INTERNATIONAL MONETARY FUND

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BHUTAN

May 2022

2022 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 2022 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 May 13, 2022 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 May 13, 2022, following discussions that ended on February 18, 2022, 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 April 26, 2022.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staff[s] of the IMF and the World Bank.
- 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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International Monetary Fund
Washington, D.C.

IMF Executive Board Concludes 2022 Article IV Consultation with Bhutan

FOR IMMEDIATE RELEASE

Washington, DC – May 24, 2022: On May 13, 2022, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Bhutan.

Prior to the pandemic, Bhutan had made significant strides in improving per capita income and reducing poverty, qualifying for its graduation from the Least Developed Country (LDC) status in 2023. The pandemic has had a substantial impact on the economy. Real GDP contracted for two fiscal years, with contact-intensive and externally oriented sectors most affected. The wide-ranging policy responses, aided by Bhutan's impressive vaccination campaign, helped mitigate adverse impact on lives and livelihoods. The responses included the deployment of the National Resilience Fund, the Economic Contingency Plan, and a series of fiscal, monetary, financial, and labor market measures.

While the pandemic and the war in Ukraine are weighing on the near-term outlook, medium term growth is expected to be driven by a recovery in services, manufacturing, and hydropower. Growth is projected at 4.4 percent in FY2021/22, with the negative impacts from the Omicron outbreak and higher commodity prices partly offset by higher electricity exports, ongoing policy support, and base effects. Inflation is projected to remain elevated in FY2021/22, owing also to higher commodity prices and supply disruptions. Over the medium term, hydropower generation capacity is expected to double, supporting growth, the current account balance, and the fiscal position. Inflation is projected to remain in line with that in India, Bhutan's key trading partner, given the ngultrum's peg to the rupee. The fiscal deficit is expected to moderate as pandemic-related measures are gradually phased out and revenue reforms deepen. The current account deficit and reserve coverage are expected to improve from declining hydropower-related imports and rising hydropower exports.

Uncertainty around the economic outlook is elevated, with the balance of risks tilted to the downside. External risks include a sharper-than-expected global slowdown and/or a slowdown in India, including from future pandemic waves, an intensification of geopolitical tensions, and a slow recovery in tourism. Domestic risks stem from pandemic-related uncertainties, elevated financial sector strains amid limited fiscal space and delays in hydro projects, which would affect growth, external buffers, and debt dynamics. That said, recent increases in hydropower production and remittances have supported reserves.

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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 commended the authorities' response to the pandemic, which included Bhutan's record setting vaccination campaign, and wide ranging policy measures. These measures have helped mitigate adverse impact of the pandemic on lives and livelihoods.

Directors agreed that fiscal policy has appropriately supported the pandemic and recovery efforts. A gradual medium-term consolidation, underpinned by revenue mobilization, would be important amid higher debt levels and limited fiscal space. They encouraged the authorities to further develop a domestic bond market, which would support stable and longer term funding, and increase supply of risk free assets. Directors welcomed the authorities' efforts in broadening the revenue base, including the planned introduction of the Goods and Services Tax.

Directors noted that monetary policy has been appropriately accommodative but should be gradually normalized as the recovery takes hold, amid rising inflationary pressures. They welcomed efforts by the Royal Monetary Authority to modernize the monetary policy framework by introducing a Domestic Liquidity Management Framework. Further reforms, including in the liquidity management framework and digitalization, would support market development.

Directors highlighted the need to address risks in the banking sector while supporting the economic recovery. They agreed that a well-communicated plan for withdrawing broad based policy support would be warranted, as activities gradually normalize. Directors welcomed the authorities' progress in implementing a risk based supervisory framework, and emphasized the importance of monitoring cash flows, assessing corporate viability, and a steadfast implementation of the new NPL resolution framework.

Directors agreed that the exchange rate peg to the Indian rupee has served Bhutan well and remains an appropriate nominal anchor. Directors welcomed the recent steps to remove some foreign exchange restrictions and encouraged elimination of the remaining restrictions as soon as macroeconomic conditions allow.

Directors acknowledged that the post-pandemic recovery offers an opportunity to lay the groundwork for a shift towards greater diversification and a knowledge-based economy. They agreed that continued improvements in physical and digital infrastructure should help support Bhutan's development goals and economic transformation and further progress with improving access to finance remains crucial. Directors welcomed the authorities' plan for climate change adoption and further greening of energy sources.

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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 summing up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

Table 1. Bhutan: Selected Economic and Financial Indicators, 2017-23

	2017/18	2018/19	2019/20	2020/21 Est.	2021/22 Proj.	2022/23 Proj.
	(In percent of GDP, unless otherwise indicated)					
National Accounts						
Nominal GDP (in millions of ngultrum)	163,456	172,951	175,067	176,671	196,161	217,004
Real GDP growth (percent change)	3.8	4.4	-2.4	-3.7	4.4	4.5
Prices						
Consumer Prices (EoP; percent change)	2.5	2.7	4.5	9.0	6.5	5.1
Consumer Prices (avg; percent change)	3.7	2.8	4.2	8.2	7.9	5.4
General government accounts						
Total revenue and grants	31.9	24.3	31.2	33.8	28.7	24.1
Domestic Revenue	22.6	20.1	20.7	20.3	17.5	19.8
Tax revenue	16.6	15.7	13.0	11.7	11.8	13.8
Non-tax revenue	6.0	4.4	7.7	8.6	5.7	6.0
Foreign Grants	9.1	6.1	9.4	8.4	10.8	4.3
Total expenditure /1	33.5	25.9	33.1	40.1	38.8	31.7
Current expenditure	16.8	16.1	21.7	24.6	20.7	17.8
Capital expenditure	17.6	9.4	12.6	15.6	18.2	13.9
Primary expenditure /1	33.1	24.5	33.8	39.2	37.5	30.1
Primary balance	-0.3	-0.7	-1.5	-5.3	-8.8	-6.0
Fiscal balance	-1.6	-1.6	-1.9	-6.3	-10.2	-7.7
Interest	1.3	0.9	0.5	1.1	1.4	1.6
General government debt 2/	113	106	131	135	133	131
Domestic	5	3	9	10	6	6
External	108	104	122	125	127	125
Monetary sector						
Broad money (M2) growth (percent change)	10.4	5.6	19.3	24.4	8.8	0.6
Private Credit to GDP ratio	53.2	60.6	67.9	71.6	69.9	71.0
Private credit growth (percent change)	15.7	20.5	13.3	6.5	8.3	12.5
Balance of payments						
Current account balance	18.4	-20.5	-12.4	-11.8	-10.6	-9.7
Goods balance	16.6	-16.4	-10.0	-7.1	-9.6	-7.3
Hydropower exports	6.8	6.4	13.0	14.8	14.4	15.9
Non-hydropower exports	17.2	18.5	13.9	15.3	14.9	14.5
Imports	40.6	41.2	36.9	37.2	39.0	37.8
Services balance	-1.4	-2.1	-2.9	-4.8	-4.8	-3.4
Primary income	-8.4	-9.0	-6.6	-5.7	-6.4	-5.1
Secondary income	8.1	7.0	7.1	5.9	10.3	6.1
Capital account balance	7.3	5.1	5.9	3.7	7.7	4.4
Financial account balance	17.2	-14.7	-21.0	-21.5	-14.3	-11.1
Net errors and emissions	19.4	-0.1	-2.3	-13.4	0.0	0.0
Overall balance	25.4	-0.8	12.2	-3.5	11.5	5.8
Gross official reserves (in USD millions)	1111	1345	1344	1558	1844	1977
(In months of goods imports)	13.1	16.0	18.1	21.0	21.4	21.8
(In months of goods and services imports)	10.7	13.1	14.7	18.2	18.7	19.3

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 payment support to borrowers financed by the National Resilience Fund.

2/ Public and publicly guaranteed debt, including loans for hydropower projects.

INTERNATIONAL MONETARY FUND

BHUTAN

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION

April 26, 2022

KEY ISSUES

Context: The pandemic has had a substantial impact on the economy, straining pre-pandemic gains in income and poverty reduction. The wide-ranging policy measures, including containment protocols, rapid vaccination and booster campaigns, direct income support, and policy support for borrowers and businesses, mitigated the adverse impact on lives and well-being. As the pandemic recedes and in light of the uncertainties from the war in Ukraine, the focus needs to be on securing livelihoods and ensuring strong and job-rich medium-term growth, while minimizing any persistent adverse effects from the pandemic and mitigating risks.

Main Policy Recommendations: Policies need to support the recovery in the context of heightened uncertainties from the pandemic and the economic implications of the war in Ukraine, diversify the economy, and boost growth potential.

- **Fiscal policy**. Fiscal policy should be anchored within a transparent, rolling, and multi-year budget framework, integrated within the five-year plan cycle and support a gradual fiscal consolidation over the medium term. Amid higher debt levels and limited fiscal space, revenue mobilization, including through a smooth implementation of the Goods and Services Tax (GST), is needed to finance Bhutan's development goals and support the most vulnerable, while ensuring fiscal sustainability. Further developing the domestic debt market would help public financing.

- **Monetary and financial sector policy**. Accommodative monetary policy remains appropriate amid subdued activity. However, the Royal Monetary Authority (RMA) should shift toward providing targeted support while continuing to closely monitor activity, inflationary pressures, and excess liquidity, and addressing elevated non-performing loans (NPLs).

- **Structural policies**. Creating new sources of growth, including through digitalization and the ongoing focus on skills, can boost productivity, growth, and employment. Furthering the climate change adaptation agenda will help increase economic resilience.

Approved By
Nada Choueiri (APD) and Kevin Fletcher (SPR)

Remote discussions took place during February 4-18, 2022. The team comprised F. Ahmed (Head), V. Ashtakala, M. MacDonald, T Xu (all APD), and L. Breuer (Senior Resident Representative). T Natarajan (OED) attended all mission meetings. The mission met with the Minister of Finance H.E. Lyonpo Namgay Tshering, the Governor of the Royal Monetary Authority Dasho Penjore, the Minister of Economic Affairs H.E. Lyonpo Loknath Sharma, and other senior government and the RMA officials, along with representatives from the private sector and development partners. M. Conde Panesso (APD) assisted in the preparation of this report.

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APPENDICES

CONTEXT AND RECENT DEVELOPMENTS

1. **Prior to the pandemic, Bhutan had made significant strides in improving per capita income and reducing poverty**, qualifying for its graduation from the Least Developed Country (LDC) status in 2023. Looking ahead, Bhutan faces the challenges of diversifying the economy, while facing continued uncertainty about the future path of the pandemic and minimizing any persistent impact.

2. **The pandemic had a broad-based adverse impact on the economy.**

- **GDP** contracted by 2.4 percent in FY2019/20 and 3.7 percent in FY2020/21. Transportation, construction, and tourism suffered the most, but with some offsets from an increase in hydropower production, which accounts for around 17 percent of GDP. Overall and youth **unemployment** roughly doubled to around 5 and 22.6 percent at end-2020.

- **Inflation** peaked in early 2021 from higher food prices and supply chain disruptions. Despite recent moderation, it remained elevated at 5.3 percent (year-over-year) in February 2022. Higher global commodities prices stemming from the war in Ukraine and continued supply disruptions are expected to keep inflation elevated throughout 2022 but will be partially offset by favorable base effects.

- The **fiscal deficit** increased to 6.3 percent of GDP in FY2020/21, reflecting higher pandemic-related expenditure, with the Twelfth Five Year Plan (FYP) re-prioritized and front-loaded. The National Resilience Fund (NRF) provided income support to individuals directly affected by the pandemic and interest payment support to individuals and businesses.

- While the pandemic impacted non-hydro exports, higher hydropower exports provided some offset, narrowing the **current account deficit** (CAD) marginally to 11.8 percent of GDP in FY2020/21.

- **Private sector credit** growth slowed to 6.5 percent in June 2021, an 8-year low, reflecting weak demand. Financial sector vulnerabilities have increased amid elevated non-performing loans (14.1 percent in June 2021) and concentration risks (services and housing sectors, and large borrowers).

3. **The wide-ranging policy responses helped contain the spread of the virus and cushion the impact of the pandemic (Appendix I)**. Bhutan's vaccination campaign has been one of the fastest in the world, achieving full vaccination of the adult population by end-July 2021 and of children aged five and older by end-March 2022. Booster doses have also been administered to the population aged twelve and older, starting since December 2021. Decisive public health measures helped contain the health burden and the loss of lives. The wide-ranging policy responses have helped mitigate the socio-economic costs of the pandemic. The responses include the deployment of the National Resilience Fund (NRF), the Economic Contingency Plan (ECP), and a series of fiscal, monetary, financial, and labor market measures (including the "Desuung" Guardians of Peace program, a value-based skills development program providing community- and nation-building volunteer opportunities for the unemployed youth).

OUTLOOK AND RISKS

4. The near-term outlook is weighed down by pandemic and geopolitical uncertainties. A gradual recovery is expected in FY2021/22, with growth projected at 4.4 percent, supported by Bhutan's record-setting vaccination campaign, higher electricity exports, ongoing fiscal support, and base effects. The lockdowns to contain the omicron variant and global ramifications of the war in Ukraine are expected to impact Bhutan's economy through weaker demand (including a weaker rebound in tourism), higher oil and commodity prices (with implications for transportation, food and other inputs costs), and potential supply disruptions. Inflation is projected to remain elevated at 7.9 percent in FY2021/22 (average), given Bhutan's dependence on imports of both oil and food, whose prices are rising, as well as continued supply disruptions. The overall fiscal deficit is expected to widen to 10.2 percent in FY2021/22 on account of continued fiscal stimulus, including higher capital expenditure. The current account deficit is projected to moderate to 10.6 percent of GDP in FY2021/22, with reserve coverage reaching about 19 months of imports.

5. Over the medium term, growth is expected to be driven by a recovery in services and manufacturing and hydropower, with generation capacity expected to more than double by FY26/27. Inflation is projected to remain in line with that in India, Bhutan's key trading partner, given the ngultrum's peg to the rupee. The fiscal deficit is expected to moderate as pandemic-related measures are gradually phased out and revenue reforms deepen. The CAD and reserve coverage are expected to improve from declining hydropower-related imports and rising hydropower exports.

6. Bhutan's long-term growth strategy has benefitted from its unique developmental approach, prioritizing overall well-being and environmental sustainability. Bhutan's Gross National Happiness (GNH) is a multi-dimensional development approach that seeks to achieve a balance between material well-being and the spiritual, emotional, and cultural needs of the citizens, with emphasis on access to education, health, and finance (see CR/18/300). One of the three carbon negative countries in the world, Bhutan is exposed to risks of natural disasters stemming from climate change, particularly in water-dependent sectors (hydropower, agriculture, and forestry).

7. Uncertainty around the economic outlook is elevated, with the balance of risks tilted to the downside (Appendix II). External risks include a sharper-than-expected global slowdown and/or a slowdown in India, including from future pandemic waves, an intensification of geopolitical tensions, and a prolonged decline in tourism. Domestic risks stem from pandemic-related uncertainties. Other domestic risks include prolonged financial sector strains amid limited fiscal space, including from any contingent liabilities in the financial sector masked by the broad-based pandemic support measures—and delays in hydro projects, which would affect growth, external buffers, and debt dynamics. That said, recent increases in hydropower production and remittances have supported reserves.

8. The authorities broadly agreed with staff's assessment of the near- and medium-term outlook and risks. The authorities' growth projections are broadly in line with staff's. Agreeing with staff, the authorities highlighted inflation as an important concern and expected it to remain elevated in the near term. Potential future pandemic waves and a continued stringent COVID policy, while the latter has been critical for savings lives, have increased risks to growth and fiscal space. Beyond the near term, the authorities conveyed guarded optimism about the recovery as pandemic-related restrictions on labor and goods movement across borders ease, and tourism slowly re-opens. They also emphasized the role that government capital spending and new hydropower projects have played in supporting growth.

Text Table. Bhutan: Selected Economic and Financial Indicators, 2017-26

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27
	Act.	Act.	Act.	Est.	←		Proj.			→
	(In percent of GDP, unless otherwise indicated)									
National Accounts										
Real GDP growth (percent change)	3.8	4.4	-2.4	-3.7	4.4	4.5	6.7	6.2	5.9	5.8
Prices										
Consumer Prices (avg; percent change)	3.7	2.8	4.2	8.2	7.9	5.4	4.6	4.2	4.1	4.0
General government accounts										
Total revenue and grants	31.9	24.3	31.2	33.8	28.7	24.1	26.2	28.0	28.2	28.1
Total expenditure 1/	33.5	25.9	33.1	40.1	38.8	31.7	31.2	31.0	31.0	30.6
Primary balance	-0.3	-0.7	-1.5	-5.3	-8.8	-6.0	-2.8	-0.4	0.1	0.7
Overall balance	-1.6	-1.6	-1.9	-6.3	-10.2	-7.7	-5.0	-3.0	-2.8	-2.4
General government debt 2/	113	106	131	135	133	131	128	122	117	113
Monetary sector										
Broad money (M2) growth (percent change)	10.4	5.6	19.3	24.4	8.8	0.6	12.2	11.2	10.5	10.2
Private credit growth (percent change)	15.7	20.5	13.3	6.5	8.3	12.5	13.9	14.2	14.5	14.5
Balance of payments										
Current account balance	-18.4	-20.5	-12.4	-11.8	-10.6	-9.7	-5.6	-1.4	-0.9	0.2
Overall balance	25.4	-0.8	12.2	-3.5	11.5	5.8	6.6	9.1	7.7	7.3
Gross official reserves (in USD millions)	1111	1345	1344	1558	1844	1977	2152	2451	2701	2954
(In months of goods and services imports)	10.7	13.1	14.7	18.2	18.7	19.3	19.9	21.4	21.9	22.6

Sources: Bhutanese authorities; and Fund staff projections.

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

2/ Public and publicly guaranteed debt, including loans for hydropower projects.

POLICIES TO SECURE THE RECOVERY AND STRENGTHEN THE OUTLOOK

A. Fiscal Policy

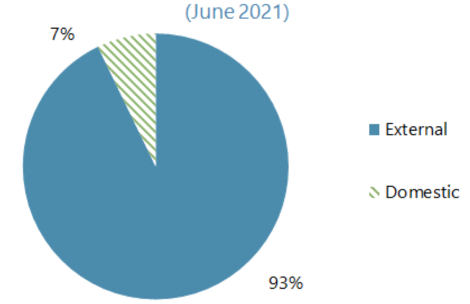
9. **The FY2021/22 fiscal response has appropriately prioritized measures to support the recovery**. The budget focused on health, education, and infrastructure. About 33 percent of the capital outlay in the Twelfth FYP (19 percent of GDP) has been allocated to FY2021/22, although the recent pandemic wave and labor constraints increased implementation challenges. The public infrastructure projects are primarily geared towards generating employment and exports and developing ICT and innovation. As a result, the fiscal deficit is projected to rise to 10.2 percent of GDP. The phasing out of support measures is expected to be gradual, given pandemic and geopolitical uncertainties. Going forward, fiscal policy should balance the need to support the livelihood of the most vulnerable and sustainability considerations, by focusing on more targeted

measures[1], to mitigate the longer-term impact of the pandemic and the potential spillover effects of the war in Ukraine on vulnerable households. The gradual phasing out of support measures should be well-communicated and predictable to ensure that individuals, businesses, and the financial sector can adequately prepare for the post-pandemic development phase.

10. The Goods and Services Tax (GST) is scheduled to be implemented in July 2022, following some IT-system and pandemic-related delay. Its steadfast implementation would broaden the tax base, reduce compliance costs, and support revenue mobilization. The GST rate would be set at 7 percent. Preliminary analysis suggests the revenue boost from the GST could amount to about 0.4 percent of GDP initially, and to about 2 percent of GDP in the medium term.

11. Bhutan's risk of overall and external debt distress is assessed to be moderate, but with limited space for additional shocks. The stock of public and publicly guaranteed (PPG) debt increased to 135 percent of GDP in FY2020/21. While the mechanical results point to a high risk of overall and external debt distress, with breaches in the indicators under the baseline scenario, judgment was applied to the risk ratings given unique mitigating factors supporting the sustainability of Bhutan's debt stock. First, almost three quarters of Bhutan's PPG external debt is linked to hydropower project loans from India, which covers both financial and construction risks of the projects and buys surplus electricity at a price reflecting cost plus profits. Second, while the pandemic increased the debt stock, the debt dynamics are expected to improve over the medium term, driven by a significant increase in electricity exports and the completion of hydropower construction. Stress tests suggest that Bhutan's external debt trajectory could be vulnerable to exchange rate and export shocks, while the overall debt sustainability could be susceptible to contingent liability shocks. Within the moderate rating, Bhutan is assessed to have limited space to absorb additional shocks without changing its risk rating.

Outstanding PPG Debt by Source
(June 2021)



Source: Royal Monetary Authority.

12. A gradual medium-term fiscal consolidation, underpinned by revenue mobilization and greater expenditure efficiency, is critical to increase policy space and support Bhutan's development goals. A gradual consolidation will bolster macroeconomic stability by reducing debt vulnerabilities and external imbalances, while balancing Bhutan's developmental needs. Revenue mobilization, including through a smooth implementation of the GST, could help offset a projected decline in grants. Furthermore, updating the base of land/property taxes and gradually rationalizing tax exemptions would boost revenue. On the expenditure side, pandemic-related fiscal expenditures should become more targeted from FY2022/23, following the expiration of current measures. Some of the broad-based measures, particularly regarding financial sector support, could be re-oriented to support the most vulnerable and to other priority items including education, health, and

[1] For example, the income support under Kidu targets individuals most affected by the COVID-19 pandemic, including those who have been laid off, or placed on unpaid leave or faced reduced salary from businesses in tourism and tourism-dependent sectors, and who do not have any other means of sustaining their livelihoods.

infrastructure. In this context, it would be important to continue improving access to quality health care, strengthening the quality of education including through vocational training and digitalization, and providing access to subsidized childcare to raise female labor force participation in urban centers.

13. **Fiscal policy could integrate a transparent, rolling, multi-year budget framework within the FYP cycle**. Bhutan's system of FYPs, guided by the GNH Commission, provides important anchors for budgetary planning and development goals. At the same time, a rolling and multi-year budget framework integrated within the FYP could make capital spending and growth less volatile and improve the efficiency of expenditure over the medium term. One possible approach would be to provide indicative fiscal targets for the next five years during the mid-term review. Such an approach could also help facilitate the implementation of large capital projects across multiple FYPs, increase the operational focus on long-term growth issues, such as the strategic priorities including health, education, and infrastructure developments, informed by the GNH principles (Box 1). Furthermore, enhanced fiscal transparency—including by reflecting pandemic support measures on-budget (e.g., the NRF) and timely evaluation of project implementation—should aid an effective re-prioritization of fiscal resources post-pandemic. The authorities should also ensure governance safeguards and accountability of crisis-related spending, including transparency in procurement (e.g., publication of contracts and beneficial ownership information of awarded companies).

14. **Staff supports the authorities' plan to further develop the domestic debt market, based on a medium-term debt management strategy**. At present, domestic debt financing remains limited (7 percent of total PPG debt), primarily through short-term T-bills and recent bond issuances. Developing domestic sources of stable and longer-term funding will be important, especially as the share of concessional external debt is expected to decline with Bhutan's graduation from the LDC status. Domestic debt issuances would increase supply of risk-free assets and help improve liquidity management. Going forward, the RMA should focus on developing monetary policy tools, including by implementing the liquidity management framework to establish an active interbank market and reference rate, and the Ministry of Finance should introduce a more regular issuance calendar.

15. **The authorities broadly agreed with staff's call for revenue mobilization and medium-term fiscal consolidation**. Besides the introduction of the GST in July 2022, the authorities are planning on direct tax and property tax reforms to further broaden the tax base and increase revenue. The authorities concurred that pandemic support measures should be more targeted going forward given sustainability and financial stability considerations. They noted that although the public debt ratio has increased significantly, the risk of debt distress remained moderate due to the unique mitigating factors supporting the sustainability of Bhutan's debt stock. Furthermore, the authorities expect a moderation in the debt-to-GDP ratio over the medium term, aided by a gradual fiscal consolidation, a significant increase in electricity exports, and the completion of hydropower construction. On the budgetary framework, the authorities emphasized the importance of the FYPs in providing a blueprint for long-term planning and in attracting financing from development partners and expressed interest in integrating a rolling budget framework within the FYP to reduce volatility and to facilitate longer-term projects. Finally, the authorities reiterated the importance of further developing the domestic bond market as an alternative source of funding and strengthening fiscal-monetary coordination.

B. Monetary Policy

16. Monetary policy has been appropriately accommodative but should be gradually normalized as the recovery strengthens and considering inflationary pressures from supply-side shocks. The Cash Reserve Ratio (CRR) was reduced by 300 basis points to 7 percent in 2020, the first easing since 2015, to support liquidity and credit, accompanied by various financial sector measures.[2] Money supply witnessed strong growth in FY2020/21, driven by deposits amid broad-based pandemic-relief measures and limited investment opportunities. While accommodative monetary policy has been appropriate amid elevated uncertainties, the RMA needs to plan for a phased withdrawal of support as the recovery takes hold, unemployment declines, and credit growth picks up amid inflationary pressure. This includes a gradual increase in the CRR, aided by forward-looking communication and close monitoring of excess liquidity and prices.

17. Staff continues to support modernization of the monetary policy framework. The Domestic Liquidity Management Framework (DLMF) benefitted from Fund CD and was announced in December 2020 for liquidity forecasting and management and carried out through overnight, weekly, and long-term (90-day) operations. While excess liquidity has stalled its operationalization, the overnight marginal lending facility should help establish an interest rate corridor, deepen the interbank market, and facilitate policy transmission. Debt market development will increase the supply of risk-free assets, build a benchmark yield curve, and help with monetary policy implementation.

18. Further reforms, including in the liquidity management framework and digitalization, would support market development. A phased reduction in excess liquidity stemming from pandemic-related policies would create two-way demand and foster interbank market development. The authorities' recent advances in financial market digitalization, including payment systems, can also deliver significant benefits for a country with Bhutan's topography (Box 2). The recently announced central bank digital currency (CBDC) pilot should initially focus on capacity building and be tailored to development needs.

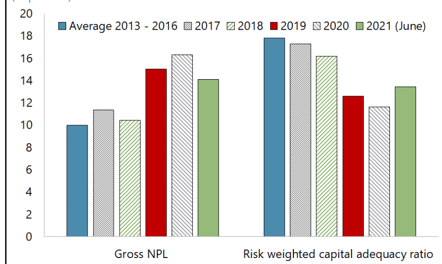
19. The authorities concurred that the pandemic warranted accommodative monetary policy, but excess liquidity has strained modernization of the monetary policy framework. The authorities highlighted that the monetary measures, including the reduction in CRR, helped banks extend short-term concessional bridge loans for businesses' working capital. They noted that excess liquidity is mainly driven by a mismatch between strong growth in (short-term) deposits and tepid (long-term) credit demand, including from a saturated housing market and construction-related demand. Finally, the authorities expressed a willingness to continue making progress on the DLMF and digitalization of the financial system. including exploring a CBDC through a pilot program focused on capacity building.

[2] The CRR remains the RMA's main monetary policy instrument until the new liquidity framework is fully operationalized.

C. Financial Sector Policy

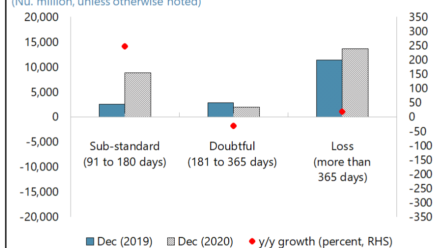
20. Bhutan's financial sector faced pre-pandemic vulnerabilities from high NPLs and low profitability. In 2019, the return on assets, return on equity, and system-wide non-performing loan (NPL) ratios weakened relative to their recent historical averages.

Weakening Financial Stability Indicators Pre-Pandemic
(In percent)



Sources: Royal Monetary Authority of Bhutan; and IMF staff estimates.

Change in NPL Classification, Dec-19 to Dec-20
(Nu. million, unless otherwise noted)



Sources: Royal Monetary Authority of Bhutan Annual Supervision Report; and IMF staff estimates.

21. Credit quality indicators are expected to worsen when policy support expires. The RMA introduced a loan repayment moratorium, an interest waiver on loans supported by the NRF, and a comprehensive NPL resolution framework to provide relief to both borrowers and financial institutions and facilitate credit supply. Despite an incentive scheme to repay loans, less than half of borrowers have taken advantage, straining bank profitability. NPLs remain elevated, amid increasing substandard classification and decreasing provisioning. Liquidity in the banking system remained elevated, with the statutory liquidity ratio rising to over 30 percent and deposits increasing 26 percent in June 2021. Despite the RMA's support and various initiatives, credit provision remained subdued reflecting weak demand, with private sector credit growth at 6.5 percent in June 2021.

22. Policies should urgently address the NPLs in the banking sector, while balancing the need for continued near-term targeted support. A significant deterioration in NPLs would weaken banks' capital position.[3] Going forward, a well-communicated plan for withdrawing broad-based policy support should be accompanied by banks' focus on monitoring cash flows, assessing corporate viability and targeting resources to viable but illiquid firms. In addition, a moratorium on dividend payments can support bank capitalization. Any extension of broad-based moratoria could further mask financial sector risks, weaken medium-term growth potential, increase inequality, and create contingent liabilities for the government. While the new NPL resolution framework is an important step, its steadfast implementation would require improved asset valuation.

23. Some progress has been made in implementing a risk-based supervisory (RBS) framework. In 2019 the RMA adopted an RBS framework and issued risk management guidelines, bringing its supervisory practices closer in line with recommendations of the Basel Framework (the set of international standards for prudential bank regulations). In 2020, the RMA conducted an RBS pilot for two financial institutions and published the results of basic stress tests in the first risk-based Annual Supervision Report. Going forward, the RMA plans to gradually implement the RBS across all financial institutions, requiring institutions to put in place an efficient risk management architecture, adopt risk-focused internal audit procedures, strengthen management information systems, and set

[3] RMA results suggests a doubling of NPL ratio (to 30 percent) would reduce the system-wide capital adequacy ratio to 9.2 percent, below the minimum requirement (10 percent).

up risk functions. The risk management framework would be proportionate to institutions' size, activities, and complexity. A new regulatory framework for developing a resilient and credible insurance sector is also under development.

24. Staff supports the authorities' plan to further strengthen financial supervision, building on recent progresses. Future priorities include i) closely monitoring loan performance, including by analyzing cash-collection rate and the migration of NPLs; ii) requiring banks to assess the viability of large borrower exposures and submit a detailed large-loan exposure report; iii) ensuring that the loan origination and provisioning standards and loan loss classifications are strictly enforced; iv) ensuring that financial institutions are carefully monitoring all prudential and integrity risks, including by conducting stress tests; v) rolling out the prudential and AML/CFT RBS to all financial institutions and strengthening internal risk management. Furthermore, modernizing the insolvency and bankruptcy process, including for cottage and small industries, would help timely and efficient resolution of stressed assets.

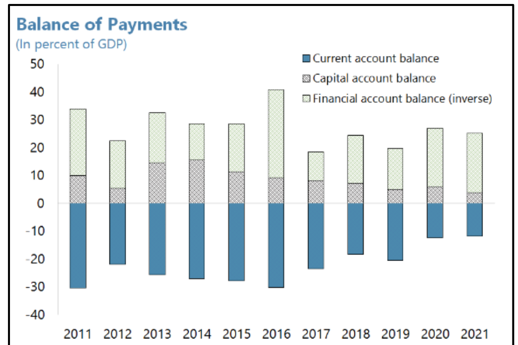
25. The authorities acknowledged the risks to the financial sector stemming from pre-pandemic vulnerabilities, masked by the generous pandemic support. They emphasized that the broad-based financial sector support reflected their core values of ensuring social cohesion during the crisis. They acknowledged, however, that such broad-based support is beginning to reach its fiscal limits and any future support better target the sectors, individuals, and businesses most affected by the pandemic. Moreover, the authorities concurred that close collaboration with the banks will be key to monitor risks from higher NPLs and better target future policy support programs. Separately, the authorities are committed to continuing implementation of the NPL resolution framework and the RBS framework, which should boost longer-term financial stability.

D. External Sector and Exchange Rate Policy

26. Bhutan's exchange rate peg has been an adequate nominal anchor and remains appropriate. The peg has important implications for debt and reserve management. Seventy percent of public external debt is denominated in Indian rupees, and over 90 percent of trade is with India. Rupee reserve constituted about 26 percent of total reserves in FY2020/21, up from around 16 percent two years ago. In line with past advice, staff recommends further increasing the share of rupee reserves, consistent with trade and financial flows. Staff supports the authorities' plan to keep the recent SDR allocation as part of Bhutan's international reserves, given a lack of near-term financing pressures. In addition, staff supports the authorities' recent relaxation on foreign exchange restrictions, including on the access to foreign currency by industries.[4]

[4] See Informational Annex for more details.

27. Staff assesses Bhutan's external position to be broadly in line with the level implied by fundamentals and desirable policies (Appendix III). Both the EBA-lite current account and the IREER methodologies support this assessment. The CAD has narrowed in recent years, as hydropower exports picked up, coupled with a decline in construction-related imports. The overall balance remains positive supported in part by grant financing. The net international investment position (NIIP) is projected to narrow gradually in the medium term under current policies. Given the concessional nature of grant financing and the long-term FDI-like loan liability structure, the risks of imminent external financing stress are low. Bhutan's reserve coverage remains adequate. Going forward, higher electricity exports, accompanied by medium-term fiscal consolidation, should further support an improvement in the CAD and NIIP.



Sources: Royal Monetary Authority of Bhutan; and IMF staff estimates.

28. The authorities concurred with the staff's external sector assessment and agreed with the appropriateness of the peg as a nominal anchor. They emphasized the importance of the hydropower sector in supporting external stability and agreed that the CAD would improve over the medium term, with the onboarding of new hydropower plants and a pickup in electricity exports. Furthermore, the authorities reiterated the importance of rupee reserves as an external buffer and highlighted that convertible currency reserves can be exchanged into rupee reserves, if needed.

E. Structural Reforms

29. The post-pandemic recovery offers an opportunity to lay the groundwork for greater diversification, including through higher value-added activities. The Digital Drukyul Flagship Program appropriately aims to leverage digitalization to promote inclusion and transform the economy (Box 2). The authorities' efforts in improving tourism infrastructure, skills training, and dissemination of digital content can help upgrade the industry. Prioritizing 'High Value, Low Volume' tourism would help address both revenue and sustainability concerns (Box 3). Improving export market access through digital platforms can increase agribusiness demand and output.

30. Further progress with improving access to finance remains crucial. Despite important progress on financial inclusion, focus needs to be on bridging gaps across gender, age, and regions as well as types of financial products.[5] Efforts towards further digitalization, which include expanding digital payments and digital IDs, will help deepen access (Box 2).

31. Policies and programs to address skill mismatches, exacerbated by the pandemic, are welcome and should continue. To address the joint problem of pandemic-related labor shortages in critical industries (e.g., construction) and high youth unemployment stemming from closures in the tourism and hospitality sector, several skilling and re-skilling programs were initiated. These increased the availability of courses, provided graduate-employer-matching, and subsidized temporary job

[5] As of 2020, 76 percent of the adult population had a bank account, but only 21 percent had accessed credit facilities and 25 percent had an insurance policy.

placement. Going forward, fiscal allocation for vocational education, teachers' training and remedial education for lost schooling should be maintained. To meet short-term labor needs, continued training, job-matching assistance, as well as lower barriers for skilled immigration would be warranted. Better access to subsidized childcare could also help increase female labor force participation in urban areas.

32. **Further improvements in infrastructure development should help support Bhutan's development goals and economic transformation**. Bhutan is ranked 149th among 160 economies in the World Bank's 2018 Logistics Performance Index (latest publication). Further developing the digital infrastructure could help support Bhutan's transition to a knowledge-based economy.

33. **Bhutan faces a pressing need for climate change adaptation**.[6] With most of the population living in river valleys and economic activity heavily reliant on water sources, lives and livelihoods are at heightened risk from climate vulnerabilities. Furthermore, rapid urbanization and the use of fuel wood are adding pressures on the ecosystem. Staff supports the authorities' plans for climate change adaptation, disaster risk management and further greening of energy sources, including through climate-resilient budgeting and with a focus on infrastructure.

34. **The authorities concurred that progress on structural reforms is critical to diversifying the economy and boosting long-term growth**. They noted the pandemic offers an opportunity to boost diversification through digitalization and improved skill-matching. They highlighted their extensive programs to address skill mismatches and unemployment during the pandemic, and the intention to continue with many of these programs post-pandemic. They also agreed with staff's assessment on the need to improve infrastructure—both physical and digital—to help support domestic economic activity. Such measures, with a focus on improving productivity, will be prioritized in the upcoming Thirteenth FYP (2023-2028).

F. Other Issues

35. **The IMF stands ready to provide further capacity development (CD), including through the South Asia Technical Assistance and Training Center (SARTTAC)**. Since the pandemic, the CD engagement has been recalibrated towards online delivery but remained focused on major policy reforms (Appendix IV). Ongoing CD workplans include medium-term budget frameworks, rebasing of national accounts, development of high frequency indicators, GST implementation, risk-based supervisory framework, and liquidity management.

36. **The authorities conveyed their appreciation for ongoing CD support** and expressed interest in deepening collaboration with staff, including in areas of bond market development and digital currency. They highlighted that improving data coverage remains a priority.

[6] Forrest coverage (about 71 percent of the country, above the government's mandated target of 60 percent) and renewable energy offset carbon emissions.

STAFF APPRAISAL

37. The pandemic has had a substantial impact on Bhutan's economy. Real GDP contracted for two fiscal years, with contact-intensive and externally oriented sectors most affected, including transportation, construction, and tourism. The wide-ranging policy response helped mitigate adverse impact on lives and livelihoods. Nonetheless, the socio-economic impact has been sizable.

38. While pandemic and geopolitical uncertainties are weighing on the near-term outlook, medium-term growth is expected to be driven by a recovery in services, manufacturing, and hydropower. Growth is projected at 4.4 percent in FY2021/22, with the negative impacts from the omicron outbreak and rising commodity prices stemming from the war in Ukraine, partially offset by Bhutan's record-setting vaccination campaign, higher electricity exports, ongoing fiscal support, and base effects. Inflation is projected to remain elevated in FY2021/22, owing also to higher oil, food, and commodity prices and supply disruptions. Over the medium term, hydropower generation capacity is expected to double, supporting growth, the current account balance, and the fiscal position. Inflation is projected to remain in line with that in India, Bhutan's key trading partner, given the ngultrum's peg to the rupee.

39. While fiscal policy has appropriately supported the pandemic response and recovery efforts, a gradual medium-term consolidation, underpinned by revenue mobilization, is critical. Staff welcomes the budget's focus on health, education, and infrastructure. Going forward, fiscal policy should balance the need to support the most vulnerable and sustainability considerations, by focusing on more targeted measures. Fiscal policy should be anchored within a transparent, rolling, and multi-year budget framework, integrated within the FYP cycle. Amid higher debt levels and limited fiscal space, revenue mobilization, including through a smooth implementation of the GST, is needed to finance Bhutan's development goals, while ensuring fiscal sustainability. Further developing the domestic debt market would help public financing and provide risk-free instruments for domestic investors.

40. Monetary policy has been appropriately accommodative but should be gradually normalized as the recovery strengthens and in light of inflationary pressures. Amid heightened uncertainties and a nascent recovery, accommodative monetary policy remains appropriate in the near term. The RMA nonetheless needs to plan for a phased withdrawal of support as the recovery takes hold, unemployment declines, and credit growth picks up amid elevated inflationary pressures. A gradual increase in the CRR, aided by forward-looking communication and close monitoring of excess liquidity and inflation will be necessary. As liquidity conditions normalize, progress on operationalizing the DLMF and overnight marginal lending facility should be prioritized, which will help with interbank market development and monetary policy transmission. Digitalization of the financial system has proceeded at a rapid pace throughout the pandemic and should continue to support productivity and diversification.

41. Financial sector policy should address risks in the banking sector while supporting the recovery. As pandemic-related restrictions are withdrawn and activity normalizes, a well-communicated plan for withdrawing broad-based policy support is needed. This should be accompanied by banks' focus on monitoring cash flows, assessing corporate viability and targeting resources to viable but illiquid firms. In addition, if further support for bank capitalization is needed, a renewed moratorium on dividend payments could be implemented. A steadfast implementation of the new NPL resolution framework would benefit from improved asset valuation. Building on the recent progress, steadfast implementation of risk-based supervisory framework remains important.

42. Bhutan's external position is assessed to be broadly in line with the level implied by fundamentals and desirable policies in FY2020/21. Bhutan's peg has been an adequate nominal anchor and remains appropriate, given its trade patterns. The reserve coverage remains adequate. In line with past advice and consistent with Bhutan's trade and financial flows, staff recommends further increasing the share of rupee reserves. Going forward, higher electricity exports, accompanied by medium-term fiscal consolidation, should further support the current account balance and NIIP. The authorities' recent relaxation of foreign exchange restrictions would facilitate Bhutan's financial integration.

43. The post-pandemic recovery offers an opportunity to lay the groundwork for a shift towards greater diversification and a knowledge-based economy. Prioritizing 'High Value, Low Volume' tourism would help address both revenue and sustainability concerns. Further increasing digitalization, including by expanding digital payments and digital IDs, will help improve efficiency and expand access to finance of greater segments of the population, particularly those in rural areas. Improving market access through digital platforms can increase external demand for agricultural products. More broadly, continued improvements in physical and digital infrastructure should help support Bhutan's development goals and economic transformation. Labor market policies and programs to address skill mismatches, exacerbated by the pandemic, are welcome and should continue. Finally, staff supports the authorities' plans for climate change adaptation, disaster risk management and further greening of energy sources, including through climate-resilient budgeting and with a focus on resilient infrastructure.

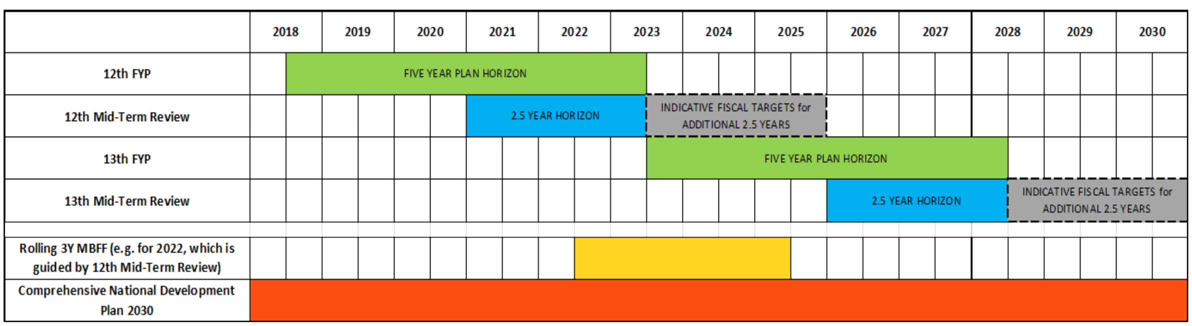
44. Staff recommends that the Article IV consultation with Bhutan remain on a 24-month cycle.

Box 1. Multi-Year Rolling Budget Framework Integrated in FYP

Fiscal policy in Bhutan reflects coordination across multiple agencies and with the planning process. The Ministry of Finance drafts the fiscal framework, while the Gross National Happiness Commission (GNHC)—which plays a central role in Bhutan's national planning—is guided by this framework in developing the national plan. The finance ministry also coordinates macroeconomic interventions and is responsible for financing the fiscal framework through revenue, while the GNHC prepares projections for grants.

Bhutan has in the past experienced large fluctuations in expenditure and deficits. The fluctuations were related to the electoral cycle and its link with the five-year planning horizon. More recently, the COVID-19 shock has created disruption and volatility in fiscal policy, prompted by the need to frontload much of the capital and current expenditures to mitigate the immediate impact of the pandemic.

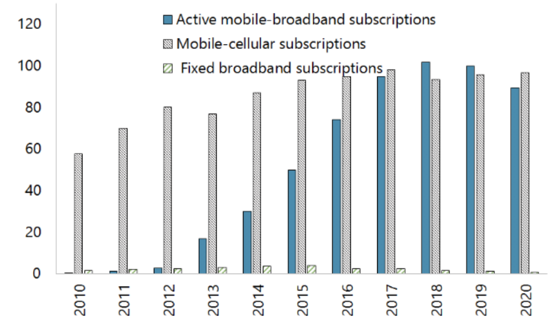
To help reduce the volatility in fiscal policy, there is scope to integrate a rolling, multiyear budget framework within the FYP. This will also allow the authorities to identify a pragmatic and strategic fiscal objective to anchor the FYP, while allowing for flexibility to accommodate unexpected shocks. For example, one possible approach would be to provide indicative fiscal targets for the next five years during the mid-term review (covering the first half of the upcoming FYP, see gray in the figure below), which could make capital spending less volatile and more efficient, supporting sustained investment and economic growth. Such an approach would also increase the operational focus on long-term growth agenda and the strategic priorities including health, education, and infrastructure developments, and facilitate the implementation of large capital projects across multiple FYPs.



Box 2. Digitalization for Economic Transformation

Bhutan has witnessed a rapid rise in digital adoption, but still faces some constraints in achieving widespread digital access. Access to the internet has risen and the cost of access, particularly through mobile-cellular devices, has been steadily declining. Nonetheless, internet access is highly concentrated in urban areas. Given the country's topography and population distribution, improving connectivity infrastructure remains difficult and costly. The legal and regulatory framework relating to the digital economy remains incomplete and improving digital literacy is a key constraint.

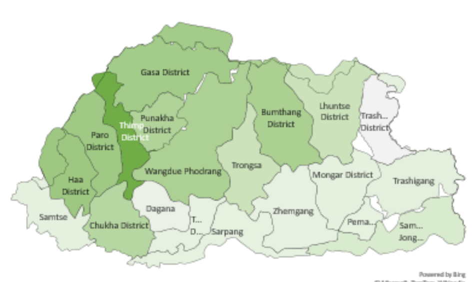
ICT Access
(Per 100 inhabitants)



Source: International Telecommunication Union.

Digital adoption is expected to increase amid various government-led initiatives. As part of the Twelfth FYP, the Digital Drukyul Flagship Program was introduced with the aim of using information and communication technology (ICT) to transform Bhutan into a digital and inclusive society. The program focuses on seven areas: i) digitalization of health care; ii) provision of broadband connection to 1,000 schools, hospitals, and offices; iii) One Digital Identity (biometric ID); iv) integration of digital business licensing and single customs-trade systems; v) digitalization of key public services; vi) professional ICT certification and digital literacy for non-ICT workers; and vii) digitalization schools through e-learning platforms and education management information systems.

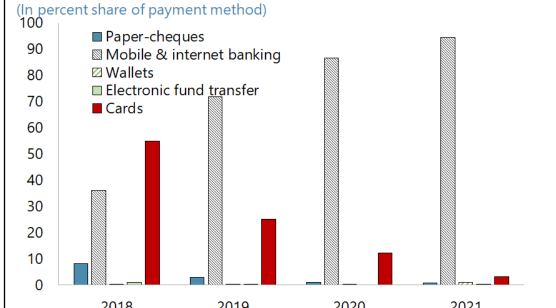
Share of Population with Internet Access 1/
(In percent)



Source: National Statistics Bulletin Bhutan.
1/ Darker green shade represents higher internet penetration (max 84 percent); lighter green represents lower internet penetration (min 18.7 percent)

Efforts by the RMA to digitalize the payment systems have advanced. Bhutan made important progress in the digitalization of the financial system from 2017-20, including the Bhutan Intermediate Payment Service (interbank transfers via internet, mobile, and ATMs instantaneously 24/7), the Global Interchange for Financial Transactions (large value fund transfer between banks on a real-time gross settlement basis), RuPay (Indian banks cards to be used a local ATMs), and the QR-code payment system. Since the onset of the pandemic, Bhutan has witnessed a sharp rise in both value and volume of transaction through electronic means and in major cities all vendors now accept some form of digital payment.

Payment Transaction Volume, by Type 1/
(In percent share of payment method)



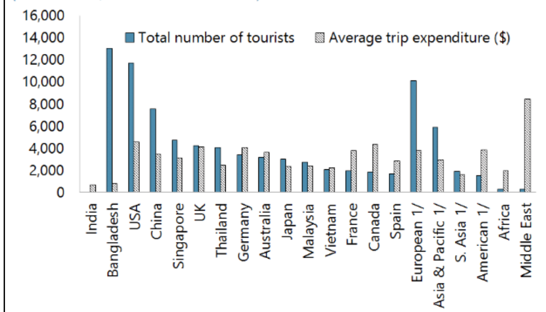
Sources: Royal Monetary Authority of Bhutan; and IMF staff estimates.
1/ Data for 2020 is available for Q1-Q3, data for 2021 is available for Q1 and Q2. Data for Payment Gateway, available only in 2021, is not shown and accounts for less than 0.6 percent of total transaction volume and less than 0.05 percent of total transaction value.

Efforts to expand digitalization should continue. Major initiatives under the Digital Drukyul program, including the digital ID, which have been delayed during pandemic lockdowns should be advanced. Continued fiscal support for investment in physical infrastructure needed for digitalization should also be prioritized. Digitalization of the payment systems, particularly elements connecting Bhutan with international payments systems, should continue to be explored in line with Bhutan's export diversification strategy and the return of international tourism.

Box 3. On Transforming Bhutan's Tourism Sector

Tourist arrivals reached a peak of 316 thousand visitors in 2019. There was significant variation in the nationality and expenditure of visitors. Those from outside the region provide significantly higher value per visitor, consistent with the Minimum Daily Package Rate (MDPR) program, which requires international visitors except those from India, Bangladesh, and the Maldives, to pay a minimum daily rate (USD 250) and book their visit through authorized travel agencies. In 2020, in an effort to reduce the footprint on the ecology, the Tourism Levy and Exemption Bill was introduced which requires regional visitors previously exempt from the MDRP to pay a small levy for entry to Bhutan**.**

Inbound Tourism, by Nationality
(In thousands, unless otherwise noted)

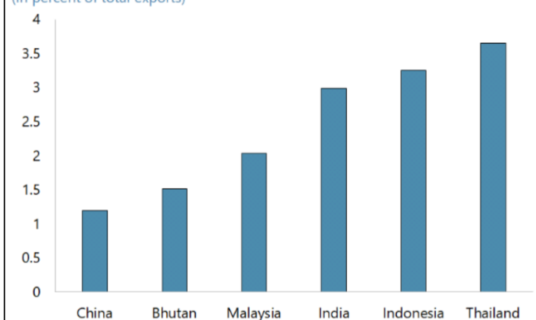


Sources: World Tourism Organization; Bhutan Tourism Council; and IMF staff estimates.
1/ Includes all countries except those listed individually

Bhutan's governing tourism philosophy of "High Value, Low Volume "to ensure sustainability offers an opportunity post-pandemic. The philosophy would support an acceleration of the planned pivot towards wellness tourism, while remaining an exclusive travel destination based on the GNH values. The introduction of the regional levy is a step towards this goal. Bhutan can also explore other niche tourism segments, like ecotourism and virtual tourism that could support quality growth and job creation.

Wellness tourism is growing in popularity globally, and Bhutan is well-placed to take advantage of the trend. Wellness tourism can include traditional and preventative medicines, personal care, beauty, spa, thermal and mineral springs. In 2018 the global industry was worth US$ 639 billion, of which US$ 137 billion was spent in the Asia-pacific region. The Bhutanese market is currently small, and the expected rise in demand for wellness tourism post-pandemic could be harnessed.

Wellness Tourism
(In percent of total exports)



Sources: IMF WEO; Global Wellness Institute; and IMF staff estimates.

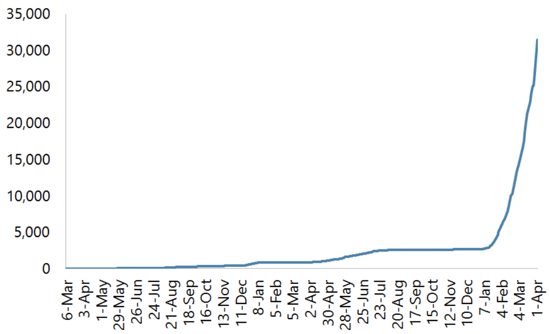
Eco-tourism and virtual tourism. Eco-tourism is one of the highest value-added tourism activities and has significant existing demand from high-income tourists. In this respect, Bhutan could learn from other small eco-tourist countries like Costa Rica and Botswana. Virtual tourism—web-based video tours conducted by a local guide on the ground and watched by individuals located elsewhere—also gained popularity during pandemic lockdowns, allowing foreigners to experience a country for a nominal fee at little environmental cost. Given Bhutan's digitalization strategy, virtual tourism could be an important source for future tourism, particularly amid continued pandemic uncertainty and boost demand for future in-person visits.

During the post-pandemic phase, it will be important to be mindful of tradeoffs among different forms of tourism. Bhutan will need to identify and calibrate a well-sequenced and comprehensive set of policies to promote the tourism sector that coordinates the public and private sector, complies with health and safety needs, and builds trust and confidence with travelers.

Figure 1. Bhutan: COVID-19 Developments

Total confirmed COVID-19 cases have increased…

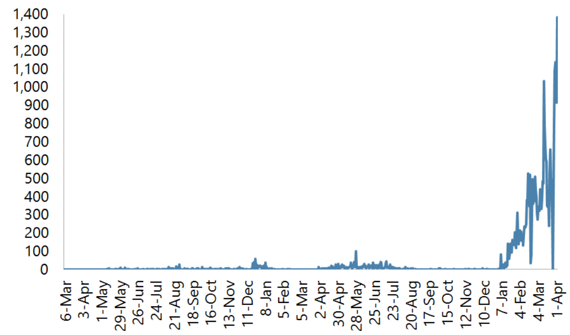
COVID - 19: Cumulative Confirmed Cases



Sources: Our World in Data; and JHU CSSE COVID-19 Data.

…from the Omicron variant.

COVID - 19: Daily New Confirmed Cases

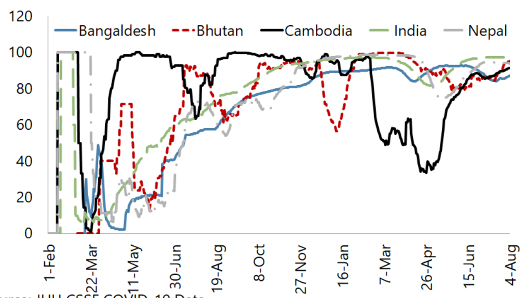


Sources: Our World in Data; and JHU CSSE COVID-19 Data.

The recovery rate has steadily improved…

COVID - 19: Recovery Rate 1/

(In percent share of recovered cases to confirmed cases)



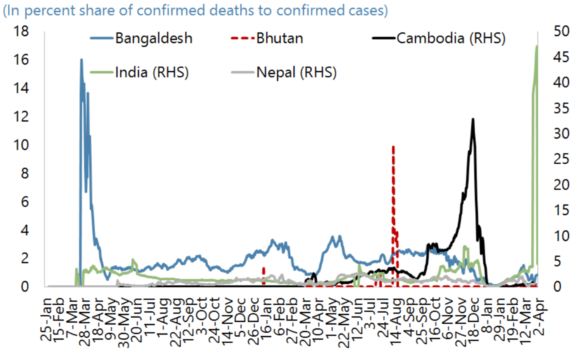
Source: JHU CSSE COVID-19 Data.

1/ Dataset updates for recovered cases are no longer provided by source, the last observation is August 8, 2021.

…and the case fatality rate in Bhutan remains very low.

COVID - 19: Case Fatality Rate

(In percent share of confirmed deaths to confirmed cases)

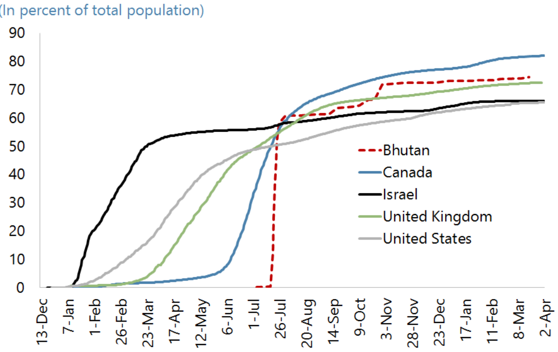


Sources: Our World in Data; and JHU CSSE COVID-19 Data.

The vaccination rate is among the highest, globally.

COVID - 19: Share of Fully Vaccinated Population

(In percent of total population)

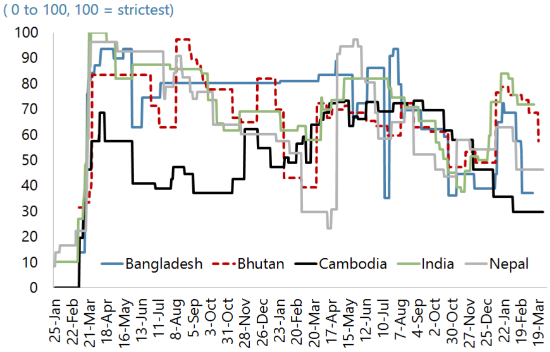


Sources: Our World in Data; and United Nations World Population Prospects.

Lockdown measures are gradually easing.

COVID - 19: Stringency Index

(0 to 100, 100 = strictest)

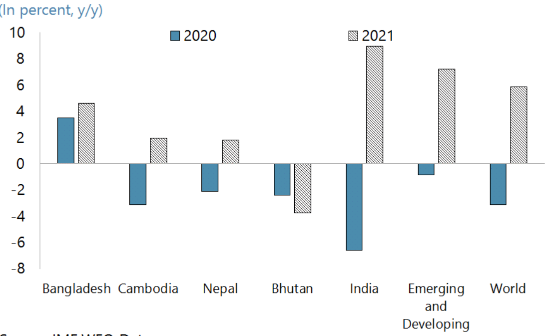


Sources: Our World in Data; and Oxford COVID-19 Government Response Tracker.

Figure 2. Bhutan: Real Sector Developments

Bhutan saw a large contraction in growth in both 2020 and 2021...

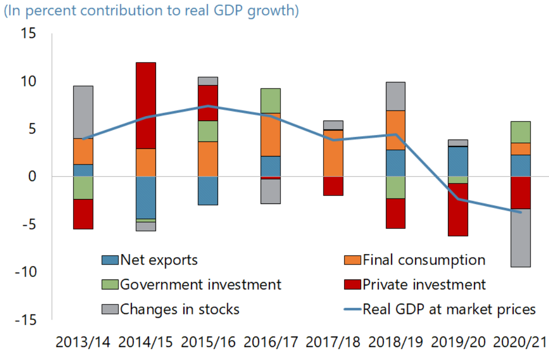
Real GDP Growth Rate 1/
(In percent, y/y)



Source: IMF WEO Data.
1/ Data for Bhutan and India are in shown FY, 2020 is FY2019/20 and 2021 is FY2020/21

...mainly due to negative investment and flat consumption.

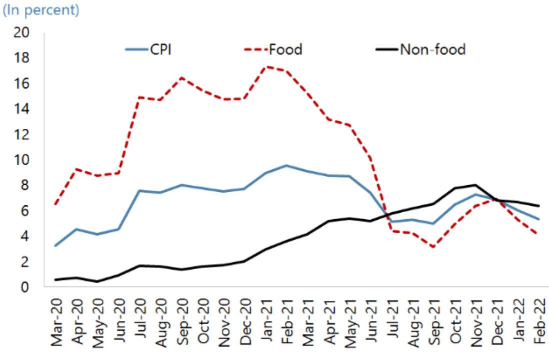
Sources of Growth
(In percent contribution to real GDP growth)



Source: IMF staff estimates.

Food prices put strong upward pressure on prices ...

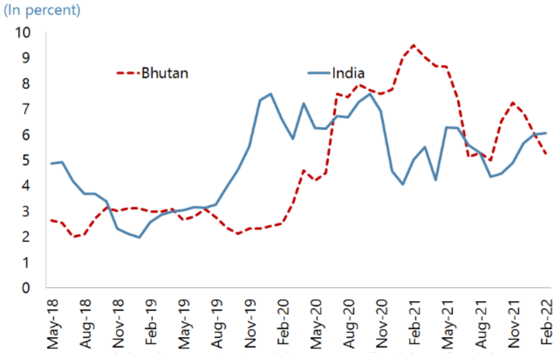
Consumer Price Inflation
(In percent)



Sources: Bhutan National Statistics Bureau; and IMF staff estimates.

...as inflation rose faster than that in India in 2021.

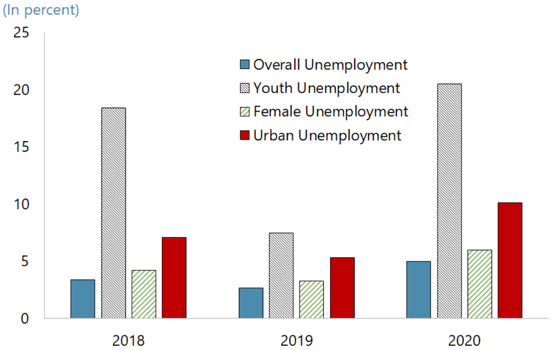
CPI Inflation Relative to India
(In percent)



Sources: Haver Analytics; Bhutan National Statistics Bureau; India Ministry of Statistics Programme Implementation; and IMF staff estimates.

Unemployment rose, especially for the more vulnerable.

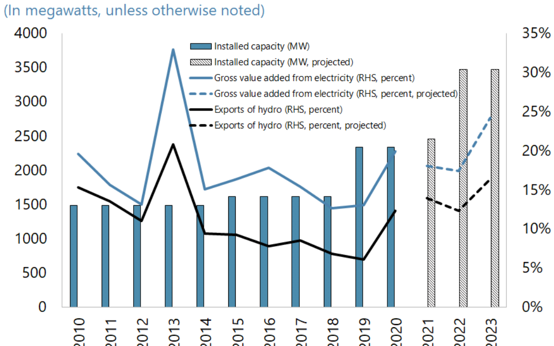
Unemployment Rate
(In percent)



Source: Bhutan National Statistics Bureau Labor Force Survey Report.

Hydropower is expected to continue driving growth.

Hydrpower Capacity and Output
(In megawatts, unless otherwise noted)



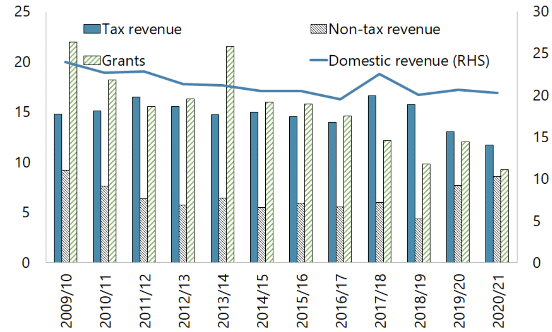
Source: IMF staff estimates.

Figure 3. Bhutan: Fiscal Developments

Tax revenue and grants have decreased recently…

Total Revenue and Grants

(In percent of GDP)

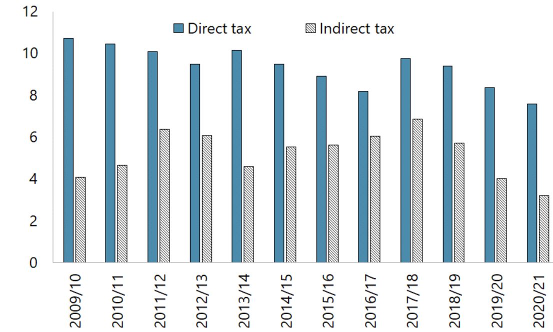


Sources: Bhutanese authorities; and IMF staff estimates.

…with a decline in direct and indirect tax collection.

Tax Revenue Breakdown

(In percent of GDP)

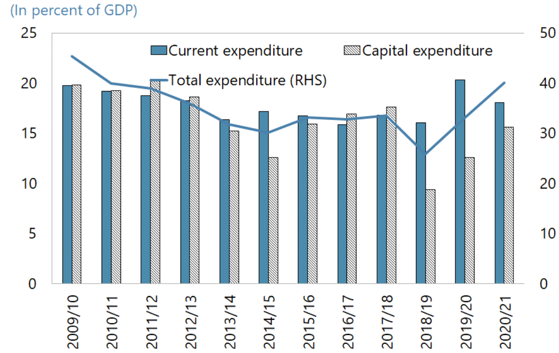


Sources: Bhutanese authorities; and IMF staff estimates.

Expenditure rose to mitigate the impact of the pandemic…

Current and Capital Expenditure

(In percent of GDP)

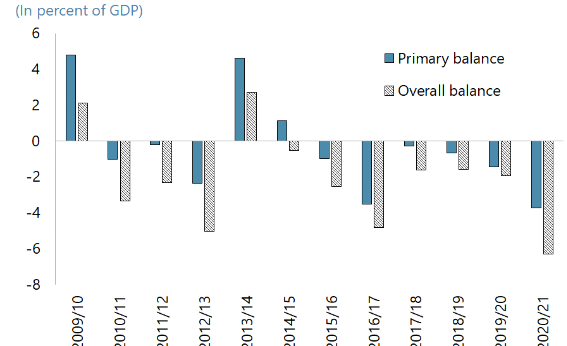


Sources: Bhutanese authorities; and IMF staff estimates.

… widening the primary and overall fiscal deficits.

Fiscal Deficit

(In percent of GDP)

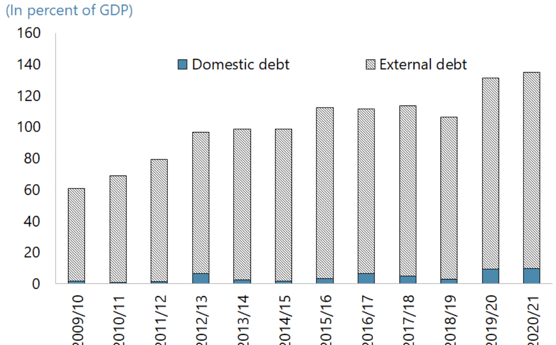


Sources: Bhutanese authorities; and IMF staff estimates.

Public debt rose steadily in recent years …

Public Debt Profile

(In percent of GDP)

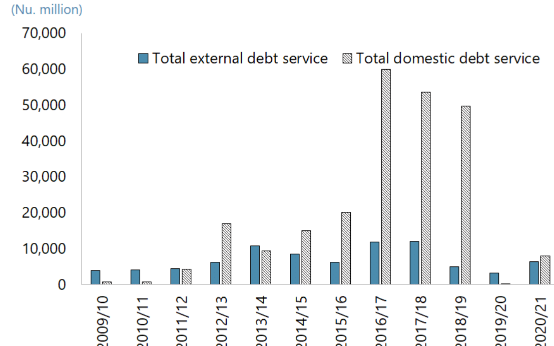


Sources: Bhutanese authorities; and IMF staff estimates.

…accompanied by higher debt service.

Total External and Domestic Debt Service

(Nu. million)

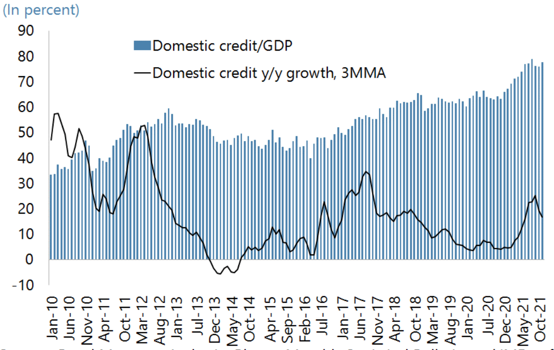


Sources: Bhutanese authorities; and IMF staff estimates.

Figure 4. Bhutan: Financial and Monetary Developments

Credit growth remains well below pre-pandemic levels…

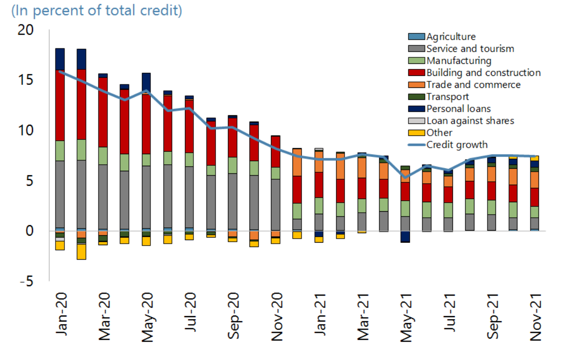
Bank Credit
(In percent)



Sources: Royal Monetary Authority Bhutan Monthly Statistical Bulletin; and IMF staff estimates.

…led by weaker credit flows to services and construction.

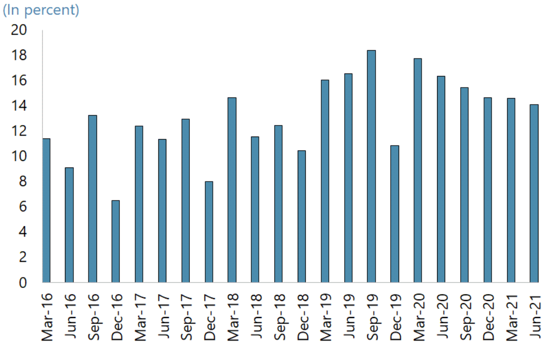
Sectoral Contributions to Credit Growth
(In percent of total credit)



Sources: Royal Monetary Authority Bhutan Monthly Statistical Bulletin; and IMF staff estimates.

NPL levels remain elevated, despite COVID moratoria.

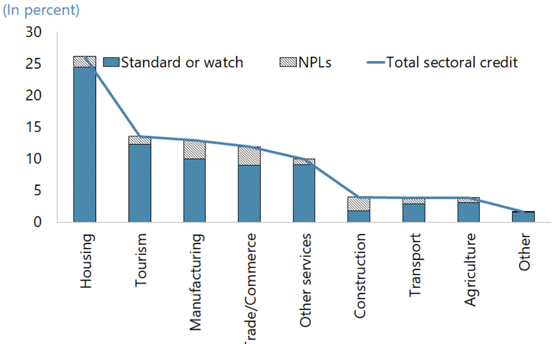
Gross NPL Ratio
(In percent)



Sources: Royal Monetary Authority of Bhutan Annual Supervision Report; and IMF staff estimates.

NPLs display sectoral concentration (e.g., construction).

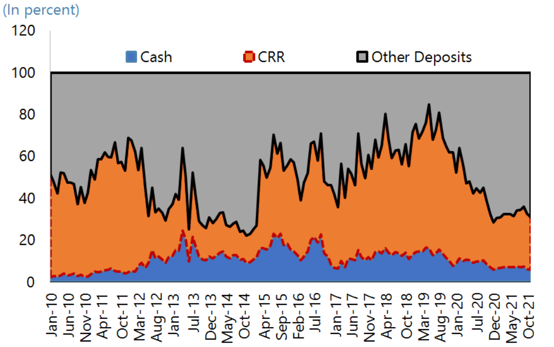
Sectoral Credit
(In percent)



Sources: Royal Monetary Authority Bhutan Annual Supervision Report; and IMF staff estimates.

Deposits rose significantly during the pandemic.

Breakdown of Commercial Banks' Reserves
(In percent)



Sources: Royal Monetary Authority Bhutan Monthly Statistical Bulletin; and IMF staff estimates.

Bhutan issued its first two long-term bonds in FY2020/21.

First RGoB Bond Issuances

	Sep-20	Feb-21
Maturity	3 years	10 years
Coupon rate	6.50%	3.98
Exchange Rate	72.5 (Nu/US$)	73.7 (Nu/US$)
Allotment	Nu 3 billion (US $ 41,379,310)	Nu. 700 million (US $9,497,965)
Total subscription amount received	Nu. 9,109,327,000 (US$ 125,645,890)	Nu. 2,900,100,000 (US$ 39,350,068)
Bid-to-coverage ratio	3.04	4.14
No. of subscribers	56	6
Individual	48	1
Institution	7	4
Other	1	0

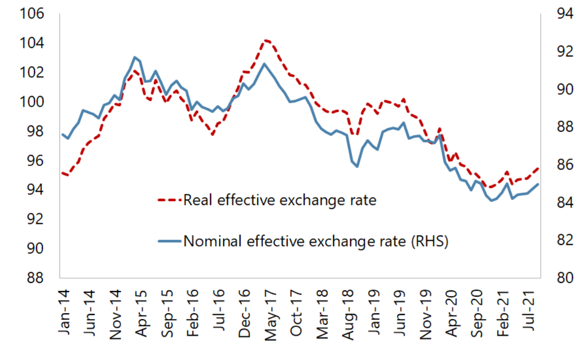
Source: Royal Monetary Authority Bhutan.

Figure 5. Bhutan: External Developments

The REER and NEER depreciated in the past two years…

Nominal and Real Effective Exchange Rates

(Index, 2010=100)

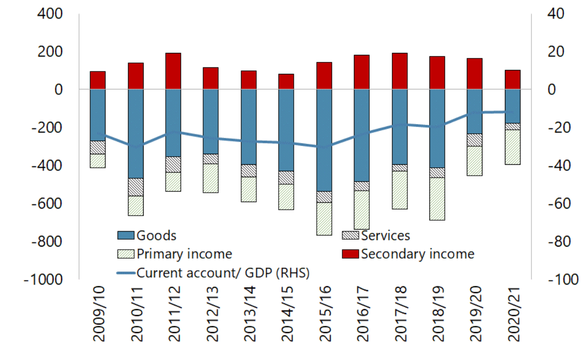


Source: IMF INS data.

…with a moderation in the current account deficit.

Current Account and Components

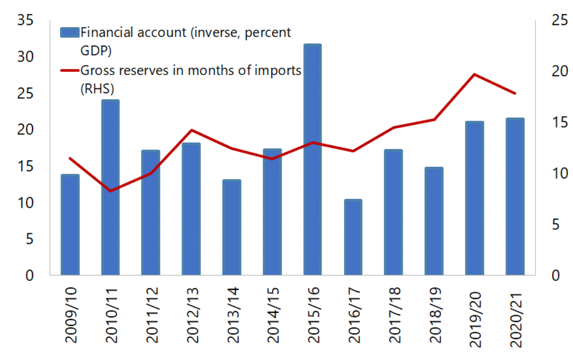
($ million)



Sources: Royal Monetary Authority of Bhutan; and IMF staff estimates.

Reserves have increased steadily in recent years…

Financial Account and Gross Reserves

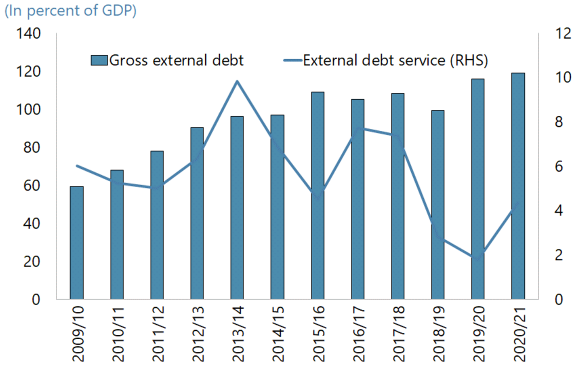


Sources: Royal Monetary Authority of Bhutan; and IMF staff estimates.

…with lower external debt service.

External Debt Services

(In percent of GDP)

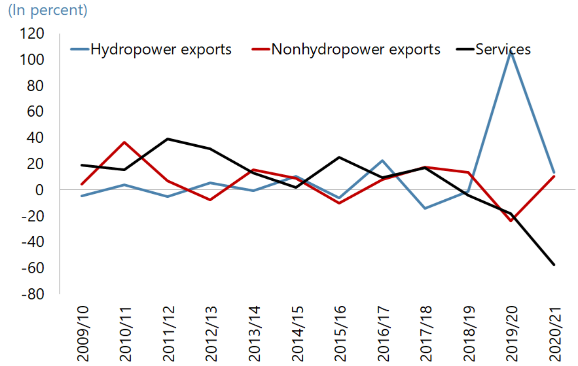


Sources: Royal Monetary Authority of Bhutan; and IMF staff estimates.

Hydro exports provided some offsets to the decline in services and non-hydro exports….

Exports Growth

(In percent)

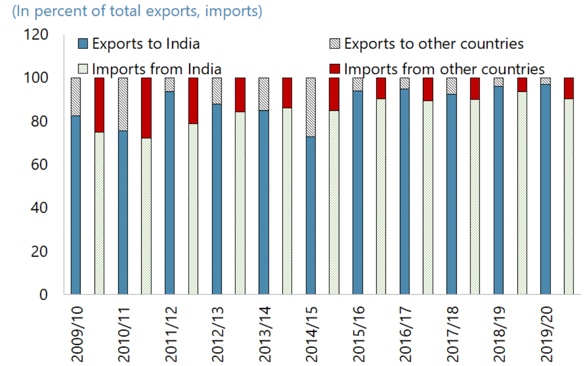


Sources: Royal Monetary Authority of Bhutan; and IMF staff estimates.

…and India remains Bhutan's major trading partner.

Foreign Trade

(In percent of total exports, imports)



Sources: Royal Monetary Authority of Bhutan; and IMF staff estimates.

Table 1. Bhutan: Medium-Term Macroeconomic Framework, 2017–27

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27
	Act.	Act.	Act.	Est.	←			Proj.		→
	(In percent of GDP, unless otherwise indicated)									
National Accounts										
Nominal GDP (in millions of ngultrum)	163,456	172,951	175,067	176,671	196,161	217,004	243,570	270,831	299,389	329,922
Real GDP growth (percent change)	3.8	4.4	-2.4	-3.7	4.4	4.5	6.7	6.2	5.9	5.8
Consumption	7.8	6.4	0.0	2.0	9.8	4.2	3.7	1.0	5.4	5.6
Investment	-1.6	-4.3	-10.6	-15.3	0.0	-4.7	-4.6	5.5	3.2	2.1
Private	-4.9	-8.5	-17.0	-12.5	7.4	0.4	-4.2	1.4	1.9	0.6
Public	0.6	-19.9	-8.6	26.7	37.5	-13.7	-5.5	14.2	5.5	4.9
Exports of G&S	5.5	9.6	-4.1	-1.9	4.2	10.7	20.2	13.5	8.2	6.7
Imports of G&S	3.1	0.0	-9.2	-6.3	8.9	-0.1	2.1	2.9	5.0	3.5
Gross national saving	25	17	13	16	30	27	27	31	31	31
Gross capital formation	48	40	35	34	40	37	33	33	32	31
Public	12	9	9	11	14	12	11	11	11	11
Private	37	33	27	24	26	25	22	21	20	19
Prices										
Consumer Prices (EoP; percent change)	2.5	2.7	4.5	9.0	6.5	5.1	4.3	4.1	4.0	4.0
Consumer Prices (avg; percent change)	3.7	2.8	4.2	8.2	7.9	5.4	4.6	4.2	4.1	4.0
GDP deflator (percent change)	3.3	1.3	3.7	4.8	6.4	5.9	5.2	4.7	4.4	4.2
General Government Accounts										
Total revenue and grants	31.9	24.3	31.2	33.8	28.7	24.1	26.2	28.0	28.2	28.1
Domestic Revenue	22.6	20.1	20.7	20.3	17.5	19.8	21.5	23.0	23.7	24.1
Tax revenue	16.6	15.7	13.0	11.7	11.8	13.8	15.2	15.8	16.3	16.2
Non-tax revenue	6.0	4.4	7.7	8.6	5.7	6.0	6.3	7.2	7.4	7.8
Foreign Grants	9.1	6.1	9.4	8.4	10.8	4.3	4.6	5.0	4.5	4.1
Internal and other receipts	0.2	-1.8	1.1	5.1	0.3	0.0	0.0	0.0	0.0	0.0
Total expenditure 1/	33.5	25.9	33.1	40.1	38.8	31.7	31.2	31.0	31.0	30.6
Current expenditure	16.8	16.1	21.7	24.6	20.7	17.8	17.7	17.6	17.8	17.7
Capital expenditure	17.6	9.4	12.6	15.6	18.2	13.9	13.5	13.4	13.2	12.9
Primary expenditure 1/	33.1	24.5	33.8	39.2	37.5	30.1	29.0	28.4	28.1	27.4
Primary balance	-0.3	-0.7	-1.5	-5.3	-8.8	-6.0	-2.8	-0.4	0.1	0.7
Overall balance	-1.6	-1.6	-1.9	-6.3	-10.2	-7.7	-5.0	-3.0	-2.8	-2.4
General government debt 2/	113	106	131	135	133	131	128	122	117	113
Domestic	5	3	9	10	6	6	8	9	10	10
External	108	104	122	125	127	125	120	113	107	102
Monetary Sector										
Broad money (M2) growth (percent change)	10.4	5.6	19.3	24.4	8.8	0.6	12.2	11.2	10.5	10.2
Private credit growth (percent change)	15.7	20.5	13.3	6.5	8.3	12.5	13.9	14.2	14.5	14.5
Balance of Payments										
Current account balance	-18.4	-20.5	-12.4	-11.8	-10.6	-9.7	-5.6	-1.4	-0.9	0.2
Goods balance	-16.6	-16.4	-10.0	-7.1	-9.6	-7.3	-3.2	0.5	1.8	3.0
Hydropower exports	6.8	6.4	13.0	14.8	14.4	15.9	18.7	20.0	18.6	19.0
Non-hydropower exports	17.2	18.5	13.9	15.3	14.9	14.5	14.8	15.0	14.3	14.3
Imports of goods	40.6	41.2	36.9	37.2	39.0	37.8	36.8	34.5	31.1	30.2
Services balance	-1.4	-2.1	-2.9	-4.8	-4.8	-3.4	-1.6	-1.6	-1.7	-1.7
Primary balance	-8.4	-9.0	-6.6	-5.7	-6.4	-5.1	-6.0	-5.6	-5.8	-5.4
Secondary balance	8.1	7.0	7.1	5.9	10.3	6.1	5.2	5.3	4.8	4.3
Capital account balance	7.3	5.1	5.9	3.7	7.7	4.4	3.8	4.1	3.6	3.2
Financial account balance	-17.2	-14.7	-21.0	-21.5	-14.3	-11.1	-8.4	-6.5	-5.0	-3.9
Net errors and emissions	19.4	-0.1	-2.3	-13.4	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	25.4	-0.8	12.2	-3.5	11.5	5.8	6.6	9.1	7.7	7.3
Gross official reserves (in USD millions)	1111	1345	1344	1558	1844	1977	2152	2451	2701	2954
(In months of goods and services imports)	10.7	13.1	14.7	18.2	18.7	19.3	19.9	21.4	21.9	22.6
Memorandum Items										
Ngultrum per U.S. dollar (eop)	68.6	68.9	...	...	...	...	...	...	...	...
Population in million (eop)	0.7	0.7	0.7	0.8	0.8	0.8	0.8	0.8	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 payment support to borrowers financed by the National Resilience Fund.

2/ Public and publicly guaranteed debt, including loans for hydropower projects.

Table 2. Bhutan: Government Budget Summary, 2017–27

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27
	Act.	Act.	Act.	Est.	←			Proj.		→
	(In percent of GDP, unless otherwise indicated)									
Revenue and grants	31.9	24.3	31.2	33.8	28.7	24.1	26.2	28.0	28.2	28.1
Domestic revenue	22.6	20.1	20.7	20.3	17.5	19.8	21.5	23.0	23.7	24.1
Tax revenue	16.6	15.7	13.0	11.7	11.8	13.8	15.2	15.8	16.3	16.2
Direct tax	9.7	9.8	8.8	8.3	7.5	8.4	9.0	9.2	9.6	9.6
Indirect tax	6.9	5.9	4.2	3.4	4.3	5.4	6.2	6.6	6.7	6.6
Nontax revenue	6.0	4.4	7.7	8.6	5.7	6.0	6.3	7.2	7.4	7.8
Other receipts	0.2	-1.8	1.1	5.1	0.3	0.0	0.0	0.0	0.0	0.0
Foreign grants	9.1	6.1	9.4	8.4	10.8	4.3	4.6	5.0	4.5	4.1
India	6.9	3.7	6.5	5.8	8.5	2.7	2.9	3.8	3.5	3.1
Other	2.2	2.3	2.8	2.6	2.2	1.2	1.2	1.2	1.1	1.0
Internal and other receipts	0.2	-1.8	1.1	5.1	0.3	0.0	0.0	0.0	0.0	0.0
Expenditure	33.5	25.9	33.1	40.1	38.8	31.7	31.2	31.0	31.0	30.6
Current expenditure 1/	16.8	16.1	21.7	24.6	20.7	17.8	17.7	17.6	17.8	17.7
Interest expenditure	1.3	0.9	0.5	1.1	1.4	1.6	2.2	2.6	2.9	3.2
Pay and allowances	5.9	6.7	9.3	9.5	9.4	9.2	9.3	9.1	9.0	8.9
Capital expenditure 2/	17.6	9.4	12.6	15.6	18.2	13.9	13.5	13.4	13.2	12.9
Structure	11.6	5.7	7.2	9.8	12.9	9.6	8.9	9.4	9.2	8.7
Primary balance	-0.3	-0.7	-1.5	-5.3	-8.8	-6.0	-2.8	-0.4	0.1	0.7
Overall balance	-1.6	-1.6	-1.9	-6.3	-10.2	-7.7	-5.0	-3.0	-2.8	-2.4
Financing	1.6	1.6	1.9	6.3	10.2	7.7	5.0	3.0	2.8	2.4
Net lending	-1.3	-0.8	-0.4	-0.4	-1.6	-1.5	-2.1	-1.2	-1.1	-1.0
Net borrowings	0.1	0.8	1.5	5.9	8.6	6.2	2.9	1.7	1.6	1.4
Disbursement	1.8	2.2	2.6	8.0	11.5	8.3	6.4	6.6	7.1	7.4
Amortization	1.7	1.4	1.1	2.1	2.9	2.1	3.5	4.9	5.5	6.0

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

1/ Pandemic-related spending (the National Resilience Fund) accounted for 1.4 percent and 6.6 percent of GDP in FY2019/20 and FY2020/21, respectively. Pay and allowances is the most important category of current expenditure, accounting for 9.5 percent of GDP in FY20/21.

2/ Infrastructure spending (expenditure on structure) is the most important category of capital expenditure, accounting for 9.8 percent of GDP in FY20/21.

Table 3. Bhutan: Balance of Payments, 2017–27

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27
	Act.	Act.	Act.	Est.	←			Proj.		→
	(In millions of U.S. dollars, unless otherwise indicated)									
Current Account Balance (Including Official Grants)	**-462**	**-502**	**-301**	**-282**	**-280**	**-279**	**-179**	**-49**	**-35**	**6**
Trade balance (Goods, net)	-417	-402	-242	-171	-256	-211	-102	19	67	122
Exports	602	609	649	720	779	878	1066	1217	1241	1358
Of which: Hydropower	171	156	313	355	382	459	596	696	703	775
Of which: Non-Hydropower	431	453	337	365	397	419	470	521	538	583
Imports	1020	1011	891	891	1035	1089	1168	1198	1174	1236
Services, net	-35	-51	-70	-115	-127	-97	-51	-57	-63	-69
Credit	191	169	134	22	22	43	79	122	245	266
Debit	226	219	205	136	149	141	130	178	308	335
Primary income	-212	-221	-159	-137	-171	-146	-191	-194	-218	-222
Credit	37	37	29	25	34	37	41	45	49	53
Debit	249	258	188	162	205	183	233	239	267	276
o.w. Interest paid on INR hydropower loans	19	9	18	18	43	50	78	108	133	159
o.w. Accrued Interest on INR hydropower loans	179	147	116	129	0	0	0	0	0	0
Secondary income	203	171	171	141	274	175	165	183	180	177
Credit	231	202	191	182	342	186	182	229	225	221
o.w. Budgetary grants	95	99	94	78	137	74	73	91	90	88
Debit	28	31	21	41	68	11	17	46	45	44
Capital Account Balance 1/	**182**	**124**	**143**	**90**	**205**	**127**	**122**	**141**	**136**	**132**
o.w. Budgetary grants for investment	113	58	89	83	164	89	87	110	108	106
o.w. Grants for hydropower development	70	66	54	6	41	38	34	31	29	26
Financial Account Balance	**431**	**360**	**508**	**514**	**380**	**319**	**268**	**225**	**190**	**161**
Direct investment, net	7	13	-3	1	5	6	6	7	8	8
Other Investment, net	393	327	511	418	375	313	261	218	183	153
o.w. INR Hydropower loan liabiities (net, excl accrued interest)	139	124	117	96	131	116	125	120	155	152
o.w. RGOB CC loans	1	13	129	68	213	89	84	53	58	59
Net Errors & Omissions	486	-1	-57	-322	0	0	0	0	0	0
Overall Balance	637	-19	294	-84	306	166	211	317	292	299
Memorandum Items	(In percent of GDP)									
Current account balance	-18.4	-20.5	-12.4	-11.8	-10.6	-9.7	-5.6	-1.4	-0.9	0.2
Trade balance (goods)	-16.6	-16.4	-10.0	-7.1	-9.6	-7.3	-3.2	0.5	1.8	3.0
Services balance	-1.4	-2.1	-2.9	-4.8	-4.8	-3.4	-1.6	-1.6	-1.7	-1.7
Primary income	-8.4	-9.0	-6.6	-5.7	-6.4	-5.1	-6.0	-5.6	-5.8	-5.4
Secondary income	8.1	7.0	7.1	5.9	10.3	6.1	5.2	5.3	4.8	4.3
Capital account balance	7.3	5.1	5.9	3.7	7.7	4.4	3.8	4.1	3.6	3.2
Financial account balance	17.2	14.7	21.0	21.5	14.3	11.1	8.4	6.5	5.0	3.9
Direct investment, net	0.3	0.5	-0.1	0.0	0.2	0.2	0.2	0.2	0.2	0.2
Overall balance	25.4	-0.8	12.2	-3.5	11.5	5.8	6.6	9.1	7.7	7.3
External debt	108.4	103.6	121.9	125.3	127.0	125.0	120.2	113.1	107.5	102.3
Trade balance	-16.6	-16.4	-10.0	-7.1	-9.6	-7.3	-3.2	0.5	1.8	3.0
Gross official reserves (in USD millions)	1111	1345	1344	1558	1844	1977	2152	2451	2701	2954
(In months of goods and services imports)	10.7	13.1	14.7	18.2	18.7	19.3	19.9	21.4	21.9	22.6

Sources: Data provided by the Royal Government of Bhutan; and IMF staff estimates and projections.
1/ Including grants for hydropower projects (Tala, Puna I, Puna II, Mangdechhu, Kholongchhu, Bunakha, Chamkarchhu, and

Table 4. Bhutan: Monetary Survey, 2013–21

	2013/14 June	2014/15 June	2015/16 June	2016/17 June	2017/18 June	2018/19 June	2019/20 June	2020/21 June
Monetary Survey	(In millions of ngultrum, unless otherwise indicated)							
Net foreign Assets	53,886	58,249	67,816	68,187	66,006	63,921	84,091	98,552
Indian Rupee	265	4,034	7,315	18,237	6,423	5,592	6,583	-245
Other	53,621	54,214	60,499	50,239	60,351	58,329	77,507	98,797
Net Domestic Assets	9,501	10,096	11,347	35,927	48,967	57,496	60,800	81,762
Net claims on government 1/	-1,978	-7,740	-5,570	2,853	5,029	2,407	-3,840	6,404
Claims on nongovernment	54,277	63,995	71,263	82,232	95,291	111,081	125,953	136,418
Public enterprises 2/	4,438	7,174	6,106	7,047	8,306	6,231	7,141	9,856
Private sector 3/	49,839	56,821	65,157	75,185	86,985	104,851	118,812	126,561
Other items (net) 4/	-42,798	-46,160	-54,346	-49,158	-51,353	-55,992	-61,313	-61,059
Broad Money	63,388	68,344	79,163	104,114	114,974	121,417	144,890	180,314
Narrow Money	39,702	41,676	44,934	60,723	66,295	69,203	85,576	101,826
Currency	5,705	5,946	6,102	8,788	9,234	9,744	11,783	11,875
Demand Deposits	33,997	35,729	38,832	51,936	57,061	59,459	73,793	89,951
Quasi-Money 5/	23,686	26,669	34,229	43,390	48,679	52,213	59,315	78,488
RMA								
Net Foreign Assets	50,575	55,113	64,173	64,821	61,418	59,109	79,127	93,730
Indian Rupee	-507	2,827	5,214	16,496	4,838	3,259	4,862	-2,002
other	51,082	52,286	58,959	48,325	56,580	55,850	74,265	95,732
Net Domestic Assets	-23,937	-28,864	-36,370	-30,493	-27,948	-27,135	-34,077	-31,452
Net claims on government	-3,855	-7,780	-10,200	-7,152	-3,020	-1,810	-5,705	-8,147
claims	0	0	0	0	0	2,500	0	0
Minus: deposits	-3,855	-7,780	-10,200	-7,152	-3,020	-4,310	-5,705	-8,147
Claims on DMB	282	1,697	267	578	709	725	760	884
Claims on private sector	14	28	33	36	32	26	21	17
Minus: RMA bills	0	0	0	0	0	0	0	0
Other items (net)	-20,377	-22,809	-26,470	-23,955	-25,669	-26,076	-29,153	-24,206
Reserve Money	26,638	26,249	27,803	34,328	33,470	31,974	45,050	62,278
Memorandum Items								
	(Change in percent of initial stock of broad money)							
Broad money	6.6	7.8	15.8	31.5	10.4	5.6	19.3	24.4
Net foreign Assets	8.9	6.9	14.0	0.5	-2.1	-1.8	16.6	10.0
Net Domestic Assets	-2.3	0.9	1.8	31.0	12.5	7.4	2.7	14.5
Net claims on government	-8.9	-9.1	3.2	10.6	2.1	-2.3	-5.1	7.1
Claims on private sector	5.1	11.0	12.2	12.7	11.3	15.5	11.5	5.3
Other items (net)	-2.1	-5.3	-12.0	6.6	-2.1	-4.0	-4.4	0.2
	(Change in percent of initial stock of reserve money)							
Reserve money	11.0	-1.5	5.9	23.5	-2.5	-4.5	40.9	38.2
Net foreign assets	20.6	17.0	34.5	2.3	-9.9	-6.9	62.6	32.4
Net domestic assets	-9.6	-18.5	-28.6	21.1	7.4	2.4	-21.7	5.8
Money multiplier	2.4	2.6	2.8	3.0	3.4	3.8	3.2	2.9
Velocity of money	1.7	1.8	1.7	1.5	1.4	1.4	1.2	1.0
Broad money/GDP	0.6	0.6	0.6	0.7	0.7	0.7	0.8	1.0
Broad money growth (12-month percent change)	6.6	7.8	15.8	31.5	10.4	5.6	19.3	24.4
Reserve money growth (12-month percent change)	11.0	-1.5	5.9	23.5	-2.5	-4.5	40.9	38.2
Credit to the private sector (12-month percent change)	6.4	14.0	14.7	15.4	15.7	20.5	13.3	6.5

Source: Royal Monetary Authority of Bhutan; and IMF 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 join corporations, 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 5. Bhutan: Selected Economic and Financial Stability Indicators, 2013-21

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
	June	June	June	June	June	June	June	June
Risk-Weighted Capital Adequacy Ratio								
Financial sector	18.9	17.2	16.9	17.3	16.2	12.6	11.6	13.5
Banks	20.0	17.5	17.9	17.2	16.4	15.8	12.1	13.9
Nonbanks	14.0	15.7	13.0	17.4	15.1	-5.1	9.1	10.9
Non-Performing Loans								
Financial sector	12.0	9.5	9.1	11.4	10.4	15.0	16.3	14.1
Banks	12.1	9.7	9.8	12.5	10.8	9.9	14.5	11.5
Nonbanks	11.3	7.9	5.8	6.8	9.4	30.6	21.8	22.4
Return on Assets								
Financial sector	0.7	0.5	0.2	-0.5	0.5	-0.9	-1.4	0.1
Banks	...	0.4	...	-0.7	0.4	0.0	-1.6	0.0
Nonbanks	...	1.8	...	0.7	1.0	-7.2	-0.2	1.2
Credit to Deposit Ratio (banks only)	82.9	86.4	86.6	73.4	78.9	87.4	81.1	75.0
Statutory Liquidity Requirement Ratio (SLR)								
Banks	38.8	29.6	26.0	33.8	31.0	22.6	27.6	32.9
Nonbanks	31.2	23.5	12.8	10.4	13.1	10.5	11.9	17.5

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

Appendix I. COVID-19 Policy Response

Background

Bhutan closed its international borders in March 2020 following the first observed COVID-19 case and announced lockdowns in August 2020 and December 2020, under which only designated shops and essential services were open and all schools, institutions, offices, and business establishments were closed. Targeted lockdowns continued throughout the pandemic in select areas. From February 1, 2021, the lockdown was eased, allowing economic activities, schools, offices, and business to resume. Following widespread outbreaks of the omicron variant, targeted lockdowns resumed from January to March 2022. Starting in April 2022, after all children aged 5-11 have been vaccinated, the country is no longer resorting to strict lockdowns when COVID-19 cases are detected.

Fiscal

- Deferral of CIT and BIT filing for FY 2019 until June 2021.
- Deferral of sales tax and customs duty on essential items for April to June 2020.
- Waiver of payment of monthly rent and other charges up to June 2021 for tourism-related business entities leasing Government property.
- Deferral of electricity charges and waiver of penalty on late payments for industries to June 2021.
- Budget support for COVID-19 related activities to ensure an uninterrupted supply of essential items, fuel, PPE suit, drugs, non-drugs, and logistics and food for quarantine during the pandemic.
- Revision of mobilization advance from 10 percent to 20 percent to make adequate cash available in keeping with the prices of goods/materials and to expedite capital works.
- Application of Limited Enquiry Method and Increase of Bid Capacity to fast-track procurement of works and ensure their timeliness, cost-effectiveness, efficiency, and fair and equal access.
- Simplified Procurement Rules and Regulations procurement of goods, works, and services.

Monetary and Macro-Financial

- Moratorium on loan repayment (*Phase I-III)*
- Interest waiver on loans *(Full waiver Phase I; 50 percent Phase II and III).*
- Short-term bridge loans to tourism, manufacturing, and retail sectors (*Phase I-III)*
- Soft short-term micro loans to CSI at concessional interest rates (*Phase I - II)*
- Extension of gestation period for projects under construction and a waiver of interest accrued on loans under gestation (*Phase I - II)*
- Reduce the Cash Reserve Ratio (CRR) by 300 basis points from 10 percent to 7 percent (*April 2020)*
- Relaxed the capital conservation buffer by 2.5 percent (from 12.5 to 10 percent).
- Dividend payment restrictions for financial institutions for the year ending 2020.

Appendix II. Risk Assessment Matrix[1]

Source of Threat	Likelihood	Direction of Impact	Impact	Policies to Minimize Impact
Domestic Risks				
Bank balance sheet risks	High		ST/MT: COVID-related loan deferment and interest relief policies masking underlying weakness, which could weigh on financial stability and credit growth as policies expire.	Support the exit of non-viable firms, ensure efficient restructuring. Banks should build capital buffers and recognize problem loans.
Delayed project implementation	Medium		ST/MT: Delayed completion of hydropower projects (partly due to labor shortages from pandemic-related border closures) could lower electricity exports, worsen balance of payments, and increase the fiscal deficit.	Implement measures to broaden the tax base, improve tax administration, and further diversify the economy.
Debt sustainability	Medium		LT: The new generation of hydropower projects, may have some risks shifting to the Government of Bhutan, if they rely on joint ventures.	Strengthen the capacity to evaluate and manage the risks from joint venture hydropower projects.
GST implementation	Medium-Low		ST: Expected July 2022. The taxpayer-facing elements are expected to be completed but other components may face delays. On the upside, revenue projections could be higher than projected.	Ensure timely implementation of the GST and related actions, through progress on IT solutions.
Persistently high inflation in India	High		ST: Inflation pressure could persist in India amid continued global inflation pressures, pushing up import prices in Bhutan and hurting lower income populations.	Tighten monetary conditions and reduce bank liquidity to prevent second round effects, while being cognizant of continued subdued activity due to the ongoing pandemic
External Risks				
Outbreaks of lethal and highly contagious COVID-19 variants lead to subpar/volatile growth	High		ST: Rapidly increasing hospitalizations and deaths force lockdowns and increased uncertainty. Policies to cushion the economic impact are constrained by lack of space.	Maintain sufficient policy space to enable a flexible response as the pandemic evolves.
Rising and volatile food and energy prices	High		ST: Commodity prices are volatile and trend up amid post-pandemic pent-up demand and supply disruptions.	Reserve buffers can be used to smooth adjustment to oil price shocks.
Geopolitical tensions	High		ST/MT: Intensified geopolitical tensions and conflicts cause economic disruptions. Associated supply chain disruptions and commodity price shocks give rise to inflationary pressures.	Tighten monetary policy to help offset rising inflation, while monitoring activity and employment as the pandemic recovery takes hold.
Natural disasters related to climate change	Medium		ST/MT: Higher frequency of natural disasters cause severe economic damage to small vulnerable economies and accelerate emigration. Disasters hitting key infrastructure or disrupting trade raise commodity price levels and volatility.	Continue to focus on investment in climate change adaptation

[1] *"L"=Low; "M"=Medium; "H"=High. "ST" = short term; "MT= medium term; "LT"=long-term. The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path. 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. External Sector Assessment

The external position of Bhutan in 2020-21 was broadly in line with the level implied by fundamentals and desirable policies. The current account deficit has narrowed in recent years, as hydropower exports started to pick up, coupled with a decline in hydropower construction-related imports. The overall balance remains 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. Going forward, a continued increase in electricity exports, together with medium-term fiscal consolidation should further support an improvement in the current account balance and net international investment position.

Foreign Assets and Liabilities: Position and Trajectory

Background. The net international investment position (NIIP) was $-2.8 billion (116 percent of GDP) by end-2021[1], $0.5 billion lower than by end-2020. External assets were $1.5 billion (61 percent of GDP), mainly consisting of reserve assets ($1.3 billion) and other assets ($0.2 billion) including currency and deposits and trade credit. External liabilities were $4.2 billion (177 percent of GDP), mainly consisting of loans ($4 billion) and direct investment ($0.1 billion). The loans are mostly long-term debt held by non-financial corporations, households and NPISHs, followed by general government and central bank. As mentioned in the DSA, 73 percent of external debt was hydropower debt, financed by India under an intergovernmental agreement, where 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. Over the past five years, the net NIIP was broadly stable, largely driven by developments in the financial account balance.

Assessment. The NIIP is projected to narrow gradually in the medium term under current policies. The current account deficit is expected to taper as hydropower-related exports pick up, which should support an improvement in the NIIP.

Current Account

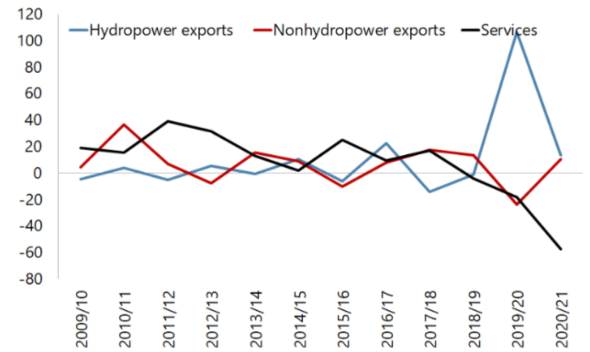
Background. The current account deficit (CAD) narrowed to around 11.8 percent in 2021 from an average of 21.9 percent of GDP during 2015-20 due to lower hydropower construction-related imports and increased electricity exports. While the pandemic has temporarily impacted non-hydropower exports and services exports (tourism sector), the decline was partially offset by a pickup in hydropower exports in 2021. At the same time, the primary and secondary income balances have remained relatively stable overtime. Going forward, the CAD is expected to narrow further with a rise in electricity exports in coming years.

Assessment. Both the EBA-lite current account (CA) and the IREER methodologies suggest that the external position is broadly in line with the level implied by fundamentals and desirable policies.

Based on the EBA-lite CA approach, the adjusted CA was -8.9 percent of GDP, reflecting cyclical contributions (0.9 percent) and a COVID-19 adjustor (0.7 percent) capturing a temporary decline of tourism. The CA norm based on the regression model was estimated to be -8.2 percent of GDP, implying a CA gap of -0.7 percent of GDP. The relative policy gap was 3.4 percent of GDP, largely reflecting positive contributions of a change in reserves due to a pick-up in hydropower related exports, fiscal policy, and private credit growth. Based on the EBA-lite IREER methodology, the CA gap is estimated to be 0.1 percent of GDP.

Given that the current account gap is estimated to be between -1 percent and 1 percent using both the EBA-lite CA and IREER methodologies, the external position is assessed to be broadly in line with the level implied by fundamentals and desirable policies.

Exports Growth
(In percent)



Sources: Royal Monetary Authority of Bhutan; and IMF staff estimates.

Bhutan: Model Estimates for 2021 (in percent of GDP)

	CA model	REER
CA-Actual	**-8.8**	
Cyclical contributions (from model) (-)	0.9	
COVID-19 adjustor (+) 1/	0.7	
Natural disasters and conflicts (-)	-0.1	
Adjusted CA	**-8.9**	
CA Norm (from model) 2/	**-8.2**	
Adjusted CA Norm	**-8.2**	
CA Gap	**-0.7**	**0.1**
o/w Relative policy gap	3.4	
Elasticity	-0.28	
REER Gap (in percent)	**2.4**	**-0.2**

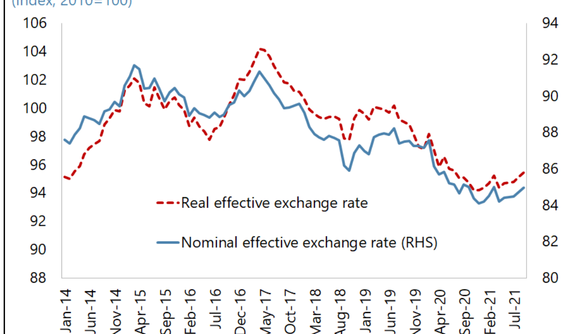
1/ Additional cyclical adjustment to account for the temporary impact of the tourism (about 2 percent of GDP).
2/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate

Background. The ngultrum is pegged to the rupee at par and has been depreciating in real effective terms in recent years. Specifically, the REER depreciated by 0.9 percent in 2021, and by 6 percent compared with 2015. Movements in the REER 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.

Assessment. Both the EBA-lite CA and the IREER methodologies are used to assess the REER gap for Bhutan. Based on the EBA-lite CA approach, the implied REER gap was estimated to be 2.4 percent, where the elasticity between CA gap and the REER gap is calculated as the difference between the elasticity of exports and imports weighted by their respective GDP shares. The EBA-lite IREER methodology implied a REER gap of -0.2 percent of GDP. The policy gap was estimated to be 2.8 percent of GDP, partly reflecting a recent pick up in private credit and a change in reserves due to an increase in hydropower-related exports.

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



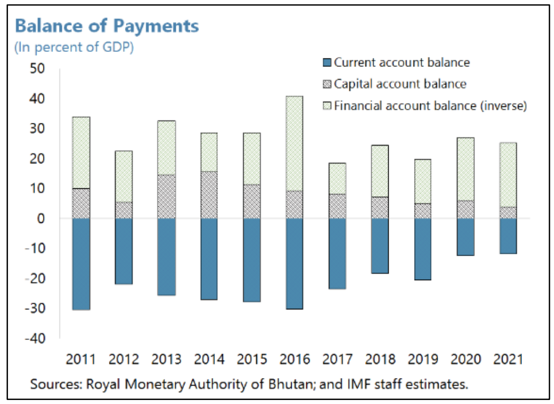
Source: IMF INS data.

Overall, the EBA-lite CA and the IREER methodologies estimate the REER gap to be between -0.2 percent and 2.4 percent of GDP in 2021.

Capital and Financial Accounts: Flows and Policy Measures

Background. Bhutan's capital account stood at $89.5 million (3.7 percent of GDP) at end-2021, lower than an average of 7.8 percent of GDP during 2015-20. The capital account largely consists of budgetary grants for investment ($83 million) and grants for hydropower development ($6 million). Bhutan's financial account remained stable at around $-514 million (21.5 percent of GDP) at end-2021, broadly in line with the 5-year average during 2015-20. The financial account balance reflects net direct investment of $0.8 million and net other investment

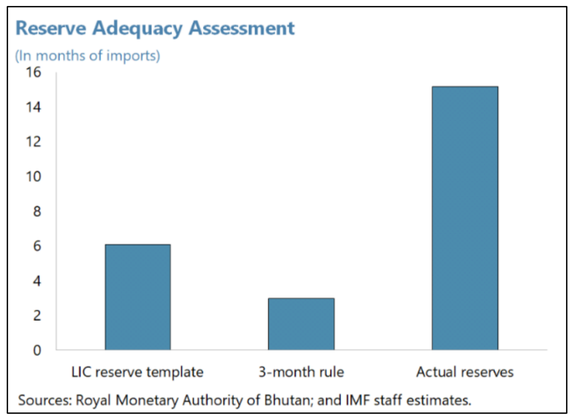
($418 million) that includes hydropower related long-term loan liabilities in rupees and Royal Government of Bhutan convertible currency loans. The current account deficit is financed by both grants (capital account) and loans (financial account), with a negative overall balance of $84 million (3.5 percent of GDP) at end-2021.



Assessment. The capital and financial accounts are projected to decline gradually over the medium term, as debt disbursements and grants related to hydro power projects decline and electricity exports boost the current account balance. Given the concessional nature of grant financing and the long-term FDI-type of loan liability structure, the risks of imminent external financing stress related to capital flows are low in both the short- and medium-term.

FX Intervention and Reserves Level

Background. Bhutan's total reserves stood at $1.6 billion at end-2021 (65 percent of GDP), covering 21 months of merchandise imports and 18 months of merchandise and services imports. The accumulation in reserves in the past few years is explained by a gradual pick-up in hydropower related exports, which led to an improvement in the current account balance. As discussed earlier, the ngultrum is pegged to the rupee at par.



Assessment. Bhutan has adequate reserve buffers, according to the reserve adequacy template for credit constrained economies. Given Bhutan's classification as a resource rich economy, the fixed exchange rate regime, and the estimated cost of holding reserves of 6.2 percent (based on the marginal product of capital), reserve adequacy is assessed to be around 6.1 months of current imports. Bhutan's actual reserve is above the assessed reserve adequacy level.

[1] In the external sector assessment, 2021 refers to fiscal year 2020/21, which runs from July 2020 to June 2021. End-2021 therefore refers to June 2021.

Appendix IV. Recent and Planned Capacity Development

1. The Fund's capacity development (CD) activities in Bhutan have continued through the pandemic. Since the pandemic, the CD engagement has been recalibrated towards online delivery but remained focused on major policy reforms. The online delivery (e.g., implementation of GST, compilation and data dissemination, improving the quality and coverage of fiscal reporting, risk-based supervisory framework, liquidity management, and macro forecasting) allowed high-level participation with the authorities, aided by the participation of local resident advisor.

2. SARTTAC is the main deliverer of CD in Bhutan (and the region). SARTTAC continued to play an important role during the pandemic. As highlighted in its FY2020 Annual Report, SARTTAC provided extensive training and TA in the Fund's core areas of expertise such as training on macro-fiscal forecasting, financial programming, national accounts, and public financial management. Ongoing workplans have included medium-term budget frameworks, rebasing, updating PPI, development of high frequency indicators, finalizing the GST implementation, risk-based supervisory framework, liquidity management. CD from functional departments (MCM) is also planned (e.g., development of local debt markets).

3. In line with the Fund's strategy, CD activities in Bhutan are tailored to the country's needs and are integrated with surveillance:

- Recent activities and collaboration with the Bhutanese authorities has helped with customization for country needs. The online delivery since the pandemic allowed CD in critical areas like GST implementation to continue and facilitated broad-based participation.

- CD activities have been further integrated with surveillance and IMF policy advice. In addition to the regular CD delivery, APD and functional departments (e.g., FAD, MCM, STA) have worked with the authorities on specific queries that can aid policy formulation amid pandemic related uncertainties and other developments (e.g., domestic debt markets).

Appendix V. Uptake of Previous IMF Advice

1. **The pandemic shock presented new challenges for Bhutan, but policies have been broadly consistent with previous advice**. Fiscal, monetary, and financial sector policies since the last Article AIV have been broadly consistent with IMF advice, against the backdrop of the COVID-19 shock. Challenges remain related to financial sector reforms, however, and some of the structural reforms have been delayed.

2. **Fiscal policy has appropriately focused on supporting the vulnerable and the economy amid the unprecedented COVID-19 shock**. The accommodative fiscal stance, with emphasis on health and social support, reflected general Fund advice on pandemic management. As pandemic-related restrictions ease, fiscal spending should be targeted with a medium-term rolling framework to help reduce volatilities. Additionally, the shift towards capital expenditure projects will help address Bhutan's significant infrastructure needs, as past Fund advice noted.

3. **The implementation of the GST has continued despite pandemic-related delay, consistent with boosting the domestic revenue base**. The implementation of the GST in June 2022 continues to be supported by Fund technical assistance (TA). Following past staff advice, it will be relatively broad-based and would have a simple rate structure.

4. **With regards to monetary policy, a new liquidity management framework has been developed with support from the Fund, but its operation is delayed**. With support from SARTTAC the RMA's liquidity management and forecasting capabilities have been enhanced, along with the structure in place to establish an interest rate corridor. However, given the ample liquidity during the pandemic stemming from fiscal and financial sector policy support, demand for overnight lending facilities has yet to materialize. It is expected to become operational as policy support is withdrawn and liquidity declines.

5. **Loan moratoria and other borrower relief measures have taken pressure off the financial sector during the pandemic but must be wound down**. Staff past advice on financial sector reforms, including strengthening resilience and modernizing the regulatory regime (e.g., tighten loan classification requirements for banks, mandate risk-based provisioning) remains relevant. The RMA is making progress towards risk-based supervision, consistent with Fund advice and with TA support.

INTERNATIONAL MONETARY FUND

BHUTAN

April 26, 2022

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of February 28, 2022)

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	25.54	100.00
Holdings	25.68	100.56

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				
	2022	2023	2024	2025	2026
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) foreign exchange balancing requirement on remittances of income in convertible currencies or other foreign currencies from FDI; and (ii) 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) requiring FDI companies to pay for their operational expenses (including insurance payments) from their own foreign exchange resources; and (iii) requiring Bhutanese companies to pay the interest on and amortization of external loans from their own foreign currency resources.[2]

More recently, Bhutan introduced new provisions in the Foreign Exchange Rules and Regulations 2020 and several other initiatives to further liberalize the exchange system. On the relaxation on access to foreign currency for industries, new provision was inserted: "RMA shall provide convertible currency (CC) requirement for the import of raw materials (up to 6-months) for newly established companies as a start-up support and proprietary raw materials (10 percent of actual sales) approved by the RGoB". Moreover, CC eligibility for local industries was increased from 80 to100 percent for their exports. In addition, existing regulations were streamlined and aligned with other relevant regulations. For example, the prepayment of ECB loans was aligned with the ECB guidelines 2019 and the foreign currency operational expenses requirement of FDI companies was aligned with the FDI Investment Rules and Regulations 2019. New provision was also included to streamline FC account operations held by local NGOs and CSOs.

Finally, Bhutan has launched Incentive on Inward Remittance Pilot Project[3] to promote inward remittance, through which the RMA i) facilitated 1 percent incentive amount on every converted convertible currency remitted to Bhutan by non-resident Bhutanese (NRB); and 2) support authorized

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[1] At the time of the previous Article IV consultation with Bhutan, the member maintained one other exchange restriction subject to Article XIV, which was removed upon the entry into force of the 2020 Foreign Exchange Rules and Regulations 2020. This restriction was on the availability of foreign exchange for travel, except for medical travel abroad by Bhutanese citizens, invisibles, and private transfers.

[2] At the time of the previous Article IV consultation with Bhutan, the member maintained two other exchange restrictions subject to Article VIII, which were removed upon the entry into force of the 2020 Foreign Exchange Rules and Regulations 2020 and the 2019 Penalty Rules and Regulations. These restrictions were on (i) banning residents who do not comply with the requirement to repatriate export proceeds from accessing FX for unrelated imports, and (ii) restricting the availability of Indian rupees for making payments and transfers to India for certain current international transactions and banning access to Indian rupees for unrelated current international transactions for those who contravene RMA's 2012 guidelines on Indian rupee transactions.

[3] See [Incentive on Remittance May 12, 2021 – Ministry of Foreign Affairs (mfa.gov.bt)]

banks and money transfer agents with infrastructure/setup or annual AML/CFT compliance/statutory costs for 1 year on a cost-sharing basis.

Article IV Consultation

Bhutan is on a 24-month consultation cycle. The 2022 Article IV consultation was concluded by the Executive Board on May 11, 2022.

Technical Assistance

In recent years Bhutan has received technical assistance in the areas of macro-fiscal capacity building, budget planning, treasury and cash management, national accounts statistics, balance of payments statistics, e-GDDS, government debt markets, 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, implementation of the goods and services tax, tax administration, national accounts and BOP statistics.

A Resident Goods and Services Tax Advisor was installed at the Ministry of Finance since 2018.

Resident Representative

Mr. Luis Breuer has been the Senior Resident Representative since 2019. 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/countries/bhutan/main

STATISTICAL ISSUES

(As of April 4, 2022)

<table>
<tr><th colspan="2">I. Assessment of Data Adequacy for Surveillance</th></tr>
<tr><td colspan="2">General: Data provision is broadly adequate for surveillance but has areas for improvements in national accounts, balance of payments, and fiscal data.</td></tr>
<tr><td colspan="2">Real sector: Since 2017, technical assistance (TA) is being provided through the South Asia Training and Technical Assistance Center (SARTTAC), with TA focused on national accounts statistics, updating producer price indices, and establishing high frequency indicators.

National Accounts: The current base year of the national accounts is 2000, which may affect the accuracy and reliability of the GDP estimates given the changing structure of the Bhutanese economy in the decades since. The National Statistical Bureau (NSB) is currently carrying out a project, with TA provided through SARTTAC, to rebase GDP from 2000 to 2017, including conducting an Economic Census and populating supply and use tables. The TA has also focused on easing capacity constraints in NSB, which continues to face a shortage of qualified personnel and facilities. The NSB is also constrained by the absence of a Statistics Act. Thus far, Bhutan does not produce quarterly national accounts data.

Price statistics: Starting in January 2013, the consumer price index (CPI) is compiled on a monthly basis. Weights for the current CPU are based on the 2017 Bhutan Living Standard Survey (BLSS), a survey conducted every five years. A Producer Price Index is compiled monthly but disseminated quarterly. It covers manufacturing, mining, utilities, transport, information, and communication activities. The current index weights are calculated using an establishment census with a reference period of 2010. TA is currently being provided to the National Statistics Bureau to update to index weights using the 2017 Economic Census.</td></tr>
<tr><td colspan="2">Government finance statistics: The quality of government finance statistics (GFS) has improved in recent years. The authorities have started producing and publishing quarterly budget performance report since FY2020/21. Despite the important progress, there remains some issues with the consolidation of the GFS, particularly relating to the treatment of SOE debt. Further improvements in GFS are expected under the ongoing SARTTAC technical assistance on fiscal data.</td></tr>
<tr><td colspan="2">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.</td></tr>
<tr><td colspan="2">Balance of payments: External sector statistics (ESS) have improved in recent years. The RMA compiles and disseminates quarterly balance of payments (BOP) and international investment position (IIP) data (published and updated at a monthly frequency) 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. While the coverage, accuracy, and timeliness of ESS data has improved, there remains some gaps between the BOP and the IIP data and some components of the BOP statistics.</td></tr>
<tr><th colspan="2">II. Data Standards and Quality</th></tr>
<tr><td>Bhutan participates in the enhanced General Data Dissemination System and maintains a regularly updated National Summary Data Page.</td><td>No data ROSC is available.</td></tr>
</table>

Bhutan: Table of Common Indicators Required for Surveillance

(As of April 4, 2022)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[8]	Frequency of Publication[8]
Exchange rates	Mar-22	Mar-22	D	D	D
International reserve assets and reserve liabilities of the Monetary Authorities[1]	Sep-21	Mar-22	M	M	M
Reserve/base money	Nov-21	Mar-22	M	M	M
Broad money	Nov-21	Jan-22	M	M	M
Central bank balance sheet	Nov-21	Nov-21	M	M	M
Consolidated balance sheet of the banking system	NA	NA	M	M	M
Interest rates[2]	Mar-22	Mar-22	M	M	M
Consumer price index[3]	Feb-22	Mar-22	Q/M	M	M
Revenue, expenditure, balance and composition of financing[4] – general government[5]	FY2020/21	Nov-21	A	A	A
Revenue, expenditure, balance and composition of financing[3]– central government	Dec-21	Dec-21	M	M	M
Stocks of central government and central government-guaranteed debt[6]	Q4 2021	Feb-22	Q	Q	Q
External current account balance	Q4 2021	Feb-22	Q	Q	M
Exports and imports of goods and services	Q2 2021	Sep-21	Q	Q	Q
GDP/GNP	Q4 2021	Mar-22	Q	Q	M
Gross external debt	FY2020/21	Mar-22	A	A	M
International investment position[7]	Sep 2021	Mar-22	M	M	M

[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)

BHUTAN

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

April 26, 2022

Approved By
Nada Choueiri, Kevin Fletcher (IMF) and Marcello Estevão, Zoubida Kherous Allaoua (IDA)

Prepared by the staffs of the International Monetary Fund (IMF) and the International Development Association (IDA)

Risk of external debt distress	*Moderate*
Overall risk of debt distress	*Moderate*
Granularity in the risk rating	*Limited space to absorb shocks*
Application of judgment	*Yes. The risk of debt distress is assessed as moderate due to the FDI nature of hydro-related loans and the projected improvement of medium-term dynamics due to hydro exports and revenues.*

Bhutan's risk of overall and external debt distress is assessed as moderate, unchanged from the 2018 DSA.[1] *While the mechanical results point to a high risk of overall and external debt distress, with breaches in the indicators under the baseline scenario, judgement was applied given the unique mitigating factors. First, the majority of the outstanding public and publicly guaranteed 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 commits to buy all surplus electricity at a price reflecting cost plus margin. Second, the debt dynamics are set to improve further over the medium term, driven by a significant increase in electricity exports and a decline in imports associated with hydropower construction. Overall, the analysis shows that external debt sustainability could be vulnerable to export and depreciation shocks, while the overall debt sustainability could be susceptible to contingent liabilities shocks. Within the moderate rating, Bhutan is assessed to have limited space to absorb additional shocks. Going forward, a gradual fiscal consolidation and revenue mobilization, a stable peg with the Indian rupee, and reforms to improve productivity and competitiveness of the non-hydropower sector, could help support debt sustainability.*

[1] The current debt carrying capacity is consistent with a medium classification. The composite index (CI), estimated at 3.08 based on the October 2021 World Economic Outlook (WEO) and the 2020 World Bank Country Policy and Institutional Assessment (CPIA) data, indicates a strong debt-carrying capacity for Bhutan. The debt-carrying capacity is maintained at medium until two consecutive strong readings are obtained.

PUBLIC DEBT COVERAGE

1. **The coverage of public debt in this debt sustainability analysis (DSA) includes public and publicly guaranteed (PPG) debt**. PPG debt in Bhutan includes central government debt, central government borrowing on-lent to state-owned enterprises (SOEs) (including for hydropower-related projects), external guaranteed debt contracted by SOEs,[2] and central bank debt (standby credit facilities). Bhutan's local governments, social security fund and extra budgetary funds do not have any outstanding debt.[3] The coverage of public debt in the 2022 DSA is broadly the same as that in the 2018 DSA. The external debt definition is based on residency. The calibration of the contingent liability shock is based on the default values, which account for domestic non-guaranteed SOE debt (2 percent of GDP), financial market component (5 percent of GDP), and public private partnerships (PPPs) (2 percent of GDP).

Table 1. Bhutan: Debt Coverage

	Subsectors of the public sector	Sub-sectors covered
1	Central government	X
2	State and local government	
3	Other elements in the general government	
4	o/w: Social security fund	
5	o/w: Extra budgetary funds (EBFs)	
6	Guarantees (to other entities in the public and private sector, including to SOEs)	X
7	Central bank (borrowed on behalf of the government)	X
8	Non-guaranteed SOE debt	

	The country's coverage of public debt	The central government, central bank, government-guaranteed debt			
		Default		Used for the analysis	Reasons for deviations from the default settings
2	Other elements of the general government not captured in 1.	0	percent of GDP	0.0	
3	SoE's debt (guaranteed and not guaranteed by the government) 1/	2	percent of GDP	2.0	
4	PPP	35	percent of PPP stock	2.0	
5	Financial market (the default value of 5 percent of GDP is the minimum value)	5	percent of GDP	5.0	
	Total (2+3+4+5) (in percent of GDP)			9.0	

1/ The default shock of 2% of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1.). If it is already included in the government debt (1.) and risks associated with SoE's debt not guaranteed by the government is assessed to be negligible, a country team may reduce this to 0%.

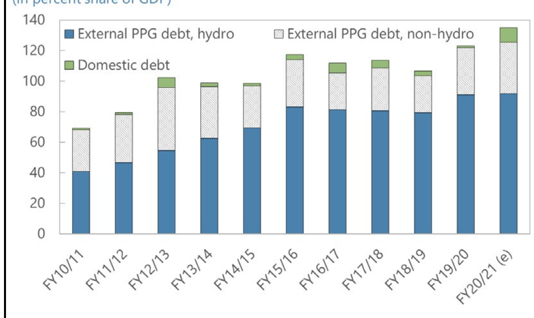
[2] All external debt contracted directly by the SOEs is guaranteed by the government. According to the 2016 Public Debt Policy, SOEs are required to seek approval from the Minister of Finance and Cabinet to contract external debt.

[3] Non-guaranteed domestic SOE debt is limited, and the government is working to standardize the reporting of SOE debt. As part of the Sustainable Development Policy Financing (SDFP) of the IDA, Bhutan is implementing Performance and Policy Actions (PPAs) to improve debt management and transparency, as well as to manage fiscal risks. For instance, the authorities published quarterly public debt reports, the Medium-Term Debt Management Strategy (FY2020/21 to FY2022/23) and mandated the annual publication of the national DSA to strengthen the institutional capacity for risk assessment and monitoring of public debt. In addition, authorities have improved the reporting of SOEs to strengthen the fiscal oversight of SOEs and related fiscal risks.

BACKGROUND ON DEBT

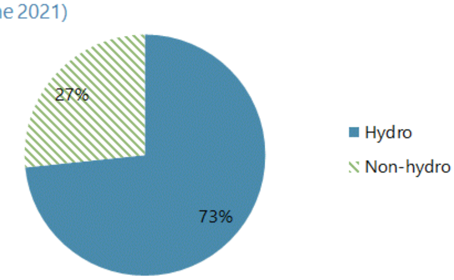
2. **The stock of PPG debt has increased significantly over the past decade, driven by investments in hydropower projects, and more recently the COVID-19 pandemic**. Bhutan has experienced rapid economic growth in the last decade, supported by public sector-led hydropower development. While large investments in hydropower resulted in substantial external debt accumulation, risks of debt distress were mitigated by a bilateral agreement with India, the main creditor of the country's external debt. Hydropower loans are mostly supplied by the Government of India (GoI) and on-lent to SOEs, which carry out the financing and the management of hydropower infrastructure on behalf of the government. Non-hydropower external PPG debt has helped finance infrastructure projects focusing on urban development, rural electrification, and the agriculture sector, with most owed to external creditors in concessional terms. On domestic debt, there has recently been successful issuances of government bonds, but domestic debt is mostly in shorter-term T-Bills for cash management purposes. Compared with FY2016/17, PPG debt increased by about 23 percent of GDP. Hydropower debt increased from about 81 percent to 92 percent of the GDP, reflecting loan disbursements for ongoing hydropower projects from the GoI. Non-hydropower external PPG debt rose from about 24 percent to 33 percent, remaining within the threshold under the government's public debt policy of 35 percent of GDP. In addition, domestic debt rose slightly from 6.6 percent to 9.7 percent in the same period. The increase in non-hydropower external PPG debt and domestic debt in FY2019/20 and FY2020/21 reflects higher gross financing needs, driven by the impact of and responses to the COVID-19 pandemic.

Public and Publicly Guaranteed Debt
(In percent share of GDP)



Source: Royal Monetary Authority.

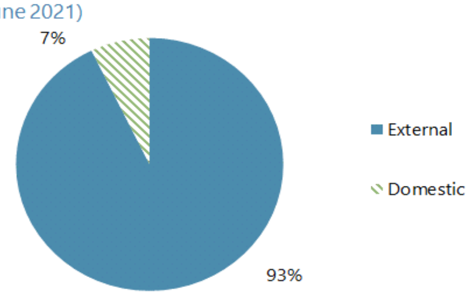
Outstanding PPG External Debt by Purpose
(June 2021)



Source: Royal Monetary Authority.

3. **Total PPG debt stood at 135 percent of GDP in FY2020/21.** External debt accounted for 93 percent of total PPG debt, with the remaining being domestic debt. Hydropower debt was the largest part of external debt, comprising 73 percent of the PPG external debt stock in FY2020/21. Most of the hydropower projects were financed by India, with 70 percent of PPG external debt denominated in India rupees. Non-hydropower debt comprised 27 percent of the total external PPG debt stock in FY2020/21, which is predominantly owed to multilateral

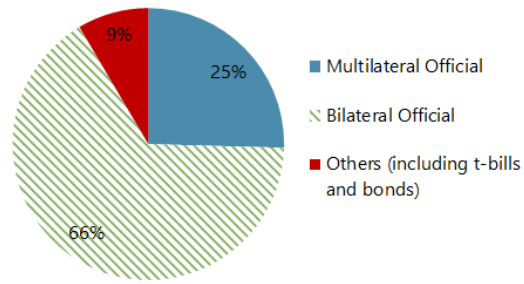
Outstanding PPG Debt by Source
(June 2021)



Source: Royal Monetary Authority.

(87 percent) and bilateral creditors (12 percent), with some guaranteed SOE debt (2 percent). About 93 percent of the total external PPG debt was from official creditors, with the GoI lending the largest share at 65 percent, followed by the Asian Development Bank (ADB, 12.5 percent) and the International Development Association (IDA, 11.4 percent).[4] The domestic PPG debt was mostly in the form of treasury bills (5.5 percent of total PPG debt) and 3-year and 10-year government bonds (1.6 percent). About 96 percent of the total PPG debt was based on a fixed interest rate, with the remaining four percent pegged to a floating rate.

Outstanding PPG Debt by Creditor
(June 2021)



Source: Royal Monetary Authority.

4. The hydropower-related debt from the GoI is akin to foreign direct investment (FDI). As emphasized in the last three DSAs[5], India provides financing for hydropower projects under an intergovernmental agreement, which guarantees returns from electricity exports and mitigates exchange rate risks. The GoI bears the construction and financial risks and commits to buy all surplus electricity at a purchase price at cost (including costs of the project, financing costs, and operation and maintenance charges) plus a margin. The price of electricity is set at the time of project commissioning, when actual costs are known, and are set to allow revenue to service debt and a financial return, with the rate revisited every three years to incorporate changes in costs. Hydropower projects are insured (and re-insured) for natural disaster. In addition, debt service begins only after the hydropower projects are commissioned. The financing arrangements mitigate exchange rate risks because both the electricity export receipts and the hydropower debt services are denominated in Indian Rupees, to which the Ngultrum is pegged. In other words, risks associated with hydropower-related project and debt is largely mitigated by the guarantees provided by the GoI.

ASSUMPTIONS ON MACRO PROJECTIONS

5. The near-term growth outlook is weighed down by pandemic- and geopolitical-uncertainties, but hydropower exports should help support medium-term growth and current account.[6] Growth had been strong prior to the COVID-19 pandemic, due to solid performances in the hydropower and service sectors. Compared with the 2018 DSA, recent growth outcomes are weaker, with GDP contracting by 2.4 percent in FY2019/20 and 3.7 percent in

[4] The completed and ongoing hydropower development projects with the GoI are mostly financed through commercially priced loans (with a repayment period of 10-15 years, a grace period of 8-9 years, and an interest rate of 9-10.75 percent) and capital grants from India. The share of capital grants in the total capital cost is about 30 to 60 percent depending on the project (with the remainder being financed by commercially prices loans).

[5] For more details, please see Box 1 of the 2014 Bhutan Article IV DSA.

[6] The hydropower sector accounted for about 27 percent of GDP in 2020 (including the electricity and construction sector, which is mainly related to hydropower construction), and 49 percent of total goods exports in FY20/21. Hydropower-related revenues accounted for about 37 percent of total domestic revenues in FY20/21 (including corporate income tax from the Druk Green Power Corporation (DGPC), royalties from hydropower, dividends from Druk Holdings and Investment (DHI), and profit transfers from new hydropower projects).

FY2020/21, resulting from the immediate impact of the pandemic and lockdown measures. While the hydropower sector supported industrial growth, construction and manufacturing sectors were adversely affected by labor shortages, high input prices, and weaker demand. On the demand side, private investment and consumption contracted sharply due to domestic COVID-19 containment measures and lower income. Expansionary fiscal policy in the past two years supported the pandemic response and recovery efforts. The 12th Five Year Plan (FYP) was re-prioritized and front-loaded, with higher expenditures on health, essential food and fuel, and income support. The National Resilience Fund (NRF) provided income support to individuals directly affected by the pandemic and interest payment support to individuals and businesses. Reflecting pandemic-related current and capital expenditure, the fiscal deficits in the near term are higher than envisaged in the 2018 DSA, contributing to a higher starting debt stock of 135 percent of GDP in FY2020/21. Over the medium term, GDP growth, current account and fiscal positions are expected to improve, with hydropower-related imports declining and electricity exports picking up, broadly in line with the assumptions in the 2018 DSA. The planned fiscal adjustment is supported by revenue mobilization, including the planned introduction of the Goods and Services Tax (GST), a significant increase in hydropower revenue over the medium term, and a projected economic recovery.

6. The main baseline macroeconomic assumptions underpinning the 2022 DSA are as follows:

- **Real GDP growth and inflation:** After two consecutive years of contraction, growth is expected to expand by 4.4 percent in FY2021/22, supported by Bhutan's rapid vaccination campaign[7] and ongoing fiscal support, but weighed down somewhat by pandemic lockdowns, higher commodity prices, and weaker external demand stemming from geopolitical tensions. Over the medium term, growth will be driven by new hydropower plants coming on stream, a recovery and reorientation of the tourism sector towards higher value visitors, and a recovery in services and manufacturing sectors. The capacity of hydropower generation is expected to approximately double with the onboarding of four hydropower projects, which will support GDP growth, and result in an increase in electricity exports and hydropower revenues.[8] Long-term growth is projected to be around 5.8 percent, supported by reforms that boost economic diversification, digitalization, and private-sector-led growth. This is broadly along the lines of the last DSA but below the pre-COVID ten-year historical average (6.2 percent). The inflation rate rose from 3 percent in FY2019/20 to 8.2 percent in FY2020/21 owing to a surge in food prices. In the near term, average inflation in FY2021/22 is expected to remain elevated at 7.9 percent (6.5 percent end-of-period), owing to continued supply disruptions and high non-food inflation. Over the medium- and long-term,

[7] Vaccination efforts are well advanced, and the country started giving COVID-19 booster shots to the general population in February 2022.

[8] Four hydropower projects—Nikachhu (118 MW, expected in 2023), Punatsangchhu 2 (1,020 MW, expected in 2023), Kholongchhu (600 MW, expected in 2025), and Punatshangchhu 1 (1,200 MW, expected in 2025)—will significantly expand the installed generation capacity between 2023 and 2026, from 2,334 MW to 5,273 MW. In the past, hydropower-related activities have played an important role in supporting GDP growth, through a sharp increase in investment during the construction phase of new hydropower plants and a spike in electricity exports to India when new plants are commissioned. On the supply side, the output in the electricity sector typically rose markedly when plants are commissioned.

inflation is projected to be in line with that in India, given the ngultrum's peg to the rupee. The GDP deflator is assumed to move in tandem with inflation. Amid the pandemic and geopolitical tensions, uncertainty around the economic outlook is elevated, with the balance of risks tilted to the downside. External risks include a sharper-than-expected global slowdown and/or a slowdown in India, including from future pandemic waves, an intensification of geopolitical tensions, and a prolonged decline in tourism, which could result in lower external demand for non-hydropower-related goods and services. Domestic risks stem from pandemic-related uncertainties. Other domestic risks include prolonged financial sector strains amid limited fiscal space, including from any contingent liabilities in the financial sector masked by the broad-based pandemic support measures. Furthermore, delays in hydropower projects and lower-than-expected hydropower production could have significant impact on growth, fiscal revenues, and exports. In addition, Bhutan could be vulnerable to climate-related shocks. For instance, climate-induced changes to glacial-fed rivers and adverse weather patterns could reduce hydropower generation and exports.

- **Fiscal balance:** The fiscal (primary) deficit is projected to peak at 10.2 (8.8) percent of GDP in FY2021/22 due to the planned increase in COVID-19-related current and capital expenditure and subdued revenue performance. In contrast, the 2018 DSA had projected a primary surplus in the near term, in absence of any COVID-related measures. The fiscal deficit is expected to moderate from FY2022/23 as pandemic-related fiscal measures are phased out amid an improvement in economic conditions. Nevertheless, the phasing out of support measures is expected to gradual, given pandemic and geopolitical uncertainties. Domestic revenues (excluding grants) are expected to increase over the medium term, supported by hydropower revenues and policies aimed at mobilizing non-hydropower revenues, including the planned introduction of the GST in FY2022/23. External grants are projected to decline as Bhutan's GDP per capita rises. In the long term, the primary fiscal balance is expected to stabilize at around 1.7 percent of GDP, broadly in line with the assumptions in the 2018 DSA.

- **External balance:** The current account deficit (CAD) is expected to narrow slightly to 10.6 percent in FY2021/22.[9] Starting from FY2022/23, the CAD is projected to moderate further, due to a sharp increase in electricity exports associated with the doubling of hydropower capacity and a gradual decline in hydropower-related imports after the completion of several hydropower construction projects. High oil prices and weaker external demand resulting from the war in Ukraine are expected to weigh on the balance of payments, however, Bhutan's sizeable exports of ferro-alloy could provide some offset. The overall balance of payments, which has been supported by grant financing, is expected to remain positive over the medium term. In the long term, the current account is projected to stay in surplus, supporting the overall balance and reserve accumulation. Compared with the 2018 DSA, the increase in exports is driven by the onboarding of several hydro projects in the short and medium term, which is expected to double the generation capacity by FY2026/27. External risks could include higher commodity prices, including of fuel and food, weaker external demand from geopolitical tensions, and lower exports from delays in the onboarding or construction of hydropower projects.

[9] Non-interest CAD is projected at 8.9 percent in FY2021/22.

- **Financing mix:** The gross financing needs in the projection period are expected to be financed by both external and domestic debt. The financing mix envisages that external loans (including from IDA) would finance around 80 percent of gross financing needs in the medium term, with the remaining 20 percent financed by domestic borrowing. In the long term, the share of domestic financing is expected to increase gradually to around 40 percent of total financing needs by 2042, with a gradual shift from short-term treasury bills to medium- and longer-term bonds, due to further developments of the domestic bond market, consistent with authorities' debt market development plan.[10] The share of concessional external debt is expected to decline over the long term as Bhutan graduates from the LDC status and as its income level rises. The cost of domestic debt is assumed to be around 6.5 percent for longer-dated bonds.

Text Table. Bhutan: Key Macroeconomic Assumptions

	2022 DSA				2018 DSA			
	2020	2021	MT (2022-2027)	LT (2028-2042)	2020	2021	MT (2022-2027)	LT (2028-2038)
Real GDP Growth (%)	-2.4	-3.7	5.6	5.8	6.3	6.0	6.6	6.2
GDP deflator in US dollar terms (in percent)	0.9	3.1	5.1	4.0	0.7	1.6	4.3	4.3
Non-interest current account balance (in percent of GDP)	-11.6	-10.4	-4.7	4.0	-7.8	-4.5	8.6	6.0
Growth of exports of G&S (US dollar terms, in percent)	0.8	-5.3	14.1	5.4	12.3	5.6	10.9	2.0
Growth of imports of G&S (US dollar terms, in percent)	-10.9	-6.2	7.4	4.9	2.0	1.1	3.7	1.7
Primary Fiscal Balance (% of GDP)	-1.5	-5.3	-2.9	1.7	2.5	2.9	4.7	1.6

Sources: Bhutanese authorities and IMF staff estimates.
Note: 2020 refers to FY2019/20.

7. **The realism tools suggest that macroeconomic and fiscal assumptions are broadly reasonable (Figures 3 and 4).** The 3-year adjustment in the primary balance is near the median of the sample of the 3-year fiscal adjustments for low-income countries (LICs) that were under an IMF supported program since 1990. Under various assumptions on fiscal multipliers, growth would be lower than in the baseline scenario. The deviation of the growth projection from what is implied by the fiscal multipliers can be explained by the fact that growth in FY2021/22 largely reflects the gradual normalization of economic activities from COVID-19, a sizable base effect from the sharp contraction in FY2019/20 and FY2020/21, and the on-streaming of hydropower projects that support exports and economic growth.[11] Moreover, the contribution of government capital to GDP growth is broadly consistent with historical average. Over the projection horizon, other factors including reforms that boost economic diversification, digitalization, and private-sector-led growth are expected to support long-term GDP growth. Finally, historically, the PPG external debt has been driven by a large CAD, reflecting large hydro-related imports. Going forward, the CAD is projected to moderate, reflecting the increase in electricity exports and a gradual decline in hydropower-related imports.[12]

[10] The financing mix is consistent with the strategy outlined in the authorities' Medium-Term Debt Management Strategy (FY2020/21 to FY2022/23). The strategy outlines planned activities to support the development of a domestic debt market, including the development of a government securities issuance system, consultation meetings with investors, the publication of a bond issuance calendar, and the preparation of education materials on government bonds.

[11] The 2018 DSA did not provide a breakdown between public and private investment rates. Therefore, it is not possible to draw comparison in Figure 4 on the realism tool.

[12] The relatively sizable residuals and residual financing in the historical data could be attributed to a discrepancy between national statistics and debt data. The discrepancy could be due to a difference in the treatment of

COUNTRY CLASSIFICATION AND DETERMINATION OF SCENARIO STRESS TESTS

8. **Bhutan's debt carrying capacity (DCC) is assessed as medium, based on the October 2021 WEO and the 2020 World Bank CPIA.** The Composite Indicator (CI) is based on a weighted average of several factors such as the country's real GDP growth, remittances, international reserves, world growth, and the World Bank CPIA score. The CI is calculated based on the last two WEO vintages (October 2021 and April 2021 WEO), using 10-year averages of these variables (5 years of historical data and projections, respectively). While the latest CI based on the October 2021 WEO and the 2020 WB CPIA suggests a strong debt carrying capacity for the current vintage (3.08), the country classification would only be revised up from medium to strong if two consecutive signals suggest a strong rating. Given that the classification based on the previous vintage was medium, the DCC is considered medium for the purpose of the 2022 DSA, the same as the 2018 DSA.

9. **The DSA thresholds applicable for Bhutan are correspondingly medium.** For external debt, the thresholds are 180 percent for the present value (PV) of external debt to exports ratio and 40 percent for the PV of the external debt to GDP ratio. For external debt servicing, the thresholds are 15 percent of debt service to exports ratio and 18 percent debt services to revenue ratio. Finally, the application benchmark for public debt is 55 percent for the PV of total public debt in percent of GDP.

Debt Carrying Capacity and Thresholds

Country	Bhutan
Country Code	514
Debt Carrying Capacity	Medium

Final	Classification based on current vintage	Classification based on the previous vintage	Classification based on the two previous vintage
Medium	Strong 3.08	Medium 3.02	Medium 3.01

Note: Until the April 2019 WEO vintage is released, the two previous vintages ago classification and corresponding score are based solely on the CPIA per the previous framework.

Applicable thresholds

APPLICABLE	
EXTERNAL debt burden thresholds	
PV of debt in % of	
Exports	180
GDP	40
Debt service in % of	
Exports	15
Revenue	18

APPLICABLE	
TOTAL public debt benchmark	
PV of total public debt in percent of GDP	55

hydropower debt and the BOP and fiscal statistics, or a difference in the treatment of the transfers between central government and SOEs.

DEBT SUSTAINABILITY

A. External Debt Sustainability Analysis

10. Under the baseline scenario, Bhutan's PPG external debt indicators exceed the thresholds for several years, before falling below the thresholds in later years. From a stock perspective, the present value (PV) of debt to GDP ratio would exceed the threshold until 2039, with the PV of debt to exports falling below the threshold in 2034, reflecting a projected pick-up in hydro-related exports. From a flow perspective, the debt service to exports ratio and the debt-service to revenue ratio would fall below their respective thresholds from 2039, as hydropower projects are expected to generate exports and revenue to cover external debt service (Figure 1). Specifically, the total PPG debt to GDP ratio is expected to moderate from around 135 percent in 2021 to about 105 in the medium term (by 2027) and reduce further to about 37 percent in the long term (by 2042, Table 2). Similarly, the external debt to GDP ratio will fall from around 125 percent in 2021 to 102 percent in the medium term, and to 35 percent in the long term (Table 1).

11. Stress tests suggest that Bhutan's external debt trajectory could be vulnerable to the exchange rate and export shocks, similar to the 2018 DSA. A depreciation in the ngultrum could increase the value of Bhutan's external liabilities, which are largely denominated in foreign currency (particularly in rupees).[13] An exchange rate shock could then imply a higher debt stock and higher debt service, with the PV of debt to GDP ratio and debt service to revenue ratio falling below the thresholds later in 2040. Similarly, a shock to exports would imply a deterioration in Bhutan's repayment capacity, with the PV of debt to exports ratio and debt service to exports ratio above the thresholds even towards the end of the horizon. Export shocks could stem from delays in the onboarding or construction of hydropower projects. In addition, as noted earlier, Bhutan is vulnerable to climate shocks.[14]

B. Public Debt Sustainability Analysis

12. Similar to the 2018 DSA, Bhutan's public debt follows closely the dynamics of external debt and does not pose an additional risk to the debt profile. Domestic debt only accounted for about 7 percent of total outstanding debt in FY2020/21. While the 2022 DSA assumes a gradual increase in domestic financing to about 40 percent of new debt, external debt remains the most

[13] The ngultrum is pegged to the rupee at par and has been depreciating in real effective terms in recent years. Movements in the real effective exchange rate (REER) 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. A stable peg could help mitigate the impact of exchange rate shocks on the economy. Furthermore, Bhutan's reserve coverage is assessed to be adequate based on the External Sector Assessment of the 2022 Article IV.

[14] The historical scenario is based on the 10-year historical average of key macroeconomic variables, instead of the baseline projection. The historical scenario differs from the baseline scenario due to several factors, including a contraction in growth due to the COVID shock, higher government spending and weaker current account position in recent years. These factors resulted in an increase in higher future gross financing needs and total PPG debt levels under the historical scenario. In contrast, the baseline scenario envisages a recovery in GDP growth following the pandemic shock, a gradual consolidation of fiscal deficit and more favorable current account dynamics, reflecting the increase in electricity exports and a gradual decline in hydropower-related imports.

important source of financing. Under both baseline and stress scenarios, the PV of the debt to GDP ratio would exceed the threshold until around 2035. Similarly, the PV of debt to revenue ratio and debt service to revenue ratio would also be on a downward trajectory. Going forward, the authorities plan to further develop the domestic debt market, including through the issuance of longer-term domestic bonds (Figure 2).

RISK RATING AND VULNERABILITIES

13. **The 2022 DSA assesses Bhutan at moderate risk of external and overall debt distress, similarly to the 2018 DSA.** While the mechanical results point to a high risk of overall and external debt distress, with breaches in the indicators under the baseline scenario, judgment was applied given unique mitigating factors supporting the sustainability of Bhutan's debt stock. Almost three quarters of Bhutan's PPG external debt is linked to hydropower project loans from GoI, which covers both financial and construction risks of the projects and commits to buy all surplus electricity at a price reflecting cost plus profits. In addition, debt dynamics are set to improve further over the medium term driven by a significant increase in electricity exports and a decline of imports associated with hydropower construction. Overall, the analysis shows that external debt sustainability could be vulnerable to export and depreciation shocks, while the overall debt sustainability could be susceptible to contingent liabilities shocks. Within the moderate rating, Bhutan is assessed to have limited space to absorb additional shocks without being downgraded to a high risk of debt distress - (Figure 5). As noted earlier, the baseline is subject to important risks, including uncertainties related to the pandemic and geopolitical tensions, further delays in the completion of hydropower plants, and the materialization of financial sector contingent liabilities. Going forward, a gradual fiscal consolidation and revenue mobilization, a stable peg with the Indian rupee, and reforms to improve productivity and competitiveness of the non-hydropower sector, could help support debt sustainability.

AUTHORITIES' VIEW

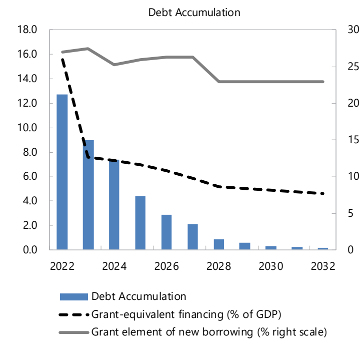
14. **The authorities broadly agreed with staff's assessment of debt sustainability and the need for revenue mobilization, and fiscal consolidation over the medium term.** The authorities noted that although public debt ratio has increased to relatively high levels, the risk of debt distress remained moderate due to the unique mitigating factors supporting the sustainability of Bhutan's debt stock. Furthermore, the authorities expect a gradual fiscal consolidation and a moderation in the debt-to-GDP ratio over the medium-term, driven by a significant increase in electricity exports and the completion of hydropower construction. On revenue mobilization, in addition to the introduction of the GST in July 2022, the authorities are planning on direct tax and property tax reforms to further broaden the tax base and increase revenue. The authorities concurred that pandemic support measures would need to be more targeted going forward given sustainability and financial stability considerations. Finally, the authorities reiterated the importance of further developing the domestic bond market as an alternative source of funding and to strengthen fiscal-monetary coordination.

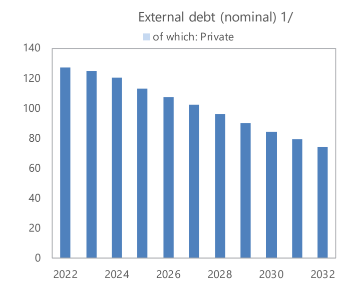
Table 1. Bhutan: External Debt Sustainability Framework, Baseline Scenario, 2019-42

(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 8/	
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2032	2042	Historical	Projections
External debt (nominal) 1/	**105.7**	**123.6**	**125.3**	**127.0**	**125.0**	**120.2**	**113.1**	**107.5**	**102.3**	**74.2**	**35.1**	**106.0**	**101.7**
of which: public and publicly guaranteed (PPG)	**103.6**	**121.9**	**125.3**	**127.0**	**125.0**	**120.2**	**113.1**	**107.5**	**102.3**	**74.2**	**35.1**	**104.5**	**101.7**
Change in external debt	-4.9	17.9	1.7	1.7	-2.0	-4.9	-7.0	-5.6	-5.2	-4.9	-3.8		
Identified net debt-creating flows	**23.1**	**13.9**	**12.8**	**5.6**	**4.4**	**-1.9**	**-5.4**	**-5.2**	**-5.9**	**-8.7**	**-6.5**	**18.7**	**-4.6**
Non-interest current account deficit	**19.1**	**11.6**	**10.4**	**8.9**	**8.0**	**3.2**	**-1.7**	**-2.6**	**-4.0**	**-7.4**	**-5.2**	**20.1**	**-2.0**
Deficit in balance of goods and services	18.4	12.9	11.9	14.5	10.7	4.8	1.1	-0.1	-1.3	-4.7	-2.9	**21.4**	**0.8**
Exports	31.7	32.4	31.0	30.2	32.0	36.0	38.5	39.4	39.7	34.3	27.1		
Imports	50.2	45.4	42.9	44.6	42.7	40.8	39.6	39.3	38.4	29.6	24.2		
Net current transfers (negative = inflow)	-7.0	-7.1	-5.9	-10.3	-6.1	-5.2	-5.3	-4.8	-4.3	-3.4	-2.5	**-7.1**	**-5.0**
of which: official	-4.0	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)	7.7	5.7	4.3	4.8	3.3	3.6	2.5	2.2	1.6	0.7	0.2	**5.8**	**2.1**
Net FDI (negative = inflow)	**0.1**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Endogenous debt dynamics 2/	**3.9**	**2.4**	**2.4**	**-3.3**	**-3.5**	**-5.1**	**-3.7**	**-2.6**	**-1.8**	**-1.3**	**-1.3**		
Contribution from nominal interest rate	1.4	0.8	1.4	1.6	1.7	2.5	3.1	3.5	3.9	2.9	0.8		
Contribution from real GDP growth	-5.0	2.6	4.6	-5.0	-5.3	-7.5	-6.8	-6.1	-5.7	-4.2	-2.1		
Contribution from price and exchange rate changes	7.6	-1.0	-3.7	...	...	...	...	...	...	...	...		
Residual 3/	**-28.0**	**4.0**	**-11.1**	**-3.9**	**-6.4**	**-2.9**	**-1.7**	**-0.4**	**0.7**	**3.8**	**2.7**	**-13.0**	**-0.1**
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		
Sustainability indicators													
PV of PPG external debt-to-GDP ratio	**...**	**...**	**112.4**	**113.0**	**112.3**	**108.5**	**103.3**	**97.7**	**92.1**	**63.9**	**27.0**		
PV of PPG external debt-to-exports ratio	**...**	**...**	**363.1**	**374.6**	**351.3**	**301.1**	**268.2**	**248.2**	**232.0**	**186.3**	**99.5**		
PPG debt service-to-exports ratio	**9.4**	**5.5**	**11.5**	**21.7**	**18.0**	**17.8**	**17.0**	**19.4**	**19.1**	**20.6**	**12.0**		
PPG debt service-to-revenue ratio	**16.3**	**8.1**	**14.0**	**36.6**	**29.1**	**29.7**	**28.4**	**32.2**	**31.6**	**28.7**	**12.2**		
Gross external financing need (Million of U.S. dollars)	550.7	331.7	334.0	410.6	395.2	304.3	168.9	189.4	145.5	-20.2	-259.8		
Key macroeconomic assumptions													
Real GDP growth (in percent)	4.4	-2.4	-3.7	4.4	4.5	6.7	6.2	5.9	5.8	5.8	5.8	**3.6**	**5.7**
GDP deflator in US dollar terms (change in percent)	-6.4	0.9	3.1	6.0	3.9	3.4	2.9	2.6	2.4	2.2	2.2	**0.0**	**3.0**
Effective interest rate (percent) 4/	1.2	0.8	1.1	1.4	1.5	2.2	2.8	3.4	3.9	3.9	2.2	**2.0**	**3.2**
Growth of exports of G&S (US dollar terms, in percent)	-1.9	0.8	-5.3	7.9	15.1	24.4	16.8	11.0	9.3	4.1	6.1	**0.2**	**10.0**
Growth of imports of G&S (US dollar terms, in percent)	-1.2	-10.9	-6.2	15.2	3.9	5.6	6.0	7.7	6.0	5.2	6.4	**-2.2**	**5.2**
Grant element of new public sector borrowing (in percent)	...	...	...	26.9	27.5	25.2	25.9	26.3	26.3	22.9	22.9	**...**	**24.8**
Government revenues (excluding grants, in percent of GDP)	18.2	21.8	25.4	17.9	19.8	21.5	23.0	23.7	24.1	24.6	26.6	**21.7**	**22.9**
Aid flows (in Million of US dollars) 5/	633.7	845.4	201.9	336.2	173.2	172.3	198.3	195.4	192.5	207.8	373.7		
Grant-equivalent financing (in percent of GDP) 6/	...	...	...	15.6	7.6	7.3	7.0	6.5	5.9	4.6	3.2	**...**	**6.8**
Grant-equivalent financing (in percent of external financing) 6/	...	...	...	54.6	46.4	47.8	55.4	54.0	54.0	53.5	72.4	**...**	**52.9**
Nominal GDP (Million of US dollars)	2,452	2,416	2,397	2,653	2,881	3,179	3,474	3,775	4,089	6,052	13,208		
Nominal dollar GDP growth	-2.3	-1.5	-0.8	10.7	8.6	10.3	9.3	8.7	8.3	8.1	8.1	**3.6**	**8.8**
Memorandum items:													
PV of external debt 7/	...	...	112.4	113.0	112.3	108.5	103.3	97.7	92.1	63.9	27.0		
In percent of exports	...	...	363.1	374.6	351.3	301.1	268.2	248.2	232.0	186.3	99.5		
Total external debt service-to-exports ratio	10.2	6.9	11.5	21.7	18.0	17.8	17.0	19.4	19.1	20.6	12.0		
PV of PPG external debt (in Million of US dollars)			2693.8	2998.2	3235.5	3448.8	3588.6	3687.7	3766.5	3866.1	3562.8		
(PVt-PVt-1)/GDPt-1 (in percent)				12.7	8.9	7.4	4.4	2.9	2.1	0.2	-0.7		
Non-interest current account deficit that stabilizes debt ratio	24.0	-6.3	8.7	7.3	9.9	8.0	5.4	3.0	1.1	-2.5	-1.4		

Definition of external/domestic debt	**Residency-based**
Is there a material difference between the two criteria?	**Yes**





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) + Ɛα (1+r)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, ρ = growth rate of GDP deflator in U.S. dollar terms, Ɛ=nominal appreciation of the local currency, and α= share of local currency-denominated external debt in total external debt.

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

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

6/ 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).

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

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

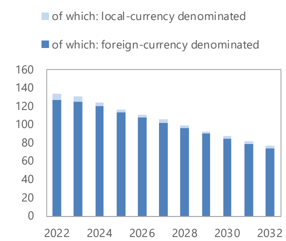
Table 2. Bhutan: Public Sector Debt Sustainability Framework, Baseline Scenario, 2019–42

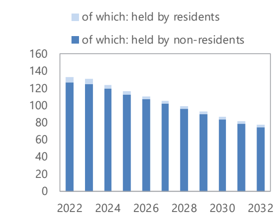
(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 6/	
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2032	2042	Historical	Projections
Public sector debt 1/	**106.5**	**131.2**	**134.9**	**133.5**	**130.9**	**124.2**	**116.4**	**110.7**	**105.4**	**77.2**	**36.9**	**109.4**	**105.4**
of which: external debt	**103.6**	**121.9**	**125.3**	**127.0**	**125.0**	**120.2**	**113.1**	**107.5**	**102.3**	**74.2**	**35.1**	**104.5**	**101.7**
Change in public sector debt	-6.9	24.7	3.8	-1.5	-2.6	-6.7	-7.8	-5.7	-5.2	-4.8	-4.3		
Identified debt-creating flows	**-3.6**	**11.1**	**3.3**	**1.8**	**-0.6**	**-5.2**	**-5.8**	**-4.9**	**-3.8**	**-3.9**	**-3.8**	**-0.7**	**-3.8**
Primary deficit	**0.7**	**1.5**	**5.3**	**8.8**	**6.0**	**2.8**	**0.4**	**-0.1**	**-0.7**	**-1.6**	**-2.1**	**0.9**	**0.6**
Revenue and grants	24.3	31.2	33.8	28.7	24.1	26.2	28.0	28.2	28.1	28.0	29.4	**31.2**	**27.6**
of which: grants	6.1	9.4	8.4	10.8	4.3	4.6	5.0	4.5	4.1	3.4	2.8		
Primary (noninterest) expenditure	25.0	32.6	39.0	37.5	30.1	29.0	28.4	28.1	27.4	26.4	27.3	**32.1**	**28.3**
Automatic debt dynamics	**-4.3**	**9.6**	**-2.0**	**-7.1**	**-6.6**	**-8.0**	**-6.2**	**-4.8**	**-3.1**	**-2.2**	**-1.7**		
Contribution from interest rate/growth differential	-5.3	2.2	4.4	-7.1	-6.6	-8.0	-6.2	-4.8	-3.1	-2.2	-1.7		
of which: contribution from average real interest rate	-0.5	-0.4	-0.7	-1.4	-0.9	0.2	1.1	1.7	3.0	2.2	0.5		
of which: contribution from real GDP growth	-4.8	2.6	5.1	-5.7	-5.7	-8.2	-7.2	-6.5	-6.0	-4.5	-2.2		
Contribution from real exchange rate depreciation	1.0	7.4	-6.4	...	...	...	...	...	...	...	...		
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**	**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 contingent liabilities (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		
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 debt creating or reducing flow (please specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual	**-3.3**	**13.6**	**0.5**	**-3.2**	**-2.0**	**-1.5**	**-2.1**	**-0.8**	**-1.4**	**-0.9**	**-0.4**	**7.3**	**-1.5**
Sustainability indicators													
PV of public debt-to-GDP ratio 2/	**...**	**...**	**122.2**	**120.6**	**119.2**	**113.5**	**106.6**	**100.9**	**95.3**	**66.9**	**28.8**		
PV of public debt-to-revenue and grants ratio	**...**	**...**	**361.8**	**420.8**	**495.2**	**433.5**	**380.8**	**357.9**	**338.4**	**238.7**	**97.9**		
Debt service-to-revenue and grants ratio 3/	**13.0**	**6.5**	**12.1**	**46.5**	**38.8**	**42.0**	**33.8**	**35.3**	**34.9**	**32.5**	**16.0**		
Gross financing need 4/	3.8	3.5	9.3	22.1	15.4	13.8	9.8	9.8	9.1	7.5	2.6		
Key macroeconomic and fiscal assumptions													
Real GDP growth (in percent)	4.4	-2.4	-3.7	4.4	4.5	6.7	6.2	5.9	5.8	5.8	5.8	**3.6**	**5.7**
Average nominal interest rate on external debt (in percent)	1.2	0.7	1.2	1.4	1.5	2.2	2.8	3.4	3.9	3.9	2.2	**2.1**	**3.2**
Average real interest rate on domestic debt (in percent)	2.3	4.3	1.0	-4.6	0.3	2.1	2.4	2.7	2.2	2.5	3.5	**0.8**	**1.5**
Real exchange rate depreciation (in percent, + indicates depreciation)	1.0	7.0	-5.0	...	...	...	...	...	...	...	...	**2.0**	**...**
Inflation rate (GDP deflator, in percent)	1.3	3.7	4.8	6.4	5.9	5.2	4.7	4.4	4.2	4.0	4.0	**5.0**	**4.6**
Growth of real primary spending (deflated by GDP deflator, in percent)	-19.0	27.7	15.1	0.2	-16.1	2.7	4.0	4.8	3.3	6.3	6.6	**4.7**	**2.2**
Primary deficit that stabilizes the debt-to-GDP ratio 5/	7.5	-23.2	1.5	10.3	8.6	9.4	8.2	5.6	4.5	3.1	2.2	**-4.7**	**5.9**
PV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		

Definition of external/domestic debt	**Residency-based**
Is there a material difference between the two criteria?	**Yes**

Public sector debt 1/





Sources: Country authorities; and staff estimates and projections.

1/ Coverage of debt: The central government, central bank, government-guaranteed debt . Definition of external debt is Residency-based.

2/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.

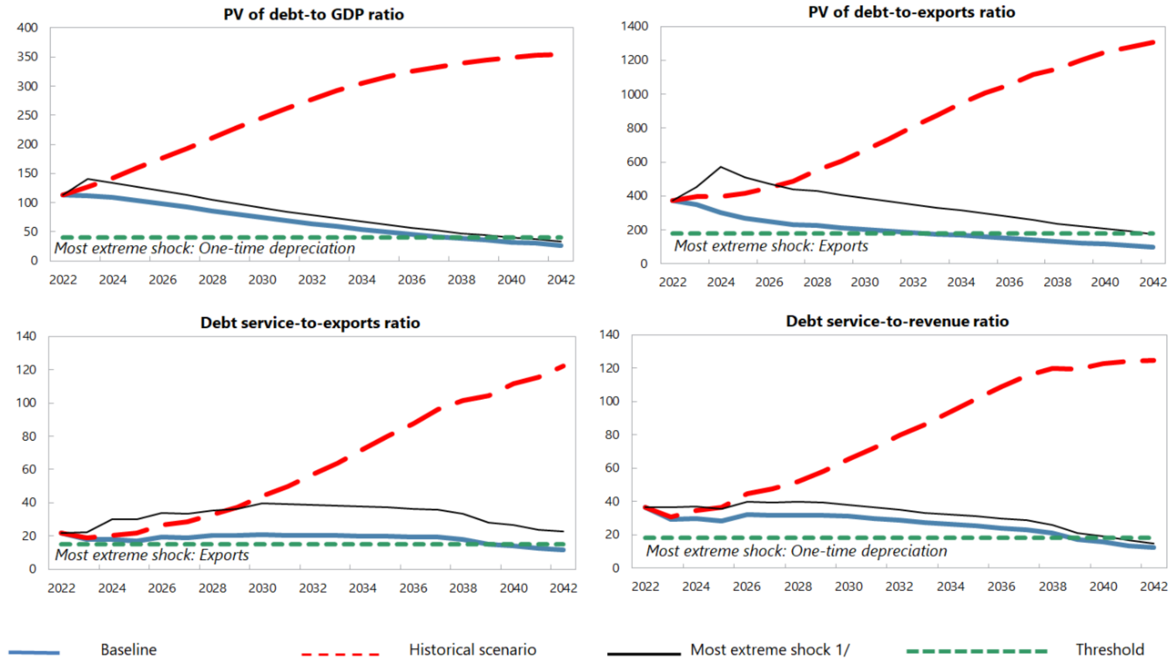
3/ Debt service is defined as the sum of interest and amortization of medium and long-term, and short-term debt.

4/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period and other debt creating/reducing flows.

5/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio ((-): a primary surplus), which would stabilizes the debt ratio only in the year in question.

6/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

Figure 1. Bhutan: Indicators of Public and Publicly Guaranteed External Debt Under Alternatives Scenarios, 2022–2042 1/ 2/



Customization of Default Settings		
	Size	Interactions
Tailored Stress		
Combined CL	No	
Natural disaster	n.a.	n.a.
Commodity price	n.a.	n.a.
Market financing	n.a.	n.a.

Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

Borrowing assumptions on additional financing needs resulting from the stress tests*		
	Default	User defined
Shares of marginal debt		
External PPG MLT debt	100%	
Terms of marginal debt		
Avg. nominal interest rate on new borrowing in USD	2.4%	2.4%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	20	20
Avg. grace period	5	5

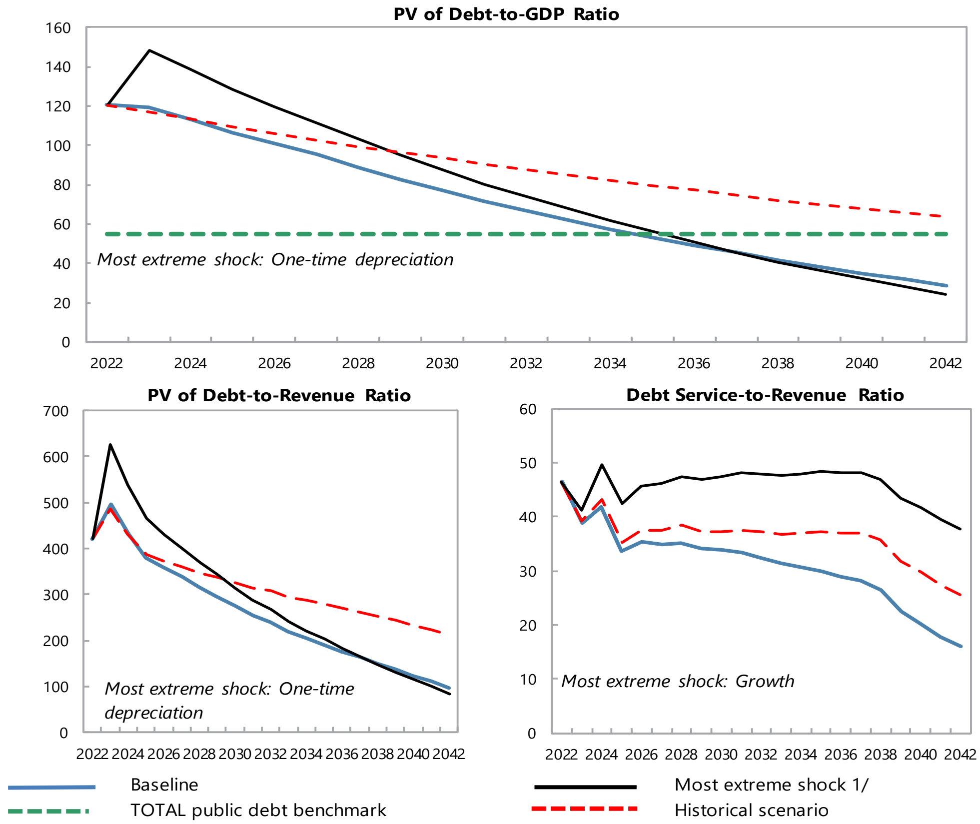
* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2032. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

2/ The magnitude of shocks used for the commodity price shock stress test are based on the commodity prices outlook prepared by the IMF research department.

Figure 2. Bhutan: Indicators of Public Debt Under Alternative Scenarios, 2022–2042 1/



Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	75%	75%
Domestic medium and long-term	8%	8%
Domestic short-term	17%	17%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	2.4%	2.4%
Avg. maturity (incl. grace period)	20	20
Avg. grace period	5	5
Domestic MLT debt		
Avg. real interest rate on new borrowing	6.0%	6.0%
Avg. maturity (incl. grace period)	2	2
Avg. grace period	1	1
Domestic short-term debt		
Avg. real interest rate	-0.6%	-0.6%

* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the shocks under the stress tests in the public DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2032. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Table 3. Bhutan: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2022–32

(In percent)

	Projections 1/										
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
PV of debt-to GDP ratio											
Baseline	**113**	**112**	**108**	**103**	**98**	**92**	**86**	**80**	**74**	**69**	**64**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	**113**	**127**	**143**	**160**	**176**	**194**	**211**	**228**	**246**	**262**	**278**
B. Bound Tests											
B1. Real GDP growth	**113**	**121**	**130**	**124**	**117**	**110**	**103**	**96**	**89**	**82**	**76**
B2. Primary balance	**113**	**114**	**112**	**107**	**101**	**96**	**89**	**83**	**77**	**72**	**67**
B3. Exports	**113**	**119**	**128**	**122**	**115**	**109**	**102**	**95**	**88**	**81**	**75**
B4. Other flows 3/	**113**	**114**	**112**	**107**	**101**	**95**	**89**	**83**	**77**	**71**	**66**
B5. Depreciation	**113**	**141**	**133**	**127**	**120**	**113**	**105**	**98**	**91**	**85**	**78**
B6. Combination of B1-B5	**113**	**128**	**133**	**127**	**120**	**113**	**106**	**98**	**91**	**84**	**78**
C. Tailored Tests											
C1. Combined contingent liabilities	**113**	**117**	**114**	**109**	**104**	**98**	**91**	**85**	**79**	**74**	**69**
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	40	40	40	40	40	40	40	40	40	40	40
PV of debt-to-exports ratio											
Baseline	**375**	**351**	**301**	**268**	**248**	**232**	**225**	**211**	**203**	**193**	**186**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	**375**	**396**	**396**	**415**	**448**	**488**	**551**	**604**	**672**	**737**	**810**
B. Bound Tests											
B1. Real GDP growth	**375**	**351**	**301**	**268**	**248**	**232**	**225**	**211**	**203**	**193**	**186**
B2. Primary balance	**375**	**356**	**310**	**277**	**257**	**241**	**233**	**220**	**212**	**201**	**194**
B3. Exports	**375**	**454**	**571**	**508**	**471**	**442**	**430**	**405**	**388**	**367**	**352**
B4. Other flows 3/	**375**	**357**	**311**	**277**	**257**	**240**	**233**	**219**	**211**	**200**	**192**
B5. Depreciation	**375**	**351**	**295**	**263**	**243**	**227**	**220**	**207**	**199**	**189**	**183**
B6. Combination of B1-B5	**375**	**438**	**315**	**431**	**399**	**374**	**362**	**340**	**327**	**310**	**298**
C. Tailored Tests											
C1. Combined contingent liabilities	**375**	**367**	**317**	**284**	**263**	**246**	**239**	**225**	**217**	**207**	**200**
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	180	180	180	180	180	180	180	180	180	180	180
Debt service-to-exports ratio											
Baseline	**22**	**18**	**18**	**17**	**19**	**19**	**20**	**20**	**21**	**21**	**21**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	**22**	**19**	**21**	**22**	**27**	**29**	**33**	**37**	**44**	**50**	**57**
B. Bound Tests											
B1. Real GDP growth	**22**	**18**	**18**	**17**	**19**	**19**	**20**	**20**	**21**	**21**	**21**
B2. Primary balance	**22**	**18**	**18**	**17**	**20**	**19**	**20**	**21**	**22**	**21**	**21**
B3. Exports	**22**	**22**	**30**	**30**	**34**	**33**	**35**	**36**	**40**	**39**	**39**
B4. Other flows 3/	**22**	**18**	**18**	**17**	**20**	**19**	**20**	**21**	**22**	**21**	**21**
B5. Depreciation	**22**	**18**	**18**	**17**	**19**	**19**	**20**	**20**	**20**	**20**	**20**
B6. Combination of B1-B5	**22**	**21**	**28**	**27**	**30**	**30**	**32**	**33**	**34**	**33**	**33**
C. Tailored Tests											
C1. Combined contingent liabilities	**22**	**18**	**18**	**17**	**20**	**20**	**21**	**21**	**21**	**21**	**21**
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	15	15	15	15	15	15	15	15	15	15	15
Debt service-to-revenue ratio											
Baseline	**37**	**29**	**30**	**28**	**32**	**32**	**32**	**32**	**31**	**30**	**29**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	**37**	**31**	**34**	**36**	**45**	**48**	**52**	**58**	**66**	**72**	**80**
B. Bound Tests											
B1. Real GDP growth	**37**	**31**	**36**	**34**	**39**	**38**	**38**	**38**	**37**	**36**	**34**
B2. Primary balance	**37**	**29**	**30**	**29**	**33**	**32**	**32**	**32**	**32**	**31**	**30**
B3. Exports	**37**	**30**	**31**	**31**	**35**	**34**	**34**	**35**	**37**	**35**	**34**
B4. Other flows 3/	**37**	**29**	**30**	**29**	**33**	**32**	**32**	**32**	**32**	**31**	**30**
B5. Depreciation	**37**	**36**	**37**	**35**	**40**	**39**	**40**	**39**	**38**	**36**	**35**
B6. Combination of B1-B5	**37**	**32**	**36**	**34**	**38**	**38**	**38**	**39**	**38**	**36**	**35**
C. Tailored Tests											
C1. Combined contingent liabilities	**37**	**29**	**30**	**29**	**33**	**32**	**32**	**32**	**32**	**30**	**29**
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	18	18	18	18	18	18	18	18	18	18	18

Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the threshold.
2/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
3/ Includes official and private transfers and FDI.

Table 4. Bhutan: Sensitivity Analysis for Key Indicators of Public Debt 2022–32

	Projections 1/										
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
	PV of Debt-to-GDP Ratio										
Baseline	**121**	**119**	**114**	**107**	**101**	**95**	**89**	**83**	**77**	**72**	**67**
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	**121**	**117**	**114**	**110**	**106**	**103**	**100**	**96**	**94**	**91**	**88**
B. Bound Tests											
B1. Real GDP growth	**121**	**129**	**140**	**135**	**132**	**128**	**124**	**119**	**116**	**112**	**109**
B2. Primary balance	**121**	**121**	**118**	**110**	**105**	**99**	**92**	**86**	**80**	**75**	**70**
B3. Exports	**121**	**124**	**129**	**121**	**115**	**109**	**102**	**95**	**88**	**82**	**76**
B4. Other flows 3/	**121**	**121**	**117**	**110**	**104**	**99**	**92**	**86**	**80**	**74**	**69**
B5. Depreciation	**121**	**149**	**139**	**128**	**120**	**112**	**103**	**95**	**88**	**80**	**74**
B6. Combination of B1-B5	**121**	**119**	**118**	**111**	**105**	**99**	**93**	**87**	**81**	**75**	**70**
C. Tailored Tests											
C1. Combined contingent liabilities	**121**	**127**	**120**	**113**	**107**	**101**	**94**	**88**	**82**	**77**	**72**
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
TOTAL public debt benchmark	55	55	55	55	55	55	55	55	55	55	55
	PV of Debt-to-Revenue Ratio										
Baseline	421	495	434	381	358	338	315	295	275	255	239
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	421	486	431	386	371	359	347	338	327	316	307
B. Bound Tests											
B1. Real GDP growth	421	530	518	467	453	443	427	415	402	388	379
B2. Primary balance	421	504	449	395	371	351	327	307	286	265	249
B3. Exports	421	515	493	433	408	387	361	339	314	290	270
B4. Other flows 3/	421	503	448	393	370	350	326	306	284	263	246
B5. Depreciation	421	626	538	465	430	401	369	343	315	289	266
B6. Combination of B1-B5	421	495	450	395	372	352	328	308	287	266	250
C. Tailored Tests											
C1. Combined contingent liabilities	421	526	459	403	379	359	334	314	293	273	256
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	Debt Service-to-Revenue Ratio										
Baseline	46	39	42	34	35	35	35	34	34	34	32
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	46	39	43	35	37	38	38	37	37	38	37
B. Bound Tests											
B1. Real GDP growth	46	41	50	42	46	46	47	47	47	48	48
B2. Primary balance	46	39	44	37	37	36	36	35	35	35	34
B3. Exports	46	39	42	35	37	36	36	36	38	37	36
B4. Other flows 3/	46	39	42	34	36	35	35	35	35	34	33
B5. Depreciation	46	41	48	41	44	43	44	43	43	42	41
B6. Combination of B1-B5	46	38	43	35	37	37	37	36	36	35	34
C. Tailored Tests											
C1. Combined contingent liabilities	46	39	48	38	37	36	36	35	35	34	33
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

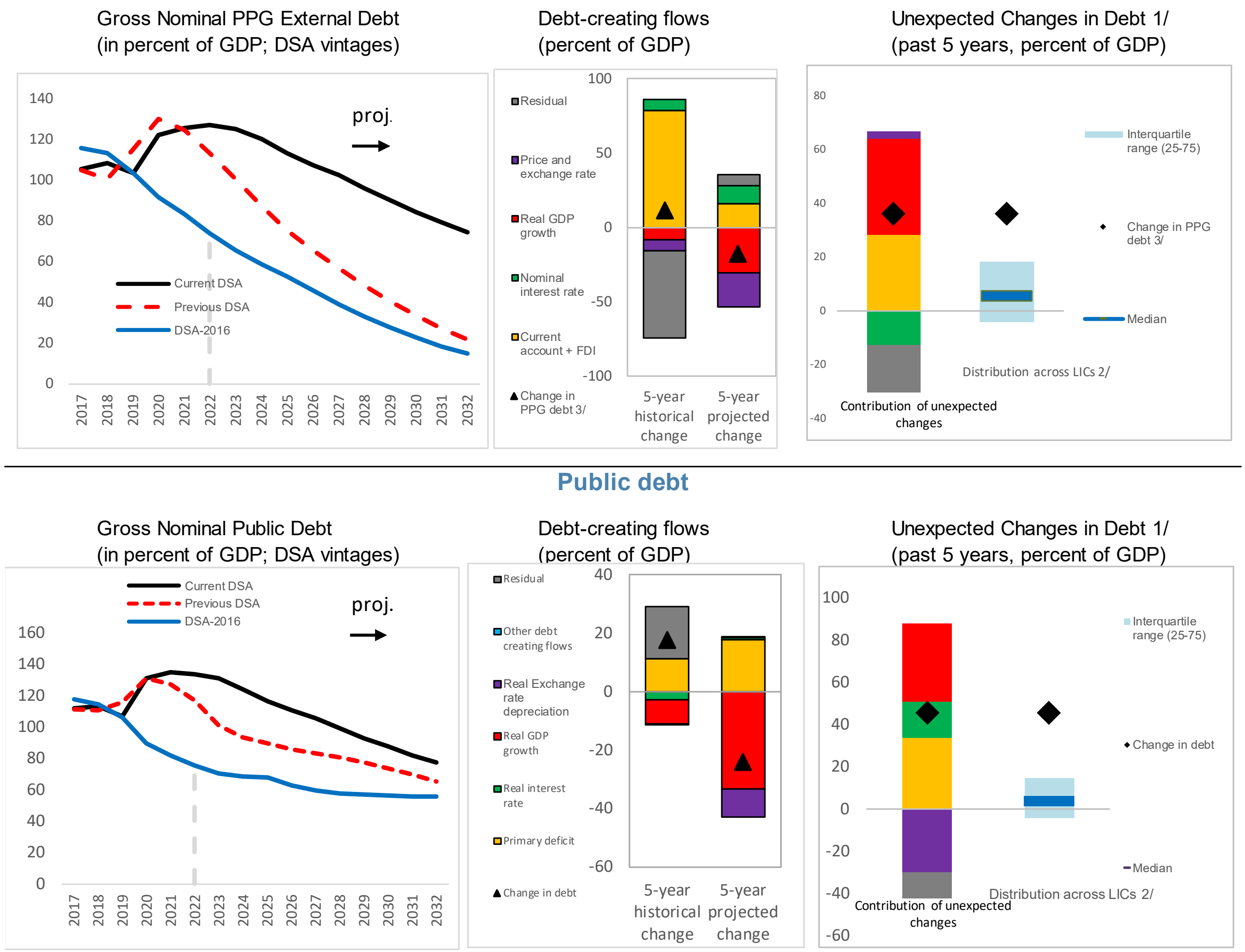
Sources: Country authorities; and staff estimates and projections.

1/ A bold value indicates a breach of the benchmark.

2/ Variables include real GDP growth, GDP deflator and primary deficit in percent of GDP.

3/ Includes official and private transfers and FDI.

Figure 3. Bhutan: Drivers of Debt Dynamics—Baseline Scenario



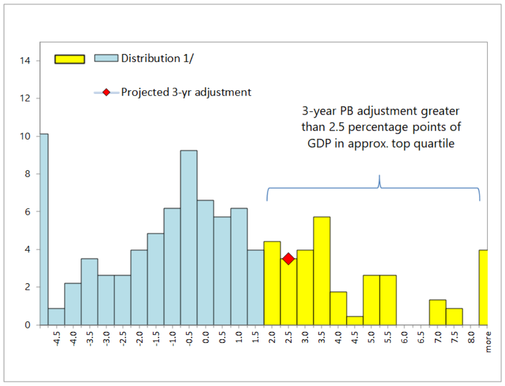
1/ Difference between anticipated and actual contributions on debt ratios.

2/ Distribution across LICs for which LIC DSAs were produced.

3/ Given the relatively low private external debt for average low-income countries, a ppt change in PPG external debt should be largely explained by the drivers of the external debt dynamics equation.

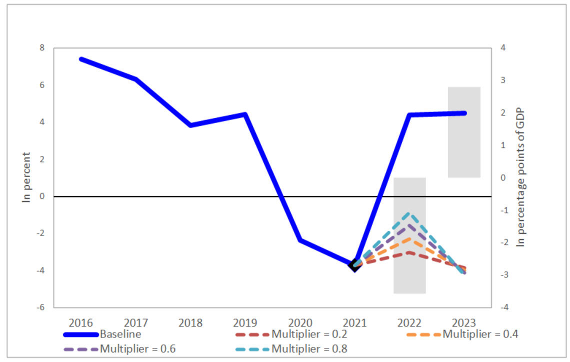
Figure 4. Bhutan: Realism Tools

3-Year Adjustment in Primary Balance
(Percentage points of GDP)



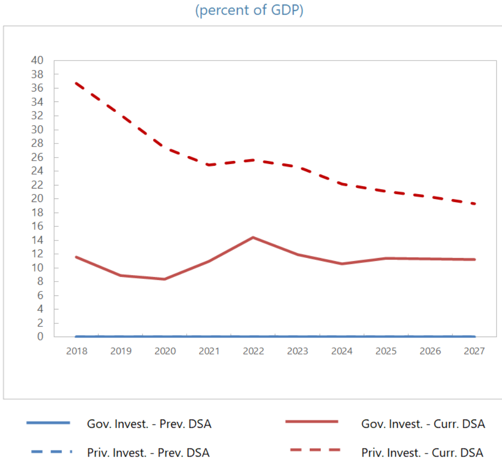
1/ Data cover Fund-supported programs for LICs (excluding emergency financing) approved since 1990. The size of 3-year adjustment from program inception is found on the horizontal axis; the percent of sample is found on the vertical axis.

Fiscal Adjustment and Possible Growth Paths 1/



1/ Bars refer to annual projected fiscal adjustment (right-hand side scale) and lines show possible real GDP growth paths under different fiscal multipliers (left-hand side scale).

Public and Private Investment Rates
(percent of GDP)



Contribution to Real GDP growth
(percent, 5-year average)

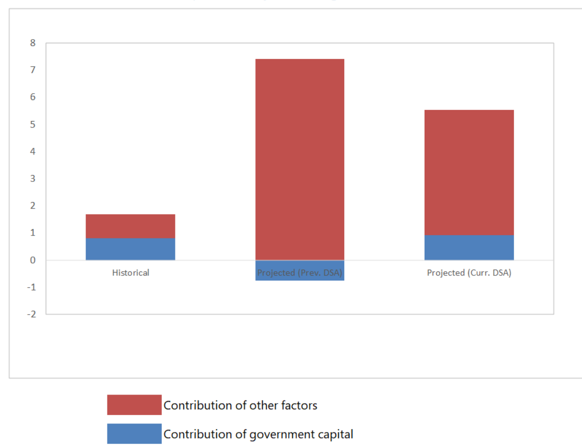
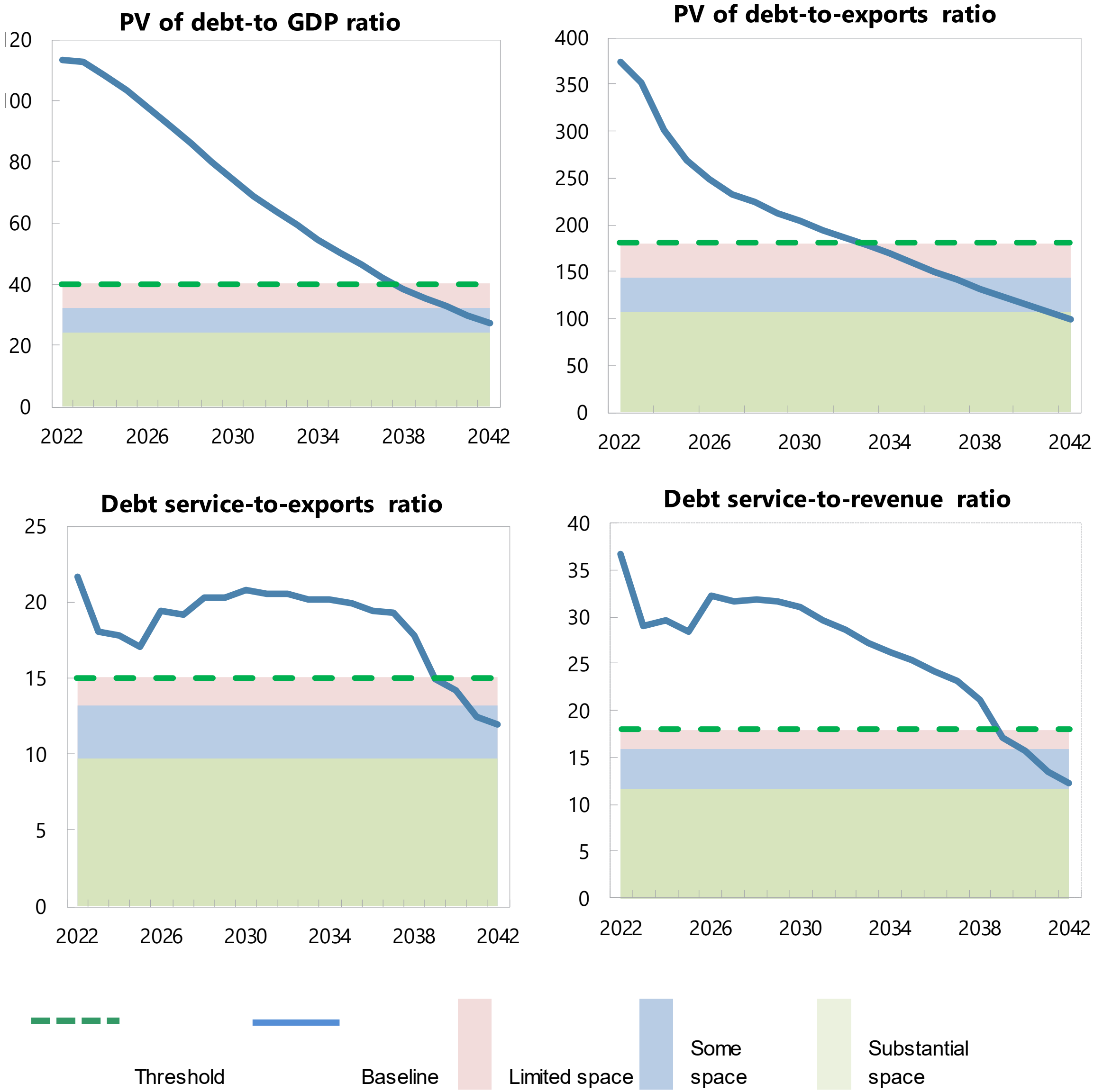


Figure 5. Bhutan: Qualification of the Moderate Category 2022-2042 1/



Sources: Country authorities; and staff estimates and projections.

1/ For the PV debt/GDP and PV debt/exports thresholds, x is 20 percent and y is 40 percent. For debt service/Exports and debt service/revenue thresholds, x is 12 percent and y is 35 percent.

Statement by Mr. Surjit Bhalla, Executive Director for Bhutan, and Mr. Thiruvenkadam Natarajan, Senior Advisor to Executive Director May 13, 2022

On behalf of our Bhutan authorities, we thank the IMF team led by Mr Ahmed for the productive engagement during the Article IV consultations. Our authorities are appreciative of their deep understanding of the macro-economic situation in Bhutan and the constructive discussions on a wide range of policy issues. They highly value the staff report, assessments, and recommendations. Our remarks will focus on the macroeconomic outlook and important policy issues.

Recent Economic Developments and Macroeconomic Outlook

1. Economic activity was severely impacted due to the COVID-19 pandemic and the adoption of various containment measures including periodic lockdowns, business closures, border closures, and social distancing norms. GDP contracted by 2.4 percent in 2019-20 and 3.7 percent in 2020-21 compared to a growth of 4.4 percent in 2018-19. The stark contrast to the 6.3 and 6 percent growth estimated for 2019-20 and 2020-21 in the 2018 Article IV Report provides a measure of the extent of impact of the pandemic. The severity of contraction was most pronounced in construction, transportation, and tourism sectors. On the upside, agriculture and electricity sectors witnessed notable performance during the period.

2. Decisive policy measures taken by the authorities helped to contain the pandemic and loss of lives and mitigate socio-economic costs. Performing one of the fastest vaccination campaigns in the world, Bhutan achieved full vaccination of the adult population by July 2021 and of children above 5 years by March 2022. Supported by an effective vaccination campaign and strong hydroelectricity exports, the economy is expected to witness gradual recovery in 2021-22 and is projected to grow at 4.4 percent.

3. The continuing uncertainties due to the new omicron variant, geopolitical conflicts, supply disruptions, and high oil and commodity prices are expected to weaken demand in the economy. The overall annual CPI inflation stood at 5.3 percent in February 2022 compared to 9.5 percent during the same month of the previous year The non-food prices recorded an increase of 6.4 percent, while the food prices recorded a growth of 4.1 percent. The non-food price increase

accounted for 62 percent of the overall inflation rate while the remaining was contributed by food prices.

4. Medium-term growth is expected to be driven by the revival of services and manufacturing activities and a boost in hydropower generation. As the pandemic-related measures are phased out, the fiscal position is expected to significantly improve. The current account deficit and reserve coverage are expected to improve due to an increase in hydropower exports and a decrease in hydropower-related imports. The hydropower sector constitutes 17 percent of Bhutan's GDP and the share of electricity exports which was 26 percent of exports in 2018-19 is estimated to increase to 49 percent 2021-22 and is projected to further increase to 57 percent in 2026-27.

Gross National Happiness

5. Bhutan's long-term growth strategy is underpinned by its unique developmental philosophy, Gross National Happiness (GNH). This multi-dimensional development approach built on 4 pillars of sustainable & equitable socio-economic development, good governance, environmental conservation, and preservation & promotion of culture seeks to achieve a balance between material well-being and the spiritual, cultural, and material needs of the citizens. Gross National Happiness Commission plays a central role in Bhutan's national planning with emphasis on education, health, and finance. With focused efforts, Bhutan's human development index has improved from 0.52 in 2005 to 0.628 in 2015 and 0.654 in 2019. Significant improvement was made in per capita income and reducing poverty prior to the pandemic, qualifying Bhutan's graduation from least developed country status by 2023. The share of population living on less than $ 3.20 per day fell from 14.7 percent in 2012 to 10.7 percent in 2019, marginally increasing to 11.2 percent in 2020.

6. Tourism is anchored on the GNH approach to sustainability and wellness. The sector suffered severely during the pandemic as international tourism receipts declined from about US $120 million in 2019 to 84 million in 2020. During the same period, international tourism receipts as a share of exports declined from 15.4 to 10.7 percent significantly impacting employment and livelihood. Giving thrust to transform the tourism sector, the authorities are making intense efforts to build the 'Brand Bhutan' based on the 'high value and low volume' approach to promote wellness, agro-tourism, community, and eco-tourism products.

Fiscal Policy

7. Five-Year Plans (FYP) provide a blueprint for long-term planning and integrating a rolling budget framework within FYP can help to reduce volatility in managing long-term projects. About 33 percent of the capital outlay in the 12th FYP has been allocated to budget 2021-22 with a focus on health, education, and infrastructure. Capital expenditure which was 12.6 percent of GDP in 2019-20 is expected to increase to 18.2 percent in 2021-22. Targeted pandemic measures can reduce the fiscal deficit which increased to about 6.3 percent in 2020-21 compared to 1.9 percent in 2019-20 due to pandemic-related expenditure.

8. Our authorities recognize the need for ramping up revenue mobilization and medium-term fiscal consolidation. Implementation of GST is expected to kickstart soon and along with proposed direct tax and property tax reforms is expected to provide a significant boost to revenue mobilization. Preliminary assessments indicate an increase in tax revenue by about 0.4 percent of GDP initially and increasing to 2 percent in the medium-term.

9. Overall debt stress is moderate despite a significant increase in the debt-to-GDP ratio by about 29 percent, reaching about 135 percent in 2020-21. Taking note of the staff assessment of debt sustainability, the authorities highlight the mitigating factors that support debt sustainability, enhance fiscal consolidation, and moderate debt-to-GDP ratio. Apart from tax revenue mobilization measures, these include a significant increase in electricity exports and the completion of hydropower construction. External debt risk is expected to remain moderate as most of Bhutan's external debt is linked to hydropower loans from India which covers the financial and construction risks.

Monetary Policy

10. Monetary measures taken during the pandemic enhanced liquidity and credit and helped banks to extend concessional loans to businesses. Excess liquidity was a result of a mismatch due to strong growth in deposits and weak credit demand. Broad money grew by 17.0 percent in November 2021 compared to 21.4 percent in the previous year. Aggregate deposits held by the commercial banks grew by 18.7 percent in November 2021 compared to 22.3 percent in the previous period, domestic credit witnessed an increase in growth by 23.9 percent compared to

only 2.3 percent in the previous period. Going forward, the authorities concur on the need for Domestic Liquidity Management Framework (DLMF) and digitalization of the financial system.

Financial Sector

11. Our authorities recognize the risks to the financial sector stemming from pre-pandemic vulnerabilities and the need to move from broad-based support measures to provide support to targeted sectors, individuals, and businesses that are most affected by the pandemic. They are committed to continuing the implementation of the NPL resolution framework and Risk-based Supervisory framework (RBS) to boost long-term financial stability. This includes implementation of RBS across all financial institutions and putting in place an efficient risk management framework.

External Sector and Exchange-Rate Policy

12. Current account deficit has narrowed due to an increase in hydropower exports and a decline in construction-related imports. With adequate reserve coverage and an expected increase in electricity exports, the external financing risk is assessed to be low. Our authorities concur with the staff assessment of the adequacy and appropriateness of the exchange rate peg as a nominal anchor and reiterate the importance of Rupee reserves as external buffer. Rupee reserves have increased over the two years from 16 to 26 percent in 2020-21.

Structural Reforms

13. Structural reforms are critical for diversifying the economy and boosting long-term growth. The post-pandemic recovery provides an opportunity for diversification that include high value-added activities. One of the three carbon negative countries in the world, Bhutan is exposed to risks of natural disasters stemming from climate change, particularly in water-dependent sectors. Climate-resilient budgeting is aimed to support climate change adaptation, disaster risk management, and further greening of energy sources.

14. Special attention is given to the tourism sector by the authorities by improving infrastructure, provision of skills training, and dissemination of related digital content. Digital Drukyul Flagship program is aimed to promote inclusion by leveraging digitalization. During the pandemic, extensive programs for addressing skill mismatches and unemployment were

executed, and many could be continued post-pandemic. Measures for enhancing physical and digital infrastructure with a focus on productivity would be a priority in the 13th FYP.

Capacity Development

15. Our authorities are deeply appreciative of the ongoing CD support provided by the Fund and expressed keenness in strengthening collaboration in digital currency, bond market development, and data coverage.