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November 22, 1991

To: Members of the Executive Board

From: *The Secretary*

Subject: Bhutan - Staff Report for the 1991 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1991 Article IV consultation with Bhutan, which is tentatively scheduled for discussion on Monday, December 23, 1991. A draft decision appears on page 17.

Mr. Schulz (ext. 7342) or Mr. Gunjal (ext. 7888) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

BHUTAN

Staff Report for the 1991 Article IV Consultation

Prepared by the Central Asia Department

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

Approved by Mr. Y. Horiguchi and S. Kanesa-Thanan

November 21, 1991

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I. Introduction

The 1991 Article IV consultation discussions with Bhutan were held in Thimphu during August 20-September 3, 1991. 1/ The mission met with Mr. Lyonpo C. Dorji, Minister of Planning; Mr. Lyonpo D. Tshering, Minister of Finance; Mr. Bap Kesang, Managing Director of the Royal Monetary Authority of Bhutan (RMA); and other senior government officials. Bhutan has been placed on the bicyclic consultation procedure, and interim Article IV consultation discussions were held in August 1990. The previous discussions for the Article IV consultation with Bhutan took place in September 1989, and the staff report (SM/89/236) was discussed at the Executive Board on December 15, 1989 (EBM/89/164).

Bhutan joined the Fund in 1981 and avails itself of the transitional arrangements under the provisions of Article XIV, Section 2.

Bhutan, a small landlocked country with a population of over half a million, 2/ is situated in the eastern Himalayan ranges wedged between India and China. Partly reflecting its geographic location, Bhutan's economy has maintained close links with India. Its interlinkages stem from Bhutan's currency arrangement under which the Indian rupee is permitted to circulate freely and at par with the Bhutanese ngultrum (Nu). Also, a trade agreement allows goods to move freely between the two countries (83 percent of total imports originated in India and 90 percent of exports were sold in India in 1990/91). In addition, grants from India have financed a substantial, albeit declining, proportion of government budgetary expenditures (25 percent of total expenditures in 1990/91). 3/ Indian nationals make up much of Bhutan's foreign labor force. Imports from third countries are tightly regulated by quantitative restrictions and are small compared to grants and concessional loans from such countries aimed at facilitating the development effort in Bhutan. As a result, there has been a large buildup of convertible foreign currency reserves over time. An important consequence of the differences in the trade regimes is that excessive growth in domestic demand in Bhutan tends to leak into imports from India. 4/

Bhutan has adopted a development strategy that is primarily oriented toward the home market and the highly protected Indian market, relying heavily on direct government controls in many areas of economic activity.

1/ The mission comprised Messrs. Schulz (Head), Gunjal, Khan (all CTA), Mr. Wang Jun (SEA), and Miss Singh (Staff Assistant, SEA).

2/ The Government has officially announced that Bhutan's de jure population is 600,000. De facto, the population is larger because it includes a substantial number of nonnationals.

3/ Bhutan's fiscal year runs from July 1 to June 30.

4/ It may be noted that, through its effect on liquidity and domestic demand, the increase in convertible foreign currency reserves, unsterilized, has been from time to time a major factor behind downward pressure on Indian rupee reserves.

The Government has exercised these controls as a dominant entrepreneur in the industrial and service sectors and through detailed bureaucratic controls over economic activity. This strategy has led to substantial price distortions.

II. Economic Background

From the early 1980s through a few years ago, the Bhutanese economy generally experienced high growth, moderate inflation, and rising external reserves (Table 1 and Chart 1). Not only was the external environment favorable during this period but the stance of domestic financial policies was restrained. The first signs of macroeconomic instability emerged in the fiscal year 1988/89 when slower growth in output 1/ met with a strong rise in demand, fueled mainly by expansionary fiscal and monetary policies. These adverse trends were exacerbated in 1989/90 when a large bank-financed budget deficit, combined with strong growth in bank credit to the private sector, contributed to a rapid depletion of the Indian rupee reserves (to three months' imports of goods and services from India from earlier levels of about six months' import cover).

In its appraisal for the staff report on the 1990 interim Article IV consultation discussions (SM/90/197, 10/16/90), the staff noted improvement on the growth and inflation fronts in 1989/90, but voiced concern about a weakening in the external position and urged the authorities to tighten financial policies. Toward that end, the staff reiterated Directors' earlier call for current expenditure restraint and a strict limit on monetary financing of the fiscal deficit. The staff also supported structural initiatives, with particular emphasis on privatization of public enterprises.

The expansionary fiscal developments of the previous two years were reversed somewhat in 1990/91 as the deficit was reduced to 3 percent of GDP from the average of about 11 percent of GDP (Table 2 and Chart 2). However, liquidity continued to grow rapidly mainly due to a large transfer of unrealized foreign exchange profits from the Royal Monetary Authority of Bhutan (RMA) to the Government (Table 3 and Chart 3). The continued expansion in domestic demand in the face of a slowdown in output growth as a result of the fallout of events in the Gulf war and the outbreak of law and order problems in the south of Bhutan was reflected in the widening of the external current account deficit vis-à-vis India. Despite substantially higher inflows of grants from India, rupee reserves fell to about 1 1/2 months of imports. The external current account vis-à-vis third countries remained in deficit in 1990/91 at about the same level as in the previous year. Convertible currency reserves, however, continued to grow, exceeding \$77 million by June 1991, owing to sustained aid inflows from

1/ Mainly reflecting the completion of large public sector projects financed mainly by grants from abroad.

Table 1. Bhutan: Economic Trends, 1980/81-1991/92 ^{1/}

(Period averages; changes in percent)

	1980/81- 1986/87	1987/88	1988/89	1989/90	Est. 1990/91	Proj. 1991/92
Real GDP	7.3	17.8	1.0	5.0	3.1	3.0
Of which:						
Agriculture and forestry	6.0	5.1	1.5	2.5	2.7	2.8
Manufacturing and mining	14.2	35.8	2.1	15.9	11.7	11.5
Electricity	19.1	279.1	-1.7	2.8	0.6	1.5
Overall budgetary balance/GDP	-17.2 ^{2/}	-1.8	-12.8	-9.0	-3.0	-0.6
Total liquidity ^{3/}	25.4 ^{4/}	6.0	36.5	26.4	29.8	16.6
Consumer prices (end of period)	9.0	4.8	10.5	9.1	10.7	10.0
Merchandise exports/GDP	<u>11.4</u>	<u>19.0</u>	<u>25.1</u>	<u>26.4</u>	<u>26.2</u>	<u>26.6</u>
India	11.2	18.8	23.9	23.8	23.5	23.2
Third countries	0.2	0.3	1.2	2.7	2.7	3.4
Current account/GDP	<u>-44.9</u>	<u>-19.4</u>	<u>-25.8</u>	<u>-11.6</u>	<u>-13.6</u>	<u>-19.1</u>
India	-35.0	-11.9	-9.4	-8.2	-10.2	-7.0
Third countries	-9.9	-7.5	-16.4	-3.5	-3.4	-6.1
Gross international reserves (US\$ mn., end of period)	62.6	89.1	97.1	88.9	88.9	100.5
External debt/GDP	...	37.2	48.0	49.0	44.8	35.2
Debt service ratio ^{5/}	...	18.0	18.9	30.1	22.9	31.2

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

^{1/} Fiscal year data, except for data for GDP and consumer prices which are on a calendar year basis, and for total liquidity, which are end-December data through 1987.

^{2/} Covers the period 1981/82-1986/87.

^{3/} End period; changes in percent.

^{4/} 1982-86.

^{5/} Convertible currencies.

Table 2. Bhutan: Government Budget Summary, 1986/87-1991/92 ^{1/}

	1986/87	1987/88		1988/89	1989/90	1990/91		1991/92
		Actual	Est. Annualized			Budget	Actual	Budget
(In millions of ngultrum)								
Revenue and grants	<u>1,122</u>	<u>1,772</u>	<u>1,417</u>	<u>1,596</u>	<u>1,476</u>	<u>1,975</u>	<u>2,061</u>	<u>1,804</u>
Domestic revenue	<u>345</u>	<u>842</u>	<u>673</u>	<u>805</u>	<u>953</u>	<u>1,067</u>	<u>1,020</u>	<u>1,142</u>
Tax revenue	174	236	189	232	232	251	251	282
Nontax revenue	171	606	485	573	721	816	769	860
Of which: Chukha revenue	23	297	238	254	277	390	401	384
Sales of shares	--	--	--	--	53	44	18	6
Grants	<u>777</u>	<u>930</u>	<u>744</u>	<u>791</u>	<u>523</u>	<u>908</u>	<u>1,041</u>	<u>662</u>
From India	481	709	567	564	290	441	566	214
Other	296	221	177	227	233	467	475	448
Expenditure	<u>1,356</u>	<u>1,856</u>	<u>1,484</u>	<u>2,128</u>	<u>1,895</u>	<u>2,086</u>	<u>2,220</u>	<u>1,840</u>
Current expenditure	423	774	619	909	1,069	1,094	1,165	1,028
Capital expenditure and net lending	933	1,082	865	1,219	826	992	1,055	812
Capital expenditure	798	848	678	1,086 ^{3/}	778	1,135	1,056	795
Net lending ^{2/}	135	234	187	133	48	-143	-1	17
Current balance (excluding grants)	<u>-78</u>	<u>68</u>	<u>54</u>	<u>-104</u>	<u>-116</u>	<u>-27</u>	<u>-145</u>	<u>114</u>
Overall balance	<u>-234</u>	<u>-84</u>	<u>-67</u>	<u>-532</u>	<u>-419</u>	<u>-111</u>	<u>-159</u>	<u>-36</u>
Financing	234	84	67	532	419	111	159	36
Foreign, net ^{2/}	305	326	261	553 ^{3/}	86	18	20	121
Banking system	-71	-242	-194	-21	333	93	139	-85
(In percent of GDP)								
Revenue and grants	37.4	...	37.9	38.5	31.9	37.3	39.0	29.5
Domestic revenue	11.5	...	18.0	19.4	20.6	20.2	19.3	18.7
Of which: Tax revenue	5.8	...	5.0	5.6	5.0	4.7	4.7	4.6
Foreign grants	25.9	...	19.9	19.1	11.3	17.2	19.7	10.8
Expenditure	45.2	...	39.7	51.3	40.9	39.4	42.0	30.1
Current expenditure	14.1	...	16.6	21.9	23.1	20.7	22.0	16.8
Capital expenditure and net lending	31.1	...	23.1	29.4	17.8	18.7	19.9	13.3
Current balance (excluding grants)	<u>-2.6</u>	<u>...</u>	<u>1.5</u>	<u>-2.5</u>	<u>-2.5</u>	<u>-0.5</u>	<u>-2.7</u>	<u>1.9</u>
Overall balance (including grants)	<u>-7.8</u>	<u>...</u>	<u>-1.8</u>	<u>-12.8</u>	<u>-9.0</u>	<u>-2.1</u>	<u>-3.0</u>	<u>-0.6</u>
Foreign financing (net)	10.2	...	7.0	13.3	1.9	0.3	0.4	2.0
Bank financing	-2.4	...	-5.2	-0.5	7.2	1.8	2.6	-1.4
Overall balance (excluding grants)	<u>-33.7</u>	<u>...</u>	<u>-21.7</u>	<u>-31.9</u>	<u>-20.3</u>	<u>-19.3</u>	<u>-22.7</u>	<u>-11.4</u>

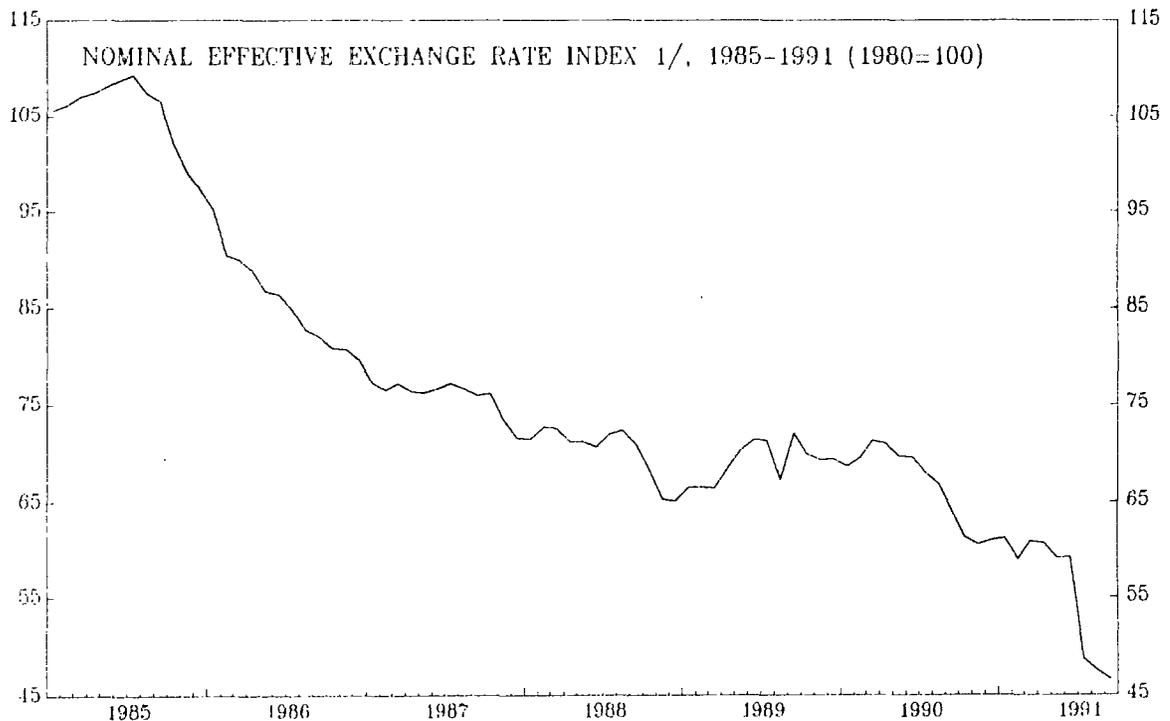
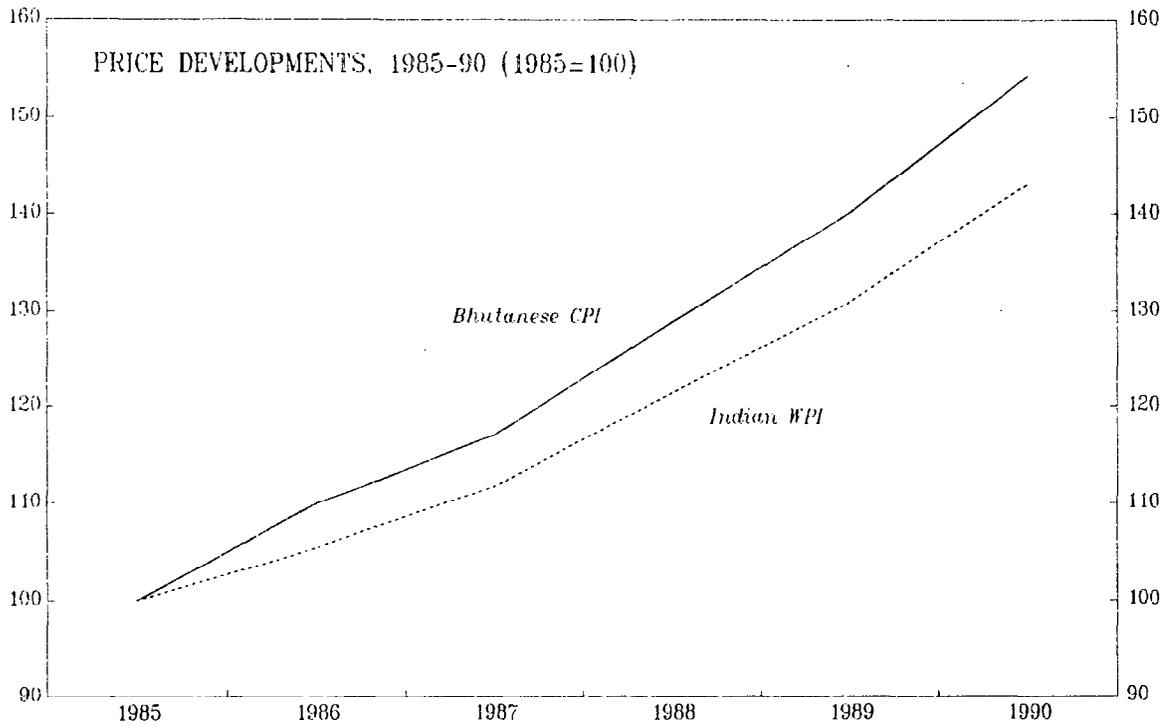
Source: Data provided by the Bhutanese authorities.

^{1/} Bhutan's fiscal year through 1986/87 ran from April to March and data for 1986/87 cover this 12-month period. The new fiscal year runs from July to June and data for 1988/89-1991/92 cover this 12-month period. The data for 1987/88 are shown both for the transitional 15-month period and also on an annualized basis.

^{2/} Includes on-lending of external funds to the public enterprises.

^{3/} Includes Nu 300 million in commercial borrowing by the Government that was on-lent to the Druk Air Corporation for the purchase of an aircraft.

PRICES AND NOMINAL EFFECTIVE EXCHANGE RATE INDEX,
1985-91

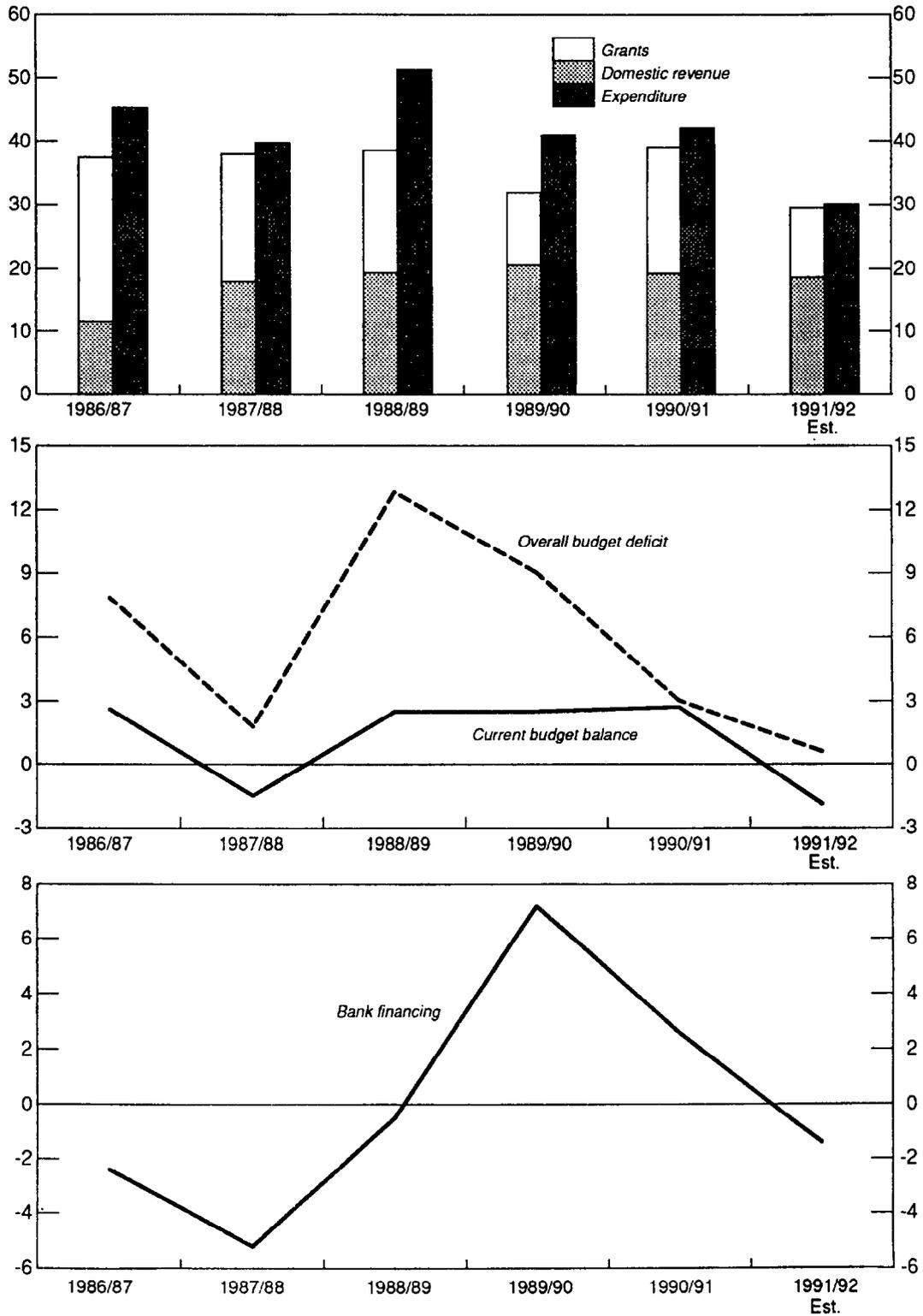


Source: IMF, *International Financial Statistics*.
1/ The index is based on trade-weighted exchange rates with Bhutan's 10 largest trading partners excluding India. A decrease indicates depreciation.

OVERALL GOVERNMENT BUDGETARY OPERATIONS,

1986/87-1991/92

(In percent of GDP)



Source: Data provided by the Bhutanese authorities.

Table 3. Bhutan: Monetary Survey, 1987-91 ^{1/}

	1987	1988	1989	1990	1991
(In millions of ngultrum; end of period)					
Foreign assets (net)	912.1	1,209.1	1,536.6	1,408.6	1,720.2
Ruppee	509.1	637.7	705.0	270.2	100.3
Other	403.0	571.4	831.6	1,138.4	1,619.9
Net domestic assets	-232.2	-488.2	-552.3	-252.2	-218.9
Domestic credit	51.2	-124.2	-103.1	354.4	334.3
Government (net)	-72.5	-267.3	-288.0	39.0	-22.2
Public enterprises	26.7	32.8	26.0	41.7	53.4
Private sector	75.9	87.3	133.9	241.4	261.6
Other financial institutions	21.1	23.0	25.0	32.3	41.5
Other items (net)	-283.5	-364.0	-449.2	-606.6	-553.2
Total liquidity (M2)	679.8	720.9	984.3	1,156.4	1,501.3
Narrow money (M1) ^{2/}	279.9	373.2	467.2	518.1	632.6
Currency	90.5	126.4	157.8	176.1	238.5
Demand deposits	189.3	246.8	309.4	342.0	394.1
Quasi-money ^{3/}	400.0	347.7	517.1	638.3	868.7
Memorandum items:					
Change in liquidity	252.4	41.1	263.4	172.1	344.9
Foreign assets (net) ^{4/}	373.3	237.0	252.5	-211.0	68.6
Domestic credit	-59.7	-175.4	21.1	457.5	-20.1
Other items (net) ^{4/}	-61.2	-20.5	-10.2	-74.4	296.4 ^{5/}
(Annual percentage change)					
Total liquidity	59.1	6.0	36.5	26.4	29.8
Narrow money (M1)	23.7	33.4	25.2	33.3	22.1
Currency	13.6	39.7	24.8	39.6	35.4
Demand deposits	29.2	30.4	25.4	30.4	15.2
Quasi-money	98.8	-13.1	48.7	18.0	36.1
Credit to private sector	22.4	15.0	53.4	80.3	8.4
(Contribution to growth of total liquidity, in percent)					
Foreign assets (net) ^{4/}	87.3	34.9	35.0	-21.4	5.9
Domestic credit	-14.0	-25.8	2.9	46.5	-1.7
Of which:					
Credit to Government (net)	-17.3	-27.5	-3.6	35.6	-5.3
Credit to private sector	3.3	1.7	6.5	10.9	1.7
Other items (net)	-14.3	-3.0	-1.4	-7.6	25.6 ^{5/}

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

^{1/} End-of-June figures.

^{2/} Includes savings deposits.

^{3/} Fixed-term deposits (time deposits and foreign currency deposits).

^{4/} Excluding valuation adjustment.

^{5/} Includes transfer of unrealized foreign exchange profit of Nu 200 million to the Government.

third countries (Table 4 and Chart 4). In July 1991, in step with the India rupee devaluation, the ngultrum was depreciated by 19 percent against the U.S. dollar from Nu 21.3 to Nu 25.5 per U.S. dollar.

III. Report on the Discussions

The need for curbing demand pressures remained the focus of the discussions for the 1991 Article IV consultation. Given the authorities' reaffirmation of their commitment to strict fiscal discipline, the main issues in this regard related to the appropriate mix of spending and revenue measures and to the need for strong monetary controls to supplement the fiscal restraint being sought. Discussions also extensively covered structural reforms as it was clearly recognized that the timing was propitious for these policy initiatives in view of the recent policy changes in India and the impending adoption of the Seventh Development Plan (1992-97) in Bhutan.

1. Financial policies

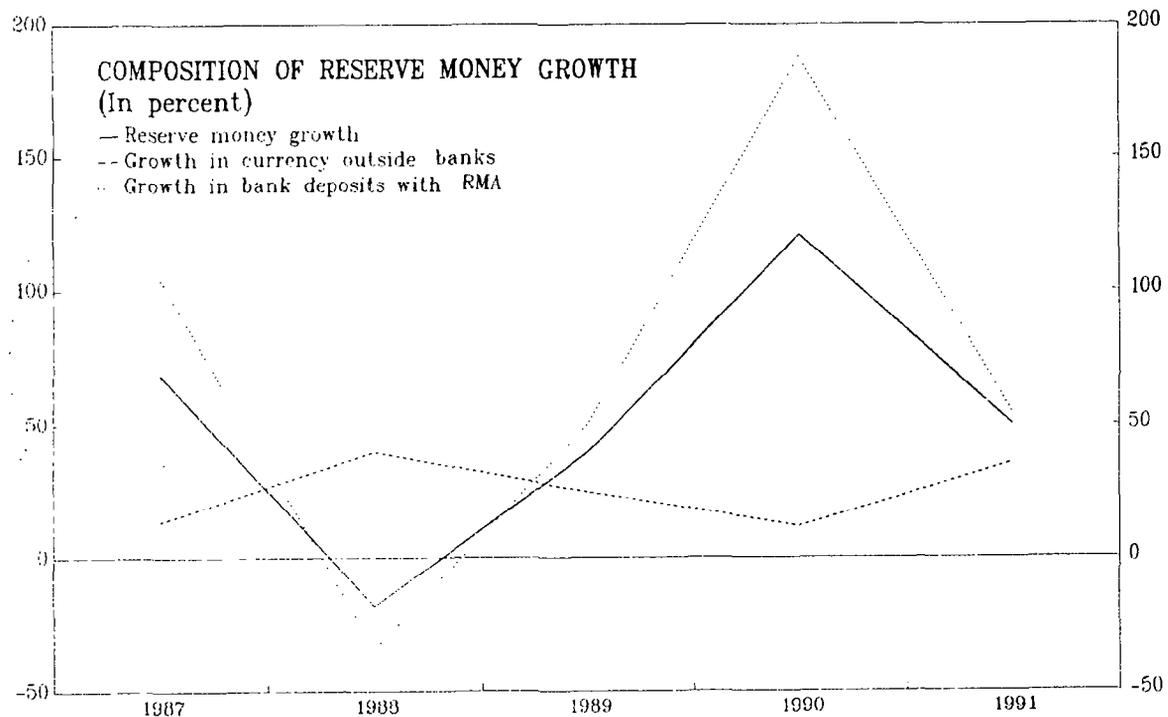
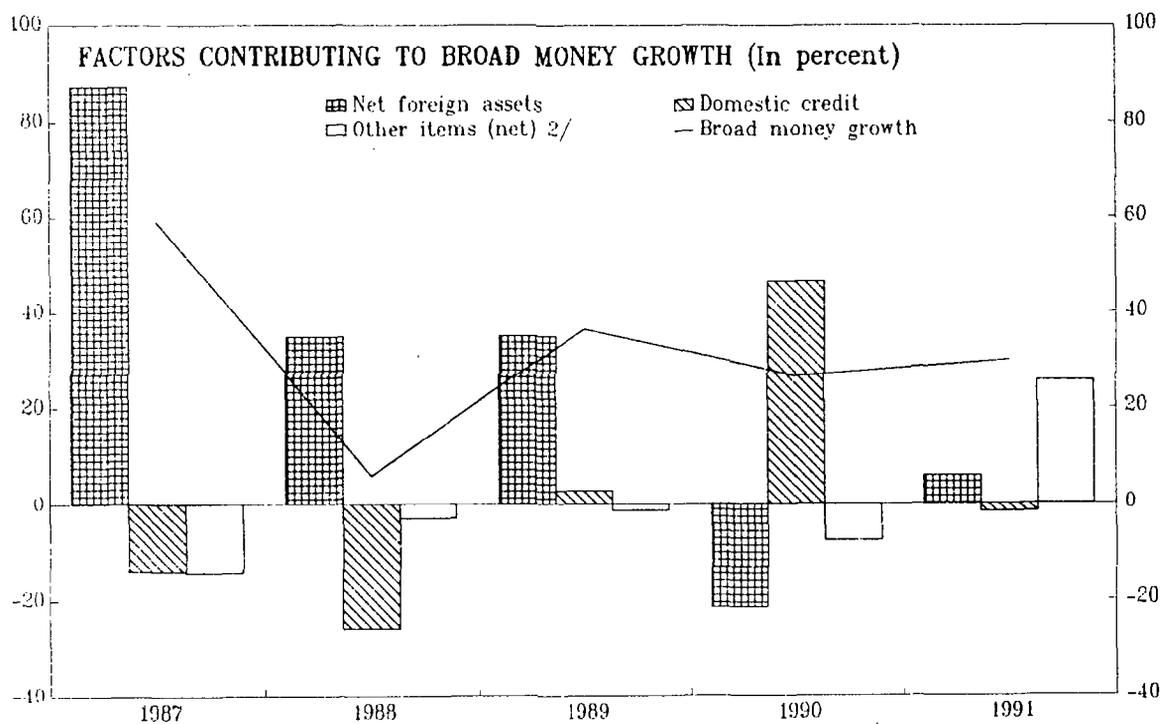
a. Public finance

The authorities viewed the budget deficits and the recourse to large bank financing in the past few years as the main culprits for the weakening in the external position and the depletion of Indian rupee reserves. They were particularly concerned about the prospect of having to meet their Indian rupee obligations by using convertible currency reserves. They wished to maintain the latter at current levels to safeguard against external shocks to which Bhutan's economy had shown a high degree of vulnerability.

In view of the weakening in the external position, the authorities have decided to sharply reduce domestic demand in 1991/92 by pursuing a strategy of tight financial policies with fiscal austerity as its centerpiece. The seriousness of this effort is reflected in drastic cuts in expenditure (in excess of 10 percentage points of GDP) proposed in the budget through wage restraint and a freeze in the size of the civil service, tight controls over expenditure on goods and services, and a reduction in the cash subsidy for third country exports. Domestic revenues are projected to grow slightly less than nominal GDP, in the absence of new tax measures. The budget targets a buildup of net government deposits with the banking system of the order of 1 1/2 percent of GDP based on the projected deficit of 1/2 percent of GDP.

While agreeing that the targeted buildup in net government bank deposits (and the associated deficit goal) was appropriate for the restoration of macroeconomic stability, the staff expressed concern over the way in which the necessary fiscal adjustment was being sought. This concern stemmed, in particular, from the extent of expenditure compression, on the one hand, and the absence of new revenue measures on the other. Not only

MONETARY DEVELOPMENTS, 1987-91 1/



Source: Data provided by the Bhutanese authorities.

1/ End-June.

2/ In 1991, includes large transfer of unrealized foreign exchange profit to the Government.

Table 4. Bhutan: Balance of Payments Summary, 1986/87-1990/91

	1986/87	1987/88 ^{1/}	1988/89	1989/90	Est. 1990/91
(In millions of U.S. dollars)					
Exports, f.o.b.	33.4	54.5	68.7	72.2	74.0
India	33.2	53.8	65.3	64.9	66.4
Third countries	0.2	0.7	3.4	7.3	7.7
Imports, c.i.f.	100.5	91.5	123.8	104.3	106.4
India	77.5	74.3	79.5	85.2	88.7
Third countries ^{2/}	23.0	17.2	44.2 ^{2/}	19.1	17.7
Trade balance	-67.1	-37.0	-55.0	-32.1	-32.4
India	-44.3	-20.5	-14.2	-20.3	-22.3
Third countries	-22.8	-16.5	-40.8	-11.8	-10.0
Services and private transfers (net)	-22.7	-18.7	-15.7	0.4	-6.0
India	-16.6	-13.7	-11.6	-2.0	-6.4
Third countries	-6.1	-5.0	-4.1	2.3	0.4
Current account balance	-89.8	-55.6	-70.7	-31.8	-38.4
India	-60.9	-34.2	-25.8	-22.3	-28.8
Third countries	-28.9	-21.4	-44.9	-9.5	-9.6
Official transfers	73.8	66.9	65.0	41.5	57.4
India	53.7	56.9	54.5	32.4	45.0
Third countries	20.1	10.0	10.5	9.1	12.4
Loans (net)	21.9	23.5	33.4	1.0	1.9
India	10.7	6.6	2.8	-0.1	-0.1
Third countries	11.2	16.9	30.6 ^{3/}	1.1	2.0
Errors and omissions ^{4/}	5.9	-8.4	-19.7	-18.9	-21.0
India	0.8	-15.0	-33.3	-33.3	-28.5
Third countries	5.1	6.7	13.6	14.2	7.5
Overall balance	11.8	26.4	8.0	-8.2	--
India	4.4	14.3	-1.8	-23.1	-12.3
Third countries	7.4	12.1	9.9	14.9	12.3
(In percent)					
Memorandum items:					
Exports/GDP	14.2	19.0	25.1	26.4	26.2
India	14.1	18.8	23.9	23.8	23.5
Third countries	0.1	0.3	1.2	2.7	2.7
Imports/GDP	42.8	31.9	45.2	38.2	37.7
India	33.0	25.9	29.0	31.2	31.4
Third countries	9.8	6.0	16.2	7.0	6.3
Current account/GDP	-38.3	-19.4	-25.8	-11.6	-13.6
India	-25.9	-11.9	-9.4	-8.2	-10.2
Third countries	-12.3	-7.5	-16.4	-3.5	-3.4
Foreign aid/GDP ^{5/}	40.8	29.8	36.0	15.6	18.9
India	27.4	22.2	20.9	11.8	13.8
Third countries	13.3	7.7	15.0	3.7	5.1
Gross international reserves					
(US\$ millions) end-of-period	62.6	89.1	97.1	88.9	88.9
(In months of imports of goods and services)	(5.2)	(8.0)	(8.5) ^{6/}	(8.1)	(7.8)
Exchange rate (Nu/US\$, period average)	12.8	13.1	15.1	17.0	18.9

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

^{1/} Annualized 15-month fiscal year (April-June).

^{2/} Including the purchase of an aircraft for \$26.5 million.

^{3/} Including a commercial loan of \$21.5 million to finance the above-mentioned aircraft purchase.

^{4/} The large negative errors and omissions may be attributable to an underestimation of imports and grants, estimates for which are based on partial data.

^{5/} Comprising official transfers and loans (net).

^{6/} Excludes purchase of aircraft.

was the feasibility of the ambitious cuts in expenditure uncertain but there was also a distinct possibility that, if achieved, such cuts would end up curtailing essential government services, in particular road repair, medical and school facilities, power supply to industry, and maintenance of other essential infrastructure. In addition, cutbacks to government departments, such as Revenue and Customs would adversely affect the Government's ability to collect revenue. While some room for cuts existed outside the areas already touched by the budget, on balance the staff estimated that an increase in spending of about 10 percent from the currently budgeted level (i.e., an increase equivalent to about 3 percentage points of GDP) would be needed to safeguard the provision of essential services.

At the same time, the staff urged the authorities to raise additional revenue and grants of broadly similar magnitude during this fiscal year in support of the fiscal adjustment being envisaged. Various potential revenue sources were identified in this connection, including a strengthening of the collection of sales and corporate taxes, a broadening of the sales tax base, higher mineral royalties and utility tariffs, and the introduction of cost recovery fees in health and education with exemptions for low-income groups. There was also scope for mobilizing additional revenue by substituting customs duties for import licenses with respect to third country products. ^{1/} Moreover, in light of recent increases in excise duties on a range of high-valued consumer goods in India, which are also imported into Bhutan, there may be good reason for renegotiating a further upward adjustment in the excise duty refund from India.

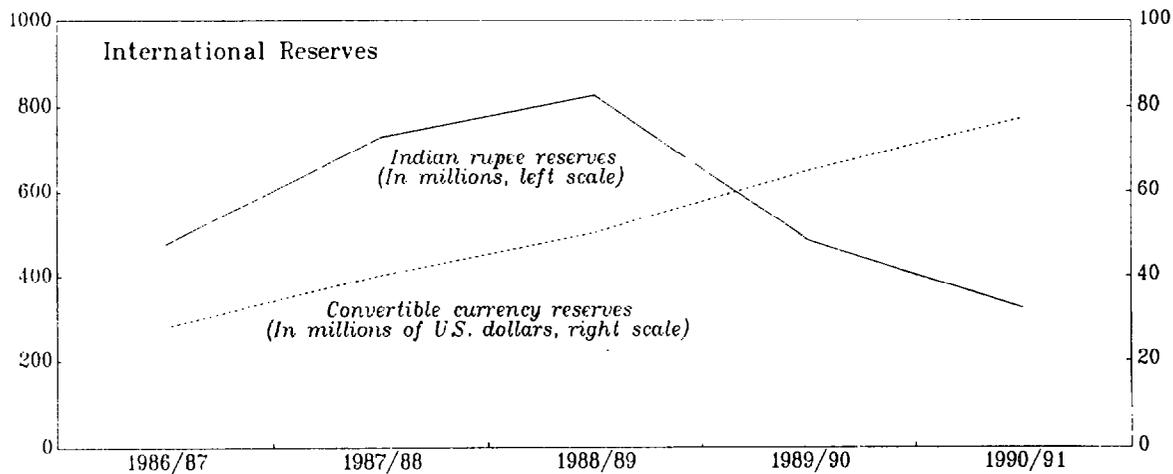
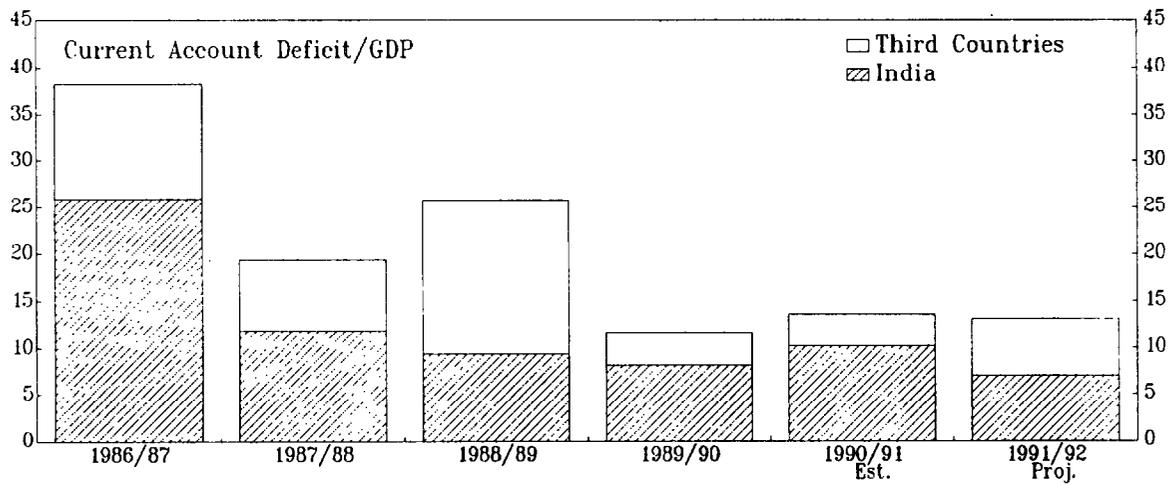
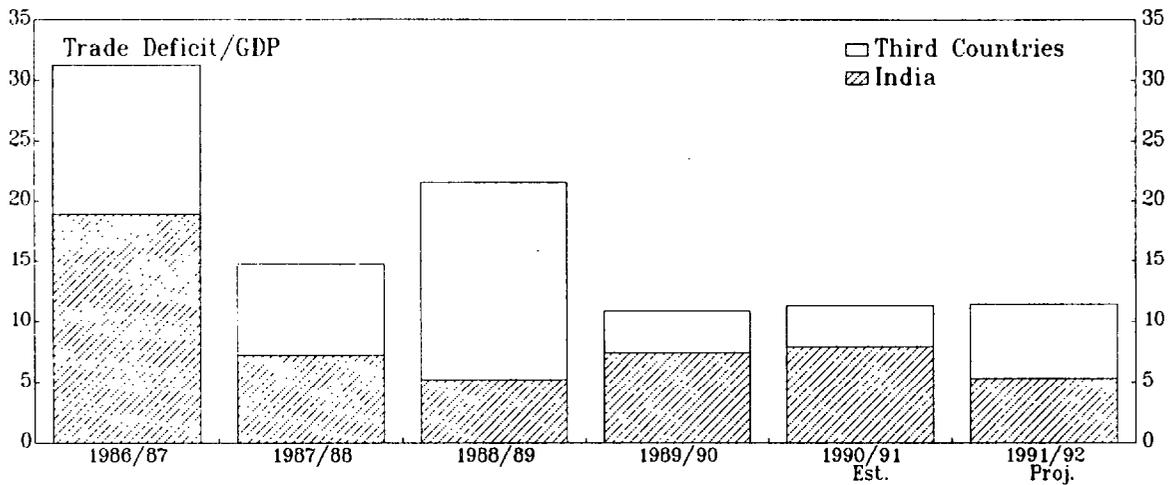
The authorities reiterated their firm commitment to the fiscal strategy as enunciated in the budget, but acknowledged that expenditure overruns might occur, albeit of a lesser magnitude than considered possible by the mission. Accordingly, they said they would reassess possible sources for additional revenue mobilization, including those identified by the staff. They questioned, however, whether the amount suggested by the staff could be realized in full during this fiscal year given administrative constraints. They indicated that, if a gap were to persist between expenditure overruns and additional revenue, an option they would pursue would be to canvass special cash grants from donors, including India.

b. Monetary policy

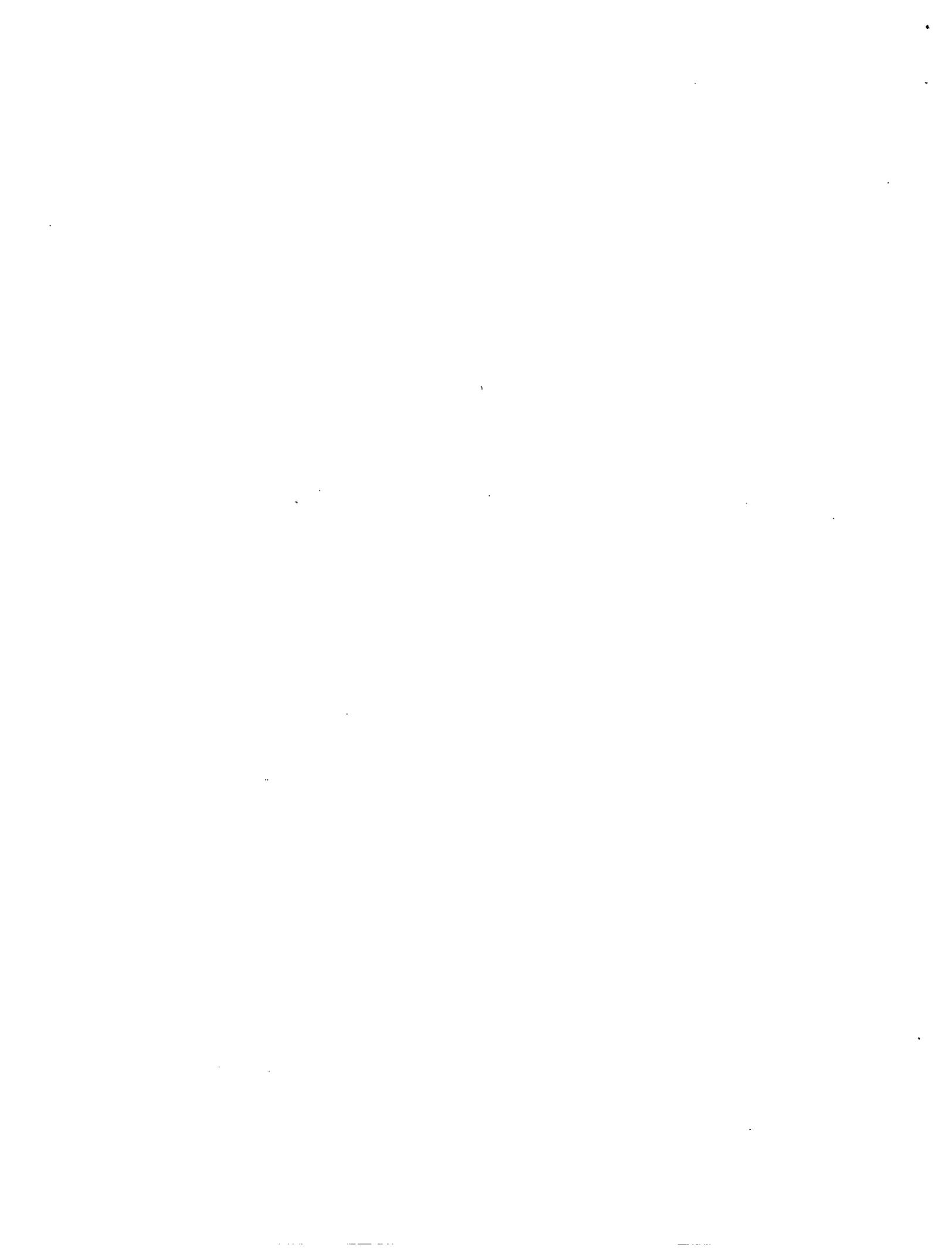
In support of fiscal policy, the authorities have followed a restrictive credit policy stance, with a view to gradually restoring Indian rupee reserves to the equivalent of six months' imports from India coupled with some further gains in convertible currency reserves. As noted earlier, they have decided to restrain domestic credit by budgeting a buildup in net government deposits while allowing credit to the private sector to grow at a pace commensurate with the privatization effort and strong investment. In

^{1/} Or, alternatively, from auctioning licenses; if a start were made in liberalizing the trade regime.

BALANCE OF PAYMENTS, 1986/87-1991/92



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



line with an upward adjustment in India's interest rates, the Royal Monetary Authority raised the interest rate on commercial lending in August by one percentage point to a maximum of 16 percent. 1/

In the discussions on credit policy and monetary developments, the staff supported the restrictive policy stance being pursued and the increase in the lending rate that had been implemented. The authorities, in explaining their policy intention in the period immediately ahead, cited a modest increase of Nu 300 million in external reserves and a reduction of inflation to 10 percent as broad goals of a financial program in 1991/92. No increase in total domestic credit would be allowed during the current fiscal year if credit policy is to be consistent with these goals of the program. Nevertheless, if a budgeted increase in net government deposits is achieved, the program would allow an expansion of credit to the private sector at an annual rate of 25 percent.

Based on the projected growth of about 17 percent in demand for broad money, and given a liquidity overhang from previous years 2/, the financial program implies, according to the staff's estimates, a reduction in reserve money during the current fiscal year. To ensure such a result, the staff suggested that the RMA start issuing its own securities. 3/ This would also require that the RMA strengthen its system of reserve money monitoring and forecasting in the broader context of its monetary programming. In addition, the Government should refrain from covering possible expenditure overruns during this fiscal year by borrowing from the banking system and, in particular, to desist from further transfers of unrealized foreign exchange profits from the RMA.

While, as noted above, steps have been taken to raise lending rates, no such action has been taken on the side of deposit rates. With the rise in inflation since the late 1980s nearly all deposit rates have become negative. Also, a rate differential in favor of India (up to 2 percent) has emerged after a further upward adjustment in deposit rates there. The staff pointed out that an adjustment in Bhutan similar in magnitude to that in India was called for to provide sufficient incentives for domestic financial savings and to discourage an outflow of funds. The staff added that a remaining issue in the area of interest rate policy requiring prompt attention was a rationalization of the present system of multiple preferential lending rates for priority sectors.

1/ Since then, there have been further upward adjustments in Indian interest rates.

2/ During 1988/89-1990/91, the holdings of currency outside banks doubled and the deposits of the Bank of Bhutan at the RMA rose sixfold, resulting in a four-and-a-half fold increase in reserve money.

3/ The issuance of RMA securities would have the advantage, inter alia, of preparing the ground for the development of a government securities market at a later stage.

In response to the staff's assessment of the financial program for 1991/92, the authorities emphasized that they would not be seriously concerned even if total liquidity (M2) growth were to exceed 20 percent as there was evidence for continued monetization of the economy and increased substitution of the ngultrum for the Indian rupee. Accordingly, they took the view that a somewhat faster rate of monetary expansion than that underlying the program could be accommodated by allowing a modest expansion in total domestic credit without jeopardizing the targeted rise in external reserves.

2. Wage and labor policies

The authorities introduced restrictions on the employment of foreign labor in 1988 in the context of a policy initiative to enhance national identity and self-reliance. Since then, a large number of nonnationals have left Bhutan with implications for the demand/supply balance in the labor market. As a result, labor costs have been rising sharply, despite the introduction of fixed daily wage rates for unskilled labor concurrently with the restrictions on foreign labor. Addressing this issue, the authorities explained that, according to current regulations, all new foreign workers were employed under three- to five-year contracts. Public and private sector employers are required to obtain clearance from the Royal Civil Service Commission for both the contract period and the employment of foreign workers. Clearance is liberally handled in the case of foreign laborers with skills not available in Bhutan and a more liberal entry policy is envisaged in the future for nonnational laborers needed in large-scale public projects.

The Government has recently raised the ceiling on the total number of foreign laborers to 30,000. In order to alleviate the shortage of skilled national manpower, the authorities have accorded human resource development top priority in the forthcoming development plan, with 20 percent of total expenditure for this purpose being allocated to training programs in the private sector. The staff encouraged the authorities to ease labor restrictions also for private sector employees while at the same time pressing ahead with programs to train local workers.

3. External policies

On the assumption that financial policies will be carried out broadly in line with the stated intention of the authorities, the balance of payments is expected to turn into surplus in the current fiscal year, which the mission estimated at \$12 million (5 percent of GDP) in the current fiscal year. Since the improvement stems mainly from a reduction in demand, it is expected to affect primarily the payments position vis-à-vis India with a rebuilding of Indian rupee reserves to about three months of imports being a main result. The balance of payments vis-à-vis third countries is also expected to be in surplus reflecting several factors: continued growth of exports to third countries encouraged by the recent depreciation of the ngultrum vis-à-vis convertible currencies; increased earnings from tourism

following privatization of tourism operations; and an increase in foreign loan disbursements. Starting from the next fiscal year, exports both to India and to third countries will be spurred by the coming on stream of exports from the ferrosilicon joint-venture project and a further upward adjustment in the export price of electricity.

The staff expressed concern that Bhutan may have lost competitiveness vis-à-vis India, especially in view of the recent escalation in wage and transportation costs. While sharing this concern, the authorities noted that Bhutan still enjoys a competitive edge over India for a variety of products owing to its unique natural resource endowment (hydropower) or climatic factor (horticulture). Nevertheless, they concurred with the staff that there was a need for strengthening competitiveness which they intend to achieve through a judicious mix of prudent demand management and appropriate structural reforms.

The authorities have reduced the cash subsidy for exports to third countries from a uniform rate of 30 percent to four rates ranging from 5 percent to 20 percent with the lowest rate applying to unprocessed primary products and the highest rate applying to processed products. This decision was made before the large depreciation of the ngultrum in July in view of the substantial depreciation of the ngultrum vis-à-vis convertible currencies since 1988 when the subsidy was introduced. The authorities agreed that there was little justification now to maintain the subsidy for fruit exports to Bangladesh. However, in their view, other exports continued to require subsidization to cover high transportation costs associated with Bhutan's landlocked location. The staff contested this view and noted that the abolition of such subsidies also would have favorable fiscal consequences.

At end-June 1991, total outstanding external debt amounted to more than \$120 million or 45 percent of GDP, including both debt to India and to third countries. The debt service ratio has been relatively stable in recent years but is expected to rise several percentage points from next year onward when Bhutan starts servicing loan that financed the Chukha hydro-power project.

Bhutan continues to maintain exchange restrictions under Article XIV. The trade and exchange system remained virtually unchanged in 1990/91. Licenses for imports of capital goods and inputs for industries for approved projects are given liberally; no tariffs apply to these imports. Other imports from third countries are subject to high tariffs, except for certain goods brought in under the very liberal personal baggage rule. There are also limitations on the availability of exchange for invisible payments, in particular on travel allowances. The restrictions are mainly intended to conserve convertible currencies. The staff encouraged the authorities to administer these restrictions in a liberal manner.

4. Development strategy and structural policies

During the Sixth Plan (1987/88-1991/92) the Government started a process of disengagement from economic activity. Initially, this process concentrated on privatization of public enterprises, which has by now encompassed a significant number of enterprises in manufacturing, transportation, and tourism, to which will soon be added postal and telephone services.

In discussing the basic features of the Seventh Plan (1992/93-1997/98) for which preparations had not been completed at the time of the mission, the authorities explained that fiscal consolidation, efficiency, and ecological sustainability are important guiding principles. Real GDP growth is targeted at 5 percent per annum, compared with an average rate of 6 percent in the previous Plan. Sectoral priorities include education and health under an intensified program of human resource development, an increased share of export industries with greater private sector participation, and further development of the power and communication sectors.

The staff supported the guiding principles of the Seventh Plan. However, it noted that in the absence of large-scale development projects which propelled growth during the Sixth Plan period, the targeted growth of real GDP may not be attainable unless there were material gains in investment efficiency and labor productivity. In order to achieve these gains, the authorities would have to shift their development strategy more decisively toward an outward orientation, combined with emphasis on market forces and greater private sector participation. Important steps have already been initiated in this direction, notably by setting in motion a forceful program of privatization and by according high priority to export industries in the industrial development program. However, to bring these initiatives to fruition, it was necessary, in the staff's view, that the authorities break further away from detailed bureaucratic controls of economic activity. In this connection, the staff discussed a number of reform initiatives concerning public enterprises, industrial and import licensing, taxation, financial institutions, tourism, and foreign direct investment. Some of these initiatives are discussed below.

a. Industrial and trade reforms

The industrial licensing system is discretionary and functions on a case-by-case basis. The staff suggested that the Government publicize the regulations and spell out the criteria on which a license application is judged. Over time, industrial licensing should be relaxed and made automatic. This would include a withdrawal of the annual renewal provision, which acts as a deterrent to private investors.

Quantitative restrictions on imports from third countries have introduced an anti-export bias in Bhutan's trade regime. In order to reduce this anti-export bias, the staff recommended the replacement of import

licensing with tariffs at rates that are high enough to forestall re-exports to India, with provisions to exempt intermediate inputs and capital goods from tariffs and other charges upon proof of actual use in the production of exports to third countries. In timing these measures, the authorities will have to carefully monitor similar reforms in India.

b. Tax reform

A determined effort is called for to broaden the tax base, raise tax elasticity, simplify the tax system, and strengthen tax administration. Fund technical assistance has already identified concrete measures in this regard which the staff reiterated in the discussions. Among them, the staff singled out the reintroduction of a tax on net rental income as well as the introduction of a personal income tax for which further Fund technical assistance was requested.

c. Tourism

The authorities expect that efforts to privatize tourism operations that have been under way will help revive that industry. This, in turn, would allow a better payload for the single existing passenger aircraft of Druk-Air and, eventually, profitable operation of a second aircraft. While expressing appreciation for the fact that the operations of Druk-Air provide a crucial link to the outside world, the staff suggested to the authorities that they defer the purchase of a second aircraft until after financial stability has been restored and commercial viability of such a purchase is assured.

d. Foreign direct investment

Foreign direct investment is currently allowed on a case-by-case basis and only in the form of a joint venture with maximum foreign equity participation of 49 percent. Consideration is being given to raising the limit in selected cases, especially for export-oriented industries. The authorities are also studying a proposal by the staff to make foreign investment approval more automatic and the rules and regulations more transparent.

e. Medium-term outlook

The staff discussed with the Bhutanese authorities the medium-term prospects for the economy in the context of two scenarios spanning the Seventh Plan period. The two scenarios were set in a common external environment which also assumed a gradual but small decline in grants available to Bhutan and a fixed nominal exchange rate. Due to the openness of Bhutan's small economy to the Indian economy, inflation was assumed to be largely imported from India, declining from about 11 percent in 1991/92 to 5 percent by 1996/97, consistent with the stabilization policies adopted in India.

The staff's analysis indicated that the growth target (5 percent per annum) could be achieved without compromising external viability but provided that the inflow of foreign aid and grants continued at about the present level (Table 5). However, the outlook was not without risks. The staff's scenario analysis illustrated that a package of policy changes including revenue increases cum tax reform, budgetary expenditure control, liberalization of industrial and trade regulation, and a general outward-orientation of policies, would serve Bhutan well in reducing the risk of facing foreign resource constraints associated with a potential reduction in aid inflows. The authorities concurred with the broad thrust of the scenario exercise, illustrating the policy choices.

5. Environment

Bhutan has an exemplary track record of environmental protection that is worthy of international support. Appendix I highlights the achievements and constraints, as well as the basic thrust of Bhutan's strategy in preserving its natural environment.

IV. Staff Appraisal

Until a few years ago the Bhutanese economy experienced high growth, moderate inflation, and rising external reserves, aided by a favorable external environment and a prudent stance of financial policies. Macroeconomic imbalances emerged in 1988/89 when a slowdown in output growth met with a strong rise in domestic demand, fueled mainly by expansionary fiscal and monetary policies.

Although there was some tightening in the fiscal stance in 1990/91, demand remained excessive in the face of a weakening in output growth. The external position continued to worsen, particularly vis-à-vis India, and near double-digit inflation persisted.

The authorities responded by an adjustment strategy with fiscal austerity as its centerpiece. The budget for 1991/92 provides for a significant reduction in the overall deficit and a buildup of government deposits with the banking system, steps obviously in the right direction. Nevertheless, the budget raises several issues. In particular, very heavy reliance on expenditure cuts calls into question the feasibility of the intended fiscal correction but also causes concern that it may result in a curtailment of essential government services and a weakening of revenue collection. The tax effort has remained weak and the budget does not provide for new revenue measures. Therefore, the staff urges the authorities to strengthen their efforts on the revenue side along the lines of the suggestions made during the mission, while persevering in efforts to curtail nonessential expenditures, including export subsidies.

Table 5. Bhutan: Medium-Term Scenarios--Main Indicators

	1990/91 Est.	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97
		Projections					
		(In percent)					
Real GDP growth	3.1	3.1	4.0	4.5	5.0	5.0	5.0
GDP deflator	9.1	11.0	10.5	9.0	7.0	5.5	5.0
		(In percent of GDP; unless otherwise stated)					
Baseline scenario <u>1/</u>							
Tax revenue	4.8	5.2	5.3	5.3	5.4	5.4	5.5
Current expenditure	22.1	20.2	21.0	21.4	20.1	19.6	19.2
Capital expenditure	20.0	13.4	14.0	14.5	14.5	14.8	15.0
Overall budget deficit	-3.0	-0.6	-3.9	-6.9	-7.1	-8.2	-8.9
Exports	26.3	26.9	30.9	30.0	30.9	30.4	29.9
Imports	37.9	37.1	35.6	36.4	37.4	38.1	38.4
Current account	-13.6	-13.2	-6.7	-7.8	-6.2	-6.9	-7.5
Debt service/current receipts	22.9	31.2	28.5	24.9	23.6	23.9	23.6
Debt service/current receipts (Indian)	0.2	--	3.3	5.8	4.9	4.3	3.8
Debt (total)	44.9	55.2	47.2	40.3	34.9	30.5	26.8
Rupee reserves (in months of imports)	1.8	3.1	4.0	3.8	3.6	3.0	2.4
Convertible currency reserves (US\$ million)	77.3	80.8	84.8	87.3	93.1	97.8	100.4
Alternative scenario <u>2/</u>							
Tax revenue	4.8	5.2	6.5	7.0	7.5	8.0	8.5
Current expenditure	22.1	20.2	20.6	21.0	19.7	19.3	18.8
Capital expenditure	20.0	13.4	14.0	14.0	14.0	14.0	14.0
Overall budget deficit	-3.0	-0.6	-2.1	-3.8	-3.3	-3.3	-3.1
Exports	26.3	26.9	31.2	30.6	31.8	31.1	30.9
Imports	37.9	37.1	35.1	35.0	35.3	35.2	35.6
Current account	-13.6	-13.2	-5.8	-5.7	-2.7	-2.7	-2.7
Debt service/current receipts	22.9	31.2	27.4	23.2	21.3	20.8	19.5
Debt service/current receipts (Indian)	0.2	--	3.3	5.7	4.8	4.3	3.7
Debt (total)	44.9	55.2	47.2	40.3	34.9	30.5	26.8
Rupee reserves (in months of imports)	1.8	3.1	4.4	5.0	5.9	6.6	7.3
Convertible currency reserves (US\$ million)	77.3	80.8	86.2	90.8	99.2	107.2	113.5

Sources: Data provided by the Bhutanese authorities; and staff projections.

1/ Projections without policy reform.

2/ Projections with policy reform.

Fiscal adjustment will have to be buttressed by a restrictive monetary and credit stance to achieve the desired stabilization effect. While adherence to the budget goals as regards the deficit and the buildup of government bank deposits is crucial, additional action is needed to absorb excess liquidity in the economy. In this regard, issuance of RMA securities at an early date would be helpful. The Government should also refrain from using transfers of unrealized foreign exchange profits to finance a budget deficit. Given the rate of inflation and recent increases in interest rates in India, an upward adjustment in the level of both lending and deposit rates is also called for.

The Government has relaxed its restrictive labor policy by raising the maximum limit for foreign laborers and intends to handle requests for employment of foreign workers under large public projects more liberally. In order to reduce labor costs and raise productivity, the authorities should also liberalize the employment of foreign workers in the private sector especially if sufficient national labor with matching skills is not available while pressing ahead with training programs.

The guiding principles of the Seventh Plan, namely, consolidation, efficiency, and sustainability are appropriate and the principal directions are also well chosen. In particular, the Government's disengagement from entrepreneurial activities is welcome as it would encourage private sector initiatives. However, this policy will not come to fruition if it is not accompanied by a more liberal regulatory environment on a wide front in which market forces--both domestic and external--are given greater latitude to operate. The timing is propitious for a major reform agenda in view of similar policy changes under way in India.

The medium-term growth target set in the Seventh Five-Year Plan seems attainable but there are risks to this outlook. The staff's scenario exercise suggests that a development strategy that is more outward-oriented, and provides for greater public resource mobilization, would allow Bhutan to meet possible shortfalls in foreign grants or adverse developments in the external environment without undue pressures on its external reserve position.

In accordance with the Statement by the Managing Director on Temporary Changes in Article IV Consultation Cycles (Buff Document No. 91/210), it is proposed that Bhutan be placed on the 24-month consultation cycle. Accordingly, the next Article IV consultation with Bhutan will be completed within 24 months of the present consultation.

V. Proposed Decision

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

1. The Fund takes this decision in concluding the 1991 Article XIV consultation with Bhutan, in light of the 1991 Article IV consultation with Bhutan conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance Over Exchange Rate Policies).
2. The restrictions on the making of payments and transfers for current international transactions described in SM/91/224 are maintained by Bhutan in accordance with Article XIV, Section 2. The Fund encourages the authorities to administer these restrictions in a liberal manner.

Bhutan: A Balanced Approach to Sustainable
Development and Environment Conservation

This appendix highlights the achievements and constraints, as well as the strategies, of the Kingdom of Bhutan in preserving its natural environment.

Situated on the southern slopes of the Eastern Himalayas, the Kingdom of Bhutan is endowed with a rich ecological system. 1/ In contrast with some of the neighboring countries, Bhutan has been able to maintain its natural heritage largely intact: about 60 percent of the land is still under forest coverage and the air and waters remain basically unpolluted. Amid the ever-increasing awareness of the need for environmental protection, Bhutan has been highly regarded for its success in and unparalleled commitment to environment conservation.

Having come late to the scene of modern economic development, Bhutan has been able to avoid the mistakes in other countries where economic welfare frequently was achieved at the expense of environment. The authorities have introduced an environmentally sensitive development strategy that "ensures primarily the preservation of the environment, and only thereafter derivation of economic benefits that flow from a rationally managed resource." 2/ This strategy is fully reflected in the economic planning and day-to-day activities. An outstanding testimony to the strategy is the national forest policy. In 1979, logging production was nationalized to pre-empt deforestation by commercial logging; and the overall rates of felling are kept well below the regeneration capacity of forests although in the more heavily populated and traveled areas there has been some forest and land degradation. It has been made mandatory that forestry coverage is maintained at over 60 percent at all costs.

The same degree of precaution has been observed in the exploitation of the abundant hydropower resources. Owing to careful site selection and project implementation, the Chukha Hydropower Station, which was commissioned in 1987, has had minimal negative impact on the environment. With the assistance of the World Bank and the United Nations Development Programme (UNDP), the authorities are formulating a Power Master Plan, a

1/ The moist forests in the south and the temperate and subalpine forests in the north provide habitat for a wide range of fauna and flora, including 770 bird species and 5,000 species of vascular plants, many of which are now thought to be found only in Bhutan.

2/ National Forest Policy of Bhutan - 1985, p. 6.

major objective of which is to assess the environmental implications of future hydro-electric projects. Despite the ready markets in India and the export earnings that hydro-electric projects generate, it is the firm intention of the authorities that no major projects will be launched until possible environmental degradation is ruled out.

The environmental strategy of the authorities has deep roots among the Bhutanese people who have a strong cultural and religious tradition, a central element of which is a profound respect for the environment and life in all forms. 1/ Building on the strength of the traditional conservation ethic, the authorities have been vigorously promoting people's awareness of environment and environment conservation. Teaching about the environment and nature conservation has been built into the curriculum of every primary and secondary school of the country, and environmental study programs are being developed at the college level. The weekly national newspaper regularly carries entire pages of articles on environment.

While Bhutan has so far avoided the environmental degradation so predominant in the region, it still has a long way to go in preserving its pristine environment. This task has been made particularly arduous by the fact that the soil of Bhutan is rather fragile and erosion-prone because the Himalayas are still a young and rising mountain range. In addition, pressures on the environment have been building in recent years, mainly from the following sources.

- Population growth, which has been at about 2 percent per annum, is likely to accelerate because of better health programs that lead to lower infant mortality and longer life expectancy. This, together with the proliferation of livestock population, will encroach into marginal land and exert heavier demand on the natural resources and the environment.

- Partial deforestation has taken place although most of the original forest cover remains intact. The rapid development of the road network, while instrumental in opening up remote areas for modernization, has caused erosion and deforestation, which is visible along the highways and in the most densely populated areas.

- The lack of well-trained managers and skilled workers poses another serious constraint on the rational management of the environment and sustainable use of natural resources.

The Bhutanese authorities are fully aware of these potential threats as they tread along the narrow path between sustainable economic development and environmental conservation. An integrated environment strategy is being formulated in order to find comprehensive and lasting solutions to the

1/ In the Buddhist belief, the mountains, rivers, lakes, streams, rocks and soil are the domain of different spirits. Pollution and disturbance, to these sites are believed to be the cause of deaths and diseases.

problems in preserving the environment. In particular, the Forestry and Nature Conservation Act of 1991 is expected to be enacted soon. It covers almost all aspects of natural conservation, ranging from forests, wildlife, biological diversity, and related natural resources. In addition, a Trust Fund for Environmental Conservation in Bhutan was agreed upon early this year by the Royal Government of Bhutan, the World Wildlife Fund, and the UNDP. It is set up as a permanent endowment, aiming to preserve Bhutan's unique forest resources. So far a number of bilateral and multilateral donors have made commitments to the Trust Fund. The authorities said that to make it operative, more contributions will be needed. The conservation efforts of Bhutan are transboundary and will benefit the world at large as well as Bhutan, and it was on this ground that the authorities considered their efforts as worthy of continued international support.

Bhutan: Basic Data 1/

Area:	46,500 square kilometers				
GDP per capita (1990) 2/:	\$310				
	1987/88	1988/89	1989/90	1990/91 Est.	1991/92 Proj.
(Change in percent)					
GDP and prices					
Real GDP 3/	17.8	1.0	5.0	3.1	3.0
Nominal GDP 3/	28.0	9.1	11.2	10.3	13.0
Consumer prices 4/	10.5	9.1	10.7	12.0	10.0
(In millions of ngultrum)					
Government budget 5/					
Revenue and grants	1,417	1,596	1,476	2,061	1,804
Domestic revenue	673	805	953	1,020	1,142
Of which: Chukha revenue	(238)	(254)	(277)	(401)	(384)
Foreign grants	744	791	523	1,041	662
Total expenditure	1,484	2,128	1,895	2,220	1,840
Current expenditure	619	909	1,069	1,165	1,028
Capital expenditure and net lending	865	1,219	826	1,055	812
Overall surplus/deficit. (-)	-67	-532	-419	-159	-36
Foreign financing	261	553	86	20	121
Banking system	-194	-21	333	139	-85
Money and credit 6/					
Net foreign assets	1,209	1,537	1,409	1,720	...
Domestic credit	-124	-103	354	334	...
Net credit to Government	(-267)	(-288)	(39)	-22	...
Broad money	721	984	1,156	1,501	...
(Percentage change)	(6.0)	(36.5)	(26.4)	(29.8)	(...)
Reserve money (percentage change)	-18.0	39.0	121.0	50.0	...
Interest rate on one-year deposits	9.0	9.0	9.0	9.0	...
(In millions of U.S. dollars)					
Balance of payments					
Exports, f.o.b.	54.5	68.7	72.2	74.0	63.7
To India	(53.8)	(65.3)	(64.9)	(66.4)	(55.6)
Imports, c.i.f.	-91.5	-123.8 7/	-104.3	-106.4	-88.0
From India	(-74.3)	(-79.5)	(-85.2)	(-88.7)	(-68.5)
Current account balance	-55.6	-70.7	-31.8	-38.4	-31.3
With India	(-34.2)	(-25.8)	(-22.3)	(-28.8)	(-16.7)
Official loans and transfers	90.4	98.4 8/	42.5	59.3	38.8
From India	(63.5)	(57.3)	(32.3)	(38.9)	(26.5)
Overall balance	26.4	8.0	-8.2	--	11.5
With India	(14.3)	(-1.8)	(-23.1)	(-12.3)	(8.0)
Reserves, external debt, and exchange rate 9/					
Convertible currency; end of period	40.2	50.1	65.0	77.3	80.8
(In months of third country imports)	(27.6)	(28.4) 10/	(40.8)	(53.0)	(49.7)
Convertible currency debt; end of period	40.4	71.4	77.8	79.9	84.4
Convertible currency					
Debt service ratio (in percent)	18.0	18.9	30.1	22.9	31.2
Exchange rate (period average) Nu/US\$	13.1	15.2	17.0	18.7	25.5
(In percent)					
Ratios to GDP					
Government domestic revenue	18.4	19.8	21.2	20.0	19.4
Government total expenditure	40.6	52.3	42.1	43.6	31.3
Overall budget surplus/deficit (-) (after grants)	-1.6	-13.1	-9.3	-3.1	-0.6
Of which: Bank financing	-5.3	-0.5	7.4	2.7	-1.4
Exports of goods	19.0	25.1	26.4	26.2	26.9
Imports of goods	31.9	45.2	38.2	37.7	37.1
Current account balance	-19.4	-25.8	-11.6	-13.6	-13.2
India	-11.9	-9.4	-8.2	-10.2	-7.0
Third countries	-7.5	-16.4	-3.5	-3.4	-6.2

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

1/ Bhutan's fiscal year through 1986/87 was on an April-March basis and from 1988/89 on a July-June basis, with the transitional 1987/88 fiscal year lasting 15 months.

2/ Based on revised population estimate.

3/ Based on calendar year data.

4/ June/June changes.

5/ Figures for 1987/88 have been annualized from 15-month budget data. The 1991/92 data are original budget estimates.

6/ End-June data.

7/ Includes \$26.5 million for the purchase of an aircraft.

8/ Includes a \$21.5 million commercial loan for the purchase of an aircraft.

9/ Data for 1987/88 are annualized 15-month fiscal year data. Debt data are end-June for 1987/88.

10/ Excludes purchase of an aircraft.

Bhutan--Fund Relations (continued)
(As of October 31, 1991)

VII. Country has not used Fund resources to date

(B) Nonfinancial Relations

VIII. Exchange Rate Arrangement

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

IX. Last Article IV Consultation

Staff discussions were held during August 3-15, 1990 (SM/90/197, 10/16/90). The Executive Board adopted the following decision:

1. The Fund takes this decision in concluding the 1990 Article XIV consultation with Bhutan, in light of the staff report on the 1990 interim Article IV consultation discussions with Bhutan conducted under Decision No. 5392-(77/63) adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions described in SM/90/197 are maintained by Bhutan in accordance with Article XIV, Section 2. The Fund encourages the authorities to administer these restrictions in a liberal manner.

X. Technical Assistance

a. CBD

Technical assistance was provided in setting up the Royal Monetary Authority of Bhutan created by the Government Order of December 7, 1982. The RMA commenced operations on November 1, 1983. A technical expert from the CBD panel worked as General Advisor for operations with the RMA from August 1982 until August 1986. A second technical expert was assigned in August 1983 to work as an Advisor, Research and Statistics, for a period of one year. In October 1984, a new Advisor, Research and Statistics, took up his assignment; this assignment ended in 1988. A second General Advisor for operations will complete his term in January 1992. An advisory mission visited Bhutan in May 1989 to provide a review of the financial system, and another mission visited in February 1991 to consult with the authorities on new legislation for the financial sector and develop supervisory capabilities for this sector. Finally, a technical expert was assigned in July 1991 to work as an Advisor in Bank Supervision.

Bhutan--Fund Relations (concluded)
(As of October 31, 1991)

b. Fiscal

Two FAD missions visited Bhutan (in April 1982 and June 1983) to provide assistance on tax policy, budgeting, and accounting. A technical expert from the FAD panel was assigned as Advisor to the Ministry of Finance for one year in March 1984, but had to leave after four months for health reasons. Another FAD expert participated in the Legal Department mission in April 1984. In November 1984, an expert from the FAD panel was assigned as General Fiscal Advisor to the Ministry of Finance. The assignment was extended for two more years. A new General Fiscal Advisor began a one-year term in April 1988; this assignment was subsequently extended through October 1989. A three-member technical assistance mission, which visited Bhutan during November 28-December 18, 1987, completed a report on the tax system and public enterprises in April 1988; a follow-up mission visited Bhutan during July 7-14, 1989.

c. Legal

Several visits by a staff member of the Legal Department took place during 1982-84 in connection with the drafting of tax legislation.

d. Statistics

A mission from the Statistics Department visited Bhutan in September 1988 to review trade statistics. The report was issued in January 1989. During April 24-May 6, 1990, a multitopic mission visited Bhutan to review the data situation.

e. IMF Institute

An Institute course on financial programming was held in Thimphu during April 24-May 8, 1991.

XI. Resident Representative/Advisor

None.

Bhutan: Relations with the World Bank Group

(As of August 31, 1991)

Project	Total Commitments (Original)	Disbursed	Undisbursed
<u>(In millions of U.S. dollars)</u>			
Technical assistance	3.0	3.3	--
Forestry development	5.5	4.6	2.3
Calcium carbide	9.0	7.2	5.0
Primary education	4.2	0.3	3.8
Secondary forestry development	1.1	0.3	0.8
Total	<u>22.8</u>	<u>15.7</u>	<u>12.3</u>
Debt outstanding (including undisbursed)	28.6		
IFC net commitment <u>1/</u>	...		
Latest economic mission	August 1991		
Aid Consultative Group Meetings	Bhutan participated in the United Nations Round Table Meeting on the Asian and Pacific Least Developed Countries, which was held in April 1986 in Geneva. A Round Table Meeting on Bhutan, jointly sponsored by the World Bank and the UNDP, was held in November 1988 in Paris. The next Round Table Meeting is tentatively scheduled for June 1992.		

Source: The World Bank.

1/ Bhutan has not joined IFC.

Bhutan--Relations with the Asian Development Bank

(As of September 30, 1991)

<u>Project</u>	<u>Amount ('000 \$)</u>	<u>Year</u>
<u>Loans</u>		
Multiproject	5,000	1983
Second Multiproject	7,400	1984
Chirang Hill Irrigation	3,480	1985
Roadworks Mechanization	4,500	1986
Highland Livestock Development	4,300	1987
Urban Centers Sewerage	3,300	1987
Industrial Estates	1,150	1988
Bhutan Development Finance Corporation	2,500	1988
Technical and Vocational Education and Training	7,130	1990
<u>Technical assistance</u>		
Urban Centers Sewerage	350	1987
Institutional Strengthening of the Ministry of Agriculture and its Operational Departments	305	1987
Institutional Strengthening of the Department of National Budget and Accounts of the Ministry of Finance	230	1988
Low-Income Housing Finance	96	1988
Master Plan for Forestry Development	738	1988
Agricultural Extension Course	75	1988
Institutional Support to the Bhutan Development Finance Corporation	270	1988
Women in Development Profiles in Highland Livestock Development	30	1988
Institutional Strengthening of the Department of Trade and Industry	250	1988
Technical Education and Vocational Training	100	1989
Study on Promotion of Export-Oriented Industries	300	1989
Institutional Improvements in Technical and Vocational Education and Training	750	1990
Institutional Strengthening of the Bhutan Development Finance Corporation	431	1991
Renewable Resources Sector Development Plan	100	1991
Institutional Strengthening of the Department of National Budget and Accounts (Phase II)	600	1991

The Asian Development Bank has made no equity investments in Bhutan.

Source: The Asian Development Bank.

Bhutan--Social and Demographic Indicators

Area:	46,500 sq. kilometers
Population (1991 estimate)	0.6 million
Urban population as percent of total population	5 percent
Crude birth rate (per '000)	39
Crude death rate (per '000)	17
Infant mortality rate (1984) (per '000 live births) <u>1/</u>	102
Average annual growth of population (1980-88)	2.4 percent
Life expectancy at birth	48 years
Of which: Female	(47 years)
Adult literacy rate	15 percent
Number enrolled in primary schools (1990) (as percentage of age group)	28
Of which: Female	(32)
Number enrolled in secondary schools (as percentage of age group)	5
Population per physician (1988)	9,700
Average annual growth of labor force (1980-85)	1.9 percent
Population of working age (15-64)	57 percent
Labor force in agriculture (1984)	87 percent
Deforestation rate (net)(annual)	0.2 percent

Sources: IBRD, Social Indicators of Development, 1990; and information provided by the Bhutanese authorities.

1/ Number of infants who die before reaching the age of one year.

Bhutan--Statistical Issues

1. Outstanding statistical issues

The authorities have decided to pool all statistical services in an enlarged Central Statistical Organization (CSO). Most existing statistical cells of government departments will be transferred to the CSO. In this regard, the staff recommended that more resources be allocated to the collection and compilation of current economic indicators, particularly in the areas of production, prices, and foreign trade.

a. Real sector

Real sector data are generally dated; national accounts statistics are available in IFS only through 1988, and trade data are published through 1989.

b. Balance of payments

Bhutan's balance of payments data are weak and rudimentary and are compiled on a mixed calendar and fiscal year basis.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Bhutan in the November 1991 issue of the IFS.

Sector	Series	Latest Data in Nov. 1991 <u>IFS</u>
Real Sector	- National Accounts	1988
	- Prices: WPI	n.a.
	CPI	December 1990
	- Production: electricity	December 1990
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/surplus	1990
	- Financing	1990
	- Debt	1990
Monetary Accounts	- Monetary Authorities	March 1991
	- Deposit Money Banks	March 1991
	- Other Banking Institutions	n.a.

Bhutan--Statistical Issues (concluded)

Sector	Series	Latest Data in Nov. 1991 <u>IFS</u>
External Sector	- Merchandise trade:	
	Values	1989
	Volumes	n.a.
	Prices	n.a.
	- Balance of payments	1989
	- International reserves	March 1991
- Exchange rates	July 1991	
