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One Instrument, Many Targets:

Timor-Leste's Macroeconomic Policy Challenge

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It is difficult to be sanguine about Timor-Leste's progress towards achieving the localized Millennium Development Goals (MDGs). The share of people living under the national poverty line increased from 36 per cent in 2001 to 50 per cent in 2007. The maternal mortality ratio remains unacceptably high. About half of the children are underweight. In Dili, the capital, 58 per cent of the youth have no jobs (Government of Timor Leste and UN, 2009). Can Timor-Leste scale-up MDG-related investments?

The good news is that the country has been blessed by offshore oil and gas fields. Resource revenues rose from US$29.5 million in 2002 to US$993.1 million in 2006. The government followed the Norwegian model and set up a Petroleum Fund. The proceeds are invested in safe US government bonds at a 5–6 per cent return. As of June 2009, US$4.8 billion was accumulated in the fund and part of it was invested. The fund is expected to total US$8 billion by 2012.

The government withdraws roughly 3–6 per cent a year from the Petroleum Fund. This strategy ensures that temporary gains spread into future benefits, especially in the event of a fall in oil prices. In 2008, US$396 million was withdrawn. The government estimates that by the end of 2009 it will be able to withdraw US$589 million. The projections are based on oil prices of between US$40 and US$60 until the petroleum deposits are depleted a decade and half from now.

Essentially, the Petroleum Fund is what makes up government spending. Oil and gas revenues constitute 98 per cent of total government budget and nearly fivefold the value of GDP. Domestic revenue has been more or less constant since 2002. The table shows that without oil and gas revenues, the overall fiscal balance will drop to a deficit of 97 per cent of GDP. The not-so-good news is that the non-oil economy remains dangerously small and the country is dependent on a highly volatile and finite revenue source. The oil sector is an enclave that has virtually no linkages to the rest of the economy. It creates no employment for the domestic work force.

Our focus here, however, is on the macroeconomic challenges. Timor-Leste has adopted the US dollar as its official currency.[1] The absence of a national currency has constrained monetary and exchange rate policies. There is neither interest rate policy, nor broad money management, nor reserve ratio requirements.

Fiscal policy is the only effective instrument available to moderate inflationary pressures and expand MDG-related investments. According to the Banking and Payments Authority (BPA), yet to be transformed into a full central bank, food prices increased by 14 per cent in 2008. The inflation rate rose to 12.4 in July of the same year from 1.3 per cent in February, and averaged 9.2 per cent for the year. The consumer price index weight for food is 57 per cent. Public

Central Government Budget as Percentage of Non-Oil GDP

	2002	2003	2004	2005	2006	2007	2008
Oil and gas revenues	10	14	46	107	195	330	481
Domestic revenues	7	10	10	11	10	11	9
Expenditure	23	21	20	26	32	59	106
Non-oil fiscal balance	-5	0	1	-5	-21	-46	-97
Overall balance	5	14	46	102	174	284	384

Source: IMF (2008). *Country Report* 08/203 and *Country Report* No. 09/219. International Monetary Fund (Washington, D.C.). Found on IMF website <http://www.imf.org/>.

expenditure has more than doubled since 2002 but the government is planning major cutbacks in spending because of fears of further increases in inflation. The latest IMF Press Release stated that its staff "welcome the authorities' intention to reduce the spending envelope in the 2010 budget … and support the maintenance of the current monetary and exchange rate regime to preserve macroeconomic stability" (IMF, 2009). The argument is that oil and gas revenues, unlike tax revenues, do not reduce private sector income. Hence the expenditure is seen as adding to aggregate demand.

If macroeconomic stability is the overriding objective of fiscal policy, how is the MDG challenge to be tackled? A zealous anti-inflation policy will be socially counterproductive. The answer may lie in adopting monetary policy, which implies Timor-Leste having its own currency. This might resolve the trade-off between macroeconomic stability and poverty reduction. Subsequently, greater coordination of expansionary monetary and fiscal policies with exchange rate policy is required.

Fiscal policy could be used to scale-up public investment in rural infrastructure and increasing productive capacity to stimulate food supply as well as crowd-in private investment. In the short run, labour-intensive public work programmes can be effective. Monetary policy, through interest rates, can be used to crowd in private investment by improving access to credit. While the financial sector matures, the central bank could play the role of a development bank and an intermediary of last resort. A managed exchange rate could be used as an inflationary anchor and to create incentives for diversifying into non-oil activities. A coordinated macroeconomic policy would tackle the inflationary pressures without resorting to contractionary measures.

Note:

1. The government introduced coins that have equivalent values to US cents. The coins are issued for convenience rather than for their impact on monetary variables.

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