July 2005
IMF Country Report No. 05/245

Democratic Republic of Timor-Leste: 2005 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Democratic Republic of Timor-Leste

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with the Democratic Republic of Timor-Leste, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 25, 2005, with the officials of the Democratic Republic of Timor-Leste on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 31, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its June 15, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the authorities of the Democratic Republic of Timor-Leste.

The documents listed below have been or will be separately released.

Joint Staff Assessment of the Poverty Reduction Strategy Paper
Poverty Reduction Strategy Paper
Selected Issues Paper and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for
the 2005 Consultation with Timor-Leste

Approved by Daniel Citrin and Ambroise Fayolle

May 31, 2005

- A staff team—Ms. Creane (head), Ms. Fichera and Messrs. Bhundia and Porter (EP) (all APD), and Mr. Y. Kim (FAD)—visited Dili during March 10-25 to hold the 2005 Article IV consultation discussions. The mission was assisted by Mr. I. Kim (Resident Representative). Mr. Saramago (OED) joined the discussions. The team coordinated closely with the World Bank and the Asian Development Bank.

- Discussions were held with Prime Minister Alkatiri, Finance Minister Boavida, General Manager of the Banking and Payment Authority (BPA) De Vasconselos, other senior officials, and representatives of the donor and business community. The team also met President Gusmão.

- The last Article IV consultation was concluded on July 16, 2004, and Directors comments may be found at http://www.imf.org/external/np/sec/pn/2004/pn04118.htm.

- Timor-Leste has accepted the obligations of Article VIII, sections 2, 3, and 4 and maintains an exchange system free of restrictions on payments and transfers for current international transactions. Data provision for surveillance purposes is adequate overall, but weaknesses in the national accounts and balance of payments complicate analysis (Annex IV).

- The authorities indicated their intention to publish the staff report and background documents.

Contents Page

Annexes

EXECUTIVE SUMMARY

Economic and Policy Developments

- **A moderate economic recovery is underway, while inflation remains subdued**. A post drought rebound in agriculture and expansion in banking activity offset the impact of a further decline in donor activity in 2004. The official dollar-based monetary and exchange regime helped keep inflation in check.

- **Fiscal policy has remained cautious despite large oil/gas revenue inflows**. The onset of oil production in 2004 resulted in the emergence of a large fiscal surplus, an increase in the external current account surplus (including international aid) and accumulation of international reserves equivalent to about 15 months of imports (March 2005).

- **However, growth prospects are hampered by slow execution of public investment projects and limited progress in attracting private sector investment**. Notwithstanding large development needs and a favorable revenue picture, budget execution has been poor particularly for capital projects and in rural areas. At the same time, the private sector remains inactive as establishment of a legal and regulatory framework is not yet complete.

Key Policy Issues

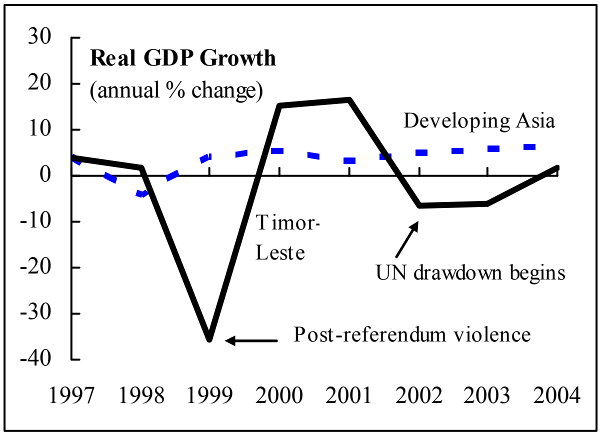
- **The authorities face the challenge of harnessing its new oil/gas wealth within a policy framework supportive of continued macroeconomic stability, higher growth and reduced poverty**. The creation of a Norwegian-style petroleum fund and the adoption of a cautious saving policy are major steps in the right direction. Efforts are now needed to ensure productive use of oil/gas revenue takes place, in parallel with safeguarding long-term fiscal sustainability.

- **Recent measures to improve administrative capacity and remove obstacles to smooth budget execution are important steps toward resolving expenditure execution difficulties, but more remains to be done**. The articulation of the sector investment programs should improve the ability to plan and focus spending on feasible and needed investment projects, and better align increasingly limited donor activity with the government's priorities. Further efforts are needed to reorient expenditure toward improving human capital, infrastructure, and other development needs. Investment spending remains relatively low in the current medium-term fiscal framework.

- **More rapid and better coordinated implementation of measures to establish an attractive environment for non-oil private sector activity is needed**. The basic legal and regulatory framework for the private sector remains incomplete, although progress has been made in key areas including the adoption of investment laws and land related legislation.

I. INTRODUCTION

1. **Five years after the international community stepped in to assist Timor-Leste in the aftermath of post-referendum violence, the country is successfully transitioning from post-conflict status**.[1] Security has been broadly restored and macroeconomic stability re-established and maintained through the adoption of the US dollar as legal tender and cautious fiscal management. However, the economy remains fragile. Cumulative growth over the last three years was negative—mainly reflecting the drawdown in the international presence. Unemployment is high, 40 percent of the population lives below the poverty line, and social indicators are poor. At the same time, human capital remains scarce, and physical infrastructure inadequate and financing opportunities limited. Administrative capacity is weak in the public and private sectors. The winding down of international support at a time when domestic capacity is still weak and the coming on stream of large oil/gas revenue in 2004 present new challenges (Figure 1 and Table 1).



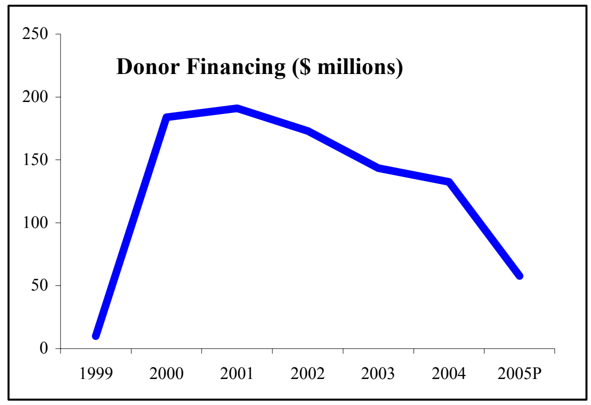
Gross Domestic Product (GDP) Per Capita and Human Development Index (HDI)
in Timor-Leste and Comparator Countries

	HDI Rank 1/	GDP Per Capita in US$ (2004)	Real GDP Per Capita Annual Growth Average 2000-04
Cambodia	130	314.1	5.5
Papua New Guinea	133	686.2	0.2
Lao P.D.R.	135	415.7	5.7
Bangladesh	138	376.4	3.5
Nepal	140	238.6	3.9
Timor-Leste 2/	**158**	**366.6**	**0.7**

Sources: UN Human Development Report, 2004, and IMF.
1/ Rank out of 177 countries.
2/ Non-oil GDP.

[1] The UN peacekeeping mission has been gradually reduced since independence was restored in 2002, and in May 2005 will be replaced by a downsized number of civilian and police advisors. Parliamentary and presidential elections are scheduled for 2007.

2. **Looking ahead, the pace and quality of economic development will depend on Timor-Leste's ability to manage its new oil/gas wealth effectively, and to establish the environment needed for investment and growth in the non-oil sector**. The authorities have designed a development strategy, with the objectives set out in the 2002 National Development Plan (NDP) and subsequent documents, incorporated in the Poverty Reduction Strategy Paper and assessed in the Joint Staff Advisory Note, which are being presented to the Executive Board alongside this Article IV Staff Report.[2] At the same time, the domestic political environment is becoming more difficult as popular impatience is growing with the absence of a visible improvement in the quality of life. Given the new oil/gas revenue and continued tapering off of external financing, donors are now focused on providing continued technical assistance for strengthening administrative capacity to ensure that progress to date in institution-building is not lost.



II. Recent Economic Developments

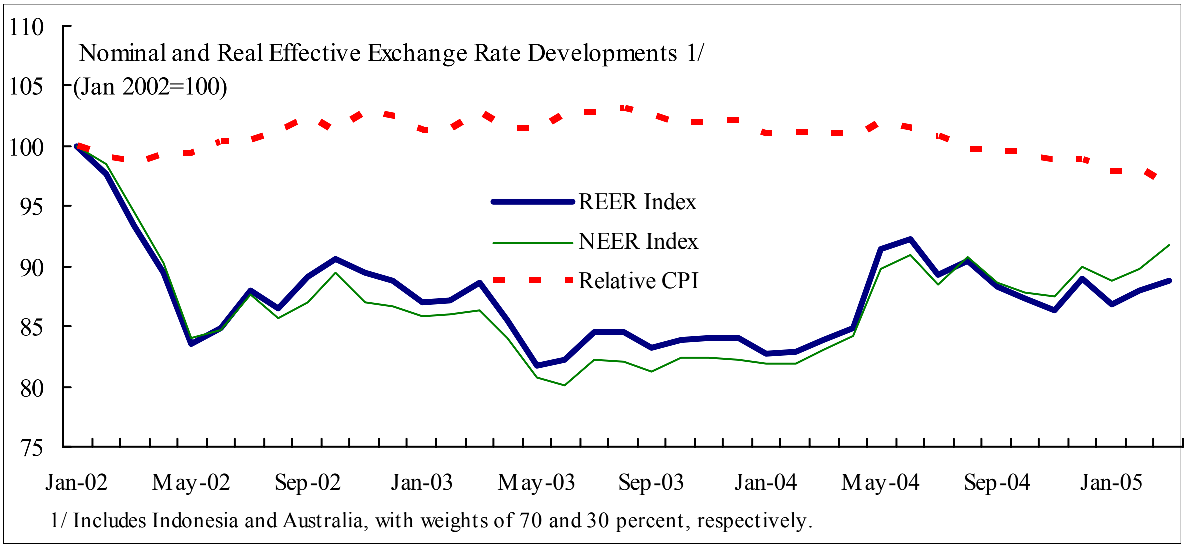
3. **More recent developments indicate a modest recovery in non-oil economic activity in 2004, subdued inflation, and large oil/gas revenue inflows** (Figure 2 and Table 2).

- Despite a further decline in donor activity, non-oil GDP growth recovered, reflecting a post-drought rebound in the agriculture sector and expansion in banking sector activity.
- Inflation declined over the course of 2004, leveling off at about 2 percent since August (year-over-year), in response to moderate domestic demand and stable non-oil import prices.
- The external current account surplus (including international assistance) widened sharply to 35 percent of non-oil GDP in 2004, due to large oil/gas tax and royalty income. Coffee exports rose, mainly reflecting a supply response to higher world prices.
- Measured against Indonesia and Australia, Timor-Leste's main trading partners, overall external price competitiveness deteriorated somewhat, reflecting the significant depreciation of the rupiah against the U.S. dollar (Timor-Leste legal tender). Given low inflation in Timor-Leste, relative prices have improved over the

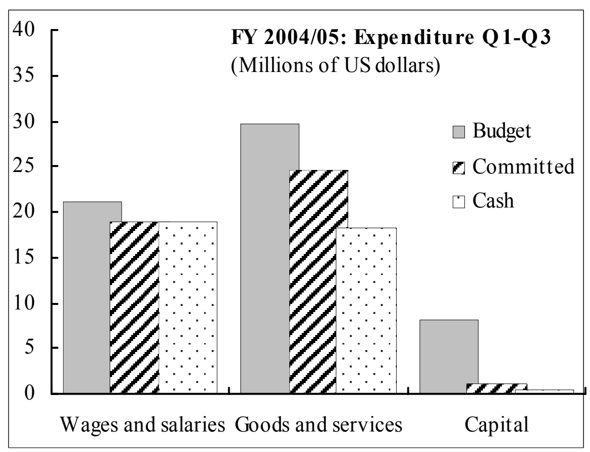
---

[2] (EBD/05/55, Supl. 1 and 2) and (EBD/05/56).

same period. In the absence of labor market data, anecdotal evidence suggests that Timor-Leste wages remain well above those in Indonesia, continuing to reflect the impact of the international presence.



4. **The fiscal outcome for FY 2004/05 is now expected to be stronger than envisaged, due not only to better-than-expected oil/gas revenue but also stronger non-oil tax administration and weak expenditure execution** (Table 3).[3] A central government surplus (including grants) of 68 percent of non-oil GDP is now expected, compared with the surplus of 33 percent of non-oil GDP expected in the revised FY04/05 budget. The rise in domestic revenue reflects improved tax administration and enhanced use of the Automated System for Customs Data Administration (ASYCUDA). At the same time, budget execution through March remained poor, particularly for capital spending. On a "combined sources" basis (the authorities' broad estimate of the total public sector including off-budget donor activities), the fiscal balance will move into a surplus of 30 percent of GDP

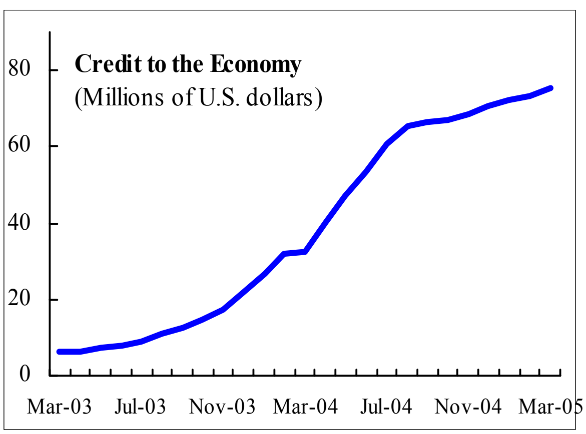


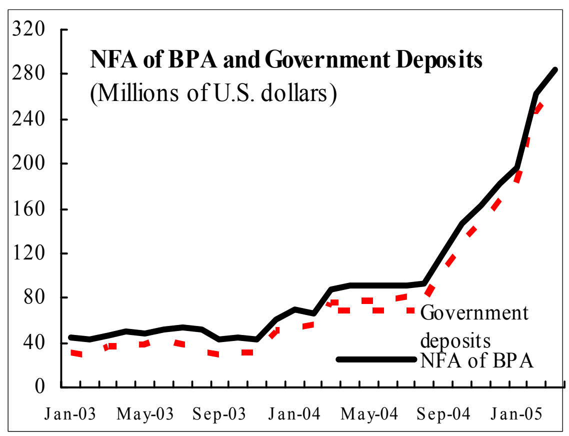
[3] The fiscal year is July–June.

in FY04/05 (Table 4).[4] The authorities continue to follow a policy of avoiding domestic or external borrowing and have no debt.[5]

5. **The government is making good progress with the measures necessary to handle its new oil/gas wealth responsibly**. Oil/gas taxation has been streamlined, the Norwegian-style petroleum fund is on track to be operational by July 2005 and a long-term fiscal savings policy has been adopted (Box 1), with assistance from FAD and LEG. Under the new saving policy, annual budget "sustainable" spending is set equal to the sum of annual non-oil revenue and the estimated permanent income from the total oil/gas wealth. The draft Petroleum Fund Act was submitted to Parliament in April. The government has indicated its commitment to the principles of the Extractive Industries Transparency Initiative (EITI). Finally, the preliminary Sector Investment Programs (SIPs) set out a public investment strategy for Timor-Leste's long-term economic development to be financed by domestic revenue and donor funds (Box 2).

6. **Bank lending to the private sector increased rapidly during 2004** (Table 5). As a share of non-oil GDP, credit tripled to 21 percent at end 2004. The bulk of the increase financed construction and personal loans for small transportation business. One bank accounts for most of the expansion, mainly funded by its foreign parent. Financial intermediation remains concentrated in Dili, while access to financing in rural areas is limited to the operations of a few rural cooperatives and microcredit institutions.





7. **Net foreign assets of the Banking and Payment Authority (BPA) rose sharply, reflecting the sizable accumulation of government deposits from strong oil/gas revenue.** At end-March net foreign assets reached US$285 million, more than 15 months of projected imports for 2005 (Table 6).

---

[4] Based on pledges and commitments as reported by donors.

[5] A debt sustainability analysis was not conducted given the absence of debt.

Box 1. Petroleum Policy—Key Features

The government is seeking to introduce best-practices for managing the oil wealth through a Norwegian-style petroleum fund and the adoption of a long-term fiscal sustainability policy.

Petroleum Fund

- The **Petroleum Fund Act,** drafted with the support of an FAD resident advisor, has been submitted to Parliament and is expected to become operational as of July 1, 2005.

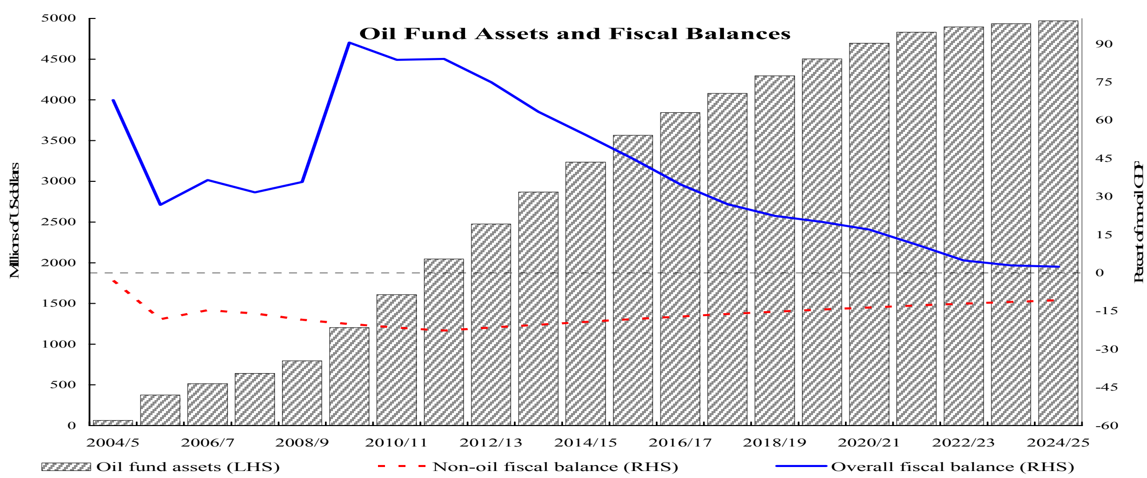
- The fund will be **integrated into the central government budget.** Transfers from the fund will only be made to finance the non-oil fiscal deficit, and the sum of all transfers in a fiscal year may not exceed a ceiling set by Parliament on the basis of the fiscal sustainability policy. Fund assets are to be invested abroad, thus minimizing pressures for real exchange rate appreciation.

- The petroleum fund is to be managed with a **high standard of transparency and accountability**. The government will be responsible for overall management, with operational management handled by the BPA. An investment advisory board and a parliamentary council will monitor operations and internationally recognized accounting firms will carry out annual external audits. Information disclosure requirements will be guided by EITI standards.

Fiscal Sustainability Policy

- The government has adopted a **long-term fiscal sustainability policy** for intergenerational equity. The key element is a saving rule under which only interest income will be used to finance the non-oil fiscal deficit.

- The new policy thus sets annual budget spending equal to the **sum of domestic non-oil revenue and the estimated permanent income from the oil wealth**. Although in a given year spending may exceed this limit, over the long-term the rule should minimize the potential for procyclical spending in response to volatile revenue inflows.[1]



[1] Real oil wealth is the sum of oil savings to date plus the present value of future oil revenue, at constant prices, and permanent income is the real interest income on the real oil wealth.

Box 2. The Sector Investment Programs (SIPs)

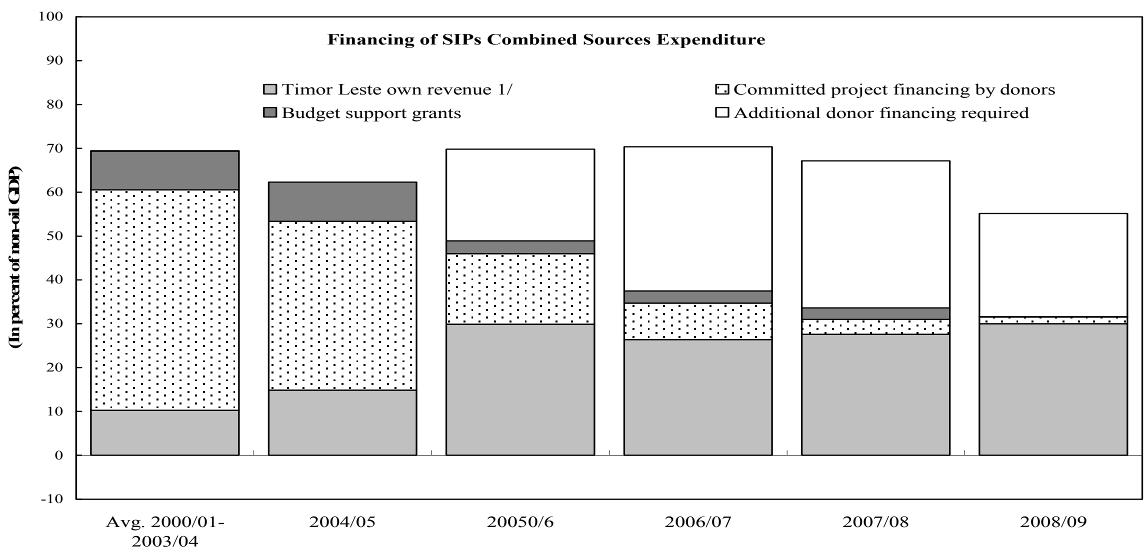
- As a vehicle for achieving National Development Plan (NDP) objectives and the Millennium Development Goals (MDGs), the government prepared a comprehensive package of investment programs for FY 2004/05-2008/09 in 15 economic sectors including health, education, public works and agriculture.

- The SIPs: (i) define sector priorities linked to NDP objectives and MDGs; (ii) establish links between policies, programs and expenditure; (iii) identify shortfalls between planned expenditure and available funding; and (iv) provide an institutional setting for communication with and among donors to improve donor coordination and better align external assistance with government priorities.

- The FY05/06 draft budget and medium-term fiscal plans have been cast in a "combined sources" budget framework, based on the SIPs, that covers public expenditure funded by the central government budget and by programs for which the government has received or is requesting financing by donors. The authorities' long-term objective is to bring all budget and donor-funded spending programs under one "combined sources budget" managed and monitored by the government.

- SIPs' spending proposals for 2005/06-2008/09 as a share of non-oil GDP are similar to the average "combined sources" expenditure over the previous 4-year period. However, the part of spending financed by central government (Timor Leste) revenue is higher.

- If the SIPs' proposals are to be executed in full, and the government's oil saving policy honored as intended (Box 1), the government will need to raise significant additional financing from donors over the medium term. The government should be prepared to further prioritize spending should the additional financing not materialize as hoped.



1/ From 2005/06 includes transfers from the petroleum fund to finance the central government non-oil fiscal deficit.

8. **Capacity building at the BPA progressed over the past year**. All managerial positions are now held by Timorese and resident foreign assistance is limited to an MFD central bank advisor to the General Manager. A central bank law, and payment system and anti-money laundering legislation are in final stages of preparation. A financial intelligence unit is planned for the BPA by the end of the year.

9. **The pace of establishing the necessary environment to encourage private sector activity has accelerated; nonetheless, the agenda ahead remains heavy** (Box 3). Over the past six months good progress has been made in some areas, with key land legislation, the insurance law, and the domestic and foreign investment laws all either approved or submitted to Parliament. However, the overall legal framework is still incomplete, and complex regulations, an ineffective administration and weak judiciary continue to discourage private activity and create opportunities for weak governance. Finally, while administrative skill levels are improving slowly, local capacity remains thin.

III. Policy Discussions

10. **The 2005 discussions focused on strategies for harnessing Timor-Leste's new oil/gas resources within a policy framework supportive of higher economic growth and reduced poverty, and consistent with macroeconomic stability over the long term**. The authorities already have began to implement this framework, all of which is in line with Fund advice in past Article IV consultations. The key policies include: (i) the adoption of a long-term strategy for effective management of the oil/gas wealth through the petroleum fund and a fiscal sustainability policy; (ii) the implementation of a public investment program focused on human capital accumulation, infrastructure provision, and basic services to urban and rural areas; and (iii) the establishment of the legal, regulatory and institutional framework needed to promote private sector activity in the non-oil sector. The authorities additionally have reiterated their continued commitment to maintain the official dollarized monetary and exchange rate regime, as recommended by the Fund in past consultations, acknowledging that it has been essential in ensuring low inflation. Where differences with past Fund advice occurred, these have largely related to the pace of policy implementation, mainly due to institutional and capacity constraints. The authorities also indicated that they generally found recommendations from past Article IV consultations useful.

A. The Economic Outlook

11. **The staff and the authorities agreed that the near-term macroeconomic prospects are relatively positive** (Table 7). Under current policies and trends, the outlook is for a pick up of growth in 2005 and a doubling of growth in 2006 to 5 percent. The improvement mainly reflects the start of increased investment spending in the second half of 2005 and the full year effect in 2006. Private sector activity is expected to respond to higher public spending, particularly in the construction and service sectors. Expanded provision of technical extension services to subsistence farmers, the development of nascent agro-business and the start of fishing licensing should result in above average growth in the agriculture sector, assuming normal weather prevails.

**Box 3. Private Sector Development and Public Investment:
Removing Impediments to Growth**

The growth path in post-conflict Timor Leste has so far been driven by the dynamics of the UN presence. Emergency reconstruction, humanitarian aid and consumption from expatriates spurred the economic recovery in 2000-01. Since 2002, the numbers of UN appointed international staff has been declining in parallel with economic activity. **To fully benefit from the "peace dividend" and absorb a rapidly expanding labor force, new engines for growth are needed**. The low level of development pre-1999, and the limited stock of physical assets following the 1999 destruction suggest that well-targeted public and more private investment could trigger a significant growth response.

With the transition from emergency status now over, public investment could become more growth-oriented. The SIPs focus on human capital development and infrastructure is appropriate, but execution of public investment must accelerate, particularly to off-set the slack from declining donor financing. Public resources should be directed to growth-enhancing infrastructure projects (e.g., roads, communication, power, and water access) that are complementary to private investment.

To strengthen growth prospects and ensure employment absorption, Timor Leste needs the emergence of small and medium-sized, labor-intensive private enterprises. The current stable macroeconomy and liberal trade regime satisfy two preconditions for private sector development. However, the incomplete legal and regulatory framework, an ineffective administration and a weak judiciary have discouraged faster private domestic and foreign investment.

Recent steps are welcome:

- New land-lease legislation should encourage property rental;
- The new investment laws, despite potential drawbacks from the envisaged fiscal incentives, are a major step forward in setting up the broad legal framework needed to attract investment;
- The imminent establishment of a "one-stop shop" for business registration under the new Investment and Export Promotion Agency is a positive sign;
- The prospective enactment of the insurance law should set the stage for the development of an insurance market, providing instruments for reducing investment risks; and
- The establishment of a regular dialogue between government and business to exchange views on solutions for the most urgent legal and administrative impediments to the development of private sector activity.

However, further rapid action is needed to encourage a strong private-sector response through:

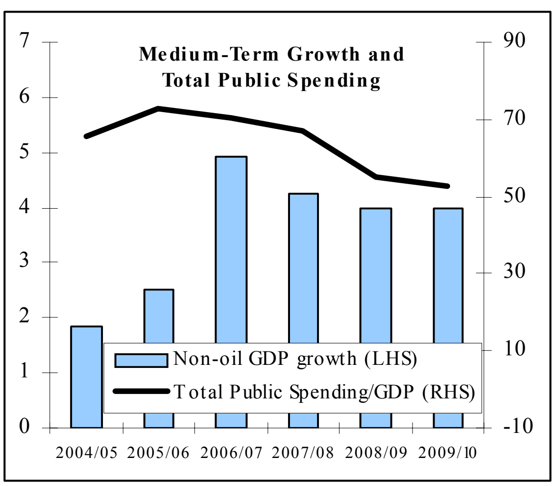
- Additional steps to streamline business registration practices, reduce set-up costs and simplify interaction with the administration;
- Establishment of a comprehensive land-titling system, the absence of which hinders land improvement and limits the use of land as collateral;
- A regulatory framework for company incorporation, mediation and arbitration;
- The finalization of bankruptcy legislation to fill a regulatory vacuum on creditor rights in case of business solvency problems;
- Licensing of insurance companies; and
- Renewed efforts to develop a strong and independent judiciary, given that a fair judicial system able to enforce contracts consistently is a primary requisite for private economic activity.

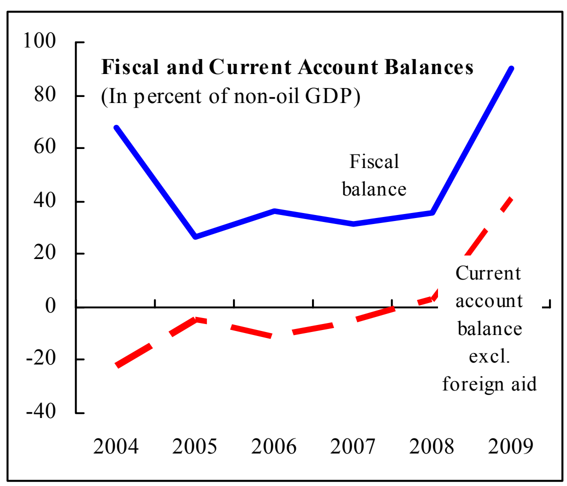
12. **The authorities and staff concurred that stronger non-oil growth is essential to absorb the rapidly increasing labor force over the medium term**. In view of the projected dynamics in the labor force (see box below), the authorities are focusing efforts on labor intensive sectors such as tourism and agrobusiness. However, staff suggested that under current policies the authorities' medium-term growth objective of 6 percent will be difficult to achieve in light of continued difficulties in budget execution, tapering off of donor activity, and an incomplete legislative and regulatory framework needed to attract private investment. In addition, even a more rapid growth rate may be needed to absorb likely new entrants to the labor force, further giving emphasis to the need for reinvigorated and focused efforts to put in place the appropriate environment to stimulate private activity (Box 3).

Growth and Employment

- Unemployment is roughly estimated at about 20 percent of the labor force. Based on rapid annual population growth of about 3 percent, a youthful population (60 percent are 16 and under) and an increase in the participation rate to a level common in low income countries, staff estimates that about 20,000 new entrants would be added each year to the labor force.
- Based on elasticity of employment to growth comparable to that found in representative cross-country studies, non-oil growth of about 7 percent would be needed to generate enough jobs to keep unemployment from rising further and growth of 10 percent would be needed to help halve unemployment rates over the medium term.

On inflation, both staff and authorities agreed that it should remain moderate, barring major external shocks and assuming continuation of the current monetary and exchange rate regime. Based on anticipated oil/gas production from existing fields, current WEO oil price projections, and some progress in improving spending capacity, large fiscal surpluses averaging 32 percent of non-oil GDP should emerge over the medium-term (Figure 3).

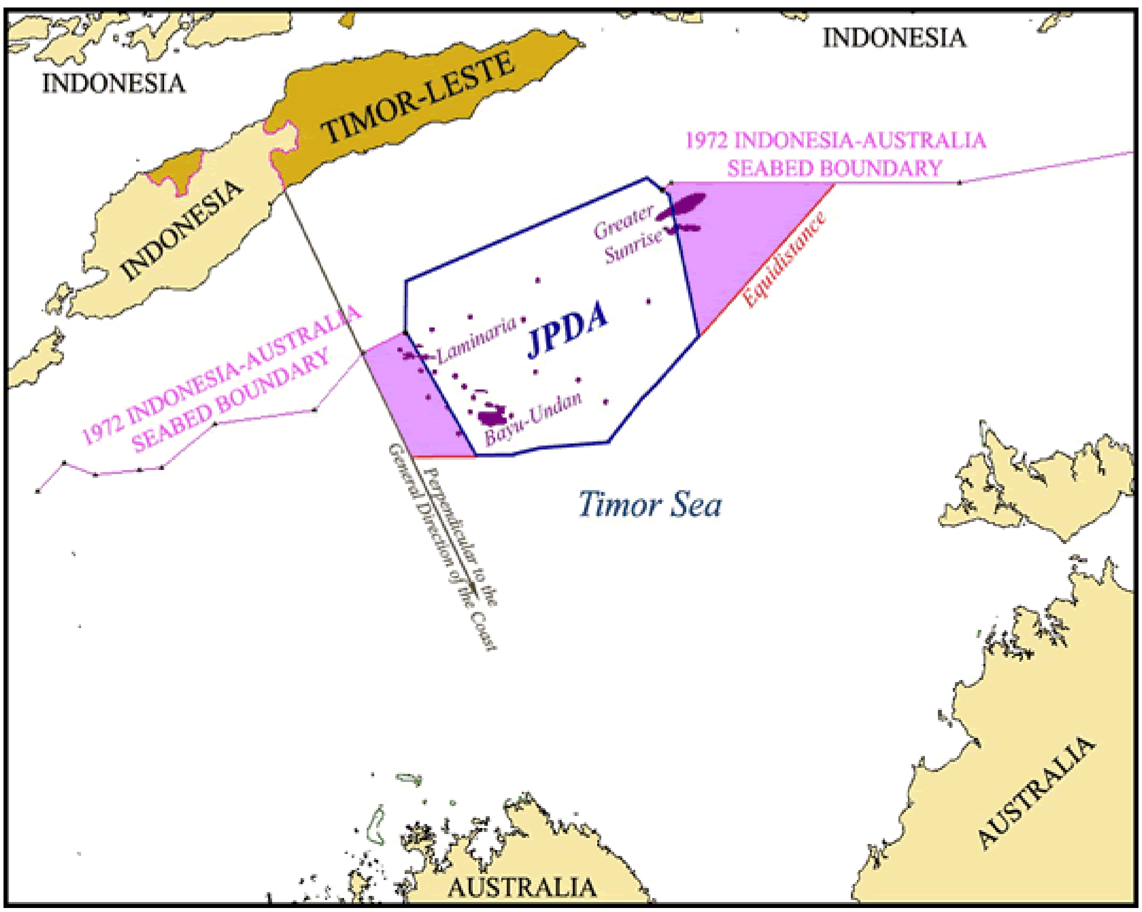




Box 4. Oil Prospects

- Timor-Leste's known oil/gas resources are concentrated in the Timor Sea in an area of disputed sovereignty with Australia. The sharing with Australia of oil revenue and royalties in the Joint Development Area (JPDA), where the Bayu Undan field is located, follows an existing bilateral agreement that favors Timor-Leste with a 90/10 split. Recent negotiations on revenue-sharing for the Greater Sunrise field (revenue potential significantly larger than Bayu Undan) reportedly went well. Australia claims most of Sunrise based on a 1972 border agreement with Indonesia. Timor Leste claims jurisdiction on the basis of the equidistance line.

- Revenue from Bayu Undan is estimated at $3.2 billion (NPV terms) over 20 years, more than nine times Timor-Leste's 2004 non-oil GDP. An agreement on Greater Sunrise could add up to $5 billion in revenue for Timor-Leste. In addition, recent seismic surveys reportedly suggest considerable additional resources offshore (in undisputed areas); the Timorese government will open bids for developing these areas later this year. Finally, some as yet unexplored onshore resources also exist.



Source: Timor Sea Office.

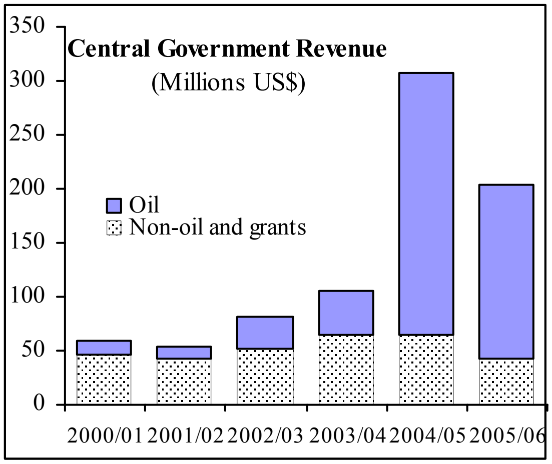
13. **The risks to the growth outlook largely relate to oil prices and the pace and strength of further reform**. On the upside, the private sector could respond more positively than expected to current reform, while a more accelerated and pronounced implementation of reform and improvement in capacity would also trigger more rapid non-oil growth. Among the downside risks, vulnerability to changes in world oil prices figures prominently. A US$10 decline in world oil prices would reduce revenue by US$150 million on average each year, requiring expenditure cuts of US$54 million on average each year over the medium-term under the government's saving policy (Figure 4). In addition, given the dominance of coffee in non-oil exports, a negative price or weather shock in the coffee sector could worsen the already poor non-oil export performance. Other potential risks to the growth outlook include further delays in the reform agenda deterring private investment, too rapid increases in fiscal spending—particularly in the wage bill—creating demand pressure on prices, and prolonged weak administrative capacity curbing needed development spending. The authorities were well aware of these risks, and discussed a low-oil price scenario in the FY05/06 budget documents to raise public awareness of the possible impact of oil price volatility. The authorities also noted that the potential for additional revenue from new oil fields over the longer term could offset the impact of lower oil prices (Box 4).[6]

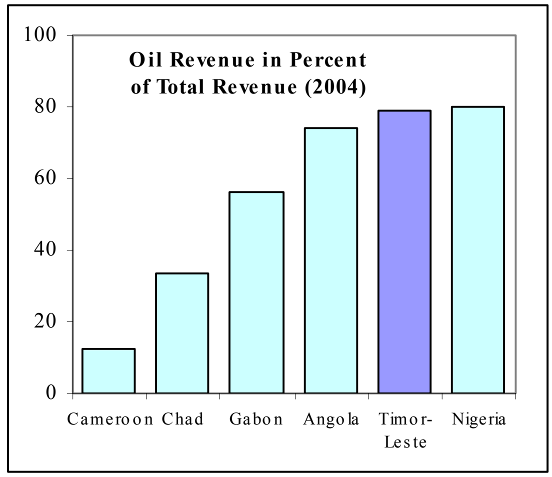
B. Fiscal Policy

14. **The authorities' past success in maintaining fiscal discipline under a tight revenue constraint will be tested in the new environment of large oil/gas revenue inflows**. Staff stressed that to continue with good fiscal management, the authorities will need to build upon their track-record of resisting expenditure pressure for non-priority objectives and keep control of the growing non-oil fiscal deficit, while raising expenditure.

15. **The FY05/06 and medium-term central government budget framework show a welcome shift toward spending to improve human capital and basic infrastructure and to meet other development needs required to raise growth**. Nonetheless, a more sustained orientation toward development spending is needed, given the importance of public investment at this early stage of development. As a share of GDP or total expenditure, capital expenditure has been declining and, under the current budget framework, will level off over the medium-term after a one-step increase in the FY05/06 budget. The staff also cautioned the authorities to ensure that the full maintenance costs of the increased investment spending were incorporated into projections for current expenditure. The authorities explained that the medium-term development spending path had not yet been fully elaborated and would be reassessed based on the performance in meeting the targets in the next year.

[6] In addition, the budget is based on conservative oil price assumptions, with a 15 percent discount off revenue projections derived on the basis of NYMEX future price minus 5 U.S. dollars.





16. **The central government budget outlook is based on maintaining public sector wage levels and the employment ceiling broadly at current levels, and the authorities reiterated their intention to keep the wage bill in check.** Difficulties in filling high-level managerial positions continued, due to wage compression and limited suitable candidates. Nonetheless, the authorities were reluctant to raise high-level salaries lest these feedback into pressure for low-skill wage increases in the public and private sector, thereby increasing price pressure, and further reducing competitiveness and discouraging employment creation in the private sector. At the same time, the authorities indicated they were weighing options for civil service reform, with assistance from the World Bank.

17. **The large one-step spending increase in the proposed FY05/06 central government budget raises some concerns, although government expenditure would remain below the estimated "sustainable" level**. Staff observed that it supported a move to the sustainable level of expenditure under the fiscal sustainability policy as quickly as feasible, given the extensive development needs in Timor-Leste. However, the proposed one-step spending increase by 10 percentage points of GDP in one year would be difficult to achieve without a sharp improvement in spending capacity. It therefore raised the risks of unproductive spending occurring and inflation pressure building. Staff viewed a more

Central Government Budget Spending

	FY 04/05	FY 05/06	FY 06/07	FY 07/08	FY 08/09
	(in millions of US dollar)				
Sustainable spending 1/	...	131.9	136.1	140.8	145.8
Draft budget proposed spending 2/	78.7	119.5	106.2	112.0	109.6
Staff's projections 2/	74.3	107.6	99.3	109.3	115.1

1/ On the basis of the new fiscal sustainability and oil fund policy.
2/ For FY 2005/06 includes US$ 10.5 million for the final capitalization of the BPA.

gradual movement toward reaching the sustainable spending level, focused on development expenditure, as more realistically reflecting the likely measured progress in administrative capacity and the economy's absorptive capacity. The authorities noted that about 3 percentage points of the increase in central government capital spending in FY05/06 was for the one-off final capitalization of the BPA. In addition, the overall public sector spending envelope, including requested donor-financed off-budget SIPS projects, would be roughly unchanged compared with earlier years, although an increasing share would now be brought on-budget to be undertaken by the government. Thus, they anticipated that as aggregate public spending would not increase, inflation pressure would not arise. Any upward pressure on wages also could be offset by downward pressure on wages as demand ebbed with the declining UN presence.

18. **Even modest central government spending increases would require improvements in administrative capacity, the removal of obstacles to smooth budget execution, and careful prioritization**. The authorities were fully aware that budget execution problems would need to be addressed if the FY05/06 budget expenditure increases were to be realized and accordingly announced the introduction of a number of measures with the new budget cycle (Box 5). While welcoming the new measures, which mainly address capacity problems at line ministries, staff encouraged the consideration of further reform to ease bottlenecks at the treasury and procurement stage. In parallel, increased and strengthened ex-post auditing could help prevent misappropriation. In light of continued budget difficulties, and in response to a request from the authorities, FAD has agreed to provide a resident advisor to the head of the treasury directorate in the MOPF.[7] The authorities also pledged to work with donors to speed the start of the institution and capacity building program aimed at improving the ability to design, execute and monitor development projects in line ministries.

19. **Staff welcomed the strengthening of links between Timor-Leste's development needs, the medium-term central government budget and donor activity through the SIPs**. The SIPs include the sector projects which the government has identified as necessary to achieve NDP and MDG objectives. Thus, the integration of the SIPs into budget planning, together with increased donor-government coordination in the SIPs working groups, will improve the authorities' ability to focus spending on feasible and needed projects, while better aligning donor activity with the government's priorities. At the same time, information on the execution of off-budget expenditure is still limited, and staff encouraged the authorities to establish an effective reporting mechanism, in coordination with donors. Staff also noted that maintenance and operations related to investment spending under off-budget donor projects would require increasing allocations for recurrent spending which were not yet incorporated in the medium-term budget plan. More broadly, staff noted that the overall

[7] The FAD resident advisor will assist in establishing a modern treasury system with a well-defined regulatory framework and in developing adequate capacity both in the Ministry of Finance and the line ministries so that expenditure execution bottlenecks are removed.

Box 5. Meeting the Budget Execution Challenge

A combination of complex and over-centralized processes in the treasury and procurement offices, and weak human resource and institutional capacity on the one hand, and a high level of commitment to fiduciary accountability on the other, has resulted in very low levels of budget execution. As a result, a high percentage of budgeted resources remain unspent—particularly for capital projects and spending for rural areas.

FY 2004/05: Cumulative budget expenditure Q1-Q3

	In percent of annual budget allocation		
	Executed 1/	Committed 2/	Total
Total 3/	48	16	64
Salary and Wages	67	0	67
Goods and Services	46	16	62
Capital (minor)	16	31	47
Capital Development	6	58	64

Sources: Timor-Leste Treasury.

1/ Goods or service delivered and payment executed.

2/ Spending request approved by treasury, but procurement process not yet completed.

3/ Some spending may overflow to the following year.

To address the problem without sacrificing cautious fiscal management, the authorities introduced a number of measures with the current budget cycle:

- Creation of a committee reporting to the Prime Minister to monitor progress on budget execution.
- An earlier start of the budget process to allow more planning time for ministries.
- Posting of technical advisors to key ministries during the planning process.
- Improved coordination between the treasury and procurement division.
- Establishment of a liaison officer from key ministries in the procurement office.
- More detailed specification of capital spending by project and geographic location to permit closer monitoring.

Additional steps which will take effect with the next fiscal year include:

- A reorganization to relieve the two ministries facing the most difficulties in executing capital spending, Education and Public Works, of other responsibilities.
- The creation of regional state ministers reporting directly to the Prime Minister to ensure adequate spending to rural areas takes place.
- Some easing of procurement approval requirements.
- Further education of line ministries on the procurement process.

SIPs expenditure proposals appear ambitious—with 80 percent of proposed donor support still uncommitted over the FY05/06-08/09 period, and encouraged the authorities to strengthen prioritization given the risk of a shortfall in expected donor contributions and the need to adhere to sustainable spending identified under the saving policy. While the authorities remained optimistic that donors would commit new resources for the SIPs, they noted that shortfalls in external support would be met by greater prioritization and that central government spending would be capped at the sustainable spending level identified under the oil saving policy (Box 1).

SIPs Combined Sources Expenditure and Financing

	Average 2000-2004	2004/05	2005/06	2006/07	2007/08	2008/09
	Estimate		Projections			
			(Percent of non-oil GDP)			
Total SIPs planned expenditure 1/ 2/	69.5	62.3	69.8	70.4	67.2	55.1
financed by:						
Timor Leste revenue 3/	10.2	14.9	29.9	26.4	27.6	30.0
Budget support grants	8.8	8.9	2.9	2.8	2.6	0.1
Off-budget committed donor financing	50.3	38.5	16.1	8.3	3.4	1.5
Additional financing requested 4/	0.0	0.0	20.9	32.9	33.6	23.5

Source: Timor-Leste authorities and staff estimates.
1/ Includes off-budget sector projects which the government has identified as necessary to achieve NDP and MDG objectives.
2/ In 2005/06 excludes capitalization of the BPA.
3/ Includes petroleum fund transfers in line with savings policy, net of increase in government cash balances.
4/ New commitments requested from donors for the implementation of the SIPs to achieve NDP and MDG objectives.

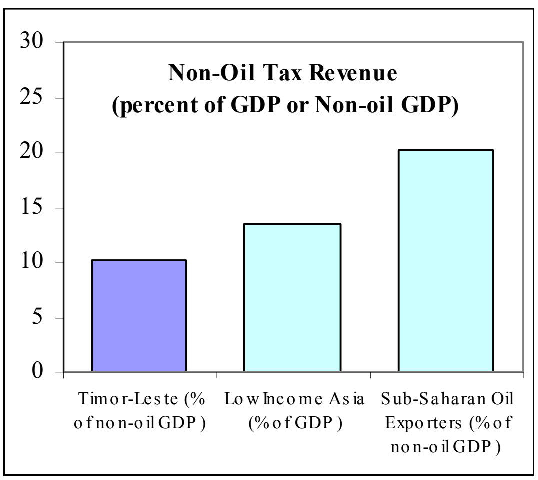
20. **Major progress has been made toward introducing the petroleum fund, and remaining efforts should focus on ensuring the smooth start of its operations with the next fiscal year**. Should delays occur in the passage of the law, staff suggested oil revenue should nonetheless be treated in a manner consistent with the key principles of transparency and accountability to build confidence regarding the authorities' long-term commitment. The authorities noted their intention to establish promptly the investment advisory board and the petroleum fund consultative council, and set up the framework for regular reporting in time to support the launch of the petroleum fund. The staff encouraged the authorities to transfer the bulk of the past accumulated cash balances from FY04/05 oil/gas tax revenue to the new petroleum fund. Although the utilization of the cash balances would not have significant implications for the medium-term spending path, transferring the larger part would send a concrete signal regarding commitment to the new oil/gas saving policy.[8] The staff also

[8] Staff projections assume that US$30 million (40 percent of current spending) would be kept for cash flow management purposes and the remaining US$217 million would be transferred to the petroleum fund. Pending a decision by the government, the draft budget uses the technical assumption that all cash balances remain intact.

encouraged cautious management of oil fund resources, which could jump from US$60 to US$400 million in the first year, in line with FAD-MFD expert advice and with joint Ministry of Planning and Finance (MOPF)-BPA oversight. The authorities agreed and requested the assistance of a full time advisor to assist in investment and reserve management of the petroleum fund during its first year of operation.

21. **The authorities intend to establish a national oil company to capture a larger share of the oil wealth**. Staff invited the government to weigh carefully the costs and benefits given Timor-Leste's limited capacity and recommended that the company's structure be fully consistent with the central principles of the petroleum fund legislation. The authorities assured the staff of their intention that all oil income would be transferred directly to the fund and that subsequent transfers to the oil company would be explicitly detailed in the central government budget. The company's organization and governance structures would be transparent and operations run on market principles. In particular, the authorities noted their aim to avoid the creation of a large company that could produce distortions in the economy and create an alternative power base within the public sector.

22. **Despite gains in improving tax administration, the authorities and staff agreed further steps are needed to strengthen non-oil revenue and avoid excessive reliance on oil/gas revenue over the long term.** Non-oil revenue—at about 10 percent of non-oil GDP—is relatively low in Timor-Leste, even compared with other oil economies, and under current policies is expected to taper off over time as a share of non-oil GDP. The recovery of past-due tax liabilities in FY04/05 contributed to a one-off boost in tax revenue. At the same time, several factors—including continued overall poor compliance, smuggling and the introduction of tax incentives in the new investment laws—point to difficulties in raising revenue levels over the medium term. As a number of taxes are collected at the border, further modernization of customs procedures—including through the extension of ASYCUDA outside Dili and additional training—would be helpful in curtailing undervaluation and misclassification of imports. Enforcement capacity would also need to be improved to combat smuggling. Staff also encouraged the authorities to ensure that the revenue service is adequately staffed in auditing, collection and tax counsel positions. In addition, given the inclusion of tax incentives in the investment laws, the authorities were urged to introduce monitoring procedures to limit potential abuses and to identify the foregone revenue explicitly in the budget.[9] The authorities observed that



[9] The investment tax incentives provide income tax credits for hiring of new Timorese employees and duty-free imports of capital goods, raw materials and semi-finished products for new or additional investment.

the second phase of ASYCUDA implementation was in progress, although complicated by departing technical experts and the absence of electricity outside Dili. They also argued that the positive impact of the investment laws on economic activity would offset the revenue loss from the new tax incentives. Finally, the authorities indicated their intention to seek follow-up technical assistance in tax policy and administration to build on gains made to date and to reflect the changing nature of the Timorese economy.

Composition of non-oil domestic revenue

	FY 2003/04	FY 2004/05	FY 2005/06	
		Staff est.	Draft budget	Staff Proj.
	(millions of US dollars)			
Total	64.0	64.0	46.9	42.4
Direct taxes	6.6	7.6	7.7	7.7
Indirect taxes	18.1	19.5	19.2	19.2
Non tax revenue 1/	4.5	6.1	9.5	5.0
Grants	34.8	30.8	10.5	10.5
Memorandum items:				
Treasury cash balances	62.5	247.0	242.6	30.0
Petroleum fund balances	13.9	63.1	149.3	376.2

1/ The difference in non tax revenue relates to interest earned on treasury cash balances. Staff assumes bulk of cash balances are transferred to petroleum fund. The draft budget is based on the technical assumption that accumulated cash balances are maintained as of end-June 2005.

23. **The power authority has made progress in moving to financial independence, but continues to rely on budget transfers; further reform is needed**. Revenue collection improved markedly in the second half of 2004, but is still below target. New pre-paid meters and outsourced management improved performance, but difficulties continue, including with an unreliable billing system, user non-payment, controlled tariffs, and heavy interference in management decisions. The authorities agreed and noted that regulatory framework for the electricity sector, which would allow more independent decision-making to address operational problems, was near finalization. They were of the view, however, that electricity tariffs were already high and did not plan increases.

C. Monetary and Financial Sector Issues

24. **The authorities agreed with staff that the current monetary and exchange rate regime has served Timor-Leste well, and expect to maintain this arrangement for the foreseeable future**. The dollar regime remains broadly appropriate given the need for a credible nominal anchor, the still limited institutional capacity and the absence of a well-developed foreign exchange market. The authorities concurred that removal of these constraints should be considered preconditions to the introduction of a national currency and were well aware that the current regime need to be supported by appropriate fiscal and wage policy to help improve competitiveness and maintain macroeconomic stability.

25. **While welcoming the increase in financial intermediation, staff noted the need to remain vigilant to possible emerging risks, particularly given the rapid growth and**

sector concentration of bank credit. The BPA was of the view that the financial sector remained healthy. With assistance from an MFD banking supervision expert, the banks' loan portfolios have been assessed as being of appropriate quality and in compliance with supervision regulations, including for loan provisioning. Staff noted that plans underway to create a bank credit registry would help limit credit risk in the banking system. The BPA requested technical assistance on reserve management, in light of the BPA's pending responsibilities with the petroleum fund.

D. Private Sector Development and Institution and Capacity Building

26. **The high growth rate and job creation targeted under the NDP require accelerated efforts to establish an attractive environment for private investment and stimulate non-oil private activity** (Box 3). Staff noted that the needed large-scale job creation should come mainly from small and medium-size private enterprises, rather than from the public or oil/gas sectors. Hence, it recommended the authorities extend resources to shape the framework of the non-oil sector as they have done for the oil/gas sector. Successful efforts in this direction are essential for the long-term diversification of Timor Leste's export base and reduced vulnerability of the economy to volatile oil and coffee prices. Visible progress with pending economic legislation and faster issuance of simple implementing regulations are needed to send a credible signal to the business community that Timor Leste is "open for business." The authorities agreed fully with this analysis, noting that delays were largely related to both the need to create a coherent legal framework from a past mix of Portuguese, Indonesian and UNTAET legislation and to limited domestic capacity. In addition, they viewed the recent passage of the investment laws as a major achievement toward attracting new investment.

27. **With the departure of UN-appointed technical experts, the authorities have taken a pragmatic approach to the continuing need to strengthen administrative capacity**. The Consolidation Support Program, a multi-donor budget support program coordinated by the World Bank, will assist in building capacity across the public sector, including in the judicial education, and health sectors. With regard to economic management, although capacity at the MOPF and BPA has improved, the agencies have continued to rely heavily on international experts for daily operations. With the scaled-back UN mission, the lack of domestic capacity could become a major obstacle to faster development. In response, the authorities have designed a planning and financial management capacity building project to continue building institutional capacity and improved service delivery at the MOPF and other government agencies and line ministries. The project is consistent with the SIPs and would be supported by donor financing.

28. **The authorities indicated appreciation for outreach and capacity building undertaken during the Article IV consultation mission**. Together with EXR, and with the collaboration of the World Bank, the mission presented a two-day workshop for Parliamentarians on the role of the Fund and its activities in Timor-Leste. In addition, and with the additional cooperation of the Asian Development Bank, a workshop was held for civil society on measures to improve private sector activity.

E. Other Issues

29. **While data provision for surveillance is adequate overall, continuing weaknesses complicate policy decision-making and surveillance**. The authorities acknowledged that domestic capacity to compile the national accounts and the balance of payments does not yet exist, although with the assistance of the multi-sector STA expert progress is being made. Given the considerable data shortcomings, the authorities are seeking additional donor assistance through the SIPs and the planning and financial management capacity building project.

30. **Timor-Leste continues to maintain an open trade regime and exchange system that is free of restrictions on payments and transfers for current international transactions**. There were no developments in the trade and exchange regime since the last Article IV consultation.

IV. Staff Appraisal

31. **Over the past few years Timor-Leste has achieved good progress in establishing the basis for a stable and healthy economy**. As the transition from post-conflict status ends, Timor-Leste's challenge is how best to harness its new oil/gas resources within a policy framework that would support higher non-oil GDP growth, reduce poverty, and maintain macroeconomic stability over the long term. The government has followed prudent fiscal and monetary and exchange rate policies over the past few years and is now making promising progress on introducing a long-term strategy for effective management of its oil/gas wealth. Key areas remaining to be addressed include the realization of a public investment strategy focused on basic services and infrastructure spending and supported by sharp improvements in the capacity to design and execute expenditure programs, and an intensified effort to complete the establishment of an environment to attract private investment and stimulate private non-oil activity—the primary source of future job creation.

32. **Given the considerable development needs in Timor Leste, the staff supports moving toward the sustainable spending level as quickly as possible without aggravating either nonpriority spending or inflation pressure**. In that light, the proposed FY05/06 spending increase appears ambitious, given still limited administrative capacity in the government and absorptive capacity in the domestic economy. At the same time, there also remain downside risks on revenue related to oil price volatility.

33. **Recent measures to improve administrative capacity and remove obstacles to smooth budget execution are important steps toward resolving current expenditure execution difficulties**. These include improving monitoring of spending through an itemized program budget, and placing advisors in line ministries to assist with budget preparations. However, to fully resolve the spending execution difficulties without weakening fiduciary responsibility, additional measures are needed to further build administrative capacity at line ministries and the MOPF and to ensure treasury and procurement processes do not create bottlenecks.

34. **The progress in strengthening the links between Timor-Leste's development needs outlined in the SIPs and the budget are welcomed**. The integration of the SIPs into the budget, together with the increased donor-government coordination through the SIPs working groups, is likely to improve the government's ability to plan and focus spending on feasible and needed investment projects, and better align increasingly limited donor activity with the government's priorities.

35. **Further efforts are recommended to reorient expenditure toward improving human capital, infrastructure, and other development needs**. Investment spending remains relatively low in the current medium-term framework. At this early stage of development, the economic returns on public investment are particularly high. Staff also welcome the authorities' commitment to maintaining the existing restraint on the wage bill.

36. **The government's intention to ensure the needed legislative framework is in place for the petroleum fund to start with the new fiscal year is welcome**. Key steps to support the fund will include the establishment of the investment advisory board, the petroleum fund consultative council, and a framework for regular public reporting in time to support the launch of the petroleum fund. Careful consideration should be given to the costs and benefits of establishing a national oil company; the authorities' intention to ensure it would be fully consistent with the principles of the petroleum fund is welcome.

37. **Consolidation of the progress made in non-oil revenue and power sector finances is needed**. Notwithstanding the large oil/gas revenue inflows, a well-functioning tax administration is needed for a stable and robust non-oil revenue base. Further action is recommended, therefore, to continue strengthening tax administration. Continued reform is needed to allow the power authority to gain financial independence.

38. **The current monetary and exchange regime remains appropriate as it provides a credible nominal anchor which continues to serve the country well**. The staff agrees with the authorities' view that a strengthening of institutional capacity and the creation of a well-developed foreign exchange market remain preconditions to the introduction of a national currency. The continuation of prudent fiscal and wage policies is critical to avoid an erosion in external competitiveness.

39. **Further improvement in financial intermediation remains critical for future economic growth**. The BPA has made good progress in developing a strong supervision and regulatory environment and in moving forward with the legislative agenda to help establish the necessary legal structure for banking and private activity. This agenda should be quickly completed, including approval of the central bank, payment system and anti-money laundering legislation. The recent increase in financial intermediation is welcome; at the same time, continued vigilance over bank portfolios is needed to ensure continued soundness.

40. **Accelerated efforts are needed to establish an environment to attract private investment and stimulate non-oil private activity**. Rapid enactment of remaining economic legislation and issuance of streamlined implementing regulations that are simple to

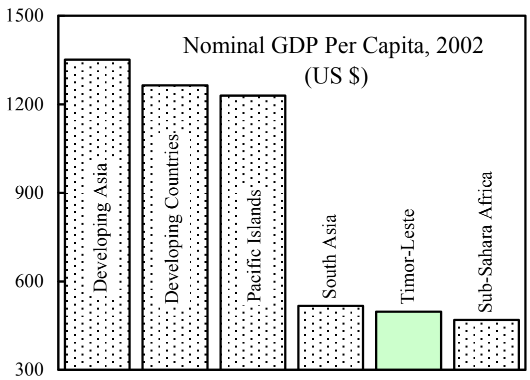
administer would set the basis for stronger non-oil sector growth. In addition, tax incentives under the investment laws should be well-targeted to avoid unwarranted revenue loss.

41. **Developing strong institutions and local capacity is essential for effective economic management and Timor-Leste's economic development**. The authorities' planning and capacity building program now under development is an important step forward as the international presence declines. Gaps in macroeconomic data continue to create difficulties for surveillance and policy decision-making, and the authorities are urged to take early steps to build domestic capacity to compile the national accounts and the balance of payments.

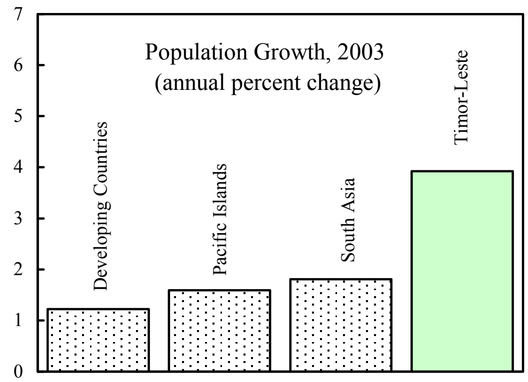
42. **It is proposed that the next Article IV consultation be conducted on the standard 12-month cycle**.

Figure 1. Timor-Leste: Regional and Global Comparators

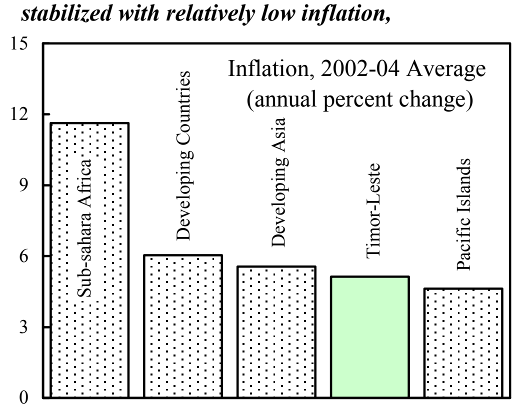
Timor-Leste's per capita GDP is low, reflecting negative economic growth since 1999,



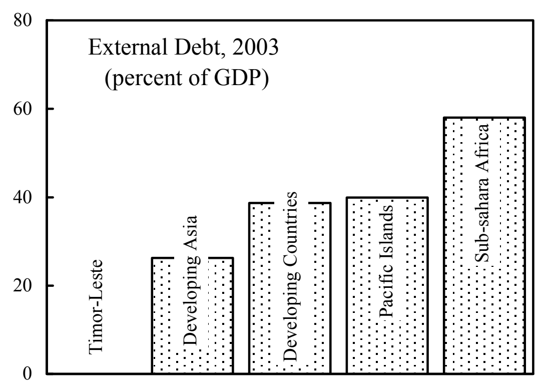
... and rapid population growth rates,



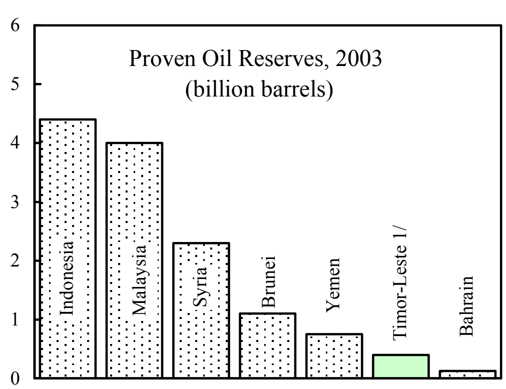
At the same time, the macroeconomic situation has stabilized with relatively low inflation,

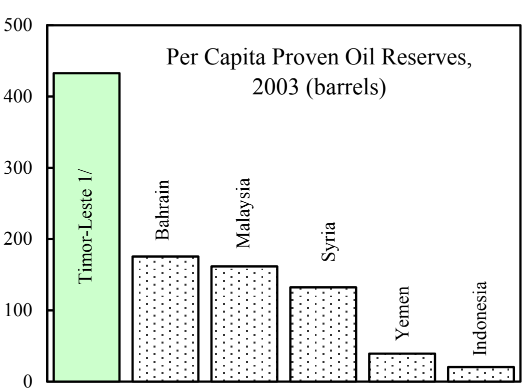


and no external debt overhang.



Finally, the onset of oil production and the high level of estimated per capita oil reserves provides Timor-Leste with the means for improving living standards.



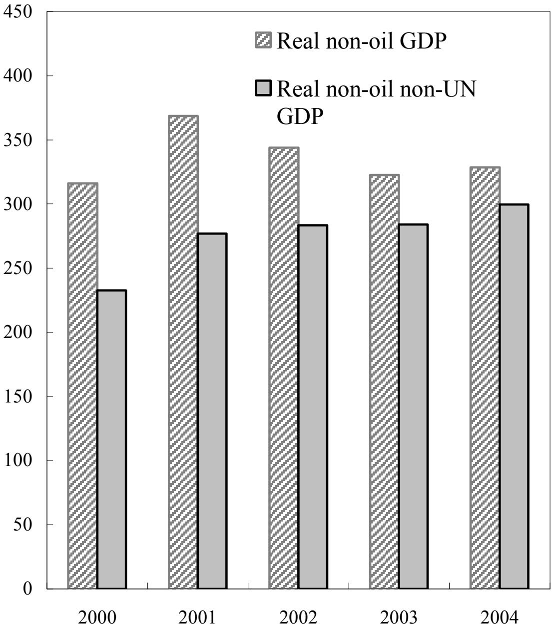


Source: Timor-Leste authorities; British Petroleum annual report; and Fund staff estimates.

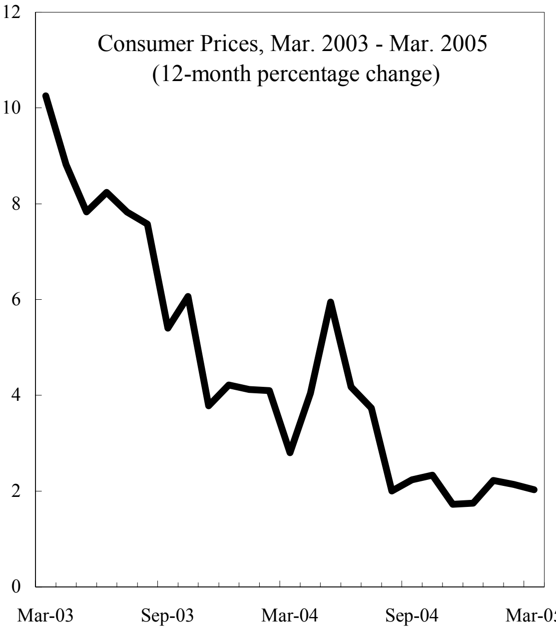
1/ Bayu Undan field only. Reserves would be larger if the Great Sunrise field begins production. In addition, there are significant gas reserves.

Figure 2. Timor Leste: Recent Macroeconomic Developments

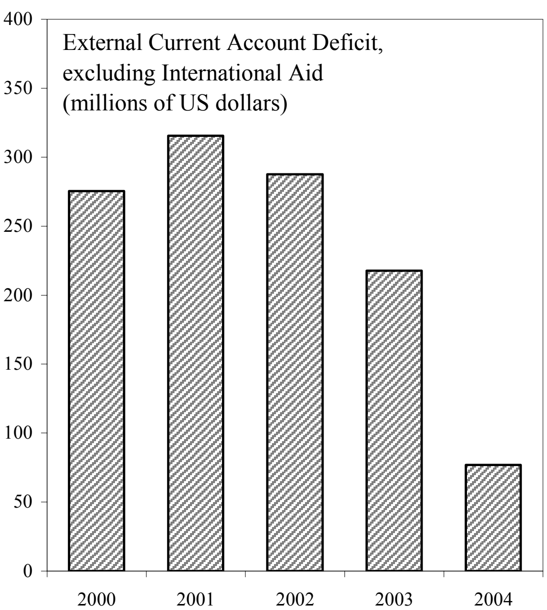
Output recovered in 2004, after declines in 2002-03 linked to UN withdrawal.



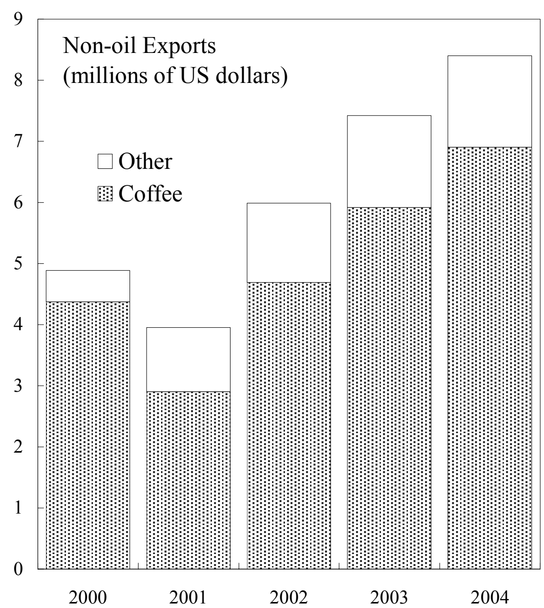
Inflation has been below 3 percent since August 2004.



The current account deficit narrowed, reflecting new oil revenue inflows,

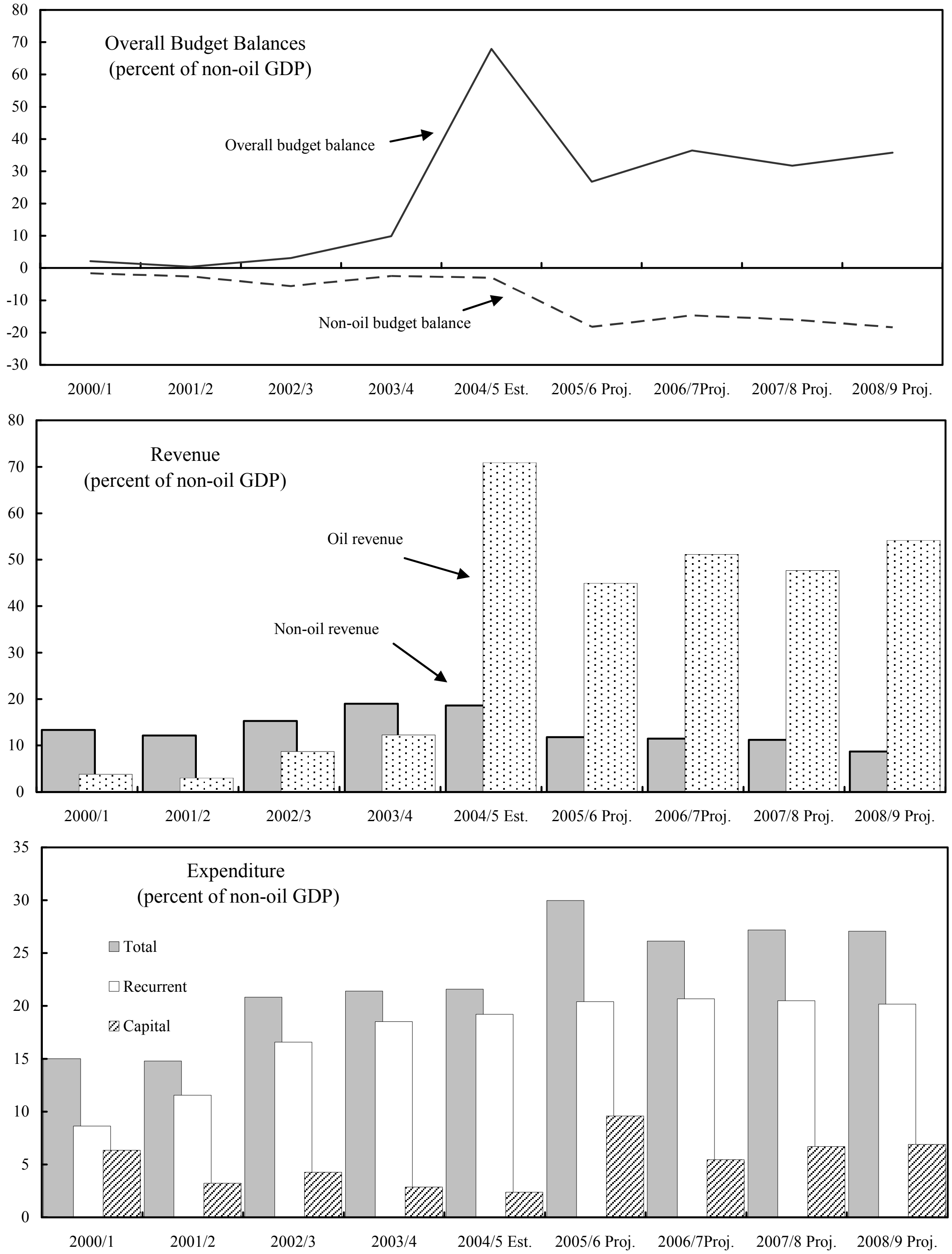


...but non oil exports remain modest, and dominated by coffee.



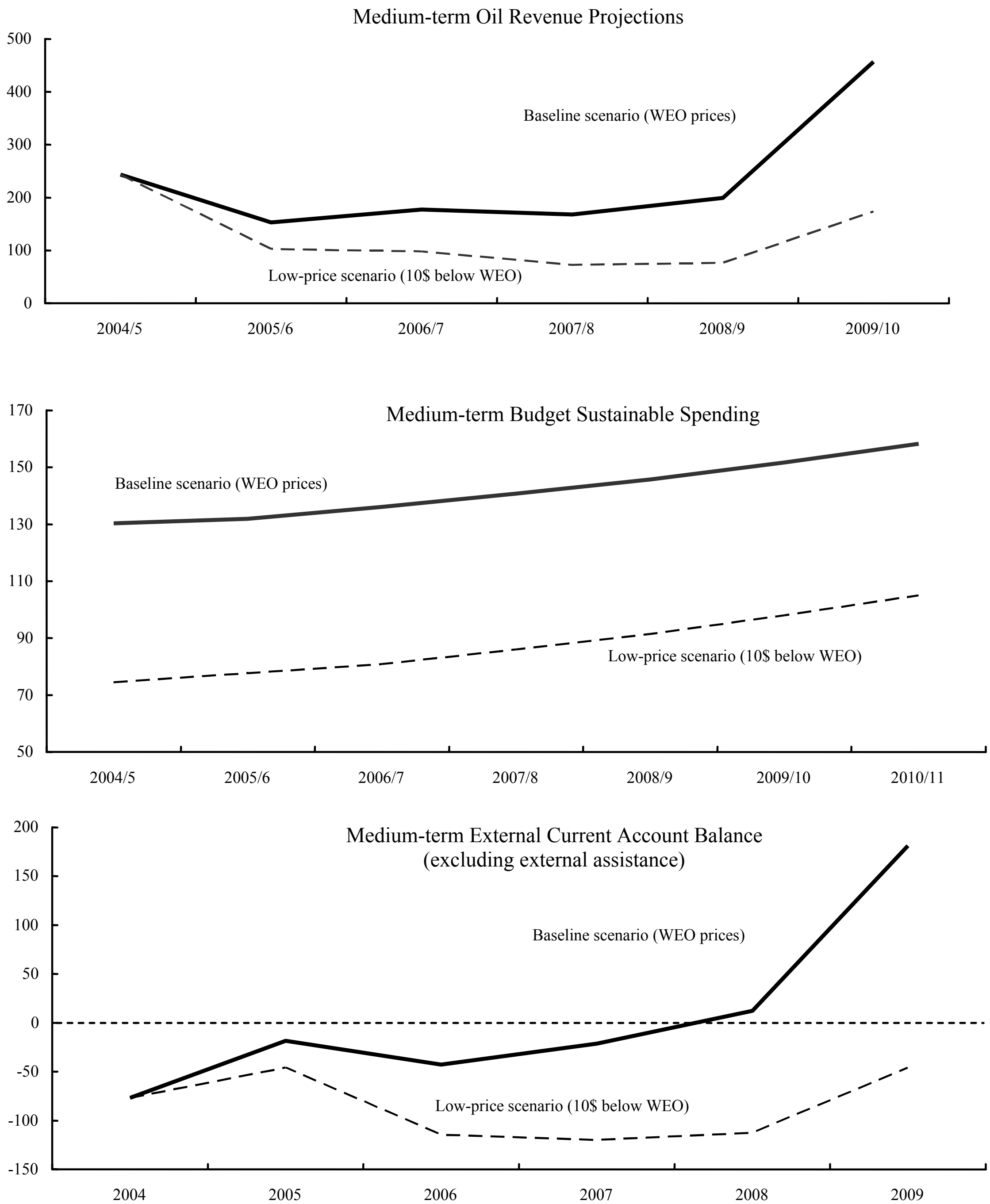
Source: Timor-Leste authorities; and Fund staff estimates and projections.

Figure 3. Timor Leste: Central Government—Fiscal Developments and Outlook
FY 2000/01- 2008/09



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

Figure 4. Timor-Leste: Medium-Term Projections—Baseline and Low Oil Price Scenarios
(Millions of U.S. dollars)



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

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

	Timor-Leste		East Asia and Pacific island countries		Low income countries	
Gross national per capita income (U.S. dollars)	417		1,080		450	
Area (in thousands of square kilometers)	15		...		...	
Demography						
Total population (in millions)	0.925	2/	1,855		2,310	
Population growth (in percent) 3/	4.0		1.2		2.0	
Life expectancy and mortality						
Life expectancy at birth (years)	62		70		58	
Male	60		68		57	
Female	64		71		59	
Infant mortality (per thousand live births)	89		32		80	
Under 5 mortality rate (per thousand live births)	107		41		123	
Education						
Illiteracy rate (in percent) 4/	51		10	5/	49	5/
Male	46		...		...	
Female	55		...		...	
Net primary school enrollment rate (in percent)	75		93	5/	77	5/
Health						
Immunization rate						
(in percent of children aged 12 to 23 months)						
Measles	60		82		65	
DPT	70		82		67	
Other indicators 6/						
The population below the poverty line	40	5/	…		...	
Households with access to electricity	26		…		...	
Households with access to safe water	52	7/	78	7/	75	7/

Sources: UNDP Human Development Report 2004, World Bank, and Fund staff estimates.

1/ Data are for 2003, unless otherwise indicated.
2/ Data for 2004. Provisional population count from 2004 census.
3/ For Timor Leste, average growth over 2000-2004, including returning refugees. For comparators average for 1990-2003.
4/ For ages 15 and above.
5/ Figures are for 2001.
6/ In percentage share of the total.
7/ Figures are for 2002.

Table 2. Timor-Leste: Selected Economic Indicators, 2000-2005

	2000 1/	2001 1/	2002 1/	2003 1/	2004 Est.	2005 Proj.
Output and prices 1/						
Non-oil GDP	316	368	343	336	339	349
Real non-oil GDP growth (percentage change)	15.4	16.6	-6.7	-6.2	1.8	2.5
Inflation (percentage change, end-period) 2/	3.0	-0.3	9.5	4.2	1.8	2.5
			(In percent of non-oil GDP)			
Investment-saving balance						
Gross investment 3/	41	42	36	31	28	32
Non-government	7	9	7	9	9	9
Government	34	32	28	23	19	23
Gross national savings	-46	-44	-48	-34	6	27
Non-government	-51	-50	-54	-44	-36	-26
Government	5	6	6	10	42	53
External savings	87	86	84	65	23	5
Central government budget 4/						
Revenues	17	15	24	31	90	57
Domestic revenues	4	6	6	9	10	9
Oil/gas revenues	4	3	9	12	71	45
Grants	9	6	10	10	9	3
Expenditure	15	15	21	21	22	30
Recurrent expenditure	9	12	17	19	19	20
Capital expenditure	6	3	4	3	2	10
Overall balance	2	0	3	10	68	27
Public debt	0	0	0	0	0	0
Combined sources fiscal operations 4/ 5/						
Revenues	18	16	25	33	92	15
Expenditure	69	70	73	66	62	70
Recurrent expenditure	35	38	44	44	45	41
Capital expenditure	34	32	30	22	18	29
Overall balance	-52	-53	-48	-33	29	-55
Money and credit						
Broad money (end-period) 6/	6	14	16	22	25	28
Net domestic assets (end-period)	-4	-4	-10	-11	-30	-84
			(In millions of U.S. dollars)			
External sector						
Current account excl. international assistance	-275	-316	-288	-218	-77	-18
Current account incl. international assistance	37	46	26	17	119	149
Trade balance	-237	-280	-260	-213	-194	-204
Merchandise exports 7/	5	4	6	7	8	10
Merchandise imports 8/	-242	-284	-266	-221	-202	-214
Overall balance	16	8	20	18	122	216
			(In percent of non-oil GDP)			
Current account excl. international assistance	-87	-86	-84	-65	-23	-5
Current account incl. international assistance	12	13	8	5	35	43
Trade balance	-75	-76	-76	-64	-57	-58
Merchandise exports 7/	2	1	2	2	2	3
Merchandise imports 8/	-77	-77	-78	-66	-60	-61
Overall balance	5	2	6	5	36	62

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

1/ Non-oil GDP and national accounts data for 2000-2003 are based on estimates prepared by BIDE consultants in October 2004.
2/ CPI for Dili.
3/ Excludes oil/gas sector investment.
4/ Fiscal year basis (July-June); for example, 2000 refers to FY2000/01.
5/ Includes fiscal and quasi-fiscal expenditure programs undertaken by bilateral donors and international financial institutions, outside the central government budget. The sharp revenue decline in FY 2005/06 reflects the adoption of the new savings and petroleum fund policy according to which only the sustainable income from the oil wealth is transferred to the budget.
6/ Exclude currency holdings by the public, for which no data are available.
7/ Excludes oil/gas revenue, which are recorded under the income account (royalties) and transfers (tax revenues).
8/ In 2005 includes the transfer of assets from UNMISET, valued at approximately US$ 12 million.

Table 3. Timor-Leste: Central Government Budget FY2003/04-FY2008/09 1/

	2003/04	2004/05		2005/6	2006/7	2007/08	2008/09	2005/06	2006/07	2007/08	2008/09
		Revised Budget	Staff Proj. 2/	Draft Budget 2005/06 3/				Staff Projections 3/			
				(In millions of U.S. dollars)							
Revenue 4/	105.4	192.2	308.0	205.6	234.8	232.5	262.7	203.7	237.9	236.7	267.4
Domestic revenues	29.2	31.6	33.2	36.4	38.6	40.8	43.6	31.9	33.1	34.7	36.5
Oil/gas revenues	41.4	129.8	244.0	158.7	185.7	181.2	218.6	161.3	194.3	191.5	230.4
Tax revenues	38.0	93.9	194.8	112.0	135.0	127.3	113.1	112.0	135.0	127.3	113.1
Royalties and interest	3.4	35.9	49.2	46.7	50.7	53.9	105.5	49.3	59.3	64.2	117.3
Grants	34.8	30.8	30.8	10.5	10.5	10.5	0.5	10.5	10.5	10.5	0.5
Expenditure 5/	72.2	78.7	74.3	119.5	106.2	112.0	109.6	107.6	99.3	109.3	115.1
Recurrent expenditure	62.5	67.8	66.1	77.8	80.8	82.4	84.3	73.3	78.6	82.4	85.8
Wages and salaries	24.0	28.2	28.2	28.9	31.3	32.3	33.6	28.9	31.3	32.3	33.6
Goods and services	38.5	39.6	32.6	45.3	45.0	44.6	45.6	40.8	42.8	44.6	47.1
Subsidies			5.3	3.6	4.5	5.5	5.1	3.6	4.5	5.5	5.1
Capital expenditure and net lending 6/	9.7	10.9	8.2	41.7	25.4	29.6	25.3	34.4	20.7	26.9	29.3
Overall balance	33.2	113.5	233.7	86.2	128.6	120.5	153.1	96.0	138.6	127.4	152.2
Financing	-33.2	-113.5	-233.7	-86.2	-128.6	-120.5	-153.1	-96.0	-138.6	-127.4	-152.2
Changes in cash balances (increase -)	-29.8	-77.6	-184.5	0.0	0.0	0.0	0.0	217.0	0.0	0.0	0.0
Oil/gas revenue savings (increase -)	-3.4	-35.9	-49.2	-86.2	-128.6	-120.5	-153.1	-313.1	-138.6	-127.4	-152.2
				(In percent of non-oil GDP)							
Revenue	31.2	55.9	89.5	57.3	61.8	57.8	61.8	56.7	62.6	58.9	62.9
Domestic revenues	8.7	9.2	9.6	10.1	10.2	10.1	10.3	8.9	8.7	8.6	8.6
Oil/gas revenues	12.3	37.7	70.9	44.2	48.9	45.1	51.4	44.9	51.1	47.6	54.2
Grants	10.3	8.9	8.9	2.9	2.8	2.6	0.1	2.9	2.8	2.6	0.1
Expenditure	21.4	22.9	21.6	33.3	27.9	27.9	25.8	30.0	26.1	27.2	27.1
Recurrent expenditure	18.5	19.7	19.2	21.7	21.3	20.5	19.8	20.4	20.7	20.5	20.2
Capital expenditure	2.9	3.2	2.4	11.6	6.7	7.4	5.9	9.6	5.5	6.7	6.9
Overall balance	9.8	33.0	67.9	24.0	33.8	30.0	36.0	26.7	36.5	31.7	35.8
Financing	-9.8	-33.0	-67.9	-24.0	-33.8	-30.0	-36.0	-26.7	-36.5	-31.7	-35.8
Memorandum items:				(In millions of US dollars, unless otherwise specified)							
Non-oil fiscal balance (in percent of non-oil GDP)	-2.4	-4.7	-3.0	-20.2	-15.0	-15.1	-15.4	-18.2	-14.7	-16.0	-18.4
Financing of non-oil fiscal balance from oil savings	...	...	...	72.6	57.1	60.7	65.5	65.3	55.7	64.2	78.2
Net allocation to petroleum fund from savings rule	...	...	...	58.6	82.6	75.1	109.3	61.3	91.2	85.4	121.1
Net allocation to the petroleum fund 7/	...	35.9	49.2	86.2	128.6	120.5	153.1	313.1	138.6	127.4	152.2
Cumulative oil gas savings (end-period)	13.9	49.8	63.1	149.3	277.9	398.4	551.5	376.2	514.8	642.2	794.4

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

1/ Fiscal year: July-June.

2/ Based on budget execution as of March 2005.

3/ Assumes authorities' new permanent income savings policy is in place. Only the real permanent income derived from oil wealth may be spent in any year.

4/ Differences in draft budget and staff projections for the period 2005/06-2008/09 reflect different treatment of treasury's cash balances at end FY 2004/05. Budget non-oil revenue is higher than staff 's projections because it includes interest on high cash balances. Vice-versa, oil revenue are higher in staff's projections because of higher interests accruing to the petroleum fund, endowed with the bulk of end of FY 2004/05 cash balances (see footnote 7, below).

5/ The draft budget is based on expenditure commitments. Staff's projections are based on estimates of likely execution.

6/ In FY 2005/06 includes US$ 10.5 million to capitalize the BPA.

7/ Staff projections assume that at end-June 2005, existing oil savings and government cash balances above those needed to maintain a cushion against temporary fluctuations in revenue are moved to the petroleum fund. Pending a policy decision, the draft budget document is based on the technical assumptions that only accumulated royalties (FTP) are transferred to the petroleum fund and the treasury keeps for cash-flow management the large cash balances accumulated as of end-FY 2004/05 at the BPA.

Table 4. Timor Leste: SIPs Combined Sources Budget FY 2003/04 - 2008/09

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
	Est.	Staff projections 1/				
			(In millions of U.S. dollars)			
Revenue	111.1	315.7	52.7	55.1	57.4	50.0
Domestic revenue 2/	29.2	33.2	31.9	33.1	34.7	36.5
Autonomous agencies own revenue	5.7	8.2	10.3	11.5	12.2	13.0
Oil/gas revenue 2/	41.4	243.5	0.0	0.0	0.0	0.0
Grant financing (budget support)	34.8	30.8	10.5	10.5	10.5	0.5
Expenditure	221.4	214.4	260.6	267.5	270.1	234.5
Recurrent expenditure	147.0	153.8	148.1	142.0	140.1	125.1
Central government budget (incl. autonomous agencies)	66.3	71.6	80.1	86.2	90.5	94.5
Donor projects 3/	80.8	82.2	68.0	55.8	49.6	30.6
Capital expenditure	74.3	60.6	112.5	125.5	130.0	109.5
Central government budget (incl. autonomous agencies)	11.6	10.9	37.8	24.6	31.0	33.7
Donor projects 3/	62.7	49.7	74.7	100.9	99.0	75.8
Overall balance	-110.3	101.3	-208.0	-212.4	-212.8	-184.6
Financing	110.3	-101.3	123.0	87.4	77.8	84.6
Oil fund financing of central government non-oil fiscal deficit	...	...	65.3	55.7	64.2	78.2
Oil/gas revenue savings (increase -)	-3.4	-49.2	...	...	...	...
Committed project financing by donors	143.5	132.4	57.7	31.7	13.6	6.4
Change in treasury cash balances (increase -)	-29.8	-184.5	0.0	0.0	0.0	0.0
Additional financing requests 4/	0.0	0.0	-85.0	-125.0	-135.0	-100.0
			(In percent of non-oil GDP)			
Revenue	32.9	91.7	14.7	14.5	14.3	11.7
Domestic revenue 2/	8.7	9.6	8.9	8.7	8.6	8.6
Autonomous agencies own revenue	1.7	2.4	2.9	3.0	3.0	3.1
Oil/gas revenue 2/	12.3	70.8	0.0	0.0	0.0	0.0
Grant financing (budget support)	10.3	8.9	2.9	2.8	2.6	0.1
Expenditure 3/	65.6	62.3	72.6	70.4	67.2	55.1
Recurrent expenditure	43.6	44.7	41.3	37.4	34.9	29.4
Capital expenditure	22.0	17.6	31.3	33.0	32.3	25.7
Overall Balance	-32.7	29.4	-57.9	-55.9	-52.9	-43.4
Financing	32.7	-29.4	34.3	23.0	19.3	19.9
Oil fund financing of central government non-oil fiscal deficit	...	...	18.2	14.7	16.0	18.4
Oil/gas revenue savings (increase -) 2/	-1.0	-14.3	...	...	...	...
Committed project financing by donors	42.5	38.5	16.1	8.3	3.4	1.5
Change in treasury cash balances (increase -)	-8.8	-53.6	0.0	0.0	0.0	0.0
Additional financing requests 4/	0.0	0.0	-23.7	-32.9	-33.6	-23.5
Memorandum items:			(In millions of U.S. dollars unless otherwise specified)			
Non-oil fiscal balance	-8.2	-10.3	-65.3	-55.7	-64.2	-78.2
Transfer from the petroleum fund 2/	...	...	65.3	55.7	64.2	78.2
Oil fund balance (in percent of non-oil GDP)	4.1	18.4	104.8	135.5	159.8	186.8
Total donor financing requested	143.5	132.4	142.7	156.7	148.6	106.4
Committed	143.5	132.4	57.7	31.7	13.6	6.4
Uncommitted	0.0	0.0	85.0	125.0	135.0	100.0

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

1/ Based on April 2005 SIPs spending proposals and requests for project financing by donors. Assumes implementation of the oil fund and fiscal sustainability policy starting in FY 2005/06; Fund staff projections for central government revenue and expenditure.

2/ Oil gas revenue are included in the budget up to FY 2004/05. Thereafter it is assumed that oil revenue flows directly to the petroleum fund, from which the amount necessary to cover the non-oil fiscal budget deficit is then transfered, up to the estimated sustainable income and recorded as a financing item.

3/ Includes sector projects which the government has identified as necessary to achieve NDP and MDG objectives, but for which donor financing is not yet fully committed.

4/ Project financing requested from donors; still uncommitted.

Table 5. Timor-Leste: Monetary Developments, 2001-2005

	2001	2002	2003	2004	2005 March	2005 Dec Proj.
	(In millions of U.S. dollars; at end-period)					
Banking System						
Net foreign assets	65.4	89.9	108.3	186.6	283.7	392.3
Assets	72.9	93.3	141.6	228.2	326.1	436.3
Cash holdings	11.7	18.1	19.0	28.4	24.5	28.4
Claims on foreign banks	61.2	75.3	122.6	65.8	65.5	54.5
Other 1/	0.1	0.0	0.0	134.0	236.1	353.3
Liabilities	7.5	3.5	33.3	41.6	42.4	44.0
Net domestic assets	-14.3	-35.3	-36.0	-102.6	-197.0	-294.5
Claims on government (net)	-21.1	-33.7	-49.7	-168.4	-269.0	-373.7
Claims on private sector	3.0	5.1	22.1	70.5	75.6	91.6
Other items (net)	3.8	-6.7	-8.4	-4.7	-3.6	-12.4
Broad money 2/	51.1	54.6	72.3	84.0	86.7	97.8
Demand deposits	36.9	39.1	40.1	49.4	52.4	57.5
Other deposits	14.2	15.5	32.2	34.6	34.2	40.3
BPA						
Net foreign assets	23.7	43.5	61.3	183.1	284.5	398.9
Assets	23.7	43.5	61.3	183.1	284.5	398.9
Liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Net domestic assets 3/	-22.7	-39.1	-55.0	-177.6	-279.0	-393.4
Liabilities	1.0	4.5	6.3	5.5	5.4	5.5
Commercial banks 4/						
Net foreign assets	41.7	46.4	47.0	3.5	-0.8	-6.6
Net domestic assets	12.9	10.7	28.8	81.2	87.7	105.1
Deposit liabilities	51.1	54.6	72.3	84.0	86.7	97.8
Liabilities to BPA	3.5	2.4	3.4	0.7	0.2	0.7
Memorandum items						
Net foreign assets (annual percentage change)	37.4	37.4	20.5	72.3	122.1	110.2
Credit to the economy (annual percentage change)	1000.0	170.4	432.4	218.8	133.6	30.0
Credit/GDP	0.8	1.5	6.6	20.8	21.7	26.2
Credit to deposits ratio	5.9	9.4	30.6	83.9	87.2	93.7
Deposits/GDP ratio	13.9	15.9	21.5	24.8	24.8	28.0

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

1/ Investment of oil revenue in US treasury bills on behalf of the government.
2/ Excludes currency in circulation, for which no data are available due to dollarization of the financial system.
3/ The large decrease in 2004 reflects the increase of oil-related government deposits.
4/ Includes the micro-finance institution.

Table 6. Timor-Leste: Balance of Payments 2000-2005

	2000	2001	2002	2003	2004	2005
	Estimates					Proj.
	(In millions of U.S. dollars)					
Current account excl. international assistance	-275	-316	-288	-218	-77	-18
Current account incl. international assistance	37	46	26	17	119	149
Trade balance	-237	-280	-260	-213	-194	-204
Exports of goods 1/	5	4	6	7	8	10
O/w: coffee	4	3	5	6	7	8
Imports of goods	-242	-284	-266	-221	-202	-214
O/w: international assistance-related	-148	-163	-141	-109	-100	-108
Services (net)	-52	-56	-56	-48	-34	-27
Income (net)	2	5	6	5	30	54
O/w: oil/gas royalty and interest	2	4	4	3	26	49
Current transfers (net)	325	377	337	273	317	326
O/w: oil/gas tax revenue	5	8	16	32	116	153
international assistance	313	362	314	235	195	167
Capital and financial accounts	-29	-40	-11	16	7	67
Official capital transfers	80	86	71	53	47	61
Financial account	-109	-127	-82	-37	-40	6
Errors and omissions (net)	7	2	5	-15	-4	0
Overall balance	16	8	20	18	122	216
Changes in foreign assets (increase -)	-16	-8	-20	-18	-122	-216
Oil/gas revenue savings (increase -)	-19	-2	-13	-16	-119	-205
Other	3	-6	-7	-2	-3	-11
	(In percent of non-oil GDP)					
Current account excl. international assistance	-87	-86	-84	-65	-23	-5
Current account incl. international assistance	12	13	8	5	35	43
Trade balance	-75	-76	-76	-64	-57	-58
	(In millions of U.S. dollars)					
Memorandum items:						
Oil/gas revenue	7	12	20	35	143	203
Gross foreign assets (end-period)	16	24	44	61	183	399

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

1/ Exclude oil/gas revenues, which are recorded under the income (royalties) and transfers (tax revenues) because of lack of detailed data on the oil/gas sector (including production, exports, service payments, and profit remittances).

Table 7. Timor-Leste: Medium-Term Outlook, 2004-2009

	2004	2005	2006	2007	2008	2009
	Est.			Proj.		
Output and prices						
GNP at current prices (in millions of US dollars)	482	552	547	584	624	803
Non-oil GDP	339	349	369	391	413	438
Oil/gas income	143	203	178	193	211	365
Real non-oil GDP growth (percentage change)	1.8	2.5	4.9	4.2	4.0	4.0
Inflation (percentage change at end-period) 1/	1.8	2.5	2.5	2.5	2.5	2.5
		(In percent of non-oil GDP)				
Investment-saving balance						
Gross investment 2/	28	32	34	31	30	27
Gross national saving	6	27	22	26	33	69
External saving	23	5	12	5	-3	-41
Central government budget 3/						
Revenue	90	57	63	59	63	119
Domestic revenue	10	9	9	9	9	9
Oil/gas revenue	71	45	51	48	54	111
Grants	9	3	3	3	0	0
Expenditure	22	30	26	27	27	29
Recurrent expenditure	19	20	21	21	20	22
Capital expenditure	2	10	5	7	7	7
Overall balance	68	27	36	32	36	90
Public debt	0	0	0	0	0	0
Combined sources fiscal operations 3/4/						
Revenues	92	15	14	14	12	12
Expenditure	62	70	70	67	55	53
Recurrent expenditure	45	41	37	35	29	30
Capital expenditure	18	29	33	32	26	23
Overall balance	29	-55	-56	-53	-43	-41
Financing	-29	34	23	19	20	20
Net transfers from oil fund	...	18	15	16	18	20
Committed financing by donors	38	16	8	3	2	0
Change in cash balances	-54	0	0	0	0	0
Financing gap	0	-21	-33	-34	-24	-21
Money and credit						
Broad money (end-period) 5/	25	28	…	…	…	…
Net domestic assets (end-period)	-30	-84	…	…	…	…
		(In millions of U.S. dollars)				
External sector						
Current account excl. international assistance	-77	-18	-43	-21	12	181
Current account incl. international assistance	119	149	90	89	99	244
Trade balance	-194	-204	-208	-204	-192	-181
Merchandise exports 6/	8	10	10	12	12	14
Merchandise imports 7/	-202	-214	-218	-216	-205	-195
Oil income and transfers	143	203	178	193	211	365
Overall balance	122	216	117	133	140	281
Gross foreign assets (end-period)	183	399	516	649	789	1070
(in months of imports of goods and services)	11	22	28	36	46	66
		(In percent of non-oil GDP)				
Current account excl. international assistance	-23	-5	-12	-5	3	41
Current account incl. international assistance	35	43	24	23	24	56
Overall balance	36	62	32	34	34	64

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

1/ CPI for Dili.
2/ Excludes oil/gas sector investment.
3/ Fiscal year (July-June); for example, 2004 relates to FY2004/05.
4/ On a fiscal year basis. Includes fiscal and quasi-fiscal expenditure programs undertaken by bilateral donors and international financial institutions outside the central government budget. Projections based on April 2005 SIPs requirements.
5/ Excludes currency holdings by the public, on which no data are available.
6/ Excludes oil/gas revenue, which is recorded under the income account (royalties) and transfers (tax revenue).
7/ In 2005 includes the transfer of assets from UNMISET estimated at US$12 million.

Table 8. Timor-Leste: Vulnerability Indicators, 2000–05

	2000	2001	2002	2003	2004 Est.	2005 Proj.
	(In percent of GDP; unless otherwise indicated)					
Financial sector risk indicators						
Public debt	0.0	0.0	0.0	0.0	0.0	0.0
Broad money (percent change, 12-month basis) 1/	...	155.5	6.9	32.4	16.1	16.4
Private Sector credit (percent change, 12-month basis)	...	900.0	70.4	332.4	218.8	30.0
Share of demand deposits in broad money (percent)	96.5	72.2	71.5	55.4	58.8	58.8
External indicators						
Exports (percent change, 12-month basis in U.S. dollars)	-90.5	-19.1	51.4	23.9	13.3	15.4
Imports (percent change, 12-month basis in U.S. dollars)	104.2	17.4	-6.3	-17.1	-8.4	5.7
Current account balance (excl. international assistance)	-87.1	-85.8	-83.8	-64.9	-22.7	-5.3
Gross official reserves (in millions of U.S. dollars)	16.0	23.7	43.5	61.3	183.1	398.9
(in months of corresponding imports of goods)	0.8	1.0	2.0	3.3	10.9	22.4
Net Foreign assets of commercial banks (in millions of U.S. dollars)	17.8	41.7	46.4	47.0	3.5	-6.6
Total external debt 2/	0.0	0.0	0.0	0.0	0.0	0.0
In percent of exports of goods and services	0.0	0.0	0.0	0.0	0.0	0.0
External debt-service (in percent of exports of goods and services)	0.0	0.0	0.0	0.0	0.0	0.0

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

1/ Excludes currrency in circulation on which no data are available.
2/ No external or domestic debt has been contracted.

TIMOR-LESTE: FUND RELATIONS
(AS OF APRIL 30, 2005)

I. **Membership Status**: Joined 7/23/2002; Article VIII

II. **General Resources Account**:

	SDR Million	% Quota
Quota	8.20	100.00
Fund holdings of currency	8.20	100.00
Reserve position in Fund	0.00	0.00

III. **SDR Department**:

Net cumulative allocation	None
Holdings	None

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangements**

On January 24, 2000, the U.S. dollar was adopted as the official currency of then East Timor by the United Nations Transitional Administration in East Timor (UNTAET). This arrangement has been maintained after Timor-Leste's independence on May 20, 2002. At present, the monetary authority does not undertake foreign exchange transactions; they are handled by commercial banks on the basis of rates quoted in the international markets.

VIII. **Article IV Consultations**

The 2004 Article IV consultation discussions with the authorities were held during April 8–21, 2004. The Executive Board discussed the staff report (IMF Country Report 04/321, 10/12/04) and concluded the consultation on July 16, 2004.

IX. **Technical Assistance**

Since late 1999, a significant amount of technical assistance has been provided by the Fund as part of the international community's efforts to reconstruct the Timor-Leste economy in the aftermath of the widespread violence and destruction that followed the August 1999 referendum. The Fund's technical assistance has focused on establishing key economic institutions (especially fiscal and monetary authorities) essential for macroeconomic management, as well as on developing local capacity to manage them. It also played a key role in the adoption of a new currency arrangement based on the U.S. dollar. Between late 1999 and early 2005, numerous technical assistance missions (including staff visits) took place, making Timor-Leste one of the largest recipients of Fund technical assistance.

FAD: A series of multi-topic FAD missions took place to establish and develop the Central Fiscal Authority (CFA, February 2000), which now functions as the Ministry of Planning and Finance. In this connection, assistance was provided to develop budget preparation, establish tax policy and administration, strengthen treasury and expenditure management, and advise on oil sector fiscal regimes and the establishment of an oil fund. In addition, long-term resident advisors were assigned to the Ministry of Planning and Finance and the Revenue Service of Timor-Leste to advise the authorities on a number of fiscal areas (including budget policy and tax administration) partly under a cost sharing arrangement with the UN. Since August 2004, a resident advisor is providing assistance for the design and establishment of a Petroleum Fund. FAD has recently agreed to provide a long-term advisor to the Treasurer of the Ministry of Planning and Finance to strengthen expenditure management and budget execution.

LEG: A number of LEG missions have been to Timor Leste to advise the authorities on key fiscal and financial legislation. These included the customs law and directives, income tax legislation, directives and rulings, the budget and financial management law, and banking regulations (relating to the monetary authority, the banking system, and the payments system). Jointly with MFD, technical assistance has recently been provided to assist the authorities in drafting an AML/CFT Law. LEG has also recently provided assistance, in collaboration with FAD, for the drafting of the Petroleum Fund Act, and Petroleum Fund Management Agreement, and in collaboration with MFD, for the drafting of the Central Bank Law.

MFD: A large number of MFD missions took place to establish and develop the Central Payments Office (CPO, January 2000), which was transformed subsequently into the Banking and Payments Authority (November 2001). To this end, assistance was provided to establish a payment system, prepare banking legislation, and develop key functions of the monetary authority, including banking supervision, asset management, accounting, and organization and management. Assistance was also provided on the introduction of a dollar-based currency system and to issue domestic coins to supplement the use of U.S. dollar coins. More recently, assistance has been provided to (i) develop a framework for insurance supervision, (ii) to train officers in the supervision department, and (iii) address a broad range of issues relating to money laundering and financing of terrorism. In addition, long-term resident advisors, including on bank supervision, payments, and accounting, have been assigned to the Central Payments Office and the Banking and Payments Authority under a cost sharing arrangement with the UN. In 2004, technical advice on the drafting of an insurance law, the design of a more effective organizational structure at the BPA and the strengthening of its investment management capabilities was also provided. Since early 2005, an MFD long-term advisor has been assisting the BPA general manager.

STA: A multi-sector statistical mission took place in November 2000 to assess the availability and quality of official macroeconomic data, and help establish the Statistic Division of the Ministry of Planning and Finance. A long-term statistical advisor assists the authorities in improving data compilation and developing local capacity.

X. Resident Representative

A resident representative office was established in Dili in August 2000. The current resident representative, Mr. Insu Kim, assumed the post in August 2004.

TIMOR-LESTE: RELATIONS WITH THE WORLD BANK GROUP
(As of April 30, 2005)

1. Timor-Leste joined the World Bank Group on July 23, 2002. It became eligible for IDA assistance on October 9, 2002. Thus far, there has been no lending to Timor-Leste, reflecting the authorities' policy to avoid external borrowing, including concessional loans. However, the World Bank has been actively involved in the reconstruction and development of the economy since late 1999, by playing a key catalytic role in mobilizing and coordinating international assistance to Timor-Leste.

2. During the transition to independence, the World Bank's involvement centered around its role as trustee and co-manager of the Trust Fund for East Timor (TFET), which was established in December 1999 as a vehicle to provide grant assistance for reconstruction activities and economic development in Timor-Leste.[1] Under the TFET, which is co-managed with the Asian Development Bank (ADB), the World Bank has administered projects relating to social services (especially health and education), agriculture, private sector development, community development and governance, economic capacity building, and petroleum sector development. Total funding for the World Bank-administered projects reached $115 million, of which $94 million was disbursed by end-March 2005. The World Bank has also provided analytical and advisory services, including through a Country Economic Memorandum, a Poverty Assessment, a Public Expenditure Management and Accountability Note, a Public Expenditure Review, and an Education Sector Review.

3. In addition to its involvement through the TFET, the World Bank has also been playing a key role in mobilizing budgetary assistance for the post-independence period through the annual multi-donor Transition Support Program. The first Transition Support Program (TSP I) was approved by the World Bank Board in July 2002 and focused on creating institutions, establishing a legislative and regulatory framework, and strengthening the management systems required for core government functions. IDA financing consisted of a $5 million grant in support of the FY2003 budget. The second Transition Support Program (TSP II) was approved in July 2003. IDA financing consisted of a $4 million grant in support of the FY2004 budget. The third Transition Support Program (TSP III) was approved in October 2004. IDA financing consisted of a $5 million grant in support of the FY2004 budget. Both TSP II and TSP III have focused on three thematic areas: (1) good governance, including developing a legal framework for governance and the judiciary and strengthening public expenditure management; (2) service delivery for poverty reduction, particularly in education and health; and (3) job creation, especially through private sector development,

[1] Pledges to the TFET were made by 12 donor countries, the European Commission, and the World Bank, with the total amount of funds reaching $178 million. This comprises donors' contributions of $169 million (including $10 million by the World Bank) and investment income of $8.7 million. Of this total, $148 million was disbursed by end-March 2005. TFET projects are expected to wind down by end-2007.

agriculture, and improvements in basic infrastructure. The TSPs have been used as a unifying framework for donors' budget support, mobilizing a total of $99 million over three years from 10 bilateral donors (including parallel financing from Portugal).[2] The Government has requested the extension of budget support for an additional three years, through FY2008, under the Consolidation Support Program (CSP) to reflect the shift from post-conflict transition to consolidation of gains made thus far.

4. Prior to Timor-Leste's independence, the World Bank co-chaired six bi-annual donors' meetings with the UN. After independence, the World Bank has co-chaired the Timor-Leste and Development Partners Meeting (TLDPM) with the Government of Timor-Leste. The TLDPM has taken place in December 2002, June 2003, December 2003, May 2004, and April 2005.

[2] The bilateral donors who have participated in one or more TSPs consist of Australia, Canada, Finland, Ireland, New Zealand, Norway, Portugal, Sweden, the United Kingdom, and the United States. In addition, China, Japan, Malaysia, ADB, UNMISET, UNDP, and UNICEF have been providing technical assistance in support of the TSP.

TIMOR-LESTE: RELATIONS WITH THE ASIAN DEVELOPMENT BANK
(AS OF APRIL 30, 2005)

1. Timor-Leste joined the Asian Development Bank (AsDB) on July 24, 2002. To date, there has been no lending to the country, reflecting the authorities' policy to avoid external borrowing. However, like other international financial institutions and bilateral donors, the AsDB has been actively involved in the reconstruction and development of the economy since late 1999.

2. The AsDB's involvement has centered around co-managing with the World Bank the Trust Fund for East Timor (TFET), which was established in December 1999 as a vehicle to provide grant assistance for reconstruction activities and economic development in Timor-Leste.[1] AsDB is now preparing its "consolidation" phase program to be funded predominantly from Asian Development Fund grants ($15.2 million over 4 years) and technical assistance (about $4.0 million over 4 years). Under the TFET, the AsDB has managed six projects with total funding of $53 million,[2] which aimed at the rehabilitation of physical infrastructure (rural power, rural roads, ports, and water and sanitation) and the development of microfinance. In the wake of the post-referendum destruction, the focus of the projects was on providing emergency assistance, but subsequently shifted to meeting the country's long-term development needs. At end-March 2005, disbursements for AsDB-managed projects totaled $45 million. Most projects were completed at the end of 2004. Only one project (EIRP-2) is ongoing, with completion expected by November 2006.

3. The AsDB has also been actively involved in technical assistance. Thus far, the AsDB has approved 24 technical assistance programs totaling $10 million. Most technical assistance programs have been undertaken in parallel with the implementation of the TFET-funded projects, focusing on project preparation and sector-specific capacity/institution building essential for project implementation. The latter includes the development of regulatory and legislative frameworks, the analysis of sectoral policy issues, poverty assessment and statistics, and strategies for economic and social development and planning. As of end-March 2005, 14 technical assistance programs were completed and 10 programs continued.

---

[1] See footnote 1 in Relations with the World Bank Group.

[2] These projects comprise the Emergency Infrastructure Rehabilitation Project ($29.8 million); the Emergency Infrastructure Rehabilitation Project 2 ($9 million); the Water Supply and Sanitation Rehabilitation Project ($4.5 million); the Water Supply and Sanitation Rehabilitation Project 2 ($4.5 million); the Hera Fisheries Port Facilities Rehabilitation Project ($1 million); and the Microfinance Development Project ($4 million).

TIMOR-LESTE: STATISTICAL ISSUES

Significant weaknesses remain in the macroeconomic data available for surveillance, especially regarding balance of payments and national accounts. This reflects limited institutional capacity in Timor-Leste and the legacy of post-referendum turmoil. Prior to 1999, macroeconomic data in Timor-Leste (including national accounts, prices, labor, provincial budget, and money and credits) were compiled by the Indonesian Central Bureau of Statistics (Badan Pusat Statistik, BPS) and the Central Board of Statistics of the East Timor Province. While these data provided useful economic information, their improvement was viewed as necessary especially in terms of coverage and methodology. The most serious data problem lay in the balance of payments statistics, which were almost nonexistent as Timor-Leste was previously treated as one of the Indonesian provinces.

Compilation of macroeconomic data was seriously disrupted in 1999, as the post-referendum turmoil led to the destruction of databases and the collapse of institutional capacity as a result of the departure of most Indonesian statistical officers. Under the economic reconstruction process beginning in late 1999, efforts have been made to begin the compilation of key macroeconomic data through technical assistance provided by international financial institutions and bilateral donors.

To this end, a multi-sector Fund statistics mission visited Dili in November 2000 and assisted the authorities in establishing short- and long-term objectives for the restoration of economic statistics and in setting up a Statistical Division in the Ministry of Planning and Finance in 2001. Also, a long-term resident statistical advisor was attached to the Statistical Division during November 2001-Februray 2004 to lay a basis for compilation of macroeconomic data while developing local capacity. This effort continues with a new resident advisor, in post since October 2004. The new advisor is focusing efforts on developing capacity to produce methodologically sound national accounts and balance of payments data. Institutional capacity remains very limited, constraining progress in collection and compilation of macroeconomic data. Availability, coverage, and quality of data remain very weak.

National accounts

Under a World Bank-financed project, national accounts data for 2000 (both type of activity and expenditure basis) were estimated by the Boston Institute for Developing Economies (BIDE). Also, Fund staff produced estimates for 1999-2003 on the basis of information obtained during various missions. In late 2004, BIDE, under a follow-up World Bank project, produced methodologically sound national account estimates for 2001-2003. Nonetheless, the robustness of the new estimates still suffers from limited available data and substantial extrapolation. Given the limited skills and human resources, it is not certain that the Division of Statistics would be able to replicate the BIDE estimation exercise for 2004 without additional assistance. To make further progress on the compilation of the national accounts, there is a need to plan and execute substantial data collection and elaboration for the different economic sectors.

Prices, employment, and wages

Following the disturbances of 1999, a consumer price index was compiled on a monthly basis for Dili and on a quarterly basis for the whole of Timor-Leste, with April 2000 as a base period. However, the price index suffered from a number of problems, including its weighting scheme, which was based on a household expenditure survey conducted by the BPS for Jakarta. To address these problems, the commodity basket and the weighting scheme were revised in mid-2003 under a donor-supported project to better reflect the expenditure composition of households, and a new monthly consumer price index for Dili has been compiled, with December 2001 as a base period. Data on public sector employment and wages are available on an annual basis through fiscal data. However, no official data are compiled regularly on private sector employment and wages, although some partial data are available through household surveys conducted jointly by the UNDP, AsDB, and World Bank.

Government financial statistics

Official data on the central government's revenues and expenditures are published on a semi-annual basis as part of the budget preparation and review process. In addition, monthly data are available on request (mainly in connection with missions' visits) through the budget, treasury, and revenue services. The compilation of revenue and expenditure follows the *Manual on Government Finance Statistics (GFSM 1986)* classification (including expenditure data on the basis of both functional and economic classification), and steps need to be taken in order to compile the data on the basis of the *Government Finance Statistical Manual 2001 (GFSM 2001)*. However, data on financing are incomplete and are estimated by Fund staff on the basis of various sources. Only limited data are available on fiscal and quasi-fiscal activities undertaken by bilateral donors and special funds established for economic reconstruction outside the central government budget (e.g., the Trust Fund for East Timor). At present, there are three non-financial public enterprises, and only partial data are available on their operations. No data are currently reported for the *GFS Yearbook* and the *International Financial Statistics*.

Monetary accounts

Monetary statistics on the banking system are compiled by the Banking and Payments Authority (BPA), generally following the classification recommended by the Fund. There is scope for the BPA to collect more detailed information on the banking system's assets and liabilities with nonresidents and sectorization of the domestic institutional units. Monetary survey data are incomplete because of the absence of official data on currency holdings by the public, which are difficult to compile under the current currency regime. Statistics on key monetary aggregates are now published on a monthly basis in the BPA's website and on a yearly basis in the BPA's annual report. Compilation of data on interest rates (both deposit and lending rates) and bank lending and investment in a comprehensive manner has begun only recently. However, the availability of these data is extremely limited because the BPA is concerned that their public release will reveal confidential information concerning commercial bank operations (especially with regard to lending) given the very small number (four) of banks comprising the banking system. No monetary data are currently reported to STA for publication in the *International Financial Statistics*.

Balance of payments

No official data on the balance of payments are available, except for data on merchandise exports and imports. Merchandise trade data are compiled on the basis of customs data with a breakdown according to major commodity categories, and are available on a monthly basis starting March 2000. However, these data are incomplete, and their classification by commodities and trading partners needs improvement. The data do not include large unrecorded border trade. Data on oil/gas revenue are currently recorded under the income account (for royalties) and under transfers (for tax revenue) on the basis of fiscal data, as no comprehensive information on production and investment in the oil/gas sector is available. All other major items in the balance of payments, including the services account, transfers, and capital and financial account transactions, are estimated by Fund staff on the basis of information obtained during staff visits from various sources, including bilateral donors.

Timor-Leste: Table of Common Indicators Required for Surveillance
(As of April 30, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	Not applicable				
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	03/2005	05/2005	M	M	Q
Reserve/Base Money (*excludes currency in circulation*)	03/2005	05/2005	M	M	M
Broad Money (*excludes currency in circulation*)	03/2005	05/2005	M	M	M
Central Bank Balance Sheet	03/2005	05/2005	M	M	M
Consolidated Balance Sheet of the Banking System	03/2005	05/2005	M	M	M
Interest Rates[2]	03/2005	3/2005	A	A	...
Consumer Price Index	03/2005	05/2005	M	M	M
Revenue, Expenditure, Balance and Composition of Financing – General Government[4]	...	...	...	...	...
Revenue, Expenditure, Balance and Composition of Financing– Central Government	03/2005	04/2005	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt	No debt contracted				
External Current Account Balance	Data not available				
Exports and Imports of Goods and Services [5]	03/2005	03/2005	M	M	M
GDP/GNP	2003	10/2004	...	...	...
Gross External Debt	Not applicable				

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic non-bank financing.
[4]The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. For Timor Leste it includes public spending from donors, on which data on execution are not available
[5] Includes only goods. No information on services is available.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); NA: Not Available

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/92
FOR IMMEDIATE RELEASE
July 20, 2005

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with the Democratic Republic of Timor-Leste

On June 15, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the 2005 Article IV consultation with Timor-Leste.[1]

Background

Five years after the international community stepped in to assist Timor-Leste in the aftermath of post-referendum violence, the country is successfully transitioning from post-conflict status to relative calm. Security has been broadly restored and macroeconomic stability re-established and maintained through the adoption of the U.S. dollar as legal tender and through cautious fiscal management. However, the economy remains fragile. Cumulative growth over the last three years was near zero—mainly reflecting the drawdown in the presence of international agencies. Unemployment is high, 40 percent of the population lives below the poverty line, and social indicators are poor. At the same time, human capital remains scarce, physical infrastructure inadequate and financing opportunities limited. The winding down of international financial and technical support at a time when domestic capacity is still weak and large oil and gas revenue is coming on stream present new challenges and opportunities.

Looking ahead, the pace and quality of economic development will depend on Timor-Leste's ability to manage its new oil/gas wealth effectively, and on the establishment of the environment needed for investment and growth in the non-oil sector. The authorities have designed a development strategy, with the objectives set out in the 2002 National Development Plan (NDP) and subsequent documents, that is incorporated in the Poverty

---

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Reduction Strategy Paper and assessed in the Joint Staff Advisory Note of the IMF and World Bank.

More recent developments indicate a modest recovery in non-oil economic activity in 2004, subdued inflation, and large oil/gas revenue inflows. Despite a further decline in donor activity, non-oil GDP growth recovered, reflecting a post-drought rebound in the agriculture sector and expansion in banking sector activity. Inflation declined over the course of 2004, leveling off at about 2 percent since August 2004 (year-over-year), in response to moderate domestic demand and stable non-oil import prices. The external current account surplus (including international assistance) widened sharply to 35 percent of non-oil GDP in 2004, due to large oil/gas tax and royalty income. Coffee exports rose, mainly reflecting a supply response to higher world prices. Measured against Indonesia and Australia, Timor-Leste's main trading partners, overall external price competitiveness deteriorated somewhat through March 2005, reflecting the significant depreciation of the rupiah against the U.S. dollar (Timor-Leste legal tender). In the absence of labor market data, anecdotal evidence suggests that Timor-Leste wages remain well above those in Indonesia, continuing to reflect the impact of the international presence.

The fiscal outcome for FY 2004/05 is now expected to be stronger than envisaged, due not only to better-than-expected oil/gas revenue but also stronger non-oil tax administration and weak expenditure execution. A central government surplus (including grants) of 68 percent of non-oil GDP is now expected, compared with the surplus of 33 percent of non-oil GDP expected in the revised FY04/05 budget. On a "combined sources" basis (the authorities' broad estimate of the total public sector including off-budget donor activities), the fiscal balance will move into a surplus of 29 percent of GDP in FY04/05.

The government is making good progress with the measures necessary to handle its new oil/gas wealth responsibly. The Norwegian-style petroleum fund is on track to be operational by July 2005 and a long-term fiscal savings policy has been adopted. Under the new savings policy, annual budget "sustainable" spending is set equal to the sum of non-oil revenue and the estimated permanent income from the oil/gas wealth. The government has indicated its commitment to transparency and accountability principles in line with the Extractive Industries Transparency Initiative (EITI). Finally, the preliminary Sector Investment Programs (SIPs) set out a public investment strategy for Timor-Leste's long-term economic development to be financed by domestic revenue and donor funds.

Bank lending to the private sector increased rapidly during 2004. As a share of non-oil GDP, credit tripled to 21 percent at end 2004. Financial intermediation remains concentrated in Dili, while access to financing in rural areas is limited to the operations of a few rural cooperatives and microcredit institutions. Net foreign assets of the Banking and Payment Authority (BPA) rose sharply, reflecting the sizable accumulation of government deposits from strong oil/gas revenue. At end-March net foreign assets reached US$284 million, more than 15 months of projected imports for 2005. Capacity building at the BPA progressed over the past year. A central bank law, and payment system and anti-money laundering legislation are in final stages of preparation, and a financial intelligence unit is planned for the BPA by the end of the year.

The pace of establishing the necessary environment to encourage private sector activity has accelerated; nonetheless, the agenda ahead remains heavy. Over the past six months good progress has been made in some areas, with key land legislation, the insurance law, and the domestic and foreign investment laws all either approved or submitted to Parliament. However, the overall legal framework is still incomplete, and complex regulations, an ineffective administration and weak judiciary continue to discourage private activity. Finally, while administrative skill levels are improving slowly, local capacity remains thin.

Executive Board Assessment

Executive Directors welcomed the progress that Timor-Leste has made towards establishing the basis for a stable and healthy economy. In particular, Directors commended the authorities for maintaining prudent macroeconomic policies at a time when the country is transitioning from post-conflict status, donor support is declining, and oil/gas revenue is coming on stream. While a moderate recovery in the non-oil economy is underway, Directors stressed that stronger performance will be needed to reduce poverty and create sufficient jobs for a rapidly increasing labor force.

Directors agreed that the pace and quality of Timor-Leste’s economic development will depend on the effective management of its new oil/gas wealth and creation of an environment conducive to private investment and activity in the non-oil economy. They concurred that the authorities’ long-term strategy based on a fiscal sustainability policy, a sound public investment strategy as set out in the Sector Investment Programs (SIPs), and the productive use of the oil/gas resources, including through the establishment of the petroleum fund, provides a solid basis for addressing these challenges and making progress towards achieving the Millennium Development Goals.

In light of Timor-Leste’s considerable development needs, Directors supported the authorities’ budgetary objective of moving quickly toward the sustainable spending level, without creating inflationary pressures or undertaking non-priority expenditure. The proposed spending increase for fiscal year 2005/06 appears nevertheless ambitious, given still limited administrative capacity and limited absorptive capacity in the domestic economy. While welcoming recent measures to remove obstacles to smooth budget execution, Directors called for early additional steps to eliminate remaining bottlenecks, particularly for capital spending. They welcomed the provision of Fund technical assistance in this area. Consideration might also be given to spreading out the spending commitment over a somewhat longer period. Directors also encouraged further efforts to shift spending toward improving human capital and basic infrastructure, and welcomed the authorities’ intention to maintain the restraint on the wage bill.

Directors saw the SIPs as providing an appropriate framework linking Timor-Leste’s development needs, available donor assistance, and the budget process. While the SIPs will help ensure that donor support is in line with the government’s priorities, it will be important to strengthen SIP prioritization further in light of the still large amount of uncommitted external financing, and Directors welcomed the authorities’ assurances in this regard.

Directors commended the progress made in establishing the legislative framework needed to make the petroleum fund operational by the beginning of the new fiscal year. They saw the establishment of the investment advisory board and the petroleum fund consultative council as key steps, and especially welcomed the intention to operate the fund in a transparent and accountable manner consistent with the Extractive Industries Transparency Initiative. They cautioned the authorities to carefully weigh the costs and benefits of the intended creation of a national oil company. Directors also noted the favorable developments in non-oil revenue. They encouraged a further strengthening of the tax and customs administration, and stressed the need for careful administration of the tax incentives in the new investment laws.

Directors endorsed the authorities' plan to maintain the current monetary and exchange rate regime, which provides a credible nominal anchor and continues to serve the country well. They agreed with the authorities' view that stronger institutional capacity and a well-developed foreign exchange market are essential preconditions to the introduction of a national currency. Going forward, continued cautious fiscal and wage policies will be key to preserving external competitiveness.

Directors welcomed progress at the Banking and Payments Authority in developing a strong supervisory and regulatory environment, particularly in light of the recent increase in financial intermediation. They encouraged continued vigilance over bank portfolios and looked forward to the early approval of central bank, payment system, and anti-money laundering legislation. The authorities were also encouraged to support the expansion of financial institutions to rural areas.

Noting that strong, sustainable growth and poverty alleviation require a dynamic labor-intensive private sector, Directors urged the authorities to accelerate efforts aimed at establishing an environment conducive to private investment and non-oil private sector activity. They welcomed the maintenance of a liberal trade and investment regime, and called for early enactment of pending economic legislation and the issuance of regulations that are transparent and simple to administer. Directors stressed in particular the importance of finalizing bankruptcy legislation, developing a strong and independent judiciary system, and establishing a comprehensive land-titling system. Given that local capacity and strong institutions will be critical for effective economic management and rapid economic development, Directors urged the prompt implementation of the new planning and capacity building program. Close coordination with, and continued technical assistance from, the donor community will be key in this respect.

To address weaknesses in macroeconomic data, Directors encouraged the authorities to seek additional assistance to strengthen domestic capacity, particularly for the compilation of national account and balance of payments statistics.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Timor-Leste: Selected Economic Indicators, 2000–2005

	2000	2001 1/	2002 1/	2003 1/	2004	2005
					Est.	Proj.
Output and prices 1/						
Non-oil GDP	316	368	343	336	339	349
Real non-oil GDP growth (percentage change)	15.4	16.6	-6.7	-6.2	1.8	2.5
Inflation (percentage change; end-period) 2/	3.0	-0.3	9.5	4.2	1.8	2.5
			(In percent of non-oil GDP)			
Investment-saving balance						
Gross investment 3/	41	42	36	31	28	32
Non-government	7	9	7	9	9	9
Government	34	32	28	23	19	23
Gross national savings	-46	-44	-48	-34	6	27
Non-government	-51	-50	-54	-44	-36	-26
Government	5	6	6	10	42	53
External savings	87	86	84	65	23	5
Central government budget 4/						
Revenues	17	15	24	31	90	57
Domestic revenues	4	6	6	9	10	9
Oil/gas revenues	4	3	9	12	71	45
Grants	9	6	10	10	9	3
Expenditure	15	15	21	21	22	30
Recurrent expenditure	9	12	17	19	19	20
Capital expenditure	6	3	4	3	2	10
Overall balance	2	0	3	10	68	27
Public debt	0	0	0	0	0	0
Combined sources fiscal operations 4/ 5/						
Revenues	18	16	25	33	92	15
Expenditure	69	70	73	66	62	70
Recurrent expenditure	35	38	44	44	45	41
Capital expenditure	34	32	30	22	18	29
Overall balance	-52	-53	-48	-33	29	-55
Money and credit						
Broad money (end-period) 6/	6	14	16	22	25	28
Net domestic assets (end-period)	-4	-4	-10	-9	-11	-18
			(In millions of U.S. dollars)			
External sector						
Current account excl. international assistance	-275	-316	-288	-218	-77	-18
Current account incl. international assistance	37	46	26	17	119	149
Trade balance	-237	-280	-260	-213	-194	-204
Merchandise exports 7/	5	4	6	7	8	10

Timor-Leste: Selected Economic Indicators, 2000–2005

Merchandise imports 8/	-242	-284	-266	-221	-202	-214
Overall balance	16	8	20	18	122	216
	(In percent of non-oil GDP)					
Current account excl. international assistance	-87	-86	-84	-65	-23	-5
Current account incl. international assistance	12	13	8	5	35	43
Trade balance	-75	-76	-76	-64	-57	-58
Merchandise exports 7/	2	1	2	2	2	3
Merchandise imports 8/	-77	-77	-78	-66	-60	-61
Overall balance	5	2	6	5	36	62

Sources: Data provided by the Timor-Leste authorities; and IMF Staff estimates.

1/ Non-oil GDP and national accounts data for 2000–2003 are based on estimates prepared by BIDE consultants in October 2004.

2/ CPI for Dili.

3/ Excludes oil/gas sector investment.

4/ Fiscal year basis (July-June); for example, 2000 refers to FY2000/01.

5/ Includes fiscal and quasi-fiscal expenditure programs undertaken by bilateral donors and international financial institutions outside the central government budget. The sharp revenue decline in FY2005/06 reflects the adoption of the new savings and petroleum fund policy according to which only the sustainable income from the oil wealth is transferred to the budget.

6/ Excludes currency holdings by the public, for which no data are available.

7/ Excludes oil/gas revenue, which are recorded under the income account (royalties) and transfers (tax revenues).

8/ In 2005 includes the transfer of assets from UNMISET, valued at approximately US$12 million.

Statement by Pier Carlo Padoan, Executive Director for the Democratic Republic of Timor-Leste and Luis Saramago, Advisor to Executive Director
June 15, 2005

Main Highlights

- *A prudent approach to policy has been the authorities' trademark , upheld in recent times and to be kept in the future – namely, but not exclusively, as regards the fiscal stance, monetary policy and the framework for dealing with oil/gas revenues;*

- *Such prudence is particularly appropriate in view of the still exceptionally difficult challenges facing the country, not the least in terms of poverty reduction, basic services provision and capacity building, as underscored in the PRSP;*

- *The magnitude of those challenges, as well as the economy's limited absorption capacity, should be taken into account when considering recent and future (confirmed and uncertain) inflows of oil/gas revenues – and their macroeconomic impact;*

- *Well aware of how crucial it will be to ensure that oil/gas wealth be put to good use, the authorities have been especially careful in setting up an appropriately cautious and transparent framework for that purpose, following international best practices;*

- *Taking into consideration that oil/gas revenues are to a large extent uncertain and must be used in a sustainable way, the country will require a continued commitment from the international community to address its manifold development needs;*

- *In order to better channel such external support, as well as the domestic contribution, recently concluded Sector Investment Programs will be critical – aiming to put the economy on firmer grounds, together with reforms for private sector enhancement.*

At the outset, and on behalf of the authorities, we would like to thank staff for their very useful and highly professional work during this consultation, which is well reflected in the quality of the reports.

Recent developments and general remarks

After two years of significant contraction, essentially determined by the progressive UN withdrawal but also by last year's drought, the economy of Timor-Leste started growing again in 2004 – more precisely its non-oil/gas part, at an estimated rate of 1.8 per cent in real terms. Although modest, especially if set against what would be necessary for an adequate pace of job creation and poverty reduction, that represents a welcome shift towards reliance on truly domestic (in lieu of expatriate-induced) demand. Moreover, it could hopefully represent the beginning of a new dynamism from small private business, while reflecting further progress towards overcoming the widespread destruction of 1999.

That tentative recovery was accompanied by a slowdown of inflation to less than 3 per cent (year-on-year) from August 2004 onwards, thanks to the benefits of official dollarization but mostly to reduced demand pressures, as the international presence subsided. This trend culminated less than a month ago, with the replacement of UNMISET by much downscaled UNMOTIL, which has a mandate for another year, focusing on broad capacity building. Lower inflation allowed for an improvement of relative prices, thus helping to sustain external competitiveness, one of the critical elements for broad-based sustainable growth.

Recent macroeconomic developments were further dominated by the impact of sizeable oil/gas revenue inflows, which allowed for a significant improvement of the fiscal and external positions. Such enhanced inflows had no effect on the authorities' consistently prudent approach to policymaking – government savings reached 42 per cent of non-oil/gas GDP in 2004, while recurrent expenditures are estimated to be kept at the same level of the previous year (19 per cent of non-oil/gas GDP). Indeed, the crucial framework for disposing of hydrocarbon revenues in a sustainable way, following international best practices, is broadly on-track to become operational with the new fiscal year, starting next July.

That will be one of the main instruments on which the authorities rely to address the country's huge needs, summarized in its ranking as the Asian country with the lowest Human Development Index. After being introduced three years ago, the strategy for overcoming poverty has been progressively refined – lately through Sector Investment Programs (SIP) that take the National Development Plan (NDP) a step further. Sustained growth is naturally emphasized as a cornerstone, requiring that a combination of factors are gathered, notably security maintenance, macroeconomic stability preservation, a well-focused public investment effort and a business-friendly environment – all on-going parts of the development strategy pursued by the authorities. In what can be seen as a basic dilemma facing these latter ever since independence was regained, in 2002, such aspirations will have to be reconciled with a variety of conditioning factors – among them weak institutions, capacity constraints and the economy's limited absorption possibilities.

Fiscal Policy

Even more than in most other places, this is an area particularly critical for Timor-Leste, in view both of the fact that those conditioning factors significantly constrain fiscal policy and that it touches, to a large extent, most of the main challenges faced by the country. It falls, in fact, within the context of fiscal policy to take a leading role as a vehicle for tackling poverty; to be at the center of macroeconomic stability preservation, as results from the officially dollarized environment that has been instrumental for the purpose; and to assume paramount responsibility for sustaining the implementation of basic infrastructures, essential in attracting investment and promoting growth.

Against this background, the authorities can claim to have followed, and intend to maintain, an appropriately prudent and transparent line – reflected, for instance, in their choice not to borrow or in the sizeable accumulation of oil/gas savings. On the revenue side, in addition to adopting the set-aside rule which allowed for that accumulation – to be consolidated for the future through the upcoming hydrocarbon framework – their long-term commitment is to broaden the base for non-oil/gas revenues. This is to be pursued, even after accounting for well-focused investment incentives, by means of actions like the extension and improvement of ASYCUDA or several measures aimed at enhancing tax administration, thus ultimately pointing to long-term fiscal sustainability.

As for expenditures, its recurrent part is to remain subdued, as was the case so far – namely regarding wages, for the sake of stability and competitiveness, while maintenance costs for public investment are to be accommodated. Taking into due account the strategic importance of capital expenditures, the authorities are well aware of the need to enhance its execution rate and have made a considerable effort towards it, pushing forward the SIP framework and a diversified array of measures – acknowledged in Box 5 of the staff report. Nevertheless, if implementation shortfalls persist, the authorities are prepared to further refine expenditure prioritization, as they have done in the past and the SIP exercise allows for. Moreover, prioritization will also be in line if identified financing gaps prove difficult to fulfill – even though the authorities trust the international community's continued commitment – since the framework for disposing of revenues, notably from oil/gas, is to be overriding.

Hydrocarbon Sector Issues

As staff rightfully emphasizes and further elaborates, oil/gas revenues must be harnessed within an adequately supportive framework if they are to fulfill their unique potential as a vehicle for faster growth and poverty reduction in Timor-Leste. After careful preparation, with technical assistance from the Fund, such a framework is broadly on-track to become operational for the next fiscal year, starting July. It will follow international best practices and is based both on the establishment of a Norwegian-inspired Petroleum Fund – currently under detailed scrutiny by the Parliament, after general approval a couple of weeks ago – and on the adoption of a savings policy aimed at long-term fiscal sustainability.

This policy is essentially based on striking an inter-generational balance, thus establishing that annual government spending will be equal to the sum of domestic non-oil/gas revenues and the estimated permanent income resulting from oil/gas wealth – an estimate subject to annual reviews, guided by the principle of preserving the real value of that wealth. This latter is to be administered by the upcoming Petroleum Fund, which will accumulate all hydrocarbon revenues accruing to the authorities and invest them abroad – to counter pressures for real exchange rate appreciation. Furthermore, that is to be done according to prudent and clear guidelines, while following the highest standards of transparency and accountability, including those set by the EITI.

Monetary Policy and Financial Sector

The fundamental reason why Timor-Leste opted for a monetary regime based on official dollarization – simplicity – is still largely pertinent, the more so since it has indeed provided an effective anchor for price stability and further allowed for broad preservation of external competitiveness, thanks also to adequate support from fiscal and incomes policies. In fact, the authorities are well aware that human and institutional capacity constraints might arguably have undermined, also in this context and to a significant extent, the potential benefits associated with an independent monetary policy.

Conversely, being relieved from the operational burden of conducting it, the Banking and Payments Authority (BPA) could devote its time and efforts to other pressing needs – from preparation of basic legislation to practical concerns related to areas such as the payment system or banking supervision. Actually, this latter is closely following credit developments, namely a slight rise of the NPL to total loans ratio since mid-2004 – although it still considerably improved on 2003 figures and banking indicators remain fundamentally sound. That rise followed the significant increase of credit to the private sector that took place from the second half of 2003 onwards – a trend that has since subsided, and will go on requiring careful surveillance from the BPA, but that is essentially welcome, since it did not compromise macroeconomic stability and represents financial intermediation in action, favoring both social advancement and private sector enhancement.

Structural Reforms and Poverty Reduction Strategy

A dynamic private sector is, in fact, acknowledged by the authorities as the critical determinant of long-term sustainable growth, on which effective poverty reduction is contingent, largely through the main vehicle of accelerated job creation. Efforts aimed at this latter are to be complemented, for the purpose of poverty reduction, by parallel action in other crucial areas – such as provision of basic social services, where on-going substantive progress has already been achieved, or strengthening institutions in crucial fields like justice administration, where new momentum is being instilled.

Intensive legislative action at different levels in recent years allowed for much of the legal and regulatory framework to be already in place – although the authorities recognize that additional steps are in order, including some streamlining. Besides promoting an adequately pro-business environment, they will continue to focus on the more immediately growth-enhancing task of advancing public investment – towards which the SIP process is already being instrumental. Indeed, it builds on the NDP as well as on its ensuing Road Map and essentially supplies focused structures that aim to address previous shortcomings such as insufficient coordination with and among donors or a general lack of quantification and alignment with the budget process.

Concluding Remarks

The authorities wish to express their appreciation for the technical assistance provided by the Fund, including within the context of Article IV consultations and especially in view of prevalent capacity constraints as well as pressing institution building requirements, which prompt them to request that the Fund's effort be maintained.