

Consolidation of recent efforts to maintain fiscal discipline mainly through strict expenditure controls were an underlying factor as were interest savings due to lower domestic interest rates in the budgetary outcome of a surplus equivalent to about 2 percent of GDP, compared to the budgeted deficit of 1 percent of GDP. Windfall tax revenues from higher than budgeted oil and gold prices also contributed to this favorable outcome. Government also continued to make progress in reducing domestic payments arrears from earlier periods and restructure its domestic debt obligations from shorter to longer term maturities. In line with these developments public sector debt continued to decline from 55 percent of GDP in 2004 to about 50 percent of GDP in 2005, while the ratio of public external debt declined from 32 percent of GDP to 27 percent of GDP over the same period.

Despite a continued resurgence in imports in 2005 the trade balance remained in surplus, fueled by high global commodity prices. The pick-up in imports reflected growing domestic demand and underlying improvements in consumer confidence. The current account remained in surplus, equivalent to an estimated 4.2 percent of GDP. For 2006 a similar outcome is presently expected. The currency remained stable during 2005, appreciating by about 1 percent against the U.S. dollar.

The downward trend in inflation experienced since 2003, when it averaged 14 percent, continued in 2005 with inflation estimated at 1 percent over the year. Continued monetary easing in 2005 resulted in further declines in Treasury bill yields from about 5 percent to less than 4 percent over the year. Commercial bank interest rates mirrored these developments with the average lending rate approaching 10 percent by year-end. The strong fiscal stance together with these monetary policy developments set the stage for an expansion of about 20 percent in private sector credit, the first increase since 2001. External reserves increased slightly over the year to about US\$800 million, equivalent to nearly six months of non-mineral imports.

*Political Developments.* Political stability has been maintained and the coalition government now stands to be the first since independence to complete its term in office. The Enhanced Cooperation Program with Australia—which was designed to provide direct personnel support to Papua New Guinea to stem the long term deterioration in law and order and to strengthen economic management—has been streamlined and reinstated, following an earlier Supreme Court ruling which had disrupted it.

### **Solomon Islands**

With the restoration of law and order and stabilization of social conditions (largely attributable to the continued presence of the Regional Assistance Mission to Solomon Islands - RAMSI - since 2003), macroeconomic stability has been maintained and small improvements in service delivery have been made. Work on structural

reforms has also started, but implementation prospects are difficult to predict in view of the political calendar. Parliament was dissolved in December 2005 and preparations are underway for national elections in April 2006. Pressure for federalization persists, especially leading up to the elections. Concerns remain regarding the viability of a federal system given the fragility of central government finances and limited capacity of provincial governments.

Economic growth slowed from 5.5 percent in 2004 to 4.4 percent in 2005, and is forecast to remain slightly below 5 percent in 2006, reflecting the anticipated slowdown in logging. The reopening of the palm oil plantations and the rehabilitation of the gold mine in early-2005 should support non-logging growth. Inflation in 2005 persisted at around 7 percent, largely due to higher oil prices.

After enjoying a large surplus of about 8 percent of GDP in 2004, the Government budget was closer to balance, recording a deficit of 0.5 percent of GDP in 2005. A wider deficit of about 4 percent of GDP is projected for 2006, reflecting rising recurrent costs, declining donor funds for budget support and lower tax receipts from logging.

Public debt has declined since 2003 but the debt situation remains fragile. Central government debt (including arrears) fell from 122 percent of GDP in 2003 to about 89 percent in 2005, and its external debt also declined from 71 to 62 percent of GDP in the same period. In mid-October 2005, the Government met with its major creditors (the Honiara Club) to renegotiate the terms of its external debt. Some bilateral and commercial creditors who attended the meeting agreed to help lower the Government's debt burden while Government agreed to observe good budget practices and advance in implementing economic reforms.

The external position weakened in 2005 as the current account recorded a deficit of 11 percent of GDP, largely reflecting higher oil prices and non-oil imports, the latter boosted by investment projects. The deficit is anticipated to widen to 14 percent in 2006. Gross reserves amounted to US\$78.5 million at end-2005, nearly 5 months of projected import cover. Despite the prospective current account deficit, nominal reserves are expected to remain relatively stable, aided by an increase in FDI linked to the two major projects underway.

A number of important reforms are high on the policy agenda. The proposed Foreign Investment Bill, a step towards regulatory reform aimed at promoting and facilitating private investment, was endorsed by Parliament in December 2005. A tax reform is currently being considered, and the introduction of a Value-Added Tax is envisaged.

### **Timor Leste**

Timor-Leste has made solid progress in nation-building, maintaining peace and unity, converting its

petroleum wealth into a sustainable source of revenue for future generations, and restoring public services. The country now faces the challenges of building on this progress in the context of very limited human resources, embryonic institutions, slow growth of the non-petroleum economy, and high levels of poverty and unemployment.

Subsequent to the ratification of the Timor Sea Treaty in March 2003, development of the Bayu-Undan oil and gas field has proceeded and liquids production began in April 2004. In January 2006, the Governments of Timor-Leste and Australia reached an agreement to evenly share revenues emanating from the Greater Sunrise oil and gas field for 50 years, thus postponing a decision on the delimitation of the maritime boundary between the two countries. A Petroleum Act, a Petroleum Taxation Law, and a Petroleum Fund Law were promulgated in early FY06. Separately, in February 2006, the Government of Timor-Leste launched bidding for the licensing of near-shore oil exploration.

Having embraced the principle of transparent management of petroleum revenues well before the launch of the Extractive Industries Transparency Initiative, Timor-Leste is a pilot country for EITI. The Petroleum Fund Law establishes a savings policy aimed at preserving the real value of petroleum wealth by spreading expenditures over an infinite horizon, safeguarding a sustainable budget in perpetuity. In September 2005, the Government established a Petroleum fund to collect all revenues from petroleum. Annual withdrawals of the sustainable income have to be approved by Parliament and are integrated into regular budget processes. An Investment Advisory Board was created in late 2005, and two quarterly reports have been released on time. In the context of historically high oil prices and the acceleration of offshore production, Timor-Leste's petroleum revenues have risen from \$41 million in FY04 to about \$266 million in FY05, more than three times the \$74 million spent in the FY05 budget and more than twice the revised FY06 budget of \$130 million. Petroleum revenues are projected to jump sharply in the medium term. As a result, already large budget surpluses are projected to increase in parallel, reflecting not only the prudent savings policy but also constrained budget execution capacity. By

end-December 2005, the Petroleum Fund had accumulated deposits amounting to \$370 million.

While petroleum GDP is thus growing rapidly, developments in the non-petroleum sector have been much weaker. After declining by about 6 percent per year during 2002-03, non-petroleum GDP is estimated to have grown modestly during 2004-05. But with population growing at around 3.9 percent, non-petroleum GDP per capita likely declined even in the recent period, and is estimated at US\$366 in 2004. Non-petroleum exports, essentially consisting of coffee, are estimated at \$8 million in 2005. However, including revenue and royalties from oil and gas, as well as international aid, Timor-Leste's current account surplus is estimated at about \$275 million in 2005 and is projected to rise sharply in the medium term in line with estimates of higher petroleum revenue. Inflation fell to about 1 percent in 2005, aided by the use of the U.S. dollar as the national currency. The overall wage level remains relatively high in comparison with neighboring countries, undermining competitiveness and limiting job creation for unskilled labor. Unemployment in the capital, Dili, where about a quarter of the formal labor force resides, is estimated at about 27 percent, and youth unemployment is a particular problem. Unemployment rates in the rest of the country are much lower, with the national rate estimated at 8.5 percent, reflecting the prevalence of self-employed and subsistence workers and a relatively small formal labor force.

Promotion of trade and investment has begun with the establishment in July 2005 of the *Instituto de Apoio do Desenvolvimento Empresarial*, the domestic investment promotion agency, and TradeInvest Timor-Leste, the foreign investment and export promotion agency, which has received several proposals to date. Financial sector activity continues to expand, with bank deposits increasing to 28 percent of non-petroleum GDP at end-December 2005 and bank loans reaching 25 percent of non-oil GDP.