FOR AGENDA

SM/87/155

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July 8, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Bhutan - Staff Report for the 1987 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1987 Article IV consultation with Bhutan, which will be brought to the agenda for discussion on a date to be announced. A draft decision appears on page 15.

Mr. B. J. Smith (ext. 7301) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

BHUTAN

Staff Report for the 1987 Article IV Consultation

Prepared by the Staff Representatives for the 1987
Article IV Consultation with Bhutan

Approved by W.M. Tilakaratna and H.B. Junz

July 6, 1987

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I. Introduction

The 1987 Article IV consultation discussions were held during April 16-30. The staff team, consisting of Mr. Smith, Ms. Bond, Messrs. Shah and Pinho (all ASD), and Ms. Greene (EXR), had discussions with Dasho D. Tshering, Deputy Minister of Finance, Dasho Om Pradhan, Deputy Minister of Trade and Industry, and other officials of government ministries, the Royal Monetary Authority, and public entities.

Bhutan continues to avail itself of the transitional arrangements of Article XIV.

II. Background to the Discussions

1. Economic framework

Bhutan is a small, landlocked, Himalayan kingdom. Bordered by the Tibet autonomous region of China in the north, with which traditional ties were severed almost three decades ago, Bhutan's economy is closely linked to that of India to its south. Trade with India is free, which provides Bhutan preferential access to India's large and protected market; India provides substantial assistance--equivalent to about one third of GDP; and the Indian rupee circulates freely, at par with the ngultrum, as domestic currency. The economy is largely rural based, with agriculture and livestock providing incomes for over 90 percent of the population. Other resource endowment includes forests, minerals--with substantial deposits of dolomite, limestone and gypsum--and an enormous potential for hydropower. The mountainous terrain and the country's landlocked location creates major transport and communications difficulties, and infrastructure is undeveloped. Population is relatively small (perhaps 1.2 million), with literacy and life expectancy low, and health and education services are not widely available (Annex II).

2. Recent economic developments

Reliable estimates of national income are not available; indicative staff estimates suggest that GDP in 1986 amounted to about Nu 2.5 billion ($200 million). It appears that growth performance was mixed in 1985 and 1986. Construction activity, which had provided the underpinning for growth in earlier years, slowed in 1985 and 1986, with the winding down of construction at the Chukha hydropower project and other development projects. Although the Chukha project came onstream late in 1986, a moderate increase in electricity generation only partly offset the decline in 1985. On the other hand, logging activity rose abruptly in 1986 as forest salvage operations expanded, and tourist activity increased. In agriculture, production of rice, potatoes and oranges

increased over the course of 1985 and 1986, but for most other items output stagnated. Overall, the staff estimates real GDP increased by some 2-3 percent in 1985 and about 5-6 percent in 1986.

Because of close trading and monetary links with India, price developments in Bhutan largely follow those in India, although price levels tend to be notably higher, because of high transportation costs and a less competitive market. Consumer price inflation rose from 5 percent in 1985 to 12 percent in 1986; the sharp increase measured in 1986 is not believed to accurately reflect overall inflation, which remained moderate. Food prices, which rose by 4 percent in 1985, increased by 8 percent in 1986.

Budgetary transactions resulted in a large deficit in 1985/86 (fiscal year ending March). A sizable rise in capital spending and sluggish growth in revenues and grants led to a deficit of some Nu 180 million (about 8 percent of GDP). Government bank borrowing to finance the deficit rose by Nu 84 million, and the broad ngultrum money stock rose by 27 percent in 1985. Preliminary estimates indicate the budget deficit declined to about Nu 100 million (4 percent of GDP) in 1986/87 as a strong increase in revenues and, particularly, grants exceeded a sizable increase in spending. With a further increase in foreign loans, outstanding bank borrowings were reduced by about Nu 59 million, and the expansion in the broad ngultrum money supply slowed to 15 percent in 1986.

The bulk of Bhutan's external transactions are with India. As the Indian rupee circulates as domestic currency in parallel with the ngultrum, the balance of transactions with India is usually in surplus, reflecting an expanding domestic demand for rupees. Developments in 1985/86 represented a departure from this norm: exports rose strongly, and although imports also increased, the deficit on services account contracted sharply (associated with the slowing of Chukha construction). The current account deficit fell slightly to Nu 763 million (34 percent of GDP), but with lower aid flows from India, the overall balance shifted from sizable surpluses in previous years to a deficit of Nu 10 million. In 1986/87, the overall external balance with India returned to a surplus of Nu 70 million. Exports again rose briskly, but imports and net service payments increased by much more. While the current account deficit expanded to Nu 929 million (37 percent of GDP), this was more than matched by an increase in Indian assistance.

Transactions with other countries, involving convertible currencies, are much smaller in volume and current payments and capital transactions are subject to approval on a case by case basis. Despite negligible export earnings and only moderate increases in tourist and other exchange earnings in 1985/86 and 1986/87, convertible currency imports rose by a quarter in 1985/86 and by a further third in 1986/87, financed by higher official assistance. The overall surplus on convertible transactions rose from $6 million in 1985/86 to an estimated

$9 million in 1986/87. In March 1987, gross international reserves amounted to $63 million, equivalent to 9 months of total imports; convertible currency reserves were $29 million, about two years of convertible currency imports.

III. Policy Discussions

1. Financial policies

a. Public finances

Up until 1985/86, fiscal policy had been cautious in its framing and largely predictable in its outcome. Although reliance on foreign grants (both for projects and general budget support) was heavy--covering some two thirds of total spending --the budget position (including bank financing) was maintained at near balance (Chart 1). The budgets for 1985/86 and 1986/87 represented something of a departure from this tradition, providing for expanding spending and deficits, financed in part, for the first time, by foreign borrowing on a sizable scale. In the event, the overall deficit in 1985/86 was substantially in excess of the amount budgeted, largely because of a shortfall in revenues, and Indian grants were lower than expected. The weak revenue performance was mainly due to low profit transfers from public enterprises.

The authorities view the large recourse to bank financing in 1985/86 as being excessive. However, to the extent that it reflected mainly temporary and timing factors affecting profit transfers and reimbursements under aid programs, it was not a cause for undue concern. Indeed, in 1986/87 the budgetary outturn improved substantially, and the bulk of the bank borrowing in 1985/86 was repaid. This was made possible by a rebound in domestic revenues, especially of profits from public enterprises, including the first receipts of electricity revenues from Chukha. In addition, the authorities requested and received an additional Nu 140 million of general budgetary support grants from India in light of the budgetary gap in 1985/86.

The rapid increase in spending during 1985/86 and 1986/87--which amounted to 68 percent over the two years--was mainly concentrated in capital expenditures, which doubled. This was due mainly to large increases in spending for development projects, including investments in commercial undertakings, but also including social infrastructure. It was associated with a large increase in foreign borrowing on concessional terms, which expanded from Nu 15 million in 1984/85 to Nu 156 million in 1986/87. These borrowings, from the Kuwait Fund, the AsDB, IFAD and the World Bank, are focused in agriculture, forestry and industry.

The budget for 1987/88 has not yet been finalized, pending completion of the Sixth Plan (expected by July) and associated with the change in the fiscal year to a July-June basis. However, provisional budget projections suggest that, on an annualized basis, revenues and grants would rise by 5 percent and expenditures by 9 percent. Although the overall budget deficit would increase to about 6 percent of GDP, and be some Nu 63 million higher than in 1986/87, the increase would be more than matched by higher concessional loans, and there would be a further net repayment of government credit to the banks. The authorities are concerned that expenditures may exceed the budgeted amount, partly as a result of a planned 50 percent increase in salary levels which had been eroded, and are currently reviewing expenditure items with the aim of trimming excesses. Also, actual receipts from the sale of electricity to India from Chukha in 1987/88 could well be considerably larger than the budget allowance of Nu 80 million; the authorities expect that profits from the sale of electricity to India will, in due course, yield budget revenues of around Nu 200 million per annum after debt servicing charges. On balance, it would appear that the budget outturn for 1987/88 may well be even more favorable than now forecast.

The favorable budgetary prospects for 1987/88 are largely the result of the sizable boost to revenues coming from the start-up of Chukha. However, within a few years, these revenues will be fully absorbed as the budget grows. The authorities are therefore concerned to avoid any relaxation of resource mobilization efforts. The tax system is fragmented and efforts to rationalize it--along lines identified with Fund assistance--have so far been thwarted by manpower shortages. The authorities are at present assessing the tax system with a view to taking a limited number of steps in the direction of simplification and rationalization, consistent with their implementation capacities. These might include widening the excise tax net, and strengthening business taxes. At the same time, it is clear that the public enterprises have an important role to play in resource mobilization. At present, performance is mixed, with some enterprises being lucrative and others involving losses. The authorities recognize that public enterprises can contribute more than at present. They are considering steps to establish appropriate guidelines for the operations of public enterprises, but the conflict between the objectives of commercial independence and public accountability, especially in an environment where trained manpower is scarce, makes it necessary to proceed cautiously.

b. Money and credit

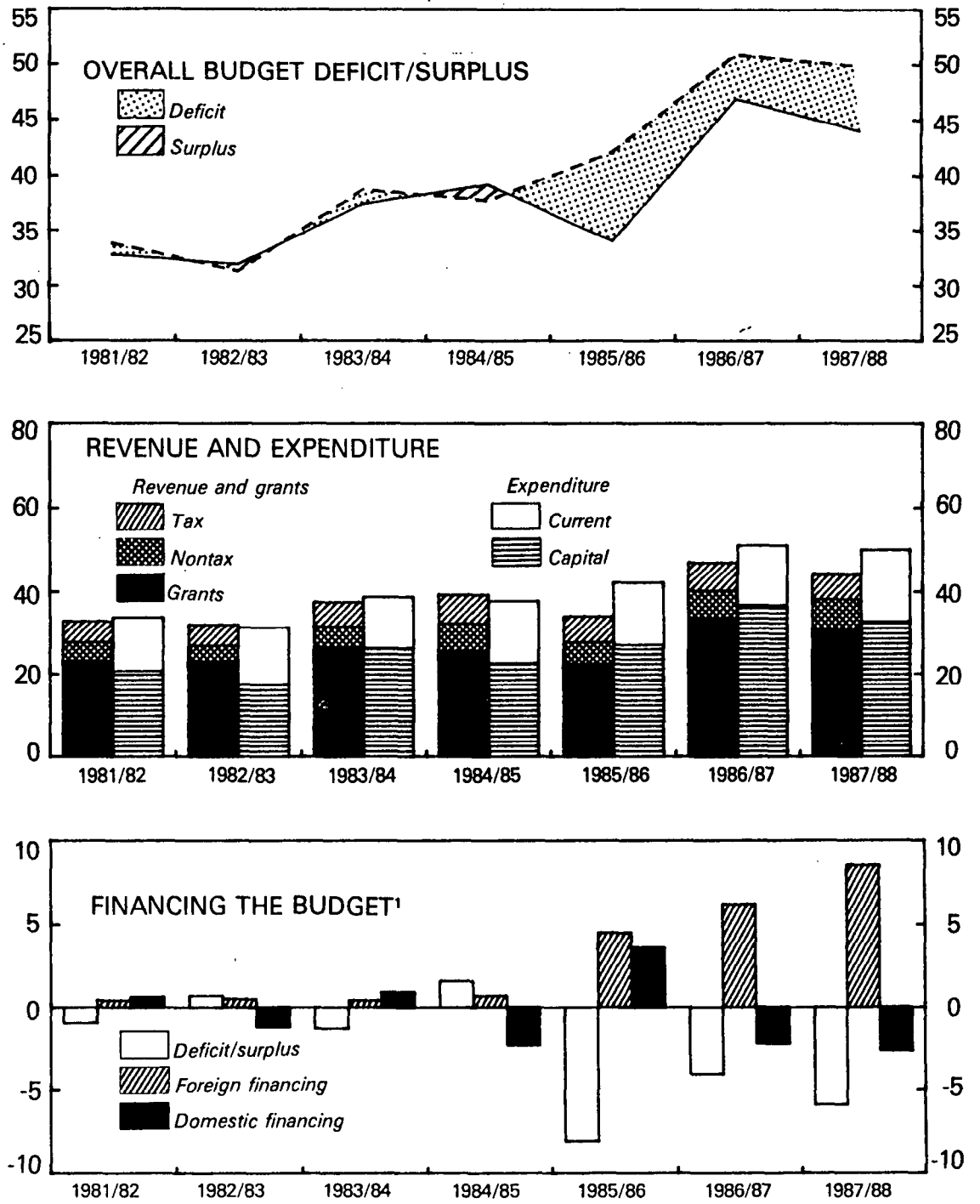
The effective role of monetary policy is limited. The share of ngultrum in money holdings is believed to have increased considerably over recent years although rupees remain important, especially in border areas; data on rupee holdings are not available. The Royal Monetary Authority (RMA), which was created in 1982, has assumed the function of currency issue and taken control of non-rupee international reserves.

CHART 1

BHUTAN

FISCAL PERFORMANCE, 1981/82-1987/88

(In percent of GDP)



Sources: Royal Government of Bhutan, Budgetary Accounts; and staff estimates.

[1] Foreign and domestic financing is shown above the central line; domestic financing below the central represents a reduction in domestic credit.

However, most rupee reserves remain with the Bank of Bhutan (BoB), the sole commercial bank, which also remains banker to the Government. With the BoB in a strongly liquid position, the RMA's influence on credit developments is largely through moral suasion.

The broad ngultrum money stock has expanded rapidly over recent years, associated with the continuing rapid monetization of the economy, and the progressive substitution of ngultrum for rupees as a medium of exchange. Monetary growth has been fueled mainly by external transactions. The 27 percent increase in broad money in 1985 was associated both with a large increase in net foreign assets and, unusually, an increase in domestic credit largely reflecting the budget deficit in 1985/86. In 1986 there was a further large surplus on external transactions, but with the budgetary turnaround, domestic credit contracted and the growth of broad money slowed significantly. The deceleration is believed to reflect a slowdown in monetization. There may possibly have also been some reaction to very rapid increases in ngultrum balances reflected in some portfolio switching into rupees, although supporting data are not available.

Lending by the BoB to the private sector is small--amounting to less than 10 percent of the bank's assets--and has grown only slowly. Over half of the BoBs assets are rupee deposits with the State Bank of India (which partly owns BoB) at favorable interest rates. The bank indicates that this asset distribution is due to a shortage of bankable lending opportunities in the private sector, and not the attractiveness of risk-free deposits in India. Indeed, a special fund was established in an effort to meet the credit needs of small entrepreneurs unable to provide collateral to the bank's normal standards. However, there has so far been no demand for this financing. Most seasonal and medium-term credit needs of the agricultural sector are provided through a special agricultural credit scheme administered by the RMA and funded under foreign assistance. Disbursements rose sharply in 1985 and 1986. Plans are advancing for the establishment of an industrial credit scheme, to be financed by the AsDB, and to administer agricultural and industrial credit under an independent Development Finance Institute.

An important development in recent years has been the emergence of the Unit Trust of Bhutan (UTB) and the Royal Insurance Corporation of Bhutan (RICB) as rapidly growing financial entities. The UTB has developed as an aggressive and competitive deposit raising institution and funds raised by the UTB, together with resources of the Government Employees Provident Fund, are invested through the RICB. Credit extended by the RICB rose by 31 percent in 1985 and 37 percent in 1986, and the share of the RICB in total credit to the private sector rose from 60 percent in 1983 to 70 percent in 1986 (Chart 2). Until now, RICB lending has mainly been for real estate financing, although the share of lending for industry has increased sharply in the last few years and the areas of competition between the RICB and the BoB are expanding.

While the authorities set lending interest rates, deposit interest rates offered by the BoB have, in the past, followed rates offered in India. However, competition for funds from the UTB has prevented the BoB from reducing deposit rates to match a recent decline in India.

2. Development policies

a. Development priorities

The authorities' development strategy gives top priority to agriculture because of its importance to the vast bulk of the population. More generally, policies are aimed at improving living standards in rural areas, not only by increasing agricultural incomes, but also by improving the quality of housing, health and education services. Within agriculture, the principal objective is self sufficiency in cereals, and in the period ahead particular emphasis is to be given to rice self sufficiency. Efforts are being made to increase yields through the provision of a balanced package of inputs, incorporating improved technology. At present, yields are low and costs of production high relative to those in neighboring India, in part because of high agricultural wages induced by a scarcity of rural wage labor. The authorities emphasize that cereal self sufficiency is motivated mainly by national food security considerations, but that with the spread of new techniques, including mechanization in a selective manner, it is expected that costs can be reduced to match those in India. Prospects are also favorable for increasing production of cash crops such as chillies, potatoes and oranges which find a ready market in India.

Livestock production offers the greatest scope for increasing incomes in mountainous regions, and steps are in train to improve cattle and yak productivity, and improve marketing outlets for animal products. Forests represent a major resource endowment, although their exploitation at present is mainly concentrated in the salvage by the public sector of timber from dead trees. The authorities are seeking to determine the most appropriate commercial forest management techniques and to reopen the timber sector to supervised private activity in due course.

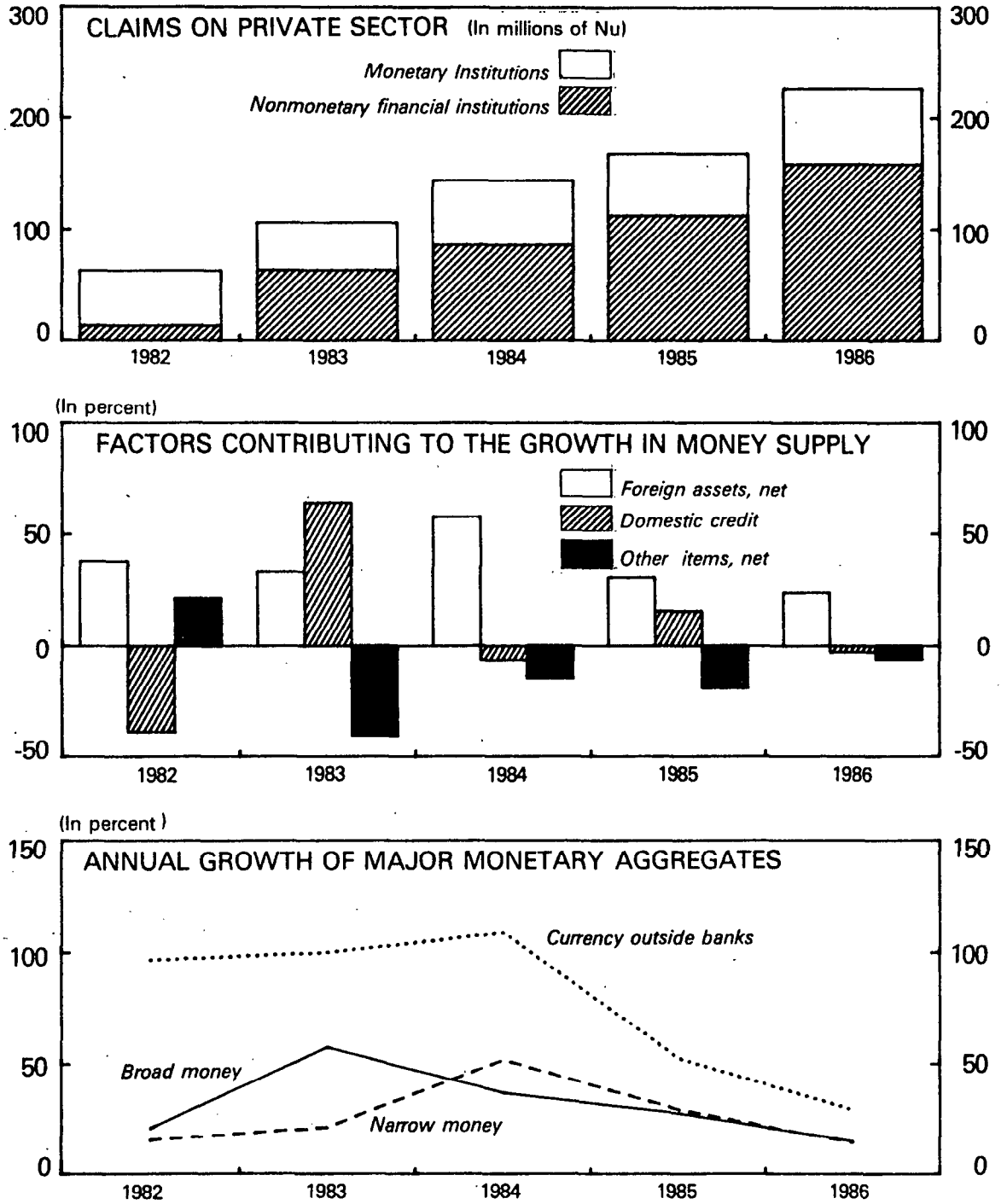
Tourism also presents important development opportunities. At present, tourism is limited to controlled group tours organized through the public sector. The authorities see scope for some expansion in tourism so that available facilities are more fully utilized, but are loth to consider substantial or uncontrolled expansion because of the cultural threat this would pose.

In the field of secondary industry, the priority is to develop industries based on indigenous resources, and that contribute to government revenues and have a positive impact on the balance of payments. A number of large projects have been set up or are in the

CHART 2

BHUTAN

MONETARY INDICATORS, 1982-86



Sources: Royal Monetary Authority of Bhutan; and staff estimates.

process of construction. These include hydropower, wood processing, cement, and calcium carbide.

b. Trade and industry

Free trade and differences in resource endowment make India Bhutan's natural export market. Indeed, many of the faster expanding areas of production, such as potatoes and oranges, have been founded on sales to India, and the prospect of remunerative sales to India underlies the feasibility of several major development projects. The Chukha hydropower project is the most obvious example, but cement, calcium carbide and dolomite also fit this pattern. Exporting to India is of major economic benefit, both in generating incomes and earning rupees to finance imports, especially of manufactures where Bhutan has little productive capacity. However, rupee export receipts are not convertible into the other currencies necessary both to purchase goods and services from third countries and service convertible currency debt.

Beyond tourism, convertible currency earnings are very small. While many Bhutanese products could find markets in third countries, the natural attractions of India's protected and high priced market make this uneconomic. Added to this, there are formidable and costly logistical barriers to third country trade which must transit through India. The authorities are anxious to expand earnings of convertible currencies, as urged by Directors during the last Board discussion, and are well aware of the difficulties in doing so. They see Bangladesh and Nepal as offering important new trade opportunities and initial steps are being taken to exploit this through the opening up of trade routes and trial shipments. In newly established industries, the authorities are taking the view that technology and efficiency must be such that they are competitive not only in India, but in broader international markets as well. They see industries based on high quality domestic minerals and cheap power as having considerable potential in this regard. Nevertheless, special incentives are needed to offset the attractiveness of exports to India. The authorities have experimented in providing budget subsidies to encourage direct sales of cardamom to third markets, rather than through the intermediation of Indian traders. Consideration was being given to tax and other types of incentives that might be appropriate in the circumstances.

c. Manpower and the role of the private sector

Unlike many of its neighbors, manpower is a relatively scarce resource in Bhutan. There are substantial imports of labor, both to meet skill needs and for the construction and upkeep of infrastructure. The authorities are encouraging a pattern of development which takes account of the need to economize on manpower use, especially in the adoption of modern labor saving technologies and limiting the size of public employment.

Shortages of trained manpower is one of the most binding constraints on development. Most advanced training has to be undertaken abroad, predominantly under foreign assistance. While manpower training is included in many aid programs, these opportunities do not always match the areas of greatest need, and the Government is now endeavoring to take more steps to ensure that training needs in critical areas are met. Capacity to absorb technical assistance is stretched by a shortage of counterpart personnel. There are major gaps in economic statistics which hamper analysis and policy assessment; the Fund is providing technical assistance in the fiscal and monetary areas, partly with the objective of addressing these problems, but progress will take time.

Outside agriculture, private entrepreneurship is largely absent. During the last Board discussion Executive Directors welcomed the authorities' intention to strengthen the role of the private sector. Programs are being developed to foster entrepreneurial development and provide investment financing. Until a significant private business capacity emerges, the Government believes it is both inevitable and appropriate that the public sector assume a major role in business. The objective of policies in this area is to limit the claims on manpower and other resources that heavy reliance on foreign aid and public enterprise tends to generate; utilize the private sector as fully as possible; privatize public enterprises when feasible; and establish suitable guidelines for the operation of public enterprises. In 1987 the Government is attempting to reduce the size of public employment by up to 20 percent, and envisages that those employees released will increase the vitality of private business. Joint ownership of corporations by the public and private sectors is proving a flexible instrument which allows private ownership to increase in line with its capacity. The Government has also recently privatized a number of public commercial enterprises including operations in transport, food distribution, and animal feed. In view of Bhutan's situation, foreign equity investment is considered on a case by case basis, but is generally not permitted. However, the Government is currently considering allowing foreign ownership in integrated agricultural enterprises.

3. The medium-term outlook

a. The Sixth Development Plan

The authorities are in the process of finalizing the Sixth Development Plan which will cover the five years beginning in July, 1987. It is expected that government spending over the Plan period will total Nu 9.5-10 billion, compared with an estimated Nu 5.7 billion in the previous five years (including Chukha spending outside the Plan). In real terms, therefore, the likely increase in public spending will be modest. Indicative allocations of spending over the five-year period reveal noticeable frontloading, with projected spending peaking in 1988/89 and declining progressively over the subsequent three years. This pattern is due to the work schedule for several of the major

projects in the Plan. Because the projects involve sizable reliance on external financing and imports, the uneven spending pattern would be unlikely to create difficulties for the economy. In any case, a more even pattern would emerge if normal delays are encountered.

Details of the financing of the Plan were not final at the time of the discussions, pending agreement with India on the level of its assistance. However, with many of the major projects already under construction, or at least with agreed financing, the main dimensions of the financing framework appear to be in place. Indian assistance, mainly in the form of budgetary and project related grants, would cover more than 40 percent of projected total spending. Other external assistance, from bilateral donors and multilateral agencies, would bring the share of total spending financed by foreign grants and soft loan assistance to about two thirds. Internal tax and nontax revenue would cover a further quarter, leaving a residual financing requirement (including domestic borrowing) of about Nu 0.7 billion, 7 percent of the total.

The authorities see the projected continued heavy reliance on external grants and loans in financing the Sixth Plan as inevitable at this stage in Bhutan's development. However, this proportion would be significantly lower than the average proportion of almost 80 percent during 1982/83-1986/87 (including Chukha). Domestic revenue is expected to substantially exceed the conservative allowance in the Plan, which would reduce both the projected reliance on external financing and the residual financing requirement. Over the longer term, the authorities would look to increase the share of total spending covered by domestic revenues to over half.

Regarding domestic borrowing from the banking system, the authorities reaffirm their traditional cautious policies. Generally, no bank borrowing in excess of Nu 100 million in any year would be countenanced. In the event that sizable bank borrowings are undertaken in any year, the budget for the following year would include provision for its repayment.

b. <u>The external outlook</u>

The authorities expect that economic growth over the course of the next five years will average in the 7-8 percent range. Output of products such as electricity, calcium carbide, cement and wood products will expand substantially as investments mature, and the bulk of this additional production will be exported to India; tentative projections put rupee export growth at about 15 percent per annum during this period. There seems every reason to believe that the availability of rupee resources will not be an economic constraint in the period immediately ahead.

The situation with respect to transactions in convertible currencies is much different, and during the last Board discussion, Directors expressed concern about weakness in exports to third markets. Although the Indian market is large and diversified, there is an obvious need for Bhutan's economy to expand its access to imports and technology from competitive and advanced international markets.

Bhutan has begun to incur convertible currency debt on a significant scale only very recently. In March 1985, total convertible currency debt outstanding amounted to only $3.2 million. However, disbursements increased considerably in 1985/86 and 1986/87, and by March 1987 debt had risen to $24.5 million, and undisbursed loan commitments amounted to $66.9 million. All these loans, which are mainly from multilateral development agencies, are on soft terms, and debt service payments in 1986/87 were no more than $0.6 million, or 9 percent of convertible currency receipts. However, disbursements of aid loans are expected to increase substantially over the course of the Sixth Plan.

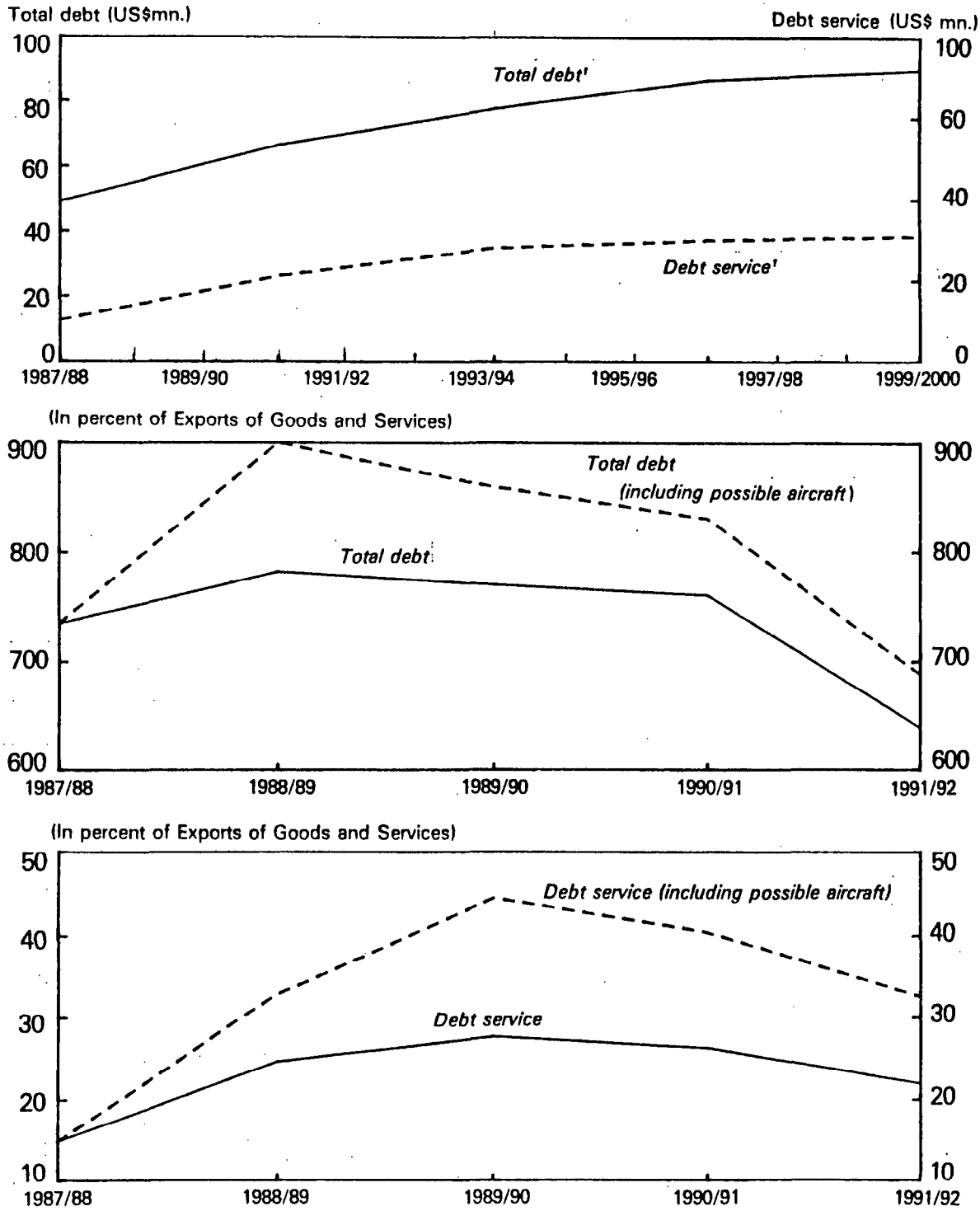
Table 1 provides balance of payments projections for convertible currency transactions up to 1991/92. The projections are consistent with the tentative Sixth Plan targets, and projected external borrowings. They assume that efforts to expand exports to third countries are successful in raising export receipts significantly--although the projected value at the end of the period remains small, both in absolute size and relative to the ultimate potential. They also assume that policies are adopted which will lead to a significant, although limited, increase in earnings from tourism. On this basis, convertible currency earnings would be adequate to sustain a healthy growth in self-financed imports from third countries, and the present almost complete reliance on foreign aid financing for this purpose would be reduced substantially. Convertible currency reserves would increase substantially, and at the end of the period would still amount to 17 months convertible currency imports. Debt servicing, as a percentage of current convertible currency receipts, would rise to a peak of 28 percent in 1989/90, but subsequently decline significantly (Chart 3). Looking further into the future--when the burden of such concessional debt might be expected to be higher--debt servicing costs on this debt would remain manageable up to the end of the century, allowing scope to draw down additional concessional loans beyond the Sixth Plan period.

In managing the debt position the authorities have tended to become increasingly cautious in undertaking new borrowing even though on highly concessional terms; such caution was encouraged during the last Board discussion. They are now, for example, reluctant to accept loan assistance for social projects. They are also anxious to increase convertible currency earnings, although in some important potential areas, such as tourism and timber, they are constrained by the need to avoid undesirable effects on the culture and environment. At the same

CHART 3

BHUTAN

CONVERTIBLE CURRENCY DEBT AND DEBT SERVICING PROJECTIONS, 1987/88-1999/2000



Sources: Data provided by the Bhutanese authorities, international institutions: and staff estimates.
[1]Covers only debt incurred up to end of the Sixth Plan (1991/92).

Table 1. Bhutan: Medium-Term Balance of Payments with Countries Other than India, 1987/88-1991/92

(In millions of U.S. dollars)

	1987/88	1988/89	1989/90	1990/91	1991/92
Exports, f.o.b.	0.3	0.5	0.7	1.0	1.5
Imports, c.i.f.	-15.4	-17.9	-20.6	-23.7	-27.2
Aid related	-14.2	-16.2	-14.5	-15.9	-13.1
Other	-1.2	-1.7	-6.0	-7.7	-14.2
Trade balance	-15.1	-17.4	-19.9	-22.7	-25.7
Service receipts	4.4	5.9	7.2	8.0	10.2
Tourism	(3.3)	(3.9)	(4.2)	(5.1)	(6.1)
Service payments	-16.8	-19.3	-18.0	-20.0	-17.1
Interest	(-0.8)	(-1.2)	(-1.)	(-1.1)	(-1.2)
Private transfers	2.0	2.1	2.2	2.4	2.4
Current account balance	-25.4	-28.8	-28.5	-32.3	-30.2
Foreign aid	33.1	36.9	32.6	35.7	29.0
Grants	14.9	20.9	20.9	26.3	24.8
Loans, net	18.3	16.0	11.7	9.4	4.3
Receipts	18.6	17.1	13.3	11.1	6.0
Repayments	-0.3	-1.1	-1.6	-1.7	-1.8
Errors and omissions	--	--	--	--	--
Overall balance	7.7	8.1	4.0	3.5	-1.2
Memorandum items:					
Outstanding debt	49.2	66.5	77.8	86.7	90.0
Debt service	1.0	2.1	2.8	3.0	3.1
Ratio to current receipts (in percent)	(14.9)	(24.7)	(27.7)	(26.3)	(22.0)
Convertible currency reserves	41.0	49.1	53.1	56.6	55.4

Source: Projections by the Fund staff.

time, they see a pressing need to address the difficulty posed in international transport, and are contemplating a commercial aircraft purchase. It is likely that the financing of this purchase would involve borrowings of about $10 million on near commercial terms. While this would increase outstanding debt by only about 10 percent, it would substantially raise the debt servicing burden over the next few years, to over 40 percent. The authorities stress that no decision has yet been taken on this purchase and that, while the purchase has potential effects which go beyond the economic area, the economic implications will be carefully assessed.

IV. Staff Appraisal

Bhutan's economy has continued to develop along satisfactory lines in the almost two years since the last consultation. Output expanded in important areas, sizable investments were undertaken, inflation has broadly followed the moderate rates experienced in India, and the external position has remained strong, with international reserves rising markedly. International economic relationships have expanded considerably, adding new dimensions to the tasks of economic management. At the same time, policies have remained firmly based in a framework notable for caution and pragmatism, and have continued to be broadly appropriate to the evolving situation.

Budgetary developments were unusually expansionary in 1985/86, but this partly reflected transitory factors and with the aid of additional budgetary assistance from India, the position improved considerably in 1986/87. The budgetary prospects for 1987/88, and indeed the coming few years, are generally favorable as a result of large additions to revenues from the Chukha project. Nevertheless, public finances remain structurally weak. Most obviously, the reliance on foreign financing of expenditures is high and seems unlikely to decline substantially in the foreseeable future. There seems no reason to doubt that substantial assistance on generous terms will continue to be available from India and other donors. However, such heavy reliance on foreign assistance brings with it a need for additional matching domestic resources and tends to lead to an enlargement in the size of the public sector and its demands on scarce financial and manpower resources. Three policy approaches suggest themselves. First, the Government must be vigilant in guarding against an escalation in the size of Government. The current program of civil service retrenchment is well conceived in this context, although the planned large increase in government salaries would partly offset the potential gains. Second, development projects must be assessed critically against a range of criteria extending beyond the availability of soft-term financing to ensure that the reliance on external financing is for truly worthwhile purposes. Third, efforts must be intensified to strengthen domestic resource mobilization. Steps to streamline the tax system, as identified by Fund assistance, would play a part. Equally, an improvement in the revenue contribution of the

large public enterprise sector is both feasible and essential if budgetary self reliance is to be strengthened.

The role of monetary policy remains limited. The growth in the ngultrum money stock, which increased strongly as a result of the large budgetary recourse to bank finance in 1985/86, has since slowed, reflecting improved public finances, decelerating monetization of the economy, and possibly, some reduction in the public's acceptance of ngultrum in response to rapid increases over recent years. Caution will therefore be needed in future in financing budget deficits; in this connection, the authorities' policy of avoiding persistent bank financing of budget deficits is reassuring. There are signs that the traditional sluggishness of credit to the private sector, which is both a reflection and cause of weak development in private business, is beginning to break down. In this area, the expanding activities of the nonbank financial institutions are playing a useful role in increasing competitiveness and efficiency within the financial system as a whole.

The Sixth Plan, which is to be inaugurated in 1987/88, appears, in its broad dimensions, to set realistic goals that should be financeable without undue strains. The principal directions of the Plan also seem well chosen. These include promoting agricultural and other rural industries, raising rural living standards, encouraging investments based on domestic energy, minerals and forest resources, and alleviating manpower constraints. At this stage, most development activity is concentrated in the public sector reflecting the absence of a strong private business establishment. In a number of areas policies are being framed with a view to encouraging the emergence of a stronger private sector. Nevertheless, there is an obvious danger that the well-intentioned efforts of the Government and aid donors to temporarily substitute for the private sector may have a perverse effect. This would tend to reinforce arguments favoring a highly selective approach to public commercial investment, privatization of public enterprises, selective relaxation of public regulations affecting business, and a more sympathetic attitude to the contributions that foreign investment can offer.

Bhutan's close relations with India bring many advantages, including generous amounts of assistance and preferential access to India's otherwise protected market. However, the almost irresistible attraction of the Indian market to exporters brings with it the danger that Bhutan's economy will develop in a way that mirrors that of India, even though Bhutan's circumstances are much different. It is essential that policies be framed with a view to ensuring, as far as possible, that producers are exposed to competition in the free international economy and, through access to imports and technology that can be purchased with convertible currency, are provided with the means to develop efficiently. Tentative steps have been taken in this direction, with steps to establish trade with Bangladesh and Nepal and to experiment with incentives to offset the natural attraction on exports

to India, but concerted efforts to promote a balanced pattern of trading will be needed in the years ahead.

The staff's medium-term scenario suggests that, with appropriate policies, it should be feasible to finance growing self-financed imports from third countries and service convertible currency debt into the 1990s. However, this favorable prospect would require that positive steps are taken to develop convertible currency earnings, although within the constraints imposed by cultural and environmental considerations. It also is contingent upon the limiting of external borrowing within reasonable bounds, and to that on highly concessional terms, such as is provided for in the Sixth Plan. Undertaking debt on commercial terms would be inadvisable at this stage and would, at the minimum, require much stronger efforts to expand convertible exchange earnings than seem feasible at this stage.

It is recommended that Bhutan be placed on a bicyclical procedure and the next discussions be held under the simplified interim procedure.

V. Proposed Decision

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

1. The Fund takes this decision in concluding the 1987 Article XIV consultation with Bhutan, in the light of the 1987 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, as described in SM/87/.., 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

Basic Data 1/

	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88
GDP and prices			(Change in percent)			
Real GDP 2/	10.8	6.1	2.6	2.8	6.0	6.5
Nominal GDP 2/	20.9	15.7	11.6	10.6	12.3	11.8
Consumer prices 2/	8.1	11.5	12.4	4.9	12.4	...
Government budget 3/			(In millions of ngultrum)			
Revenue and grants	498	675	790	757	1,172	1,229
Domestic revenue	138	197	278	259	336	368
Foreign grants	360	478	512	498	836	861
Total expenditure	488	699	758	936	1,273	1,393
Current expenditure	213	223	304	334	354	480
Capital expenditure	275	476	454	602	919	913
Overall surplus/deficit (-)	10	-24	32	-179	-101	-164
Foreign financing	9	7	15	99	156	237
Other	-19	17	-47	80	-55	-73
Money and credit 4/						
Net foreign assets	292	346	490	596	700	...
Domestic credit	-65	37	21	74	61	...
Net credit to Government	(-161)	(-63)	(-78)	(-8)	(-23)	(...)
Broad money	160	251	342	435	500	...
(Percentage change)	(20.7)	(57.2)	(36.5)	(27.1)	(14.8)	(...)
Balance of payments			(In millions of U.S. dollars)			
Exports, f.o.b.	16.6	15.6	17.4	22.2	25.3	...
To India	(16.3)	(15.2)	(16.8)	(22.1)	(25.0)	(...)
Imports, c.i.f.	-67.2	-70.8	-69.4	-75.7	-88.0	...
From India	(-56.8)	(-58.3)	(-61.0)	(-65.7)	(-74.3)	(...)
Current account balance 5/	-82.2	-93.1	-77.8	-78.6	-94.7	...
With India	(-70.4)	(-74.3)	(-67.3)	(-62.3)	(-72.7)	(...)
Foreign aid 6/	88.4	101.0	89.1	84.1	109.3	...
From India	(75.7)	(79.3)	(73.1)	(61.5)	(78.2)	(...)
Overall balance	6.2	7.9	11.3	5.5	14.5	...
With India	(5.3)	(5.0)	(5.8)	(-0.8)	(5.5)	(...)
Reserves, external debt, and exchange rate						
Gross foreign reserves; end of period	33.4	38.3	44.9	50.8	62.6	...
(In months of imports)	(6.2)	(6.7)	(8.1)	(8.1)	(8.6)	(...)
Convertible currency debt; 7/ end of period	1.22	2.03	3.19	11.46	24.50	49.25
Debt service ratio (in percent)	0.2	0.4	1.1	5.0	8.9	14.9
Exchange rate (period average) Nu/US$	9.630	10.312	11.887	12.237	12.787	...
Ratios to GDP (percent)						
Government domestic revenue	8.8	10.9	13.8	11.6	13.4	13.2
Government total expenditure	31.3	38.7	37.7	42.1	50.9	49.9
Overall surplus/deficit (-)	0.7	-1.3	1.6	-8.1	-4.0	5.9
Broad money	10.2	13.9	17.0	19.6	20.0	...
Exports	10.2	8.9	10.3	12.2	12.9	...
Imports	41.5	40.5	41.0	41.6	45.0	...
Current account balance 5/	-50.8	-53.8	-46.0	-43.2	-48.5	...

1/ Data relate to fiscal years ending March 31, unless otherwise indicated. Some of the 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/ Calendar years, beginning with 1982.

3/ Revenue and expenditures associated with the Chukha Hydroelectricity Project not included until 1986/87. For later years, revenue estimates include transfer to the budget by the Chukha Authority. 1987/88 figures have been annualized from 15-month budget data.

4/ End-December data.

5/ Goods, services and private transfers.

6/ Comprising official transfers and loans; includes errors and omissions.

7/ Disbursed debt only.

Social Indicators

Area	46,500 square kilometers
GDP per capita (1985/86)	US$150
Population (mid-1985)	1.2 million
Crude birth rate (per '000) (1984)	43
Crude death rate (per '000) (1984)	21
Infant mortality ('000 live births) (1984) 1/	135
Average annual growth of population (1973-84)	1.9 percent
Life expectancy at birth (1984)	44
Adult literacy rate (1985)	12 percent
Number enrolled in primary schools (as percentage of age group) (1983)	25
Number enrolled in secondary schools (as percentage of age group) (1983)	4
Population per physician (1981)	18,160
Average annual growth of labor force (1973-84)	1.9 percent
Population of working age (15-64) (1984)	56 percent
Labor force in agriculture (1980)	92 percent
Labor force in industry (1980)	3 percent
Labor force in services (1980)	5 percent
Urban population as percent of total population (1984)	4 percent

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

Bhutan: Fund Relations
(As of May 31, 1987)

I. Membership Status

(a)	Date of Membership	September 28, 1981
(b)	Status	Article XIV

(A) Financial Relations

II. General Department

(a)	Quota:	SDR 2.5 million
(b)	Total Fund holdings of ngultrum:	SDR 1.93 million (77.2 percent of quota)
(c)	Fund credit:	None
(d)	Reserve tranche position:	SDR 569,900
(e)	Current operational budget:	Not applicable
(f)	Lending to the Fund:	Not applicable

III. Current Stand-by or Extended Arrangement and Special Facilities

Not applicable

IV. SDR Department

(a)	Net cumulative allocations:	None
(b)	Holdings:	SDR 123,176
(c)	Current Designation Plan:	Not applicable

V. Administered Accounts

(a)	Trust Fund loans	
	(i) Disbursed:	None
	(ii) Outstanding:	None
(b)	SFF Subsidy Account:	Not applicable

VI. Overdue Obligations to the Fund

Not applicable

Bhutan--Fund Relations (cont'd)

VII. Country has not Used Fund Resources to Date

(B) Nonfinancial Relations

VIII. Exchange Rate Management:

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

IX. Last Article IV Consultation:

August 28, 1985 (85/127). Staff discussions were held during June 4-18, 1985 (SM/85/220, 8/8/85 and SM/85/216, 7/31/85). The Executive Board adopted the following decision:

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/85/220, 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.

X. Technical Assistance

(a). CBD:

Technical assistance was provided in setting up the Royal Monetary Authority of Bhutan (RMA) 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 operation 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 is now in its third year.

Bhutan--Fund Relations (concluded)

(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. Since November 1984, an expert from the FAD panel has been working as General Fiscal Advisor to the Ministry of Finance. The assignment was extended for a second year and has been subsequently extended for a third year.

(c) Legal

Several visits by a staff member of the Legal Department, most recently in April 1984, took place in connection with the drafting of tax legislation.

(d) Other

The Bureau of Statistics has expressed willingness to provide assistance in the statistical field should the Bhutanese authorities request such assistance. At present the authorities' capacity to absorb such assistance is limited.

Bhutan: Relations with the World Bank Group
(As of June 17, 1987)

Name of Project	Credit No.	Sector	Disbursed	Undisbursed
			(In millions of U.S. dollars)	
Technical assistance	1,416	other	0.3	3.3
Forestry development	1,460	agriculture	2.0	4.9
Calcium carbide	1,596	industry	1.8	10.3
Total			4.1	18.5
Debt outstanding (including undisbursed)	22.60			
IFC net commitment 1/	...			
Latest economic mission	May 1985 2/			
Aid Consultative Group	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. An Aid Group meeting jointly sponsored by the World Bank and UNDP will be held in the spring of 1988.			

Source: Data provided by the World Bank.

1/ Bhutan has not joined the IFC.
2/ Next mission is scheduled for October 1987.

Bhutan--Statistical Issues

Currently, Bhutan does not have a page in International Financial Statistics nor are any data reported for other Bureau of Statistics' publications. The only statistics in the Bureau's data base for Bhutan relate to exchange rates and Fund accounts. No effective correspondence relationship has so far been established between Bhutan and the Bureau of Statistics.

Mr. Klaus Dornseif, who was formerly a Bureau staff member, has been assigned to the Royal Monetary Authority of Bhutan as a CBD Advisor on research and statistics. He has assisted the authorities in their efforts to develop statistics in money and banking and also to collect and transmit the available data in other statistical areas.

Although the Bureau of Statistics has offered to provide technical assistance on several occasions in the past few years, staff visits in statistics have not materialized because of the lack of resources available to the authorities to make such visits productive. The potential for productive technical assistance in this area is being kept under review.