

Democratic Republic of Timor-Leste

An improvement in law and order enabled the economy to recover in 2007 from a slump the previous year. Economic prospects rest on the maintenance of internal stability and continued expansion of public expenditures. On the expectation that these conditions will be met in 2008, the economy is forecast to grow moderately. Surging petroleum revenues are building the nation's financial wealth and provide the opportunity to fund public economic and social programs, as well as to strengthen the institutions needed for development.

Economic performance

Economic activity rebounded in 2007 following violent civil unrest in 2006, which caused a sharp contraction in the economy. The international security and police forces built up in 2006 under the auspices of the United Nations (UN) remained through 2007 and underpinned law and order. Presidential and parliamentary elections were held and a new government was installed in August. The improved civil conditions, demand stimulus from the international forces, and expanding public spending programs helped lift GDP by an estimated 7.8% in 2007 (excluding offshore oil and natural gas and the UN contribution to government operations).

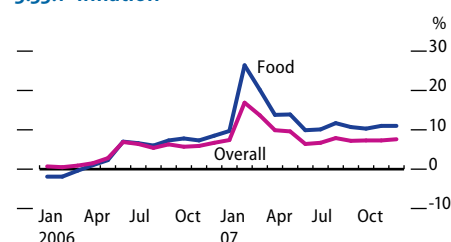
Agriculture, which accounts for about 80% of employment, contracted in 2007 due to shortages of seed, locust infestations, and bad weather. The preliminary estimate put the decline in production at 2.2%, although some indicators pointed to a larger fall. This led to projections of a cereal deficit for the 6 months to April 2008 of 86,000 tonnes, and a requirement of 15,000 tonnes of cereal in emergency assistance. Up to 30% of the population received some support last year from the World Food Programme, which estimated that production of cereals, tubers, and maize was 20–30% below the average level of the past few years.

Shortfalls in domestic food production and low inventories, plus rising rice prices in Southeast Asia, contributed to a surge in inflation in February 2007, when food prices in Timor-Leste rose by 26.4% (Figure 3.33.1). That surge subsided, but year-on-year inflation remained high at 7.6% at end-2007, and averaged 8.9% over the year.

Merchandise imports soared by 85.1% over the first 6 months of 2007 from the year-earlier period, with the jump largely a result of the rising international presence and public investment. A sharp increase in oil exports, as well as coffee shipments, produced a trade surplus, though.

Substantial revenues to the Government from petroleum production are deposited in the nation's Petroleum Fund and invested abroad, with only the estimated sustainable income drawn down each year by

3.33.1 Inflation



Source: Timor-Leste National Directorate of Statistics, *Quarterly Reports*, various issues.

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the Government to fund expenditures. This income financed a near doubling of such expenditures (excluding donor projects) in FY2007 (ended 30 June 2007) and a further rise was budgeted for July–December 2007 (Figure 3.33.2). The budget surplus was almost three times GDP in FY2007, and remained high over the second half of 2007.

The economic rebound was evident in the banking sector. Loans rose by 8.8%, with most of the increase in lending to individuals and, to a lesser extent, to the construction, trading, and finance subsectors. Broad money rose by 44.0% in 2007 as the large international presence added to deposits with the banking system. Nonperforming loans remained a problem. Bad loans increased because of weak credit assessment policies and difficulties in contract enforcement and loan recovery. They rose rapidly in 2006 as the economy contracted, and remained at around 30% in 2007 (Figure 3.33.3). The three commercial banks are branches of foreign banks, so this moderates the risk of financial sector instability.

Economic prospects

GDP (excluding hydrocarbons and UN operations) is projected to expand by 6.5% in 2008 (Figure 3.33.4), provided that there are no civil disturbances. A large projected increase in public expenditures is expected to drive growth. Budgeted expenditures for 2008 are just 3% higher than the allocation for FY2007 (from 2008 the Government's fiscal year is the calendar year). However, large amounts of committed yet unspent funds will feed into the economy over the medium term. For example, budgeted expenditure was \$329 million in FY2007, but only \$170 million was actually spent during the year. As of mid-December 2007, about \$154 million of unspent funds were available. Consequently, actual expenditures are likely to grow over 2008–2009 (Figure 3.33.5) because the Government is expected to improve its rate of disbursement. Economic growth is projected to slow over 2009 as the expansion in actual government expenditure moderates.

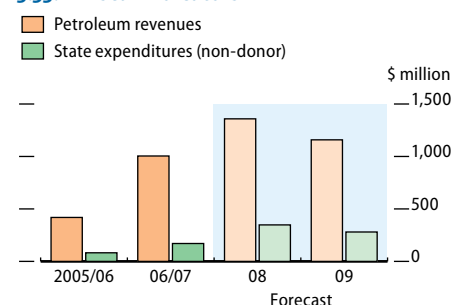
The new Government is focusing on administrative reform, internal security, expansion of public works, and a more generous transfer program targeting the disadvantaged. The budget surplus in 2008 is once more likely to be substantial.

Inflation is expected to slow to 7.0% in 2008 and 6.6% in the next year, assuming that prices of imported food rise at a more moderate level from later this year and that there are no major disruptions to local production (food accounts for 58% of the consumer price index).

However, this positive outlook for key economic aggregates masks a deep problem with food availability. Preliminary analysis of a 2007 household survey found that food consumption was low for 3.2 months of the year, with 73% of households experiencing at least 1 month of low food consumption last year. These results were only a small improvement on the figures for 2001, of 3.6 months and 86%, respectively. The 2007 survey also found that 54% of households self-assessed their food consumption as less than adequate, again only a small improvement on the 59% seen in 2001.

The shortage of food arises from low agricultural output and very limited alternative means of earning income in rural areas. Agriculture was highly protected before 1999, and then abruptly exposed to

3.33.2 Fiscal indicators

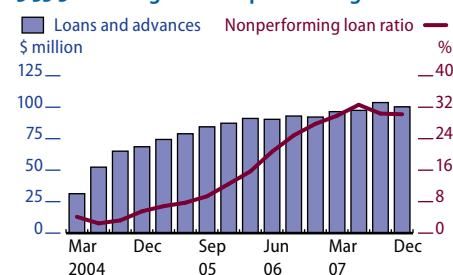


Note: Fiscal year changed to a calendar year basis in 2008.

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

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3.33.3 Lending and nonperforming loans



Source: Banking and Payments Authority.

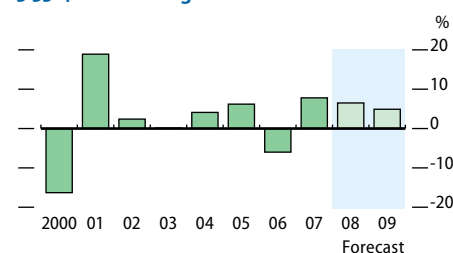
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3.33.1 Selected economic indicators

	2008	2009
GDP growth	6.5	4.9
Inflation	7.0	6.6
Current account balance (% of GDP)	-	-

Source: Staff estimates.

3.33.4 Real GDP growth



Note: Non-oil, non-UN GDP.

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

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international competition. Extended drought has added to difficulties. The sector is unable to support the large majority of the population reliant on it and many people face regular food shortages. A recovery in production in the forecast period hinges on government support to farmers for infrastructure and extension services, on better weather, and on a reduction in losses caused by locusts.

Internal instability remains a risk to the forecasts. The UN Security Council has said that unless differences among national leaders are resolved, political uncertainty will persist, together with the prospect of renewed violence. In February 2008, the president was seriously wounded in an attack by a leader (himself killed in the attack) of a group of ex-military personnel. Almost 10% of the population still lived in temporary camps or with host families at end-2007, having been displaced from their homes by the civil unrest of the year before. They face many difficulties in rebuilding damaged homes, livelihoods, and community relations. The international presence is important to medium-term prospects, given its contribution to internal security and the spillover effects of its expenditure. (The UN Mission has an annual budget around half that of the Government.) Timor-Leste's president has requested an extension in the UN Mission to 2012, from its current mandate that has been extended to February 2009.

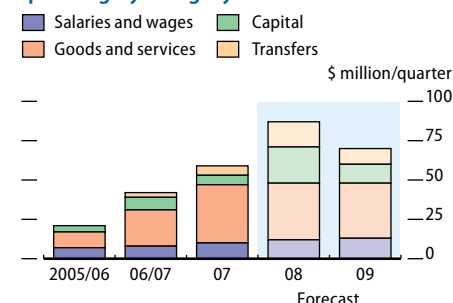
Development challenges

Low rural incomes, high population growth rates, and pressures for rapid urbanization are major challenges. Even the strong inflows of petroleum revenues risk creating economic distortions if they are mishandled. High demand for skilled people suited to public administration and to construction has pushed up wages in these areas, with a flow-on impact to general wage levels. This relatively high wage structure, combined with the poor state of physical infrastructure, internal instability, and a still-emerging legal framework, adds to business costs and reduces potential returns from investment. This in turn deters expansion of the formal private sector, except for businesses that supply the public sector or the international community.

Reflecting the small size of the formal private sector, paid employment accounts for less than 15% of total hours worked, and about 70% of paid employment is within the public sector, public works, or nongovernment organizations, according to preliminary results of the 2007 household survey. The 2004 census found that the unemployed and those discouraged from seeking work accounted for half the people aged 15–24 years living in Dili, the capital. The subsistence and informal sectors of the economy also face significant problems.

Working in the country's favor, national income has risen substantially and financial wealth is accumulating (Figure 3.33.6), which should finance public programs for many years and provide an environment to strengthen state institutions, including systems to manage public expenditures. The quality of public expenditures is critical for the conversion of the growing financial wealth into higher living standards, through a healthier and better educated population, supported by improved physical infrastructure.

3.33.5 Average quarterly government spending by category

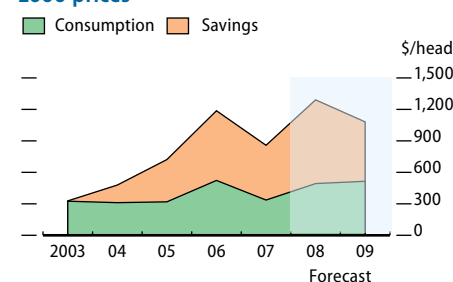


Note: Fiscal year changed to a calendar year basis in 2008.

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*, December 2006 and *Annual Financial Report and Accounts Fiscal Year 2006–07*, December 2007.

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3.33.6 Savings and consumption, 2000 prices



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

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