Timor-Leste's Economic Prospects and Challenges[1]
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Timor-Leste is one of the world's newest, smallest and least developed countries and a post-conflict state that faces many challenges. The island nation is located far from other countries (except Indonesia and Australia) and has a population of just 1.1 million. Estimated per capita income, including oil and gas income, was $2,300 in 2008. After being abandoned by its former colonial master, Portugal in 1975, Timor-Leste declared its independence but was soon invaded and occupied by Indonesia. Following years of repression and rising discontent, a UN-supervised referendum in 1999 recorded a vote for independence but was followed by bloody fighting, in which some 1,400 people were killed and 300,000 refugees fled to Indonesian West Timor. The violence wrecked the capital, Dili, and destroyed many homes, schools, water supply and irrigation systems as well as nearly all the power grid. One estimate is that 70% of the infrastructure was demolished. Even after internationally recognized independence was achieved in 2002, serious episodes of violence occurred, most recently the attempted assassination of the president and prime minister in February 2008. The risk of political instability remains, although mercifully an international peacekeeping force and rural reconstruction effort have helped to make the past year a period of relative calm.

Despite its many problems, Timor-Leste possesses a major development asset and opportunity in the significant oil and natural gas deposits that have been found to lie beneath its territorial waters. Revenue from exploitation of the offshore Bayu Undan field flows into the Petroleum Fund, which is managed by the Banking and Payments Authority, a precursor to a future central bank. At the end of June 2009, the Fund's assets were valued at more than $4.9 billion, up 50% from a year earlier. The growing fund provides an important buffer against future shocks. Oil revenue will expand further after the Greater Sunrise field starts producing in 2013.

The major challenge for economic development in Timor-Leste is to find ways to use the relatively abundant revenue that flows from oil and gas extraction to raise the living standards of its citizens and develop a sustainable non-oil economy. Widespread poverty and inequality have posed threats to political and economic security and complicated post-conflict recovery. Approximately 50% of the population lives below the national poverty line and as much as 70% of the labor force is unemployed or underemployed. Between 2002 and 2006 real non-oil GDP contracted and the majority of the population continued to rely on subsistence agriculture for their livings. The industrial and service sectors are small and underdeveloped. Demographic factors – a high population growth rate, a large youth bulge in the age structure of the population and rising population density in rural areas – pose additional threats. Forty-three percent of Timor-Leste's youth are estimated to be unemployed. Infrastructure systems and social services are among the world's worst.

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Economic growth has been achieved since 2007, led by government expenditure of oil funds and foreign aid spending. Its isolation from the world economy has sheltered Timor-Leste from the effects of the global economic crisis. Aside from coffee, which accounts for 90% of non-oil exports, Timor-Leste sells hardly anything to the world market. External linkages through non-energy trade, non-energy investment and financial markets are all small. Non-oil GDP (excluding locally paid compensation to United Nations peacekeeping and administrative staff) rose by 12.8% in 2008, according to IMF estimates. Growth continued in 2009, at an expected annual rate of 7-8%, thanks in part to a good year for agriculture as rice and maize production increased. Other than some growth in the services and tourism sectors, the private sector remains stagnant, constrained by low skills, productivity and competitiveness. Private investment is low and bank lending to the private sector is flat.

Economic growth in Timor-Leste is almost exclusively driven by government expenditure. Offshore oil and gas production creates very few jobs and the oil and gas flow to Australia, not to Timor-Leste. It is only through government expenditure that the great majority of citizens can gain any benefit from oil and gas development.

The government has pursued expansionary fiscal policy over the past three years in an effort to meet Timor-Leste's pressing needs and promote peace and stability. Government expenditures jumped from 32% of non-oil GDP in 2006 to 106% in 2008. Despite some recent increases, non-oil revenue collections are only 11% of non-oil GDP. Given rapidly rising expenditures and slow-growing or stagnant non-oil revenues, the near-term trend may be toward growing fiscal deficits that will have to be financed by withdrawals from the Petroleum Fund. Although this trend does not pose immediate problems, the IMF worries that it could reduce the government's fiscal flexibility in the future.

The 2010 budget projects lower spending than in 2009 because of reduced expenditure to resettle displaced persons as well as smaller outlays for rice subsidies. In 2010 planned government consumption will fall as public sector wages are frozen and spending on goods and services is cut by 30%. Meanwhile, public investment is expected to rise, especially through expenditure on a large electricity project. Despite the lower level of planned expenditure, however, the government expects to draw more than $400 million from the Petroleum Fund. This exceeds the "estimated sustainable income" that the government estimates it can withdraw annually without depleting the fund. The government argues that the extra drawing is needed to develop the national infrastructure and improve internal security. However, in late 2008 the Court of Appeal blocked excess withdrawals in the mid-2008 budget on the basis that the government had failed to demonstrate the need for them as required by law. In 2010, if the political opposition challenges the constitutionality of the expenditure plans the government may be required to cut back. Government finances are thus in a somewhat precarious state, owing primarily to the absence of significant domestic revenues.

The government's capacity to plan and manage economic development is weak. Allocated amounts for public investment expenditure have often been underspent in the past because of low absorptive capacity. Improving the prioritization and efficiency of public sector spending is a major challenge. Currently, the government is implementing tax policy and administrative reforms introduced in 2008. The World Bank considers targeted investments in critical infrastructure and structural reforms such as liberalization of telecommunications to be fundamental for promoting competitiveness and private investment.

Parliament recently approved an updated law on Budget and Financial Management. This includes a provision that would allow the government to borrow. Timor-Leste has never borrowed and has no domestic or external debt, relying entirely on withdrawals from the Petroleum Fund to cover its budget deficits. The World Bank believes that borrowing on concessional terms could make sense, provided that the cost is lower than the foregone income from the Petroleum Fund and the quality of the proposed investments is high. The government has signed a Memorandum of Understanding with Portugal for a line of credit of €100 million per year, but it can draw on this line of credit only if Parliament approves.

Monetary policy is constrained by use of the U.S. dollar as the local currency. The IMF argues strongly that this arrangement should continue for the foreseeable future, believing that stronger institutional capacity would be needed before Timor-Leste could issue a national currency.

The rate of private investment is low and the institutional framework for private sector growth is poor. There is hardly any foreign direct investment outside the oil and gas sector. Timor-Leste's ranking on the World Bank's Ease of Doing Business Index for 2010 is a lowly 164^{th} out of 183 countries covered, which at least shows some improvement (reflecting reforms enacted in 2008) over its 2009 ranking of 173^{rd}. Contracts are essentially unenforceable in Timor-Leste, since according to the World Bank it takes 51 procedures and nearly four years to resolve a contract dispute while the cost of resolving the dispute exceeds the value of the claim. The country also falls at or near the bottom of the global rankings with respect to registering property and getting credit. Improving the business environment is an urgent need in the quest to improve competitiveness and stimulate private investment in the non-oil economy.

Inflation climbed to 8.9% in 2007, driven by rising world food prices and reflecting food's 57% weighting in the consumer price index, but turned negative in early 2009. The prospect for the year as a whole is for virtual stability in consumer prices.

The trade deficit is widening as the value of exports falls and the value of imports rises. Although the import bill peaked in the first quarter of the year, imports continued to outweigh exports. Despite the worsening trade deficit, the overall external balance has remained strong. Foreign exchange reserves moved up and down during the year, driven more by financial flows than by trade flows.

Serious issues of poverty, education and public health need to be addressed more vigorously over a number of years. Rates of fertility and maternal mortality are among the highest in the world and infant and under-five death rates are also high. Malaria, tuberculosis and dengue fever are endemic diseases in Timor-Leste.

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