

**FOR
AGENDA**

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July 9, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Democratic Republic of Timor-Leste—Staff Report for the
2009 Article IV Consultation—Informational Annex**

The attached informational annex is being issued as a supplement to the staff report for the 2009 Article IV consultation with the Democratic Republic of Timor-Leste (SM/09/184, 7/9/09), which is tentatively scheduled for discussion on **Wednesday, July 22, 2009**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the Democratic Republic of Timor-Leste indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Schule (ext. 34563) and Mr. Cubero (ext. 36005) 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.

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INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF TIMOR-LESTE

Staff Report for the 2009 Article IV Consultation—Informational Annex

Prepared by the Staff Representatives for the 2009 Consultation with Timor-Leste

(In Consultation with Other Departments)

July 8, 2009

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ANNEX I. TIMOR-LESTE: FUND RELATIONS

(As of May 29, 2009)

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

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

III. SDR Department:	SDR Million	% Allocation
Holdings	0.00	N/A

IV. Outstanding Purchases and Loans: None

V. Latest 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 2008 Article IV consultation discussions with the authorities were held during April 16–30, 2008; the consultation was concluded on June 25, 2008. The Public Information Note may be found at <http://www.imf.org/external/np/sec/pn/2008/pn0878.htm>.

IX. Technical Assistance

Since late 1999, a significant amount of technical assistance has been provided by the Fund as part of the international community's efforts to

reconstruct the Timor-Leste economy. The Fund's technical assistance has focused on establishing key economic institutions (especially fiscal and monetary authorities) essential for macroeconomic management, as well as on developing local capacity to manage them. It also played a key role in the adoption of a new currency arrangement based on the U.S. dollar. Since late 1999, Timor-Leste has been one of the largest recipients of Fund technical assistance.

FAD: A series of multi-topic FAD missions took place early on to establish and develop the Central Fiscal Authority (CFA, February 2000), which developed into the Ministry of Planning and Finance. Assistance was provided to develop budget preparation, establish tax policy and administration, strengthen treasury and expenditure management, and advise on oil sector fiscal regimes. Long-term resident advisors were assigned to the Ministry of Planning and Finance and the Revenue Service of Timor-Leste to cover a wide range of issues, partly under a cost sharing arrangement with the UN. Over August 2004–July 2005, a FAD resident advisor assisted in the design and establishment of the Petroleum Fund, which started operations in August 2005. A FAD resident advisor to the Treasurer of the ministry finance started work in December 2006 to help strengthen expenditure management, reporting and budget execution—after a short break, a replacement has continued this work since July 2008. In 2007, a FAD TA mission provided guidance for future reform of the non-oil tax regime. In April 2009 a FAD technical assistance mission provided advice on implementation of the fiscal regimes for petroleum.

LEG: A number of LEG missions have been to Timor-Leste to advise the authorities on key fiscal and financial legislation. These included tax legislation, the budget and financial management law, and banking regulations (relating to the monetary authority, the banking system, and the payments system). Jointly with MFD (now MCM), technical assistance has been provided to assist in drafting an Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) Law. LEG has also provided assistance, in collaboration with FAD, for the drafting of the Petroleum Fund Act and tax consolidation, and in collaboration with MCM, for the drafting of the Central Bank Law.

MCM: A large number of missions took place early on to establish and develop the Central Payments Office (CPO, January 2000), which was transformed subsequently into the Banking and Payments Authority (BPA) (November 2001). Assistance was provided to establish a payments system, prepare banking legislation, and develop key functions of the monetary authority, including banking supervision, asset management, accounting, and organization and

management. Assistance was also provided on the introduction of a dollar-based currency system and to issue domestic coins to supplement the use of U.S. dollar coins. More recently, assistance has been provided to (i) draft the insurance law and develop a framework for insurance supervision; (ii) strengthen banking supervision; (iii) address a broad range of issues related to AML/CFT; (iv) establish and train the investment unit responsible for managing petroleum fund assets (funded by Norway, a resident adviser commenced in March 2005 and, after a break due to contract renegotiations, a replacement continued this work from November 2008); (v) prepare for the establishment of the central bank; (vi) design of a more effective organizational structure at the BPA; and (vii) modernize payment systems, and accounting for the Petroleum Fund. In addition, up until 2006 long-term resident advisors, including on banking supervision, payments, and accounting, have been assigned to the BPA under a cost-sharing arrangement with the UN. A long-term resident advisor assisted the BPA General Manager from February 2005 until February 2008, with that support subsequently provided on a peripatetic basis and funded by a Japanese grant.

STA: A multi-sector statistical mission took place in November 2000 to assess the availability and quality of official macroeconomic data, and help establish the Statistic Division of the Ministry of Planning and Finance. Assistance was provided by long term statistical advisors during November 2001-October 2005. Since 2007, a peripatetic statistical advisor has provided assistance for improving data compilation and developing local capacity to prepare balance of payments statistics—responsibility for this was transferred to the BPA in 2007. Provisional annual balance of payments statements for 2006 and 2007 were published in December 2008. In early 2008 a monetary and financial statistics (MFS) mission helped introduce the standardized report forms (SRFs) for reporting monetary data to the IMF and an integrated monetary database. Subsequently, Timor-Leste has, for the first time, been able to publish a country page in *IFS*. A March 2009 follow-up MFS mission assisted in expanding the institutional coverage of depository corporations to include microfinance institutions and in revising the call report form that will be used to collect balance sheet data.

X. Resident Representative

A resident representative office was established in Dili in August 2000. The current resident representative, Mr. Tobias Rasmussen, assumed the post in February 2006. The resident representative office closed at end-June 2009.

ANNEX II. TIMOR-LESTE: RELATIONS WITH THE WORLD BANK GROUP
(As of May 25, 2009)

1. Timor-Leste joined the World Bank Group on July 23, 2002. It became eligible for IDA assistance on October 9, 2002. Thus far, there has been no lending to Timor-Leste, reflecting the authorities' policy to avoid external borrowing, including concessional loans. However, the World Bank has been actively involved in the reconstruction and development of the economy since late 1999, by playing a key catalytic role in mobilizing and coordinating international assistance to Timor-Leste. Timor-Leste joined IFC in September 2004 and, together with the Pacific Enterprise Development Facility, an office was opened in Dili in 2006.
2. During the transition to independence, the World Bank's involvement centered around its role as trustee and co-manager of the Trust Fund for East Timor (TFET), which was established in December 1999 as a vehicle to provide grant assistance for reconstruction activities and economic development in Timor-Leste. Under the TFET, which is co-managed with the Asian Development Bank (ADB), the World Bank has administered projects relating to social services (especially health and education), agriculture, private sector development, community development and governance, economic capacity building, and petroleum sector development.¹
3. In addition to its involvement through the TFET, the World Bank played a key role in mobilizing budgetary assistance for the post-independence period through an annual multi-donor budget support operation. The Transition Support Program (TSP) from FY 2003 to 2005, was followed by the Consolidation Support Program (CSP) to FY2006/07, to reflect the shift from post-conflict transition to consolidation of gains made thus far. The TSP programs brought about \$30 million in budget support annually with about \$5 million financed by IDA, and the balance financed by 9 bilateral partners. The CSP program brought around \$10 million in budget support annually, with about \$0.5 million financed by IDA. Both the TSP and the CSP programs focused on three thematic areas: (1) good governance, including developing a legal framework for governance and the judiciary and strengthening public expenditure management; (2) service delivery for poverty reduction, particularly in education and health; and (3) job creation, especially through private sector development, agriculture, and improvements in basic infrastructure.

¹ Pledges to the TFET were made by 12 donors, including the European Commission and the World Bank, with the total amount of funds reaching \$178 million. This comprises donors' contributions of \$167 million (including \$10 million by the World Bank) and investment income of \$9 million. TFET projects are expected to wind down by end-2010.

4. The World Bank has also provided analytical and advisory services, including through a Country Economic Memorandum, a Poverty Assessment, a Public Expenditure Management and Accountability Note, a Public Expenditure Review, an Education Sector Review, and a Paper on Strengthening the Institutions of Governance in Timor-Leste. The “Doing Business” report for 2006 featured Timor-Leste for the first time and was updated for 2007 and for 2008. The World Bank has also produced short, just-in-time reports on Key Lessons from the Creation of Veterans Policy in Timor-Leste (September 2008), Policy Note on Population Growth and its Implications in Timor-Leste (October 2008), and Timor-Leste: Poverty in a Young Nation (November 2008).

5. In July 2005 the World Bank adopted a Country Assistance Strategy for FY 2006–08. The International Development Association (IDA) and the International Finance Corporation (IFC) are currently preparing an Interim Strategy Note, scheduled to be presented to the Board of Executive Directors in June 2009. As of March 2009, the World Bank Group had a total commitment of US\$69.8 million (including an IDA commitment of US\$12.4 million) with 9 active projects in the health and education sectors, in agriculture, in support to youth development, in planning and public financial management, and in the energy sector.

6. As budget support is no longer required given the increase in petroleum revenue, the CSP program was replaced by donor support for the Government’s National Priorities Program launched in 2008. The annual program was continued in 2009 and included seven priority areas: (i) agriculture and food security; (ii) rural development; (iii) human resources development; (iv) social protection and social services; (v) public safety and security; (vi) clean and effective Government; (vii) access to justice.

7. The eighth and latest Timor-Leste Development Partners Meeting (TLDPM) took place on April 2–4, 2009. The World Bank helped the preparation of the Government’s background paper to the TLDPM.

ANNEX III. TIMOR-LESTE: RELATIONS WITH THE ASIAN DEVELOPMENT BANK
(As of May 26, 2009)

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

2. Prior to 2008 the AsDB's involvement centered around co-managing with the World Bank the Trust Fund for East Timor (TFET), which was established in December 1999 as a vehicle to provide grant assistance for reconstruction activities and economic development in Timor-Leste.² Under the TFET, AsDB managed six projects with total funding of \$51.7 million,³ which aimed at the rehabilitation of physical infrastructure (urban and rural power, national roads, ports, and water and sanitation) and the development of microfinance. In the wake of the post-referendum destruction, the focus of the projects was on providing emergency assistance, but subsequently shifted to meeting the country's long-term development needs.

3. The AsDB's Country Operations Business Plan for 2008 to 2010 identifies infrastructure development and management as the primary focus of AsDB support to Timor-Leste. An ongoing road rehabilitation project (\$10 million grant) and Dili water supply project (\$6 million grant) are funded through the 9th Asian Development Fund (ADF IX). The recently negotiated ADF X allocates approximately \$20 million for the first biennial period 2009-2010, entirely on a grant basis. Most of this money will support road maintenance, rehabilitation, and improvement. Additional AsDB technical assistance will average approximately \$2 million per annum. Allocations will be confirmed in a new Country Partnership Strategy for 2009–2013. Timor-Leste is the recipient of AsDB's largest ever technical assistance (TA) grant, the Infrastructure Project Management TA. This \$15 million four-year package, co-financed with AusAID, finances international and domestic project engineers, procurement specialists, and others to work within the Ministry of Infrastructure to help plan, prepare, and execute the Government's capital development program.

² See footnote 1 in Annex II, Relations with the World Bank Group.

³ These projects comprise the Emergency Infrastructure Rehabilitation Project (\$29.8 million); the Emergency Infrastructure Rehabilitation Project 2 (\$9 million); the Water Supply and Sanitation Rehabilitation Project (\$4.5 million); the Water Supply and Sanitation Rehabilitation Project 2 (\$4.5 million); the Hera Fisheries Port Facilities Rehabilitation Project (\$1 million); and the Microfinance Development Project (originally \$4 million, but reduced to \$2.7 million).

4. AsDB is currently preparing a new ADF-funded project in road network development and a project on community based roads maintenance drawing on the Japan Fund for Poverty Reduction. A regional private sector development support program, can also support access to finance (micro-finance and secured transactions) and public-private-partnerships in infrastructure development. AsDB has also intensified efforts to strengthen and divest the Microfinance Institute of Timor-Leste (IMfTL). It is also designing a technical assistance program in support of statistics and macro economic management.

ANNEX IV. TIMOR-LESTE: STATISTICAL ISSUES

As of June 30, 2009

I. Assessment of Data Adequacy for Surveillance

General: Data provision to the Fund has serious shortcomings that significantly hamper surveillance. Weaknesses remain in the macroeconomic data, especially the national accounts. A multi-sector Fund statistics mission visited Dili in November 2000 and assisted the authorities in establishing objectives for restoring economic statistics and in setting up a Statistical Division in the Ministry of Planning and Finance in 2001. A long-term resident statistical advisor assisted the Statistical Division during November 2001–February 2004, and was succeeded by a new resident advisor until September 2005. Technical assistance in balance of payments (peripatetic) and monetary statistics to the Banking and Payments Authority (BPA) began in mid 2007 and January 2008, respectively, and will continue through at least FY 2010.

National Accounts: Under a World Bank-financed project, national accounts data for 2000 (both sector and expenditure basis) were estimated by the Boston Institute for Developing Economies (BIDE). In late 2004, BIDE, under a follow-up World Bank project, produced GDP estimates for 2001-03 that suffer from limited source data and substantial extrapolation. The Statistics Directorate has not been able to replicate the BIDE estimation exercise. Consequently, estimates of GDP (including for the oil sector) have been prepared by Fund staff in cooperation with the Macroeconomic Unit in the Ministry of Finance. To improve national accounts data, appropriate staff and substantial efforts in data collection and compilation are needed. Using World Bank funding and commencing in April 2009, the authorities are employing a consultant to develop annual estimates of GDP.

Price statistics: A consumer price index has been compiled for Dili since December 2001 and for the whole country since June 2003. Prices for all items in the basket are collected on a monthly basis in the Dili region. Elsewhere, prices are collected at quarterly intervals for a representative selection of other regions throughout Timor-Leste. The measure of the interim monthly price movements for each item outside the Dili region is then estimated using the corresponding Dili region item price movement as an indicator series. To address quality weaknesses, in particular inappropriate and outdated weights, the commodity basket and the weighting scheme were revised in mid-2003 under a donor-supported project. A further update of CPI weights based on detailed consumption patterns is expected to commence later in 2009 using data derived from the Timor-Leste Living Standards Survey that was conducted in 2006/7. An update of products and outlets is also needed.

Labor market statistics: Annual data on public sector employment and wages are available in official budget documentation. No official data are compiled regularly on private sector employment and wages, except for partial data from various household surveys conducted by UNDP, ILO, ADB, and the World Bank.

Government finance statistics: Official data on central government revenue and expenditure are published quarterly. Audited annual financial statements of the executed budget are made available to APD as soon as they are released, normally three months after the end of the fiscal year. In addition, monthly data are available on request through the budget, treasury, and revenue services. The compilation of revenue and expenditure follows the classification of the *Manual on Government Finance Statistics (GFSM 1986)* (including expenditure based on both functional and economic classification). Only partial data are available on fiscal and quasi-fiscal activities undertaken by bilateral donors outside the central government budget. Currently, there are four non-financial public enterprises, which are treated as government agencies and data on their operations are available in the audited annual financial statements. No data are currently reported for the *GFS Yearbook* and the *International Financial Statistics*.

Monetary statistics: Monetary statistics are compiled by the BPA, generally following the methodology of the *Monetary and Financial Statistics Manual*. However, data are incomplete because of the absence of official data on public currency holdings—which are difficult to compile under the current currency regime—and of banks' positions with public nonfinancial corporations. The BPA publishes current monetary data on its website on a regular monthly basis and a quarterly bulletin and an annual report with key monetary aggregates.

Detailed monthly monetary data are now available from July 2002 onward following the introduction of the standardized report forms (SRFs). Beginning in February 2008, monetary data are reported to the IMF for publication in the *International Financial Statistics*. SRF-based data are used for the Fund's operational and publication purposes. The BPA is planning to introduce a new chart of accounts for the BPA in the coming months and a revised call report form (CRF) in mid-2009 to obtain balance-sheet information from other depository corporations (ODCs). A March 2009 mission assisted the authorities in finalizing the design of the CRF and expanded the institutional coverage of the ODCs to include all microfinance institutions. A follow-up mission has been tentatively scheduled during FY 2010 to assist the authorities in introducing the SRFs for the central bank based on the new chart of accounts of the BPA and for the ODCs based on the revised CRF and including the credit unions in the institutional coverage of the ODCs.

Balance of payments: Monthly data on merchandise exports and imports have been produced starting March 2000, based on customs reports with a breakdown for major commodity categories. Data do not include oil and gas exports or an estimate of the large, unrecorded border trade. The monthly trade data are now published regularly but there are significant gaps in the series for 2006 and 2007. In the Fund staff estimates, data on oil/gas revenue are currently recorded as current income based on fiscal data.

With technical assistance provided by the IMF's Statistics Department, annual balance of payments data for 2006 and 2007 were published by the BPA in December 2008. The 2008 estimates have not yet been finalized.

While methodology for the production of basic annual estimates of the balance of payments statistics are in place, further development work is anticipated to address limitations of existing data sources, in particular grants, merchandise trade statistics, and travel exports.

The coverage of the survey of foreign direct investment enterprises needs to be expanded, and the exploration and extraction activities, in the Joint Petroleum Development Area and in the exclusive territory, will require continuous coverage. As the economy grows, it will be important to monitor new activities such as new direct investment. Currently, there is limited information on remittances from Timorese working abroad and improvement in the estimation/compilation procedures of such remittances should be pursued.

Some data on stocks of financial assets and liabilities have been collected as the balance of payments development has taken place, and the annual international investment position statements should be finalized. Development of quarterly statistics should also be pursued.

II. Data Standards and Quality

Not a General Data Dissemination System participant.

No data ROSC is available.

Timor-Leste: Table of Common Indicators Required for Surveillance
(As of June 24, 2009)

	Date of latest observation	Date received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of publication ⁶
Exchange Rates	5/2009	6/2009	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	5/2009	6/2009	M	M	M
Reserve/Base Money (<i>excludes currency in circulation</i>)	5/2009	6/2009	M	M	M
Broad Money (<i>excludes currency in circulation</i>)	5/2009	6/2009	M	M	M
Central Bank Balance Sheet	5/2009	6/2009	M	M	M
Consolidated Balance Sheet of the Banking System	5/2009	6/2009	M	M	M
Interest Rates ²	5/2009	6/2009	M	M	M
Consumer Price Index	3/2009	5/2009	M	M	Q
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	3/2009	6/2009	Q	Q	Q
Stocks of Central Government and Central Government-Guaranteed Debt	No debt contracted				
External Current Account Balance	2007	12/2008	A	A	A
Exports and Imports of Goods and Services ⁵	4/2009	6/2009	M	M	M
GDP/GNI	2003	10/2004
Gross External Debt	Not applicable				
International Investment Position ⁷	Not available				

¹Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

²Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³Foreign, domestic bank, and domestic nonbank financing.

⁴The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. For Timor-Leste it includes public spending from donors, on which regular data on execution are not available.

⁵Includes only goods. There are significant gaps in the series. No information on services is available.

⁶Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); NA: Not Available.

⁷Includes external gross financial asset and liability positions vis-à-vis nonresidents.

ANNEX V. POVERTY REDUCTION: THE ROLE OF INFRASTRUCTURE

Timor-Leste is one of the poorest countries in Asia. A 2001 household income and expenditure study estimated that 36 percent of the population lived below the national poverty line, almost all of whom were in rural areas with poor access to water, sanitation and health care. A 2007 update suggests that many key dimensions of living standards have improved, as shown by improved self-assessments of living standards, and in school enrolment rates, immunization rates and the availability of many basic services.⁵ However, the share of the population living below the poverty line was found to have increased to about 50 percent. Half of the children less than five years were underweight in 2007, with 12 percent to 18 percent of children under five years severely underweight. Large gaps remain in access to education and health care and other essential services and in the quality of these services. Living standards are noticeably lower in rural areas, with about three quarters of the poor living in rural areas.

Shortcomings in infrastructure appear to be central to the poverty problem. They make it more difficult for the poor to access markets for their products and essential services and add to the cost of goods and services needed by the poor. The poor are also more likely to face the shortcomings in infrastructure. For example, at the national level, 64 percent of the poor have access to all weather roads, compared with 76 percent of the non-poor. And in rural areas the proportion of poor with access to all weather roads decreases further to 58 percent compared with 68 percent of the non-poor.

Much of Timor-Leste's infrastructure was badly damaged immediately following the referendum in 1999, either during the violence that ensued or subsequently because of the damage from heavy vehicles, lack of maintenance or heavy rain. Despite efforts at rehabilitation, critical infrastructure has deteriorated further since then. This is particularly the case for the road network.

Road is the primary mode of transport, carrying 70 percent of freight and 90 percent of passengers. Timor-Leste has an extensive road network of about 6,000 km, half of which are currently undeveloped rural tracks. The core network comprises 1,400 km of national roads connecting the 13 districts and 900 km of district roads linking major population centers to the national roads. About 80 percent (or 1,800 km) of core roads are, or used to be paved. Almost the whole core road network needs rehabilitation works to restore the network to a maintainable condition as road conditions demonstrate premature deterioration due to lack of routine and preventive maintenance. This is compounded by intense rainfalls and unstable geotechnical conditions in mountainous areas causing frequent landslides.

⁵ Timor-Leste Ministry of Finance, and World Bank. 2008. *Timor-Leste: Poverty in a Young Nation*. Dili.

According to a recent Asian Development Bank road condition survey, almost the whole core road network has deteriorated into conditions that are no longer maintainable; about 22 percent of the core roads are in poor condition and about 70 percent in very poor condition. The needs of annual maintenance expenditure for the whole core road network are estimated in the order of \$20–30 million under current road conditions.

Power and water supply and sanitation infrastructure are also degraded. Access to regular power supply in urban areas has deteriorated, and access to clean water remains problematic in both urban and rural areas. There are three contributing factors: the poor and deteriorating nature of existing physical infrastructure; cost and logistical issues in accessing rural areas; and weak public sector capacity in terms of infrastructure planning, management and prioritization.

**ANNEX VI. PROSPECTS FOR FINANCIAL DEVELOPMENT:
THE EMERGING ROLE OF MICRO-FINANCE**

While there is a high level of excess liquidity in the financial system, the commercial banks have become reluctant to lend to local businesses. Foreign banks cannot own land and need to rely on land leases or other assets as security. But uncertainty over the legitimacy of land titles and the nascent state of the system of land leases make it difficult for land to be used as collateral. Use of other assets as collateral is hindered by the absence of a local insurance industry. The still developing civil court system is slow as it is heavily overworked, adding to uncertainty in the ability to access security in the event of loan default. These difficulties contributed to the quick emergence of a non-performing loan problem following a surge in domestic credit.

Microfinance has a narrow coverage, but is showing it can find ways of working within the heavily constrained environment. The largest microfinance institution, Instituição de Micro Finanças de Timor-Leste (IMfTL) has operated since 2002. It has built itself on loans secured by public sector salaries. Many loans were for housing and other household needs, but loans were also used within extended families to start small-scale business enterprises, such as small trading and taxi operations. A \$1 million ceiling on deposits under the Banking and Payments Authority (BPA) Act delayed expansion plans (IMfTL is the only microfinance institution regulated by the BPA). The ceiling was lifted to \$3 million after the government took sole ownership of, and recapitalized, IMfTL in December 2008.

Deposits with IMfTL, from around 23,000 depositors, had reached \$1.4 million by March 2009. Total loans of \$4.0 million as of March 2009 were well above the \$2.3 million of December 2007. Seven district offices are now established and offices are planned for all districts by 2011. Salary loans still account for 75 percent of total loans, but alternative products—i.e., micro finance group loans, market vendor loans, agriculture loans and micro enterprises loans—are rising. The salary-backing of most loans and careful lending practices are credited with a low overall provision for non-performing of only 2.2 percent of the total value of loans.

Other key microfinance institutions are Moris Rasik and Tuba Rei Martin. Moris Rasik is the leading microfinance institution for poverty reduction. It operates solely in rural areas and lends only to women, along the lines of the well-known Grameen Bank approach. Total loans were \$2.2 million as of December 2007 and deposits from 11,500 accounts totaled \$0.8 million. Tuba Rei Martin held around \$0.4 million in deposits from almost 3,000 accounts as of July 2008, with loans of \$0.4 million. Credit unions, which have a long-standing presence in Timor-Leste, are also active, as are pawn shops, money lenders and a number of small donor-funded loan facilities.

A recent assessment concluded there is considerable unmet demand for microfinance.⁶ The shortfall was estimated to be as much as 80,000 micro-credit loans worth more than US\$50 million. Lack of credit is a particularly important constraint to agriculture, which accounts for about 80 percent of employment. Agribusiness is hindered because loans are generally unavailable for the purchase of farm inputs or improvements, or for trade in farm products. Micro-savings services are also under-supplied.

Interest rates are high. IMfTL for example lends at 16 percent to 18 percent per annum and rates at Tuba Rei Martin are up to 70 percent per annum. The high interest rates primarily reflect the high cost of providing a large number of small transactions. In an effort to lower interest costs, the Inclusive Finance for the Under-Served Economy (or INFUSE) project has been proposed as source of low cost wholesale funds (and technical support). However, care is needed to ensure that this inflow of foreign funds does not impede deposit taking.

There are long standing proposals for a government-owned national development bank. Key issues to be faced by such a bank would be: the potential to displace rather than supplement existing financial operations; the potential fiscal downside of carrying too much risk in an effort to kick-start development; and whether it is desirable for governments to own financial institutions. An alternative approach could be to provide support through new, targeted programs implemented through existing institutions. An emphasis on helping potential borrowers develop and then implement good loan projects rather than just providing cheap loans is likely to offer the highest development impact.

⁶ Australian Agency for International Development, 2008, *Review of the Microfinance Sector in East Timor*, Final Report, December; and Instituição de Micro Finanças de Timor-Leste (IMfTL), personal communication.