

## POLICY BRIEF

# Increasing Timor-Leste's Global Competitiveness



High inflation and appreciation of the US dollar, Timor-Leste's official currency, has reduced the country's external competitiveness. Photo credit: ADB.

*Raise the efficiency of public procurement and land and labor markets to boost productivity, and address growth constraints on agriculture and tourism.*

## Introduction

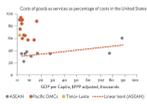
Although Timor-Leste shares some of the characteristics of Pacific island countries, it looks to Southeast Asia and the membership of the Association of Southeast Asian Nations (ASEAN) for a pathway to prosperity. Diversification of the economy through the development of tradeable sectors, such as agriculture and tourism, is essential for sustained growth. However, a high-cost structure and an overvalued real exchange rate make it harder to produce goods and services competitively.

This article, adapted from the July 2018 edition of the *Pacific Economic Monitor*, considers the factors that have contributed to Timor-Leste's recent loss of competitiveness and identifies policy measures to improve competitiveness in the medium term.

## Analysis

Goods and services in Timor-Leste are expensive compared with ASEAN member countries. The high costs reflect a small market, low economies of scale in production, and high trade costs, which are also faced by other developing countries in the Pacific.

## Figure 1: Price Levels and per Capita Incomes, 2016

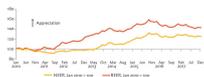


ASEAN = Association of Southeast Asian Nations, DMC = developing member country of Asian Development Bank, GDP = gross domestic product, PPP = purchasing power parity.  
Source: Asian Development Bank estimates using data from World Development Indicators.

Timor-Leste uses the United States dollar as its official currency, so the comparison of costs with the United States is not affected by exchange rate movements. However, competitiveness vis-à-vis other countries is affected by the exchange rate and has been undermined by a significant appreciation of Timor-Leste's nominal and real effective exchange rates since 2010.

A 2017 International Monetary Fund (IMF) assessment concluded that Timor-Leste's real exchange rate is overvalued by 26.6%–44.1%. Figure 2 decomposes the movements in the real exchange rate into nominal exchange rate movements and differences in the inflation rates between Timor-Leste and its trading partners. Since 2012, real exchange rate appreciation has been driven by the nominal appreciation of the US dollar. Inflation in Timor-Leste has been lower than that seen in key trading partners, but this has not been sufficient to offset the impact of a stronger US dollar. The real appreciation has not had a significant impact on the current production of oil, gas, and coffee, as these commodities are generally priced and traded in US dollars. However, it does add to the challenge of establishing new exports or developing local production to replace imports.

## Figure 2: Timor-Leste Nominal and Real Exchange Rates



NEER = nominal effective exchange rate, REER = real effective exchange rate.  
Source: Central Bank of Timor-Leste.

In principle, moving to an alternative currency regime, such as a peg to a trade-weighted basket of currencies, could help Timor-Leste achieve a more stable and competitive exchange rate. Many small states do manage their own currencies, including several Pacific countries with populations significantly smaller than that of Timor-Leste. However, recent assessments continue to conclude that use of the US dollar is appropriate, given capacity constraints and limited development of the finance sector (IMF 2017). This suggests that Timor-Leste is unlikely to move away from dollarization within the next 5 years.

It is therefore important to consider what else could be done to improve competitiveness and mitigate the impacts of a stronger US dollar. Maintaining low inflation is crucial. A previous episode of high inflation was seen during 2009–2012, where Timor-Leste’s inflation was significantly higher than other small states. The inflation spike was associated with a sudden increase in public spending that exceeded the local absorptive capacity. Price stability should, therefore, be incorporated as an explicit consideration in the formulation of fiscal policy. The inflation target of 4%–6% per annum, established in Timor-Leste’s Strategic Development Plan 2011–2030, should also be lowered.

A range of other policies can help to mitigate the loss of exchange rate competitiveness. Lowering transaction costs by investing in basic infrastructure and making financial intermediation more efficient are clear and widely recognized priorities. Efforts in these areas should be complemented by policies to improve productivity by increasing competition, improving the functioning of markets for land and labor, and working to address sector-specific constraints in agriculture and tourism.

## Policy Considerations

### Stimulating market competition through procurement reform

It is common for the public sector to account for a larger share of economic activity in small states because of indivisibilities in public service provision. Nonetheless, the size of Timor-Leste’s public sector makes it an outlier in Asia and the Pacific. During 2012–2017, annual government expenditures were, on average, equivalent to 87.2% of non-oil GDP. Of this, spending on goods, services, and capital projects averaged 54.3% of non-oil GDP. This expenditure represents the single largest source of demand for private businesses operating in Timor-Leste and means that government procurement practices are crucial in shaping the incentives for businesses to become more productive and efficient.

Policymakers recognize issues in procurement that need to be addressed. These include lack of competition, corruption, gaps, and ambiguities in the legal framework, and capacity constraints. Significant resources were invested in preparing a package of procurement reforms, including replacing existing decrees with single, updated procurement law. These reforms did not progress due to a change in political priorities, but should now be revisited to ensure that public procurement is as transparent and competitive as possible.

### Developing land markets

Challenges in accessing land can constrain productive activities and add to costs. In Timor-Leste, the history of Portuguese and Indonesian administration has resulted in complex overlapping land claims. The resulting uncertainty about land ownership is likely to have constrained the development of formal land markets and limits the use of land as collateral for borrowing thus impeding financial sector development.

A program to develop a national cadastre through spatial mapping and documentation of land claims began in 2015. This was followed by approval of new land law in 2017 that defines processes for

registering ownership and resolving competing claims. The land law and cadastral project pave the way for the establishment of a land registry, issuance of titles, and development of a formal market. This is an important enabler of commercial activity, but implementation will take time and disputes will need to be carefully managed.

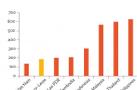
To date, the leasing of state land has been the most secure means for businesses to access land. Specific legislation regulates the leasing of state land and allows for leases of up to 50 years. By law, state property that is being made available for medium- or large-scale commercial activities should be offered to potential users on an open and competitive basis, but these provisions have generally not been implemented. Timor-Leste's Civil Code also enables leases between private parties. It is reported that uncertainty about underlying ownership has slowed the development of private leasing, but this is difficult to assess as there is no centralized registry for recording lease agreements.

While the implementation of the cadastral project will take time, clarifying the availability of existing state land and implementing more transparent processes for leasing this land could be done quickly. Consideration should also be given to strengthening the broader framework for land leasing and the potential to record lease agreements in a central registry.

### Increasing labor market efficiency

The availability of labor at various skill levels and costs is a key driver of competitiveness. Timor-Leste's labor regulations include a statutory minimum wage of \$125 per month (including 13<sup>th</sup>-month pay). Comparisons based on market exchange rates show that this is higher than minimum wage rates in some ASEAN members, and is high relative to GDP per capita. Increased competitiveness, therefore, calls for a slower pace of growth in nominal wages. However, adjustment to reflect differences in the cost of living between countries suggests that Timor-Leste's minimum wage is not especially generous to workers (Figure 3).

**Figure 3: Purchasing Power Parity-Adjusted Minimum Wage in Timor-Leste and Southeast Asia (\$ per month)**



Lao PDR = Lao People's Democratic Republic.

Sources: International Labour Organization, World Development Indicators, and Asian Development Bank estimates.

Recent increases in public sector wages may contribute to pressure to increase the minimum wage. However, any changes in the minimum wage should be based on careful analysis of the likely impact on current employees and businesses, and on the employment prospects of people who are not formally employed. Regulatory changes, such as a relaxation of current limits on the use of fixed-term contracts, could help to stimulate job creation and should be considered when labor laws are reviewed.

Where there are clear skills shortages, a facilitating approach should be taken to enable the employment

of foreign workers. Attention should also be given to strengthening training and skills development for local workers. At the same time, investments to strengthen secondary education and post-secondary technical and vocational education and training should be prioritized as this will help to improve the skills base and work-readiness of the working-age population.

## Raising agricultural productivity

Food products account for 64.3% of the nationally-representative household consumption basket, and 62.0% of the consumption basket for households living in Dili. This means that movements in food prices play a significant role in determining consumer price inflation, wage expectations, and the overall price level in the economy. Improving the productivity of the domestic agriculture sector can, therefore, contribute to improving overall competitiveness.

Subsistence and semi-subsistence farming systems are prevalent in Timor-Leste. Policies to stimulate domestic production through improved productivity should be given priority. There has been clear progress in developing domestic value chains of fruits and vegetables, but many inefficiencies remain. Improving basic rural infrastructure and intensifying the provision of market-oriented extension services can help to accelerate the adoption of improved technologies and the integration of small producers into markets.

There may also be scope for targeted policy interventions to increase the local production of grain, meat, and fish. Private entrepreneurs have begun to grow maize on large areas of previously uncultivated land on Timor-Leste's south coast. Increased grain production can be supplied to consumers and used as an input into locally produced animal feeds. Developing an efficient animal feed industry, using both imported and locally produced inputs, would help to promote production of both meat and fish, thus increasing the supply of these products and lowering their prices. The government can help to enable this by encouraging private investment in the agriculture sector, facilitating access to land and technical expertise, and working with entrepreneurs to resolve specific issues as they emerge.

## Growing the tourism sector

High costs are likely to deter price-sensitive tourists who can choose to visit cheaper destinations in Southeast Asia. With little prospect for an immediate restoration of exchange-rate competitiveness, efforts to develop tourism should focus on developing product offerings that are consistent with the overall cost structure, and implementation of sector-specific initiatives to reduce costs.

The cost of air travel to Timor-Leste from key markets such as Australia is relatively high and could be reduced through the licensing of additional air carriers. New carriers have expressed interest but may be deterred by perceived risks. In this case, risk-sharing arrangements between the government and private airlines during the trial phases of new air routes could be considered.

Efforts to develop new air routes should be closely coordinated with tourism product development and marketing. Hoteliers and tour operators should take the lead in this area with support and facilitation from the government. A well-coordinated marketing strategy would support a steady increase in tourist

arrivals. This would contribute to industry learning, improve capacity utilization in existing hotels, and help to achieve other economies of scale within the sector, leading to a gradual reduction in costs and improvement in the quality of the product offering.

## Conclusion

A period of high inflation during 2009–2012 and appreciation of the US dollar during 2012–2017 have reduced Timor-Leste’s external competitiveness. This will make it harder to develop new export sectors such as tourism, or to displace imports with local production. A move to an alternative exchange rate regime could be considered but is unlikely to be feasible in the short to medium term. This raises the question of how best to restore competitiveness.

Maintaining low inflation is key, but beyond this, there are no simple answers. Policy reforms to make public procurement more competitive, and improve the efficiency and depth of markets for land and labor, would help to boost productivity and restore competitiveness. Carefully considered policies in the agriculture and tourism sectors can also help to accelerate the development of these sectors and offset the impact of high costs.

## Resources

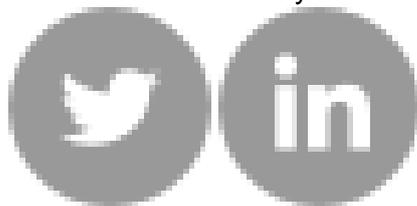
D. Freeman. 2018. Increasing Competitiveness in Timor-Leste. *Pacific Economic Monitor*. July. Manila: Asian Development Bank.



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Last updated: June 2020