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NATIONAL COUNCIL OF BHUTAN

Review of Policy and Issues Pertaining to the Indian Rupee Shortfall in Bhutan

ECONOMIC AFFAIRS COMMITTEE (EAC)

20th February 2013

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[Report submitted to the Tenth Session of the National Council of Bhutan]

Contents

A. Background

In November 2011 Bhutan’s available Indian Rupee (INR) balance reached negative 14.4 billion causing serious economic concerns. Since India is Bhutan’s largest trading partner and the single largest source for our imports, it will be vital to address the INR shortfall for our long term economic security and stability.

In March 2012, the government in an attempt to curtail INR outflows announced series of administrative and policy measures (such as import ban on selected goods and ban on construction loans, streamlining of INR payments). Although these measures may have been necessary to prevent the situation from worsening, they caused serious concerns among the general population and shook public confidence in the institutions entrusted to govern the nation’s economic policies. An assessment of the data and information of the past two decades or so shows that that issues related to INR shortfall are not entirely new and extend as far back as early nineties.

The country is paying a heavy price to service the rupee loans taken from the Government of India and two Indian commercial banks to meet the INR shortfall. As of January 2013 Bhutan’s borrowings on this front exceed INR 17 billion.

Since early 2012, several studies have been conducted to find the causes of the INR shortfall and to recommend solutions. These studies mainly point the cause to Bhutan’s economic structure, trade imbalance, excessive import and consumption pattern, expansionary fiscal policy, high credit growth etc. Invariably this led to an active finger pointing in the news media basically concluding that every citizen is responsible.

While the causes of the INR shortfall have largely been attributed to our economy and trade structure it is vital to note that neither the political economy nor the market economy exists in abstraction or in a policy vacuum. The economy including the government expenditure, market dynamics and consumer behavior are heavily influenced by public institutions and their policies and decisions.

Therefore, the Economic Affairs Committee (EAC) of the National Council deems it vital to review the role of key public institutions and policies in causing this INR shortfall problem to assume the severity and magnitude it did by the end of 2011. As this review report will focus primarily on policy issues, it is recommended that, for comprehensive understanding of the issue, this report be read along with the Government's Task Force Report published in 2012, which analyses the causes as well as provides economic and technical solutions to the problem.

The National Council in the Eight Session mandated the Economic Affairs Committee to conduct a policy review on the INR shortfall. Since the economic and structural causes of the INR shortfall have been covered in various studies conducted thus far, the intent of the National Council's Review Report is to review policy, institutional and administrative causes that led to the INR shortfall.

However, due to lack of adequate and timely cooperation coupled with attempts to deny information by agencies such as the Royal Monetary Authority (RMA), the report has not attained the desired level of comprehensiveness. Despite the stated limitations, the report will seek to provide recommendations for more effective macroeconomic policy coordination and higher level of accountability.

B. Latest Indian Rupee Position

In November 2011, the INR balance had deteriorated to negative INR14.4 billion. Due to the severity of the situation, in December 2011, the government approved the sale of USD 200 million from the convertible currency reserves to liquidate the SBI Over Draft Facility (ODF) amounting to INR 10.29 billion. This provided only temporary respite as latest figures show that as of 26 January 2013 INR balance is at negative 17.249 billion. The details are shown in table below.

Table 1. Details of INR Balance as of January 2013

		Millions of INR
1	Royal Monetary Authority	191.17
2	Overdraft Facility with SBI (Limit of 10,000 million @9.75% per annum)	(9,649.19)
3	Overdraft Facility with PNB (Limit of 5,000 million @ 10.50% per annum)	(1499.99)
4	Standby Credit facility with GOI (@5% per annum fully used since June 2012)	(6,000.00)
5	Commercial Banks	632.41
6	Obligations of Commercial Banks	(924.36)
	Actual Rupee Position	**(17, 249.96)**

Source: Royal Monetary Authority, 7 February 2013

In January 2013, Bhutan and India formalized an agreement whereby India has agreed to provide an additional sum of INR 4 billion as standby credit facility. As this borrowing is cheaper at 5percent per annum, it is expected to be used to liquidate the more expensive borrowings from Indian commercial banks.

In addition to the current situation which is still dire, projections obtained from the RMA shows that the problems related to INR shortfall is likely to persist during the next five years or so. The net INR reserves are projected to hit negative 20.348 billion in 2017/18.

C. Legal Basis for the Review

The review is based on the mandate provided for in the following laws:

1. Constitution of the Kingdom of Bhutan

Article 10.2 of the Constitution provides the basis for parliamentary review of executive functions when it says: *“Parliament shall ensure that the Government safeguards the interests of the nation and fulfils the aspirations of the people through public review of policies and issues, Bills and other legislations, and scrutiny of State functions.”*

The Constitution in Article 11.2 also confers specific additional powers on the National Council to *“act as the House of review on matters affecting the security and sovereignty of the country and the interests of the nation and the people that need to be brought to the notice of the Druk Gyalpo, the Prime Minister and the National Assembly*”.

2. National Council Act 2008:

Section 10. In exercising its review function, the National Council shall:

a) Review and comment on the policies, plans and programmes of the government;

b) Review performance of the government;

c) Review implementation of resolutions and laws; and

d) Review issues of national importance.

Despite the strong legal basis for the National Council to conduct the review, the committee would like to place in record the lack of willingness to share information and absence of cooperation from key agencies like the RMA. As a result the review report could not be presented at the 9th Session of Parliament and the difficulties encountered were reported in detail to the House at that session. It is only after a formal Summon issued to the Governor of the RMA at Ninth Session that some kind of meaningful information was shared, but that too in a highly selective manner. Due to the inability to get comprehensive information on the Minutes of the Board Meetings and Executive Committee Meetings of the RMA, the report may have some shortcomings.

D. Identifying the Causes of the Indian Rupee Shortfall

The problems related to the INR shortfall and the policy action taken thereafter have caused public inconvenience and shaken their confidence in the economic policy institutions. Allowing the economy to reach such a dire situation also has the potential to undermine Bhutan's security and sovereignty. Therefore, it is vital to identify not only the structural and economic causes but also equally important to find the institutional causes and policy lapses and fix accountability.

Rather than accepting responsibility for the INR shortfall, the government and related economic policy institutions entrusted to manage the economy, engaged in a blame game once the problem became public. For example:

- On 13 July 2009, the Managing Director of the Royal Monetary Authority reported to the Finance Minister on decline in INR reserves and indicated its causes as being fiscal expansion which translated to INR imports and rapid credit growth. The Managing Director urged the RGOB to view the matter seriously.

- On 17 March 2012, at a press conference, the Finance Minister said it was not the government expenditure that affects the shortage of INR but it was the high rate of lending from banks and borrowing by the private sector.

- In March 2012, the Economic Affair Minister in his meeting with the business Community of Phuentsholing said that, if such a situation is to be controlled, the only way is to increase export. "It's the responsibility of everyone to eradicate such a crunch, and become part of the solution," he said.

- In May 2012, Experts at the Economic Forum on "Macroeconomic Challenges and Policy Options for Bhutan" attributed the INR problem to have been aggravated by the Reserve Management Practices of the RMA.

Some people have blamed the ambitious hydropower sector for aggravating the INR shortfall. The Economic Affairs Minister, during a press conference in early June 2011, said that hydropower projects as such did not and will not affect the country's INR reserve. "The money to build hydropower projects comes from India in the form of Indian Rupees and, although major works are carried out by the Indian contractors taking the INR back to India, the reserves are not touched at all," the minister said.

On the contrary, others respond that while hydropower development may not have directly contributed to the shortfall, auxiliary activities related to the projects had led to increased INR spending. For example, the projects, created huge demand for machinery, trucks and fuel which are not financed by the Indian Government in INRs.

On 20th June 2012, during Question Hour at the National Assembly, the Finance Minister, in his response to a question from the Opposition Leader on who is responsible for the INR situation, stated that **everyone** is responsible.

From the varied responses, it is evident that our economic policy institutions were caught unaware. Hence, the immediate response had been to engage in a blame game.

In 2012 the Government instituted a Task Force to study the INR problem. The report stated that: “The present Rupee shortage in the country can be attributed to two main factors (i) rise in aggregate demand; and (ii) limited supply. In particular, the following causes were identified:

1) High rate of credit expansion (averaging 35percent per annum over last few years);
2) Indirect impact of the budget on the expansion of credit through multiplier effect;.
3) Large investment in hydropower project and the growth in demand for ancillary goods and services; and
4) INR expenditures related to Dagachhu Hydropower Project and Dungsam Cement project.

What is visible from the report is that the task force has limited its study on causes of the problem to structural economic factors. From the Task Force report it is clear that if Bhutan is to find a durable solution to the current economic challenge, it will be vital to diversify the economy, enhance productivity and competitiveness to boost exports, manage credit growth and implement fiscal measures to control consumption and imports.

While the above steps to address structural challenges may be necessary, they are not sufficient to avert similar problems in the future. It will be equally vital to understand the policy and institutional causes of the INR shortfall so that reforms and measures are in place to ensure that the problem does not repeat in the future.

E. Role of Key Institutions and Policies leading to the Rupee Shortfall

While the causes of the INR shortfall have largely been attributed to our economy and trade structure, it is vital to note that neither the political economy nor the market economy exists in abstraction or in a policy vacuum. The macro-economy and the market are heavily influenced by public institutions and their policies and decisions.

The key institutions that have a bearing on the direction of the economy are:

1. Ministry of Finance primarily through its Fiscal Policy;
2. Royal Monetary Authority primarily through its Monetary Policy.

The RMA Act 2010 Sec. 146 states that: "It *shall be the duty of the Authority to inform and advise the Royal Government concerning any matter which, in the opinion of the Authority, is likely to affect the achievement of monetary stability or of the other purposes and functions of the Authority as provided for in this or any other Act*."

Therefore, in identifying causes of the INR shortfall, it is vital to understand the role of the key institutions in the crisis and the actions or lack thereof that has directly impacted the economy.

Since a comprehensive summary of policy and government policy and decisions does not exist in the public domain, this report has attempted to construct a chronology of events leading up to the peak of the INR crisis in March 2012. This has been collated with information from the articles in the press and information made available to the EAC by the RMA. (Chronology in Annex I)

What is evident from the chronology of events is that the INR shortfall is not an entirely new economic phenomenon that emerged in the last year or so. Rather, it has existed since early 1990s. The shortfall was addressed through availing Over Draft facility from external commercial banks and later through a line of credit extended by the Government of India and sale of convertible currency reserves. What is different this time is the magnitude of the shortfall.

This section provides an overview of the government policies or lack thereof which led to the aggravating INR problems.

1. Lack of Attention and Awareness of the Looming INR Shortfall

The two key institutions for managing the economy are the Ministry of Finance (MOF) and the Royal Monetary Authority (RMA). Till the enactment of the RMA Act 2010, the Finance Minister was also the Chair of the RMA and the Finance Secretary the Vice Chair.

From the chronology of events, it is evident that shortfall of INR is not a new issue and that the RMA brought this issue to the attention of the government since 2007. As the Annual Budget report provides the Government's Fiscal Policy position on the economic situation and trajectory, it should provide a perspective on the government's stance on this issue. However, a thorough review of the annual National Budget Report since 2007 shows no mention of the possibility of INR shortfall. Reference to the INR, if any, is limited to accounting inflows of foreign aid, hydropower, INR debt and exchange rate movements. This is indicative of the lack of awareness or attention of the government despite the notifications from the RMA.

Although the Economic Affairs Committee (EAC) requested for Board Meeting Minutes from 2007 onwards, it must be noted that the EAC only received selected excerpts of the Minutes of the RMA Board Meetings from 30th April 2007 onwards.

A review of the minutes of Board Meetings that were made available to the Economic Affairs Committee is very revealing. In most meetings, at least those up to 2010, the INR issue was discussed as peripheral issue under "Any Other Business" and not as a main agenda item despite the fact that the RMA management submits it as a serious concern. For example, during the 49th Board Meeting held on 30th April 2007 and 51st Board Meeting held on 30th June 2007, RMA Managing Director appraises the Board of the "critical rupee position." The limited information available in the minutes of the meeting shows that the Board approves sale of US Dollars to meet the INR requirements and asks RMA to do a study of the situation.

During the 52nd Board meeting of 18 December 2007, INR Balance and related issues are discussed under “Any Other Business” agenda. At this meeting RMA management again reports to the Board on the INR situation and seeks government’s views on likely deterioration of INR balances after payment of hydropower debt. The senior government officials instruct the RMA to “*make preparations and await for government instructions which will be conveyed soon*.” It is not clear what was conveyed and how soon it was conveyed as the Committee did not have access to all the Board Minutes.

By March 2009, issues related to the INR shortfall increasingly becomes severe with Bhutan availing the GoI line of credit of INR 3 billion and RMA resorting to SBI Overdraft Facility of INR 8 billion at an interest rate of 10percent per annum against the pledge of US$ 180.4 million of the convertible currency (CC) reserve. In July 2009, the RMA Managing Director reports to Finance Minister on decline in INR reserves and indicates causes to fiscal expansion which translated to INR imports and rapid credit growth. The Managing Director urges the RGOB to view the matter seriously.

During the 60th Board Meeting held on 11 July 2009, the RMA management informs the board that the INR balance stands at negative Rs. 3,154.06 million and warns of further deterioration. The Minutes of the meeting shows that the Board “*noted the issue*” and moved on to discuss list of essential imports.

During the 64th meeting held on 1 January 2010, the Board is apprised of the INR situation and the Board inquires what options are available “in case there is a Rupee Shortage.” The management responds that the options are SBI over draft facility and GOI Standby credit. The Board advised the management to submit to the Cabinet a proposal for extension of Standby Credit Facility from Government of India.

During the same meeting the RMA suggests the board to consider Strengthening INR Management as a Strategy for effective monetary operations. The management submits need to streamline INR issuance and hence policy measures to closely track INR outflows and improve data management. To this the Board responds that "*any policy change in regard to availability of INR and the manner in which it is introduced is very sensitive and would require detailed discussion and proper planning. It may require government concurrence*." The management is again advised to conduct a proper study and submit to the board.

During the 66th Board Meeting held on 1 April 2010, the Management reports to the Board on the need to formulate a Strategic Rupee Management System. The Board once again "notes" the issue and does not approve the proposal as it would entail expansion of RMA manpower and increase administrative costs. Once again the management is asked to submit a background paper.

From 2010, the RMA Board accords higher degree of attention to the looming INR shortage and its impact on the economy and only thereafter the issue merits more intense discussions.

What is evident from the studying the limited available information of the Minutes of the Board meeting is the lack of serious attention paid to the emerging problem by the Royal Monetary Authority and its Board. The INR shortage is discussed largely in isolation and Board minutes do not indicate any linkages with the overall macroeconomic health of the country. Furthermore, the solutions offered at best by the management and Board is limited to more studies and resorting to additional INR borrowings to meet the INR deficit. Till about 2007 there is no mention of the need to implement other monetary policy options to curtail credit growth and domestic consumption.

The Economic Affairs Committee also received selected minutes of the Meeting of the Executive Committee of the RMA. The Executive Committee (established as per the

RMA Act 2010) is entrusted to assist the Governor in the implementation of the Board's policy and the management of the Authority. The information made available to the Committee shows that the INR shortfall issue is discussed in the Executive Committee's Seventh, Tenth and Twelfth meetings held on 8th February, 26th April and 13th July 2012 respectively. This also indicates the Board may not have provided sufficient attention to the INR shortfall issue till early 2012.

Due to limited information available to this Committee it is difficult to be convinced that the Board of the RMA actually understood the link between the INR shortfall and the overall dynamics that the economy was experiencing.

Furthermore, the lines of accountability between the Ministry of Finance and RMA are also unclear as the Finance Minister was the Chairperson of the RMA and the Finance Secretary was the Vice Chairperson. Hence, it is not clear how seriously the Ministry of Finance took the recommendations of the RMA as the authority ultimately lay in the same person.

During the Committee Hearing, with the Ministry of Finance, held on 14 February 2013, the Finance Secretary stated that there were no records of meetings to indicate that the Macroeconomic Framework Coordination Committee (MFCC) was aware of the looming INR shortfall. The MFCC is the highest level committee to coordinate macroeconomic policies in the country established as per the Public Finance Act 2007. However, its function has been limited to preparation of the budget report and it does not have any avenue to influence economic policy direction.

2. Bias for Foreign Currency

Although Bhutan's payment liabilities for imports or debt are dominated by INR, there has always been a bias favoring convertible currency. This was because the possibility to earn INR was taken for granted or thought to be much easier. For example, the FDI policy of 2002 permitted Foreign Direct Investment FDI only in convertible currency.

Similarly, the various economic incentives granted by the government to the private sector also encouraged businesses that earned convertible currency. For example, the National Budget Report 2002–2003 provided the following tax incentives:

- Removal of sales tax on raw materials and even removal of customs duty for raw materials used by convertible currency earning businesses;
- Income earned in convertible currency by manufacturing industries, Information Technology industries or services, and agriculture produce to be exempt from income tax.

This bias was further reinforced by the Economic Development Policy 2010 which is evident from the following sections of the policy:

- EDP Section 9.1,3 Export earnings in convertible currency of business enterprises established between 1 January 2010 and 31December 2015 shall be exempted from corporate or business income tax for a period of 10 years.
- EDP Section 9.1.4 Export earnings in convertible currency of existing business enterprises established between 1 January 2004 and 31 December 2009 shall be exempted from corporate or business income tax for a period of 5 years until 31st December 2014.
- EDP 9.3.3.4 Export earnings in convertible currency by the IT business/companies operating from the parks shall be exempted from Corporate Income Tax for the duration of the tax holiday.

The FDI Policy of May 2010, broadens the scope of FDI by allowing FDI in INR. It defines “Currency of investment’ means either the Indian rupee or convertible currency in which the investment was made by the foreign investor.” This could have been influenced more by the weak inflow of FDI from other sources since 2002 rather than as a response to the INR shortage.

The Central Bank operations also showed bias for convertible currency reserves. For example, on 23 Jul 2008 the RMA Managing Director urgently reports to Finance Minister that from early 2008 INR balance has been deteriorating and that as of 17 July 2008 INR balance is now negative at 2.08 billion. The Managing Director reports that RMA arranged for SBI ODF of INR 2 billion at 10percent per annum. An open option is presented to sell convertible currency reserves but RMA recommends ODF. The financial implication for Bhutan is immense as the interest earned by convertible currency deposits in overseas Banks is close to 1percent while the cost of borrowing INR is 10percent.

3. Emergence of Fronting Industry and distortion of Balance of Payment (BOP)

There was an unintended consequence of the government's economic policy of favoring convertible currency earning enterprises. This was the emergence of businesses that sought to maximize the benefits of the tax incentives as well as exploit the tax differential between India and Bhutan. It is common knowledge that several fronting industries related to palm oil refinement, software, copper etc were established in Bhutan. By 2007, export of Palm Oil, copper and software featured among the top ten exports of Bhutan.

These industries inevitably had an impact on the INR situation. An investigation done by a joint team from the Royal Monetary Authority, Ministry of Economic Affairs and Ministry of Finance with the mandate to look into the reasons for a INR crunch in 2007 revealed the following anomalies between quantum of export to India recorded in the trade statistics did not match the INR inflows of these companies. For instance, between 2006 to May 2007, 10 industries had exported Nu 7.51bn worth of goods but received only Nu 3.73bn as shown in table 2.

Table 2. Comparison of export value vis-a- vis inflows for the year 2006 and Jan - May 2007

		2006			January to May 2007		
	Exporter	Total Export to India	Total Inflow	Diference	Total Export to India	Total inflow	Difference
1	Jigme Polytex Pvt. Ltd	243.34	38.95	-204.39	112.12	30.73	-81.39
2	Singye Vanaspati Pvt. Ltd	850.8	656.16	-194.64	294.49	193.1	-101.39
3	Mega Pvt. Ltd	42.56	91.86	49.3	215.66	237.61	21.95
4	Yarab Pvt. Ltd	622.219	422.88	-199.339	214.02	175.9	-38.12
5	Bhutan Metal Pvt. Ltd	1656.09	726.57	-929.52	1105.62	183.23	-922.39
6	Kenpa Pvt. Ltd	574.13	157.37	-416.76	255.18	144.29	-110.89
7	Rangsher Pvt. Ltd	409.3	275.12	-134.18	270.05	13.64	-256.41
8	Yarkay Pvt. Ltd	170.61	104.93	-65.68	81.39	25.47	-55.92
9	Choden Wire Pvt. Ltd	19.89	72.37	52.48	113.54	34.28	-79.26
10	RSA	163.181	104.07	-59.111	100.07	40.96	-59.11
	Total	**4752.12**	**2650.28**	**-2101.84**	**2762.14**	**1079.21**	**-1682.93**

Source: Business Bhutan " the fronting investigation that never made it to the front," 23 October 2010

The mismatch between the total exports to India and the inflows of INR into Bhutan was a cause of concern for the RMA. On 29 June 2007, the Managing Director of RMA reports to Finance Minister of the inconsistency between trade statistics and RMA's INR reserve position pointing out to significant INR outflows through "unconventional" channels.

The fronting industries contributed to the INR shortage because these industries distorted the balance of payments statistics thereby misleading the actual balance of payments situation and this may have sent wrong signals to decision makers. For example, software exports grew to Nu.619 million in 2009 and to Nu 2.1billion in 2010 and recorded exports of Nu3.5 billion in 2011. The other aspect to this is the allegation that software export industries were essentially helping to launder money on behalf of non-Bhutanese for a small commission. In a statement made to Kuensel on 10 April 2007, trade ministry officials refute these allegations saying that “these exports fall under outsourcing, a global phenomena. It was legitimate and transparent and all transactions were handled through the bank.”

The government failed to take this matter seriously and it was only in early 2012 that issues related to fronting were addressed with some seriousness when the government closed down the dubious “software” industry.

4. Failure to Detect High Credit Disbursement Trends

Rapid credit expansion in the financial sector has been blamed for aggravating the problems related to the INR Shortfall, albeit indirectly. This is because expansion in local currency credit translates to expansion of imports. For example, about 25 percent of the credit portfolio is allocated to the building and construction sector. Of this, it is estimated that the import component of the total construction cost could be as high as 80 percent of the total cost.

An analysis of the data of credit disbursement trends shows that the overall credit of the financial sector has been increasing steadily at an average rate of 32percent since 2007. For instance, within three years, total financial institutions credit more than doubled from Nu. 9.8 billion in 2005 to Nu. 21.9 billion in 2008 and in the following three years, once again more than doubled to Nu. 44 billion in 2011.

Table 3: Credit Growth Trends from 2002-2011

Indicator	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Credit concentration by institution										
Total financial institutions' credit	**6,019.5**	**6,812.8**	**9,657.5**	**9,887.37**	**12,647.8**	**16,453.35**	**21,982.85**	**26,283.18**	**36,005.02**	**44,040.70**
Growth (%)	38.5	13.18	41.75	2.38	27.92	30.09	33.61	19.56	36.99	22.32
o/w banking sector credit	**4,376.80**	**5,411.5**	**8,401.1**	**8,168.80**	**10,110.0**	**13,139.70**	**17,729.60**	**20,986.80**	**31,436.70**	**38,823.20**
% share of total credit										
Government	22.2	14.7	30.0	11.0	5.7	4.4	3.3	2.5	3.4	3.3
Government corporations	5.8	12.6	9.3	8.6	7.3	5.0	3.0	3.1	1.2	1.0
Private sector	72.0	72.8	60.7	80.4	87.0	90.6	93.7	94.4	95.5	95.6

Source: Task Force "REPORT ON BALANCE OF PAYMENTS WITH INDIA AND THE RUPEE SHORTAGE" 2012

The Governor of the RMA, during the annual meeting with the financial institutions on 2 December 2012 stated that: '*By international standards, excessive credit is often measured as the difference between the growth in nominal GDP and bank credit. In the last five years, Bhutan's credit growth has outpaced and more than doubled that of nominal GDP.*

During the committee hearing held with the RMA on 6 February 2013, the RMA Governor repeatedly explained that decisions of the RMA are based on data and trends. When asked if the RMA was alarmed with the rapid credit expansion and its implications, the Governor was honest to admit, at the Committee Hearing, that the RMA was caught unaware by this issue. For an institution that bases its decisions on data and trends, lack of awareness of rapid credit growth and its linkages with import demands and subsequent pressures on INR indicate failure of the department in the RMA entrusted to regulate and supervise the financial institutions.

5. Poor Coordination of Economic Policies

By 2010, it is clear that the INR situation was indeed serious. However, after analyzing government documents and polices, it is clear that there was lack of coordination among key economic institutions.

In addition to the continuous cautions expressed by the RMA, in December 2009, the IMF in the Article IV Consultation advises Bhutan to adopt clear guidelines for reserve management to align the currency composition of reserves with external liabilities and import demand. However, neither the RMA concerns expressed at the Board level nor the IMF cautionary notes received sufficient attention from key government agencies.

For example, in April 2010, the government released the Economic Development Policy in April 2010. Its purpose is stated to serve as: "*the apex policy for economic development of the country and shall be the guiding document for all ministries and agencies to stimulate the economy growth*.." However, this policy document of high significance charting the economic course of the country makes no reference of the INR shortfall or balance of payments. This indicates economic policy making in isolation.

In seeking to understand the level of coordination between the various agencies involved in economic policy decisions, the Committee during its hearings with the Ministry of Finance and the RMA inquired on the coordination mechanisms.

The Committee was informed that the main coordination forum is the Macroeconomic Framework Coordination Committee. However, the impact of this committee on economic policy is limited as the main inputs are for the preparation of the annual budget. While the Committee is chaired by the Finance Secretary, other agencies are represented at lower levels thus reducing the impact of committee decisions on other sectors. While the Committee was instituted since 2007, records of meetings were not available. Apart from this committee there is no other forum for macroeconomic policy coordination thus highlighting a significant gap in policy making and policy coordination.

From the available documents, it is also clear that there is lack of coordination and information sharing among institutions. For example, during the 75th RMA Board meeting held on 30 August 2011, a member categorically places on record the lack of dialogue/communication between the RMA and the Ministry of Finance and the need to work closely.

Beyond the formal hearings, the Committee members also sought views of key government officials on the quality of cooperation and coordination among key economic policy institutions. Many officials confided rather candidly that formal and informal coordination was made all the more difficult due to personality issues of certain individuals and obsession with status (of position) making it impossible to strike a conversation let alone get any information. It is vital that for better coordination on issues of such national importance, people in key positions, become more accessible and approachable so that there are more avenues for dialogue and discussions.

F. Recommendations

It is apparent to all Bhutanese that the INR shortfall has not only caused immense difficulties for the government, businesses and consumers alike but could also seriously jeopardize security and sovereignty of the nation.

Therefore, it is very important to ensure that we emerge from the present difficulties with greater realization of the need to address structural and trade imbalances, strengthen exports and rationalize import and consumption. At the same time, it will be equally vital to strengthen economic policy institutions to pick up signals of approaching difficulties and provide anticipatory policy responses rather than waiting for a crisis to hit before we seek solutions.

A review of the roles of institutions and policies shows that the key economic agents of the state failed to provide sufficient and timely response to avert the INR shortfall from attaining crisis proportions. The section below provides some institutional and policy recommendations which must be implemented to address the present problem and avert such problems in the future.

1. Establish Robust Mechanism for Coordination of Economic Policies

One of the most glaring and obvious problems is the lack of a proper coordination forum or mechanism among key agencies for coordinating economic policies. Some of the examples cited in this report elucidate clearly that Ministries and agencies operate in isolation. The currently existing Macroeconomic and Fiscal Coordination Committee is largely a technical body that does not have the mandate or the ability to guide future economic directions of the country.

There is a clear need to immediately and formally institute a high level economic coordination committee to facilitate dialogue among key economic policy institutions. There are many well educated and experienced people trained in this area whose expertise could be better utilized. The Committee commends the cooperation established between the RMA, the Department of Revenue and Customs to streamline export and import transactions and linking with the payments mechanism. This goes on to show the potential for collaboration exists and one need not wait for a crisis situation to begin such useful inter agency collaboration.

One of the main concerns raised by senior government officials when discussing failure of coordination in relation to the INR shortfall is the lack of time. For example, one government secretary shared that in addition to running a central Ministry; he was also a member of more than twenty Boards. This leaves very little time for proper study, reflection and to provide guidance on core economic matters. There is an urgent need to rationalize time use and this could begin by limiting membership of any individual to a maximum of 5 Boards/Committees per senior civil servant. Otherwise, lack of time could become an excuse for non-performance and to shrug off any accountability.

The Prime Minister's Office take the lead role to establish a High Level Economic Coordination Committee. This committee could be entrusted to provide objective economic analysis and advice to the Government on the development and implementation of economic policy issues and submit periodic reports to the Cabinet on important macroeconomic issues and its implications for policy.

2. Fix Accountability

The review of the Minutes of the Board meetings shows that the Board was reminded time and again of the looming INR crisis. However due to limited access to RMA documents, it is not clear what kind of decisions were made. Considering that the INR problem assumed the magnitude it eventually did by early 2012, effective decision making was clearly lacking.

Hence, there is a need to fix accountability on the RMA Board members for the lack of seriousness in addressing the problem. The same also goes for the concerned Government officials of the Ministry of Finance who failed to heed to the consistent cautions of the RMA on the problem.

3. Address Capability Deficit at the RMA

Rapid credit expansion is attributed as one of the core reasons for growth of imports and thereby the INR shortage. As admitted by the Governor, at the committee hearing, the RMA failed to take necessary action to curtail credit growth. It is, therefore, recommended that the RMA fix accountability on the responsible division/department for the failure. It would be vital for the RMA to assess the capabilities of key officials and ensure that people in key positions have adequate industry experience that extends beyond a career in the RMA. Hence, it is recommended that the next parliament review the RMA Act 2010 to make provision for one of the two Deputy Governors to come with the financial sector expertise. Otherwise there is every risk that decision making process in RMA could become insular and text book oriented with little knowledge of the overall economic and financial reality of Bhutan.

4. Propose Stronger Fiscal Measures

The collective experience since March 2012 shows that the adhoc administrative measures adopted to stem INR outflows (such as bans on loans for construction, import bans on vehicles, alcohol and furniture) have not been successful in improving the situation as evident in the current INR deficit which exceeds INR 17 billion.

Furthermore, “bans” are typically imposed as a temporary stop gap measure to address an emergency situation and are usually time bound till other measures are in place. For instance, a country may ban import of meat items from another country in case a disease outbreak is reported in the exporting country. But such measures are temporary and time bound.

The current bans imposed in Bhutan have no time frame and its legality could be questioned. What is now clear is the import ban has continued because the government has failed to come up with other measures to control imports. The inability of the government to get the tax bill thorough the National Assembly in the Ninth Session in 2012 is evidence of such failure.

The need for stronger fiscal measures was highlighted by the RMA Governor in December 2011, when he urged the government to look at fiscal policy to check the spiraling demand for INR as all monetary policy tools had been exhausted

In the long term addressing the INR shortfall will require Bhutan to not only enhance exports but also curtail imports and this is best sustained by coordination of fiscal, monetary and economic policies.

Hence, the committee recommends the Ministry of Finance to prepare a comprehensive fiscal policy response to complement other economic tools to dampen the demand for INR. The need for such a comprehensive response is reiterated as the last tax proposal made by the government to Parliament in 2012 was not able to convince the members of the National Assembly, let alone the National Council.

5. Need for an effective monitoring mechanism from MoEA

RMA in collaboration with the Department of Revenue and Customs and the commercial banks has instituted trade flow monitoring system, mainly to monitor INR flows of sales proceeds from exports and movement of imports based on import payments. The effectiveness of this mechanism was asked during the Committee Hearing with the RMA. The Governor apprised the Committee that those firms (exporters/importers) who fail to declare the export proceeds within 91 days shall not be granted any INR withdrawals from the banks. To in-reinforce this measure, and also to deter non-declarations of export proceeds, the Ministry of Economic Affairs may also initiate appropriate deterrence measures to confront the reported fronting activities happening near the border towns.

6. Provide priority lending for constructions

There are many places in the country with acute housing problems. Furthermore, in some Dzongkhags, Government has already allotted land and granted approvals to construct buildings to establish towns, not to mention that in some cases the Government had given even deadlines to complete the constructions. However, due to unavailability of Construction Loans, the business communities are unable to either complete or begin constructions. Therefore, it is recommended that priority lending for constructions be considered for areas where there is acute shortage of housing and where constructions do not require and/or requires minimum import of construction materials. Use of domestically produced construction materials be encouraged.

G. Conclusion

In conclusion, the Economic Affairs Committee would like to thank the Hon'ble Members of the National Council for participating in the several meetings held to prepare this report.

We would also like to thank the House for the understanding shown when the committee could not present the report in the Ninth Session due to lack of cooperation from other institutions. The Committee benefitted immensely from the guidance and support received from the Hon'ble Chairman and the House in our endeavour to get such information.

We would like to seek further support and guidance from the House in proposing a strong set of recommendations to improve institutional coordination and enhance policy coherence so that problems such as the INR shortfall can be averted in the future.

Annex I: Chronology

Date	Event/Issue
1991-1994	INR reserves fall to INR 97.8 million for FY 1991/92 further down to INR 79.8million in FY 1992/93 and INR 71 million in 1993/94.
Early 1992	OD of INR 191 million availed from Citibank
January 1994	GOI Credit facility increased from INR 100m to 250 million. By May 1999 credit availed through standby credit facility fully repaid through INR reserve build up
1998	For the first time, the RMA borrows ₹ 800 million under the SBI OD facility to inject INR liquidity for public and private banking transactions.
2003	SBI ODF enhanced to ₹ 2 billion
2007	RMA notes that from Feb 2006, INR reserves deplete persistently on account of reduced aid inflows and increased imports
2007	SBI ODF enhanced to ₹ 4 billion
March 2007	As interim measure RMA avails two ODs (amounting to Rs. 700m) to replenish BOB requirements.
12 Jun 2007	Officiating RMA MD reports to MOF Secretary about inconsistency between trade surplus in FY 2006/07 of Nu. 9.1 billion and INR reserve balance off only Nu. 1.1 billion.
29 June 2007	MD, RMA reports to Finance Minister of the inconsistency between trade statistics and RMA's INR reserve position pointing out to significant INR outflows through "unconventional" channels. Calls for an in depth study of irregular outflows.
13 Aug 2007	RMA MD writes to Finance Secretary on the negative ₹ balance owing to declining aid flows and increased imports and proposes selling USD 25 million from the reserves and calls for RGOB to arrange temporary GOI credit line facility.
28 Jan 2008	RMA writes to BOB and BNB to be judicious in INR payments due as INR management measure and
7 Feb 2008	RMA writes t BOB and BNB to inform that the INR working balance for the two banks at given point in time shall not exceed INR 500 million.
April 2008	As a INR management measure, the RMA issues Memo to BOB and BNB of maximum INR operating balance of ₹ 500 million and **disallows keeping INR in fixed deposits in India.**
23 Jul 2008	RMA MD urgently reports to Finance Minister that from early 2008 ₹ balance has been deteriorating and that as of 17 July 2008 ₹ balance is now negative at 2.08 billion an reports that RMA arranged for SBI ODF of ₹ 2 billion at 10percent/annum. Option provided to sell convertible currency reserves but RMA recommends ODF.

March 2009	Bhutan fully avails the GoI line of credit of ₹ 3 billion and RMA resorts to SBI Overdraft Facility of ₹ 8 billion at an interest rate of 10percent per annum against the pledge of US$ 180.4 million of the convertible currency (CC) reserve
13 Jul 2009	RMA MD reports to Finance Minister on decline in INR reserves and indicates causes to fiscal expansion which translated to INR imports and rapid credit growth. MD urges the RGOB to view the matter seriously.
Dec 2009	IMF in the Article IV Consultation advises Bhutan to adopt clear guidelines for reserve management to align the currency composition of reserves with external liabilities and import demand.
11 Sept 2011	RMA publishes a short study on "Indian Rupee Flow and Reserve Position."
2011	SBI ODF enhanced to ₹ 8 billion
28 Nov2011	RMA holds emergency board meeting during which it was reported that Bhutan's available INR balance as of November 24, 2011 had reached negative ₹ 14.4 billion
1 Dec 2011,	RMA sells US$ 200 million from CC reserves for ₹ 10.29 billion to liquidate the SBI ODF
3 Dec 2011	RMA Governor urges RGOB to look at fiscal policy to check the spiraling demand for INR as all monetary policy tools had been exhausted.
25 Feb2012	The INR Reserve position becomes negative ₹ 5.89 billion
March 2012:	Central bank stops replenishing banks with INR
6March 2012	"After Losar, we simply had no money" says RMA Governor to BBS
March 8:	RMA issues circular on Foreign currency Allows INR transaction for select priority imports like fuel, capital goods, education, medical supplies and construction materials. Suspends new housing loans and INR payments for vehicle imports Withdrawal limit reduced to Rs 10,000 from Rs 40,000 a day
9 Mar 2012	All non-resident foreigners to close accounts by 15 March 2012
March 9	Finance minister said that (RGOB) requested India to increase the standby credit line from Rs 3bn to Rs 6bn
March 12:	Banks install software to monitor INR withdrawals. On behalf of the central bank, Bank of Bhutan collected Rs 1,000M from State Bank of India, and distributes Rs 300M to Bhutan National Bank and Rs 200M to Druk Punjab National Bank.
March 15:	RMA orders All the existing deposit accounts of non-resident foreigners be closed Fixed deposit accounts of Jaigaon traders in Bhutanese banks worth Nu 2B closed.
March 17:	At a press conference, the finance minister says it was not the government expenditure that affects the shortage of INR but it was the high rate of lending from banks and borrowing by the private sectors. http://www.businessbhutan.bt/?p=9239

	Finance and economic affairs ministers meet with Phuentsholing residents on the INR issue
March 19:	First signs of Ngultrum devaluing by up to 20 percent against the INR in border towns.
March 22:	Bhutanese in border towns rush for Master, Maestro and Visa domestic debit cards to withdraw INR in India.
March 23:	Issue of new import licenses suspended
March 24:	Banks in Phuentsholing collect Nu 311M from traders in the bordering towns following central bank directive
March 27:	Import of non-essential items from third countries suspended
March 29:	RMA suspends Rs 10,000 a person a day withdrawal limit
April 2	RMA directs not to issue INRs in cash
April 3:	Government announces plans to raise taxes on non-essentials and selective credit sanctioning as key measures to address crunch
April 7 :	Wholesale businesses liberalized. Jaigaon ATMS kept busy by Bhutanese INR borrowings reach INR 9.7B
April 8:	Foreign workers recruitment agencies experience a slowdown Contractors meet to discuss INR shortage and related expat labour problems
April 10:	Ministries asked to slash expenses
April 12:	Government receives INR 1.62B from India for small grants project PM asks people to discipline their expenditure in a nationwide televised address
April 13:	Government taskforce redefines essential items
April 16:	Economic affairs minister Khandu Wangchuk meets people of Samdrup Jongkhar to discuss INR problem
April 17:	Central bank increases INR withdrawal limits to pay construction workers from Rs 6,000 to Rs 10,000 a month and advance payment to Rs 8,000 a month.
Apr 21	FIs increase interest rates
29 May 2012	Experts at the Economic Forum on “Macroeconomic Challenges and Policy Options for Bhutan” attribute the INR problem to have been aggravated by the Reserve Management Practices of the RMA.
	Source: Kuenselonline; information from RMA and other newspapers.

Annex I: Resolutions of the 10th Sessions of the National Council of Bhutan

The Economic Affairs Committee presented the report to the 10th Session of the National Council of Bhutan on 25th February 2013. After a thorough deliberation, the House endorsed the report with some improvements on the Committee's recommendations No. 1 and 2 and inclusion of two additional recommendations. The House resolved the following:

1. Establish Robust Mechanism for Coordination of Economic Policies:

(a) Government review number of members and qualifications required for Boards and ascertain the number of Boards a senior public servant can be a member of;

(b) Royal Audit Authority conduct performance audit on the constitution/composition and performance of Board of Directors of various Boards; and,

(c) The Prime Minister's Office take the lead role to establish a High Level Economic Coordination Committee. This committee could be entrusted to provide objective economic analysis and advice to the Government on the development and implementation of economic policy issues and submit periodic reports to the Cabinet on important macroeconomic issues and its implications for policy.

2. Fix Accountability:

Accountability must be fixed on the following:

(a) Board of RMA from June 2007;

(b) RMA Management; and,

(c) Ministry of Finance.

The Cabinet Secretariat to submit a "report on the actions taken on fixing accountability" to the Second Parliament.

3. Address Capability Deficit at the RMA: (as proposed by EAC)

4. **Propose Stronger Fiscal Measures:** (as proposed by EAC)
5. **Need for an effective monitoring mechanism from MoEA:** (as proposed by EAC)
6. **Provide priority lending for constructions: (**as proposed by EAC)

7. Government to ensure availability of information to the Parliament:

The Parliament is often denied information by some public institutions/agencies thereby rendering it difficult for the Members of Parliament to perform their parliamentary functions. Therefore, it is recommended that Government ensure that all public institutions/agencies share any information required by the Parliament as per the existing laws of the country.

8. Improve Foreign Reserve Management:

The Foreign Exchange Reserves, in excess of that required by the Constitutional requirement of 12 months essential imports, may be utilized to address rupee needs since it is not practical to hold dollar reserves at nominal interest rates while borrowing INR at higher rates of 5-10.5% per annum.

The House also resolved that the report be submitted to the concerned institutions/agencies after the EAC has included the resolutions of the House in the report.

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