September 11, 2008
Approval: 9/18/08

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 08/55-3

5:05 p.m., June 25, 2008

3. Democratic Republic of Timor-Leste—2008 Article IV Consultation

Documents: BUFF/08/86; SM/08/164; SM/08/165 and Supplement 1

Staff: Creane, APD; Boote, PDR

Length: 29 minutes

Executive Board Attendance

T. Kato, Acting Chair

Executive Directors	Alternate Executive Directors
	S. Itam (AE)
	E. Ndong Ondo Bilee (AF), Temporary
	V. De la Barra (AG), Temporary
	S. Na (AU), Temporary
	D. Orynbayev (BE), Temporary
	H. Mori (BR), Temporary
	Y. Liu (CC), Temporary
	L. Jimenez (CE), Temporary
	M. Morgan (CO), Temporary
	A. Lahreche (FF), Temporary
	A. Rieck (GR), Temporary
	D. Mohanty (IN), Temporary
A. Sadun (IT)	
	M. Nozaki (JA), Temporary
	S. Maherzi (MD), Temporary
	A. El-Ganainy (MI), Temporary
	T. Galac (NE), Temporary
	J. Bergo (NO)
	A. Shabunina (RU), Temporary
	S. Alnefaee (SA), Temporary
	C. Sucharitakul (ST)
	N. Raman (ST), Temporary
	P. Gasiorowski (SZ), Temporary
	F. Parodi (UA), Temporary
	H. Rab (UK), Temporary

B. Esdar, Acting Secretary
P. J. Walker, Assistant

Also Present
African Department: N. Funke. Asia and Pacific Department: D. Citrin, S. Creane, O. Erdembileg, P. Tumbarello, M. Zavadjil. Office of the Managing Director: T. Kato. Secretary's Department: B. Esdar, M. Miller, P. Walker, M. Yslas. Senior Advisors to Executive Directors: D. Abazorius (NO), N. Klein (NE). Advisors to Executive Directors: J. Cardoso (IT), M. Maia (BR), E. Uanguta (AE), F. Waqabaca (ST).

3. DEMOCRATIC REPUBLIC OF TIMOR-LESTE—2008 ARTICLE IV CONSULTATION

Mr. Sadun and Mr. Cardoso submitted the following statement:

On behalf of the Timorese authorities, we wish to express our sincere gratitude and appreciation to the staff for the thorough, constructive, and insightful approach to this Article IV consultation. The Timorese authorities welcome the IMF consultations, as well as the very interesting technical discussions and presentations to Timorese officials and staff, since they provide a unique opportunity to discuss policy options and IMF recommendations.

Introduction

Timor-Leste has been gradually reinforcing its democratic institutions and maturity, but this construction has not been a smooth process. The emergence of the crisis in 2006, triggered by rivalry within the Timorese security forces that rebelled, and the insecurity resulting from it, illustrate the extreme fragility of this post-conflict country. Notwithstanding the severe adversities, the country has already clearly demonstrated its democratic maturity when it comes to elections. Timor-Leste held a national presidential election in April and May 2007, and legislative elections in June 2007. These were the first national post-independence elections organized by the Timorese authorities and, as such, were an important step in the consolidation of democracy in the country.

The population of Timor-Leste is about one million inhabitants. More than half is illiterate and most of the labor force (over 4/5) gets its subsistence from agriculture and fishery. After independence, the population has grown at a rate of about 3.5 percent a year. About 70 percent of the population is under 30-years-old and life expectancy is about 56 years old. Unemployment rates are high, especially in the capital (home to about a quarter of the labor force) and among youth aged 15 to 29. In this last group (youth workforce in the capital), unemployment stands at about 40 percent. The full reintegration of some one hundred thousand Internally Displaced Persons (IDPs) is far from achieved. About 30 percent of them continue to reside in 58 camps, mainly in the capital. Timor-Leste is ranked 150 out of 177 countries in the 2007/2008 United Nations Development Programme (UNDP) Human Development Index (HDI). Estimates suggest that as much as 42 percent of the population is now below the national poverty line of $0.55 per day, which reveals a deterioration of this indicator during recent years. Compared with the countries of the ASEAN region, Timor-Leste is the poorest country, with non-oil GDP per capita of $378 in 2007.

Macroeconomic overview

Following the civil unrest of 2006—responsible for a contraction of real non-oil GDP (which excludes offshore oil and natural gas, and the UN contribution to government operations) of about 5.8 percent—real non-oil GDP is estimated to have rebounded to 7.8 percent in 2007, largely driven by government and donor spending. Economic recovery could have been higher if not for the unstable security conditions that subdued private activity, and the drought and locust infestations that generally hit agricultural production. In the case of coffee, the main export crop, the decline in production was about 20 percent.

The government's prudent and responsible macroeconomic framework has successfully contained inflation in Timor-Leste, but recent shocks pose some risks to price stability and food security to the most vulnerable population.

Important policy measures adopted by the Timorese authorities have proven its effectiveness in containing inflation, namely: the USD as the currency of legal tender—whose simplicity is well-suited for the country's constraints and provides an effective nominal anchor for price stability (notwithstanding the negative effects of its recent depreciation in a country very dependent upon imports)—along with the strategy to invest abroad the wealth from oil-and-gas, and the responsible fiscal policy tracked by sustainable spending defined by the Petroleum Fund Law (explained in Section 3). Within this adequate macroeconomic framework, inflation has stood at levels well below that of comparator countries.

However, the higher international food prices, especially rice, were an exogenous shock that, along with poor harvests and some difficulties to secure normal imported rice levels, instigated a hike in inflation in the first quarter of 2007. However, by the end of the year, the price level had already fallen significantly and inflation averaged 8.9 percent over the year. It should be noted that food represents a high portion of the CPI (about 58 percent) and that about half of the food items are imported. Excluding food, inflation actually recorded a slight reduction in 2007 to under 3.5 percent on average. Whether including or excluding food in the CPI, inflation in Timor-Leste remains relatively low when compared regionally with similar countries or with its trading partners.

The authorities recognize that external and supply-side shocks may pose some risks to price stability. As inflation, essentially on food items, particularly hurts the most vulnerable population, and since the most pressing item has been the price of rice, the authorities have decided to import rice for resale to local retailers at subsidized prices. This measure, representing an additional cost to the budget, has successfully mitigated the pass-through of international rice prices, and its benefits are being essentially felt by the poor, given the relatively high portion of their income that is spent on rice.

The external current account and the fiscal position have continued to accrue rising surpluses, notwithstanding sharply increased government spending, since the offshore oil-and-gas sector has not been affected by the civil unrest, and reflecting rising revenues due to a peak in production and high international prices. Petroleum revenue reached 340 percent of non-oil GDP in 2007, with petroleum fund assets increasing to $2.6 billion at end-March 2008 (about 6 times non-oil GDP). The Greater Sunrise oil/gas field could commence production by 2014, although serious questions remain on the project's financial viability.

The sharp increase recorded during 2007 in government spending must be understood by the fact that government spending has been covering the gradual decline in donors' spending. Therefore, the rise in total expenditure effectively spent has been much lower than the rise in government spending. However, the authorities are vigilant to any demand pressures that might arise given the limited absorption capacity of the domestic economy, especially if the increasing management capacity starts to produce results on higher rates of budget execution. The Timorese authorities note that, in the staff's financial programming for 2008, projected government cash spending is the double of that in FY2006/07 and 60 percent higher than the annual rate in the second half of 2007. This is an optimistic sign that the measures in progress by the Timorese authorities are expected to be effective in strengthening management capacity.

Additionally, despite the rise in government spending, it remained far below appropriations and the sum of sustainable resources drawn from the Petroleum Fund, in strict respect of the Petroleum Fund Law. Less than 60 percent of the transitional 2007 budget (second half of 2007) was spent on a cash basis, with an execution rate of just 12 percent for capital expenditure. The carry-over of financial resources, due to significant execution difficulties that delay spending to the next financial year, does not represent a violation of the Petroleum Fund Law. Resources drawn from the Petroleum Fund have respected the annual estimated sustainable limits established by the Law.

Some procedures have already been introduced to limit the carry-over of obligations between fiscal years, but the authorities recognize that the execution constraints will continue to be felt for the near future, although less pronouncedly over time.

As to the financial system, the rise in nonperforming loans and provisioning reflect essentially the deterioration of the recent past security conditions. At present, the fact that-several commercial banks—which are branches of foreign banks—already expressed interest in opening new branches within the country outside the capital suggests no evidence of a systemic risk.

Oil and gas resources

With the purpose of managing the revenues from oil-and-gas production in a way to assure not only inter-generational equity but also fiscal sustainability, the Timorese authorities established in 2005 the Timor-Leste Petroleum Fund, modeled after the Norwegian petroleum fund experience on such type of sovereign wealth fund, and with the valued support from the IMF and other external partners. The Petroleum Fund is integrated into the central government budget. Transfers from the Petroleum Fund to the budget are subject to a spending ceiling set on the basis of the fiscal sustainability policy. The annual sustainable spending is equal to the sum of the estimated permanent (interest) income from the oil-and-gas wealth and domestic non-oil revenue. The Petroleum Fund Law allows drawings to exceed the sustainable level, if necessary and justifiable as being in the long-term interest of the country, under approval by the parliament, through a highly responsible and transparent process, but this option has never been used. The Petroleum Fund assets are invested abroad to limit risk and minimize real exchange rate appreciation pressures.

The Minister of Planning and Finance is responsible for the overall management and investment strategy of the Petroleum Fund, and the operational management is the responsibility of the Banking and Payments Authority (BPA)—the incumbent central bank. The BPA submits quarterly reports on the performance of the Petroleum Fund to the Minister of Planning and Finance. In turn, the Ministry publishes an annual report containing a more complete description of the Petroleum Fund’s activities and the financial statements certified by an internationally recognized audit firm. The Petroleum Fund is generally considered at the top of international rankings for transparency and accountability. Additionally, an Investment Advisory Board provides strategic investment advice concerning the investments of the

Petroleum Fund to the Minister of Planning and Finance, and an independent Consultative Council advises Parliament on Petroleum Fund issues.

Regarding the investment strategy, all assets have been invested in short and medium-term U.S. government bonds and managed passively to track the Merrill Lynch US government bond index. The government recognizes that it is now time to develop a long-term investment strategy. In this regard, the Timorese authorities announced this month that a step was already taken forward in the operational management of the Petroleum Fund by signing a Global Custody Agreement, following an international tender procurement process, with an internationally recognized financial services firm, to act as the global custodian for the Petroleum Fund's assets.

Besides the effective custody of the investments, the Agreement also includes the provisioning of related services. This firm will receive and arrange the settlement of trading instructions from external managers, and will monitor their performance. This step will support the future appointment of specialized external managers to manage portions of the Petroleum Fund, a necessary move to implement the government's intention to broaden the investment mandate of the Petroleum Fund, in order to achieve higher long-term returns. Additionally, this firm will also provide the BPA with investment performance and compliance services, as well as the Petroleum Fund's financial accounting and reporting. This is the first-step in the implementation of the BPA's strategy to form a team of finance professionals to manage the assets of the Petroleum Fund. The Timorese authorities appreciate the assistance of the World Bank and BIS for the initial phase of this challenging process.

After some meetings of Timor-Leste's Multi-Stakeholder Working Group for the Extractive Industries Transparency Initiative (EITI) initiated last year—which brought together representatives from relevant government agencies, civil society, and the petroleum industry—Timor Leste was accepted in February as an EITI Candidate Country. The Secretary of State of Natural Resources is the government official responsible for undertaking the EITI validation. In this area—as in the one related to the Petroleum Fund—the Timorese authorities are deeply committed to fully complying with the international best-practices.

Poverty Reduction and Structural Reforms

Despite the broadly recognized meritorious efforts to manage oil-and-gas resources, progress on economic and social development has been more elusive, and the population has yet to see any real change in their daily lives. A general perception exists that the wealth from oil-and-gas resources has not been directed to social support, which has put significant pressure on solving immediate social problems. However, the problem has resided on the country's poor budget execution, namely on investment spending, due to a weak administrative capacity and, to some extent, domestic disturbances. The Timorese authorities recognize that the broad challenge is how to implement economic and social development measures to alleviate immediate social needs and security problems, while developing a strong non-oil economy and maintaining low inflation. In this regard, we should distinguish between short-term priorities and long-term priorities.

Short-term priorities pursue the immediate goal of food security and social cohesion. An important measure to assure food security was the subsidization of the price of rice, which successfully shielded the most vulnerable population from the threat of famine due to supply shortages looms, weather disturbances, and plagues that have recently disrupted agricultural production. Additionally, after the 2006 civil unrest, the authorities have been vigilant to factors that might trigger threats to the security conditions. A pacification policy has been followed to ensure public safety through the reintegration of petitioners from the 2006 rebellion into military and civilian life, and IDPs into an integrated life, with particular attention to housing, under the National Recovery Strategy endorsed by the Timorese authorities in December 2007 with the involvement of the United Nations, development partners, and civil society. Finally, the severe difficulties that elderly and disabled people are facing are also being addressed. All these measures—further strengthened in the 2008 mid-year budget update, recently approved by the Council of Ministers and to be sent to parliament shortly—respond to the rationale that it is not possible to foster economic development without solving first the most basic needs of food security and social cohesion.

Long-term priorities aim the development of a sustainable non-oil economy within a stable macroeconomic environment. For more than two decades in the recent past, the public administration employed civil servants with very low levels of productivity, while productive sectors of the economy were left underdeveloped. As a result of this approach—which is still a very entrenched mindset—the private sector continues to be very insipient, consisting of micro and small-businesses that have been unable to create employment and are very much dependent upon Government contracts. The authorities are determined to reform the business environment—which has been constraining some meritorious private initiatives and, according to the recent 2008 Doing Business report, is still ranked very low, although improving—to enhance competitiveness and to promote a self-creating employment private sector. In this regard, the authorities agree on the need to strengthen public investment in three areas: infrastructure, namely road building, housing, water supply, and electricity generation, among other important projects, using labor-intensive strategies whenever possible and adequate, to promote employment among a vast low-skilled population; human capital, through the strengthening of the educational system and professional qualification (including the introduction of a policy of free basic education and nine years of compulsory attendance in school); and institutional and regulatory framework.

In this last area, an important incentive to foster the private sector is the tax reform recently approved by parliament. The new non-petroleum tax system significantly reduced tax rates, lowered compliance costs, and streamlined regulations. The expected decline in non-oil tax revenue, from about 10 percent to 5 percent of non-oil GDP, is a budgetary cost that the authorities assume in this effort to create the necessary conditions to boost a formal private sector in Timor-Leste, taking advantage of the sustainable fiscal space derived from oil-and-gas revenues.

Now that the tax reform has been completed, the authorities plan to address other important bottlenecks to the economic activity, namely: to promote measures to expand access to financial services, especially in the districts, by encouraging the expansion of existing commercial banks' branches of established foreign banks, and by creating a National Development Bank, run on a commercial basis and supervised under domestic financial law (although the plans for the National Development Bank are still under analysis); to implement a land reform, expected to be completed by the end of the year, in order to create a framework for land ownership, titling, and registration; and to advance with the judicial reform, including judicial decisions enforcement. For these purposes, again, substantial physical and human investment is necessary, along with technical support to create the necessary expertise.

If a strategy of external debt borrowing is adopted to cope with the financial requirements for these long-term priorities, one of the areas in which expertise would have to start from scratch would be debt management. Being one of the youngest countries in the world, Timor-Leste has no external public debt. Although eventually justifiable from a financial point of view, the recourse to external financing will have to be carefully studied through a cost/benefit analysis. For the very immediate future, external financing could prove to be less favorable when compared with the possibility of using resources from the Petroleum Fund.

Given the lower donor support and the above explained severe needs that the country is facing, the 2008 mid-year budget update, to be sent to parliament shortly, presents those needs and justifies, as being in the long-term interest of the country, spending above the estimated sustainability limit. Notwithstanding the still pressing execution difficulties that probably will contain spending below this limit, the government—conscientious of a potential inflationary risk from higher government spending in a country with a limited absorption capacity—intends to contain any inflationary pressures, which may be felt essentially on construction materials. In this regard—and included in a broad measure to keep a tight vigilance on price developments, under the exchange rate regime of official dollarization—the government already approved this week the establishment of a Fund for Economic Stability, to contain the rise in prices of food, fuels, and construction materials. Therefore, the medium-term goal of this Fund is to reconstruct the capacity of the economy and to develop programs to help the population deal with the effects of the crisis, in support of the achievement of the above explained short and long-term priorities within a stable macroeconomic framework.

To conclude, we emphasize that all the decisions already taken and to be sent to parliament for approval respect the Law and all the transparency requirements that characterize the Timor-Leste Petroleum Fund.

Final Remarks

Timor-Leste is living a time of great opportunity. After the rebel attacks in February, the rebels have surrendered, disturbances have significantly diminished, and the country has returned to a state of normalcy. However, the fragility of this post-conflict country remains latent pending the near-term consolidation of the social cohesion and the eradication of food insecurity, and the long-term development of a sustainable formal non-oil economy. Under the current circumstances, the involvement of the international community is essential to sustain the current juncture.

On the economic sphere, in which the IMF has a particular role and responsibility, the task is huge and requires a permanent in situ counseling. The Timorese authorities reiterate their high appreciation for the IMF support and count on the current level of involvement to not be abruptly interrupted in the immediate future. To conclude, the Timorese authorities express their deepest appreciation for the competence and personal engagement of the IMF resident representative.

Mr. Heath and Mr. Wood submitted the following statement:

Growing revenues from oil and gas present considerable opportunities for Timor-Leste if managed wisely. We appreciate the perspective of Messrs. Sadun and Cardoso's buff statement, and we support the staff's urging of the authorities to focus on long-term fiscal sustainability, investment in infrastructure and human capital, and expedited structural reforms.

External Sector and Monetary Policy

We accept the staff's assessment that the exchange rate does not appear to be out of line with fundamentals, with effective exchange rates not greatly changed over the past few years. Use of the U.S. dollar has been helpful in providing a nominal anchor. We note the conclusion of the Selected Issues paper that recent higher inflation rates mainly reflect global increases in food prices, and that non-food inflation has remained relatively low. However, we also note that inflation pressures have started to appear where rising government spending has put pressure on limited local supplies, such as in construction materials. This points to how further rapid growth in public expenditures could generate significant inflation pressures over time unless structural reforms and well-targeted infrastructure investment can reduce bottlenecks.

Fiscal Policy and Structural Reforms

The key issue for Timor-Leste is how to use the wealth from the country's oil and gas reserves to raise living standards in a sustainable manner. The petroleum fund is well-designed to promote macroeconomic stability and preserve wealth for future generations. We support the recommendation to continue the current arrangement, which provides ample space for government spending to build infrastructure and raise living standards. We share the staff's concern, however, about the recent sharp increase in spending appropriations to stabilize the price of food, fuel, and construction supplies. Fiscal relief packages should be targeted to the most needy, otherwise letting markets work.

Non-oil growth currently is driven mainly by the public sector. Development of the private sector will require well-known steps included in the staff appraisal. Primary among these is an effective legal system to enforce contractual rights and settle disputes. Land titling is vital, and we support the proposed law on land ownership. Greater efforts by the authorities to promote financial intermediation will encourage private investment and build on Timor-Leste's hopeful macroeconomic foundation for economic development.

Mr. Mori submitted the following statement:

We thank staff for the informative set of papers and Messrs. Sadun and Cardoso for their helpful buff statement.

We welcome the rapid recovery of the non-oil economy in Timor-Leste. As the oil sector was not affected by the civil unrest, it continues to provide the needed resources to support the government's efforts to restore the growth momentum and implement the public policies. Like in other countries, the inflation rate has accelerated caused by higher food and energy prices, while in Timor-Leste the poor harvest domestically has further intensified the shock. Inflation is hence the major concern as it affects directly the majority of the population. Measures to mitigate price pressures on food are, therefore, fully justified.

Government actions have contained further acceleration by re-selling imported rice at subsidized prices. Resources from the oil sector have been instrumental to finance such a policy, alleviating near term adverse impact on the population. Although we agree that the use of oil revenue in the domestic economy has to be made in a sustainable way in order not to exacerbate price pressures, especially in the non-tradable sector, the financing of food imports seems inevitable in view of the needs of the poor and reduction in the donors' support. As staff reminded us, the situation remains critical because of displaced population and widespread poverty. The policy has to be understood as a short-term, emergency one.

On the exchange rate, there seems to be no clear answer to the appropriate regime. For a small economy with one predominant source of income, it can adopt its own currency to buffer shocks. But given the size of Timor-Leste, the latitude to accommodate shocks would be limited. Experience in other similar countries could be applied as a basis for the choice of the appropriate regime. The current arrangement seems to have worked well for its objective of providing nominal anchor to the economy.

Staff indicated a comprehensive agenda of reforms to support the private sector development. The main constraint to their implementation seems to be currently the scarcity of human resources. An adequate sequencing has then to be followed to identify priorities to avoid the overburdening of the resources. In this context, two development issues should be highlighted:

First, investment in education is a clear priority, in particular given that almost half of the population is under 15 years of age. The question is whether there are appropriate contingents of well-prepared teachers to fulfill this complex task. A well-designed strategy has to be worked out to be implemented efficiently.

Second, the agricultural sector requires an appropriate stimulus. Given the high reliance on imports and the current favorable prices for producers, actions that could contribute to expand the supply of food items domestically would be instrumental to mitigate the demand constraints. This would include appropriate financing to the sector and/or, as it is a risky activity, an insurance scheme for the producer. A related infrastructure to facilitate the marketing of goods has to be part of the framework.

Other items to develop a sustainable non-oil economy, though important, can be introduced gradually. At the current juncture, the main impediment to private sector activities seems to be the uncertain economic prospects. It would not to be expected, in this context, that credit would expand at a regular pace. It is desirable that the financial deepening is carried out in a gradual and solid way. Although we are not concerned with the limited credit market, we agree on the need to strengthen the prudential framework before the credit growth is restored. As banks in Timor-Lest are branches of foreign institutions, this also calls for support from supervisors in the home country for a coordinated supervision.

The authorities' plan to borrow abroad to finance large-scale infrastructure development has to be assessed carefully. For Timor-Leste, the ideal seems to be, if possible, to rely basically on its own resources. External debt, though sometimes is in more favorable financial terms, can bring some problems. In some instances, the resources are allocated to the priorities of creditors and not necessarily to the country's needs. There is also the risk of overborrowing in a way inconsistent with the government's income flows. Unless strictly necessary, external borrowing should be avoided. If required, safeguards have to be in place not to lose sight of long-term budgetary constraints.

Mr. Yamaoka and Mr. Nozaki submitted the following statement:

We thank the staff for a well-crafted set of papers and Mr. Sadun and Mr. Cardoso for their informative statement. We welcome Timor-Leste's bright medium-term prospects supported by rich oil resources and improved security conditions. Having said that, we are concerned about rising inflation like that of many other countries. Thus, we reiterate the importance of implementing prudent economic policies, mainly fiscal policy, to contain inflation by utilizing market mechanisms, while making fiscal expenditures efficient and well-targeted to society's poorest.

Inflationary Pressures and Fiscal Expenditures

We are worried about rising inflation in Timor-Leste. The costs generated by high inflation could be significant for Timor-Leste, as the country still faces widespread poverty and its nascent yet underdeveloped non-oil sector implies that income may not easily catch up with inflation. Moreover, Timor-Leste's full dollarization suggests that an inflation rate higher than that of its trading partners could jeopardize its competitiveness and deter the country from further diversifying its economy beyond the oil sector. Additionally, the co-existence of heightened inflationary pressures and a fragile political situation is likely to lead to blanket subsidization and the further increase in government spending.

Against this background, we agree with the staff that expanding fiscal spending raises inflationary concerns. Particularly, we are worried about the increase in the projected current expenditures for 2008, by almost a whopping 80 percent of non-oil GDP (compared with 2007H2, and according to the recently approved mid-year budget update); such a massive increase will almost certainly lead to heightened price pressures. Moreover, we are concerned that budgeted expenditures by far exceed the estimated sustainable spending level defined under the Petroleum Fund arrangement. Thus, we urge the authorities to be vigilant against inflation risks and exert restraint in their spending.

The Economic Stabilization Fund (ESF)

It is a broadly-shared view that blanket subsidization and extensive price controls would eventually lead to the misallocation of economic resources, deter price-mechanism adjustments in the balance of supply-demand, and prolong inflationary pressures. It is also a matter of course that income policies should be well-targeted to the most vulnerable segments of society. In this regard, the planned establishment of the Economic Stabilization Fund (ESF) may present risks with respect to the following aspects.

According to the staff's statement, the ESF is planning to broaden the range of blanket subsidization, from rice to include other foods, fuel and construction materials. In this regard, the ESF may pose a risk to the autonomous adjustment mechanisms of the economy.

In principle, blanket subsidization should be a temporary and emergency measure, and the establishment of the ESF could increase the fiscal burden and reduce the flexibility of the fiscal policy over the medium term. It is not certain whether the current hike in commodity prices would be short-lived or not, and it would be difficult for the authorities to terminate the subsidization policy as long as commodity prices stay high, especially amid political fragility.

It would be difficult to justify the subsidization of construction materials as a tool of "defending lifelines." Subsidizing construction materials would inevitably favor a specific sector, such as the construction sector (as this sector could increase demand while avoiding a rise in input prices), and this is not a sector that can be categorized as being among the poorest. In addition, the ESF would increase the marginal costs of government infrastructure investments, because the increase in investments would intensify upward pressure on construction materials and thus call for further subsidization. In this regard, the ESF would not lead to an efficient use of oil/gas revenue.

We would welcome the staff's views on the establishment of the ESF, if any. Noting the high unemployment rate, we hope fiscal spending will instead be targeted toward the creation of jobs and human capital so as to reduce poverty. In addition, although a rise in commodity prices is likely to be explained by each country as exogenous, from the perspective of the global economy it is considered to be endogenous, and each country's appropriate policy conduct is critical toward stabilizing both commodity prices and global inflation expectations.

The Petroleum Fund and Infrastructure

We encourage the authorities to build up institutions and policy capacity in order to foster sustainable development and growth. The Petroleum Fund is an indispensable institutional arrangement, and should be preserved despite pressures to spend oil wealth, which may very well emerge amid record-high petroleum prices, the rising cost of food and energy products, and widespread poverty and political fragility. Thus, we welcome the authorities' reassured commitment to the basic principle of the Petroleum Fund arrangement.

With these remarks, we wish the authorities every success in their policy making.

Mrs. Sucharitakul and Mr. Waqabaca submitted the following statement:

We thank staff for the set of well-written papers and Messrs. Sadun and Cardoso for their helpful buff statement. Despite the fragile security and political situation in Timor-Leste, a rebound in non-oil growth to 8 percent was realized in 2007. Inflation, whilst high at around 8.9 percent, is not incomparable to other South East Asian neighbors and trading partners. Nevertheless, Timor-Leste remains amongst the least developed countries globally, which intensifies the policy challenges for the authorities. Having said this, we welcome the emphasis of the National Development Plan (NDP) to promote growth through prudent fiscal management and cultivating a friendly private-investment environment. We encourage the authorities to address the capacity issues that may hinder the realization of plans under the NDP, the updating of which is also essential. Furthermore, investment in infrastructure and human capital consistent with prioritized NDP would be steps in the right direction.

Sustainable management of the growing oil/gas revenue (340 percent of non-oil GDP in 2007) is vital for achieving a stable non-oil economy. In this respect, we are encouraged by the authorities' continuing prudent management of these resources. Managed properly, the petroleum fund has the potential to accelerate development and raise living standards substantially. Having said that, we saw from the update from the Staff Representative that the mid-year appropriation target has been substantially revised upward, which would require recourse to using the resources of the petroleum fund. In theory, we are not averse to using the fund's resources, so long as macroeconomic stability is maintained, but it is not clear that the Timorese economy can fully absorb the planned spending. Further, we note that the authorities' plan envisages support for more than just rice, which had been the initial thrust of mitigation policy during the mission, but will now also cover such items as construction materials. Such an expanded mitigation policy in dealing with price pressures may not be sustainable over the long term and we agree that recourse to blanket support in this manner should be avoided. Having said that, a country that has no central bank nor a currency of its own is hardly likely to be able to implement a targeted social safety net in response to the price shocks. There may be no way out in the medium term than to resort to less-than-ideal solutions. This makes it even more crucial that such support, if implemented, be time-bound, and complemented by the necessary structural reforms.

We also note the authorities are considering the various options on how to finance the building of necessary infrastructure, and staff's misgivings in this area. We note that the NDP will outline the medium-term priorities of the authorities, and would appreciate updates on possible projects that the authorities are considering. We agree that the choice of projects needs to be fully congruent with the immediate developmental needs of the Timorese people, and focus should be on improving medical access, human capital development and the agriculture sector. As for the choice of funding options, we note that staff would prefer the use of concessional financing, which brings other benefits, including the embedded technical advice. The other option is to use the petroleum fund for domestic investment, an option staff feel is financially equivalent to taking on non-concessional debt. We would appreciate some elaboration on staff's conclusions, noting Mr. Sadun and Mr. Cardoso's assessment that the safer option for Timor-Leste might be to use the fund and thus insulate the economy from the risks that arise from leverage.

On the financial sector, we note that the banking system remains rudimentary and relatively concentrated in Dili. We sympathize with the authorities when they note that without growth in bank branches, the economy will not have adequate access to the formal financial sector, and growth will be retarded. Therefore, we agree that some role for the public sector exists in the early period of a development plan, would note that many southeast Asian countries established specialized development financial institutions. The key issue pertains to how these institutions will operate. In our experience, they work best when they catalyze credit and deposit-taking activity, extending financial inclusion to segments of the population that were previously outside the sector's umbrella. As such, it is important that the managements of these institutions pay due regard to their balance sheets and risks, and that financial regulators apply prudential standards to the fullest right from the start. In this way, the benefits of financial inclusion can be spread widely, while fiscal and financial risks are contained.

With these remarks, we wish the authorities every success in the challenging period ahead.

Mrs. Mañalac and Mr. Na submitted the following statement:

We thank staff for a well-focused report, and Mr. Sadun and Mr. Cardoso for their helpful buff statement.

It is commendable that Timor-Leste has maintained a good foundation for economic development through a sound fiscal and monetary framework set out in the National Development Plan (NDP), and a well-managed oil/gas sector policy under the Petroleum Fund Law, notwithstanding the civil unrest of the past two years. Additionally, it is reassuring that the new government intends to update the NDP later this year, following the discussion of national priorities defining near-term goals for recovery.

However, the authorities need to be cautious and proactive in tackling many risk factors, including higher global food prices and constraints on the government's capacity to spend, when implementing reform policies. Particularly in relation to inflation risks, staff pointed out that more recent food price increases require urgent intervention, with the government facing a sharp increase in subsidy costs. Furthermore, based on Q1 2008 data, staff assessed that the second-round impact of oil price increases on inflation is emerging. The authorities thus need to remain more attentive to emerging inflationary pressures.

There is no doubt that building a strong and sustainable non-oil economy is the top priority.

Towards this end, and considering that the increase in petroleum-financed public spending could pose demand pressures for future inflation, the authorities are encouraged to set up well-targeted public investment schemes focusing on infrastructure and human capital. Investment projects therefore need to be prioritized and monitored carefully with a well-sequenced timetable and monitoring framework. In tandem, given that a number of structural factors have dampened competitiveness and growth, structural reforms for a supportive institutional framework are also warranted to ensure a sustainable non-oil economy.

Box 3 of the staff report indicates that average wages are relatively high from a global perspective, although private sector wages appear relatively unchanged over the past several years. We therefore agree with staff that the authorities need to be careful in considering public wage increases, given the indirect influence of such increases to private wages. We also note that civil servants have already benefited from a new 13th-month payment and continued rice allowances.

It was noted that budget execution remains constrained by weak planning and procurement capacity. In this vein, the new government's updated NDP and medium-term fiscal framework are expected to strengthen the authorities' planning capacity. Likewise, streamlining payments procedures and accelerating capacity-building efforts would help enhance procurement capacity.

While we welcome the progress in building a credit registry as well as the improvement in banking supervision, we encourage the authorities to be involved in the financial system on commercial terms and supervised under domestic banking laws. Long-pending financial sector legislations, including the law to transform the existing Banking and Payments Authority (BPA) into a full-fledged central bank, need to be promptly enacted.

We take note of the significant progress in the preparation and dissemination of monetary aggregates and financial data. However, we urge the authorities to urgently address the absence of good quality data particularly for the national accounts, in order to better facilitate macroeconomic analyses and policy decisions.

With these remarks, we wish the authorities all the success in their future endeavors.

Mr. Fayolle submitted the following statement:

We thank the staff for an informative set of papers, as well as Messrs. Sadun and Cardoso for a comprehensive buff statement.

Timor Leste has a huge development agenda to tackle, but can rely on a large and well-managed oil fund, which is an asset of considerable value. In this regard, the report's focus on the best use possible of hydrocarbon revenue to develop a sustainable non-oil economy relevantly addresses the main issue facing the country. In this regard, we are concerned by information provided by the staff in their buff, stating that the budget update allows for a very large increase in public expenditure. To what extent is this increase in expenditure sustainable?

The oil sector has already assumed an overwhelming place in the economy. With oil accounting for most of the GDP and a very limited non-oil sector, developing the non-oil economy will be a challenge. The Petroleum Fund has so far served as a powerful instrument for the intertemporal smoothing of consumption and investment. As the political situation settles down and demands for rapid development rise, it will be important to resist the urge to spend, while building capacity with a view to prioritize development spending. In this regard, technical assistance obviously has a major role to play, and we welcome the engagement of the Fund with the country. Indeed, TA is instrumental in designing a framework for realistically assessing the absorptive capacities and managing available resources more efficiently. In particular, we agree with the staff on the need to develop a medium-term budgetary framework in order to ensure a proper implementation of the development strategy.

One of the risks associated with large public spending is a surge in demand-driven inflation. In the current context of high imported inflation, it will be important to avoid adding another round of price increases, especially as a dollarized economy is by definition devoid of any monetary policy tool, which makes the struggle against inflation particularly difficult.

We note that for the time being price pressures have not resulted in a loss of price competitiveness. However, it is important going forward to ensure that relative prices provide consistent incentives for the development of the private, non-oil sector. Moreover, there is a need to implement measures designed to improve structural competitiveness. Enhancing the business climate as well as ensuring a high level of education are all key items on the structural reform agenda of the authorities.

Finally, we note plans to rely more on the external debt. The current non-existence of the debt and the ability to tap concessional financing can actually make external debt an alternative worth considering, compared to using the oil fund. However, we urge the authorities to exercise the highest level of caution, in order to avoid outbreaks of excess indebtedness and to ensure that the absorptive capacities of the economy are not overwhelmed.

Mr. Larsen and Mr. Rab submitted the following statement:

We are grateful to staff for an excellent set of papers and to Messrs. Sadun and Cardoso for a comprehensive statement.

Rapidly Rising Oil Revenues

Rapidly rising oil revenues provide enormous potential for growth and development. We commend the authorities for the sustainable and transparent management of these revenues under the Petroleum Fund Law. It is essential to maintain this discipline. These measures have helped to insulate the Timorese economy from shocks and instability. We note two challenges to translating rising domestic revenue into growth enhancing public spending. Firstly, effective budget execution, particularly in relation to capital spending, is constrained by capacity. Secondly, rising inflation is further skewing spending towards recurrent costs, in particular by increasing spending on subsidies, which in turn potentially raises further risks of inflation.

Capacity Constraints and Budget Execution

On capacity constraints, we welcome the steps taken by the authorities to draw on external expertise for the design and implementation of capital projects. The gradual upward trend in expenditure, notwithstanding the dip last year due to instabilities, is encouraging. Capacity building support should help improve planning and budgeting across government, which should enable more effective delegation of authority.

We encourage the authorities to develop a medium-term fiscal framework that sets expenditure targets in line with macro stability and absorptive capacity. We note that in the Mid-Year Budget Update overall spending is budgeted to increase by over 50 percent. Timor-Leste does not face a situation of constrained fiscal space. But we agree with staff that very rapid increases in a capacity constrained environment may raise concerns over efficiency and inflation. It may also raise issues over the credibility of the budget. In this regard, we encourage the authorities to move towards cash-based budgeting.

Inflationary Pressures and Government Response

Rising international food prices are fuelling inflationary pressures. We note that the authorities' response to alleviating some of the impact has been to provide rice subsidies. We would welcome staff comments on the scale of the impact and whether the authorities have taken any other measures to address the impact.

Rising consumption-related spending are expected in these instances. We agree with staff on the importance of ensuring these are well targeted. In this regard, we encourage the authorities to avoid measures such as the 13^{th} month payment and continued rice allowances to civil servants. We would welcome staff views on the status of the Fund for Economic Stability.

Tackling inflation will clearly require more than just fiscal policy, but it is important to ensure that fiscal policy is consistent with this objective. As staff note, rising expenditure in earlier periods were not inflationary due to spare capacity in the economy. But bottlenecks are starting to appear. There has to be therefore due attention to the quality of spending.

Promoting Growth and Reducing Poverty

Effective public spending should help crowd in the private sector, but we would also encourage the authorities to address some of the structural measures that are constraining private investment. These are potentially low cost-high return in terms of encouraging the growth of the non-oil sector. We note that areas for potential growth include commercial agriculture, tourism and fisheries.

We welcome plans to update the National Development Plan, with prioritized policies and expenditure plans. Social indicators suggest the need to raise public spending on health and education. The revised National Development Plan will hopefully help address these issues.

We support staff recommendations on priorities to strengthen the financial sector, including financial sector legislation; facilitating loan recovery and contract enforcement; and strengthening bank supervision. The slowdown in credit growth is understandable given recent instability. We would welcome staff comments on whether the instability has had an impact on banking deposits.

Finally, recent events have clearly had a major impact, with the non-oil economy contracting for the first time in 2006/07 since 2003. Lack of development opportunities are likely to fuel conflict. Therefore implementation of a prioritized NDP, which leads to improved standards of living should help consolidate stability.

With these comments, we wish the authorities success with their reform efforts.

Mr. Rutayisire submitted the following statement:

We thank staff for the comprehensive report, and Mr. Sadun and Mr. Cardoso for their insightful buff statement.

We welcome Timor-Leste's improving macroeconomic performance in 2007, in spite of a difficult social and climatic environment. We also welcome measures to diversify the economy from its dependence to oil and natural gas. It is thus encouraging that non-oil average growth rate is estimated to have reached about 8 percent in 2007. The buoyant export earnings coupled with sound fiscal policies contributed to further improving the fiscal and external positions. We commend the authorities for stepping up actions to implement policies set forth in the National Development Plan (NDP) which should be conducive to a private sector-led economy, and in line with sustained macroeconomic stability.

Going forward, the medium-term outlook is encouraging, with non-oil growth expected to be at about 5 percent over this period. Nevertheless, Timor-Leste continues to face several challenges, which include notably the need to effectively manage abundant oil revenue, develop a sustainable non-oil economy, and accommodate internally displaced citizens. Moreover, sharply rising inflation as well as increasing food and fuel prices remains big concerns. The banking system is still recording large volumes of non-performing loans, and access to financial services remains limited. We welcome the authorities' plans to take appropriate actions to address these concerns.

On the fiscal front, we welcome the spending ceiling adopted by the authorities for transfers from the Petroleum Fund to the budget and we note that the Petroleum Fund Law defines estimated sustainable income as 3 percent of total petroleum wealth. We welcome the renewed commitment of the authorities to the basic principles of the petroleum fund arrangement. We also take note of the ongoing initiative of reforming the tax system with a view of revisiting non-oil taxation, reducing income tax, import duties and sales tax, service tax. We concur that this reform provides the opportunity to streamline existing tax incentives and to facilitate achievement of the authorities' goal of fostering private sector development.

As regard financial sector, we welcome the authorities' efforts to address the existing weaknesses in the financial system, notably the high volume of NPLs, the rising inflation, and the low rate of credit flows to private sector. We encourage the authorities to continue working towards further enhancing banking supervision, facilitating loan recovery and contract enforcement initiatives. In this respect, the ongoing measures including the expected launch of the central credit information registry unit and a continued enhancement of the banking supervision are commendable. Moreover, the regulatory framework of the banking system should be strengthened, with adequate legal protection for supervisors. We also call on the authorities to further consider the benefits of enacting the legislation on the transformation of the BPA into a full-fledged central bank.

Finally, we encourage the authorities to continue to develop an institutional framework to support the development of the non-oil private sector. The proposed land law that seeks to provide a framework for land ownership, titling and registration is a positive step in that regard. Further efforts to simplify business regulations and improve the judicial system will be also needed. Building capacity on statistical areas will be also important to improve data quality, notably on national accounts.

With these remarks, we wish the authorities success in their challenging endeavors.

Mr. Bergo and Mr. Abazorius submitted the following statement:

We thank staff for a well-written set of papers and Messrs. Sadun and Cardoso for their comprehensive buff. As we are in broad agreement with staff's views we shall limit ourselves to a few points for emphasis.

The abundant petroleum resources relative to the non-oil economy put Timor-Leste in a unique position. While the existence of these natural resources is a most welcome feature handling oil revenues topping 400 percent of non-oil GDP is a substantial challenge. The petroleum fund mechanism is key in this respect and the authorities stand to be commended for having established a sound institutional framework with a high degree of transparency. However, the low absorption capacity of the Timor-Leste economy contrasts with the sharp increase in the "sustainable" spending limit following from the high oil prices. The limits might be sustainable in an accounting sense but the increasing spending ceilings offer great scope for wasteful spending, build-up of inflationary pressures and Dutch disease if actual spending is not very much tuned to the administrative and absorptive constraints that exist. The authorities have so far managed to strike a balance between the need to increase investments in infrastructure and poverty alleviation on the one hand and ensuring continued macroeconomic stability on the other, but the proposal to increase spending by more than double that in the original 2008 budget is alarming. Adjusting spending upwards towards the "sustainable" limits should be done most carefully and guided by strict prioritizing in the NDP and keeping spending in line with implementation capacity. Is there in staff's view a need to supplement the petroleum fund mechanism with fiscal rules that more clearly recognize these limitations?

Like Messrs. Yamaoka and Nozaki, we see risks with the planned Economic Stabilization Fund. While the general rice subsidy might have been a relatively effective measure to assist the poor in the short term, given the high poverty rate, establishing institutions to do this on a more permanent basis and broadening the blanket subsidization to fuel and construction materials does not seem advisable.

Structural reforms are necessary to achieve sustainable growth of the formal non-oil economy to fight the poverty and to maintain the competitiveness. Improvements in infrastructure and education, reduced costs of doing business would accelerate the private activity and diversify the export base. We look forward to seeing the implementation of measures to improve the business environment as noted in Mr. Sadun’s and Mr. Cardoso’s buff. We encourage the authorities to step up efforts to simplify business regulations and to improve the judicial system to help courts to address commercial disputes. To spur private sector activity, the pending land law establishing a framework for land ownership, titling, and registration needs to be adopted as soon as possible. A more advanced financial sector is crucial to support private sector growth. We welcome the authorities plans to expand access to financial services, and we encourage the strengthening of the banking supervision. However, public sector involvement in financial sector should be based on commercial terms.

Mr. Charleton and Ms. Morgan submitted the following statement:

We thank the staff for the well-written reports and Messrs. Sadun and Cardoso for their comprehensive statement. We agree with the thrust of the staff's appraisal and offer the following comments for emphasis.

The task of stabilizing Timor-Leste's economy has begun. Growth rebounded in 2007 and the potential exists for the country to move to an even higher growth path. However, continuing civil unrests and political uncertainty remain major risks to growth and development. Given the country's history, the tremendous pressure for the authorities to convert Timor-Leste's newfound wealth from the offshore oil and gas sector into tangible benefits for the benefits of the citizens is understandable.

The major challenge facing the authorities is to address pressing short-term humanitarian needs arising from the civil unrests and emerging food insecurity, and promoting growth without risking macroeconomic stability. Intensification of the structural reform agenda to build institutional and administrative capacity, and strengthen the legal and regulatory framework to facilitate private sector development is a prerequisite.

Substantial revenue flows from the offshore oil and gas sector provide the authorities with ample resources to undertake necessary public investment in infrastructure and human capital. These are vital for tackling the country's pressing short and medium-term social and developmental needs. Given widespread poverty and inequality, very high level of unemployment and underemployment, particularly among the youth, severe shortage of personnel with the requisite skills to staff emerging institutions, and with more than half the population illiterate, there is an urgent need to tackle the country's social problems. Substantial increases in public investment in health, education and social protection are required.

Efficient and effective public spending has however been constrained by limited institutional and administrative capacity. In this context, we concur with the staff on the need for targeted spending, project prioritization in line with implementation and absorptive capacities, a carefully sequenced time-table and a framework for monitoring performance. To ensure quality investment of the resources, further improvements in budget execution and continued reform of public financial management cannot be overemphasized.

We note the authorities' plan to seek external loans to fund major infrastructure projects but see merit in Messrs. Sadun's and Cardoso's statement that in the immediate future, external financing could prove less favorable vis-à-vis the possibility of utilizing resources from the petroleum fund. However, if the strategy is adopted, we concur with the staff and other Directors that such borrowing must undergo careful cost-benefit analyses. In addition, we urge the authorities to ensure that adequate debt management capability is put in place.

We welcome the steps taken over the years to strengthen the institutional capacity of the Banking and Payment Authority (BPA). Potential inflationary pressures from significant increase in public expenditure and from external and supply-side shocks underscore the need for the BPA to be provided with adequate tools for monetary policy management. We encourage the authorities to enact legislation to transform the BPA into a fully functioning central bank.

While economic activity is currently driven by public spending, achieving sustained economic development requires a more active and vibrant private sector. The underdeveloped nature of the private sector must be addressed as a matter of priority. Messrs. Sadun and Cardoso have assured us of the authorities' determination to reform the business environment, including the plan to pass the land law this year. We urge the authorities to move ahead with implementation of reforms to reduce red tape, strengthen the weak legal and regulatory environment, address the poor state of physical and human infrastructure and further strengthen the financial sector to expand access to financial services.

Timor-Leste's acceptance as an EITI candidate country is a welcome development and we are also encouraged by the authorities' commitment to fully comply with international best practices.

We wish the authorities well as they seek to tackle the challenges ahead.

Mr. He and Ms. Liu submitted the following statement:

We thank staff for their insightful papers and Mr. Sadun and Mr. Cardoso for their helpful and comprehensive buff statement. As we generally agree with staff's appraisal, we wish to make the following comments for emphasis.

We are pleased that Timor-Leste's economy has partially recovered from the setbacks in 2006. However, poverty remains widespread. Compared with its neighboring countries in the ASEAN region, Timor-Leste remains among the poorest. We agree with the authorities that the short-tem priority is to stabilize prices—to realize the immediate goals of food security and social cohesion.

The oil sector has assumed a central role in the economy. How to manage oil and gas revenues appropriately and protect the vulnerable population from the threat of famine are the main challenges confronting the authorities. In this regard, we view the additional withdrawal from the Petroleum Fund as necessary for the pressing food needs. However, given the weak administrative capacity, we share staff's concern that the operational details of spending should be well-prioritized and carefully managed. Furthermore, we wish to reiterate the importance of the operational details of the Economic Stabilization Fund as the limited resources should be used to help the most vulnerable. Although we agree that the subsidization of food prices is an important measure to ensure food security, we encourage the authorities to design an exit mechanism so that such subsidies would not become permanent.

In the absence of monetary policy, we note that fiscal policy has assumed a central role in the face of exogenous shocks. In recognizing the need to enhance its resilience to such shocks the authorities are working toward building a strong and sustainable non-oil economy to create employment.

We take note of the authorities' intention to borrow external debt to finance large-scale infrastructure development and their consideration of the pros and cons of external borrowing. However, we sympathize with their view that the involvement of international financial institutions will help in building project management capacity and thereby improve the efficiency of investment. Staff's comments on such possible externalities will be appreciated.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Guzmán and Mr. Jiménez submitted the following statement:

We thank the staff for a very informative set of papers and Mr. Sadun and Mr. Cardoso for an insightful buff statement. We learn that despite a significant rebound of economic activity in 2007 (after the conflict and civil unrest in 2006), the security and political situation remain fragile and, in particular, that unstable security conditions continue affecting private sector activity. As a result of recent external shocks, the country faces additional risks to price stability and food security for the most vulnerable sectors of the population.

Last year we expressed our belief that two conditions were necessary for re-attaining higher growth rates in the future: The first one was the reinstatement of social and political stability after the outbreak of violence in 2006 (notwithstanding the fiscal cost), and the second one was the preservation of the macroeconomic framework, including a sound monetary policy and the use of the U.S. dollar as legal tender. In our view, these two conditions together would be the basis for a development-oriented fiscal expansion and represented an excellent opportunity for structural reform. We also believe some progress has been achieved in both fronts.

We praise the authorities for their recent efforts in order to revive the economy. The surge in government spending together with donor spending has been key to restart growth, while high international oil prices have helped to boost revenue. Moreover, the continuation of the Petroleum Fund's arrangements has supported macroeconomic stability–this is indeed a cornerstone for sound management of the country's resources. The government has also strengthened budget execution, improved financial sector regulation and made some progress in structural reform. The existing exchange rate regime remains appropriate and has been key to contain inflation.

Regarding policy recommendations, we agree with the strategy set out in the original National Development Plan and the staff assessment. It is true that the key challenge is to ensure that government spending (based on abundant petroleum revenue) is invested productively to support sustainable growth, alleviate poverty and develop a sustainable private, non-oil economy.

On the one hand, budget execution needs to be improved and, while there is ample room and need to increase spending, it should indeed be better prioritized and targeted to reduce waste. Well-targeted development spending should include education and basic infrastructure. On the other hand, structural reforms need to be further advanced. It is essential that reforms aim to support private sector activity and create a more competitive environment, which continues to be one of the main drawbacks of the Timor-Leste economy.

Finally, regarding current supply-side shocks which may imply increased inflation risks and food insecurity, it is essential that the monetary and exchange rate regime be preserved. We learn from the selected issues paper that while inflation in Timor-Leste has been recently driven by higher food prices abroad (a supply-side development), domestic demand pressures are increasingly a concern. Hence the need for the authorities to remain vigilant in both the monetary and the fiscal fronts (particularly regarding the management of oil wealth). Increased inflation risk is another reason why fiscal spending must be prioritized, even more so because of the potential effect of larger spending increases in 2008 on inflationary expectations. In this respect, the staff says that planned "increased spending appears beyond what can be soundly executed". We would like to hear more from the staff in this regard, although we concur with the view that some current expenditure (e.g. ad-hoc wage increases) seems inappropriate and care should be taken to avoid long-term entitlements.

Finally, another concern is the fact that the security situation remains fragile and more than 10 percent of the population remains internally displaced. Solving this problem should be a priority, and budget resources to address this issue are money put to good use.

With these remarks, we wish authorities every success in their endeavors.

Mr. Itam made the following statement:

We thank the staff for their informative report and Selected Issues paper, and Mr. Sadun and Mr. Cardoso for their insightful buff statement.

The Timorese authorities have maintained a sound macroeconomic policy framework which has ensured macroeconomic stability amidst the country's civil unrest and social concerns. Going forward, we note that the country still faces enormous challenges, including adopting measures to alleviate immediate social needs and security concerns, managing petroleum revenue to support the country's long-term development objectives, and continuing to maintain stability.

On the fiscal front, we urge the Timorese authorities to continue public financial management reforms, including improvement of budget execution. We agree with staff views that an increase in spending should be better prioritized and targeted to maximize benefits and avoid fueling inflationary pressures.

While we understand the capacity constraints, we would like to ask the staff to clarify why the authorities see merit in using concessional external borrowing, accompanied by technical assistance support, rather than using resources from the Petroleum Fund.

Like Mr. Mori, we would like to emphasize that, at a glance, external borrowing may look favorable, but it may pose a host of other problems to the recipient country. Therefore, we caution the authorities to carefully assess these options, taking into account explicit and implicit cost considerations.

On monetary policy, we support the authorities' reaffirmed commitment to use the U.S. dollar as the official currency to provide a credible nominal anchor and help to keep inflation in check. We consider this arrangement as appropriate in the interim, while the authorities work on measures to improve their capacity to manage monetary and exchange rate policies independently.

On structural reform, we note that relatively low social indicators to its comparators make Timor-Leste among the least developed countries globally. In this regard, we encourage the authorities to take advantage of large revenue inflows from offshore oil and gas to scale up investment in infrastructure and human capital development consistent with the priorities in the National Development Plan and the evolving implementation capacity.

Finally, Mr. Chairman, efforts to build institutions and improve the absorptive capacity in the country should remain a key priority. Improving the overall security situation in the country is also vital to resuscitate the subdued private sector activities.

With these comments, we wish the Timorese authorities success in their reform and future development agenda.

The staff representative from the Asia and Pacific Department (Ms. Creane), in response to questions and comments from Executive Directors, made the following statement:

> Directors' questions all related to the broader issue of how best to use Timor-Leste's gas resources to promote growth while keeping inflation in check. In that light, there was interest in issues related to the proposed mid-year 2008 budget update.
>
> A perennial issue for Timor-Leste has been weak budget execution, especially for capital projects. While there has been progress over the past few years, cash spending has increased but still remains far below appropriations each year. The new budget appropriation proposal is 2½ times the last full-year budget appropriation, and relative to what actual cash expenditure has been, it is a quintupling.
>
> Given the still low administrative capacity, we do not believe that the budget will be fully executed. We are concerned that what is spent will be tilted toward current spending or lower priority spending rather than the needed capital spending.
>
> While we would agree there is a need to increase spending, particularly given the social unrest in the past few years, our concern is that these budget increases are beyond the capacity to implement them. As a result, expenditure controls will be weakened, monitoring will be weakened, and there could also be an increase in price pressures.
>
> While the spending request that is being asked for—a withdrawal from the Petroleum Fund over the sustainable income level by about 60 percentage points of GDP—is in line with the rules of the Petroleum Fund framework, if it were to continue over time, spending of this size and kind would not be sustainable, and would call into question the current Petroleum Fund arrangements and saving rule. We would expect that they would have to be revisited. However, we do believe that the current arrangements remain appropriate, and that they provide a good fiscal framework for the Timor-Leste government in managing their spending over the longer term; that is if they are followed, as with any fiscal rule.

The government intends to invest in physical and human capital to help boost growth. The National Development Plan is still being updated. We understand that there are large-scale plans to invest in infrastructure across-the-board, including electricity, roads, water, agriculture, health, and education.

Let me turn to some specific points that were raised regarding government spending plans for the new Economic Stability Fund and other measures that the authorities have in mind in order to address the current food price crisis. The Economic Stability Fund is the authorities' response to the global rise in commodity prices, particularly for rice, which has hit Timor-Leste hard. Over the past year, rice import prices have tripled, and it would have had a major impact on inflation if it were not for the current government rice subsidies. The weight in the consumer price index is about 13 percent of the total, and costs of other goods, including fuel, have gone up.

The full scope and mechanisms for operating this new Fund, however, are not yet determined, and there is likely to be considerable debate when this is discussed in parliament in the next few weeks. We would expect that the rice subsidy program that is currently in place would continue, but the government has also stated that it would like to expand this to other foods, construction materials, and some other goods. Price controls have also been mentioned.

While we recognize that the government is in a difficult position given the social unrest—there were some rice riots a year back because of the scarcity of rice—the late timing of this budget, and the low administrative capacity, we do not expect a lot of this appropriation from the Fund to actually take place this year.

But given the large size of it—about 50 percentage points of GDP and about one third of the proposed new budget—and given the absence of details of how it would be spent, we are concerned about the need for better planning, and the possible impact of distorting the economy in the future. This would be a particular concern if it is expanded to other goods besides rice or other staples, or if price controls were introduced.

Other steps that the government is taking to address food issues are investment in local agriculture production, including seed experimentation and provision of heavy equipment to domestic farmers, such as tractors. Of course, we support these measures, but we recognize, as the government does, that it would take some time before they have some real impact.

There were a number of questions regarding the choice between spending Petroleum Fund resources versus beginning to borrow externally, which up until now the authorities have not done. This possibility of borrowing is one that the authorities themselves have proposed, and they are specifically considering whether to borrow on concessional terms from bilateral or multilateral creditors.

There would potentially be a financial gain, the authorities argue, from borrowing at low concessional rates, particularly if the return on Petroleum Fund resources is higher. In addition, the authorities consider that borrowing could provide access to technical assistance that would help to implement some of the projects that they have not been able to carry through up to now.

Mindful of the experience of many other countries, we have cautioned the authorities that if they proceed in this way, they should very carefully weigh and analyze all the pros and cons, including: that the proposal does indeed have adequate concessionality; that there is a net positive rate of return; that it is consistent with their own medium-term Development Plan; and, that it does not create problems for macroeconomic stability. Before the authorities commence any borrowing, they would need to set up a debt management capacity, which currently does not exist. In any case, as the authorities have observed, these proposals are still at an early stage and not likely to be acted on any time in the near future.

Finally, there was a question related to the important role of finance for future growth, especially about what has been happening with bank deposits. In the past two years, there has been a split between, on the one hand, continued increases in banking deposits and, on the other hand, stagnant credit growth. The civil unrest and the disruption to private businesses limited the extension of new credit. At the same time, growth of deposits initially stalled at the peak of the crisis in mid-2006. Since then, with the scaling up of international presence and increased government spending, deposits have again been taking off. Because credit is still being subdued and banks are still reluctant to lend domestically, they have been placing these excess funds abroad for the time being.

Mr. Mori made the following statement:

I am not much concerned with this last point on credit, because countries without much credit can still grow without too much difficulty. It is better to normalize the political situation first, and then start the borrowing activities of the private sector. The private sector is depositing money, and the

> money is still there for them to invest by themselves, so I think that we can wait on that. It is important to take time to enforce the prudential framework, particularly given that the three banks in Timor-Leste are foreign.
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> On foreign borrowing, it is a concern if the authorities can borrow and receive technical assistance in the same way as they could finance a project with their own resources and choose the project that provided technical assistance.
>
> Timor-Leste has no independent monetary policy, and the only instrument for macroeconomic management is controlling the flow of foreign resources domestically. With this increase in the budget, most of the expenditure is on foreign currencies, so there will be no pressure domestically.
>
> But what type of mechanism operates to put pressure on the nontradable sector? Despite inflation, and despite the fact that the country is using the dollar as its currency, inflation is relatively high: what is the reason for this inflation?

The staff representative from the Asia and Pacific Department (Ms. Creane) explained that, to date, inflation pressures had mainly emanated from the supply-side, spurred by higher global prices for food and fuel. However, while prices had been rising, inflation was still lower than in comparator countries in the region. Signs of possible demand-side led inflation had emerged, with bottlenecks for construction materials and, potentially, for labor.

Mr. Mori asked for clarification on whether construction materials in Timor-Leste were produced domestically or were imported.

The staff representative from the Asia and Pacific Department (Ms. Creane) confirmed that some construction materials—such as wood and bricks—were produced domestically, while other materials were imported.

Mr. Sadun made the following concluding statement:

> At the outset, I would like to thank the staff for their excellent work, for their excellent cooperation, and for their insights and advice which were provided to the authorities. Let me extend the same thanks to my colleagues who, through their grays, clearly grasp and understand the basic problems that Timor-Leste is facing.

The two more sensitive issues facing the country are the security situation, which has already been mentioned, and the fact that the country is one of the poorest countries in the region and, I would say, globally. About one half of the entire population is on the poverty line, and about 10 percent of the entire population is considered as displaced. These are the two overriding factors which characterize and, at this particular juncture and to a very large extent, condition any other consideration, including fiscal policy.

The authorities' top priority is to stabilize the security situation. It appears that the worst of the latest outbreak is over, although the situation is still very fragile. The authorities have to be very careful that economic and social pressures do not trigger another bout of security instability.

It is within these exceptional circumstances that the authorities have taken this attitude with the mid-year budget, which has to be considered as an extraordinary measure. There are no indications that this attitude will be ongoing; it is just to be prepared to cope with the situation, keeping in mind recent events.

The staff and Directors in their grays have wondered about the need to increase the appropriation if capacity, and the ability to actually spend the money, is so limited. I would say that the authorities' attitude to some extent reflects the need to be prepared to face unforeseen circumstances.

It was not long ago that the inflationary pressures on energy and foods that we are now seeing were not so severe. In many instances, many commentators have been surprised by the speed with which this situation has developed. I think that the authorities want to put themselves in the best situation to be prepared to tackle unexpected pressures of this kind.

The need to alleviate the pressure on food prices is self-evident, indeed so self-evident that I do not think it is worthwhile to elaborate on. But there is another aspect that perhaps should be clarified, because some of the efforts to alleviate pressure also include non-food and non-energy materials, such as construction.

In this regard, I wanted to reassure you that we are not talking about subsidizing construction materials in the sense of triggering another housing boom. Rather, subsidies are necessary to provide shelter to a very large percentage of the population. The authorities are trying to use the resources that are available through the Petroleum Fund to address two basic needs: food and shelter. With this kind of strategic framework, and having put this into context, I think that the decision that the authorities have recently taken will appear reasonable.

The authorities intend to remain vigilant to a number of potential problems which might arise on the fiscal side, as well as in relation to other aspects. We will have to hope that the international environment, particularly concerning the price of commodities, does not deteriorate. We have to hope that the security situation will not deteriorate either.

I wanted to conclude by expressing my appreciation for the support that has been indicated, through you, from the international community, and I will convey to the authorities the specific comments that have been put forward in your grays.

The Acting Chair (Mr. Kato) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They praised the authorities for Timor-Leste's solid recent macroeconomic performance. Despite civil unrest, macroeconomic stability has been maintained, aided by a sound fiscal and monetary framework. Looking forward, the key challenge remains to use the growing oil and gas revenue to develop a sustainable non-oil economy, while alleviating social problems and maintaining macroeconomic stability.

Directors believed that the strategy set out in the current National Development Plan remains valid. This includes the long-term oil and gas revenue savings policy, well-targeted development spending, a monetary and exchange rate regime that preserves macroeconomic stability, and a supportive environment for private investment and activity.

To ensure sustainable growth and poverty reduction, Directors stressed the need to encourage the development of the private sector. The comfortable level of resources should permit a stepping up of public investment in support of this, particularly in infrastructure and human capital development, as well as expenditures to address immediate security and humanitarian needs. Directors welcomed the tax reform, which should promote business formation, and called for further reforms to simplify business regulations, clarify land tenure rights, and improve the judicial system.

Directors observed that the increase in government expenditure planned for the midyear 2008 budget will call for careful planning and monitoring to ensure that such expenditure is productive while avoiding inflationary pressures. Adoption of cash-based budgeting would also be helpful. Directors noted the importance of enhancing Timor-Leste's administrative and absorptive capacities so that budget operations are accomplished efficiently and in a timely manner, and in full accordance with the authorities' program goals. Continued technical assistance will be needed in this regard. Looking further ahead, Directors encouraged the authorities to develop a medium-term fiscal framework that is in line with macroeconomic stability and the country's absorptive capacity.

Directors viewed the Petroleum Fund as a cornerstone for sound management of the country's resources, ensuring fiscal sustainability and macroeconomic stability. The Fund smoothes budget spending, provides for investment abroad of resources not required for budget execution, and mandates transparency in its operations. Looking forward, Directors encouraged the authorities to preserve these principles. They welcomed the acceptance of Timor-Leste as a candidate country in the Extractive Industries Transparency Initiative (EITI).

Directors agreed that the use of the U.S. dollar as the currency of Timor-Leste has served the economy well by providing a credible nominal anchor for price stability. They noted the staff assessment that the current level of the exchange rate appears broadly consistent with its equilibrium level. They observed that stronger institutional capacity will be needed before considering a move to introduce a national currency.

Directors welcomed the initiatives to strengthen the financial sector, including the progress made on a credit registry and the strengthening of banking supervision. Additional efforts are needed on pending financial sector legislation and the creation of an alternative dispute resolution mechanism. Any public sector participation in the financial system should be on commercial terms and supervised under domestic banking laws. Directors cautioned that proposals to begin external borrowing should be weighed carefully and analyzed transparently to ensure that such borrowing is adequately concessional, will deliver a clear net positive rate of return, and is consistent with macroeconomic stability.

Directors commended the authorities for the progress made on the compilation of financial and balance of payments statistics. They encouraged them to better monitor real sector activity through the compilation of national accounts.

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

APPROVAL: September 18, 2008

SHAILENDRA J. ANJARIA
Secretary