Office Memorandum

To: Members of the Executive Board — April 22, 2005

From: The Secretary

Subject: **Timor-Leste—Statement by the IMF Staff Representative at the Donors' Meeting**

Attached for the **information** of the Executive Directors is the statement to be delivered by the Fund staff representative at the Donors' meeting for Timor-Leste, which will be held on April 25 and 26, 2005 in Dili, Timor-Leste.

Questions may be referred to Ms. Fichera, APD (ext. 38479).

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TIMOR-LESTE AND DEVELOPMENT PARTNERS MEETING

IMF Staff Statement

Asia and Pacific Department

Dili, April 25-26, 2005

1. It is a great pleasure for me to represent the International Monetary Fund in this meeting today and have the opportunity to present this statement. Looking back over the past few years, Timor-Leste has achieved good progress in establishing the basis for a stable and healthy economy. At the same time, challenges remain ahead in consolidating these achievements; most important of these is how best to manage the new oil/gas wealth effectively to support Timor-Leste's economic development.

2. This statement draws on the recently held annual economic policy consultation discussions between IMF staff and the Timor-Leste authorities. It covers recent economic developments and the economic outlook in Timor-Leste, and focuses on the policy issues facing the government as it pursues the objectives of accelerating growth while maintaining macroeconomic stability.

I. RECENT DEVELOPMENTS AND ECONOMIC OUTLOOK

3. **2004 saw a modest recovery in non-oil economic activity, lower inflationary pressures, and large oil/gas revenue inflows**. Despite a further decline in donor activity, non-oil GDP growth recovered, reflecting a rebound in agricultural activity following the 2003 drought, and expansion in banking sector activity. Inflation declined over the course of 2004, falling below 2 percent in December (year/year), with the continued downsizing of the international presence and stable non-oil import prices. The external current account surplus (including international assistance) widened sharply in 2004, mainly due to large oil/gas revenue.

4. **This favorable economic performance has been supported by continued cautious macroeconomic policies.** The central government budget outcome for FY 2004/05 is now expected to be considerably stronger than budgeted. Higher world oil prices will prompt a much higher than expected rise in oil/gas revenue. At the same time, domestic revenue is strong, reflecting improved tax administration, while budget execution remains poor, particularly in capital spending. As a result, the central government balance is now expected to end with a surplus of about 70 percent of non-oil GDP, compared with the projected surplus of 7 percent of non-oil GDP, and to a surplus of 10 percent of non-oil GDP in FY 2003/04 (with grants).

5. **The government is moving forward commendably to ensure that the new oil/gas revenue will be managed and spent wisely**. Oil/gas taxation has been streamlined, the

Norwegian-style petroleum fund is on track to be operational by July 2005, and a long-term savings policy is being adopted which establishes annual sustainable spending equal to the sum of domestic non-oil revenue and the estimated permanent income from the oil wealth. The draft Petroleum Fund Act is expected to be submitted to Parliament in April. The government has indicated its commitment to the standards of the Extractive Industries Transparency Initiative (EITI). The preliminary Sector Investment Programs (SIPs) set out a public investment strategy for Timor-Leste's long-term economic development, to be financed by oil revenue (in amounts reflecting the new savings policy), in addition to non-oil revenue and donor funds.

6. **Bank lending to the private sector increased rapidly during 2004**. As a share of non-oil GDP, credit tripled to 22 percent of non-oil GDP at end 2004, mainly in construction and personal loans for small transportation business, and concentrated in Dili. Reflecting high government cash balances resulting from strong oil/gas revenue, net foreign assets of the Banking and Payment Authority (BPA) rose to more than 10 months of imports at end-January.

7. Over the last half year, the pace of establishing the necessary legal framework to encourage private sector activity has accelerated; nonetheless, the agenda ahead remains heavy. Good progress has been made in some areas, including some land-related legislation. However, complex regulations continue to discourage private activity, as outlined in the recent Transition Support Program report on private sector development. The government also has plans for expanding public sector involvement in the economy through creation of public enterprises, which could discourage private activity. Progress in strengthening the courts has suffered a set-back, due to lack of competent personnel. Finally, administrative capacity, critical for Timor-Leste's long-term development prospects, is improving slowly because of continued scarcity of needed skills.

II. Key Policy Issues

8. **As the transition from post-conflict status ends, Timor-Leste's challenge is how best to harness its new oil/gas resources within a policy framework that would support higher non-oil GDP growth, reduce poverty, and maintain macroeconomic stability over the long term.** The government has followed prudent fiscal and monetary and exchange rate policies over the past few years and is now making promising progress on introducing a long-term strategy for effective management of its oil/gas wealth. Key areas remaining to be addressed include a public investment strategy focused on basic services and infrastructure spending and supported by sharp improvements in the capacity to design and execute expenditure programs, and an intensified effort to complete the establishment of an environment to attract private investment and stimulate private non-oil activity—the primary source of future job creation.

9. **Against the background of a better-than-expected outlook for fiscal revenue, the FY05/06 budget targets a significant jump in total expenditure.** Given the considerable development needs in Timor Leste, we support moving toward the sustainable spending level

(estimated at about $130 million annually) as quickly as administrative and absorptive capacity in the economy would allow without aggravating either nonpriority spending or inflationary pressures. Part of the proposed increase in FY05/06 reflects budget support under the donor Consolidated Support Program, which allows for the gradual shift on budget of programs currently executed by donors off budget. Nonetheless, the overall proposed spending increase of about $35 million (about 9 percentage points of non-oil GDP) in the next year still appears ambitious, barring a sharp improvement in spending capacity. Increases in this range also raise the risk of less well prioritized spending and of triggering inflationary pressures, given still limited absorptive capacity in the domestic economy. At the same time, although the current expectation is for high oil prices to persist over the medium-term, there remain significant downside risks to these projections, given considerable oil price volatility. Therefore a more gradual but steady movement toward reaching the sustainable spending level would be advisable.

10. **While the overall public sector spending envelope implied under the medium-term SIPs proposals is broadly unchanged compared to past years (as a share of GDP), the government is expected to undertake an increasingly larger share compared to donors.** Sizeable gaps nonetheless emerge between current donor commitments and the additional donor financing needed to meet the SIPs development objectives. At the same time, these proposals do not yet fully incorporate the need for related recurrent expenditure. To the extent that further recurrent expenditure is needed, an even greater effort would be required to overcome limited absorptive capacity.

11. **In that light, we welcome the recent measures to improve administrative capacity and remove obstacles to smooth budget execution as a first step toward resolving current expenditure execution difficulties.** These include improving monitoring of spending through an itemized program budget (initially in health and education), commencing the budget process early, and placing advisors in line ministries to assist with budget preparations. However, to fully resolve the spending execution difficulties, additional measures to further build administrative capacity at line ministries and the Finance Ministry and to ensure streamlined treasury and procurement procedures are needed.

12. **We also welcome the progress in strengthening the links between Timor-Leste's development needs (outlined in the SIPs) and the budget process, and urge a further reorientation of expenditure toward human capital, infrastructure, and other development spending needed to raise growth.** The integration of the SIPs into the budget process, together with the increased donor-government coordination through the SIPs working groups, is likely to improve the government's ability to plan and focus spending on feasible and needed investment projects, and better align donor activity with the government's priorities. At this early stage of development in Timor-Leste, the economic returns on public investment are particularly high. We would also recommend maintaining the existing restraint on wages and adherence to current staff ceilings as higher public wages could feed back to the private sector, with a negative impact on external competitiveness.

13. **The preparations for the introduction of a best-practice petroleum fund which will assist in the distribution of the benefits of Timor-Leste's wealth across generations are nearing completion.** We welcome the government's intention to have the needed legislative framework in place for the fund to start with the new fiscal year. The government is encouraged to endow the fund with the accumulated oil savings in excess of those required to maintain sufficient precautionary cash balances for treasury operations, thereby starting the fund off in a manner most fully consistent with its basic principles. We also look forward to the establishment of the investment advisory board, the petroleum fund consultative council, and a framework for regular public reporting in time to support the launch of the petroleum fund.

14. **While fiscal policy thus far has been focused on strengthening oil/gas revenue management, consolidation of the progress made in other areas is needed, including in non-oil revenue and power sector finances.** Notwithstanding the large oil/gas revenue inflows, it will be important to have in place a well-functioning tax administration to provide a stable non-oil revenue base. Further action is needed, therefore, to continue strengthening tax administration and broaden the non-oil tax base. The power authority has also made progress in moving to financial independence, with revenue collection markedly improved in the second half of 2004, although still below target. Given the need to extend the electricity power structure throughout Timor-Leste as a requisite to more rapid non-oil sector growth, continued reforms are strongly encouraged.

15. **Further improvement in financial intermediation remains critical for future economic growth**. The BPA has made good progress in developing a strong supervision and regulatory environment and in moving forward with the legislative agenda to help establish the necessary legal structure for banking and private activity. It will be important to complete this agenda quickly, including approval of the central bank, payment system and anti-money laundering legislation. We welcome the recent increase in financial intermediation, and are encouraged that the banking system's portfolios appear to be generally sound, with the amount of nonperforming loans remaining modest, while noting the continuing need to remain vigilant.

16. **To achieve the high growth rate and employment targeted under the National Development Plan, accelerated efforts are needed to establish an environment to attract private investment and stimulate non-oil private activity.** The public sector must carry the initial burden of investment, including through improved infrastructure and programs in basic and vocational education to build up still scarce human capital. Still, global experience shows that sustained growth comes from private investment and that job creation comes mainly from small and medium-size private enterprises, rather than from public or oil/gas sectors. Therefore, rapid enactment of pending economic legislation and issuance of streamlined implementing regulations that are equitable and simple to administer—including to ease the hiring of skilled foreign workers until a domestic human capital base can be established—would send a powerful signal to the private sector that Timor Leste is "open for business" and set the basis for the needed strong non-oil sector growth. In addition, we would stress the

importance of ensuring that tax incentives under the investment laws are well targeted to avoid unwarranted revenue loss.

17. **Developing strong institutions and local capacity remains critical for effective economic management and Timor-Leste's economic development.** We are therefore encouraged by the authorities' planning and capacity building program now under development. The Fund will continue to remain engaged to assist in establishing institutions and capacity through surveillance missions, technical assistance and training activities. **While the quality of macroeconomic data has improved, continuing gaps in data create difficulties for policy decision-making.** The authorities are urged to take early steps to build domestic capacity to compile the national accounts and the balance of payments.

III. CONCLUDING REMARKS

18. Over the past few years the government of Timor Leste has achieved much in establishing the necessary conditions for economic growth and stability, in partnership with the international community. Since 1999 when the IMF first provided assistance to Timor Leste in establishing new fiscal and monetary institutions, we have remained closely engaged through a continuous policy dialogue and through technical assistance in fiscal reforms—including in the oil sector, monetary and banking reforms, and economic statistics. In all of these efforts, we have also worked closely with our partners in the international community. However, the authorities continue to face difficult challenges ahead and the pace and quality of economic development will depend on the ability to manage Timor-Leste's new oil/gas wealth effectively and to establish the environment needed for private investment and growth in the non-oil sector. In that context, the IMF looks forward to continuing to support Timor Leste's efforts through the provision of technical assistance, training, and policy advice.

Table 1. Timor-Leste: Medium-Term Outlook, 2004-2009

	2004	2005	2006	2007	2008	2009
	Est.			Proj.		
Output and prices						
GNP at current prices (in millions of US dollars)	482	549	544	580	618	794
Non-oil GDP	339	347	368	389	412	437
Oil/gas income	143	202	176	190	206	358
Real non-oil GDP growth (percentage change)	1.8	2.6	5.0	4.1	4.1	4.0
Inflation (percentage change at end-period) 1/	1.8	2.5	2.5	2.5	2.5	2.5
			(In percent of non-oil GDP)			
Investment-saving balance						
Gross investment 2/	28	31	32	30	28	26
Gross national savings	7	28	23	26	31	66
External savings	21	2	9	4	-3	-40
Central government budget 3/						
Revenues	89.8	56.9	62.6	58.4	61.7	117.7
Domestic revenues	9.7	9.2	9.0	8.9	8.8	8.9
Oil/gas revenues	71.1	44.8	50.9	46.9	52.8	108.8
Grants	9.0	2.9	2.8	2.6	0.1	0.0
Expenditure	21.7	26.6	25.0	26.0	26.9	28.8
Recurrent expenditure	19.2	20.1	20.2	19.9	20.5	22.2
Capital expenditure	2.6	6.5	4.8	6.1	6.5	6.6
Overall balance	68.0	30.3	37.6	32.3	34.8	89.0
Public debt	0.0	0.0	0.0	0.0	0.0	0.0
Combined sources fiscal operations 4/						
Revenues	77.8	14.5	14.2	13.9	11.2	…
Expenditure	57.5	65.5	68.1	64.7	54.3	…
Overall balance	20.3	-50.9	-53.8	-50.8	-43.0	…
Financing	-23.1	29.1	21.8	18.1	19.6	…
Net transfers from oil fund	...	-48.4	13.5	14.7	18.1	…
Committed financing by donors	31.6	16.1	8.3	3.4	1.5	…
Change in cash balances	-54.7	61.4	0.0	0.0	0.0	…
Financing gap	-2.8	-21.8	-32.0	-32.7	-23.5	…
Money and credit						
Broad money (end-period) 5/	25	26	…	…	…	…
Net domestic assets (end-period)	-30	-52	…	…	…	…
			(In millions of U.S. dollars)			
External sector						
Current account excl. international assistance	-71	-7	-33	-14	13	174
Current account incl. international assistance	120	154	95	90	96	237
Trade balance	-189	-190	-191	-189	-180	-172
Merchandise exports 6/	8	10	10	12	12	14
Merchandise imports 7/	-197	-199	-202	-201	-193	-186
Overall balance	122	205	125	136	139	275
			(In percent of non-oil GDP)			
Current account excl. international assistance	-21	-2	-9	-4	3	40
Current account incl. international assistance	35	44	26	23	23	54
Overall balance	36	59	34	35	34	63

Sources: Data provided by the Timor Leste authorities; and Fund staff estimates and projections.

1/ U.S. dollar-based CPI for Dili.

2/ Excludes investment relating to the oil/gas sector.

3/ Consolidated Fund for East Timor (CFET), on the basis of fiscal year (July-June); for example, 2004 relates to FY2004/05.

4/ On a fiscal year basis. It includes fiscal and quasi-fiscal expenditure programs undertaken by bilateral donors and international financial institutions outside the central government budget. Projections based on SIPs requirements.

5/ Excludes currency holdings by the public, on which no data are available.

6/ Excludes oil/gas revenues, which are recorded under the income account (royalties) and transfers (tax revenues).

7/ In 2005, it includes the transfer of assets from UNMISET estimated at US$ 12 million.