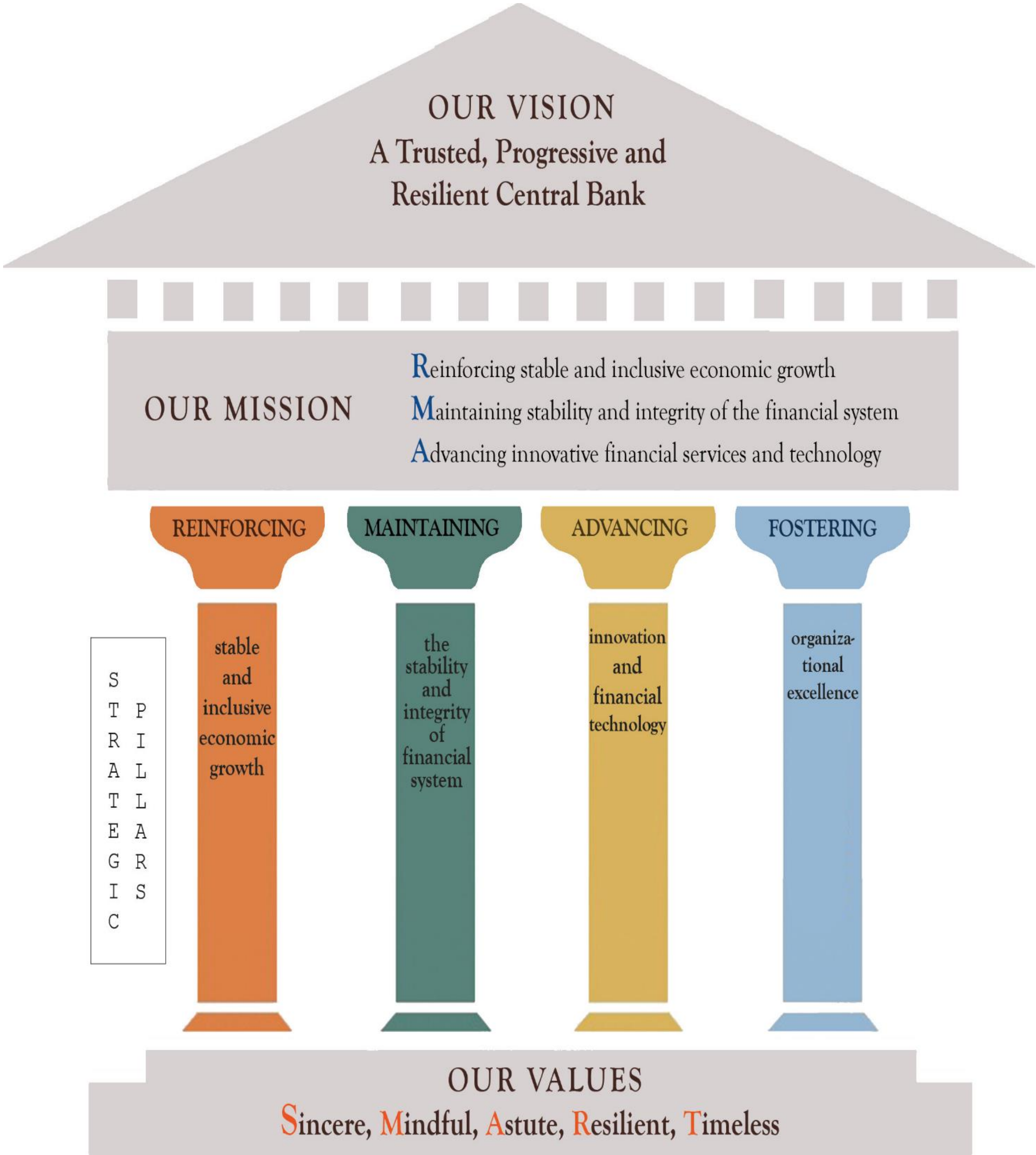
Royal Monetary Authority of Bhutan

MONETARY POLICY STATEMENT

July 2019

Vision, Mission and Values



MONETARY POLICY STATEMENT

In accordance with Chapter II, Section 7 of the Royal Monetary Authority Act of Bhutan 2010, the Royal Monetary Authority is assigned with the primary objective "to formulate and implement monetary policy with a view to achieving and maintaining price stability."

In that context, the Monetary Policy Statement of the Royal Monetary Authority of Bhutan is hereby issued in accordance with Chapter II, Section 10 of the Royal Monetary Authority Act of Bhutan 2010. The Monetary Policy Statement is issued annually in July, coinciding with the first month of the new fiscal year.

Macroeconomic statistics presented in this Statement are based on multi-sector Macroeconomic Framework Coordination Technical Committee (MFCTC) projections, endorsed by the policy-level Macroeconomic Framework Coordination Committee (MFCC).

CONTENTS

ACRONYMS

BEFIT	Bhutan Economic Forum for Innovative Transformation
CPI	Consumer Price Index
CSI	Cottage and Small Industry
CEFL	Consumer Empowerment and Financial Literacy
FI	Financial Institution
FY	Fiscal Year (July 1 – June 30)
FYP	Five Year Plan
FIS	Financial Inclusion Secretariat
GDP	Gross Domestic Product
GST	Goods and Services Tax
IMF	International Monetary Fund
INR	Indian Rupees
M2	Broad Money
MFCC	Macroeconomic Framework Coordination Committee
MFCTC	Macroeconomic Framework Coordination Technical Committee
MFI	Microfinance Institution
MoF	Ministry of Finance
NFIS	National Financial Inclusion Strategy
NFLS	National Financial Literacy Strategy
NFA	Net Foreign Assets
RBI	Reserve Bank of India
RGoB	Royal Government of Bhutan
RMA	Royal Monetary Authority of Bhutan
USD	US Dollars

MONETARY POLICY LANDSCAPE

Since the introduction of Ngultrum in 1974, the Ngultrum has been pegged at par to the Indian Rupee. Intermediate target for achieving and maintaining price stability in Bhutan is the one-to-one peg with the Indian Rupee. Maintenance of a fixed exchange rate has been beneficial for Bhutan. The peg arrangement not only contributed to low volatility in the bilateral real exchange rate with India, which served as a nominal anchor for monetary policy for managing domestic inflation but also helped to promote confidence in the local currency, which supported the process of monetization and economic development. Thus, in order to support the fixed exchange rate arrangement, the RMA always ensures availability of adequate Indian Rupee on demand for exchange with the Ngultrum for meeting payments with India, and with the provision of 100 percent reserve backing for all Ngultrum issued in the country.

However, the fixed exchange rate targeting limits the RMA's monetary policy independence and flexibility, in terms of policy choices available to effectively respond to adverse external shocks. For instance, price movements in Bhutan to a large extent, is exogenously determined by the price development in India. Continued inflationary pressure in the domestic market would not only put pressure on international reserves but also on the exchange rate arrangement.

The RMA currently uses both direct and indirect instruments to conduct monetary policy operation. The Cash Reserve Ratio (CRR) is used as the main policy instrument to influence the level of bank reserves and manage liquidity in the banking system. For liquidity management, the RMA also sterilize volatile liquidity through sweeping arrangement to contain unwarranted build-up of inflationary pressure, weakening of balance of payments, and contingent effect on the financial market.

To further strengthen the existing monetary policy operation system, the RMA will be introducing a new market based monetary policy operation framework. The main objectives of the framework are to (i) facilitate monetary policy signaling (ii) maintain an optimal level of liquidity in the banking system and (iii) allow banks to enhance their treasury function, leading to reduced liquidity costs and settlement risks, and (iv) support development of the domestic money market.

POLICY STATEMENT

The RMA continued to rely on CRR as the key monetary policy tool. With the changing landscape in the financial sector, strengthening existing monetary policy operation system became a priority. Accordingly, the RMA formulated a market based monetary policy operation framework, which is currently at the final stage of implementation. Under this new framework, the short-term interest rate (policy rate) will signal the RMA's monetary policy stance. This new monetary policy framework will be complemented by both micro and macro prudential regulations and prudent reserve management to support achievement of price stability and managing the pegged exchange rate arrangement.

Currently, to achieve low and stable domestic Consumer Price Index (CPI) inflation, the RMA pursues credit and monetary aggregate growth as an intermediate target, while using reserve money as the main operational target. Although, the RMA does not have an explicit CPI inflation target, it attempts to align the CPI inflation with Indian inflation target of 4 percent within a band of +/- 2 percent, since 52 percent of the items in the CPI basket are imported from India. Looking at the current trend, the domestic CPI inflation moderated to 3 percent as of March 2019, compared to 3.2 percent during previous year, supported by fall in the imported food prices. Low and stable CPI inflation in the recent years benefited both investors and savers with positive real returns.

The real GDP growth slowed down to 4.6 percent in 2017/18 from 6.3 percent in the previous year largely due to deferment of the commissioning of Mangdechhu Hydropower Project (MHP). As in the past, Bhutan's economic growth continued to be predominantly driven by hydropower investment. Given high dependency on imports and narrow export base, the current account deficit continued to remain elevated at 18.4 percent of GDP in 2017/18. Higher public spending combined with easy access of credit to private sector (particularly in consumption and import oriented sectors) also contributed to widening of the current account deficit. Thus, persistent external imbalance in the economy continues to exert pressure on international reserves and exchange rate stability.

The domestic economy remained less integrated with the global market, Bhutan's financial and trade relationship with India deepened further with large hydropower investment, higher tourism inflows and enhanced inter-connectivity of payments and settlement system. The economic and policy reforms in India will have a direct impact on the domestic economy, mainly transmitted through prices and cross border trade. Strong economic growth of 7.7 percent in 2017/8 and subdued inflation in India has a positive spillover impact in the domestic economy.

Looking forward, the CPI inflation is expected to remain moderate with the easing of both food and non-food inflation. The real GDP growth is projected at 5.5 percent in 2018/19 and 7.2 percent in 2019/20 on the assumption that the MHP will come on stream as planned. With the recent pay revision, the private demand is also likely to contribute to growth though higher spending. With increased electricity production and nearing completion of hydropower projects, the current account deficit is likely to improve, making a positive impact on the level of international reserves.

The domestic macroeconomic prospects remain favorable over the medium term. However, the downside risks persist associated with softening of interest rates, particularly in consumption and import oriented sectors, continued dependency on the financial and trade flows with India and potential external shocks. Persistent external imbalances arising from the associated downside risks would put pressure on international reserves and pegged exchange rate arrangement.

In view of the above challenges, the RMA continues to focus on addressing both demand as well as supply front issues through policy interventions. Some of the interventions made by the RMA include; (i) broadening and deepening of financial sector through promotion of financial inclusion and financial literacy (ii) promoting easy access to finance for CSIs and priority sectors (iii) promotion of alternative equity financing options (iv) collaborating with the government in promoting economic diversification and developing entrepreneurial ecosystem for CSIs (v) formulation of market based monetary policy operation framework and (v) enhanced digitization and inter-connectivity in the payments and settlement system both domestically and in the region, starting with India.

The RMA's monetary policy stance will remain accommodative over the medium term to support the national objective of achieving a balanced, sustainable and inclusive economic growth. However, the RMA will keep close vigilance of the financial sector and overall macroeconomic developments and remain prepared to mitigate risk and challenges, guiding the economy to a sustainable path.

1. RECENT MACROECONOMIC DEVELOPMENTS

1.1 Macroeconomic Review[1]

Amidst ballooning global trade tension and tightening financial conditions in the advanced economies, world economy recorded a growth of 3.6 percent in 2018, slightly lower than the projected growth of 3.9 percent. Weaker consumer and business confidence in Euro area and prospects of disorderly exit of United Kingdom from European Union followed by policy uncertainties across many countries contributed in weakening of global growth in 2018. The global headline inflation remained low in the second half of 2018 with a drop in commodity prices - fuel and food prices and weak global demand, however the beginning of 2019 witnessed a recovery in the global fuel and food prices (*World Economic Outlook, April 2018)*.

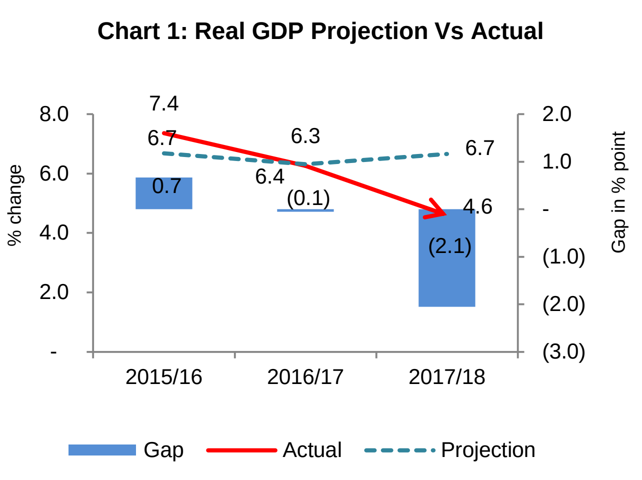
Within the region, Indian economy reflected a strong growth momentum in 2018 despite the lingering after-effects of demonetization and the GST implementation. The real GDP growth was recorded at 7.7 percent in fourth quarter of 2017/18, largely contributed by upturn in domestic investment and construction activities, and strong global demand. Enhancement in domestic demand through record expansion in agriculture production and increased rural housing and infrastructure development also supported the growth.

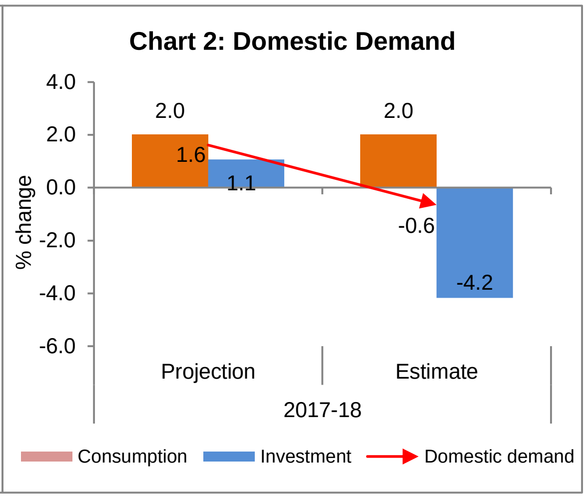
Indian CPI inflation declined to 2.9 percent in March 2019, compared to 4.3 percent in the previous year. Lower CPI inflation was driven by favorable supply side shocks and moderation in food and fuel prices. The slippage in prices of food and vegetables in the domestic market and reversal of crude oil price (to USD 52 per barrel) during the end of 2018 helped to pull down the overall price level in India.

The domestic economy grew at 4.6 percent during 2017/18, compared to initial projection of 6.7 percent. Downward revision of growth was attributed to deferment of commissioning of the MHP until 2019 and unfavorable hydrological flows. Initially

[1]*Comparisons between initial projections and revised estimates/projections are based on the April 2018 and April 2019 projections conducted by the MFCTC, respectively. The April 2019 projections are featured in the 2019 Monetary Policy Statement of RMA. All ratios to GDP using fiscal year GDP has been derived by averaging two calendar year GDPs. Other publications of RMA use calendar year GDP in all ratios; and therefore figures may vary slightly.*

electricity generation was projected to grow at 5.3 percent during 2017/18. However, due to deferment of commissioning of MHP in 2019, the electricity generation grew only by 1.4 percent, 3.9 percentage points lower than earlier projected.

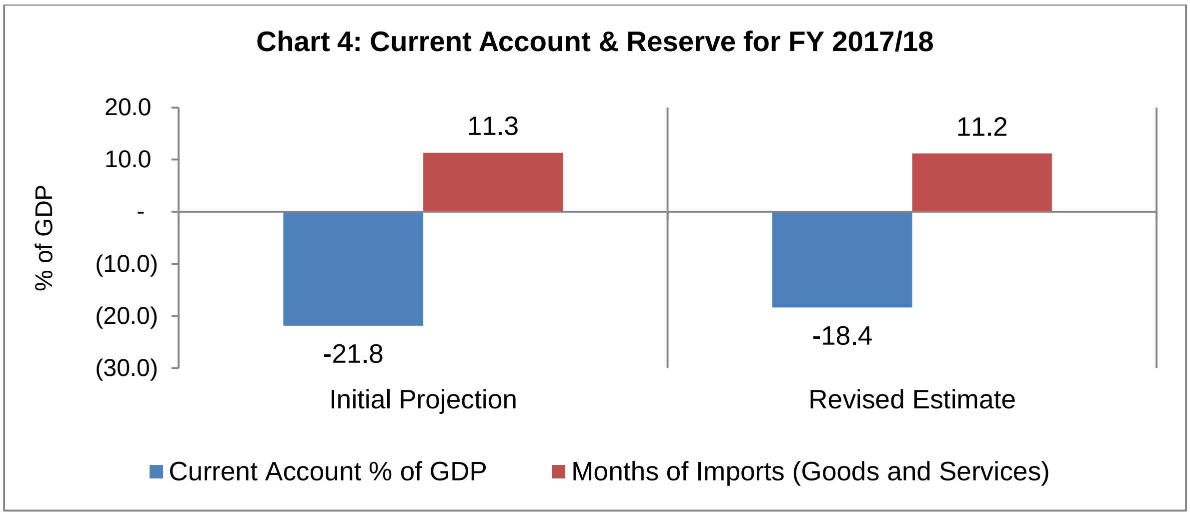




Similarly, growth in domestic demand (investment and consumption combined) fell by 0.6 percent during 2017/18, compared to 1.6 percent from earlier projection. Further, a significant drop in government investment resulted into fall in investment demand by 4.2 percent.

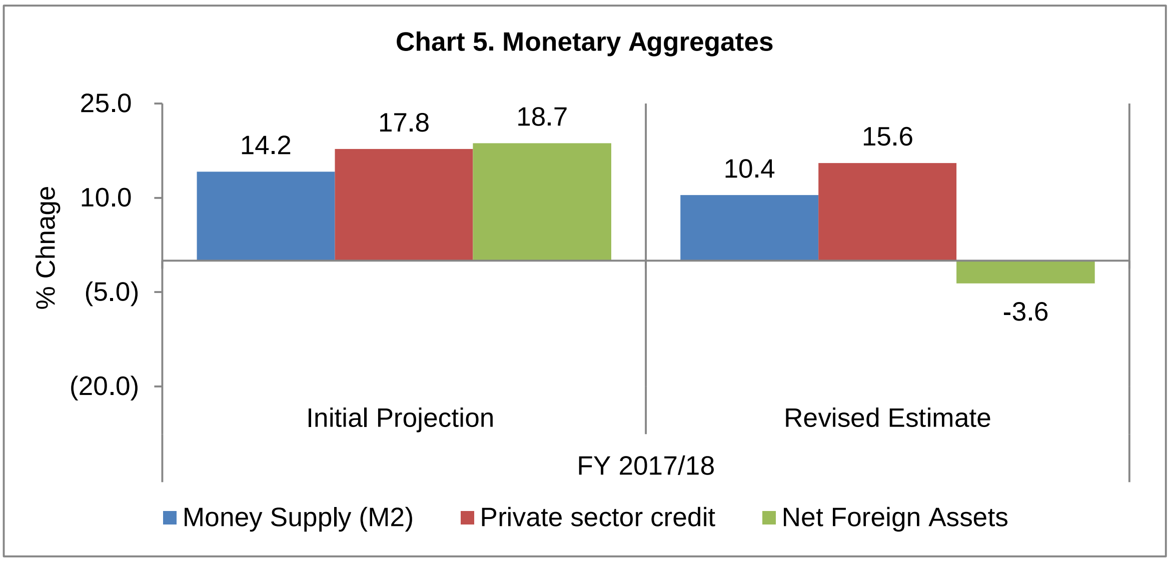
On budgetary front, the fiscal stance improved with the deficit at 0.3 percent of GDP, against the estimated deficit of 2.1 percent in the revised budget of 2017/18. Improvement was largely on account of lower level of capital and current expenditures which dropped by 15.4 percent and 3.7 percent respectively. The actual resources for expenditure spending also declined by 8.2 percent, due to decline in external grants. With lower level of expenditure, the domestic borrowing by the government for short-term fiscal management also reduced from initial estimate of Nu. 3,373 million to Nu.647 million during 2017/18.

Current account deficit improved at 18.4 percent of GDP during 2017/18 compared to initial projection of 21.9 percent. Lower trade deficit due to drop in merchandise import by 2.4 percent on account of slowdown in hydropower related imports contributed to the overall improvement in the current account balance.



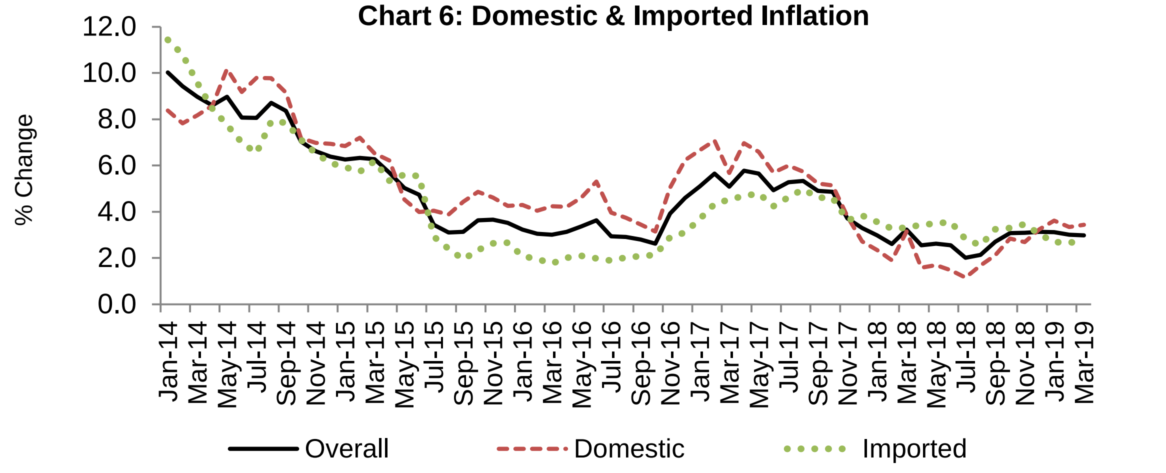
As in the past, the capital and financial account remains positive. During 2017/18, the balance of payment position improved to Nu. 4,857.2 million, compared to the initial projection of Nu. 1,925 million. Improvement in external position was mainly attributed to hydropower inflows, budgetary borrowings and short term INR Swap.

As a result, the gross international reserves stood at USD 1,110 million during 2017/18, lower by 10.6 percent as initially projected, sufficient to finance 28.8 months of essential imports. To manage international reserves, the RMA continues to invest in short term RBI T-Bills and also avail the GoI credit line and Swap facilities for financing the balance of payments and managing the exchange peg with India.



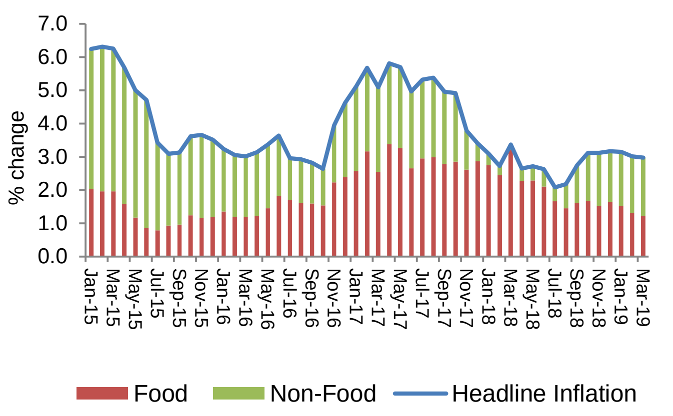
In tandem with developments in the fiscal and external sector, the financial sector also witnessed moderation in major monetary aggregates. The broad money supply (M2) decreased to 10.4 percent during 2017/18, lower by 3.8 percentage points as initially projected. Downward revision in growth of M2 is attributed to significant fall in Net Foreign Assets (NFA) by 3.6 percent as initially projected at 18.7 percent. Consequently, fall in NFA helped to reduce the build-up of excess liquidity in the banking sector, restraining the credit growth. Credit to private sector grew at 15.7 percent during 2017/18, compared to 17.8 percent as initially projected. As witnessed in the past, the credit allocation continues to be concentrated in selective sector, particularly in housing and construction and personal loans. Downside risk of softening interest rates in non-productive sector and rising Non Performing Loan (NPL) continued to remain as a challenge.

Chart 6: Domestic & Imported Inflation



On inflation front, historical decomposition of CPI inflation reveals that imported inflation has remained mostly moderate on average compared to domestic inflation. As an outturn, low inflationary pressure in India combined with decline in domestic food price helped to

Chart 7: Contribution of Food & Non Food Inflation to Headline Inflation



slightly edge down CPI inflation to 3 percent in March 2019 from 3.2 percent in March 2018.

Overall, CPI inflation has been largely driven by both domestic and imported food prices. In terms of contribution, vegetables and bread & cereals (weight 19.6% and 24.4% respectively) are main drivers of food inflation. However, contribution of vegetables to food inflation has been on a declining trend over the years. Within the food basket, fish and meat recorded higher inflation during March 2019, while their weights remain relatively lower than vegetables, cereals and diary items.

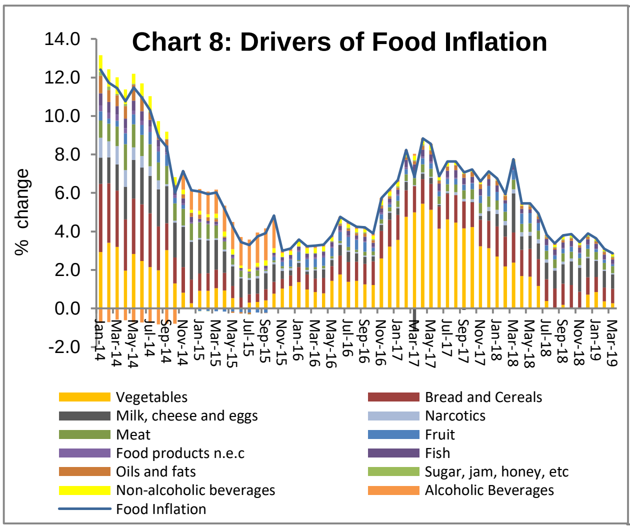


Chart 8: Drivers of Food Inflation

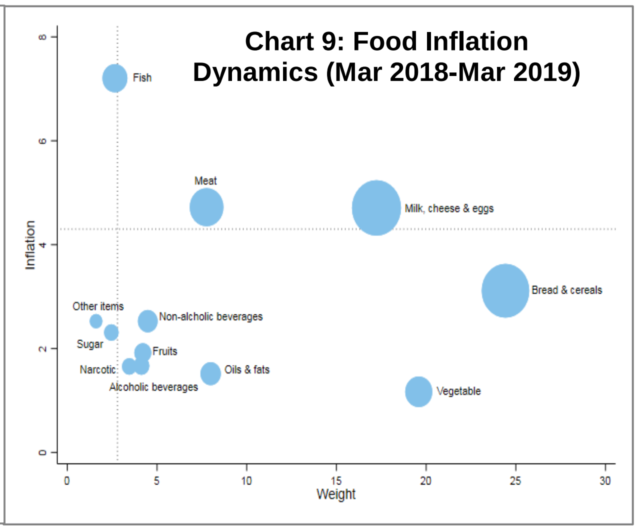


Chart 9: Food Inflation Dynamics (Mar 2018-Mar 2019)

Despite higher weight assigned to non-food basket, non-food prices remained relatively lower than food prices. Among the non-food items, housing (weight: 21.7%) continued to remain as a top driver followed by transport (weight: 11.9%) and clothing (9.2 %). Although, share of housing and transport to non-food inflation constituted

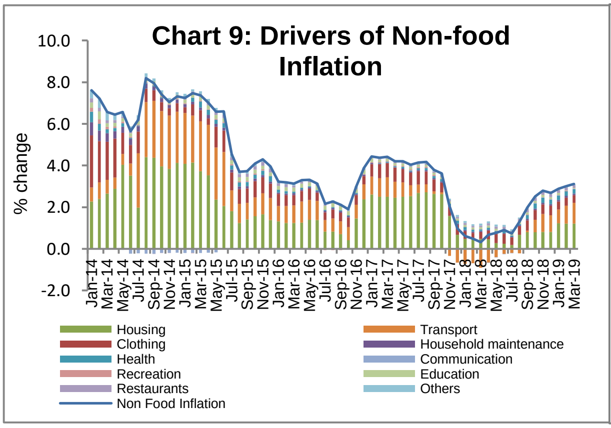


Chart 9: Drivers of Non-food Inflation

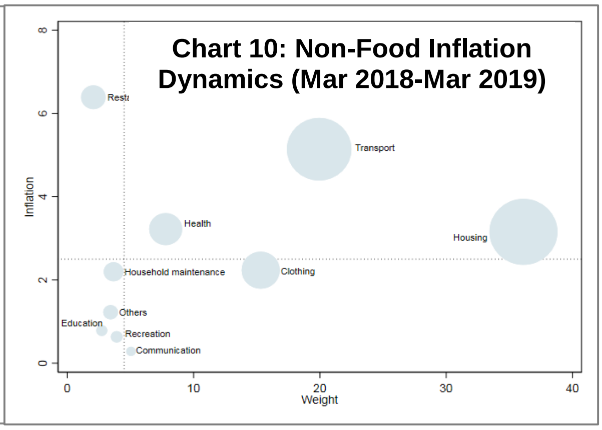
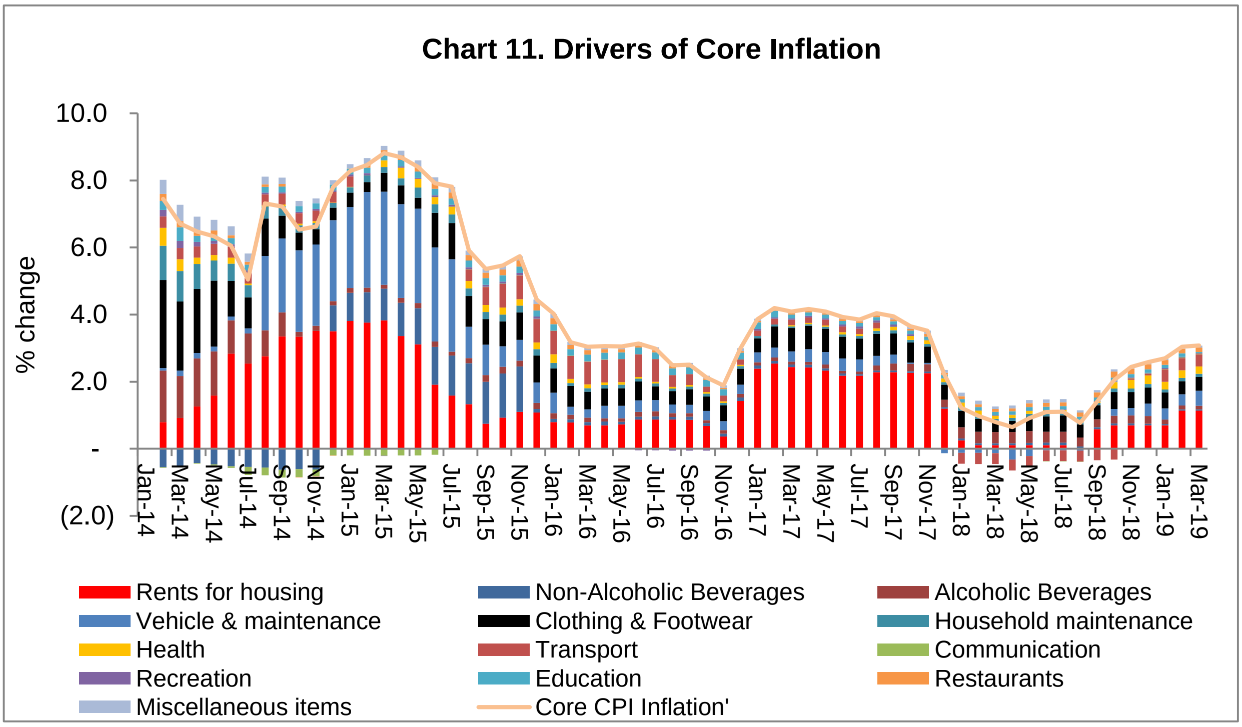


Chart 10: Non-Food Inflation Dynamics (Mar 2018-Mar 2019)

relatively higher than other items, restaurant recorded the highest inflation during March 2019.

The core inflation, excluding food and fuel price, was recorded at 2.9 percent in March 2019, compared to 0.6 percent in March 2018. However, rebound in vehicle import price and pick up in house rent had resulted in higher core inflation, converging with the CPI inflation.

Similarly, core inflation was driven by rents for housing (1.2%), followed by vehicle imports and maintenance (1%). Rise in cost of construction is one of contributing factors for increase in the price of housing.



2. UPDATES ON RMA'S KEY POLICY INTERVENTIONS

The RMA initiated a number of supply side interventions following BEFIT 2017.The BEFIT was instituted in 2017 as a national platform for policy dialogue and to foster partnership and coordination among various agencies and leveraging international expertise to find innovative and sustainable solutions to address contemporary challenges faced by the economy. Following BEFIT 2017, some of the notable initiatives undertaken by the RMA to improve access to finance and enhance financial inclusion include;

1. Formulation and implementation of Bhutan National Financial Inclusion Strategy (2019-2023) and National Financial Literacy Strategy (2019-2023).

2. Issuance of licenses to (i) Five Microfinance Institutions (ii) Three Private Money Lenders and (iii) Two E-money Issuers. In terms of financial inclusion coverage, as of December 2018, there were 169 bank branches and 70 bank extension offices with 246 numbers of ATMs and 779 numbers of Point of Sales facilities. Similarly, 452 agent bankers and 1944 insurance agent licenses were issued across the country.

3. Reinforcing momentum in the priority sector lending activities in the Dzongkhags. As of December 2018, 20 Dzongkhags collectively received 1,274 applications for Cottage and Small Industries sector. Of the total applications, 1009 projects were approved and a total of Nu. 305.8 million loans were sanctioned to 316 projects by the financial institutions. Of the total, 78 percent of the projects were related to agricultural CSIs and remaining were non-agricultural CSIs.

4. To assist start–up businesses with equity financing, Jabchor was launched on December 13, 2018. Jabchor is an initiative for "angel investors" to partner with innovative entrepreneurs and grow with them into a successful venture, based on trust and confidence supported by legally executed business partnership deed.

5. The RMA in collaboration with the National Payments Corporation of India will soon be connecting the Bhutan Financial Switch with the National Financial Switch in India and join the RuPay network. Through this initiative, interconnectivity of two national switches will promote cross-border interoperability in conducting banking transactions using their local bank ATM or debit cards through any of the delivery channels such as ATMs, PoS or merchant's e-commerce sites. This integration is expected to pave way for the RuPay brand to become one of the growing payment networks in the cards space, at par with the dominant international players.

6. Safeguarding the consumers in the financial market. The RMA in collaboration with Office of the Consumer Protection of Ministry of Economic Affairs is currently in the process of finalizing the Consumer Protection for Financial Services Rules and Regulations.

7. Organizing second International Conference from July 16-18, 2019 in collaboration with the Government, under the platform of BEFIT on the theme of "Catalysing CSIs to drive Bhutan's economic diversification" with an aim to achieve inclusive, sustainable and equitable economic growth based on GNH values.

3.MEDIUM TERM MACROECONOMIC OUTLOOK

3.1 Medium-term Outlook[2]

Domestic CPI inflation over the medium term is projected at 4.7 percent, remaining within the range of Indian inflation target of 4 percent with a band +/- 2 percent. Domestic CPI inflation, which constitutes 48 percent basket items, is expected to be driven by food prices and house rent. With rebound in electricity production, the real GDP is projected to grow at 5.5 percent in 2018/19 and 7.2 percent in 2019/20. The electricity production is projected to grow at 6.9 percent in 2018/19 and 11.1 percent in 2019/20 with commissioning of hydropower projects . The fiscal deficit is estimated at 1.9 percent of GDP in 2018/19, subsequently to 3 percent in 2019/20, largely on account of repayment for external borrowing and pay revision.

Over the medium term, trade balance is projected to improve significantly at 8.7 percent of GDP in 2018/19, contributed by higher growth in export (24.3%) on account of electricity sale and fall in hydro related imports. As a result, the current account deficit is projected to improve at 13.4 percent of GDP in 2018/19 and 9.7 percent in 2019/20. As usual, other official inflows in the form of capital transfers and external loans will continue to finance current account deficit, leading to overall positive balance of payment at 1.1 percent of GDP in 2018/19 and 9.2 percent of GDP in 2019/20. Due to net surplus of capital and financial flow, the gross international reserve is projected at Nu. 124,430 million (USD 1800) on average during the medium term, sufficient to cover 26.7 months of essential imports.

The M2 is expected to increase at 8.3 percent in 2018/19 and 17.8 percent in 2019/20. The pathway of M2 outlook remains volatile on the account of uncertainty of NFA flows. Due to decline in projection of official financial flows, the NFA is expected to grow modestly at 1.9 percent during 2018/19. With increasing effort to deepen financial inclusion, the private sector credit is projected to grow at 14.1 percent in 2018/19 and 11.3 percent in 2019/20.

[2] *Medium-term outlook has been revised, based on the outturn of the FY 2017/18 and new developments. Medium term refers to FY 2018/19 to FY 2019/20.*

Particulars	2017/18	2018/19	2019/20	2020/21
	Actual	(Projections)		
Output and Prices				
Nominal GDP at market prices (Mn. of Nu)	173,365.40	192,827.04	216,655.93	241,361.35
Real GDP (annual % change)	4.60	5.53	7.21	5.91
Agriculture & allied activities	4.10	4.42	4.18	4.36
Industry	1.13	3.91	7.14	3.81
Manufacturing	7.95	10.27	10.27	10.27
Electricity & water	-3.88	6.86	11.06	2.16
Construction	0.60	-4.75	-0.91	-0.81
Services	7.45	9.64	11.09	8.86
CPI (annual % change)	2.55	4.70	4.50	4.60
Balance of Payments and Reserves (Mn. of Nu)				
Current account balance	32,032.71	-25,823.59	-21,092.50	-17,368.58
(in % of FY GDP)	-18.48	-13.39	-9.74	-7.20
Merchandise exports	38,859.25	48,292.98	57,287.75	61,303.11
(growth in %)	5.39	24.28	18.63	7.01
Merchandise imports (c.i.f.)	66,390.34	64,992.53	67,994.71	70,452.13
(growth in %)	-2.40	-2.11	4.62	3.61
Trade balance (% of FY GDP)	-15.88	-8.66	-4.94	-3.79
Current and capital grants	18,088.89	5,521.31	11,371.22	14,381.73
of which, budgetary grants	13,552.89	5,521.31	11,371.22	14,381.73
Financial account balance	-10,206.64	-17,978.60	-26,648.11	-13,282.70
Overall balance (Mn. of Nu)	4,857.21	2,196.57	19,859.59	12,362.17
International Reserves (Mn. of USD)	1,110.91	1,119.68	1,409.43	1,591.35
(Months of essential imports)	28.81	23.68	26.98	27.61
(Months of merchandise imports)	13.01	14.07	13.83	16.73

Particulars	2017/18	2018/19	2019/20	2020/21
	Actual	(Projections)		
National Budget (Mn. of Nu)				
Total Resources	52,113.17	42,949.11	54,619.19	57,467.48
(in % of FY GDP)	30.06	22.27	25.21	23.81
Domestic revenue	36,871.37	34,321.82	43,299.07	43,053.48
(in % of FY GDP)	21.27	17.80	19.99	17.84
Grants	14,847.07	8,262.86	10,934.31	14,181.97
Total expenditure	56,331.36	46,724.59	61,197.31	69,714.64
Current	27,494.71	29,105.46	34,652.77	41,845.67
Capital	28,836.65	17,619.12	26,544.54	27,868.98
Fiscal balance	-545.50	-3,775.47	-6,578.11	-12,247.17
(in % of FY GDP)	-0.31	-1.98	-3.04	-5.07
Money and Credit (Mn. of Nu)				
Money Supply (M2)	113,121.66	122,534.66	143,931.58	163,051.47
(annual % change)	10.43	8.32	17.46	13.28
(in % of FY GDP)	65.25	63.55	66.43	67.55
(Income velocity)	1.53	1.57	1.51	1.48
Credit to private sector	86,985.09	98,803.00	110,002.83	122,026.97
(in % of FY GDP)	50.17	51.24	50.77	50.56

Data are as of FY ending June, including GDP which is also presented on FY basis. Source: MFCTC, Ministry of Finance (projections as of April 2019) and IMF. 1) The source of fiscal projection is the Ministry of Finance. 2) The RMA is the source for BOP data. 3) GDP data are sourced from the National Statistics Bureau. 4) Indian CPI Inflation data are sourced from the RBI Monetary Policy Report, April 2019.

4. RISKS AND CHALLENGES

Over the medium term, the economy continues to remain dependent on external sector. Delays in hydropower project completion and deferred electricity export and its proceeds will be the immediate risk of managing the sector. Continued dependence on import due to domestic supply bottleneck is a persistent challenge faced by the economy. As a result, maintaining a sufficient level of international reserves to manage the current account deficit and pegged exchange arrangement becomes crucial. Efforts towards promoting economic diversification and employment generation will be the priority intervention over the medium term. This calls for a collective, coordinated and cross sectoral intervention supported by a well-organized financial sector.

Further, the economy will continue to be exposed to external shocks transmitted through financial and trade flows from India. With recent experience, the commodity prices and exchange rate volatilities are the predominant factors that influenced the domestic prices and trade. With pegged exchange arrangement, the movement in Real Effective Exchange Rate (REER) in Bhutan is strongly correlated with Indian Rupee exchange rate and its price movements. As of December 2018, the Indian Rupee depreciated by 9.2 percent against the US dollars. As a result, the REER and Nominal Effective Exchange Rate in Bhutan also depreciated by 2.7 percent and 1.1 percent respectively. In nominal terms, the exchange rate depreciation of Ngultrum impacted the external debt, increasing both stock of debt and debt servicing. The domestic economy will continue to remain vulnerable to exchange rate volatilities over the medium term.

Promoting easy access to finance for productive investment becomes critical, while the concern on rising Non Performing Loan (NPL) and ensuring financial sector stability remains and requires close monitoring and supervision. Implementing risk based supervision backed by micro and macro prudential measures will be crucial to prevent potential risks in the financial sector. Further, concerns on softening of interest rate in consumption and import oriented loans continues to drive the outflow of international reserves and trade imbalances particularly with India putting pressure on the exchange rate peg.

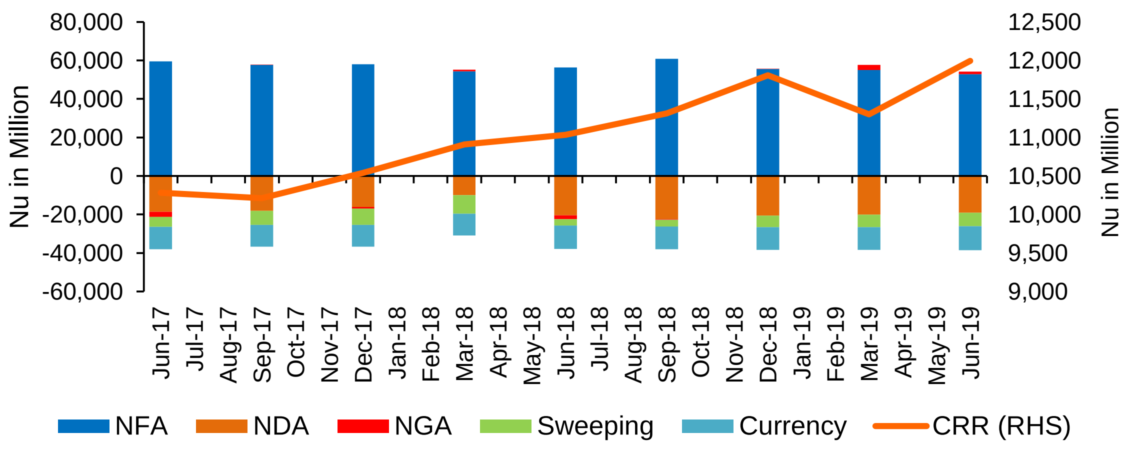
5. LIQUIDITY CONDITIONS AND MONETARY POLICY

5.1 Liquidity Conditions in the Banking System

Development of liquidity in the banking sector affects the growth of M2 and credit. To support the price stability and pegged exchange arrangement, effective management of liquidity in the banking system is crucial . Liquidity conditions in the banking sector is determined by autonomous factors[3] of the RMA balance sheet, namely (i) Net Foreign Assets (NFA) (ii) Currency in Circulation, (iii) Net Domestic Assets (NDA), (iv) Net Government Account (NGA) and (v) Sweeping of Accounts.

In absence of foreign exchange intervention, the NFA was the main driver of liquidity in the banking sector. The inflow of funds related to hydropower projects and official grants resulted in accumulation of NFA, leading to structural surplus liquidity in the banking sector.

Chart 12: Autonomous Liquidity Drivers

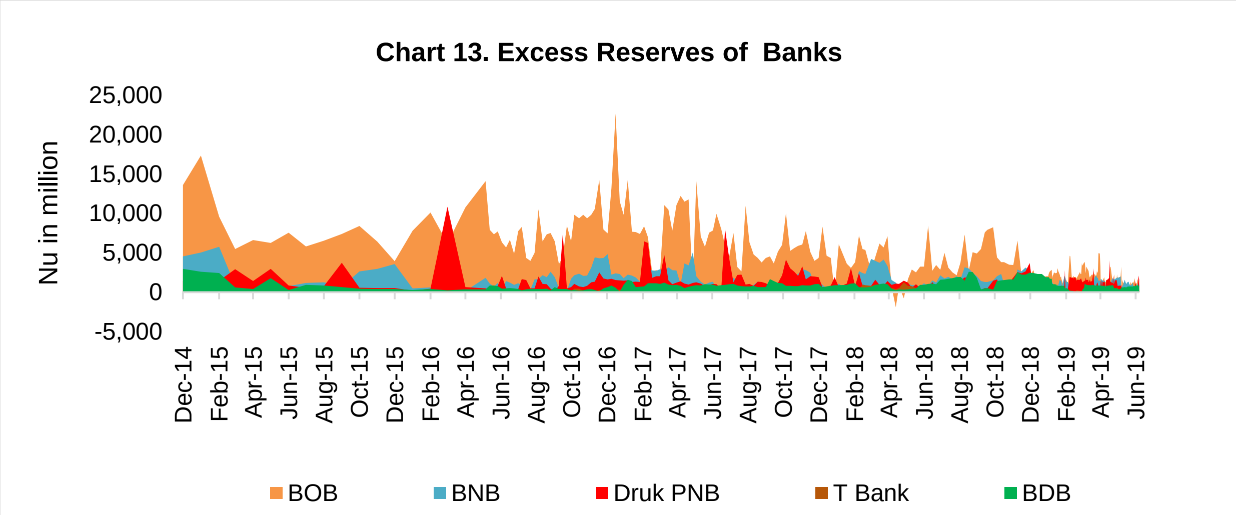


In terms of liquidity distribution among the banks, the Government owned bank, the Bank of Bhutan holds high liquidity surplus compared to other banks (Chart 12). Since majority of the government transactions (managing government deposits and

[3] The items on the RMA's balance sheet, either on assets or liabilities side are not controlled by the RMA in its monetary policy role.

disbursements) are managed by the Bank of Bhutan, there is a resultant build-up of liquidity surplus. In absence of fully functional inter-bank market and liquidity concentration in few banks, the transmission of monetary policy is likely to become ineffective.

Currently, the government issues T-bills in the domestic market to manage short term cash deficits. Given the structural liquidity surplus and limited investment avenues, the banking sector has incentive to invest in short-term government securities at a competitive rate. However, due to uneven distribution of liquidity and lack of demand for short term funds in the economy, the T-bills rate do not signal the benchmark rate for short term funds in the market.



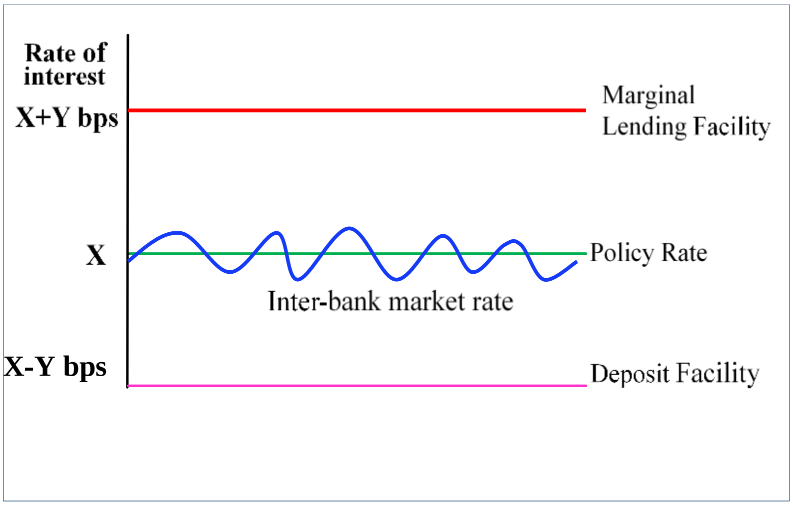
Analysis on the position of excess liquidity of the banking sector reveals that they are on a declining trend in the recent years. The RMA's continued effort to widen the scope of sweeping account to reduce volatility in overall liquidity of the banking sector has contributed for this development.

5.2 Open Market Operations by RMA

The RMA's new monetary policy operation framework will be conducted through Open Market Operations (OMOs). The OMO refers to buying and selling of securities by RMA to keep the short-term rate (policy rate) at the targeted level. The policy rate will be determined based on market condition and broader macroeconomic consideration.

Through buying and selling of securities, the RMA will use short-term interest rate (Poicy rate) to influence the cost of fund in the banking sector.

For instance, if economy experiences inflationary pressure, the RMA may decide to hike the short-term interest by selling securities through OMOs. By selling the securities, it will reduce availability of liquidity in the banking sector, which will increase the cost of fund.



When cost of fund increases, lending will decline, resulting into fall in aggregate demand and investment. Eventually, this would transmit into easing of domestic inflationary pressure. Effectiveness of OMOs depends on transmission mechanism and accuracy of liquidity forecast.

To manage the liquidity at desired level in the banking sector, the RMA will set an interest rate corridor in the form of Marginal Lending Facility (MLF) and Deposit Facility (DF) as illustrated in the Chart 13. The MLF and DF are upper and lower bound within which interbank rate operates. For instance, if a commercial bank faces liquidity shortage, it may resort to interbank borrowing as long as interest rates are below the MLF rate. Otherwise, it may prefer to borrow from the RMA using the MLF. Under the MLF, the RMA will use collateralized overnight standing facilities as instrument to inject liquidity in the banking sector.

5.3 Monetary Policy Stance

Keeping view of macroeconomic developments and challenges, the RMA's monetary policy will continue to remain accomodative to support government's overarching objectives of promoting economic diversification for achieving balanced, sustainable and inclusive economic growth over the medium term. The RMA will continue to accord high priority to promote access to finance and technical backstopping for CSI sector development.

At the same time, the RMA will continue to strengthen monetary policy operation framework to support pegged exchange rate arrangement with Indian Rupee. To maintain exchange rate stability, the RMA will ensure availability of adequate Indian Rupee all the times. Effective and efficient management of international reserves and foreign exchange flows will continue to remain a vital strategic priority for the RMA over the medium term.