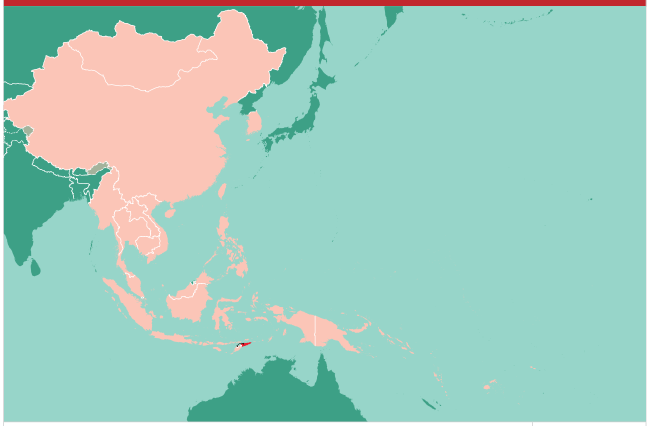
TIMOR-LESTE



	2016
Population, million	1.3
GDP, current US$ billion[a]	1.6
GDP per capita, current US$[a]	1,239
Basic needs poverty rate[a]	41.8
Poverty rate ($1.9/day 2011PPP terms)[a]	30.3
School enrolment, primary (% net)[b]	96.6
Life expectancy at birth, years[b]	68.0

Source: World Bank WDI and Macro Poverty Outlook.
Notes: (a) Most recent value (2014). (b) Most recent WDI value (2014).

Summary

As Timor-Leste enters an election year, it can look back on considerable gains made in poverty reduction at a faster pace than in most countries. Nevertheless, poverty rates remain high, and there is a heightened risk of backsliding on progress to date. Oil production is ceasing, leaving a large fiscal deficit and a depleting sovereign fund. An accelerated public infrastructure program aims to raise prospects for growth, support the diversification of the economy, and create a sustainable tax base. However, the success of this strategy depends on investments representing value for money and on meeting the economic and social development needs of the country.

Recent Developments

The latest poverty estimates indicate that in 2014, about 42 percent of people lived in basic needs poverty. This is a significant reduction from the 50 percent poverty rate in 2007, following the end of a period of conflict. Over the same period, the domestic economy grew by 77 percent, with per capita GDP up by 48 percent, although most of this growth was seen in public-sector-led areas of the economy. Using the international US$1.90 a day poverty line, poverty has fallen even more rapidly—from 47.2 to 30.3 percent over the period—a rate of 2.4 percentage points a year. That is rapid progress, and faster than most developing countries have achieved over a similar period. Nonincome indicators of poverty have also improved rapidly, with electricity extended to 72 percent of the population, compared to 37 percent in 2007, and markedly increased access to improved sanitation and water sources. However, unemployment and under-employment remain high, education levels low, and malnutrition and other health problems severe.

Domestic (excluding offshore oil) economic activity is projected to have grown at a reasonable pace of 4.3 percent in 2014, and around 5 percent in 2015. Trends in government spending—both public investment and current spending—continue to have the most direct effect on economic growth. From 2012 to 2014, GDP growth rates varied in line with stop-start government spending trends. Inflation has been low for the last three years, and over 2016 the economy experienced deflation, with the national consumer price index falling in each month except for December. Falling prices have been led by an appreciating U.S. dollar, Timor-Leste's official currency, which has led to a generalized fall in prices of imports. Continued low commodity prices over 2016, especially oil and food have also contributed to falling prices.

Offshore oil production continues to decline as existing oil fields are depleted. While in 2016 Timor-Leste ceased publishing oil production volumes as part of its reporting in the annual Government Budget, estimates derived from government revenue indicate that production may have fallen by as much as 50 percent in 2016. Timor-Leste's non-oil exports are basic and small scale. The most significant commodity export is coffee, while tourism affords some additional income-generating activities. Coffee has been a long-standing cash crop in Timor-Leste, but the sector has been stagnant for the last decade, suffering from a lack of investment and facilitation services. However, provisional data indicate that coffee exports rose sharply over 2016, with annual exports of almost US$30 million more than double their level over the last three years. This is likely due to a combination of sale of stockpiles built as coffee prices fell, and improvements in yield following adverse weather conditions in the previous two years. While up-to-date information on visitor arrivals is not available, the latest estimates from 2014 indicate that the number of visitors is very low by international standards, at just 60,000 per year, although the number has been gradually increasing.

In 2016, government receipts from the petroleum sector fell sharply from close to US$1 billion in 2015 to a projected US$400 million in 2016. Over the same period, government expenditure is projected to have increased by US$350 million, opening up a wider fiscal gap. The overall government budget (including oil revenues) fell into deficit for the first time since oil revenues came on stream in 2005, with a deficit of 6.4 percent of overall GDP. In 2016, this deficit is projected to reach 29 percent of overall GDP. This indicates that even after accounting for the investment returns from the Petroleum Fund, the government is running down its financial assets. The independently estimated level of sustainable budget financing from the Petroleum Fund in 2016 was US$545 million, whereas actual withdrawals amounted to almost double that level, at US$900 million.

In July 2016, the government announced a supplementary budget to increase expenditure appropriations by US$400 million (or 26 percent of nonoil GDP) for the rest of the year to December 2016. The supplementary budget documentation notes that expenditure is being front-loaded in advance of elections, planned to take place in mid-2017. Projected government expenditure increased by over 20 percent in 2016, and by 50 percent since 2013. Government transfers and capital expenditure have accounted for the majority of increased spending. Transfer payments of veterans' pensions have continued, supplemented by large (US$218 million in 2016) transfers to the autonomous zone of Oecusse, a district of Timor-Leste of approximately 60,000 inhabitants—a budget allocation of around US$3,500 per person for one year. Increased capital expenditure includes a number of road projects, which vary radically in cost—one road under construction in a rural, sparsely populated area costs US$10 million per kilometer and is intended to serve a possible future oil industry. A government contribution towards a new public-private partnership container port development of US$131 million was also transferred to an escrow account in 2016.

Outlook

Economic activity is expected to be manifestly affected by the conduct of both presidential and parliamentary elections in 2017. Some productive activity is expected to be diverted to campaigning efforts, while the recently prepared 2017 budget marks a reduction in planned expenditure as the administration moves to "caretaker mode" during the election year. As a result, GDP growth is expected to fall to 4 percent in 2017, before recovering to 5 percent in 2018 with the first full-year budget of the new government and continuation of planned public and private investment activities.

Following a smooth completion of elections in 2017, foreign direct investment is expected to continue on a modest upward trend, although substantial scaling up of investment is likely to require significant policy efforts in areas of key concern to business—including the quality of ICT and connective infrastructure and effective governance, particularly in areas of property rights (particularly land) and government service provision.

Continued government investment in basic infrastructure such as national highways, local roads, community irrigation, and water and sanitation is expected to support relatively robust poverty-reduction, both via improved standards of living and opportunities for income generation. However, high-cost developments such as the Tasi Mane project are expected to have only a very weak impact on poverty reduction in the near term, and may never yield a social return in a range of feasible scenarios.

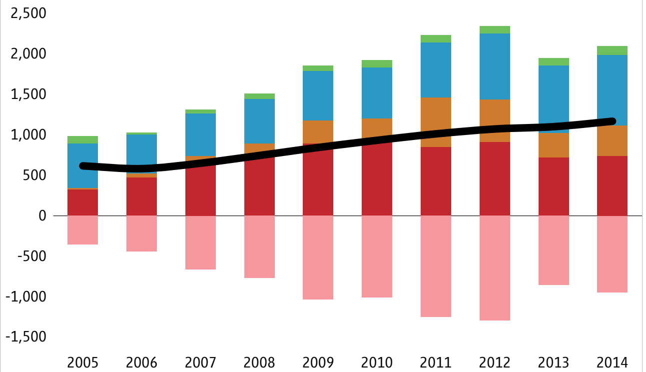
Risks and Challenges

Recent surveys show that since the period of civil conflict in 2006, Timor-Leste has made good progress in alleviating poverty, and the benefits of public investments are becoming evident with sharply improved access to electricity and significant improvements in other basic infrastructure services. However, while it may be appropriate for an initial stage of development, these investments and the associated gains have been achieved using a finite resource of oil revenues. The overriding fiscal challenge for Timor-Leste is to transition to a more sustainable model and rebalancing towards private-sector-led growth over the next 5 to 10 years.

The prospect of new oil fields being exploited in Timor-Leste remains highly uncertain. A recent joint statement by the governments of Australia and Timor-Leste indicated that they are engaging in discussions on a permanent maritime boundary, which would determine the national claims to the vast majority of viable oil fields that lie in Australian waters. Even if viable fields were developed, which is unlikely to happen for 10 years, efforts to diversify towards sustainable models of private sector growth would be just as important to provide a range of economic livelihood opportunities and guard against possible effects of Dutch disease.

Figure 1. Gross domestic product, expenditure components

Constant prices, US$ million

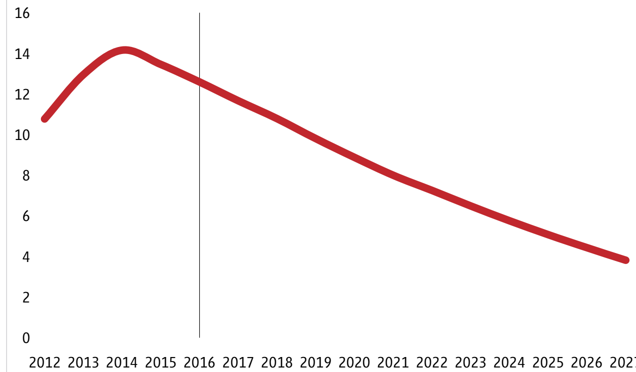


Government consumption | Government investment | Private consumption | Private investment | Net exports | GDP

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

Figure 2. Petroleum Fund wealth per capita

Constant prices, US$



Sources: World Bank staff estimates.

TIMOR-LESTE Selected Indicators	*2014*	*2015*	*2016e*	*2017f*	*2018f*	*2019f*
GDP growth, at constant market prices (non-oil)	5.9	4.3	5.0	4.0	5.0	6.0
Exports, goods and services, US$ million[a]	15.5	18.0	27.4	28.5	29.6	30.8
Imports, goods and services, US$ million	-764.0	-692.0	-728.0	-864.0	-914.0	-930.0
Trade in services, net, US$ million	-388.0	-414.0	-486.0	-648.0	-647.0	-605.0
CPI inflation, period average	0.7	0.6	-1.3	3.0	4.0	4.0
Current Account Balance, % of GDP[a]	27.6	12.2	2.4	-11.2	-13.7	-14.8
Foreign Direct Investment, US$ million	47.0	35.0	170.0	200.0	200.0	220.0
Fiscal Balance, % of GDP[b]	21.8	-6.4	-29.2	-18.8	-35.1	-34.9

Sources: Government of Timor-Leste and World Bank staff estimates.
Notes: e = estimate, f = forecast. (a) Denominator is total GDP, since current account includes offshore oil sector as domestic activity. (b) Overall balance including incorporating petroleum receipts and current earnings from Petroleum Fund, as a proportion of total GDP.