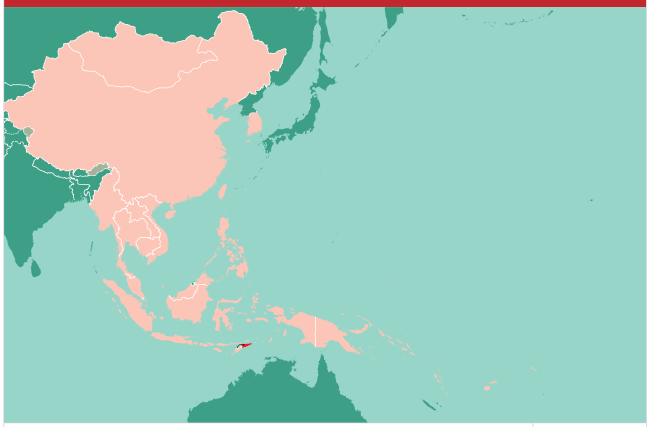
TIMOR-LESTE



	2015
Population, million[a]	1.2
GDP, US$, billion[a]	1.4
GDP per capita, current US$[a]	1192
Life expectancy[b]	68
School enrollment rate, net primary[c]	91

Sources: Authorities and staff estimates and projections.
Note: (a) Projections; (c) Data as of 2011; (c) Data as of 2011.

Summary

Timor-Leste, previously one of the most oil-dependent countries in the world, is undergoing a momentous transition as the oil sector begins to decline. The nation's development prospects rely on the domestic economy, supported by a sovereign wealth fund as well as continued external assistance. To make the difficult transition to a higher income level, the nation faces the challenge of how to use its finite resources and focus reform efforts to catalyze investment and job creation.

Recent Economic Developments

Economic growth in the non-oil economy of Timor-Leste bottomed out in 2013, reaching a low of 2.8 percent. Growth is estimated to have recovered to around 6 percent in 2014 and just over 4 percent in 2015, although official data are not yet available. This growth marks a slowdown from nearly 15 years of double-digit growth following independence, as the economy developed rapidly from a low base. Growth continues to be led by government spending, with both the slowdown in 2013 and subsequent recovery largely due to changes in government expenditure. However, as infrastructure and domestic market conditions improve, stronger private sector growth is a possibility. There is the potential for the development of a number of sectors in Timor-Leste, based on its geographic positioning near Australia and within East Asian value chains, including basic manufacturing, tourism, and niche agriculture.

Developments in the oil sector have had a severe effect on macroeconomic indicators, although the real impact on the country and government budget is well buffered by large financial reserves. Overall GDP, including oil production from the Joint Petroleum Development Area, stood at US$6.8 billion in 2012 and fell to a projected US$2.6 billion in 2015. This is due to both a collapse in prices and declining volumes of oil production as oil fields are becoming depleted. The main transmission mechanism for shocks in the oil sector to feed through to the domestic economy is the government budget, since oil fields are offshore and there is little local employment or domestic value added. Government revenue from the petroleum sector fell from US$3.9 billion in 2013 to US$0.96 billion in 2015.

Consumer price inflation was below 1 percent in both 2014 and 2015. Timor-Leste uses the US dollar as its legal tender, and changes in its terms of trade are mostly determined by US dollar movements. The US dollar continues to appreciate against a basket of currencies, and lower prices of imports, particularly foodstuffs, alcohol, and tobacco, have kept inflation low in Timor-Leste. The appreciation makes Timor-Leste's exports relatively less attractive in international financial markets, which presents an increased challenge for export-oriented economic diversification.

At present, the most significant non-oil export product is coffee. Export values and volumes have fallen from US$18.8 million (34 million kilograms [kg]) in 2012 to US$15.8 million (17.6 million kg) in 2013 and

US$13.8 million (10.2 million kg) in 2014, although this reflects local production factors rather than changes in the internationally traded price of coffee. Overall, the balance of payments surplus has declined along with falling oil exports, from 42 percent of GDP in 2013, to 24 percent in 2014 and a projected 4.3 percent in 2015.

The government's fiscal position is mostly determined by petroleum revenues, both on-stream now and those built up in a sovereign wealth fund (the Petroleum Fund). For 10 years, Timor-Leste has been one of the most oil-dependent countries in the world, and has established a strong governance framework that has enabled the country to amass US$16 billion in financial assets. The wealth in the Petroleum Fund supports a perpetual return to the government budget, currently estimated at about US$500 million a year. However, the value of oil yet to be extracted has fallen sharply since the collapse in prices, so the country has faced a sharp slowdown in the accumulation of reserves and a tighter fiscal envelope.

At the same time that the fiscal envelope has shrunk, the government has embarked on a large public investment program, with the 2016 Budget announcing a government infrastructure investment program over the next three years of nearly US$2.5 billion. This level of investment would constitute a significant reduction in the principal of the Petroleum Fund, reducing the amount the country can expect to earn in perpetuity. The aim of this "frontloaded" investment program is to crowd-in private investment to boost long-term growth and thereby achieve social returns greater than would have been possible by keeping the funds in the Petroleum Fund. While a feasible strategy, and one that may be appropriate given Timor-Leste's stage of development, the success of such an investment program critically depends on the quality of the investments made and the social returns that accrue. The overall budget balance has dropped from a surplus of 53 percent of total GDP in 2013 to a projected budget deficit of 6.6 percent of total GDP in 2015. As oil prices remain low and production drops even further, the budget deficit is expected to increase in 2016 and 2017.

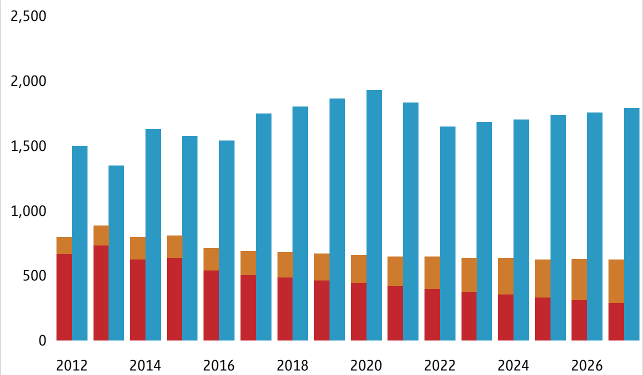
Outlook

The oil sector is expected to continue to decline before production ceases completely in 2022. The onshore economy is expected to continue to grow at around 4 to 6 percent, supported by government investment. The fiscal balance will remain weaker on lower oil revenue and heightened spending, which will necessitate a drawdown from the Petroleum Fund in excess of the estimated sustainable income, as well as increased borrowing. As a result, the balance in the Petroleum Fund is expected to decline each year.

Emerging Challenges

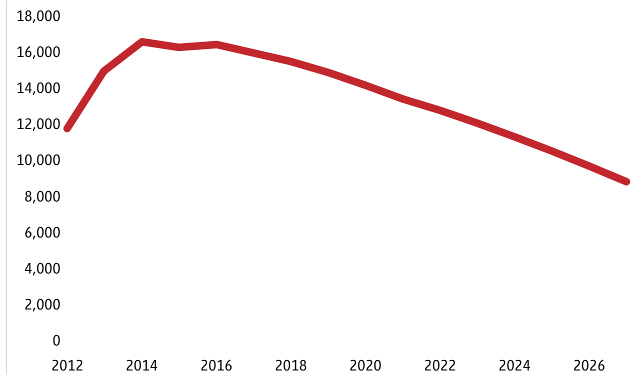
While Timor-Leste faces a daunting infrastructure gap, there are a variety of other constraints that would also need to be addressed to support private-sector-led, inclusive growth. Timor-Leste still ranks as having one of the least conducive regulatory environments for business in the world. A lack of functioning state systems for identification, registration, and dispute resolution over land title make it extremely difficult to secure a claim over land, making it difficult for businesses to commit to investments. The lack of laws governing the enforcement of commercial and credit contracts also make it harder to do business. While Timor-Leste has much to offer, concerted effort is needed to address these critical constraints before it can realistically expect to attract foreign investment and spur domestic enterprise.

Figure 1. Projected fiscal revenue and expenditure



Sources: WB Staff estimates based on GoTL data.

Figure 2. Projected Petroleum Fund balance



Sources: WB Staff estimates based on GoTL data.

TIMOR-LESTE Selected Indicators	*2013*	*2014*	*2015*	*2016*	*2017*
Real gross domestic product (nonoil)	2.8	6.0	4.3	5.0	5.5
Exports, goods and services, US$ million	61.0	89.5	89.0	88.0	102.0
Imports, goods and services, US$ million	1,204	1,430	1,198	1,315	1,650
CPI inflation, period average	9.5	0.7	0.6	1.5	3.8
Current account balance, % of GDP	42.7	24.4	4.3	13.6	-5.0
Fiscal balance, % of GDP	53.2	25.8	-6.6	-11.6	-12.7

Source: Government of Timor-Leste and World Bank staff estimates.