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May 11, 2022

**Statement by Mr. Velloso and Ms. Florestal on Bhutan
(Preliminary)
Executive Board Meeting
May 13, 2022**

We thank staff for the report and Messrs. Bhalla and Natarajan for their helpful statement. We agree with the thrust of the staff appraisal and commend the authorities for the recent steps to further liberalize the exchange system through the introduction of new provisions in the 2020 Foreign Exchange Rules and Regulations and several other initiatives to lessen exchange restrictions subject to Articles VIII and XIV.

We welcome the authorities' uptake of previous Fund policy advice and their concurrence with key recommendations in the current Article IV staff report. The commonality of views on the external sector assessment and on the appropriateness of the peg as a nominal anchor as well as the acknowledgment of risks to the financial sector stemming from pre-pandemic vulnerabilities, including elevated NPLs, should be noted. Progress towards risk-based bank supervision, implementation of the GST, and willingness to introduce in due course a rolling multi-year budget framework is testimony to the constructive dialogue of the authorities with the Fund.

The outlook remains broadly positive but subject to risks. Growth is projected to resume in FY22 mostly due to a sharp increase in electricity exports associated with the doubling of the country's hydropower capacity, and in the medium term by the recovery of services and manufacturing activities. However, the growth trajectory is lower than expected prior to the pandemic and is too dependent on the hydropower sector. Hence, constraints to the development of the non-hydropower sector must be addressed, including by improving the investment climate. The authorities' plans for climate change adaptation, disaster risk management, and further greening of energy sources are also crucial given the risks from natural disasters. We take note that efforts to build a high-value and low-volume brand is supporting the transformation of the tourism sector while maintaining Bhutan's unique developmental philosophy of Gross National Happiness.

Bhutan has successfully countered the impact of the pandemic with a comprehensive policy package, but supportive measures must be gradually withdrawn as the economy recovers. Infection rates and deaths have remained limited, and the vaccination rate is amongst the highest in the world, with full vaccination of the adult population as underscored in the BUFF statement. However, trade restrictions and support measures continue to weigh heavily on the fiscal accounts and need to be progressively withdrawn as the economy recovers. Monetary conditions may need to be less accommodative to fend off further inflationary pressures that are intensified by higher international commodity prices and global supply chain disruptions.

Bhutan's large digital infrastructure has facilitated the development of mobile and internet banking, but additional efforts are needed to increase financial inclusion while strengthening the financial sector. Like staff, we encourage the authorities to focus on bridging gaps across gender, age, and regions as well as types of financial products. NPLs remain elevated, and we agree, as noted in the staff report, that steadfast implementation of the new resolution framework would benefit from improved asset valuation.

We take note of staff's assessment that Bhutan's debt is at moderate risk of distress given mitigation factors that imply low refinancing and exchange rate risks. While the mechanical application of the debt sustainability framework would imply a high risk of debt distress, the shouldering by India of financial and construction risks of hydropower projects on which the economy's recovery and future growth depends is an important mitigation factor. The peg to the Indian rupee and Bhutan's adequate international reserve coverage lessens risks to external shocks.

We agree with the authorities and staff that debt sustainability would be further supported by gradual fiscal consolidation through revenue mobilization and more targeted pandemic support measures coupled with improved productivity in the non-hydropower sector. We also concur with staff's decision to cautiously maintain the assessment of debt-carrying capacity at medium until there would be two consecutive readings of strong capacity. Risks to the DSA's baseline scenario are numerous and include possible delays in the completion of hydropower plants under construction and the materialization of financial sector contingent liabilities. Thus, the development of the domestic bond market, as underscored by the authorities, would offer an alternative source of funding for development.

Finally, we are pleased that IMF technical assistance and training has been demand driven and played an instrumental role in policy design and implementation in Bhutan. The role played by online technical assistance delivery and the South Asia Regional Training and Technical Assistance Center (SARTTAC) must also be underscored.

With these remarks we wish the authorities of Bhutan success in their future endeavors.