Timor-Leste

The economy contracted as political uncertainty disrupted and reduced public spending. Inflation revived, and the current account deficit narrowed. The formation of a new government and approval of the 2019 budget pave the way for fiscal stimulus that will drive growth in 2019 and 2020. While the government plans to play a more active role in developing onshore oil and gas processing, diversification into hardwood forestry could, if sustainably managed, offer valuable benefits.

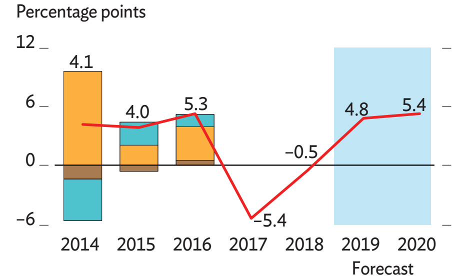
Economic performance

Reductions in public spending caused GDP excluding the large offshore petroleum sector (hereafter GDP) to contract by 0.5% in 2018 (Figure 3.35.1). Following a sharp decline in 2017, public expenditure excluding grants from development partners, which are off budget, fell by a further 2.8% in 2018 to $1.16 billion. While public capital investment increased significantly, it was more than offset by lower recurrent spending. Payments for salaries and wages fell by 2.2%, purchases of goods and services by 9.3%, and transfer payments by 23.9%, reflecting lower payments to the Special Administrative Region of Oe-Cusse Ambeno (Figure 3.35.2).

Public spending problems reflected political uncertainty that continued through much of 2018. Parliament was dissolved in March without approving a budget. This left the government to operate in the first part of the year under a duo-decimal budget regime, which allowed monthly budget appropriations of up to one-twelfth of the 2017 budget. In September, a budget for the remainder of 2018 was approved. It called for rapidly scaling up expenditure, but implementation was constrained by its late approval. The resulting decline in public spending was compounded by a reported 10.3% drop in grants from bilateral and multilateral development partners to $156.0 million, equal to 9.5% of GDP (Figure 3.35.3).

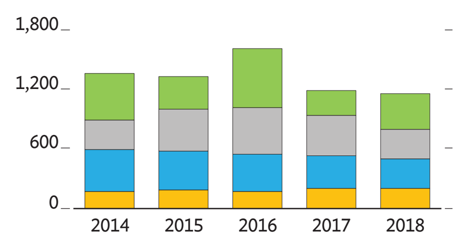
Tighter fiscal policy constrained demand for a range of consumption and investment goods. Merchandise imports declined by 11.5% on lower imports of food, consumer goods, construction materials, and equipment and machinery. With new vehicle registrations down by 19.4%, the value of vehicle imports fell by 48.1%. Shifts in the aviation market saw a reduction in the number of international flights and large increases in ticket

3.35.1 Supply-side contributions to growth



Sources: Statistics Timor-Leste; ADB estimates.

3.35.2 Public expenditure components



Source: Timor-Leste Budget Transparency Portal.

This chapter was written by David Freedman of the Timor-Leste Resident Mission, ADB, Dili.

prices on key routes. These developments and reduced demand from business travelers saw growth in international visitor arrivals plunge from 12.0% in 2017 to 1.1% in 2018.

Production of maize and rice, the two largest staple crops, posted large gains in 2018 on expanded planting area and a modest increase in productivity. Cash crop production was also strong, with coffee exports up by 34.3% and rising exports of niche products such as cloves and vanilla.

The consumer price index rose by 2.1% in 2018 despite weak consumer demand, with food up by 1.5%, tobacco up by 17.1%, and transportation up by 3.9% because of higher fuel prices. While inflation was driven largely by higher prices for imported goods, prices for non-tradable items also increased, by 2.0%. Conditions in the financial sector reflected the challenges caused by tighter fiscal policy. Bank deposits reversed average growth of 20.5% per annum during 2013–2017 to fall by 1.6% in 2018. Separately, one bank closed its retail operations. Lending to the private sector increased by 3.6%, with reduced lending to construction firms and private individuals being offset by increased lending to businesses in other sectors.

Tasi Mane, a government project to develop oil and gas processing on the south coast, gained momentum in 2018. The government has agreed to purchase the equity of two existing stakeholders in the Greater Sunrise gas field. This will give the government a 56.6% majority share in the joint venture, which may remove key obstacles to developing the field and the onshore processing of gas at a new liquefied natural gas plant at Beacu, a town on the south coast. Investments to support this plan moved forward in 2018 with the opening of a new international airport in Suai and the completion of the first phase of a new highway linking Suai to Beacu.

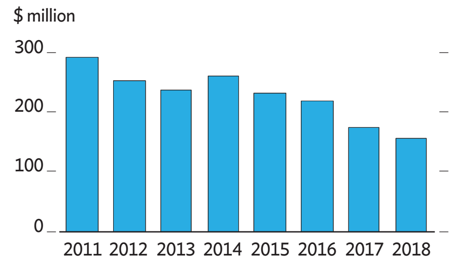
Taxes and royalties from the Bayu-Undan oil field rose by 21.0% in 2018 and accounted for 48.2% of government revenues. Petroleum Fund investments generated $365.1 million in cash income, but overall return on assets posted a loss of 2.6%, largely because of a sharp decline in the fund's equity portfolio in the final quarter. The fund ended the year with a balance of $15.8 billion, or $12,500 per capita (Figure 3.35.4).

Income from petroleum production that beat expectations, and a narrowing of the trade deficit in goods and services, narrowed the current account deficit from the equivalent of 17.5% of GDP in 2017 to 11.8%.

Economic prospects

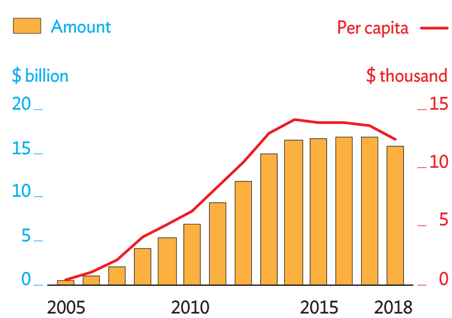
The economy is projected to grow by 4.8% in 2019 and 5.4% in 2020 on fiscal stimulus and renewed investor confidence. Inflation is projected to accelerate to 3.0% in 2019 as domestic demand recovers and to 3.3% in 2020 with higher prices for imported food (Figure 3.35.5).

3.35.3 Grant inflows



Source: Timor-Leste Budget Transparency Portal.

3.35.4 Petroleum fund balance



Source: Timor-Leste national budget documents, various years.

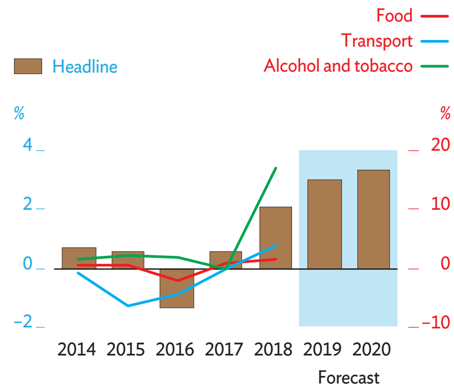
The 2019 state budget will provide strong fiscal stimulus. Approved in February 2019, the budget plans $1.48 billion in expenditure, and a further $162.6 million in grants from development partners spent off budget. Full execution would see public spending rise by 22.3% over 2018. Planned increases are concentrated in recurrent spending, budgeting 6.8% more for salaries and wages, 13.4% more for goods and services, and 35.6% more for transfer payments. These increases are partly driven by a budgeted 17.8% increase over the 2015–2018 average allocated for health programs and a 32.1% increase allocated for education (Figure 3.35.6).

The budget includes $2.0 billion for capital investment from 2019 to 2023, with 82.9% of it implemented through the Infrastructure Fund, an autonomous agency mandated to coordinate the preparation and financing of major projects. Public capital investment is set to increase by 27.6% in 2019 and a further 64.5% in 2020. Upgrading roads and bridges accounts for 59.4% of capital investment in 2019 and 2020, with investment in the Tasi Mane project accounting for a further 16.2% (Figure 3.35.7). Several other large investment projects are expected to move forward this year and next with government support. Construction on the new Tibar Bay port formally commenced in August 2018 and will ramp up in 2019. The initial investment to develop the project is estimated at $280 million, of which the government contributed $129.5 million. Separately, the government has contributed $50 million for equity investment and other support to develop limestone mining and cement manufacturing in the Baucau region.

Rising capital investment will stimulate demand for construction services and boost employment. In agriculture, coffee production is expected to increase in 2019 with favorable weather so far, and the government will seek to consolidate recent increases in the area planted with maize and rice. Prospects for further growth in tourism hinge on a sustained reduction in the cost of travel to and from Timor-Leste, which rose sharply in 2018. Two separate groups of investors are developing plans for hotel and resort complexes close to Dili, and these projects will move ahead in 2019 and 2020 if they can secure the required financing and government support.

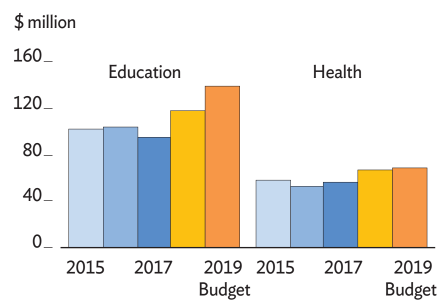
The revenue the government collects from domestic sources is projected to grow by an average of 5.0% annually during 2019–2023, but the bulk of public spending will be financed using withdrawals from the Petroleum Fund. The fund is currently invested in relatively low-risk foreign assets, with 60% invested in high-quality bonds and the remaining 40% in equities. The investment strategy is expected to change in 2019 following equity investment in the Greater Sunrise gas joint venture. In February the government adjusted the Petroleum Fund's investment rules to enable up to 5% to be invested in new petroleum operations in Timor-Leste.

3.35.5 Inflation



Sources: Statistics Timor-Leste; ADB estimates.

3.35.6 Expenditure on education and health



Source: Timor-Leste national budget documents, various years.

3.35.1 Selected economic indicators (%)

	2019	2020
GDP growth	4.8	5.4
Inflation	3.0	3.3
Current account balance (share of GDP)	–12.0	–12.0

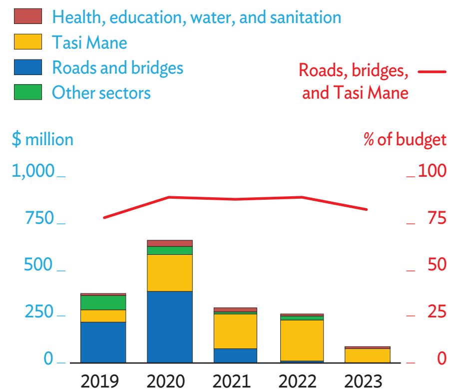
Source: ADB estimates.

These investments will be channeled through the national oil company, Timor Gap, and be structured as interest-bearing debt securities with a yield of 4.5% per annum. Once implemented, these changes will reduce to 35% the share of the portfolio that is allocated to international equities.

The Petroleum Fund's sustainable income, or the amount that can be withdrawn from the fund each year without depleting it, is estimated at $529.0 million in 2019. Given planned spending, actual withdrawals are projected at $1.19 billion in 2019 and $1.24 billion in 2020. Inflows to the fund from taxes and royalties from the Bayu-Undan field are projected to fall to $343.7 million in 2019 (equal to 19.3% of GDP), rise modestly in 2020, and come to an end in 2023. Planned withdrawals in 2019 and 2020 mean that the Petroleum Fund balance is now projected to decline to $15.1 billion at the end of 2020.

The fiscal stimulus that is planned for 2019 and 2020 will affect the current account balance. Increased imports of goods and services offset gains from higher petroleum income and grants, leaving the current account deficit at the equivalent of 12.0% of GDP in 2019 and 2020.

3.35.7 Infrastructure fund budget



Sources: Timor-Leste State Budget 2019; ADB estimates.

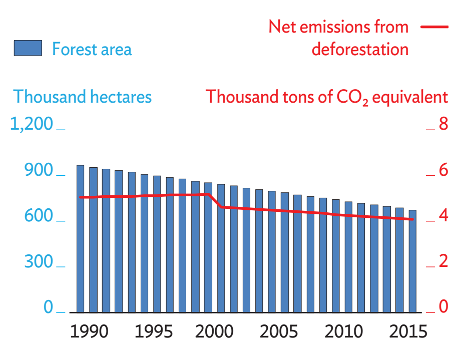
Policy challenge—developing a sustainable forestry industry

The development of forestry could make an important contribution to growth and job creation in the medium term. However, this would be sustainable only with well-coordinated policies to strengthen forest management and encourage tree planting.

The climate and soils in Timor-Leste are well suited to growing a range of valuable tropical hardwoods, and forests still cover an estimated 58% of Timor-Leste's land area (Figure 3.35.8). Sandalwood, which is prized for its fine fragrance, was the largest export for much of the colonial period. However, the overharvesting of wild stocks in the years before independence steadily undermined production, prompting a current moratorium on exports. Deforestation from population growth and the expansion of subsistence farming is an issue and one of the largest emitters of greenhouse gases in the country.

The government is committed to halting deforestation and developing new plantation forests. It has begun to establish sandalwood plantations in some areas, and many households plant small numbers of trees close to their homes. Recent analysis of satellite data found 2,400 hectares of teak growing in stands of 0.1 hectares or larger. These stocks support a local furniture industry, but current production volumes would not support significant exports.

3.35.8 Forest area



CO_2 = carbon dioxide.
Source: Food and Agriculture Organization.

Developing forestry exports would require a significant increase in the area that is planted with teak and other valuable tree species. Analysis of satellite data has identified around 32,500 hectares of suitable land that is not currently forested, protected, or used to grow food. Preliminary estimates suggest that the development of a 30,000 hectare plantation estate could support the production of $100 million worth of teak per year, equal to 6.3% of current GDP. The bulk of this production would be exported, and the establishment, maintenance, and harvesting of tropical hardwoods could create employment equal to 2,000 full-time jobs. Potential also exists to increase the value of wood generated in and harvested from natural forests by restocking selected native species such as sandalwood.

Developing a successful plantation sector is a long-term undertaking, requiring first the strengthening of forest management. In the short term, the key priorities include building human resources, developing an integrated forest information management system, and establishing long-term research and trial plots across the main agroecological zones. While some stakeholders may wish to see tree planting increased very rapidly, doing so without first establishing a strong knowledge base would pose an unnecessary risk that new plantations perform poorly or fail.

New plantations could be established using various models focused on smallholders and communities, or ranging up to government-managed planting on state land or larger-scale private investment. Uncertain land tenure is likely to deter private investment, but the government should try to leverage private sector capacity by developing a model for public–private partnership or using other mechanisms to mitigate risks and incentivize tree planting.