Democratic Republic of Timor-Leste

Estimates show a contraction in non-oil GDP last year after an extended outbreak of civil unrest, though a sharp rebound is projected for 2007, based on increased spending by the Government and by international personnel deployed in the country. Achieving development objectives hinges on the state's ability to translate a strong flow of oil and gas revenues into capital spending, since the public sector's limited capacity restricts budget execution, hindering the growth of sectors that could generate employment and reduce poverty.

Economic performance

Economic activity in 2006 was severely hampered by civil unrest, which began in the capital, Dili, in April, culminated in armed conflict between the National Defence Force and the National Police, and continued until September, with occasional disturbances reported after that. About 2,200 houses were burned, which led to around 50% of Dili's population leaving the city, according to United Nations (UN) estimates. By the end of May, the UN and many foreign embassies had withdrawn nonessential staff. The Government requested external assistance to guarantee the peace, and by end-2006 more than 2,000 international forces were deployed. Somewhat earlier, in June, the prime minister had stepped down to be replaced by the former foreign minister. This year, a presidential election is scheduled for April and a parliamentary election in May.

Before the upsurge in violence, the economy was in an expansionary phase that indicated some success in meeting its major development challenge since independence in 2002: to use wealth from offshore oil and gas resources to generate growth that reduces severe poverty. About 40% of a fast-growing population of 1 million is estimated to live below the national poverty line, with three quarters living in rural areas and having limited access to safe water and sanitation. Two thirds of the rural population relies almost exclusively on subsistence agriculture, and coffee is the major cash crop.

In 2005, oil and gas income and non-oil GDP were approximately of equal size at $350 million, with oil and gas revenues paid into a petroleum fund that is invested abroad and supports government spending under a long-term fiscal sustainability policy that allows only "permanent" interest income from the fund to be appropriated annually. Non-oil GDP, which includes agriculture (32%), the public sector and the UN (35%), and nonfarm private sector activity (33%), was originally expected to grow by around 5% in 2006, boosted by higher public investment financed by income from the petroleum fund. The private sector should have benefited from planned public construction projects, and coffee exports were expected to increase.

The civil unrest, which occurred at the peak of the coffee harvest season, damaged production. Other agricultural products, notably

2.32.1 Balance of trade

Source: International Monetary Fund, *Article IV Consultation*, July 2005 and February 2007.

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livestock and dairy, also suffered. Public investment projects were suspended and commercial activity was heavily restricted. Capital left the country and banks were closed for a time, during which bad loans accumulated and new loans ceased being filed. One bank reported that the typical loan default rate of 5% jumped to 30% by year-end, as many borrowers fled.

These negative impacts were offset by the presence of the international forces and restart of some projects, which increased aggregate demand and thus imports. A surge in fund transfers to pay staff at international agencies injected an estimated $40 million–$50 million into the economy in December (Figure 2.32.1 above).

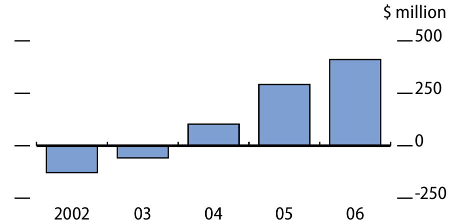
Official national accounts are not prepared, but the International Monetary Fund estimates a 1.6% contraction in non-oil GDP in 2006. Given population growth of 4.0%, per capita non-oil GDP declined significantly. In contrast, the offshore oil and gas sector was not directly affected by the civil unrest, with production increasing in the context of high global prices. Oil and gas revenues rose by an estimated 44% to $492 million in 2006, increasing the current account surplus and foreign reserves (Figure 2.32.2). At year-end, the book value of the petroleum fund was $1.0 billion, with the fund gaining an estimated $80 million a month (Figure 2.32.3).

Growth in oil and gas receipts also ensured a considerable surplus in the Government's accounts for FY2006 (ended 30 June 2006), equivalent to 103% of non-oil GDP (Figure 2.32.4). While revenue growth exceeded budget estimates, both recurrent and capital expenditures fell short. Capital spending in the combined sources budget, which included donor-funded recurrent and capital projects equivalent to 59.0% of total expenditures, again fell short of planned figures, indicating a continuation of capacity constraints in executing budget projects. The FY2007 budget estimates that revenues will rise by 85.6% because of further growth in oil and gas receipts, while expenditures are estimated to more than double to $309 million, leaving an overall surplus of $424 million, or about 100% of non-oil GDP.

The increase in planned outlays includes spending on emergency assistance, urban reconstruction, and grants to rural communities, as well as civil service wages. Capital spending estimates are more than three times the FY2006 budget estimate as the Government substitutes its spending for that of declining donor-funds and seeks to accelerate implementation of sector investment programs formulated under the 2002 National Development Plan. The focus is on sector projects in the transportation, education, and power generation sectors. However, given past difficulties in budget execution, actual spending is likely to be below the planned level, which is within the sustainable level determined under a long-term fiscal expenditure and savings policy.

Timor-Leste uses the US dollar as the official unit of currency and consequently has no independent monetary policy. Inflation is largely determined by inflation rates in trading partners, but the civil unrest created some inflationary pressures last year. The consumer price index rose by less than 1% year on year in early 2006, but this rate of increase accelerated to about 6% from June through December (Figure 2.32.5). This reflected both limited supplies of goods caused by the violence and strong

2.32.2 Current account balance



Source: International Monetary Fund, *Article IV Consultation*, July 2005 and February 2007.

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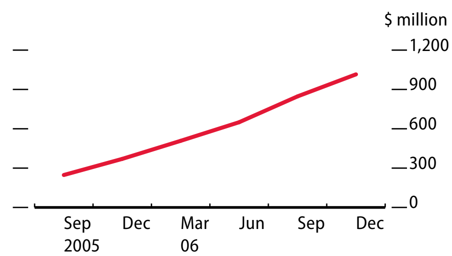
2.32.3 Petroleum fund assets



Source: Banking and Payments Authority, January 2007.

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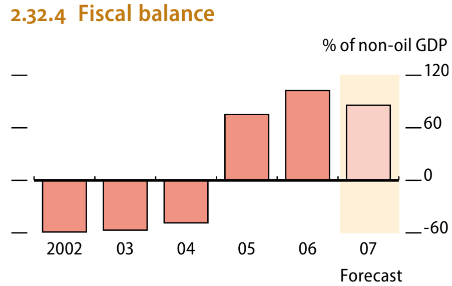
2.32.4 Fiscal balance



Sources: Ministry of Planning and Finance; International Monetary Fund, *2006 Article IV Consultation*, February 2007.

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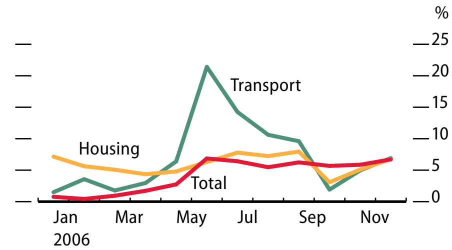
demand by international defense forces for goods and services, notably housing and transportation. For 2006 as a whole, inflation averaged 4.2%, up from 1.8% in 2005.

Efforts to strengthen the legislative framework and judicial system and to implement the National Development Plan continued in 2006, but the environment for the private sector remained poor. The country ranked second to last among 175 countries in the World Bank's *Doing Business* indicators. It takes 160 days to set up a business as against an average of 70 days in the Asia-Pacific region, and an overloaded court system means 175 days to enforce a contract. Weak infrastructure and utility services add to the difficulties.

2.32.5 Year-on-year CPI movements



Source: National Statistics Directorate, *Consumer Price Index*, December 2006.

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Economic prospects

Hydrocarbons production is expected to grow substantially and provide funding for development spending. The petroleum fund set up in 2005 is managed in a transparent manner, is subject to independent audit, and is integrated into the government budget in a way that ensures that the fund's asset base is protected while fund income supports public spending. Potential revenue flows in the medium term are boosted by high global prices, and in the long term by an agreement with Australia to share royalties from exploitation of the Greater Sunrise gas field, which could start production in 2013 and generate $10 billion in revenues over its productive life. The Timor Sea has other potential fields that are under 100% Timorese jurisdiction. Oil and gas income is projected to more than double in 2007–2008 as production from existing fields increases.

The non-oil economy is expected to rebound from the 2006 contraction and expand by about 32% in 2007 and 3.5% in 2008 (Figure 2.32.6). The sharp recovery seen for this year reflects a jump in government spending in FY2007 (though probably not to the planned level), and the establishment of a UN Integrated Mission (to stay until February 2008) to support recovery and improved governance. The presence of more than 2,000 international personnel for peacekeeping and to assist in the conduct of the elections will generate high demand for housing, goods, and services that will put some upward pressure on prices, but will contribute to the maintenance of law and order and the expected smooth completion of the elections, which are prerequisites to a revival of investor confidence.

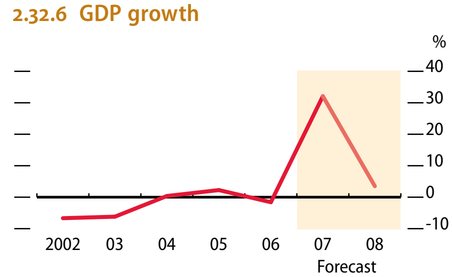
The growth and inflation projections assume that a new government will be formed after the elections and will adhere to the economic policies of the previous administration. These include the fiscal sustainability policy, implementation of sector investment programs, continued use of the US dollar as the official unit of currency, and efforts to stimulate private sector investment through legal and regulatory reform and infrastructure development. It is also assumed that commercial bank lending will gradually improve as borrowers return to Dili. In this scenario, macroeconomic stability is ensured, with inflation anchored by the use of the US dollar and likely to run at about 5.0% in 2007, slowing to 4.0% in 2008 (Figure 2.32.7). The modest growth forecast for 2008 reflects both some recovery in private investment and further expansion in public spending (on the assumptions of continued legal and regulatory

2.32.1 Selected economic indicators

	2007	2008
GDP growth	32.1	3.5
Inflation	5.0	4.0
Current account balance (% of GDP)	-	-

Source: Staff estimates.

2.32.6 GDP growth



Sources: Ministry of Planning and Finance; International Monetary Fund, *2006 Article IV Consultation*, February 2007.

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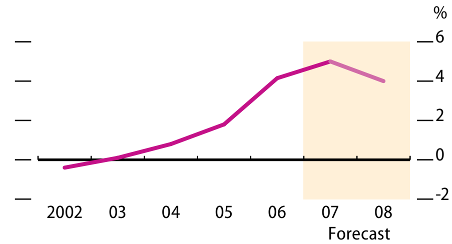
reform and of improved budget execution). Growth could be faster if public investment in infrastructure accelerates further because of funding available under the United States Millennium Challenge Account. The Millennium Development Corporation is expected to approve a compact with the country by the middle of this year.

Downside risks to the forecasts would emerge if the elections were marred by civil unrest that proved difficult to subdue, if oil and gas prices dropped below forecast levels, or if the new administration adopted an irresponsible fiscal policy. A surge in public spending that was not in alignment with the priorities of the National Development Plan and involved, for example, public service wage rises beyond those granted in the 2007 budget, would jeopardize efforts to facilitate rural development, push up inflation, and retard the restoration of investor confidence.

Growth needs to accelerate significantly to make inroads into poverty. In turn, that requires a substantial rise in private investment in agriculture, fisheries, and tourism, complemented by improved implementation of public investment projects in infrastructure, health, and education.

2.32.7 Inflation



Sources: Ministry of Planning and Finance; National Statistics Directorate; staff estimates.

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Development challenges

Near-term challenges are to ensure political stability, prevent civil unrest, and maintain macroeconomic stability. Longer term, the effort to reduce poverty and develop the economy faces two major tasks. One is to ensure that oil and gas wealth is managed to protect the interest of future generations while supporting current investment for essential social and economic development. Fiscal sustainability and intergenerational equity are being achieved through the long-term fiscal expenditure and savings policy, whereby the Government's annual sustainable spending is equal to domestic revenues plus the estimated permanent income from petroleum fund assets. However, actual public capital expenditures fall short of planned levels because of weak budget execution. The Government intends to improve this by outsourcing large infrastructure projects internationally, carrying out a donor-supported financial management reform program, and using rural development and education cash grants more frequently (though these will need to be carefully targeted and reported).

The second task is to encourage private investment by reducing the costs of doing business. A low, uniform tariff regime is in place, but there is room for tax reforms, especially given the strong growth in oil revenues. Such reform would involve the passage of pending consolidated tax legislation and would be aimed at reducing administrative costs and encouraging compliance through reducing rates, increasing minimum thresholds, and simplifying procedures. Foreign investment would be encouraged if legislation were passed permitting long-term leasing of state-owned land. Investment in general would be encouraged if business licensing procedures could be streamlined, dispute resolution through arbitration introduced (to relieve the burden on the court system), and contract enforcement strengthened.