Statement by Mr. Arrigo Sadun, Executive Director for the Democratic Republic of Timor-Leste and Mr. José Cardoso, Advisor to the Executive Director January 19, 2011

We thank staff for visiting Timor-Leste. The authorities of Timor-Leste have always highly valuated the dialogue with the IMF, not only under the framework of Article IV consultations, but also in the context of important technical assistance missions.

The authorities of Timor-Leste do not consider the 2010 Article IV staff report to reflect appropriately the most important recent economic and social developments, and also the medium- and long-run prospects of Timor-Leste. The authorities would have preferred a more appropriate guidance of the mission, and consider that the insufficient understanding of Timor-Leste's reality has undermined the quality of the report. Additionally, this is the first Article IV consultation after the closing of the IMF Resident Representative (ResRep) Office in June 2009. In this regard, in the Buff statement for the last Article IV staff report, we had already expressed that "the authorities expect, under the new circumstances, a deeper engagement of the Fund given the extremely challenging endeavors that Timor-Leste faces ahead".

At the last Article IV discussion — and also at the IMF/WB Spring and Annual Meetings, and other bilateral contacts — the authorities have regretted the Fund's decision of closing the ResRep Office. In a fragile and post-conflict country, with less than a decade of existence, the presence of a ResRep Office makes a difference for Timor-Leste, and apparently also for the IMF. We recall the fact that the decision of closing the ResRep Office was motivated, at the time, by financial constrains and in the context of the IMF downsizing. Such motivation no longer persists. Once again, the authorities of Timor-Leste would like to express their interest in the reopening of the ResRep Office in Díli.

The following paragraphs present what the Timor-Leste authorities consider the most important disagreements with the Article IV staff report:

- Front page; point 2: On growth prospects, the staff report says, "in 2010 non-oil GDP growth is expected to slow to around 6 percent due to the impact of adverse weather on harvests". The authorities' estimate of non-oil GDP growth in 2010 is higher at 9.5 percent. Food production has been affected by unseasonal rains, but the share of agriculture in the non-oil GDP is relatively small at 26 percent, and the absence of growth in agriculture has been more than compensated for by buoyancy in the sectors of transport and communications, manufacturing, wholesale and retail trade, and private construction.

- The past experience is that staff projections of non-oil GDP growth in Timor-

Leste have been on the pessimistic side. For example, following the 2009 Article IV consultation, staff had estimated 7.4 percent for the 2009 growth rate, whereas the authorities had estimated 12.2 percent. The actual outturn for 2009 was higher than the staff's figure, and the authorities' figure has even proved to be slightly on the conservative side. The actual outturn for the 2009 growth rate was (in the 2010 Article IV staff report) 12.9 percent.

- Front page; point 2: The staff report says "there is uncertainty about the size, timing and quality of capital spending". The authorities feel that the finalization of the Strategic Development Plan (SDP) for 2011-2030, and the proposed establishment of the Infrastructure Fund in 2011 will contribute to a reduction in the uncertainties about the future path of public investment. This multi-annual and fungibility fund will allow the authorities to review the proposed projects and Bill of Quantities (BoQs) with the aim to reduce inefficiencies. The government is committed to ensuring high quality of public spending and is in no hurry to implement projects by December 31, if this hurrying can produce inefficiencies.

- Page 4, paragraph 6: The staff report says "given procurement delays, primarily for capital spending, staff suggests that 2010 cash spending will be around $650 million, well below the revised spending envelope". Once again, this has proven to be on the pessimistic side, as the actual estimate of cash spending in 2010 is $731.9 million, representing a rate of execution of 87.3 percent (even higher than the conservative authorities' estimation). Moreover, the budget execution rate will be, at the end, somewhat higher, because according to the prevailing international standards, closure of accounts is only fully booked two months after the end of the concerned financial year. It is important to highlight that, over the last few years, the budget execution rate has been rising steadily.

- Page 5, paragraph 9: According to the staff report, "GDP growth is expected to increase to around 7⅓ percent in 2011". The authorities expect close to double-digit growth in 2011 based on the recovery of agriculture, rapid buildup in capital spending, and continued buoyancy in the private sector especially in construction, trade and transport, wholesale and retail trade, financial services, and public utilities.

- Page 5, paragraph 9: The staff report says that "non-oil growth is to gradually converge to around 6 percent in the long-run". The authorities expect a higher growth rate to be sustainable in the long-run once the productive capacity of the economy has been substantially augmented by the planned investments in infrastructure and human capital development. Coupled with contemplated improvements in the business environment, this will provide for the emergence of a strong private sector, both domestic and foreign, beyond 2015. Thus, a double digit growth can be sustained in the next two decades.

- Page 6, paragraph 11: The authorities had suggested to staff to provide upper and lower bounds for projections, namely regarding economic growth. These projections are given on page 8 in the two tables on Medium-Term Fiscal Outlook. For 2011, the range of the projected growth rate is 6.1-7.3 percent, and the average for 2012-2015 is 7.8-9.0 percent. The authorities' analysis, based on the reasons presented above, is that the upper bound is a double-digit growth rate in this period, as well as beyond 2015.

- Page 8, Table on Medium-Term Fiscal Outlook: Given the new basis for the estimated sustainable income (ESI), the staff report projects ESI at $734 million in 2011, rising to $740 million by 2015 in the Baseline Scenario, and to $771 million in the Alternative Scenario. These projections appear to be predicated on very conservative assumptions about the future outlook for oil prices. According to Table 7, crude oil prices are expected to be at $68 per barrel in 2011, rising to $81 by 2015. It is important to highlight that oil prices have already approached $90 per barrel, and that, as the world economy recovers, they could rise even further.

- Page 8, paragraph 16: The staff report says "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". The authorities would like to indicate that a reduction is proposed in the level of public transfers in the budget for 2011, while emphasizing that the policy of social protection is important from the viewpoint of containing poverty, and preserving peace and stability, through support that targets the most vulnerable groups, such as veterans, the elderly, internally displaced persons (IDPs), widows, and invalids.

- Page 9, paragraph 17: The staff report highlights the low domestic tax to non-oil GDP ratio of only 8 percent. The authorities fully recognize the need for reforms, both in tax administration and tax policy, not only from the viewpoint of mobilizing more resources, but also for redistributive purposes. A phased strategy is being implemented with an initial focus on improvements in tax administration, taxpayer education, and measures to improve compliance, including expansion in the regime of withholding tax. Beyond this, it is proposed to broaden the tax base, enhance the tax system, and raise some tax rates, namely on luxury goods and services.

- Page 9, paragraph 20: The staff report indicates that "significant gaps remain in PFM". The authorities have placed great emphasis on improvements in public financial management (PFM) in recent years, which has led to a substantial enhancement in the budget execution rate. A Strategic Plan for PFM was finalized in early 2010 and is being implemented in key areas related to accounting systems, procurement practices, internal audit, staff capacity building, etc. Strong anti-corruption mechanisms are being put in place. Two important facts should have been highlighted: (i) it is reassuring that the Transparency International Corruption

Perceptions Index of 2010 shows an improvement of 19 positions by Timor-Leste in the past 12 months; and (ii) Timor-Leste was the third country worldwide to achieve the status of full compliance with the Extractive Industry Transparency Initiative.

- Page 10, paragraph 21: The staff report says that "ambiguity as to who will be the manager of the Petroleum Fund is likely to create uncertainty". We highlight the fact that the authorities propose to provide flexibility in the Petroleum Fund Law as to which institution would be the Operational Manager of the Petroleum Fund in the future. The Banking and Payments Authority (BPA) of Timor-Leste is currently assigned to conduct this task, but the government proposes that it may be the future Central Bank or any other public entity established by the National Parliament in the future. This entity will be independent from the government, and there will be a clear division of responsibilities between the overall manager of the Petroleum Fund (the government) and the Operational Manager.

- Page 15, Box 1: The staff report says "In the medium run, the current account surplus is projected to remain below its sustainable level by about 30 percent of the GDP". This seems to be a biased and non-clear normative approach for estimating the "sustainable" level, especially when the surplus remains high at over 100 percent of the non-oil GDP up to 2015.

- Page 25: Table on Medium-Term Outlook: A number of projections have been made in the staff report of the Medium-Term Outlook for Timor-Leste during the period, 2011-2015. The authorities have the following views on the projections:

  (a) Non-oil GDP growth rate: The average growth rate projected for the next five years is 8.7 percent. However, the authorities are confident that attaining an average of a double-digit growth rate over the period is feasible in light of the fact that growth will start from a low base in a relatively small economy, and that plans, policies, and institutions will be put in place to achieve this growth rate. The growth rate will be driven by public capital spending, the increase of agricultural productivity, and continued high growth in the industry and services sector.

  (b) Domestic revenue: This is shown as remaining, more or less, constant at 11 percent of GDP up to 2015. The authorities are working with the target of 20 percent of GDP in the next five years.

  (c) Capital expenditure: Central government capital expenditure is projected to reach a peak of 62 percent of the GDP in 2013 and then fall sharply to 44 percent by 2015. The authorities feel that the level of public investment as a percentage of the non-oil GDP will decline less rapidly and that it will be sustained by larger financing through domestic revenues. In addition, the better prospects for private investment due to improved infrastructure and a businessfriendly environment will preserve the growth momentum.

(d) Crude oil price: As already mentioned, the forecast for crude oil price, as highlighted above, is conservative at $68 per barrel in 2011, rising to $81 by 2015. The price is already close to $90 per barrel and the outlook is bullish given recovery in the world economy. A higher price of oil than projected will, of course, mean a higher ESI, a larger balance in the Petroleum Fund, and a higher surplus in the current account.

Overall, the authorities appreciate the fact that the staff report for the 2010 Article IV Consultation recognizes the post-conflict strong economic recovery in this fragile state since 2006, with significant reduction in the incidence of poverty and major strides in key social indicators. However, the report is (again, proven by existing data) excessively biased on the pessimistic side regarding the strong potential for a double-digit growth rate in the medium- to long-run. The current momentum will be boosted by infrastructure and human capital development (financed mostly by oil revenues), which will also be promoted by the emergence of the nascent and dynamic private sector, especially the industry and services. As this potential gets recognition by the international markets, foreign direct investment could also flow into Timor-Leste. The transition from conflict to development that has taken place amidst the recently found peace, stability, and growth holds out the prospects that Timor-Leste will join the rank of upper middle-income countries within the next two decades, as envisioned by the SDP.

To conclude, we would like to express two very positive and encouraging assessments. First, the UNDP 2010 Human Development Report has recently been released, and it now ranks Timor-Leste at 120 out of 169 countries, based on 2009/2010 data. This represents a spectacular improvement in Timor-Leste's relative position (from 162 out of 182 countries, based on 2007 data, in UNDP 2009 Human Development Report). In the process, Timor-Leste has made an important transition from a low level of human development to a medium level of human development. Second, the recent MEASURE Demographic and Health Surveys (DHS) 2009-10 project — funded by the US Agency for International Development (USAID) — reveals a significantly more positive assessment on key social and human development indicators.

These two positive assessments further encourage the authorities' revealed determination to continue the implementation of a very ambitious reform agenda in order to develop the country and profit both the current and future generations, and reveals that this strategy is already paying off. Good results only mean that it is possible to reach the end of the path faster. The recent achievements in poverty reduction and growth are very encouraging, but there is still a challenging path ahead, and, therefore, the authorities of Timor-Leste invite the international community's involvement in the current strong momentum.