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Country Paper for SAARCFINANCE Seminar
On
“Trading in Local Currencies: Problems and Prospects for the SAARC Countries”
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Bhutan's current Exchange Rate Regime:

The Ngultrum (Nu) has been pegged at par with the Indian Rupee (INR) since 1974, a decision made during a period when various exchange rate regimes were gaining popularity. This arrangement has been beneficial for Bhutan due to its strong economic ties with India. The fixed exchange rate has reduced trade uncertainties, stabilized prices, encouraged investments and tourism, and facilitated cross-border transactions. It has also made Bhutan an attractive destination for Indian tourists by eliminating exchange rate risks.

Moreover, the convertibility of INR to Nu has lowered transaction costs and improved the ease of doing business across borders. By benefiting from India's low inflation, Bhutan has maintained stable inflationary expectations, contributing to overall macroeconomic stability and providing a reliable environment for businesses and consumers. The peg has allowed the Royal Monetary Authority (RMA) to maintain financial stability without constant adjustments in response to international exchange rate fluctuations.

Therefore, it is imperative to ascertain whether Bhutan's economic characteristics support the optimum currency criteria, meaning that the existing pegged regime is optimal for Bhutan under the current economic conditions. However, it is important to note that a pegged exchange rate also comes with certain challenges & risks. One of the key challenges is the inability to respond to external shocks or changes in economic conditions. Thus, any effort to evaluate the current peg arrangement with India will promisingly depend on its evolving economic conditions and objectives.

Optimum Currency Area.

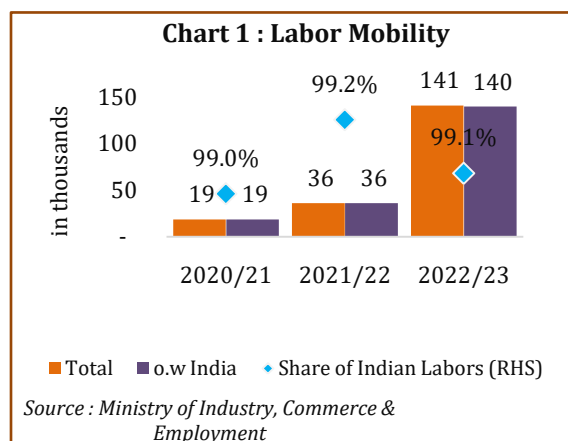
An Optimal Currency Area (OCA) refers to a specific geographic region where adopting a single currency would yield the highest economic advantages. Historically, individual countries have typically retained their distinct national currencies. However, Robert Mundell's research in the 1960s proposed that this conventional approach might not be the most efficient economic structure. Specifically, the nations with strong economic ties might do better if they used the same currency. This helps their financial markets work together



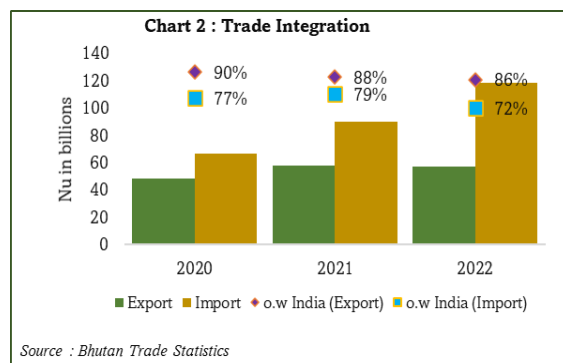
better and makes trading easier. But it also means that each country gives up some control over their money policies to keep their economy stable.

In this regard, we examine the specific economic characteristics outlined by Robert Mundell in 1961 for an OCA. This analysis aims to determine whether Bhutan's current macroeconomic indicators align with these criteria and support the sustainability of its fixed exchange rate arrangement with India. The OCA theory provides a framework for countries to assess the advantages and disadvantages of adopting either a fixed or flexible exchange rate system based on their economic situations. However, it's important to note that no universally agreed-upon method or index definitively indicates whether a country should join a currency union or not. Therefore, we assess four commonly used criteria to gauge Bhutan's suitability for such an arrangement.

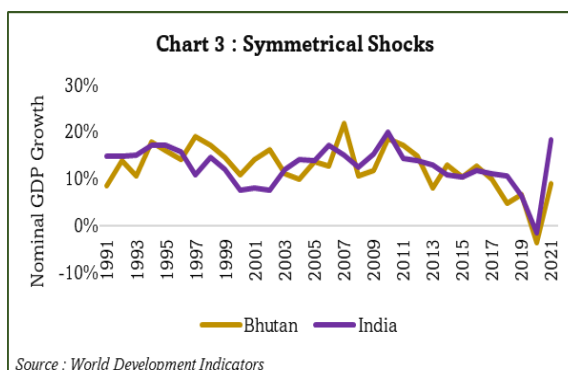
A. Labour mobility: Labor mobility is really important when countries decide to use a fixed exchange rate. If workers can easily move between countries, it helps to ease the problem of unemployment and wage differences. In Bhutan, the majority of the foreign workers are from India, and at the same time, Bhutanese workers can legally work in India. For example, from 2014 to 2018, around 2,201 Bhutanese workers worked in India on average. Kinds of literature have also recognized the significance of labour mobility in many countries.



B. Trade Integration: The more deeply integrated an economy's trade is with its partner nation, it's more beneficial to use a fixed exchange rate. If a country sets a fixed exchange rate peg, it gets rid of this problem and facilitates seamless international trade. Although Bhutan's trade diversification with other countries has been expanding, India predominantly remains as its largest trading partner.



C. Symmetrical Shock: While there are potential trade benefits associated with

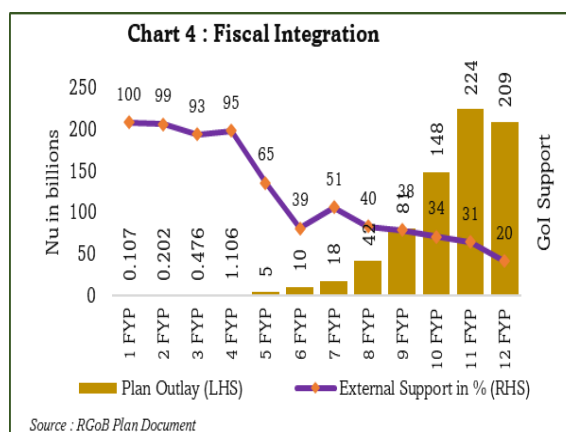




a pegged exchange rate, challenges may arise if a country's economic cycle does not align with that of its primary trading partner, against whose currency the exchange rate has been fixed. Consequently, the level of cyclical synchronization becomes a crucial factor in assessing the effectiveness of such a regime. Ideally, countries should share similar preferences concerning key macroeconomic variables such as GDP or they should be able to swiftly reach consensus on target values, particularly during periods of crises and unforeseen shocks.

D. Fiscal Integration: A strong fiscal integration among countries allows them to cushion economic shocks by sharing funds. This helps them maintain fixed exchange rates with lower costs. However, Bhutan's situation is unique. Its fiscal policies are closely tied to India's, especially for development projects. India heavily funds Bhutan's hydropower projects, creating jobs and creating investment avenues.

Additionally, India's 2014 and 2024 Economic Stimulus Plan aimed to boost small-scale industries and employment, highlighting the significant fiscal ties between the two countries. India also plays a major role in financing Bhutan's development plans, showcasing the depth of their fiscal partnership.



Exchange rate Development.

In the view of considering the one-to-one peg of Nu to the Indian Rupees (INR), the fluctuations in the INR also directly impact the standing of the Ngultrum in international markets. So, if the INR depreciates internationally, the Ngultrum does too. In the last two years, the INR has experienced considerable volatility and has undergone a significant depreciation against the Greenback. This happened because the aggressive tightening of monetary policy by the US Federal Reserve¹ made it harder to get money, and US Treasury yields² went up. Additionally, the combination of elevated crude oil prices and Foreign Portfolio Investment (FPI) outflows from Indian capital markets has placed additional

¹ The US Fed raised the rates 11 times since early 2022 in an effort to reduce liquidity in the financial markets and tamp down inflation. The recent rise in the interest rates was following its meeting on July 25-26, 2023 by 0.25 percentage points taking the federal funds rate to a target of 5.25 to 5.5 %

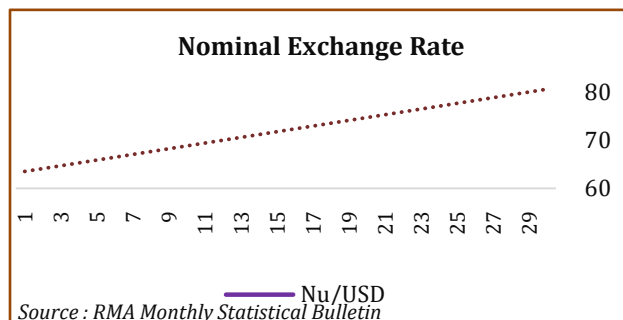
² The yield on one-month US Treasury securities was 5.52 percent on 11th September 2023 compared to 0.01 percent in May 2021.



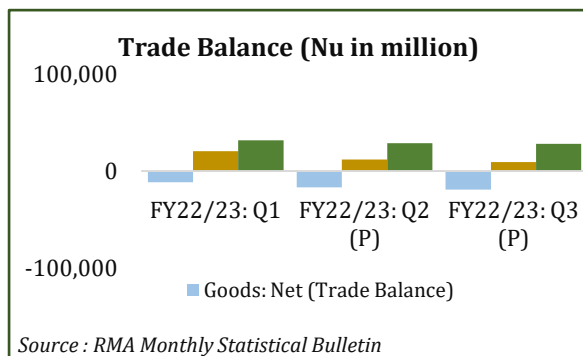
pressure on the INR³. The INR has been in depreciation, especially after the supply chain disruptions given the geopolitical fragmentation and rising cost of crude oil. More than 85 percent of India's energy requirement depends on crude oil imports and higher oil import bills have put strain on India's trade balance⁴.

The Nominal Exchange rate and implication.

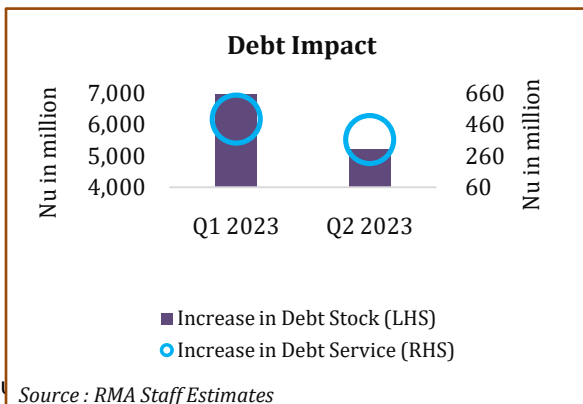
At the beginning of the third quarter of 2022, the Bhutanese Ngultrum (Nu) has been consistently trading around the US Dollar 80 mark. It reached its highest in the fourth quarter of 2022 at 82.87 Nu per US dollar. By the second quarter of 2023, it experienced a 3.9 percent depreciation compared to the same period in the previous year, with an average depreciation of 2.4 percent over 2022. This trend reflects changes in Nu's dynamics relative to the US Dollar.



A weaker Nu against the US Dollar can affect Bhutan's trade balance, making imports more expensive and potentially boosting exports. However, Bhutan's strong economic ties with India, which makes up about 80 percent of its trade including hydropower exports have helped cushion the volatility. Under these circumstances, the depreciation of Nu does not necessarily lead to a more favourable balance of trade for Bhutan. Thus, there is a limited direct impact on the cost of trade for Bhutan in such an economic situation.



The depreciation of Nu also impacts the country's debt portfolio, especially when debts are in Convertible Currencies (CC) like the US Dollar. While Indian Rupee (INR) denominated debt benefits from currency fluctuations, CC-denominated debts are exposed to exchange rate risks. With Nu depreciating significantly, debt service



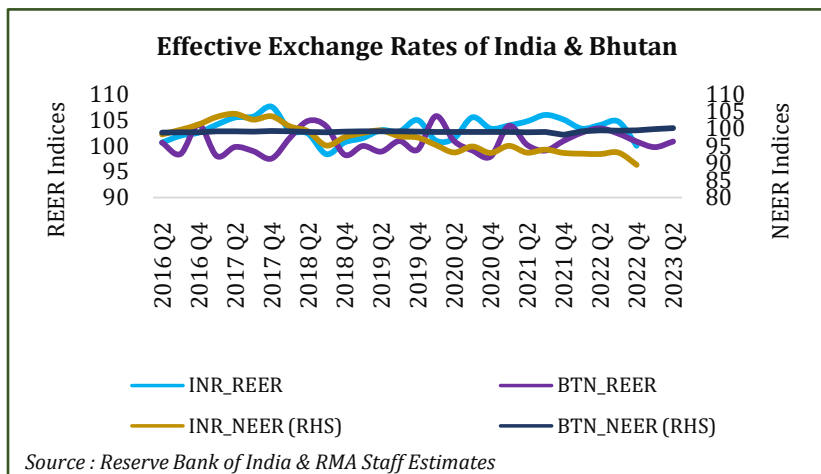
³ As per the RBI Annual Report, the net inflows from FDI decreased from the previous year's figure of USD 38.6 billion. Additionally, there were net portfolio outflows totaling USD 5.9 billion during the year.



obligations have increased. Although Nu slightly appreciated in the second quarter of 2023, concerns remain about debt sustainability, particularly if foreign exchange earnings are insufficient.

The Effective Exchange Rates

The variations in the nominal exchange rate signal the amount of domestic currency needed to purchase foreign currency. It does not exactly reveal the true competitiveness of the currency. Thus, it is important to assess its Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rates (REER)⁵, which serve as crucial tools for evaluating a country's economic competitiveness internationally. The NEER focuses on the changes in currency value and the REER provides a more comprehensive view by incorporating price differential, making it a key indicator of a nation's trade competitiveness by taking account of both exchange rates and relative price levels.



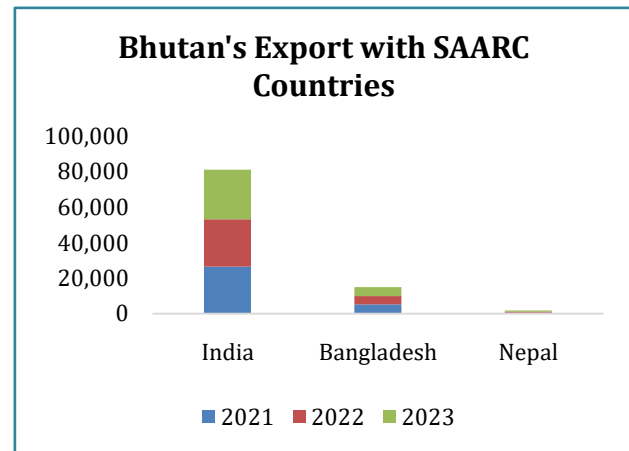
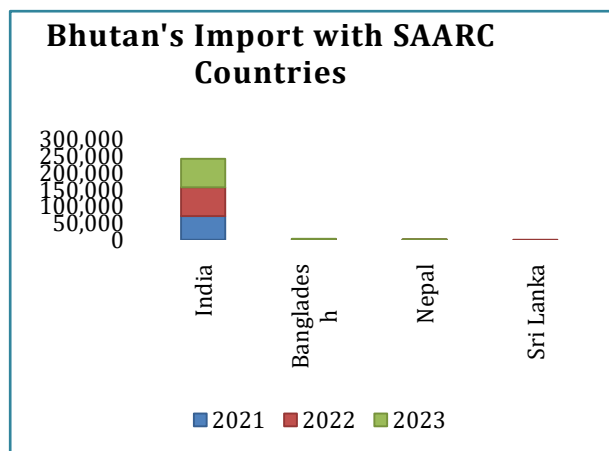
The chart provides an overview of the NEER and REER for both India and Bhutan, providing a representation of how the effective exchange rates have evolved over the specified periods⁶. The BTN_NEER has consistently remained stable over the period relative to the currencies included in the basket, fluctuating within a narrow range of 98.2 to 100.1. Unlike the usual scenario where an increase in trade share with trading partners tends to exert upward pressure, it has remained constant. The stability can be attributed to the current exchange rate regime and its heavy reliance on trade with India. The BTN_REER, in contrast, has exhibited fluctuation over the period and during certain periods, it appears to closely track the trend of the INR_REER. The decline in BTN_REER in 2022 is largely because of the depreciation of Nu against the basket of currencies and rising inflation among Bhutan's trading partners.

In the Indian case, (NEER/ REER) moved with a depreciating bias during 2022-23. On an average basis, the 40-currency NEER and REER depreciated by 2.0 per cent and 1.8 per cent, respectively, during the year (Reserve Bank of India).

Major Trading Partner



India has been Bhutan's largest trading partner with an import value of Nu 85 billion in 2023 alone. This relationship is strengthened by their geographical proximity and historical ties. China followed closely as the second-largest trading partner with an import value of Nu. 6.8 billion, indicating a consistent growth in trade relations over the past few years. Singapore also played a significant role, with trade amounting to Nu. 5.5 billion, providing Bhutan with access to global markets. Bhutan's trade relations extended to other member states, promoting regional economic cooperation. These main trading partners are crucial to Bhutan's economic development and efforts towards trade diversification, highlighting its commitment to promoting regional economic



cooperation and integration.

Alternative Exchange Rate Regime

The choice and structure of an exchange rate regime are critical considerations for policymakers, as they impact a country's ability to manage its economy effectively, maintain financial stability and respond to various economic challenges. Developing countries with limited capital mobility typically experience relatively low price levels and often opt for pegged exchange rate regimes. Exiting from pegged exchange rate regimes has historically been associated with crisis and decline in economic activity.

India will likely continue to be Bhutan's primary trading partner for the foreseeable future. The close geographical proximity, historical ties and economic interdependence between India and Bhutan have contributed to this enduring trade relationship. Thus, any attempt to transition away from a pegged exchange rate regime requires a meticulous assessment of the economic fundamentals. Any attempt to deviate from the current exchange rate regime will have serious implications for Bhutan, as the exits from fixed to other regimes are very complex from an institutional and operational perspective. The challenges in various economic factors such as **foreign exchange reserves, fiscal sustainability, capital mobility,**



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and export diversification can present a significant challenge for Bhutan's macroeconomic management and stability if the current exchange regime is abandoned.

The choice of exchange rate regime is not solely determined by economic fundamentals but also represents a broader monetary policy framework. This monetary policy framework or strategies includes Exchange Rate Anchor, Monetary Aggregate Target, Inflation-targeting Framework and Others that have no explicitly stated nominal anchor (including Bhutan).

Submission:

The advancement of digital assets and FinTech underscores the need for a prudent monetary policy. While Bhutan does have challenges concerning its fixed exchange rate regime, which limits the flexibility of monetary policy operations, the Department of Macroeconomic Research & Statistics is actively exploring alternative policy approaches that align well with the unique fundamentals of the Bhutanese economy. In pursuit of this goal, the Department is engaged in ongoing discussions with international institutions and central banks. The collaboration aims to establish a framework that best suits Bhutan's economic context.

Since the majority of our trade is with India, and considering all the macroeconomic benefits, it can be acknowledged that it is in the best interest of Bhutan to trade in the Indian Rupee.