“Can Timor-Leste have its own currency? Perspectives and Challenges”

Rui A. Gomes, Ph.D.[1]

I want to start by congratulating the East Timor Institute of Business for organizing this Seminar on such an important issue as the adoption a national currency for our own country.

Thank you for inviting me to speak at this Seminar, giving me the opportunity to share with a broad audience the views of the Minister of Planning and Finance on this issue.

As suggested by the organizers I will focus my presentation on the issues related to the role of the Government and particularly of the Ministry of Planning of Finance, leaving the other aspects for the other speakers. Particularly, my friend the Governor of the BCTL will certainly address the more technical requirements of the adoption of a national currency.

As many of you will know, as an academic I have many years ago put forward a proposal for the country to adopt is own currency. I am therefore completely at ease, and currently my opinion on this issue is that we shall have a very pragmatic approach.

I dare to say that you all agree with me that at the dawn of our life as an independent country, due to the conditions that prevailed at the time, the adoption of the US Dollar as the sole legal tender was the right if not the best choice.

At the current juncture, two questions should be asked: How well has the U.S. Dollar served the development of our country? If future development of the economy requires the adoption of a national currency, how should we prepare ourselves for that?

I will now address each of these questions and I will then conclude.

How well has the U.S. Dollar served the development of our country?

It is a shared assessment that the current currency regime has till now served well the development of the national economy, being one of the cornerstones of the macroeconomic stability which is a condition for economic growth. Both The International Monetary Fund (IMF) and the World Bank have recently reiterated this assessment[2].

[1] Minister of Planning and Finance of the 7th Constitutional Government. The author is grateful for the inputs received by Mr. Carlos Augusto Burgo, Senior Adviser of Public Financial Management, Ministry of Planning and Finance. The views expressed here are those of the author’s alone and do not represent any of the Ministry’s.

[2] “*The use of the U.S. dollar as sole legal tender remains appropriate given institutional capacity constraints and limited financial development. The fully dollarized regime has worked well for Timor-Leste, given the high dependence on oil revenue and limited other non-oil exports. Sound macroeconomic policies, including improved fiscal policies, together with further progress in financial sector and institutional developments, would be needed over the long run to pave the way for any change in exchange rate regime*.” (IMF, 2017 Article IV Staff Report).

From 2007 to 2016 growth averaged 6.5 %. The wellbeing of the Timorese people improved markedly, with significant strides being done toward the reduction of poverty. Expenditures toward the development of human capital (health, education) were greatly expanded and critical infrastructure are being built.

The National Economy

Gross National Income	2012	2013	2014	2015	2016
GNI ($m)	4,350	4,170	3,345	2,805	2,278
Oil sector	2,820	2,470	1,576	887	262
Non-oil sector	1,530	1,700	1,769	1,919	2,016
GNI per capita ($)	3,760	3,521	2,758	2,261	1,796
Oil sector	2,438	2,086	1,299	714	207
Non-oil sector	1,322	1,435	1,459	1,546	1,589
Gross domestic product					
GDP ($m)	6,671	5,650	4,045	3,104	2,521
Oil sector	5,477	4,234	2,591	1,496	820
Non-oil sector	1,194	1,415	1,454	1,609	1,701
GDP per capita ($)	5,767	4,770	3,336	2,502	1,988
Oil sector	4,735	3,575	2,136	1,205	646
Non-oil sector	1,032	1,195	1,199	1,296	1,342

Source: DGE, National Accounts 2000-2016

In fact, the use of the US Dollar as the sole legal tender was in accordance with the structural characteristics of the economy:

- Small, open economy, very dependent on imports, with a very limited production base and highly dependent on oil receipts;
- High export concentration (oil and coffee) and revenues that are subject to price volatility;
- Limited and undeveloped financial sector;
- Private sector flows are negligible.

It is obvious that in such an economy there is a relative rigidity in the elasticity demand/price for imports and supply of exports which limits the utility of the exchange rate - a key instrument in the competitiveness of the economy. Hence, a depreciation of the currency will neither dynamize exports nor reduce the volume of imports, given the inexistence of national production. Any depreciation of the currency will increase inflation, thus invalidating the effect of external competitiveness.

Timor-Lest is the most dependent country on natural resources. Oil production has been the main driver of economic growth, with oil accounting for 96% of exports of goods and services in 2016 and oil revenue for more than 80 % of government revenues in 2017. Coffee is the only other significant export. Both Oil and Coffee are invoiced in Dollars.

External Trade ($m)

Trade Statistics	2012	2013	2014	2015	2016
Exports of goods and services	6,526	5,310	3,898	2,327	1,458
Oil sector	6,401	5,217	3,824	2,276	1,400
Non-oil sector	124	94	74	50	58
Imports of goods and services	2,392	2,074	2,407	1,690	1,518
Oil sector	987	1,044	1,275	786	585
Non-oil sector	1,406	1,030	1,132	904	933

Source: DGE, National Accounts 2000-2016

The price volatility of the principal export commodities implies that any small shock may provokes big oscillations in the exchange rate, which may, in turn, destabilize the economy. A reduced dimension and lack of liquidity in the currency market may contribute to high currency *spreads*, which can further aggravate the costs for international trade.

A developed financial system and a certain level of financial intermediation in the economy are key factors in the transmission mechanism for monetary policy. Setting up a reference for the interest rate by central bank that reflects the decisions of the economic agents requires significant financial intermediation in the economy. A less efficient and uncompetitive financial system, which constrain credit activity, can lead to high banking *spreads,* thus reducing the effects of the central bank’s intervention.

The injection of oil revenues is the main source of financing of the non-oil economy. Public financing accounts for almost 95% of the total financing. Private flows are negligible. The formal business sector employs less than 1/10 of the working age population and is characterized by a strong dominance of the construction sector, which depends strongly on the portfolio of public works.

If future development of the economy requires the adoption of a national currency, how should we prepare ourselves for that?

With the depletion of the oil fields and the growth levelling off, Timor-Leste needs new sources of growth. It faces the challenge of diversifying its economy and creating new jobs, especially for the young people.

Besides investing in human capital and infrastructure, the Government should put in place the legal and institutional infrastructure of the market economy and markedly improve the business climate since the diversification of the economy will greatly depend on private investment (both domestic and foreign) and the development of the private sector.

To succeed in the new phase of development the country has to become sufficiently competitive. Structural reforms have to be implemented in order to get the necessary level of efficiency and flexibility in the economy.

The key question is whether it is possible to obtain the necessary level of competitiveness with the current currency regime, with the US Dollar as the sole legal tender. Looking at the trend of the effective exchange rates, it may be legitimate to have serious doubt whether this is easily feasible.

There has been strong pressures pushing toward the appreciation of the effective exchange rates, both in nominal and in real terms. From 2010 to 2016 the effective exchange rate appreciated by 20% in nominal and 45.9% in real terms. In 2017 the evolution has been probably more benign, due to the depreciation of the dollar and low level of domestic inflation.

This trend points to the fact that the inflation differential relatively to the main trading partners has registered a detrimental evolution. The inflationary process in Timor-Leste has to be better understood. There may be both structural and demand related factors behind the domestic inflation.

One driver of the inflation may be related to the fact that most of the investment is public and in infrastructure. In some cases, namely the investments in utilities, the new infrastructures deliver services that improve the efficiency of the economy.

However, this is not always the case. New infrastructures do not always translate into extended supply capacity, at least not in the short term, while having strong impact on the demand in the economy due to the spending during construction.

This is a well-known phenomenon linked to the investment profile whose impact is particularly felt when investments in infrastructure do not crowd in private investment that increase the supply in the economy.

There are other disadvantages of having the dollar as the legal tender. The US Dollar is the main reserve currency of the international monetary system. At same time it is the national currency of the USA whose central bank, the Federal Reserve, the FED, is bound by a dual mandate – price stability and full employment in the USA. The FED is accountable only to the Congress for this dual mandate.

Spillovers effects on other countries are too often neglected if not ignored in the conducting of the monetary policy by the FED. One consequence for a country using the US Dollar as legal tender is that it may import a lot of procyclality into its economy. This procyclality is coupled with the great volatility of the exchange rate inherent to the role of the Dollar in the International Financial System.

Also to be mentioned is the loss of *seigniorage*, the revenue that a central bank extracts from the issuance of currency. This loss is not negligible since our economy is still strongly cash based. The central bank, an institution which plays a central role in the economic management of a country, is usually financed by *seigniorage* revenues. In our case, only the fact that the BCTL earns a sizable commission as the operational manager of the Petroleum Fund masks the problem. Nonetheless the Government is still required to periodically recapitalize the central bank.

As Timor-Leste progresses in the path of building a diversified and service based economy the balance of costs and benefits may tilt in favor of the adoption of its own national currency. A national currency may even become a crucial condition for obtaining the level of competitiveness required to succeed in this transition.

Now, for large developing and emerging countries much has been argued in favor of a floating of the exchange rate as an important part of the adjustment mechanism to external shocks. In the case of Timor-Leste a more adequate solution would probably be to peg the national currency to a basket of currencies in accordance with the respective weights in the flows of the current account.

Dornbush, Rudiger stated that the keys to prosperity are “Free Markets, Sound Money, and a Bit of Luck”. We may not totally agree with this strong statement. Shared prosperity may require much more and, after the Great Economic and Financial Crisis, many doubts emerged regarding the capacity of “free markets” delivering socially and politically desired and acceptable outcomes. Nonetheless the role of sound money is unquestionable.

This is to say that the adoption of our own national currency is only worth being considered if it is to be “sound”, since price stability, e.g. low inflation, is generally accepted as a requirement for economic growth, the basic condition of prosperity.

Besides delivering price stability, the national currency would have to be widely convertible. Not only would the current account have to be fully convertible. Financing flows would have to be largely liberalized in order to support the functioning and development of the economy.

The adoption of a national currency will require appropriate institutional development. A critical factor is ensuring the independence of the central bank in conducting monetary policy. But, foremost, a sound and convertible money requires sound macroeconomic policies. Fiscal discipline, sustainability of public finances, structural reforms to ensure competitiveness and flexibility of the economy are basic requirements.

To be clear, sustainability of public finance and structural reforms are unavoidable in the path of growth and development even with the current currency regime. They are however of upmost importance if we are to, successfully, adopt our own currency. To obey to my terms of reference I shall focus on the issues related to the management of public finance.

The Strategic Development Plan (SDP) has a clear vision for sustainable development through modernization of the infrastructure, diversification of the economy, social as well as institutional development. We have been using the oil resources we are blessed with, to finance development and have made remarkable progress in the implementation of the SDP.

Due to the low level from which we started, we have decided to frontload expenditures to alleviate poverty, to accelerate the building of human capital, the construction of infrastructures and the expansion of public services. However we are currently in a juncture where we ought to take stock of the challenges ahead and adopt the right policies.

The Government Program points to a new set of policies, a new development model, seeking an appropriate balance between investing in human capital and institutional development on one side, and investing in physical infrastructure on the other. In is our strong belief that the quality of its human capital and the institutional framework will be the decisive factors for the development of our country.

Overarching the new set of policies are the goals of achieving a higher efficiency in the use of public funds and ensuring fiscal sustainability. This will require limiting excessive withdrawals from Petroleum Fund, a better allocation of funds among sectors and linking budget allocations to policies and outputs.

It is generally accepted that fiscal discipline requires an appropriate architecture for the management of fiscal risk. Fiscal Responsibility Laws, Fiscal Rules and Fiscal Councils are the three pillars usually recommended. Timor-Leste adopted from the start a strong framework guiding the use of its oil resources and there is an implicit fiscal rule in the governance framework of the Petroleum Fund (PF): the Estimated Sustainable Income (ESI), 3% of the Petroleum Wealth calculated yearly, may be used to finance the Budget[3].

However, this rule isn't in place since sizable and increasing excessive withdrawals have been made since 2014 to fund the policy of frontloading of expenditures. Excessive withdrawals have been used not only to finance the construction of infrastructures but also to finance recurrent expenditures. There is currently no constraint to public expenditures and the incentives for the efficient use of public funds are weak. Moreover, following recent trends of excessive withdrawals would lead to a more or less rapid depletion of the resources of the PF.

To put it bluntly, we would risk having the resources of the Petroleum Fund depleted without having reached our goal of achieving shared prosperity for our people. An extreme scenario would even lead to a fiscal cliff, a point where the Government wouldn't be able to fund its operating budget[4].

It would be unwise not to adjust policies in order to ensure fiscal sustainability. A robust fiscal rule is urgently needed and should probably be enshrined in Law. In any case the budget strategy of my Government is to gradually lower the deficit of the operating budget (including the ESI as revenue) aiming at balancing it within 5 to 7 years. This budget strategy will be translated into a Medium Term Financial Framework. My success will be measured by how close I come to this goal.

Probably the main challenges we face in the management of public finance is to find the right balance in infrastructure building. Modern infrastructure is a basic condition of development. We know too well that our country has a huge infrastructure deficit. And it is much better to have our financial resources invested in the upgrade of the infrastructure in our country than abroad in financial markets of developed countries.

There is however an important caveat to this standpoint. The infrastructure built has to translate into new business opportunities, to increase economic efficiency and competitiveness and to lead to a higher level of wellbeing of the people. Infrastructure has to be built efficiently and, hand in hand with the implementation of structural reforms, to improve the business climate and the setup of adequate institutional framework.

Studies by very credible institutions[5] have concluded that huge bouts of infrastructure building rarely translate into increased growth potential. The pace of construction of physical infrastructure should be in accordance with our absorption capacity and we should increase this capacity by "invest in investing", to increase that capacity.

This is why my Government has as a top priority in the design and implementation of an Investment Management System aiming at improving all dimensions of infrastructure building, particularly the project

[3] One may argue against this rule because of its procyclicality.
[4] See Fiscal Scenarios in Annex.
[5] Namely the International Monetary Fund (IMF).

selection process, the integrity of the procurement and the accounting for maintenance of the physical assets.

In addition, we should adopt a Medium Term Infrastructure Building Plan, which may be rolling, with well-defined priorities and a clear established financial envelope. By planning in the medium term the excessive withdrawals from the Petroleum Fund, we would improve the conditions for its management, thus increasing its returns.

But fiscal sustainability shall not only depend on the management of public expenditures. Mobilization of domestic resources is equally important. Currently, domestic revenues only amount to about 8% of non-oil GDP. The goal is to reach 15% in the medium term. Building on the Fiscal Reform Program the Government intends to develop in a participative way a Medium Term Revenue Strategy which should be broadly supported by the whole nation as an important pillar of fiscal sustainability and economic stability.

The quality of public services, the reach of the social programs and the promotion of development require adequate and sustainable funding of Government. The core of the Medium Term Revenue Strategy will be the design and implementation of a modern tax framework. It is of essence to have a tax system that ensures not only adequate level of tax collection but also competitiveness of the economy and incentives for the development of the private sector.

In this new tax system the central role will be played by the Value Added Tax (VAT), whose adoption should not be delayed. The VAT is a very efficient tax which will greatly enhance the tax collection potential without imposing too much distortion on the allocation of resources. It is to a great extent self-enforcing, not too demanding regarding tax administration and helps the enforcement of other taxes, particularly of the income taxes.

The VAT is very sensitive to the performance of the economy, meaning that with the development of the private sector and the emergence of a diversified and service based economy the Government will have an increasing revenue base. It may be designed to well suit the characteristics of the local economy, excluding the informal sector and exempting the basket of goods and services making the main share of the consumption of the poor. Moreover, by exempting exports it favors the external competitiveness.

Sound and efficient public finance management will require the enforcement of the principle of cost recovery to ensure the sustainability and quality of services of utilities. Access of the poor to basic goods and services should be warranted through well targeted income transfer programs instead of price and tariff subsidies.

To fully perform its functions in the economy a currency needs a certain level of development of the financial system. The development of the financial systems requires that adequate infrastructure exists. Effective regulation and supervision is a basic requirement. For the intermediation to develop, information for risk assessment and collateral have to be available and creditor rights are to be protected. Where needed the Government should share the intermediation risk through appropriate mechanisms, namely partial guarantee schemes.

One of the main functions of the financial system is to intermediate risk. The risk intermediation depends critically on the ability of the financial system to price risk and to ensure liquidity. To deliver on pricing and liquidity the financial system requires the development of public debt markets. Risks are priced relatively to the return of riskless assets, mainly Treasuries.

At the same time, public debt markets are the more liquid ones and help to manage the liquidity of financial institutions, particularly of the monetary institutions that create money - the banks. Public debt is usually one of the main portfolios of financial institutions.

The credibility of a currency is warranted not only by establishing it as the legal tender. It depends mainly on the demand for it. It goes without saying that the soundness of the financial system, particularly of the banks, which create money, is the main pillar of the money demand. Another important pillar of the demand for the national currency is the fact that people need it to pay taxes and to transact on public debt.

There is another important reason why the financial system needs riskless assets: it increases the efficiency of the system. The addition of riskless assets open to the investors the possibility of optimizing their portfolios along the Capital Market Line[6] - a superior outcome compared to the efficient frontier, by combining the market portfolio with riskless assets in accordance with their risk preferences.

Public Debt is therefore a "public good" and there should be enough supply of it to meet the demand. Because the *Sovereign* in Timor-Leste has a strong long financial position, we haven't felt until now the need to issue debt. However, for reasons mentioned above, the issuance of public debt in national currency may be advisable to support its adoption.

Moreover, for treasury management, we already feel the need to issue public debt. Until now the treasury management is done through the Petroleum Fund with opportunity costs negatively impacting the return of its portfolio of investments. It would be much more transparent to have the costs of treasury management paid directly by the Treasury.

Furthermore, with a national currency comes the need for the central bank to implement the monetary policy. The most efficient way of monetary management is through intervention in the secondary markets of treasuries.

Conclusion

Let me conclude by highlighting that given the structural characteristics of our economy – a small, open economy, very dependent on imports, with a very limited production base and highly dependent on oil receipts, having the US Dollar as the sole legal tender has served the country well.

However, as we progress toward a diversified economy, well integrated in the region, the competitiveness management may require having the monetary policy as an additional tool of macroeconomic management.

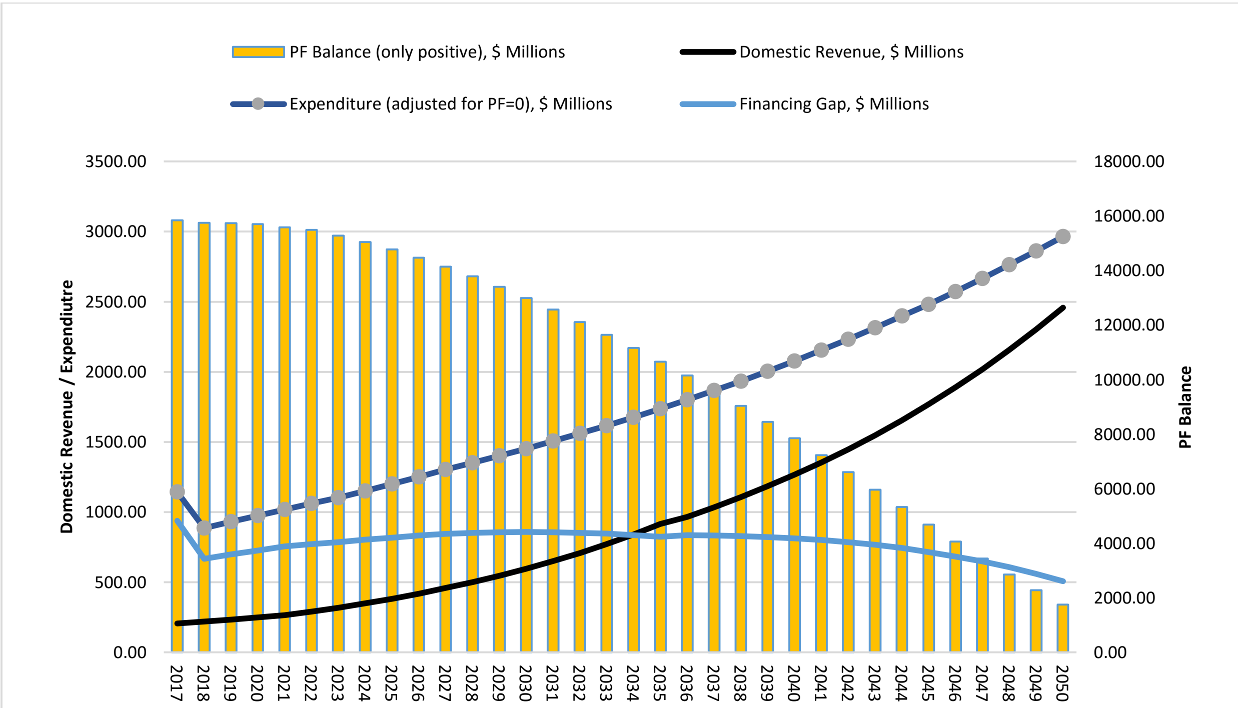
Yet, the credibility of the currency depends on fiscal discipline, the efficiency of the economy, a developed and sound financial system and appropriate institutional framework.

The Program of the Seventh Constitutional Government is oriented toward strong macroeconomic and structural policies and lays the foundation for a sustainable fiscal policy, a key requirement for the adoption of an own national currency.

[6] See CAPM (Capital Asset Pricing Model)

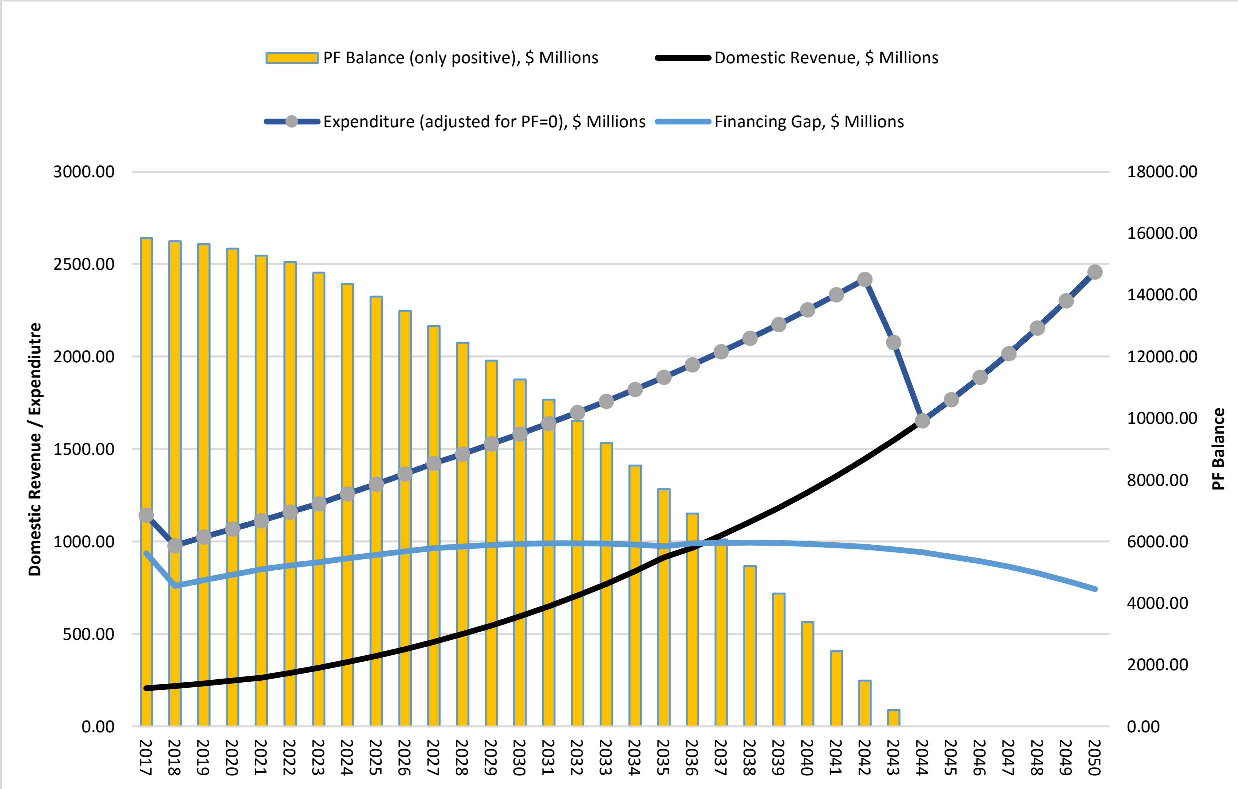
Annex – Fiscal Scenarios

Scenario I (Ideal): $1,000 m



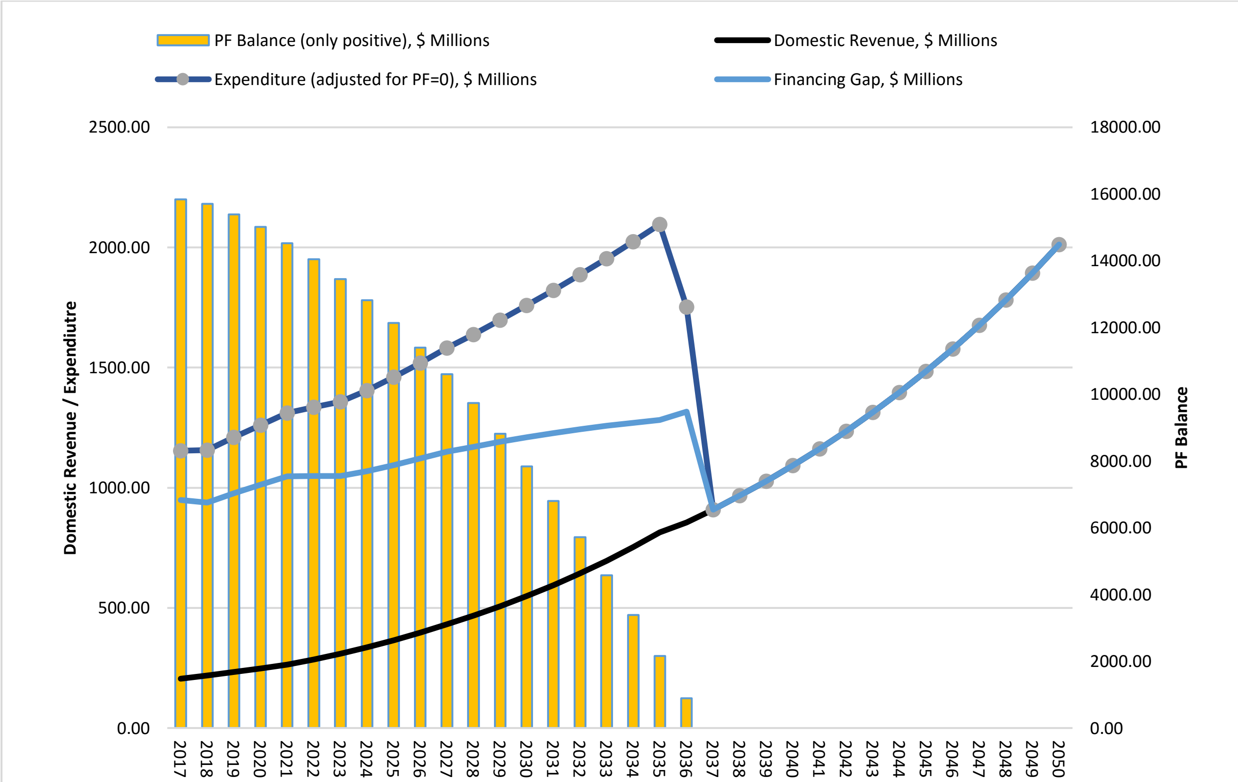
Source: MPF, DNPE

Scenario II (Desirable): $1,100 m



Source: MPF, DNPE

Scenario III (Undesirable): $1,200 m



Source: MPF, DNPE