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Country Brief : East Timor

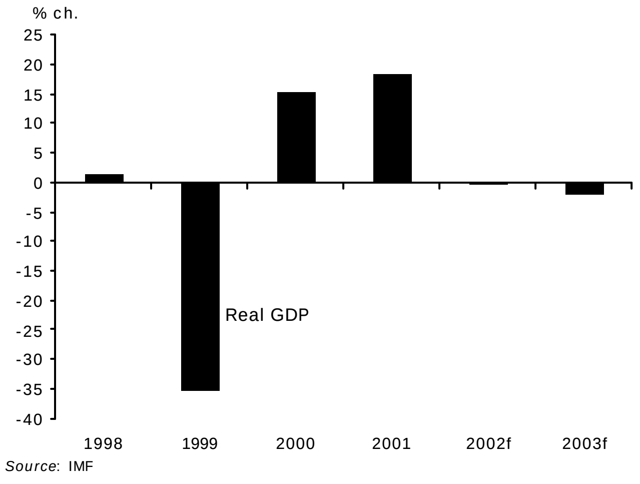
With independence on 20 May 2002 has come a new era for East Timor. These are challenging times for the government as it strives to lift socio-economic standards and develop an economic base for sustainable growth. A bright spot on the horizon is the expected revenue flows from offshore oil and gas developments. International support for the world's newest nation remains strong but the government will have to demonstrate effective macroeconomic policy management in order to draw foreign investment and technical expertise to help build up its non-oil economy.

Smooth political transition

The official handover of administration from a UN-led force to a locally-elected parliament proceeded smoothly in May 2002. Both President Xanana Gusmao and the government, under the leadership of Prime Minister Mari Alkatiri, have taken positive steps to maintain support of the international community and integrate into the world economy. East Timor has become a member of a number of multilateral institutions including the World Bank, IMF, UN and ADB. Bilateral ties are also being fostered. In particular, ties with Portugal have strengthened and relations with Indonesia are improving.

East Timor enjoyed two years of buoyant economic growth in 2000 and 2001 after the devastating violence in the aftermath of the referendum on independence in 1999. Real GDP expanded by 15.4% in 2000 and a further 18.3% in 2001 according to the IMF, boosted by the arrival of thousands of UN personnel and expatriates with hard currency to spend, and reconstruction efforts. GDP (at current prices) is estimated to have recovered by 2001, to close to its 1998 level of US$390 mn.

Sharp swing in GDP growth



Source: IMF

The subsequent reduction of UN staff following independence has brought the growth of economic activity down from unsustainably high rates. Not unexpectedly, East Timor's economy is forecast to slip into recession in 2002 and 2003 as it adjusts to activity driven mainly by its people rather than an expatriate presence as well as infrastructure investment and export opportunities. According to the IMF, real GDP is forecast to decline by 0.5% in 2002 and 2.2% in 2003 before a gradual pick up in growth in subsequent years.

Challenging times ahead

With independence celebrations behind it, the government faces the daunting task of lifting the socio-economic standards of its people and building a strong economic base for sustainable growth. The world's newest nation ranks amongst the poorest countries with per capita GDP of around US$480 (2001), average life expectancy of only 57 years and less than half the population are literate. Physical and services infrastructure are inadequate. East Timor will be dependent on foreign financial assistance for the next few years until expected revenue from offshore oil and gas development flows through. Further development assistance in the form of technical expertise and skills training to help restore health services and improve education will be needed over the longer term.

Foreign aid has been forthcoming with more than US$440 mn having been pledged by donors over the next three years to help fund government expenditure. It is hoped that government revenue can be improved through more effective tax collection, electricity billing and car registration. Nevertheless, a lot is riding on expected royalty payments from offshore oil & gas developments, which are expected to start to come through in three to four years' time. This would assist the economy to become less reliant on aid. Royalties and taxes of the order of US$6 bn over 20 years have been estimated.

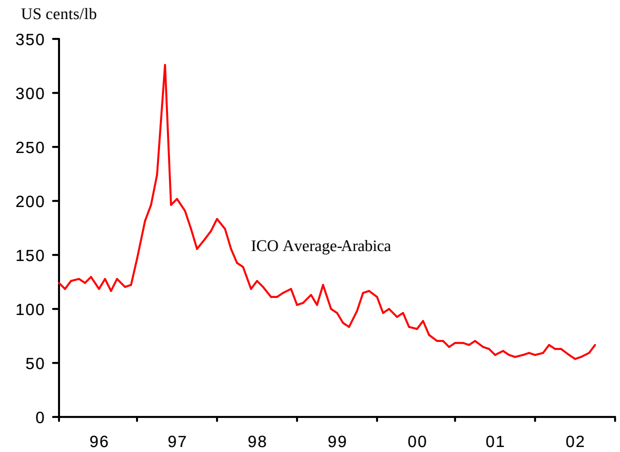
It is, however, hoped that joint agreements between East Timor and Australia over the development of the oil & gas fields be ratified soon as delays could jeopardise projects planned by energy consortiums as their customers look elsewhere for supplies. The two pacts that have yet to be ratified are the Timor Sea Treaty and the Greater Sunrise unitisation agreement. The Timor Sea Treaty sets out how economic benefits of energy developments in the

Joint Petroleum Development Area are shared between the two countries. East Timor is to receive 90% of royalties and Australia, 10%. The Greater Sunrise unitisation agreement covers the Greater Sunrise fields where 80% lies in Australian waters and 20% in the Joint Petroleum Development Area.

The offshore oil & gas fields will provide important financial resources over the medium term to meet budgetary requirements and infrastructure investment. However, there is a pressing need to develop other sectors of the economy to create employment opportunities and improve income levels.

Non-oil resource development, such as in coffee cultivation and tourism offers good potential. Climatic and environment conditions provide good scope for the cultivation of high-grade, organically-grown coffee which commands a premium. This niche, however, has not been fully exploited due in part to the lack of skill and attention to the harvesting process, which has, in some instances, undermined the quality of the product. In addition, international coffee prices are at very low levels, making it an even more difficult operating environment.

Weak coffee prices



Source : Datastream

Tourism is a relatively untapped revenue source. To develop it into a major foreign exchange earner would require significant infrastructure investment and skills training in hospitality services. The global tourism industry has, however, been hit hard by renewed safety fears and terrorism concerns, limiting the prospects for tourist-related development for the time being.

Nevertheless, an overriding factor in attracting investment is the need to tackle key issues such as land rights where competing title claims as a result of different legal systems adopted through its history, namely the Portuguese and Indonesian systems, alongside indigenous-based claims, have caused great confusion. The lack of land security has deterred foreign investment as well as bank lending. Uncertainty over investment-related regulations and a weak judicial system have added to investor concerns.

On the domestic political front, potential investors and aid donors are likely to keep a close watch on how the Fretilin-dominated parliament led by Prime Minister Mari Alkatiri, and President Xanana Gusmao, who is largely a figurehead, but is hugely popular, manage their differences. This, in turn, will determine the pace of development.

Conclusion

International support and goodwill for East Timor will remain strong. The government has made a positive start on the difficult road to economic development. The potential for investment and resource development is substantial. However, the scope for significant foreign investment flows is limited by the diminished risk appetite for investing in the Southeast Asian region, in general, amidst heightened security fears, and domestic uncertainties in areas such as property, tax and investment rules, which are likely to deter long-term investments. The government will need to demonstrate effective macroeconomic policy management to draw foreign investment and technical expertise to help build a strong economic base.

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