MONETARY POLICY STATEMENT

July 2016

Royal Monetary Authority of Bhutan

Monetary Policy Statement

The Monetary Policy Statement of the Royal Monetary Authority of Bhutan is being issued in accordance with Chapter II, Section 10 of the Royal Monetary Authority Act of Bhutan 2010.

The Monetary Policy Statement 2016 was endorsed by the Board of Directors of the Royal Monetary Authority of Bhutan during its 113th meeting held on 27th June 2016. The Monetary Policy Statement will henceforth be issued annually in July, coinciding with the first month of the new fiscal year.

Macroeconomic projections are based on the work of the multi-sector Macroeconomic Framework Coordination Technical Committee, endorsed by the policy-level Macroeconomic Framework Coordination Committee, composed at both levels by various government and statistical agency representatives, and led by the Ministry of Finance, Royal Government of Bhutan.

Contents

Acronyms

BOP	Balance of Payment
CC	Convertible Currency
CPI	Consumer Price Index
CRR	Cash Reserve Ratio
CSI	Cottage and Small Industry
FDI	Foreign Direct Investment
FI	Financial Institution
FY	Fiscal Year (July 1 – June 30)
GDP	Gross Domestic Product
IMF	International Monetary Fund
INR	Indian Rupees
MFCC	Macroeconomic Framework Coordination Committee
MFCTC	Macroeconomic Framework Coordination Technical Committee
MFI	Microfinance Institution
RMA	Royal Monetary Authority of Bhutan
USD	US Dollars

Governor's Statement

Macroeconomic conditions have improved since the slowdown brought about by the 2012 Indian Rupee shortages in the Bhutanese financial markets. Real GDP growth has rebounded to 5.2 percent in FY 2014/15 from the lows of below 4 percent in the two preceding years. Inflation has also moderated considerably, and declined to 6.6 percent in FY 2014/15, and further to 3.3 percent in the first three quarters of FY 2015/16. While the slowdown in credit in 2013 and 2014 has been partly reversed in 2015 because of the removal of restrictions on housing and transport loans, credit growth remains contained at below 15 percent. On the fiscal front too, the fiscal deficit of 4.2 percent of GDP in FY 2012/13 turned into a surplus of 3.8 percent and 1.5 percent of GDP respectively, in FY 2013/14 and FY 2014/15.

However, in the balance of payments, the current account deficit continues to remain elevated at close to 30 percent of GDP and the RMA views the current account deficit as the biggest medium-term challenge for the economy. The events of the 2012 Indian Rupee shortages have clearly demonstrated the vulnerabilities of our import-dependent economic structure and the macro-financial links between excessive credit growth and rising external imbalances: credit growth translated into large increases in imports, which in turn resulted in the buildup of pressures in the external sector.

The consequent tightening of credit and monetary terms and conditions in the financial institutions (FIs) and the market helped to alleviate the pressures to a certain degree. **Combined with fiscal measures adopted and implemented by the government, growth has rebounded and seems to be on an upward trajectory of recovery.**

Going forward, growth is expected to average 9.0 percent in the medium-term with the partial commissioning of Punatsangchu II and Mangdechhu by FY 2017/18. **The RMA will support growth through an accommodative monetary policy stance that channels credit to growth drivers, while at the same time, increasing vigilance over and monitoring and containing credit for import-heavy consumption.**

This is because the current account deficit still remains one of the biggest challenges facing Bhutan in the medium-term and addressing this challenge will require both monetary and fiscal policy measures as well as other sector-specific reforms. On

its part, t**he RMA's monetary policy measures will be channeled through the prudent management of reserves and credit**.

On the **reserves** front, the RMA is focused on strengthening its role as the "owner, depository and manager" of the country's external reserves, as entrusted by the RMA Act of Bhutan 2010. **Maintaining the stability of the exchange rate peg of the Ngultrum to the Indian Rupee remains one of the cornerstones of RMA's monetary and reserve management policy.** Towards this objective, the RMA will ensure the availability of sufficient Indian Rupees on demand for all legitimate purposes, thereby maintaining the value of and confidence in the Ngultrum.

Measures such as the re-opening of Indian Rupee cash exchange counters in January 2016 were aimed at reinforcing the national policy of maintaining the one-to-one parity between the Ngultrum and the Indian Rupee. While temporary administrative controls were put in place in 2012, these controls have outlived their relevance and are no longer necessary. More importantly, the RMA is finalizing a **long-term strategy to manage reserves** – both convertible currency and Indian Rupees – on an efficient and sustainable basis. An envisaged outcome of this strategy is that the RMA will be able to hold larger levels of Indian Rupee reserves and not have to resort to ad-hoc interventions and administrative controls that risk the value of the Ngultrum.

The Constitution of the Kingdom of Bhutan mandates the overarching framework to guide reserve management by stipulating that "***a minimum foreign currency reserve that is adequate to meet the cost of not less than one year's essential imports must be maintained***". Foreign currency reserves have been maintained in excess of the constitutional requirement. Additionally, the RMA's long-term reserve management strategy is now also aimed at proactively maintaining adequate **liquidity buffers for Indian Rupee** reserves at an internally determined level that has taken into consideration demand for Rupees over several years as well as anticipated needs over the medium-term. **The renewed focus on reserve management is based on a twin-approach of efficiently and effectively managing existing reserves as well as providing incentives to encourage inflows,** targeting in particular, inward remittances from non-resident Bhutanese as well as the earnings of exporters and FDI companies.

On the **credit** front, mindful of the important role of finance in promoting investment, the RMA is committed to complement the efforts of the Government to achieve sustainable economic development. Under the broader Financial Sector Development Action Plans, the focus for the RMA for the next year will be on the following key fronts:

i. Interest Rates – ensuring an **interest rate structure** that encourages competition and professionalism among the financial institutions, for a balanced approach of engaging in financial intermediation – resulting in favourable lending to productive sectors while also considering real interest rates for depositors.

ii. Strengthening the **supervision** and **corporate governance** of the financial system through periodic reviews and implementation of **prudential regulations** and **stress-testing exercises** to ensure the soundness and stability of the financial system.

iii. Developing a **financial deepening strategy** that takes an **integrated** approach to financing productive sectors through the promotion of **specialized institutions** such as microfinance institutions (MFIs) and cottage and small industry (CSI) banks as well as through a **directed lending policy**. The strategy will also cover the development of a liquidity management framework that can serve as the policy basis for changing the CRR as well as the development of a money market to strengthen the RMA's monetary policy framework.

As a first step, the RMA is currently reviewing the existing base rate system to ensure a more **market-driven interest rate that allows healthy competition among the financial institutions as well as favourable lending to productive sectors**. The new approach will be simple, transparent and forward-looking. The new approach will also be an integrated approach, supplemented by other policy measures to address the objectives of efficient credit allocation.

The new approach will be supplemented by other policy tools such as the use of both macro- and micro-prudential measures to address potential buildup of exposure and pressures. The RMA will rely extensively on prudential tools to manage both the quantum and price of credit, in particular for credit that finances consumption with large import implications. Furthermore, under the financial deepening strategy, lending to productive sectors will be allowed through a combination of relatively easier conditions for strategic lending as well as the promotion of specialized institutions, such as MFIs and CSI banks.

Measures by the RMA must be complemented by appropriate fiscal policy interventions and other cross-cutting reforms. While monetary policy works largely via its influence on aggregate demand, it is fiscal policy that has a direct impact on supply side dynamics. **The Government is best placed to intervene on the resource mobilization front as well as through the introduction of tax measures and focusing investment and expenditure towards productive sectors.**

In particular, addressing the large current account deficit requires coordinated policies to boost domestic productive capacity and employment.

On our part, the RMA will support the Government in all initiatives that are aimed at addressing the issues and challenges facing our economy. The development and management of hydropower projects in particular presents opportunities that must be tapped and managed properly. **Hydropower will remain an integral part of our economy and therefore, focused interventions to ensure that spillovers are managed effectively will require the coordinated actions of many authorities as well as the community in which the project is being developed.**

The management of spillovers, particularly in terms of enhancing the local capacity to provide goods and services during the construction phase has the potential to generate additional growth, such as for example, through the provision of construction services by the Construction Development Corporation Limited. Also, the efficient management of the consumption needs of the labour force through the local supply of goods and services has huge positive implications on the retention of Indian Rupees and generation of employment.

Beyond the medium-term, expectations of a turn-around in the current account deficit are being driven because of the commissioning of several hydropower projects. **His Majesty the Druk Gyalpo of Bhutan has, time and again, expressed that hydropower is a resource that belongs to all the people of Bhutan**. Therefore, while the boost in export revenues from hydropower is a welcome development, authorities must already start planning and implementing proper fiscal rules and investment policies to ensure that the hydropower dividend is managed prudently in order to benefit all Bhutanese citizens for all times to come.

As the RMA works to complement the efforts of the Government to boost growth and ensure a sustainable development process, I am confident that under the wise guidance of Their Majesties the Fourth Druk Gyalpo and the Druk Gyalpo of Bhutan, we will succeed in our endeavor.

Tashi Delek!

(Dasho Penjore)
Governor
July 2016

Medium-term Outlook and Key Challenges

I. Macroeconomic Review[1]

Macroeconomic conditions have improved since the slowdown brought about by the 2012 Indian Rupee shortages. While real GDP growth was initially forecast to increase to 6.8 percent in FY 2014/15, revised estimates indicate a growth of 5.2 percent[2]. Growth has nonetheless rebounded from less than 4 percent in the two preceding years and is projected to continue on an upward trajectory of recovery.

Inflation has also moderated considerably, from the high of 13.5 percent in the second quarter of 2012 to 6.6 percent in FY 2014/15, and further to 3.3 percent in the first three quarters of FY 2015/16. While the slowdown in credit in 2013 and 2014 has been partly reversed in 2015 because of the removal of restrictions on housing and transport loans, **credit growth remains contained at below 15 percent.**

On the fiscal front too, the fiscal outcome for FY 2014/15 was much stronger than initially projected[3]. The fiscal deficit of 4.2 percent of GDP in FY 2012/13 turned into a surplus of 3.8 percent and 1.5 percent of GDP respectively, in FY 2013/14 and FY 2014/15.

In the balance of payments, the current account deficit continues to remain elevated. The initial projection for FY 2014/15 of the current account deficit of 26.3 percent of GDP has been revised upward to 28.8 percent of GDP, driven by larger than expected imports.

Historically, net inflows in the capital and financial account, made up largely of grant and loans, have financed the current account deficit, with a resulting buildup in the country's international reserves. While reserves were initially expected to increase to USD 1.1 billion by June 2015, the larger than expected current account deficit has pushed reserves to USD 958.5 million as of June 2015.

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1 *Comparisons between initial projections and revised estimates/projections are based on the March 2015 and April 2016 projection results of the MFCC/MFCTC, respectively. The March 2015 projections were featured in the 2015 Monetary Policy Statement of the RMA. All ratios to the GDP use fiscal year GDP, which are derived by averaging two calendar year GDPs. In contrast, other publications of the RMA use calendar year GDP in all ratios; and therefore figures may vary slightly.*

2 *The revised real GDP growth was lower because initial projections assumed better outcomes in the secondary sector (mining & quarrying, manufacturing, electricity and water, and construction).*

3 *The initial projection for FY 2014/15 was a deficit of 2.3 percent of GDP. However, current and more so, capital expenditures were much lower than budgeted. A possible reason was that since FY 2014/15 was the second year of the 11th five-year plan, the focus was on preparatory works and mobilization of resources.*

Going forward, the medium-term outlook (FY 2015/16 – FY 2017/18) has been revised based on both the outcomes of FY 2014/15 as well as new developments in the last year.

II. Medium-term Outlook

Despite a slightly lower than expected outcome in FY 2014/15, real GDP growth is projected to increase from 5.2 percent to 7.0 percent in FY 2015/16, stimulated and driven by an increased momentum of activities in mining, construction and services. The partial commissioning of the Punatsangchu II and Mangdechhu hydropower projects is expected to accelerate growth to 12.4 percent in FY 2017/18.

In terms of inflation, Bhutan's inflation is expected to remain below the inflation in India in the medium term with added benefits from India's adoption of flexible inflation targeting. Inflation in India is currently within the 4 ±2 percent band while headline CPI inflation is projected to moderate in 2016/17 to around 5 percent, although an unfavorable monsoon and an expected public sector wage increase pose upside risks. Globally too, inflation has been declining as a result of lower prices for oil and other commodities, including food, which has a larger weight in the consumer price indices of emerging market and developing economies (IMF World Economic Outlook, April 2016).

On the fiscal front, according to the National Budget Report presented to the summer session of the National Assembly 2016, a fiscal deficit of 3.0 percent of GDP is expected in FY 2015/16, further increasing to 5.3 percent by FY 2016/17, driven by capital spending, projected to increase by close to 70 percent in FY 2015/16. By FY 2017/18 however, with the end of the 11th five-year plan, the fiscal deficit is projected to fall to less than 1 percent of GDP.

In the external sector, the current account deficit is expected to increase further in FY 2015/16 before decreasing slightly as a result of increased hydropower exports from the partial commissioning of Punatsangchu II and Mangdechhu.

However, the overall trade deficit is still expected to persist due to the large and sustained growth of overall imports that are not offset by the increase in hydro exports. As a result, the current account deficit is expected to remain elevated, averaging 26.2 percent over the medium-term.

Official inflows in the form of capital transfers (grants for hydropower development) and external loans of the Government are expected to continue to finance the current account deficit. The net surpluses in the capital and

financial account are anticipated to be slightly larger than the current account deficit, resulting in a gradual buildup of reserves over the medium-term.

III. Assessment of Key Challenges

The RMA views the current account deficit as the biggest challenge for the economy over the medium-term. Addressing this challenge will require monetary and fiscal measures as well as other sector-specific policies and reforms. In particular, the stance of both monetary and fiscal policies can directly impact the magnitude and direction of the current account deficit.

- From the **monetary policy** front, credit growth has a direct impact on the current account deficit because we are highly import dependent and therefore a large portion of any credit extended by the financial sector translates into imports and subsequent pressures on the external sector (rising current account deficit and pressures on gross international reserves). While credit for investment and productive sectors may initially raise the deficit, over the medium- to long-term, returns and benefits are expected to accrue that will ultimately correct the deficit. However, on the other hand, excessive credit growth to finance consumption will cause the deficit to deteriorate to unsustainable levels, resulting in potential crisis situations.

- From the **fiscal policy** front, large increases in expenditure and expansion of the fiscal deficit also translate into increased imports and external sector pressures. As the largest economic sector, the Government is best placed to intervene on both the resource mobilization front as well as on focusing investment and expenditure towards productive sectors. In addition, the Government can also introduce taxation measures to contain consumption. While monetary policy works largely via its influence on aggregate demand, fiscal policy has a direct impact on supply side dynamics to boost domestic productive capacity and employment.

Beyond the medium-term, the accelerated growth in GDP and a turn-around in the current account deficit are being anticipated because of the commissioning of several hydropower projects. On the one hand, the construction and development of the projects are currently being fully financed through external financing (Indian Rupees and convertible currency) while the completion of these projects is expected to boost export revenues and reserves. During the construction phase however, if spillovers to other sectors in the form of increased demand for transport and housing, and other auxiliary services

are not managed properly, there will be additional build-up of pressures in the current account.

Focused interventions to ensure that spillovers are managed effectively will require the coordinated and concerted efforts of many authorities as well as the community in which the project is being developed. On our part, the RMA will support the Government in all initiatives that are aimed at addressing the challenges, in addition to ensuring appropriate credit policies that will be central to help stakeholders take advantage of the spillovers from hydropower development.

IV. Way Forward

The policy imperative is to coordinate monetary and fiscal policies to achieve the broader national growth and development objectives. The RMA's monetary policy measures will be focused on the prudent management of reserves and credit. On the reserves front, the RMA's renewed focus on reserve management will be based on the twin-objective of effectively managing existing reserves as well as providing incentives to encourage foreign exchange inflows. On the credit front, the RMA will support credit to growth drivers while increasing vigilance over and limiting credit for unproductive, heavy import driven consumption.

Measures adopted by the RMA must be complemented by appropriate fiscal policy interventions and other broad cross-cutting reforms. The Government must ensure support for investment and productive expenditure as well as taxes on consumption, being mindful of the external sector pressures that a large fiscal deficit can cause if proper mechanisms are not put in place well on time.

Medium-term Macroeconomic Forecasts FY 2015/16 – FY 2017/18

Particulars	2014/15	2015/16	2016/17	2017/18
	(prov)	(projections)		
Output and Prices				
Nominal GDP at market prices (mn. of Nu, fiscal year)	125184.8	139999.4	157628.1	184449.6
Real GDP (annual % change)	5.2	7.0	7.7	12.4
Agriculture & Allied	2.7	3.3	3.5	3.6
Industry	4.0	8.3	8.7	19.3
Mining and quarrying	7.0			
Manufacturing	5.7	7.8	9.9	9.9
Electricity & water	-1.5	1.7	3.0	45.4
Construction	7.8	15.6	13.4	2.1
Services	8.1	8.1	8.3	8.4
CPI (annual % change)	6.4	4.4	4.6	5.1
Balance of Payments and Reserves (mn. of Nu)				
Current account balance	-36084.7	-43590.5	-43701.9	-36250.4
(in % of FY GDP)	*-28.8*	*-31.1*	*-27.7*	-19.7
Merchandise exports	35901.8	36307.8	36812.7	45697.9
(growth in %)	*6.9*	*1.1*	*1.4*	24.1
Merchandise imports (c.i.f.)	61923.4	71887.1	72536.9	74521.3
(growth in %)	*12.0*	*16.1*	*0.9*	2.7
Trade balance (% of FY GDP)	-20.8	-25.4	-22.7	-15.6
Current and capital grants	*20855.2*	*32093.5*	*29683.4*	35393.5
of which, Budgetary Grants	*9193.0*	*16448.0*	*13766.7*	18254.3
Financial account balance	-23886.1	-23742.5	-27067.5	-30421.6
Overall balance (mn. of Nu)	-560.4	1544.1	2259.4	19327.2
International Reserves (mn. of USD)	958.5	937.3	967.6	1262.5
(months of essential imports)	25.3	24.1	23.5	28.9
(months of merchandise imports)	*11.8*	*10.0*	*10.3*	13.1
National Budget (mn. of Nu)	*Actual*	*Revised*	*Budget*	*Projection*
Total Resources	36231.1	43735.0	41605.9	*44090.5*
(in % of FY GDP)	*28.9*	*31.2*	*26.4*	*23.9*

Particulars	2014/15	2015/16	2016/17	2017/18
	(prov)	(projections)		
Domestic revenue	*25141.0*	*26293.7*	*27247.2*	*28434.8*
(in % of FY GDP)	*20.1*	*18.8*	*17.3*	*15.4*
Grants	*9955.0*	*16988.0*	*14338.7*	*15655.7*
Total expenditure	36475.8	49712.8	51884.4	*47613.3*
Current	21032.0	23909.5	25387.0	*26923.2*
Capital	*15443.8*	*25803.3*	*26497.3*	*20690.1*
Net Lending	*-2552.7*	*-1758.5*	*-1902.8*	*-2090.3*
Fiscal balance	1896.8	-4219.3	-8375.7	*-1432.5*
(in % of FY GDP)	*1.5*	*-3.0*	*-5.3*	*-0.8*

Data as of the FY ending June, including GDP which is also on FY basis. Source: MFCTC, Ministry of Finance (projections as of April 2016) and IMF. 1) Fiscal projection source: Ministry of Finance. 2) BOP data source: RMA. 3) GDP data source: National Statistics Bureau. 4) CPI Inflation data source: IMF. Calendar year essential imports have been projected using an inflation of 6% (upper band of India's inflation target).

Renewed Focus on Reserve Management

The management of reserves, in particular of Indian Rupee reserves, remains one of the key challenges for the RMA because of the persistently high current account deficit. Addressing the challenge of the current account deficit will require **longer-term structural measures and policies aimed at channeling investments into productive sectors, diversifying the economy, increasing productivity and building the domestic supply and production base**.

In the meantime, because of its relative flexibility and ease of use, reserve management can be used as a policy tool to maintain adequate buffers for financing the current account deficit. However, reserve management is at best only a short-term tool, unsustainable over the long run and so, must be complemented by longer term government policies that improve the supply side dynamics.

The Constitution of the Kingdom of Bhutan mandates the overarching framework to guide reserve management. Foreign currency reserves have been maintained at levels well above the constitutional requirement of covering the cost of one year's **essential imports**[4].

Reserve Cover of Essential Imports	2012	2013	2014	2015	2016				
					Jan	Feb	Mar	Apr (p)	May (p)
CC Reserves (in USD millions)	752.5	821.8	852.5	814.1	785.2	784.9	828.2	828.0	841.6
Total Reserves: CC+INR (in USD millions)	776.8	895.0	1032.8	1040.0	999.8	1022.3	1171.4	1093.1	1051.2
Essential Imports (in USD millions)	449.0	469.3	456.4	452.5	479.6	479.6	479.6	479.6	479.6
Reserve Cover of Essential Imports (months)	20.8	22.9	27.2	27.6	25.0	25.6	29.3	27.3	26.3

(p) - provisional data. Reserve positions in each calendar year are the average of month-end positions for all months in the year. Values of essential imports for 2016 are estimates.

4 *Essential imports were defined by the Indian Rupee Taskforce constituted in 2012. Based on the 2012 definition, the RMA has updated the value for essential imports for the years 2013, 2014 and 2015 using data from the trade statistics publications of the Ministry of Finance. Henceforth, the RMA will undertake periodic reviews of the definition of essential imports in consultation with relevant stakeholders, bearing in mind the original sacrosanct reasons for having the requirement in the Constitution.*

In addition, the RMA also maintains a **daily liquidity buffer of Indian Rupee reserves** at a consistent and comfortable level to meet all balance of payments requirements and to maintain public confidence in the Ngultrum-Rupee parity.

The Ngultrum has been pegged at par to the Indian Rupee ever since its introduction in 1974. With the continuing dominance of bilateral trade (over 80 percent of total imports and close to 90 percent of total exports) and financial flows (for economic developmental aid and loans for hydro power projects) from India, the pegged exchange rate continues to be the best choice of exchange rate policy – an anchor for macroeconomic stability - guiding fiscal and monetary developments in Bhutan.

Maintaining the stability of the exchange rate peg of the Ngultrum to the Indian Rupee remains one of the cornerstones of RMA's monetary and reserve management policy.

The 2012 Indian Rupee shortages not only exposed the vulnerabilities of our heavily import-dependent structure but also revealed challenges related to the composition and management of reserves. While on the one hand, a comfortable level of convertible currency reserves was being maintained, on the other hand, several expensive Indian Rupee loans were availed to meet the shortages. We have historically been very cautious in using our convertible currency reserves because our export earnings are limited and the buildup of CC reserves has been driven through grants and concessional borrowings. We have also been cautious in terms of holding Indian Rupees because the Rupee is not convertible, despite the dominance of bilateral trade with India.

An important policy imperative for the RMA is to address this challenge by exploring arrangements to allow the convertibility of the Indian Rupees into US dollars in order to comfortably allow the RMA to hold higher levels of Indian Rupee reserves and actively manage the composition of reserves between the Rupee and other freely convertible currencies. In addition, the RMA is also exploring viable investment avenues for the investment of our Indian Rupee reserves in Government of India securities.

While the Government is better suited to implement supply-side policy measures to boost domestic capacity and promote exports, the RMA is also considering active interventions to encourage the inflow of foreign exchange.

The RMA's renewed focus on reserve management is based on a twin-approach of efficiently and effectively managing existing reserves as well as providing incentives to encourage foreign exchange inflows.

As a first step, the RMA will implement within the year, appropriate regulations, infrastructure and incentives to encourage inward remittances by Bhutanese living and working abroad.

Secondly, the RMA is also putting in place appropriate systems to monitor foreign exchange flows, in particular to review the performance of foreign exchange earners such as exporters and FDI companies. Assessments of whether exporters and FDI companies have a net benefit on the economy as foreign exchange earners and through the inflow of net export proceeds have not been carried out so far and will provide a fair basis on which to review existing policies that provide incentives and exemptions while also ensuring the formulation of better targeted policies.

Strategic Finance: Directing Credit to Productive Purposes

Annual growth in credit to the private sector had averaged 33 percent in the five years leading up to the 2012 Indian Rupee shortages. While the growth has now been contained at below 15 percent, **credit remains concentrated in a few sectors** – housing, trade/ commerce and personal loans – **while also largely financing consumption related imports**. Pressures on reserves, Indian Rupee reserves in particular, have abated to a large degree, but these pressures remain, with the trade and current account deficit expected to remain elevated at over 20 percent of GDP in the medium term.

While inflation has moderated as a result of the sharp decline in global commodity prices and the outlook remains favourable, **growth performance is being driven by hydropower** – with the commissioning of three major projects by FY 2018/19. Even as hydropower boosts export earnings and drives growth, the performance of the non-hydro sector is not visible in the growth projections. Despite increased hydro export earnings, the overall trade deficit is still expected to persist because of a large and sustained growth in overall imports that are not offset by the increase in hydro exports. As a result, the current account deficit is expected to remain elevated and risks of persistent pressure on reserves remain.

Against this backdrop, the task for the RMA is to ensure that **credit is allocated to productive purposes and excessive credit growth for consumption is curtailed**, all the while ensuring the stability of our exchange rate peg.

The most important first step for the RMA is to ensure **an interest rate structure that encourages competition and professionalism among the financial institutions, for a balanced approach of engaging in financial intermediation – resulting in favourable lending to productive sectors while also considering real interest rates for depositors**. Therefore, the RMA continues to look for the best approach of determining the setting of interest rates in the financial market. As part of this endeavor, the RMA is reviewing the current Base Rate system, given the associated rigidities that have become apparent since its implementation in September 2012, and developing a new approach to address the rigidities.

The new approach is being designed to be simple, transparent, and market driven – allowing room for healthy competition among the financial institutions, while being based on forward-looking parameters.

While the new approach may bring about a new level of interest rates, the

RMA expects a time-frame of up to over one year before visible impacts are seen and the objectives of the approach are realized. **If the new approach results in a lowering of interest rates over time, the RMA will use other supplementary policy tools to contain credit and reduce pressures on the current account**. Such supplementary policy tools include the use of prudential regulations and directed lending strategies.

As the oversight authority of the financial sector, the RMA is responsible for licensing, regulating and supervising the financial institutions and financial service intermediaries. Regulations such as the macro- and micro-prudential regulations are not only aimed at promoting good governance and ensuring the prudence, stability and integrity of the financial system against potential systemic risks, but can also be used as a tool to regulate the quantum and direction of credit, whether towards productive sectors or to contain import-heavy consumption.

Both micro- and macro-prudential tools will be used to support the RMA's pro-growth monetary policy stance, in particular, to limit both the quantum and price of credit that finances consumption with large import implications. On the other hand, lending for productive sectors will be allowed under relatively relaxed regulations.

The following macro-prudential regulations have already been implemented:

- Minimum Ceiling on Leverage Ratio
- Loan to Value and Loan to Income ratios
- Debt to Equity ratio
- Distribution of Profit
- Disclosure Requirement
- The margin requirement component of the "time varying capital provisioning and margin requirement" regulation

The following are in place to be implemented, when required:

- Counter-cyclical capital buffer
- Sectoral capital requirement
- The time varying capital provisioning component the "time varying capital provisioning and margin requirement" regulation

Next, in the context of **directed lending**, notwithstanding the absence of a nationally articulated priority sector lending policy, the RMA anticipates its role in any directed lending strategy to be in the field of credit and finance, while the provision of fiscal incentives and other market support schemes such as credit guarantees and interest subsidies may rest under the ambit of the Government.

From this perspective, the RMA is already considering **an integrated approach to financing strategic/ productive sectors through the promotion of specialized institutions such as microfinance institutions and CSI banks,** under the umbrella of a broader financial deepening strategy. Within the broad financial deepening strategy, the RMA aims

to promote financial inclusion, direct credit to productive sectors and design an overall guiding framework for the development and direction of Bhutan's financial system.

Progress under this strategy, related in particular to the twin objectives of promoting financial inclusion and financing productive sectors, include the following:

- Under the regulation for non-deposit taking microfinance institutions issued in 2014 ("Regulations for Microloan Institutions in Bhutan"), two institutions were registered in 2016, while the RMA is also actively involved in advocacy and awareness to register more non-government organizations that are involved in such micro-lending activities.

- Regulations for deposit-taking microfinance institutions have been drafted and are awaiting the review and consideration of the RMA Board.

- Agent Banking Rules and Regulations are being drafted to increase financial services outreach and to promote financial inclusion to the unbanked and under-banked population without risking the safety and soundness of the banking system; and to encourage institutions to use agents in the provision of banking services in order to reduce the cost of financial services.

Finally, in line with the Government's efforts to promote cottage and small scale industries, the RMA will also consider the CSI sector (erstwhile defined under the small and medium enterprise or SME sector) as a strategic sector for improving access to financial services.

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