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DEMOCRATIC REPUBLIC OF TIMOR-LESTE

2013 Article IV Consultation

December 2013

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2013 Article IV Consultation with Timor-Leste, the following documents have been released and are included in this package.

- The **Staff Report** for the 2013 Article IV Consultation, prepared by a staff team of the IMF for Executive Board's consideration on October 23, 2013, following discussions that ended on June 17, 2013, with the officials of Timor-Leste on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 7, 2013.
- A **Debt Sustainability Analysis** prepared by the IMF.
- An **Informational Annex** prepared by the IMF.
- A **Staff Statement** of October 23, 2013 updating information on recent developments.
- A **Press Release** summarizing the view of the Executive Board as expressed during it October 23, 2013 consideration of the staff report that concluded the Article IV consultation with Timor-Leste.
- A **Statement by the Executive Director** for the Democratic Republic of Timor-Leste.

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DEMOCRATIC REPUBLIC OF TIMOR-LESTE

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

October 7, 2013

KEY ISSUES

Context. The economy is very dependent on natural resources. Government spending, funded by oil exports, has driven rapid non-oil GDP growth but with high inflation, a loss of competitiveness, and weak employment generation. The political situation is relatively stable with elections in 2012 and the long-term UN presence has ended but fragilities persist as poverty remains high. The Strategic Development Plan guides policies, aiming for upper middle-income status and significant poverty reduction by 2030.

Outlook and Risks. Non-oil GDP growth should average around 8 percent assuming structural reforms to catalyze the private sector and a sustainable fiscal stance. Key risks are: (i) fiscal slippages risk sustainability and inflation remains high, hampering diversification and poverty reduction; (ii) no agreement on the development of a major new oil field leads to the end of oil production by 2024; and (iii) lack of inclusiveness and poverty reduction results in social discontent and pressures for expansionary policies.

Policy assessment. Policy discussions focused on shifting to a higher quality and poverty reducing growth path with stability and sustainability. Policy challenges include:

- Ensuring a sustainable level of public spending that is well targeted on projects with high socio-economic returns and calibrated to reduce inflationary pressures and improve competitiveness.
- Developing an asset-liability management framework linking debt accumulation with the Petroleum Fund; avoiding off-balance sheet and non-concessional liabilities.
- Enacting structural reforms to create an enabling environment, promote access to finance, provide basic infrastructure, and investment in human capital.
- Strengthening the Banco Central de Timor-Leste's prudential and supervisory regime, preparing a crisis management framework, and developing a strategy for the financial system to support inclusive growth. Full dollarization remains appropriate for now given limited capacity for independent monetary and exchange rate policies.

Approved By
Brian Aitken and Dhaneshwar Ghura

Discussions were held in Dili during June 4-17, 2013. The staff team comprised Neil Saker (Head), Masahiko Kataoka, Luthfi Ridho (all APD), Maria Guerra-Bradford (SEC), Lukas Kohler (FIN) and Hans Beck (World Bank). Ben Bingham, Jakarta based Res. Rep., joined the mission and Ivan Luis Gonçalves de Oliveira Lima (OED) participated in some of the discussions. The mission met with the Minister of Finance, the Governor of the Banco Central de Timor-Leste (BCTL), senior officials, and representatives of the international community, private sector and civil society. A press statement was issued. After the mission, Mr. Saker presented the main findings at the Timor-Leste Development Partners Meeting that was attended by the international community, senior government officials, and civil society, and met with Prime Minister Xanana Gusmão.

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CONTEXT

1. **Timor-Leste has made substantial progress in overcoming the difficult challenges it has faced as a sovereign nation.** A number of key milestones have been achieved as it enters its second decade as a sovereign nation. The 13 year UN presence was concluded successfully in 2012 and parliamentary and presidential elections were held in mid-2012, with Prime Minister Xanana Gusmão re-elected to head a coalition government. A Strategic Development Plan (SDP) to guide Timor-Leste to upper middle-income status and a significant reduction in poverty by 2030 started in 2011. Timor-Leste is a founding member of the g7+ group of 18 fragile and conflict-affected countries and has taken a leadership role, pioneering the *New Deal* approach that is consistent with its SDP (Box 1). Developmental partners including the IFIs and bilateral donors have worked collaboratively with the Timorese authorities on policies and operational reforms required to achieve the goals of the SDP and New Deal.

2. **Nevertheless fragilities remain.** Timor-Leste is one of the most natural resource dependent countries in the world with large developmental needs. Oil revenues have been used to promote development but reserves with production agreements will end in 2024 and many uncertainties persist over potential production from new fields (Box 2).[1] Diversification is crucial to generate much needed employment and poverty reduction. The government has scaled up expenditures with the aim of kick starting the non-oil sector and developing forward and backward linkages from oil production. However, higher spending has faced significant capacity and absorptive constraints and has led to inefficiencies, the emergence of rent seeking behavior, and persistently high inflation that hurts the poor and undermines long-term growth.

3. **Governance frameworks are in place but policy implementation capacity is limited.** There is a relatively strong governance framework that promotes accountability with an active civil society. A well regarded Petroleum Fund (PF) has assets equivalent to over two times GDP and is compliant with the Extractive Industries Transparency Initiative and the Santiago Principles with firm parliamentary oversight. Oil revenues are solely channeled through the PF and withdrawals are limited by law to the Estimated Sustainable Income (ESI) that is calculated as 3 percent of estimated oil wealth—although excess withdrawals are allowed under certain circumstances. Under this fiscal rules based approach, expenditures are constrained by the ESI and non-oil revenues. Given full dollarization, this serves as the nominal anchor. Policy making is conducted by a small technocratic elite but implementation capacity is weak, constraining the effectiveness of policies and outcomes.

RECENT DEVELOPMENTS

4. **The non-oil economy has grown rapidly averaging over 12 percent from 2008 to 2011 allowing per capita incomes to steadily increase**.[2] Domestic demand was driven by the rapid

[1] Production is mainly gas although some liquids are produced. For simplicity, oil is used here to denote the sector.

[2] GDP data for 2012 have yet to be released. The authorities projected non-oil growth of 10.6 percent (in the 2013 Budget Book). Staff expects a downward trend in the growth momentum due to a significant under-spending on

(continued)

increases in government current and capital spending that also fueled high import growth. On the supply side, growth was led by sectors that were highly dependent on government spending such as construction. Conversely, the contributions from labor intensive sectors such as agriculture and manufacturing have been weak. As a result, living standards appear not to have increased in line with GDP growth indicating a lack of inclusion (Box 3).

5. **Despite full dollarization, inflation has risen, touching 15.4 percent in 2011.** Inflation moderated in 2012 but is still running at well over 10 percent –much higher than in other fully dollarized economies. Initially the high inflation was driven by high international commodity prices (in dollar terms). More recently it appears to reflect the interaction of strong demand led by government recurrent expenditures and structural bottlenecks (Box 4).

6. **High levels of government spending have risked sustainability but revised budgetary plans in 2013 now anticipate a substantial moderation.** Persistently large non-oil deficits at over 70 percent of non-oil GDP have been funded by the PF with large excess withdrawals at over 100 percent of the ESI justified by the policy of scaling up investment to promote development. The 2012 and 2013 budgets set out very ambitious spending plans with expenditures stabilizing at around $2 billion to 2018. This would be more than double the revenue from the ESI and non-oil taxes necessitating high levels of excess withdrawals from the PF and borrowing on concessional terms. Continuation of these trends would not be sustainable as net public sector assets would steadily fall (see the accompanying DSA). However, preliminary 2012 data show a significant under-spending on capital items due to capacity constraints but a continued rise in current spending. The unsustainable nature of the ambitious plans has now been recognized by the authorities and, in the revised medium-term budgetary plans (the so-called "Yellow Road" process), adopted by the Council of Ministers in June 2013, spending plans were significantly scaled back, starting in 2013.[3]

OUTLOOK AND RISKS

7. **The medium-term growth outlook will hinge on the pace of fiscal consolidation, the reprioritization of expenditures, and sound implementation of structural reforms.** These are required to expedite the transition to higher quality private sector led growth. Given the declining trend of oil production, overall GDP growth will be weak and volatile but real non-oil GDP (which directly affects living standards and can be influenced by policies) should average around 8.5 percent—significantly lower than the double digit rates experienced from 2008 to 2011. However, with the right policies, lower growth will be of a higher quality with sustainable job creation and poverty alleviation and more inclusive and broad-based growth. Under the baseline

capital projects with a projection of around 8 percent. However, there are downside risks given the considerable statistical uncertainties, especially relating to agricultural production and other hard-to-measure private sector activities. The end of the UN peacekeeping role may have had a more significant second round impact on growth than the headline numbers would imply.

[3] The Yellow Road process is an internal discussion of budgetary plans, albeit with contributions from outside parties, and was conducted just before the mission. In the process, the overall expenditure envelope has been substantially reduced compared to the original 2013 budget plans. The reprioritization of expenditures is still underway.

scenario the reprioritization of government expenditures and reforms would boost the private sector, with a pickup in agricultural and manufacturing growth plus robust growth in private services providing an offset to the declining contribution from public administration and construction. As a result inflation would fall and real living standards rise. A higher growth scenario in which non-oil GDP growth averages over 10 percent might be achievable if deeper reforms and expeditious implementation of basic infrastructure projects induce a strong private sector investment response.

8. **Given the environment, there are a number of downside risks.** A weaker pace of structural reforms and fiscal consolidation, and poor implementation of basic infrastructure projects (especially roads and ports) would lead to a slower growth path, especially if the weaker reform environment and high inflation result in a poor private sector investment response. Spillovers from adverse global developments would likely have a relatively limited impact in the short term given the low integration into global (non-oil) trade and investment networks. The impact of short-term oil price volatility on the budget is smoothed by the ESI rule. However, longer-term global economic instability and/or a permanent fall in oil (and especially) gas prices would undermine the oil sector's prospects and reduce inward investment. The resulting fall in net oil wealth, and thus the ESI, would necessitate a tighter fiscal stance and slower GDP growth.

POLICY DISCUSSIONS

9. **Policy discussions focused on the challenge of shifting to a higher quality growth path.** Given the large developmental needs amid persistently high poverty levels and the emergence of macroeconomic imbalances, policies need to evolve. Consistent with the objectives of the SDP and the Fragility Assessment conducted under the New Deal, this will involve three broad elements. Firstly, the fiscal policy challenge of reining in public expenditure to that consistent with the authorities' fiscal rule, improving its quality to promote inclusive growth through changes in the composition of spending, and diversifying revenues. Secondly, the complementary reforms needed to catalyze the private sector to induce more labor-intensive growth that reduces poverty. Thirdly, financial sector development to support a higher quality growth path driven by the private sector; this will require, inter alia, better access to finance and improved regulation and supervision.

A. Bolstering the Macroeconomic Framework

10. **The high government spending in recent years has led to macroeconomic imbalances as well as unbalanced growth and a lack of inclusion.** These macroeconomic imbalances have been manifest in a number of ways including very high non-oil fiscal deficits, inflation stabilizing at high levels, an erosion of sustainability, and a significant decline in competitiveness. Although data limitations and uncertainties over future resource production limit the scope for macroeconomic balance type analysis, high inflation, the appreciation of the REER, the very low level of non-resource exports, lack of foreign direct investment in labor intensive sectors, and rising imports suggest that the underlying exchange rate is overvalued. In a fully dollarized economy, this indicates that the fiscal stance has been too expansionary given absorptive capacities.

Unsustainable debt dynamics and persistently high inflation

11. **Continuation of recent expenditure trends is not sustainable**. Staff's analysis of potential illustrative scenarios indicates that a continuation of the 2013 budget plans that included high excess withdrawals from the PF would significantly run down the net assets of the public sector (Text Table 1, scenario A) whereas strict adherence to the authorities fiscal rule (scenario B) is fully sustainable. Given that after 2024, investment income derived from the PF would be the main source of revenue, a continuation of expenditure trends in excess of investment income would lead to a depletion of net assets as debts steadily rise and assets fall. In addition, inflation has resulted from high levels of government spending especially on current items including transfers. This has reduced competitiveness, hampering employment generation, undermining social cohesiveness and generally exacerbating fragilities as the poor are hurt the most.

12. **Staff welcomed the revised budgetary plans that anticipate a stabilization of public expenditure** (Figure 1). Under this framework, budgeted expenditure (excluding donor projects) would stabilize at around $1.3 billion in the medium term compared with around $2 billion in the original 2013 budget. On the revenue side, non-oil revenues are targeted to increase by 15 percent a year from a low base with more intensive tax reforms. As a result, the non-oil fiscal deficit steadily falls from a budgeted 92 percent in 2013 to 27.5 percent by 2018.

13. **Full and consistent implementation of these measures will ensure the sustainability of the fiscal position and the value of the Petroleum Fund preserving inter-generational equity.** Under the Yellow Road baseline, the authorities' fiscal rule will be met and borrowing needs would steadily fall and end by 2023 (scenario C). This would allow external and public debt to remain sustainable (Supplement 1). Lower expenditures and higher non-oil revenues mean that the non-oil funding gap would steadily fall and so excess withdrawals from the PF and/or debt accumulation would fall over time. This allows the value of the PF to stabilize in the medium term. The more restrained fiscal policy now envisaged would also help dampen inflationary pressures curtailing the recent trend of substantial appreciation of the real effective exchange rate.

Authorities' Views

14. **The authorities agreed with the staff analysis on the unsustainable and inflationary nature of the budgetary plans and have built a consensus on the need for restraint.** Officials noted that the ramp up of spending in recent years has produced positive results e.g. the installation of the national electricity grid, but recognized that capacity constraints have been reached in spending ever increasing budgeted funds. They were particularly concerned that the scope for rent seeking activities has increased.

15. **The new expenditure plans focus on projects that have a clear impact on poverty reduction (e.g. basic infrastructure and human capital development) while maintaining value-for-money and the elimination of waste.** The authorities recognized that moving to higher quality growth that is consistent with the SDP objectives of inclusive and non inflationary economic development and with the aspirations of the New Deal would be best served through deeper structural reforms and a focus on creating an enabling environment. The fact that the Council of

Ministers has approved the new stance is an important sign that there is political consensus on this approach. This will help to minimize the risks of fiscal slippages in years ahead.

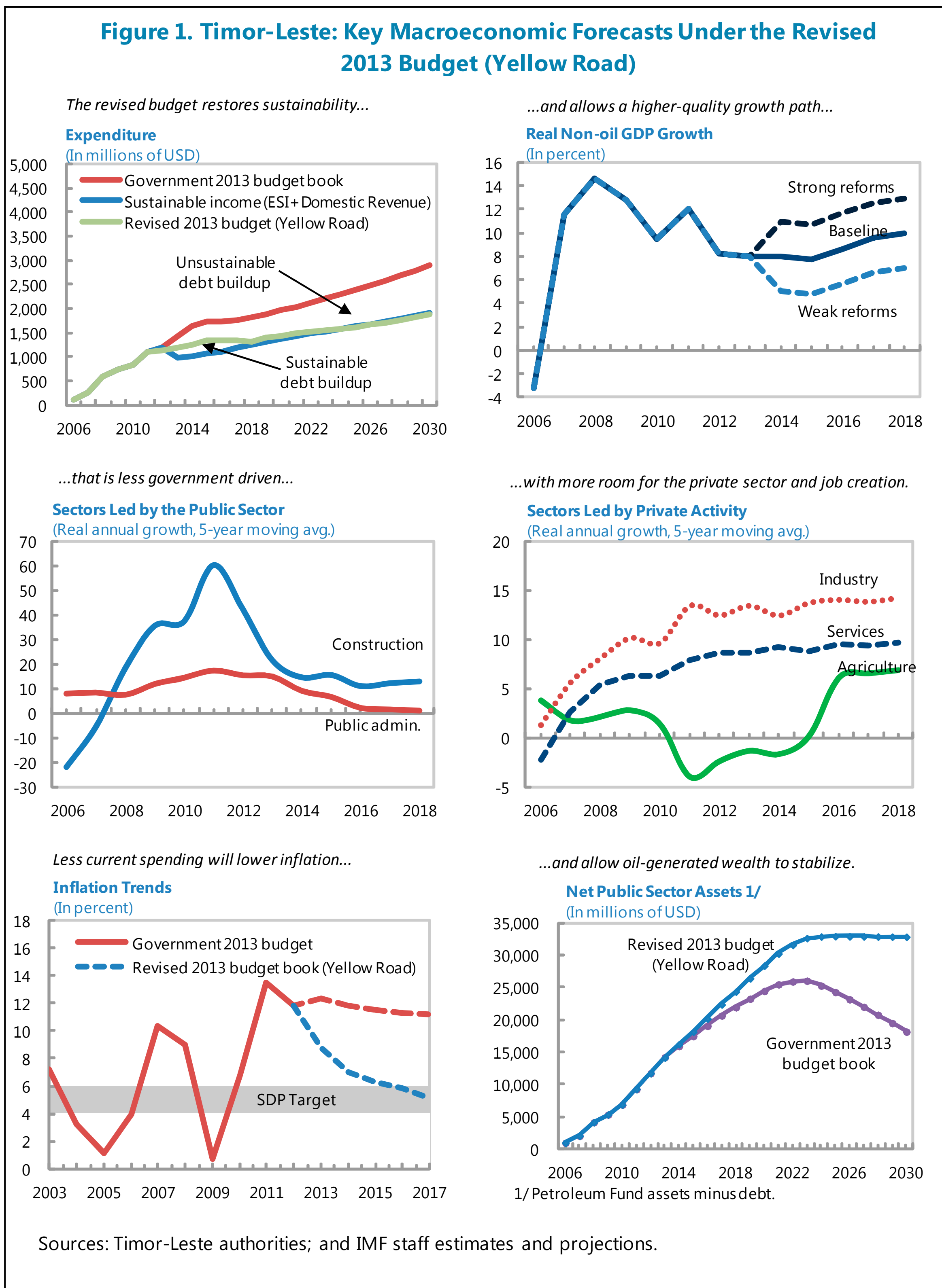


Figure 1. Timor-Leste: Key Macroeconomic Forecasts Under the Revised 2013 Budget (Yellow Road)

Sources: Timor-Leste authorities; and IMF staff estimates and projections.

Text Table 1. Illustrative Scenarios of Sustainable Macroeconomic Frameworks 1/

Scenario	Impact on PF	Impact on Debt	Growth Outcome	Inflation Outcome	Comments
A. 2013 Budget Framework. 2/ 3/	Gross assets are steadily depleted reducing investment income inflows.	Debt stock rises rapidly and net assets are steadily depleted.	Higher expenditures lead to higher GDP levels but with reduced private sector development. Risks of sharp slowdown when debt limits are reached.	High inflation as absorptive capacity is exceeded. Competitiveness is undermined.	Not sustainable. Scenario is eventually constrained by the ability to borrow on concessional terms. Required policy adjustments would be destabilizing.
B. Expenditures limited by ESI withdrawal rule.	PF value stabilizes in 2024 and is maintained in real terms. Intergenerational equity is satisfied.	No debt is undertaken.	Growth is substantially reduced until the private sector picks up.	Low inflation that is positive for competitiveness and poverty reduction.	Fully sustainable outcome but provision of required basic infrastructure may be more limited reducing growth prospects.
C. Yellow Road budget framework: expenditures stable at around $1.3 billion and limited concessional borrowing. 3/	PF value stabilizes in 2024 and is maintained in real terms but at a slightly lower level than in scenario B. Intergenerational equity is satisfied.	Slow pace of debt accumulation.	Growth can be higher than in scenario B if debt is used efficiently on growth enhancing projects.	Inflation falls toward target by 2018.	Sustainable outcome with low inflation assuming debt is used for growth enhancing investments. Use of concessional debt allows the involvement of IFIs improving governance.

1/ Assumes that oil production ceases by 2024 and no new production comes on stream.
2/ Assumes continuation of expenditures at 25 percent of GDP.
3/ Funding in excess of ESI is undertaken via concessional debt rather than excess ESI withdrawals given the lower interest rate on concessional debt compared to the expected higher yields on the PF.

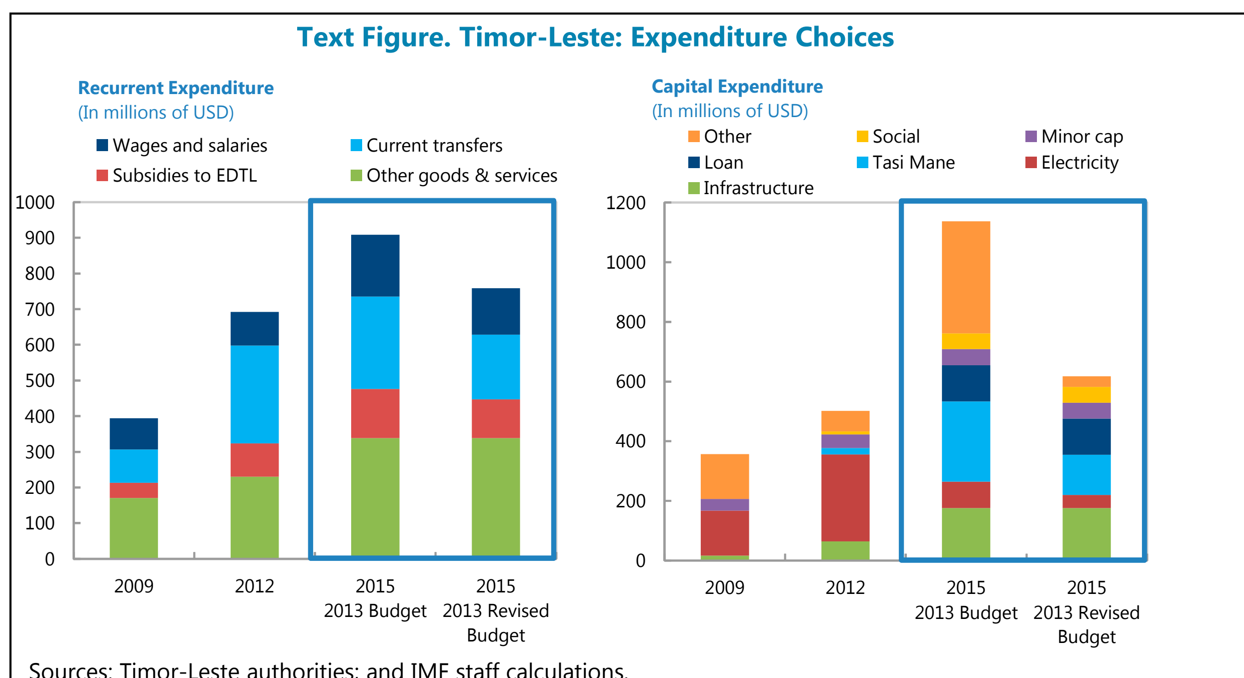
B. Fiscal Policy

Expenditure Choices

16. **The new budget framework implies a sharply lower spending path than that envisaged in the 2013 budget plans.** After significant under-spending in 2012 especially on capital items but a continued rise in current spending, expenditures will be stabilized at around current levels and will fall in GDP terms. The revised plans will provide an opportunity to improve the overall quality of expenditure that is consistent with promoting efficiency and inclusive poverty reducing growth as per the SDP and provide rapid and sustainable benefits in terms of high growth and job creation. These effects could come through: (i) a greater prioritization of public investment on projects that will generate sustainable employment generation in the private sector (especially on basic infrastructure such as roads and ports plus human capital enhancing projects especially on health and education); and (ii) a more general focus on value for money in budget planning and execution. However, realizing the new expenditure path will require some difficult policy choices:

- Capital expenditures: there will be a trade-off between greater spending on high profile capital-intensive projects and increased funding of basic infrastructure (roads, port and airport) with direct links to export and high employment generating sectors (Box 5).

Text Figure. Timor-Leste: Expenditure Choices



Sources: Timor-Leste authorities; and IMF staff calculations.

- Recurrent expenditures: the challenge will be to restrain the growth of the wage bill and better target subsidies and transfers to generate space for much needed higher spending on operations and maintenance and provisions of essential supplies in health and education. It will be important to contain electricity subsidies as these could well rise sharply as consumption will increase in line with newly installed capacity. Nevertheless, cuts to subsidies and transfers will need to be at a measured pace given the need to maintain social cohesion.

17. **Staff welcomed the authorities' plans to raise non-oil revenues and continued reform of public financial management.** On the revenue side, the main priorities are to support revenue diversification and strengthen the capacity in tax administration to limit tax evasion. The former would be based on the introduction of new taxes e.g., a VAT in line with recent FAD TA advice. This would broaden the tax base, raise buoyancy, and limit the dependence on (declining) oil revenues. The main impediment to the introduction of VAT so far has been poor capacity at the Ministry of Finance (MoF). This is being addressed through staffing reforms but further TA on implementation would be useful. It is important to ensure that customers pay equitably for electricity usage as the de facto large subsidy will rise as new capacity is utilized. There has been progress made in strengthening expenditure and cash management at the MoF. The next step is to strengthen budget planning and implementation capacity in line ministries. TA donors are working with the MoF on these areas.

Developing an Asset-Liability Management Framework

18. **The government will need a strong asset-liability management framework as its balance sheet becomes more complex.** In the period ahead, the government is planning to take on new debt liabilities and enter into public-private partnerships (PPPs) that may generate contingent liabilities.[4] On the asset side, there are plans for government and/or government owned entities to take equity positions in major capital projects. Key considerations are:

- Public debt. Contracting concessional debt from developmental partners is beneficial as it could improve the quality and returns of capital projects. Non-concessional debt should be avoided.

- Off-budget investments. Major capital-intensive projects tend to have complex financing structures and the cost-benefit of public participation in these projects can be difficult to assess. All such projects should be transparent and subject to the full scrutiny of the Major Projects Secretariat and the Audit Court whose capacity needs to be strengthened. Off-balance sheet liabilities, including by state owned companies should be avoided.

- Petroleum Fund. The revised Petroleum Fund Law allows a shift in strategic asset allocation away from high quality bonds toward global equities with a 50:50 split allowed with an intention to maximize returns. This may be appropriate from a long-term inter-generational perspective, but the risk-return trade-offs in inherently volatile global financial markets need to be carefully considered. The new provision to allow the PF to guarantee government debts (up to 10 percent of the PF's assets) is potentially risky and should be avoided as should any domestic investments.

[4] PPP projects currently under development comprise the new Dili Port and the enhancement of Dili Airport. These are both important projects, with the PPP tender for the new Port at Tibar Bay launched in August 2013 and work on-going for the airport. The authorities are working with IFC. The details have yet to be finalized but it is estimated that investment in the Port will be $300-400 million with significant private sector participation. The overall size of the airport project is not yet finalized but the expected level of private investment is likely to be much smaller.

Authorities' Views

19. **The authorities agreed that a reprioritization of expenditures is warranted.** This would align expenditures with the SDP's key objectives of poverty reduction and sustainable growth while reducing waste, increasing value-for-money and improving employment generation. Particular focus is planned on reducing subsidies especially regarding the electricity sector, limiting transfers, and on civil service reforms. The capital budget will also be assessed much more carefully to prioritize key projects that have high rates of return and employment generation but the scope of the Tasi Mane project (Box 5) has yet to be fully determined. The MoF plans to raise non-oil tax revenues through better administration and the introduction of a VAT in line with recent Fund TA. Measures to improve capacity in tax administration are underway and this will smooth the introduction of the VAT.

C. Boosting Growth by Catalyzing the Private Sector

20. **Given fiscal retrenchment, growth can only come through private sector development requiring steps to improve competitiveness and address structural bottlenecks.** The "organic" private sector that is not linked to government contracts remains very small. Impediments to private sector development include low human capital, bureaucratic obstacles, lack of contract enforcement, and limited access to finance. This pattern reflects structural problems and a number of binding legacy issues as well as the existence of "Dutch disease" type issues. The government has several initiatives underway to boost quickly the private sector and stimulate entrepreneurship including the establishment of a one-stop shop for new businesses and the development of PPPs.

21. **Staff argued that the pervasive state role needs to be carefully managed within a sound governance framework and based on sound cost-benefit assessments.** Developing the fundamental prerequisites for growth and creating an enabling environment and complementary infrastructure are vital for private sector development. Some steps could be done relatively quickly in order to allow a more rapid transmission of growth to the overall population. This is particularly so in the agricultural sector where new and better maintained roads, irrigation facilities, and technical training could produce an immediate supply response. Staff noted that the international experience with establishing institutions to promote development such as special economic zones (SEZs) and development banks is mixed with successful outcomes focusing on overcoming clear market failures with proper governance, full transparency and accountability. Staff noted that the priority should be to extend required key reforms across the country rather than partially through the establishment of SEZs. Regarding the development bank, considerable work will be needed to build the institutional and operational capacity to ensure that this would operate efficiently and without risking the public sector balance sheet. TA, especially from countries that have had successful track records regarding SEZs and developmental banks, would be useful.

22. **With regard to labor cost competitiveness, the key priority is to reduce general and wage inflation in the economy.** Lower spending plans will facilitate this, but minimum wage levels in Timor-Leste should be brought in line with peers in the ASEAN region as they now are at levels that discourage foreign investment in labor intensive sectors. In addition, progress is needed regarding:

- Logistics. Investment in basic transport infrastructure (roads, ports, and airport) remain a high priority requiring a mix of investment strategies covering self funded, donor funded, and PPPs.

- Structural Reforms. Priorities include implementation of the Land Law, improving the investment climate by reducing red tape, streamlining the Investment Law, and increasing legal certainty especially with regard to contract enforcement.

Authorities' Views

23. **The authorities agreed that the private sector needs to develop and become independent of the government.** There was widespread recognition that reliance on government contracts led to rent seeking type behavior and inefficiencies. However, the authorities were confident that recent steps such as the establishment of a one-stop shop for investors and the PPP financed airport and port projects will encourage considerable foreign investment that will, in turn induce domestic investment in areas such as cement production. The authorities noted that these developments will help boost growth prospects offsetting the contractionary fiscal impulse.

D. Monetary and Exchange Rate Policies

24. **The use of the U.S. dollar remains appropriate.** This implies that to improve competitiveness that has been eroded by high inflation a restrained fiscal stance is required. Longer-term, the SDP raises the possibility of Timor-Leste introducing its own national currency. The pros and cons of any reform to the exchange rate arrangement will need to be carefully considered. Staff noted that analytically, there are two separate although interrelated issues, viz.: (i) issuing a national currency; and (ii) the exchange rate arrangement with a wide spectrum of options. Issuance of a new national currency that is linked to the US dollar in a hard peg arrangement (for instance, a currency board) would have conceptual similarities to the present arrangement of full dollarization. Softer pegs or more flexible arrangements would imply more space for independent monetary policy and act as a buffer in case of oil shocks.

25. **However, such moves would require a number of institutional and operational prerequisites including the sustained enhancement of the BCTL capacities.** These would inevitably take considerable time to be implemented. In any case, a sound and prudent fiscal policy is needed and the consistent adherence to the Yellow Road framework is a positive step. The introduction of the 100 centavo coin (replacing the one U.S. dollar note) and its usage will be a useful learning experience for the BCTL as it assesses potentially more fundamental innovations.

Authorities' Views

26. **There was no firm view within government on the need to move away from full dollarization.** It was uniformly accepted that it is too early for any fundamental change and that further research is needed on the various options. MoF officials noted that the prudent fiscal stance as set out in the Yellow Road process would help restore competitiveness in tandem with the provision of basic infrastructure and structural reforms that will lower the high cost base. The BCTL

described on-going work with partner central banks on the theoretical and practical issues regarding the introduction of a currency and the most appropriate long-term exchange rate arrangement.

E. Financial Policies

27. **The financial sector remains small with low penetration rates and limited access to finance for the private sector.** The banking sector comprises four banks and a number of micro credit institutions. Three banks are branches of international banks (from Australia, Indonesia, and Portugal) and there is one local bank (that is government owned) that was recently upgraded from a micro credit institution—it is the only bank with its own capital base. Banks maintain substantial excess liquidity that is placed abroad as lending is problematic. Judicial enforcement of problem loans is poor and NPLs are high, especially at one particular bank as the result of problems associated with the political violence in 2006. Reflecting high risks, interest rate spreads are wide.

28. **Safeguarding the soundness of the banking system will become increasingly important as it grows and develops.** The main priority is to continue to strengthen prudential supervision, including the development of a crisis management framework. The placement of most of the deposit base overseas with parent banks raises country, counterparty, and concentration risks. It will be important to avoid the risks inherent in lending to priority sectors through the state-owned bank. Progress in enhancing the anti-money laundering and combating the financing of terrorism framework as identified by the mutual evaluation conducted by the Asia/Pacific Group on Money Laundering in 2012 will also be important. Key actions include the enactment of appropriate legislation, the establishment of a Financial Intelligence Unit, and the mobilization of the anti-money laundering framework to further support the authorities' anti-corruption efforts.

Authorities' Views

29. **There was general agreement that the financial system has not supported growth and policies need to be put in place to create the incentives for lending.** These include legal changes such as the introduction of the Land Law to boost the mortgage market and enacting a law on electronic banking, institutional changes such as modernizing the payments system, and improving the oversight role of the BCTL. A new Financial Sector Master Plan will address the weaknesses. Senior management at the BCTL agreed that an increased engagement with the Fund would be useful and requested a TA Needs Assessment mission to identify priority areas for enhancement.

F. Other Issues

Developing Official Statistics

30. **Data shortcomings due to limited capacity hinder analysis but there are notable strides in putting in place key data series and statistical reporting is steadily improving.** National income accounts to 2011 are now available for the first time but substantial ongoing revisions and lack of timeliness limit the analysis of trends and structural changes. The inflation methodology has been substantially improved but more work needs to be done regarding the accuracy and timeliness of poverty data. Work is on-going to improve fiscal reporting in line with GFSM 2001. Staff

welcomed the participation in the Fund's General Data Dissemination System (GDDS) in October 2012. This will help develop the statistical system supported by continued TA from the Fund in collaboration with other donors.

TA Needs

31. **Despite high TA delivery, the next step, consistent with the New Deal's focus on country ownership, is to boost knowledge transfer and avoid over dependence on expatriate staff.** TA has been received in many policy and operational areas and the IFIs have worked collaboratively alongside bilateral donors in line with the objectives of the SDP. The IMF has provided high levels of TA to the MoF and the BCTL in core macroeconomic areas; the WB has recently concluded its Country Partnership Strategy that is fully aligned with the goals of the SDP; and the ADB is, inter alia, supporting the development of key infrastructure and human capital enhancing projects. To facilitate knowledge transfer and lower dependency, the training of local officials is vital. The conference on natural resource management held in Dili in September 2013, co-hosted by the IMF with the ADB, JICA, and the WBG provided a good opportunity to highlight international experience and best practices.

32. **The IMF stands ready to continue to provide the authorities with technical assistance in its areas of expertise.** In addition to the assistance to the BCTL to strengthen supervision, planned technical assistance includes on estimating the ESI and Petroleum Fund asset management. Assistance on the development of an asset-liability management framework would be useful. The authorities also requested TA on integrating national accounts and the balance of payments, in addition to continued TA on developing the statistics infrastructure and on fiscal reporting.

STAFF APPRAISAL

33. **The strategic challenge is to convert oil wealth into long-term sustainable growth, generating broad based increases in living standards—essential given the high poverty rate.** After six years of strong non-oil GDP growth driven by large increases in public expenditure, the next step is to generate a shift to higher-quality growth in which an organic private sector, operating independently from government contracts, takes the lead. This is required as the economy needs to generate employment opportunities for a fast growing labor force to ensure broad based poverty reduction and as the government has reached capacity limits in productively spending more.

34. **Staff welcomed the more prudent budgetary plans but stressed that potential slippages need to be contained.** This framework, that is consistent with the SDP's key objectives, will: (i) reduce inflationary pressures, help tackle poverty and improve competitiveness; (ii) ensure sustainability and preserve the PF assets; and (iii) improve the quality of public expenditure. Provided structural reforms are accelerated, this framework is consistent with strong growth in household consumption, lower inflation, and declining poverty. Slippages need to be contained to avoid the risks to sustainability, especially as the outlook for gas prices remains highly uncertain—a sustained fall would necessitate further fiscal restraint.

35. **Realizing the new expenditure path will require policy choices.** In general, there is a need to maintain expenditure on high priority programs that can generate sustainable growth and poverty reduction plus a greater focus on cost-benefit analysis, value-for-money and budgetary planning and execution. On the capital side, funding of basic infrastructure (roads, port and airport) should be prioritized over capital-intensive projects with low employment generation. On the recurrent side, the challenge will be to generate space for much needed higher spending on operations and maintenance and provision of health and education. This can be done via greater restraint in the wage bill, and better targeted subsidies and transfers.

36. **To protect wealth for future generations, the government needs to strengthen the asset-liability management framework as its balance sheet becomes more complex.** The government is planning to take on debt for the first time and enter into PPPs that may generate contingent liabilities and these need to be comprehensively assessed. On the asset side, plans to take equity positions in major capital projects need to be carefully evaluated to ensure that public participation is justified. The shift in strategic asset allocation toward equities by the PF needs to be properly managed with the priority toward capital preservation rather than maximizing returns.

37. **Catalyzing an organic private sector will become an increasing priority to shift the economy from public to private-sector led growth.** This will require steps to improve competitiveness and address structural bottlenecks and there are a number of steps that can be taken that will enhance living standards especially in the rural sector. With regards to labor cost competitiveness, the key priority is to reduce inflation and ensure that wage levels are in line with peers in the ASEAN region. Investments in basic transport infrastructure remain a high priority. Structural reforms need to be advanced and there are a number of institutional and operational considerations that suggest the piecemeal implementation via SEZs is unlikely to be optimal.

38. **The BCTL needs to enhance its capacity for core central banking activities**. In a number of key areas, the BCTL needs to upgrade its capabilities and the deeper TA engagement with the Fund is welcome. Safeguarding the soundness of the banking system will become increasingly important as it develops and TA in this area will be valuable. Regarding the possible move away from full dollarization, there was agreement that considerable further work is required regarding the pros and cons of issuing a national currency and the associated exchange rate arrangement. The introduction of the 100 centavo coin is a welcome step and learning opportunity for the BCTL.

39. **Further work on improving statistical data shortcomings due to capacity constraints is needed.** The production of disaggregated national accounts and improved CPI statistics are positive steps but their timeliness and accuracy need to be improved. The recent participation in the GDDS is welcome but the on-going development of a broader range of economic and social indicators, particularly regarding trends in living standards, would enhance analysis and better guide policies.

40. **It is expected that the next Article IV consultation with Timor-Leste will be held on the standard 12-month cycle.**

Text Table 2. Timor-Leste: Risk Assessment Matrix

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next one–three Years 1/ (high, medium or low)	**Expected Impact if Threat is Realized** (high, medium or low)
1. Delays regarding Greater Sunrise Field	**High** The demarcation of the maritime boundary with Australia is subject to international arbitration that could take some time to conclude. This will delay key decisions on the project's development.	**High** Long-term growth prospects would be curtailed as potential foreign investment flows would be limited. Lower future revenues means a firm limit on spending plans to maintain fiscal sustainability.
2. Over investment in projects with low returns	**Medium/High** This could be due to the implementation of capital-intensive projects with overly ambitious cost-benefit analysis. Strong oil prices may heighten this trend but relatively strong governance may be an offset.	**High** There is a high opportunity cost. Capital-intensive projects that have limited linkages with the rest of the economy mean that job creation and poverty reduction is limited.
3. Higher inflation	**Medium** Inability to restrain current expenditures as planned raise inflation, which is already too high, back to close to 20 percent as the absorptive capacity of the economy is limited. This hurts the poor and limits diversification.	**Medium** High inflation adversely affects the poor leading to social discontent. Higher subsidies and transfers to compensate would place pressure on spending as would higher public sector wages.
4. Political Instability	**Medium** Instability could break out within the ruling coalition or through popular protests. These could be triggered by public perceptions that oil wealth is not trickling down, not reducing poverty but raising inequality and corruption.	**High** Higher rent seeking behavior and more pressures to raise current expenditures and lower the quality of public investments. Foreign investment, vital for new oil production and diversification may be discouraged.
5. Global economic shocks	**Medium** Global economic weaknesses emanating from: (i) a reemergence of tensions in the euro area; (ii) a deeper than expected slowdown in emerging markets: (iii) or a sharp slowdown in China.	**Low** These could lead to lower global trade and capital flows, weak demand for oil and accommodative monetary policies. The impact is limited by low levels of non-oil trade and capital account integration.
6. Financial sector contagion Financial stress in the euro area re-emerges	**Medium** This could be triggered by stalled or incomplete delivery of national and euro area policy commitments The main banks are foreign branches of international banks (one is from a eurozone crisis country) and place high levels of excess liquidity with their parents.	**Medium** Renewed global shocks that affect international banking operations could impact on local liquidity conditions. No crisis management or contingency planning frameworks are in place. Prolonged weakness in credit supply would limit private sector growth and diversification efforts.
7. Global oil price risk	**Low** Global oil shock triggered by geopolitical events (driving oil prices to $140 per barrel). Conversely, low prices for gas could emerge as a result of technology-induced new global supply.	**Medium** PF acts a stabilizer to limit short-term volatility. However, fiscal discipline may be more difficult in a high price scenario. If prices trend downwards, expenditure plans will need to be scaled back to limit risks to sustainability.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities.

Box 1. The g7+ and Timor-Leste

Timor-Leste is a key member of the g7+ grouping that is becoming increasing influential in the global development debate. The g7+ was formed in 2010 and comprises 18 countries that are or have been affected by conflict and are now in transition to the next stage of development. The main objective of the g7+ is to share and learn from experiences and to argue for reforms to the way the international community engages in conflict-affected states. The Minister of Finance of Timor-Leste is currently the Chair of the g7+.

In an important step, the g7+ issued the *New Deal for Engagement in Fragile States* in Busan, Korea in 2011. This calls for more effective engagement between fragile countries and developmental partners to support inclusive country-led and country-owned transitions out of fragility. The New Deal takes an integrated approach to development that prioritizes ownership of the developmental process as key for successful outcomes. The New Deal has three important pillars:

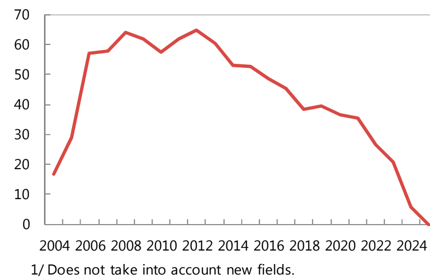
- Peace-Building and State-Building Goals (PSGs) as the foundation to enable progress towards the MDGs. This pillar consists of 5 main principles:
  - Legitimate Politics–fostering inclusive politics and conflict resolution
  - Security–establishing and strengthening the population's security
  - Justice–addressing injustice and increasing access to justice
  - Economic Foundation–generating employment and improving livelihoods
  - Revenue and Services–managing revenues and building capacity for better delivery of government services
- New ways of engagement to support inclusive country-led and country-owned transitions out of fragility; and
- Better and more effective management of aid and domestic resources and the alignment of these resources to achieve the key PSGs.

A number of countries including Timor-Leste are piloting the implementation of the New Deal in partnership with key donors and the track record will be assessed in 2015. An important part of this process is the Fragility Assessment that looks at the country's situation regarding the PSGs. Timor-Leste was assessed in mid 2012. Key findings were that: *Security* has made the biggest improvement; *Legitimate Politics* and *Revenue and Services* have made good progress but more work needs to be done on *Justice* and *Economic Foundations* to ensure their sustained improvement.

Box 2. Recent Developments in the Petroleum Sector

The oil and gas sector is the mainstay of the economy. Although modest by international standards with production at 65 million barrels of oil (equivalent) per year, the country's oil and gas resources are vast compared to its small non-oil GDP. The sector accounts for around 78 percent of GDP and 95 percent of exports of goods and services. Revenues are comprised of a complex set of taxes and royalties. These are paid into the PF that transfers funds to the government according to a rules based approach designed to preserve the real value of oil wealth for future generations—the ESI is set at three percent of the present value of oil wealth (PF assets plus reserves with production agreements) and is based on conservative assumptions. The flows from the PF account for around 95 percent of government (non grant) revenues. However, as production is offshore and raw natural gas is piped from the main Bayu-Undan field to Australia for processing into liquefied natural gas (LNG), the sector directly accounts for virtually no on-shore employment. Its economic impact is entirely via government spending.

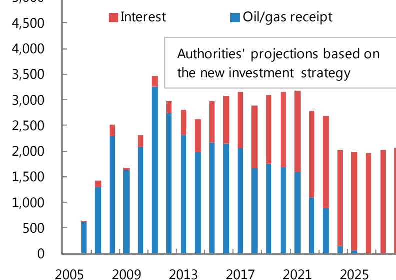
It is subject to a number of uncertainties. There is a complex set of interim arrangements for the sharing of resources in the Timor Sea. Timor-Leste has no maritime boundaries there, but has three interlocking treaties with Australia, covering the Joint Petroleum Development Area, JPDA (currently in production) and the Greater Sunrise area (as yet undeveloped). The latter is currently subject to international arbitration to delineate the maritime border.



1/ Does not take into account new fields.

Production of proven reserves has peaked but Greater Sunrise, a large new field, has yet to be developed. Overall production in current fields within the JPDA is estimated to have peaked in 2012 and will likely cease by 2024. The government has recently established a national oil company, the Timor Gap, which will work with foreign partners on exploration projects. Production at the Greater Sunrise field is contingent on a number of factors that remain unresolved, viz.: (i) the finalization of the demarcation of the maritime boundary; and (ii) the decision as to the handling and processing of the raw natural gas. As the resolution of these factors will take time, no contribution of the Greater Sunrise field is assumed in the ESI or PF calculation or in any macro projections by Fund staff or the authorities.

An important implication of the trends in the oil industry is that inflows from oil revenues into the PF will steadily decline as output falls. Conversely, the contribution to the PF assets from investment income will steadily increase, putting a greater premium on the safety of the assets and on the strategic asset allocation process.



Box 3. Economic Growth and Living Standards in Timor-Leste

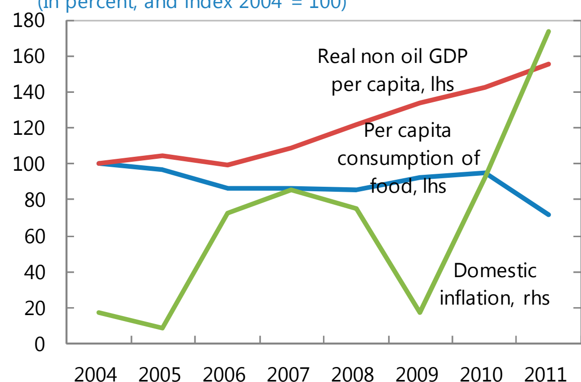
The preparation of disaggregated national accounts data for the first time in 2012 allows a greater understanding of the performance of the Timorese economy. However, the lack of recent data on living standards prevents a conclusive analysis on the relationship between growth and poverty alleviation. The data indicate that the economy has grown rapidly since the onset of the oil sector with real per capita non-oil income rising at an average of close to 10 percent growth per year between 2007 and 2011 but methodological problems with the recent survey on living standards have prevented the calculation of a new poverty rate. However, overall living standards appear not to have increased: for instance, real consumption of food per capita has shown a downward trend—particularly worrisome given the modest progress toward reducing hunger by half by 2015, which is one of the targets of the MDGs.

This dichotomy reflects that government spending has boosted the public sector and construction sector and has been highly import intensive but has had little wider impact. Growth opportunities in employment intensive sectors such as agriculture (relied on by over 50 percent of households for income) and labor intensive manufacturing have been hampered meaning limited progress in poverty reduction especially in rural areas. Inflation has also risen, mainly driven by government spending. This has had a number of adverse consequences:

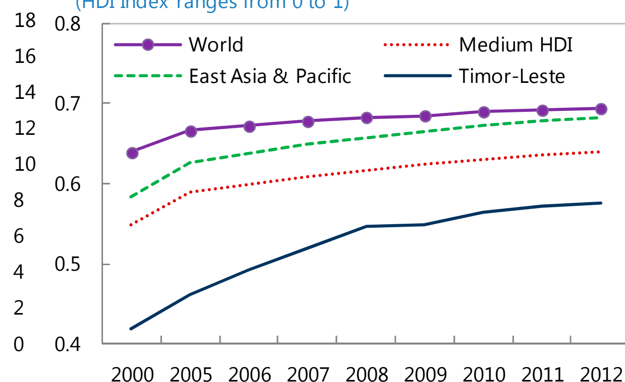
- Undermining the living standards of the overwhelming majority of the population that are outside the small formal sector, exacerbating poverty.
- Reducing competitiveness and the scope for diversification and the establishment of labor-intensive manufacturing export sectors that are vital for employment growth and poverty reduction.

A greater focus on poverty reduction will be key under a high quality growth scenario. Provided the government's economic strategy focuses on generating sustainable employment growth, especially in agriculture, manufacturing and services such as tourism, even the lower growth scenarios should generate a more sustained increase in living standards and reductions in poverty than achieved over the last decade. Lower inflation as envisaged under the more prudent fiscal framework that is now underway will also help improve consumption and help boost employment growth as competitiveness is restored.

Inflation, Food Consumption, and Non Oil GDP per capita
(In percent, and index 2004 = 100)



Human Development Index
(HDI Index ranges from 0 to 1)



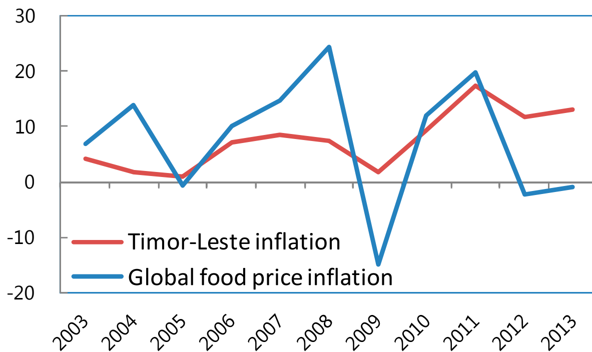
Box 4. Inflation and Government Spending

Inflation in Timor-Leste has remained in double digits since early 2011 after a long period of tracking international inflationary trends. Inflation in Timor-Leste was in line with global trends, consistent with the high import dependence, but rose sharply after 2009 partly driven by higher food prices. However, food prices in Timor-Leste have not fallen in line with global food prices and continue to lead headline inflation. Food price inflation was 15.6 percent in June 2013, which is much higher than in other Asian low income countries.

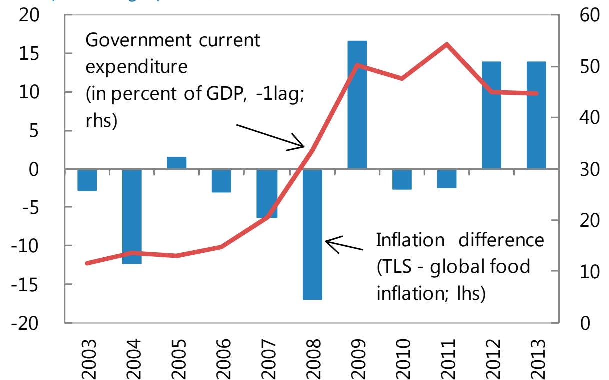
There is strong evidence that the growth in recurrent expenditure in Timor-Leste has contributed to high inflation. Statistical analysis suggests a one percent increase in recurrent expenditure as a percent of GDP causes 0.20 percent increase in the inflation rate This indicates that inflationary pressures are due to the intersection between excess demand growth driven by an expansionary fiscal policy and a number of structural barriers to external and internal trade e.g. poor infrastructure including inadequate transport links that keep prices higher than the global level.

The more restrained medium-term budget framework will help reduce inflationary pressures. The original 2013 budget called for significant increases in public expenditure that would have exacerbated inflation; it would have been very unlikely that inflation would have fallen to 7 percent as outlined in the budget or the 4-6 percent range targeted in the SDP. However, the Yellow Road budget that calls for real cuts in recurrent expenditures should significantly reduce inflation—staff's analysis suggests this would allow inflation to fall toward the targeted level by 2018. The rate of deceleration of inflation would be boosted by invigorated supply side policies that reduce the high cost structure. These trends will be positive for poverty reduction and diversification in line with the SDP objectives.

Timor-Leste CPI versus Global Food Price Inflation
(Year-on-year percent change)



Inflation Difference and Government Expenditure
(In percentage points)



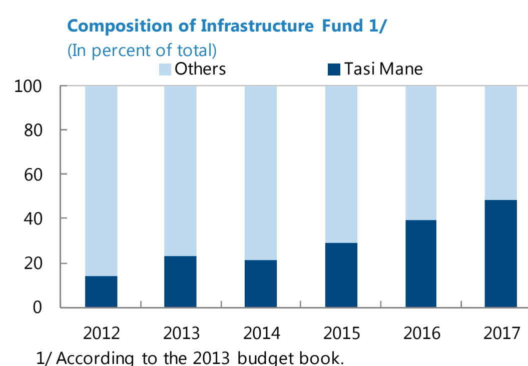
Box 5. Development Strategy and Industrial Policy

The current developmental strategy includes a strong focus on industrialization to attain the key goals of upper middle income status and reduction in poverty. Diversification is promoted through the development of the industrial sectors, such as petrochemicals, that leverage off the oil resources. To achieve these goals, the SDP calls for more activist policies including the creation of an infrastructure fund, a human capital fund, a number of special economic zones (SEZs), and a development bank. A national oil company (the Timor Gap) has recently been established.

Integral to these plans is the development of the south coast of Timor-Leste (the *Tasi Mane* project). Plans call for the comprehensive development of the area based on the establishment of three industrial clusters each with a specific focus, supporting infrastructure within new towns, with the intention that backward and forward linkages will generate much needed employment. The plans comprise:

- Supply base area, industrial estates. The plan is for the supply base to service offshore production facilities including those in Australian waters based on perceived costs advantages.
- Refinery and petrochemical complex. To supply fuel to the local markets and for export.
- LNG plant complex. To process raw gas feedstock for export.
- The development of supporting infrastructure is also planned (including a major highway linking the three clusters, other roads, a seaport, an airport and heliport).

The national oil company, Timor Gap, is acting as the lead in the Tasi Mane project but final costs have yet to be determined. Already the contracting process for the supply base and part of the highway are underway. The costing of the project remains to be finalized but the 2013 Budget Report forecasts that developmental expenditures would account for almost half of the total infrastructure spending by 2017. Many aspects of the project are independent of the Greater Sunrise project (e.g. the building of the supply base) but how and when the new field is implemented and whether the pipeline comes onshore could be important aspects to its overall viability.



Box 6. Implementation of Past IMF Policy Recommendations

Recent Article IV missions have emphasized the need for fiscal restraint. The planned investment in infrastructure was welcomed, but staff advised slowing planned increases in spending to better align expenditures with the absorptive capacity of the economy and administrative constraints. Staff also highlighted the inflationary consequences of this strategy and the adverse consequences for the poor. Staff set out a path for reducing expenditures but the authorities have hitherto preferred to maintain high expenditures given the large developmental needs.

The continuation of high inflation and the slow pace in poverty reduction has led to an increased acceptance of Fund advice. The revised budgetary framework that has been approved by the Council of Ministers in June 2013 is in line with Fund advice on a tighter fiscal envelope. The next stage will be to ensure a reprioritization of expenditures to increase their effectiveness.

Public financial management has improved. The government has enhanced the PFM system in line with Fund recommendations and new institutions have been established to manage large public investment programs. The operations of the PF have been improved consistent with Fund advice. Previous missions have highlighted the need to contain subsidies especially regarding electricity consumption but consensus on reforms has been slow to emerge.

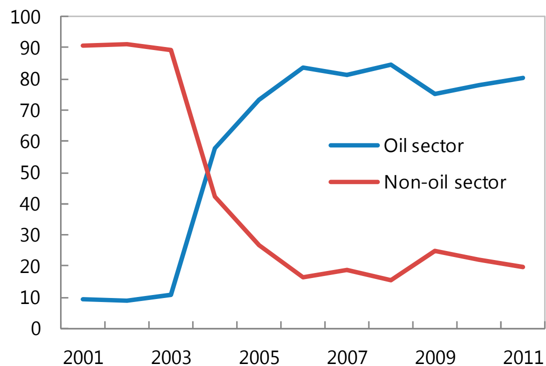
Advice on structural reforms has been broadly followed. In line with recommendations on reducing impediments to business, the authorities have made a number of steps recently including establishing one stop shop for business investors and on promoting PPPs.

Fund advice on financial sector development has been accepted. The authorities are planning to implement a new Financial Sector Master Plan and have requested Fund TA on enhancing the capacities of the BCTL. However, a number of crucial laws have yet to be passed e.g. the Land Law that would allow the development of the mortgage market, as it has proved difficult to reach a consensus on land issues.

Figure 2. Timor-Leste: Stylized Facts

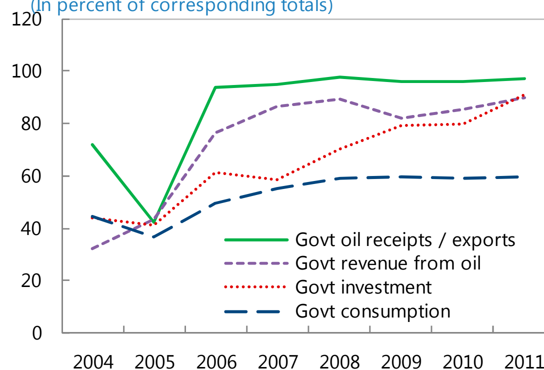
The economy is dominated by the oil sector...

Share of Oil and Non-oil Sectors in Total GDP
(In percent)



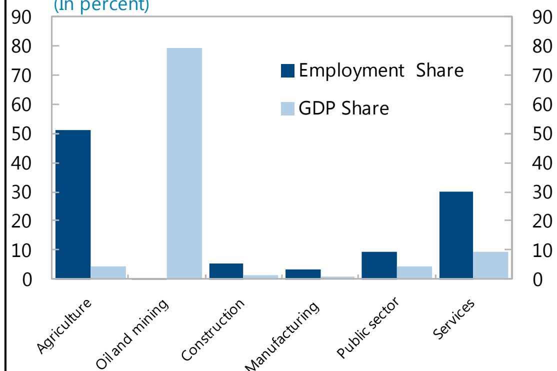
...that fuels the government's role in the economy...

Government Sector Revenue, Consumption, Investment, and Exports
(In percent of corresponding totals)



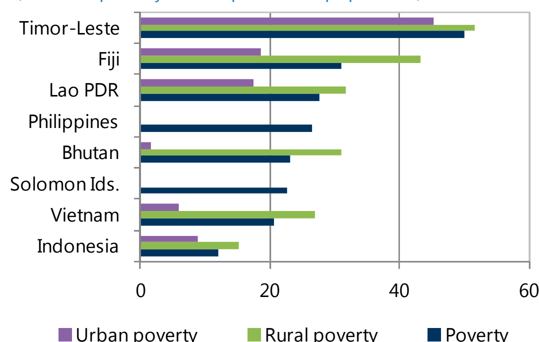
...but does not generate jobs.

Employment and GDP Share
(In percent)



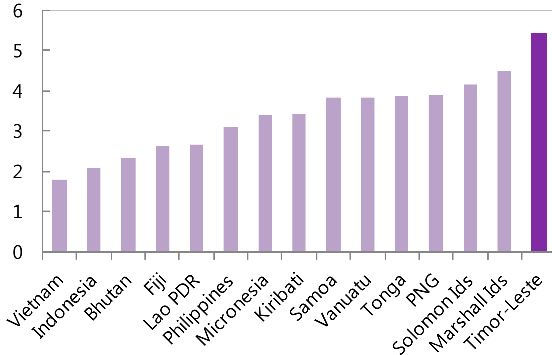
Poverty remains elevated...

Poverty Headcount Ratio: Selected Lower-Middle-Income Developing Asian Countries
(National poverty line, in percent of population)



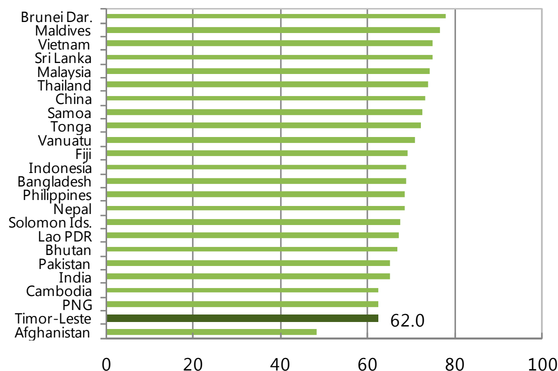
...with high population growth compared to peers...

Fertility Rate: Selected Lower-Middle-Income Developing Asian Countries
(Births per woman)



...and short life expectancy.

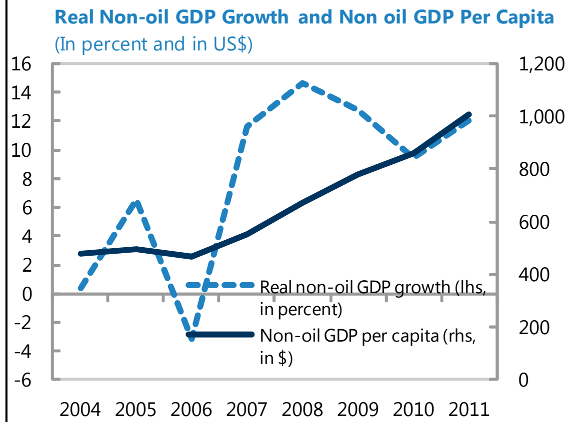
Life Expectancy for Timor-Leste and Selected Economies
(In years)



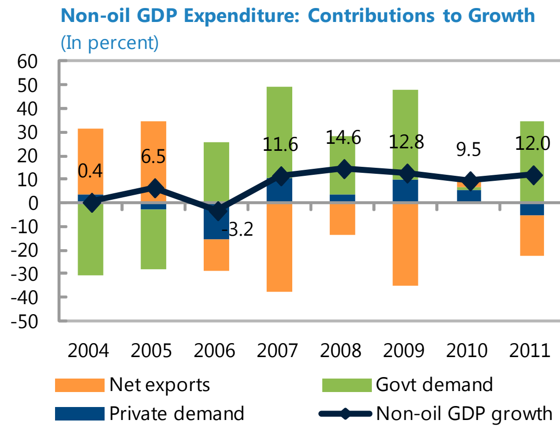
Sources: Timor-Leste authorities (Budget Book 2013, Labor Force Survey 2010); World Bank Development Indicators, latest available data; and IMF staff calculations.

Figure 3. Timor-Leste: Recent Economic Developments

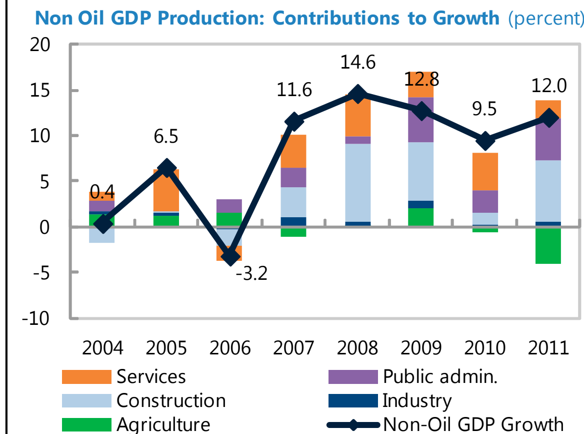
Non-oil growth has been strong...



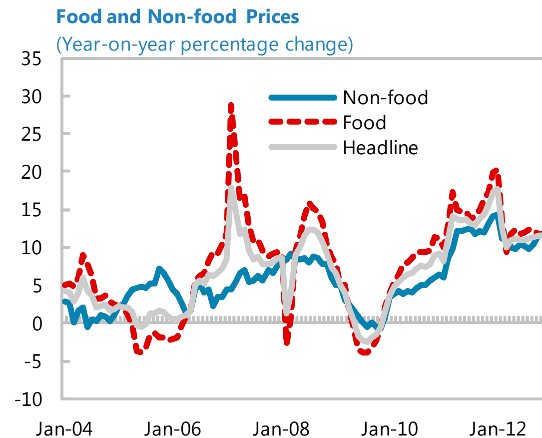
... boosted by strong government spending.



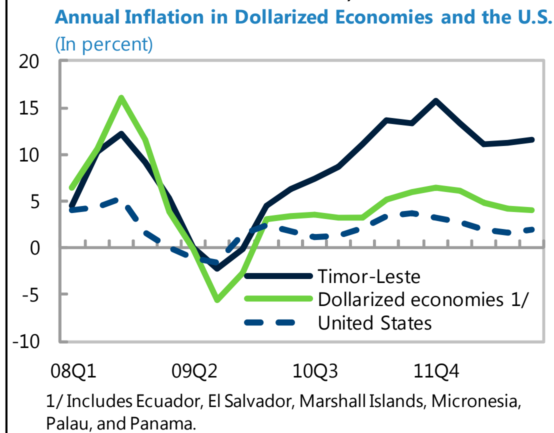
Non-tradable sectors have done well, but agriculture and manufacturing remain weak.



Inflation has risen and remains high...

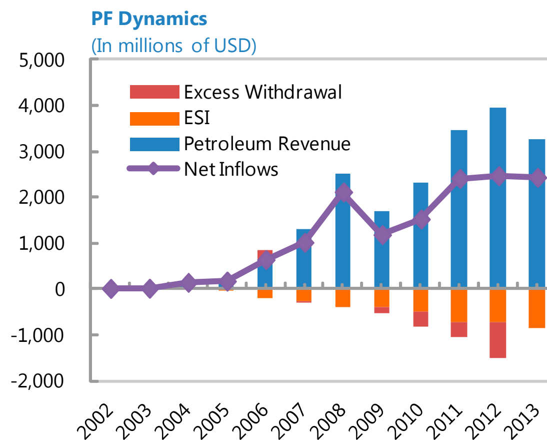


...unusual in a dollarized economy.



1/ Includes Ecuador, El Salvador, Marshall Islands, Micronesia, Palau, and Panama.

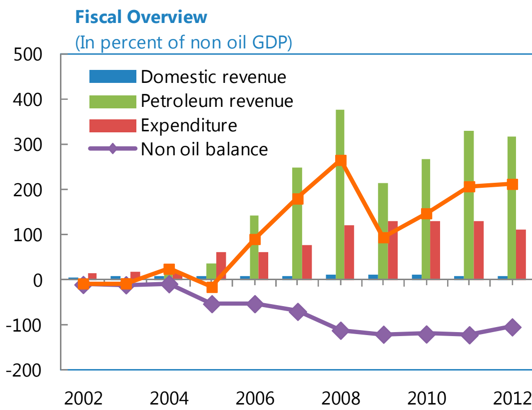
While the Petroleum Fund has accumulated assets.



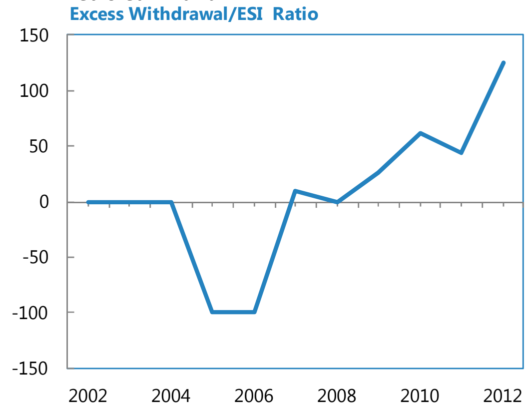
Sources: Timor-Leste authorities (National Accounts, May 2013); Information Notice System (INS) and Real Sector and Government Finance Data (GSTS); and IMF staff calculations.

Figure 4. Timor-Leste: Fiscal Developments

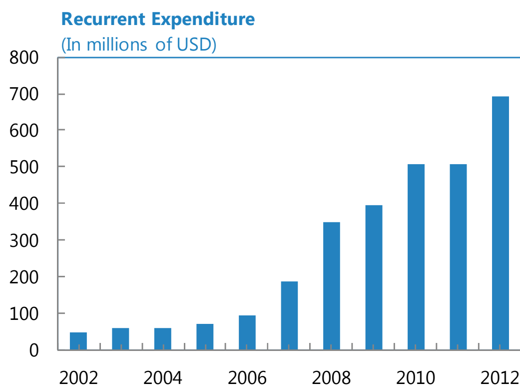
An expenditure surge has driven the non-oil deficit...



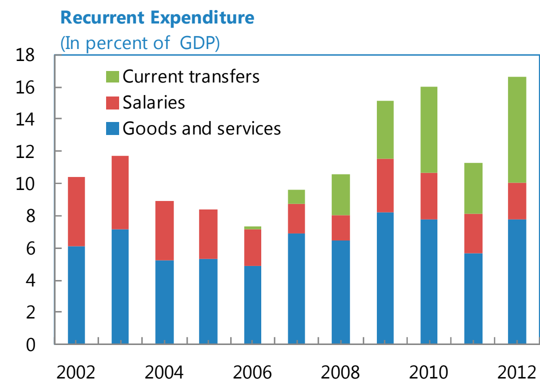
...funded by large excess withdrawals from the Petroleum Fund.



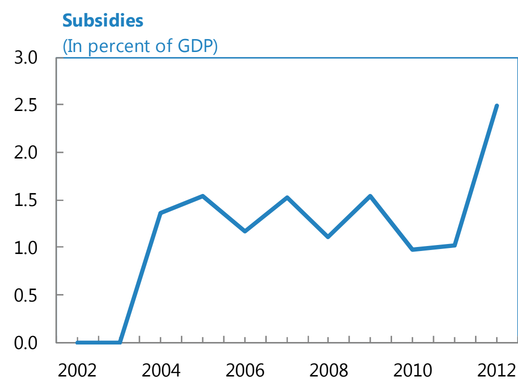
Recurrent expenditures have risen persistently...



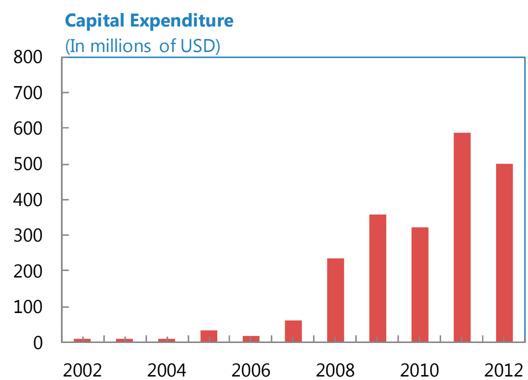
...including on more transfers...



...and subsidies.



Capital spending has risen sharply.



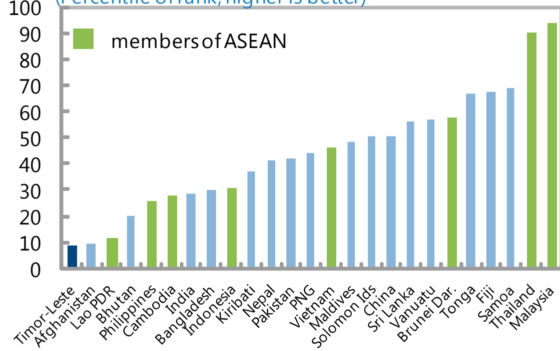
Sources: Timor-Leste authorities; and IMF staff calculations.

Figure 5. Timor-Leste: Structural Reform Agenda

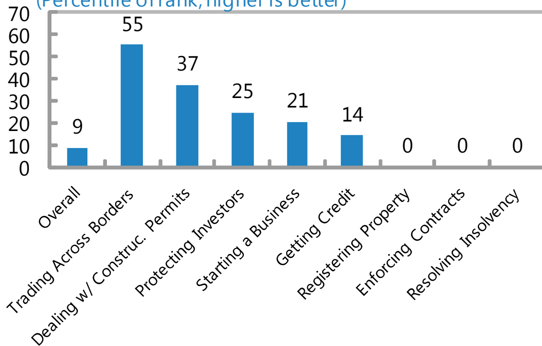
Inflation is eroding competitiveness...

1/ Includes Bangladesh, China, Indonesia, and Vietnam.

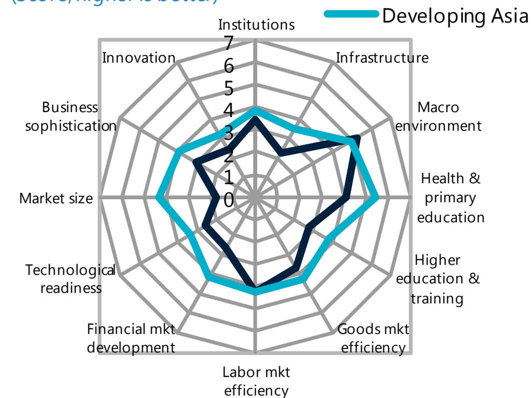
...compounding structural problems...



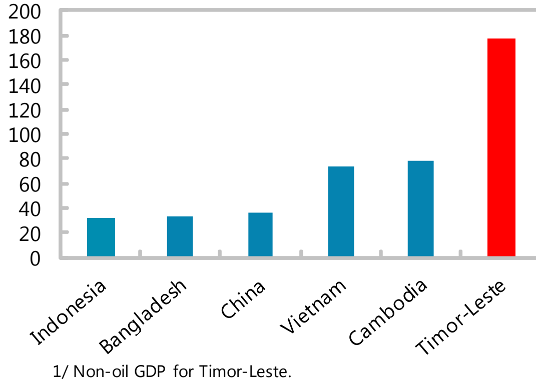
...that restrain the private sector...



...with a need to focus on the business environment.

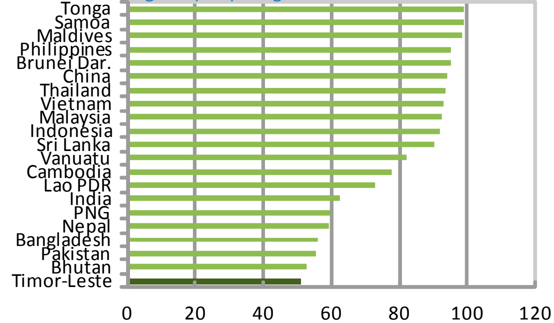


Wage levels are uncompetitive...

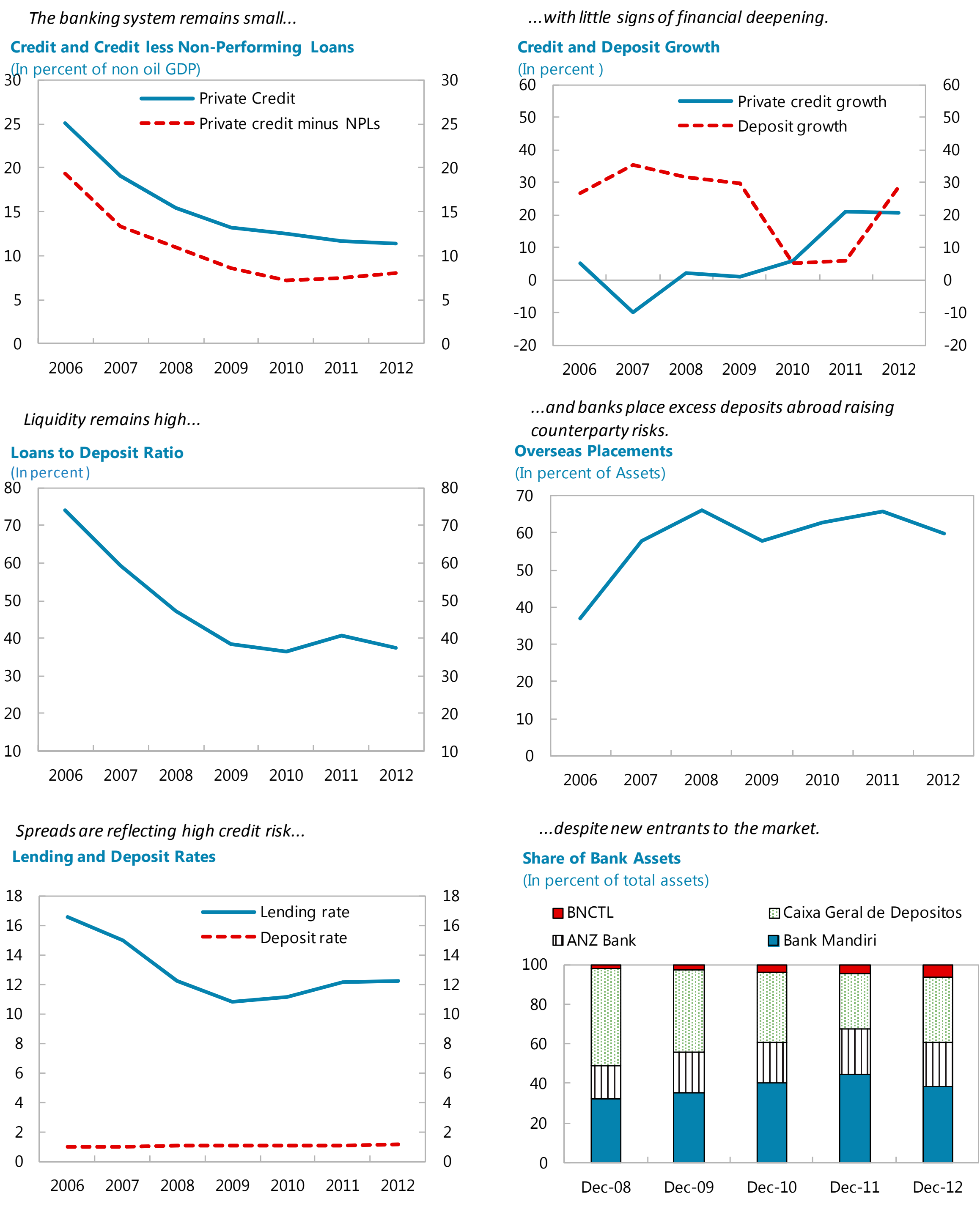


1/ Non-oil GDP for Timor-Leste.

...and human capital is weak.



Sources: World Bank Doing Business Report, 2013; World Economic Forum Global Competitiveness Report, 2013; World Development Indicators, latest available data; U.S. Department of Labor and WageIndicators.org; and IMF staff calculations. Care needs to be taken in the interpretation of the Doing Business ranking.



Sources: Central Bank of Timor-Leste; and IMF, Integrated Monetary Database.

Table 1. Timor-Leste: Selected Economic and Financial Indicators, 2009-14

GDP at current prices (2012):	US$6.3 billion
Population (2012):	1.1 million
GDP per capita (2012):	US$5,643
Non-oil GDP per capita (2012):	US$1,175
Quota:	SDR 8.2 million

	2009	2010	2011	2012	2013	2014
				Est.	Proj.	
			(Annual percent change)			
Real sector						
Real total GDP	-6.7	-1.4	7.3	5.7	-3.2	-6.9
Real non-oil GDP	12.8	9.5	12.0	8.3	8.1	8.0
CPI -Timor Leste (annual average)	0.1	4.5	11.7	13.1	10.6	9.5
CPI - Timor Leste (end-period)	1.1	8.0	15.4	10.8	10.4	8.5
			(In percent of GDP, unless otherwise indicated)			
Central government operations						
Revenue	62.6	64.9	66.5	69.1	59.7	63.6
Domestic revenue	2.8	2.3	1.9	2.2	2.4	3.3
Petroleum revenue	51.3	55.3	59.7	62.9	53.4	56.1
Grants	8.5	7.3	4.9	4.0	3.9	4.2
Expenditure	31.3	27.0	23.8	22.1	23.5	26.5
Recurrent expenditure	12.0	12.0	8.8	10.7	10.8	11.1
Capital expenditure	10.8	7.6	10.1	7.3	8.8	11.2
Donor project	8.5	7.3	4.9	4.0	3.9	4.2
Overall balance	31.3	37.9	42.7	47.0	36.2	37.1
Non-oil overall balance (in percent of non-oil GDP)	-79.8	-78.3	-87.5	-73.7	-65.2	-56.7
			(Annual percent change, unless otherwise indicated)			
Money and credit						
Deposits	38.7	9.8	8.9	26.2	21.2	21.7
Credit to the private sector	1.1	5.9	21.1	20.5	21.2	21.7
Lending interest rate (percent, end-period)	11.2	11.0	11.0	12.2	...	...
			(In millions of U.S. dollars, unless otherwise indicated)			
Balance of payments						
Current account balance 1/	1,287	1,676	2,340	2,738	2,105	1,819
(In percent of GDP)	39.0	39.8	40.4	43.5	34.3	32.1
Trade balance	-320	-277	-349	-639	-731	-829
Exports 2/	15	29	25	33	37	42
Imports	335	306	374	672	769	871
Services (net)	-774	-961	-1,415	-921	-1,004	-1,118
Petroleum revenue	1,692	2,331	3,461	3,960	3,273	3,183
Overall balance	39	156	55	422	-194	122
Public foreign assets (end-period) 3/	5,627	7,303	9,765	12,652	14,419	16,748
(In months of imports)	58	65	63	91	93	96
Exchange rates						
NEER (2005=100, period average)	95.4	89.3	84.2	86.4	...	...
REER (2005=100, period average)	105.2	102.3	105.6	118.1	...	...
NEER (2005=100, end-period)	89.3	86.7	86.0	86.5	...	...
REER (2005=100, end-period)	99.1	101.7	114.8	125.8	...	...
Memorandum items:						
GDP at current prices:	3,299	4,216	5,797	6,300	6,129	5,673
Non-oil GDP	827	934	1,128	1,355	1,615	1,901
Oil GDP	2,472	3,281	4,669	4,945	4,514	3,772
Crude oil prices (U.S. dollars per barrel, WEO)	62	79	104	105	104	101
Petroleum Fund balance (in millions of U.S. dollars)	5,377	6,897	9,303	11,768	14,206	16,535
Petroleum Fund balance (in percent of non-oil GDP)	650	738	825	868	880	870
Public debt (in millions of U.S. dollars)	0	0	0	0	44	267

Sources: Timor-Leste authorities; and IMF staff estimates and projections.
1/ Excludes trade in goods and services of entities located in the Joint Petroleum Development Area which are considered non-resident entities.
2/ Excludes petroleum exports, the income of which is recorded under the income account.
3/ Includes Petroleum Fund balance and the central bank's official reserves.

Table 2. Timor-Leste: Summary Operations of the Central Government, 2009-18 1/

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Staff Proj.		Projections 2/			
(In millions of U.S. Dollars)										
Revenue	**2,064.9**	**2,737.0**	**3,853.6**	**4,351.2**	**3,659.6**	**3,609.0**	**3,499.4**	**3,632.2**	**3,764.2**	**3,556.2**
Petroleum revenue	1,691.7	2,331.3	3,461.3	3,959.9	3,273.1	3,183.4	3,044.9	3,150.7	3,221.2	2,962.3
Oil/gas receipts	1,660.2	2,110.2	3,240.1	3,559.1	2,725.7	2,451.2	2,176.7	2,144.7	2,058.5	1,668.4
Interest	31.5	221.1	221.2	400.8	547.3	732.1	868.2	1,006.1	1,162.7	1,293.9
Taxes	43.5	50.2	78.4	98.5	106.7	119.8	140.6	162.1	218.8	255.9
Taxes on income, profits, and capital gains	13.3	18.2	27.8	37.2	42.1	48.8	58.0	67.5	77.7	90.9
Taxes on goods & services	23.9	26.5	34.2	47.9	53.2	59.7	70.7	82.2	128.2	150.0
Taxes on international trade & transactions	6.3	5.5	16.4	13.4	11.3	11.3	11.9	12.3	12.9	15.0
Grants	281.8	309.3	283.9	253.8	239.0	240.8	243.0	242.9	242.8	242.8
Other revenue	47.9	46.2	30.0	38.9	40.9	65.0	70.8	76.5	81.4	95.2
Expenditure	**1,032.6**	**1,137.2**	**1,379.6**	**1,389.7**	**1,439.0**	**1,503.2**	**1,579.5**	**1,575.5**	**1,571.5**	**1,567.7**
Current expenditure	394.2	506.1	507.7	674.1	660.6	627.6	596.2	596.2	596.2	596.2
Wages and salaries	87.3	91.5	111.6	130.3	126.1	120.4	113.9	114.1	113.9	113.9
Current transfers	94.1	168.7	142.6	215.1	187.7	179.2	169.6	169.9	169.5	169.5
Goods and services	212.8	245.9	253.5	328.7	346.8	328.0	312.7	312.2	312.8	312.8
Subsidies	40.0	30.9	45.5	104.1	106.7	102.4	93.4	85.2	77.7	75.0
Capital expenditure	356.6	321.8	588.0	461.8	539.4	634.8	740.3	736.4	732.6	728.7
Donor project	281.8	309.3	283.9	253.8	239.0	240.8	243.0	242.9	242.8	242.8
Overall balance	**1,032.3**	**1,599.8**	**2,474.0**	**2,961.5**	**2,220.7**	**2,105.8**	**1,919.9**	**2,056.7**	**2,192.6**	**1,988.5**
Transfer to Petroleum Fund	**1,179.7**	**1,520.3**	**2,406.3**	**2,904.9**	**2,430.5**	**2,329.1**	**2,180.8**	**2,274.5**	**2,329.8**	**2,051.1**
Non-oil overall balance	**-659.4**	**-731.6**	**-987.3**	**-998.5**	**-1052.4**	**-1077.6**	**-1125.1**	**-1094.0**	**-1028.6**	**-973.8**
Funded by										
ESI	408.0	502.0	734.0	734.0	842.6	854.3	864.1	876.2	891.4	911.2
Withdrawals above ESI	104.0	309.0	321.0	321.0	0.0	0.0	0.0	0.0	0.0	0.0
Use of cash balance	148.0	-79.4	-67.6	-56.5	166.2	0.0	0.0	0.0	0.0	0.0
Borrowing	0.0	0.0	0.0	0.0	43.6	223.3	260.9	217.9	137.2	62.6
(In percent of GDP)										
Revenue	**62.6**	**64.9**	**66.5**	**69.1**	**59.7**	**63.6**	**60.9**	**63.4**	**64.2**	**60.6**
Petroleum revenue	51.3	55.3	59.7	62.9	53.4	56.1	53.0	55.0	55.0	50.4
Oil/gas receipts	50.3	50.1	55.9	56.5	44.5	43.2	37.9	37.4	35.1	28.4
Interest	1.0	5.2	3.8	6.4	8.9	12.9	15.1	17.6	19.8	22.0
Taxes	1.3	1.2	1.4	1.6	1.7	2.1	2.4	2.8	3.7	4.4
Taxes on income, profits, and capital gains	0.4	0.4	0.5	0.6	0.7	0.9	1.0	1.2	1.3	1.5
Taxes on goods & services	0.7	0.6	0.6	0.8	0.9	1.1	1.2	1.4	2.2	2.6
Taxes on international trade & transactions	0.2	0.1	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.3
Grants	8.5	7.3	4.9	4.0	3.9	4.2	4.2	4.2	4.1	4.1
Other revenue	1.5	1.1	0.5	0.6	0.7	1.1	1.2	1.3	1.4	1.6
Expenditure	**31.3**	**27.0**	**23.8**	**22.1**	**23.5**	**26.5**	**27.5**	**27.5**	**26.8**	**26.7**
Current expenditure	12.0	12.0	8.8	10.7	10.8	11.1	10.4	10.4	10.2	10.2
Wages and salaries	2.6	2.2	1.9	2.1	2.1	2.1	2.0	2.0	1.9	1.9
Current transfers	2.9	4.0	2.5	3.4	3.1	3.2	3.0	3.0	2.9	2.9
Goods and services	6.5	5.8	4.4	5.2	5.7	5.8	5.4	5.4	5.3	5.3
Subsidies	1.2	0.7	0.8	1.7	1.7	1.8	1.6	1.5	1.3	1.3
Capital expenditure	10.8	7.6	10.1	7.3	8.8	11.2	12.9	12.9	12.5	12.4
Donor Project	8.5	7.3	4.9	4.0	3.9	4.2	4.2	4.2	4.1	4.1
Overall balance	**31.3**	**37.9**	**42.7**	**47.0**	**36.2**	**37.1**	**33.4**	**35.9**	**37.4**	**33.9**
Borrowing	0.0	0.0	0.0	0.0	0.7	3.9	4.5	3.8	2.3	1.1
Transfer to Petroleum Fund	**35.8**	**36.1**	**41.5**	**46.1**	**39.7**	**41.1**	**37.9**	**39.7**	**39.8**	**34.9**
(In percent of non-oil GDP)										
Non-oil revenue	**45.1**	**43.4**	**34.8**	**28.9**	**23.9**	**22.4**	**20.9**	**19.2**	**18.5**	**17.3**
Expenditure	**124.9**	**121.7**	**122.3**	**102.5**	**89.1**	**79.1**	**72.8**	**62.7**	**53.7**	**45.8**
Non-oil overall balance	**-79.8**	**-78.3**	**-87.5**	**-73.7**	**-65.2**	**-56.7**	**-51.8**	**-43.5**	**-35.1**	**-28.4**
Funded by										
Borrowing	0.0	0.0	0.0	0.0	2.7	11.7	12.0	8.7	4.7	1.8
Memorandum items:										
Current expenditures (in percent of non-oil GDP)	47.7	54.2	45.0	49.7	40.9	33.0	27.5	23.7	20.4	17.4
Capital expenditures (in percent of non-oil GDP)	43.1	34.4	52.1	34.1	33.4	33.4	34.1	29.3	25.0	21.3
Rice operations (in millions of U.S. dollars):										
Sales	20.4	12.6	1.0	4.6	2.5	2.6	2.8	3.1	3.3	3.8
Purchases	31.8	35.0	2.0	9.4	5.1	5.3	5.8	6.2	6.6	7.7
Petroleum Fund balance (in millions of U.S. dollars)	5,377	6,897	9,303	11,768	14,199	16,528	18,709	20,983	23,313	25,364
Petroleum Fund balance (in percent of GDP)	163.0	163.6	160.5	186.8	231.8	291.5	325.6	366.3	397.9	432.0
Crude oil price (U.S. dollar per barrel, WEO)	61.8	79.0	104.0	105.0	104.5	101.3	95.3	91.2	88.5	86.7
Non-oil GDP at current prices (in millions of U.S. dollars)	827	934	1,128	1,355	1,615	1,901	2,171	2,513	2,928	3,425
GDP at current prices (in millions of U.S. dollars)	3,299	4,216	5,797	6,300	6,129	5,673	5,748	5,730	5,860	5,872

Sources: Timor-Leste authorities; and IMF staff estimates.

1/ This presentation of government operations as well as the related comments in the main text of the report do not follow the GFSM 2001 format. Accepted international standard, and IMF best practices use the GFSM 2001 for international comparability purposes. Deviations from GFSM 2001 are included in this presentation.

2/ Staff projections incorporate the Yellow Road budget envelope.

Table 3. Timor-Leste: Monetary Developments, 2009-2014

	2009	2010	2011	2012	2013	2014
					proj.	
	(In millions of U.S. dollars)					
Banking system 1/						
Net foreign assets 2/	**443**	**622**	**689**	**1,179**	**986**	**1,108**
Gross reserves	250	406	462	884	213	213
Other foreign assets	219	244	295	368	845	967
Foreign liabilities	26	28	68	72	72	72
Net domestic assets	**-174**	**-327**	**-366**	**-772**	**-492**	**-508**
Net credit to central government	-206	-331	-413	-841	-648	-770
Net credit to state and local government	0	0	0	0	0	0
Net credit to public nonfinancial corporations	0	0	0	0	0	0
Credit to private sector	104	110	133	160	194	236
Other items (net)	-72	-105	-87	-91	-39	26
Broad money	**268**	**295**	**322**	**407**	**493**	**600**
Narrow money	157	141	163	206	249	303
Currency in circulation 3/	3	3	4	5	6	7
Transferable deposits	155	138	159	201	244	296
Other deposits	111	154	160	201	244	297
Central Bank						
Net foreign assets 2/	**238**	**394**	**450**	**872**	**201**	**201**
Gross reserves	250	406	462	884	213	213
Foreign liabilities	12	12	12	12	12	12
Net domestic assets	**-182**	**-340**	**-415**	**-772**	**-583**	**-705**
Net credit to central government	-163	-318	-406	-819	-625	-747
Net credit to other depository corporations	2	24	23	71	66	66
Other items (net)	-21	-45	-33	-24	-23	-23
Monetary Base	**56**	**55**	**34**	**100**	**-382**	**-504**
Currency in circulation	3	3	4	5	6	7
Other liabilities to depositary corporations	53	51	31	95	-388	-511
Others 3/	0	0	0	0	0	0
Memorandum items	(In percent, unless otherwise indicated)					
Annual broad money growth	39.3	9.9	9.3	26.2	21.2	21.7
Annual reserve money growth	120.4	-2.7	-37.0	189.7	-482.1	32.0
Annual credit to the private sector growth	1.1	5.9	21.1	20.5	21.2	21.7
Credit/non-oil GDP	13.1	12.5	11.7	11.4	11.4	11.4
Broad money/non-oil GDP	34.1	33.7	28.3	29.0	29.0	29.0
Credit/deposits	39.0	37.6	41.7	39.8	39.8	39.8
Non-performing loans/total loans	32.1	41.7	36.3	30.8	…	…
Amounts of non-perfoming loans (in millions of U.S. dollars)	35.6	46.3	47.7	48.0	…	…
Loan rate 4/	10.8	11.1	12.1	12.2	…	…
Deposit rate 5/	1.1	1.1	1.1	1.1	…	…

Sources: Central Bank of Timor-Leste; and IMF staff estimates.

1/ Includes the Central Bank, 4 commercial banks (including 3 branches of foreign banks).

2/ An oil fund was created in September 2005 and the deposits were moved off-shore and onto the Government balance sheet.

3/ Includes only coinage issued by the Central Bank. No data is available for notes due to dollarization of the financial system.

4/ Rate charged by other depository corporations on loans in U.S. dollars. The rate is weighted by loan amounts.

5/ Rate offered by other depository corporations on three-month time deposits in U.S. dollars. The rate is weighted by deposit amounts.

Table 4. Timor-Leste: Balance of Payments, 2009-2018

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Projections					
					(In millions of U.S. dollars)					
Current account balance 1/	1,287	1,676	2,340	2,738	2,105	1,819	1,551	1,588	1,665	1,477
Excluding official grants	843	1,232	1,883	2,343	1,815	1,616	1,348	1,385	1,461	1,477
Trade balance	-320	-277	-349	-639	-731	-829	-904	-976	-1,026	-1,068
Exports 2/	15	29	25	33	37	42	46	57	75	84
of which: Coffee	14	27	24	26	33	37	37	47	60	65
Imports	-335	-306	-374	-672	-769	-871	-950	-1,033	-1,101	-1,151
Consumption & Intermediate Goods	-279	-256	-306	-549	-628	-700	-764	-835	-915	-1,007
Capital Goods	-56	-50	-68	-123	-141	-171	-185	-198	-187	-144
Services (net)	-774	-961	-1,415	-921	-1,004	-1,118	-1,191	-1,216	-1,192	-1,106
Receipts	52	75	79	69	86	106	126	148	173	204
of which: Travel	16	31	24	21	26	32	40	48	58	70
Payments	-826	-1,036	-1,494	-990	-1,090	-1,224	-1,318	-1,364	-1,365	-1,310
Construction	-166	-324	-655	-276	-314	-376	-407	-432	-409	-324
Income (net)	1,930	2,435	3,577	3,873	3,394	3,297	3,154	3,264	3,340	3,080
of which: Oil/gas receipts and interest	1,692	2,331	3,461	3,960	3,273	3,183	3,045	3,151	3,221	2,962
Current transfers (net)	451	480	527	425	447	469	492	517	543	570
of which: official grants	444	445	457	395	290	203	203	203	203	0
Capital and financial accounts	-1,245	-1,506	-2,249	-2,305	-2,299	-1,697	-1,487	-1,619	-1,866	-1,848
Official capital transfers	27	31	26	23	28	27	27	27	27	27
Financial account	-1,273	-1,537	-2,275	-2,328	-2,326	-1,724	-1,514	-1,645	-1,892	-1,874
of which: Oil/gas savings	-1,330	-1,579	-2,432	-2,465	-2,431	-2,124	-1,983	-2,118	-2,258	-2,050
FDI	50	29	80	6	53	116	139	182	157	42
External debt	-6	4	59	8	44	275	319	278	194	117
Errors and omissions (net)	2	14	36	-12	0	0	0	0	0	0
Overall balance	39	156	55	422	-194	122	64	-30	-201	-371
Financing										
Change in net foreign assets	-39	-156	-55	-422	194	-122	-64	30	201	371
					(In percent of GDP)					
Current account	39	40	40	43	34	32	27	28	28	25
Trade balance	-10	-7	-6	-10	-12	-15	-16	-17	-18	-18
Exports	0	1	0	1	1	1	1	1	1	1
Imports	-10	-7	-6	-11	-13	-15	-17	-18	-19	-20
Services (net)	-23	-23	-24	-15	-16	-20	-21	-21	-20	-19
Income (net)	59	58	62	61	55	58	55	57	57	52
Current transfers (net)	14	11	9	7	7	8	9	9	9	10
Capital and financial accounts	-38	-36	-39	-37	-38	-30	-26	-28	-32	-31
Overall balance	1	4	1	7	-3	2	1	-1	-3	-6
					(In percent of non-oil GDP)					
Current account	156	179	207	184	118	87	65	57	52	39
Trade balance	-39	-30	-31	-43	-41	-40	-38	-35	-32	-28
Exports	2	3	2	2	2	2	2	2	2	2
Imports	-40	-33	-33	-45	-43	-42	-40	-37	-34	-31
Services (net)	-94	-103	-125	-62	-56	-54	-50	-44	-37	-29
Income (net)	233	261	317	260	190	158	131	118	104	82
Current transfers (net)	55	51	47	29	25	22	20	19	17	15
Capital and financial accounts	-151	-161	-199	-155	-128	-81	-62	-58	-58	-49
Overall balance	5	18	8	29	-11	6	3	-1	-6	-10
					(In millions of U.S. dollars, unless otherwise indicated)					
Memorandum items:										
Public foreign assets (end-period)	5,627	7,310	9,772	12,659	14,419	16,543	18,526	20,644	22,902	24,952
in months of imports of G&S	58	65	63	91	93	95	98	103	111	122
of which: Central bank reserves	250	406	462	884	213	213	213	213	213	213
Petroleum Fund balance	5,377	6,904	9,310	11,775	14,206	16,330	18,313	20,431	22,689	24,739
NFA of the banking sector 3/	443	622	689	1,179	986	1,108	1,172	1,141	941	570
Non-oil GDP at current prices	827	934	1,128	1,487	1,791	2,085	2,404	2,774	3,213	3,757
GDP at current prices	3,299	4,216	5,797	6,300	6,129	5,673	5,748	5,730	5,860	5,872

Sources: Data provided by the Timor-Leste authorities; and IMF staff estimates.

1/ Excludes trade in goods and services of entities located in the Joint Petroleum Development Area which are considered non-resident entities.

2/ Excludes petroleum exports, the income of which is recorded under the income account.

3/ Net foreign assets of the banking sector including claims on non-residents held at the central bank. Excluding PF savings which are held abroad.

Table 5. Timor-Leste: Medium-Term Scenario, 2009-18

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
				Est.			Projections 5/			
Real sector										
GDP at current prices (in millions of U.S. dollars)	3299	4216	5,797	6,300	6,129	5,673	5,748	5,730	5,731	5,732
Non-oil GDP	827	934	1,128	1,355	1,615	1,901	2,171	2,513	2,514	2,515
Oil GDP	2472	3281	4,669	4,945	4,514	3,772	3,578	3,216	3,217	3,218
Real non-oil GDP growth (percentage change)	12.8	9.5	12.0	8.3	8.1	8.0	7.7	8.6	9.6	10.6
CPI (percentage change, period average) 1/	0.1	4.5	11.7	13.1	10.6	9.5	8.1	7.1	6.3	5.8
CPI (percentage change, end-period) 1/	1.1	8.0	15.4	10.8	10.4	8.5	7.6	6.5	6.1	5.5
					(In percent of GDP)					
Central government operations										
Revenue	62.6	64.9	66.5	69.1	59.7	63.6	60.9	63.4	64.2	60.6
Domestic revenue	2.8	2.3	1.9	2.2	2.4	3.3	3.7	4.2	5.1	6.0
Petroleum revenue	51.3	55.3	59.7	62.9	53.4	56.1	53.0	55.0	55.0	50.4
Grants			4.9	4.0	3.9	4.2	4.2	4.2	4.1	4.1
Expenditure	31.3	27.0	23.8	22.1	23.5	26.5	27.5	27.5	26.8	26.7
Recurrent expenditure	12.0	12.0	8.8	10.7	10.8	11.1	10.4	10.4	10.2	10.2
Capital expenditure	10.8	7.6	10.1	7.3	8.8	11.2	12.9	12.9	12.5	12.4
Donor project			4.9	4.0	3.9	4.2	4.2	4.2	4.1	4.1
Overall balance	31.3	37.9	42.7	47.0	36.2	37.1	33.4	35.9	37.4	33.9
Non-oil overall balance	-20.0	-17.4	-17.0	-15.8	-17.2	-19.0	-19.6	-19.1	-17.6	-16.6
					(In percent of non-oil GDP)					
Revenue	249.8	292.9	341.5	321.0	226.6	189.8	161.2	144.5	128.6	103.8
Domestic revenue	11.1	10.3	9.6	10.1	9.1	9.7	9.7	9.5	10.3	10.3
Petroleum revenue	204.6	249.5	306.8	292.2	202.6	167.4	140.3	125.4	110.0	86.5
Grants			25.2	18.7	14.8	12.7	11.2	9.7	8.3	7.1
Expenditure	124.9	121.7	122.3	102.5	89.1	79.1	72.8	62.7	53.7	45.8
Recurrent expenditure	47.7	54.2	45.0	49.7	40.9	33.0	27.5	23.7	20.4	17.4
Capital expenditure	43.1	34.4	52.1	34.1	33.4	33.4	34.1	29.3	25.0	21.3
Donor project			25.2	18.7	14.8	12.7	11.2	9.7	8.3	7.1
Overall balance	124.9	171.2	219.3	218.5	137.5	110.8	88.4	81.8	74.9	58.1
Non-oil overall balance	-79.8	-78.3	-87.5	-73.7	-65.2	-56.7	-51.8	-43.5	-35.1	-28.4
					(In millions of U.S. dollars, unless otherwise indicated)					
Balance of payments										
Current account balance 2/	1,287	1,676	2,340	2,738	2,105	1,819	1,551	1,588	1,665	1,477
Trade balance	-320	-277	-349	-639	-731	-829	-904	-976	-1,026	-1,068
Exports 3/	15	29	25	33	37	42	46	57	75	84
Imports	335	306	374	672	769	871	950	1,033	1,101	1,151
Services (net)	-774	-961	-1,415	-921	-1,004	-1,118	-1,191	-1,216	-1,192	-1,106
Petroleum revenue	1,692	2,331	3,461	3,960	3,273	3,183	3,045	3,151	3,221	2,962
Petroleum Fund balance	5,377	6,897	9,303	11,768	14,206	16,535	18,716	20,990	23,320	25,370
(In months of imports)			299	210	222	228	236	244	254	264
					(In percent of GDP)					
Current account balance 2/	39.0	39.8	40.4	43.5	34.3	32.1	27.0	27.7	28.4	25.1
Trade balance	-9.7	-6.6	-6.0	-10.1	-11.9	-14.6	-15.7	-17.0	-17.5	-18.2
Exports 3/	0.4	0.7	0.4	0.5	0.6	0.7	0.8	1.0	1.3	1.4
Imports	10.1	7.3	6.4	10.7	12.5	15.4	16.5	18.0	18.8	19.6
Services (net)	-23.5	-22.8	-24.4	-14.6	-16.4	-19.7	-20.7	-21.2	-20.3	-18.8
					(In percent of non-oil GDP, unless otherwise indicated)					
Current account balance 2/	155.6	179.4	207.4	202.0	130.3	95.7	71.5	63.2	56.9	43.1
Trade balance	-38.7	-29.7	-30.9	-47.1	-45.3	-43.6	-41.6	-38.8	-35.1	-31.2
Exports 3/	1.8	3.1	2.2	2.5	2.3	2.2	2.1	2.3	2.6	2.4
Imports	40.5	32.8	33.1	49.6	47.6	45.8	43.8	41.1	37.6	33.6
Services (net)	-93.6	-102.8	-125.4	-67.9	-62.2	-58.8	-54.9	-48.4	-40.7	-32.3
Public external debt										
(In millions of U.S. dollars)	0.0	0.0	0.0	0	44	319	638	916	1,110	1,227
(In percent of GDP)	0.0	0.0	0.0	0.0	0.7	5.6	11.1	16.0	18.9	20.9
Memorandum items:										
Crude oil prices (U.S. dollars per barrel, WEO) 4/	61.8	79.0	104.0	105.0	104.5	101.3	95.3	91.2	88.5	86.7
Petroleum Fund balance (in percent of GDP)	163	164	160	187	232	291	326	366	398	432
Petroleum Fund balance (in percent of non-oil GDP)	650	738	825	868	880	870	862	835	796	741

Sources: Timor-Leste authorities; and IMF staff estimates and projections.
1/ Inflation as measured in Timor-Leste.
2/ Excludes trade in goods and services of entities located in the Joint Petroleum Development Area which are considered non-resident entities.
3/ Excludes petroleum exports, the income of which is recorded under the income account.
4/ A simple average of UK Brent, Dubai, and WTI crude oil prices; September 2013 WEO assumptions.
5/ Staff projections.

Table 6. Timor-Leste: Millennium Development Goals Progress, 1990-2012

	1990	1995	2000	2005	2009	2012
Goal 1: Eradicate extreme poverty and hunger						
Employment to population ratio, 15+, total (%)	67	67	65	68	68	68
Income share held by lowest 20%	...	...	7	9	9	9
Malnutrition prevalence, weight for age (% of children under 5)	...	...	41	42	...	45
Poverty headcount ratio at $1.25 a day (PPP) (% of population)	...	...	53	37	37	37
Goal 2: Achieve universal primary education						
Primary completion rate, total (% of relevant age group)	...	...	...	...	68	66
Total enrollment, primary (% net)	...	...	...	67	80	86
Goal 3: Promote gender equality and empower women						
Proportion of seats held by women in national parliaments (%)	...	...	...	25	29	32
Ratio of female to male primary enrollment (%)	...	...	...	92	95	96
Ratio of female to male secondary enrollment (%)	...	...	...	100	...	101
Ratio of female to male tertiary enrollment (%)	...	...	127	...	71	71
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	...	...	35	...	...	...
Goal 4: Reduce child mortality						
Immunization, measles (% of children ages 12-23 months)	...	...	56	48	70	...
Mortality rate, infant (per 1,000 live births)	135	112	86	64	51	46
Mortality rate, under-5 (per 1,000)	180	148	109	79	61	54
Goal 5: Improve maternal health						
Adolescent fertility rate (births per 1,000 women ages 15-19)	...	85	78	59	54	...
Births attended by skilled health staff (% of total)	...	26	24	18	29	...
Contraceptive prevalence (% of women ages 15-49)	25	23	8	20	22	...
Maternal mortality ratio (modeled estimate, per 100,000 live births)	650	880	610	410	...	300
Pregnant women receiving prenatal care (%)	...	...	43	61	...	84
Goal 6: Combat HIV/AIDS, malaria, and other diseases						
Children with fever receiving antimalarial drugs (% of children under age 5 with fever)	...	...	47	...	...	6
Incidence of tuberculosis (per 100,000 people)	...	...	...	733	703	643
Prevalence of HIV, female (% ages 15-24)	...	...	...	...	...	...
Prevalence of HIV, male (% ages 15-24)	...	...	...	...	...	...
Prevalence of HIV, total (% of population ages 15-49)	...	...	...	...	...	...
Tuberculosis case detection rate (%, all forms)	...	...	64	76	84	...
Goal 7: Ensure environmental sustainability						
CO2 emissions (kg per PPP $ of GDP)	...	...	0.0	0.2	0.2	...
CO2 emissions (metric tons per capita)	...	...	0.0	0.2	0.2	...
Improved sanitation facilities (% of population with access)	...	37	39	43	46	47
Improved water source (% of population with access)	...	52	54	62	67	69
Marine protected areas (% of territorial waters)	0.0	0.0	1.0	1.0	6.7	6.7
Goal 8: Develop a global partnership for development						
Internet users per 100 inhabitants	...	...	...	0.1	0.2	0.9
Memorandum items:						
GNI per capita, Atlas method (current US$)	...	...	320	740	2,250	3,670
GNI, Atlas method (current US$) (billions)	...	...	0.3	0.7	2.5	4.4
Gross capital formation (% of GDP)	...	...	25.6	...	...	...
Life expectancy at birth, total (years)	45.8	51.3	56.2	59.6	61.5	62.5
Literacy rate, adult total (% of people ages 15 and above)	...	...	37.6	50.6	...	58.3
Population, total (thousands)	...	...	897	970	1,060	1,120

Source: Millennium Development Goals database, 2013; World Development Indicators database, 2013; and Timor-Leste authorities.

INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

October 7, 2013

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

Approved By
Brian Aitken and Dhaneshwar Ghura (IMF)

Prepared By[1]
International Monetary Fund

Timor-Leste is at low risk of debt distress on the basis of the revised fiscal framework that leads to low debt accumulation and a continuation of a high level of assets in the Petroleum Fund. Under this baseline, debt ratios are comfortably below thresholds.[2] This compares with the adverse debt dynamics inherent in the 2013 Budget Book that would have led to a steady fall in net assets. This assessment is fully contingent and conditional on the authorities consistently implementing the revised fiscal framework. This implies a tighter budget envelope with a reprioritization of spending on projects that spur sustainable growth, and borrowing only on concessional terms from multilateral and bilateral donors. The challenge to long-term debt sustainability comes from slippages to the revised budgetary plans, an inefficient investment program, and the maintenance of high current spending that does not enhance growth prospects. Risks from off-balance sheet operations that are likely to become more complex should be closely monitored and assessed.

[1] This DSA has been prepared by IMF staff with input from World Bank staff, using the debt sustainability framework for low-income countries approved by the Boards of both institutions.

[2] The DSA presented in this document is based on the standard low-income countries (LIC) DSA framework. See "Debt Sustainability in Low-Income Countries: Proposal for an Operational Framework and Policy implications" (http://www.imf.org/external/np/pdr/sustain/2004/020304.htm) and "Debt Sustainability in Low-Income Countries: Further Considerations on an Operational Framework, Policy Implications" (http://www.imf.org/external/np/pdr/sustain/2004/091004.htm).

UNDERLYING ASSUMPTIONS

1. **The assessment has been updated from the previous DSA work undertaken in 2011 and 2010 in light of the new policy that allows the buildup of external debt for developmental purposes.** This DSA is based on the macroeconomic framework outlined in the IMF's staff report for the 2013 Article IV consultation. The revised medium-term fiscal framework reflects more conservative spending plans consistent with macroeconomic and debt sustainability. The assessment assumes for analytical purposes that debt accumulation reflects the gap between revenues (ESI and non-oil revenues) and expenditures, e.g., the non-oil fiscal deficit is funded through external borrowing rather than excess withdrawals from the PF as in the past. This is to highlight that excess withdrawals from the PF are a form of borrowing from future generations and in light of the financial advantage of borrowing—as the return on the PF assets is likely higher than the interest cost on concessional borrowings. Since the public sector only borrows externally and the private sector does not incur any medium- or long-term external liabilities, the DSA does not separately assess external and public sector debt sustainability (they are essentially equivalent barring that the public sector external debt is partially illustrated in net terms).

2. **The DSA is based on the following:**

- Timor-Leste has a weak Country Policy and Institutional Assessment (CPIA) performance rating, corresponding to the lowest set of indicative debt thresholds.

- An estimate of gross national disposable income (GNDI) is replaced by gross domestic product (GDP), components of which are now available to more accurately capture the debt servicing capacity of the wider economy—excluding payments to non-residents in the petroleum sector and including transfers from abroad (grants).

- A wide concept of exports includes exports of goods and services as well as primary oil-related income.

- Total public sector revenue equals non-oil tax revenues plus the estimated sustainable income (ESI) from the PF.

- All debt is undertaken by the central government and no off-balance sheet debt is accumulated, including by state owned enterprises, such the national oil company, the Timor Gap.

- Oil reserves are depleted by 2024 and no new reserves come on stream during the forecast horizon.

FISCAL FRAMEWORK

3. **The DSA is based on the authorities' current fiscal framework outlined in the accompanying Staff Report, which significantly improves the fiscal and public balance sheet outlook over the long term compared to the 2013 Budget Book plans**. The so-called Yellow Road framework cuts expenditure growth over the medium term vis-à-vis the 2013 Budget, thereby also lowering the need for financing either through external borrowing or excess PF withdrawals (see text table). Under this framework, staff projects that external borrowing ceases by 2022 yielding stable long-term dynamics regarding public assets in gross and net terms. This contrasts with the unsustainable scenario set out in the 2013 Budget framework that projected large excess PF withdrawals and debt accumulation. This implied a rapid drawdown of public assets after 2024 when oil production is projected to end (see text figure). The unsustainable debt dynamics of the 2013 budget plans are highlighted in Figure 1a.

Projected Medium-Term Fiscal Funding Gaps under 'Yellow Road' and the 2013 Budget
(In millions of US$ unless otherwise noted)

	2013	2014	2015	2016	2017	2018
Baseline: Yellow Road 1/	260	275	319	278	195	124
percent of GDP	4.1	4.7	5.3	4.6	3.2	2.0
2013 Budget 2/	479	661	725	700	723	745
percent of GDP	7.8	11.5	12.1	11.5	11.5	11.6
Difference	-219	-386	-406	-422	-528	-622
percent of GDP	-3.6	-6.8	-6.8	-6.9	-8.3	-9.6

1/ "Yellow Road" framework agreed to by the Council of Ministers in June 2013.
2/ Timor Leste 2013 State Budget Book 1.

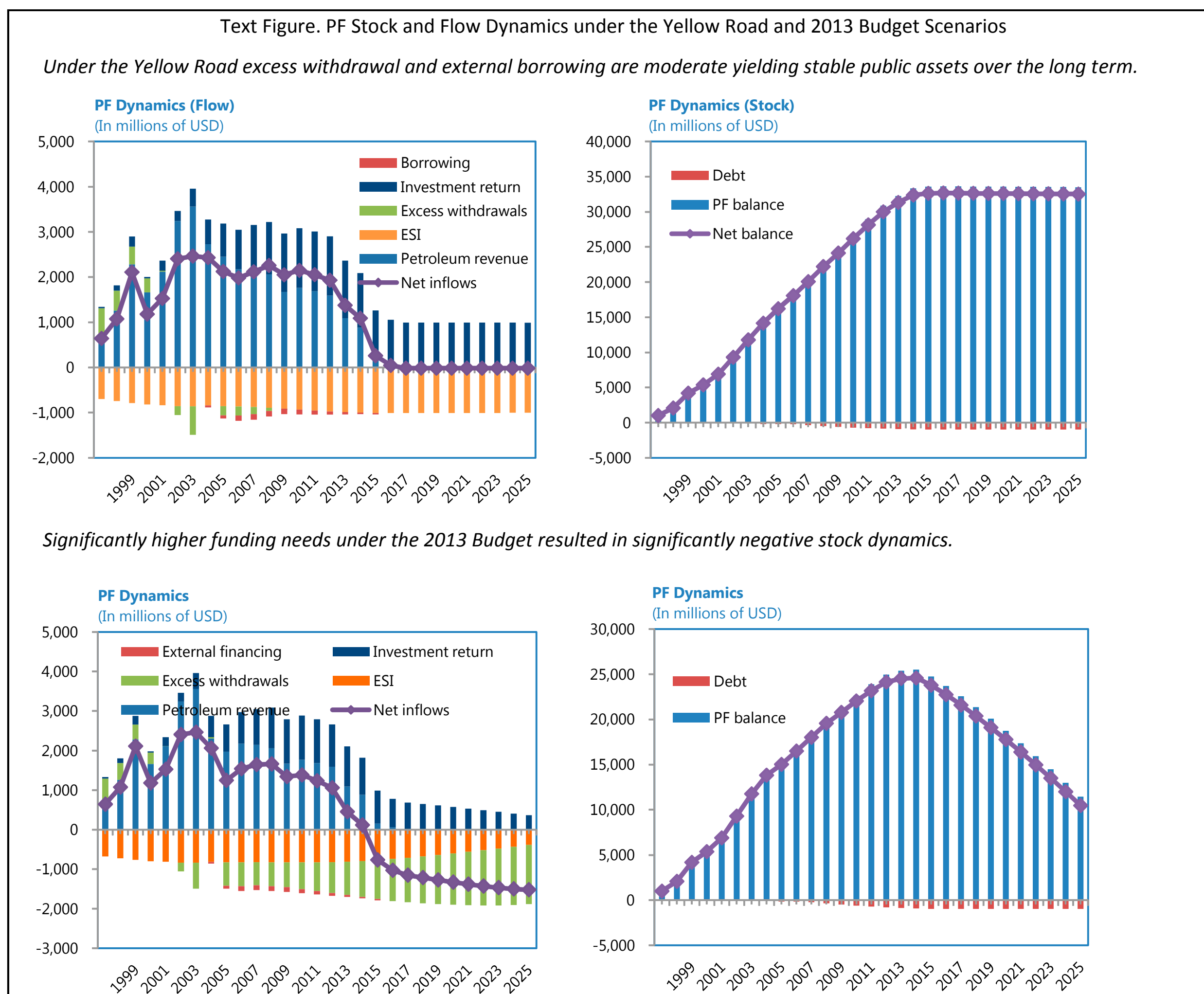
4. **The government will need a strong asset-liability management framework as its balance sheet becomes more complex.** In the period ahead, the government is planning to take on new debt liabilities and enter into public-private partnerships (PPPs) that may generate contingent liabilities.[3] On the asset side, there are plans for government and/or government owned entities to take equity positions in major capital projects. Key considerations are:

- Public debt. Contracting concessional debt from developmental partners is beneficial as it could improve the quality and returns of capital projects. Non-concessional debt should be avoided.

- Off-budget investments. Major capital-intensive projects tend to have complex financing structures and the cost-benefit of public participation in these projects can be difficult to assess. All such projects should be transparent and subject to the full scrutiny of the Major Projects Secretariat and the Audit Court whose capacity needs to be strengthened. Off-balance sheet liabilities, including by state owned companies such as newly established oil company, Timor Gap, should be avoided.

[3] PPP projects currently under development comprise the new Dili Port and the enhancement of Dili Airport—both important projects, with the PPP tender for the Port at Tibar Bay launched in August and work ongoing for the airport. The authorities are working with IFC. The details have yet to be finalized but it is estimated that investment in the Port will be $300-$400 million with significant private sector participation. The overall size of the airport project is not yet finalized but the expected level of private investment is likely to be much smaller.

- Petroleum Fund. The revised Petroleum Fund Law allows a shift in strategic asset allocation away from purely high quality bonds toward equities with a 50:50 split allowed with an intention to increase returns. This may be appropriate from a long-term inter-generational perspective, but the risk-return trade-offs in inherently volatile global financial markets need to be carefully considered. The new provision to allow the PF to guarantee government debts (up to 10 percent of the PF's assets) is potentially risky and should be avoided.



Text Figure. PF Stock and Flow Dynamics under the Yellow Road and 2013 Budget Scenarios

ASSESSMENT

5. **Staff's debt sustainability analysis suggests that the authorities' revised fiscal framework outlined in the Staff Report is consistent with external and public debt sustainability.** Under the current medium-term expenditure framework, a moderate accumulation of gross debt through 2021 with the debt stock peaking at under 12 percent of GDP in present value terms in 2018 is forecast (see Table 1, Figure 1, panels a & b). Due to the high stock of public assets in the Petroleum Fund, at around $13 billion, and continued asset accumulation through 2024, net

public debt remains negative in nominal and present value terms throughout the period (see Table 2, Figure 2). In general, contracting concessional debt from developmental partners is beneficial as it should improve the quality and returns of capital projects. Non-concessional debt should be avoided. Not harnessing resources to stimulate long-term growth in the context of ending petroleum production in the future represents the main risk to debt sustainability.

6. **Risks relating to off-balance sheet liabilities need to be very carefully monitored.** The government is developing a more complex balance sheet, entering into PPPs for the first time and has recently established a national oil company. These developments pose risks that may be opaque and not immediately identifiable. All such liabilities should be subject to the full scrutiny of the Ministry of Finance whose capacity in this regard needs to be strengthened. It is especially important to minimize contingent liabilities and to avoid guarantees (either explicit or implicit) being made by the government.

7. **Within the next ten years, there is a low risk of debt distress under the baseline.** As long as the authorities stick their plans for a prudent fiscal framework allowing the PF assets to continue to grow, there is a low risk of debt distress throughout the period. This is reflected by debt ratios which are projected to remain well below thresholds (Figure 1) even taking into consideration the projected end of oil inflows in 2024 and the small non-oil export sector. Under current projections, debt amortization beginning in 2020 mitigates stock ratios even as oil inflows are projected to end, which has a deleterious effect on GDP, export and revenue growth (Figure 1, panels a-d). At the same time, given the concessionality of the debt and moderate pace of accumulation, debt service ratios remain well within debt stability tolerances even after oil flows are projected to cease (Figure 1, panels e & f).

8. **Risks to the outlook are reflected in the non-debt creating flows shock (the most extreme) and the less favorable terms of new debt shock, illustrating the low debt carrying capacity of the economy given its narrow base.** While net public debt will remain significantly negative as a percent of GDP and in PV terms throughout the period in the baseline scenario (Figure 2), lower permanent growth of about 1.5 percentage points over the baseline consistently worsens the debt outlook. The worsening net debt-to-GDP ratio as of 2024 under the baseline is a function of GDP declining faster than the accumulation of public foreign assets in the context of oil inflows ending. However, gross public external assets are projected to increase throughout the forecast period based on the assumption that the authorities maintain their plan of ending excess PF withdrawals.

9. **These conclusions critically depend on maintaining the prudent fiscal policies outlined in the staff report.** In particular, policies to eliminate excess PF withdrawals and enhance the quality of expenditures to diversify the economy must be followed through. Figure 1 demonstrates the importance of oil flows and of diversifying the economy as the shock to non-debt creating flows is the most adverse, with the stock equalling the threshold in the stress scenario. This illustration also underscores the importance of borrowing only on concessional terms as the less favorable terms scenario is the second worst shock. The importance of maintaining an appropriate fiscal stance and diversifying growth is illustrated by the fixed primary balance and permanent growth shocks in

Figure 2, particularly in order to maintain a sustainable debt service burden. Similarly, avoiding significant negative returns on the PF is critical to maintaining debt sustainability given the lack of alternative debt servicing capacity, suggesting a conservative and carefully considered investment strategy is called for.

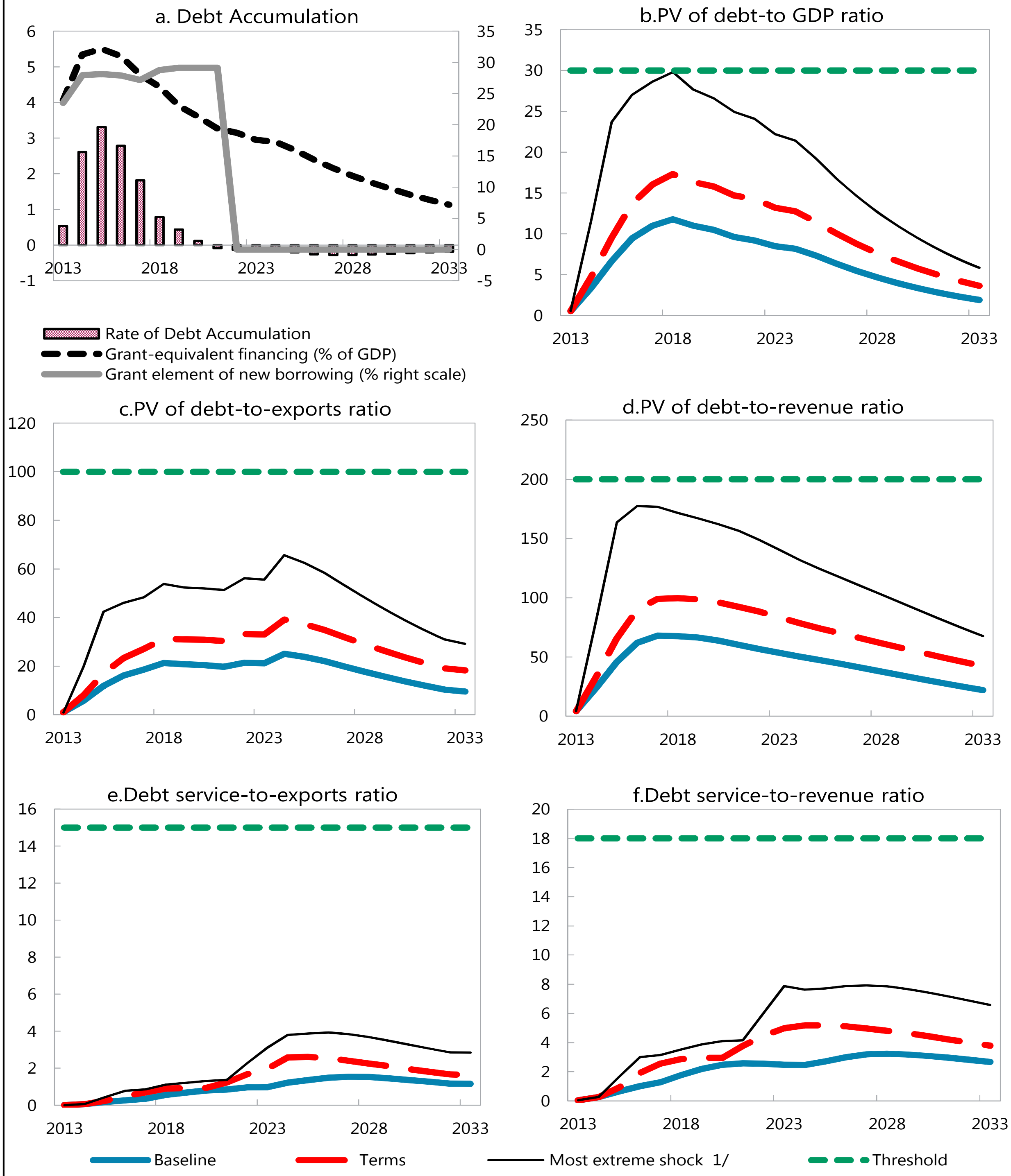
AUTHORITIES' VIEWS

10. **Authorities agreed with the conclusions of the DSA.** In discussions with the mission, it was recognized that adopting the Yellow Road framework would stabilize the long-term PF balance and external debt outlook, implying a low risk of debt distress.

CONCLUSION

11. **Critical to Timor Leste's debt sustainability is the adoption of a prudent fiscal policy and diversifying the economy to realize growth in the non oil sector.** The revised fiscal framework, Yellow Road that replaces the 2013 Budget Book would ensure sustainability. However, consistent implementation will be critical to maintaining sustainability. Policy slippages would increase risks to the external debt outlook, particularly in view of Timor Leste's narrow economic base and low debt servicing capacity. Consistent with this fiscal path will be the need for higher quality growth in the non-oil sector. This will require, inter alia: (i) structural reforms to stimulate the private sector; (ii) careful prioritization of complementary public investments that efficiently support the development of labor-intensive and export orientated sectors; and (iii) a public asset-liability management framework that optimizes the financing mix from the PF and development partners. The authorities should avoid non-concessional financing and the buildup of contingent liabilities.

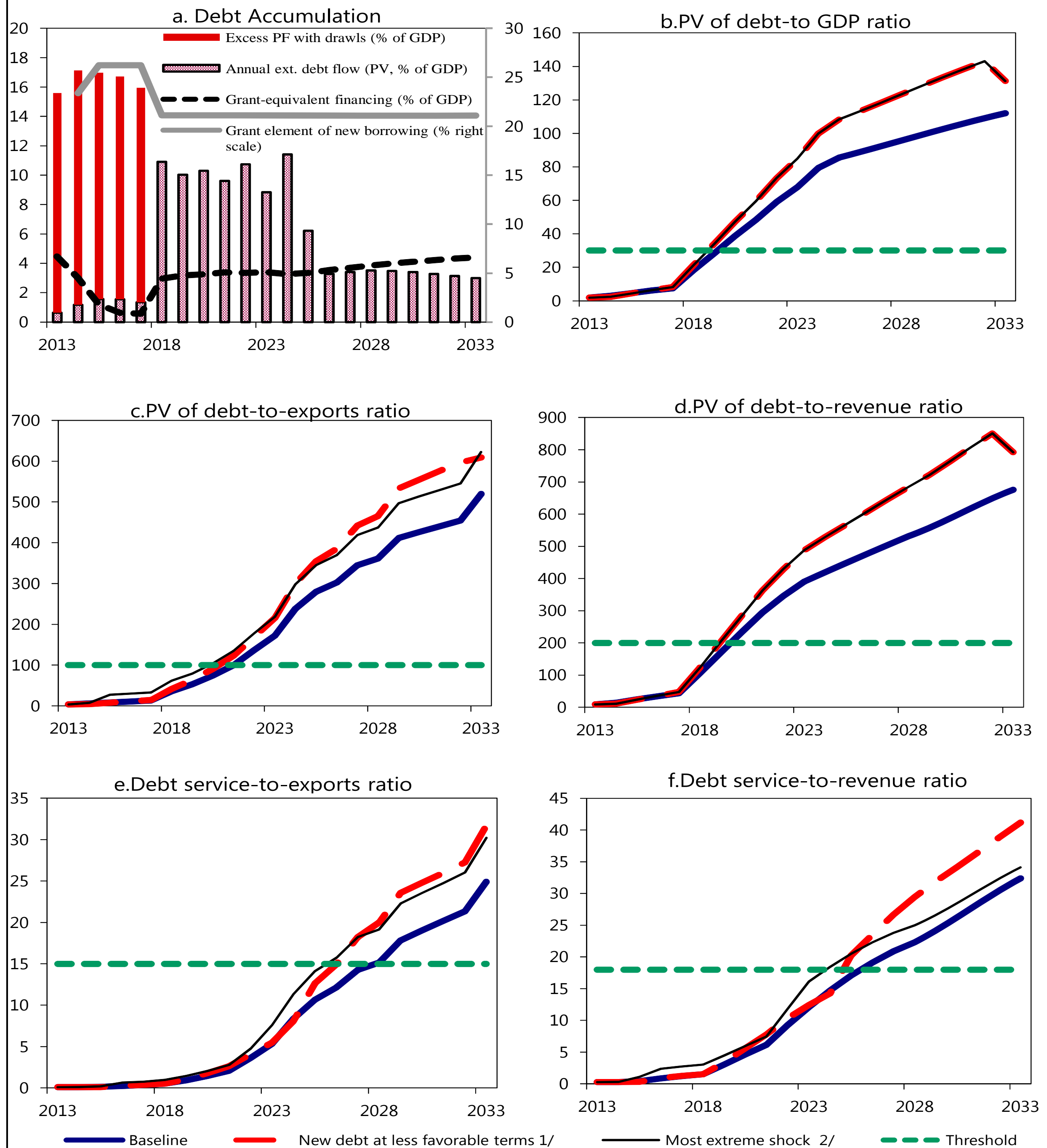
Figure 1. Timor-Leste: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2013-2033 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2023. In figure b. it corresponds to a Non-debt flows shock; in c. to a Non-debt flows shock; in d. to a Non-debt flows shock; in e. to a Non-debt flows shock and in figure f. to a Non-debt flows shock

Figure 1a. Timor-Leste: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2013-2033 1/



Sources: Timor-Leste authorities; and IMF staff estimates and projections.
1/Assumes accumulations above MDB exposure ceilings are allocated half at IDA and half at IBRD terms. As of 2018, debt accumulation is equivalent to forgone excess PF withdrawls.

2/ The most extreme stress test is the test that yields the highest ratio in 2023. Panels b and d correspond to new debt on less favorable terms, panel c and e correspond to an export shock of historical average growth minus one standard deviation in 2014-2015, and panel f corresponds with a shock to non-debt creating flows of historical average growth minus one standard deviation in 2014-2015.

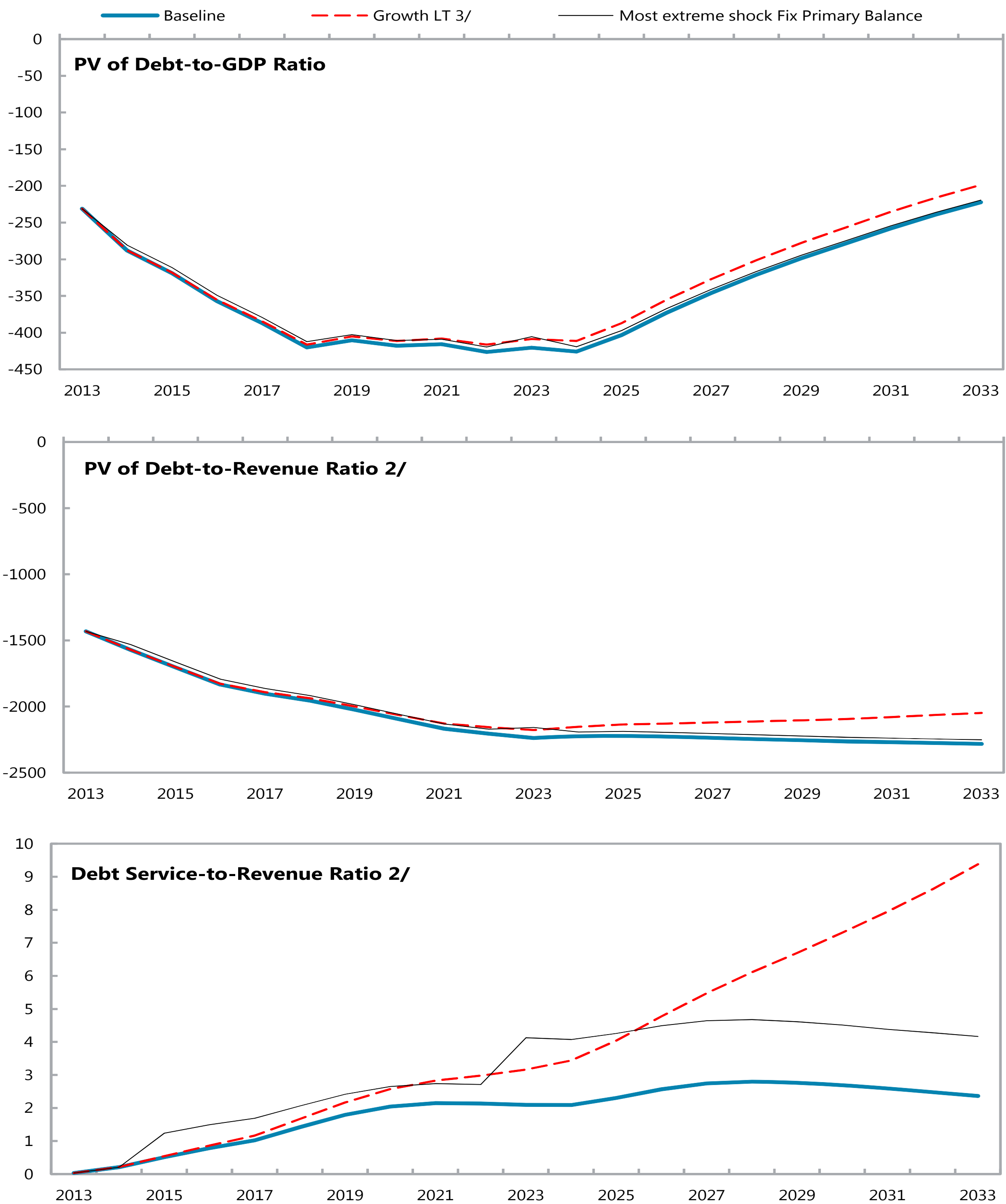
Table 1: External Debt Sustainability Framework, Baseline Scenario, 2010-2033 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/	Standard Deviation 6/	Projections									
	2010	2011	2012			2013	2014	2015	2016	2017	2018	2013-2018 Average	2023	2033	2019-2033 Average
External debt (nominal) 1/	**0.0**	**0.0**	**0.0**			**0.7**	**4.7**	**9.2**	**13.0**	**15.0**	**16.0**		**11.2**	**2.5**	
of which: public and publicly guaranteed (PPG)	0.0	0.0	0.0			0.7	4.7	9.2	13.0	15.0	16.0		11.2	2.5	
Change in external debt	0.0	0.0	0.0			0.7	4.0	4.5	3.8	2.0	0.9		-1.0	-0.5	
Identified net debt-creating flows	...	...	...			-35.2	-34.1	-29.5	-30.7	-30.9	-25.1		-12.7	-2.7	
Non-interest current account deficit	**-39.8**	**-40.4**	**-43.5**	**-27.9**	**18.9**	**-34.3**	**-32.1**	**-27.1**	**-27.9**	**-28.6**	**-25.4**		**-10.9**	**0.3**	-6.0
Deficit in balance of goods and services	-25.9	-29.3	-38.1			-25.1	-21.8	-16.5	-16.7	-17.1	-13.4		-0.9	5.5	
Exports	57.8	61.5	64.5			55.4	58.7	56.0	58.6	59.2	55.3		39.9	19.9	
Imports	31.8	32.2	26.4			30.3	36.9	39.4	41.8	42.1	41.9		39.1	25.4	
Net current transfers (negative = inflow)	-11.4	-9.1	-6.8	-14.9	15.3	-7.3	-8.3	-8.6	-9.0	-9.3	-9.7		-8.9	-5.5	-7.9
of which: official	-10.5	-7.9	-6.3			-4.7	-3.6	-3.5	-3.5	-3.5	0.0		0.0	0.0	
Other current account flows (negative = net inflow)	-2.5	-2.0	1.4			-2.0	-2.0	-2.0	-2.1	-2.2	-2.2		-1.1	0.4	
Net FDI (negative = inflow)	**-0.7**	**-1.4**	**-0.1**	**-1.0**	**1.0**	**-0.9**	**-2.0**	**-2.4**	**-3.2**	**-2.7**	**-0.7**		**-2.2**	**-2.8**	-2.3
Endogenous debt dynamics 2/	**...**	**...**	**...**			**0.0**	**0.1**	**0.0**	**0.3**	**0.3**	**1.0**		**0.3**	**-0.2**	
Contribution from nominal interest rate	...	...	...			0.0	0.0	0.1	0.2	0.2	0.2		0.1	0.0	
Contribution from real GDP growth	0.0	0.0	0.0			0.0	0.1	-0.1	0.2	0.1	0.8		0.2	-0.2	
Contribution from price and exchange rate changes	0.0	0.0	0.0			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**...**	**...**	**...**			**35.9**	**38.1**	**34.0**	**34.5**	**33.0**	**26.0**		**11.7**	**2.1**	
of which: exceptional financing	...	...	...			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	0.0			0.5	3.4	6.6	9.4	11.0	11.8		8.5	1.9	
In percent of exports	...	...	0.0			1.0	5.8	11.8	16.1	18.6	21.3		21.2	9.5	
PV of PPG external debt	**...**	**...**	**0.0**			**0.5**	**3.4**	**6.6**	**9.4**	**11.0**	**11.8**		**8.5**	**1.9**	
In percent of exports	**...**	**...**	**0.0**			**1.0**	**5.8**	**11.8**	**16.1**	**18.6**	**21.3**		**21.2**	**9.5**	
In percent of government revenues	**...**	**...**	**0.0**			**4.4**	**24.2**	**45.8**	**62.0**	**67.9**	**67.7**		**53.5**	**22.1**	
Debt service-to-exports ratio (in percent)	**0.0**	**0.0**	**0.0**			**0.0**	**0.1**	**0.2**	**0.3**	**0.4**	**0.6**		**1.0**	**1.2**	
PPG debt service-to-exports ratio (in percent)	**0.0**	**0.0**	**0.0**			**0.0**	**0.1**	**0.2**	**0.3**	**0.4**	**0.6**		**1.0**	**1.2**	
PPG debt service-to-revenue ratio (in percent)	**0.0**	**0.0**	**0.1**			**0.0**	**0.3**	**0.7**	**1.0**	**1.3**	**1.8**		**2.5**	**2.7**	
Total gross financing need (Billions of U.S. dollars)	-1.7	-2.4	-2.7			-2.2	-1.9	-1.7	-1.8	-1.8	-1.5		-1.0	-0.5	
Non-interest current account deficit that stabilizes debt ratio	-39.8	-40.4	-43.5			-35.1	-36.1	-31.6	-31.7	-30.6	-26.3		-9.8	0.8	
Key macroeconomic assumptions															
Real GDP growth (in percent)	-1.4	7.3	5.7	26.4	44.5	-3.2	-6.9	1.7	-2.1	-1.1	-5.3	-2.8	-1.6	8.0	3.5
GDP deflator in US dollar terms (change in percent)	29.6	28.1	2.9	8.5	17.2	0.5	-0.6	-0.4	1.8	3.5	5.8	1.8	8.4	3.4	5.6
Effective interest rate (percent) 5/	...	...	...	0.0	0.0	0.0	5.0	2.1	1.7	1.5	1.4	1.9	1.3	0.9	1.2
Growth of exports of G&S (US dollar terms, in percent)	38.5	46.4	13.9	57.1	56.1	-16.4	-1.9	-3.4	4.3	3.4	-6.3	-3.4	-0.7	0.0	2.1
Growth of imports of G&S (US dollar terms, in percent)	15.7	39.2	-11.0	17.3	30.1	11.8	12.7	8.2	5.7	2.9	-0.2	6.9	6.6	4.4	5.5
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	23.5	27.9	28.1	27.9	27.2	28.8	27.2	0.0	0.0	5.8
Government revenues (excluding grants, in percent of GDP)	6.9	9.6	9.8			12.3	14.1	14.5	15.2	16.2	17.4		15.8	8.6	13.5
Aid flows (in Billions of US dollars) 7/	0.3	0.3	0.3			0.2	0.4	0.4	0.4	0.3	0.3		0.2	0.2	
of which: Grants	0.3	0.3	0.3			0.2	0.2	0.2	0.2	0.2	0.2		0.2	0.2	
of which: Concessional loans	0.0	0.0	0.0			0.0	0.1	0.2	0.1	0.1	0.0		0.0	0.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			4.1	5.3	5.5	5.3	4.8	4.4		3.0	1.1	2.4
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			88.2	65.3	62.8	65.9	73.7	85.4		100.0	100.0	98.9
Memorandum items:															
Nominal GDP (Billions of US dollars)	4.2	5.8	6.3			6.1	5.7	5.7	5.7	5.9	5.9		8.2	21.5	
Nominal dollar GDP growth	27.8	37.5	8.7			-2.7	-7.4	1.3	-0.3	2.3	0.2	-1.1	6.7	11.7	9.1
PV of PPG external debt (in Billions of US dollars)			0.0			0.0	0.2	0.4	0.5	0.6	0.7		0.7	0.4	
(PVt-PVt-1)/GDPt-1 (in percent)						0.5	2.6	3.3	2.8	1.8	0.8	2.0	-0.1	-0.2	-0.1
Gross workers' remittances (Billions of US dollars)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of PPG external debt (in percent of GDP + remittances)	...	...	0.0			0.5	3.4	6.6	9.4	11.0	11.8		8.5	1.9	
PV of PPG external debt (in percent of exports + remittances)	...	...	0.0			1.0	5.8	11.8	16.1	18.6	21.3		21.2	9.5	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	0.0			0.0	0.1	0.2	0.3	0.4	0.6		1.0	1.2	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.
2/ Derived as $[r - g - \rho(1+g)]/(1+g+\rho+g\rho)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that PV of private sector debt is equivalent to its face value.
5/ Current-year interest payments divided by previous period debt stock.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.
7/ Defined as grants, concessional loans, and debt relief.
8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Figure 2.Timor-Leste: Indicators of Public Debt Under Alternative Scenarios, 2013-2033 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2023.

2/ Revenues are defined inclusive of grants.

3/ The historical reference period for calculating the size of the GDP shock is shortened by three years to exclude the period when Timor Leste's petroleum production came on stream.

Table 2.Timor-Leste: Public Sector Debt Sustainability Framework, Baseline Scenario, 2010-2033

(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2010	2011	2012	Average 5/	Standard Deviation 5/	2013	2014	2015	2016	2017	2018	2013-18 Average	2023	2033	2019-33 Average
Public sector debt 1/	0.0	0.0	0.0			0.7	4.7	9.2	13.0	15.0	16.0		11.2	2.5	
net of external public assets	0.0	0.0	0.0			-231	-288	-319	-357	-387	-420		-420	-222	
Change in public sector debt	0.0	0.0	0.0			0.7	4.0	4.5	3.8	2.0	0.9		-1.0	-0.5	
Identified debt-creating flows	...	...	...			...	8.2	8.7	8.1	6.2	5.2		1.8	0.5	
Primary deficit	12.8	9.3	8.2	8.0	4.6	7.3	8.1	8.7	7.9	6.3	5.0	7.2	2.4	0.8	2.0
Revenue and grants	14.2	14.5	13.8			16.2	18.3	18.7	19.5	20.3	21.5		18.8	9.7	
of which: grants	7.3	4.9	4.0			3.9	4.2	4.2	4.2	4.1	4.1		3.0	1.1	
Primary (noninterest) expenditure	27.0	23.8	22.0			23.5	26.5	27.4	27.3	26.6	26.5		21.2	10.6	
Automatic debt dynamics	...	...	...			...	0.1	0.0	0.2	-0.1	0.2		-0.6	-0.3	
Contribution from interest rate/growth differential	...	...	...			...	0.1	-0.1	0.2	0.1	0.8		0.1	-0.3	
of which: contribution from average real interest rate	...	...	...			...	0.0	0.0	0.0	-0.1	-0.1		-0.1	0.0	
of which: contribution from real GDP growth	0.0	0.0	0.0			0.0	0.1	-0.1	0.2	0.2	0.8		0.2	-0.2	
Contribution from real exchange rate depreciation	...	...	...			...	0.0	0.1	0.0	-0.2	-0.6		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	...	...	...			...	-4.2	-4.2	-4.2	-4.2	-4.2		-2.8	-1.0	
Other Sustainability Indicators															
PV of public sector debt	...	...	0.0			0.5	3.4	6.6	9.4	11.0	11.8		8.5	1.9	
of which: foreign-currency denominated	...	...	0.0			0.5	3.4	6.6	9.4	11.0	11.8		8.5	1.9	
of which: external	...	...	...			0.5	3.4	6.6	9.4	11.0	11.8		8.5	1.9	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	12.8	9.3	8.2			7.3	8.2	8.8	8.0	6.5	5.3		2.8	1.0	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	0.0			3.4	18.6	35.4	48.5	54.1	54.7		45.1	19.5	
PV of public sector debt-to-revenue ratio (in percent)	...	...	0.0			4.4	24.2	45.8	62.0	67.9	67.7		53.5	22.1	
of which: external 3/	...	...	...			4.4	24.2	45.8	62.0	67.9	67.7		53.5	22.1	
Debt service-to-revenue and grants ratio (in percent) 4/	0.0	0.0	0.1			0.0	0.2	0.5	0.8	1.0	1.4		2.1	2.4	
Debt service-to-revenue ratio (in percent) 4/	0.0	0.0	0.1			0.0	0.3	0.7	1.0	1.3	1.8		2.5	2.7	
Primary deficit that stabilizes the debt-to-GDP ratio	12.8	9.3	8.2			6.6	4.1	4.2	4.1	4.3	4.0		3.4	1.3	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	-1.4	7.3	5.7	26.4	44.5	-3.2	-6.9	1.7	-2.1	-1.1	-5.3	-2.8	-1.6	8.0	3.5
Average nominal interest rate on forex debt (in percent)	...	...	...	0.0	0.0	...	5.0	2.1	1.7	1.5	1.4	2.3	1.3	0.9	1.2
Average real interest rate on domestic debt (in percent)	...	...	...	0.0	0.0	...	...	...	...	...	...	0.0	...	...	0.0
Real exchange rate depreciation (in percent, + indicates depreciation)	-20.3	-19.5	-0.3	-5.0	17.2	1.1	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	29.6	28.1	2.9	8.5	17.2	0.5	-0.6	-0.4	1.8	3.5	5.8	1.8	8.4	3.4	5.6
Growth of real primary spending (deflated by GDP deflator, in percent)	-0.2	-0.1	0.0	0.4	0.8	0.0	0.0	0.1	0.0	0.0	-0.1	0.0	-0.1	0.0	0.0
Grant element of new external borrowing (in percent)	...	...	...	...	...	23.5	27.9	28.1	27.9	27.2	28.8	27.2	0.0	0.0	...

Sources: Country authorities; and staff estimates and projections.

1/ The public sector refers to the central government.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

October 7, 2013

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | Asia and Pacific Department
(In consultation with other departments)

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FUND RELATIONS

(As of August 31, 2013)

Membership Status
Joined: July 23, 2002; Article VIII

General Resources Account

	SDR Million	Percent Quota
Quota	8.20	100.00
Fund holdings of currency	8.20	100.00
Reserve position in Fund	0.00	0.01

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	7.73	100.00
Holdings	7.75	100.31

Outstanding Purchases and Loans
None

Latest Financial Arrangements
None

Projected Obligations to Fund
None

Exchange Rate Arrangements
On January 24, 2000, the U.S. dollar was adopted as the official currency of then East Timor by the United Nations Transitional Administration in East Timor (UNTAET). This arrangement has been maintained after Timor-Leste's independence on May 20, 2002. At present, the monetary authority does not undertake foreign exchange transactions; they are handled by commercial banks on the basis of rates quoted in the international markets. Timor-Leste has accepted the obligations under Article VIII, Sections 2(a), 3 and 4, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. The authorities noted that no changes have been made to the exchange system since the last Article IV mission.

Article IV Consultations

Timor-Leste is on a 12-month consultation cycle. The previous Article IV consultation was concluded on January 31, 2012. The Public Information Notice may be found at http://www.imf.org/external/np/sec/pr/2013/pr13222.htm. The Article IV consultation in 2012 was delayed by the change in government.

Technical Assistance (TA) and Training

Since late 1999, Timor-Leste has been one of the largest recipients of Fund technical assistance as part of the international community's efforts to reconstruct the Timor-Leste economy. The Fund's technical assistance and training has focused on establishing key economic institutions (especially what are now the Ministry of Finance and central bank) essential for macroeconomic management, as well as on developing local capacity to manage them. More recently, technical assistance provision has been focused in key areas including the Estimated Sustainable Income (ESI) calculation, the Petroleum Fund's (PF) investment strategy and improving statistics. TA has been provided by HQ based staff and experts in collaboration with the Pacific Financial Technical Assistance Centre (PFTAC). Current and planned technical assistance is described in more detail below:

FAD: Building on the high level of technical assistance delivery in the past, recent technical assistance has focused on follow up to the Public Expenditure Financial Assessment and fiscal ROSC that were conducted in 2010 as well as in specific areas. To support the 2011 Ministry of Finance Strategic Plan (MoFSP), follow-up TA mission on treasury management was delivered in 2012, laying the groundwork for the placement of a resident advisor to the Ministry of Finance. The advisor started working on Public Finance Management in March 2012 and concluded in March 2013. Recent FAD TA missions include (i) strengthening macro-fiscal capacity; and (ii) non-oil tax policy and administration. Planned TA for 2013/14 includes on: (i) the ESI calculation; and (ii) public expenditure management in collaboration with other donors.

MCM: The recent focus has been on the PF, with a mission in 2013 on improving its governance and investment capabilities as it moves to a more sophisticated investment approach. Follow-up TA is likely in 2014. During the 2013 Article IV mission, the BCTL requested TA on a number of core central banking areas and a Needs Assessment mission will visit toward the end of 2013 to identify key areas. Subsequent more focused follow-up missions are planned to the BCTL in 2014.

STA/PFTAC: Recent missions have focused on (i) government finance statistics as part of an on-going project regarding the compilation of fiscal data for operational and statistical purposes—based on the GFSM 2001 framework—and publishing Timorese data in the International Financial Statistics; (ii) balance of payments including on ensuring compliance with the Balance of Payments and International Investment Position Manual (BPM6); and (iii) national accounts statistics collaboratively between PFTAC and the Australian Bureau of Statistics (ABS) in order to review the methodology and the compilation system. Follow-up TA in these areas is planned for 2014. IMF staff has also worked closely with other TA providers especially on enhancing the inflation methodology

and preparing national income accounts. The authorities have requested TA on ensuring consistency in the treatment of oil exports in the national income accounts and the balance of payments.

STI/PFTAC: Government officials from Timor-Leste generally attend IMF training courses on macroeconomic and financial policies including statistics and legal issues offered by the STI, both in Singapore and in the region. During 2012, a total of nine participants attended STI training courses in Singapore and in the region (officials attended the Financial Programming course offered by ICD/STI/PFTAC in Fiji during November-December 2012). Going forward, the STI will continue to focus on macro-critical capacity building needs and developing synergies between TA and training will also be a priority. In FY 2014 it is expected that staff from the Ministry of Finance and the CBTL will participate in regional courses and workshops organized by PFTAC's macroeconomic advisor.

Resident Representative

The resident representative office in Dili, established in August 2000, closed at end-June 2009.

WORLD BANK-IMF COLLABORATION

The Bank and Fund country teams for Timor-Leste, led by Mr. Luis Constantino (World Bank country manager) and Mr. Neil Saker (IMF mission chief), have closely cooperated on macroeconomic issues and macro-critical structural reforms. The Bank's country economist, Mr. Hans Beck, joined the 2013 Article IV consultation mission.

The two teams have worked closely on the following:

- Macroeconomic developments and economic updates. There has been close dialogue throughout the year on macro policies and economic developments. There is regular sharing of information and development of common policy recommendations. The Fund provided comments on the Bank's Country Partnership Strategy that was finalized in 2013.

- Public finance management. Bank staff has been following up on the PEFA and ROSC recommendations, including helping the Ministry of Finance (MoF) put together a Strategic Plan.

- External debt. The teams have engaged very closely on discussions around the government's plans to borrow. A joint DSA was been conducted in July 2013, which is an important building block for the Bank's creditworthiness assessment.

- Capacity building. The Fund and the Bank both co-hosted alongside the Government of Timor-Leste, the Asian Development Bank (AsDB), and Japan International Cooperation Agency (JICA), the conference on *Harnessing Natural Resource Wealth for Inclusive Growth and Economic Development*, held in Dili in September, 2013.

The teams agreed that Timor-Leste's main macroeconomic challenge is to manage the country's petroleum wealth effectively and sustainably develop a stronger non-oil economy and reduce poverty. To meet this challenge, Timor-Leste needs to shift to a higher quality and poverty reducing growth path while ensuring macroeconomic stability and fiscal sustainability. This will require a prudent fiscal stance, the prioritization of public expenditures; strengthened public financial management and an acceleration of reforms to promote productivity and competitiveness. The government launched the Strategic Development Plan (SDP) 2011–30 in July 2011 and both the Bank and Fund have made concrete recommendations to help ensure that it achieves its goals.

Based on this shared assessment the following structural reform areas were identified as macro-critical:

- Medium-term fiscal plans. The government is working on a revised medium-term budget that will stabilize public spending at sustainable levels. Expenditures will be prioritized to ensure value for money and compliance with SDP objectives.

- Public financial management (PFM) reform. The recent Fiscal ROSC and PEFA missions and the Bank's review of the Planning and Financial Management Capacity Building Program found solid progress but also highlighted pressing issues around medium-term budgeting, expenditure (in particular public investment) management and procurement, and auditing. These areas are critical for the quality of expenditure.

- Promoting productivity and competitiveness: Timor-Leste faces a number of challenges to promoting productivity, competitiveness and diversification in the non-oil economy. Key priorities include addressing human capital; improving access to finance; improving the agriculture sector; and strengthening the business environment, in particular access contract enforcement.

The teams agreed to continue the close cooperation going forward. The table below details the specific activities planned by the two country teams in 2013/14 period. In summary, the Fund will continue to lead on macro issues, and the Bank will continue to lead PFM and macro critical structural reform issues.

Timor-Leste: Bank and Fund Planned Activities in Macro-Critical Areas

June 2013–June 2014

Title	Products	Provisional Timing	Expected Delivery of Output
1. Bank Work Program	Ministry of Finance Strategic Plan	November/December 2011	Completed June 2012
	Ministry of Finance PFM Program	Ongoing	January 2014 (program closes)
	Participation in the Timor-Leste Development Partners Meeting	June 2013 and 2014	June 2013 and 2014
	Co-hosting Conference on *Harnessing Natural Resource Wealth for Inclusive Growth and Economic Development*	September 2013	September 2013
	Public Expenditure Review of Infrastructure	February 2014	February 2014
	Support on Public Investment Management	January 2014	June 2014
	Parliamentary seminars on lending, social transfers, infrastructure financing, Private Sector Development	Ongoing	Ongoing
2. Fund Work Program	2014 Article IV Consultations	Staff visit in January 2014 and Article IV mission in June 2014	January 2014 and September 2014
	Participation in the Timor-Leste Development Partners Meeting	June 2013 and 2014	June 2013 and 2014
	Co-hosting Conference on *Harnessing Natural Resource Wealth for Inclusive Growth and Economic Development*	September 2013	September 2013
	TA: PF investment management	Ongoing	
	TA: Needs Assessment at BCTL	October 2013	November 2013
	TA: ESI and fiscal regime for petroleum	August 2013	September 2013
	TA: Government Finance Statistics	Ongoing	
	TA: Monetary and Financial Statistics	Ongoing	
3. Joint Work Program	DSA update	June 2014	October 2014

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of June 2013)

Timor-Leste joined the AsDB in 2002. The relationship evolved from an initial focus on rehabilitation and reconstruction to developing vital infrastructure to support economic growth and development. The relationship is currently guided by the AsDB's country partnership strategy (CPS), 2011–2015 that aligns the engagement with Timor-Leste's Strategic Development Plan, 2011–2030. The CPS outlines a five-year strategic partnership with the government in support of infrastructure, financial services, and the skills training required to meet the needs of a growing economy. It will support the private sector to help Timor-Leste make the transition from a public sector-led economy. Assistance will also be provided for governance and capacity development, gender equity, knowledge solutions, and helping Timor-Leste integrate regionally.

Timor-Leste first accessed the Asian Development Fund (ADF) in 2005. The ADF has provided grants for road rehabilitation, water supply and technical and vocational education and training projects. Timor-Leste is the recipient of one of AsDB's largest ever technical assistance (TA) grant, the Infrastructure Project Management TA. This $15 million six-year package, co-financed with AusAID, helps plan, prepare, and execute the government's capital development program. Other AsDB activities include support for regional economic integration, the finance sector, small-scale infrastructure, and the strengthening of statistics and macroeconomic management, the civil service, and environmental management. The AsDB has provided technical support for the establishment of the Petroleum Fund and other core elements of public sector management. The AsDB helped establish the Institute of Microfinance in Timor-Leste, which, in July 2011, became the country's first locally owned commercial bank, the Banco Nacional Comércio de Timor-Leste (BNCTL).

In October 2011, available resources were increased following Timor-Leste's reclassification as a B member country. This provides access to AsDB's ordinary capital resources, while retaining access to Asian Development Fund (ADF). The indicative ordinary capital resources allocation for 2013–2015 is $60 million, with actual allocation to depend on demand and on portfolio performance. The $50.32 million in ADF resources for 2013–2015 are available as loans only. Under the CPS, financial resources for 2011–2015 are expected to be concentrated on major roads, seaports, mid-level skills training, and water supply and sanitation in urban centers. The AsDB will promote the provision of a range of infrastructure services, including operations and maintenance by the private sector. Road transport has been identified as the main infrastructure subsector, reflecting the AsDB's presence in the subsector, the substantial resources needed to achieve the government's targets, and the importance of quickly improving of road infrastructure. In 2012, Timor-Leste received $68.7 million loan cofinancing from the government of Japan for the Road Network Upgrading Project.

The AsDB also co-hosted alongside the government of Timor-Leste, the IMF, the World Bank, and Japan International Cooperation Agency (JICA) the conference on *Harnessing Natural Resource Wealth for Inclusive Growth and Economic Development*, held in Dili in September, 2013.

STATISTICAL ISSUES

(As of June 2013)

I. Assessment of Data Adequacy for Surveillance
General: Data provision to the Fund has shortcomings due to capacity constraints that significantly hamper surveillance. Most affected areas are national accounts and trade statistics. TA is being provided by the Fund and other donors to help improve capacity.
National Accounts: The national accounts have been developed for 2004–11, with details of GDP and its components available for the first time. This has been developed by a national accounts advisor funded by donors. To improve national accounts data further, appropriate staff and substantial efforts in data collection and compilation are needed. With TA from PFTAC and in conjunction with the ABS, the methodology was reviewed in May 2013 and assessed as broadly compliant with the *System of National Accounts 2008*. The review also recommended identifying areas for simplification of the compilation system to facilitate the compilation of future national accounts estimates by the General Directorate of Statistics and reduce its reliance on external assistance. In the longer term, a new compilation system might be redeveloped with support from the ABS which is likely to provide substantive TA in the future.
Price Statistics: The inflation methodology has recently been enhanced. Starting 2013, CPI has been rebased and basket weights updated using data derived from the Household Income and Expenditure Survey (HIES) that was conducted in 2011. Data is released monthly for Dili but the national data is only available quarterly. Shortcomings in data collection, especially in rural areas, also remain and products and outlets should be updated.
Government Finance Statistics: The compilation of revenue and expenditure is moving toward the *GFSM 2001* approach but progress has been hampered by capacity constraints. STA has an ongoing technical assistance project to facilitate the migration to *GFSM 2001*. A technical assistance mission conducted in early 2013 was able to update both the chart of accounts (COA) classifications and public sector delineation. However, only partial data are available on fiscal and quasi-fiscal activities undertaken by bilateral donors outside the central government budget.
Monetary and Financial Statistics: Monetary statistics are compiled by the BCTL, generally following the methodology of *the Monetary and Financial Statistics Manual*. However, data are incomplete because of the absence of official data on public currency holdings—which are difficult to compile under the current currency regime—and of banks' positions with public nonfinancial corporations. Detailed monthly monetary data are available from July 2002 onward, following the introduction of the standardized report forms (SRFs) for the central bank and other depository corporations (ODCs). Currently, there is a need to: (i) introduce SRFs for the central bank based on the new chart of accounts and for the ODCs based on the revised call report form, (ii) include the credit unions in the institutional coverage of the ODCs, and (iii) introduce the SRF for other financial corporations.

Balance of payments: While progress has been made, measuring non-PF related current account transactions accurately remains a work in progress. Monthly merchandise trade data are now published regularly but there are significant gaps in the series for 2006 and 2007. Data on monthly merchandise exports and imports is based on the tariff system – ASYCUDA. Significant underestimation of transactions stem from the large, unrecorded border trade; the exemption of some goods from customs duties; and the undervaluation of declared goods, particularly for imports. Service transactions are largely estimated with data collection largely limited to the official and tourism sectors. Currently, primary and interest oil/gas revenues are recorded as current income based on fiscal data.

With technical assistance provided by the IMF's Statistics Department, annual balance of payments data are now available for 2006–12. While methodology for the production of basic annual estimates of the balance of payments statistics are in place, further development work is needed to address limitations of existing data sources, in particular, merchandise trade statistics and service transactions. This includes work to ensure consistency between current account data and the new National Accounts Statistics, particularly related to the exports of commodities and imports of services. The authorities are considering the recording of primary oil/gas income as an export to mirror the treatment in the National Accounts Statistics in the context of upcoming TA missions. The coverage of the survey of foreign direct investment enterprises needs to be expanded, and the exploration and extraction activities in the Joint Petroleum Development Area and in the exclusive territory, requires ongoing monitoring.

Currently, there is limited information on remittances from Timorese working abroad and improvement in the estimation and compilation procedures of such remittances should be pursued.

Since October 2012, Timor-Leste participates in the Japan Administered Account for Selected IMF Activities (JSA) Project on the Improvement of External Sector Statistics in the Pacific Region. TA under this project has resulted in the dissemination of annual IIP data on the central bank's website and an improvement in the periodicity and timeliness of external sector statistics.

II. Data Standards and Quality	
Participant in the Fund's General Data Dissemination System (GDDS) since October 31, 2012.	No Data ROSC is available.

III. Reporting to STA

No data on government finance statistics are currently reported for the *GFS Yearbook* and the *International Financial Statistics (IFS).*

Monetary data are reported to the IMF for publication in the *IFS* on a regular monthly basis

Timor-Leste: Table of Common Indicators Required for Surveillance

(As of August 21, 2013)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	7/2013	8/2013	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	1/2013	5/2013	M	M	M
Reserve/Base Money	6/2013	8/2013	M	M	M
Broad Money	6/2013	8/2013	M	M	M
Central Bank Balance Sheet	6/2013	8/2013	M	M	M
Consolidated Balance Sheet of the Banking System	6/2013	8/2013	M	M	M
Interest Rates[2]	6/2013	8/2013	M	M	M
Consumer Price Index	6/2013	7/2013	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	...	...	...	...	...
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	2012	2013	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2012	6/2013	A	A	A
External Current Account Balance	2012	6/2013	A	A	A
Exports and Imports of Goods and Services	6/2013	8/2013	Q	Q	Q
GDP/GNP	2011	6/2013	A	A	A
Gross External Debt	2012	6/2013	A	A	A
International Investment Position[6]	2012	2013	A	A	A

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. The authorities are working on upgrading the fiscal reporting in this regard.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

Statement by the IMF Staff Representative on Timor-Leste
October 23, 2013

This statement contains information that has become available since the staff report was circulated to the Executive Board. This information does not alter the thrust of the staff appraisal.

1. Following the revision of the discount rate approved by the IMF and World Bank Boards on October 11, 2013, staff has recalculated the debt sustainability assessment for Timor-Leste using the new five percent discount rate. This results in a slightly more favorable outlook for the calculated net present value of debt in relation to GDP and exports. The overall assessment of risk of debt distress and debt vulnerabilities discussed in the staff report and DSA remains unchanged.

2. The budget for 2014 remains under preparation but discussions with the authorities indicate that actual expenditures are planned to be stable in line with the framework agreed with Fund staff in June 2013. This is important not only for fiscal sustainability but for lowering inflation that remains above 10 percent, despite the recent appreciation of the U.S. dollar against regional currencies.

Press Release No. PR/13/430
FOR IMMEDIATE RELEASE
November 7, 2013

International Monetary Fund
700 19th Street, NW
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation with Timor-Leste

On October 23, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Timor-Leste.[1]

Timor-Leste has made substantial progress as it enters its second decade as a sovereign nation. A number of key milestones have been achieved. The 13 year UN presence was concluded successfully in 2012. Parliamentary and presidential elections were held in mid 2012 and a coalition government was formed. A Strategic Development Plan (SDP) to guide Timor-Leste toward upper middle-income status was developed in an inclusive manner and its implementation started in 2011. Timor-Leste has accumulated a highly regarded Petroleum Fund that now stands at over $13 billion. Oil revenues have been used to tackle large developmental needs, but oil production has peaked and many uncertainties persist over the development of new fields. Fragilities persist as poverty remains high.

The non-oil economy has grown rapidly in recent years with growth averaging close to 12 percent from 2008 to 2011, allowing the average per capita income to steadily increase. The growth was driven by a rapid increase in government spending which boosted the public administration and construction sectors. So far, the contributions from agriculture and manufacturing have been modest, hampering employment opportunities outside of the public sector and constraining widespread growth in living standards.

Despite falling from the peak of over 15 percent in 2011, the inflation rate is still in double digits. Initially inflation was driven by high international commodity prices but more recently it appears to reflect, among other factors, the interaction of strong demand led by government recurrent expenditures and structural bottlenecks. In addition to hitting the low-income households, high inflation in a dollarized economy hampers Timor-Leste’s ability to diversify and generate employment growth.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

High levels of government spending have risked sustainability, but revised budgetary plans in 2013 now anticipate a substantial moderation. In the revised medium-term budgetary plans (the so-called "Yellow Road" process), adopted by the Council of Ministers in June 2013, spending plans were significantly scaled back, starting in 2013. This will bring a number of benefits. Firstly, it will reduce inflationary pressures in the economy, helping reduce poverty. Secondly, by largely eliminating excess withdrawals from the Petroleum Fund, the financing of the budget will be placed on a long-term sustainable path. Lastly, it will provide an opportunity to improve the overall quality of public expenditure.

The medium-term growth outlook will hinge on the pace of fiscal consolidation and the on-going implementation of structural reforms to expedite the transition to higher quality private sector led growth. Under the baseline scenario the reprioritization of government expenditures and reforms would boost the private sector, allowing more inclusive and broad-based growth. Key risks include a weaker pace of reforms, poor implementation of key infrastructure projects (especially transport links), or an adverse external environment.

Executive Board Assessment[2]

Executive Directors welcomed Timor-Leste's substantial progress as it enters its second decade as a sovereign nation. The end of the 13-year UN presence, the successful elections in 2012, and the accumulation of substantial assets in the well regarded Petroleum Fund are important indicators that Timor-Leste is overcoming the fragilities inherent in a post-conflict nation.

Directors recognized that substantial development challenges remain given still high levels of poverty. The overriding challenge now is to successfully use oil revenues to foster economic and social development and the diversification of the economy. Directors supported the goals of the authorities' Strategic Development Plan that aims for upper-middle income status and a substantial reduction in poverty by 2030.

Directors noted that, after six years of strong non-oil GDP growth driven by large increases in public expenditure, the next step is to generate a shift to higher-quality growth in which an organic private sector, operating independently from government contracts, increasingly takes the lead. This would support economic diversification, increase employment opportunities, and ensure that economic growth results in broad based poverty reduction.

As part of this approach, Directors welcomed the revised budgetary framework that anticipates a stabilization of government expenditures and revenue diversification. Given the dollarized economy, a restrained fiscal stance that contributes to lower inflation will also have benefits for external competitiveness. Directors also welcomed the on-going reprioritization of expenditures

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

with a renewed focus on growth-enhancing investments in basic infrastructure and a shift away from transfers and subsidies. Directors stressed that although the revised framework limits the buildup of public sector debt, contingent and off-balance sheet liabilities will need to be avoided. In addition, it will be important to ensure that withdrawals from the Petroleum Fund are in line with fiscal sustainability and absorptive capacities, while also carefully monitoring their asset allocation strategy.

Directors emphasized that catalyzing the private sector will require steps to improve the business climate and address structural bottlenecks through improvements in infrastructure and the implementation of productivity-enhancing structural reforms. Directors noted that the priorities include implementation of the Land Law, streamlining the Investment Law, and improving contract enforcement.

Directors observed that the official dollarization of the economy has played a positive role, especially in light of underdeveloped or missing financial and money markets. In this regard, Directors encouraged the authorities to enhance their capacity to support a potential transition over the long term to a monetary and exchange rate framework that provides more autonomy and flexibility.

Directors noted that financial deepening and improving access to credit will become increasingly important as the economy develops. At the same time, safeguarding the soundness of the banking system will require strengthening central bank prudential supervision, developing a crisis management framework, and addressing weaknesses in the anti-money laundering framework.

Directors welcomed the closer dialogue between the Fund and the authorities. They noted the important role that Fund technical assistance can play in a number of areas to help the authorities achieve their development goals.

Table 1. Timor-Leste: Selected Economic and Financial Indicators, 2009–14

	2009	2010	2011	2012	2013	2014
				Est.	Proj.	
			(Annual percent change)			
Real sector						
Real total GDP	-6.7	-1.4	7.3	5.7	-3.2	-6.9
Real non-oil GDP	12.8	9.5	12.0	8.3	8.1	8.0
CPI -Timor Leste (annual average)	0.1	4.5	11.7	13.1	10.6	9.5
CPI - Timor Leste (end-period)	1.1	8.0	15.4	10.8	10.4	8.5
			(In percent of GDP, unless otherwise indicated)			
Central government operations						
Revenue	62.6	64.9	66.5	69.1	59.7	63.6
Domestic revenue	2.8	2.3	1.9	2.2	2.4	3.3
Petroleum revenue	51.3	55.3	59.7	62.9	53.4	56.1
Grants	8.5	7.3	4.9	4.0	3.9	4.2
Expenditure	31.3	27.0	23.8	22.1	23.5	26.5
Recurrent expenditure	12.0	12.0	8.8	10.7	10.8	11.1
Capital expenditure	10.8	7.6	10.1	7.3	8.8	11.2
Donor project	8.5	7.3	4.9	4.0	3.9	4.2
Overall balance	31.3	37.9	42.7	47.0	36.2	37.1
Non-oil overall balance (in percent of non-oil GDP)	-79.8	-78.3	-87.5	-73.7	-65.2	-56.7
			(Annual percent change, unless otherwise indicated)			
Money and credit						
Deposits	38.7	9.8	8.9	26.2	21.2	21.7
Credit to the private sector	1.1	5.9	21.1	20.5	21.2	21.7
Lending interest rate (percent, end-period)	11.2	11.0	11.0	12.2	…	…
			(In millions of U.S. dollars, unless otherwise indicated)			
Balance of payments						
Current account balance 1/	1,287	1,676	2,340	2,738	2,105	1,819
(In percent of GDP)	39.0	39.8	40.4	43.5	34.3	32.1
Trade balance	-320	-277	-349	-639	-731	-829
Exports 2/	15	29	25	33	37	42
Imports	335	306	374	672	769	871
Services (net)	-774	-961	-1,415	-921	-1,004	-1,118
Petroleum revenue	1,692	2,331	3,461	3,960	3,273	3,183
Overall balance	39	156	55	422	-194	122
Public foreign assets (end-period) 3/	5,627	7,303	9,765	12,652	14,419	16,748
(In months of imports)	58	65	63	91	93	96
Exchange rates						
NEER (2005=100, period average)	95.4	89.3	84.2	86.4	…	…
REER (2005=100, period average)	105.2	102.3	105.6	118.1	…	…

Sources: Timor-Leste authorities; and IMF staff estimates and projections.
1/ Excludes trade in goods and services of entities located in the Joint Petroleum Development Area which are considered non-resident entities.
2/ Excludes petroleum exports, the income of which is recorded under the income account.
3/ Includes Petroleum Fund balance and the central bank's official reserves.

Statement by Paulo Nogueira Batista, Executive Director for Timor-Leste and Ivan Oliveira Lima, Alternate Executive Director and Felipe Santarosa, Advisor

1. On behalf of the Timorese authorities, we would like to thank staff for the constructive dialogue during this Article IV consultation. Timor-Leste has continued on an accelerated economic trajectory with non-oil GDP growing 11.5 percent on average from 2007 to 2012. The authorities have demonstrated strong commitment to sustained economic growth and poverty reduction in tandem with their Strategic Development Plan (SDP). This long-term strategy envisions the utilization of oil revenues to foster economic and social development and the diversification of the economy. Timor-Leste's aim is to transition from low to high middle-income status by 2030. The SDP foresees the development of three core sectors – petroleum, agriculture and tourism – by means of targeted investment in infrastructure, education and human and social capital.

2. The authorities are aware of the formidable challenges ahead. Timor-Leste is a young nation still coping with the legacy of long-lasting conflicts and the need to build solid institutions to manage its natural resources and deliver the services required by its citizens. Peace-building and state-building have been at the forefront of the government's priorities, in line with the principles of the "New Deal for Engagement in Fragile States" advocated by the g7+ grouping, currently chaired by Timor-Leste. Progress in these two crucial areas can be attested by the peaceful handover of power to the V Constitutional Government in 2012 and the smooth withdrawal of the United Nations mission in January 2013.

3. The authorities are determined to further consolidate democracy and strengthen social inclusion. This will go hand in hand with efforts to enhance institutional and administrative capacities, which will contribute to maximize the positive impact of public expenditures on living standards. In the Risk Assessment Matrix, staff considers political instability as a risk with medium probability of materializing. We find this assessment rather pessimistic, given the social and political progress achieved in only one decade of independence. These accomplishments and the favorable track record in setting up key institutions would suggest a low probability of political instability.

Recent economic developments and medium term outlook

4. Besides an impressive economic growth, Timor-Leste has exhibited sturdy fiscal indicators. As of May 2013, the Petroleum Fund (PF) balance was 13.6 billion US dollars and rising – it is expected to reach the 14 billion mark by January 2014, according to official data. As can be seen from Tables 1 and 2 of the staff report, the PF balance has risen from 650 percent of non-oil GDP in 2009 to as much as 868 percent in 2012. The overall government balance for 2012 is estimated by IMF staff at 47 percent of non-oil GDP.

5. The external position is also very strong. According to staff estimations, the current account surplus reached 43.5 percent of GDP in 2012. Public foreign assets (the sum of the PF balance and the central bank's official reserves) rose from 58 to 91 months of imports from 2009 to 2012 (Tables 1 and 4 of the staff report). Very few IMF members can display such strong fiscal and external indicators.

6. The medium term outlook is positive. After peaking at 15.4 percent in 2011, inflation fell to 10.8 percent in 2012 and is projected to continue on a declining trend, albeit still somewhat high for a dollarized economy. While real non-oil GDP growth is likely to moderate slightly in the coming years, it is expected to remain robust by international standards, averaging about 8.5 percent according to staff's projections. The authorities are projecting a medium term outlook somewhat better than staff's. The government has received strong indications that private sector investment will substantially increase in coming years as a result of past and ongoing reforms, contributing to the expansion of the non-oil economy. Enhanced political stability should also play a role in attracting greater private sector participation.

7. We note that staff has consistently underestimated Timor-Leste's non-oil GDP growth prospects. In the 2009 Article IV consultation, staff had projected non-oil GDP growth for 2009 at 7.4 percent – the actual result was 12.8 percent, much closer to the authorities' forecast of 12.2 percent. In the 2010 Article IV report, non-oil GDP growth for 2010 was expected to "slow to around 6 percent due to the impact of adverse weather on harvests", whereas the authorities' estimate was 9.5 percent. Food production was indeed affected by rains but the absence of growth in agriculture was more than compensated by buoyancy in other sectors and non-oil GDP grew in line with the authorities' projections. In the subsequent Article IV report, of January 2012, staff again underestimated non-oil GDP growth, expecting it to "remain strong at about 10 percent" in 2011– the final numbers were even stronger with non-oil GDP expanding by 12 percent in 2011.

Fiscal policy and debt sustainability

8. Timor-Leste has put in place a strong fiscal framework with the successful implementation of the PF and the concept of Estimated Sustainable Income (ESI). This has reduced unpredictability in oil revenues and enhanced transparency in public spending. The authorities agree with staff's overall assessment that the revised medium-term budget framework outlined by the Council of Ministers in June 2013 – the so-called Yellow Road process – is consistent with non-oil GDP growth, falling inflation, poverty reduction and fiscal sustainability. The Yellow Road framework has already been reflected in the revised 2013 budget and in the preparation of the 2014 budget. It strikes an appropriate balance between strict adherence to the ESI, which would not be consistent with the required scaling up of infrastructure to address supply bottlenecks, and the need to limit withdrawals from the PF so as to preserve oil wealth for future generations.

9. As stated in the staff report, the recourse to concessional borrowing and public-private partnerships (PPPs) to complement budget resources for capital investment is

likely to render public financial management more complex over time. The authorities concur that the development of a strong asset-liability framework will be critical and would like to remain engaged with the Fund and other multilateral financial organizations to receive technical assistance in this area. However, it should be noted that Timor-Leste's current level of debt is very low with most loan agreements signed on highly concessional terms. According to the Debt Sustainability Analysis, the implementation of the Yellow Road baseline entails a moderate accumulation of public debt, yet the present value of the gross debt-to-GDP ratio will continue to be low throughout the forecast period. Moreover, net debt will remain negative both in nominal and present value terms, given the high stock and continued accumulation of assets in the PF.

Monetary and financial sector developments

10. The debate on dollarization versus national currency has been a long-standing one. International experience shows that full dollarization is not easy to reverse. Nonetheless, the possibility of introducing a national currency is contemplated in the SDP and a study was made in the past with the help of the central bank of Portugal. Another one is planned by the Central Bank of Timor-Leste (*Banco Central de Timor-Leste* - BCTL). Staff asserts that "full dollarization remains appropriate for now given limited capacity for independent monetary and exchange rate policies". However, if the country is still adopting full dollarization it is because the authorities see advantages in retaining it at the current stage and not necessarily because they lack the capacity to implement alternative policies.

11. As highlighted in the report, the small banking system has not adequately supported growth. Policies are needed to create incentives for lending, such as ensuring timely recovery of collateral. The Land Law currently under discussion is expected to address legal uncertainties related to the use and ownership of real estate in Timor-Leste. This is fundamental for a more sustained expansion of agribusiness and will also open the way for the future development of a mortgage market. Additionally, enhancing the supervisory capacity of the BCTL and reinforcing the legal and institutional framework for financial sector regulation are priority areas on which the authorities have requested Fund's technical assistance.

Structural reforms and poverty reduction

12. Timor-Leste's structural reform agenda builds on the country's considerable resources and potential to achieve economic growth and diversification while also fostering a higher presence of the private sector. In that vein, the authorities have taken steps to reduce the cost of doing business, strengthen the judicial system and the rule of law, and improve the country's infrastructure. Together with the planned introduction of the Land Law, an important step to enhance the business climate has been the implementation of the one-stop shop for investors. Also, substantial progress in basic infrastructure is under way with the recent launching of phase two of the National Electrical Grid and the development of PPPs for the improvement of Dili airport and the construction of the new port at Tibar Bay.

13. Economic and social development requires a reduction in inequality. The authorities continue to promote active social policies targeted at the most vulnerable. A cash transfer program directed to poor families – *Bolsa da Mãe* – has been launched and welfare benefits are being provided to the elderly and other groups in need. Progress has also been made on health and education. The number of vaccinated children has risen whereas infant and maternal mortality have decreased. There has also been an increase in the number of schools and enrolled children country-wide. The expansion in financing for higher education, both inside the country and abroad, is part of a sustained effort to develop human capital.