Public Disclosure Authorized

TIMOR-LESTE

Table 1	2022
Population, million	1.3
GDP, current US$ billion	1.7
GDP per capita, current US$	1284.3
International poverty rate ($2.15)[a]	24.4
Lower middle-income poverty rate ($3.65)[a]	69.2
Gini index[a]	28.7
School enrollment, primary (% gross)[b]	110.7
Life expectancy at birth, years[b]	68.5
Total GHG emissions (mtCO2e)	5.7

Source: WDI, Macro Poverty Outlook, and official data.
a/ Most recent value (2014), 2017 PPPs.
b/ Most recent WDI value (2020).

The economy rebounded in 2022 on the back of rising public consumption and investment as well as release of pent-up demand. The re-opening of the economy has also supported a rise in the employment rate, but the quality of jobs remains challenging. The economy is projected to grow by about 3.1 percent per year over the medium term. However, the outlook is subject to material downside risks namely from global slowdown and slow implementation of structural reforms.

Key conditions and challenges

Sustaining economic growth in Timor-Leste is hindered by numerous challenges, many of which stem from its small state status and post-conflict legacy. Its remoteness from international markets and poor connectivity leads to higher input costs for domestic production and exports. Moreover, the small domestic market makes it difficult for firms to achieve economies of scale and agglomeration economies. Other challenges include low economic diversification and vulnerability to shocks and natural disasters. Institutional weaknesses, gaps in infrastructure and human capital, and political instability have further exacerbated these challenges.

The economy relies heavily on government spending, but domestic revenues are limited. Public expenditure levels are among the highest globally, equivalent to 92.5 percent of non-oil GDP in 2021, while domestic revenue collection stands at around 10 percent of non-oil GDP. Although government spending has led to some improvements in infrastructure, including near-universal access to electricity, as well as human capital development through improved access to basic healthcare and education, economic growth remains low. This reflects weak fiscal multipliers and the significant import content of government spending.

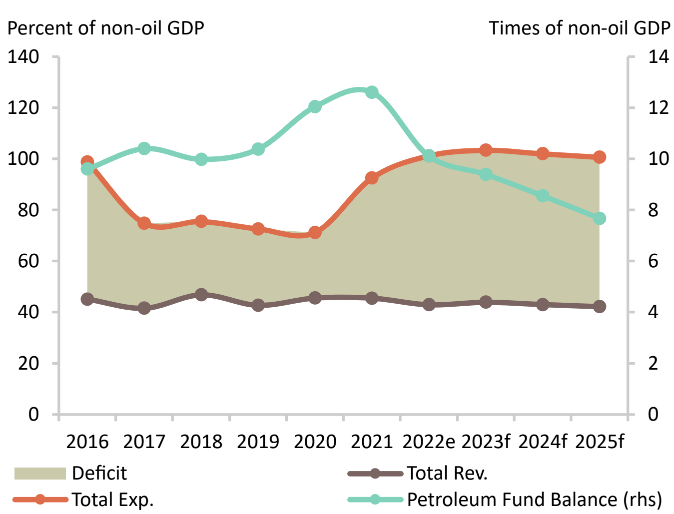
Since 2005, the Government has saved a portion of the oil revenues in the Petroleum Fund (PF), which has been the primary source of financing for large fiscal and trade deficits. However, as hydrocarbons production stopped in early 2023, the Fund balance is rapidly declining. The Ministry of Finance projects that under current spending levels, the PF will be depleted by 2034. Avoiding this fiscal cliff is the most important policy challenge facing the country.

Recent developments

As the impact of the pandemic recedes, the economy is showing signs of recovery, with non-oil GDP growth reaching 3.5 percent in 2022, up from 2.9 percent in 2021. Growth was largely attributed to a rise in government spending. The lifting of the emergency status and the resumption of cross-border movement also helped release pent-up demand and boost private consumption. The re-opening of the economy has also supported a rise in the employment rate. Nevertheless, the quality of jobs remains challenging, with more than 70 percent being informal.

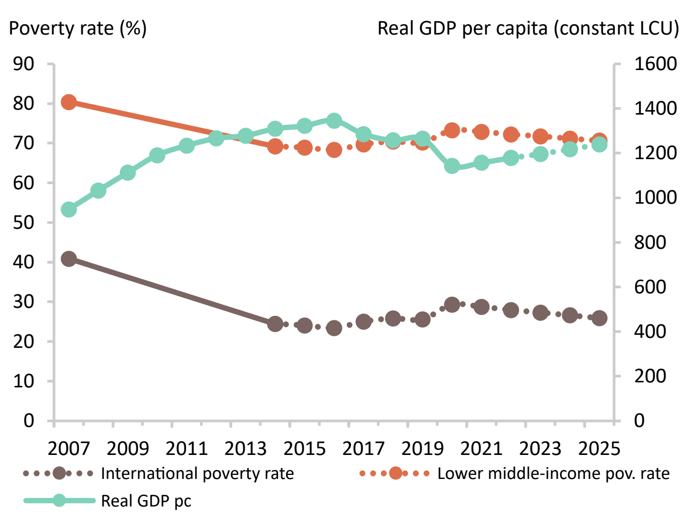
The recovery has turned the current account surplus in 2021 (2.7 percent of non-oil GDP) into an 11.8 percent deficit in 2022. Although service exports, particularly in the tourism sector, expanded, they were outpaced by import growth due to recovering domestic demand. With limited availability of financial inflows, including FDI at only 2 percent of non-oil GDP, external financing requirements were primarily met

FIGURE 1 Timor-Leste / Fiscal spending remains high



Source: World Bank staff calculations using data from the Ministry of Finance.

FIGURE 2 Timor-Leste / Actual and projected poverty rates and real non-oil GDP per capita



Source: World Bank. Notes: see Table 2.

through Petroleum Fund withdrawals. Foreign reserves stand at close to US$1 billion or 7 months of imports.

Headline inflation rose to 6.9 percent in December 2022, driven by global fuel and food prices. Rising agriculture input costs such as transport, fertilizer, and animal feed have led to soaring food prices (up 6.8 percent in December). In response, the authorities allocated in-kind transfers and subsidies to ease the impact on vulnerable households. The stronger US dollar, which Timor-Leste has adopted as legal tender, helped to moderate price pressures somewhat but weighs on export competitiveness.

The lack of recent household data makes it challenging to monitor development progress. Poverty stood at 24.4 percent of the population (at USD 2.15 per day line, 2017 PPP) according to the latest representative household survey conducted in 2014. However, there are indications of mixed progress since then. Recent household phone surveys reveal that the prevalence of severe food insecurity has halved from 19.3 percent in 2021 to 8.7 percent in 2022. Labor force participation rate, however, has declined from 46.9 in 2016 to 30.5 percent in 2021 partly due to the increasing share of subsistence farmers. A concerted effort by the Government to collect more recent household data is underway including the Timor-Leste Survey of Living Standard planned in the second half of 2023.

With the pandemic impact receding, government spending in 2022 increased from 92.5 to 101.2 percent of non-oil GDP on the back of rising government goods and services, as well as capital spending. Domestic revenue collection has not returned to pre-pandemic level and consequently the fiscal deficit widened from 47 percent of non-oil GDP in 2021 to 58.3 in 2022. Budget financing was secured from PF withdrawals, depleting the Fund further. PF balance was down from 12.6 times of non-oil GDP in 2021 to 10.1 times in 2022. By August 2022, the debt-to-GDP ratio stood at 15.5 percent.

Outlook

Over the medium term (2023-2025), the economy is projected to grow at an average annual rate of 3.1 percent driven by higher public consumption and investment as more infrastructure projects and government activities are executed following the cessation of mobility restrictions. High food and commodity prices coupled with a closing output gap are expected to drive inflation, which is projected to average 3.9 percent (2023-2025). Without oil export, the balance of the PF will deteriorate further, and the current account balance will shift back to staggering deficits. Without revenue reforms, the fiscal deficit is projected to hover at 50 percent of non-oil GDP in the medium-term.

Downside risks are material and include global slowdown, natural disasters and worsening global financial conditions. High international commodity prices, especially food, can significantly impact the purchasing power of poorer households and therefore impact private consumption. The appreciation of the US dollar could strengthen the purchasing power of Timorese, but this effect may be offset by cost-push inflation given the large dependency on imported goods. Meanwhile depressed international stock markets would affect the PF's investment returns.

To achieve the 7 percent growth target envisaged in the government program, it is crucial to support private sector development and enhance competitiveness through structural reforms including investing in human capital formation. Furthermore, fiscal consolidation is essential to avoid the fiscal cliff and ensure the perpetuation of government spending to support economic growth.

TABLE 2 Timor-Leste / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2020	2021	2022e	2023f	2024f	2025f
Real GDP growth, at constant market prices	-8.3	2.9	3.5	3.0	3.2	3.2
Private Consumption	-3.1	-2.7	3.8	3.6	3.7	3.8
Government Consumption	4.9	3.5	4.3	2.9	3.5	3.3
Gross Fixed Capital Investment	-42.5	-13.0	15.2	6.9	3.6	3.9
Exports, Goods and Services	-51.1	151.9	3.0	3.0	3.6	3.7
Imports, Goods and Services	-7.1	-9.1	8.5	5.0	4.3	4.4
Real GDP growth, at constant factor prices	-8.3	3.8	3.5	3.0	3.3	3.2
Agriculture	0.6	5.5	5.5	2.9	2.9	2.9
Industry	-14.0	-14.0	2.4	2.4	2.4	2.4
Services	-10.1	3.8	3.0	3.0	3.4	3.2
Inflation (Consumer Price Index)	0.5	3.8	7.0	5.5	3.3	2.8
Current Account Balance (% of GDP)	-19.1	2.7	-11.8	-45.2	-52.2	-56.3
Net Foreign Direct Investment Inflow (% of GDP)	-4.6	-4.4	-4.0	-4.1	-4.0	-4.0
Fiscal Balance (% of GDP)[a]	-25.9	-47.0	-58.3	-59.4	-58.8	-58.3
Revenues (% of GDP)	46.1	45.5	42.9	43.9	43.0	42.2
Debt (% of GDP)	13.8	15.2	17.0	17.5	18.5	19.0
Primary Balance (% of GDP)	-25.8	-46.8	-58.1	-59.3	-58.8	-58.3
International poverty rate ($2.15 in 2017 PPP)[b,c]	29.3	28.8	28.0	27.3	26.6	25.9
Lower middle-income poverty rate ($3.65 in 2017 PPP)[b,c]	73.3	72.9	72.3	71.8	71.2	70.6
GHG emissions growth (mtCO2e)	-4.4	-3.2	-2.8	-2.7	-2.3	-2.0
Energy related GHG emissions (% of total)	9.3	9.9	10.6	11.4	12.1	12.9

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices. Emissions data sourced from CAIT and OECD.
Notes: e = estimate, f = forecast.
a/ The ESI is part of total revenue, while excess withdrawals from the PF is a financing item.
b/ Calculations based on EAPPOV harmonization, using 2007-TLSLS and 2014-TLSLS. Actual data: 2014. Nowcast: 2015-2022. Forecasts are from 2023 to 2025.
c/ Projection using annualized elasticity (2007-2014) with pass-through = 1 based on GDP per capita in constant LCU.