

IMF Publication

**Bhutan - Assessment Letter
for the World Bank**

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Bhutan—Assessment Letter for the World Bank

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Bhutan's growth was resilient to the financial crisis and the outlook remains positive.

- Given the concentration of trade and financial linkages with India, the impact of the global crisis was small and limited to tourism and a few manufacturing industries. GDP growth is estimated at 5½ percent in 2008/09, and projected to be 6–7 percent in 2009/10 and in the medium term, driven by developments in the hydropower sector. Inflation is rising in line with pressures in India, but still manageable at 5¾ percent in Q1 of 2010.
- The level of rupee reserves remains highly volatile due to linkages with the hydropower cycle, but rupee credit lines with India (totaling Rs 7 billion or 4½ months of goods imports from India) provide a useful safeguard. Convertible currency reserves, however, are less volatile and more than adequate at US\$ 825 million in March 2010 (16 months of imports), thanks to the substantial aid flows which have resulted in a balance of payments surplus, offsetting the volatile trade deficits arising from the hydropower cycle.
- Banking sector indicators are generally sound. Banks' capital adequacy ratio was 15 percent at end-2009; gross non-performing loans declined and its ratio to total loans fell by 1½ percentage points during 2009 to 6 percent. While credit growth is slowing, it is still strong at 18 percent in the year to March 2010. Meanwhile, banks' excess liquidity climbed sharply in 2009—the ratio to total assets jumped from 7 percent in June to 21 percent in December.

Containing fiscal expansion and enhancing liquidity management are necessary to avoid economic overheating. Strengthening bank supervision is also a top priority.

- Given higher development spending to meet the goals of the 10th Five Year Plan, and the recent wage increases, the fiscal deficit has been rising. Preliminary estimates indicate a deficit of 6½ percent of GDP in 2009/10, and one of similar magnitude in the 2010/11 budget, creating overheating risks. Moreover, high spending pressures combined with the possibility of shortfalls in largely aid-based foreign financing due to weak global recovery, risks further build up of already high public debt levels (70 percent of GDP), jeopardizing public debt sustainability. In particular, excessive domestic debt buildup could undermine the most recent debt sustainability assessment of moderate debt distress.
- Maintaining monetary policy consistent with the rupee peg, and improved liquidity management are necessary for economic stability. The rising yield spread between India and Bhutan due to a decline in Bhutan's T-bill rate relative to comparable Indian bills is a source of concern, especially in light of increasing imported inflationary pressures.

Intensified monetary operations are also needed to drain the high level of excess liquidity which poses risks of a sharp increase in credit growth.

- The entry of two new banks this year creates much needed competition in Bhutan's banking sector and could help lower the level of excess liquidity. With more banks, and in light of the rapid credit growth, enhanced supervision over banks' risk management practices and financial disclosure are necessary for maintaining asset quality and financial sector stability.
- Continued efforts to enhance private sector development remain an important priority. In this regard, advancing donor-supported SME-lending schemes and steps to develop a commercial paper market are needed to improve the financing mix available to the private sector.

Status of IMF Relations. The 2009 Article IV Consultation was concluded on December 15, 2009. A staff visit is planned for late 2010, and the next Article IV is expected in December 2011.