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Democratic Republic of Timor Leste: 2003 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion for the Democratic Republic of Timor Leste

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with the Democratic Republic of Timor Leste, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **April 15, 2003,** with the officials of the Democratic Republic of Timor Leste on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 27, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 14, 2003 discussion** of the staff report that concluded the Article IV consultation.

The document(s) listed below have been or will be separately released.

Selected Issues Paper and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the
2003 Consultation with Timor-Leste

(In consultation with other Departments)

Approved by Daniel Citrin and Liam P. Ebrill

June 27, 2003

- A staff team visited Dili during April 2–15 to hold the first Article IV consultation discussions with Timor-Leste, which joined the Fund on July 23, 2002. The discussions were held with President Gusmao, Prime Minister Alkatiri, Finance Minister Boavida, other senior officials, representatives of key donors and the business community, and the resident missions of the World Bank and the Asian Development Bank.

- The staff team comprised Messrs. Kim (head), Baqir, and Vardy (EP) (all APD) and Mr. Ogata (FAD), and was assisted by Mr. Al-Eyd (Senior Resident Representative). Mr. Santos (OED) attended some of the meetings.

- The compilation of macroeconomic data in Timor-Leste has been severely hampered by the departure of Indonesian statistical officers following the turmoil of 1999 and by slow progress in institution and capacity building. Surveillance is particularly constrained by data problems in the areas of national accounts and the balance of payments.

- With the Timor-Leste economy dollarized, macroeconomic policy discussions focused on public finances, especially the budget for FY2003/04 (fiscal year: July-June) and a medium-term fiscal strategy to ensure the productive use of growing oil/gas revenues. Discussions of structural issues centered on private sector development and capacity building to lay a basis for higher growth and poverty reduction.

- The authorities notified the Fund that Timor-Leste would accept the obligations of Article VIII, Sections 2, 3, and 4, with the acceptance taking effect from the date of membership.

- It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

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EXECUTIVE SUMMARY

Economic and policy developments

- **After a strong recovery from the 1999 destruction, economic activity has slowed down since mid-2002.** Real GDP is estimated to decline by 2 percent in 2003, reflecting the winding-down of the international presence and a delayed rainy season. Inflation fell substantially over the last three years despite an upturn in recent months.

- **Fiscal developments for FY2002/03 (fiscal year: July–June) are marked by weaker-than-expected expenditure execution.** This is attributable to a slow recruitment of civil servants and a delay in capital project implementation. Revenue is exceeding projection, aided by higher oil/gas revenues. The overall deficit continues to be financed by cash grants.

- **The U.S. dollar is firmly established as the official currency.** The banking sector is recovering further from the 1999 destruction. However, financial intermediation remains weak, with the bulk of bank deposits invested abroad.

- **Initial steps are taken to foster private sector development and to build institutional and local capacity.** The former centers on establishing a legal and regulatory framework, while the latter focuses on strengthening the government's capacity, particularly for fiscal management.

Policy issues

- **Fiscal policy should play a central role in maintaining macroeconomic stability.** In the near term (before oil/gas revenues increase substantially), the major task of fiscal policy should be to contain expenditure within levels consistent with the availability of donor assistance and budget execution capacity, while meeting pressing development needs. Over the medium term, the authorities need to develop a fiscal strategy to ensure the productive use of growing oil/gas revenues under a stable macroeconomic environment.

- **The use of the U.S. dollar should remain the cornerstone of macroeconomic management.** The regime has provided an effective mechanism to restore the stability of the financial system and moderate inflation. The authorities agreed to avoid a premature introduction of a national currency until appropriate conditions are fully developed.

- **Improvement in growth prospects and alleviation of poverty continue to pose major challenges for the authorities.** To address them, further actions need to be taken to promote the development of a dynamic private sector, including early enactment of key economic legislation. It remains critical that further efforts be made to strengthen the capacity of the fiscal and monetary authorities.

I. Introduction and Background

1. **Timor-Leste gained independence on May 20, 2002, after a 2½-year rule of the United Nations Transitional Administration in East Timor (UNTAET).**[1] The establishment of the transitional administration followed the widespread violence and destruction that erupted in reaction to a national referendum (August 1999), which overwhelmingly supported then East Timor's independence from Indonesia. Notwithstanding some early political challenges,[2] the new government has endeavored to consolidate its administrative reach in the context of a reduced international presence,[3] while taking initial steps toward nation-building as set out in the National Development Plan (NDP) (¶7). Timor-Leste joined the Fund and the World Bank Group on July 23, 2002.

2. **With poor infrastructure, limited administrative capacity, and nascent institutions, Timor-Leste is one of the most underdeveloped economies in the region.** Per capita income is estimated at about $470 in 2001, and underemployment is widespread. Key social indicators, including life expectancy, and health and education indices, are also low (Table 1). The economy is marked by subsistence agriculture (accounting for one-fourth of GDP and three-fourths of employment) and a limited foreign exchange earning capacity. Over the medium term, however, Timor-Leste is expected to benefit significantly from the commercial exploitation of oil/gas resources in the Timor Sea, which is projected to increase government revenues sharply (Box 1).

3. **The economy is still in the process of reconstruction from the turmoil of 1999**. During the turmoil, two-thirds of the physical infrastructure is estimated to have been

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[1]Upon independence, Timor-Leste adopted a parliamentary system of government, under which the prime minister possesses strong executive power. Parliament consists of 88 seats, of which 55 are currently held by the Revolutionary Front of Independent East Timor (Fretilin) led by the prime minister. Together with coalition partners, the ruling partly holds an overwhelming majority.

[2]Such challenges included demands by veterans of the resistance movement for welfare assistance and employment, and the civil unrest in Dili last December (triggered by firing by security forces on student demonstrations). In response to these events, the government announced an action program (the "stability" program) in early 2003, calling for the strengthening of governance (especially improvement in the justice system and the capacity of the police and security forces), the adoption of measures to create job opportunities (especially for youth and veterans), and the enhancement of government service delivery.

[3]The UN continues to assist Timor-Leste through a scaled-back presence under a successor mission—the UN Mission in Support of East Timor (UNMISET). The UNMISET's assistance comprises both military and civilian components (the latter includes the provision of experts for 100 key public administration posts).

BOX 1. OIL AND GAS RESOURCES

- **Timor-Leste is expected to benefit considerably from the commercial exploitation of rich oil/gas resources in the Timor Gap (an area of disputed sovereignty)**. Major oil/gas fields discovered thus far include the Elang-Kakatua-Kakatua-North (EKKN), Bayu-Undan, and Greater Sunrise fields. At present, the EKKN field is the only field developed; production commenced in mid-1998, generating relatively modest oil/gas revenues which consist of royalties and tax revenues. Over the medium term, a major increase in oil/gas production is projected for the Bayu-Undan and Greater Sunrise fields. The former is estimated to contain 370 million barrels of liquids (condensate and LPG) and 2.7 trillion cubic feet of gas, and the latter to contain 7.6 trillion cubic feet of gas.

- **To govern the commercial exploitation of oil/gas resources in the Timor Gap, the Timor Sea Treaty was signed between Timor-Leste and Australia on May 20, 2002**. The Treaty, which came into effect on April 2, 2003, has replaced the Zone of Cooperation (ZOC) Treaty concluded between Australia and Indonesia in 1989. The Timor Sea Treaty preserves the main principles set out under the ZOC Treaty, including the partition of the Timor Gap into three areas: A (the Joint Petroleum Development Area, JPDA), B (area under Australian jurisdiction), and C (area under Timor-Leste jurisdiction). Under the new Treaty, however, Timor-Leste's revenue share in the JPDA has been increased to 90 percent from 50 percent set under the ZOC Treaty.[1] The Bayu-Undan field is located entirely in the JPDA, while the Greater Sunrise field straddles the JPDA (about 20 percent of the field lie within the JPDA, subject to the resolution of seabed boundaries between Timor-Leste and Australia).

- **Negotiations with oil companies (operators) for the commercial exploitation of the Bayu-Undan field have recently been completed**. Agreement was reached on May 16, 2003 with oil companies on a production sharing contract and development plan for the field. The development of the field is estimated to provide Timor-Leste with oil/gas revenues totaling $3 billion over a 20-year horizon beginning 2004 (export prices are assumed to remain equivalent to a crude oil price of about $19 per barrel at 2002 prices, on average). For the Greater Sunrise field, Timor-Leste and Australia reached agreement on revenue sharing arrangements (the International Unitization Agreement) on March 6, 2003.[2] However, the development of the field is still uncertain, partly due to disagreement among oil companies over development plans for oil/gas resources.

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[1]Under the ZOC Treaty, oil/gas revenues were shared between Australia and Indonesia with a 50/50, 90/10, and 10/90 split, respectively, corresponding to the three areas where production takes place.

[2]Under the agreement, subject to ratification by the parliaments of the two countries, oil/gas revenues from the Greater Sunrise field will be shared by Timor-Leste and Australia according to a 18/82 split.

destroyed, and key economic institutions collapsed as a result of the departure of civil servants and experts, leading to a sharp fall in output (by more than 30 percent; Table 2). Under the UNTAET, the reconstruction process began with significant financial support from the international community. With substantial technical assistance from the Fund (Annex I), the fiscal and monetary systems were reestablished and initial steps were taken to develop a statistics office. However, these institutions are still in their infancy, relying heavily on international experts, and their further development, including the building-up of local capacity, remains a major challenge for the authorities.

4. **Fiscal and quasi-fiscal operations in Timor-Leste are undertaken by the central government, three autonomous agencies (the power, airport, and port authorities), multilateral institutions, and bilateral donors**. Central government fiscal operations—the Consolidated Fund for East Timor (CFET)—are marked by large deficits, reflecting pressing needs for reconstruction expenditures in the face of limited revenues (Table 3). The deficits have been financed mostly through cash grants from donors, due to the lack of access to domestic borrowing (see ¶6) and the authorities' intention to avoid external borrowing, including concessional loans.[4] Substantial budgetary support by donors is expected to continue at least through FY2004/05 (the last "lean year" before oil/gas revenues begin to increase substantially).[5] Budgetary operations have also been characterized by an ad-hoc saving policy for oil/gas revenues, under which all royalties are automatically saved and only tax revenues are available for financing of budgetary expenditures.[6]

5. **A principal part of fiscal and quasi-fiscal activities undertaken outside the CFET budget has also been funded by external financial support (also grants)**. Such external financial support includes the Trust Fund for East Timor (TFET, comanaged by the World Bank and the Asian Development Bank; Annexes II and III), bilateral donor assistance, and UN-related financial contributions, and has provided the principal vehicle for reconstruction activities. With the reconstruction phase winding down, the focus of the assistance has been increasingly geared toward supporting the government in the implementation of the NDP (¶7). Total outlays under "combined fiscal operations" encompassing the central government, the autonomous agencies, multilateral institutions, and bilateral donors have been substantial

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[4]In Timor-Leste's budgetary presentation, grants are shown "below the line" to highlight the amount of donor assistance required to close financing gaps.

[5]At the meeting held in Dili in May 2002, donors committed budgetary support totaling $81 million for the three "lean years" through FY2004/05, covering 90 percent of the financing gap projected for the period. In addition, they pledged nonbudgetary grant assistance totaling $280 million (about 75 percent of estimated GDP for 2002) for the same period.

[6]This policy was adopted under the UNTAET to foster saving discipline for oil/gas revenues and make adequate fiscal resources available when then East Timor became independent. The NDP envisions that the policy will be maintained until FY2004/05 and thereafter replaced by a "flexible" saving policy, under which all oil/gas revenues, including those saved in the past, will be in principle available to finance budgetary expenditures.

(Table 4).[7] As revenues are limited only to those raised by the central government and the autonomous agencies, the resulting large deficits have been financed through external grants.

6. **Exchange rate and monetary policies are constrained by the dollarization of the financial system, with the U.S. dollar adopted as the official currency in January 2000.** Under current regulations, the monetary authority—the Banking and Payments Authority (BPA)—is not empowered to extend credits either to the government or to commercial banks. The banking sector (comprising the BPA, three foreign-owned commercial banks, and a microfinance institution) is at an early stage of development: interbank transactions are virtually nonexistent and financial intermediation is limited by the lack of viable domestic lending opportunities and an underdeveloped legal framework. However, adequate prudential regulations and bank supervision have been developed through MFD technical assistance.

7. **The NDP covering FY2002/03–2006/07, prepared on the basis of a nationwide consultation process, lays out Timor-Leste's wide-ranging development objectives.** Among them, the attainment of higher growth (about 5 percent per year over the medium term) and the alleviation of poverty constitute principal objectives. The NDP recognizes that the development of a dynamic private sector and the building-up of institutions and local capacity, together with the maintenance of a stable macroeconomic environment, are critical for the realization of the growth target. To flesh out the NDP in operational terms and incorporate actions set out under the "stability" program (especially good governance and job creation; see ¶1, footnote 2), a medium-term action plan covering four years through FY2006/07 (the Road Map) was worked out in early 2003. The Road Map provides a comprehensive list of priority programs to be implemented by each ministry, together with their appropriate sequencing.[8]

II. Recent Economic Developments

8. **Economic activity exhibited a strong recovery from the post-referendum destruction, but has slowed down considerably since mid-2002.** Following the sharp fall

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[7]In FY2002/03, for example, total expenditure under "combined fiscal operations" is estimated at about $330 million, about five times larger than CFET expenditures. However, expenditures under "combined fiscal operations" are charaterized by a large external leakage, as a substantial part of non-CFET expenditures falls on goods and services (including technical assistance) which have a high import intensity.

[8]The Road Map describes main development issues facing each ministry, outlines key steps to be taken to address them, and presents an annual action plan over the next four years. It also presents detailed estimates of funding requirements for each ministry to implement the action plan, thus providing key inputs for preparation of annual budgetary allocations. The Road Map is also used as a vehicle to explain the authorities' policy intention to donors and seek their assistance.

in 1999, real GDP is estimated to have reached close to preconflict levels by 2001, aided by the large international presence and a rebound in agricultural production (Figure 1 and Table 2). The former spurred business activity in the services and construction sectors. However, the winding-down of the international presence since independence, coupled with weaker-than-expected public investment, has exerted a dampening effect on the economy. Real GDP growth is estimated to have moderated to 3 percent in 2002.

9. **Inflationary pressures have subsided significantly over the past three years, although there are signs of an upturn in recent months**. CPI inflation fell below 1 percent in October 2002 from 140 percent at end-1999 (on a year-on-year basis), in response to a recovery in the supply of goods in the aftermath of the 1999 destruction, as well as the adoption of the U.S. dollar-based currency system. Since then, inflation has risen to around 7 percent by April 2003 (on a year-on-year basis), owing mainly to a drought-induced scarcity of agricultural goods. Wage pressures (especially in the services and construction sectors) have moderated since mid-2002 after a substantial increase that tracked higher public sector wages set by the transitional government. Nevertheless, Timor-Leste's overall wage level still remains relatively high in comparison with neighboring countries at a similar stage of development,[9] constraining external competitiveness.

10. **External developments have been characterized by large current account deficits, financed by official transfers**. Exports have been depressed due to falling international prices of coffee and a limited production base, while imports have remained high because of donor-financed economic activities (Table 6). Nonetheless, the current account deficit (excluding official transfers) narrowed in 2002 (to $230 million or 61 percent of GDP), as imports declined with the reduced international presence. With the commencement of oil/gas production in 1998, oil/gas receipts—recorded under the income account (for royalties) and transfers (for tax revenues)—increased to $16 million (4 percent of GDP) by 2002.[10] Reflecting the authorities' reluctance to undertake external borrowing, no external debt has been accumulated.

11. **The outturn of the CFET budget thus far in FY2002/03 suggests that the overall deficit for the year will be smaller than budgeted**. Revenue is estimated at 12.4 percent of GDP, exceeding the budget estimate by 4 percent due primarily to higher-than-expected oil/gas revenues. Expenditure is estimated at 19.8 percent of GDP, falling short of the budget estimate by about 5 percent (on a commitment basis), due to slow recruitment of civil servants and delays in capital projects. Despite the shortfall, expenditure execution, which was extremely sluggish during the first half of FY2002/03, has improved significantly since

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[9] Anecdotal information suggests that wages in the service and construction sectors in Timor-Leste are, on average, about one-third to one-half higher than those in Indonesia.

[10] This accounting treatment reflects the nonavailability of detailed information on production, exports, and investment activities in the oil/gas sector.

March in response to remedial measures taken early in 2003 (especially to familiarize line ministries with procurement procedures). The overall deficit estimated at 7.4 percent of GDP is 1.4 percent of GDP below the budget estimate and will be more than financed by donor cash grants (Table 3).

12. **In terms of "combined fiscal operations," the overall deficit is estimated to decline to about 80 percent of GDP in FY2002/03, about 15 percent of GDP lower than in FY2001/02** (Table 4). This primarily reflected a substantial fall in expenditures (by 12 percent of GDP), owing mainly to the winding-down of UN operations. Among the autonomous agencies, the power authority's financial position remains weak due to the dismal collection of user fees (less than half the budget target), reflecting poor management and an ineffective billing system, and its overall deficit is estimated to exceed the budget estimate substantially.

13. **Recovery of the banking sector from the 1999 disruption continues, although financial intermediation remains limited**. The third commercial bank has recently been licensed for operation, the microfinance institution is expanding its operations, and initial steps have been taken to develop a regulatory framework for insurance companies. Despite a substantial increase in deposits, domestic bank lending remains limited; as of end-March 2003, total loans (mostly housing loans) stood equivalent to roughly 10 percent of bank deposits (Table 5). With the bulk of deposits invested in short-term foreign assets and nonperforming loans remaining modest, risks in the banking system are very low.

14. **After initial delays, steps have been taken to foster private sector development and to strengthen institutional and local capacity**. Measures for private sector development have centered on establishing a legal and regulatory framework. This includes parliamentary approval of a basic law for land ownership and the establishment of a ministerial committee to prepare key economic legislation (including the investment, company, bankruptcy, and insurance laws) for submission to the Council of Ministers by mid-2003. With regard to institution and capacity building, actions have been taken under the World Bank's Transition Support Program (TSP) to foster the government's capacity, especially for poverty reduction planning, public expenditure management, governance, and power sector management. Also, Fund technical assistance has been provided to strengthen fiscal and monetary institutions, including the development of a medium-term capacity building program for the Ministry of Planning and Finance (jointly with the World Bank), advice on the establishment of a petroleum fund (¶22), and assistance for the BPA in the development of a legal framework for insurance supervision and in the introduction of domestic coins (small denomination) to supplement the use of U.S. dollar coins.

III. Policy Discussions

The key challenge facing the authorities is to lay the ground for higher growth and poverty reduction, while maintaining macroeconomic stability. For the former, actions need to be taken swiftly to foster private sector development and strengthen institutions and local capacity. For the latter, fiscal policy has to play a key role, given the dollarization of the *economy. The challenge of maintaining macroeconomic stability will become greater over the medium term, when oil/gas revenues provide the government with growing resources to spend.*

A. Economic Outlook

15. **Economic activity remains weak in the near term**. Real GDP is projected to contract by 2 percent in 2003, reflecting the continued effect of a reduced international presence and the adverse impact of a delayed rainy season on agricultural output. Inflation is projected to decline to 4 percent by end-2003 with the return of normal weather conditions. For the medium term, the mission noted the possibility of a gradual acceleration in economic growth, to 5 percent by 2007, accompanied by moderate inflation, of around 3 percent per year (Table 7).

16. **The mission stressed that the realization of the projected growth outlook will depend critically on policy initiatives in many areas, while price stability would be conditional on the pursuit of prudent fiscal policy**. In particular, the projected upturn in output will require the maintenance of adequate public expenditures (especially those for capital projects; ¶19) and their improved execution, so as to ensure the provision of essential infrastructure and economic services. These steps will need to be accompanied by increased efforts to create an economic environment conducive to private sector development (¶25–26) and to build institutions and capacity (¶27–29). The mission also underlined the importance of actions to promote an expansion in agricultural production and reduce its vulnerability to weather conditions, given the sector's significant role in improving living standards and alleviating poverty. The authorities concurred with the mission's view and indicated their plans to develop a policy framework for the sector, which will encompass the strengthening of infrastructure, the promotion of the use of modern inputs (fertilizer and new varieties of seeds), and assistance for the marketing of agricultural products.

B. Fiscal Policy

CFET budget for FY2003/04

17. **The authorities indicated that fiscal policy for the "lean years" will continue to aim at containing expenditure at levels consistent with the availability of fiscal resources (especially donor assistance), while meeting pressing reconstruction and development needs**. Key factors underlying this policy objective are the authorities' intention to avoid external borrowing (including concessional project loans) and the lack of access to domestic borrowing. The budget for FY2003/04 was prepared on the basis of this policy stance, as well as two major changes unanticipated at the time of the midyear budget review (December 2002). These include (i) downward revisions of oil/gas tax revenues (by about $7 million or 2 percent of GDP, due to a change in production schedules and projected operating costs), making the overall funding position tighter despite larger donor support; and (ii) a considerably weaker-than-expected financial position of the power sector,

necessitating a substantial increase in appropriations (by $4 million or 1.2 percent of GDP; ¶20).

18. **Against this background, the budget for FY2003/04, which was developed in close consultation with the mission, is marked by expenditure adjustments and steps to alleviate potential weaknesses in domestic revenues**. Expenditure exclusive of allocations for the power sector is reduced by $5 million (1.5 percent of GDP) for FY2003/04, in comparison with the midyear budget review estimates. The adjustment is borne mainly by nonwage expenditures (both appropriations for goods and services and capital expenditures), as the wage bill is set to increase further to meet the planned recruitment of civil servants.[11] Within total nonwage expenditure, care is taken to safeguard expenditures for social services (especially education and health). On the revenue side, the budget incorporates measures to increase nontax revenues (through higher charges for passport issues and fees for domestic mineral resource extraction) and strengthen tax administration (especially through more stringent audit and enforcement), so as to compensate for a projected fall in indirect taxes. The mission noted that a further improvement in capacity building at the Timor-Leste Revenue Service will be essential for the attainment of the revenue estimate.

19. **The authorities envisage that total expenditure in terms of "combined fiscal operations" will continue to decline in FY2003/04, exerting a dampening effect on the economy**. While this mainly reflects a further scale-down in UN operations, the authorities are concerned about a leveling-off of capital projects funded by TFET and bilateral donors combined, given pressing development needs. Consequently, the authorities are making a renewed call for additional external assistance to fund capital projects and key programs envisaged under the Road Map over the coming years.[12] The mission noted that, if sufficient donor assistance does not materialize, the CFET budget will have to absorb increased capital expenditures in the years to come, given the importance of strengthening social and physical infrastructure. However, the increase in CFET capital expenditures will be subject to further improvements in the government's capacity to manage capital projects, as well as the need to contain overall fiscal expenditures within a sustainable level (¶21).

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[11]The size of the civil service will be kept below the overall ceiling set by the government (17,200). The public sector pay scale is currently under review to better differentiate wages/salaries according to skills, responsibility, and performance, but no major pay increase is budgeted for FY2003/04.

[12]At the donors' meeting (Timor-Leste and Developing Partners Meeting) held in Dili during June 3–5, 2003, the authorities stressed the need for additional donor assistance, including beyond the "lean years." The request is expected to be addressed in depth at the next meeting scheduled for late 2003.

Power sector issues

20. **There was agreement that improvement in the financial position of the power authority remains critical for containing pressures on the budget**. Given the poor collection of electricity charges, total budgetary allocations to the power sector (mostly subsidies) for FY2002/03 are estimated to reach $8.4 million (12 percent of total expenditure), more than double the original budget estimate. The mission welcomed the authorities' decisions in late 2002 to place the power authority under a three-year external management contract (starting mid-2003) and to improve the billing system, including the installment of prepaid meters. Despite a substantial improvement in revenue collections envisaged as a result of these measures, the financial position of the power authority is expected to improve only gradually due to increasing operating costs, reflecting external management fees and higher electricity generation. Given this prospect, the authorities estimate that substantial budgetary support (1.5 percent of GDP per year, on average, almost three times larger than earlier estimated) will be required over the coming three years. The mission noted that, despite the substantial upward revisions, these estimates may still prove to be optimistic, given the needs for appropriations for adequate maintenance and capital investment.

Medium-term fiscal policy and management of oil/gas revenues

21. **A major issue beyond the "lean years" is how best to use prospective oil/gas revenues for the country's economic development**. The mission discussed with the authorities a medium-term fiscal strategy, which addresses a sustainable level of budgetary expenditure consistent with (i) the medium-term macroeconomic objectives (especially growth), and (ii) the maintenance of a sound fiscal position in the long run (once nonrenewable oil/gas resources are depleted). The proposed fiscal strategy, developed on the basis of certain assumptions regarding risks associated with public investment and key macroeconomic parameters, calls for a relatively large portion of oil/gas wealth (about two-thirds) to be saved in financial assets until the country's absorption capacity improves significantly; consequently, a relatively small portion would have to be used to meet investment needs for infrastructure and human capital development (Box 2). The authorities were in broad agreement with the thrust of such a strategy, and indicated their intention to develop an appropriate saving/investment strategy for oil/gas revenues in tandem with the establishment of a petroleum fund.

22. **The authorities indicated that they plan to establish a petroleum fund by June 2004, in time for the inflow of large oil/gas revenues**. They are in the process of studying various petroleum fund models to decide on basic modalities. The mission stressed that the key to effective functioning of a petroleum fund is a prudent expenditure policy, backed by a well-defined framework for transparency and accountability. Accordingly, the mission encouraged the authorities to incorporate the recommendations made by the FAD technical assistance mission (October 2002), which incorporate these principles on the basis of a Norwegian model (Box 3). The mission noted that, among the recommendations, deserving of special attention are the use of the fund solely to finance fiscal deficits through a stringent

BOX 2. MEDIUM-TERM FISCAL STRATEGY

The development of a medium-term fiscal strategy aims to address what would be the sustainable levels of government expenditure and optimum drawdowns of oil/gas wealth for Timor-Leste in order to meet the following two policy objectives:

- **Strengthening of the country's growth prospects to alleviate poverty**. To this end, the government will invest part of the oil/gas wealth in development projects to improve infrastructure and human capital, so as to promote economic growth (to 5 percent per year over the medium term—an ambitious target set under the NDP— before moderating to about 3.5 percent in the long run, partly due to a rise in the ICOR and a slowdown in the population growth).

- **The maintenance of a sound fiscal position in the long run**: Once oil/gas resources are depleted, the government aims to finance budgetary expenditures through two financial sources: domestic revenues and interest income from financial savings. Such a policy would permit Timor-Leste to remain free of borrowing and potential debt burden, while preserving the stock of financial savings.

The medium-term fiscal strategy to meet these two objectives is developed on the basis of a macroeconomic framework which is anchored on a number of assumptions with regard to risks associated with public investment, economic policies, and exogenous parameters.

- **Risks associated with public investment**: The size of public investment is limited to that consistent with the growth target set by the NDP. The adoption of a more expansionary investment program in an attempt to achieve higher growth is avoided, owing to recognition of risks associated with public investment, especially in terms of the extent to which it can improve overall productivity and generate increased domestic revenues in the future. Such risks are partly related to uncertainty regarding the government's capacity to execute investment programs effectively, as well as the absorption capacity of the economy.

- **Key macroeconomic policy assumptions** include: (i) strong actions to promote private investment (reaching 13 percent of GDP in the long run, including foreign investment); (ii) a step-up in efforts to increase non-oil/gas revenues (to about 14 percent of GDP in the long run), especially through tax reforms aimed at broadening the tax base; (iii) the maintenance of a cautious external borrowing policy; and (iv) a gradual winding-down of external assistance over the medium term.

- **Assumptions on main exogenous parameters** include: (i) international oil prices averaging $19 per barrel at 2002 prices; (ii) the rate of return on financial assets sustained at 3.5 percent in real terms (the average rate of return on U.S. long-term government bonds over the last 10 years); and (iii) oil/gas revenues generated mainly from the Bayu-Undan project.

The macroeconomic framework based on these assumptions leads to the following policy implications for government expenditure and drawdown of oil/gas wealth over the medium term.

- Given overall investment required to achieve the targeted growth rate and the projected increase in private investment, government investment should increase from 3 percent of GDP in FY2001/02 to 11 percent of GDP by the end of this decade, before falling gradually to 7 percent of GDP in the long run (Figure 2). At the same time, recurrent expenditure would need to be reduced from about 17 percent of GDP projected for the end of this decade to 13 percent of GDP in the long run, in order to realize sufficient financial assets to meet the long-run resource needs. **Given this outlook, overall government expenditure could increase to about 30 percent of GDP by the end of this decade, but would need to fall gradually to 20 percent of GDP in the long run.**

- **To meet this expenditure path, roughly one-third of oil/gas wealth would need to be drawn down over the medium term, the remainder to be invested in financial assets and saved for future generations (Figure 3).** Given the rate of return on financial assets assumed in the scenario, the stock of financial assets would generate annual interest income equivalent to 6 percent of GDP in the long run.

- **The level of capital expenditures will depend critically on Timor-Leste's absorption capacity**. Larger investment can be undertaken, as the country's absorption capacity improves substantially. This will help strengthen the overall productivity of the economy and generate higher domestic revenues in the long run.

budgetary process, the appointment of a high level council to monitor operations of the fund, the adoption of a comprehensive reporting and auditing system, and the establishment of an investment advisory committee. The authorities noted that due consideration will be given to these recommendations in establishing a petroleum fund.

BOX 3: NORWEGIAN MODEL OF A PETROLEUM FUND

- **Norway's State Petroleum Fund (SPF) is characterized as a financing fund, which is designed to finance the fiscal deficit**. The budget is required to transfer all oil revenues to the SPF; in turn, the SPF finances the non-oil resource deficit of the budget through reverse transfer. The accumulation of assets in the SPF thus represents the government's net financial savings (namely, cumulative surpluses in government finances). The SPF does not attempt to deal directly with stabilization and savings issues associated with oil revenues, which are addressed in the context of the budgetary process.

- **The critical prerequisite for the effective functioning of a financing fund is prudent fiscal policy**. The fund is not subject to predetermined rules for the accumulation or drawdowns of oil revenues. Such rules are typical for stabilization and saving funds, but do not address government fiscal policy, thus often failing to achieve the stated objectives of such funds. Under a financing fund, the flows in and out of the fund therefore depend crucially on fiscal policy pursued by the government. The fund's resources will be depleted easily if an unduly expansionary fiscal policy is maintained for a prolonged period.

- **The SPF is effectively little more than a government account**. Its features ensure integration into a unitary fiscal system. SPF assets are under the control of the Ministry of Finance, which sets the guidelines for the SPF's investment strategy. On the basis of the strategy, the Central Bank manages the portfolios of the SPF.

- **Transparency and accountability are the founding principles of the SPF**. Transfers to and from the SPF need parliamentary approval, and its operations are incorporated into the fiscal accounts. The Central Bank is required by law to provide information concerning the fund's management to the public. The quarterly and annual reports provide detailed information on the SPF's operations, including on the valuation, composition, and returns of portfolios, as well as on transfers to and from the budget. The SPF's accounts are regularly audited, and the audit reports are made public. These stringent mechanisms help ensure accountability and prevent the misuse of funds.

Source: "Stabilization and Savings Funds for Nonrenewable Resources," *Occasional Paper* 205, International Monetary Fund, 2001.

C. Financial Sector Issues

23. **The authorities agreed with the mission's view that the current monetary and exchange rate regime should remain the cornerstone of macroeconomic management for the foreseeable future**. The current regime has provided an effective mechanism to restore the stability of the financial system. It has also proved to be a workable arrangement, especially given the limited institutional capacity and the lack of sufficient official reserves for the adoption of a pegged system (or the absence of a well-developed foreign exchange market for the adoption of a flexible rate). The authorities acknowledged that the current regime complicates the process of relative price/wage adjustments and that there are political pressures to introduce a national currency. Notwithstanding these factors, they indicated that a premature introduction of a national currency will be avoided until appropriate institutional and financial conditions are fully developed.

24. **The authorities are aware that improved financial intermediation is essential for economic growth**. They agreed that a first step to this end will be to strengthen the legal framework for bank lending (including strengthening of the judiciary system in general, and the enactment of a bankruptcy law in particular), in tandem with the enactment of key economic legislation aimed at fostering an environment conducive to an expansion in business activity (¶25). The authorities indicated that a draft law is currently under preparation to ensure that the banking system will remain free of money laundering and the financing of terrorism.

D. Private Sector Development

25. **The authorities recognize that the development of a dynamic private sector is critical to strengthen Timor-Leste's growth prospects**. Their efforts will continue to focus on establishing a legal framework for business activity. They acknowledged that progress has been somewhat slower than expected, but stressed that the establishment of the ministerial committee to prepare major economic legislation (including the investment law) would help gain ground.[13] They also noted that the enactment of the basic law for land ownership paved the way for the preparation of legislation governing the lease and sale of government-owned property, which is expected to contribute to an expansion in business activity, especially by foreign investors. The mission encouraged the authorities to press ahead with securing the early approval by parliament of the economic legislation.

26. **The authorities reiterated their commitment to maintain a liberal trade and investment regime**.[14] This will be reflected in the investment law, key provisions of which

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[13]Among the main laws to be prepared by the committee, the company law has been completed and submitted to parliament in early June.

[14]Under the present trade regime, a uniform 6 percent import duty is applicable to all imports except for those undertaken by UNTAET/UNMISET and those associated with bilateral

(continued)

include nondiscrimination between domestic and foreign investors (especially in terms of tax incentives), the adoption of a one-stop-shop approval procedure, and the avoidance of a reserved list for domestic production. The mission stressed that these provisions are essential for attracting foreign direct investment, which could play a major role in promoting economic growth, especially in the area of tourism. The authorities noted that strong political pressures persist for the government to introduce populist measures, including administrative intervention to fix the prices of essential goods and ensure a minimum wage to workers. They indicated, however, that they intend to resist the adoption of such administrative measures to the extent possible.

E. Institution and Capacity Building

27. **The authorities expressed their strong commitment to institution and capacity building**. They noted that this is one of the central issues to be addressed in the Road Map. They recognize that rapid progress toward the objective is all the more important in view of the expected winding-down of the UN-supported capacity-building program, under which international experts have been appointed to key public administration posts ("core and development posts").

28. **The authorities indicated that some of the key actions for institution and capacity building envisaged under the Road Map will be taken in connection with the World Bank-supported second-year TSP**. Under the program, further steps will be implemented to strengthen the government's capacity for poverty reduction planning, budget formulation, and expenditure execution (with a focus on improvement in procurement). Actions are also envisaged to develop the legal framework for the civil service (especially the finalization of the civil service statute); improve human resources management for the public sector (including the establishment of a recruitment policy and the implementation of a personnel registry); and strengthen the judiciary (including the enactment of legislation on public prosecutors and defenders).

29. **Supporting the authorities' policy initiatives, the mission also underscored the critical importance of further strengthening economic institutions**. With regard to the Ministry of Planning and Finance, the mission urged the authorities to implement the medium-term capacity-development program. In particular, the authorities were encouraged to: (i) appoint a "Director General" (who will assume responsibility for operational matters) in order to strengthen management oversight; and (ii) establish a human resource management unit with a view to developing competent local staff and appointing staff on the basis of merit. Regarding the BPA, the authorities were encouraged to appoint the remaining Board members so as to foster its institutional autonomy.

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assistance programs (on the basis of bilateral agreements). No imports are subject to quotas, licenses, bans, and other forms of quantitative restrictions, although the importation of certain categories of goods is banned for health and security reasons.

F. Other Issues

30. **Economic monitoring and analysis are seriously hampered by the limited availability of macroeconomic data**. Despite increased efforts to compile key economic data, progress has been slow reflecting the nascent institutional capacity, and macroeconomic data remain weak in terms of availability, coverage, and quality. Data problems are especially serious in the areas of national accounts and the balance of payments (Annex IV). The mission stressed that a critical initial step in improving data compilation is the enactment of a statistical law to empower the Statistics Division to collect essential raw data. The authorities indicated that a draft statistical law has been under preparation and that they will secure its early approval by the Council of Ministers to pave the way for its issue as a decree law.

31. **The mission updated developments in the exchange and trade system since the membership mission (February 2002), when the system was last examined**. During the membership process, the authorities notified the Fund that Timor-Leste accepts the obligations of Article VIII, Sections 2, 3, and 4, with the acceptance taking effect from the date of Timor-Leste's membership in the Fund. The mission ascertained that, since the date of Timor-Leste's membership, its exchange system remains free of restrictions on payments and transfers for current international transactions (Annex V).

IV. Staff Appraisal

32. **Timor-Leste has made impressive strides in recovering from the severe post-referendum destruction**. Real GDP has rebounded strongly, inflation has moderated sharply, and basic institutions for economic management have been restored. The recovery was assisted importantly by substantial financial and technical assistance from the international community. With the international presence winding down, however, economic growth is slowing down considerably.

33. **The major challenge for the authorities is to move forward to strengthen the country's growth prospects and alleviate widespread poverty, building on the progress made thus far**. Rapid progress toward these goals has become all the more important, as the stimulus to the economy from the large international presence wanes precipitously and people's expectations for employment opportunities and improved living standards grow. It is critical that these goals be pursued under a sound macroeconomic environment.

34. **Given the dollarization of the financial sector, fiscal policy should bear the major burden of maintaining macroeconomic stability**. In view of the authorities' reluctance to borrow externally, the absence of access to domestic borrowing, and the current saving policy for oil/gas revenues, it is appropriate that fiscal management during the "lean years" aims at containing expenditure within available fiscal resources, while meeting pressing development needs. This policy principle is well reflected in the budget for FY2003/04, which incorporates an appropriate expenditure adjustment in response to changed fiscal conditions, while safeguarding essential expenditures, including those for key

social services. For the budget to be credible, it is important that expenditure execution (especially for capital projects) improves significantly, so as to ensure the timely provision of government services and to give a much-needed stimulus to the economy. At the same time, efforts should be stepped up to further strengthen tax administration to realize domestic revenues as budgeted.

35. **The authorities are commended for their cautious approach to external borrowing**. There is a strong risk that hasty external borrowing in the absence of sufficient capacity for economic management and project implementation would give rise to serious debt problems. The relaxation of the current external borrowing policy therefore should be considered only after Timor-Leste's absorption capacity has improved significantly. Even in the event that such a policy change becomes possible, borrowing should be limited to concessional loans geared toward strengthening capital projects essential for the country's economic development.

36. **A significant improvement in the power sector's financial position is essential to keep the budget on a sustainable path**. The recent decisions taken by the authorities to strengthen the management of the sector through an external management contract and to reform the billing system are steps in the right direction. Nonetheless, fiscal transfers required for the sector are expected to decline only moderately over the coming years. Given this outlook, it is essential that reform measures be rigorously implemented under the new external management, so as to avoid any further increases in budgetary support for the sector.

37. **Beyond the "lean years," a major challenge for fiscal policy is how best to use growing oil/gas revenues in order to promote economic growth and alleviate poverty (including through a better provision of social services), while safeguarding macroeconomic stability**. With the inflow of substantial oil/gas revenues becoming more certain following the ratification of the Timor Sea Treaty and agreement on the development plan with oil companies, there is an urgent need to work out a medium-term fiscal strategy. The development of such a strategy is essential to keep fiscal expenditure at sustainable levels, which would permit Timor-Leste to meet its development needs while sustaining a sound fiscal position in the long run. While an urgent need for improvements in infrastructure and human capital calls for increased fiscal expenditure, caution should be exercised against embarking on a large investment program prematurely until the country's absorption capacity has improved significantly.

38. **With growing oil/gas revenues in sight, the authorities' plan to establish a petroleum fund merits strong support**. The principal objective of a petroleum fund should be to enhance transparency and accountability for management of oil/gas savings. To this end, it is important that a petroleum fund be used solely for budget finances through a stringent budgetary process, a high level supervisory committee be established, and a well-defined framework for reporting and auditing be adopted. The authorities should be mindful that a petroleum fund in itself does not guarantee a prudent fiscal policy. Rather, such a fiscal policy is a critical prerequisite for the effective functioning of a petroleum fund.

39. **It is appropriate that the current monetary and exchange rate regime be maintained for the foreseeable future**, in view of its contribution to the restoration of financial stability, as well as existing constraints on institutional capacity. The authorities' intention to avoid any premature introduction of a national currency deserves strong support, despite the inconveniences associated with the current regime in terms of relative price/wage adjustments.

40. **Private sector development is essential to strengthen Timor-Leste's growth prospects**. To this end, there is an urgent need to enact key economic laws so as to establish a clear legal and regulatory framework for business activity. The authorities should be commended for their intention to maintain a liberal trade and investment regime. In particular, liberal provisions envisaged for the investment law are appropriate to attract foreign investment which will be essential for Timor-Leste's economic development. The authorities' intention to avoid administrative interference in the market mechanism should go a long way to strengthen business confidence in the economy.

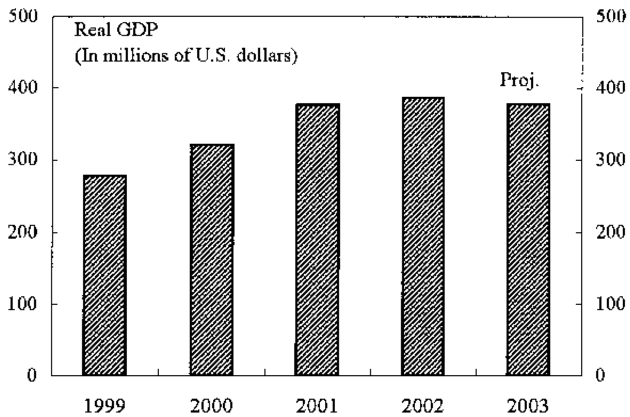
41. **Nascent institutions and limited local capacity are a major constraint for Timor-Leste's economic development**. The challenge for the authorities is to further accelerate the momentum of institution building that was initiated over the last three years. This is especially important for institutions responsible for economic management. To this end, early actions should be taken to implement a medium-term capacity-building program for the Ministry of Planning and Finance and appoint the remaining Board members of the BPA in order to strengthen its institutional autonomy.

42. **There is an urgent need to improve the compilation of macroeconomic data in order to strengthen the monitoring and analysis of economic developments and assist timely policy decisions by the authorities**. Early actions are especially needed to collect sectoral data, so as to lay a basis for the compilation of key macroeconomic data, especially on national accounts and the balance of payments. As the first step to this end, the authorities are urged to secure the early enactment of a statistical law.

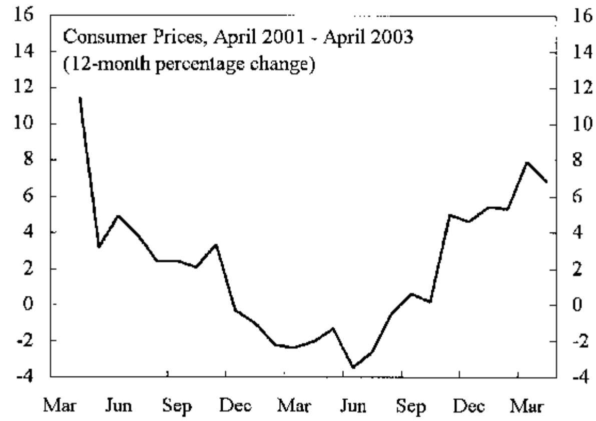
43. **It is proposed that the next Article IV consultation with Timor-Leste be held on the standard 12-month cycle**.

Figure 1. Timor-Leste: Selected Economic Indicators

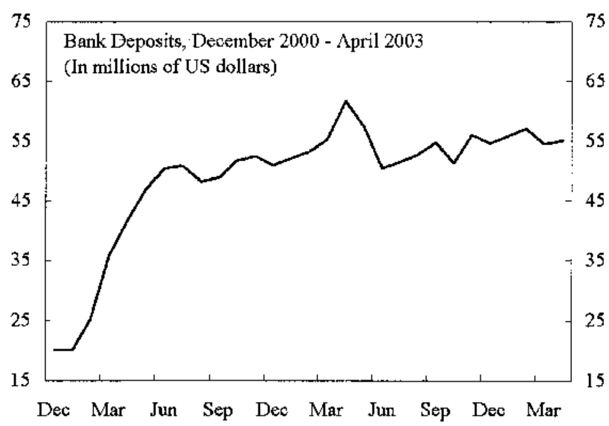
Output is contracting, after a rapid expansion in the previous three years...



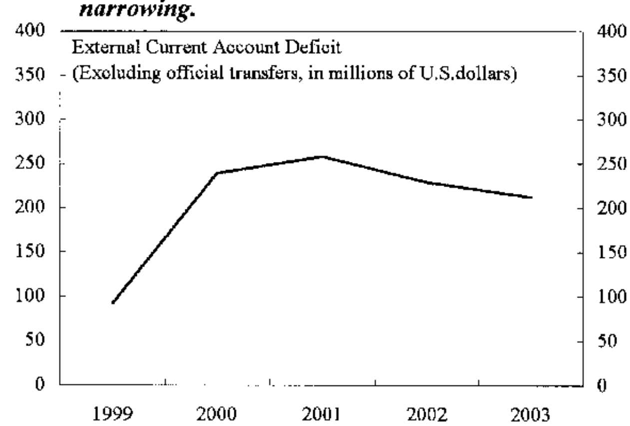
...while, inflation is picking up, after having come down significantly.



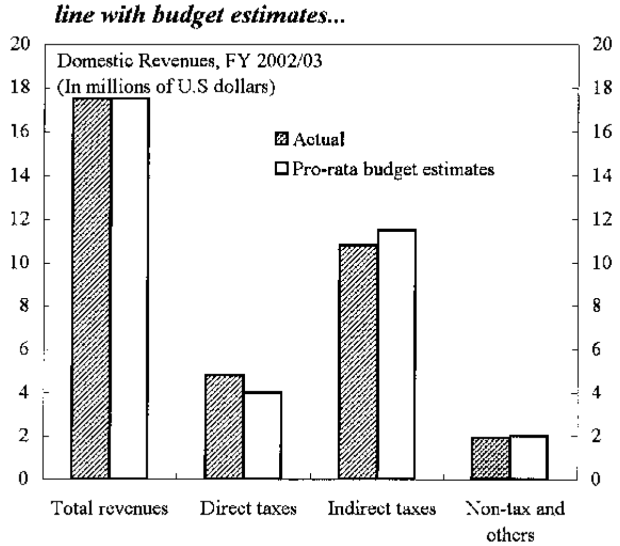
...bank deposits continue to grow, albeit modestly...



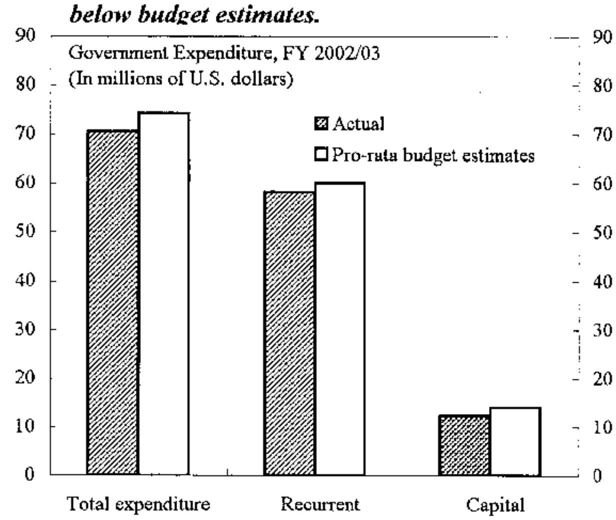
...and external current account deficit is narrowing.



Domestic revenue collection is estimated to be in line with budget estimates...



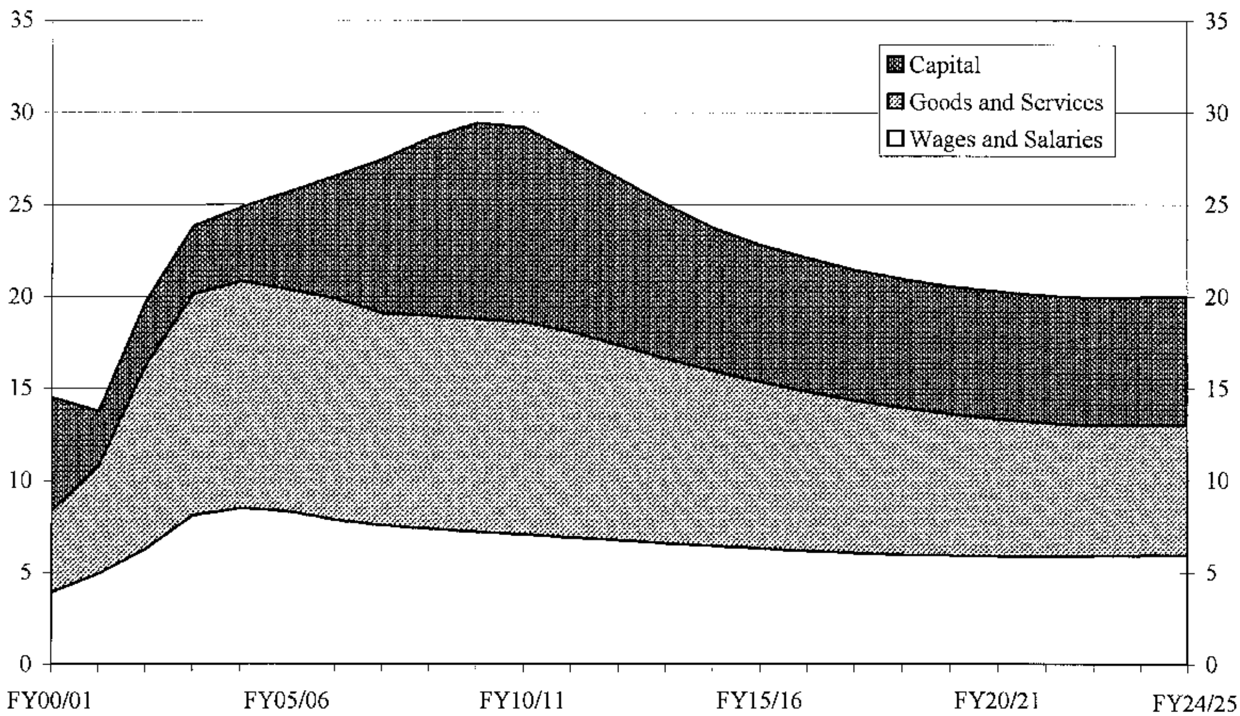
...but, expenditure levels are likely to be below budget estimates.



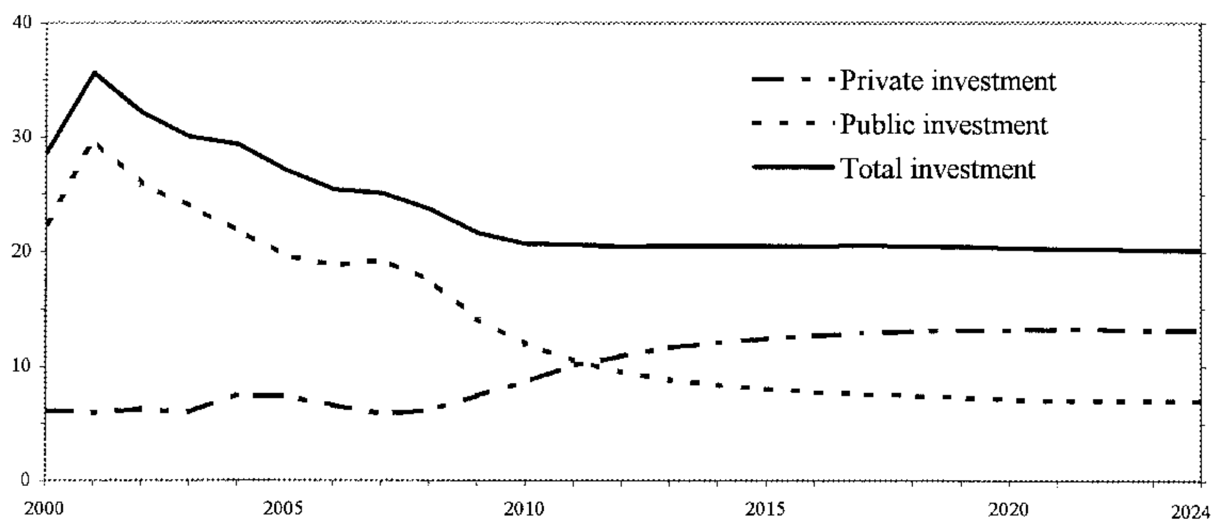
Sources: Data provided by the Timor-Leste authorities; and Fund Staff estimates.

Figure 2. Timor-Leste: Developments in Government Expenditures and Investment

(a) CFET Expenditure Composition (in percent of GDP; FY00/01-FY24/25)



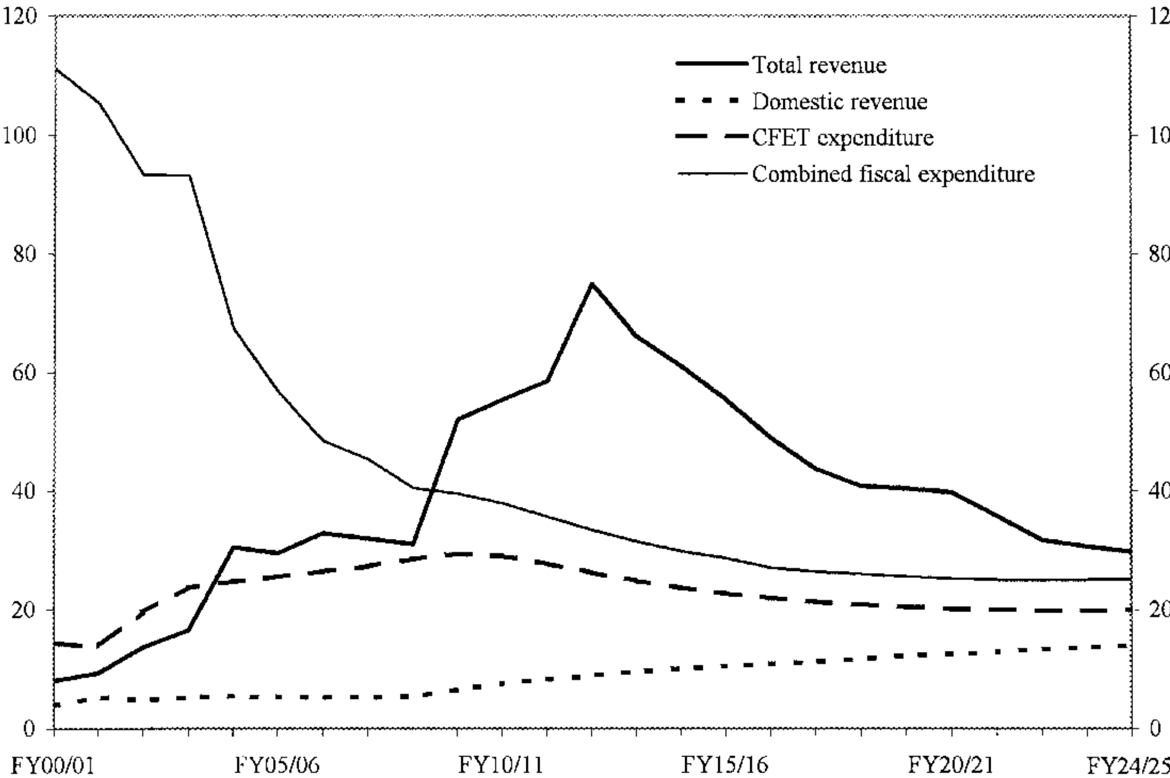
(b) Investment (in percent of GDP; CY2000-2024)



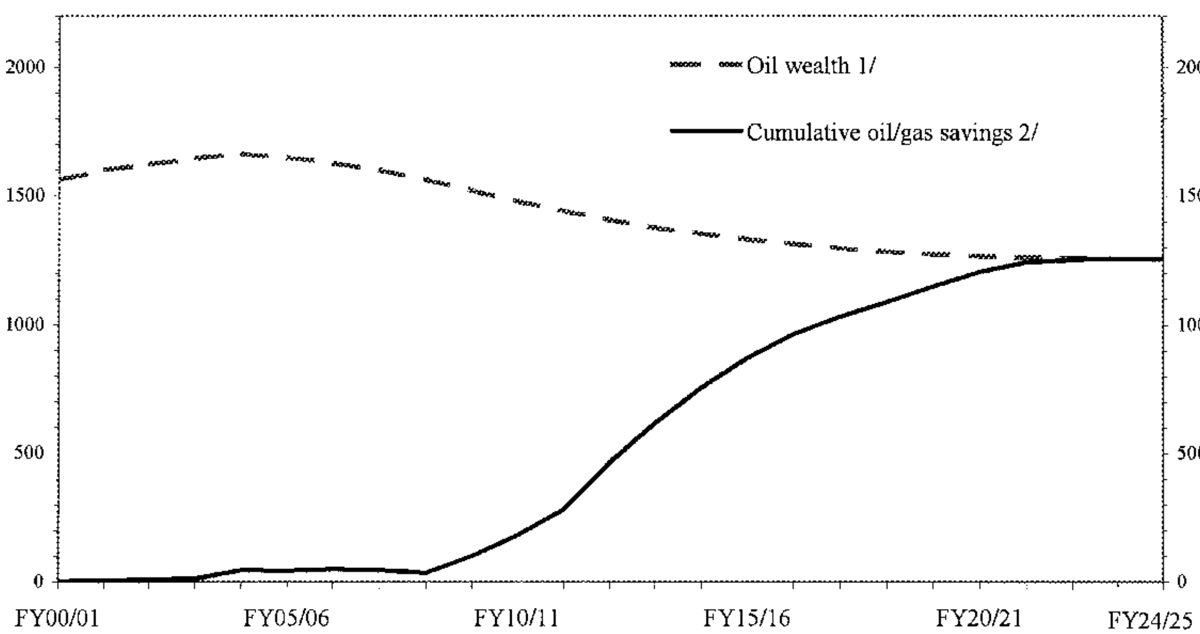
Sources: Data provided by the Timor-Leste authorities; and Fund staff projections.

Figure 3. Timor-Leste: Revenue, Expenditure, and Oil Wealth, FY2000/01-FY2024/25

(a) Revenues and Expenditures (in percent of GDP)



(b) Oil Wealth (in millions of U.S. dollars; FY00/01 prices)



Sources: Data provided by the Timor-Leste authorities; and Fund staff projections.
1/ In terms of the real present value of projected oil/gas revenues.
2/ Stock of oil/gas financial assets in real terms.

Table 1. Timor-Leste: Selected Social Indicators 1/

	Timor-Leste	East Asia and Pacific island countries	Low-income countries
Per capita income (U.S. dollars)	**472**	1,060	420
Area (in thousands of square kilometers)	**15**	...	...
Demography			
Total population (in thousands)	**825**	1,855,200	2,459,800
Population growth (in percent)	**1.9** 2/	1.0	1.9
Life expectancy and mortality			
Life expectancy at birth (years)	**57**	69	59
Male	**56**	67	58
Female	**59**	71	64
Infant mortality (per thousand live births)	**80**	36	76
Male	**88**	...	...
Female	**72**	...	...
Under 5 mortality rate (per thousand live births)	**144**	45	115
Male	**156**	...	...
Female	**132**	...	...
Education			
Illiteracy rate (in percent) 3/	**57**	15	39
Male	**57**	...	...
Female	**57**	...	...
Net primary school enrollment rate (in percent)	**76**	99	86
Health			
Hospitals (per thousand)	**0.5** 4/	1.1	...
Doctors (per thousand)	**0.2** 4/	...	...
Nurses (per thousand)	**1.4** 4/	...	...
Other indicators			
Population below the poverty line 5/	**41**	29	...
Households with access to electricity 5/	**36**	...	...
Households with access to drinking water 5/	**65**	75	76

Sources: UNDP Human Development Report 2002; World Bank; and Fund staff estimates.

1/ Relate to 2001, unless otherwise indicated.

2/ Average rate for the 1990s.

3/ Relates to the population of ages 15 and above.

4/ Relates to 1997.

5/ In percentage share of the total.

Table 2. Timor-Leste: Selected Economic Indicators, 1999–2003

	1999	2000	2001	2002	2003
		Est.			Proj.
Output and prices					
GNP at current prices (in millions of U.S. dollars)	270	328	397	394	369
GDP	270	321	385	378	338
Oil/gas income	0	7	12	16	32
Real GDP growth (percentage change)	-35	15	17	3	-2
Inflation (percentage change at end-period) 1/2/	140	3	0	5	4
	(In percent of GDP)				
Investment-saving balance					
Gross investment 3/	21	29	36	32	30
Gross national savings	-13	-44	-44	-41	-29
External savings	34	73	80	73	59
Government budget (CFET) 4/					
Revenues	...	7.7	8.2	12.4	18.0
Domestic revenues	...	4.0	5.4	4.9	5.3
Oil/gas revenues	...	3.7	2.8	7.5	12.7
Expenditure	...	14.5	13.8	19.7	23.9
Recurrent expenditure	...	8.4	10.7	16.3	20.1
Capital expenditure	...	6.1	3.0	3.5	3.7
Overall balance	...	-6.8	-5.5	-7.4	-5.8
Money and credit					
Broad money 5/6/	48	6	13	15	16
Net domestic assets 6/	47	-4	-4	-10	-11
	(In millions of U.S. dollars)				
External sector					
Current account excluding official transfers	-92	-237	-257	-230	-212
Current account including official transfers	6	68	45	37	19
Trade balance	-67	-213	-212	-180	-163
Merchandise exports 7/8/	52	5	4	6	7
Merchandise imports 7/	-119	-218	-216	-186	-171
Overall balance	0	16	8	23	-3
	(In percent of GDP)				
Current account excluding official transfers	-34	-74	-67	-61	-63
Current account including official transfers	2	21	12	10	6
Trade balance	-25	-66	-55	-48	-48
Merchandise exports 7/8/	19	2	1	2	2
Merchandise imports 7/	-44	-68	-56	-49	-51
Overall balance	0	5	2	6	-1

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

1/ Rupiah-based CPI for Dili through 2000 and, thereafter, dollar-based CPI for Dili.

2/ The figure for the latest month in 2003 (April) is 7 percent on a year-on-year basis.

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

4/ On the basis of fiscal year (July-June); for example, 2000 relates to FY2000/01.

5/ Figures after 1999 exclude currency holdings by the public, on which no data are available.

6/ Figure for 2003 relates to March.

7/ Figures after 2000 exclude unrecorded border trade.

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

Table 3. Timor-Leste: Fiscal Accounts of the Consolidated Fund for East Timor (CFET), FY2000/01–FY2003/04 1/

	FY2000/01	FY2001/02	FY2002/03 Est.	FY2003/04 Budget 2/	Memorandum items: Midyear budget estimates 3/ FY2002/03	FY2003/04
			(In millions of U.S. dollars)			
Revenue	27.1	31.3	44.2	59.8	42.3	66.0
Domestic revenue	14.1	20.5	17.5	17.6	17.5	17.5
Direct taxes	0.6	5.4	4.8	4.7	4.0	4.0
Indirect taxes	11.6	12.7	10.8	10.2	11.5	11.6
Nontax revenue	1.9	2.4	1.9	2.7	2.0	2.0
Oil/gas revenues	13.1	10.8	26.7	42.2	24.8	48.5
Tax revenues	9.9	6.5	24.6	29.3	23.8	36.2
Royalties and interest	3.1	4.3	2.1	12.9	1.0	12.3
Royalties	3.0	4.2	1.7	12.3	0.9	11.8
Interest on oil/gas revenue savings	0.1	0.1	0.4	0.6	0.1	0.6
Expenditure	51.3	52.6	70.6	79.1	74.2	80.1
Recurrent expenditure	29.6	41.1	58.2	66.8	60.1	65.1
Wages and salaries	13.9	18.8	22.5	27.0	23.9	27.6
Goods and services	15.7	22.2	35.7	39.8	36.2	37.6
Capital expenditure	21.7	11.5	12.4	12.3	14.1	14.9
Overall balance	-24.2	-21.3	-26.4	-19.4	-31.9	-14.0
Financing	24.2	21.3	26.5	19.3	31.9	9.0
Donor support (grants)	31.6	22.7	33.0	28.0	30.9	21.3
Pledges made at the May 2002 meeting	...	...	30.9	24.0	29.3	21.3
Confirmed	...	...	25.7	21.8	...	...
To be confirmed	...	...	5.1	2.2	...	...
Other	...	...	2.2	4.0	1.5	0.0
Change in CFET cash balances (increase -) 4/	-4.2	2.8	-4.4	4.2	2.0	0.0
Oil/gas revenue savings (increase -) 5/	-3.1	-4.3	-2.1	-12.9	-1.0	-12.3
Financing gap	0.0	0.0	-0.1	0.0	0.0	5.1
			(In percent of GDP)			
Revenue	7.7	8.2	12.4	18.0	11.8	19.9
Domestic revenue	4.0	5.4	4.9	5.3	4.9	5.3
Oil/gas revenues	3.7	2.8	7.5	12.7	6.9	14.7
O/w: Tax revenues	2.8	1.7	6.9	8.9	6.7	10.9
Expenditure	14.5	13.8	19.8	23.9	20.8	24.2
Recurrent expenditure	8.4	10.8	16.3	20.2	16.8	19.7
Capital expenditure	6.2	3.0	3.5	3.7	4.0	4.5
Overall balance	-6.8	-5.6	-7.4	-5.8	-8.9	-4.2
Financing	6.8	5.6	7.4	5.8	8.9	2.7
Financing gap	0.0	0.0	0.0	0.0	0.0	1.5
			(In millions of U.S. dollars)			
Memorandum items:						
Expenditure excluding the power sector	42.9	45.8	62.2	72.3	65.7	77.1
Recurrent expenditure	21.7	35.2	51.8	59.9	53.7	62.7
Wages and salaries	13.5	18.5	22.2	26.6	23.6	27.2
Goods and services	8.2	16.6	29.6	33.3	30.1	35.5
Capital expenditure	21.2	10.7	10.3	12.3	12.0	14.4
Expenditure for the power sector 6/	8.4	6.7	8.4	6.8	8.4	2.9
Accumulated oil/gas revenue savings (end-period)	3.1	7.4	9.5	22.4	8.4	21.7
CFET cash balances (end-period)	8.6	5.8	10.2	6.0	3.8	3.8

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

1/ Fiscal year: July-June.

2/ Approved by the Council of Ministers on May 23, 2003.

3/ Revised budget estimates made under the midyear budget review (December 2002), approved by parliament in March 2003.

4/ Net of unsettled expenditures due to technical delays, including float; not necessarily corresponding to changes in government deposits shown in monetary data.

5/ Assumes that the current saving policy, under which royalties and interest income are automatically saved and only tax revenues are available for budget financing, is maintained.

6/ The original budget estimate for FY2002/03 was $4.0 million.

Table 4. Timor-Leste: Combined Fiscal Operations, FY2000/01–FY2003/04 1/

	2000/01	2001/02	2002/03	2003/04
		Est.		Proj.
	(In millions of U.S. dollars)			
Revenue	29	36	49	67
CFET	27	31	44	60
Autonomous agencies	1	4	5	7
Total expenditure	392	400	333	310
CFET 2/	43	46	62	72
Non-CFET	349	354	270	238
Autonomous agencies	9	9	11	15
TFET	48	46	43	26
Bilateral	79	116	109	121
UNTAET/UNMISET 3/	213	183	108	76
Recurrent expenditure 4/	292	300	243	223
CFET 2/	22	35	52	60
Non-CFET	271	265	191	163
Autonomous agencies	8	8	9	13
TFET	19	18	17	11
Bilateral	42	60	57	63
UNTAET/UNMISET 3/	201	178	108	76
Capital expenditure	99	100	90	87
CFET 2/	21	11	10	12
Non-CFET	78	89	80	75
Autonomous agencies	1	1	2	1
TFET	29	27	25	16
Bilateral	37	56	52	58
UNTAET/UNMISET 3/	12	5	0	0
Overall balance	-363	-364	-284	-243
Financing	363	364	284	243
CFET 2/	23	19	25	20
Non-CFET	340	345	259	223
TFET	48	46	43	26
Bilateral	79	116	109	121
UNTAET/UNMISET 3/	213	183	108	76
	(In percent of GDP)			
Revenue	8	9	14	20
Total expenditure	111	105	93	93
CFET 2/	12	12	17	22
Non-CFET	99	93	76	72
Recurrent expenditure 4/	83	79	68	67
CFET 2/	6	9	15	18
Non-CFET	77	70	53	49
Capital expenditure	28	26	25	26
CFET	6	3	3	4
Non-CFET	22	23	22	23
Overall balance	-103	-95	-79	-73
Financing	103	95	79	73
CFET	7	5	7	6
Non-CFET	96	90	72	67

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

1/ Comprise the combined sources budget in the official presentation and UNTAET/UNMISET operations as defined in footnote 3; includes technical assistance.

2/ Net of CFET budget transfers to autonomous agencies.

3/ Excludes military expenditures and those not directly related to government operations.

4/ Includes technical assistance.

Table 5. Timor-Leste: Money and Credit, 2000–2003

(In millions of U.S. dollars; at end-period)

	2000	2001	2002				2003
	Dec.	Dec.	Mar.	June	Sept.	Dec.	Mar.
Banking system							
Net foreign assets	33.8	65.4	72.9	68.9	77.3	89.9	92.8
Assets	33.8	72.9	80.9	72.7	80.4	94.5	97.0
Cash holdings	6.3	11.7	12.1	7.7	12.4	18.0	15.1
Claims on foreign banks	27.5	61.2	68.8	65.0	68.1	76.5	81.9
Other	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Liabilities	0.0	7.5	8.0	3.8	3.1	4.6	4.2
Net domestic assets	-13.8	-14.3	-17.7	-18.4	-21.8	-34.4	-37.6
Claims on government (net)	-19.0	-21.1	-22.3	-19.2	-20.8	-33.7	-36.3
Claims on private sector	0.3	3.0	3.5	4.4	4.5	5.1	6.1
Other items (net)	4.9	3.8	1.2	-3.5	-5.5	-5.8	-7.4
Broad money 1/	20.0	51.1	55.2	50.5	55.6	55.5	55.2
Demand deposits	19.3	28.9	40.1	36.2	40.4	40.0	38.3
Saving deposits	0.0	16.2	9.7	8.4	9.4	10.2	11.7
Time deposits	0.7	6.0	5.4	5.9	5.8	5.3	5.2
BPA							
Net foreign assets	16.0	23.7	28.2	26.7	33.2	43.5	46.3
Assets	16.0	23.7	28.2	26.7	33.2	43.5	46.3
Cash in vault	1.3	4.9	8.7	5.7	8.5	13.0	12.2
Claims on central banks	14.7	18.8	19.5	21.0	24.8	30.5	34.1
Other	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net domestic assets	-16.0	-22.7	-25.7	-23.0	-27.0	-38.1	-41.6
Government (net position)	-19.0	-21.1	-22.3	-19.2	-20.8	-33.7	-36.3
Claims on domestic banks	3.0	3.5	1.7	2.4	0.9	2.4	1.7
Other items (net)	0.0	-5.0	-5.1	-6.2	-7.1	-6.9	-7.0
Of which: capital and reserves	-0.7	-5.0	-5.0	-5.6	-6.9	-6.9	-6.9
Liabilities	0.0	1.0	2.5	3.7	6.3	5.4	4.7
Financial institutions	0.0	1.0	2.5	3.6	5.5	4.5	4.0
Private enterprises	0.0	0.0	0.0	0.1	0.8	0.9	0.7
Commercial banks 2/							
Net foreign assets	17.8	41.7	44.7	42.2	44.1	46.4	46.5
Assets	17.8	49.2	52.7	46.0	47.2	51.0	50.7
Cash holdings	5.0	6.8	3.4	2.0	3.9	5.0	2.9
Claims on foreign banks	12.8	42.4	49.3	44.0	43.3	46.0	47.8
Liabilities	0.0	7.5	8.0	3.8	3.1	4.6	4.2
Net domestic assets	5.2	12.9	12.3	10.6	11.6	10.7	9.7
Deposits with BPA	0.0	1.0	2.5	3.6	5.5	4.5	4.0
Claims on government (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Claims on private sector	0.3	3.0	3.5	4.4	4.5	5.1	6.1
Other items (net)	4.9	8.9	6.3	2.7	1.6	1.1	-0.4
Deposit liabilities	20.0	51.1	55.2	50.4	54.8	54.6	54.5
Demand deposits	19.3	28.9	40.1	36.1	39.6	39.1	37.6
Saving deposits	0.0	16.2	9.7	8.4	9.4	10.2	11.7
Time deposits	0.7	6.0	5.4	5.9	5.8	5.3	5.2
Liabilities to BPA	3.0	3.5	1.7	2.4	0.9	2.4	1.7
Memorandum items:							
Total lending	1.8	7.0	6.8	7.0	6.5	6.8	7.2
Bank lending	0.3	3.0	3.5	4.4	4.5	5.1	6.1
On-lending for SEP 3/	1.5	4.0	3.3	2.7	2.0	1.7	1.1

Sources: Central Payments Office; Indonesian authorities; and Fund staff estimates.

1/ Exclude currency in circulation , on which no data are available due to dollarization of the financial system.

2/ Includes the microfinance institution.

3/Refers to loans extended under the Small Enterprise Project funded by the TFET.

Table 6. Timor-Leste: Balance of Payments, 1999–2003

	1999	2000	2001	2002	2003
		Est.			Proj.
			(In millions of U.S. dollars)		
Current account excl. official transfers	-92	-237	-257	-230	-212
Current account incl. official transfers	6	68	45	37	19
Trade balance	-67	-213	-212	-180	-163
Exports of goods 1/2/	52	5	4	6	7
Of which : Coffee	...	4	3	5	6
Imports of goods 1/	-119	-218	-216	-186	-171
Of which : UNTAET/UNMISET and humanitarian	-58	-115	-64	-18	-8
Services (net)	-25	-28	-50	-54	-52
Income (net)	0	3	5	4	3
Of which : Oil/gas royalty and interest	0	3	4	3	2
Current transfers (net)	98	305	303	267	231
Of which : Oil/gas tax revenues	0	5	8	13	29
UNTAET/UNMISET and humanitarian	43	232	190	143	92
Capital and financial accounts	-3	-38	-27	5	-22
Official capital transfers	0	63	83	83	76
Financial accounts	-3	-101	-110	-78	-97
Errors and omissions (net)	-3	-13	-10	-18	0
Overall balance	0	16	8	23	-3
Changes in foreign assets (increase -)	...	-16	-8	-23	3
Oil/gas revenue savings (increase -)	0	-3	-4	-3	-2
Other	...	-13	-3	-20	5
			(In percent of GDP)		
Current account excluding official transfers	-34	-74	-67	-61	-63
Current account including official transfers	2	21	12	10	6
Trade balance	-25	-66	-55	-48	-48
Memorandum items:					
Oil/gas revenues (in millions of U.S. dollars)	0	7	12	16	32
Gross foreign assets (in millions of U.S. dollars)	0	16	24	47	44
Of which : Oil/gas revenue savings	0	3	7	11	13

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

1/ Figures after 1999 exclude unrecorded border trade.

2/ Exclude oil/gas revenues, which are recorded under the income (royalties) and transfers (tax revenues).

Table 7. Timor-Leste: Medium-Term Outlook, 2002–2007

	2002	2003	2004	2005	2006	2007
	Est.	Proj.				
Output and prices						
GNP at current prices (in millions of U.S. dollars)	394	369	381	408	456	498
GDP	378	338	326	343	372	405
Oil/gas income	16	32	55	65	84	93
Real GDP growth (percentage change)	3	-2	1	3	4	5
Inflation (percentage change at end-period) 1/2/	5	4	3	3	3	3
	(In percent of GDP)					
Investment-saving balance						
Gross investment 3/	32	30	29	27	25	25
Gross national savings	-41	-29	-13	-7	-1	2
External savings	73	59	42	34	26	23
Government budget (CFET) 4/						
Revenues	12.4	18.0	27.3	25.8	29.0	27.2
Domestic revenues	4.9	5.3	5.4	5.4	5.5	5.5
Oil/gas revenues	7.5	12.7	21.9	20.3	23.5	21.6
Expenditure	19.7	23.9	24.8	25.7	26.5	27.1
Recurrent expenditure	16.3	20.1	20.8	20.4	19.9	18.7
Capital expenditure	3.5	3.7	4.0	5.3	6.6	8.3
Overall balance	-7.4	-5.8	2.5	0.1	2.5	0.1
Money and credit						
Broad money 5/6/	15	16	...	...	...	...
Net domestic assets 6/	-10	-11	...	...	...	...
	(In millions of U.S. dollars)					
External sector						
Current account excluding official transfers	-230	-212	-169	-125	-112	-106
Current account including official transfers	37	19	21	5	-2	-3
Trade balance	-180	-163	-146	-128	-124	-123
Merchandise exports 7/	6	7	8	10	13	14
Merchandise imports	-186	-171	-155	-138	-137	-137
Overall balance	23	-3	17	13	5	5
	(In percent of GDP)					
Current account excluding official transfers	-61	-63	-52	-36	-30	-26
Current account including official transfers	10	6	6	2	-1	-1
Trade balance	-48	-48	-45	-37	-33	-30
Merchandise exports 7/	2	2	3	3	3	3
Merchandise imports	-49	-51	-47	-40	-37	-34
Overall balance	6	-1	5	4	1	1

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

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

2/ The figure for the latest month in 2003 (April) is 7 percent on a year-on-year basis.

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

4/ On the basis of fiscal year (July-June); for example, 2002 relates to FY2002/03.

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

6/ Figure for 2003 relates to March.

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

TIMOR-LESTE: FUND RELATIONS
(As of May 31, 2003)

I. Membership Status: Joined 7/23/2002; Article VIII

II. General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	8.20	100.00
Fund holdings of currency	8.20	99.99
Reserve position in Fund	0.00	0.01

III. SDR Department:	
Net cumulative allocation	None
Holdings	None
IV. Outstanding Purchases and Loans:	None
V. Financial Arrangements:	None
VI. Projected Obligations to Fund:	None

VII. Exchange Rate Arrangements

On January 24, 2000, the U.S. dollar was adopted as the official currency of then East Timor by the United Nations Transitional Administration in East Timor (UNTAET). This arrangement has been maintained after Timor-Leste's independence on May 20, 2002. At present, the monetary authority does not undertake foreign exchange transactions; they are handled by commercial banks on the basis of rates quoted in the international markets.

VIII. Article IV Consultations

The first Article IV consultation discussions with the authorities were held during April 2–15, 2003.

IX. Technical Assistance

Since late 1999, a significant amount of technical assistance has been provided by the Fund as part of the international community's efforts to reconstruct the Timor-Leste economy in the aftermath of the 1999 destruction. The Fund's technical assistance has focused on establishing key economic institutions (especially fiscal and monetary authorities) essential for macroeconomic management, as well as on developing local capacity to manage them. It also played a key role in the adoption of a new currency arrangement based on the U.S. dollar. Between late 1999 and 2003, numerous technical assistance missions (including staff visits) took place, making Timor-Leste one of the largest recipients of Fund technical assistance.

FAD: A series of multi-topic FAD missions have taken place to establish and develop the Central Fiscal Authority (February 2000), which now functions as the Ministry of Planning and Finance. In this connection, assistance has been provided to develop budget preparation, establish tax policy and administration, strengthen treasury and expenditure management, and advise on oil sector fiscal regimes, and the establishment of a petroleum fund. In addition, long-term resident advisors have been assigned to the Ministry of Planning and Finance and the Revenue Service of Timor-Leste to advise the authorities on a number of fiscal areas (including budget policy and tax administration) partly under a cost-sharing arrangement with the UN.

LEG: A number of LEG missions have taken place to advise the authorities on key fiscal and financial legislation. These included the customs law and directives, income tax legislation, the budget and financial management law, and banking regulations.

MFD: A large number of MFD missions have taken place to establish and develop the Central Payments Office (CPO (January 2000)), which was transformed into the Banking and Payments Authority subsequently (November 2001). To this end, assistance has been provided to establish a payment system, prepare banking legislation, and develop key functions of the monetary authority, including banking supervision, asset management, accounting, and organization and management. Technical assistance has also been provided on the introduction of a dollar-based currency system. More recently, the authorities have been assisted in developing a legal framework for insurance companies and issuing domestic coins to supplement the use of U.S. dollar coins. In addition, long-term resident advisors, including on bank supervision, payments, and accounting, have been assigned to the CPO and the Banking and Payments Authority under a cost sharing arrangement with the UN.

STA: A multi-sector statistical mission took place in November 2000 to assess the availability of official macroeconomic data and their quality and help establish the Statistics Division of the Ministry of Economic Affairs and Development. Since November 2001, a long-term statistical advisor has been assigned to assist the authorities in improving data compilation and developing local capacity.

X. Resident Representative

A Resident Representative office was established in Dili in August 2000. Since March 2002, Mr. Kadhim Al-Eyd has taken up the post as Senior Resident Representative.

TIMOR-LESTE: RELATIONS WITH THE WORLD BANK GROUP
(As of April 30, 2003)

Timor-Leste joined the World Bank Group on July 23, 2002. It became eligible for IDA assistance on October 9, 2002. Thus far, there has been no lending to Timor-Leste, reflecting the authorities' policy to avoid external borrowing, including concessional loans. However, the World Bank has been actively involved in the reconstruction and development of the economy since late 1999, by playing a key catalytic role in mobilizing and coordinating international assistance to Timor-Leste.

During the transition to independence, the World Bank's involvement centered around its role as a trustee and co-manager of the Trust Fund for East Timor (TFET), which was established in December 1999 as a vehicle to provide grant assistance for reconstruction activities and economic development in Timor-Leste.[1] Under the TFET, which is comanaged with the Asian Development Bank (AsDB), the World Bank has administered projects relating to social services (especially health and education), agriculture, private sector development, and economic capacity building, while the AsDB has been responsible for projects in the areas of infrastructure rehabilitation and microfinance. Total funding for the World Bank-administered projects reached \$113 million, of which \$70 million was disbursed by end-April 2003. The World Bank has also provided analytical and advisory services, including a Country Economic Memorandum, a Poverty Assessment Paper, and a Public Expenditure Management and Accountability Note.

In addition to its involvement through the TFET, the World Bank has also been playing a key role in developing assistance for the post-independence period, especially a period before the inflow of substantial oil/gas revenues starts. As an initial step for such assistance, the World Bank approved the Transition Support Program I (TSP I, \$5 million grant in support of the FY2002/03 budget) in July 2002, focusing on fostering the development of institutions, a legislative framework, and management systems required for core government functions. The program was also used as a unifying framework for donors' budget support for FY2002/03, mobilizing \$28 million from ten bilateral donors. A follow-up program, TSP II (\$4 million grant in support of the FY2003/04 budget), is currently under preparation.

Prior to Timor-Leste's independence, the World Bank cochaired six biannual donors' meetings with the UN. After independence, the World Bank has cochaired a donors' meeting with the Timor-Leste government ("Timor-Leste and Development Partners Meeting") in December 2002 and June 2003.

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[1]Pledges to the TFET were made by 12 donor countries, the European Commission, and the World Bank, with the total amount of funds reaching \$177 million. This comprises donors' contributions of \$169 million (including \$10 million by the World Bank) and investment income of \$8 million. Of this total, \$122 million was disbursed by end-April 2003. TFET projects are expected to wind down by end-2005.

TIMOR-LESTE: RELATIONS WITH THE ASIAN DEVELOPMENT BANK
(As of April 30, 2003)

Timor-Leste joined the Asian Development Bank (AsDB) on July 24, 2002. To date, there has been no lending to the country, reflecting the authorities' policy to avoid external borrowing, including concessional loans. However, like other international financial institutions and bilateral donors, the AsDB has been actively involved in the reconstruction and development of the economy since late 1999.

The AsDB's involvement has centered around comanaging with the World Bank the Trust Fund for East Timor (TFET), which was established in December 1999 as a vehicle to provide grant assistance for reconstruction activities and economic development in Timor-Leste.[1] Under the TFET, the AsDB has managed six projects with total funding of \$53 million,[2] which aimed at the rehabilitation of physical infrastructure (rural power, rural roads, ports, and water and sanitation) and the development of microfinance. In the wake of the postreferendum destruction, the focus of the projects was on providing emergency assistance, but subsequently shifted to meeting the country's long-term development needs. At end-April 2003, disbursements for AsDB-managed projects totaled \$44 million. Most projects are expected to be completed by end-2004.

The AsDB has also been actively involved in technical assistance. Thus far, the AsDB has approved 20 technical assistance programs totaling \$8.7 million. Most technical assistance programs have been undertaken in parallel with the implementation of the TFET-funded projects, focusing on project preparation and sector-specific capacity/institution building essential for project implementation. The latter includes the development of regulatory and legislative frameworks; the analysis of sectoral policy issues; poverty assessment and statistics; and strategies for economic and social development and planning. As of April 2003, 11 technical assistance programs were completed and 9 programs were still going on.

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[1] Pledges to the TFET were made by 12 donor countries, the European Commission, and the World Bank, with the total amount of funds reaching \$177 million. This comprises donors' contributions of \$169 million (including \$10 million by the World Bank) and investment income of \$8 million. Of this total, \$122 million was disbursed by end-April 2003. TFET projects are expected to wind down by end-2005.

[2] These projects comprise the Emergency Infrastructure Rehabilitation Project (\$29.8 million); the Emergency Infrastructure Rehabilitation Project 2 (\$9 million); the Water Supply and Sanitation Rehabilitation Project (\$4.5 million); the Water Supply and Sanitation Rehabilitation Project 2 (\$4.5 million); the Hera Fisheries Port Facilities Rehabilitation Project (\$1 million); and the Microfinance Development Project (\$4 million).

TIMOR-LESTE: STATISTICAL ISSUES

Prior to 1999, macroeconomic data in Timor-Leste (including national accounts, prices, labor, provincial budget, and money and credit) were compiled by the Indonesian Central Bureau of Statistics (Badan Pusat Statistik (BPS)) and the Central Board of Statistics of the East Timor Province. While these data provided useful economic information, their improvement was viewed as necessary especially in terms of coverage and methodology. The most serious data problem lay in balance of payments statistics, which were almost nonexistent as Timor-Leste was treated as one of the Indonesian provinces.

Compilation of macroeconomic data was seriously disrupted in 1999, as the turmoil of that year led to the destruction of databases and to the collapse of the institution as a result of the departure of most statistical officers. Under the economic reconstruction process beginning late 1999, efforts have been made to begin the compilation of key macroeconomic data through technical assistance provided by international financial institutions and bilateral donors.

To this end, a multi-sector Fund statistics mission visited Dili in November 2000 and assisted the authorities in establishing short- and long-term objectives for the restoration of economic statistics and in setting up a Statistics Office with the Ministry of Economic Affairs and Development in 2001, which was transformed to the Statistics Division of the Ministry of Planning and Finance in 2002. Also, a long-term resident STA advisor has been attached to the Statistics Division since November 2001 to lay a basis for compilation of macroeconomic data while developing local capacity. Nonetheless, progress in data compilation has been slow, constrained by the nascent institutional capacity, and macroeconomic data remain very weak, especially in terms of availability, coverage, and quality.

National accounts

No official national accounts statistics are compiled at present, mainly because of the lack of sectoral data. Under a World Bank-financed project, however, national accounts data for 2000 (both on a sectoral and expenditure basis) were estimated by the Boston Institute for Developing Economies. Also, Fund staff have produced estimates for 1999–2002 on the basis of information obtained during staff visits. These estimates are highly preliminary, and there is an urgent need to develop sectoral data as an initial step toward the compilation of official national accounts data.

Prices, employment, and wages

A consumer price index is currently compiled by the Statistic Division on a monthly basis for Dili and on a quarterly basis for the whole of Timor-Leste. The index was compiled on the basis of rupiah prices until April 2000; since then it has been compiled in terms of U.S. dollars, as all prices began to be quoted in the U.S. currency under the dollarization policy. However, the consumer price index is subject to a number of problems, including its weight scheme, which is based on a household expenditure survey conducted by the BPS for Jakarta. To address the problems, a new consumer price index for Dili is currently under preparation to revise the commodity basket and the weight scheme, so as to better reflect the expenditure composition of households. Data on public sector employment and wages are available on an annual basis through fiscal data. However, no data are compiled on private sector employment and wages, although some partial data are available through recent household surveys conducted jointly by the UNDP, AsDB, and World Bank.

Government financial statistics

Official data on the central government's revenues and expenditures are published on an annual and semi-annual basis as part of the budget preparation and review process. In addition, monthly data are available by request (mainly in connection with missions' visits) through the Budget Department of the Ministry of Finance, the Treasury, and the Revenue Services of Timor-Leste. The compilation of revenues and expenditures follows the 1986 GFS classification (including expenditure data on the basis of both functional and economic classification), and steps need to be taken in order to compile the data on the basis of the *Government Finance Statistical Manual 2001*. However, data on financing are incomplete and estimated by Fund staff based on various sources. Only limited data are available on fiscal and quasi-fiscal activities undertaken by bilateral donors and special funds established for economic reconstruction outside the central government budget (e.g., the TFET). At present, there are three nonfinancial public enterprises, and only partial data are available on their operations.

Monetary accounts

Monetary statistics on the banking system are compiled by the Banking and Payments Authority (BPA), following the classification recommended by the Fund. However, monetary survey data are incomplete because of the absence of official data on currency holdings by the public, which are difficult to compile under the current currency regime. Monetary statistics are not published on a regular basis at present and are available only by request. Compilation of data on interest rates (both deposit and lending rates) has begun only recently. Also, the desegregation of data on bank lending and investment is limited.

Balance of payments

No official data on the balance of payments are available, except for data on merchandise exports and imports. Trade data are compiled on the basis of customs data, and available on a monthly basis starting March 2000. However, the data are viewed as incomplete, because they do not include unrecorded border trade, which is estimated to be substantial, and because no detailed commodity breakdown is available at present. Data on oil/gas revenues are currently recorded under the income account (for royalties) and under transfers (for tax revenues) on the basis of fiscal data, as no comprehensive information on production and investment in the oil/gas sector is available. All other major balance of payments data, including the services account, transfers, and capital transactions, are estimated by Fund staff on the basis of information obtained during staff visits from various sources, including bilateral donors.

Timor-Leste: Reporting of Main Statistical Indicators[1]

(As of May 31, 2003)

<table>
<tr><th></th><th>Exchange rates [2]</th><th>International reserves</th><th>BPA balance sheet</th><th>Bank deposits[3]</th><th>Interest rates</th><th>Consumer price index</th><th>Exports / imports</th><th>Current account balance</th><th>Overall government balance</th><th>GDP/GNP</th><th>External debt</th></tr>
<tr><td>Date of latest observation</td><td rowspan="8">Not applicable</td><td>04/03</td><td>04/03</td><td>04/03</td><td rowspan="8">Data not available</td><td>04/03</td><td>12/02</td><td rowspan="8">Data not available [4]</td><td>03/03</td><td rowspan="8">Data not available</td><td rowspan="8">No external debt contracted</td></tr>
<tr><td>Date received</td><td>05/03</td><td>05/03</td><td>05/03</td><td>05/03</td><td>1/03</td><td>04/03</td></tr>
<tr><td>Frequency of data [5]</td><td>M</td><td>M</td><td>M</td><td>M</td><td>M</td><td>Q</td></tr>
<tr><td>Frequency of reporting</td><td>M</td><td>M</td><td>M</td><td>M</td><td>V</td><td>Q</td></tr>
<tr><td>Source of update [6]</td><td>G</td><td>G</td><td>G</td><td>G</td><td>G</td><td>G</td></tr>
<tr><td>Mode of reporting [7]</td><td>E</td><td>E</td><td>E</td><td>E</td><td>E</td><td>E</td></tr>
<tr><td>Confidentiality</td><td>No</td><td>No</td><td>No</td><td>No</td><td>No</td><td>No</td></tr>
<tr><td>Frequency of publication</td><td>Q</td><td>Q</td><td>Q</td><td>R</td><td>R</td><td>R</td></tr>
</table>

[1] Most data not officially published. Timor-Leste has not started official reporting to the Fund.
[2] The domestic currency is the U.S. dollar.
[3] Because of dollarization, the stock of currency in the hands of the public is not known.
[4] Data on services, investment income, and transfers are not available.
[5] M-monthly, Q-quarterly, A-annually, V-irregularly, generally in conjunction with staff visits.
[6] G-Authorities.
[7] E-electronic data transfer, F-cable or facsimile, V-staff visits.

TIMOR-LESTE: SUMMARY OF THE EXCHANGE AND PAYMENTS SYSTEM

(Position as of April 30, 2003)

I. Status Under IMF Articles of Agreement

1. Date of membership	Yes	July 23, 2002.
Article VIII	Yes	

II. Exchange Arrangement

1. Currency		The currency of the Democratic Republic of Timor Leste is the U.S. dollar.
a. Other legal tender	No.	
2. Exchange rate structure		
a. Unitary	Yes	
3. Classification		
a. Exchange arrangement with no separate legal tender	Yes	The dollar is legal tender and circulates freely. The current currency regime provides no scope for an independent exchange rate policy. Foreign exchange transactions are effected through two (foreign-owned) commercial banks and one licensed currency exchange bureau.
4. Exchange tax	No	
5. Exchange subsidy	No	
6. Forward exchange market		
a. Official cover of forward operations	No	

III. Arrangements for Payments and Receipts

1. Prescription of currency requirements		
a. Controls on the use of domestic currency		All domestic transactions and settlements must be in the domestic currency (U.S. dollar).
b. Use of foreign exchange among residents		Withdrawals from bank accounts denominated in foreign currencies must be made in U.S. dollars, though bank transfers from foreign currency accounts abroad may be made in foreign currencies.
2. Payments arrangements	None	
3. Administration of control		Overall responsibility for the administration of exchange controls rests with the BPA, which has the power to regulate payment and settlement systems in domestic and foreign currency.
4. International security restrictions	No	
5. Payments arrears	No	
6. Controls on trade in gold (coins and/or bullion)	No	

7. Controls on exports and imports of banknotes		
a. On exports	No	
b. On imports		
1. Domestic currency	No	
2. Foreign currency	Yes	Imports of foreign currencies exceeding the equivalent of $2,000 are prohibited without a permit from the BPA; imports of those currencies whose issuers maintain export restrictions are limited to equivalent to $500 without a permit from the BPA

IV. Resident Accounts

1. Foreign exchange accounts permitted		
a. Held domestically	No restriction	There are no restrictions on the holding of foreign exchange accounts, but withdrawals from the accounts should be made in domestic currency (U.S. dollar).
Approval required	No	
b. Held abroad	No restrictions	
Approval required	No	
2. Accounts in domestic currency held abroad	No restricitons	
3. Accounts in domestic currency convertible into foreign currency	Restricted	Withdrawals from bank accounts in foreign currency are prohibited.

V. Nonresident Accounts

1. Foreign exchange accounts permitted	No restrictions	
a. Approval required	No	
2. Domestic currency accounts	No restrictions	
a. Convertible into foreign currency		Withdrawals from bank accounts in foreign currency are prohibited.
b. Approval required	No	
3. Blocked accounts	No	

VI. Imports and Import Payments

1. Foreign exchange budget	No	
2. Financing requirements for imports	No	
3. Documentation	No	

requirements for release of foreign exchange for imports		
4. Import licenses and other nontariff measures	No	
5. Import taxes and/or tariffs		
a. Taxes collected through the exchange system		There are no quantitative restrictions on imports. With the exception of selected items (e.g., cigarettes and alcohol with certain limits, household effects of returning former residents), a uniform ad-valorem tariff (6 percent) is levied on all imports. Also, excise taxes are levied on imports of selected goods at specific or ad-valorem rates (12 percent) depending on types of goods. In addition, the sales tax (6 percent) is levied on the sum of customs value, import duty, and excise payable.
6. State import monopoly	No	

VII. Exports and Export Proceeds

1. Repatriation requirements	No	
2. Financing requirements	No	
3. Documentation requirements	No	
4. Export licenses	No	
5. Export taxes	No	

VIII. Payments for Invisible Transactions and Current Transfers

Controls on transfers	No	

IX. Proceeds from Invisible Transactions and Current Transfers

1. Repatriation requirements	No	
2. Restrictions on use of funds	No	

X. Capital Transactions

A. Controls on capital transactions		
1. Controls on capital and money market instruments	No	No domestic capital and money markets have developed yet.
2. Controls on derivatives and other instruments	No	
3. Controls on credit	No	

operations		
4. Controls on direct investment	No	
5. Controls on liquidation of direct investment	No	
6. Controls on real estate transactions		
a. Purchase abroad by residents	No	
b. Purchase locally by nonresidents	Yes	The constitution prohibits ownership of land by foreigners.
c. Sale locally by nonresidents	Yes	The constitution prohibits ownership of land by foreigners.
7. Controls on personal capital transactions	No	
8. Provisions specific to commercial banks and other credit institutions		
a. Borrowing abroad	No	
b. Maintenance of accounts abroad	No	
c. Lending to nonresidents (financial or commercial credits)	No	
d. Lending locally in foreign exchange	Yes	All domestic transactions must be made in the domestic currency.
e. Purchase of locally issued securities denominated in foreign exchange	Yes	All domestic transactions must be denominated in the domestic currency.
f. Differential treatment of deposit accounts in foreign exchange	No	
g. Differential treatment of deposit accounts held by nonresidents	No	
h. Investment regulations	No	
i. Open foreign exchange position limits	No	
9. Provisions specific to institutional investors	No	
10. Other controls imposed by securities laws	No	

Changes During 2002

Fund status	July 23, 2002	Timor-Leste became Fund member.
Imports and import payments	July 1, 2002	The import duty was raised from 5 percent to 6 percent; the ad-valorem rates of excise taxes were raised from 10 percent to 12 percent and their specific rates were increased by 10-170 percent; and sales tax was raised from 5 percent to 6 percent.

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IMF Concludes 2003 Article IV Consultation with the Democratic Republic of Timor-Leste

On July, 14, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Democratic Republic of Timor-Leste.[1]

Background

Timor-Leste gained independence on May 20, 2002, which also marked the end of the 2½-year rule of the United Nations Transitional Administration in East Timor (UNTAET). The establishment of the transitional administration followed the widespread violence and destruction that erupted in reaction to a national referendum held in August 1999, which overwhelmingly supported then East Timor's independence from Indonesia. Notwithstanding some early political challenges, the new government has endeavored to consolidate its administrative reach in the context of a reduced international presence, while taking initial steps toward nation-building as set out in the National Development Plan (NDP). Timor-Leste joined the Fund and the World Bank Group on July 23, 2002.

With poor infrastructure, limited administrative capacity, and nascent institutions, Timor-Leste is one of the most underdeveloped economies in the region. Per capita GDP is estimated at about US$470 in 2001, and underemployment is widespread. Key social indicators, including life expectancy, and health and education indices, are also low. The economy is marked by subsistence agriculture (accounting for one-fourth of GDP and three-fourths of employment)

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

and a limited foreign exchange earning capacity. Over the medium term, however, Timor-Leste is expected to benefit significantly from the commercial exploitation of oil/gas resources in the Timor Sea, which is projected to increase government revenues sharply.

The economy is still in the process of reconstruction from the turmoil of 1999. During the turmoil, two-thirds of the physical infrastructure is estimated to have been destroyed, and key economic institutions collapsed as a result of the departure of civil servants and experts, leading to a sharp fall in output (by more than 30 percent). Under the UNTAET, the reconstruction process began with significant financial support from the international community. With substantial technical assistance from the IMF, the fiscal and monetary authorities were reestablished and initial steps were taken to develop a statistics office. Also, the U.S. dollar was adopted as the official currency in January 2000. However, these institutions are still in their infancy, relying heavily on international experts, and their further development remains a major challenge for the authorities.

The NDP covering FY2002/03-2006/07 (fiscal year: July-June), prepared on the basis of a nationwide consultation process, lays out the attainment of higher growth (about 5 percent over the medium term) and the alleviation of poverty as two major principal objectives. The NDP recognizes that the development of a dynamic private sector and the building-up of institutions and local capacity, together with the maintenance of a stable macroeconomic environment, are critical for the realization of the growth target. To flesh out the NDP in operational terms and incorporate actions set out under a short-term priority program (the "stability program," focusing on good governance and job creation), a medium-term action plan (the Road Map) covering four years through FY2006/07 was worked out in early 2003.

Economic activity initially exhibited a strong recovery from the post-referendum destruction. Real GDP reached close to pre-crisis levels, aided by the large international presence and a rebound in agricultural production. However, growth has moderated substantially since mid-2002 as a result of a winding-down of the international presence. CPI inflation fell from 140 percent at end-1999 to 7 percent at end-April 2003 (on a year-on-year basis) in response to the increased availability of basic goods, as well as the adoption of the U.S. dollar-based currency system. The external current account has been in large deficit, reflecting substantial imports associated with donor-assisted reconstruction activities. The deficit, however, has been more than financed by official transfers, and the external current account inclusive of these transfers has been in surplus.

Central government budgetary operations have been marked by large deficits, reflecting pressing needs for reconstruction expenditures in the face of limited revenues. The deficits have been financed mostly through cash grants from donors, due to the lack of access to domestic borrowing and the authorities' cautious approach to external borrowing. Progress has been made in restoring the banking system, which now comprises the monetary authority, three foreign-owned commercial banks, and a microfinance institution. Deposits also increased substantially over the last three years. Nonetheless, the banking system is still at an early stage of development, with financial intermediation limited by the lack of viable domestic lending opportunities and an underdeveloped legal framework.

Executive Board Assessment

Executive Directors extended a warm welcome to Timor-Leste as the Fund's newest member. Directors commended Timor-Leste's impressive strides in recovering from the turmoil of 1999 under a reconstruction program supported by the international community. Real GDP has rebounded, inflation has moderated, and basic institutions for economic management have been restored. However, Directors stressed that the successful recovery from the turmoil is only the initial step toward addressing the enormous economic challenges facing the country, particularly poverty reduction. Noting the slowdown in business activity due to a winding-down of the international presence, they underscored the critical importance of strengthening growth prospects over the coming years while maintaining a stable macroeconomic environment. They considered the National Development Plan, which was prepared with the wide participation of the civil society, to be an appropriate basis for achieving these objectives.

Directors stressed that fiscal policy should bear the major burden of sustaining macroeconomic stability in view of the dollarization of the economy. Supporting the cautious external borrowing policy, they agreed that the thrust of fiscal policy in the short term should be to adjust overall expenditure in accordance with available fiscal resources, while meeting essential development and social needs. They welcomed the adoption of this principle in the budget for fiscal year 2003/04. To make the budget credible, they underscored the importance of improving expenditure execution and further strengthening tax administration to realize budgeted revenues.

Directors expressed concern about the financial problems facing the power authority, which have necessitated substantial budgetary transfers. They welcomed the authorities' decision to address poor management and bill collection through the introduction of an external management contract, and the adoption of a prepaid meter system. They urged prompt implementation of these reforms, as part of a longer-term strategy for the management of the power utility, in order to keep the budget on a sustainable path.

Directors stressed that a major challenge for fiscal policy in the medium term is how best to use the growing oil and gas revenues to promote growth and alleviate poverty, while safeguarding macroeconomic stability and a sound fiscal position. They encouraged development of a medium-term fiscal strategy that addresses the issue of the appropriate size of drawdowns on oil and gas wealth. While acknowledging that increased investment in infrastructure and human capital is needed, Directors advised the authorities to tailor the investment program to the country's absorptive capacity. In addition, they stressed the importance of domestic revenue mobilization to reduce the excessive dependence on oil and gas revenues, which are subject to volatile price fluctuations.

Against this background, Directors supported the authorities' plan to introduce a petroleum fund, noting that the principal objective of such a fund should be to enhance transparency and accountability in the management of oil and gas revenue so as to avoid corruption and mismanagement. They stressed that the key to effective functioning of a petroleum fund is the maintenance of a prudent fiscal policy. They welcomed the authorities' intention to follow the recommendations made by the technical assistance mission from the Fund's Fiscal Affairs Department regarding the operations of such a fund.

Directors endorsed the authorities' plan to maintain the current monetary and exchange rate regime and avoid introduction of a national currency for the time being. They observed that the current regime has contributed to financial stability, and is a workable framework given limited institutional capacity and lack of financial and market development. Directors welcomed the banking sector's steady recovery from the 1999 turmoil, but observed that financial intermediation needs to be improved in order to reduce interest rate spreads and make adequate credit available to the private sector. Directors were encouraged by the authorities' efforts to combat money laundering and terrorism financing, and urged enactment of legislation in this area compatible with international standards.

Directors considered private sector development to be crucial to Timor-Leste's growth prospects. They stressed the urgency of establishing a proper legal and regulatory framework for business activity, especially an independent judiciary, and encouraged early preparation and parliamentary approval of legislation for this purpose. They commended the authorities' intentions to maintain a liberal trade and investment regime, and to avoid administrative interference in the free functioning of the market mechanism, which are especially important for attracting foreign investment.

Directors emphasized that capacity building is a prerequisite for economic development in Timor-Leste. They noted the progress in institutional development over the last three years, especially in the area of economic management, but stressed that considerable work remains to be done. They therefore encouraged early development of a medium-term capacity-building program for the Ministry of Planning and Finance, and strengthening of the autonomy of the monetary authority.

Directors noted significant weaknesses in Timor-Leste's macroeconomic database, especially in the areas of the national accounts and the balance of payments. They welcomed the Fund's technical assistance in this area, and urged enactment of a statistical law as the first step toward improving the database.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Timor-Leste is also available.

The Democratic Republic of Timor-Leste: Selected Economic Indicators, 1999–2003

	1999	2000	2001	2002	2003
		Est.			Proj.
Output and prices					
GNP at current prices (in millions of U.S. dollars)	270	328	397	394	369
GDP	270	321	385	378	338
Oil/gas income	0	7	12	16	32
Real GDP growth (percentage change)	-35	15	17	3	-2
Inflation (percentage change at end-period) 1/2/	140	3	0	5	4
		(In percent of GDP)			
Investment-saving balance					
Gross investment 3/	21	29	36	32	30
Gross national savings	-13	-44	-44	-41	-29
External savings	34	73	80	73	59
Government budget (CFET) 4/					
Revenues	...	7.7	8.2	12.4	18.0
Domestic revenues	...	4.0	5.4	4.9	5.3
Oil/gas revenues	...	3.7	2.8	7.5	12.7
Expenditure	...	14.5	13.8	19.7	23.9
Recurrent expenditure	...	8.4	10.7	16.3	20.1
Capital expenditure	...	6.1	3.0	3.5	3.7
Overall balance	...	-6.8	-5.5	-7.4	-5.8
Money and credit					
Broad money 5/6/	48	6	13	15	16
Net domestic assets 6/	47	-4	-4	-10	-11
		(In millions of U.S. dollars)			
External Sector					
Current account excluding official transfers	-92	-237	-257	-230	-212
Current account including official transfers	6	68	45	37	19
Trade balance	-67	-213	-212	-180	-163
Merchandise exports 7/8/	52	5	4	6	7
Merchandise imports 7/	-119	-218	-216	-186	-171
Overall balance	0	16	8	23	-3
		(In percent of GDP)			
Current account excluding official transfers	-34	-74	-67	-61	-63
Current account including official transfers	2	21	12	10	6
Trade balance	-25	-66	-55	-48	-48
Merchandise exports 7/8/	19	2	1	2	2
Merchandise imports 7/	-44	-68	-56	-49	-51
Overall balance	0	5	2	6	-1

Sources: Data provided by the Timor-Leste authorities; and IMF staff estimates.

1/ Rupiah-based CPI for Dili through 2000 and, thereafter, dollar-based CPI for Dili.

2/ The figure for the latest month in 2003 (April) is 7 percent on a year-on-year basis.

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

4/ On the basis of fiscal year (July-June); for example, 2000 relates to FY 2000/01.

5/ Figures after 1999 exclude currency holdings by the public, on which no data are available.

6/ Figure for 2003 relates to March.

7/ Figures after 2003 exclude unrecorded border trade.

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