.7	12.5	
Nominal dollar GDP growth	10.8	4.4	13.6			9.1	8.2	7.1	7.8	9.1	9.4	8.4	7.9	9.2	8.1
PV of PPG external debt (in Billions of US dollars)			3.7			3.9	4.3	4.7	4.8	4.9	4.9		3.7	0.8	
(PVt-PVt-1)/GDPt-1 (in percent)						9.7	15.9	11.4	4.8	3.5	-1.0	7.4	-5.2	-0.8	-4.3
Gross workers' remittances (Billions of US dollars)	...	...	...			...	...	...	...	...	...		...	...	
PV of PPG external debt (in percent of GDP + remittances)	...	...	148.7			144.9	148.2	151.8	148.4	139.3	126.5		64.8	6.5	
PV of PPG external debt (in percent of exports + remittances)	...	...	644.4			664.5	587.6	574.1	572.6	506.0	389.6		234.9	42.6	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	33.3			38.0	9.9	18.0	26.6	17.5	22.7		31.4	11.5	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 2. Bhutan: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2018–2038

(In percent)

	Projections							
	2018	2019	2020	2021	2022	2023	**2028**	2038
PV of debt-to GDP ratio								
Baseline	145	148	152	148	139	126	**65**	7
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2018-2038 1/	145	152	162	169	173	180	**211**	209
A2. New public sector loans on less favorable terms in 2018-2038 2	145	156	159	153	144	131	**71**	14
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2019-2020	145	153	156	149	140	127	**65**	6
B2. Export value growth at historical average minus one standard deviation in 2019-2020 3/	145	159	169	162	152	139	**73**	9
B3. US dollar GDP deflator at historical average minus one standard deviation in 2019-2020	145	167	179	172	161	146	**75**	7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2019-2020 4/	145	152	153	146	137	125	**64**	6
B5. Combination of B1-B4 using one-half standard deviation shocks	145	162	175	168	158	144	**75**	8
B6. One-time 30 percent nominal depreciation relative to the baseline in 2019 5/	145	215	216	207	194	176	**90**	9
PV of debt-to-exports ratio								
Baseline	665	588	574	573	506	390	**235**	43
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2018-2038 1/	665	601	613	651	629	555	**764**	1363
A2. New public sector loans on less favorable terms in 2018-2038 2	665	617	600	591	524	405	**256**	88
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2019-2020	665	606	580	566	500	385	**231**	41
B2. Export value growth at historical average minus one standard deviation in 2019-2020 3/	665	906	1187	1160	1026	794	**493**	106
B3. US dollar GDP deflator at historical average minus one standard deviation in 2019-2020	665	606	580	566	500	385	**231**	41
B4. Net non-debt creating flows at historical average minus one standard deviation in 2019-2020 4/	665	604	579	565	499	384	**231**	40
B5. Combination of B1-B4 using one-half standard deviation shocks	665	826	988	965	854	659	**405**	82
B6. One-time 30 percent nominal depreciation relative to the baseline in 2019 5/	665	606	580	566	500	385	**231**	41
PV of debt-to-revenue ratio								
Baseline	683	762	717	735	687	531	**307**	27
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2018-2038 1/	683	779	765	835	855	757	**1000**	871
A2. New public sector loans on less favorable terms in 2018-2038 2	683	800	749	758	712	552	**335**	56
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2019-2020	683	786	737	739	691	534	**308**	26
B2. Export value growth at historical average minus one standard deviation in 2019-2020 3/	683	817	799	803	752	584	**348**	37
B3. US dollar GDP deflator at historical average minus one standard deviation in 2019-2020	683	859	847	849	794	613	**354**	30
B4. Net non-debt creating flows at historical average minus one standard deviation in 2019-2020 4/	683	783	723	725	678	524	**302**	26
B5. Combination of B1-B4 using one-half standard deviation shocks	683	835	828	831	778	603	**356**	35
B6. One-time 30 percent nominal depreciation relative to the baseline in 2019 5/	683	1107	1021	1024	958	740	**426**	37

Table 2. Bhutan: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2018–2038 (concluded)

(In percent)

Debt service-to-exports ratio

Baseline	38	10	18	27	17	23	**31**	12
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2018-2038 1/	38	10	18	27	20	26	**51**	105
A2. New public sector loans on less favorable terms in 2018-2038 2	38	10	17	26	18	23	**33**	11
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2019-2020	38	10	18	27	17	23	**31**	11
B2. Export value growth at historical average minus one standard deviation in 2019-2020 3/	38	14	35	53	36	45	**65**	27
B3. US dollar GDP deflator at historical average minus one standard deviation in 2019-2020	38	10	18	27	17	23	**31**	11
B4. Net non-debt creating flows at historical average minus one standard deviation in 2019-2020 4/	38	10	18	27	17	23	**31**	11
B5. Combination of B1-B4 using one-half standard deviation shocks	38	13	29	45	30	38	**54**	21
B6. One-time 30 percent nominal depreciation relative to the baseline in 2019 5/	38	10	18	27	17	23	**31**	11

Debt service-to-revenue ratio

Baseline	39	13	22	34	24	31	**41**	7
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2018-2038 1/	39	13	23	35	27	35	**66**	67
A2. New public sector loans on less favorable terms in 2018-2038 2	39	13	21	34	24	31	**43**	7
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2019-2020	39	13	23	35	24	31	**42**	7
B2. Export value growth at historical average minus one standard deviation in 2019-2020 3/	39	13	23	37	26	33	**46**	9
B3. US dollar GDP deflator at historical average minus one standard deviation in 2019-2020	39	14	26	40	28	36	**48**	8
B4. Net non-debt creating flows at historical average minus one standard deviation in 2019-2020 4/	39	13	22	34	24	31	**41**	7
B5. Combination of B1-B4 using one-half standard deviation shocks	39	13	25	38	27	35	**47**	9
B6. One-time 30 percent nominal depreciation relative to the baseline in 2019 5/	39	18	32	48	33	44	**58**	10
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	19	19	19	19	19	19	**19**	19

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after t
an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 3. Bhutan: Public Sector Debt Sustainability Framework, Baseline Scenario, 2015–2038

(In percent of GDP, unless otherwise indicated)

	Actual			Average 5/	Standard Deviation 5/	Estimate	Projections								
	2015	2016	2017			2018	2019	2020	2021	2022	2023	2018-23 Average	2028	2038	2024-38 Average
Public sector debt 1/	95.7	114.2	106.3			102.7	103.9	107.4	104.6	95.8	82.8		66.3	39.5	
of which: foreign-currency denominated	94.0	110.9	100.0			96.2	99.7	103.2	98.8	90.1	79.6		38.4	3.9	
Change in public sector debt	-0.6	18.5	-7.9			-3.6	1.2	3.5	-2.8	-8.8	-13.1		-1.8	-2.4	
Identified debt-creating flows	-6.6	-3.7	-15.0			-8.0	-10.0	-4.6	-5.4	-9.9	-12.9		-1.1	-2.3	
Primary deficit	-3.5	-0.7	1.7	-2.3	2.7	-0.7	-3.8	-2.5	-2.9	-4.1	-9.1	-3.8	-1.6	-0.3	-2.2
Revenue and grants	28.8	29.9	26.7			31.1	22.1	28.1	28.0	26.3	26.6		22.1	24.2	
of which: grants	7.9	10.6	8.1			9.9	2.6	6.9	7.8	6.0	2.8		1.0	0.2	
Primary (noninterest) expenditure	25.3	29.3	28.4			30.4	18.3	25.6	25.2	22.2	17.4		20.5	23.9	
Automatic debt dynamics	-3.0	-3.0	-16.7			-7.3	-6.3	-2.1	-2.5	-5.8	-3.8		0.5	-1.9	
Contribution from interest rate/growth differential	-0.5	-4.8	-8.8			-0.6	-0.5	-1.6	-1.3	-2.7	-1.1		1.3	-1.8	
of which: contribution from average real interest rate	5.1	1.7	-0.9			5.2	4.2	4.6	4.8	4.3	5.6		5.2	1.1	
of which: contribution from real GDP growth	-5.6	-6.5	-7.9			-5.8	-4.7	-6.2	-6.1	-7.0	-6.7		-3.9	-2.9	
Contribution from real exchange rate depreciation	-2.5	1.8	-7.9			-6.7	-5.8	-0.5	-1.2	-3.1	-2.7		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	6.0	22.2	7.2			4.4	11.2	8.1	2.6	1.1	-0.2		-0.7	-0.2	
Other Sustainability Indicators															
PV of public sector debt	...	...	155.0			151.4	152.4	156.0	154.2	145.0	129.6		92.8	42.0	
of which: foreign-currency denominated	...	...	148.7			144.9	148.2	151.8	148.4	139.3	126.5		64.8	6.5	
of which: external	...	...	148.7			144.9	148.2	151.8	148.4	139.3	126.5		64.8	6.5	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	3.2	3.9	13.6			7.7	-1.1	2.5	4.2	1.0	-1.5		8.3	3.4	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	579.7			486.9	690.6	556.1	550.1	551.9	487.9		420.2	173.8	
PV of public sector debt-to-revenue ratio (in percent)	...	...	832.8			714.1	783.3	736.8	763.6	715.5	544.3		440.2	175.4	
of which: external 3/	...	...	799.0			683.1	761.6	716.8	734.7	687.3	531.0		307.5	27.2	
Debt service-to-revenue and grants ratio (in percent) 4/	23.3	15.3	29.1			27.1	11.9	17.5	25.3	19.5	28.8		44.7	15.5	
Debt service-to-revenue ratio (in percent) 4/	32.1	23.7	41.8			39.8	13.5	23.2	35.1	25.2	32.1		46.8	15.7	
Primary deficit that stabilizes the debt-to-GDP ratio	-3.0	-19.2	9.5			2.8	-5.0	-6.0	-0.1	4.7	3.9		0.2	2.1	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	6.2	7.3	7.4	7.0	2.4	5.8	4.8	6.3	6.0	7.2	7.5	6.3	6.0	7.3	6.2
Average nominal interest rate on forex debt (in percent)	2.3	1.9	1.7	3.7	1.4	1.7	1.6	3.0	3.1	3.1	5.2	2.9	11.6	11.5	14.6
Average real interest rate on domestic debt (in percent)	-3.6	1.4	-2.4	0.0	3.7	-1.7	-2.0	0.1	1.3	1.3	1.3	0.1	1.3	1.6	1.5
Real exchange rate depreciation (in percent, + indicates depreciation	-2.7	2.0	-7.7	-0.4	7.2	-6.7	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	5.4	4.0	6.0	6.1	1.5	4.3	4.3	4.1	3.8	4.3	4.3	4.2	4.3	4.3	4.3
Growth of real primary spending (deflated by GDP deflator, in percer	-1.4	24.4	4.2	2.7	7.7	13.0	-36.8	48.7	4.3	-5.6	-15.5	1.4	7.7	9.3	8.5
Grant element of new external borrowing (in percent)	...	...	...	...	...	13.0	15.4	18.8	13.5	21.6	49.4	22.0	33.1	28.1	...

Sources: Country authorities; and staff estimates and projections.

1/ Gross government debt including hydro-related liabilities.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 4. Bhutan: Sensitivity Analysis for Key Indicators of Public Debt, 2018–2038

	Projections							
	2018	2019	2020	2021	2022	2023	2028	2038
PV of Debt-to-GDP Ratio								
Baseline	151	152	156	154	145	130	93	42
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	151	150	153	150	143	134	96	36
A2. Primary balance is unchanged from 2018	151	155	160	160	153	144	114	61
A3. Permanently lower GDP growth 1/	151	153	158	157	149	134	102	62
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2019-20	151	153	159	158	148	133	97	47
B2. Primary balance is at historical average minus one standard deviations in 2019-202	151	156	162	160	150	135	97	45
B3. Combination of B1-B2 using one half standard deviation shocks	151	153	159	157	147	132	94	42
B4. One-time 30 percent real depreciation in 2019	151	213	216	214	202	184	138	70
B5. 10 percent of GDP increase in other debt-creating flows in 2019	151	160	164	162	153	137	99	46
PV of Debt-to-Revenue Ratio 2/								
Baseline	487	691	556	550	552	488	420	174
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	487	683	549	541	548	505	434	149
A2. Primary balance is unchanged from 2018	487	702	570	570	582	542	516	252
A3. Permanently lower GDP growth 1/	487	694	561	558	563	503	460	257
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2019-20	487	692	565	559	563	500	438	195
B2. Primary balance is at historical average minus one standard deviations in 2019-202	487	706	577	570	573	508	440	185
B3. Combination of B1-B2 using one half standard deviation shocks	487	695	567	560	562	497	427	174
B4. One-time 30 percent real depreciation in 2019	487	965	769	762	769	694	624	291
B5. 10 percent of GDP increase in other debt-creating flows in 2019	487	727	585	578	581	515	447	189
Debt Service-to-Revenue Ratio 2/								
Baseline	27	12	18	25	19	29	45	16
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	27	12	17	25	19	28	44	15
A2. Primary balance is unchanged from 2018	27	12	18	26	20	30	49	22
A3. Permanently lower GDP growth 1/	27	12	18	26	20	30	47	21
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2019-20	27	12	18	26	20	29	46	17
B2. Primary balance is at historical average minus one standard deviations in 2019-202	27	12	18	26	20	30	46	17
B3. Combination of B1-B2 using one half standard deviation shocks	27	12	18	26	20	29	45	16
B4. One-time 30 percent real depreciation in 2019	27	14	24	36	28	42	66	28
B5. 10 percent of GDP increase in other debt-creating flows in 2019	27	12	19	27	20	30	47	17

Sources: Country authorities; and staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

Statement by Subir Gokarn, Executive Director for Bhutan and Petal Dhillon, Advisor to Executive Director October 26, 2018

1. Our Authorities would like to thank the IMF team led by Mr. David Gregorian for the very constructive and productive discussions. The mission chief, and his team have an excellent understanding of the macro-economic situation in Bhutan, including the unique features of the country's economy. Our Authorities are highly appreciative of the Fund for providing opportunities for enhancing human resource capacities through training and technical assistance. Policies have been largely in line with past Fund advice and the Authorities greatly value the staff report and broadly agree with the assessment made in the Article IV report.

2. After experiencing rapid growth during 2006-2016, the Bhutanese economy is benefiting from macroeconomic stability accompanied by stronger underlying fundamentals, growth in services and significant decline in poverty. Single-digit inflation, declining external imbalances and accumulating international reserves attest to the stability. Nevertheless, structural challenges remain, including a large current account deficit, high public debt, an underdeveloped private sector, and high youth unemployment. Our Authorities are committed to building on the progress so far to ensure both inclusive growth and macroeconomic stability.

Recent Economic Developments and Economic Outlook

3. Bhutan is committed to graduate to middle-income status by 2023. It has achieved economic progress while preserving its traditions and values and combining sustainable development with enhanced happiness for its people. Poverty has declined significantly, from 12 percent in 2012 to 8.2 percent in 2017, with extreme poverty falling to just 1.5 percent. GDP has maintained momentum at 7.4 percent in FY2017, far exceeding the global growth rate. Headline inflation decreased to a historic low of 2.6 percent in June 2018 from 4.9 percent in June 2017, contributed by decrease in the non-food prices.

4. Our Authorities broadly agree with the staff assessment of outlook and risks for the economy. However, even as they acknowledge the potential strain on GDP growth from low capital expenditures in FY2019, they are more optimistic about medium-term growth than the staff projection of 4.8 percent in FY2019 and 6 percent in FY2019-20. This stems from the anticipated impetus to output and exports, as well as to fiscal revenues with the commissioning of new hydropower projects. Further, agriculture and tourism are also projected to grow steadily. This and the implementation of the 12th Five-year plan agreed by the new Government will positively stimulate the economic activity. The CPI inflation is expected to be around 3 to 5 percent. At the end of June 2018, the gross international reserves were recorded at USD 1,110.9 million, sufficient to finance 13.01 months of merchandise imports.

Fiscal Policy

5. Bhutan has achieved a balanced budget over a five-year period. After following an expansionary fiscal stance to support implementation of the last year of the of the 11th Five-Year Plan, our Authorities are cognizant of the concerns on the contraction in capital spending in FY2019. But they were restricted by operational constraints in force during the electoral cycle until the new Cabinet approves the additional spending. The Authorities have initiated comprehensive reforms for a strengthened fiscal framework as a top priority. Core elements are as follows:

- GST implementation is scheduled for July 2020, supported by Fund Technical Assistance. Authorities are firmly committed to the target date and are mobilizing the required project funding and planning to put in place a robust IT framework.
- The revised budget saw the fiscal deficit improve from 2.47 percent of GDP to 1.01 percent, with higher resource mobilization. From now on, once approved the 12th Five-Year Plan would help narrow the gap arising from the short term decrease in capital spending.
- Establishment of a stabilization fund to manage hydropower revenues and business cycle fluctuation. Starting with the seed money of USD 1.54 million, it is presently proposed that 5 percent minimum on royalties from hydropower be transferred to the Bhutan Economic Stabilization Fund (BESF).
- Debt-related risk is moderate due to the foreign direct investment-like nature of most of Bhutan's debt. Its dynamics will improve in the medium term with the substantial increase in electricity exports and decline of construction related imports.
- Public financial management reforms, including an electronic payment system, is being implemented and a commitment to improve budget transparency and undertake more frequent fiscal reporting is present.

6. Speedy implementation of these measures will be critical to boost revenue flows, incentivize investment and economic growth and to establish a more synchronized tax regime and our Authorities are diligently working on this. Staff advice on developing a domestic public debt market in Bhutan is noted and we welcome a thorough analysis of the demand patterns and market requirements to exploit the potential.

Monetary Policy

7. Monetary policy conditions have remained stable in recent years and staff's advice on this is consistent with the Authorities' own views. Credit growth has slowed from 35 percent on average in 2005–11 to 15 percent in 2012-17. Private sector credit growth was 15.69 percent in June 2018, about the same as the 15.39 percent rate in June 2017. Importantly, access through financial inclusion is contributing to credit growth. The overall CPI inflation recorded at 2.55 percent in June 2018 compared to 4.94 percent during the same month of the previous year, the fall being aided by decrease in the prices of non-food commodities. On the other hand, domestic inflation during June 2018 was recorded at 1.47 percent while imported inflation was recorded at 3.56 percent due to food prices.

8. The Authorities have carefully considered the well thought out staff proposals and will follow a graduated approach in moving forward, mindful of the need for adequate institutional capacities and supporting legal frameworks. Undoubtedly, there are challenges while moving from a quantity to interest rate signaling. This may send confusing signals to market participants on the policy stance, which in turn could undermine the anchoring of inflation. That said, our Authorities are fully aligned with the staff view on upgrading to a more modern monetary policy framework, supported by TA from the South Asia Regional Training and Technical Assistance Center, especially on forecasting and establishment of an interest rate corridor. This is expected to be rolled out by November 2018.

External Sector and Exchange rate policy

9. The Authorities agree that the peg continues to be the appropriate exchange rate regime and has served the economy well. Maintaining an adequate buffer of Indian rupees is a critical part of the reserve management and significant pillars have been developed as supportive arrangements. The RMA's swap agreement with the RBI and access to the Government of India Credit line is a key stabilizing mechanism. Alternate arrangements to sell or buy Indian Rupees against USD and gain access to Indian Government securities are being currently pursued. Moving ahead, electricity exports from the commissioning of three hydroelectric plants beginning FY 2019 and up to by FY2023 are expected to turn the current account positive in the medium term and structurally improve the Rupee liquidity.

Financial Sector

10. On the financial sector assessment, our Authorities broadly concur with the findings of the staff report and, on the need, to further tighten financial sector regulation and supervision. Financial soundness indicators for Bhutan remain generally comfortable, with capital adequacy and liquidity well above the required prudential norms, although the proportion of non-performing loans has increased in the recent period.

11. The nascent banking sector has the tough task of building profitability and resilience in a challenging environment. Our Authorities have made much progress in key areas including corporate governance regulations for financial institutions, a new regulatory framework for insurance, review of the macroprudential framework and pension policy review. Continued vigilance is, however, needed especially for NPLs which have shown a slight increase to 11.5 percent in June 2018, up from 11.4 percent in June 2017. Our Authorities remain alert to systemic vulnerabilities and are working on further streamlining the regulatory regime including reduced liquidity requirements. At the current juncture, however, preference has been given to deepening access to finance even while containing risk. The financial inclusion strategy 2018-2023 was issued in August 2018. It is intended to enhance access to and usage of quality and affordable formal financial services through an inclusive financial system.

Structural Issues

12. Bhutan has always approached development from a holistic perspective, based on the concept of Gross National Happiness. Our Authorities have a strong commitment to diversifying the economy and providing high-paying jobs for the population, especially youth. Bhutan maintains strong fundamentals which include political stability, education in English, very low levels of corruption, good governance and preferential access to the vast Indian market. Coherent action to more strategically advance economic diversification, is being pursued to reduce economic vulnerability, raise GDP, and secure competitive advantages within product niches. Developing infrastructure and easing of structural bottlenecks are key to this strategy. The second annual event of the Bhutan Economic Forum for Innovative Transformation, to be held in July 2019, will be on issue of economic diversification through catalyzing the cottage and small industries (CSI) sector.

13. Education quality, with a predominant base in the urban areas, is a pressing concern as is the mismatch between the products of the education system and the present and future needs and demands of the market. Addressing these issues is a priority for our Authorities; a review of the educational system is ongoing. Overall, sustained actions have contributed to an improvement in the country's business environment which saw Bhutan rise sharply from 148th in 2013 to 75th in 2018 in the World Bank's global Doing Business survey. Large scale donor-funded training programs are being provided. Our Authorities recognize the role of FDI thresholds and, going forward, aim at the right mix of employment generation and technology enrichment.

14. On access to finance, the Authorities began implementing a priority sector lending initiative in January 2018 for CSI to encourage entrepreneurship and experimentation in new types of business ventures. Given the development orientation of the PSL objectives and the early stages, the Authorities would await unfolding experiences before recalibrating the guidelines to staff recommendations.

15. To conclude, our Authorities are very appreciative of the Fund's inputs and support over the years as they strive to maintain the balance between inclusive and sustainable growth, macroeconomic stability and tangible improvements in the welfare of the citizens, using the concept of Gross National Happiness. They look forward to continued engagement as they initiate strategies to diversify the economy's production base, with a view to expanding livelihood opportunities and reducing vulnerabilities.