INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

Staff Report for the 2010 Article IV Consultation[1]

Prepared by Staff Representatives for the 2010 Consultation with the Democratic Republic of Timor-Leste

Approved by Ray Brooks and Dhaneshwar Ghura

December 3, 2010

Key Issues and Recommendations:

- ***Context:*** Petroleum-financed government spending supported double-digit growth in 2007–09 and commendable progress was made in reducing poverty.
- ***Growth prospects:*** in 2010 non-oil GDP growth is expected to slow to around 6 percent due to the impact of adverse weather on harvests. Scaled up public investment will be a key driver of growth in the medium-run, though there is uncertainty about the size, timing, and quality of capital spending.
- ***Focus:*** Discussions focused on how to manage the petroleum wealth to develop the non-oil economy.
- ***Appropriate pace of public spending growth:*** The government plans to fast-track development by ratcheting up capital spending rapidly. The mission supported well-managed infrastructure investment but suggested a more-gradual-than-planned pace of growth in capital spending while lowering capacity constraints.
- ***External stability:*** Officially dollarized, competitiveness depends on business-enabling reforms, raising labor skills, and a slower pace of government spending to contain inflationary pressures.

[1] The report is based on discussions during October 26–November 9, 2010, with Prime Minister Gusmao, Finance Minister Pires, General Manager of the Banking and Payments Authority Vasconcelos, State Secretaries of agriculture, commerce and tourism, and other senior officials, and representatives of donors, the business community, and civil society. The team comprised Messrs. Schule (head), Ochirkhuu, Ms. Sun (all APD), Mr. Cardoso (OED), Messrs. Rab, Suri (both World Bank), and Kang (Asian Development Bank).

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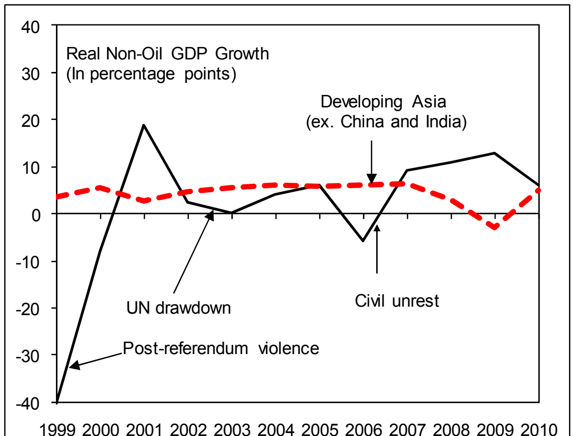
I. Context

1. **In its first eight years as an independent nation, Timor-Leste has made commendable economic progress, though it still faces many development challenges.** About 40 percent of the population still lives in poverty and the 2010 Human Development Report (based on 2009/10 data) ranked Timor-Leste at 120 out of a total of 169 countries (Figure 1). Years of conflict have destroyed a large part of its infrastructure. However, the country is blessed with natural resources, with offshore oil production starting in 2004. Although its oil wealth is currently estimated at $24.3 billion or $22,000 per capita, and more reserves such as the Greater Sunrise have been discovered, it is neither a major oil producer nor an upper middle income country. It stands out as the most oil dependent country globally. In 2009, petroleum income accounted for about 95 percent of total government revenue and almost 80 percent of GNI.

2. **An overarching challenge for Timor-Leste is to manage petroleum wealth effectively to raise growth and living standards on a sustainable basis.** The 2010 Article IV Consultations took place against a backdrop of the authorities' plans to fast track development by scaling up public investment in infrastructure and human capital. The government has outlined its strategy in a summary of the Strategic Development Plan (SDP) for 2011–2030 (Annex 1). The authorities have been generally responsive to the Fund's past policy advice (Appendix Table 1).

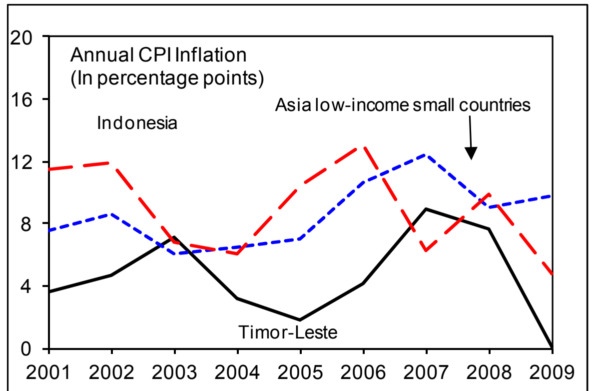
II. Recent Developments

3. **The past three years saw rapid economic growth and reduced poverty.** Improved security following the 2006 civil unrest, higher oil-financed public spending, and a rebound in agriculture from the 2007 drought have contributed to non-oil GDP growth averaging 11 percent during 2007–09 (Figure 2). Staff expects non-oil GDP growth to drop to about 6 percent in 2010, largely reflecting the detrimental impact of unseasonal rainfall and floods on agricultural production. Foreign direct investment increased, mainly in the petroleum sector, but private investment remains modest at about 10 percent of non-oil GDP. A recent estimate by the World Bank shows a decline of poverty incidence from 50 percent in 2007 to 41 percent in 2009.



Sources: Country authorities; and Fund staff calculations.

4. **Inflation largely reflected movements in international food and energy prices.** Annual CPI inflation fell sharply from 12 percent in mid-2008 to just 1 percent at end-2009, and has since risen to 5.3 percent year on year in the September quarter of 2010. Domestic



Sources: Contry authorities; CEIC Data Co, Ltd.; and IMF, *APDLISC* database.

price pressures have been rising and are particularly high in some segments of the economy, such as housing and construction, and in the capital Dili where annual inflation reached 7.5 percent in September 2010. In each of the past two years, wages in the public sector increased by 25 percent and, according to a provisional survey by the Ministry of Finance, 9 percent in the private sector in 2010.

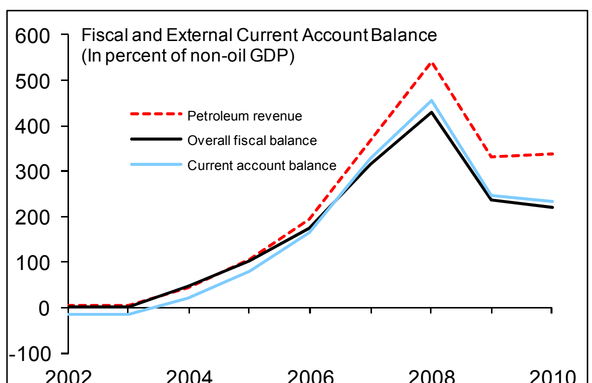
5. **The fiscal position strengthened in 2009.** Following a 130 percent increase in 2008, public spending grew by a more moderate rate of 8 percent to $604 million in 2009, with capital expenditure accounting for most of the increase. As a result, the non-oil fiscal deficit fell by 17 percentage points to 92 percent of non-oil GDP. For the first time, the deficit was financed by $512 million withdrawals from the petroleum fund (PF) in excess of the $408 million certified estimated sustainable income from petroleum (ESI). The ESI guides fiscal policy as to the amount that can be withdrawn from the PF without depleting it over time (Annex 2).

Whole of Government Expenditure and Financing

	2008 Actual	2009 Prel.	2010 Proj.
	(in millions of US dollars)		
Revenue	**2,469**	**1,933**	**2,148**
Domestic revenues	70	91	93
Petroleum revenue	2,399	1,842	2,055
Expenditure	**557**	**604**	**651**
Capital expenditure	175	209	175
Non-oil balance	**-487**	**-513**	**-557**
Financing	487	513	557
Petroleum Fund withdrawals	396	512	636
Memorandum items (in percent of non-oil GDP unless otherwise specified)			
Expenditure	125	109	104
Capital expenditure	39	38	28
Non-oil balance	-110	-92	-89
Petroleum Fund balance (in US$ millions)	4,197	5,377	6,744
Estimated sustainable income (in US$ millions)	396	408	502

Sources: Timor-Leste authorities; and Fund staff estimates.
1/ Including autonomous agencies and without adjustment for rice sales.

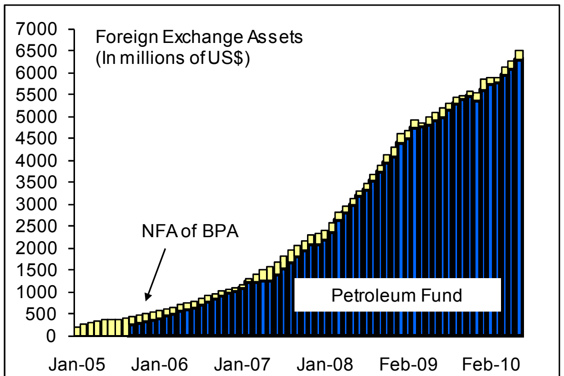
6. **The original 2010 budget foresaw continued moderate spending growth.** However, in June 2010, the authorities introduced a supplemental budget that enlarged this year's spending envelop to $838 million, an increase of almost 40 percent over actual spending in 2009, largely financed by withdrawals of $811 million from the PF. But given procurement delays, particularly for capital spending, staff suggest that 2010 cash spending will be around $650 million, well below the revised spending envelope.



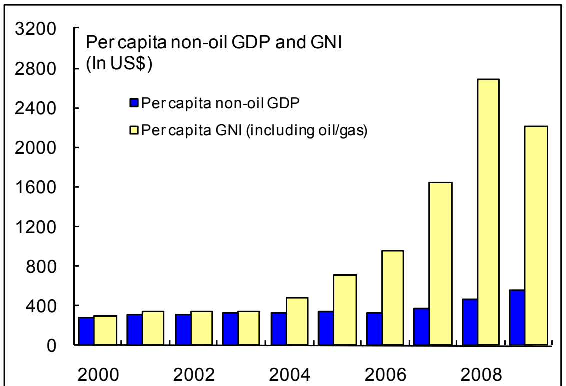
Sources: Country authorities; and Fund staff calculations.

7. **The current account surplus in percent of non-oil GDP declined by almost half to 245 percent in 2009.** Lower international oil prices reduced oil earnings, recorded as income on the balance of payments. Non-oil exports such as coffee and tourism have remained insignificant compared to oil. Merchandise imports grew by 24 percent, reflecting higher public spending and the economy's limited absorptive capacity.

8. **The PF assets have accumulated substantially over the past 5 years to reach $6.5 billion or about ten times non-oil GDP at end-August 2010.** Owing to lower international oil prices, petroleum-related revenue declined in 2009, but is expected to recover to $2.1 billion in 2010. As a result, the overall fiscal surplus to non-oil GDP ratio is projected to decline from 430 percent in 2009 to 240 percent in 2010.



Source: Country authorities.



Sources: Country authorities; and Fund staff estimates.

III. Outlook and Risks

9. **The growth outlook remains positive, supported by social and political stability and increased government spending.**

- **Near term.** GDP growth is expected to increase to around 7⅓ percent in 2011, driven by government spending, which is projected to increase by almost 40 percent in 2011. Activity in private construction and commerce is also expected to be dynamic, while the recovery in agriculture remains gradual. Inflation is expected to average 4½ percent in 2010, and to increase to 6 percent in 2011.

- **Medium term.** Scaled-up public investment will remain a key driver of growth in the medium term, although its effectiveness may be limited by Timor-Leste's weak public financial management capacity and a disproportionally small size of the private sector. As a result, annual non-oil growth is expected to re-accelerate in 2012 and to peak at 9¾ percent in 2013 (Figure 3).

- **Long term.** Non-oil growth is to gradually converge to around 6 percent in the long run, when the private sector will have to become the main driver of growth.

10. **However, large uncertainties surround the outlook.** Oil revenues are sensitive to volatile international oil prices and to interruptions in production. Domestically, there is uncertainty about the size, timing, and quality of capital spending, especially for the medium term. Moreover, the depth and pace of business-enabling reforms is difficult to predict.

Authorities' Views

11. **The authorities shared the mission's positive assessment of the economy, but expected double-digit growth rates.** They projected a higher growth impact of public investment and more private sector growth and noted that staff's 2008–09 growth projections were consistently below actual outturns. For 2010, the authorities agreed that the economy would slow down, but could still approach a double-digit growth rate. The authorities projected the economy to continue recording double-digit growth in the medium and long run, with improving budget planning and execution. There was an agreement that any projections are surrounded by large uncertainties given data constraints and a rapid change in the structure of the non-oil economy. The authorities suggested that staff provide upper and lower bounds of projections in the future pursuant to the conditions of Timor-Leste.

IV. Policy Discussions

A. Fiscal Policy

The Pace of Public Spending Growth

12. **Pressing development needs call for more and better public spending.** Petroleum wealth provides a unique opportunity to transform Timor-Leste into a higher middle income country. Following rapid growth in recent years, the level of public expenditure per capita exceeds that of many other petroleum-exporting LICs. A key challenge going forward is to enhance the effectiveness of public spending and address supply and structural constraints in the non-oil economy. The SDP is a positive step toward defining a growth and poverty-reduction strategy. However, concrete implementation plans remain to be worked out and projects need to be costed and prioritized. The timing of large infrastructure projects should take account of Timor-Leste's institutional weaknesses, administrative capacity constraints, and limited absorptive capacity of the economy, in particular due to the shortage of skilled labor and managerial capacity.

Public Expenditure ratios in low and middle income countries

Countries 1/	Per capita primary spending (US$)				
	2000	2007	2008	2009	2010
Congo DR (USD 171)	6	26	38	41	61
Yemen, Republic of (USD 1061)	46	55	56	41	45
Cameroon (USD 1114)	84	165	222	202	205
Sudan (USD 1398)	39	313	340	271	333
Vietnam (USD 1068)	96	223	278	341	342
Indonesia (USD 2330)	105	339	416	362	466
Timor-Leste (USD 543)	**53**	**231**	**515**	**542**	**566**
Colombia (USD 5167)	563	1158	1211	1345	1555
Azerbaijan, Rep. of (USD 4807)	132	971	1618	1664	1834
Kazakhstan (USD 7019)	-	1613	2302	1713	2212
Gabon (USD 7468)	662	1510	1844	1744	1814
Algeria (USD 3996)	443	1271	1856	1646	2144
Equatorial Guinea (USD 9580)	273	1978	3208	4688	2977
Libya (USD 9511)	2034	3850	5697	5259	5534
Bahrain (USD 19817)	2798	6708	7682	6007	5902

1/ All countries are net petroleum exporters for which data are available. 2009 GDP per capita in parenthesis.

13. **The government's fiscal projections foresee significant and front-loaded scaling up of public investment and moderate growth in current spending.**

- For 2011, the draft budget presents an envelope of $985 million, an increase of over 50 percent from the spending expected by staff in 2010. However, such a large increase may be challenging to execute and staff expect cash expenditure in 2011 to grow at a slower pace and reach about $900 million. The draft budget foresees current spending to grow moderately at 4 percent without taking account of the recurrent cost associated with public investment. The government plans to limit withdrawals from the PF to the 2011 ESI of $734 million. The remaining financing will come from non-oil domestic revenue and the government's cash balance that has built up due to under-execution of the budget in 2010.

- In 2012–13, the authorities plan to increase public investment at an average rate of about 30 percent, and to maintain this level in 2014–15. Without taking account of the recurrent cost of capital spending, the government projects current spending to grow by only 4 percent per year over 2012–15. Staff projects that the government's spending plans, if largely implemented, will require withdrawals from the PF exceeding the ESI by an annual average of about $300 million. Staff expects a significantly reduced overall fiscal surplus of 107 percent of non-oil GDP in 2015, while the non-oil fiscal deficit averages 108 percent of non-oil GDP during 2012–15.

14. **Staff recommended a more moderate increase in spending, accompanied by capacity building.** Specifically:

- Staff supports government investment in public infrastructure, health and education, if such spending has a sufficiently high rate of return, is well managed and efficiently and transparently implemented. Such investment would raise economic growth and the standard of living of Timorese people.

- However, present spending levels are stretching administrative capacities and creating bottlenecks in the economy. Outsourcing can help ease administrative capacity constraints, and staff encouraged the authorities to take full advantage of the expertise provided by the World Bank, ADB, and bilateral donors. Yet, managing outsourcing is a challenge in itself.

- The ESI continues to serve as guidance for public spending that should anchor fiscal policy over the medium term**.** The PF framework does not stand in the way of financing worthy investment projects even if that implies temporarily spending in excess of the ESI. Moreover, the move from using the low oil price forecast published by the U.S. Energy Information Administration (EIA) to using the average of EIA low and reference case oil price[1] has raised the ESI from $502 million in 2010 to $734 million in 2011. The sum of domestic revenues and higher ESI, projected at $835 million in 2011, forms a sustainable spending envelope for anchoring fiscal policy. Specifically, given the need to build up capacity, staff advised an average

[1] This mid-price is still some $15 below market futures and can be considered prudent, as required by the PF law. See The Estimated Sustainable Income Calculation and Selected Petroleum Fiscal Issues, IMF TA report September 2010.

spending growth of around 10 percent annually over the medium term. This spending path would entail that withdrawals from the PF are in line with the ESI levels on average (Annex 2) over the medium term, with withdrawals from the PF below the ESI in early years and above the ESI in later years.

Timor-Leste: Medium-Term Fiscal Outlook

	Baseline Scenario								
	2008	2009	2010	2011	2012	2013	2014	2015	2011-15 2/
	Act.	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Real non-oil GDP growth (percent)	11.0	12.9	6.1	7.3	8.6	9.7	9.4	8.2	8.7
Expenditure of the whole government (US$ millions) 1/	557	604	651	898	1062	1205	1278	1271	1143
Non-oil balance of the whole government (US$ millions)	-487	-513	-557	-798	-946	-1075	-1133	-1109	-1012
in percent of non-oil GDP	-110	-92	-89	-113	-117	-116	-106	-91	-109
Withdraw from the PF (US$ millions)	396	512	636	734	929	1045	1091	1054	971
Change of government's cash balance (US$ millions)	-4	8	79	-64	0	0	0	0	-13
Loan disbursement (US$ millions)	-	-	-	0	17	30	42	55	29
Estimated sustainable income (US$ millions)	396	408	502	734	744	745	743	740	741
Petroleum Fund assets (US$ millions)	4,197	5,377	6,744	8,271	9,735	10,834	12,176	13,524	13,524
	Alternative Scenario								
	2008	2009	2010	2011	2012	2013	2014	2015	2011-15 /2
	Act.	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Real non-oil GDP growth (percent)	11.0	12.9	6.1	6.1	6.6	7.4	8.2	8.9	7.4
Expenditure of the whole government (US$ millions) 1/	557	604	651	724	800	892	985	1,088	898
Non-oil balance of the whole government (US$ millions)	-487	-513	-557	-625	-687	-762	-833	-910	-763
in percent of non-oil GDP	-110	-92	-89	-91	-91	-91	-89	-86	-89
Withdraw from the PF (US$ millions)	396	512	636	624	669	732	791	855	734
Change of government's cash balance (US$ millions)	-4	8	79	-	-	-	-	-	-
Loan disbursement (US$ millions)	-	-	-	0	17	30	42	55	29
Estimated sustainable income (US$ millions)	396	408	502	734	747	757	765	771	755
Petroleum Fund assets (US$ millions)	4,197	5,377	6,744	8,383	10,116	11,551	13,227	14,819	14,819

Sources: Fund staff estimates.
1/ Without adjustment for rice sales.
2/ PF assets end of 2015.

15. **The key advantage of the staff's alternative strategy is balanced and sustainable economic growth.** A more gradual increase in public investment–accompanied by strengthening public financial management and accelerating reforms to improve the business environment–would raise the efficiency of public investment and likely crowd-in private investment. While GDP growth may be slightly lower than in the baseline in the short run, economic development would become more balanced, with a stronger role of the private sector, and yield higher long-run growth rates. Spending would be more aligned with the absorptive capacity of Timor-Leste's economy, exert less inflationary pressures, and therefore reduce the risk of Dutch disease. The recommended spending path would also maintain fiscal sustainability without reliance on oil revenues from Greater Sunrise. Moreover, a binding medium-term budget constraint would help improve the budget process by providing incentives for cost control, prioritization and better planning.

16. **The composition of public spending warrants close examination.** The implications of higher public investment for recurrent spending need to be carefully considered to ensure that the scaling-up of public investment does not jeopardize fiscal sustainability. Furthermore, the composition of public expenditure should take account of both economic and social objectives. Within current spending, there is room to restrain wage growth, phase out subsidies, including on rice and electricity, and to better target transfers to the most needy.

17. **The sustainability of public spending will also depend on the government's ability to realize the fiscal dividends of growth.** Compliance with tax obligations is weak,

despite low statutory tax rates—10 percent on income, and 2½ percent customs duty and sales tax. As a result, in 2009 the domestic tax to non-oil GDP ratio was only 8 percent. The authorities are aware that tax collection is ineffective outside the petroleum sector. Staff welcomed the governments' ongoing efforts to strengthen the tax administration, including by improving taxpayer registration, following through on non-compliance, and building tax audit capacity. However, should these measures prove insufficient to reach a short-term revenue target of $200 million (about 25 percent of non-oil GDP in 2012), higher tax rates, and new taxes, including on land, should be considered. Conversely, new tax breaks in the draft Investment Law go in the wrong direction and may prove ineffective in raising private sector investment.

18. **The government is considering borrowing to finance large infrastructure projects.** Current development plans could be exclusively financed by withdrawals from the PF. However, development partners may offer financing at concessional terms or at interest rates below expected returns on PF assets, which could increase from the historical annual return of 4½ percent with the planned change of PF investment strategy. Importantly, such borrowing may come with the transfer of knowledge from these institutions. The mission welcomed the authorities' intention to channel borrowing through the budget subject to parliament approval, and suggested that any borrowing should substitute for withdrawals from the PF. Staff cautioned against borrowing from international financial markets.

19. **A first joint World Bank-IMF debt sustainability analysis (DSA) found that Timor-Leste is at low risk of debt distress**. A key assumption is that Timor-Leste would resort to limited borrowings from development partners over the next 20 years, which carry an average interest rate of not more than 4½ percent. The DSA also highlights Timor-Leste's sensitivity to petroleum price and production shocks. Therefore, to minimize the risk of debt distress, it is advisable for Timor-Leste to take a gradual and moderate approach to borrowing from development partners and be fiscally prudent.

Public Financial Management

20. **Staff commended the authorities' ongoing efforts to improve the public financial management (PFM) system and their resolve to address remaining weaknesses.** The recent fiscal ROSC and PEFA missions found solid progress albeit from a low base. Nevertheless, despite of the government's ongoing efforts, significant gaps remain in PFM, notably little project assessment capacity, in particular on the capital side, weak planning and implementation capacity in line ministries, a haphazard procurement process, and an absence of internal audits (Annexes 3 and 4). The draft SDP is a welcome first step, but further work is needed to improve medium-term budgeting and planning. Reforms should be prioritized and consolidated while line ministries should participate fully in the PFM reform agenda. The Ministry of Finance is taking steps in this direction through the development of a Strategic Plan for PFM.

21. **The PF remains the cornerstone for managing the country's oil-based financial resources.** The ESI has proven to be a useful benchmark to inform fiscal policy and public discussion, while the PF framework is flexible enough to allow for spending above the ESI in the long-term interest of Timor-Leste, subject to parliament approval. Staff welcomed that planned revisions to the PF Law leave its basic principles—transparency, accountability, and inter-generational equity—intact. However, some specifics as to what "justifies" withdrawals from the PF in excess of the ESI, such as financial or social returns, would be helpful to focus the public debate. Also, ambiguity as to who will be the manager of the PF is likely to create uncertainty.

22. **Staff encouraged the authorities to address under-spending problems, in particular regarding multi-annual capital projects and capacity building.**

- The first best approach would be to undertake comprehensive budget modernization to enhance budget credibility, both in terms of quantity and quality, in line with the recommendations of the Fund's fiscal ROSC, PEFA, and treasury management missions.

- The second option, adopted by the government, of creating special investment funds can be effective, if adequate yet flexible controls are established to prevent the funds from taking on undesirable characteristics of extra-budgetary funds. Therefore, staff welcomed the government's commitment to allocate money into these funds through the same budget rules as all other expenditures; to appropriate the use of fund resources to an identified entity and project; and to link non-lapsing provisions to a list of projects that have been approved through the normal budget process. The government is also committed to keep resources in the treasury single account and use the IFMIS system for the funds.

23. **The authorities' efforts to improve cost and quality control and combat corruption are commendable.** The planned centralization of project evaluation and approval in a new agency, which will report directly to the Prime Minister and be staffed by well-qualified professionals, can help address the lack of administrative assessment capacity and ensure more effective cost and quality control. At the same time, greater oversight and transparency of project approval and monitoring could help reduce corruption.

Authorities' Views

24. **The authorities emphasized the need to scale up public investment quickly.** They noted that many years of conflict have left the country's infrastructure in shambles. Given the country's stage of development, the state has to play a leading role in providing basic infrastructure. Rehabilitating existing and building new roads, providing access to reliable electrical power and clean water are seen by the authorities as a prerequisite to attract private investment. The government is conscious of many difficulties and has been working

tirelessly to overcome capacity constraints. It has identified main investment priority areas, in line with the Strategic Development Plan, and felt the urgency to act without delay in order not to lose another generation.

25. **The authorities felt that front-loaded scaling up of public investment would be consistent with long-term fiscal sustainability.** Their position was that such spending serves the long-run interest of the country even though it requires withdrawals from the PF in excess of the ESI in the short run.

- Ultimately, a vital private sector will need to become the source of jobs, income, and fiscal revenue. However, without an essential public infrastructure in place, no such economy is likely to emerge.

- Once basic infrastructure is in place, large public spending can be reduced and withdrawals from the PF can return to sustainable levels.

- The current ESI does not capture potential revenues from the Greater Sunrise field, a confirmed petroleum resource. Moreover, more natural resources might be discovered.

26. **The authorities felt that the composition of public spending reflects adequately the country's needs.** Spending was increased rapidly in recent years to address the people's immediate social needs, laying the foundation of peace and security. Nonetheless, the authorities thought that the mission's recommendations of curbing wage growth, phasing out rice and electricity subsidies, and better targeting transfers to the most needy are not supported by the importance of maintaining overall stability and would have ramifications in a post-conflict and fragile nation. They considered that now is the time to shift the focus to public capital.

V. External Stability and Competitiveness

27. **Official dollarization has provided a strong nominal anchor.** Dollarization has served the country well and there is currently no obvious alternative. Running an independent monetary policy would be extremely difficult given the absence of a well functioning financial market and limited administrative capacity.

28. **Fiscal policy holds key to competitiveness and external sustainability.** Standard analysis of exchange rate misalignment is currently neither feasible nor very meaningful for Timor-Leste. The lack of data on its nascent economy leaves little scope for econometric techniques. The external current account balance is driven largely by oil and gas revenue, with a small non-oil export sector, contributing only about 3 percent to BoP income. Against this background, it is hard to ascertain a current account norm. The sustainability of the current account in the medium-term is primarily dependent on fiscal policy (Box 1).

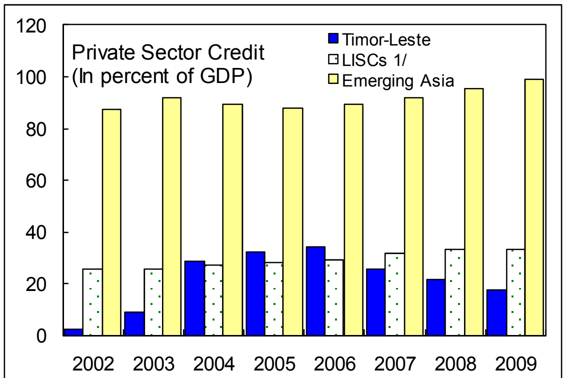
29. **Expediting business-enabling reforms is critical to enhance competitiveness and promote private sector-led growth.** Commendable progress includes the establishment of a one-stop-shop for investors and the passage of the Transitional Land Law by the Cabinet (though Parliamentary approval is pending). According to the World Bank's Doing Business Indicator, improving land access, easing business start-up, enforcing contract, and enhancing access to finance are key interrelated areas to focus on. Staff welcomed the authorities close cooperation with the World Bank in designing and implementing an action plan guided by the recommendations of the Timor-Leste Diagnostic Trade Integration Study.

Authorities' Views

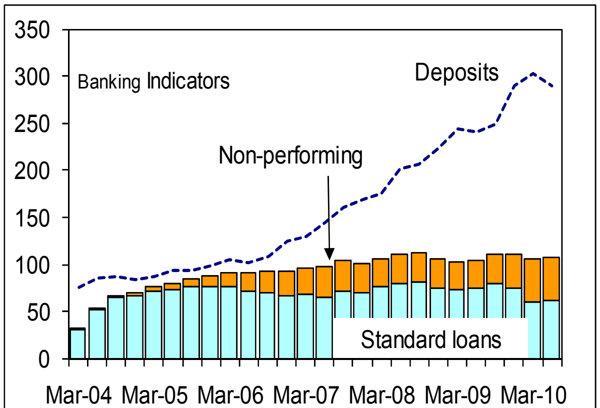
30. **The authorities agreed that dollarization has served the country well and indicated that there are currently no plans to change the exchange rate regime**. However, they raised questions about the impact of dollarization on the competitiveness of Timor-Leste relative to its neighboring countries.

VI. Financial Sector Policy

31. **The financial sector remains at an embryonic stage of development, with financial services reaching only a small portion of the population.** Three foreign bank branches dominate the financial sector, in addition to a small state-owned microfinance institution and a newly established insurance company. Despite bank deposit growth (30 percent in 2009), private sector credit has remained stagnant since 2005, with surplus funds held mainly abroad, and the loan-to-deposit ratio is about 20 percent. The non-performing loan to asset ratio has remained at 18 percent since 2008, but provisioning remains sufficient.



Sources: IMF, *APDLISC* database, *International Financial Statistics*; and Fund staff estimates.
1/ Low-income and small states in Asia.



Source: Country authorities.

32. **Staff suggested speeding up passage of key legislations and regulations to stimulate financial sector development.** Unclear property rights, in particular regarding land ownership, and weak contract enforcement prevent efficient collateralization of loans.

The central bank law to safeguard Banking and Payments Authority's autonomy and the anti-money laundering law were submitted for discussion by relevant Parliament committees.

33. **The authorities have continued to strengthen financial supervision.** Close coordination with foreign banks' home supervisors is also warranted. Staff encouraged continued efforts of data collection and analysis, and on-site and off-site supervision.

Authorities' Views

34. **The authorities indicated that commercial banks' high lending rates of 15–20 percent are disincentives for credit growth.** They expressed interest in receiving technical assistance to promote financial sector development.

VII. Statistics

35. **The availability, quality and timeliness of data continue to pose challenges to policy formulation and surveillance.** With extensive technical assistance (TA) from the Fund and other development partners, Timor-Leste has made welcome progress in improving statistics. For the first time, the authorities provided historical non-oil GDP data that entered into staff's analysis. However, important data remain unavailable, and the quality of data, notably national accounts, continues to have significant shortcomings that hamper policy analysis and surveillance. The mission suggested that adequate resources be provided to compile key economic statistics. Participation in the General Data Dissemination System (GDDS) would be beneficial to Timor-Leste.

VIII. Staff Appraisal

36. **After three years of double-digit expansion, economic growth is likely to slow to about 6 percent in 2010, mainly because adverse weather has slashed agricultural production.** As from next year, growth is expected to gradually gather speed and peak at around 9¾ percent in 2013–14, mainly driven by scaling up public investment, but also supported by dynamism in the non-oil private sector, including a recovery in agriculture. In the long term, growth is expected converge to about 6 percent given by supply-side fundamentals. Price pressures have been rising in 2010 and are particularly notable in some segments of the economy, such as construction, and in the skilled labor market. Inflation is expected to increase to 6 percent, somewhat above the average rate in neighboring countries.

37. **Timor-Leste should use its oil wealth wisely to build a strong, sustainable non-oil economy that would permanently reduce poverty and raise living standards.** The governments' resolve to step up development is admirable. After years of conflict, there is a need to reconstruct basic infrastructure. If well selected and managed, investment in infrastructure could have sufficiently high returns to justify withdrawals from the PF in excess of sustainable income. However, the planned rapid expansion of public investment in infrastructure risks overstretching the country's current ability to plan, evaluate, and

implement given its institutional weaknesses and administrative capacity constraints. There are also signs of rising inflation as the economy is reaching its absorptive capacity limit, due to the shortage of skilled labor and the small size of the private sector.

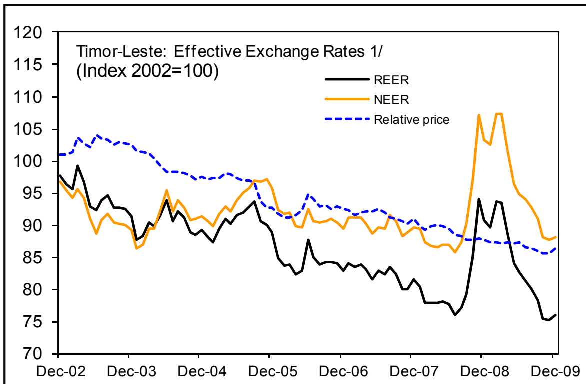
38. **Therefore, a more-gradual-than-planned pace of spending increases is advisable.** Recent years have seen rapid spending growth to address pressing social needs and to lay the foundation for peace in the aftermath of the 2006/7 civil unrest. By 2009, public spending per head has reached a level that is above many comparable countries. The revised higher ESI has created room for additional investment in a limited number of priority projects while gaining experience with the management of capital spending. Spending at a measured pace would stand a better chance of realizing high quality investment, crowding in private investment, and thereby achieve balanced and sustainable growth.

39. **At the same time capacity constraints should be addressed and business-enabling reforms implemented.** The government's plan to address budget under-execution and to build administrative capacities (to "invest in investing") is encouraging. A new agency, reporting directly to the Prime Minister, will be in charge of major project evaluation, approval, and quality control. It will be important that the agency recruits well-qualified staff. A more efficient administration and business friendlier regulations would make life easier for businesses. The introduction of a one-stop-shop for business is a welcome step in this direction. Reforms to enhance property rights, such as the pending land law should be accelerated. Efficient collateralization would enable the financial sector to extend credits to local businesses.

40. **Fiscal policy should be mindful of competitiveness and external stability.** Official dollarization has helped keep inflation under control and should be maintained. But dollarization needs to be supported by accelerating productivity-enhancing structural reforms and raising labor skills to improve competitiveness in non-oil industry and services. A slower pace of public spending growth would help to contain inflationary pressures.

41. **Staff recommends that the next Article IV consultation be held on the standard 12-month cycle.**

Box 1. Exchange Rate, Competitiveness, and External Sustainability Assessment



1/ Calculated using nonfood CPI as proxy for nontradable good prices. Weights (Indonesia: 55; Singapore 18; Australia 17; Vietnam 5; and Japan: 5) are based on import shares during 2004-06.

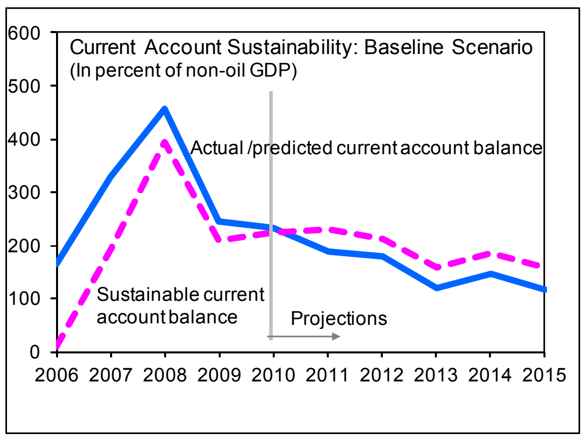
The real effective exchange rate is a poor indicator of Timor-Leste's competitiveness. Lack of data prevents the estimation of equilibrium exchange rates. Moreover, petroleum and coffee, the country's main sources of foreign income, are denominated in U.S. dollars, and the CPI is poorly measured. Competitiveness indicators based on unit costs are unfortunately not available. However, wages, driven by the public sector, have been rising fast, while productivity has been lagging behind and terms-of-trade have improved significantly.

Assessment of Business Climate, 2009-2010

Doing Business			Global Competitiveness Index		
Countries	Rank among 181 (2010)	Rank among 181 (2009)	Countries	Rank among 133 (2010)	Rank among 133 (2009)
Vietnam	93	92	Thailand	38	36
Papua New Guinea	102	95	Indonesia	44	54
Sri Lanka	105	102	Vietnam	59	75
Bangladesh	119	110	Sri Lanka	62	79
Nepal	123	121	Philippines	83	87
Indonesia	122	129	Bangladesh	103	106
Cambodia	145	135	Cambodia	105	110
Philippines	144	140	Nepal	124	125
Timor-Leste	164	170	Timor-Leste	127	126

Sources: World Bank, *World Development Indicators;* and World Economic Forum.

Timor-Leste's business climate has little improved. The 2010 Doing Business ranking improved due to the 2008 cuts in business and income taxes. However, in terms of overall ranking Timor-Leste is still among the lowest performers out of the 181 countries which participated in the survey. Timor-Leste fell back one rank on the 2010–11 Global Competitiveness ranking, and is at the bottom of the Asia-Pacific region. According to the GCI, the most problematic factors for doing business in Timor-Leste are access to financing, poor skills and work ethic, inefficient government bureaucracy, inadequate infrastructure, and corruption.[1]

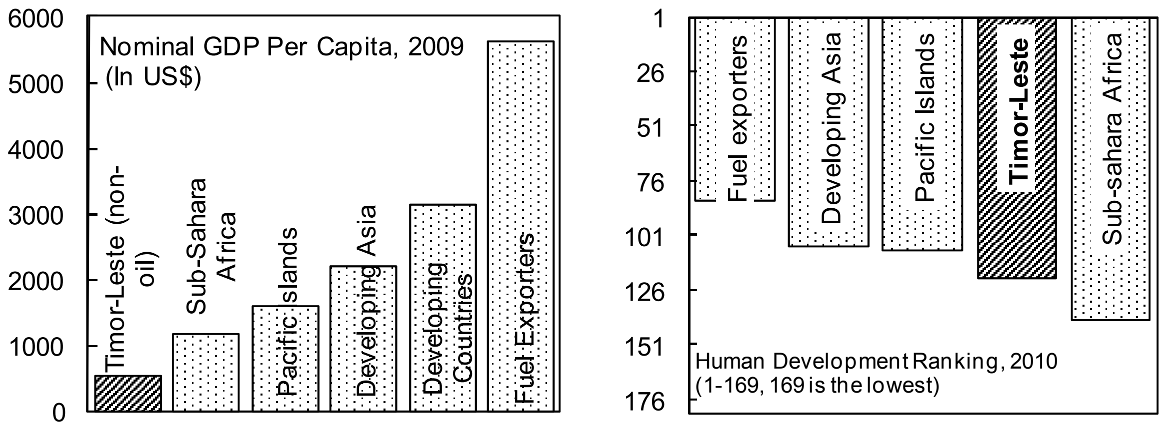


Current spending plans risk undermining external stability. From a macroeconomic balance perspective the current account mirrors petroleum-financed public spending. In 2011, the current account surplus is expected to fall below its sustainable level, computed as the difference between petroleum income and the ESI. In the medium run, the current account surplus is projected to remain below its sustainable level by about 30 percent of GDP.

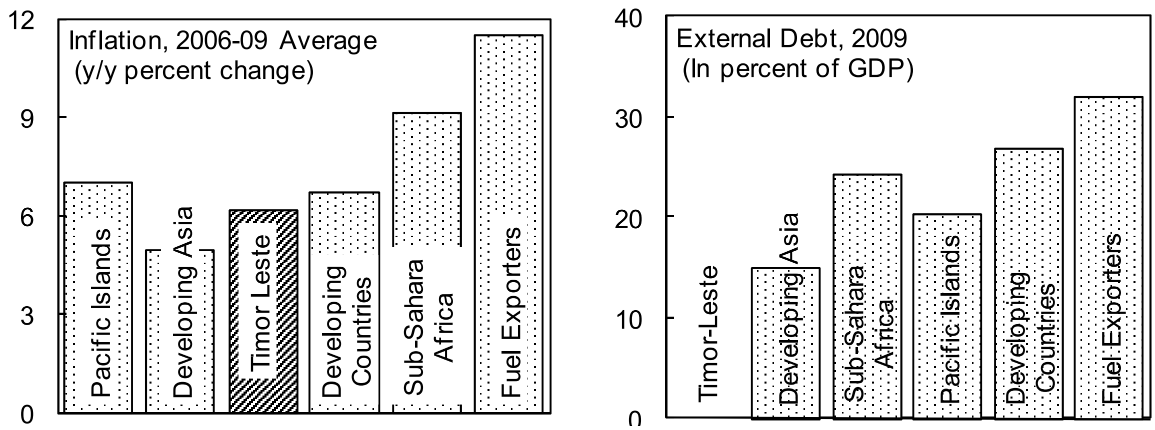
[1] The Global Competitiveness Report 2010–2011, World Economic Forum.

Figure 1. Timor-Leste: Regional and Global Comparisons 1/

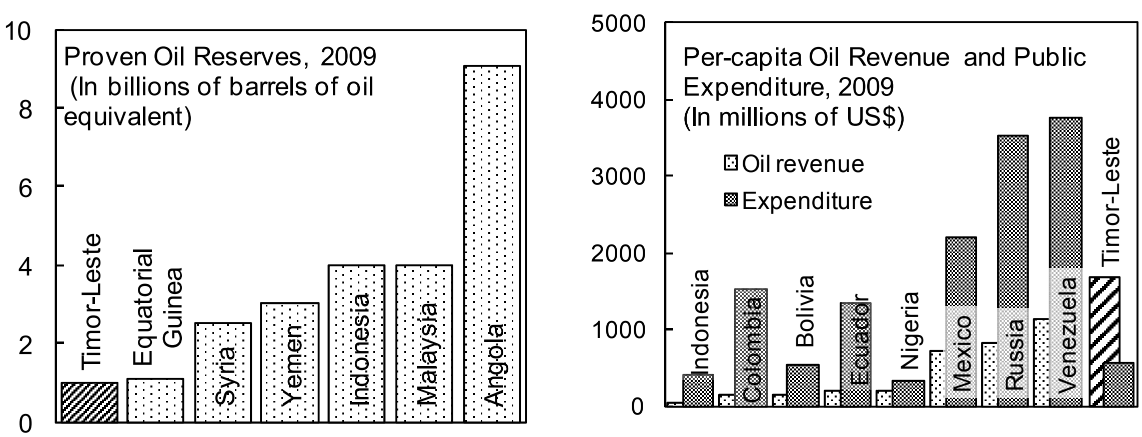
Timor Leste's living standards remain low in the developing world.



However, if the good macroeconomic policies so far are maintained, with low inflation and no public or external debt,...



...and the considerable oil wealth is effectively and sustainably harnessed, there is significant scope for promoting non-oil growth. 2/



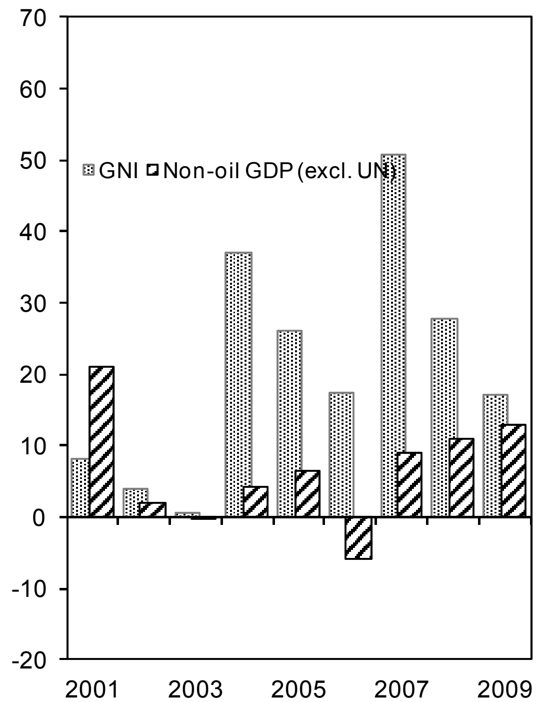
Sources: Authorities; UN, *Human Development Indicators, 2009/10*; IMF, *World Economic Outlook* and *FAD-DEME* databases; PennWell Corporation, *Oil & Gas Journal*, December, 2009; and Fund staff estimates.

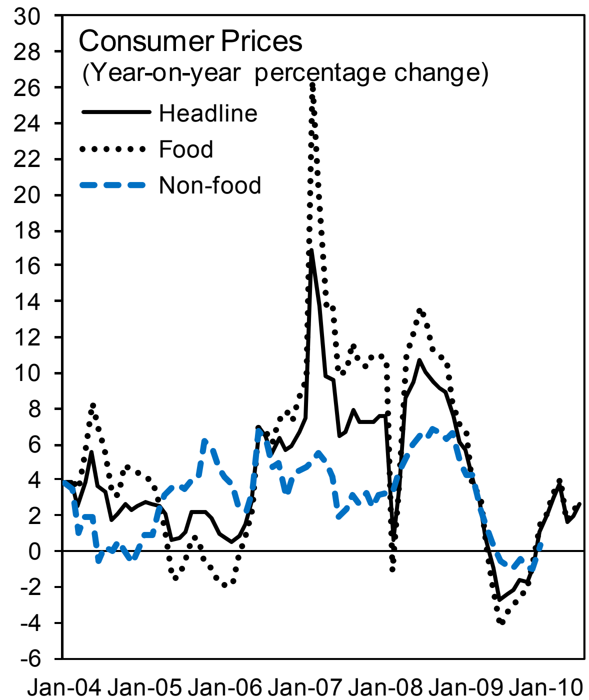
1/ For Timor-Leste, calculations in non-oil GDP.

2/ Bayu Undan field only.

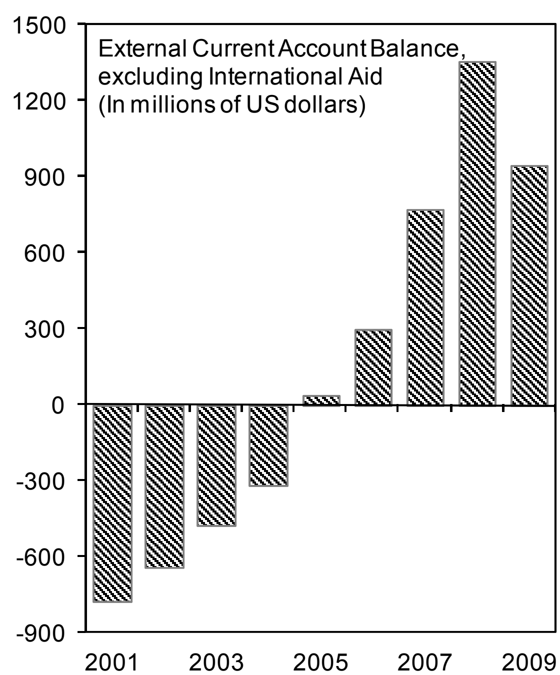
Figure 2. Timor Leste: Recent Macroeconomic Developments

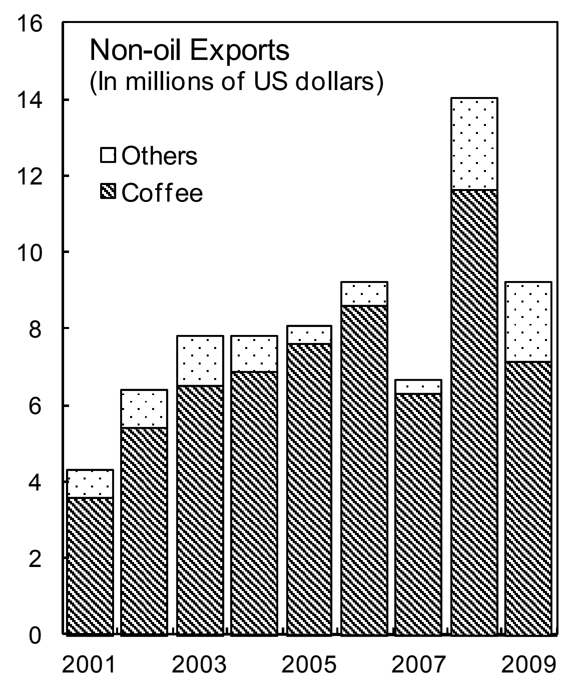
Rapidly rising public spending and an agricultural rebound have fueled high non-oil growth in the last three years. Inflation rose in 2008 along with food prices, but has abated somewhat.





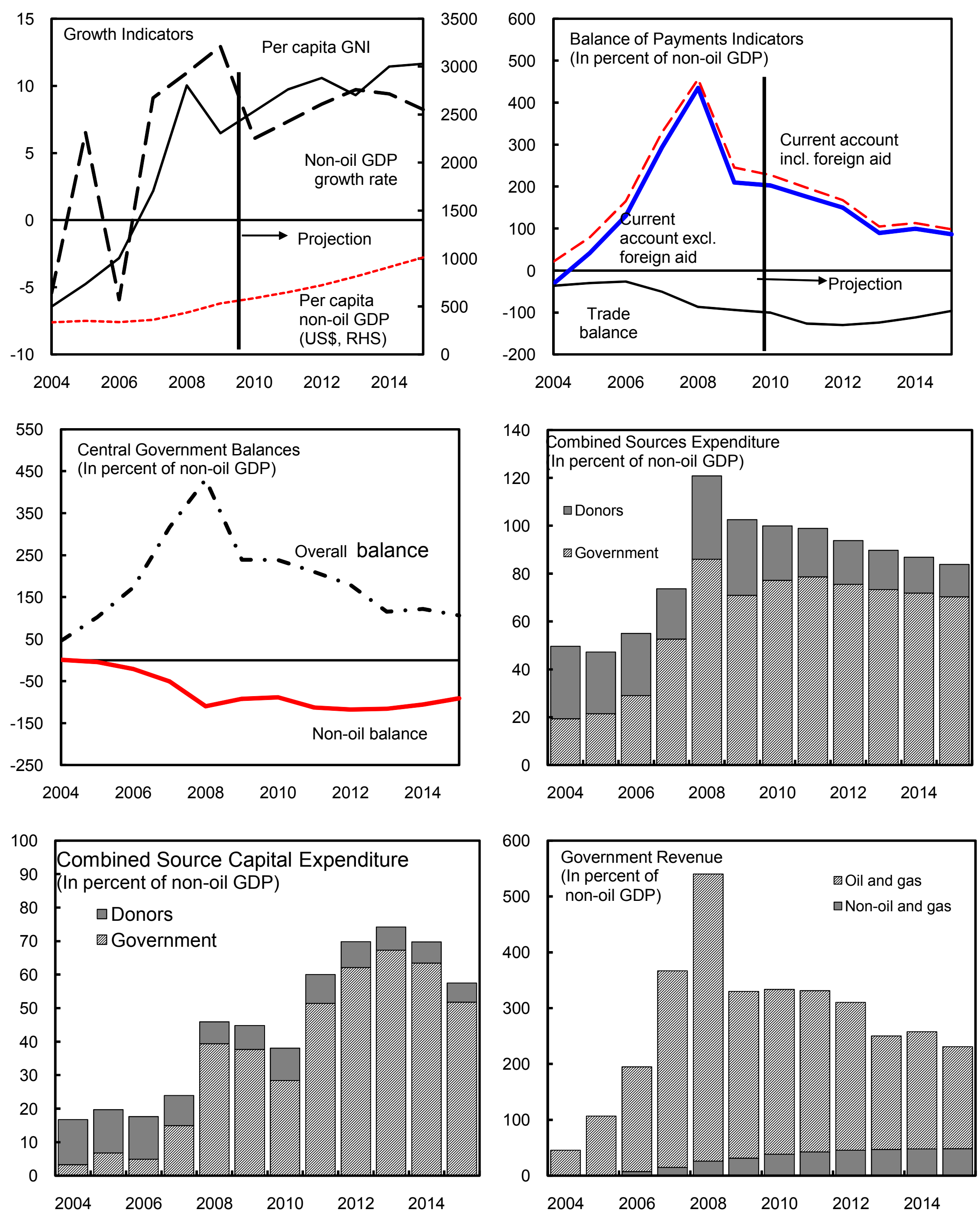
Oil/gas revenue has dominated national income and the current account surplus. Non-oil exports remain very small.





Sources: Timor-Leste authorities; and Fund staff estimates and projections.

Figure 3: Timor Leste: Medium-term Baseline Scenario



Sources: Country authorities and Fund staff estimates.

Table 1. Timor-Leste: Selected Social Indicators 1/

	Timor-Leste		East Asia and Pacific Island countries		Low income countries	
Gross national income per capita (US$) 2/	2306		2,644		523	
GDP per capita (PPP, current US$)	534		5,446		1,352	
Area (in thousands of square kilometers)	15		16		28	
Demography						
Total population (in millions)	1.1		1,930		976	
Population growth (in percent) 3/	2.4		0.8		2.1	
Life expectancy and mortality 4/						
Life expectancy at birth (years)	61		72.2		59.0	
Male	60		70.4		57.7	
Female	62		74.0		60.3	
Infant mortality (per thousand live births)	67		23.1		75.9	
Under 5 mortality rate (per thousand live births)	93		28.5		117.9	
Education (in percent)						
Literacy rate 5/	47		93.1		83.0	
Male	56		96.0		75.8	
Female	39		90.1		63.0	
Gross primary school enrollment rate	107		112.2		100.9	
Health						
Immunization rate (in percent of children less than 5 years old)						
Measles	57		91.4	4/	78.0	4/
DPT	68		92.3	4/	79.9	4/
Other indicators (in percent)						
The population below the poverty line	41	6/	…		...	
Households with access to electricity	36		-		...	
Population with access to improved water source	62		87.0	4/	86.0	4/

Sources: World Bank, *World Development Indicators;* and Country authorities.

1/ Data are for 2009, unless otherwise indicated.
2/ For comparators, GNI is calculated using Atlas method.
3/ Average growth over 2000-09.
4/ Figures are for 2008.
5/ For Timor-Leste, ability to read and write a letter without difficulty among population above age 18.
6/ Figure is for 2009.

Table 2. Timor-Leste: Selected Social and Economic Indicators

I. Social and Demographic Indicators

Income (2010)		**Education and health** (2007)	
GNI per capita (in U.S. dollars):	2,458	Literacy rate (in percent)	47.3
Non-oil GDP per capita (in U.S. dollars):	570	Infant mortality rate (per 1000 births)	68
Population characteristics (2010)		**Poverty and access to services** (2007)	
Total population (in millions):	1.1	Poverty rate (in percent, 2009)	41.0
Population growth (in percent):	2.4	Access to improved water (in percent)	64.7
Life expectancy at birth (years, 2006):	59	Access to electricity (in percent)	36.1

II. Economic Indicators

	2004	2005	2006	2007	2008	2009 Prel.	2010 Proj.	2011 Proj.
Output and prices								
GNI at current prices (US$ million)	460	695	972	1,689	2,851	2,401	2,704	3,019
Non-oil GDP at current prices (US$ million)	309	332	327	358	444	556	627	708
Real non-oil GDP growth (percentage change)	4.2	6.2	-5.8	9.1	11.0	12.9	6.1	7.3
Including United Nations 1/	0.4	2.3	-3.4	18.2	10.6	9.1	5.0	6.2
Inflation (CPI, percentage change, end-period)	2.5	1.0	6.7	7.6	6.1	1.1	6.5	6.0
Inflation (CPI, percentage change, period average)	3.2	1.8	4.1	8.9	7.6	0.1	4.5	6.0
	(in percent of non-oil GDP)							
Savings and investment								
Gross investment 2/	21	21	23	29	63	55	48	70
Gross national savings	42	99	188	358	518	301	276	267
External savings	-21	-79	-166	-329	-456	-245	-227	-197
Central government finances								
Revenues	67	128	205	382	551	342	338	334
Domestic revenues	10	11	10	12	10	11	11	11
Petroleum revenue	46	107	195	367	540	332	328	323
Grants	11	10	0	3	0	0	0	0
Expenditure (cash basis)	20	26	32	66	120	103	100	123
Recurrent expenditure	17	19	27	51	81	65	72	73
Capital expenditure	3	7	5	15	39	38	28	50
Overall balance	46	102	174	316	431	239	239	210
Non-oil fiscal balance	1	-5	-21	-51	-110	-92	-89	-113
Combined sources fiscal operations 3/								
Domestic revenue and budget grants	23	24	13	17	12	13	13	13
Expenditure	66	67	73	98	163	144	133	154
Recurrent expenditure	50	47	55	74	117	99	96	95
Capital expenditure	17	20	18	24	46	45	37	59
Overall balance	-43	-43	-60	-81	-151	-131	-121	-141
Money and credit								
Broad money (end-period) 4/	21	23	31	40	43	48	…	…
Net domestic assets (end-period)	-38	-24	-3	-48	-42	-30	…	…
	(in millions of U.S. dollars, unless otherwise indicated)							
External sector								
Current account	65	261	541	1,177	2,023	1,363	1,425	1,395
Merchandise exports 2/	8	8	9	7	14	9	11	14
Merchandise imports	122	112	101	176	311	385	575	802
Memorandum items:								
Donor development assistance (% of non-oil GDP)	55	49	39	33	42	39	32	28
Crude oil price ($ per barrel) 5/	38	53	64	71	97	62	77	68
Oil/gas receipts	141	349	612	1,258	2,284	1,660	1,816	1,992
Petroleum Fund withdrawals	n.a.	0	0	-300	-396	-512	-636	-734
Petroleum Fund balance (end-period) 6/	14	370	1,012	2,086	4,197	5,377	6,744	8,271
Petroleum Fund balance (percent of non-oil GDP) 6/	5	112	310	583	945	968	1,076	1,169

Sources: Data provided by the Timor-Leste authorities; and Fund 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/ Simple average of EIA's low case and reference prices.

6/ Figure for 2004 refers to the Timor-Sea account, which preceded the August 2005 establishment of the Petroleum Fund.

Table 3. Timor-Leste: Central Government Budget FY2005/06-2011 1/

	2005/06	2006/7		2007H2		2008			2009		2010			2011
		Budget	Act.	Budget	Act.	Budget	Supl.	Act.	Budget	Prel.	Budget	Supl.	Proj.	Proj.
	(in millions of US dollars, unless otherwise specified)													
Revenue	**516**	**733**	**1,045**	**575**	**692**	**1,379**	**1,979**	**2,445**	**1,312**	**1,902**	**1,463**	**1,906**	**2,122**	**2,363**
Domestic revenues	34	39	40	19	20	21	40	45	59	60	70	62	67	76
Direct taxes	9	8	12	6	5	3	13	19	11	13	12	28	16	19
Indirect taxes	16	21	19	10	9	8	18	19	38	30	48	20	34	40
Nontax revenues and other	9	10	9	3	6	9	10	6	10	16	9	14	17	18
Petroleum revenue	482	683	993	556	672	1,359	1,939	2,399	1,253	1,842	1,393	1,844	2,055	2,287
Oil/gas receipts	469	644	956	519	640	1,250	1,846	2,284	1,163	1,660	1,243	1,694	1,816	1,992
Interest	13	40	37	37	32	109	93	115	90	182	150	150	239	295
Grants	1	10	11	0	0	0	0	1	0	0	0	0	0	0
Expenditure (commitment basis) 2/	**119**	**309**	**258**	**109**	**98**	**341**	**742**	**...**	**...**	**...**			**...**	
Recurrent expenditure	77	173	159	101	88	250	592	...	...	...			...	
Wages and salaries	26	47	40	27	24	50	61	...	...	...			...	
Goods and services	46	94	83	48	37	124	171	...	...	...			...	
Transfers	0	18	17	12	12	64	132	...	...	...			...	
Subsidies	6	13	18	14	15	11	228	...	...	...			...	
Capital expenditure and net lending	42	137	99	8	10	91	150	...	...	...			...	
Minor capital	7	17	18	3	5	24	37	...	...	...			...	
Development capital	25	113	79	4	4	60	99	...	...	...			...	
Subsidies and transfers 3/	11	7	2	0	1	7	13	...	...	...			...	
Expenditure (cash basis) 4/	**93**	**...**	**173**	**...**	**105**	**...**	**...**	**532**	**649**	**573**	**647**	**806**	**625**	**874**
Recurrent expenditure	66	...	134	...	62	...	...	358	406	363	420	555	450	519
Wages and salaries	26	...	40	...	24	...	...	53	91	86	96	97	96	103
Goods and services	34	...	64	...	15	...	...	154	163	158	183	224	161	240
Transfers	0	...	12	...	8	...	...	88	96	94	105	195	153	124
Subsidies	6	...	17	...	15	...	...	63	55	26	35	40	40	51
Capital expenditure and net lending	16	...	21	...	1	...	...	175	243	209	228	251	175	355
Minor capital	3	...	9	...	1	...	...	47	36	36	19	35	14	20
Development capital	2	...	12	...	0	...	...	114	191	162	194	202	151	316
Subsidies and transfers 3/	11	...	0	...	0	...	...	14	16	11	15	15	9	19
Carry-over 4/	11	...	18	...	42	...	...	...	...	...	...	...	...	...
Overall balance	**424**	**423**	**872**	**466**	**587**	**1,038**	**1,237**	**1,912**	**663**	**1,329**	**815**	**1,099**	**1,498**	**1,489**
Non-oil balance	**-58**	**-260**	**-121**	**-90**	**-85**	**-321**	**-702**	**-487**	**-590**	**-513**	**-578**	**-745**	**-557**	**-798**
Financing	58	260	121	90	85	321	702	487	590	513	578	745	557	798
Petroleum Fund withdrawals	0	260	260	40	40	260	687	396	589	512	502	811	636	734
Changes in cash balances (increase = '-')	58	0	-139	50	45	61	15	91	1	1	76	-66	-79	64
	(in percent of non-oil GDP)													
Revenue	**157**	**214**	**305**	**322**	**387**	**311**	**446**	**551**	**236**	**342**	**233**	**304**	**338**	**334**
Domestic revenues	10	11	12	11	11	5	9	10	11	11	11	10	11	11
Petroleum revenue	146	200	290	311	376	306	437	540	226	332	222	294	328	323
Grants	0	3	3	0	0	0	0	0	0	0	0	0	0	0
Expenditure (commitment basis) 2/	**36**	**90**	**75**	**61**	**55**	**77**	**167**	**...**	**...**	**...**	**...**	**...**	**...**	**...**
Recurrent expenditure	23	50	46	57	49	56	133	...	...	...	...	...	...	...
Capital expenditure and net lending 3/	13	40	29	4	6	21	34	...	...	...	...	...	...	...
Expenditure (cash basis) 4/	**28**	**...**	**50**	**...**	**59**	**...**	**...**	**120**	**117**	**103**	**103**	**129**	**100**	**123**
Recurrent expenditure	20	...	39	...	35	...	...	81	73	65	67	89	72	73
Capital expenditure and net lending 3/	5	...	6	...	1	...	...	39	44	38	36	40	28	50
Carry-over 4/	3	...	5	...	23	...	...	...	...	...	...	...	...	...
Overall balance	**129**	**124**	**255**	**261**	**328**	**234**	**279**	**431**	**119**	**239**	**130**	**175**	**239**	**210**
Non-oil balance 5/	**-18**	**-76**	**-35**	**-50**	**-48**	**-72**	**-158**	**-110**	**-106**	**-92**	**-92**	**-119**	**-89**	**-113**
Memorandum items:														
Petroleum Fund balance (in US$ millions)	650	...	1,394	...	2,086	...	...	4,197	...	5,377	...	...	6,744	8,271
Petroleum Fund balance (end-year)	197	...	407	...	583	...	...	945	...	968	...	...	1,076	1,169
Estimated sustainable income (in US$ millions) 5/	...	283	...	133	...	294	396	...	408	...	502	502	...	...
Estimated sustainable income 6/	...	83	...	74	...	66	89	...	73	...	80	80	...	...
Sustainable spending 7/	...	97	...	85	...	71	98	...	84	...	91	90	...	...

Sources: Timor-Leste authorities; and Fund staff estimates.

1/ Fiscal year: July-June until June 2007; calendar year starting 2008. Central Government includes subsidies to Autonomous Agencies.
Revenue from government rice sales (estimated at $17 million in 2008, $20 million in 2009, and $14 million in 2010) is excluded and only the net subsidy included in recurrent expenditure.

2/ The budget moved toward a cash basis in 2008 and the authorities stopped reporting commitments. Of the $528 million reported as spent in 2008, an estimated $80 million was actually paid out in 2009, with spending under the 2008 budget allowed to continue in early 2009 as a transitional measure before fully applying cash-based principles.

3/ Includes allocations for BPA capitalization ($10.5 million in 2006/07).

4/ Cash expenditure includes carry-over expenditure from previous years (the reporting of which was not disaggregated prior to 2008).

5/ Defined as overall balance minus petroleum revenue.

6/ Permanent income from oil and gas, estimated according to the Petroleum Fund law for each budget.

7/ Adds non-petroleum revenue to estimated sustainable income from petroleum.

Table 4. Timor Leste: Combined Sources Budget 2004 - 2011

	2004	2005	2006	2007	2008	2009 Prel.	2010 Proj.	2011 Proj.
	(in millions of U.S. dollars)							
Revenue	72	79	42	60	53	70	79	90
Domestic revenue 1/	30	37	34	42	45	60	67	76
Direct taxes	7	11	10	13	19	13	16	19
Indirect taxes	19	17	17	19	19	30	34	40
Nontax revenues and other	5	9	7	11	6	16	17	18
Autonomous agencies own revenue	7	8	7	7	8	10	12	14
Grant financing (budget support)	35	33	1	11	1	0	0	0
Expenditure (cash basis)	205	222	238	349	724	799	837	1,088
Recurrent expenditure	154	157	180	263	520	550	602	673
Central government and autonomous agencies	60	71	95	188	365	374	462	533
Donor projects 2/	94	86	85	75	155	176	141	141
Capital expenditure	52	66	58	86	204	249	234	415
Central government and autonomous agencies	10	22	16	53	175	209	175	355
Donor projects 2/	41	43	42	32	29	40	59	59
Overall balance	-133	-144	-196	-289	-671	-728	-757	-998
Financing	133	144	196	289	671	728	757	998
Oil fund financing of central govt. non-oil fiscal deficit	137	-4	0	300	396	512	636	734
Project financing by donors 3/	135	129	126	107	184	216	200	200
Change in cash balances (increase -)	-122	21	62	-126	4	-8	-79	64
	(in percent of non-oil GDP)							
Revenue	23	24	13	17	12	13	13	13
Domestic revenue 1/	10	11	10	12	10	11	11	11
Autonomous agencies own revenue	2	2	2	2	2	2	2	2
Grant financing (budget support)	11	10	0	3	0	0	0	0
Expenditure (cash basis) 2/	66	67	73	98	163	144	133	154
Recurrent expenditure	50	47	55	74	117	99	96	95
Capital expenditure	17	20	18	24	46	45	37	59
Overall Balance	-43	-43	-60	-81	-151	-131	-121	-141
Financing	43	43	60	81	151	131	121	141
Oil fund financing of central govt. non-oil fiscal deficit	44	-1	0	84	89	92	101	104
Project financing by donors	44	39	39	30	41	39	32	28
Change in cash balances (increase -)	-39	6	19	-35	1	-1	-13	9

Sources: Timor-Leste authorities; and Fund staff estimates.

1/ Oil/gas revenue is not included as a budget revenue item and flows directly to the petroleum fund. The amount necessary to cover the non-oil fiscal deficit is withdrawn from the fund and transferred to the budget and recorded as a financing item. Rice sales are excluded from domestic revenue in this table.

2/ Includes sector projects which the government has identified as necessary to achieve development objectives, but may not be wholly funded by the government.

3/ Donor grants excluding budget support.

Table 5. Timor-Leste: Balance of Payments 2004–2011

	2004	2005	2006	2007	2008	2009 Prel.	2010 Proj.	2011 Proj.
	(In millions of U.S. dollars)							
Current account	65	261	541	1,177	2,023	1,363	1,425	1,395
Trade balance	-115	-104	-91	-169	-297	-376	-564	-788
Exports of goods 1/	8	8	9	7	14	9	11	14
Of which: Coffee	7	8	9	6	12	7	8	11
Imports of goods	122	112	101	176	311	385	575	802
Services (net)	-186	-130	-198	-263	-444	-505	-409	-444
Exports	47	37	34	63	44	47	68	72
Of which: Travel	19	21	20	26	14	18	20	22
Imports	233	167	232	325	488	552	477	516
Of which: UN and donor related	201	137	204	286	364	375	351	345
Income (net)	151	363	645	1,331	2,407	1,846	2,077	2,311
Of which: Oil/gas receipts and interest	141	354	637	1,312	2,399	1,842	2,055	2,287
Current transfers (net)	215	133	185	278	357	399	321	316
Of which: International assistance	215	133	184	281	355	362	321	316
Capital and financial accounts	56	-291	-610	-1,031	-2,043	-1,324	-1,338	-1,458
Official capital transfers	41	43	42	32	17	27	59	59
Financial account 2/	14	-334	-652	-1,063	-2,060	-1,351	-1,397	-1,518
Of which: Oil/gas savings	-3	-358	-637	-1,012	-2,003	-1,330	-1,419	-1,553
Overall balance	121	-29	-70	147	-20	39	88	-63
Changes in foreign assets (increase -)	-121	29	70	-147	20	-39	-88	-64
	(In percent of non-oil GDP)							
Current account	21	79	166	329	456	245	227	197
Trade balance	-37	-31	-28	-47	-67	-68	-90	-111
Services (net)	-60	-39	-61	-73	-100	-91	-65	-63
Income (net)	49	109	197	372	542	332	331	327
Current transfers (net)	70	40	57	78	80	72	51	45
Capital and financial accounts	18	-88	-187	-288	-460	-238	-213	-206
Overall balance	39	-9	-21	41	-4	7	14	-9
	(In millions of U.S. dollars)							
Memorandum item:								
Public foreign assets (end-period)	135	524	1,096	2,316	4,407	5,627	7,081	8,545

Sources: Data provided by the Timor-Leste authorities, and Fund staff estimates.

1/ Excludes oil/gas receipts, which are recorded under the income account because of lack of detailed data on the oil/gas sector (including production, exports, service payments, and profit remittances).

2/ Includes errors and omissions.

Table 6. Timor-Leste: Monetary Developments, 2004-2009

	2004	2005	2006	2007	2008	2009
			(in millions of U.S. dollars)			
Banking System						
Net foreign assets	**184**	**159**	**113**	**318**	**393**	**443**
Assets 1/	227	206	144	356	422	469
Gross reserves	182	153	84	230	210	250
Liabilities	43	47	31	38	29	26
Net domestic assets	**-116**	**-80**	**-11**	**-172**	**-187**	**-169**
Claims on government (net)	-187	-151	-83	-219	-230	-206
Claims on private sector	88	106	111	101	102	104
Other ("net other assets")	0	0	0	0	0	0
Other items, net (incl capital account)	-18	-35	-40	-54	-60	-66
Broad money 2/	**66**	**78**	**100**	**144**	**193**	**268**
Narrow money	32	39	54	75	104	157
Currency in circulation	1	2	2	2	2	3
Demand deposits	31	38	52	73	102	155
Other deposits	34	38	46	68	88	111
Non-liquid liabilities	2	1	2	2	13	5
Banking and Payments Authority (central bank)						
Net foreign assets 1/	**182**	**153**	**84**	**230**	**210**	**238**
Assets	182	153	84	230	210	250
Gross reserves	182	153	84	230	210	250
Others	0	0	0	0	0	0
Liabilities	0	0	0	0	0	0
Net domestic assets	**-175**	**-147**	**-74**	**-210**	**-173**	**-179**
Central Government (net position)	-169	-129	-56	-190	-196	-163
Claims on domestic banks and other claims	-8	-19	-19	-20	22	-17
Other items, net	1	1	1	1	1	1
Liabilities	**7**	**6**	**9**	**21**	**37**	**59**
Currency in circulation 2/	1	2	2	2	2	3
Financial institutions	5	5	6	18	23	53
Other deposits and liquid liabilities	0	0	0	0	0	0
Non-liquid liabilities	1	0	1	0	12	3
Commercial banks 3/						
Net foreign assets	**1**	**6**	**29**	**88**	**182**	**205**
Assets	44	52	61	126	211	219
Liabilities	43	47	31	38	29	14
Net domestic assets	**65**	**71**	**70**	**55**	**9**	**63**
Deposits with BPA	5	3	5	16	-19	51
Claims on government (net)	-18	-23	-27	-28	-34	-44
Claims on private sector	88	106	111	100	102	103
Capital accounts	-14	-15	23	19	12	4
Other items (net)	4	1	-43	-52	-52	-52
Deposit liabilities	**66**	**77**	**99**	**143**	**191**	**266**
Demand deposits	31	38	52	73	102	155
Time and Savings Deposits	34	38	46	68	88	111
Deposits Excluded from Broad Money	1	1	1	2	1	0
Memorandum items						
Petroleum Fund balance (US$ millions) 1/	...	370	1,012	2,086	4,197	5,377
Net foreign assets (percentage change)	70.0	-13.4	-28.8	181.1	23.4	12.8
Credit to the private sector (percentage change)	237.2	19.8	5.2	-9.8	1.9	0.9
Credit ratio to non-oil GDP (percent)	28.6	31.9	34.1	28.1	23.1	18.6
Broad money ratio to non-oil GDP (percent)	21.3	23.5	30.6	40.2	43.4	48.3
Credit ratio to deposits (percent)	133.9	137.4	112.5	70.1	53.5	38.9

Sources: Banking and Payments Authority; and Fund staff estimates.

1/ An oil fund was created in September 2005 and the deposits were moved off-shore and onto the Government balance sheet.
2/ Includes only coinage issued by the BPA. No data is available for notes due to dollarization of the financial system.
3/ Includes 3 commercial banks (branches of foreign banks) and a micro-finance institution.

Table 7. Timor-Leste: Medium-Term Outlook, 2006-2015

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
					Projections					
Output and prices										
GNI at current prices (in millions of US dollars)	972	1,689	2,851	2,401	2,704	3,019	3,225	3,096	3,520	3,637
Of which: Non-oil GDP	327	358	444	556	627	708	806	930	1,068	1,215
Petroleum revenue	637	1,312	2,399	1,842	2,055	2,287	2,393	2,145	2,433	2,401
Real non-oil GDP growth (percentage change)	-5.8	9.1	11.0	12.9	6.1	7.3	8.6	9.7	9.4	8.2
Including United Nations 1/	-3.4	18.2	10.6	9.1	5.0	6.2	7.4	4.2	5.4	8.2
Inflation (percentage change, period average)	4.1	8.9	7.6	0.1	4.5	6.0	6.0	6.0	6.0	6.0
	(in percent of non-oil GDP)									
Investment-saving balance										
Gross investment 2/	23	29	63	55	48	70	78	80	74	62
of which: public	18	24	46	45	37	59	67	68	62	49
Gross national saving	188	358	518	301	276	267	246	185	187	160
External saving	-166	-329	-456	-245	-227	-197	-168	-105	-113	-99
Central government finances										
Revenues	205	382	551	342	338	334	308	242	238	208
Domestic revenue	10	12	10	11	11	11	11	11	11	10
Petroleum revenue	195	367	540	332	328	323	297	231	228	198
Grants	0	3	0	0	0	0	0	0	0	0
Expenditure	32	66	120	103	100	123	128	126	116	101
Recurrent expenditure	27	51	81	65	72	73	69	64	60	57
Capital expenditure	5	15	39	38	28	50	59	62	56	44
Overall balance	174	316	431	239	239	210	179	115	122	107
Non-oil fiscal balance	-21	-51	-110	-92	-89	-113	-117	-116	-106	-91
Combined sources fiscal operations 3/										
Revenues	13	17	12	13	13	13	13	13	13	13
Expenditure	73	98	163	144	133	154	155	150	137	120
Overall balance	-60	-81	-151	-131	-121	-141	-142	-137	-125	-108
	(in millions of U.S. dollars, unless otherwise specified)									
External sector										
Current account balance	541	1,177	2,023	1,363	1,425	1,395	1,352	975	1,205	1,198
Trade balance	-91	-169	-297	-376	-564	-788	-915	-1,006	-1,040	-1,019
Merchandise exports 4/	9	7	14	9	11	14	17	23	29	35
Merchandise imports	101	176	311	385	575	802	933	1,029	1,068	1,054
Petroleum revenue	637	1,312	2,399	1,842	2,055	2,287	2,393	2,145	2,433	2,401
Overall balance	-70	147	-20	39	88	-63	0	0	0	0
Public foreign assets (end-period)	1,096	2,316	4,407	5,627	7,081	8,545	10,009	11,108	12,450	13,798
(in months of merchandise imports)	131	158	170	175	148	128	129	130	140	157
	(in percent of non-oil GDP, unless otherwise specified)									
Current account	166	329	456	245	227	197	168	105	113	99
Trade balance	-28	-47	-67	-68	-90	-111	-114	-108	-97	-84
Merchandise exports 4/	3	2	3	2	2	2	2	2	3	3
Merchandise imports	31	49	70	69	92	113	116	111	100	87
Overall balance	-21	41	-4	7	14	-9	0	0	0	0
Memorandum items:										
Crude oil price ($ per barrel) 5/	64	71	97	62	77	68	71	75	79	81
Petroleum Fund withdrawals	0	-84	-89	-92	-101	-104	-115	-112	-102	-87
Petroleum Fund balance (end-period)	310	583	945	968	1,076	1,169	1,208	1,165	1,140	1,113

Sources: Data provided by the Timor Leste authorities; and Fund staff estimates and projections.

1/ Includes locally paid compensation of UN peacekeeping mission staff.
2/ Excludes oil/gas sector investment.
3/ Includes autonomous agencies and fiscal and quasi-fiscal expenditure programs undertaken by bilateral donors and international financial institutions outside the central government budget.
4/ Excludes oil/gas revenue, which is recorded under the income account.
5/ Simple average of EIA's low case and reference prices.

Table 8. Timor-Leste: Vulnerability Indicators, 2004-2009

	2004	2005	2006	2007	2008	2009
Financial sector risk indicators						
Public debt 1/	0.0	0.0	0.0	0.0	0.0	0.0
Broad money (percent change, 12-month basis) 2/		18.3	28.2	43.9	34.1	39.3
Private Sector credit (percent change, 12-month basis)		19.8	5.2	-9.8	1.9	1.1
External indicators						
Goods exports (percent change, 12-month basis in U.S. dollars)	0	3	14	-28	111	-34
Goods imports (percent change, 12-month basis in U.S. dollars)	6	-8	-11	75	77	24
Current account balance	21	79	166	329	456	245
Public foreign assets (in millions of U.S. dollars) 3/	182	524	1,096	2,316	4,407	5,627
(in months of corresponding imports of goods)	18	56	131	158	170	175
Net Foreign assets of commercial banks (in millions of U.S. dollars)	1	6	29	88	182	205
Total external debt 1/	0	0	0	0	0	0
External debt-service (in percent of exports of goods and services)	0	0	0	0	0	0

Sources: Timor-Leste authorities; and Fund staff estimates.
1/ No external or domestic debt has been contracted.
2/ Excludes currency in circulation on which no data are available.
3/ Includes investments of Petroleum Fund assets overseas.

Table 9. Timor-Leste: Millennium Development Goals Progress, 1990-2008

	1990	1995	2000	2005	2008
Goal 1: Eradicate extreme poverty and hunger					
Target 1.A: Halve, between 1990 and 2015, the proportion of people whose income is less than $ 1 a day					
Poverty gap at $1.25 a day (PPP) (%)	..	..	*19*	*9*	*9*
Poverty headcount ratio at $1.25 a day (PPP) (% of population)	..	..	*53*	*37*	*37*
Income share held by lowest 20%	..	..	*7*	*9*	*9*
Malnutrition prevalence, weight for age (% of children under 5)	..	..	*41*	..	..
Target 1.B: Achieve full and productive employment and decent work for all, including women and young people					
Employment to population ratio, 15+, total (%)	*64*	64	65	65	67
Employment to population ratio, ages 15-24, total (%)	*51*	51	51	55	58
Goal 2: Achieve universal primary education					
Target 2.A: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling					
Primary completion rate, total (% of relevant age group)	..	..	..	*70*	80
Total enrollment, primary (% net)	..	..	..	69	77
Goal 3: Promote gender equality and empower women					
Target 3.A: Eliminate gender disparity in primary and secondary education, preferably by 2005, and in all levels of education no later than 2015					
Proportion of seats held by women in national parliaments (%)	..	..	..	25	29
Ratio of female to male primary enrollment (%)	..	..	..	92	94
Ratio of female to male secondary enrollment (%)	..	..	..	100	..
Ratio of female to male tertiary enrollment (%)	..	..	*127*	..	*71*
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	..	..	*35.0*	..	..
Goal 4: Reduce child mortality					
Target 4.A: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate					
Mortality rate, infant (per 1,000 live births)	138	114	84	61	51
Mortality rate, under-5 (per 1,000)	184	150	106	74	60
Goal 5: Improve maternal health					
Target 5.A: Reduce by three quarters, between 1990 and 2015, the maternal mortality ratio					
Maternal mortality ratio (modeled estimate, per 100,000 live births)	650	590	520	420	370
Births attended by skilled health staff (% of total)	..	*26*	*24*	*18*	..
Target 5.B: Achieve, by 2015, universal access to reproductive health					
Contraceptive prevalence (% of women ages 15-49)	..	..	*8*	*20*	*20*
Adolescent fertility rate (births per 1,000 women ages 15-19)	..	..	89	59	53
Pregnant women receiving prenatal care (%)	..	..	*43*	*61*	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases					
Target 6.C: Have halted by 2015 and begun to reverse the incidence of malaria and other major diseases					
Tuberculosis case detection rate (all forms)	..	..	*64*	76	60
Incidence of tuberculosis (per 100,000 people)	500	500	500	500	500
Children with fever receiving antimalarial drugs (% of children under age 5 with fever)	..	..	*47*	..	..
Goal 7: Ensure environmental sustainability					
Target 7.A: Integrate the principles of sustainable development into country policies and programmes and reverse the loss of environmental resources					
Target 7.B: Reduce biodiversity loss, achieving, by 2010, a significant reduction in the rate of loss					
Forest area (% of land area)	65.0	61.2	57.4	53.7	*52.2*
Marine protected areas (% of total surface area)	..	..	..	..	0
Terrestrial protected areas (% of total surface area)	..	..	..	..	15
Target 7.C: Halve, by 2015, the proportion of people without sustainable access to safe drinking water and basic sanitation					
Improved sanitation facilities (% of population with access)	..	..	32	44	50
Improved water source (% of population with access)	..	..	52	63	69
Goal 8: Develop a global partnership for development					
Target 8: Various					
Net ODA received per capita (current US$)	0	0	284	186	253
Other					
Fertility rate, total (births per woman)	5	6	7	7	6
GNI per capita, Atlas method (current US$)	..	..	*330*	740	2,460
GNI, Atlas method (current US$) (billions)	..	..	*0.3*	0.7	2.7
Gross capital formation (% of GDP)	..	..	25.6	..	..
Life expectancy at birth, total (years)	46	51	56	60	61

Figures in italics refer to periods other than those specified.

Source: World Development Indicators database, 2010.

Appendix Table 1. Authorities' Response to Recent Fund Policy Advice 1/

Fund Recommendations	Policy Actions
Monetary and Exchange Rate Policy	
Official dollarization has helped keep inflation under control, and should be maintained.	Continued commitment to build up institutional capacity before any policy change.
Fiscal Policy	
Public spending should return to a sustainable path over the medium term, and be targeted to growth promotion and poverty reduction.	Spending growth in 2009 has been moderate and cash expenditures are expected to remain below sustainable levels in 2010. However, the authorities plan to step up capital spending in 2011-15 to promote growth and poverty reduction.
Fiscal prudence is also needed to support competitiveness and external sustainability.	The authorities are aware of competitiveness problems but consider infrastructure investment a priority.
Petroleum Fund remain at the center of petroleum based revenue management.	Current draft amendment to Petroleum Fund law leaves its core principles intact, and increases flexibility in investment and budget process. However, accountability to parliament might be weakened.
A medium-term expenditure framework should be introduced, and capital investment projects should be carefully prioritized and costed.	The Strategic Development Plan 2011-30 lays out the five-year public investment budget plan with sectoral priorities. But details have to be worked out and administrative capacity constraints hamper public investment management.
Foreign borrowing should be subject to Parliamentary approval and proper justification.	The authorities are considering the option of borrowing, and parliament approval has been made a legal requirement.
Financial Sector Policy	
Continued efforts are needed to strengthen financial sector supervision and promote financial development.	Banking supervision enhancement continues. As part of the effort to improve financial sector supervision, the authorities established the Credit Registry Agency.
Structural Reforms	
Reforms to enhance property rights are also needed to promote financial development.	Land Law progressing but other steps are still pending.

Source: IMF Staff.
1/ Advice from the 2009 Article IV Consultation.

ANNEX 1. TIMOR-LESTE: STRATEGIC DEVELOPMENT PLAN[1]

In April 2010, the Timor-Leste authorities published a summary of Strategic Development Plan (SDP) for 2011–2030, with the full SDP yet to be officially released. Immediately after the publication, the Prime Minister started country-wide consultation of the SDP.

The SDP summary defines challenges faced by the country. It outlines target growth rates for public investment and financing until 2015, provides a "framework of action until 2020" and the government's "visions" of the country's stage of development in 2030. The authorities plan to establish an Economic Planning and Investment Agency (EPIA) in charge of the design, budgeting, and implementation of the SDP.

- Main challenges that the SDP will address include urban-rural and regional imbalances, shortage of skilled human resources, fragile institutions of the state, and post-conflict mentality.

- The SDP aims to put Timor-Leste among the upper-middle-income countries by 2030, supported by strong growth of the non-oil economy at an average rate of 12 percent per year during 2010–20 and 10 percent per year during 2020–30.

- With public investment taking the lead, the framework of action to 2020 entails major public and private investment projects in human capital, infrastructure, and strategic sectors such as agriculture, petroleum (including downstream), and tourism. Improving the business environment is also seen as a fundamental priority.

- The public investment plan to 2015 defines a five-year public investment budget in the order of 30 percent of GNP per year and focuses on eight priority areas: health and nutrition, education and research, roads, power, seaports and airports, agriculture, petroleum, and tourism. Financing options of the public investment will include withdrawals from the PF in excess of the ESI or concessional borrowing. The government intends to keep current expenditure within the ESI.

[1] Based on the 2010 "Public Financial Management—Performance Report" and the "Report on Observance of Standards and Codes (ROSC)—Fiscal Transparency Module."

ANNEX 2. THE ESTIMATED SUSTAINABLE INCOME

- The Petroleum Fund (PF) Law defines the estimated sustainable income (ESI) as 3 percent of Timor-Leste's total petroleum wealth, including the current PF balance plus the net present value of future petroleum receipts.

- Rather than a rigid fiscal ceiling, the ESI is a benchmark to guide budget withdrawals from the PF and inform policy discussions. Actual withdrawals can exceed the ESI as long as the government delivers a detailed explanation to parliament why doing so is in the long-run interest of country.

- The ESI is calculated every year based on a set of assumptions on petroleum output and prices. The PF Law requires prudent assumptions to be used, as 70 percent of Timor-Leste's oil wealth remains under the sea and there is no diversification across multiple projects.

- Only projects with an approved development plan and firm investment commitment (i.e., the Bayu Undan and Kitan fields) have been included in the ESI calculation. The Greater Sunrise field has been declared a commercial discovery, but does not have an approved development plan, and therefore according to current policy should not be included in ESI. Further, its exclusion appears justified given the material uncertainties surrounding the technical and commercial configuration of the project and the potential for significant delays. However, Sunrise is a confirmed petroleum resource and its exclusion from ESI arguably puts some strain on the credibility of the policy.

- Nevertheless, the Ministry of Finance should begin evaluating its potential effect on petroleum wealth and fiscal financing. Perceived petroleum wealth from Sunrise is already informing wider thinking in government and civil society about sustainable spending levels, and quantification of the potential revenue flows would help to inform and guide that discussion. In particular, this exercise would allow the authorities to manage expectations and encourage a more realistic assessment of the potential addition to petroleum wealth from Sunrise.

- Until 2010, the oil price used for ESI calculation has been the "low" case from the U.S. Energy Information Administration (EIA) Annual Energy Outlook. To address the concern within the government that the low case lies materially below market and other respected forecasters expected prices, the authorities recently explored other alternative methodologies for determining a price forecast more reflective of expectations but still prudent. It came to a conclusion of using the average of the EIA low and reference cases, which balances between being realistic and prudent. For 2011, the average price generates an ESI of $734 million compared to $548 million under the EIA low case price.

ANNEX 3. TIMOR-LESTE: FISCAL ROSC AND PEFA ASSESSMENTS

The 2010 fiscal ROSC and PEFA exercises evaluated the strengths and weaknesses of Timor-Leste's public financial management (PFM) system. In response to the authorities' request, the Fund carried out both exercises with participation of the WB and the ADB. This diagnostic work will form the basis for the IMF's input in helping the authorities elaborate a comprehensive PFM reform strategy in close cooperation with the World Bank.

The assessments suggest that overall Timor-Leste has made solid progress in strengthening the PFM system from a low base. Key strengths in fiscal transparency include: a well-structured, basic budget process; a well-managed and supervised framework for the petroleum sector; comprehensive budget documentation and regular fiscal reporting; a modern integrated financial management information system; and an efficient Treasury Single Account. Notable gains have also been made in funding predictability, timeliness and quality of bank reconciliation and financial statements, legislative scrutiny, functionality of the treasury system, and external audit process.

However, substantial weaknesses in the PFM system remain.

- The budget is not a good predictor of actual spending, mainly reflecting large supplementary budgets.
- Budget Review in the Ministry of Finance has very little assessment capacity, especially on the capital side.
- Budget planning and implementation capacity in line ministries are still very weak. Budget oversight of autonomous government agencies and public enterprises, albeit relatively few in number, is weak and associated fiscal risks are not monitored.
- Independent internal and external audit process is lacking.
- Procurement has been in a state of flux for many years, with less competitive instruments becoming more prevalent.
- The budget is only weakly linked to policy objectives and the implications of capital spending for recurrent budgets are ignored.
- The Ministry of Finance has little capacity to adequately review the rationale, costing, and impact of public investment.
- A solid multi-year perspective on fiscal planning, expenditure policy, and budgeting is missing.

Despite improved transparency in tax payer obligations, compliance and tax audit remain a major issue.

ANNEX 4. INDEX OF BUDGET INSTITUTIONS

Staff constructed two inter-related indexes of budget institutions to capture the quality of budget institutions in Timor-Leste.[1] The first dimension (stage index) is along three budget stages including planning, approval, and implementation. The second dimension (category index) covers five cross-cutting categories at each budgetary stage: top-down procedures; rules and controls; sustainability and credibility; comprehensiveness; and transparency. Based on the recent fiscal ROCS and PEFA results, a score ranging from 0–4 is assigned to each dimension and category according to a common scoring methodology documented in Dabla-Norris et al (2010). The overall stage index and category index are simple averages of sub-indexes.

Results suggest that Timor-Leste's budget institutions are relatively strong on transparency and comprehensiveness, but score below low-income countries (LICs) on average. The overall stage index (1.6) is lower than the average of LICs (1.9), reflecting weaknesses in budget planning and approval. Important shortcomings include (i) unclear fiscal targets; (ii) a dual budget process where capital and current budgets are developed separately; and (iii) inadequate analysis of fiscal risks. The overall category index (1.7) is also lower than the average of LICs (1.9). Particularly, Timor-Leste scores poorly in fiscal rules and controls, and sustainability and credibility, reflecting the absence of a solid medium-term fiscal perspective, large gaps in internal and external audit, and inadequate monitoring of fiscal risks. A commendable achievement for Timor-Leste is its relatively high fiscal transparency, which is measured to be close to the average of middle-income countries (MICs). Budget documents also provide fairly comprehensive information compared with those of many other LIC peers.

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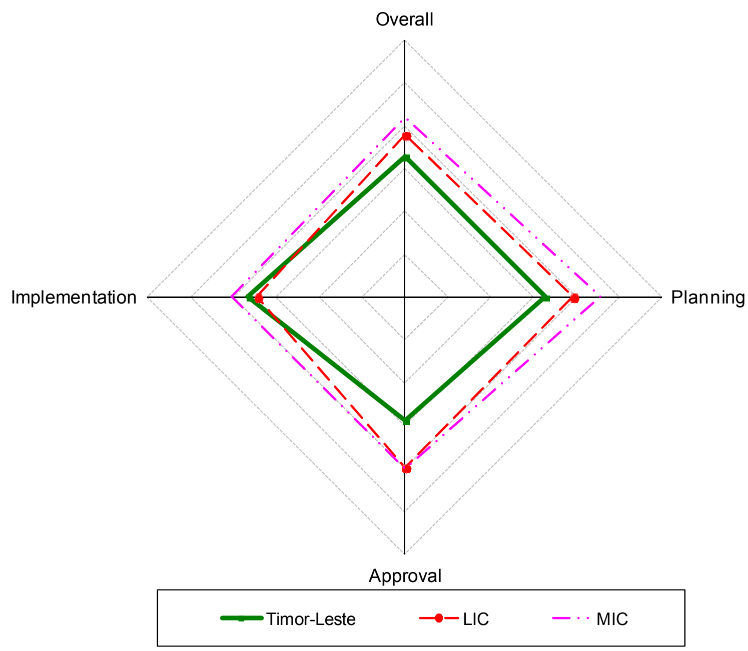
[1] The methodology is taken from "Budget Institutions and Fiscal Performance in Low-Income Countries" by E. Dabla-Norris et al (IMF Working Paper 10/80). The lower is the index, the weaker are budget institutions.

Timor-Leste: Stage Index of Budget Institutions



Timor-Leste: Category Index of Budget Institutions