The financial system of Timor-Leste: some characteristics and indicators

Note that...

? **A financial structure should cover the roles of the key institutional players, including the central bank, commercial banks and others financial institution**

? The importance of a country's financial system can be measured in two fundamental ways: through total value of its assets and calculating this value in relation to the GDP

? **Is necessary to guarantee from the beginning a solid bank system, because a weak system in the medium -long run would tend to be damaging to the functioning of our economy**

? The financing development may have sources through the domestic saving, loans, development aids and foreign direct investment

? **The savings are truly important only when they are transformed into** *productive investment*

? **Is very important the mobilization of domestic resources (domestic savings) to financing the development**

A country's financial system is one of the most important features of that country's economy. Timor-Leste is no exception and the purpose of this text is to outline key characteristics and indicators in our country's financial system.

A recent publication from the World Bank and the International Monetary Fund (*Financial sector assessment: a handbook*, Washington D.C., 2005) says that:

"[A country's] Financial Structure is defined in terms of the aggregate size of the financial sector, its sectoral composition, and a range of attributes of individual sectors that determine their effectiveness in meeting users' requirements. The evaluation of financial structure should cover the roles of the key institutional players, including the central bank, commercial banks, savings institutions, development finance institutions, insurance companies, mortgage entities, pension funds, and financial market institutions [such as the stock exchanges]".
(www.imf.org/external/pubs/ft/fsa/eng/index.htm, p.15)

In general, a financial system comprises the central bank and the commercial banks, but also other financial institutions such as insurance companies, pension funds, stock exchanges and eventually, development banks.

These financial institutions are of great importance in more developed countries but in most developing countries it is the central bank and commercial banks that have predominance.

The overall importance of a country's financial system can be measured in two fundamental ways: one absolute (the total value of its assets) and another relative, where these assets are related to the value of total production, which consequently calculates the weight of the financial sector in the total of Gross Domestic Product, which helps to compare the situation with other countries.

However, the value of financial assets and their weight in the overall of production can be obtained with different structures of the financial sector. Per example, the meaning of these totals will be different accordingly to the result of having, many small, some medium, or one or two large size institutions, within a country's economy. The degree of control of these institutions over the whole of the financial system – and national economy through it – depends on their dimension and it is not indifferent to a fi-

nancial system if it has one or many institutions operating in the country.

In the same way, it is equally important to know if these institutions are mainly commercial banks or other type of institutions.

In a dynamic perspective it is important to obtain information on the evolution of assets and the number and type of institutions, seeing as the different phases of economic development tend to correspond to the different structures of the financial system.

An aspect that influences this evolution is the policy followed by the national monetary authorities (usually Central bank concerning banks) and other entities (concerning other financial institutions). This policy includes simplifying conditions for "entrance in the market" of new financial institutions (by granting more licenses for the setting up of commercial banks, and approving the functioning of insurance companies, "stock exchanges", and other financial intermediaries such as investment banks and pension funds).

The financial system in Timor-Leste includes, as foretold in law, banks and insurance companies; however, none of these is still active.

Our banking system comprises the Banking and Payments Authority – BPA (which in fact is our central bank), three commercial banks – which in reality are three branches of foreign commercial banks, since there are no banks headquartered in Timor Leste –, and Micro-Finance Institution of Timor-Leste, which is a small institution, mainly commercial, that takes deposits and grants small loans.

Products and services offered by the bank and that correspond to their main tasks are the ones that result from their function as intermediary between depositor – people that have savings and put them in the bank – and those people in need of financial resources (credit) for their activities. A bank mainly exists to receive deposits from its clients and, based largely on those resources, grant loans to those that need them.

As for the evolution of our financial system over time, it has been slow but steady in terms of number and variety of institutions.

Some time after the transformations of 1999 that our country underwent, commercial banks have installed two branches in Timor-Leste, namely, an Australian and a Portuguese bank. Later on (in September 2002) the Micro-Finance Institution started operating and a year after the Mandiri bank.

During fiscal year 2004/2005 an application to establish another commercial bank was placed only to be refused for not fulfilling the necessary requisites, which was something that was not the first time it had occurred. Some might say that the present legislation is quite demanding but such was thought necessary in order to guarantee from the beginning a solid bank system, because a weak system in the long run would tend to be damaging to the functioning of our economy. It is only necessary to recall the Indonesian economic crisis of 1997/98 and the social costs that the financial rupture of some Indonesian banks had in the sequence of that crisis, making numerous people lose the money they had deposited in those banks.
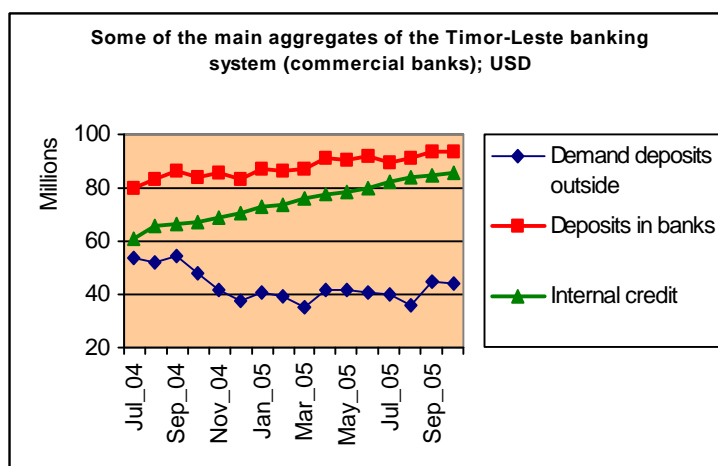
An important aspect of the financial system structure is the number of existing bank branches. BPA opened, in September 2004, a branch in Oécussi, a district that has a branch of a commercial bank. This same bank has seven more branches in the country, being two located in Dili and the rest of them in the capitals of some of the districts (namely Baucau, Gleno, Maliana, Suai and Viqueque). The other two larger commercial banks are solely branched in Dili. MFITL has branches in four districts, mainly in the country's western region: Dili, Maliana, Ermera and Aileu.

An indicator of the relative importance of the financial system, in the context of a country, is the correspondence between the amount of bank branches and the totality of the population. In the beginning of 2004 the population of Timor Leste was of 925 thousand inhabitants (Census of July 2004) and there were 10 branches of commercial banks, being the ratio of about 95 thousand inhabitants per bank branch. If to the branches of the biggest commercial banks we add the four from MFITL, the sum will be 14 and the ratio will lower to about 66 thousand inhabitants per branch.

It is important to note that due to the bank branches' location and our scattered population there is still a big part of the population without any access to the banking system (yet). Increasing the number of bank branches might help improve the banking system – at least one per capital of district? – and consequently make possible the access to the system of the population in general. However, this is a purely commercial decision on the part of banks and if they decide that such is not rentable, then the opening of new bank branches will not occur in places of little movement.

Another indicator of the financial system development that is usually mentioned in specialized text books is the one referring to the relative importance of bank assets in the whole system. Being that in our country the financial system presently includes only banks (central and commercial) this is an indicator of 100%, which is representative of the modest complexity of the system and the need to make it more complete.

The indicator that relates the total of bank assets with national production, GDP – Gross Domestic Product is also fundamental. According to the International Monetary Fund, in 2004 non-oil GDP was estimated in 339 million USD. If we take the total of the financial system's assets in June 30th 2005 (157 million USD), we obtain an approximate ratio of 46%. However, it is important to note that these aggregates' dates differ and therefore some (small) distortion in the figures may occur.

An important part (about 50%) of these assets represented credits from banks to clients, which at that time summed up 80 million USD. Noteworthy is the fact that bank loans had a remarkable evolution since January 2003, when they amounted to 5.4 million USD, increased to 26.4 million a year later and in January 2005 already totaled 72.4 million. This represents a credit increase of about 46 million USD in 2004 alone, which most certainly had a positive impact in economic growth and employment, given that some of these loans could absorb a part – although a small one yet – of our country's unemployment.

In December 2004 bank credit (granted in total by commercial banks) had a ratio vs. the GDP of about 21%, a significant increase when compared to the 6.6%, in 2003 (credit in December 2003 / GDP 2003).

Finally, another indicator of the importance of the financial system in any given economy is the percentage of deposits from the private sector (individual and business companies) in commercial banks vs. the whole of GDP. In Timor-Leste case and for the year 2004 this percentage was of 24.5%, given that the entirety of deposits made in December of 2004 was of 83 million USD.

In conclusion we can say that if a lot has been done in the last few years to improve the functioning of the financial system in our country, it is also true that there is still a long way to go, namely in diversification, and mainly in deepening of the financial products available to the public. The beginning of operation of insurance companies in the near future will be an important step in the process of deepening the role of the financial system in the national economy.

Some of the main aggregates of the Timor-Leste banking system (commercial banks); USD

Legend:
- Demand deposits outside
- Deposits in banks
- Internal credit

The Monterrey Conference, held in Mexico in 2002, focused on the needs to finance economic development. The subject was mainly the mobilization of national resources of domestic origin, those that do not depend on foreign economic operators.

It is important to point out that financing development may have the following main sources:

Domestic savings – family, industry or State generated;

Loans (usually by large companies or the State) obtained from international financial organizations (e.g.: The World Bank, Asian Development Bank; etc.) or from large global banks;

"Development aid" offered by the "partners in development" (international organizations, nation states, etc.); and, last but not least, *Foreign Direct Investment* (FDI)

These savings sources (domestic and foreign) are at the core of economic growth and poverty eradication in any country. Both of them (growth and poverty eradication) will increase with the increase of the financial resources mobilized to finance them; there is a cause-consequence relationship (in trend and rhythm) between the level of savings – or, better, their application through investments – and economic growth. Usually, the greater the investments/savings, the faster will growth and poverty reduction be.

If we look into our country historical background we will realize that its low stage of development is partially due to the reduced investment made along its History. The respective development financing sources, we will identify a common feature in all of them: investment was mainly external to the national economy.

With the recuperation of full independence in May 2002, however, since then until today, one can notice that the development financing has once again a prominently "external" characteristic: the aid given to us by our "partners in development", and the Timor Sea revenues (mainly since mid 2004).

It is not healthy for an economy to be excessively dependent on "external accumulation", and efforts should be made to increase internal economic financing resulting from the "normal" functioning of the national productive system and having its origin in households, the business sector and the State (not including savings from oil).

The purpose of this text is to not only to emphasize the importance of such "national savings" in turning development less dependent on the "external savings" it always relied on – and still does due to oil revenues and donors' support–, but also to point out some of the major mechanisms that can contribute to the increase of the savings rate from internal resources, not external ones. Some of these (mainly bank loans and FDI) will be the subject of our future analysis in another Bulletin issue.

The chart illustrates the importance of savings on the acceleration of economic growth rates. We notice that countries in East Asia, especially China, have the largest percentage of savings vs. national production. Regions as large as Sub-Saharan Africa and Latin America that have

the lowest annual economic growth rates are exactly those with lower saving rates – which are decreasing since the 1970's –, whereas those with the most rapid economic growth are also those with increasing saving rates.

But savings are truly important only when they are transformed into **productive investment**. In some countries, even the poorest ones – and Timor-Leste is one of them –, there is some capacity for saving. However, they are not transformed into productive investments, but rather into investments more or less unproductive, albeit socially important to "lubricate" the social relationships from which families are still largely dependent, due to the still strong importance of the "extended family". Such is the case of expenses with *barlaque*, wedding, christening and mourning ceremonies.

One fundamental aspect of the process of development
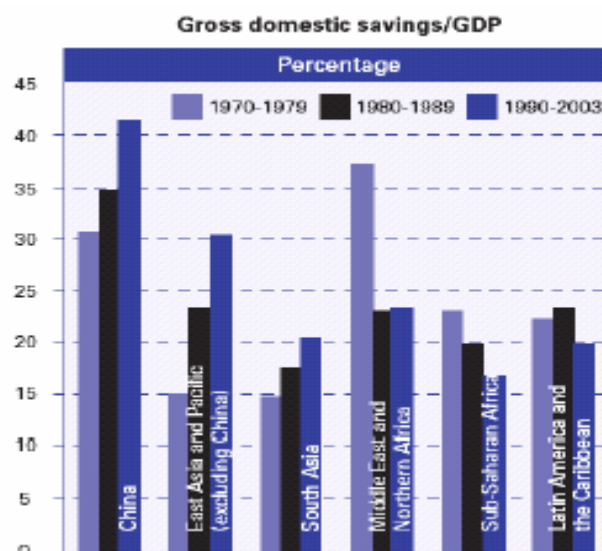
Source: World economic & social survey, UN

is to find mechanisms that enable the transformation of this important, albeit unproductive, family based social investment into a more productive one, generator of employment and new resources.

One way of achieving this is by encouraging investment in privately owned houses with characteristics that, by its improved quality vs. "traditional" houses, improve living conditions – including sanitation, and those with an impact in the population health.

Naturally, the increase in the income of households is also a determining factor in savings and investment. However, experience tells us that some of the countries with the highest saving-rates have comparatively low levels of income *per capita*. China is the best example because, with a *per capita* income of about 850 USD, it has a savings rate of more than 40% of the national income, which

is one of the secrets of the rapid growth of its overall income (9% yearly), and per capita income (roughly 7%), translating into an accelerated improvement in the living conditions of the population.

Another fundamental feature in the increase of savings and the investment withdrawn from it is the creation of a healthy business atmosphere, which is mainly a task for the State.

For such, the State must provide **physical infrastructures** (roads and other means of transporting goods and people within the territory, etc.), which will act as "veins" carrying the life-giving "blood" to the national economy. Therefore, the State needs resources to invest in these infrastructures. If we put aside the access to "exceptional" incomes such as those resulting from the exploitation of natural resources, then the main source of State incomes are the people (as individuals or as business companies) through **tax revenues.** Due to this it does not come as a surprise to note that during the long process of development, and in order to attain it, the State is (will be) forced to, sooner or later, **increase the burden of taxes** on the population by widening the basis for tax collection (taxing other economic activities) and increasing their rates.

The Government of Timor-Leste can not avoid such course of action. However, it is necessary to ensure that these collected resources return to the population by means of various direct benefits: additional roads, new and improved hospitals, schools and social services, thus reducing to a minimum the eventual, yet unavoidable, waste of resources.
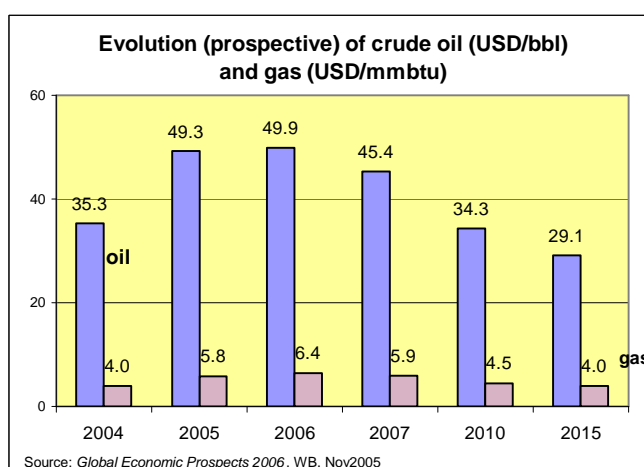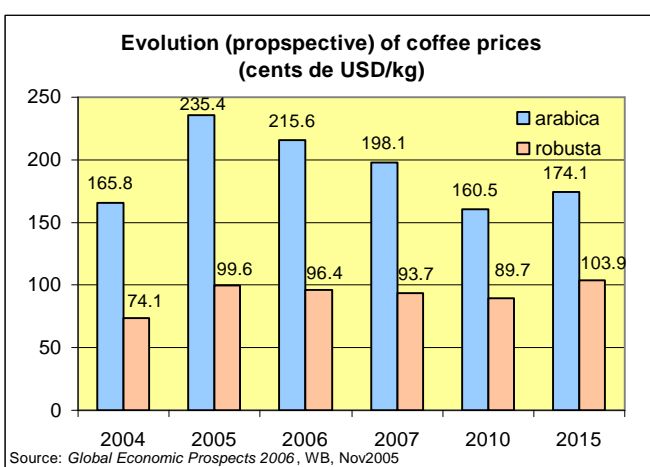
But the growth of savings and investment and therefore of the national economy is not only sustained by the construction of roads and other physical infrastructures. Just as important is the **legal and regulating environment** that protects economic activities. Examples are regulations to protect property and that stimulates the development of modern economic activities. Protection of property is of high importance as to ensure stability to entrepreneurs and to enable them to use such property as real

guarantee when they need them to get credit in a banking institution. When such guarantees are minimal, as is the case in many developing countries (including Timor-Leste for various reasons, such as the situation in land and property registrations), the risk of investment is higher and, consequently, the interest rates charged by the banks to provide loans will increase, which will damage economic growth. As a result, to clarify this legal and property environment is essential for a more rapid growth; otherwise investments will be limited.

Nevertheless, creating laws will do little unless they are implemented and courts should take speedy decisions. Therefore, a **proper functioning of the judicial system** is important to protect creditors' rights; its inappropriate functioning will act as an obstacle to investment since the level of risk due to the business's uncertainty is high and so are the costs. Some court decisions in the past may have cost our country a significant loss in investments.

A **strong financial system** is another crucial element in mobilizing national savings, which will enable the financing of investment. In general, the financial system comprises the central bank and the commercial banks but also other financial institutions such as insurance companies, pension funds, stock exchanges and development banks.

In countries with a lower level of development, the banking sector is the central component of the financial system. This allows mobilization of individual and business savings deposited in the commercial banks to provide credit for entrepreneurs to invest. However, a financial system comprised of only a banking system is limited in the services it can provide. The creation of capital markets, including insurance companies and pension funds, is a contribution to increase the capacity to mobilize savings and apply them in investment, and in financial stability, which is essential to macroeconomic stability and, in turn, essential to investment, creating employment and increasing revenues.

Evolution (propspective) of coffee prices (cents de USD/kg)

	arabica	robusta
2004	165.8	74.1
2005	235.4	99.6
2006	215.6	96.4
2007	198.1	93.7
2010	160.5	89.7
2015	174.1	103.9

Source: *Global Economic Prospects 2006*, WB, Nov2005

Evolution (prospective) of crude oil (USD/bbl) and gas (USD/mmbtu)

	oil	gas
2004	35.3	4.0
2005	49.3	5.8
2006	49.9	6.4
2007	45.4	5.9
2010	34.3	4.5
2015	29.1	4.0

Source: *Global Economic Prospects 2006*, WB, Nov2005

million USD dollars	Sep_05	Oct_05	Nov_05	Dec_05
Net foreign assets	**415,005**	**451,738**	**508,945**	**531,259**
Claims on non-residents	*484,623*	*523,147*	*565,227*	*587,716*
Claims of the ABP/BPA	432,684	473,430	514,899	535,492
Claims of the commercial banks	51,938	49,717	50,329	52,225
Liabilities to non-residents	*69,617*	*71,409*	*56,282*	*56,457*
Liabilities of the ABP/BPA	11,944	11,944	11,944	11,944
Liabilities of the commercial banks	57,673	59,465	44,338	44,513
Internal credit	**-309,671**	**-349,693**	**-388,995**	**-410,792**
Credit to the Central Administration/Government	0	0	0	0
credit from ABP/BPA	0	0	0	0
credit from commercial banks	0	0	0	0
Deposits of the Central Administration/Government	394,830	436,165	475,715	498,783
deposits with ABP/BPA	394,830	436,165	475,715	498,783
deposits with the comemrcial banks	0	0	0	0
Net credit to Central Administration = credit - deposits (1)	-394,830	-436,165	-475,715	-498,783
Credit to private sector (corporations, individuals)	85,158	86,472	86,720	87,991
credit from the ABP/BPA	0	0	0	0
credit from comemrcial banks	85,158	86,472	86,720	87,991
Deposits of the commercial banks with ABP/BPA	**3,853**	**5,226**	**6,560**	**4,417**
Demand and term deposits	**93,594**	**93,975**	**96,773**	**97,170**
Demand deposits with commercial banks	**57,011**	**56,599**	**59,070**	**58,686**
From non-financial public corporations	0	0	0	0
From corporations and individuals	57,011	56,599	59,070	58,686
Term deposits	**36,583**	**37,377**	**37,703**	**38,484**
ABP/BPA term deposits	0	0	0	0
Corprorations and individuals	36,583	37,377	37,703	38,484
Other net assets				
from ABP/BPA	722	759	737	763
from commercial banks	-62	-1,174	-1,700	-2,155
Equity and reserves	**35,931**	**36,066**	**35,868**	**36,359**
Equity contributed by owners	**26,884**	**26,884**	**26,884**	**26,884**
ABP/BPA	18,227	18,227	18,227	18,227
Commercial banks	8,657	8,657	8,657	8,657
Earnings	**3,842**	**4,708**	**4,971**	**4,963**
ABP/BPA	460	475	490	722
Commercial banks	3,382	4,233	4,481	4,241
General and special reserves	**5,205**	**4,474**	**4,013**	**4,512**
ABP/BPA	1,922	1,922	1,922	1,922
Commercial banks	3,284	2,552	2,091	2,590

(1) The negative value of "net claims on central government" means that the banking system is holding more government deposits than government debt (of which there is none in Timor-Leste). For a similar reason "domestic claims" is also negative

    The country's claims to non-resident during the quarter to December registered an increase of 18%, corresponding roughly of 116 million of USD. The increase basically due to the external application, in United State government bonds (with the increase of this about 24%), of BPA resources resulting by government deposits. The significant part of these have origin from Timor Sea revenue.

    To be notice that the value of claims to non-resident include the amount of Petroleum Fund. At the end of December 2005 the total amount of that Fund reached USD370,249,161.38.

    The loans from commercial banks to the economy increase somewhat during the quarter: +3.3%, corresponding roughly of 2.8 million of USD.

    In the same time, the commercial banks deposits increase of 6% or about of 3.6 million of USD compare to the last quarter.

Prices evolution in Dili

Inflation Rate (%)

Source: National Statistics Department
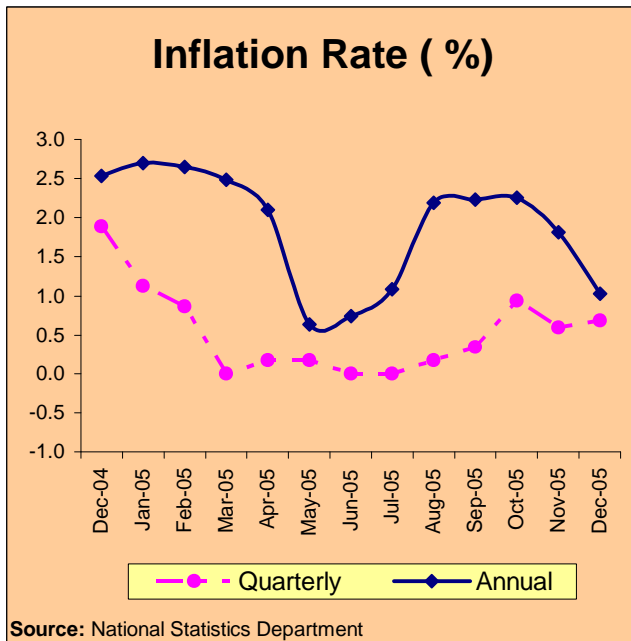
As published by the National Statistic Department of Ministry of Planning and Finance of Timor-Leste, Consumer Price Index (CPI) indicates that consumer prices have risen roughly 0.7%, during the quarter that finished last December comparatively with the previous quarter, when the variation was of 0.3%.

The increase on prices was due to a price raise in expenses with lodging and with beverages. The first had the biggest increase in the quarter, with an increase of 6.9% that compares to -1.1% during the previous quarter. Beverages also had a raise of 4.5% that compares to -0.4% during the previous trimester.

The annual inflation rate has dropped to 1% vs. the 2.5% in the previous civil year. The slowing down of inflation was mainly due to price decrease in expenses with leisure and with education (-2.3%). This price decrease in education is due to the announcement of government policy of subsidizing school costs.

Interim Summary Financial Statements of ABP/BPA

Autoridade Bancária e de Pagamentos de Timor-Leste
Banking and Payments Authority of Timor-Leste

Avª Bispo Medeiros, PO Box 59, Dili, Timor-Leste

RESUMO TRIMESTRAL DO BALANÇO E DEMONSTRAÇÃO DE RESULTADOS

BALANÇO		DEMONSTRAÇÃO DE RESULTADOS	
Em 31 de Dezembro de 2005		Segundo Trimestre Terminado 31 de Dezembro 2005	
ACTIVOS	US Dollars	PROVEITOS	US Dollars
Caixa e Depósitos	31,650,513	Juros Recebidos de Activos Financeiros	1,268,356
Investimentos	135,147,703	Transferência Orçamental	120,000
Investimento do Fundo Petrolífero	370,249,161	Rendimento de Títulos de Governos Estrangeiros	2,692,453
Outros Activos	1,059,453	Taxas e Recuperação de Custos	145,929
TOTAL do ACTIVO	538,106,830	Remuneração Gestão do Fundo Petrolífero	90,000
		Outras Receitas	(16,457)
PASSIVO		TOTAL dos PROVEITOS	4,300,281
Moeda Emitida	1,789,993		
Depósitos do Governo	128,534,105	CUSTOS	
Fundo Petrolífero de Timor-Leste	370,249,161	Despesas Financeiras	3,154,958
Depósitos de Instituições Financeiras Nacionais	4,521,803	Distribuição de Moeda	39,514
Depósitos de Instituições Financeiras Estrangeiras	11,944,229	Despesas com Pessoal	146,919
Outros Passivos	196,566	Despesas Operacionais	155,069
TOTAL do PASSIVO	517,235,857	Depreciação	81,797
		TOTAL dos CUSTOS	3,578,257
ACTIVOS LÍQUIDOS	20,870,973		
SITUAÇÃO LÍQUIDA			
Capital	18,227,188		
Reserva Geral	1,921,761		
Lucros Retidos	722,024		
TOTAL da SITUAÇÃO LÍQUIDA	20,870,973	RESULTADO LÍQUIDO	722,024

As contas sumariadas acima são apresentadas de acordo com o artigo 56.2 do Regulamento 2001/30 e foram preparadas com base nos registos financeiros da ABP tal como existentes até a data de 31 de Dezembro de 2005. Estas contas não foram auditadas.

Abraão de Vasconselos
Director Geral

13 de Janeiro de 2006

In the two graphs below and to the left, where we can see the amount of foreign currency (AUD-Australian dollar, and Euro) that each unit of national currency (USD) can buy, a depreciation of USD is represented by an ascent of the respective curve. In the graph of the right, representing the amount of Indonesian rupiahs bought by each USD, a depreciation of the USD is represented by a descent of the curve because it will allow to buy less rupiahs.
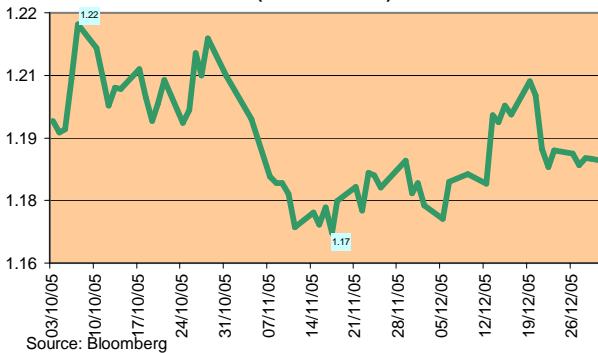
USD per AUD
(Oct - Dec 2005)

IDR per USD
(Oct - Dec 2005)

Source: Bloomberg

Source: Bloomberg
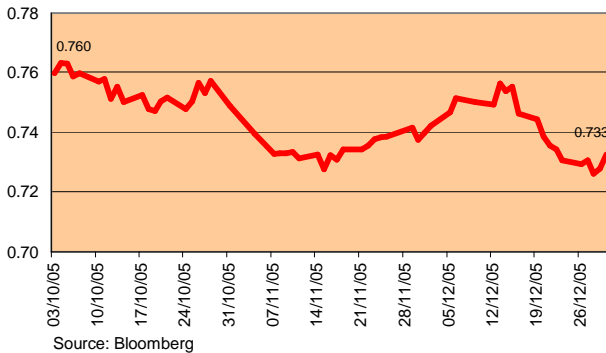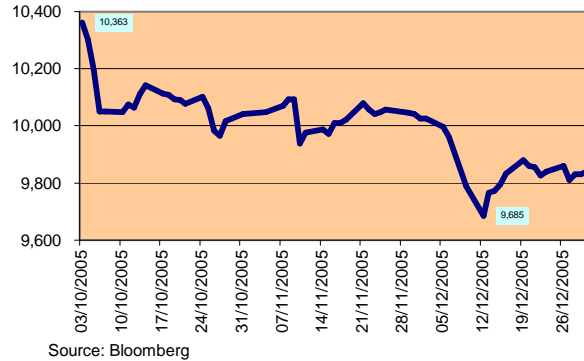
USD per Euro
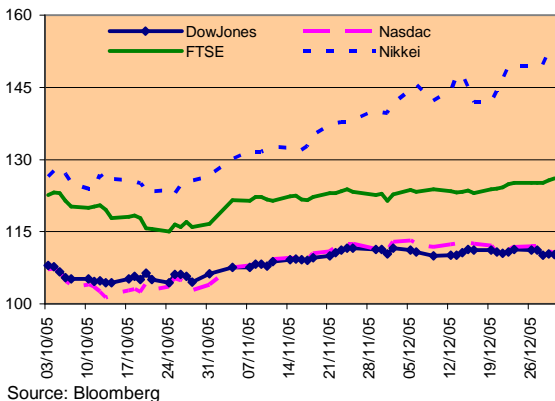**(Oct - Dec 2005)**

Source: Bloomberg

The graphics show that in the last quarter of 2005 the USD kept on registering instability after having suffered from that same illness in the previous semester vs. the AUD and Euro. Compared to Indonesian rupiah the USD kept on enduring devaluation during that period – to which corresponds the rupiah's revaluation, and therefore, a relative price raise on imports from the neighboring country. As for exchange rates vs. the AUD and Euro, after a revaluation up until mid November, it devaluated until mid December and has revaluated since then. This rise was influenced by the differential of interest rates between the USA, Australia and the Euro area.
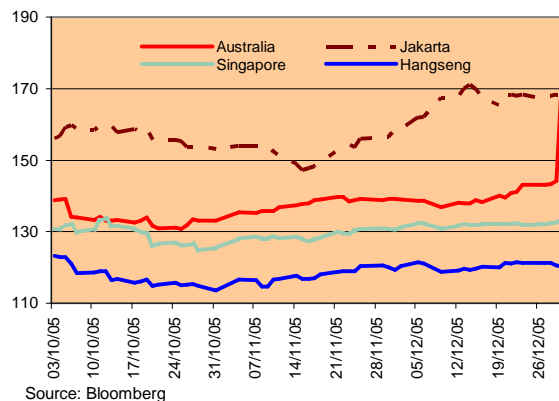
Financial Markets
Latest developments

Evolution of stock exchange indexes
31/Dec/2003=100

Legend: DowJones, Nasdac, FTSE, Nikkei

Source: Bloomberg

Evolution of stock exchange indexes
31/Dec/2003=100

Legend: Australia, Jakarta, Singapore, Hangseng

Source: Bloomberg

Recent evolution of the Indonesian economy

The purpose of this text is to focus on the evolution of Indonesian economy, the neighboring country with which Timor-Leste has a very close economic relationship. One of the indicators of this relationship is the fact that half of our imports come from there.

In the second half of 2005, mainly after August, the Indonesian economy weakened due to the pressure in fiscal policy translated in the decrease of oil subsidies – that translated in the increase of diesel and gasoline – and in the difference between domestic and international interest rates.

Financial market was under pressure – sliding roughly 18% - and the rupiah depreciated much, having had the biggest depreciation since April 2001 with a percentage of 3.6% in August 29th, 2005.

Source: Bloomberg.

As known, during 2005 there was a significant increase in the international price of oil.

This raise complicated Indonesian authorities' decisions, since oil derivatives price raises were due to the reduction of funding that ended up being larger than foreseen, forcing the increase in the global value of these derivatives. The initial premise was that they would represent only 0.7% of the GNP, but they ended up being 5%, an important sum that put pressure on public budget.

This evolution has medium and long term consequences due to the need to reduce investment expenses, which would improve the state of affairs of the economy in the future. All this came as a contribution to investors' pessimism, which translated in an increase of investment flows toward other countries, compromising even more economy development.

The current account balance also had a deficit in the second quarter, although in the first quarter it had a 920 million USD surplus.

These evolutions net result represented a downgrade in the balance of payment, which lowered foreign exchange reserves from 36.3 billion USD, in December 2004, to 31.1 billion USD, by the end of August 2005. This evolution required an exchange rate policy toward preservation of economy's external competitiveness, which translated in the ongoing of rupiah's depreciation.

Central bank's policy, due to financial market's instability, was to increase both the interest rate (to 10%) and the level of reserves requirement. In the beginning of September 2005 authorities have imposed a margin limit to rupiah's trade in order to contribute to stability in rupiah's exchange rates. This policy has somewhat improved the situation, for the rupiah has recovered some stability, but foreign reserves kept on diminishing to 30.3 billion USD.

In mid October, the market was not yet stabilized when authorities once again announced a cut in funding to oil derivatives, just so that their price in internal market would come close to international prices. With this announcement, fuel price raise went up to 165%.

Such as it happens in most central banks, one of the purposes for monetary policy was the maintenance of price stability. It was with that purpose that the Indonesian central bank raised tax rates in 2.75 percentage points, to 12.75%. This increased internal tax rates and helped reduce the flow of capital out of the country, attracting some people and allowing an increase in foreign exchange reserves in 2 billion USD.