

EAST TIMOR ECONOMIC UPDATE

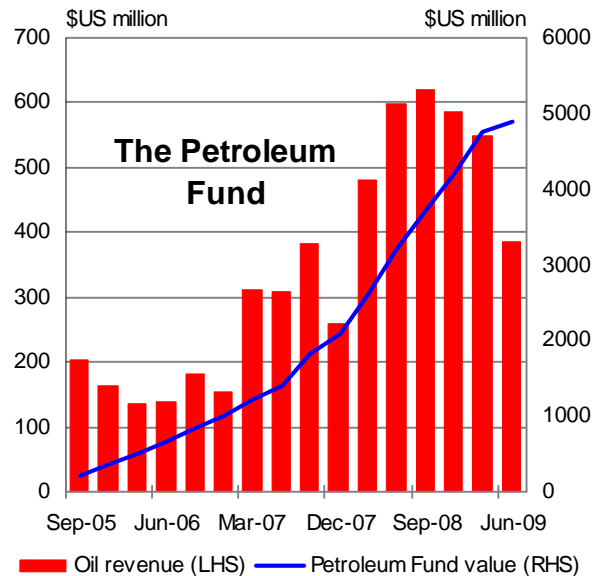
SUMMARY

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- The **Petroleum Fund**, established in 2005, receives all oil revenue and is currently worth US\$4.8 billion (841 per cent of non-oil GDP). The Fund currently invests in US Treasury bonds leaving it untouched by recent equity market falls.
- In 2009, for the first time, the government will withdraw more than the **estimated sustainable amount** from the Petroleum Fund. Transfers are unlikely to return to sustainable levels until 2012.

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Government and UN operations

The East Timor government and UN operations account for 45 per cent of GDP. The government receives substantial revenue from oil and gas production – over the last four years it has averaged \$1.3 billion (270 per cent of GDP) annually. This revenue is placed in the Petroleum Fund (see Box 2) from which the government is expected to take a sustainable amount to fund its Budget. A tiny portion of expenditure is funded by domestic taxation.

¹ All dollar figures are US dollars.

² IMF Art IV

³ ADB ADO 2009

⁴ FAO/WFP

⁵ ABD ADO 2009

BOX 1: THE OIL AND GAS SECTOR

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⁶ 2009 Budget, p119.

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External position

Thanks to the oil and gas sector, East Timor maintains a strong external balance. The current account balance has averaged above 200 per cent annually over the last four years. The non-oil merchandise trade deficit, however, continues to widen as government expenditure increases. Even after significant growth in the production of coffee (the vast majority of non-oil exports) in 2008, non-oil merchandise exports totalled just 2 per cent of GDP. Imports were equivalent to 18 per cent of GDP.

Currency

The US dollar was adopted as the official currency in January 2000. Small denomination Timorese coins were introduced in November 2003 to encourage greater monetisation of the economy.

The US dollar has served East Timor well. Its adoption has avoided the problems of currency convertibility and monetary instability and has allowed the Petroleum Fund, which invests primarily in US bonds, to be protected from currency risk.

While it has removed a substantial public policy lever, significant fiscal policy freedom and an undeveloped financial sector mean this loss has had no significant cost. With no independent monetary policy, domestic inflation is largely determined by inflation rates in trading partners.

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⁷ ADB 2008 ADO

⁸ ADB, Key Indicators for Asia and the Pacific, 2008. World Bank – ‘An estimated 75 per cent of the population was displaced and nearly 70 per cent of all buildings, homes, schools etc were destroyed...’

⁹ Ibid. and WHO report ‘The independence of East Timor in August 1999 led to an influx of 290,000 refugees into West Timor’ and Wikipedia – ‘300,000 forcibly pushed into West Timor as refugees’

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BOX 2: THE PETROLEUM FUND

The introduction of large-scale oil production in 2004 resulted in significant revenue increases for the East Timor government. Originally revenue from Timor Sea production was placed in the First Tranche Petroleum account (the 'Timor Gap' account) held at the East Timor Banking and Payments Authority (BPA), and in consolidated revenue.

The Petroleum Fund was established in August 2005 to improve management and investment of oil and gas revenue.¹⁰ Managed by the BPA, its current custodian is the investment bank J. P. Morgan (which replaced the Federal Reserve Bank of New York in June 2008).¹¹ Royalties and tax revenue from the oil and gas sector are automatically placed in the Fund. At the end of March 2009 the Fund was worth \$4.75 billion.

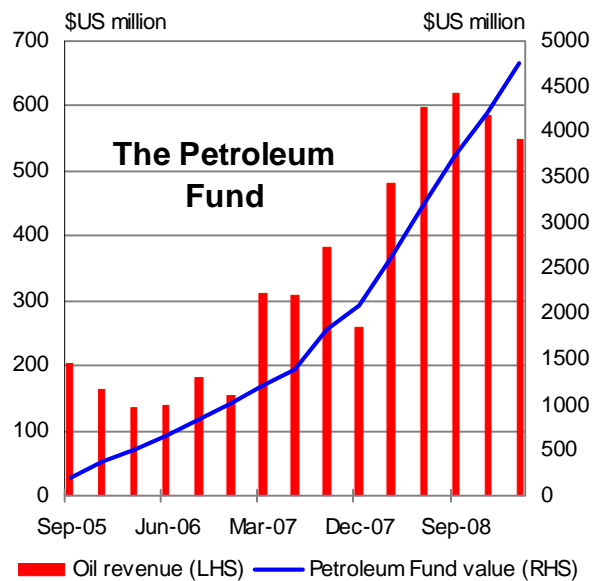
All investments are currently made in AAA-rated US government debt instruments (although legally 10 per cent of the fund may be invested in equities).

Section 33 International Relations

The safety of the Fund's investments, however, has seen it outperform other sovereign wealth funds (SWF) recently. While Norway's SWF lost 23 per cent of its value in 2008 and Singapore's 31 per cent, the Petroleum Fund doubled in size.

In the absence of extenuating circumstances, the government is unable to withdraw more than the Estimated Sustainable Income (ESI) annually from the Fund. The ESI is designed to ensure a constant stream of revenue from the Fund in perpetuity and is set at 3 per cent of petroleum wealth (ie the balance of the Fund plus the net present value of future petroleum revenue). If the government wishes to withdraw more than the ESI it must provide a 'detailed explanation to parliament of why it is in the long-term interests of East Timor'.¹² This explanation can be challenged in court.

In 2007, the Peterson Institute for International Economics ranked the Petroleum Fund third (out of 32) on its list of SWFs, finding that the Fund had excellent structure, governance, and transparency and accountability.¹³



¹⁰ First quarterly report, 30 September 2005.

¹¹ The First Tranche Petroleum account (the "Timor Gap" account) combined with \$125 million from consolidated revenue provided the Petroleum Fund with an opening balance of \$205 million.

¹² East Timor Petroleum Fund Law, Law No. 9 /2005

¹³ <http://www.iie.com/research/topics/hottopic.cfm?HotTopicID=11>

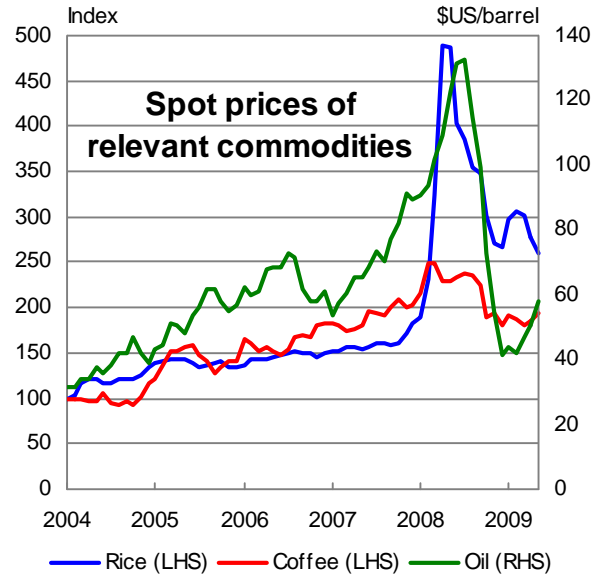
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The 2009 Budget assumes an oil price of \$60 and an ESI of \$408 million. The 2009 average oil price to date is \$51 a barrel. If oil prices average \$60 over the next 5 years, as the World Bank is forecasting, one year of low oil prices will only reduce the ESI by about \$10 million. However if oil prices stabilise at \$50, the ESI will fall more than \$80 million.

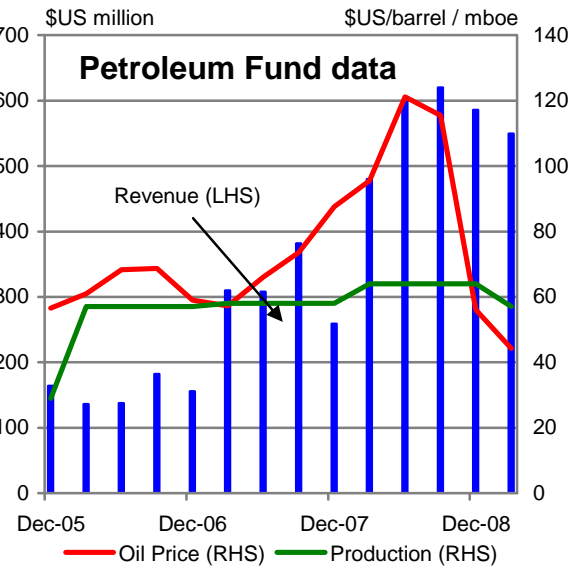
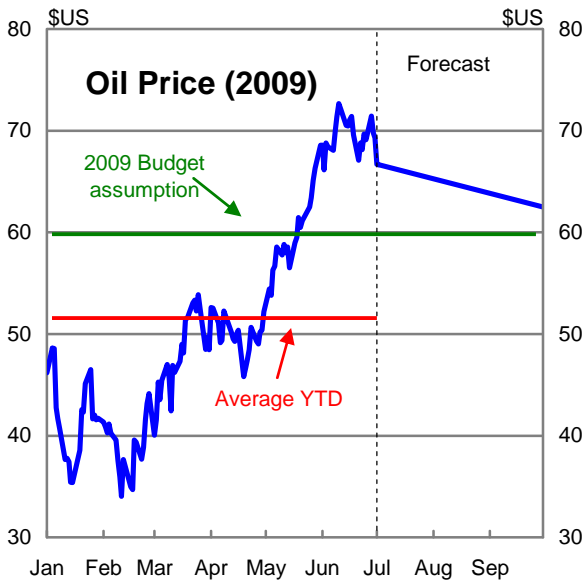
As the budgeted withdrawals from the Fund exceed the ESI in 2009 this is unlikely to affect the government's behaviour. An oil price of \$50, however, particularly in conjunction with drawdowns above ESI, will limit future expenditure.

The extent of the impact of falling oil prices has not yet been felt by the Petroleum Fund due to the lagged manner in which revenue is received.

Revenue will be further hit this year as Bayu Uden production falls to a forecast 57 million barrels of oil equivalent (mboe) from 64 (mboe) in 2008.



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Section 33 International Relations

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