Macroeconomic Situation Report

Second Quarter Update: FY 2021-22

Department of Macroeconomic Affairs

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Contents

	Preface	
1	**External Economic Environment**	
1.1	Global and Regional Overview	3
2	**Domestic Economic Developments**	
2.1	Growth Performance and Outlook	4
2.3	Employment	8
3	**Fiscal Developments**	
3.1	Resources	9
3.2	Expenditure	11
3.3	Fiscal Balance	11
3.4	Public Debt Stock	12
4	**Balance of Payment**	
4.1	Current Account Balance	15
4.2	Trade Performance	16
4.3	Gross International Reserves	17
5	**Monetary Management and Financial Intermediation**	
5.1	Monetary Aggregates	18
5.2	Liquidity Conditions	19
5.3	Credit Growth	19
5.4	Sectoral Non-Performing Loans	20
6	**Prices and Inflation**	**21**
7	**Risks And Challenges**	**22**

Preface

The ***Macroeconomic Situation Report*** is a quarterly report produced by the Department of Macroeconomic Affairs (DMEA), Ministry of Finance (MoF) presenting a comprehensive macroeconomic performance and outlook of the economy based on the technical inputs from the Macroeconomic Framework Technical Committee (MFCTC) and strategic guidance from the **Macroeconomic Framework Coordination Committee (MFCC)**. The report embodies the broad four sectors of the economy including the assessment of the risks from macroeconomic developments, examining the impact of new fiscal policies on fiscal developments and economic growth. The report also monitors the macro economy, fiscal policy implementations, and budget execution, in order to identify deviations from the annual budget forecasts.

The report presents various facets of the public finances of the State including revenue resources and expenditure trends, major fiscal indicators and also highlights some of the monetary aggregates. **The report will provide an overview of the economic progress, advice the government, as well as policy recommendations for economic development based on the macroeconomic risk and challenges, in order to ensure macroeconomic stability and inclusive growth. It can also be used as a reference document for policy makers, and those with a long-term interest in many aspects of the state's economy.**

This report presents the state of the economy, fiscal position and current economic situation as of 31st December 2021.

1. EXTERNAL ECONOMIC ENVIRONMENT

1.1 GLOBAL AND REGIONAL OVERVIEW

- Two years into the COVID-19 pandemic, the global economy continues to be plagued by uncertainty, with resurgent waves of new variants, persistent labour market challenges, lingering supply-chain constraints and rising inflationary pressures. After a sharp contraction of 3.1 percent in 2020 and following the expansion of 5.9 percent in 2021, the global economy is estimated to grow at 4.4 percent in 2022. However, further developments will depend on the path of the health crisis recovery and it also hinges on how effectively economic policies are deployed under high uncertainty.

- For emerging and developing Asia, growth is projected to rebound from -0.8 percent in 2020 to 7.2 percent in 2021, before moderating to 5.9 percent in 2022. While few smaller countries in the region have successfully managed to roll-out the vaccines, the largest economies continue to struggle in containing the increasing wave of infections. India has been particularly affected by a brutal second wave decelerating its growth to -7.3 percent in 2020, however it witnessed a positive revival of 9 percent in 2021. The Indian economy is estimated to grow at 8.7 percent in 2022 and 6.6 percent in 2023 supported by widespread vaccine coverage, robust export growth and huge investments in the private sector.

- Rising inflationary pressure in major developed economies and a number of large developing countries present additional risks to recovery. In 2021 inflation picked up globally as economic activity revived with the opening-up of economies. Global headline inflation rose to an estimated 5.2 percent in 2021, more than 2 percentage points above its trend rate in the past 10 years. The surge in energy prices, food and non-food commodities, input prices and persistent supply-chain disruptions across the globe stoked the inflation during that period. Crude oil prices also witnessed an upswing during the year on the back of increased demand from the recovering economies and supply cut by the Organization of Petroleum Exporting Countries and its allies (OPEC).

2. DOMESTIC ECONOMIC DEVELOPMENTS

In Brief

- *The economy is projected to rebound and grow at 3.7 percent in 2021 and moderate to 4.5 percent in 2022, as domestic demand recovers and economic activity normalizes supported by robust policy measures.*

- *The agriculture sector, having performed extremely well in 2020, is expected to slow down in 2021, owing to heavy monsoon rains that damaged tons of harvested fields across the country, as well as losses in the poultry farm.*

- *As Manufacturing output increased and industrial production grew, the industry sector's output is anticipated to improve. Due to growing trade and strong global and domestic demand, exports and imports have also increased significantly.*

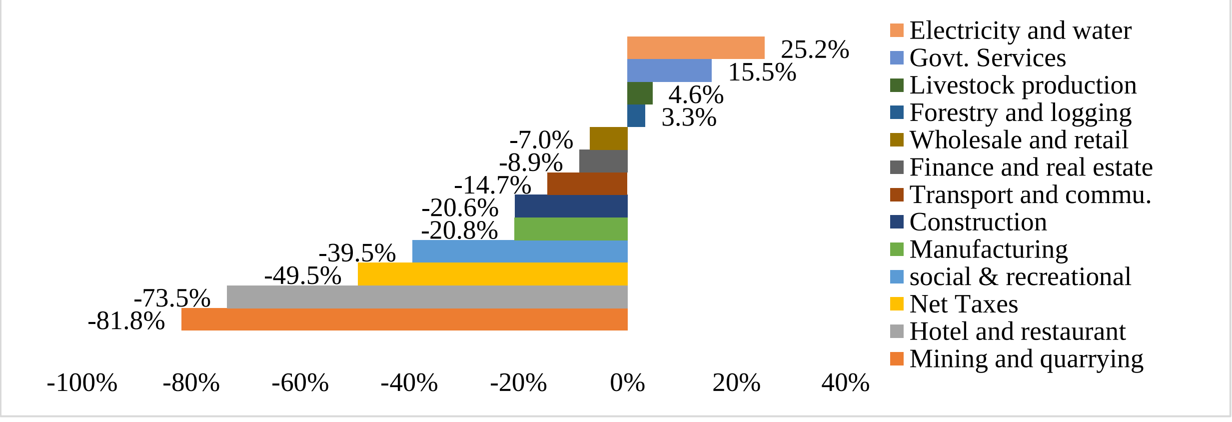
- *With the tourism sector being on a standstill, the medium-term growth outlook of the service sector remains subdued.*

- *Employment is yet to fully recover from the unprecedented shock of the pandemic and it is estimated to remain lagged and below pre-pandemic level.*

2.1 Growth Performance and Outlook

The economy has been severely affected by COVID-19 and the subsequent containment measures to contain the domestic outbreak of the pandemic. Economic growth dropped to a historic low of -10.08 percent in 2020 from 5.76 percent in 2019. The key sectors that contributed to the contraction of the economy were Mining & Quarrying; Hotel & Restaurants; Manufacturing, Construction, and Transport & Communication.

Chart 2.1 Economy Output Loss in 2020



The net taxes on products (indirect taxes) also decreased by -49.5 percent mainly attributable to fall in import duty and excise duty collections. The overall output in real terms declined by Nu. 7.25 billion in 2020. Without quick interventions in the form of Royal Kidu support (Income support and Loan Interest Waiver) and immediate policy responses by the Government through various fiscal and monetary measures, the economic loss could have reached Nu 10.5 billion.

Hydropower has been the major driver of growth through its contribution in the industry sector and the output loss would have been much higher had it not been for the hydropower sector (25.2 percentage), which remained inelastic to the pandemic. Substantial increase in electricity export earnings enhanced by MHP coming on stream have offset the setback in the industry sector to a large extent. Furthermore, the Agriculture sector's proportion to GDP which continues to be minimal also recorded significant growth of 4.6 percent. This can be an indication of increase in agricultural productivity, which can be attributed to the government's efforts to mechanize farming.

As COVID-19 spread slowed and containment measures were progressively eased, economic activity began to resume in the first quarter of 2021. Manufacturing output grew, as industrial production improved. Exports and imports have also expanded significantly, owing to increased trade and strong foreign and domestic demand. In this context, the economy is projected to rebound and grow at 3.7 percent in 2021 from the first quarter estimates of 3.3 percent. The upward revision of 0.4 percentage points mainly emanates from the industry sector, for which the forecast has been slightly upgraded from 3.2 percent to 4.6 percent, as most industry sub-sectors are expected to accelerate, indicating a continuation of the economy's anticipated recovery.

As domestic demand recovers and consumer confidence returns as more pandemic-related restrictions are relaxed, growth in wholesale and retail commerce, as well as hotels and restaurants, has been revised upward.

However, owing to heavy monsoon rains that damaged tons of harvested fields across the country, as well as losses in the poultry farm, the agriculture sector's growth is projected to slow down by around 2.8 percentage points.

Chart 2.2 Growth Performance and Outlook

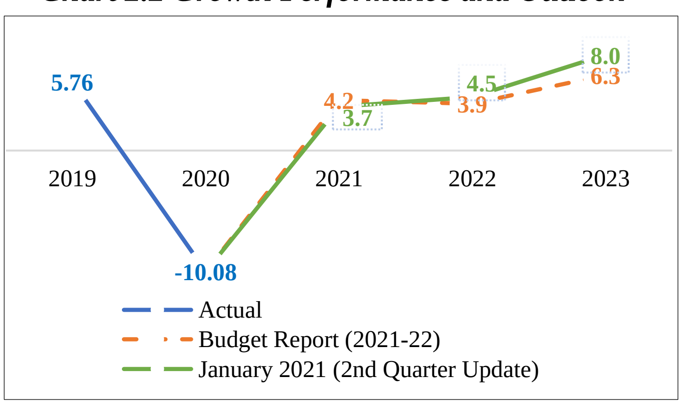


Table 2.1 Sectoral Update

Percentage Change (YoY)	1st Qtr. Update (Sep 2021)		2nd Qtr. Update (Dec 2021)	
	2021	**2022**	**2021**	**2022**
GDP Growth Rate	**3.27**	**5.42**	**3.67**	**4.47**
Agriculture, livestock, and forestry	6.83	3.27	3.98	2.64
Industry	3.21	4.74	4.60	3.74
Services	2.68	5.91	3.15	5.04
Net Taxes	1.14	16.55	1.51	13.03

Growth in 2022 is expected to improve and reach 4.5 percent, due to sustained progress in containing the pandemic and a gradual rollout of booster vaccines backed by robust policy measures. The growth trajectory is based on the assumption that there will be no mass community transmission with further easing of containment measures allowing free movement of products and services, and the government capital investment would be implemented on time.

However, following the case of local transmission, a recent lockdown imposed on the 16th of January 2022 has affected various economic sectors. The government's significant capital investment and spending plans have also been stalled, which is expected to have a spillover effect on other sectors of the economy. Despite numerous intervention measures, disruptions in materials supply, trade, and labor shortages are projected to stymie development progress. Based on the preliminary assessment, the economy's output is likely to fall by 1.39 percentage points as the majority of sectors are expected to experience output declines.

In the medium term, the recovery in services and hydropower is expected to drive growth, with electricity generation capacity expected to double with the commissioning of Nikhachhu HP (December 22), PHP-II (June 2023), PHP-I (March 2025) and Kholongchhu HP (October 2025).

Box A: Economic Growth – Econometric Approach

The ongoing pandemic and its associated disruptions have heightened the need for robust and reliable forecasting approaches to inform decision making and make forecasting more intuitive. In order to do so, a macro-econometric model with structured linkages and a specified behavioral structure is used to forecast alternative economic growth.

The model, which consists of a set of equations, is designed to provide us with a better insight and understanding of the structural linkages that exist between the various macroeconomic factors that underpin the economy. The domestic absorption block, fiscal block, external block, and monetary block are the four important economic blocs in the model and there are sets of equations defining the relationship between different macroeconomic variables under each block.

While the model will not be able to accommodate every relevant or statistically significant parameter, it will be based on some predictable mechanics that would allow us to explain the projected outcomes of particular model actions. It is also important since it allows for a logical justification of each decision taken. While this is also possible within the existing MEF framework, it necessitates the manual entry of several numbers and is primarily mechanical in nature rather than behavioral. Therefore, to complement the existing method of MEF framework built by technical inputs from MFCTC, an alternate approach using a macro-econometric model is employed to forecast GDP from expenditure side, whereby:

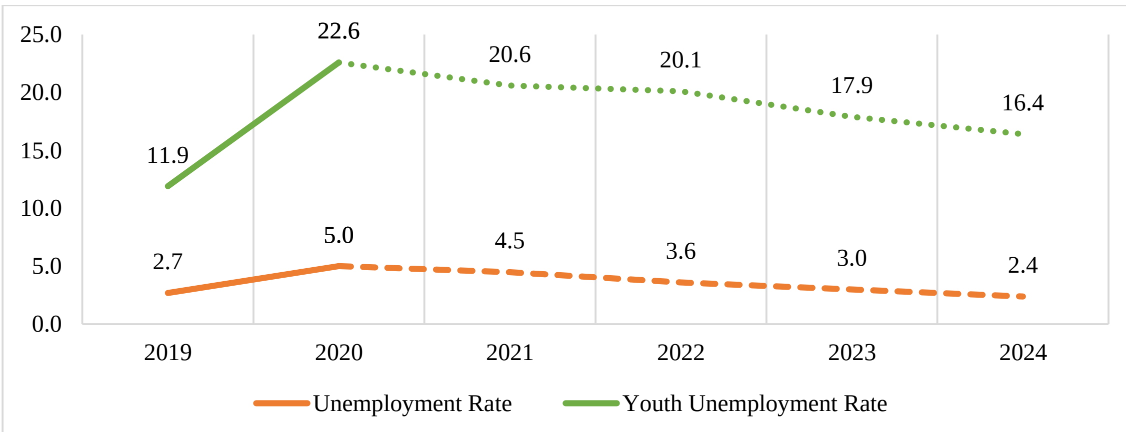
GDP = Consumption + Investment + Export – Import

The model predicts 3.6 percent growth in 2021 based on exogenous variables taken from the 2nd quarter MEF updates for FY 2021-22. The economy is expected to rebound to pre-pandemic levels in the medium term, growing at a rate of 6.06 percent on average. From 2022, trade performance, gross fixed capital formation (private and government investment), and household consumption are expected to improve as economic activity rises due to the anticipated booster vaccine-powered recovery. Although the vaccine roll outs have raised hopes of a turnaround in the pandemic, renewed waves and new variants of the virus pose concerns for the outlook. There is still a lot of uncertainty that surrounds this outlook, related to the pandemic path, how successful policy assistance will be in providing a bridge to vaccine-powered normality, and how the financial situation will evolve.

2.2 EMPLOYMENT

Given the increased number of new entrants into the job market and limited work opportunities, the pandemic has aggravated the pre-existing unemployment situation. In 2020, the overall unemployment rate reached 5 percent with 16,660 people out of work, negatively affecting their social and economic situations. Similarly, youth unemployment rate doubled from 11.9 percent in 2019 to 22.6 percent in 2020.

Chart 2.3 Unemployment Rate



Employment is yet to fully recover from the unprecedented shock of the pandemic and it is estimated to remain lagged and below pre-pandemic level. However, considering various intervention measures such as the economic stimulus package, Build Bhutan Project and other employment engagement schemes, and taking stock of the existing labor force market, the overall unemployment rate is estimated to slightly decline to 4.5 percent in 2021 and 3.6 percent in 2022. Labor market conditions are expected to improve but a full employment recovery is projected only in 2023 in line with aggregate output returning to pre-pandemic level.

3. FISCAL DEVELOPMENTS

In Brief

- *The domestic revenue target for FY 2021-22 is revised downward by 3.5 percent mainly attributed to short fall in profit transfer from RMA.*
- *On the assumption that only 75 percent of the approved budgetary grants will be realized this FY, total budgetary grants have been lowered down by 23 percent.*
- *While the capital expenditure for FY 2021-22 has been revised upward to Nu. 41,785.4 million, owing mostly to the incorporation of external donors worth Nu. 3.2 billion, the expenditure utilization is expected to be Nu. 33,428.3 (80 percent) in line with actual utilization trends and lower grant expectations.*
- *The fiscal deficit is estimated at 8.6 percent of GDP amounting to Nu. 17,153 million in FY 2021-22.*
- *The total public debt stock as of 31 December 2021 stood at Nu. 239,792.039 million, accounting for 126.8 percent of the GDP.*

3.1 RESOURCES

Total resource is estimated at Nu. 56,756.6 million as per the approved budget for the FY 2021-22. Of which, the domestic revenue is Nu. 35,600 million, with tax revenue accounting for 65 percent and non-tax revenue accounting for 35 percent while the remaining is from external grants.

3.1.1 Domestic Revenue

The half-yearly collection (July-December) amounts to Nu. 17,742 million (49.8 percent against the approved budget), which is 4.8 percent lower compared to the same period in the previous year.

Based on the 2nd quarter update, the domestic revenue forecast for FY 2021-22 is revised down to Nu. 34,367 million, mainly to account for the short fall in profit transfer from RMA by Nu. 1 billion. Similarly, the tourism royalty of Nu. 466.98 million is unlikely to be realized this FY as tourism is expected to resume in June 2022 and hence excluded from the estimates. As such, the revenue collections from both tax and non-tax sources have been accordingly revised down by 3.6 percent and 3.2 percent, respectively. As a result, overall reduction of Nu. 1.2 billion will impact coverage of current expenditure during the FY.

For the next FY 2022-23, revenue is estimated at Nu. 36,368 million of which tax revenue constitutes 69 percent (Nu. 24,932 million) and non-tax revenue constitutes 31 percent (11,436 million).

Table 3.1 Revenue Performance

		Budget	6 months Collection Status	In year Revision	Variance (%)
	Total Revenue	**35,600**	**17,742**	**34,367**	**(3.5)**
I	**Tax Revenue**	**22,931**	**10,905**	**22,099**	**(3.6)**
1	**Direct Tax**	**15,103**	**7,199**	**17,308**	**14.6**
	o.w. CIT	7,090	2,649	7,268	2.5
	BIT	1,023	428	1,111	8.6
	PIT	1,538	768	1,538	-
	Hydro Royalty	4,023	3,078	3,910	(2.8)
2	**Indirect Tax**	**7,828**	**3,706**	**7,439**	**(5.0)**
	o.w. Sales tax	5,188	2,615	5,188	-
	Excise Duty	765	188	376	(50.8)
	Green Tax	962	496	962	-
	Custom Duty	486	205	486	(0.1)
II	**Non-Tax Revenue**	**12,699**	**6,837**	**12,269**	**(3.4)**
	o.w. DHI Dividend	3,659	- -	3,659	-
	Profit Transfer RMA	1,500	440	439	(70.7)
	Profit Transfer MHP	3,747	4,404	4,403	17.5
	Int. Receipt	2,542	1,279	2,542	-
	Rev from Govt. Agencies	1,154	624	1,154	-

3.1.2 Grants

Total grants received as of December 2021 is Nu. 9,030.7 million (42 percent against the approved budget) of which Nu. 1,650 million was received as program grant and Nu. 7,117.4 million as project-tied assistance.

Total budgetary grants for the FY 2021-22 is revised down from Nu. 21,714.79 million to Nu. 16,286 million on the assumption that only 75 percent will be realized this FY based on prior trends and half-yearly status.

Table 3.2 Grants

		Budget	6 months Collection Status	In year Revision	Variance (%)
I	**External Grants**	**20,526**	**8,767**	**15,806**	**(23.0)**
1	**GoI**	**16,339**	**6,959**	**12,666**	**(22.5)**
	PTA & SDP	12,584	5,309	9,438	(25.0)
	Programme Grants	3,754	1,650	3,228	(14.0)
2	**Others**	**4,187**	**1,809**	**3,140**	**(25.0)**
	Project-tied Grants	4,187	1,809	3,140	(25.0)
	Programme Grants				
ll	**Internal Grants (Trust Funds)**	**640**	**263**	**480**	**(25.0)**
	Total Grants	**21,166**	**9,031**	**16,286**	**(23.1)**

For the next FY, total budgetary grant of Nu. 11,455 million is estimated, which is the balance of the revised committed grants for 12th FYP.

3.2 EXPENDITURE

The highly uneven incidence of infections, coupled with varied public health responses has alleviated the expenditure. Total expenditure outlay for the current FY as per the approved budget is Nu. 73,919.3 million, of which capital expenditure is Nu. 38,320.7 million and Nu. 35,598.7 million is current expenditure.

Table 3.3 Expenditure

	Budget	6 months Status	In year Revision	Variance (%)
Total Expenditure	**73,919**	**27,058**	**77,384**	**(4.7)**
Current Expenditure*	**35,599**	**17,457**	**35,599**	**-**
Primary Current	32,250	14,958	32,250	-
Interest Payment	3,348	1,497	3,348	-
Capital Expenditure	**38,321**	**10,557**	**41,785**	**(9.04)**

The current expenditure is estimated to increase by 11.6 percent from the previous FY to provide for mandatory increase in pay and allowances, LG election and interest payment. Although requirement for the current budget has increased due to emerging priorities, it has been rationalized and adjusted to maintain within the estimated domestic revenue. The capital expenditure allocated for the current FY is the highest annual allocation of the 12th FYP mainly to stimulate economic stability through resilient recovery.

Based on the 2nd quarter update, the capital expenditure is revised upward to Nu. 41,785.4 million (an increase of 9 percent against the approved budget) due to incorporation of external funded projects amounting Nu. 3.2 billion from ABD, EU, Austria, UN, WHO, WB and GFATM. The total capital budget utilization at the end of December 2021 is Nu. 10,557.2 million accounting for 27.6 percent utilization against the total approved budget. *Therefore, given the size of the capital expenditure, close monitoring of capital works needs to be carried out to ensure capital budget is fully utilized for development projects*

3.3 FISCAL BALANCE

Considering a likely shortfall scenario for domestic revenue, the fiscal deficit is estimated at 8.6 percent of GDP amounting to Nu. 17,153 million in FY 2021-22. The fiscal deficit may need to be financed largely through domestic markets as the borrowing from external sources, mainly the multilateral development banks, which are highly concessional depends on the agreed Country Partnership Framework for a certain period.

However, with the incorporation of additional commitment from the development partners amounting to Nu. 3.2 billion the fiscal deficit is expected to further elevate to 9.9 percent of the GDP. Accordingly, an alternate estimate is made where capital budget utilization may be 80 percent considering the setback of the current lockdown and also in keeping with the past trends. With this the fiscal deficit is expected to be around 9.7 percent.

Table 3.4 Fiscal Performance

		FY 2021/22 (Approved Budget)	FY 2021/22 (Revision with incorporation)	FY 2021/22 (Alternate Estimates)	FY 2022/23 (Estimates Budget Call)
A	**Revenue & Grants**	**56,765.60**	**58,609.40**	**50,653.50**	**55,240.40**
1	Domestic Revenue	35,600.00	34,367.40	34,367.40	36,368.30
2	Grants	21,165.60	24,242.00	16,286.10	18,872.10
B	**Outlay**	**73,919.30**	**77,383.40**	**69,026.20**	**70,543.90**
1	Current	35,598.70	35,598.00	35,598.00	35,992.60
2	Capital	38,320.70	41,785.40	33,428.30	34,551.30
C	**Fiscal Balance**	**(17,153.80)**	**(18,773.90)**	**(18,372.80)**	**(15,303.50)**
	Fiscal deficit (% of GDP)	**(8.6)**	**(9.9)**	**(9.7)**	**(7.3)**
D	**Financing**	**17,153.80**	**18,773.90**	**18,372.80**	**15,303.50**
	Net lending	*(3,085.60)*	*(3,085.60)*	*(3,085.60)*	*(2,307.80)*
	Net External	*444.8*	*3,812.30*	*3,812.30*	*3,222.90*
	Net Domestic	*13,623.30*	*11,876.00*	*11,474.80*	*9,772.80*
	Nominal GDP est.	***199,654.70***	***188,881.20***	***188,881.20***	***208,652.20***

3.4 PUBLIC DEBT STOCK

The total public debt stock as of 31 December 2021 stood at Nu. 239,792.039 million, accounting for 126.8 percent of FY 2021-22 GDP estimate. The total public debt comprised the external debt stock of Nu. 222,717.602 million (92.9 percent) and the domestic debt stock of Nu. 17,074.437 million (7.1 percent).

Total public debt stock decreased by Nu. 1,105.75 million (0.5 percent), compared to the public debt stock on 30 September 2021. The decrease was mainly on account of redemption of T-Bills stocks of Nu. 4,000 million. However, the drop was offset by Nu. 2,894.243 million due to increase in external debt stock.

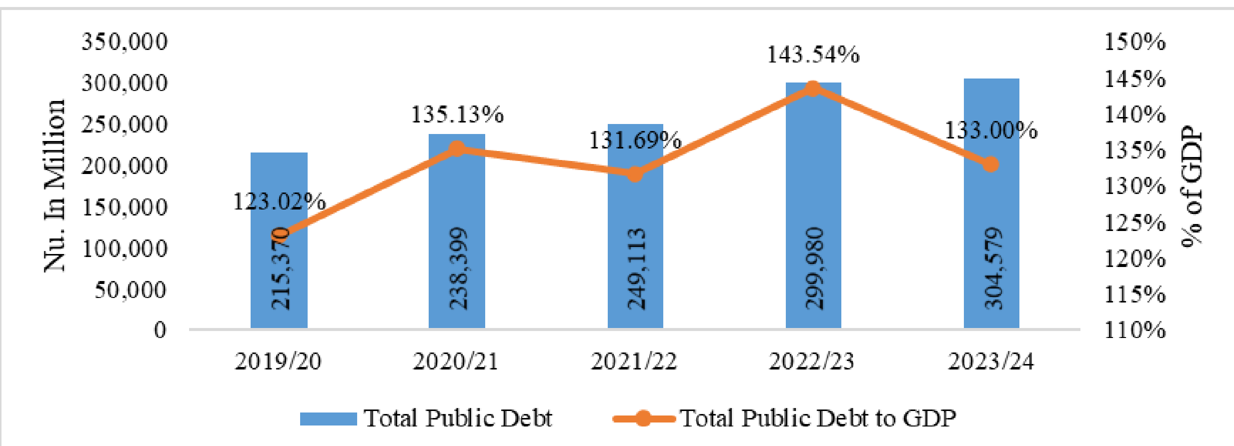
The external debt stock increased mainly on account of disbursement of $30 million by ADB for the Financial Market Development Program during the second quarter of the FY. In addition, the disbursement of INR 800 million for the ongoing hydropower projects during the second quarter increased the external debt stock.

Table 3.5 Debt Situation

Category	30 September 2021	31 December 2021	Change (amount)	Change (%)
Total Public Debt	**240,897.89**	**239,792.03**	**(1,105.75)**	**(0.5)**
Percent of GDP	127.3%	126.8%		
External Debt	**219,823.35**	**222,717.60**	**2,894.24**	**1.3**
Percent of GDP	116.2%	117.7%		
Percent of Total Public Debt	91.3%	92.9%		
Domestic Debt	**21,074.43**	**17,074.43**	**(4000.00)**	**(19.0)**
Percent of GDP	11.1%	9.0%		
Percent of Total Public Debt	8.7%	7.1%		
Hydro Debt Stock	**161,651.95**	**162,486.54**	**(834.59)**	**(0.52)**
Percent of GDP	85.5%	85.9%		
Non-Hydro Debt Stock	**58,717.40**	**60,231.05**	**1513.65**	**2.58**
Percent of GDP	30.8%	31.8%		

The total public debt stock in FY 2021-22 is projected at Nu. 249,113.49 million, accounting for 131.7 percent of GDP, and is expected to rise by 20.4 percent in FY 2022-23, owing mostly to the capitalization of Puna-II IDC (about Nu. 36.5 billion) following its commissioning in June 2023. Non-hydro debt stock is projected to increase by 7.8 percent and 8.9 percent in the two fiscal years, respectively, as concessional borrowings to cover the budget deficit (capex) are expected to rise. The non-hydro-to-GDP ratio of 33.6 percent in FY 2021-22 and 33.1 percent in FY 2022-23 is well within the Public Debt Policy threshold of 35 percent.

Chart 3.1 Total Public Debt Stock



While the total public debt level remains elevated at 126.8 percent of GDP as of Dec 2021, the overall risk is deemed manageable and the risk of debt distress is considered moderate. The major portion of external debt is on account of hydropower projects that are deemed commercially viable, with a ready export market in India. The fixed interest rate debt accounted for 95.5 percent of the total public debt and the average time to re-fixing (ATR) is estimated at 9.8 years. Thus, due to the long ATR and the low portion of the variable-interest-rate debt, the interest rate risk is considered low. Furthermore, 90.7 percent of the hydro debt is denominated in INR, to which the Ngultrum is pegged at par, mitigating exchange rate risks.

Similarly, the non-hydro debts are contracted from bilateral and multilateral development banks at highly concessional terms, with very low interest rate ranging from 0.75 percent to 1.5 percent, and repayment period as long as 30 years. Therefore, the debt servicing per installment is very low, minimizing the risk of debt default. In the medium to long term, the non-hydro debt is projected to decline, reducing the debt burden over the period.

4. BALANCE OF PAYMENT

In Brief

- *The current account balance in FY 2021-22 is estimated at 22 percent of GDP, largely contributed by a high trade deficit of 21.2 percent of GDP.*
- *As of December 2021, trade performance significantly improved, surpassing the pre-pandemic threshold. Total exports increased by 18.9 percent and imports increased by 35.8 percent compared to 2020.*
- *Gross reserve assets for FY 2021-22 are projected to decrease to $1.42 billion and are estimated to cover 25 months of essential imports fulfilling the constitutional requirement on reserve adequacy.*

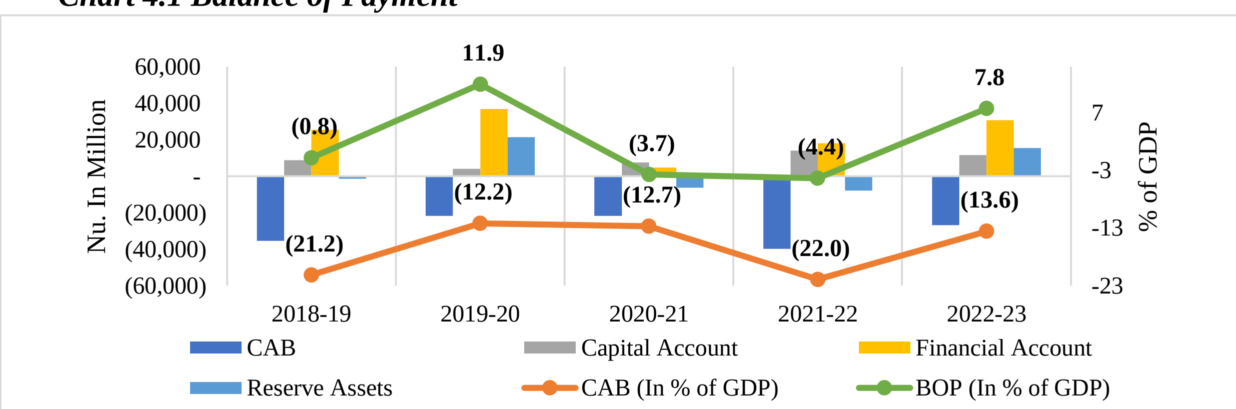
4.1 CURRENT ACCOUNT BALANCE

On the external front, the current account balance (CAB) is estimated to deteriorate from 12.7 percent of GDP in FY 2020-21 to 22 percent of GDP in the current FY, as a result of widening trade deficit of 21.2 percent of GDP.

The Capital Account is projected to grow by 87.6 percent in FY 2021-22, from Nu. 7,415.2 million in FY 2020-21 to Nu. 13,915.8 million in FY 2021-22, as budgetary allocations for investments and grants for hydropower development are expected to rise. Similarly, the Financial Account is projected to improve in FY 2021-22, as net inflows from multilateral agencies' concessional borrowings are expected to increase.

With negative reserve assets in FY 2020-21 and widening current account deficit, the forecast on overall balance of payment is Nu. -7,912.8 million (-4.4% of GDP). In the medium term, the current account deficit is expected to narrow as trade balance improves and electricity exports increase, culminating in a positive balance of payments.

Chart 4.1 Balance of Payment

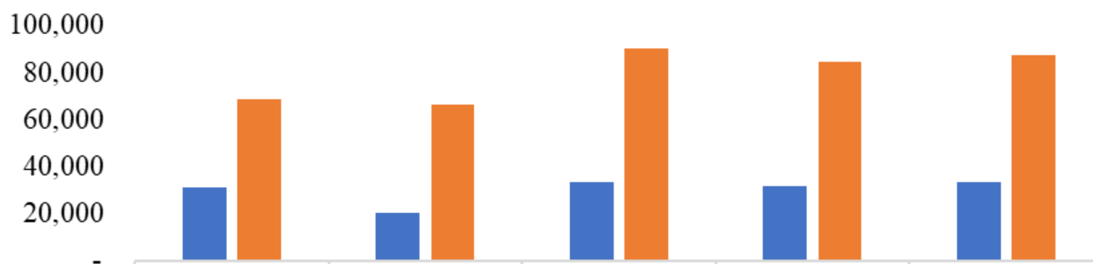


4.2 Trade Performance

As of December 2021, trade performance significantly improved surpassing the pre-pandemic threshold. Total exports increased by 18.9 percent and imports increased by 35.8 percent compared to 2020. Merchandise export was much stronger as it increased from Nu. 20,732.2 million in 2020 to Nu. 33,427.7 million in 2021, an increase by 61.2 percent while hydro export remained subdued in 2021.

Significant increase in overall import is attributable to increase in import from India by 39.2 percent and COTI imports by 24.5 percent. Excluding the one-time import of aircraft by Druk Air in 2020 (Nu. 6.23 billion), COTI imports in 2021 have significantly increased by Nu. 10,590 million depicting a growth of more than 100 percent.

Chart 4.2 Trade Performance



	2019	2020	2021	2022	2023
Export	31,249.95	20,732.24	33,427.65	31,754.06	33,448.42
Import	68,906.11	66,456.12	90,259.75	84,838.76	87,583.92

Primary drivers for the increase in imports were:

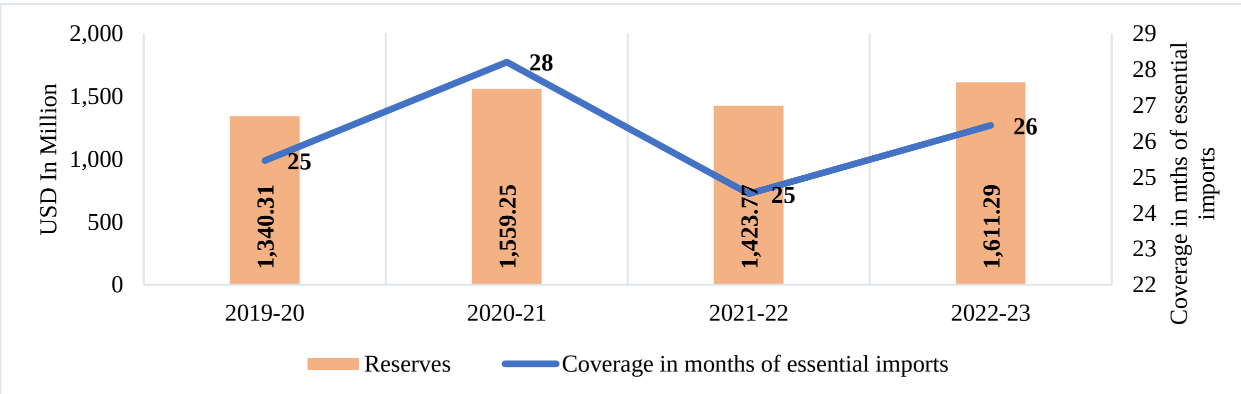
- Increase in import of processing unit and storage units by DHI for special projects;
- Increase in import of fossil fuels (Petrol and Diesel) in terms of both the price and quantity from Nu. 6.25 billion in 2020 to Nu. 8.34 billion in 2021;
- Increase in import of raw materials for Pasakha Industries from 8.3 billion in 2020 to 11.12 billion in 2021;
- Increase in import of pharmaceutical products;
- Increase in import of vehicles especially utility vehicles of Nu. 700 million.

With improved trade performance, the baseline scenario projects that overall exports will increase by 24.3 percent and imports by 22.8 percent in 2022 compared to the pre-pandemic level. However, the trade outlook remains susceptible to potential restrictions in the economic activities with new COVID-19 variants emerging posing considerable downside risks and policy uncertainties.

4.3 GROSS INTERNATIONAL RESERVES

Due to widening of CAB, the gross reserve assets in the FY 2021-2022 is estimated to deplete to $1.42 billion compared to $1.55 billion in previous FY. However, it will be adequate to cover 25 months of essential imports fulfilling the constitutional requirement on reserve adequacy.

Chart 4.3 Reserves Estimates



5. MONETARY MANAGEMENT & FINANCIAL INTERMEDIATION

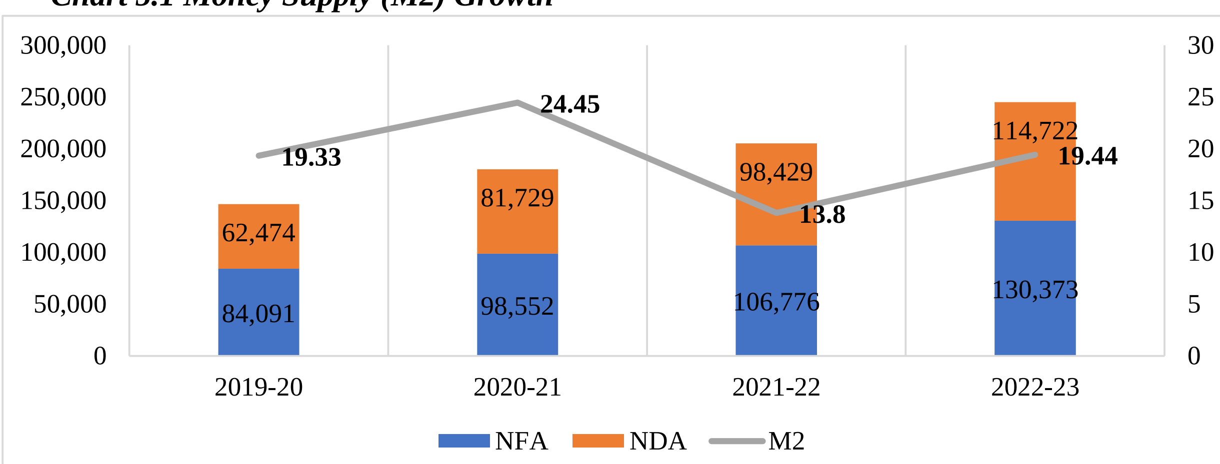
In Brief

- *For the FY 2021-22, money supply is estimated to grow by 13.8 percent owing to substantial increase in total deposits held by the commercial banks.*
- *As of December 2021, the banking sector is estimated to have adequate liquidity recording a surplus of Nu. 41,962.8 million which will be available for Government deficit financing, without crowding out credit to the private sector as economic activities picks-up.*
- *Credit growth slowed from the second half of 2020 and is estimated to decline from 13.2 percent in the FY 2020-21 to 6.5 percent in FY 2021-22 impacting private sector investments.*
- *Non-performing loans as of September 2021 stands at Nu. 21,769.6 million, a decline of 15 percent compared to the same period previous year.*

5.1 MONETARY AGGREGATES

Despite slowdown in the economy and high inflation, the monetary and credit situation remained favorable, supported by accommodative monetary and expansionary fiscal policies. Money supply, measured by broad money, is estimated to grow at 13.8 percent in the FY 2021-22, owing to an increase in total deposits (13.4 percent) held by the commercial banks which accounts for 93.1 percent of money supply components.

Chart 5.1 Money Supply (M2) Growth

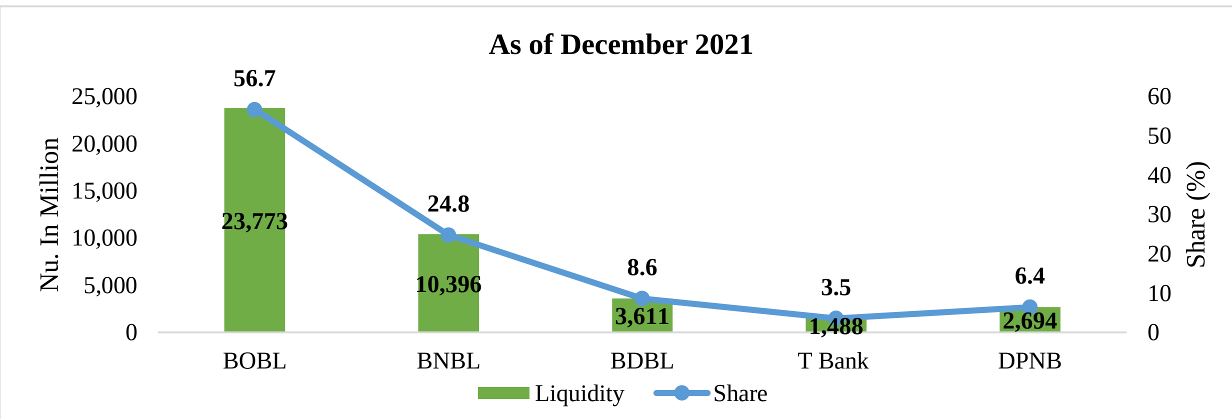


On the asset side, growth in M2 was mainly driven by the performance of net foreign assets (NFA) and net domestic assets (NDA). NFA is estimated to grow by 8.3 percent while NDA will grow by 20.4 percent in the FY 2021-22. The growth in NFA will be contributed by inflow of convertible currency which is expected to grow by 22.3 percent by the end of this FY. The money supply in FY 2022-23 is projected to grow by 19.4 percent.

5.2 Liquidity Conditions

With constant built-up of liquidity in 2020, the banking sector is estimated to have adequate liquidity in 2021, recording a surplus of Nu. 41,962.8 million (as of December 2021). The increase in liquidity is mainly attributed to increase in NFA inflows (in the form of loans, grants and hydropower receipts) and deposits. The liquidity surplus will be adequate to meet the government deficit financing, without crowding out credit to the private sector as economic activities picks-up. BOBL holds the highest liquid asset amounting to Nu. 23,773.3 million (56.6 percent) due to significant current account deposits held by the bank followed by BNBL at Nu. 10,396.3 million (24.7 percent). However, the excess liquidity if not managed deftly, might weaken the monetary policy transmission mechanism and ability of monetary authority to influence demand conditions in the economy.

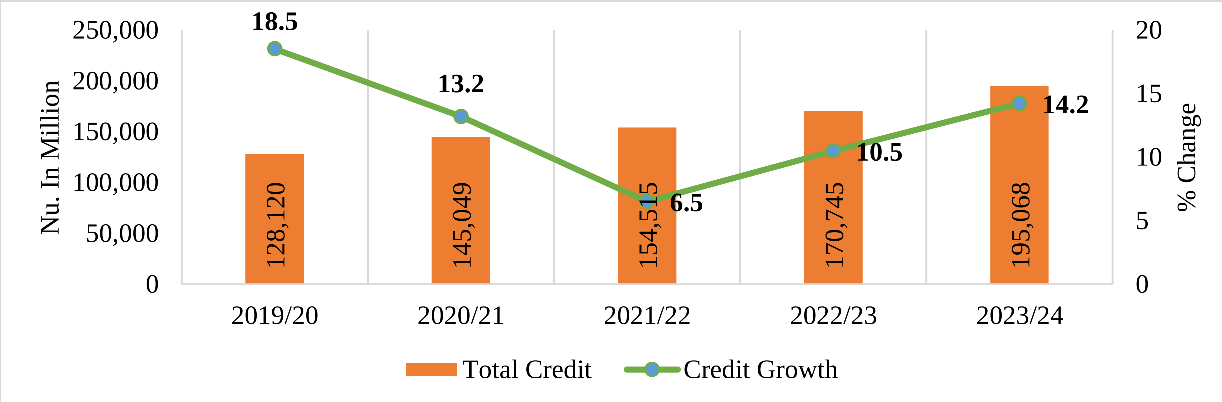
Chart 5.2 Excess Liquidity and its Share of the respective Banks



5.3 Credit Growth

Credit growth, which is determined by developments in the real sector and government expenditure, slowed from the second half of 2020. It is estimated to decline from 13.2 percent in the FY 2020-21 to 6.5 percent in FY 2021-22 impacting private sector investments. The fall in private investments and consumption demand followed by delay in execution of government capital works has disrupted the credit flow. However, with the gradual easing of containment measures and anticipated rebound in economic activities, the credit to the private sector is projected to grow at 10.5 percent in the FY 2022-23.

Chart 5.3 Total Credit and its Growth

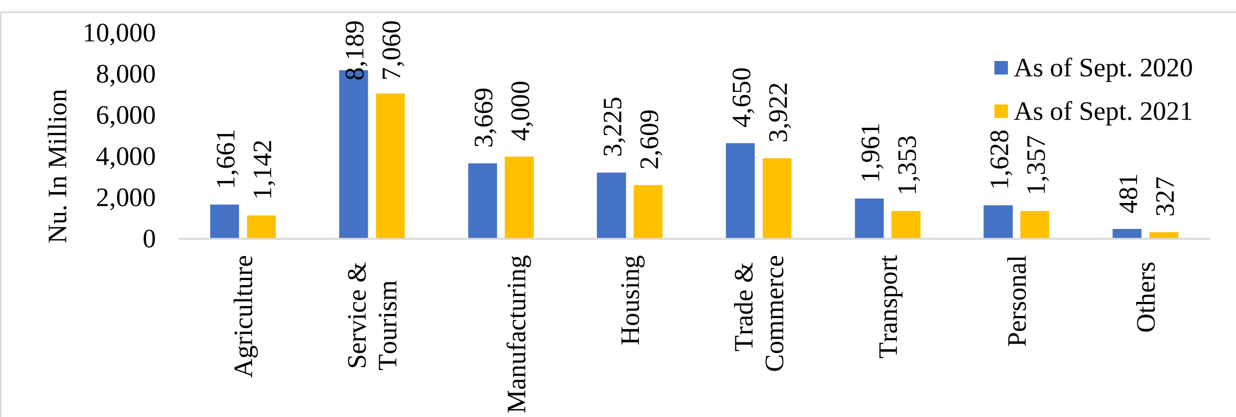


Of the total credit to the private sector, the housing sector receives the highest in terms of share to the total loan portfolio with 26.8 percent, closely followed by the service and tourism sector at 26.5 percent. While the manufacturing sector receives a credit of 13.3 percent, trade & commerce 12.8 percent, the lowest credit is availed by the agriculture sector at 4 percent.

5.4 Sectoral Non-Performing Loans

In terms of soundness of the financial sector, the overall asset quality of the financial institutions improved with the decline in NPL by 14.5 percent from 25,462.94 million in September 2020 to Nu. 21,769.54 million in September 2021. In terms of sectoral NPL the highest was recorded in the service & tourism sector at 32.4 percent, followed by manufacturing at 18.4 percent as these two sectors were severely affected by the pandemic. The decline in NPL is due to the interest payment relief, loan deferments and NPL resolution framework which is in place helping in alleviating the effect of the pandemic on the NPLs to a large extent and allowing for new credit supply in the economy.

Chart 5.4 Sectoral Non-Performing Loan (NPL)



6. PRICES AND INFLATION

Rising prices and supply chain disruptions have resulted in higher and more broad-based inflation than anticipated. Inflation peaked during the first half of 2021 where commodity prices increased significantly reaching a peak of 9.54 percent in February 2021. Inflationary pressures have been building up in recent months as domestic and imported food prices continue to rise due to limited supply and higher transport costs. Overall inflation in 2021 peaked at 7.35 percent, an increase of 1.72 percentage point compared to 5.63 percent increase in 2020. The increase in inflation in 2021 was due to an increase in the non-food by 5.62 percent compared to 1.24 percent increase in 2020.

Since, around 54 percent of the CPI basket is imported, inflationary pressure from India is expected to keep pushing up food prices in the medium term. The timing and sequencing of monetary policies by the central bank will remain critical to curb inflationary pressure. Under the baseline scenario, annual inflation is forecasted to fall to 5.15 percent in 2022 and 3.53 percent in 2023, returning to its pre-pandemic trend.

Chart 6.1 CPI Inflation M-o-M

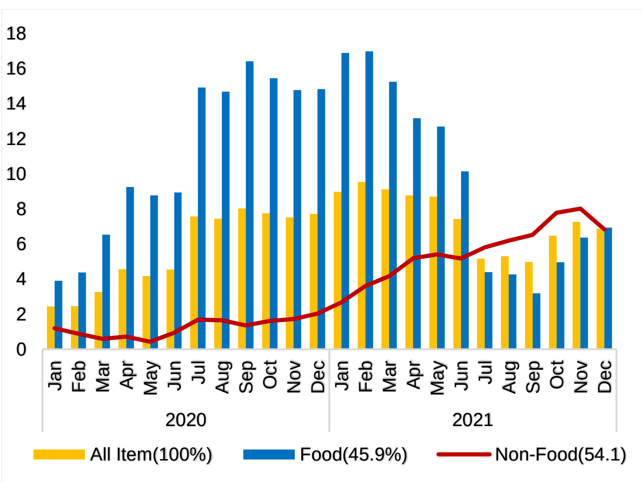
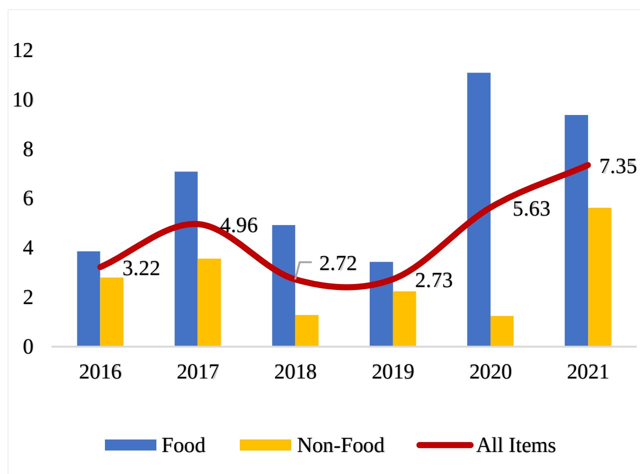


Chart 6.2 CPI Inflation Y-o-Y



7. RISKS AND CHALLENGES

Given the recent global developments and high degree of uncertainty with the pandemic situation, risks to economic growth and recovery could emanate from both external and domestic environments. External risks such as slowdown in global growth or in the region, rise in crude oil prices, new waves of infection, and restrictions on tourism related travel. Domestic risks include disruptions related to pandemics and uncertainties surrounding it.

Besides the broad macroeconomic challenges such as economic diversification, vulnerabilities from climate change and unemployment, some of the possible risks and challenges to economic recovery based on the current update are listed below:

Inflationary Pressure: Domestic food prices remain elevated due to disruptions in the supply chain and spillover effect of inflationary pressure from India. As a result, inflation has been persistent over the past two years and signs of persistent inflation continue as both food and non-food prices are on the rise, which poses a risk of depressing an already weak economy. Surge in prices combined with low growth and high unemployment could lead to a stagflation.

Fiscal Risk: With expected decline in domestic revenue, fulfilling the constitutional mandate of meeting the current expenditure fully is at risk. Therefore, immediate interventions need to be undertaken to enhance domestic revenue or rationalize expenditure to ensure 100 percent coverage.

The capital budget allocation for this fiscal year is one of the highest in order to increase demand for economic activities through capital works implementation. However, the utilization rate for the first half of the year was just 25%, indicating a slowdown in public investments and, as a result, a slowdown in growth. To boost economic activity and create demand, the capital budget must be used efficiently and effectively, and steps to improve should be implemented.

The growing fiscal deficit, which has increased from Nu. 17 billion to Nu. 18 billion, is putting pressure on the financing requirement. While additional borrowings from external sources have been mobilized, increased borrowings add on to non-hydro debt stock. Despite the threshold, borrowings to invest in social sectors could pose risks if the fiscal situation doesn't improve. This is a medium-term risk, and certain steps for improved readiness could be implemented. The mobilization of domestic revenues and prudent management of hydropower revenues to finance adequate levels of public spending against the backdrop of decreasing foreign assistance, while ensuring macroeconomic stability, are key medium-term policy challenges.

Further, with the present pandemic-related challenges, such as labour and material shortages, completing and commissioning Punatsangchhu II on schedule will be challenging, potentially affecting medium-term economic growth. This could lead to lower electricity exports and larger fiscal deficits.

External Risk: A resurgence in the COVID-19 pandemic particularly in India remains the main risk to the growth prospects. Given the country's significant tourism and trade ties with India, the cross-border spillover could affect manufacturing and exporting industries and reduce demand for non-hydro exports. While trade performance exceeded the pre-pandemic level in 2021, boulder exports are still lagging behind as issues at the border areas remain unresolved.

Further, with the pegged exchange rate regime, any depreciation of the Indian rupee would raise the cost of imports from third countries and place pressure on the convertible currency debt stock.

Liquidity management: Excess liquidity management is more of a challenge, since it has increased by more than 50 percent in the last two years, largely through growing fixed deposits of around 30 percent, indicating a lack of demand generating activities and restricted investment avenues.

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