

Timor-Leste

The strong growth of the past 6 years continued on the back of public expenditure and private sector activity, and this performance is expected to be maintained. Inflation moderated in 2013 but will likely reaccelerate if planned increases in public spending are fully implemented. A major policy challenge is to design fiscal policies to translate oil and gas revenues into sustainable and inclusive growth.

Economic performance

GDP excluding the offshore petroleum industry is estimated to have grown by 8.0% in 2013 as rapid private sector growth helped offset reductions in public investment (Figure 3.35.1). The public sector continues to be the main source of demand. While government expenditure of \$1.3 billion was lower than in 2012, it remained close to recent highs, equivalent to 86% of non-oil GDP.

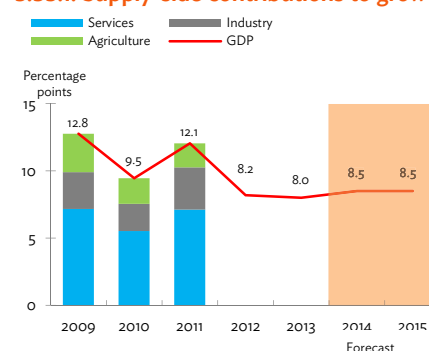
Royalty payments to the government from offshore oil and gas production totaled \$3.1 billion in 2013. This dwarfed tax and other non-oil revenues of \$150 million and enabled the government to post a \$2.1 billion budget surplus that was deposited in the Petroleum Fund. Public savings, defined as the Petroleum Fund plus foreign exchange reserves, are \$14.9 billion, which is 9.2 times annual non-oil GDP or about \$12,400 per capita.

The 2013 budget planned \$807 million in capital investment, but delays in project implementation meant only 43% of this was spent. The budget planned a 22% increase in recurrent expenditure over 2012, but actual spending was only 4% higher as reduced expenditures on transfers offset increased spending on salaries, wages, goods, and services.

Slower growth of total government expenditure (in particular recurrent expenditure), lower international food prices, and US dollar appreciation against the currencies of most of Timor-Leste's major trading partners contributed to lower inflation in 2013. Average annual inflation fell to 9.5% from 10.9% in 2012 (Figure 3.35.2). Toward the end of 2013, inflationary pressures waned as government expenditures and import prices fell, taking year-on-year inflation in December to just 4%.

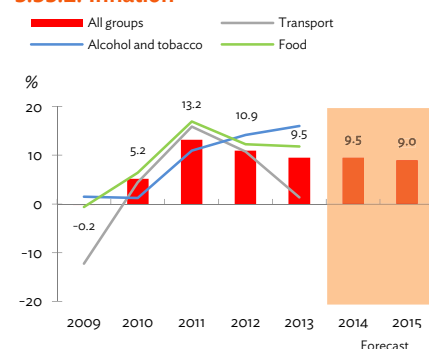
Agricultural production declined in 2013. Coffee exports slipped from the high recorded in 2012, and cereal production fell by 20% because of reduced rice planting and unfavorable weather. Spending on imported grain fell by 27% in 2013, though global and regional grain prices were down by less than 10%, implying weaker demand and reduced grain imports. A 13.6% expansion in private sector credit supported strong business growth, but financial markets remain

3.35.1. Supply-side contributions to growth



Source: Timor-Leste National Statistics Directorate; ADB estimates.

3.35.2. Inflation



Source: Timor-Leste National Statistics Directorate; ADB estimates.

underdeveloped, with the ratio of private sector credit to non-oil GDP only 11.3%.

Export growth lagged behind the rise in imports despite strong growth in services exports reported by the International Monetary Fund. Timor-Leste had another large trade deficit, but income from oil and gas royalties greatly exceeded the deficit, allowing the country to register a large current account surplus of \$1.9 billion, or 1.2 times non-oil GDP (Figure 3.35.3).

Economic prospects

Growth is forecast to remain strong at 8.5% in 2014 and 2015 as government expenditure increases and the private sector continues to expand. Although earlier plans for major capital investments have been scaled back amid concerns about implementation capacity and expenditure effectiveness, the 2014 budget projects a 38% rise in recurrent expenditure and a 47% increase in government capital investment. However, the effect of this spending on growth and inflation is hard to gauge, as actual expenditures have fallen short of budgeted amounts in recent years.

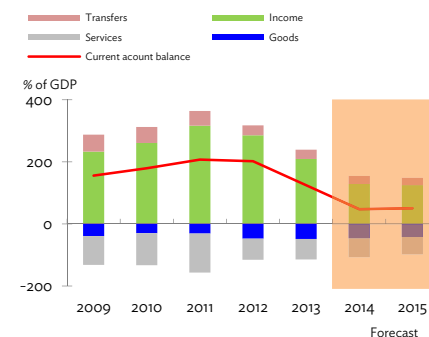
The development of basic infrastructure is a government priority, with 27% of spending from the government's multiyear infrastructure fund allocated to road and bridge construction in 2014. Funding for the Tasi Mane project—intended to catalyze development on the south coast—has been reduced but still accounts for 13% of planned infrastructure spending, while spending to expand electricity service accounts for 15%.

In previous years, infrastructure bottlenecks and limited private sector capacity meant that rising government expenditure—especially recurrent expenditure that is weighted toward local content—has caused inflation. Strong demand flows from increased government spending mean that inflation is forecast to remain high at 9.5% in 2014, easing to 9.0% in 2015 as growth in government spending slows and global prices trend lower.

The offshore Bayu-Udan gas field brings in 95% of Timor-Leste's oil and gas royalties. Estimates of the field's size have recently been downgraded and production is now thought to have peaked in 2012., Conservative forecasts project that reserves in the field will be exhausted by 2021, which is 4 years earlier than previously forecast (Figure 3.35.4). This, together with softening oil prices, is expected to reduce the fiscal surplus from 141% of non-oil GDP in 2013 to 44% in 2014 and 2015 (Figure 3.35.5) and the current account surplus, from 125% of non-oil GDP in 2013 to 47% in 2014 and 50% in 2015.

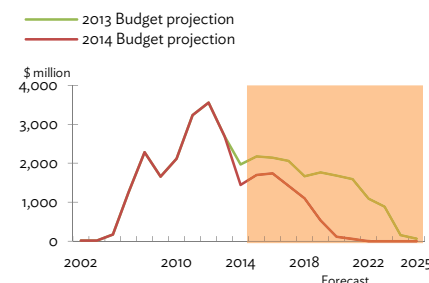
The downward revision in production forecasts also has longer-term implications. The forecasted net present value of future petroleum revenue has been cut from \$13.2 billion to \$7.0 billion. This lowers the sustainable amount that can be withdrawn from the Petroleum Fund each year by 22% to \$632 million which is only 70% of the planned 2014 budget withdrawal of \$903 million. Expenditures planned for 2015–2018 are also expected to exceed the estimated sustainable income but by amounts that are small relative to the value of the Petroleum Fund.

3.35.3. Current account components



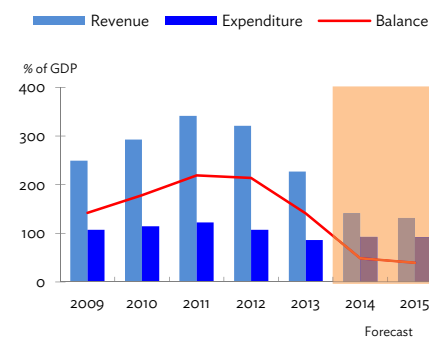
Sources: International Monetary Fund. 2013. *Democratic Republic of Timor-Leste: Staff Report for the 2013 Article IV Consultation*. December; Timor-Leste 2014 State Budget; ADB estimates.

3.35.4. Adjustment to projected petroleum revenues



Sources: Timor-Leste 2013 and 2014 state budget; ADB estimates.

3.35.5. Government revenues and expenditures



Sources: International Monetary Fund. 2013. *Democratic Republic of Timor-Leste: Staff Report for the 2013 Article IV Consultation*. December; Timor-Leste 2014 State Budget; ADB estimates.

Policy challenge—fiscal policy for inclusive growth

An enduring challenge for policy makers in Timor-Leste is to translate the country's petroleum wealth into sustainable and inclusive growth that will reduce poverty and provide jobs for the country's young population.

Timor-Leste has made significant progress in expanding primary education and reducing infant and maternal mortality, but recent poverty assessments cast doubt on the inclusiveness of growth from 2006 to 2011. A 2007 survey of living standards found 49.9% of the population living in poverty and high rates of malnutrition in young children. The 2009–2010 Demographic and Health Survey did not measure poverty but found little improvement in childhood nutrition since 2007, with 45% of children under 5 years old underweight and 58% stunted, of whom 33% were severely stunted.

Strong economic growth since 2007 likely reduced measured poverty rates, but the data on childhood nutrition raises questions about the inclusiveness of this growth. Analysis of newly published national accounts for 2000–2011 suggests that the amount the poor spend on food has not kept pace with GDP growth and that high inflation has reduced purchasing power and food consumption (Figure 3.35.6).

Timor-Leste's Strategic Development Plan, 2011–2030 identifies increased agricultural production as a driver of inclusive growth. Ongoing programs to rehabilitate rural roads, improve crop storage, and disseminate improved seed varieties have the potential to make food more available and improve rural livelihoods, provided the rural poor have access to land. The government safeguards food security through a range of policy measures including rice subsidies, a school lunch program, and transfer payments to vulnerable groups such as the elderly and single mothers of school-aged children. In the 2014 budget, funding for the school lunch program rose to \$25.8 million, boosting spending per child per day from \$0.15 to \$0.25. The largest government transfer program pays pensions to veterans of the country's long fight for independence toward achieving a peaceful transition to democracy but does not target poverty reduction as its main objective.

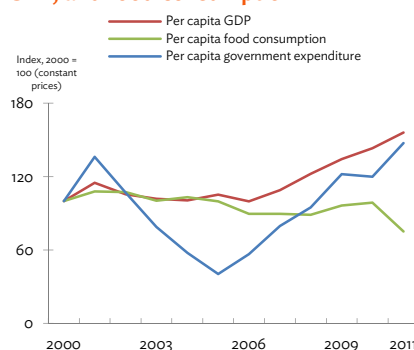
Timor-Leste's policy makers face a trade-off between using scarce public funds for current consumption or for longer-term investment. Targeted transfers to the poor can immediately reduce poverty, but the effect is likely to be temporary and inflationary without accompanying investments that improve poor families' income prospects. Large infrastructure investments like those planned for 2014–2018 have the potential to raise productivity in the long term, but in the short run they risk stoking inflation that undermines real incomes. So it is crucial that the investment program be scaled appropriately and targeted to relieve infrastructure bottlenecks. The government can enhance the contribution that new infrastructure makes to inclusive growth by continuing its reforms to improve service delivery and support job creation in the private sector.

3.35.1 Selected economic indicators (%)

	2014	2015
GDP growth	8.5	8.5
Inflation	9.5	9.0
Current account balance (share of GDP)	47.0	50.3

Source: ADB estimates.

3.35.6. Trends in government spending, GDP, and food consumption



Sources: ADB estimates based on data from Timor-Leste National Statistics Directorate. 2013. Timor-Leste National Accounts 2000–2011: Statistics and analysis. May.

3.35.1 Social transfers as a tool for inclusive growth in Timor-Leste

Following the 2006 conflict, the Government of Timor-Leste initiated ambitious fiscal transfer programs to provide social assistance to selected segments of the population. It could afford these expenditures because its revenues had ballooned from fees and royalties derived from offshore oilfields. While expenditures on social transfers rose rapidly, the country still managed to accumulate significant resources into its Petroleum Fund, which holds \$14.9 billion (\$12,400 per capita). Three main transfer programs were established along with a number of smaller programs. The largest program pays pensions to veterans of the struggle for independence. The second-largest pays pensions to the elderly and disabled, and the third-largest, a conditional cash transfer program, benefits single mothers with children enrolled in school. The three programs currently have about 110,000 beneficiaries. The number of beneficiaries has increased by more than 16% per annum since 2009 as the government registered eligible citizens. Transfer payments vary greatly across programs. Conditional cash transfers are limited to \$240 per year, elderly pensions are \$360 per year, and annual veterans' pensions range from \$2,760 to \$9,000.

From 2009 to 2013, spending on transfer programs averaged 14.0% of government expenditure, or 11.4% of non-oil GDP, making Timor-Leste's social transfers larger than those of its peer countries (box figure 1). The transfers have contributed to post-independence stability and economic recovery, supporting consumption that

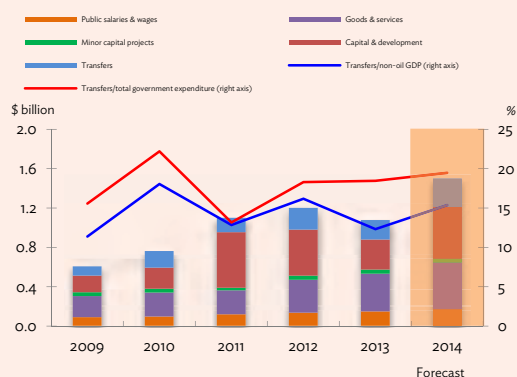
has fueled retail business formation and associated job creation.

In an economy dominated by energy exports that generate little domestic employment, these transfers have helped to transfer benefits of the oil boom to the population. They have been relatively easy to administer and have directly benefited many citizens. Budget execution on the three main social transfer programs averaged 91.1% from 2008 to 2013. This compares favorably with a rate of 70.0% for government capital expenditures (box figure 2).

Before 2012, transfer programs were funded from government revenue and sustainable Petroleum Fund withdrawals. Since 2012, increases in government spending, mainly to develop infrastructure, have required larger withdrawals from the Petroleum Fund, but the transfer programs remained affordable. Although the number of beneficiaries has increased, total payments for veteran pensions will decline over time. This program currently accounts for 60% of transfers, and the Ministry of Finance is applying actuarial modeling to assess its long-term fiscal impact.

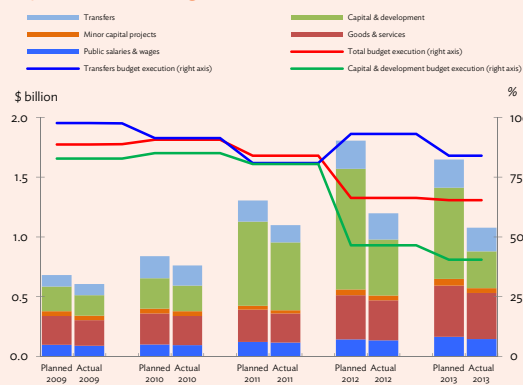
How much existing transfer programs reduce poverty is little understood. A few of the transfers are allocated according to need, but younger households with children—the largest demographic group in the country—are underserved. To ensure transfers are sustainable and benefit recipients over the longer term, the economy must expand opportunities for recipients to invest in productive activity, not just consumption. The Government of Timor-Leste clearly recognizes this, as shown by its ambitious plans to expand market access to its more impoverished rural areas.

Government spending on transfers and other major categories of expenditure in Timor-Leste



Sources: Timor-Leste Budget Transparency Portal (accessed 5 February 2014), 2014 Budget

Budget execution in Timor-Leste across major expenditure categories



Source: Timor-Leste Budget Transparency Portal (accessed 5 February 2014).