

Timor-Leste

<insert map>

Population	1.2 million
Population growth	2.9 percent
GDP (PPP, int'l US\$) 1/	2.0 billion
GDP per capita (PPP, int'l US\$) 2/	1,660
Surface area	14,870 sq. km.
Capital	Dili

Source: World Development Indicators.

1/ The equivalent in 2011 nonoil GDP at current market prices is US\$1.128 billion.

2/ The equivalent in 2011 nonoil GDP at current market prices is US\$1,007.

Summary

Timor-Leste's economy remains heavily dependent on petroleum. The recently approved FY14 budget is 89 percent financed by petroleum revenues. The budget is also nearly 10 percent lower than in FY13, lowers medium-term spending plans, and hence reduces the outlook for nonoil economic growth. Estimates of petroleum production from current fields have been reduced, which lowers estimates of petroleum wealth and the sustainable income from that wealth. However, the Petroleum Fund continues to grow, passing US\$15 billion in January 2014. Headline inflation dropped sharply in the fourth quarter of 2013 after peaking at 13.5 percent in the second quarter.

Recent Economic Developments

Parliament unanimously approved an FY14 budget of US\$1.5 billion on January 24, 2014. This is nearly US\$150 million less than the 2013 budget in an attempt to return to fiscal sustainability, ease aggregate demand pressures and inflation, and improve budget credibility. Despite smaller budgets, budget execution is deteriorating. Nominal spending fell for the first time in 2013. Given the importance of public spending for growth, the government in November 2013 sharply lowered its 2012 and 2013 nonoil GDP (Timor-Leste's preferred measure of economic activity) growth estimates from 10.4 percent and 10.6 percent to 8.2 percent and 8 percent, respectively. Final numbers will depend heavily on estimates of agricultural and private sector activity. Long-term petroleum revenue forecasts, and the Estimated Sustainable Income Timor-Leste earns on its petroleum wealth, fell as production forecasts from fields currently under development fell. Inflation fell sharply in the final quarter of 2014, but the 2013 average is likely to remain in the double digits, well above the 7.6 percent estimate, despite falling global food prices, and an appreciation of the U.S. dollar (Timor-Leste's currency). This reflects continued demand pressures and supply bottlenecks.

Growth

The significant downward revisions in November to the government's 2012 and 2013 nonoil growth estimates were driven largely by an upward revision in 2011 nonoil GDP, recently published in the 2000–2011 National Accounts, and lower than anticipated growth in public spending, agriculture, and private investment. The estimate for 2013 may need to be revised further downward in light of the confirmed decline in 2013 nominal spending, although a 15 percent increase in vehicle ownership in 2013 and a 6 percent increase in electricity consumption provides some upside potential.

Fiscal

The 64 members of Parliament voted unanimously in favor of the US\$1.5 billion FY14 budget. While US\$200 million higher than the May 2013 fiscal envelope, the budget is nearly US\$150 million lower than the FY13 budget, which itself was US\$150 million lower than the FY12 budget. The medium-term spending plan has also been reduced in relation to the medium-term spending plan proposed in the FY13 budget. While the budget is planned to grow to US\$1.9 billion in 2016, the 2018 budget will return to the same size (in nominal terms) as the 2014 budget. The overall reduction is both a step toward greater fiscal sustainability and budget credibility, and an attempt to reduce demand-driven inflationary pressures. However, within the budget, the recurrent budget has risen by 32 percent in relation to the 2013 budget, driven by a 22 percent increase in transfers. The capital and development budget has been scaled back by 55 percent, as the government seeks to overcome administrative challenges related to procurement and contracting, and ultimately to improve the quality of public infrastructure spending.

Overall budget execution deteriorated in 2013. In absolute terms, nominal spending fell for the first time, with only US\$1.076 billion spent compared with US\$1.198 billion in 2012. During the last seven weeks of the year, US\$403 million, representing 38 percent of total 2013 spending, was spent. Execution also deteriorated in relative terms. Despite a smaller 2013 budget, only 65 percent was executed, compared with 66 percent in 2012, weighed down by a 40 percent execution rate on capital and development. Furthermore, execution was only 37 percent on the portion of capital and development financed from the Infrastructure Fund (compared with 45 percent in 2012)—a ring-fenced, multiyear part of the budget with dedicated large-project management institutions. Some of this underperformance can be explained by project profiles, since smaller projects, for instance, roads, have followed lumpy investments in electricity in 2011 and 2012. But most of the underperformance is explained by thin administrative capacity.

The government stuck to its de-facto fiscal anchor in 2013, withdrawing US\$57 million less than the US\$787 million Estimated Sustainable Income (ESI) from the Petroleum Fund, and instead ran down unspent cash balances from previous excess withdrawals. However, the government plans to make excess withdrawals in 2014. In total, excess withdrawals are planned to finance 45 percent of total public spending between 2014 and 2018.

More specifically, the 2014 budget includes US\$166 million of domestic revenues, representing 11 percent of estimated 2014 nonoil GDP, roughly equivalent to the budget. Remaining financing will come from ESI of US\$632 million, US\$270 million in excess withdrawals, US\$380 million from cash balances, and US\$51 million in loans.

ESI, which is sensitive to petroleum production and global oil prices, has fallen by around 20 percent in relation to 2013 estimates, since fields currently under development are now forecast to end by 2020 rather than 2023. This emphasizes the importance of improving the domestic tax effort with both policy reform (a value-added tax is being discussed) and administrative reform. Audits of the taxpayer database have recently been completed and the new one-stop shop for business registration can provide a more orderly registration process, also for tax purposes.

The 2013 nonoil fiscal deficit (domestic revenue less total spending) was 61 percent of nonoil GDP, but overperformance on petroleum revenues lifted this to an overall surplus (including petroleum revenues) of 88 percent of estimated 2013 nonoil GDP, well above the original 54 percent forecast.

Inflation and Financial Sector Issues

The government will miss its 2013 inflation target of 7.6 percent (headline inflation is the year-on-year Consumer Price Index in Dili). Estimated average year-on-year inflation for 2013 is 11.3 percent, driven largely by a 14.6 percent average rise in the price of food. Inflation peaked at 13.5 percent in May,

although falling global food prices and an appreciation in the U.S. dollar (Timor-Leste's official currency) may have contributed with a lag to the sharp fall in inflation in the last quarter of 2013. The fourth quarter peak in public spending and a related increase in aggregate demand may have a lagged upward impact on inflation in the first quarter of 2014, as supply bottlenecks persist.

Net credit to the private sector picked up in the second half of 2013, from 4 percent growth in the first half, contributing to a full-year expansion of 13 percent, to US\$177 million. This represents 11.5 percent of estimated 2013 nonoil GDP. Of total credit, 41 percent was held by individuals, and 23 percent was extended to trade and finance and 22 percent to construction. Credit to industries and manufacturing contracted by 29 percent in 2013 relative to 2012. Spreads widened, as lending rates rose from 12.13 percent in January 2013 to 12.48 percent in December while deposit rates remained flat at 0.56 percent. The share of nonperforming loans, a legacy from the period around the 2006 security crisis, continues to decline, to 28 percent at end-December 2013 from 31 percent at end-2012. Loan loss provisions were US\$58.4 million, or 118 percent of the value of nonperforming loans, effectively mitigating the risk to the banking system.

External Balance

The trade balance deteriorated in 2013 in relation to 2012. Coffee exports fell to US\$15.8 million in 2013, compared to US\$18.8 million in 2012, as both production and global Arabica prices fell. Official trade data showed a 27 percent increase in imports over the same period to US\$843 million, mostly related to pharmaceuticals and machines and parts. The resulting US\$827 million trade deficit, or 54 percent of estimated 2013 nonoil GDP, was lifted to a current account surplus of US\$1.97 billion by petroleum revenues, which are recorded as income on the current account.

The Petroleum Fund, Timor-Leste's Sovereign Wealth Fund, reached US\$15 billion in value at the end of January 2014, nearly 10 times estimated 2013 nonoil GDP, and up from US\$11.8 billion at end-2012. The government transferred US\$730,000 from the Petroleum Fund to the Treasury to finance spending during 2013. In strong performance, revenue inflows to the Fund were US\$2.8 billion, well over the full-year estimate of US\$2.3 billion. At the end of December, official reserves were US\$675 million, or nearly nine months of imports. This fell from nearly 15 months of import cover at end-2012, as average monthly imports picked up. But adding the Petroleum Fund increases cover to 223 months of imports.

Outlook and Emerging Challenges

Prime Minister Kay Rala Xanana Gusmao formally announced in his January 2014 budget speech that he would step down from his post by September. Preparations are underway for an orderly handover, but reports in the press of cabinet reshuffles and ministerial departures may affect budget execution, and could fuel investor uncertainty.

The ongoing arbitration between Timor-Leste and Australia over the Greater Sunrise field became contentious as Timor-Leste accused Australia of spying during the negotiation of the treaties governing the field. The case increases uncertainty around revenue potential from fields not currently under development. This may also have implications for the next exploration licensing round, which has yet to be launched.

The FY14 budget expenditure circular was issued in February, for the first time as a formal decree of the council of ministers. It contains measures to improve the quality of spending, such as a ceiling on the share of budget appropriations that can be spent by single-sourced procurement. This may also slow spending. Given continued challenges to budget execution, growth will depend on the prospects for an

uptick in private sector activity that is not directly linked to government contracts. Recent private projects under discussion include a cement plant, an international hotel, and a retail and housing complex.

The leader of the opposition has been appointed as head of an authority to develop the enclave of Oecusse as a special economic zone for social markets. The district of Oecusse lies within West Timor, Indonesia, and has the most challenging human development indicators in Timor-Leste, itself a lagging country. An integrated development plan that builds on relative strengths in agriculture and informal financial intermediation to address competitiveness, infrastructure, and service delivery constraints, can help transform the lives of Oecusse's roughly 65,000 inhabitants.

Timor-Leste: Key Indicators

	2012	2013e	2014f	2015f	2016f
	Year	Year	Year	Year	Year
Output, Employment and Prices					
Real GDP (% change yoy)	5.7	-3.2	-6.9	1.7	-2.1
Real nonoil GDP (% change yoy)	8.3	8.1	8.0	7.7	8.6
Consumer price index (% change yoy, annual average)	13.1	10.6	9.5	8.1	7.1
Public Sector					
Government revenues (% GDP)	69.1	59.7	63.6	60.9	63.4
Government expenditures (% GDP)	22.1	23.5	26.5	27.5	27.5
Government balance (% GDP)	47.0	36.2	37.1	33.4	35.9
Nonoil government balance (% GDP)	-15.8	-17.2	-19.0	-19.6	-19.1
Nonoil government balance (% nonoil GDP)	-73.7	-65.2	-56.7	-51.8	-43.5
Public sector debt (% GDP) /1	0.0	0.7	5.6	11.1	16
Foreign Trade, BOP and External Debt					
Trade balance (millions US\$)	-639	-731	-829	-904	-976
Exports of goods (millions US\$)	33	37	42	46	57
(% change yoy)	32.0	12.1	13.5	9.5	23.9
Imports of goods (millions US\$)	672	769	871	950	1,033
(% change yoy)	79.7	14.4	13.3	9.1	8.7
Current account balance (millions US\$)	2,738	2,105	1,819	1,551	1,588
(% GDP)	43.5	34.3	32.1	27.0	27.7
Foreign direct investment (millions US\$)	6	53	116	139	182
External debt (millions US\$)	8	44	275	319	278
(% GDP)	0.1	0.7	4.8	5.5	4.9
Debt service ratio (% exports of g&s)	0.0	0.0	0.1	0.2	0.3
Public foreign assets, gross (millions US\$) 2/	12,659	14,419	16,543	18,526	20,644
(months of imports of g&s)	91	93	95	98	103
Foreign exchange reserves, gross (millions US\$)	884	213	213	213	213
Financial Markets					
Domestic credit (% change yoy)	20.5	21.2	21.7		
Short-term interest rate (% p.a.)	12.20				
Real effective exchange rate (2005=100) (period average)	118.1	134.5			
(% change yoy)	11.8	13.9			
Memo: Nominal GDP (millions US\$)	6,300	6,129	5,673	5,748	5,730

Sources: National data sources; IMF; World Bank staff estimates.

e = estimate.

f = forecast.

1/ External debt.

2/ Central bank foreign exchange reserves + Petroleum Fund balance.