

Bhutan—Assessment Letter for the Asian Development Bank August 23, 2021

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

I. Recent Developments, Outlook, and Risks

1. Prior to the COVID-19 pandemic, in the context of its 11th Five-Year Plan, Bhutan made significant strides in improving per capita income and reducing poverty. Poverty declined significantly from 12 percent in 2012 to 8.3 percent in 2017, with extreme poverty falling to just 1.5 percent, while the Gini coefficient remained roughly unchanged at 0.38. After some moderation in recent years amid slowing investment in the hydropower sector, growth was expected to pick-up due to new electricity supply following the commissioning of the Mangdechhu hydro project.

2. The pandemic and the ensuing lockdowns on economic activities have had substantial impact. The hotels, transportation, communication, and construction sectors have suffered the most, but with some offsets from the increase in hydropower exports and monetary and fiscal policy measures. Both overall and youth unemployment have doubled, with youth unemployment reaching 22.6 percent. Inflation remains elevated at 8.7 percent in May 2021 due to higher food prices and pandemic-related supply chain disruptions. In line with weaker private sector demand, credit growth moderated to about 9 percent in 2020, compared with about 18 percent prior to the pandemic. While policies—including the loan moratorium, various liquidity measures, and credit guarantees—have provided some temporary relief, financial stability risks stem from elevated nonperforming loans (14.6 percent in December 2020), amid concentration risks from select sectors (e.g., tourism, construction) and large borrowers, with the full impact of the pandemic on corporate and bank balance sheets yet to materialize.

3. The wide-ranging policy responses have helped mitigate the economic, social, and health costs of the pandemic. The swift public health measures in response to the pandemic have thus far been highly effective in containing the health burden of the pandemic. Bhutan's vaccination campaign has proceeded at record speed (over 90 percent of adult fully vaccinated), an important step toward the post-pandemic phase.

4. The near-term growth outlook for Bhutan is weighed down by pandemic uncertainties, although increasing hydropower exports have served as a cushion. Following a contraction of -0.8 percent in FY2019/20 (FY is July to June), the economy is estimated to have declined by -2.0 percent in FY2020/21. The growth estimates reflect the domestic COVID-19 impact from the unprecedented national lockdowns that led to a sharp decline in tourism receipts and related spending, the potential adverse impact on asset quality in the financial sector, and ongoing weak external demand. A gradual recovery is expected in FY2021/22, with

growth at 4.2 percent, supported by Bhutan's rapid, record- setting vaccination campaign, higher electricity exports, and ongoing fiscal support. Inflation is estimated to have remained elevated at 5.8 percent in FY2020/21, owing to supply disruptions and high food inflation, and the current account deficit is estimated to have moderated to around 9 percent of GDP from 12.2 percent in the previous fiscal year. At the same time, the overall fiscal deficit is estimated to have reached around 9 percent of GDP on account of domestic fiscal stimulus and support programs and the previous increase in public sector wages.

5. Amid the pandemic, the balance of risks is tilted to the downside. External risks include a sharper- than-expected global slowdown and/or a slowdown in India, including from the recent surge in virus cases and the possibility of a prolonged decline in tourism. Domestic risks remain elevated from the uncertainties surrounding the pandemic, even though active reported cases remain low and most adults are fully vaccinated. Other domestic risks include the possibility of worsening asset quality in the banking system and delays in hydro projects, which would adversely impact growth, external buffers, and debt dynamics. A crucial mitigating factor is that hydropower production aided by the Mangdechhu plant and exports to India remain uninterrupted, bringing in sizable foreign exchange inflows and helping the central bank maintain a comfortable reserve buffer.

II. Assessment and Fund Relations

6. Ongoing management of the COVID-19 pandemic remains a near-term priority, including by assessing the effectiveness of ongoing social insurance and provision of health services. The authorities have taken a number of measures in this regard, and further actions (e.g., continuation of cash-based transfers) will need to be guided by the development of new cases and virus variants at home and abroad.

7. Medium-term challenges of revenue mobilization, macro-financial stability, and targeted structural reforms remain. As and when the COVID-19 shock eases, attention will need to return to ongoing reforms, including policies to contain economic and financial vulnerabilities, diversify the economy, and enhance its overall competitiveness to sustain growth. Fiscal policy needs to be anchored within a transparent, rolling, and multiyear budget framework to make capital spending and growth less volatile and improve the efficiency of expenditure. Enhanced fiscal transparency can help with an effective re-prioritization of fiscal resources in the post-pandemic period and ensure the effective use of fiscal resources towards meeting the nation's goal of creating an inclusive and prosperous state. To finance Bhutan's ambitious development goals, mobilizing additional government revenue remains critical, which should be supported by effective implementation of the recently passed Goods and Services Tax law, which has been delayed and is expected to be implemented in 2022. Safeguarding financial stability is necessary to support financial inclusion and development. Recent regulatory and supervisory initiatives, including the Domestic Liquidity Management and the NPL Resolution Framework, could play an important role in supporting financial stability. Given elevated nonperforming

assets, steadfast implementation is needed to ensure financial sector resilience. In the monetary sector, the ngultrum's peg to the Indian rupee has served the economy well, and ongoing reform of the liquidity management framework will further strengthen the Royal Monetary Authority's capacity to align money market conditions with the monetary policy stance. Finally, the post-pandemic recovery could offer an opportunity to lay the groundwork for Bhutan's transition to a knowledge-based economy.

8. The risk of debt distress was assessed as moderate in the last Article IV report, published in October 2018. Before the COVID-19 shock, public and publicly guaranteed debt stood at 107 percent of GDP, implying that all debt indicators breach the critical thresholds under the baseline projections. But mitigating circumstances exist. A large share (over 75 percent) of the debt was linked to hydropower project loans from the Government of India, which covers both the financial and construction risks of the projects and buys surplus electricity at a price reflecting cost plus a 15 percent net return. The COVID-19 shock is expected to lead to an increase in debt in the near term (about 15 percent of GDP) compared to the pre-pandemic path, while not fundamentally altering the dynamics of debt going forward. In particular, debt dynamics are set to improve over the medium term, driven by a significant increase in electricity exports and a decline in imports associated with the completion of hydropower construction.

9. Bhutan's external position was assessed as moderately weaker than warranted by fundamentals and desirable policies in FY2017/18, with the next assessment expected later in 2021. Although shrinking, the current account deficit has been temporarily large in recent years due to hydropower- construction-related imports. Still, the overall balance was positive, supported in part by grant financing. Bhutan's peg has been an adequate nominal anchor and remains appropriate, as India is Bhutan's largest trade and development partner. Reserve coverage remains adequate (about 18 months of imports in FY2020/21). The next external assessment will be conducted in the context of the next Article IV consultation.

10. Bhutan is a large recipient of IMF technical assistance, including from the South Asia Regional Training and Technical Assistance Center (SARTTAC) and has no outstanding financial arrangements with the IMF. Bhutan is on a 24-month consultation cycle. The last Article IV consultation was concluded by the Executive Board on October 26, 2018. A virtual Staff Visit took place in May 2021. The next Article IV consultation mission, which had been expected to take place in late 2020 before the COVID-19 shock, is scheduled to take place later in 2021.

Bhutan: Selected Economic and Financial Indicators, 2016/17-2021/22						
	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
				Est.	Proj.	
(In percent of GDP, unless otherwise indicated)						
National Accounts						
Nominal GDP (in millions of ngultrum)	152,390	163,456	172,759	178,370	183,551	201,585
Real GDP growth (percent change)	6.3	3.8	4.3	-0.8	-2.0	4.2
Prices						
Consumer Prices (EoP; percent change)	4.9	2.5	2.7	4.5	7.1	4.5
Consumer Prices (avg; percent change)	4.3	3.7	2.8	4.2	5.8	5.8
General government accounts						
Primary balance	-2.2	0.9	0.1	-2.4	-7.8	-5.4
Total revenue and grants	28.0	31.9	24.3	29.5	24.9	26.1
<i>Domestic Revenue</i>	19.5	22.6	20.1	20.3	18.1	19.1
<i>Foreign Grants</i>	8.5	9.1	6.1	9.2	6.8	6.9
Primary expenditure 1/	31.5	33.1	24.6	31.8	33.4	31.9
Net lending and other payments	-1.3	-2.2	-0.3	0.1	-0.7	-0.4
Interest	1.3	1.3	0.9	0.5	1.1	1.3
Overall balance	-3.5	-0.4	-0.8	-2.9	-8.9	-6.7
General government debt	112	110	107	121	123	121
Monetary sector						
Broad money (M2) growth (percent change)	21.3	15.0	5.5	17.9	22.2	6.3
Private Credit to GDP ratio	45.9	52.7	60.1	66.2	69.0	68.4
Private credit growth (percent change)	9.8	23.3	20.5	13.8	7.1	9.0
Balance of payments						
Current account balance	-24.0	-19.1	-21.1	-12.2	-8.8	-12.1
Hydropower exports	8.5	6.8	6.3	12.7	13.7	12.4
Non-hydropower exports	15.7	17.2	18.5	13.7	9.6	15.0
Imports of goods	44.9	41.1	40.4	36.2	31.6	34.6
Gross official reserves (in USD millions)	1072	1170	1313	1353	1411	1241
<i>(In months of imports)</i>	13.0	14.0	17.4	20.7	17.9	15.5
Memorandum items:						
Ngultrum per U.S. dollar (eop)	66.4	65.1	70.6
Population in million (eop)	0.7	0.7	0.7	0.7	0.8	0.8

Sources: Bhutanese authorities; and Fund staff projections.

1/ The expenditure for FY2020/21 and FY2021/22 includes an estimated amount for income support provided to individuals and loan interest payemnt support to borrowers financed by the National Resilience Fund.