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SM/85/216

Correction 2

CONTAINS CONFIDENTIAL
INFORMATION

September 4, 1985

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

The following corrections have been made in SM/85/216 (7/31/85):

Page 2, para. 3, lines 6 and 7: for "the overall...instance."
read "the corresponding...of GDP."

Page 16, under Balance of
payments, column 4, last two lines: for "12.4" and "(5.8)"
read "7.6" and "(1.0)"

Corrected pages are attached.

Att: (2)

Other Distribution:
Department Heads

I. Introduction

Article IV consultation discussions were held with the Bhutanese authorities in Thimphu during the period June 4-18, 1985. The staff team comprised D. Ripley (Head of mission), R. Hides, A. Salehizadeh, and R. Kibria (EP), with J. Ranasinghe as secretary (all ASD). The mission met with Dasho Dorji Tshering, Deputy Minister of Finance; Dasho Lam Penjor, Deputy Minister of Planning; Mr. Yeshey Zimba, Managing Director, Royal Monetary Authority; and with senior officials of other Government ministries and enterprises. Bhutan continues to avail itself of the transitional arrangements of Article XIV.

The last consultation discussions took place in August 1983, and the Staff Report (SM/83/228) was discussed by the Executive Board on November 28, 1983 (EBM/83/151). At that time Executive Directors welcomed the authorities' prudent financial policies. Their willingness to postpone investment projects until satisfactory financing could be secured, coupled with restraint in government reliance on bank credit, were commended. Directors also commented favorably on the importance given to promoting the decentralization of the development effort and to encouraging the growth of the private sector. The caution of the authorities in contracting external debt found broad support, while the authorities' awareness of the need to follow a more active export promotion policy to nontraditional markets was noted.

II. The Setting

Bhutan is a small, sparsely populated and landlocked country. Arable land accounts for only 3 percent of the land surface. Agriculture, including animal husbandry and forestry, accounts for more than 50 percent of GDP and involves 90 percent of the population. The skill level and availability of indigenous labor pose a constraint on economic growth. The forest cover provides an important natural resource, but its exploitation is constrained, inter alia, by environmental considerations and very limited infrastructure. The mountainous terrain lends itself to hydroelectric generation, but until the coming onstream of the Chukha hydroelectric project, now scheduled for 1986, interruptions in the power supply will continue to pose major problems for the growth of industry. Domestic transportation costs are high, and at present trade with countries other than India typically involves overland transport to and from Calcutta. ^{1/} Alternative export routes to third countries, both by land and water through Bangladesh, have been established, but the necessary infrastructure to make the routes operational has yet to be put in place.

^{1/} A land transit route to Nepal has been agreed, and some exports to Nepal have been effected using this route.

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Close ties exist between the Bhutanese and Indian economies. There is assured and free convertibility at parity between the ngultrum and the rupee, while the rupee accounts for some 65 percent of currency in circulation. Some 90 percent of Bhutan's total trade is with India, and Indian external assistance has financed most of Bhutan's development effort since its inception in the early 1960s. Other external assistance, primarily from the U.N. system, and associated with it, trade with third countries, are increasing markedly, but are still small in absolute terms.

III. Recent Economic Developments

Real GDP is estimated to have increased by over 5 percent per annum since the beginning of the Fifth Plan in 1981/82, 1/ (Chart 1 and Annex I). The authorities estimated that GDP per capita is now about \$250, though this figure is still highly tentative, and is likely to be revised following the completion of a project to compile national accounts statistics. 2/ Real growth of agricultural output has averaged 3-4 percent per annum. Though increases in industry and services have been fairly buoyant, with the coming onstream of several medium-size projects and the increasing monetization of the economy, they have bolstered only modestly the overall rate of growth because of their small sectoral base. Consumer prices were estimated to have risen by roughly 10 percent per annum over the last five years, broadly in line with price developments in India; though the recorded rate of inflation had slowed to 7 percent in 1984/85, price pressures were expected to intensify somewhat in the coming months, if only because of a recent increase in public sector wages.

Bhutan's overall balances on external account, with India and with third countries, have typically been in significant surplus: concessional loans and grants have exceeded the current account deficits. Thus, for 1984/85 the current account deficits with India and with third countries were estimated at 25 percent and 3 percent of GDP, respectively, and the corresponding overall surpluses at 1/2 percent and 2 percent of GDP. The rise in reserve holdings was particularly marked in the two years to 1984/85, amounting to some \$6 1/2 million per annum. Convertible currency reserves, held largely in U.S. dollars, now account for one third of total reserves, and are equivalent to 20 months of merchandise imports from the convertible currency area. Total reserves amount to eight months of imports.

About 60 percent of total imports of goods and services are tied to external assistance. Merchandise imports have grown broadly in line with nominal GDP, and their share in GDP has remained stable at about

1/ Fiscal year, April 1-March 31.

2/ Section IV.4 and Annex IV review the difficulties of the statistical base in Bhutan.

VII. Proposed Decision

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

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Bhutan, in the light of the 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/85/ , are maintained by Bhutan in accordance with Article XIV and are not subject to approval under Article VIII. The Fund encourages the authorities to administer these restrictions in a liberal manner.

Bhutan: Basic Data 1/

Area:	46,500 square kilometers
Population (mid-1982):	1.2 million
GDP (1984/85):	US\$300 million
GDP per capita (1984/85):	US\$250

	1981/82	1982/83	1983/84	1984/85	1985/86 Proj.
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(Changes in percent)

<u>GDP and prices</u>					
Real GDP	5.9	2.2	6.5	6.7	7.0
Consumer prices	8.3	8.6	13.2	7.3	9.0

(In millions of ngultrum)

<u>Government budget 2/</u>					
Revenue and grants	425.4	527.9	599.3	736.3	762.2
Domestic revenue	(124.0)	(137.6)	(225.2)	(278.7)	(274.4)
Foreign grants	(301.4)	(390.3)	(374.1)	(457.6)	(487.8)
Total expenditure	436.1	553.9	630.7	724.6	861.3
Current expenditure	(169.0)	(208.9)	(215.6)	(247.6)	(281.3)
Capital expenditure	(267.1)	(345.0)	(415.1)	(477.0)	(580.0)
Overall balance	-10.7	-26.0	-31.4	11.7	-99.1
External financing	(4.5)	(8.9)	(6.7)	(14.9)	(102.0)
Other	(6.3)	(17.1)	(24.7)	(-26.6)	(-2.9)

Money and credit 3/

Net foreign assets	311.9	372.3	435.7	570.2	...
Domestic credit	-17.9	-65.3	37.1	20.8	...
Net credit to Government	(-101.4)	(-160.5)	(-63.3)	(-78.3)	...
Total liquidity	202.1	239.5	340.7	422.3	...

(In millions of U.S. dollars)

<u>Balance of payments</u>					
Exports, f.o.b.	19.2	16.6	15.6	15.1	15.7
To India	(18.6)	(16.3)	(15.2)	(14.6)	(15.2)
Imports, c.i.f.	-65.6	-67.2	-80.4	-69.4	-71.8
From India	(-58.3)	(-56.8)	(-67.3)	(-61.0)	(-60.7)
Current account balance 4/	-75.6	-87.3	-101.1	-82.2	-80.0
With India	(-64.9)	(-73.0)	(-85.4)	(-73.0)	(-65.2)
Capital and official transfers	72.4	91.2	89.9	77.0	70.1
From India	(60.3)	(76.5)	(77.7)	(67.1)	(53.9)
Overall balance	4.0	4.6	9.0	7.6	1.3
With India	(2.0)	(4.8)	(6.7)	(1.0)	(-)

Reserves, external debt
and exchange rate

Gross foreign exchange reserves (end of period)	29.0	31.9	38.4	45.1	...
Rupee reserves	(21.5)	(24.6)	(29.2)	(30.8)	...
Total reserves in months of imports	5.6	5.9	6.0	8.1	...
External public debt (end of period)	0.3	1.3	1.9	3.1	11.3
Debt service ratio (in percent)	--	--	1.4	1.6	4.7
Exchange rate 5/ (Nu/SDR)	10.293	10.523	10.912	11.924	...
(Nu/US\$)	8.929	9.628	10.312	11.887	...

(In percent)

<u>Selected ratios to GDP</u>					
Government domestic revenue	5.4	5.3	7.2	7.8	6.6
Total government expenditure	18.9	21.3	20.2	20.3	20.7
Overall budget balance	-0.5	-1.0	-1.0	0.3	-2.4
Total liquidity	8.8	9.2	10.9	11.8	...
Exports	7.4	6.1	5.1	5.0	4.6
Imports	25.4	24.9	26.5	23.1	21.1
Current account balance	-29.3	-32.4	-31.3	-27.4	-23.5

1/ Data relate to fiscal years ending March 31, unless otherwise indicated. Most of these figures are staff estimates based on limited information, and it is not possible to reconcile a number of inconsistencies in the monetary, fiscal, and balance of payments accounts.

2/ Revenues and expenditures associated with the Chukha Project are not reflected in the budgetary accounts, nor are certain other expenditures financed by the Indian Government. The unidentified financing item "other" is thought to reflect misclassifications of revenues and expenditures rather than domestic financing.

3/ Data relate to end-December 1981, 1982, 1983, and 1984, respectively.

4/ Goods, services, and private transfers.

5/ Period averages.