IMMEDIATE ATTENTION

SM/12/13
Supplement 3

January 25, 2012

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Democratic Republic of Timor-Leste—Staff Report for the 2011 Article IV Consultation—Draft Public Information Notice**

Attached for consideration by the Executive Directors is the draft Public Information Notice (PIN) relating to the staff report for the 2011 Article IV consultation with the Democratic Republic of Timor-Leste (SM/12/13, 1/20/12), which is being considered on a lapse of time basis by **noon on Friday, January 27, 2012**. In the absence of a request for a Board discussion, the Executive Board Assessment section of the PIN will be based on the staff appraisal, as attached.

At the time of circulation of this paper to the Board, the authorities of the Democratic Republic of Timor-Leste have indicated that they need more time to consider whether they will consent to the Fund's publication of this PIN. Publication will only proceed upon the receipt by the Fund of the member's explicit consent.

Questions may be referred to Mr. Jang (ext. 34169) and Mr. Ochirkhuu (ext. 37662) in APD.

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

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 12/xx
FOR IMMEDIATE RELEASE
February [dd], 2012

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2011 Article IV Consultation with the Democratic Republic of Timor-Leste

On February 1, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Democratic Republic of Timor-Leste and considered and endorsed the staff appraisal without a meeting.[1]

Background

After emerging from a long struggle for independence and internal conflicts between 1999 and 2006, Timor-Leste has made substantial progress toward restoring stability and rebuilding the country. Rising government spending and a rebound in agriculture supported strong non-oil GDP growth since 2007, averaging 12 percent. Despite unseasonal rain that damaged agricultural produce, growth is estimated to remain strong at about 10 percent in 2011 on the back of high government spending. Inflation in Dili, however, rose to 17½ percent (year-on-year) in December 2011, due to high food prices, a weak U.S. dollar, and strong demand from rising government spending, and it is becoming broad-based.

The government launched its Strategic Development Plan to transform Timor-Leste into an upper-middle-income country by 2030. To achieve this goal, the government plans to scale up public investment to improve poor infrastructure. Capital expenditure has increased rapidly in 2011 so total government spending is estimated to rise to $1.2 billion from $0.8 billion in 2010. Owing to rising petroleum revenue, however, the overall fiscal balance is expected to continue to record a large surplus of 50 percent of GDP in 2011, and the Petroleum Fund has risen to about $9 billion. Most of the Petroleum Fund is invested in US government bonds.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Credit to the private sector has recently started rising after being stagnant for a few years. However, it remains low at only 13 percent of non-oil GDP, reflecting the lack of collateral and weak contract enforcement. These weaknesses together with high nonperforming loans have contributed to high lending rates in Timor-Leste. Nonperforming loans are high at almost 40 percent of total loans but are fully covered by provisions. Three foreign bank branches dominate the financial sector. The Banking and Payments Authority was recently transformed to a central bank, with no change in its function. The U.S. dollar is the legal tender.

The current account surplus is estimated to remain large at over 50 percent of GDP in 2011 due to high oil revenue. Non-oil exports, excluding coffee, are minimal and the country depends highly on imports given almost no domestic production base except subsistence farming and coffee. Foreign assets have risen to an all-time high at 170 months of imports. The real effective exchange rate has appreciated by 6 percent in 2011.

The outlook for growth and poverty reduction is promising as Timor-Leste stands to benefit enormously from its petroleum wealth in coming years. Using this wealth, the government has resolved to step up development. With rising government spending, non-oil GDP growth is projected to remain strong at about 10 percent in 2012 and over the medium term and the current account surplus is projected to decline. Key risks to the outlook are high inflation, a fall in oil prices, and slow progress in building public financial management capacity.

Executive Board Assessment

In concluding the 2011 Article IV consultation with Timor-Leste, Executive Directors endorsed staff’s appraisal as follows:

Rising government spending has supported strong economic growth, but inflation has jumped to double digits. Using its petroleum wealth, the government has resolved to step up development by scaling up investment in infrastructure. Real non-oil GDP growth is projected to remain strong at about 10 percent in 2012 and over the medium term. Key risks to the outlook are oil price volatility and the possibility that inflation continues to rise on the back of large increases in government spending.

Given development needs, investment in infrastructure is welcome, but the planned increase of spending over the next few years needs to be slowed to better align with the absorptive capacity of the economy and administrative constraints. Continued large increases in government spending would raise inflationary pressure further, and high inflation will impose significant costs on the poor. In the absence of monetary policy, sound fiscal policy is key to containing high inflation and sustaining strong economic growth. The government’s intention to consider adjusting the pace of 2012 budget execution if inflation remains high is welcome. Staff stressed the importance of continued progress in improving the capacity to implement capital projects.

The authorities’ plan to reduce the non-oil fiscal deficit to a sustainable level over the next 10 years is appropriate. This will provide an important anchor for fiscal policy. To achieve this goal, the government may need to take substantial measures, including containing spending growth and increasing domestic revenue. In addition, the medium-term budget framework needs to be strengthened by including the full costs of planned major projects and recurrent costs once they are available. The authorities' intention to review the recent FAD mission's recommendations to raise non-oil revenue, including the introduction of a VAT over the medium term, is welcome. Repealing the very generous tax holidays under a new private investment law is recommended.

The government has made solid progress in improving public financial management (PFM). A well-managed Petroleum Fund is in place. Further progress has been made in addressing the weaknesses in PFM by establishing new institutions to strengthen public investment management. The lack of skilled personnel is the key constraint to PFM so the government's focus on training Timorese should help build capacity.

Developing the financial sector and strengthening the credit culture are critical for sustained growth in the private sector. The Central Bank's continued efforts to strengthen financial sector supervision and regulations are welcome. Banks tightened their lending standards and improved credit assessments. Speeding up the passage of key legislations such as the land law would help financial sector development.

The use of the U.S. dollar is appropriate given the limited capacity for independent monetary and exchange rate policies. Non-oil exports, excluding coffee, are minimal and the country depends highly on imports. Accelerating structural reforms is needed to improve competitiveness. Prudent fiscal policy will be key to maintaining external stability over the long term.

Data quality and availability need to be improved. More staff and training are needed to improve the data necessary for policy analysis and formulation.

Table 1. Timor-Leste: Selected Economic and Financial Indicators, 2007–12

GDP at current prices (2010): US$3.2 billion
Population (2010): 1.1 million
GDP per capita (2010): US$2,908
Non-oil GDP per capita (2010): US$821
Quota: SDR 8.2 million

	2007	2008	2009	2010	2011	2012
					Proj.	Proj. 1/
	(Annual percent change)					
Real sector						
Real non-oil GDP growth	11.7	14.6	12.8	9.5	10.6	10.0
CPI (annual average) 2/	10.3	9.0	0.7	6.8	13.5	8.0
CPI (end-period) 2/	8.6	7.5	1.7	9.2	17.4	8.0
	(In percent of GDP, unless otherwise indicated)					
Central government operations						
Revenue	75.4	80.8	72.5	75.2	78.1	72.6
Domestic revenue	2.7	1.7	2.5	2.6	2.6	3.3
Petroleum revenue	72.6	79.1	70.0	72.6	75.6	69.3
Expenditure	13.5	19.6	23.8	24.8	28.0	34.8
Recurrent expenditure	8.8	13.5	15.4	16.5	13.0	16.7
Capital expenditure	4.8	6.1	8.4	8.4	15.0	18.1
Overall balance	61.8	61.2	48.7	50.4	50.2	37.9
Non-oil overall balance (in percent of non-oil GDP)	-39.6	-85.3	-71.1	-81.1	-104.0	-102.2
	(Annual percent change, unless otherwise indicated)					
Money and credit						
Deposits 3/	44.2	34.9	38.7	9.8	14.2	…
Credit to the private sector 3/	-9.8	1.9	1.1	5.9	23.6	…
Lending interest rate (percent) 3/	15.0	13.1	11.2	11.0	10.8	…
	(In millions of U.S. dollars, unless otherwise indicated)					
Balance of payments						
Current account balance	1177	2023	1363	1538	2375	1773
(In percent of GDP)	65.1	66.7	51.7	48.1	55.0	43.5
Trade balance	-169	-297	-376	-374	-666	-795
Exports 4/	7	14	9	18	22	33
Imports	176	311	385	392	689	829
Petroleum revenue	1313	2400	1845	2323	3261	2821
Overall balance	147	-20	39	156	-3	160
Public foreign assets (end-period) 3/ 5/	2316	4407	5627	7310	9743	11487
(In months of imports)	158	170	175	224	170	166
Exchange rates						
NEER (2000=100, period average) 3/	94.4	92.1	95.4	89.3	83.8	…
REER (2000=100, period average) 3/	100.9	102.3	105.1	102.3	103.9	…
NEER (2000=100, end-period) 3/	91.8	100.3	89.3	86.7	84.7	…
REER (2000=100, end-period) 3/	98.7	112.0	99.8	102.4	108.2	…
Memorandum items:						
GDP at current prices:	1808	3035	2634	3199	4315	4073
Non-oil GDP 6/	494	635	790	876	1054	1252
Oil GDP 7/	1313	2400	1845	2323	3261	2821
Crude oil prices (U.S. dollars per barrel, WEO) 8/	71	97	62	79	104	100
Petroleum Fund balance (in millions of U.S. dollars) 3/	2086	4197	5377	6904	9338	10923
Petroleum Fund balance (in percent of non-oil GDP) 3/	422	661	681	788	886	872
Public debt (in millions of U.S. dollars)	0	0	0	0	0	43

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

1/ Staff proposals.
2/ For Dili (capital city). The countrywide CPI is available on a quarterly basis only.
3/ Data for 2011 is as of end-October.
4/ Excludes petroleum exports, the income of which is recorded under the income account.
5/ Includes Petroleum Fund balance and the central bank's official reserves.
6/ Based on the resident national accounts advisor's new estimates.
7/ Petroleum revenue is used as a proxy for oil GDP.
8/ September 2011 WEO assumptions.