Timor-Leste

Driven by increases in government expenditure, this petroleum-dependent economy grew rapidly in 2010 and is forecast to record double-digit growth in 2011 and 2012. Higher oil prices are positive overall for the country, but they have also fueled inflation. Longer-term prospects rest on using government investment to build human and physical capital and to trigger a transition to private sector–led growth.

Economic performance

Economic momentum generated by a rapid buildup in government spending has resulted in the preferred measure of GDP—excluding offshore petroleum production and the United Nations (UN) peacekeeping mission—averaging double-digit growth in 2007–2010. This measure of GDP rose by 9.5% in 2010, moderating from a very high rate in 2009.

Government expenditure, funded mainly by income from offshore petroleum production, increased steeply from about $220 million in 2006 to around $825 million in 2009, and was budgeted at $967 million for 2010 (although actual outlays probably fell short of the budget) (Figure 3.34.1).

Much of the additional government spending was on items that fed quickly into the local economy. Private consumption was boosted in 2010 by a continued rise in public sector wages and salaries, as well as cash transfers provided in rural areas through a wide-ranging social safety net. There was a further large expansion last year both in small, rural infrastructure projects and in larger public projects in the capital, Dili.

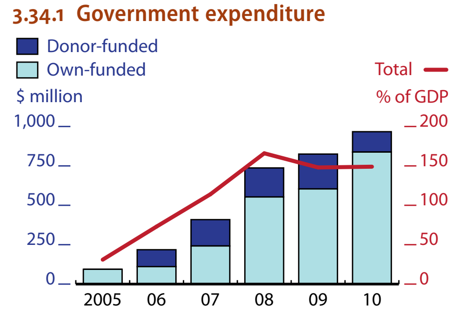
Private investment also climbed as local and overseas-owned businesses geared up to take advantage of the opportunities presented by rising public investment and buoyant consumer spending.

A high level of aggregate demand is reflected in a range of indicators, including new vehicle registrations, electricity use, and mobile phone subscribers (Figure 3.34.2), albeit with some sign of an easing in growth in 2010.

Construction expanded alongside rising investment. Agricultural output, which contributes around 30% of GDP, barely rose in 2010 because of bad weather and continuing transport problems. This followed 2 years of 13% growth in the sector, when it was bolstered by government-led distribution of better seeds and of tractors, and by the introduction of extension services. The Ministry of Agriculture estimated that rice production declined by 6.4% in 2010. Maize production, though, rose by an estimated 10.5%, and coffee exports rose from an unusually low 10,000 tons in 2009 to 25,600 tons in 2010.

Merchandise exports, mainly coffee, represent less than 10% of the

3.34.1 Government expenditure



Note: Nonpetroleum, non-UN GDP.

Source: ADB estimates based on Government of Timor-Leste. 2009. *General Budget of the State* and *State Plan for 2010*. October.

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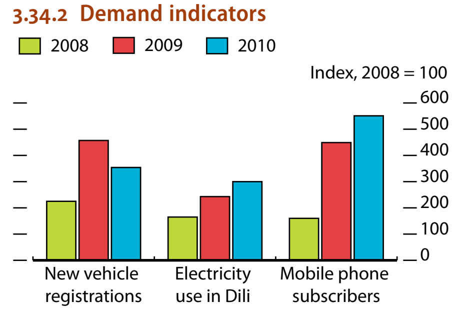
3.34.2 Demand indicators



Source: ADB estimates from Timor-Leste National Directorate of Statistics data.

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This chapter was written by Craig Sugden of the Special Office in Timor-Leste, ADB, Dili.

value of merchandise imports. The wide trade deficit, in the order of 65% of nonpetroleum, non-UN GDP, is outweighed by a surplus in the income account attributable to petroleum revenue. In 2010, such revenue rose to an estimated $2.1 billion, and provided for a current account surplus equivalent to 238% of nonpetroleum, non-UN GDP.

Growth in broad money supply slowed to a more normal 9.7% in 2010, from the exceptional 39.6% in the previous year when the banking system saw a buildup of unspent government funds. Bank lending remained constrained by a backlog of nonperforming loans and a continuing problem of securing land as collateral. Consequently, commercial bank credit to the private sector was unchanged in 2010 from 2009.

Inflation accelerated to average 6.8% in 2010 and was running at 9.2% year on year in December (Figure 3.34.3). Rising food prices were the main reason, themselves largely due to higher international prices. Inflation was lower for prices set by domestic rather than international conditions, suggesting that inflation was cost push rather than demand pull.

Economic prospects

Outlooks for the short and medium term rest heavily on developments in government expenditure. The government has budgeted to boost its own-funded spending by about 50% to $1.27 billion in 2011. Much of the increase is for a multiyear national electrification project and will not be fully spent in 2011, but a sizable increase in actual expenditure is projected for 2011. The government has foreshadowed that its own-funded spending will rise to about $1.45 billion by 2015. Total infrastructure investment over 2011–2015 is projected to exceed $3 billion.

This surge in government outlays will continue to support aggregate demand and construction. Barring disruptive shocks, economic growth is likely to remain high at around 10% over the forecast period (Figure 3.34.4).

The UN mission is phasing down toward a scheduled departure at end-2012, which will have a damping effect on growth, mainly in 2013. Until then, expansion in government expenditure will more than offset that effect.

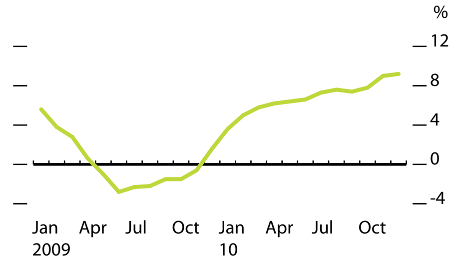
High world oil prices are boosting public saving, providing the financial resources to sustain the investment surge. The nation's Petroleum Fund held $6.9 billion in offshore investments at end-2010, and even with large withdrawals planned to finance the budget, the value of the fund is projected to rise above $14 billion by 2015.

Petroleum income exceeding $2 billion annually is likely to lead to further large budget and current account surpluses in 2011 and 2012. The budget surplus is, however, projected to decline this year as the expansion in government expenditure is expected to outweigh the additional revenue provided by higher world oil prices. From 2012, restraint in recurrent spending and a planned leveling off in public investment are seen easing the downward trend in the budget surplus (Figure 3.34.5).

Inflation is forecast to average 7.5% in 2011, before decelerating in 2012 as upward pressure on commodity prices eases.

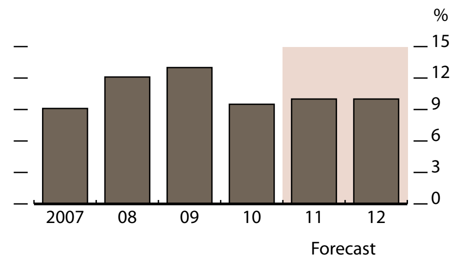
While the rise in oil prices is a positive factor overall for this economy, the government needs to carefully manage the resultant

3.34.3 Year-on-year inflation



Source: Timor-Leste National Statistics Directorate. Consumer Price Index. http://dne.mof.gov.tl (accessed 25 February 2011).
Click here for figure data

3.34.4 GDP growth



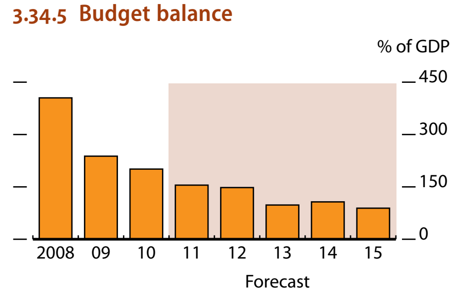
Note: Nonpetroleum, non-UN GDP, annual growth.
Sources: Government of Timor-Leste. 2010. *State Budget 2011: Budget Overview. Book 1.* November; ADB estimates.
Click here for figure data

3.34.1 Selected economic indicators (%)

	2011	2012
GDP growth	10.0	10.0
Inflation	7.5	5.3
Current account balance (share of GDP)	233.7	205.8

Source: ADB estimates.

3.34.5 Budget balance



Note: Ratio to nonpetroleum, non-UN GDP.
Sources: Government of Timor-Leste. 2010. *State Budget 2011: Budget Overview. Book 1.* November; ADB estimates.
Click here for figure data

inflation. It should avoid continually adjusting public sector wages to compensate for the higher cost of living, which could result in a wage–price spiral. That would have the potential to turn what is largely a problem of imported inflation into a deeper risk to macroeconomic stability.

The high rate of economic growth projected for the medium term will see further inroads into poverty. Average household incomes rose by about 20% in 2007–2009, helping to reduce the incidence of poverty from an estimated 50% to a still high 41%. The rate of progress in poverty reduction will rest on success in continuing to expand basic public services and in providing economic opportunities in rural areas.

Development challenges

Development is being fast-tracked through the conversion of petroleum wealth into physical and human capital. The surge in government expenditure funded from petroleum revenue is enabling a rapid expansion in public services and has provided a public social safety net for many. After ranking 150 of 159 countries in the United Nations Development Programme's 2005 human development index, Timor-Leste's position improved to 120 of 162 in the 2010 index.

Still, development challenges are daunting. Income from petroleum lifted Timor-Leste to lower-middle-income country status in 2007, but other indicators of development generally remain those of a low-income country. Of the 21 measurable Millennium Development Goals, about half are unlikely to be met by the target date of 2015, notably those relating to poverty and nutrition. The coverage of electricity, water, and telecommunications infrastructure has expanded, but access and service quality are below potential. Most of the road network is in poor condition.

Public investment needs are likely to stay high over the next decade and beyond (Box 3.34.1). Fiscal constraints will, however, ultimately limit public investment's ability to support the economy. Sustaining a high rate of economic growth will rest on a transition from public to private sector–led investment. As the domestic private sector is still emerging and not yet ready for major investments, there is likely to be a gap that will need to be filled by foreign inflows. The country's success in establishing itself as one of developing Asia's investment destinations will therefore be pivotal to its growth path.

Ideally the level of public investment will be responsive to the returns that it generates. The fundamental rule of public investment is that it should generate an economic return—broadly defined to capture the full range of factors that determine community welfare—at least as high as the economic cost of funding. Most public investment will need to be funded by withdrawals from the Petroleum Fund. Such investment should aim for a return that exceeds the cost of withdrawals, being the financial return that would have been earned if savings had remained in the fund.

The government has flagged the prospect of borrowing on concessional terms to fund public investment. Similarly, any public investment funded from borrowing should aim for a return higher than the interest rate paid, plus any other costs. Borrowing makes sense if it allows savings to be kept in the Petroleum Fund to earn a return higher than the cost of the debt.

3.34.1 How much investment does Timor-Leste need?

An economy's longer-term investment needs can be understood through growth accounting, which decomposes growth into its components: the accumulation of capital and labor, and productivity improvements.

For Timor-Leste, projections prepared in this way highlight the economy's potential to grow robustly over the next two decades. Factors in Timor-Leste's favor include a growing labor force, an ability to fund a high rate of public investment from petroleum revenue, and the potential for a quick catch-up in education and technology.

A continuation of recent double-digit rates of economic growth would probably require investment rising above $1 billion annually within 5 years and above $1.5 billion within 10 years (in 2010 prices). This would be a very large increase on the 2010 investment level of about $300 million.

Projections made using the growth accounting framework show that lower, but still internationally high, rates of economic growth could be achieved if investment was around half these levels. This lower estimate of annual investment—at least $500 million and $750 million—sets a minimum target.

Source: C. Sugden. Forthcoming. *Timor-Leste: Economic Growth to 2030.* Asian Development Bank, Manila.