FOR AGENDA

SM/13/274
Supplement 1
Correction 2

October 18, 2013

To: Members of the Executive Board

From: The Secretary

Subject: **Democratic Republic of Timor-Leste—Staff Report for the 2013 Article IV Consultation—Debt Sustainability Analysis**

The attached correction to SM/13/274, Sup. 1 (10/9/13) has been provided by the staff:

Evident Ambiguity

Page 4, para. 4, 3rd bullet, line 3: for "maximize" read "increase"

Questions may be referred to Mr. Saker (ext. 37969) and Ms. Hunter (ext. 38877) 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

FISCAL FRAMEWORK

3. **The DSA is based on the authorities' current fiscal framework outlined in the accompanying Staff Report, which significantly improves the fiscal and public balance sheet outlook over the long term compared to the 2013 Budget Book plans**. The so-called Yellow Road framework cuts expenditure growth over the medium term vis-à-vis the 2013 Budget, thereby also lowering the need for financing either through external borrowing or excess PF withdrawals (see text table). Under this framework, staff projects that external borrowing ceases by 2022 yielding stable long-term dynamics regarding public assets in gross and net terms. This contrasts with the unsustainable scenario set out in the 2013 Budget framework that projected large excess PF withdrawals and debt accumulation. This implied a rapid drawdown of public assets after 2024 when oil production is projected to end (see text figure). The unsustainable debt dynamics of the 2013 budget plans are highlighted in Figure 1a.

Projected Medium-Term Fiscal Funding Gaps under 'Yellow Road' and the 2013 Budget
(In millions of US$ unless otherwise noted)

	2013	2014	2015	2016	2017	2018
Baseline: Yellow Road 1/	260	275	319	278	195	124
percent of GDP	4.1	4.7	5.3	4.6	3.2	2.0
2013 Budget 2/	479	661	725	700	723	745
percent of GDP	7.8	11.5	12.1	11.5	11.5	11.6
Difference	-219	-386	-406	-422	-528	-622
percent of GDP	-3.6	-6.8	-6.8	-6.9	-8.3	-9.6

1/ "Yellow Road" framework agreed to by the Council of Ministers in June 2013.
2/ Timor Leste 2013 State Budget Book 1.

4. **The government will need a strong asset-liability management framework as its balance sheet becomes more complex.** In the period ahead, the government is planning to take on new debt liabilities and enter into public-private partnerships (PPPs) that may generate contingent liabilities.[3] On the asset side, there are plans for government and/or government owned entities to take equity positions in major capital projects. Key considerations are:

- Public debt. Contracting concessional debt from developmental partners is beneficial as it could improve the quality and returns of capital projects. Non-concessional debt should be avoided.

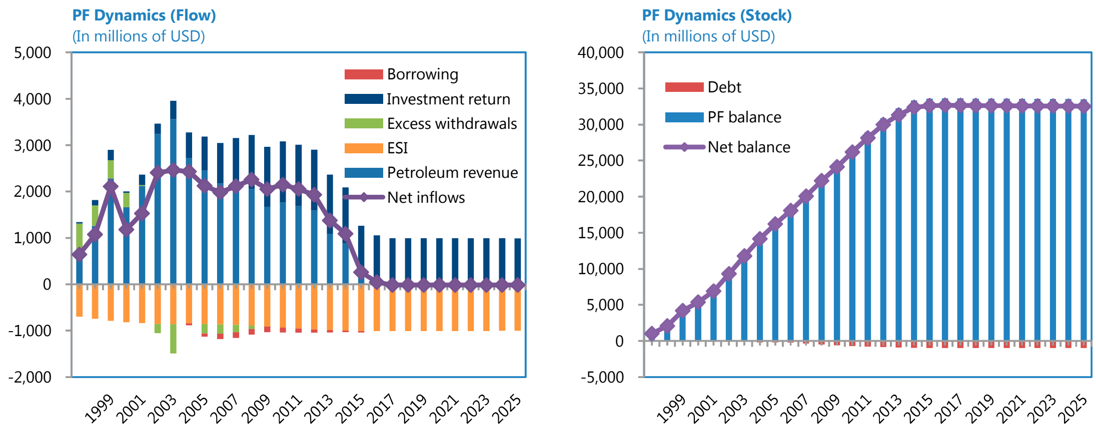
- Off-budget investments. Major capital-intensive projects tend to have complex financing structures and the cost-benefit of public participation in these projects can be difficult to assess. All such projects should be transparent and subject to the full scrutiny of the Major Projects Secretariat and the Audit Court whose capacity needs to be strengthened. Off-balance sheet liabilities, including by state owned companies such as newly established oil company, Timor Gap, should be avoided.

[3] PPP projects currently under development comprise the new Dili Port and the enhancement of Dili Airport—both important projects, with the PPP tender for the Port at Tibar Bay launched in August and work ongoing for the airport. The authorities are working with IFC. The details have yet to be finalized but it is estimated that investment in the Port will be $300-$400 million with significant private sector participation. The overall size of the airport project is not yet finalized but the expected level of private investment is likely to be much smaller.

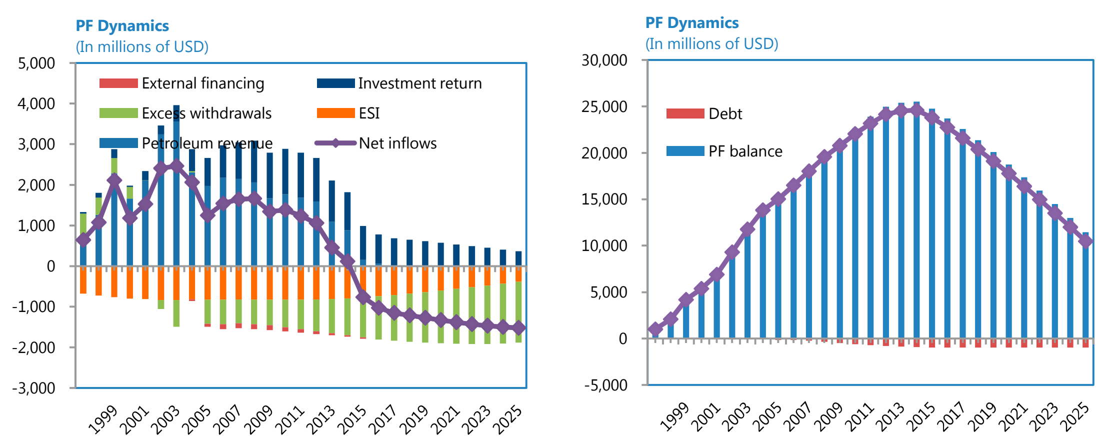
- Petroleum Fund. The revised Petroleum Fund Law allows a shift in strategic asset allocation away from purely high quality bonds toward equities with a 50:50 split allowed with an intention to increase returns. This may be appropriate from a long-term inter-generational perspective, but the risk-return trade-offs in inherently volatile global financial markets need to be carefully considered. The new provision to allow the PF to guarantee government debts (up to 10 percent of the PF's assets) is potentially risky and should be avoided.

Text Figure. PF Stock and Flow Dynamics under the Yellow Road and 2013 Budget Scenarios

Under the Yellow Road excess withdrawal and external borrowing are moderate yielding stable public assets over the long term.



Significantly higher funding needs under the 2013 Budget resulted in significantly negative stock dynamics.



ASSESSMENT

5. **Staff's debt sustainability analysis suggests that the authorities' revised fiscal framework outlined in the Staff Report is consistent with external and public debt sustainability.** Under the current medium-term expenditure framework, a moderate accumulation of gross debt through 2021 with the debt stock peaking at under 12 percent of GDP in present value terms in 2018 is forecast (see Table 1, Figure 1, panels a & b). Due to the high stock of public assets in the Petroleum Fund, at around $13 billion, and continued asset accumulation through 2024, net