Oil, debt and sustainability: Timor-Leste’s borrowing plans and their implications for the future

By Niall Almond, Researcher, La’o Hamutuk, September 2017

Introduction

Between 2006 and 2012, Timor-Leste received more than $20 billion from exporting oil and gas; however, revenues have plummeted since 2012, and are predicted to fall to less than $90 million per year from 2018 onwards, and end entirely by 2021 (La’o Hamutuk 2016, 3). As a result, Timor-Leste has gone from being one of the most petroleum-export-dependent countries in the world, to being almost entirely dependent on the Petroleum Fund (PF) and its investment earnings. However, the Government has withdrawn excessively from the PF almost every year to finance major infrastructure and growing public administration costs, and the PF’s balance has been falling since 2015 (La’o Hamutuk 2016, 5). The 2017 State Budget shows that this pattern is set to continue, with excess withdrawals planned for 2018-2021 (RDTL 2016a, 61).

To relieve pressure on its limited fiscal resources, while allowing it to continue implementing an ambitious infrastructure construction program, the Government has begun borrowing from international agencies and foreign governments. Borrowing plans have accelerated rapidly since the signing of the first loan contract in 2012, and the 2017 Budget envisions spending more than $1 billion in borrowed money between 2017 and 2021 (RDTL 2016a, 65).

This paper will analyse the Timor-Leste Government’s current and future borrowing, including reviewing several of the arguments for borrowing given by the Government and international lenders, and the types of projects being borrowed for. It will also assess Timor-Leste’s economic and fiscal situation and its ability to repay its current and future debts, and discuss some of the potential negative consequences of falling into unsustainable debt.

Borrowing is accelerating

In 2009, the Government passed laws paving the way to borrow from foreign institutions (La’o Hamutuk 2009), and it began to sign loan contracts in 2012. Borrowing plans gradually increased in State Budgets between 2012 and 2015; however, beginning with the 2016 Budget, these plans began to accelerate rapidly: the 2015 State Budget projected spending $610 million in borrowed funds between 2015 and 2019, while the 2016 Budget projected $1,021 million from 2016-2020, and the 2017 Budget projects $1,189 million in loan spending from 2017-2021 (RDTL 2015, 77; RDTL 2016a, 65). Moreover, in late 2016 and early 2017, the Government signed additional loans worth $85 million for ongoing projects; these were not anticipated in the budget, so total loan spending for 2017 to 2021 could be as high as $1,274 million.

1 The total loan spending described in Book 1 of the 2017 State Budget is higher, but a $220 million loan for Tíbar port has been cancelled.

http://www.laohamutuk.org/econ/OGE17/FinalBks/FinalOJE17Bk3AFeb17en.pdf

2 The figures for 2017-2021 in the graph below do not include the cancelled Tíbar port loan, but do include the additional loans signed in late-2016/early-2017.
While contracts for the largest loans included in the State Budget have yet to be agreed, around $400 million in loan contracts has already been signed with the Asian Development Bank (ADB), World Bank, Japan International Cooperation Agency (JICA) and the China Export-Import (EXIM) Bank, all of which expect one are for road projects. Out of the total contracted, only around $83 million had been disbursed from lenders and spent by the Timor-Leste Government as of September 2017. However, this is likely to increase rapidly in coming years, as seven new loan agreements have been signed since 2015, and the Government’s capacity for project management and budget execution has improved considerably.

The following table contains details on all Timor-Leste’s currently-signed loans. The table is divided by project; some projects are being funded by more than one loan, as indicated in the far-right column.

<table>
<thead>
<tr>
<th>Project</th>
<th>Lending Agency</th>
<th>Year signed</th>
<th>Scheduled project completion date</th>
<th>Repayments of principal begin</th>
<th>Repayments continue until</th>
<th>Amount to be borrowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dili-Baucau road</td>
<td>JICA</td>
<td>2012</td>
<td>June 2017 (construction ongoing due to project delays)</td>
<td>2022</td>
<td>2042</td>
<td>¥5.3 billion (around $47 million at July 2017 exchange rates)</td>
</tr>
<tr>
<td>Dili-Liquiça and Tibar-Gleno roads</td>
<td>ADB</td>
<td>2012</td>
<td>December 2016</td>
<td>2017/2020</td>
<td>2037/2044</td>
<td>$40m ($31m plus $9m Special Funds (SF))</td>
</tr>
<tr>
<td>Manatuto-Natarbora road</td>
<td>ADB</td>
<td>2013</td>
<td>December 2019</td>
<td>2019</td>
<td>2038</td>
<td>$50m ($40m plus $10m SF)</td>
</tr>
</tbody>
</table>

3 Source: RDTL Transparency Portal and disbursement data from lenders.
### Project Details

<table>
<thead>
<tr>
<th>Project</th>
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<th>Amount to be borrowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dili-Ainaro road</td>
<td>World Bank</td>
<td>2013</td>
<td>December 2018</td>
<td>2019/2022</td>
<td>2038/2041</td>
<td>$40m ($25m IDA plus $15m IBRD)</td>
</tr>
<tr>
<td>Tasitolu-Tibar dual carriageway road</td>
<td>ADB</td>
<td>2015</td>
<td>December 2017</td>
<td>2019</td>
<td>2039</td>
<td>$12m</td>
</tr>
<tr>
<td>Upgrade and construct Dili drainage system</td>
<td>Chinese Government Export-Import (EXIM) Bank</td>
<td>2015</td>
<td>2018</td>
<td>2022</td>
<td>2037</td>
<td>$50m</td>
</tr>
<tr>
<td>Baucau-Lautem, Maubara-Karimbala and Atabae-Mota-Ain roads</td>
<td>ADB</td>
<td>2016</td>
<td>December 2020</td>
<td>2021</td>
<td>2040</td>
<td>$76m ($53m IDA plus $23m SF)</td>
</tr>
<tr>
<td>Dili-Baucau road</td>
<td>ADB</td>
<td>2016</td>
<td>April 2019</td>
<td>2021</td>
<td>2040</td>
<td>$50m</td>
</tr>
<tr>
<td>Lauara-Solerema road</td>
<td>World Bank</td>
<td>2017</td>
<td>December 2021</td>
<td>2022</td>
<td>2042</td>
<td>$35m</td>
</tr>
</tbody>
</table>

**Total to be borrowed under current agreements:** $400 million


### Justifications for borrowing do not stand up to scrutiny

The Government and international agencies advising it give several justifications for borrowing, the principal one being that Timor-Leste requires major infrastructure investments, with limited financial resources with which to finance them. They argue further that borrowing is cheaper than withdrawing equivalent amounts from the Petroleum Fund (PF), as the lost opportunity cost from a reduced PF balance is estimated to be greater than the interest on the loans (RDTL 2016a, 61). While no-one denies Timor-Leste needs to improve its infrastructure, there are several problems with these pro-borrowing arguments.

First, the ‘frontloading’ infrastructure policy—which involves the rapid construction of major physical infrastructure requiring excess withdrawals from the PF in the medium-term—has not been effective, nor is it sustainable. This is demonstrated by the fact that, despite the Government spending billions of dollars on infrastructure since 2011, over 40% of Timor-Leste’s population continues to live in poverty (RDTL 2016b, 3), while a recent report estimates that about half of Timorese children under-5 in 2015 were stunted due to malnourishment (ADB 2017, 11). In addition, while there have been improvements in some areas, large numbers of Timorese people still lack access to adequate water and sanitation (RDTL 2016c, 3-7), and infant and mortality rates are some of the highest in the region (UNICEF 2016, 1). Frontloading has also failed produce significant

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4 According to the RDTL Transparency Portal, executed spending from the Infrastructure Fund between 2011 and September 2017 was $2.2 billion. This does not include other infrastructure spending, such as that under the ZEESM project in Oecussi, so the total amount is much higher.
improvements in Timor-Leste’s domestic economy - productive non-oil sectors such as agriculture and manufacturing have not grown since independence, with most growth in ‘non-oil’ GDP being driven by government spending (La’o Hamutuk 2016, 16).

This lack of improvement in basic indicators is largely due to the bulk of infrastructure spending in Timor-Leste (as well as planned spending over the next five years) being allocated to large-scale projects such as national roads, power plants, ports and airports, while the Government has spent comparatively little on improving water systems, sanitation, hospitals, clinics, schools and rural roads, or on developing sustainable, productive economic sectors such as agriculture.  

The other major problem with the frontloading policy is that current levels of spending (including on infrastructure) are unsustainable – Timor-Leste’s oil and gas revenues will effectively end in 2018, there are no other known oil and gas fields due to come online in the near future and non-oil, domestic revenues make up less than one-fifth of the State’s income (RDTL 2016a, 48). This means that the Government is now almost entirely dependent on the Petroleum Fund (PF) and its investment earnings to finance the state’s activities.

However, the PF’s sustainability is now in doubt, due to a combination of excess withdrawals, dwindling revenues and lower-than-expected investment returns. Moreover, the 2017 State Budget shows that the Government plans to withdraw almost four times the Estimated Sustainable Income (ESI) – a guideline designed to ensure the long-term sustainability of the PF, calculated at 3% of total petroleum wealth – each year from 2018 to 2021. The Budget also predicts that the balance of the PF will fall to $12.3 billion by the end of 2021 (RDTL 2016a, 60) – a drop of over $4 billion from today’s $16.5 billion balance (RDTL 2017a, 1). If these excessive withdrawals continue, some analysts predict that the PF could be entirely depleted by 2026 (Scheiner 2015, 14).

As regards the argument that borrowing is ‘cheaper’ than withdrawing from the Petroleum Fund, while this may be true in the narrow sense when comparing interest rates on concessional loans

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5 Independent monitoring NGO La’o Hamutuk calculates that together, education, health, agriculture, water and sanitation received less than one-fifth of total State Budget allocations each year on average between 2011 and 2017.
with projected investment returns, it is problematic for several reasons. First, it assumes that returns on the PF’s investments will be as high as or higher than the projections made by the Ministry of Finance. However, these have been consistently overly-optimistic — for example, the Government predicted $874 million and $532 million in returns during 2016 and 2015 (RDTL 2015, 63), whereas actual 2016 returns were $648 million, and negative $21 million in 2015, or less than half of the expected total (RDTL 2017b, 5); RDTL 2016d, 3).

Secondly, and more fundamentally, continued excess withdrawals are threatening the sustainability of the State’s only major source of finances. This effectively renders the question of whether borrowing is cheaper than withdrawing from the PF moot — the Fund is already rapidly losing value, and if it is completely gone or severely depleted ten years from now, Timor-Leste will be left with only its tiny non-oil domestic revenues to provide essential services and carry out the basic functions of government. The burden of debt will thus put even greater pressure on the country’s limited finances, and the likely subsequent cuts to public services will cause great hardship for the most vulnerable sections of the population.

Another key justification given by loan proponents is that borrowing can be used to finance key infrastructure projects that will produce social and economic returns that outweigh the cost of the loans. All except one of Timor-Leste’s currently-signed loans are for upgrading national roads (the other is for constructing drainage systems in Dili), which are being prioritised on the grounds that improving them will reduce travel times and transportation costs between Timor-Leste’s major population centres, thereby stimulating economic growth and improving access to services for people in rural areas.

However, while Timor-Leste’s roads are certainly in need of improvement, agricultural and other rural infrastructure are receiving comparatively little public investment; as the loan-funded roads connect Dili with the Indonesian border, Tibar port and regional towns, for now, the new roads built with borrowed money will mostly facilitate the flow of imported goods. Thus, rather than aiding rural development, the loan-funded road projects could instead damage domestic productivity by reducing the costs of imported agricultural products, ushering Timor-Leste further along the unsustainable path it is already on.

In addition, the largest planned loans in successive State Budgets are not for roads and other infrastructure which could help Timor-Leste’s people or economy — instead, they are for megaprojects with extremely dubious economic and social benefits. Out of a total $1.3 billion in projected loans spending between 2017 and 2021, $900 million is for just three projects: two components of the Tasi Mane petroleum infrastructure project — the south coast ‘highway,’ the Suai Supply Base — plus the expansion of Dili airport (RDTL 2016e, 30).
Independent analysts have argued that the social, economic and environmental costs of these projects, particularly Tasi Mane, but also Dili airport, far outweigh their potential benefits (Cryan 2015; La’o Hamutuk 2016, 9-11). In addition, the other, much larger components of the Tasi Mane project – the petrochemical refinery at Betano and the LNG processing plant at Beaçu – are not included in the above figures. If the Government continues to implement these projects as planned, and borrows to pay for them, Timor-Leste could accumulate billions of dollars in debt for projects with no guarantee of return.

How much will Timor-Leste have to pay back?

The 2017 State Budget contains appropriations to repay loans, but greatly underestimates future repayment obligations – the Budget projects that $8.2 million will be paid between 2016 and 2021 (RDTL 2016f, 379), whereas repayments for currently-signed loans will be $14 million in 2020 alone, nearly ten times the amount estimated in the budget for that year.

Although the Government says that it is aware of the dangers of becoming indebted to international agencies, and the Debt-Management Unit in the Ministry Finance claims to be carefully monitoring Timor-Leste’s indebtedness, there are no publicly available data on Timor-Leste’s debt obligations other than the erroneous figures in the State Budget books. Moreover, although State Budgets project figures five years into the future, most of Timor-Leste’s loans come with grace periods that extend beyond 2021, the last year covered by the budget documents.

Therefore, this researcher has attempted to calculate Timor-Leste’s future debt obligations, based on currently-available information from lenders and the Government. The analysis shows that, if Timor-Leste signs no additional loan agreements to those it has already contracted, it will have to pay back an average of $24 million per year between 2022 and 2036. If no other oil and gas fields
come online, the Petroleum Fund runs out in the mid-2020s, and domestic revenues increase by 9% per year starting in 2018, the State’s total annual income will average at about $420 million per year throughout the 2020s, meaning that around 6% of Timor-Leste’s domestic revenues will have to be set aside for loan repayments.

However, if the Government carries out all of the plans in the 2017 Budget and borrows a further $1.3 billion between 2017 and 2021, Timor-Leste will have to this over the coming three decades, in addition to around $400 million in interest. This will average at around $100 million per year on debt service from 2025-2035 – almost a quarter of all revenues. This will leave around $320 million – plus whatever remains of the PF – to fund Timor-Leste’s entire State Budget. If domestic revenues do not increase by 9% each year (and there is every reason to believe they won’t), there will be even less money available. Moreover, recurrent spending will be even higher by then, as Timor-Leste will have more, older infrastructure to maintain, and the population will have increased by about 20%.

If Timor-Leste can’t pay: default, bailout and austerity

Timor-Leste is therefore at increasing risk of falling into unsustainable debt. Although the Government hasn’t yet signed loan agreements for the largest projects, the fact that these projects have been repeatedly included in State Budget documents warrants serious analysis. This researcher is not alone in having concerns about Timor-Leste’s indebtedness – the international agencies which advise the Government (and lend to it) are also aware of the risks posed by Timor-Leste’s increasing debt and lack of alternative economic activity.

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6 This is highly optimistic - domestic revenues increased by an average of 5% between 2013 and 2016, according to State Budget documents, and this fails to take into account that a proportion of domestic revenues are fees which the Government pays to itself.

7 To put this in perspective, recurrent spending alone during 2016 was $857 million.
The Debt Sustainability Analysis (DSA) in the IMF’s 2016 Article IV Report warns that Timor-Leste is now at a moderate risk of falling into unsustainable debt (downgraded from ‘low’ since the previous DSA) (6). Further, without major adjustments to current plans, the report predicts that the Petroleum Fund’s balance will fall to about $6 billion by 2030, and it recommends that the Government reduce planned spending between 2017 and 2020 by half, while keeping expenditures under $1.4 billion during 2022-2026.

If the Government fails to heed this advice, and finds itself in a position where it is cannot or will not repay its debts, Timor-Leste may have to default. This is likely to lead to a loss of sovereignty, as the Government is forced to accept conditions which give creditor agencies control over domestic economic and social policies. Measures imposed to ensure repayment could include privatization of public assets, cuts to spending on healthcare, education and other social services, deregulation of local markets, and weakening of environmental and labour protection laws.

The slashing of state-spending in order to reduce fiscal deficits – otherwise known as ‘austerity’—has frequently resulted in increased poverty, unemployment and reduced access to basic services. Privatization of public services and deregulation also result in increased costs for basic goods and services such as fuel, healthcare and water. In addition, many countries – particularly resource-rich, developing countries – have used their natural resources as collateral, run up unsustainable debts, defaulted and fallen into debt-cycles which have proven extremely difficult to escape (Kretzmann and Nooruddin 2005).

Conclusion

Since Timor-Leste’s oil revenues will soon end, and non-oil revenues are not increasing fast enough to replace oil, Timor-Leste will soon face huge spending cuts in wages, social services and infrastructure. The austerity will be much worse if Timor-Leste has wasted large amounts of its resources on misguided projects and failed to make meaningful progress in improving basic services and the non-oil economy. With so little money available to meet people’s basic needs and pay for the basic functions on the state, repaying debt at the same time will put an even heavier burden on Timor-Leste’s people.

Diverting tens of millions of dollars to pay back creditors for projects carried out a decade previously, while slashing already under-funded public services will not only cause great suffering for many people, but it will likely lead to civil unrest and political chaos. This instability will make successful, sustainable development even more difficult. On the other hand, if Timor-Leste defaults on its debts, it will likely be forced to hand over sovereignty to its creditors, who will dictate its economic policies and how its resources are used, reversing decades of struggle for self-determination.

All Governments borrow, and Timor-Leste could use concessional loans to its advantage; however, borrowing must always be coupled with sensible, sustainable fiscal and social policies which guarantee that the loans can be paid back without impacting essential services. Therefore, Timor-Leste’s policy makers must evaluate major projects – and its plans to borrow for them – to determine their economic viability, at the same time as investing heavily in basic infrastructure and essential services, particularly in rural areas, and making serious efforts to develop agriculture and small industries to reduce imports and create employment.
Bibliography


