

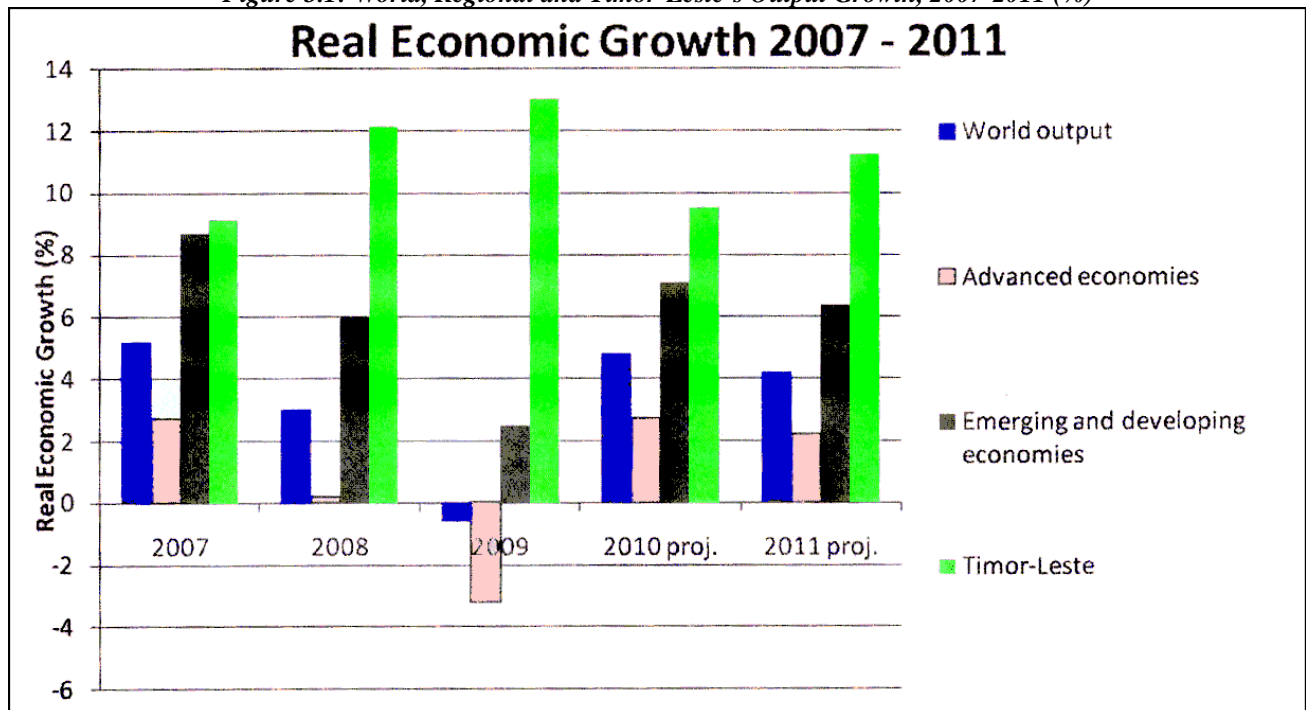
## PART 3. ECONOMIC OUTLOOK

### 1. International Economy

The international economy has begun to recover from the financial crisis that plunged major advanced economies into recession and impacted adversely on the majority of emerging and developing countries. Over the first half of 2010 the world economy expanded at just over 5%, on an annual basis, according to the October 2010 IMF World Economic Outlook (WEO). Global output is now expected to rise by 4.8% in 2010 and 4.1% in 2011 and IMF's assessment is that the risk of a strong global downturn in economic activity is low. Figure 3,1 shows world output between 2007 and 2011 and the impact of the recession and subsequent recovery. Timor-Leste was relatively sheltered from the crisis and its economic growth remained strong throughout.

Overall, inflation rates around the world are forecast to stay low due to excess capacity and high levels of unemployment. Financial markets have begun to return to their pre-crisis level, although in early 2010 financial market volatility increased and investor confidence dropped. This highlights the fragility of the recovery process. However, the extent of recovery varies substantially across regions; Asia and Latin America are the fastest rebounding regions.

*Figure 3.1: World, Regional and Timor-Leste's Output Growth, 2007-2011 (%)*



Source: IMF, World Economic Outlook, October 2010.

### Advanced Economies

Growth has accelerated in Europe in 2010, but elsewhere in the USA and Japan economic activity slowed in the second quarter of 2010. Advanced economies are battling with the need to reduce high levels of public and private debt, while consumption remains low due to a lack of consumer confidence and reduced household incomes. Advanced economies were hit hardest by the spread of global unemployment and in 2010 unemployment rates in advanced economies have dipped modestly from peak rates. There is also a pressing need to reform financial sectors, which are still vulnerable to shocks. Growth rates are reportedly slowing as public sector stimulus eases and IMF projects only 2.7% and 2.2% in output growth for 2010 and 2011 respectively in advanced economies.

## Asia

Economies of advanced Asia (apart from Japan) experienced a strong rebound, with output already exceeding pre-crisis levels. Large manufacturing sectors in these countries have benefited from renewed levels of international trade. A strong demand-driven recovery is underway in Asia's newly industrialized economies (NIEs<sup>2</sup>) and the ASEAN economies<sup>3</sup>, with strong domestic activity coupled with healthy regional demand, particularly from China. Demand for commodities and electronics in particular is benefiting exporting countries and private investment activity is strong (although in Malaysia investment is not in full swing as in other countries).

Emerging Asia has also seen capital inflows return after the international crisis; inflows have increased by more than four times over the four quarters to October 2010. Many of these economies have already adopted prudent macroeconomic policies to protect against adverse effects from potential volatility of capital flows. Demand from Asian economies, particularly China, India and Indonesia has spurred growth in emerging Asia as well, with economic growth averaging 9.5% over the first half of 2010. In most Asian countries the transition from public sector-driven growth to private sector-driven growth is making good progress. The post-crisis era is a good time for Timor-Leste to take advantage of strong regional demand by increasing exports. *Table 3.1* shows the extent and timing of the economic recovery in selected Asian countries.

**Table 3.1: Real Economic Growth in Asian Economies, 2007 - 2011 (%)**

	Actual			Projection	
	2007	2008	2009	2010	2011
China	14.2	9.6	9.1	10.5	9.6
Australia	4.8	2.2	1.2	3.0	3.5
Singapore	8.5	1.8	1.3	15.0	4.5
ASEAN-5	6.7	4.6	1.4	6.5	5.3
Indonesia	6.3	6.0	4.5	6.0	6.2
Vietnam	8.5	6.2	5.3	6.5	6.8
Philippines	7.1	3.7	1.1	6.0	4.0
Thailand	4.9	2.5	-2.2	7.5	4.0
Malaysia	6.5	4.7	-1.7	6.7	5.3
Timor-Leste	9.1	12.1	13.0	9.5	11.2

Sources: IMF, *World Economic Outlook* October 2010; Macroeconomic Directorate, Ministry of Finance (for Timor-Leste data).

## Emerging and Developing Countries

Emerging and Developing countries' prudent policies have led the IMF to project significantly improved medium-term growth compared to previous post-global recession periods; 7.1% growth in 2010 and 6.4% in 2011. As with all regions, recovery has been heterogeneous, with developing and emerging countries growing significantly faster; Timor-Leste is an example of such a country. Countries that were hit hard by the recession are straining to sustain economic growth after the crisis; these include many regions in emerging Europe and the Commonwealth of Independent States.

Noting that developing countries have begun to benefit from the higher post-crisis levels of global trade, which is contributing to their strong growth, IMF recommends measures to improve developing countries' market access, for example, 100% duty-free and quota-free market access for the least developed countries, complemented by liberal rules of origin. This should be implemented alongside programs aimed at strengthening low income countries' capacity to trade. Trade facilitation is especially important at a time when capital is scarcer than before the global recession and developing countries must rely more heavily on domestic revenues. Policy to supplement traditional forms of financing could include public-private partnerships (PPP) and South-South investment initiatives.

<sup>2</sup> NIEs include Hong Kong SAR, South Korea, Singapore and Taiwan Province of China.

<sup>3</sup> Indonesia, Philippines, Malaysia and Thailand

## World Prices

The main impact of world economic activity on Timor-Leste is on oil revenues, through changing prices in oil. However, through saving the majority of oil revenues and spending via the mechanism of the Estimated Sustainable Income, Government spending in the domestic economy is protected from oil price fluctuations. Changing oil prices have no short-term impact on economic growth. In 2008 the world price of oil collapsed from over \$140 per barrel mid-year to just \$40 by the end of 2008. Since then, oil prices have risen and stabilized at around \$70-80 a barrel and oil demand became stronger in the first half of 2010, particularly in China, on the back of strong global activity. Oil demand is projected to rise with economic recovery but advanced economies' slow-paced recovery will counteract much of the expected rise in demand for oil from emerging and developing countries. Oil prices are projected to rise gently but not exceed \$90 per barrel by 2013. A more detailed description of the impact of oil prices on Timor-Leste's oil wealth and projected oil revenue streams can be found in the Petroleum Sector section below.

Commodities are real assets as well as goods, and accordingly their prices can be affected by changing expectations over the global economic forecast. The IMF report that rapidly changing expectations in May and June 2010 resulted in broader financial market volatility spilling over into commodity markets, observed by a decline in commodity prices, after peaking in early May 2010. Since the decline, most commodity prices are on the rise again but only food, beverage and agricultural commodity prices have exceeded their peak in May. Rising food prices are a result of recent supply shocks from bad weather leading to poor harvests. Specifically, drought and wildfire in Russia and in other major exporters resulted in low wheat harvests with consequent surges in wheat prices in July and August 2010. The impact of rising global food prices can be seen in markets in Timor-Leste, mostly in Dili (see the Inflation section below).

Wheat markets are more vulnerable to shocks over this harvest period and the IMF assessment is that any further shocks to this harvest would probably spill over and impact on other major crop prices. Over the medium-term commodity prices are forecast to remain relatively high, accompanied by upside risks.

## 2. Domestic Economy

### Non-oil GDP

Table 3.2 shows the evolution of the structure of Non-Oil Domestic Product (GDP) over seven years in Timor-Leste. The public sector's share in economic output increased from 31.6% to 38.4% between 2002 and 2009 while the United Nations' share decreased across this period by 61%. This is true despite the increased role of the United Nations since 2005, which has only partly offset the decline in UN presence in the four years leading up to the 2006 crisis. After 2003 the economy moved into recovery, driven by moderate growth in agriculture and public sector production. However, social unrest in 2006 destroyed parts of the economy, reducing the size of the economy by almost 6% in real terms.

*Table 3.2: Sectoral share of real non-oil GDP, 2002 - 2009 (%)*

	2002	2003	2004	2005	2006	2007	2008	2009
<b>Real Non-oil GDP, Excl. UN</b>	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<b>Including UN</b>	119.0	113.0	109.4	105.6	108.1	115.2	114.7	111.7
Agriculture	33.5	32.7	33.3	33.2	35.3	30.6	30.9	30.8
Industry and Services	34.9	34.9	34.2	32.9	29.9	31.6	31.3	30.8
Public Sector	31.6	32.4	32.5	33.9	34.9	37.8	37.8	38.4
<b>United Nations</b>	19.0	13.0	9.4	5.6	8.1	15.2	14.7	11.7

Source: Macroeconomic Directorate. Ministry of Finance, 2010

Table 3.4 illustrates that over the years since 2007, the Timor-Leste non-oil economy has continued to expand rapidly, driven primarily by public sector spending. Government spending has stimulated both the demand and supply sides of the domestic economy, contributing to impressive growth rates in many areas of the private sector. On the demand side, government funds have been allocated to social transfer schemes as well as creating tens of thousands of jobs for unskilled labourers through infrastructure spending. Infrastructure developments

and improvements in public services and public utilities have boosted the production capacity of private businesses. Overall real economic growth in Timor-Leste in 2009 is estimated at 13.0%, with public sector production contributing 5.6 of the 13 growth percentage points, agriculture contributing 3.9 of the points and industry and services contributing 3.5 of the percentage points to growth in Non-Oil GDP of Timor-Leste.

**Table 3.3: Nominal GDP by sector**

	2002	2003	2004	2005	2006	2007	2008	2009
<b>Non-oil GDP, Excl. UN</b>	257.7	266.9	280.8	301.9	297.1	357.8	444.6	557.8
<b>Agriculture</b>	86.1	87.7	93.4	100.4	104.8	102.1	122.4	146.3
<b>Industry and Services</b>	90.2	94.4	96.0	99.2	88.8	111.3	135.1	161.7
<b>Public Sector, excl. UN</b>	81.4	84.8	91.4	102.3	103.6	144.4	187.1	249.8

Source: Macroeconomic Directorate, Ministry of Finance, 2010.

**Table 3.4: Real GDP Growth Rate (%)**

	2002	2003	2004	2005	2006	2007	2008	2009
<b>Non-oil GDP, Excl. UN</b>	2.1	0.1	4.4	6.5	-5.9	9.1	12.1	13.0
<b>Agriculture</b>	3.1	-2.5	6.2	6.4	-0.1	-5.4	13.4	12.6
<b>Industry and Services</b>	1.6	0.0	2.1	2.6	-14.6	15.3	11.2	11.2
<b>Public Sector, excl. UN</b>	1.7	2.3	5.0	10.8	-3.1	18.5	11.7	15.0

Source: Macroeconomic Directorate, Ministry of Finance, 2010

Due to poor weather conditions in 2007, the agriculture sector suffered badly, with negative growth reported. However, the sector recovered in 2008 and stronger growth in the food sector is reported through into 2009. Ministry of Agriculture and Fisheries (MAF) report that productivity of land, particularly for rice and maize, rose sharply in 2009 following distribution of seeds, fertilizer and hand tractors. A poor year for coffee production was reported in 2009, with minimal or negligible growth levels experienced by many farmers. High hopes for 2010 coffee production were dashed, largely due to persistent unseasonal rains, and only slight growth on 2009 is anticipated overall for 2010.

In the industry and service sector, wholesale and retail trade grew most rapidly in 2009 with substantial real growth also observed in transport and communications, manufacturing and private construction sectors. Overall, the private sector has seen double-digit growth since 2007.

### **Government Expenditures**

Expenditure in 2009 reached a record \$603.6 million, increasing on 2008 expenditure levels by 25%. In 2009, 35% of the executed budget was spent on Capital and 65% on recurrent expenditure. This represents an increase in the proportion of spending afforded to capital, relative to recurrent items. In 2008, the split was 26% and 74% respectively. The budgeted divide in 2010 is 34% for capital spending and 66% for recurrent spending, maintaining 2009 allocations between these two broad categories. Total budget execution (including obligations) until 12 November 2010 was 75.6% of the \$838 million approved by the National Parliament in the Rectified 2010 Budget. In cash the budget execution until 12 November 2010 was 52.1%, which is very similar to 2009 execution rates at the same time of year.

During 2008, 2009, and 2010, the Government has placed public financial management on firm foundations. The direction and progress of the Government was confirmed by a number of independent reviews undertaken by leading international financial institutions. This included a Public Expenditure and Financial Accountability (PEFA) assessment and a Report on the Observance of Standards and Codes (ROSC) carried out by the IMF.

Improved service delivery by decentralisation remains a focus of Government. This related particularly to increased financial capacity and autonomy in line ministries and decentralisation of procurement. As a result of visits to the districts by the Prime Minister, local management of smaller projects were envisaged. To achieve the Government's priorities while maintaining fiscal responsibility has required reduced expenditure in areas of lower priority.

**Table 3.5: Whole of Government Expenditures (\$; million), including Auto Agencies.**

	02/03	03/04	04/05	05/06	06/07	2007	2008	2009	12 Nov 2010	Budget 2010
<b>Total expenditures</b>	<b>60.7</b>	<b>70.5</b>	<b>70.2</b>	<b>93.7</b>	<b>170.5</b>	<b>97.2</b>	<b>483.9</b>	<b>603.6</b>	<b>436.6</b>	<b>838.0</b>
<i>Recurrent expenditures</i>	49.9	59.2	59.9	71.2	139.5	63.1	356.0	394.3	342.2	550.7
Wages and Salaries	20.5	23.1	24.8	26.1	33.8	17.4	50.3	87.3	65.8	99.1
Goods and Services	29.4	36.0	35.2	45.1	93.9	37.1	221.4	212.8	182.7	267.0
Transfers	0.0	0.0	0.0	0.0	11.8	8.6	84.3	94.2	93.7	184.6
<i>Capital expenditures</i>	10.9	11.3	10.3	22.5	31.0	34.1	127.9	209.3	94.40	287.3
Minor Capital	Unknown distribution				9.3	0.7	41.4	38.5	11.6	34.5
Development & Major Capital					11.7	0.7	86.5	170.8	82.8	252.8
Capital Transfers	0.5	0.4	0.0	10.9	0.0	0.0	0	0		0.0
Unallocated Capital Carryovers	5.7	7.3	8.4	8.3	10.0	32.7	--	--		

Source: Timor-Leste Ministry of Finance, Treasury Department and 2009 Budget for actual values; Macroeconomic Directorate for 2010 projections.

Note: The amounts in the highlighted column in Table 3.5 are the cash execution as at 12 November 2010.

## Domestic Revenues

Overall, domestic revenues are estimated to reach \$94.7 million in 2010, up from \$90.8 million in 2009. Although this growth rate of 4.3% is significantly slower than the 30.3% achieved last year, it was to be expected that strong growth would be achieved from the lows of the crisis period. The fall in growth rates also is accounted for by reductions in rice revenues (subsidy) intended only as a temporary measure.

Government tax revenues increased by 16.7% in 2009 to \$43.6 million or up from \$37.3 million in 2008. Tax revenues will continue to increase in 2010 reaching \$47.5 million (*Table 3.6*). Direct Tax revenues performed better than expected in 2009 in light of the tax reforms of 2008. But the resuming growth in 2010 will bring revenues from Direct Taxes back to the levels of 2008 (\$18 million). It is projected further growth in Direct Taxes in the coming years as the economy continues to expand. Indirect Tax revenues grew strongly from \$19.3 million in 2008 to \$30.3 million in 2009 despite Tax Reforms in 2008. It is estimated that Indirect Taxes will be \$31.5 million in 2010 and continue to grow in the years to come.

User Fees and Charges is another area that showed increased growth from 2008 to 2009. The significant increase from \$6.2 million in 2008 to \$16.4 million in 2009 is attributable to an extraordinary refund. It is projected to be \$14.1 million in 2010 and \$16.2 million in 2011.

Autonomous Agency revenues grew from \$7.9 million in 2008 to \$10.4 million in 2009. It is estimated at \$13.0 million in 2010. This is driven largely by increased revenue performance by EDTL, as their efforts to increase pay for use and higher tariffs take effect. Rice subsidies were introduced in 2008 to protect the Timorese people from spikes in international food prices. Revenues flowing from these measures increased from \$16.8 million in 2008 to \$20.4 million in 2009. It is expected to be \$20 million in 2010. However, as world food prices stabilize and the need for government subsidy is reduced, revenues in this area are estimated to fall to \$10.0 million in 2011.

**Table 3.6: Domestic Revenues 2002-2010 (\$ million)**

	2002	2003	2004	2005	2006	2007	2008	2009	2010 Estimate
<b>Total Domestic Revenue</b>	<b>24.8</b>	<b>29.9</b>	<b>36.8</b>	<b>45.2</b>	<b>40.9</b>	<b>48.9</b>	<b>69.7</b>	<b>90.8</b>	<b>94.7</b>
Direct taxes	5.8	5.9	6.6	10.6	10.1	12.6	18.0	13.3	16.0
Indirect taxes	12.9	14.8	18.6	17.5	16.6	18.8	19.3	30.3	31.5
User fees and charges	1.4	3.3	4.5	4.3	3.1	4.3	6.2	16.4	14.1
Autonomous Agencies	4.6	5.8	7	7.9	6.8	6.9	7.9	10.4	13.0
Interest	0.1	0.1	0.1	4.9	4.3	6.3	1.5	0.0	0.1
Rice sales	0	0	0	0	0	0	16.8	20.4	20.0

Source: Timor-Leste Ministry of Finance, Directorate of Treasury 2002 -2009 for actual values; Macroeconomic Directorate for 2010 Estimate.

## **Petroleum Revenues**

Timor-Leste's Petroleum Revenues, inclusive of Petroleum Fund interest, were \$1.84 billion in 2009 with oil price of \$62 per barrel and an estimated \$2.02 billion in 2010 with expected oil price per barrel to be \$76. However, lower commodity prices over the near term bring with them lower crude oil prices. Using the projections by the US Energy Information Administration (EIA) for crude oil,<sup>4</sup> petroleum receipts will significantly exceed the 2009 Budget projections for both 2009 and 2010 because of higher production levels than the conservative production estimates required and new negotiated contracts favorable to Timor-Leste.

The Petroleum Revenues are expected to remain high in 2011 and 2012 due to relatively stable production and oil price forecasts such that petroleum revenues are estimated at \$2.29 billion and \$2.40 billion in 2011 and 2012 respectively.

The Petroleum Fund balance is expected to be \$6.62 billion by end of 2010, which is up from \$5.38 billion by end of 2009. The Petroleum Fund balance is estimated at \$8.17 billion by the end of 2011, \$9.82 billion by the end of 2012 and \$14.60 billion by end of 2015.

The Estimated Sustainable Income (ESI) is calculated at \$734 million for 2011, which is an increase of \$232 million from 2010. The main reason for the increase is a change of methodology of the ESI calculation. While Energy Information Administration's (EIA) Low Case has been used as the West Texas Intermediate (WTI) oil price forecast in the past, the average of EIA's Low and Reference Case is now used as the long term oil price forecast in the ESI calculation for 2011. The WTI oil price forecast for 2011 and 2012 is \$68 and \$71 per barrel respectively and increases to \$110 in 2024.

The Government has over the last three years gradually developed the investment strategy of the Petroleum Fund. The objective is to diversify the portfolio into a range of asset classes, regions and currencies in order to reduce risks and increase expected return. A range of foreign Government bonds and bonds issued by Supranational Organizations have been added to the portfolio since 2009 and in October 2010 the Fund commenced investing in global equities.

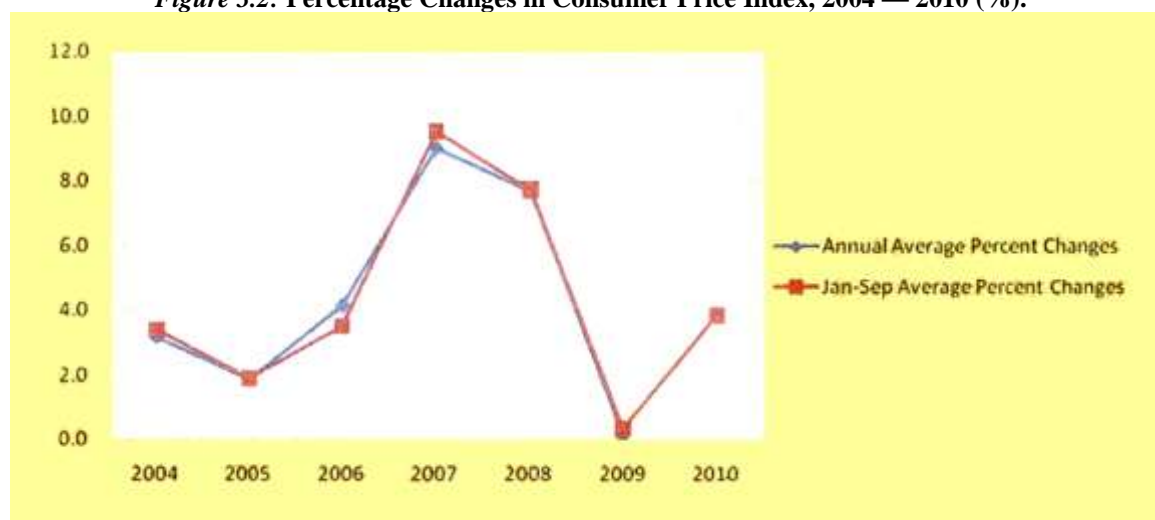
Further diversification requires changes in the Petroleum Fund Law. The investment strategy will be further developed once the amendments to the Petroleum Fund Law are approved by Parliament.

## **Inflation**

Headline inflation year-on-year in 2009 in Timor-Leste and Dili was 0.1% and 0.7% (DNE, 2009) respectively. These figures represent a drop in inflation rates from 2007 and 2008, when prices rose sharply, putting pressure on consumers' purchasing power. *Figure 3.2* shows annual trends in inflation in Timor-Leste.

<sup>4</sup> Annual Energy Outlook 2009 - Official US Government Energy Statistics, Energy Information Administration March 31, 2009.

**Figure 3.2: Percentage Changes in Consumer Price Index, 2004 — 2010 (%).**



Source: National Directorate of Statistics, Ministry of Finance, 2010.

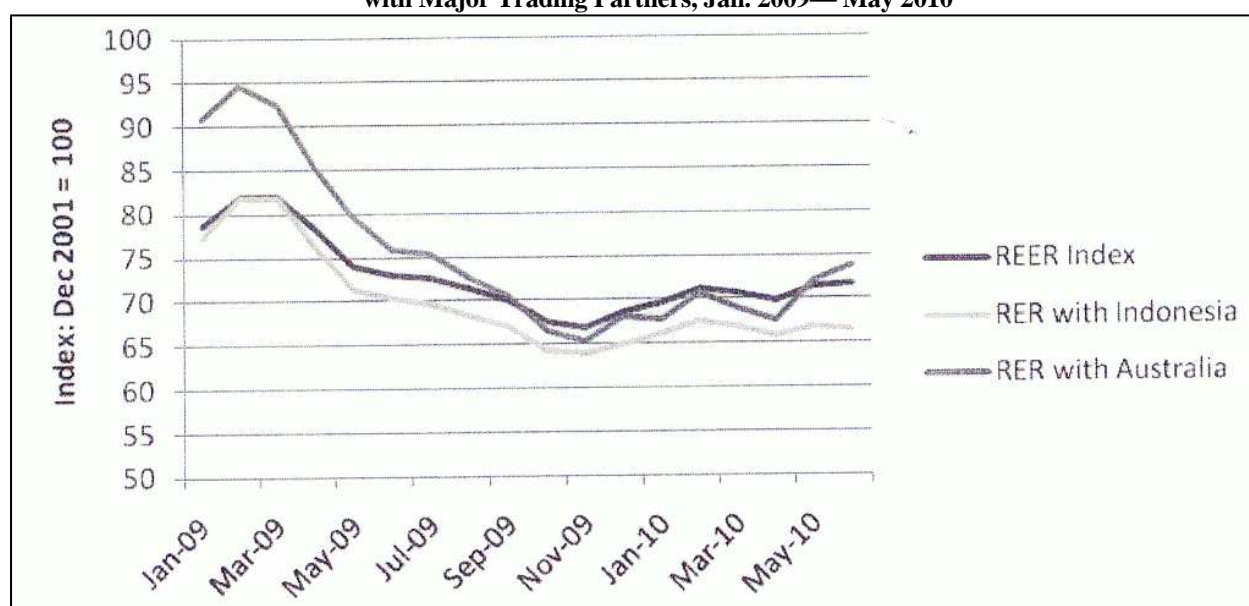
Relatively low levels of inflation in 2009 and continuing through to 2010, reflect lower inflation of all categories of goods, but primarily food, which peaked in 2007 and 2008 following the “global food price crisis”. The second and third quarters of 2009 prices actually fell; or year-on-year deflation over these two quarters were -2.8% and -1.7% respectively. By the fourth quarter of 2009 prices started to pick up and in 2010 this trend continues; 2010 inflation to date exceeds 2009 inflation but remains well below 2007 and 2008 levels. Year-on-year inflation in the second quarter of 2010 was 2.5%. Headline Inflation in Dili has steadily increased in the first half of 2010, showing higher rates of inflation than those in Timor-Leste overall. June 2010 price levels in Dili are 6.6% higher than June 2009. Part of this inflationary pressure, in Timor-Leste especially Dili comes from price rises for food, in particular cereals, following sharp international price rises for cereals (see International Economy Section). The year-on-year inflation rate for ‘cereals, roots and their products’<sup>5c</sup> in Dili in June 2010 was 14.1%.

The potential for high inflation remains a concern particularly in the short-term with increased public spending and rising food prices. However, public spending on core infrastructure, advancement of the business environment and improving the capacity of the port should improve the efficiency and capacity of the supply side of Timor-Leste, putting downward pressure on inflation over the medium term. Subsidized rice protected Timor-Leste from steep rises in the world price of rice in 2008. However, since the price of rice has declined sharply in international markets after its peak in mid-2008, the need for subsidies has greatly diminished. Despite signs in mid-2010 of an increased world price of rice the September 2010 Thai rice price remains at half its peak value of 2008.

Figure 3.3 shows the evolution of the real effective exchange rate (REER) between the US Dollar and the currencies of Timor-Leste’s major trading partners. The real exchange rate between the US Dollar and the currencies of Australia and Indonesia are also displayed. Over 2009 a real depreciation was observed, meaning Timor-Leste’s exports became more competitive in foreign markets. In the first half of 2010 the REER has started to appreciate, coincidentally with rising inflation,

<sup>5</sup> This category includes local rice, imported rice, cassava, wheat flour and instant noodles.

**Figure 3.3: Real Effective Exchange Rate and Real Exchange Rate Changes with Major Trading Partners, Jan. 2009— May 2010**



Source: Bank and Payments Authority, Timor-Leste.

## Employment

Timor-Leste has a rapidly expanding labour force together with high levels of unemployment and underemployment. The size of the labour force (15 – 64 year olds in work, or unemployed but actively seeking work) in 2010 is approximately 375,000, with an estimated 10,000 - 15,000 newcomers each year. The private sector employs less than 10% of the labour force, as does the public sector, so the vast majority have no choice but to participate in low-productivity subsistence agriculture. Unemployment is largely an urban phenomenon and can pose a threat to social stability. Spending on infrastructure projects has the potential to absorb some of this labour in the short-term through well-targeted infrastructure projects that employ relatively more labour than capital. Timor-Leste potentially has a competitive advantage in such labour-based infrastructure projects, but quality of the projects' outcomes must be ensured.

The Government of Timor-Leste has strived to create short-term jobs for unskilled labour, with an estimated 33,020 'full-time-equivalent'<sup>6</sup>, unskilled jobs created from public infrastructure spending in 2008 and 61,174 'full-time-equivalent' jobs generated for unskilled labourers from infrastructure spending in 2009. The infrastructure content in the 2010 Rectified Budget is larger still, leading to an estimated 64,921 unskilled full-time-equivalent jobs that could potentially be created for unskilled labourers<sup>7</sup>. Secretary of State for Professional Training and Employment (SEFOPE) contributed an additional 4,363 'full-time equivalent' jobs, over 2008 and 2009, through their targeted labour-intensive infrastructure projects.

## Poverty and MDGs

A household is said to be poor if per capita consumption falls below the 'basic needs' poverty line. Those living below the poverty line are therefore unable to afford 2,100 calories per day while also meeting basic non-food needs. In a 2007 survey<sup>8</sup>, 49.9% of the population were estimated to live below the poverty line.<sup>9</sup> However, in 2010, the World Bank reported that in 2009, 41% of the population lived below the poverty line. The fall of almost 9 percentage points is partly because of higher rate of real economic growth since 2007 and social transfer programs such as pensions for elderly, veterans, housing subsidy for IDPs, and cash for work programs

<sup>6</sup> Full-time-equivalent (FTE) jobs are based on 249 calendar days a year constituting a full-time job.

<sup>7</sup> Macroeconomic Directorate, Ministry of Finance. 2010 estimate uses 2009 budget execution rate.

<sup>8</sup> Timor-Leste: Poverty in a Young Nation, 2008, National Directorate of Statistics (DNE), Ministry of Finance.

<sup>9</sup> World Bank methods ensure comparability between this prediction and the 2007 estimates produced by ONE. Details taken from World Bank Poverty Note, 2010.



that contributed to increase of private consumption. Low inflation rates since mid-2008 also increased private consumption levels because of increase in purchasing power.

The UN 2010 Human Development Report recently released, positions Timor-Leste at 120 out of 169 countries, which is an improvement of 14 places. From 2005 to 2010, Timor-Leste's HDI value increased from 0.428 to 0.502, an increase of 17%.

Besides consumption, preliminary analysis of the Demographic Health Survey 2009-2010 (DHS 2009-2010) compared to DHS 2003 and TL-SLS 2007 suggest improvements in living conditions in recent years. For example, 45% of children are underweight in Timor-Leste, which represents a drop from 48.6% estimated for 2007 in the TL-SLS. Further, the incidence of wasting fell from 24.5% in 2007 to 19% in 2009. Wasting occurs when children become severely underweight for their height, due to very low energy intake in the short term, which is closely linked to changes in the level of poverty<sup>10</sup>.

In the education sector, the net enrolment rate in primary education has increased from 65.6% in 2007 to 82.7% in 2009. Additionally, the completion rate increased from 47% in 2004 to 56.9% in 2009. This is in the context of increasing school enrolments, which rose from 65% in 2007 to 83% in 2009/2010.

Timor-Leste has surpassed the MDG target for 2015 for both under-five mortality rate and infant mortality rate based on targets set in 2004 and also the detection and cure of Tuberculosis with new target being set. In 2009, the National TB program has achieved the two key global targets for TB control namely, a New Smear Positive (NSP) case detection rate of 70% (global target 70%) and treatment success rate of 85% among NSP cases registered in previous year (global target is 85%).

In addressing the need to fast track achievement towards the MDGs, the government has created an innovative program to be launched in 2011, the MDG Sucos program. This program will provide 11,140 houses in 2,228 aldeias to the most vulnerable families together with power, water, and sanitation, enabling their participation in the development process.

### **Medium-Term Prospects (2011-2015)**

The Government of Timor-Leste is designing a 20-year Strategic Development Plan (SDP) targeting double-digit growth over the period of SDP. Timor-Leste will be an upper-middle income country no later than 2030, with the gap closed with today's richer neighbors, such as Indonesia, Thailand, and Malaysia. The SDP sets out a plan to increase government capital and development spending over the short-term in a bid to fast-track critical infrastructure development in Timor-Leste. The government will strive towards this target predominantly through capital and development spending plans on critical infrastructure such as roads, electricity, housing, water and sanitation that boosts the productive capacity of the private sector.

In the medium-term (2011 – 2015), besides infrastructure, public spending also will be directed to agriculture, tourism, and hydrocarbon sectors to maintain the double digit growth through 2015 and sustain it beyond that period en route to middle income country by 2030. Human resources development also is an integral part of the medium to long-term strategy.

In addition, the government also aims to undertake aggressive policies to improve business environment so that Timor-Leste can attract foreign direct investment. In a recent international conference organized by the Ministry of Finance, participants discussed several policy choices that Timor-Leste need to explore to attract investment both domestic and international. Firstly, improve the conditions of doing business in Timor-Leste, which includes creating an investment package that allows:

- Clear, fast, and ready to go procedures to curtail the current lengthy business registration process.
- For land laws and titling processes to provide collateral.
- The rule of law.
- Timely bankruptcy procedures.

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<sup>10</sup> World Bank Poverty Note, 2010

- Access to credit.
- Clear mechanism for investors to follow including a one-stop shop.

Secondly, explore ways to finance large-projects with the private sector such as Private-Public-Partnership (PPP) that can contribute to additional investment, efficiency/productivity gains, and improvement in quality of service. Project financing of large projects is another option within the PPP framework.

Thirdly, revisit Timor-Leste's tax regime and possibility of shifting to Value Added-Tax (VAT) to further attract private investment. Fourthly, invest in infrastructure such as roads, power, telecommunications, and water and sanitation, which can also be the subject of PPPs.

Finally, special attention must be given to structural bottlenecks that add higher transaction costs to the economy.

If the renewed post-crisis growth in Asia is maintained and advanced economies continue their recovery, Timor-Leste could be in a good position to attract foreign investment over the medium term. This will rely on continued social and political stability in the country as well as realization of infrastructure development plans and improvements in the business environment. Policy to extend this impressive growth through private sector participation could include the following:

- Address the skills deficit through Vocational Educational Training (VET) and on-the-job training, in both the agriculture and industry and service sectors.
- Update agro-processing machinery along with improved road networks from rural farming areas to the port and border crossing with Indonesia, in order to boost export earning potential in agriculture.
- Continue efforts in reducing Customs delays and modernizing their procedures.

In short, Timor-Leste requires policies and actions to reduce the skills deficit, secure access to land, improve the business environment (through institutions that improve service delivery), develop road links (particularly important trade corridors) and increase the port capacity.