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November 4, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Bhutan - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Bhutan. A draft decision appears on page 14.

This subject has been tentatively scheduled for discussion on Monday, November 28, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Evers (ext. (5)7611) or Mr. Niebuhr (ext. (5)7315).

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BHUTAN

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983
Consultation with Bhutan

(In consultation with the Fiscal Affairs, Legal,
and Treasurer's Departments)

Approved by Tun Thin and Manuel Guitian

November 4, 1983

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I. Introduction

Discussions for the 1983 Article IV consultations were held in Thimphu during August 3-17, 1983. The representatives of Bhutan included Lyonpo Dawa Tsering, Minister of External Affairs; Dasho Lam Penjore, Deputy Minister, Planning Commission; Dasho Dorji Tshering, Secretary, Ministry of Finance; Yeshey Zimba, Managing Director of the Royal Monetary Authority; and senior officials of various government departments and corporations. The staff team also had discussions in Phuntsholing with Mr. P.K. Jayaswal, Managing Director of the Bank of Bhutan, and with the management of the Royal Insurance Corporation of Bhutan and the Unit Trust of Bhutan. The staff representatives were Messrs. Willem Evers (Head of Mission, ASD), Sukhdev Shah (ASD), Shigyo Kimura (ASD), and Mrs. Clara Eulate (ASD).

Bhutan avails itself of the transitional arrangements of Article XIV. Summaries of Bhutan's relations with the Fund and the IBRD are provided in Annexes I and II, and selected economic indicators in Annex III.

II. Background and Recent Economic Developments

The Bhutanese economy consists mostly of small subsistence communities. Agriculture and animal husbandry account for almost half of GDP and provide the main livelihood for about 95 percent of the population. The modern sector, which has grown rapidly in recent years, is based mainly on the processing of natural resources, the cultivation of a number of cash crops, and the provision of government services. The production of foodgrains has generally kept up with the rise in population, but imports have been increasing due to growing per capita consumption and, more recently, poor harvests. The economy is markedly dependent on India. Most of the Government's capital expenditure and about 35 percent of its current expenditure are financed with aid from that country. Total foreign aid receipts amount to about 50 percent of GDP, which is estimated at Nu 1.4 billion or \$150 million. By far the largest development project is the 336 mw. hydroelectric power plant at Chukha, which is financed with loans and grants from India; the plant is projected to start generating in 1985. Recently completed projects include a cement plant and a plywood factory. About 95 percent of foreign trade is with India, with which Bhutan maintains an open border. The Government has issued a small amount of ngultrum, the domestic currency, but the Indian rupee continues to be the principal medium of exchange. The ngultrum and the Indian rupee are exchanged on a one-to-one basis.

Due to a severe drought, which affected the rice crop as well as the cultivation of fruit and vegetables, the economy slowed down in 1982/83. 1/ Growth of real GDP fell to 1-2 percent from an average

1/ The fiscal year ends in March.

of 6 percent during the previous three years, despite a rebound in timber production, and continued expansion in industrial output. As the result of another spell of dry weather, the growth rate is expected to remain depressed in 1983/84.

The decline in agricultural output led to sharply higher prices for food items, which comprise about two thirds of consumer expenditure, and inflation rose from 9 percent in 1981/82 to 17 percent in 1982/83. The acceleration occurred despite a marked slowing of price increases of imported goods from India.

Government expenditures rose from the equivalent of 36 percent of GDP in 1981/82 to 38 percent in 1982/83, due to continued growth in development outlays and the granting of an 8-17 percent salary increase to civil servants (Table 1). However, foreign aid receipts rose more or less in line with the growth in development expenditure, and there was a substantial increase in revenue following the introduction of a 30 percent profit tax on eight public enterprises. ^{1/} Reflecting mainly a shift from grants to loans in the total amount of foreign assistance, the overall deficit rose from 2.4 percent of GDP in 1981/82 to 5.3 percent in 1982/83. A small part of the deficit was financed by borrowing from domestic nonbank financial institutions. Except for seasonal ways and means financing, the Government has continued to refrain from borrowing from the banking system to finance the budget deficit.

Consistent with a rise in net foreign assets, total liquidity rose by 18 percent during 1982 (Table 2). Domestic credit fell during the year as bank lending to public enterprises and the private sector was more than offset by a decline in net credit to the Government. In recent years, government deposits with the Bank of Bhutan, the only commercial bank, have been rising more or less in line with the growth of cash grants received from India. After the quarterly disbursement of these grants, government deposits may account for as much as 45 percent of deposit liabilities of the Bank of Bhutan. The liquidity position of the Bank has remained comfortable; at the end of 1982, its balances with the State Bank of India amounted to 85 percent of its total deposit liabilities. Interest rates follow closely those in India.

The balance of payments in 1982/83 was characterized by lower exports of cardamom and cement and a sharp increase in imports of food and equipment. Exports of cement fell because of its sharply higher use in the construction of the Chukha project. Although tourist

^{1/} These enterprises were the Bank of Bhutan, the Royal Insurance Corporation of Bhutan, the Unit Trust of Bhutan, the Penden Cement Authority, Government Workshops and Central Stores, the State Lottery, the Government Printing Shop, and the Tourism Commercial Organization.

Table 1. Bhutan: Summary of Government Budget ^{1/}

(In millions of ngultrum)

	1980/81 (Actual)	1981/82 (Provisional)	1982/83	1983/84 (Budget)
Revenue and grants	<u>321.2</u>	<u>408.0</u>	<u>476.0</u>	<u>588.7</u>
Revenue	<u>101.7</u>	<u>100.7</u>	<u>132.0</u>	<u>188.7</u>
Tax revenue	52.8	59.7	78.4	84.1
Royalties	10.5	5.0	12.2	17.3
Transfers from public enterprises	34.8	31.0	38.2	83.6
Other revenue	3.6	5.0	3.2	3.7
Grants	<u>219.5</u>	<u>307.3</u>	<u>344.0</u>	<u>400.0</u>
India	155.7	196.5	258.0	255.3
Other donors	63.8	110.8	86.0	144.7
Expenditures	<u>330.2</u>	<u>437.0</u>	<u>553.0</u>	<u>702.0</u>
Current	<u>169.5</u>	<u>170.0</u>	<u>208.0</u>	<u>209.0</u>
Of which: salaries	...	66.0	80.7	84.7
Development	160.7	267.0	345.0	493.0
Overall surpluses or deficit (-)	<u>-9.0</u>	<u>-29.0</u>	<u>-77.0</u>	<u>-113.3</u>
Financing				
External loans	--	29.0	71.0	103.3
Domestic nonbanks	9.0	--	6.0	10.0
<u>Memorandum items:</u>	<u>(As percentage of estimated GDP)</u>			
Revenue minus current expenditure	-6.6	-5.6	-5.3	-1.2
Total expenditure	-32.3	-35.9	-38.2	-40.4
Overall deficit	-0.9	-2.4	-5.3	-6.5
Foreign loans	--	2.4	4.9	6.0
Foreign loans and grants	21.5	27.6	28.7	29.0

Source: Data provided by the Bhutanese authorities.

^{1/} Fiscal year ends March 31. Budget accounts exclude receipts and expenditures for the construction of the Chukha hydroelectric power project, which is financed entirely with aid from India. Annual expenditures for the project, which is expected to be completed in 1985, average about Nu 200 million per year.

Table 2. Bhutan: Monetary Survey

(In millions of ngultrum)

	1980	1981	1982	1983 June
Net foreign assets	130.7	234.0	282.8	297.0
Rupée	89.1	168.5	196.3	226.2
Other	41.6	65.5	86.5	70.8
Domestic credit	23.1	-11.2	-33.9	-19.5
Government (net)	-79.5	-101.4	-160.5	-159.9
Public enterprises	51.6	35.5	45.7	47.3
Private sector	51.0	54.7	80.9	93.1
Total liquidity	155.0	202.1	239.5	275.7
Money	102.7	121.5	137.4	147.7
Ngultrum in circulation	3.1	6.1	12.2	16.7
Rupée in circulation	60.0	70.0	80.0	85.0
Demand deposits	39.6	45.4	45.2	46.0
Quasi-money	52.3	80.6	102.1	128.0
Other items (net) <u>1/</u>	1.2	-20.7	-9.4	-1.8

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

1/ Includes counter-entry for rupee in circulation.

receipts increased, the current account deficit rose from \$58 million in 1981/82 to \$71 million in 1982/83 (about 45 percent of GDP). Due to a rise in aid disbursements, the overall balance of payments registered a surplus of \$3.2 million, but, for the first time in five years, there was a small overall payments deficit of \$0.2 million with countries other than India. At the end of March 1983, gross foreign exchange reserves (including Indian rupees) amounted to the equivalent of \$31.9 million, or about seven months of imports. Convertible currency reserves amounted to \$7.3 million, or about seven months of imports from countries other than India. In addition to the loan from India for the Chukha project, Bhutan has contracted a \$7 million loan from the International Fund for Agricultural Development and a \$10 million loan from the Kuwait Fund for Arab Economic Development. Because of long grace periods, debt service payments on these loans are not expected to be a burden on the balance of payments in the near future. The loan received for the Chukha project (estimated at \$80 million) will be repaid over a period of 15 years following the completion of the project.

III. Report on the Discussions

The principal objectives of economic policy have been formulated in the Fifth Plan (1981-87), which was recently adopted after a full-scale review of the experience gained during the previous four Plans. Despite impressive accomplishments in road building, the establishment of other infrastructure, and the training of managers and administrators, this review brought to the fore a number of structural problems. Foremost among these were the continued reliance on foreign grants to finance a growing gap between domestic revenue and current expenditures, and the excessive centralization of government functions and responsibilities that had accompanied the development process. The authorities have become concerned that the traditional self-reliance of the Bhutanese people is giving way to dependence on the Government as a source of their livelihood and an arbiter of their interest. In order to address these issues, the Fifth Plan emphasizes domestic resource mobilization and decentralization of the development effort. Accordingly, about one quarter of total expenditure under the Plan will be devoted to projects that are prepared and implemented locally. With the exception of specialized inputs, local administrations will make available construction materials for development projects in their regions and arrange for voluntary labor. Despite additional demands for technical and managerial skills, both of which are in short supply, the first experiences with this new approach have been favorable, leading in many cases to a significant reduction in project costs.

With the already existing infrastructure, it will be possible to increase substantially investment in resource-based and export-oriented industries, particularly in hydropower, forestry, and minerals. These projects also have considerable scope for raising the Government's revenue base, which is consistent with the objective of the Plan to bring domestic revenues in line with current expenditures by 1986/87.

1. Production and investment policies

The Government aims at raising foodgrain production by 25 percent so as to achieve self-sufficiency in food by the end of the Plan period. Although a small extension of the area under cultivation is still feasible, further gains in output of foodgrains will depend largely on the success of yield-raising techniques. The authorities intend to bring 13,000 ha. (10 percent of cultivated land) under irrigation during the Plan period, and to promote the use of fertilizer, high variety seeds, and pesticides. In view of the dependence of production on weather conditions, not only in Bhutan but also in the adjoining parts of India, part of the increased output of foodgrains will be set aside as a security stock. The cultivation of fruits and vegetables will be promoted through the distribution of high quality seeds. The objective of industrial development is to maximize output and added value of resource-based and export-oriented industries, and, in order to supplement rural incomes, to promote traditional crafts and cottage industries. Major projects that might be completed during the Fifth Plan include a new cement plant with a capacity of 1,300 tons a day, a calcium carbide plant, a factory for high-density polythene pipes, and new mines for gypsum, graphite, and slate. The four existing industrial estates will be expanded and two new industrial estates will be established to facilitate in particular food processing and the application of improved technology to handicrafts.

The average annual growth targets of the Fifth Plan are 7.5 percent for the agricultural sector and 22 percent for industry and mining; GDP is estimated to grow by 8.5 percent per annum. The high growth rate projected for industry is in part due to the completion of the Chukha hydroelectric project, which is expected to raise electricity output more than two hundred times. The authorities indicated that the quantitative targets of the Plan are merely indicative of the direction in which the economy is to be developed; the targets do not constitute a quantitative framework for policy formulation. Investment decisions will be taken on the basis of technical and economic feasibility and the availability of domestic and external financing resources. Hence, despite the objective of attaining self-sufficiency in foodgrains, the subsidy on fertilizer use was recently removed because of the high cost in relation to potential benefits. However, the Government will continue to subsidize the transportation of fertilizer within Bhutan so that farmers can become familiar with its use.

Although the Government is committed to promoting the private sector, it also recognizes that the development of large-scale investment in natural resources is currently beyond the capability of private entrepreneurs. In addition, it is important that the exploitation of natural resources is carried out with minimum damage to the environment and with appropriate contributions to the public treasury. While no activity is reserved exclusively for the public sector, the Government reserves the right to own large-scale industries that require an initial

investment of over Nu 10 million. For these industries, the Government stands ready to enter joint ventures, providing technical and marketing assistance and up to 80 percent of the project cost. However, public ownership of these industries will be temporary; the Government intends to divest itself of its holdings of public enterprises as managerial capabilities in the private sector improve. Investments of less than Nu 10 million are eligible for concessional loans, technical training, and marketing assistance. A Companies Act will shortly be submitted to Parliament for the regulation and control of industrial and commercial undertakings. Although the Government welcomes foreign assistance from private entrepreneurs abroad, it does not envisage a major role for foreign direct investment or foreign equity participation. In the absence of a foreign investment code, proposals from foreign investors will be dealt with on a case-by-case basis.

2. Financial policies

Budget estimates for 1983/84 project total expenditures to grow at a somewhat faster rate than revenue and grants, with the overall deficit expected to increase from 5.3 to 6.5 percent of GDP. Revenue and grants are estimated to rise by 24 percent, about one-and-a-half times the rate of increase of the previous year, mainly because of higher profit transfers from public enterprises and, following the recent completion of a plywood factory, an increase in royalty payments from the forestry sector. An important part of the increase in profit transfers will be on account of the reorganization in 1982 of the state lottery, which is expected to result in a tripling of lottery sales in the Indian market. Tax revenue will benefit from the extension of the corporate profit tax to a number of additional enterprises, but the increase in total tax receipts is expected to be relatively modest. Total expenditures are budgeted to rise by 27 percent. The increase is almost exclusively due to outlays for development and reflects higher external assistance. Mainly because of the introduction of stricter expenditure control measures, including a mandatory 5 percent reduction in budgetary allocations of most departments, current expenditures are estimated to remain at about the same level as in 1982/83. The projected fiscal deficit of Nu 113 million will be financed with foreign and domestic nonbank borrowing; recourse to the banking system is expected to be limited to seasonal requirements.

Capital expenditures under the Fifth Plan have been projected at Nu 3,176 million, and available resources, including domestic borrowing, at Nu 1,841 million. The unfinanced gap of Nu 1,335 million is associated mainly with industrial and commercial projects for which feasibility studies have not yet been completed; foreign financing for these projects could become available once their technical and financial viability has been established. However, as the Government intends to provide about one third of the cost of these projects in the form of equity participation, the financing gap of the Plan would

still amount to Nu 310 million, even if all industrial and commercial undertakings received foreign financing for the remainder of the project cost.

Developments during the first three years of the Plan indicate that total capital expenditures might be 20 percent below the Plan targets. In addition, the Plan objective of matching current budget expenditures with domestic revenue by 1986/87 is likely to be met one year earlier because of profit transfers from the Chukha hydroelectric project. These profits, which were not included in the original revenue projections, are estimated at Nu 30 million in 1985/86 and Nu 120 million 1986/87. Because of these factors, the unfinanced gap of the Plan might be considerably less than the projected Nu 310 million. In addition, the authorities intend to postpone implementation of commercial industrial undertakings if adequate domestic or foreign financing cannot be secured.

The projected resources of the Plan include Nu 200 million of domestic borrowing. Part of this amount could be accommodated by non-bank financial institutions, but up to Nu 150 million may have to be borrowed from the Bank of Bhutan. Such borrowing could substantially reduce the Bank's holdings of Indian rupees with the State Bank of India (Nu 278 million in June 1983), particularly if credit demand of public enterprises and the private sector increases during the final years of the Plan. The authorities indicated that it would be their policy to limit government borrowing from the banking system in case the credit needs of the private sector could not be met or the holdings of Indian rupees fell below the equivalent of three months of nonaid imports.

During the remaining period of the Plan, government revenue is likely to benefit from substantial increases in receipts of royalties from the forestry sector, the extension of the corporate profit tax to more enterprises, and the reorganization of sales taxes and excise duties. Negotiations are also under way to increase the annual refund by India for the excise duties paid on exports to Bhutan. Despite a considerable rise in these exports, the refund has remained at Nu 25 million during the last several years.

An important element in the Government's efforts to raise public savings will be the control of current expenditure. Recommendations by the Civil Service Commission, which was established in 1982, have already led to a slowing in the growth of the number of civil servants and a better allocation of manpower in the public sector. The remuneration of civil servants includes payment by the Government of rent for the houses. These payments can amount to 200 percent of salary, in part because rents are based on depreciation charges calculated over the period of the mortgage, which is five years. The Civil Service Commission is considering a system of remuneration for civil servants that does not include the payment of rents. The introduction of such a system might have to be accompanied by rent guidelines during a

transitional period and by the adoption of longer mortgage periods by financial institutions. The program to privatize commercial undertakings of the Government, which was begun in 1982/83, is expected to lead to important budgetary savings. ^{1/} Where feasible these undertakings will be sold or leased to the private sector; others will be operated by the Government along commercial lines that will include the achievement of a minimum rate of return. Telephone services, several government workshops, and a tourist booking agency have recently been transferred to private management.

Since its establishment at the end of 1982, the Royal Monetary Authority (RMA) has assumed control of the Government's foreign exchange holdings and the holdings of unissued ngultrum notes. Although the RMA has started research in monetary and statistical subjects, it does not intend to assume an active policy role until an adequate institutional and operational framework has been developed and staff officers have been properly trained. The authorities intend to gradually substitute ngultrums for the Indian rupees that are currently in circulation, but no timetable for the substitution has been adopted. The rupees that will be received in exchange for ngultrum will be added to the foreign exchange reserves.

3. External policies

Despite a reduction in food imports and higher earnings from tourism and exports of cardamom, the deficit of the current account of the balance of payments is estimated to widen during both 1983/84 and 1984/85 (Table 3). The rise in the deficit will be mainly on account of higher imports of equipment for development projects. With foreign aid receipts declining, the overall balance of payments is expected to show a deficit in both years. The current account deficit is expected to narrow considerably after 1985. Following the completion of the Chukha project, exports of electricity are projected to add \$16 million and exports of cement \$3 million a year to total foreign exchange earnings.

Although Bhutan's foreign debt is still relatively small, this might change as financing of the development effort will increasingly be in the form of foreign loans from India as well as from other countries. Even if some of these loans are on concessional terms, the authorities intend to limit foreign loan financing to those projects that save foreign exchange either through additional exports or through import substitution. An important objective of the Plan is to raise export earnings in convertible currencies. Despite limitations imposed by Bhutan's geographical location, the small size of individual

^{1/} These undertakings include distribution of electricity, bus transportation, retail shops, work shops, tourist services (including hotels), industrial estates, farms, processing plants, leasing of agricultural equipment, printing shops, and handicraft centers.

Table 3. Bhutan: Balance of Payments

(In millions of U.S. dollars)

	1979/80	1980/81	1981/82	1982/83	1983/84 Est.	1984/85 Proj.
Trade balance	<u>-26.4</u>	<u>-32.3</u>	<u>-32.0</u>	<u>-41.8</u>	<u>-46.8</u>	<u>-47.2</u>
India	<u>-24.7</u>	<u>-29.1</u>	<u>-26.1</u>	<u>-29.0</u>	<u>-34.0</u>	<u>-35.0</u>
Other countries	<u>-1.7</u>	<u>-3.2</u>	<u>-5.9</u>	<u>-12.8</u>	<u>-12.8</u>	<u>-12.2</u>
Exports, f.o.b.	<u>16.5</u>	<u>16.7</u>	<u>20.9</u>	<u>16.7</u>	<u>18.8</u>	<u>20.9</u>
India	<u>15.9</u>	<u>16.5</u>	<u>20.2</u>	<u>16.2</u>	<u>18.0</u>	<u>20.0</u>
Other countries	<u>0.6</u>	<u>0.2</u>	<u>0.7</u>	<u>0.5</u>	<u>0.8</u>	<u>0.9</u>
Imports, c.i.f.	<u>-42.9</u>	<u>-49.0</u>	<u>-52.9</u>	<u>-58.5</u>	<u>-65.6</u>	<u>-68.1</u>
India	<u>-40.6</u>	<u>-45.6</u>	<u>-46.3</u>	<u>-45.2</u>	<u>-52.0</u>	<u>-55.0</u>
Other countries	<u>-2.3</u>	<u>-3.4</u>	<u>-6.6</u>	<u>-13.3</u>	<u>-13.6</u>	<u>-13.1</u>
Services and transfers	<u>-16.0</u>	<u>-18.0</u>	<u>-25.7</u>	<u>-29.5</u>	<u>-29.1</u>	<u>-29.9</u>
India	<u>-12.5</u>	<u>-14.7</u>	<u>-17.0</u>	<u>-19.6</u>	<u>-16.3</u>	<u>-16.0</u>
Other countries	<u>-3.5</u>	<u>-3.3</u>	<u>-8.7</u>	<u>-9.9</u>	<u>-12.8</u>	<u>-13.9</u>
Of which:						
Tourist receipts	(1.3)	(1.4)	(0.9)	(1.4)	(1.6)	(1.7)
Current account	<u>-42.4</u>	<u>-50.3</u>	<u>-57.7</u>	<u>-71.3</u>	<u>-75.9</u>	<u>-77.1</u>
India	<u>-37.2</u>	<u>-43.8</u>	<u>-43.2</u>	<u>-48.6</u>	<u>-50.3</u>	<u>-51.0</u>
Other countries	<u>-5.2</u>	<u>-6.5</u>	<u>-14.5</u>	<u>-22.7</u>	<u>-25.6</u>	<u>-26.1</u>
Capital and official transfers	<u>41.3</u>	<u>46.9</u>	<u>62.6</u>	<u>77.2</u>	<u>69.5</u>	<u>70.0</u>
India	<u>34.8</u>	<u>41.3</u>	<u>48.9</u>	<u>58.0</u>	<u>45.5</u>	<u>44.0</u>
Other countries	<u>7.5</u>	<u>7.1</u>	<u>15.7</u>	<u>20.2</u>	<u>25.0</u>	<u>27.0</u>
Increase in rupee circulation (-)	<u>-1.0</u>	<u>-1.5</u>	<u>-2.0</u>	<u>-1.0</u>	<u>-1.0</u>	<u>-1.0</u>
Overall balance	<u>-0.2</u>	<u>5.8</u>	<u>4.0</u>	<u>3.2</u>	<u>-5.4</u>	<u>-6.1</u>
India	<u>-1.3</u>	<u>3.5</u>	<u>2.0</u>	<u>3.4</u>	<u>-4.8</u>	<u>-7.0</u>
Other countries	<u>1.1</u>	<u>2.3</u>	<u>2.0</u>	<u>-0.2</u>	<u>-0.6</u>	<u>0.9</u>

Sources: Based on data provided by the Bhutanese authorities, and staff estimates.

shipments, and as yet insufficient knowledge about foreign markets, the authorities believe that prospects exist for convertible currency exports of high quality veneers and some processed food items.

The exchange and trade system is basically liberal in that there are no restrictions of any kind on transactions in Indian rupees. Payments and transfers in other currencies require authorization by the Ministry of Finance which uses its discretionary authority to approve or deny requests for foreign exchange. Most requests for convertible foreign exchange originate from other government departments. The authorities intend to transfer the exchange control authority to the Royal Monetary Authority and to formalize the controls with official regulations. The regulations, which are not intended to intensify restrictions, will include a provision requiring the registration of capital inflows.

IV. Staff Appraisal

Following several years of relatively high growth rates, economic performance in 1982/83 was marked by a severe drought which affected production of foodgrains and a number of export crops. Despite a rebound in timber production and continued expansion of the industrial sector, real GDP increased only marginally. Inflation accelerated largely because of tighter food supplies. The introduction of a corporate profit tax was a welcome development in the mobilization of domestic resources. Budget expenditures rose rapidly, but, except for seasonal financing, the Government has continued to refrain from borrowing from the banking system. Although a fall in exports and higher imports of rice and equipment contributed to a widening of the deficit of the current account, the overall balance of payments remained in surplus. Prospects for a resumption of growth in 1983/84 have been limited by another spell of dry weather.

In order to counter recent trends toward centralization of functions and responsibilities, the Government has made self-reliance, participation by the people, and decentralization of the development effort important objectives in its overall development strategy. Although these objectives will not be easy to achieve and the decentralization of the development effort in particular may tend to exacerbate existing shortages of qualified personnel, the staff believes that they will serve Bhutan well in the long term by improving efficiency and limiting the burdens on the budget.

Notwithstanding increases in revenues and foreign grants, the overall budget deficit has been on a rising trend in recent years. The main factors have been substantial increases in development expenditures and, in 1982/83 in current outlays. While in the past the overall budget deficits were covered by foreign loans, the further large increase in the development effort envisaged during the remaining period of the Plan will necessitate borrowing from the banking system.

The staff considers that such borrowing must be circumscribed by the need to meet the credit requirements of other sectors of the economy and to maintain an adequate level of reserves. It is therefore important that steps be taken to limit the overall deficit to prudent levels. In this regard, the Government's readiness to postpone projects for which adequate financing has not been arranged is appropriate; moreover, procedures should be implemented soon to carefully assess both the feasibility and efficiency of the public investment program on a continuing basis. It is also important that measures to mobilize additional resources be devised and implemented; this is particularly so because the large public development effort must be accompanied by sufficient resources for the proper operation and maintenance of completed projects.

An important goal of the Government is to raise domestic revenues so that by the end of the Fifth Plan, they will fully cover current expenditure. Although this objective may be achieved well ahead of schedule due in part to the revenues that will accrue from the sale of electricity following the completion of the Chukha project, uncertainties remain regarding the availability of adequate resources to finance the development effort. This points therefore to the need for no longer delaying the reorganization of the tax system. The staff welcomes the fact that after the large increase in current outlays in 1982/83, no further increase has been budgeted for the current year. In view of the pressing development needs of the country, continued restraint on current expenditures will remain necessary. In this context, the staff welcomes the authorities' intention to put in place a more rational system of remuneration of civil servants. The further privatization of the commercial functions of the Government will improve operational efficiency and reduce the need for government subsidies. There is also a need for devising efficient monitoring and control procedures for current outlays.

Although the importance of the private sector in the development effort appears limited, the Government intends to give it a more expanded role as management capabilities develop by, among other things, permitting greater equity participation in public enterprises. In view of Bhutan's relative lack of experience in commercial and industrial undertakings, the Government's decision not to institute firm rules for private foreign investments, but to consider each case on its own merits, is a pragmatic one. However, whenever possible the Government should continue its policy of attracting foreign expertise in management, technology, and marketing.

Although not yet an immediate burden on the balance of payments, foreign debt service payments, particularly those in convertible currencies, may rise rapidly during the final years of the 1980s. It is therefore important that the Government manage its external borrowing with prudence and strengthen its efforts to increase earnings in convertible currencies by promoting tourism and providing marketing and other assistance to exporters.

The authorities are considering the formalization of existing discretionary controls on payments and transfers in currencies other than the Indian rupee by the introduction of official regulations. The staff notes that it is not the intention to intensify the restrictiveness of the exchange system, and urges the authorities to ensure that an intensification of restrictions does not, in effect, occur.

As the overall economic situation does not pose any immediate problems, the staff believes, and the authorities agree, that the next Article IV consultation can be held on an 18-month cycle.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Bhutan, in the light of the 1983 Article IV consultation with Bhutan conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions, as described in SM/83/229, are maintained by Bhutan in accordance with Article XIV. The Fund encourages the authorities to administer these restrictions in a liberal manner.

Bhutan: Relations with the Fund
(As of September 30, 1983)

Date of membership: September 28, 1981

Status: Article XIV

Quota: SDR 1.7 million (proposed quota
SDR 2.5 million)

Reserve position in the Fund: SDR 369,900

Use of Fund resources: None

Fund holdings of ngultrum: SDR 1.33 million or 78.3 percent
of quota.

SDR position: Bhutan is a participant, but has
received no allocations. Present
holdings are SDR 16,477.

Exchange rate arrangements: Since its introduction in 1974,
the ngultrum has been pegged to
the Indian rupee at a rate of
Nu 1 = Re 1.

Technical assistance: Technical assistance was provided
in setting up the Royal Monetary
Authority of Bhutan, which came
into operation in April 1983. Two
FAD missions have visited Bhutan--
one in April 1982 and the other in
June-July 1983--to provide assis-
tance on tax policy, budgeting, and
accounting. Bhutan has requested
further technical assistance in
these areas. Two technical experts
from the CBD panel are currently
working for the Royal Monetary
Authority of Bhutan.

Bhutan: Relations with the World Bank
(As of September 30, 1983)

Bhutan joined the World Bank in September 1981, but it is not yet a member of IFC. An IDA credit of \$3 million to finance technical assistance for the evaluation of new projects was negotiated in June 1983. The Bank also is considering financing projects in forestry, education, and the industrial sector.

Article XIX
SDR 1.7 million (proposed quota)
SDR 5.7 million (proposed quota)

Reserve position in the Fund: SDR 2.7 million

Use of Fund resources: None

Fund holdings of ngultrum: SDR 1.37 million or 78.3 percent of quota.

SDR position: Bhutan is a participant, but has received no allocations. Present holdings are SDR 16,477.

Exchange rate arrangements: Since the introduction in 1974, the ngultrum has been pegged to the Indian rupee at a rate of Nu 1 = Re 1.

Technical assistance: Technical assistance was provided in setting up the Royal Monetary Authority of Bhutan, which came into operation in April 1983. Two PAD missions have visited Bhutan--one in April 1982 and the other in June-July 1983--to provide assistance on tax policy, budgeting, and accounting. Bhutan has requested further technical assistance in these areas. Two technical experts from the CBD panel are currently working for the Royal Monetary Authority of Bhutan.

Bhutan: Basic Data

Area:	46,500 square kilometers
Population:	1.2 million
GDP (1982/83):	\$150 million
GDP per capita	\$125

	<u>1979/80</u>	<u>1980/81</u>	<u>1981/82</u>	<u>1982/83</u>
	(Annual rate of increase in percent)			
<u>Output and prices</u>				
Real GDP	4.3	5.2	8.8	1.4
Consumer prices	14.9	11.1	9.5	17.4

	(In millions of ngultrum)			
<u>Budget</u>				
Revenue and grants	307.1	321.2	408.0	476.0
Total expenditure	325.6	330.2	437.0	553.0
Overall balance (deficit -)	-18.5	-9.0	-29.0	-77.0
<u>Money and credit 2/</u>				
Net foreign assets	145.3	130.7	234.0	282.8
Domestic credit	-30.8	23.1	-11.2	-33.9
Total liquidity	139.1	155.0	202.1	239.5

	(In millions of U.S. dollars)			
<u>Overall balance of payments</u>				
Exports, f.o.b.	16.5	16.7	20.9	16.7
Imports, c.i.f.	-42.9	-49.0	-52.9	-58.5
Current account balance	-42.4	-50.3	-57.7	-71.3
Overall balance	-0.2	5.8	4.0	3.2

<u>Balance of payments with countries other than India</u>				
Exports, f.o.b.	0.6	0.2	0.7	0.5
Imports, c.i.f.	-2.3	-3.4	-6.6	-13.3
Current account balance	-5.2	-6.5	-14.5	-22.7
Overall balance	-1.1	2.3	2.0	-0.2
<u>Reserves and external debt</u>				
Gross foreign exchange reserves (end-period)	19.1	26.1	29.0	31.9
(In months of imports)	(5.3)	(6.4)	(5.9)	(6.7)
External public debt (end-period) 3/	--	--	3.3	10.6

	(In percent)			
<u>Selected ratios to GDP</u>				
Deficit on the current account of the balance of payments	-39.3	-38.9	-42.6	-47.5
Budget deficit	-2.1	-0.9	-2.4	-5.3

1/ Fiscal year ends March 31.

2/ As of December 31.

3/ In convertible currencies.

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