

Democratic Republic of Timor-Leste

A large expansion in government expenditure and increased agriculture production lifted economic growth to an estimated 10% in 2008. Public spending, funded by revenue from offshore petroleum production, will continue to rise this year and keep economic growth high. Inflation is expected to ease. However, a rise in poverty points to the need for better targeted government spending to address a lack of basic services and rural underdevelopment.

Economic performance

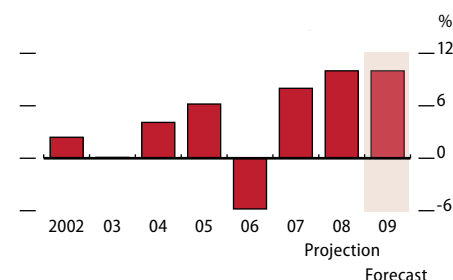
Expansion of public spending programs funded by revenue from offshore petroleum production spurred the economy in 2008. Actual government expenditure more than doubled from 2007 to reach an estimated \$450 million. This lifted the ratio of government expenditure to GDP to the order of 100%, excluding petroleum and the United Nations (UN) contribution to government operations.

About 2,000 international security and police personnel are still in Timor-Leste, under the auspices of the UN, to support law and order following outbreaks of civil unrest, including extensive unrest in 2006 and attacks on the president and prime minister in early 2008. These international forces, combined with civilian support and a large donor presence, provide an important source of demand in the economy. Economic activity was also supported over the year by an improved political and security situation, one that, though generally calm, remains fragile.

Agriculture, which accounts for about 85% of employment, recovered after being hit in 2007 by bad weather. An increase in the harvested area saw rice production rise by 21% such that it met about 40% of annual requirements (100,000 metric tons). The public sector accounts for around half the employment outside agriculture. Wholesale and retail trading and other private services (petroleum operations are entirely offshore), engage much of the rest of the working population. Non-petroleum, non-UN GDP grew by an estimated 10% in 2008 (Figure 3.34.1).

The surge in international commodity prices in 2008 propelled inflation to as high as 10.6% in June, year on year (Figure 3.34.2). Inflation then eased as the international price of crude oil and other commodities declined, putting the year-end rate at 7.6%. The Government increased subsidies for imported rice in 2008, and this suppressed the impact of higher international food prices (Figure 3.34.3). Nevertheless, around half the inflation last year was attributable to higher food prices (food accounts for 58% of the consumer price index). Most of the increase in

3.34.1 GDP growth

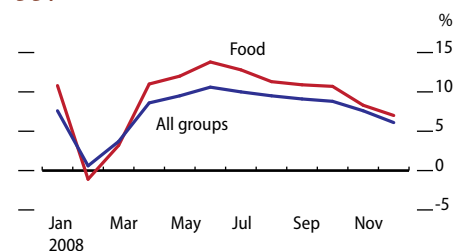


Note: Non-petroleum, non-UN GDP.

Sources: Government of Timor-Leste, *General Budget of State 2006–07 and 2008*.

[Click here for figure data](#)

3.34.2 Inflation



Source: Timor-Leste National Directorate of Statistics, *Consumer Price Index December Quarter 2008*.

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food prices was in turn a result of higher prices of rice, corn, and other cereals, as well as cassava and other root crops.

Strong growth in domestic demand was evident in a large rise in imports. Merchandise imports rose from \$68.6 million in the first half of 2007 to \$89.9 million in the first half of 2008. Excluding the offshore petroleum operations, merchandise exports (mainly coffee) are a small fraction of imports. Even after a bumper coffee harvest, merchandise exports totaled just \$11.6 million in 2008.

Loans and advances by commercial banks leveled off in 2008, suggesting slower growth in private business activity (Figure 3.34.4). Broad money supply rose by 33.1% as the international forces increased deposits with the banking system. The shortage of lending opportunities saw the commercial banks' liquid asset ratio rise to 79.4% by end-2008 from 71.3% a year earlier. Nonperforming loans remain a problem for the banks, even though their ratio to total loans eased to 28.2% by end-2008 from 30.2% at end-2007.

Access to microfinance is largely limited to loans secured by public sector salaries. This hampers development of agribusiness, in particular, because loans are not generally available for the purchase of rural products. The poor pay very high rates of interest to money lenders, estimated at up to 25% a month.

The Government made transfer payments totaling around \$100 million in 2008. These included subsidies for the aged and the vulnerable, pensions for former public office holders, and pensions for ex-combatants. It also paid people to return to their villages from temporary camps (more than 10% of the population was displaced by the 2006 violence). These payments supported consumption and helped achieve civil stability. However, outbreaks of civil strife remain a risk, as highlighted by heightened tension following the serious wounding of the president in a February 2008 attack.

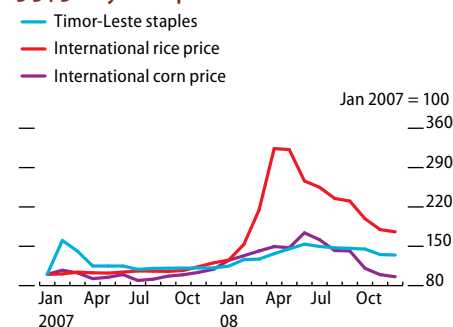
Economic prospects

The economy will remain dominated by government activities over the medium term. Almost all the Government's own revenue is drawn from the Petroleum Fund, which receives income from the nation's offshore petroleum production. The Petroleum Fund more than doubled in value to an estimated \$4.2 billion by end-2008, almost all invested in United States (US) government securities. The use of the US dollar as the national currency protected Timor-Leste from adverse exchange rate effects.

Prior to 2008, drawdowns from the Petroleum Fund were limited to its "sustainable income," so that the Fund's capital would be maintained indefinitely. The Government budgeted to draw down more than the sustainable income in 2008, a decision that led to intense political debate. While the actual drawdown did ultimately match the end-year estimate of sustainable income, budgeted drawdowns for 2009 and 2010 are well above that rate.

The 2009 budget increases government expenditure to \$902 million, almost double the 2008 estimate of non-petroleum, non-UN GDP. Much of the additional expenditure is for imported goods (including capital goods) and services, and so there will only be a muted effect on

3.34.3 Key food price indexes

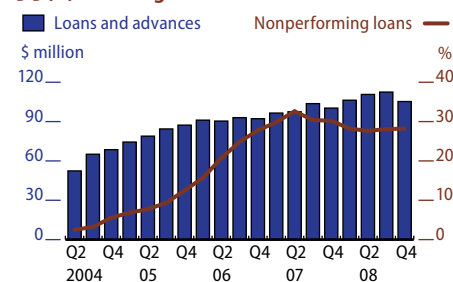


Note: Timor-Leste price index for cereals, roots, and their products; Bangkok rice price; and US (gulf ports) corn price shown.

Sources: Timor-Leste National Directorate of Statistics, *Consumer Price Index December Quarter 2008*; International Monetary Fund, *International Financial Statistics* online database, downloaded 4 February 2009.

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3.34.4 Lending indicators



Source: Banking and Payments Authority.

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3.34.1 Selected economic indicators (%)

	2009	2010
GDP growth	10.0	8.0
Inflation	7.1	6.5
Current account balance (share of GDP)	-	-

Source: Staff estimates.

GDP growth. The most direct impact on the economy will be from a further increase in public sector wages and salaries, which have almost tripled over 3 years. The Government also plans substantial spending on electrification (Box 3.34.1).

Non-petroleum, non-UN GDP is expected to grow by a further 10% in 2009, supported by a February 2009 decision of the UN Security Council to extend for at least 12 more months to February 2010 the UN Mission and international security presence. Nevertheless, civil unrest remains a downside risk for growth over the medium term. GDP growth is expected to ease in 2010 as budgeted declines in government expenditure feed through the economy (Figure 3.34.5). The actual outcome will rest on budget disbursement rates, which have been low (but increasing) in recent years because of difficulties in project planning and delays in procurement. Inflation is expected to ease in the forecast period to about 7.1% in 2009 and 6.5% 2010, as global food price inflation slows from 2008 levels.

Development challenges

The positive outlook for key economic aggregates masks deep poverty. The share of the population living below the poverty line increased from about 36% in 2001 to about 50% in 2007, according to the nation's second poverty study. Poverty is largely a rural problem (three quarters of the poor live in rural areas), although its incidence also is rising in towns. The Food and Agriculture Organization and World Food Programme have estimated that 30% of the population, for at least 2 months each year, lives on a diet that is insufficient to meet basic human needs. Food shortages arise from low agricultural output, high post-harvest cereal losses (up to 90% in upland corn), distortionary food subsidies, limited market access, and the very few alternative means of earning incomes in rural areas.

Low rural incomes, high population growth rates, rapid urbanization, and the after-effects of civil unrest are major challenges. The quality of government expenditure will be central to responding to them and to setting Timor-Leste's development path. The expansion in expenditure now under way has the potential to share the rapidly accumulating financial wealth with the population. Well-managed spending can generate additional wealth by converting low-return savings in financial instruments into high-return investments in human and physical capital.

More could be done to raise development returns from public expenditure. For example, the subsidization of imported rice shielded many people from rising international prices, but it also suppressed prices received by domestic growers. This damped a much-needed supply response from farmers, and consequently held down growth in their incomes.

Furthermore, the subsidies benefit the better-off more than the poor, as the better-off consume more rice and the poor rely more on corn and cassava. A government decision to hold 2 years of rice imports in storage as a buffer against price hikes will have similar side-effects, suppressing farm production and rural incomes. One alternative would be cash transfers to the poor. This approach would enable them to buy rice when the price rises and to pass on to farmers the benefit of the higher prices.

3.34.1 Electrification

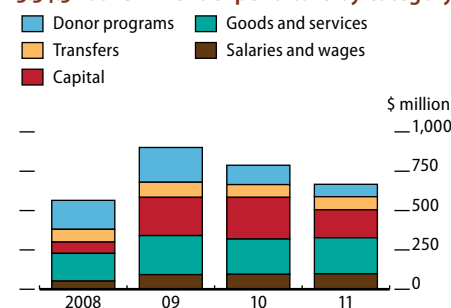
More than half the \$616 million capital expenditure budgeted in 2009–2012 is to be spent on building power stations fueled by imported oil to electrify urban (and later rural) areas. The Government has contracted to install 180 megawatts (MW) in generating capacity by end-2010, with supporting transmission and distribution lines. This represents a very large increase on current capacity of 40 MW.

This electrification program was announced in mid-2008 and the contracts were signed by year-end. A longer preparation phase would have been helpful to allow a fuller consideration of development issues involved.

A key issue is whether the supply expansion will outstrip demand—a 2004 power sector study found the country needed 50–100 MW of additional capacity by 2025 to lift the electrification rate to 80% from 20%. Another issue is whether electrification should be such a high budget priority.

Electricity is a service that can be at least partly self-funded from user charges. But because services such as law and order, road maintenance, and education and health services for the poor generally cannot be self-funded, they should be the priority for budget resources.

3.34.5 Government expenditure by category



Sources: Government of Timor-Leste, *General Budget of State 2006-07 and 2008*; Directorate of Treasury, Ministry of Planning and Finance, *Democratic Republic of Timor-Leste Annual Financial Report and Accounts 2005-06 and 2006-07*; staff estimates.

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