The Monitor provides an update of developments in Pacific economies and explores topical policy issues.

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Highlights

Recent developments. The Pacific countries continued to benefit in from the recovery in the world economy over 2010. Economic growth for the year as a whole was, however, low in most cases. In the Pacific islands, growth was 0.8% overall in 2010. The resource-rich Papua New Guinea (PNG) and Timor-Leste continued their recent good performance, growing by 7.0% and 9.5%, respectively, in 2010. The Pacific (the Pacific islands and PNG and Timor-Leste) grew by an estimated 5.3% in 2010.

Outlook. The resource-rich economies are again expected to be the best performers in 2011. Timor-Leste is projected to grow by 10.0% on the back of continuing expansion in government expenditure funded by offshore petroleum revenue. Preparations for production of liquefied natural gas will continue to support PNG economy, which is projected to grow at 8.5% in 2011. The recommencement of gold production is projected to help expand the Solomon Islands economy by 7.5% in 2011. Increased phosphate exports are expected to help Nauru return to a moderate growth rate.

A positive outlook for the Australian and New Zealand economies underpins an expected rise in tourism to the Pacific islands in 2011 and some recovery in remittance flows. These sources of growth will be particularly important for the Cook Islands, the Fiji Islands, Kiribati, Samoa, Tonga, Tuvalu, and Vanuatu.

The Pacific island economies are projected to grow by only 1.7% in 2011, while the Pacific is expected to record overall growth of 6.3% in 2011. Growth is expected to remain close to these levels in 2012.

The recent rise in commodity prices will reinforce the pattern of relatively better performance from the resource-rich economies. As in the 2008 episode of high commodity prices, the region’s producers of petroleum and mineral commodities and the exporters of agricultural products will benefit. Other Pacific economies will bear the brunt of the rise in import prices, and face the prospect of higher inflation that will erode living standards.

The more remote and import-dependent Pacific island economies—notably the Federated States of Micronesia, Kiribati, the Marshall Islands, and Tuvalu—are particularly exposed to the economic costs of higher world fuel and food prices.

Inflation of 4.0% is expected across the Pacific island economies in 2011. Inflation of 6.5% is projected for the entire Pacific, up slightly on the 5.3% in 2010. If commodity prices stay close to recent highs, higher inflation rates can be expected.

Economic policy and management. This issue explains the techniques used by the Monitor team to forecast inflation and tourism. Long-term projections of economic growth are presented for Timor-Leste drawing on Asia’s experience.

This issue also provides an update on the Asian Development Bank’s regional technical assistance, the Pacific Economic Management Project, and in the provision of economic support by the Pacific Financial Technical Assistance Centre.
This edition of the Monitor was prepared by Elbe Aguba, Robert Boumphrey, Guida Correa Frelas, Joel Hernandez, Malie Lototele, Milovan Lucich, Dominic Mellor, Adolf Moises Nicolas, Rommel Rabanal, Craig Sugden, Laisiasa Tora, and Emma Veve of the Pacific Department.

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Abbreviations

$ US dollars, unless otherwise stated
ABS Australian Bureau of Statistics
ADB Asian Development Bank
AUS Australia
AUD Australian dollar
CPI consumer price index
e estimate
f free on board
FPM Fiscal year
GDP gross domestic product
IMF International Monetary Fund
lhs left hand scale
LNG liquefied natural gas
m.a. moving average
NZL New Zealand
NZD New Zealand dollar
PEM Pacific Economic Management
PNG Papua New Guinea
rhs right hand scale
RMI Republic of the Marshall Islands
SIS Solomon Islands dollar
SOE state-owned enterprise
TA technical assistance
US United States
VAT value-added tax
y-o-y year-on-year

Note: Projections are as of February 2011 and refer to fiscal years. Regional averages of gross domestic product (GDP) growth and inflation are computed using weights derived from levels of gross national income in current US dollars following the World Bank Atlas method. Averages for the Pacific islands exclude Papua New Guinea and Timor-Leste. Timor-Leste GDP is exclusive of the offshore petroleum industry and the contribution of the United Nations.

Source: ADB estimates.
International developments

World economic recovery continues; outlook for remittances positive

- The global recovery is continuing but the pace is varying across regions. The International Monetary Fund (IMF) estimates that world GDP expanded by 5.0% in 2010, and projects growth at 4.4% in 2011 and 4.5% in 2012. Growth in developing Asia remains robust, supported by strong domestic demand and industrial production.

- Economic recovery is well advanced in the United States (US). In February 2011, consumer confidence reached a 3-year high, and firms are expected to increase capital spending this year. Labor market conditions are, however, yet to show significant improvement. Fiscal consolidation and the flow-through effect of sovereign debt problems in Europe are restraining growth in the US to moderate levels.

- The economic outlook for Australia and New Zealand is slightly more positive, despite recent natural calamities. Disaster recovery expenditure and rising commodity prices are expected to boost their gross domestic product (GDP) through 2011.

- The world recovery is supporting a sustained increase in remittance flows to developing countries. The World Bank forecasts that overall remittances to East Asia and the Pacific will increase by 7.5% in 2011, after a rise of 6.4% in 2010. This provides some confidence for an increase in remittances to the Pacific over the medium term.

Unemployment high; commodity prices rising

- Unemployment in Australia, New Zealand, and the US remains above pre-crisis levels. The unemployment rate in Australia and the US during fourth quarter of 2010 was unchanged from the previous quarter, and rose slightly to 6.8% in New Zealand. Among Pacific islanders in New Zealand, the unemployment rate remained unchanged at 13.5% in fourth quarter of 2010.

- Employment growth in Australia and New Zealand was rising throughout 2010. If these economies continue to grow, as expected, the unemployment problem should ease over the medium term.

- Inflation pressures are increasing because of rising prices of key commodities. The increase in commodity prices became acute in the latter part of 2010. The IMF’s food index rose sharply in December 2010 to a level close to its June 2008 peak. Prices of coconut oil, palm oil, and logs, the region’s major export commodities, are also up. Continued robust demand from Asia and weather-induced supply disruptions are among the factors contributing to the price increase.

- Oil prices have recently reached multiyear highs on the back of the risk of supply disruptions, a result of the volatile political situation in a number of countries in the Middle East and North Africa.

GDP growth (% annual)

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<tr>
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<tr>
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<td>3.0</td>
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Sources: IMF World Economic Outlook (January 2011 and October 2010).

Labor trend in key economies

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Key commodity prices

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<th>Logs</th>
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Recent developments

- Economic momentum has been generated by a rapid buildup in government spending. This has resulted in average double digit growth since 2006 in the preferred measure of GDP—nonpetroleum, non-United Nations GDP. There was some easing in economic growth in 2010. Nonetheless, the growth in the preferred measure of GDP remained at an internationally high rate of 9.5%.

- Government expenditure rose from approximately $100 million in 2006 to $604 million in 2009, and was budgeted at $838 million for 2010. While the budget will probably not be fully spent, expenditure was on track to exceed the previous year’s level. As of early November 2010, own-funded cash expenditure was $437 million, compared with around $300 million over the same period of 2009, and expenditure inclusive of obligations had reached $635 million.

- Much of the additional government expenditure has been on items that have fed quickly into the local economy. Wages and salaries have continued to rise, and a wide-ranging social safety net is providing cash transfers to rural areas. There was a further large expansion in 2010 in small, rural infrastructure projects implemented by local contractors, as well as the larger public projects in the capital, Dili. Private investment has also risen as local and overseas contractors take advantage of the booming economy.

- The high level of aggregate demand is reflected in improvements in a range of demand indicators (e.g., new vehicle registrations, tax revenue, electricity usage, and mobile phone connections), albeit with some sign of an easing over 2010 in the rate of growth.

- The construction sector has expanded with rising investment, and high aggregate demand has fueled growth rates in the wholesale and retail industries. The recent recovery in the agriculture sector, which contributes around 30% of the preferred measure of GDP, slowed during 2010 because of adverse weather and continuing transport problems. The sector had grown by an estimated 13.4% in 2008 and 12.6% in 2009, boosted by the government-led distribution of better seeds and tractors and reestablishment of extension services.

- The Ministry of Agriculture estimates that production of rice, the staple most favored by households, declined by 6.4% in 2010. Maize production, however, rose by an estimated 10.5%, while coffee exports rose from the unusually low 10,000 tons reported in 2009 to 25,600 tons for 2010.

- Coffee continues to account for almost all merchandise exports. The large trade deficit, of the order of 65% of the preferred measure of GDP, is outweighed by the surplus on the income account attributable to petroleum revenue. Petroleum revenue reached an estimated $2.1 billion in
2010, and provided for a current account surplus more than twice the preferred measure of GDP.

- Broad money expanded by 9.7% in 2010, well down on the 39.6% increase of the previous year. Cautious lending practices (a response to the backlog of non-performing loans) and the ongoing problems of securing land as collateral continued to restrain bank lending, and commercial bank credit to the private sector was basically unchanged over the year.

- Inflation rose quickly in 2010 and above regional comparators, at 9.2% on a year-on-year basis in December and 6.8% on an annual average basis. Most of the inflation is attributable to a rise in food prices, which has been driven by international developments. Inflation is lower among items with prices that follow domestic rather than international conditions, suggesting inflation can be characterized as cost "push" rather than demand "pull."

**Outlook**

- The short- and medium-term economic outlook rests on developments in government expenditure. Own-funded government expenditure has been budgeted to increase by about 50% to $1,265 million in 2011, and the government has foreshadowed the budget for own-funded expenditure rising to about $1,450 million by 2015. Total infrastructure investment between 2011 and 2015 is projected to exceed $3 billion. The surge in government expenditure will continue to support aggregate demand and expansion in the construction and other service industries. Economic growth is likely to remain at internationally high levels of around 10% per annum.

- The United Nations mission to Timor-Leste is phasing out, with the phase-out expected to gather pace following the national elections due in the first half of 2012. The United Nations contribution to the economy (about $65 million) is estimated as the equivalent of around 10% of the preferred measure of GDP. While the phase-out and then departure will not have a direct effect on the preferred measure of GDP (as it excludes the United Nations contribution), it will have an indirect, dampening effect over the medium term.

- This dampening effect will, however, be mainly felt in 2013 and until then will be more than offset by the demand stimulus provided by the expansion in government expenditure.

- Inflation is projected to stay high in 2011 at 7.5% on an annual average basis, before easing in 2012 as the growth in world commodity prices slows. While the rise in oil prices is positive overall for the petroleum-dependent economy, the higher inflation it has caused needs to be carefully managed. It will be important to avoid repeat adjustments to public sector wages for the higher cost of living, which can turn into a wage-price spiral. This has the potential to turn what is now largely a problem of imported inflation into a deeper risk to macroeconomic stability.
Key issues

- Offshore petroleum revenue has allowed Timor-Leste to initiate a new development phase. Development is being fast tracked through the conversion of petroleum wealth into human and physical capital. Rising government expenditure funded from petroleum revenue is allowing a rapid expansion in public services and has provided a public social safety net for many of the vulnerable members of the community. After ranking 150 out of 159 countries in the 2005 Human Development Index, Timor-Leste reached 120 out of 162 countries in the 2010 index. The incidence of poverty is estimated by the World Bank to have declined from 50% in 2007 to 41% by 2009.

- The windfall offered by the rise in world oil prices over the past decade is central to Timor-Leste’s success. High world oil prices are providing the financial resources to sustain a surge in public investment and recurrent expenditure. In 2004, the International Monetary Fund estimated that Timor-Leste would earn a total of $3.3 billion from the offshore petroleum developments now producing revenue (at an oil prices of $20 per barrel, in 2002-03 prices). Timor-Leste is now earning this in less than 2 years. Total revenue from existing developments is estimated by the 2011 budget as $22.5 billion (in net present value terms).

- By the end of 2010, the Petroleum Fund held $6.9 billion in offshore investments. Even with the large withdrawals now planned, the value of the fund is projected to exceed $14 billion by 2015.

- The quality of the investments funded by these withdrawals is a key issue for the economy, as it will determine the sustainability of the recent surge in economic growth. It will be important that investments funded from withdrawals earn a good rate of return. A good “rule of thumb” is to target a return higher than the cost of withdrawals, being the financial return that would have been earned had savings remained in the Petroleum Fund.

- Even with these recent achievements, the development challenges remain daunting. The rising offshore income lifted Timor-Leste to lower middle-income country status in 2007, but the non-income indicators of development generally remain those of a low-income country. Of the 21 measurable Millennium Development Goal indicators, about half are off track, notably in relation to poverty and nutrition. The coverage of infrastructure—electricity, water, and especially telecommunications—has expanded during the last 10 years, but coverage and service quality remain below potential. The road network is in decline due to inadequate rehabilitation and maintenance (the most recent survey found that 92% of the core road network was in a poor or very poor condition) and the only seaport is approaching full capacity.

- Public investment thus needs to remain strong over the next decade and be focused on high-value uses (see the article on long-term growth projections for Timor-Leste on page 26).
Timor-Leste: Growth to 2030

Timor-Leste became a lower middle-income country in 2007. Its Strategic Development Plan 2011-2030 presents the goal of achieving upper middle-income status by 2030. This goal would require an increase in per capita gross national income—i.e. nonpetroleum GDP plus net offshore income—from approximately $2,500 in 2010 to about $4,000 by 2030 (in 2010 prices).

Timor-Leste’s petroleum revenue is expected to be low in 2030. This means nonpetroleum GDP per capita will need to rise from the 2010 level of approximately $600 to almost $4,000 by 2030 (in 2010 prices). Double-digit rates of growth in nonpetroleum GDP may be needed over 2011–2030 to reach the Strategic Development Plan’s income target.

What is needed to sustain such a high growth rate in nonpetroleum GDP? Long-run economic growth results from the combined accumulation of three factors: production, capital and labor, and productivity improvements. This simple formulation underpins what is known as growth accounting. This article applies the insights from recent growth accounting exercises undertaken of emerging Asia by ADB. It estimates the key inputs required by the Timor-Leste economy over 2011-2030, including the required accumulation of human and physical capital and of improvements in total factor productivity.

Projections of the basic growth accounts for 2011–2030 are prepared for Timor-Leste for five scenarios:

**TIM A**, the baseline scenario. This is based on recent trends in Timor-Leste; parameters from the international literature; and the experience of emerging Asia. A key assumption is that total factor productivity growth will match the average achieved by emerging Asia over 1981–2007.

**TIM B**, which is the same as the baseline scenario but with total factor productivity growth at a rate required for average double-digit growth in nonpetroleum GDP.

**TIM C**, which is the same as TIM B but with achievement of the Strategic Development Plan’s goal of all students completing 12 years of schooling, and a rate of total factor productivity growth that will achieve average double-digit growth in nonpetroleum GDP.

**TIM D**, which is the same as the baseline scenario but with an investment ratio required for average double-digit growth in nonpetroleum GDP.

**TIM E**, which is the same as TIM D, but with the ratio of investment to gross national income capped at about 60%. Total factor productivity is assumed to grow a rate required for average double-digit growth in nonpetroleum GDP.

It is concluded that an internationally high rate of economic growth is achievable if Timor-Leste matches standards achieved elsewhere in developing Asia.

Growth factors in Timor-Leste’s favor include a growing labor force, an ability to fund a high rate of public investment from petroleum revenue, and the potential benefits of catching up in education and technology. It is projected the economy could grow faster than much of developing Asia over the next 2 decades, and quickly narrow the income gap with upper middle-income countries.

The relatively high growth rate projected for Timor-Leste is consistent with the “conditional convergence” effect. Economic theory and empirical analysis have found that a country with a low initial income level relative to its potential income level will tend to grow faster than a country that is closer to its potential income level. This is mainly because of the potential for a quick catch-up through the adoption of more advanced technology, better techniques, etc. than was available to higher income economies in their earlier development.

The projections identify what is required to sustain double-digit growth in nonpetroleum GDP.

The projections find that double-digit economic growth can only be achieved if there is a very high rate of investment. Capital accumulation has contributed most of developing Asia’s economic growth, and is also likely to contribute most of Timor-Leste’s growth during 2011-2030. This suggests that a high rate of productive public investment and efforts to improve the climate for private investment are priorities for Timor-Leste.

It is also found that the growth in total factor productivity must at least match some of the best performers of developing Asia. A typical low-income economy can rely on factor accumulation for its early growth, and only become dependent on high productivity growth later on. Timor-Leste would need to achieve good productivity growth earlier in its development process than other economies of emerging Asia.

It is found that the growth projections are not overly sensitive to assumptions regarding how quickly Timor-Leste is able to expand participation in education.
Timor-Leste: Growth to 2030

Basic growth accounts for Timor-Leste

<table>
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<tr>
<th>Variable</th>
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Basic growth accounts for emerging Asia

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<th>7 ADEs</th>
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Contributions to GDP growth: Forecasts for 2011-2030

ADES=Asian developing economies; GDP=gross domestic product; PRC=People’s Republic of China; NIEs=newly industrializing economies; TFP = total factor productivity; TIM=Timor-Leste, TIM A=baseline scenario, TIM B=high TFP growth scenario, TIM C=education catch-up scenario, TIM D=high investment scenario, TIM E=broad-based, double-digit growth scenario.

Notes: (a) GDP for Timor-Leste refers to nonpetroleum GDP excluding the contribution of the United Nations, (b) averages for country groups of developing Asia are simple averages, (c) the addition of the individual contributions to growth equals the GDP growth rate.

Timor-Leste: Growth to 2030

If double-digit rates of economic growth are to be sustained, investment will probably need to rise above $1 billion per annum within 5 years and above $1.5 billion per annum within 10 years (in 2010 prices). This would be a very large increase on the 2010 investment level of about $300 million. It is projected that lower, but still internationally high, rates of economic growth could be achieved if investment was around half these levels. This lower level of investment, of at least $0.5 billion per annum within 5 years and more than $0.75 billion per annum within 10 years (in 2010 prices), could be used as a minimum target investment level.

The public sector is currently funding most investment. Fiscal constraints will probably prevent it from doing so during the whole 2011-2030 period. It follows that sustaining a high rate of economic growth rests on achieving a transition from public to private sector-led investment.

The best prospects for much of Timor-Leste’s private sector are in the micro, small, and medium-sized enterprises. However, the economy needs large-scale investment to achieve high rates of economic growth. Foreign investment will be needed to help fill the gap. Timor-Leste’s success in establishing itself as one of developing Asia’s investment destinations will, therefore, be pivotal to the economy’s growth path.

As illustrated by the success of emerging Asia, achieving a high rate of economic growth will require a supportive policy and institutional setting, a high standard of infrastructure, and a well educated labor force. Emerging Asia’s development record in these areas provides a benchmark standard that Timor-Leste could use to set targets.

Matching emerging Asia overall will be important to ensuring that Timor-Leste is internationally competitive, particularly in terms of attracting private investment. If Timor-Leste is unable to match emerging Asia in some areas (e.g., wage rates), it will need to do better than emerging Asia in others if it is to be competitive (e.g., infrastructure standards, education standards). Key initiatives to achieve competitiveness are provided by the Strategic Development Plan 2011-2030, and early implementation will do much to enhance the prospects for sustainable economic growth.

A reference to a source is provided: