FOR AGENDA

SM/04/201

June 28, 2004

To: Members of the Executive Board

From: The Secretary

Subject: **Democratic Republic of Timor-Leste—Staff Report for the 2004 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2004 Article IV consultation with the Democratic Republic of Timor-Leste, which is tentatively scheduled for discussion on **Friday, July 16, 2004**. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of the Democratic Republic of Timor-Leste indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. I. Kim (ext. 30037) and Ms. Poirson (ext. 37072) in APD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the Asian Development Bank, following its consideration by the Executive Board.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for
the 2004 Consultation with Timor-Leste

(In consultation with other Departments)

Approved by Daniel Citrin and Juha Kähkönen

June 25, 2004

- A staff team visited Dili during April 8–21 to hold the 2004 Article IV consultation discussions. The discussions were held with Prime Minister Alkatiri, Finance Minister Boavida, other senior officials, representatives of key donors and the business community, and the resident missions of the World Bank and the Asian Development Bank.

- The mission comprised Messrs. Kim (head), Chensavasdijai and Nozaki (EP), and Ms. Poirson (all APD), and was assisted by Mr. Al-Eyd (Senior Resident Representative). Mr. Santos (OED) attended some of the meetings.

- Timor-Leste's statistical base remains weak due to slow progress in institution and capacity building. The weakness is especially pronounced in the areas of national accounts and the balance of payments, constraining surveillance seriously.

- Timor-Leste has accepted the obligations of Article VIII, Sections 2, 3, and 4, and it maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.

- The authorities expressed their consent to the publication of the 2004 Article IV consultation staff report, together with the supporting document.

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

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EXECUTIVE SUMMARY

Economic and policy developments

After a strong recovery from the 1999 destruction, economic activity slowed down substantially. Real GDP declined by 3 percent in 2003 and is expected to recover only modestly in 2004, reflecting the lingering impact of a reduced international presence. Inflation, however, moderated in recent months. The Bayu-Undan project has come on stream, paving the way for increased oil/gas revenues over the medium term.

Fiscal policy remains prudent. The budget for FY2003/04 (fiscal year: July–June) was tightened during the mid-year budget review in response to a perceived weakening of oil/gas revenues. A significant expenditure compression was also incorporated into the budget estimates for FY2004/05 and over the medium term to address large financing gaps and downside risks to oil/gas revenues.

Expansion in the banking sector continues. A third commercial bank started operations last August, and bank loans have recently been picking up. Nonetheless, financial intermediation remains modest, with a substantial portion of bank deposits invested abroad and banking services largely limited to Dili.

Steps have been taken to address Timor-Leste' deep-rooted structural problems, especially the underdeveloped private sector and nascent institutions and capacity. Several laws have been enacted toward establishing a legal framework for business activity, and efforts are being made to strengthen the government's capacity for governance and service delivery.

Policy issues

The near- and medium-term challenge for fiscal management is to make the FY2004/05 budget estimates credible and ensure adequate government services. To this end, efforts need to be stepped-up to prioritize expenditures, improve budget execution (particularly for capital projects), and restrain the increase in wages and salaries. For the long term, the authorities need to develop a fiscal strategy to ensure the productive use of oil/gas revenues. A petroleum fund should be established swiftly toward sound management of oil/gas savings.

The current U.S. dollar-based monetary and exchange rate regime should be maintained until adequate institutional and financial conditions develop. With bank loans increasing, the authorities should remain vigilant over bank portfolios to keep them sound.

The authorities need to step up their efforts to address Timor-Leste's serious structural problems. In particular, further actions are needed to improve infrastructure and develop a legal framework for private sector activity. Steps should be taken urgently to strengthen institutions and capacity, especially at the Ministry of Planning and Finance and the monetary authority, to counter a further winding-down of the UN-supported capacity building program.

I. INTRODUCTION AND BACKGROUND

1. **Timor-Leste has begun nation-building following its independence in May 2002**.[1] Progress has been made in consolidating the new government's administrative power and fostering a stable political environment despite some early challenges.[2] Further steps have been taken under the government's initiatives to reconstruct the economy from the severe destruction of 1999 that followed the national referendum overwhelmingly supporting independence from Indonesia.

2. **Despite progress in economic reconstruction, significant economic challenges remain ahead**. These challenges center around the strengthening of medium-term growth prospects to alleviate widespread poverty (Table 1).[3] Meeting the challenges requires the authorities to address deep-rooted structural problems, including poor infrastructure, low productivity (notably in agriculture), an underdeveloped legal system for business activity, and serious institutional and capacity constraints. Added to this task is the need for the productive use of growing oil/gas revenues expected over the medium term from the exploitation of oil/gas resources in the Timor Sea (Box 1).

3. **The economy operates under a U.S. dollar-based currency regime**.[4] Combined with the monetary authority's lack of legal power to lend, the currency regime constrains the

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[1] Independence came after a 2½ year-rule of the United Nations Transitional Administration in East Timor (UNTAET). Following independence, the UN's assistance to Timor-Leste has been provided through a scaled-back presence—the UN Mission in Support of East Timor (UNMISET). UNMISET was initially scheduled to be replaced by a further scaled-back successor mission in May 2004, but its presence was extended for another year (subject to a review in late 2004) to ensure the maintenance of security.

[2] The government has faced a number of political challenges since independence (including the civil unrest in Dili in December 2002 and recent bribery allegations made by a U.S. oil company in a lawsuit to claim its right to develop oil/gas fields in the Timor Sea). However, these challenges were ridden out without much political damage, aided by a dominant parliamentary majority held by the ruling party led by Prime Minister Alkatiri.

[3] Per capita GDP is estimated at about $415 in 2003, and more than 40 percent of the population falls below the national poverty line. Although no official data are available, unemployment and underemployment are estimated to be widespread, particularly among the young.

[4] Timorese coins were introduced in November 2003 to complement the U.S. dollar coins. The new coins (comprising five denominations equivalent to 50 cents, quarter, dime, nickel, and penny) are issued only in exchange for U.S. dollars and their introduction does not change the basic nature of the existing monetary and exchange rate regime.

scope for monetary and exchange rate policies.[5] However, it has been instrumental in restoring financial confidence in the aftermath of the 1999 destruction, while reducing the risk of fiscal instability through government borrowing from the monetary authority.

Box 1. Oil/Gas Resources

- **Major oil/gas fields**: Timor-Leste's oil/gas revenues are generated from the commercial exploitation of oil/gas resources in the Timor Gap (an area of disputed sovereignty).[1] Major oil/gas fields discovered to date include the Elang-Kakatua-Kakatua-North (EKKN), Bayu-Undan, and Great Sunrise fields. The EKKN field is estimated to contain small oil reserves (less than 30 million barrels); the Bayu-Undan field, 370 million barrels of liquids (condensate and LPG) and 2.7 trillion cubic feet of gas; and the Greater Sunrise field, 7.6 trillion cubic feet of gas. With oil reserves in the EKKN field likely to be depleted in 2005 and the development of the Greater Sunrise still uncertain, the Bayu-Undan field is currently expected to constitute the major source of oil/gas revenues for Timor-Leste.

- **Bayu-Undan project**: A development plan and production sharing contracts to exploit oil/gas reserves in the Bayu-Undan field were agreed on May 16, 2003 between oil companies (led by ConocoPhillips) and the Joint Commission representing Timor-Leste and Australia. The development plan aims at producing both liquids and gas, with the latter to be transported to Australia for downstream activities, including power generation and LNG production for Asian markets. Following the development of the field since early 2000, the production of liquids started in April 2004. The exploitation of oil/gas reserves in the field is estimated to provide Timor-Leste with oil/gas revenues totaling $3.2 billion over a 20-year horizon (on the basis of an average export price equivalent to a crude price of about $20 per barrel at 2002/03 prices).

- **Revenue sharing arrangement**: The commercial exploitation of oil/gas resources in the Timor Gap is governed by the Timor Sea Treaty signed between Timor-Leste and Australia on May 20, 2002. Under the Treaty, the Timor Gap is partitioned into three areas: A (the Joint Petroleum Development Area—JPDA); B (area under Australian jurisdiction), and C (area under Timor-Leste jurisdiction). Oil/gas revenues in the JPDA are shared between Timor-Leste and Australia with a 90/10 split. The Bayu-Undan field is located entirely in the JPDA, while the Greater Sunrise field straddles the JPDA (about 20 percent of the field lies within the JPDA, subject to the resolution of seabed boundaries between Timor-Leste and Australia).[2]

[1] The emergence of the Timor Gap goes back to 1972, when a treaty was signed between Australia and Indonesia setting the permanent seabed boundary between the two countries. However, the treaty failed to cover an area adjacent to then East Timor (the Timor Gap), as agreement could not reach with Portugal (then administrative power governing East Timor) on the seabed boundary in that region.

[2] The first round of discussions on seabed boundaries took place in April 2004, with the next round scheduled for September 2004.

[5] The monetary authority (Banking and Payments Authority—BPA) is an autonomous body and performs all functions of a central bank except for monetary, interest, and exchange rate policies.

4. **Fiscal operations are key to macroeconomic management**. They consist of (i) the central government budget (the Consolidated Fund for East Timor—CFET; Table 3) and (ii) various reconstruction and development programs funded and undertaken by bilateral donors and multilateral institutions outside the central government budget (non-CEFT fiscal and quasi-fiscal operations). Total outlays under these CFET and non-CFET fiscal operations (defined as "combined sources fiscal operations") increased sharply in the aftermath of the 1999 destruction, but have been falling substantially since then, as non-CFET reconstruction-related programs have been winding down (Table 5).[6]

5. **The central government budget carries several features**. These include (i) an absence of borrowing (the lack of access to domestic borrowing combined with the authorities' policy to avoid external loans); (ii) heavy reliance on external cash grants for budget financing; and (iii) an ad-hoc oil/gas saving policy (under which royalties are automatically saved, with only tax revenues available for expenditure financing). Reflecting limited revenues, external assistance has financed about one-half of government expenditures to meet pressing reconstruction and development needs. The lack of budget financing through borrowing, together with limited oil/gas revenues thus far, has contributed to restraining an excessive expansion in expenditures. Fiscal policy, however, is expected to face more serious challenges over the long term, as the resource constraint eases with a sharp increase in oil/gas revenues. Such challenges include (i) the development of an expenditure strategy consistent with macroeconomic and fiscal stability and (ii) the sound management of oil/gas savings.

6. **Initial actions are being taken to address structural problems through the implementation of the Road Map** (Box 2). The Road Map focuses on strengthening governance, promoting the development of a dynamic private sector, and building Timor-Leste's institutions and capacity. For the latter, key institutions (particularly the monetary and fiscal agencies) have been restored since the devastation of 1999 and the government's capacity has been developed through (i) significant Fund technical assistance (Annex I), (ii) the World Bank-supported Transition Support Programs (TSPs; Annex II), and (iii) bilateral donor assistance. Nonetheless, Timor-Leste continues to depend heavily on international experts for its daily administrative operations, and acceleration in institution and capacity building remains a major challenge, especially in view of a further winding-down of the UN-supported capacity building program.[7]

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[6] Data on non-CFET fiscal and quasi-fiscal operations, however, are incomplete and highly preliminary.

[7] Over the two years after independence, a UN-supported capacity-building program has played a key role in funding key public administration posts (comprising 100 "core" posts directed funded by UNMISET and 200 "development" posts jointly funded by UN and bilateral and other donors). The number of posts supported by the program is to be reduced by almost half (comprising 58 "most critical" posts and 99 "critical" posts) in FY2005/06.

Box 2. Road Map and Sector Investment Programs

- The **Road Map** was developed in 2003 to set out an annual action plan for each ministry through FY2006/07 to achieve main objectives of the National Development Plan (especially higher growth and poverty alleviation) and the "stability" program; the latter was announced in early 2003 to strengthen governance, create job opportunities, and improve government service delivery. The implementation and funding of the Road Map have heavily depended on international assistance (mainly through non-CFET operations).

- The Road Map is expected to be replaced in FY2005/06 by the **Sector Investment Programs (SIPs)**, which cover 14 sectors, including primary sectors (especially, agriculture) and key sectors relating to infrastructure (power, communications, and transport) and social services (education and health). The SIPs, which are currently under preparation, are aimed at (i) clarifying sectoral goals (including National Millennium Development Goals), (ii) establishing comprehensive policies and strategies, and (iii) laying out essential investment programs. As a way to secure funding from donors, SIPs are to be formally integrated into the combined sources fiscal operations.

II. Recent Economic Developments

7. **Recent economic developments have been marked by a slowdown in growth, a moderation in inflation, and a large, albeit declining, external current account deficit**.

- **Real GDP** is estimated to have declined by 3 percent in 2003, following a sharp recovery in the aftermath of the 1999 destruction (Figure 1 and Table 2). The slowdown reflects the adverse impact of the winding-down of the international presence, compounded by a fall in agricultural production due to droughts.

- **Inflationary pressures** have been waning in recent months. CPI inflation declined to 4 percent (year-on-year) in April 2004, after hovering around 8–10 percent during late 2002 to mid-2003, owing to a drought-induced scarcity of agricultural goods.

- **The external current account excluding official transfers** remains in large deficit, but the deficit is narrowing (to about $230 million or 65 percent of GDP in 2003), reflecting a further reduction in imports (Table 7). Exports remain little changed, with coffee exports (the principal export item) estimated at about two-thirds of their peak level prior to the 1999 destruction due to still weak international prices.

- **The development of the Bayu-Undan oil/gas field** was adversely affected by technical problems during the second half of 2003, generating expectations that oil/gas production may be delayed substantially. However, the situation has improved since then, with production starting in April 2004. Nonetheless, oil/gas production in the first few years is still estimated to be substantially lower than projected a year ago.

8. **The central government budget for FY2003/04 (fiscal year: July–June) was tightened during the mid-year budget review (November 2003)**. This reflected (i) emerging concerns about potential shortfalls in oil/gas revenues,[8] and (ii) a rapid increase in expenditures (mainly for vehicle purchases and maintenance, domestic and overseas travel, and the hiring of temporary staff) due to less stringent expenditure control during the first four months of the year. In response, total expenditure was cut by 1.5 percent of GDP and expenditure control was tightened (Table 3).[9]

9. **The fiscal outturn thus far, however, points to a considerably smaller overall deficit for FY2003/04**. During the first three quarters of the year, total revenue exceeded the revised budget projection by about one-third, owing mainly to a shift in import composition toward goods subject to duties (particularly higher excises), a strengthening of tax administration,[10] and buoyant oil/gas revenues; the latter reflected higher-than expected international oil prices and more stringent revenue collections from oil/gas companies. Total expenditure was about 15 percent below the revised budget target (on a commitment basis), as a result of the continued slow recruitment of civil servants and delays in the implementation of capital projects, combined with tightening of expenditure control. On the basis of these developments, the overall deficit for FY2003/04 as a whole is estimated at 4½ percent of GDP, about half of that envisaged during the mid-year budget review.

10. **Reform measures have been taken to strengthen the power authority, but its financial position remains weak**. After initial delays, the installment of prepayment meters has been accelerated in recent months, reaching 75 percent of the target by end-April.[11] Also the power authority has been placed under an externally-contracted new management team since March 2004. However, total bill collections were 30 percent below target through March 2004 and are estimated to fall short of the annual target by more than 20 percent. The shortfall is estimated to be largely covered by unbudgeted external assistance and no additional budgetary appropriations would be required.

[8] The shortfalls, estimated at about 5 percent of GDP, reflect a number of ad-hoc factors unexpected during the FY2003/04 budget preparation, including tax refunding due to the retroactive application of changes in the tax arrangement following the finalization of the Bayu-Undan project.

[9] The expenditure cuts fell mainly on wages and salaries (due to slow recruitment of civil servants) and appropriations for less essential expenditures.

[10] This reflects improved compilation of tax information as a result of the adoption of the SIGTAS and ASYCUDA systems, increased efforts to strengthen compliance by large taxpayers, and tighter border control.

[11] The installment of prepayment meters covers about one-fourth of the customer base, with the remaining customers continuing to be billed under the conventional meters.

11. **The expansion of the banking system continues, although its activity remains largely confined to the Dili area**. Bank deposits increased to 23 percent of GDP by end-March 2004, as a third commercial bank commenced operations in mid-2003 and micro-financing operations gained momentum (Table 6). Although a substantial portion of deposits continue to be invested abroad, bank lending (mainly to the construction and trading sectors) has started to pick up since mid-2003, reflecting the adoption of a more active lending policy by one of the commercial banks. Despite the increase, the amount of nonperforming loans has remained modest (about 1 percent of total lending). Steps have been taken under MFD technical assistance to prepare a payments law to address risks associated with the payments system and develop an insurance law to foster insurance activities, as well as build a framework for insurance supervision.

12. **Progress has been made in implementing structural measures relating to private sector development and institution and capacity building**. A commercial code and a company law were enacted as initial steps to establish a legal and regulatory framework for business activity. A policy paper on private investment was placed for public consultation in last November and draft domestic and foreign investment laws have been submitted to the Council of Ministers. Following the enactment of a basic law for land ownership in early 2003, draft laws for (i) leasing of private and public land and (ii) land and property dispute mediation are currently being reviewed by the Council of Ministers for enactment by mid-2004. To strengthen institutions and capacity (particularly those relating to governance and service delivery), actions are being taken in the context of the World Bank-supported Second Transition Support Program (TSP II). However, progress has been slow in the area of governance, especially the judiciary.

III. Policy Discussions

13. **In concluding the 2003 Article IV consultation, Directors underscored the importance of strengthening growth prospects and alleviating widespread poverty**. To this end, they stressed the need for actions to foster private sector development and further build Timor-Leste's institutions and capacity. Supporting the current U.S. dollar-based monetary and exchange rate regime, they indicated that fiscal policy should bear the major burden in sustaining macroeconomic stability. In particular, they encouraged the authorities to develop a long-term fiscal strategy to make the best use of the increasing oil/gas revenues to promote growth, while safeguarding a sound fiscal position. The authorities were in broad agreement with the Executive Board's recommendations, and have been taking steps in line with them. However, progress has been relatively slow, especially in the implementation of structural measures to strengthen growth and build institutions, due mainly to severe capacity constraints. The mission's discussions continued to center on the macroeconomic and structural policy issues raised by the Executive Board, stressing the importance of early implementation of necessary policy measures.

A. Economic Outlook

14. **The short-term outlook is for a gradual recovery in economic activity**. Real GDP is projected to show a modest upturn (1 percent) in 2004, as agricultural production is expected to recover with the return of normal weather conditions, offsetting the impact of a further winding-down of the international presence (Table 8). Inflation is projected to moderate to 3 percent by end-2004 barring major external shocks. Over the medium term, it is possible that real GDP growth could accelerate to 5 percent, with inflation contained within low single digits, as envisaged by the National Development Plan (NDP).

15. **The mission stressed that strong policy actions will be required for this outlook to materialize**. Key to the projected acceleration in growth will be the early completion and effective implementation of the Sector Investment Programs (SIPs; Box 2) underpinned by appropriate funding arrangements. In particular, the mission reiterated the importance of developing the agricultural sector (through improved productivity of food production and the expansion in cash crop production) in view of its potentially significant contributions to alleviating poverty. The increase in public investment should be accompanied by steps to foster business activity (¶26–27) and further strengthen institutions and capacity (¶28–30). At the same time, the mission stressed that the maintenance of a prudent fiscal policy will be critical to limit pressures on nontraded goods prices and avoid further erosion in external competitiveness (¶16–19).[12] Sharing the mission's view, the authorities indicated their intention to complete the SIPs by end-August 2004 for implementation starting FY2005/06.

B. Near- and Medium-Term Budget Management

Central government budget estimates for FY2004/05–FY2007/08

16. **Central government budget estimates for FY2004/05 and three-year forward projections through FY2007/08 are marked by a major tightening of expenditure policy**. Total expenditure is budgeted to be compressed by 12 percent, on average, in comparison with the November 2003 mid-year budget review estimates (Box 3 and Table 4). The authorities indicated that the expenditure compression is aimed at narrowing the significant financing gaps that were projected during the mid-year budget review due to a substantial weakening in the outlook of oil/gas revenues. They emphasized that the budgeted expenditure cuts are also appropriate in view of (i) the need to safeguard against large downside risks to oil/gas revenues despite their improved outlook (the third bullet point in

[12] No comprehensive official data relating to external competitiveness, including wages, are available. However, anecdotal information suggests that the average wage rate in the formal sector in Dili is relatively high in comparison with neighboring countries at a similar stage of development, although the increase in wages has leveled off since the winding-down of UN operations. The computation of the real exchange rate is constrained by the absence of reliable trade data.

Box 3. Budget Estimates for FY2004/05-FY2007/08

- **Total expenditure is budgeted to be compressed by 12 percent, on average, compared with expenditure projections for FY2004/05–FY2006/07 that were made during the 2003 mid-year budget review** (Table 4). Expenditure compression is aimed at (i) narrowing the significant financing gaps ($125 million or 11 percent of GDP per year, on average) that was projected during the mid-year budget review due mainly to an expected delay in oil/gas production (¶6), and (ii) safeguarding against large downside risks to oil/gas revenues (see below).

- **The expenditure cuts are expected to fall primarily on appropriations for less essential goods and services, including fuels, vehicle maintenance, and office equipment**. Capital expenditures are also budgeted to be reduced, although efforts were made to broadly maintain their share in total expenditure. Wages and salaries are subject to the least cuts, but are allowed to increase only modestly.

- **Total revenue is budgeted to be more than 45 percent higher, on average, than projected during the 2003 mid-year budget review**. This is primarily attributable to an improved outlook for oil/gas revenues, reflecting an upward revision of the production profile, higher international oil prices, and a smaller deduction for depreciation.[1] However, the revenue estimates are subject to significant downside risks, as the tax arrangement is characterized by large fluctuations in income tax in response to a change in oil/gas production and prices.[2] Domestic revenues are also expected to be better than earlier anticipated (by 16 percent, on average) due partly to improved tax administration.

- **On the basis of these revenue and expenditure projections, the overall fiscal position is projected to improve substantially, although some financing gaps still remain**. Given large donor grants already committed for FY2004/05, together with CFET cash balances available, no financing gap is expected for the coming fiscal year. However, financing gaps totaling about $30 million (3 percent of GDP per year, on average) are expected for the following three years, if the current oil/gas saving policy, as well as CFET cash balances sufficient to cushion against temporary fluctuations in revenues, are to be maintained.

- **The financing gaps, however, are expected to be largely covered by further donor budgetary support**. At the meeting held in Dili during May 17–18, 2004, donors indicated that they would extend their budgetary support for another two years through FY2006/07. The assistance will continue to be provided under the World Bank-supported TSPs, which have also been extended through FY2006/07.[3]

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[1] Official estimates of oil/gas revenues incorporate (i) relatively conservatives oil prices (about $24 barrel) and (ii) a 15 percent discount of baseline projections to provide the budget with an adequate cushion against unforeseen declines in oil/gas production and prices.

[2] The authorities' estimates show that a decline in oil prices by $2 per barrel from the baseline projections, combined with a fall in oil/gas production by about 15 percent, would reduce total oil/gas revenues over the next four years by 40 percent, with the reduction accounted for largely by tax revenues.

[3] Donors are expected to make formal pledges for additional budgetary support (as well as non-budgetary assistance) at a meeting scheduled for mid-2005. At present, budgetary support is committed only through FY2004/05, which was previously viewed as the last "lean year" before the Bayu-Undan project comes on stream.

Box 3) and (ii) ministries' limited capacity for effective expenditure execution. At the same time, however, the authorities recognized the adverse impact of the expenditure cuts on the economy, especially in view of weak business activity and pressing needs for government services for economic reconstruction and development. They stressed that expenditure estimates over the medium term will be reviewed, as necessary, to ensure an adequate level of government services in accordance with the availability of budgetary resources and improvement in expenditure execution.

17. **While supporting the budget estimates, the mission stressed a number of prerequisites for these estimates to be credible**. In particular, there should be rigorous efforts to prioritize expenditures over the medium term in order to safeguard essential government services, especially for education and health. Prioritization should be accompanied by efforts to strengthen budget execution and ensure the timely delivery of government services, particularly in rural areas.[13] Also, containment of wages and salaries within the budget estimates will require the authorities to adhere strictly to the current ceiling on the total number of civil servants and avoid a major increase in the wage rate. The authorities concurred with the mission's view and indicated that necessary steps will be taken to meet the budget targets.

18. **The mission expressed concern about the low level of budget estimates for capital expenditures**, which may not be compatible with the growth objectives set by the NDP. The authorities shared the mission's concern, but noted that the increase in capital expenditures is severely constrained by the government's capacity for project preparation and implementation. While urging the authorities to step up their efforts to improve ministries' absorption capacity, the mission underscored the importance of actions, in the interim, to secure adequate public investment through capital projects undertaken by bilateral donors and multilateral institutions. Accordingly, the mission encouraged the authorities to move forward swiftly to finalize the SIPs as planned, so as to mobilize donor support for capital projects.

19. **The authorities stressed significant downside risks to oil/gas revenues and a possibility that the financing gaps could be larger than budgeted**. While sharing the authorities' concern, the mission noted the cautious nature of official oil/gas revenue projections (footnote 1 in Box 3) and the substantial amount of government cash balances available for budget financing. Should downside risks materialize and donor assistance fall short of closing the financing gaps, the mission advised the authorities to consider additional financing measures in view of the limited scope for further cuts in expenditures or increases in domestic tax revenues. These measures would include a change in the present oil/gas

[13] Under the World Bank-supported TSPs, efforts have been made to improve expenditure execution. These efforts focus on improvements in procurement services, procedures for expenditure authorization, budget planning for capital projects, and line ministries' capacity for service delivery.

saving policy to permit the increased use of oil/gas revenues (a flexible oil/gas saving policy)[14] and a cautious relaxation of the current non-external borrowing policy to allow concessional loans. The latter option would not be inappropriate, as long as concessional loans are a cheaper source of funding (in comparison with the use of oil/gas revenues) and limited to fund mainly capital projects consistent with the government's absorption capacity. The authorities indicated that their preference would be for the increased use of oil/gas revenues, and they would remain cautious about external borrowing.

Power sector issues

20. **The mission stressed that further efforts will be necessary to improve the power authority's financial position**. Notwithstanding the installment of prepayment meters and expected improvement in the authority's management under the new external management team, there are risks that revenue collections may remain below budgeted over the medium term. This reflects a possibility that progress can be made only gradually in improving the existing billing system and enforcing measures against nonpayment by customers who are still billed under the conventional meters. The mission stressed, and the authorities agreed, that rigorous implementation of the reform measures (including the planned installment of additional prepayment meters), combined with stringent oversight of the external management contract, will be critical to prevent further overruns in budgetary allocations to the power authority.

C. Long-Term Fiscal Strategy and Management of Oil/Gas Revenues

21. **The mission underscored the urgent need for establishing a long-term fiscal strategy to ensure the productive use of oil/gas wealth while safeguarding fiscal stability**. The key policy issue for such a strategy is what would be an appropriate level of fiscal expenditure over the long term to achieve these objectives. To address the issue, which is closely associated with the saving policy for oil/gas wealth, the mission updated the long-term fiscal scenario that was presented to the authorities for discussion during the 2003 Article IV consultation and reiterated major caveats associated with the scenario. Among them is that part of oil/gas wealth should be used to meet pressing investment needs for infrastructure and human capital development in order to achieve the growth objectives set under the NDP. However, an unduly expansionary fiscal program aimed at more ambitious growth objectives should be avoided in view of risks associated with public investment until the government's absorptive capacity improves substantially.

[14] The FY2004/05 budget projects that oil/gas saving would reach almost $130 million (about 180 percent of recurrent expenditure) by end-FY2007/08 under the current oil/gas saving policy (Table 4). Together with the conservative oil price assumption used for the budget estimates, this would provide the authorities with a financial cushion large enough to ride out an oil price shock, as long as oil prices do not fall below $20 per barrel for a prolonged period.

22. **Based on these caveats, the mission's scenario suggests that government expenditure should be restrained to around 20 percent of GDP over the long term** (Annex V). The containment of expenditure at this level would permit Timor-Leste to preserve about 85 percent of oil/gas wealth in financial assets for future generations.[15] This scenario depends on oil/gas prices and the return on financial savings, as well as a number of policy assumptions. The latter includes: (i) actions to increase non-oil/gas tax revenues to supplement oil/gas revenues; and (ii) strong efforts to restrain recurrent expenditures to provide appropriate funding for capital expenditures. The authorities were in broad agreement with the thrust of the scenario, and indicated that efforts will be stepped up to build a national consensus to address the issues, especially with regard to the size of oil/gas wealth to be saved for future generations; this will be done in tandem with the establishment of a petroleum fund.

23. **The authorities indicated that a petroleum fund will be established by June 2005 to manage oil/gas savings in a sound manner**. They acknowledged a delay in the timetable for the fund partly due to their limited capacity. The mission strongly supported the authorities' intention to base the petroleum fund on a Norwegian model (as recommended by the October 2002 FAD technical assistance mission)[16] and noted the Fund's commitment to assist Timor-Leste in establishing the fund through providing a long-term resident advisor. The authorities were reminded that the key principle of a Norwegian model is to ensure transparency and accountability in the management of the fund[17] and that prudent expenditure policy is the principal prerequisite for the effective functioning of the fund (Annex VI).

D. Financial Sector Issues

24. **The authorities expressed their intention to maintain the current monetary and exchange rate regime for the foreseeable future**. While recognizing that the current regime complicates relative price adjustments, they consider that it is appropriate under the present

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[15] This size of oil/gas wealth drawn down is smaller than the one discussed during the 2003 Article IV consultation (about one-third of oil/gas wealth). The reduction reflects greater uncertainty about progress in developing Timor-Leste's absorption capacity.

[16] Key recommendations included (i) the use of a petroleum fund solely to finance fiscal deficits through the rigorous budgetary process, (ii) the avoidance of rigid, pre-determined saving rules for oil/gas revenues, (iii) the appointment of a high level council to supervise operations of the fund, and (iv) the establishment of an investment advisory committee.

[17] With oil/gas production in the Bayu-Undan field expected to start in 2004, the authorities participated in the London conference on the Extractive Industries Transparency Initiative (EITI) in June 2003. While indicating their support for the new initiative, the authorities have yet to make a formal decision as to their participation in the EITI.

circumstances, particularly given the limited institutional capacity, the lack of sufficient official reserves, and the absence of well-developed financial markets (including the foreign exchange market). Accordingly, they would consider the introduction of a national currency only after these institutional and financial constraints have been substantially eased. The authorities agreed to the staff's view that, given the constraints on relative price adjustments, issues relating to external competitiveness should be addressed primarily through fiscal and labor market policies.

25. **The authorities recognize that further improvement in financial intermediation remains important despite recent increases in domestic bank lending**. They attribute limited financial intermediation to the absence of viable lending opportunities and the underdeveloped legal system to safeguard the recovery of bank loans. Accordingly, the authorities' efforts will continue to focus on strengthening the legal and regulatory framework to foster business activity (¶26–27) and facilitate loan recovery, while avoiding recourse to administrative measures to artificially promote bank lending. The mission underscored the importance of continued stringent supervision by the monetary authority of bank lending to ensure that bank portfolios remain sound. The authorities indicated their intention to (i) move forward swiftly to enact the payments and insurance laws, and (ii) prepare necessary legislation through Fund technical assistance to combat money laundering and the financing of terrorism.

E. Private Sector Development

26. **The authorities recognize the critical role played by the private sector in improving growth prospects and alleviating poverty**. They indicated that a key step to foster increased private sector activity will be to improve infrastructure, particularly the road network, which will go a long way toward broadening the domestic market, especially for agricultural products. At the same time, efforts will be stepped up to enact economic legislation (particularly, domestic and foreign investment laws, and land and land-related regulations) to set out a basic regulatory framework for business activity. The mission encouraged the authorities to work toward early parliamentary approval of these laws and regulations.

27. **The authorities reaffirmed their commitment to maintain a liberal trade and investment regime**.[18] For the latter, they stressed that the draft domestic and foreign investment laws are designed to incorporate key provisions to ensure a liberal environment to

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[18] Timor-Leste maintains an open trade regime. Under the present regime, the import duty is limited to a uniform 6 percent, which is applicable to all imports except for a number of selected items (e.g., cigarettes and alcohol), as well as those undertaken by UNMISET and associated with bilateral assistance programs. No imports are subject to quotas, licenses, bans, and other forms of quantitative restrictions, although the importation of certain categories of goods is banned for health and security reasons.

potential investors. These include nondiscrimination between domestic and foreign investors, the adoption of a one stop-shop approval procedure, free repatriation of profits, and the avoidance of establishing special areas reserved only for domestic producers. The draft investment laws, however, incorporate tax incentives linked to the size of employment as a way to promote labor-intensive business activity. The mission noted the general ineffectiveness of such tax incentives and potentially large revenue losses, and encouraged the authorities to remove the tax measures from the laws. The authorities expressed their commitment to avoid the introduction of populist measures (including a minimum wage scheme for workers and administrative determination of prices of essential goods) despite continued political pressures.

F. Institution and Capacity Building

28. **The mission underscored the critical importance of strengthening key economic institutions and capacity for Timor-Leste's development**. This is becoming all the more urgent in view of a further scale-back in the UN-supported capacity building program (see footnote 7 in ¶6). The cut-back is expected to hit particularly hard the Ministry of Planning and Finance (MOPF) and, to a lesser extent, the Banking and Payments Authority (BPA), which have relied heavily on UN-supported international experts for their daily operations.

29. **Against this background, the mission urged the MOPF and BPA to intensify their efforts for institution and capacity building**. With regard to the MOPF, the mission underscored the importance of expeditiously implementing the medium-term capacity development program worked out jointly by the World Bank and the Fund. Key components of the program include appointment of a non-political "Director General" who will assume responsibility for day-to-day institution development matters, strengthening of the recently established human resources management unit, and appointment and training of local counterparts to all internationals in line positions. In the interim, the mission encouraged the authorities to retain an adequate number of international experts to avoid disruption in the MOPF's operations. As for the BPA, the mission encouraged the authorities to "Timorize" senior positions of the monetary authorities, with international experts playing an advisory role, as recommended by a recent MFD technical assistance mission. The authorities indicated that an East-Timorese staff will be appointed General Manager starting FY2004/05, to be followed by Timorization of other senior positions in due course.

30. **The authorities expressed their commitment to move forward with further actions for institution and capacity building under the TSP III**. These actions will continue to focus on (i) governance and (ii) service delivery (particularly for education and health). The former will center on strengthening legal and institutional frameworks for the judiciary, public sector personnel management, and public expenditure management.

G. Other Issues

31. **The mission urged the authorities to step up their efforts to improve macroeconomic data**. Data problems are especially serious in the areas of national accounts

and the balance of payments where no official statistics are currently available (Annex IV). The mission stressed the need for increased staffing for the Statistics Division of MOPF and the early initiation of data compilation relating to sectoral production and external transactions, to build on the enactment last August of the statistics law. While agreeing with the mission's view, the authorities noted that the lack of qualified staff poses a severe constraint and that continued Fund technical assistance remains important.

32. **The mission reviewed developments in the exchange and trade system since the last Article IV consultation**. Timor-Leste has accepted the obligations of Article VIII, Sections 2, 3, and 4, effective the date of its membership in the Fund. Timor-Leste maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.[19]

IV. Staff Appraisal

33. **Following the impressive recovery from the severe post-referendum destruction, Timor-Leste's economic activity has weakened significantly**. Real GDP fell in 2003 and is expected to recover only modestly in 2004, reflecting a continued winding-down of the international presence. Inflation, however, has moderated partly in response to a continued cautious fiscal management. Also, encouraging initial progress has been made in addressing the country's deep-rooted structural problems.

34. **With the economic slowdown reinforcing widespread poverty and serious underemployment, there is an urgent need to strengthen the country's growth prospects**. This would foremost require a significant stepping-up in the authorities' efforts to develop a dynamic private sector and strengthen Timor-Leste's institutions and capacity. These efforts should be accompanied by the productive use of growing oil/gas revenues over the long term to fund essential government services, especially for infrastructure and human capital, while sustaining macroeconomic stability.

35. **Notwithstanding the difficult economic situation, fiscal policy has remained prudent**. The FY2003/04 budget was tightened at the mid-year budget review in response to perceived weaknesses in oil/gas revenues. A significant expenditure compression was also incorporated into the FY2004/05 budget and the three-year forward fiscal projections to narrow sizeable financing gaps projected over the medium term, as well as to safeguard against potential downside risks to oil/gas revenues.

36. **While the authorities are commended for the recent fiscal adjustments, follow-up actions are essential to make the adjustment credible and minimize its adverse impact**. In particular, it is important to ensure that the expenditure cuts will not jeopardize Timor-Leste's development process and that essential government services, especially for infrastructure and social services, will be safeguarded. To this end, expenditure composition

[19] Timor-Leste's exchange system is summarized in Annex VII.

should be kept under constant review to ensure appropriate prioritization; increases in wages and salaries need to be restrained; and budget execution should be improved substantially to ensure the timely delivery of government services. For the latter, it is essential for ministries to improve their capacity to execute capital projects in support of the achievement of Timor-Leste's growth objectives.

37. **Despite the significant expenditure adjustment, some financing gaps still remain over the medium term**. Although these gaps are likely to be narrowed substantially by continued donor assistance, consideration should be given to additional steps particularly in the event financing gaps prove to be larger than projected. In view of the limited scope for further fiscal adjustment, such steps would comprise largely financing measures, including the modification of the existing oil/gas saving policy consistent or relaxation of the current non-external borrowing policy to tap concessional loans. Although the authorities are commended for their cautious approach to external borrowing, the suggested policy change merits consideration as long as concessional loans constitute a cheaper source of funding (than the use of oil/gas revenues) and are limited to fund mainly capital projects consistent with the government's absorption capacity.

38. **Ensuring the productive use of growing oil/gas revenues while maintaining a sound macroeconomic environment remains a major policy challenge for the authorities over the long term**. To this end, the authorities are urged to develop a long-term fiscal strategy that sets out an appropriate level of government expenditure. Such a strategy should address the need to improve infrastructure and human capital to accelerate growth and alleviate poverty, consistent with Timor-Leste's absorption capacity, while at the same time securing a sound fiscal position in the long run. Given uncertainty over the improvement in absorption capacity at present, however, the authorities are cautioned against embarking on an unduly large public investment program, and encouraged to save a major portion of oil/gas wealth in financial assets for future generations.

39. **With the Bayu-Undan oil/gas project coming on stream, it is important that a petroleum fund be established swiftly in time for increased inflows of oil/gas revenues**. The authorities are therefore urged to step up their efforts to make the fund operational by mid-2005, as currently planned. The authorities' intention to base the fund on a Norwegian model, which is designed to ensure transparency and accountability in the management of oil/gas savings, deserves strong support. The staff stresses that the maintenance of a prudent fiscal policy is a critical prerequisite for the effective functioning of the fund.

40. **Progress has been made in implementing key reform measures toward improving the financial position of the power authority**. However, risks remain that revenue collections continue to be constrained by deep-rooted problems associated with nonpayment and the existing billing system. Therefore, rigorous implementation of the reform measures, combined with stringent oversight of the external management contract, is critical.

41. **The current monetary and exchange rate regime provides an appropriate cornerstone for macroeconomic management in view of the existing institutional and financial constraints**. The staff supports the authorities' intention to defer the introduction of a national currency until these constraints have substantially been eased. Given the limited scope for relative price adjustments under the current regime, prudent fiscal and wage policies are critical to forestall an erosion in external competitiveness. The recent increase in bank lending is a welcome development toward improved financial intermediation. At the same time, it calls for the monetary authority to remain vigilant over bank portfolios to keep them sound.

42. **Timor-Leste's progress in improving growth prospects and alleviating poverty hinges critically on the development of a dynamic private sector**. Key to this objective is improvement in infrastructure through the effective implementation of a public investment program, combined with the early establishment of a clear regulatory framework for business activity. For the latter, efforts need to be stepped up to secure early enactment of key legislation, including domestic and foreign investment laws. The authorities are commended for their continued commitment to maintain a liberal trade and investment regime. The staff welcomes the generally liberal nature of the draft domestic and foreign investment laws, but the authorities are cautioned against the introduction of tax incentives to promote investment.

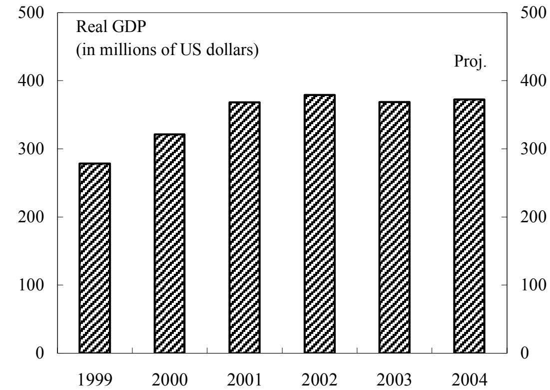
43. **There is an urgent need to intensify the authorities' efforts to strengthen nascent institutions and develop local capacity**. The urgency has been heightened by a further scale-back in the UN-supported capacity building program. Given this outlook, early actions should be taken to implement a medium-term capacity building program for the MOPF. The monetary authority is encouraged to move forward with "Timorization" of the remaining senior positions. The staff welcomes the authorities' commitment to further build Timor-Leste's institutions and capacity under the Bank-supported TSP III.

44. **Improvement in macroeconomic data remains critical**. The effective monitoring of the economic situation and timely policy decisions remain seriously hampered by the lack of data, especially on national accounts and balance of payments. To build on the enactment of the statistics law, the authorities are therefore urged to take initial steps to compile data on sectoral production and external transactions. Actions also need to be taken to strengthen training of staff and increase its number for the Statistics Division of MOPF.

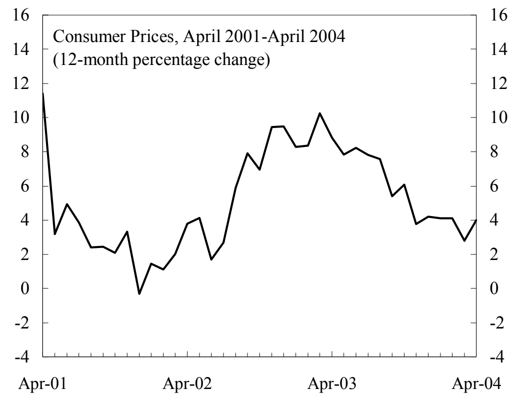
45. **It is proposed that the next Article IV consultation with Timor-Leste be held on the standard 12-month cycle**.

Figure 1. Timor Leste: Selected Economic Indicators

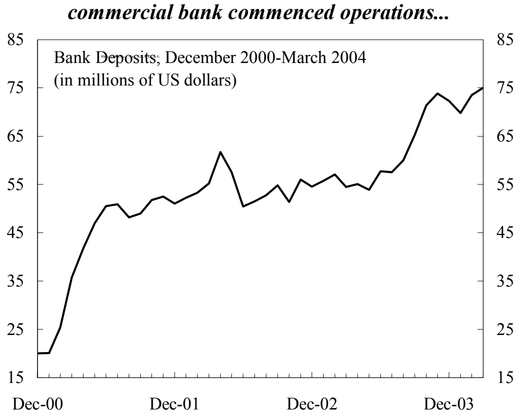
Output remains weak, after a rapid expansion in the previous years...



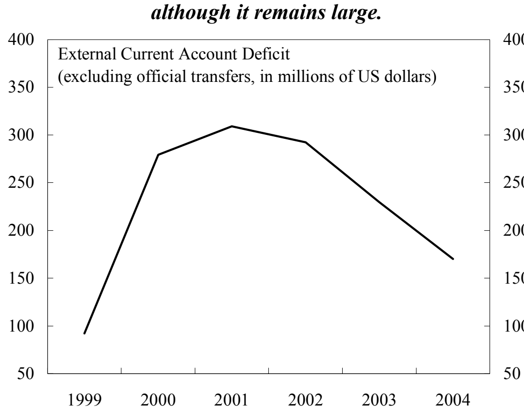
...while inflation shows signs of moderation, after accelerating sharply.



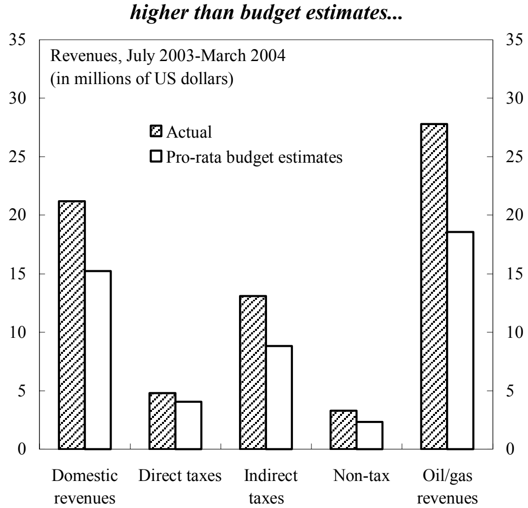
Bank deposits are growing further as a third commercial bank commenced operations...



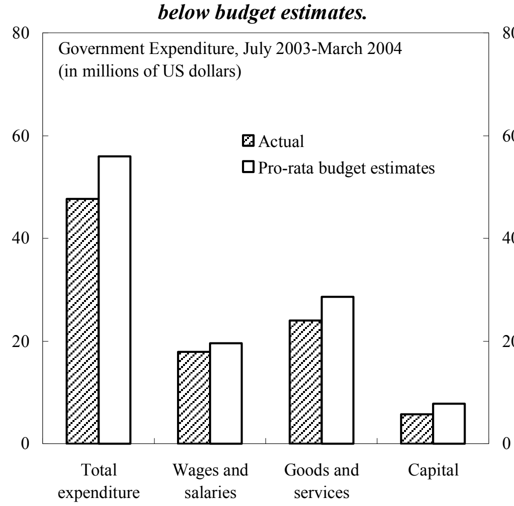
...and the external current account deficit is narrowing, although it remains large.



Revenue collections are significantly higher than budget estimates...



...while expenditures are running below budget estimates.



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

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

	Timor-Leste	East Asia and Pacific island countries	Low income countries
Per capita income (U.S. dollars, 2003)	**415**	1,267	432
Area (in thousands of square kilometers)	**15**	…	…
Demography			
Total population (in thousands)	**825**	1,838,371	2,495,033
Population growth (in percent)	**1.9** 2/	1	2
Life expectancy and mortality			
Life expectancy at birth (years)	**57**	69	59
Male	**56**	68	58
Female	**59**	71	60
Infant mortality (per thousand live births)	**80**	33	81
Male	**88**	…	...
Female	**72**	…	...
Under 5 mortality rate (per thousand live births)	**144**	41	115
Male	**156**	…	...
Female	**132**	…	...
Education			
Illiteracy rate (in percent) 3/	**57**	13	37
Male	**57**	7	28
Female	**57**	18	47
Net primary school enrollment rate (in percent)	**76**	93	74
Health			
Number of hospitals (per thousand)	**0.5**	…	...
Number of doctors (per thousand)	**0.2**	…	...
Number of nurses (per thousand)	**1.4**	…	...
Other indicators			
The population below the poverty line 4/	**41**	29	...
Households with access to electricity 4/	**36**	…	...
Households with access to drinking water 4/	**65**	75	76

Sources: UNDP Human Development Report 2003, World Bank, and Fund staff estimates.

1/ Relate to 2002, unless otherwise indicated.

2/ Average rate for the 1990s.

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

4/ In percentage share of the total.

Table 2. Timor-Leste: Selected Economic Indicators, 1999-2004

	1999	2000	2001	2002	2003	2004
			Est.			Proj.
Output and prices						
GNP at current prices (in millions of U.S. dollars)	270	329	400	397	372	370
GDP	270	321	387	381	341	328
Oil/gas income	0	8	13	17	31	42
Real GDP growth (percentage change)	-35	15	15	3	-3	1
Inflation (percentage change at end-period) 1/2/	140	3	0	10	4	4
			(In percent of GDP)			
Investment-saving balance						
Gross investment 3/	21	33	31	29	27	24
Gross national savings	-13	-53	-47	-43	-32	-21
External savings	34	85	78	73	60	45
Government budget (CFET) 4/						
Revenues	...	7.7	8.1	13.5	17.7	20.4
Domestic revenues	...	4.0	5.3	5.3	8.2	7.0
Oil/gas revenues	...	3.7	2.8	8.2	9.5	13.4
Expenditure	...	14.5	13.7	19.6	22.1	22.8
Recurrent expenditure	...	8.4	10.7	15.6	19.0	19.7
Capital expenditure	...	6.1	3.0	4.0	3.1	3.1
Overall balance	...	-6.8	-5.5	-6.1	-4.4	-2.4
Combined sources fiscal operations 4/5/						
Revenues	...	8	9	15	19	22
Expenditure	...	122	121	105	91	79
Recurrent expenditure	...	96	97	82	72	62
Capital expenditure	...	26	23	22	19	17
Overall balance	...	-114	-111	-90	-72	-56
Money and credit						
Broad money (end-period) 6/	48	6	13	14	21	23
Net domestic assets (end-period)	47	-4	-4	-9	-11	-18
			(In millions of U.S. dollars)			
External sector						
Current account excl. official transfers	-92	-279	-309	-292	-230	-170
Current account incl. official transfers	6	48	54	44	43	40
Trade balance	-67	-235	-264	-245	-195	-158
Merchandise exports 7/8/	52	5	4	6	7	8
Merchandise imports 7/	-119	-240	-268	-251	-203	-167
Overall balance	0	16	8	20	18	17
			(In percent of GDP)			
Current account excl. official transfers	-34	-87	-80	-77	-67	-52
Current account incl. official transfers	2	15	14	12	13	12
Trade balance	-25	-73	-68	-64	-57	-48
Merchandise exports 7/8/	19	2	1	2	2	3
Merchandise imports 7/	-44	-75	-69	-66	-59	-51
Overall balance	0	5	2	5	5	5

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

1/ Rupiah-based CPI for Dili through 2000 and, thereafter, dollar-based CPI for Dili.
2/ The figure for 2004 relates to April.
3/ Excludes investment relating to the oil/gas sector.
4/ On the basis of fiscal year (July-June); for example, 2000 relates to FY2000/01.
5/ Include fiscal and quasi-fiscal expenditure programs undertaken by bilateral donors and international financial institutions outside the central government budget.
6/ Figures after 1999 exclude currency holdings by the public, on which no data are available. The figure for 2004 relates to March.
7/ Figures before 2000 include unrecorded border trade.
8/ Excludes oil/gas revenues, which are recorded under the income account (royalties) and transfers (tax revenues).

Table 3. Timor-Leste: Central Government Budget Operations (CFET), FY2000/01-FY2003/04 1/

	FY2000/01	FY2001/02	FY2002/03	FY2003/04		
				Budget	Revised 2/	Est. 3/
			(In millions of U.S. dollars)			
Revenue	27.1	31.3	48.8	59.8	45.1	59.3
Domestic revenues	14.1	20.5	19.3	17.6	20.3	27.5
Direct taxes	0.6	5.4	5.3	4.7	5.4	6.1
Indirect taxes	11.6	12.7	11.7	10.2	11.8	16.9
Nontax revenues and other	1.9	2.4	2.3	2.7	3.1	4.5
Oil/gas revenues	13.1	10.8	29.5	42.2	24.8	31.8
Tax revenues	9.9	6.5	26.4	29.3	17.1	27.2
Royalties and interest	3.1	4.3	3.1	12.9	7.7	4.6
Royalties	3.0	4.2	3.0	12.3	7.6	4.5
Interest	0.1	0.1	0.1	0.6	0.1	0.1
Expenditure	51.3	52.6	70.8	79.1	74.6	74.1
Recurrent expenditure	29.6	41.1	56.2	66.8	64.2	63.7
Wages and salaries	13.9	18.8	21.9	27.0	26.1	25.6
Goods and services	15.7	22.2	34.3	39.8	38.1	38.1
Capital expenditure	21.7	11.5	14.5	12.3	10.4	10.4
Overall balance	-24.2	-21.3	-22.0	-19.3	-29.5	-14.8
Financing	24.2	21.3	22.0	19.3	29.6	14.8
Grants 4/	31.6	22.7	32.5	28.0	33.8	35.6
Changes in CFET cash balances (increase -)	-4.2	2.7	-8.6	4.2	3.5	-16.2
Oil/gas revenue savings (increase -) 5/	-3.1	-4.3	-3.1	-12.9	-7.7	-4.6
Other	-0.1	0.2	1.1	0.0	0.0	0.0
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0
			(In percent of GDP)			
Revenue	7.7	8.1	13.5	18.0	13.5	17.7
Domestic revenues	4.0	5.3	5.3	5.3	6.1	8.2
Oil/gas revenues	3.7	2.8	8.2	12.7	7.4	9.5
O/w: Tax revenues	2.8	1.7	7.3	8.8	5.1	8.1
Expenditure	14.5	13.7	19.6	23.9	22.3	22.2
Recurrent expenditure	8.4	10.7	15.6	20.1	19.2	19.0
Capital expenditure	6.1	3.0	4.0	3.7	3.1	3.1
Overall balance	-6.8	-5.5	-6.1	-5.8	-8.8	-4.4
Financing	6.8	5.5	6.1	5.8	8.8	4.4
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0
			(In millions of U.S. dollars unless otherwise indicated)			
Memorandum items:						
Cumulative oil/gas savings (end-period)	3.1	7.4	10.5	22.4	18.3	15.1
(In percent of recurrent expenditure)	10.6	18.1	18.7	33.6	28.4	23.8
CFET cash balances (end-period) 6/	8.9	6.3	14.8	6.0	11.3	31.0
Appropriations to the power authority	8.4	6.7	8.4	6.8	6.8	6.8
Non-oil overall fiscal balance	-37.3	-32.0	-51.4	-61.5	-54.3	-46.6
(In percent of GDP)	-10.5	-8.3	-14.3	-18.6	-16.2	-13.9

Sources: Data provided by the Timor-Leste authorities; and Fund staff estimates.
1/ Fiscal year: July-June.
2/ Revised estimates made during the mid-year budget review (November 2003).
3/ Staff estimates based on the actual outcome through March 2004.
4/ In the official presentation, grants are shown "below the line" to highlight the amount of donor assistance required to close financing gaps.
5/ Under the current oil/gas saving policy, royalties and interest income are automatically saved and only tax revenues are available for budget financing.
6/ The budge estimate for FY2003/04 was derived on the basis of CFET cash balances ($10.2 million) projected during the 2002 mid-year budget review.

Table 4. Timor-Leste: Central Government Budget Estimates (CFET), FY2004/05-FY2007/08 1/

	FY2003/04	FY2004/05	FY2005/06	FY2006/07	FY2007/08	Memorandum items: FY2004/05	FY2005/06	FY2006/07
	Est.	Budget estimates 2/				2003 MYBR estimates 3/		
				(In millions of U.S. dollars)				
Revenue	59.3	67.2	86.4	110.7	103.9	48.6	54.6	78.1
Domestic revenues	27.5	23.0	23.8	25.0	26.6	20.0	20.5	21.2
Direct taxes	6.1	5.4	5.5	5.6	6.0	5.2	5.2	5.2
Indirect taxes	16.9	13.6	13.9	14.7	15.4	11.3	11.6	11.7
Nontax revenues and other	4.5	4.0	4.4	4.7	5.2	3.5	3.8	4.3
Oil/gas revenues	31.8	44.2	62.6	85.7	77.3	28.6	34.1	56.9
Tax revenues	27.2	18.3	35.2	56.4	47.7	9.7	7.7	28.8
Royalties and interest	4.6	25.8	27.4	29.3	29.7	18.9	26.4	28.1
Royalties	4.5	25.5	26.1	26.9	25.9	18.5	25.5	26.3
Interest	0.1	0.3	1.3	2.4	3.7	0.4	0.9	1.8
Expenditure	74.1	75.1	78.9	81.9	84.2	83.2	88.0	96.0
Recurrent expenditure	63.7	64.9	66.8	68.9	70.3	69.7	72.9	77.1
Wages and salaries	25.6	28.2	28.9	29.5	30.0	28.4	29.8	30.6
Goods and services	38.1	36.7	37.9	39.4	40.3	41.2	43.1	46.5
Capital expenditure	10.4	10.2	12.1	12.9	13.9	13.5	15.2	18.9
Overall balance	-14.8	-7.9	7.5	28.8	19.7	-34.6	-33.4	-17.9
Financing	14.8	7.9	-27.4	-29.3	-29.7	14.1	-26.4	-28.1
Grants 4/	35.6	30.8	0.0	0.0	0.0	29.2	0.0	0.0
Changes in CFET cash balances (increase -)	-16.2	3.0	0.0	0.0	0.0	3.8	0.0	0.0
Oil/gas revenue savings (increase -) 2/	-4.6	-25.8	-27.4	-29.3	-29.7	-18.9	-26.4	-28.1
Financing gap	0.0	0.0	19.9	0.5	9.9	20.5	59.8	46.0
				(In percent of GDP)				
Revenue	17.7	20.4	25.3	30.3	26.0	14.7	16.0	21.4
Domestic revenues	8.2	7.0	7.0	6.8	6.7	6.1	6.0	5.8
Oil/gas revenues	9.5	13.4	18.4	23.5	19.3	8.7	10.0	15.6
O/w: Tax revenues	8.1	5.6	10.3	15.4	11.9	2.9	2.3	7.9
Expenditure	22.2	22.8	23.1	22.4	21.0	25.2	25.8	26.3
Recurrent expenditure	19.0	19.7	19.6	18.9	17.6	21.1	21.4	21.1
Wages and salaries	7.6	8.5	8.5	8.1	7.5	8.6	8.7	8.4
Goods and services	11.4	11.1	11.1	10.8	10.1	12.5	12.6	12.7
Capital expenditure	3.1	3.1	3.5	3.5	3.5	4.1	4.4	5.2
Overall balance	-4.4	-2.4	2.2	7.9	4.9	-10.5	-9.8	-4.9
Financing	4.4	2.4	-8.0	-8.0	-7.4	4.3	-7.7	-7.7
Financing gap	0.0	0.0	5.8	0.1	2.5	6.2	17.5	12.6
				(In millions of U.S. dollars unless otherwise indicated)				
Memorandum items:								
Cumulative oil/gas savings (end-period)	15.1	41.0	68.4	97.6	127.3	37.1	63.6	91.6
(In percent of recurrent expenditure)	23.8	63.1	102.3	141.7	181.0	53.3	87.3	118.8
CFET cash balances	31.0	28.0	28.0	28.0	28.0	7.6	7.6	7.6
Appropriations to the power authority	6.8	5.7	4.1	3.4	3.1	5.2	3.6	3.0
Non-oil overall fiscal balance	-46.6	-52.1	-55.1	-56.9	-57.6	-63.2	-67.5	-74.8
(In percent of GDP)	-13.9	-15.8	-16.2	-15.6	-14.4	-19.2	-19.8	-20.5

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

1/ Fiscal year: July-June.

2/ Assumes the maintenance of the current oil/gas saving policy under which royalties and interest income are automatically saved and only tax revenues are available for budget financing.

3/ Estimates made during the November 2003 mid-year budget review.

4/ In the official presentation, grants are shown "below the line" to highlight the amount of donor assistance required to close financing gaps.

Table 5. Timor-Leste: Combined Sources Fiscal Operations, FY2000/01-FY2004/05 1/

	FY2000/01	FY2001/02	FY2002/03	2003/04	FY2004/05
		Est.			Proj.
	(In millions of U.S. dollars)				
Revenue	29	36	54	65	74
CFET	27	31	49	59	67
Autonomous agencies	1	4	5	6	7
Total expenditure	432	463	378	305	260
CFET 2/	43	46	62	67	75
Non-CFET	389	417	317	238	185
Autonomous agencies	9	9	11	15	16
TFET	47	46	25	20	20
Bilateral	139	161	153	126	100
UNTAET/UNMISET 3/	194	201	128	77	49
Recurrent expenditure 4/	340	374	297	241	203
CFET 2/	22	35	47	56	63
Non-CFET	318	339	250	184	140
Autonomous agencies	8	8	9	13	15
TFET	24	23	12	10	10
Bilateral	92	106	101	84	66
UNTAET/UNMISET 3/	194	201	128	77	49
Capital expenditure	92	89	81	65	57
CFET 2/	21	11	15	11	12
Non-CFET	71	78	66	54	45
Autonomous agencies	1	1	2	1	1
TFET	23	23	12	10	10
Bilateral	47	55	52	43	34
UNTAET/UNMISET 3/	0	0	0	0	0
Overall balance	-403	-428	-324	-241	-186
Financing	403	428	324	241	186
CFET 2/	23	19	19	17	17
Non-CFET	380	408	305	224	169
TFET	47	46	25	20	20
Bilateral	139	161	153	126	100
UNTAET/UNMISET 3/	194	201	128	77	49
	(In percent of GDP)				
Revenue	8	9	15	19	22
Total expenditure	122	121	105	91	79
CFET 2/	12	12	17	20	23
Non-CFET	110	109	88	71	56
Recurrent expenditure 4/	96	97	82	72	62
CFET 2/	6	9	13	17	19
Non-CFET	90	88	69	55	43
Capital expenditure	26	23	22	19	17
CFET	6	3	4	3	4
Non-CFET	20	20	18	16	14
Overall balance	-114	-111	-90	-72	-56
Financing	114	111	90	72	56
CFET	7	5	5	5	5
Non-CFET	107	106	85	67	51

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

1/ Include expenditure programs undertaken by bilateral donors, UNTAET/UNMISET, and international financial institutions outside the central government budget. The coverage of UNTAET/UNMISET operations differs from the official budget presentation.

2/ Net of CFET budget transfers to autonomous agencies.

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

4/ Includes technical assistance.

Table 6. Timor-Leste: Monetary Developments, 2000-2004

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

	2000	2001	2002	2003				2004
	Dec.	Dec.	Dec.	Mar.	June	Sept.	Dec.	March
Banking System								
Net foreign assets	33.8	65.4	89.9	92.8	99.7	103.1	108.3	133.7
Assets	33.8	72.9	93.3	97.0	104.7	106.0	141.6	154.1
Cash holdings	6.3	11.7	18.1	15.1	10.5	15.3	19.0	28.6
Claims on foreign banks	27.5	61.2	75.3	81.9	94.1	90.7	122.6	125.6
Liabilities	0.0	7.5	3.5	4.2	5.0	2.9	33.3	20.4
Net domestic assets	-13.8	-14.3	-35.3	-38.4	-41.9	-37.6	-36.0	-58.7
Claims on government (net)	-19.0	-21.1	-33.7	-36.3	-41.5	-28.3	-49.7	-74.3
Claims on private sector	0.3	3.0	5.1	6.1	7.8	12.6	22.1	32.4
Other items (net)	4.9	3.8	-6.7	-8.1	-8.2	-21.9	-8.4	-16.8
Broad money 1/	20.0	51.1	54.6	54.4	57.7	65.5	72.3	75.0
Demand deposits	19.3	36.9	39.1	37.5	39.2	43.1	40.1	44.0
Saving deposits	0.0	8.2	10.2	11.7	13.7	16.6	22.6	25.1
Time deposits	0.7	6.0	5.3	5.2	4.9	5.8	9.6	6.0
BPA								
Net foreign assets	16.0	23.7	43.5	46.3	51.4	42.3	61.3	86.8
Assets	16.0	23.7	43.5	46.3	51.4	42.3	61.3	86.8
Cash in vault	1.3	4.9	13.0	12.2	7.7	10.1	6.9	20.4
Claims on central banks	14.7	18.8	30.5	34.1	43.6	32.1	54.4	66.4
Liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net domestic assets	-16.0	-22.7	-39.1	-42.3	-46.6	-34.8	-55.0	-80.9
Government (net position)	-19.0	-21.1	-33.7	-36.3	-41.5	-28.3	-49.7	-74.3
Claims on domestic banks	3.0	3.5	2.4	1.7	2.1	1.6	3.4	2.5
Other items (net)	0.0	-5.0	-7.8	-7.7	-7.2	-8.1	-8.8	-9.2
Liabilities	0.0	1.0	4.5	4.0	4.8	7.5	6.3	5.9
Financial institutions	0.0	1.0	4.5	4.0	4.8	7.5	6.3	5.9
Private enterprises	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks 2/								
Net foreign assets	17.8	41.7	46.4	46.5	48.3	60.8	47.0	47.0
Assets	17.8	49.2	49.8	50.7	53.3	63.7	80.3	67.4
Cash holdings	5.0	6.8	5.0	2.9	2.8	5.2	12.1	8.2
Claims on foreign banks	12.8	42.4	44.8	47.8	50.5	58.5	68.2	59.2
Liabilities	0.0	7.5	3.5	4.2	5.0	2.9	33.3	20.4
Net domestic assets	5.2	12.9	10.7	9.7	11.5	6.2	28.8	30.6
Deposits with BPA	0.0	1.0	4.5	4.0	4.8	7.5	6.3	5.9
Claims on government (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Claims on private sector	0.3	3.0	5.1	6.1	7.8	12.6	22.1	32.4
Other items (net)	4.9	8.9	1.1	-0.4	-1.1	-13.9	0.4	-7.7
Deposit liabilities	20.0	51.1	54.6	54.4	57.7	65.5	72.3	75.0
Current deposits	19.3	36.9	39.1	37.5	39.2	43.1	40.1	44.0
Saving deposits	0.0	8.2	10.2	11.7	13.7	16.6	22.6	25.1
Time deposits	0.7	6.0	5.3	5.2	4.9	5.8	9.6	6.0
Liabilities to BPA	3.0	3.5	2.4	1.7	2.1	1.6	3.4	2.5

Sources: Data provided by the Banking and Payments Authority; and Fund staff estimates.

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

2/ Includes the micro-finance institution.

Table 7. Timor-Leste: Balance of Payments, 1999-2004

	1999	2000	2001	2002	2003	2004
			Est.			Proj.
			(In millions of U.S. dollars)			
Current account excl. official transfers	-92	-279	-309	-292	-230	-170
Current account incl. official transfers	6	48	54	44	43	40
Trade balance	-67	-235	-264	-245	-195	-158
Exports of goods 1/2/	52	5	4	6	7	8
O/w: Coffee	...	4	3	5	6	6
Imports of goods 1/	-119	-240	-268	-251	-203	-167
O/w: International assistance-related	-58	-125	-129	-126	-104	-84
Services (net)	-25	-48	-49	-48	-40	-32
Income (net)	0	3	5	1	6	20
O/w: Oil/gas royalty and interest	0	3	4	0	4	19
Current transfers (net)	98	327	363	336	273	210
O/w: Oil/gas tax revenues	0	5	8	16	27	24
International assistance	43	315	347	314	240	181
Capital and financial accounts	-3	-54	-61	-36	-16	-23
Official capital transfers	0	71	74	71	58	48
Financial accounts	-3	-125	-134	-107	-74	-71
Errors and omissions (net)	-3	23	14	12	-10	0
Overall balance	0	16	8	20	18	17
Changes in foreign assets (increase -)	0	-16	-8	-20	-18	-17
Oil/gas revenue savings (increase -)	0	-3	-4	0	-3	-19
Other	0	-13	-3	-20	-15	2
			(In percent of GDP)			
Current account excl. official transfers	-34	-87	-80	-77	-67	-52
Current account incl. official transfers	2	15	14	12	13	12
Trade balance	-25	-73	-68	-64	-57	-48
			(In millions of U.S. dollars)			
Memorandum items:						
Oil/gas revenues	0	8	13	17	31	42
Gross foreign assets (end-period)	0	16	24	44	61	78
O/w: Oil/gas revenue savings	0	3	7	7	11	29

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

1/ Figures before 2000 include unrecorded border trade.

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

Table 8. Timor-Leste: Medium-Term Outlook, 2003-2008

	2003	2004	2005	2006	2007	2008
	Est.			Proj.		
Output and prices						
GNP at current prices (in millions of US dollars)	372	370	391	438	478	523
GDP	341	328	332	350	380	420
Oil/gas income	31	42	59	88	97	103
Real GDP growth (percentage change)	-3	1	1	2	4	5
Inflation (percentage change at end-period) 1/2/	4	4	3	3	3	3
			(In percent of GDP)			
Investment-saving balance						
Gross investment 3/	27	24	23	21	20	20
O/w: Public investment	21	18	16	13	12	11
Gross national savings	-32	-21	-9	3	7	10
External savings	60	45	32	18	13	10
Government budget (CFET) 4/						
Revenues	17.7	20.4	25.3	30.3	26.0	32.3
Domestic revenues	8.2	7.0	7.0	6.8	6.7	6.8
Oil/gas revenues	9.5	13.4	18.4	23.4	19.3	25.5
Expenditure	22.1	22.8	23.1	22.4	21.1	20.3
Recurrent expenditure	19.0	19.7	19.6	18.9	17.6	16.7
Capital expenditure	3.1	3.1	3.5	3.5	3.5	3.6
Overall balance	-4.4	-2.4	2.2	7.9	4.9	12.0
Combined sources fiscal operations 4/5/						
Revenues	19	22	28	33	28	35
Expenditure	91	79	69	62	59	49
Recurrent expenditure	72	62	54	49	45	39
Capital expenditure	19	17	16	13	14	11
Overall balance	-72	-56	-42	-29	-30	-15
Money and credit						
Broad money (end-period) 6/7/	21	23	…	…	…	…
Net domestic assets (end-period) 7/	-11	-18	…	…	…	…
			(In millions of U.S. dollars)			
External sector						
Current account excl. official transfers	-230	-170	-132	-116	-109	-106
Current account incl. official transfers	43	40	29	37	44	45
Trade balance	-195	-158	-137	-128	-125	-126
Merchandise exports 8/	7	8	10	13	14	14
Merchandise imports	-203	-167	-148	-140	-138	-140
Overall balance	18	17	17	28	29	41
			(In percent of GDP)			
Current account excl. official transfers	-67	-52	-40	-33	-29	-25
Current account incl. official transfers	13	12	9	11	12	11
Trade balance	-57	-48	-41	-36	-33	-30
Merchandise exports 8/	2	3	3	4	4	3
Merchandise imports	-59	-51	-45	-40	-36	-33
Overall balance	5	5	5	8	8	10

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

1/ U.S. dollar-based CPI for Dili.
2/ The figure for 2004 relates to April.
3/ Excludes investment relating to the oil/gas sector.
4/ On the basis of fiscal year (July-June); for example, 2003 relates to FY2003/04.
5/ Include fiscal and quasi-fiscal expenditure programs undertaken by bilateral donors and international financial institutions outside the central government budget.
6/ Excludes currency holdings by the public, on which no data are available.
7/ The figure for 2004 relates to March.
8/ Excludes oil/gas revenues, which are recorded under the income account (royalties) and transfers (tax revenues).

TIMOR-LESTE: FUND RELATIONS
(As of April 30, 2004)

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

II. General Resources Account:

	SDR Million	% Quota
Quota	8.20	100.00
Fund holdings of currency	8.20	100.00
Reserve position in Fund	0.00	0.00

III. SDR Department:

Net cumulative allocation	None
Holdings	None

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund: None

VII. Exchange Rate Arrangements

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

VIII. Article IV Consultations

The first, 2003 Article IV consultation discussions with the authorities were held during April 2-15, 2003. The Executive Board discussed the staff report (SM/03/224, 06/30/03) and concluded the consultation on July 14, 2003.

IX. Technical Assistance

Since late 1999, a significant amount of technical assistance has been provided by the Fund as part of the international community's efforts to reconstruct the Timor-Leste economy in the aftermath of the widespread violence and destruction that followed the August 1999 referendum. The Fund's technical assistance has focused on establishing key economic institutions (especially fiscal and monetary authorities) essential for macroeconomic management, as well as on developing local capacity to manage them. It also played a key role in the adoption of a new currency arrangement based on the U.S. dollar. Between late 1999 and early 2004, numerous technical assistance missions (including staff visits) took place, making Timor-Leste one of the largest recipients of Fund technical assistance.

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

LEG: A number of LEG missions have taken place to advise the authorities on key fiscal and financial legislation. These included the customs law and directives, income tax legislation, the budget and financial management law, and banking regulations (relating to the monetary authority, the banking system, and the payments system). Technical assistance has recently been provided to assist the authorities in drafting an AML/CFT Law.

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

STA: A multi-sector statistical mission took place in November 2000 to assess the availability of official macroeconomic data and their quality, and help establish the Statistic Division of the Ministry of Economic Affairs and Development. A long-term statistical advisor was assigned between November 2001 and February 2004 to assist the authorities in improving data compilation and developing local capacity.

X. Resident Representative

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

TIMOR-LESTE: RELATIONS WITH THE WORLD BANK GROUP
(As of April 30, 2004)

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

2. During the transition to independence, the World Bank's involvement centered around its role as a trustee and co-manager of the Trust Fund for East Timor (TFET), which was established in December 1999 as a vehicle to provide grant assistance for reconstruction activities and economic development in Timor-Leste.[1] Under the TFET, which is co-managed with the Asian Development Bank (AsDB), the World Bank has administered projects relating to social services (especially, health and education), agriculture, private sector development, and economic capacity building. Total funding for the World Bank-administered projects reached $115 million, of which $78 million was disbursed by end-January 2004. The World Bank has also provided analytical and advisory services, including through a Country Economic Memorandum, a Poverty Assessment Paper, a Public Expenditure Management and Accountability Note, and an Education Sector Review.

3. In addition to its involvement through the TFET, the World Bank has also been playing a key role in mobilizing budgetary assistance for the post-independence period, before the inflow of substantial oil/gas revenues starts. As an initial step for such assistance, the World Bank Board approved the first Transition Support Program I (TSP I, $5 million grant in support of the FY2002/03 budget) in July 2002, focusing on fostering the development of institutions, a legislative framework, and management systems required for core government functions. Following TSP I, the second Transition Support Program (TSP II, $4 million grant in support of the FY2002/03 budget) was approved in July 2003 to assist the authorities in strengthening public expenditure management, improving the delivery of key social services (especially, education and health), fostering private sector development, and developing a legal framework for governance and the judiciary. The TSPs

[1] Pledges to the TFET were made by 12 donor countries, the European Commission, and the World Bank, with the total amount of funds reaching $177 million. This comprises donors' contributions of $169 million (including $10 million by the World Bank) and investment income of $8 million. Of this total, $131 million was disbursed by end-March 2004. TFET projects are expected to wind down by mid-2006.

have been used as a unifying framework for donors' budget support, mobilizing $33 million in FY2002/03 and $35 million (estimate) in FY2003/04 from 10 bilateral donors.[2]

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

[2] These bilateral donors consist of Australia, Canada, Finland, Ireland, New Zealand, Norway, Portugal, Sweden, the United Kingdom, and the United States. In addition, People's Republic of China, Japan, Malaysia, the Asian Development Bank, UNMISET, UNDP, and UNICEF have been providing technical assistance in support of the TSPs.

TIMOR-LESTE: RELATIONS WITH THE ASIAN DEVELOPMENT BANK
(As of April 30, 2004)

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

2. The AsDB's involvement has centered around co-managing with the World Bank the Trust Fund for East Timor (TFET), which was established in December 1999 as a vehicle to provide grant assistance for reconstruction activities and economic development in Timor-Leste.[1] Under the TFET, the AsDB has managed six projects with total funding of $53 million,[2] which aimed at the rehabilitation of physical infrastructure (rural power, rural roads, ports, and water and sanitation) and the development of microfinance. In the wake of the post-referendum destruction, the focus of the projects was on providing emergency assistance, but subsequently shifted to meeting the country's long-term development needs. At end-December 2003, disbursements for AsDB-managed projects totaled $45 million. Most projects are expected to be completed by end-2004.

3. The AsDB has also been actively involved in technical assistance. Thus far, the AsDB has approved 21 technical assistance programs totaling $9.2 million. Most technical assistance programs have been undertaken in parallel with the implementation of the TFET-funded projects, focusing on project preparation and sector-specific capacity/institution building essential for project implementation. The latter includes the development of regulatory and legislative frameworks, the analysis of sectoral policy issues, poverty assessment and statistics, and strategies for economic and social development and planning. As of end-December 2003, 13 technical assistance programs were completed and 8 programs were still going on.

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

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

TIMOR-LESTE: STATISTICAL ISSUES

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

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

To this end, a multi-sector Fund statistics mission visited Dili in November 2000 and assisted the authorities in establishing short- and long-term objectives for the restoration of economic statistics and in setting up a Statistical Office with the Ministry of Economic Affairs and Development in 2001, which was transformed to the Statistical Division of the Ministry of Planning and Finance in 2002. Also, a long-term resident statistical advisor was attached to the Statistical Division during November 2001–Februray 2004 to lay a basis for compilation of macroeconomic data while developing local capacity. Nonetheless, progress in data compilation has been slow, constrained by the nascent institutional capacity, and macroeconomic data remain very weak in terms of availability, coverage, and quality.

National accounts

No official national accounts statistics are available at present, mainly because of the lack of sectoral data. Under a World Bank-financed project, national accounts data for 2000 (both sectoral and expenditure basis) were estimated by the Boston Institute for Developing Economies. Also, Fund staff have produced estimates for 1999–2003 on the basis of information obtained during various staff visits, as well as the 2003 Article IV consultation mission. These estimates, however, are highly preliminary, and there is an urgent need to collect sectoral data as an initial step toward the compilation of official national accounts data. To improve national accounts data, a follow-up World Bank-financed project is to be initiated to produce estimates for 2001 and 2002.

Prices, employment, and wages

Following the disturbances of 1999, a consumer price index was compiled on a monthly basis for Dili and on a quarterly basis for the whole of Timor-Leste, with April 2000 as a base period. However, the price index suffered from a number of problems, including its weighting scheme, which was based on a household expenditure survey conducted by the

BPS for Jakarta. To address the problems, the commodity basket and the weighting scheme were revised in mid-2003 under a donor-supported project to better reflect the expenditure composition of households, and a new monthly consumer price index for Dili has been compiled, with December 2001 as a base period. Data on public sector employment and wages are available on an annual basis through fiscal data. However, no data are compiled on private sector employment and wages, although some partial data are available through household surveys conducted jointly by the UNDP, AsDB, and World Bank.

Government financial statistics

Official data on the central government's revenues and expenditures are published on an annual and semi-annual basis as part of the budget preparation and review process. In addition, monthly data are available on request (mainly in connection with missions' visits) through the Budget Department of the Ministry of Finance, the Treasury, and the Revenue Services of Timor-Leste. The compilation of revenues and expenditures follows *A Manual on Government Finance Statistics (GFSM 1986)* classification (including expenditure data on the basis of both functional and economic classification), and steps need to be taken in order to compile the data on the basis of the *Government Finance Statistical Manual 2001 (GFSM 2001)*. However, data on financing are incomplete and are estimated by Fund staff on the basis of various sources. Only limited data are available on fiscal and quasi-fiscal activities undertaken by bilateral donors and special funds established for economic reconstruction outside the central government budget (e.g., the Trust Fund for East Timor). At present, there are three nonfinancial public enterprises, and only partial data are available on their operations. No data are currently reported for the *GFS Yearbook* and the *International Financial Statistics*.

Monetary accounts

Monetary statistics on the banking system are compiled by the Banking and Payments Authority (BPA), generally following the classification recommended by the Fund. However, monetary survey data are incomplete because of the absence of official data on currency holdings by the public, which are difficult to compile under the current currency regime. Statistics on key monetary aggregates are now published on a quarterly basis through the BPA's quarterly bulletin and on a yearly basis through the BPA's annual report. Monetary data with a detailed breakdown are also available on a monthly basis, but only on request. Compilation of data on interest rates (both deposit and lending rates) and bank lending and investment in a comprehensive manner has begun only recently. However, the availability of these data is extremely limited because the BPA is concerned that their public release will reveal confidential information concerning commercial bank operations (especially with regard to lending) given a very small number (only three) of banks comprising the banking system. No monetary data are currently reported to STA for publication in the *International Financial Statistics*.

Balance of payments

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

Timor-Leste: Reporting of Main Statistical Indicators[1]
(As of May 31, 2004)

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

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

TIMOR-LESTE: LONG-TERM FISCAL STRATEGY

1. Given a substantial amount of oil/gas revenues expected to flow into Timor-Leste over the next 20 years, a central fiscal issue facing the authorities is what would be an appropriate level of government expenditure over the long term. One way to address this issue would be to view the adequacy of financing as a key determinant.[1] Given this approach, the appropriateness of government expenditure depends critically on three factors in the case of Timor-Leste. These are (i) saving policy regarding oil/gas wealth, (ii) prospective developments in non-oil/gas revenues, and (iii) borrowing policy.

2. **This annex develops an illustrative scenario concerning these factors to derive an appropriate level of government expenditure over the long term**. This will be followed by discussion of a scenario concerning the composition of government expenditure, which will address an adequate level of government capital expenditures to meet growth objectives. These scenarios relate primarily to the "oil/gas period" over which oil/gas production continues.

Saving policy for oil/gas wealth

3. **Given growing oil/gas revenues, the level of central government expenditure depends critically on Timor-Leste's decision as to how much of oil/gas wealth should be saved in financial assets for future generations**. This decision can be alternatively phrased as how much of oil/gas wealth should be invested in "physical" assets (namely, investment in projects to improve physical infrastructure and human capital).[2]

[1] Alternatively, the appropriateness of government expenditure may be assessed in terms of maintaining macroeconomic stability, especially to avoid the Dutch disease. This approach is not adopted in the scenario presented below because it requires a comprehensive macroeconomic analysis (particularly with regard to impacts of government expenditure not only on the overall price level, but also on relative prices between traded and nontraded goods) and is therefore less practical for policy discussions. However, the importance of macroeconomic stability is addressed indirectly as the scenario calls for a relatively small amount of oil/gas wealth to be drawn down for fiscal programs over the long term.

[2] Return on financial assets takes the form of interest income, while return on "physical" assets will be given by the form of increased output, including through improvement in productivity of factors of production. Generally speaking, how oil/gas wealth should be held depends on the expected relative rate of return between financial and "physical" assets. In general, the greater the potential contribution of investment in physical assets to improvement in productivity (and economic growth), the smaller should be the share of oil/wealth held in financial assets. In practice, however, it is difficult to measure the rate of return on "physical" assets, and a decision regarding oil/gas wealth savings should rely heavily on judgmental factors.

4. **Various saving policies are available for the authorities' considerations**. Among them are:

- **Saving of entire oil/gas wealth in financial assets**: This saving policy aims at preserving all of oil/gas wealth (in real terms) in financial assets. Under this policy, financial resources available for the government to finance budget deficits would be limited to the real interest income generated from oil/gas wealth, so as to avoid any drawdown of oil/gas wealth in real terms.

- **Saving of oil/gas wealth in financial assets on a per capita basis**: Oil/gas wealth might be entirely saved in financial assets and maintained constant (in real terms) on a per capita basis. Under this policy, part of the real interest income would need to be saved to ensure that real oil/gas wealth increases over time in line with population growth.

- **Partial drawdown of oil/gas wealth**: This saving policy permits part of oil/gas wealth (in real terms) to be invested in "physical" assets. Under this policy, the amount of oil/gas revenues available for budget financing depends crucially on how much of oil/gas wealth would be permitted to be drawn down.[3]

5. **In Timor-Leste's context, there are three considerations that should be taken into account in deciding what type of saving policy to be adopted**. These are:

- **Need to strengthen the country's growth prospects to alleviate poverty**: The attainment of this objective would require the adequate provision of government services, especially to improve infrastructure and human capital, toward the growth objective set by the National Development Plan (5 percent per year over the long term).

- **Need to secure appropriate funding for budgetary expenditures during the post-oil/gas period**: After oil/gas resources are depleted, budgetary expenditures would have to be funded through domestic revenues and interest income from oil/gas savings, provided that the borrowing option is excluded (¶8). An excessively low

[3] Each oil/gas saving policy implies a different decision regarding inter-generational distribution of oil/gas wealth. Among the three different oil/gas saving policies mentioned above, the third saving policy favors the current generation most, while the second saving policy ensures benefits of oil/gas wealth are fully passed on to future generations. The first saving policy could be viewed as relatively neutral in terms of inter-generational distribution of oil/gas wealth.

level of oil/gas savings would result in a low level of interest income and necessitate substantial fiscal adjustments during the post-oil/gas period.[4]

- **Prospects of absorption capacity**: A critical factor affecting the rate of return on "physical" assets is the government's capacity to carry out investment programs for infrastructure and human capital productively. Caution is necessary in embarking on large-scale public investment programs if the governments' absorption capacity is limited.

6. **Against this background, the scenario assumes that Timor-Leste opts for drawing down a portion of oil/gas wealth in real terms during the oil/gas period to fund public investment programs**. However, the amount of oil/gas wealth invested in "physical" assets is limited to a relatively modest portion—about 15 percent of the total—with the remainder held in financial assets for future generations (Figure 1-b).[5] This reflects uncertainty about the government's capacity to execute investment programs productively, as well as the need to avoid major fiscal adjustment during the post-oil/gas period. Under this saving policy, the stock of oil/gas savings held in financial assets at the end of the oil/gas period would reach $1.3 billion in terms of real present value.

Non-oil/gas revenues

7. **Non-oil/gas revenues are assumed to increase from 7 percent of GDP in FY2004/05 to 10 percent of GDP by FY2024/25 (the end-year of the oil/gas period)**. The profile of the non-oil/gas revenues/GDP is rather conservative compared with the revenue/GDP ratios that are observed in other developing countries. However, the assumed increase in the non-oil/gas revenue/GDP ratio would require (i) substantial improvements in Timor-Leste's capacity for tax administration following the full winding-down of international technical assistance for the Revenue Service of Timor-Leste and (ii) increased

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[4] It should be stressed that whichever saving policy might be adopted, interest income from oil/gas savings would fall steadily in relation to GDP during the post-oil/gas period, unless the real rate of interest exceeds the real rate of economic growth significantly. This means that expenditure in relation to GDP should be adjusted downward steadily to the non-oil/gas revenues/GDP ratio, or steps should be taken to mobilize additional non-oil/gas revenues if expenditure is to be maintained in relation to GDP. Without these adjustments, further draw-downs of oil/gas wealth would be necessary, leading to an eventual depletion of oil/gas wealth. The extent of fiscal adjustment required would be smaller, the larger the size of oil/gas savings at the end of the oil/gas period.

[5] Under the scenario which was discussed with the authorities during the 2003 Article IV consultation, about one-third of oil/gas wealth was proposed to be drawn down to fund government expenditures. The reduction in the size of oil/gas wealth to be drawn down reflects greater uncertainty over progress in Timor-Leste's absorption capacity.

efforts to mobilize additional non-oil/gas revenues during the course of the next 20 years. Such revenue mobilization efforts would include tax reforms aimed at broadening the tax base (e.g., the introduction of VAT), as well as a steady improvement in compliance. These reform measures are assumed to be taken gradually during the second half of the next 20-year time span.

Borrowing

8. **The authorities continue to avoid borrowing for budget financing**. This implies that (i) they remain cautious about external borrowing and (ii) the current monetary and exchange rate regime is maintained, with the banking system providing no financing for budgetary operations.

Appropriate level of government expenditure

9. **Simulation exercises based on these scenarios concerning oil/gas saving policy, prospective developments in non-oil/gas revenues, and borrowing policy suggest that CFET expenditure during the oil/gas period might be maintained at around 21 percent of GDP, on average** (Figure 1-a). This estimate is conditional on prospective developments in oil prices and the rate of return on financial assets, which would affect the size of oil/gas wealth and streams of interest income. In the scenario, it is assumed that (i) the rate of return on financial assets would be sustained at 3.5 percent in real terms,[6] and (ii) international oil prices would average $20 per barrel at 2002/03 prices.

10. **The level of CFET expenditure is sensitive to the assumptions on non-oil/gas revenues, the rate of interest, and the size of oil/gas wealth**. A sensitivity analysis indicates that CFET expenditure should be lowered by about 1-2 percent of GDP, on average, in order to limit the drawdown of oil/gas wealth to 15 percent, if one of the following alternative assumptions is made to these parameters: (i) non-oil gas revenues in relation to GDP remain unchanged at the FY2007/08 level during the oil/gas period; (ii) the average rate of interest is lower by one percentage point compared with the central scenario; and (iii) oil/gas revenues beyond FY2007/08 are 10 percent lower than projected.

Expenditure composition

11. **Given the appropriate level of central government expenditure, another key fiscal issue that has to be addressed by the authorities is expenditure composition**. This issue relates to the need to ensure an adequate amount of capital expenditures toward the achievement of the growth target, while funding necessary recurrent expenditures. The composition of central government expenditure will be affected by the following factors.

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[6] This rate is close to the average real rate of return on U.S. long-term government bonds over the past 10 years.

- **Total investment**: The National Development Plan envisages that economic growth would accelerate to 5 percent over the long term. The extent to which this growth target would be achieved depends importantly on the size of investment. On the basis of a scenario concerning the incremental capital output ratio (ICOR), total investment needs to be sustained at about 22 percent of GDP over the long term in order to meet the targeted growth rate (Figure 2-b).[7]

- **Private investment**: Private investment is assumed to increase from 7 percent of GDP in 2004 to 14 percent of GDP by 2024. The achievement of this increase would require strong measures to promote private investment. Such measures include actions to improve physical and human capital, establish a legal and regulatory framework, and maintain a liberal trade and investment regime. The latter will be essential to attract foreign investment in those sectors that have high potential for growth, including tourism.

- **Public investment and donor-funded capital projects**: Given the expansion in private investment and overall investment requirements, public investment is projected to decline from 18 percent in 2004 to 8 percent by 2024. The decline is consistent with an expected winding-down of capital projects undertaken by bilateral donors and multilateral institutions (non-CFET capital expenditures) over the coming years. Such capital projects are assumed to decline from 14 percent of GDP in 2004 to nil by 2024.

12. **On the basis of the scenarios regarding public investment and donor-funded capital projects, central government capital expenditures would have to increase from 3 percent of GDP in FY2004/05 to 8 percent of GDP in FY2024/25**. The increase is rather modest, reflecting an assumption that the government's absorption capacity would improve only gradually. To accommodate the increase in capital expenditures with overall expenditure, recurrent expenditure would need to be adjusted downward, from 20 percent of GDP in FY2004/05 to about 14 percent of GDP by FY2024/25 (Figure 2-a). Such an adjustment would require restraints on the increase in the average wage rate and the number of civil servants and cuts in appropriations for less essential goods and services, while protecting key social services.

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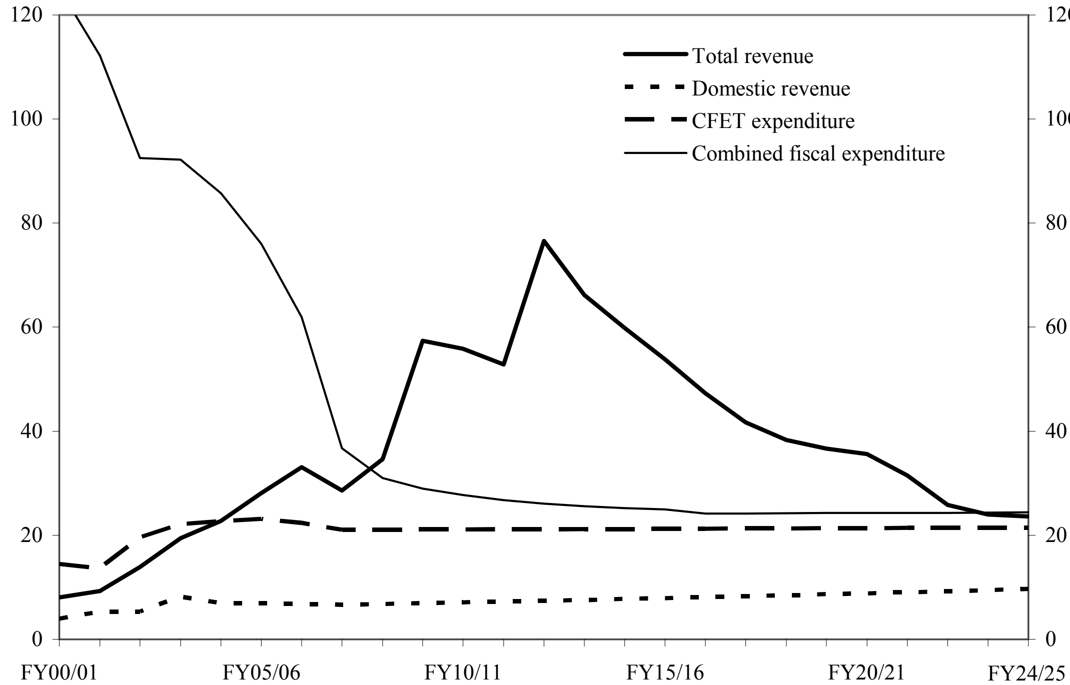
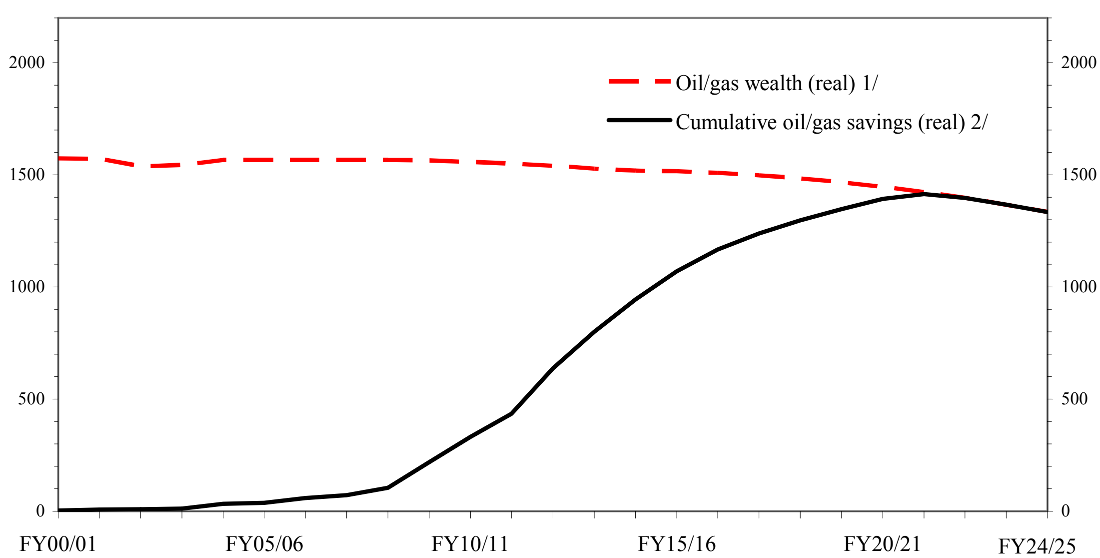
[7] In the scenario, economic growth is assumed to moderate to 3.5 percent in the long run, partly reflecting a decline in marginal productivity of capital and a slowdown in population growth.

Figure 1. Timor-Leste: Revenue, Expenditure and Oil Wealth; FY2000/01 - FY2024/25

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



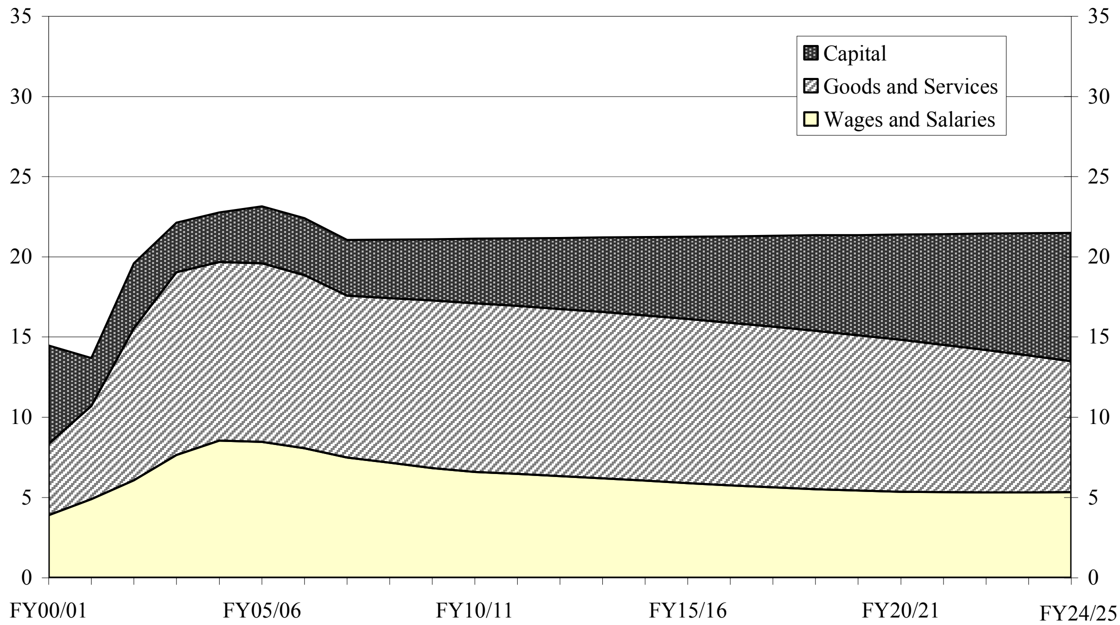
(b) Oil Wealth (in millions of U.S. dollars; FY2000/01 prices)



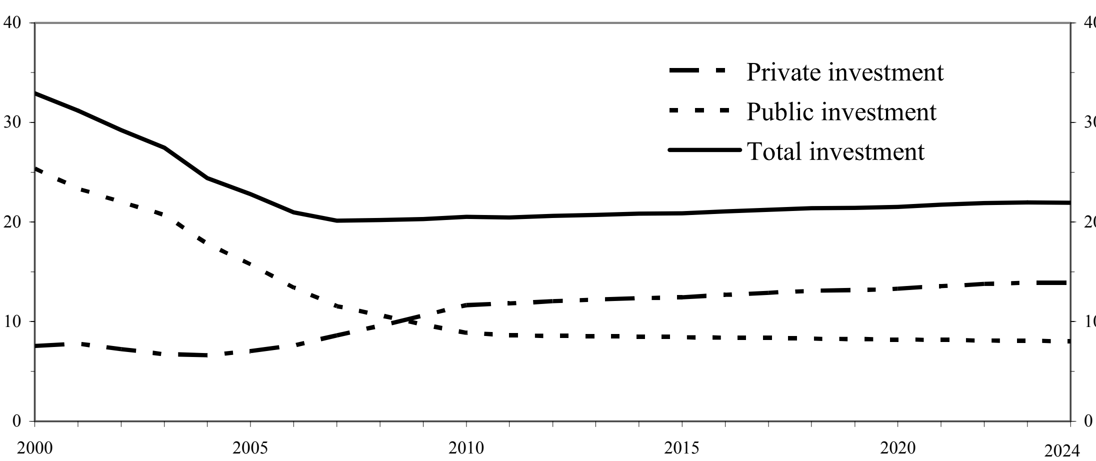
Sources: Information provided by the Timor-Leste authorities; and Fund staff projections.
1/ In terms of the real present value of projected oil/gas revenues.
2/ Stock of oil/gas financial assets in real terms.

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

(a) CFET Expenditure Components (in percent of GDP; FY2000/01-FY2024/25)



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



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

TIMOR-LESTE: KEY FEATURES OF A NORWEGIAN MODEL OF A PETROLEUM FUND

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

- **The critical prerequisite for the effective functioning of a financing fund is prudent fiscal policy**. The fund is not subject to pre-determined specific rules for accumulation or drawdowns of oil revenues. Under a financing fund, the flows in and out of the fund therefore depend crucially on fiscal policy pursued by the government.

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

- **Transparency and accountability are the founding principles of the SPF**. Transfers to and from the SPF require parliamentary approval, and its operations are incorporated into the fiscal accounts. The Central Bank has legal obligations to provide information on the SPF's operations to the public on a regular basis, including on the valuation, composition, and returns of portfolios, as well as on transfers to and from the budget. The SPF's accounts are regularly audited, and the audit reports are made public.

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

TIMOR-LESTE: SUMMARY OF THE EXCHANGE AND PAYMENTS SYSTEM

(Position as of April 30, 2004)

I. Status Under IMF Articles of Agreement

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

II. Exchange Arrangement

1. Currency		The currency of the Democratic Republic of Timor Leste is the U.S. dollar.
a. Other legal tender	Yes	On November 10, 2003, Timorese coins were introduced to serve as fractional currency to the U.S. dollar.
2. Exchange rate structure		
a. Unitary	Yes	
3. Classification		
a. Exchange arrangement with no separate legal tender	Yes	The dollar is legal tender and circulates freely. Foreign exchange transactions are effected through three (foreign-owned) commercial banks and one licenced currency exchange bureau.
4. Exchange tax	No	
5. Exchange subsidy	No	
6. Forward exchange market		
a. Official cover of forward operations	No	

III. Arrangements for Payments and Receipts

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

(coins and/or bullion)		
7. Controls on exports and imports of banknotes		
a. On exports	No	
b. On imports		
1. Domestic currency	No	
2. Foreign currency	No	

IV. Resident Accounts

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

V. Nonresident Accounts

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

VI. Imports and Import Payments

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

imports		
4. Import licenses and other nontariff measures	No	
5. Import taxes and/or tariffs		
a. Taxes collected through the exchange system		There are no quantitative restrictions on imports. With the exception of selected items (e.g., cigarettes and alcohol with certain limits, household effects of returning former residents), a uniform ad-valorem tariff (6 percent) is levied on all imports. Also, excise taxes are levied on imports of selected goods at specific or ad-valorem rates (10-170 percent) depending on types of goods. In addition, the sale tax (6 percent) is levied on the sum of customs value, import duty, and excise payable.
6. State import monopoly	No	

VII. Exports and Export Proceeds

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

VIII. Payments for Invisible Transactions and Current Transfers

Controls on transfers	No	

IX. Proceeds from Invisible Transactions and Current Transfers

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

X. Capital Transactions

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

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

Changes During 2003

Exchange arrangement	Nov. 10	Timorese coins were introduced to serve as fractional currency to the U.S. dollar.
Arrangements for payments and receipts	Nov. 13	A new currency law revoked the restrictions on importing foreign currencies. (Previously, imports of foreign currencies exceeding the equivalent of $2,000 are prohibited without a permit from the BPA. Also imports of currencies issued by countries which maintain export restrictions were limited to the equivalent of $500 without BPA approval.)

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IMF Concludes 2004 Article IV Consultation with the Democratic Republic of Timor-Leste

On [July 16, 2004], the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Democratic Republic of Timor-Leste.[1]

Background

Timor-Leste has begun nation-building following its independence in May 2002. Progress has been made in consolidating the new government's administrative power and fostering a stable political environment despite some early challenges. Further steps have been taken under the government's initiatives to reconstruct the economy from the severe destruction of 1999 that followed the national referendum overwhelmingly supporting independence from Indonesia.

Despite progress in economic reconstruction, significant economic challenges remain ahead. These challenges center around the strengthening of medium-term growth prospects to alleviate widespread poverty. Meeting the challenges requires the authorities to address deep-rooted structural problems, including poor infrastructure, low productivity (notably in agriculture), an underdeveloped legal system for business activity, and serious institutional and capacity constraints. Added to this task is the need for the productive use of growing oil/gas revenues expected over the medium term from the exploitation of oil/gas resources in the Timor Sea.

After a strong recovery from the 1999 destruction, economic activity has slowed down substantially since mid-2002. Real GDP is estimated to have declined by 3 percent in 2003, reflecting the lingering impact of a reduced international presence, compounded by a fall in

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the [July 16, 2004] Executive Board discussion based on the staff report.

agricultural production. Inflationary pressures, however, have been waning in recent months, with CPI inflation declining to 4 percent (year-on-year) in April 2004. The external current account excluding official transfers remains in large deficit, but the deficit is narrowing, due to a further reduction in donor-assisted reconstruction activities. The Bayu-Undan oil/gas project has come on stream, paving the way for increased oil/gas revenues over the coming years. However, in the near and medium term, these revenues are projected to be substantially smaller than earlier projected due to lower oil/gas production in the initial few years.

Fiscal policy remains prudent. The budget for FY2003/04 (fiscal year: July-June) was tightened at the mid-year budget review (November 2003) in response to a potential decline in oil/gas revenues. A major tightening of expenditure policy was also incorporated to budget estimates for FY2004/05 and three-year forward projections through FY2007/08, with total expenditure compressed by 12 percent, on average, in comparison with the estimates envisaged during the November 2003 mid-year budget review. The expenditure compression is aimed at narrowing significant financing gaps projected over the medium term, as well as safeguarding against large downside risks to oil/gas revenues. The policy stance reflects the authorities' continued avoidance of external borrowing, as well as the lack of access to domestic borrowing under the current U.S. dollar-based monetary and exchange rate arrangement.

The expansion of the banking system continues, although its activity remains largely confined to the Dili area. Bank deposits increased by more than 35 percent (year-on-year) during the 12-month ending March 2004, as a third commercial bank commenced operations in mid-2003 and micro-financing operations gained momentum. Although a substantial portion of deposits continue to be invested abroad, bank lending (mainly to the construction and trading sectors) has started to pick up since mid-2003. Steps have been taken to prepare a payments law to address risks associated with the payments system and develop an insurance law to foster insurance activities.

Progress has been made in implementing structural measures relating to private sector development and institution and capacity building. A commercial code and a company law were enacted as initial steps to establish a legal and regulatory framework for business activity. A policy paper on private investment was placed for public consultation in last November and draft domestic and foreign investment laws have been submitted to the Council of Ministers. Following the enactment of a basic law for land ownership in early 2003, draft laws for (i) leasing of private and public land and (ii) land and property dispute mediation are currently being reviewed by the Council of Ministers. To strengthen institutions and capacity, actions are being taken in the context of the World Bank-supported Second Transition Support Program. Nonetheless, Timor-Leste continues to depend heavily on international experts for its daily administrative operations, and acceleration in institution and capacity building remains a major challenge, especially in view of a further winding-down of the UN-supported capacity building program

Executive Board Assessment

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Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.