HIGH-LEVEL SUMMARY TECHNICAL ASSISTANCE REPORT

BHUTAN

Development of an Interest Rate Corridor Framework

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High-Level Summary Technical Assistance Report
Monetary and Capital Markets Department
SARTTAC

Bhutan - Development of an Interest Rate Corridor Framework
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The *High-Level Summary Technical Assistance Report* series provides high-level summaries of the assistance provided to IMF capacity development recipients, describing the high-level objectives, findings, and recommendations.

ABSTRACT: At the request of the Royal Monetary Authority of Bhutan (RMA), an IMF South Asia Regional Training and Technical Assistance Center (SARTTAC) visited Thimphu during August 20-29, 2024. The mission's objectives were to assist the authorities in setting up interest rate corridor (IRC) and operationalizing the related instruments, operations, liquidity forecasting, and collateral frameworks.

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Background

At the request of the Royal Monetary Authority of Bhutan (RMA), an IMF South Asia Regional Training and Technical Assistance Center (SARTTAC) visited Thimphu during August 20-29, 2024. The mission's objectives were to assist the authorities in setting up interest rate corridor (IRC) and operationalizing the related instruments, operations, liquidity forecasting, and collateral frameworks.

Summary of Findings

In a context of international reserves below an adequate level, the RMA does not have an appropriate and functioning Domestic Liquidity Management Framework (DLMF) to support the peg. Neither has the RMA in place monetary policy instruments that would allow to deal with changing systemic liquidity conditions and challenges to financial stability in a flexible way. Exclusive reliance on administrative instruments and controls, such as a Cash Reserve Ratio (CRR), sweeping arrangements, capital flow management measures, while appropriate price incentives (i.e., a level of domestic interest rates consistent with the peg to the Indian rupee) are lacking can only solidify the preference of Bhutanese residents for foreign exchange and, therefore, reinforce the pressures on the peg, in particular through measures to evade capital controls.

Summary of Recommendations

The mission provided the RMA with an IRC framework covering five of its building blocks relevant for the RMA at this juncture as follows:

- ***Sweeping arrangements*****.** Re-instate broad sweeping arrangements of government-related accounts in the context of launching active liquidity management operations. By creating a structural liquidity deficit the measure would facilitate aligning short-term money market rates with the RMA Policy Rate.

- ***Liquidity monitoring and forecasting framework***. Enhance further the coordination and exchange of information with the Treasury (i.e., regular participation in bi-weekly meetings and transmission to the RMA of government cash flow forecasts). RMA's staff capacity can also be enhanced by their participating in the regional workshop for liquidity forecasting planned for the first quarter of 2025 and, if need be, follow-up TA.

- ***Collateral framework***. Operate under a narrow collateral framework for monetary operations, accepting only government securities. In that context, addressing the abnormally high fees charged by the RSEB in relation to the operations of its Central Securities Depository (CSD) is a matter of high priority.

- ***Money market development***. Phase out the fixed rate at which commercial banks currently trade liquidity among themselves, and re-instate the Money Market Contact Group (MMCG) as a platform for communication with commercial banks to discuss monetary operations and initiatives for the development of interbank operations.

- ***Adopt a phased approach to the introduction of the IRC:***

  - In the preparation stage, finalize relevant external and internal documents and conduct mockup operations.

  - In the first phase, introduce a one-week main Open Market Operations (OMO)s, conducted weekly at the Policy Rate and with full allotment. Ensure automatic access to the IRC's standing facilities (SFs). Adopt a width for the IRC wider than that of the anchor currency to stimulate interbank trading.

  - *Later*, rely on fixed-quantity, variable-rate OMOs, using liquidity forecasting to calibrate OMOs. At that time, move to averaging for the CRR.