Macroeconomic Situation Report

Fourth Quarter Update: FY 2021-22

Department of Macroeconomic Affairs

August 2022

Contents

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 economic advice to 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 **30th June, 2022.**

1. GLOBAL & REGIONAL OUTLOOK

1.1 GLOBAL ECONOMIC SITUATION

Global economic prospects have worsened due to significant rise in overall uncertainties and risks. Higher inflation worldwide, especially in the United States and major European economies, a sharp tightening of global financial conditions in advanced economies, disruption of global supply chain due to economic slowdown in China, and ongoing geopolitical tension between Ukraine and Russia are forces shaping the global economic outlook. These strong headwinds are heightening the global risks and recession concerns.

- *Global growth:* Global economic growth is projected to slow from an estimated 6.1 percent in 2021 to 3.2 percent in 2022 and moderate to 2.9 percent in 2023, 0.4 and 0.7 percentage points, lower than in the April 2022 World Economic Outlook (WEO) update, respectively. Downward revision in growth is largely due to sharper slowdown in the United State and major European economies on account of a steeper tightening in monetary conditions and negative spill-overs impact from the war in Ukraine.

- *Inflation*: Global inflation has been revised up to 8.3 percent in 2022 from 6.9 percent and 4.8 percent in 2023, largely contributed by significant increases in headline inflation among major economies such as the United Kingdom at 10.5 percent and the euro area at 7.3 percent. The upward revisions of inflation are due to rising food and energy prices and lingering supply-demand imbalances caused by supply chain disruption and war conflict in Ukraine, blocking the export of wheat and fertilizers. The supply-related shocks to food and energy could sharply increase headline inflation and pass to core inflation. The inflation is expected to reach pre-pandemic level by 2024 as the fuel price pressure begins to ease.

- *Global trade:* Global trade growth is expected to slow down in 2022 and 2023 due to demand and supply chain problems. The dollar's appreciation in 2022- by about 5 percent in nominal terms as of June – is likely to have slowed world trade growth for a country trade transaction are carried out in dollar-denomination. The decrease in global trade is expected to significantly impact in building international reserves and increasing the external debt repayment burden.

1.2 Regional Economic Situation

For emerging and developing Asia, the growth is estimated at 4.6 percent in 2022 and 5 percent in 2023, 0.8 and 0.6 percentage points lower than the previous forecast. It is mainly on account of the sharp slowdown of China's economy and the moderation in India's economic growth due to less favorable external conditions and more rapid policy tightening (WEO, July 2022).

- India's recovery phase is facing growing risks most notably from rising prices stoked largely by its reliance on imported oil. In 2021, fuel accounted for 30 percent of India's imports by value and as of June 2022, India recorded a trade deficit of US$ 26.2 billion, the highest among Asian economies, largely due to crude oil imports. India's current account in 2022 is projected to fall further (-2.8 percent of GDP) due to surging imports and higher inflation. The projected CAD is one of the largest among significant Asian economies, second to the Philippines (Financial Times).

- In the case of Bangladesh, a large trade deficit in the face of depreciation of local currency against USD and declining remittance from overseas has weakened the nation's finances. The bank's foreign exchange reserves fell to $39.67 billion as of July 2022– sufficient for imports for more than five months – from $45.5 billion a year earlier. As an austerity measure, the Bangladesh Bank recently announced a policy to preserve dollars by discouraging imports of luxury goods, fruits, non-cereal foods, and canned and processed foods (Aljazeera News).

- While the economies in the region have performed fairly well in terms of growth, external imbalances continue to persist due to fall in forex earnings. Countries, such as Sri Lanka, Pakistan ($6 billion), Bangladesh ($4.5billion) have approached the IMF for loans to support the balance of payment crisis.

- Maldives which mainly depends on the tourism sector may be an interesting case study. After a significant decline of 33.5 percent in 2020, the annual GDP grew by 37.0 percent in 2021. The strong rebound was mainly driven by robust recovery of the tourism sector in addition to positive contributions of other major sectors such as transportation and communication, construction, and wholesale and retail trade. After the re-opening of the international borders in July 2020, the total tourist arrivals in 2021 (1.3 million) was 77.6 percent of 2019 (1.7 million).

2. OVERVIEW

The economy recorded a positive growth of 4.1 percent in 2021 supported by accelerated public expenditure and implementation of various developmental projects. Following expansionary fiscal policy and accommodative monetary policy, the credit growth heightened leading to the growth of private sector invariably. Overall trade performance improved remarkably indicating signs of economy revival. On the other hand, abrupt pick-up in economic activities was underpinned by high inflationary pressure owing to continued supply chain disruptions and higher commodity prices. The fiscal deficit remained elevated reflecting scale up in capital expenditures and revenue performance remaining subdued. Current account balance widened further driven by significant increase in the trade deficit leading to drawdown of foreign reserves. Given these rising external vulnerabilities, risk of macroeconomic instability has been heightened.

3. DOMESTIC ECONOMIC DEVELOPMENTS

3.1 GROWTH PERFORMANCE AND OUTLOOK

Growth rebounded moderately in 2021 as economic activities picked up supported by expansionary fiscal policy, monetary support and progressive relaxation of containment measures. The economy grew at 4.1 percent in 2021, an increase of 14.1 percentage points compared to a decline of -10.0 percent in 2020. All the sectors exhibited a robust growth due to strong domestic demand and in tandem with the global economic recovery. Industrial output grew by 1.9 percent after an all-time low of -12.9 percent in 2020. The sub-sectors contributing to the industrial growth were mining & quarrying, and construction sector. Manufacturing production (cement, food, chemical and metal industries) also improved buoyed by government's counter-cyclical programs and monetary relief measures.

With the gradual easing of mobility restrictions and resumption of economic activities, service sector recorded a positive growth of 6.3 percent in 2021. Despite tourism industry being on a standstill, the revival in retail trade and other domestic businesses, steered the growth of the service sector, contributing around 44.0 percent to the GDP in 2021. Agriculture growth decelerated to 2.1 percent in 2021 compared to 4.6 percent in 2020 attributable to reduced production in livestock and forestry sector.

Economic growth of 4.9 percent anticipated in 2022 despite the two prolonged lockdowns from mid-January to March to contain the spread of the virus. With the nation achieving mass vaccination (almost 90 percent of its adult total population has received a booster dose by early March 2022) backed by robust policy measures and gradual opening up of tourism by September 2022, the economy is projected to sustain a growth of 4.9 percent. The growth trajectory is based on the assumption that there will be no emergence of new variants or mobility restrictions while government spending continues to boost aggregate demand and investments are implemented on time.

However, amidst heightened global and regional uncertainties coupled with emerging issues within the domestic economy, downside risk to growth is anticipated. The consequences of rising geopolitical conflict and increasing food and energy prices will adversely impact the economy posing risks to growth prospects. In the medium term, the recovery in services and hydropower is expected to drive growth, with electricity generation capacity expected to double provided the commissioning of various hydro-power projects takes place on targeted time.

Chart 3.1 Contribution to Growth, Supply Side (in %)

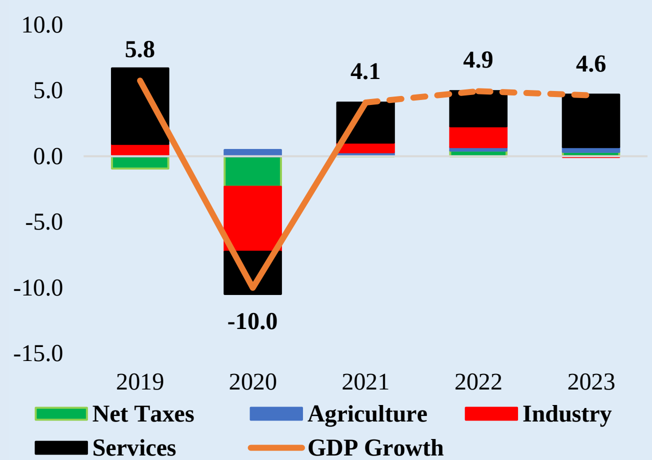


Table 3.1 Sectoral Update

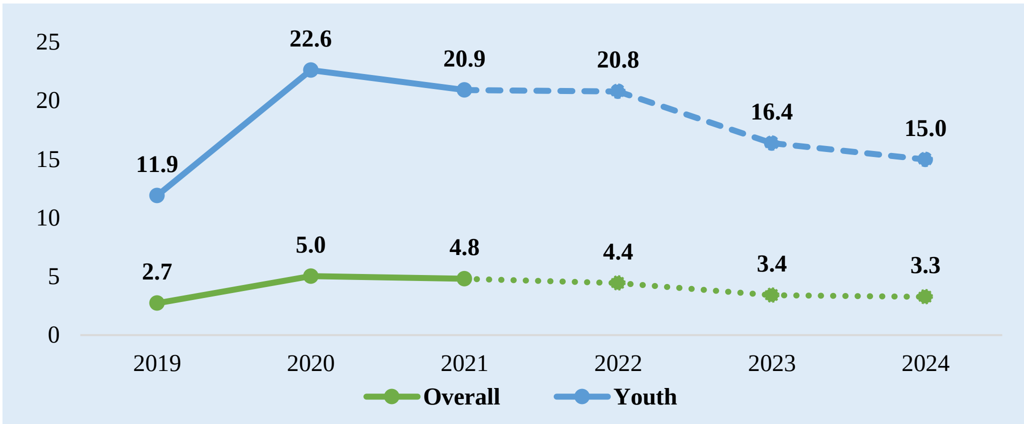
Percent Change (YoY)	2020	2021	2022	2023
	Act.		*Est.*	
GDP Growth	**(10.01)**	**4.09**	**4.95**	**4.63**
Agriculture, Livestock & Forestry	4.57	2.05	2.18	3.23
Industry	(12.84)	1.96	4.37	(0.15)
Services	(6.93)	6.32	5.42	8.08
Net Taxes	(49.48)	2.73	16.83	11.27

3.2 Employment

Overall unemployment situation improved in tandem with economic revival in 2021. With the improvement in the overall economic situation and implementation of numerous skilling programs such as Skills Development Plan (SDP), Entrepreneurship Courses, Build Bhutan Project (BBP) and Youth Engagement and Livelihood Programs (YELP), the unemployment situation improved to 4.8 percent (16,254 persons) in 2021 from 5 percent (16,660 persons) in

2020. Similarly, youth unemployment rate improved to 20.9 percent in 2021 compared to 22.6 percent in 2020.

Chart 3.2 Unemployment Situation (in%)



Despite various policy measures, employment is yet to fully recover from the unprecedented shock of the pandemic. While Labor market conditions are expected to improve but a full employment recovery is projected only after 2025 in line with aggregate output returning to pre-pandemic level.

3.3 Inflation

Inflation peaked at 8.2 percent by the end of FY 2021-22 mainly driven by increase in non-food prices. For the last two years, inflation was mainly driven by increased food prices, which was on a higher end compared to non-food prices. However, starting from July 2021, increase in non-food prices added to the inflationary pressure. Sudden hike in the fuel prices (petrol and diesel) due to limited supply and geopolitical tensions in the region caused drastic increase in the overall commodity prices. As of June 2022, inflation increased to 6.5 percent compared to June 2021 due to increase in both food prices by 5.1 percent and non-food prices by 7.8 percent.

Inflationary pressure will persist in the medium-term with the surge in both food and non-food prices. Overall inflation for FY 2021-22 was recorded at 5.9 percent, a decrease of 2.3 percentage points compared to FY 2020-21. It was mainly attributable to slowdown in food inflation (primarily vegetables and meat) as price were regulated by the concerned authority, and also due to rationalization of customs duties for the imports from COTI. Under the baseline scenario, annual inflation is estimated at 7.0 percent in current FY 2022-23 and 6.7 percent in FY

2023-24. However, as 80 percent of Bhutan's import is associated with India, any inflationary pressure in India is expected to transmit to domestic inflation though with a time lag. Thus, estimates of inflation remains highly uncertain.

Chart 3.3 CPI Inflation Trend (YoY %)

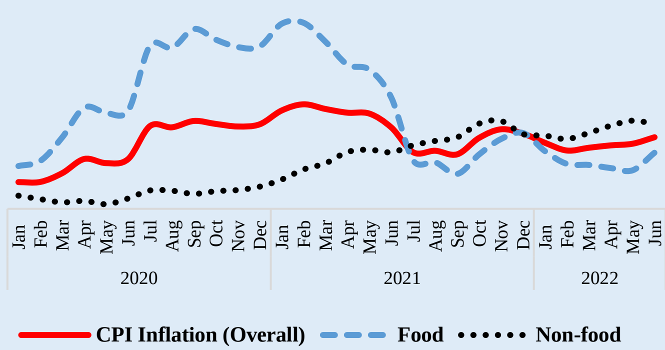
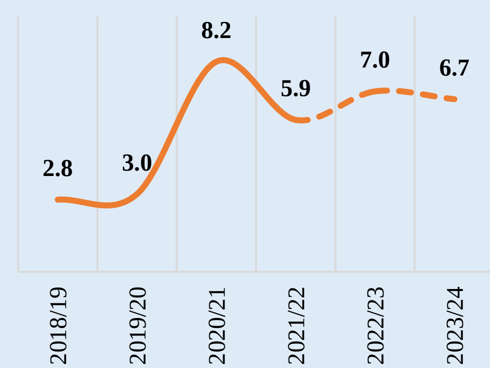


Chart 3.4 Headline CPI Inflation (% Change)



4. FISCAL DEVELOPMENTS

Fiscal deficit remained elevated as resource mobilization were lower compared to increased spending requirements related to COVID-19 pandemic. For the FY 2021-22, total expenditure increased by 16.4 percent *(exclusive of NRF)*, while total revenue mobilized reduced by 12.7 percent translating to a fiscal deficit of 8.9 percent of GDP (provisional). The increase in spending was primarily driven by capital expenditure reflecting a targeted scale up in public infrastructure projects to support economic revival. Capital expenditure is estimated to have increased by 25.2 percent while recurrent expenditure was maintained within the domestic revenue. On the resources side, domestic revenue exhibited a growth of 8.9 percent due to increase in tax revenue by 25.1 percent mainly stemming from improved collection in CIT, BIT, PIT, Sales tax and Green tax. While grants remained on a lower end with receipt of 61.7 percent only compared to the budgeted amount.

For the current FY 2022-23, fiscal deficit is estimated at 9.0 percent of GDP as government spending continues to accelerate economic recovery. The total expenditure is estimated to increase by 8.0 percent with capital budget of Nu. 38.5 billion, which is one of the highest constituting 51.5 percent of the total outlay. Domestic revenue is revised from an estimated of Nu. 36.4 billion to Nu. 41.3 billion, with the inclusion of royalty from tourism industry and broad-based improvement in the collection from both direct and indirect taxes. In terms of grant mobilization, residual amount of 12th FYP amounting to Nu. 14.8 billion is estimated to be received in the current FY.

Table 4.1 Fiscal Accounts

Particulars (Nu. In Million)		2018/19	2019/20	2020/21	2021/22	2022/23
			Act.		Prov.	Est.
A	**Resources**	**42,033**	**54,604**	**59,696**	**52,107**	**56,151**
1	**Domestic Revenue**	**34,708**	**36,219**	**35,855**	**39,043**	**41,279**
	Tax Revenue	27,171	22,793	20,662	25,842	27,653
	Non-tax Revenue	7,537	13,426	15,194	13,200	13,626
2	**Grants**	**10,516**	**16,426**	**14,882**	**13,064**	**14,872**
B	**Expenditure**	**44,777**	**57,989**	**70,836**	**69,198**	**74,747**
1	Current	27,769	35,525	43,516	34,683	36,280
2	Capital	16,285	22,047	27,576	34,515	38,467
C	**Fiscal Balance**	**(2,743)**	**(3,385)**	**(11,140)**	**(17,091)**	**(18,595)**
	Fiscal deficit (% of GDP)	**(1.6)**	**(1.9)**	**(6.2)**	**(8.9)**	**(9.0)**

Total public debt is estimated to increase although the overall risk is deemed manageable as the risk of debt distress is considered moderate. As major portion of external debt is in hydropower projects, which are commercially viable and deemed self-liquidating, increase in debt ratio may not be a cause of concern. For FY 2021-22, total public debt stock stood at Nu. 257.6 billion, accounting for 132.9 percent of GDP, of which external debt stock comprised of Nu. 229.6 billion. While the domestic debt stock stood at Nu. 28.1 billion, an increase of 64.4 percent due to issuance of government bonds of Nu.8.5 billion.

For FY 2022-23, total public debt stock is estimated to increase to Nu. 263.2 billion (128.0 percent of the GDP) and to Nu. 318.8 billion in the FY 2023-24 accounting for 144.2 percent of GDP mainly on account of PHPA II disbursements and inclusion of upcoming new small hydropower projects. Non-hydro debt is also projected to increase over the medium-term as concessional borrowings would be undertaken to meet the fiscal deficit.

Table 4.2 Debt Situation

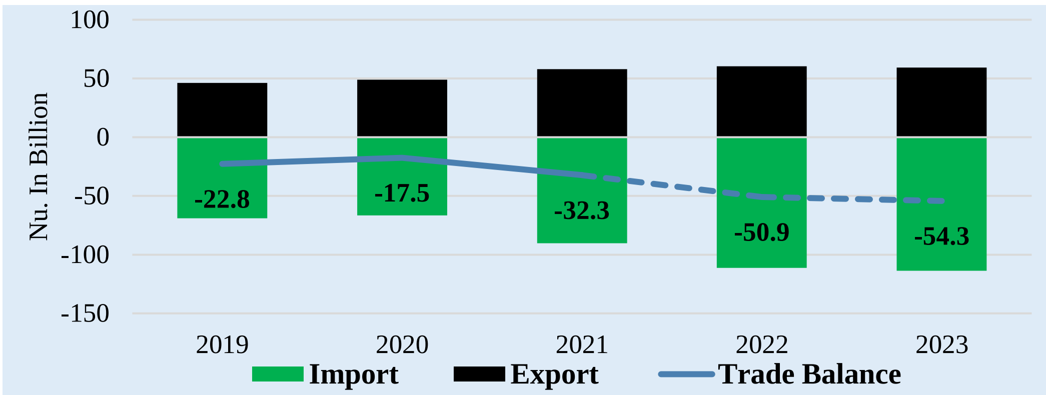
Particulars (Nu. In Million)	2018/19	2019/20	2020/21	2021/22	2022/23
			Act.		Est.
Total Public debt	**184,175**	**215,370**	**238,399**	**256,237**	**263,119**
% of GDP	*106.5*	*122.8*	*132.4*	*132.9*	*128.0*
1. Domestic debt	**5,060**	**1,987**	**17,074**	**28,061**	**28,627**
% of GDP	*2.9*	*1.1*	*9.5*	*14.6*	*13.9*
% of Total Public Debt	*2.7*	*0.9*	*7.2*	*11.0*	*10.9*
2. External debt	**179,115**	**213,383**	**221,324**	**228,176**	**234,493**
% of GDP	*103.6*	*121.6*	*122.9*	*118.3*	*114.0*
% of Total Public Debt	*97.3*	*99.1*	*92.8*	*89.0*	*89.1*
2.1 Hydro debt	137,005	159,360	162,359	164,219	167,107
2.2 Non-hydro debt	42,110	54,024	58,965	63,957	67,386
2.3 Rupee debt	131,433	152,197	155,005	156,673	159,689
2.4 CC Debt	47,682	61,186	66,320	71,504	74,804

5. BALANCE OF PAYMENT

The current account balance (CAB) is expected to deteriorate from negative 12.1 percent of GDP in FY 2020-21 to negative 28.0 percent in the FY 2021-22, as a result of widening trade deficit. With the normalization in situation and resumption of economic activities, trade flows picked up surpassing the pre-pandemic threshold. However, the increase in imports were much higher compared to the exports leading to a huge trade deficit of 19.3 percent in the FY 2021-22 from 6.9 percent in the FY 2020-21. As a result, CAB is expected to remain elevated in the medium-term with imports increasing exponentially and exports remaining subdued.

The recovery in trade performance has been immediate and widespread across all the sectors of the economy after a significant drop in 2020. The overall import in 2022 (January- June) increased by 52.0 percent as compared to the same period in the previous year whereas exports increased by 24.3 percent only. If similar trade pattern continues in the upcoming months, the baseline scenario projects that by the end of 2022, overall import value will stand at Nu. 111.3 billion and export at Nu. 60.4 billion. As the magnitude of increase in imports is much higher compared to the export, trade deficit is expected to widen further.

Chart 5.1 Trade Performance



The balance of payment situation is expected to worsen as current account balance deteriorates in the medium term. The net financial inflows which is used to finance the current account deficits over the period has been decreasing due to lower inflow of official grants, thereby impacting the gross international reserves. The gross international reserve depleted from US$ 1,559.2 million in FY 2020-21 to US$ 1,120.5 million in FY 2021-22.

As of June 2022, the reserve stood at US$ 839.6 million (Monthly Statistical Bulletin, RMA), which is much lower compared to the June 2021. Further, as prospects of tourism sector remains unpredictable due to global economic uncertainties, prolong impact of Covid-19 pandemic particularly rising inflationary pressure, depreciation of exchange rate in emerging economies, and with the expected rise in imports, the external reserve position for FY 2022-23 is estimated to remain around US$ 845.2 million. In order to prevent from breaching of the constitutional requirement, an appropriate policy measures are warranted to build the external reserves and also avert any economic vulnerabilities and shocks.

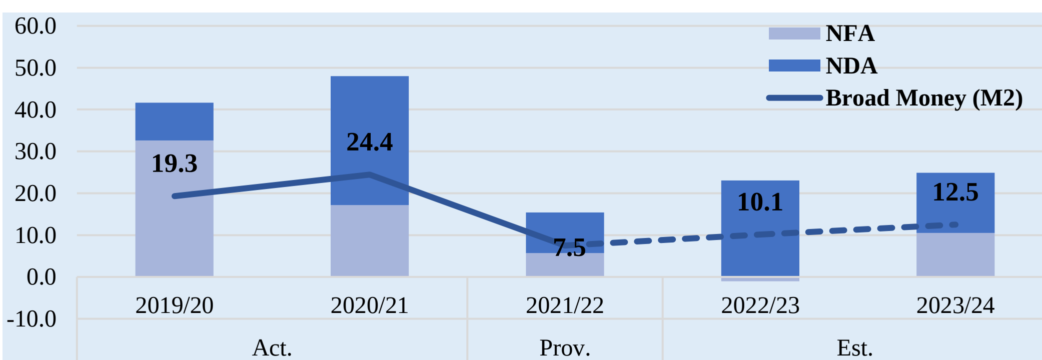
Table 5.1 External Accounts

Particulars (Nu. In Million)	2019/20	2020/21	2021/22	2022/23
	Act		Prov.	Est
Trade Balance	(22,726)	(12,430)	(37,239)	(39,050)
% of GDP	***(13.0)***	***(6.9)***	***(19.3)***	***(19.0)***
Current Account Balance	(27,712)	(21,778)	(53,996)	(51,969)
% of GDP	***(15.8)***	***(12.1)***	***(28.0)***	***(25.3)***
Capital Account	10,373	7,415	7,810	13,560
% of GDP	***5.9***	***4.1***	***4.1***	***6.6***
Financial Account	(27,252)	(4,656)	(18,976)	(16,724)
% of GDP	***(15.5)***	***(2.6)***	***(9.8)***	***(8.1)***
GIR (US$ in million)	**1,340**	**1,559**	**1,120**	**845**

6. MONETARY MANAGEMENT & FINANCIAL INTERMEDIATION

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 (M2), measured by broad money, is estimated to grow at 7.5 percent in the FY 2021-22, owing to an increase in total deposits (7.2 %) held by the commercial banks, accounting for 93.1 percent of money supply components. On the asset side, growth in M2 is driven by improved performance in both net foreign assets (NFA) and net domestic assets (NDA). The money supply in FY 2022-23 is projected to grow by 10.1 percent.

Chart 6.1 Money Supply (YoY Change)



Domestic credit growth is estimated to have slowed down to 4.8 percent in the FY 2021-22 compared to 6.5 percent in FY 2020-21. The slower growth was most accentuated in the manufacturing, construction, and service & tourism sector, reflecting an adverse impact of the pandemic including delays in government spending on capital projects. Going forward, domestic credit is projected to grow at 10.8 percent in FY 2022-23 and 12.3 in FY 2023-24 in tandem with economic growth and supportive monetary measures.

In terms of soundness of the financial sector, the overall asset quality of the financial institutions weakened with the marginal increase in NPL by 2.1 percent in the FY 2021-22. In terms of sectoral NPL, the highest was recorded in the service & tourism sector at 29.3 percent, followed by trade & commerce sector at 19.5 percent and manufacturing sector at 19.2 percent, as these sectors were severely affected by the pandemic.

Supported by various policy measures, overall banking liquidity remains adequate to facilitate credit growth in FY 2022-23. The excess liquidity in banking sector for FY 2021-22 was estimated at Nu. 19.9 billion (equivalent to 10.3 percent of money supply) compared to Nu. 32.2 billion in the FY 2020-21. The reduction was mainly on account of economic activities picking up and gradual fall in term deposits. However, the liquidity position in FY 2022-23 is expected to remain just adequate to meet the government's domestic borrowing. While continuity of expansionary monetary stance in the medium term is expected to poses risks in meeting the fiscal obligations with crowding out private credit.

Chart 6.2 Credit Growth (in %)

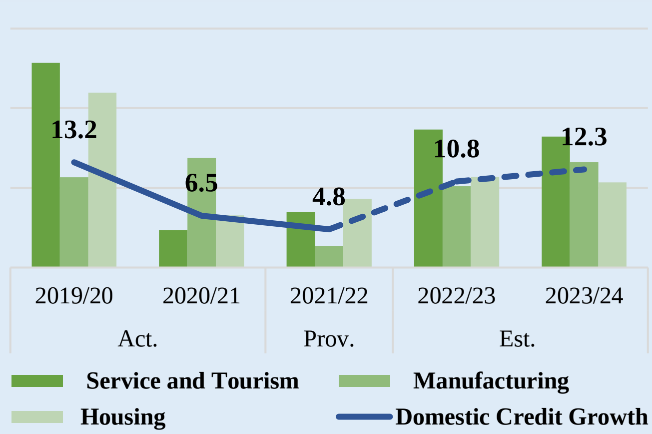
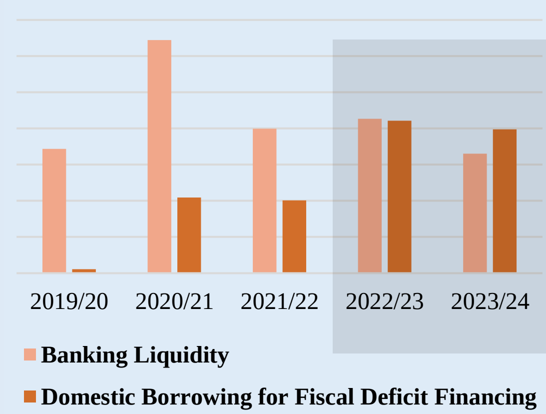


Table 6.1 Banking Liquidity & Domestic Borrowing (Nu. In billion)



7. RISKS AND CHALLENGES

With the recent on-going geopolitical conflict and high degree of uncertainty with the pandemic situation, risks to economic growth and recovery could emanate from both external and domestic environments. 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:

Widening current account deficit will put further strain on the overall reserve of the economy. As the economy returned to normalcy with the relaxation of containment measures, economic activities including public infrastructure as well as hydropower projects resumed resulting in significant imports. The growth in imports were much stronger than the exports, leading to deterioration of the trade balance and the CAB.

As the financial inflows are not adequate to meet the current account deficit, the negative balance of payments will lead to depletion of overall reserve assets posing risk to the constitutional mandate of meeting 12 months of essential imports. The macroeconomic imbalance emanating from the external sector is likely to spillover to other sectors of the economy eventually impacting growth prospects.

The rising geopolitical tension will aggravate the already existing inflationary pressure. Against the already turbulent backdrop of global inflationary pressures following the COVID-19 pandemic, the war between Russia and Ukraine has exacerbated supply chain disruptions leading to a spike in commodity prices and broadening price pressures. The geopolitical conflict is likely to have a prolonged impact especially on food and energy prices leading to demand-supply imbalances.

With the war-induced commodity price increase, the impact will be felt mostly through higher cost-push inflation weighing on all the economic sectors including households, businesses and government. As an import dependent economy, higher energy and food prices will increase the import prices resulting in an increase in prices of domestic production. Therefore, surge in prices combined with low growth and high unemployment may lead to stagflation crippling the economy.

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