Timor-Leste

The economy contracted as political impasse held back public spending and private investment slowed. Prospects hinge on decisive results in this year's election and a restoration of public spending to complement large private projects in the near term. Recent developments in oil and gas boost the outlook over the longer term. Renewed emphasis on skills development and a more facilitating approach to labor migration would give young people better access to employment.

Economic performance

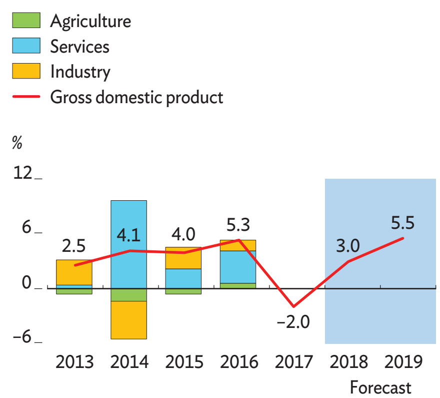
Sharply reduced public spending and a slowdown in private investment caused GDP excluding the large offshore petroleum sector (hereafter GDP) to contract by 2.0% in 2017 (Figure 3.35.1). Public expenditure excluding off-budget grants from development partners fell by 26.8%. Spending cuts were concentrated in capital investment, which plunged by 56.6%. Recurrent spending fell by 8.4% with reductions by 13.4% in purchases of goods and services and by 21.1% in transfer payments to the Special Administrative Region of Oe-Cusse Ambeno (Figure 3.35.2). Development partner grants fell by 36.0% to the equivalent of 8.8% of GDP.

Lower public spending in 2017 was linked to political events. Plans for government investment were scaled back in preparation for presidential elections in March and parliamentary elections in July. After no party won a majority in Parliament, protracted negotiations yielded a coalition government in September. However, the government's 5-year program and a proposal to increase the 2017 budget by 16.1% were rejected by Parliament.

The slowdown in public capital investment reduced demand for machinery and construction services. Agriculture, which generated 16.8% of GDP, also faced challenges in 2017. Production of paddy and maize, the two main staple crops, was hit by erratic rains. Cereal production was, at 130,000 tons, stable from 2016 but 20% below the 5-year average. Erratic weather also hit coffee, the main cash crop, pushing yield down by more than half and coffee export earnings down by 48.6%.

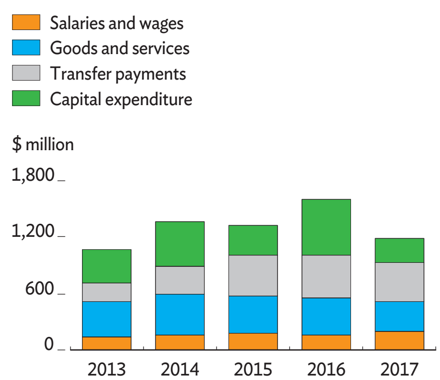
Many indicators reflected challenging conditions in 2017. Growth in household electricity consumption, for example, slowed from 35.5% in 2016 to 11.2%. Growth in electricity use by businesses also slowed, and motorbike registration fell by

3.35.1 Supply-side contributions to growth



Sources: Statistics Timor-Leste; ADB estimates.
Click here for figure data

3.35.2 Public expenditure components



Source: Timor-Leste Budget Transparency Portal.
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This chapter was written by David Freedman of the Timor-Leste Resident Mission, ADB, Dili.

4.6% after several years of double-digit growth. On the other hand, fiscal policy supported private consumption, with social assistance payments higher by 1.7% and government spending on salaries and wages up by 14.8%. International visitor arrivals were a bright spot, up by 12.0%.

A fifth bank commenced operations in Timor-Leste in 2017. Other developments in finance reflected trends in the wider economy. Slower public spending saw bank deposit growth halve from an annual average of 30.7% in 2015–2016 to 14.9% in 2017. Lending to the private sector expanded by 7.5% year on year in the first 3 quarters with large increases for construction. Bank deposits and net foreign asset holdings grew by 10.6% to $1.25 billion, equal to 75.0% of GDP.

Timor-Leste emerged from deflation in 2017 with the consumer price index up by 0.6%. However, inflation was lower than projected as economic activity faltered and reflected mainly higher food prices, especially in the capital. There were modest declines in communications and housing costs.

Government revenue exceeded expectations. Timor-Leste received $417.7 million in petroleum taxes and royalties in 2017, up from $223.9 million in 2016 as oil and gas prices rose and the government completed agreed repayments to field operators (Figure 3.35.3). However, production from the Bayu-Undan oil field continued to decline, falling by 18% in 2017. Domestic revenue was in line with budget forecasts. Petroleum Fund of Timor-Leste investments performed exceptionally well. Its bond and equity investments earned $301.0 million, equal to 17.9% of GDP, and generated a return on assets of 10.4%, the highest since the fund was established in 2005.

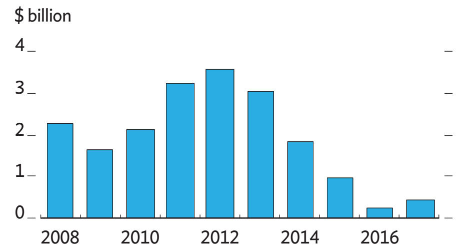
The fund ended the year with a balance of $16.8 billion, or $13,500 per capita (Figure 3.35.4). Strong performance in petroleum taxes and Petroleum Fund investments was reflected in the current account surplus, estimated to equal 0.8% of GDP, up from a deficit of 30.7% in 2016 despite higher merchandise imports. Also reflected in the surplus was a narrower service trade deficit as construction slowed.

Economic prospects

Growth is projected to accelerate to 3.0% in 2018 and 5.5% in 2019 on new government programs and renewed investor confidence. Inflation is also projected to accelerate as the economy picks up, to 2.0% in 2018 and 3.0% in 2019 on higher food and fuel prices (Figure 3.35.5).

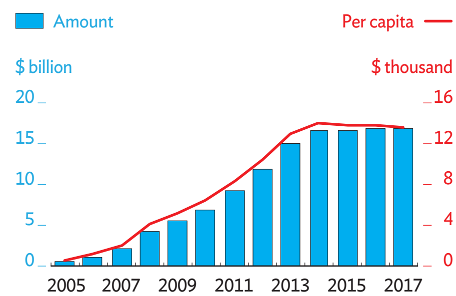
Economic prospects are linked to the political outlook. Fresh parliamentary elections will be held in May 2018, and a new government is likely to be sworn in by July, but this could be delayed if election results fail again to be decisive. Election campaigns will begin in April and boost economic activity across the country. However, government expenditure

3.35.3 Petroleum taxes and royalties



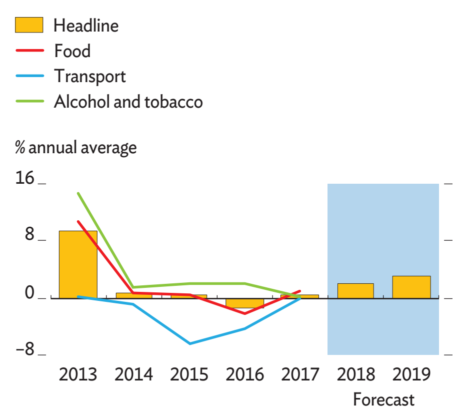
Sources: Timor-Leste Petroleum Fund reports, various years.
Click here for figure data

3.35.4 Petroleum Fund balance at year-end



Sources: Timor-Leste Petroleum Fund reports, various years; Timor-Leste National Census 2015.
Click here for figure data

3.35.5 Inflation



Sources: Statistics Timor-Leste; ADB estimates.
Click here for figure data

leading up to the elections is likely to be constrained for lack of an approved budget for 2018. In the meantime, the government is restricted to monthly appropriations of no more than a twelfth of the annual budget for 2017. This so-called duodecimal regime does not automatically enable the government to use the petroleum fund to cover expenditure, as the law stipulates that withdrawals from the fund can be made only with approval from Parliament. Government cash holdings were estimated at $369.6 million at the end of December 2017. With these reserves and domestic revenue, the government should be able to sustain operations until the elections, but expenditure in the first half of 2018 will likely be significantly lower than in recent years. The government may seek parliamentary approval for petroleum fund withdrawals to ensure that execution of the duodecimal budget is not constrained.

Lower public expenditure in the first half of 2018 is likely to be offset by accelerated spending after a new government is formed. It will immediately be tasked with formulating a budget for the remainder of 2018 and another for 2019 and may use this opportunity to scale up spending. The private sector should also provide a boost in 2018. The Tibar Bay port project secured its environmental license in February 2018, with construction expected to begin in the second half of the year. Total investment in the port is estimated at $278.3 million, equal to 16.7% of GDP.

Several other large private investment projects are poised to move ahead in 2018 and 2019. Investors are preparing to build a $100 million hotel and apartment complex on the outskirts of Dili beginning in the second half of 2018. Other resort developments are being considered, and plans for a $200 million cement factory near Baucau may go ahead before the end of 2019. However, as political stability and government support are essential for private investment, there are clear risks that project timelines may slip.

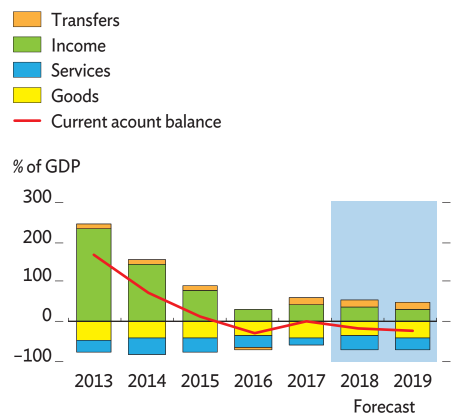
Agriculture is expected to pick up in 2018 with a large increase in coffee production and improved prospects for maize and paddy following good rains. Oil and gas exploration onshore, led by a state-owned enterprise, is set to continue in 2018 and 2019. New wells planned for the offshore Bayu-Undan oil field should help slow a decline in production—and in taxes and royalties received—extending the field's life by 2 years to 2022. As a consequence, the forecast for Bayu-Undan production from 2018 to 2022 has almost tripled, with discounted revenue to Timor-Leste in this period now projected at $1.3 billion, up from a previous estimate of $0.3 billion. This pushes the petroleum fund's estimated sustainable income—the amount that can be withdrawn from the fund each year without depleting it—up by 13.1% to $544.8 million.

3.35.1 Selected economic indicators (%)

	2018	2019
GDP growth	3.0	5.5
Inflation	2.0	3.0
Current account balance (share of GDP)	–15.2	–22.0

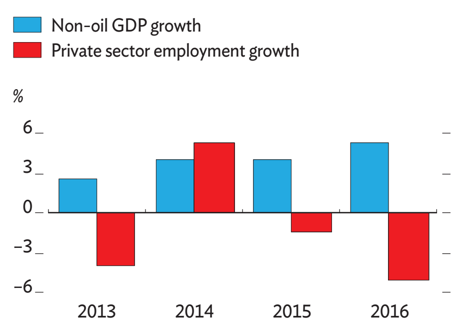
Source: ADB estimates.

3.35.6 Current account components



Sources: Central Bank of Timor-Leste; ADB estimates.
Click here for figure data

3.35.7 Growth in GDP and private employment



Sources: Timor-Leste Business Activity Survey 2016; Timor-Leste National Accounts 2016.
Click here for figure data

Longer-term prospects for oil and gas are promising. On 6 March 2018, the governments of Australia and Timor-Leste signed a treaty that establishes a permanent maritime boundary between them, defines the latter's exclusive economic zone, and paves the way for developing Greater Sunrise, a large oil and gas field in the Timor Sea. Under the treaty, Timor-Leste will receive 70% of production taxes and royalties on oil and gas from Greater Sunrise processed in Timor-Leste and 80% on production processed in Australia. The undiscounted value of Timor-Leste's share of these revenues is estimated at between $21 billion and $28 billion. Further, the treaty increases Timor-Leste's share of Bayu-Undan revenues from 90% to 100% and gives the country exclusive rights to any revenue from the development of the smaller Buffalo oil field.

The new treaty awaits ratification by both Australia and Timor-Leste. A number of conditions need to be met before Greater Sunrise can be developed, which may not happen until well into the 2020s. For now, the treaty will likely reassure policy makers about long-term fiscal sustainability and may accelerate infrastructure development on the south coast. Rising imports for public and private investments and a gradual decline in production from Bayu-Undan will mean continued current account deficits, projected to equal 15.2% of GDP in 2018 and 22.0% in 2019 (Figure 3.35.6).

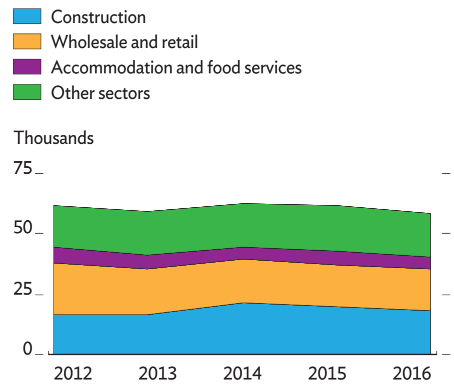
Policy challenge—providing opportunities for young workers

Timor-Leste struggles to employ a young and growing population. A recent survey found that, while GDP grew by 16.9% from 2012 to 2016, formal employment in the private sector fell by 5.4% in that period (Figure 3.35.7). Formal employment in 2016 stood at only 58,200 jobs, or 7.7% of the working-age population. Construction, which was the largest private employer, with 32% of the total, is highly dependent on public expenditure.

Declining employment from 2012 to 2016 reflected fewer jobs in retail, wholesale, restaurants, and accommodation, though the actual change may be less than surveyed as micro enterprises are not included (Figure 3.35.8). An annual enterprise skills survey with wider coverage found slightly higher employment in the private sector, up by 3.7% in the first 10 months of 2017. In any case, the current pace of job creation is clearly far too low, with only 4,000 new jobs each year (Figure 3.35.9).

Sustained job creation will depend on the development of tradable sectors such as tourism, agribusiness, and manufacturing. Supportive public policy can help to develop

3.35.8 Private employment by sector



Source: Timor-Leste Business Activity Survey.
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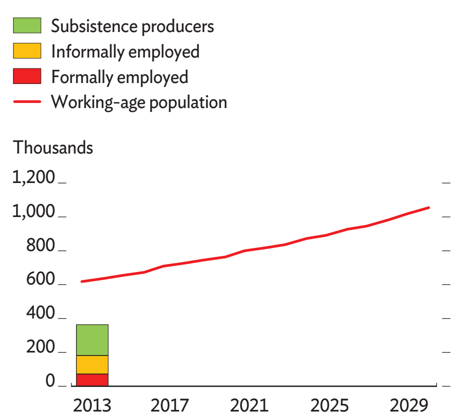
3.35.9 Working-age population and employment



Sources: Timor-Leste Labour Force Survey. 2013; Timor-Leste Census 2010.
Click here for figure data

these industries by stimulating investment and new business formation. Improving basic education and developing more market-oriented technical and vocational training can narrow skills mismatches and enable young people entering the workforce to take advantage of new opportunities.

Labor mobility offers promise as part of an integrated employment strategy. Most Timorese are eligible for Portuguese citizenship, enabling them to work in the European Union, including 16,000–19,000 in the United Kingdom and smaller numbers in Portugal and other countries. Remittances from migrant workers, including more than $28 million from the United Kingdom in 2017, are increasingly important to Timorese households.

More government support for labor mobility can help to expand opportunities for Timorese workers. The government has long-established programs with Australia and the Republic of Korea to facilitate labor migration, with 750 Timorese currently participating. Such government-to-government programs could be expanded in the coming years with more partner governments and concerted efforts to identify suitable workers. The government should also consider options for supporting migration to the European Union. Gaps in public records leave some Timorese struggling to prove that they are entitled to Portuguese citizenship. Others struggle to meet the cost of migration to Europe or to prepare for the opportunities available there. A more proactive and facilitating approach to skills development and labor migration would help to address the job shortage in Timor-Leste and expand workers' access to opportunities in other countries.