ECONOMIC ANALYSIS (SUMMARY)

A. Economic Structure

1. Timor-Leste’s economy has historically been centered on the agriculture sector, with high levels of subsistence production and modest exports of coffee and other agricultural products. Before regaining independence in 2002, public administration and related services were the main sources of formal employment, and a small domestic tax base meant that net transfers were required to finance fiscal and trade deficits. From 2002 to 2006 Timor-Leste was highly dependent on international aid, but income from offshore oil and gas production has ended this dependence. The share of petroleum production in total gross domestic product (GDP) peaked at 84% in 2008 and fell to 76% in 2013. Prudent management of petroleum income is essential if Timor-Leste is to achieve sustainable long-run growth. Economic monitoring and policy dialogue between the government and its development partners are focused on the non-oil economy and non-oil GDP owing to (i) the short time horizon for current petroleum production, which is forecast to end in 2021; (ii) the volatility of petroleum income; and (iii) the separation of the petroleum sector from the rest of the economy. This is consistent with the imperative of developing the non-oil economy so there is a sustainable economic base when petroleum production ends. In 2013, the population was estimated at 1.18 million with non-oil GDP per capita of $1,118 (footnote 1).

2. A sovereign wealth fund, the Petroleum Fund of Timor-Leste, was established in 2005 to support prudent management of petroleum income. The Petroleum Fund’s design and operation is consistent with the “Santiago Principles” on sovereign wealth fund management and incorporates additional rules and oversight mechanisms to support macroeconomic stability and long-term fiscal sustainability. The Petroleum Fund is managed by the Central Bank of Timor-Leste, which is responsible for implementing an investment strategy based on asset allocation limits and yield benchmarks set by the Ministry of Finance. All petroleum income is paid into the Petroleum Fund, and the government is legally entitled to withdraw the estimated sustainable income (ESI) from the Fund each year to finance public spending. The ESI is defined as the maximum annual withdrawal that could be sustained indefinitely in real terms. It is equal to the average expected real rate of return on total petroleum wealth and is calculated as 3% of the sum of the current Petroleum Fund balance and a discounted forecast of future petroleum revenues. The government can make withdrawals above the ESI if they are budgeted and approved by the Parliament.

3. The public sector is the main source of demand in the non-oil economy. This is reflected in the exceptionally high ratio of public spending to non-oil GDP, which reached a peak of 135% in 2011. The share of capital investment in non-oil GDP rose from 13% in 2006 to 66% in 2011 before falling back to 39% in 2013 as major public investments were completed (footnote 1). Private investment accounted for 7% of non-oil GDP in 2007 and grew modestly to reach 9% of non-oil GDP in 2013 (footnote 1). Increases in public spending have led to a deterioration in the non-oil trade balance as imports have grown rapidly (Figure 2).

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2 The Santiago Principles consist of 24 generally accepted principles and practices that have been voluntarily endorsed by members of the International Forum of Sovereign Wealth Funds (http://www.ifswf.org/santiago-principles-landing/santiago-principles).
4. Comparison of the 2010 and 2013 labor force surveys gives an indication of labor market trends during a period in which the non-oil economy was expanding. During 2010-2013 the working age population increased by 10% and the labor force participation rate rose from 25% to 31%. Most of the growth in the labor force was accommodated by increased employment, but unemployment also rose from 8% to 11%. Timor-Leste’s young population means that the working age population will continue to grow by 3% per annum during 2016–2020. This highlights the importance of job creation and the need to ensure that the education system is preparing young people for productive employment.

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B. Recent Economic Performance

5. Timor-Leste benefited from the high oil prices seen from 2007 to 2014. The large fiscal and current account surpluses resulting from petroleum production have been saved in the Petroleum Fund, which held a balance of $16.2 billion (11 times non-oil GDP) in December 2015. However, forecasts for future oil revenues have been cut since 2013 due to production downgrades and a weaker price outlook, reducing the estimated value of Timor-Leste’s petroleum wealth from $26.2 billion in 2013 to $18.2 billion in 2015, with a corresponding reduction in the ESI from $787 million to $545 million.6

6. The transparency and integrity of the Petroleum Fund’s management have been maintained since it was established in 2005. Petroleum Fund savings were initially invested in low-risk sovereign bonds, but in 2011 the Petroleum Fund Law was amended to allow investment of up to 50% of holdings in international equities.7 Diversification of the investment portfolio will increase the exposure to short-term losses but is consistent with a prudent long-term investment strategy. Following the legal change, the Petroleum Fund’s investment portfolio was gradually rebalanced toward equities, and since 2014, 40% of assets have been held in international equities. Investment income has been in line with relevant benchmark yields. From 2008 to 2011, the Petroleum Fund’s investments produced an average nominal return of 2.9%, while for 2012 to 2014, the average nominal return was 4.1%. The Ministry of Finance’s longer-term modeling assumes an annual nominal investment return of 5.7%; achievement of this target would ensure the sustainability of Petroleum Fund withdrawals at the level of the ESI.

7. Public expenditures rose from $218.3 million in 2006 to reach $1.63 billion in 2014 as the government used Petroleum Fund withdrawals in excess of the ESI to frontload investments in infrastructure and human capital. The stimulus from rising spending saw non-oil GDP growth average 10.6% during 2007–2012 before dropping to an estimated 4.3% during 2013–2015 as growth in public expenditure eased. Growth since 2007 has been concentrated in sectors with clear links to public spending, such as construction and public administration. Excluding these sectors, the non-oil economy grew by an average of 3.4% per annum during 2007–2013.

Figure 5: Growth of the non-oil economy


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6 This does not include any estimate of income from resources for which no production agreement is in place. Source: Government of Timor-Leste, Ministry of Finance. 2015 State Budget 2016: Book 1. Dili.

8. Timor-Leste uses the United States dollar as its official currency. This limits the scope for an independent monetary policy and is generally associated with low inflation. Inflation rose sharply during 2010–2012, averaging 9.8%. Comparison with inflation in other dollarized economies suggests that this period of high inflation was due to local factors (Figure 7). The most plausible explanation is the demand pressures stemming from sharp increases in public spending and domestic supply constraints. Inflation has fallen sharply since 2013.

![Figure 6: Petroleum Fund Balances](source)

![Figure 7: Consumer Price Inflation](source)

9. During preparation of the 2014, 2015, and 2016 State Budgets the government proposed to stabilize budgeted expenditures (excluding grants) at $1.3 billion. Spending at this level would still require withdrawals above the ESI but is consistent with a fiscal path in which the Petroleum Fund balance is maintained in nominal terms. However, the approved budgets were $1.50 billion for 2014, $1.57 billion for 2015, and $1.56 billion for 2016, and each of these budgets projected large increases in spending in subsequent years. Bottlenecks in budget execution mean that actual spending has frequently fallen below budgeted levels (Figure 8). However, lower oil prices and declining production highlight the growing risk of delaying the necessary adjustment to a more sustainable fiscal path. The overarching risk is that fiscal frontloading will prove difficult to reverse, resulting in rapid depletion of the Petroleum Fund.

C. Inclusive Economic Growth

10. Timor-Leste has made steady progress in expanding access to basic public services such as health, education, water and sanitation, and electricity, but is unlikely to have achieved any of the Millennium Development Goals by 2015. Income poverty rose from 36% in 2001 to 50% in 2007 due to the stagnation of non-oil GDP, declining per capita consumption, and the disruption to livelihoods caused by the 2006 political crisis. Rapid economic growth means that poverty is likely to have fallen since 2007, and updated poverty indicators from a new nationwide household survey are expected in 2016. In the absence of these updates, other

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8 International Monetary Fund. 2013. Democratic Republic of Timor-Leste: Staff Report for the 2013 Article IV Consultation. Washington, DC.
10 Poverty Analysis (Summary) (accessible from the list of linked documents in appendix 2 of the ADB Country Partnership Strategy: Timor-Leste 2016-2020).
sources can be used to assess the extent to which the rapid growth seen since 2007 has been inclusive. Trends in childhood nutrition since 2003 are consistent with a pattern of rising poverty during 2002–2007 and gradually falling poverty since then (footnote 12). A national survey in 2013 found the lowest rates of malnutrition among children aged under 5 since 2002, but Timor-Leste still performs very poorly when compared to other countries in Asia and the Pacific.11

11. Timor-Leste’s constitution establishes social assistance as a right of all citizens with a particular focus on veterans of the fight for independence, the elderly, disabled, and children and youth. Since 2008, the government has implemented cash transfer programs to honor this responsibility. This includes a $30 per month pension for the elderly (aged 60 and above) and disabled, and a conditional cash transfer program that pays $5 per child per month to vulnerable households. The majority of cash transfers (64% in 2013) are paid to veterans of the fight for independence. These payments are not principally intended to relieve poverty, but are paid in recognition of past sacrifices and to support social stability.

12. An independent review by the World Bank of the social transfer programs found that poverty reduction has not been commensurate with the resources used because a significant proportion of the poor and vulnerable population is not supported by any assistance program.12 Improved targeting of social assistance would provide more cost-effective support for poverty reduction, but any reduction of existing entitlements would be difficult to implement.

D. Binding Constraints to Growth

13. The private sector is at an early stage of development and still depends on the demand from government spending. Analysis of binding constraints must therefore focus on the key constraints to private sector development and a broader transformation in the structure of the economy. This transformation is constrained by poor quality infrastructure, skills shortages, low levels of general education, and a weak business enabling environment. These constraints have been confirmed by surveys of businesses operating in the country that identify limited access to finance, corruption, public sector inefficiency, the poor work readiness and education levels of the labor force, and poor quality infrastructure as the top six constraints to business activity.13

14. Cross-country comparisons demonstrate the challenge of creating an enabling environment for the private sector in Timor-Leste. The World Economic Forum’s Global Competitiveness Report, 2014–2015 ranks Timor-Leste 136 out of 144 countries (footnote 13) and the World Bank’s Doing Business Indicators ranking Timor-Leste 173 out of 189 countries in 2015.14 The Doing Business scores reflect poor performance in contract enforcement, property rights, and access to finance due to the challenges of resolving land tenure and developing a functional justice system in a post-conflict environment. The World Economic Forum’s report gives a broader view of constraints and suggests that Timor-Leste has particular weaknesses in the quality of its road infrastructure, the level of education and work readiness of its labor force, and the depth and sophistication of its financial system (Figure 9).15

15 Footnote 13 pp362.
15. There are clear opportunities to improve welfare and grow non-oil exports through development of the agriculture sector. Average yields of key crops such as rice, coffee, and maize are currently far below the yields achieved in neighboring countries under similar conditions. There is also untapped potential for high-value exports of fresh produce, spices, tree crops, and marine produce. Most farming households have minimal engagement with agricultural markets and can be characterized as low-input, low-output producers. The factors that contribute to low productivity include poor infrastructure, limited availability of extension services, low usage of agricultural inputs, and low uptake of improved crop varieties. In some cases, these factors may be linked to deeper issues of low social trust and high risk aversion. There is a clear role for the government to design and implement a strategy to develop the agriculture sector in partnership with the private sector and development partners.

16. Developing other productive sectors of the economy will be harder but is essential for growth and job creation. There is potential to develop tourism through a coordinated approach in which the government provides key public goods and an enabling environment for private investment. There is also scope to develop manufacturing; import substitution of some bulky goods appears commercially viable despite the small local market, and there is also potential for value-added processing of primary commodities such as limestone. Labor-intensive manufacturing in sectors such as apparel could create significant employment, but Timor-Leste is unlikely to be competitive in these sectors given current labor market policies.

E. Economic Prospects for 2016–2020

17. Official government forecasts show revenues from existing petroleum production declining steadily before ending in 2022 (figure 10). In the absence of new developments, fiscal sustainability will require public spending to stabilize at or below current levels, thus removing the fiscal impulse from rising public spending. Prospects for growth will therefore depend on the private sector. Rising private investment would support more sustainable growth but is unlikely to fully replace the stimulus provided by government. Economic performance since 2013

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suggests that annual non-oil GDP growth of 4%–6% can be achieved in the absence of fiscal stimulus.

The major downside risk to the growth forecast is that political instability will disrupt economic activity. Upside risks are centered on the prospects for oil and gas production and public spending. The revenue from existing production may exceed current forecasts, thus enabling a further expansion of public spending. The economy could also receive a major boost from an agreement between the governments of Timor-Leste and Australia on development of the Greater Sunrise oil and gas field. The impact of an agreement will depend on the allocation of the benefits between Timor-Leste and Australia, the fiscal arrangements made with the project developers, and the profitability of the project. One possibility is that an agreement would lead to development of downstream processing facilities in Timor-Leste which would likely generate significant spillovers during construction.

Notwithstanding any onshore processing, fiscal policy will continue to provide the main link between the petroleum sector and the domestic economy. Prudent fiscal policy can help promote macroeconomic stability and continued growth during 2016–2020. Imprudent fiscal policy may yield a temporary increase in growth rates, but would do so at the expense of future welfare and macroeconomic stability. Preliminary modelling of the total revenues that Timor-Leste could receive from development of the Greater Sunrise oil and gas field has produced estimates ranging from $4.9 billion to 15.6 billion. Development of the field would allow the government to maintain public spending at higher levels, but would not change the core structural challenge of developing a viable non-oil economy that can create jobs and support sustainable improvements in welfare.

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17 Greater Sunrise is an oil and gas field in an area of the Timor Sea that lies between Timor-Leste and Australia. Treaties between the governments of Timor-Leste and Australia have established a legal framework for development of the field and the distribution of revenues between the countries. However, subsequent disagreements between the countries have prevented the field from being developed.