MONETARY POLICY STATEMENT

June 2011

Royal Monetary Authority of Bhutan

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ROYAL MONETARY AUTHORITY OF BHUTAN

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This Report has been prepared by the Royal Monetary Authority of Bhutan in accordance with Chapter II Section 10 of the RMA Act of Bhutan 2010.

Unless specified, the source of data presented in tables and charts is the Royal Monetary Authority of Bhutan or the National Statistics Bureau. Macroeconomic projections presented in the Outlook Section of this Report have been prepared by the Multi-Sectoral Macroeconomic Framework Coordination Technical Committee composed of various government and statistical agency representatives, and led by the Ministry of Finance, Royal Government of Bhutan. Projections and assumptions adopted thereof are a representation of collective judgment.

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ACRONYMS

BDBL	Bhutan Development Bank Limited
BIL	Bhutan Insurance Limited
BNBL	Bhutan National Bank Limited
BOBL	Bank of Bhutan Limited
BOP	Balance of Payments
CAR	Capital Adequacy Ratio
CPI	Consumer Price Index
CRR	Cash Reserve Ratio
CY	Calendar Year
DPNBL	Druk Punjab National Bank Limited
FDI	Foreign Direct Investment
FI	Financial Institution
FSA	Financial Services Act
FY	Fiscal Year (July 1 – June 30)
FYP	Five Year Plan
GDP	Gross Domestic Product
GoI	Government of India
LDC	Least Developed Country
M0	Reserve Money
M1	Narrow Money
M2	Broad Money
MFCC	Macroeconomic Framework Coordination Committee
MFCTC	Macroeconomic Framework Coordination Technical Committee
MW	Megawatt
NBFI	Non-Bank Financial Institution
NFA	Net Foreign Assets
NPL	Non Performing Loans
NSB	National Statistics Bureau
ODF	Overdraft Facility
OIN	Other Items Net
RGOB	Royal Government of Bhutan
RICBL	Royal Insurance Corporation of Bhutan Limited
RMA	Royal Monetary Authority
RSEBL	Royal Securities Exchange of Bhutan Limited
SBI	State Bank of India
SCF	Standby Credit Facility
SLR	Statutory Liquidity Ratio
T-Bill	Treasury Bill
TBL	T-Bank Limited
QM	Quasi Money
Y-O-Y	Year-On-Year
WPI	Wholesale Price Index

FOREWORD

The enactment of the Royal Monetary Authority Act of Bhutan 2010 in June 2010 has called for the redefining of the nation's Central Bank's accountability and responsibility in all aspects of monetary and financial sector related policies. It has conferred the RMA with a significant degree of autonomy to enable it to pursue an appropriate policy stance in response to the evolving economic outlook for Bhutan and abroad.

While the RMA's recent transition bestows it with greater independence, as a public institution in a democratic environment, the RMA is bound by the basic tenets of transparency and accountability, and as such, must disclose and explain its actions and decisions to the Government and people of Bhutan to support and enhance the overall democratic process.

The primary function or objective of the RMA, as stipulated in the RMA Act 2010, is to formulate and implement monetary policy with a view to achieving and maintaining price and financial stability (Chapter II, Section 7). Other secondary objectives that evolve around the primary objectives are to a) formulate and apply financial regulations and prudential guidelines to ensure the stability and integrity of the financial system as empowered by the Act; b) promote an efficient financial system comparable to international best practices; c) promote, supervise and, if necessary, operate national and international payment and settlement systems including the electronic transfer of funds by financial institutions, other entities and individuals; d) promote sound practices and good governance in the financial services industry to protect it against systematic risks; and e) promote macro-economic stability and economic growth in Bhutan.

As one of the core functions of the RMA is the conduct of monetary policy, monetary policy communication will be considered a vital component, as will information

covering the surveillance of the financial sector, in safeguarding the stability and integrity of the financial system. To that end, it shall be imperative for the RMA to articulate and communicate these policies, strategies, and assessments through the issue of a monetary policy Statement at least once a year for the following period (Chapter II, Section 10).

Price stability or a low and stable rate of inflation is universally viewed as desirable for the substantial benefits that accrue, and to facilitate balanced and sustainable economic growth, an ultimate goal of monetary policy. However, for the successful conduct of monetary policy, decades of evolved thinking around the world on the subject highlight that price stability is best served as a long-term goal of monetary policy and that it is best served when fiscal and monetary policies are aligned, given fiscal dominance is a common characteristic of least developed economies. Moreover, past and recent economic downturns have reiterated how crucial it is that the conduct of monetary policy includes measures to safeguard and strengthen the soundness and growth of the financial sector. All of this has been duly considered when formulating and implementing the monetary policy strategy for Bhutan.

In accordance with the RMA Act of Bhutan 2010, commencing in 2011, a Monetary Policy Statement shall be issued by the RMA on an annual basis. This Statement shall present an overview of monetary and financial developments, including recent policy measures and prospects for monetary and financial conditions, with the objective of conveying the rationale behind the RMA's decisions on monetary policy for the benefit of our stakeholders and the general public.

Daw Tenzin
Governor
June 2011

I. Overview of RMA's Monetary Policy Framework

1. In the pursuit of price stability, the cornerstone of Bhutan's monetary policy is that of **Exchange Rate Targeting**. Since the introduction of the Ngultrum in 1974, the Ngultrum has been pegged at par to the Indian Rupee which circulates freely in Bhutan and serves as legal tender (*a system similar to that of a currency board*).

2. The fixed exchange rate serves as an **explicit nominal anchor** that solidifies Bhutan's commitment to price stability. Generally, in most central banks, price stability is quantified, e.g., in the case of the European Central Bank, price stability is equivalent to a (year-on-year) rate of change of the CPI below or close to 2%, to be maintained over the medium term (inflation targeting). Other nominal anchors include money supply growth targets. The intermediate target for achieving and maintaining price stability in Bhutan is the one-to-one peg with the Indian Rupee.

3. Maintenance of a fixed exchange rate regime has been beneficial for Bhutan. Pursuing Exchange Rate Targeting as a policy measure has not only contributed to low volatility in the bilateral real exchange rate with India, it has greatly facilitated smooth trade integration between India and Bhutan, while safeguarding competitiveness, which is critical to avoid unwarranted pressures on net reserves. Moreover, the peg arrangement has been instrumental in maintaining confidence in the local currency, while tying Bhutan to relatively stable economic and monetary conditions in India.

4. However, the **choice of anchor precludes Bhutan from an independent monetary policy stance and limits monetary policy flexibility**, implying the loss of a first line of defense in response to adverse sector and country-specific shocks. Under these circumstances, changes in net foreign assets and reserve money are highly exogenously determined; interest rates and prices in Bhutan track developments in India. Consistent balance of payments related surpluses associated with official flows of aid in grants and loans together with export earnings, largely from the hydropower sector, in the past contributed to a build-up of excess liquidity in the domestic banking system. These balance of payments surpluses in the past were highly instrumental in increasing the stock of Indian Rupees in circulation. However, this complicates the monitoring of monetary aggregates

since it is difficult to estimate the amount of Indian Rupees in circulation, although this distortion is considered to be low.

5. Nevertheless, the RMA does have some room to operate monetary policy, particularly through **capital and prudential controls and reserve management, by influencing the level of bank reserves, and management of banking system liquidity** to regulate credit expansion and its impact on Bhutan's external position, price levels, and the health of the financial system.

6. The RMA is responsible for ensuring the **sustainability of the fixed exchange rate** system by always making available, sufficient Indian Rupees on demand for the exchange with the Ngultrum for payments with India, and the provision of at least 100% reserve backing for all Ngultrum issued in the country. A major aspect of RMA's monetary policy framework is to manage overall banking sector liquidity to smooth out sharp and undesirable liquidity fluctuations in the financial system. Sterilizing any persistent growth in banking sector liquidity is carried out to forestall unwanted build-up of inflationary pressures, a weakening of the balance of payments, and a contingent effect on the financial market. Additional monetary policy measures involve confidence-building measures for the Ngultrum and credible RMA and RGOB policies.

7. Monetary policy is currently implemented through the use of **direct and indirect instruments in Bhutan**. Since the RMA has statutory regulatory control over the financial institutions, monetary policy instruments include **reserve and liquidity requirements** stipulating that deposit money banks[1] hold a portion of their deposit liabilities as cash or deposits, limiting the supply of reserve money[2] and thereof the amount of excess reserves and loanable funds commercial banks can issue as credit to the domestic economy. The cash reserve ratio (CRR) has a holding and maintenance period of one month, and is calculated on a holding period averaging basis. In recent years, the RMA has chosen to tighten monetary conditions by maintaining a CRR of 17%. The CRR maintained as a current account deposit with the RMA, was raised from 15% in August 2008.

8. Similarly, the RMA also stipulates a **statutory liquidity ratio (SLR)**

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1 *A deposit money bank is also referred to as a commercial bank or depository institution.*

2 *Reserve money = RMA liabilities in the form of (1) currency outside banks, (2) deposit money banks cash in hand plus their required and current deposits with the RMA, (3) demand deposits of the rest of the domestic economy excluding the deposits of the deposit money banks and RGOB.*

requiring all financial institutions to maintain minimum liquidity at all times to meet anticipated and contingent obligations in the form of quick assets. Revised in 2009, the SLR is now set at 20% for commercial banks and 10% of total liabilities for non-bank financial institutions.

9. Monetary operations include the sale or purchase of government securities by the central bank in exchange for domestic currency or central bank deposits, changing the monetary base and domestic money supply, either contracting or expanding it. The issue of **RMA Discount Bills** which was launched in 1993 was recently replaced by the issue of the **91-Day RGOB Treasury Bills** (uniform price auction basis) by the Ministry of Finance and the RMA at the end of 2009. This was a step towards establishing a short-term market-based borrowing program in the domestic market, and to be used both as a short-term fiscal financing source as well as liquidity management instrument. The first issue of the T-Bills worth Nu.2 billion was issued on December 14, 2009 and sold at a discount rate of 2.5%. As of date, four series of the T-Bills have been issued by the RMA.

10. The introduction of **T-Bills** is an integral element in the country's process of liberalising interest rates and promoting capital and debt market development. The sale or auction of government securities not only helps the RGOB to borrow funds at a market-driven price, it also assists in creating additional investment opportunities for domestic investors and fund managers in the financial market. In order to set up a credible domestic debt market, both from the perspective of issuing agents and market participants (as a reliable source of funds and investment avenues), the RMA proposed that the RGOB issue debt securities (government papers) on a regular basis to benefit the budget process and liquidity management. Nonetheless, institutionalization and operationalization of debt markets, particularly, short term debt securities remains an essential part of fiscal and monetary policy management.

11. Other instruments at the discretion of the RMA include the enforcement of **prudential measures and guidelines** as embodied in the RMA's Prudential Regulations 2002, to influence the operations of depository institutions, as well as the prudent management of Bhutan's foreign exchange balances. The RMA is owner, depository and manager of the nation's official external assets, and under Article 14 of the Constitution is mandated to maintain foreign currency reserves adequate to meet not less than 1 year of essential imports. As such the RMA is accorded full powers to issue

regulations covering all international transactions. Maintaining adequate foreign exchange reserves remains the cornerstone of Bhutan's monetary policy.

12. The RMA in its role as central bank is accorded great **instrument independence** in the conduct of monetary policy. Decisions regarding the choice of instruments of monetary policy are made by the RMA's Board of Directors, chaired by the Governor of the RMA and aided by the RMA's Executive Committee.

13. Given the **long-term goal of price stability**, assessments of Bhutan's monetary policy stance both domestically and aboard are widely accepted as more beneficial than costly for Bhutan. The exchange rate peg has contributed to low volatility of the bilateral real exchange rate with India and has facilitated trade integration between the two countries. Trade diversification over the years in Bhutan has been minimal, and as such the current policy supports Bhutan's close economic and financial relationship with its neighbor, eliminating any uncertainty about exchange rate developments between the two trading partners. India's dominance in Bhutan's trade and investment flows is expected to continue in the future, and consequently, the exchange rate peg provides clear benefits in tying Bhutan to a credible nominal anchor with relatively stable monetary and financial conditions. Therefore, Bhutan's monetary policy decision is deemed prudent and appropriate.

Overview of Monetary Policy Instruments

The Cash Reserve Ratio (CRR)

- The CRR, introduced in 1984, was set at 3% for all deposits with the BOBL.
- It was revised in 1994 to 15% for all deposit liabilities; cash in vaults being counted towards the CRR after the introduction of the RMA Discount Bills and government bonds.
- With the conversion of the Unit Trust of Bhutan into Bhutan's second commercial bank, BNBL, the CRR was adjusted in July 1997 to 15% for demand deposits only; cash in vaults being counted towards the CRR.
- In January 2000, the CRR was further adjusted to 10% for all deposits; cash in vaults not being counted towards the CRR.
- On July 1, 2002, in a move to sterilize additional excess liquidity from the banking system, the CRR was further revised to 20% on total deposit liabilities, while interest payable on the balance was also revised from 2% to 3% per annum.
- In order to provide adequate liquidity to meet credit growth and support investment and export demand in the economy, RMA revised the volume of CRR downward from 20% to 13% of total deposit liabilities with effect from March 1, 2004. The rate of interest payable on CRR balances was revised from 3% to 1.5% per annum.
- With effect from September 2007, RMA tightened monetary conditions by raising the CRR from 13% to 15% and then to 17% in 2008, and discontinued the payment of interest on it.

RMA Discount Bills and RGOB Treasury Bills

- The RMA Discount Bills (maturity of 31 days) were introduced in December 1993 at the discount rate of 11%. From April 1994, the maturity period of the Bills was extended to 91 days. Till October 29, 2001, the selling procedure was based on auctions and after that it was discontinued and tap sales were introduced.
- As a measure to absorb excess liquidity from the banking system and to stimulate market interest rates, beginning August 2008, the RMA increased the discount rate on RMA Bills from 5% to 6% per annum.
- From December 2009, the Royal Government issued 91 days T-Bills replacing the RMA Bills.

II. The State of the Bhutanese Economy: Recent Developments[3]

14. **Real GDP growth** in Bhutan remained robust at 6.7% during 2009. The electricity and construction sectors continued to dominate output, with shares of 19.3% and 12.2% to GDP, respectively. Improved performance in these sectors reflects ongoing pre-construction as well as construction works on new hydropower projects. Foundation stones were laid for the Punatsangchhu II (990MW) and Mangdechhu (720MW) hydropower projects in May 2010.

15. While growth was robust, **inflationary conditions** in Bhutan worsened during the year due to generalized inflationary pressures, largely carried over from across the border in India. Food commodities constitute 27.7% of Bhutan's CPI's basket weights, and 95.6% of all food and processed foods and beverages imports are derived from India. Annual inflation in Bhutan maintained an upward trend, rising to 9.1% during the last quarter of 2010, against a lower rate of inflation of 4.1% during the same period in 2009. Similarly, price levels in India as featured by their WPI (RBI) grew by 8.9% for the fourth quarter of 2010, which may have been a slight improvement over the spike in WPI by 10.6% and 9.3% for the second and third quarters of 2010, respectively, but contrasts with the 4.3% WPI for the same quarter ending 2009.

16. Corresponding to overall growth, **monetary expansion** continued, with money supply (M2) growing by 16.5% as at the end of December 2010 (year-on-year change), driven mainly by the expansion in domestic credit by 51%, against 44.2% in June 2010. In tandem, growth in credit to the private sector remained accelerated at 51.6%, against 38.6% in June 2010. In particular, the lending of the financial institutions concentrated mostly in the building and construction (24.8%), manufacturing (16.5%), service and tourism (16.4%), and trade and commerce (15.9%) sectors. The entry of new banks and non-banking institutions over the year has injected much needed competition into Bhutan's financial system and simultaneously contributed to rapid credit growth. However, this escalation in domestic credit, largely on account of special circumstances and an increased base effect implies that achieving a similar and sustained

3 *Please see Annex 1 for a summary of Bhutan's latest Key Economic Indicators and charts. More recent information is provided where available.*

high growth will be difficult and is not expected in the coming year.

17. Nevertheless, in the aftermath of the global financial crisis, **financial indicators** reveal strong and sustained growth in the Bhutanese financial sector. As of the fourth quarter ending December 2010, Bhutan's FIs are well capitalized. As of December 2010, the combined assets of the financial sector grew by 33.2% to Nu.64.3 billion, of which 91% belonged to the commercial banks and the residual to NBFIs. Bhutan's banking sector assets grew by 28.5% to Nu.58.5 billion, while that of the NBFIs increased by 111.4% to Nu.5.8 billion, mostly due to the re-categorization of the Bhutan Development Bank Limited as a depository institution after receiving its new license in March 2010. Moreover, the financial system's NPL ratio has also progressively improved, dropping to 5.4% at the end of December 2010 (y-o-y change), down from 10.1% at the end of the FY 2009/10, and compared to 8.6% as of the third quarter of 2010.

18. **Meanwhile, overall liquidity in the domestic banking system** totaled Nu.24.1 billion by the fourth quarter of 2010. Excess liquidity in the banking system at 48.5% of reserve money remained high for the year ending December 2010. However, as of mid-May 2011 excess liquidity levels have halved to Nu.5.7 billion.

19. Developments in Bhutan's external sector as indicated by the **balance of payments** were characterized by a widening in the current account deficit to 14.3% of GDP during FY 2009/10 (Nu.8.8 billion) from 1.7% of GDP in 2008/09. This has been underpinned by a substantial widening of the trade deficit to 22.8% of GDP (Nu.13.9 billion) due to rapid growth in merchandise imports, especially imports from countries other than India which more than doubled during the FY 2009/10 to Nu.11 billion. Much of the surge in commodity imports can be attributed to recent developments in the hydropower sector and its related industries. India remains Bhutan's largest trading partner, accounting for 92% of commodity exports and 72% of commodity imports during FY 2009/10. Hydropower exports to India continue to be Bhutan's largest export, accounting for 39.2% of total exports during the year.

20. It is essential to note that as a predominantly **import and aid dependent economy**, trends in Bhutan's BOP reflect large trade deficits that extend to the services and invisibles accounts, resulting in persistent current account deficits that are financed by substantial inflows of official aid in grants and

concessional loans as opposed to export performance, with subsequent spillovers to reserve accumulation. As such, the BOP also mirrors Bhutan's vulnerability to corresponding developments in the hydropower sector. Recent net inflows of capital grants (largely associated with the Punatsangchhu I hydropower project) and concessional publicly guaranteed loans amounting to Nu.6.5 billion were a huge factor in building the net surplus in the capital and financial account balance which totaled Nu.7 billion at the end of June 2010. These capital and financial flows helped finance Bhutan's current account deficit, with a final overall surplus in the BOP totaling Nu.4.4 billion (7.2% of GDP).

21. Corresponding to the surplus in the balance of payments, Bhutan's **official international reserves** grew to USD 858.4 million for the year ending June 2010, sufficient to finance 12.2 months of commodity imports. International reserve levels have now risen to USD 1 billion as of December 2010 and are adequate to finance **13.8 months of commodity imports**. Entrusted with managing the nation's international reserves, this responsibility has become immensely challenging for the RMA, due to the need to ensure adequate Rupee reserves to safeguard the integrity of the exchange rate peg with India. And with the nation's widening current account deficit with India, the Ngultrum's fixed peg to the Indian Rupee has placed **additional pressure to ensure adequate Rupees** to meet the economy's requirements. Recent data now indicates that the net Rupee balance available[4] with the RMA has become negative at ₹ 8.5 billion as of mid May 2011, with substantial borrowings being undertaken by the RMA to address liquidity shortages in the banking system to meet short-term transactions.

22. Bhutan's **external debt obligations** continue to rise with the commencement of new hydropower projects. At the end of the fourth quarter of 2010, Bhutan's **external debt** outstanding totaled USD 837.7 million, or 61.8% of GDP (as compared to 64.1% of GDP at the end of FY 2009/10). Indian Rupee denominated debt constitutes 56% of Bhutan's external debt and Rupee denominated debt expanded substantially during the year on account of borrowings from the Government of India towards the construction of the Punatsangchhu I hydropower project and for Rupee reserve management purposes[5]. Corresponding to the expansion in

4 *This is inclusive of the RMA and the commercial banks, and is net of their Rupee obligations.*

5 *Bhutanese authorities availed of the short term overdraft facility from the SBI at an interest rate of 8.5% per annum.*

both public and private external debt, Bhutan's debt service ratio continues to remain elevated at 37.2% for the quarter ending December 2010 up from 29.5% at the end of June 2010.

23. Meanwhile, Bhutan's **fiscal policy** remained accommodative during the last year with the national budget deficit expanding to 6.7% of GDP for the FY 2009/10 (revised budget[6]) from a surplus of 2% of GDP as of FY 2008/09. Total expenditure grew from 40.9% of GDP during 2008/09 to 49.7% of GDP, attributed to the incorporation of additional budget allocations for both capital and current expenditures during the financial year. Fiscal spending continues to drive overall growth in Bhutan and is an underlying factor behind mounting pressures on external debt and the government deficit. On the other hand, total revenue including grants, marginally increased from 42.9% of GDP to 43.1% of GDP during 2009/10. Current expenditure was estimated at Nu.13.8 billion, and was completely financed by domestic revenue amounting to Nu.15.9 billion, while capital expenditure was estimated at Nu.16.6 billion. Grant support helped finance 34.2% of total expenditure. Of the total deficit, 16% was financed through external concessional borrowing and the remaining through domestic sources.

6 *Source: National Budget Report for the FY 2010/11, Ministry of Finance, June 2010.*

III. RMA Monetary Policy Operations: FY 2009/10

In the Aftermath of the Global Financial Crisis

24. Bhutan was largely insulated from the full-on effects of the **global financial crisis** which was underpinned by excessive growth based on leverage and under-regulated financial innovation ("*innovation before regulation*") against a backdrop of increased financial globalization and integration. Bhutan escaped relatively unscathed largely due to sound macroeconomic management and the underdeveloped nature of our financial markets with limited exposure to international markets. There was some evidence that Bhutan had been adversely impacted in certain quarters; inflation in Bhutan hit a high of 8.8% mid-2008. Meanwhile, interest on earnings from deposits and investments abroad took a hit during 2008/09 following US Fed Reserve reductions in its interest rates; RMA's interest income for that year declined by 61%. Today, RMA's revaluation reserves continue to be hit by developments in US markets and the associated devaluation of the US Dollar.

25. The global financial turmoil may not have had systemic implications for Bhutan's financial system however there were certain **spill-over effects to the domestic manufacturing and industry sector** due to poor external demand, resulting in loan repayment constraints manifesting in a significant level of NPLs for that sector during 2008. The manufacturing and industry sector experienced its highest NPL ratio for the first time at about 30% of overall NPLs, surpassing the all-time high portfolio risk normally represented by the housing loan sector. Subsequently, the RMA revisited the provisioning requirements for the FIs and required FIs to raise an additional 10% for the highest exposed sector.

26. **Costly lessons** emanated from the global financial crisis that financial integration and innovation, while welcome, must be approached cautiously vis-à-vis economic fundamentals. When not sequenced prudently, financial integration can create perverse incentives, reduce transparency, and ultimately destabilize the financial system, thus making due vigilance over financial sector size, integration and regulation vital.

Recent Monetary Policy Operation and Instruments

27. Against the backdrop of development outcomes during FY 2009/10, the

RMA pursued a **subdued monetary policy stance**. Given the weak link between excess liquidity levels and credit expansion, as well as other indicators including output and inflation, **aggressive sterilization efforts were not justified in light of the substantial costs imposed on the RMA**[7]. On the domestic front, the RMA had already tightened monetary conditions by raising the CRR first to 15% in September 2007, and then further to 17% in August 2008. It is not advisable for the RMA to use non-market remedies such as reserve requirements frequently as liquidity instruments, given their strong monetary signaling and potentially distorting impact. Reserve requirements are blunt instruments for liquidity management and tax commercial banks' profitability. In a similar manner, frequent **reductions in reserve requirements through the CRR are not advisable for macro-prudential reasons to ensure risk-free deposits in the banking system.**

28. Monetary operations through the auction of the **91-Day RGOB T-Bills** were executed and 2 series (R203 and R204) were issued during FY 2009/10 of Nu.1 billion each, at discount rates of 2.8% and 1.4%, respectively during the months of July and October 2010. 5 issues of T-Bills have been made since its introduction in December 2009; 2 issues prior to FY 2009/10 and the final 5th issue of Nu.500 million made only to fund government expenditure at a discount rate of 0.5% (March 2011).

29. To make monetary operations more effective, **government corporations' accounts held with the oldest and largest commercial bank, the BOBL**, were shifted to the RMA from June 1, 2008. Deposits of government corporations no longer remain with the BOBL and at the end of every day are transferred to the RMA. This is due to the fact that the sheer size of government corporation deposits tends to increase volatility or "frictional" liquidity levels.

30. The banking sector's **total liquidity** position for the fourth quarter ending December 2010 was Nu.24.1 billion and overall **sterilization of excess liquidity** by the RMA totaled Nu.10.8 billion for the fourth quarter of 2010 (please refer to Annex 2). Excess liquidity in Bhutan is defined as the commercial banks' bank balances maintained with the RMA in excess of their cash in hand, mandatory CRR balances and holdings of market-bearing interest instruments including the T-Bill. From a policy perspective, central banks may be less

7 *Substantial costs incurred on sterilization would ultimately adversely impact the level of net profits transferred by the RMA to the RGOB at the end of the FY.*

concerned by the existence of surplus liquidity if it is a conscious decision to strengthen liquidity positions of commercial banks. The latter may not be the case for Bhutan, where excess liquidity is to a great extent a structural issue, given the reality of small and low density markets and limited credit risk assessment expertise in the financial sector, thus warranting appropriate policy intervention when necessary.

31. **Concerns of excess liquidity in the banking sector** stem from fears of transmission through credit, higher domestic consumption and imported inflation. Since liquidity is largely concentrated in one commercial bank, these do not pose considerable risks. As iterated earlier, due to the weak linkage between excess liquidity and credit expansion, high levels of excess liquidity will not necessarily translate to rapid credit growth. Moreover, excess liquidity is highly seasonal in tandem with flows associated with current transfer and capital and financial account flows (much of which is related to hydropower sector activities), rather than on account of deposit mobilization. These present circular challenges in the conduct of RMA's monetary policy, and instruments to sterilize liquidity are therefore administrative to throw sand in the wheels in an inevitable attempt to try and cool credit wherever possible. In that respect, the RMA may consider extending the amount and duration of monetary operations in an attempt to withdraw further liquidity from the markets while simultaneously encouraging inter-bank markets and secondary market trading in the financial system.

32. However, as mentioned in Section II, rather than a liquidity surplus, the banking system in the near present is experiencing a **liquidity crunch for short-term transactions** (*negative Rupee position mid-May 2011*), indicative of banking asset-liability mismatches, reflecting long-term lending, largely to the construction sector, pitted against short-term deposit holdings.

Foreign Exchange Management

33. Entrusted with managing the nation's international reserves, this responsibility has become immensely challenging for the RMA due to the need to ensure adequate **Rupee reserves** to safeguard the integrity of the exchange rate peg with India. And with the nation's widening current account deficit with India, the Ngultrum's fixed peg to the Indian Rupee has placed additional pressure to ensure adequate Rupees to meet the economy's requirements. Growth in Rupee reserves continue to be greatly dependent on inflows related to grants and loans. In line with official fund

flow cyclical patterns, surpluses tend to build up during the fourth quarter of every year, which is then wiped out by debt repayments during the first quarter of the next year, and followed by persistent shortages during the next two quarters thereafter.

34. Following last year's plans to design a new strategy to **streamline Rupee management and circulation in Bhutan** and as a confidence building measure for the Ngultrum, the RMA delegated the exchange of Ngultrum with Indian Rupees to the commercial banks with effect from May 1, 2010. Individuals are now able to access Rupees in cash up to a daily limit of ₹ 40,000, with unlimited access for Rupee transactions channeled through the banking system, based on the submission of supporting documents.

35. Moreover, commencing August 2010, the RMA has entered into a special agreement with the **State Bank of India**, Hashimara, under a "*sweeping arrangement*" for the daily transfer of Rupee balances from and to the BOBL up to a limit of Nu.1.5 billion to meet the banking sector's shortfall requirements, in a bid to minimize idle funds and reduce costs associated with the ODF.

36. Similarly, besides the SCF availed by the RMA from the GoI (Nu.3 billion at an interest rate of 5% per annum), that has been fully utilized, the RMA recently negotiated an increase in the **limit on the SBI ODF** to Nu.5 billion for a year with effect from April 2011 at an interest rate of 9% per annum (and previously operated a Nu.4 billion limit at the rate of 8.5% interest per annum). As of the quarter ending December 2010, the RMA incurred a cost of Nu.4.9 billion towards interest and principal repayments for the GoI SCF and the SBI ODF.

37. Meanwhile, the RMA continues to replenish **commercial banks' convertible currency balances** as and when required through foreign exchange operations. Prudent management of convertible currency reserves and implementation of the RMA's Foreign Exchange Regulations, serve to ensure adequate level of reserves as backing for RMA's liabilities including the domestic currency in support of the exchange rate peg, while additionally operating as a pledge against Rupee OD facilities, meeting external payment obligations of the nation, and in lieu of contingencies.

Financial Sector Supervision, Regulation and Reform

38. **Macro-prudential policies** remain integral to mutually reinforcing RMA's monetary policy operations by avoiding severe financial imbalances, while paying attention to the close

nexus between the macroeconomy and financial system.

39. The Financial Regulation and Supervision Department of the RMA conducts regular **monitoring of the Bhutanese financial sector** through off-site surveillance, on-site inspection and special on-site inspections, applying international Basel 1 and CAMEL principles. The main objective of off-site surveillance is to serve as an "early warning system" to detect emerging problems before they potentially lead to crisis, threatening the viability of an individual FI or systematically the financial sector as a whole. Detection is complemented by the analysis of key financial ratios and other financial data generated from periodic reports submitted to the RMA, and the production of quarterly performance reports. Further, in order to closely monitor and supervise FIs, a Relationship Manager for each institution has been appointed at the RMA. During on-site inspections, the RMA reviews the operations of FIs, focusing on credit and operational risks, while assessing the quality of the governance structure and system. Moreover, the RMA has for the first time developed and submitted financial soundness indicators to the International Monetary Fund for their assessment; this will soon form part of the RMA's regular reporting.

40. In light of **recent expansion in the financial system** with more players, the RMA is aware of the necessity to enhance supervision over banks' risk management practices and financial disclosure to safeguard and maintain desirable asset quality and financial sector stability. In retrospect, the RMA **raised provisioning requirements of sub-standard and doubtful loans** of FIs from 20% to 30% and from 50% to 60% respectively, for the highest exposed sectors in 2008. Similarly, the **capital base of banks** was increased to Nu.300 million while that of NBFIs were increased to Nu.100 million with effect from January 2008, in line with measures to insulate the Bhutanese financial sector during the global financial crisis.

41. Since then, the RMA has also undertaken numerous **financial sector reforms** during the FY 2009/10 aimed at supporting and strengthening financial sector development and growth in the economy. These include the launching of Bhutan's first **credit information bureau** in September 2009 to promote credit and exchange conditions and a sound financial structure that is conducive to the balanced growth of the economy. RMA hopes to fill essential institutional gaps to strengthen Bhutan's financial infrastructure[8].

8 *Till date, the credit information bureau has captured almost 90% of all FI data.*

Prior to this, the RMA celebrated the historic inauguration of the **Electronic Fund Transfer and Clearing System** (EFTCS), a milestone in the development of Bhutan's payments and settlement systems.

42. Once the RMA's **Financial Services Act (FSA)** is formally endorsed in 2011, this will empower the RMA to further introduce new avenues and opportunities for innovative financial market providers that will meet the diverse financial needs of private sector and general public. In the meantime, the RMA has completed its up-gradation of the Prudential Regulations 2002[9] to revise asset classifications, making the provisioning requirements of NPLs more stringent. This has had a positive impact in promoting overall soundness of FIs. The RMA also declared a **moratorium on the issue of commercial bank licenses** till the end of 2013 in line with economic market surveys.

43. Similarly, during the year the RMA initiated the drafting of **several key policies for the financial sector** including the Microfinance Regulations, Branchless Banking Regulations, Corporate Governance Regulations, and the Establishment of Re-insurance companies in Bhutan. Anti-Money Laundering/Combating of Financial Terrorism Frameworks for Bhutan, including regulations, guidelines, and reporting formats were also prepared in 2010-2011. A Financial Intelligence Unit was established at the RMA in 2010, which will become fully operational after the enactment of the FSA.

44. Meanwhile, under the **Financial Sector Development Program** between the RMA and the Asian Development Bank, a Bhutanese Accounting and Auditing Standards Committee has been created with representation from other stakeholder agencies to undertake accounting and auditing reforms in the nation. The committee established the **Accounting and Auditing Standard Board of Bhutan** on 26th July 2010. Under the Program, plans are also underway to establish a **Central Registry** to promote secured transactions and ease collateral requirements and security interests in movable and immovable property of borrowers.

45. Notably, **social provisions** have been introduced in the RMA FSA and Prudential Regulations, under which the RMA shall have the authority to stipulate provisions to enhance

9 *Other up-gradations in the Prudential Regulations 2002 pertain to sections on Related Party Transactions, Share Ownership and Equity Investment (requiring all FIs to be a public limited company), Consortium Financing, interest calculation, etc.*

the flow of credit to priority sectors (based on BASEL norms), including small scale and export-oriented industries. Given the recent trends in labor and unemployment, this issue is of integral concern when it comes to output growth. As highlighted, the RMA is also currently framing **microfinance legislation under a financial inclusion policy framework** to encourage and streamline these financial activities in the market.

46. And, the RMA in collaboration with other financial institutions conducted another round of the **Financial Literacy Program** early 2010 in six key districts. It is the RMA's hope that these efforts will go a long way to promote and enhance the general public's understanding of the financial sector to enable them to make sound financial decisions and to avoid predatory lending and credit schemes.

IV. Medium Term Outlook for Bhutan[10] : FY 2010/11-2012/13

Macroeconomic forecasts for Bhutan's medium-term (typically for three years) are usually prepared by the multi-sectoral MFCTC taskforce and endorsed by the high-level RGOB Macroeconomic Framework Coordination Committee (MFCC) chaired by the Finance Secretary. The compilation of macroeconomic and fiscal projections involves estimating revenues, issuing a statement of strategic fiscal policy, and establishing a budget envelope for the medium-term period. The MFCTC and MFCC facilitate the regular preparation of reliable and systematically compiled macroeconomic and fiscal projections. Careful monitoring of possible policy changes is vital to prepare and address emerging issues in the Bhutanese context, where a few variables can have a dramatic effect on the overall macroeconomic and fiscal picture.

47. On the whole, **growth prospects** appear favorable for Bhutan, and growth is expected to stay strong for the remainder of the 10th Five Year Plan (2010-2013), growing on average by approximately 8% per year for the remaining years of the Plan period, propelled by new developments in the hydropower sector. For the year 2010/11, it is anticipated that real GDP growth will improve to 8.1% based on the momentum of activities in the construction sector. The outlook for **inflation** remains uncertain, reflecting substantial movements in commodity prices especially in India and its influence on domestic price levels for both goods and services. To the extent that fuel prices continue to harden and face upward pressures in 2011, inflation in Bhutan is projected to rise in tandem with developments in India; domestic inflation has already hit 9.6% as of the third quarter of FY 2010/11 (March 2011).

48. According to the IMF, **global oil markets** will be dragged through a period of increased scarcity, with rapid growth in international consumption against oil supply constraints (short-term fixed supply of oil vis-à-vis its low short-term demand elasticity). **Recent developments in India** indicate that further fuel price hikes can be expected in the near future (80% of crude oil in India is imported). After 9 price increases in 9 months, and deregulated petrol prices from June 2010, there are indications of GoI plans to reduce the fiscal burden from large subsidy payouts on diesel, kerosene and natural gas products. As for petrol, the hike needed to make domestic rates at par with international prices is ₹ 9.5-10 per

10 *Please see Annex 3 for a summary of Bhutan's macroeconomic projections for the years FY 2010/11 and FY 2011/12. Kindly note that macroeconomic projections are subject to sector wise revisions as and when new data is available, thus potentially generating variations in different forecasts published.*

litre; oil companies in their latest revision have chosen to hike the rate by just half, clearly a prediction of oil price increases on the cards.

49. Against this backdrop, Bhutan's **current account deficit** is projected to persist during FY 2010/11, albeit slightly lower than 2009/10 at 7.9% of nominal GDP while averaging between 12% to 22% of GDP for the remainder of the 10th FYP, underpinned by a deterioration in the **trade account deficit** between 14% to 21% of GDP between FY 2010/11 and 2012/13. With construction works fully underway for the Dagachhu, Punatsangchhu I and II, and Mangdechhu hydropower projects; and planned construction on the Kholongchhu hydropower project (650MW) from 2011/12, growth in merchandise imports is expected to experience rapid growth during the medium-term. Within the invisibles account, net inflows in the services and current transfers (largely budgetary grants) are expected to partially offset the deficits in the trade and income accounts.

50. **External grant support** (current and capital) will continue to play a significant role in Bhutan's BOP, and are expected to increase substantially in the projection period (10% per annum on average). Moreover, as in the past, official inflows in the capital and financial account in the form of capital transfers (grants for hydropower development) and external loans of the RGOB are expected to largely finance the current account deficit, especially with the onset of aid inflows related to new hydropower projects. Consequently, with anticipated surpluses in the capital and financial account, Bhutan's **overall balance** is forecast to be positive in the projection period (4% to 11% of GDP), implying growth in the nation's gross international reserves (USD 1 billion projected for FY 2010/11). Corresponding to projected BOP flows, Bhutan's gross **foreign currency reserves** are expected to grow on average by about 12% annually during the projection period, sufficient to finance between **15 to 16 months of merchandise imports** (15.3 months for FY 2010/11).

51. On the domestic front, the RGOB anticipates a **fiscal deficit** of 4.8% of GDP during 2010/11 (5% on average for the next two years till the end of the 10th FYP). While **revenue receipts** are projected to grow during 2010/11, this situation is expected to worsen for the final year of the plan period on account of an anticipated drop in other country program grants; grant revenue currently comprises over a third of total RGOB revenue. On the other hand, set against revenue flows, **public expenditure** is projected to grow by 12.3% during 2010/11 (current expenditure to grow by 14%

and capital expenditure by 10.9%). Forecasts are based on judgments surrounding cyclical patterns of Plan expenditure and other expected developments including the run-up to the 2012 national elections and local government elections. While **current expenditure** is forecast to continue on an upward trajectory for the remaining years of the 10th FYP by 10% on average, **capital expenditure** is targeted to fall in the final year of the Plan period in conjunction with associated large contractions in project-tied grant assistance.

Outlook for India: FY 2011/12

According to the Reserve Bank of India, while India's macroeconomic outlook for 2011/12 remains favorable, high oil prices pose the biggest risk to both growth and inflation. The RBI has lowered its growth forecast to 8.2% from 8.5% for the year 2011/12. As domestic prices adjust further to international commodity prices, persistent high inflation now poses risk to sustaining high growth. Mitigating factors however, exist in the form of strong private demand, expected normal monsoon, good pipeline investment; some deceleration in growth can be anticipated.

Going forward the RBI will face policy trade-offs with downside risks to growth and upside risks to inflation increase, but generalization of inflationary pressures to manufacturing products continue to be the major policy concern. Besides oil prices, increases in global food prices may need to be closely watched and counter-policy measures prepared. The RBI has recommended deregulation of diesel prices and raising administered prices in fuel and fertilizers to create fiscal space. The latter could enable fiscal policy to turn counter-cyclical in the event of output slackening. RBI plans to continue anti-inflationary monetary policy measures to sustain the growth momentum. There has been an effective increase in the policy rate by 350 basis points since March 2010.

Quarterly and Annual Forecasts of Selected Economic Indicators

	2010-11 (Annual)	2010-11	2011-12			
		Q4	Q1	Q2	Q3	Q4
Real GDP growth rate (%)	8.5	8.2	8.3	8.1	8.2	8.5
Inflation, WPI (average, %)	9.4	8.9	8.2	7.8	7.5	6.7
Exchange Rate (INR/USD end period)	44.7	44.7	44.5	44.7	44.5	44.5

1) *The annual forecasts for 2010-11 and Q4 of 2010-11 are based on the latest round of forecasts.*
2) *Inflation and exchange rate projections for 2010-11 and Q4 of 2010-11 are actual figures.*
3) *All projections for Q1-Q4 of 2011-12 are based on the latest round of forecasts.*

Source: All excerpts and tables from the RBI Macroeconomic and Monetary Developments in 2010-11, May 2011 (Issued with the Monetary Policy Statement 2011-12)

V. BHUTAN: RISKS AND CHALLENGES[11]

52. ***It is important to emphasize that the role of monetary policy by the RMA in the current economic environment and in the coming year will be to provide meaningful support to RGOB policies and programs aimed at poverty reduction and sustainable economic growth, while maintaining price and financial stability.*** The RMA remains committed to pursuing the same monetary policy stance, especially with regard to its macro-prudential policies, effective management of the nation's limited reserves to support the peg and meet international transactions, and to moderate liquidity in the financial system in keeping with monetary policy objectives.

53. **Growth and inflation forecasts for Bhutan shall be subject to certain risks/policy challenges that warrant close monitoring and policy awareness.** On the upside, sustained growth in India will ensure steady demand for domestic exports, and additional boost to output could stem from investment and development spending. However, accommodative fiscal policy (concentrated in non-productive investment) and exogenous price shocks could result in inflationary pressures and a deterioration of Bhutan's external balance. Bhutan will need to promote sound fundamentals both on the income and fiscal side for sustainable growth, especially if it is to achieve its implicit fiscal deficit target of 5% of GDP in the medium term. **Similarly, RGOB could promote the issue of corporate bonds for government-owned corporations in raising affordable funds while promoting domestic capital markets.**

54. Inflation is clearly a dominant issue and concerns have been raised about inflationary risks posed by developments in India, especially in light of the recent oil price hike[12]. Discussing the matter however requires looking into pressures posed by the **growing government expenditure bill and induced consumption**. While inflation is generally associated with monetary expansion, to a large extent most agree fiscal imbalances play a key role in explaining price changes in Bhutan due to fiscal dominance in aggregate demand and output, passed through the external account

11 *Please refer to the Annexures, including Annex 4 for presentation of data supporting this Section.*

12 *Imports of major fuel components totaling Nu.3 billion, constituted 5.1% of GDP and 14.9% of total commodity imports from India during 2009 (Source: Ministry of Economic Affairs).*

(highly characteristic of LDC countries). While Bhutan's fiscal stance has been touted as prudent, authorities agree that in light of medium-term prospects, there is a need to create additional fiscal space to finance investment and address the anticipated decline in aid. Under the current arrangement, ways and means (WMA) advances are extended by the RMA through the BOBL to the RGOB, for deficit financing on a short-term basis when necessary.

55. Associated risks also have implications for **Bhutan's debt sustainability and deteriorating external balance**. An assessment of debt structure is key when evaluating risks, and Bhutan's **external debt**, most of which is government and publicly-guaranteed debt, has grown on average by 20.3% per annum in the last decade. As of December 2010, total external debt was 61.8% of GDP. Of this, 56% are Rupee-denominated debt and approximately 1% private convertible currency commercial debt. 42.7% of overall external debt outstanding is concessional convertible currency debt, and 55.6% of overall debt is hydropower-related debt. While much of the expanding debt burden is concessional, these still represent future obligations; the concern is not only the size of debt in relation to GDP, but rather as a proportion to domestic revenue. Similarly, it is important to remember that though external debt is largely mitigated by its composition and concentration in commercially-viable hydropower projects self-liquidating in nature, these levels are still prohibitively high and growing.

56. As discussed in Bhutan's outlook, rather than the level of the **projected current account deficit for Bhutan**, the sustainable financing of the deficit poses risks which are likely to be reinforced by the expected drying up of external assistance. In terms of the level of the projected current account deficit, a growing current account deficit is an indicator of Bhutan's macro fundamentals, that of being an import and aid-driven economy, but may not necessarily be alarming to the extent that it reflects growing investment and import of capital at this stage of development.

57. As for other risks to Bhutan's medium term outlook, these include contingent pressures on Bhutan's reserve levels in light of **global trade integration and liberalization**. At present, Bhutan maintains essential foreign exchange controls on current as well as capital international transactions under its Article XIV Status with the International Monetary Fund. Therefore, **synchronization of policies between the RGOB and the RMA on potential impacts on the**

limited level of Bhutan's reserves is vital.

58. The combined risks from inflation, accommodative fiscal policy, debt and the external position contribute to an increase in uncertainty about economic outcomes for Bhutan in the medium term. Nevertheless, it remains absolutely essential that fiscal policy be aligned with RMA's monetary policy operations that could go a long way in promoting sustained growth. To that end, the RMA is committed to working closely with the RGOB and other stakeholders in effectively addressing these risks and challenges.

ANNEX 1

BHUTAN: KEY ECONOMIC INDICATORS

Indicator	2006/07	2007/08	2008/09	2009/10(p)	Dec'10
GDP Growth and Prices (% change)					
GDP at Constant (2000) Price (a), (b)	6.8	17.9	4.7	6.7	n/a
Consumer Prices (c)	5.9	8.8	3.0	6.1	9.1
Wholesale Prices (India) (d)	5.5	9.0	0.5	10.6	8.9
Government Budget (in millions of Nu.) (e)					
Total Revenue and Grants	16083.1	18316.9	23443.0	26361.1	n/a
Of which: Foreign Grants	6000.9	5935.4	6575.1	10423.4	n/a
Total Expenditure and Net Lending	15795.4	17913.4	22350.5	30451.6	n/a
Current Balance	2390.8	2655.8	5806.5	2100.4	n/a
Overall Balance	287.7	403.5	1092.5	-4090.5	n/a
In % of GDP	0.7	0.8	2.0	-6.7	n/a
Money and Credit (%, end of period)					
Broad Money, M2	8.6	2.3	24.6	30.1	16.5
Credit to Private Sector	35.5	37.4	31.1	38.6	51.6
Interest Rates (end of period)					
One Year Deposits	4.5	4.8	4.8	4.8	5.0
Lending Rate	10.00-16.00	10.00-16.00	10.00-16.00	10.00-16.00	9.75-16.00
91-day RMA Bills/ Treasury Bills	3.5	6.0	6.0	2.0	1.4
Balance of Payments (in millions of Nu.)					
Trade Balance	2061.8	-2921.6	-4322.4	-13938.2	n/a
(In % of GDP)	5.1	-5.9	-7.9	-22.8	n/a
With India	4447.6	-27.8	-278.6	-4933.6	n/a
Current Account Balance	6417.2	-1080.2	-948.7	-8754.9	n/a
(In % of GDP)	15.8	-2.2	-1.7	-14.3	n/a
With India	5882.1	-142.4	-1098.8	-4002.6	n/a
(In % of GDP)	14.5	-0.3	-2.0	-6.5	n/a
Foreign Aid (Concessional Loans net)	783.3	1015.0	4193.3	2215.2	n/a
Of which: India	-30.3	482.6	3163.1	794.2	n/a
Errors and Omissions	-6091.4	-2613.4	1578.3	6139.8	n/a
Overall Balance	5421.2	1957.0	5694.8	4401.4	n/a
(In % of GDP)	13.3	4.0	10.4	7.2	n/a
External Indicators (end of period)					
Gross Official Reserves (in millions of USD)	608.4	655.3	772.7	858.4	1001.6
(In months of merchandise imports)	12.8	12.4	15.3	12.2	13.8
(In % of external debt)	84.1	80.0	97.3	103.3	83.6
External Debt (% of GDP)	80.8	67.0	70.1	64.1	61.8
Debt-Service Ratio (f)	3.6	18.3	30.5	29.5	37.2

Item	2006/07	2007/08	2008/09	2009/10(p)	Dec'10
Memorandum Items:					
Nominal GDP (in millions of Nu.) (a), (b)	40673.5	49456.5	54713.0	61222.6	n/a
Ngultrum per USD (fiscal year period average)	44.2	40.4	47.8	46.7	45.2
Money Supply, M2 (end of period)	25208.5	25780.7	32114.83	41778.7	51111.7
Money Supply, M1 (end of period)	13542.1	14392.4	18375.0	22537.7	29042.6
Counterparts					
Foreign Assets (Net)	24881.3	26365.6	33074.0	35236.5	41995.8
Domestic Credit	9345.1	12794.2	15122.7	21811.1	26818.3
Claims on Private Sector	10111.7	13890.4	18216.0	25246.1	30038.5
Components					
Currency Outside Banks	3166.0	3640.8	4541.8	5386.5	5608.53
Demand Deposits	10376.3	10751.6	13833.2	17151.2	23434.1
Quasi-Money	11666.4	11388.3	13739.8	19241.0	22069.1
Reserve Money , M0, of which	13319.6	12871.0	14696.5	20574.7	27248.6
Banks' Deposits	9982.3	8685.7	9810.2	14683.9	21059.2
Money Multiplier (M2/M0)	1.9	2.0	2.2	2.0	1.9
Income Velocity (GDP/M2)	1.6	1.9	1.7	1.0	n/a
Population Growth Rate (a), (g), (h)	1.3	1.3	1.3	1.3	n/a
Unemployment Rate (a), (h)	3.2	3.7	n/a	4.0	3.3

a) On a calendar year basis, e.g., the entry under 2006/07 is for 2006. - b) Source: National Accounts Statistics (2009), NSB - c) Data till 2002/03 are based on the old half-yearly average CPI of the NSB (1979 base year). This was replaced by a new quarterly CPI with a revised basket and Q3 of 2003 as the base. Rates of change (year-to-year) for the quarterly CPI are therefore not available prior to Q3, 2004. The CPI reflected in this table is for the last quarter of the fiscal year. - d) Source: Reserve Bank of India. Wholesale Price Index of All Commodities, 2004-05 base; reference period same as for Bhutan CPI - e) Data for 2009/10 are revised estimates. - f) Debt service payments in percent of exports of goods and services.-(g) Data for 2005 is from the Population & Housing Census of Bhutan 2005.-(h) Source: Comparative Socio-Economic Indicators for Bhutan, NSB; Labour Market Information Bulletin (2009), MLHR. Source of the unemployment rate for 2010: Ministry of Labor and Human Resources.

Chart 1: Sectoral Growth of GDP

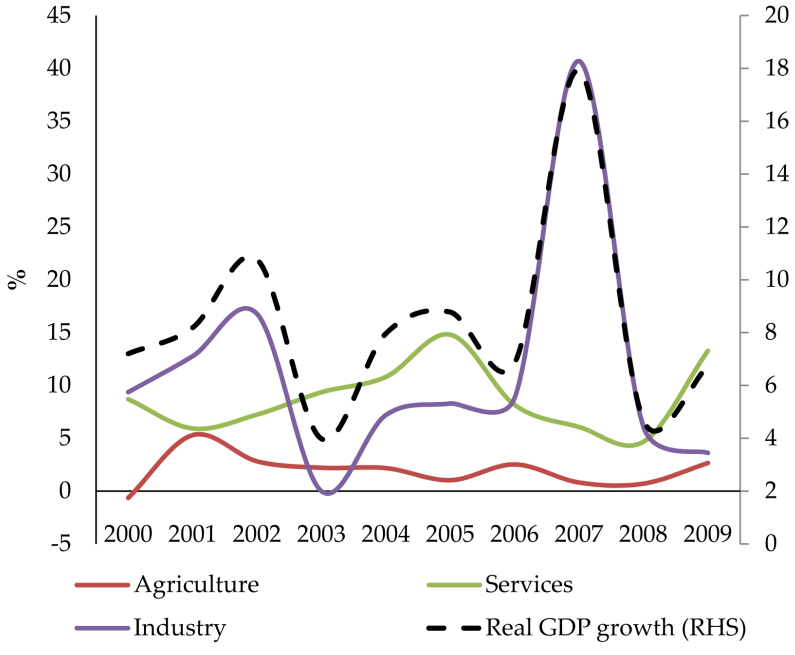


Chart 2: CPI Inflation (y-o-y)

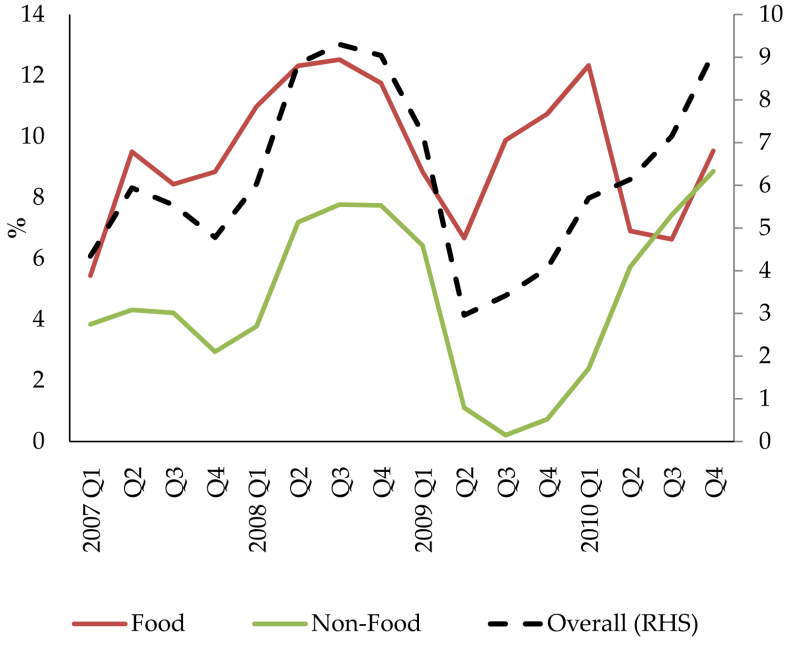


Chart 3: CPI Inflation (y-o-y June-end average)

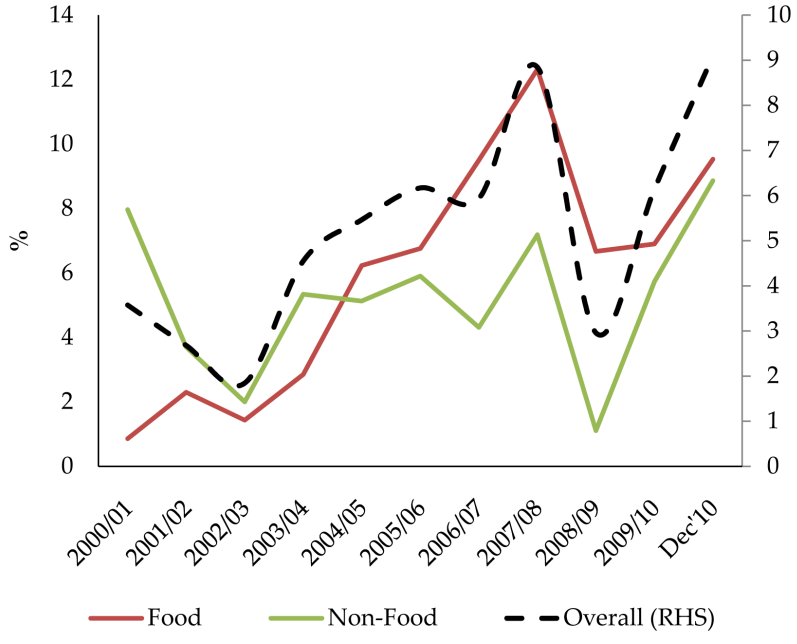
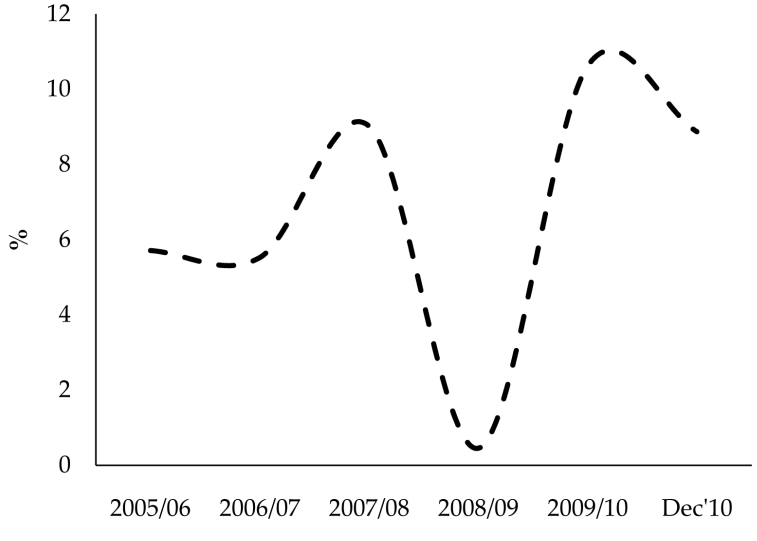


Chart 4: India WPI (quarter average)



MONETARY AGGREGATES (y-o-y Growth in %)

	2006/07	2007/08	2008/09	2009/10	Dec'10
M2	8.6	2.3	24.6	30.1	16.5
Reserve Money	-1.2	-3.4	14.2	40.0	32.4
Net Foreign Assets	10.6	6.0	25.4	6.5	7.5
Net Domestic Assets	-53.5	-78.8	64.2	-781.1	90.4
Domestic Credit	15.5	36.9	18.2	44.2	51.0
Credit to the private sector	35.5	37.4	31.1	38.6	51.6
Credit to the public sector	221.7	-43.0	-182.2	-11.0	-56.7

Source: RMA.

MONETARY AGGREGATES (% Share of M2)

	2007	2008	2009	2010
Nu. in Millions				
M2	27670.1	31384.4	43862.8	51111.7
Domestic Credit	10146.1	10269.2	17763.3	26818.3
Cr. Pvt	11912.3	16633.1	19818.6	30038.5
% growth rate				
M2	12.2	13.4	39.8	16.5
Domestic Credit	18.3	1.2	73.0	51.0
Cr. Pvt	35.3	39.6	19.2	51.6
% share of M2				
Domestic Credit	36.7	32.7	40.5	52.5
Credit to the Private Sector	43.1	53.0	45.2	58.8
CD ratio (%)*	53.6	64.4	54.0	67.9
CA ratio (%)**	45.7	50.2	46.1	52.8

*/ CD ratio refers to credit to deposit ratio of commercial banks.

**/ CA ratio refers to credit to asset ratio of commercial banks.

Chart 5: Broad Money

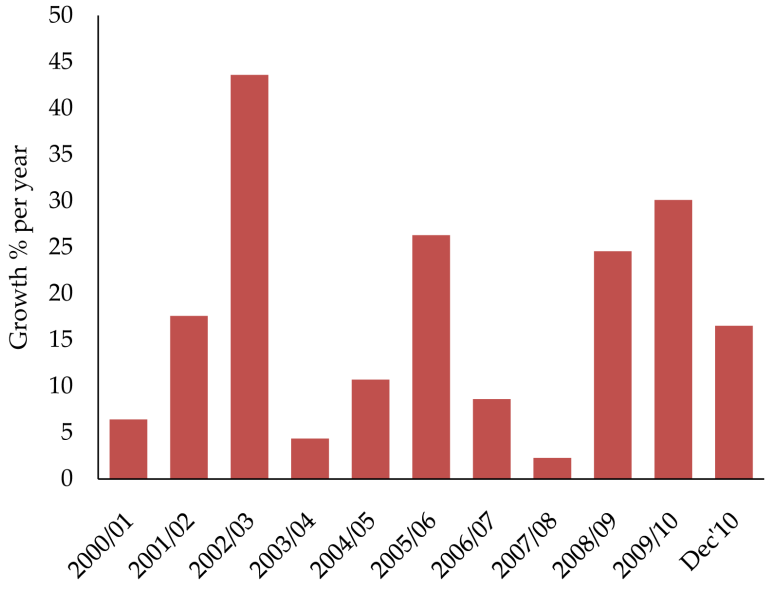


Chart 6: Domestic and Private Sector Credit

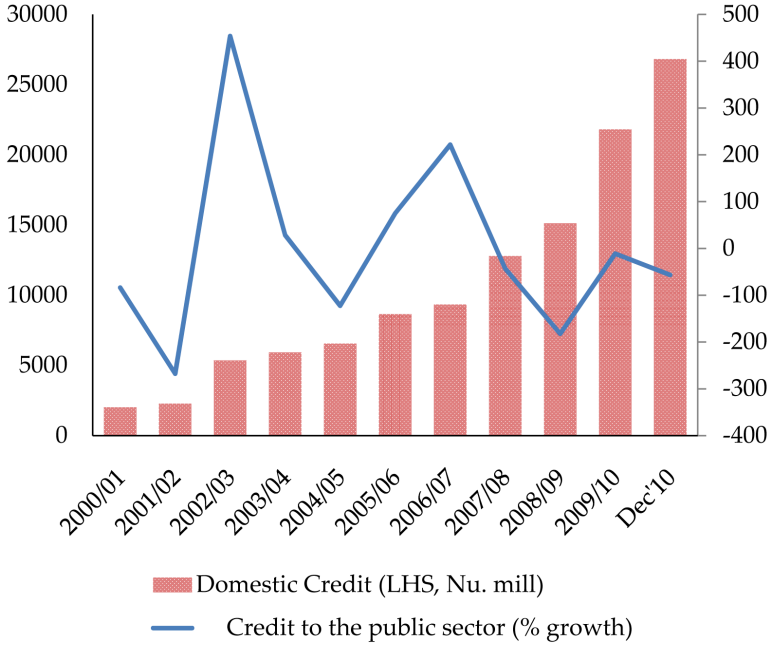


Chart 7: Net Foreign Assets

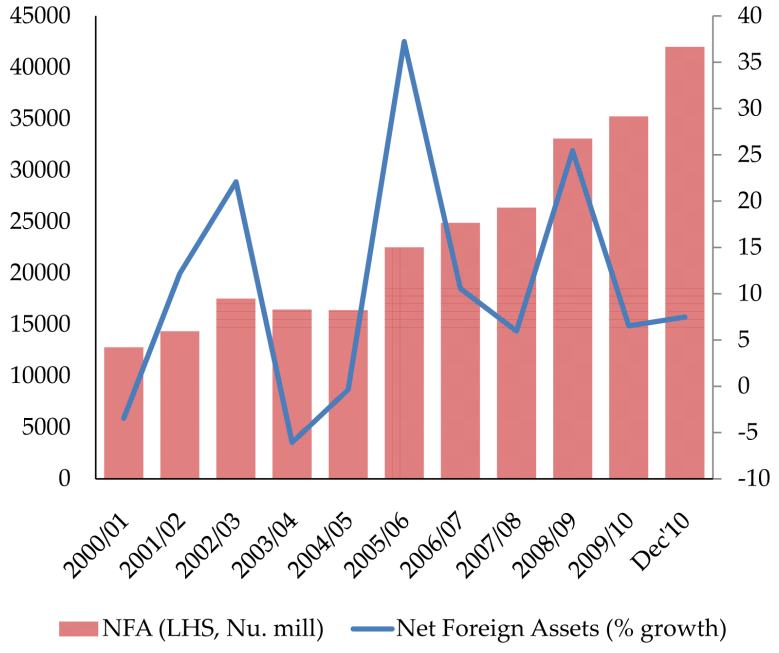
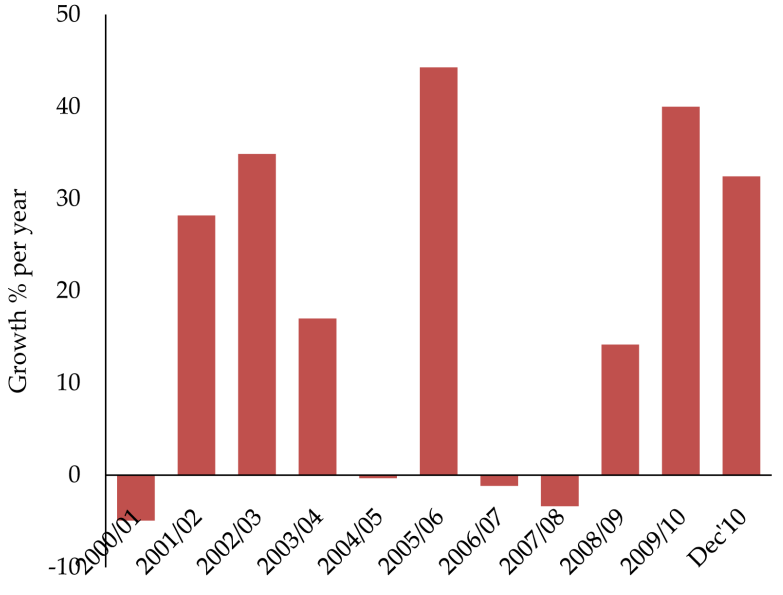


Chart 8: Reserve Money



SECTORAL CREDIT OF FINANCIAL INSTITUTIONS

June-end; Millions of Ngultrum

Sector	2007	2008	2009	2010	Dec'10	% of Total
Agriculture	306.6	523.4	658.1	492.2	499.5	1.4
Service and Tourism	2,035.1	2,678.5	3,177.6	4,352.8	5,905.9	16.4
Manufacturing	2,679.0	3,280.5	4,702.0	5,085.8	5,928.5	16.5
Building & Construction	4,999.1	5,670.6	6,072.6	7,615.8	8,936.1	24.8
Trade & Commerce	2,194.9	3,390.7	4,231.3	4,761.7	5,707.0	15.9
Transport (Heavy)	420.3	485.8	713.9	1,335.1	2,093.6	5.8
Transport (Light)	522.2	683.0	801.3	963.5	1,103.3	3.1
Personal Loans	1,163.0	1,859.3	3,367.9	4,552.5	5,094.3	14.1
Staff Loan	107.2	233.6	372.2	406.9	437.4	1.2
EDP Loans	6.5	7.8	10.4	6.6	50.3	0.1
Small Business and Artisan Schemes	2.5	1.8	0.9	0.9	15.4	0.0
Loan Against Shares	50.5	108.7	148.5	201.9	221.1	0.6
Others	-	-	-	-	12.6	0.0
Total Loans of FI	**14,487.0**	**18,923.6**	**24,256.7**	**29,775.9**	**36,005.0**	**100.0**

Source: Financial institutions (excluding the NPPF).

NON-PERFORMING LOANS OF FINANCIAL INSTITUTIONS

June-end; Millions of Ngultrum

Sector	2007	2008	2009	2010	Dec'10	% of Total
Agriculture/Animal Husbandry	125.6	193.8	205.3	110.0	90.8	4.7
Manufacturing/Industry	273.5	369.1	1,099.0	244.5	191.6	9.9
Trade & Commerce	138.1	184.2	382.9	216.0	117.9	6.1
Service & Tourism	153.4	289.3	774.2	424.4	130.9	6.7
Housing	453.9	552.1	763.2	726.0	429.3	22.1
Transport *(Heavy)*	54.3	69.0	105.3	121.4	130.4	6.7
Transport *(Light Vehicle)*	28.5	29.8	45.9	57.0	69.2	3.6
Loan Against Shares	2.2	6.5	41.7	1.2	7.2	0.4
Personal	107.6	136.9	316.0	303.9	310.7	16.0
Staff	1.1	2.1	5.7	13.2	4.2	0.2
EDP *(Entrepreneurship Loan)*	1.3	4.6	2.4	1.6	1.7	0.1
Small Business & Artisan Scheme	2.0	1.8	0.9	0.5	-	-
Overdraft/Working Capital	450.2	687.2	696.1	799.3	458.1	23.6
Total NPL	**1,791.7**	**2,526.3**	**4,438.4**	**3,018.9**	**1,941.8**	**100.0**
Total Loans of FI	**14,487.0**	**18,923.6**	**24,256.7**	**29,775.8**	**36,005.0**	
Total NPL Ratio	**12.4**	**13.4**	**18.3**	**10.1**	**5.4**	

Source: Financial institutions (excluding the NPPF).

ANNEX 2

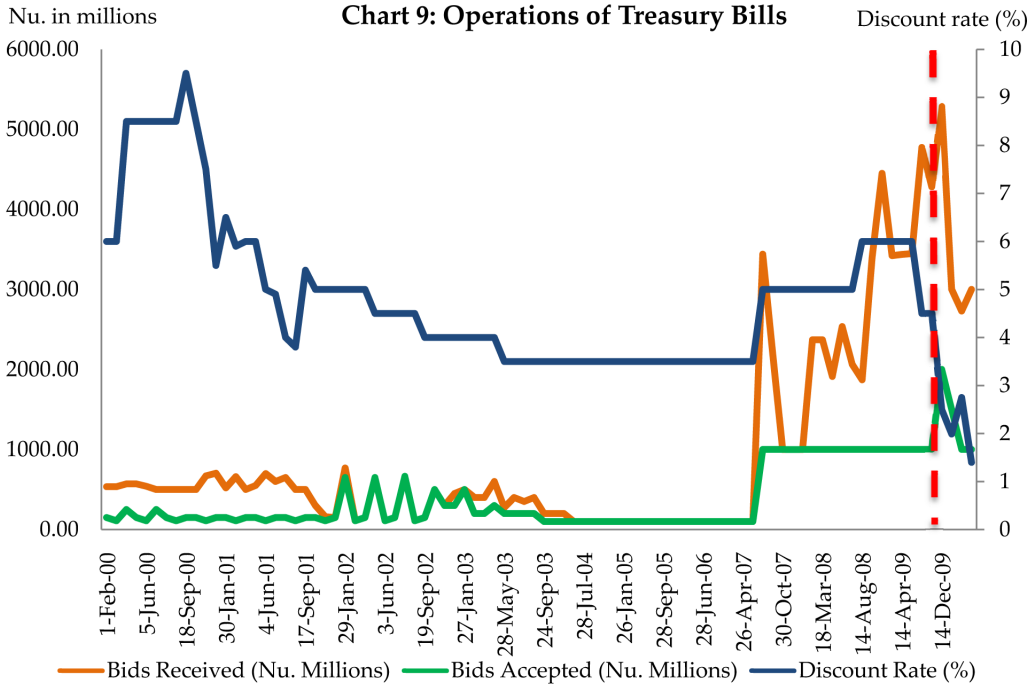
EXCESS LIQUIDITY OF THE BANKING SECTOR AND STERILIZATION BY INSTRUMENT

Millions of Nu.

	Jun-06	Jun-07	Jun-08	Jun-09	Jun-10	Dec '10
Total Domestic Liquidity	**10788.9**	**10553.1**	**9873.2**	**11689.1**	**16472.1**	**24062.3**
Excess Liquidity	**7604.6**	**7371.8**	**5180.8**	**5342.7**	**8121.2**	**13215.3**
Total Sterilized, of which	**3184.3**	**3181.3**	**4692.4**	**6346.4**	**8350.8**	**10847.1**
CRR	2862.3	2889.3	3734.6	5256.0	6846.9	9270.40
% of total sterilized liquidity	37.6	39.2	72.1	98.4	84.3	70.1
RMA Bills/Govt.T.Bills*	165.2	121.1	414.2	745.8	1000.0	996.4
% of total sterilized liquidity	2.2	1.6	8.0	14.0	12.3	7.5
Cash in Hand	156.8	170.9	543.6	344.6	503.9	580.3
% of total sterilized liquidity	2.1	2.3	10.5	6.4	6.2	4.4

Source: RMA and commercial banks. Excess liquidity is defined as the commercial banks' balances (reserves) maintained with the RMA in excess of their cash in hand, the mandatory cash reserve requirement (CRR), and holdings of interest bearing market instruments such as RMA Bills/ Government Treasury Bills.

NB:(*) The issue of RMA Bill has been discontinued w.e.f December 14, 2009 and has been replaced by Government Treasury Bills (T-Bills) thereafter.



ANNEX 3

MACROECONOMIC FORECAST: FY 2010/11-2011/12

	2009/10	2010/11	2011/12
	Prov.	Proj.	
Output and Prices			
Nominal GDP at market prices (mn. of Nu)	61222.6	75690.5	84399.9
Real GDP (annual % change)	6.7	8.1	6.4
Agriculture & Allied	2.7	1.8	1.8
Industry	3.6	10.3	6.3
Mining and quarrying	-6.9	7.0	7.0
Manufacturing	6.9	8.6	10.5
Electricity, gas & water	-2.4	5.6	-2.2
Construction	16.5	20.7	17.3
Services	13.3	8.0	8.3
CPI (annual % change)	6.1	9.6	6.5
Balance of Payments and Reserves (mn. of Nu)			
Current account balance	-8754.9	-6000.8	-10075.5
(as a % of GDP)	-14.3	-7.9	-11.9
Merchandise exports	25401.8	25494.9	25794.7
(growth in %)	3.0	0.4	1.2
Merchandise imports (c.i.f.)	-39340.0	-36501.5	-41639.6
(growth in %)	35.7	-7.2	14.1
Trade balance (% of GDP)	-22.8	-14.5	-18.8
Current and capital grants	12628.5	19486.2	20434.0
Capital and financial account balance	7016.5	12495.2	19528.4
Overall balance (mn. of Nu)	4401.4	6494.4	9452.9
International Reserves (mn. of USD)	858.4	1018.3	1162.9
(months of merchandise imports)	12.2	15.3	16.1
National Budget (mn. of Nu)			
Total revenue and grants	26361.1	30549.7	32480.6
(as a % of GDP)	43.1	40.4	38.5
Domestic revenue	15937.8	16962.6	18607.0
(as a % of GDP)	26.0	22.4	22.0
Grants	10423.4	13314.0	13793.7
Total expenditure	30451.6	34196.6	37857.8
Current	13837.4	15772.3	17185.3
Capital	16614.3	18424.3	20672.5
Fiscal balance	-4090.5	-3647.0	-5377.2
(as a % of GDP)	-6.7	-4.8	-6.4
Domestic financing, net	3433.2	2888.6	5327.4

Data as of the FY ending June. Source: MFCTC, Ministry of Finance. 1) Fiscal data for FY 2009/10: National Budget Report for the FY 2010/11, Ministry of Finance, June 2010. Fiscal projection source: Ministry of Finance. Capital expenditure is inclusive of net lending. 2) BOP data source: RMA. 3) GDP and CPI data source: NSB. GDP data for FY 2009/10 corresponds to CY 2009 data. The rate of inflation for the FY 2010/11 is as of the quarter ending March 2011.

ANNEX 4

SELECTED DEBT INDICATORS

Rupee Debt in millions of INR; CC Debt in millions of USD

	2006/07	2007/08	2008/09	2009/10	Dec'10
Overall External Debt Outstanding (USD millions)	723.8	819.1	794.3	840.7	837.7
(Growth in %)	-7.2	13.2	-3.0	5.8	-0.4
Rupee Debt	18369.9	18948.4	21400.7	22777.9	21184.2
(Growth in %)	10.6	3.0	16.5	20.2	-1.0
Convertible Currency (CC) Debt	308.1	349.7	346.4	352.5	368.6
(Growth in %)	2.0	-5.2	12.4	0.8	6.4
Hydropower Debt (Millions of Nu)	21207.0	20290.8	20551.9	20980.1	21017.0
(Growth in %)	0.6	-4.3	1.3	2.1	0.2
Rupee interest payments	209.6	1548.5	1598.4	1686.2	209.4
Rupee principal payments	274.2	2697.1	6143.5	5795.2	4892.1
Total Rupee debt service	483.8	4245.7	7741.9	7481.4	5101.6
CC interest payments	7.3	5.2	4.2	9.1	1.8
CC principal payments	4.7	9.0	8.5	11.6	3.2
Total CC debt service	12.0	14.3	12.7	20.7	5.0
Fiscal Balance (Millions of Nu.)	287.7	403.5	1092.5	-4090.5	n/a
External financing	*530.1*	*-1143.9*	*-1218.7*	*657.3*	*n/a*
Internal financing	*-175.3*	*-175.3*	*126.2*	*3433.2*	*n/a*

Source: Department of National Budget and the Department of Public Accounts, Ministry of Finance and Private Enterprises for Commercial Debt data. Fiscal data for the year 2009/10 are revised estimates.