Timor-Leste

Large increases in public spending accelerated economic growth in 2014. Growth is expected to be slower in 2015 but recover in 2016 if major investment projects proceed as planned. Inflation eased under favorable external conditions but is projected to rise in 2015 and 2016. Declining petroleum production and low energy prices highlight the need to diversify the economy by encouraging private investment.

Economic performance

Economic growth accelerated in 2014, with GDP excluding the offshore petroleum sector (non-oil GDP) expanding by an estimated 7.1% (Figure 3.35.1). Improvements in budget execution saw own-funded government expenditures rise by 26.5% as the proportion of planned expenditures that were actually disbursed improved from 62% in 2013 to over 90% in 2014. Total public expenditures, including activities funded by development partners, were equivalent to 110% of non-oil GDP in 2014.

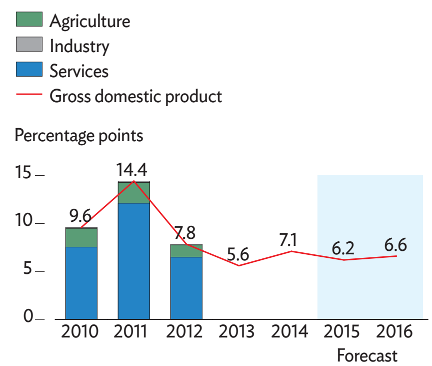
The private sector remains reliant on demand from government spending. This was highlighted by the recently published *Business Activity Survey of Timor-Leste 2013*, which provides the most recent comprehensive data on formally registered businesses. Public spending fell by 7.5% in 2013 and this contributed to an estimated 4.1% fall in formal employment in the private sector and a 3.5% drop in sector profits. The new data imply that non-oil GDP growth in 2013 was significantly lower than the most recent official estimate of 5.6%.

Fiscal stimulus in 2014 supported increased commercial activity and strong growth in private consumption. Electricity use by businesses rose by 10.9%. Motorcycle and passenger vehicle registration increased by 60.4%. The entry of a new airline restored competition on the Bali–Dili route. While total passenger numbers were flat, the number of Timorese passengers more than doubled.

Inflation continued its downward trend in 2014 as annual average inflation slowed to 0.7% despite higher demand from rising public spending (Figure 3.35.2). As the US dollar is the official currency of Timor-Leste, its continued strength against the currencies of trading partners such as Indonesia was a key factor. Lower oil prices reduced transport costs and lower international food prices kept local prices stable in the face of rising demand.

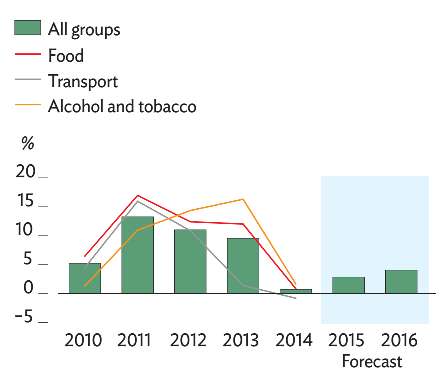
The 2014 budget introduced new regulations to improve the quality of public spending, including limits on single-source procurement, conditions linking withdrawals from the Petroleum Fund to timely budget execution, and controls on advance payments. Several of these

3.35.1 Supply-side contributions to growth



Sources: Statistics Timor-Leste; ADB estimates.

3.35.2 Inflation



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

This chapter was written by David Freedman, consultant, Timor-Leste Resident Mission, ADB, Dili.

regulations were subsequently relaxed as budget execution lagged. This helped push own-funded capital expenditures up by 27.8% to $448 million in the year, with more than half of this higher spending in November and December.

The government continued to invest in the national electricity network. Expenditures of $133 million in 2014 brought investment on the network since 2008 to $1 billion. Despite excess generation capacity, additional investment and reform are needed to reduce operating subsidies of $87 million in 2014—equal to 6% of non-oil GDP.

Government revenues totaled $3.0 billion in 2014 and yielded a fiscal surplus equivalent to 1.3 times non-oil GDP. This surplus was saved in the government's Petroleum Fund, increasing the Fund's balance to $16.5 billion or $13,700 per capita. Fund investments obtained a nominal return of 3.3% in 2014. This was consistent with the benchmark yields established by the fund's investment mandate, but investment income nevertheless fell 35% short the 2014 budget forecast.

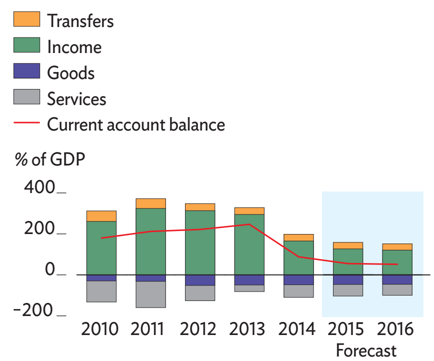
Real sector outcomes were mixed in 2014. Construction is estimated to have grown rapidly on the back of increased public capital investment and sustained demand from the private sector, though official trade statistics reported lower imports of such inputs as cement and steel. Heavy rains contributed to a 29% fall in coffee production, but coffee export revenues fell by only 12% thanks to higher international prices. The Food and Agriculture Organization estimated that rice and maize production increased by 18% with expanded planted area, the adoption of new technologies, and favorable growing conditions.

Lending to businesses and individuals was flat in 2014 but showed significant variation by sector. Lending for trade and finance accounted for 20% of all private sector credit in 2013 but fell by more than 64% in 2014, while lending for transport and communication fell by 18%. Lending to all other sectors grew. Credit to individuals rose by 11% and to construction firms by 15%. Lending for agriculture, manufacturing, and tourism accounted for 6% of all lending in 2013 but grew rapidly in 2014 to account for 13% of total private sector credit by the end of the year.

Businesses continued to accumulate bank deposits in 2014. Growth in business deposits averaged 46% year on year, such that the stock of deposits now exceeds total credit to the private sector. This growth, which started in 2013, suggests that more businesses can now use retained earnings to finance their operations.

Despite declining petroleum income, Timor-Leste once again posted a current account surplus, equal to 88% of non-oil GDP in 2014, as higher petroleum income offset a large deficit in goods and services trade (Figure 3.35.3).

3.35.3 Current account components



Sources: Banco Central de Timor-Leste; ADB estimates.

Economic prospects

Growth is expected to slow to 6.2% in 2015 as stimulus from rising public spending eases, then rise to 6.6% in 2016 as major public and private investment projects move forward. Inflation is forecast at 2.8% in 2015 and 4.0% in 2016 as the deflationary effects of the strong dollar and low international food prices dissipate and domestic demand builds.

3.35.1 Selected economic indicators (%)

	2015	2016
GDP growth	6.2	6.6
Inflation	2.8	4.0
Current account balance (share of GDP)	55.0	51.6

Source: ADB estimates.

While growth is forecast to be lower than in recent years, encouraging signs have emerged of a more active private sector. Work on a new $45 million brewery and bottling plant is set to begin in 2015, and domestic and foreign investors are considering several other major investment projects.

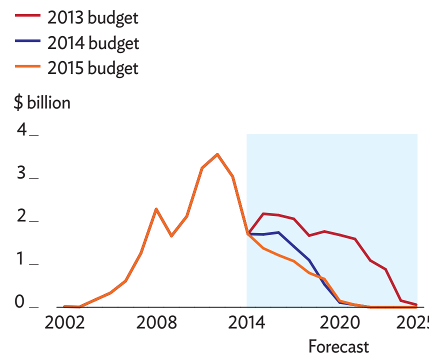
Budgeted spending for 2015 is 5% above the 2014 budget envelope and 21% above the government's own target for long-term fiscal sustainability. The share of recurrent spending in the budget has continued to rise, with social transfers and grants accounting for more than a quarter of public spending. The government has also maintained plans for large public capital projects. The 2015 public investment program includes $66 million to upgrade national roads and bridges and an additional $57 million for the electricity system. Work to develop a new international port is expected to start, and the budget anticipates investments in other transport infrastructure to be greatly scaled up in 2016.

Taxes and royalties from petroleum production provided 57% of government revenues in 2014. Production from current fields peaked in 2012 and is forecast to end in 2020, while the prospects for new development remain uncertain. The 2015 budget cut the discounted forecast of future petroleum revenues by 16% to $4.7 billion in anticipation of production downgrades, rising costs, and lower prices (Figure 3.35.4). This forecast assumes an average oil price of $89 per barrel from 2015 to 2020. As it was prepared in May 2014, it did not factor in the sharp fall in oil prices in the second half of 2014. In January, the World Bank forecast the average price of crude at $63 per barrel during 2015–2020.

Lower oil prices will likely narrow the current account. Surpluses are expected to fall to 55% of non-oil GDP in 2015 and 51.6% in 2016. The fiscal surplus will fall to 36% of non-oil GDP in 2015 and 8% in 2016 if planned spending increases go ahead (Figure 3.35.5). The 2015 budget estimated that the Petroleum Fund could sustain annual withdrawals of $638.5 million without losing value in real terms. However, lower oil prices will likely cut the estimated sustainable income to less than $600 million—significantly below planned withdrawals of $1.3 billion in 2015 and $1.7 billion in 2016.

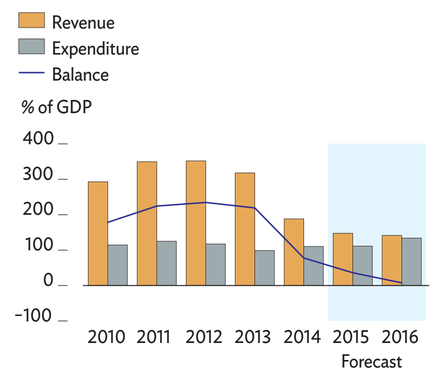
The government of Timor-Leste decided in October to establish a special commission to negotiate maritime boundaries with Australia. Progress in resolving territorial disputes could pave the way for developing the Greater Sunrise gas field, though prospects remain uncertain. As revenues from existing fields decline, prudent fiscal policy is needed avoid rapidly depleting savings in the Petroleum Fund. Fiscal consolidation is likely to mean a period of lower growth, but improving the quality of public spending can bring sustained improvement in living standards.

3.35.4 Adjustment to projected petroleum revenues



Sources: Timor-Leste 2013, 2014, and 2015 State Budget; ADB estimates.

3.35.5 Government revenues and expenditures



Sources: Timor-Leste State Budget (various years); ADB estimates.

Policy challenge—encouraging private investment

Growth and job creation increasingly depend on the private sector, which has expanded rapidly in recent years but remains at an early stage of development. Limited domestic capacity means that foreign investors can play important roles by providing access to capital, technology, and new markets.

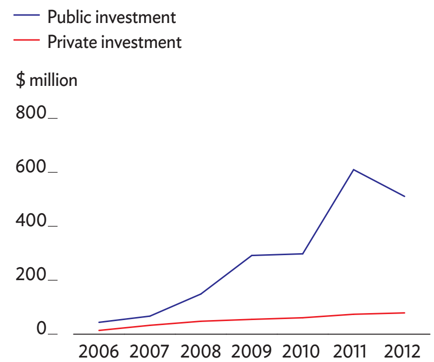
Successive governments have implemented policies and laws to encourage foreign investment. The 2005 Foreign Investment Law established a framework for investment by foreign citizens and nonresident Timorese. The law guaranteed foreign investors equal treatment and established an investment certification process with modest tax incentives and few restrictions on the sectors open for investment. To encourage investment, tax reform in 2008 slashed corporate tax from 30% to 10%, which compares favorably with the average corporate tax rate of 23% among members of the Association of Southeast Asian Nations. Further incentives were provided in the 2011 Investment Law to encourage investment by foreign nationals and resident Timorese citizens. Investors who meet legal requirements can receive tax exemptions for up to 10 years.

Despite these incentives, private investment has increased only moderately. National accounts data show that private capital formation has grown modestly since 2007 when compared with the rapid increases in public investment (Figure 3.35.6). Growth in the number of registered foreign investments has also been slow. The government has registered an average of six foreign investments per year since 2006, with an average of $2.9 million per investment equal to 0.2% of non-oil GDP (Figure 3.35.7).

Investors from Australia, the People's Republic of China, Indonesia, Portugal, and Viet Nam have been most active in the country since 2006, and there is clear potential to attract greater foreign investment. However, current low investment reflects the country's challenging business environment and the failure of incentives to overcome these challenges.

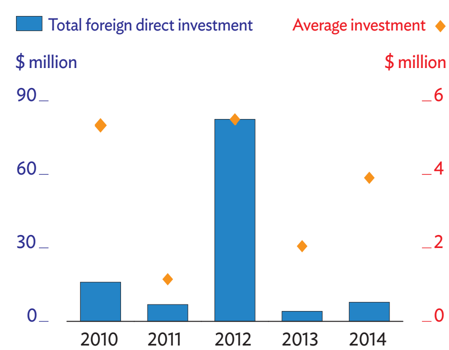
To attract greater investment from overseas, the government has established a new agency to promote Timor-Leste as an investment destination and facilitate the entry of new investors. This could significantly improve investment flows if supported by a credible program to improve the business environment. Planned reviews of the investment law and tax code offer opportunities to ensure that tax incentives are clearly defined and well targeted. Legal reform to ensure clear and straightforward access to land is another priority and there is scope to streamline business licensing and improve access to foreign skilled labor where needed.

3.35.6 Capital formation by government and the private sector



Sources: Timor-Leste National Accounts. 2012.

3.35.7 Foreign Direct Investment



Sources: Timor-Leste Specialized Investment Agency.