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Correction 1

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INFORMATION

August 1, 1985

To: Members of the Executive Board
From: The Secretary
Subject: Bhutan - Staff Report for the 1985 Article IV Consultation

An incorrect earlier version of Section VI was inadvertently included in SM/85/216 (7/31/85). Corrected pages 13 and 14 are attached.

Att: (2)

Other Distribution:
Department Heads

VI. Staff Appraisal

Data are limited, but the Bhutanese economy would appear to have performed satisfactorily in recent years. Real growth has averaged some 5 percent. Inflation has been roughly in line with that of Bhutan's dominant financial partner, India, and the overall balances on external account have registered surpluses. The exchange rate policy, based on the maintenance of parity between the ngultrum and the rupee, would seem appropriate to current circumstances, as is the continuation of a gradual approach to the substitution of ngultrum for rupees in circulation.

Financial policies were described at the time of the last Executive Board discussion as both cautious and pragmatic. This assessment remains appropriate for policies pursued since then. The reluctance of the Government to borrow in recent years is reflected both in the low debt service ratio for external loans at present and the small size of the domestic financing requirement. Even this requirement may, in the event, have been overstated, as banking statistics suggest that actual expenditures have fallen short of appropriations. Liquidity growth has been associated with a rise in foreign assets, while credit to the private sector has virtually stagnated.

The Government is to be commended on its efforts to strengthen internally-generated revenues, most recently through improvements in tax administration, in its effort to reduce reliance on external assistance. In this connection, the staff notes the manpower constraint, which is also prevalent in government circles, as well as the multi-tiered sales tax structure and the lack of precision in the definition of net profits. The effectiveness of administrative reforms would be greatly enhanced by a simplification of the current tax system. Even after making allowance for grants or revenues from abroad, the staff believes that expenditures must be monitored carefully lest a sudden rise in the demand for domestic services, in an economy characterized by labor shortage and a low supply response, be reflected in inflationary pressures.

The staff concurs with the view of the authorities that the primary constraint on growth lies in the scarcity and the low skill level of the indigenous labor force. The staff would stress the importance of increasing labor productivity in agriculture. The intention of the authorities to establish agricultural marketing centers throughout the country is to be welcomed. Consideration might be given to a more active policy of support prices to encourage steady supply, while the adequacy of the network of agricultural extension workers should be reviewed. On the financial side, the current system of rural credit should find support from the banking system; the branch network of the banks should be expanded, not only to mobilize savings, but also to make the banking community more responsive to the credit needs of the agricultural sector. The banking community should be urged to seek more

actively economically justified demands for agricultural credit. The preferential interest rate currently accorded agriculture might usefully be reviewed to see whether it might pose a deterrent to the availability of agricultural credit.

The authorities have again expressed interest in diversifying their export commodities and export markets, and concern about the expected rise in the debt service ratio in convertible currencies. The staff shares this concern. In the staff's view, more active measures to encourage exports are necessary if imports conducive to growth are not to be constrained. The promotion of merchandise exports is all the more necessary, given the time lags involved and the Government's reluctance to actively promote tourism. A number of agricultural commodities with high value added have been identified by the authorities for export to third countries, but as noted, availability of credit and adequate financial incentives--including marketing centers-- will be necessary to encourage the growth of exportable surpluses. The authorities will also have to play an active role in identifying potential industrial exports and encouraging their production. The external debt servicing burden arising from the financing of such projects must also be reviewed against the magnitude and timing of the expected stream of export earnings available for debt servicing.

Requests for foreign exchange for the import of goods and services from third countries are approved on a case-by-case basis but the authorities have explained that this system is managed in a liberal manner. The staff urges that no intensification in restrictions be introduced.

While there do not appear to be any immediate problems of internal or external imbalance, there is nonetheless an urgent need to establish a reliable monitoring system for the development of key economic indicators. Should difficulties emerge, such information would be essential to establish the magnitude of the problem and to design an appropriate policy response. Further, a monitoring system would provide evidence that the policies supported by the authorities were being implemented effectively.

It is proposed that Bhutan remain on an 18-month consultation cycle, but that the next consultation be concluded not later than January 1987.