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REPUBLIC OF TIMOR-LESTE

June 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR 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 2016 Article IV consultation with Timor-Leste, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its May 11, 2016 consideration of the staff report that concluded the Article IV consultation with Timor-Leste.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 11, 2016, following discussions that ended on February 12, 2016, with the officials of Timor-Leste on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 7, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the International Development Association (IDA).
- A **Statement by the Executive Director** for Timor-Leste.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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May 25, 2016

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IMF Executive Board Concludes 2016 Article IV Consultation with Timor-Leste

On May 11, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the 2016 Article IV Consultation with Timor-Leste.[1]

Non-oil real GDP growth is estimated to have declined to 4.3 percent in 2015 from 5.5 percent in 2014, due to weaker government spending. Both headline and core inflation eased to below 1 percent in 2014 and 2015, reflecting lower commodity prices, a stronger U.S. dollar against Timor-Leste's trading partners' currencies, and some improvement in supply bottlenecks.

The fiscal position weakened in 2015 due largely to lower petroleum revenue. Petroleum revenue fell by 40 percent in 2015 mainly on account of the slump in global oil prices. Staff's estimate points to an overall fiscal surplus of 4.2 percent of GDP in 2015, a considerable reduction from the large surpluses in previous years. Prudent saving of its oil wealth in the Petroleum Fund (PF), Timor-Leste's sovereign wealth fund, has provided a financial cushion to help offset revenue losses. Withdrawals from the PF remained above the level consistent with the estimated sustainable income, in part to finance front-loaded capital investments. This, coupled with lower oil receipts and negative net investment returns due largely to foreign exchange valuation losses, saw the balance of the PF decline for the first time, to $16.2 billion as of end-2015.

The external current account surplus was halved to 25 percent of GDP in 2014 and is estimated to have shrunk further to 17 percent of GDP in 2015. This is largely due to lower income from declining oil and gas receipts and weak investment returns on the PF portfolio against weak global equity market performance in 2015. The banking system is highly liquid and well capitalized. Growth of private sector credit picked up to 10.5 percent (y/y) in December 2015 from 5.5 percent in December 2014. Excess liquidity in the banking system and banks' overseas placements of deposits have remained high.

[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.

The medium-term growth outlook depends critically on economic diversification and ensuring a sustainable fiscal position. Average non-oil real GDP growth in the medium-term is projected at 5.5 percent, supported by increasing public spending and foreign direct investment. This hinges on successful prioritization of government expenditures to facilitate high-return infrastructure investments in tandem with structural reforms that catalyze non-oil private sector growth.

The main sources of risk over the medium- to long-term are higher fiscal spending, public investments not yielding adequate returns and enhanced growth, and inadequate mobilization of domestic revenues.

Executive Board Assessment[2]

Executive Directors commended the authorities for the progress made in nation building and economic and social development. However, Directors noted that Timor-Leste faces difficult policy challenges from the fall in oil revenue and the country's large development needs. Going forward, they emphasized the importance of achieving fiscal sustainability and economic diversification.

Directors saw a need for continued fiscal consolidation. They encouraged the authorities to strengthen non-oil revenue, rationalize current spending, and adhere to a medium-term adjustment plan. Recognizing the need for capital spending, Directors encouraged the authorities to prioritize public investment plans, focusing on high-return infrastructure projects through rigorous investment appraisal, so that such spending is in line with implementation capacity and debt sustainability. Directors stressed that optimizing the composition and quality of spending to help close Timor-Leste's infrastructure gap will be key to long-term fiscal sustainability and inclusive growth.

Directors welcomed the authorities' commitment to preserving the assets of the Petroleum Fund. In this context, they supported higher use of concessional financing for large infrastructure projects, which would reduce reliance on withdrawals from the Petroleum Fund and support greater discipline in investment spending. Directors also welcomed plans to introduce a value-added tax, which will help achieve the government's target of raising non-oil revenues.

Directors supported the efforts to improve financial inclusion, underscoring the importance of striking the right balance with safeguarding financial stability. They saw a need for continued efforts in strengthening regulatory and supervisory capacity and improving central bank functions. Directors called for a strategy to fully resolve legacy non-performing loans.

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[2] 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors concurred that the use of the U.S. dollar as legal tender has served Timor-Leste well. They supported the authorities' plan to pursue further financial sector and institutional development to pave the way for any potential change in the monetary and exchange rate regime.

Directors emphasized that medium-term growth will depend critically on economic diversification. In this context, they agreed that priority should be given to boosting the private sector by building infrastructure, improving the business climate and enhancing competitiveness. Improvement in social conditions and investment in human capital will also be necessary. Directors called for continued efforts to improve statistical capacity as well as the quality and timeliness of data, which are crucial for policy formulation. They encouraged the authorities to further leverage technical assistance from the Fund and other development partners.

Table 1. Timor-Leste: Selected Economic and Financial Indicators, 2012–21

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
			Est.	Prel.	Proj.					
	(Annual percent change)									
Real sector										
Real total GDP	5.3	-13.9	-15.8	-0.6	-8.8	-12.9	-3.9	-9.4	-9.2	-8.8
Real non-oil GDP	6.4	2.8	5.5	4.3	5.0	5.5	6.0	6.5	5.5	5.5
CPI (annual average)	10.9	9.6	0.8	0.6	1.5	3.8	4.0	4.0	4.0	4.0
CPI (end-period)	10.9	4.0	0.3	-0.6	3.6	4.0	4.0	4.0	4.0	4.0
	(In percent of GDP, unless otherwise indicated)									
Central government operations										
Revenue	61.1	66.1	63.2	61.5	63.1	52.6	49.0	46.0	42.7	40.0
Domestic revenue	2.0	2.7	3.9	6.5	8.0	7.6	7.3	7.2	7.1	7.3
Petroleum revenue (incl. PF interest)	55.5	58.7	53.2	48.9	48.3	41.1	37.7	34.8	31.5	28.7
Grants	3.7	4.7	6.2	6.1	6.8	4.0	4.0	4.0	4.0	4.0
Expenditure	22.0	24.0	37.4	57.3	73.5	73.1	69.1	67.2	65.0	58.5
Recurrent expenditure	10.4	13.1	20.9	39.1	49.3	45.8	43.8	43.1	42.2	40.9
Capital expenditure	7.9	6.3	10.2	11.7	17.4	23.3	21.3	20.1	18.8	13.6
Donor project	3.7	4.7	6.2	6.1	6.8	4.0	4.0	4.0	4.0	4.0
Overall balance	39.1	42.1	25.9	4.2	-10.4	-20.5	-20.1	-21.2	-22.4	-18.5
Non-oil overall balance (in percent of non-oil GDP)	-86.0	-70.5	-86.9	-82.8	-83.3	-81.8	-73.5	-66.1	-59.7	-49.5
	(Annual percent change, unless otherwise indicated)									
Money and credit										
Deposits	26.5	22.4	19.6	22.8	21.6	21.3	21.9	21.6	21.6	21.7
Credit to the private sector	20.5	13.6	5.5	10.5	13.3	13.7	12.5	13.2	13.1	12.9
Lending interest rate (percent, end-period)	12.2	12.4	12.9	13.5	…	…	…	…	…	…
	(In millions of U.S. dollars, unless otherwise indicated)									
Balance of payments										
Current account balance 1/	2,736	2,391	1,096	431	41	-281	-315	-334	-359	-241
(In percent of GDP)	40.2	42.7	25.1	16.5	2.0	-11.9	-12.2	-12.2	-12.2	-7.8
Trade balance	-638	-679	-749	-684	-710	-844	-892	-901	-917	-892
Exports 2/	33	18	15	9	17	20	21	24	26	28
Imports	672	696	764	692	728	864	914	925	943	920
Services (net)	-920	-437	-388	-414	-486	-648	-647	-646	-637	-524
Petroleum revenue	3,775	3,286	2,319	1,281	1,014	972	976	955	925	889
Overall balance	422	-197	-376	127	8	6	3	1	1	1
Public foreign assets (end-period) 3/	12,659	15,639	16,849	16,655	16,552	16,247	15,944	15,600	15,226	14,816
(In months of imports)	91	156	165	169	153	122	115	110	106	110
Exchange rates										
NEER (2010=100, period average)	96.7	101.9	106.8	120.2	…	…	…	…	…	…
REER (2010=100, period average)	115.5	131.6	134.9	150.1	…	…	…	…	…	…
Memorandum items:										
GDP at current prices:	6,807	5,595	4,361	2,620	2,100	2,368	2,589	2,746	2,933	3,094
Non-oil GDP	1,295	1,319	1,371	1,412	1,480	1,782	2,037	2,323	2,647	2,948
Oil GDP	5,512	4,276	2,990	1,207	620	587	552	423	286	147
GDP per capita	5,673	4,974	3,807	2,244	1,769	1,959	2,104	2,192	2,300	2,384
Crude oil prices (U.S. dollars per barrel, WEO)4/	105	104	96	51	35	41	45	48	49	51
Petroleum Fund balance (in millions of U.S. dollars) 5/	11,775	14,952	16,539	16,218	16,106	15,795	15,489	15,144	14,769	14,359
Petroleum Fund balance (in percent of non-oil GDP)	909	1,134	1,206	1,148	1,088	887	760	652	558	487
Public debt (in millions of U.S. dollars)	0	6	22	46	153	326	541	777	1,059	1,219

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

1/ Excludes trade in goods and services of entities located in the Joint Petroleum Development Area, which are considered non-resident.

2/ Excludes petroleum exports, the income of which is recorded under the income account.

3/ Includes Petroleum Fund balance and the central bank's official reserves.

4/ Simple average of UK Brent, Dubai, and WTI crude oil prices based on April 2016 WEO assumptions.

5/ Closing balance.

INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

April 7, 2016

KEY ISSUES

Context: Timor-Leste has been making steady progress in nation building and economic development. However, adjusting from high oil dependency, large social and infrastructure development needs, and weak institutional capacity poses considerable challenges. While prudent saving of its oil wealth in the Petroleum Fund (PF) has provided Timor-Leste with a financial cushion to help offset revenue losses related to the recent fall in global oil prices, fiscal trends under existing capital expenditure plans are unsustainable as the PF will be depleted in the long term at the current rate of withdrawals. The debt sustainability assessment has deteriorated and points to a moderate risk of debt distress reflecting the government's plan to tap concessional borrowing to finance front-loaded public investments. Restoring fiscal sustainability hinges on fiscal consolidation and successful prioritization of government expenditures to facilitate high-return infrastructure projects and catalyze non-oil private sector growth to achieve economic diversification.

Policy challenges center on achieving fiscal sustainability and economic diversification. Policy imperatives include:

- **Fiscal policy**. Achieving fiscal sustainability requires scaling back plans to front-load public investment, rationalizing recurrent spending, mobilizing non-oil revenues, and adhering to a medium-term fiscal consolidation plan.

- **Debt sustainability.** Staff supports the authorities plan to tap concessional borrowing to finance higher frontloaded capital expenditures, which would help preserve the assets of the Petroleum Fund as an endowment fund, while stressing the need to strengthen debt management capacity. Bold fiscal consolidation measures are also needed to safeguard long-term fiscal and debt sustainability.

- **Financial policy.** Efforts to promote financial inclusion need to strike a balance with safeguarding financial stability by strengthening regulatory and supervisory capacity.

- **Structural reforms.** Continuing effort to develop human capital, boost competitiveness, and create an enabling business environment is key to economic diversification and private sector growth.

Approved By
Hoe Ee Khor (APD) and Andrea Richter Hume (SPR)

Discussions were held in Dili during February 1–12, 2016. The staff team comprised Ms. Wong (head), Messrs. Washimi and Jamaludin, and Ms. Liu (all APD). Mr. Knight (World Bank Group) participated in the meetings. Mr. Canuto (ED) joined at the end of the mission.

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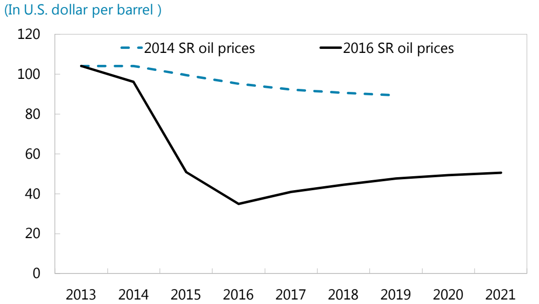
APPENDICES

CONTEXT

1. **A smooth political transition has been achieved with elections due next year.** The sixth constitutional government was formed in February 2015 under Prime Minister (PM) Dr. Rui Maria de Araújo. Former PM Gusmão remains in the Cabinet as Mentoring Minister and Minister of the new Planning and Strategic Investment Ministry. Mari Alkatiri, the first elected PM, has been appointed to head the Special Administrative Region (SAR) of Oecusse Ambeno and the Oecusse Ambeno and Atauro Special Zones for Social Market Economy (ZEESM). The smooth transition to the new government and strong cross-party cooperation underscored political stability. Presidential and parliamentary elections are due in early 2017.

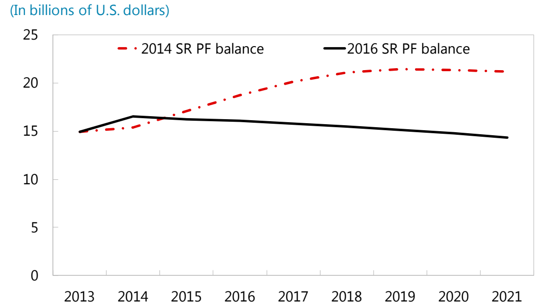
2. **Timor-Leste is facing difficult policy challenges due to the sharp fall in oil revenue and large developmental needs**. Highly dependent on oil exports, it is also a fragile low-income country. According to industry estimates, unless new oil reserves are developed, oil production is expected to decline further and cease by 2023. The impact of persistently low oil prices on fiscal spending is limited in the short run due to the buffer provided by the Petroleum Fund (PF), as about 80-90 percent of the oil reserves has been extracted and transformed into financial assets of the PF. However, over the long run, low oil prices would delay potential investment in new oil fields and weaken the prospects for developing the petroleum sector. Fiscal revenues will be highly dependent on the investment returns of the PF (Appendix 1). The deterioration in the global outlook and lower oil prices weigh on growth prospects and add strain to the fiscal position. Compared to the previous Article IV consultation concluded in 2014, the projected trajectory of the PF balance is significantly lower in the outer years, reflecting the higher rate of excess withdrawals. This underscores the urgency of measures to restore fiscal sustainability. Under the Strategic Development Plan (SDP) introduced in 2011, Timor-Leste aims to achieve upper-middle income status by 2030, by targeting infrastructure and human capital development, promoting economic diversification, and reducing poverty. Infrastructure development needs remain critical and past expenditure results have been mixed, due largely to low implementation capacity affecting effectiveness. In the presentation of the 2016 Budget, the PM highlighted the need to ensure that public resources are used efficiently and effectively to provide quality services. The authorities have received intensive technical assistance from the Fund in the first decade since independence and have made satisfactory progress in implementing the Fund's recommendations, although implementation challenges remain, including on the fiscal reform agenda (Appendix 2).

Oil Price Projections: 2014 SR vs. 2016 SR 1/
(In U.S. dollar per barrel)



1/ Simple average of UK Brent, Dubai, and WTI crude oil prices. SR = staff report. For 2014 SR (2016 SR), projections start in 2014 (2016),
Source: IMF staff estimates and projections.

Petroleum Fund Balance Projections: 2014 SR vs. 2016 SR 1/
(In billions of U.S. dollars)



1/ SR = staff report. For 2014 SR (2016 SR), projections start in 2014 (2016).
Sources: Timor-Leste authorities; IMF staff estimates and projections.

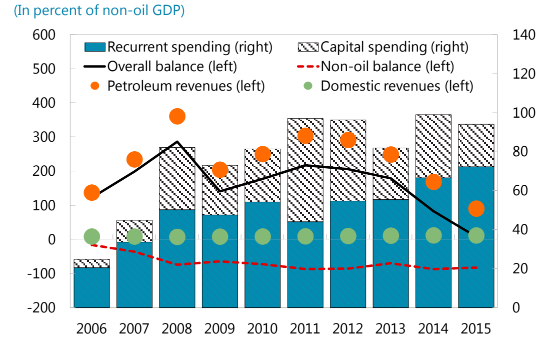
RECENT DEVELOPMENTS AND OUTLOOK

A. Recent Developments

3. **Growth has moderated while inflation has fallen sharply**. Non-oil real GDP growth is estimated to have declined to 4¼ percent in 2015 from 5½ percent in 2014, due to reduced government spending. Total real GDP is estimated to have contracted by 0.6 percent in 2015 due to declining oil production. Both headline and core inflation eased to below 1 percent in 2014 and 2015 from double-digit levels in previous years, reflecting lower commodity prices, a stronger U.S. dollar against Timor-Leste's trading partners' currencies, and some improvement in supply bottlenecks (Figure 1, Table 1).

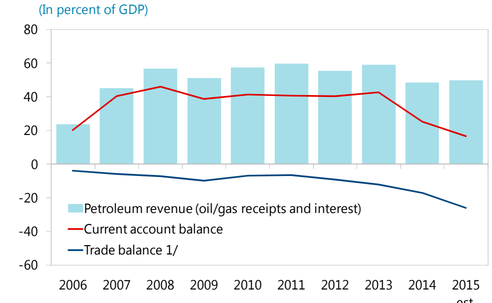
4. **The fiscal position weakened in 2015 due largely to lower petroleum revenue.** Petroleum revenue fell by 40 percent in 2015 mainly on account of the slump in global oil prices. Despite lower revenues at $1.45 billion (excluding grants), in light of the smaller expenditure outturn at $1.34 billion (compared with $1.57 billion in the 2015 rectification budget[1]), staff estimates an overall surplus of 4.2 percent of GDP in 2015, a considerable reduction from the large surpluses in previous years. The shortfall in revenue was largely met by a substantial drawdown of the PF. Excess withdrawal (defined as withdrawal in excess of the estimated sustainable income (ESI) calculated as 3 percent of petroleum wealth—net present value of expected future petroleum revenue plus the estimated value of the PF) in 2015 was more than six times the level in the previous year. This, coupled with lower oil receipts and negative net investment return due largely to foreign exchange valuation losses, saw the balance of the PF decline for the first time, to $16.2 billion as of end-2015. Financing by external borrowing remained low at under 1 percent of GDP (Figures 2 and 3, Table 2).

Fiscal Balances
(In percent of non-oil GDP)



Sources: Ministry of Finance of Timor-Leste; IMF staff calculations

Current Account Balance
(In percent of GDP)



1/ Oil and gas receipts are recorded as income.
Sources: Country authorities; and IMF staff calculation.

5. **The approved expenditure in the 2016 budget is marginally smaller than the 2015 rectification budget**. However, if fully executed, the 2016 budget of $1,562.2 million (excluding donor projects) would represent an expenditure increase of 17 percent (11 percent of 2016 GDP) compared to the estimated outturn for 2015. Capital expenditures is about 49 percent higher than the 2015 estimated outturn. Current transfers would increase by 11 percent, half of which is allocated to the Oecussi SAR and ZEESM.

[1] The 2015 rectification budget was presented to the parliament on April 1, 2015 to reflect the new structure of the 6th constitutional government led by PM Araújo. It superseded the 2015 budget approved in December 2014.

6. **The external current account position has also deteriorated sharply**. The current account surplus was halved to 25 percent of GDP in 2014 and is estimated to have shrunk further to 17 percent of GDP in 2015. This is largely due to lower income from declining oil and gas receipts and weak investment returns on the PF portfolio against weak global equity market performance in 2015. Against the backdrop of a significant appreciation of the effective exchange rate and lower commodity prices, imports is estimated to have declined by 9 percent in 2015. Non-oil exports such as coffee and tourism remain insignificant. The growth in coffee exports also slowed due to drought and low coffee prices (Table 4).

7. **Private credit growth has picked up at a moderate pace.** Money supply M2 growth slowed to 7.1 percent (y/y) in December 2015 due largely to an increase in central government deposits. Growth of private sector credit picked up to 10.5 percent (y/y) in December 2015 from 5.5 percent (y/y) in the previous year. However, the bank lending survey in mid-2015 suggested that banks are cautious in lending to business enterprises due to credit risks. Credit to individuals accounted for the largest share at 43 percent, followed by the construction sector constituting 28 percent of total private sector credit as of end-2015. Excess liquidity in the banking system and banks' overseas placements of deposits have remained high. The non-performing loan (NPL) ratio declined to 23 percent as of end-December 2015 from 27 percent at end-December 2014 with full loan-loss provisions. About two-thirds are legacy bad loans with one commercial bank accumulated during the mid-2000s (Figure 4, Table 3).

B. Outlook and Risks

8. **The medium-term growth outlook depends critically on economic diversification.** Prioritization of government expenditures to facilitate high-return infrastructure investments is key in tandem with structural reforms that catalyze non-oil private sector growth. Under the baseline scenario, average non-oil real GDP growth in the medium term is projected to moderate to 5.5 percent, supported by increasing public spending and foreign direct investment. FDI projects in the pipeline, including a beer and beverage factory, a cement plant, the development of the Tibar Bay Port and a high-end resort hotel, which are expected to spur private sector development and create employment opportunities. The impact of persistently low oil prices on fiscal spending is limited in the short run due to the buffer provided by the PF, but persistently low oil prices would delay potential investment in new oil fields and hurt the prospects for developing the petroleum sector. Given that Timor-Leste is fully dollarized and has no independent monetary policy, adjustments to shocks will need to fall on fiscal policy but fiscal space is constrained by limited domestic revenue mobilization and the depleting PF balance in the medium to long term (Table 5).

9. **Higher fiscal spending and inadequate mobilization of domestic revenues are the main sources of risk over the medium-long term (Table 6).** Failure to properly conduct feasibility studies to ensure that public investment is efficient, yields adequate returns, and sufficiently enhanced growth could amplify risks to fiscal sustainability. Steady depletion of the PF over the medium-long term due to excess withdrawals to fund existing expenditure plans implies a heightened risk of fiscal distress unless new non-oil revenues are generated or existing expenditure

plans are revised downwards. Moreover, given the increased share of global equities in the PF's portfolio, its investment returns are exposed to the volatility of global financial markets.

Authorities' Views

10. The authorities broadly agree with the staff's outlook and risk assessment. However, they stressed that frontloaded infrastructure spending is expected to diversify the economy, boost potential growth, and alleviate capacity constraints. They were also of the view that the current low inflationary environment provides more space for increasing government spending with little risk of overheating.

POLICY DISCUSSIONS: FACILITATING SUSTAINABLE GROWTH

A. Fiscal Policy[2]

11. The 2016 Budget outlined a significant scaling up of public investment in 2017-19, which will strain fiscal sustainability. The multi-year budget plan proposed large front-loaded infrastructure investment in roads, bridges, ports, and airports, deemed essential to lay the foundation for private sector-led development and achieving the 2011-30 SDP goals. This includes the multi-year development of the Tasi Mane[3] project on the south coast requiring government investment of $0.8 billion, close to a quarter of total capital spending in 2017–20. While frontloading of this investment may be desirable from the point of view of development needs, the total capital budget amounts to US$3.4 billion (130 percent of GDP) and would entail an overall fiscal

Timor-Leste State Budget 2016 1/

	2016	2017	2018	2019	2020	2017–20 (Total)
	(In millions of US dollars)					
Revenue	1,765	1,450	1,447	1,191	1,107	5,195
Domestic revenue	171	181	190	201	210	783
Petroleum revenue	1,594	1,269	1,257	990	897	4,412
Expenditure	1,562	1,973	2,494	2,114	1,747	8,327
Recurrent expenditure	1,107	1,150	1,203	1,256	1,307	4,915
of which: Public transfers	476	495	515	536	557	2,102
Capital expenditure	455	823	1,291	858	440	3,412
Overall balance	203	-523	-1,047	-923	-640	-3,132
Nonoil balance	-1,391	-1,792	-2,304	-1,913	-1,536	-7,545
Financing	1,391	1,792	2,304	1,913	1,537	7,545
Petroleum Fund withdrawal	1,284	1,444	1,937	1,752	1,497	6,631
External loans	107	348	366	161	39	914
	(In percent of GDP)					
Revenue	84.1	61.1	55.8	43.3	37.7	
Domestic revenue	8.2	7.6	7.3	7.3	7.2	
Petroleum revenue	75.9	53.5	48.5	36.0	30.5	
Expenditure	74.4	83.2	96.2	76.9	59.5	
Recurrent expenditure	52.7	48.5	46.4	45.7	44.5	
of which: Public transfers	22.7	20.9	19.9	19.5	19.0	
Capital expenditure	21.7	34.7	49.8	31.2	15.0	
Overall balance	9.7	-22.1	-40.4	-33.6	-21.8	
Nonoil balance	-66.2	-75.6	-88.9	-69.6	-52.3	
Financing	66.2	75.6	88.9	69.6	52.3	
Petroleum Fund withdrawal	61.1	60.9	74.7	63.7	51.0	
External loans	5.1	14.7	14.1	5.8	1.3	

1/ Approved State Budget 2016, Budget Book 1

[2] For the three scenarios presented in this section, the Budget scenario is based on the authorities ' oil prices assumption which on average is 60 percent higher than the WEO assumption on oil prices used for the baseline and adjustment scenarios for 2016-21. Assumptions on economic growth, inflation and current account under these scenarios are shown in Box 1.

[3] The Tasi Mane project on the southern coast, consisting of the Suai Supply Base, Betano Refinery and Petrochemical Complex and Beaco LNG complex, is designed to form the backbone of the country's petroleum industry.

deficit averaging 30 percent of GDP. The proposed capital spending of $0.8-1.3 billion per annum risks stretching administrative capacities, and creating bottlenecks and imbalances in the economy. On average, the execution rate of capital projects in 2008–14 was 73 percent of planned expenditures (about US$375 million per annum), and past performance suggests an inverse correlation between the size of capital spending and the execution rate. Under the budget scenario, financing will be mainly met through excess withdrawals from the PF, amounting to US$4.6 billion during 2017-20, or 28 percent of the balance of the PF at end-2015. This would be in addition to the ESI withdrawals, which would amount to about $2 billion. In staff's view, these excess withdrawals will jeopardize the PF's role as a sovereign wealth fund.

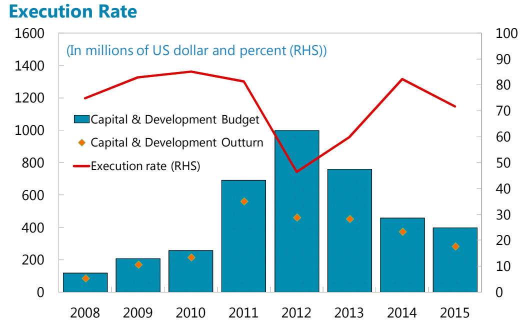
12. Staff's baseline fiscal scenario reflects a lower infrastructure spending due to weak implementation capacity. As staff consider that the budget entails an overly optimistic rate of project implementation, it used as its baseline a fiscal scenario with infrastructure spending in line with historical project implementation rates. Under this baseline scenario, staff assumes the following:

- **More realistic rate of project execution**. Key capital expenditures—about two-thirds of the planned capital expenditure for 2017–20—are assumed to be spread over a longer period of five years (compared to the budget assumption of three years).

- **More stable macroeconomic performance.** The baseline scenario is expected to have a smoother non-oil GDP growth and inflation trajectory and a healthier current account balance than the budget scenario, reflecting less severe supply bottlenecks and a smaller increase in imports.

- **Lower excess withdrawal from the PF, though still at levels above the ESI, meaning a continued decline of PF.** As a result of lower expenditures, excess withdrawal is reduced to about $3.0 billion or one-third lower than that planned for 2017-20. However, the PF balance is projected to decline to about two-thirds of its current value by 2030 (see Box 1 for the comparison). The dynamic of the PF is also such that a lower PF balance will reduce the level of ESI, resulting in higher excess withdrawal to close a given financing gap, highlighting the need to curb the rapid loss in PF wealth.

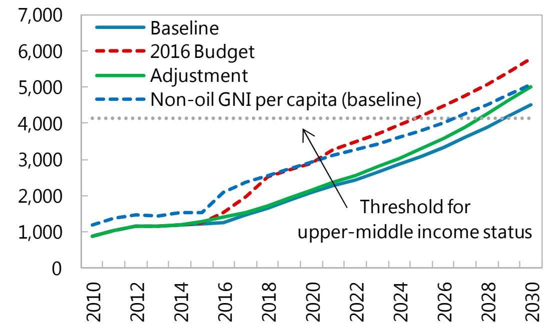
Capital and Development Expenditure: Budget and Execution Rate



Source: Timor-Leste Budget Transparency Portal.

13. Bold fiscal consolidation measures are needed to safeguard long-term fiscal and debt sustainability. Given the risks outlined above under the baseline scenario, staff advised a set of measures under an adjustment scenario. Box 1 provides a comparison of the principal macroeconomic and fiscal outcomes under the budget, baseline, and adjustment scenarios. Under staff's proposed adjustment scenario, total spending (excluding grants) should be capped at around US$1.4 billion per annum between 2017 and 2026 (representing a total expenditure reduction from 65 percent of GDP in 2017 to 29 percent in 2026), and remain broadly constant at 26 percent of GDP thereafter. The expenditure ceiling up to 2026 is broadly in line with the fiscal envelope of $1.3 billion that was estimated to maintain fiscal sustainability in the Yellow Road Workshop discussion in May 2013.The proposed lower capital expenditure (which would amount to one-half of the budgeted amount) would support growth by focusing on high-priority, high-return infrastructure projects. PF drawdown should be minimized by greater use of concessional borrowing to finance high-quality infrastructure projects while maintaining debt sustainability. The government should cease making PF withdrawals in excess of the ESI at the latest by 2026. This scenario recognizes that an immediate reduction of excess withdrawal would imply limited financing for essential capital spending (assumed at $325 million per year or 10 percent of GDP) to close the infrastructure gap. This scenario also reflects the authorities' reform target to increase domestic tax mobilization through the introduction of a value-added tax (VAT) over the medium term (as discussed below). Staff projects a tax revenue increase equivalent to about 5 percentage point of non-oil GDP is needed for tax revenue to reach 13 percent in 2021, and this should be achieved largely through revenue mobilization by the VAT. The level of fiscal spending in the long term should depend on the strength of domestic tax mobilization. Staff's preliminary analysis suggests that a more gradual per capita income trajectory under the adjustment scenario with higher investment efficiency gain and lower cost overrun, is projected to lead to upper-middle income status while maintaining macroeconomic stability and fiscal sustainability (text chart).

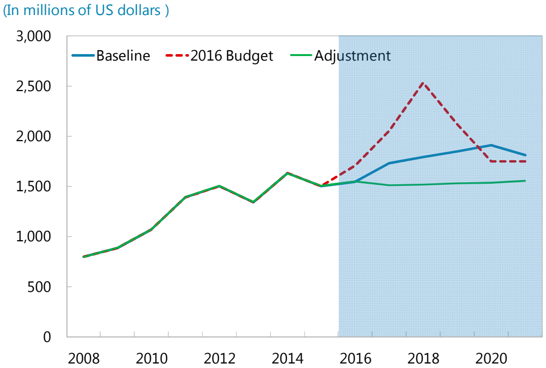
Non-oil GDP per capita
(In US dollar)



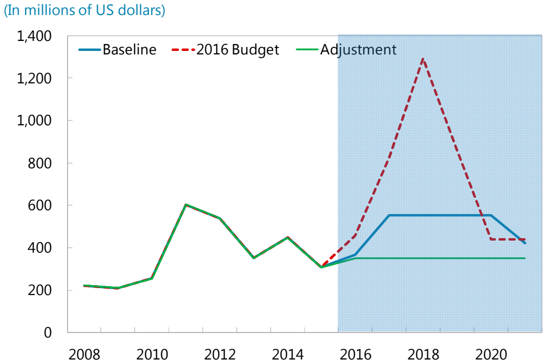
Box 1. Timor-Leste: Macroeconomic Impact under Different Fiscal Policy Scenarios

Scenario	Impact
2016 Budget Framework • Full implementation of 2017–20 frontloaded infrastructure spending • No limit on PF withdrawal in the medium term • Long-run convergence to baseline scenario (including PF withdrawal limit) • Use concessional financing	• Spikes in non-oil growth and inflation in the earlier part of the budget horizon; considerably weaker current account balance in the medium term • Faster decline in the PF balance and per capita net public assets relative to the baseline
Baseline • 2017–20 capital outlay reduced by a third and spread over 5 years • PF withdrawal capped at US$1.3 billion per annum • Use concessional financing	• Relatively smooth non-oil growth and inflation trajectory, and broadly healthy current account balance relative to the Budget scenario • Gradual decline in the PF balance and per capita net public assets
Adjustment Scenario • 2017–20 capital outlay reduced by half and spread over 5 years • Total spending (excl. grants) kept at under US$1.4 billion after 2021; spending is kept constant as a percent of non-oil GDP after 2027 • PF withdrawal capped at US$1.3 billion up to 2025, and limited to ESI thereafter. • Fiscal reforms to mobilize domestic revenues (including VAT), which reduces need for concessional financing	• Smoother non-oil growth and inflation trajectory, and healthier current account balance relative to the baseline • Slow decline in per capita net public assets relative to the baseline. • PF balance stabilizes in the medium term and increases in the long term

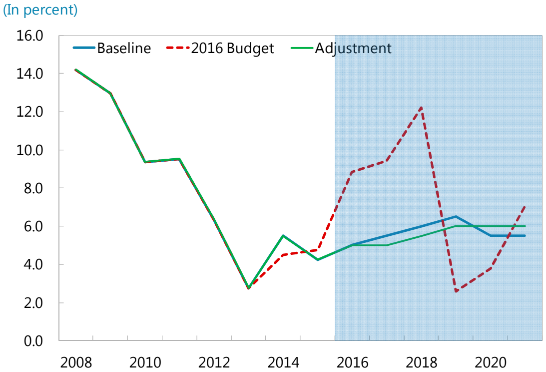
Total Government Expenditure
(In millions of US dollars)



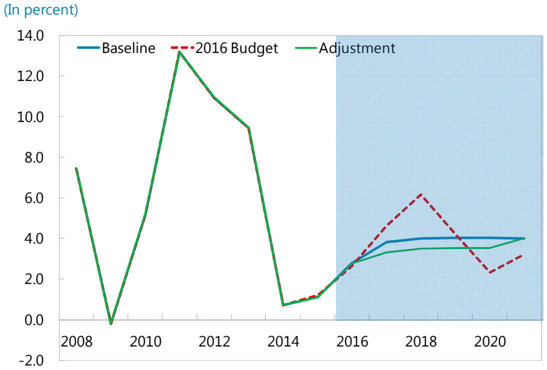
Capital Expenditure
(In millions of US dollars)



Non-Oil Growth
(In percent)

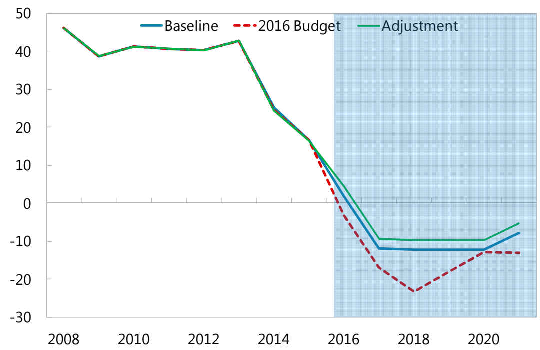


Inflation
(In percent)

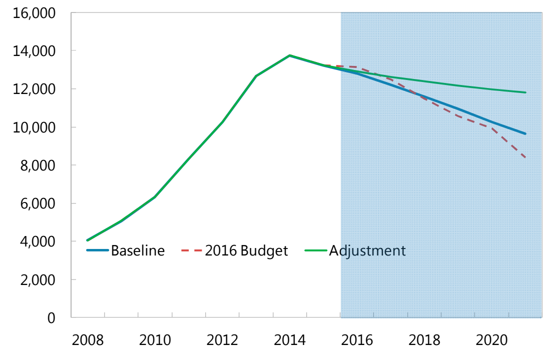


Box 1. Timor-Leste: Macroeconomic Impact under Different Fiscal Policy Scenarios (concluded)

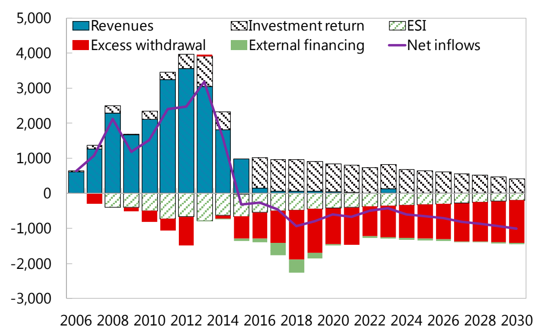
Current Account Balance
(In percent of GDP)



Net Public Sector Assets Per Capita
(In US dollars)

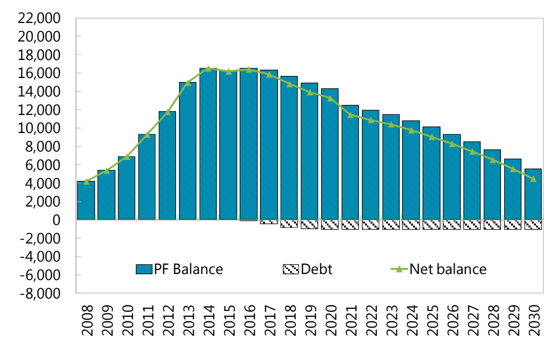


PF Dynamics: 2016 Budget Scenario (flow) 1/
(In millions of US dollars)



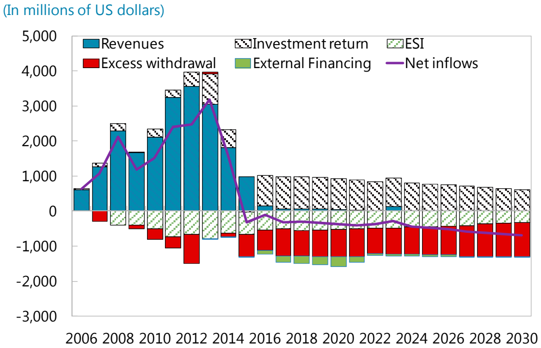
1/ Staff extrapolation from 2021.

PF Dynamics: 2016 Budget Scenario(stock) 1/
(In millions of US dollars)

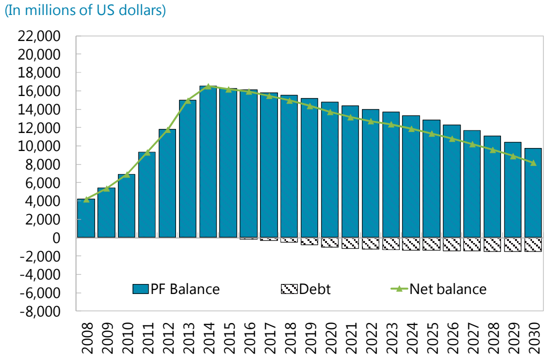


1/ Staff extrapolation from 2021.

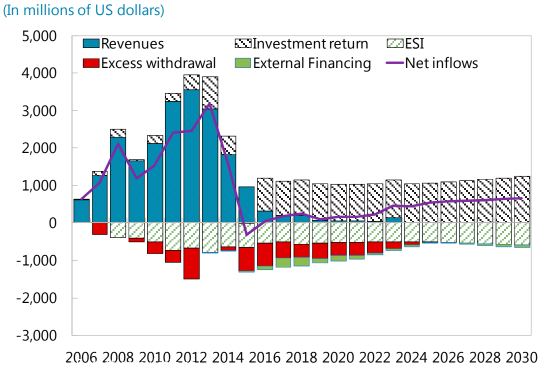
PF Dynamics: Baseline Scenario (flow)
(In millions of US dollars)



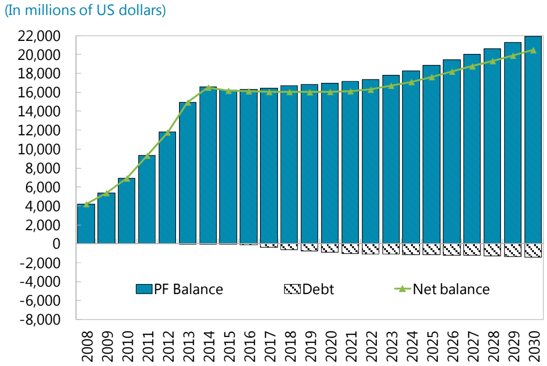
PF Dynamics: Baseline Scenario (stock)
(In millions of US dollars)



PF Dynamics: Adjustment Scenario (flow)
(In millions of US dollars)



PF Dynamics: Adjustment Scenario (stock)
(In millions of US dollars)



14. More could be done to improve spending efficiency. Although the overall allocation to health and education expenditures has been increasing up to 2015, health expenditure appears low in comparison to peers, and there is a need to increase the returns on higher education spending.[4] More detailed analysis at the sector level on these social spending components and outcomes would contribute to better resource allocation. The government should also take the lead in exercising strong wage restraint to avoid losing cost competitiveness. Further, the extension of fiscal autonomy to Oecusse ZEESM needs to be carefully managed to minimize risks of off-budget expenditures and the accumulation of contingent liabilities.

15. Domestic non-oil revenues need to be mobilized urgently. Ongoing work by the Fiscal Reform Commission to introduce a value-added tax (VAT) regime together with the review of income tax and other taxes is a step in the right direction to achieve the government's goal of raising domestic non-oil revenues from an average of 11 percent of non-oil GDP in 2011–15 to 15 percent of non-oil GDP by 2020. In the near term, focus needs to be given to broadening the tax base and enhancing tax compliance. While more details in the design and implementation of the VAT and other taxes still need to be fleshed out, staff recommended the following:

- **VAT.** A single-rate VAT, with exemptions restricted to a minimum and a sufficiently high registration threshold at the start to exclude most small businesses in consideration of the limited tax administration capacity, should be implemented as soon as feasible. The choice of the tax rate should be primarily driven by revenue mobilization needs, and go beyond replacing current service tax, sales tax, and customs duties.

- **Other taxes.** Staff also recommended raising other taxes to bolster revenue. IMF technical assistance has recommended that higher excise duties on tobacco and petroleum products and raising the income tax rate from 10 to 15 percent could yield additional tax revenue of close to 2 percent of GDP. Staff also welcomed the authorities' plans to review and streamline existing tax holidays on investment.

16. The PF is a source of confidence for the economy and should be preserved as an endowment fund. The authorities remain committed to a transparent and accountable fiscal framework that has allowed oil revenues to be saved through the PF—an internationally well-regarded institution. The ESI, which functions as a fiscal rule, was intended by the Timor-Leste government to act as an annual withdrawal limit from the PF, so that the PF assets could be preserved in real terms and generate a permanent level of investment income to support government expenditures. While some drawdown of the assets of the PF is justified for infrastructure investment in order to diversify the economy and boost growth potential, the assets also need to be preserved at a level that is sufficient to provide adequate investment income for future generations. The experience of other well-managed natural resource funds suggests that strong fiscal discipline and binding fiscal rules are needed. In this context, the adoption of the policies under the

[4] See World Bank Group (2013), FY2013 – 2017 Country Partnership Strategy: The Democratic Republic of Timor-Leste" February 19, 2013.

adjustment scenario will facilitate a return to strict compliance of the fiscal rule under the ESI within a feasible timeframe. At the same time, consideration could be given to revising certain aspects of the PF legal framework to strengthen the withdrawal rule and reduce room for discretion.

17. Greater use of concessional loans could help preserve the PF. Staff welcomes the government's plans to tap more concessional borrowing to finance large infrastructure projects instead of just drawing down the PF. The financing gap could be met by external loans, if the borrowing cost is lower than the opportunity cost of tapping into the PF as measured by the PF's expected investment return, and guided by the Debt Sustainability Analysis (DSA). The discipline of debt sustainability monitoring by creditors may also come with the transfer of knowledge by these multilateral or bilateral institutions. So far, the government has been very conservative in its borrowing.

18. The debt sustainability assessment has deteriorated, and the risk of external debt distress has increased to moderate. Even though the baseline fiscal scenario does not entail breaches of any DSA threshold, stress tests resulted in breaches for all but one indicator. The increased risk of debt distress reflects the authorities' plan to increase concessional borrowing to finance higher frontloaded capital expenditures, compared to their plans when the last DSA was undertaken in 2014. Higher concessional borrowing would however help preserve the assets of the PF by reducing the need for excess withdrawals. In this context, maintaining a sustainable fiscal framework (as outlined under staff's adjustment scenario) is crucial to long-term debt sustainability.

19. Further strengthening of public financial management (PFM) capacity is needed to cement progress. The economic and social impact of public investment depends critically on its efficiency. Recent analytical work by the IMF[5] shows that economic dividends from closing the efficiency gap can be substantial. Improvements in public investment management (related to planning, allocation and implementation) could increase the efficiency and productivity of capital spending. The Public Investment Management Assessment (PIMA) tool developed by the IMF would help identify reform priorities and develop capacity building strategies. The recently adopted PPP policy for the Tibar Port could provide a strong template for future PPPs.

Authorities' Views

20. The authorities consider total annual expenditure of US$1.4 billion in the medium term to be insufficient, given the urgency to develop infrastructure. The government remains committed to its medium-term infrastructure spending plans as outlined in the SDP as they consider the infrastructure investments to be essential to economic diversification and raising the potential growth of the economy. Lower spending would constrain the authorities' ability to pursue any new opportunities to boost potential growth. They highlighted the need to improve infrastructure to attract FDI for achieving economic diversification.

[5] IMF(2015), Making Public Investment More Efficient, June 11, 2015.

21. The authorities concur on the need to ensure the quality of investment spending through robust feasibility assessments and appraisal of public investment projects. They seek the Fund's support to determine the desirable level of infrastructure investment. The authorities also pointed out that while the Tasi Mane project focuses on facilitating the development of oil and gas industries, it will also boost general development along the south coast. Further, a significant share of the government's total capital spending is channeled towards improving overall infrastructure in the south coast. They recognized the risk of moving the Tasi Mane project ahead and broadly shared the staff's recommendation (see paragraph 31) to remain flexible in the timing and scope of the project's implementation, to better manage risks by taking into account changing economic conditions and opportunities.

22. The authorities shared staff's view on the need for timely efforts to mobilize domestic revenue. Fiscal reform plans in the pipeline include the introduction of the VAT, which will boost domestic revenues and further bolster fiscal sustainability.

23. The authorities consider the risk of debt distress to be contained despite higher borrowing, but see value in further strengthening debt management capacity. The authorities reiterated their commitment to preserve the assets of the PF and the government's plan to utilize more concessional financing for large infrastructure projects. Although the projected external borrowing to finance the government's infrastructure spending over the next few years is considerable, the authorities view the borrowing projections under the baseline scenario as close to the upper limit of the financing needed. Actual borrowing will be determined by the pace of project implementation. The accumulated savings in the PF also provide ample buffer against debt distress. Furthermore, higher growth resulting from infrastructure development is expected to contribute towards ensuring debt sustainability. The authorities have also expressed interest in Fund TA to strengthen capacity in debt management.

B. Financial Policy: Safeguarding Stability and Inclusion

24. Limited progress in financial intermediation is a key constraint on inclusive growth. There are four banks, of which three are branches of foreign banks (incorporated in Australia, Indonesia, and Portugal) and one is a locally incorporated, wholly government-owned bank, Banco Nacional de Comércio de Timor-Leste (BNCTL). BNCTL is the smallest bank but has a predominantly Timorese customer base, in part because it was a micro-finance institution from 2001 until it was transformed into a bank in 2011 with an initial capital of $2 million. The banking system is highly liquid and well capitalized with BNCTL reporting a capital adequacy ratio of 45 percent as of September 2015, bolstered by a $10 million capital injection by the government in 2014. However, a very large portion of the economy is cash-based, making payments inefficient and insecure. While the soundness of banks' lending remains fundamental, the strong deposit growth and continued decline in loans-to-deposits ratio suggest that banks are falling short in their role of financial intermediation. Challenges remain in expanding bank credit to SMEs and rural businesses. Private sector development is also perceived to be constrained by limited access to long-term credit at affordable rates.

25. The progress in promoting financial inclusion is commendable. Banco Central de Timor-Leste (BCTL)'s Financial Sector Master Plan, launched in August 2014, set out a roadmap for financial sector development to 2025 (Appendix 3). The installation of the Automatic Payment System and passage of the Law on National Payments System are major milestones towards achieving a more efficient and secure interbank payments system. Timor-Leste has also adopted a bank-based model for mobile banking and all four banks are currently in the process of introducing branchless banking facilities. The recent publication of the *Financial System Review* by the central bank is a further step in reviewing the stability of the financial system and monitoring progress towards the sound development of the financial sector.

26. Enhancing financial inclusion needs to strike a balance with safeguarding financial stability. It is commendable that the BCTL is strengthening its capacity in banking supervision, supported by TA from development partners. A strategy for resolving legacy NPLs (concentrated in one commercial bank) should be put in place as soon as practical. The BCTL's aim to enhance its role as lender of last resort with clear protocols and an appropriate legal framework is commendable. Although the conceptualization of a development bank is still at an early stage, the authorities should be vigilant to the risk of contingent fiscal liabilities. International experiences also suggest that a development bank should have a clear mandate and strong governance structure. Staff and the BCTL agreed that financial sector entities in the Oecusse ZEESM should remain under the supervision of the central bank.

27. Efforts to strengthen the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework should continue. Timor-Leste has completed the national risk assessment and the final report is expected to be released in 2016. The BCTL is in the process of issuing revised instructions for banks and other financial institutions on enhanced due diligence requirements for high-risk customers in line with the FATF standard.

28. The use of the U.S. dollar as legal tender remains appropriate in light of institutional capacity constraints and limited financial development. The current U.S. dollar regime has served Timor-Leste well, given the country's high dependence on oil exports. A review of the exchange rate regime, to study the merits of adopting its own currency as set out in the SDP, will be conducted by the central bank this year. Staff underscored that financial sector and institutional developments would be needed to pave the way for any potential exchange rate regime change to enhance external competitiveness as the economy diversifies away from oil and gas.

Authorities' Views

29. The authorities broadly concurred with the staff's assessment of the financial sector. They noted that banks' balance sheets are sound, but lending growth has been lagging behind deposit growth. They shared the staff's recommendation to resolve legacy NPLs as soon as feasible. Following the Financial Sector Master Plan, the central bank is working closely with banks to increase their presence in all the municipalities. The central bank also launched the National Strategic Plan on financial literacy to provide a framework to raise awareness at the national level. The authorities recognized that not all international experiences of development banks have been positive, and that a development bank should be run in a way that supports market competition and limits contingent liabilities to the government. They seek the support of development partners in conducting a review of the exchange rate regime as a longer-term policy option.

C. Structural Reforms: Enabling Private Sector Diversification

30. Medium-term growth depends critically on economic diversification. Similar to other small states, the Timorese economy faces impediments to development including low human capital, poor infrastructure and connectivity, a small domestic market, limited financial sector development, and high business cost structure. The diversification imperative has gained added urgency in light of the near depletion of oil production in existing oil fields. The associated reduction of fiscal resources also implies that the public sector would increasingly have less capacity to boost growth through government spending and procurements generated from public investment projects. Continuing efforts to improve health, education, and quality of life, including under the rubric of the Sustainable Development Goals (SDGs), would also help to lift potential growth (Appendix 4).

31. Some degree of government involvement in industrial development is warranted in cases of missing and incomplete markets. However, this should be well-targeted and implemented under appropriate risk-sharing arrangements to minimize contingent liabilities. Efforts aimed at economic diversification present an opportunity to reorient the economy away from the oil sector. There is concern about the economic viability of the state-initiated development of key petroleum projects without an agreed commitment with the oil companies to develop new oil fields. In this context, staff urged the authorities to be flexible in the timing and speed of implementation, taking into account changing economic conditions and opportunities.

32. Catalyzing private sector development will need an enabling business environment and measures to boost competitiveness. Timor-Leste, with its young labor force, is well placed to take advantage of global and regional integration trends and has applied for ASEAN membership. To maximize benefits from these opportunities, the private sector should leverage Timor-Leste's comparative advantage in labor-intensive sectors such as agriculture and tourism through better branding and marketing, product innovation, and explore niche markets. A recent ADB study[6] also emphasizes the need to build agricultural markets and develop tourism which would require improving crop quality, productivity (low relative to peers), and supply consistency, while ensuring price incentives and land tenure arrangements support farm investment and production. Improving tourism data collection, including market perceptions of Timor-Leste as a tourism destination, is also key. In this regard, the priority of the government in creating a business and investment climate to develop a diversified private sector is commendable and the role of the government as a facilitator could be enforced through increased dialogue and partnership with the private sector. At the same

[6] ADB (2015), "A Private Sector Assessment for Timor-Leste: Growing the Non-oil Economy."

time, efforts to increase cost effectiveness are important in order to restore external competitiveness (Box 2). The mission highlighted the following priority areas. Specifically:

- ***Business climate.*** Strengthening the enforcement of contracts, resolving insolvency, registering property, and improving the ease of getting credit, would help to bolster the ease of doing business (Figure 5). In particular, accelerating the ongoing work on the reform of land law to clarify land ownership would help to improve the availability of collateral for lending and facilitate investments.

- ***Wage competitiveness***. Relatively high wages in Timor-Leste, in part reflecting the public service's minimum wage level, could discourage FDI in labor-intensive sectors (Box 2). Public sector wages should grow in line with productivity gains. This would also have an important impact on private sector wages, given that the public sector wage has an important role in private sector wage determination.

- ***Labor market***. Continued emphasis on quality of spending and outcomes in health and education, including strengthening vocational and technical education, are needed to strengthen human capital formation (Figure 6 and Appendix 5).

Authorities' Views

33. The authorities reiterated their commitment to further implementing structural reforms, as set out in the SDP. Currently, the government is reviewing the investment law, and land and property law to attract more FDI and promote the commercial use of land as collateral in borrowing/lending. They emphasized that development of essential infrastructure is a priority to lay the ground for economic diversification.

D. Statistics and Technical Assistance

34. The timeliness and quality of data continue to pose challenges to surveillance and staff supports ongoing efforts to improve statistical capacity. With extensive TA from the Fund and other development partners, much progress has been made in improving statistics. Ongoing key issues include:

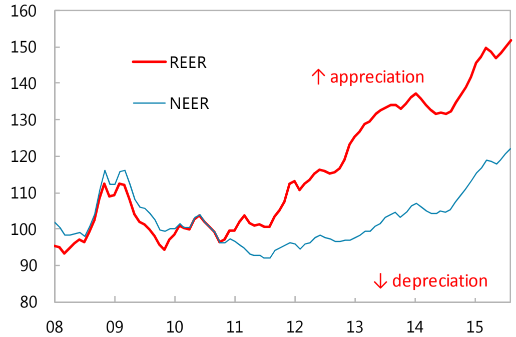
- ***National Accounts.*** Improvements have occurred in recent years with TA and from donor-provided experts. Improving timeliness and further development of the methodology are necessary, given source data weaknesses. Continued efforts to close the divergence between expenditure and production based estimates are needed, including to start the compilation of producer prices needed for measuring real national product. Staff welcomed the plan to publish quarterly GDP data and urged closer cooperation and institutional support to the General Directorate of Statistics for timely compilation of quarterly estimates.

Box 2. Timor-Leste: External Competitiveness

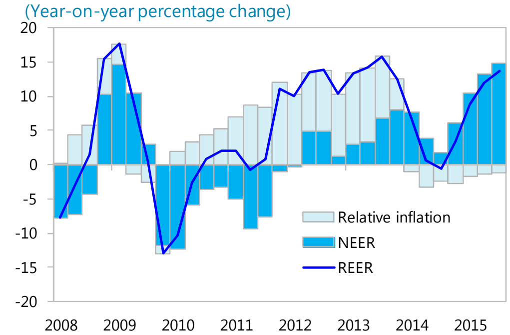
A rising real effective exchange rate (REER) has led to an erosion of external competitiveness. The real effective exchange rate (REER) has appreciated by 11 percent since 2014 as gains from closing the inflation differential with trading partners have been more than offset by an appreciation of the nominal effective exchange rate (NEER) as the U.S. dollars strengthened against other currencies. While not conducive to enhancing export performance, petroleum and coffee—the country's main exports—are denominated in U.S. dollars, and the economy is highly dependent on imports. The medium term current account deficit is projected to widen, due mainly to an increase in imports related to capital spending accompanied by falling oil and gas export receipts.

Structural reforms remain crucial to boost external competitiveness. For the development of the non-oil private sector to gain traction, greater efforts are needed to diversify export products and improve the business climate to increase global competitiveness. Ensuring the minimum wage is in line with firms' productivity and regional norms will also help boost export competitiveness and attract foreign direct investment. The wage gap between Timor-Leste and regional peers has narrowed recently due largely to an increase in minimum wages in comparators. However, Timor-Leste faces strong competition from its comparators at comparable wage level in attracting investors to expand or relocate labor intensive production to a frontier market.

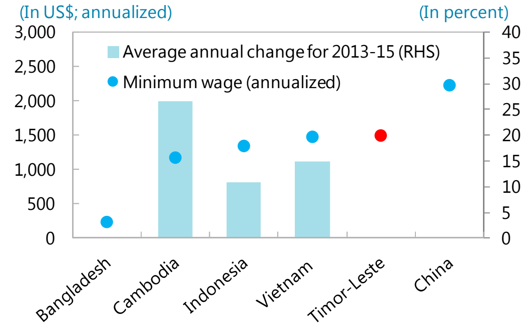
Effective Exchange Rates
(2010=100)



Real Effective Exchange Rate: Contribution to Change
(Year-on-year percentage change)



Minimum Wages in Comparator Countries 1/
(In US$; annualized) (In percent)



1/ No change in minimum wage for Bangladesh, China, and Timor-Leste between 2013-15.

1/ A standard exchange rate assessment is not feasible due to data limitations.

- ***Poverty.*** Regular and timely poverty measurements are needed for poverty analysis and policy review and formulation. The last official poverty indicators were based on 2007 data. A living standards measure survey that is underway with support from the World Bank will provide the basis to update poverty related data.

35. There is a large need for TA and training to support the government's reform and development agenda, and to improve human capital. The IMF is providing TA in areas of its expertise, in close coordination with other development partners. TAs delivered in 2015 include on-site examination of commercial banks, government finance statistics, and external sector statistics. The IMF also organized a regional workshop—with the participation of Timorese mid-level officials—to strengthen fiscal framework and planning capacity. Capacity development initiatives in the pipeline include TA on debt management, support for assessment of public infrastructure investment, and the continuation of TA on strengthening financial institution oversight.

STAFF APPRAISAL

36. Timor-Leste is facing difficult policy challenges due to the sharp fall in oil revenue and large developmental needs. Against the backdrop of low oil prices and a weakening external environment, growth has moderated and inflation is subdued. However, low oil revenue and plans to significantly frontload public investment are leading to a significant deterioration in fiscal and external positions. While savings in the PF have provided some cushion to the reduction of oil income, the authorities' spending plan is unsustainable, as at the current rate of withdrawals, the PF will be depleted in the long term. At the same time, large infrastructure and social development needs require efficient allocation of public investment.

37. Fiscal consolidation is needed to safeguard long-term fiscal sustainability. Achieving fiscal sustainability requires scaling back large front-loaded public investment plans in line with implementation capacity, rationalizing recurrent spending, strengthening non-oil revenues, and adhering to a medium-term fiscal consolidation plan. In addition, there should be better prioritization of public investment plans, focusing on high-return infrastructure projects through rigorous investment appraisal. Optimizing the composition and quality of spending to help close Timor-Leste's infrastructure gap is key to long-term fiscal sustainability. The assets of the PF need to be preserved to provide adequate investment income for future generations. Higher utilization of concessional financing for large infrastructure projects would reduce reliance on excess withdrawals from the PF and support greater discipline in investment spending. The introduction of the VAT will be instrumental in achieving the government's target of raising non-oil revenues to 15 percent of non-oil GDP by 2020 and help reduce reliance on the PF.

38. Medium-term growth depends crucially on economic diversification through catalyzing private sector development. The diversification imperative has gained added urgency in light of the near depletion of oil production in existing oil fields and the associated reduction of fiscal resources. Catalyzing the development of the nascent non-oil private sector will need an enabling business environment, improvement in social conditions, and investment in human capital to improve competitiveness. The private sector should leverage Timor-Leste's comparative advantage in sectors such as agriculture and tourism through better branding and marketing, product innovation, and exploration of niche markets.

39. Financial inclusion will help enhance economic growth but needs to strike an appropriate balance with safeguarding financial stability. The progress in promoting financial inclusion is promising. The financial sector is developing and is sound but continued effort in strengthening regulatory and supervisory capacity and improving central bank functions is key. A strategy to fully resolve legacy NPLs should be put place as soon as practical.

40. The use of the U.S. dollar as legal tender has served Timor-Leste well. Going forward, financial sector and institutional developments would be needed to pave the way for any potential change in the monetary and exchange rate regime.

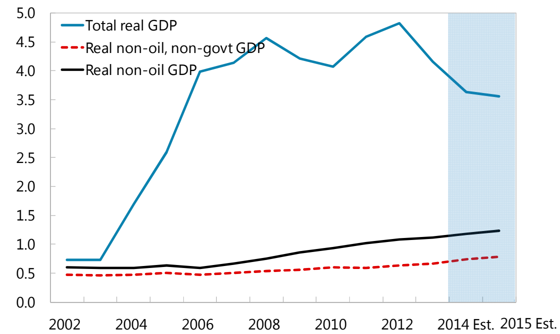
41. Continued efforts are required to improve statistical capacity, as limitations in this area continue to pose challenges to surveillance. Further work is needed to increase the quality and timeliness of data, which are crucial to policy formulation. The authorities should further leverage TA from the Fund and other development partners to this end.

42. It is expected that the next Article IV consultation with Timor-Leste will be held on the standard 12-month cycle.

Figure 1. Timor-Leste: Real Sector Developments

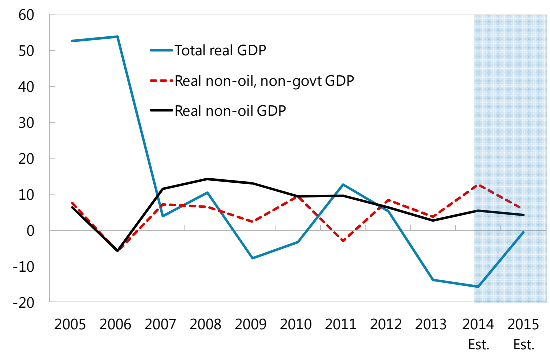
The economy remains dominated by the oil sector despite declining oil production…

Real GDP: Total, Non-Oil and Non-Government
(In billions of US dollars)



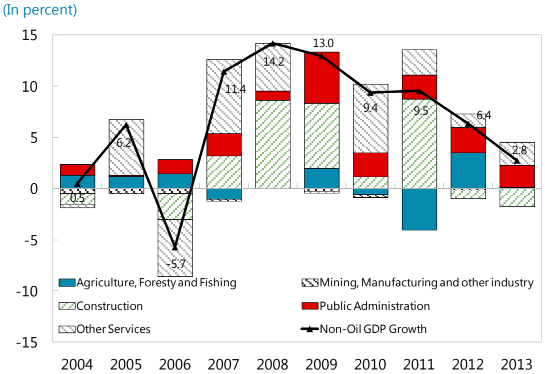
…with moderate non-oil GDP growth in 2014-15.

Real GDP: Total, Non-Oil and Non-Government
(Annual percentage change)



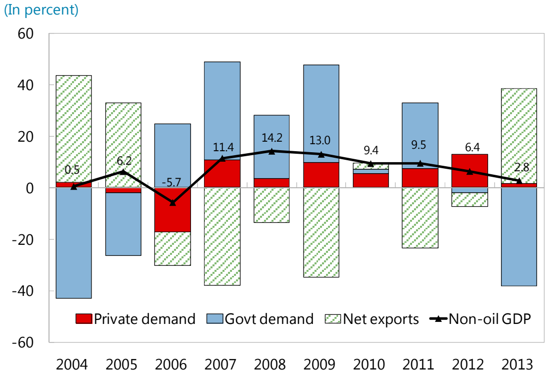
Non-oil real GDP growth has been subdued in recent years…

Non-Oil GDP Production: Contributions to Growth
(In percent)



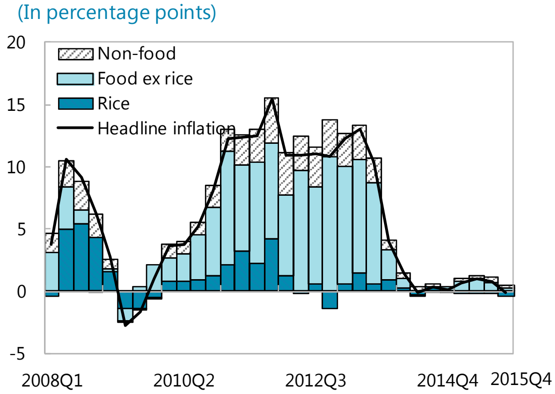
…and is for the most part driven by net exports and government spending.

Non-Oil GDP Expenditure: Contributions to Growth
(In percent)



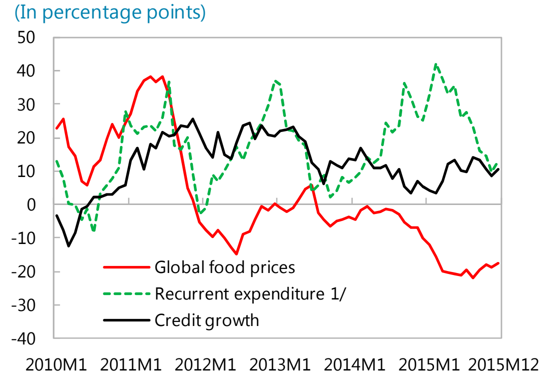
Inflationary pressures are subdued…

Contribution to Headline Inflation
(In percentage points)



…amid low global commodity prices, and in line with trends in other dollarized economies.

Global Food Prices and Recurrent Spending
(In percentage points)



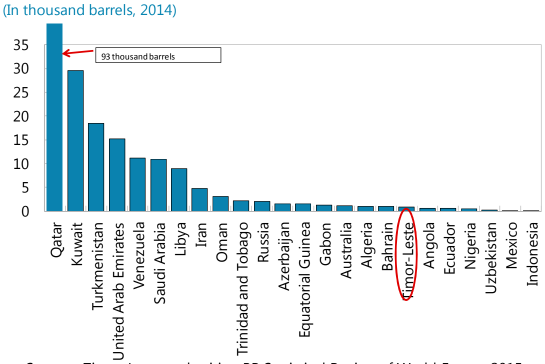
1/ 12-month moving average.

Sources: Timor-Leste authorities; Information Notice System (INS); and IMF staff estimates and projections.

Figure 2. Timor-Leste: Developments in the Petroleum Fund 1/

Despite the importance of the oil sector in the economy, Timor-Leste's oil wealth per capita is relatively modest…

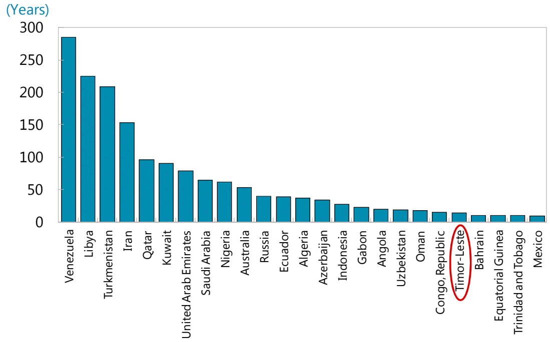
Oil Reserves Per Capita
(In thousand barrels, 2014)



Sources: Timor-Leste authorities, BP Statistical Review of World Energy 2015.

…with comparatively few remaining years of developed reserves…

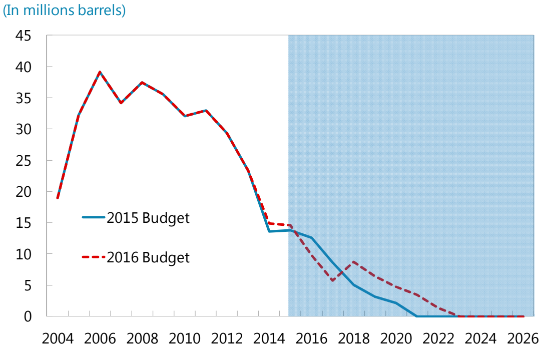
Years of Oil Reserves Remaining at 2014 Production Rates
(Years)



Sources: Timor-Leste authorities, BP Statistical Review of World Energy 2015

…with production projected to cease by 2023.

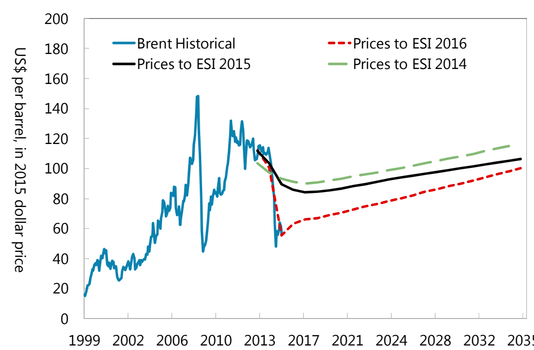
Estimated Production of Barrels of Oil Equivalent
(In millions barrels)



Source: IMF staff estimates.

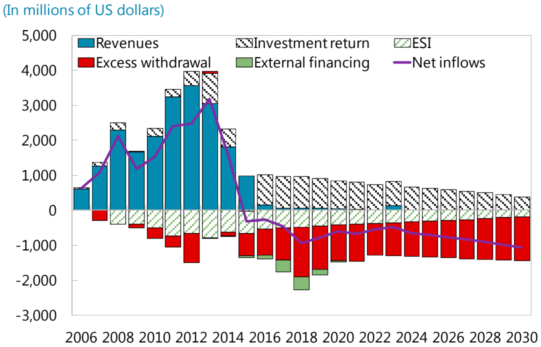
The resulting fall in oil and gas receipts are exacerbated by downward revisions in oil price forecasts.

Oil Prices, Historical and EIA-AEO Forecast



Net Petroleum Fund inflows turned negative in 2015 due to excess withdrawals and falling petroleum revenues …

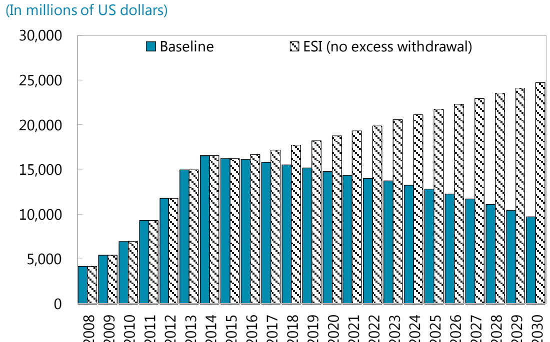
PF Dynamics: 2016 Budget Scenario (flow) 1/
(In millions of US dollars)



1/ Staff extrapolation from 2021.

…undermining the role of the Estimated Sustainable Income (ESI) as an anchor for long-term fiscal sustainability.

Petroleum Fund Balance: Baseline vs. ESI Scenarios
(In millions of US dollars)

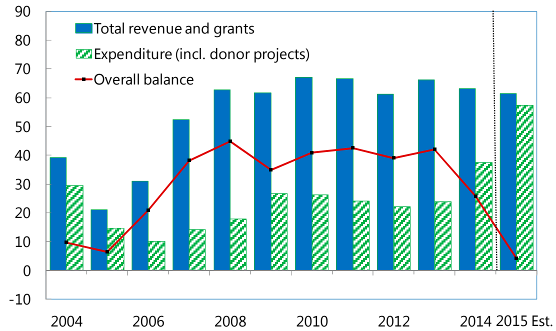


Sources: Timor-Leste authorities; IMF staff calculations and estimates; and BP Statistical Review of World Energy 2015.
1/ ESI= Estimated Sustainable Income.

Figure 3. Timor-Leste: Fiscal Developments

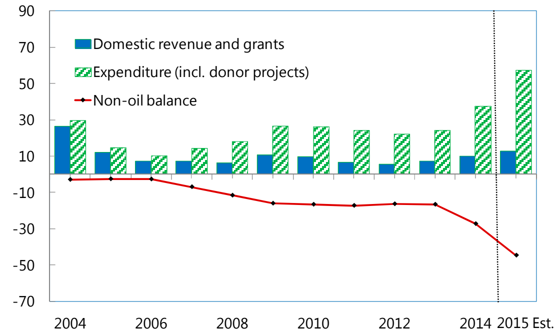
Overall fiscal balance is estimated to become a smaller surplus in 2015....

Overall Balance
(In percent of GDP)



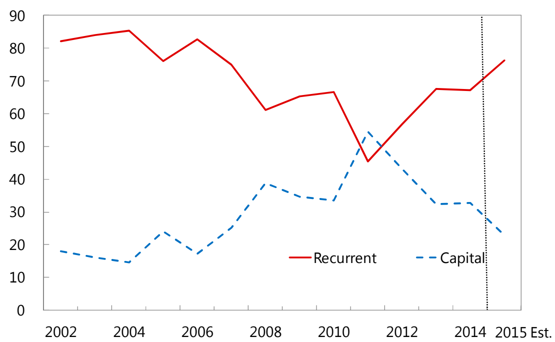
...accompanied by a further deterioration in the non-oil balance.

Non-Oil Balance
(In percent of GDP)



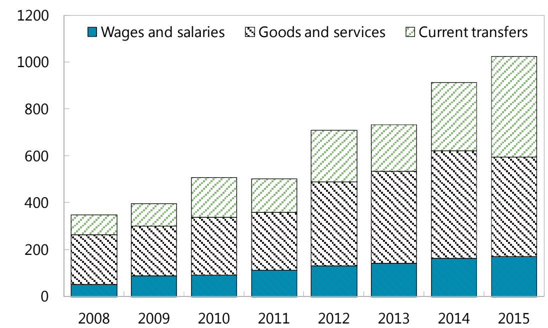
The importance of recurrent spending in the budget has continued to grow at the expense of capital expenditure...

Expenditure Shares
(In percent of expenditure, excl. donor projects)



...reflecting the rising importance of current transfers...

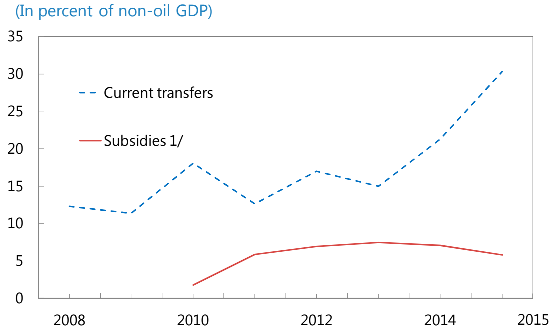
Recurrent Spending
(In million of US dollars)



Sources: Ministry of Finance of Timor-Leste; IMF staff compilation

...which have also increased significantly in size relative to GDP.

Transfers and Subsidies
(In percent of non-oil GDP)



1/ Include rice and electricity subsidies.

Budgeted expenditure continues to be under-executed on account of capacity constraints.

Expenditure Execution Rates: Total Budget
(In percent)

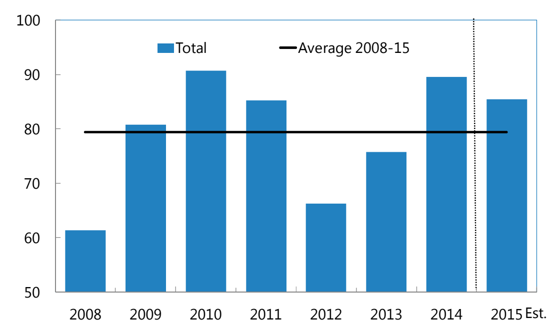
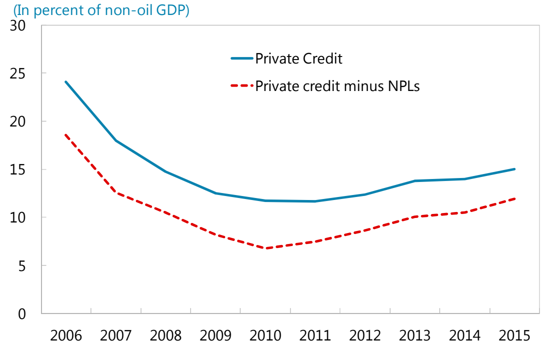


Figure 4. Timor-Leste: Financial Developments

The banking system remains small relative to the size of the economy.

Credit and Credit less Non-Performing Loans

(In percent of non-oil GDP)

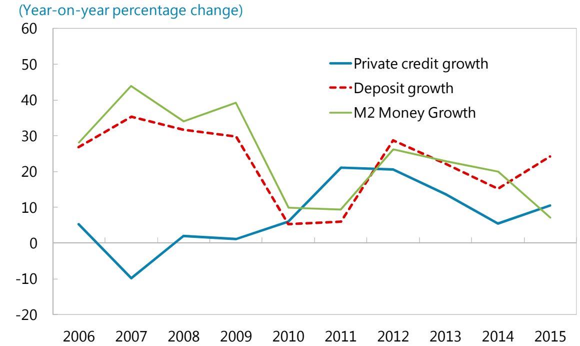


Sources: Central Bank of Timor-Leste,and IMF, Integrated Monetary Database.

Private credit growth has lagged behind deposit growth.

Credit and Deposit Growth

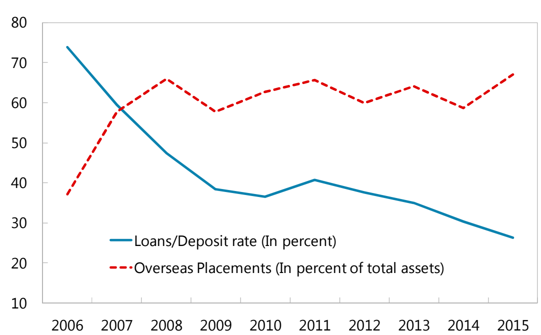
(Year-on-year percentage change)



Sources: Central Bank of Timor-Leste and IMF, Integrated Monetary Database.

Liquidity in the banking system remains high...

Liquidity Ratios

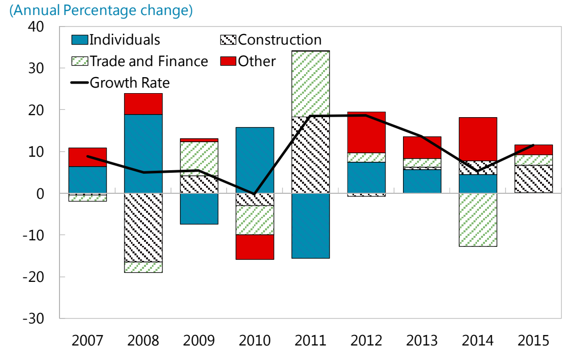


Source: Central Bank of Timor-Leste.

...and growth in private sector credit recovered in 2015, driven by lending to the construction sector.

Loans to Private Sector: Contributions to Growth

(Annual Percentage change)

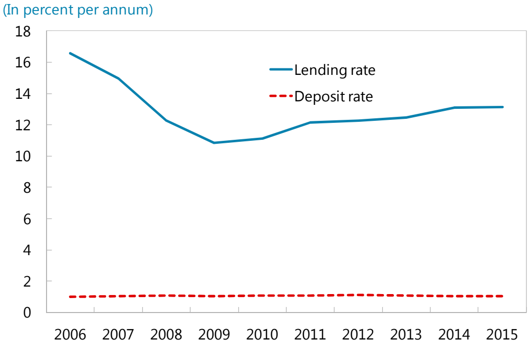


Sources: Commercial banks; BCTL; and IMF staff calculation.

High interest rate spreads suggest persistent inefficiencies in the domestic financial system...

Lending and Deposit Rates

(In percent per annum)

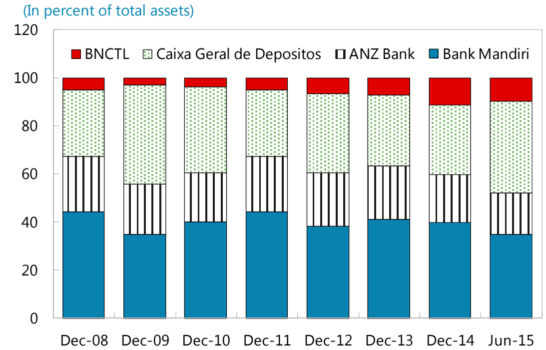


Sources: Central Bank of Timor-Leste and IMF, Integrated Monetary Database.

...despite steadily increasing competition for market share among financial institutions.

Share of Bank Assets

(In percent of total assets)



Source: Central Bank of Timor Leste.

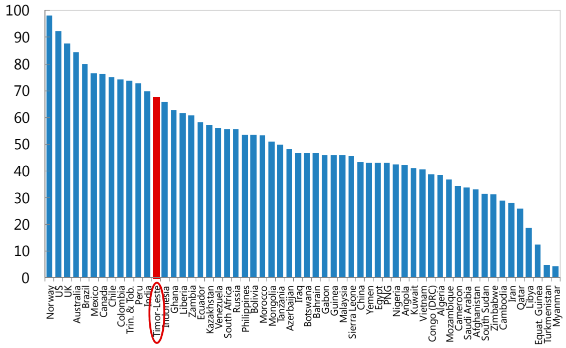
Sources: Central Bank of Timor-Leste; and IMF, Integrated Monetary Database.

Figure 5. Timor-Leste: Business Environment and Governance

The governance of the Petroleum Fund is strong by international standards...

Resource Governance Index

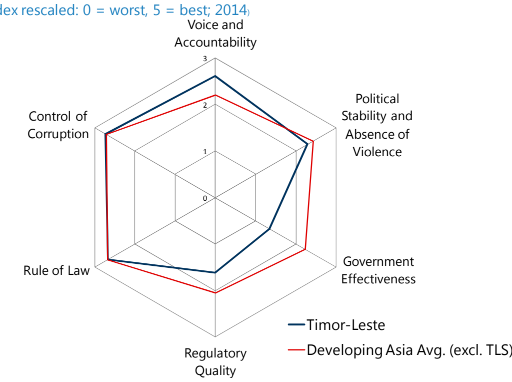
(Index ranges from 0 - 100, where higher is better' 2013)



...and measures of government effectiveness, regulatory quality and political stability have strengthened...

Governance Indicators

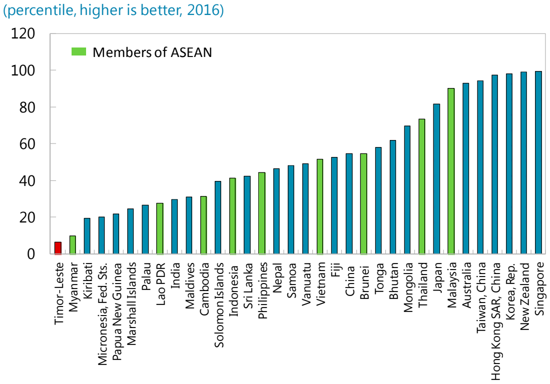
(Index rescaled: 0 = worst, 5 = best; 2014)



...although much more needs to be done to make the domestic environment more conducive for business.

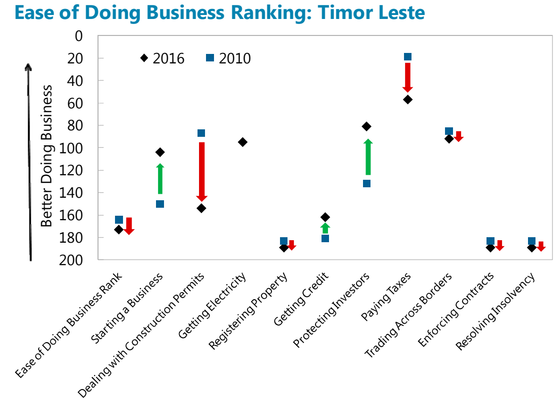
Developing Asia, Doing Business Ranking

(percentile, higher is better, 2016)



Improvements in ease of doing business remain limited...

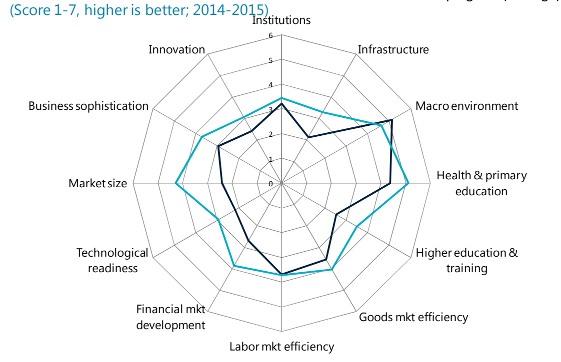
Ease of Doing Business Ranking: Timor Leste



...requiring greater competitiveness in most areas.

Pillars of Global Competitiveness

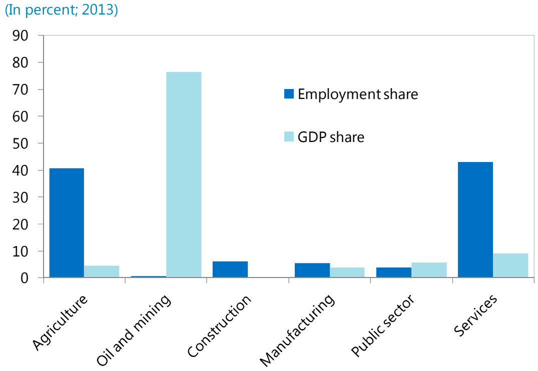
(Score 1-7, higher is better; 2014-2015)



Agriculture and services generate most of the employment, despite their small shares in the domestic economy.

Employment and GDP Share

(In percent; 2013)

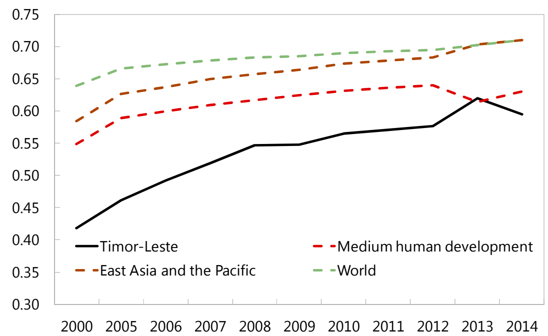


Sources: Revenue Watch Institute, 2013; Worldwide Governance Index, 2015 update; the Global Competitiveness Index 2014-2015; and World Bank Development Indicators, latest available data.

Figure 6. Timor-Leste: Social Economic Development

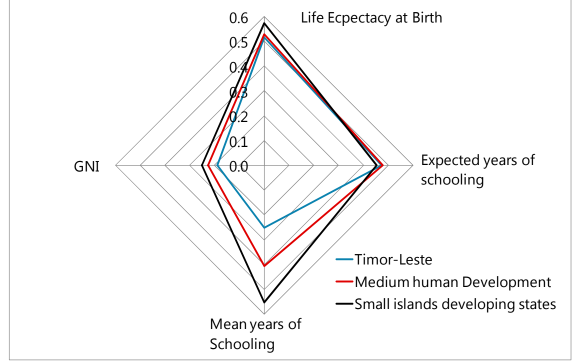
Ranking in human development falls in 2014 due to a decline in Gross National Income (GNI)...

Human Development Index
(Higher is better; 2014)



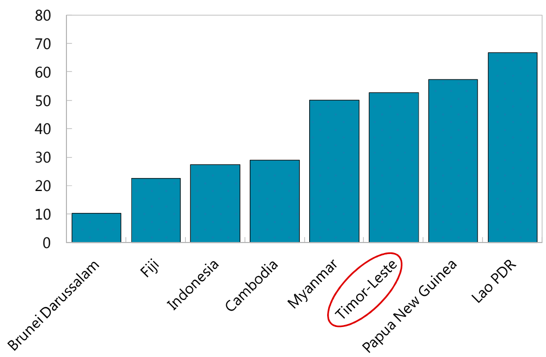
...and Timor-Leste lags its peers significantly in years of schooling...

HDI Components
(Index rescaled; 0=worst, 1=best; 2014)



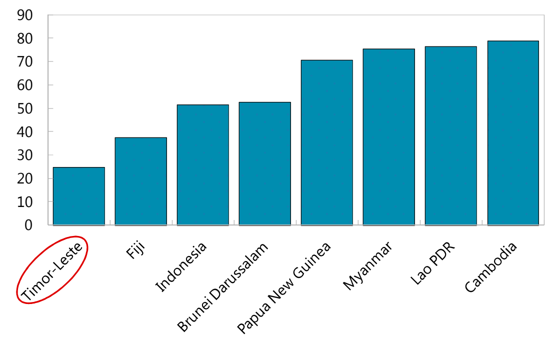
...a moderate under-5 mortality rate among its peers...

Under-5 Mortality Rate
(Per 1,000; 2015)



...but low female participation in the labor force..

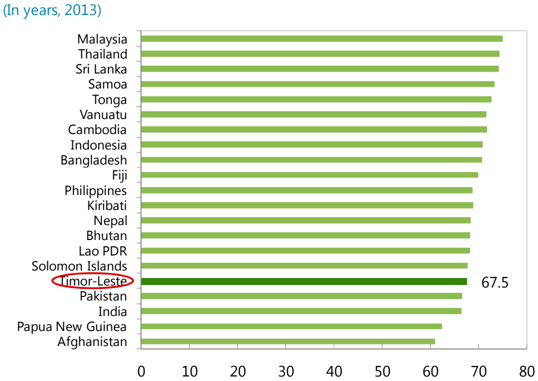
Female Labor force participation rate 1/
(In percent of female population ages 15+, 2013)



1/ modeled ILO estimate.

More needs to be done to increase life expectancy...

Life Expectancy: Selected Asian Economies
(In years, 2013)



...and improve literacy.

Literacy Rate: Selected Asian Economies
(Perecentage of people age 15 and above; 2013)

Sources: Revenue Watch Institute, 2013; Worldwide Governance Index, 2014; Human Development Report, 2015; and World Bank Development Indicators, latest available data.

Table 1. Timor-Leste: Selected Economic and Financial Indicators, 2012-21

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
			Est.	Prel.			Proj.			
					(Annual percent change)					
Real sector										
Real total GDP	5.3	-13.9	-15.8	-0.6	-8.8	-12.9	-3.9	-9.4	-9.2	-8.8
Real non-oil GDP	6.4	2.8	5.5	4.3	5.0	5.5	6.0	6.5	5.5	5.5
CPI (annual average)	10.9	9.6	0.8	0.6	1.5	3.8	4.0	4.0	4.0	4.0
CPI (end-period)	10.9	4.0	0.3	-0.6	3.6	4.0	4.0	4.0	4.0	4.0
					(In percent of GDP, unless otherwise indicated)					
Central government operations										
Revenue	61.1	66.1	63.2	61.5	63.1	52.6	49.0	46.0	42.7	40.0
Domestic revenue	2.0	2.7	3.9	6.5	8.0	7.6	7.3	7.2	7.1	7.3
Petroleum revenue (incl. PF interest)	55.5	58.7	53.2	48.9	48.3	41.1	37.7	34.8	31.5	28.7
Grants	3.7	4.7	6.2	6.1	6.8	4.0	4.0	4.0	4.0	4.0
Expenditure	22.0	24.0	37.4	57.3	73.5	73.1	69.1	67.2	65.0	58.5
Recurrent expenditure	10.4	13.1	20.9	39.1	49.3	45.8	43.8	43.1	42.2	40.9
Capital expenditure	7.9	6.3	10.2	11.7	17.4	23.3	21.3	20.1	18.8	13.6
Donor project	3.7	4.7	6.2	6.1	6.8	4.0	4.0	4.0	4.0	4.0
Overall balance	39.1	42.1	25.9	4.2	-10.4	-20.5	-20.1	-21.2	-22.4	-18.5
Non-oil overall balance (in percent of non-oil GDP)	-86.0	-70.5	-86.9	-82.8	-83.3	-81.8	-73.5	-66.1	-59.7	-49.5
					(Annual percent change, unless otherwise indicated)					
Money and credit										
Deposits	26.5	22.4	19.6	22.8	21.6	21.3	21.9	21.6	21.6	21.7
Credit to the private sector	20.5	13.6	5.5	10.5	13.3	13.7	12.5	13.2	13.1	12.9
Lending interest rate (percent, end-period)	12.2	12.4	12.9	13.5	...	...	...	...	...	...
					(In millions of U.S. dollars, unless otherwise indicated)					
Balance of payments										
Current account balance 1/	2,736	2,391	1,096	431	41	-281	-315	-334	-359	-241
(In percent of GDP)	40.2	42.7	25.1	16.5	2.0	-11.9	-12.2	-12.2	-12.2	-7.8
Trade balance	-638	-679	-749	-684	-710	-844	-892	-901	-917	-892
Exports 2/	33	18	15	9	17	20	21	24	26	28
Imports	672	696	764	692	728	864	914	925	943	920
Services (net)	-920	-437	-388	-414	-486	-648	-647	-646	-637	-524
Petroleum revenue	3,775	3,286	2,319	1,281	1,014	972	976	955	925	889
Overall balance	422	-197	-376	127	8	6	3	1	1	1
Public foreign assets (end-period) 3/	12,659	15,639	16,849	16,655	16,552	16,247	15,944	15,600	15,226	14,816
(In months of imports)	91	156	165	169	153	122	115	110	106	110
Exchange rates										
NEER (2010=100, period average)	96.7	101.9	106.8	120.2	...	...	...	...	...	...
REER (2010=100, period average)	115.5	131.6	134.9	150.1	...	...	...	...	...	...
Memorandum items:										
GDP at current prices:	6,807	5,595	4,361	2,620	2,100	2,368	2,589	2,746	2,933	3,094
Non-oil GDP	1,295	1,319	1,371	1,412	1,480	1,782	2,037	2,323	2,647	2,948
Oil GDP	5,512	4,276	2,990	1,207	620	587	552	423	286	147
GDP per capita	6,159	4,974	3,807	2,244	1,769	1,959	2,104	2,192	2,300	2,384
Crude oil prices (U.S. dollars per barrel, WEO) 4/	105	104	96	51	35	41	45	48	49	51
Petroleum Fund balance (in millions of U.S. dollars) 5/	11,775	14,952	16,539	16,218	16,106	15,795	15,489	15,144	14,769	14,359
Petroleum Fund balance (in percent of non-oil GDP)	909	1,134	1,206	1,148	1,088	887	760	652	558	487
Public debt (in millions of U.S. dollars)	0	6	22	46	153	326	541	777	1,059	1,219

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

1/ Excludes trade in goods and services of entities located in the Joint Petroleum Development Area, which are considered non-resident.

2/ Excludes petroleum exports, the income of which is recorded under the income account.

3/ Includes Petroleum Fund balance and the central bank's official reserves.

4/ Simple average of UK Brent, Dubai, and WTI crude oil prices based on April 2016 WEO assumptions.

5/ Closing balance.

Table 2. Timor-Leste: Summary Operations of the Central Government, 2013-21 1/

	2013	2014	2015		2016		2017	2018	2019	2020	2021
		Est.	2015 Rectification Budget	Estimate	2016 Budget	Proj.			Projection		
					(In millions of U.S. Dollars)						
Revenue	**3,697.8**	**2,555.1**	**1,818.8**	**1,611.8**	**1,908.3**	**1,325.7**	**1,246.6**	**1,269.1**	**1,263.9**	**1,251.2**	**1,238.8**
Petroleum revenue	3,286.4	2,116.8	1,394.1	1,280.8	1,593.5	1,014.1	972.2	976.5	954.8	925.0	889.3
Oil/gas receipts	3,041.8	1,817.0	861.9	978.9	718.7	145.0	67.3	62.8	57.2	47.4	31.9
Investment returns 2/	244.6	299.8	532.2	301.9	874.8	869.1	904.9	913.7	897.6	877.6	857.4
Taxes	104.7	123.8	125.6	119.8	116.4	115.2	121.5	126.6	131.8	137.1	147.7
Taxes on income, profits, and capital gains	40.2	53.0	45.7	53.3	52.3	52.3	56.3	60.4	64.5	68.5	73.9
Taxes on goods & services	51.8	57.3	63.8	54.1	52.1	52.1	52.7	53.2	53.7	54.4	58.7
Taxes on international trade & transactions	12.5	13.4	15.9	12.1	11.8	10.6	12.3	12.8	13.3	13.9	15.0
Grants	260.3	270.3	254.3	161.0	143.4	143.4	94.8	103.7	110.0	117.5	124.6
Other revenue	46.4	44.2	44.8	50.3	55.0	53.0	58.1	62.4	67.3	71.6	77.3
Expenditure	**1,341.7**	**1,629.4**	**1,824.3**	**1,501.2**	**1,705.6**	**1,543.8**	**1,731.0**	**1,789.7**	**1,845.7**	**1,907.7**	**1,809.9**
Expenditure excluding donor projects	1,081.4	1,359.1	1,570.0	1,340.2	1,562.2	1,400.4	1,636.1	1,686.0	1,735.7	1,790.2	1,685.2
Current expenditure	730.8	912.7	1,147.7	1,023.2	1,106.9	1,034.3	1,084.0	1,133.7	1,183.4	1,237.9	1,264.7
Wages and salaries	141.8	162.5	177.5	170.4	181.9	163.7	179.7	186.9	194.4	208.9	207.0
Current transfers	197.0	291.5	454.5	428.3	476.0	466.5	485.2	504.6	524.8	545.8	569.7
Goods and services	392.0	458.7	515.7	424.5	449.0	404.1	419.1	442.3	464.2	483.2	488.0
Of which: Subsidies	98.4	96.5	0.0	81.5	-	85.2	75.0	75.0	75.0	75.0	75.0
Interest payments	0.1	0.3	0.7	0.7	2.3	2.3	4.9	8.1	11.7	15.9	18.3
Contingency spending				10.6	-	-	-	-	-	-	-
Capital expenditure	350.6	446.4	422.3	306.4	455.3	366.1	552.2	552.3	552.3	552.3	420.5
Donor project	260.3	270.3	254.3	161.0	143.4	143.4	94.8	103.7	110.0	117.5	124.6
Overall balance	**2,356.1**	**925.7**	**-5.5**	**110.6**	**202.7**	**-218.1**	**-484.4**	**-520.5**	**-581.8**	**-656.5**	**-571.0**
Net Transfer to the Petroleum Fund (PF) 3/	**2,556.4**	**1,384.8**	**66.6**	**2.3**	**309.7**	**-111.1**	**-311.1**	**-305.9**	**-345.2**	**-375.0**	**-410.7**
Non-oil overall balance	**-930.3**	**-1,191.1**	**-1,399.6**	**-1,170.1**	**-1,390.8**	**-1,232.2**	**-1,456.5**	**-1,497.0**	**-1,536.6**	**-1,581.5**	**-1,460.3**
Financing:	930.3	1,191.1	1,399.6	1,170.1	1,390.8	1,232.2	1,456.5	1,497.0	1,536.6	1,581.5	1,460.3
Petroleum Fund withdrawals	730.0	732.0	1,327.5	1,278.5	1,283.8	1,125.2	1,283.2	1,282.4	1,300.0	1,300.0	1,300.0
Estimated Sustainable Income (ESI) 4/	730.0	632.3	638.5	638.5	544.8	544.8	505.2	567.0	537.4	522.8	509.1
Withdrawals above ESI	0.0	99.7	689.0	640.0	739.0	580.4	778.0	715.4	762.6	777.2	790.9
Change in cash balance (increase="-")	194.0	443.3	2.1	-132.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Borrowing	6.3	15.8	70.0	23.8	107.0	107.0	173.3	214.6	236.6	281.5	160.3
					(In percent of GDP)						
Revenue	**66.1**	**58.6**	**69.4**	**61.5**	**90.9**	**63.1**	**52.6**	**49.0**	**46.0**	**42.6**	**40.0**
Petroleum revenue	58.7	48.5	53.2	48.9	75.9	48.3	41.0	37.7	34.7	31.5	28.7
Oil/gas receipts	54.4	41.7	32.9	37.4	34.2	6.9	2.8	2.4	2.1	1.6	1.0
Investment returns	4.4	6.9	20.3	11.5	41.7	41.4	38.2	35.2	32.6	29.9	27.7
Taxes	1.9	2.8	4.8	4.6	5.5	5.5	5.1	4.9	4.8	4.7	4.8
Taxes on income, profits, and capital gains	0.7	1.2	1.7	2.0	2.5	2.5	2.4	2.3	2.3	2.3	2.4
Taxes on goods & services	0.9	1.3	2.4	2.1	2.5	2.5	2.2	2.1	2.0	1.9	1.9
Taxes on international trade & transactions	0.2	0.3	0.6	0.5	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Grants	4.7	6.2	9.7	6.1	6.8	6.8	4.0	4.0	4.0	4.0	4.0
Other revenue	0.8	1.0	1.7	1.9	2.6	2.5	2.5	2.4	2.4	2.4	2.5
Expenditure	**24.0**	**37.4**	**69.6**	**57.3**	**81.2**	**73.5**	**73.0**	**69.0**	**67.1**	**64.9**	**58.4**
Current expenditure	13.1	20.9	43.8	39.1	74.4	49.3	45.7	43.7	43.0	42.1	40.8
Wages and salaries	2.5	3.7	6.8	6.5	8.7	7.8	7.6	7.2	7.1	7.1	6.7
Current transfers	3.5	6.7	17.3	16.3	8.7	22.2	20.5	19.5	19.1	18.6	18.4
Goods and services	7.0	10.5	19.7	16.2	22.7	19.2	17.7	17.1	16.9	16.4	15.7
Of which: Subsidies	1.8	2.2	0.0	3.1	-	4.1	3.2	2.9	2.7	2.6	2.4
Capital expenditure	6.3	10.2	16.1	11.7	17.4	17.4	23.3	21.3	20.1	18.8	13.6
Donor Project	4.7	6.2	9.7	6.1	6.8	6.8	4.0	4.0	4.0	4.0	4.0
Overall balance	**42.1**	**21.2**	**-0.2**	**4.2**	**9.7**	**-10.4**	**-20.4**	**-20.1**	**-21.2**	**-22.3**	**-18.4**
Net Transfer to the PF	**45.7**	**31.8**	**2.5**	**0.1**	**14.7**	**-5.3**	**-13.1**	**-11.8**	**-12.6**	**-12.8**	**-13.3**
Non-oil overall balance	**-16.6**	**-27.3**	**-53.4**	**-44.7**	**-66.2**	**-58.7**	**-61.4**	**-57.8**	**-55.9**	**-53.8**	**-47.1**
Financing:	**16.6**	**27.3**	**53.4**	**44.7**	**66.2**	**58.7**	**61.4**	**57.8**	**55.9**	**53.8**	**47.1**
Petroleum Fund withdrawals	13.0	16.8	50.7	48.8	61.1	53.6	54.1	49.5	47.3	44.2	41.9
ESI	13.0	14.5	24.4	24.4	25.9	25.9	21.3	21.9	19.5	17.8	16.4
Excess withdrawal	0.0	2.3	26.3	24.4	35.2	27.6	32.8	27.6	27.7	26.5	25.5
Borrowing	0.1	0.4	2.7	0.9	5.1	5.1	7.3	8.3	8.6	9.6	5.2
					(In percent of non-oil GDP)						
Non-oil revenue (excluding grants)	**11.5**	**12.2**	**12.1**	**12.0**	**11.6**	**11.4**	**10.1**	**9.3**	**8.6**	**7.9**	**7.6**
Expenditure	**101.7**	**118.8**	**129.2**	**106.3**	**115.3**	**104.3**	**97.0**	**87.7**	**79.3**	**71.9**	**61.3**
Current expenditures (in percent of non-oil GDP)	55.4	66.5	81.3	72.4	74.8	69.9	60.7	55.6	50.9	46.7	42.8
Capital expenditures (in percent of non-oil GDP)	26.6	32.5	29.9	21.7	30.8	24.7	30.9	27.1	23.7	20.8	14.2
Donor funded expenditures (in percent of non-oil GDP)	19.7	19.7	18.0	11.4	9.7	9.7	5.3	5.1	4.7	4.4	4.2
Non-oil overall balance	**-70.5**	**-86.8**	**-99.1**	**-82.8**	**-94.0**	**-83.3**	**-81.6**	**-73.4**	**-66.0**	**-59.6**	**-49.5**
Non-oil primary balance	**-70.5**	**-86.8**	**-99.0**	**-82.8**	**-93.8**	**-83.1**	**-81.3**	**-72.8**	**-65.2**	**-58.4**	**-48.1**
Memorandum items:											
Funding gap (in millions of U.S. dollars) 5/	-200.3	-558.8	-761.1	-531.6	-846.0	-687.4	-951.3	-930.0	-999.2	-1058.7	-951.2
Petroleum Fund balance (in millions of U.S. dollars)	14,952	16,539	16,218	16,218	17,967	16,106	15,795	15,489	15,144	14,769	14,359
Petroleum Fund balance (in percent of GDP)	267.2	379.2	619.1	619.1	685.9	767.1	666.2	597.6	550.7	502.7	463.3
Non-oil GDP at current prices (in millions of U.S. dolla	1,319	1,372	1,412	1,412	1,480	1,480	1,784	2,040	2,327	2,652	2,952
GDP at current prices (in millions of U.S. dollars)	5,596	4,362	2,620	2,620	2,100	2,100	2,371	2,592	2,750	2,938	3,099

Sources: Timor-Leste authorities and IMF staff estimates.

1/ This presentation of government operations do not entirely follow the GFSM 2014 format. Deviations from GFSM 2014 are included in this presentation.

2/ In accordance with GFSM 2014, investment returns in the operations statement exclude valuation gains/(losses) due to financial asset price and exchange rate changes.

3/ Petroleum revenue minus Petroleum Fund withdrawal

4/ Staff projections of the ESI are based on the findings of IMF TA mission conducted by the Fiscal Affairs Department and funded under the Managing Natural Resource Wealth Topical Trust Fund.

5/ Funding gap is the deficit as per the fiscal rule, and equals ESI plus domestic revenue less expenditure.

Table 3. Timor-Leste: Monetary Developments, 2012-17

	2012	2013	2014	2015	2016	2017
			Est.	Prel.	Projections	
	(In millions of U.S. dollars)					
Banking system 1/						
Net foreign assets 2/	**1,179**	**1,072**	**757**	**1,016**	**1,007**	**1,012**
Gross reserves	884	687	311	438	446	452
Other foreign assets	368	461	521	661	644	644
Foreign liabilities	72	77	76	83	83	83
Net domestic assets	**-772**	**-572**	**-157**	**-363**	**-313**	**-218**
Net credit to central government	-841	-651	-207	-339	-339	-339
Net credit to state and local government	0	0	-1	0	0	0
Net credit to public nonfinancial corporations	0	0	0	0	0	0
Credit to private sector	160	182	192	212	240	273
Other items (net)	-91	-103	-141	-236	-215	-152
Broad money	**407**	**500**	**600**	**642**	**693**	**794**
Narrow money	206	279	343	398	429	492
Currency in circulation 3/	5	7	10	12	13	15
Transferable deposits	201	273	333	386	416	477
Other deposits	201	221	257	245	-165	-189
Central Bank						
Net foreign assets 2/	**872**	**675**	**300**	**427**	**435**	**441**
Gross reserves	884	687	311	438	446	452
Foreign liabilities	12	12	11	11	11	11
Net domestic assets	**-772**	**-590**	**-154**	**-208**	**-208**	**-208**
Net credit to central government	-819	-634	-181	-238	-238	-238
Net credit to other depository corporations	71	72	71	75	75	75
Other items (net)	-24	-28	-44	-44	-44	-44
Monetary Base	**100**	**86**	**147**	**213**	**227**	**233**
Currency in circulation	5	7	10	12	13	15
Other liabilities to depositary corporations	95	79	137	201	214	218
Others 3/	0	0	0	0	0	0
	(12-month percentage change)					
Broad money growth	26.2	22.9	19.9	7.1	7.9	14.6
Reserve money growth	189.7	-14.4	71.4	45.5	6.5	2.5
Credit to the private sector growth	20.5	13.6	5.5	10.5	13.3	13.7
Memorandum items	(In percent, unless otherwise indicated)					
Credit/non-oil GDP	12.4	13.8	14.0	15.0	16.2	15.3
Broad money/non-oil GDP	31.4	37.9	43.7	45.5	46.8	44.6
Credit/deposits	39.8	36.8	32.5	44.3	47.9	45.2
Amounts of non-perfoming loans (in millions of U.S. dollars)	48.0	49.5	47.4	43.7	…	…
Non-performing loans/total loans	30.8	28.0	26.8	22.9	…	…
Loan rate 4/	12.2	12.4	12.9	13.5	…	…
Deposit rate 5/	1.1	1.1	1.1	1.0	…	…

Sources: Central Bank of Timor-Leste; and IMF staff estimates.

1/ Includes the Central Bank, 4 commercial banks (including 3 branches of foreign banks).

2/ An oil fund was created in September 2005 and the deposits were moved off-shore and onto the Government balance sheet.

3/ Includes only coinage issued by the Central Bank. No data is available for notes due to dollarization of the financial system.

4/ Rate charged by other depository corporations on loans in U.S. dollars. The rate is weighted by loan amounts.

5/ Rate offered by other depository corporations on three-month time deposits in U.S. dollars. The rate is weighted by deposit amounts.

Table 4. Timor-Leste: Balance of Payments, 2012-21

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
			Est.	Prel.	Projections					
	(In millions of U.S. dollars)									
Current account balance 1/	2,736	2,391	1,096	431	41	-281	-315	-334	-359	-241
Trade balance	-638	-679	-749	-684	-710	-844	-892	-901	-917	-892
Exports 2/	33	18	15	9	17	20	21	24	26	28
of which: Coffee	32	17	15	8	16	17	18	20	22	24
Imports	-672	-696	-764	-692	-728	-864	-914	-925	-943	-920
Services (net)	-920	-437	-388	-414	-486	-648	-647	-646	-637	-524
Receipts	69	70	74	79	83	93	107	127	148	167
of which: Travel	21	29	35	33	36	42	49	60	71	80
Payments	-989	-508	-462	-492	-569	-741	-754	-773	-785	-691
Income (net)	3,862	3,327	2,149	1,304	1,001	964	967	944	913	879
of which: Investment income	207	275	331	327	869	905	914	898	878	857
Other primary income (oil/gas)	3,559	3,042	1,817	979	145	67	63	57	47	32
Current transfers (net)	432	180	84	225	236	246	257	268	282	296
Capital and financial accounts	-2,220	-2,545	-1,391	-304	-33	287	319	335	360	242
Official capital transfers	23	20	-3	28	20	19	19	19	19	19
Financial account	-2,243	-2,564	-1,387	-332	-53	268	300	316	341	223
of which: Oil/gas savings	-2,280	-2,556	-1,385	-2	111	311	306	345	375	411
FDI	51	62	47	35	170	200	200	155	150	150
External debt	0	6	16	25	107	172	209	226	266	142
Errors and omissions (net)	-94	-43	-81	0	0	0	0	0	0	0
Overall balance	422	-197	-376	127	8	6	3	1	1	1
Financing										
Change in net foreign assets	-422	197	376	-127	-8	-6	-3	-1	-1	-1
	(In percent of GDP)									
Current account	40.2	42.7	25.1	16.5	2.0	-11.9	-12.2	-12.2	-12.2	-7.8
Trade balance	-9.4	-12.1	-17.2	-26.1	-33.8	-35.6	-34.5	-32.8	-31.3	-28.8
Exports	0.5	0.3	0.4	0.3	0.8	0.8	0.8	0.9	0.9	0.9
Imports	-9.9	-12.4	-17.5	-26.4	-34.7	-36.5	-35.3	-33.7	-32.1	-29.7
Services (net)	-13.5	-7.8	-8.9	-15.8	-23.1	-27.4	-25.0	-23.5	-21.7	-16.9
Income (net)	56.7	59.5	49.3	49.8	47.7	40.7	37.4	34.4	31.1	28.4
Current transfers (net)	6.3	3.2	1.9	8.6	11.2	10.4	9.9	9.8	9.6	9.6
Capital and financial accounts	-32.6	-45.5	-31.9	-11.6	-1.6	12.1	12.3	12.2	12.3	7.8
Overall balance	6.2	-3.5	-8.6	4.9	0.4	0.2	0.1	0.0	0.0	0.0
	(In percent of non-oil GDP)									
Current account	211.3	181.3	79.9	30.5	2.8	-15.8	-15.5	-14.4	-13.6	-8.2
Trade balance	-49.3	-51.4	-54.6	-48.4	-48.0	-47.4	-43.8	-38.8	-34.6	-30.3
Exports	2.6	1.3	1.1	0.6	1.2	1.1	1.0	1.0	1.0	1.0
Imports	-51.9	-52.8	-55.7	-49.0	-49.2	-48.5	-44.9	-39.8	-35.6	-31.2
Services (net)	-71.0	-33.2	-28.3	-29.3	-32.8	-36.4	-31.8	-27.8	-24.1	-17.8
Income (net)	298.2	252.3	156.7	92.3	67.6	54.1	47.5	40.7	34.5	29.8
Current transfers (net)	33.4	13.6	6.1	15.9	15.9	13.8	12.6	11.6	10.6	10.0
Capital and financial accounts	-171.4	-192.9	-101.4	-21.5	-2.2	16.1	15.6	14.4	13.6	8.2
Overall balance	39.9	-11.6	-21.5	9.0	0.5	0.3	0.2	0.0	0.0	0.0
	(In millions of U.S. dollars, unless otherwise indicated)									
Memorandum items:										
Public foreign assets (end-period)	12,659	15,639	16,849	16,655	16,552	16,247	15,944	15,600	15,226	14,816
in months of imports of G&S	91	156	165	169	153	122	115	110	106	110
of which: Central bank reserves	884	687	311	438	446	452	455	456	457	458
Petroleum Fund balance 3/	11,775	14,952	16,539	16,218	16,106	15,795	15,489	15,144	14,769	14,359

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

1/ Excludes trade in goods and services of entities located in the Joint Petroleum Development Area which are considered non-resident entities.

2/ Excludes petroleum exports, the income of which is recorded under the income account.

3/ Closing balance.

Table 5. Timor-Leste: Medium-Term Scenario, 2012-21

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
			Est.	Prel.	Projections					
Real sector										
GDP at current prices (in millions of U.S. dollars)	6,807	5,596	4,361	2,620	2,100	2,368	2,589	2,746	2,933	3,094
Non-oil GDP	1,295	1,319	1,371	1,412	1,480	1,782	2,037	2,323	2,647	2,948
Oil GDP	5,512	4,276	2,990	1,207	620	587	552	423	286	147
Real non-oil GDP growth (percentage change)	6.4	2.8	5.5	4.3	5.0	5.5	6.0	6.5	5.5	5.5
CPI (percentage change, period average)	10.9	9.6	0.8	0.6	1.5	3.8	4.0	4.0	4.0	4.0
CPI (percentage change, end-period)	10.9	4.0	0.3	-0.6	3.6	4.0	4.0	4.0	4.0	4.0
	(In percent of GDP)									
Central government operations										
Revenue	61.1	66.1	63.2	61.5	63.1	52.6	49.0	46.0	42.7	40.0
Domestic revenue	2.0	2.7	3.9	6.5	8.0	7.6	7.3	7.2	7.1	7.3
Petroleum revenue (incl. PF interest)	55.5	58.7	53.2	48.9	48.3	41.1	37.7	34.8	31.5	28.7
Grants	3.7	4.7	6.2	6.1	6.8	4.0	4.0	4.0	4.0	4.0
Expenditure	22.0	24.0	37.4	57.3	73.5	73.1	69.1	67.2	65.0	58.5
Recurrent expenditure	10.4	13.1	20.9	39.1	49.3	45.8	43.8	43.1	42.2	40.9
Capital expenditure	7.9	6.3	10.2	11.7	17.4	23.3	21.3	20.1	18.8	13.6
Donor project	3.7	4.7	6.2	6.1	6.8	4.0	4.0	4.0	4.0	4.0
Overall balance	39.1	42.1	25.9	4.2	-10.4	-20.5	-20.1	-21.2	-22.4	-18.5
Non-oil overall balance	-16.4	-16.6	-27.3	-44.7	-58.7	-61.5	-57.8	-55.9	-53.9	-47.2
	(In percent of non-oil GDP)									
Revenue	321.4	280.3	201.0	114.1	89.6	70.0	62.3	54.4	47.3	42.0
Domestic revenue	10.3	11.5	12.2	12.0	11.4	10.1	9.3	8.6	7.9	7.6
Petroleum revenue (incl. PF interest)	291.5	249.2	169.1	90.7	68.5	54.6	47.9	41.1	34.9	30.2
Grants	19.6	19.7	19.7	11.4	9.7	5.3	5.1	4.7	4.4	4.2
Expenditure	115.9	101.7	118.8	106.3	104.3	97.2	87.9	79.5	72.1	61.4
Recurrent expenditure	54.7	55.4	66.6	72.4	69.9	60.8	55.7	50.9	46.8	42.9
Capital expenditure	41.6	26.6	32.6	21.7	24.7	31.0	27.1	23.8	20.9	14.3
Donor project	19.6	19.7	19.7	11.4	9.7	5.3	5.1	4.7	4.4	4.2
Overall balance	205.5	178.6	82.2	7.8	-14.7	-27.2	-25.6	-25.0	-24.8	-19.4
Non-oil overall balance	-86.0	-70.5	-86.9	-82.8	-83.3	-81.8	-73.5	-66.1	-59.7	-49.5
	(In millions of U.S. dollars, unless otherwise indicated)									
Balance of payments										
Current account balance 1/	2,736	2,391	1,096	431	41	-281	-315	-334	-359	-241
Trade balance	-638	-679	-749	-684	-710	-844	-892	-901	-917	-892
Exports 2/	33	18	15	9	17	20	21	24	26	28
Imports	672	696	764	692	728	864	914	925	943	920
Services (net)	-920	-437	-388	-414	-486	-648	-647	-646	-637	-524
Petroleum revenue (incl. PF interest)	3,775	3,286	2,319	1,281	1,014	972	976	955	925	889
Petroleum Fund balance	11,775	14,952	16,539	16,218	16,106	15,795	15,489	15,144	14,769	14,359
(In months of imports)	85	149	162	164	149	118	111	107	103	107
	(In percent of GDP)									
Current account balance 1/	40.2	42.7	25.1	16.5	2.0	-11.9	-12.2	-12.2	-12.2	-7.8
Trade balance	-9.4	-12.1	-17.2	-26.1	-33.8	-35.6	-34.5	-32.8	-31.3	-28.8
Exports 2/	0.5	0.3	0.4	0.3	0.8	0.8	0.8	0.9	0.9	0.9
Imports	9.9	12.4	17.5	26.4	34.7	36.5	35.3	33.7	32.1	29.7
Services (net)	-13.5	-7.8	-8.9	-15.8	-23.1	-27.4	-25.0	-23.5	-21.7	-16.9
	(In percent of non-oil GDP, unless otherwise indicated)									
Current account balance 1/	211.3	181.3	79.9	30.5	2.8	-15.8	-15.5	-14.4	-13.6	-8.2
Trade balance	-49.3	-51.4	-54.6	-48.4	-48.0	-47.4	-43.8	-38.8	-34.6	-30.3
Exports 2/	2.6	1.3	1.1	0.6	1.2	1.1	1.0	1.0	1.0	1.0
Imports	51.9	52.8	55.7	49.0	49.2	48.5	44.9	39.8	35.6	31.2
Services (net)	-71.0	-33.2	-28.3	-29.3	-32.8	-36.4	-31.8	-27.8	-24.1	-17.8
Public external debt										
(In millions of U.S. dollars)	0	6	22	46	153	326	541	777	1,059	1,219
(In percent of GDP)	0.0	0.1	0.5	1.8	7.3	13.8	20.9	28.3	36.1	39.4
Memorandum items:										
Crude oil prices (U.S. dollars per barrel, WEO) 3/	105.0	104.1	96.2	50.8	34.8	41.0	44.5	47.6	49.4	50.5
Petroleum Fund balance (in percent of GDP) 4/	173.0	267.2	379.3	619.1	767.0	667.0	598.3	551.4	503.5	464.0
Petroleum Fund balance (in percent of non-oil GDP)	909.3	1,133.6	1,206.2	1,148.2	1,088.3	886.6	760.4	651.9	557.9	487.1

Sources: Timor-Leste authorities; and IMF staff estimates and projections.
1/ Excludes trade in goods and services of entities located in the Joint Petroleum Development Area which are considered non-resident entities.
2/ Excludes petroleum exports, the income of which is recorded under the income account.
3/ Simple average of UK Brent, Dubai, and WTI crude oil prices; April 2016 WEO assumptions.
4/ Closing balance.

Table 6. Timor-Leste: Risk Assessment Matrix 1/

Source of Risks	Overall Level of Concern		Policy Recommendations
	Likelihood (high, medium or low)	**Expected Impact if Realized** (high, medium or low)	
1. Sharper-than-expected global growth slowdown	**Low/Medium** This could be due to (i) significant China slowdown in 2016-17; and/or **Medium** (ii) turning of the credit cycle generating disorderly deleveraging in large emerging economies and potential spillbacks to advanced economies.	**Medium/Low** These could lead to lower global trade and weak demand for oil, adversely impacting revenues. The impact is limited by the insulating role of the Petroleum Fund (PF) and low levels of non-oil trade and capital account integration.	Expenditures plans need to be scalable and efforts to raise non-oil revenues need to be intensified..
2. Tighter or more volatile global financial sector conditions	**Medium** Sharp asset price adjustment as investors reassess underlying risk and response to unanticipated change in growth and financial intermediation; Fed policy rate path, and increase in U.S. term premium, with poor market liquidity amplifying volatility. **High** A further surge in the U.S. dollar boosting non-U.S. trade but creating balance sheet strains for dollar debtors.	**Medium/Low** PF would gain from higher global interest rates but could incur capital losses on its bond portfolio. Renewed global shocks that affect international banking operations could impact local liquidity conditions. No crisis management or contingency planning frameworks are yet in place. Prolonged weakness in credit supply would limit private sector growth and diversification efforts.	The BCTL's regulatory and supervisory framework and crisis management toolkit need to be enhanced, with support from TA donors.
3.Persistently low energy prices	**Medium** Low oil and gas prices triggered by global supply factors reversing only gradually and due to continuing weak global demand.	**Medium** Low energy prices delay investment decisions in new oil fields and investment may become not profitable. The scope for government spending is reduced, lowering GDP growth.	As for 1 above.
4.Higher inflation	**Medium** Inability to moderate public expenditures raises inflation as the absorptive capacity of the economy is limited.	**Medium** High inflation adversely affects the poor and vulnerable. Higher transfers to compensate and higher public sector wages add to spending pressures.	Fiscal policy needs to be adaptable to maintain macro-stability, preserve competitiveness and better protect the poor.
5.Over investment in projects with low returns	**Medium** This could arise due to the implementation of capital-intensive projects with ambitious cost-benefit analysis.	**High** Capital-intensive projects that have limited linkages mean that job creation and poverty reduction is limited while depleting PF and risk fiscal sustainability.	Projects should be subject to transparent and realistic cost benefit assessments and risk analysis, and only go ahead if the social returns are higher than the opportunity costs.
6.Failure to secure inclusive growth	**Low/Medium** Discontent could be triggered by public perception that oil wealth is not trickling down and not reducing poverty.	**High** Higher rent seeking behavior and more pressures to raise expenditures and that may lower the quality of public investments. Foreign investment, vital for private sector growth, may be discouraged.	Sound policy frameworks and governance structures to be reinforced, especially through more transparency and accountability.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent; "medium" a probability between 10 and 30 percent; and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities.

Appendix I. Timor-Leste Petroleum Fund: Cornerstone of Fiscal Sustainability

The oil and gas sector has long been the mainstay of the Timorese economy. It accounted for about 70 percent of GDP and almost 90 percent of total government revenue during 2010–15. In recent years, oil and gas have been produced in two oil fields—Bayu Undan and Kitan—although under the baseline scenario, all production is expected to cease by 2023 as reserves become depleted. Prospects for the development of the Greater Sunrise fields remain uncertain amid unresolved issues over maritime borders and a revenue sharing agreement with Australia, as well as a bearish outlook for the global energy markets. Therefore, the Greater Sunrise project has not been factored in by the authorities and Fund staff into the calculation of the wealth of the Petroleum Fund (PF), the estimated sustainable income (ESI), or in any macro projections.

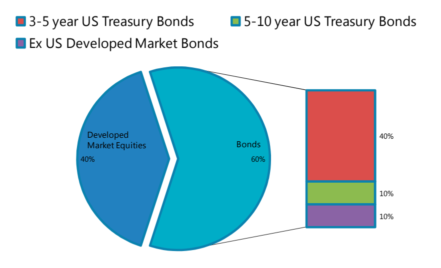
The PF was set up under the Petroleum Fund Law in 2005 for the management of petroleum revenue. It helps to smooth the spending of temporarily high petroleum income, shield against the volatility of petroleum prices, and safeguard the sustainable use of public finances to ensure intergenerational equity. The PF Law requires that all petroleum revenues are transferred to the PF and invested abroad in financial assets. The PF's only outgoings are transfers back to the central government budget based on parliamentary approval. The PF law defines the Estimated Sustainable Income (ESI) as 3 percent of the total petroleum wealth, which includes the current PF balance plus the net present value of expected future petroleum revenue.

The ESI could be seen as a form of fiscal rule but without a rigid fiscal ceiling. Actual withdrawal may exceed the ESI as long as the government provides detailed explanation to the parliament why doing so is in the interest of the country. The PF is expected to peak in nominal terms in 2016 and declines thereafter if annual PF withdrawal remains at about US$1.3 billion for the next 10 years against an average projected ESI of US$537 for 2015–20.

Oil prices for estimating ESI are projected under prudent assumption required under the PF Law. This is based on the U.S. Energy Information Administration's (EIA) long-term forecasts of the Brent crude oil prices using an average of the EIA low and reference cases. In recent years, falling oil prices have limited the build-up of the PF to its original targeted balance. However, the risk posed by low oil prices is becoming less significant as around 80–90 percent of the PF are already in the form of financial assets.

The Central Bank of Timor-Leste undertakes the operational management of the PF. It invests the Fund's capital according to guidelines established by the Ministry of Finance and mandates developed by the Investment Advisory Board. Management of parts of the portfolio is delegated to external investment managers. The PF was initially invested only in bonds, although an amendment to the PF Law in 2011 allowed up to 50 percent allocation in equities to better achieve the real return target. As at end-2015, 40 percent of the PF's investment was invested in equities. PF wealth declined for the first time in 2015 on account of valuation losses.

Petroleum Fund Investment Allocation, End-2015
(In percent)



Sources: Banco Central de Timor-Leste; IMF staff compilation

Analytical Framework for the Petroleum Fund

	2012	2013	2014	2015
Opening balance	9,310	11,775	14,952	16,539
Net acquisition of financial assets 1/	2,280	2,556	1,385	2
Other economic flows	185	620	202	-323
Closing balance	11,775	14,952	16,539	16,218

Sources: Banco Central de Timor-Leste; IMF staff calculations

1/ Derived by taking the difference between the closing balance and the sum of the opening balance and other economic flows. Other economic flows reflect valuation gains/(losses) due to financial asset price and exchange rate changes.

Appendix II. Key Policy Recommendations from Previous Article IV Consultation

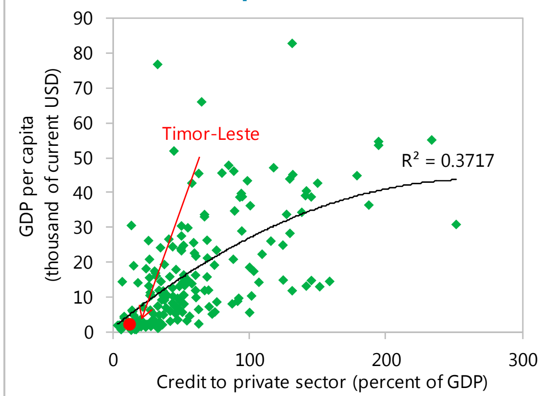
Past Staff Recommendations	Implementation
Fiscal policy	
Greater focus on fiscal sustainability with a front-loading strategy in line with the SDP objectives should see expenditure stabilized at $1.3 billion.	Broadly accepted by the authorities in the Yellow Road Process. Expenditure outturns (excluding grants) in 2014 and 2015 were $1.36 billion and $1.34 billion, respectively, lower than the budgeted amount of $1.50-1.57 billion.
Improve the composition of government expenditure, including rigorous cost-benefit analysis for large scale projects, scaling back planned infrastructure for cases ahead of demand, higher recurrent budget for maintenance cost for infrastructure development, curtail rapid increase in transfer and subsidies.	On-going progress but challenges remain. The authorities recognized public investment plans should be subject to robust appraisal but need to build capacity.
Raise non-oil domestic revenues.	Fiscal Reform Commission is working on the introduction of value-added tax in the medium term. The authorities are also reviewing tax incentives for corporates.
Financial Sector	
Implement the Financial Sector Master Plan to strengthen financial system oversight and development.	BCTL is making progress in building up supervisory capacity with the support of IMF TA.
Faster progress in reform of the land law to improve the availability of collateral to expand lending and borrowing.	Early attention to be given to enable moveable property to be used as collateral; follows by the use of immoveable property such as land and building as collateral when land titles have been clarified.
Establishing appropriate AML/CFT framework.	Good progress is being made.
The financial system in Oecusse special economic zone continues to be within the mandate of the BCTL.	Accepted by the BCTL authorities.
Dollarization remains appropriate given current conditions.	The authorities agreed with the staff's views given competing development goals and while the financial markets remains underdeveloped. A review of the exchange rate regime is required by the SDP.
Growth and Development	
Non-oil GDP growth of 5-7 percent over the medium term led by the private sector is more inclusive and sustainable.	The 2016 Budget assumed non-oil GDP will grow between 4-7.5 percent in the medium term and placed heavy emphasis on economic diversification and private sector led growth.
Measures to alleviate impediments to private sector development.	Ongoing progress but challenges remain.

Appendix III. Advancing Financial Inclusion and Safeguarding Stability

Financial inclusion increases economic growth at initial stage of financial development. Defining financial inclusion as the access to and use of formal financial services by households and firms, IMF (2015) found the initial levels of various types of financial inclusion indicators have a positive impact on 10-year growth. Nevertheless, determining the direction of causation between financial inclusion and economic growth remains a challenge. The study also points to evidence that financial stability risks increase when access to credit is expanded without proper supervision.[1]

Timor-Leste has much scope to facilitate access to finance given its re latively shallow financial market. There are only four commercial banks with 31 branches in the country, translating to about 5.6 bank branches per 100,000 adults. Albeit significant recent increase in the number of deposit accounts, overall only two in five Timorese have a bank account and a slow-growing access to non-bank financial institutions such as credit unions and microfinance. Timor-Leste's credit to private sector—a common indicator of financial sector depth— was 15 percent of GDP in 2015, well below the weighted average for Pacific island small states (68 percent of GDP in 2014) and East Asia and Pacific developing countries (131 percent of GDP in 2014). This indicates that continued efforts are needed to develop the financial system, broaden the provision of financial services, and increase financial literacy, as set out in the Banco Central de Timor-Leste (BCTL)'s Master Plan for Financial Sector Development. The Master Plan aims to increase the proportion of adult population with bank accounts to 90 percent by 2025, including through promoting mobile banking.

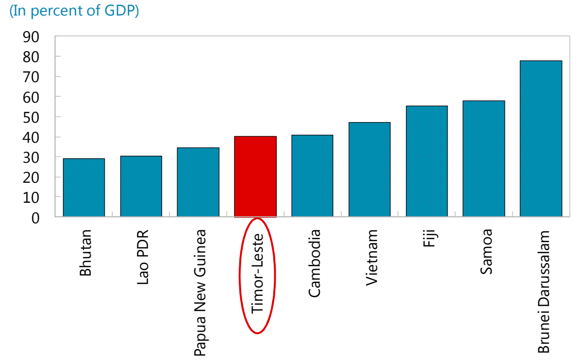
Financial Sector Depth, 2014



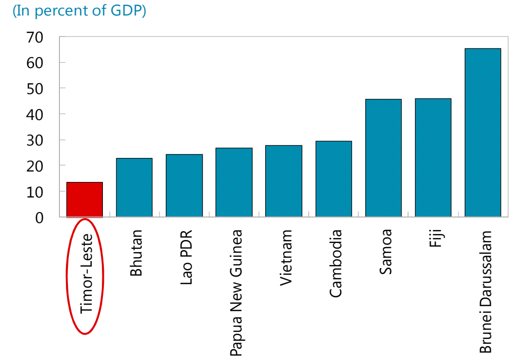
Source: World Bank, World Development Indicators.

At the same time, mitigating the potential risks to financial stability from an unchecked broadening of access to credit is needed. Sustainable financial inclusion requires balancing opportunity and innovation in financial markets with the establishment of safeguards to prevent excesses in both the supply of and demand for credit. The BCTL is making progress in enhancing its supervisory capacity for both on-site and off-site examination of banks in line with recent technical assistance. The BCTL is also expected to resume oversight of the non-bank financial sector which includes credit unions and microfinance in the near future, with TA support from the Pacific Financial Technical Assistance Centre (PFTAC).

Deposits
(In percent of GDP)



Private Credit
(In percent of GDP)



Sources: Timor-Leste Financial System Review; and WorldBank FinStats.
Note: Timor-Leste as of June 2015; others latest available.

[1] IMF Staff Discussion Note (2015) "Financial Inclusion: Can It Meet Multiple Macroeconomic Goals?"

Appendix IV. Transition to Sustainable Development Goals

The Sustainable Development Goals (SDGs) are replacing the Millennium Development Goals (MDGs). Broader in scope than the MDGs, the SDGs aim to achieve high and sustainable growth economically, socially and environmentally. A working group led by the Prime Minister's office is reviewing the Strategic Development Plan (SDP) for any adaptation needed to align with the SDGs. Timor-Leste played a key role in adopting SDG 16 (peace, justice, and strong institution) by its efforts and engagement at the global level through coordinating with g+7 countries.

Timor-Leste: Sustainable Development Goals Analysis

Current MDGs	Key Policies Requirements	Corresponding SDGs
1 Eradicate extreme poverty and hunger	**Economic diversification and transformation** Sustainable and inclusive growth Domestic revenue mobilization	1 No poverty 2 End hunger 8 Decent work and inclusive economic growth 9 Industry, innovation & infrastructure
2 Achieve universal primary education 3 Promote gender equality and empower women 4 Reduce child mortality 5 Improve maternal health 6 Combat HIV/AIDs, malaria and other diseases	**Economic, gender, and financial inclusion** Financial inclusion and financial stability Investing in human capital Data enhancement	3 Good health and well-being 4 Quality education 5 Gender equality 10 Reduced inequalities
7 Ensure environmental sustainability	**Environmental sustainability** Reducing inefficient energy subsidies	6 Clean water & sanitation 7 Affordable and clean energy 12 Responsible consumption 13 Climate action
8 Develop partnership for development	**Stable and effective governance and public order**	16 Peace, justice, and strong institution 17 Partnerships for the goals

Source: United Nations; and IMF staff estimates.

Some progress in achieving the MDGs. Timor-Leste is on-track in promoting gender equality, reducing child mortality, and combating malaria and other diseases.[1] Notably, infant and child mortality rates have declined sharply by 50 percent during 2001-09. However, Timor-Leste continues to face challenges in improving other social indicators. Raising the level and efficiency of health and education spending is essential. The government has taken initiatives to promote inclusive growth through various social programs.

Initiatives to promote health care and education

1. Health Care Service

* ***Saude da Familia (Family Health):*** to classify all households as healthy, at risk, sick or in rehabilitation by November 2016. Data will be available on the Ministry of Health website to assist program planning and implementation.

* ***Servisu Integradu Saude Komunitariu (Integrated Community Health Service):*** to ensure all communities have access to health services within an acceptable walking distance.

* ***The environmental/public health program:*** to focus on nutrition and communicable diseases through programs that deal with tuberculosis, HIV, and sexually transmitted diseases (STDs).

2. Education

* ***Key targets for next two years***

- Enrolment of all children in the first year of basic education at the proper age
- Reduction of school dropouts
- Acquisition of minimum literacy and numeracy skills
- Implementation and monitoring of the new base national curriculum for the 1st and 2nd cycles of basic education.

Source: Timor-Leste authorities.

IMF could help Timor-Leste achieves SDGs through policy support and technical assistance. Key priority areas include domestic revenue mobilization, financial sector supervision and data enhancement.[2] Domestic revenues mobilization would create the fiscal space to increase social and pro-growth spending. Financial inclusion through expanding financial access well supported by legal, regulatory, and institutional framework would help narrow income and gender inequality. Continued data enhancements are crucial to monitor and assess progress.

[1] Government of Timor-Leste (2014), The Millennium Development Goals Report 2014.

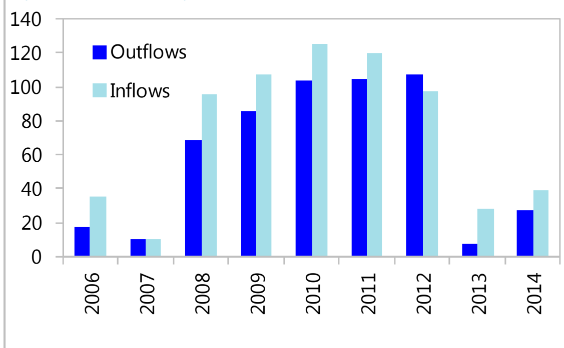
[2] IMF (2015), From Ambition to Execution: Policies in Support of Sustainable Development Goals, Staff Discussion Note 15/18.

Appendix V. Remittances and Labor Flow Dynamics

Remittance outflows from Timor-Leste have increased since 2006,[1] reflecting the reliance on foreign workers for high-skill managerial jobs. The 2014 Enterprise and Skills Survey shows that the number of foreign workers is relatively high in managerial and professional positions, especially in oil and gas sector. This suggests the existence of a skill gap, with the demand for workers with specific qualifications and skills not being met by the supply from local workers. According to the 2013 Labor Force Survey, a small percentage of the labor force has either a vocational/polytechnic diploma (5.3 percent) or a university degree (8.9 percent). More generally, human resource constraints remain severe as 40 percent of the population over 15 years old has not had any education.[2]

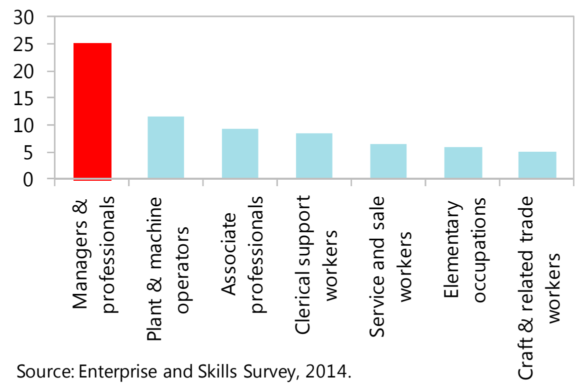
Also, remittance inflows have increasingly become an important income source for households, albeit from a low base. Outward labor flows provide employment opportunity, while the private sector in Timor-Leste is developing. According to the UN statistics, migrants from Timor-Leste are currently estimated at around 33,000 (3 percent of the population).

Remittance Inflows and Outflows
(In millions of USD)



Sources: Country authorities; and staff estimates.

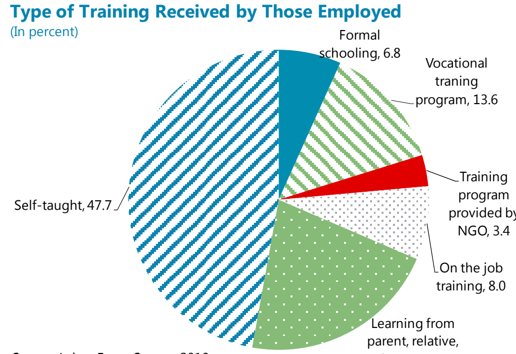
Share of Foreign Workers by Occupation
(In percent)



Source: Enterprise and Skills Survey, 2014.

Closing the skill gap in Timor-Leste requires more targeted training and education of the workforce. Vocational training has been underutilized given that most of the population have been self-taught or trained by relatives or friends. As of 2010, only 13.6 percent of the population had gone through a vocational training program. To enhance the educational quality and vocational training, a key priority could be to develop well designed, targeted skill improvement programs in coordination with the private sector. Timorese working abroad could also bring their experiences and business know-how (e.g., tourism, and services) when they return home. Going forward, it will be important to increase skilled job opportunities and incentives so that they can return and choose suitable jobs.

Type of Training Received by Those Employed
(In percent)



Source: Labor Force Survey, 2010.

Reliable data on remittance flows is key to monitoring external balance, labor market dynamics, and their impact on households' standard of living. Further improvement in recording compensation of employees and personal transfers from Timorese residents and national working abroad in the balance of payments statistics based on available information from financial institutions is currently being reviewed by the BCTL with the support of Fund TA.

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[1] Remittances in 2013 and 2014 are staff's crude estimates using the transaction data from money transfer operators. The end of UN peacekeeping operation in 2012 contributed to some extent the decline in outflows.

[2] Timor-Leste National Strategic Development Plan 2011-2013.

INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 7, 2016

Prepared By

Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of February 29, 2016)

Membership Status

Joined: July 23, 2002; Article VIII

General Resources Account

	SDR Million	Percent Quota
Quota	25.60	100.00
Fund holdings of currency	21.25	83.01
Reserve position in Fund	4.35	17.00

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	7.73	100.00
Holdings	3.40	44.01

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Obligations to Fund: None

Exchange Rate Arrangements

The exchange rate arrangement (de jure and de facto) is an exchange arrangement with no separate legal tender. 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. Timor-Leste has accepted the obligations under Article VIII, Sections 2(a), 3 and 4, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

Article IV Consultations

Timor-Leste is on a 12-month consultation cycle. The last Article IV consultation was concluded on September 15 , 2014. The press release may be found at http://www.imf.org/external/np/sec/pr/2014/pr14478.htm.

Technical Assistance (TA) and Training

TA has been provided by HQ based staff and experts in collaboration with the Pacific Financial Technical Assistance Centre (PFTAC), in close collaboration with development partners. Significant

TA has been provided in areas of public financial management, including on critical calculations for Estimated Sustainable Income (ESI). TA on statistics is continuing including on the Government Financial Accounts. In addition, a large multi-year TA work program is being developed with the BCTL to support the BCTL's Financial Sector Development Master Plan. Current and planned technical assistance is described in more detail below:

FAD: Significant TA has been provided to the Ministry of Finance on treasury and expenditure management and developing non-oil revenues. Recent TA has focused on the ESI calculation. This is a key input to the budget and IMF assistance in this area has an important role in maintaining the credibility of the fiscal rules-based approach.

FAD/ICD/PFTAC: Representatives from Timor-Leste participated in a high-level dialogue in June 2015 that was co-hosted by the IMF and the Government of Fiji in Nadi, Fiji, which focused on strategies and policies to make Pacific Island economies more resilient to natural disasters. It was preceded by a three-day workshop on fiscal framework organized by the IMF and PFTAC with funding from the Australian Government. The workshop was designed to give mid-level officials responsible for fiscal planning an overview of key elements of the fiscal planning process, with a focus on strengthening the linkages between policy formulation, planning and execution.

MCM: Recent TA has focused on the financial sector and on the Petroleum Fund as it develops its investment strategy to encompass a wider range of investments. In November 2013, an MCM TA mission to the BCTL assessed gaps in institutional capacity in key areas—banking supervision, crisis management, payments system, and research and analysis. This laid the basis for a multi-year TA work program on financial sector issues that is currently being discussed with the authorities and development partners. There is also scope for follow up work on enhancing the Petroleum Fund's investment strategy.

MCM/PFTAC: Two missions to Timor-Leste were conducted by PFTAC's Financial Supervision Sector during the first half of 2014, aimed at reviewing the status of the country's non-bank sector. This was followed in 2015 with the drafting of a Credit Union Act, with the assistance of the IMF Legal Department. An on-site examination program was initiated in mid 2015 with the support of a short term expert who provided training with on-site examination preparedness and provided support with the execution of the on-site examination of a commercial bank. In consultation with the Central Bank of Timor-Leste (BCTL), PFTAC will continue to provide technical support to the Supervision Department by implementing a banking supervision training program in 2016, aimed at providing the staff with the tools required to adequately perform the examination of a financial institution. The credit union program will resume in 2016 with the staging of a workshop on credit union financial reporting. This will also include a training component for the staff of the BCTL on how to adequately perform the oversight of the credit union sector.

STA/PFTAC: Recent missions have focused on: (i) government finance statistics as part of an on-going project regarding the compilation of fiscal data for operational and statistical purposes—based on the GFSM 2001 framework—and publishing Timorese data in the International Financial Statistics; and (ii) balance of payments including on ensuring compliance with the Balance of Payments and International Investment Position Manual (BPM6). The national accounts statistics have been supported in the last two years by donor-funded experts and the Australian Bureau of

Statistics and PFTAC has had reduced involvement other than having staff attend training workshops.

MACROECONOMIC ANALYSIS/PFTAC :

STI: Government officials from Timor-Leste attend IMF training courses on macroeconomic and financial policies including statistics and legal issues offered by the STI, both in Singapore and in the region. In 2014–15, a total of 15 participants from Timor-Leste attended STI training courses in Singapore.

Resident Representative

The resident representative office in Dili, established in August 2000, closed at end-June 2009.

WORLD BANK—IMF COLLABORATION

The Bank and Fund country teams for Timor-Leste, led by Ms. Bolormaa Amgaabazar (World Bank Country Representative) and Ms. Yu Ching Wong (IMF mission chief), are cooperating closely on macroeconomic and macro-critical structural reform issues. The Bank's country economist, Mr. David Knight, participated in the 2016 Article IV consultation mission.

The two teams have worked closely on the following:

- **Macroeconomic developments and economic updates**: There has been close dialogue throughout the year on macro policies and economic developments. There is regular sharing of information and development of common policy recommendations.

- **Growth prospects and economic diversification**: The teams exchanged views on potential areas of diversifications and key policies to support diversification away from the oil sector. The Bank's forthcoming *East Asia Pacific Update* will contain a special feature on 'diversified development' on resource-rich countries in the region, including Timor-Leste.

- **Fiscal sustainability and investment management**: Both teams highlighted longer-term fiscal sustainability as a major challenge facing Timor-Leste, particularly in light of recent adverse global market conditions in the petroleum sector. Following the Infrastructure Public Expenditure Review published in March 2015, the World Bank is working on a medium-term expenditure pressures note for the health sector and is preparing to start work on a public expenditure review of the agriculture sector. The Fund and the Bank stand ready to provide further support on fiscal policy and public expenditure analysis.

- **Revenue mobilization**: Both teams have discussed domestic revenue mobilization potential and policy reforms underway. The Bank is has provided ad-hoc support to the fiscal reform including by advising on non-tax revenue legislation and mining legislation. Both institutions stand ready to provide further assistance to support the implementation of key aspects of the government's fiscal reform program.

- **Debt management**: The teams have engaged very closely on discussions around the governments growing debt portfolio and its reforms to strengthen debt management systems. The Bank and the Fund stand ready to provide complementary technical assistance upon government's request. A full DSA was collaboratively updated in February 2016.

The World Bank Group assistance to Timor-Leste is guided by the Country Partnership Strategy (CPS) that was approved by the Executive Board in February 2013. The CPS outlines a program that supports Timor-Leste by utilizing financing available from IBRD and IDA and trust fund resources to support investments in critical infrastructure that reduces poverty and boosts shared prosperity, improve service delivery and effective macroeconomic, social and fiscal management.

Both teams agreed that Timor-Leste's main macroeconomic challenges lie in developing a stronger non-oil economy that reduces poverty and in safeguarding long-term fiscal sustainability. To meet these challenges, Timor-Leste needs to shift to a higher quality and poverty reducing growth path while ensuring macroeconomic stability. Achieving fiscal sustainability will require prioritization of public investments through rigorous investment appraisal and further strengthening of public financial management, mobilizing non-oil revenues, and adhering to a medium-term fiscal consolidation plan. An acceleration of reforms to promote productivity and competitiveness is also important.

The teams agreed to continue the close cooperation going forward. The Table below details the specific activities planned by the two country teams in 2016-17 period.

Title	Products	Provisional Timing	Expected Delivery of Output
1. Bank Work Program	Oecusse trade and competitiveness review	Completed	April 2016
	Support to Living Standards Measure Survey and Poverty Profile	Ongoing	
	Support to Poverty Analysis	Planned	
	Support to Fiscal Reform	Planned	
	Debt management TA	Planned for October 2016	
	PFM for Service Delivery	Planned	
	Public expenditure analysis (medium-term expenditure pressures in health; agriculture public expenditure review)	Ongoing and planned	
2. Fund Work Program	2017 Article IV Consultations	Staff visit in September 2016 and Article IV mission in February 2017	September 2016 and April 2017
	Participation in the Timor-Leste Development Partners Meeting	Planned	June 2016
	TA: Debt management	Planned	
	TA: Multi-year TA at BCTL	Ongoing	
	TA: Fiscal reform	Planned	
	TA: Government Finance Statistics	Ongoing	
	TA: Balance of Payments statistics	Ongoing	
3. Joint Work Program	DSA update	February 2017	April 2017

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of March 2016)

Timor-Leste joined the Asian Development Bank (AsDB) in 2002. The relationship has evolved from an initial focus on rehabilitation and reconstruction to development of the infrastructure and institutional capacity needed for growth and poverty reduction. AsDB is supporting the implementation of Timor-Leste's Strategic Development Plan 2011-2030 (SDP). A five year country partnership strategy guided AsDB's support for the first phase of the SDP and a new strategy for 2016-2020 is now being finalized in collaboration with the government. The new strategy will support economic diversification by working with the government to remove infrastructure bottlenecks and institutional constraints, and invest in skills development.

Timor-Leste first accessed the Asian Development Fund (ADF) in 2005. The ADF has provided grants for road rehabilitation, water supply and technical and vocational education and training projects. AsDB has worked closely with the government to develop capacity for infrastructure management. A $15 million six-year technical assistance package, that was co-financed with AusAID, helped plan, prepare, and execute the Government's capital development program and train government officials. Subsequent projects have supported infrastructure management together with policy and planning for transport, urban water supplies, and the electricity sector.

AsDB is helping Timor-Leste to prepare for membership of the Association of Southeast Asian Nations and to develop a competitive financial sector. The AsDB helped establish the Institute of Microfinance in Timor-Leste, which, in July 2011, became the country's first locally owned commercial bank, the Banco Nacional Comércio de Timor-Leste (BNCTL). AsDB continues to support the growth and commercialization of BNCTL and is also helping the government to establish a legal framework for bankruptcy and secured transactions. The AsDB provided technical support for the establishment of the Petroleum Fund and other core elements of public sector management. It is also supporting the government's fiscal reform program and helped to design a new value added tax that could be used to increase domestic revenue collection.

The availability of AsDB resources increased in 2011 following Timor-Leste's reclassification as a group B member country. This provides access to AsDB's ordinary capital resources (OCR), while retaining access to loans from the Asian Development Fund (ADF). Timor-Leste has borrowed $42.21 million of ADF and $135.63 million of OCR since 2011 to finance upgrading of national roads. Further lending for investment in roads, a seaport, urban water supply and electricity services is planned for 2016–2018. AsDB continues to promote the provision of a range of infrastructure services, by the private sector and will help the government to leverage private sector expertise.

The indicative ADF allocation for 2016–2018 is $73.16 million and the indicative OCR allocation for 2016–2018 is $78.07 million. Actual allocations will depend on demand and on portfolio performance.

STATISTICAL ISSUES

(As of February, 2016)

I. Assessment of Data Adequacy for Surveillance
General: Data provision to the Fund has serious shortcomings that significantly hamper surveillance. The enhancement of the General Directorate of Statistics within the Ministry of Finance is an ongoing priority.
National Accounts: Improvements have occurred in recent years with TA from donor-provided experts and the Australian Bureau of Statistics and through PFTAC training. Source data weaknesses for some components continue to hamper improvement of methodology and timeliness.
Price Statistics: Starting 2013, CPI was rebased and basket weights updated using data derived from the 2011Household Income and Expenditure Survey (HIES). Data are released monthly for Dili, regions other than Dili and Timor-Leste with a December 2012 reference period (i.e., December 2012=100).
Government Finance Statistics: The compilation of revenue and expenditure is moving toward the *GFSM 2001* approach despite capacity constraints. A three-year TA project financed by the government of Japan ended in May 2015.
Monetary and Financial Statistics: The Banco Central de Timor-Leste (BCTL) compiles monetary statistics generally following the methodology of the *Monetary and Financial Statistics Manual*. 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—and of banks' positions with public nonfinancial corporations. In addition, analysis of credit conditions is complicated by the fact that overseas borrowings of residents are not accounted for. The BCTL reports detailed monthly monetary data for the central bank and other depository corporations are using the standardized report forms (SRFs). Data for other financial corporations, mainly insurance companies, are not compiled. An integrated monetary database meeting the monetary data needs of the BCTL, APD, and STA is in operation.
Financial Sector Surveillance: Only basic market based indicators are available, and their coverage, valuation and timeliness vary across such indicators. Data are not sufficiently available to conduct stress tests of the banking system or Balance Sheet Approach analysis. Cross border exposure data for financial corporations are not available. Financial soundness indicators are not reported to STA.
External Sector Statistics: While progress has been made, measuring non-Petroleum Fund-related current account transactions accurately remains a work in progress. Monthly merchandise trade data are now published regularly but there are significant gaps in the series for 2006 and 2007. Data on monthly merchandise exports and imports are based on the Automated System for Customs Data

(ASYCUDA). Service transactions are largely estimated with data collection largely limited to the official and tourism sectors. Interest revenue from oil/gas is recorded as primary income.

Quarterly balance of payments data are available for 2006–Q3/2015. While methodology for the production of basic annual estimates of the balance of payments statistics are in place, further development is needed to address limitations of existing data sources, in particular, merchandise trade statistics and service transactions. This includes work to ensure consistency between current account data and the new National Accounts Statistics, particularly related to the exports of commodities and imports of services. The coverage of the survey of foreign direct investment enterprises needs to be expanded, and the exploration and extraction activities in the Joint Petroleum Development Area (JPDA) and in the exclusive territory require additional monitoring.

Currently, there is limited information on remittances from Timorese working abroad and improvement in the estimation and compilation procedures of such remittances should be pursued.

The October 2015 TA mission on ESS found that important improvements have been made on the integrated IIP, namely the classification of components; the treatment of changes in prices and changes in exchange rates; and the treatment of positions of the Petroleum Fund and IMF-related accounts (reserve position in the IMF, SDR allocations, and SDR holdings). Compilers should improve the coverage of the FDI survey to include transactions and positions of JPDA companies' equity valued at Own Funds at Book Value. Compilers also need to review the current estimates, updating the information for compensation of employees, and assessing the information on personal transfers that the financial institutions (banks and money transfer operators) are reporting on a regular basis to the Bank Supervision Division (BSD).

II. Data Standards and Quality

Timor-Leste began participating in the IMF's General Data Dissemination System (now the enhanced GDDS) in 2012, marking a major step forward in the development of its statistical system.	No data ROSC is available.

III. Reporting to STA

Data on government finance statistics is available in the *GFS Yearbook* for the 2013. Timor-Leste do not report to the Quarterly Public Sector Debt database (QPSD), jointly developed by the World Bank and IMF. Beginning in February 2008, monetary data have been reported to the IMF for publication in the *IFS*. Quarterly balance of payments and IIP data are reported timely to STA for publication in the IFS.

Table of Common Indicators Required for Surveillance

(As of March 15, 2016)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	3/2016	3/2016	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	1/2016	2/2016	M	M	M
Reserve/Base Money	1/2016	2/2016	M	M	M
Broad Money	1/2016	2/2016	M	M	M
Central Bank Balance Sheet	1/2016	2/2016	M	M	M
Consolidated Balance Sheet of the Banking System	1/2016	2/2016	M	M	M
Interest Rates[2]	1/2016	2/2016	M	M	M
Consumer Price Index	1/2016	3/2016	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2015	3/2016	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	2015	3/2016	A	A	A
Central Government and Central Government-Guaranteed Debt[5]	2015	3/2016	A	A	A
External Current Account Balance	Q3/2015	1/2016	Q	Q	Q
Exports and Imports of Goods and Services	Q3/2015	1/2016	M	M	M
GDP/GNP	2013	6/ 2015	A	A	A
Gross External Debt	12/2015	3/2016	Q	Q	Q
International Investment Position[6]	Q3/2015	1/2016	Q	Q	Q

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[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 nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and stat and local governments.
[5] Includes only goods. There are significant gaps in the series. No information on services is available.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); NA: Not Available.

INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

April 7, 2016

Approved By
Hoe Ee Khor and Andrea Richter Hume (IMF) and Satu Kahkonen (IDA)

Prepared by Staff of the International Monetary Fund and the International Development Association[1]

The Debt Sustainability Analysis (DSA) indicates that Timor-Leste is at moderate risk of debt distress.[2] This represents a downgrade from a low risk of debt distress at the time of the 2014 DSA. The deterioration in the debt rating reflects a shift in the authorities' financing strategy, namely to increase the use of concessional borrowing to finance frontloaded infrastructure spending in order to reduce financing by the drawdown of the assets of the Petroleum Fund (PF). At end-2015, net public assets (oil-related savings accumulated in the PF and currently negligible debt stock) stood at over $16 billion. The DSA suggests that current fiscal spending plans are unsustainable as the PF will be depleted in the long term given the current rate of withdrawals under existing expenditure plans. Achieving fiscal sustainability requires scaling back large front-loaded public investment plans in line with implementation capacity, rationalizing recurrent spending, and strengthening non-oil revenues. Bold fiscal consolidation measures are needed to safeguard long-term fiscal and debt sustainability. High fiscal spending and inadequate mobilization of domestic revenues are the main sources of risk. Feasibility studies to ensure that public investment is efficient and yields adequate returns would help to ensure fiscal sustainability.

[1] This DSA has been prepared by the IMF staff with input from World Bank Group staff, using the debt sustainability framework for low-income countries approved by the Boards of both institutions.

[2] The DSA presented in this document is based on the standard low-income countries (LIC) DSA framework. See "Debt Sustainability in Low-Income Countries: Proposal for an Operational Framework and Policy implications" (http://www.imf.org/external/np/pdr/sustain/2004/020304.htm) and "Debt Sustainability in Low-Income Countries: Further Considerations on an Operational Framework, Policy Implications" (http://www.imf.org/external/np/pdr/sustain/2004/091004.htm).

UNDERLYING ASSUMPTIONS

1. **This DSA is based on the macroeconomic framework outlined in the IMF's staff report for the 2016 Article IV consultation.** Staff projections are for total nominal GDP to contract through 2016, as oil production declines. Staff projects real non-oil GDP growth to be in the range of 5–6½ percent in the medium term. This growth is expected to be more private-sector led than in the past in Timor-Leste, and is lower than previously projected, reflecting a weaker global outlook. Inflationary pressure is expected to remain low in the medium term due to lower global commodity prices and continued strength of the U.S. dollar against Timor-Leste's trading partners' currencies. However, compared to the 2014 DSA, the external current account balance is expected to deteriorate due to a greater decline in oil and gas prices and diminishing oil exports. Macroeconomic assumptions for this DSA are outlined in Box 1. To illustrate the impact of different policy options on debt sustainability, three scenarios were considered in this DSA which are outlined below.

2. **The 2016 Budget scenario assumes full implementation of frontloaded capital spending in 2017–20.** Total capital spending during this period will reach US$3.4 billion consisting of proposed front-loaded infrastructure investments in roads, bridges, ports, and airport deemed essential to lay the foundation for private sector-led development for achieving the Strategic Development Plan 2011-30. On average, 70 percent of the larger financing gap in 2017–20 will be met by withdrawals from the Petroleum Fund (PF), the bulk of which will consist of withdrawals above the Estimated Sustainable Income (ESI), complemented by concessional borrowing (see text table).

3. **The baseline fiscal scenario reflects a reduction in capital spending to reflect implementation capacity.** Given capacity constraints and past low implementation rates of large capital projects, the frontloading of capital spending under the baseline scenario is assumed to be two-third of the amount for 2017-20 outlined in the 2016 Budget. The investment plans underlying this scenario (and the adjustment scenario) are proposed mid-sized key infrastructure projects such as roads and bridges, a subset of the infrastructure plans. The baseline scenario also assumes a cap on total withdrawal of the PF of US$1.3 billion, broadly in line with the notional budget envelope proposed during the Yellow Road Workshop discussions of domestic stakeholders that will ensure fiscal sustainability. Despite lower capital spending, the expected borrowing during 2017–20 is comparable to that under the 2016 Budget scenario given lower excess PF withdrawal.

4. **Under staff's proposed adjustment scenario, bold policy actions are adopted to ensure long-term fiscal sustainability.** Under this scenario, the increase in capital spending projected by the 2016 Budget over 2017–20 is reduced by one-half. Total spending is kept at under $1.4 billion (excluding donor projects) during 2022–26 and as a constant share of GDP after 2027. This scenario also assumes domestic revenue mobilization measures including the introduction of a value-added tax (VAT) in the medium term to achieve the government's tax revenue goal of 15 percent of non-oil GDP in 2020. Over the long term, the need for concessional borrowing is lower compared to the

baseline and budget scenarios on account of stronger revenue mobilization. Reliance on excess PF withdrawals is lower, and ceases beyond 2025. Figure 1 and the text table show the profile of the PF balance and fiscal funding gaps under the three scenarios.

Box 1. Timor-Leste: Macroeconomic Assumptions Underlying the DSA

- **Real GDP growth is projected to fall in the medium term on account of declining oil production**. Oil production is estimated to run out by 2023. Non-oil GDP growth is projected to be in the range of 5–6½ percent over the medium term in part supported by expected foreign direct investment inflows and to stabilize at around 5.5 percent for 2021–35. Growth assumptions are lower relative to the 2014 DSA reflecting a weaker global outlook.

- **Inflation** is expected to increase steadily over the medium term to about 4 percent on account of some spillovers from public investment activity and is maintained at that level in the long run.

- **The current account balance** is expected to remain in surplus up to 2016, after which it moves into deficit, reflecting lower oil and gas receipts and higher imports generated by infrastructure projects. These current account balance assumptions are substantially weaker relative to the 2014 DSA on account of lower global oil prices.

Key Macroeconomic Assumptions Underlying the DSA

	Current DSA		Previous DSA	
	Medium Term 2015-2021	Long Term 2022-2035	Medium Term 2014-2020	Long Term 2021-2034
Real GDP Growth (in percent)	5.5	5.5	7.0	7.0
Inflation (in percent)	3.3	4.0	3.5	4.0
Overall fiscal balance (in percent of GDP)	-15.5	-10.5	19.5	-9.0
Current account (in percent of GDP)	-5.4	-15.8	20.7	-5.7
Revenue (in percent of GDP)	50.7	20.7	56.9	26.5
Borrowing (in millions of USD, period average)	171	37	91	50

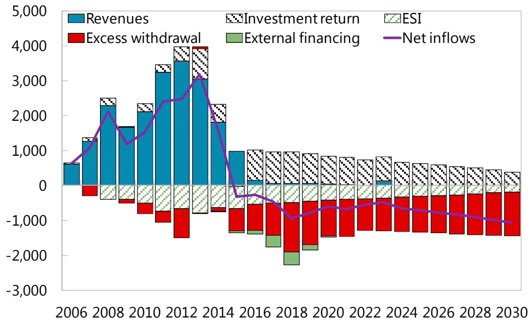
Source: IMF staff estimates

- **The grant element of loans** is assumed to decline over the medium term reflecting the financing needs of frontloaded infrastructure projects and to stabilize at about 40 percent in the long run after the infrastructure spending peak is over. The average interest rate on concessional loans for 2021–35 is projected at 1.8 percent.

- **External borrowing.** Given the front-loading of capital expenditure projects in 2017-21 under the baseline scenario, borrowing is projected to decline rapidly from $171 million per annum in the medium term to $37 million per annum in the long term**.**

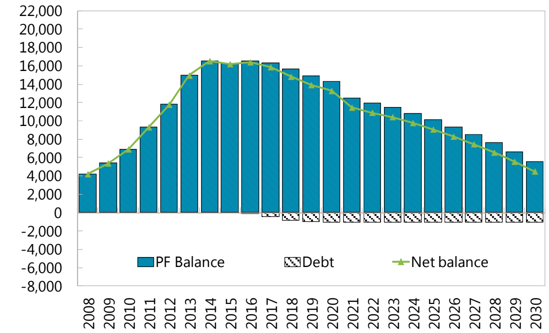
Figure 1. Timor-Leste: Petroleum Fund Balance Dynamics Under the 2016 Budget, Baseline, and Adjustment Scenarios

PF Dynamics: 2016 Budget Scenario (flow) 1/
(In millions of US dollars)



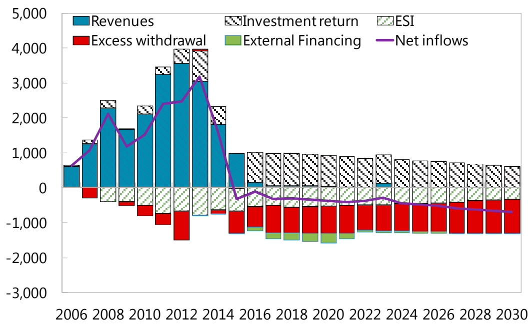
1/ Staff extrapolation from 2021.

PF Dynamics: 2016 Budget Scenario(stock) 1/
(In millions of US dollars)

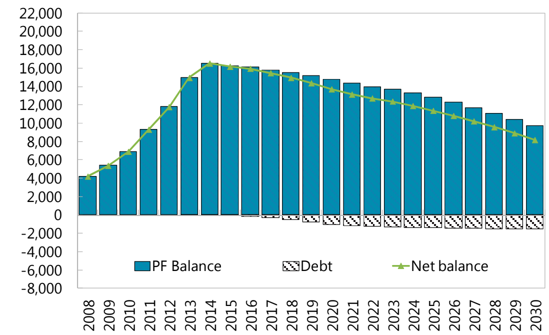


1/ Staff extrapolation from 2021.

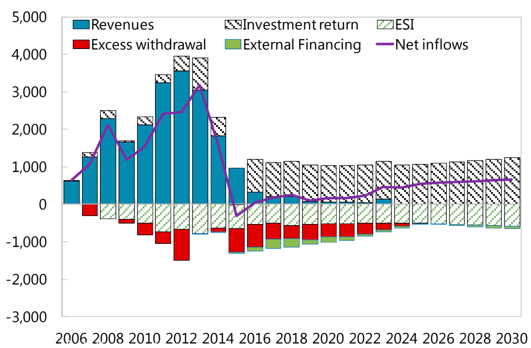
PF Dynamics: Baseline Scenario (flow)
(In millions of US dollars)



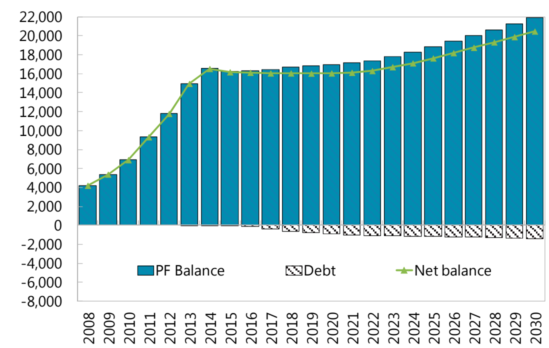
PF Dynamics: Baseline Scenario (stock)
(In millions of US dollars)



PF Dynamics: Adjustment Scenario (flow)
(In millions of US dollars)



PF Dynamics: Adjustment Scenario (stock)
(In millions of US dollars)



Projected Medium-Term Fiscal Funding Gaps Under the 2016 Budget, Baseline, and Adjustment Scenarios 1/
(In millions of US dollars)

	2017	2018	2019	2020	2021	Total (2017–21)
2016 Budget Framework 2/						
Funding gap	1,258	1,784	1,423	1,072	1,012	6,547
Excess PF Withdrawal	909	1,417	1,262	1,033	1,000	5,621
Borrowing	348	366	161	39	12	926
Baseline Scenario						
Funding gap	951	930	999	1,059	951	4,890
Excess PF Withdrawal	778	715	763	777	791	3,824
Borrowing	173	215	237	281	160	1,066
Adjustment Scenario						
Funding gap	675	583	533	491	449	2,730
Excess PF Withdrawal	426	336	409	345	349	1,865
Borrowing	248	246	124	147	100	865

1/ Funding gap is defined as financing need not met by withdrawal of the Estimated Sustainable Income (ESI)
2/ Timor-Leste 2016 State Budget Book 1 (Approved)

5. **The DSA is based on the following**:

- Timor-Leste has a weak Country Policy and Institutional Assessment (CPIA) performance rating, corresponding to the lowest set of indicative debt thresholds.
- The DSA framework uses a 5 percent discount rate.
- Concessional debt is defined as debt that exceeds a minimum grant element of 35 percent. Semi-concessional debt has a positive grant element that does not meet the minimum grant element.
- The DSA adopts a broad concept of exports which includes exports of goods and services, as well as primary oil-related incomes.
- Total public sector revenue is defined as non-oil domestic revenue plus the estimated sustainable income (ESI) from the PF. The funding gap is met by PF withdrawals in excess of the ESI and external borrowing.
- All debt is undertaken by the central government. No off-balance sheet debt is accumulated, including by state-owned enterprises such as the national oil company, the Timor GAP.
- Debt financing contracted by the central government relating to the funding of infrastructure projects should be on a concessional basis.

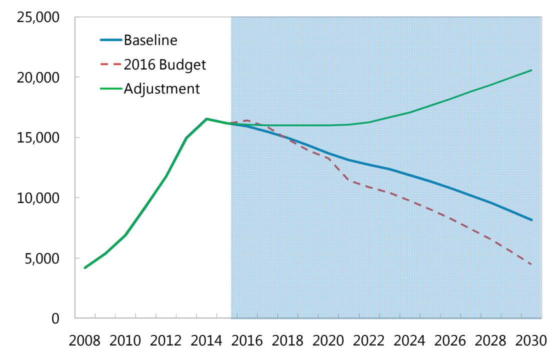
- Since the public sector only borrows externally with no domestic liabilities issued and the Timorese private sector does not incur any medium- or long-term external liabilities, the public DSA and external DSA are combined.

BACKGROUND

6. The government currently holds a strong net asset position due to the accumulation of substantial assets in the PF and limited public debt. However, a combination of higher PF withdrawals in excess of the Estimated Sustainable Income (ESI), lower oil revenues, and negative investment returns saw the PF balance decline in 2015, for the first time since its creation. At end-2015, the PF balance stood at US$16.2 billion or 169 months of imports of goods and services.

7. The government has adopted a prudent policy of utilizing the most concessional loans available to them. External loans signed as of end-2015 stood at $240 million (9 percent of GDP), consisting of concessional loans from the Asian Development Bank, the World Bank Group, and Japan International Cooperation Agency, and a recently signed semi-concessional loan of $50 million from China EXIM Bank to upgrade Dili's drainage system.

Net Public Sector Assets
(In millions of US dollars)



ASSESSMENT

8. Timor-Leste's risk of debt distress has deteriorated from low to moderate since the 2014 DSA. Although the fiscal projections under the baseline scenario do not lead to breaches of thresholds, stress tests—corresponding to export shock scenarios—resulted in breaches for all but one indicator (Figure 2). The deterioration in the debt rating is mainly driven by the projected front-loading of infrastructure spending, and the associated increase in public external borrowing via concessional loans. Nevertheless, under the baseline scenario, which does not assume substantial fiscal consolidation or domestic revenue mobilization based on new policy, the government will also continue to draw down on the PF in excess of the ESI, further eroding PF wealth.

9. Net debt remains negative throughout the forecast period under the baseline scenario, but is projected to deteriorate progressively reflecting the reduction in PF assets and increase in external debt. Increased excess PF withdrawals to meet higher financing needs are expected to heighten the loss in investment income in the medium term, accelerating the depletion of PF wealth (Figure 1).

10. Assessment of the adjustment scenario demonstrates that fiscal consolidation coupled with fiscal reforms could ensure long-term fiscal sustainability. Under this scenario, debt ratios are projected to remain well below indicative thresholds. The lower financing needs associated with a more moderate pace of infrastructure spending would imply lower external borrowing and less reliance on excess PF withdrawals. With fiscal reforms—including the introduction of a value-added tax aimed at boosting domestic revenues to 15 percent of non-oil GDP—excess PF withdrawals could be gradually reduced to zero in the long term. This would allow PF assets to grow, ensuring the PF's long-term sustainability. In addition, adopting policies to boost growth potential (through infrastructure and human capital investment) and enhance competitiveness (in wages and business conditions), would help to reduce the risks of weaker growth and help enhance fiscal and debt sustainability.

11. A strong debt management and asset-liability framework is needed to complement a prudent fiscal policy focused on long-term sustainability. The increased use of concessional financing and increased avenues for the government's exposure to contingent liabilities—for instance, through higher use of public-private partnerships (PPPs)— are expected to increase the complexity of the consolidated government balance sheet. Key considerations include**:**

- **New debt liabilities**. Non-concessional debt should be avoided.
- **Public-private partnerships**. Need to be undertaken with realistic and transparent project assessments to reduce contingent liabilities.
- **Off-budget activities.** Major capital-intensive projects tend to have complex financing structures and the cost-benefit of public participation in these projects can be difficult to assess. All such projects should be transparent and subject to full scrutiny.
- **Off-balance sheet activities should be avoided.** This is particularly relevant for state-owned companies such as the oil company, Timor GAP, which should avoid undertaking equity positions in joint venture projects or issue liabilities in overseas markets.
- **Fiscal autonomy**. The extension of a high level of fiscal autonomy to the ZEESM and the Oecusse SAR raises risks of off-budget expenditures and the accumulation of contingent liabilities.
- **Petroleum Fund**. The strategic asset allocation away from purely high quality bonds toward equities with a 50:50 split (60:40 bond-to-equities as at end-2015) may be appropriate from a long-term intergenerational perspective, but the risk-return trade-offs in inherently volatile global financial markets need to be carefully considered. The provision to allow the PF to guarantee government debts (up to 10 percent of the PF's assets) continues to be potentially risky and should be avoided.

AUTHORITIES' VIEWS

12. The authorities consider the risk of debt distress to be contained despite higher borrowing. Although projected external borrowing to finance government's infrastructure spending over the next few years is considerable, the authorities view the projections under the baseline scenario as close to the upper limit of their expected financing needs. Their view is that actual borrowing will be determined by the pace of project implementation, which may be slower than projected in the baseline scenario of the DSA. The authorities also pointed out that the accumulated savings in the PF provide an ample buffer against debt distress. Moreover, the authorities highlighted the importance of infrastructure development as part of the Strategic Development Plan to transition Timor-Leste to upper middle income status by 2030. The resulting increase in growth potential is expected to contribute towards ensuring debt sustainability.

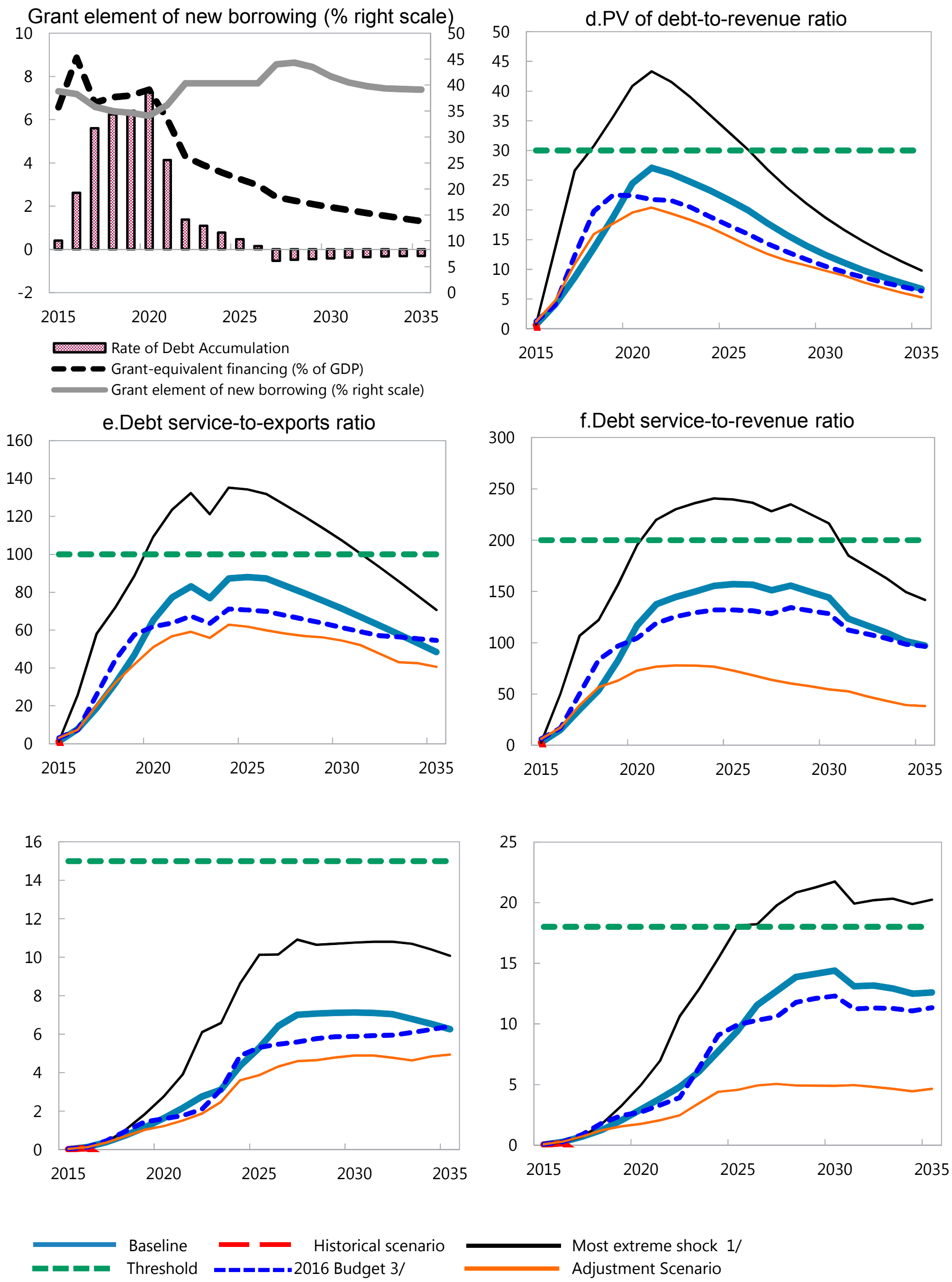
13. The authorities remain committed to long-term fiscal sustainability. Fiscal reform plans in the pipeline—which include the introduction of the value-added tax—will boost domestic revenue and help to ensure fiscal and debt sustainability. The authorities have also expressed interest in Fund TA to strengthen their capacity in debt management.

CONCLUSION

14. Timor-Leste's debt is at moderate risk of debt distress driven by higher external borrowing. The plan to increase the utilization of external concessional financing reflects the government's frontloaded infrastructure spending and strategy to preserve the wealth of the PF. The PF is a source of confidence for the economy and should be preserved as an endowment fund. The PF assets should be preserved in real terms and generate a permanent level of investment income to support government expenditures. While some drawdown of the assets of the PF is justified for infrastructure investment in order to diversify the economy and boost growth potential, the assets also need to be preserved at a level that is sufficient to provide adequate investment income for future generations. Meeting the financing gap through external loans is warranted, especially if the borrowing cost is lower than the opportunity cost of tapping into the PF as measured by the PF's expected investment return, and guided by the DSA. The discipline of debt sustainability monitoring by creditors may also come with other benefits such as the transfer of knowledge by these multilateral or bilateral institutions.

15. Bold fiscal consolidation measures are needed to safeguard long-term fiscal and debt sustainability. Achieving fiscal sustainability requires scaling back large front-loaded public investment plans in line with implementation capacity, rationalizing recurrent spending, strengthening non-oil revenues, and adhering to a medium-term fiscal consolidation plan. In addition, better prioritization of public investment plans, focusing on high-return infrastructure projects through rigorous investment appraisal is important. Optimizing the composition and quality of spending to help close Timor-Leste's infrastructure gap is key to long-term fiscal and debt sustainability

Figure 2. Timor-Leste: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2015-2035 2/



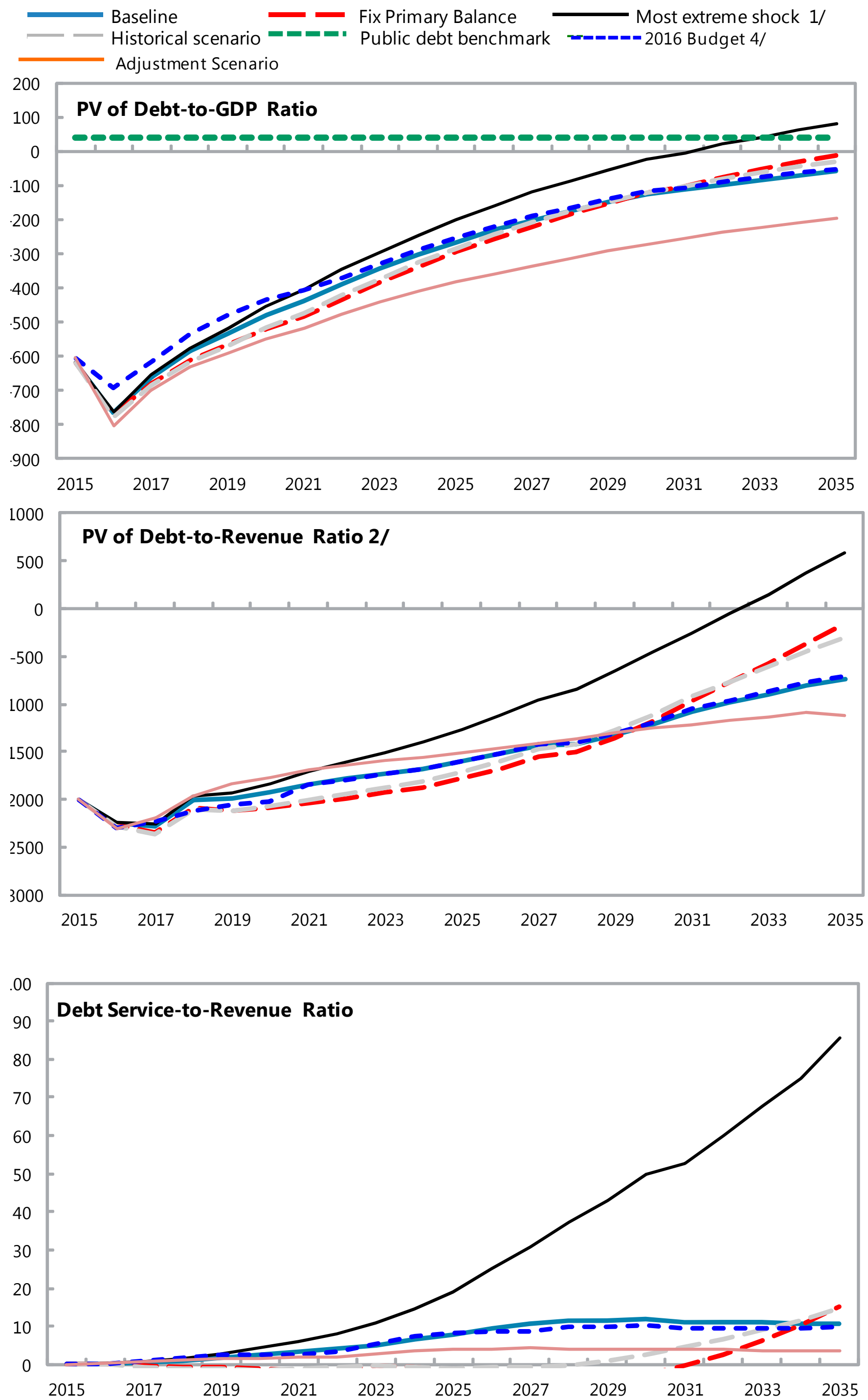
Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025. In figure b. it corresponds to a non-debt flows shock; in c. to a non-debt flows shock; in d. to a non-debt flows shock; in e. to a terms shock and in figure f. to a terms shock.

2/ Under the historical scenario, debt-to-GDP ratio is negative after 2017, due to large current account surpluses. Net debt creating dynamics are assumed to depend on the historical average of non-interest current account balances. However, these do not reflect declining oil production in future.

3/ Staff extrapolation after 2021.

Figure 3.Timor-Leste: Indicators of Public Debt (Net) Under Alternative Scenarios, 2015-2035 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025.

2/ Revenues are defined inclusive of grants.

3/ Negative debt burden indicators arise because the strong current account surpluses historically led to the accumulation of net assets.

4/ Staff extrapolation after 2021.

Table 1A.Timor-Leste: External Debt Sustainability Framework, Baseline Scenario, 2012-2035 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections									
	2012	2013	2014			2015	2016	2017	2018	2019	2020	2015-2020 Average	2025	2035	2021-2035 Average
External debt (nominal) 1/	**0.0**	**0.1**	**0.5**			**1.9**	**7.7**	**14.5**	**21.9**	**29.6**	**37.6**		**31.4**	**9.9**	
of which: public and publicly guaranteed (PPG)	0.0	0.1	0.5			1.9	7.7	14.5	21.9	29.6	37.6		31.4	9.9	
Change in external debt	0.0	0.1	0.4			1.4	5.8	6.8	7.4	7.7	8.0		-2.6	-1.2	
Identified net debt-creating flows	...	...	-26.2			-17.8	-9.8	4.3	5.0	8.5	9.7		5.3	13.6	
Non-interest current account deficit	**-40.2**	**-42.7**	**-25.1**	**-34.9**	**10.9**	**-16.4**	**-2.0**	**11.7**	**11.9**	**11.7**	**11.7**		**12.7**	**20.5**	14.8
Deficit in balance of goods and services	-32.6	-38.9	-22.5			-8.0	8.7	21.9	21.8	21.6	21.4		20.6	23.9	
Exports	57.0	60.4	50.6			53.2	53.1	45.8	42.7	40.3	37.5		24.7	13.9	
Imports	24.4	21.5	28.1			45.2	61.8	67.8	64.4	61.8	58.9		45.3	37.8	
Net current transfers (negative = inflow)	-6.3	-3.2	-1.9	-8.2	3.7	-8.6	-11.2	-10.4	-9.9	-9.8	-9.6		-8.1	-5.4	-7.3
of which: official	-6.3	-6.2	-6.2			-6.1	-6.8	-6.1	0.0	0.0	0.0		0.0	0.0	
Other current account flows (negative = net inflow)	-1.3	-0.6	-0.7			0.1	0.6	0.2	0.1	-0.1	-0.2		0.2	2.0	
Net FDI (negative = inflow)	**-0.8**	**-1.1**	**-1.1**	**-0.8**	**0.5**	**-1.3**	**-8.1**	**-8.4**	**-7.7**	**-5.6**	**-5.1**		**-6.5**	**-6.6**	-6.4
Endogenous debt dynamics 2/	**...**	**...**	**0.0**			**0.0**	**0.2**	**1.0**	**0.8**	**2.4**	**3.1**		**-1.0**	**-0.4**	
Contribution from nominal interest rate	...	...	0.0			0.0	0.0	0.1	0.3	0.4	0.6		0.6	0.2	
Contribution from real GDP growth	0.0	0.0	0.0			0.0	0.2	0.9	0.5	1.9	2.5		-1.5	-0.6	
Contribution from price and exchange rate changes	0.0	0.0	0.0			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**...**	**...**	**26.6**			**19.2**	**15.6**	**2.5**	**2.4**	**-0.8**	**-1.7**		**-7.9**	**-14.8**	
of which: exceptional financing	...	...	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	0.0			0.7	4.1	8.6	13.6	18.9	24.5		21.7	6.7	
In percent of exports	...	...	0.0			1.3	7.7	18.8	31.8	46.8	65.3		88.0	48.4	
PV of PPG external debt	**...**	**...**	**0.0**			**0.7**	**4.1**	**8.6**	**13.6**	**18.9**	**24.5**		**21.7**	**6.7**	
In percent of exports	**...**	**...**	**0.0**			**1.3**	**7.7**	**18.8**	**31.8**	**46.8**	**65.3**		**88.0**	**48.4**	
In percent of government revenues	**...**	**...**	**0.0**			**2.7**	**15.1**	**34.5**	**53.9**	**82.6**	**116.9**		**157.1**	**97.2**	
Debt service-to-exports ratio (in percent)	**0.0**	**0.0**	**0.0**			**0.0**	**0.1**	**0.4**	**0.7**	**1.2**	**1.6**		**5.3**	**6.3**	
PPG debt service-to-exports ratio (in percent)	**0.0**	**0.0**	**0.0**			**0.0**	**0.1**	**0.4**	**0.7**	**1.2**	**1.6**		**5.3**	**6.3**	
PPG debt service-to-revenue ratio (in percent)	**0.0**	**0.0**	**0.0**			**0.0**	**0.3**	**0.7**	**1.3**	**2.0**	**2.9**		**9.5**	**12.6**	
Total gross financing need (Billions of U.S. dollars)	-2.8	-2.5	-1.1			-0.5	-0.2	0.1	0.1	0.2	0.2		0.3	1.6	
Non-interest current account deficit that stabilizes debt ratio	-40.2	-42.8	-25.5			-17.8	-7.7	4.9	4.5	4.0	3.6		15.3	21.7	
Key macroeconomic assumptions															
Real GDP growth (in percent)	5.3	-13.9	-15.8	9.8	24.8	-0.6	-8.8	-12.9	-3.9	-9.4	-9.2	-7.4	4.9	5.6	4.0
GDP deflator in US dollar terms (change in percent)	11.7	-4.6	-7.5	8.0	18.1	-39.6	-12.1	29.5	13.7	17.1	17.6	4.4	4.5	3.5	5.0
Effective interest rate (percent) 5/	...	...	0.0	0.0	0.0	-3.8	0.8	2.0	2.1	2.1	2.1	0.9	1.8	1.8	1.8
Growth of exports of G&S (US dollar terms, in percent)	8.7	-12.8	-34.8	37.8	53.3	-36.9	-20.0	-2.7	1.8	0.1	-0.6	-9.7	1.2	5.5	2.2
Growth of imports of G&S (US dollar terms, in percent)	-11.0	-27.5	1.9	18.9	41.3	-3.4	9.5	23.7	4.0	1.8	1.8	6.2	7.2	7.5	6.0
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	38.8	38.3	35.8	35.0	34.6	34.1	36.1	40.4	39.1	40.6
Government revenues (excluding grants, in percent of GDP)	8.0	11.1	12.2			24.7	27.1	24.9	25.2	22.8	20.9		13.8	6.9	11.7
Aid flows (in Billions of US dollars) 7/	0.3	0.3	0.3			0.2	0.2	0.1	0.2	0.2	0.2		0.1	0.1	
of which: Grants	0.3	0.3	0.3			0.2	0.1	0.1	0.1	0.1	0.1		0.1	0.1	
of which: Concessional loans	0.0	0.0	0.0			0.0	0.0	0.1	0.1	0.1	0.1		0.0	0.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			6.6	8.9	6.8	7.0	7.1	7.4		3.3	1.3	2.7
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			90.7	72.9	57.7	55.5	54.8	53.0		82.9	84.3	85.1
Memorandum items:															
Nominal GDP (Billions of US dollars)	6.8	5.6	4.4			2.6	2.1	2.4	2.6	2.7	2.9		4.5	10.8	
Nominal dollar GDP growth	17.6	-17.8	-22.1			-39.9	-19.8	12.8	9.3	6.1	6.8	-4.1	9.6	9.3	9.1
PV of PPG external debt (in Billions of US dollars)			0.0			0.0	0.1	0.2	0.4	0.5	0.7		1.0	0.7	
(PVt-PVt-1)/GDPt-1 (in percent)						0.4	2.6	5.6	6.2	6.4	7.3	4.8	0.5	-0.3	0.3
Gross workers' remittances (Billions of US dollars)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of PPG external debt (in percent of GDP + remittances)	...	...	0.0			0.7	4.1	8.6	13.6	18.8	24.5		21.7	6.7	
PV of PPG external debt (in percent of exports + remittances)	...	...	0.0			1.3	7.7	18.8	31.8	46.8	65.3		87.9	48.4	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	0.0			0.0	0.1	0.4	0.7	1.2	1.6		5.3	6.3	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 1B. Timor-Leste: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2015-2035

(In percent)

	Projections							
	2015	2016	2017	2018	2019	2020	2025	2035
PV of debt-to GDP ratio								
Baseline	1	4	9	14	19	24	22	7
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	1	-13	-32	-49	-65	-79	-137	-209
A2. New public sector loans on less favorable terms in 2015-2035 2	1	5	12	19	26	34	32	14
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	1	4	9	15	21	27	24	7
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	1	2	9	14	19	25	22	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	1	4	12	19	27	34	30	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	1	14	27	31	36	41	33	10
B5. Combination of B1-B4 using one-half standard deviation shocks	1	-2	-7	-1	4	10	11	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	1	6	13	21	29	37	33	10
PV of debt-to-exports ratio								
Baseline	1	8	19	32	47	65	88	48
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	1	-24	-70	-115	-161	-210	-556	-1503
A2. New public sector loans on less favorable terms in 2015-2035 2	1	10	26	44	65	91	128	98
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	1	8	19	32	47	65	88	48
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	1	4	22	36	53	73	98	54
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	1	8	19	32	47	65	88	48
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	1	26	58	72	89	109	134	71
B5. Combination of B1-B4 using one-half standard deviation shocks	1	-3	-10	-2	7	17	30	18
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	1	8	19	32	47	65	88	48
PV of debt-to-revenue ratio								
Baseline	3	15	35	54	83	117	157	97
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	3	-48	-129	-194	-284	-375	-993	-3020
A2. New public sector loans on less favorable terms in 2015-2035 2	3	20	48	75	115	163	229	197
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	3	16	38	59	91	129	173	107
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	3	8	37	57	85	120	161	100
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	3	15	49	76	116	164	221	137
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	3	50	107	122	156	195	240	142
B5. Combination of B1-B4 using one-half standard deviation shocks	3	-7	-28	-5	18	47	82	56
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	3	23	52	82	125	177	239	148

Table 1B. Timor-Leste: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2015-2035 (continued)

(In percent)

	Projections							
	2015	2016	2017	2018	2019	2020	2025	2035
Debt service-to-exports ratio								
Baseline	0	0	0	1	1	2	5	6
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	0	0	-1	-2	-3	-4	-15	-58
A2. New public sector loans on less favorable terms in 2015-2035 2	0	0	0	1	2	3	10	10
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	0	0	0	1	1	2	5	6
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	0	0	0	1	1	2	6	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	0	0	0	1	1	2	5	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	0	0	1	2	2	3	9	9
B5. Combination of B1-B4 using one-half standard deviation shocks	0	0	0	0	0	0	1	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	0	0	0	1	1	2	5	6
Debt service-to-revenue ratio								
Baseline	0	0	1	1	2	3	9	13
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	0	0	-1	-3	-5	-7	-27	-116
A2. New public sector loans on less favorable terms in 2015-2035 2	0	0	1	2	3	5	18	20
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	0	0	1	1	2	3	10	14
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	0	0	1	1	2	3	10	13
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	0	0	1	2	3	4	13	18
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	0	0	2	3	4	5	17	19
B5. Combination of B1-B4 using one-half standard deviation shocks	0	0	0	0	0	1	3	7
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	0	0	1	2	3	4	14	19
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	34	34	34	34	34	34	34	34

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels.)

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 2A. Timor-Leste: Public Sector Debt Sustainability Framework, Baseline Scenario, 2012-2035

(In percent of GDP, unless otherwise indicated)

	Actual			Average 5/	Standard Deviation 5/	Estimate	Projections								
	2012	2013	2014			2015	2016	2017	2018	2019	2020	2015-20 Average	2025	2035	2021-35 Average
Public sector debt 1/	0.0	0.1	0.5			1.9	7.7	14.5	21.9	29.6	37.6		31.4	9.9	
of which: foreign-currency denominated	0.0	0.1	0.5			1.9	7.7	14.5	21.9	29.6	37.6		31.4	9.9	
Change in public sector debt	0.0	0.1	0.4			1.4	5.8	6.8	7.4	7.7	8.0		-2.6	-1.2	
Identified debt-creating flows	...	...	19.0			26.8	40.0	43.3	38.7	39.1	38.2		18.9	9.7	
Primary deficit	10.3	8.2	19.0	11.2	3.3	26.5	39.5	44.0	39.7	40.0	39.5	38.2	21.3	10.5	3.0
Revenue and grants	11.7	15.7	18.3			30.9	34.0	28.9	29.2	26.8	24.9		16.6	8.1	
of which: grants	3.7	4.7	6.2			6.1	6.8	4.0	4.0	4.0	4.0		2.8	1.2	
Primary (noninterest) expenditure	22.0	24.0	37.4			57.3	73.5	73.0	68.9	66.8	64.5		37.9	18.5	
Automatic debt dynamics	...	...	0.0			0.3	0.5	-0.7	-1.0	-0.8	-1.3		-2.4	-0.8	
Contribution from interest rate/growth differential	...	...	0.0			0.0	0.2	1.1	0.6	2.2	3.0		-1.6	-0.6	
of which: contribution from average real interest rate	...	...	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
of which: contribution from real GDP growth	0.0	0.0	0.0			0.0	0.2	1.1	0.6	2.3	3.0		-1.6	-0.6	
Contribution from real exchange rate depreciation	...	...	0.0			0.3	0.3	-1.9	-1.5	-3.1	-4.3		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	...	...	-18.7			-25.4	-34.3	-36.5	-31.3	-31.4	-30.2		-21.5	-10.9	
Other Sustainability Indicators															
PV of public sector debt	...	...	0.0			0.7	4.1	8.6	13.6	18.9	24.5		21.7	6.7	
of which: foreign-currency denominated	...	...	0.0			0.7	4.1	8.6	13.6	18.9	24.5		21.7	6.7	
of which: external	...	...	...			0.7	4.1	8.6	13.6	18.9	24.5		21.7	6.7	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	10.3	8.2	19.0			26.5	39.6	44.2	40.0	40.4	40.1		22.6	11.3	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	0.0			2.2	12.1	29.8	46.5	70.3	98.1		130.6	83.4	
PV of public sector debt-to-revenue ratio (in percent)	...	...	0.0			2.7	15.1	34.5	53.9	82.6	116.9		157.1	97.2	
of which: external 3/	...	...	...			2.7	15.1	34.5	53.9	82.6	116.9		157.1	97.2	
Debt service-to-revenue and grants ratio (in percent) 4/	0.0	0.0	0.0			0.0	0.2	0.6	1.1	1.7	2.5		7.9	10.8	
Debt service-to-revenue ratio (in percent) 4/	0.0	0.0	0.0			0.0	0.3	0.7	1.3	2.0	2.9		9.5	12.6	
Primary deficit that stabilizes the debt-to-GDP ratio	10.3	8.1	18.6			25.1	33.8	37.2	32.3	32.3	31.5		23.9	11.7	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	5.3	-13.9	-15.8	9.8	24.8	-0.6	-8.8	-12.9	-3.9	-9.4	-9.2	-7.4	4.9	5.6	4.0
Average nominal interest rate on forex debt (in percent)	...	...	0.0	0.0	0.0	-3.8	0.8	2.0	2.1	2.1	2.1	0.9	1.8	1.8	1.8
Average real interest rate on domestic debt (in percent)	...	...	...	0.0	0.0	...	...	...	...	...	...	0.0	...	...	0.0
Real exchange rate depreciation (in percent, + indicates depreciation)	-7.6	8.1	0.4	-4.0	15.3	67.2	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	11.7	-4.6	-7.5	8.0	18.1	-39.6	-12.1	29.5	13.7	17.1	17.6	4.4	4.5	3.5	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-3.3	-6.3	31.3	2.3	10.4	52.6	16.9	-13.5	-9.3	-12.1	-12.4	3.7	-2.8	-1.7	-4.2
Grant element of new external borrowing (in percent)	...	...	...	...	...	38.8	38.3	35.8	35.0	34.6	34.1	36.1	40.4	39.1	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2B. Timor-Leste: Sensitivity Analysis for Key Indicators of Public Debt, 2015-2035

		Projections						
	2015	2016	2017	2018	2019	2020	2025	2035
PV of Debt-to-GDP Ratio								
Baseline	1	4	9	14	19	24	22	7
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	1	-11	-16	-18	-17	-14	3	37
A2. Primary balance is unchanged from 2015	1	-4	-10	-13	-16	-18	-9	53
A3. Permanently lower GDP growth 1/	1	5	13	23	35	49	87	147
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2016-2017	1	6	12	19	26	34	34	18
B2. Primary balance is at historical average minus one standard deviations in 2016-2017	1	-12	-25	-19	-13	-6	-2	-5
B3. Combination of B1-B2 using one half standard deviation shocks	1	-12	-21	-18	-16	-12	-15	-19
B4. One-time 30 percent real depreciation in 2016	1	4	7	11	15	20	19	6
B5. 10 percent of GDP increase in other debt-creating flows in 2016	1	11	15	19	24	30	26	9
PV of Debt-to-Revenue Ratio 2/								
Baseline	2	12	30	47	70	98	131	83
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	2	-32	-58	-64	-68	-62	21	517
A2. Primary balance is unchanged from 2015	2	-13	-36	-45	-59	-71	-52	660
A3. Permanently lower GDP growth 1/	2	16	44	76	125	187	465	1408
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2016-2017	2	16	42	65	97	133	202	214
B2. Primary balance is at historical average minus one standard deviations in 2016-2017	2	-35	-87	-64	-47	-25	-14	-67
B3. Combination of B1-B2 using one half standard deviation shocks	2	-35	-75	-64	-59	-50	-95	-244
B4. One-time 30 percent real depreciation in 2016	2	11	24	38	57	80	114	77
B5. 10 percent of GDP increase in other debt-creating flows in 2016	2	31	50	66	91	120	156	109
Debt Service-to-Revenue Ratio 2/								
Baseline	0	0	1	1	2	2	8	11
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	0	0	-1	-1	-1	-1	-1	15
A2. Primary balance is unchanged from 2015	0	0	0	-1	-1	-1	-2	15
A3. Permanently lower GDP growth 1/	0	0	1	2	3	4	19	86
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2016-2017	0	0	1	1	2	3	11	19
B2. Primary balance is at historical average minus one standard deviations in 2016-2017	0	0	-1	-2	-1	-1	-4	-2
B3. Combination of B1-B2 using one half standard deviation shocks	0	0	-1	-2	-1	-1	-5	-13
B4. One-time 30 percent real depreciation in 2016	0	0	1	2	3	4	11	17
B5. 10 percent of GDP increase in other debt-creating flows in 2016	0	0	1	2	2	3	10	13

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

Statement by Otaviano Canuto, Executive Director for Timor-Leste, Pedro Fachada, Alternate Executive Director, and Alisson Souza Gasparete, Advisor to Executive Director

May 11, 2016

1. On behalf of our Timorese authorities, we thank the mission team for the constructive dialogue and policy advice during this year's Article IV consultation. The authorities highly appreciate the candid discussions with staff and all the support received from the Fund.

2. Since independence in 2002, Timor-Leste has achieved enormous progress in nation-building and social development. Our authorities strongly agree with staff that the country's medium-term outlook will depend critically on economic diversification amid potentially declining hydrocarbon resources. In this regard, they are committed to improving infrastructure and human capital, providing better education and health services to the population, and developing private sector entrepreneurship. Such commitments are underpinned by political stability, credible institutions, and good governance in the management of public resources.

3. Our authorities broadly concur with the policy recommendations put forth in the staff report. However, to fulfill their development objectives and the legitimate aspirations of the Timorese people, they stress the need to accelerate capital spending. This may require drawing down on resources from the Petroleum Fund above the pace advised by staff.

Recent economic developments

4. The recent fall in global oil prices has weakened overall macroeconomic prospects of oil exporters. Timor-Leste, however, has been cushioned by the prudent saving of its oil wealth in the Petroleum Fund. The new oil price environment has not only reduced petroleum revenues but has also affected investment in new fields. Proven oil and gas reserves are low and may be exhausted in a few years, although upside risks should not be disregarded. The authorities are conscious of the international oil market scenario and fully aware about the need to diversify the economy away from hydrocarbons.

5. After expanding on average above 10 percent annually from 2007 to 2012, non-oil GDP growth decelerated to an estimated 4.3 percent in 2015 and is projected to be close to 5 percent this year. Over the medium-term, both staff and the authorities expect non-oil GDP to grow in the range of 5 to 7 percent.

6. The deceleration in non-oil economic activity has been followed by a sharp decline in inflation, which came down from two-digit figures in mid-2013 to close to zero in recent quarters. A strong monetary anchor (the dollarization regime), combined with lower commodity prices and dollar appreciation *vis-à-vis* other trading partner currencies, has driven the disinflationary process.

7. Despite lower than previous years, the current account surplus is estimated at 16.5 percent of GDP in 2015. The Timorese government expects a negative external balance over the medium-term due to, among other factors, lower petroleum revenues and increased imports of capital goods. Public foreign assets, however, will continue to represent a strong external buffer.

Fiscal policy and debt sustainability

8. Despite the sharp fall in petroleum revenues, the fiscal balance remained positive in 2015 (4.2 percent of GDP). Current expenditure was 11 percent lower than projected in the rectification budget presented to parliament in April last year. Capital spending was almost 30 percent below the budget.

9. Throughout the years, the Timorese authorities have shown a strong track-record of responsible use of the oil wealth. Going forward, they remain committed to a prudent fiscal stance that seeks to preserve the resources of the Petroleum Fund and ensure public debt sustainability. There is agreement with staff on the need to mobilize domestic non-oil revenues. The Fiscal Reform Commission, a technical body under the Ministry of Finance, is in charge of broadening the tax base and increasing the efficiency of tax collection. A value-added tax (VAT) is expected to be introduced once ongoing consultations with the private sector, civil society and other stakeholders are concluded.

10. On the expenditure side, the authorities note some room to revise down the 2016 envelope to around $1.4 billion. However, they consider that Timor-Leste cannot afford to strictly adhere to the Estimated Sustainable Income (ESI) of the Petroleum Fund. Although they recognize that the ESI is an indispensable tool for fiscal planning, it should not hold back much-needed investment in infrastructure projects. At the same time, the government believes that tapping concessional borrowing to finance capital spending may be appropriate, helping preserve the resources of the Petroleum Fund. Borrowing would only be justified if the costs are lower than the expected investment return of the Fund.

11. Staff has revised Timor-Leste's debt sustainability analysis and underlines a risk of moderate external debt distress. This seems somewhat exaggerated in light of the low level of gross external debt under the alternative scenarios developed by staff, as well as the very comfortable public foreign assets position of the country (equivalent to more than fourteen years of imports of goods and services, or nearly 640 percent of 2015

GDP). We also consider the recommendation by staff that "**bold** *(emphasis added)* fiscal consolidation measures are needed to safeguard long-term fiscal and debt sustainability" to be overstated.

Monetary policy and financial sector

12. Timor-Leste is a dollarized economy. The government considers that the monetary regime has served the country well, anchoring inflation and neutralizing overvaluation pressures in times of very high current account surpluses. Since 2014, inflation has been close to zero and is forecasted to remain low in the medium to long term. As noted by staff, the Central Bank of Timor-Leste (BCTL) has received a mandate, under the 2011-2030 Strategic Development Plan, to assess the merits of adopting its own currency. The authorities concur with staff that any decision on "de-dollarization" should be preceded by further financial and institutional development and by strengthening the BCTL's operational capacity.

13. The BCTL has been making efforts to strengthen its capacity in banking regulation and supervision. The banking system, with only four institutions, is well capitalized and highly liquid. Three of these institutions are branches of foreign banks. The fourth bank is a stated-owned institution that plays an important role in providing banking services to the poor and small businesses, including in rural areas. Contrary to other small island states in the Asia-Pacific region, de-risking by global banks has not affected Timor-Leste so far, possibly because the bulk of the banking system is foreign-owned and the limited importance of remittance inflows to the country.

14. Timor-Leste has made significant advances in financial inclusion and all banks are adapting their services to branchless and mobile platforms. The authorities are also engaging in fostering financial literacy. A new payments system legislation has been introduced, aiming at reducing the costs of doing business and the reliance on cash transactions, and promoting economic growth outside the urban areas.

Structural reforms

15. The Timorese authorities remain committed to advance their structural reforms agenda, well aware that it might take some years to bear fruits. Efforts are being made to attract foreign investment and to foster private-sector job creation. The authorities believe that the discussions with staff have helped them strike the right balance between carrying out infrastructure projects and preserving the Petroleum Fund. This trade-off is critical given that potential investors have repeatedly emphasized that improving basic infrastructure is paramount to attract foreign investment.

16. Public investment in infrastructure continues to be the priority. In particular, improving basic transport infrastructure, including roads, the Dili airport and the new port at Tibar Bay (to be financed, built and operated under a Public Private Partnership) is

fundamental to promote economic integration across the territory and strengthen links with the rest of the world. The government is also committed to integrate and develop the Oecusse district (a remote enclave of Timor-Leste on the north coast of Indonesian West Timor) through the creation of a Special Zone for Social Market Economy, among other initiatives.

17. Given the role of the petroleum sector to the Timorese economy, the authorities have envisaged the Tasi Mane project as a driver of progress along the south coast of the country, facilitating not only the development of the hydrocarbons industry but also manufacturing and tourism. Nationwide, developing the tourism sector in a sustainable way is another priority under the Strategic Development Plan. The sector is traditionally labor-intensive, which may contribute to increase formal employment and boost government revenues. In addition to building infrastructure, efforts are being carried out to promote the country in tourist centers in the Asia-Pacific.

18. As documented by staff (Appendix IV), Timor-Leste has made substantial progress in achieving the Millennium Development Goals (MDG). This is particularly true for the goal to "Promote Gender Equality and Empower Women", which has been fully achieved. The country has also made substantial progress in reducing child mortality and malnutrition, combating malaria and tuberculosis, increasing primary school enrolment and enhancing access of the population to clean water sources.

Conclusion

19. Our authorities' strong commitment to sustainable and inclusive growth and to careful management of the petroleum wealth is leading Timor-Leste to gradually improve living standards, develop human capital and overcome lack of basic infrastructure. The authorities agree with staff that there is still a large need for technical assistance and training to support their bold reform and development agenda. Once again, they reiterate their appreciation to the Fund and other development partners for their relentless role in nation-building and capacity development.