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October 9, 2007

**The Acting Chair's Summing Up  
Bhutan—2007 Article IV Consultation  
Executive Board Meeting 07/87  
October 5, 2007**

Executive Directors agreed with the thrust of the staff appraisal. They commended Bhutan's prudent macroeconomic policies and political stability, which have yielded robust growth, an appreciable improvement in social indicators, and progress toward meeting the Millennium Development Goals, contributing to a solid foundation for the transition to a constitutional monarchy in 2008.

Directors welcomed the favorable macroeconomic outcomes and good medium-term growth prospects. Rapid real GDP and per capita income growth over the last decade was led by the Tala hydroelectric power project. The additional power projects in the pipeline, with strong donor support, would maintain the growth momentum. Inflation has remained in line with price developments in India and overall international reserves have remained adequate.

On monetary management, Directors called on the Royal Monetary Authority (RMA) to remain watchful of excess liquidity and rapid credit growth. They welcomed the steps being taken to tighten monetary conditions to deal with the temporary shortfall in rupee reserves and rein in private sector credit growth. They recommended enhancing the RMA's capacity in monetary and foreign exchange reserve management, and supported the authorities' request for Fund technical assistance in this area.

Directors highlighted the need to limit the balance sheet exposures of financial institutions to sectoral and macroeconomic risks, and to improve the ability of these institutions to monitor and manage such risks. The development of government securities markets over the medium term should help manage liquidity and provide alternative investment vehicles for financial institutions. Directors encouraged the RMA to further enhance its capacity for financial sector supervision.

Directors agreed that the exchange rate peg of the ngultrum to the Indian rupee and the level of the peg remain appropriate. The peg has anchored inflation expectations and facilitated trade with India. Should the revenues from the Tala project lead to upward pressures on the real exchange rate, fiscal tightening to moderate a rise in the prices of nontradable goods could mitigate such pressures. Over the medium term, competitiveness could be enhanced by raising private sector productivity.

Directors underscored the importance of ensuring fiscal sustainability by limiting domestically financed deficits and mobilizing external aid on a timely basis. This would help to maintain the public debt-to-GDP ratio on a downward trajectory. Directors supported efforts to raise domestic revenues by broadening the tax base and strengthening tax administration, including through a rationalization of the sales tax and import duty rates. They encouraged the authorities to plan expenditure in a medium-term framework. Directors concluded that Bhutan's risk of external debt distress is moderate, reflecting the authorities' good record of implementation of externally financed hydroelectric projects, high level of overall foreign exchange reserves, and strong external donor support for the power sector projects.

Directors advised the authorities to accord high priority to private sector development and economic diversification to ensure job creation. This would help overcome the constraints of Bhutan's landlocked location and small size. Key reforms include aligning Bhutan's education system to market needs, strengthening infrastructure, and further streamlining the regulatory regime. Directors welcomed Bhutan's plans to join the World Trade Organization.

Directors considered that Bhutan's strong external position provides scope for further gradual liberalization of exchange restrictions. The authorities were encouraged to eliminate restrictions subject to approval under Article VIII as soon as possible, and to eliminate the restrictions maintained under Article XIV as soon as Bhutan's balance of payments position permits. Fund technical assistance to help develop a foreign exchange market and market-based instruments to manage hard currency flows would facilitate the elimination of these restrictions and allay concerns about their removal.

Directors welcomed the authorities' efforts to strengthen Bhutan's statistical data. In particular, data in the fiscal and external sectors need to be upgraded.

It is expected that the next Article IV consultation with Bhutan will be held on the 24-month cycle.