

DOCUMENT OF INTERNATIONAL MONETARY FUND  
AND NOT FOR PUBLIC USE

FOR  
AGENDA

MASTER FILES

ROOM C-120

01

SM/85/216

CONTAINS CONFIDENTIAL  
INFORMATION

July 31, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Bhutan - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Bhutan. A draft decision appears on page 15.

Ms. Ripley (ext. 6531) is available to answer technical or factual questions relating to this paper prior to the Board discussion, which has been tentatively scheduled for Wednesday, August 28, 1985.

Att: (1)

Other Distribution:  
Department Heads

INTERNATIONAL MONETARY FUND

BHUTAN

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the  
1985 Article IV Consultations with Bhutan

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

Approved by Richard C. Williams and Manuel Guitian

July 30, 1985

<u>Contents</u>	<u>Page</u>
I. Introduction	1
II. The Setting	1
III. Recent Economic Developments	2
IV. Report on the Discussion	4
1. The real economy	5
2. Financial and exchange rate policies	7
3. Trade policy	9
4. Statistical issues	10
V. Medium-Term Prospects	11
VI. Staff Appraisal	13
 <u>Tables in the Text</u>	
1. Medium-Term Scenarios for the Balance of Payments in Convertible Currencies, 1985/86-1988/89	12
 <u>Annexes</u>	
I. Basic Data	16
II. Fund Relations	17

Annexes (cont'd)

III.	Relations with the World Bank	20
IV.	Statistical Issues	22

Charts

1.	Output and Prices, 1980/81-1984/85	2a
2.	Fiscal and Monetary Indicators, 1980-1985/85	4a
3.	Exchange Rates of the Ngultrum vis-a-vis Selected Currencies, 1980-85	8a

## I. Introduction

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

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

## II. The Setting

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

---

<sup>1/</sup> A land transit route to Nepal has been agreed, and some exports to Nepal have been effected using this route.

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

### III. Recent Economic Developments

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

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

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

---

<sup>1/</sup> Fiscal year, April 1-March 31.

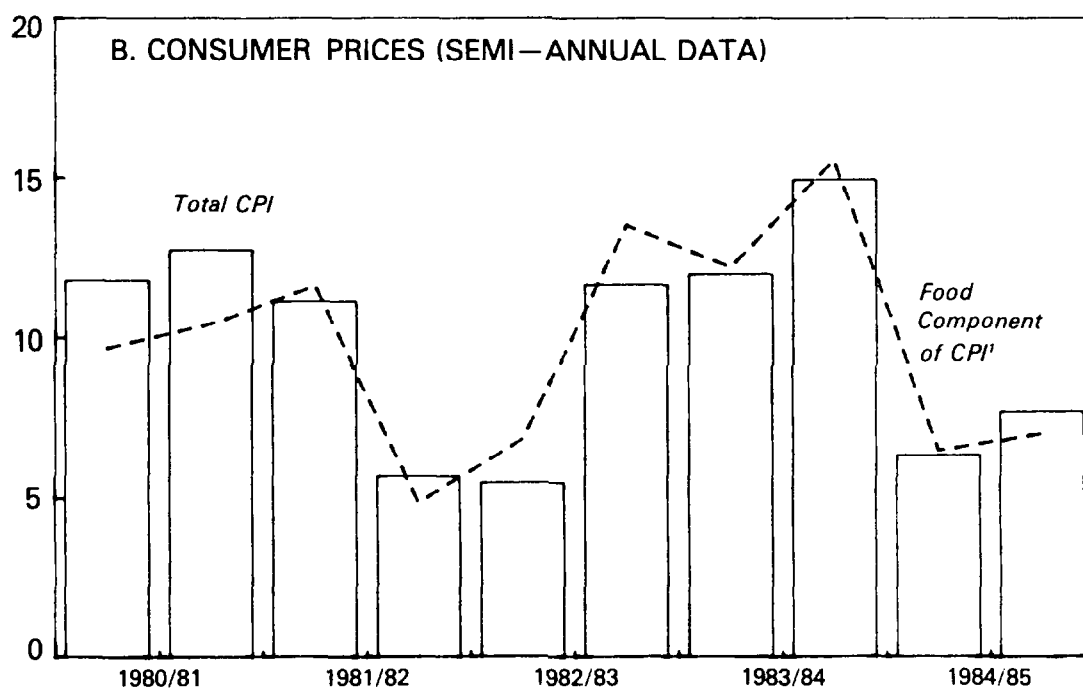
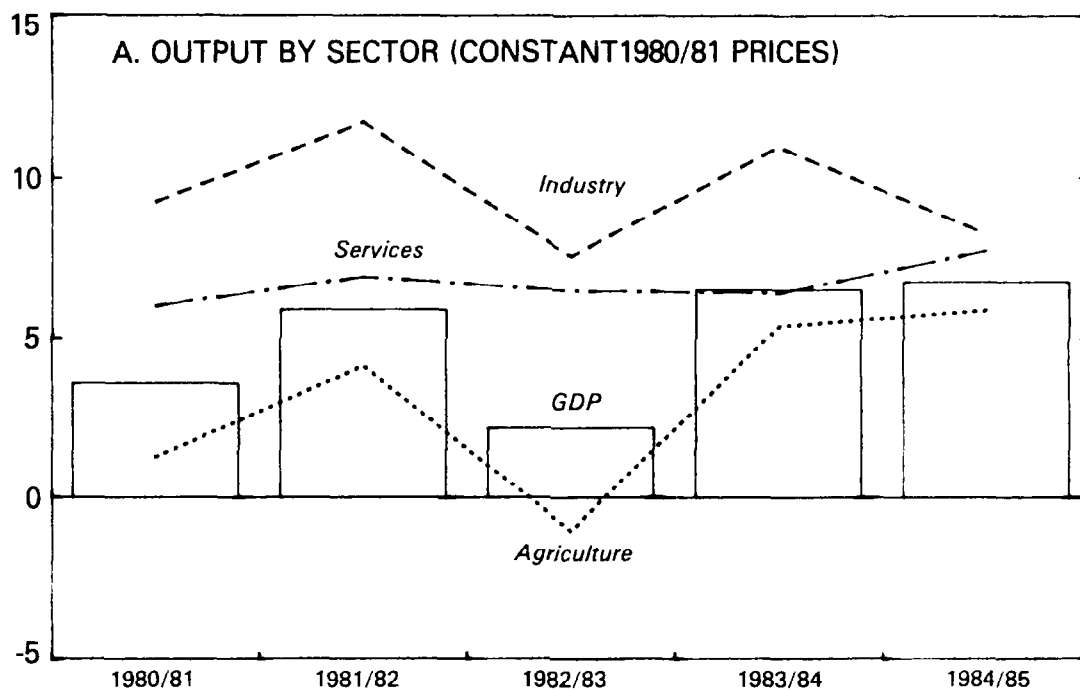
<sup>2/</sup> Section IV.4 and Annex IV review the difficulties of the statistical base in Bhutan.

CHART 1

BHUTAN

OUTPUT AND PRICES, 1980/81-1984/85

(Change from previous year or corresponding period of previous year, in percent)



Sources: Data provided by Bhutanese authorities, and staff estimates.

<sup>1</sup> Food items have a weight of 75 percent in the CPI.



one quarter. Export growth has been significantly weaker, with the share of exports declining from a peak of 7 1/2 percent of GDP in 1981/82 to 5 percent in 1984/85. Exports to India, expressed in U.S. dollars, have shown a declining trend, whereas the growth of exports to third countries, which still account for only 4 percent of the total, has proved erratic. Cardamom is the dominant export item to third countries, while food (especially fruits and fruit products) and cement are important exports to the Indian market.

Service receipts from third countries have proved buoyant because of increased interest receipts and sales of stamps. The near stagnation of tourist receipts since 1980/81 reflects in part a more cautious attitude toward the promotion of tourism than first envisaged in the Fifth Plan. The reluctance of the authorities to incur external debt, especially on commercial terms, is reflected in a debt service ratio in convertible currencies of less than 2 percent in 1984/85 and a ratio of debt to GDP of about 1 percent.

The estimated budget balance is subject to a large margin of error, if only because certain expenditures and their financing are recorded on an allocation rather than a disbursement basis. This being said, the budget figures for 1981/82-1983/84 show modest overall deficits, covered largely by the residual domestic financing item, and in 1984/85, a small surplus (Chart 2). The overall deficit, excluding foreign grants, has amounted to 12-13 percent of GDP in the last two years. The monetary statistics suggest that the Government position as a creditor to the banking system has strengthened in all years but 1983. However, comparisons between monetary and fiscal data are complicated by differences in reference periods; <sup>1/</sup> by the difficulties noted above in measuring actual expenditures; and by some inconsistencies in the data as to the definition of government.

Government expenditures in 1984/85 amounted to 20 percent of GDP, of which two thirds were classified as capital expenditure. Since 1981/82, the annual rate of rise of current expenditures has averaged 14 percent; capital expenditures have risen by 21 percent over the same period. For capital expenditures, the growth rates have varied by sector, reflecting expenditures for specific projects. New investments in forestry have decelerated markedly, while expenditure for public works, mostly for roads, and power have more than doubled.

The share of domestic revenues in total government receipts, including grants, rose from 26 percent in 1982/83 to almost 40 percent in 1983/84 and retained that share in 1984/85. Domestic nontax revenues have been bolstered since 1982/83 by transfers from public enterprises as well as rising interest earnings on foreign reserves; direct tax

---

<sup>1/</sup> Calendar years are generally used in monetary accounts, whereas fiscal years are used for budgetary accounts and certain indicators for the real economy.



receipts have been strengthened by the introduction of a 30 percent tax on net corporate profits. Thus, since 1983/84 domestic revenues have fully financed estimated current expenditures, a major goal set down in the Fifth Plan, while budgeted development expenditures continue to be financed by foreign grants, primarily from India.

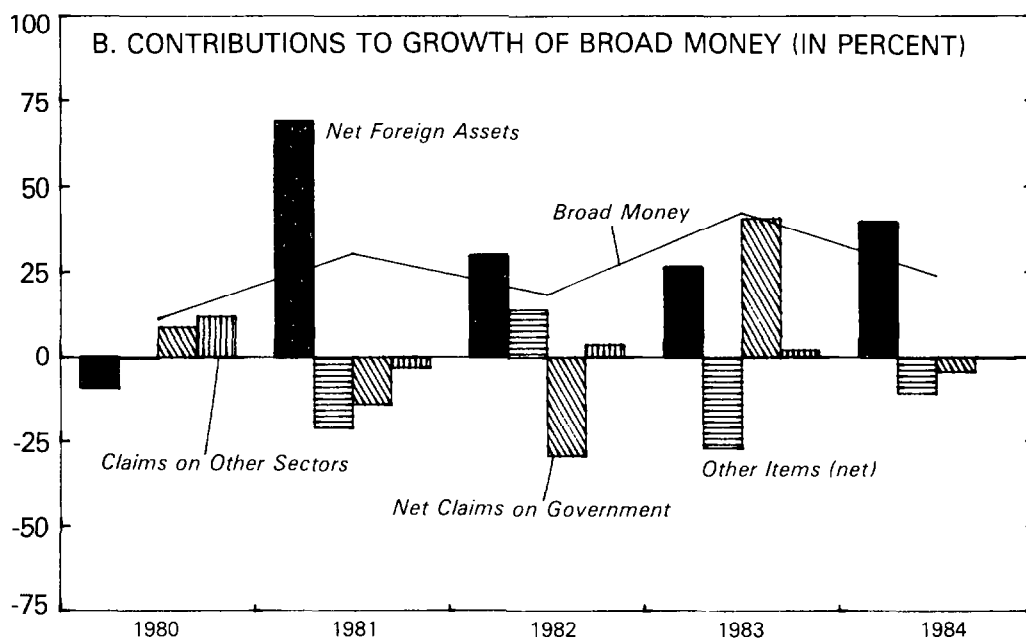
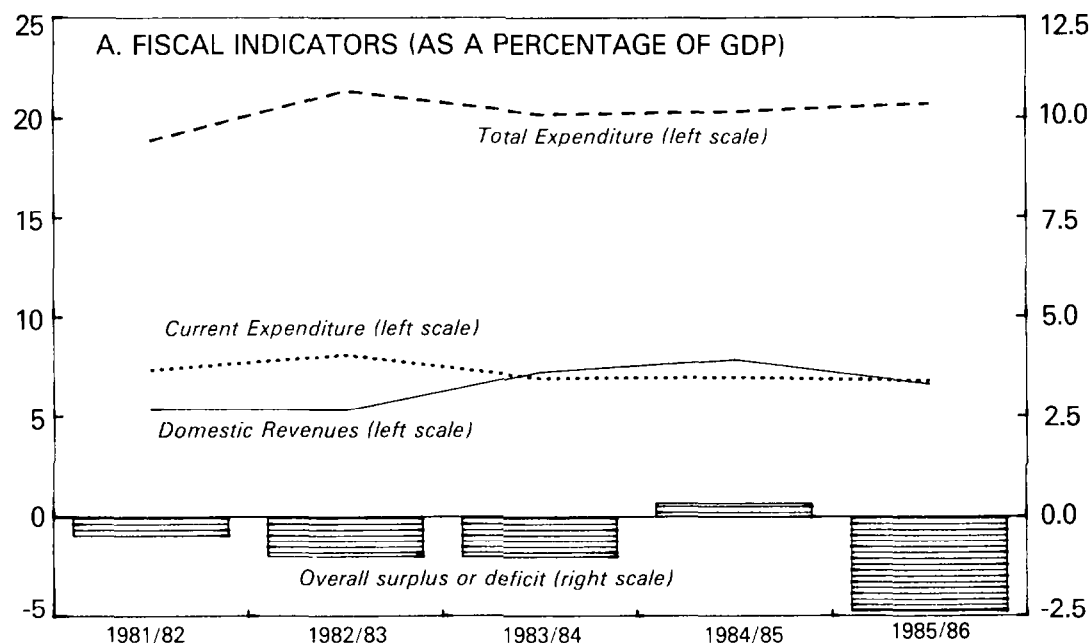
During the period 1980-84, narrow money increased by some 17 percent per annum, somewhat faster than nominal GDP. By contrast, the very rapid growth in fixed term deposits raised the growth of broad money to almost 30 percent per annum. The growth of these deposits has been matched by a rise in the net foreign assets of the banking system, and particularly of rupee assets invested with the State Bank of India (SBI) (Chart 2). The ratio of total domestic credit (including credit to the Government and government enterprises) to total deposits is estimated to have remained constant at about one third in the two years to end-1984.

#### IV. Report on the Discussion

For the past several years, policy formulation has been guided by the broad objectives of the Fifth Plan. Principal among them is improving the material living standard of the people consistent with the maintenance of social harmony and environmental integrity. To this end, self-reliance is a primary consideration. Undue dependence on external resources, both in the form of capital and labor, is to be avoided though at this stage of development, financial and technical assistance and foreign contract labor continue to be needed. Self-reliance is also interpreted as popular participation in decision-making and acceptance of local responsibility for the completion of agreed projects--in part by voluntary labor contributions. Admittedly, the role of the private sector in Bhutan's development effort remains small--but the objectives of the authorities are to enhance efficiency by strengthening this sector, by transferring to it activities now undertaken by public sector enterprises, and by making enterprises remaining in the public sector financially autonomous. The privatization measures of 1982-83 are to be followed in 1985/86 by the sale of 20 percent of the shares of the Government's profitable Penden Cement Authority. Further sales are envisaged.

Decentralized planning is expected to be taken further in the Sixth Plan, which starts in 1987/88. The planning unit will shift from the level of districts, of which there are 18, to blocks, of which there will be about 100. Blocks will be the focal point for educational, health, and financial services, as well as the site of markets for the collection of cash crops and the sale of necessities. The implementation of several large industrial projects, largely under government auspices and already foreseen under the Fifth Plan, will continue in the Sixth Plan. At present, it is expected that the private sector will initiate most of the new industrial projects to be undertaken during the Sixth Plan period.

CHART 2  
BHUTAN  
FISCAL AND MONETARY INDICATORS 1980-1985/86



Sources: Data provided by Bhutanese authorities, and staff estimates.



1. The real economy

The Bhutanese authorities noted that there were severe manpower constraints both for skilled and unskilled labor. Despite a significant improvement in the skills and educational level of the indigenous labor force, a further strengthening of the human resource base is seen by the authorities to be of the highest priority, if the Government's development strategy is to be successful. Similarly, the introduction of advanced labor-saving technologies is essential if reliance on imported labor is to be diminished without adversely affecting growth prospects.

The authorities recognized the dominant role played by the agricultural sector and the heavy demands for labor stemming from labor-intensive techniques of cultivation. Any increase in labor productivity in this sector could greatly ease the labor constraint throughout the economy, though mechanization was limited by the terrain. A well-elaborated network of agricultural extension agents has been developed, and in the early 1980s, a rural credit scheme financed by the International Fund for Agricultural Development and the United Nations Capital Development Fund was introduced to support productive outlays. In effect, the commercial banking system does not extend credit to the agricultural sector. The authorities noted that there had been some relaxation in the conditions governing the availability of rural credit, though they remained quite stringent and the available funds had not been fully disbursed. They felt that additional financial support for the agricultural sector might be warranted.

One objective of the Fifth Plan was self-sufficiency in rice production. The emphasis has subsequently shifted somewhat toward the promotion of cash crops, both to improve the relative income position of farmers, but also the growth prospects for agricultural exports. Cash crops with export potential (for example, mushrooms) are being identified and their production is being supported. Marketing facilities will be made more readily available to encourage steady supply.

Forests are owned by the Government, and commercial logging operations by the private sector are not permitted. The policy is one of cautious exploitation involving the removal of diseased trees and the highly selective cutting of healthy trees in designated areas. Reforestation is being pursued with assistance from bilateral and multi-lateral aid groups, including the World Bank. With the limited supply of logs suitable for processing in existing facilities, forest products are not expected to be a major source of industrial or export growth in coming years.

Power failures in Bhutan are common, and the authorities have actively discouraged a number of industrial investments pending the resolution of the power constraint. With the coming onstream of the Chukha Project in 1986, the power situation in western and southern Bhutan will alter radically. It is estimated that 10-15 percent of the output from Chukha could eventually be consumed domestically. No large

power projects are envisaged during the Sixth Plan. However, access to electricity is expected to increase markedly with the putting in place of small-scale hydroelectric units. The low production costs at Chukha will permit a substantial cut in the price of electricity.

Bhutan's major identified mineral resources include dolomite, graphite, gypsum, and limestone. Mineral resources are owned by the Government, and leases, currently of five years' duration, are given to private interests for the extraction of minerals in conformity with the Government's policy of developing the private sector; the authorities have indicated that the lease period will be extended to ten years to encourage mineral producers to invest in suitable mining equipment and thus bring down the cost of production. The bulk nature of the known mineral resources and their costs of transportation limit their export potential, particularly to third countries. Significant growth is expected in the manufacture of mineral-based products, most notably in the production of cement and calcium carbide.

Licenses are required for all investments. Requests for licenses for large projects are generally handled within six months, while the processing time for small projects is much shorter, and the scrutiny, less rigorous. Investment applications are reviewed with a view to assuring the efficient allocation of capital. The authorities explained that once a project had been approved, the foreign exchange necessary for its implementation was made available. Government equity participation of 20 percent may be required for certain projects. Foreign equity participation is precluded. The Bhutanese see foreign equity investment as endangering their objective of strengthening the indigenous private sector. However, they are willing to consider other foreign collaborative arrangements.

Tourism clearly offers the greatest potential for generating convertible foreign exchange receipts, particularly over the short- to medium term. However, concerns about its impact on the environment and traditional cultural values have induced the authorities to adopt a passive stance toward its promotion. Existing hotel facilities are thought to be adequate to cope with 5,000 visitors a year, and at present, occupancy rates are low. Tourist arrivals have averaged about 2,000 in recent years and a shortfall from the Fifth Plan target of 5,000 visitors by 1986/87 is foreseen. Thought is being given to adopting a somewhat more active promotional policy, especially in the United States and Japan. The possibility of widening markets and improving access, for example, by establishing air linkages with Nepal, is being actively discussed. However, no significant expansion in facilities is presently contemplated, and it is now expected that the target of 5,000 tourist arrivals may be attained by the end of the Sixth Plan.

## 2. Financial and exchange rate policies

Financial policies may be generally characterized as cautious. Some longer-term domestic borrowing does take place to finance the Government's equity participation in specific investment projects. However, ways and means borrowing is expected to be transitory. Thus, in its budgeting, the Government has generally been able to limit its claims on private domestic savings, which in turn has contributed to a steady accumulation of the banking system's net foreign assets.

While the economy is dependent on development assistance from abroad, primarily from India but increasingly from other donors, care has been taken to minimize borrowing and its attendant servicing costs. Nevertheless, the need to finance imports of advanced technology suitable to Bhutan's circumstances has been reflected in rising loan financing, albeit on highly concessional terms, and Bhutan's foreign debt will increase sharply in coming years. By far the largest increase will occur in 1986 when the Chukha Project comes onstream. At that time, Bhutan will incur a debt to India of at least Rs 830 million (40 percent of the project cost). This debt will be serviced through sales of electricity to India; proceeds from these sales are also expected to significantly strengthen budget revenues. However, convertible currency debt is projected to rise sharply in percent of GDP, as is the debt service ratio. These trends are a cause of concern to the authorities because of the expected rate of rise and the weakness of the export base.

In recent years there has been a marked increase in domestic revenue as the Government took measures to strengthen its resource base. A corporate tax of 30 percent of net profits was introduced in 1982/83 for a number of the larger enterprises, with the coverage being subsequently extended in 1983/84. <sup>1/</sup> Tax collections could be hampered, in future, by the weakness of the tax administration as well as by ambiguity in the meaning of corporate profits. Transfers from government enterprises have also risen.

Sales tax is now assessed at rates of 3, 5, and 8 percent, depending on the type of commodity, while the turnover tax for larger outlets is set at 2 percent. Though there has been some discussion of a change from the turnover and sales tax system to a system based on a retail sales tax at a uniform rate, the authorities did not suggest that any change in the tax system was in prospect in the near term. However, determined efforts were to be made, with Fund technical assistance, to improve both direct and indirect tax administration.

As part of the effort to contain current expenditures and to increase the efficiency of the public sector, a major review of the

---

<sup>1/</sup> The tax is now levied on 19 businesses operating under royal charter or industrial license.

structure and size of the Government was underway to assure that bureaucratic efficiency would be enhanced. Jobs are being scrutinized to see whether they are necessary and whether the incumbent is performing satisfactorily. Redundancies are being declared. <sup>1/</sup> As part of the effort to promote efficiency in the public service, significant wage increases were provided for in 1984/85 and 1985/86. Action to rationalize the structure of salaries is expected in the coming years.

Capital expenditures in 1985/86 would be bolstered by several important projects, which were to receive substantial foreign financing, including the first disbursements from the World Bank in support of a calcium carbide project. The budget deficit was projected to rise to almost Nu 100 million (2 1/2 percent of GDP), though no domestic borrowing was foreseen. More generally, the authorities were well aware of the pressures that could be placed on scarce domestic resources by large increases in government expenditure--and the potential for inflationary pressures--even though this expenditure found external sources of finance.

The Fifth Plan foresaw total expenditures of Nu 4 1/4 billion, with some three fourths of the total being allocated to capital expenditures. Government revenues were to cover current outlays by the end of the period. Notwithstanding the faster-than-expected growth in current expenditures, the goal of financing such expenditures with domestic revenues was achieved well ahead of schedule.

The broad objectives of the Sixth Plan are only now being established. The authorities indicated that the rate of rise of expenditure would be moderated from earlier plans, and that annual outlays might reach Nu 1 1/2 billion. External assistance of the magnitude of Nu 800 million per year was envisaged.

Since its introduction in 1974, the ngultrum has been freely convertible, at par, with the Indian rupee (Chart 3). The parity relationship was essential at first to establish confidence in the ngultrum in an environment in which the rupee was the main medium of exchange. The dominant trade and financial linkages with India argue for the continuation of the parity relationship for some time to come, notwithstanding the increase in the ngultrum in circulation. The authorities recognized that the exchange rate policy now pursued limits the scope for monetary policy.

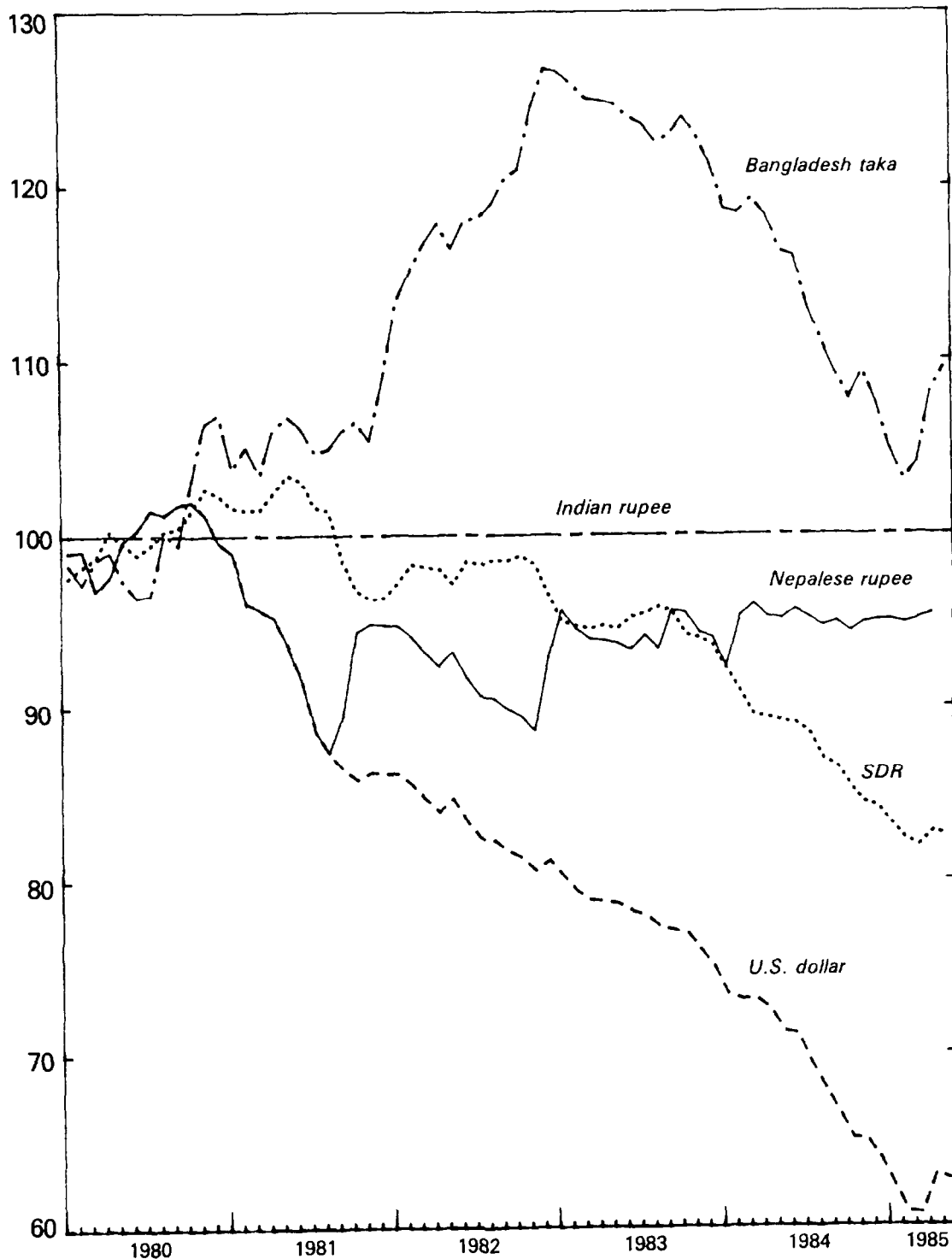
The Royal Monetary Authority (RMA), which started operation in 1983, has taken over the issue of the ngultrum; between end-1983 and end-1984 the share of the ngultrum in currency in circulation is

---

<sup>1/</sup> Looking to the longer term, it was not clear what impact decentralization to the block level would have on government employment, though, ceteris paribus, one could expect some rise in the number of government employees.

CHART 3  
BHUTAN  
EXCHANGE RATES OF THE NGULTRUM  
VIS-A-VIS SELECTED CURRENCIES, 1980-85

(Indices: 1980 = 100)







estimated to have risen from 20 percent to over 35 percent. It is still the intention of the authorities to gradually replace the rupee with the ngultrum, and the rate of issue is gauged so as not to jeopardize confidence. The RMA has also assumed the management of the convertible currency reserves previously held by the Government with the Bank of Bhutan (BOB). The BOB, the only commercial bank, is owned jointly by the Government (three fourths) and the State Bank of India (SBI) (one fourth). It continues to manage the Government's rupee reserves as well as the Government's accounts because of preferential investment opportunities available to it through the SBI. 1/ The Bhutanese authorities are exploring the possibility of shifting management of all foreign assets from the BOB to the RMA.

Instruments of monetary policy include a 3 percent cash reserve ratio and the setting of lending and deposit rates. Given the free convertibility of the ngultrum, deposit rates in Bhutan have typically been set at levels closely approximating those prevailing in India, while lending rates have been somewhat lower. Effective September 1984, the structure of sectoral lending rates was revised, and the preferential rate earlier accorded to government employees was eliminated. Lending rates for the private sector now range from 10 percent for agriculture to 16 percent, while deposit rates effectively range from 5-11 percent. The authorities indicated that there was little demand for bank credit by the private sector.

The outflow of domestic savings is a cause of concern but has been attributed to difficulties in identifying financially attractive investment projects in Bhutan, particularly when contrasted with the secure and remunerative investment opportunities offered by the SBI. To promote the flow of funds to industry, proposals are being considered to set up a second commercial bank to provide competition to the BOB and an Industrial Development Bank or an industrial credit scheme. Recently, the BOB has also been directed to make greater efforts to identify suitable investment opportunities in Bhutan.

### 3. Trade policy

Trade with India is largely unrestricted. Certain items imported from India are subject to Bhutanese sales tax, and the Indian authorities pay an annual excise tax rebate to compensate for excise duties levied in India. The State Trading Corporation of Bhutan (STCB) handles imports of goods from India provided under quota arrangements whereas imports of goods purchased on the free market in India may be arranged by the ultimate purchasers. Approval for the import of goods or services from third countries, and for the associated release of foreign exchange, must be sought on a case-by-case basis; the system is thought by the authorities to be managed in a liberal manner, though the

---

1/ Interest of 11 1/2 percent, tax free, is available on 61-day deposits placed with the SBI.

required approval procedures could discourage some applicants. Imports from third countries are required to be channeled through government agencies, in effect, the STCB.

Most exports to India are unrestricted. However, exports of agricultural cash crops such as cardamom are handled by the Food Corporation of Bhutan. By contrast, the Export Development Corporation handles exports to third countries. The authorities felt that canalization of exports to third countries was necessary, as Bhutanese products were not well known and initial marketing costs were likely to be high. The Export Development Corporation has typically purchased domestic goods for sale abroad; its role is expected to shift to that of intermediary, with the profits and losses to be borne by the exporter.

The authorities are eager to diversify the commodity composition of merchandise exports and also their export markets. High transportation costs, coupled with a concentration in bulk mineral-based products, are seen as a major constraint on exports, particularly to third countries. The authorities are seeking to identify and encourage the production of goods with high value added so that air transport may prove feasible, and to enhance quality control.

#### 4. Statistical issues 1/

The authorities were well aware of the deficiencies in the statistical base which complicate the tracking of recent developments and the monitoring of policy. Work is underway, with assistance provided by the Fund, to improve the accuracy and timeliness of the monetary and fiscal accounts; 2/ technical assistance had been offered in the compilation of trade statistics, while work in the national accounts area and in monitoring price developments will be initiated shortly. Information on actual disbursements of external assistance were not readily available at the time of the discussions, but the RMA had recently been requested to monitor all data pertaining to external debt.

The Bhutanese noted the need for longer-term technical assistance in the statistical field and the number of offers outstanding. A major constraint in accepting offers of assistance lay in the paucity of Bhutanese counterparts needed for the establishment and maintenance of statistical information. Statistical difficulties also arose from the different time periods for which data were collected. The authorities explained that they were considering shifting the fiscal year to start July 1, as well as encouraging all data to be collected on a fiscal year basis.

---

1/ See Annex IV for a description of the data base.

2/ See Annex II, Section X, for a description of Fund technical assistance.

## V. Medium-Term Prospects

Assuming the continuation of current policies, prospects are for rates of real growth of 4-6 percent over the medium term. Growth of industry and services is likely to continue to be more buoyant than that of agriculture, particularly in view of expected developments in the power sector. However, given the small size of the Bhutanese market, larger projects now in the pipeline will have to produce for export. The high costs of transportation will continue to constrain the growth of exports to third countries. Thus, exports of goods and services to India--some of which are necessarily tied to debt servicing--will tend to strengthen. With the continued weak export growth foreseen to third countries, and rising debt service commitments stemming from project financing, the convertible currency debt service burden will grow rapidly.

Medium-term balance of payments scenarios have been drawn up to identify the probable evolution of the balance of payments with third countries under alternative assumptions. In all scenarios it is assumed that nominal exchange rates remain constant, and that Bhutanese exports are supply rather than demand determined. In the base scenario presented in Table 1, it is assumed that the volume of exports will rise by 2 percent, and the volume of non-aid imports by 10 percent on the basis of historical experience and assuming increased need for imports embodying advanced technology. No deterioration in the aid climate is projected by the staff. The historical relationship between aid disbursements and imports of goods and services is assumed to continue. A rise in tourist arrivals in line with the figures suggested for the Sixth Plan has been used to project tourist receipts, while interest receipts are expected to rise in line with the accumulation of convertible foreign exchange reserves. It is assumed that the pattern of disbursements of project aid now foreseen by the authorities will be adhered to; a delay would imply a slower rise in the debt service ratio.

The base scenario, reflecting largely disbursements for capital projects already in the pipeline, suggests that the debt service ratio in convertible currencies will rise from its current level of 1 1/2 percent, to 22 percent by 1988/89. This rise must be seen against Bhutan's initial reserve position, and the projected increase in convertible foreign exchange reserves over the forecast period. In 1988/89, reserves are equivalent to 13 months of imports from third countries, or 38 months of discretionary non-aid imports. The longer-term potential for export growth to third countries of the projects financed with convertible currency credits is not captured in the trade figures, partly because of the long gestation periods for these projects.

Table 1. Bhutan: Medium-Term Scenarios for the Balance of Payments in Convertible Currencies, 1985/86-1988/89

	Base Scenario	More Favorable Scenario	Less Favorable Scenario
In percent unless otherwise specified			
Average annual growth in value			
Exports	7	12	2
Non-aid imports	15	20	20
Tourism receipts	21	29	14
Government service payments	9	9	14
Foreign grants	9	16	9
Debt service ratio in 1988/89 <sup>1/</sup>	22	19	26
Reserves in 1988/89 (\$mn.)	22	24	17
Reserves/debt ratio	.35	.38	.27
Reserves/imports ratio in 1988/89 (months of imports)	13	13	10

Source: Staff estimates.

<sup>1/</sup> In 1984/85 this ratio was estimated at 4 1/2.

The more favorable scenario reflects more active promotion of both exports of goods and tourism; a larger inflow of foreign grants is also foreseen. Import growth under this scenario is allowed to accommodate increased purchases of foreign technology. In this instance, by 1988/89, the debt service ratio rises to 19 percent while end-period reserves remain unchanged at 13 months of imports. Thus, a higher rate of growth of GDP could be attained consistent with a reduction in external financing constraints. Relative to the base scenario, the less favorable scenario reflects slower growth in receipts from exports and tourism and higher government expenditures on imported goods and services. In these circumstances, the debt service ratio rises at a faster rate and the decline in the reserves to imports ratio is much more pronounced.

## VI. Staff Appraisal

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

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

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

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

preferential interest rate currently accorded agriculture might usefully be reviewed to see whether it might pose a deterrent to the availability of agricultural credit.

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

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

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

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

VII. Proposed Decision

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

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Bhutan, in the light of the Article IV consultation with Bhutan conducted under Decision No. 5392-(77/63) adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions, as described in SM/85/ , are maintained by Bhutan in accordance with Article XIV and are not subject to approval under Article VIII. The Fund encourages the authorities to administer these restrictions in a liberal manner.



Bhutan: Basic Data 1/

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

	1981/82	1982/83	1983/84	1984/85	1985/86 Proj.
<u>(Changes in percent)</u>					
<u>GDP and prices</u>					
Real GDP	5.9	2.2	6.5	6.7	7.0
Consumer prices	8.3	8.6	13.2	7.3	9.0
<u>(In millions of ngultrum)</u>					
<u>Government budget 2/</u>					
Revenue and grants	425.4	527.9	599.3	736.3	762.2
Domestic revenue	(124.0)	(137.6)	(225.2)	(278.7)	(274.4)
Foreign grants	(301.4)	(390.3)	(374.1)	(457.6)	(487.8)
Total expenditure	436.1	553.9	630.7	724.6	861.3
Current expenditure	(169.0)	(208.9)	(215.6)	(247.6)	(281.3)
Capital expenditure	(267.1)	(345.0)	(415.1)	(477.0)	(580.0)
Overall balance	-10.7	-26.0	-31.4	11.7	-99.1
External financing	(4.5)	(8.9)	(6.7)	(14.9)	(102.0)
Other	(6.3)	(17.1)	(24.7)	(-26.6)	(-2.9)
<u>Money and credit 3/</u>					
Net foreign assets	311.9	372.3	435.7	570.2	...
Domestic credit	-13.9	-65.3	37.1	20.8	...
Net credit to Government	(-101.4)	(-160.5)	(-63.3)	(-78.3)	...
Total liquidity	202.1	239.5	340.7	422.3	...
<u>(In millions of U.S. dollars)</u>					
<u>Balance of payments</u>					
Exports, f.o.b.	19.2	16.6	15.6	15.1	15.7
To India	(18.6)	(16.3)	(15.2)	(14.6)	(15.2)
Imports, c.i.f.	-65.6	-67.2	-80.4	-69.4	-71.8
From India	(-58.3)	(-56.8)	(-67.3)	(-61.0)	(-60.7)
Current account balance 4/	-75.6	-87.3	-101.1	-82.2	-80.0
With India	(-64.9)	(-73.0)	(-85.4)	(-73.0)	(-65.2)
Capital and official transfers	72.4	91.2	89.9	77.0	70.1
From India	(60.3)	(76.5)	(77.7)	(67.1)	(53.9)
Overall balance	4.0	4.6	9.0	12.4	1.3
With India	(2.0)	(4.8)	(6.7)	(5.8)	(--)
<u>Reserves, external debt and exchange rate</u>					
Gross foreign exchange reserves (end of period)	29.0	31.9	38.4	45.1	...
Rupee reserves	(21.5)	(24.6)	(29.2)	(30.8)	...
Total reserves in months of imports	5.6	5.9	6.0	8.1	...
External public debt (end of period)	0.3	1.3	1.9	3.1	11.3
Debt service ratio (in percent)	--	--	1.4	1.6	4.7
Exchange rate 5/					
(Nu/SDR)	10.293	10.523	10.912	11.924	...
(Nu/US\$)	8.929	9.628	10.312	11.887	...
<u>(In percent)</u>					
<u>Selected ratios to GDP</u>					
Government domestic revenue	5.4	5.3	7.2	7.8	6.6
Total government expenditure	18.9	21.3	20.2	20.3	20.7
Overall budget balance	-0.5	-1.0	-1.0	0.3	-2.4
Total liquidity	8.8	9.2	10.9	11.8	...
Exports	7.4	6.1	5.1	5.0	4.6
Imports	25.4	24.9	26.5	23.1	21.1
Current account balance	-29.3	-32.4	-33.3	-27.4	-23.5

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

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

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

4/ Goods, services, and private transfers.

5/ Period averages.

Bhutan: Fund Relations  
(As of June 30, 1985)

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<br>of ngultrum: | SDR 1.93 million<br>(77.2 percent of quota) |
| (c) | Fund credit:                        | None  |
| (d) | Reserve tranche<br>position:        | SDR 569,900                                 |
| (e) | Current operational<br>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<br>allocations: | None           |
| (b) | Holdings:                      | SDR 66,570     |
| (c) | Current Designation<br>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: November 28, 1983; Decision No. 7568-(83/163). Staff discussions were held during August 3-17, 1983 (SM/83/228, 11/4/83; and SM/83/229, 11/8/83). The Executive Board adopted the following decision:

1. "The Fund takes this decision in concluding the 1983 Article IV consultation with Bhutan, in the light of the 1983 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/83/229, are maintained by Bhutan in accordance with Article XIV. 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. A technical expert from the CBD panel was appointed in August 1982, and continues to work as General Advisor for operations with

Bhutan--Fund Relations (concluded)

- (a) CBD (cont'd): the RMA. 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.
- (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 of Bhutan for one year in March 1984, but had to leave after four months because of health reasons. Another FAD expert participated in the Legal Department mission in April 1984. Since November 1984, a general fiscal advisor from the FAD panel has been working in the budget, revenue and accounting areas in the Ministry of Finance.
- (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.

ANNEX III

Bhutan: Relations with the World Bank

Bhutan became a member of the World Bank and the International Development Agency (IDA) in 1981. Several credits have been extended by IDA, but disbursements to date are minimal. There is no resident World Bank mission. In May 1983, Bhutan participated in the United Nations Round Table Meeting on the Asian and Pacific Least Developed Countries; a second Round Table Meeting is scheduled, again under the auspices of the U.N., for the spring of 1986.

In October 1983, a credit of SDR 2.8 million was approved to assist in the identification and evaluation of new projects and the establishment of a telex link. Of this credit, only SDR 20,000 had been disbursed as of April 1985. A project valued at SDR 5.4 million was agreed in April 1984 in support of reforestation efforts and institutional developments in the forestry sector; and of this SDR 50,000 had been disbursed as of April 1985. On May 16, 1985 the World Bank Board approved the cofinancing of a calcium carbide plant to be established in southern Bhutan, in association with the Kuwait Fund and the Government of Norway, as well as the Government of Bhutan and representatives of the private sector. The project costs are estimated at \$24.2 million, while the IDA contribution is to amount to SDR 9.4 million. Work on site preparation is already well underway and the disbursements are expected to be completed by 1989.

The World Bank has generally supported the investment strategy incorporated in the Fifth Development Plan, though, in the Bank's view, more emphasis should have been given to the development of human resources through a further improvement in education and health. The World Bank staff does not have sufficient information at this time to assess the overall development strategy of the Sixth Plan, though it strongly endorses a number of specific measures now foreseen under this Plan, particularly the upgrading of social services and their extension to much of the rural population. It also supports a more active export promotion policy.

Collaboration between the staff of the IMF and the World Bank has consisted of an exchange of views and information at Headquarters.

ANNEX III

Bhutan: Relations with the World Bank

(In millions of SDRs; end-June 1985)

IDA Lending	Disbursed <u>1/</u>	Undisbursed
Technical assistance	0.02	2.78
Agriculture (including forestry)	0.05	5.35
Industry	<u>--</u>	<u>9.40</u>
Total	0.07	17.53
Payments	--	
Debt outstanding (including undisbursed)	17.60	
Commitments after June 1985	--	
IFC net commitment <u>2/</u>	...	
Latest economic mission	October/November 1984.	
Aid Consultative Group	Bhutan participated in the United Nations Round Table Meeting on the Asian and Pacific Least Developed Countries which was held in May 1983 in Geneva. A second U.N. Round Table Meeting is tentatively scheduled for the spring of 1986.	

Source: Data provided by the World Bank.

1/ As of end-April 1985.

2/ Bhutan has not joined the IFC.

Bhutan--Statistical Issues

Bhutan does not have a country page in the (International Financial Statistics (IFS)). The only statistics in the Data Fund relate to exchange rates and Fund accounts. At present, Bhutan is not in a position to report data to the Bureau of Statistics on a regular basis.

The statistical base for Bhutan is at a formative stage. The Bhutanese authorities are aware of the deficiencies in the data base and are assigning high priority to the setting up of an accurate base for monitoring developments in major areas of policy interest. Offers of technical assistance in the statistical field are abundant, but staffing constraints on the Bhutanese side limit the ability of the authorities to accept such offers. Staff training will be necessary at all levels to assure the accurate and timely flow of information, once the design of the statistical base has been established.

At present, it is thought that the figures for rupee and convertible foreign exchange reserves are both reliable and current. A project is underway to improve the quality of the fiscal accounts; expenditure estimates and financing items are seen to be particularly weak. Technical assistance in this field is being provided by a general fiscal advisor from the Fiscal Affairs Department panel. Attention is being devoted both in the Ministry of Finance and in the Royal Monetary Authority (RMA) to the construction of a system for monitoring disbursements of external grants and loans. Efforts are also being made to improve the flow of information to the RMA on the development of monetary aggregates, with the assistance of two persons appointed by the Central Banking Department. The monetary data are seen as an important consistency check on the accuracy of fiscal and external accounts.

Information on developments in the real economy and in the balance of payments, particularly with India, is limited. Studies to develop a set of national accounts and an appropriate consumer price index will be initiated shortly. Information on trade with third countries is thought to be reliable since it is channeled through the State Trading Corporation of Bhutan; however, the open border with India makes it difficult to monitor the bulk of trade. The International Trade Center in Geneva has offered assistance in setting up of system to more effectively monitor trade with India.

At present statistical information for the financial institutions typically pertains to calendar years, while government accounts are for the fiscal year starting April 1. Enterprise accounts are not standardized as to the time periods that they cover. It is planned to shift the fiscal year to start from July 1 starting in the Sixth Plan (1987/88) and to encourage the compilation of all statistics for the fiscal year.