

# MONETARY POLICY STATEMENT JULY 2020

## INFOGRAPHIC

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Budget

Value for mo



## ROYAL MONETARY AUTHORITY OF BHUTAN

+ 10

+ 10



## OUR VISION

A trusted, progressive and resilient Central Bank

## OUR MISSION

**R**einforcing stable and inclusive economic growth **M**aintaining stability and integrity of the financial system **A**dvancing innovative financial services and technology

## STRATEGIC PILLARS

Reinforcing stable and inclusive economic growth

Maintaining the stability and integrity of the financial system

Advancing innovation and financial technology

Fostering organizational excellence

## OUR VALUES

**S** - Sincere **M** - Mindful **A** - Astute **R** - Resilient **T** - Timeless





## MONETARY POLICY STATEMENT

The Monetary Policy Statement is prepared by the Royal Monetary Authority of Bhutan in accordance with Chapter II, Section 10 of the Royal Monetary Authority Act of Bhutan 2010. The Statement is issued annually in July, coinciding with the first month of the new financial year. The Statement highlights recent macroeconomic developments and economic outlook, review of Phase I monetary policy measures initiated during the FY 2019-2020, and the Phase II monetary policy measures. The Statement also presents special analysis on selected macroeconomic topics.

The Statistics presented in this Statement are based on Multi-sector Macroeconomic Framework Coordination Technical Committee projections, endorsed by the policy-level Macroeconomic Framework Coordination Committee.

## ACRONYMS

BEFIT	Bhutan Economic Forum for Innovative Transformation
CPI	Consumer Price Index
CSI	Cottage and Small Industry
FI	Financial Institution
FY	Fiscal Year (July 1 – June 30)
FYP	Five Year Plan
GDP	Gross Domestic Product
GST	Goods and Services Tax
LAF	Liquidity Adjustment Facility
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
MLR	Minimum Lending Rate
NFA	Net Foreign Assets
RBI	Reserve Bank of India
RMA	Royal Monetary Authority of Bhutan
WALR	Weighted Average Lending Rate
WEO	World Economic Outlook
USD	US Dollars



# CONTENTS

<b>Policy Statement</b>	<b>7</b>
<b>Macroeconomic Developments</b>	<b>9</b>
<b>Inflation</b>	<b>14</b>
<b>Macroeconomic Outlook</b>	<b>17</b>
<b>Review on Monetary Policy Measures: Phase I</b>	<b>26</b>
i. Reduction of Cash Reserve Ratio and Liquidity	26
ii. Minimum Lending Rate	27
iii. Concessional Term Based Working Capital for Wholesale Distributors	29
iv. Concessional Term Based Working Capital for Tourism and Related Business	29
v. Concessional Term Based Working Capital for Industries	30
vi. Deferment of Loan Repayment	30
vii. Interest Waiver	31
viii. Extension of Gestation Period for Projects under Construction	31
ix. Loans to Cottage and Small Industries	31
<b>Monetary Policy Measures: Phase II</b>	<b>32</b>
i. Conversion of Term Based Working Capital Facility	32
ii. Deferment of Loan Repayment	32
iii. Interest Waiver	33
iv. Concessional Short Term Loans to Micro Business and CSIs	33
v. Concessional Term Loans to Businesses (Bridging Loans)	33
vi. Liquidity Adjustment Facility	33
<b>Box 1: Potential Output</b>	<b>34</b>
<b>Box 2: Revision of Cash Reserve Ratio</b>	<b>36</b>
<b>Box 3: 21<sup>st</sup> Century Financial Sector Roadmap</b>	<b>40</b>





## POLICY STATEMENT

**H**igh uncertainty on the severity and duration of the COVID-19 pandemic fallout has brought a unique challenge for the central banks across the globe in calibrating an effective monetary policy. In the worst-case scenario, without considerable implementation of monetary and fiscal policy measures at the wake of increasing COVID-19 outbreak within and among its trading partners, the domestic economic growth is forecasted to contract by -1.1 percent in 2020. Thus, the economy is projected to perform below its potential level, resulting in higher unemployment.

In order to maneuver the immediate impact of the COVID-19 pandemic and to position for quick recovery during the post-crisis, maintaining an adequate level of liquidity in the banking system and keeping interest rates low is the forefront of monetary policy until the economy returns to a new normal. This will help to attain output and employment, maximizing growth within a reference rate of inflation over the medium-term.

With the pandemic and containment measures, many firms are facing declining revenue, falling investment and labor demand. On the household front, rising job losses and cutback in wages has reduced household spending thereby impacting both supply and demand. The supply side sectors, except in the electricity and agriculture sector, industrial production has been adversely affected with the severe regional and global supply chain disruptions. In addition, internal containment measures have resulted in temporary closure of several economic activities. The tourism, hospitality and entertainment sectors are experiencing the stiffest hit, followed by the construction sector. As per the scenario analysis, the tourism and allied sectors are forecasted to remain almost shutdown for more than a year and the construction sector to fall at an unprecedented level.

Ever since the outbreak of the pandemic followed by rapid containment measures, economic activities began to experience downward trend. The RMA made its first monetary policy decision to reduce the CRR by 100 basis points on 17th March 2020. Simultaneously, the Authority in close consultation with the banks and the government implemented various measures to support the disrupted sectors. The measures include providing term based soft working capital at concessional interest rates to industries, wholesalers, and tourism and allied sectors. Further, the deferment of loan and interest waiver for a period of three months until June 2020 was also granted under The Grant of the Druk Gyalpo's Relief Kidu through the National Resilience Fund.

The interventions were mainly to signal confidence in the market and to provide short term liquidity support to affected households and business firms, until the commencement of the implementation of the government fiscal stimulus. The sizeable stimulus of about 15 percent of GDP was announced in April 2020 which will be implemented within the next 15 months' to boost domestic demand and supply. To ensure continued liquidity support and to boost market confidence, the RMA further reduced the CRR by 200 basis points on

27th April 2020. Within one and half months, the reduction of CRR from 10 percent to 7 percent contributed towards injecting an additional liquidity amounting to Nu 4.22 billion into the banking system.

More importantly, the successive CRR cuts and credit relaxations have helped to maintain credit flows and augmented the cash flow for the borrowers, and prevented sectoral spillover effects. The Grant of the Druk Gyalpo's Relief Kidu along with the broad-based monetary and fiscal policy response has provided passable relief for the households and business firms initially, and prevented economy from further contraction.

As an outcome of these measures, the economy is expected to revive at 1.0 percent growth in 2020, compared to the baseline scenario (-1.0% growth). Moreover, contraction of domestic demand is forecasted to narrow to -5.1 percent from -6.9 percent. Likewise, the level of unemployment is expected to improve with a modest inflationary pressure. Over the medium term, if the pandemic subsides, growth is projected to rebound at pre-COVID level at 5.2 percent by the end of 2021 and macroeconomic conditions to normalize by the end of 2022.

With the downward trend in both domestic and external demand, over the medium term, the upward inflationary pressure will remain below an implicit target of 4.5 percent. Considering macroeconomic outlook and challenges posed by the COVID-19 pandemic on the economy, a targeted accommodative monetary policy stance will continue during the FY 2020-21.

Accordingly, the RMA has formulated and implemented Phase II monetary policy measures to support the COVID-19 affected sectors, while keeping vigilance and maintaining the overall financial stability in the financial sector. While doing this, the cross sectoral collaboration and efforts in mitigating the adverse impact of the pandemic on the health and the economic front needs to be optimally ensured and strategized as undertaken in the past in order to revive the growth to a new normal.

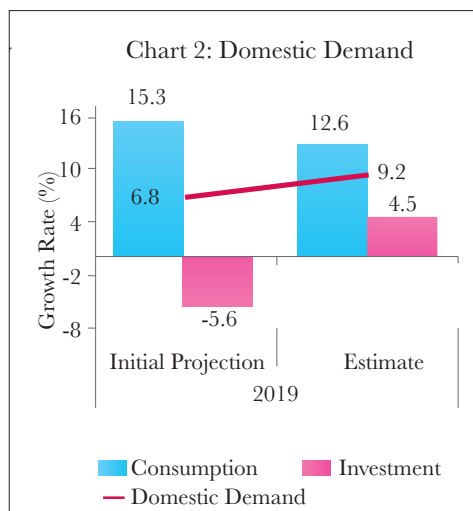
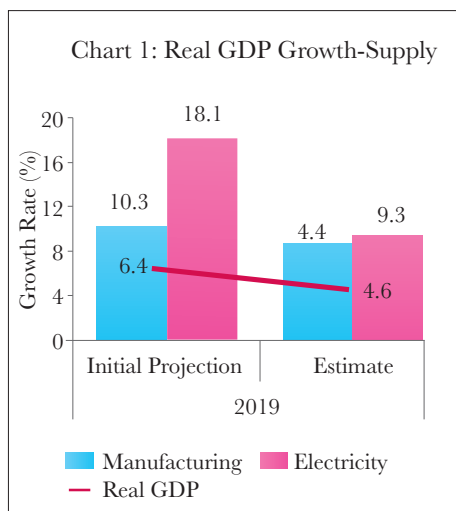
## MACROECONOMIC DEVELOPMENTS

**The prolonged trade disputes, weaker investment demand, and flaring-up in geopolitical tensions have adversely impacted global growth in 2019.** The world economy recorded a 2.9 percent growth—the lowest growth since the global financial crisis in 2009. A downward growth trend was experienced across the globe, more pronounced in major advanced and emerging economies. This broad-based economic slowdown in 2019, largely resulted from a sharp slowdown in international trade, dampening investment and industrial growth. The softening demand in the global market has affected world commodity prices where price levels remained muted in the advanced economies and slight moderation in the emerging and developing economies. Against this backdrop, continued easing of monetary policy in several economies till the second half of the year supported economic stabilization. As per the World Economic Outlook (WEO) update, January 2020, the growth in 2019 would have been at least 0.5 percentage points lower than the realized growth without given accommodative monetary policy measures. The United States, the world's largest economy experienced a growth slowdown from 2.9 percent (2018) to 2.2 percent (2019), despite several interest rate cuts. In the Asian region, China, the second largest economy and the region's powerhouse growth also trended downward.

**Within the South-Asia, India, the most dominant economic player in the region also experienced a sharp economic slowdown at 4.2 percent in 2019 (FY 2019-20)-the lowest growth since 2008 (4.0 percent).** The two percentage points drop from 2018 was the worst economic deceleration since 2016, attributed to contraction in investment demand and manufacturing sector production. The household investment demand dropped by -3.0 percent against 9.0 percent increase in 2018, as a result of slowdown in the economy. Amidst the growing concern on growth prospects with the rise in food prices, headline inflation surged to 4.5 percent against 3.4 percent in 2018. The excessive and unseasonal rain towards the last quarter of 2019 resulted into exceptionally high vegetable and fruit prices, pushing the headline inflation to 4.6 percent in the month of October above the target of 4 percent. Inflationary pressure up ticked in December 2019 to 7.3 percent, breaching the upper threshold inflation level of 6 percent, the highest since July 2014. In the wake of rising price level and downward slide in economic growth, the Reserve Bank of India (RBI) reduced the policy rate consecutively for five times in 2019.

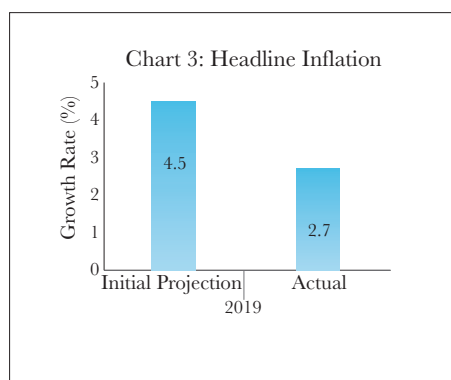
**Reflecting on the recent development in the domestic economy, Bhutan also witnessed a downward growth trend since 2017.** As per the latest estimate, in 2019, the economy grew by 4.6 percent. The deceleration in growth from an initial projection of 6.4 percent is attributed by lower realization in the electricity, manufacturing and construction sectors. Electricity generation was projected to grow at 18.1 percent, but witnessed a growth of 9.3 percent. The decline in the growth was due to rescheduling of the Mangdechhu project to the second half of year from the initial commissioning date which was at the beginning of 2019. Similarly, with the declining demand, largely the investment demand through government expenditure and hydropower construction, there

has been a sharp downward revision in the manufacturing sector growth at 4.4 percent and construction sector at -9.4 percent against 10.3 percent and -4.7 percent respectively. During the period, the realized growth in service sector remained at the initial level at 11.1 percent from 2018.



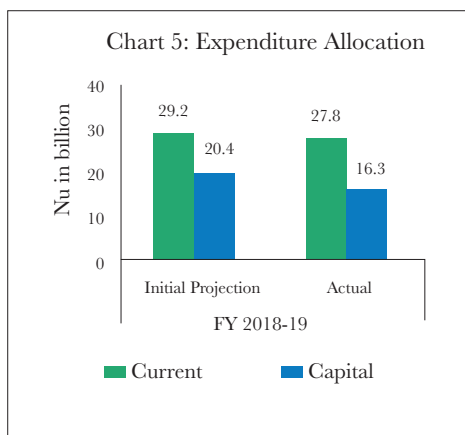
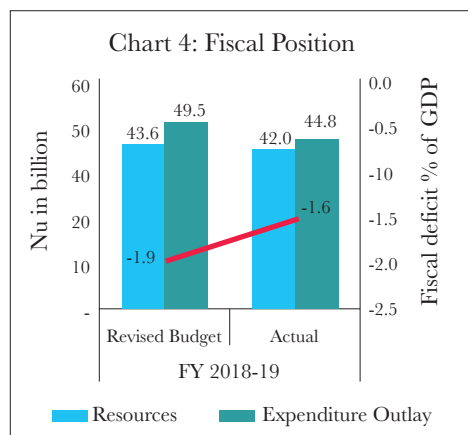
**On the demand side, the gross domestic demand in 2019 grew by 9.2 percent compared to 6.8 percent from the earlier projection.** This has been driven through higher growth realization in consumption demand in the household sector and marked enhancement in the investment expenditure. The growth in private sector credit and lower level of commodity prices supported the household consumption growth at 12.6 percent. Further, the enhanced capital budget through revised budget of FY 2018-19 has drastically narrowed the projected drop in government investment from -21.4 percent to -1.4 percent. As a result, the overall investment growth expanded by 4.5 percent against -5.6 percent drop in the initial projection. The enhanced gross domestic demand at 9.2 percent against a moderate supply growth at 4.6 percent pushed the trade deficit to 16.4 percent of GDP, against 10.4 percent of GDP in the earlier projection.

**On the inflation front, despite growing inflationary pressure in India, the headline inflation in Bhutan remained at a modest level<sup>1</sup>.** As per the initial projection, price level was projected to elevate at 4-5 percent with the likely development of



<sup>1</sup>Anchored to reference economy where the Ngultrum is pegged at one-to-one with the Indian Rupees.

price pressure in India. However, during the review period, the weaker price transmission through imported inflation retained price level at 2.7 percent. In tandem to food price inflation in India, since the end of 2019, domestic food inflation drove the overall inflation, while non-food price pressure remains subdued throughout the review period.



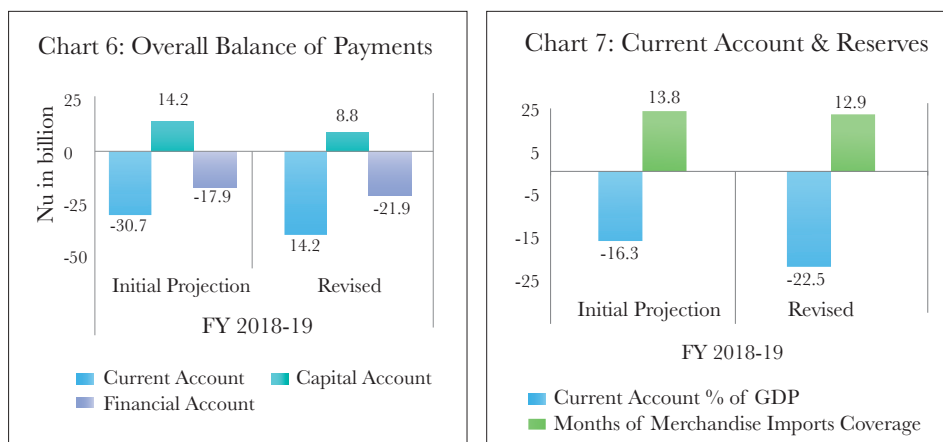
**In the financial year 2018-19, the actual budget outlay accounted for 25.4 percent of GDP as opposed to the projected 25.7 percent of GDP.** Accordingly, the fiscal stance improved marginally to 1.6 percent of GDP, as against the anticipated deficit of 1.9 percent of GDP. This marginal improvement in the fiscal deficit was mainly on account of lower level of spending on both current and capital expenditure by 4.7 percent and 8.0 percent respectively. The total resources also dropped to Nu 42.0 billion from the initial estimate of Nu 43.6 billion with the fall in domestic revenue.

In terms of revenue mobilization, the total domestic revenue during the FY 2018-19 was Nu 34.7 billion, a decrease of 6.2 percent from the previous year. The reduced domestic revenue was mainly due to low electricity production and delay in commissioning of the Mangdechhu hydro project<sup>2</sup>. Nevertheless, as mandated by the Constitution and the Fiscal Policy, domestic resources covered the entire current expenditure and also financed almost 20 percent of the capital expenditure. During the FY 2018-19, a total grant of Nu 10.5 billion was received, witnessing a decrease of 29.2 percent from the previous year. The fiscal deficit in comparison to the preceding FY 2017-18 has widened to Nu 2.7 billion (1.6% of GDP).

<sup>2</sup> The MHP was initially projected to commission in June 2018, however, following the technical complexities, it commissioned only in August 2019.

**Following the fiscal deficit, the balance of payments continued to record a deficit in the current account with Nu 39.68 billion during FY 2018-19, compared to the initial projection of Nu 25.82 billion.** The capital inflows in the form of budgetary grants decreased to Nu 8.77 billion from the initial projection of Nu 14.17 billion on account of decline in hydropower related grants. However, the net financial inflows largely constituting of FDI flows, currency deposits and external loans, during the review period was recorded at Nu 21.88 billion, against Nu 17.87 billion in the initial projection.

As compared to the initial projection, current account deficit widened by 22.5 percent of GDP against the 16.3 percent of GDP. The widening of current account deficit was mainly

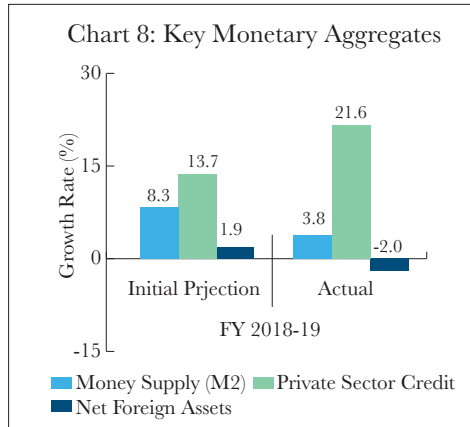


on account of increase in net service payments and primary income payments. The trade deficit also deteriorated slightly from the initial projection of Nu 29.72 billion to Nu.29.88 billion, while the net secondary income receipts remained almost at a same level.

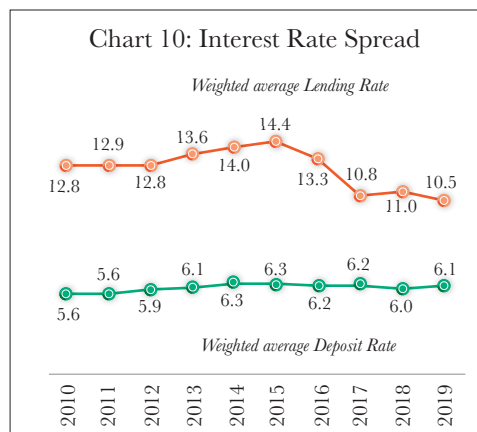
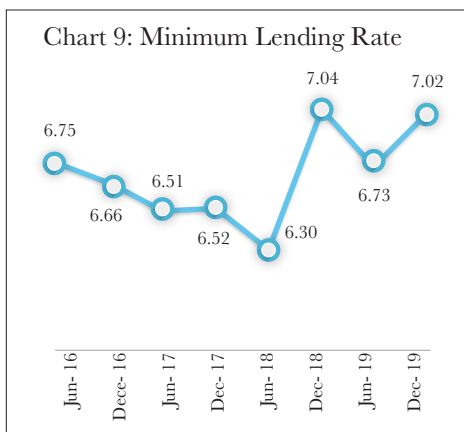
With the decline in the hydropower grants, the net capital receipts decreased by 38.1 percent while the net financial receipts increased by 22.4 percent from the initial projection. The net capital and financial inflows were able to finance only 77.2 percent of current account deficit. As a result, the gross international reserves decreased to USD 1,064.77 million in FY 2018-19, compared to USD 1,110.91 million in FY 2017-18. During the period, the reserves were adequate to cover 12.9 months of merchandise imports. Of the total reserves, USD 843.67 million were convertible currency and 15.24 billion in INR. In order to meet the balance of payments obligations with India, the economy continues to rely on the INR Swap facility and the Standby Credit Facility.

<sup>2</sup> The MHP was initially projected to commission in June 2018, however, following the technical complexities, it commissioned only in August 2019.

**With the economic slowdown, the money supply which was projected at 8.3 percent in FY 2018-19, slowed down to 3.8 percent.** The drop in monetary base by -4.5 percent is driven by decline in excess reserves maintained at the RMA<sup>3</sup>. Currency in circulation, which accounted for 39.2 percent of reserve money grew by 2.3 percent, compared to 6.4 percent during the previous year. The Net Foreign Asset (NFA) which is the main contributor of money supply dropped by -2.0 percent which was anticipated to grow at 1.9 percent in the earlier projection.



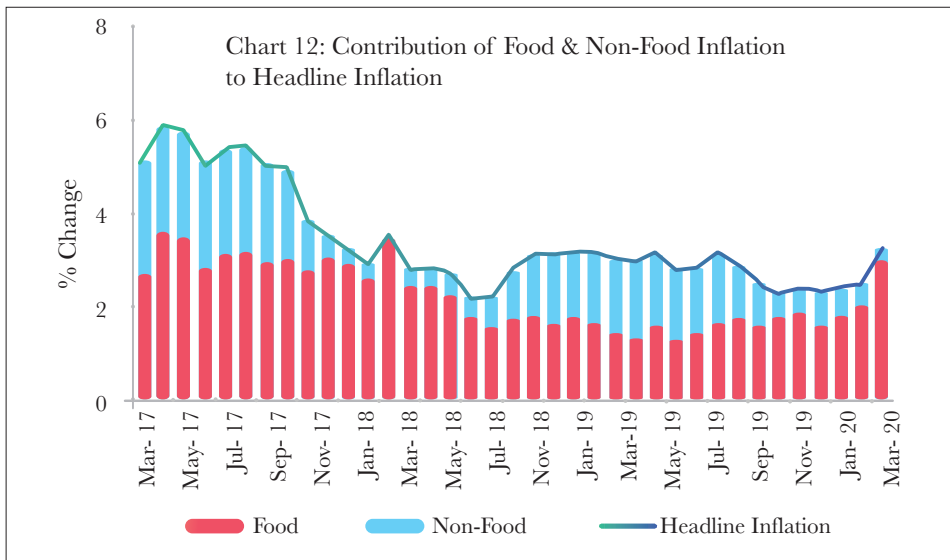
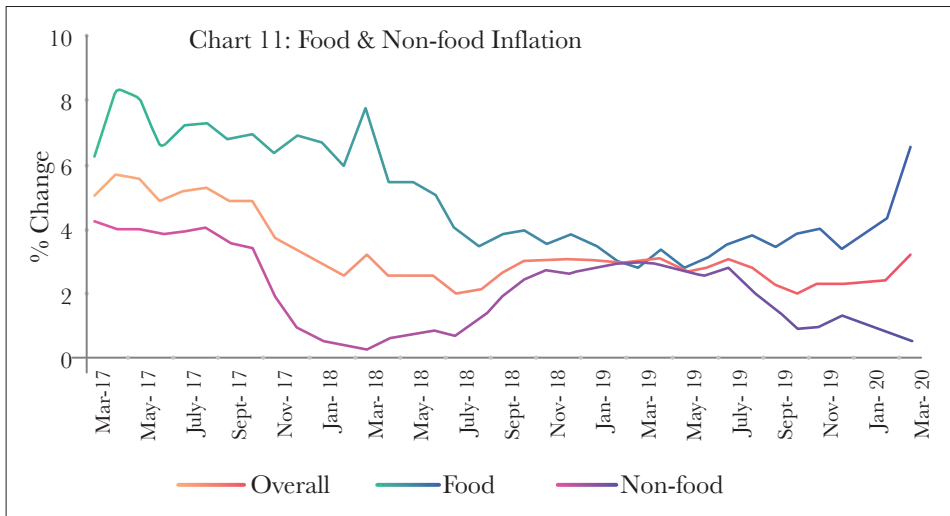
The fall in hydropower receipts, official grants and increase in scheduled repayment for the short-term borrowing led to the decline in NFA. Despite the drop in NFA, the private sector credit grew by 21.6 percent, primarily driven by the construction, service sector, and personal loans. Thus, the credit to deposit ratio increased from 86 percent in December 2018 to 95 percent in December 2019. The implementation of Minimum Lending Rate (MLR) since July 2016 also aided the softening of interest rate in the recent years. Although the annual MLR did not vary significantly since its implementation, averaging at 6.7 percent, the changes in the interest spread witnessed a notable reduction from almost 7 percent in 2016 to less than 5 percent in 2019. The Weighted Average Lending Rate (WALR) also reduced from 13.3 percent in 2016 to 10.8 percent, while deposit rate remained almost constant in 2019.



<sup>3</sup> The decline in monetary base was attributed to RMA's effort to sterilize bank's access reserves through sweeping of the current account which are mostly volatile inflows, particularly the hydropower project financing and budgetary grants. Currency in circulation to GDP ratio also decreased by 0.4 percent in FY2018/19.

## INFLATION

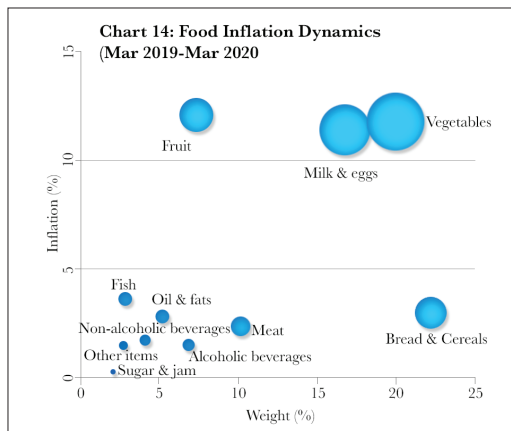
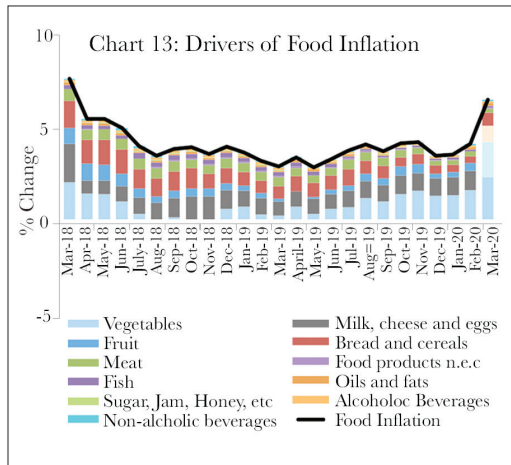
More recently, since the last quarter of 2019, there has been a gradual rise in inflation. This was largely attributed to rising food inflation transmitted through imports—largely from India. Given the double-digit food inflation in India, food prices in Bhutan also rose steadily from 2.2 percent in October 2019 to 3.3 percent in March 2020. Moreover, with the update in CPI basket from earlier reference period in





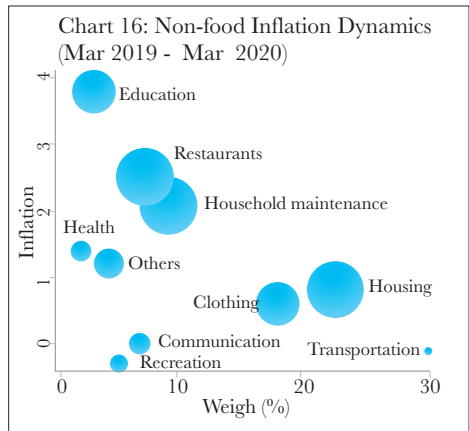
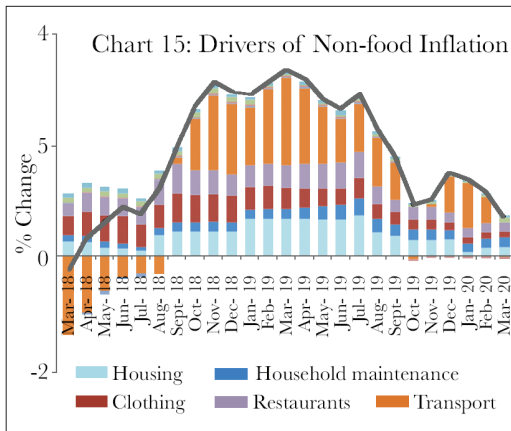
2012 to 2017, the share of food price increased to 45.3 percent from 39.9 percent and share of non-food declined to 54.7 percent<sup>4</sup>. On year-on-year basis, food inflation in March 2020 surged to 6.5 percent against 2.8 percent in March 2019. The relative food price contribution to the overall inflation increased from a low 46.0 percent in March 2019 to 76.7 percent (in October 2019) and then to 90.2 percent in March 2020.

The development in food inflationary pressure within the last one year was mainly driven by exceptionally high vegetable and fruit prices in India. For instance, at the end of 2019, the onion price in India was four times higher due to supply-chain disruptions in the market. Such exorbitant rise in prices of vegetables, fruits and other food items in India directly impacted the food inflation in Bhutan. The relative share of vegetable price to food inflation increased at 35.5 percent in March 2020 against 8.0 percent in March 2019, followed by milk, cheese and eggs at 29 percent and bread and cereals at 11 percent.

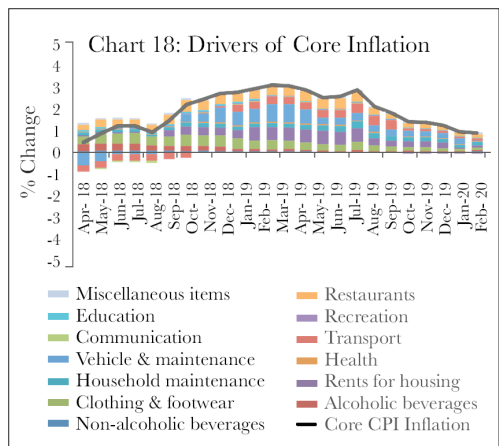
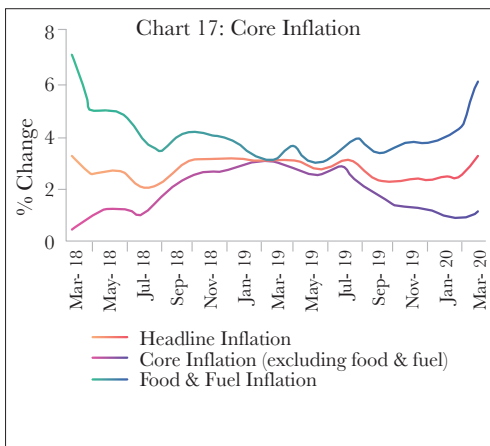


As compared to food prices, generally the prices of non-food items are less volatile in nature except with the fuel prices which evolved from the supply disruptions. As reflected in the graph, since the end of the first quarter of 2019, there has been a divergence in food and non-food price path with a sliding trend in non-food price. The deflation in transport related prices through falling fuel prices has resulted into overall disinflation in non-food prices. Except in the prices of education largely contributed by hike in fees and charges in the private education services, the prices of other non-food items remain subdued within the last one year.

<sup>4</sup> The consumer price index was rebased in April 2019 (April=100) from December 2012. The revised weights in the consumer basket was based on Bhutan Living Standard Survey 2017.



The core inflation, excluding food and fuel prices measures the relative change in the price of non-volatile consumer price item. The core inflation remains subdued over the last twelve months. Despite a modest pickup at the end of 2019, core prices started to decline steadily from 3.0 percent in March 2019 to 1.1 percent in in March 2020. The slowdown in the core inflation is attributed to fall in communication and recreational service prices, followed by modest increase in maintenance of vehicles, transport and house rent.



## MACROECONOMIC OUTLOOK

**A**s a result of the COVID-19 pandemic, the global economic conditions have deteriorated sharply since the end of the first quarter 2020. The pandemic has brought high uncertainty and changed the global economic prospect from short-term to longer-term. By the pandemic itself and through the containment measures such as isolation, social distancing, lock downs and increased cross border controls by individual countries, there has been a substantial reduction in both global demand and supply. As per the April 2020 WEO, IMF, the global growth is estimated to contract sharply by - 3 percent in 2020- much worse than the global financial crisis of 2009 (-0.07 %). With the declining market confidence and slow progress in development of vaccine, global growth is forecasted to rebound to pre-COVID level only by mid-2021.

**Similarly, the South Asian region is also equally impacted by the pandemic and projected to experience the worst economic performance in 40 years.**

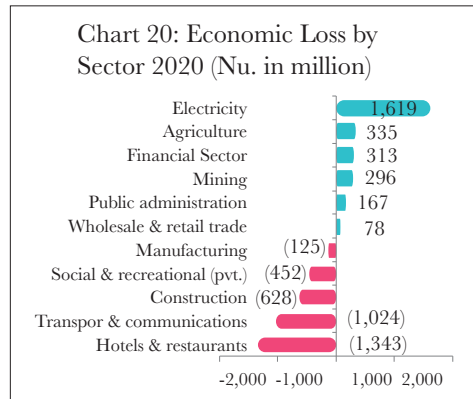
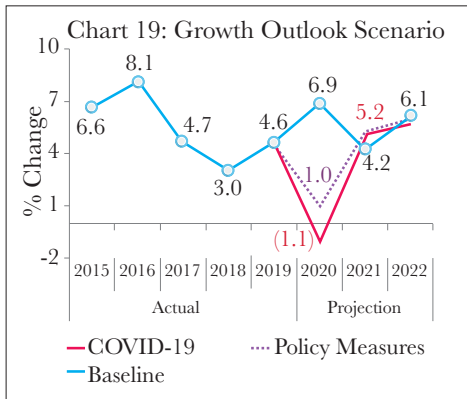
Amidst experiencing slower economic growth in 2019, India, the most dominant economic player in the region is forecasted to face further economic slowdown with the onset of the pandemic at 5.0 percent (RBI), 1.9 percent (WEO, IMF) from the initial projection of 7.0 percent in 2020 (FY 2019-2020). With the unfavorable base effect coupled by supply disruptions from the pandemic and rapid depreciation of INR, inflationary pressure in FY 2020 is most likely to rise. On the positive side, the timely monetary easing measures such as reduction of key policy rate five times from high of 6.5 percent in 2018 to 5.2 percent in October 2019 and further by 75 basis points in March 2020 (4.4%) and sizeable fiscal stimulus (of about 10% of GDP) are anticipated to reposition the economy once the pandemic subsides.

**Being a small and open economy, Bhutan has also been experiencing a severe economic impact from the COVID-19 pandemic.**

The unlikely scenario of the pandemic subsiding over the next one to two years and constant containment measures is expected to constrain growth prospect. The temporary ban on tourist arrival and preventive measures such as closure of schools, social distancing, closure of border gates and simultaneous national lockdown in India affected the economic activities in the country. The host of these measures consequently depressed the economic growth at -1.0 percent (supply shock) in 2020, the lowest growth in the economic history-worst case scenario<sup>5</sup>. However, under the national economic response plan, the estimated fiscal stimulus and monetary measures are likely to boost domestic demand and reverse economic growth at 1.0 percent (200 bps higher than worst case scenario).

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<sup>5</sup>In conjunction to global growth contraction by 3 percentage points in 2020 and sharp economic slowdown in India, Bhutan anticipates the COVID-19 pandemic will continue throughout 2020. The worst case scenario of economic growth does not include impact of policy measures.



The service sector which is the highest contributor to the economic growth and largely dependent on the tourist arrival is severely hit. The service sector production is projected to shrink by -6.5 percent with economic loss in the hotel and restaurants, transportation and entertainment services. The restriction on import of foreign workers has derailed construction activity in the beginning of 2020 and is most likely to continue with limited scope for relaxation in cross-border labor mobility in the near term. With the declining domestic and external demand for finished products, the industrial production is also projected to fall in 2020. On the upside, hydro electricity production is the only sector which remains unaffected from the COVID-19 that will cushion further economic deterioration.

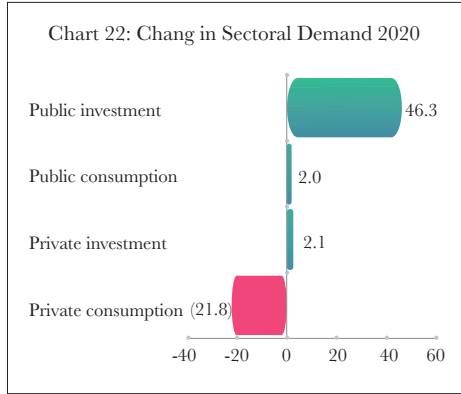
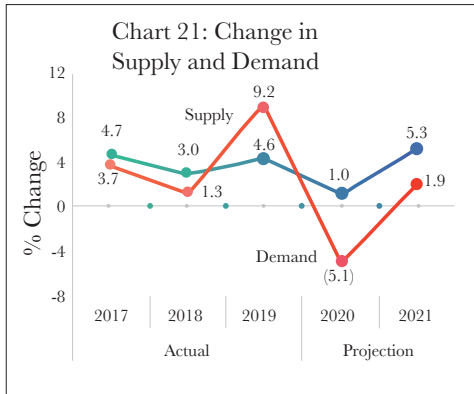
Similarly, the limited external market access, internal containment measures, and enhanced demand for domestic agriculture produce are expected to boost agriculture production. Given the swift and strong monetary easing measures implemented since March 2020, followed by the proactive fiscal measures, the coordinated and broad-based policy response is expected to protect the economy from falling into recession and bounce to full recovery by the end of 2021 as the pandemic subsides. As per the forecast, the growth estimate is expected to pick-up at 1.0 percent in 2020 and projected to rebound to pre-COVID level by the end of 2021 with the ongoing policy measures.

**The overall standstill in economic activities has immediately impacted household and business income, thereby affecting the domestic demand.**

Compared to supply side, the overall demand is forecasted to shrink by -5.1 percent in 2020 (demand shock). This is mainly driven by the expected fall in private consumption by -21.8 percent, comprising about 73 percent of total consumption (45% of GDP). This unprecedented drop is partly due to diminishing purchasing power of consumers with the change in consumption pattern and consumer behavior. Although consumption

<sup>3</sup>In conjunction to global growth contraction by 3 percentage points in 2020 and sharp economic slowdown in India, Bhutan anticipates the COVID-19 pandemic will continue throughout 2020. The worst case scenario of economic growth does not include impact of policy measures.

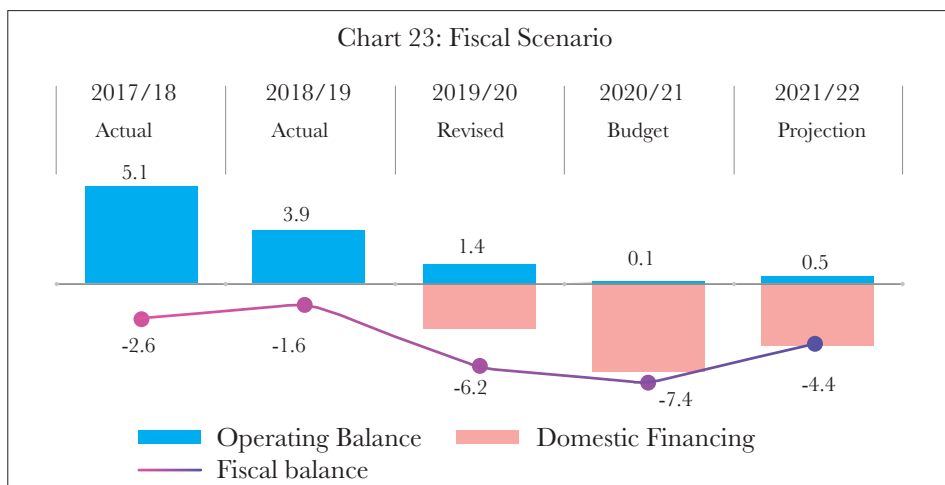
expenditure on essential food items remains more or less constant, the lower level of demand for lifestyle food and non-food items has perceptibly impacted consumer spending. With the loss in confidence and limited expectation on the progress of household income, consumer spending would continue to remain below normal level over the medium term. On the positive side, enhancement of government consumption expenditure is expected to help mitigate the worsening of consumption demand in the economy.



Like private consumption demand, through the income effect, the private investment is also forecasted to experience lackluster growth in 2020, with 2.0 percent against 7.1 percent in 2019. Despite recent private investment revival in 2019, the investors’ appetite for risk is expected to decrease with the drop in both domestic and external demand as a result of the pandemic. The investment in construction sector is severely affected, firstly due to the problem of labor shortage with the restriction of foreign workers, and secondly, due to continuous dip in demand for construction. On the comforting prospect, due to the pandemic, new investment opportunities are laid out for targeted sectors including agriculture and CSIs to promote innovation and bring more values to consumers and businesses. Further, it provides renewed opportunities to invest and upgrade existing core infrastructure through construction sector- addressing the country’s critical constraint of development and growth.

**As part of policy response to stimulate economic growth, the enhanced government capital expenditure budget in FY 2020-21 by 46.3 percent is expected to lift overall investment demand.** The FY 2020-21 budget appropriation has approved Nu 36.3 billion (16<sup>0</sup> of GDP), the highest capital outlay, which is projected to enhance overall investment demand in the economy by 11.9 percent during the financial year. Through the fiscal multiplier effect, it would generate additional investment and consumption demand in the subsequent years, while positioning the economy for quick recovery post COVID-19. Therefore, amid the pandemic, the government sector will be the key driver of aggregate demand until the private sector returns to a new normal.

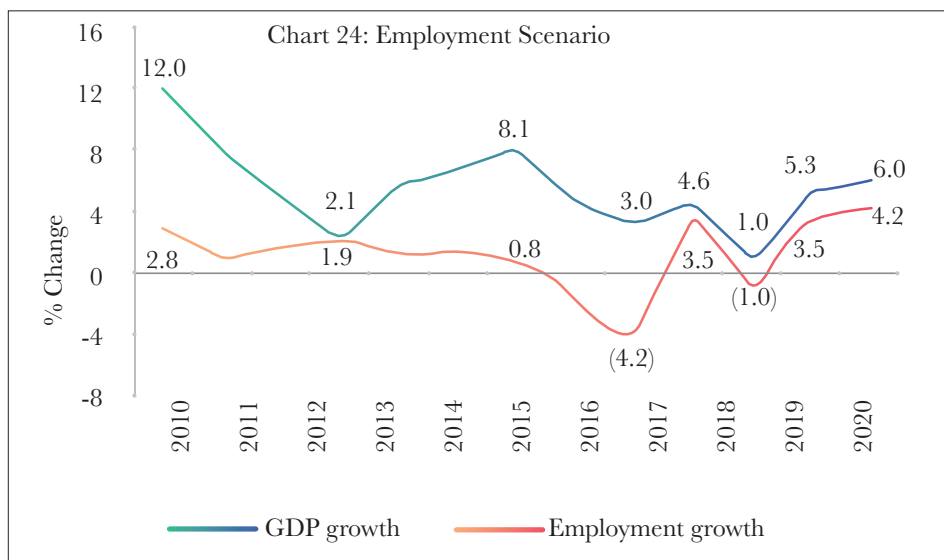
**With the downward growth trend and high uncertainty of economic recovery from the COVID crisis, the impact on labor market would be significant.** As per the rapid socio-economic impact assessment of the COVID-19 in the tourism sector, more than one third of the respondents are either laid off or have closed their own-account business and over 60 percent responded that their monthly income dropped by more than 50 percent<sup>6</sup>. This indicates that within a month (April 2020) from the COVID-19 outbreak and through various containment measures, the households and businesses are severely impacted mainly through loss of employment. With the forecasted economic growth at a historic low, as per the estimated growth-employment elasticity, the overall employment



level in 2020 is expected to fall by -1.0 percent<sup>7</sup>. Given the limited opportunities for the existing unemployed, increasing displacement of employees and closure of on-account business, growing number of returnees from overseas employment, and increasing number of new graduates; the rate of unemployment in 2020 is forecasted to be almost in double digit under the worst-case scenario. The tourism and allied sectors under the service industry is hit the hardest and gradually the impact is foreseeable in other sectors, except in agriculture and electricity sector. Given that more than 50 percent of total employment is in agriculture, the possible positive growth in agri-related activities would prevent further worsening of the employment scenario. With the unlikely subsiding of the pandemic in the near future and spread of diminishing labor demand in various sectors, unemployment level is projected to rebound to pre-COVID level only by the end of 2021. However, the constant policy interventions to boost aggregate demand would assist quick recovery in labor market situation as the pandemic subsides gradually.

<sup>6</sup> “The Rapid Socio-economic Impact Assessment of the COVID-19 on Tourism Sector” in Bhutan was carried out jointly by the NSB, TCB, GNHC and UNDP based on Survey in May 2020.

<sup>7</sup> The simple arc elasticities and point elasticities is calculated to find co-efficient of employment elasticity to growth for the potential output estimation and to find direction of the unemployment rate. In view of limited time series data, the estimate is based on arc elasticities with desk’s judgement.

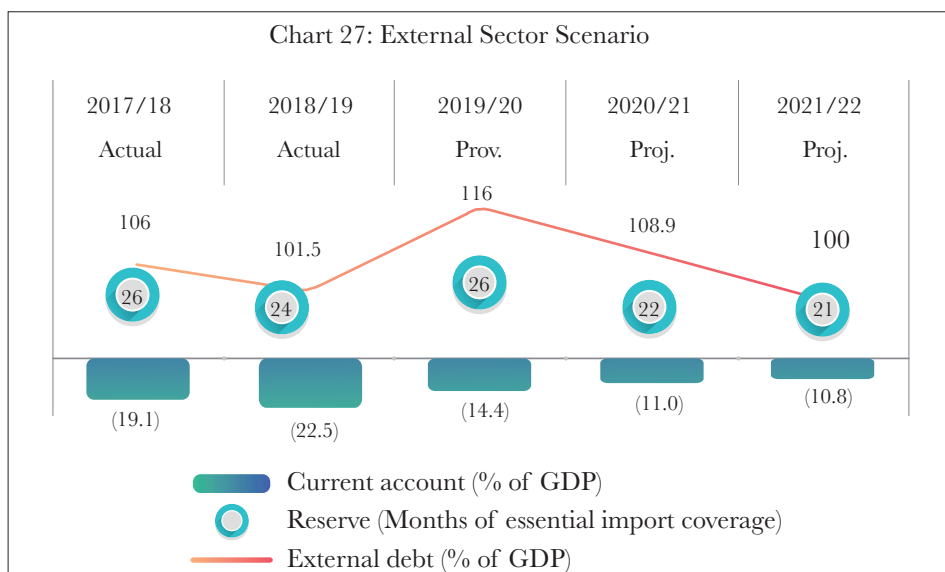


**Supported by the declining global fuel price, the softening of price pressure in India, and weak domestic demand conditions, the domestic price is expected to continue within the benchmark or implicit inflation target level.** Despite weaker domestic demand, the inflation level is forecasted to pick slightly in the near term within a range of 3-4 percent with growing market uncertainty. Moreover, there will be a downside risk of rapid depreciation of INR and supply disruptions potentially inducing inflationary pressure through import.

**On the external front, in the short run, trade imbalance is expected to slightly improve with the lower domestic demand for imports and continued electricity exports.** Conversely, with continued rise in the COVID-19 cases and stringent containment measures in the region and abroad, regaining of external demand for exports of goods and revival of tourism business are unlikely and would worsen the current account imbalances. Despite projected fall in imports with lower domestic demand, the downside risk of lower external demand for non-electricity merchandise exports and tourism services would result in external imbalances, if the COVID-19 prolongs beyond 2020. At the same time, with the reduced investment demand, the projected fall in financial inflows would also impact accumulation of external reserves. With the net zero impact of narrowing current account deficit and declining financing inflows for reserves, the coverage of essential imports is projected to remain at the existing range of 20-23 months in the medium term.

The external debt stock as of March 2020 stood at USD 2.8 billion (Nu 207.6 billion), equivalent to 112 percent of GDP. In terms of external debt by currency, about 73 percent (INR 150.8 billion) of external debt is Indian Rupee debt and of which 86 percent of INR debt is hydro related. The recent INR depreciation against US dollar has impacted convertible currency debt servicing and also increased overall debt stock by 2.5 percentage

points of GDP, compared to March 2019. Moreover, an increase of about 2.0 percent of GDP fiscal deficit financing through external sources during FY 2020-21 and persistent fiscal deficit over the medium term would increase the external debt burden.

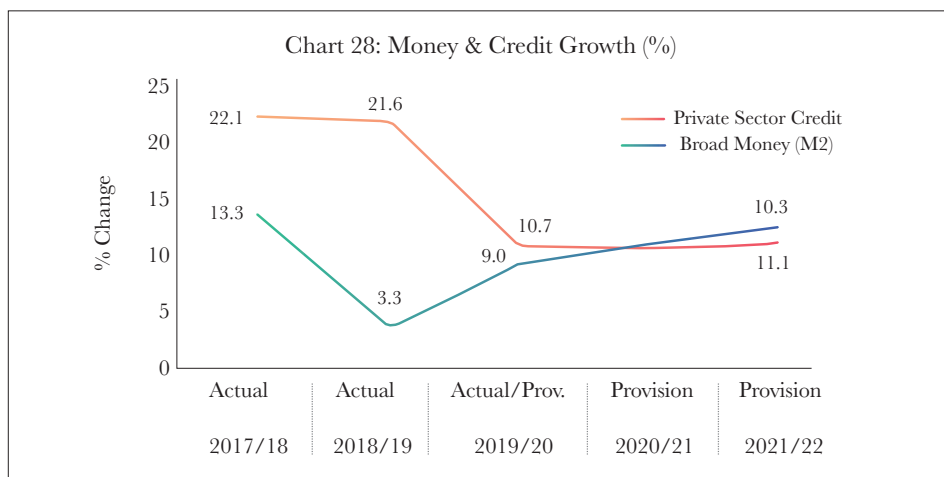


**Despite recent slow down in economic growth, the enhanced domestic credit has been instrumental for maintaining moderate level of aggregate demand.**

The monetary aggregate (M2) constantly expanded in tandem to nominal GDP growth and remained supportive of economic growth. The availability of credit at lower interest rates attributes to growing demand for private consumption and investment demand. For instance, average weighted lending rate was reduced on an average by one percentage point annually since the implementation of MLR in 2016. This was partly due to adequate liquidity in the banking system as reflected by the credit to deposit ratio at above 95 percent. However, optimism on the supportive domestic credit market suddenly dimmed with the onset of the COVID-19 crisis in the beginning of March 2020. The impact of the pandemic began to be felt as the government prepared containment measures where demand for credit is projected to decline at 10.7 percent by June 2020.

As a result, accommodative monetary policy stance to support growth and to safeguard the livelihoods of individuals and business firms was undertaken strategically by the RMA. It was mainly to signal its responsiveness for ensuring confidence in the financial system, and to provide liquidity support as a broad-based COVID-19 measures in coordination with the government. The degree of uncertainty on how bad the impact of the pandemic will be across the sectors, how long the containment measures will persist, how the households and consumers will change their behaviour, and how effective the mitigating policy measures





will be, will call upon the Authority to consider the pandemic differently from economic shocks for response measures. To this, the Authority as a first monetary policy response, provided lower interest rate for the working capital loan to stock essential items for sustaining basic household needs. Secondly, without any emerging signs of liquidity stress, reserve requirement was reduced by three percentage points from 10 percent. This was mainly to ensure that the financial system meets the needs of the real economy and to help defend the potential economic downturns.

Thirdly, with a thorough assessment of banks' resilience and to prevent sectoral or household insolvency propagation to market-wide disruptions, three months loan deferment was granted across the sectors. Fourthly, with substantial fiscal support package and voluntary response from the financial institutions, as a relief measure for the households and firms to boost confidence in all the economic sectors, three months interest waiver was granted by The Druk Gyalpo's Relief Kidu through the National Resilience Fund. This mix of conventional and non-conventional monetary approach supported by the fiscal measures helped in maintaining a certain level of economic momentum and supported the livelihood of the affected individuals. The financial sector remains resilient so far, the money supply witnessed a growth of 13 percent in December 2019 to around 16 percent in April 2020 and credit to private sector by 22 percent.

Now with the end of the first phase of monetary and fiscal policy measures for the last three months, the unlikely scenario of the pandemic receding and weaker domestic demand conditions, there is high risk of economic fallout to continue. On the brighter side, in the tailwinds of substantial fiscal support package (15% of GDP) and accelerated 12<sup>th</sup> FYP implementation would make economic slowdown would be less protracted and position well for quick recovery during the post crisis phase. With this, over the medium term, monetary condition is projected to remain more responsive and supportive to rebound the economy by 2021.

**TABLE: 1 MACROECONOMIC OUTLOOK**

Financial Year (FY)	2017/18	2018/19	2019/20	2020/21	2021/22
Calendar Year (CY)	2017	2018	2019	2020	2021
	Actual	Actual	Actual/ Prov.	Projection	
<b>Production (Supply)*</b>					
Real GDP	4.7	3.0	4.6	1.0	5.3
Agriculture	2.9	4.4	3.3	4.4	4.7
Industry	2.5	-4.8	1.8	11.5	5.9
Manufacturing	6.5	3.7	4.4	-2.0	3.7
Electricity & water	-3.8	-14.9	9.3	17.8	1.0
Construction	6.2	-8.0	-9.4	15.2	11.0
Services	6.7	9.0	10.7	-6.5	9.2
<b>Expenditure (Demand)*</b>					
Gross domestic demand	3.7	1.3	9.2	-5.1	1.9
Consumption	8.9	6.8	12.6	-16.4	0.3
Public	4.4	3.0	2.2	2.0	2.4
Private	10.6	8.1	16.0	-21.8	-0.5
Investment	-2.1	-5.6	4.5	11.9	3.8
Public	12.2	-9.7	-1.4	46.3	0.3
Private	-4.4	-5.2	7.1	2.1	5.2
Output gap (% of potential)*	0.1	-2.2	-2.9	-3.7	-3.0
Unemployment rate (%)	3.1	3.4	2.7	6.7	5.0
<b>Prices</b>					
Headline inflation	5.0	2.7	2.7	3.0	3.8
Implicit Inflation target/ reference inflation rate	4.5	4.5	4.5	4.5	4.5
<b>Fiscal (% of GDP)</b>					
Operationing balance	5.1	3.9	1.4	0.1	0.5
Fiscal balance	-2.6	-1.6	-6.2	-7.4	-4.4
Domestic financing requirement	0.0	0.0	3.4	6.5	4.6
<b>External (% of GDP)</b>					
Current account balance	-19.1	-22.5	-14.4	-11.0	-10.8
Trade balance (goods)	-18.7	-20.4	-12.4	-6.0	-6.1
Gross reserves (Mill USD)	1,123.7	1,055.2	1,049.9	1,080.2	1,074.5
Reserves to Essential Import Coverage (Months)	26.4	24.0	23.2	22.1	21.2
External debt	106.1	101.5	115.9	108.9	100.0
Exchange rate (Nu/USD)	65.1	70.6	75.0	73.0	72.5

<b>Monetary Sector</b>					
Reserve Money (M0)					
Currency issued	-2.5	-4.5	6.5	11.1	12.2
Demand deposits	5.1	5.5	6.5	11.1	12.2
Reserve requirement	9.9	4.2	9.0	11.1	12.2
Broad Money (M2)	7.0	-74.6	6.5	11.1	12.2
Net Foreign Assets (NFA)	13.3	3.3	9.0	11.1	12.2
Net Domestic Asset	-4.7	-2.0	1.2	3.7	-1.5
o.w credit to private sector	45.9	19.2	11.4	18.5	24.2
Credit to deposit ratio	22.1	21.6	10.7	9.6	10.8
	94.8	102.3	97.3	97.3	98.5
<b>External Environment</b>					
Global GDP*	3.9	3.6	2.9	-3.0	5.8
GDP growth, India*	7.2	6.8	6.1	7.0	7.4
Inflation, India	3.3	4.0	3.7	3.3	4.0
LIBOR*	1.5	2.5	2.3	1.9	1.9
Key policy rate, India*	6.1	6.3	5.7	4.7	5.2
Exchange rate (INR/USD)	65.1	70.6	75.0	73.0	72.5
Memo:					
Nominal GDP at market prices (Mn. of Nu)-FY	163,449.3	176,404.3	192,353.1	208,199.7	229,952.9
<i>Data are as of FY ending June unless marked with (*) are in calendar year basis. Source: Macroeconomic Framework Coordination Committee (MFCC), Ministry of Finance, April 2020 updates, World Economic Outlook, IMF, April 2020 update, and Reserve Bank of India (RBI).</i>					

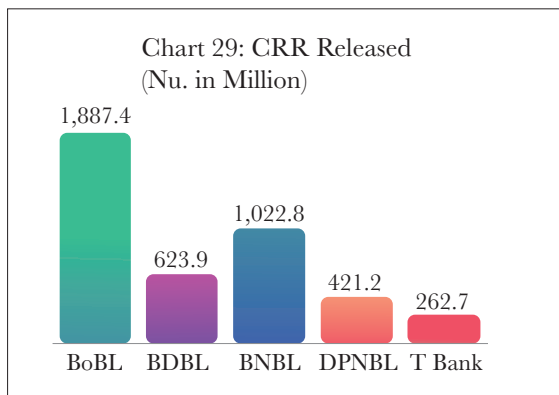
# REVIEW ON MONETARY POLICY MEASURES: PHASE I

Global Financial Markets turned volatile between the latter part of 2019 and commencement of 2020 against the backdrop of the US-China Trade tensions, the US -Iran geo-political rigidities and uncertainty regarding the Brexit. The global market further experienced a fitful meltdown due to the rapid spread of the COVID-19 out of China and crude oil price war between Saudi Arabia and Russia in March 2020. These hosts of factors combined with the COVID-19 pandemic have subdued the global economic activity. The consequences of the pandemic and severity of the associated economic and financial repercussions is no exception to Bhutan, despite the fact that its representations to the global GDP and international trade are less than 0.01 percent each. Similar to the policy response to COVID-19 crisis implemented by central banks and Governments across the globe, the monetary and fiscal measures in Bhutan have been swift and generous, guided by His Majesty The Druk Gyalpo's wisdom to ensure that the relief measures are adequate and inclusive. In view of this, the monetary measures implemented by the RMA are based on two key attributes. Firstly, the monetary measures focused to prevent employees' lay-off from the sector affected by COVID-19 and secondly, to ensure adequate liquidity and maintain overall financial stability. The key highlights of the RMA's monetary policy measures and its outcome are summarized below;

## I. REDUCTION OF CASH RESERVE RATIO AND LIQUIDITY

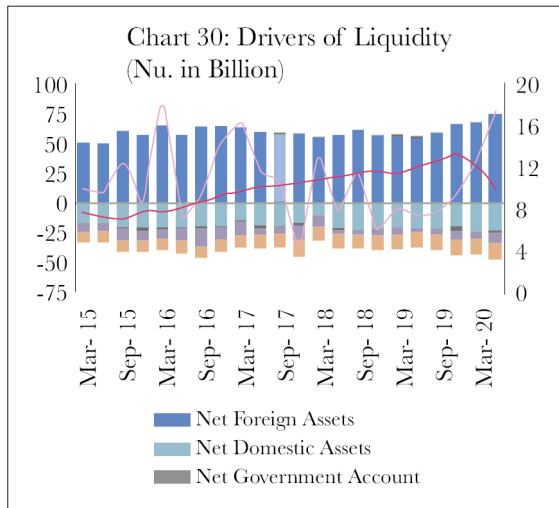
In an early attempt to ensure that there is adequate liquidity in the banks to support the operations of the financial sector, the RMA on 17th March 2020 and 27th April 2020 reduced the CRR by 100 basis and 200 basis points respectively. The reduction in CRR provided an additional liquidity of Nu 4.22 billion in the banking sector. As of 1st July 2020, Nu 2.1 billion has been utilized to finance the working capital loans from the reduction of CRR.

As a result of reduction in CRR, the total autonomous factors witnessed an increase from Nu 15.33 billion in May 2019 to Nu 28.49 billion in May 2020. From the liquidity surplus of Nu 28.49 billion, an amount of Nu 10.22 billion is absorbed by CRR. Thus, after accounting Nu 3 billion as precautionary liquidity buffer, the pure excess reserve amounted to Nu 18.12 billion as on 29th May 2020. The banking sector



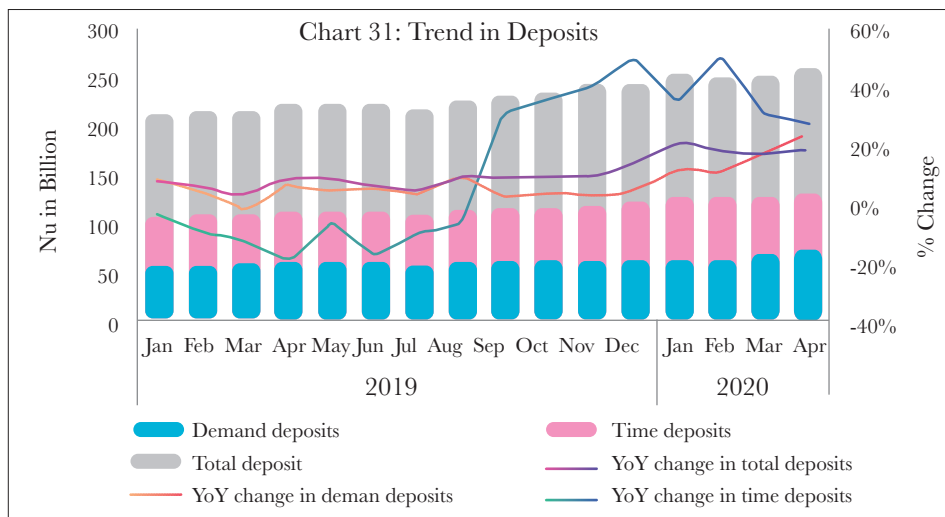
continues to maintain a sustainable level of deposits- the key source of fund for investment.

The year on year deposits has increased by 17 percent from Nu 111.01 billion in April 2019 to Nu 129.89 billion in April 2020, contributed by increase in the time deposits held by individuals. Time deposits held by individuals has been one of the stable sources of fund for the banking sector, which witnessed a growth of almost 26 percent during the review period. Stable sources of fund and reduction in CRR has helped the banking sector to maintain a comfortable level of liquidity to meet the financing requirement in the economy.



## II. MINIMUM LENDING RATE (MLR)

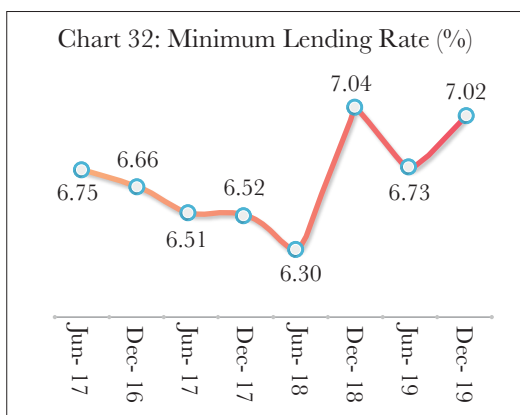
The single Minimum Lending Rate (MLR) based on the figure of December 2019 was computed at 7.02 percent, slightly higher by 0.28 percentage point from 6.73 percent as of June 2019. With the onset of COVID-19 pandemic, the reduction of CRR helped the banks in easing the overall cost of lending through reduction of their negative carry charges on CRR. The reduction in CRR from 10 percent to 7 percent in the recent months has reduced the Single MLR by 0.16 basis point. Reduction of CRR and its impact on MLR provided new incentives for the banks and the financial institutions to provide loans at a



lower lending rates and to support the COVID-19 affected sectors.

Besides, managing domestic liquidity, the RMA has also been playing a critical role in managing the INR liquidity to support the one-to-one pegged exchange arrangement. This necessitated the RMA to maintain a sufficient buffer of INR reserves in the external reserve portfolio, largely managed through investment in GoI Treasury Bills, Currency Swap facility and conversion of a fraction of CC reserves into INR as a last resort, for

financing the balance of payment obligations with India. The demand for INR, channeled through banking sector in the form of outward INR flows has been on the rise over the recent years. During 2018, the outward INR flows amounted to almost ₹116 billion, witnessing a moderation to ₹ 111 billion in 2019. Almost 80 percent outflows were on account of imports of goods and services. As of May 2020, there was a significant fall in the INR outflows which amounted to ₹ 4.65 billion due to the outbreak of COVID-19 and persistent containment measures, helping to maintain a positive net flows amounting to ₹ 13.99 billion.

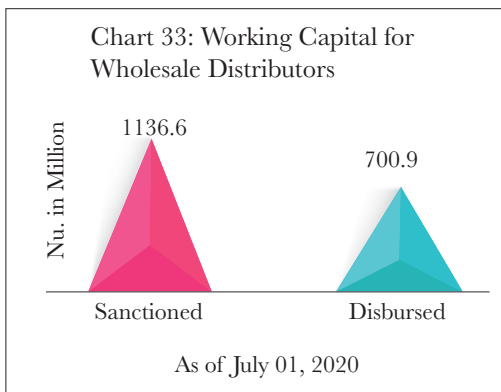


**Table 2: Major components of Indian Rupee flows**

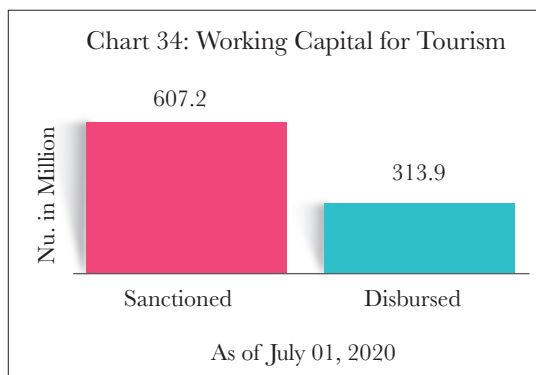
INR in Million	2017	2018	2019	2020 (May)
<b>INR Outflows</b>	<b>89,661.7</b>	<b>115,943.9</b>	<b>111,019.3</b>	<b>4,653.4</b>
Debt service	3,003.9	16,289.6	14,470.6	0.0
Govt & Corporation	5,107.0	5,350.0	5,676.2	602.2
Construction Companies	1,138.1	1,555.9	2,924.0	80.5
Hydro-project	6,871.6	4,217.9	3,707.7	117.1
Industry	10,597.9	12,687.8	7,929.8	822.9
Vehicle	1,198.4	8,505.1	6,224.8	60.6
Fuel	6,500.7	9,241.7	8,717.7	568.5
Other imports	48,944.9	51,472.0	51,357.7	2,061.5
Education/Fee	853.7	747.5	688.2	7.9
Remittance	3,741.4	2,269.3	7,440.5	328.9
Card settlement	739.2	2,527.5	1,016.4	0.0
Cash over the counter	964.6	1,079.0	865.4	2.9
<b>INR Inflows</b>	<b>89,638.2</b>	<b>98,808.4</b>	<b>122,823.9</b>	<b>18,646.5</b>
<b>Net INR flows</b>	<b>-23.5</b>	<b>-17,135.5</b>	<b>11,804.6</b>	<b>13,993.0</b>

### III. CONCESSIONAL TERM BASED WORKING CAPITAL FOR WHOLESALE DISTRIBUTORS

In addition to lowering of CRR, the RMA also announced liquidity support measures on 26th March 2020 to grant short-term financing at an interest rate of 5 percent per annum to wholesale distributors engaged in import and supply of essential commodities. As of 1st July 2020, the financial sectors sanctioned Nu 1,136.6 million and disbursed Nu 700.9 million of working capital for wholesale distributors in Bhutan.



### IV. CONCESSIONAL TERM BASED WORKING CAPITAL FOR TOURISM AND RELATED BUSINESS

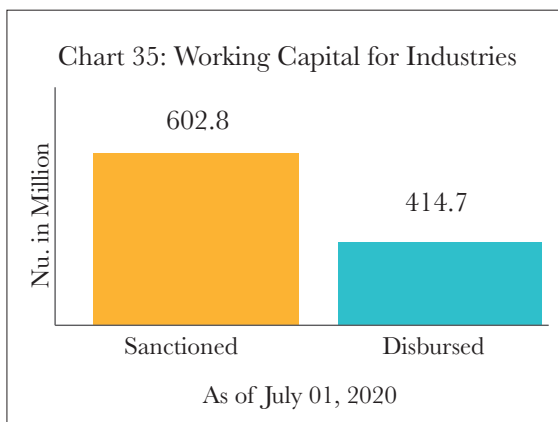


One of the severely affected industries by the COVID-19 is the tourism and service sector. To keep the sector afloat, meeting the daily operational expenses of the sector to avoid workers lay-off, a short-term financing (WC) for tourism related companies/businesses is available at a concessional interest rate of 5 percent for four years including the gestation period. With the monetary measures in effect, as of 1st July 2020, the financial institutions collectively sanctioned a short-term finance of

Nu 607.2 million and disbursed Nu. 313.9 million to the tourism and services sector.

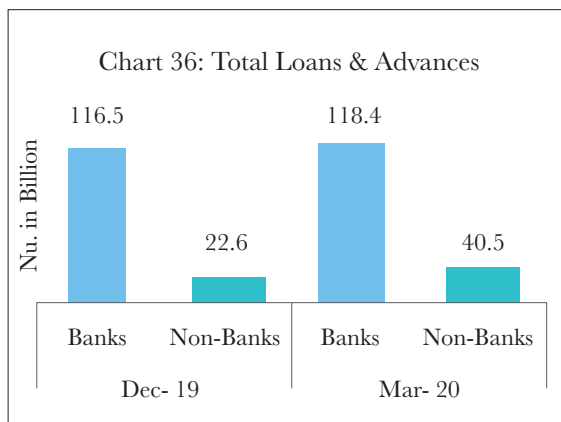
## V. CONCESSIONAL TERM BASED WORKING CAPITAL FOR INDUSTRIES

Industries in Bhutan have always been the backbone of the economy in promoting exports and generating employment. With the COVID-19 pandemic affecting their operations, on 21st April 2020, the RMA provide Working Capital loan for manufacturing industries identified by the Ministry of Economic Affairs. The objective is to support the import of raw materials at concessional interest rate to cater to local markets and for export-oriented business. The maximum interest rate cap for the WC was set at the prevailing minimum lending rate (7.02 percent) or the institution specific minimum lending rate, whichever



is higher. As of 1st July 2020, the financial institutions sanctioned a working capital of Nu 602.8 million, of which Nu 414.7 million were disbursed to the manufacturing industries.

## VI. DEFERMENT OF LOAN REPAYMENT



All the loan repayments were deferred for a period of three months from April to June 2020 for performing as well as non-performing loans (except loans to Government, loans to Financial Institutions and Staff Incentive Loans). The total loan outstanding of the financial sector as of March 2020 stands at Nu 158.9 billion, against a total NPL of Nu 28.2 billion<sup>8</sup>. The repayment relaxations have deferred a payment to 139,096 loan accounts.

<sup>8</sup> Includes the NPPF



## VII. INTEREST WAIVER

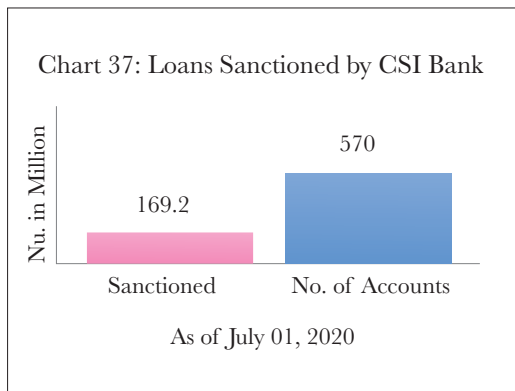
The waiver of interest payments for the period of three months from April to June 2020 was applied for both performing as well as non-performing loans that benefitted 139,096 account holders. The biggest beneficiary was the housing sector that received about 25 percent (Nu 314.9 million) of the total waiver. Tourism and service sector, which is the most affected sector, was the second largest beneficiary, attributing 23 percent share with a benefit of Nu. 293.5 million. Similarly, the financial institutions waived a total of Nu 189.4 million to production and manufacturing sector, benefiting 2,443 loan accounts from the tax waiver. The cost of the interest waiver is shared equally between the Government under The Grant of the Druk Gyalpo's Relief Kidu through the National Resilience Fund and the financial institutions. For the month of April, the interest waiver cost for the government and financial sector amounted to Nu 1,251.9 million.

## VIII. EXTENSION OF GESTATION PERIOD FOR PROJECTS UNDER CONSTRUCTION

The financial institutions were directed to provide additional gestation period of three months and the interest accrued on loans under gestation were also waived off. The model of sharing the cost of interest waiver is similar to the interest waiver modality.

## IX. LOANS TO COTTAGE AND SMALL INDUSTRIES

During this pandemic, keeping the CSIs afloat is the biggest challenge. Focusing on actions to enable business continuity and setting the grounds for recovery are crucial to alleviate job losses and pave the way out of crisis. Keeping this in view, the National CSI Development Bank will provide loans up to Nu 500,000 at an interest rate of 2 percent per annum to promote agriculture and rural activities. The WC loan at an interest rate of 4 percent per annum was provided to help the CSI for three months' period from April 2020. As of 1st July 2020, the National CSI Development Bank sanctioned Nu. 169.2 million, of which Nu. 154.6 million in the form of micro loans and Nu. 14.6 million as working capital to the CSIs. Of the total loan sanctioned, Nu. 158.9 million has been disbursed, Nu. 148.2 million for micro loans and remaining as a working capital loans to the CSIs.



## **MONETARY POLICY MEASURES: PHASE II**

Uncertainty posed by the COVID-19 pandemic fallout has brought a unique challenge for the central banks across the globe in calibrating the effectiveness of its monetary policy implementation measures. The wide spread economic disruptions as a result of the pandemic and containment measures constrained major economic activities affecting the entire gamut of production and consumption cycles. Given the current development, it is most likely that the pandemic will prevail over the near term with continued containment measures, affecting the business and economic growth prospects. With the daily rising COVID-19 cases within and in the region, achieving a modest level of growth at 1 percent during 2020 would still be a challenge for Bhutan as the service sector continue to remain at standstill. Besides the service sector's contribution to employment, the foreign exchange earning sourced from service industry will also put a dent on the level of international reserves. Triggered by COVID-19 mitigating measures to boost domestic production, the increased level of financing for both private sector and the Government to fill the fiscal deficit is likely to pose further pressure on the domestic liquidity.

Keeping in view of the emerging and medium-term macroeconomic conditions, the monetary policy stance for medium term is targeted to support the domestic demand based on priority and need of the economy to revive the COVID-19 affected sectors and support economic and employment growth. Accordingly, the policy stance is programed based on macroeconomic outlook and challenges- duration of the COVID-19 fallout and impact assessment of Phase I monetary policy measures. Along with fiscal measures and The Grant of the Druk Gyalpo's Relief Kidu, the RMA introduced Phase II monetary measures to help the economy to recover from the COVID-19 pandemic starting July 2020. The key highlights of the Phase II monetary policy measures are as follows;

### **I. CONVERSION OF TERM BASED WORKING CAPITAL FACILITY**

The three working capital facilities provided for wholesale distributors engaged in import and supply of essential commodities; tourism and allied sectors, and industries extended in the Phase I monetary policy measures has been converted to term-based loans at a concessional interest rate of 5 percent per annum with maximum loan tenure of 4 years.

### **II. DEFERMENT OF LOAN REPAYMENT**

Deferment of loan repayments, which was initially provided for three months from April to June 2020 under the Phase I monetary policy measures has been further extended by another one year until June 30, 2021. The loan deferment will be subjected to accrual of interest at a normal rate on the principal amount during the deferment period, resulting in increase in Equated Monthly Instalments or extension of loan tenure.

### **III. INTEREST WAIVER**

As a relief measure, the full interest waiver shall be granted by another three months (July to September 2020), followed by 50 percent interest waiver from October 2020 to March 2021 for loans outstanding as of April 10th 2020 through The Grant of the Druk Gyalpo's Relief Kidu through the National Resilience Fund.

### **IV. CONCESSIONAL SHORT TERM LOANS TO MICRO BUSINESS AND CSIS**

Realizing the importance of the CSI as one of the five economic jewels of the country, the Phase II monetary measures outlines several support schemes and incentives to help the CSI sector during the Pandemic. Similar to the Phase I monetary measures, the scheme will provide concessional loans from the National CSI Development Bank, Bhutan Development Bank and the Microfinance Institutions, specifically targeted for the micro clients and CSI borrowers including both informal and mobile business.

### **V. CONCESSIONAL TERM LOANS TO BUSINESSES (BRIDGING LOANS)**

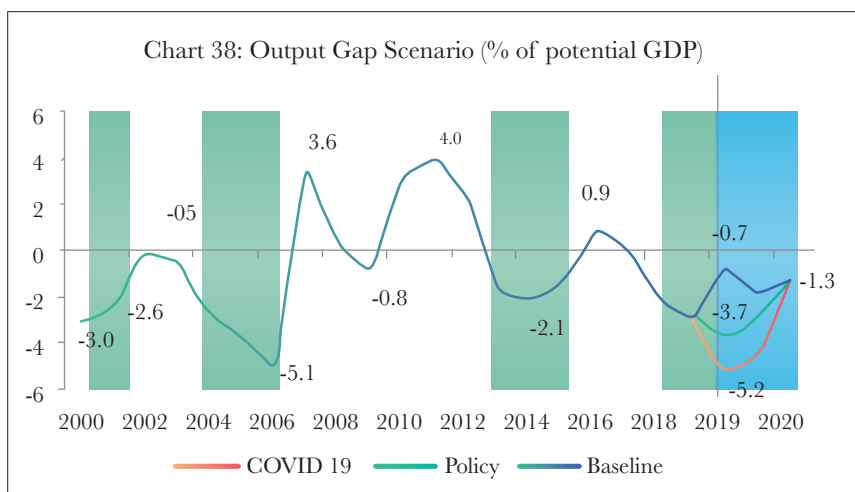
To support the financing of operational cost such as salaries of the employees, utility bills, lease and rents of corporate and business entities affected by COVID-19, the financial institutions will provide a soft bridging loans at a concessional interest rate of 5 percent per annum for a period of 4 years.

### **VI. LIQUIDITY ADJUSTMENT FACILITY**

To ease the cash flow and smoothen the distribution of liquidity within the financial sector, the RMA will be activating the Liquidity Adjustment Facility (LAF). Opening of LAF will provide new avenue for the financial institutions to mobilize liquidity from the market and help to develop the inter-financial institutions lending operation.

## BOX 1: POTENTIAL OUTPUT

The potential output reflects the productive capacity of the economy. It is a situation where an economy can produce maximum goods and services over the longer term without generating downward or upward pressure on prices-optimal GDP. The difference between the actual output and its potential output is known as output gap and is a key economic indicator used to identify and measure the state of an economy relative to its potential. If an economy is performing above the potential level, it is termed as positive output



gap, indicating capacity pressure on limited resources and likely demand-driven inflationary pressure. On the other hand, negative output gap suggests that there is slack in the economy through weak demand conditions resulting in downward price pressure. Firstly, in the short-run, the current economic state relative to potential output provides insights for the policymakers, particularly to access the existing monetary policy stance and to adjust future course of policy action in achieving the price stability mandate. Secondly, faster growth in potential output would generate strong economic output without causing undue price pressure. Therefore, the knowledge of the determinants of the potential output assists in formulating structural growth maximization policies.

Despite being reasonably intuitive and conceptually useful, and being an unobservable variable, finding a true estimation value is a key challenge. There are wide range of estimation methods, from simple univariate times series (HP filter) to structural models, depending on the availability of data and its application. In the case of Bhutan, the RMA uses production function to estimate potential output and its determinants, thereby assessing the state of the economy for the monetary policy formulation. In addition, the HP filter is used in gauging the production function estimate.

As per the estimates, in the recent past years, the economy has been sliding below the potential output. Since 2018, owing to slower investment rate and drop in employment (-4.5%), the actual economic output was 2.2 percent below potential output and it further entered into negative output gap at 2.9 percent in 2019. In general, economic growth cycle usually fallback at lower level in the beginning of every plan period due to lower government expenditure demand which constitutes about one third of the GDP<sup>9</sup>. Prior to the COVID-19, under the baseline scenario, with higher growth expectation, negative output gap was expected to narrow at 0.8 percent. However, with high uncertainty of the COVID-19, the gap forecasted a record high of -5.2 percent by the end of 2020. Given the limited possibility for quick recovery, the economy is projected to remain below the potential in the near term. The implementation of several economic responses against the COVID-19 and several others to be implemented in the near-term, with rebound in GDP growth by 2.0 percentage points, negative output gap is expected to narrow by 1.5 percent in 2020 with a quick recovery in the near term.

Over the medium-term, despite various monetary and fiscal policy measures, the economy is expected to experience a weaker demand condition and continue with lower level of inflation. With uncertainty of the COVID-19, there is upward risk on price pressure due to market disruptions. Maintaining key policy rate in India at current level with the expected inflation within the targeted range and lower domestic demand pressure, headline inflation is more likely to remain within the medium-term implicit inflation target of  $\pm 4.3$  percent range. On the downside, there is higher downward risk on the growth through weaker domestic demand on economic growth and slower rate of growth in potential output in longer-term. The policy measures in particular a stimulatory fiscal expenditure is required to revive the economic growth over the medium-term. Such policy would not only boost domestic demand, but also build market confidence for the household and in the labor market.

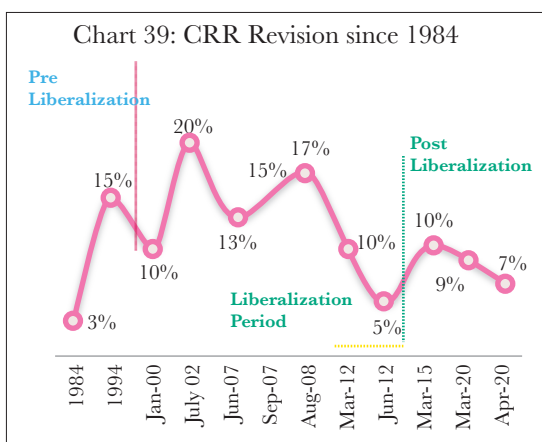
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<sup>9</sup> *In every first year of the plan period, government focuses more on the FYP preparation and resources mobilization. There is a fallback in government expenditure demand which constitutes about one third of the GDP.*

## BOX 2: REVISION OF CASH RESERVE RATIO

Since the establishment of the RMA in 1983, several prudential and monetary measures have been configured to support planned economic development through its monetary policy operations. Strengthening the financial stability in particular necessitated the RMA in formulating a sound monetary policy operation framework. Since then, to manage domestic liquidity and financial stability, the RMA relied on maintaining cash reserve requirements (CRR), as a key monetary policy instrument, supported by macro-prudential regulations.

Initially, the CRR was set at 3 percent of all deposits. Absence of complementary monetary policy instruments made the CRR ineffective. However, with the introduction of the RMA discount bills and in the face of rising liquidity conditions, the CRR was revised for the first time in 1994 to 15 percent on all deposits. With the conversion of Unit Trust of Bhutan to Bhutan National Bank (BNB), the second commercial bank established in 1997, the CRR was adjusted from all deposits to only demand deposits and cash in vaults are also included as part of the CRR. The CRR deposits held with the RMA were remunerated at 2 percent of interest rate per annum.



In January 2000, the CRR was further adjusted to 10 percent for all deposits and the cash in vaults was not accounted in computation of CRR. The reduction in the CRR was influenced by a slower growth in the total deposits, in particular owing to sluggish growth in the time deposits. In 1998 and 1999, the time deposits amounted to only Nu 2.84 billion and Nu 2.86 billion respectively. On July 1st, 2002, in a move to sterilize additional excess liquidity from the banking system, the CRR was further revised upward to 20 percent, all time high in the calendar of CRR revision, along with which the interest rate payable on the balance was increased from 2 percent to 3 percent per annum. A record high revision of CRR to 20 percent in

2002 was prompted by substantial growth in current account deposits and foreign currency deposits, which grew at a rate of 89 percent and 307 percent respectively. A significant growth in foreign currency deposits was contributed by the Dai Nippon Constructions, SNV, Helvetas and Bhutan Trust Fund in the form of capital and financial inflows.

The record high CRR revision had to be soon adjusted to 13 percent by the end of June 2003, due to progressive decline in liquidity through increased lending. The financial sector experienced a growth of 39 percent in the total loan portfolio from Nu 4.33 billion in 2001 to Nu 6.02 billion in December 2002. Growth in domestic credit was fueled by economic activities involving large hydropower projects like Tala, Kurichu and Basochu Projects. In accordance to the emerging situation, the interest rate on the CRR balance was also reduced from 3 percent to 1.5 percent.

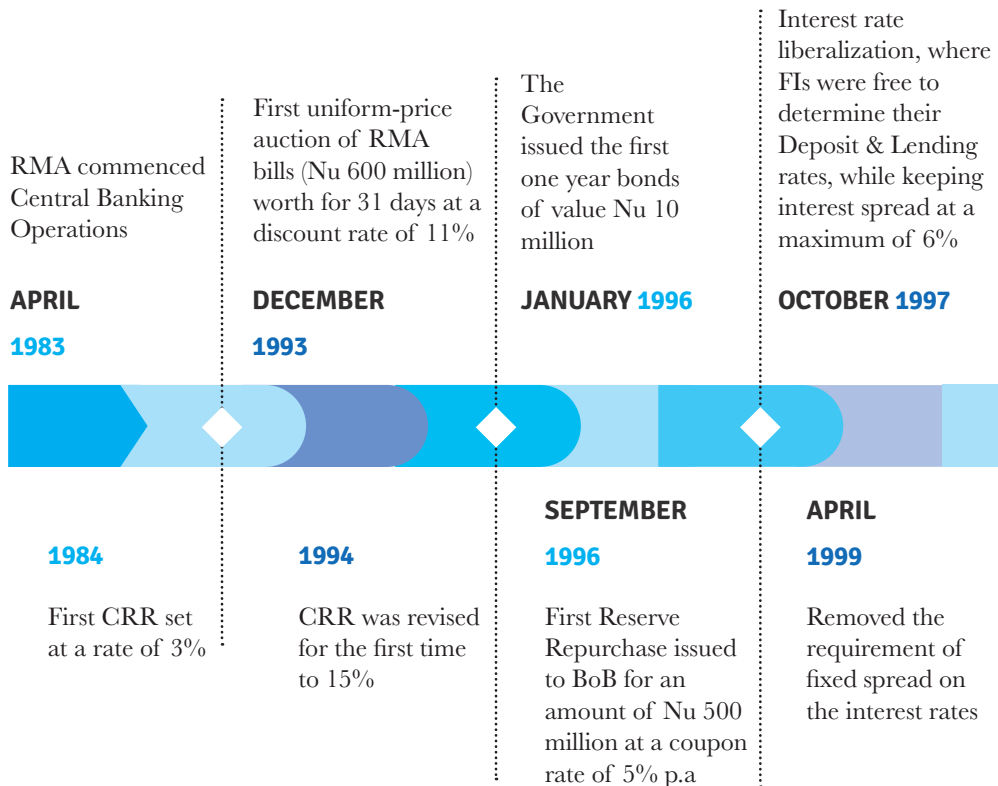
In light of the exponential credit growth in the financial sector and global financial developments, the RMA tightened its monetary policy to safeguard the financial sector by adjusting CRR to 15 percent in September 2007 and to 17 percent in August 2008. Additionally, the growth in time deposits was negative during 2007, while gross credit extended by financial institutions peaked to Nu 19.0 billion during the FY 2007-08. When the CRR was revised on September 2007, the RMA also announced discontinuation of interest payment on CRR balance.

The Rupee shortage episode of 2012 exerted a downward pressure on growth and external sector. What initially started as an external sector issue soon had a ripple effect on other key macroeconomic indicators. The banking sector during this period experienced pressing liquidity conditions due to credit growth and rigid deposit base. As of June 2012, the overall term deposits to credit ratio of the banking sector slowed down to 24.6 percent from 29.5 percent in June 2011, as time deposits and foreign currency deposits declined from Nu 20.4 billion to Nu 18.1 billion. To address the tight liquidity situation, the RMA carried out two rounds of CRR reduction to enable the commercial banks to meet their committed loan obligations (to 10 % in March 2012 and to 5 % in June 2012). This successive reduction in CRR pumped a total liquidity of Nu 6 billion to the commercial banks.

As the economy began to stabilize following the turbulence created by the Rupee Shortage and as liquidity persistently began to build up in the banking sector, the CRR was increased to 10 percent from March 2015.

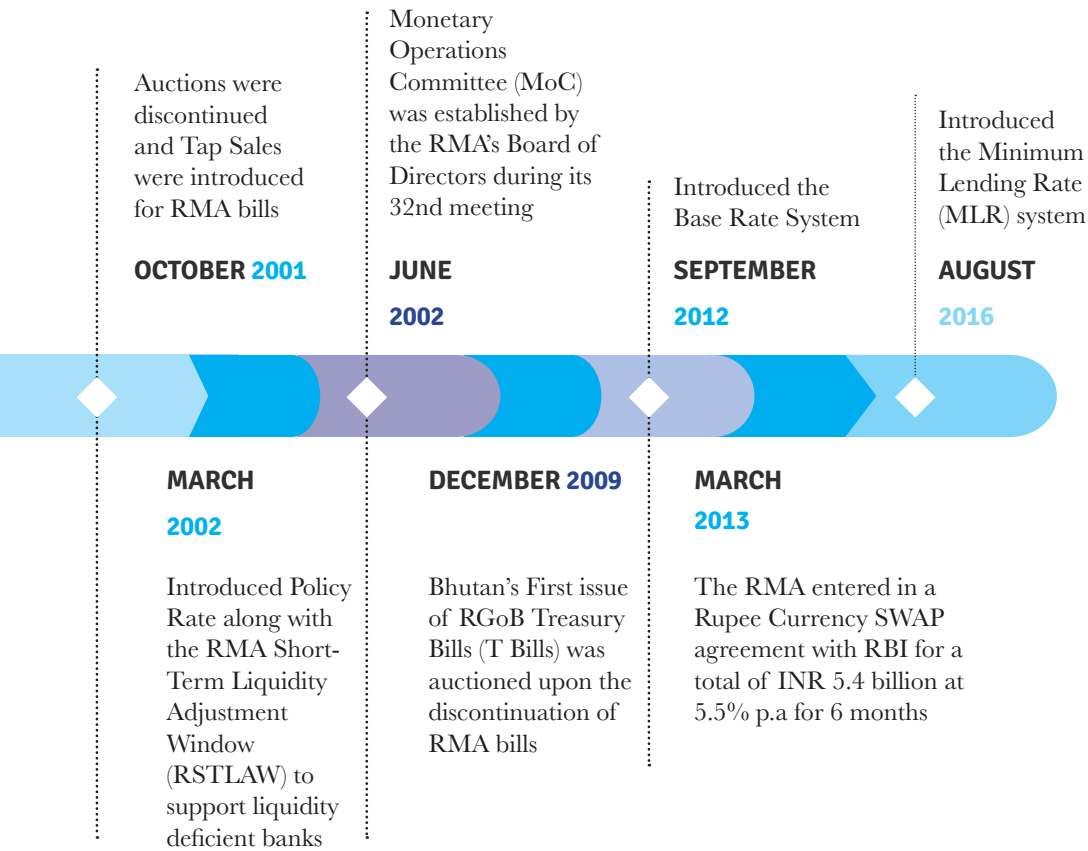
In the recent years, in the wake of the COVID-19 pandemic, supportive monetary measures were required to ease the liquidity conditions, which led to the reduction in CRR to 9 percent in March and further down to 7 percent in April 2020. The reductions in CRR augmented primary liquidity in the banking sector by Nu 4.22 billion, with additional cushioning of RMA's regulatory requirements through provision of soft term based working capital loan.

# CHRONOLOGY OF KEY MONETARY POLICY





# INTERVENTIONS, SINCE 1983



## BOX 3:

### 21<sup>st</sup> CENTURY FINANCIAL SECTOR ROADMAP

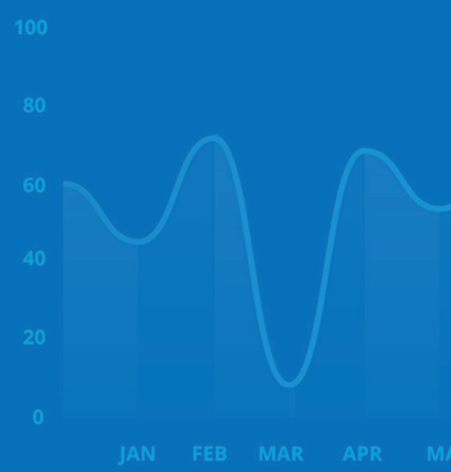
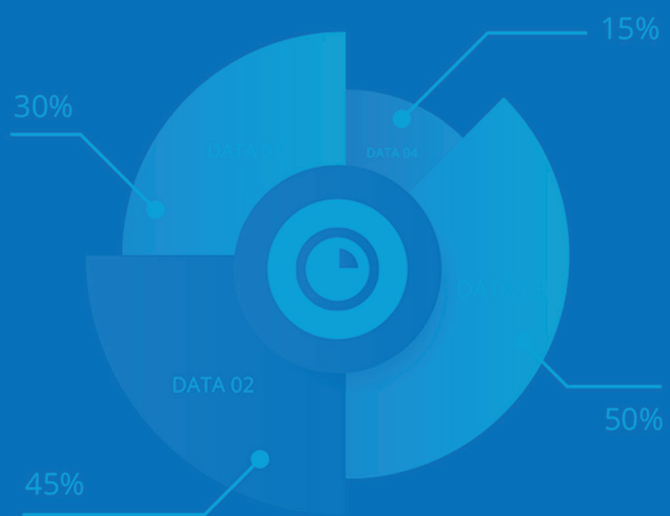
Upon the command of His Majesty The Druk Gyalpo during the 112th National Day Royal Address, the Royal Government of Bhutan initiated the development of the Economic Roadmap for the 21st Century. Drawing inspiration from the farsighted wisdom of His Majesty The Druk Gyalpo's long-term vision and in line with the national objective of promoting an efficient and stable Financial System, the RMA has initiated the development of the 21st Century Financial Sector Roadmap. The roadmap charts out a clear direction for the strategic plan of the Financial Sector in the 21st Century and focuses on the following four thematic areas:

- I. Renewed Focus on Financial Inclusion and Literacy:** Recognizing the significant role of financial inclusion and literacy in spurring economic transformation, the RMA has embarked to adopt vital approaches in financial inclusion and literacy. The roadmap aims to educate the Bhutanese population in making prudent financial management practices to become financially independent individuals. While promoting the ongoing initiatives, the financial inclusion will focus on five key thrust areas (i) creating and enabling financial regulatory space (ii) reinforcing supply side financial landscape and infrastructure (iii) reshaping consumer focused quality and affordable financial products (iv) enhancing targeted digital access and usage and (v) strengthening targeted financial capability, education and consumer protection. The five key thrust areas on financial inclusion will be supported by five enablers (i) partnership between stakeholders (ii) establishment of 'creative market' funds for R&D grants and startup funds (iii) leverage on e-commerce platforms for creative market startups (iv) collaboration in risk sharing and incentivizing creative market and (v) harnessing data and measurement. The RMA is currently working with the Ministry of Education to introduce financial literacy curriculum in the schools across the country, attempting to provide e-learning of financial literacy through social media. The Financial Institutions Training Institute (FITI) is also working towards providing appropriate and adequate trainings to employees of the financial institutions to equip them with the latest professional skills and expertise in banking and finance.
  
- II. Digitization of Banking and Payments System:** As articulated by His Majesty The Druk Gyalpo, Bhutan's readiness to embrace the economic opportunities and challenges of the 21st century hinges on digital technology.

The RMA has set digital priorities for the sector for moving forward to the enhanced use of ICT for expanding digital financial services, regulatory technologies (RegTech), back-end systems, and digital financial inclusion. The RMA will be launching e-Know Your Customers and digital banking systems. Soon Bhutan will also have a dynamic internet banking and payments system to improve assessment of credit risk and enable faster processing of loan applications and disbursement. The RMA aims to implement a digital financial stack to deliver quality and innovative digital services through various digital access points, such as Mobile, Web, Biometric, ATMs, PoS, QR, and Web based platforms. The RMA is also encouraging all financial institutions to upgrade their core banking solutions and payment gateways. Additionally, the RMA will also be launching the FINTECH Grant to drive financial innovation and technology in the financial institutions across the country.

**III. Promoting Sustainable Green Finance:** As a country guided by the principles of Gross National Happiness, Bhutan attempts to pioneer finance and lending based on a Green framework. The RMA has formulated the Green finance strategy, aligning financial sector policies with environmental conservation and the real sector economy. The RMA will be prioritizing the promotion of innovative green finance products. The RMA in collaboration with the Government, public and private sectors have already initiated formulation of a regulatory framework for Impact Investment that re-emphasizes the significance of green investment. The RMA is currently working with the Alliance for Financial Inclusion towards finalizing the Green Finance Framework, in line with the best international practices to make the financial system more robust and resilient in the wake of the COVID-19 pandemic and mitigation of similar future catastrophes.

**IV. Developing a Competent Digital Human Resource Capability:** The RMA is introducing three certificate programs at the FITI to train employees of the financial institutions from 2020. All programs are centered around digital innovation and technology. The RMA is also working towards bringing in the best international practices and knowledge in promoting human resource capabilities through tailor-made programs in green and sustainable finance, to ensure that the financial sector is proficient with relevant knowledge of banking and finance to meet the demand of financially literate new generation of 21st century.

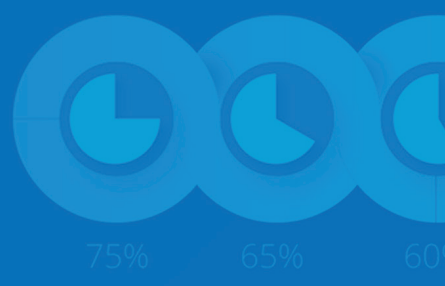


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**INFOGRAPHIC**

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