IMF Executive Board Concludes 2013 Article IV Consultation with Timor-Leste

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On October 23, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Timor-Leste.[1] Timor-Leste has made substantial progress as it enters its second decade as a sovereign nation. A number of key milestones have been achieved. The 13 year United Nations (UN) presence was concluded successfully in 2012. Parliamentary and presidential elections were held in mid 2012 and a coalition government was formed. The Strategic Development Plan (SDP) to guide Timor-Leste toward upper middle-income status was developed in an inclusive manner and its implementation started in 2011. Timor-Leste has accumulated a highly regarded Petroleum Fund that now stands at over US$13 billion. Oil revenues have been used to tackle large developmental needs, but oil production has peaked and many uncertainties persist over the development of new fields. Fragilities persist as poverty remains high.

The non-oil economy has grown rapidly in recent years with growth averaging close to 12 percent from 2008 to 2011, allowing the average per capita income to steadily increase. The growth was driven by a rapid increase in government spending which boosted the public administration and construction sectors. So far, the contributions from agriculture and manufacturing have been modest, hampering employment opportunities outside of the public sector and constraining widespread growth in living standards.

Despite falling from the peak of over 15 percent in 2011, the inflation rate is still in double digits. Initially inflation was driven by high international commodity prices but more recently it appears to reflect, among other factors, the interaction of strong demand led by government recurrent expenditures and structural bottlenecks. In addition to hitting the low-income households, high inflation in a dollarized economy hampers Timor-Leste’s ability to diversify and generate employment growth.

High levels of government spending have risked sustainability, but revised budgetary plans in 2013 now anticipate a substantial moderation. In the revised medium-term budgetary plans (the so-called “Yellow Road” process), adopted by the Council of Ministers in June 2013, spending plans were significantly scaled back, starting in 2013. This will bring a number of benefits. Firstly, it will reduce inflationary pressures in the economy, helping reduce poverty. Secondly, by largely eliminating excess withdrawals from the Petroleum Fund, the financing of the budget will be placed on a long-term sustainable path. Lastly, it will provide an opportunity to improve the overall quality of public expenditure.

The medium-term growth outlook will hinge on the pace of fiscal consolidation and the on-going implementation of structural reforms to expedite the transition to higher quality private sector led growth. Under the baseline scenario the reprioritization of government expenditures and reforms would boost the private sector, allowing more inclusive and broad-based growth. Key risks include a weaker pace of reforms, poor implementation of key infrastructure projects (especially transport links), or an adverse external environment.

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[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.

Executive Board Assessment[2]

Executive Directors welcomed Timor-Leste's substantial progress as it enters its second decade as a sovereign nation. The end of the 13-year UN presence, the successful elections in 2012, and the accumulation of substantial assets in the well regarded Petroleum Fund are important indicators that Timor-Leste is overcoming the fragilities inherent in a post-conflict nation.

Directors recognized that substantial development challenges remain given still high levels of poverty. The overriding challenge now is to successfully use oil revenues to foster economic and social development and the diversification of the economy. Directors supported the goals of the authorities' SDP that aims for upper-middle income status and a substantial reduction in poverty by 2030.

Directors noted that, after six years of strong non-oil GDP growth driven by large increases in public expenditure, the next step is to generate a shift to higher-quality growth in which an organic private sector, operating independently from government contracts, increasingly takes the lead. This would support economic diversification, increase employment opportunities, and ensure that economic growth results in broad based poverty reduction.

As part of this approach, Directors welcomed the revised budgetary framework that anticipates a stabilization of government expenditures and revenue diversification. Given the dollarized economy, a restrained fiscal stance that contributes to lower inflation will also have benefits for external competitiveness. Directors also welcomed the on-going reprioritization of expenditures with a renewed focus on growth-enhancing investments in basic infrastructure and a shift away from transfers and subsidies. Directors stressed that although the revised framework limits the buildup of public sector debt, contingent and off-balance sheet liabilities will need to be avoided. In addition, it will be important to ensure that withdrawals from the Petroleum Fund are in line with fiscal sustainability and absorptive capacities, while also carefully monitoring their asset allocation strategy.

Directors emphasized that catalyzing the private sector will require steps to improve the business climate and address structural bottlenecks through improvements in infrastructure and the implementation of productivity-enhancing structural reforms. Directors noted that the priorities include implementation of the Land Law, streamlining the Investment Law, and improving contract enforcement.

Directors observed that the official dollarization of the economy has played a positive role, especially in light of underdeveloped or missing financial and money markets. In this regard, Directors encouraged the authorities to enhance their capacity to support a potential transition over the long term to a monetary and exchange rate framework that provides more autonomy and flexibility.

Directors noted that financial deepening and improving access to credit will become increasingly important as the economy develops. At the same time, safeguarding the soundness of the banking system will require strengthening central bank prudential supervision, developing a crisis management framework, and addressing weaknesses in the anti-money laundering framework.

Directors welcomed the closer dialogue between the Fund and the authorities. They noted the important role that Fund technical assistance can play in a number of areas to help the authorities achieve their development goals.

IMF COMMUNICATIONS DEPARTMENT

Public Affairs		Media Relations	
E-mail:	publicaffairs@imf.org	E-mail:	media@imf.org
Fax:	202-623-6220	Phone:	202-623-7100

[2] 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Timor-Leste: Selected Economic and Financial Indicators, 2009–14

	2009	2010	2011	2012	2013	2014
				Est.	Proj.	
Real sector	(Annual percent change)					
Real total GDP	-6.7	-1.4	7.3	5.7	-3.2	-6.9
Real non-oil GDP	12.8	9.5	12.0	8.3	8.1	8.0
CPI -Timor Leste (annual average)	0.1	4.5	11.7	13.1	10.6	9.5
CPI - Timor Leste (end-period)	1.1	8.0	15.4	10.8	10.4	8.5
Central government operations	(In percent of GDP, unless otherwise indicated)					
Revenue	62.6	64.9	66.5	69.1	59.7	63.6
Domestic revenue	2.8	2.3	1.9	2.2	2.4	3.3
Petroleum revenue	51.3	55.3	59.7	62.9	53.4	56.1
Grants	8.5	7.3	4.9	4.0	3.9	4.2
Expenditure	31.3	27.0	23.8	22.1	23.5	26.5
Recurrent expenditure	12.0	12.0	8.8	10.7	10.8	11.1
Capital expenditure	10.8	7.6	10.1	7.3	8.8	11.2
Donor project	8.5	7.3	4.9	4.0	3.9	4.2
Overall balance	31.3	37.9	42.7	47.0	36.2	37.1
Non-oil overall balance (in percent of non-oil GDP)	-79.8	-78.3	-87.5	-73.7	-65.2	-56.7
Money and credit	(Annual percent change, unless otherwise indicated)					
Deposits	38.7	9.8	8.9	26.2	21.2	21.7
Credit to the private sector	1.1	5.9	21.1	20.5	21.2	21.7
Lending interest rate (percent, end-period)	11.2	11.0	11.0	12.2	…	…
Balance of payments	(In millions of U.S. dollars, unless otherwise indicated)					
Current account balance 1/	1,287	1,676	2,340	2,738	2,105	1,819
(In percent of GDP)	39.0	39.8	40.4	43.5	34.3	32.1
Trade balance	-320	-277	-349	-639	-731	-829
Exports 2/	15	29	25	33	37	42
Imports	335	306	374	672	769	871
Services (net)	-774	-961	-1,415	-921	-1,004	-1,118
Petroleum revenue	1,692	2,331	3,461	3,960	3,273	3,183
Overall balance	39	156	55	422	-194	122
Public foreign assets (end-period) 3/	5,627	7,303	9,765	12,652	14,419	16,748
(In months of imports)	58	65	63	91	93	96
Exchange rates						
NEER (2005=100, period average)	95.4	89.3	84.2	86.4	…	…
REER (2005=100, period average)	105.2	102.3	105.6	118.1	…	…

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

1/ Excludes trade in goods and services of entities located in the Joint Petroleum Development Area which are considered non-resident entities.

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

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