

August 29, 2019
Approval: 9/6/19

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/86-3

4:00 p.m., October 26, 2018

3. Bhutan—2018 Article IV Consultation

Documents: SM/18/213 and Supplement 1; and Supplement 2; and Supplement 3

Staff: Grigorian, APD; Fletcher, SPR

Length: 21 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors Alternate Executive Directors

K. Obiora (AE)
 M. Bangrim Kibassim (AF), Temporary
 J. Corvalan (AG), Temporary
 S. David (AP), Temporary
 P. Fachada (BR)
 X. Cai (CC), Temporary
 M. Mulas (CE), Temporary
 J. Weil (CO), Temporary
 O. Bayar (EC)
 P. Rozan (FF), Temporary
 K. Merk (GR)

S. Gokarn (IN)

I. Lopes (IT), Temporary
 H. Mori (JA), Temporary
 K. Badsı (MD), Temporary
 M. Merhi (MI), Temporary
 S. Harutyunyan (NE), Temporary
 T. Sand (NO), Temporary
 Z. Smirnova (RU), Temporary
 F. Rawah (SA), Temporary
 E. Villa (ST)
 P. Inderbinen (SZ)
 M. Cowie (UK), Temporary
 S. Vitvitsky (US), Temporary

G. Bauche, Acting Secretary

S. Kalra, Summing Up Officer

E. Mannefred / R. Smith Yee, Board Operations Officers

L. Nagy-Baker, Verbatim Reporting Officer

Also Present

Asia and Pacific Department: W. Bauer Stampfli, D. Grigorian, R. Moussa, R. Salgado.

Legal Department: Luca Ioana, D. Schwarz. Monetary and Capital Markets Department:

D. Grigorian. Strategy, Policy, and Review Department: K. Fletcher. Research Department:

A. Mohommad. Senior Advisors to Executive Directors: M. Alle (AF), H. Joshi (IN), N. Jost

(NE), M. Shaari (ST), A. Tivane (AE). Advisors to Executive Directors: S. Buetzer (GR), P. Dhillon (IN), A. Souza (BR).

3. **BHUTAN—2018 ARTICLE IV CONSULTATION**

Mr. Gokarn and Mrs. Dhillon submitted the following statement:

Our Authorities would like to thank the IMF team led by Mr. David Gregorian for the very constructive and productive discussions. The mission chief, and his team have an excellent understanding of the macro-economic situation in Bhutan, including the unique features of the country's economy. Our Authorities are highly appreciative of the Fund for providing opportunities for enhancing human resource capacities through training and technical assistance. Policies have been largely in line with past Fund advice and the Authorities greatly value the staff report and broadly agree with the assessment made in the Article IV report.

After experiencing rapid growth during 2006-2016, the Bhutanese economy is benefiting from macroeconomic stability accompanied by stronger underlying fundamentals, growth in services and significant decline in poverty. Single-digit inflation, declining external imbalances and accumulating international reserves attest to the stability. Nevertheless, structural challenges remain, including a large current account deficit, high public debt, an underdeveloped private sector, and high youth unemployment. Our Authorities are committed to building on the progress so far to ensure both inclusive growth and macroeconomic stability.

Recent Economic Developments and Economic Outlook

Bhutan is committed to graduate to middle-income status by 2023. It has achieved economic progress while preserving its traditions and values and combining sustainable development with enhanced happiness for its people. Poverty has declined significantly, from 12 percent in 2012 to 8.2 percent in 2017, with extreme poverty falling to just 1.5 percent. GDP has maintained momentum at 7.4 percent in FY2017, far exceeding the global growth rate. Headline inflation decreased to a historic low of 2.6 percent in June 2018 from 4.9 percent in June 2017, contributed by decrease in the non-food prices.

Our Authorities broadly agree with the staff assessment of outlook and risks for the economy. However, even as they acknowledge the potential strain on GDP growth from low capital expenditures in FY2019, they are more optimistic about medium-term growth than the staff projection of 4.8 percent in FY2019 and 6 percent in FY2019-20. This stems from the anticipated impetus to output and exports, as well as to fiscal revenues with the commissioning of new hydropower projects. Further, agriculture and

tourism are also projected to grow steadily. This and the implementation of the 12th Five-year plan agreed by the new government will positively stimulate the economic activity. The CPI inflation is expected to be around 3 to 5 percent. At the end of June 2018, the gross international reserves were recorded at US\$1,110.9 million, sufficient to finance 13.01 months of merchandise imports.

Fiscal Policy

Bhutan has achieved a balanced budget over a five-year period. After following an expansionary fiscal stance to support implementation of the last year of the 11th Five-Year Plan, our Authorities are cognizant of the concerns on the contraction in capital spending in FY2019. But they were restricted by operational constraints in force during the electoral cycle until the new Cabinet approves the additional spending. The Authorities have initiated comprehensive reforms for a strengthened fiscal framework as a top priority. Core elements are as follows:

GST implementation is scheduled for July 2020, supported by Fund Technical Assistance. Authorities are firmly committed to the target date and are mobilizing the required project funding and planning to put in place a robust IT framework.

The revised budget saw the fiscal deficit improve from 2.47 percent of GDP to 1.01 percent, with higher resource mobilization. From now on, once approved the 12th Five-Year Plan would help narrow the gap arising from the short term decrease in capital spending.

Establishment of a stabilization fund to manage hydropower revenues and business cycle fluctuation. Starting with the seed money of US\$1.54 million, it is presently proposed that 5 percent minimum on royalties from hydropower be transferred to the Bhutan Economic Stabilization Fund (BESF).

Debt-related risk is moderate due to the foreign direct investment-like nature of most of Bhutan's debt. Its dynamics will improve in the medium term with the substantial increase in electricity exports and decline of construction related imports.

Public financial management reforms, including an electronic payment system, is being implemented and a commitment to improve budget transparency and undertake more frequent fiscal reporting is present.

Speedy implementation of these measures will be critical to boost revenue flows, incentivize investment and economic growth and to establish a more synchronized tax regime and our Authorities are diligently working on this. Staff advice on developing a domestic public debt market in Bhutan is noted and we welcome a thorough analysis of the demand patterns and market requirements to exploit the potential.

Monetary Policy

Monetary policy conditions have remained stable in recent years and staff's advice on this is consistent with the Authorities' own views. Credit growth has slowed from 35 percent on average in 2005–11 to 15 percent in 2012-17. Private sector credit growth was 15.69 percent in June 2018, about the same as the 15.39 percent rate in June 2017. Importantly, access through financial inclusion is contributing to credit growth. The overall CPI inflation recorded at 2.55 percent in June 2018 compared to 4.94 percent during the same month of the previous year, the fall being aided by decrease in the prices of non-food commodities. On the other hand, domestic inflation during June 2018 was recorded at 1.47 percent while imported inflation was recorded at 3.56 percent due to food prices.

The Authorities have carefully considered the well thought out staff proposals and will follow a graduated approach in moving forward, mindful of the need for adequate institutional capacities and supporting legal frameworks. Undoubtedly, there are challenges while moving from a quantity to interest rate signaling. This may send confusing signals to market participants on the policy stance, which in turn could undermine the anchoring of inflation. That said, our Authorities are fully aligned with the staff view on upgrading to a more modern monetary policy framework, supported by TA from the South Asia Regional Training and Technical Assistance Center, especially on forecasting and establishment of an interest rate corridor. This is expected to be rolled out by November 2018.

External Sector and Exchange Rate Policy

The Authorities agree that the peg continues to be the appropriate exchange rate regime and has served the economy well. Maintaining an adequate buffer of Indian rupees is a critical part of the reserve management and significant pillars have been developed as supportive arrangements. The RMA's swap agreement with the RBI and access to the Government of India Credit line is a key stabilizing mechanism. Alternate arrangements to sell or

buy Indian Rupees against U.S. dollars and gain access to Indian Government securities are being currently pursued. Moving ahead, electricity exports from the commissioning of three hydroelectric plants beginning FY2019 and up to by FY2023 are expected to turn the current account positive in the medium term and structurally improve the Rupee liquidity.

Financial Sector

On the financial sector assessment, our Authorities broadly concur with the findings of the staff report and, on the need, to further tighten financial sector regulation and supervision. Financial soundness indicators for Bhutan remain generally comfortable, with capital adequacy and liquidity well above the required prudential norms, although the proportion of non-performing loans has increased in the recent period.

The nascent banking sector has the tough task of building profitability and resilience in a challenging environment. Our Authorities have made much progress in key areas including corporate governance regulations for financial institutions, a new regulatory framework for insurance, review of the macroprudential framework and pension policy review. Continued vigilance is, however, needed especially for NPLs which have shown a slight increase to 11.5 percent in June 2018, up from 11.4 percent in June 2017. Our Authorities remain alert to systemic vulnerabilities and are working on further streamlining the regulatory regime including reduced liquidity requirements. At the current juncture, however, preference has been given to deepening access to finance even while containing risk. The financial inclusion strategy 2018-2023 was issued in August 2018. It is intended to enhance access to and usage of quality and affordable formal financial services through an inclusive financial system.

Structural Issues

Bhutan has always approached development from a holistic perspective, based on the concept of Gross National Happiness. Our Authorities have a strong commitment to diversifying the economy and providing high-paying jobs for the population, especially youth. Bhutan maintains strong fundamentals which include political stability, education in English, very low levels of corruption, good governance and preferential access to the vast Indian market. Coherent action to more strategically advance economic diversification, is being pursued to reduce economic vulnerability, raise GDP, and secure competitive advantages within product niches. Developing infrastructure and easing of structural bottlenecks are key

to this strategy. The second annual event of the Bhutan Economic Forum for Innovative Transformation, to be held in July 2019, will be on issue of economic diversification through catalyzing the cottage and small industries (CSI) sector.

Education quality, with a predominant base in the urban areas, is a pressing concern as is the mismatch between the products of the education system and the present and future needs and demands of the market. Addressing these issues is a priority for our Authorities; a review of the educational system is ongoing. Overall, sustained actions have contributed to an improvement in the country's business environment which saw Bhutan rise sharply from 148th in 2013 to 75th in 2018 in the World Bank's global Doing Business survey. Large scale donor-funded training programs are being provided. Our Authorities recognize the role of FDI thresholds and, going forward, aim at the right mix of employment generation and technology enrichment.

On access to finance, the Authorities began implementing a priority sector lending initiative in January 2018 for CSI to encourage entrepreneurship and experimentation in new types of business ventures. Given the development orientation of the PSL objectives and the early stages, the Authorities would await unfolding experiences before recalibrating the guidelines to staff recommendations.

To conclude, our Authorities are very appreciative of the Fund's inputs and support over the years as they strive to maintain the balance between inclusive and sustainable growth, macroeconomic stability and tangible improvements in the welfare of the citizens, using the concept of Gross National Happiness. They look forward to continued engagement as they initiate strategies to diversify the economy's production base, with a view to expanding livelihood opportunities and reducing vulnerabilities.

Mr. Inderbinen and Mr. Imashov submitted the following statement:

We commend the authorities for the favorable economic outcome over the two-year surveillance cycle. Growth remains strong, and the authorities have made significant progress in further reducing poverty under their 11th Five-Year-Plan. We note the broad agreement between the authorities and staff on the outlook and the main policy challenges. It is also encouraging that reforms have reflected past Fund advice.

The authorities' cautious fiscal stance is warranted. With grants declining, and given the impending loss of EDR revenue, as well as the foreseen technical difficulties in implementing a GST, the authorities are well-advised to restrain public expenditure. While we follow staff's argument for a more gradual consolidation from a purely cyclical perspective, we question the realism of bringing significant maintenance expenditure forward. Also, advising the authorities to take recourse to domestic financing of the budget over the short term seems questionable, given the very limited depth of the domestic debt market. Could staff comment on the consistency of this advice with their finding in paragraph 17 that the treasury bill market is 'subject to high roll-over risk'?

Ongoing efforts to strengthen PFM are welcome. We join staff in encouraging the authorities to develop a multi-year budgetary framework, and we welcome the commitment to increased fiscal reporting and transparency mentioned in Mr. Gokarn and Mrs. Dhillon's helpful BUFF statement. We also see much merit in establishing the Bhutan Economic Stabilization Fund. The staff's recommendations on the design of the wealth fund would certainly warrant the authorities' attention.

The work underway to modernize the monetary policy framework is welcome. We commend the efforts of RMA to improve liquidity management and forecasting, and to transition to an interest-signaling framework. Against the prevailing uncertainties, staff's advice on the initial breadth of the corridor is certainly valuable. More generally, given the peg to the Indian rupee, management of INR liquidity would seem central to the monetary conditions in Bhutan. Could staff provide background on the still relatively low share of Indian rupees in official reserves?

Directed lending should be resisted. We take good note of the importance of the CSI sector in Bhutan. We also agree that further progress in improving access to finance is important. However, it would seem debatable whether the recently launched PSL program is the best option to ensure financing of CSI activity in a sustained manner. We note that staff advises to keep the outcomes of the PSL program under review. It would, however, seem preferable to prioritize the work on an effective framework to enable the provision of collateral and the enforcement of creditor rights. We understand that work in this area is in fact underway. We take note of staff's recommendations in Appendix I, but we would be interested in staff's overall appraisal of the PSL.

We encourage the authorities to consent to the publication of the staff report, as they did back in 2016.

Mr. Leipold, Mr. Merk, Mr. Rashkovan, Mr. Buetzer, Ms. Harutyunyan, and Ms. Lopes submitted the following joint statement:

We thank staff for the concise report and Mr. Gokarn and Mrs. Dhillon for their informative buff statement. We broadly share staff's appraisal and would like to make the following comments for emphasis.

It is encouraging to see the progress that Bhutan has made on its path to becoming a middle-income economy. Robust growth has been accompanied by significant poverty reduction and improvements in social outcomes. We welcome the analysis on this topic (Box 1) and look forward to the findings of further research on the drivers of poverty reduction, which can hopefully be useful for broader policy advice.

Going forward, Bhutanese authorities should focus on how to sustainably raise growth over the longer term, notably through diversification. On the external side, potentially weaker growth and higher inflation in India as well as higher oil prices could negatively affect Bhutan's current account and fiscal deficit. Domestically, delays in expanding revenue mobilization and completing hydropower projects also pose key risks.

On the fiscal front, the authorities should strive to sustainably enhance their domestic revenue collection. In particular, the goods and services tax (GST) should be implemented without further delays. In this regard, we take positive note of the Technical Assistance that the Fund is providing. Enhanced revenue mobilization is also important to enable a more even fiscal spending path and thus facilitate progress on structural change. The additional domestic tax revenue mobilization through the GST could help to implement a more even fiscal spending path than what is implied in the draft of the 12th Five Year Plan. We would encourage the authorities to pursue staff's proposed alternative fiscal path, and use it to further promote structural change, including through the diversification of the economy, facilitating private sector development, improved training of the youth, infrastructure development and reducing barriers to foreign direct investment.

Furthermore, the sharp reduction in budgeted investment for FY2019 is regrettable. We note that the authorities share staff's concerns in this regard, but operational constraints seem to be curtailing their ability to address it. In this context, the fiscal framework should be strengthened to avoid the

recurrence of such cliffs—as it is recognized in the buff statement. Could staff provide further details on the specific measures being foreseen to strengthen the fiscal framework?

While the intergovernmental agreement with India has been mitigating risks associated with Bhutan's high public and external debt, going forward these risks need to be monitored closely. As external concessional financing is projected to decrease, domestic debt markets should be developed in a prudent and sustainable manner.

The current account deficit has narrowed recently and is expected to decline further as hydropower-related exports increase, however it still remains high. In this respect, we were wondering about staff's view on the implications of India's adoption of the GST (and the removal of excises on exports) for the current account balance and inflation in Bhutan as imports might become cheaper and exports more expensive. Also, we would appreciate if the staff could comment on the authorities' credit policy to restrain demand for imports from India due to the GST introduction as stated in the 2017 update of the Asian Development Outlook of the ADB.

Regarding the financial sector, we echo staff's call for continued vigilance and see merit in the recommendation to strengthen financial sector resilience. The regulatory framework should be modernized to prevent the build-up of risks, as inter alia the NPL ratio is still high and projected to increase further. Moreover, care is needed to avoid distortions as a result of the new Priority Sector Lending Program.

We agree with staff that the exchange rate restrictions under the transitional arrangements of Article XIV should be gradually eased. We can support the proposed decision as outlined in Supplement 3 and thus urge the authorities to eliminate the exchange rate restrictions which are subject to fund approval under Article VIII as soon as possible.

Lastly, we encourage the authorities to consent to the publication of the staff report.

Mr. Castets and Mr. Rozan submitted the following statement:

We thank the staff for their thorough report on the Bhutanese economy, as well as Mr. Gokarn and Mrs. Dhillon for their insightful buff statement. We generally agree with the staff appraisal and wish to offer the following comments.

The Bhutanese economy continues to demonstrate strong growth, mainly driven by the hydropower and services sectors, and a commendable track record in poverty alleviation. Inflation is moderate, and external imbalances should begin to decline in the medium term.

We concur with the staff appraisals of the fiscal consolidation, which is needed to strengthen the fiscal position and reduce external imbalances. We also share staff's concerns on the consolidation path, which appears too steep and which could unduly impair growth prospects. In this regard, we take note of the authorities' response regarding the election calendar. Can the staff elaborate on the existence of a pipeline for investment projects that could easily be rolled out and disbursed after the elections?

We encourage the authorities to implement a rolling multiyear budgeting process, to reduce cyclicality of the fiscal policy. The creation of Stabilization Fund will help in this regard. In addition, revenue reform should be implemented to ensure that tax to GDP ratio does not decline. GSP implementation should remain an important priority.

We concur with the staff that monetary conditions continue to remain appropriate, and support the authorities' effort to modernize their monetary policy framework through targeted technical assistance. We support the authorities' commitment to enhance their policy toolkit. The ngultrum's rupee peg appears warranted, given the strong linkages with the Indian economy ; in this regard, we support the staff recommendation to increase the share of rupee reserves, to above 50 percent.

Regarding the financial sector, while the supervisory framework has been steadily improved, prudential rules should be enforced more strictly and regularly, and we welcome the authorities commitment to continue to modernize the regulatory regime.

Finally, on the structural issues, we note the significant and rising contribution of the hydropower sector the economy. Bhutan should strive to diversify its economy as a matter of priority, and generate higher quality jobs, in particular for its youth. Improving the business environment as well as infrastructures and access to finance should help develop the private sector. We welcome the Bhutanese authorities' commitment in this regard.

Mr. Lopetegui and Mr. Corvalan Mendoza submitted the following statement:

We thank staff for the report and Mr. Gokarn and Mrs. Dhillon for their comprehensive buff statement. Ongoing efforts to diversify the hydropower-rich production economy towards agriculture, tourism, mining, etc. might prove helpful in the near future. We are encouraged by the authorities' efforts to generate high-quality jobs for the youth as envisaged in the 12th Five-Year Plan (FYP). This structural change is being built upon the country's solid buffers and good track record, with strong growth and poverty levels on a declining path.

Short-term economic challenges are being tackled and the authorities are more optimistic on the outlook than staff. The economy is growing well, the peg to the Indian Rupee keeps inflation under control, the fiscal sector is gradually consolidating, and reserve coverage is at adequate levels. While we concur with staff that risks are skewed to the downside due to weaker growth and higher inflation in India (its most important trading partner) and possible delays to implement the goods and services taxes (GST) or delays to complete hydropower projects, the 12th FYP might prove useful at this juncture to minimize these risks. The plan to diversify the economy away from hydropower production is on the right path, but we are aware that this process of diversification could take time. We see merit in staff's advice to look at the adoption of GST as soon as possible, and encourage the authorities to speed up the process to generate additional revenues to tackle the structural reforms needed, like training for Bhutanese workers for example.

Medium-term structural challenges are being addressed well in advance. The fiscal sector will become an important tool for gearing the new growth model transformation toward a more diversified economy. We take positive note of the socio-economic outcomes reached with the current FYP, which guided the decision-making process for the past decades with good results. Could staff clarify the reason to advise the authorities to replace the current FYP cycles with a rolling multi-year budget framework? What are the pros and cons of switching away from the current mechanism?

We welcome the authorities' commitment to modernize its monetary policy framework which aims to move from quantity to interest rate signaling, in an environment of an exchange rate peg. The staff advises to increment the rupee reserves to above 50 percent of total reserves for liquidity reasons are understandable, but we are more inclined to agree with the RMA Board decision, to reject further increases in the rupee share of reserves as it is today

(above 30 percent). The diversification process of the economy might also require a diversified portfolio on RMA reserves holdings. Also, the receipts from hydropower exports denominated in rupees might need further consideration from staff to support the country's diversification plan. We would appreciate staff's ideas on how to prepare the country to eventually let the currency freely float.

With these comments, we wish Bhutan and its people all the best in their future endeavors.

Mr. Johnston and Mr. David submitted the following statement:

We thank staff for their positive reports on Bhutan's 2018 Article IV consultations and Mr. Gokarn and Mrs. Dhillon for their buff statement. We support the proposed decision.

We take note of the impressive record in reducing poverty in Bhutan between 2007 and 2017. The authorities' efforts in reducing poverty from 23.2 percent in 2007 to 8.2 percent in 2017 as part of their successive Five-Year Plans are commendable. While staff noted that the Gini coefficient remained roughly unchanged at 0.38 between 2012 and 2017, we would ask if this level is commensurate with a country at Bhutan's stage of development. The staff's comments are welcome.

The staff recommended higher spending in FY2019 in light of the projected sharp contraction in capital spending, along with gradual fiscal consolidation in the medium term. Whilst broadly agreeing, the authorities advise that for FY2019, this was not feasible given the appointment of a new Cabinet in October. Could staff advise on any updates regarding this matter? For the medium term, we agree on a gradual fiscal consolidation to reduce vulnerabilities. Although the risk of debt distress is considered moderate based on the unique features of Bhutan's public debt, it is important to build fiscal buffers given past experiences of large swings in expenditure and deficits, the up-coming loss of GST refunds from India after FY2020, and the heavy reliance on hydropower export revenues. We welcome the plan to set up a stabilization fund along the lines of the 'Santiago Principles' of sovereign wealth funds to manage hydropower revenue flows.

We encourage the authorities to operationalize the new monetary policy framework. The proposed liquidity management framework will help improve monetary policy management in line with the currency peg. It is therefore important that the Fund continue to provide support, including

policy advice and capacity development to the Bhutanese authorities to implement these plans. Notwithstanding support from the swap arrangement with the Reserve Bank of India and the credit line with the Government of India, we agree with staff on the need to ensure sufficient rupee liquidity that reflects prevailing trade patterns.

We are encouraged by the authorities' ongoing commitment to undertaking structural reforms. We welcome the focus in the upcoming 12th FYP initiatives to broaden the economic base, improve the business environment and provide educational and job opportunities for the population. Diversifying the economy into the other sectors of agriculture, tourism, mining, and cottage and small industries would assist in improving the balance of payments position and enable Bhutan to remove the measures and restrictions on a number of international transactions relating to Articles XIV and VIII, respectively.

Mr. Daïri and Mr. Badsì submitted the following statement:

We thank staff for the well-written set of papers and Mr. Gokarn and Mrs. Dhillon for their informative buff statement.

Bhutan continues to enjoy robust economic growth, along with declining inflation and external imbalances. We commend the authorities for the significant strides in improving per capita income while reducing poverty and unemployment. The authorities' commitment to ensure both inclusive growth and macroeconomic stability, as stated by Mr. Gokarn and Mrs. Dhillon, is encouraging. While the medium-term outlook is favorable, risks are tilted to the downside, including from delays in adopting revenue measures and in completion of hydropower projects. We concur with the thrust of the staff appraisal.

While the fiscal stance is deemed to be prudent over the cycle, the fiscal position is characterized by sharp swings, both surplus and deficits, which reflects the high dependence of the economy on hydropower generation. We note that in FY 2018, economic growth is projected to decrease markedly at a time when public investments are expected to maintain their upward trend. The staff's comments are welcome. We would also welcome staff elaboration on the steep reduction in capital spending in FY2019 and its growth impact, and support staff call for a more gradual fiscal consolidation under the 12th Five-Year Plan. The authorities' interest in developing a domestic public debt market, as suggested by staff, is encouraging, and we look forward to completion of the comprehensive

reforms to strengthen the fiscal framework, as enumerated by Mr. Gokarn and Mrs. Dhillon.

Although adequately capitalized and benefiting from comfortable buffers to absorb potential losses, the banking sector suffers from low profitability and high NPLs. We share staff call for modernizing the regulatory framework and enhancing banking supervision. We are pleased to note the agreement between the authorities and staff on exchange rate policy, and welcome the authorities' intention to swiftly put in place the new monetary policy framework based on indirect instruments.

The authorities' strong commitment to diversifying the economy, including by developing infrastructure and addressing structural bottlenecks, as indicated by Mr. Gokarn and Mrs. Dhillon, should help the country reach middle-income status in the medium term. We welcome their outstanding performance in the 2018 World Bank Doing Business. We are comforted by their awareness of the need for deep-rooted reforms in the education system, and their intention to expedite implementation of staff recommendations to further improve access to finance.

With these remarks, we wish the Bhutanese authorities continued success.

Mr. Ostros and Ms. Sand submitted the following statement:

We thank staff for the well-written report and Mr. Gokarn and Mrs. Dhillon for their informative buff statement. Both documents shed light on the unique features of Bhutan's economy, the significant progress made in reducing poverty and increasing per capita income, and the efforts to further improve gross national happiness combined with sustainable economic development. We broadly support staff's assessment and policy recommendations and would like to add the following comments for emphasis.

We welcome the ongoing initiative to strengthen public financial management (PFM) and recognize that strengthening of the fiscal framework ranks high on the authorities' agenda. On the revenue side, we look forward to the introduction of the broad-based goods and services tax (GST) and welcome the extensive support provided by the Fund to ensure successful implementation. Over the medium term it will be important to increase capital expenditure to support higher growth given the significant infrastructure needs of Bhutan, and we agree with staff that a more gradual fiscal consideration

may be appropriate. The growing importance of hydropower means putting in place a framework for prudent management of hydropower revenues is essential. In this regard, the proposed floor for transfers to the fund seems to be a bit low, and we agree with staff's recommendations that a more ambitious target would be advisable to ensure meaningful countercyclical contributions from the fund to the expenditure envelope. Transparent and rules-based principles of the fund's operations is also advisable. Overall, we welcome the authorities' openness to Fund advice and their willingness to engage through extensive technical assistance and training, including exploring options for the removal of the exchange restrictions when the balance of payment positions permit. Hence, we are confident the authorities will strive to conduct sustainable economic and monetary policies going forward.

With Bhutan moving to middle-income status, focus should also be on the remaining structural challenges, such as an underdeveloped private sector and high youth unemployment. Economic diversification is essential to further enhance its overall competitiveness and create job opportunities. In this regard, further progress with improving the business environment and improved access to finance should aid private sector development. We note initiatives are underway, such as the recently introduced financial inclusion strategy. Alongside, efforts to modernize the regulatory framework should be stepped up to safeguard financial stability and provide a solid foundation for the private sector's access to finance. On the supply side, addressing education quality and skills mismatches is critical to achieve higher and more inclusive economic growth.

Mr. Moreno and Ms. Mulas submitted the following statement:

We welcome the well-written and balanced staff report and Mr. Gokarn and Mrs. Dhillon for their insightful buff statement. We broadly agree with staff's appraisal and have the following additional comments.

Bhutan has made outstanding economic and social progress in recent years. By maintaining a robust growth rate, the country has reduced its poverty rate from 23.2 percent in 2007 to 8.2 percent in 2017. Equally impressive improvements were made in access to basic services such as health, education and asset ownership. We commend the authorities for these remarkable achievements and encourage them to continue along this path.

The recent developments on strong lending growth, inflation, exchange rates and international reserves show that Bhutan maintains a solid

and stable growth. In FY2015/16, Bhutan's economic growth continued to accelerate driven by the hydropower sector and is estimated to remain robust in FY2016/17, with vigorous growth in services and manufacturing offsetting, to some extent, a tapering in hydropower-related construction. However, GDP growth is now projected to decelerate in the next two years, reflecting a sharp decline in public investment in transition to the 12th FYP and continued tapering of hydropower construction. Only growth is expected to gain traction again when new hydropower projects are on stream. Against this background, we would appreciate staff's assessment of the implications in Bhutan's economic growth of further delays in projected complementation of hydropower projects.

Timely introduction of structural policies would help sustain inclusive growth. We welcome the authorities' commitment to diversifying the economy to avoid an overdependence of the energy export sector. We also note the need to address persistent skills mismatches. Like staff, we believe that more training is desirable to meet short-term labor needs. Another important job challenge is youth unemployment which has increased in 2016, especially among educated youth, which suggests that the high economic growth in recent few years was unable to create enough job opportunities for the youth. The staff's elaboration on this pressing challenge is welcome.

On fiscal policy, identified measures need to be implemented in due time to further strengthen the fiscal policy. In this context, we share staff's concerns regarding the delays in adopting revenue measures and in implementing the goods and services tax (GST) to make up for the impending revenue shortfall from India's withdrawal of excise duty refunds, following its adaptation of a national GST in July 2017. The compensatory tax measures that have been identified by the authorities are needed to pay off the sizable revenue impact of India's withdrawal of excise duty refund. Therefore, we welcomed those measures as well as authorities' commitment to GST implementation to help contain fiscal deficits and debt and related vulnerabilities. We would also like to acknowledge the IMF for its support of the GST implementation, as well as the authorities for effectively utilizing Fund's advice.

Mr. Obiora, Mr. Razafindramanana Mr. Alle and Mr. Tivane submitted the following joint statement:

We thank staff for a concise report and Mr. Gokarn and Mrs. Dhillon for their helpful buff statement.

Bhutan continues to make headways in improving socio-economic conditions, preserving sound macroeconomic fundamentals, and gradually transitioning to middle-income status. The economy is projected to grow robustly over the medium term, aided by the commissioning of new hydropower projects, services and manufacturing. Nevertheless, addressing the risks emanating from the economy's heavy and singular reliance on hydropower revenue remains the most pressing challenge facing the country going forward. Against this backdrop, we encourage the authorities to press ahead with the implementation of reforms to diversify the economy, boost competitiveness and private sector development, and bolster employment opportunities, especially for the youth. We broadly share the staff's appraisal and policy priorities and wish to make the following comments for emphasis.

A prudent fiscal stance anchored by robust fiscal rules is warranted to smoothen the fluctuations of hydropower revenue and preserve macroeconomic stability. While we welcome the authorities' commitment to sustain fiscal prudence in the coming years, we agree with staff's proposal that the pace of fiscal consolidation should be appropriately calibrated in alignment with the urgent need to address pressing development needs. Given this, a swift implementation of the goods and services tax (GST), coupled with enhancement of public financial management (PFM), and establishment of fiscal rules for the Bhutan Economic Stabilization Fund (BESF), should be given priority. Similarly, proactive measures to promote the domestic public debt market would be needed to support the Bhutan's development agenda, especially in light of decreasing donor support.

Although the debt vulnerability risks appear to be manageable given the projected rise in electricity exports in the near term, we are concerned that staff may not be paying adequate attention to potential crystallization of the risks associated with the country's debt. We are not comforted by the fact that Bhutan's debt to GDP ratio is currently about 99.7 percent. More worrisome, even the scenario that assumes new and significant inflows from electricity exports only reduces the debt to GDP ratio down to 79.6 percent. In line with the Managing Director's warning in the GPA, we are of the view that this matter warrants further attention. Could staff elaborate on their analysis of the debt situation and why they have reached the conclusions that this may not pose an imminent threat to Bhutan's economic stability.

The monetary policy stance remains suited to economic conditions. We are pleased with the Royal Monetary Authority's commitment to strengthen the monetary policy framework with support from Fund technical assistance. While the financial stability risks owing to the cross exposures

between banks, corporations, households and the budget appear to be contained, the authorities should remain vigilant and further strengthen the macroprudential regulations and bank supervision. While we agree that the ngultrum's peg to the rupee continues to serve the country well, we see merit in the staff's advice to raise the share of rupee reserves, given the large exposure of the public balance sheet to the rupee.

Bhutan continues to face considerable challenges to bolster economic competitiveness, foster economic diversification, and improve job creation. Addressing these challenges would require deploying comprehensive structural measures to, inter alia, raise fiscal space for infrastructure investments aimed at lifting productivity growth and improving the business climate. We therefore, support the invigoration of measures to improve access to finance, expand the credit information bureau, address the skill mismatch, enhance dispute resolution mechanisms, and improve human capital development.

Mr. Bayar and Mr. Varga submitted the following statement:

We thank staff for the well-written report and Mr. Gokarn and Mrs. Dhillon for their helpful buff statement. With their last Five-Year Plan (FYP), the Bhutanese authorities managed to maintain the economic momentum and significantly improve socioeconomic conditions, advancing their country to middle-income level. In the medium term, growth is likely to stay at its current higher level, as new hydropower projects are coming online and the support from the Indian government is secured for the authorities' 12th FYP. Despite these positive developments and projections, the implementation of sound macroeconomic policies and structural reforms are necessary to offset the challenges Bhutan's economy is facing. We broadly share staff's assessment regarding the necessary policy mix and provide the following comments for emphasis.

Given the high indebtedness of the Bhutanese economy, we see merit in gradual fiscal consolidation which would also avoid sharp swings in the fiscal stance. Although it is mostly project-financed, the level of public and external debt is well above sustainable levels and that of Bhutan's regional peers, limiting the room of fiscal policy to respond to external shocks, which is well depicted by the current difficulties to replace the expected loss of excise duty refunds from India. Therefore, fiscal consolidation is warranted to reduce debt levels and its service costs., We do however share staff's concerns that this should be executed in a growth friendly manner. As the authorities' current plan implies sizable cuts in capital spending which dampens

short-term growth prospects, we wonder whether the authorities are considering to engage with other development partners so as to diversify their funding base and relax the budgetary constraints on capital projects. We also wonder whether there is still untapped hydropower potential in Bhutan, which—if utilized—could provide a steady pipeline of capital investments, and an eco-friendly and durable revenue stream for the Bhutanese government. The staff's comments are welcome. On the revenue side, the authorities should seek raising tax revenues, which are still low relative to GDP, by improving the tax administration and replacing the current sales tax with a general Goods and Services Tax. Given the difficult nature of this undertaking, we welcome the authorities' strong engagement with the Fund and the use of its technical assistance. Going forward, we welcome the creation of a stabilization fund, but strongly encourage the authorities to ensure that adequate capacity and governance are in place to maintain and properly manage such a fund.

Reforms in the monetary policy framework and financial regulation are required to maintain the hard-earned macroeconomic stability. The Royal Monetary Authority (RMA) was successful recently to evade liquidity shocks from hydropower income and curb excess credit growth. We welcome the authorities' plan to modernize the RMA's liquidity management framework, with the support of SARTTAC, to further enhance monetary policy effectiveness through the money markets. These improvements will also help to maintain the currency peg to the Indian rupee, which we deem appropriate, given Bhutan's dominant economic linkages to India. Regulatory reforms in the financial sector should focus to address the increased level of non-performing loans, by improving classification and introducing risk-based provisioning. Could staff give an indication, how NPL ratios developed since December 2017?

Access to credit and deep structural reforms are essential to diversify the economy away from hydropower. The focus of the 12th FYP to diversify the economy in five specific sectors is commendable, but the authorities need to first address the barriers to doing business, including the stark skill mismatches, insufficient infrastructure and the crowding out effect of public employment. Although Bhutan experienced excess credit growth a few years ago, there are segments of the economy, especially the SME sector, which still does not have adequate access to financial intermediation. We, therefore, concur with staff's recommendations to implement reforms to extend the credit registry, enhance the effectiveness of the legal system to settle disputes and improve the land registry. Stronger SMEs will also likely boost job

creation, which is paramount to address the high level of unemployment, especially among the youth.

Ms. Villa and Mr. Shaari submitted the following statement:

We thank staff for the comprehensive report and Mr. Gokarn and Mrs. Dhillon for their informative buff statement. Bhutan has demonstrated commendable economic progress in recent years, while also significantly reducing poverty and lifting per capita income levels. To build on this achievement and transition swiftly to middle-income status, sustained structural reforms and adoption of prudent policies are essential. We broadly concur with the staff's assessment and recommendations and offer the following views for emphasis.

Implementing structural reforms to diversify the economy is critical to create employment and sustain growth. We welcome the authorities' reiterated commitment to develop industries other than hydropower, and address labor supply gaps, weaknesses in the business environment and access to finance as part of Bhutan's 12th Five Year Plan. Structured plans to expand domestic production and reduce import dependency through identifying the five priority sectors are appropriate and should be complemented with continued focus to mobilize greater private sector participation by enhancing the business environment and access to finance. We welcome efforts to coordinate interventions among various government agencies to help stimulate the CSI sector, given its importance in the economy. However, we caution against prescribed lending, and encourage the authorities to carefully consider staff recommendations detailed in Appendix 1.

We see merit in staff's recommendation for a more gradual fiscal consolidation path over the medium term but are cognizant of the near-term limitations faced by the authorities surrounding the electoral transition. In addition, to strengthen the effectiveness of fiscal management, improvement in key aspects of current fiscal practices should also be pursued. In particular, to smoothen the impact of fiscal stimulus on the growth trajectory, we support the recommendations for the authorities to introduce a rolling multiyear budget framework, strengthen public financial management and enhance fiscal transparency. These improvements should be complemented with measures to enhance the domestic revenue base and efforts to develop the domestic public debt market. In this regard, we look forward to the successful implementation of the GST as scheduled in July 2020. We also welcome the authorities' ongoing efforts to establish the Bhutan Economic Stabilization Fund (BESF) as a dedicated entity to manage hydropower revenues. In

operationalizing the BESF, we strongly encourage the authorities to consider adopting best practices of managing sovereign wealth fund that staff outlined in Appendix III of the report.

Operation of a strong and credible monetary policy framework is essential for effective macroeconomic management. We welcome the Royal Monetary Authority's (RMA) efforts to modernize Bhutan's monetary policy framework by introducing a more market-based liquidity management framework which would strengthen RMA's capacity to influence money market conditions and improve the overall effectiveness of its monetary policy stance. The successful operation of the market-based interest rate system will facilitate the development of the domestic money market and pave the way for a more efficient credit intermediation in Bhutan's banking system. Could staff comment on the state of monetary transmission channel in Bhutan, particularly about the strength of the interest rate channel? Besides modernizing the liquidity operation, effective monetary policy framework should be complemented with good policy signaling and communication. We encourage the authorities to initiate work in this area and should capitalize on technical assistance from SARTTAC in this regard. We concur that the current exchange rate peg to the Indian rupee remains appropriate and encourage the authorities to continue their efforts to improve the share of rupees in the total reserves. Efforts to diversify the export sectors is also essential to strengthen Bhutan's external position.

Strengthening regulation and supervision of the financial sector will improve the resilience of the financial system. Active participation of the private sector in the economy needs to be supported by efficient credit intermediation from a strong financial system. Towards this end, efforts to strengthen the regulation and supervision framework should remain as key policy priorities in Bhutan's overall development strategy.

With these remarks, we wish the authorities continued success in their policy endeavors.

Ms. Horsman, Ms. McKiernan and Mr. Weil submitted the following statement:

We thank staff for their report and Mr. Gorkan and Mrs. Dhillon for their helpful buff statement. We take note of the remarkable progress made by the authorities to reduce poverty levels, as well as the robust growth, declining imbalances, and traction with respect to the Fund's policy advice. However, Bhutan's capital spending is constrained by the electoral cycle in a way that risks undermining growth, there are signs of financial sector vulnerabilities,

and economic diversification remains a key priority. We broadly agree with The staff's assessment and offer the following comments for emphasis.

Poverty levels have been significantly reduced and growth remains robust. Poverty has fallen significantly since 2012 supported by robust growth driven by hydropower construction and exports. We look forward to the authorities' planned study on the drivers of the remarkable pace of poverty reduction and any lessons that may be learned.

One of Bhutan's greatest fiscal challenges is the uncertainty caused by its own rules governing capital spending during electoral cycles. The self-imposed investment cliff could put the continued expansion at risk by curtailing investment in productive infrastructure. A revised budgetary framework that provides greater flexibility and certainty for capital spending during electoral cycles would help reduce this unnecessary fiscal volatility. We encourage the authorities to enhance revenue mobilization and the Fund staff to continue providing technical assistance to support the implementation of the goods and services tax, as a key measure to broaden the tax base.

The financial sector is showing signs of vulnerability. After several years of trending downward, bank non-performing loan ratios have spiked to their highest levels since 2009. Regulators should ensure that provisions are adequate, and monitor balance sheets for systemic vulnerabilities. The authorities should also continue taking steps to more generally improve financial supervision and regulation to close gaps that currently exist in the regulatory framework.

The authorities should address skills mismatches and prioritize economic diversification. We welcome the authorities' intention to pursue labor market reforms to address persistent skills mismatches, which is especially important for addressing high youth unemployment. There is continued dependence on hydropower construction and exports that are vulnerable to risks, such as construction delays and climate change. The authorities should continue prioritizing economic diversification to promote sustainable inclusive growth, with improvements to the business climate as a starting point.

Mr. Alogeel and Mr. Rawah submitted the following statement:

We thank staff for the well-written report and Mr. Gokarn and Mrs. Dhillon for their helpful buff statement. It is encouraging to note that Bhutan's growth has been strong, spurring the good progress in poverty

reduction. We also welcome the authorities' economic diversification efforts, which are especially important to secure a more sustainable growth going forward as the country now is transitioning to a middle-income status. However, further efforts are warranted to address fiscal stance volatility, enhance business environment, and foster financial sector stability. We broadly share staff conclusions and policy recommendations and would like to make the following points for emphasis.

The establishment of Bhutan Economic Stabilization Fund (BESF) to address the volatility in fiscal revenues and expenditures is a welcome step. Like staff, we encourage the authorities to finalize the rules governing the BESF operations soon. In this regard, we encourage the authorities to consider staff's useful recommendations outlined in Appendix III. In addition, the large fiscal stance swings could be reduced by adopting a medium-term budgetary framework. Public financial management reforms, including the implementation of an electronic payment system, are welcome and we look forward to efforts to improve budget transparency, including through frequent fiscal reporting.

We welcome the authorities' efforts to modernize the monetary policy framework, and the expected issuance of the financial inclusion strategy. Also, we take note of the launch of the Priority Sector Lending (PSL) program in January 2018 as part of the authorities' planned efforts to improve access to credit. Like staff, we would like to underscore the importance of frequent reviews of the progress under the program to avoid a build-up of risks and contingent liabilities.

Finally, we are encouraged by the emphasis placed on improving the business environment. Further efforts are, however, warranted to enhance labor productivity, improve access to finance, review the FDI thresholds and improve the infrastructure. We look forward to further progress as these reforms are crucial for spurring private sector development, strengthening job creation especially for youth, and ultimately achieving a more diversified economy.

With these remarks, we wish the authorities further success.

Mr. Palei and Ms. Smirnova submitted the following statement:

We thank staff for their comprehensive report and Mr. Gokarn and Mrs. Dhillon for their informative buff statement. We welcome substantial poverty reduction and growth in per capita incomes in Bhutan. Overall,

economic conditions in Bhutan look favorable, as inflation is low, the external imbalances are declining, and the risks of debt distress are moderate.

Domestic risks to the outlook include possible delay in implementation of the goods and services tax (GST) and sharp decrease of capital spending, but they seem to be under the authorities' control and could be mitigated to some extent. External risks, such as those associated with the slowdown on the Indian economy or volatility of oil prices, could be addressed through the Bhutan Economic Stabilization Fund. We broadly support staff's assessment and would like to draw attention to the following points.

On fiscal policy, the authorities aim to maintain the current pace of economic development, while carefully monitoring fiscal risks arising next year. Next year Bhutan faces government revenue contraction due to the expected decline in foreign grants and a lower excise duty refund from India. The authorities currently plan to decrease capital spending from 17 percent of GDP, in FY 2018, to only 5.6 percent of GDP, in FY 2019. We are concerned that such a sharp change could cause dislocations in the labor market and affect income of many people. As a side effect, these developments can reverse the achievements in poverty reduction and can slow down Bhutan's transition to middle-income economy. We also note that Bhutan needs to persevere with the development of infrastructure. Compared to the level cited in the staff report, Bhutan's position in the Logistics Performance Index in 2018 dropped further to 149 and is at the lowest level since 2007.

Thus, we tend to agree with staff that the decline in capital spending should be much smaller, given that the risks of debt distress are moderate. It would be preferable for the authorities to focus on the revenue side and to put a maximum effort in implementing GST as soon as possible.

On monetary and exchange rate policy, we strongly agree with staff that, given Bhutan's interlinkages with the Indian economy, as well as the existing currency peg, it is highly recommended to bring the Indian rupee share to a level above 50 percent of total foreign exchange reserves. A larger buffer would substantially decrease the risks of financial instability due to any balance of payments pressures.

On structural reforms, we believe that lifting FDI restrictions would be beneficial for the economy, especially if lifting the existing restrictions allows foreign enterprises to decrease some regulation-related costs and increase salaries for skilled workers. This could also contribute to reducing public and private sector compensation mismatch and attracting more skilled youth to the private sector.

With these remarks, we wish the authorities success in facing challenges ahead.

Ms. Pollard and Mr. Vitvitsky submitted the following statement:

We thank staff for the Article IV and Messrs. Gokarn and Dhillon for their informative buff statement. Bhutan's macroeconomic framework appears sensible, and we commend the authorities for their success in reducing poverty and boosting per capita incomes. At the same time, we are concerned by the degree of capital expenditure volatility and join staff in pushing for pushing for a smoother fiscal cycle. We broadly agree with staff's appraisal in the Article IV and encourage the authorities to eliminate restrictions under Articles XIV and VIII.

The growth model for Bhutan is focused on the production and export of hydroelectric power to India, with estimates of massive untapped hydropower potential. Building out the hydropower sector represents an opportunity for steady public investment and employment. Therefore, it is surprising that public investment is so volatile, leading to the assessment of volatility in growth, employment, and public revenues. We encourage the authorities to take steps to smooth out public investment in hydropower with the result that employment and growth trajectories are more stable and sustainable. Even if public investment cannot be smoothed, is there a way to smooth fiscal expenditure over time even though hydropower investment happens to be lumpy? The staff's comments are welcome.

Additionally, we encourage the authorities to further steps to enhance financial inclusion. Can IMF staff comment on the authorities' financial inclusion strategy? We would also appreciate staff views on the sequencing of reforms on financial inclusion: should the authorities broaden and deepen access to finance before putting in place tighter financial sector regulation and supervision, or vice-a-versa?

Ms. Mori made the following statement:

I thank the staff for the report and Mr. Gokarn and Ms. Dhillon for the informative buff statement.

It is encouraging to the see the favorable macroeconomic situation in Bhutan, with robust growth and stable inflation as well as progress in reducing poverty and increasing per capita income. We also welcome the authorities'

ongoing efforts to strengthen the fiscal position, modernize the monetary policy framework, and improve financial access. That being said, there are some risks, including goods and services tax (GST) implementation and hydropower project management.

In this regard, we would like to briefly touch on the GST implementation. We see this case as a good example of integration of surveillance and technical assistance (TA), as the identified urgent need to develop GST capacity is addressed by TA in a timely fashion, and the authorities showed their strong commitment and ownership to achieve this objective.

As a donor to this TA project, we expect the authorities to implement the GST as scheduled, supported by Fund TA. With these comments, we wish the authorities success.

Mr. Fachada made the following statement:

I thank the staff for the report and Mr. Gokarn and Ms. Dhillon for the buff statement. Our chair did not issue a gray statement, but we would like to make a few comments on Bhutan's economy.

Bhutan's achievement in maintaining high growth and reducing poverty, as well as pursuing development while preserving its traditions, values, and environment is commendable. Moreover, Bhutan's authorities continue to deserve praise and admiration for focusing their policies on the well-being and happiness of the population. We also commend the good governance and political stability in Bhutan, which have earned the country important economic benefits.

We are pleased to hear that there is agreement between the staff and the authorities on policies going forward. On the fiscal front, we see merit in the staff's proposal to calibrate the fiscal consolidation path in a way that will minimize the impact on growth. We also support the recommendations regarding the implementation of the GST and the appropriate use of resources on the economic stabilization front.

On the financial sector, we encourage the authorities to continue to improve regulation and strengthen supervision to avoid the buildup of fiscal risks, while maintaining their agenda to promote financial inclusion.

On structural issues, we agree that diversifying the economy away from the hydropower sector is warranted, and we welcome the authorities' efforts to improve the education system and provide high-quality jobs for the population, especially the youth.

Finally, I support the provision of TA to Bhutan and recognize the importance of the new South Asia Regional Training and Technical Assistance Center (SARTTAC) in India.

Mr. Inderbinen made the following statement:

We thank the staff for the report and for the written responses, and Mr. Gokarn and Ms. Dhillon for their buff statement. In our gray statement, we commended the authorities on the favorable outcome over the surveillance cycle and under the last five-year plan. I wanted to follow up on two aspects that we mentioned in our gray statement—one on the fiscal stance, and the other on the financial sector, particularly the priority sector lending (PSL) program that the authorities have recently initiated.

On the fiscal stance, we sympathize with the authorities' cautious position, and in contrast, the staff is advocating for a smoother reduction in expenditure, and we take this from a cyclical policy, conjunctural point of view. But we did question the realism of the advice to ramp up maintenance expenditure that quickly in a country like Bhutan, and also in the domestic financing of the budget. Now we have the concrete question of whether the financing could be taken up by the domestic sector given the limitations mentioned in paragraph 17 of the staff report, and the staff's written responses indicate that there would be a demand for longer-term maturity paper that could be taken up.

My follow-up question would be what the supply-side looks like. Do the authorities have such paper outstanding already over the longer-term? Is there yield curve in Bhutan for public debt over this term? If this were not the case, is there legal basis given for such longer-term paper, and is there debt management capacity for this? I would be interested if the staff could elaborate on that.

On the PSL program, we found Annex I, outlining the staff's recommendations to the authorities, to be very informative. However, I missed an overall appraisal of this program, given experiences in other countries. It looks suspiciously like a directed lending program, which we all know has shortcomings. I would have expected something on this issue in the

staff appraisal. I recognize the staff's point—provided in the written responses—that there has not been much experience with this program yet given that it has been recently initiated. But from an ex ante standpoint, an appraisal by the staff would have been useful.

The staff representative from the Asia and Pacific Department (Mr. Grigorian), in response to questions and comments from Executive Directors, made the following statement:¹

I will take the realism question first. As we indicated in our response, in consultations with the technical staff, we have developed a sense that there is room for increasing capital expenditure at least by about 1.5 percentage points in the upcoming fiscal year after the new government takes position, and potentially beyond if maintenance expenditures can be frontloaded. We have no doubt that some increase can be feasibly achieved.

On the financing, in consultations with market participants, we have a stronger sense that there is a strong demand for longer-term paper. Banks in particular, but also the state pension fund, as well as insurance companies, would be willing to take paper of two and three years' longer maturity. There is nothing outstanding currently, outside of shorter-term paper with three- to six-month maturities, but the demand is clearly there. The banks are sitting on a significant amount of liquidity, which if turned into demand for paper under some regulatory treatment could credibly finance any shortfall in government revenues. We have no doubt that can be achieved.

On the debt strategy, the authorities are working with the World Bank, and a medium-term debt strategy mission is forthcoming. They will have one in place that should provide a good justification on a risk-cost basis for the government to issue securities within that range. We have no doubt that would be a good strategy, underpinned by a strategy paper but also a market development strategy, which is important.

On the PSL, the authorities are well aware of the shortcomings of a directed lending approach, which is why the limits that are imposed on the rates are minimal, and to minimize the disincentives for the banks to get into that, they also provide compensatory tax benefits for engaging in that scheme. That being said, we expect that the total portfolio of PSL loans for any bank will not exceed 1 percent of their outstanding loans, which is a small number

¹ Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

by any measure, and will be subject to continuous reviews by their own monetary authorities.

Mr. Gokarn made the following concluding statement:

On behalf of our authorities, I thank the Fund team led by Mr. Grigorian for their productive engagement with the authorities and responses to Directors' questions. Our authorities greatly value the staff report and are deeply appreciative of the Fund's continuous support for institutional capacity building, human resource development, and policy guidance. When we were in Bhutan for the Article IV meetings, we were told that there had been about 82 TA programs provided to Bhutan since it became a member of the Fund. That reflects the very high-level of engagement and reliance on the Fund's advice.

I also thank Directors for their gray statements and interventions. We will convey the valuable insights to our authorities. I would just like to mention that our authorities have already conveyed their consent for publication of the staff report.

Bhutan has performed well in terms of economic growth and modernization. Along with major improvements in social indicators, communications, governance, and the standard of living, there has been a significant decline in poverty over the last decade. Firmly rooted in its culture and traditions, Bhutan has made advances through its own barometer of gross national happiness, which emphasizes a holistic approach to development.

However, as it transitions to a middle-income country, Bhutan faces challenges as it attempts to expand and, most importantly, diversify its economic base and make its growth more inclusive, especially for unemployed youth. Our authorities remain optimistic about the medium-term growth prospects, spurred by impulses from clean, renewable hydropower projects, services, agriculture, and tourism. But in this context—and this relates to the point that Mr. Inderbinen made about the PSL—cottage and small industry is expected to play a significant role in the pursuit of sustainable diversification.

On the fiscal front, as many Directors have pointed out—including Ms. Horsman, Mr. Palei, Mr. Leipold, Mr. Merk, and Mr. Rashkovan—our authorities continue to focus their efforts on boosting revenue mobilization for a more predictable resource trajectory. To this end, our authorities are working on the timely implementation of the GST with TA from the Fund, a

point as emphasized by Ms. Mori. They have also prioritized many reforms for a strengthened fiscal framework, including the establishment of a stabilization fund and public financial management reforms. Keeping in mind evolving experiences, our authorities are committed to synchronizing the implementation with the well-taken staff recommendations, including on the stabilization front and the fiscal side.

With the new government taking over in Bhutan and the consequent rollout of the Twelfth Five-Year Plan, many gains are expected, particularly to bridge the gap rising from the short-term decrease in capital spending. The modernization of monetary policy is ongoing, and our authorities look forward to continued support of the Fund for policy advice and capacity building on this exercise.

With an eye on resilience, our authorities remain committed to enhancing financial sector regulation and supervision, and stand ready to check the NPL ratio and ensure an effective and robust new regulatory framework for insurance, a review of the macroprudential framework, and pension policy review.

It is in this context that the PSL issue comes up from a development standpoint, and particularly with the authorities' focus on encouraging entrepreneurship and ensuring credit to catalyze the cottage and small industry sector and create jobs. We note the caution expressed by Mr. Inderbinen, Mr. Alogeel, and Ms. Villa, and would like to underscore that the authorities will continue to monitor and evaluate the progress under the program and take corrective steps to avoid a buildup of risks. Beyond this, our authorities are expecting positive results from the financial inclusion strategy initiated in August 2018, both in terms of enhancing access to and usage of quality and affordable formal financial services.

To conclude, our authorities are very appreciative of the Fund's input and support over the years and strive to maintain the balance between inclusive and sustainable growth using the concept of gross national happiness. We look forward to continued engagement and guidance as we initiate strategies to diversify the economy's product base and expand options for growth.

The Acting Chair (Mr. Furusawa) noted that Bhutan is an Article XIV member. Bhutan also maintained exchange restrictions subject to Fund approval under Article VIII, Section 2(a). Fund approval of those measures was not recommended.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the significant improvements in per capita income and poverty indicators, with strong economic growth and low inflation. They also welcomed progress made on structural reforms, especially in access to finance and economic diversification. However, Directors observed that while external imbalances are declining, they are still large. In addition, key medium-term policy challenges remain, including domestic revenue mobilization and prudent management of hydropower revenues, while maintaining macroeconomic stability, enhancing competitiveness and further diversifying the sources of growth.

Directors noted that the FY2019 interim budget implies a sharp fiscal withdrawal and may impact growth. Given Bhutan's infrastructure needs, Directors called for higher capital expenditure supported by additional domestic revenue and a modest increase in domestic financing. They welcomed the authorities' commitment to implement a broad-based GST by July 2020 and called for a rationalization and gradual curtailment of tax exemptions. Directors encouraged the authorities to develop a domestic public debt market and further strengthen public financial management. They commended the steps taken to establish a macroeconomic stabilization fund to manage hydropower revenues and business fluctuations and noted the importance of transparent and rule-based principles for the fund's operations.

Directors considered the current monetary policy stance to be broadly appropriate. They welcomed efforts by the Royal Monetary Authority (RMA) to modernize the monetary policy framework by enhancing its liquidity management and forecasting capabilities. Directors also encouraged the establishment of an interest rate corridor and steps to develop the interbank market. This framework would help support the ngultrum's peg with the Indian rupee. Once this framework is fully operational, the minimum lending rate could be abolished.

While the risk of systemic distress remains low, the nascent banking sector needs to be strengthened. Directors underlined the need to further improve the prudential framework for the financial sector and strengthen oversight to avoid a build-up of risks. They welcomed the priority sector

lending program which is expected to improve access to finance for cottage and small industries but emphasized the need to monitor its performance.

Directors agreed that the exchange rate peg to the Indian rupee has served Bhutan well and remains an appropriate nominal anchor. Bhutan's reserve cover remains adequate but its composition may benefit from a higher share in rupees.

Directors encouraged elimination of exchange rate restrictions as soon as macroeconomic conditions allow.

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

The Executive Board took the following decision:

Bhutan—2018 Article IV Consultation

1. The Fund takes this decision in concluding the 2018 Article XIV consultation with Bhutan.
2. Bhutan continues to maintain restrictions on the making of payments and transfers for current international transactions under the transitional arrangements of Article XIV, Section 2, and several exchange restrictions subject to Fund approval under Article VIII, Section 2(a), as described in SM/18/213, Supplement 1. The Fund encourages Bhutan to eliminate the measures maintained under Article XIV as soon as its balance of payments position permits, and urges Bhutan to eliminate the exchange restrictions that are subject to approval under Article VIII as soon as possible. (SM/18/213, Supplement 3, 8/17/18).

Decision No. 16434-(18/86), adopted
October 26, 2018

APPROVAL: September 6, 2019

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. ***GDP growth is now projected to decelerate in the next two years, reflecting a sharp decline in public investment in transition to the 12th FYP and continued tapering of hydropower construction. Only growth is expected to gain traction again when new hydropower projects are on stream. Against this background, what is the staff's assessment of the implications in Bhutan's economic growth of further delays in projected complementation of hydropower projects?***
 - As hydropower projects come on stream, growth in construction is expected to become negative (as activities in the sector wind down significantly) and growth in the electricity generation accelerates. A delay in the completion of hydropower projects would be moderated in part by a more gradual slowdown in construction activity.

Fiscal Policy and Debt Management

2. ***While we follow staff's argument for a more gradual consolidation from a purely cyclical perspective, we question the realism of bringing significant maintenance expenditure forward. Also, advising the authorities to take recourse to domestic financing of the budget over the short term seems questionable, given the very limited depth of the domestic debt market. Could the staff comment on the consistency of this advice with their finding in paragraph 17 that the treasury bill market is 'subject to high roll-over risk'?***
 - On additional capital expenditure, see our response to Question 3.
 - On domestic financing, staff are of the view that there is presently appetite among market participants (banks, pension funds, and insurance companies) for securities with slightly longer maturities (2- and 3-year), which the authorities could tap into. At present, the entire stock of outstanding government securities is in very short maturities, making it subject to rollover risk (at reissuance).
3. ***We also share staff's concerns on the consolidation path, which appears too steep and which could unduly impair growth prospects. In this regard, we take note of the authorities' response regarding the election calendar. Can the staff elaborate on the existence of a pipeline for investment projects that could easily be rolled out***

and disbursed after the elections?

- Capital expenditure plans in Bhutan are linked to the five-year plans (FYP) and have some cyclicity. Typically, in the beginning of any FYP, capex is slow as projects are developed. Execution then picks up significantly in later years and falls sharply as FYP ends. The staff's interactions with the authorities on the existence of a pipeline of projects suggest that by pushing the limits of implementation capacity the authorities could increase the share of total 12th Plan capex spent in FY2019 to 12 percent of the total FYP envelope, raising capex by 1.5 percent of GDP.
4. *The staff recommended higher spending in FY2019 in light of the projected sharp contraction in capital spending, along with gradual fiscal consolidation in the medium term. Whilst broadly agreeing, the authorities advise that for FY2019, this was not feasible given the appointment of a new Cabinet in October. Could the staff advise on any updates regarding this matter?*
- While the appointment of new Prime Minister has been announced following the second round of elections to the National Assembly in early-October, no cabinet appointments have been made yet. As a result, no updates are available yet regarding the authorities' new fiscal plans for FY2019.
5. *We note that in FY 2018, economic growth is projected to decrease markedly at a time when public investments are expected to maintain their upward trend. Could the staff comment?*
- The slowdown of growth in FY2018 was due to a moderation in construction activities associated with the hydropower sector (most notably, the completion of the Mangdechhu hydropower project, and the corresponding decline in construction activity), which are off budget.
6. *Could the staff elaborate on the steep reduction in capital spending in FY2019 and its growth impact?*
- The authorities have acknowledged that the reduction in capex is a matter of concern but stated that the timing of the July 2018 elections (coinciding with the budget approval cycle) made it impossible for the outgoing parliament and cabinet to approve a full budget, leaving it the prerogative of the incoming government (which will not be appointed until October/November 2018). This limited the capital budget for FY2019 to spillover projects from the previous year and maintenance expenditure, leading to the cliff in capital spending. The precise impact of budgetary capex on growth in Bhutan is difficult to estimate analytically given the size of the hydropower

sector (and related construction/capital spending and related spillovers), which are off budget.

7. *As the authorities' current plan implies sizable cuts in capital spending which dampens short-term growth prospects, could the staff comment on whether the authorities are considering engaging with other development partners so as to diversify their funding base and relax the budgetary constraints on capital projects?*

- Bhutan is already engaged extensively with other development partners (most notably, World Bank and ADB) and benefited significantly from their assistance. However, the current capex reduction is by and large a policy choice, driven by political calendar (as explained in our answer to Question 6), rather than funding constraints.

8. *We wonder whether there is still untapped hydropower potential in Bhutan, which—if utilized—could provide a steady pipeline of capital investments, and an eco-friendly and durable revenue stream for the Bhutanese government, could the staff comment?*

- Bhutan has vast identified hydropower potential of 30,000 MW, with the developed hydropower capacity (1,060 MW) representing a small fraction of that. Another 3,600 MW are currently under development, expected to come on-stream by 2023. Finally, plans are underway to develop up to 10,000 MW additional capacity over time. These projects form the cornerstone of Bhutan's future revenue stream and development strategy. However, there are substantial risks to this strategy (e.g., hydrological and geographical risks, funding, market for power, etc.), which should also be viewed in the context of the need for economic diversification.

9. *Even if public investment cannot be smoothed, is there a way to smooth fiscal expenditure over time even though hydropower investment happens to be lumpy? Could the staff comment?*

- The staff agree that a smoother path of fiscal expenditures would be supportive of stable growth in Bhutan. Currently, fiscal policy is guided only by an overall spending envelope driven by development priorities in the FYP and a fiscal rule (to cover all recurrent spending and 20 percent of capital spending from domestic revenues). The economy is also on the cusp of undergoing a major transition to much higher hydropower revenues as several large projects come on-stream in the near-term. The authorities have moved forward to establish a hydropower fund to manage these flows and should use this opportunity to establish a fiscal anchor that will underpin a smoother expenditure path and enable countercyclical fiscal policy.

10. *Could staff provide further details on the specific measures being foreseen to strengthen the fiscal framework?*

- One of staff's main fiscal policy recommendations is to switch over to a rolling multi-year budget framework, to replace the current FYP framework, which provides little guidance in setting the annual budget parameters and linkage between the FYP and the annual budget. Due to this and other shortcomings in the budgeting process, efforts are in place to modernize budgeting process and make fiscal data reporting more transparent.

11. *Could staff clarify the reason to advise the authorities to replace the current FYP cycles with a rolling multi-year budget framework? What are the pros and cons of switching away from the current mechanism?*

- FYPs have served Bhutan well in laying out its growth strategy, reflecting the changing priorities of the country as its standard of living rises. However, the FYP framework serves as a mechanical guide for budgeting capital expenditure resulting in capex cycles (surpluses in early plan years and deficits later on) and providing unwarranted fiscal impulses. Moving to a flexible multi-year budget framework would provide more flexibility and serve as a more meaningful guide for annual budgeting by avoiding unnecessary cycles.

12. *Could the staff share its view on the implications of India's adoption of the GST (and the removal of excises on exports) for the current account balance and inflation in Bhutan as imports might become cheaper and exports more expensive?*

- The implementation of GST in India is unlikely to have significant macroeconomic implications for Bhutan. Prices of some imports (such as fuel and cars, key sources of compensatory excise duty refunds for Bhutan) have declined following India's adoption of its GST. This has resulted in a one-off adjustment in price levels, likely to be reversed in the future as Bhutan implements its own GST and/or compensatory revenue-raising measures. Overall, while design of the GST remains underway, under typical settings (including zero-rating for exports), Bhutan's exports to India should not be affected due to India's GST.

13. *Could the staff comment on the authorities' credit policy to restrain demand for imports from India due to the GST introduction as stated in the 2017 update of the Asian Development Outlook of the ADB?*

- The staff are not aware of any targeted restrictions to credit policy in place to limit imports from India. Indian exports to Bhutan are zero-rated under the GST making them relatively cheaper for Bhutanese consumers. Available data on the balance of

trade with India show that the trade deficit in goods in the first three quarters of FY18 has not deteriorated. The trade deficit in services has declined because of lower imports for hydropower construction.

- 14. *We are not comforted by the fact that Bhutan's debt to GDP ratio is currently about 99.7 percent. More worrisome, even the scenario that assumes new and significant inflows from electricity exports only reduces the debt to GDP ratio down to 79.6 percent. In line with the Managing Director's warning in the GPA, we are of the view that this matter warrants further attention. Could the staff elaborate on their analysis of the debt situation and why they have reached the conclusions that this may not pose an imminent threat to Bhutan's economic stability?***
- Over three quarters of external debt of Bhutan is owed to India and is associated with building hydropower plants under a bilateral intergovernmental agreement between the two countries. This agreement makes the debt more akin to FDI since all financial risk is carried by the Indian side, with India contractually committed to purchasing all generated electricity as a cost-plus-margin pricing scheme. Finally, hydropower plants are insured against calamities, leaving only hydrological risk for Bhutan to bear.

Monetary Policy

- 15. *Could the staff comment on the state of monetary transmission channel in Bhutan, particularly about the strength of the interest rate channel?***
- Currently, the RMA uses a Minimum Lending Rate that banks use as a reference for their lending rates. The impact of this system on the availability of credit and monetary transmission has not been explicitly assessed. This said, important structural impediments to monetary transmission exist (most notably, lack of a well-functioning money market), which are being addressed by technical assistance from SARTTAC.

External Sector and Exchange Rate Policy

- 16. *Could the staff share its ideas on how to prepare the country to eventually let the currency freely float?***
- As noted, the peg to the Indian rupee remains appropriate given the important linkages with the Indian economy. In the future, as Bhutan diversifies its trade and becomes more financially integrated with other economies, a flexible exchange rate regime may be more appropriate.

17. *Could the staff provide background on the still relatively low share of Indian rupees in official reserves?*

- The share of Indian rupees in official reserves has improved compared to past years. Despite the close linkages with the Indian economy (70-90 percent of trade is with India), Bhutanese authorities hesitate to increase holdings of Indian reserves that are not convertible to U.S. dollars, preferring instead to maintain a swap arrangement with the RBI.

Financial Sector

18. *We take note of staff's recommendations in Appendix I, but could the staff comment on its overall appraisal of the PSL?*

- The process has so far taken up gradually, with only a few hundred applications received via the banks' PSL windows. Since the program only started in January 2018, no information is available to date to assess the quality of the outcome.

19. *Could staff give an indication, how NPL ratios developed since December 2017?*

- No data are available on NPLs in 2018. However, given the strong seasonality and ongoing regulatory tightening, it will be largely impossible to gauge the level of NPLs until end-2018 data are published.

Structural Issues

20. *An important job challenge is youth unemployment which has increased in 2016, especially among educated youth, which suggests that the high economic growth in recent few years was unable to create enough job opportunities for the youth. Could the staff elaborate on this pressing challenge?*

- The authorities have several initiatives in place to increase employment among youth including vocational training, and entrepreneurship initiatives, some of which are funded by IFIs. Greater diversification in the economy, including the services sector, will introduce more jobs to educated youth.

21. *While staff noted that the Gini coefficient remained roughly unchanged at 0.38 between 2012 and 2017, we would ask if this level is commensurate with a country at Bhutan's stage of development. Could the staff comment?*

- The Gini coefficient decreased from 38.8 in 2012 to 37.4 in 2017 and is broadly within the range of countries with similar GDP per capita. The authorities' efforts to

increase financial inclusion and youth employment along with efforts to provide more skill training and entrepreneurship in cottage industries should cause a more equitable distribution of wealth from growth in the future.

22. *Can the staff comment on the authorities' financial inclusion strategy?*

- Efforts to improve financial inclusion (FI) are underway (in consultations between RMA and local stakeholders) and the FI strategy paper is due to be issued in December 2018. The staff have not had an opportunity to comment on the draft paper.

23. *Could the staff share its view on the sequencing of reforms on financial inclusion: should the authorities broaden and deepen access to finance before putting in place tighter financial sector regulation and supervision, or vice-a-versa?*

- Given the nascent state of the financial sector institutions in Bhutan, a more gradual approach to FI will be preferred but can also be pursued slowly along with strengthening financial regulation and oversight. At present, efforts are underway by RMA to improve financial sector regulation and supervision, including with help from TA from SARTTAC.