



<i>Population</i>	1.1 million
<i>Population growth</i>	3.2 percent
<i>Surface area</i>	14,870 sq. km.
<i>Capital</i>	Dili

Source: World Development Indicators.

Timor-Leste has seen rapid economic growth in the past three years, though inflationary pressures are starting to rise. Fiscal policy continues to be highly expansionary in response to development needs, including a 55 percent increase in planned spending for 2011 compared to the revised 2010 budget. Petroleum receipts in 2010 were strong, and Petroleum Fund (PF) savings are now in excess of \$7 billion (over ten times the estimated non-oil GDP in 2010), providing an important buffer against potential shocks. Medium-term economic prospects are strong, and hinge on not only the quantity, but importantly the quality, of government spending. Risks include inflationary pressures; the timing of new oil and gas discoveries; and the expected decline in UN presence over the coming two years.

The economy continues to grow rapidly on the back of government spending. Growth in 2009 was estimated at 12.9 percent, with some moderate slowdown expected in 2010 due to a fall in agricultural output resulting from extended rains. Government spending, however, picked up rapidly in the second half of 2010 and other indicators (e.g. electricity consumption, credit growth) also point to strong demand in the economy. These developments are starting to contribute to poverty reduction and improved social outcomes. The recent census and labor force survey however show that the

population and employment activity have gradually concentrated in Dili in recent years. The government's efforts to stimulate economic opportunities across the country are therefore important to help reduce vulnerability to shocks.

With strong growth there are also price pressures, with headline inflation rising to 8 percent in the year to December 2010. This was largely driven by the rise in international commodity prices. Food prices in Timor-Leste rose by over 10 percent in the year to December 2010. The rise in fuel prices have contributed to increased transportation costs (6 percent in the year to December 2010). The real effective exchange rate depreciated in the third quarter due to a weakening of the U.S. dollar against the currencies of Timor-Leste's major trading partners, which will have further contributed to inflation. Aside from exogenous factors, however, rapid fiscal expansion including infrastructure spending is likely to be putting pressure on domestic supply networks. House building costs have consistently risen over the past twelve months, reaching 8 percent in the year to December 2010.

Credit to the private sector picked up very slightly in the last quarter of 2010, though it has remained flat in the last three years. Non-performing loans rose quickly in 2010, from around 30 percent of total loans and advances in 2009 to around 40 percent in December 2010. This is associated with a relative increase in lending to the construction sector (and reduced lending to other sectors), resulting from a ramping up of government spending on infrastructure. This does not pose systemic risk. Deposits have increased significantly in the last quarter from \$261 million to \$303 million. The spread between lending and deposit rates remains high at around 10-15 percent. Efforts are under way to improve access to finance by strengthening risk management, including the recent development of a credit information reporting system by the Banking and Payments Authority.

The trade deficit remains large, but declined slightly in the third quarter of 2010. Helped by a rise in international prices, coffee exports increased following a sharp drop

in production in the first half of 2010. Official statistics show that production also bounced back quite sharply in third quarter of 2010. Imports slowed down in the third quarter but they are likely to have picked up again at the end of the year as execution of the government's budget improved.

The overall balance of payments is strong thanks to petroleum receipts, which were close to \$2.2 billion in 2010. This was higher than projected in the revised 2010 budget, and was thanks to higher international oil prices. But the increase was also due to improved tax collection on petroleum profits resulting from better enforcement. Despite a decline in U.S. Treasury bond yields in the third quarter of 2010, the overall investment performance of the PF was stronger than the same period last year. In September 2010, the government appointed Schroeders Investment Management Ltd. to invest 4 percent of the PF into equities. The government is further exploring options to diversify PF assets, including through amendments to the PF Law, with the aim of securing higher returns over the longer-term.

Fiscal policy remains highly expansionary. In 2010, the government increased spending appropriations from \$660 million to \$838 million. After a slow start, government spending picked up in the last quarter reaching nearly \$748 million at the end of the budget year. The non-oil deficit is large, financed entirely by withdrawals from the PF, which exceeded Estimated Sustainable Income for 2010 by nearly \$300 million. However, non-petroleum revenue collection is gradually improving, reflecting strengthened tax administration and enforcement capacity. The final 2011 budget approved by Parliament on 28 January is around \$1.31 billion and envisages a major scaling up of capital spending, which is close to half the budget. The government is introducing several institutional changes, including the establishment of infrastructure and human capital funds, to try and accelerate capital spending whilst addressing weaknesses in project design and implementation.

The 2011 budget provides a strong indication of priorities for the government's upcoming Strategic

Development Plan. The government envisages a heavily frontloaded investment strategy to address major infrastructure, skills, and other structural gaps. The objective is to create the conditions to generate a strong private sector supply response. This will depend critically on the prioritization and quality of investment, but also on absorptive capacity, both macroeconomic and administrative.