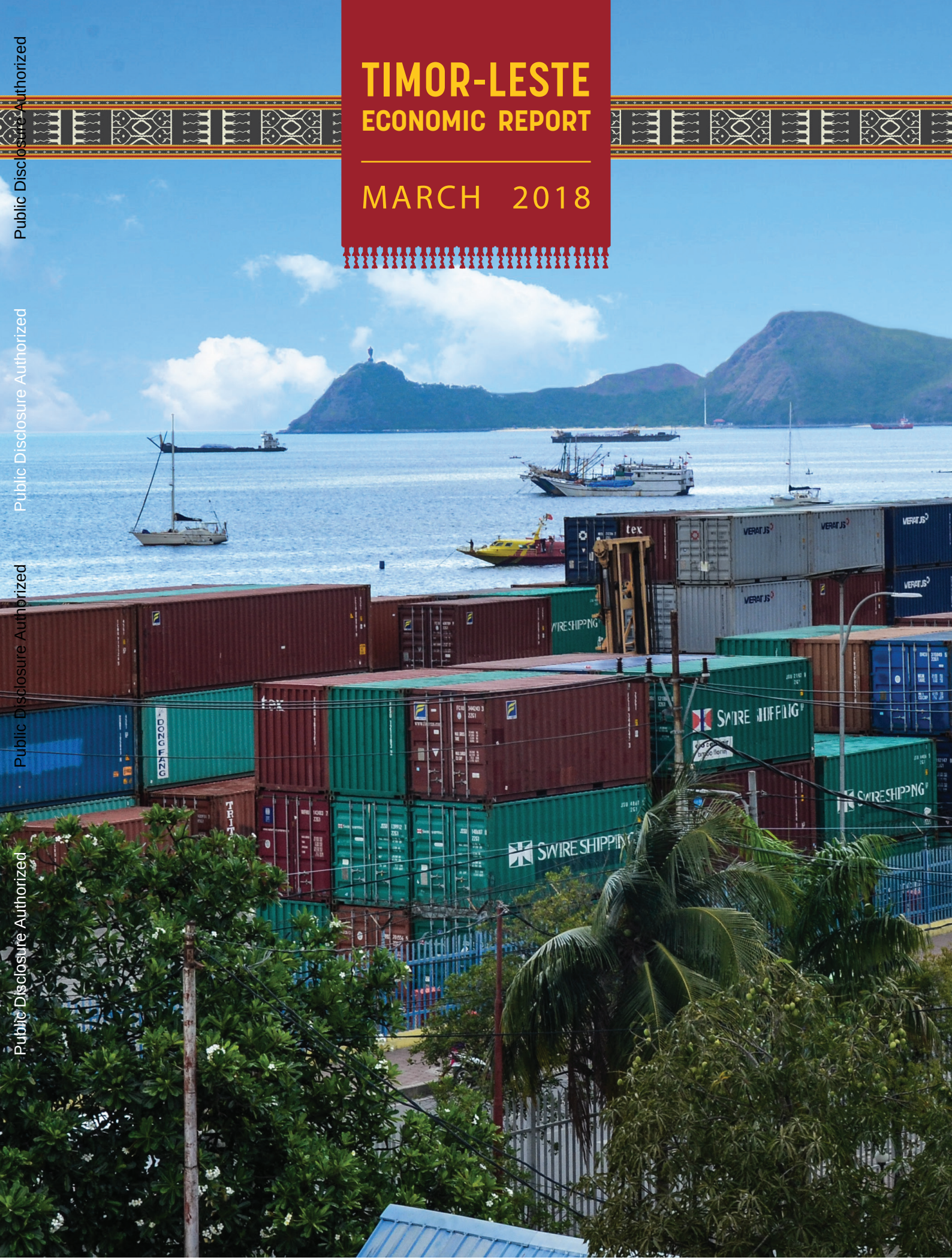
TIMOR-LESTE
ECONOMIC REPORT

MARCH 2018



WORLD BANK GROUP

KEY INDICATORS (2017)	
Population, million	1.3
GDP, current US$ billion[a]	1.7
GDP per capita, current US$[a]	1,299
GNI per capita, Atlas US$	2,244
Basic needs poverty rate[b]	41.8
Poverty rate ($1.9/day 2011PPP terms) [b]	30.3
School enrolment, primary (% net) [b]	95.6
Life expectancy at birth, years[b]	68.6

Sources: World Bank WDI and World Bank staff estimates
Notes: (a) GDP excluding offshore oil sector, (b) most recent WDI value (2015)

ACKNOWLEDGEMENTS

We would like to acknowledge the General Directorate of Statistics (GDS) of the Ministry of Planning and Finance of Timor-Leste and the Central Bank of Timor-Leste (BCTL) as the producers and/or compilers of many of the statistics that this report is based on. This report has also benefitted from information from the National Authority of Petroleum and Minerals (ANPM), the General Directorate of State Finance of the Ministry of Planning and Finance, La'o Hamutuk and the International Monetary Fund (IMF).

SUMMARY

RECENT DEVELOPMENTS

- Gross domestic product (GDP)[1] growth is expected to have fallen sharply in 2017 to a projected -1.8 percent from 5.3 percent the year before. This contraction is driven by a reversal of trend in government spending.
- In the last six months, the political impasse has worsened, with the President declaring a "serious institutional crisis" and dissolving Parliament in January 2018. The current government has not been able to pass its rectification budget for 2017 nor a budget for 2018 to date. The resulting tight budget envelope has led to a sharp reduction in government expenditure of some 24 percent year-on-year, especially felt in the last three months of the year.
- With government expenditure making up about 75 percent of GDP, weakening expenditure has had a significant downwards impact on growth in 2017.
- Offshore petroleum production has continued to gradually decline over 2017 as existing fields are steadily depleted, while coffee exports were lower in 2017 due to poor weather conditions. International arrivals by air continued to grow, suggesting that the international visitor market has held up.
- Private consumption has been more robust in 2017, but investment – both public and private – has declined and foreign direct investment (FDI) has dried up.

OUTLOOK AND RISKS

- With new elections announced and ongoing political uncertainty, the first half of 2018 is expected to see a continuation of the government's constrained operating environment, and in the next six months, there is a risk of even deeper government cuts unless budget legislation can be passed or budget financing is identified.
- Following parliamentary elections in mid-2018, a new government is expected to be formed, which would have the numbers in parliament to pass critical legislation and government operations would be expected to moderate upwards again beginning in the second half of 2018, and private investment to begin returning.
- Without serious attention, the government budget will remain deeply in deficit, financed by a liquidation of the Petroleum Fund assets raising the likelihood of a damaging fiscal cliff when PF resources are depleted.

FOCUS TOPIC: PATHWAYS FOR A NEW ECONOMY AND SUSTAINABLE LIVELIHOODS IN TIMOR-LESTE

- There remains an urgent long-term agenda of development in Timor-Leste which a new government program could focus on. Key priority reform areas include addressing the multi-sectoral challenge of severe malnutrition, improving systems of public service delivery, supporting a broadening and diversification of the economy, and putting environmental and fiscal management back on a sustainable path
- Existing fiscal reserves provide a golden opportunity to achieve these reforms, but only if they are utilized to support a transition to a long-term sustainable economic and fiscal model.

[1] Unless specified, GDP is always used to refer to the domestic economy excluding production activity in areas of joint-sovereignty, such as the Joint Petroleum Development Area (JPDA). This is sometimes also referred to as 'non-oil GDP' to distinguish it from measures of GDP that include some proportion of activity from joint-sovereignty areas (or 'total GDP').

THE LAST SIX MONTHS IN CHARTS

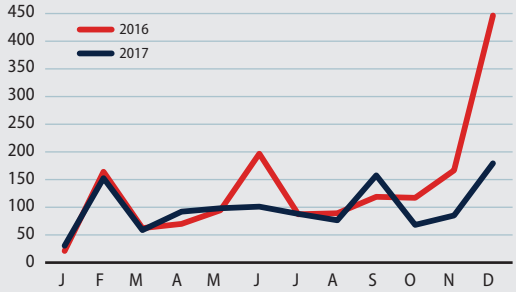
A sharp Government contraction drove a slowdown in 2017

Government exependiture by its components in 2017 (annual % change)

Source: Ministry of Finance, GoTL

…especially in the last three months of the year

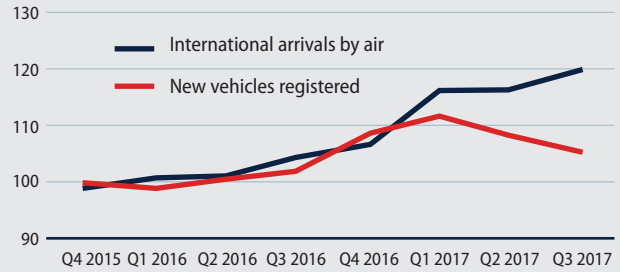
Monthly government expenditure in 2016 and 2017 ($m)



Source: Ministry of Finance, GoTL

Domestic indicators were mixed, with air arrivals growing,

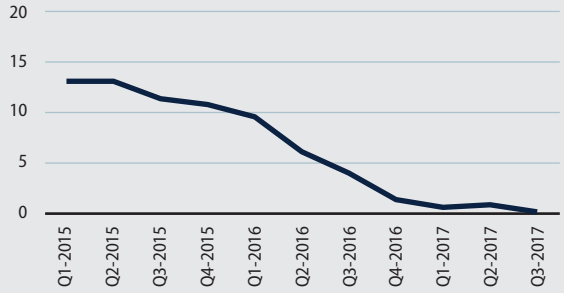
4-quarter index of:



Source: General Directorate of Statistics, MoF GoTL

... while FDI has dried up as uncertainty persisted over the year.

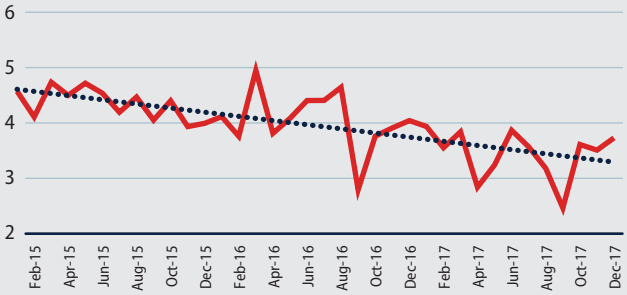
4-quarter average, net foreign direct investment (US$ m)



Source: Central Bank of Timor-Leste

Offshore production of oil and gas continued to decline.

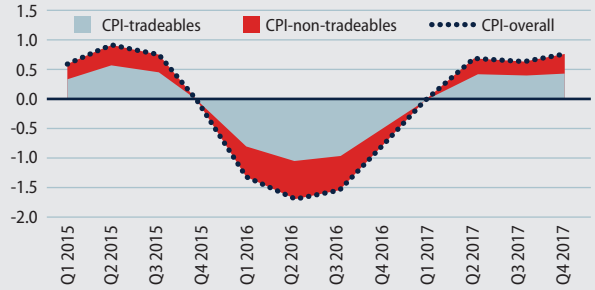
Monthly petroleum production (million barrels of oil equivalent)



Source: National Authority for Petroleum and Mineral Resources Timor-Leste

Inflation remains low

Consumer price inflation (eop %), by tradeables and non-tradeables



Source: General Directorate of Statistics, MoF GoTL

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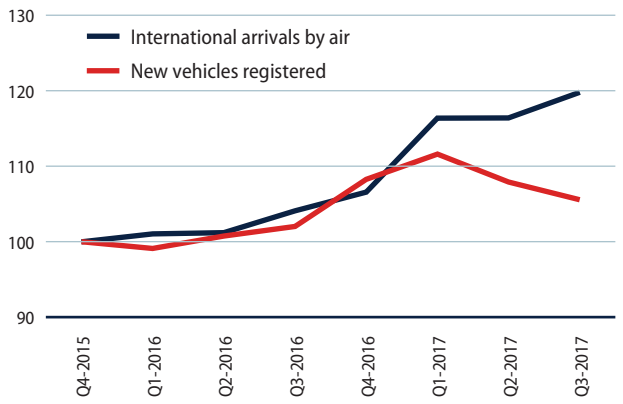
PART 1.

RECENT ECONOMIC DEVELOPMENTS

A GOVERNMENT CONTRACTION LIKELY DROVE THE DOMESTIC ECONOMY INTO RECESSION IN 2017

Gross domestic product (GDP)[2] growth is expected to have fallen sharply in 2017 to a projected -1.8 percent from 5.3 percent the year before. This contraction is driven by a reversal of trend, with government spending contracting in 2017 following years of positive GDP growth driven by rapidly expanding public spending. The fall in growth has been sharper than was predicted 6 months ago, largely because Parliament did not pass a proposed rectification budget, leading to especially large falls in expenditure year-on-year in the last three months of the fiscal year. Exports and investment figures have also weakened over the last six months, contributing to the downturn. Contracting government consumption and investment in 2017 will together exert the biggest drag on GDP growth. Overall public spending fell by 24 percent, and since the value added from government consumption and investment corresponds to 75 percent of GDP, this constitutes a very large adjustment. While private consumption is expected to be more resilient than government consumption in 2017 given public servant wages and salaries have been protected (see Figure 9), it is likely to have slowed and some proxies of domestic private consumption have weakened as 2017 has proceeded with, for instance, new vehicle registrations peaking on an annualized basis in Q1 2017 and falling in Q2 and Q3. Overall, consumption expenditure is expected to grow weakly, by around 1.5 percent in 2017.

Figure 1. Domestic activity indicators are mixed over 2017 to date (4-quarter index)

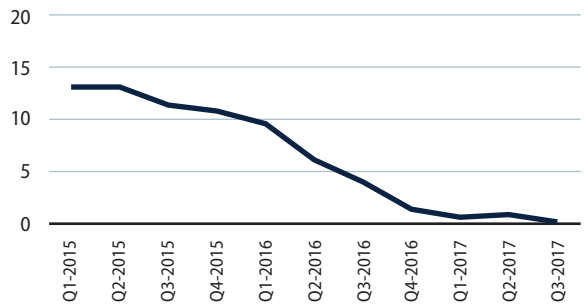


Definitions and notes
Arrivals by air: *Total international passenger arrivals at airports (includes both residents and non-residents)*
New vehicles registered: *Newly registered vehicles of any kind (motorcycles, light vehicles for passengers, heavy and light vehicles for cargo)*

Source: General Directorate of Statistics, MoF GoTL

[2] Unless specified, GDP is always used to refer to the domestic economy excluding production activity in areas of joint-sovereignty, such as the Joint Petroleum Development Area (JPDA). This is sometimes also referred to as 'non-oil GDP' to distinguish it from measures of GDP that include some proportion of activity from joint-sovereignty areas (or 'total GDP').

Figure 2. Foreign direct investment has dried up (4-quarter average, net foreign direct investment (US$ m))

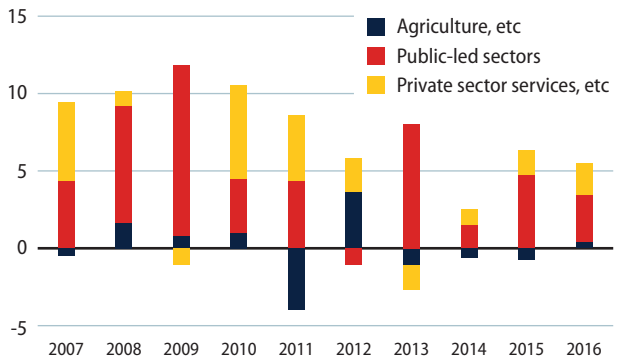


Source: Central Bank of Timor-Leste

Gross fixed capital formation (GFCF) is expected to have fallen sharply in 2017 with the fall in public investment accompanied by declining inward foreign investment over the course of 2017. Some of the largest planned private sector investments, such as the Tibar Bay container port development, ran behind schedule and construction did not start in earnest in 2017. Overall, GFCF is projected to have fallen by some 20 percent over the year.

The contribution of net exports to growth in 2017 is relatively unclear at this stage as exports have had a mixed year and import data is thought to have been affected by changes in reporting. But the central projection is that the net deficit has narrowed by 7 percent on the back of lower import demand. Over the course of 2017 to date, air passenger arrivals have continued to strengthen, and by Q3 were 12 percent higher than their level over 2016 on an annualized basis, suggesting that service exports due to the international visitor market continue to grow, albeit from a low base (Figure 1). It is not known whether this increase is due to greater numbers of international visitors, or returning diaspora, and strong growth in the first quarter of 2017 may be related to Timorese returning to vote in Presidential and Parliamentary elections which were both held. International passenger capacity has also increased with Citilink, a subsidiary of Garuda Indonesia, commencing scheduled services in mid-2017 and a new international route from Dili to Kupang, Indonesia opening in late 2017. Total aircraft movements, including domestic flights, stood at 856 in the third quarter of 2017, the highest quarterly level recorded to date. However, export shipments of coffee, Timor-Leste's main non-petroleum merchandize export, have fallen sharply in 2017 compared to 2016. The value of coffee shipments has been highly volatile over years, dependent of variable weather and crop management. In-year merchandize import data is particularly difficult to interpret for 2017, with the strong growth in reported nominal import values likely to be due to changes in port management and reporting behavior over the year (see the Trade section below for more details). But with falling investment and weaker consumption, volumes of imports are expected to be lower in real terms than 2016, with constant price net imports falling projected to fall by around 8 percent over the year.

Figure 3. Growth to 2016 has been mainly a story of public sector expansion (Contribution to overall GDP growth, constant price)



Definitions and notes
Agriculture, etc: *Agriculture, forestry & fishing*
Public-led sectors: *Sectors either wholly or mainly financed by government (public admin, other service activities, construction)*
Private sector services, etc: *All other sectors*

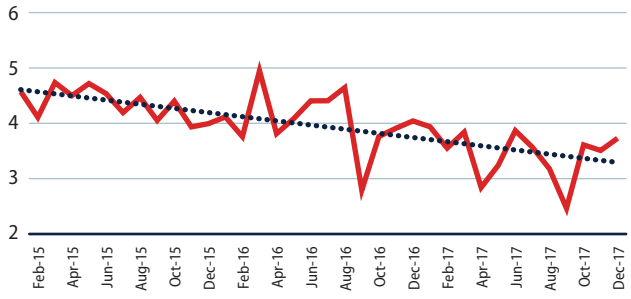
Source: General Directorate of Statistics, MoF GoTL

OFFSHORE OIL PRODUCTION REMAINS ON A DECLINING TREND, BUT STRONG PETROLEUM FUND RETURNS LIFTED GNI

The offshore petroleum sector, not part of GDP presented here due to its disputed sovereignty status, continues to decline, with a year-on-year fall in production in 2017 of 15 percent. Petroleum production levels peaked in 2012 at nearly 75 million barrels of oil equivalent (mboe) from two fields, but as of 2017 production was down to 42 mboe, with only one field remaining active.

An alternative measure of GDP, which includes both onshore economic activity and a pro-rated amount of activity from the offshore oilfields (where sovereignty is shared with Australia) is expected to have grown by 1 percent in 2016 before contracting by approximately 10 percent in 2017 in real terms.

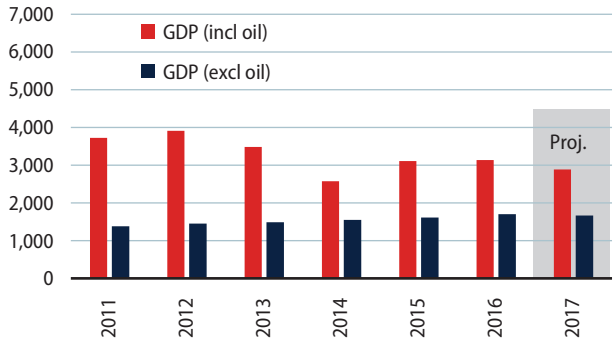
Figure 4. Offshore petroleum production is steadily declining (Monthly petroleum production (million barrels of oil equivalent))



Source: National Authority for Petroleum and Mineral Resources Timor-Leste

Gross national income is volatile, driven by both income from offshore petroleum production and returns from Timor-Leste's large sovereign wealth fund, all of which is held offshore. With declining oil production, GNI has fallen from a peak of US$4.5bn in current prices in 2011 to US$2.3bn in 2016, and is projected to recover to US$2.9bn in 2017 on higher petroleum receipts following substantial repayments that were made in 2016.

Figure 5. Both mesaures of real GDP fell in 2017 (Gross domestic product, constant price US$m)



Source: General Directorate of Statistics, MoF GoTL & WB Staff estimates

Figure 6. ..while nominal GNI rose in 2017 (Gross national indocome, current price US$m)

Source: General Directorate of Statistics, MoF GoTL & WB Staff

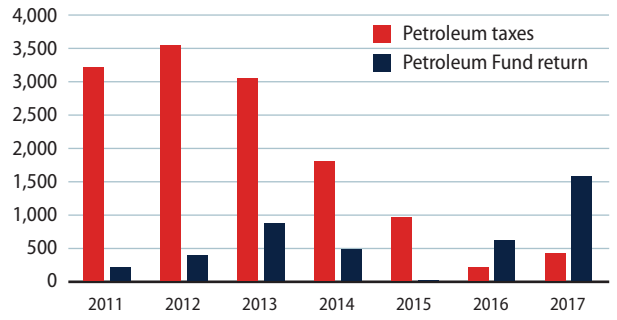
Definitions and notes
GDP (excluding oil): *Gross domestic product excluding the offshore petroleum-producing area where sovereignty is disputed*
GDP (including oil): *GDP including 90% of GVA of this area, following the convention in official GoTL National Statistics documentation*
GNI: *Gross national income equal to GDP (on either definition) plus net incomes from abroad*

UNABLE TO PASS SUPPLEMENTARY BUDGET LEGISLATION, GOVERNMENT HAS BEEN HIT BY A SEVERE CONTRACTION IN 2017

Despite an improvement in 2017, the smoothed, ESI-adjusted budget balance (explained below), is deeply in deficit and as national monetary assets are depleted, investment returns fall further. This deficit, unless addressed in the near-term, may lead to an increasingly unsustainable fiscal position which may then require a sharp and damaging adjustment at some point in the future. In that respect, the budget consolidation that occurred in 2017 is a positive development, particularly if it was able to protect high-priority expenditure.

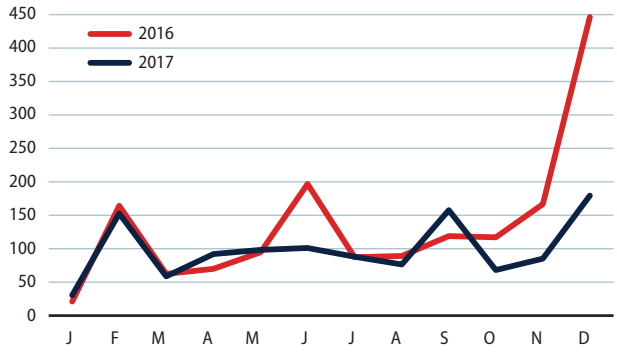
2017 was a strong year for government receipts overall, with tax revenue from the offshore petroleum sector and investment returns from the Petroleum Fund (PF) both strengthening. But this overall performance masks continued weak non-oil domestic revenue mobilization, and declined in 2017 as one-off factors in 2016 moved into the baseline, and the economy weakened. Revenue from the offshore petroleum sector is a combination of a number of different revenue streams, which can be broadly split into the categories of 'taxes', 'royalties' and 'profit oil', and receipts are sensitive to production levels but also prices and profits, so total receipts have been variable in line with changes in oil and gas prices in recent years. In addition, reported petroleum revenue is net of repayments, and in 2015 and 2016 the government was obliged to make repayments following historical overassessment of tax liabilities[3]. In 2017, these repayments have fallen and with market prices recovering, net petroleum revenues have recovered, rising from US$224m in 2016 to US$420m (Figure 7). The Petroleum Fund (PF), a sovereign wealth fund which receives all petroleum sector revenue receipts and provides financing for the government budget, was capitalized with US$15.8bn in resources at the beginning of 2017. All of this value is held in overseas assets, with a target value of 60 percent held in interest-bearing assets and 40 percent in equities. Investment returns to the PF have been very high in 2017, with a total change in valuation of US$1.6bn equating to an investment return of nearly 10 percent. 80 percent of the return has been due to growth in asset prices, while only 20 percent is interest and dividends. Factoring in petroleum receipts and government withdrawals, the balance of the PF ended 2017 at US$16.8bn. Domestic revenues are projected to have declined in 2017 to US$180m, or 10.7 percent of GDP as the high inland tax take of 2016, buoyed by one-off collections, is not repeated and higher indirect tax receipts are not enough

Figure 7. Petroleum revenues are now mainly PF investment returns (Petroleum revenues (US$m))



Source: National Authority for Petroleum and Mineral Resources Timor-Leste

Figure 8. Expenditure in 2017 was lower at the end of the year than 2016 (Monthly government expenditure in 2016 and 2017 ($m))



Source: Ministry of Finance, GoTL

Figure 9. Most public expenditures fell year-on-year over 2017 (Governement exependiture by component (annual % change))

Source: Ministry of Finance, GoTL

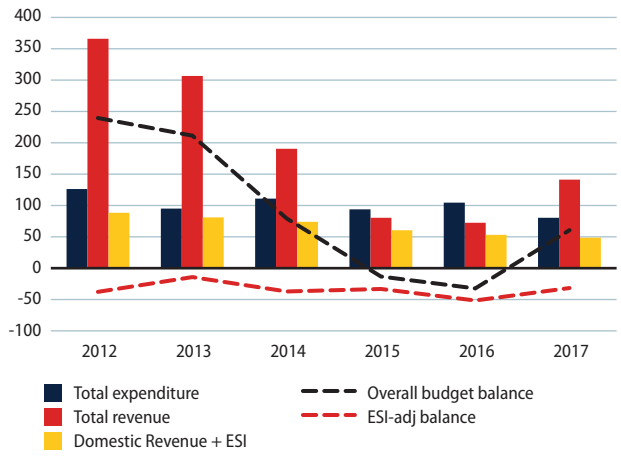
[3] These repayments relate back to historical tax assessments which have been challenged by the operators. An arbitration process under UNCITRAL rules was concluded in 2016 with an agreement for the authorities to repay an unspecified amount of over-assessed tax. To date, official data only reports repayments of around US$25m in 2015, but larger payments were reportedly made in 2016.

to offset the drop. Total receipts from all these sources and on-budget development grants were approximately US$2.4bn, around double the US$1.2bn in 2016.

Government expenditure, which reached an unprecedented level in 2016, has fallen back in 2017 due to both a more conservative budget laid at the beginning of the year, and the inability of the new government to pass a Rectification Budget (supplementary appropriation) in the latter part of the year. As Figure 8 shows, expenditure in 2017 was especially lower than the previous year in the last quarter, when budget resources became limited. Total expenditure, including on-budget development grants and concessional loan-financed expenditure, is estimated to have been just above US$1.35bn, 24 percent lower than the US$1.77bn expenditure in 2016. In fact, not only was there no rectification budget, but provisional full-year expenditure was almost US$200m lower than the original budget, suggesting weaker budget execution has also contributed to falling expenditure. While lower expenditure marks a positive move towards a more sustainable fiscal position, there are concerns that the unplanned and sharp nature of the decline this year might have negatively affected service delivery and business confidence. The sharpest fall has been in capital expenditure, which more than halved from US$600m in 2016 to US$250m in 2017[4]. Most of 2017 capital expenditure – around US$150m – went to road construction. Current expenditure also contracted, by an estimated 8 percent to US$940m in 2017 – only the second year in which current expenditure has dropped in Timor-Leste and by far the largest contraction in any year since independence. Wages and salaries were the only category of expenditure which grew in 2017, by 10 percent, reflecting an upwards revision to the civil service pay scales, with goods and services and transfer payments, both falling significantly. 2017 also marked the first year in which amortization payments fell due on concessional loans, which began disbursing 5 years ago. Since almost all government loans have interest payments capitalized while the loan is disbursing, as the loans close and begin repayment, the interest payments will also begin to appear on the government budget. Debt servicing is projected to have gone from a negligible level in 2016 to US$1.4m in 2017.

As it is driven by volatile trends both petroleum receipts and investments returns, the overall government budget position is highly volatile from year to year, and has been a relatively poor indicator of the underlying sustainability of the budget. While the overall budget balance moved into deficit in 2015 and 2016, it swung back in 2017, and moved to a projected 60 percent surplus. A better way to assess fiscal sustainability it to the use the Estimated Sustainable Income (ESI) as a smoothed measure of petroleum revenue. The ESI is set in Timorese law as the amount that can be sustainably drawn each year from the PF, based on latest assessments of existing and expected future petroleum wealth[5]. The annually-set ESI has been falling in recent years as the government has drawn down on the capital of the PF and the outlook for petroleum markets has deteriorated, as can be seen in the downward trend in "domestic revenue + ESI in Figure 10. While in 2013, the ESI was US$730m, by 2017 it has fallen to US$482m. The "ESI-adjusted budget balance", which is calculated as domestic revenue plus ESI less total expenditure, has been steadily deteriorating, although in

Figure 10. Despite an uptick in 2017, the underlying budget position lacks sustainability (Fiscal aggregates (% of GDP))



Source: Ministry of Finance, GoTL

Definitions and notes
Total expenditure: *Government-reported expenditure from all sources, including reported development partner spending*
Total revenue: *Government receipts from all sources including petroleum tax receipts, actual PF returns, domestic revenue and grants (but excluding loans).*
Overall budget balance: *Total expenditure less financed by total revenue*
ESI-adjusted budget balance: *Total expenditure less domestic revenue and ESI*

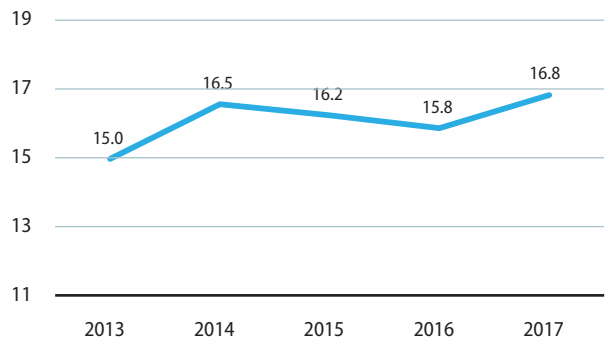
[4] 2016 expenditure includes a US$129.5m transfer of government funds to an oversea escrow account to guarantee its future commitments to the Tibar Bay project. Even when excluding this from the baseline, capital expenditure still fell in 2017 by 30 percent.

[5] It is calculated as 3 percent of the total value of petroleum wealth.

2017, the fiscal consolidation which has occurred has led it to recover from -52 percent of GDP in 2016 to -32 percent of GDP in 2017 (Figure 10).

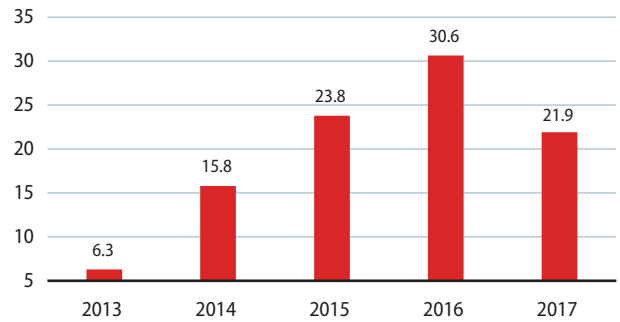
Budget financing to date in Timor-Leste has been overwhelmingly drawn from the PF. Total PF withdrawals over 2017 amounted to US$1,079m or 80 percent of total expenditure. Based on provisional fiscal outturn data, central government cash balances outside of the PF are estimated to have increased by just under US$100m over 2017. The only other source of budget financing was external borrowing of US$22m, all of which was on concessional terms from the Asian Development Bank, the World Bank and JICA.

Figure 11. The PF balance rose over 2017 after 2 years of decline (Petroleum Fund end of year balance (US$bn))



Source: Central Bank of Timor-Leste

Figure 12. External debt remains only a tiny fraction of total budget financing (Concessional external loan disbursements (US$m))



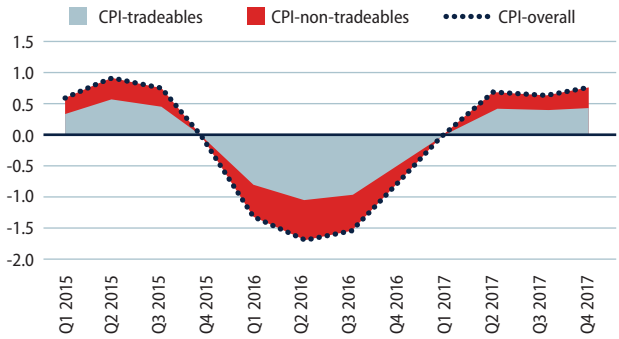
Source: Central Bank of Timor-Leste

DOMESTIC INFLATION IS LOW AND STABLE, BUT TIMOR-LESTE'S EXCHANGE RATE REMAINS STRONG

Annual average consumer price index (CPI) inflation has increased moderately over 2017 to 0.6 percent, from average deflation of 1.3 percent in 2016. Recent inflation trends have been largely driven by prices in the tradable sector, which saw marked deflation in 2015 followed by a reversal to inflation in 2016, following the trend in US$ exchange rate against the currencies of Timor-Leste's major importation partners such as Indonesia. To date, considerable spikes in oil prices since the beginning of 2016 have only moderately fed into consumer prices, as government subsidies and price regulation in the energy and petroleum sectors, respectively, have stabilized prices.

Timor-Leste uses the US dollar as its sole national currency. Over the last five years, the dollar has appreciated substantially against the currencies of many of Timor-Leste's major trading partners, such as Indonesia, Malaysia and Australia, although less so against the Chinese Renminbi, while inflation in Timor-Leste prior

Figure 13. Inflation remains low and mostly driven by the tradeables sector (Consumer price inflation (year-on year eop %), by tradeables and non-tradeables)

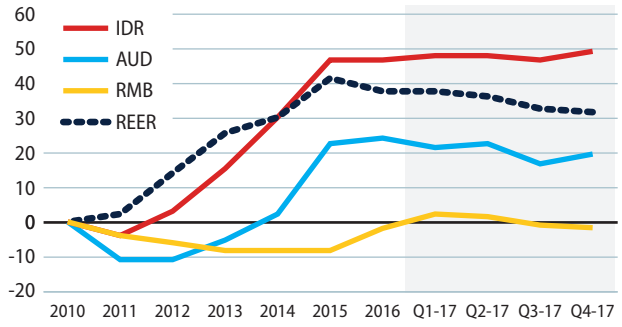


Source: General Directorate of Statistics, MoF GoTL

Definitions and notes
Consumer price index inflation: *Change in price of a representative basket of goods and services consumed by households in Dili and other municipality centers.*
Tradeable: *CPI sub-index that measures inflation of items that are subject to international competition.*
Non-Tradeable: *CPI sub-index that measures inflation of items that are subject to international competition.*

to 2014 was considerably higher that USA domestic inflation. Accordingly, Timor-Leste's Real Effective Exchange Rate (REER) has appreciated since 2010, driven by a combination of both factors. This has acted to lower the price and improve the competitiveness of imports to Timor-Leste. Timor's two major exports – petroleum products and coffee are traded in US dollar-denominated international markets so they are less directly affected by the REER shift. However, the competitiveness of other export sectors, such as tourism, has fallen with the strengthening of the US dollar. Although the REER remains heightened, it began depreciating again in 2016 by 2 percent and then a further 3 percent over 2017 with continued stabilization of the US dollar and very low domestic inflation in Timor-Leste.

Figure 14. The REER has decpreciated slightly in 2017, but remains elevated (Cumulative appreciation in exchange rates (percent since 2010))



Source: WB Staff estimates based on marker rates from OANDA and bilateral trade data from COMTRADE

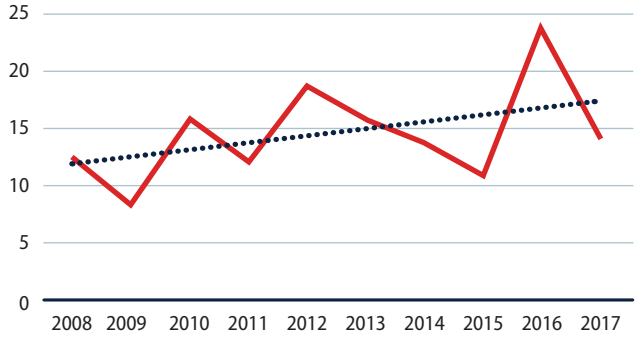
Definitions and notes
REER: *Real effective exchange rate, estimated based on Timor-Leste top 20 trading partners.*
IDR: *US dollar to Indonesian Rupiah nominal exchange rate*
AUD: *US dollar to Australian dollar nominal exchange rate*
RMB: *US dollar to Chinese Renminbi nominal exchange rate*

Timor-Leste's two significant goods exports are Liquid Natural Gas (LNG) and coffee. LNG prices have recovered by 9 percent over 2017, but they remain well below their level in 2015 and previous years, and supply remains high relative to demand. LNG prices are rebounding more slowly than crude oil prices, which rose 16 percent over 2017. Cumulatively, traded LNG prices remain 48 percent lower in December 2017 than at the end of 2014. The price of internationally traded coffee was broadly flat over 2016, with Arabica prices rising by 2 percent and Robusta by 0.6 percent. In 2017, Arabica prices have fallen around 8 percent, while Robusta has risen quite sharply by 24 percent. Given Timorese coffee is a unique hybrid of both varieties, the price it attracts is likely to reflect a combination of these trends.

COFFEE EXPORTS HAVE BEEN RISING, BUT WEAKENED IN 2017[6]

Coffee exports usually account for more than 95 percent of Timor-Leste's merchandise exports[7], but they have tended to be highly volatile from year to year, and this continues to be the case in 2017. Annual coffee exports reached a record high of US$23m in 2016, before collapsing in 2017 to US$14m (Figure 15), reportedly due to a particularly bad harvest contributed by poor rainfall. Over the longer term, despite the volatility from year to year, coffee exports from Timor-Leste seem to be trending upwards, with significant growth on average in nominal export values over the last 10 years. This indicates either increasing volumes or improved quality and value-added as internationally traded coffee prices over the same period have not shown similar growth.

Figure 15. Despite a bad year in 2017, coffee exports are trending upwards (Annual coffee exports from Timor-Leste, US$m)



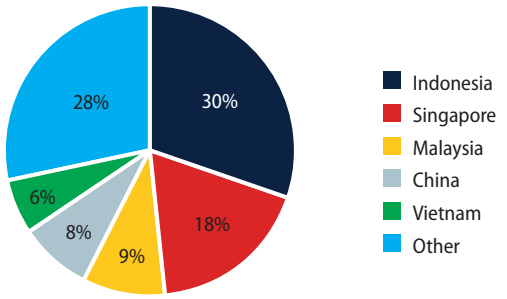
Source: General Directorate of Statistics, MoF GoTL

[6] We do not report current account or overall balance of payment information because there exist discrepancies in the official data, based on a lack of an agreed definition on the treatment of the Joint Petroleum Development Area for statistical purposes.

[7] Not including re-exports.

IMPORTS WERE UNEXPECTEDLY UP IN 2017, PROBABLY DRIVEN BY CHANGES IN REPORTING BEHAVIOR

Figure 16. Trade is increasingly with ASEAN neighbors (Percent of Timor-Leste's total mechandise trade, 2012-14)

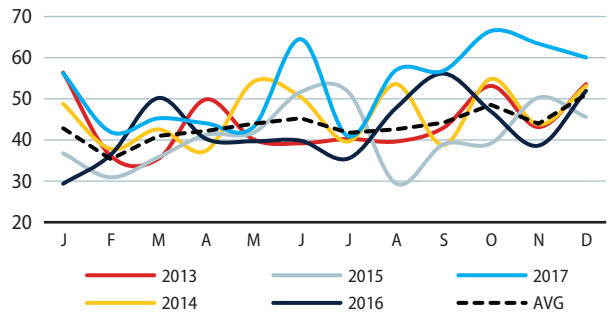


Source: UN COMTRADE

Timor-Leste generally has a high level of reliance on imports as a small country with limited domestic industry. In 2017, merchandise imports bucked the trend of muted economic activity by increasing sharply over the year, by 25 percent in nominal terms, to reach US$638m. This marks the highest recorded merchandise import bill since 2012 but is likely driven by changes in compliance at the port and reporting of imports in 2017, rather than an actual increase in the value of imports of this size. Imports were strong throughout the year, but were especially high in the last quarter of the year (Figure 17). With significant weakening of government expenditure, we would normally expect import demand to have weakened, so strong growth in imports seems at odds with other provisional 2017 data. Considering the typical seasonal pattern, imports in 2017 were unusually high in June and in the last five months of the year. This does not seem related to in-year trends in government activity since public expenditure was particularly constrained in the latter part of the year, while there are no obvious signs of increased private consumption or investment over this part of the year.

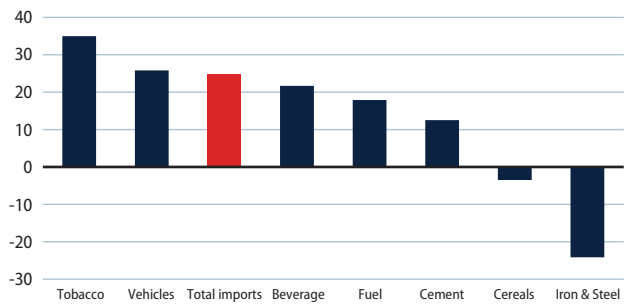
A possible explanation is that reforms underway at the port and in the Customs Authority, have led to reductions in under-reporting of import values. A new Customs Authority was established in May 2017 and in June, a new electronic clearance system, ASYCUDA World, became effective. Some of the largest increases in reported values are for commodities that are more highly taxed, which supports this explanation (Figure 18). Those items which attract both standard importation taxes but also an additional excise duty include tobacco, beverages (including alcohol), and vehicle imports showed the largest increase. Tobacco import values have grown by 35 percent year-on-year, beverages, has grown by 22 percent, and vehicles have increased by 26 percent.

Figure 17. Imports were unexpectedly high in the second half of 2017, probably due to changes in reporting (Monthly merchandise imports (US$m))



Source: General Directorate of Statistics, MoF GoTL

Figure 18. Higher-taxed goods registered the biggest growth (Percent change in nominal value of imports, by category for 2017)

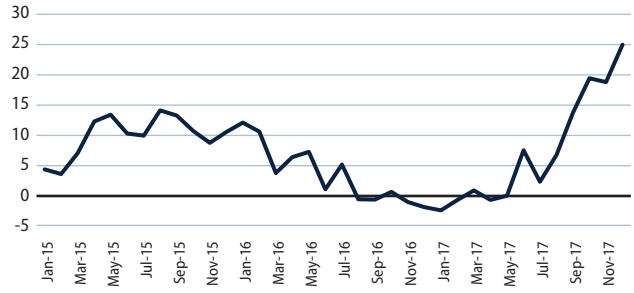


Source: General Directorate of Statistics, MoF GoTL

THE BANKING SYSTEM IS ADDRESSING LEGACY ISSUES AND PRIVATE SECTOR CREDIT BEGAN TO RISE AGAIN IN 2017

Credit to the private sector has been stagnant for some time as banks have struggled with a very large portfolio of non-performing loans (NPLs) and ongoing weaknesses in the financial sector regulation. However, 2016 saw a significant amount of the existing NPL portfolio written off, and private sector credit has started to grow rapidly again, increasing by 25 percent over 2017. While still high by international standards, the proportion of non-performing loans has fallen from 23 percent in 2015 to 15 percent in Q2 2017. Lending interest rates, though, remain extremely high due to a high-risk lending environment and the average spread between the lending and demand-deposit rate over 2016 was almost 14 percentage points and the credit to deposit ratio is very low, at less than 0.5.

Figure 19. Prvate sector credit has begun growing again (Private sector credit, annual percentage change)



Source: Central Bank of Timor-Leste

ECONOMIC INDICATORS

	Actual			Projection	Forecast	
	2014	2015	2016	2017	2018	2019
Real sector	(annual percentage change, constant prices, unless stated)					
GDP (excluding oil) growth	4.1	4.0	5.3	-1.8	2.2	4.2
Total consumption expenditure	8.5	1.6	2.9	4.3	2.6	3.2
Gross fixed capital formation	6.0	-3.6	16.0	-15.4	8.6	8.6
CPI inflation, annual average	0.7	0.6	-1.3	0.6	1.5	2.5
CPI inflation, end of period	0.3	-0.1	-0.7	0.8	1.5	2.5
GDP deflator	-1.3	6.4	0.4	1.0	2.0	3.0
External sector	(percentage of GDP excluding oil, unless stated)					
Export of goods and services	5.1	3.1	3.4	3.6	4.0	4.6
Import of goods and services	77.8	56.2	54.8	48.1	56.5	61.3
Foreign direct investment, inward (US $ million)	49.3	43.0	5.5	3.8	17.4	33.9
Nominal Effective Exchange Rate index	112.0	124.6	125.8	125.9	..	..
Real Effective Exchange Rate index	129.4	140.6	137.4	134.5	..	..
Government sector	(percentage of GDP excluding oil, unless stated)					
Total revenue	189.6	80.1	71.4	140.5	92.1	81.5
Of which domestic revenue	11.5	10.6	11.8	10.7	10.3	10. 2
Total expenditure	110.5	93.3	104.2	80.0	81.9	82.9
Current	62.8	64.3	60.4	55.8	58.3	56.6
Capital (including donor expenditure)	47.8	29.1	43.8	23.7	23.7	29.8
Overall budget balance (-ve indicates a deficit)	79.0	-13.2	-32.8	60.5	10.1	-1.3
Monetary and financial sector	(annual percentage change, unless stated)					
Credit to private sector	5.5	10.5	-1.8	24.8	..	..
Interest rate spread (percentage points)	11.9	12.9	13.3	12.5	..	..
Memorandum items	(US$ million, unless stated)					
GDP (excluding oil)	1,454	1,609	1,702	1,688	1,760	1,888
GDP (including oil)	4,045	3,104	2,521	2,955	2,660	2,594
Gross national income	3,345	2,805	2,278	2,915	2,710	2,728
GDP (excluding oil) per capita, US$	1,200	1,292	1,338	1,299	1,326	1,394
GNI per capita, US$	2,760	2,253	1,790	2,244	2,042	2,015
Oil production (million barrels oil equivalent)	45	48	49	42	27	20
Petroleum Fund closing balance	16,539	16,218	15,844	16,799	16,922	16,910
Estimated Sustainable Income	632	639	545	482	540	529
ESI-adjusted balance (% of GDP)	-36.9	-33.0	-52.0	-31.5	-35.1	-38.8
Debt stock (face value)	22	46	77	99	183	261

Unless stated, GDP refers to GDP excluding the offshore petroleum sector

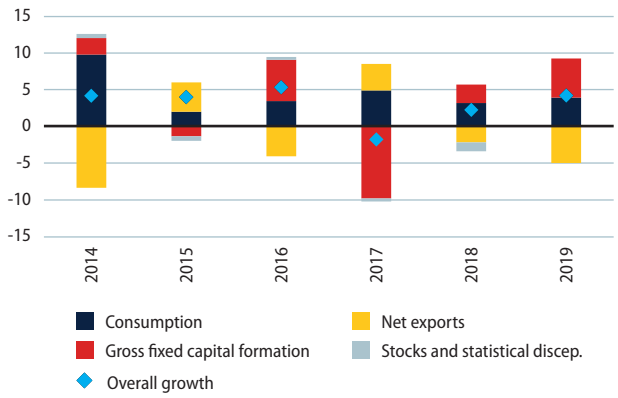
PART 2.

OUTLOOK AND RISKS

THE OUTLOOK IS UNCERTAIN, HINGING ON THE COURSE OF POLITICAL EVENTS, AND GROWTH IS EXPECTED TO BE MUTED IN 2018

The outlook for growth in 2018 depends on how the political situation evolves over the year, as this will have a bearing on both the capacity of the public sector to deliver public services as well as the program of the government. With new parliamentary elections to be held in 2018, it is unlikely a 2018 budget will be approved until after a government is formed sometime around the middle of the year, and there could be an ongoing period of slower economic activity. From the lower base of 2017, positive growth is expected to return in 2018, but at 2.2 percent, it is lower than the 4 percent forecast 6 months ago due to continued slow government spending in the first half of the year. The return to growth would be driven by a moderate rebound in government expenditures – particularly in latter part of the year. While the outlook further ahead will be strongly affected by the program of the incoming government, a gradual continuation of historical government policy and recovery in private sector confidence is expected to see growth of 4.2 percent in 2019.

Figure 20. Consumption is expected to maintain growth in 2018 and beyond (Contribution to overall GDP growth, constant prices)



Source: General Directorate of Statistics, MoF GoTL & WB Staff estimates

WHILE CLEAR OPPORTUNITIES EXIST, ACTIVITY WILL REMAIN SUBDUED, AS THE COUNTRY UNDERGOES A PERIOD OF POLITICAL UNCERTAINTY

The outlook for the private sector is now more uncertain than it was six months ago, and reestablishing regular government operations would be important to strengthen confidence in the positive future trajectory of the economy and re-establish growth. FDI stands at its lowest levels than any time in the last 10 years. Some projects which were slow to get started in 2017, such as the new Tibar Bay container port development, may start in earnest in 2018, while other going projects, such as the new Hilton hotel, will continue. Together with ongoing smaller scale investments, particularly in the Dili area, this means that inward investment levels are expected to recover modestly

in 2018 and assuming a normalization of government operations and new government program launched, continue to gather pace in 2019. A number of relatively large projects are currently under discussion in the tourism and light manufacturing sectors which are not explicitly included in the forecast, and should these projects become confirmed, the private investment outlook may strengthen further.

OVER THE MEDIUM-TERM, POTENTIAL FOR DEVELOPMENT EXIST IN OFFSHORE PETROLEUM, THE TOURISM AND COFFEE SECTORS

The medium-term outlook is uncertain because of the ongoing political impasse and the downturn in public expenditure and economy activity. However, business and adventure tourism is anticipated to be a potential source of increased demand in the coming years, although significant effort by both the public sector and private operators would be required to facilitate the sector's development. The number of international connections and flights from Dili have both increased in the last year, while modernization of the airport's management and facilities has begun. Supported by tourism infrastructure investments, a new civil aviation regulatory framework and a new tourism sector plan, major brands such as Hilton have committed to entering the market.

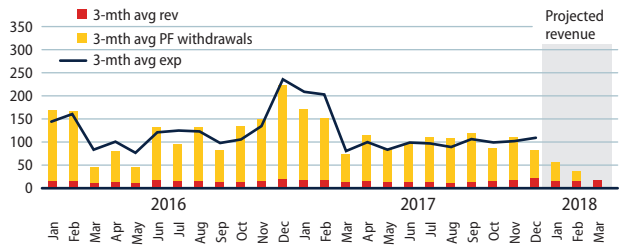
Merchandise exports, primarily coffee, face a number of constraints, including an uncompetitive exchange rate, low volumes, high costs of doing business and lack of investment. However, Timorese coffee does offer growth potential, as it occupies a niche as being the only Robusta-Arabica hybrid that is known to have developed naturally. Efforts underway now to support a new industry body to help to strengthen the brand of Timorese coffee and improve quality standards hold promise to support improved export values over the medium term.

The outlook for future offshore petroleum production reflects two factors. First, existing production in the active Bayu-Udan field is expected to continue to decline over the next three years before production is expected to cease around 2021, although three new infill wells are expected to be drilled later this year, which may temporarily boost production. Second, the outlook for further petroleum production in other fields remains highly uncertain. Although in the last year Australia and Timor-Leste have reportedly agreed a maritime boundary which could facilitate the development of an LNG project in the Greater Sunrise field, global conditions in gas markets remain depressed and it is unclear how soon such a potential project would move ahead, even in the absence of political barriers. After an investment decision is made, project development would take some years, placing the date for potential new production capacity to come online well beyond the forecast horizon of three years presented here.

OVER 2018, GOVERNMENT SPENDING IS EXPECTED TO REMAIN CONSTRAINED

The biggest driver in the short-term of headline GDP growth will be the government's expenditure program. Yet with neither a new government program nor a budget for 2018 approved at the time of writing, the direction of fiscal policy is unclear. Until a budget is approved for 2018, government expenditure is likely to be severely constrained. Budgetary law in Timor-Leste allows for a continuation of government expenditure in the absence of a budget on a month-to-month basis, with monthly appropriations of 1/12th the previous year's approved budget. However, it is not clear that a similar 1/12th rule applies to budget financing from the Petroleum Fund

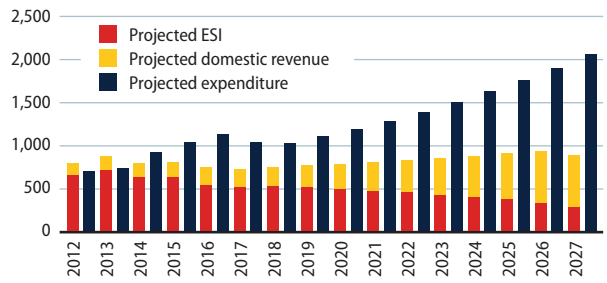
Figure 21. Cashflow will be severely restricted in 2018 until new PF withdrawals are authorized (Monthly receipts and expenses to the Government Consolidated Fund, US$m)



Source: Ministry of FInance GoTL, Central Bank of Timor-Leste & WB Staff estimates

(PF), which requires separate Parliamentary approval under the Petroleum Fund Law. With the government budget overwhelmingly financed from the PF, limited cash reserves and no established domestic financing sources, shortages of funds may lead to even lower expenditure over the year. Figure 21 illustrates the adjustment in the first quarter of 2018 on a three-month rolling basis. While the expected date of budgetary approval is unclear in 2018, expenditures would be expected to rebound after that time. Beyond 2018, expenditure growth is expected to resume, particularly with increasing capital expenditure and goods and services expenditure. These forecasts are based on a return to typical levels of expenditure, rather than forward estimates of expenditure drawn from the Government Budget, since no such estimates have been approved since late 2016.

Figure 22. Fiscal revenue is expected to remain fixed in nominal terms, while expenditures increase (Fiscal aggregates, US$m current prices)



Source: Ministry of Finance GoTL & WB Staff estimates

Revenue forecasts assume only limited additional domestic revenue mobilization effort, as planned tax policy reforms that were proposed by the previous government in 2015 have not progressed, and revenue as a percent of GDP is expected to remain below 12 percent, although improvements in administration at the customs and tax authorities are expected to provide some tax buoyancy. While lower spending has led to an increase in PF balances in 2017, and this may be continued in 2018, this uptick is expected to be temporary, and assuming that the government continues to finance the budget far in excess of the ESI, the PF balance is expected to decline again from 2019.

PART 3.

IN FOCUS - KEY FINDING FROM THE TIMOR-LESTE SYSTEMATIC COUNTRY DIAGNOSTIC:

PATHWAYS FOR A NEW ECONOMY AND SUSTAINABLE LIVELIHOODS IN TIMOR-LESTE

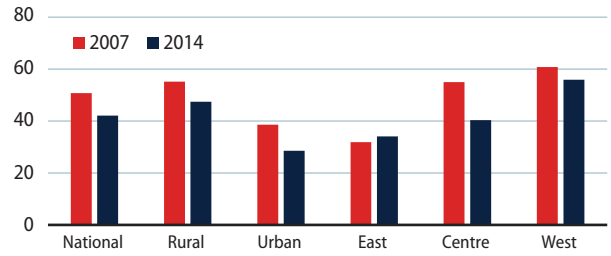
This focus note highlights a set of key constraints and areas of reform effort to support poverty eradication and shared prosperity, in line with Timor-Leste's national development goals, drawn from the recently completed Timor-Leste Systematic Country Diagnostic. This section summarizes selected key findings from the World Bank's recently completed Systematic Country Diagnostic, presents recommendations that would make best use of the opportunities that exist for Timor-Leste to achieve its development objectives as rapidly and as efficiently as possible.. Despite good development progress in a number of areas over the last fifteen years, a detailed review of performance against the goals of eliminating extreme poverty, boosting shared prosperity and a range of other national development goals shows still-severe constraints and point to a set of three pathways of change which could help achieve rapid and significant progress. These are: i) continuing to invest in human capital and improved service delivery; ii) sustained economic growth and private sector job creation; and iii) sustainable management of both the natural environment and public finances. This focus topic will provide some more detail of the constraints and means of addressing these constraints along each pathway[8].

Prospects for Timor-Leste will hinge on whether the country can continue to consolidate developmental gains, or becomes subject to the various destabilizing risks inherent in a fragile state. Timor-Leste has made great strides towards securing lasting peace and stability over the last fifteen years, having improved security and living standards and begun the long process of strengthening institutions and raising capital levels in the country. When Timor-Leste became the first new sovereign state of the 21st century in May 2002, all public infrastructure including roads, ports and airports, water and sanitation systems, and government facilities were either non-existent, destroyed or severely dilapidated. Correspondingly, there were severe shortages of human capital; few Timorese had government experience, or were equipped with adequate skills for professional services or business, and the general level of formal education of the population was very low. And Timor-Leste's institutional frameworks were exceptionally weak, as the country has undergone a series of markedly different institutional regimes in recent times. Extreme poverty and hunger were widespread and conflict and violence was an ongoing threat. Today, Timor-Leste is an a more peaceful, democratic nation yet poverty levels remain very high. In a context where a new national compact to secure peace and inclusion is only just emerging, there remain elevated risks that may thwart further development progress or even move the country backwards.

[8] This focus note draws on the findings of the recently completed World Bank Group Systematic Country Diagnostic for Timor-Leste.

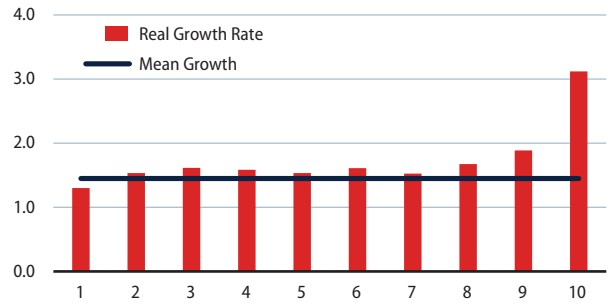
The imperative for action is clear, with Timor-Leste still experiencing very high levels of extreme poverty, hunger and child malnutrition, as well as low levels of formal education. More than 40 percent of the population is estimated to lack the minimum resources needed to satisfying basic needs in Timor-Leste, based on the latest household survey (Figure 23), and 30 percent of the population still lives below the $1.90 a day international poverty line. Coupled with this, various surveys indicate that half of all children suffer from stunting due to a lack of adequate nutrition, and calorie consumption across the population is very low. While all income deciles have seen some growth since 2007, the top decile has also seen the fastest increase in income (Figure 24).

Figure 23. Although extreme poverty has declined, it remains elevated (Poverty headcount rate (percent) at national poverty line)



Source: Timor-Leste Survey of Living Standards (TLSLS) publications

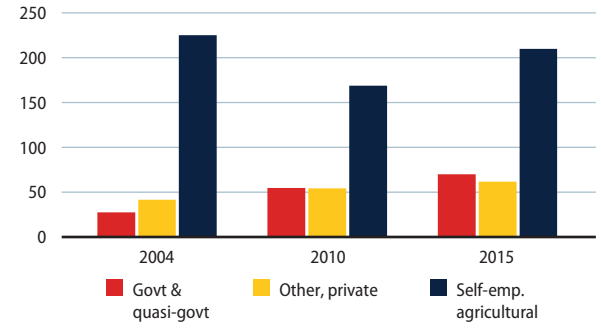
Figure 24. …while the proceeds of growth have benefited the richest the most (Annualized % consumption growth by decile, 2007 to 2014)



Source: Timor-Leste Survey of Living Standards (TLSLS) publications

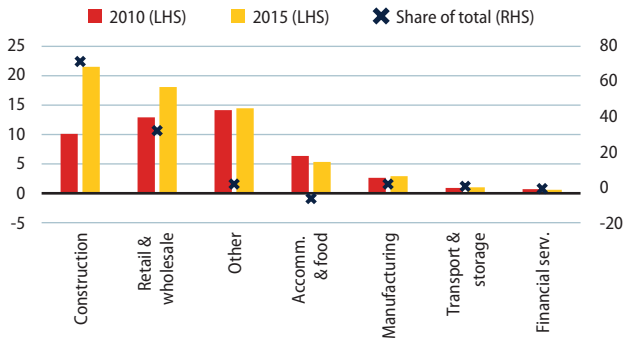
Timor-Leste will need to foster a private sector that can create jobs for its fast-growing working age population. Over the last decade, Timor-Leste has been able to create jobs, but this has largely been due to expansion of the public sector, while the majority of the population remain in the subsistence agriculture sector (Figure 25). Both a need to level off public sector expansion and an acceleration in working age population growth means that supporting the development of sustainable jobs in the private sector is urgent, both to take advantage of the potential of a demographic dividend to accelerate growth and prosperity, and to avoid the possible negative social impacts of a large and growing number of unemployed youths and adults.

Figure 25. Government expansion has driven job creation (Employment ('000 working age population))



Source: Census publications, multiple years

Figure 26. …with most new private sector jobs in construction and retail (Private sector job creation (000s) and share of employment growth)

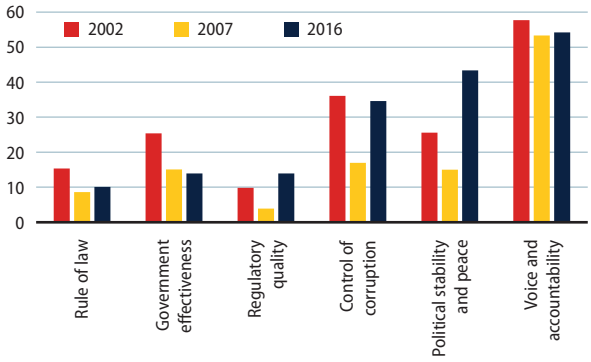


Source: Business Activity Survey, 2015

While Timor-Leste has succeeded in saving the proceeds of its natural resource endowment, the key challenge now is to ensure that these fiscal resources are well spent, and the natural environment is preserved as an important economic and social resource for future generations. Thanks to petroleum resource development, and the government's astute management of petroleum revenues, Timor-Leste now has a sizeable financial reserve to support development. Yet it faces risks and difficult decisions in how to spend this money in the most effective way that supports both rapid and sustainable development. With limited institutional capacity, there are risks that spending too much too quickly will lead to wasteful spending, which would not have the intended impact of securing lasting, shared prosperity. Aside a decline in from petroleum resources, a range of measures show that ecological depletion is proceeding in Timor-Leste at an alarmingly rapid rate., The government will need to stem the destruction of forest and mangrove, the loss of biodiversity, and the degradation of land to limit the negative impacts on livelihoods in the future.

In a young country with a fast-changing political and social landscape, there is a need to focus on strengthening institutions that create the enabling environment for good policy-making, economic prosperity and inclusivity. The development of public institutions that enable the private sector, provide public services and are accountable, is a long process that needs to be sustained over time. In Timor-Leste, a resource-rich country, there is a heightened risk that institutional development may become stalled by entrenched interest groups. While certain institutions, such as democratic and security mechanisms have improved rapidly, in many other areas there is far less progress and institutions are either lacking, ambiguous or unenforced (Figure 27). The impact of this institutional fragility manifests itself in weak public service delivery mechanisms and a private sector that is yet to show vitality. The 2017 World Development Report on Governance and the Law highlights the importance of institutional development and how political economy should be integrated into development programs, particularly for countries like Timor-Leste that seek to make the transition out of fragility.

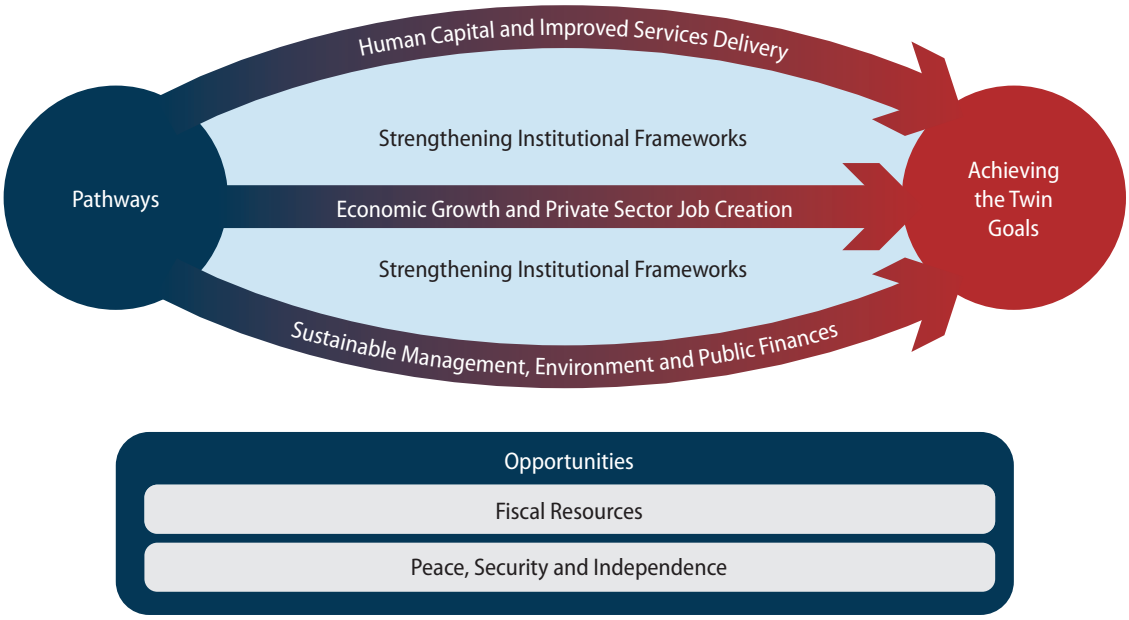
Figure 27. Governance indciators are weak and in some areas, declining (World government indicators, ranking in world)



Source: WB Worldwide Governance Indicators

The diagnostic identified several priority reform areas, set along three pathways towards achieving the goals of eliminating extreme poverty and promoting shared prosperity. The three pathways, discussed in more detail below, and summarized in the figure, and were identified from a growth diagnostic approach, adapted to focus on poverty and shared prosperity, and incorporating a broad range of quantitative and qualitative analysis. While the three pathways reflect distinct thematic areas of development policy, there are also strong interconnections between them and significant progress would be required to really achieve the twin goals and associated development outcomes. The identification of priorities is conducted mindful of existing development trajectories and opportunities in Timor-Leste. In considering Timor-Leste's short, medium and long-term prospects, it is important to factor in the historical perspectives that have shaped the country's development trajectory to where it stands today. Many – if not most – of Timor-Leste's main development challenges are rooted prior to independence in 2002 and the initial conditions at this turning point in its history. Many of these challenges are well-recognized and are being addressed, but the process to address them – developing capable and accountable institutions, and building human capital - is a long and ongoing one. A key cross-cutting theme that emerges from the diagnostics is the need to accelerate the pace of institutional development, which is judged to be of critical importance in many different areas. The analysis also highlights opportunities which place Timor-Leste in a stronger position to achieve their development goal – namely a significant, though finite, fiscal resource to support development and the relatively recent emergence of general peace and security and the absence of widespread violence or threat of violence throughout the country.

Figure 28. The pathways and priorities for action



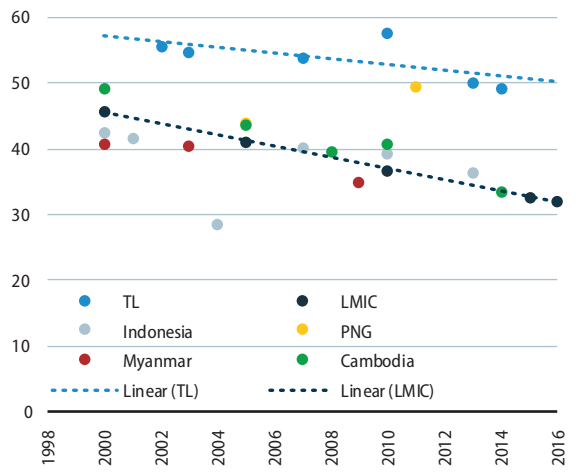
I. CONTINUING TO INVEST IN HUMAN CAPITAL AND IMPROVED SERVICE DELIVERY

Access to public services is improving, but Timor-Leste still faces huge public health and education challenges. Chronic malnutrition remains stubbornly high and is amongst the most severe in the world (Figure 29). While other health outcomes are poor, some are improving markedly. Rural populations still report very low levels of access to, and use of, health services (Figure 30), water and sanitation. While access to basic services has improved, it is not always fit for purpose and resourced properly. On paper, primary education has been extended to all, but a confusing array of languages and poor student attendance mean pupils are not gaining an education, while secondary education enrollment and completion is low. At the root of the persistent social development challenges is chronic poverty that is starkly manifested through high levels of hunger and malnutrition. Poverty, hunger and associated ill-health fundamentally inhibits households from make making investments necessary to access opportunities; good health and adequate education. Restricting the capacity of the government to address these problems is a weak system of allocating and delivering resources to local service delivery units, with long delays in budget and frequent stock-outs common. The Government operates generous social assistance programs, which do not directly target the most vulnerable. The program (Bolsa de Mae) which does target the poor provides only very small payments. As a result, overall social assistance spending is not having the significant impact on reducing poverty and inequality it could be having. Gender equality is relatively well reflected in law, but prevalence of violence against women remains extremely high, and women have more difficulties to access economic resources. Prioritizing the reduction of child malnutrition, planning and financial management of service delivery provision, and the extension of a targeted social protection program, are expected to have a strong impact in supporting the achievement of the twin goals.

The prioritized policy areas under this pathway are:

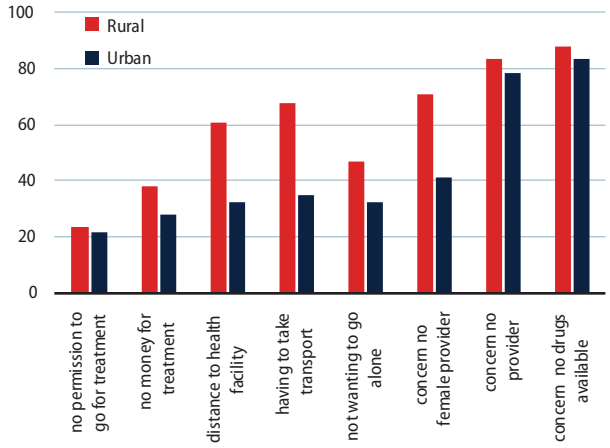
- ***Frontline services need to be better supported by adequate, timely and appropriate resourcing***
- ***Addressing malnutrition requires an integrated program, a critical component of which is addressing water and sanitation deficiencies in rural areas***
- ***Scale up targeted social assistance programs such as Bolsa de Mae to tackle poverty now and break the cycle of poverty***
- ***Ending gender-based violence***

Figure 29. Severe malnutrition is stubbornly persistent in Timor-Leste (Percentage of under-5s stunted)



Source: WB WDI and TLSLS 2014

Figure 30. ...and people have low opinions of public health services (Reason given by those not accessing health services in Timor-Leste)



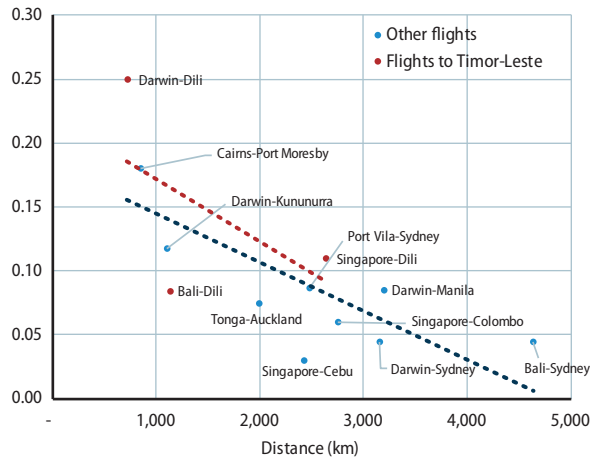
Source: DHS 2010

II. SUSTAINING ECONOMIC GROWTH AND PRIVATE SECTOR JOB CREATION

Timor-Leste needs to develop new engines of growth powered by the private sector. From a low level of development, Timor-Leste has grown quickly with the aid of petroleum revenue, but the current dependency on a public sector financed by finite petroleum wealth is not sustainable. It is necessary to develop substantial new markets to support jobs and a sustainable revenue base for public services. When petroleum exports cease, Timor will be left with a very small exports base, consisting of coffee and some tourism-related services. While Timor-Leste is less likely to see opportunities arise in internationally competitive, low value-added industries, it should seek to develop new international markets for its goods and services which effectively compete on quality or brand value. There are several small, existing markets that could be scaled up (such as coffee) or new economic sectors developed, for instance, tourism.

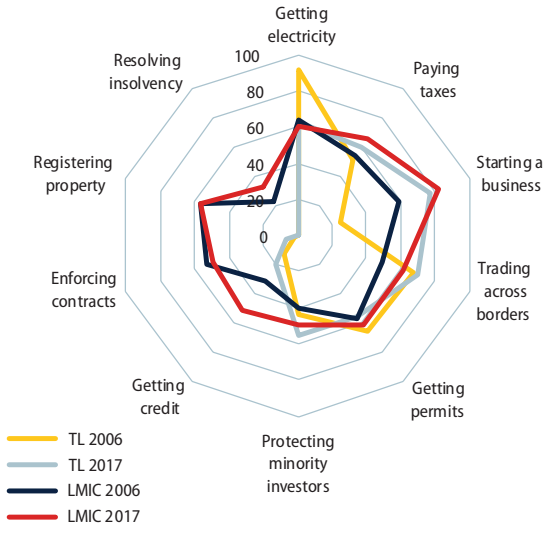
To ensure the private sector in Timor-Leste grows and reaches its full potential, the government has an essential enabling role to play. Successive governments have highlighted the priority of rebuilding Timor-Leste's connective infrastructure. New investment projects are needed, but should ensure value-for-money, while upkeep of the growing stocks of new public infrastructure assets will need to be planned and budgeted for. Figure 31 issues that international connectivity, particularly important for a small island state, remains costlier than in other small islands, due to weak infrastructure and sector regulation. Lack of, or ineffective, regulation is also a major constraining factor for business in Timor-Leste (Figure 32). An economic policy could focus on: i) removing critical, nationwide constraints for business to operate more easily; ii) developing sound sectoral regulatory regimes; iii) investing resources in key sectors in partnership with private companies. An approach of this kind would enable the private sector to lead the way in market development, with the public sector providing an essential, facilitating and regulatory role. An improved enabling environment – economic, legal and regulatory – for business is expected to support more domestic and foreign private investment, which will in turn create jobs and incomes for Timorese. This will also facilitate private sector solutions where increased commercial financing maximizes the impact of public resources, instead of the public sector directing resources into specific sectors or firms that may never become viable. In providing sustainable livelihoods, Timor-Leste will also have to balance the need to develop new markets which will take some time, and to improve prospects for the majority of the population, who are still mostly in the subsistence agriculture sector.

Figure 31. Air transport fare costs to Timor-Leste are higher than comparators (Total airfare cost per distance (US$ per Km))



Sources: Skyscannet.net; KAYAK

Figure 32. Costs of doing business are high (Doing business[10] – distance to frontier socres by component)



Source: Doing Business Survey, multiple years

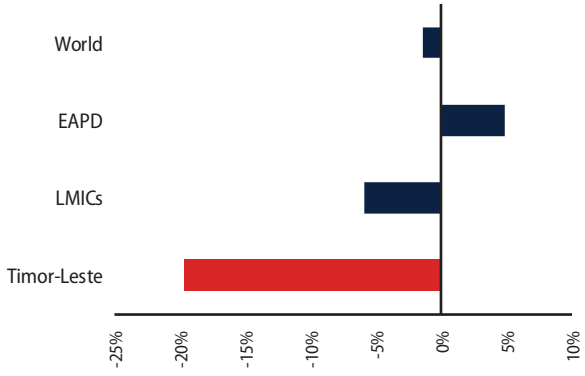
[10] This chart presents 'distance to frontier' scores which range between 0 (worst performance) and 100 (in line with best global performance).

The prioritized policy areas under this pathway are:

- ***Identifying an economic strategy to sustainably increase private sector growth***
- ***Strengthening the legal foundations of a market economy***
- ***Increasing productivity in agriculture, fisheries and forestry***
- ***Developing multi-purpose, appropriate and resilient connective infrastructure***

III. SUSTAINABLE MANAGEMENT, OF BOTH THE NATURAL ENVIRONMENT AND PUBLIC FINANCES

Figure 33. Deforestration is occuring extremely rapidly (% change in forest coverage, 2000-2015)



Source: WB WDI

There is a high risk that Timor-Leste's development gains could be undermined by the need to consolidate the budget in future, while the natural environment which is critical for livelihoods is subject to substantial stress. The government's existing fiscal strategy is high-risk, as it is based on running down fiscal assets now in the hope of spurring economic growth and government revenues in the future. Risks should be mitigated as much as possible, aided by robust analysis of planned growth-enhancing investments, and strengthening of domestic revenue mobilization capacity, both of which will be essential for a transition to a sustainable budget financing model. The vast majority of Timor-Leste's livelihoods are currently directly dependent on natural resources and the environment, and these assets can support new and improved sustainable livelihoods in the future – notably higher-yield agriculture and tourism. But in an already precarious ecological environment of a small island, poverty, conflict and resource extraction have led to rapid environmental degradation. Figure 33 shows the extremely rapid rate of deforestation in Timor-Leste. In addition, Timor-Leste's fragile ecosystems endure relatively severe weather variations. A focus on protecting and strengthening natural assets and environmental systems will help reverse this trend and ensure these valuable sources of livelihoods are maintained.

The prioritized policy areas under this pathway are:

- ***Public finances need to be very carefully managed to avoid a damaging fiscal cliff***
- ***Natural landscapes, seascapes and ecosystems should be managed as valuable, sustainable resources***

CROSS-CUTTING THEME OF STRENGTHENING INSTITUTIONAL FRAMEWORKS

A common theme to all three pathways is the need for continued institutional development in Timor-Leste. Notwithstanding the gains made since independence, institutional fragility remains at the core of many of Timor-Leste's biggest challenges. A recognition of where these fragilities exist and how to address them in an appropriate and sustainable way, will be one of the most important enabling factors in achieving real progress against each of the pathways. Institutions in this context are referred to as the set of organizations, laws, rules, practices and systems overseen, if not implemented, by the state that are used to structure society, enforce law and delivery public goods and services. There are a variety of specific cases of institutional weaknesses that are considered as part of the full diagnostic. These include the need to improve the capacity of the justice sector to enforce commercial disputes in additional to criminal justice, improving the efficiency of public resource management to enable higher quality public services to be delivered nationwide and the strengthening of frameworks to ensure the sustainability of natural resources, such as fish stocks, forests, soils and watersheds. Additional details can be found in the World Bank Systematic Country Diagnostic for Timor-Leste, available online at [insert hyperlink here].

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