Democratic Republic of Timor-Leste

High government expenditure, largely funded by revenue from petroleum production, supported moderate but slower growth in 2009. The economy is forecast to pick up in 2010, again driven by government spending. Inflation is likely to rise from last year's low levels. The government plans to borrow, for the first time, to accelerate investment in infrastructure. Sound investment of borrowed funds and prudent management of national savings are central to the achievement of sustainable economic growth.

Economic performance

Momentum from a buildup in government spending over recent years underpinned economic growth in 2009. GDP, excluding offshore petroleum production, expanded by 5.0% (Figure 3.34.1). That was around half the 10.5% average expansion in the preceding 2 years because the rate of increase in government expenditure slowed.

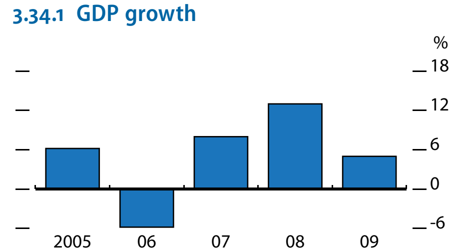
Government spending dominates this economy, with its ratio to nonpetroleum GDP close to 168% (Figure 3.34.2). A large portion of the buildup in public outlays has been in public sector wages, minor capital works, and cash transfers to the elderly, internally displaced persons, ex-combatants, and others. Such expenditure has fed quickly into the economy and generated multiplier effects that have further lifted aggregate demand. Poverty, however, remains widespread.

Up-to-date economic data are limited, though the uptrend in various indicators of demand suggests a significant rise in private consumption in recent years. For example, there was one cell phone subscriber for every 9.3 adults in mid-2007; by end-2009, there was one for every 1.7 adults. Over 11,000 new motor vehicles were registered in 2009, more than double the number in 2008. Private electricity consumption is also on a rising trend (Figure 3.34.3).

While aggregate demand rose on average in 2009 relative to 2008, it softened during the year, as illustrated by a trending down in imports (Figure 3.34.4). By December 2009, their real value was down by 38.1% from the prior-year period. The value of merchandise exports, mainly coffee and excluding petroleum, fell by around a third, as the volume of coffee exports fell sharply. Exports are less than 3% of the value of merchandise imports, leaving a huge trade deficit.

The government allocated $681 million of its own funds for budget spending in 2009, up 23% from its own-funded spending in 2008. But continuing problems in carrying out budget projects meant that actual spending, of about $500 million, fell short of the allocation. Including donor-funded activities, total government expenditure is estimated to have declined slightly in 2009 from 2008.

3.34.1 GDP growth



Note: Nonpetroleum, non-United Nations, annual GDP growth.

Source: Ministry of Finance. *General Budget of the State*. Various issues. http://www.mof.gov.tl

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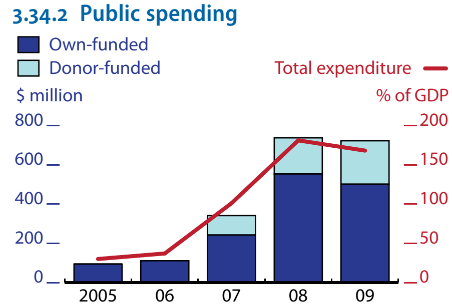
3.34.2 Public spending



Source: ADB estimates based on Ministry of Finance. 2009. *General Budget of the State and State Plan for 2010*. October. http://www.mof.gov.tl

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This chapter was written by Craig Sugden of the Pacific Department, ADB, Manila.

The government's income from offshore petroleum production in 2009 was $1.65 billion. That amount lifted savings held in the nation's Petroleum Fund to almost $5.4 billion by year-end, equivalent to about nine times annual GDP (excluding petroleum production). The annual sustainable drawdown is estimated at about $500 million, which is enough to fund 80% of the government's own contribution to the budget. Still, the authorities budgeted to draw down more than the sustainable income in 2009. The estimate of sustainable income was revised up later in the year as higher energy prices were factored in, to levels close to the 2009 drawdown rate.

Owing to the large inflows of petroleum income, the budget surplus was about 145% of nonpetroleum GDP in 2009, and the external current account recorded a very large surplus equivalent to nearly 300% of GDP.

Lower global oil and food prices suppressed inflation to just 0.1% on average last year, as it decelerated from about 8% in 2008. The consumer price index fell on a year-on-year basis from May through November. The direction of inflation has generally followed that of Indonesia, Timor-Leste's primary trading partner, in the past 2 years (Figure 3.34.5).

Large deposits by international agencies and rising incomes continued to inject liquidity into the banking system. Broad money supply expanded by about 30% in 2009. Bank lending, however, was sluggish and the ratio of nonperforming loans remained high at about 28% of total loans. (Banks hold adequate provisions against nonperforming loans.)

The climate for development of the private sector remains very difficult. Timor-Leste is one of the weakest performers in the World Bank's *Doing Business 2010* report, with a rank of 164 out of 183 countries in 2010 (a slight improvement from 170 in 2009). Issues concerning land, credit, contracts, and setting up a business are paramount concerns. In one area, tax reform, considerable progress has been made. A reduction in taxes on business boosted the ranking in this indicator from 79 in 2009 to 19 in 2010.

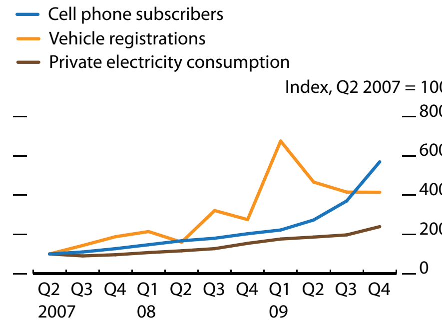
Economic prospects

The economic outlook remains highly dependent on the budget. In this context, a budgeted increase of 27.3% in own-funded government expenditure (all funding excluding donor support) in 2010 over actual spending last year (Figure 3.34.6) is expected to more than offset a decline in donor funding, leaving a small overall increase in budgeted expenditure.

As in earlier years, the own-funded part of the budget is unlikely to be fully spent. But the higher level of funding, coupled with gradual improvements in implementation capacity, will likely lead to an increase in spending in 2010. This is forecast to lift economic growth slightly to about 7.0% this year. Capital expenditure by the government is expected to gather momentum in 2011, helping to maintain growth at about 7.0%.

The presence of international police and security forces in Timor-Leste under the auspices of the United Nations has been extended until at least early 2011. This will help safeguard security, and spending by the United Nations forces will support aggregate demand. Next year, though, their presence is scheduled to decline, with a reduction in the number of police personnel from 1,608 to 1,280 by midyear.

3.34.3 Indicators of private consumption



Source: ADB estimates based on the National Statistics Directorate. *Quarterly Statistical Indicators*. Various issues. http://dne.mof.gov.tl

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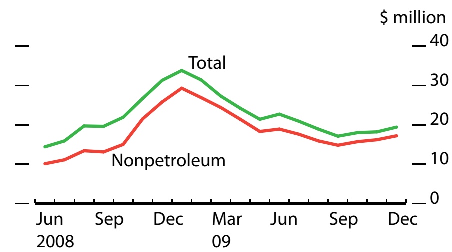
3.34.4 Real value of imports



Note: US$ million deflated by consumer price index; 3-month moving averages.

Source: ADB estimates based on the National Statistics Directorate. *Quarterly Statistical Indicators*. Various issues. http://dne.mof.gov.tl

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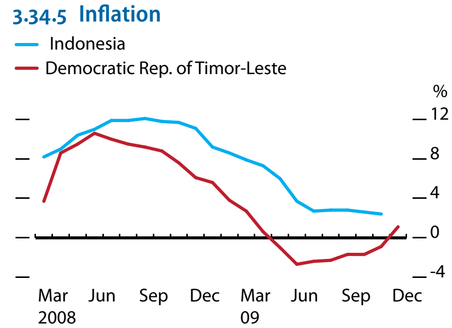
3.34.5 Inflation



Sources: National Statistics Directorate. *Consumer Price Index*. Various issues. http://dne.mof.gov.tl; Bank Indonesia. http://www.bi.go.id (accessed 17 February 2010).

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3.34.1 Selected economic indicators (%)

	2010	2011
GDP growth	7.0	7.0
Inflation	3.2	3.8
Current account balance (share of GDP)	271.7	-

Source: ADB estimates.

Higher prices of imported commodities are forecast to contribute to a step up in inflation to 3.2% in 2010 and to 3.8% in 2011. Inflows of petroleum income will produce another large current account surplus in 2010.

Savings in the Petroleum Fund are projected to rise steadily to about $9 billion by 2013 (Figure 3.34.7), providing substantial funding for the budget in the years ahead. Initial steps were taken last year to increase the return from the Fund by diversifying a small part of its investments from US government bonds into other governments' bonds and into various other currencies.

Development challenges

The main challenge is to use revenue generated from petroleum production to develop the human and physical capital needed to generate private sector–led growth, which should expand employment and reduce poverty. At the same time, substantial national saving of petroleum revenue need to be preserved for future generations. A national strategic plan being prepared will provide for an integrated approach to development, and will be central to guiding decisions on the use of petroleum revenue.

The latest national poverty survey shows that the share of the population living below the poverty line increased to about 50% in 2007, from 36% in 2001. Most of the population relies on agriculture, but low output, high postharvest losses, and limited alternative sources of income have resulted in rising numbers of poor people in rural areas. High population growth rates of over 3% annually, rapid urbanization, and a small formal sector have resulted in slow rates of job creation in urban areas and have also pushed up poverty rates there.

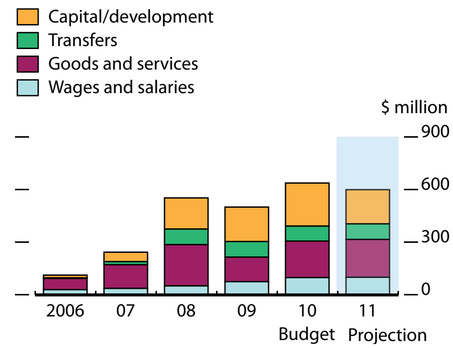
In an effort to bring forward public investment and accelerate the rate of development, the government has initiated plans to secure concessional loans. In September 2009, Parliament approved legislative amendments that enable the government to borrow, for the first time. (Assets in the Petroleum Fund cannot be used as security, however.)

Also in September, the government agreed to a credit line from the Government of Portugal. The 5-year line will, with parliamentary approval, enable concessional borrowing of up to €100 million a year. The funds will be used for construction and rehabilitation of health care and education facilities and for infrastructure. The 2010 budget foreshadows total borrowing of as much as $3 billion over the medium to long term.

Projections of petroleum revenue suggest that future budgets will have the capacity to service a prudent level of concessional borrowing. To ensure that the fiscal and debt positions are sustainable, borrowed funds must be used efficiently to raise the productive capacity of the economy, and not for consumption purposes.

Achieving this outcome will require a sound process for selecting high returning investment projects; an emphasis on investment in human capital and productive physical capital; and efforts that investments pay for themselves through user charges, as much as feasible. The formulation of the national strategic plan provides an opportunity to lock in these three elements of a successful fiscal and debt strategy.

3.34.6 Own-funded government expenditure



Source: ADB estimates based on Ministry of Finance. 2009. *General Budget of the State and State Plan for 2010*. October. http://www.mof.gov.tl

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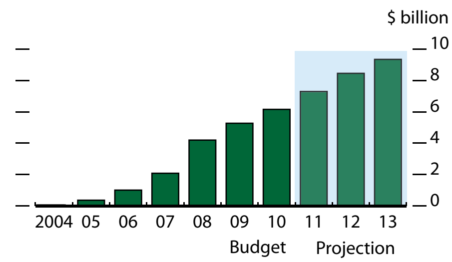
3.34.7 Petroleum Fund balance



Sources: Ministry of Finance. 2009. *General Budget of the State and State Plan for 2010*. October. http://www.mof.gov.tl; International Monetary Fund. 2009. *Article IV Consultation*. July. http://www.imf.org

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