# Timor-Leste

Economic growth slowed in 2015 as fiscal stimulus eased. Growth is expected to accelerate in 2016 and 2017 on rising public and private investment, but declining oil production highlights the need to diversify the economy. A young population lends Timor-Leste great potential to raise its long-term growth prospects by investing in human capital and encouraging broader participation in the labor market.

## Economic performance

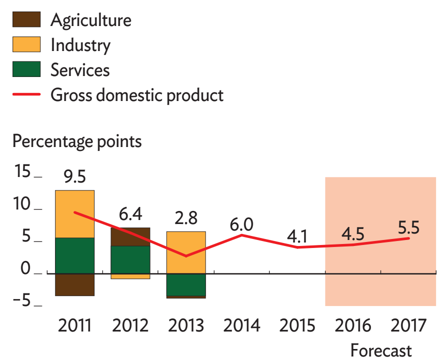
Growth slowed in 2015 as GDP excluding the large offshore petroleum sector expanded by an estimated 4.1% (Figure 3.35.1). Public spending, which has been the major driver of growth since 2007, declined modestly in 2015 with total expenditures excluding grants falling by an estimated 1.5%. Despite this decline, public spending excluding grants still equaled 91.2% of non-oil GDP (hereafter GDP). (Figure 3.35.2).

The composition of public spending changed significantly in 2015 as increased transfers offset declines on purchases of goods and services, and capital investment. Growth in spending on salaries and wages halved from an average of 12.4% per annum in 2009–2014 to an estimated 6.3% in 2015. Spending on goods and services was cut by an estimated 9.1% year on year to $389.7 million in 2015. Savings on fuel from lower oil prices accounted for 39.8% of the reduction in goods and services purchases, and there were also significant cuts to spending on operational expenses, building and vehicle maintenance, and domestic and international travel by government officials.

Public transfers increased by 48.1% and accounted for almost one-third of public spending in 2015. This increase was driven by a doubling of payments to veterans of the fight for independence to $124.6 million and a $133.4 million transfer payment to the newly established Special Administrative Region of Oe-Cusse Ambeno. The region has been granted significant autonomy and is working to establish a special economic zone that will encompass the Oe-Cusse exclave and Atauro Island. It allocated 85.6% of its budget to capital investments in roads, the airport, electricity upgrades, a small aircraft, and a passenger ferry.

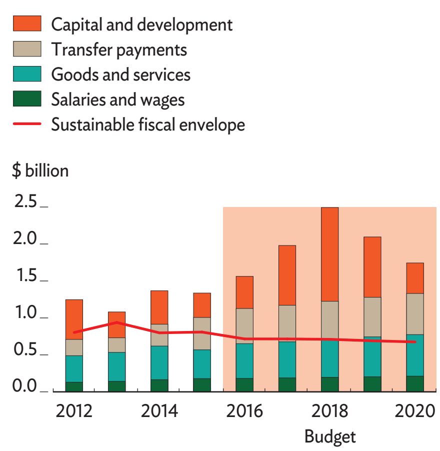
Capital investment through Timor-Leste's multiyear Infrastructure Fund fell by 22.8% to $239.4 million in 2015, though total capital investment is likely to have increased once investment by Oe-Cusse is included. Road and bridge upgrades took more than half of all Infrastructure Fund spending, and the electricity system a further 17.8%. Despite efforts to improve budget execution, a strong seasonal trend still marked capital disbursements (Figure 3.35.3).

### 3.35.1 Supply-side contributions to growth




*Sources:* Statistics Timor-Leste; ADB estimates.

### 3.35.2 Actual and budgeted expenditures




*Source:* Government of Timor-Leste, Budget Books, various years.

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Income from offshore petroleum fell significantly in 2015 but still supplied 84.9% of government revenues excluding grants. The volume of petroleum production exceeded the budget forecast by 16.6%, but petroleum revenues were 19.8% less than forecast. Investments through Timor-Leste's Petroleum Fund recorded a net loss of $21.4 million in 2015—far below the forecast net income of $915.8 million—due to stock market volatility and foreign exchange losses caused by the appreciation of the US dollar, the official currency. Domestic revenues represented 12.8% of GDP in 2015 and grew by 1.2% year on year as a small decline in tax receipts was offset by improved collection of fees and charges for government services such as electricity. Lower petroleum income and poor investment returns saw Timor-Leste's fiscal position swing from a surplus equal to 79.9% of GDP in 2014 to a deficit estimated at 14.2%. The Petroleum Fund balance consequently edged down to $16.2 billion by year-end, or $13,000 per capita.

The consumer price index rose by 0.4% in Dili and 1.3% elsewhere to yield a weighted annual national inflation rate of 0.6% (Figure 3.35.4). Price stability stemmed from falling international prices for key commodity imports, including rice and fuel, and the continued appreciation of the US dollar against the currencies of Timor-Leste's major trading partners in Southeast Asia.

Heineken broke ground on a new brewery and bottling plant due to begin operations late this year, and several economic indicators suggest good business conditions in 2015. Lending to the private sector increased by 10.5% with strong growth in construction and services. Business deposits in banks rose by 9.0%. Commercial electricity consumption climbed by 7.6%. International passenger arrivals rose by 5.3% year on year in the first 3 quarters.

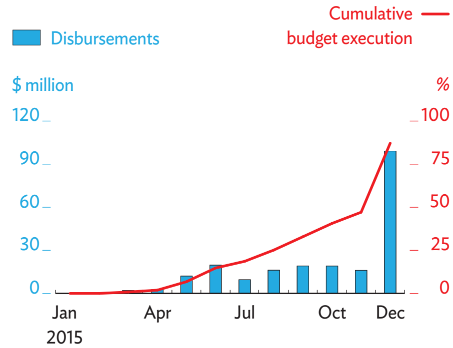
Initial analysis suggests that recent increases in the planted area of rice and maize were sustained in 2015 and that high rainfall allowed good grain harvests in the first half. An improved coffee harvest saw export volume increase by an estimated 51% from a low base in 2014, but depressed international prices sent earnings marginally lower.

Merchandise imports increased by an estimated 10.9% despite lower commodity prices and a stronger US dollar. The resulting merchandise trade deficit of $537.9 million equaled 36.6% of GDP, in line with recent years. Lower income from petroleum production and the poor performance of Petroleum Fund investments saw the current account surplus tumble from 75.1% of GDP in 2014 to an estimated 14.2% in 2015 (Figure 3.35.5).

## Economic prospects

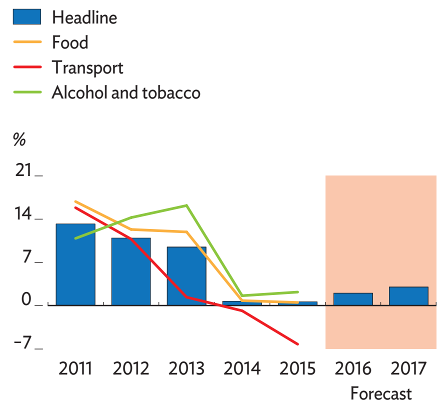
GDP growth is forecast at 4.5% in 2016, rising to 5.5% in 2017 on large public and private investments. A public–private partnership to build a new international seaport west of Dili is expected to break ground in 2017 and will require an investment of $290 million, equivalent to 19.8% of GDP in 2015. Private sector financing is set to cover more than half of this cost. The government is planning major investments in other economic infrastructure, while private consortia are preparing to invest in cement manufacturing and tourism. The onset of El Niño in late 2015

### 3.35.3 Infrastructure fund disbursements



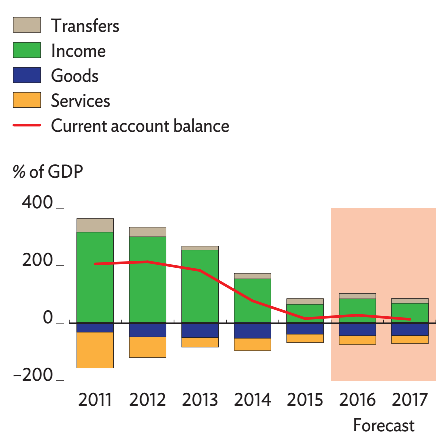

*Source:* Timor-Leste Budget Transparency Portal.

### 3.35.4 Inflation




*Sources:* Timor-Leste National Statistics Directorate; ADB estimates.

### 3.35.5 Current account components




*Sources:* Banco Central do Timor-Leste; ADB estimates.

is expected to hurt 2016 grain harvests enough to require increased food imports, but the coffee harvest is expected to be significantly better in 2016 than in 2015.

Inflation is projected to increase modestly to 2.0% in 2016 and 3.0% in 2017 as the deflationary effects of the strong dollar and low commodity prices ease. Declining oil income has highlighted the challenge of balancing public investment needs with the twin goals of long-term fiscal sustainability and intergenerational equity. The 2016 budget trimmed forecasts for petroleum production volumes and reduced the undiscounted forecast for petroleum revenues during 2016–2022 by 56.4% relative to the 2015 budget forecast (Figure 3.35.6). This has reduced the estimate of sustainable annual income from the Petroleum Fund to $544.8 million from the 2015 estimate of $638.5 million. Yet the 2016 budget assumes an average oil price of $71.2 per barrel in 2016–2020, without taking into account the sharp decline in oil prices since mid-2015.

The government had initially targeted a significant fiscal adjustment for 2016 and 2017 to cut budgeted expenditures excluding grants from $1.57 billion in 2014 to $1.30 billion in 2016 and $1.20 billion in 2017. However, this adjustment has been deferred, and the 2016 budget has spending at $1.56 billion this year and projects average annual spending at $2.08 billion for 2017–2020 to complete major capital investments. Reforms to boost non-oil revenue collection are being prepared but are unlikely to mobilize significant domestic revenues in the short term. Domestic non-oil revenues are expected to average 10.8% of GDP in 2016 and 2017.

While total budgets in 2015 and 2016 are very similar, the composition of planned spending has changed significantly. The allocation to Oe-Cusse in 2016 rose sharply by 63.3% as the region's capital investment budget expanded by 49.6%. This compares with a 6.9% increase in budgeted capital investment for the rest of the country. These commitments are accommodated by cutting the recurrent budgets of most line ministries, which has contributed to lower budgets for health (–21%), education (–10%), and agriculture (–32%).

The capital investment budget for major projects during 2016–2020 is equivalent to 248.8% of last year's GDP. More than three-quarters of this budget is allocated to roads and bridges, expanding Dili's airport, new public buildings, and the Tasi Mane project to develop a petrochemical industry on the south coast (Figure 3.35.7). Fully implementing this investment program would strain government management capacity and risk wasting scarce public resources (Figure 3.35.8). The weak outlook for oil prices may threaten the commercial viability of new state-sponsored petrochemical developments, so careful appraisal of the proposed investment is warranted.

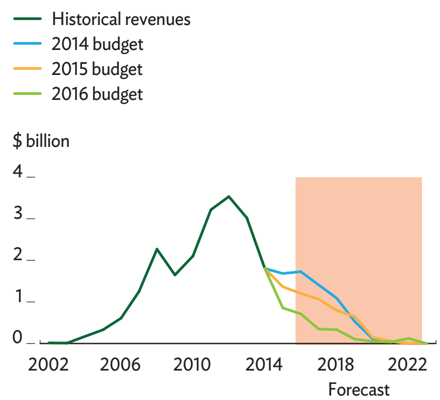
The 2016 budget law includes reform to restructure the Infrastructure Fund as an autonomous agency. Legislation specifying the details of the reform has yet to be tabled but could provide a timely opportunity to strengthen public investment management. In the short term, disruption associated with reform may delay the implementation of the 2016 capital budget. Over the longer term, reform may smooth budget execution and improve the quality of spending. The government

**3.35.1 Selected economic indicators (%)**

| | 2016 | 2017 |
|---|---|---|
| GDP growth | 4.5 | 5.5 |
| Inflation | 2.0 | 3.0 |
| Current account balance (share of GDP) | 26.1 | 11.8 |

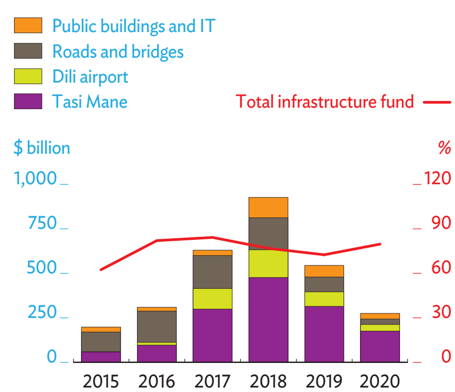
*Source:* ADB estimates.

**3.35.6 Adjustment to projected petroleum revenues**




*Sources:* Budget Books, 2014–2016; ADB estimates.

**3.35.7 Major infrastructure fund programs**




*Source:* National Budget 2016.

also aims to complete reforms to improve the business enabling environment and stimulate financial sector development before national elections in mid-2017.

Income from petroleum production and Petroleum Fund investments will continue to be important to the current account balance. Improved returns on Petroleum Fund investments will partly offset declining petroleum production. As a result, the current account surplus is seen to rise to 26.1% of GDP in 2016 as investment returns improve, before falling to 11.8% in 2017 as petroleum production declines.

## Policy challenge—realizing a demographic dividend

Timor-Leste can raise its potential growth rate by strengthening human capital formation and fostering labor market participation. Rapid population growth since independence has created a youthful nation, with 42% of citizens younger than 16. Timor-Leste's dependency ratio—the number of children and retired adults for each working-age adult—is one of the highest in the world. At the same time, adult participation in the labor force is relatively low.

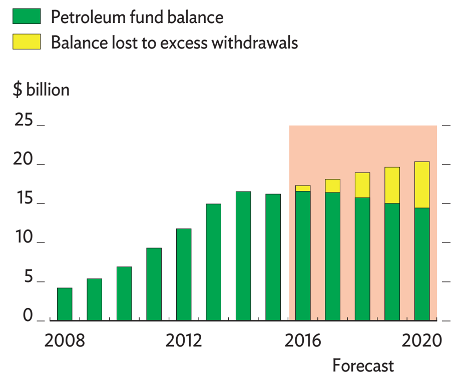
As the young mature, Timor-Leste's working-age population will expand by 2.8% compounded annually from 2015 to 2050, which is forecast to rein in the dependency ratio from 0.89 in 2015 to 0.61 in 2050. These trends can provide powerful economic stimulus if policy makes the most of Timor-Leste's demographic potential (Figure 3.35.9).

Expanded access to health care and education have produced clear gains since independence, with infant mortality halving from 2003 to 2009 and primary school enrolment rising from 65.6% in 2007 to 91.9% in 2013. However, malnutrition among young children remains high, and assessments of learning outcomes highlight the need to further strengthen preschool and primary education (Figure 3.35.10).

Investments to improve maternal and child health and strengthen education will raise long-term growth potential by improving future labor productivity. In the short term, growth may be enhanced and formal employment stimulated by reducing the costs employers face when hiring new workers. Timor-Leste's labor code imposes a range of restrictive and costly conditions on employers. The minimum wage of $115 per month may be high, given current workforce productivity and the large number of unskilled workers without jobs who may be willing to work for less.

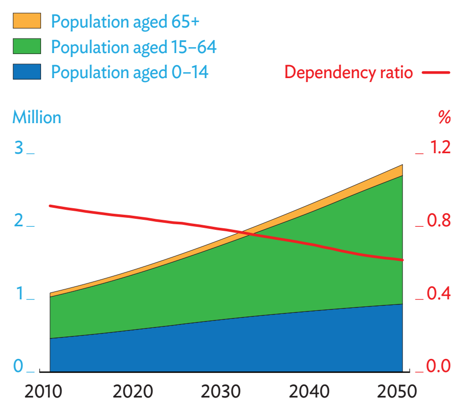
At present, only 11.2% of the working-age population is formally employed, and half of these workers are directly employed by the government. Regulations that impede workers' move from informal to formal employment can be counterproductive and should be reviewed. It is also important to consider how social assistance transfers, equal to 11.8% of GDP in 2015, modify incentives for human capital accumulation and labor force participation.

**3.35.8 Actual and forecast Petroleum Fund balances**



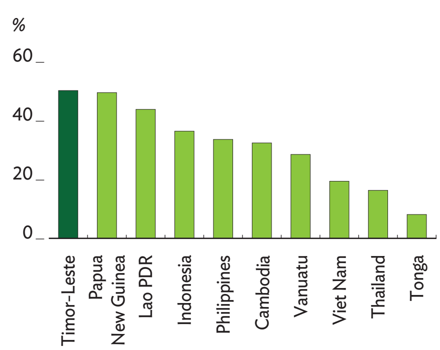

*Sources:* National Budget 2016; ADB estimates.

**3.35.9 Demographic projections, 2010–2050**




*Source:* Timor-Leste census, 2010.

**3.35.10 Incidence of stunting in children aged under-5**




*Note:* Most recent data during 2010–2014 is shown for each country.

*Sources:* World Development Indicators, Timor-Leste Food and Nutrition Survey 2013.