



República Democrática de Timor-Leste
Ministério das Finanças
Gabinete Ministerial



“Seja um bom cidadão, seja um novo héroi para a nossa Nação”

No: 048 / VI/GM/ 2015-03

Dili, 9 March 2015

To:
Mr. Juvinal Dias
Mr. Adilson da Costa Junior
Mr. Charles Scheiner
Mr. Pelagio Doutel
Mr. Niall Almond
La'ó Hamutuk Economic and Natural Resources Team

Dear All,

H.E. Prime Minister asked the Ministry of Finance to respond to the letter from La'ó Hamutuk dated 24th of February 2015.

We would like to take this opportunity to thank La'ó Hamutuk for its letter. Your letter serves to stimulate debate concerning important fiscal and economic issues and the Government welcomes such debate. Whilst we may not entirely agree with your analysis it is encouraging to see that these issues are being debated and we would like to encourage you to continue to contribute to the “evidence based policy” process in public sector.

It is in that spirit that we write to you as it is important to understand that there are many views, options and opinions on what will happen in the future because nobody can know for certain what will happen especially in today's global environment. The Government always has to take into consideration a range of options in order to decide the most reasonable way forward.

In your letter, you advise that the Government reduce the 2015 State Budget to \$1,135 million (from \$1,570 million) or less. This advice is based on the three interlinked arguments:

1. the appreciation of the USD should lead to an immediate decline in the price of some goods purchased by the Government;
2. that when oil prices fall the budget should be immediately cut;
3. that lower oil prices will reduce the ESI to \$450 million in the long-term.

These are all valid issues worthy of analysis and I think the debate could be strengthened by looking at each of them in more detail which we try and do below.

First Argument: the Appreciation of the USD should lead to an Immediate Decline in the Price of Goods Purchased by the Government

You calculate that \$519 million of state expenditure is on imports. Your letter also notes that the USD has appreciated by 10% against the Rupiah, and a similar amount against other currencies, over the last twelve months. It is further argued in your letter that it will therefore cost the Government \$52 million less to purchase the same volume of imports, as it would have in the past year. The

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implication is that there are \$52 million of savings that the Government could easily identify in the 2015 State Rectification Budget.

Your letter does not provide a detailed breakdown of the \$519 million of state expenditure that you claim the Government spends on imports. So it is unclear how this figure was calculated.

The calculations in your letter assume that the USD appreciated by 10% against the currency of every countryⁱ. This assumption is incorrect. For example, from the 23rd of February 2014 to the 22nd of February 2015 the USD appreciated by less than 10% and 1% against the Singapore Dollar and Thai Baht respectivelyⁱⁱ.

Your analysis also assumes that an appreciation in the USD immediately results in lower prices. This is likely incorrect. Companies that import goods for sale (including to Government) in Timor-Leste will often absorb changes in exchange rates and not change prices. Indeed, while exchange rates change every day import prices remain constant for much longer periods. In addition, in some cases, contracts specify a fixed price in USD over many months and therefore the price of these goods will not vary in the short-term.

One implication of your advice is that the Government should rectify the State Budget every time the USD significantly appreciates. Exchange rates are extremely volatile and such a policy could easily lead to many rectification budgets each year. This would complicate and arguably undermine the budget process.

The Government is committed to ensuring value for money whenever it procures goods. We do not, however, consider that the Government should react to every short-term change in exchange rates by proposing a rectification budget.

Second Argument: When Oil Prices Fall the State Budget should be Immediately Cut

Your letter argues that because oil prices have recently fallen, oil revenue will fall and the Government should use the rectification budget to cut spending. The underlying logic of this argument is that every time oil prices significantly change the Government should propose a new rectification budget with a new level of public spending. In other words, you are arguing that the Government should link spending to volatile international oil prices in the short-term.

Many oil-producing countries do not have sovereign wealth funds and therefore have to reduce spending shortly after oil revenues and prices fall. In these countries, volatile oil prices have led to volatile, inefficient expenditure. A Ministry of Health whose budget increases by 30% one month (when oil prices and revenue increase) and then decreases by 30% the next month (when oil prices and revenues decrease) is unlikely to provide effective health services.

These countries have also suffered from macroeconomic instability. The increase in spending due to high oil prices increases aggregate demand, inflation, economic growth and consumption in the short-term. When spending is cut inflation, economic growth and consumption all sharply fall. This makes it difficult for businesses to plan and invest, which reduces long-term investment and economic growth.

Linking spending to short-term changes in oil prices is a key component of the resource curse. Immediately reducing the budget when oil prices fall, as you advise, would lead to volatile and inefficient expenditure, macroeconomic instability and low long-term economic growth.

The Government has long been aware of the resource curse. It, therefore, wisely established the petroleum fund and ESI to delink Government spending from short-term changes in oil prices. The petroleum fund provides a buffer so that the budget does not have to change in response to short-term changes in the price of oil. One of the main points of the petroleum fund is to avoid the need to cut spending every time volatile international oil prices decline.

Reducing or increasing the budget every time there is a significant change in the oil price would also lead to many rectification budgets each year. This would create uncertainty and would distract line ministries from implementing key Government programs. Drafting a budget every time the oil price significantly changed would also inevitably lead to a rushed budget process with insufficient time for detailed analysis and discussion. In turn, this could lead to poor decision-making and inefficient spending.

We consider that the Government should not link spending to short-term changes in oil prices. The Government will not panic and change the budget every time oil prices change and it will not allow volatile international prices to create instability in our economy. The Government will instead continue to determine the overall level of spending once a year through the annual budget process based on a detailed consideration of long-term fiscal sustainability.

Third Argument: Lower Oil Prices Will Reduce the ESI to \$450 million

You argue that the recent fall in oil prices will reduce the ESI to \$450 million. Based on this calculation you argue that the rectification budget should reduce spending to \$1,135 million or less.

The calculations in your letter assume that oil prices are \$40 per barrel in 2015 and \$45 per barrel in the long-term. These oil price forecasts are not taken from any internationally recognised agency and the only justification that you offer to support them is that is they are “reasonable”. Your letter does not contain any discussion of likely demand or supply trends in oil and it is not at all clear that there is any evidence whatsoever to support your “reasonable” estimate.

The Government does not produce its own estimates of long-term international oil prices. It instead uses a prudent estimate of long-term oil prices when calculating the ESI based on the average of the EIAⁱⁱⁱ low case and reference case for Brent as the benchmark price. The EIA International Energy Outlook report for 2014 forecasts for the low case a price of Brent of \$77 in 2015 increasing to \$86 per barrel by 2025. This is well above your long-term estimate of \$45. In addition, even after the recent falls in the price of oil the spot price for Brent as of the 2nd of March 2015 was \$62.17^{iv} per barrel..

It would be surprising if the average of the EIA medium and low case used in the 2016 ESI calculation was less than the previous low case forecast and lower than the current spot price. It would be more reasonable to assume that the EIA forecast for the first few years will be close to (likely above) the current spot price and that oil prices will then be forecasted to climb towards the EIA’s previous long-term forecast. In other words, the EIA forecasts will prescribe some of the recent decline in oil prices to short-term volatility in international prices and some to a new lower long-term price for oil.

Your letter argues that the ESI should be recalculated mid-year because oil prices have recently fallen. This presumably means that La’o Hamutuk considers that the ESI should be recalculated every time oil prices significantly increase or decrease. Regularly recalculating the ESI would be problematic as much of the underlying data, such as forecasts of international oil prices and oil

production figures from the operators, is only updated once a year. Recalculating the ESI now would mean that the Government could not use internationally recognised oil price forecasts from a reliable source such as the EIA. In our opinion, regularly recalculating and publishing the ESI in year, with unreliable data, would undermine the accuracy of the ESI.

Recalculating the ESI every time oil prices significantly change would also undermine its entire purpose. The ESI is designed to give a long-term, relatively stable and accurate forecast of sustainable income from the petroleum wealth. Recalculating the ESI every time international oil prices change, as your argument implies, based on an unrealistic and unjustified long-term forecast of oil prices (which would inevitably be strongly correlated with short-term prices) would make the ESI overly sensitive to changes in short-term oil prices.

In addition, the ESI is calculated based on 3% of petroleum wealth. This consists of the balance in the petroleum fund and future petroleum revenue. Future petroleum revenues currently account for less than 30% of total petroleum wealth and their importance has decreased over time and will decrease further (as more oil revenue is saved in the petroleum fund and there is less oil in the ground). This means that the ESI is much less sensitive to changes in the price of oil than it was in past years. Therefore, as the Government did not publish a midyear ESI in past years due to changes in oil prices (even through the ESI was more sensitive to changes in oil prices in the past), we consider that the rationale for publishing a new ESI at this time is weak.

The Government's Policy: Balancing Short-term Stability and Long-term Sustainability

The key question, which we think is also the intention of your analysis, is how to balance short-term stability and long-term sustainability? We certainly welcome your thoughts on this important issue.

In our opinion we think it prudent that the Government should not change expenditure every time oil prices change as this would lead to volatile, inefficient expenditure and macroeconomic instability. On the other hand, a sustained decline in oil prices over the long-term does reduce oil revenue, the ESI and the level of public spending which is sustainable. The Government considers that the best course of action to balance short-term stability and long-term sustainability is to:

- maintain current spending of \$1,570 million in the 2015 Rectification Budget. Moreover, changing the budget mid-year due a change in oil prices should always be avoided if at all possible;
- calculate the ESI for the 2016 State Budget based on all availability data. This means the ESI will use forecasts of oil prices from the EIA that will account for the impact of the recent fall in oil prices on long-term prices;
- for the 2016 State Budget the Ministry of Finance will recalculate the level of spending which is sustainable given the 2016 ESI. The 2016 State Budget should not exceed this sustainable level of spending;

Conclusion

In conclusion, the Government will continue to balance short-term stability and long-term sustainability. The Government will achieve this by maintaining the size of the current budget for 2015 and setting a sustainable level of public spending in the 2016 budget. This sustainable level of

spending will be based on a detailed fiscal sustainability analysis and the 2016 ESI, which will be based on internationally recognized forecasts for oil prices that account for the recent fall in the price of Brent.

Once again we thank La'o Hamutuk for their contribution to the debate and suggest that if your analysts would like to discuss this further they are more than welcome to meet with technical officials within the Ministry of Finance.

ⁱ Formally this is every country that goods the Government purchased were originally imported from.

ⁱⁱ Exchange rates taken from: <http://www.xe.com/currencytables/?from=USD&date=2014-02-23>

ⁱⁱⁱ Energy Information Agency

^{iv} <http://www.bloomberg.com/energy/>

Thank you



Helder Lopes
Vice Minister of Finance

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1. *H.E. Rui Maria de Araujo, Prime Minister*
2. *H.E. Santana J.R.F. Viegas Cardoso, Minister of Finance*