



TIMOR-LESTE ECONOMIC REPORT

Fit for Purpose: Crafting a Stable, Inclusive and Resilient Financial Sector

January 2024



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Timor-Leste Economic Report

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Acknowledgment

The Timor-Leste Economic Report (TLER) is a bi-annual World Bank report that assesses recent macroeconomic developments, outlook, and risks, as well as specific development challenges for the Timorese economy. In doing so, the TLER aims to inform the public policy debate and is geared towards a wide audience, including the general public, the government, the private sector, civil society organizations, and other domestic and international stakeholders.

The TLER is a product of the World Bank Jakarta and Timor-Leste office and receives strategic guidance from an editorial board chaired by Satu Kahkonen, Country Director for Indonesia and Timor-Leste. The report is prepared by the Macroeconomics, Trade, and Investment (MTI) Global Practice team, under the guidance of Lars Christian Moller (Practice Manager), Rinku Murgai (Practice Manager), Cecile Thioro Niang (Practice Manager) Bernard Harborne (Resident Representative), Habib Rab (Program Leader and Lead Economist), and Francesco Strobbe (Lead Financial Sector Economist). The production of the report's first and second chapters is led by Alief Aulia Rezza and Yus Medina Pakpahan. Bambang Suharnoko Sjahrir and Cigdem Celik authored Section 1.2. Ananda Nathan Narasimhan contributed to Box 1.1. The chapter focusing on the Financial Sector was authored by Salman Alibhai, I Gede Putra Arsana, Calvin Koenig, and Alexandre Hugo Laure. Ana de Oliveira provided administrative support and coordinated the organization of the report's launch event.

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KEY INDICATORS

Population (million)	1.3
GDP non-oil & gas(nominal USD billion, 2022)	1.6
GDP per capita (USD, 2022)	1,247
Poverty headcount ratio -national poverty line (% population)	41.8
Poverty headcount ratio-USD 1.90 a day (2011 PPP, % population)	22.0
Poverty headcount ratio-USD 3.20 a day (2011 PPP, % population)	65.9
GINI index	28.7

Notes: Population and GDP data are for 2019. Poverty and inequality data are for 2014 (with revised PPPs).



Summary

1. Recent Developments

The final national accounts for 2022 have slightly raised the non-oil growth rate, with consumption driving economic activities.¹ The 2022 growth was adjusted to 4.0 percent, slightly higher than the initial estimate of 3.9 percent. Although this represents a continuation of the 2.9 percent growth experienced in 2021, the country's output level is yet to return to its pre-pandemic level. The strong private consumption in 2022 was driven by government transfers and remittances. However, the persistent weakness in both public and private investment over recent years raises concerns about the prospects for long-term recovery, potentially impacting future output potential and productivity.

The IX Constitutional Government has an ambitious target of creating some 50 000 jobs over the next five years, but the lack of economic dynamism hinders job creation for rapidly expanding workforce. Labor force participation has stagnated at approximately 30.6 percent over an eight-year period, one of the lowest levels in the world, as indicated by successive Labor Force Surveys. Additionally, labor productivity has decreased, with the population growth outpacing the rise in gross value added. A worrying trend is the increasing concentration of employment in sectors with declining labor productivity.

In response to severe slow budget execution, the new government revised the 2023 budget, decreasing planned expenditure by 12 percent, aligning closely to the actual spending in 2022. All spending categories, except salaries and wages, were reduced, with capital spending facing the largest cut. Concurrently, the government reversed recent initiatives to boost revenue. Taxes on sugar and sugary drinks were repealed while import duties and tobacco excise rates were reduced to the previous year's levels. Following these adjustments, the fiscal outlook for the year improved, with the deficit now projected to be just under 60 percent of GDP.

For the first nine months of 2023, consumer price inflation remained high at 8.3 percent year-on-year, driven by a notable rise in both food and non-food prices. This upward trend has persisted despite a decrease in inflation rates among Timor-Leste's key trading partners and the strengthening of the US dollar. Although the government has made efforts to curb inflation and despite a general decline in global prices, the cost of tradable goods has remained high.

The growth in money supply has paralleled fiscal expansion, leading to substantial liquidity in the banking sector which remains largely unutilized by the real sector. The ratio of broad money to GDP nearly doubled, increasing from 42.4 percent in October 2019 to 78.8 percent in September 2023. A significant portion of banking sector assets are however held overseas while loans to the private sector have only recently shown signs of growth. Challenges in risk assessment for potential borrowers and the absence of a legal framework for loan protection remain key structural issues.

There have been consistent trade deficits since Q4 2022, reaching 17.1 percent of GDP by September 2023. The deficit is more pronounced when oil and gas exports are excluded. The large external imbalances are primarily due to persistent expansionary fiscal policy that surpasses the economy's capacity to absorb, coupled with limited domestic production and exports that are insufficient to counterbalance the significant trade deficit.

¹ The bifurcation of the Gross Domestic Product (GDP) into oil and non-oil in Timor-Leste not only underscores the impact of oil revenues on the national economy but also originates from the maritime boundary dispute, settled in 2019. This settlement influenced the acknowledgment and administration of oil and gas production. In the context of this report, any mention of GDP, unless explicitly differentiated, pertains to the non-oil GDP.

2. Outlook and Risks

The economy is expected to maintain its growth in 2023, sustaining the gradual recovery that began in 2021. The growth rate is anticipated to taper to 2.3 percent in 2023, attributed to a deceleration in economic activities during political transitions and consequent pauses in government spending. Economic growth is projected to average at 4.1 percent in 2024 and 2025. The government's focus on capital expenditure and infrastructure investment, increasing the budget from 18.4 percent of GDP in 2023 to 24.5 percent of GDP in the 2024, is likely to further drive growth. However, export growth may face constraints, largely due to the dependence on coffee as the primary export commodity.

Inflation is projected to ease in 2024, driven by a moderation in global commodity prices and a stabilization of global food security conditions. Additionally, reduced inflation rates in the trading partners of Timor-Leste are expected to lessen the impact of imported inflation. Albeit beneficial in easing price pressures, the new government's decision to revoke the implementation of revenue measures, such as excise duties on sugar, sugary beverages, and tobacco, may undermine efforts aimed at increasing revenue collection and controlling the consumption of goods that have negative health impacts.

The fiscal deficit is expected to hover around 43 percent of GDP over the medium term without fiscal reforms. The budget shortfall is being covered through withdrawals from the rapidly declining Petroleum Fund. Before the Fund is completely depleted, which the Government projects to occur in 2034, it will need to either identify new revenue sources to replace more than 70 percent of its current revenues or implement significant spending cuts. The latter could lead to a substantial reduction in public services, a situation often referred to as the 'fiscal cliff.'

The outlook is subject to several downside risks. Adverse weather events, notably those associated with El Niño, could disrupt rice availability and imports. Additionally, high energy prices are likely to increase transportation and electricity costs domestically. Rising food and energy prices may require a fiscal response, potentially impeding expenditure restraint efforts. Furthermore, the performance of the US dollar, Timor-Leste's legal tender, directly impacts domestic economy. A stronger dollar makes exports costlier and imports cheaper, while a weaker dollar does the opposite, affecting both revenues and costs from international trade as well as local cost of living.

Reaching the IX Constitutional Government's target of 5 percent annual economic growth relies on policies that support a sustainable, diversified economy. A robust private sector is essential for providing stable employment and sustaining private consumption. In turn, the development of private sectors requires an environment that fosters its growth and dynamism. In this regard, financial deepening and inclusion are essential, as they provide the private sector with access to financial products and services that enables businesses to drive economic activities and contributes to overall economic growth (see Chapter 3).

3. Special Focus: Building a Stable, Inclusive and Resilient Financial Sector in Timor-Leste

The development of a robust financial sector can hasten Timor-Leste's pursuit of broad-based and inclusive economic growth. Access to formal financial services, such as savings accounts, credit facilities, insurance, and payment systems, can help households to accumulate assets and smooth consumption, thereby reducing vulnerability to shocks, and helping break the cycle of poverty. These same financial services can also mobilize domestic savings and channel investments towards productive sectors, enabling firms to innovate and grow. Meanwhile, a stable and well-regulated financial sector can attract greater foreign investment and mitigate the impact of economy-wide shocks, such as those posed by diminishing resource reserves and natural disasters.

As one of the world’s youngest countries, Timor-Leste’s financial sector appears remarkably vibrant in some respects, with a wide variety of financial sector actors, relatively developed financial sector infrastructure, and adequate levels of liquidity and risk management in the banking sector. Peering slightly below the surface, however, several critical constraints emerge, which limit the ability of the financial sector to play its full role in supporting the economy and its people. The level of credit to the private sector in Timor-Leste – a key indicator of the reach and inclusiveness of the financial sector – stands at only 28.9 percent of GDP, among the lowest levels in the world. Digital bank accounts and digital payments, which could reduce costs and expand outreach of financial services to marginalized segments of the population, are utilized by only 10 to 15 percent of the population. Meanwhile, the country’s financial sector stands exposed to outsized economic risks from natural disasters and other shocks.

Three watchwords can guide the development of Timor-Leste’s financial sector: inclusion, stability, and resilience. Digitizing financial services and improving access to credit for firms can boost inclusion, helping Timorese households invest in their own welfare and reap the benefits of economic growth. More use of data and early warning systems can ensure that the country’s financial sector remains stable even as it expands and grows. Finally, dedicated strategies and financing instruments can ensure that the financial sector is resilient enough to mitigate the impact of natural disasters and other shocks on the broader economy. Taken together, these measures can help Timor’s financial sector mature into one that can support the country’s aspirations for economic growth and poverty reduction in the decades ahead.



1. Recent Developments



1.1. Global economic activity continues to soften and while the prices of most commodities have retreated from their 2022 peaks, they remain higher than pre-pandemic levels.

The global economy is gradually recovering from a series of shocks, while the economic performance in most of East Asia and the Pacific (EAP) is influenced by China's growth momentum. Global activity has not yet returned to its pre-pandemic trends. The long-term effects of the pandemic and the war in Ukraine are hindering the recovery. The challenges are compounded by the impacts of monetary policy tightening and fiscal consolidation after exceptional support during COVID as well as extreme weather events.² The EAP region has benefited from a surge in domestic demand as Asia's economic reopening from COVID-19 health restrictions occurred later than elsewhere. More recent data nevertheless indicate a slowing momentum. The recovery in China is losing pace as conditions in the real estate sector continue to weaken. This slowdown is likely to impact the wider region, especially commodity exporters with strong trade links to China.

Most commodity prices declined in 2023 due to moderating demand, but they remain above pre-pandemic levels. Oil prices were highly volatile in the second half of 2023 amid OPEC+ production cuts and the Middle East conflict. Food commodity prices moderated as well, reflecting improved supplies for major crops. Food insecurity remains a key challenge amid high, albeit declining, consumer food price inflation. The number of people who are severely food insecure globally is estimated to have risen from 624 million in 2017 to 900 million in 2022 (FAO et al. 2023). The recent surge in rice prices is likely to exacerbate food insecurity as rice is a staple food for over half the world's population, providing more than 20 percent of the calories consumed worldwide.

² Readers are invited to refer to the World Bank's January 2024 Global Economic Prospect for a detailed analysis pertaining to the global economy.

1.2. Consumption-fueled recovery coupled with concerning decline in investment.

With limited ties to the global economy, Timor-Leste is on the path to recovery from its recent economic downturn caused by COVID-19 and the impacts of Tropical Cyclone Seroja. After a significant contraction of 8.3 percent in 2020, the non-oil economy recovered only partially, growing by 2.9 percent in 2021 and then by 4.0 percent in 2022 (Figure 1.1). Despite these two consecutive years of positive growth, Timor-Leste's economic output has yet to reach its pre-pandemic levels. The recovery rate is slower compared to the average for East Asia and Pacific (EAP) countries, as well as the average for low and middle-income countries, but it is faster than that of the Pacific Island countries (Figure 1.2). Private consumption has been the main driver of growth, fueled by the post-pandemic reopening. Exports and Foreign Direct Investment in the non-oil and gas sectors remain very small. The limited domestic production base means that the economy remains heavily dependent on imports. As a result, global economic conditions, particularly fluctuations in commodity prices, impact significantly on Timor-Leste's domestic economy.

The final national accounts for 2022 have marginally revised up the non-oil growth rate, with notable changes in the drivers of growth. GDP growth for 2022 was revised up slightly from 3.9 percent, preliminarily announced in March 2023, to 4.0 percent. However, the revision also significantly altered the drivers of growth. Both private consumption and exports have been revised upwards, while the growth rates for government consumption and investment have been reduced (Table 1.1). The growth of imports has seen a slight downward adjustment.

Table 1.1: Timor-Leste's 2022 Growth Performance

(in percent)

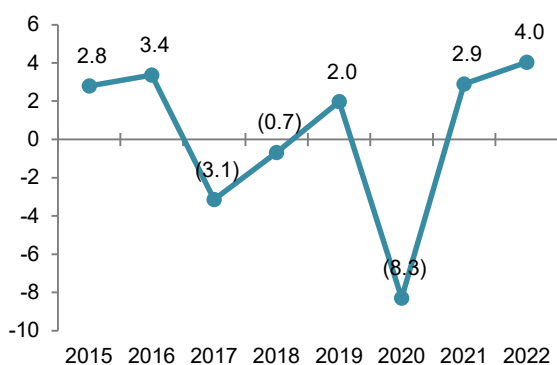
	2022e	2022f
Real non-oil GDP growth	3.9	4.0
Private Consumption	1.8	14.0
Government Consumption	6.9	-0.2
Gross Fixed Capital Investment	44.8	29.4
Export, Goods and Services	0.0	32.5
Import, Goods and Services	19.6	22.8

Source: Ministry of Finance. e: Government's estimates; f: final figures

Strong private consumption was driven by a combination of government transfers and remittances. Following the revision of the 2022 Budget, fiscal and quasi-fiscal measures were implemented to shield households from the impacts of escalating commodity prices caused by Russia's invasion of Ukraine. Government assistance programs included the universal disbursement of a "thirteen-month" salary of USD 200 paid in December 2022 but announced in May 2022, fuel vouchers, the *Cesta Basica* (Food Basket program), and the *Bolsa de Mae* programs. Additionally, the government capped electricity prices through subsidies for the electricity utility. Private consumption was further bolstered by a robust growth in remittances, which recorded a year-on-year increase of 31.2 percent at the end of December 2022, maintaining an average growth of around 30 percent since 2020.

Figure 1.1: The economy continued its recovery in 2022...

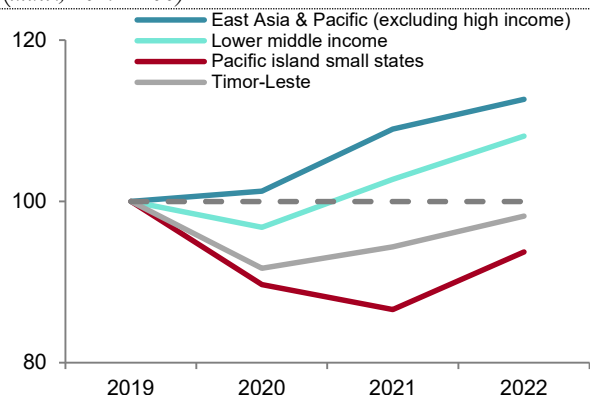
(real growth, percent)



Source: INETL

Figure 1.2: but the country's output is yet to return to its pre-pandemic level

(index, 2019=100)



Source: INETL. World Bank Staff calculation.

Most of the population received various forms of government support while the number of remittance recipients doubled. A survey conducted by The Asia Foundation in 2023 showed that nearly all respondents reported that either they or someone in their household had received government payments. The most common form of support was the universal USD 200 payment distributed in December 2022 followed by the *Cesta Basica* program (Figure 1.3). Additionally, the survey highlighted that 20 percent of respondents had received money from a family member or friend abroad, a considerable increase from a similar survey conducted a year earlier. Consistent with trends seen in national account data, most of these remittances were used for consumption-related activities rather than investment (Figure 1.4).

Figure 1.3: Majority of population received various social assistances.

(percent of respondents, percent)

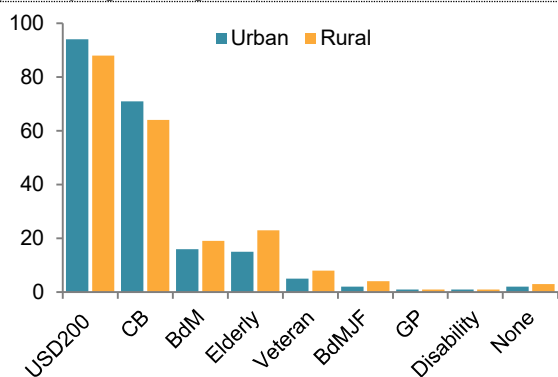
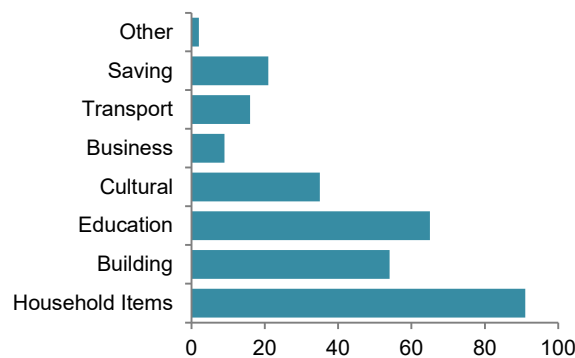


Figure 1.4: Remittances are mainly used for consumption.

(percent of respondents, percent)

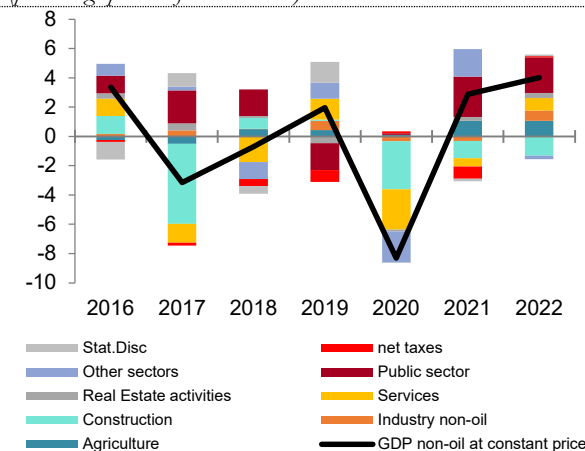


Source: The Asia Foundation Tatoli! 2023 Survey. Note: Respondents can receive multiple social assistance. CB: *Cesta Basica*; BdM: *Bolsa de Mae*; BdMJF: *Bolsa de Mae Jerasaun Foun*; GP: Government or Parliamentary Pension

The public sector generated the highest value added but other industries have experienced strong growth, albeit from a low starting point. Excluding the oil and gas extraction sector, the main sectors in the economy include public administration, agriculture, real estate, retail services, and construction (Figure 1.5). Both public administration and agriculture have been crucial, as they were the only sectors to exhibit growth during the pandemic years. Manufacturing and financial sectors have shown strong growth from a very low base, continuing the consistent upward trend observed in the pre-pandemic years. To generate job opportunities for the young Timorese workforce, there is a need for economic diversification that fosters new engines of growth beyond the traditional sectors.

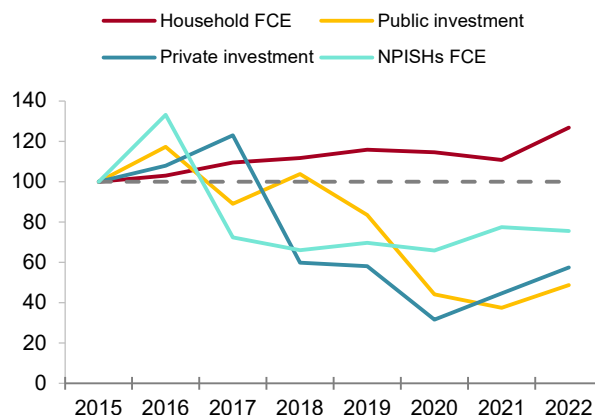
Weak public and private investment point to worrying signs for longer-term recovery and growth. Over the past decade, substantial government spending, exceeding the fiscal rule on Estimated Sustainable Income (ESI) was justified on the basis of investment needs. The peak of budget allocation for capital spending occurred in 2016, but it has rapidly declined since then, even as the total budget envelope continued to increase. The reduction in government investment, alarmingly, has coincided with persistent difficulties in executing the allocated budget which leads to sub-optimal outcomes in terms of efficiency and effectiveness of public spending. Compounding these issues is the fact that private investment has been declining since 2017, showing no signs of recovery (Figure 1.6). Low investments will weigh on output potential and productivity, thereby hindering job creation for the country’s young and dynamic workforce. According to the World Bank Enterprise Surveys (2015, 2021) access to finance remains one of the top three persistent business constraint faced by entrepreneurs (see Chapter 3).

Figure 1.5: GDP growth has mainly been driven by expansion of public sector.
(percentage points of contribution)



Source: INETL

Figure 1.6: Both public and private investment were still below the 2015 level.
(real output, index 2015=100)

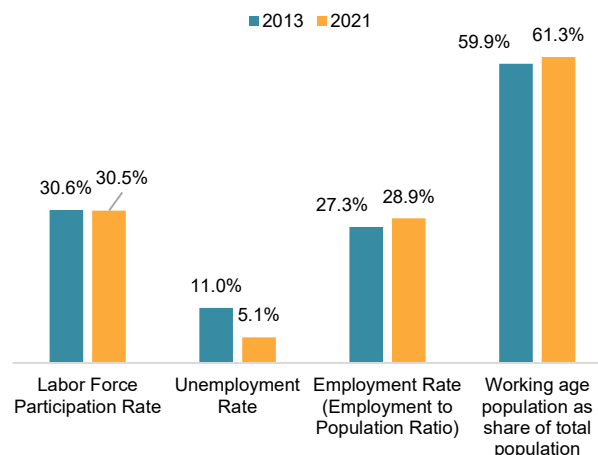


Source: INETL and World Bank Staff Calculations.
Note: FCE: final consumption expenditure
NPISHs: Non-profit institutions serving households

1.3. Lack of economic dynamism hinders job creation.

The labor force participation rate remained low between 2013 and 2021.³ An analysis conducted using Labor Force Survey microdata showed that the labor force participation rate in Timor-Leste was practically unchanged from 30.6 in 2013 to 30.5 percent in 2021 (Figure 1.7).⁴ While the global pandemic severely impacted labor market conditions across all countries, the situation in Timor-Leste stands out. Compared to other small states surveyed during the pandemic, Timor-Leste has the lowest labor force participation rate (Figure 1.8).⁵ While the unemployment rate halved, falling from 11 percent to 5 percent, the employment rate saw only a modest increase from 27 to 29 percent. The number of employed increased by 44.5 thousand people (23.5 percent) while the number of unemployed decreased by 10.8 thousand people, leading to a total increase in the labor force of 33.7 thousand people (15.8 percent). Concurrently, the working-age population grew by 16.2 percent and the segment of the population not participating in the labor force also saw a 16.4 percent increase (Figure 1.9).⁶

Figure 1.7: Labor Force Participation and employment rates remained at a low base.



Source: World Bank staff calculations using INETL 2021 and 2013 TL-LFS microdata

³ Beyond the limited economic dynamism of an economy reliant on government spending, low labor force participation may also stem from skill mismatches, substantial emigration, and a high degree of informality. These issues fall outside the scope of this report for a detailed discussion.

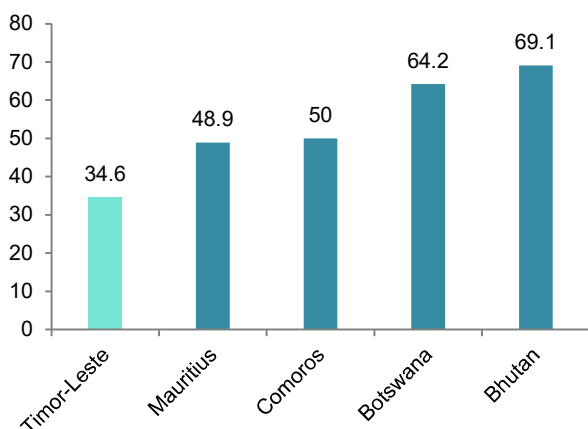
⁴ Since its independence in 2002, Timor-Leste has conducted three Labor Force Surveys in 2010, 2013, and 2021, and a Child Labor Survey in 2016 with a subsequent smaller scale study. The 2021 survey, conducted from October to November, sampled 7275 households. The 2013 survey, from October 5 to December 5, covered 7080 households.

⁵ Data permitting, throughout this report, Timor-Leste is systematically benchmarked against relevant peers. See Annex 2: Peer Selection.

⁶ The labor force participation rate indicates the percentage of working-age individuals who are either employed or actively looking for work and available to work. The unemployment rate, on the other hand, measures the percentage of the labor force that is currently

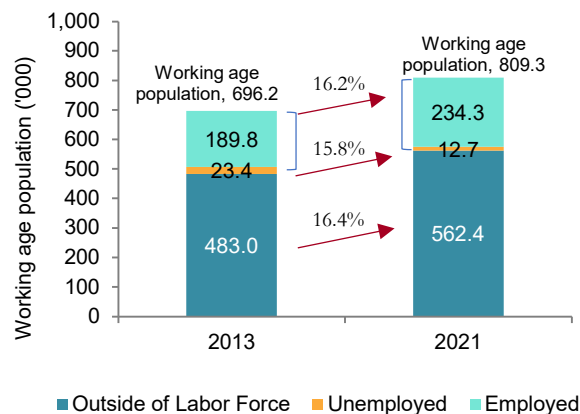
The per capita Gross Value Added (GVA) and labor productivity declined. While non-oil GVA grew by an average 0.7 percent annually, the population increased at a faster rate of 1.6 percent during the same period. As a result, labor productivity, measured as GVA generated per worker, declined at a rate of 2.1 percent (Table 1.2). A decomposition analysis indicates that the decline in labor productivity was the primary reason for the reduction in GVA per capita (Figure 1.10). Additionally, the slight decrease in the labor force participation rate from 30.6 to 30.5 percent also contributed negatively.⁷ On the other hand, demographic factors and the falling unemployment rate, which implies a higher employment-to-labor-force-ratio, helped mitigate the adverse impacts of the falling labor productivity.

Figure 1.8: Timor-Leste has the lowest labor force participation among selected small states...
(labor force participation rate 2021, percent)



Source: ILOSTAT

Figure 1.9: Unemployment declined, while number of people out of labor force rose faster than the labor force.



Source: World Bank staff calculations using INETL 2021 and 2013 TL-LFS microdata

Table 1.2: Per Capita Value Added and labor productivity declined between 2013 and 2021.

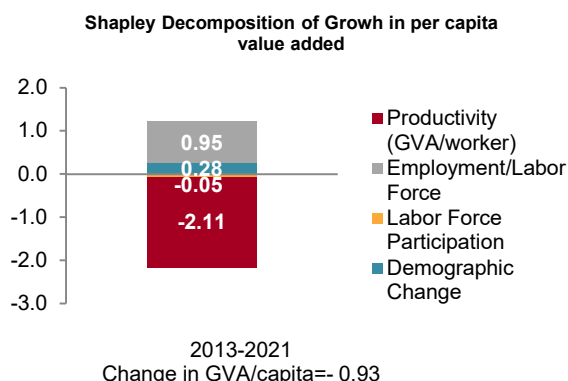
	2013	2021	Annual percentage growth
GVA (non-oil sector, 2015 constant prices, USD million)	1,468	1,550	0.7%
Agriculture	300	304	0.1%
Industry (incl. manufacturing)	13	28	10.3%
Construction	255	146	-6.7%
Services	899	1,072	2.2%
Population ('000)	1,162	1,321	1.6%
GVA/capita (non-oil sector, 2015 constant prices, USD)	1,263	1,173	-0.9%
Employment ('000)	187	233	2.8%
GVA/worker (non-oil sector, 2015 constant prices, USD)	7,865	6,647	-2.1%

Source: INETL and World Bank staff calculations

jobless but actively seeking employment and available to work. These two figures together provide a holistic understanding of the state of the workforce. The unemployment rate alone could be misleading as it doesn't consider those who've stopped looking for work (the 'discouraged workers'). A low unemployment rate may seem positive, but if paired with a low labor force participation rate, it could suggest a high number of discouraged workers who've left the labor market. Similarly, a high labor force participation rate indicates a more engaged workforce, which can be beneficial for economic growth. Thus, assessing both figures is vital for a nuanced understanding of labor market dynamics.

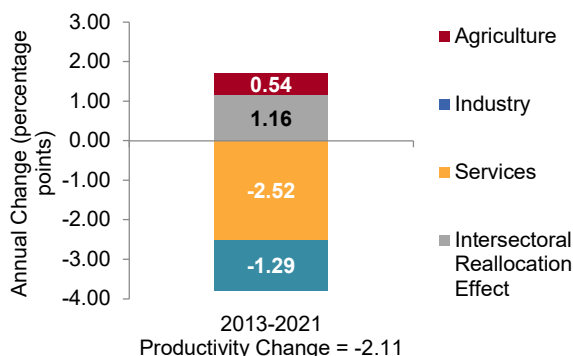
⁷ The annual change in the per capita Gross Value Added can be decomposed into four factors: change in labor productivity, change in labor force participation rate, change in employment to labor force ratio, and demographic change (change in the share of working age population)

Figure 1.10: GVA/capita reduction was primarily driven by falling labor productivity.



Source: World Bank staff calculations using INETL 2021 and 2013 TL-LFS microdata and INETL National Accounts data in constant prices

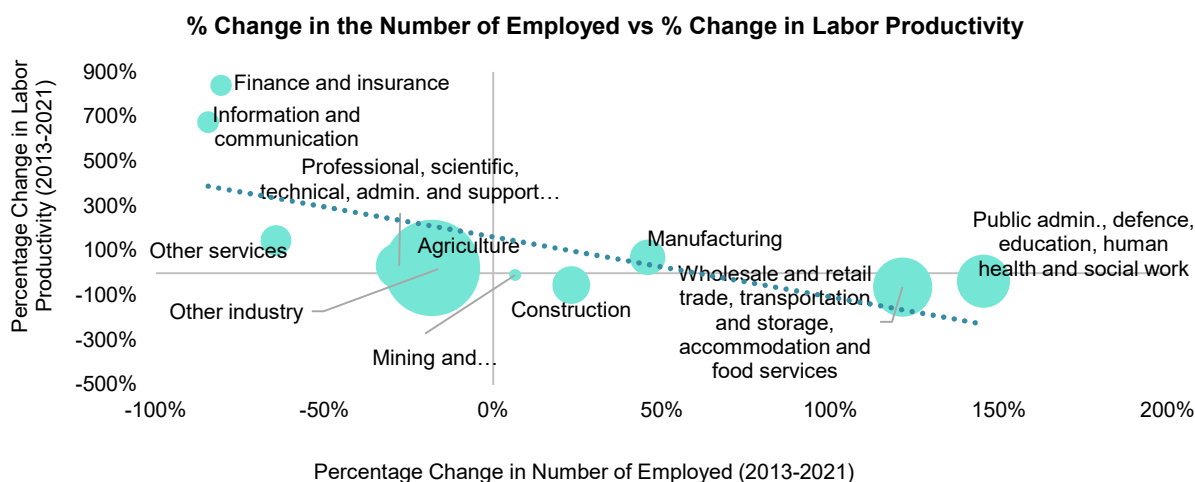
Figure 1.11: Structural transformation helped partially offset the effects of reduced labor productivity in services and industry sectors.



Source: World Bank staff calculations using INETL 2021 and 2013 TL-LFS microdata and INETL National Accounts data in constant prices

While across broad sectors structural transformation helped partially offset the effects of reduced labor productivity in services and industry sectors (Figure 1.11), a more detailed analysis of sector-specific productivity changes shows that sectors experiencing reduced labor productivity also saw employment growth (Figure 1.12). Notably, public administration (combined with defense, health and social work sectors) and wholesale and retail trade (combined with transportation, food and accommodation sectors) exemplify this trend. In contrast, sectors with improved productivity such as ICT and Finance, faced significant drops in employment.⁸ By 2021, sectors with labor productivity below the national average accounted for two-thirds of total employment. The ICT and finance sectors collectively constituted a mere 0.6 percent of total employment. Moreover, the manufacturing sector, despite representing 6.5 percent of total employment, had labor productivity levels even lower than agriculture and low-productivity service sectors such as wholesale and retail trade (as indicated in Figure 1.13).

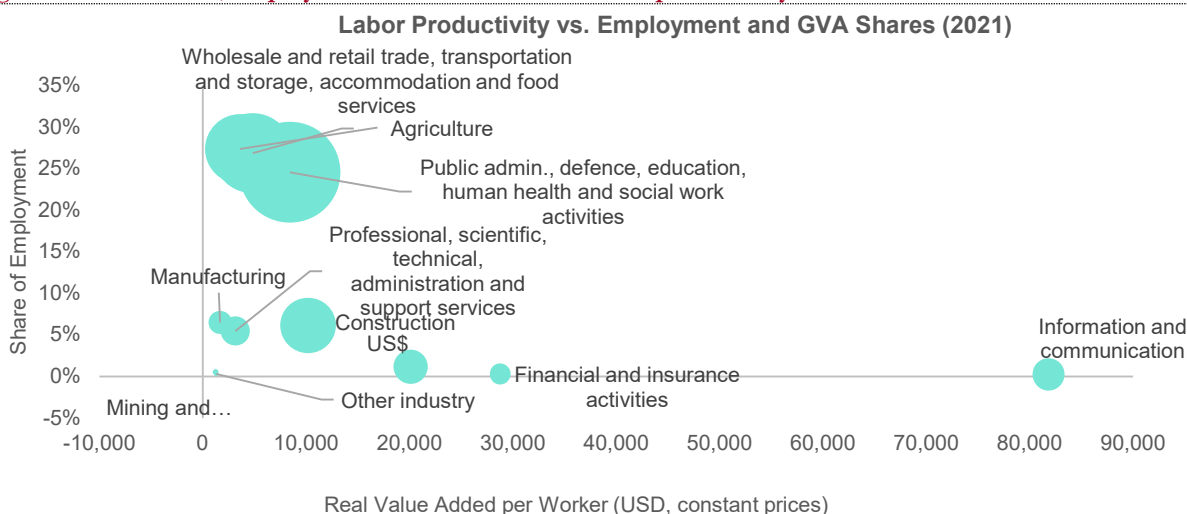
Figure 1.12: Sectors that have seen declines in labor productivity also experienced an increase in employment.



Source: World Bank staff calculations using INETL 2021 and 2013 TL-LFS microdata and INETL National Accounts data in constant prices. Note: The Size of the bubbles reflect percentage employment share of each sector in 2013.

⁸ ICT and finance sectors also had very low levels of initial employment at the baseline, with approximately 4000 employees working in each sector in 2013.

Figure 1.13: As of 2021, employment is concentrated in lower productivity sectors.



Source: World Bank staff calculations using INETL 2021 and 2013 TL-LFS microdata and INETL National Accounts data in constant prices. Note: The Size of the bubbles reflect percentage GVA share of each sector in 2021

1.4. The fiscal position has improved due to difficulties in executing the budget.

The IX Constitutional Government, inaugurated in July 2023, rectified the 2023 budget to improve the pace of budget execution and to align the budget with the new Government’s objectives. The amendment primarily aimed to address the slow budget execution, support the reorganization of the government and facilitate a 120-day “review and planning” agenda and priorities of the new administration. The challenge of slow budget execution was particularly severe. By the end of the second quarter of 2023, budget execution stood at less than 30 percent, making it highly improbable for the budget to be fully utilized by year-end. The government's restructuring was quite extensive, involving significant changes in at least 10 ministries or government offices, including mergers, the creation of new entities, splits, or dissolutions.

Table 1.3: 2023 Budget Structure before and after rectification
(in USD million)

	2023 Original	2023 Rectified
Total Expenditure for Central Administration & RAEOA	1,920.00	1,716.76
Salary and Wages	443.61	448.74
Goods and Services	425.62	373.77
Public Transfers	661.06	575.75
Minor Capital	56.39	51.78
Capital and Development	333.32	266.74

Source: Ministry of Finance

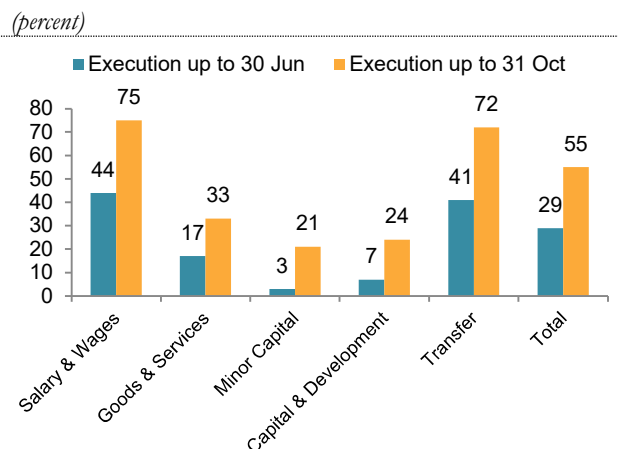
The rectification reduced the 2023 budgeted expenditure by 12 percent, thereby lowering the estimated fiscal deficit to 60 percent of GDP. The 2023 budgeted expenditure was originally set at USD 1.9 billion⁹, (111 percent of GDP), before being amended to USD 1.7 billion (99 percent of GDP) (see Table 1.3). Every spending category except for salaries and wages was reduced, with capital spending experiencing the most significant cut. The compensation for temporary workers, employed to support the Parliamentary and later *Sukos* elections, was a key factor driving the higher spending in salaries and wages. The fiscal position for the year has improved post rectification with the deficit now estimated at 60 percent of GDP, lower than the pre-rectification estimate of 72 percent of GDP. In line with usual practices, the budget deficit will be primarily financed by additional withdrawals from the Petroleum Fund, supplemented by cash balances, and a small proportion of borrowing and direct budget support.

⁹ Total approved expenditure for Central Government and RAEOA (Special Administrative Region of Oé-cusse Ambeno)

During the budget adjustment, the government withdrew its recent, albeit modest, efforts to increase revenue. The previous government had introduced several initiatives in January 2023 including raising of import duties and tobacco excises as well as new taxes on sugar, sugary drinks. These were rolled back as part of an effort to tackle the persistently high inflation seen throughout the year.¹⁰ Preliminary assessments by the authorities also showed that these revenue measures had mixed results. Notably, the rise in tobacco excise taxes led to a significant decline in tobacco duty collections, possibly due to undeclared imports of cigarettes. In the absence of new revenue measures, the 2023 Budget will largely depend on income from Autonomous Agencies, along with revenues from various fees and charges.

Budget execution of recurrent spending has accelerated since the rectification but challenges in executing capital spending persist. As of end October 2023, 55 percent of the adjusted 2023 budget has been executed. This marks a significant increase from the 29 percent execution rate in June 2023 (Figure 1.14). However, the execution figure should be approached with caution. There have been instances where the transfers spending, although disbursed from the government's treasury account, remains unutilized in the bank accounts of various institutions or organizations, thus failing to impact the economy. The execution of capital expenditure continues to face hurdles, with only 8 percent executed by June and 24 percent of the rectified budget by October 2023, partly attributed to the new government's ongoing review process of contracts agreed upon by the previous administration.

Figure 1.14: The budget execution rate accelerated by the end of October.



Source: Ministry of Finance and World Bank staff calculations

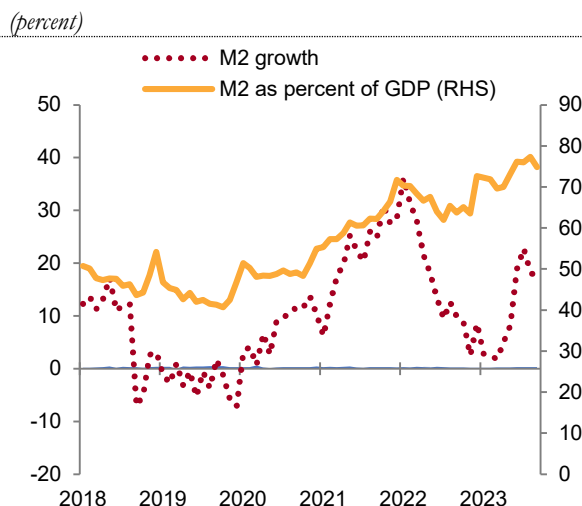
The Petroleum Fund's balance is currently at 10.5 times of GDP, yet its long-term sustainability remains at risk. Petroleum revenue is projected to reach USD 441.2 million in 2023, significantly surpassing the initial forecast of USD 109 million. The increase is primarily due to elevated oil and gas prices throughout the year and payments of delayed profit oil and gas sales receipts. However, production from the Bayu-Undan field has decreased, with revenues from oil and gas sales expected to fully cease in 2023. The field's oil production was recorded at 37.2 million barrels of oil equivalent (boe) in 2021, dropped to 17.3 million boe in 2022, and further declined to just 3 million boe by May 2023. In the absence of oil and gas receipts, future transfers to the state budget will need to be financed by liquidating some of the Petroleum Fund's capital assets, thereby posing a threat to the Fund's sustainability.

1.5. Fiscal expansion has led to ample bank liquidity...

Money supply growth has mirrored fiscal expansion and substantially increased banking sector liquidity. Broad money (M2) as a percentage of GDP has increased rapidly, nearly doubling from 40.7 percent in October 2019 to 74.8 percent in September 2023 (Figure 1.15). This growth rate is higher compared to other Pacific Island countries (Table 1.4). Timor-Leste's money supply growth has closely followed fiscal dynamics. There was a contraction in money supply during the political impasse of 2018 – 2019, followed by slow growth during the pandemic. Subsequently, the expansion in the money supply reflects the significant fiscal expansion in the following years to address the impact of the pandemic and the escalation of commodity prices.

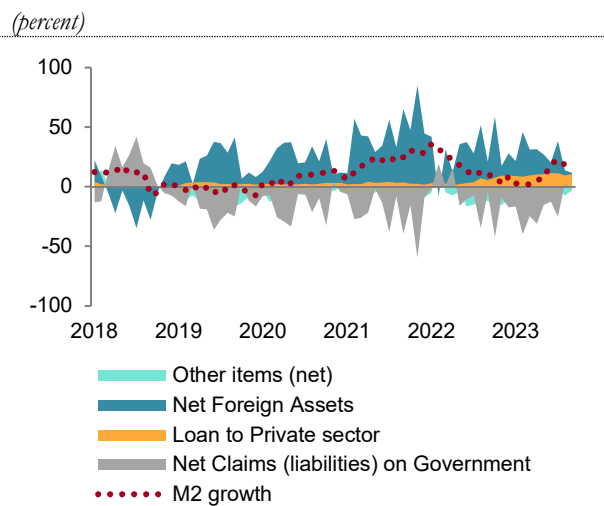
¹⁰ If these revenue measures had been maintained, the estimated revenue impact would have been an increase of around 1.0 percent of GDP.

Figure 1.15: Broad money as a share of GDP nearly doubled between 2019 and 2023.



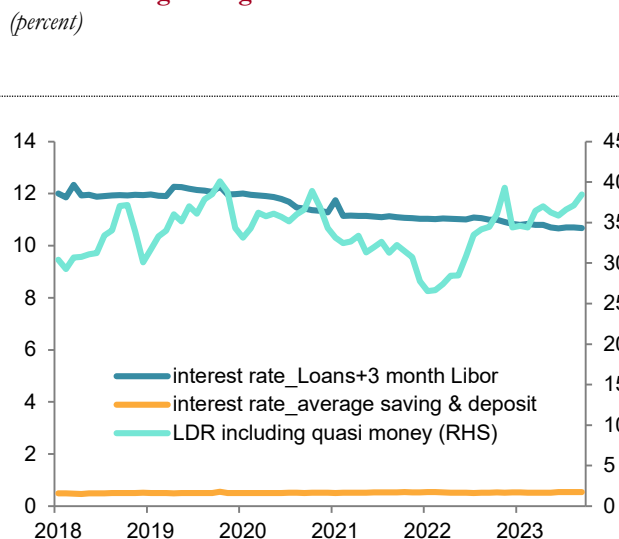
Source: BCTL (Timor-Leste Central Bank)

Figure 1.16: Large overseas placement of bank assets has been the norm.



The very high levels of liquidity in the banking sector is not channeled to the real sector. The banking sector’s assets are mostly placed overseas (Figure 1.17Figure). Loans to the private sector have only recently shown improvement, following the central bank's directive for commercial banks to achieve a loan-to-deposit ratio of 35 percent by the end of 2023 (Figure 1.18). The banks' challenges in assessing the risk from potential borrowers and the lack of a robust legal framework to protect the loans are persistent structural impediments that need to be addressed. Additionally, large government deposits may reflect difficulties in executing the government budget.

Figure 1.17: Loan to deposit ratio continued to recover after declining during the Pandemic.



Source: BCTL (Timor-Leste Central Bank)

Table 1.4: Compared to other Pacific Island Countries, Timor-Leste’s bank credit was relatively low, but the money supply was at the high side.

PICs with central banks	Domestic bank credit as % of GDP (2021)	M2 as a % of GDP (2021)
Fiji	90.5	108.9
PNG	14.1	28.6
Samoa	54.1	60.8
Solomon Island	20.5	44.9
Timor-Leste*	19.5	71.7
Tonga	39.9	55.4
Vanuatu	59.4	92.0

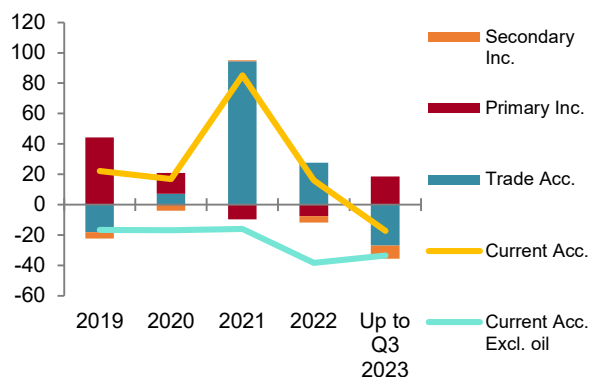
Source: World Development Indicators database for domestic bank credit, World Bank. Asian Development Bank for M2/M3 data. Note: * recalculated as percent of non-oil GDP

1.6. ... and caused large and persistent external imbalances.

The significant external imbalances in Timor-Leste's economy are a result of its persistent and sizable fiscal deficit, coupled with an economy that lacks diversification. Following a surplus in 2021, the current account has experienced sustained quarterly deficits from Q4 2022. By September 2023, the deficit reached 17.1 percent of GDP. The situation appears even more stark when excluding oil and gas exports from the calculations (see Figure 1.18). The imbalances are compounded by highly expansionary fiscal policy that exceeds the economy's absorptive capacity. Conversely, Timor-Leste's domestic productive capacity is insufficient to generate exports that could offset the significant trade deficit. In the first nine months of 2023, cumulative merchandise exports, excluding coffee, plummeted by 85 percent compared to the previous year. This decline was primarily due to the reduction in oil and gas production at the Bayu-Undan field.

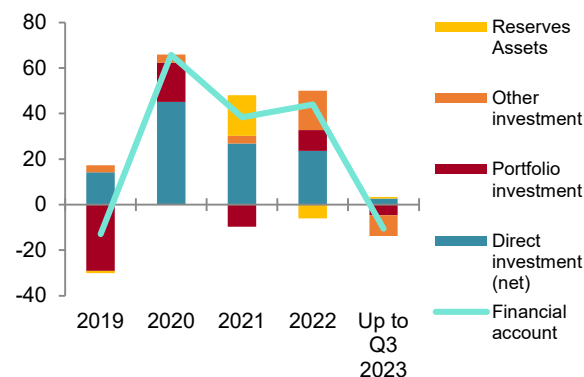
Non-oil and gas exports in Timor-Leste are volatile and relatively minor compared to the overall economy, while the pattern of imports reflects the execution of government spending. In the first nine months of 2023, coffee export revenue saw a 29 percent decrease from the previous year. This decline is partially due to a 21.7 percent fall in the global price of Arabica coffee varieties during the same timeframe. Additionally, the volume of coffee exports has been on a downward trend since reaching its peak in 2016 and has remained low (Figure 1.20). Challenges such as flooding, decreased rainfall, drought, and the overarching impact of climate change have increasingly made coffee cultivation in Timor-Leste much more challenging. Merchandise imports have seen a contraction compared to the previous year, partially owing to the reduced and sluggish government spending (refer to Figure 1.21).

Figure 1.18: The current account deficit worsened due to the deterioration of the trade balance.
(percent of GDP)



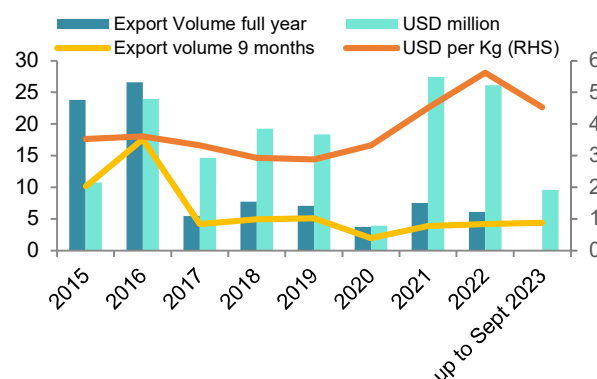
Source: BCTL and World Bank Staff calculation
Note: 2023 Quarterly GDP is estimated by taking the average GDP in 2021 and 2022.

Figure 1.19: The cumulative net financial account recorded a negative balance, driven by low FDI and negative portfolio investment.
(percent of GDP)



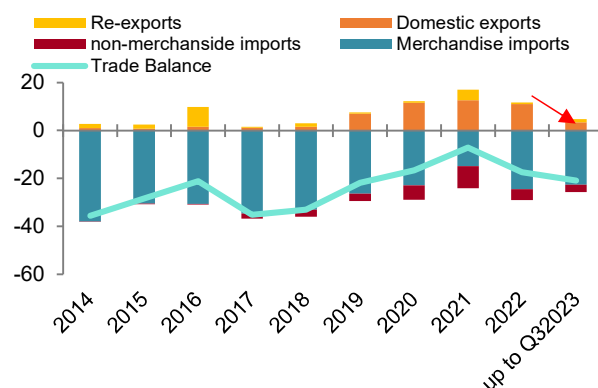
Source: Monthly Trade Report, INETL and World Bank Staff calculation
Note: Merchandise exports and imports include oil and non-oil goods. 2023 GDP is estimated by taking the average GDP in 2021 and 2022.

Figure 1.20: Receipts of coffee exports declined sharply owing to falling prices
(volume (million kg), export value (USD million), and coffee price (USD/kg (RHS)))



Source: Monthly Trade Report, INETL, World Bank Commodity Markets Reports, and World Bank Staff calculation
Note: Coffee price is taking the average price of Arabica Coffee in each respective year or the past 9 months in 2023.

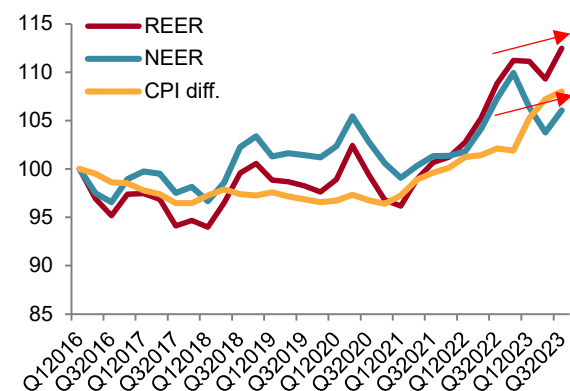
Figure 1.21: Goods imports remained high and contributed to the consistently high trade deficit.
(percent of GDP)



Source: Monthly Trade Report, INETL and World Bank Staff calculation
Note: Nominal GDP number include oil since 2019. 9 months GDP in 2023 is estimated by taking the average GDP in 2021 and 2022.

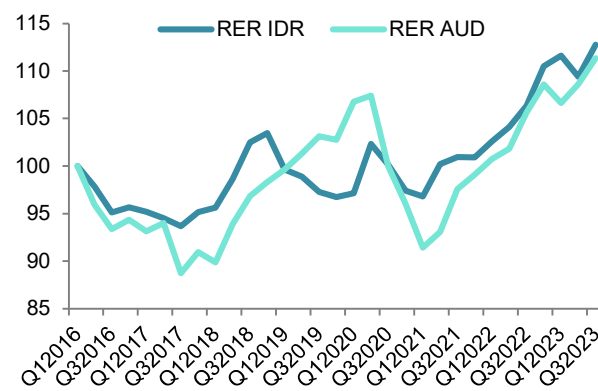
The Real Effective Exchange Rate has appreciated whilst the Nominal Effective Exchange Rate has depreciated slightly, adding to inflation pressures. In the third quarter of 2023, both the indices of US dollar, the legal tender in the country, against the currencies of Timor-Leste's primary trading partners and the Real Effective Exchange Rate (REER) appreciated (Figure 1.22, see also). Year-on-year, the REER increased by 3.3 percent in Q3 2023, while the Nominal Effective Exchange Rate (NEER) decreased slightly by 1.1 percent. A higher NEER and REER add to Timor-Leste's competitiveness constraints. Over the past two years, Timor-Leste's REER index has consistently outpaced the NEER, revealing that inflation in Timor-Leste continues to outpace that of partner countries (Figure 1.23). This pattern is distinct from other regional nations like Thailand, Indonesia, and the Philippines, which have experienced depreciating REERs and slowing inflation rates.

Figure 1.22: REER continued to appreciate, surpassing NEER, due to high domestic inflation.
(index, 2016Q1=100)



Source: BCTL
Note: REER: real effective exchange rate which measuring the average of the bilateral RERs between the country and each of its trading partners along with each trade weights.
NEER: Nominal effective exchange rate

Figure 1.23: Real exchange rate against Indonesia Rupiah and Australian Dollar continued to appreciate.
(index, 2016Q1=100)



Source: BCTL
Note: RER; real exchange rate indexes (adjusted with relative price of goods) between two countries i.e Timor-Leste with Indonesia or Timor-Leste with Australia

Box 1.1: Exchange Rate Regimes in Timor-Leste

The adoption of the US dollar as the official currency in Timor-Leste was initially aimed at addressing the inefficiencies and complications associated with using multiple currencies following the independence referendum in 1999. Presently, the US dollar also aids in facilitating international trade, especially since the country's exports, such as oil and coffee, are primarily denominated in dollars. This strategy has contributed to price stability and reduced exchange rate fluctuations. From 2001 to 2021, Timor-Leste maintained an average annual inflation rate of 4.5 percent, along with a relatively stable real effective exchange rate.

However, this reliance on the US dollar also has drawbacks. A major disadvantage is that it limits Timor-Leste's ability to use monetary policy for macroeconomic stabilization. By adopting the US dollar, the country forfeits control over its exchange rate policy, which is crucial for mitigating the impact of external shocks, like surging food prices.

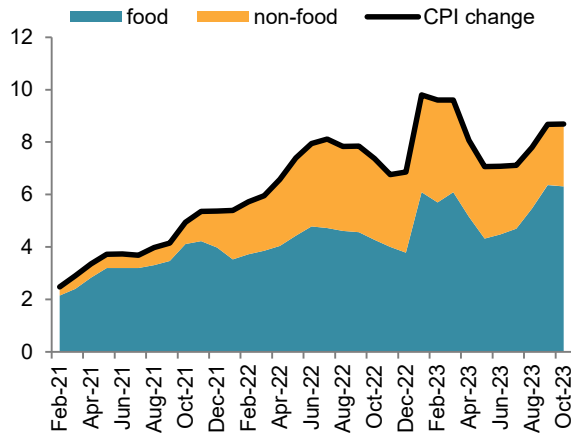
For Timor-Leste to reap the full benefits of introducing its own national currency, the country must first address its fiscal and external imbalances. The current unsustainable fiscal position poses a significant challenge for the Central Bank in managing monetary policy and maintaining price stability. Furthermore, the country's ability to maintain a dollarized economy relies on the Petroleum Fund, as it ensures a consistent supply of US dollars that is important in financing its import expenses. In parallel, establishing effective monetary policymaking would require the development of financial markets, regulatory reforms, and enhancing the technical capabilities of the central bank.

1.7. Despite some moderation, price pressures remain.

Consumer price inflation has remained elevated due to a significant increase in food and non-food prices. The average inflation rate for the first nine months of 2023 was 8.3 percent yoy, 1 percentage point higher than the previous year's inflation rate for the same period (Figure 1.24). The rise in the prices of food and non-alcoholic beverages was mainly driven by higher prices of rice, vegetables, and sugary foods (Figure 1.25). India's policy of banning rice exports was partly responsible for the rise in rice prices globally. Despite the government's efforts to reduce tax rates, including import and sugar taxes, along with the general decline in global prices (Figure 1.26, the cost of tradable goods has continued to stay elevated. This trend persists even with the observed decrease in inflation rates among Timor-Leste's key trading partners (Figure 1.27).

Prices pressures persist despite the appreciation of the US dollar. Consumer Price Inflation in Timor-Leste is driven primarily by global energy prices and NEER (see Box 1.1 of July 2023 Timor-Leste Economic Report). Despite recent minor depreciation, the NEER overall strengthened in 2023 compared to 2022. However, a relatively stronger US dollar has not resulted in lower domestic prices, which may be attributed to several factors. The government's imposition of revenue measures in early 2023 could be a contributing factor. Prices remain elevated, even if these policies are later reversed during budget adjustments, due to ongoing contracts and hedging arrangements that may dampen or delay the effect of exchange rate fluctuations on domestic prices. Additionally, 'menu costs' could be at play, where it becomes impractical for companies to frequently adjust their prices in response to minor exchange rate movements. Moreover, supply-side challenges in the country caused by logistical issues or infrastructure limitations can create bottlenecks that maintain relatively high prices, irrespective of changes in the exchange rate.

Figure 1.24: Inflation remained high, due to food and non-alcohol beverages price inflation.
(percent, change YoY)



Source: INETL

Figure 1.25: The price inflation of rice, vegetables, and sugar related goods were the main contributors to the price's inflation of food and non-alcoholic beverages items.
(percent, change YoY)

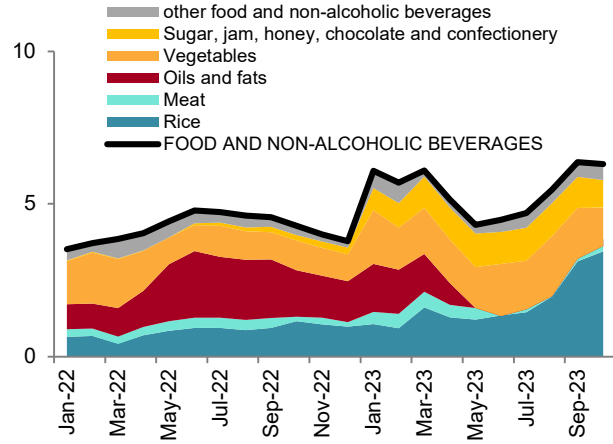
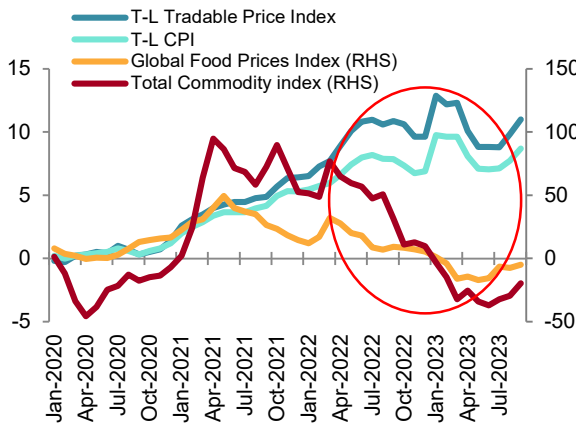
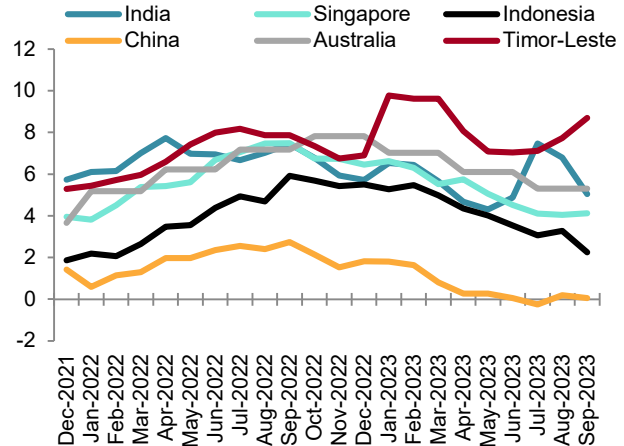


Figure 1.26: Tradable goods prices remained high amidst the deceleration of global prices.
(percent, change YoY)



Source: INETL, World Bank Commodity Markets Reports, and World Bank Staff calculation.

Figure 1.27: Inflation had been declining in Timor-Leste major trading partners.
(percent, Consumer Price Index inflation YoY)



Source: INETL, Haver Analytics and World Bank Staff calculation



BEM-VINDO A WELCOME TO
TIMOR LESTE

2. Outlook and Risks



The economy is expected to maintain its growth trajectory in 2023, extending the slow recovery that began in 2021. Following the severe impacts of the Tropical Cyclone Seroja and Covid-19 pandemic, Timor-Leste’s economy recorded growth of 2.9 percent and 4.0 percent in 2021 and 2022, respectively. However, the growth rate is expected to taper to 2.1 percent in 2023. This deceleration aligns with historical trends observed in years of parliamentary elections, where economic activities typically slow during periods of political transition, primarily due to a decrease in government spending (See Box 2.1). Despite the fiscal drag, the economy is buttressed by relatively resilient private consumption, underpinned by robust remittance inflows and a marked rise in tourist arrivals.

Table 2.1: Economic Forecast
(percent)

	2020	2021	2022	2023e	2024f	2025f	2026f
Real non-oil GDP growth	-8.3	2.9	4.0	2.1	3.6	4.5	4.0
Private Consumption	-1.3	-2.7	14.0	3.0	4.0	5.0	5.5
Government Consumption	4.9	2.9	-0.2	3.1	2.4	2.4	1.4
Gross Fixed Capital Investment	-46.9	-6.1	29.4	10.8	10.6	10.7	9.3
Public investment	-47.2	-14.9	29.7	13.2	12.2	12.2	10.2
Private Investment	-45.5	40.9	28.6	3.0	5.0	5.0	5.5
Export, Goods and Services	-47.3	79.3	30.3	1.0	2.0	2.0	2.0
Import, Goods and Services	-7.0	-9.0	22.8	5.0	5.0	5.0	5.0
Inflation (Consumer Price Index)	0.5	3.8	7.0	8.4	3.3	2.8	2.5
Fiscal Balance (percent of non-oil GDP)	-25.3	-47.0	-60.7	-44.4	-43.5	-45.9	-47.6
Current Account Balance (percent of non-oil GDP)	-19.1	2.8	-17.0	-20.6	-42.0	-43.1	-45.1

Source: INETL, World Bank Staff Estimate and Forecasts.

Economic growth is projected to average 4.0 percent in 2024 and 2026 (Table 2.1). In the aftermath of the election and the ensuing orderly transition of government, both private consumption and investment are projected to increase their contributions to economic activity. Moreover, the government's emphasis on capital expenditure and infrastructure spending is expected to further stimulate growth. Nevertheless, export growth is expected to face limitations, primarily due to the reliance on coffee as the main export commodity.

Box 2.1: Growth and Budget Execution during Political Years

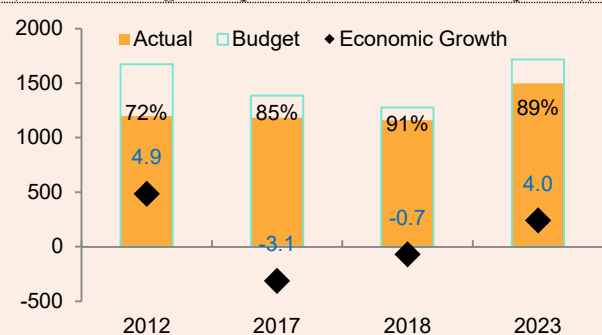
Timor-Leste's government spending has been the main driver of the economy. The incoming government in 2007 took the decision to scale up spending beyond what the ESI could finance to speed up the pace of development. GDP growth in the years following reflected this scaling up of public spending from a low base. The relatively high growth then tailed off once public spending stabilized at a new level, evident in falling average growth rates since 2012. Private consumption has also contributed to growth, likely explained by second round effects of increased government spending, particularly increases in cash transfer programs. On the other hand, contribution of private investment to growth has been relatively small compared to the public sector.

Regular budget revisions take place during the year. The initial budget approved by Parliament often suffers modifications, either through a budget rectification or virements. While this flexibility enables a response to changing circumstances, it also undermines the credibility of the budget as a statement of government policy. During the last five years, budget rectifications – which are amendments that require parliamentary approval – were made in almost every year except in 2019 and 2020. The budgets, however, were approved by considerable delay during the two years by more than a month and 9 months, respectively. Virements – which entail a shift of appropriations – have also occurred nearly every year.

The allocated budget has rarely been fully executed, particularly during political cycles, which leads to subdued economic performances. Yearly budget execution rates show significant variations. Notable under-budgeting is observed in 2008 and 2010 while considerable over-budgeting occurred in most years, indicating sub-optimal planning, budgeting, and implementation. The challenges in budget execution were particularly pronounced during the pandemic years of 2020 until 2022 and in most of the election years. The sub-optimal budget execution can be attributed to reduced government activities near elections and the new government's focus on adjusting the budget, leading to a shorter timeframe for budget execution within the year. Consequently, both budget execution and economic growth performance have suffered during these periods (Figure 2.1).

Figure 2.1: The low budget execution, especially during the election years, led to poor economic performance.

(USD million, growth (percent) and execution rate (percent))



Source: Ministry of Finance
Note: compared to revised budget

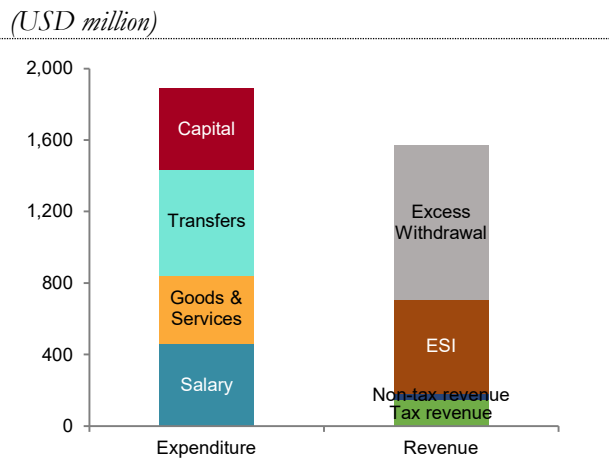
Inflation is projected to ease in 2024. Price pressures are forecast to abate during the year, driven by a moderation in global commodity prices and a stabilization of global food security conditions.¹¹ Additionally, reduced inflation rates in the trading partners of Timor-Leste are expected to lessen the impact of imported inflation.¹² Albeit beneficial in easing price pressures, the new government's decision to revoke the implementation of revenue measures, such as excise duties on sugar, sugary beverages, and tobacco, may undermine efforts aimed at increasing revenue collection and controlling the consumption of goods that have negative health impacts.

¹¹ See World Bank October 2023 World Food Security Outlook.

¹² The CPIs of Indonesia, China and Singapore, have retreated to 2.9 percent, 0 percent and 4.1 percent respectively in Q3 of 2023, a significant decline from 5.2 percent, 2.6 percent and 7.3 percent during the same period in 2022.

Without significant fiscal reforms, the fiscal deficit is expected to persist at around 43 percent of GDP in the medium term. Recent efforts to increase domestic revenue collection have been rescinded while government spending has seen a marginal nominal increase for 2024. With expenditures reaching close to 90 percent of GDP in 2023, Timor-Leste's spending ranks among the highest globally and is unsustainable. The budget gap is being bridged by withdrawals from the Petroleum Funds, but this source is diminishing rapidly. Once the Petroleum Fund is entirely depleted, a scenario currently anticipated to occur in 2034, the government will be required to identify alternative revenue sources to supplant the withdrawals from the Fund, which currently represent 70 percent of the 2023 revenues (See Figure 2.2). Without these measures, a significant reduction in spending will be necessary, potentially leading to a sharp decrease in the provision of public services, a situation often described as the 'fiscal cliff'.

Figure 2.2: Nearly 70 percent of revenues is at risk in the event of the complete depletion of Petroleum Fund.



Source: Ministry of Finance

The outlook is subject to downside risks. The consequences of severe weather events, particularly those associated with El Niño, are likely to affect rice availability. Concurrently, elevated international commodity prices may erode the purchasing power of less affluent households. Moreover, increased energy prices are expected to influence both transportation costs and electricity generation prices. The augmented food and energy prices, which constitute more than half of consumption basket, may necessitate a fiscal response that could hinder efforts to restrain expenditures. The performance of the US dollar—which serves as the country's legal tender—against the currencies of Timor-Leste's primary trading partners significantly affects the real effective exchange rates. This, in turn, impacts international competitiveness. Should international stock markets experience a downturn, the Petroleum Fund's investment returns could be adversely impacted.

Timor-Leste faces the critical challenge of balancing its developmental needs, which require substantial government spending, with the imperative of fiscal consolidation to ensure the sustainability of the Petroleum Fund. Timor-Leste continues to grapple with gaps in human resources, institutional capacities, and infrastructure. Successive governments have adopted a policy of frontloading public investments to stimulate the economy. The proposed 2024 budget commendably prioritizes capital expenditures (See Box 2.2). However, it also outlines planned increases in recurrent expenditures and exhibits an ongoing rise in overall government spending, projected to increase annually by 7 percent from 2024 until 2028, despite the acknowledgment of the impending depletion of the Petroleum Fund. Considering that substantial public expenditure have thus far yielded limited benefits, it is plausible for the government to improve spending efficiency so that the growth levels can be maintained with a more restrained budget.

Achieving the IX Constitutional Government's 5 percent annual economic growth target hinges on implementing policies for a sustainable and diversified economy. While enhancing the efficiency and effectiveness of government spending may stimulate growth, the impacts of this strategy are likely to be significant only in the short-term. As such, maintaining growth at the 5 percent level depends largely on robust contribution from private consumption and investments. In turn, a key factor in sustaining private consumption is a vibrant private sector that provides stable employment opportunities. The success of the private sector however relies on creating an environment that supports its dynamism and growth. In this regard, financial deepening and inclusion are essential, as they provide the private sector with access to financial products and services that enables businesses to drive economic activities and contributes to overall economic growth (see Chapter 3).

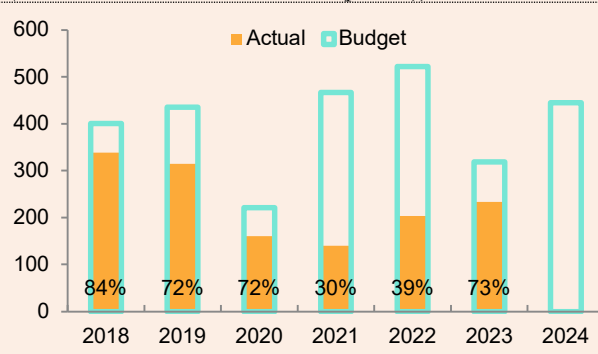
Box 2.2: Proposed 2024 Budget

The proposed 2024 budget, the first to be comprehensively assembled by the IX Constitutional Government, is outlined in a document titled "Bridging for Tomorrow: Investing in the Productive Sectors and Social Capital".¹³ The document allocates an amount equivalent to 101 percent of the GDP, marginally higher than the 2023 rectification budget.

The 2024 budget draft suggests an increase in capital spending from 18.4 percent of GDP in the 2023 rectification budget to 24.5 percent of GDP. This expansion is a positive step towards bridging the country's significant infrastructure gap. Well-planned and executed capital spending can help ease the economy's supply constraints, lower production costs for the private sector, encouraging its growth or crowd-in private investment. However, implementing the proposed budget allocation poses challenges. The capital spending allocation for 2024 surpasses the highest level of capital expenditure ever executed in the country's history. Notably, capital spending is a category that has consistently posed execution challenges (Figure 2.3). Effective execution of capital expenditure requires the government to implement complementary reforms simultaneously. Key among these are procurement reforms, which are crucial for alleviating procurement bottlenecks and improving competitiveness and transparency. Additionally, enhancing public investment management is essential to ensure that public spending positively impacts economic growth.

Figure 2.3: Planned capital budget was high, but execution was low.

(USD million and execution rate (percent))



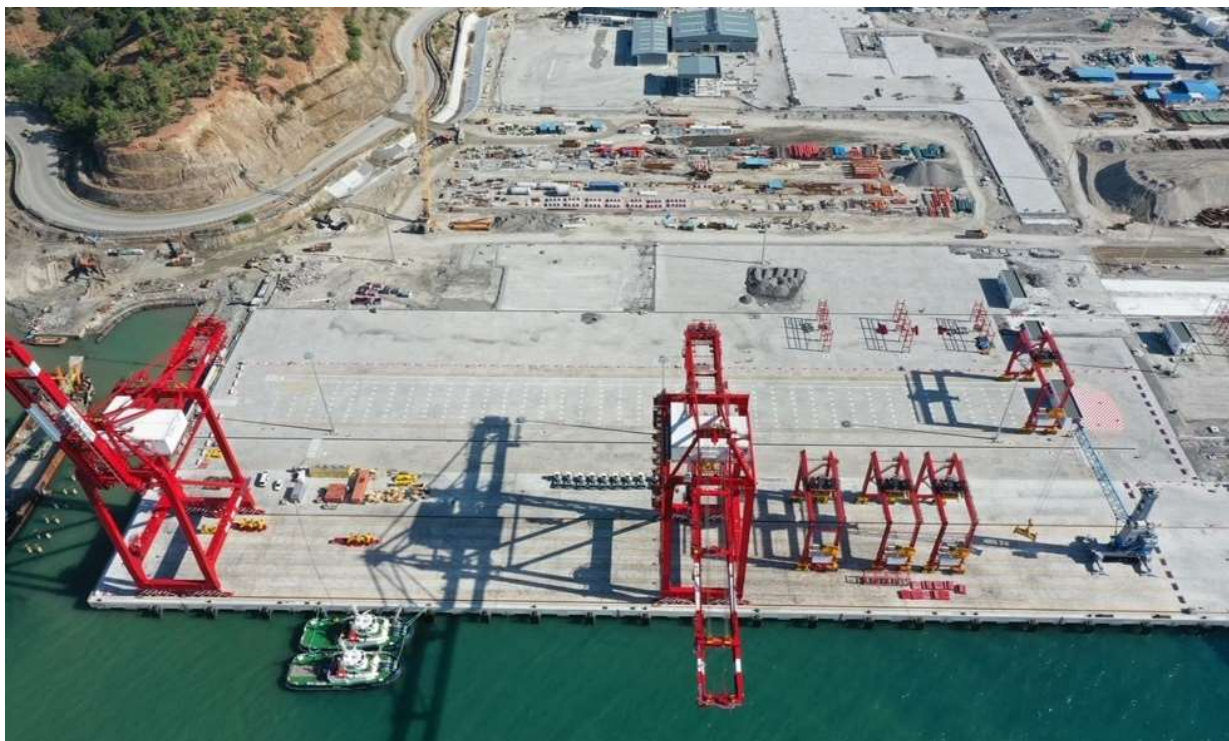
Source: Ministry of Finance

The expenditure on salaries and wages continues to grow and requires scrutiny. The government allocates 25.8 percent of GDP to wage bills, which is slightly lower than the rectified budget, but 1.2 times nominally higher than the pre-pandemic 2019 budget. This increase is attributed to several factors: (i) the reallocation of consultant compensation, previously recorded under goods and services, (ii) the increase in Timor-Leste's regional and global presence following efforts to join both the WTO and ASEAN, and (iii) the expansion of government presence domestically, in line with efforts to further decentralize service delivery. While spending on salaries and wages does not make up a large portion of total expenditure, it is relatively high compared to regional and income peers, as well as other small (island) states. Public sector reforms and innovation are necessary to prevent a rapid increase in fiscal rigidity caused by inefficient public sector spending.

Enhancing transparency, effectiveness, and efficiency is crucial, as public transfers have significantly increased and now represent the largest budget allocation. The 2024 budget sets aside 32.5 percent of GDP for this purpose, almost similar to the 2023 budget but 63 percent nominally higher than in the pre-pandemic year of 2019. While there is scope for enhancing social protection (see the December 2022 Timor-Leste Economic Report), improved transparency and stronger justification for transfer spending would be beneficial. For example, despite substantial cash balances reported for RAEOA, EDTL, Timor-Gap, and BeeTL, the budget continues to allocate considerable sums to these entities without adequate explanation. A combined total of USD 179.2 million, equivalent to 9.5 percent of the 2024 budget (10 percent of GDP), is also designated for State-Owned Enterprises, with the expectation that this support will continue until they achieve financial independence. Medium- and long-term planning for these organizations is essential to reduce the financial burden they place on the budget and to safeguard fiscal consolidation reforms.

¹³ The draft of 2024 budget was presented to the Parliament on November 23, 2023. At the time of the writing, the budget is yet to be discussed with debate on specifics is scheduled for December 14 – 20 and for the President to enact before the new year starts. Changes between the draft and the final version are likely to happen.

3. Fit for Purpose: Crafting a Stable, Inclusive and Resilient Financial Sector in Timor-Leste



3.1. Introduction

Timor-Leste has made important development gains since its birth as a nation in 2002 yet remains beset by low and volatile economic growth. Over the past two decades, public institutions have been built up from scratch, poverty has gradually declined, and commodities have buoyed public revenues.¹⁴ However, pursuing a growth model driven heavily by public spending, the country has faced substantial challenges in expanding its private sector, diversifying drivers of growth, and generating jobs for young people entering the workforce. Given declining oil reserves and the diminishing returns of public investments, pursuing a sustainable development path now requires a shift towards a more dynamic, private sector driven growth model.

The development of a robust financial sector can hasten Timor-Leste's pursuit of broad-based growth. Access to formal financial services such as savings, credit, insurance, and other financial tools can enable households to save and invest in income-generating activities, education, healthcare, and housing, breaking the cycle of poverty. Moreover, an inclusive financial system can ensure that marginalized communities, including women and rural populations, can participate in economic activities and benefit from the country's economic progress. Modernizing and digitizing financial services can spread the reach of safety nets and social transfer programs to those who still lack formal bank accounts, smoothing household incomes and enabling economic opportunities for those most in need.

¹⁴ The impact of recent developments on poverty reduction is uncertain due to the absence of updated data. Between 2007 and 2014, poverty dropped from 50.4 percent to 41.8 percent. A new Living Standards Survey is planned for 2024.

Financial sector development can be a gateway for structural transformation of Timor-Leste’s resource dependent-economy. A well-regulated and transparent financial sector attracts foreign direct investment (FDI) and stimulates domestic investment. Investors, both local and international, are more likely to engage in economic activities when they have confidence in the financial institutions and regulatory frameworks. The inflow of capital not only supports the expansion of existing businesses but also contributes to the development of new industries, fostering resilience and much needed economic diversification away from the overreliance on hydrocarbon exports. As Timor-Leste diversifies its economic base, it becomes less susceptible to external shocks which benefits long-term stability and protects economic livelihoods.

The special chapter of the Timor-Leste Economic Report analyzes Timor-Leste’s financial sector through the inter-related lenses of financial stability, financial inclusion, and financial resilience. Within each area of analysis, the chapter analyzes the current state of play, identifies key development priorities, and articulates strategies and areas of engagement to address key priorities. The note has been developed through a close partnership between the World Bank and Timor-Leste’s central bank, Banco Central Timor-Leste (BCTL).

3.2. Financial Sector Context

For a small low-income country, the financial sector in Timor-Leste is remarkably diverse, encompassing a variety of actors. Banks dominate the financial system in terms of the size of their assets and customer base, but the financial system also includes insurance companies, money transfer operators, financial cooperatives, credit unions, and microfinance institutions. The central bank, Banco Central de Timor-Leste (BCTL), serves as the monetary authority and regulator of financial institutions in the country. It also has responsibility for overseeing the payment system and performs key functions in the payment and settlement system, including facilitating inter-bank settlement.

The banking system is comprised of five banks, four of which are branches of foreign-owned banks.¹⁵ The foreign-owned banks primarily serve international organizations and their staff, and businesses and nationals from their respective home countries. Products for Timorese citizens are largely limited to basic savings accounts and fee-based services, with issues around land titling and contract enforcement constraining bank risk appetite in extending credit. Non-deposit lending institutions including microfinance institutions also operate in the market. The only local bank, Banco Nacional de Comercio de Timor-Leste (BNCTL), is owned by the government. BNCTL has a large and predominantly local customer base, making it strategically important in Timor-Leste’s pursuit of a more inclusive finance sector. It also has the widest outreach and branch network of all the banks operating in the country.

Non-bank financial markets and capital markets are yet to take root in Timor-Leste. A legal framework for providing insurance is in place, and there are three licensed firms providing business insurance, which includes general business, liability, property and casualty insurance, and life insurance. ^(b)Insurance is compulsory but unenforced. Micro-insurance products have been piloted through partnerships between insurance companies and microfinance institutions, but do not have wide outreach. Overall, the market for insurance remains embryonic¹⁶ with only a small proportion of the population accessing some form of insurance product. ^(b)The limited use of insurance is an impediment to business and the availability of credit. So far, Timor-Leste does not have equity and bond markets, and no government bonds are issued.

¹⁵ The international banks operating in Timor-Leste are BNU (Portugal), ANZ (Australia), Bank Mandiri (Indonesia) and Bank Rakyat Indonesia (Indonesia). Together, the banking sector controls 97.2 percent of financial sector assets in Timor-Leste, and over 90 percent of the customer base, with the remainder from microfinance institutions.

¹⁶ Consumer confidence in the country’s insurance providers might be low due to a series of financial irregularities and misappropriation of funds at National Insurance Timor-Leste, which led to the imposition of sanctions and a subsequent management takeover by BCTL in 2017.

Macro-financial indicators

Figure 3.1: Domestic credit (percent of GDP)

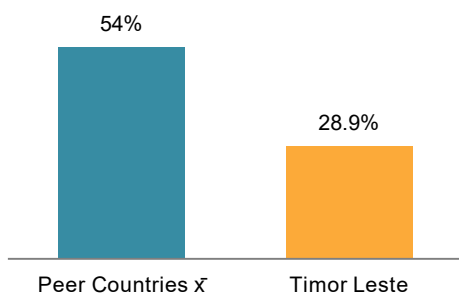
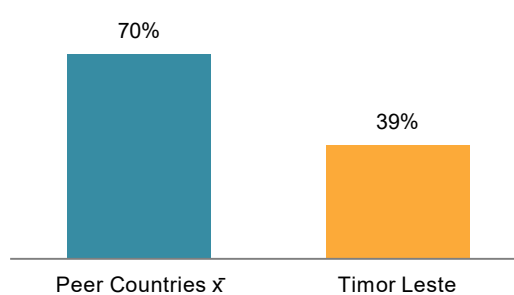


Figure 3.2: Broad money (percent of GDP)



Key financial inclusion indicators

Figure 3.3: Bank Branches per 1'000 adults

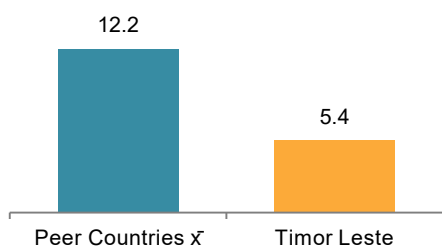
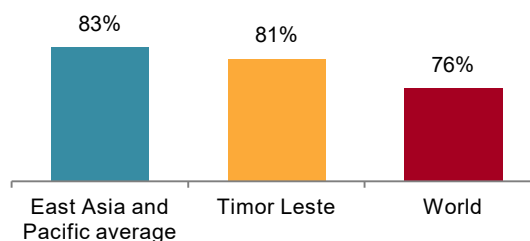


Figure 3.4: Account ownership at a financial institution or with a mobile money service provider



Key financial stability indicators

Figure 3.5: Capital Adequacy Ratio

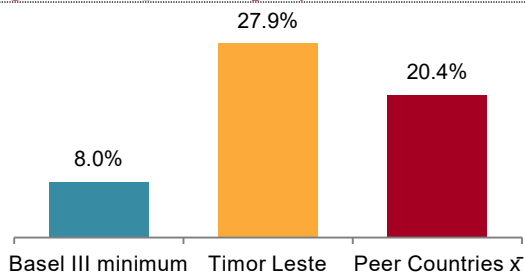
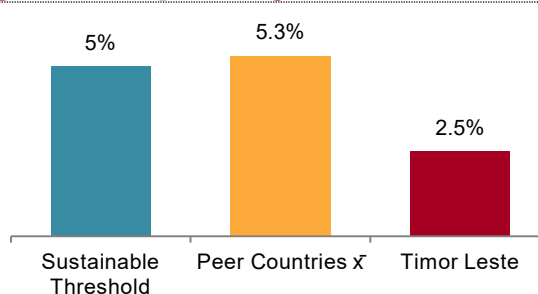


Figure 3.6: Non-performing loan ratio



Source: BCTL Annual Report 2021, World Bank Data, IMF Financial Access Survey
Peer countries include Papua New Guinea, Fiji, Comoros, Mauritius, Cabo Verde, Bhutan, and Rwanda.

Overall, access to basic financial services in Timor-Leste is trending upwards, while more sophisticated financial services remain nascent. Among the adult population, 64 percent had access to a bank account in 2022, an increase from 61 percent in 2020. However, only 8 percent of account holders report ever having accessed credit from their financial institution. BCTL has placed significant emphasis on enhancing the outreach of financial services, by expanding access to both bank branches and digital financial services. With BCTL's support, two of the country's Telcom providers have introduced e-wallets that can be used for payments, transfers, and other transactions.¹⁷ While promising, these digital products are yet to achieve scale and reach a broader user base, with 22 percent of the adult population registered as e-wallet clients, and the number of active users being considerably smaller.

¹⁷ These online services have been the main driver of a 200 percent increase in financial service access points and the improved financial access in the more remote areas of the country. Currently, all subdistricts are covered by financial services access points, and 391 out of 452 of villages have at least one financial service access point.

Timor-Leste's financial sector is stable, and with careful prudential management it has remained resilient in the face of temporal shocks. The COVID-19 pandemic substantially weighed down domestic economic activity, but adverse impacts on financial sector stability remain limited. After a sharp contraction in economic growth in 2020, Timor-Leste subsequently rebounded, with non-oil GDP rising by 2.9 percent in 2021. Despite the challenging macroeconomic context, authorities maintained financial sector stability and mitigated the impacts of the pandemic by providing rapid and timely interventions, including a credit moratorium and forbearance measures in August 2020. The stability of Timor-Leste's credit markets is closely correlated with their limited outreach, however, with no financial institutions exposed in a meaningful way to either consumer or corporate credit. As a result of limited bank exposures, capital adequacy and liquidity ratios were comfortably above regulatory thresholds in the years preceding the pandemic and have remained stable through the pandemic period. Non-performing loans (NPLs) remain low and comparable to pre-pandemic levels, at 2.5 percent (2021).¹⁸

3.3. Financial Stability in Timor-Leste

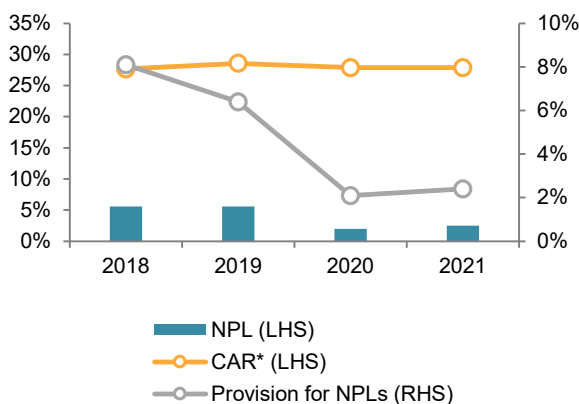
Timor-Leste's financial system is relatively stable and has remained resilient in the face of temporal shocks. The banking sector has been clearing a legacy of bad debts related to premature expansion of banking sector credits: pre-COVID-19, the non-performing loan (NPL) ratio has been on a declining trend from 42 percent in 2010 to 5.6 percent in 2019. This trend continued with the banking sector's NPLs standing at 2.5 percent in 2021, a slight increase from the 2.0 percent recorded in 2020. Prudential policy has been successfully used to mitigate the financial impacts of the pandemic. BCTL took an accommodative stance towards loan impairment by introducing a credit moratorium in August 2020, which led to 23 percent of total bank loans being restructured. The scheme was extended several times and then phased out in March 2022, when risks had subsided. In general, small and highly selective credit portfolios limit banking sector exposures.

High levels of capitalization provide a considerable source of strength for the banking sector in terms of future capacity to absorb potential losses. The financial sector continues to be financed almost entirely on the basis of resident deposits. Deposits increased from USD1,108 million in 2020 to USD1,448 million in 2021; deposits accounted for 73.5 percent of banking liabilities in 2020, and 77.5 percent in 2021. Less than a third of these resources are lent to companies and individuals, so that the banking system as a whole continues to record a robust liquidity position. Branches of foreign-owned banks are not subject to capital adequacy requirements by the central bank. The only local bank, BNCTL, has capital levels comfortably above the regulated minimum with a capital adequacy ratio of 27.9 percent at the end of 2021, but its state ownership raises potential risks of directed lending. BNCTL's limited risk management controls and exposure to political pressure (to lend) pose some risks.

Robust profitability levels of banks are also conducive to financial stability. Bank profits, mainly consisting of interest income and fees charged to their customers, have been at solid levels in the past years and act as a buffer against negative shocks. In 2021, banks' operating revenues amounted to a total of USD42.8 million, a decrease of 8.8 percent compared to the previous year and offsetting the upward trend recorded since the end of 2018. With interest costs, commissions, and taxes the banking system's consolidated net income decreased to USD14.3 million in 2021 from USD17.1 million in the previous year. This decrease explained the bulk of the contraction in the return on assets (RoA) ratio in 2021 to 0.78 percent, compared to 1.16 percent in 2020 as well as the reduction in the return on equity (RoE) ratio to 10.6 percent from 13.1 percent. It should be noted, however, that these two ratios decreased more than the fall in absolute net income, which was explained by the expansion of banks' assets and capital.

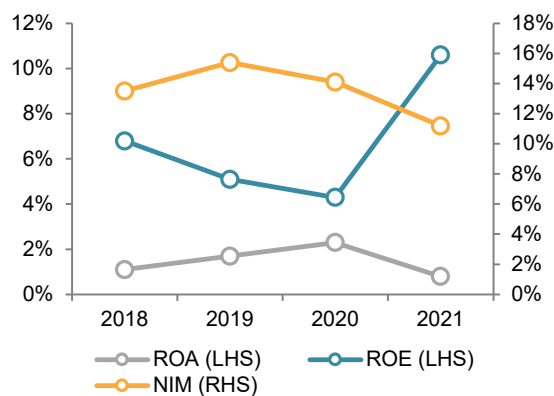
¹⁸ Loans at Risk (LARs) are not tracked by BCTL. However, discussions with banks indicate that LARs do not seem to be elevated, with most restructured loans during the pandemic benefiting from a grace period, but now in good status.

Figure 3.7: Asset Quality



Source: BCTL Annual Report (2021); IMF Financial Soundness Indicators (2022.)
 Note: * Covers BNCTL only.

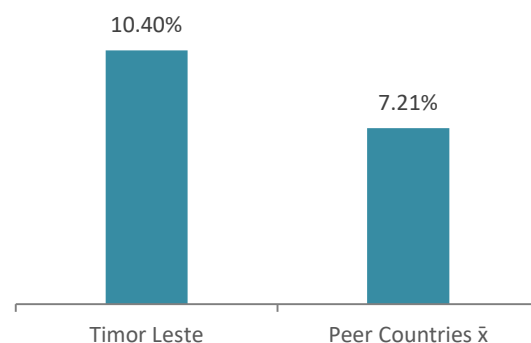
Figure 3.8: Profitability



Source: IMF Article IV (2022), BCTL Annual Report (2021)

While profitability of banks contributes to broader financial stability, high interest rate spreads also signal distortions in financial markets. Interest rate spreads, defined as the difference between the lending and deposit rates, serve as a critical determinant of the cost of capital for businesses and individuals. The net interest rate spread of banks in Timor-Leste remains well above the average of peer countries (7.2 percent), although it reached a ten-year low of 10.4 percent in 2022. As a result of high costs of borrowing, the private sector may be unable to generate positive returns on financed investments, and instead opts to hold funds in low-yielding deposits without investing it. Additionally, the high cost of borrowing can dampen consumer spending, further restraining economic activity.

Figure 3.9: Net Interest Margins



Source: World Bank Data (2022)

Quality of risk management of financial institutions is adequate, given that banks are limited in number and are highly selective when providing credit. There exists a credit registry information system, which is not fully optimal, but is operational with participation of all commercial banks and has the ability to exchange detailed information about borrowers and better supervise their portfolios. In the absence of secure collateral arrangements, commercial banks impose rigorous checks and documentation requirements on applications for credit.

Whilst current banking supervision is effective and has proven resilient to the pandemic-induced shock, emerging economic risks necessitate an ongoing focus on the development of early warning indicators and stress testing. The Central Bank currently collects large amounts of financial sector data, which could be further leveraged to provide country-level assessments and detect emerging financial sector stress points. Regular financial stability assessments and the collection of data on specific early warning indicators could support the institution in anticipating emerging risks. Greater integration between stress testing and the calibration of prudential regulation and supervision could also ensure that financial sector data has a real-time impact on policies and regulation. Finally, working with banks to improve the quality of financial reporting to a level consistent with international standards could add greater confidence to banking sector data.

Vulnerability exists in terms of recovery and resolution capacity, and due to the absence of financial safety nets. Financial safety nets are largely absent in the country. No deposit insurance scheme is in place and there is no structured systemic resolution funding. As such, if the need for resolution arises, financial supervisory authorities would largely depend on ad-hoc public bailouts, which are prone to moral hazard and fiscal risks. Desirable initiatives would include the establishment of pre-funded deposit insurance schemes and systemic resolution funding mechanisms that could provide a safety buffer in the event of a banking sector crisis. These could be publicly funded initially but include the capacity for ex-post levies on banks to recover net outlays.

Table 3.1: Financial Stability in Timor-Leste
(in percent)

	2018	2019	2020	2021
Capital Adequacy				
Capital Adequacy Ratio	27.7	28.6	27.9	27.9
Non-performing loans to total gross loans	5.6	5.6	2.0	2.5
Provision for loan losses to total gross loans	8.1	6.4	2.1	2.4
Earnings and Profitability				
Return on Assets	1.1	1.5	1.1	0.8
Return on Equity	16.0	18.5	13.1	10.6
Liquidity				
Liquid Assets to Total Assets (Liquid Asset Ratio)	80.5	91.1	79.5	79.0

Source: IMF, Financial Soundness Indicators Database; BCTL Annual Reports

Foreign banks provide benefits for Timor-Leste's financial stability but are at the same time a source of risk. The presence of foreign banks is beneficial for the domestic financial system including through strengthened competition, provision of deeper and more diverse financial services, and a deepening of credit channels. On top of that, foreign banks with strong parentage and sound home supervision, as is the case for the banks from Australia (ANZ) and Portugal (BNU) for example, improve the resilience of the financial system to domestic economic shocks, given their ability to absorb credit losses with little impact on the strength of the parent banking group balance sheet. Against these benefits, the presence and importance of foreign banks also pose a risk to financial stability. A withdrawal or retrenching of foreign banks would lead to a reduction in competition, a contraction of available financial services and could lead to their acquisition by banks with poorer standards of governance, risk management, and capital strength. BCTL's ongoing oversight of foreign banks and its policies governing withdrawal of operations remain important buffers in mitigating these risks.

3.4. Financial Inclusion in Timor-Leste

Financial inclusion means that individuals and businesses have access to useful and affordable financial products and services that meet their needs – transactions, payments, savings, credit and insurance – delivered in a responsible and sustainable way. The analysis that follows explores financial inclusion of both firms and households in the country, with a view to understanding key constraints and challenges.

3.4.1. Access to finance for firms

The private sector in Timor-Leste is small and incipient, and its development will be essential to accelerate growth and sustainably raise living standards. With fewer than 7,000 registered firms employing 52,200 workers, Timor-Leste's non-oil private sector must grow substantially to meet national targets of the creation of at least 50,000 new jobs over the next five years.¹⁹ Data from World Bank Enterprise Surveys, most

¹⁹ Timor-Leste's Strategic Development Plan 2011-2030 prioritizes private-sector growth, calling for (i) an average economic growth rate above 7 percent, (ii) an increase in private investment by at least 10 percent per annum, and (iii) the creation of at least 60,000 new jobs per year. The 9th Constitutional Government adopted a more realistic job creation target of 50,000 jobs over 5 years.

recently conducted in 2022, show that access to finance has been consistently identified as one of the top three obstacles for firms in Timor-Leste since 2009. As a result of limited access to finance, as well as related challenges of political instability, World Bank Enterprise Survey data indicates that private investments in workers, innovation and productive assets in Timor-Leste are a fraction of the levels of regional comparators.

Access to credit is reported as a leading challenge by firms in the country, limiting their expansion and growth. While three out of four firms have a checking or savings account, only 8 percent have a loan or a line of credit, far below the average in peer countries (36 percent). Most firms rely on internal funds to finance their investment and working capital. A large share of firms financed their needs internally (92 percent) and a small percentage of firms use banks to finance working capital (5 percent) and for investments in fixed assets (3 percent). While around 15 percent of manufacturing firms have a loan or line of credit, only 6 percent of firms in the services sector do.

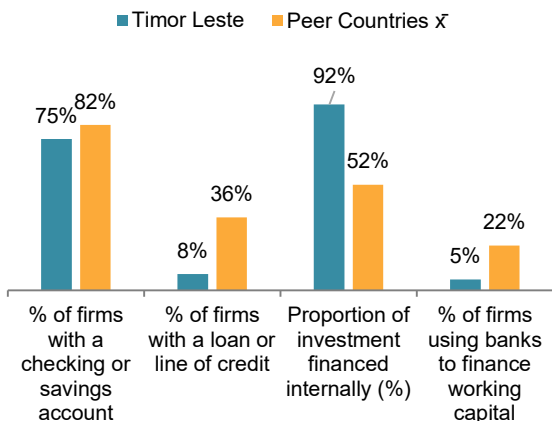
Lack of sufficient collateral and high interest rates are the main constraints expressed by firms in accessing loans. On average, firms must have collateral as much as 325 percent of the loan size, significantly higher than the average collateral needed in the region at 242 percent. Lending rates are an additional constraint. For example, 17.7 percent of firms reported being discouraged from obtaining new loans due to unfavorable interest rates, which usually exceed 10 percent per annum. An additional impediment to improving formal financial access is the lack of interest from the private sector in such bank services. Indeed, the latest World Bank Enterprise Survey (2022) showed that 63 percent of firms decided not to apply for a loan due to the lack of need for additional bank financing.

Banks are risk-averse in granting credit, due to a number of institutional constraints, chief amongst which are insecure property rights, contract enforcement challenges, and absence of common accounting rules. Property rights remain highly uncertain in Timor-Leste, which means that land often cannot be used as collateral.²⁰ This is reflected in statistics which show that 70 percent of respondents in Timor-Leste used equipment as collateral to secure a loan. In peer countries, the common collateral was land. The lack of a common accounting model and absence of audited financial statements allowing for a clear and objective assessment of the financial condition of a given company applying for credit, also constitutes a major obstacle that prevents the commercial banks from granting credit due to the high perceived credit risk involved. An outdated bankruptcy framework and weak contract enforcement systems also add uncertainty about lenders' rights.

The host of constraints facing financial institutions are echoed in the low credit provided to the private sector. The country's private sector credit-to-GDP ratio has grown over the past few years, reaching a high of 28.9 percent in 2023. Despite this rise, the ratio remains substantially below the average of peer countries, which stands at 54 percent. In absolute terms, private sector credit recorded a significant increase of 33 percent (US\$89 million) in 2022, continuing the incremental increase in credit granted by banks since 2019. Overall, credit composition of banks has historically been dominated by individual consumer loans (53 percent). Credit is not only limited in volume but is also allocated sub-optimally across sectors. In the context of corporate credit, the construction (18.2%), and transport and communication (13.3%) continue to receive the lion's share of corporate credit and experienced a significant growth in 2022. This results from banks' tendency to finance corporate clients that have secured large government contracts for infrastructure or works. The agriculture and industry sectors, two important sectors for the country's economic development, represent only 0.4 percent and 4.6 percent of total loans granted.

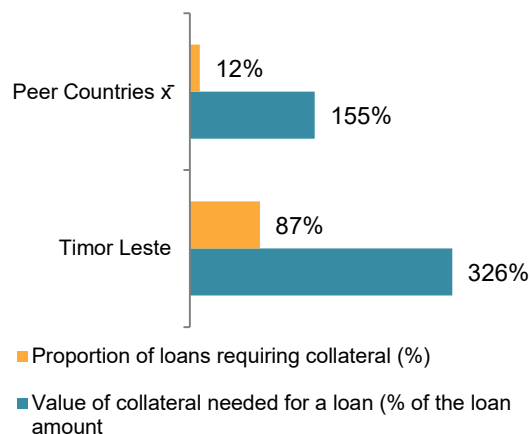
²⁰ Article IV IMF states that "weaknesses in the collateral regime, contract enforcement and in credit registry information were noted as significant obstacles to credit expansion, especially to businesses."

Figure 3.10: Access to finance for firms (cross-country comparison)



Source: World Bank Enterprise Surveys

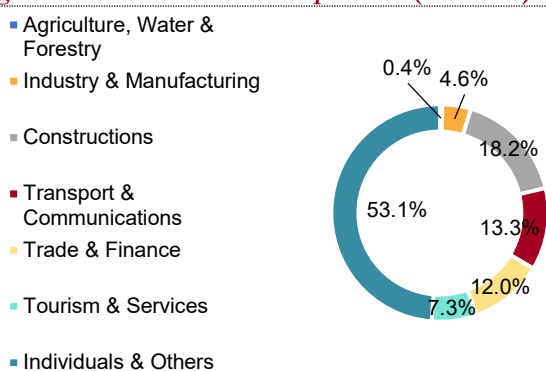
Figure 3.11: Loan and collateral



Source: World Bank Enterprise Surveys

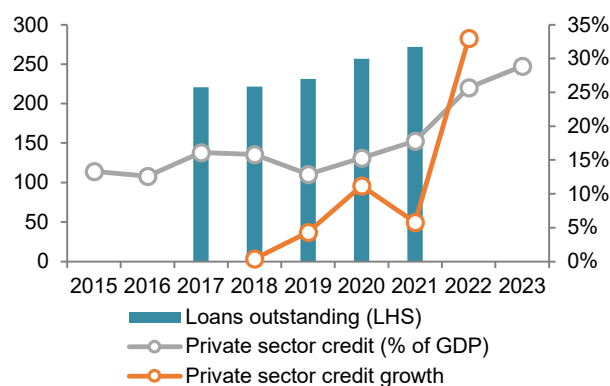
The lack of credit to the private sector is driven by institutional and policy constraints, rather than by lack of liquidity or funding within the financial sector. Foreign-owned banks routinely place excess deposits offshore, rather than providing additional capital to the domestic economy. Higher lending risks related to difficulties with collateral and recovery have made domestic lending a less-attractive venture for Timor-Leste’s formal banking sector, and this has been borne out by experience. Both BNCTL and several foreign owned-banks ventured into domestic lending when they launched operations in the country in the early 2000s, but in the absence of an enabling environment for recovery, the banks quickly encountered high levels of default, with sector-wide non-performing-loans in excess of 42 percent reported in 2010. Banks summarily retrenched and folded domestic credit schemes. At present, banks concentrate their efforts on large and well-established businesses in sectors that rely on government contracts and public investments, and on consumer loans against paychecks and salary guarantees.

Figure 3.12: Bank’s credit composition (Dec 2021)



Source: BCTL Annual Report 2021

Figure 3.13: Private sector credit overview



Source: BCTL Annual Report 2021; IMF Article IV (2022)

Policymakers in Timor-Leste have undertaken several targeted program and policy initiatives to expand private sector credit. This includes the development of a secure transaction framework, the introduction of a partial credit guarantee, prudential requirements for banks, and a soft loan scheme. Fine-tuning and updating the design of some of these initiatives could help in fully addressing underlying market failures and unlocking private financing at scale.

Box 3.1: Initiatives to expand private sector credit in Timor-Leste

- **Credit Guarantee System (CGS) for SMEs**

In 2019, BCTL introduced a Credit Guarantee System (CGS) for SMEs. The scheme provides partial coverage of 70 percent of capital losses on credits extended by commercial banks to eligible small and medium enterprises (SMEs). The CGS applies to credits granted to firms doing business in the areas of agriculture, forestry, livestock, fisheries, manufacturing, transport, and tourism, in line with the Strategic Development Plan 2011-2030. While the CGS has the potential to unlock finance for SMEs, some banks have been reluctant to participate in the scheme because of regulatory uncertainty on the distribution of credit risk and reimbursement of losses. Since its establishment in 2019, the CGS scheme has been under-utilized relative to targets. However, commercial banks report that they would be likely to utilize the scheme if several design tweaks were introduced.

- **Prudential requirements for commercial banks**

In November 2021, BCTL announced a measure requiring banks to maintain a loan to deposit ratio (“LDR”) of not less than 35 percent and a loan to MSME sector ratio of not less than 35 percent of the loan portfolio. If a given bank does not comply with this ratio, it is required to deposit an amount equivalent to the relevant LDR shortfall multiplied by the deposit liabilities (excluding Government deposits) in a non-interest-bearing bank account opened with BCTL.²¹ As the mandated lending requirements are being implemented gradually, their impact on the financial sector is difficult to assess yet. However, banks which fall below the target generally cite an inability to change their credit assessment policy and expand credit until structural impediments to MSME lending such as collateral and land issues are addressed.

- **Soft loan scheme**

The Government of Timor-Leste, through the Office of the Prime Minister and the Ministry of Tourism, Trade, and Industry (MTCI) also announced in 2022 the launch of a USD 50 million soft loan scheme aimed at providing SMEs with subsidized credit. The scheme aims to provide loans at a fixed interest rate of 3 percent to eligible SMEs while providing a first-loss fund for banks to tap into to cover losses on the subsidized loan portfolio. Private banks have declined participation in the scheme, due to concerns that the fixed interest rate is too low to cover their cost of lending and would not be profitable, even with the provision of the first loss fund. The only participant in the scheme, BNCTL, will serve as both the host of the fund and the lender. Interest subsidy schemes of this nature can expand lending to under-banked firms, but also carry a risk of exacerbating credit constraints for firms in the long run, by distorting market-based lending.

- **Secured Transactions Framework**

Lack of an appropriate secured transactions framework to enable movables assets such as vehicles, inventory, and accounts receivable to be used as collateral is one of the main reasons that banks are reluctant to lend to businesses in the country. BCTL is undertaking a comprehensive initiative to build the foundations for secured transactions in the country. This includes the preparation of a secured transactions law, creation of a collateral registry and the development of initial lending capacities. In addition, as non-deposit taking lenders (NDTLs) are a key player in any movables finance market, BCTL also enacted a Regulation on NDTLs in September 2023, enabling NDTLs to play a greater role in financing the private sector. International experience has demonstrated that expanding movables finance can significantly increase the availability of financing for all types of businesses, such as SMEs, agri-businesses, traders or infrastructure operators, and will also provide the necessary basis for capital market and housing finance development.

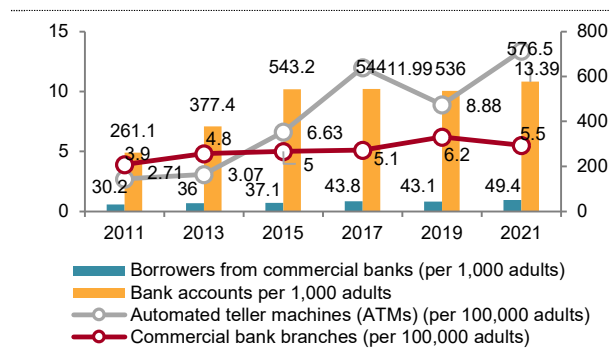
²¹ In addition, banks that fail to make such deposit with the BCTL may be subject to an administrative monthly penalty of up to 0.15 bp of the relevant LDR shortfall portion multiplied by the deposit liabilities (excluding Government deposits).

3.4.2. Access to finance for households

For households, the uptake of financial services has seen positive developments over the past few years, though last-mile challenges remain. Access to deposit and savings accounts has increased with a concerted push from BCTL, resulting in a declining share of the adult population excluded from financial services. According to BCTL’s 2022 Financial Inclusion report, 64 percent of the adult population in Timor-Leste had access to regulated financial services (banks). While women generally exhibit higher levels of financial inclusion, they predominantly constitute the clientele of banks and other financial institutions, whereas a greater proportion of men tend to utilize e-wallet services. However, only an estimated 8 percent of bank clients had a bank loan. BNCTL has been instrumental in expanding access to financial services, substantially growing its saving portfolio after being granted a banking license and taking on government payments responsibilities. The change is significant to the country’s rural reach as BNCTL is present in rural population centers nationally.

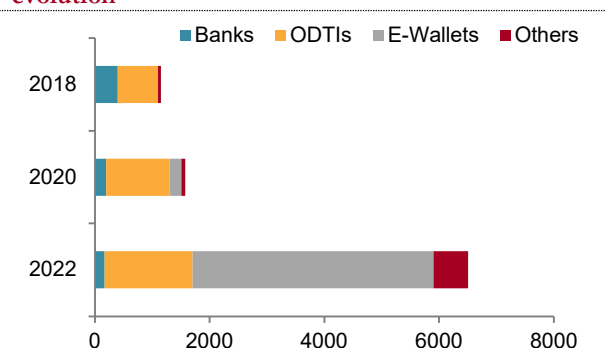
Digital financial services (DFS) are poised to play a meaningful role in expanding financial inclusion in Timor-Leste but adoption remains low. Riding the rails of Timor-Leste’s relatively well-developed payments infrastructure, two e-wallet operators MOSAN (Telemor) and T-Pay (Telcomcel) have established operations in the country and have the potential for wide outreach with more than 4,000 agents and merchants in place nationwide. Authorized in 2018, the two e-wallet providers have already helped in making payment services more convenient, especially for those without a formal bank account. This has led to an almost 300 percent jump in the availability of financial services access points during 2018-2022 (Figure 3.15), albeit with uneven geographical distribution. Agent access points established by the e-wallet providers now have a significantly higher presence compared to both bank branches and ATMs. Still, with limited internet penetration very limited. According to official statistics from BCTL, 22 percent of the population have registered for e-wallets. However, lacking practical applications, only 10 to 15 percent of the population are actively using e-wallets.

Figure 3.14: Financial access indicators



Source: IMF Financial Access Survey (2022)

Figure 3.15: Financial services access point evolution



Source: BCTL Financial Inclusion Report (2020)

Regulatory frameworks and financial literacy are critical enablers for the responsible expansion of digital finance. Rapid growth in the accessibility of digital financial services has changed the way consumers in the country interact with financial products and services. Prudential and risk assessment methodologies have not always followed suit and need to be enhanced to address concerns around data privacy, consumer protection, and cyber-security. These risks are amplified by the low levels of digital and financial literacy in Timor-Leste.²² Expanding DFS use cases in tandem with campaigns to increase digital financial literacy will help increase responsible expansion of financial services to individuals and households across the country. A case in point is BCTL’s Digital Village program, which combines the ongoing expansion of DFS agents in rural

²² For example, BCTL’s Financial Inclusion Report (2020) found that only 6 percent of adults can calculate a simple percentage correctly. Moreover, consumer remain largely unaware of grievance mechanisms. The same survey found that 5 percent of users stated they felt mistreated by a financial institution’s staff in the last 12 months, but very few clients escalated to the financial sector regulator or a consumer protection authority, with only 8 complaints registered to BCTL’s consumer protection hotline.

areas with digital financial literacy campaigns for communities, allowing households to receive and cash out domestic remittance payments digitally, reducing costs and increasing transparency.

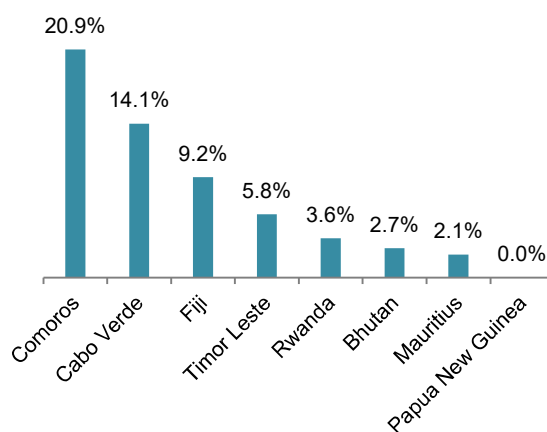
3.4.3. Enabling Infrastructure for Financial Inclusion

Relatively mature DFS infrastructure and products are in place in Timor-Leste. The government has made substantial progress in the development of Timor-Leste’s payment system. The R-TIMOR interbank network, a hybrid automated transfer system that combines a Real Time Gross Settlement and Clearing House system, was established by BCTL in 2015. The R-TIMOR system facilitates individuals, companies, state organizations, and other entities to make electronic payments in the country. In 2019, the ‘P24 system’, the country’s card switch, was introduced and enables instant transactions between and across banks by making use of the R-TIMOR network. The system currently covers four out of the five active banks in the country (BNU, Mandiri, BNCTL, BRI), with full interconnectivity between all banking networks likely to be achieved soon. More payment services are also being added to the P24 rails such as payment of taxes electronically through P24 ATMs, or fund transfers from bank accounts to e-wallet accounts and vice versa. Full interoperability has yet to be achieved as there are still ATMs and debit cards in circulation which are not connected to the P24 network.

The state of DFS infrastructure is sufficient to enable the digitalization of government payments to citizens (G2P). In addition to DFS infrastructure, the government has made important strides in advancing the three building blocks for an effective G2P system, namely a unique ID, socio-economic databases that are linked to the unique ID, and channels for digital delivery. The unique ID system, for which a government tender is currently underway, will operate under the existing national ID card scheme, but will be simpler, digital, and more inclusive. Socio-economic databases are already used to assess eligibility for G2P schemes, but information is spread across different databases that are not yet interconnected, preventing the government from better targeting resources. Significant coverage in terms of access points, mainly thanks to the proliferation of mobile money agents, allows for the delivery of cash transfers. Internet coverage is broad, albeit slow and intermittent (95 percent of the population has access to a mobile network) and stands to be improved through operationalization of a submarine fiber-optic cable system.

Despite sufficient DFS infrastructure, the levels of usage of digital financial services are very low, with only 10 to 15 percent of Timorese actively using digital financial services, compared to an East Asia Pacific (EAP) average of 76 percent. Piloting and scaling use-cases of DFS could provide the impetus needed to catalyze broader adoption of DFS. Use cases for the digital delivery of social assistance payments, which would in turn increase the take-up of digital payments, have not yet been exploited sufficiently. Timor-Leste has made some initial forays in introducing digital channels into some of its social assistance programs, but these remain at an exploratory stage. For example, the Ministry of Social Solidarity and Inclusion (MSSI) has partnered with MOSAN to digitize the notification and verification process for flooding disaster relief payments for beneficiaries in certain parts of the country. In a similar vein, Bolsa da Mae Jerasaun Foun, the now-cancelled non-conditional cash transfer program for children and expectant mothers, was digitizing parts of its fund transfer process using mobile-money providers. The planned reform of the original version of the Bolsa da Mae program also presents an opportunity to efficiently increase the frequency of the cash payments by continuing the mobile money modality.

Figure 3.16: Remittances inflow
(percent of GDP)



Source: World Bank Data (2022)

Leveraging remittances presents another opportunity to advance financial inclusion and scale DFS.

With a significant percentage of the working-age population leaving Timor-Leste to earn money and find work, remittance flows into Timor-Leste have become a crucial component of the country's economic landscape. While precise data is subject to limitations, remittance inflows have shown a notable increase in recent years, reaching an estimated USD 185 million in 2022, continuing the consistent growth path recorded since 2013 when inward remittances accounted for a mere USD33 million. These flows offer an important avenue for expanding financial inclusion by encouraging remittance recipients to utilize formal banking channels and access a wider range of financial services, including digital solutions developed to provide more convenient money transfer services. Developing and promoting digital remittance solutions could serve multiple outcomes, increasing remittance flows, reducing the cost of remitting, and expanding the use of other financial services.

The Government can play a critical role in expanding the reach of DFS and thereby broadening financial inclusion by actively sponsoring and promoting use-cases. Existing pilots around digitizing social assistance and disaster relief payments remain at early stages and could benefit from a concerted push. Digital remittance solutions could catalyze widespread adoption of DFS, as well as bring tangible financial benefits to remittance recipients. Additional public sponsored use-cases could include digital payment of customs fees or taxes, digital payment of utility bills, digital delivery of salaries and allowances to public sector employees, or the creation of special electronic payment zones in government-run public spaces such as airports, ports, or tourist attractions. Expansion of these use-cases will make full use of the successful investments in DFS infrastructure in the country and yield meaningful advances in financial inclusion.

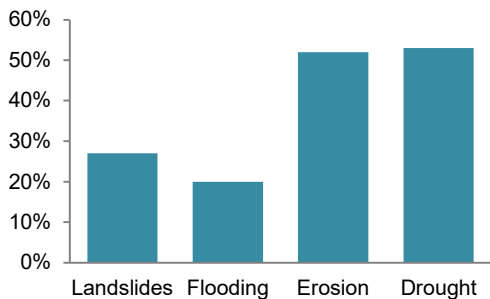
3.5. Financial Resilience in Timor-Leste

Timor-Leste is exposed to climate-related and natural hazards, which incur heavy economic and social tolls. The country has experienced a total of 14 large-scale natural disasters since 2001 including landslides, floods, tropical cyclones, droughts, earthquakes, volcanic activity, and tsunamis. Floods accounted for more than 40 percent of disasters due to heavy rainfalls, low soil absorption capacities, and rapid and excessive runoffs from steep mountain slopes to lower streams. Droughts and storms occur frequently while the country experiencing a tropical cyclone once every five years on average. Most recently, in 2021, Tropical Cyclone Seroja which caused flash floods and landslides led to devastating effects, damaging critical infrastructure and agriculture crops, and negatively impacting livelihoods and basic services. Damages to agriculture, infrastructure and housing alone amounted to USD 245 million (14.5 percent of non-oil GDP) with total recovery costs amounting to approximately USD 422 million (25 percent of non-oil GDP). At the same time, the economic risk of earthquakes in terms of asset damages is over seven times higher than from tropical cyclones risk due to the country's location in a highly active seismic zone between the Banda Sea and Australian tectonic plates.

The country's vulnerability to climate-related and natural hazards is among the highest in the world and is expected to worsen. Although the small island nation has moderate exposure to hazards compared to neighboring countries in the region, a lack of coping and adaptive strategies makes it the 7th most disaster-prone country in the world. Limited access to resources and services, a history of conflict and political instability, and limited governance arrangements for risk reduction and climate adaptation contribute to the country's vulnerability. Models suggest that climate-related risks will rise over the medium and long-term as a result of increasing temperatures, changing precipitation patterns, and increased heavy rainfall events. Tropical cyclones will decrease in frequency but increase in intensity, and the sea level continues to rise, exposing coastal areas to more storms, tidal surges, and strong winds. In total, economic losses associated with climate change are estimated to increase by 20 to 50 percent (see Figure 3.17) which would also increase the cost of construction, operations, and maintenance of infrastructure considerably. Average annual losses, currently accounting for 3.3 percent of GDP, are expected to rise to 4.0 percent in a moderate case scenario (RCP 4.5)²³ and to 4.5 percent of GDP under a worst-case scenario (RCP 8.5) (see Figure 3.18).

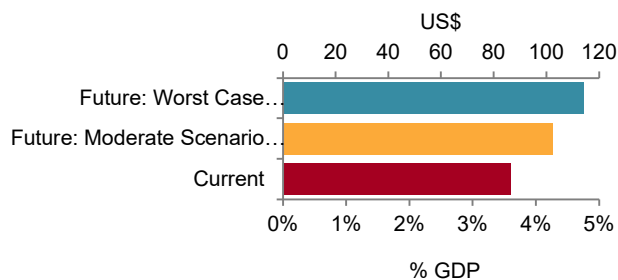
²³ RCP 4.5 is described by the Intergovernmental Panel on Climate Change (IPCC) as a moderate scenario in which emissions peak around 2040 and then decline. RCP 8.5 is the highest baseline emissions scenario in which emissions continue to rise throughout the twenty-first century.

Figure 3.17: Increased impact of natural disasters due to climate change



Source: Timor-Leste National Adaption Plan (2021)

Figure 3.18: Average Annual Losses under different climate change scenarios



Source: UNESCAP Disaster Risk and Resilience Portal (2021)

People’s livelihoods are significantly affected by these changes, with economic losses most pronounced in the agriculture sector. Although the Government mainly relies on the oil and gas industry for revenue, and despite rapid urbanization, agriculture represents a major socioeconomic sector, making up 17 percent of GDP (2020) and representing the main source of income generation for 64 percent of the population. Changing rainfall patterns, higher temperatures, and drought risks are projected to decrease agricultural income substantially. Women will face a disproportionate share of that burden as they depend comparatively more on agricultural income and already produce 15 percent less output than their male counterparts.

Fostering financial inclusion in Timor-Leste can bolster the resilience of vulnerable households and MSMEs in the face of climate shocks and natural disasters. Financial inclusion plays a pivotal role in providing a pathway for households and MSMEs to access vital financial tools, ultimately aiding them in building resilience to climate shocks. By expanding access to financial services, such as savings accounts, credit, and insurance, vulnerable households can accumulate funds for emergencies, invest in climate-resilient practices, and navigate the financial impact of climate-related events. MSMEs, on the other hand, can leverage financial tools to adopt sustainable technologies, implement climate-smart practices, and diversify their income streams, enabling them to better withstand and adapt to climate shocks. Financial products specifically tailored to climate risks, such as climate insurance for crop failure or property for example, can complement generic financial products to better encompass risks and needs associated with climate change. In addition, adaptive social protection programs from governments and humanitarian organizations can help people prepare for shocks and recover from the immediate aftermath of a climate shock or natural disaster — especially severe and large-scale shocks that poor and vulnerable populations cannot manage on their own.

Climate-related risks are also increasingly relevant to preserve the country’s financial stability. Timor-Leste is highly exposed to physical and transition risks that arise from climate change. Physical risks impact the country either acutely through extreme weather events or chronically as the climate is gradually shifting. Transition risks stem from the possible process of adjustment to a low carbon economy and its possible effects on the value of financial assets and liabilities. Both these risk types could impair the value of certain financial assets, increase the costs of credit via higher-risk premiums, or result in higher operational losses - all of which pose significant risks to financial sector stability.

Increased physical risks could result in both market and credit risks to the financial system. For financial institutions in Timor-Leste, physical risks can materialize directly through their exposures to corporations and households that experience climate shocks. In varying parts of the country, commercial real estate, business, and agricultural loans are susceptible to losses related to severe weather events and other environmental changes. These could decrease the value of damaged assets and put a strain on borrowers’ ability to repay lenders, leading to increased levels of default and losses on these credit portfolios. Given the relatively low credit exposure of banks to the agricultural (0.7 percent) and tourism sectors (1.2 percent), two sectors significantly adversely impacted by climate change, defaults in these segments are unlikely to have a systemic

effect on financial stability. Rather, physical risks for the banking sector seem to be concentrated in civil construction (18 percent) and in lending to individuals (53 percent), but more data is needed to accurately assess banks' total credit portfolio exposure to physical risks.

Financial institutions are subject to transition risks, but their true exposure is unclear due to a lack of data. Climate policy measures or technological breakthroughs relevant to climate change mitigation can generate significant indirect risk for financial institutions in the country. They may be invested in or extend loans to companies that are unable to keep pace with political measures or technological developments, resulting in stranded assets and decreasing asset quality of banks. As petroleum resources in the country are depleted, these transition risks will be amplified. Although no granular data is available for Timor-Leste, it is feasible to assume that financial institutions' portfolios consist of extractive sectors (crude oil, natural gas, minerals) or firms whose business models rely on using fossil fuels (transport, steel industry etc.) – assets which are at risk of being devalued.

Financial institutions may also be exposed to operational risks. In the aftermath of extreme weather events, financial institutions in Timor-Leste may be faced with severe disruptions to operations resulting from damage to infrastructure and branches, as evidenced by Tropical Cyclone Seroja. Depositors and other investors may withdraw funds from their banks, both to cover post-disaster expenses, as well as for fear of solvency problems with their banks, especially if they believe banks have substantial exposure to vulnerable areas. In the medium- to long-term banks may face adverse impacts on their liquidity positions as climate sensitive incomes, for example, in the agricultural sectors, decline and deposits fall.

Climate impacts loom large on the horizon for insurers and will test their resilience. Rising sea levels, increasing exposure and vulnerability to storm surges, and the prospect of more severe tropical cyclones pose a threat to insurers' capital and profitability as insurance policies generate claims with higher frequency and severity than originally expected. Claims faced by non-life insurers in Timor-Leste are likely to be higher due to increases in exposure (i.e., increased value of property in areas prone to physical risks) and/or increases in severe weather events. In the long run, physical risks could also translate into greater claims for life and health insurers, if they impact the population's mortality and demographics. Raising premiums and changes in insurance conditions (e.g., higher deductibles, lower limits, and exclusion in risky areas) will be likely consequences. This could have a substantial negative impact in terms of insurability and affordability and will likely hinder the development of Timor-Leste's embryonic insurance market, wherein only 1 in 20 firms have some form of insurance against damages from extreme weather events. In the absence of feasible insurance options to absorb losses, the economic impacts of disaster events will be compounded, exacerbating threats to the stability of the country's financial system.

While policymakers have gradually progressed in improving climate readiness and awareness²⁴, public spending on climate relevant programs and activities has been declining in recent years. In 2018, highly climate-relevant²⁵ public expenditures accounted for 4.7 percent of GDP, but this share has steadily been declining and only accounted for 2.31 percent of GDP in 2020. Most of these expenditures have been financed by internal resources through the country's Infrastructure Fund, but the amount of funding allocated through this vehicle classified as highly climate relevant has been declining at a fast rate (2018: USD 48,168,000; 2020: USD 20,724,000). The country continues to be highly dependent on development partners for climate finance, in particular in the health and tourism sectors, a source of funding which has also been declining, albeit at a slower rate. It is worth noting that Timor-Leste's access to climate financing in terms of the amount of funding approved to GDP is one of the lowest in the Pacific region.

²⁴ Countries with a high ability to leverage investments and convert them to adaptation actions have a high climate readiness.

²⁵ If the climate relevant percentage of the total budget is above 60 percent, the programme is marked as "highly relevant"; if between 20 percent to 60 percent marked as "relevant"; below 20 percent marked "neutral".

Timor-Leste has outlined different national adaptation strategies to deal with climate change, but a dedicated climate and disaster risk management financing policy is needed. Although policymakers have outlined priorities to adapt to the adverse economic and social impacts caused by climate change, specific actions needed to achieve these have not yet been integrated into budgetary planning, and coordination amongst various public stakeholders and human capacity remain key challenges. More fundamentally, Timor-Leste does not yet have a comprehensive and strategic way to manage the financial impacts of disasters triggered by natural hazards, for example as part of a tailored financial protection strategy, including consideration of appropriate asset insurance and adaptive social protection mechanisms.

3.6. Policy Interventions and Ways Forward

The foundations for the development of an inclusive, stable, and resilient financial sector in Timor-Leste have been established nearly from scratch over the past two decades. As one of the world's youngest countries, Timor-Leste's financial sector appears remarkably vibrant in some respects, with a wide variety of financial sector actors, relatively developed financial sector infrastructure, and adequate levels of liquidity and risk management in the banking sector. Peering slightly below the surface, however, several critical constraints emerge, which limit the ability of the financial sector to play its full role in financial intermediation and support to the real sector. Several areas of risk and vulnerability also loom on the horizon.

Three watchwords can guide the development of Timor-Leste's financial sector: inclusion, stability, and resilience. Digitizing financial services and improving access to credit for firms can boost inclusion, helping Timorese households invest in their own welfare and reap the benefits of economic growth. More use of data and early warning systems can ensure that the country's financial sector remains stable even as it expands and grows. Finally, dedicated strategies and financing instruments can ensure that the financial sector is resilient enough to mitigate the impact of natural disasters and other shocks on the broader economy. Taken together, these measures can help Timor's financial sector mature into one that can support the country's aspirations for economic growth and poverty reduction in the decades ahead. Building on BCTL's existing activities to address these critical needs, a shortlist of priority areas of intervention follows.

3.6.1. Financial Inclusion: Empowering Stakeholders for Lasting Impact

3.6.1.1. Piloting Use-Cases for Digital Finance

Digital solutions can play a powerful role in advancing financial inclusion in Timor-Leste. Digital payments and transaction accounts can be an important first step for households to access formal financial services and can also serve as a foundation for lending to individuals and MSMEs with limited or no credit history. Although the country possesses essential infrastructure for DFS, its adoption is hindered by a lack of compelling use-cases. To boost adoption, a crucial step involves the piloting of innovative use-cases for electronic and digital payments. Initiatives such as digitizing social assistance transfers, enabling digital solutions for remittances, piloting digital utility bill payments, or establishing special electronic payment zones have the potential to serve as critical enablers, providing tangible benefits to users and driving the widespread adoption and scalability of digital financial services.

3.6.1.2. Enhancing and Adapting SME Credit Schemes

Enhancing and adapting SME credit schemes to maximize their impact can have long-run impacts on increasing the flow of funding to the private sector. Under the leadership of BCTL, efforts to revamp the SME Credit Guarantee Scheme to attract a broad range of banks could sustainably expand access to credit for SMEs. Meanwhile, passing of the planned secured transactions law and creation of a collateral registry could catalyze the use of movable assets to secure loans, further unlocking private sector financing. Finally, ensuring that policies and reforms incentivize and crowd-in financial institutions can have long-run effects on the credit ecosystem.

3.6.2. Financial Stability: Strengthening the Foundation

3.6.2.1. Improving Data Collection and Utilization

Further strengthening the collection and use of financial sector data can help bolster financial stability in Timor-Leste. As the financial sector grows, gaps in the availability and quality of financial data will hinder the ability to make informed policy decisions and effectively monitor key financial sector stability indicators. Given its pivotal role in overseeing the nation's monetary policy and financial systems, BCTL is well-positioned to champion and coordinate the optimization of data collection and utilization, empowering policymakers with the necessary tools to proactively identify emerging risks, monitor market trends, and devise timely interventions. Cultivating a culture of data transparency and cooperation among financial institutions would further contribute to a more resilient financial ecosystem, enabling stakeholders to respond swiftly to challenges and disruptions.

3.6.2.2. Establishing Financial Safety Nets

The creation of comprehensive financial safety nets stands as another imperative reform to fortify Timor-Leste's financial stability. The absence of adequate safety nets exposes the economy to heightened vulnerabilities during periods of economic downturns or external shocks. Instituting mechanisms such as deposit insurance, emergency liquidity facilities, and contingent fiscal measures can mitigate the impact of financial crises on both individuals and institutions. By establishing a robust safety net framework, the government can instill confidence in the financial system, encouraging savings and investment while shielding vulnerable populations from the adverse effects of economic turbulence.

3.6.3. Financial Resilience: Charting a Secure Future

3.6.3.1. Formulating a Climate and Disaster Risk Management Financing Strategy

Timor-Leste's heightened vulnerability to climate change and natural hazards necessitates a proactive approach to safeguard the nation's financial stability. To comprehensively safeguard the financial sector against the adverse impacts of climate-related risks, Timor-Leste could develop and implement a focused strategy tailored specifically to address climate and disaster risk management financing options, that could include access to emergency funds, contingent financing, insurance programs, and adaptive social protection mechanisms. Integrating financial instruments of this nature into the financial landscape will help to absorb and manage the financial repercussions of climate-related events. This forward-thinking and proactive approach not only enhances the financial sector's resilience but also aligns with global good practices in climate resilience and disaster risk management, contributing to Timor-Leste's broader sustainable development goals and ensuring a more secure and sustainable financial future.

Annex 1: Key Indicators

Economic Indicators

	2016	2017	2018	2019	2020	2021	2022
Real sector	<i>(annual percentage change, constant)</i>						
Gross domestic product (non-oil)	3.4	-3.1	-0.7	2.1	-8.3	2.9	4.0
Final consumption expenditure	1.7	-1.3	0.8	3.5	1.5	-0.05	7.0
Gross fixed capital formation	15.3	-16.7	-1.5	-17.4	-46.9	-6.1	29.4
Consumer price index, period average	-1.5	0.5	2.3	0.9	0.5	3.8	7
Fiscal sector	<i>(percentage of non-oil GDP)</i>						
Total Revenue	45	42	48	43	46	45	43
Domestic revenue	12	11	13	11	12	10	10
Estimated Sustainable Income	33	30	35	31	34	35	33
Total expenditure	99	74	74	73	72	92	104
Recurrent expenditure	62	58	52	55	62	83	92
Capital expenditure	36	16	22	19	10	9	12
Fiscal balance	-54	-32	-26	-31	-25	-47	-61
Monetary and Financial sector	<i>(as stated)</i>						
Credit to the private sector (% growth)	-5.3	24.5	-2.4	4.3	11.2	5.8	33
Lending interest rate (%)	14.5	12.1	11.9	12	11.3	11	11
Nominal effective exchange rate (index)	94.4	94.8	96.3	97.4	98.7	96.5	101.6
Real effective exchange rate (index)	110.9	109	111.2	112	113.2	113.0	121.8
External sector	<i>(percentage of non-oil GDP)</i>						
Current account	-33	-18	-12	3	-3	1	-61
Goods and services	-68	-59	-59	-20	13	72	26
Primary income	33	46	53	26	-12	-72	-83
Secondary income	2	-4	-6	-4	-4	0	-4
Capital account	3	2	3	2	1	1	1
Financial account	29	31	16	-18	-38	-39	-13
Direct investment	0	0	3	-45	-51	-48	15
Portfolio investment	42	21	12	29	15	10	-9
Other investment	-12	9	0	-2	-3	0	-19
Net errors and omissions	-9	1	1	12	40	56	67
Change in reserves	9	-16	-8	1	0	-18	6
Memorandum items	<i>(as stated)</i>						
Oil production (million BOE)	47	42	39	38	36	37	11.7
Petroleum Fund, closing balance (USD million)	15,844	16,799	15,804	17,692	18,991	19,651	17,414

Source: Ministry of Finance, BCTL

Note: Starting from 2019, the BOP figures include the Export and Import Value from Oil activities.

Annex 2: Peer Selection

To benchmark Timor-Leste’s performance, this report uses three groups of peers: the regional peers, structural peers, and aspirational peers. Criteria adopted to select the peers are presented in the below table.

Annex Table 2: Peer Selection

Group	Definition	Selection Criteria	Selected countries
Regional peers	Neighbouring countries in the East Asia and Pacific region as per the World Bank classification	<ul style="list-style-type: none"> • (Relatively) Small countries in East Asia & Pacific 	<ul style="list-style-type: none"> • Papua New Guinea • Fiji
Structural peers	Countries that have similar economic characteristics as Timor-Leste in 2016-2019	<ul style="list-style-type: none"> • Countries that had a GDP per capita, Human Development Index, population, an electricity access that are +/- 30 positions distant from TL’s average rank in 2016-2019 • Countries that are commodity exporters 	<ul style="list-style-type: none"> • Comoros • Sao Tome • Solomon Island
Aspirational peers	Countries that possessed similar structural characteristics as Timor-Leste, but grew (in per capita terms) significantly faster over time	<ul style="list-style-type: none"> • Countries that were low- or lower-middle-income and a medium-size population. • Countries that had a Human Development Index, real GDP per capita, population, life expectancy and access to electricity that were +/- 50 positions distant from TL’s average rank in 2003-2006 • Countries that grew faster than TL by 2pp more than TL in 2003-2019, on average 	<ul style="list-style-type: none"> • Botswana • Cabo Verde • Mauritius • Bhutan

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