February 2007
IMF Country Report No. 07/79

Democratic Republic of Timor-Leste: 2006 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director 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 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 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 20, 2006, 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 December 27, 2006. 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 January 29, 2007 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for the Democratic Republic of Timor-Leste.

The document listed below has 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 2006 Article IV Consultation

Prepared by the Staff Representatives for
the 2006 Consultation with Timor-Leste

Approved by Daniel Citrin and Mark Plant

December 27, 2006

- Article IV discussions took place in Dili during March 1–14 and resumed in October 9–20 after the mid-year civil unrest, which led to a change of government. Discussions were held with Prime Minister Ramos-Horta, previous Prime Minister Alkatiri, Finance Minister Boavida, General Manager of the Banking and Payment Authority De Vasconselos, other senior officials, and representatives of donors, the business community, and civil society.

- In addition to Ms. Creane (head), the staff teams included Ms. Fichera, Ms. Oura, (all APD) and Mr. Kim (FAD) in March, and Ms. Mineshima, Mr. Thomas (all APD), and Mr. Norregaard (FAD) in October. Mr. Rasmussen (Resident Representative) assisted both missions and Mr. Saramago (OED) joined the discussions in March. The teams coordinated with the World Bank and the Asian Development Bank.

- The last Article IV consultation was concluded on June 15, 2005, and Directors' comments can be found at http://www.imf.org/external/np/sec/pn/2005/pn0592.htm.

- Timor-Leste uses the U.S. dollar as its official currency. It has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

- Data provision to the Fund is not adequate for effective surveillance, as significant weaknesses remain in the macroeconomic data, especially in the balance of payments and the national accounts (Appendix II, Annex IV).

- The authorities indicated their intention to publish the staff report and background documents. A press statement was issued by the Resident Representative office at the end of the consultation.

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EXECUTIVE SUMMARY

Economic and Policy Developments

- **The mid-2006 outbreak of violence and political instability disrupted private and public sector activity.** Real non-oil GDP growth in 2006 is estimated to be negative. However, the end-year re-escalation of donor activity and higher public spending should contribute to a sharp rebound in growth in 2007.

- **High oil and gas prices and production led to sizeable twin fiscal and current account surpluses** of 111 percent and 93 percent of non-oil GDP, respectively, in 2006. Petroleum fund assets should exceed 250 percent of non-oil GDP.

- **Progress on reforms needed to encourage non-oil private sector activity has stalled following the crisis.** The overall business environment remains weak, the legislative structure incomplete and the judicial system fragile.

- **Medium-term macroeconomic prospects have become more uncertain**. The outlook is highly sensitive to oil-and-gas sector developments, the still unsettled political environment, and large-scale donor activity.

Key Policy Issues

- **The underlying policy challenge remains how best to use the oil-and-gas wealth to lift the non-oil economy onto a higher growth path and reduce poverty.** The new government has affirmed its commitment to the long-standing economic strategy, which the staff supports. The strategy includes stepped up public investment, adherence to an oil-and-gas saving policy and petroleum fund, and continued macro-economic stability.

- **At the same time, the authorities need to address the physical damage caused by the recent civil unrest and to restore law and order.**

- **The 2006/07 budget targets a sharp jump in spending, focused on infrastructure, human capital, and humanitarian assistance.** The staff welcomes recent innovations to address bottlenecks that have constrained capital spending, though emphasizing the need to guard against unproductive spending and increasing inflationary pressure.

- **A vibrant private sector is essential for long-term growth.** A stronger and more coordinated effort is needed to improve the business environment.

- **The authorities reaffirmed their commitment to the U.S. dollar as Timor-Leste's currency**, given its role in maintaining macroeconomic stability and still limited institutional capacity.

I. INTRODUCTION

1. **Timor-Leste had made good progress in establishing the basis for a stable and healthy economy prior to the civil unrest in 2006, though still remaining one of the poorest countries in the world (Tables 1–2, Figure 1).**[1] Real non-oil GDP rose in 2004–05 after contracting for two years following the end of the post-conflict reconstruction boom. Macroeconomic stability was achieved through the early adoption of prudent fiscal and monetary policies. However, progress toward the country's National Development Plan (NDP) objectives and Millennium Development Goals (MDGs) was limited. Further, the violence that erupted in April 2006, although now largely quelled, has introduced new risks. Nonetheless, the onset of large oil-and-gas revenue inflows and prospects for sizable additional revenue from new fields could still, if properly managed, transform the economy in the period ahead.

2. **The security situation and domestic institutions remain fragile.** The unrest, involving clashes between the army and police and between communities from different regions, was contained by the arrival of international security forces in May. However, periodic violence continues and large numbers remain internally displaced. In addition, persistent poverty and high unemployment amid rising expectations further contributes to pressures on the authorities. These developments highlight the continuing vulnerabilities in the country's institutional capacity, notwithstanding considerable nation and capacity building over recent years.[2]

3. **Against this background, increased urgency is placed on meeting the challenge of how best to use the new oil-and-gas wealth to lift the non-oil economy onto a higher growth path and reduce poverty.** The new government endorsed the pre-existing development strategy, set out in the NDP and related documents that comprise the Poverty Reduction Strategy (PRSP).[3] This strategy focuses on reforms to promote growth, including: a long-term oil-and-gas revenue saving policy supported by a petroleum fund; well-targeted development spending under the sector investment programs (SIPs); a monetary and exchange rate regime that preserves macroeconomic stability; and a private-investment-friendly environment. However, progress on the strategy has been uneven and non-oil growth still falls short of that needed to reduce poverty. In the aftermath of the recent unrest, the government plans a new Compact with donors to reinvigorate the development strategy.

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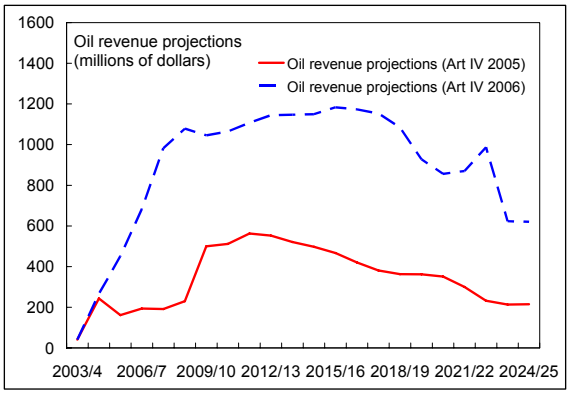
[1] Timor-Leste's independence was restored in 2002, after two decades of Indonesian rule and two years of UN administration.

[2] The most recent UN mission, UNMIT, includes a large police contingent and assistance for the 2007 parliamentary and presidential elections.

[3] The PRSP and JSAN (http://www.imf.org/external/pubs/cat/longres.cfm?sk=18437.0) http://www.imf.org/external/pubs/cat/longres.cfm?sk=18428.0 were presented to the Board together with the 2005 Article IV consultation.

II. THE CURRENT ECONOMIC SETTING

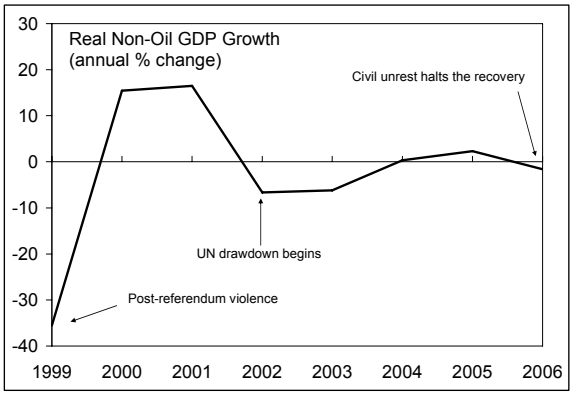
4. **High world oil-and-gas prices and increased output have raised projected revenue inflows** (Table 2, Figure 2). Oil-and-gas prices and production plans used to prepare the 2006/07 budget imply a $3 billion improvement in revenue over 2005/06–2009/10, compared with the 2005 Article IV consultation projections.

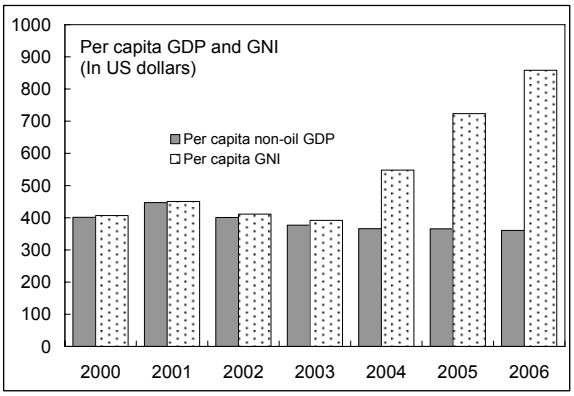


5. **Non-oil activity began to recover in 2005 as stable macroeconomic conditions and improved policies offset a scaling down of donor activity.** Real non-oil growth was estimated at 2 percent in 2005, responding to a pick-up in government spending and good weather, although still below the population growth rate of 3 percent. The acceleration of oil-and-gas production after its start in 2004 resulted in rapid GNI growth. Inflation was low through early 2006, including relative to competitors, as demand fell with the downsizing of the previous UN mission while production of basic food staples increased.

6. **However, the mid-2006 civil unrest dealt a setback to the emerging recovery.**

- The unrest paralyzed the government and disrupted private sector activity. Coffee production, the main non-oil export commodity, declined by 20 percent. Real non-oil GDP growth is estimated to be negative (about 6 percentage points lower than projected before the unrest), despite an end-year boost from public spending and international aid.

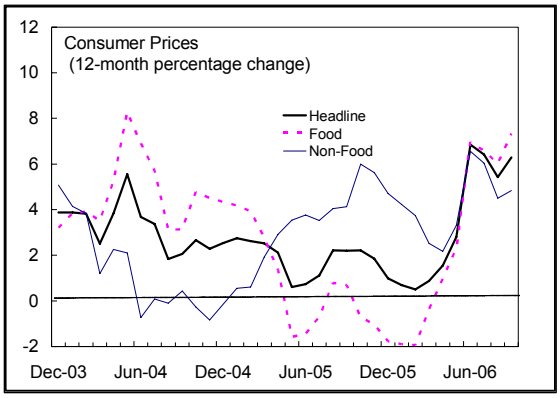


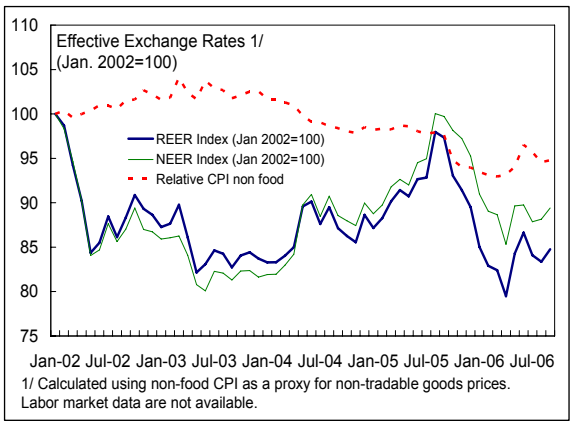


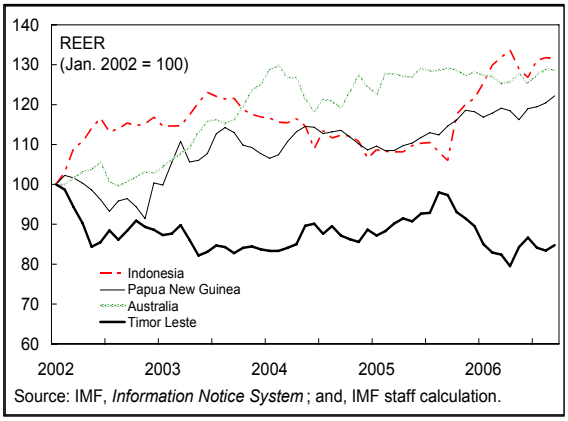
- Driven by higher transportation costs and supply disruptions, CPI inflation jumped to above 6 percent in the year to June 2006 and remains at about that level.

- The oil sector is off-shore and was not affected.

- The rise in inflation offset some of the real depreciation of the exchange rate since mid-2005. However, the real effective exchange rate (REER) remains close to previous lows in 2003.

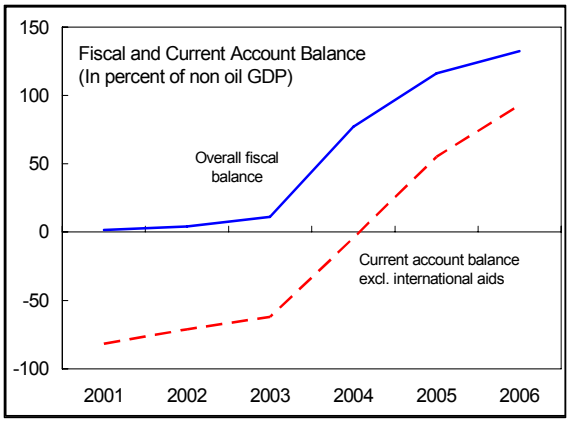






7. **Large oil-and-gas revenue inflows have led to sizeable external and fiscal surpluses, notwithstanding sharply increased government spending** (Tables 3-5).

- Oil-and-gas revenue was 128 percent of non-oil GDP in 2005/06, lifting the central government surplus to 103 percent of non-oil GDP.[4] Central government expenditure (commitments basis) of 34 percent of non-oil GDP was 13 percentage points higher than in 2004/05, but well below the annual "sustainable" spending level determined by the authorities' saving policy, estimated at 86 percent of non-oil GDP (Box 1).



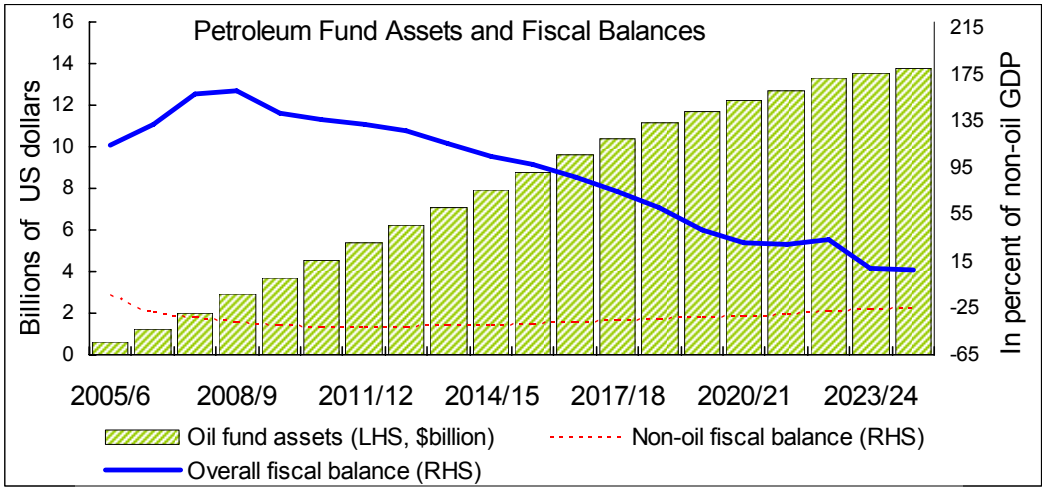
[4] The fiscal year is July–June.

Box 1. Oil Sector Policy and Outlook

Policy Features

- Inter-generational equity and fiscal sustainability are the objectives of the *long-term fiscal expenditure and saving policy,* which should also help minimize the potential for procyclical spending. Annual "sustainable" spending is equal to the sum of the estimated permanent (interest) income from the oil-and-gas wealth and domestic non-oil revenue.

- The *petroleum fund* is integrated into the central government budget and transparently managed. Transfers are subject to a spending ceiling set on the basis of the fiscal sustainability policy. Fund assets are invested abroad to limit risk and minimize real exchange rate appreciation pressures. Designated oversight bodies monitor operations and internationally recognized accounting firms conduct annual audits. All oil revenue is paid into the petroleum fund.



Outlook

- High global oil prices have boosted current and potential revenue inflows. In addition, the recently improved outlook for new oil extraction under the new treaty with Australia on the Greater Sunrise field—where the revenue potential is estimated at about 10 billion U.S. dollars (commencing in 2013)—and from newly tendered offshore blocks and promising onshore areas, could further significantly raise "sustainable" budget spending over the long-term.

- The steep increase in spending in the 2006/07 budget, approved in August, is designed in large part to respond to the recent crisis. The budget includes outlays for emergency assistance, repair of damage—including for housing reconstruction—and quick-disbursing grants for rural communities. It also contains a rise in civil servants' compensation and an increased electricity price subsidy. In addition, the budget seeks to nearly triple capital spending by accelerating implementation of the SIPs projects, especially roads, education, and power generation. Although more than doubling spending relative to 2005/06, budgeted expenditure remains just within the estimated "sustainable" level prescribed under the saving policy. Actual spending (cash basis) is expected to be much lower.

Central Government Budget
(In percent of non-oil GDP)

	2004/05	2005/06	2006/07
	Act.	Prelim.	Budget
Revenue	98	137	173
of which oil and gas	77	128	161
Expenditure (commitments)	21	34	73
Current	18	22	41
Wages and salaries	7	7	11
Goods and services	9	13	19
Subsidies and transfers	2	2	6
Capital	3	12	32
Overall balance	**76**	**103**	**100**
Memo items:			
Non-oil balance	-1	-24	-61
'Sustainable' expenditure	...	86	76
Cash expenditure 1/	21	26	40

1/ Staff estimate for 2006/07

- On a '*combined source'* basis, which includes the central government cash spending and donor spending, total expenditure in 2006/07 should increase only slightly compared to pre-2005/06 levels as increased government spending is largely offset by declining donor spending.

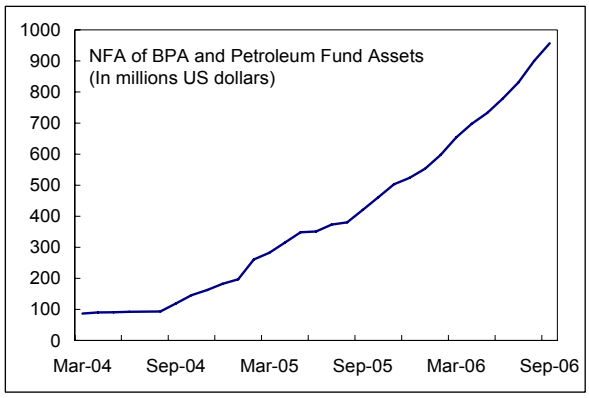
Combined Sources Expenditure and Financing
(Cash spending in percent of non-oil GDP)

	Average 2000-2004	2004/05	2005/06	2006/07
		Estimates		Proj.
Total SIPs planned expenditure 1/	69	68	62	71
financed by:				
Timor Leste revenue 2/	10	12	26	40
Budget support grants	9	10	0	2
Off-budget committed donor spending	50	45	36	29

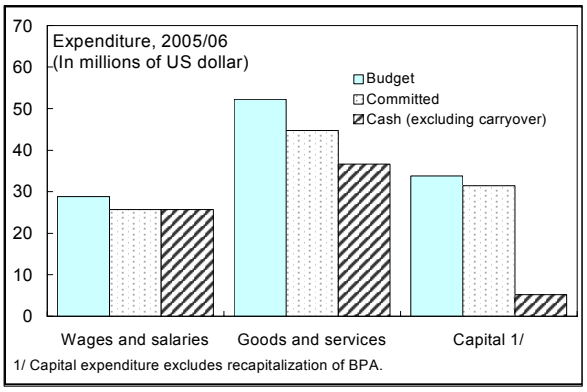
Source: Timor-Leste authorities and staff estimates.
1/ Includes autonomous agencies and off-budget projects identified under the NDP.
2/ Domestic revenue and petroleum fund transfers, net of increase in government cash balances.

- The authorities have maintained a policy of avoiding domestic or external borrowing, hence there is no public sector debt.

- A current account surplus of 93 percent of non-oil GDP (excluding international assistance) emerged in 2006. Net foreign assets of the Banking and Payments Authority (BPA), combined with the foreign assets of the petroleum fund, rose to US$957 million by September 2006 (7 years of merchandise imports).

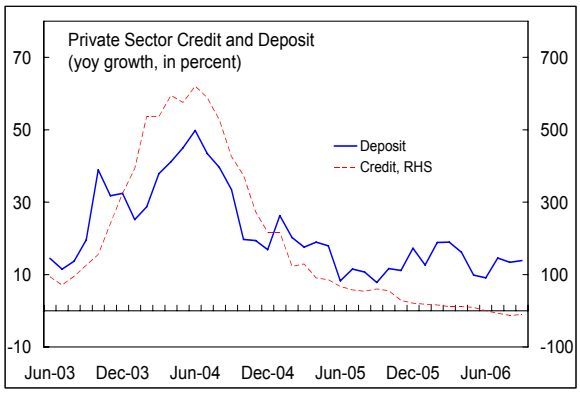


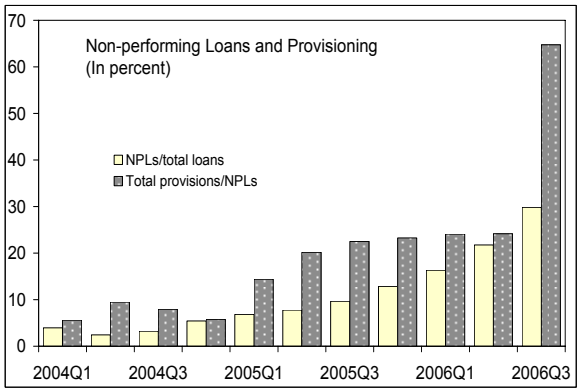
8. **Central government budget execution remains constrained by weak capacity, resulting in cash expenditure falling short of commitments.** Financial management reforms have not yet significantly eased spending constraints, particularly for capital projects, due to weak planning and procurement capacity. As a result, central government spending on a cash basis in 2005/06, estimated at 26 percent of non-oil GDP, resulted in a large and poorly monitored cash carryover.



9. **The petroleum fund became operational in July 2005**, along with the expenditure and saving policy targeting intergenerational equity and long-term fiscal sustainability. Assets in the fund reached $847 million (240 percent of non-oil GDP) at September 2006.

10. **Bank loan quality deteriorated further, post-crisis, while private credit contracted** (Table 6). The displacement of a large number of Dili residents to outlying districts following the crisis expanded the number of borrowers failing to make payments. At end-September 2006, nonperforming loans (NPLs) were 30 percent of total bank lending, while banks more aggressively provisioned for potential losses. Given still weak enforcement of creditors' rights, banks were increasingly reluctant to extend new loans; credit to the private sector fell by 10 percent on a year/year basis.





11. **Reforms needed to spur non-oil private sector activity gained some momentum prior to the crisis, but significant legal and institutional gaps remain a burden.** The World Bank ranks Timor-Leste as one of the most difficult countries for doing business. Property and business registration remain onerous, the bankruptcy law is still pending, and an overwhelmed court system is unable to handle commercial disputes. The implementation of new laws is hampered by the failure to amend related legislation or adopt regulations as needed. Poor infrastructure and lack of human capacity compound the difficulties faced in developing the non-oil economy.

Doing Business, 2006: Timor-Leste and Selected Comparators 1/

	Overall Ease	Starting a Business	Employing Workers	Registering Property	Protecting Investors	Paying Taxes	Getting Credit	Enforcing Contracts	Closing a Business
Timor Leste	174	160	115	172	142	124	159	175	151
Indonesia	135	161	140	120	60	133	83	145	136
Sub-Saharan Africa 2/	133	126	119	123	94	105	114	113	112
Asia Pacific 2/	70	70	55	77	73	61	86	89	92

Source: World Bank, *Doing Business Survey*, 2007.
1/ Countries are ranked from 1 to 175; the lower the number the easier is doing business.
2/ Average ranking (mean) for regional blocks.

12. **Administrative capacity is improving slowly, but remains low.** Service delivery for poverty reduction has improved modestly, with some success in strengthening health indicators, but there has been little progress in meeting other NDP/MDG objectives. Encouraging progress has been made at the BPA. However, for the government as a whole, the number of technical staff skilled in policy implementation remains limited. A new donor-supported Planning and Financial Management Capacity Building Program aims to strengthen capacity.

III. Policy Discussions

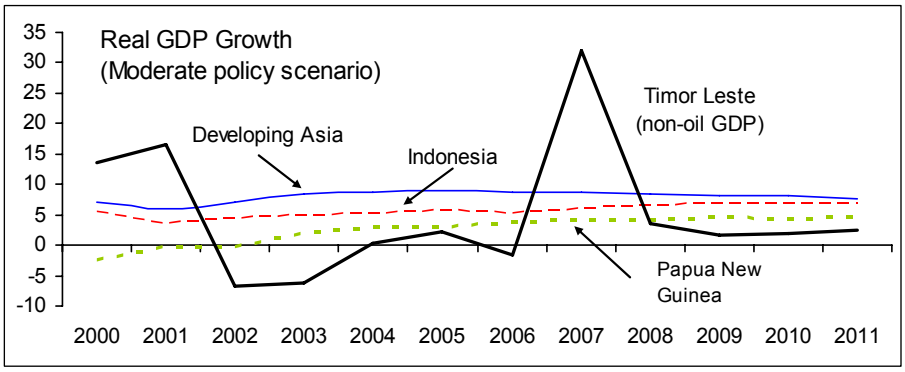
13. **The discussions focused on the policies needed to lift growth to a higher sustainable path and alleviate poverty over the medium term, while recognizing the need to respond to the crisis in the short term.** As a new country with weak institutions and infrastructure, but with low inflation, under-utilized labor and land, no public debt and large oil-and-gas revenues, Timor-Leste still has the potential to leap frog other low-income countries by adopting good policies and undertaking high-return public investment. The central question of the consultations

was how to ensure that the macroeconomic and structural environment remains on track to make the best use of the oil-and-gas wealth and avoid constraining growth and poverty reduction.

Review of Past Fund Surveillance		
Fund Policy Advice in 2003–04	**Status**	
	2005 Article IV Consultation	**2006 Article IV Consultation**
· Maintain current monetary and exchange regime, until institutional capacity is built and financial markets are sufficiently developed for the introduction of a national currency.	· Dollarized regime maintained and acknowledged as credible nominal anchor for macroeconomic and financial stability.	· Continued commitment to current monetary and exchange regime to allow build-up of institutional capacity and development of financial markets.
· Establish a long-term fiscal strategy to ensure the productive use of oil/gas wealth while maintaining a sustainable fiscal position for the future.	· Legislation to establish the Petroleum Fund and a supportive saving/spending policy aimed at long-term fiscal sustainability and inter-generational equity was enacted, following country-wide public consultations.	· Petroleum Fund operations started, and budget spending plans set in line with the established sustainability policy.
· Remove obstacles to budget execution to allow for faster increases in well-prioritized development spending, without creating inflationary pressures.	· Budget programs developed under the SIPs framework, allowing for better spending prioritization. Public sector wage levels kept unchanged.	· SIPs accelerated. · New measures to improve budget execution · Measures responding to civil unrest need to be well targeted. · Increase in public sector wage bill outside of wider administrative reform a concern.
· Establish a clear legal and regulatory framework for non-oil sector private activity.	· Some essential legislation passed (e.g. investment and insurance laws). Difficulties persist in implementation, including for contracts enforcement given weak judiciary.	· Investment and export promotion agency established. Other key legislation and institutions still pending.
· Strengthen capacity for effective macroeconomic management.	· Advanced discussions with donors for a broad capacity building program. Good progress with strengthening BPA capacity.	· Implementation of capacity building program needs to be accelerated. MOPF macroeconomic unit still understaffed.

Outlook for Growth and Stability

14. **The near-term outlook will be volatile in the aftermath of the crisis.** The buildup of the new UN mission and increased government spending, along with an expected gradual return to normal business conditions and rebound from depressed conditions in 2006 should contribute to a surge in economic growth by over 30 percent (20 percent excluding the UN) in 2007. Prices are expected to decline as the security situation stabilizes, especially after the spring 2007 elections.



15. **Beyond 2007, in addition to the implementation pace of the government's development strategy,** the outlook will be sensitive to developments in oil-and-gas revenue, the

security/political situation, and donor activity (especially the UN and the U.S. Millennium Challenge Account (MCA)).[5]

- Under a *moderate policy implementation* scenario that assumes a continuation of past policies, there should be further gradual progress in budget execution and in building the legal and institutional framework. Government expenditure would remain within sustainable limits. Civil service wages would rise from 7 percent to 11 percent of non-oil GDP within the pay structure expected to be introduced in 2007. Public investment would increase by 14 percent of non-oil GDP, supporting economic growth (excluding UN activities) of 4–5 percent per annum (Table 7 and Figure 3). Total investment would peak at 40 percent of non-oil GDP during 2008–11. Slow progress in improving the business environment would keep non-oil GDP growth below levels needed to significantly reduce poverty. If the fiscal expansion is, as planned, consistent with the SIPs, infrastructure projects will mainly require imports of basic materials, skilled labor and machinery, exerting little inflationary pressure.

Medium-term Outlook: Moderate Policy Implementation Scenario

	2005	2006	2007	2008	2009	2010	2011
	Est.	Projections					
Non-oil GDP growth	2.3	-1.6	32.1	3.5	1.8	1.9	2.4
Non-oil GDP growth (excl. UN)	6.2	-6.7	19.9	5.6	4.8	4.3	4.4
Total investment (in percent of non-oil GDP)	19	19	28	34	37	39	39
of which Public	15	15	23	27	29	30	29
CPI inflation	0.9	5.7	5.0	3.7	3.4	3.2	3.0
Per capita non-oil GDP (US$)	366	360	486	509	524	539	558

- Under a s*trong policy implementation* scenario, accelerated progress in executing well-targeted development spending in infrastructure and human capital could lift total investment to around 50 percent of non-oil GDP. More vigorous improvement in the business environment could promote a strong pick-up in private investment in agriculture, fisheries, and tourism. Inflation would be higher than under the baseline scenario, but still moderate. Annual non-oil GDP growth (excluding the impact of the expected decline in the UN mission over time) could reach 7-8 percent, contributing to a significant reduction in poverty.

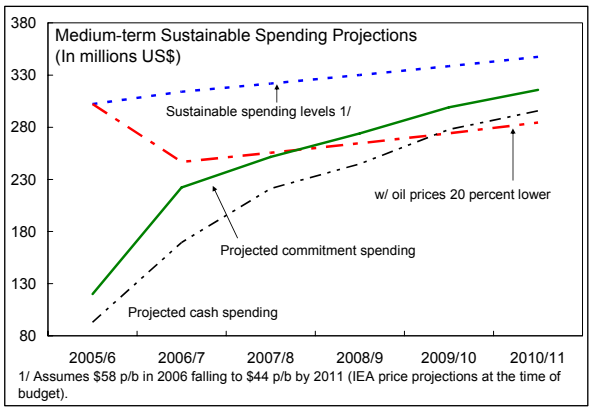
Medium-term Outlook: High Growth Scenario

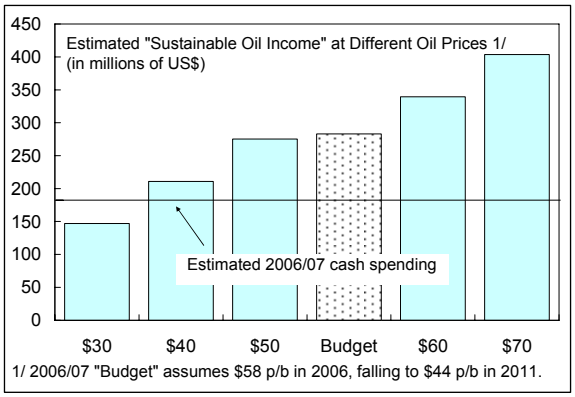
	2005	2006	2007	2008	2009	2010	2011
	Est.	Projections					
Non-Oil GDP (real growth rate)	2.3	-1.6	33.1	5.0	3.9	4.4	4.9
Non-oil GDP growth (excl. UN)	6.2	-6.7	21.1	7.4	7.3	7.2	7.1
Total investment (in percent of non-oil GDP)	19	19	31	41	48	51	51
of which Public	15	15	25	33	39	41	40
CPI inflation	0.9	5.7	6.0	4.6	4.2	3.4	3.1
Per capita non-oil GDP (US$)	366	360	494	529	560	592	628

[5] The authorities are finalizing a proposal that could release significant resources for Timor-Leste given its eligibility under the MCA.

Risks

- On the upside, the agreement with Australia on revenue-sharing from the Greater Sunrise field and new exploration prospects could double long-term oil-and-gas revenue inflows.





- However, a 20 percent or steeper decline in oil-and-gas prices from current budget assumptions would reduce annual "sustainable" spending to a level that, while above projected spending for 2006/07, would reduce the envelope for investment spending over the medium term and therefore pose difficulties in moving to a high-growth scenario.
- Continued political instability and the 2007 elections could distract from the pursuit of the reform agenda, increase pressure for public spending toward potentially more inflationary spending, and discourage private investors.
- Rapid assumption of large-scale external borrowing, particularly in the absence of a prudent debt-management strategy, could quickly erode fiscal sustainability.

Authorities' views: The authorities agreed that growth of 7–8 percent over the medium term was necessary to ensure a sustained decline in poverty and that it would require a major step-up in public investment, along with an increase in private investment and the continuation of a sound macroeconomic environment. In their view, these growth rates were within reach given plans for increased development spending, including the MCA funding.

Fiscal Issues: Managing Oil-and-Gas Wealth Through Development Spending for Investment and Growth

16. **The long-term fiscal sustainability strategy, targeting inter-generational equity through the savings policy and petroleum fund, remains an appropriate vehicle for broad management of the oil-and-gas wealth.**

- Adherence to the saving guideline and keeping spending within "sustainable" levels, along with continued prudent management of the petroleum fund should help shield Timor-Leste from the "oil curse" by smoothing spending and investing the remainder abroad, while financing the needed increase in development spending.

- The Fund's institutional arrangements are now largely completed with the first meeting of the Consultative Council in November. Transparent reporting, independent audits, and the creation of an Investment Advisory Board for the Fund have ensured a high level of accountability.[6]

- The petroleum fund's investment strategy is defined within a well-articulated asset management framework. MCM is providing support to strengthen capacity at the BPA to manage the Fund's assets.

Authorities' views: Notwithstanding the rapid accumulation of oil-and-gas savings in the Fund, the authorities consider the current conservative investment strategy to be appropriate during these initial years, given their low level of capacity in asset and risk management. However, looking forward, the authorities plan to initiate use of multilateral institutions' fund managers to bring into play the gradual diversification allowed within the law.

17. **At the same time, the crisis has made the need for significantly stepped-up development spending more pressing, particularly in human capital and infrastructure** (Box 2).

- High unemployment, low productivity and sluggish activity suggest that well-targeted public investment with a high import content could support higher growth without increasing inflation. As a share of non-oil GDP, total public sector spending is not expected to increase appreciably, although the central government's share would rise as that of donors declines.

- Nonetheless, the risks of inflation and non-priority spending are higher with the sharp increase in expenditure. In addition, the 2006/07 budget appropriation is just within "sustainable" levels. Although cash spending is likely to be lower than that appropriated given continuing budget execution problems, as spending rises and the budget constraint tightens, it is increasingly critical that spending be carefully prioritized.

- To that end, some elements of 2006/07 budget expenditure raise concerns. Fast-disbursing emergency cash grants should be carefully targeted and transparently provided to those affected by the crisis to minimize the long-term impact on the fiscal accounts, inflation and growth. Greater wage differentiation in the public sector is needed to attract qualified senior staff, but increases in wages for unskilled staff—such as through the across-the-board cost-

[6] Timor-Leste participates in the Extractive Industries Transparency Initiative.

of-living subsidy—could put upward pressure on private sector wages and reduce competitiveness.

Box 2. Fiscal Expansion: Benefits and Risks

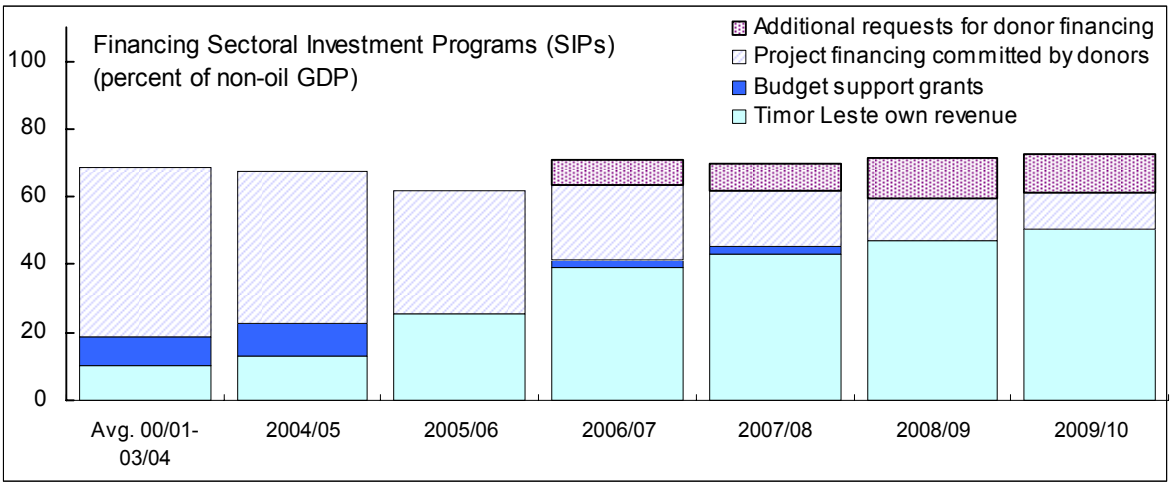
Significant development needs. Timor-Leste is one of the poorest countries in the world (Figure 1). Long-standing development needs further increased with the damage and humanitarian problems resulting from the mid-year crisis. As private investment is very low and likely to remain so over the medium-term, the burden is largely on the government to address the problems and to invest heavily to ensure that the new oil wealth raises living standards and reduces poverty.

Timor Leste and Comparator Countries 1/			
	Human Development Indicator Rank 1/	GDP per Capita in US$ (2005)	Real GDP per Capita Avg Annual Growth 2002-05
Timor Leste 2/	142	372	-5.5
Sub-Sahara Africa	148	850	2.2
Developing Asia 3/	107	1200	7.0

Sources: UN, *Human Development Report*, 2006 and IMF, *World Economic Outlook*.
1/ Rank out of 177 countries. The higher the number, the lower the level of human development.
2/ For Timor Leste, non-oil GDP. 3/ Excluding China and India.

Notwithstanding the development and humanitarian needs, rapid fiscal expansion carries risks. Much higher public expenditure could result in a build up of pressure on non-tradeable goods' prices that would impair non-oil private sector competitiveness. However, under the SIPs, benefits are expected to outweigh costs:

- SIPs investment in infrastructure and human capital are complementary to private investment and should support growth, absorb employment, and raise factor productivity in the wider economy.
- Expenditure is likely to be on traded goods, such as imported capital equipment, or on unskilled labor and other services not in limited supply in the domestic market, and therefore less likely to trigger rapid increases in prices and wages.
- Aggregate public spending is not expected to increase overall, relative to the reconstruction period as the component financed by Timor-Leste's own resources replaces donor financing.
- Experience in other open, low-income, oil-producing economies with fixed exchange rates has shown that large expenditure increases may be absorbed without a major inflationary impact.



Authorities' views: The authorities observed that the 2006/07 budget responds to the need to accelerate execution of development spending under the SIPs, which continue to guide budget planning, and for humanitarian relief. Capital expenditure is budgeted to rise to 32 percent of GDP in 2006/07. Given the sharp expenditure increase, the authorities were well aware of the need to avoid putting pressure on prices and nonproductive expenditure. The higher government wage bill reflects plans to fill long-vacant management positions and the one-off cost-of-living adjustment in 2006/07 will offset crisis-related costs for public servants and be subsumed in a new pay and grading structure in 2007, which will include the first pay rises since 2002.

18. **As weaknesses in the budget process continue to constrain needed development spending, new measures within the 2006/07 budget aim to improve execution.**

- The 2006/07 budget incorporates new measures to raise execution levels, including greater use of rural development and education cash grants; international outsourcing of design, implementation, and monitoring of capital projects; and procurement decentralization with technical support from donors.

- Adoption of the pending public-finance management law (including improved commitment monitoring and controls) would strengthen the fiduciary framework, expenditure execution, and the medium-term budget framework.

Authorities' views: The authorities are optimistic that technical assistance from the new IMF treasury advisor and other donors will boost budget planning, execution, and monitoring capacity. At the same time, they acknowledged that the effect of the measures to improve budget execution could take time to be fully realized given the low level of capacity. They plan to limit the growing carryover to capital expenditure in addition to instituting re-appropriation requirements.

19. **Against this background, the authorities should proceed cautiously when giving consideration to breaking past practice to engage in large-scale external borrowing.**

- It will be important to carefully weigh borrowing opportunities to ensure that the project to be financed is consistent with SIP priorities, the absorptive capacity of the economy, and debt management capacity within the government. A rigorous cost-benefit analysis should be undertaken to carefully assess the concessionality of the terms and conditions of the proposal to ensure that these do not prejudice future economic growth or resource management.

- Consideration of external borrowing projects should also be handled in a fully transparent manner in line with normal budget procedures.

Authorities' views: The authorities agreed with the need to look closely at the terms and conditions of any borrowing opportunity, as well as its potential macroeconomic impact. They

viewed concessional borrowing as a means to finance priority infrastructure projects necessary for raising economic growth.

20. **The favorable outlook for oil-and-gas revenue also provides a good opportunity to update the tax policy regime and reduce non-oil taxes without compromising fiscal sustainability.**

- The current tax policy regime acts as a drag on the narrow base of the non-oil sector, encouraging noncompliance. At the same time, it is a challenge to administer. Simplifying the tax structure—including by increasing minimum thresholds and reducing rates, and streamlining tax procedures—would be investment-friendly, reduce incentives for avoidance, and better suit the continued low administrative capacity.[7]

- New oil-and-gas operations also require stepped-up capacity to audit tax compliance.

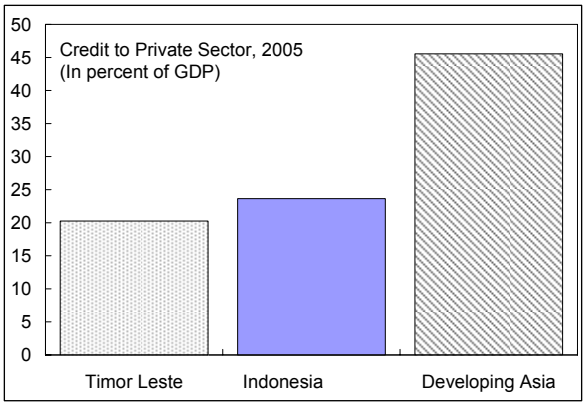
- A consolidated tax law, which has been pending for over a year, would improve taxpayer awareness and remove ambiguities.

Authorities' views: The authorities agreed that tax policy reform is a high priority. They welcomed the initial FAD tax-policy review and indicated that substantive actions would follow the full TA mission planned for January.

Monetary and Financial Sector Issues: Maintaining Macroeconomic Stability

21. **The use of the U.S. dollar as legal tender has supported macroeconomic stability by providing a credible nominal anchor for low inflation**. The authorities reaffirmed their commitment to the current monetary and exchange arrangements, which have been key to maintaining macroeconomic stability. They agreed with staff that the current level of the exchange rate does not present concerns for competitiveness, but that there was need to remain vigilant to ensure that fiscal pressures do not undermine competitiveness in the future. They also agreed that stronger institutional capacity and well-functioning financial markets are pre-requisites to the introduction of a national currency.

22. **The deceleration in credit growth since mid-2004 and the increase in banks' nonperforming assets are concerns, given the importance of finance for growth, but do not appear to reflect a systemic problem.**



[7] See Selected Issues Chapter II on taxation.

- The initial rapid expansion of bank credit to the private sector in the first half of 2004 in part represented a re-intermediation of the financial sector as the macroeconomic and political situation stabilized.

- The more recent deceleration in credit growth parallels developments in non-oil activity and the rising share of NPLs. The latter largely reflects weak credit assessment policies at one commercial bank (which have been addressed), combined with difficulties in contract enforcement and loan recovery, exacerbated by the recent civil unrest.

Timor-Leste: Banking Indicators (in percent)

	2003	2004	2005				2006		
	Q4	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Capital adequacy ratio 1/	227.9	226.5	188.1	140.3	125.5	121.2	119.1	140.3	176.1
NPLs/total loans	6.3	5.4	6.9	7.8	9.6	12.8	16.3	21.8	29.8
Total provisions/NPLs	2.2	5.8	14.4	20.2	22.5	23.2	24.1	24.2	64.8
Liquid assets/total assets	74.3	36.0	31.6	33.5	32.7	34.8	33.3	36.3	41.7

Sources: Data provided by the Timor-Leste authorities, and Fund staff estimates.
1/ Applies to IMFTL only as other banking institutions are branches of foreign banks.

- The worsening quality of banks' portfolios is unlikely to pose serious risks for depositors given that all three banks in Timor-Leste are branches of established foreign banks. However, a slowdown in financial intermediation could reduce credit availability and hamper the recovery.

- Unless operated on a commercial basis, a state-owned rural development bank as now under consideration could quickly run into NPL and solvency issues, leading to fiscal liabilities and further undermining development of the formal banking sector.

- Given current difficulties in enforcing loan contracts, an alternative means of resolving disputes is needed. In addition, land-registration legislation and commercial code regulations, both critical for a well functioning financial sector, need finalization.

- Other key legislation, including the Central Bank, Payments, and Anti-Money Laundering laws, are also still pending.

Authorities' views: The authorities pointed to the need to continue monitoring credit developments closely and to strengthen the environment for financing in the future. The BPA has taken steps to: establish a credit registry to help screen creditor quality; enhance bank supervision, including the resumption of off-site supervision with assistance from the Fund; and push for submission of the Central Bank Act to Parliament. In addition, as noted below, the authorities are considering introduction of an alternative commercial dispute mechanism.

Private Sector Development and Capacity Building for Long-term Growth

23. **For private non-oil activity to become the source of long-term growth and job creation, the business environment needs considerable strengthening.**

- Priorities include the need to pass the still-pending land law and to address the absence of effective contract enforcement. Cumbersome business licensing procedures could be streamlined. Institutions for mediation and arbitration could provide alternatives for settling commercial disputes while the law courts are being reinforced. Greater consultation with the private sector in developing and implementing laws and regulations could help ensure their effectiveness.

- Given high levels of unemployment, setting a binding minimum wage and adopting costly hiring and firing provisions would be counterproductive.

- A government coordination unit to guide the legislative and regulatory agenda could ensure: (a) appropriate consideration of laws' economic and social impact, (b) adoption of needed implementing regulations and amendments, (c) easy access to laws and regulations for the general public, and (d) adequate training of officials to implement the new framework.

Authorities' views: The authorities are committed to intensifying ongoing programs to improve the business climate and encourage private investment. Foreign investors have supported the proposals for the long-term leasing of state-owned land. Consultation with the business community is also identifying areas for reducing red tape and new training programs for civil servants should improve service provision. Proposed changes to labor legislation will be carefully evaluated to avoid hindering employment creation. Options are advancing for more effective handling of commercial disputes. However, other action on laws and regulations is likely to remain constrained by low capacity.

Other Issues

24. **Macroeconomic analysis remains hampered by weak capacity and poor data availability.** The lack of qualified candidates hinders recruitment for national accounts compilation and the macroeconomic unit in the finance ministry. In the absence of national accounts and balance of payments statistics, the authorities have begun producing quarterly macroeconomic indicators of non-oil activity based on existing data available in various parts of the administration. Formal responsibility for balance of payments statistics has been transferred to the BPA, where capacity is stronger.

25. **Timor-Leste maintains an open trade regime, with a uniform 6 percent duty on all imports and no quantitative restrictions.**

IV. Staff Appraisal

26. **Timor-Leste has made good progress in stabilizing the macroeconomy and establishing a foundation for future growth**. At the same time, growth is not yet high enough to reduce poverty and the recent civil unrest has heightened the risks to the outlook. While recognizing the need to address the short-term consequences of the crisis, the underlying challenge is how best to use the oil-and-gas resources and the stable macroeconomic environment to lift the non-oil economy onto a higher growth path.

27. **The authorities' development strategy remains sound and focuses on the core reforms needed to promote growth:** a long-term oil-and-gas revenue saving policy supported by a petroleum fund; well-targeted and prioritized development spending; maintenance of a monetary and exchange regime that preserves macroeconomic stability; and an appropriate environment for private investment and activity. Progress on some elements of the strategy has been stronger than on others and success will require more forceful progress in all areas.

28. **By targeting long-term fiscal sustainability and intergenerational equity, the saving rule and Petroleum Fund should help shield Timor-Leste from the "oil curse"** by smoothing spending and investing the remainder abroad, while leaving sufficient resources to finance the needed increase in development spending. The authorities are encouraged to continue transparent reporting of its activities.

29. **A significant stepping up of investment spending is needed and feasible given the absence of a binding financing constraint.** That said, large increases in government spending intensify the need to guard against unproductive spending and inflation pressures through careful planning and monitoring. The increase in public sector wage levels could put upward pressure on private sector wages for unskilled workers. Subsidies should be monitored carefully to ensure effectiveness.

30. **Measures to strengthen budget execution are welcome, but further reforms are necessary.** The introduction of education and community grants, international outsourcing of large infrastructure projects, additional donor support and procurement decentralization are likely to speed up budget implementation over time. Additional measures are needed to strengthen the budget process, including an effective public finance law and improved monitoring and control on a cash basis.

31. **Proposals to borrow externally should be carefully weighed.** Rigorous and transparent analysis should be undertaken to ensure the project's consistency with SIP priorities and macroeconomic stability, and the adequate concessionality of its terms.

32. **The increase in oil revenues enables wide-ranging tax reforms.** A simplified tax regime, including a reduction in tax rates and an increase in minimum thresholds, could help to encourage the private sector. Tax procedures should also be streamlined to better fit limited administrative capacity.

33. **Maintenance of the current monetary and exchange regime provides a credible anchor for maintaining macroeconomic stability.** The current level of the exchange rate is not a threat to medium-term competitiveness, though the authorities should remain vigilant to ensure that expansionary fiscal and wage policies do not increase price pressures. Staff welcomed the authorities' position that stronger institutional capacity and a well-functioning financial market were pre-requisites to the introduction of a national currency.

34. **The weakening in banks' loan portfolios does not appear to present a systemic risk.** Nonetheless, it may reduce credit availability and undermine the economic recovery. Staff welcomes plans to further strengthen supervision, create a loan registry, introduce an alternative means of resolving commercial disputes, and finalize banking sector legislation. A state-owned rural-development bank could further weaken the fragile financial system, if not operated on a commercial basis.

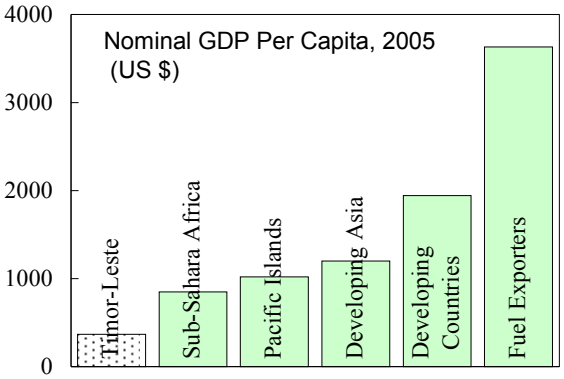
35. **Greater efforts are needed to create an environment that encourages private investment and growth.** Passage of the pending land law would support private investment, while amendments to the labor legislation under preparation should encourage greater labor market flexibility. The creation of a coordination unit to guide the legislative and regulatory agenda would be useful.

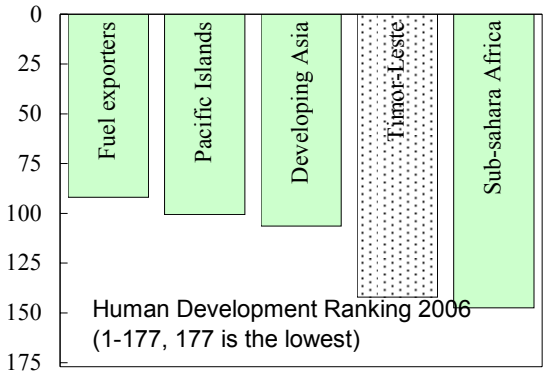
36. **The recently launched donor-supported capacity building program is welcome and should help improve financial management.** Staffing the Ministry of Finance's macroeconomic unit is a priority. Given data are not adequate for effective surveillance, intensified efforts are needed to strengthen statistical capacity to compile basic macroeconomic data.

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

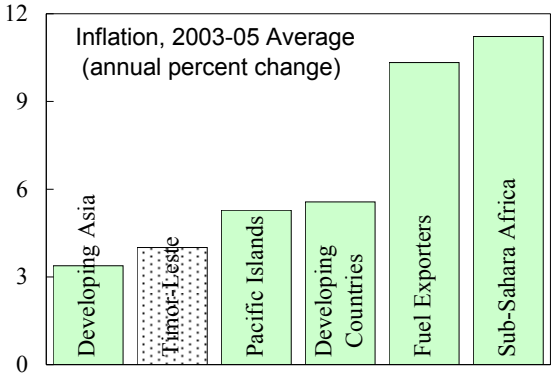
Figure 1. Timor-Leste: Regional and Global Comparisons 1/ 2/

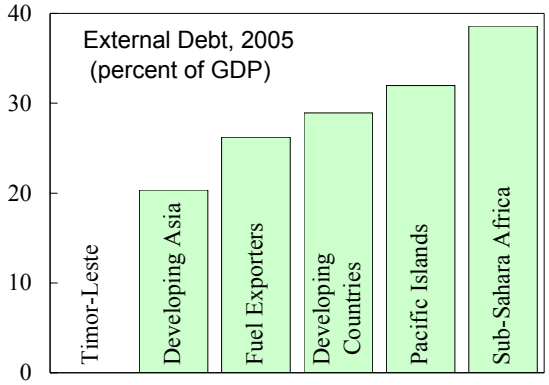
Three years after independence, standards of living in Timor Leste remain low compared to those in other developing regions in the world...



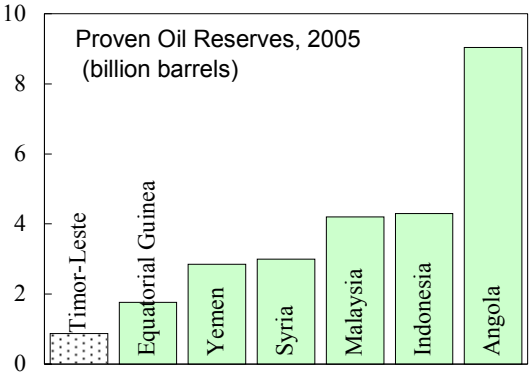


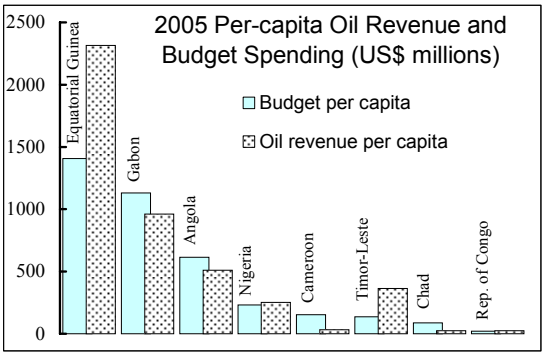
...despite good macroeconomic management, reflected in low inflation and the absence of external public debt.





However, relatively large per-capita oil reserves provide Timor Leste's policy makers with significant opportunities to strengthen growth prospects, while maintaining a stable macroeconomic environment.



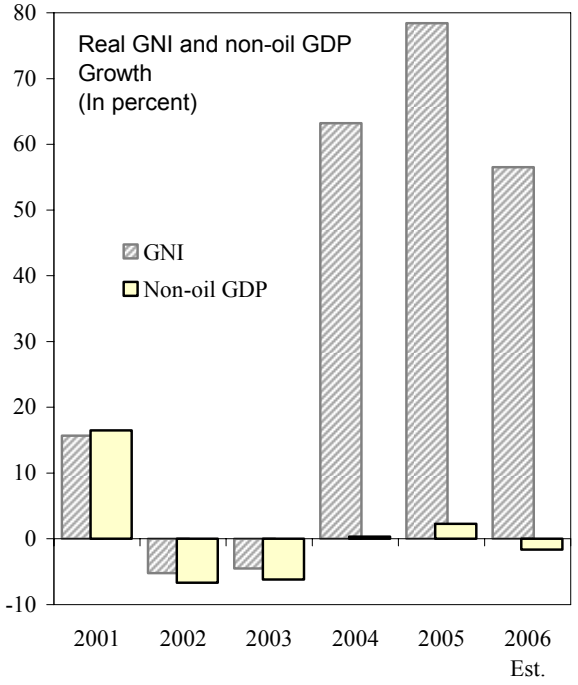


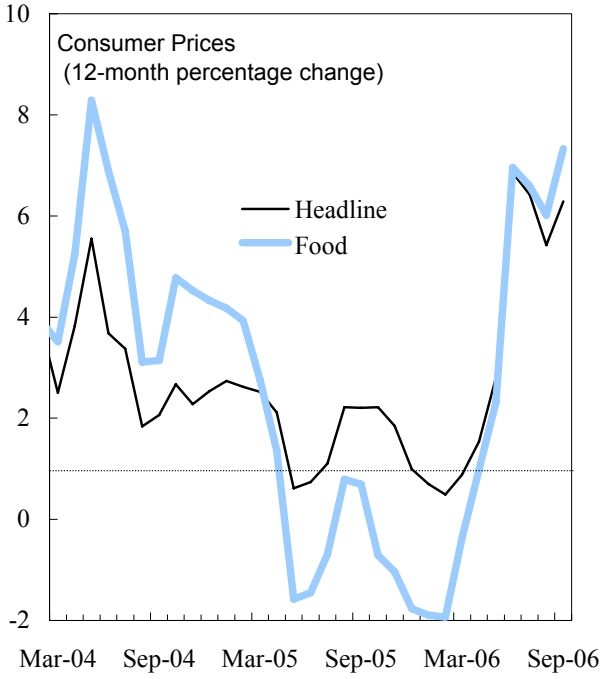
Sources: Authorities; UN, *Human Development Indicators, 2006*; IMF, *World Economic Outlook*; BP, *Statistical Review of World Energy October 2006*; and Fund staff estimates.

1/ For Timor-Leste, calculations in non-oil GDP.
2/ Bayu Undan field only. When production starts in the Greater Sunrise field, total reserves will increase significantly. In addition, Timor-Leste petroleum fields have significant gas reserves.

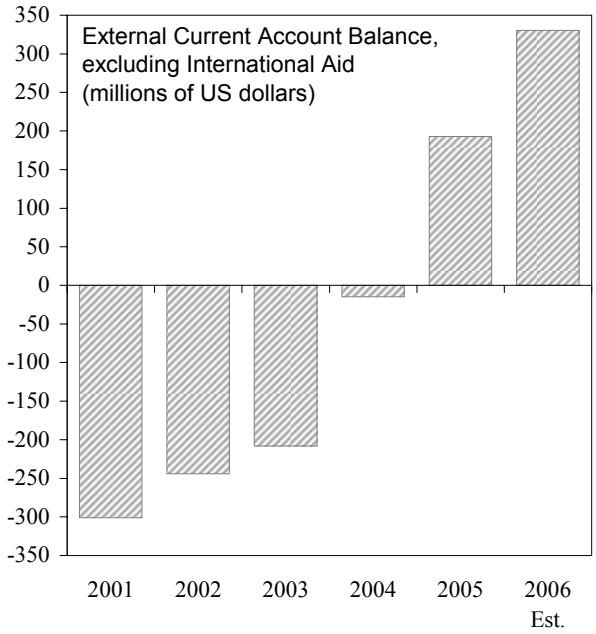
Figure 2. Timor Leste: Recent Macroeconomic Developments

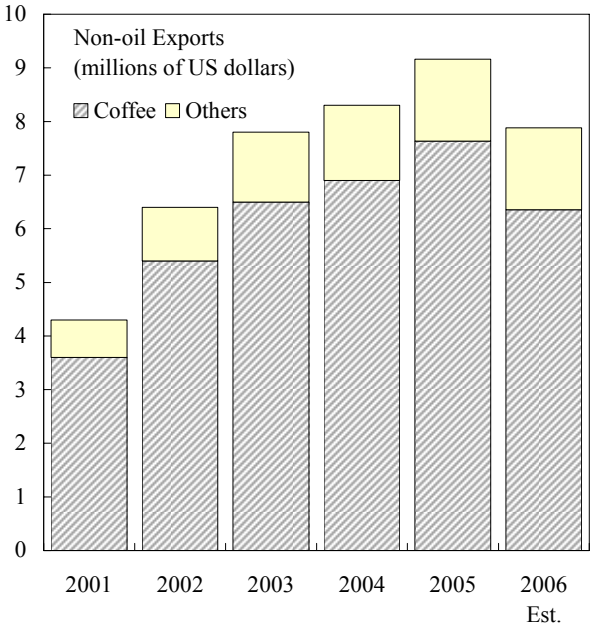
Civil unrest in 2006 halted the nascent recovery in non-oil GDP and decline in inflation that had begun in 2004. Revenue from oil boosted real national income.





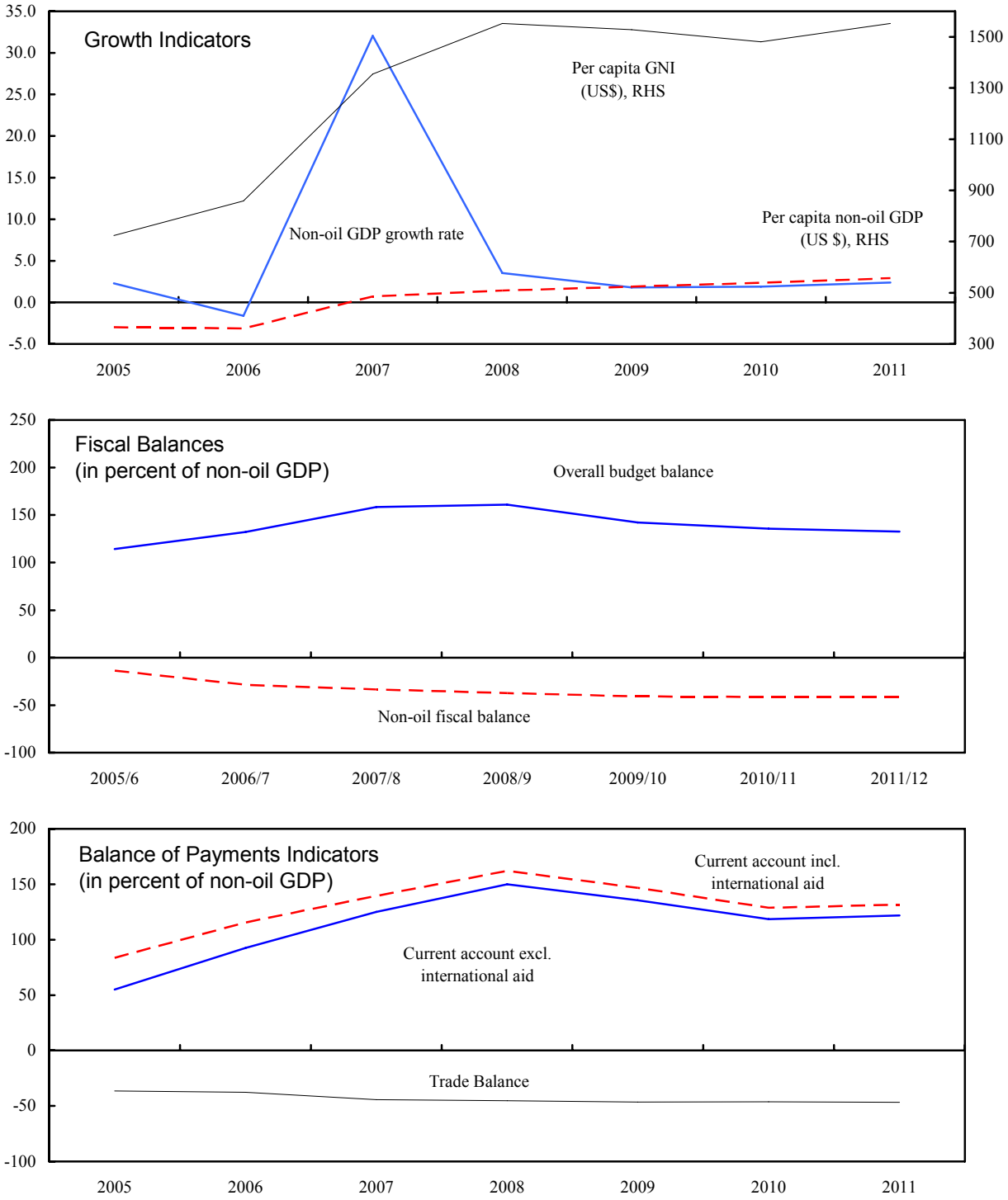
The current account balance turned into a surplus in 2005, reflecting high tax and royalty payments from foreign oil companies. But non-oil export performance was disrupted in 2006.





Sources: Timor-Leste authorities; and Fund staff estimates and projections.

Figure 3. Timor Leste: Medium-Term Moderate Policy Implementation Scenario 2005-11



Source: Authorities and Fund staff estimates.

Table 1. Timor Leste: Millennium Development Goals Progress, 1990-2005

	1990	1994	1997	2000	2003	2004	2005
Goal 1: Eradicate extreme poverty and hunger							
Target 1: Halve, between 1990 and 2015, the proportion of people whose income is less than $1 a day							
Target 2: Halve, between 1990 and 2015, the proportion of people who suffer from hunger							
Prevalence of underweight in children (under five years of age)	..	..	..	..	46	46	..
Prevalence of undernourishment (% of population)	..	..	9	..	8	8	..
Goal 2: Achieve universal primary education							
Target 3: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling							
Net primary enrollment ratio (% of relevant age group)	..	..	..	..	..	..	..
Goal 3: Promote gender equality and empower women							
Target 4: Eliminate gender disparity in primary and secondary education preferably by 2005 and in all levels of education no later than 2015							
Proportion of seats held by women in national parliament (%)	..	..	..	..	26	26	25.3
Share of women employed in the nonagricultural sector (%)	19	..	..	..	..	..	..
Goal 4: Reduce child mortality							
Target 5: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate							
Immunization, measles (% of children ages 12-23 months)	..	..	..	..	55	55	*55*
Infant mortality rate (per 1,000 live births)	130	..	..	80	..	64	*64*
Under 5 mortality rate (per 1,000)	172	..	..	102	..	80	*80*
Goal 5: Improve maternal health							
Target 6: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio							
Births attended by skilled health staff (% of total)	..	..	25.8	..	18	*18*	..
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	660	..	..	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases							
Target 7: Have halted by 2015 and begun to reverse the spread of HIV/AIDS							
Contraceptive prevalence rate (% of women ages 15-49)	..	..	..	..	10	*10*	..
Target 8: Have halted by 2015 and begun to reverse the incidence of malaria and other major diseases							
Tuberculosis cases detected under DOTS (%)	..	..	..	..	49.7	45.8	45.8
Incidence of tuberculosis (per 100,000 people)	555.5	..	..	..	..	555.5	*555.5*
Goal 7: Ensure environmental sustainability							
Target 9: Integrate the principles of sustainable development into country policies and program and reverse the loss of environmental resources							
Forest area (% of total land area)	65	..	..	57	..	..	54
Target 10: Halve, by 2015, the proportion of people without sustainable access to safe drinking water and basic sanitation							
Access to an improved water source (% of population)	..	..	..	..	..	..	*58*
Access to improved sanitation (% of population)	..	..	..	..	..	..	*36*
Target 11: Have achieved, by 2020, a significant improvement in the lives of at least 100 million slum dwellers							
Access to secure tenure (% of population)	..	..	..	..	..	..	..
Goal 8: Develop a global partnership for development							
Target 12: Various							
Aid per capita (current US$)	0.1	0.3	0.6	297.1	176.8	165.2	*165.2*
Other							
Fertility rate, total (births per woman)	..	..	..	..	*7.8*	..	..
GNI per capita, Atlas method (current US$)	..	..	..	..	420	550	750
GNI, Atlas method (current US$) (billions)	..	..	..	..	0.4	0.5	0.7
Gross capital formation (% of GDP)	..	..	..	41.3	31.3	28.4	32
Life expectancy at birth, total (years)	..	..	..	..	..	..	
Population, total (millions)	0.7	0.8	0.8	0.8	0.9	0.9	1.0

Source: World Development Indicators database, November 2006

Note: figures in italics refer to periods other than those specified; ".." indicates that data are not available.

Table 2. Timor-Leste: Selected Economic Indicators, 2002–07

	2002	2003	2004	2005	2006 Est.	2007 Proj.
Output and prices 1/						
GNI at current prices (in millions of U.S. dollars)	352	349	507	692	847	1375
Non-oil GDP	343	336	339	350	356	493
Oil/gas income	9	13	168	342	492	882
Real non-oil GDP growth (percentage change)	-6.7	-6.2	0.3	2.3	-1.6	32.1
Inflation (percentage change, end-period) 2/	9.5	4.2	1.8	0.9	5.7	5.0
			(In percent of non-oil GDP)			
Investment-saving balance						
Gross investment 3/	31	26	19	19	19	28
Private	12	10	4	4	4	5
Public	20	16	15	15	15	23
Gross national savings	-6	1	50	103	135	168
Private	-26	-17	-15	-3	0	0
Public	20	18	64	106	135	168
External savings	37	25	-30	-84	-116	-140
Central government budget (cash basis) 4/						
Revenues	24	31	98	137	172	202
Domestic revenues	6	9	11	9	9	8
Oil/gas revenues	9	12	77	128	161	192
Grants	10	10	10	0	2	2
Expenditure	20	20	21	26	40	43
Recurrent expenditure	17	18	18	20	33	29
Capital expenditure	3	3	3	7	7	14
Overall balance	4	11	77	111	132	158
Non-oil fiscal balance	-5	-1	0	-17	-29	-34
Public debt	0	0	0	0	0	0
Combined sources fiscal operations 4/ 5/						
Revenues	17	21	23	12	13	12
Expenditure	71	70	68	62	71	70
Recurrent expenditure	54	55	52	47	53	44
Capital expenditure	18	15	15	15	18	25
Overall balance	-54	-50	-45	-50	-58	-58
Money and credit						
Broad money (end-period) 6/	15.9	21.5	24.8	27.8	32.0	29.5
Net domestic assets (end-period)	-10.3	-10.7	-30.1	-17.7	-6.2	-0.1
			(In millions of U.S. dollars)			
External sector						
Current account excl. international assistance	-244	-208	-15	193	329	617
Current account incl. international assistance	-128	-85	103	292	411	688
Trade balance	-211	-186	-154	-127	-133	-219
Merchandise exports 7/	6	8	8	9	8	10
Merchandise imports	-218	-194	-163	-137	-141	-229
Overall balance	20	18	121	341	482	686
			(In percent of non-oil GDP)			
Current account excl. international assistance	-71	-62	-4	55	93	125
Current account incl. international assistance	-37	-25	30	84	116	140
Trade balance	-62	-55	-46	-36	-38	-44
Merchandise exports 7/	2	2	2	3	2	2
Merchandise imports	-63	-58	-48	-39	-40	-46
Overall balance	6	5	36	97	136	139

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

1/ Non-oil GDP and national accounts data for 2001–03 are based on estimates prepared by a World Bank consultant.
2/ CPI for Dili.
3/ Excludes oil/gas sector investment.
4/ Fiscal year basis (July-June); for example, 2001 refers to FY2001/02. Includes automous agency expenditure.
5/ Includes autonomous agencies and fiscal and quasi-fiscal expenditure programs undertaken by bilaterals and multilaterals outside the central government budget. The revenue decline in FY 2005/06 reflects the adoption of the new savings and petroleum fund policy according to which oil revenue accrue to the petroleum fund and the sustainable income from the oil wealth is transferred to the budget to finance the non-oil fiscal deficit.
6/ Excludes currency holdings by the public, for which no data are available.
7/ Excludes oil/gas revenue, which are recorded under the income account (royalties) and transfers (tax revenues). Also excludes re-exports, which primarily relate to repatriation of equipments from UN peacekeeping operations.

Table 3. Timor-Leste: Central Government Budget FY 2004/05–FY 2009/10 1/

	2004/05	2005/06		2006/7		2007/08	2008/09	2009/10
	Act.	Budget	Prelim.	Budget	Staff proj.	Staff Projections		
	(In millions of US dollars, unless otherwise specified)							
Revenue	**337**	**395**	**485**	**733**	**731**	**1,032**	**1,121**	**1,090**
Domestic revenues	37	34	33	39	37	39	42	45
Direct taxes	11	...	9	8	11	11	12	13
Indirect taxes	19	...	16	21	17	18	19	20
Non-tax revenues and other	7	...	9	10	10	10	11	12
Oil/gas revenues 2/	266	351	451	683	683	983	1,079	1,045
Tax revenues	209	266	363	558	558	820	879	813
Royalties and interest	56	85	88	125	126	163	200	233
Royalties	56	70	75	86	86	83	75	66
Interest	1	15	13	40	40	80	125	167
Grants	34	10	0	10	10	10	0	0
Expenditure (commitment basis) 3/	**74**	**132**	**120**	**309**	**222**	**251**	**274**	**299**
Recurrent expenditure	62	88	78	172	150	168	179	189
Wages and salaries	25	29	26	47	45	56	58	60
Goods and services	31	52	45	94	80	87	94	100
Subsidies	5.3	7	8	13	13	11	11	12
Transfers	0	0	0	18	13	14	15	17
Capital expenditure and net lending 4/	12	44	42	137	72	83	96	110
Overall balance (commitment basis)	**263**	**263**	**365**	**424**	**509**	**781**	**847**	**791**
Expenditure (cash basis) 5/	**71**	**...**	**93**	**...**	**170**	**221**	**245**	**278**
Recurrent expenditure	62	...	70	...	141	151	160	169
Wages and salaries	25	...	26	...	45	56	58	60
Goods and services	31	...	37	...	70	70	75	80
Subsidies	5.3	...	8	...	13	11	11	12
Transfers	0	...	0	...	13	14	15	17
Capital expenditure and net lending 4/	10	...	23	...	29	70	85	109
Overall balance (cash basis)	**265**	**...**	**392**	**...**	**562**	**811**	**876**	**812**
Non-oil balance (cash basis)	**0**	**...**	**-59**	**...**	**-122**	**-172**	**-203**	**-233**
Financing								
Changes in cash balances (increase = '-')	-265	...	-392	...	-562	-811	-876	-812
	(In percent of non-oil GDP)							
Revenue	**98**	**112**	**137**	**173**	**172**	**202**	**206**	**191**
Domestic revenues	11	10	9	9	9	8	8	8
Oil/gas revenues 2/	77	99	128	161	161	192	198	183
Grants	10	3	0	2	2	2	0	0
Expenditure (commitment basis) 3/	**21**	**37**	**34**	**73**	**52**	**49**	**50**	**52**
Recurrent expenditure	18	25	22	41	35	33	33	33
Capital expenditure and net lending 4/	3	13	12	32	17	16	18	19
Overall balance (commitment basis) 3/	**76**	**74**	**103**	**100**	**120**	**153**	**156**	**138**
Expenditure (cash basis) 5/	**21**	**...**	**26**	**...**	**40**	**43**	**45**	**49**
Recurrent expenditure	18	...	20	...	33	29	29	30
Capital expenditure and net lending 4/	3	...	7	...	7	14	16	19
Overall balance (cash basis)	**77**	...	**111**	...	**132**	**158**	**161**	**142**
Non-oil balance (cash basis)	**0**	...	**-17**	...	**-29**	**-34**	**-37**	**-41**
Financing								
Changes in cash balances (increase = '-')	-77	...	-111	...	-132	-158	-161	-142
Memorandum items (in percent of non-oil GDP, unless otherwise indicated):								
Cash spending from past budgets 5/	4	...	3	...	4	8	9	12
Non-oil fiscal balance (commitment basis)	-1	-25	-24	-61	-41	-39	-43	-44
Net allocation to the petroleum fund	...	...	111	100	132	158	161	142
Petroleum Fund balance (end-period)	...	...	184	247	285	395	533	649
Sustainable spending 6/	...	66	86	77	76	65	61	59
Public debt	0	0	0	0	0	0	0	0

Sources: Timor-Leste authorities; and Fund staff estimates.

1/ Fiscal year: July-June. Central Government includes subsidies to autonomous agencies.
2/ Oil revenue projections for the period 2006/07-2009/10 are based on August 2006 budget assumptions for price and production.
3/ Staff projections are based on past ratios of actual commitments and cash disbursements to budgeted allocations.
4/ Includes allocation for BPA capitalization ($10.5 million in 2006/07).
5/ Cash expenditure includes carry-over expenditure from previous years (the reporting of which is not disaggregated).
The carry-over is reportedly largely capital expenditure, as most recurrent expenditure is executed in the budgeted year.
6/ It includes the permanent income from oil (estimated in line with the Petroleum Fund law) and projected domestic revenue and grants.

Table 4. Timor Leste: Combined Sources Budget FY 2004/05–2009/10

	2004/05	2005/6 Est.	2006/07	2007/08	2008/09	2009/10
			Staff projections 1/			
			(In millions of U.S. dollars)			
Revenue	79	41	54	60	53	57
Domestic revenue 2/	37	33	37	39	42	45
Direct taxes	11	9	11	11	12	13
Indirect taxes	19	16	17	18	19	20
Non-tax revenues and other	7	9	10	10	11	12
Autonomous agencies own revenue	8	7	6	10	11	12
Grant financing (budget support)	34	0	10	10	0	0
Expenditure (cash basis)	232	217	300	356	388	415
Recurrent expenditure	180	164	223	228	233	241
Central government budget (incl. autonomous agencies)	68	77	147	161	171	181
Donor projects 3/	112	88	76	67	62	60
Capital expenditure	53	53	77	128	155	174
Central government budget (incl. autonomous agencies)	10	13	29	70	85	109
Donor projects 3/	42	40	48	58	70	65
Overall balance	-153	-176	-246	-296	-335	-358
Financing	153	176	216	256	270	293
Oil fund financing of central government non-oil fiscal deficit 4/	209	0	122	172	203	233
Committed project financing by donors	154	127	94	85	67	60
Change in cash balances (increase -)	-210	49	0	0	0	0
Outstanding financing requests 5/	0	0	-30	-40	-65	-65
			(In percent of non-oil GDP)			
Revenue	23	12	13	12	10	10
Domestic revenue 2/	11	9	9	8	8	8
Autonomous agencies own revenue	2	2	2	2	2	2
Grant financing (budget support)	10	0	2	2	0	0
Expenditure (cash basis) 3/	68	62	71	70	71	73
Recurrent expenditure	52	47	53	44	43	42
Capital expenditure	15	15	18	25	29	30
Overall Balance	-45	-50	-58	-58	-62	-63
Financing	45	50	51	50	50	51
Oil fund financing of central government non-oil fiscal deficit 4/	61	0	29	34	37	41
Committed project financing by donors	45	36	22	17	12	11
Change in cash balances (increase -)	-61	14	0	0	0	0
Outstanding financing requests 5/	0	0	-7	-8	-12	-11
Memorandum items:		(in millions of US dollars, unless otherwise specified)				
Non-oil fiscal balance	0	-49	-122	-172	-203	-233
Oil/Gas revenue	266	451	683	983	1079	1045
Oil fund balance (in percent of non-oil GDP)	20	184	285	395	533	649
Total donor financing requested	154	127	124	125	132	125
Committed	154	127	94	85	67	60
Uncommitted	1	0	30	40	65	65

Sources: Timor-Leste authorities; and Fund staff estimates.

1/ Based on March 2006 revised SIPs spending proposals and requests for project financing by donors, implementation of the oil fund and fiscal sustainability policy starting in FY 2005/06 and Fund staff projections for central government revenue and expenditure.
2/ Oil gas revenue are not included as a budget revenue item and flow directly to the petroleum fund. The amount necessary to cover the non-oil fiscal deficit is withdrawn from the fund transferred to the budget up to the estimated sustainable income level and recorded as a financing item.
3/ Includes sector projects which the government has identified as necessary to achieve NDP and MDG objectives, but for which donor financing is not yet fully committed.
4/ For ease of comparison over time, oil/gas revenue in 2004/05 (ahead of the establishment of the petroleum fund) are included in the line of oil fund financing.
5/ New project financing requested from donors; still uncommitted.

Table 5. Timor-Leste: Balance of Payments 2002–07

	2002	2003	2004	2005	2006	2007
	Estimates					Proj.
	(In millions of U.S. dollars)					
Current account excl. international assistance	-244	-208	-15	193	329	617
Current account incl. international assistance	-128	-85	103	292	411	688
Trade balance	-211	-186	-154	-127	-133	-219
Exports of goods 1/	6	8	8	9	8	10
Of which: coffee	5	7	7	8	6	8
Imports of goods	-218	-194	-163	-137	-141	-229
Services (net)	-44	-37	-32	-27	-33	-50
Income (net)	4	4	43	83	117	149
Of which: oil/gas royalty and interest	2	2	39	79	115	146
Current transfers (net)	123	134	246	363	460	808
Of which: oil/gas tax revenue	7	11	129	264	377	736
international assistance	116	123	118	100	82	72
Capital and financial accounts	148	103	18	49	71	-2
Official capital transfers	59	44	41	41	44	53
Financial account	89	59	-23	8	27	-55
Overall balance	20	18	121	341	482	686
Changes in foreign assets (increase -)	-20	-18	-121	-341	-482	-686
Oil/gas revenue savings (increase -)	-13	-16	-119	-330	-482	-686
Other	-7	-2	-2	-11	0	0
	(In percent of non-oil GDP)					
Current account excl. international assistance	-71	-62	-4	55	93	125
Current account incl. international assistance	-37	-25	30	84	116	140
Current account excl. oil/gas tax and royalty payments	-40	-29	-19	-14	-23	-39
Trade balance	-62	-55	-46	-36	-38	-44
	(In millions of U.S. dollars)					
Memorandum items:						
Oil/gas revenue	9	13	168	342	492	882
Gross foreign assets (end-period)	44	61	182	523	1006	1692

Source: Data provided by the Timor-Leste authorities, and Fund staff estimates.

1/ Excludes oil/gas revenues, which are recorded under the income (royalties) and transfers (tax revenues) because of lack of detailed data on the oil/gas sector (including production, exports, service payments, and profit remittances).

Table 6. Timor-Leste: Monetary Developments, 2003–07

	2003	2004	2005	2006		2007
				Sept.	Dec. Est.	Proj.
	(In millions of U.S. dollars; at end-period)					
Banking System						
Net foreign assets	108.3	186.0	161.0	133.2	136.0	146.0
Assets 1/	141.6	227.6	205.5	170.8	173.7	184.0
Liabilities	33.3	41.6	44.5	37.6	37.7	38.0
Net domestic assets	-36.0	-103.0	-63.8	-25.9	-22.2	-0.3
Claims on government (net)	-49.7	-168.6	-128.5	-85.1	-79.1	-78.1
Claims on private sector	22.1	87.6	106.0	102.0	102.2	118.0
Other items (net)	-8.4	-22.0	-41.3	-42.7	-45.2	-40.2
Broad money 2/	72.3	83.0	97.2	107.3	113.8	145.7
BPA						
Net foreign assets 1/	61.3	182.5	153.3	110.1	110.6	111.0
Liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Net domestic assets 3/	-55.0	-176.8	-148.8	-106.5	-106.2	-106.0
Liabilities	6.3	5.7	4.5	3.6	4.4	5.0
Commercial banks 4/						
Net foreign assets	47.0	3.5	7.7	23.1	25.4	35.0
Net domestic assets	28.8	82.3	93.0	85.4	89.4	112.2
Deposit liabilities	72.3	84.5	99.2	107.3	113.8	145.7
Liabilities to BPA	3.4	1.3	1.6	1.1	1.1	1.5
Memorandum items						
Net foreign assets (annual percent change)	20.5	71.7	-13.4	-20.5	-15.5	7.4
Credit to the economy (annual percent change)	324.4	218.1	21.0	-9.9	-3.6	15.5
Credit/non-oil GDP	8.4	25.9	30.3	--	28.7	23.9
Deposits/non-oil GDP	21.5	25.0	28.3	--	32.0	29.5
Credit/deposits	30.6	84.4	88.7	86.9	83.5	73.5

Sources: Banking and Payments Authority; and Fund staff estimates.

1/ The petroleum fund was created in September 2005 and related deposits were moved to off-shore investments on the government's balance sheet.
2/ Excludes currency in circulation, on which no data are available due to dollarization of the financial system.
3/ The large decrease beginning in 2004 reflects the increase of oil-related government deposits, a portion of which was later moved to the petroleum fund.
4/ Includes three commercial banks (branches of foreign banks) and one micro-finance institution.

Table 7. Timor-Leste: Medium-Term Outlook, 2006–11

	2006	2007	2008	2009	2010	2011
	Est.			Proj.		
Output and prices						
GNI at current prices (in millions of US dollars)	847	1375	1616	1627	1609	1721
Non-oil GDP	356	493	530	558	586	618
Oil/gas income	492	882	1086	1070	1023	1103
Real non-oil GDP growth (percentage change)	-1.6	32.1	3.5	1.8	1.9	2.4
Excluding United Nations	-6.7	19.9	5.6	4.8	4.3	4.4
Inflation (percentage change at end-period) 1/	5.7	5.0	3.7	3.4	3.2	3.0
			(In percent of non-oil GDP)			
Investment-saving balance						
Gross investment 2/	19	28	34	37	39	39
Private	4	5	7	8	9	10
Public	15	23	27	29	30	29
Gross national saving	135	168	196	184	168	170
Private	0	0	-1	2	4	4
Public	135	168	196	182	163	166
External saving	-116	-140	-162	-147	-129	-132
Central government budget 3/						
Revenues	172	202	206	191	185	182
Domestic revenue	9	8	8	8	8	8
Oil/gas revenue	161	192	198	183	177	174
Grants	2	2	0	0	0	0
Expenditure	40	43	45	49	49	50
Recurrent expenditure	33	29	29	30	31	32
Capital expenditure	7	14	16	19	18	18
Overall balance	132	158	161	142	136	133
Public debt	0	0	0	0	0	0
Combined sources fiscal operations 3/ 4/						
Revenues	13	12	10	10	10	10
Expenditure	71	70	71	73	72	71
Overall balance	-58	-58	-62	-63	-62	-61
Financing	51	50	50	51	50	49
Net transfers from oil fund	29	34	37	41	41	42
Committed financing by donors	22	17	12	11	9	8
Outstanding financing requests	-7	-8	-12	-11	-12	-12
			(In millions of U.S. dollars)			
External sector						
Current account balance	411	688	859	818	755	813
Trade balance	-133	-219	-241	-259	-271	-288
Merchandise exports 5/	8	10	12	13	15	17
Merchandise imports	-141	-229	-252	-272	-286	-306
Oil income and transfers	492	882	1086	1070	1023	1103
Overall balance	482	686	843	844	814	830
			(In percent of non-oil GDP)			
Current account excl. international assistance	93	125	150	136	119	122
Current account incl. international assistance	116	140	162	147	129	132
Trade balance	-38	-44	-45	-46	-46	-47
Merchandise exports 5/	2	2	2	2	3	3
Merchandise imports	-40	-46	-48	-49	-49	-49
Overall balance	136	139	159	151	139	134

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

1/ CPI for Dili.
2/ Excludes oil/gas sector investment.
3/ Fiscal year (July-June); for example, 2006 refers to FY2006/07.
4/ On a fiscal year basis. Includes autonomous agencies and fiscal and quasi-fiscal expenditure programs undertaken by bilateral donors and international financial institutions outside the central government budget.
5/ Excludes oil/gas revenue, which is recorded under the income account (royalties) and transfers (tax revenue).

Table 8. Timor-Leste: Vulnerability Indicators, 2002-07

	2002	2003	2004	2005	2006 Est.	2007 Proj.
	(In percent of GDP; unless otherwise indicated)					
Financial sector risk indicators						
Public debt 1/	0.0	0.0	0.0	0.0	0.0	0.0
Broad money (percent change, 12-month basis) 2/	6.9	32.4	14.7	17.1	17.1	28.0
Private sector credit (percent change, 12-month basis)	117.4	324.4	218.1	21.0	-3.6	15.5
External indicators						
Exports (percent change, 12-month basis in US$)	48.8	21.9	6.5	10.3	-14.0	31.0
Imports (percent change, 12-month basis in US$)	-16.8	-10.8	-16.1	-16.0	3.4	62.3
Current account balance (excl. international assistance)	-71	-62	-4	55	93	125
Gross official reserves (in millions of U.S. dollars) 3/	44	61	182	523	1,006	1,692
(in months of corresponding imports of goods)	2.4	3.8	13.4	46.0	85.4	88.5
Net foreign assets of commercial banks (in millions of US$)	46.4	47.0	3.5	7.7	25.4	35.0
Total external debt 2/	0.0	0.0	0.0	0.0	0.0	0.0
In percent of exports of goods and services	0.0	0.0	0.0	0.0	0.0	0.0
External debt-service (in percent of exports of goods and services)	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Timor-Leste authorities; and Fund staff estimates.
1/ No external or domestic debt has been contracted.
2/ Excludes currrency in circulation on which no data are available.
3/ Includes investments of Petroleum Fund assets overseas.

APPENDIX I. SUMMARY OF ANNEXES

The full annexes to this report can be viewed in CyberDocs on the Fund's intranet and on the secure extranet for Executive Directors and member officials.

Fund Relations

Timor-Leste joined the Fund in July 2002, and has no outstanding purchases or loans. On January 24, 2000, the U.S. dollar was adopted as the official currency and foreign exchange transactions are handled by commercial banks on the basis of rates quoted in the international markets. The 2005 Article IV consultation was concluded by the Executive Board on June 15, 2005 (http://www.imf.org/external/pubs/cat/longres.cfm?sk=18427.0).

Relations with the World Bank Group

Timor-Leste joined the World Bank Group in July, 2002 and became eligible for IDA assistance in October, 2002. Thus far there has been no lending. During the transition to independence, the World Bank co-managed a multi-donor Trust Fund for East Timor (TFET). Bank-administered TFET projects reached $112 million, of which $105 million was disbursed by mid-December 2006. The Bank has mobilized budget support with the most recent, Consolidation Support Program 2006–08, providing about $10 million annually, with about $0.5 million financed by IDA. The latest Country Assistance Strategy (2006–08) was adopted in July 2005 and provides for new programs in education, health, energy, and public finance capacity building, with IDA grants of about US$25 million. Timor-Leste joined the IFC in September 2004.

Relations with the Asian Development Bank

Timor-Leste joined the Asian Development Bank (AsDB) on July 24, 2002. To date, there has been no lending. The AsDB co-managed TFET with the World Bank. Under the TFET, the AsDB has managed six projects with total funding of $51.7 million, which aimed at the rehabilitation of physical infrastructure and the development of microfinance. At mid-December 2006, disbursements for AsDB-managed projects totaled $50.8 million. Most projects were completed at the end of 2004 with only one project ongoing, with completion expected by February 2007. The AsDB has also approved 27 technical assistance programs totaling $12.2 million, with 10 ongoing as of end-January 2006.

Statistical Issues

Data provision to the Fund is not adequate for effective surveillance, as significant weaknesses remain in the macroeconomic data, especially in the balance of payments and the national accounts. Institutional capacity remains very limited, and availability and quality of data are very weak.

TIMOR-LESTE—ANNEXES TO THE 2006 ARTICLE IV CONSULTATION STAFF REPORT

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Annexes:

ANNEX I. TIMOR-LESTE: FUND RELATIONS

(As of November 30, 2006)

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

II. General Resources Account:	**SDR Million**	**% Quota**
Quota	8.20	100.00
Fund holdings of currency	8.20	100.00
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 2005 Article IV consultation discussions with the authorities were held during March 10–25, 2005. The Executive Board discussed the staff report (http://www.imf.org/external/pubs/cat/longres.cfm?sk=18427.0) and concluded the consultation on June 15, 2005.

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. 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 end–2006, Timor-Leste has been one of the largest recipients of Fund technical assistance.

FAD: A series of multi-topic FAD missions took place early on to establish and develop the Central Fiscal Authority (CFA, February 2000), which developed into the Ministry of Planning and Finance. Assistance was provided to develop budget preparation, establish tax policy and administration, strengthen treasury and expenditure management, and advise on oil sector fiscal regimes. Long-term resident advisors were assigned to the Ministry of Planning and Finance and the Revenue Service of Timor-Leste to cover a wide range of issues, partly under a cost sharing arrangement with the UN. Over August 2004–July 2005, a FAD resident advisor assisted in the design and establishment of the Petroleum Fund, which started operations in August 2005. A FAD resident advisor to the Treasurer of the Ministry of Planning and Finance started work in December 2006 to help strengthen expenditure management, reporting and budget execution.

LEG: A number of LEG missions have been to Timor Leste 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 (relating to the monetary authority, the banking system, and the payments system). Jointly with MFD (now MCM), technical assistance has recently been provided to assist the authorities in drafting an AML/CFT Law. LEG has also recently provided assistance, in collaboration with FAD, for the drafting of the Petroleum Fund Act, and in collaboration with MCM, for the drafting of the Central Bank Law.

MCM: A large number of missions took place early on to establish and develop the Central Payments Office (CPO, January 2000), which was transformed subsequently into the Banking and Payments Authority (BPA) (November 2001). Assistance was 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. Assistance was also provided on the introduction of a dollar-based currency system and to issue domestic coins to supplement the use of U.S. dollar coins. More recently, assistance has been provided to (i) draft the insurance law and develop a framework for insurance supervision, (ii) strengthen banking supervision, (iii) address a broad range of issues relating to money laundering and

financing of terrorism, (iv) establish and train the investment unit responsible for managing petroleum fund assets (a resident adviser commenced in March 2005), (v) prepare for the establishment of the central bank, (vi) design of a more effective organizational structure at the BPA, and (vii) modernize payment systems, and accounting for the Petroleum Fund. In addition, long-term resident advisors, including on banking supervision, payments, and accounting, have been assigned to the CPO and the BPA under a cost sharing arrangement with the UN. Since early 2005, a long-term advisor has been assisting the BPA general manager.

STA: A multi-sector statistical mission took place in November 2000 to assess the availability and quality of official macroeconomic data, and help establish the Statistic Division of the Ministry of Planning and Finance. A long term statistical advisors was provided over the period November 2001-October 2005. A peripatetic statistical advisor is expected to be appointed in 2007 to assist the authorities in improving data compilation and developing local capacity to prepare national accounts and balance of payments statistics (responsibility for the latter was transferred to the BPA in 2006).

X. Resident Representative

A resident representative office was established in Dili in August 2000. The current resident representative, Mr. Tobias Nybo Rasmussen assumed the post in February 2006.

ANNEX II. TIMOR-LESTE: RELATIONS WITH THE WORLD BANK GROUP
(As of December 19, 2006)

1. 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. Timor-Leste also joined IFC in September 2004 and, together with the Pacific Enterprise Development Facility, an office was opened in Dili in 2006.

2. During the transition to independence, the World Bank's involvement centered around its role as 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 co-managed with the Asian Development Bank (ADB), the World Bank has administered projects relating to social services (especially health and education), agriculture, private sector development, community development and governance, economic capacity building, and petroleum sector development. Total funding for the World Bank-administered TFET projects reached $112 million, of which $105 million was disbursed by mid-December 2006.

3. In addition to its involvement through the TFET, the World Bank has also been playing a key role in mobilizing budgetary assistance for the post-independence period through an annual multi-donor budget support operation. The Transition Support Program (TSP) from FY 2003 to 2005, was followed by the Consolidation Support Program (CSP) from FY 2006 to 2008, to reflect the shift from post-conflict transition to consolidation of gains made thus far. The TSP programs brought about $30 million in budget support annually with about $5 million financed by IDA, and the balance financed by 9 bilateral partners. The CSP programs will bring about $10 million in budget support annually, with about $0.5 million financed by IDA. Both the TSP and the CSP programs focus on three thematic areas: (1) good governance, including developing a legal framework for governance and the judiciary and strengthening public expenditure management; (2) service delivery for poverty reduction, particularly in education and health; and (3) job creation, especially through private sector development, agriculture, and improvements in basic infrastructure.

4. The CSP I was approved by the Board in October 2005. A CSP progress mission in November 2005 concluded that developments had been positive and that the Government is likely to achieve its FY 2006 goals. This mission stressed however the need for actions conducive to faster private sector development. A CSP II appraisal mission in early March 2006 concluded that developments continue positive and three issues exist and need

[1] Pledges to the TFET were made by 12 donors, including the European Commission and the World Bank, with the total amount of funds reaching $178 million. This comprises donors' contributions of $167 million (including $10 million by the World Bank) and investment income of $9 million. Of this total, $160 million was disbursed by end-April 2006. TFET projects are expected to wind down by end-2007.

resolution: (i) law to harmonize legislation in the country is still pending approval, (ii) procurement is the major bottleneck for expanding government expenditures, and (iii) private sector development needs to be brought to the core of the country's reform program. The TSPs and CSPs have been praised by Government and donors alike for their beneficial effect on: (i) capacity building in Government prioritization; (ii) oversight over budget execution given the current weakness of internal oversight institutions; and (iii) donor coordination.

5. The World Bank has also provided analytical and advisory services, including through a Country Economic Memorandum, a Poverty Assessment, a Public Expenditure Management and Accountability Note, a Public Expenditure Review, an Education Sector Review, and a Paper on Strengthening the Institutions of Governance in Timor-Leste. The "Doing Business" report for 2006 featured Timor-Leste for the first time. Additional support is underway with respect to financial and private sector development, health sector development including population growth challenges, and issues pertaining to youth. The World Bank is also contributing to the FIRST Initiative's Technical Assistance Project for the Establishment of a Credit Registry.

6. In July 2005 the World Bank adopted a Country Assistance Strategy for FY 2006–08 that focuses on: (i) delivering sustainable services; (ii) creating productive employment; and (iii) strengthening governance. In addition to the annual CSP program the CAS provides for new programs in education, health, energy, and public finance capacity building, for a total amount of IDA grants of about US$ 25 million. The Planning and Financial Management Capacity Building Project was approved in March 2006; this program amounts to $37 million with $7 million from IDA and $30 million from development partners. Timor-Leste has recently also been awarded $8.2 million from the Education For All Fast Track Initiative (FTI) Catalytic Fund, the first post-conflict country to benefit from the initiative.

7. Prior to Timor-Leste's restoration of independence, the World Bank co-chaired six bi-annual donors' meetings. After independence, the World Bank has co-chaired the Timor-Leste and Development Partners Meeting (TLDPM) with the Government of Timor-Leste. The TLDPM has taken place in December 2002, June 2003, December 2003, May 2004, April 2005 and April, 2006. The sixth and latest TLDPM concluded that: (i) with key institutions of governance established, Timor-Leste enjoys an unique opportunity to sustainably increase spending on much needed services; (ii) in the short-term, well targeted public investments harbor the greatest potential for job creation and poverty reduction; and (iii) vigorous actions towards improving a private sector enabling environment are needed for longer term growth.

ANNEX III. TIMOR-LESTE: RELATIONS WITH THE ASIAN DEVELOPMENT BANK
(As of December 15, 2006)

1. Timor-Leste joined the Asian Development Bank (AsDB) on July 24, 2002. To date, there has been no lending to the country. 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.

2. The AsDB's involvement has centered around co-managing 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.[2] Under the TFET, the AsDB has managed six projects with total funding of $51.7 million,[3] which aimed at the rehabilitation of physical infrastructure (urban and rural power, national roads, ports, and water and sanitation) and the development of microfinance. In the wake of the post-referendum destruction, the focus of the projects was on providing emergency assistance, but subsequently shifted to meeting the country's long-term development needs. AsDB has prepared a "consolidation" phase program to be funded predominantly from Asian Development Fund grants ($16 million over 4 years) and technical assistance (about $4 million over 4 years). This phase comprises a more sharply focused program (infrastructure development and associated technical assistance for main roads and urban water supply and sanitation only) and strategies to leverage AsDB support by helping the Government to program and coordinate infrastructure development. At mid-December 2006, disbursements for AsDB-managed projects totaled $50.8 million. Most projects were completed at the end of 2004. Only one project (EIRP-2) is ongoing, with completion expected by February 2007.

3. The AsDB has also been actively involved in technical assistance. Thus far, the AsDB has approved 27 technical assistance programs totaling $12.2 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 end-January 2006, 16 technical assistance programs were completed and 10 programs continued.

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[2] See footnote 1 in Relations with the World Bank Group.

[3] 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 (originally $4 million, but reduced to $2.7 million).

ANNEX IV. TIMOR-LESTE: STATISTICAL ISSUES

Data provision to the Fund is not adequate for effective surveillance, as significant weaknesses remain in the macroeconomic data, especially in the balance of payments and the national accounts. Prior to 1999, macroeconomic data were compiled by the Indonesian Central Bureau of Statistics (Badan Pusat Statistik, BPS) and the Central Board of Statistics of the East Timor Province. Balance of payments statistics were almost nonexistent as Timor-Leste was treated as one of the Indonesian provinces. Data compilation was seriously disrupted in 1999, as the post-referendum turmoil destroyed databases, and institutional capacity collapsed after most Indonesian statistical officers left.

During reconstruction, international financial institutions and bilateral donors provided technical assistance. To this end, a multi-sector Fund statistics mission visited Dili in November 2000 and assisted the authorities in establishing objectives for restoring economic statistics and in setting up a Statistical Division in the Ministry of Planning and Finance in 2001. A long-term resident statistical advisor assisted the Statistical Division during November 2001–February 2004, and was succeeded by a new resident advisor until September 2005. Unfortunately, progress has been minimal, as resources at the Statistical agency are insufficient to compile a wide range of social and economic statistics. Institutional capacity remains very limited, and availability and quality of data are very weak.

National accounts

Under a World Bank-financed project, national accounts data for 2000 (both sector and expenditure basis) were estimated by the Boston Institute for Developing Economies (BIDE). In late 2004, BIDE, under a follow-up World Bank project, produced GDP estimates for 2001-2003 that suffer from limited source data and substantial extrapolation. The Division of Statistics has not been able to replicate the BIDE estimation exercise for 2004. Consequently, estimates of GDP (including for the oil sector) have been prepared by Fund staff. To improve national accounts data, appropriate staff and substantial efforts at data collection and elaboration are needed. The authorities have secured a commitment from the World Bank for continued support on national accounts.

Prices, employment, and wages

Since 1999, a consumer price index has been compiled monthly for Dili and quarterly for the whole country, with April 2000 as a base period. To address quality weaknesses, in particular inappropriate and outdated weights, the commodity basket and the weighting scheme were revised in mid-2003 under a donor-supported project, and a new monthly index for Dili has been compiled, with December 2001 as the base period. A further update of CPI weights based on detailed consumption patterns is not expected before 2007 as the authorities are focusing on the conduct of a World Bank living standards measurement survey for 2006.

Annual data on public sector employment and wages are available through fiscal records. No official data are compiled regularly on private sector employment and wages, except for partial data from household surveys conducted jointly by UNDP, ADB, and the World Bank.

Government financial statistics

Official data on central government revenue and expenditure are published semi-annually. Audited annual financial statements of the executed budget are made available to APD as soon as they are released, normally three months after the end of the fiscal year. In addition, monthly data are available on request through the budget, treasury, and revenue services. The compilation of revenue and expenditure follows the classification of the *Manual on Government Finance Statistics (GFSM 1986)* (including expenditure based on both functional and economic classification). Data on the execution of expenditure carried over from past fiscal years are not yet compiled and reported regularly. Only partial data are available on fiscal and quasi-fiscal activities undertaken by bilateral donors outside the central government budget. Currently, there are four non-financial public enterprises, which are treated as government agencies and data on their operations are available in the audited annual financial statements. No data are currently reported for the *GFS Yearbook* and the *International Financial Statistics*.

Monetary accounts

Monetary statistics are compiled by the Banking and Payments Authority (BPA), generally following the classification recommended by the Fund. However, data are incomplete because of the absence of official data on public currency holdings, which are difficult to compile under the current currency regime. The BPA publishes a quarterly bulletin and an annual report with key monetary aggregates. Detailed monthly monetary data are also available to Fund staff on request. Comprehensive compilation of data on interest rates (both deposit and lending rates) and bank lending and investment has begun only recently. However, the availability of these data is extremely limited because the BPA is concerned about revealing confidential information on commercial bank operations given the very small number (four) of banks in the economy.

No monetary data are currently reported to STA for publication in the *International Financial Statistics*. Work is ongoing for BPA to start reporting monetary statistics to STA using the standardized report forms (SRF) on a monthly basis. Such reporting will be used for the Fund's operational and publication purposes. To this end, the authorities have already reported test data for the BPA and the other depository corporations for December 2004, and are working on deriving monthly for 2005 and 2006.

Balance of payments

No official data are available, except on merchandise exports and imports (starting March 2000), which are based on customs reports with a breakdown for major commodity categories. However, data do not include oil and gas exports. Trade data do not include any estimate of large unrecorded border trade. Data on oil/gas revenue are currently recorded as income (for royalties) and transfers (for tax revenue) based on fiscal data. All other major items in the balance of payments are estimated by Fund staff on the basis of limited information obtained from various sources, including bilateral donors and banks.

To address institutional weaknesses in the compilation of the balance of payments, the Ministry of Finance has taken steps to transfer responsibility for the compilation of the balance of payments to the BPA.

Timor-Leste: Table of Common Indicators Required for Surveillance
(As of December 14, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	Not applicable				
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	9/2006	10/2006	M	M	Q
Reserve/Base Money (*excludes currency in circulation*)	9/2006	10/2006	M	M	Q
Broad Money (*excludes currency in circulation*)	9/2006	10/2006	M	M	Q
Central Bank Balance Sheet	9/2006	10/2006	M	M	Q
Consolidated Balance Sheet of the Banking System	9/2006	10/2006	M	M	Q
Interest Rates[2]	9/2006	10/2006	Q	Q	A
Consumer Price Index	9/2006	11/2006	M	M	M
Revenue, Expenditure, Balance and Composition of Financing – General Government[4]	...	...	...	...	...
Revenue, Expenditure, Balance and Composition of Financing– Central Government	3/2006	11/2006	Q	Q	A
Stocks of Central Government and Central Government-Guaranteed Debt	No debt contracted				
External Current Account Balance	Data not available				
Exports and Imports of Goods and Services [5]	03/2006	05/2006	M	M	M
GDP/GNP	2003	10/2004	...	...	...
Gross External Debt	Not applicable				

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic non-bank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. For Timor-Leste it includes public spending from donors, on which data on execution are not available
[5] Includes only goods. No information on services is available.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); NA: Not Available

Statement by Arrigo Sadun, Executive Director
for the Democratic Republic of Timor-Leste
and Luis Saramago, Advisor to Executive Director
January 29, 2007

We start by thanking staff for their much appreciated work during these consultations, partly conducted under somewhat challenging conditions. At a time of significant changes in the social and economic situation of Timor-Leste, the authorities welcomed this opportunity to discuss their policy options. Moreover, they value the analysis and recommendations of the staff report and the Selected Issues paper, which will be taken into due consideration as an important contribution for their policy decisions. They particularly appreciated staff's care to represent their views explicitly, extensively and accurately in the staff report.

Key Points

- The authorities are strongly committed to ensure that **political and social stability** is fully reinstated and durably preserved. Significant steps have been taken to promote national reconciliation and a broad social consensus, while upholding the rule of law, thus aiming for a smooth path towards the upcoming elections.

- The authorities remain firmly committed to **sound economic policies**, under the National Development strategy, as since the country regained independence in 2002. Their positive record in this regard has been widely acknowledged – also by the Fund, as again in the present report – and should be duly emphasized.

- The **development strategy**, reiterated by the current government, includes such critical pillars as the sustainable and transparent management of oil and gas resources; efficient public spending for development; macroeconomic stability, anchored on US dollar adoption; and private sector promotion, from an improved business environment.

- **Oil and gas resources** are to be the lever for long-term development, through a special framework for their sound management. Based on a Petroleum Fund and a savings rule, this framework is acknowledged to follow international best practices and has been operational since mid-2005 – including throughout the recent instability period.

Recent Developments

Under a new Prime Minister but with a broadly unchanged Cabinet, supported by the same large single-party majority in Parliament, the current government took office in July last year. It has pledged to advance national reconciliation, in the aftermath of mid-2006 civil unrest, and to prepare for the upcoming elections, while reiterating the main economic

priorities and guidelines of the previous administration – namely as expressed in the National Development strategy, and in particular as regards the framework for a sound, transparent and sustainable management of oil and gas resources.

By restating that commitment, the new government intends to uphold the positive record of economic policymaking generally acknowledged to the Timorese authorities by the international community – including the Fund – since independence was restored in 2002. At the same time, the government is determined to address certain areas on which obstacles such as capacity problems – a major constraint for Timor-Leste – have prevented faster progress. Accordingly, it plans to step-up the execution of public investment projects and to improve conditions for the attraction of private investment, both domestic and foreign.

Economic performance was affected by the mid-2006 incidents, but nevertheless a robust recovery is now underway, prompted by a rebound of the agriculture sector and mostly supported by higher, although sustainable, public spending – also compatible with self-imposed commitments, under the oil and gas savings rule. The recovery is further assisted by the impact of a re-enhanced UN mission, gradually deployed since August last year, as well as by the fact that civil unrest was largely restricted to the Díli area, thus tending to facilitate the normal resumption of economic activities.

According to available data, non-oil GDP is estimated to have contracted by around 6 percent in 2006, but should rebound by an expected 32 percent in 2007. Prospects for inflation are also brightening up, as the supply of Díli markets gradually returned to normal after an initial inflationary disruption, prompted by civil unrest. The continued inflow of sizeable offshore oil and gas revenues has, in turn, favorably shaped fiscal and external developments: the 2005/06 budget surplus reached 103 percent of non-oil GDP, in a commitment basis, while the current account surplus is estimated at 116 percent of non-oil GDP in 2006.

Oil and Gas Wealth

After careful preparation, with valued support from the Fund and other external partners, the framework for a sustainable and transparent management of oil and gas resources essentially became operational in the second half of 2005. Its cornerstone, the Petroleum Fund Law, was indeed promulgated in August that year, while other related building-blocks were gradually added, including the implementation of a Consultive Council and an Investment Advisory Board, the selection of an independent auditor through international open tender and the country's participation in the Extractive Industries Transparency Initiative. This high-quality framework follows international best practices of transparency and accountability, as well as a conservative financial approach, aimed at preserving resources for future generations, and also a prudent macroeconomic approach, aimed at minimizing any possible symptoms of the *resource curse*.

Transfers from the Petroleum Fund, which concentrates all the oil and gas revenues, can only be made into a specific Treasury account and up to an annual expenditure ceiling deemed sustainable according to a long-term savings rule: the sum of non-oil domestic revenues and the estimated permanent income from invested oil and gas revenues. This framework has proved its robustness throughout the recent period of civil unrest, by which it was not affected – revenues continued to accumulate in the Petroleum Fund, as supposed. Moreover, it will likely be able to easily accommodate the expected increase in oil and gas revenues from new sources, such as the Greater Sunrise field.

Fiscal Policy

The authorities believe that improving public service delivery by means of higher and faster-executed public investment is a key requirement to consolidate social stability. On the one hand, by the creation of conditions for private sector development, notably through infrastructure enhancement, thus promoting growth and employment. On the other hand, by implementing pro-poor initiatives that directly allow for a much-needed alleviation of harsh social conditions. The authorities will, therefore, assign a high priority to efforts aimed at overcoming implementation constraints, including by way of intra-civil service dissemination of best practices, in such areas as procurement, and greater reliance on competitive outsourcing of capital projects to foreign firms.

The priority given to expenditure execution, for such reasons, should not be seen, however, as an indication of any lesser commitment to fiscal soundness from the authorities' part. Their budget for the 2006/07 fiscal year, approved in August, does indeed allow for a significant rise in spending – to 73 percent of non-oil GDP (on a commitments basis), from an estimated 34 percent in 2005/06. Nevertheless, total revenues are expected to reach 173 percent of non-oil GDP in the same period and the level of expenditures deemed sustainable under the oil and gas savings rule is conservatively estimated at 76 percent. Furthermore, the Sector Investment Programs (SIP) framework was appropriately conceived, with support from the World Bank and other donors, to preserve the quality of public investment spending, foster its complementarities with private investment and maximize returns. As for the budgeted increase in current expenditures, it is largely non-recurrent and aimed at bridging the transition to a new efficiency-oriented wage structure – against a background of no pay rises since 2002.

An outstanding track record of fiscal soundness since independence was restored in 2002 – namely through cautious spending and prudent management of oil and gas revenues – has allowed the authorities to take credit for a rare absence of public debt. While generally believing there is no pressing need to change that approach, they nevertheless reiterate that due consideration may possibly be given to concessional financing options in the future. As for tax policy, the authorities are very keen on exploring the possibility of simplifying the tax structure and generally relieving the burden it imposes on the non-oil economy – also from

cumbersome red tape, to a large extent determined by capacity constraints. They are nevertheless aware of the need to proceed with caution and welcome the ongoing FAD mission that is taking up the issue.

Monetary Policy

The monetary framework adopted by Timor-Leste since the restoration of independence, with official dollarization as its cornerstone, remains well suited to the country's needs and constraints. Indeed, the notion that it provides an effective anchor for price stability seems to be confirmed by recent trends: inflation has started to decline, thus tending to offset the mid-2006 upsurge fueled by a post-civil unrest supply shock. Moreover, the framework has broadly been instrumental in preserving external price-competitiveness, under different and evolving conditions. Scarce human resources, that would have to be moved from other priority areas for the independent conduction of monetary policy, are an additional reason to keep the current framework – even if capacity is increasing with experience, as is particularly the case of the Banking and Payments Authority (BPA).

Banking Issues

The sizeable increase of non-performing loans since mid-2006 essentially reflects the disruption caused by civil unrest and should therefore be seen as an exceptional and to some extent reversible development. Its systemic impact is actually limited by the fact that local branches of solid foreign banks, with much larger non-Timorese operations, mostly make up the system. As far as Timor-Leste is concerned, those banks have declared themselves engaged in long-term strategies that include a gradual expansion of local activities, also in geographical terms, as the country develops. Moreover, exposure to NPLs is being significantly reduced by stepped-up provisioning and should also benefit from the credit registry system under implementation by the BPA. This latter also continues to pursue efforts aimed at finalizing and taking to Parliament such critical regulatory pieces as the Payments, the AML and the Central Bank laws.

Other Structural Issues

The authorities acknowledge that significant additional steps need to be taken in order to improve the environment for private sector activity. They are well aware of the critical importance assumed by such matters for the country's medium-term prospects and are therefore committed to take decisive action in this regard. Besides their plans for the tax system, currently under consideration and with significant business-enhancement potential, other steps include several specific measures to streamline legislation, regulation and administrative procedures relating to domestic and foreign investment. Actually, six months after taking office and in spite of still challenging security conditions, the new government can already point to a significant increase of foreign investment – about 30 new projects

approved since July 2006, amounting to about USD 180 millions (almost half of non-oil GDP), against 12 projects in the previous 12 months.

Concluding Remarks

The recent unfortunate events in Timor-Leste have once again highlighted the critical importance of building capacity and institutions in young, post-conflict countries, while carefully preserving social cohesion. Those specific events further reinforce the more general notion that a sustained involvement of the international community is a necessary requirement for success under such circumstances. Timor-Leste, in particular, will continue to rely on the valued support of its international partners, among which the Fund has a vital role to play, building on the significant contribution given for several years in its areas of expertise. The authorities reiterate their high appreciation of that contribution and thank the Executive Board, Management and staff for their support, on which they will keep counting in their challenging endeavors.

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IMF Executive Board concludes 2006 Article IV Consultation with the Democratic Republic of Timor-Leste

On January 29, 2007, 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 had made good progress in establishing the basis for a stable and healthy economy prior to the civil unrest in 2006, though it remains one of the poorest countries in the world. Real non-oil GDP growth turned positive in 2004–05 after contracting for two years following the end of the reconstruction boom of the initial post-conflict years. Macroeconomic stability was achieved through the early adoption and maintenance of prudent fiscal and monetary policies. However, progress toward the country's National Development Plan (NDP) objectives and Millennium Development Goals (MDGs) was limited. Further, the violence that erupted in April 2006, although now largely quelled, has introduced new risks to the outlook. Nonetheless, the onset of large oil-and-gas revenue inflows and prospects for sizable additional revenue from new fields could still, if properly managed, transform the economy.

The security situation and domestic institutions remain fragile. The unrest, combined with persistent poverty and high unemployment amid rising expectations highlight the continuing

[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.

vulnerabilities in the country's institutional capacity, notwithstanding considerable nation and capacity building over recent years.

Against this background, increased urgency is placed on meeting the challenge of how best to use the new oil-and-gas wealth to lift the non-oil economy onto a higher growth path and reduce poverty. The new government endorsed the pre-existing development strategy, set out in the NDP and related documents that comprise the Poverty Reduction Strategy. This strategy focuses on reforms to promote growth, including: a long-term oil-and-gas revenue saving policy supported by a petroleum fund; well-targeted development spending under the sector investment programs (SIPs); a monetary and exchange rate regime that preserves macroeconomic stability; and a private-investment-friendly environment. However, progress on the strategy has been stronger on some elements than others and non-oil growth still falls short of that needed to reduce poverty. In the aftermath of the recent unrest, the government plans a new Compact with donors to reinvigorate implementation of the development strategy.

High world oil-and-gas prices are providing a boost to Timor-Leste's fortunes by raising current and potential revenue inflows. Non-oil activity began to recover in 2005 as stable macroeconomic conditions and improved policies offset a scaling down of donor activity, though it had not yet risen above the population growth rate. However, the civil unrest in 2006 setback the growth momentum. As a result, real non-oil GDP growth is estimated to be slightly negative for the year, despite an end-year boost from public spending and international aid. Driven by crisis-related supply disruptions, inflation jumped to about 7 percent in the year to June 2006, although the impact on external price competitiveness has been muted by the recent depreciation of the exchange rate.

Large oil-and-gas revenue inflows have led to sizeable surpluses in the external current account and in the fiscal position, notwithstanding sharply increased government spending. Oil-and-gas revenue was estimated at 128 percent of non-oil GDP in 2005/06, lifting the central government surplus to 111 percent of non-oil GDP. Central government expenditure of 26 percent of non-oil GDP remained well below the sustainable spending level determined by the authorities' saving policy. The steep increase in budgeted spending for 2006/07, to 73 percent of non-oil-GDP, is designed in large part to respond to the recent crisis. However, budget execution is likely to remain constrained by weak capacity, resulting in cash expenditures continuing to fall short of commitments. On a '*combined source'* basis, which includes actual government and donor spending, total expenditure should increase only slightly compared to pre-2005/06 levels as increased government spending largely offsets lower donor financing.

The authorities have maintained a policy of avoiding domestic or external borrowing, hence there is no public sector debt. A current account surplus of 93 percent of non-oil GDP (excluding international assistance) emerged in 2006. Net foreign assets of the Banking and Payments Authority (BPA), combined with the foreign assets of the petroleum fund, rose to US$957 million by September 2006, equivalent to almost 7 years of merchandise imports.

Loan quality deteriorated further, post-crisis, while private credit contracted. At end-September 2006, nonperforming loans (NPLs) accounted for 30 percent of total bank lending, with banks now more aggressively provisioning for potential losses. Given still weak enforcement of creditors' rights, banks are increasing reluctant to extend new loans and credit to the private sector fell by 10 percent on a year/year basis.

Reforms needed to spur non-oil private sector activity gained some momentum prior to the crisis, but significant legal and institutional gaps remain a burden. The investment and export promotion agency became operational in late 2005 and projects in the fishery, coffee, and tourism sectors have begun. However, business registration and land development remain difficult, some key legislation is not yet in place, and the overwhelmed court system has not been able to address commercial disputes. Poor infrastructure and lack of human capital are additional difficulties faced in developing the non-oil economy.

Executive Board Assessment

Executive Directors commended the authorities for their progress in stabilizing the economy and establishing a foundation for future growth, while recognizing the need to address the immediate economic and humanitarian consequences of the recent civil unrest. Looking ahead, Directors considered that the main challenge is to use the oil-and-gas resources and stable macroeconomic environment to lift the non-oil economy onto a higher growth path and reduce poverty.

Directors endorsed the authorities' development strategy, which focuses on core reforms needed to promote growth. In this respect, they underscored the need to maintain a monetary and exchange regime that preserves macroeconomic stability, forceful progress to secure well-targeted and prioritized development spending, and far-reaching reforms to encourage private activity and investment.

Directors supported a sustainable stepping-up of government investment spending over the medium term to address Timor-Leste's considerable development needs. They pointed, however, to the need for careful planning and monitoring to guard against unproductive spending and welcomed measures to strengthen budget execution, including the introduction of small education and community grants, international outsourcing of large infrastructure projects, improved cash and commitment controls, and procurement decentralization.

Directors commended the authorities for the establishment of the petroleum fund, which along with the saving rule, will help achieve fiscal sustainability and intergenerational equity. They welcomed the authorities' continued policy of transparent reporting of petroleum-related activities, and the participation in the Extractive Industries Transparency Initiative.

Directors supported the current monetary and exchange regime, which provides a credible nominal anchor for macroeconomic stability. While the current level of the real exchange rate is not a threat to medium-term competitiveness, Directors called on the authorities to ensure that fiscal policies—in particularly for wages, subsidies and other recurrent costs—reflect the need

to contain price pressures. Directors agreed with the authorities that stronger institutional capacity and a well-functioning financial market need be in place before considering the introduction of a national currency.

Directors urged the authorities to limit external borrowing to ensure consistency with the government's investment priorities, the sustainable spending framework, and macroeconomic stability; and to ensure that terms are adequately concessional.

Directors agreed that favorable oil revenue developments provide a welcome opportunity to put in place wide-ranging tax reforms in the non-oil sector to help spur private economic activity. They considered that a simplified, streamlined tax regime, with low tax rates and higher minimum thresholds, would also better fit the limited administrative capacity.

Directors considered that the weakening in banks' loan portfolios is unlikely to present a systemic risk, but noted that it may reduce credit availability and slow the economic recovery. They welcomed plans to further strengthen banking supervision, create a loan registry, introduce an alternative means of resolving commercial disputes, and finalize banking sector legislation. Directors cautioned that a state-owned rural-development bank—as is being considered by the authorities—has to be operated on a strict commercial basis to avoid a further weakening of the fragile financial system.

Directors stressed that greater efforts are needed to create an environment conducive to more private investment and growth. They urged the authorities to expedite the passage of critical legislation, such as the pending land law, while noting that proposed amendments to labor legislation should encourage greater labor market flexibility.

Directors encouraged the authorities to intensify their efforts to strengthen capacity to compile and analyze basic macroeconomic data.

Timor-Leste: Selected Economic Indicators, 2002–07

	2002	2003	2004	2005	2006 Est.	2007 Proj.
Output and prices 1/						
GNI at current prices (in millions of U.S. dollars)	352	349	507	692	847	1375
Non-oil GDP	343	336	339	350	356	493
Oil/gas income	9	13	168	342	492	882
Real non-oil GDP growth (percentage change)	-6.7	-6.2	0.3	2.3	-1.6	32.1
Inflation (percentage change, end-period) 2/	9.5	4.2	1.8	0.9	5.7	5.0
			(In percent of non-oil GDP)			
Central government budget (cash basis) 3/						
Revenues	24	31	98	137	172	202
Domestic revenues	6	9	11	9	9	8
Oil/gas revenues	9	12	77	128	161	192
Grants	10	10	10	0	2	2
Expenditure	20	20	21	26	40	43
Recurrent expenditure	17	18	18	20	33	29
Capital expenditure	3	3	3	7	7	14
Overall balance	4	11	77	111	132	158
Non-oil fiscal balance	-5	-1	0	-17	-29	-34
Public debt	0	0	0	0	0	0
Combined sources fiscal operations 3/ 4/						
Revenues	17	21	23	12	13	12
Expenditure	71	70	68	62	71	70
Recurrent expenditure	54	55	52	47	53	44
Capital expenditure	18	15	15	15	18	25
Overall balance	-54	-50	-45	-50	-58	-58
Money and credit						
Broad money (end-period) 5/	15.9	21.5	24.8	27.8	32.0	29.5
Net domestic assets (end-period)	-10.3	-10.7	-30.1	-17.7	-6.2	-0.1
			(In millions of U.S. dollars)			
External sector						
Current account excl. international assistance	-244	-208	-15	193	329	617
Current account incl. international assistance	-128	-85	103	292	411	688
Trade balance	-211	-186	-154	-127	-133	-219
Merchandise exports 6/	6	8	8	9	8	10
Merchandise imports	-218	-194	-163	-137	-141	-229
Overall balance	20	18	121	341	482	686
			(In percent of non-oil GDP)			
Current account excl. international assistance	-71	-62	-4	55	93	125
Current account incl. international assistance	-37	-25	30	84	116	141
Trade balance	-62	-55	-46	-36	-38	-44
Merchandise exports 6/	2	2	2	3	2	2
Merchandise imports	-63	-58	-48	-39	-40	-46
Overall balance	6	5	36	97	136	139

Sources: Data provided by the Timor-Leste authorities; and IMF staff estimates.
1/ Non-oil GDP and national accounts data for 2001–03 are based on estimates prepared by a World Bank sponsored consultant.
2/ CPI for Dili.
3/ Fiscal year basis (July-June); for example, 2001 refers to FY2001/02.
4/ Includes autonomous agencies and fiscal and quasi-fiscal expenditure programs undertaken by bilateral and multilateral donors outside the central government budget. The revenue decline in FY2005/06 reflects the adoption of a new savings and petroleum fund policy according to which oil revenue accrues to the petroleum fund and only the sustainable income from the oil wealth may be transferred to the budget to finance the non-oil fiscal deficit. The overall balance is also partially funded from donors own funds.
5/ Excludes currency holdings by the public, for which no data are available.
6/ Excludes oil/gas revenue, which are recorded under the income account (royalties) and transfers (tax revenues). Also excludes re-exports, which primarily relate to repatriation of equipment from UN peacekeeping operations.