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FINANCIAL STABILITY, WHY IS IT IMPORTANT ?

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The term financial stability became very prominent in the recent decades after increasing occurrences of financial instability in the world especially during the last two decades. Take for example the financial instability in Mexico, Indonesia, Thailand, South Korea, and the Philippines, Japan, some Nordic countries and many other countries. The lessons learnt from those countries suggested that financial instability was influenced by the macroeconomic circumstances, microeconomics policies and banks' operational failure.

What is financial stability?

From literature searched, there is no common definition on the financial stability, although there is an explicit suggestion that financial stability requires banking system stability due to its intermediation role in the economy. The banking system is crucial and plays a vital role in the development of a country's economy. The primary function of the banking system in the economy is to '*bridge*' the needs of the people by providing the payments mechanism for households, government and business, gather savings from small and large depositors and make loans, etc. They collect savings from the individuals and companies with surplus funds and facilitate their accumulation in the form of investment capital to the economy, which is important for the economic growth and development. Therefore, instability in the banking system can trigger vast panic that will instigate bank runs thus, may create extensive contagion in the system. The descriptions imply that if the banking system can no longer do its job of bridging the needs of the economic players properly, then we might say that there is instability in the banking system.

Causes of banking system instability

Frederic Mishkin and Tony Latter both similarly identify possible causes on the onset of banking crisis or banking system instability such as macroeconomic circumstances, microeconomic policies or regulatory factors, inappropriate strategies of individual banks and the operational failures in the banks.

(a) Macroeconomic Factors

The operation of the banking system is dependent on overall economic activity, which will be affected significantly by certain macroeconomic developments such as; economic growth, inflation, interest and exchange rates and lending as well as contagion effects from other countries (it occurs for instance through trade spillovers or financial market correlations). It is a common understanding that the macroeconomic instability is sometimes cited as the principal source of banking instability vis-à-vis banking sector unsoundness, which can adversely affect the macro economic variables and damage monetary policy.

Take the example of Mexico and the East Asian countries; Thailand, Indonesia, Malaysia, South Korea, and the Philippines, which had faced high inflation rates and huge debt (short term) denominated in foreign currency.

(b) Microeconomic policies

As discussed above, banking institutions play a particularly important role in the financial system and thus problems in the banking sector may become important source of the financial instability.

There are a number of events which will preserve banking system stability such as; legal and judicial system, financial liberalization, government interference, and lack of transparency.

- Legal and judicial system

  The legal and judicial systems are very important for promoting the efficient functioning of the system and the inadequacies of legal systems in many countries are a serious problem for the banking sector. If for example, property rights, provision on bankruptcy, company law, provision on collateral, etc, are unclear or hard to enforce, the process of financial intermediation can be severely hindered. Collateral for instance, can be an effective mechanism to reduce adverse selection and moral hazard problems in credit markets because it reduces the system prevents the use of certain assets as collateral or makes attaching collateral a costly and time-consuming process. Similarly, bankruptcy procedures may result in the lengthy delays in resolving conflicting claims.
- Banking sector liberalization/deregulation

  Deregulation and liberalization are highly desirable objectives. However, if this process is not managed properly, it can be disastrous. Empirical studies reveal that liberalization/deregulation in the banking sector may encourage rush behaviour, leading to subsequent problems. If a proper bank regulatory/supervisory structure, accounting and disclosure requirements, restrictions on connected lending, and well-functioning legal and judicial systems are not in place, this state of affairs will contribute to massive risks in the system. The result will be for instance bad loans are likely, with potentially disastrous consequences for bank's balance sheets at some point in the future. This is not an argument against deregulation or liberalization but rather a reason for ensuring that bank managements, government (or regulators) understand the potential consequences might occur.
- Government interference

  Government interference in a bank's business can to some extend undermine the financial stability for example; directing banks to lend to particular customers or sectors with preferential interest rates, or to maintain or extend uneconomic branch networks – can precipitate or hasten the onset of a liquidity or solvency crisis, or contribute to an unhelpful legacy in terms of poor assets quality.
- Lack of transparency

  Another factor that can lead banking system on to trouble is the lack of transparency of a bank to depositors and other counterparties or to the shareholders.

(c) Banking strategies and operations

In many instances, the problems of a bank have been brought about by the deficiencies of its own strategy or by operational failure such as poor credit assessment, concentration of lending and connected lending, new

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FINANCIAL STABILITY,WHY IS IT IMPORTANT ?

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areas of activity and fraud and corruption and other operational failures e.g. poor quality of staff, deficient management structure with insufficiently clear lines of oversight and responsibility, over-reliance on IT systems without sufficient trialing and verification and proper audit arrangements, absence of contingency plans to deal with either external or internal emergencies, etc.

Why banking stability matter?

As discussed early that the banking system plays a key role in a country's economy since it intermediating surplus units in the economy with the deficit units, hence fulfilling the important intermediation function that is crucial for economic development. Therefore, if there is shock in the system, it will affect directly the economic development and growth. Moreover, the banking system failure could impose massive fiscal costs to the economy. For example, the recent crises in South East Asia, Indonesia and Thailand faced large resolution costs – 50% and 40% respectively of annual GDP, whereas Mexico in 1995 the fiscal costs about 20% of GDP.

What is the regulator's role?

Towards maintaining the financial stability, a sound and prudent macro economic framework and regulatory regime and practices is necessary to guarantee the soundness and efficiency of the banking system.

BPA as an autonomous institution has adopted sound principles for effective supervision of the financial system. It has powers to license, regulate and supervise banks operating in Timor-Leste.

Since regulatory and supervisory authority is vested in the central bank, it is important that the central bank should be independent from political or other outside pressure, so that its decisions can be made objectively. However, it is important that there should be a mechanism for which the regulatory/supervisory authority is accountable for the discharge of its duties (whether to government or parliament). There also should be a clear provision in which the regulatory/supervisory authority be provided with adequate resources and the statutory authority (e.g. powers to close down insolvent banks and powers to restrict a bank's activities or to direct a bank to adopt certain courses of action) to do their job effectively.

Behind the glass curtain — PAYMENTS LAW & INSURANCE SUPERVISION

A PAYMENTS LAW FOR TIMOR LESTE

The BPA/ABP is currently developing a Payments Law for consideration by the legislative authorities. A draft of the proposed law has recently been circulated for comment.

But why is a Payments Law needed at all? We give three important reasons why the people of Timor-Leste will benefit from having a Payments Law enacted.

To provide a modern legal framework for traditional payment instruments

Timor-Leste, being newly independent, has inherited many of its laws from Indonesia. Because Indonesia never enacted any new law about payments following its independence in 1945, it in turn relies on previous laws inherited from the Netherlands. The law covering payments was enacted in the 1840s and although long since replaced in the Netherlands, it seems to still be applicable in Timor-Leste! This old Dutch law sets out specific requirements for cheques that belong to an age of sailing ships and sealing wax, and not to a modern banking community whose activities are based on electronic communications. For this reason, the proposed law adopts civil law conventions that have been agreed by the international community since the 1930s concerning cheques and bills of exchange, updated to allow for electronic processing.

To reduce the risk that the government will have to bail out bad banks

Our readers will remember the banking crisis that recently occurred in Indonesia – and Indonesia is not the only country to have had this problem. Many banks experienced liquidity and solvency problems. The government and the central bank responded by providing liquidity credits (BLBI) to banks to allow them to settle their debts to the clearing house. Although the process ultimately saved the banking system, the cost to the Indonesian population was extremely high. The proposed law will allow the BPA/ABP to better manage the factors that cause such a situation to arise in the first place. While other laws give BPA the authority to supervise banks, the proposed payments law allows the BPA/ABP to regulate the transactions that take place between banks (the payment system). If a bank fails, the BPA/ABP needs authority to implement techniques to limit the "domino effect" that might cause other banks to fail. These measures will minimise the risk that the Timor-Leste government would have to step in and bail out a bad bank, or worse, the banking system.

To provide legal certainty for payment transactions

When a debt is paid in cash, it is clear to both parties that the obligation has been settled. But what if a business gives a payment order to its bank and the bank debits its account, but no credit is ever recorded in the recipient's account. Clearly the intended recipient will not agree that the debt has been settled. The payer will obviously not want to pay again. The recipient's bank will say it knows nothing about the payment. The paying bank may simply tell its customer that an intermediary bank was to blame. So whose responsibility is it to make good the error? The proposed law uses internationally recognised conventions to cover this and other situations, and provides legal certainty about the rights and obligations of each party at every stage in the payment process, and determines where the responsibility rests if something goes wrong. And yes, in our example above, the proposed law would require the sender's bank to refund the lost payment in full plus interest and other costs incurred, and have the right to make a similar claim on the intermediary bank.

THE ROLE OF ABP/BPA IN INSURANCE REGULATION AND SUPERVISION

When the Banking and Payments Authority (ABP/BPA) was created in November 2001 it was not envisaged that the new institution would have any responsibility for oversight of the insurance sector. As its name – Banking and Payments Authority – implies, the domain of the ABP/BPA was basically to be in the area of Banking, fulfilling the role that in other countries is assigned to central banks / monetary authorities.

Nonetheless, during the first quarter of 2003, the Government asked ABP/BPA to start a process that would enable the Authority to become the entity in charge of the regulation and supervision of insurance activities in Timor – Leste, because, from the point of view of the government (one that we share!) it wouldn't make sense to create another public entity for the sole purpose of dealing with this issue. It should be noted that in many countries this same approach (namely having the same entity as the regulator and supervisor of the banking and insurance sectors) is followed. This is seen most often in less developed countries (such as Timor-Leste) rather than in countries with fully developed financial systems (such as Australia or the United Kingdom)

The lack of experience in insurance regulation of the ABP/BPA's local and international staff was an important initial consideration, so the first decision was to secure proper training for national staff. Therefore three people from this Authority were sent to the Institute of Insurance of Portugal and subsequently to a Portuguese insurance company to learn and acquire the knowledge that would be needed for their future activity. This training took place between April and October 2003 and proved to be very useful.

Meanwhile ABP/BPA was able to secure the presence of an international adviser with experience on setting up the framework for insurance regulation in other countries. This Advisor stayed with us from January to May 2004 and played an important role as coordinator and trainer of our insurance supervision team.

By the end of his stay not only had the draft of the first Timorese Insurance law been prepared, but also a set of 30 Insurance Instructions needed to implement the same law.

The draft of this law was presented to the Council of Ministers last month (June) and is expected to be sent to the National Parliament for enactment in the near future.

Just because an Insurance Law (and related regulatory framework) has been enacted does not mean that the next day insurance companies will be in a rush to start business in Timor – Leste. The ABP/BPA has therefore been developing contracts with insurance companies trying to motivate them to consider establishing their business in this country.

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SHOULD BANKS OPERATE ACCORDING TO MARKET FORCES?

Financial sector as an engine for growth and development

The relationship between long-term economic growth and financial sector growth is widely acknowledged by economists. According to the renowned Nobel prize winner and former Chief Economist of the World Bank, Joseph Stiglitz, the correlation between financial development and faster rates of economic growth suggests that finance leads to faster economic growth. This view is corroborated by research findings published by Professor Maxwell Fry of the University of Birmingham. The financial sector is composed of many players, such as money markets, capital (stock) markets and financial institutions, including commercial banks. In low income developing countries like Timor-Leste, banks dominate the financial sector. The dominance of commercial banks places them in a leading position to drive financial sector activities especially the intermediation process of linking investors (borrowers) to savers (depositors). The pivotal role of commercial banks in the intermediation process, and ultimately their contribution to development, subjects them to greater scrutiny, hence the need to develop a comprehensive regulation and supervision system to forestall the catastrophic effects of bank failures.

The stability of the financial system depends on the how individual banks perform. The spate of bank distress and failures are a serious impediment to economic performance and growth and the Asia crisis served as a serious eye opener in this region, which had hitherto attained an enviable reputation of a successful and vibrant financial sector. However, the stability of the commercial banking system can be maintained only if early warning signals of distress are identified in time to avert problems through prompt corrective This reinforces why it imperative that appropriate policies and interventions are designed to ensure that the financial sector is stable.

Deregulation has intensified competition amongst financial institutions. Furthermore, the participation of non-bank financial institutions in products hitherto exclusive to commercial banks has put more pressure on their profit margins. Moreover, deregulation has not only transformed the character (in terms of range of products) of domestically owned financial institutions, but has also opened up the market to allow the participation of foreign owned institutions.

The significance of financial sector stability

The cost of business failure in any sector concerns not only the internal stakeholders (shareholders, management and employees), but also external parties as well, for instance the creditors, suppliers, government and the community. This is because each group of stakeholders will either directly or indirectly, suffer some cost or be deprived of a benefit resulting from the failure. For example the shareholders and creditors lose their investment, employees lose jobs, government will be deprived of revenue through taxation while the broader community could be affected socially.

Although all business failures have negative consequences, bank failures have greater and far-reaching consequences compared to firms in other sectors. This is because of their special intermediation function, which is to link surplus to deficit units, and also to facilitate the payments system. If banks fail therefore, the negative externalities are contagious to other businesses as well, hence the enormous interest in the development of early warning systems to detect imminent bank failures, in both developed and developing countries.

Professor Heffernan of City Business School in London identifies asset quality or bad loans as the major cause of bank distress. This implies that the models designed to predict bank failure are essentially credit risk measurement techniques. Therefore, the terms *credit risk models* and *business (bank) failure models* refer to the same concept from the perspective of predicting the risk of distress. Just as banks assess borrowers to determine credit risk, so do regulators such as the Banking & payments Authority assess banks in order to establish their vulnerability.

In the context of evaluating credit risk and bank condition respectively, the most celebrated traditional models are the 5Cs (Character, Capital, Capacity, Collateral and Conditions) and CAMEL (Capital, Assets, Management, Earnings and Liquidity). Banks apply the 5Cs model to assess credit risk of borrowers, while regulators and other analysts use CAMEL to assess bank condition and the risk of distress. A close scrutiny of these two, the 5Cs and CAMEL models, reveals interesting and remarkable similarities between them. Each of the five elements of CAMEL model has a counterpart to match in the 5Cs model, hence the term "the traditional twin models".

Should banks operate according to market forces?

Although it is undisputable that banks ought to be regulated and supervised, the orthodox approach to free markets assumes that the dynamics of demand and supply are equilibrated through the price mechanism. According to Stiglitz, free enterprise based on the principles of competitive pricing has for a long time been regarded as the most efficient way of allocating resources to stimulate growth and enhance welfare. In the context of financial markets therefore, interest rates will equilibrate demand and supply of funds. If the concept of free markets is extended to the banking sector, this implies full liberalisation devoid of external interference. But Stiglitz argues that banks are remarkably different because they involve exchanging value today for the promise to repay in the future, which introduces uncertainty and risk.

Stiglitz also points out that *free markets do not necessarily ensure efficient allocation, and it is not always true that free markets enhance welfare and economic growth.* He therefore suggests that there should be ways of regulatory or government intervention, for instance taxation, subsidies and regulation or obligatory community re-investment of a proportion of profits, in order to mitigate this anomaly. He further observes that while the concept of efficient markets assumes that material and relevant information should be available to all players in the markets, financial markets suffer from information asymmetry which leads to credit rationing, and hence the problems of adverse selection, moral hazard and enforcement of loan contracts. Such conditions make financial markets more vulnerable to fragility than other types of markets.

Credit rationing and information asymmetry may hinder development

Adverse selection effect: Banks pool savings from surplus units, and allocate them efficiently to deficit units. On the average, surplus units are dominated by individuals and households, who disparately save small amounts, whereas deficit units are dominated by corporate bodies that require large amounts for investment. Therefore banks reduce search and information costs through specialisation and economies of scale. However, banks face two main conflicting objectives in the loan making process; on one hand they would like to maximise profits, and yet they also want to make sure that funds lent are invested in safe projects to guarantee repayment. Based on the principles of free markets, banks as suppliers of credit would theoretically lend at the highest interest rates possible to equilibrate demand and supply of funds. If highest bidders (the borrowers who are willing to pay highest rates) could repay their loans, then the banks become more profitable while at the same time ensuring that funds are allocated to the projects that generate the highest returns to the promoters. If these conditions hold, then banks are effectively welfare enhancing through the efficient allocation of funds.

However, in the borrower-lender relationship, the lender (bank) has less information about the project compared to the borrower. The bank seeks those borrowers with a higher probability to repay. If the bank increases the rate of interest, this will discourage risk-averse investors who have safer or more economically viable projects, with a higher probability to repay the loan. Instead, higher interest rates will attract risk-lovers, willing to borrow at higher rates to invest in riskier or speculative projects, but increasing the probability of default. To aggravate matters, the projects selected may not be in the priority sectors that could foster economic growth and development. Under conditions of asymmetric information, expected profit to the borrower rises and expected return to the bank falls as the risks of the project increase. The problem of adverse selection therefore arises because the bank can not allocate funds according to interest criteria alone, but will ration credit to a level that optimises its returns which in effect leaves out some projects with potentially higher returns.

In their seminal paper about credit rationing, Stiglitz and Weiss describe the rate of interest at which the banks maximise returns as "a paradoxical equilibrium interest rate in the context of demand and supply because unsatisfied borrowers would offer high rates but the banks would not accept it". In effect, the bank will not extend credit to borrowers willing to offer interest rates higher than the Paradoxical Equilibrium Rate (PER), because potentially, their aggregate expected returns are lower due to higher probability of default. Individually, however, some of those projects could be safe, and therefore their exclusion leads to credit rationing arising from information asymmetry, since the bank does not have intimate knowledge on individual projects, but makes decisions based on averages. Similarly, the choice of projects that fall in the "safe interest zone" could include some whose risk profiles are above the perceived average, which implies that the adverse selection effect constrains optimal credit allocation.

Adverse Incentive Effect: The adverse incentive effect, also popularly known as the moral hazard, occurs when some form of protection, for example insurance or diversification, encourages greater risk-taking. Although it is not necessarily irrational in the context of seeking to maximise returns, moral hazard behaviour is dangerous and can lead to catastrophic losses, which may culminate in

SHOULD BANKS OPERATE ACCORDING TO MARKET FORCES? *(Continued from page 3)*

bankruptcy. In the lender-borrower relationship, the contract of servicing the credit is fixed in terms of interest. If the borrower undertakes a riskier project, he will benefit if it succeeds, whereas the position of the lender will remain unchanged. Should the project fail, the borrower's loss will be limited only to the extent of equity. This explains why borrowers are more likely to take greater risks if their equity is small relative to the debt, to the detriment of the lender who loses all or part of the funds.

In the context of commercial banks, adverse incentive could arise from two fronts. The first is between the banks and their borrowing customers, and the second is between banks and the regulators or supervising authorities. Both cases are intricately related and could potentially lead to bank failures or banking crises at a larger scale. In the case of bank-borrower relationship, risky borrower behaviour will cause default, and increase non-performing assets, which undermines the banks' solvency. The bank can mitigate moral hazard behaviour in two ways. The first could be to closely monitor the project operations as it progresses. However, this is costly, and the problems are compounded by information asymmetry. Therefore supplementary mitigation is necessary, for example the introduction of credit supports (collateral) and restrictive covenants such as limits on further borrowing or imprudent activities, curtailing disposal of core assets without approval of the bank, etc.

The other dimension of moral hazard relates banks to regulatory or government authorities. In the case of the South East Asian crisis, McKinnon and Pill attributed the "over-lending syndrome" to that moral hazard, because the higher risks normally associated with higher expected returns appeared to be insulated by some form of protection. Therefore the very instruments intended to create stability of the financial system, ended up destabilising it as a result of moral hazard. In spite of the positive role deposit insurance plays in stabilising the financial markets through the protection of depositors, it may induce banks to take greater risks. Furthermore, the depositors lose the incentive to monitor the performance and solvency of banks.

The above analysis clearly suggests that information asymmetry induces adverse selection, moral hazard and enforcement problems, which make the banking sector more susceptible to fragility. This raises the most critical question: *Should banks operate on free market basis or is government intervention necessary to foster economic development?*

Interventions in developing countries

Joseph Stiglitz and Professor Maxwell Fry are among the leading proponents of the widely held view that the banking sector plays a central role in the entire economic system. However, the standard theories of efficiency in competitive markets are based on the assumption that there is perfect competition, otherwise markets are inefficient. Informationally inefficient markets can be identified from their incentives to seek further information. Since the primary role of financial markets is to obtain and process information, it can be adduced that they are inefficient, a feature that makes them vulnerable to endemic failures. The depositors and investors need information about the solvency of a bank to entrust their funds to it. But up-to-date information entails continuous monitoring, a role privy to the Board of Directors, regulatory authorities and external auditors. Stiglitz implies that there is under-supply of relevant and timely information that the public requires, which induces moral hazard behaviour by banks and adverse selection effect by depositors and investors, to curtail the efficient performance of banks.

It can be adduced that the market imperfections lead to inefficient and suboptimal allocation of resources. Elements of imperfections pervasive in banking sectors of developing countries such as Timor-Leste, which justify interventions as suggested by Stiglitz. First, the high concentration ratios in most developing countries reflect the oligopolistic character of the commercial banking sector whereas financial markets are more competitive in the industrialised countries. Secondly, although regulations for the banking sector do exist in most developing countries, but they are not generally enforced consistently and effectively as in industrialised countries. Timor-Leste has so far performed well in this respect, with regard to enforcing regulations. Thirdly, equity markets, a key mechanism of sharing risk, are less active in developing countries, and non-existent in Timor-Leste. Fourthly, costs of information are generally higher in developing countries, because of lack of central credit bureaux or rating agencies.

In view of the above distortions, there is a case for government interventions to mitigate their effects. If credit allocation is left to market forces, some socially desirable investments for post-conflict reconstruction in Timor-Leste, would be starved of the required funding. By taxing those who make profits through the imperfect system, funds can be directed to socially desirable but under-funded, on terms deemed appropriate, including consideration of subsidies. In his key note address at the University of Manchester in April 2001, Stiglitz advocated for a legal framework that would compel banks to reinvest some of their profits in community or economically desirable projects that have been excluded through the free market system. This would be an alternative to direct interventions such as directing credit to sectors designated by government as priority to foster growth. This is especially relevant to Timor-Leste, since the major players are foreign owned.

Behind the glass curtain — PAYMENTS LAW & INSURANCE SUPERVISION *(Continued from page 2)*

Related to this, and with the purpose of being fully prepared to meet this new challenge, this Authority has established a new division: the Division of Insurance Supervision, as a new unit in its Department of Financial Supervision Department (previously known as Department of Banking Supervision). Of course the ABP/BPA's keen interest in creating the conditions for the development of insurance activities derives from the common understanding that insurance is necessary for the proper development of economic activities, namely for offering protection against risk. Clearly this protection does not come without a cost (being the premium paid by the persons insured to the insurance companies) but this cost is usually a tiny fraction of substantial losses that may be incurred should an adverse event such as a major accident happens.

Therefore we are all expecting that insurance activity can commence in Timor – Leste in the not very distant future and we know that the Banking and Payments Authority is well-prepared to properly perform its role as regulator and supervisor of this financial activity.

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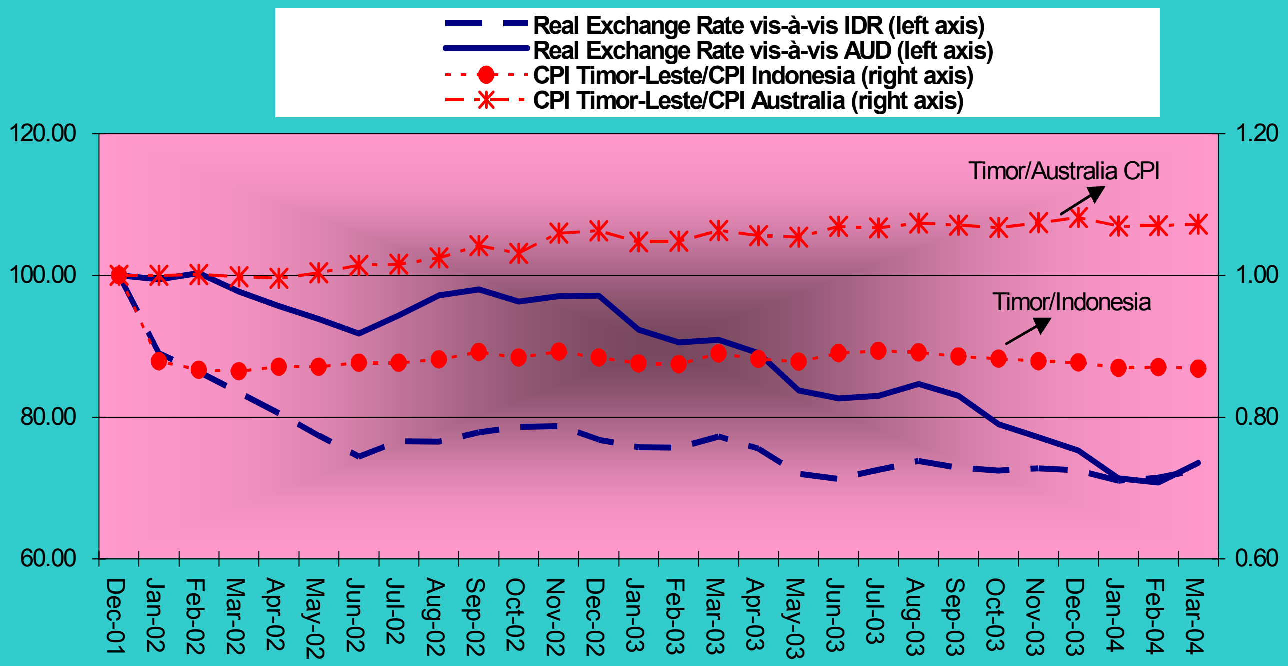
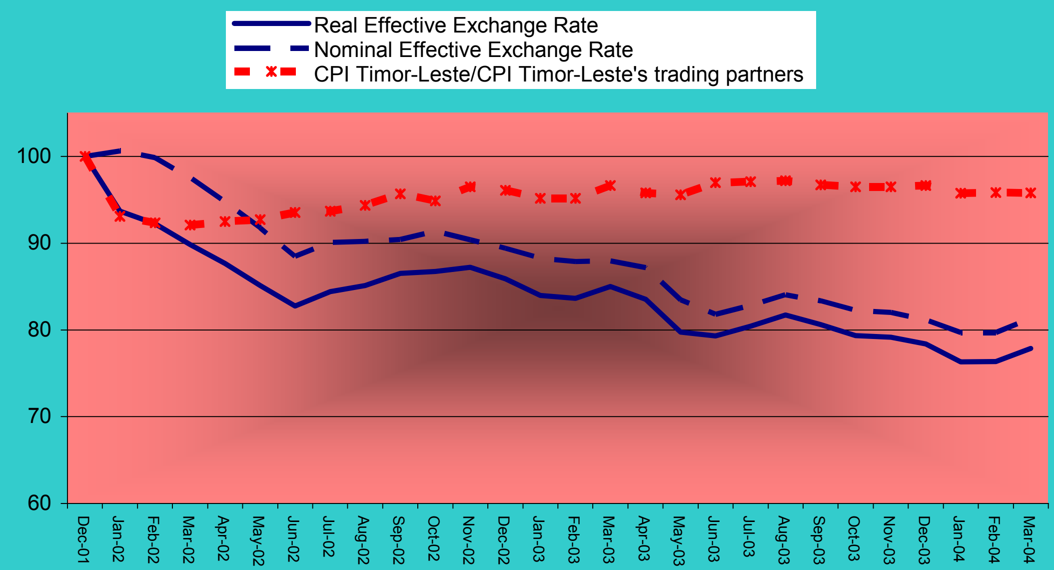
Timor-Leste's real exchange rates vis-à-vis AUD and IDR (December 2001 to June 2004)



Sources: National Statistics of Timor-Leste, Australian Bureau of Statistics, Statistics Indonesia, Oanda (exchange rates) and Banking and Payments Authority of Timor-Leste's computations

Timor-Leste's real effective exchange rate (December 2001 to June 2004)



Sources: National Statistics of Timor-Leste, Australian Bureau of Statistics, Statistics Indonesia, Singapore Department of Statistics, Portugal, Malaysia, Oanda (exchange rates) and Banking and Payments Authority of Timor-Leste´s computations.

Monetary statistics

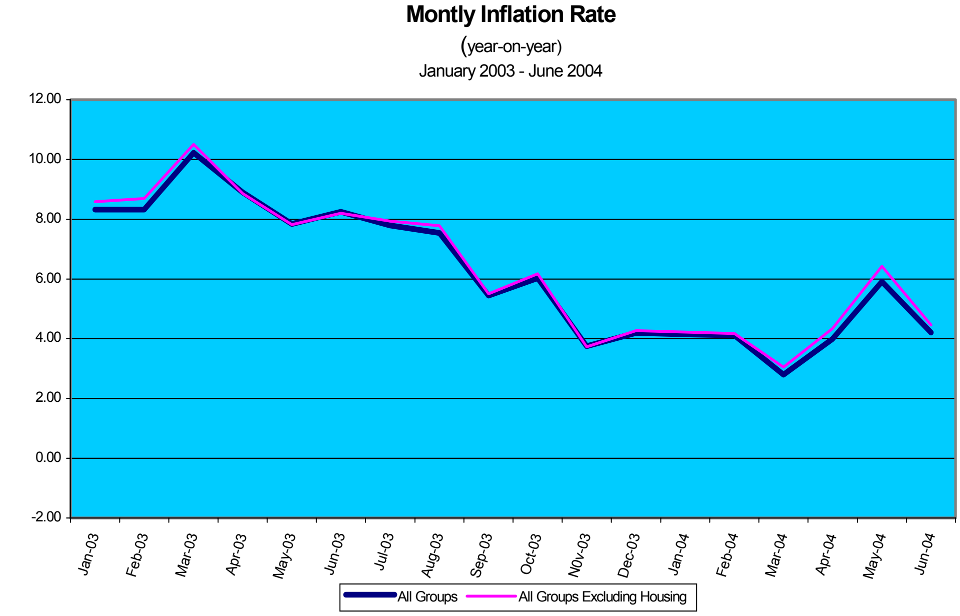
Thousands of USD	March	April	May	June
Net Foreign Assets	**127,714**	**131,467**	**123,120**	**121,988**
Claims on non residents	***195,626***	***200,193***	***205,035***	***165,999***
Claims of ABP/BPA	98,251	101,999	102,069	103,948
Claims of commercial banks (1)	97,375	98,193	102,965	62,050
Liabilities to non residents	***67,912***	***68,726***	***81,915***	***44,010***
Liabilities of ABP/BPA	11,487	11,487	11,487	12,023
Liabilities of commercial banks (1)	56,425	57,238	70,428	31,987
Domestic Claims (2)	**-30,747**	**-23,506**	**-22,502**	**-13,560**
Claims on central government	0	0	0	0
Claims of ABP/BPA	0	0	0	0
Claims of commercial banks	0	0	0	0
Deposits of Central Government	74,254	75,285	76,197	78,710
at ABP/BPA	74,254	75,285	76,197	78,710
at commercial banks	0	0	0	0
(Net claims on Central Government = Loans minus Deposits) (2)	-74,254	-75,285	-76,197	-78,710
Credit (to private sector = private and enterprises)	43,506	51,779	53,695	65,150
Credit of ABP/BPA	384	383	412	379
Credit of commercial banks (1)	43,122	51,395	53,283	64,771
Deposits of commercial banks at ABP/BPA	**5,693**	**6,846**	**5,534**	**6,142**
Deposits (Demand and time)	**75,391**	**76,244**	**76,106**	**84,687**
Demand deposits at commercial banks (1)	**44,329**	**45,553**	**44,372**	**49,993**
Public non-financial corporations	373	319	294	257
Other resident sectors	43,957	45,234	44,079	49,737
Time and Savings Deposits (1)	**31,062**	**30,691**	**31,733**	**34,693**
Deposits of ABP/BPA	0	0	0	0
Time deposits of other residents	31,062	30,691	31,733	34,693
Others Items (Net)	**-9,010**	**-10,351**	**-3,626**	**-4,172**
idem, ABP/BPA	-388	-348	-424	-388
idem, commercial banks (1)	-8,622	-10,003	-3,202	-3,784
Capital and reserves	**11,086**	**17,277**	**17,606**	**18,172**
Capital	**11,447**	**17,821**	**18,287**	**18,500**
idem, of ABP/BPA	7,727	7,727	7,727	7,727
idem, of commercial banks (1)	3,720	10,094	10,560	10,773
Retained earnings	**-821**	**-1,005**	**-1,141**	**-789**
Retained earnings of ABP/BPA	578	383	179	185
Retained earnings of commercial banks (1)	-1,399	-1,387	-1,321	-974
General and special reserve	**461**	**461**	**461**	**461**
Reserve of ABP/BPA	461	461	461	461
Reserves of commercial banks (1)	0	0	0	0

The most important facts related with the behavior of Timor Leste monetary aggregates during the last quarter are the following;

- There was a decline of Net Foreign Assets of the global banking system of Timor Leste from USD 127.7 million (in March) to USD 122.0 million (in June), but this decline was more than offset by the increase on domestic Claims, mainly due to the increase in credit provided to private sector by commercial banks.
- The aggregate balance of the Government deposit accounts in ABP/BPA continued to rise reaching USD 78.7 million by the end of June. This figures includes not only the government current account but also the Timor Sea account (future Oil Fund).
- Net claims on Central Government is define as credit minus deposits, the resulting negative value means that the volume of deposits is higher than the volume of credit (that is zero).
- Deposit of Commercial banks with ABP/BPA increased from USD 5.7 M to USD 6.1 during the quarter.
- Capital of ABP/BPA remained stable while capital of commercial banks went up from USD 3.7 million in March to USD 10.7 million in June 04. This increase was related with changes in the accounting treatment of capital by two banks that are branches of foreign banks and also an increase in provisioning.

Price dynamics in Dili

According to data released by National Statistics, the annual inflation rate in Dili stood at 4.2% in June 2004 versus 8.2% the previous year (June 2003) for all consumer goods covered by the "consumer basket" (See chart). After deducting the price variation arising from the housing sector, the inflation rate remained at 4.2%. There was some pick-up in inflation during April and May but in June the disinflation continued in Timor-Leste.



Source: National Statistics Office

During this quarter (April, May and June) the increase in the prices of the consumption basket was 1.9% (2.0% excluding the "house" group). The food group was the bigger contributor for the global increase (its prices change was 3.3%). Clothing and footwear also showed an higher increase that the general (2.9% during the quarter). On the other side three groups experienced declines in price: " alcohol and tobacco" (-8.2%) ; " housing goods and services " (-0.4%); "leisure and education expenses" (-1.4%). In terms of year-on-year (12 month) inflation the higher increase was in "food" (+7.8%) followed by "health" (+4.2%). The same three groups of goods mentioned above ("alcohol and tobacco", "housing goods and services" and "leisure and education expenses") presented also lower prices in June 04 comparing with June 03.

Moreover, the slight strengthening of the US dollar against Timor-Leste main trading partners' currencies during the

Interim Summary Financial Statements of ABP/BPA

BALANCE SHEET
As at 30 June 2004

	US Dollars
ASSETS	
Cash and Bank	92,862,371
Investments	11,487,052
Other Assets	1,256,815
TOTAL ASSETS	**105,606,238**
LIABILITIES	
Currency Issued	835,775
Government Deposits	79,010,827
Domestic Financial Institutions	5,769,802
International Financial Institutions	11,487,052
Other Liabilities	234,711
TOTAL LIABILITIES	**97,232,461**
NET ASSETS	**8,373,777**
EQUITY	
Capital	7,727,188
General Reserve	460,775
Retained Earnings	185,814
TOTAL EQUITY	**8,373,777**

PROFIT AND LOSS STATEMENT
For the year ended 30 June 2004

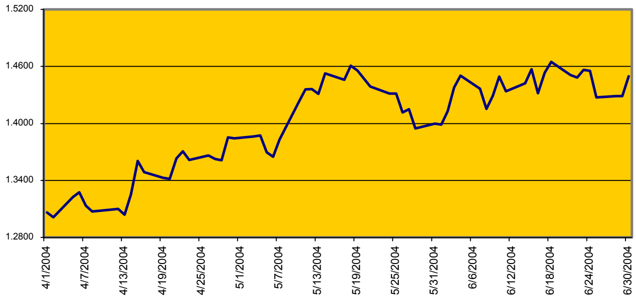
	US Dollars
INCOME	
Income from Financial Assets	600,303
Fees and Recoverable Charges	556,066
Government Appropriation	388,978
Currency Gains (Losses)	(495,051)
Other Income	86,073
TOTAL INCOME	**1,136,369**
EXPENSES	
Financial Expenses	192,690
Currency Expenses	221,340
Personnel Expenses	206,877
Administration Expenses	194,859
Depreciation of Fixed Assets	134,789
TOTAL EXPENSES	**950,555**
NET PROFIT	**185,814**

Foreign Exchange markets

Latest developments

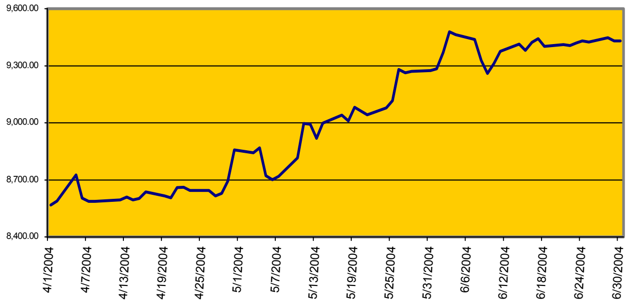
The three graphs mentioned below show the exchange rate of the USD versus three different currencies at nominal values. A downturn indicates a depreciation of the US dollar against anyone of the other currencies.

AUD per USD
(01 April 04 - 30 June 04)



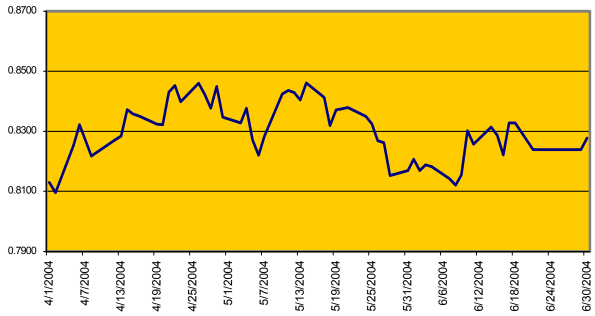
Source: Oanda

IDR per USD
(01 April 04 - 30 June 04)



Source: Oanda

EUROS per USD
(01 April 04 - 30 June 04)



Souce: Oanda

The period between April 2004 to June 2004, was essentially characterized by a moderate strengthening of the US dollar against the major currencies of the world, and against the main trading partners of Timor Leste.

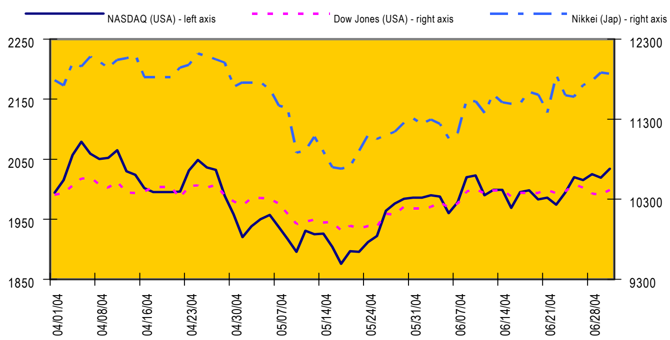
As showed by the graphs, the USD rose off the ground against the IDR, Euro and AUD. On average, the IDR was recorded at 9,001 per USD in May the exchange rate had moved to IDR 9,397 per USD in June implying a depreciation of 4.3% at value of Rupiah, related with the uncertainty of the electoral period. Overall, the strengthening was mainly driven by the solid growth of U.S economic, reinforcing expectations of a steady rise in U. S interest rates.

The USD appreciated versus the Australian dollar moving upward from 1.4178 to 1.4396, strengthening by 1.5%. On the other hand the USD depreciated versus the Euro, from 0.8333 in May to 0.8235 in June, a modest decrease of 1.1%.

Financial Markets **Latest developments**

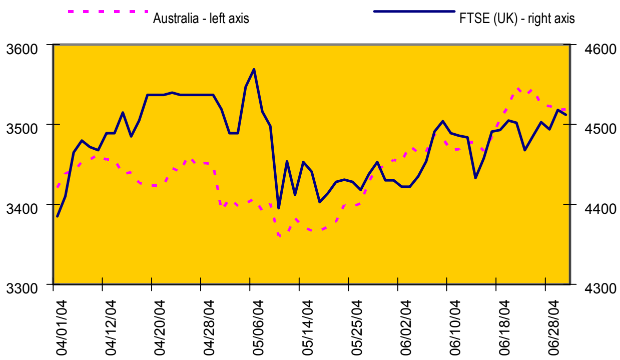
As shown in the following graphs, stock exchanges have exhibited some volatility over the last three months. The two markets with some minor gains were the Australian and the British stock markets. The American and Japanese markets finished the quarter almost at the same level as at it's begining.

Stock Exchange Indexes
(April to June 2004)



Source: oanda

Stock Exchange Indexes
(April to June 2004)



Source: Oanda

CAN TIMOR LESTE COMPETE IN TERMS OF TRADE?

AN ANALYSE BASED ON REAL EFFECTIVE EXCHANGE RATE!

Background

In the previous edition (April 2004) of this bulletin and under the title **"Real effective exchange rate: what is it? And what does it say"** the article presented the concept of real effective exchange rate (REER) which provides important information about the competitiveness of an economy. REER is defined as the product of nominal bilateral rate, expressed as the value of foreign currency in terms of domestic currency and the relative price expressed as the ratio of domestic to foreign price level. Timor Leste is an open economy that adopted a market orientated economic system and the USD as official currency. The challenge to this new country in this economic system is how to deliver in an efficient way the production and distribution of goods and services, which is not easy task. The majority of these goods (for consumption and investment) shall be imported from abroad, because there are no conditions to produce them locally. In general terms the situation of Timor Leste is similar to any other new country with limited human and financial resources.

As an open economy, Timor Leste has economic relationships with other countries, existing mainly with five big trading partners: Indonesia, Australia, Singapore, Malaysia, Portugal. Now, can Timor Leste compete in terms of trade with most trading partners countries? And in which kind of trade, import or export and with which country? Portugal, Australia and Singapore are classified as developed countries, the other two, Indonesia and Malaysia classified as developing countries. Experience of other new countries, usually is, trying to attract investment in effort to develop industries that allow import substitution or export promotion and increase the rate of competitiveness. The objective of this article is to explore the issues above.

Methodology

This study was conducted by Economic and Statistic Division (DES) of BPA, and used collected data of Nominal exchange rate of USD regarding Timor Leste's main trade partners . USD is the official currency of Timor Leste so the country is considered as dollarized economy. In this case USD is the base currency while trading partners currencies are the target currency. The traders partners currency are; Euro, Rupiah, Singapore Dollar, Ringgit and Australian Dollar for Portugal, Indonesia, Singapore, Malaysia and Australia, respectively. Besides Exchange rate data, this study also uses the consumer price index (CPI) both Timor Leste and most relevant trading partners . All CPI data of each country is reported in a different base year. Also CPI of Timor Leste began on December 2001. For the interest of this survey the differentiation of base year must be re-based in effort to harmonize the CPI data. This harmonization according to the base year of Timor Leste' s CPI. After re-base, Timor Leste CPI is compared with the re-based CPI's of trading partners in the way to obtain the Index, which is calculated from the adjusted average on value of export and import of the Timor Leste towards most trading partners countries. Calculation of nominal effective exchange rate (NEER) can also be made being the only difference the fact that differently from the REER , NEER does not take into consideration the behavior of the prices (differentials of CPI's between different countries). Real exchange rate (RER) or bilateral applies the same calculation as for the REER but usies just one trading partner. REER is calculated as the weighted average of RER used as weights the share of each countries in the external trade of domestic country. The data was collected on monthly basis, from December 2001 to March 2004.

Concept and the framework of REER .

Nominal exchange rate (NER) can be introduced as price at which the money of one country can be exchanged for one unit of some other national money or relative price of two currencies. We can obtain the real exchange rate (RER) adjusting the NER by the behavior of the relative prices between the two countries. The nominal effective exchange rate (NEER) is a summary measure of a country's trade-weighted nominal exchange rate against its trading partners. While the real effective exchange rate (REER) is a measure of competitiveness showing the evolution of the number of units of foreign goods required to buy one unit of domestic goods.

To construct the REER there are three main components of information that must be available: the nominal exchange rate, which we can obtained from daily exchange rate and transformed into monthly basis; the Consumer Price Index (CPI) that is the measure of the price of a representative consumption basket. Finally the trade-weight measured by the value of export and import of each country during a given period (monthly basis). Trading partner countries are countries with a relevant relationship in terms of external trade where we want to measure the REER.

Timor Leste 's Competitiveness

How to determine the evolution of the competitiveness of Timor Leste, can it compete? In terms of trade, the biggest import suppliers are Indonesia, Portugal, Australia, Singapore, Malaysia, Vietnam, Thailand, China, etc. While the most imported merchandise are meat, dairy products, cereal, sugar, detergents, fuels, tobacco, pharmaceutical products, construction equipment etc. The only relevant export of Timor Leste is coffee, to countries like USA, Australia, Indonesia, Singapore, Taiwan, Portugal, Hong Kong, Japan and New Zeland. In total sixteen countries purchase Timorese coffee.

To establish the overall competitiveness of Timor Leste, our Economic Division constructed the real effective exchange rate index which encompasses all trading partners. During the total period the increase in prices in Timor Leste was lower than its trading partners (mainly because of the higher inflation rate in Indonesia).That's why the Real effective Exchange rate of Timor Leste is lower than nominal effective exchange rate. The evolution of the REER can be better understood by using the chart of Timor Leste real exchange rate vis-à-vis Australian dollars (AUD) and Indonesia rupiah (IDR). Regarding Indonesia, the absolute price level there is lower than in Timor Leste, so even with an higher inflation rate in Indonesia and an appreciation of the IDR during 2003, there is no way to replace imports from Indonesia by domestic output or to change the source of imports to other countries. The inflation in Indonesia is still higher than in Timor Leste so even with a stabilization of the nominal value of the IDR towards the dollar, the price differential evolution will imply an appreciation of the real exchange rate of the IDR. Nevertheless long are gone the days of financial crisis of 1997-1998 where prices and exchange rate changed by the hour; also the soundness and stability of Indonesia banking sector is now much better compared to the situation in the 90's. But in terms of competitiveness the main feature is, like we mentioned before, the higher level of absolute prices in Timor Leste (in part due to tax system) that creates a serious handicap for the competitiveness of eventual Timor Leste domestic production. The elasticity of external trade is a good indicator to measure the reaction of trade flows to the changes in prices and getting some idea about how there flows can be affected by different price level behavior, arising from the evolution of nominal exchange rate and or inflation differentials. From what we can see in charts (see page 5) the situation of Timor Leste competitiveness has improved in recent times (since December 2001) because of lower inflation (for instance regarding Indonesia) or because of the depreciation of the USD vis-à-vis the currencies of the main trading partners (IDR,AUD,EURO). Nevertheless this improvement measured by the REER is not enough to allow Timor Leste to compete exporting more or replacing imports by local production.

In case of exports of Timor Leste coffee is the main product to export but coffee prices are determined internationally by International Coffee Organization (ICO) or oligopoly (or international Cartel) and affects all coffee producer countries. The situation is that Timor Leste in the international coffee market is a price-taker and it's coffee production will be sold at international coffee prices, no matter the level of domestic coffee production conditions.

Opportunity to Compete

After understanding the evolution of competitiveness of the country the next question is how to improve this competitiveness and what shall be done for this purpose. The National Development Plan recognizes the market forces as the main levels of the economy but also gives some power to the Authority as regulators of the economy system. To increase the competitiveness the government shall speed up the implementation of a proper legal framework facilitating not only the development of the domestic private sector but also foreign investment. The objective is how to utilize the resources. While in case exports, the issue is how to diversify the exports by developing the agro-industry. Coffee plantation is a good example: conditions should be created to reduce the export of coffee as a pure raw commodity allowing same degree of internal transformation (exporting coffee blends already processed like instant coffee or organic coffee). To achieve this goal and develop the coffee economy, attention should be focused on the entire production process, from plantating until harvesting, given technical support to the farmers and providing research and laboratories for the taste quality control and promoting Timorese coffee as an individual brand. At entrepreneur side, opportunities to penetrate global markets by use the government facilities to promote this individual product. At fiscal level the tax income will increase with the higher return and value of coffee production. The Government shall also avoid any "invisible costs" related with bureaucracy and others ways of less efficient administrative behavior. If these costs are not avoided Timor Leste will never be able to compete and our economy will never be able to achieve its ultimate goals: thus to enhance the welfare of the general public.

This publication is prepared by the Economic Studies and Statistics Division of the Banking and Payments Authority of Timor Leste
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