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## IMF Executive Board Concludes 2011 Article IV Consultation with the Democratic Republic of Timor-Leste

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On January 31, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Democratic Republic of Timor-Leste and considered, and endorsed, the staff appraisal without a meeting.<sup>1</sup>

### Background

After emerging from a long struggle for independence and internal conflicts between 1999 and 2006, Timor-Leste has made substantial progress toward restoring stability and rebuilding the country. Rising government spending and a rebound in agriculture supported strong non-oil gross domestic product (GDP) growth since 2007, averaging 12 percent. Despite unseasonal rain that damaged agricultural produce, growth is estimated to have remained strong at about 10 percent in 2011 on the back of high government spending. Inflation in Dili, however, rose to 17½ percent (year-on-year) in December 2011, due to high food prices, a weak U.S. dollar, and strong demand from rising government spending, and is becoming broad-based.

The government launched its Strategic Development Plan to transform Timor-Leste into an upper-middle-income country by 2030. To achieve this goal, the government plans to scale up public investment to improve poor infrastructure. Capital expenditure increased rapidly in 2011 so total government spending is estimated to have risen to \$1.2 billion, from \$0.8 billion in 2010. Owing to rising petroleum revenue, however, the overall fiscal balance is expected to have continued to record a large surplus of 50 percent of GDP in 2011, and the Petroleum Fund to have risen to about \$9 billion. Most of the Petroleum Fund is invested in US government bonds.

Credit to the private sector has recently started rising after being stagnant for a few years. However, it remains low at only 13 percent of non-oil GDP, reflecting the lack of collateral and weak contract enforcement. These weaknesses together with high nonperforming loans have contributed to high lending rates in Timor-Leste. Nonperforming loans are high at almost 40 percent of total loans but are fully covered by provisions. Three foreign bank branches dominate the financial sector. The Banking and Payments Authority was recently transformed to a central bank, with no change in its function. The U.S. dollar is the legal tender.

The current account surplus is estimated to have remained large at over 50 percent of GDP in 2011 due to high oil revenue. Non-oil exports, excluding coffee, are minimal and the country depends highly on imports given almost no domestic production base except subsistence farming and coffee. Foreign assets rose to an all-time high at 170 months of imports. The real effective exchange rate appreciated by 6 percent in 2011.

<sup>1</sup> 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.

**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. The [staff report](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2011 Article IV Consultation with the Democratic Republic of Timor-Leste is also available.

The outlook for growth and poverty reduction is promising as Timor-Leste stands to benefit enormously from its petroleum wealth in coming years. Using this wealth, the government has resolved to step up development. With rising government spending, non-oil GDP growth is projected to remain strong at about 10 percent in 2012 and over the medium term and the current account surplus is projected to decline. Key risks to the outlook are high inflation, a fall in oil prices, and slow progress in building public financial management capacity.

## **Executive Board Assessment**

In concluding the 2011 Article IV consultation with Timor-Leste, Executive Directors endorsed staff's appraisal as follows:

Rising government spending has supported strong economic growth, but inflation has jumped to double digits. Using its petroleum wealth, the government has resolved to step up development by scaling up investment in infrastructure. Real non-oil GDP growth is projected to remain strong at about 10 percent in 2012 and over the medium term. Key risks to the outlook are oil price volatility and the possibility that inflation continues to rise on the back of large increases in government spending.

Given development needs, investment in infrastructure is welcome, but the planned increase of spending over the next few years needs to be slowed to better align with the absorptive capacity of the economy and administrative constraints. Continued large increases in government spending would raise inflationary pressure further, and high inflation will impose significant costs on the poor. In the absence of monetary policy, sound fiscal policy is key to containing high inflation and sustaining strong economic growth. The government's intention to consider adjusting the pace of 2012 budget execution if inflation remains high is welcome. Staff stressed the importance of continued progress in improving the capacity to implement capital projects.

The authorities' plan to reduce the non-oil fiscal deficit to a sustainable level over the next 10 years is appropriate. This will provide an important anchor for fiscal policy. To achieve this goal, the government may need to take substantial measures, including containing spending growth and increasing domestic revenue. In addition, the medium-term budget framework needs to be strengthened by including the full costs of planned major projects and recurrent costs once they are available. The authorities' intention to review the recent Fiscal Affairs Department mission's recommendations to raise non-oil revenue, including the introduction of a value added tax over the medium term, is welcome. Repealing the very generous tax holidays under a new private investment law is recommended.

The government has made solid progress in improving public financial management (PFM). A well-managed Petroleum Fund is in place. Further progress has been made in addressing the weaknesses in PFM by establishing new institutions to strengthen public investment management. The lack of skilled personnel is the key constraint to PFM so the government's focus on training Timorese should help build capacity.

Developing the financial sector and strengthening the credit culture are critical for sustained growth in the private sector. The Central Bank's continued efforts to strengthen financial sector supervision and regulations are welcome. Banks tightened their lending standards and improved credit assessments. Speeding up the passage of key legislations such as the land law would help financial sector development.

The use of the U.S. dollar is appropriate given the limited capacity for independent monetary and exchange rate policies. Non-oil exports, excluding coffee, are minimal and the country depends highly on imports. Accelerating structural reforms is needed to improve competitiveness. Prudent fiscal policy will be key to maintaining external stability over the long term.

Data quality and availability need to be improved. More staff and training are needed to improve the data necessary for policy analysis and formulation.

## Timor-Leste: Selected Economic and Financial Indicators, 2007–12

GDP at current prices (2010): US\$3.2 billion  
 Population (2010): 1.1 million  
 GDP per capita (2010): US\$2,908  
 Non-oil GDP per capita (2010): US\$821  
 Quota: SDR 8.2 million

	2007	2008	2009	2010	2011 Proj.	2012 Proj. 1/
<b>Real sector</b> (Annual percent change)						
Real non-oil GDP growth	11.7	14.6	12.8	9.5	10.6	10.0
CPI (annual average) 2/	10.3	9.0	0.7	6.8	13.5	8.0
CPI (end-period) 2/	8.6	7.5	1.7	9.2	17.4	8.0
<b>Central government operations</b> (In percent of GDP, unless otherwise indicated)						
Revenue	75.4	80.8	72.5	75.2	78.1	72.6
Domestic revenue	2.7	1.7	2.5	2.6	2.6	3.3
Petroleum revenue	72.6	79.1	70.0	72.6	75.6	69.3
Expenditure	13.5	19.6	23.8	24.8	28.0	34.8
Recurrent expenditure	8.8	13.5	15.4	16.5	13.0	16.7
Capital expenditure	4.8	6.1	8.4	8.4	15.0	18.1
Overall balance	61.8	61.2	48.7	50.4	50.2	37.9
Non-oil overall balance (in percent of non-oil GDP)	-39.6	-85.3	-71.1	-81.1	-104.0	-102.2
<b>Money and credit</b> (Annual percent change, unless otherwise indicated)						
Deposits 3/	44.2	34.9	38.7	9.8	14.2	...
Credit to the private sector 3/	-9.8	1.9	1.1	5.9	23.6	...
Lending interest rate (percent) 3/	15.0	13.1	11.2	11.0	10.8	...
<b>Balance of payments</b> (In millions of U.S. dollars, unless otherwise indicated)						
Current account balance	1,177	2,023	1,363	1,538	2,375	1,773
(In percent of GDP)	65.1	66.7	51.7	48.1	55.0	43.5
Trade balance	-169	-297	-376	-374	-666	-795
Exports 4/	7	14	9	18	22	33
Imports	176	311	385	392	689	829
Petroleum revenue	1,313	2,400	1,845	2,323	3,261	2,821
Overall balance	147	-20	39	156	-3	160
Public foreign assets (end-period) 3/ 5/	2,316	4,407	5,627	7,310	9,743	11,487
(In months of imports)	158	170	175	224	170	166
<b>Exchange rates</b>						
NEER (2000=100, period average) 3/	94.4	92.1	95.4	89.3	83.8	...
REER (2000=100, period average) 3/	100.9	102.3	105.1	102.3	103.9	...
NEER (2000=100, end-period) 3/	91.8	100.3	89.3	86.7	84.7	...
REER (2000=100, end-period) 3/	98.7	112.0	99.8	102.4	108.2	...
<b>Memorandum items:</b>						
GDP at current prices:	1,808	3,035	2,634	3,199	4,315	4,073
Non-oil GDP 6/	494	635	790	876	1,054	1,252
Oil GDP 7/	1,313	2,400	1,845	2,323	3,261	2,821
Crude oil prices (U.S. dollars per barrel, WEO) 8/	71	97	62	79	104	100
Petroleum Fund balance (in millions of U.S. dollars) 3/	2,086	4,197	5,377	6,904	9,338	10,923
Petroleum Fund balance (in percent of non-oil GDP) 3/	422	661	681	788	886	872
Public debt (in millions of U.S. dollars)	0	0	0	0	0	43

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

1/ Staff proposals.

2/ For Dili (capital city). The countrywide CPI is available on a quarterly basis only.

3/ Data for 2011 is as of end-October.

4/ Excludes petroleum exports, the income of which is recorded under the income account.

5/ Includes Petroleum Fund balance and the central bank's official reserves.

6/ Based on the resident national accounts advisor's new estimates.

7/ Petroleum revenue is used as a proxy for oil GDP.

8/ September 2011 WEO assumptions.