Democratic Republic of Timor-Leste

Economic recovery continued in 2005, and the outlook is for moderate growth, supported by oil and gas revenues and donor assistance. Revenues are being invested in a fund to be tapped over the long term. High population growth, weak infrastructure, and limited institutional capacity are major hurdles to development. Growth would have to accelerate to make significant inroads into widespread poverty.

Economic performance

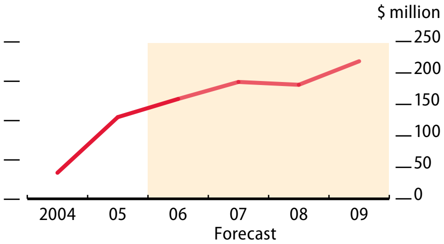
After 2 years of economic contraction caused by drought and the winding down of peace-keeping forces after independence was restored in May 2002, a recovery began in 2004 and continued into 2005. Growth was supported by a rise in government income from the country's share of oil and natural gas production in the Timor Sea, estimated at $130 million in FY2005 (ended 30 June 2005) (Figure 2.32.1). Non-oil gross domestic product (GDP), the preferred measure of the economy, was estimated at $350 million, up by 2.5% from FY2004. A pickup in agriculture, which employs about 74% of the labor force, and an expansion of bank lending also played their part.

The rising revenues from petroleum production have bolstered the fiscal position (Figure 2.32.2). Total government receipts increased from $105 million, or 31% of non-oil GDP in FY2004, to $192 million (55%) in FY2005, and are forecast to hit $206 million (57%) in FY2006. However, the execution of expenditure plans and government projects is slow, reflecting an overly centralized process, limited skills and institutional capacity, and a high level of commitment to fiduciary accountability. By March 2005, only 42% of approved procurement and just 6% of the FY2005 capital development budget had been spent. In addition, there was a large carryover of public spending from FY2004. Actual capital expenditure has been low, at less than 3% of non-oil GDP in the past 2 years. Reflecting these developments, a fiscal surplus of $114 million, or 32% of non-oil GDP, is estimated for FY2005. The authorities continue to follow a policy of no domestic or external borrowing.

A trade deficit of around $200 million (excluding oil and gas exports) has been recorded in each of the past 3 years (Figures 2.32.3 and 2.32.4). The current account, including international assistance, recorded a surplus of $149 million in 2005 (Figure 2.32.5), up substantially over 3 years because of higher oil and gas royalties, donor funding, small though increasing coffee exports ($7.6 million in 2005), and constrained imports as a result of deficient budget execution. Excluding donor assistance, the current account showed a deficit of $18 million in 2005. Official transfers and substantial oil and gas income provide considerable external purchasing capacity. International reserves in 2005 were equivalent to about 15 months of imports.

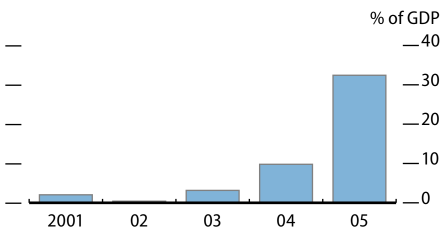
Commercial bank lending to the private sector rose by about

2.32.1 Petroleum revenue



Notes: Data are for the fiscal year ending 30 June; 2004 refers to actual data; 2005 is based on revised government budget; and 2006 onward are based on draft budget figures.
Source: Original data from Timor Leste authorities.

2.32.2 Budget balance



Note: Data are for the fiscal year ending 30 June.
Source: Banking and Payments Authority.

$20 million to over $90 million in 2005, equivalent to around 26% of non-oil GDP, with loans for construction and small transport businesses accounting for much of the increase. Deposits with commercial banks have also risen strongly since 2000. However, financial intermediation remains concentrated in Dili, with access to finance in rural areas limited to a few rural cooperatives and microfinance entities.

The Government remains committed to using the United States (US) dollar as the official unit of currency. At this stage of Timor-Leste's development, the dollar functions well in avoiding problems of currency convertibility and monetary instability, and saves the costs involved in setting up independent monetary arrangements. The dollar-based monetary and exchange rate system, together with low to moderate inflation rates in trading partner countries, have helped hold inflation to around 2–3% in the past 2 years (Figure 2.32.6).

The key macroeconomic policy development last year was enactment of the Petroleum Act to establish a long-term petroleum fund. The fund aims both to insulate the non-oil economy from potential inflationary and real exchange rate appreciation impacts and rent-seeking effects of oil and gas windfalls, and to maintain the value of the country's oil wealth, so that future generations also benefit from it. The fund has a mandate to invest solely in low-risk government bonds (it currently holds US treasury securities), with revenues subject to strict accountability and transparency measures. The intention is to limit annual budget spending to the combined total of domestic non-oil revenues and the estimated permanent, or "sustainable," income from the petroleum fund. Sustainable income is an estimate of the income that can be maintained indefinitely without depleting the fund. According to the FY2006 budget, the estimate of this income for the financial year is $103 million. Together with an estimate of nonpetroleum revenues of $47 million, this implies sustainable spending of about $150 million, and compares with FY2006 planned government-funded expenditure of $120 million, additional committed donor outlays of $32 million, and desired, but unfunded, disbursements on sector investment programs of $107 million. (These investment programs are infrastructure and social projects aimed at achieving the Millennium Development Goals.)

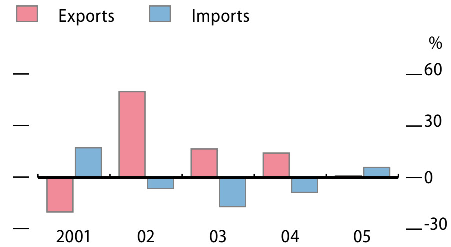
Economic outlook

The main assumptions are that donor assistance will continue to support the Government's development program, the Government will make reasonable progress in improving its execution of the budget, and commodity prices will not weaken significantly.

Prospects for 2006 and 2007

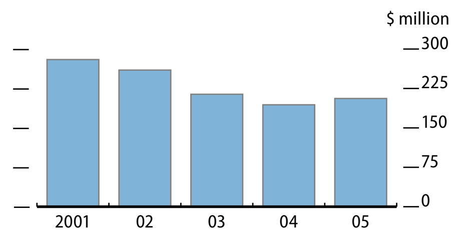
Non-oil GDP is expected to grow by around 5% in 2006 (Figure 2.32.7), boosted by higher public investment that is financed by income from the petroleum fund. Public investment and government spending will remain the drivers of growth. Coffee exports are projected to increase, if the global coffee price does not come down substantially. The private sector should benefit from planned public construction projects. The Government also proposes to enact investment laws and simplify

2.32.3 Non-oil export and import growth



Sources: International Monetary Fund, *Democratic Republic of Timor Leste: Selected Issues and Statistical Appendix*, July 2003 and June 2005; International Monetary Fund, *2005 Article IV Consultation*.

2.32.4 Non-oil trade deficit



Sources: International Monetary Fund, *Democratic Republic of Timor Leste: Selected Issues and Statistical Appendix*, July 2003 and June 2005; International Monetary Fund, *2005 Article IV Consultation*.

2.32.1 Selected economic indicators

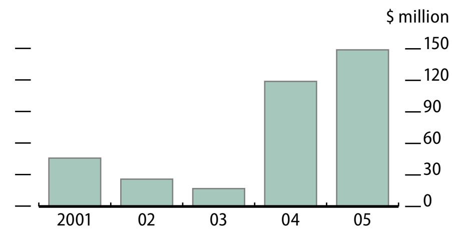
	2006	2007
GDP growth	5.0	4.0
Inflation	2.0	2.0

Source: Staff estimates.

business registration procedures, though some in the private sector doubt the likely effectiveness of these proposals. In the energy sector, the Government is seeking production-sharing contracts to develop offshore oil fields in areas under Timor-Leste's sole jurisdiction. (Current production is from an area jointly developed with Australia.) GDP growth is expected to step down a little to average around 4% for the non-oil sector in 2007. Against this, an International Monetary Fund mission to Timor-Leste in early 2006 estimated that annual economic growth of 7% or more is needed to significantly reduce poverty.

The Government has boosted planned fiscal spending by around 10% of non-oil GDP in FY2006, mainly for capital items, though the record on budget execution suggests that such an increase is unlikely to be realized. In an effort to improve performance in this area, the authorities have started addressing capacity problems in line ministries and improving monitoring of progress on budget execution. The US Millennium Challenge Corporation, which selected Timor-Leste as eligible to apply for assistance, is a potential source of funding for the sector investment programs. This assistance may reach $30 million a year.

2.32.5 Current account



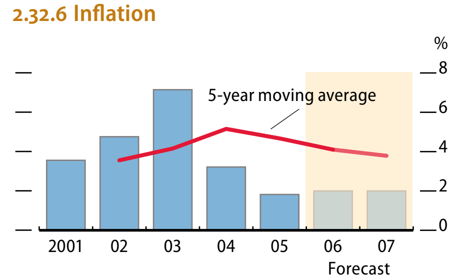
Sources: International Monetary Fund, *Democratic Republic of Timor Leste: Selected Issues and Statistical Appendix*, July 2003 and June 2005; International Monetary Fund, *2005 Article IV Consultation*.

Medium-term outlook

The decision to limit drawdowns from the petroleum fund to sustainable income assures the Government a continuing revenue flow from this source. Furthermore, the concept of insulating the economy from volatile flows of oil and gas income is sound. However, it is unclear that the current policy on drawdowns is the best approach, given the early stage of the economy's development. New discoveries of energy in the future, supplementing the savings carried forward in the fund and the likely improved state of the economy and public services, may well mean that future generations are much better off than the current generation (per capita non-oil GDP was about $350 in 2004). This raises the question of whether more of the revenue should be used for development and for social support in the short and medium term. Government policy offers scope to do this because Parliament can authorize spending from the fund in a particular year to exceed the limit. How this flexibility is used will partly determine the medium-term outlook.

Budget projections for the next 4 years have identified a financing gap for planned expenditure on sector investment programs in the range of 20–30% of non-oil GDP. The Government is hoping that donors, including the Millennium Challenge Corporation, will provide much of the funding. However, they might suggest that a large part of this financing should come from the petroleum fund—which, too, would affect the economic outlook.

2.32.6 Inflation



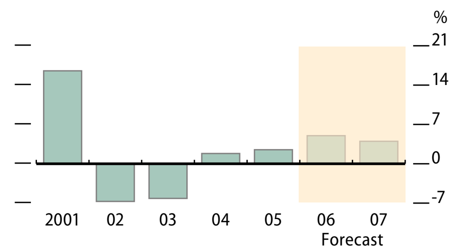
Sources: International Monetary Fund, Democratic Republic of Timor Leste: Selected Issues and Statistical Appendix, July 2003 and June 2005; International Monetary Fund, *2005 Article IV Consultation*.

Much remains to be done in terms of building physical, human, and institutional capacity. Unemployment and underemployment remain very high, against a backdrop of fast population growth (4.0% in 2005), and the number of Timorese could double in under 20 years to about 2 million. In many small Pacific countries, governments are major employers, but the Timor-Leste Government has decided to keep its public sector small, such that the private sector needs to play a larger role. The Government has taken some steps to improve the legal and regulatory environment, though rapid and broad-based development of private business is unlikely in the medium term, a result of the limited infrastructure and workforce skills and the economy's relative isolation. Development in the longer term is likely to depend on investments in infrastructure and in education and training, but substantial progress on budget execution is needed before any increase in spending can be used effectively.

Early in 2006, Australia and Timor-Leste signed an agreement to share equally oil and gas revenues in disputed territory that includes the Greater Sunrise gas field. This field is expected to generate larger receipts than the Bayu-Undan field, which is now in production, and the agreement boosts confidence in the economy's future. The start of actual revenue flows for Timor-Leste from Greater Sunrise could be some years away because the operator of the project has yet to confirm when it will proceed. In addition, sales contracts with international customers could take years to finalize; agreement needs to be reached on whether the gas is brought ashore in Australia or Timor-Leste; and revenue-sharing terms are subject to further negotiation, because 20% of the gas reservoir is estimated to be in the joint development area (where the existing Bayu-Undan field is located).

Other uncertainties about the future relate to how the authorities will deal with trade-offs in trying to insulate the economy and achieve intergenerational equity in the use of oil and gas revenues, on the one hand, while attempting to secure desirable economic development outcomes for the current generation, on the other. The Government could come under twin pressures from donors and its own citizens to contribute more of the income for near-term purposes, and from workers in the formal sector for higher wages, which would affect the economy's ability to compete in non-oil export markets. Risks to development include the difficulties in improving the implementation of government programs, slow growth of the private sector, and a reduction in donor assistance.

2.32.7 Non-oil GDP growth



Sources: Boston Institute for Developing Economies, *Gross Domestic Product East Timor 2000*, 11 March 2002; International Monetary Fund, *Democratic Republic of Timor Leste: Selected Issues and Statistical Appendix*, July 2003 and June 2005; International Monetary Fund, *2005 Article IV Consultation*.