



DEMOCRATIC REPUBLIC OF TIMOR-LESTE

July 2021

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR TIMOR-LESTE

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2021 Article IV consultation with Timor-Leste, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 9, 2021 consideration of the staff report that concluded the Article IV consultation with Timor-Leste.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 9, 2021, following discussions that ended on May 17, 2021 with the officials of Timor-Leste on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 22, 2021.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Statement by the Executive Director** for Timor-Leste.

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IMF Executive Board Concludes 2021 Article IV Consultation with Timor-Leste

FOR IMMEDIATE RELEASE

WASHINGTON, DC – July 14, 2021: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Timor-Leste.

Timor-Leste has been severely affected by the pandemic and by recent floods. Despite early success in containing the propagation of COVID-19, the recent surge in cases combined with the floods in early April will result only in a modest economic recovery in 2021. Real non-oil GDP growth in 2021 is projected at 1.8 percent, driven by higher government spending, rebounding private consumption, and the vaccination rollout that began in April. The current account deficit will continue to increase as oil revenues decline. Inflation is projected to pick up, reflecting the increase in government spending and in energy prices. Real non-oil GDP growth is projected to stabilize at around 3 percent in the medium term, as structural constraints weigh on growth potential.

In the near term, the focus should be on accelerating the ongoing rollout of vaccines and on providing relief to the most vulnerable. Once the pandemic is well contained, regaining a more solid fiscal footing should be a priority in order to preserve fiscal and external sustainability. Expenditure rationalization and revenue mobilization should underpin fiscal reforms. Structural reforms to improve the business environment, strengthen governance, raise labor productivity, and increase financial deepening, including through harnessing digitalization, would help promote private sector development, create jobs, and diversify the economy. Strengthening disaster risk management and preparedness is also crucial, given the country's vulnerability to climate shocks.

Executive Board Assessment²

Executive Directors welcomed the authorities' response to mitigate the impact of the shocks from the COVID-19 pandemic and floods. Directors noted that while a modest recovery is expected, significant challenges prevail, including the uncertainty from the pandemic. They emphasized that the immediate focus should be on accelerating the ongoing vaccine rollout and supporting the most vulnerable. In the medium and long term, policies are needed to support fiscal sustainability, develop the non-oil private sector economy, and generate jobs.

Directors welcomed the strong fiscal package to mitigate the adverse impact of the pandemic and floods and emphasized the need to report government spending in a transparent manner. They noted that once the pandemic abates, priority should be given to putting the fiscal

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.

² At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.IMF.org/external/np/sec/misc/qualifiers.htm>.

position on a more solid footing. Given the drying up of active oil fields, fiscal consolidation should be underpinned by revenue mobilization and expenditure rationalization. This should help reduce excess withdrawals from the Petroleum Fund and secure fiscal sustainability. Directors encouraged that a medium-term fiscal reform strategy should be laid out in the 2022 budget.

Directors emphasized that ongoing reforms to strengthen public financial management are necessary to improve the quality of spending and enhance the fiscal framework. They recommended that public investment projects focus on high-return projects by making them subject to thorough cost-benefit analysis, including the Greater Sunrise project, and that the basic public financial management law is aligned with international best practices.

Directors underscored that structural reforms are needed to promote economic diversification, develop the private sector, and create jobs. In this context, they called for measures to improve the business environment, strengthen governance, raise labor productivity, increase financial deepening, including through harnessing digitalization. They also noted that strengthening disaster risk management is crucial to mitigate the impact of climate shocks and that improving data quality is vital to support policy making. Directors agreed that continued technical assistance by the Fund will be helpful.

Table 1. Timor-Leste: Selected Economic Indicators, 2016-22

Non-oil GDP at current prices (2019): US\$1,674 billion							
Population (2019): 1.293 million							
Non-oil GDP per capita (2019): US\$1, 295							
Quota: SDR 25.6 million							
	2016	2017	2018	2019	2020	2021	2022
					Est.	Proj.	Proj.
(Annual percent change)							
Real sector							
Real Non-oil GDP	3.4	-4.1	-1.1	1.8	-7.6	1.8	3.8
CPI (annual average)	-1.5	0.5	2.3	0.9	0.5	1.6	2.5
CPI (end-period)	0.0	0.6	2.1	0.3	1.2	2.0	3.0
(In percent of Non-oil GDP, unless otherwise indicated)							
Central government operations							
Revenue	56.1	53.0	58.5	52.5	58.2	58.8	56.1
Domestic revenue	12.1	11.9	12.2	11.2	11.6	11.7	11.7
Estimated Sustainable Income (ESI)	33.0	30.1	35.3	31.6	34.8	35.4	32.7
Grants	11.0	11.0	11.0	9.7	11.8	11.8	11.8
Expenditure	111.5	86.6	86.7	83.4	84.3	104.9	110.0
Recurrent	64.0	59.2	53.1	54.9	62.3	74.6	60.5
Net acquisition of nonfinancial assets	36.5	16.3	22.6	18.8	10.2	18.6	37.8
Donor project	11.0	11.0	11.0	9.7	11.8	11.8	11.8
Net lending/borrowing	-55.4	-33.6	-28.2	-30.9	-26.1	-46.1	-53.9
(Annual percent change, unless otherwise indicated)							
Money and credit							
Deposits	14.1	12.3	2.8	-7.5	10.1	3.8	6.9
Credit to the private sector	-1.8	24.8	-3.8	5.5	10.1	6.6	6.9
Lending interest rate (percent, end of period)	14.5	12.5	14.5	16.3	11.3	...	...
(In millions of U.S. dollars, unless otherwise indicated)							
Balance of payments							
Current account balance 1/	-544	-284	-191	133	-302	-513	-719
(In percent of Non-oil GDP)	-33	-18	-12	8	-19	-32	-41
Trade balance	-546	-615	-589	-566	-510	-558	-657
Exports 2/	20	17	25	26	17	29	33
Imports	567	631	613	592	527	587	691
Services (net)	-569	-343	-349	-357	-269	-318	-370
Primary Income	544	735	843	1,126	620	328	320
Secondary Income	26	-61	-96	-70	-143	-74	-79
Overall balance	-157	263	129	-18	0.2	-177	144
Public foreign assets (end-period) 3/	16,125	17,343	16,477	18,348	19,647	19,265	18,964
(In months of imports)	160	195	187	212	280	241	198
Exchange rates							
NEER (2010=100, period average)	130.0	129.7	130.9	134.1	135.8	...	...
REER (2010=100, period average)	143.5	140.7	141.7	143.4	143.3	...	...
Memorandum items							
Nominal Non-oil GDP (in millions of U.S. dollars)	1,651	1,599	1,560	1,674	1,565	1,625	1,738
Nominal Non-oil GDP per capita (in U.S. dollars)	1,354	1,286	1,230	1,295	1,187	1,210	1,269
(Annual percent change)	1.6	-5.0	-4.4	5.2	-8.3	1.9	4.9
Crude oil prices (U.S. dollars per barrel, WEO) 4/	43	53	68	61	41	59	55
Petroleum Fund balance (in millions of U.S. dollars) 5/	15,844	16,799	15,803	17,692	18,991	18,785	18,340
(In percent of Non-oil GDP)	960	1,050	1,013	1,057	1,213	1,156	1,055
Public debt (in millions of U.S. dollars)	77	106	145	193	218	279	330
(In percent of Non-oil GDP)	4.7	6.6	9.3	11.5	13.9	17.2	19.0
Population growth (annual percent change)	1.9	2.0	2.0	2.0	2.0	1.9	1.9

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

1/ Excludes trade in goods and services of entities located in the Joint Petroleum Development Area which are considered non-resident entities until August 2019.

2/ Excludes petroleum exports, the income of which is recorded under the income account.

3/ Includes Petroleum Fund balance and the central bank's official reserves.

4/ Simple average of UK Brent, Dubai, and WTI crude oil prices based on April 2021 WEO assumptions.

5/ Closing balance.



DEMOCRATIC REPUBLIC OF TIMOR-LESTE

June 22, 2021

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

KEY ISSUES

Context. Although Timor-Leste has made considerable progress in many areas since its independence in 2002, it faces significant medium-term challenges. The nation has pressing development needs, young institutions, and is highly dependent on oil. Oil revenues from active fields, which have been the main source of funding for government spending, are drying up. The non-oil private sector economy remains underdeveloped and lack of good jobs and high youth unemployment are serious concerns.

Recent developments and outlook. The economy has been severely affected by the pandemic and by recent floods. Despite early success in containing the propagation of COVID-19, the recent surge in cases and floods in early April will mean only a modest economic recovery in 2021.

Themes of the Article IV. Against this background, the discussions focused on: (1) the short-term challenges of dealing with the twin shocks—COVID-19 outbreak and floods, (2) the need to put fiscal policy on a sustainable footing amid the drying up of active oil fields, and (3) structural reforms to support the development of the non-oil private sector economy and generate jobs.

Policy recommendations. In the near term, the focus should be on accelerating the ongoing rollout of vaccines and on providing relief to the most vulnerable. Once the pandemic is well contained, regaining a more solid fiscal footing should be a priority to preserve fiscal and external sustainability. Expenditure rationalization and revenue mobilization should underpin fiscal reforms. Structural reforms to improve the business environment, strengthen governance, raise labor productivity, and increase financial deepening, including through harnessing digitalization, would help promote private sector development, create jobs, and diversify the economy. Strengthening disaster risk management and preparedness is also crucial, given the country's vulnerability to climate shocks.

Approved By
APD (Alfred Schipke)
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Virtual discussions took place during May 4-17, 2021. The staff team comprised Pablo Lopez Murphy (Head), Purva Khera, and Masakazu Kumakura (all APD). Pedro Martins (World Bank) participated in several meetings. Bruno Saraiva and Diogo Coelho (OED) participated in policy discussions. Ricardo Davico and Nadine Dubost assisted in the preparation of this report.

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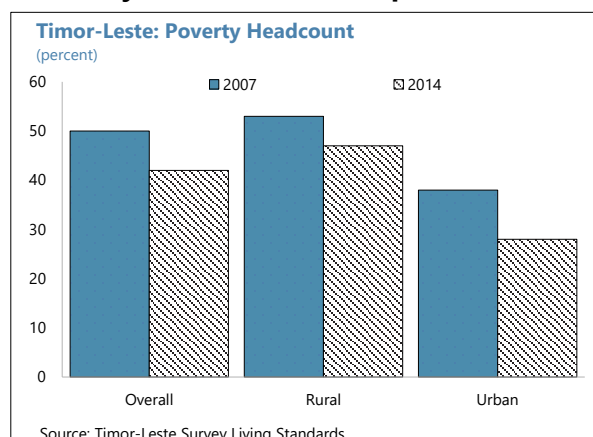
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PRE-COVID-19 CONTEXT

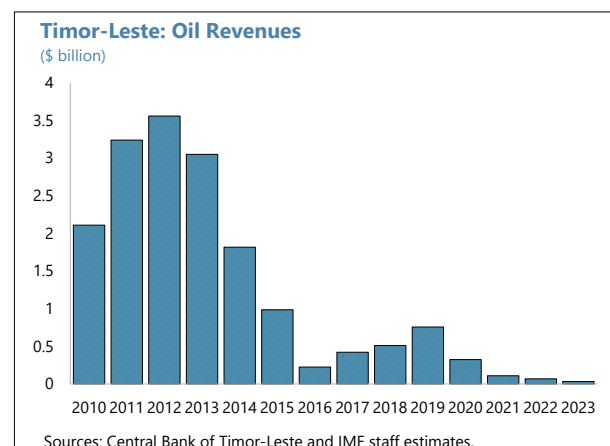
1. Timor-Leste has made significant progress in many areas since its independence in

2002. After decades of conflict, it is a stable democracy with a young and fast-growing population. Remarkable achievements include conducting transparent elections with smooth transitions in government; rebuilding basic public infrastructure, including roads, ports, airports, and water and sanitation systems; reducing poverty; and saving a significant fraction of oil revenues in the Petroleum Fund. Moreover, institutional progress has been steady, with a network of functional public institutions built from scratch quickly.



2. However, Timor-Leste faces significant medium-term challenges compounded by a drying up of oil revenues.

They include large and pressing development needs, wide-ranging institutional capacity building gaps, and high dependence on oil revenues. Oil revenues from active fields, which have been the main source of funding for government spending, are drying up. Fiscal policy needs to adjust to the new reality to preserve fiscal and external sustainability. The country's young public sector institutions and incipient governance structure also need to be further developed to overcome the country's fragility. One-third of the population suffers chronic food insecurity and significant gaps exist in health and education. The non-oil private sector economy remains underdeveloped and lack of good jobs and high youth unemployment are serious concerns.

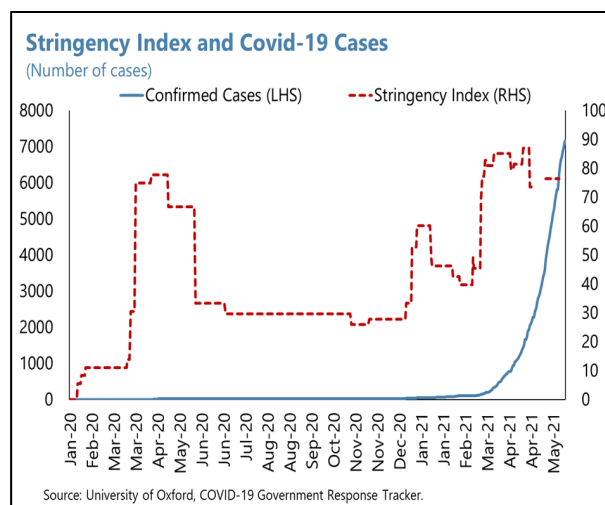


RECENT DEVELOPMENTS

3. Timor-Leste was highly effective in containing the spread of COVID-19 in 2020, however, recent developments have made it much more challenging. Just 44 confirmed cases of COVID-19 and no deaths occurred in 2020 amid severe restrictions imposed on contact with the outside world. From a low of 113 on February 28, the cumulative number of infections, however, has

been increasing fast since early March 2021 reaching 8,728 cases on June 21, and is yet to show a clear sign of slowing. Moreover, heavy rains resulting in nationwide floods in early April 2021 left about 16,000 people without homes and sheltering in refugee centers, complicating efforts to contain the spread of the pandemic.

4. Although Timor-Leste adopted a strong package to mitigate the impact of COVID-19, economic growth contracted sharply in 2020. The government spent 12.3 percent of non-oil GDP in COVID-19-related spending, including cash transfers to 334,000 households. However, with the pandemic-related disruptions to mobility and activity, real non-oil GDP is estimated to have declined 7.6 percent in 2020, the largest output contraction since independence in 2002. Government revenues remained broadly unchanged and current spending spiked driven by COVID-19 related spending. Together with a fall of public investment following long delays in passing the 2020 budget, they drove the fiscal deficit to decline to 26 percent of non-oil GDP (from 31 percent of non-oil GDP in 2019). Inflation pressures remained muted and private sector credit growth doubled to more than 10 percent year over year in 2020.



Timor-Leste Covid-19 Related Spending 2020 (percent of 2020 non-oil GDP)	
Program	Spending
Adequate quarantines	0.3
Contact tracing	0.1
Isolation and treatment	1.3
Social support to affected population	8.7
o.w. cash transfers to households	4.2
o.w. transfers to social security	2.7
o.w. basic consumption basket	0.5
o.w. wage subsidy for private sector	0.4
o.w. electricity subsidy	0.2
o.w. credit moratorium	0.3
Prevention and mitigation of COVID	0.5
Food production	0.1
Rice purchase for food security	1.1
Total	12.3

Source: Ministry of Finance.

5. The external sector position in 2020 is estimated to be substantially weaker than implied by medium-term fundamentals and desirable policy settings. The current account balance moved from a surplus in 2019 to a deficit in 2020 against declining oil revenues. The underlying current account, defined as the actual current account deficit adjusted for temporary factors, is estimated at -23 percent of non-oil GDP in 2020, about 7 percent of non-oil GDP below the "norm" backed out from setting consumption as an annuity of total wealth (Annex III). Likewise, the real exchange rate is estimated to be overvalued by about 32 percent.

6. Timor-Leste has joined the "COVAX Facility" mechanism and will have free access to the COVID-19 vaccine for 20 percent of its population. The inoculations started on April 7 and 127,074 people (17 percent of the adult population) were vaccinated by June 20. The vaccine rollout will be sequenced as follows: in the first phase (April), frontline workers, immigration officers, and people with comorbidities; in the second phase (July) people over 60 years old, healthcare workers, community leaders, teachers, and market workers; in the third phase (October), the remaining adult population.

7. Although credit growth accelerated during the pandemic, financial stability has been maintained. Credit growth doubled to 10 percent year over year in 2020, driven by high lending to individuals in public administration jobs, and to a lesser extent by loans to businesses. The authorities introduced a credit moratorium for 3 months in August 2020, which led to 23 percent of total bank loans being restructured.

This scheme has been reintroduced for 2021, with an extended duration of 9 months. Moreover, the credit guarantee scheme was extended to cover micro enterprises in addition to small and medium enterprises. Capital adequacy and liquidity ratios remain comfortably above the regulatory threshold, and nonperforming loan ratios remain low at 2 percent in end-2020.

Timor-Leste: Selected Financial Soundness Indicators, 2017-20

(In percent)

	Dec-17	Dec-18	Dec-19	Dec-20
Asset Quality				
Capital adequacy ratio ¹	32.9	27.7	28.6	27.9
Non-performing loans to total gross loans	13.5	5.6	5.6	2.0
Provision for loan losses to total gross loans	16.7	8.1	6.4	2.1
Earnings and Profitability				
Return on assets	1.4	1.1	1.7	2.3
Return on equity ¹	13.9	6.8	5.1	4.3
Liquidity				
Liquid assets to total assets	80.5	80.5	91.1	79.5
Memorandum items (In millions of U.S. dollars):				
Total assets	1,170	1,240	1384	1474
Total loans	227	222	250	281

Source: Central Bank of Timor-Leste.

¹ Covers BNCTL only.

OUTLOOK AND RISKS

8. Fiscal policy support will underpin a modest recovery in 2021 that will gain more momentum in the medium term. Real non-oil GDP growth in 2021 is projected at 1.8 percent, driven by higher government spending, a gradual rebound in private consumption, and the vaccination rollout that began in April. The 2021 budget was passed without delay in December and was followed by a revision in April 2021 aiming to respond to rising COVID-19 infections and the recent floods. The fiscal deficit is projected to increase from 26 percent of non-oil GDP in 2020 to 46 percent in 2021, 52 percent in 2022, and to stabilize around 35 percent in the medium term. The current account deficit will continue increasing as oil revenues decline. Under current policies, fiscal and external sustainability are at risk in the long term. With the drying up of oil revenues and current fiscal plans, the Petroleum Fund will be fully depleted in 21 years and the external sector position will remain weak for long. Inflation is projected to pick up, reflecting the increase in government spending and in energy prices. Real non-oil GDP growth is projected to stabilize at around 3 percent in the medium term, as structural constraints weigh on growth potential. The baseline does not include the development of the Greater Sunrise fields.¹

9. The uncertainty around the outlook is exceptionally high. An intensification of the pandemic or delays in the vaccination program could derail the recovery in the near term (Annex I). A sustained increase in the number of COVID-19 cases would hurt economic activity, as the planned resumption of infrastructure projects and activity in the services sector are further delayed. The inability to reach political consensus to implement the structural reforms needed to promote private

¹ There are no approved development plans for the Greater Sunrise fields.

sector development could undermine growth prospects over the medium term. The development of the Greater Sunrise fields could be an upside risk over the medium term. Yet, it could also be a downside risk if the project does not attract private investment for its development and the government makes big investments (Annex II).

Authorities' Views

10. The authorities broadly agreed with staff's outlook and risks. They project real non-oil GDP growth in 2021 at 2.0 percent, driven by public investment and a rebound in coffee exports. In the medium term, growth will be supported by (1) political stability (government coalitions were fragile in recent years); (2) improved budget execution underpinned by the new public financial management law; (3) many public-private partnership investment projects. They are still evaluating options for developing the Greater Sunrise fields and acknowledged the uncertainty around it. A prolonged pandemic is the main risk to the outlook since it would affect private investment, construction, household consumption, and the incipient tourism sector. Natural disasters are a risk to infrastructure and agricultural production. The evolution of international food prices is a risk to the inflation outlook.

POLICIES TO SECURE THE RECOVERY AND STRENGTHEN THE MEDIUM-TERM OUTLOOK

Against this background, policy discussions focused on: (1) the short-term challenge of dealing with a surge in COVID-19 cases and recovering from the devastating floods in early April, (2) the need to put fiscal policy on a sustainable footing amid the drying up of active oil fields, and (3) structural reforms to support the development of the non-oil private sector economy and generate jobs.

A. Providing Relief and Supporting the Recovery

11. The revised 2021 budget approved in late April includes an unprecedented fiscal response to deal with the recent twin shocks—COVID-19 and floods. Fiscal deficit is projected to expand. The COVID-19 Fund was increased to 17.7 percent of non-oil GDP while the Contingency Reserve Fund for response against natural disasters to 4 percent of non-oil GDP. The funds will be used to purchase vaccines, protective equipment, and more material for testing and treatment. They will also finance employment support, internet connections for students, a supplement for front-line workers, and a basic consumption basket.

12. In the near term, providing relief to mitigate the impact of the pandemic and the floods is appropriate with adequate transparency arrangements. The large increase in spending should prioritize the execution of measures aiming to protect the most vulnerable, support testing and tracing, strengthen the health system, and rehabilitate basic community infrastructure. While the authorities relaxed procurement safeguards in April 2021 to procure emergency medical supplies in a timely manner, they are doing procurement with the assistance of UNDP and World Health Organization as a safeguard (Annex V). The online procurement portal functions

intermittently and has no information on many important contracts. Amid that background, COVID-19-related spending and procurement processes should be reported in a full and more timely manner to mitigate vulnerabilities to corruption. The Anti-Corruption Commission intends to undertake audits of COVID-19-related spending. Given capacity constraints, the Anti-Corruption Commission could consider risk-based audits in coordination with the Supreme Audit Institution. It will also be important to ensure that the logistical, administrative, and financial requirements of the vaccine rollout are in place.

13. It would be important to intensify banking supervision to preserve financial stability.

The supervisors should have an accurate and timely picture of the financial system's health. This is particularly important in the context of the COVID-19-related credit moratorium scheme to avoid a spike in credit costs and nonperforming loans when the scheme expires. Early recognition of potential problems is also important—financial institutions should assess the borrower's capacity of repayment and performance of the loan under the revised terms, and be required to properly classify, provision, and monitor loans, including restructured loans.² In this regard, we welcome the introduction of an online reporting system for all financial institutions.

Authorities' Views

14. Their priority in 2021 is to strengthen pandemic- and flood-related economic relief measures and support the recovery. They underscored that the budget revision in April 2021 successfully refocuses spending on relief and mitigation, and its execution is on track. Concurrently, providing relief to the most vulnerable continues to be challenging as many of them are unbanked and the government lacks information on them. In this regard, they pointed out delays in the new census and poverty survey which are now planned for 2022 and 2023, respectively, and will help better target transfers in the future. They underscored the strong support to their vaccination program from Australia and China that will provide 630,000 and 100,000 vaccines, respectively.

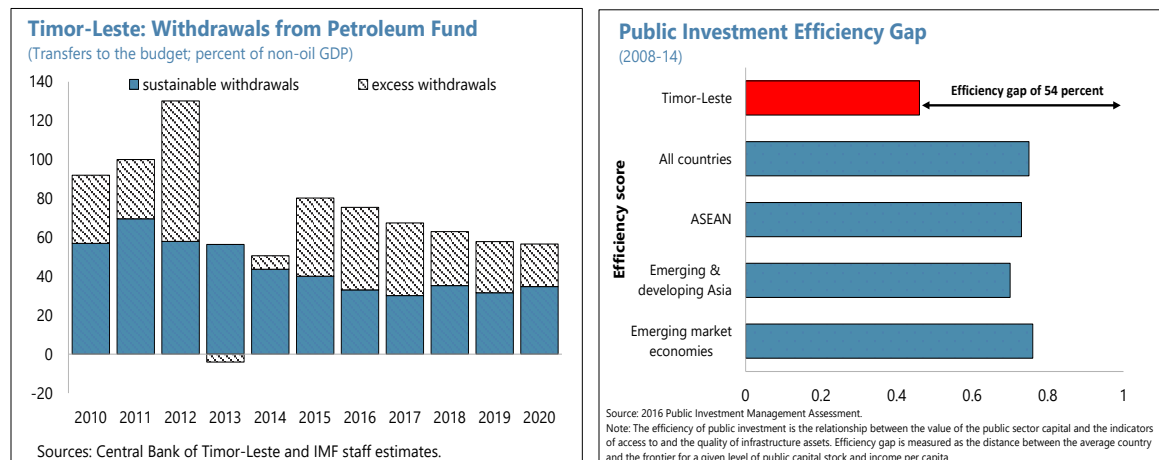
15. They acknowledged potential risks from the COVID-19-related financial sector easing measures, but also reiterated that supervision of financial institutions remains adequate. They underscored the strong stability of Timor-Leste's banking system, while noting potential weaknesses in one of the two other deposit taking institutions operating in rural areas which have been disproportionately impacted by the pandemic. They were confident that the reintroduction of the credit moratorium will help provide economic relief while agreeing with staff that the most vulnerable will not benefit much as they do not have access to formal credit. While acknowledging the risk that credit costs and nonperforming loans could spike once the credit moratorium expires, the authorities underscored recent efforts to improve the regulatory and supervisory framework, including enhanced reporting standards for the insurance sector.

² See IMF Special Series Note on COVID-19 "Banking Sector Regulatory and Supervisory Responses to Deal with Coronavirus Impact".

B. Ensuring Fiscal Sustainability

16. Timor-Leste has had a framework to manage its oil revenues that provides a benchmark for sustainable spending, but withdrawals in excess of the basic benchmark have been the norm. The framework (Annex IV) could be interpreted to be closer to the modified permanent income hypothesis approach under which frontloading of public investment financed with “excess withdrawals” from the Petroleum Fund is allowed for a temporary period to support economic growth. Although high public investment financed with excess withdrawals has been the norm since 2010, the growth dividend has been tepid, and government wealth has been eroded. Sustained excess withdrawals are possible because there are no limits to them (Annex IV), which may undermine the viability of the framework over time.

17. The authorities’ medium-term fiscal plans, published in the 2021 budget, envisage sustained government expenditure and persistent fiscal deficits that would deplete the Petroleum Fund and undermine the fiscal framework. The priority is on public infrastructure



projects, especially in electricity, airports, and roads, that help promote private sector development. The baseline fiscal scenario assumes capital spending in line with historical project average implementation rates of 70 percent and that the Petroleum Fund will remain the main source of financing, in line with the current fiscal framework. Excess withdrawals go hand in hand with a declining Petroleum Fund balance and with moderate risks of debt distress, downgrading the low risk rating in the 2019 Article IV (Debt Sustainability Analysis Supplement).³ The 2021 budget also suggests that large fiscal imbalances (averaging 31.2 percent of non-oil GDP in 2027–41) will persist in the long term and that the Petroleum Fund balance will be depleted by 2042.⁴ This will lead to a fiscal cliff that will force a reduction of the fiscal

³ The revised risk rating reflects worse initial conditions and a downgrade in debt carrying capacity from medium to weak.

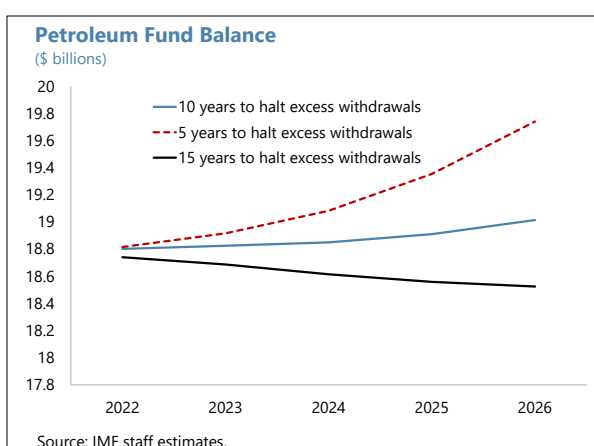
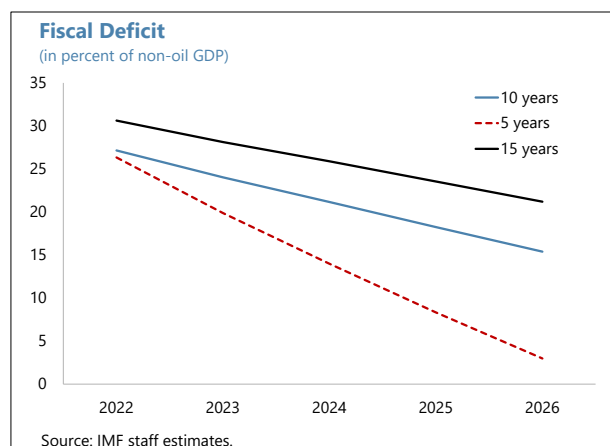
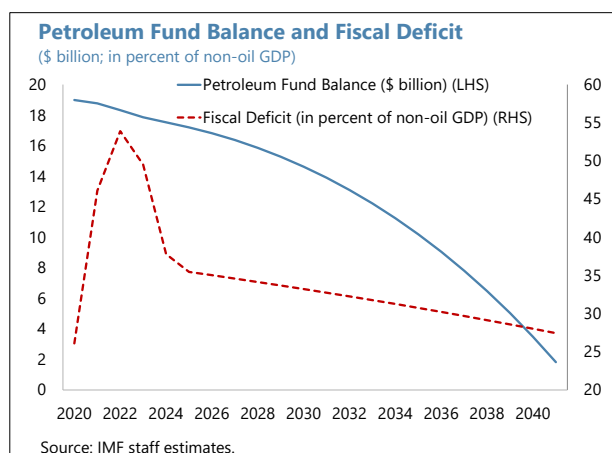
⁴ This assumes an annual nominal investment return of the Petroleum Fund at 5 percent, in line with the historical average return. If the investment return is 4 percent, then the Petroleum Fund is depleted in 2039. The lower the investment return, the sooner the Petroleum Fund is depleted (Annex I).

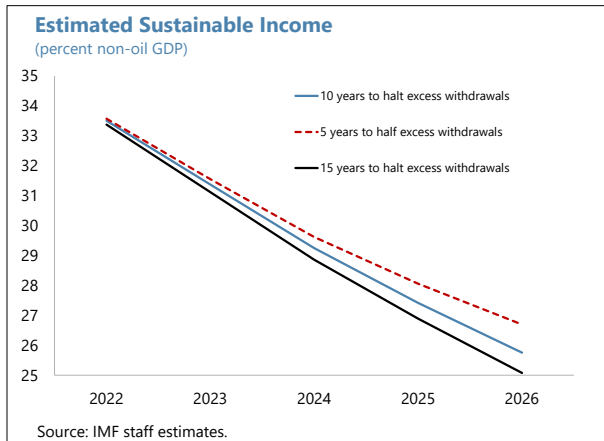
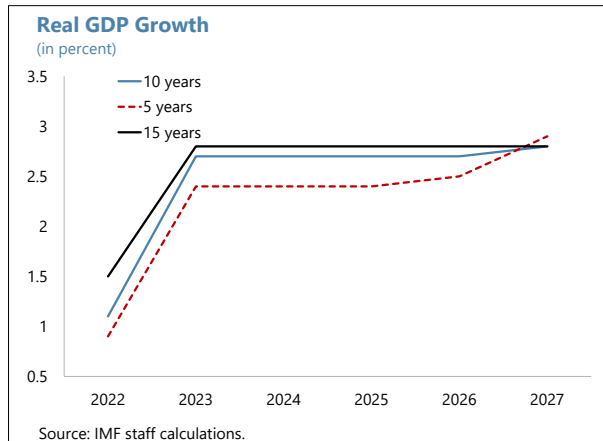
deficit by 27 percent of non-oil GDP, and hence stop the provision of basic public services, cause current account deficit financing shortages, and generate macroeconomic instability.

18. Once the pandemic is over, putting the fiscal position on a more solid footing should be a priority. The goal should be to stop relying on excess withdrawals from the Petroleum Fund to secure fiscal sustainability, underpinned by fiscal consolidation. Given that

eliminating excess withdrawals would warrant a reduction of the fiscal deficit of about 30 percent of non-oil GDP, there should be a transition period allowing a gradual fiscal consolidation to contain the adverse impact on growth (and on development needs). A fiscal strategy to stop relying on excess withdrawals should be laid out in the 2022 budget and should be supported by more impediments to authorize excess withdrawals (e.g., requiring a special majority from Parliament rather than a simple one).

19. The sooner the exit from excess withdrawals, the higher the sustainable sources of income preserved, but the larger the fiscal consolidation (and growth costs) during the transition. If excess withdrawals are eliminated in 5/10/15 years, the Estimated Sustainable Income reaches 26.7/25.8/25.1 percent of non-oil GDP in 2026 and the average annual growth during 2022–26 is 1.8/2.4/2.6 percent. It is important to note that the growth cost differential across the three scenarios will widen as the fiscal multiplier increases. Similarly, the Estimated Sustainable Income differential across the three scenarios will widen as the investment return of the Petroleum Fund lowers. Hence, the case for a faster fiscal consolidation is stronger for a lower fiscal multiplier and for a lower investment return of the Petroleum Fund. The trade-off between preserving sustainable sources of income and the growth costs from fiscal consolidation could be improved by accompanying fiscal consolidation with structural reforms to tap the country's growth potential (Section C).





20. Staff's illustrative fiscal consolidation scenario shows a gradual reduction of excess withdrawals from the Petroleum Fund until they are halted in a period of 10 years. In this way, fiscal deficit (in percent of non-oil GDP) declines much faster than under the baseline, averaging 3 percent of non-oil GDP in 2027–41. The reduction in the fiscal deficit is supported by revenue mobilization and expenditure rationalization (paragraph 21). Public investment averages 16 percent of non-oil GDP in 2022–26, requiring a better selection of investment projects than in the baseline. Non-oil GDP growth is lower than in the baseline, averaging 2.4 percent in 2022–26, owing to the output costs of fiscal consolidation.⁵ The Petroleum Fund balance is higher than under the baseline, averaging \$21.4 billion in 2027–41, which generates higher sustainable sources of revenue both in the medium and long term to support government expenditures, thus putting fiscal and debt sustainability on a solid footing.

Timor-Leste: Illustrative Fiscal Consolidation Scenario vs. Baseline Scenario 1/

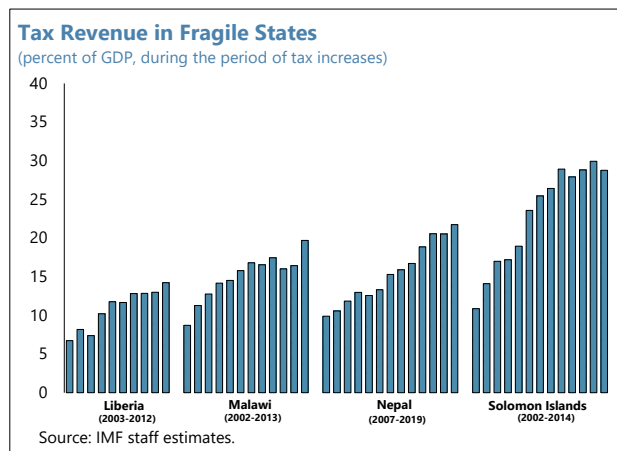
	Baseline scenario				Fiscal consolidation scenario	
	2020 Est.	2021 Proj.	2022-26 Proj.	2027-41 Proj.	2022-26 Proj.	2027-41 Proj.
Total revenue	46.4	47.1	39.3	22.1	43.0	34.5
Domestic revenue	11.6	11.7	11.7	12.0	13.5	17.5
Estimated Sustainable Income	34.8	35.4	27.5	10.1	29.5	17.1
Total expenditure	72.5	93.1	81.6	53.2	64.2	37.5
Recurrent spending	62.3	74.6	57.4	42.5	48.1	28.2
Capital spending	10.2	18.6	24.2	10.8	16.0	9.4
Net lending	-26.1	-46.1	-42.3	-31.2	-21.2	-3.0
Financing						
PF excess withdrawal	24.5	43.2	39.4	30.6	18.3	2.4
Borrowing	1.6	2.9	2.9	0.6	2.9	0.6
Outstanding public debt	13.9	17.2	21.9	19.3	21.9	20.0
Petroleum Fund balance (\$ million)	18,991	18,785	17,553	10,415	18,880	21,392
Real non-oil GDP growth	-7.6	1.8	2.8	3.0	2.4	2.9
Current account balances	-19.3	-31.6	-39.4	-32.2	-31.4	-22.9

1/ In percent of non-oil GDP, unless otherwise specified.

⁵ The fiscal multiplier is the change in real non-oil GDP growth induced by a change in the primary balance of 1 percent of non-oil GDP. It is estimated at 0.1 suggesting that much of government spending leaks into imports and/or is low quality to address supply side constraints (Timor-Leste Economic Report: Towards a Sustained Recovery, October 2020, World Bank).

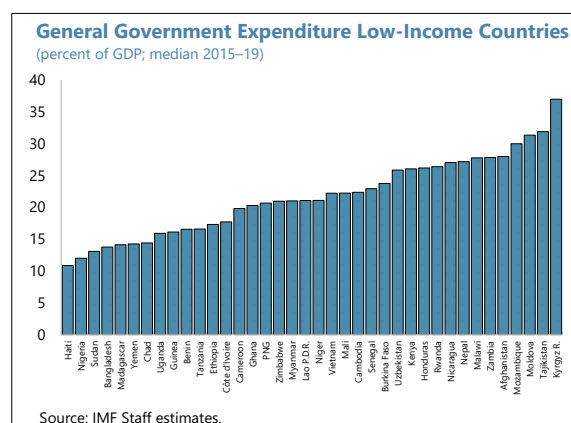
21. Fiscal consolidation should be supported by revenue mobilization and expenditure rationalization.

- Domestic revenues are low compared to other countries, averaging 12 percent of non-oil GDP during 2015–19. Tax revenues, which account for about two thirds of domestic revenues, are also low. Domestic revenue mobilization should be underpinned by a revised tax procedure code and the adoption of a Value-Added Tax. A revision of the excise tax rates is warranted (as they have been unchanged since 2008, and many are set as value per unit). The statutory income tax rate is



among the lowest in the world (so there could be some scope to increase). Strengthening tax administration to improve tax compliance with technical assistance from PFTAC should also be a priority. In staff's fiscal consolidation scenario, domestic revenues average 13.5 percent of non-oil GDP in 2022–26 and 17.5 percent of non-oil GDP in 2027–41. This is in line with the actual increases in tax revenues—between 7–20 percentage points of GDP over a decade—in four fragile states that introduced tax reforms.⁶

- Expenditure rationalization should aim to gradually put the level of government expenditure in line with sustainable sources of revenue. Government expenditure in Timor-Leste averaged 74 percent of non-oil GDP in 2015–19, an outlier compared to other countries. The ongoing public expenditure review conducted by the World Bank will provide useful information to identify large ticket expenditures that could be cut. For example, expenditure in goods and services



averaged 22 percent of non-oil GDP in 2015–19, mainly driven by spending on professional services. These include expenses related to temporary job contracts with the government, as well as payments to consultants and advisors that could be rationalized. Expenditures in transfers averaged 25 percent of non-oil GDP in 2015–19. These include pensions to veterans, old-age and disability pensions, capitalization of banks, and support to state-owned enterprises. These transfers should be reviewed and prioritized. Better selection of investment projects will allow improvement in the efficiency of public investment (paragraph 23). In staff's fiscal consolidation scenario, government expenditure remains broadly constant in nominal terms at the 2019 level

⁶ See IMF Working Paper WP/20/143.

during 2022–32 and averages 64.2 percent of non-oil GDP in 2022–26 and 37.5 percent of non-oil GDP in 2027–41, close to 15 percentage points lower than in the baseline.

22. Addressing public financial management weaknesses is essential to strengthen the current fiscal framework and improve the quality of government spending.

- The budget has limited credibility, as there are significant adjustments to budget allocations, budget revisions, and systematic under execution (Figure 2, middle-right). Moreover, medium-term expenditure projections are not anchored by fiscal sustainability considerations. This hampers fiscal discipline and the quality of government spending. Against this background, improving the annual budget process by strengthening the strategic top-down elements, tightening expenditure controls, and enhancing fiscal reporting and transparency with technical support from IMF FAD and PFTAC is recommended.
- The budget for public investment is prepared by the Ministry of Planning and the budget for current spending by the Ministry of Finance. This separation leads to fragmentation and lack of consistency between different parts of the budget, including unfunded recurrent costs of capital projects. Projects are not subject to rigorous appraisal, and cost-benefit analysis and risk assessments are not systematically carried out. According to the 2016 Public Investment Management Assessment, the average public investment efficiency gap in Timor-Leste is about 54 percent, well below the average of 24 percent for emerging market economies and 30 percent for emerging and developing Asia. A full project appraisal to get the most out of the public investment program and consolidating capital and current budget preparations, including projection selection, in the Ministry of Finance is essential.
- The authorities developed a draft law, which is currently in Parliament, to replace the 2009 Budget and Financial Management Law (Law 13/2009). The draft law should be upgraded in line with international best practices to support improved macro-fiscal management, introduce a strategic planning phase and strengthen the various accountability arrangements, besides ensuring coherence with the entire budget management cycle. IMF FAD and PFTAC stand ready to provide technical support.
- Since 2015, several autonomous agencies were created to support line ministries aiming to make public services delivery more efficient. The resources transferred to those agencies are not scrutinized with the same degree of detail and their spending is not subject to the same reporting requirements as are line ministries, undermining governance and accountability. Staff recommended stemming the proliferation of autonomous agencies and channel government spending through the budget.

23. Adoption of digital fiscal tools offers significant upside potential through higher revenues, more efficient public spending, and greater transparency. The recent implementation of an online tax payments platform through the P24 system (paragraph 27) will help improve efficiency of tax collection and compliance. Plans to implement a unique digital ID for all citizens is

also welcome, which could help improve the ability to properly target social assistance, reduce fraud, and eliminate duplication of payments.

Authorities' Views

24. They concurred with staff recommendations on the need to shift focus towards fiscal sustainability once the pandemic is over. While they underscored that frontloading government spending is warranted to build basic infrastructure and diversify the economy, they also acknowledged the tradeoffs and the adverse consequences of depleting petroleum wealth and putting fiscal sustainability at risk. The authorities plan to adopt fiscal reforms to mobilize domestic revenue through introduction of the Value-Added Tax and a revised tax procedure code. In addition, the recent implementation of program-based budgeting will facilitate the prioritization of government spending. The Ministry of Finance also agreed on the need to improve the cost-benefit analysis of public investment projects, and to review the autonomous agencies that do not generate their own revenue.

25. They emphasized ongoing efforts to improve public financial management. Ongoing reforms aim to: (1) increase the stability of the budget by introducing a strong multi-year element and connecting it to the Multiannual Strategic Plan; (2) increase predictability by establishing a Medium-Term Fiscal Framework, approved and revised annually by Parliament; (3) increase transparency by overhauling budgeting and reporting and make it more frequent; and (4) increase comparability by adopting a chart of accounts and budget classifications based on international standards.

C. Structural Reforms to Bolster Medium-Term Growth Prospects

26. A number of structural barriers need to be lifted to unleash the country's growth potential. Human capital gaps in terms of the contribution of health and education to the next generation of workers are significant. The agriculture sector employs a large fraction of the labor force, but its productivity is low (Figure 5, bottom right) and the country relies heavily on food imports. There are several impediments to private investment, including restricted access to credit, obstacles to doing business, weak governance, and limited digital infrastructure (Figures 5 and 6). Low female labor force participation (Figure 7, bottom right) limits the contribution from labor.

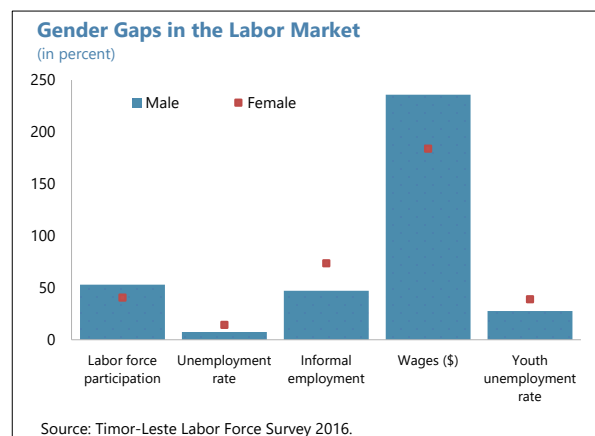
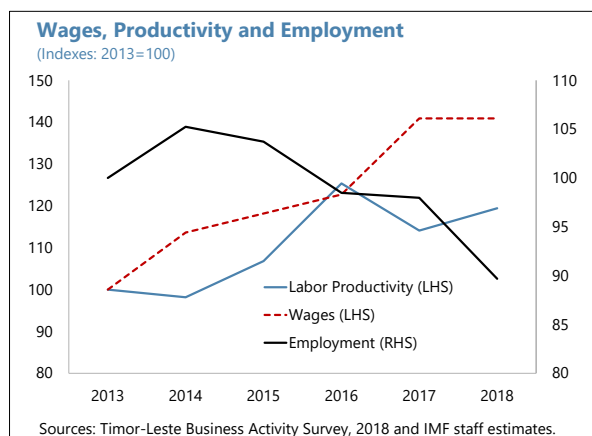
27. Government policies should prioritize strengthening human capital formation and higher productivity in the agricultural sector.

- Spending in health and education accounts for only 16 percent of the 2021 budget and should be expanded in future budgets. Investing in human capital is essential to develop a labor force able to adapt to future job opportunities and achieve economic diversification. In 2020, the Human Capital Index for Timor-Leste stood at 0.45, which means that a worker of the next generation in the country, will be only 45 percent as productive compared to what would be the case under the benchmark of complete education and full health.

- Spending in agriculture accounts for 2 percent of the budget and more than half of the population lives from agriculture. Low agricultural productivity is a key cause of food insecurity among rural households and contributes to high rates of child malnutrition. Although it is a key sector for poverty reduction and economic diversification, agriculture's share in non-oil GDP declined from 28 percent in 2000 to 17 percent in 2019. Hence, increasing public investment to improve the productivity of agriculture, including in climate resilient agricultural practices and technology, should be a priority.⁷

28. Continued efforts to strengthen institutions, the business environment, and governance are important to limit corruption vulnerabilities and lower obstacles to job-creating investment. Governance in the petroleum sector is strong, as documented in the 2019 Article IV staff report. The new anti-corruption law adopted in September 2020 is also a step in the right direction (Annex V). Significant improvements in the justice system are nonetheless warranted. One critical gap is the lack of well-trained lawyers and judges, especially on commercial issues. This complicates contract enforcement and discourages private investment. Further efforts should continue to simplify licensing requirements and improve property rights, land registration, contract enforcement, and insolvency frameworks.

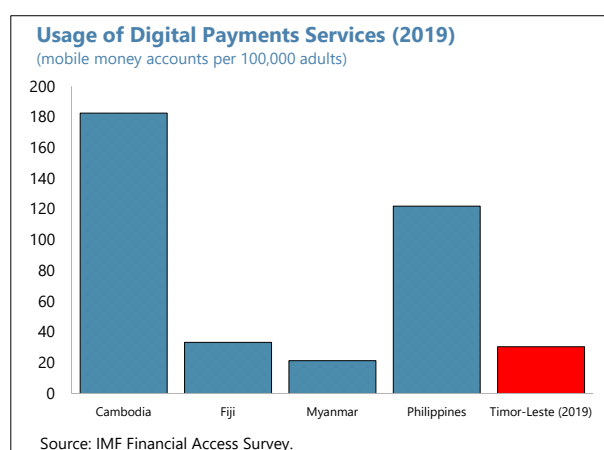
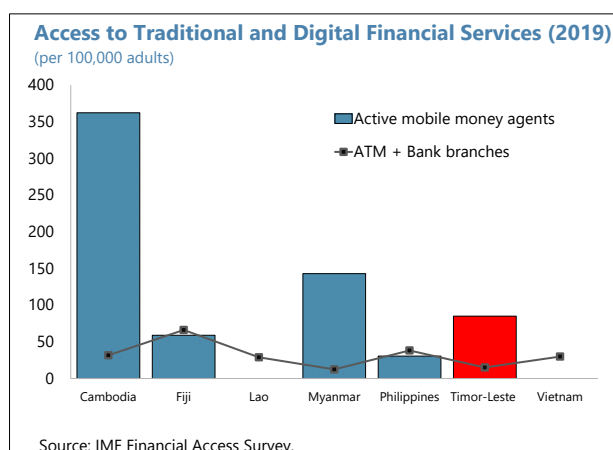
29. Labor market reforms should be prioritized to create good jobs and close gender gaps. Significant challenges remain in creating jobs for youth entering the labor force—45 percent of young people are neither employed nor studying in the education/training system. Growth in wages (likely driven by the public sector) has been outpacing growth in labor productivity, discouraging formal employment. Moreover, gender gaps in the labor market remain high—women have lower labor force participation, higher unemployment and share in informal jobs, and lower wages. Closing labor skills and gender gaps and raising labor productivity through strengthening worker skills and training remains key. There is also a need to assess the impact of public employment and wage setting on the private sector.



⁷ See Timor-Leste Economic Report: Moving Beyond Uncertainty (April 2019), World Bank Group.

30. The tourism sector is underdeveloped but could make a significant contribution to diversifying the economy. Tourism is relatively labor intensive, and with the right mix of products, services, and supporting infrastructure it could bring widespread economic benefits and create jobs for a burgeoning youth population. The national tourism policy should be reviewed and aligned with the post-COVID new normal focusing on eco-sustainable tourism services with lower density, higher value-added, and greater digitalization. A recent survey of Timor-Leste's tourism firms also identified the need for better connectivity and digital enhancement of tourism marketing to support the sector's recovery post COVID.⁸

31. Significant progress has been achieved in development of the payments system and the implementation of the financial inclusion agenda. The establishment of R-TIMOR (an electronic system of platforms that allows individuals and entities to make electronic payments) and the P24 system (connects the core banking system and payment networks) are remarkable achievements. In addition, the central bank authorized two electronic money wallet services in 2018–19 to help expand access to financial payments services in the villages and rural areas given the low accessibility to bank branches. This has contributed to a substantial improvement in financial inclusion—the share of population excluded from financial services has decreased from close to 40 percent in 2018 to 16 percent in 2020.



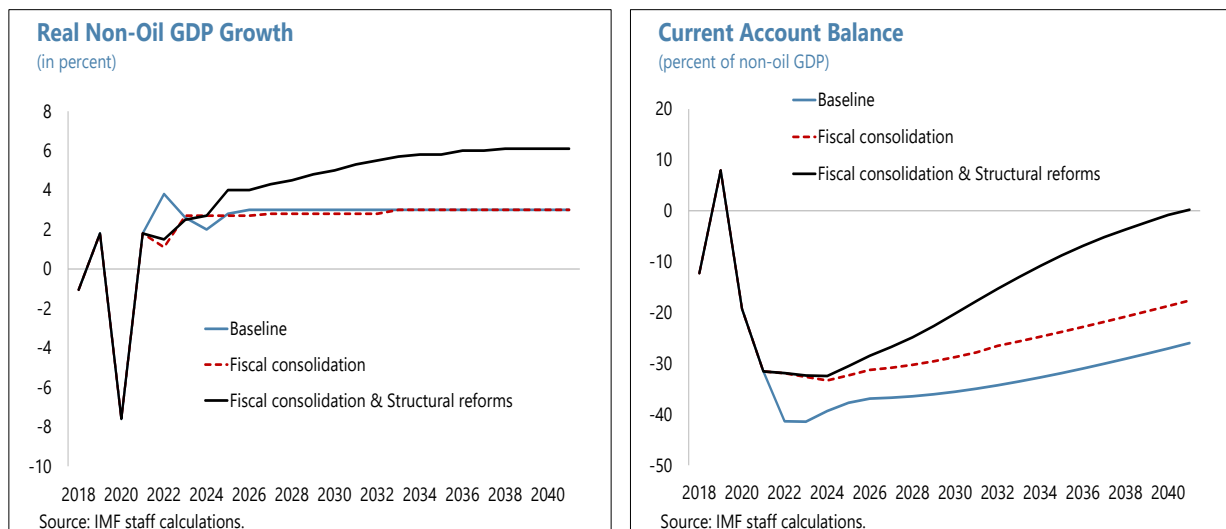
32. Nonetheless, limited access to credit for small and medium enterprises remains an important challenge reported by the private sector. Private sector credit to GDP ratios remain significantly lower than regional peers. Lending rates by commercial banks are usually higher than 10 percent and banks are reluctant to lend, despite the implementation of the credit guarantee scheme in 2019. Lending rates are expensive because property cannot be used as collateral in that there is no land registration. Digitalization could help generate alternative information to assess a borrower's creditworthiness and help expand credit to those with no collateral or limited credit history.

⁸ See "Timor-Leste Tourism Reboot Initiative: A Productive Plan for the After COVID Era", USAID's Tourism for All Project (May 2020).

33. Upgrading the financial sector regulatory and supervisory framework and expanding digital financial literacy should be a priority. Timor-Leste's prudential standards and risk assessment methodologies are still basic and need to be enhanced to capture the risk emerging in the financial sector, including those related to cybersecurity and data/consumer protection. Increasing digital financial literacy will also be crucial to expand the safe use of financial services. The central bank has already initiated some work on drafting a few prudential standards and credit risk management regulation including treatment of expected credit losses under IFRS 9 and this work should continue, with support from PFTAC.

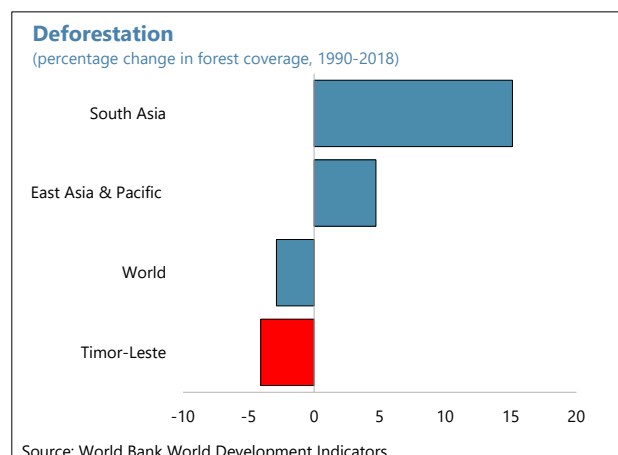
34. To tap digitalization's potential, Timor-Leste should invest in information and communication technology. While significant progress has been made in expanding the mobile phone network (more than 95 percent coverage), Timor-Leste has the second slowest internet speed in the world and the slowest in the region, which is an impediment for private sector development. Moreover, with less than 30 percent of the population using the internet, the digital divide is widening (Figure 6, bottom charts).

35. Staff's reform scenario illustrates the combined impact of fiscal consolidation with structural reforms to promote growth. It shows the gradual fiscal consolidation (paragraph 20) combined with structural reforms including higher quality of government spending, progress in facilitating doing business, addressing digital infrastructure and connectivity bottlenecks, increasing financial access, building human capacity, closing labor skill gaps, and strengthening the justice sector to improve governance. Real non-oil GDP growth is broadly similar to the baseline in the medium term (2021–26) as structural reform compensates for the growth cost of fiscal consolidation. With sustained improvement in productivity and competitiveness, the economic impact of structural reforms is higher over the long-term, where growth is projected to hover around 5–6 percent, significantly higher than under the baseline⁹, driven by higher private investment and the development of the non-oil private sector, reduced imports, and a larger exports base.



⁹ This growth performance would be closer to the average one by emerging and developing countries in 2010–19.

36. Strengthening disaster risk management and preparedness should also be prioritized. Although natural disasters such as floods and landslides are quite common, the floods triggered by Tropical Cyclone Seroja on April 4 were the most severe in decades. The United Nations reported 45 deaths, serious damage to infrastructure, and 16,000 people seeking shelter. Livestock, rice fields, and coffee plantations were also destroyed. There were no early warnings and, more importantly, no building codes preventing people from constructing precarious houses along riverbanks. Deforestation is also a problem in that it results in landslides.



37. The U.S. dollar as legal tender continues to serve Timor-Leste well. Use of the U.S. dollar can reduce external competitiveness when the currency appreciates against trading partners. However, dollarization remains appropriate given Timor-Leste's limited financial sector development, low institutional capacity, and its U.S. dollar-denominated major exports (coffee and petroleum).

38. Further efforts are required to improve statistical capacity. We commend the authorities for shortening the time lag in the release of the annual GDP data. Staff considers that data provision to the IMF is broadly adequate for surveillance, an upgrade compared to the 2019 Article IV. Yet, efforts to strengthen statistics should continue. Main areas of concern include inconsistencies between national accounts and balance of payments on petroleum-related transactions, unreliability of trade statistics, weaknesses in compilation and dissemination of government financial statistics, and delays in releasing financial soundness indicators data. The IMF is ready to provide technical assistance.

Authorities' Views

39. They noted recent efforts to prioritize investment in the people, especially the young. The increase of public expenditures in 2021 for health and education and the adoption of the Economic Recovery Plan (Annex VI) reflects a continued commitment to raise labor productivity. In addition, efforts to provide job opportunities abroad have continued, including through worker programs with Australia and Korea. However, they pointed out the need to expand the number of worker vocational training centers across the country.

40. They acknowledged that agriculture has been below potential, despite its economic importance. The 2021 budget will support the operation of irrigation schemes, water supply, and harvesting storage. The Economic Recovery Plan prioritizes the renewal of coffee plantations with new techniques enhancing productivity and the quality of coffee produced.

41. They are confident that the new anti-corruption law will help strengthen their fight against corruption. Efforts to conduct anti-corruption campaigns to raise public awareness, including in schools, are ongoing. However, the Anti-Corruption Commission highlighted human and financial resource constraints as key impediments to effective oversight and enforcement. They are implementing the second cycle of its United Nations Convention Against Corruption and expect to complete it by end-2021.

42. They acknowledged the need for improving the business environment, including through digitalization. They plan to: (1) streamline business registration and licensing, including by moving towards electronic certification; (2) strengthen the judicial system by developing extrajudicial means of dispute resolution, such as arbitration and mediation; and (3) transform internet connectivity by installing a submarine fiber-cable through Australia's northern territory to replace slow connection via satellite.

43. They agreed that structural reforms combined with fiscal consolidation are warranted to strengthen the external sector position. They nonetheless emphasized that improving competitiveness and diversifying the economy would take time. They underscored the importance of a stronger agricultural sector to increase commodity exports such as coffee and reducing food imports, to help close the current account gap.

44. They will promote the development of the tourism sector to support the economic recovery. In 2021, they will develop a new tourism policy and master plan and want to develop eco-tourism, combining accommodation with coffee and rice fields.

45. They emphasized that the modernization of the payment system, including via digitalization, has enhanced access to financial payments services and promoted a stable financial sector. The central bank is simultaneously focusing on financial literacy programs in elementary schools and launched the "Digital Village Program" to enhance safe financial inclusion. However, weaknesses in the collateral regime, contract enforcement and in credit registry information were noted as significant obstacles to credit expansion, especially to businesses.

46. They acknowledged that recent floods point to the need to enhance their disaster management strategy. They see a case for shifting towards climate-resilient infrastructure, strengthening the contingency fund, and starting territorial planning to identify and develop an integrated plan for urban and housing development, especially along riverbanks.

47. The regime of official dollarization has contributed to macroeconomic stability. Nonetheless, the central bank will review the advantages and disadvantages of the current regime versus alternative regimes.

48. The central bank is taking steps to strengthen the AML/CFT framework. The central bank introduced a new threshold for money transfer operators and e-wallet providers to report cash transactions over \$1,000 to the Financial Information Unit. The central bank has also implemented new supervisory tools to assess financial institutions' compliance with AML/CFT requirements.

49. The authorities expressed appreciation for ongoing IMF technical assistance and agreed on the need to strengthen statistics. They appreciated the ongoing technical assistance on the public financial management draft law and on balance of payments statistics. They conveyed interest in continued IMF support in the above-mentioned areas as well as Value-Added Tax implementation, and tax administration. They recognized that improved statistics are essential for better policy formulation, and plan to change the General Directorate of Statistics, currently under the Ministry of Finance, into a public institute with autonomy.

STAFF APPRAISAL

50. Timor-Leste has made significant progress in many areas since its independence, but faces significant near- and medium-term challenges. The most pressing issue in the near term is containing the adverse impact from the COVID-19 pandemic. Although the country was highly effective in limiting the spread of infections during 2020, the number of cases has been increasing fast since March 2021. Moreover, heavy floods in early April 2021 left many people without homes and sheltering in refugee centers, complicating efforts to halt the spread of the virus.

51. In the near term, the focus should be on accelerating the ongoing rollout of vaccines and on providing relief to the most vulnerable. The government appropriately responded to the twin shocks—COVID-19 outbreak and floods—with a strong fiscal package aiming to mitigate the adverse impact on the most vulnerable. A key priority should be to vaccinate the adult population as soon as possible and to provide financial relief to the most vulnerable people affected by the pandemic and the recent floods.

52. Post COVID, with oil revenues coming to a halt, fiscal consolidation is warranted to ensure long-term fiscal and debt sustainability. The 2021 budget envisages a frontloading of government spending in the medium term, large fiscal imbalances persisting in the long term, and depletion of the Petroleum Fund balance. This fiscal cliff scenario, the associated macroeconomic instability and adverse social impact should be avoided. A fiscal reform strategy aiming to put the fiscal position on a sustainable footing should be laid out in the 2022 budget.

53. Addressing public financial management weaknesses will help improve the quality of government spending and strengthen the fiscal framework. Public investment projects should focus on high-return projects by making them subject to thorough cost-benefit analysis. The basic public financial management draft law should be aligned with international best practices, with technical support from the IMF. Budget credibility should be enhanced and fiscal transparency improved to limit corruption vulnerabilities.

54. Structural reforms should underpin the diversification of the economy. Efforts to improve the business environment, strengthen governance, raise labor productivity, and increase financial deepening, including through harnessing digitalization, would help promote private sector development, create jobs, improve competitiveness, and support the external position. Improving the productivity of the agriculture sector is important given the large fraction of the population

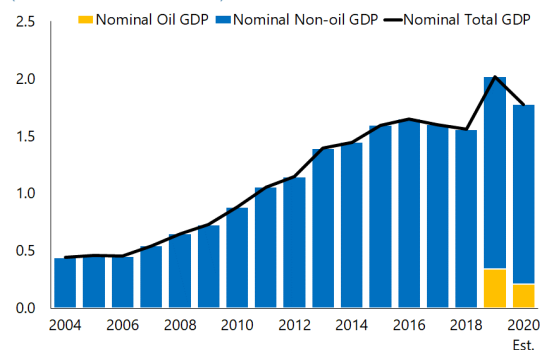
dedicated to that activity. Strengthening disaster risk management and preparedness is also crucial, given the country's vulnerability to climate shocks. Likewise, improving data quality is vital to support policy making.

55. It is proposed that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Timor-Leste: Real Sector Developments

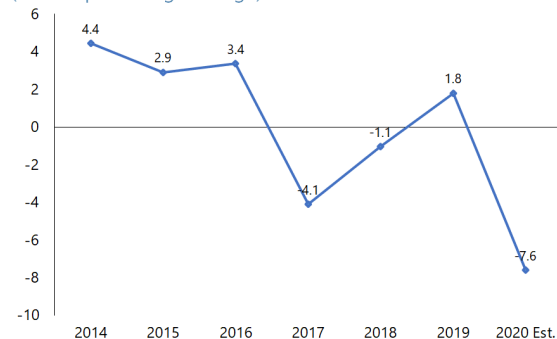
Oil production is part of GDP since September 2019 following the treaty on maritime boundaries signed with Australia.

Nominal GDP: Total, Oil, and Non-Oil
(In billions of US dollars)



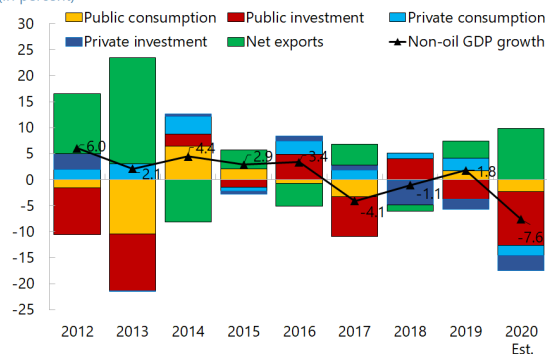
The pandemic has hit hard when the economy was still slowly recovering from recession in 2017–2018.

Real Non-Oil GDP
(Annual percentage change)



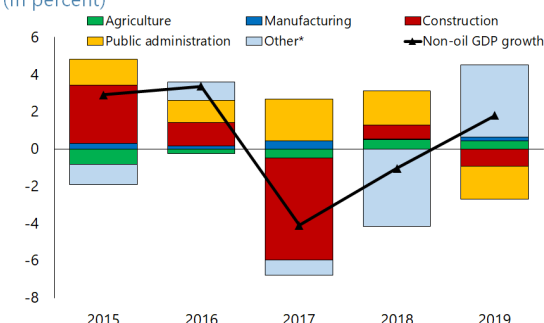
Non-oil GDP has been largely driven by government spending on the demand side...

Real Non-Oil GDP Expenditure: Contributions to Growth
(In percent)



...and by construction and public administration on the supply side.

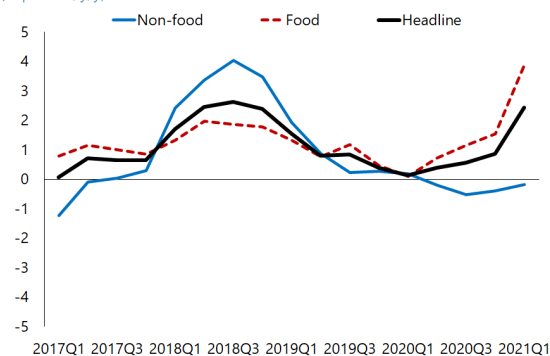
Real Non-Oil GDP Production: Contributions to Growth
(In percent)



*Other includes wholesale and retail trade, real estate services, and other activities.

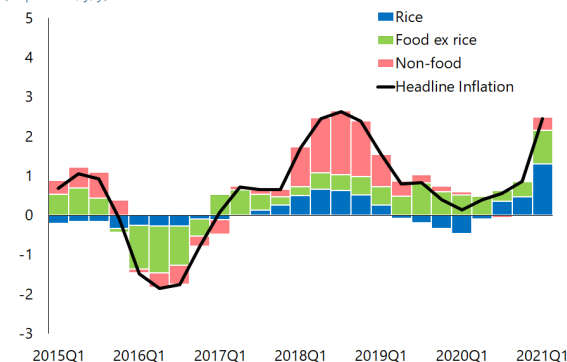
Inflation has been low but food prices are picking up amid the pandemic...

Food and Non-food Prices
(In percent, y/y)



...reflecting increase in both domestic and international rice prices.

Contribution to Headline Inflation
(In percent, y/y)



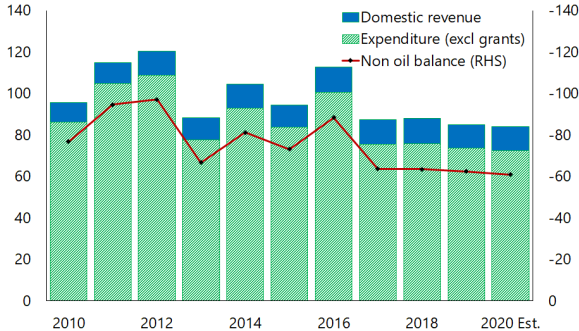
Sources: General Directorate of Statistics; and IMF staff estimates.

Figure 2. Timor-Leste: Fiscal Sector Developments

Non-oil domestic revenue has been financing a small fraction of government spending.

Non-Oil Balance

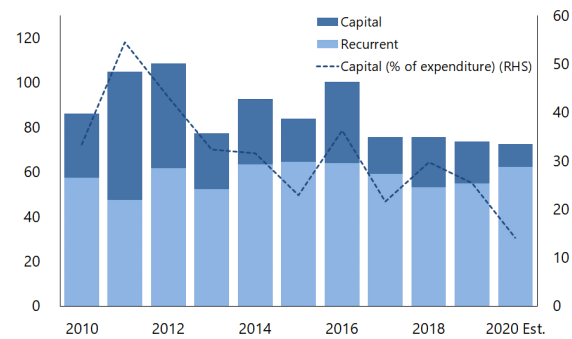
(In percent of Non-Oil GDP)



While the share of capital spending has continued to fall...

Expenditure Shares

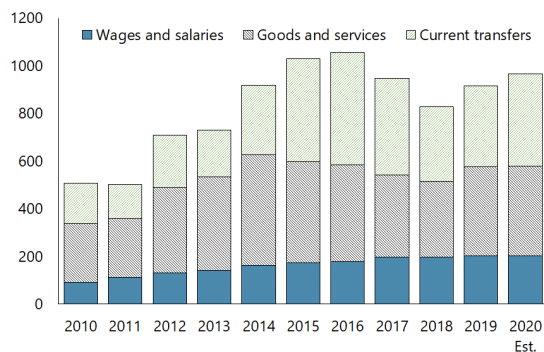
(In percent of Non-Oil GDP, excl. donor projects)



...recurrent spending has been increasing steadily since 2018

Recurrent Spending

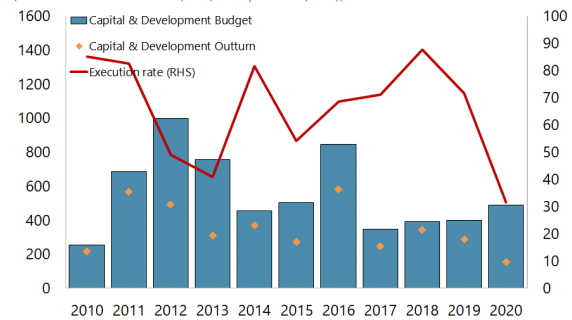
(In millions of US dollars)



There has been a significant gap between capital spending plans and execution.

Capital and Development Expenditure: Budget and Execution Rate

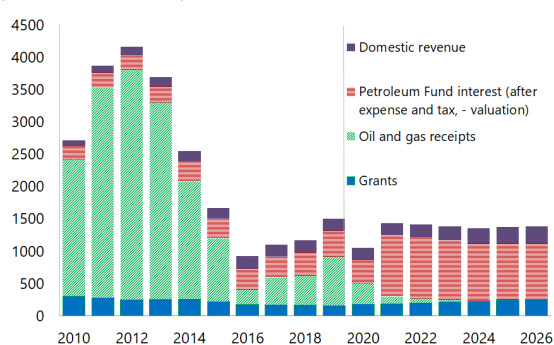
(In millions of US dollars (LHS) and percent (RHS))



With oil and gas receipts depleting in 2023, there is a greater need to increase domestic revenues...

Revenue Sources

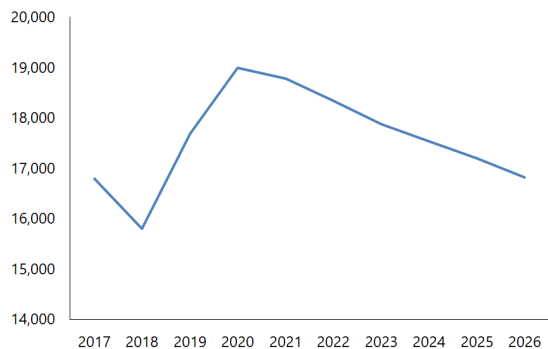
(In millions of US dollars)



...and to reduce excess withdrawals to avoid depleting the PF.

Petroleum Fund Balance

(In millions of US dollars)



Sources: Ministry of Finance of Timor-Leste; IMF staff calculations and estimates.

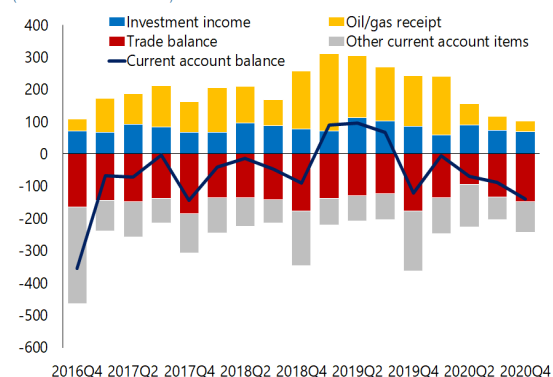
Notes: ESI= Estimated Sustainable Income; PF= Petroleum Fund.

Figure 3. Timor-Leste: External Sector Developments

The current account weakened due to lower oil/gas revenues.

Current Account Balance

(In millions of US dollars)



Non-oil exports rose in 2020 but remain volatile...

Goods Exports and Imports Growth

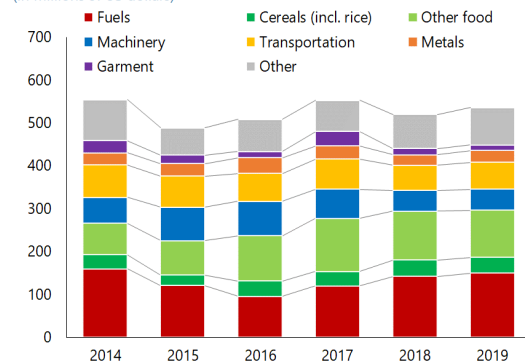
(In percent, y/y)



Fuel and food account for more than one-half of total goods import.

Goods Imports

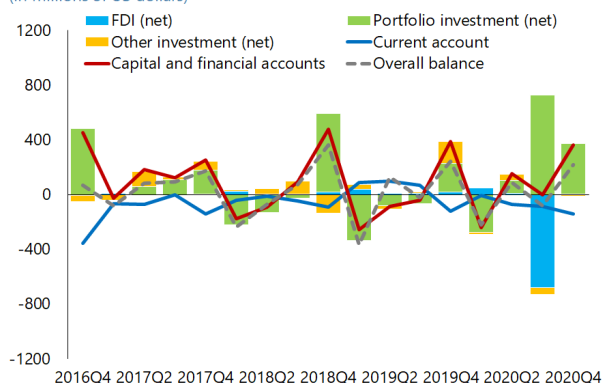
(In millions of US dollars)



Current account deficits have largely been financed by withdrawals from the PF (portfolio investment).

Financial Account Balance

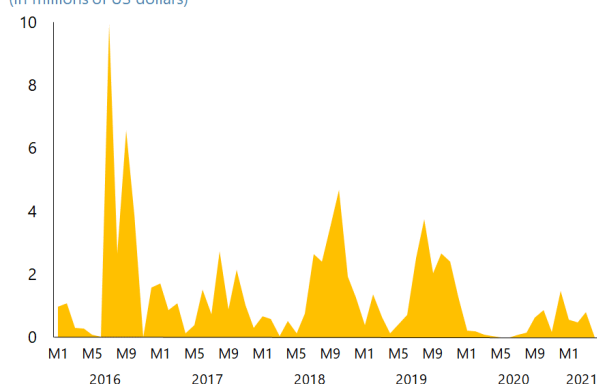
(In millions of US dollars)



...reflecting fluctuations in coffee exports, the single-largest export item after oil/gas.

Coffee Exports Value

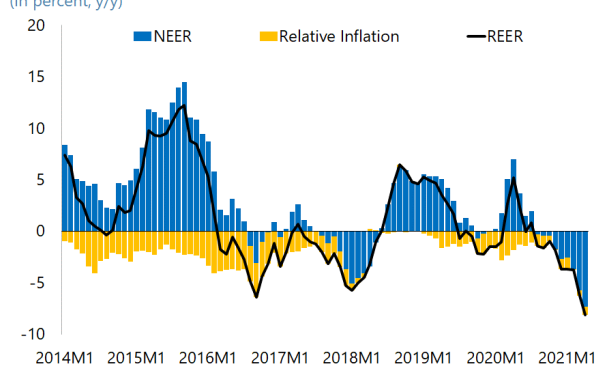
(In millions of US dollars)



The REER appreciated in 2020H1 and since then has been depreciating, mainly due to the U.S. dollar weakening vis-à-vis trading partners.

Real Effective Exchange Rate: Contribution to Change

(In percent, y/y)



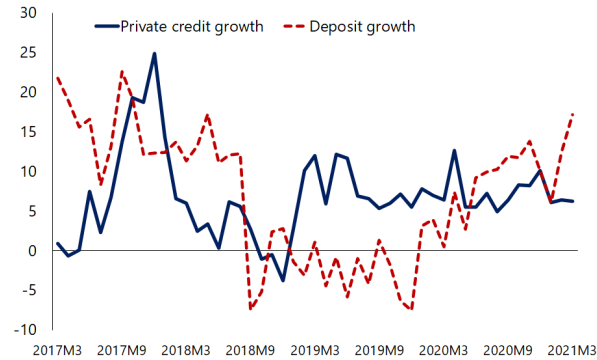
Sources: Central Bank of Timor-Leste; General Directorate of Statistics; and IMF staff estimates.

Figure 4. Timor-Leste: Monetary and Financial Sector Developments

Private sector credit growth has been growing since 2019 and deposit growth has started to rise after the pandemic.

Credit and Deposit Growth

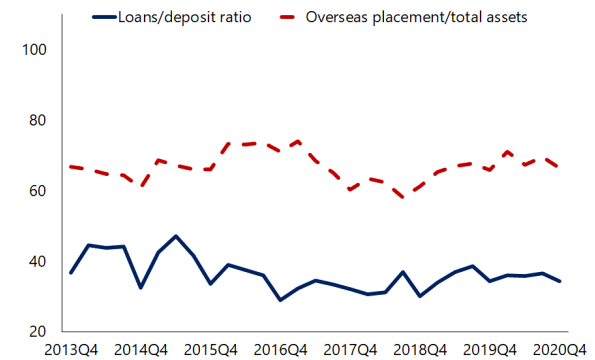
(In percent, year-on-year)



The banking sector is highly liquid with a large overseas placement of bank assets.

Liquidity Ratios

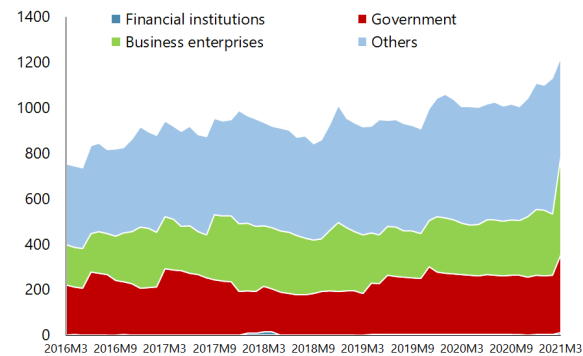
(In percent)



Deposits by the private sectors rose in 2020 while those of the public sector remained broadly stable.

Deposits by Type of Depositors

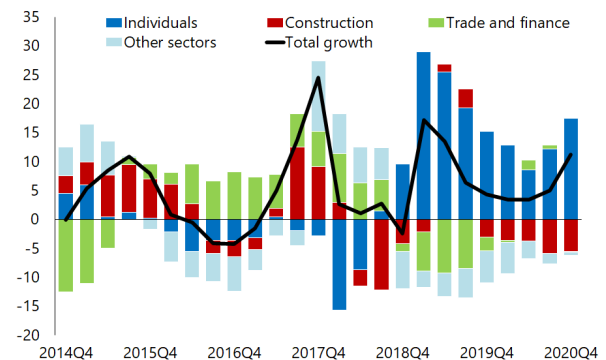
(In millions of US dollars)



Recent private sector credit has been growing driven by loans to individuals.

Loans to Private Sector: Contribution to Growth

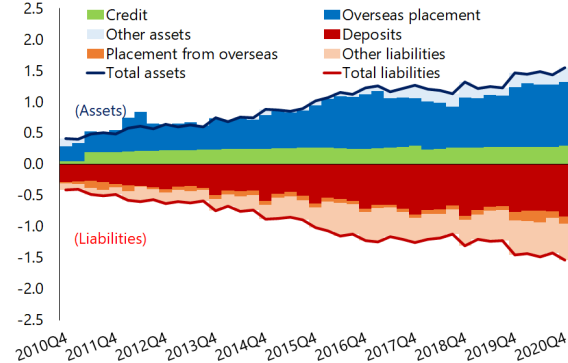
(In percent, y/y)



Overseas placement of assets constitutes a significant share of the assets of the banking sector.

Banking Sector Balance Sheet

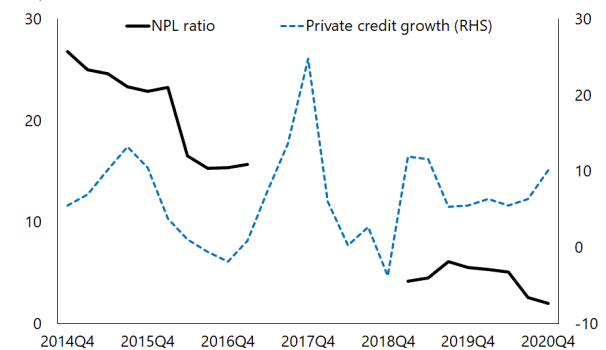
(In billions of US dollars)



The impact on NPLs by the pandemic related recession might be observed with a lag.

NPL Ratio and Private Sector Credit Growth

(In percent)



* Nonperforming Loans (NPLs) data is unavailable between 2017-18.

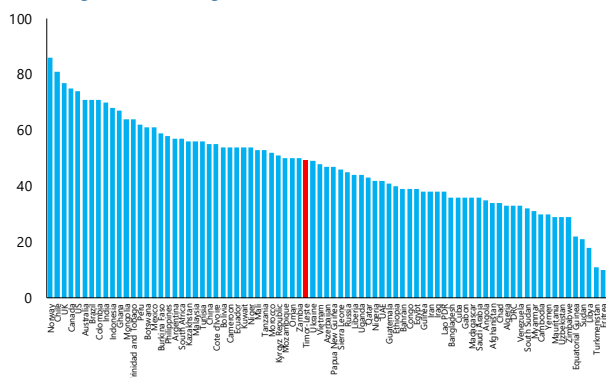
Sources: Central Bank of Timor-Leste; General Directorate of Statistics; and IMF Statistics Department.

Figure 5. Timor-Leste: Business Environment and Governance

The governance of the Timor-Leste's Petroleum Fund is strong by international standards, and...

Resource Governance Index

(Index ranges from 0-100, higher is better; 2017)

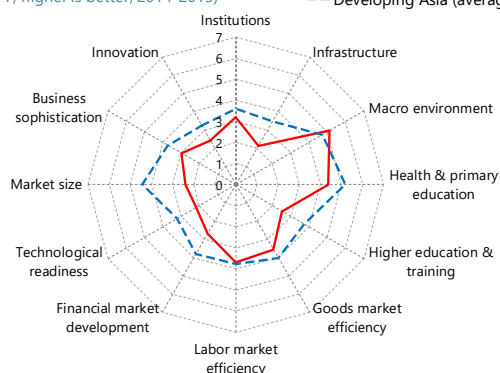


Education and infrastructure gaps undermine competitiveness.

Global Competitiveness Index

(Score 1-7, higher is better; 2014-2015)

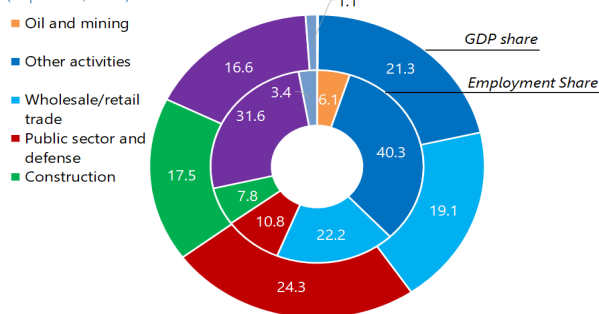
— Timor-Leste
— Developing Asia (average)



Agriculture and services absorb a large fraction of employment, despite their small share in GDP...

Employment and Real GDP Share

(In percent; 2016)



...the governance of the public sector is improving but lagging somewhat behind peers.

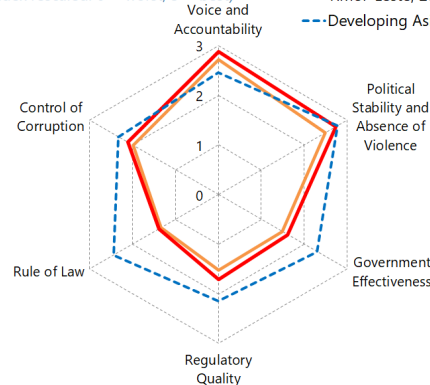
Governance Indicators

(Index rescaled: 0 = worst, 5 = best)

—Timor-Leste, 2016

— Timor-Leste, 2019

--- Developing Asia Avg. (excl. TLS)

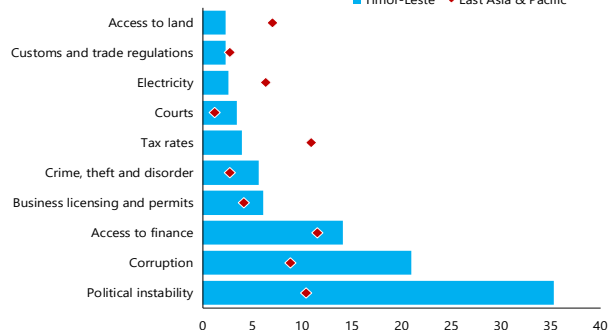


Political instability, governance and limited financial access are among the major business constraints perceived by firms.

Top ten business environment constraints

(percent of firms, 2015)

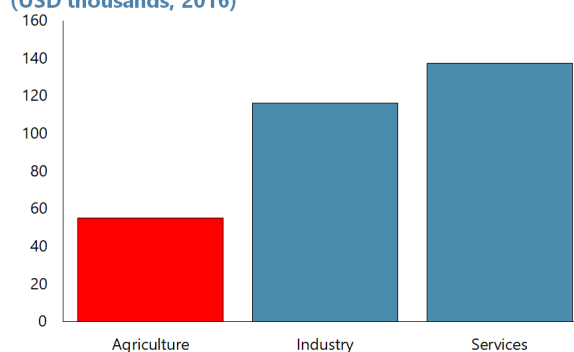
■ Timor-Leste • East Asia & Pacific



...so labor productivity in agriculture is very low.

Labor Productivity

(USD thousands, 2016)



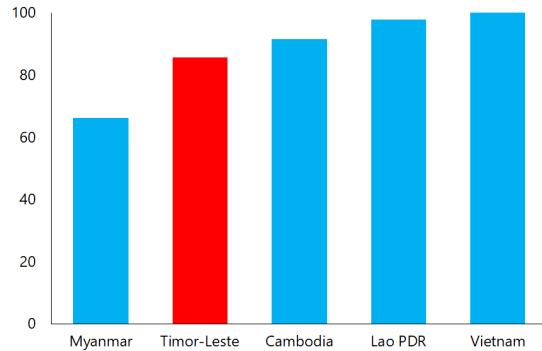
Sources: Labor Market Survey, 2016; Worldwide Governance Index, 2019; Natural Resource Governance Institute, Resource Governance Index 2017; the World Economic Forum Global Competitiveness Index 2014-2015; World Bank Enterprise Survey, 2015 and World Bank Development Indicators, latest available data.

Figure 6. Timor-Leste: Challenges to Growth—Comparison with Regional Peers

Access to electricity improved considerably and electricity tariffs are largely subsidized...

Access to Electricity

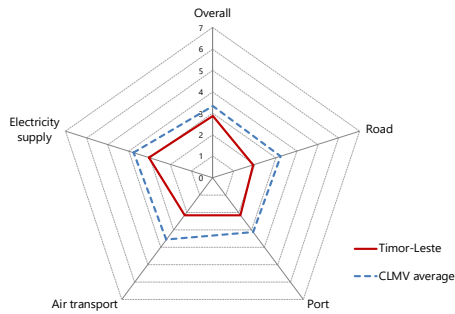
(In percent of population, 2018)



The perceived quality of infrastructure is lower than regional peers.

Quality of Infrastructure

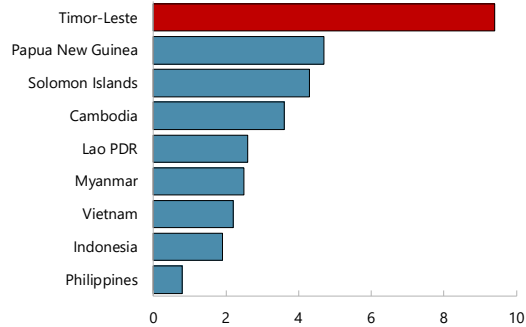
(Score 1-7, higher is better; 2014-15)



...but the losses due to electrical outages are high.

Losses due to electrical outages

(In percent of sales; 2015)

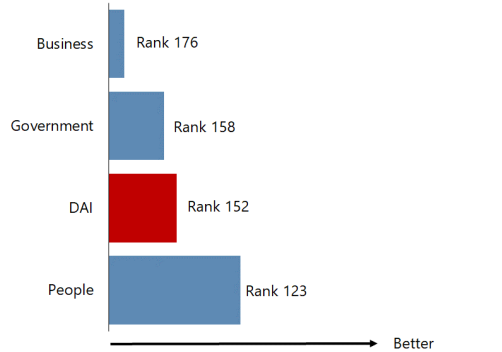


* 2016 data for Cambodia, Lao PDR, Myanmar.

Mobile penetration is high but digital adoption in business is at low level.

Digital Adoption Index

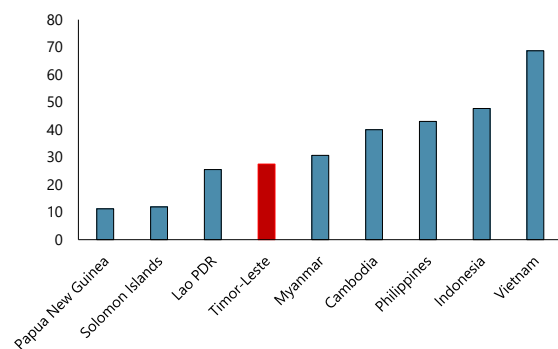
(Rank out of 183, 2016)



Access to internet is low...

Individuals using the Internet

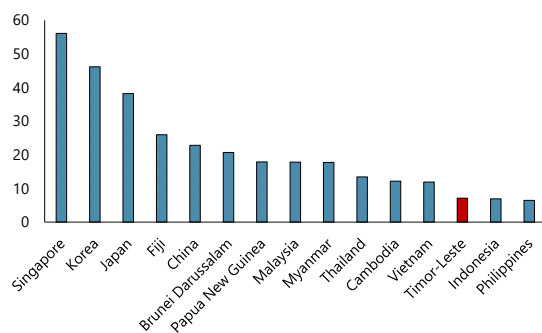
(Percent of population, 2019)



...and the service has poor quality.

Southeast Asia: Average Internet Speeds in 2020

(megabytes per second)



Sources: World Bank Development Indicators; World Economic Forum Global Competitiveness Index 2014-2015; Statista, and IMF staff calculations.

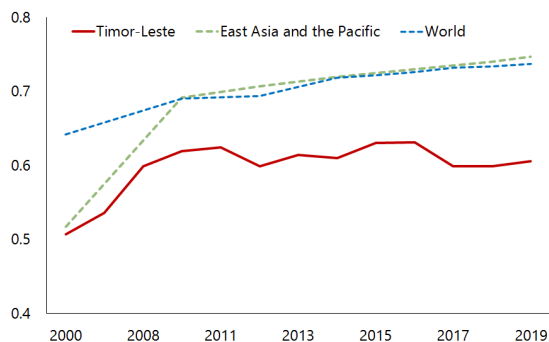
Note: CLMV denotes Cambodia, Lao PDR, Myanmar, and Vietnam.

Figure 7. Timor-Leste: Social Economic Development

Timor-Leste's human development had improved steadily until mid-2010s but has been stagnating recently...

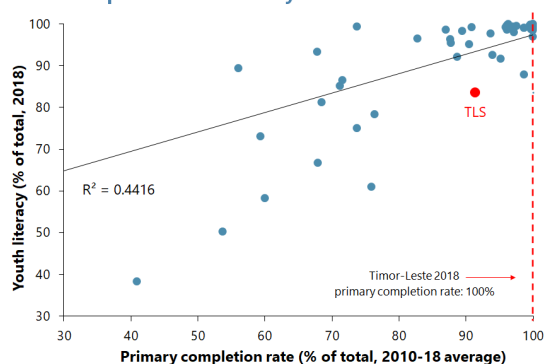
Human Development Index (HDI)

(Higher is better)



Improved completion rates of basic education achieved in recent years will help to raise the literacy rate...

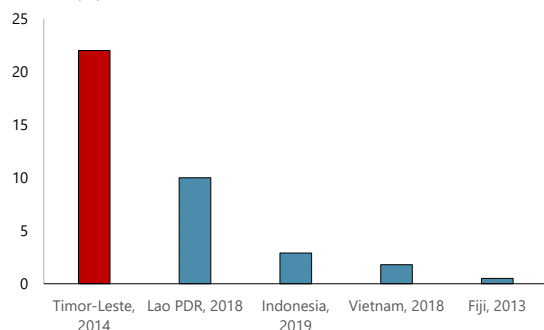
Human Capital: Youth Literacy



Poverty remains high...

Poverty Headcount Ratio at \$1.90 a Day

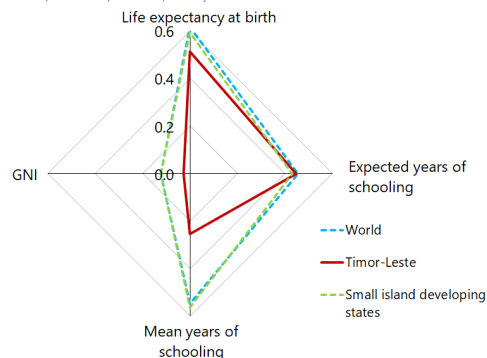
(Percent of population, 2011 PPP)



...reflecting lags among peers in average years of schooling.

HDI Components

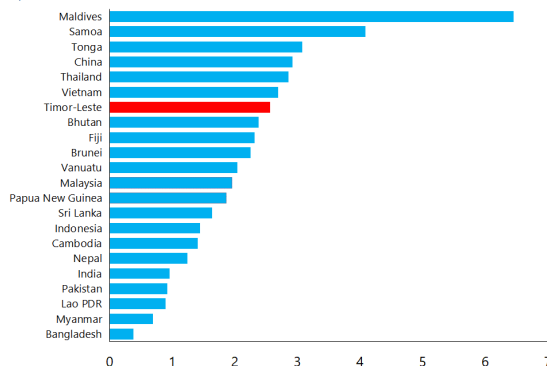
(Index rescaled; 0=worst, 1=best; 2019)



...and increasing the level and quality of public spending on health would help strengthen human capital.

Health Expenditure: Selected Developing Asian Economies

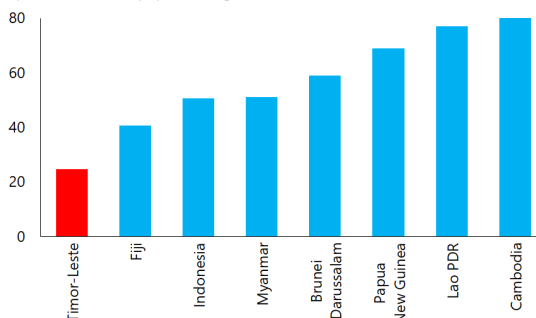
(In percent of GDP, 2017)



...while raising female participation in the labor market is a challenge.

Female Labor Force Participation Rate

(In percent of female population ages 15+, 2018)



Sources: United Nations, Human Development Report, 2020; World Bank, World Development Report, 2020; and World Bank, World Development Indicators.

Table 1. Timor-Leste: Selected Economic Indicators, 2016–22

Non-oil GDP at current prices (2019): US\$1.674 billion
 Population (2019): 1.293 million
 Non-oil GDP per capita (2019): US\$1,295
 Quota: SDR 25.6 million

	2016	2017	2018	2019	2020 Est.	2021 Proj.	2022 Proj.
(Annual percent change)							
Real sector							
Real Non-oil GDP	3.4	-4.1	-1.1	1.8	-7.6	1.8	3.8
CPI (annual average)	-1.5	0.5	2.3	0.9	0.5	1.6	2.5
CPI (end-period)	0.0	0.6	2.1	0.3	1.2	2.0	3.0
(In percent of Non-oil GDP, unless otherwise indicated)							
Central government operations							
Revenue	56.1	53.0	58.5	52.5	58.2	58.8	56.1
Domestic revenue	12.1	11.9	12.2	11.2	11.6	11.7	11.7
Estimated Sustainable Income (ESI)	33.0	30.1	35.3	31.6	34.8	35.4	32.7
Grants	11.0	11.0	11.0	9.7	11.8	11.8	11.8
Expenditure	111.5	86.6	86.7	83.4	84.3	104.9	110.0
Recurrent	64.0	59.2	53.1	54.9	62.3	74.6	60.5
Net acquisition of nonfinancial assets	36.5	16.3	22.6	18.8	10.2	18.6	37.8
Donor project	11.0	11.0	11.0	9.7	11.8	11.8	11.8
Net lending/borrowing	-55.4	-33.6	-28.2	-30.9	-26.1	-46.1	-53.9
(Annual percent change, unless otherwise indicated)							
Money and credit							
Deposits	14.1	12.3	2.8	-7.5	10.1	3.8	6.9
Credit to the private sector	-1.8	24.8	-3.8	5.5	10.1	6.6	6.9
Lending interest rate (percent, end of period)	14.5	12.5	14.5	16.3	11.3	...	...
(In millions of U.S. dollars, unless otherwise indicated)							
Balance of payments							
Current account balance 1/	-544	-284	-191	133	-302	-513	-719
(In percent of Non-oil GDP)	-33	-18	-12	8	-19	-32	-41
Trade balance	-546	-615	-589	-566	-510	-558	-657
Exports 2/	20	17	25	26	17	29	33
Imports	567	631	613	592	527	587	691
Services (net)	-569	-343	-349	-357	-269	-318	-370
Primary Income	544	735	843	1,126	620	328	320
Secondary Income	26	-61	-96	-70	-143	-74	-79
Overall balance	-157	263	129	-18	0.2	-177	144
Public foreign assets (end-period) 3/	16,125	17,343	16,477	18,348	19,647	19,265	18,964
(In months of imports)	160	195	187	212	280	241	198
Exchange rates							
NEER (2010=100, period average)	130.0	129.7	130.9	134.1	135.8	...	...
REER (2010=100, period average)	143.5	140.7	141.7	143.4	143.3	...	...
Memorandum items							
Nominal Non-oil GDP (in millions of U.S. dollars)	1,651	1,599	1,560	1,674	1,565	1,625	1,738
Nominal Non-oil GDP per capita (in U.S. dollars)	1,354	1,286	1,230	1,295	1,187	1,210	1,269
(Annual percent change)	1.6	-5.0	-4.4	5.2	-8.3	1.9	4.9
Crude oil prices (U.S. dollars per barrel, WEO) 4/	43	53	68	61	41	59	55
Petroleum Fund balance (in millions of U.S. dollars) 5/	15,844	16,799	15,803	17,692	18,991	18,785	18,340
(In percent of Non-oil GDP)	960	1,050	1,013	1,057	1,213	1,156	1,055
Public debt (in millions of U.S. dollars)	77	106	145	193	218	279	330
(In percent of Non-oil GDP)	4.7	6.6	9.3	11.5	13.9	17.2	19.0
Population growth (annual percent change)	1.9	2.0	2.0	2.0	2.0	1.9	1.9

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

1/ Excludes trade in goods and services of entities located in the Joint Petroleum Development Area which are considered non-resident entities until August 2019.

2/ Excludes petroleum exports, the income of which is recorded under the income account.

3/ Includes Petroleum Fund balance and the central bank's official reserves.

4/ Simple average of UK Brent, Dubai, and WTI crude oil prices based on April 2021 WEO assumptions.

5/ Closing balance.

Table 2. Timor-Leste: Summary of Central Government Operations, 2017–26 1/

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
(In millions of U.S. dollars)										
Revenue	848	912	879	910	956	975	988	998	1,020	1,046
Domestic revenue	190	191	188	182	189	203	217	231	247	265
Taxes	127	128	122	119	121	130	139	147	158	169
Non-tax revenue	57	63	65	63	68	73	78	83	89	96
Estimated Sustainable Income	482	550	529	544	576	568	553	536	526	516
Donor Projects	177	171	162	184	191	204	218	231	247	265
Expenditure	1,385	1,352	1,396	1,319	1,705	1,911	1,906	1,741	1,766	1,835
Expenditure excluding donor projects	1,208	1,181	1,234	1,135	1,514	1,707	1,688	1,510	1,519	1,570
Expense	1,124	1,000	1,081	1,159	1,403	1,255	1,308	1,363	1,422	1,484
Recurrent	947	829	920	975	1,212	1,051	1,090	1,132	1,175	1,220
Compensation of employees	197	197	203	202	209	217	225	234	243	252
Goods and services	344	317	374	378	392	407	422	439	455	472
Current transfers	405	312	339	387	406	420	436	451	467	484
Interest payment	1	2	3	2	5	6	7	8	10	11
Donor projects	177	171	162	184	191	204	218	231	247	265
Net acquisition of NFA	261	352	314	160	302	656	598	378	344	351
Gross operating balance	-276	-88	-203	-249	-447	-280	-320	-365	-402	-438
Net lending/borrowing	-537	-440	-517	-409	-749	-936	-918	-743	-746	-789
Statistical discrepancy	36	-27	-170	-76	0	0	0	0	0	0
Net financial transactions	-573	-412	-347	-333	-749	-936	-918	-743	-746	-789
Net acquisition of FA	-544	-373	-299	-308	-688	-886	-867	-689	-688	-727
Foreign	0	0	0	0	0	0	0	0	0	0
Domestic (net)	-544	-373	-299	-308	-688	-886	-867	-689	-688	-727
Equity	-597	-432	-440	-342	-688	-886	-867	-689	-688	-727
of which, Excess withdrawal from PF	-597	-432	-440	-342	-688	-886	-867	-689	-688	-727
Change in cash/deposit	53	59	141	34	0	0	0	0	0	0
Net incurrence of liabilities	29	39	48	25	61	51	51	54	58	62
Foreign	29	39	52	29	70	66	69	72	76	80
Domestic	0	0	0	0	0	0	0	0	0	0
Amortization			3.3	3.8	8.9	15.2	18.1	18.2	18.3	18.4
(in percent of nominal non-oil GDP)										
Revenue	53.0	58.5	52.5	58.2	58.8	56.1	53.3	50.7	48.5	46.4
Domestic revenue	11.9	12.2	11.2	11.6	11.7	11.7	11.7	11.7	11.7	11.8
Taxes	8.0	8.2	7.3	7.6	7.4	7.5	7.5	7.5	7.5	7.5
Non-tax revenue	3.6	4.0	3.9	4.0	4.2	4.2	4.2	4.2	4.2	4.3
Estimated Sustainable Income	30.1	35.3	31.6	34.8	35.4	32.7	29.8	27.3	25.0	22.9
Expenditure	86.6	86.7	83.4	84.3	104.9	110.0	102.8	88.5	84.0	81.5
Expenditure excluding donor projects	75.6	75.7	73.7	72.5	93.1	98.2	91.0	76.7	72.2	69.7
Expense	70.3	64.1	64.6	74.0	86.3	72.2	70.6	69.3	67.6	65.9
Recurrent	59.2	53.1	54.9	62.3	74.6	60.5	58.8	57.5	55.9	54.1
Compensation of employees	12.3	12.6	12.1	12.9	12.9	12.5	12.2	11.9	11.6	11.2
Goods and services	21.5	20.3	22.3	24.1	24.1	23.4	22.8	22.3	21.6	21.0
Current transfers	25.3	20.0	20.3	24.7	25.0	24.2	23.5	22.9	22.2	21.5
Donor projects	11.0	11.0	9.7	11.8	11.8	11.8	11.8	11.8	11.8	11.8
Net acquisition of NFA	16.3	22.6	18.8	10.2	18.6	37.8	32.2	19.2	16.3	15.6
Gross operating balance	-17.3	-5.6	-12.1	-15.9	-27.5	-16.1	-17.3	-18.6	-19.1	-19.5
Net lending/borrowing	-33.6	-28.2	-30.9	-26.1	-46.1	-53.9	-49.5	-37.8	-35.4	-35.0
Statistical discrepancy	2.3	-1.8	-10.1	-4.8	0.0	0.0	0.0	0.0	0.0	0.0
Net financial transactions	-35.8	-26.4	-20.7	-21.3	-46.1	-53.9	-49.5	-37.8	-35.4	-35.0
Net acquisition of FA	-34.0	-23.9	-17.9	-19.7	-42.3	-51.0	-46.8	-35.0	-32.7	-32.3
Domestic (net)	-34.0	-23.9	-17.9	-19.7	-42.3	-51.0	-46.8	-35.0	-32.7	-32.3
Equity	-37.3	-27.7	-26.3	-21.8	-42.3	-51.0	-46.8	-35.0	-32.7	-32.3
of which, Excess withdrawal from PF	-37.3	-27.7	-26.3	-21.8	-42.3	-51.0	-46.8	-35.0	-32.7	-32.3
Change in cash/deposit	3.3	3.8	8.4	2.2	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	1.8	2.5	2.9	1.6	3.8	2.9	2.7	2.7	2.7	2.7
Memorandum item										
Nominal Non-oil GDP	1,599	1,560	1,674	1,565	1,625	1,738	1,854	1,967	2,103	2,253
Petroleum Fund										
Opening balance	15,844	16,799	15,803	17,692	18,991	18,786	18,340	17,869	17,537	17,200
Comprehensive investment income	2,033	-13	2,858	2,185	1,058	1,007	950	893	877	860
Oil and gas receipts	421	447	756	326	109	68	33	0	0	0
Investment returns incl. valuation gain/ loss	1,636	-435	2,102	1,859	950	939	917	893	877	860
(Minus) Expenses and withholding tax	24	25	0	0	0	0	0	0	0	0
Withdrawal	1,079	983	969	886	1,263	1,453	1,420	1,225	1,214	1,243
ESI	482	550	529	544	576	568	553	536	526	516
Excess withdrawal	597	432	440	342	688	886	867	689	688	727
Closing balance	16,799	15,803	17,692	18,991	18,786	18,340	17,869	17,537	17,200	16,817
(In percent of non-oil GDP)	1,050	1,013	1,057	1,213	1,156	1,055	964	892	818	746

Sources: Timor-Leste authorities; IMF staff calculations.

1/This table is in accordance with the GFS format, with some modifications, to facilitate policy discussion and analysis.

Table 3. Timor-Leste: Monetary Sector Developments, 2016–21

	2016	2017	2018	2019	2020 Est.	2021 Proj.
(In millions of U.S. dollars)						
Banking system 1/						
Net foreign assets 2/	1,096	1,251	1,412	1,542	1,574	1,254
Gross reserves	271	533	663	646	645	479
Other foreign assets	876	783	823	980	1,045	890
Foreign liabilities	50	65	74	84	116	116
Net domestic assets	-362	-428	-563	-754	-705	-284
Net credit to central government	-420	-472	-531	-672	-707	-707
Net credit to state and local government	0	-12	-11	-1	-1	0
Net credit to public nonfinancial corporations	-1	-1	-50	-51	-51	0
Credit to private sector	208	260	250	264	290	309
Other items (net)	-149	-202	-221	-293	-236	113
Broad money	734	823	849	788	869	970
Narrow money	464	465	525	432	496	553
Currency in circulation 3/	15	15	18	20	23	26
Transferable deposits	450	450	507	411	473	527
Other deposits	270	358	323	357	373	416
Central Bank						
Net foreign assets 2/	271	533	663	646	645	479
Gross reserves	271	533	663	646	645	479
Foreign liabilities	0	0	0	0	0	0
Net domestic assets	-179	-359	-486	-516	-494	-394
Net credit to central government	-215	-279	-342	-397	-446	-446
Net credit to other depository corporations	90	12	17	15	86	106
Other items (net)	-54	-92	-161	-134	-135	-55
Monetary Base	91	174	177	130	151	85
Currency in circulation	15	15	18	20	23	26
Other liabilities to depository corporations	77	159	159	109	128	59
Others 3/	0	0	0	0	0	4
Commercial banks 4/						
Net foreign assets	825	717	749	897	928	774
Foreign assets	876	783	823	980	1,045	890
Foreign liabilities	50	65	74	84	116	116
Net domestic assets	-106	91	82	-130	-83	110
Net credit to central government	-204	-193	-190	-275	-261	-261
Net credit to public nonfinancial corporations	0	0	0	0	0	0
Credit to private sector	203	256	246	259	288	309
Capital accounts	67	93	102	129	144	144
Other items (net)	-38	121	127	14	34	34
Deposits	719	808	830	768	845	878
Transferable deposits	450	450	507	411	473	491
Other deposits	270	358	323	357	373	387
(12-month percentage change)						
Broad money growth	14.3	12.1	3.1	-7.1	10.2	11.6
Reserve money growth	-57.2	90.7	1.9	-26.9	16.6	-43.6
Credit to the private sector growth	-1.8	24.8	-3.8	5.5	10.1	6.6
Memorandum items						
(In percent, unless otherwise indicated)						
Credit/GDP	12.6	16.2	16.0	15.7	18.5	19.0
Broad money/GDP	44.5	51.5	54.4	47.1	55.5	59.7
Credit/deposits 4/	28.9	32.1	30.1	34.3	34.3	35.2
Amounts of non-performing loans (in millions of U.S. dollars)	28.0	31.0	12.3	...	...	...
Non-performing loans/total loans	15.4	13.5	5.6	...	...	...
Loan rate 5/	14.5	12.5	14.5	16.3	11.3	...
Deposit rate 6/	1.0	0.6	0.6	0.7	0.6	...

Sources: Central Bank of Timor-Leste; and IMF staff estimates.

1/ Includes the Central Bank, four commercial banks (including three branches of foreign banks).

2/ An oil fund was created in September 2005 and the deposits were moved off-shore and onto the Government balance sheet.

3/ Includes only coinage issued by the Central Bank. No data is available for notes due to dollarization of the financial system.

4/ Excludes government deposits.

5/ Rate charged by other depository corporations on loans in U.S. dollars. The rate is weighted by loan amounts.

6/ Rate offered by other depository corporations on three-month time deposits in U.S. dollars. The rate is weighted by deposit amounts.

Table 4. Timor-Leste: Balance of Payments, 2017–26

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
(In millions of U.S. dollars)										
Current account balance 1/	-284	-191	133	-302	-513	-719	-768	-774	-794	-831
Trade balance	-615	-589	-566	-510	-558	-657	-673	-666	-684	-710
Exports 2/	17	25	26	17	29	33	39	45	49	54
of which: Coffee	15	23	25	17	23	25	28	31	34	37
Imports	-631	-613	-592	-527	-587	-691	-712	-711	-733	-765
Services (net)	-343	-349	-357	-269	-318	-370	-352	-315	-300	-293
Receipts	93	97	91	46	55	91	105	115	127	140
of which: Travel	73	78	70	26	43	72	83	91	100	110
Payments	-436	-447	-448	-315	-372	-461	-458	-429	-426	-433
Income (net)	735	843	1,126	620	328	320	306	292	281	268
of which: Investment income	312	330	372	292	330	322	308	295	283	271
Other primary income (oil/gas) 3/	422	510	756	324	109	68	33	0	0	0
Current transfers (net)	-61	-96	-70	-143	-74	-79	-82	-86	-91	-96
Capital and financial accounts	532	301	5	275	336	863	827	709	804	852
Official capital transfers	34	52	26	12	38	38	38	38	38	38
Financial account	498	249	-21	263	298	825	789	672	766	814
Direct investment	7	48	75	-621	77	79	81	84	86	100
Portfolio investment	340	196	-269	916	210	745	707	584	672	701
Other investment	151	6	174	-32	11	1	1	4	8	13
Assets	113	-32	54	-29	-50	-50	-50	-50	-50	-49
Liabilities	38	38	120	-2	61	51	51	54	58	62
Government Debt	38	37	116	-7	61	51	51	54	58	62
Errors and omissions (net)	15	20	-155	27	0	0	0	0	0	0
Overall balance	263	129	-18	0.2	-177	144	58	-65	10	21
Financing										
Change in net foreign assets	-263	-129	18	-0.2	177	-144	-58	65	-10	-21
(In percent of Non-oil GDP)										
Current account balance 1/	-17.7	-12.3	7.9	-19.3	-31.6	-41.4	-41.4	-39.3	-37.7	-36.9
Trade balance	-38.4	-37.7	-33.8	-32.6	-34.3	-37.8	-36.3	-33.9	-32.5	-31.5
Exports 2/	1.0	1.6	1.6	1.1	1.8	1.9	2.1	2.3	2.3	2.4
Imports	-39.5	-39.3	-35.4	-33.7	-36.1	-39.7	-38.4	-36.1	-34.8	-33.9
Services (net)	-21.5	-22.4	-21.3	-17.2	-19.5	-21.3	-19.0	-16.0	-14.3	-13.0
Income (net)	46.0	54.0	67.3	39.6	20.2	18.4	16.5	14.9	13.3	11.9
Current transfers (net)	-3.8	-6.1	-4.2	-9.1	-4.6	-4.5	-4.4	-4.4	-4.3	-4.3
Capital and financial accounts	33.3	19.3	0.3	17.6	20.7	49.7	44.6	36.1	38.2	37.8
Overall balance	16.5	8.3	-1.1	0.02	-10.9	8.3	3.1	-3.3	0.5	0.9
(In millions of U.S. dollars, unless otherwise indicated)										
Memorandum items:										
Public foreign assets (end-period)	17,343	16,477	18,348	19,647	19,265	18,964	18,551	18,155	17,828	17,466
(In months of imports of G&S)	195	187	212	280	241	198	190	191	185	175
(In percent of Non-oil GDP)	1,084	1,056	1,096	1,255	1,185	1,091	1,000	923	848	775
of which: Central bank reserves	545	674	656	657	479	624	682	618	628	649
Petroleum Fund balance 4/	16,799	15,803	17,692	18,991	18,785	18,340	17,869	17,537	17,200	16,817
(In percent of Non-oil GDP)	1,050	1,013	1,057	1,213	1,156	1,055	964	892	818	746
NIIP	17,698	16,805	18,673	19,647	19,265	18,964	18,551	18,155	17,828	17,466
(In percent of Non-oil GDP)	1,107	1,077	1,115	1,255	1,185	1,091	1,000	923	848	775
Nominal Non-oil GDP	1,599	1,560	1,674	1,565	1,625	1,738	1,854	1,967	2,103	2,253
Nominal Total GDP	1,599	1,560	2,018	1,777	1,696	1,782	1,876	1,967	2,103	2,253

Sources: Data provided by the Timor-Leste authorities; and IMF staff estimates.

1/ Excludes trade in goods and services in the Joint Petroleum Development Area which are considered non-resident entities until August 2019.

2/ Excludes petroleum exports, the income of which is recorded under the income account.

3/ Since September 2019, the authorities have recorded income from the Joint Petroleum Development Area as export, but in this table, it is other primary income.

4/ Closing balance.

Table 5. Timor-Leste: Medium-Term Scenario, 2017–26

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Non-oil GDP per capita (2019): US\$1,295										
Real sector										
Nominal Non-oil GDP (in millions of U.S. dollars)	1,599	1,560	1,674	1,565	1,625	1,738	1,854	1,967	2,103	2,253
Nominal Oil GDP (in millions of U.S. dollars)	0	0	344	212	71	44	22	0	0	0
Nominal Total GDP (in millions of U.S. dollars)	1,599	1,560	2,018	1,777	1,696	1,782	1,876	1,967	2,103	2,253
Real Non-oil GDP growth (percent change)	-4.1	-1.1	1.8	-7.6	1.8	3.8	2.6	2.0	2.8	3.0
CPI (percent change, period average)	0.5	2.3	0.9	0.5	1.6	2.5	2.8	2.3	2.0	2.0
CPI (percent change, end-period)	0.6	2.1	0.3	1.2	2.0	3.0	2.5	2.0	2.0	2.0
Money and credit										
Private sector credit (annual percent change)	24.8	-3.8	5.5	10.1	6.6	6.9	6.1	...	...	...
(In percent of Non-Oil GDP)										
Central government operations										
Revenue	53.0	58.5	52.5	58.2	58.8	56.1	53.3	50.7	48.5	46.4
Domestic revenue	11.9	12.2	11.2	11.6	11.7	11.7	11.7	11.7	11.7	11.8
Estimated Sustainable Income (ESI)	30.1	35.3	31.6	34.8	35.4	32.7	29.8	27.3	25.0	22.9
Grants	11.0	11.0	9.7	11.8	11.8	11.8	11.8	11.8	11.8	11.8
Expenditure	86.6	86.7	83.4	84.3	104.9	110.0	102.8	88.5	84.0	81.5
Recurrent expenditure	59.2	53.1	54.9	62.3	74.6	60.5	58.8	57.5	55.9	54.1
Capital expenditure	16.3	22.6	18.8	10.2	18.6	37.8	32.2	19.2	16.3	15.6
Donor project	11.0	11.0	9.7	11.8	11.8	11.8	11.8	11.8	11.8	11.8
Net lending/borrowing	-33.6	-28.2	-30.9	-26.1	-46.1	-53.9	-49.5	-37.8	-35.4	-35.0
(In millions of U.S. dollars, unless otherwise indicated)										
Balance of payments										
Current account balance 1/	-284	-191	133	-302	-513	-719	-768	-774	-794	-831
Trade balance	-615	-589	-566	-510	-449	-589	-640	-666	-684	-710
Exports 2/	17	25	26	17	29	33	39	45	49	54
Imports	631	613	592	527	587	691	712	711	733	765
Services (net)	-343	-349	-357	-269	-318	-370	-352	-315	-300	-293
Primary Income	735	843	1,126	620	328	320	306	292	281	268
Secondary Income	-61	-96	-70	-143	-74	-79	-82	-86	-91	-96
(In percent of Non-oil GDP, unless otherwise indicated)										
Memorandum items										
Current account balance 1/	-17.7	-12.3	7.9	-19.3	-31.6	-41.4	-41.4	-39.3	-37.7	-36.9
Trade balance	-38.4	-37.7	-33.8	-32.6	-27.6	-33.9	-34.5	-33.9	-32.5	-31.5
Exports 2/	1.0	1.6	1.6	1.1	1.8	1.9	2.1	2.3	2.3	2.4
Imports	39.5	39.3	35.4	33.7	36.1	39.7	38.4	36.1	34.8	33.9
Services (net)	-21.5	-22.4	-21.3	-17.2	-19.5	-21.3	-19.0	-16.0	-14.3	-13.0
Primary Income	46.0	54.0	67.3	39.6	20.2	18.4	16.5	14.9	13.3	11.9
Secondary Income	-3.8	-6.1	-4.2	-9.1	-4.6	-4.5	-4.4	-4.4	-4.3	-4.3
Public external debt										
(In millions of U.S. dollars)	106	145	193	218	279	330	381	435	493	554
(In percent of Non-oil GDP)	6.6	9.3	11.5	13.9	17.2	19.0	20.5	22.1	23.4	24.6
Petroleum Fund balance (in millions of U.S. dollars) 3/	16,799	15,803	17,692	18,991	18,785	18,340	17,869	17,537	17,200	16,817
(In months of imports)	189	179	204	271	235	191	183	185	178	169
(In percent of Non-oil GDP)	1050	1013	1057	1213	1156	1055	964	892	818	746
Crude oil prices (U.S. dollars per barrel, WEO) 4/	53	68	61	41	59	55	53	51	51	51

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

1/ Excludes trade in goods and services of entities located in the Joint Petroleum Development Area which are considered non-resident entities until August 2019.

2/ Excludes petroleum exports, the income of which is recorded under the income account.

3/ Closing balance.

4/ Simple average of UK Brent, Dubai, and WTI crude oil prices; April 2021 WEO assumptions.

Table 6. Timor-Leste: Sustainable Development Goals Monitoring

Goals	2014	2016	2018
Poverty			
Income share held by lowest 20%	9.4	...	...
Poverty gap at \$1.90 a day (2011 PPP) (%)	6.7	...	...
Poverty headcount ratio at \$1.90 a day (2011 PPP) (% of population)	30.7	...	...
Poverty headcount ratio at national poverty lines (% of population)	41.8	...	...
Hunger 1/			
Prevalence of overweight, weight for height (% of children under 5)	1.6	...	...
Prevalence of stunting, height for age (% of children under 5)	51.7	...	...
Prevalence of undernourishment (% of population)	26.3	25.4	24.9
Prevalence of underweight, weight for age (% of children under 5)	37.5	...	...
Prevalence of wasting, weight for height (% of children under 5)	9.9	...	...
Good Health and Well-being			
Births attended by skilled health staff (% of total)	...	56.7	...
Mortality rate, under-5 (per 1,000 live births)	52.8	49.2	45.8
Mortality rate, neonatal (per 1,000 live births)	22.3	21.3	20.4
Demand for family planning satisfied by modern methods (% of married women with demand for family planning)	...	46.9	...
Adolescent fertility rate (births per 1,000 women ages 15-19)	36.8	34.8	32.4
Smoking prevalence, males (% of adults)	80.7	78.1	...
Source data assessment of statistical capacity (scale 0 - 100)	60.0	70.0	60.0
Gender Equity			
Proportion of women subjected to physical and/or sexual violence in the last 12 months (% of women age 15-49)	...	34.6	...
Women who were first married by age 15 (% of women ages 20-24)	...	2.6	...
Women who were first married by age 18 (% of women ages 20-24)	...	14.9	...
Clean Water and Sanitation 2/			
People using at least basic drinking water services (% of population)	72.3	76.7	78.3
People using at least basic sanitation services (% of population)	50.2	52.4	53.5
Affordable and Clean Energy			
Access to electricity (% of population)	62.4	76.5	85.6
Access to clean fuels and technologies for cooking (% of population)	6.0	6.9	...
Decent Work and Economic Growth 3/			
Number of depositors with commercial banks per 1,000 adults	450.7	495.8	510.6
Peace, Justice and Strong Institutions			
Completeness of birth registration (%)	...	60.4	...
Global Partnerships for the Sustainable Development 4/			
Individuals using the Internet (% of population)	17.5	25.2	27.5

Source: World Bank's World Development Indicators

1/ 2014 data as of 2013.

2/ 2018 data as of 2017

3/ Source: IMF's Financial Access Survey

4/ 2018 data as of 2017

Annex I. Risk Assessment Matrix¹

Source of Risk	Relative Likelihood	Source	Time Horizon	Expected Impact	Direction of Impact	Main Impacts → Recommended Policy Actions
Prolonged rise in COVID-19 infections and delays with vaccines	Medium	External	ST, MT	High	↓	This would restrict mobility and economic activity. → Provide relief to vulnerable households and intensify public health measures.
Large swings in energy prices	Medium	External	ST, MT	Low	↓ ↑	Oil revenues from active oil fields are projected to decline fast amid lower oil production. The magnitude of potential oil revenues from untapped oil fields will depend on future oil prices. → Contain government spending pressures, mobilize domestic revenue, and align spending with sustainable revenues.
Risk asset prices fall sharply	Medium	External	ST, MT	Medium	↓	The Petroleum Fund invests its assets in equities (40 percent) and bonds (60 percent). Although the investment portfolio is well diversified, a decline in risk asset prices caused by a reassessment of market fundamentals (e.g., in response to pandemic developments) could result in big losses. → Mobilize domestic revenue to reduce the reliance on the PF to finance government spending.
Political fragmentation	High	Domestic	ST, MT	Medium	↓	Lack of political consensus could impede reforms warranted to strengthen medium-term growth prospects. → Prioritize reforms to improve the business environment and help diversify the economy.
Development of Greater Sunrise or other oil fields	Low-Medium	Domestic	MT	High	↓ ↑	Significant oil revenues could support higher social spending and inclusive growth. Large public investment could deplete the PF more quickly. → Carefully assess benefits, costs, and risks from various development options before making investment decisions.
Over investment in projects with low returns	Medium	Domestic	ST, MT	High	↓	Large capital-intensive projects could yield low economic and social benefits and have large opportunity costs. → Strengthen project appraisal by developing a standard methodology and verifying that it is consistently applied across line ministries.
Higher frequency and severity of natural disasters related to climate change	Medium	Domestic	MT	Medium	↓	Floods have resulted in lower agricultural production, damage to roads, and displacement of communities. → Invest in infrastructure helping to limit the adverse impact of floods, establish contingency plans, and early warnings systems.

¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("L" (low) is meant to indicate a probability below 10 percent, "M" (medium) a probability between 10 percent and 30 percent, and "H" (high) a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex II. The Greater Sunrise Project

1. The maritime boundary treaty between Timor-Leste and Australia removed a key impediment for the development of the Greater Sunrise fields. The agreement was ratified by both governments in August 2019. The Greater Sunrise fields in the Timor Sea were discovered in 1974 but have remained undeveloped in part because of maritime boundary disputes. The agreement set a stable legal framework for both countries to jointly develop the fields and share the associated revenue.

2. The Greater Sunrise fields could yield substantial oil revenues for Timor-Leste for several years. The Greater Sunrise fields have more gas reserves than the Bayu Undan fields, which have helped rebuild Timor-Leste since independence. Estimates from Timor Gap suggest that Greater Sunrise holds 6.6 trillion cubic feet of gas and 273 million barrels of oil/condensate, estimated at a value of \$56 billion. The Bayu Undan fields had 3.4 trillion cubic feet of gas, 350 million barrels of oil/condensate, and yielded \$23 billion in cumulative oil revenues to Timor-Leste during 2006–20. Oil revenues were deposited in the Petroleum Fund, invested overseas, and gradually withdrawn to finance the budget. The Petroleum Fund was worth \$19 billion by end-2020. Oil revenues from Bayu Undan are expected to vanish after 2023.

3. The 2011 Strategic Development Plan envisaged a different development strategy for Greater Sunrise compared to Bayu Undan. While the gas from Bayu Undan was extracted from beneath the Timor Sea and piped directly to an export plant in Australia, the view in the Strategic Development Plan was to shift away from the extraction-only model to a more diversified one that would help attract other manufacturing activities and create more jobs. Specifically, the plan was to build a new \$12 billion liquefied natural gas plant and a petrochemical plant as part of the industrial complex, called Tasi Mane, to be built along the southern coast of Timor-Leste. In addition to the energy plants, Tasi Mane would include a renovated airport and a 160-kilometer highway.

4. The best option to develop the Greater Sunrise fields is unclear. No credible independent studies exist with a thorough cost-benefit analysis of the different options, which include:

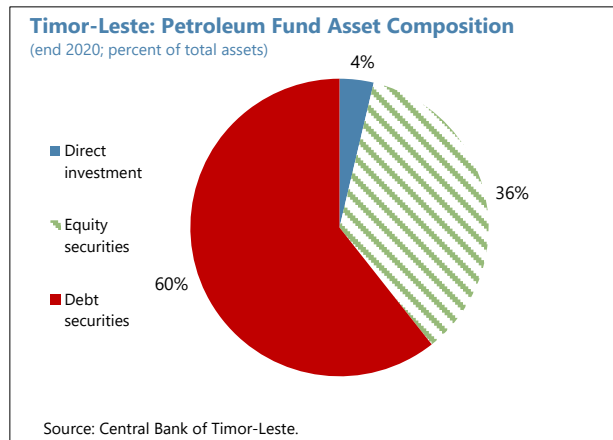
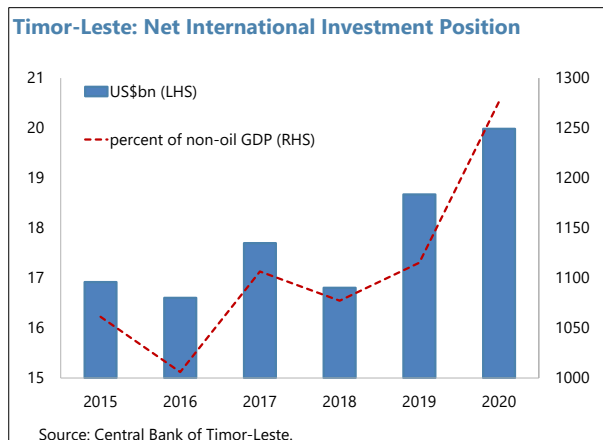
- 1) Pumping the gas to Timor-Leste, entailing huge investments costs, 70 percent of the upstream revenue, and the benefits from developing a refining industry.
- 2) Pumping the gas to an existing liquefied natural gas plant in Darwin, Australia, under which Timor-Leste would get 80 percent of the upstream revenue.

Annex III. External Sector Assessment

The external sector position in Timor-Leste in 2020 was substantially weaker than implied by fundamentals and desirable policies. This weak external sector position reflects large fiscal imbalances and the underdevelopment of the non-oil economy. Fiscal consolidation and structural reforms to promote private sector development and the diversification of the economy should help improve competitiveness and reduce the current account gap.

Foreign Assets and Liabilities

1. Background. The net international investment position was \$20 billion (1,277 percent of non-oil GDP) by end-2020, \$1.3 billion higher than by end-2019.¹ External assets and liabilities were \$20.7 billion (1,326 percent of non-oil GDP) and \$0.8 billion (49 percent of non-oil GDP), respectively. External assets mainly consist of portfolio investment for \$18.3 billion (1,168 percent of non-oil GDP) and direct investment for \$0.7 billion (45 percent of non-oil GDP) held by the Petroleum Fund, but they also include currency and deposits for \$1 billion (65 percent of non-oil GDP) and foreign reserves held by the central bank for \$0.7 billion (42 percent of non-oil GDP). Foreign direct investment liabilities were \$0.4 billion (26 percent of non-oil GDP), loans were \$0.24 billion (15 percent of non-oil GDP), and other liabilities (8 percent of non-oil GDP). About 36 percent of the assets of the Petroleum Fund are in stocks, 60 percent in bonds, and 4 percent in the Greater Sunrise fields. The net international investment position increased by \$3.1 billion during 2015–20, explained by \$1.7 billion flows from the financial account and \$1.4 billion from valuation effects.

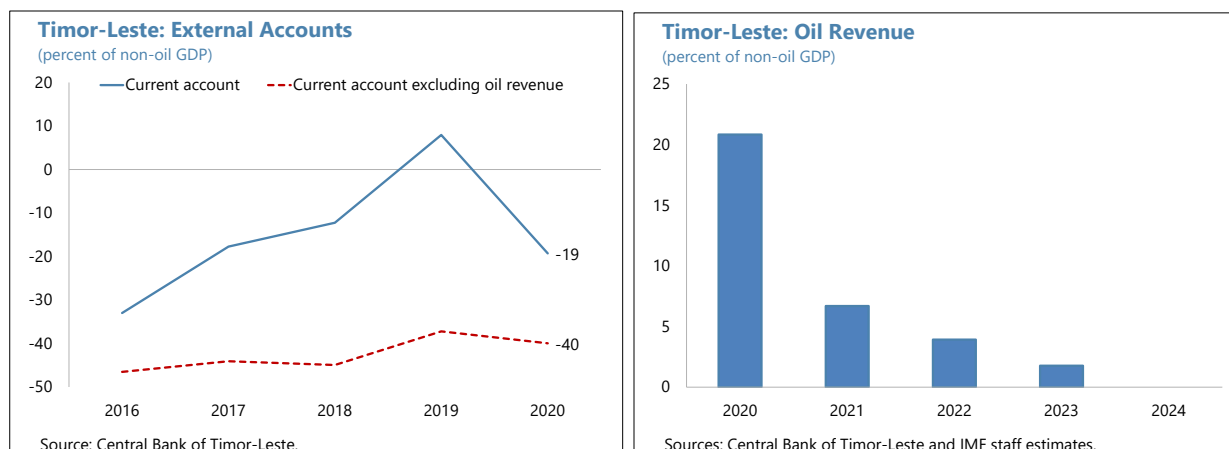


2. Assessment. The net international investment position is projected to decline in 2021 and in the medium term under current policies as large and persistent current account deficits will steadily erode the net international investment position.

¹ Non-oil GDP is estimated at about \$1.6 billion in 2020.

Current Account

3. Background. The current account balance improved steadily from -33 percent of non-oil GDP in 2016 to 8 percent in 2019, driven by growing oil revenues. In contrast, the current account balance excluding oil revenues was more stable, averaging -43 percent of non-oil GDP during 2016–19. The current account balance declined to -19 percent of non-oil GDP in 2020 amid significantly lower oil revenues. The current account excluding oil revenues was -40 percent of non-oil GDP in 2020, around 3 percentage points higher than the 2016–19 average of -43 percent of non-oil GDP. Oil revenues from active fields are expected to decline fast in coming years before vanishing in 2023.



4. Assessment. The current account gap in 2020 was estimated at -7 percent of non-oil GDP. This suggests that the external sector position was substantially weaker than fundamentals and desirable settings. The underlying current account was -23 percent of non-oil GDP and the current account norm was estimated at -16 percent of non-oil GDP. The current account gap is the difference between the underlying current account and the current account norm. This weak external sector position reflects large fiscal imbalances and the limited development of the non-oil economy. Fiscal consolidation and structural reforms to promote private sector development and the diversification of the economy should help improve competitiveness and reduce the current account gap.

5. Due to the very large sovereign wealth holdings that are not well captured by EBA-Lite's regression model, this (preferred) estimate of the current account norm was backed out from setting a norm for consumption as an annuity of total wealth. In turn, total wealth was equal to the sum of net foreign assets (above-ground wealth) and the present value of oil revenues (below-ground wealth).

6. Net foreign assets by end-2019 were \$18.7 billion and the present value of oil revenues by end-2019 was \$0.5 billion. Hence, total wealth was \$19.1 billion. Assuming that the implicit real return on total wealth is 3 percent, then the current account deficit (excluding oil revenues) norm in 2020 was around \$574 million (37 percent of non-oil GDP). Since oil revenues were \$326 million (21 percent of non-oil GDP), then the estimated current account norm was -16 percent of non-oil GDP.

The actual current account balance in 2020 was -19 percent of non-oil GDP but this was higher than in more normal circumstances because of the large contraction in economic activity. The underlying current account balance in 2020 is estimated at about -23 percent of non-oil GDP and it is equal to the actual current account balance (-19 percent of non-oil GDP) plus the deviation of the current account balance excluding oil revenue from recent trends (-3 percent of non-oil GDP).

7. The current account gap estimated using the EBA-Lite regression model also suggests that the external sector position was substantially weaker than fundamentals and desirable policy settings. The current account gap was estimated at -43.0 percent of non-oil GDP, the current account norm at 25.0 percent of non-oil GDP, and the policy gap at -8.6 percent of non-oil GDP. But the EBA-Lite regression does not provide a good fit of the current account in Timor-Leste as can be seen from the large unexplained residual equal to 34.3 percent of non-oil GDP.

Timor-Leste: Model Estimates for 2020 (in percent of non-oil GDP)	
	CA model
CA-Actual	-19.3
Cyclical contributions (from model) (-)	0.3
COVID-19 adjustor (+) 1/	0.3
Additional temporary/statistical factors (+)	0.0
Natural disasters and conflicts (-)	-1.3
Adjusted CA	-18.0
CA Norm (from model) 2/	25.0
Adjustments to the norm (+)	0.0
Adjusted CA Norm	25.0
CA Gap	-43.0
o/w Relative policy gap	-8.6
Elasticity	-0.22
REER Gap (in percent)	199.8

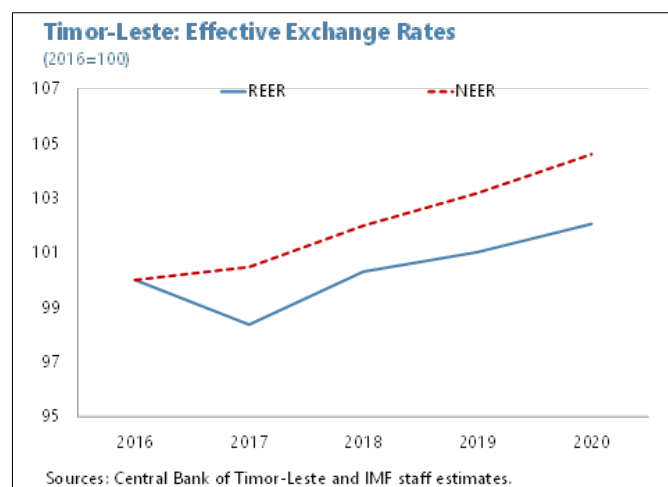
1/ Additional cyclical adjustment to account for the temporary impact of the pandemic on tourism (-0.5 percent of GDP) and on remittances (0.8 percent of GDP).
2/ Cyclically adjusted, including multilateral consistency adjustments.

Source: IMF staff estimates.

Given its residual mean squared error from the regression during 2006–20 of 224 percent, the 90-percent confidence band around EBA-Lite's current account norm of 25.0 percent of non-oil GDP encompasses the preferred estimate of a current account norm of -16 percent of non-oil GDP.

Real Exchange Rate

8. *Background.* The real effective exchange rate (REER) appreciated by about 1 percent during 2016–19 amid an appreciation of about 3 percent in the nominal effective exchange rate. Consumer price index inflation in Timor-Leste was lower relative to its trading partners, compensating for appreciation pressures on the REER coming from a stronger U.S. dollar. Small movements in the REER since 2016 were in line with the relatively stable current account balance excluding oil revenues. The REER and the nominal effective exchange rate appreciated 1.0 and 1.4 percent year over year, respectively, in 2020.



Assessment. Using a standard trade elasticity of -0.22, a current account gap at -7 percent of GDP is equivalent to a REER gap of about 32 percent.

Capital and Financial Accounts

9. *Background.* Portfolio inflows have been the main source of financing of current account deficits since 2016. They consist of withdrawals from the Petroleum Fund. FDI inflows since 2016 have been small, averaging 2 percent of non-oil GDP.

10. *Assessment.* No major vulnerabilities exist related to capital flows in the short and medium term, given the large size of the Petroleum Fund. Nonetheless, the current account deficit projected under the baseline is unsustainable in the long term.

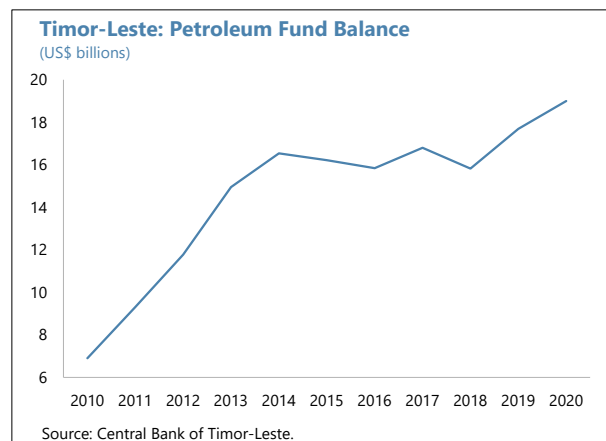
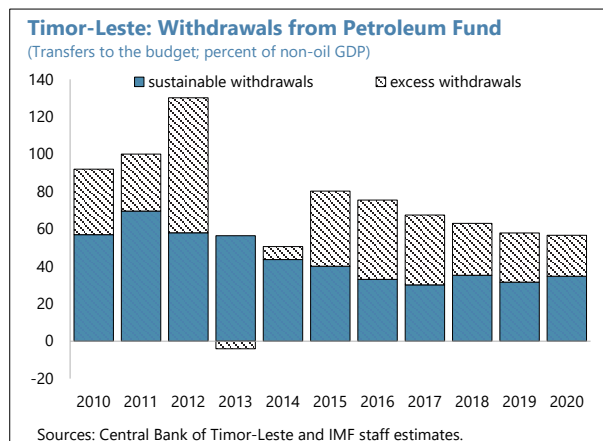
FX intervention and Reserves Level

11. *Background.* Reserves were at \$645 million at end-2020, amounting to about 8 months of imports of goods and services, 74 percent of broad money, 296 percent of external debt, and 41 percent of non-oil GDP.

12. *Assessment.* According to the template to Assess Reserve Adequacy in Credit-Constrained Economies, the optimal level of reserves for Timor-Leste is around 12 months of imports, much higher than the traditional metric of 3 months of imports. The benefits from holding reserves in the template are a function, among other variables, of the fiscal deficit, which for Timor-Leste is very large. However, the template neglects that Timor-Leste has a Petroleum Fund worth 238 months of imports.

Annex IV. The Fiscal Framework in Timor-Leste

1. **The two main components of the fiscal framework in Timor-Leste are the Petroleum Fund and a guideline focused on long-term fiscal sustainability.** The Petroleum Fund was established in 2005 and invests its assets abroad. All oil revenues go into the fund.
2. **Transfers from the fund to the budget are guided by the principle of maintaining the real value of government wealth.** Specifically, annual transfers from the Petroleum Fund to the budget are equal to the Estimated Sustainable Income (ESI), set at 3 percent of government wealth.¹ Government wealth is defined as financial assets in the fund plus the net present value of petroleum wealth under the ground. This formulation is in line with the permanent income hypothesis approach and the ESI is updated annually. In fiscal accounting, the ESI is considered a revenue item above the line and excess withdrawals are considered financing below the line.
3. **The ESI is a benchmark, not a legal obligation.** Transfers in excess of the ESI are allowed, but only after the government provides a justification that has to be approved by Parliament. The spirit of the framework was to put reasonable impediments on the ability of government to spend government wealth. This flexibility is a departure from the standard permanent income hypothesis framework and is justified by the fact that low-income countries have large investment upfront needs and very limited financing sources.



4. **Withdrawals from the Petroleum Fund averaged around 5.2 percent of government wealth during 2010–20, much higher than the 3 percent under the ESI.** Although excess withdrawals have been the norm since 2008, the Petroleum Fund balance has so far kept increasing steadily, driven by large oil revenues and strong investment returns.²

¹ The Greater Sunrise fields do not have approved development plans yet. Hence, they are not part of the baseline.

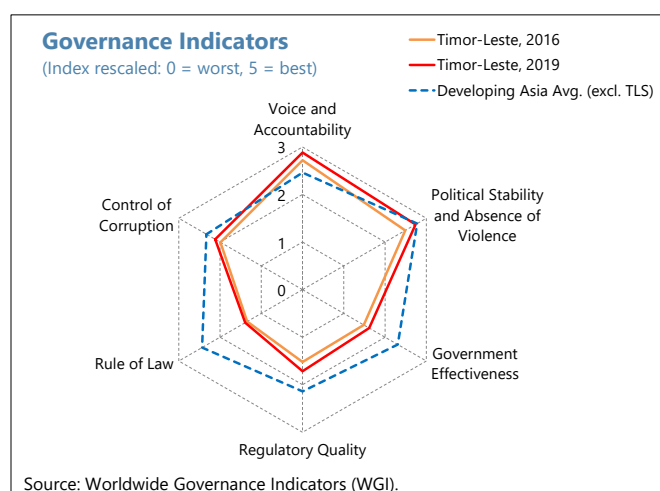
² Parliament has yet to reject a request for excess withdrawals.

Annex V. Governance Issues in Timor-Leste: Macroeconomic Implications

Corruption was a key concern in Timor-Leste even before the COVID-19 crisis given the economic importance of public services and contracts, but the pandemic has further heightened the importance of stronger governance. While additional budget has been allocated for COVID-19, bottlenecks in public financial management, procurement, and supply chains have hindered a faster response. Continued efforts to strengthen institutions, the business environment, and governance are important to limit corruption vulnerabilities and lower obstacles to job-creating investment.

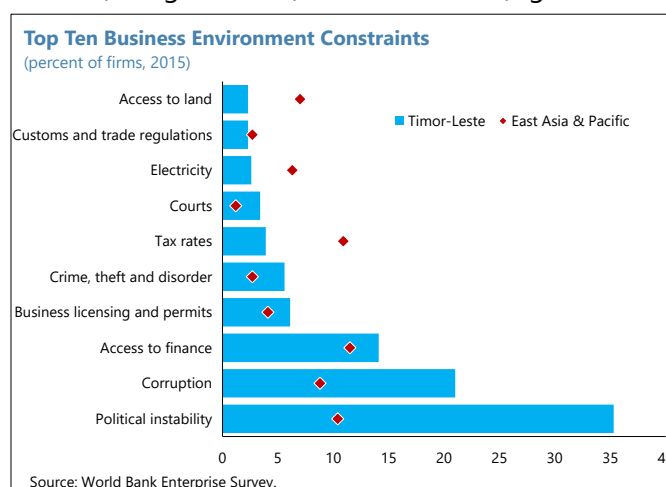
1. Although the governance of Timor-Leste's public sector is improving, it continues to lag behind regional peers, with some vital areas of weaknesses.

Governance in Timor-Leste's petroleum sector is strong¹, and steps have been taken to improve the institutional framework to combat corruption, including through the establishment of the Anti-Corruption Commission. However, the institutional framework suffers from fragmentation and weak coordination, further exacerbated by the formation of autonomous agencies, and a deficit of technical, human, and financial resources. The lack of corruption awareness and understanding of published budget documents amongst the public is also a challenge. Timor-Leste continues to rank much lower than comparator countries in budget transparency and oversight, with no significant improvements over recent years.² Moreover, governance vulnerabilities in fiscal areas (e.g., procurement in practice), regulatory framework (doing business) and rule of law (e.g., contract enforcement and property rights) remain key areas of concern.



2. Corruption and difficulty in obtaining business licensing and permits are among the major constraints to businesses.

According to the latest World Bank Enterprise Survey, private sector players argue that laws and regulations are not well-coordinated, that renewing licenses is very time consuming, and that corruption is a serious issue. Corruption is



¹ See the 2019 Article IV staff report.

² See [Timor-Leste Open Budget Survey 2019](#).

especially acute in the fiscal sector which discourages private investment—e.g., potential bribery in securing government contracts, in the procurement process, in getting construction permit, an electrical connection and obtaining an operating license.³

3. The new anti-corruption law is a step in the right direction.⁴ Adopted in September 2020, it describes the general measures to prevent corruption and the income, assets, and interests declaring regime.⁵ The law includes: publicity and transparency in public procurement procedures (see Box 1); an online declaration of income, assets, and interests for all individuals in public service and their household members; prohibition for public officials to exercise any activity in the private sector directly related with roles performed in office for a period of two years after the end of the term as public official; prohibition from taking or being in public offices for a period of 5–10 years for those convicted of a crime enshrined in this law, punishable by imprisonment.

4. However, enforcement and punishment should be further strengthened. Lack of sufficient human and financial capacity constraints enforcement, including the investigative capacity of the Anti-Corruption Commission. While this new law strengthens prevention measures, there is still scope for strengthening punishment and the asset recovery process. Moreover, asset declaration is limited to the Court of Appeals—and thus could be expanded to be made more accessible to the general public.

5. Improving public governance framework requires efforts on multiple fronts including strengthening institutions to promote integrity and accountability. Timor-Leste should start with areas of key weaknesses and higher risk—such as procurement and business licensing—as well as effective internal controls and independent external scrutiny. Concurrently, the legal and institutional oversight framework needs to be strengthened, the capacity of the Anti-Corruption Commission and court system raised to ensure effective implementation of the new anti-corruption law, and corruption awareness and public understanding of accountability and effectiveness of public spending enhanced to tackle public governance from all angles. The heads of agencies, ministries, and public enterprises must also promote ethical behavior by setting a clear tone at the top.

6. The IMF stands ready to provide technical support on the implementation of the new anti-corruption law and provide specific recommendations on how to strengthen the public financial management framework.

³ See [October 2019 Timor-Leste Economic Report: Unleashing the Private Sector](#)

⁴ See <http://timor-leste.gov.tl/?p=25518&lang=en>

⁵ It also changes the penal code with the creation of the new categories of illegal acts and the concentration of all corruption crimes in a single legal diploma. Police and judicial authorities may accept anonymous complaints, with protection for the identity of whistle-blowers and protection against reprisals.

Box 1. Procurement Process in Timor-Leste

Currently the Decree Law on the Procurement (Law No. 10/2005) provides the framework for the procurement regime in Timor-Leste. The Ministry of Finance also launched an online Procurement Portal in 2011, intended to increase transparency by providing equal access to information on government tenders and procurement contracts. The Audit Chamber, under the Court of Appeals, is responsible for reviewing government procurements above \$5 million.

However, recent assessments indicate that the current procurement process is lengthy and inefficient, which hinders budget execution, and thus the delivery of services. Moreover, the online procurement portal functions intermittently and has no information on many important contracts, including the largest ones in the last few years.

Inefficiencies in the procurement process have been especially problematic in the public health sector delivery, including during the pandemic. Bottlenecks in public financial management and in the procurement process has hindered a faster health response to the COVID crisis. To address these challenges, procurement safeguards were relaxed in April 2021 to procure emergency medical supplies in a timely manner, which is being done with the assistance of UNDP and World Health Organization.

Further upgrades to the procurement process could facilitate public spending, increase competitiveness and transparency, and lower vulnerabilities to corruption. While the Decree Law on the Procurement provides the framework for the procurement regime in Timor-Leste, transparency and reporting provisions may be strengthened in the ongoing reforms to public financial management. Particularly, procurement plans should be included in the budget cycle and presented in the budget books. Also, the transparency requirements should be clearly laid out in the public financial management law, e.g., requiring that government procurement data on resolution of complaints and annual procurement statistics will be published.

Digitalization should be harnessed to increase transparency. While Timor-Leste already established an electronic procurement system, ensuring that it is updated frequently and that it reflects full and accurate information (including publishing the contracts and the beneficial ownership information of awarded companies on a regular basis) is key.¹

¹ <https://www.state.gov/reports/2020-investment-climate-statements/timor-leste/>

Annex VI. Economic Recovery Plan 2020–23

1. In August 2020, the government approved a plan to support the economic recovery in the short and medium term. The plan includes short- and medium-term measures that will be implemented in 2020–23 as follows: a first stage aiming to mitigate the adverse impact from the COVID-19 pandemic through short-term response (mainly in the second half of 2020), and a second stage with medium-term measures aimed at addressing pre-existing structural weaknesses for long-term growth (covering a period of 2–3 years).

2. The first stage aims to avoid job losses and provide financial support with households and businesses to sustain consumption and production levels and people’s living standards. Short-term measures include the distribution of a basic food basket (or voucher), recovery subsidy for firms that resume economic activity, and social security contribution exemption for employers.

3. The second stage seeks “recovery with transformation” addressing not only challenges caused by the COVID-19 pandemic but also pre-existing structural weaknesses. Medium-term measures focus on private economic sectors (agriculture and tourism); housing; human capital (education, health, and social protection); and institutional reforms.

- Private economic sectors. In agriculture, the focus is on renewal of coffee plantations through a subsidy and implementing import substitution policy, particularly for rice. In tourism, the measures include creating a state-owned company to boost the sector, improving vocational education and training, rehabilitating infrastructure such as former administrator residences and rural roads, and promoting eco-tourism by combining accommodation with coffee or rice plantations.
- Housing. The government aims to implement a social housing program and to achieve universal provision of basic sanitation, water, and electricity across the country.
- Human capital. In education, the government will increase the proportion of the state budget allocated to the area. The measures include increasing the number of Centers for Learning and School Training, extending the network of secondary schools, pre-school and vocational training centers, and promoting the maintenance and recovery of school buildings. In health, their goals are to increase recurrent spending for improvement of health services, strengthen financial and technical support to key programs, invest in infrastructure, and improve health personnel training. In social protection, the focus is on creating alternative payment mechanisms or instruments for social benefits payment to reduce costs of social benefit measures, implementing active employment programs, and study the feasibility of a universal basic income system.
- Institutional reforms. The government will make all legislations related to land issues, prepare necessary regulatory framework for business such as access to credit, improve the functioning of the courts, and proceed with reform in the public administration. The measures also include optical fiber installation and promotion of renewable energy such as solar, hydro and wind.



DEMOCRATIC REPUBLIC OF TIMOR-LESTE

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION— INFORMATIONAL ANNEX

June 22, 2021

Prepared By

Asia and Pacific Department
(In consultation with other departments)

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FUND RELATIONS

(As of May 31, 2021)

Membership Status: Joined July 23, 2002; Article VIII.

General Resources Account:

	SDR Million	% Quota
Quota	25.60	100.00
IMF Holdings of Currency (Holdings rate)	21.25	83.01
Reserve Tranche Position	4.35	17.00

SDR Department:

	SDR Million	% Allocation
Net Cumulative Allocation	7.73	100.00
Holdings	3.39	43.86

Outstanding Purchases and Loans: None

Latest Financial Commitments: None

Projected Payments to Fund:

(SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>
Principal					
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

Exchange Rate Arrangements:

The exchange rate arrangement (de jure and de facto) is an exchange arrangement with no separate legal tender. 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. Timor-Leste has accepted the obligations under Article VIII, Sections 2(a), 3 and 4, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

Article IV Consultations:

The last Article IV consultation was concluded on March 27, 2019. The associated Executive Board assessment is available at <https://www.imf.org/en/News/Articles/2019/05/07/pr19149-democratic-republic-timor-leste-imf-executive-board-concludes-2019-article-iv-consultation> and the staff report at <https://www.imf.org/en/Publications/CR/Issues/2019/05/07/Democratic-Republic-of-Timor-Leste-2019-Article-IV-Consultation-Press-Release-Staff-Report-46874>. Timor-Leste is on the standard 12-month consultation cycle.

Resident Representative:

The resident representative office in Dili, established in August 2000, closed at end-June 2009.

INFORMATION ON THE ACTIVITIES OF OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

Information on the activities of other international financial institutions in Timor-Leste can be found at:

- World Bank: <http://www.worldbank.org/en/country/timor-leste>
- Asian Development Bank: <https://www.adb.org/countries/timor-leste/main>

STATISTICAL ISSUES

(As of May 2021)

I. Assessment of Data Adequacy for Surveillance
General: Data provision to the IMF is broadly adequate for surveillance. Areas of concern include inconsistencies between national accounts and balance of payments on petroleum-related transactions, weaknesses in compilation and dissemination of government finance statistics, and no public reporting of financial soundness indicators. The plan to change the General Directorate of Statistics, which is currently under the Ministry of Finance, into a public institute with autonomy is a good enhancement.
National Accounts: GDP is compiled annually by production, expenditure and income using a contemporary base period (2015) and using methods that are reasonably consistent with the <i>2008 System of National Accounts</i>. There was significant improvement in shortening the time lag for publishing national accounts—the 2019 national accounts were published in October 2020 and the first preliminary 2020 GDP estimates were published timely in April 2021. The national accounts assume that oil production at the Joint Petroleum Development Area is resident in Timor-Leste since September 2019 as a result of the Maritime Boundary Treaty signed in August 2019 between Timor-Leste and Australia.
Price Statistics: The monthly, national CPI uses expenditure weights derived from 2014–15 Living Standard Survey. Data are also released monthly for Dili, Baucau, and regions. Since August 2018, the basket weights were updated, and the CPI was rebased with an August 2018 reference period (i.e., August 2018 = 100).
Government Finance Statistics: Annual Government Finance Statistics (GFS) is compiled and disseminated, with 2019 central government data submitted as the latest for the Government Finance Statistics database. Compilation and dissemination of quarterly Government Finance Statistics has been deferred due to data discrepancies and challenges in resolving the source of those discrepancies. The last publication of quarterly Government Finance Statistics data was undertaken in Q3/2016. Timor-Leste does not report to the Quarterly Public Sector Debt database, jointly developed by the World Bank and IMF.
Monetary and Financial Statistics: The central bank compiles monetary statistics generally following the methodology of the <i>Monetary and Financial Statistics Manual</i>. The central bank reports detailed monthly monetary data for the central bank and other depository corporations using the standardized report forms. Timor-Leste uses the U.S. dollar as the official currency, and official data on currency holdings are difficult to compile under the current currency regime. Data for other financial corporations, mainly insurance companies, are not compiled. The central bank reports data on some series and indicators of the Financial Access Survey, including mobile money and the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the United Nations to monitor Target 8.10 of the Sustainable Development Goals (SDGs).

Financial Sector Surveillance: Only basic market-based indicators are available, and their coverage, valuation and timeliness vary across such indicators. Data are not sufficiently available to conduct stress tests of the banking system or Balance Sheet Approach analysis. Cross border exposure data for financial corporations are not available.

External Sector Statistics: While progress has been made, measuring non-Petroleum Fund-related current account transactions accurately remains a work in progress. Monthly merchandise trade data are now published regularly. Data on monthly merchandise exports and imports are based on the Automated System for Customs Data. Service transactions are largely estimated with data collection largely limited to the official and tourism sectors. Interest revenue from oil and gas is recorded as primary income.

Quarterly balance of payments and international investment position data compiled by the central bank is available for 2006–Q4/2020 and 2008–Q1/2021, respectively, according to the *Balance of Payments and International Investment Position manual*, sixth edition. While methodology to produce basic annual estimates of the balance of payments statistics are in place, further development is needed to address limitations of existing data sources, in particular, merchandise trade statistics and service transactions. This includes work to ensure consistency between current account data and the new national accounts statistics, particularly related to the exports of commodities and imports of services as well as to ensure consistency between the balance of payments and the international investment position.

Currently, publicly available information on remittances from Timorese working abroad is limited and improvement in the estimation and compilation procedures of such remittances should be pursued. The TA mission by CDOT in June 2019 provided some guidance to fine-tuning estimation models for remittances and collecting data from the money transfers operators.

The External Sector Statistics TA mission in October 2015 found that important improvements had been made on the integrated international investment position, namely the classification of components; the treatment of changes in prices and changes in exchange rates; and the treatment of positions of the Petroleum Fund and IMF-related accounts (reserve position in the IMF, SDR allocations, and SDR holdings). Progress was also verified on actions toward Timor-Leste's participation in IMF's Coordinated Direct Investment (CDIS). However, the recommendation on improving the coverage of the direct investment survey to include Joint Petroleum Development Area companies' equity valued at own funds at book value was not implemented. In addition, the treatment in External Sector Statistics of the Joint Petroleum Development Area companies' activities as well as the Greater Sunrise project consistent with national accounts, is still pending, especially with the implementation of the new Maritime Boundary Treaty. According to the central bank officials, this is due to the difficulty of obtaining source data from the National Petroleum Authority.

II. Data Standards and Quality

Timor-Leste began participating in the IMF's General Data Dissemination System (now the enhanced GDDS) in 2012, marking a major step forward in the development of its statistical system. On February 15, 2019, Timor-Leste implemented e-GDDS by publishing the [National Summary Data Page](#).

Table of Common Indicators Required for Surveillance
(As of June 15, 2021)

	Date of latest observation	Date received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷
Exchange Rates	06/14/2021	06/15/2021	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	04/2020	05/2021	M	M	M
Reserve/Base Money	04/2020	05/2021	M	M	M
Broad Money	04/2020	05/2021	M	M	M
Central Bank Balance Sheet	04/2020	05/2021	M	M	M
Consolidated Balance Sheet of the Banking System	04/2020	05/2021	M	M	M
Interest Rates ²	04/2021	05/2021	M	M	M
Consumer Price Index	04/2021	05/2021	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	2019	01/2021	A	A	A
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	2019	01/2021	A	A	A
Central Government and Central Government-Guaranteed Debt ⁵	2019	01/2021	A	A	A
External Current Account Balance	Q4/2020	03/2021	Q	Q	Q
Exports and Imports of Goods and Services	Q4/2020	03/2021	Q	Q	Q
GDP/GNP	2019	10/2020	A	A	A
Gross External Debt	Q1/2021	06/2021	Q	Q	Q
International Investment Position ⁶	Q1/2021	06/2021	Q	Q	Q

¹ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

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

³ Foreign, domestic banks, and domestic nonbank financing.

⁴ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

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

⁶ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

⁷ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); NA: Not Available.



DEMOCRATIC REPUBLIC OF TIMOR-LESTE

June 22, 2021

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION— DEBT SUSTAINABILITY ANALYSIS¹

Approved By
Alfred Schipke (IMF),
Geremia Palomba (IMF),
Hassan Zaman (IDA), and
Marcello Estevão (IDA).

Prepared by Staff of the International Monetary
Fund and the International Development Association

Timor-Leste: Joint Bank-Fund Debt Sustainability Analysis	
Risk of external debt distress	Moderate
Overall risk of debt distress	Moderate
Granularity in the risk rating	Limited space to absorb shocks
Application of judgement	Yes. Petroleum sovereign wealth fund is a strong mitigating factor for the country's debt sustainability.

The debt sustainability analysis indicates that Timor-Leste is at moderate risk of overall and external debt distress, with application of judgement, reflecting a projected increase in: (i) debt service payments as existing loan grace periods come to an end; and (ii) concessional borrowing to finance a large increase in public investment in infrastructure. This represents a downgrade from a low risk of debt distress at the time of the 2019 Article IV debt sustainability analysis, reflecting worse initial conditions and a downgrade in its debt carrying capacity from medium to weak. The present value of external debt-to-exports ratio and the debt service-to-exports ratio under the baseline are projected to breach their respective critical thresholds, triggering a high-risk mechanical rating for external and overall debt. However, the Petroleum Fund is large relative to projected debt levels and debt service requirements; and its assets are liquid and accessible, prompting the use of judgment to upgrade the risk assessment. Fiscal plans under the baseline are nonetheless unsustainable in the long term. Staff projects that the Petroleum Fund, which is the main source of funding of fiscal deficits, will be gradually depleted. Staff's alternative scenario illustrates how fiscal and structural reforms can ensure both fiscal and debt sustainability.

¹ The debt sustainability analysis follows the IMF and World Bank Staff Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-Income Countries (February 2018). Timor-Leste's debt-carrying capacity is assessed to be "weak" with composite indicator score of 2.669, which is based on the 2021 April World Economic Outlook and the 2019 Country Policy and Institutional Assessment.

PUBLIC DEBT COVERAGE

1. The coverage of public sector debt used in this report is public and publicly guaranteed debt. Timor-Leste's public and publicly guaranteed external debt is held entirely by the central government. The coverage of public sector debt includes state-owned enterprise debt. Under the Public Debt Regime Law², state-owned enterprises are not allowed to borrow for themselves and can only obtain financing via on-lending from the Ministry of Finance. The public sector only borrows externally, given a lack of domestic financing sources. The debt definition of the debt sustainability analysis is currency-based and the legal tender is the U.S. dollar.³

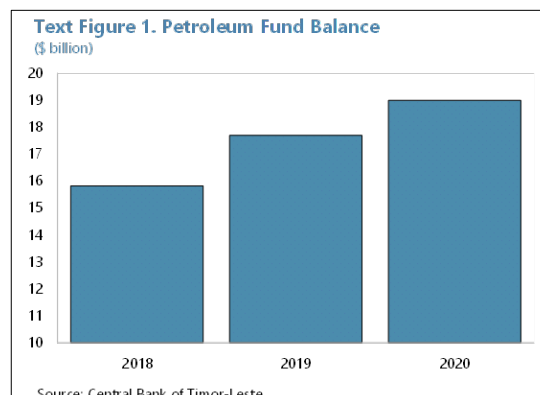
Text Table 1. Timor-Leste's Coverage of Public Debt

Subsectors of the public sector	Check box
1 Central government	X
2 State and local government	
3 Other elements in the general government	
4 o/w: Social security fund	
5 o/w: Extra budgetary funds (EBFs)	
6 Guarantees (to other entities in the public and private sector, including to SOEs)	X
7 Central bank (borrowed on behalf of the government)	
8 Non-guaranteed SOE debt	

BACKGROUND ON DEBT

2. Timor-Leste's net public asset position is currently strong due to oil-related savings accumulated in Petroleum Fund assets and low levels of public debt.

- The Petroleum Fund balance at end-2020 stood at \$19 billion (1,213 percent of non-oil GDP), covering 271 months of goods and services imports. The Petroleum Fund balance increased by \$1.3 billion in 2020 as investment income (\$1.9 billion) and oil revenues (\$0.3 billion) more than compensated for transfers to the budget (\$0.9 billion).⁴ The average return on Petroleum Fund assets during 2016–20 was 7.2 percent.



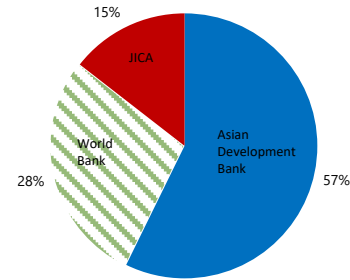
² According to the Public Debt Regime Law No. 13/2011, the Government of Timor-Leste, in particular, the Ministry of Finance, is the only entity that may engage in borrowing, motivated by financing needs generated by the need to execute the State's priority tasks relating to the building of strategic infrastructures for the country's development.

³ Domestically issued local currency-denominated debt held by non-residents and/or locally-issued FX-denominated debt held by residents are insignificant and data is not available.

⁴ The Petroleum Fund constitutes the main financing source for the budget. The amount is guided by the estimated sustainable income, which is set at 3 percent of total petroleum wealth (sum of the Petroleum Fund balance and the (continued)

- The fiscal deficit fell from 31 percent of non-oil GDP in 2019 to 26 percent in 2020 due to delays in passing the 2020 budget. Outstanding public external debt has steadily increased to \$218 million (13.9 percent of non-oil GDP) in 2020 from \$145 million (9.3 percent of non-oil GDP) in 2018. External loans signed since 2012 to mid-2020 totaled \$475 million—all consisting of concessional loans from the Asian Development Bank, the World Bank Group, and Japan International Cooperation Agency to finance mainly road infrastructure projects. The Asian Development Bank has the largest share of total external debt, comprising nearly 60 percent of total external debt in 2020.

Text Figure 2. External Debt by Creditors 2020



Source: Ministry of Finance.

BACKGROUND ON MACRO FORECASTS

3. This debt sustainability analysis is based on the macroeconomic projections underlying the 2021 Article IV consultation. To illustrate the impact of different policy options on debt sustainability, two scenarios—baseline and reform—are considered.

Text Table 2. Macroeconomic and Fiscal Assumptions: Current and 2019 Article IV

	Current (2021 Article IV)				Previous (2019 Article IV)			
	2020	2021	2021-26	2027-41	2017	2018	2018-23	2024-38
Real non-oil GDP growth (in percent)	-7.6	1.8	2.7	3.0	-4.6	0.8	4.2	4.8
CPI inflation (eop, percent)	0.8	2.0	2.3	2.0	0.6	2.1	3.2	4.0
Revenue (excl. grants, percent of non-oil GDP)	46.4	47.1	40.6	22.1	39.1	40.0	28.4	14.7
Government expenditure (percent of non-oil GDP)	72.5	93.1	83.5	53.2	69.1	68.7	58.4	28.9
Recurrent	62.3	74.6	60.2	42.5	53.9	47.3	44.0	25.8
Capital	10.2	18.6	23.3	10.8	15.2	21.4	14.4	3.1
Net lending/ borrowing (percent of non-oil GDP)	-26.1	-46.1	-43.0	-31.2	-30.0	-28.7	-30.0	-14.2
Net incurrence of liabilities (percent of non-oil GDP)	1.6	3.8	2.9	0.5	1.1	2.0	2.3	2.6
Petroleum Fund balance (USD million)	18991	18785	17758	10415	16,799	15,803	14,943	7,902
Current account balance (percent of non-oil GDP)	-19.3	-31.6	-38.1	-32.2	-16.4	-15.0	-5.0	-6.5

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

4. The macro-fiscal outlook has worsened compared to the 2019 Article IV debt sustainability analysis. Macroeconomic and fiscal projections were revised for several reasons. First, the COVID-19-related disruptions to mobility and activity combined with the delays in passing the 2020 budget are estimated to have generated the largest output drop since independence in 2002, at 7.6 percent in 2020. The outbreak in COVID-19 infections since March combined with the floods in early April suggest only a modest recovery in 2021. The floods have caused significant economic

net present value of expected future petroleum revenue). Withdrawals in excess of the estimated sustainable income can be made with the approval of Parliament. According to the Constitution, the President has the right to veto a budget that has been approved by the Parliament.

damage to public infrastructure, private homes and businesses, and have left about 16,000 people without homes and sheltering in refugee centers, further complicating efforts to contain the spread of the pandemic. Second, GDP growth performance in 2017–19 was worse than estimated previously. This was driven by difficulties in reaching political consensus on policies (e.g., the adoption of the 2018 budget was delayed several months) and by a steady decline in the dynamism of the economy in 2010–19 (e.g., the 2019 budget was adopted in time and the economy only grew 1.8 percent). Third, an analysis of the historical growth performance and the sources of growth suggests a less favorable long-term growth outlook. Fourth, the 2021 budget envisages larger and persistent fiscal deficits in the medium and long term mainly financed by withdrawals from the Petroleum Fund.

Text Table 3. Main Macroeconomic Projections, 2017–26

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Real sector										
Nominal Non-oil GDP (in millions of U.S. dollars)	1,599	1,560	1,674	1,565	1,625	1,738	1,854	1,967	2,103	2,253
Real Non-oil GDP growth (percent change)	-4.1	-1.1	1.8	-7.6	1.8	3.8	2.6	2.0	2.8	3.0
CPI (percent change, period average)	0.5	2.3	0.9	0.5	1.6	2.5	2.8	2.3	2.0	2.0
Non-oil GDP deflator growth (percent change)	1.0	-1.4	5.4	1.2	2.0	3.0	4.0	4.0	4.0	4.0
Central government operations										
	(In percent of Non-oil GDP)									
Revenue	53.0	58.5	52.5	58.2	58.8	56.1	53.3	50.7	48.5	46.4
Domestic revenue	11.9	12.2	11.2	11.6	11.7	11.7	11.7	11.7	11.7	11.8
Estimated Sustainable Income (ESI)	30.1	35.3	31.6	34.8	35.4	32.7	29.8	27.3	25.0	22.9
Grants	11.0	11.0	9.7	11.8	11.8	11.8	11.8	11.8	11.8	11.8
Expenditure	86.6	86.7	83.4	84.3	104.9	110.0	102.8	88.5	84.0	81.5
Recurrent expenditure	59.2	53.1	54.9	62.3	74.6	60.5	58.8	57.5	55.9	54.1
Capital expenditure	16.3	22.6	18.8	10.2	18.6	37.8	32.2	19.2	16.3	15.6
Donor project	11.0	11.0	9.7	11.8	11.8	11.8	11.8	11.8	11.8	11.8
Net lending/borrowing	-33.6	-28.2	-30.9	-26.1	-46.1	-53.9	-49.5	-37.8	-35.4	-35.0
Balance of payments										
	(In percent of Non-oil GDP, unless otherwise indicated)									
Current account balance 1/	-17.7	-12.3	7.9	-19.3	-31.6	-41.4	-41.4	-39.3	-37.7	-36.9
Trade balance	-38.4	-37.7	-33.8	-32.6	-27.6	-33.9	-34.5	-33.9	-32.5	-31.5
Exports 2/	1.0	1.6	1.6	1.1	1.8	1.9	2.1	2.3	2.3	2.4
Imports	39.5	39.3	35.4	33.7	36.1	39.7	38.4	36.1	34.8	33.9
Services (net)	-21.5	-22.4	-21.3	-17.2	-19.5	-21.3	-19.0	-16.0	-14.3	-13.0
Primary Income	46.0	54.0	67.3	39.6	20.2	18.4	16.5	14.9	13.3	11.9
Secondary Income	-3.8	-6.1	-4.2	-9.1	-4.6	-4.5	-4.4	-4.4	-4.3	-4.3
Memorandum items										
Public external debt (In millions of U.S. dollars)	106	145	193	218	279	330	381	435	493	554
(In percent of Non-oil GDP)	6.6	9.3	11.5	13.9	17.2	19.0	20.5	22.1	23.4	24.6
Petroleum Fund balance (in millions of U.S. dollars) 3/	16,799	15,803	17,692	18,991	18,785	18,340	17,869	17,537	17,200	16,817
(In months of imports)	189	179	204	271	235	191	183	185	178	169
(In percent of Non-oil GDP)	1050	1013	1057	1213	1156	1055	964	892	818	746
Crude oil prices (U.S. dollars per barrel, WEO) 4/	53	68	61	41	59	55	53	51	51	51

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

1/ Excludes trade in goods and services of entities located in the Joint Petroleum Development Area which are considered non-resident entities until August 2019.

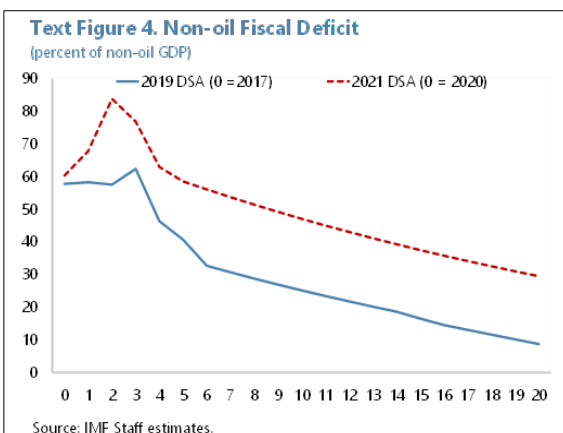
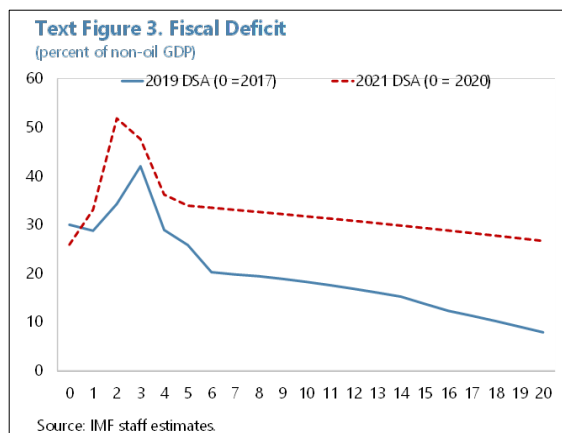
2/ Excludes petroleum exports, the income of which is recorded under the income account.

3/ Closing balance.

4/ Simple average of UK Brent, Dubai, and WTI crude oil prices; April 2021 WEO assumptions.

Macroeconomic Assumptions:

- **Real non-oil GDP** is projected to recover modestly at 1.8 percent in 2021, underpinned by a large increase in public spending, rebounding private consumption and the vaccination rollout that began in April.⁵ Growth is projected to hover in the range of 2–4 percent in the medium term (2021–26), mainly driven by the changes in government spending. Over the long term (2027–2041), growth is projected to stabilize at around 3 percent as structural constraints weigh on growth potential, significantly lower than 4.8 percent projected in the previous debt sustainability analysis, but closer to historical growth performance. Oil production from active fields is projected to cease in 2023.⁶
- **Inflation** is expected to gradually pick up in 2021–23 hand in hand with strong fiscal stimulus and higher oil prices and then converge to 2 percent over the medium and long term. This is a lower level of inflation compared to the previous debt sustainability analysis.
- **The fiscal balance** is projected to remain in a deficit of about 43 percent over 2021–26, reflecting larger spending. The fiscal deficit is projected to increase from 26 percent of non-oil GDP in 2020 to 46 percent in 2021 aiming to respond to rising COVID-19 infections and the recent floods. The fiscal deficit is projected to narrow gradually to about 31 percent on average over 2027–41, at a level significantly higher than the previous debt sustainability analysis.



- **The current account balance** is expected to remain in deficit over 2021–26, reflecting lower oil and gas receipts and higher imports of goods and services generated by higher public investment. Overall, the current account balance deficit over the medium and long term is

⁵ The vaccine inoculations started on April 7 and 127,074 people (17 percent of the adult population) were vaccinated by June 20. The vaccine rollout will be sequenced as follows: In the first phase (April), frontline workers, immigration officers, and people with comorbidities; in the second phase (July) people over 60 years old, healthcare workers, community leaders, teachers, and market workers; in the third phase (October), the remaining adult population.

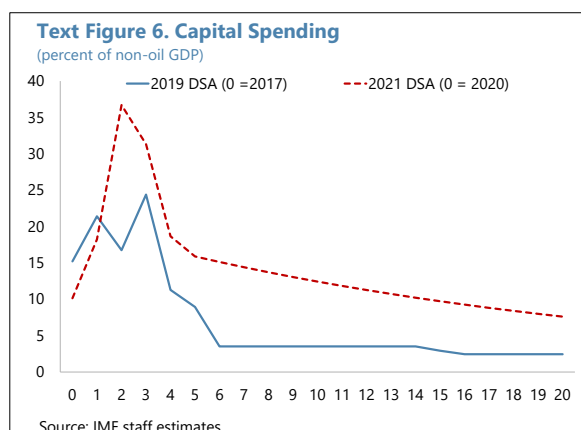
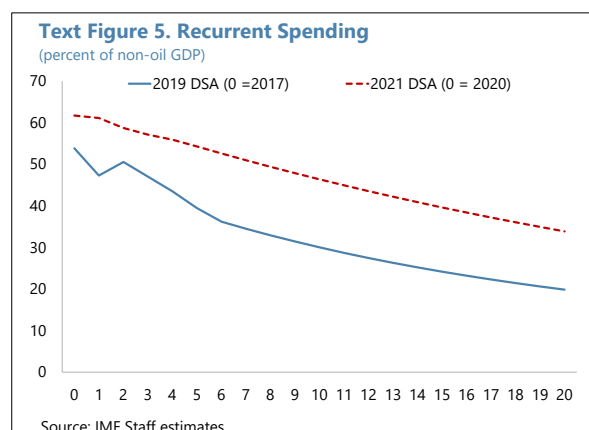
⁶ The baseline does not include the development of the Greater Sunrise fields as there are no approved development plans.

projected to be higher compared to the previous debt sustainability analysis, mainly driven by larger imports in line with higher fiscal spending.

- **External financing** consists of concessional loans from official creditors. Private external borrowing is assumed to remain negligible. Timor-Leste does not have exceptional financing such as accumulation of arrears.
- **The grant element of loans** is assumed to decline moderately over the medium term as the economy develops. Other assumptions include that no off-budget debt is accumulated including by state-owned enterprises in line with existing legislation.

5. The baseline fiscal scenario assumes lower spending than planned under the 2021 budget, reflecting historical execution rates. Specifically, capital spending in 2021–25 is assumed, on average, to be 70 percent of the planned amount in the 2021 budget.

- Government revenues are projected to decline from 46 percent of non-oil GDP in 2020 to 41 percent on average over 2021–26 and to 22 percent on average over 2027–41. Under current policies, domestic revenues, currently at 12 percent of non-oil GDP, are assumed to grow in line with nominal non-oil GDP. The decline in government revenues is driven by erosion of the Petroleum Fund, which in turn reduces the estimated sustainable income.



- Recurrent spending is projected to increase by 3.8 percent each year in line with historical trends, and capital spending in 2027–41 is projected to increase in line with inflation. This is in line with long-term projections under the 2021 budget, which assumes a continuing policy of frontloading public investment.⁷ On the other hand, the previous debt sustainability analysis envisaged a very significant decline in government spending (in percent of non-oil GDP) over the medium term, broadly in line with the 2019 budget.

⁷ Although high public investment financed with excess Petroleum Fund withdrawals has been the norm since 2010, the growth dividend has been declining and tepid, implying that public investment managements needs to be improved (see forthcoming World Bank Public Expenditure Review).

- Net external borrowing is projected at about 2.9 percent of non-oil GDP each year during 2021–26 broadly in line with recent trends and with borrowing plans described in the 2021 budget. As a result, outstanding external debt is projected to increase from 14 percent of non-oil GDP in 2020 to 25 percent in 2026.
- As the government relies on Petroleum Fund withdrawals to meet its financing needs, the Petroleum Fund falls to \$16.9 billion (746 percent of non-oil GDP) by 2026 and to \$1.8 billion (28 percent of non-oil GDP) by 2041. This assumes an annual nominal investment return on the Petroleum Fund of around 5 percent, in line with the average returns since its inception.

6. The realism tools suggest that macroeconomic and fiscal assumptions are reasonable.

No significant differences exist between the past and projected debt creating flows. A smaller primary deficit in 2015–20 than projected under the previous debt sustainability analysis largely explains the unexpected changes in debt (Figure 3).⁸ The three-year primary balance adjustment (between 2021 and 2023) is projected to be 23 percent: this represents significant stimulus to the economy, and lies near the bottom of the distribution of projections across regional peers. Impact of the political uncertainty spillovers to private investment which plunged from 11 percent of non-oil GDP in 2017 to 2 percent in 2019, and is projected to recover gradually from 2021–22 onwards as the effects of the pandemic subside and the economy makes some progress in diversification in the long term (Figure 4).

Text Table 4. Macroeconomic Assumptions: Baseline and Reform Scenarios

	Baseline Scenario				Reform Scenario			
	2020	2021	2021-26	2027-41	2020	2021	2021-26	2027-41
Real non-oil GDP growth (in percent)	-7.6	1.8	2.7	3.0	-7.6	1.8	2.8	5.5
Government expenditure (percent of non-oil GDP)	72.5	93.1	83.5	53.2	72.5	93.1	68.5	34.2
Recurrent (percent of non-oil GDP)	62.3	74.6	60.2	42.5	62.3	74.6	52.2	25.7
Capital (percent of non-oil GDP)	10.2	18.6	23.3	10.8	10.2	18.6	16.3	8.6
Revenue (excl. grants, percent of non-oil GDP)	46.4	47.1	40.6	22.1	46.4	47.1	43.5	31.9
Domestic revenue	11.6	11.7	11.7	12.0	11.6	11.7	13.2	17.5
Estimated Sustainable Income	34.8	35.4	28.8	10.1	34.8	35.4	30.2	14.4
Net lending/ borrowing (percent of non-oil GDP)	-26.1	-46.1	-43.0	-31.2	-26.1	-46.1	-25.1	-2.4
Net incurrence of liabilities (percent of non-oil GDP)	1.6	3.8	2.9	0.5	1.6	3.8	2.9	0.5
Petroleum Fund balance (USD billion)	18,991	18,785	17,758	10,415	18,991	18,785	18,877	21,592
Current account balance (percent of non-oil GDP)	-19.3	-31.6	-38.1	-32.2	-19.3	-31.6	-31.2	-11.9

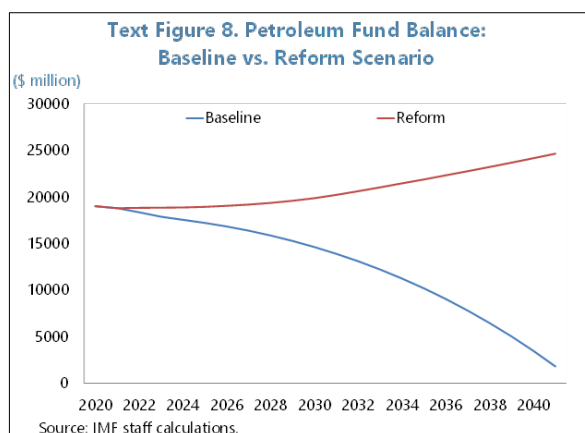
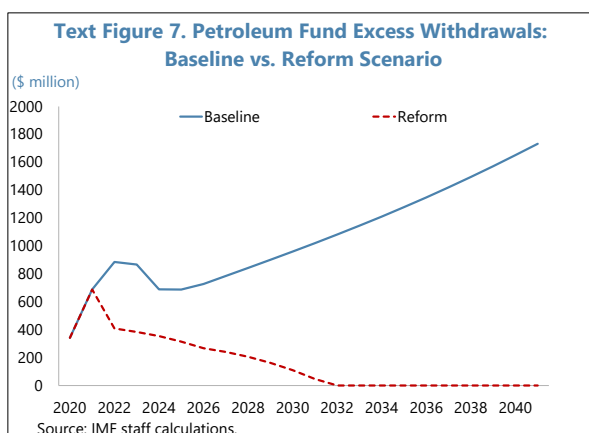
Sources: Timor-Leste authorities; IMF staff estimates and projections.

7. Under staff's reform scenario, policy actions are adopted to safeguard long-term fiscal sustainability.

- **Domestic revenue mobilization:** To achieve a domestic revenue of 15 percent of non-oil GDP by 2026, a value-added tax (VAT) should be adopted by 2023 to generate additional revenue of about 3 percent of GDP over the medium term. Strengthening tax compliance through tax administration reforms, and further tax reforms (e.g., revision of excise tax rates, increase in statutory income tax rate, adopting a property tax) are warranted in the long term to increase domestic revenue to about 20 percent of non-oil GDP.

⁸ The residual in debt-creating flows is financed through excess withdrawals from the Petroleum Fund.

- **Expenditure moderation:** The level of government spending should remain broadly constant in nominal terms at the 2019 level for a decade starting in 2022 to gradually reduce it in percent of non-oil GDP. The focus should be on enhancing the quality of government spending to maximize the growth dividend from it. The findings from the ongoing Public Expenditure Review conducted by the World Bank should help identify spending inefficiencies and prioritize spending adequately. Public investment projects should be subject to thorough and rigorous cost-benefit analysis.
- **A target to halt Petroleum Fund excess withdrawals by 2032:** More moderate levels of spending coupled with higher domestic revenue should help gradually unwind fiscal imbalances and the reliance on Petroleum Fund excess withdrawals to secure fiscal sustainability and preserve Petroleum Fund assets. The Petroleum Fund balance will gradually increase to close to \$24.6 billion in the long run, and the estimated sustainable income will decline more slowly in percent of non-oil GDP.⁹ Fiscal deficits over the medium-term would be 25 percent of non-oil GDP, instead of 43 percent under the baseline. Overall, in the reform scenario the Petroleum Fund is preserved (in real terms) and generates a permanent level of investment income to support government expenditures, thus putting fiscal and debt sustainability on a solid footing.
- Overall, external borrowing under the reform scenario is projected to be the same as the baseline scenario because the government's strategy of increasing public external borrowing via concessional loans to finance public investment in infrastructure projects in the medium-term and to preserve the Petroleum Fund wealth continues to hold.



8. At the same time, structural reforms are implemented to improve the business environment, raise productivity, and promote private sector development.¹⁰ These include progress in facilitating the ease of doing business, addressing digital infrastructure and connectivity

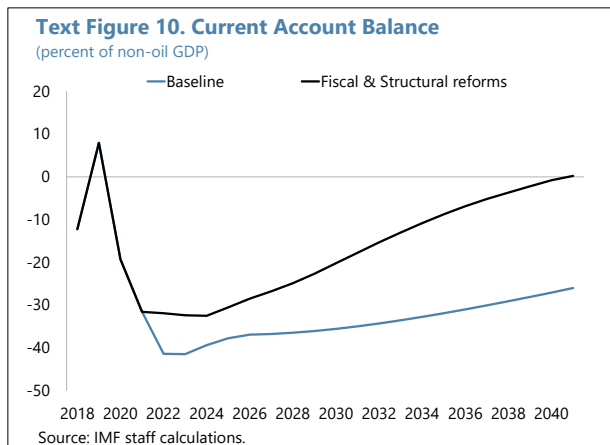
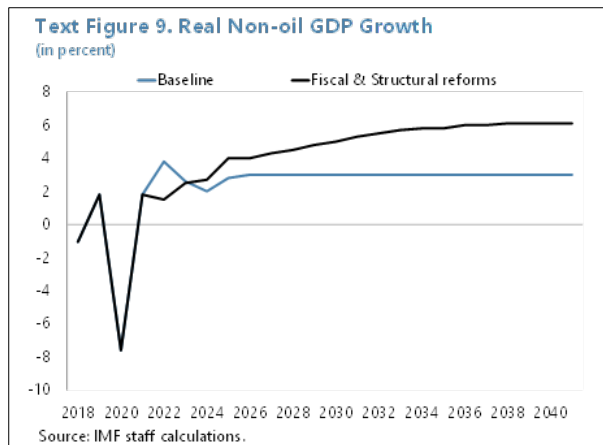
⁹ The dynamic of the Petroleum Fund is such that a lower Petroleum Fund balance will reduce the level of estimated sustainable income, resulting in higher excess withdrawals to close a given financing gap, highlighting the need to curb the rapid loss in Petroleum Fund wealth.

¹⁰ Staff estimates suggest the external sector position in 2020 was substantially weaker than implied by medium-term fundamentals and desirable policy settings.

bottlenecks, increasing financial access, building human capacity, closing labor skill gaps, and strengthening the justice sector to improve governance and reduce corruption vulnerabilities.

9. The macro-fiscal and external sector outlook is significantly stronger under the reform scenario:

- Real non-oil GDP** is projected to be broadly similar to the baseline in the medium term (2021–26). Given the low fiscal multipliers,¹¹ the growth costs of fiscal consolidation are estimated to be almost fully offset by the positive impact of reprioritization (towards growth-enhancing sectors such as health, education, agriculture, tourism, and digitalization) and improvement in the quality of public spending and structural reforms. With sustained improvement in productivity and competitiveness, the economic impact of structural reforms is higher over the long term (2027–2041), where growth is projected to hover around 5–6 percent, significantly higher than under the baseline, driven by higher private investment and the development of the non-oil private sector, reduced import dependence, and a larger export base (see Text Figure 9).



- The current account balance deficit** over the medium and long term is projected to be considerably smaller in comparison to the baseline scenario, reflecting both higher exports (economic diversification and exports of high value-added agricultural exports) and lower imports of goods and services (in line with lower fiscal spending and lower reliance on food imports)¹² (see Text Figure 10).

¹¹ Timor-Leste's fiscal multiplier, measured by the change in real non-oil GDP growth rate induced by a unit change in the primary balance (% GDP), is estimated to be close to 0.1. This is in line with other estimates in the literature which estimate it to be in the range of 0.08–0.17. Low multipliers indicate that much of the spending leaks into imports and/or is low quality to address supply side constraints (Timor-Leste Economic Report: Towards a Sustained Recovery, October 2020, World Bank Group).

¹² Lower public investment contributes to lower excess current account deficits by 2 percent of non-oil GDP by 2031/32.

COUNTRY CLASSIFICATION AND DETERMINATION OF SCENARIO STRESS TESTS

10. The debt-carrying capacity is assessed to be weak (Text Table 5). Timor-Leste's debt carrying capacity is assessed to be weak according to the Composite Indicator index of 2.67 which is calculated based on the April 2021 World Economic Outlook and the 2019 Country Policy and Institutional Assessment. The Composite Indicator is based on a weighted average of the country's real GDP growth, remittances, international reserves, world growth, and the Country Policy and Institutional Assessment score. The calculation is based on 10-year averages of the variables, across 5 years of historical data and 5 years of projections, and the corresponding Country Policy and Institutional Assessment. Accordingly, debt sustainability analysis thresholds applicable for Timor-Leste are: 30 percent for the present value of external debt-to-GDP ratio, 140 percent for the present value of external debt-to-exports ratio, 10 percent for the external debt service-to-exports ratio, 14 percent for the external debt service-to-revenue ratio, and 35 percent for the present value of public debt-to-GDP ratio. This is a downgrade from the previous debt sustainability analysis where Timor-Leste was classified as "medium", largely driven by lower 10-year average of real GDP growth and the world economic growth.¹³

Text Table 5. Timor-Leste Debt Carrying Capacity and Thresholds			
Debt Carrying Capacity and Thresholds			
Country	Timor-Leste		
Country Code	537		
Debt Carrying Capacity	Weak		
Final	Classification based on current vintage	Classification based on the previous vintage	Classification based on the two previous vintage
Weak	Weak 2.67	Weak 2.67	Medium 2.70
APPLICABLE		APPLICABLE	
EXTERNAL debt burden thresholds		TOTAL public debt benchmark	
PV of debt in % of		PV of total public debt in	
Exports	140	percent of GDP	35
GDP	30		
Debt service in % of			
Exports	10		
Revenue	14		

Sources: 2019 World Bank Country Policy and Institutional Assessment; April 2021 World Economic Outlook.

¹³ The 10-year average of the Country Policy and Institutional Assessment score deteriorated marginally, whereas the reserve coverage remained broadly unchanged and that of remittances increased.

11. The size of the shock to non-debt creating flows foreign-direct-investment-to-GDP ratio and to exports was customized to account for one-off and structural factors. In the case of the former, there is a large outflow in foreign direct investment equivalent to \$621 million in 2020 due to Petroleum Fund's investment in Timor-Gap to purchase the 56 percent stake in the Greater Sunrise joint venture.¹⁴ To prevent this one-off deviation in foreign direct investment flows from inflating the foreign direct investment-to-GDP ratio shock, the historical average and the standard deviation corresponds to 2010–19 (i.e., excludes 2020).¹⁵ Moreover, to prevent the structural oil production cycle from inflating the export shock and to account for the fact that petroleum production will cease in 2023, the export stress test was customized in line with the 2019 Article IV debt sustainability analysis.

12. The contingent liability stress test settings were also customized (Text Table 6). The default shock to contingent liabilities from state-owned enterprises debt and Public Private Partnerships is reduced to zero. This is because the former is already included in the baseline public debt, and the latter is negligible (see paragraph 1). Timor-Leste's domestic banking sector has high liquidity and capital adequacy ratios, and hence the contingent liabilities from financial market stress is set at the default value of 5 percent of GDP, consistent with the average cost to the government of a financial crisis in a low-income country since 1980.

13. The commodity price shocks were introduced in a tailored stress test, with adjustments made to the default settings. Lack of export diversification has resulted in the excessive reliance of Timor-Leste's external position on petroleum and gas receipts—the share of commodity exports in Timor-Leste's total exports was 82 percent on average over 2018–20. However, this is projected to decline to less than 40 percent on average over 2021–23, as the petroleum production from active fields comes to an end in 2023. Hence, we tailor the commodity price shocks by adjusting the share of fuel in total exports of goods and services to match the latter.

14. A stress test on natural disasters is added to the sensitivity analysis given that Timor-Leste is prone to natural disasters. The natural disaster scenario uses the default settings which assumes a one-off shock in 2022 of 10 percentage points to debt-GDP ratio with real GDP growth and exports growth lowered by 1.5 and 3.5 percentage points, respectively. These assumptions are more severe than the estimates in the literature, which suggests the macroeconomic impact of natural disasters in Timor-Leste has been much smaller. A recent study estimated the negative impact of natural disasters on Timor-Leste's real GDP growth in the range of 0.04 percent to 0.12 percent.¹⁶

¹⁴ Timor Gap is an autonomous government agency with the mandate to conduct oil and gas business on behalf of the Timor-Leste Government.

¹⁵ The customization implied that: (1) the historical average of the net non-debt creating flows foreign-direct-investment-to-GDP ratio is revised up from -1.5 to 2.5 and the standard deviation is reduced from 13.5 to 2.3; and (2) the initial standard deviation of 47.3 of the export shock was scaled down to 9.5.

¹⁶ See IMF working paper 18/108.

Text Table 6. Coverage of Public Debt and Design of Contingent Liabilities (tailored) Stress Tests

1 The country's coverage of public debt	The central government, government-guaranteed debt		
	Default	Used for the analysis	Reasons for deviations from the default settings
2 Other elements of the general government not captured in 1.	0 percent of GDP	0	
3 SoE's debt (guaranteed and not guaranteed by the government) 1/	2 percent of GDP	0	Included in the baseline public debt
4 PPP	35 percent of PPP stock	0.00	Negligible PPP stock
5 Financial market (the default value of 5 percent of GDP is the minimum value)	5 percent of GDP	5	
Total (2+3+4+5) (in percent of GDP)		5.0	

1/ The default shock of 2% of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1.). If it is already included in the government debt (1.) and risks associated with SoE's debt not guaranteed by the government is assessed to be negligible, a country team may reduce this to 0%.

ASSESSMENT

External Debt Sustainability Analysis

15. Under the baseline scenario, two of Timor-Leste's external debt indicators breach their respective debt sustainability analysis thresholds. First, the present value of external debt in percent of exports breaches the critical threshold of 140 percent between 2023 and 2033. Second, the debt-service-to-exports ratio also breaches the critical threshold of 10 percent between 2022 and 2035 (Figure 1). All the other indicators remain well below their relevant thresholds for the next 20 years. Debt dynamics reflect the following: (1) increase in debt service payments as grace periods on existing loans come to an end; and (2) government's strategy of increasing public external borrowing via concessional loans to reduce the need of tapping the Petroleum Fund from the projected expansion of public investment in infrastructure projects. Over the medium term, the present value of external debt is projected to increase gradually from 10 percent of non-oil GDP in 2020 to 16.8 percent in 2026, and thereafter decline gradually to reach 9.3 percent by 2041. Although the increasing use of concessional loans helps to reduce Petroleum Fund withdrawals, the spending plans combined with very limited domestic sources of revenue make large excess withdrawals from the Petroleum Fund unavoidable, further eroding Petroleum Fund wealth.

16. Debt dynamics show vulnerability to shocks. Standardized stress tests show that a shock to the primary balance is the most extreme shock to the debt trajectory, also causing a breach of the debt-service-to-exports, the present value of debt-to-GDP, and the present value of debt-to-exports thresholds. Timor-Leste's high vulnerability to shocks is a reflection of its very small exports and revenue bases, and, therefore, its exposure to high debt services payment risks if its positive Petroleum Fund assets position is not taken into account. While, historically, the government has typically not resorted to debt financing, and instead relied on excess withdrawals from the Petroleum Fund, further use of the Petroleum Fund to meet Timor-Leste's debt servicing needs would hasten Petroleum Fund depletion.

Public Debt Sustainability Analysis

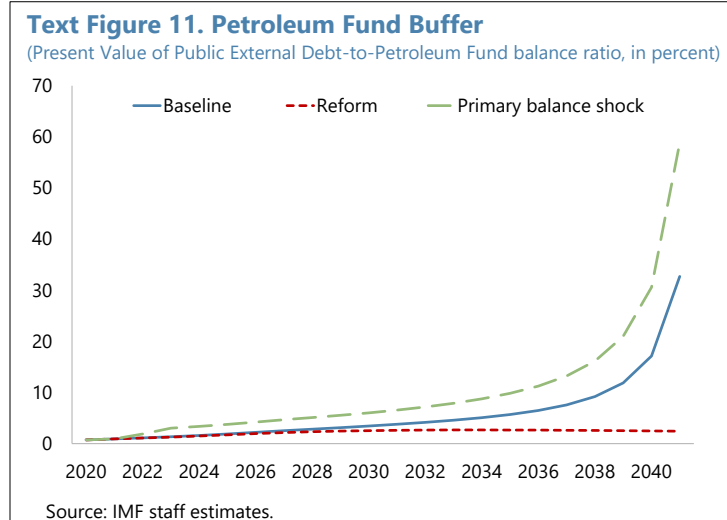
17. Under the baseline scenario, the present value of total public and publicly guaranteed debt-to-GDP ratio remains below the threshold level for the next 20 years (Figure 2). However, this indicator is vulnerable to commodity price shocks and is expected to breach the threshold

under the stress scenario starting in 2023. Among the other indicators, the present value-to-revenue ratio and the debt service-to-revenue ratio are most sensitive to the commodity price shocks as well.

Reform Scenario

18. The staff's reform scenario demonstrates that fiscal reforms coupled with structural reforms can ensure long-term fiscal and debt sustainability.

External concessional loans under the reform scenario are projected to be broadly in line with the baseline. The introduction of reforms significantly improves the debt dynamics—the paths of debt burden indicators are better. The size and duration of the breach of the present value of external debt in percent of exports and the debt-service-to-exports ratio is considerably smaller. Importantly, under the reform scenario, the Petroleum Fund balance will be preserved, and provide a large and sustainable buffer for debt sustainability in the long term.



RISK RATING AND VULNERABILITIES

19. While the debt sustainability analysis assigns Timor-Leste a mechanical rating of “high” debt distress risk, judgement is applied to upgrade the rating to “moderate”. The present value of debt-to-exports and debt-service-to-exports breach the benchmark under the baseline scenario—generating a mechanical debt distress rating of “high”. The judgment reflects the country’s large, liquid, and accessible net foreign assets in the form of the Petroleum Fund, which serves as a strong mitigating factor in Timor-Leste’s ability to carry and service debt in the medium term. Outstanding public debt was 1.1 percent of the Petroleum Fund balance by end-2020. The present value of debt does not exceed more than one-third of the projected value of the Petroleum Fund over the next 20 years under the baseline (see Text Figure 11). Under the scenario of the most extreme shock case (i.e., primary balance shock) where the present value of debt-to-exports breaches the threshold, the present value of debt-to-Petroleum Fund assets reaches close to 59 percent towards the end of the projection periods. Moreover, there is time to adopt a sustainable fiscal strategy (see paragraph 18). The authorities are aware of the challenge and requested extensive technical assistance from the IMF for ambitious fiscal reforms aiming to secure fiscal sustainability. With this, the risk of debt distress is assessed as “moderate” with limited space to absorb shocks (see Figure 5), which is a downgrade from the previous rating of “low” risk. This change is driven by: (1) worse initial conditions (i.e., higher present value of debt and higher debt service) and (2) lower debt carrying capacity (i.e., with lower critical thresholds) which result in the

present value of debt-to-exports ratio and the debt service-to-exports ratio breaching their critical thresholds under the baseline scenario.

20. Depletion of the Petroleum Fund in the long term under current policies warrants the need for a reform strategy to ensure long-term fiscal sustainability and preserve the Petroleum Fund as an endowment fund. Although the Petroleum Fund is a buffer against debt distress in the short and medium term, it is essential to protect it to secure long-term debt sustainability. Under current policies, the Petroleum Fund assets will be depleted towards the end of the 20-year projection horizon, leading to a fiscal cliff and sharp adjustment in the current account, which reinforces the need for a reform strategy. This would entail a gradual reduction of excess withdrawals from the Petroleum Fund to zero supported by expenditure rationalization, mobilizing domestic revenue, and committing to protecting Petroleum Fund wealth. Moreover, fiscal reforms should go hand in hand with structural reforms to improve the business environment and governance, to help improve competitiveness and strengthen the external sector position. This will also help restore Timor-Leste's debt carrying capacity back to medium.

21. At the same time, public debt management needs to be strengthened.¹⁷ Greater external borrowing should be embedded in a suitable institutional framework, supported by best practice debt management policies and procedures. Strengthening the organization and capacity of the debt management unit, including preparing a medium-term debt management strategy, and upgrading debt recording software are key areas for capacity building. However, in the near term, there is a need to produce comprehensive and realistic debt servicing projections for the existing debt. The monitoring and reporting of fiscal risks—such as contingent liabilities related to credit guarantees, pensions, public corporations, and public-private partnerships—should also be improved.

AUTHORITIES' VIEWS

22. The authorities consider the risk of debt distress to be contained and remain committed to long-term fiscal sustainability. They acknowledged that the Petroleum Fund is a source of confidence for the economy and should be preserved to ensure intergenerational equity. Fiscal reform plans in the pipeline—which include the introduction of the value-added tax (VAT) and a revised tax procedures code—will gradually boost domestic revenue and help to ensure fiscal and debt sustainability. In addition, recent implementation of program-based budgeting will facilitate the prioritization of government spending. The authorities have also requested technical assistance in the design of the VAT implementation plan, tax administration and Public Financial Management.

¹⁷ There have not been any noteworthy improvements in data coverage and public debt management since the 2019 Article IV.

Table 1. Timor-Leste: External Debt Sustainability Framework Baseline Scenario, 2018-2041

(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 8/ Historical Projections	
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2031	2041		
External debt (nominal) 1/ of which: public and publicly guaranteed (PPG)	9.3	11.5	13.9	17.2	19.0	20.5	22.1	23.4	24.6	23.2	12.6	5.1	22.7
	9.3	11.5	13.9	17.2	19.0	20.5	22.1	23.4	24.6	23.2	12.6	5.1	22.7
Change in external debt	2.6	2.2	2.4	3.2	1.8	1.5	1.6	1.3	1.2	-0.8	-0.9		
Identified net debt-creating flows	9.4	-13.0	59.8	26.6	36.2	36.6	34.7	33.0	31.8	27.8	19.6	2.5	31.5
Non-interest current account deficit	12.3	-8.1	19.0	31.3	41.1	41.1	39.0	37.4	36.5	34.6	25.8	-62.3	36.7
Deficit in balance of goods and services	27.4	10.0	29.1	47.2	55.2	53.5	49.8	46.8	44.6	34.6	18.6	-32.9	44.5
Exports	40.5	52.2	24.7	11.8	11.1	9.5	8.1	8.4	8.6	9.9	13.0		
Imports	67.9	62.1	53.8	59.0	66.3	63.1	58.0	55.1	53.2	44.5	31.6		
Net current transfers (negative = inflow)	6.1	4.2	9.1	4.6	4.5	4.4	4.4	4.3	4.3	6.2	5.4		
of which: official	-6.2	-7.2	-11.8	-11.8	-11.8	-11.8	-11.8	-11.8	-11.8	-6.4	-1.9		
Other current account flows (negative = net inflow)	-21.3	-22.3	-19.2	-20.4	-18.7	-16.8	-15.2	-13.7	-12.3	-6.3	1.8		
Net FDI (negative = inflow)	-3.1	-4.5	39.7	-4.7	-4.6	-4.4	-4.3	-4.1	-4.4	-6.5	-6.0		
Endogenous debt dynamics 2/ Contribution from nominal interest rate	0.2	-0.5	1.1	0.0	-0.3	-0.1	0.0	-0.2	-0.3	-0.3	-0.2	1.5	-5.1
Contribution from nominal interest rate	0.0	0.2	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.2		
Contribution from real GDP growth	0.1	-0.2	0.9	-0.2	-0.6	-0.5	-0.4	-0.6	-0.7	-0.7	-0.4		
Contribution from price and exchange rate changes	0.1	-0.5	-0.1	...	...	...	...	...	...	...	...		
Residual 3/ of which: exceptional financing	-6.7	15.2	-57.4	-23.3	-34.4	-35.0	-33.1	-31.7	-30.6	-28.7	-20.6	-0.6	-30.6
	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators													
PV of PPG external debt-to-GDP ratio	...	...	10.1	12.2	13.3	14.2	15.1	16.0	16.8	16.3	9.3		
PV of PPG external debt-to-exports ratio	...	...	41.0	103.4	120.0	148.9	186.8	190.9	194.6	164.6	71.5		
PPG debt service-to-exports ratio	0.1	0.7	2.1	6.8	10.6	13.7	15.7	14.8	14.0	11.0	6.8		
PPG debt service-to-revenue ratio	0.1	0.8	1.1	1.7	2.6	3.1	3.3	3.4	3.5	4.2	6.4		
Gross external financing need (Million of U.S. dollars)	143.8	-204.3	927.2	445.0	654.9	705.2	708.5	725.5	749.6	927.7	1305.4		
Key macroeconomic assumptions													
Real GDP growth (in percent)	-1.1	1.8	-7.6	1.8	3.8	2.6	2.0	2.8	3.0	3.0	3.0	1.4	2.8
GDP deflator in US dollar terms (change in percent)	-1.4	5.4	1.2	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0	4.7	3.7
Effective interest rate (percent) 4/	0.0	1.9	2.2	1.9	1.9	1.8	1.8	1.8	1.8	1.7	1.8	0.6	1.8
Growth of exports of G&S (US dollar terms, in percent)	18.9	38.2	-55.7	-50.3	0.2	-8.2	-9.8	10.3	10.2	10.1	10.1	-3.9	0.3
Growth of imports of G&S (US dollar terms, in percent)	-0.8	-1.9	-19.0	13.8	20.1	1.5	-2.5	1.7	3.3	3.4	3.6	-2.8	5.0
Grant element of new public sector borrowing (in percent)	...	...	...	35.3	35.3	35.3	35.3	35.3	35.3	33.2	33.2	...	35.1
Government revenues (excluding grants, in percent of GDP)	47.5	42.8	46.4	47.1	44.3	41.5	39.0	36.8	34.7	25.7	13.8	54.2	35.3
Aid flows (in Million of US dollars) 5/	171.2	161.8	184.0	219.1	230.7	245.5	260.1	277.6	296.9	221.0	136.3		
Grant-equivalent financing (in percent of GDP) 6/	...	...	...	13.3	13.1	13.1	13.0	13.0	13.0	6.9	2.1	...	11.2
Grant-equivalent financing (in percent of external financing) 6/	...	...	...	82.6	84.2	84.4	84.6	84.8	85.0	87.8	83.9	...	85.6
Nominal GDP (Million of US dollars)	1,560	1,674	1,565	1,625	1,738	1,854	1,967	2,103	2,253	3,177	6,321		
Nominal dollar GDP growth	-2.5	7.3	-6.5	3.8	6.9	6.7	6.1	6.9	7.1	7.1	7.1	6.3	6.7
Memorandum items:													
PV of external debt 7/	...	...	10.1	12.2	13.3	14.2	15.1	16.0	16.8	16.3	9.3		
In percent of exports	...	...	41.0	103.4	120.0	148.9	186.8	190.9	194.6	164.6	71.5		
Total external debt service-to-exports ratio	0.1	0.7	2.1	6.8	10.6	13.7	15.7	14.8	14.0	11.0	6.8		
PV of PPG external debt (in Million of US dollars)	...	...	158.6	198.8	231.2	263.2	298.0	335.9	377.5	517.2	589.1		
(PVt-PVt-1)/GDPt-1 (in percent)	...	...	...	2.6	2.0	1.8	1.9	1.9	2.0	0.7	0.0		
Non-interest current account deficit that stabilizes debt ratio	9.6	-10.3	16.6	28.1	39.3	39.6	37.4	36.1	35.3	35.4	26.7		

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as $[r - g - p(1+g)] / (1+g+p+g)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and p = growth rate of GDP deflator in U.S. dollar terms.

3/ The residual in debt-creating flows is financed through excess withdrawals from the Petroleum Fund. Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Current-year interest payments divided by previous period debt stock.

5/ Defined as grants, concessional loans, and debt relief.

6/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

7/ Assumes that PV of private sector debt is equivalent to its face value.

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

9/ The grant element may be overestimated due to debt projections.

Definition of external/domestic debt	Currency-based
Is there a material difference between the two criteria?	No

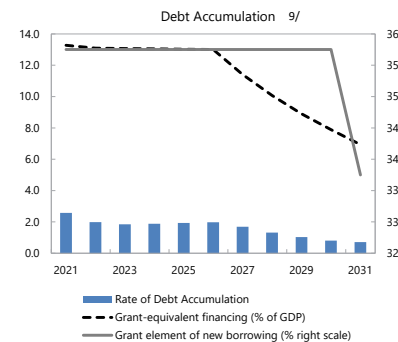


Table 2. Timor-Leste: Public Sector Debt Sustainability Framework Baseline Scenario, 2018-2041
(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 7/	
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2031	2041	Historical	Projections
Public sector debt 1/	9.3	11.5	13.9	17.2	19.0	20.5	22.1	23.4	24.6	23.2	12.6	5.1	22.7
of which: external debt	9.3	11.5	13.9	17.2	19.0	20.5	22.1	23.4	24.6	23.2	12.6	5.1	22.7
Change in public sector debt	2.6	2.2	2.4	3.2	1.8	1.5	1.6	1.3	1.2	-0.8	-0.9		
Identified debt-creating flows	28.3	27.7	26.9	45.5	52.7	48.3	36.5	33.9	33.4	31.0	26.5	34.6	37.3
Primary deficit	28.2	28.2	25.8	45.8	53.5	49.1	37.4	35.0	34.5	32.3	27.2	32.0	38.3
Revenue and grants	58.5	52.4	58.2	58.8	56.1	53.3	50.7	48.5	46.4	32.1	15.7	69.6	45.5
of which: grants	11.0	9.7	11.8	11.8	11.8	11.8	11.8	11.8	11.8	6.4	1.9		
Primary (noninterest) expenditure	86.7	80.6	84.0	104.6	109.6	102.4	88.1	83.5	81.0	64.4	42.9	101.7	83.8
Automatic debt dynamics	0.2	-0.5	1.1	-0.3	-0.8	-0.9	-0.8	-1.1	-1.2	-1.2	-0.7		
Contribution from interest rate/growth differential	-0.1	-0.2	1.1	-0.2	-0.6	-0.5	-0.4	-0.6	-0.7	-0.8	-0.4		
of which: contribution from average real interest rate	-0.2	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1		
of which: contribution from real GDP growth	0.1	-0.2	0.9	-0.2	-0.6	-0.5	-0.4	-0.6	-0.7	-0.7	-0.4		
Contribution from real exchange rate depreciation	0.3	-0.3	0.0	...	...	...	...	...	...	...	...		
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Recognition of contingent liabilities (e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other debt creating or reducing flow (please specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual 2/	-25.7	-25.5	-24.5	-42.3	-51.1	-47.1	-35.4	-33.0	-32.6	-32.3	-27.7	-32.7	-36.8
Sustainability indicators													
PV of public debt-to-GDP ratio 3/	...	...	10.1	12.2	13.3	14.2	15.1	16.0	16.8	16.3	9.3		
PV of public debt-to-revenue and grants ratio	...	...	17.4	20.8	23.7	26.6	29.9	32.9	36.1	50.7	59.3		
Debt service-to-revenue and grants ratio 4/	0.1	0.7	0.9	1.4	2.1	2.4	2.5	2.6	2.6	3.4	5.6		
Gross financing need 5/	28.2	28.4	26.3	46.6	54.7	50.4	38.6	36.2	35.7	33.3	28.1		
Key macroeconomic and fiscal assumptions													
Real GDP growth (in percent)	-1.1	1.8	-7.6	1.8	3.8	2.6	2.0	2.8	3.0	3.0	3.0	1.4	2.8
Average nominal interest rate on external debt (in percent)	0.0	1.9	2.2	1.9	1.9	1.8	1.8	1.8	1.8	1.7	1.8	0.6	1.8
Average real interest rate on domestic debt (in percent)	1.4	-3.4	1.0	-0.1	-1.1	-2.1	-2.1	-2.1	-2.1	-2.2	-2.1	-1.1	-1.9
Real exchange rate depreciation (in percent, + indicates depreciation)	3.9	-3.5	0.0	...	...	...	...	...	...	...	...	-2.6	...
Inflation rate (GDP deflator, in percent)	-1.4	5.4	1.2	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0	4.7	3.7
Growth of real primary spending (deflated by GDP deflator, in percent)	-1.0	-5.3	-3.7	26.8	8.8	-4.2	-12.3	-2.5	-0.1	-1.4	-0.9	-1.1	0.8
Primary deficit that stabilizes the debt-to-GDP ratio 6/	25.5	26.0	23.4	42.6	51.7	47.6	35.8	33.7	33.4	33.1	28.1	25.0	37.4
PV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		

Sources: Country authorities; and staff estimates and projections.

1/ Coverage of debt: The central government, government-guaranteed debt. Definition of external debt is Currency-based.

2/ The residual in debt-creating flows is financed through excess withdrawals from the Petroleum Fund.

3/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term, and short-term debt.

5/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period and other debt creating/reducing flows.

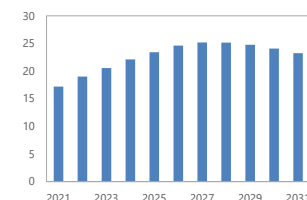
6/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio ((-): a primary surplus), which would stabilize the debt ratio only in the year in question.

7/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

Definition of external/domestic debt	Currency-based
Is there a material difference between the two criteria?	No

Public sector debt 1/

■ of which: local-currency denominated
■ of which: foreign-currency denominated



■ of which: held by residents
■ of which: held by non-residents

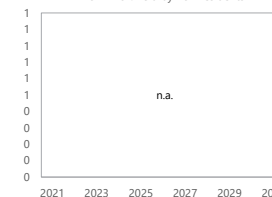


Table 3. Timor-Leste: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2021-2041
(In percent)

	Projections 1/																					
	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2037	2038	2039	2040	2041	
PV of debt-to GDP ratio																						
Baseline	12	13	14	15	16	17	17	17	17	17	16	16	15	14	14	13	12	11	11	10	9	
A. Alternative Scenarios																						
A1. Key variables at their historical averages in 2021-2041 2/	12	-54	-120	-183	-243	-302	-360	-413	-461	-505	-545	-581	-614	-642	-668	-690	-710	-726	-740	-751	-760	
B. Bound Tests																						
B1. Real GDP growth	12	15	17	18	19	20	21	21	21	20	20	19	18	17	17	16	15	14	13	12	11	
B2. Primary balance	12	21	30	31	31	32	32	31	30	29	28	27	26	25	24	22	21	20	19	18	17	
B3. Exports	12	14	17	18	18	19	20	20	19	19	18	17	17	16	15	14	13	12	12	11	10	
B4. Other flows 3/	12	19	25	26	26	27	27	26	25	24	23	22	21	20	18	17	16	15	14	13	12	
B5. Depreciation	12	17	7	8	10	11	12	12	13	13	13	13	13	12	12	12	11	11	10	10	9	
B6. Combination of B1-B5	12	20	17	19	20	20	21	21	21	20	20	19	18	17	16	15	14	14	13	12	11	
C. Tailored Tests																						
C1. Combined contingent liabilities	12	17	17	18	19	20	20	20	20	19	19	18	18	17	16	15	14	14	13	12	11	
C2. Natural disaster	12	17	18	20	21	22	23	23	23	22	22	22	21	20	20	19	18	17	17	16	15	
C3. Commodity price	12	14	16	16	16	15	14	12	11	9	7	6	4	3	2	1	0	-1	-2	-2	-3	
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
Threshold	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	
PV of debt-to-exports ratio																						
Baseline	103	120	149	187	191	195	195	190	183	174	165	154	144	133	123	113	104	95	87	79	72	
A. Alternative Scenarios																						
A1. Key variables at their historical averages in 2021-2041 2/	103	-490	-1257	-2254	-2909	-3510	-4063	-4533	-4927	-5251	-5512	-5717	-5872	-5981	-6050	-6082	-6082	-6054	-6002	-5928	-5835	
B. Bound Tests																						
B1. Real GDP growth	103	120	149	187	191	195	195	190	183	174	165	154	144	133	123	113	104	95	87	79	72	
B2. Primary balance	103	193	317	381	374	368	358	344	326	306	288	269	250	232	214	198	182	168	154	141	129	
B3. Exports	103	149	210	261	264	267	265	258	246	233	219	205	190	175	161	148	135	123	112	102	92	
B4. Other flows 3/	103	169	261	316	313	310	303	290	272	254	235	217	199	182	165	150	136	123	111	100	89	
B5. Depreciation	103	120	57	81	91	100	105	106	108	107	105	101	97	92	86	81	76	71	66	61	56	
B6. Combination of B1-B5	103	172	154	212	216	220	220	212	204	194	183	172	160	148	136	125	115	105	96	87	79	
C. Tailored Tests																						
C1. Combined contingent liabilities	103	150	183	226	228	230	228	222	213	202	191	180	168	156	144	133	123	113	104	95	87	
C2. Natural disaster	103	159	198	249	254	259	260	255	248	238	228	217	205	193	181	170	159	148	138	129	120	
C3. Commodity price	103	144	189	219	199	180	158	138	116	95	76	59	43	29	17	6	-2	-9	-15	-20	-23	
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
Threshold	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140	140	
Debt service-to-exports ratio																						
Baseline	7	11	14	16	15	14	12	12	12	12	11	11	11	11	10	9	8	8	8	7	7	
A. Alternative Scenarios																						
A1. Key variables at their historical averages in 2021-2041 2/	7	11	-4	-26	-44	-60	-77	-125	-168	-206	-240	-268	-292	-313	-331	-347	-360	-369	-377	-382	-386	
B. Bound Tests																						
B1. Real GDP growth	7	11	14	16	15	14	12	12	12	12	11	11	11	11	10	9	8	8	8	7	7	
B2. Primary balance	7	11	16	21	19	18	15	20	24	23	21	20	19	19	18	16	15	14	14	13	12	
B3. Exports	7	12	17	20	19	18	15	16	17	17	15	15	15	14	14	12	11	10	10	9	9	
B4. Other flows 3/	7	11	15	19	18	17	14	17	20	19	17	17	16	16	15	13	12	11	11	10	9	
B5. Depreciation	7	11	14	13	12	12	9	10	6	7	6	6	7	7	7	6	5	5	5	5	5	
B6. Combination of B1-B5	7	12	16	17	16	16	13	16	14	14	12	13	12	12	12	10	9	9	8	8	8	
C. Tailored Tests																						
C1. Combined contingent liabilities	7	11	15	17	16	15	12	13	13	13	12	12	12	11	11	10	9	8	8	7	7	
C2. Natural disaster	7	11	15	18	17	16	13	14	14	14	13	13	13	12	12	11	10	9	9	8	8	
C3. Commodity price	7	12	16	19	17	15	12	12	12	12	9	8	7	7	6	4	2	2	1	1	1	
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
Threshold	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	
Debt service-to-revenue ratio																						
Baseline	2	3	3	3	3	3	3	4	4	4	4	5	5	5	6	6	5	6	6	6	6	
A. Alternative Scenarios																						
A1. Key variables at their historical averages in 2021-2041 2/	2	3	-1	-5	-10	-15	-21	-37	-54	-73	-92	-113	-135	-158	-182	-209	-237	-267	-298	-331	-365	
B. Bound Tests																						
B1. Real GDP growth	2	3	4	4	4	4	4	4	5	5	5	6	6	7	7	7	7	7	7	8	8	
B2. Primary balance	2	3	4	4	4	5	4	6	8	8	8	9	9	9	10	10	10	10	11	11	12	
B3. Exports	2	3	3	3	4	4	3	4	5	5	5	5	6	6	6	6	6	6	7	7	7	
B4. Other flows 3/	2	3	3	4	4	4	4	5	6	7	7	7	8	8	8	8	8	8	8	9	9	
B5. Depreciation	2	3	4	3	4	4	3	4	2	3	3	3	4	4	5	4	4	5	5	5	6	
B6. Combination of B1-B5	2	3	4	4	4	4	4	5	5	5	5	6	6	7	7	7	7	7	7	7	8	
C. Tailored Tests																						
C1. Combined contingent liabilities	2	3	3	3	4	4	3	4	4	5	4	5	5	6	6	6	6	6	6	6	7	
C2. Natural disaster	2	3	3	4	4	4	3	4	4	5	5	5	6	6	6	6	6	6	7	7	7	
C3. Commodity price	2	3	3	4	4	4	3	4	4	4	3	3	3	3	3	2	2	1	1	1	1	
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
Threshold	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	

Sources: Country authorities; and staff estimates and projections.

1/ A bold value indicates a breach of the threshold.

2/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

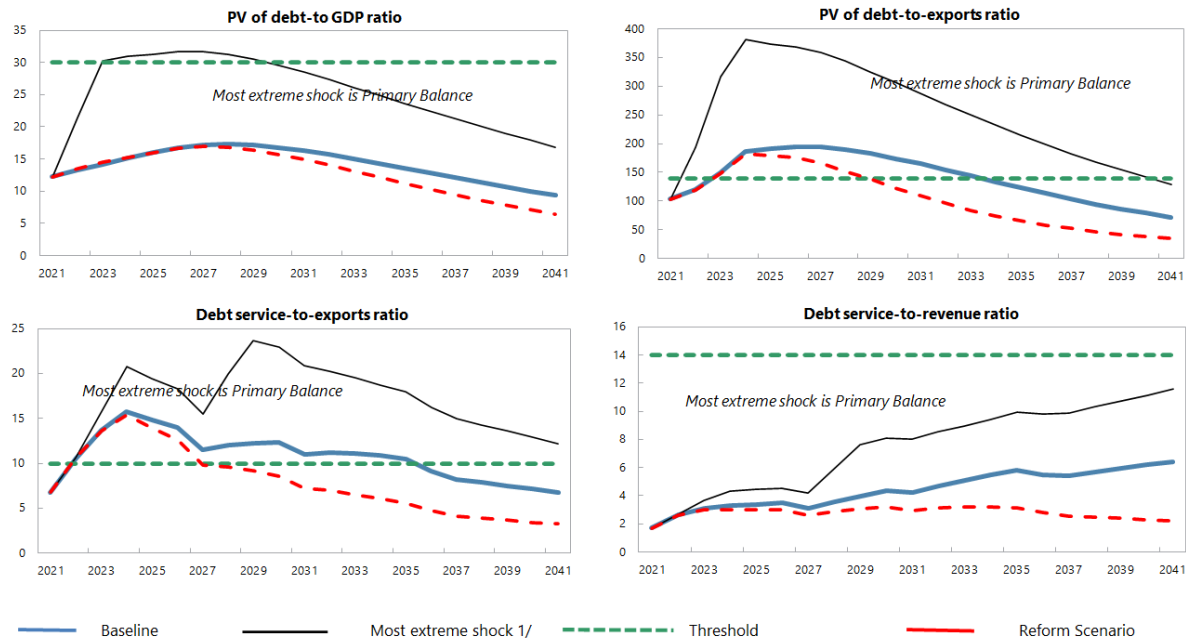
3/ Includes official and private transfers and FDI.

Table 4. Timor-Leste: Sensitivity Analysis for Key Indicators of Public Debt, 2021-2031

	Projections 1/										
	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
PV of Debt-to-GDP Ratio											
Baseline	12	13	14	15	16	17	17	17	17	17	16
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2021-2041 2/	12	0	-9	-10	-9	-9	-8	-8	-8	-7	-7
B. Bound Tests											
B1. Real GDP growth	12	18	27	34	40	45	50	54	57	59	61
B2. Primary balance	12	21	30	31	31	32	32	31	30	29	28
B3. Exports	12	14	16	17	18	19	19	19	19	18	18
B4. Other flows 3/	12	19	25	26	26	27	27	26	25	24	23
B5. Depreciation	12	15	13	11	10	9	8	6	5	4	2
B6. Combination of B1-B5	12	19	19	17	18	19	19	19	19	18	18
C. Tailored Tests											
C1. Combined contingent liabilities	12	17	17	18	19	20	20	20	20	19	19
C2. Natural disaster	12	17	18	20	21	22	23	23	23	22	22
C3. Commodity price	12	23	39	52	64	74	82	89	94	99	103
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public debt benchmark	35	35	35	35	35	35	35	35	35	35	35
PV of Debt-to-Revenue Ratio											
Baseline	21	24	27	30	33	36	40	43	46	48	51
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2021-2041 2/	21	0	-17	-19	-19	-19	-19	-20	-20	-21	-22
B. Bound Tests											
B1. Real GDP growth	21	32	48	63	78	92	110	127	145	163	181
B2. Primary balance	21	38	57	61	65	68	74	78	82	85	89
B3. Exports	21	26	31	34	37	40	44	48	51	53	55
B4. Other flows 3/	21	33	47	51	54	57	62	66	68	71	72
B5. Depreciation	21	26	25	23	21	19	18	16	13	10	7
B6. Combination of B1-B5	21	34	35	34	37	40	44	47	50	53	55
C. Tailored Tests											
C1. Combined contingent liabilities	21	30	33	36	39	43	47	50	53	56	59
C2. Natural disaster	21	31	35	39	43	47	52	57	61	65	69
C3. Commodity price	21	42	75	106	134	160	190	218	249	281	314
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Debt Service-to-Revenue Ratio											
Baseline	1.4	2.1	2.4	2.5	2.6	2.6	2.4	2.7	3.1	3.4	3.4
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2021-2041 2/	1.4	2.1	1.8	1.4	1.3	1.3	1.0	-0.3	-1.4	-1.5	-1.9
B. Bound Tests											
B1. Real GDP growth	1.4	2.3	3.0	3.4	3.7	4.0	4.1	5.2	6.7	8.3	9.4
B2. Primary balance	1.4	2.1	2.8	3.3	3.4	3.4	3.2	4.5	6.0	6.4	6.4
B3. Exports	1.4	2.1	2.5	2.6	2.7	2.7	2.5	3.0	3.5	3.8	3.8
B4. Other flows 3/	1.4	2.1	2.7	3.0	3.1	3.1	2.9	3.9	5.0	5.3	5.3
B5. Depreciation	1.4	2.4	3.1	3.1	3.0	2.9	2.5	2.4	2.3	2.2	1.6
B6. Combination of B1-B5	1.4	2.1	2.5	2.6	2.6	2.7	2.4	2.8	3.2	3.5	3.5
C. Tailored Tests											
C1. Combined contingent liabilities	1.4	2.1	2.6	2.7	2.7	2.8	2.5	2.9	3.2	3.6	3.6
C2. Natural disaster	1.4	2.1	2.7	2.7	2.8	2.9	2.7	3.0	3.4	3.8	3.8
C3. Commodity price	1.4	2.2	3.1	4.0	4.7	5.3	5.7	7.8	10.8	13.6	16.0
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the benchmark.
2/ Variables include real GDP growth, GDP deflator and primary deficit in percent of GDP.
3/ Includes official and private transfers and FDI.

Figure 1. Timor-Leste: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2021-2041



Customization of Default Settings		
	Size	Interactions
Tailored Tests		
Combined CLs	Yes	
Natural Disasters	Yes	No
Commodity Prices ^{2/}	No	No
Market Financing	n.a.	n.a.

Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

Borrowing Assumptions for Stress Tests*		
	Default	User defined
Shares of marginal debt		
External PPG MLT debt	100%	
Terms of marginal debt		
Avg. nominal interest rate on new borrowing in USD	1.8%	1.8%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	26	26
Avg. grace period	5	5

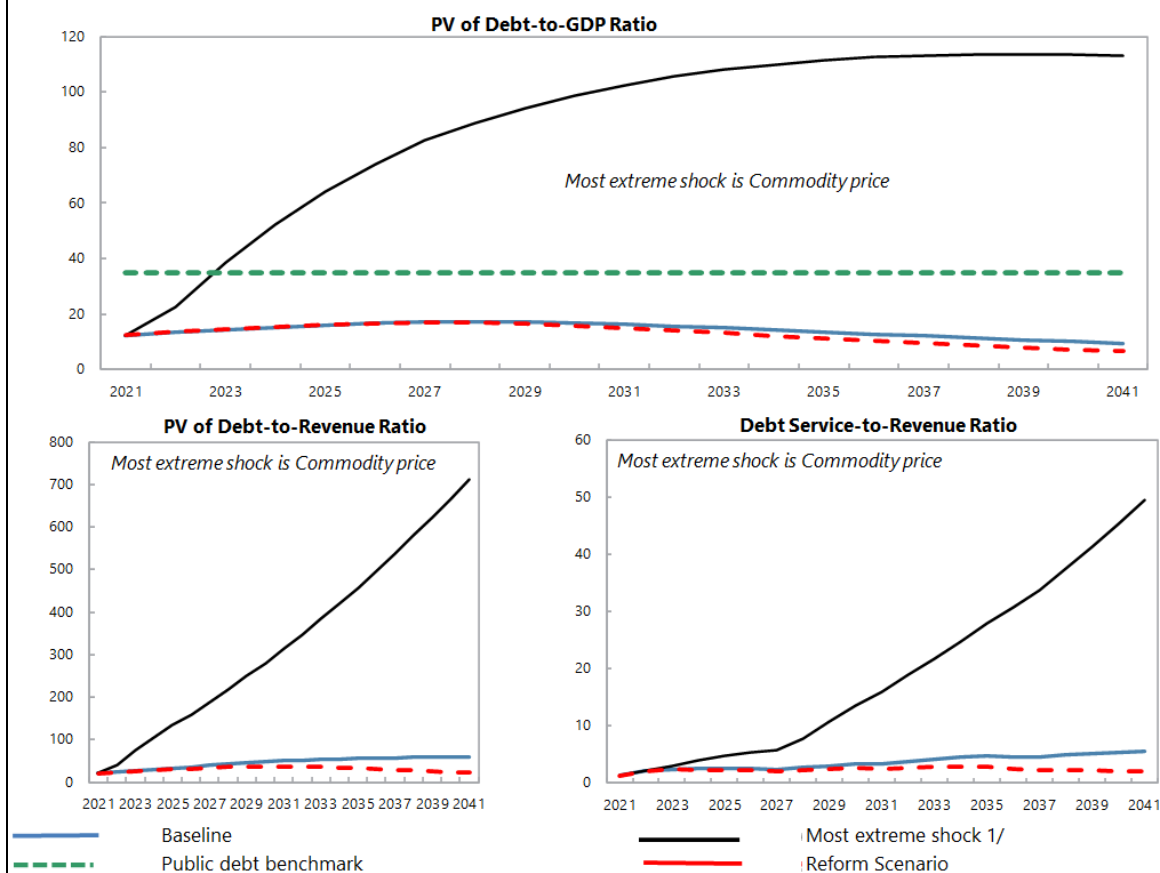
* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2031. Stress tests with one-off breaches are also presented (if any), while these one-off breaches are deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most extreme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

2/ The magnitude of shocks used for the commodity price shock stress test are based on the commodity prices outlook prepared by the IMF research department.

Figure 2. Timor-Leste: Indicators of Public Debt Under Alternative Scenarios, 2021-2041

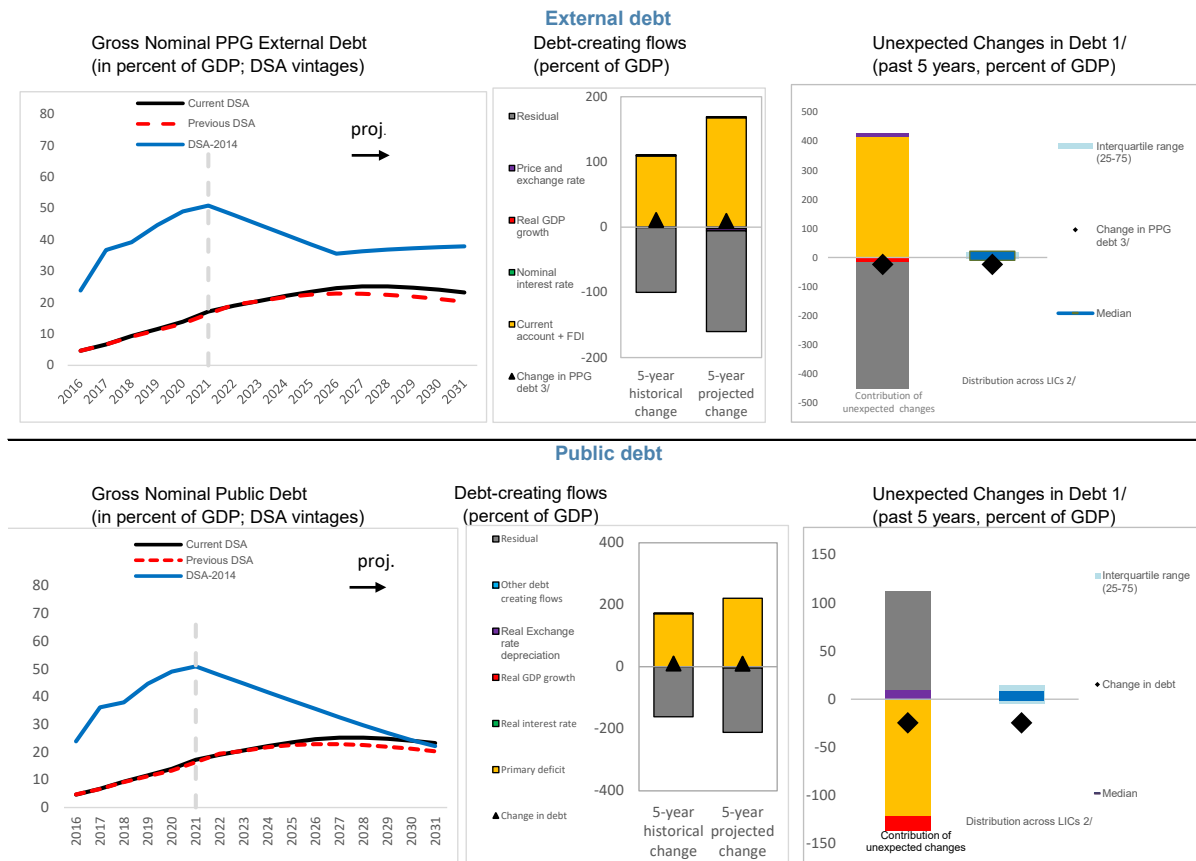


Borrowing Assumptions for Stress Tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	100%	100%
Domestic medium and long-term	0%	0%
Domestic short-term	0%	0%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	1.8%	1.8%
Avg. maturity (incl. grace period)	26	26
Avg. grace period	5	5
Domestic MLT debt		
Avg. real interest rate on new borrowing	0.0%	0.0%
Avg. maturity (incl. grace period)	1	1
Avg. grace period	0	0
Domestic short-term debt		
Avg. real interest rate	0%	0.0%

* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the shocks under the stress tests in the public DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2031. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most extreme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Figure 3. Timor-Leste: Drivers of Debt Dynamics - Baseline Scenario

1/ Difference between anticipated and actual contributions on debt ratios.

2/ Distribution across LICs for which LIC DSAs were produced.

3/ Given the relatively low private external debt for average low-income countries, a ppt change in PPG external debt should be largely explained by the drivers of the external debt dynamics equation.

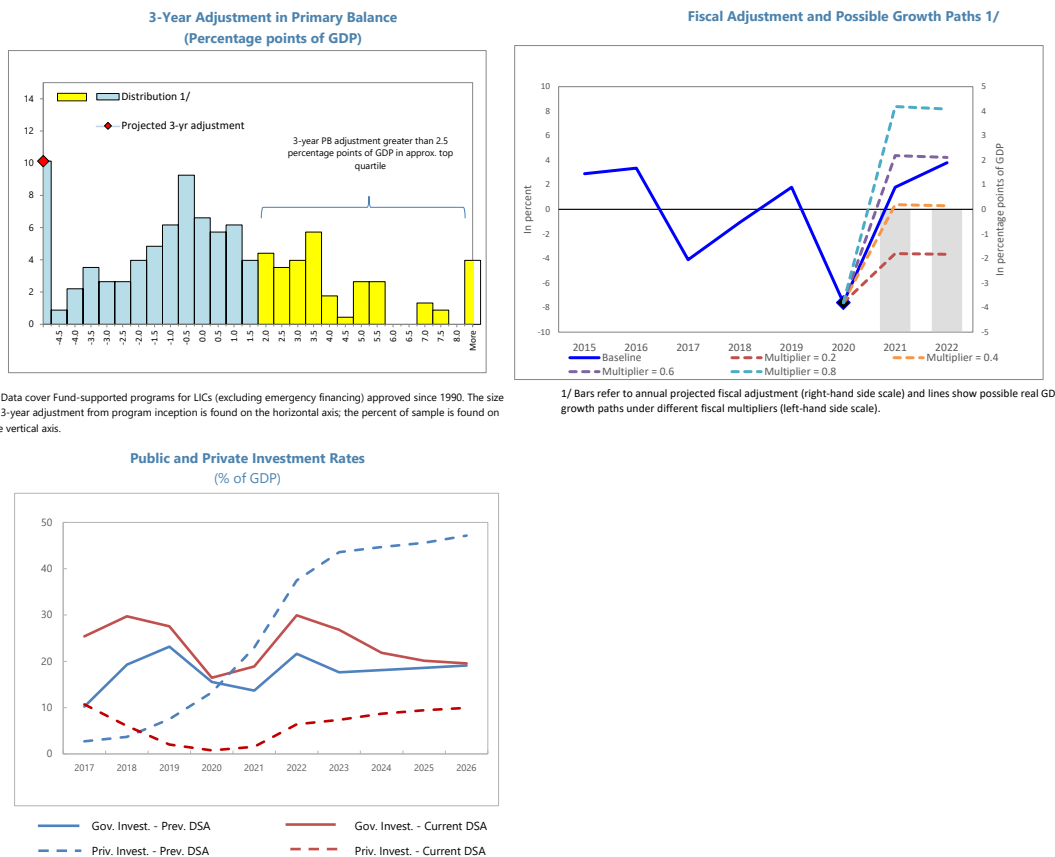
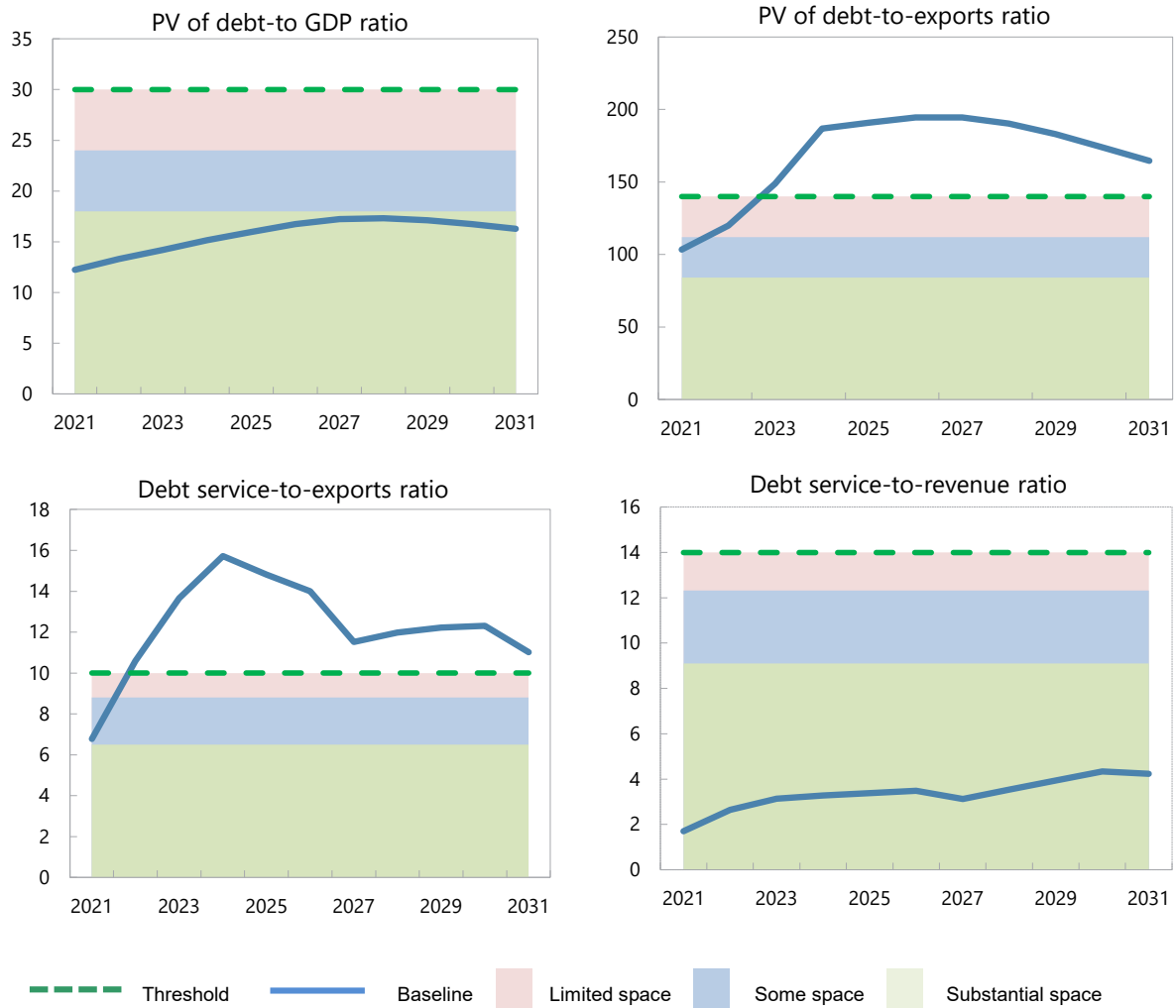
Figure 4. Timor-Leste: Realism Tools

Figure 5. Timor-Leste: Qualification of the Moderate Category, 2021-2031 1/

Sources: Country authorities; and staff estimates and projections.

1/ For the PV debt/GDP and PV debt/exports thresholds, x is 20 percent and y is 40 percent. For debt service/Exports and debt service/revenue thresholds, x is 12 percent and y is 35 percent.

**Statement by Afonso Bevilaqua, Executive Director for Timor-Leste,
Bruno Saraiva, Alternate Executive Director, and Diogo Coelho, Advisor**

July 9, 2021

On behalf of our Timorese authorities, we thank the mission chief and his team for the constructive engagement and policy dialogue during this year's Article IV consultation. Our authorities also thank the IMF for the invaluable technical assistance received through the years.

As one of the youngest countries in the world, Timor-Leste has made great strides in securing lasting peace, institutional development, and political stability. Only two decades ago, Timor-Leste rose from decades of civil conflict to become the first sovereign state of the century in May 2002. Since independence, the country has made significant progress in promoting a democratic society, with transparent elections, broad representation, separation of powers, and rule of law. Timor-Leste has also managed to build its public infrastructure from scratch, develop its institutions, promote economic development, and reduce poverty. In this process, the country has greatly benefited from international best practices and from the IMF's expertise on how to strengthen efforts to sustain macroeconomic and financial stability and improve its development trajectory.

Twin shocks and policy response

Forceful policy response last year helped to mitigate the impact of the pandemic. Preventive measures contained the spread of the novel coronavirus that causes COVID-19. The authorities also implemented an economic response package to support households and businesses, comprising a US\$200 cash transfer to most households and a 60 percent wage subsidy for registered firms. This package was vital to mitigate income losses and sustain economic activity.

However, twin shocks caused by the COVID-19 pandemic and by floods pose new challenges to the economic outlook. Timor-Leste registered its first confirmed case of community-transmitted COVID-19 in February 2021. As of end-June 2021, there were a total of 9,055 cases and 21 deaths. On April 4, 2021, a devastating flood hit the country, leaving most parts of Dili underwater. The number of dead or missing stood above 40 and around 16,000 people were displaced. These shocks create significant challenges for 2021, which promised to deliver strong growth due to improved political stability and last year's policy support following negative growth in 2020. The outlook, however, is gradually improving. Vaccination rollout began last April and, as of end-June 2021, 15.7 percent of the population received at least one dose, while two percent is fully vaccinated. Australia and China have also pledged to support the vaccination campaign with 630,000 and 100,000 doses, respectively. Through COVAX, Timor-Leste has secured additional doses for 20 percent of its population.

The twin shocks required additional fiscal policy support in 2021. The 2021 budget was rectified by the National Parliament in April 2021, providing additional spending outlays to

respond to the pandemic and floods. The fiscal deficit is now projected to increase from 26 percent of non-oil GDP in 2020 to 46 percent of GDP in 2021, considering the extraordinary expenditures to combat the crisis.

Medium-term outlook

The medium-term outlook remains positive, with the new government coalition committed to investing in human capital and encouraging private sector development. After a sequence of fragile government coalitions, political stability will contribute to advance the required reforms to improve business climate, and support economic diversification, especially the agricultural and tourism sectors. Support for the private sector will also come through legal reform and harmonization of laws to encourage private investment and job creation.

The authorities are implementing Public Financial Management (PFM) reforms and improving budget execution and fiscal outturns. With the support from the Fund and the World Bank, the authorities have drafted a new PFM Law to simplify and streamline budgeting and procurement processes. The annual budgeting process will take place within a strong multi-year framework, connecting it to the Multiannual Strategic Plan. A Medium-Term Fiscal Framework approved and revised annually by Parliament will increase predictability of the annual budget. The authorities have also recently presented to Parliament a draft of the Budget Framework Law, which will guide future budgeting and planning process, enhancing comparability by adopting a chart of accounts and budget classification based on international standards.

The authorities are fully committed to preserving the Petroleum Fund and maximizing its developmental impact. Over the years, the authorities have used oil revenues responsibly. They remain committed to a prudent management of the fiscal accounts that aims at preserving the resources accumulated in the Petroleum Fund, while addressing the development needs of the country and exploring new sources of revenues. In 2018, the Petroleum Fund had a balance of US\$ 15.8 billion. During the last Article IV consultation, the baseline scenario for 2020-2023 projected a balance of US\$ 14.5 billion. However, at end-May 2021, the Petroleum Fund had a significantly higher balance of US\$ 19.5 billion, or about 11 times last year's GDP, making it one of the largest sovereign wealth funds relative to GDP in the world. Considering that the Petroleum Fund has been fed mainly by taxes and royalties from the Bayu-Undan field, from which production is bound to expire in a few years, the authorities are investing in reducing dependence from the Petroleum Fund and increasing non-oil revenue mobilization. They are also working on a segmentation of the Petroleum Fund into separate liquid and growth portfolios, aimed at reducing investment risk, using the Petroleum Fund's balances more effectively, and encouraging medium-term fiscal planning. This new approach is based on independent advice and is consistent with industry best practices.

The Greater Sunrise fields could provide additional oil revenues, but the exploration model is still to be developed. Given its magnitude (6.6 trillion cubic feet of gas and 273 million

barrels of oil), exploration of the Greater Sunrise fields has the potential to substantially change the Timorese economy's outlook. The authorities are committed to developing a model of production and using future revenues in a manner that addresses the needs of the population, not only in the short term, but also sustainably over time.

Fiscal consolidation and Debt Sustainability Analysis

Given Timor-Leste's very low indebtedness and substantial buffers, the risk of debt distress for the foreseeable future is very low. Total external debt, all consisting of concessional loans, is only one percent of the existing balance in the Petroleum Fund. Hence, any risk of debt distress would not come from high indebtedness but rather would arise only if the fiscal position substantially deteriorates for an extended period. In this regard, the authorities are disappointed with the change in Timor-Leste's risk of debt distress assessment by staff, from low to moderate. This assessment would only hold in the highly implausible scenario of an unchanged fiscal position for more than a decade. The authorities are fully aware that important adjustments must be made, in a timely manner, to bring the fiscal accounts to a stronger footing and therefore avoid depletion of the Petroleum Fund. In this regard, our Timorese authorities are fully committed to implementing measures to substantially raise the collection of domestic revenues and ensure debt sustainability over time. They also emphasize the expected improvements in macro-fiscal conditions in the coming years, given the government's focus on political stability and fiscal responsibility. They hope therefore that this downgrade will be merely temporary, as staff considers mitigating country-specific circumstances and the forthcoming improvements in the fiscal outlook.

Timor-Leste's long-term fiscal stability prospects would be enhanced by economic diversification and additional domestic non-oil revenue mobilization. Although domestic revenue collections suffered from lower economic activity and the implementation of temporary relief measures in 2020, the authorities have implemented a wide-ranging set of actions to increase non-oil revenue mobilization by improving tax administration, promoting economic diversification, and fostering private-sector job creation. A new Value-Added Tax (VAT) Law is due in Parliament this year. Other fiscal reforms are in the pipeline, such as the new Tax & Duties Act, a revised Tax Procedures Code and the establishment of the Board of Tax and Customs Appeals' Office. In addition, the recent implementation of program-based budgeting will facilitate the prioritization of government spending.

Monetary and financial policy

The dollarized monetary regime has worked as an important anchor for the economy. In recent years, inflation has been low and close to trading partners' inflation. Inflation expectations are also well anchored. The authorities continue to carefully assess the merits of maintaining the current monetary system and stress that, while the current regime has served the country well, the central bank will keep on reviewing the merits of the current regime versus alternative ones.

The financial system continues to develop and has weathered the crisis well. Timor-Leste's incipient banking system has remained stable throughout the crisis, and the authorities are vigilant regarding risks related to increasing credit costs and nonperforming loans once the credit moratorium expires. In this regard, they have implemented measures to improve the regulatory and supervisory framework, including enhanced reporting standards for the insurance sector, such as solvency margins, good governance practices, licensing, and supervision for issuing life insurances.

The authorities are committed to furthering the development of Timor-Leste's financial system. Overall, financial inclusion has been improving. The 2020 Financial Inclusion Report, published in June 2021, showed that access to formal credit markets tripled in the last two years and about 68 percent of the adult population now have access to financial services. Recently, the Central Bank (BCTL) launched the "Digital Village Program" to enhance financial inclusion. Lower-income population in rural areas can have access to an e-Wallet account if banking services are absent in their villages. The BCTL is also modernizing the payments system, including via digitalization, while also focusing on financial literacy programs in elementary schools. In March 2021, the BCTL and the Ministry of Finance launched a system that allows taxes to be paid via ATM. Additionally, the BCTL has made substantial efforts to improve the regulatory and supervisory framework of financial institutions as noted above.

Structural reforms and engagement with the IMF

Timor-Leste is moving forward with a series of structural reforms aimed at improving the business environment and competitiveness and diversifying the economy. Recent measures include streamlining business registration and licensing, by promoting electronic certification and quickly issue licensing to low risk businesses; developing extrajudicial means of dispute resolution, such as arbitration and mediation; and enhancing internet connectivity by setting up a submarine fiber-cable through Australia's northern territory. Also, the authorities remain resolute to fight corruption and strengthen the anti-corruption and AML/CFT frameworks. The new Law on Measures to Prevent and Fight Corruption, enacted in August 2020, will strengthen governance and improve procurements processes.

Timor-Leste remains closely engaged with the Fund and other international organizations in capacity and human capital development. Investing in human capital is a key priority in Timor-Leste's institutional and capacity development strategy, aiming at providing opportunities to the new generations of Timorese. The authorities have increased their engagement with the World Bank, UNDP, and the Fund on how to drive efficiency in the health and education sectors, improve data collection, and PFM reform. The authorities have also requested technical assistance in the design of the VAT implementation plan and tax administration. With international support, the authorities have also started a program to help assess the outcomes and impacts of policies on citizen's lives. The government also plans to change the General Directorate of Statistics, currently under the Ministry of Finance, into an autonomous institute.

Sustainable Development

The authorities remain committed to a sustainable development agenda. Recent floods demonstrate the need to enhance the country's disaster management strategy. The authorities have taken measures to further develop climate-resilient infrastructure, strengthening the contingency fund and improving territorial planning for urban and housing development, especially along riverbanks. Timor-Leste has also achieved substantial progress towards the 2030 Sustainable Development Goals and the authorities remain committed to pursuing a comprehensive agenda to ensure that development follows a sustainable path.

In conclusion, Timor-Leste is a successful case of building a country under very challenging circumstances in a very short timeframe, but the task is far from complete. The Timorese authorities and people are fully cognizant of the magnitude of the mission and are committed to it for the good of not only the current, but also future generations.