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IMF Executive Board Concludes 2010 Article IV Consultation with the Democratic Republic of Timor-Leste

On January 28, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Timor-Leste.

Background

The Timorese economy has grown fast over the past three years in an environment of improved security following the 2006 civil unrest. Driven by higher oil-financed public spending and a rebound in agriculture from the 2007 drought, non-oil growth averaged 11 percent during 2007–09. A recent estimate by the World Bank also shows a decline of poverty incidence from 50 percent in 2007 to 41 percent in 2009. With increased public spending, domestic price pressures have recently been rising and are particularly high in some segments of the economy, such as housing and construction.

The fiscal position strengthened in 2009, the non-oil fiscal deficit declined by 17 percentage points to 92 percent of non-oil GDP. This reflected a moderation of

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

spending growth to 8 percent following a sharp increase of 130 percent in 2008. A supplemental 2010 budget raised the spending envelop by more than 30 percent to US$838 million, to be financed by withdrawals of US$811 million from the Petroleum Fund (PF). However, due to procurement delays actual public spending is expected to be around US$729 million, and the non-oil fiscal deficit is projected at about 100 percent of non-oil GDP.

Timor-Leste stands out as the most oil-dependent economy in the world. In 2009, petroleum income accounted for about 95 percent of total government revenue and almost 80 percent of gross national income (GNI). The PF assets reached US$6.8 billion or about ten times non-oil GDP in October 2010. The current account surplus has been driven by large oil income.

The financial sector remains at an embryonic stage of development. Three foreign bank branches dominate the financial sector, in addition to a small state-owned microfinance institution. A first insurance company has been established. Despite high bank deposit growth, private sector credit has remained stagnant, hampered by a large share of non-performing loans, weak contract enforcement, and unclear property rights.

The near-term outlook remains positive, supported by social and political stability and government spending. Preliminary data provided by the authorities indicate that GDP growth in 2010 is likely to be higher than the estimate in the Staff Report of 6 percent and closer to the government's estimate of 9½ percent, potentially pointing to a higher growth projection in 2011. Staff expects GDP growth to stay high in the medium term. Inflation is projected to increase from 4½ percent to 6 percent in 2011, higher than the average of neighboring countries. Large uncertainties surround the medium-term outlook, including the path of oil prices and production, the magnitude and quality of public spending, and progress in business-enabling structural reforms.

Executive Board Assessment

Executive Directors welcomed Timor-Leste's economic performance over the last three years and the progress made on poverty reduction and other social indicators. Following a slowdown caused by adverse weather, the medium-term outlook for growth is positive. Going forward, Timor-Leste's key challenge remains to use its petroleum wealth wisely to build a strong non-oil economy and raise living standards.

Directors welcomed the government's resolve to push ahead with its development policies. They noted that carefully selected infrastructure investment could have sufficiently high returns to justify temporary withdrawals from the PF in excess of the estimated sustainable income (ESI), and that the upward revision in the ESI has created room for additional capital expenditure. Most Directors observed, however, that spending at a slower-than-planned pace, consistent with the absorptive capacity of the economy, would stand a better chance of realizing high quality projects and crowding in private investment.

Directors praised the government's emphasis on raising the country's ability to plan, evaluate, and implement spending programs, so that any expansion of public works does not overwhelm administrative capacity. They supported plans to create a new agency, reporting directly to the Prime Minister, which will be in charge of major project evaluation and approval. Further improvements in public financial management and budget execution will also be important.

Directors welcomed the government's efforts to make the regulatory environment more business-friendly. They noted that the introduction of a one-stop-shop for start-ups is a step in this direction. Accelerated reforms to enhance property rights, such as the pending land law, would also make it easier for the financial sector to extend credits to local businesses.

Directors observed that the official dollarization has helped keep inflation under control and should be maintained, supported by a fiscal policy that is mindful of external stability. Productivity-enhancing structural reforms and efforts to build labor skills would improve competitiveness in non-oil industries and services. Directors also noted that a slower-than-envisaged pace of public spending growth would help contain inflation pressures as supply-side limitations are approached.

Directors called for an intensification of the engagement between Fund staff and the authorities. Noting differences between the official and the more conservative staff's growth projections, they encouraged a closer policy dialog and greater use of technical assistance, including to strengthen Timor-Leste's economic statistics. A number of Directors also saw merit in reopening the resident representative office.

Democratic Republic of Timor-Leste: Selected Economic Indicators, 2005–11

	2005	2006	2007	2008	2009 Prel.	2010 Proj.	2011 Proj.
Output and prices							
GNI at current prices (US$ million)	695	972	1,689	2,851	2,401	2,704	3,019
Non-oil GDP at current prices (US$ million)	332	327	358	444	556	627	708
Real non-oil GDP growth (percentage change)	6.2	-5.8	9.1	11.0	12.9	6.1	7.3
Including United Nations 1/	2.3	-3.4	18.2	10.6	9.1	5.0	6.2
Inflation (CPI, percentage change, end-period)	1.0	6.7	7.6	6.1	1.1	6.5	6.0
Inflation (CPI, percentage change, period average)	1.8	4.1	8.9	7.6	0.1	4.5	6.0
			(In percent of non-oil GDP)				
Investment-saving balance							
Gross investment 2/	21	23	29	63	55	48	70
Gross national savings	99	188	358	518	301	276	267
External savings	-79	-166	-329	-456	-245	-227	-197
Central government finances							
Revenues	128	205	382	551	342	338	334
Domestic revenues	11	10	12	10	11	11	11
Petroleum revenue	107	195	367	540	332	328	323
Grants	10	0	3	0	0	0	0
Expenditure (cash basis)	26	32	66	120	103	100	123
Recurrent expenditure	19	27	51	81	65	72	73
Capital expenditure	7	5	15	39	38	28	50
Overall balance	102	174	316	431	239	239	210
Non-oil fiscal balance	-5	-21	-51	-110	-92	-89	-113
Combined sources fiscal operations 3/							
Domestic revenue and budget grants	24	13	17	12	13	13	13
Expenditure	67	73	98	163	144	133	154
Recurrent expenditure	47	55	74	117	99	96	95
Capital expenditure	20	18	24	46	45	37	59
Overall balance	-43	-60	-81	-151	-131	-121	-141
Money and credit							
Broad money (end-period) 4/	23	31	40	43	48	…	…
Net domestic assets (end-period)	-24	-3	-48	-42	-30	…	…
			(In millions of U.S. dollars)				
External sector							
Current account	261	541	1,177	2,023	1,363	1,425	1,395
Merchandise exports 2/	8	9	7	14	9	11	14
Merchandise imports	112	101	176	311	385	575	802
			(In percent of non-oil GDP)				
Current account	79	166	329	456	245	227	197
Merchandise exports 2/	2	3	2	3	2	2	2
Merchandise imports	34	31	49	70	69	92	113
Memorandum item:							
Petroleum Fund balance (percent of non-oil GDP) 5/	112	310	583	945	968	1,076	1,169

Sources: Data provided by the Timor-Leste authorities; and IMF staff estimates.
1/ Includes locally paid compensation of UN peacekeeping mission staff.
2/ Excludes oil/gas sector.
3/ Includes autonomous agencies and quasi-fiscal expenditure by donors outside the central government budget. The revenue decline in 2005 reflects the creation of the Petroleum Fund to which all oil revenue now accrues. Income from the fund and donor assistance finances the deficit.
4/ Excludes currency holdings by the public, for which no data are available.
5/ End-period. Figure for 2004 refers to the Timor-Sea account, which preceded the August 2005 establishment of the Petroleum Fund.