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Real effective exchange rate: What is it? And what does it say?

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- **Attracting FDIs: why is it important for Timor-Leste and how could that be achieved?**

Each country in the world has a currency in which the prices of goods and services are quoted – the rupiah in Indonesia, the Australian dollar in Australia, the ringitt in Malaysia, in the case of Timor-Leste the US dollar and, since November 2003, its local denomination, the centavo. The price of one currency in terms of another is called an exchange rate. Exchange rates play a central role in international trade because they allow the computation of the relative prices of goods and services produced in different countries thereby allowing the comparison of those prices across countries.

The relative prices of currencies are usually reported daily in newspapers' financial sections. In Timor-Leste, the BPA/ABP plays such a reporting role and disseminates daily a set of selected exchange rates together with some selected information on interest rates and stock markets. Changes in exchange rates are described as depreciations or appreciations. A depreciation of the US dollar against the Indonesian rupiah is a fall in the rupiah price of the dollar, e.g. a decrease from 8800 to 8500 rupiah for one dollar. It makes the purchase of Timorese goods, for instance Timorese coffee, cheaper for Indonesian people. Conversely, an appreciation of the US dollar against the Indonesia rupiah is an increase in the rupiah price of the dollar and makes the purchase of Timorese coffee more expensive for Indonesian people. A depreciation of the US dollar against the Indonesian rupiah is the same as an appreciation of the Indonesian rupiah against the US dollar and vice versa. If Timorese goods become more expensive for Indonesian people, by the same token Indonesian goods become cheaper for Timorese people. Import and exports demands are traditionally influenced by relative prices, i.e. exchange rate movements. The exchange rate plays a crucial role in open economies, such as Timor-Leste which displays an openness ratio of around 80% (openness being measured as import and exports as percentage of gross domestic product).

Just as other prices in the economy are determined by the confrontation of supply and demand, exchange rates are determined by the interaction of buyers and sellers of foreign currencies. The trade of foreign currencies takes place in the foreign exchange markets and therefore this is where nominal exchange rates are quoted. Central banks may also fix the nominal exchange rate of their national currency. This is for instance the case in China, which has de facto fixed its national currency, the renminbi, to the US dollar since 1995.

Real exchange rates are nominal exchange rates corrected somehow by the effect of price movements (increase or decrease) in the economy. Real exchange rates are defined in terms of nominal exchange rates and price levels.

There are several different measures of price levels, which one can consider for the computation of the real exchange rate. The most commonly used one is the consumer price index (CPI), assuming that the consumer price basket of the country concerned gives a relatively heavy weight to goods produced and consumed in that country. In other words, and in our above mentioned example, the real exchange rate of the US dollar against the Indonesian rupiah can be defined as the dollar price of the Indonesian basket relative to the Timorese basket. To make it clearer, Timor-Leste real exchange rate against Indonesia can be expressed as follows:

$$RE_{USD/IDR} = (E_{USD/IDR} \times P^*) / P$$

Where
$RE_{USD/IDR}$ is the real exchange rate of the US dollar against the Indonesian rupiah
$E_{USD/IDR}$ is the nominal exchange rate of the US dollar against the Indonesian rupiah or dollar price of one rupiah
P^* is the level of prices in Indonesia
P is the level of prices in Timor-Leste

Alternative price level indexes to the CPI which can be used for the computation of the real exchange rate are for instance: the producer price index (PPI), also called the wholesale price index (WPI), the wholesale price level in the economy, and the unit labor cost index (ULC), the cost of producing goods in a specific country. Some of these indexes are not always available. The most readily available ones are the CPI and the PPI. On which index to best use, views among economists and policymakers diverge substantially. Some advocate for the PPI while others for the ULC as the best indicator to adjust the nominal exchange rate of a country. In Timor-Leste, the PPI, WPI and ULC indexes are not constructed yet, only CPI is available.

Assuming that the dollar price of one rupiah is 0.2, CPI in Indonesia is 105 and CPI in Timor-Leste 119, the above equation will be as follows:

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bancocentraltimor@yahoo.com

Real effective exchange rate

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$RE_{USD/IDR} = 0.2 \times (105/119) = 0.17$

The real exchange rate provides information on the degree of competitiveness of one country when compared to another. In the example above, the real exchange of the US dollar against the Indonesian rupiah provides information on the competitiveness of the Timorese economy compared to that of Indonesia. In this case, a decrease in the real dollar/rupiah exchange rate (which is called a real appreciation of the dollar against the rupiah) would mean a decrease in the purchasing power of the rupiah in Timor-Leste and therefore a loss in competitiveness for Timor-Leste vis-à-vis Indonesia. What matters is the trend and not the value itself. Conversely, an increase in the real dollar/rupiah exchange rate (called real depreciation of the dollar against the rupiah) would mean an increase in the purchasing power of the rupiah in Timor-leste and therefore a gain in competitiveness for Timor-Leste vis-à-vis Indonesia. One can compute for a country as many real exchange rates as the concerned country has trading partners. For instance, as far as Timor-Leste is concerned, that would be against Australia, Indonesia or Malaysia. These are called bilateral real exchange rates.

However, in order to assess the overall competitiveness of a country, one needs to construct a synthetic indicator which would encompass all trading partners at the same time. Such a synthetic indicator is called the real effective exchange rate. It is an average of bilateral real exchange rates weighted by the share of each trading partner in the overall trade. That said, the real effective exchange rate could be expressed as follows:

$$REER_{USD/IDR} = RE_{USD/IDR} \times W_{IDR} + RE_{USD/IAUD} \times W_{AUD} + RE_{USD/MYR} \times W_{MYR}$$

Where

$RE_{USD/IDR}$ is the real dollar/rupiah exchange rate,

$RE_{USD/IAUD}$ is the real dollar/Australian dollar exchange rate,

$RE_{USD/MYR}$ is the real dollar/ringitt exchange rate,

W_{IDR} is the share of Indonesia in Timor-Leste trade

W_{AUD} is the share of Australia in Timor-Leste trade

W_{MYR} is the share of Malaysia in Timor-Leste trade

There are several ways to define the weight of trading partners within the overall trade of a country, each of them entailing pros and cons. For instance, one can take into account only imports or only exports, thereby focusing either on the buying performance or on the selling performance of a country. In the case of Timor-Leste, the most straightforward one is to sum imports and exports so as to give equal importance to both.

As an indicator of international competitiveness, the real effective exchange rate is an important indicator for a particularly open economy such as Timor-Leste. Indeed, it influences developments in imports and exports and therefore in the terms of trade of the country. Furthermore, it is acknowledged that the real effective exchange rate may also influence foreign direct investment decisions as it directly affects the relative competitive position of different locations and therefore of different countries (cf. also article on p.9). Against this background, the BPA/ABP will compute the real effective exchange rate for Timor-Leste so as to monitor the developments in international competitiveness of the country. The preliminary results will be presented in the next issue of the Economic Bulletin.

Behind the glass curtain – What does the Human Resources Division do?

Article 4.2 of the BPA/ABP Regulation stipulates that BPA/ABP is a public agency with complete legal, operational, administrative and financial autonomy. As a result all operational and administrative policies of the institution are determined by its Governing Board. The General Manager, assisted by the Director of the Human Resource division (HR) is charged with the overall responsibility to ensure that approved policies are systematically implemented in the various services of the organization and that appropriate administrative and reporting procedures are put in place to monitor consistent application. The set of policies, procedures and organization of services that deal with staff matters comprise the human resource function of BPA/ABP. Organizationally, the human resources management division is an integral part of the Department of Administration. This brief article focuses on the functions of the human resources (HR) Division of the BPA/ABP.

HR Activities

To successfully accomplish its key objectives as the monetary authority (and future central bank) of Timor Leste, the BPA/ABP must, at all times provide of staff with core competencies to man its operations and support the attainment of the long term goals of the institution. Being a service institution also means that the institution's most valuable asset is its human resources. The HR division has the primary responsibility to ensure that staffing needs are properly planned and are made available to the various services in a timely fashion. A key consideration, in this respect, is the need to keep BPA/ABP compensation package and employment terms competitive enough to attract and retain potential employees with the required profile of education and experience.

Recruitment

The BPA/ABP recruits qualified staff from throughout Timor Leste. At the beginning of each round of recruitment, the HR division put out information about vacant positions and ensures that the announcement is widely circulated. In addition to posting them on a number of public boards, the announcement is broadcast on the radio which is accessible throughout the country. For each vacant position, short-listed candidates undergo a competitive interview at BPA/ABP offices. The HR division oversees the recruitment process and ensures that the process is fair, transparent and free from bias such as gender consideration.

Staff Development

As BPA/ABP operations grow and mature, there is always the need to continually align staff skills with institution's priorities. Staff must be regu-

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Becoming a founding member of the Association of Insurance Supervisory Authorities of the Portuguese speaking countries

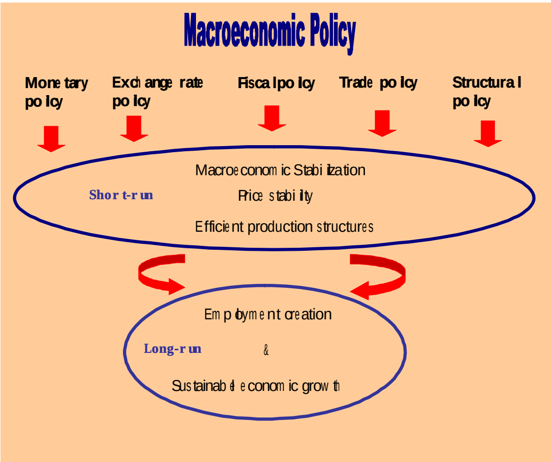
On 22 April, the BPA/ABP has become one of the founding members of the Association of Insurance Supervisory Authorities of the Portuguese speaking countries. This membership is twofold:

- It aims at promoting the development of the technical capacity required for regulation and supervising the insurance system in Timor-Leste,
- It aims at establishing working relations with other Portuguese speaking countries' insurance supervisory authorities.

Macroeconomic policy: what is it and who is responsible for it?

Macroeconomic policy is a broad concept which covers a variety of policy areas. In more narrow terms, macroeconomic policy is commonly defined by two main policies, namely monetary and fiscal policies. Macroeconomic policy refers to two concepts: macroeconomic on one hand and policy on the other hand. The expression "macro economy" refers to some macro concepts such as: income, household consumption, saving, government consumption and foreign trade, production (growth), consumption of the private sector, savings of both public and private sector, investment, government expenditure; while the expression "policy" refers to the measures taken by national authorities so as to achieve the set objectives.

Economic policy most commonly aims at achieving or maintaining macroeconomic stability through fighting inflation, fostering employment and ensuring a balanced external position so as to achieve a sustainable economic growth in the long run.



The definition by national authorities of an appropriate set of policies, which are consistent with each other, is certainly pivotal for any country as it is fundamental for Timor-Leste. To this end, it is essential to understand what the various policies are to which a country can resort, how these policies interact with each other and which authority is responsible for which policy This article aims at addressing these issues.

The various components of macroeconomic policy: their definition and traditional objectives

As mentioned above, the main objective of economic policy is to maintain economic stability in the short term and promote a sustainable economic growth in a non-inflationary environment conducive to employment in the long term. To achieve this objective, national authorities may resort to a set of policies. The most widely known policies are monetary, exchange rate and fiscal policies, but these can be supplemented by trade and structural policies.

In practical terms, monetary policy aims at regulating the supply of money provided by the banking sector to the economy. To do so, monetary policy can use a broad set of instruments such as open market operations, discount rate/window and minimum reserve requirements so as to influence interest rates.

Exchange rate policy aims at influencing the supply of national currency to foreigners through for instance the definition of an exchange rate regime and interventions in foreign exchange markets.

Fiscal policy aims at influencing the government budget and therefore the aggregate demand and supply. To do so, national authorities can increase or decrease taxes and subsidies so as to influence revenues, but they can also control expenditures for goods and services and capital.

Trade policy covers the tariffs and import quota so as to protect industry substitution import and support exports of national products to trade partner countries.

Finally, structural policy aims at shaping the functioning of national infrastructures through for instance the privatization of national enterprises, the construction of roads, the establishment of investment laws so as to put in place efficient production structures.

How do macroeconomic policies interact with each other or what are the dilemmas they are faced with?

Although the above mentioned policies may pursue different goals, they influence each other as they can't be conducted in isolation. And sometimes, the pursued goals may even conflict with each other. For instance, an expansionary fiscal policy aiming at stimulating employment and growth may conflict with a restrictive monetary policy aiming at keeping monetary base (defined as the sum of money in circulation and deposits at the Central Bank) under control. Such a conflict exists because some expansion and contraction of both monetary and fiscal policy can influence each other and the attainment of their respective goals. That may trigger some "trade off" and require choosing one policy and sacrificing the other. Because policies have a bearing on each other, coordination in defining them is instrumental in avoiding policies that become counter-productive.

The fight against inflation is usually the primary objective of monetary policy. It requires the pursuit of a restrictive monetary policy, which is achieved either by setting high interest rates or reducing money supply so as to avoid an expansion of the monetary base. However, such a restrictive monetary policy constrains economic growth as it makes consumption and investment too expensive. Conversely, while an expansionary monetary policy through low interest would encourage consumption and investment, i.e. would support aggregate demand, and boost growth, it entails the risks of triggering some overheating of the economy and thus inflationary pressures.

In the same vein, the choice of an exchange rate regime may cause a dilemma. Specifically, while a fixed exchange rate regime would underline the commitment of the national authorities to a strong policy discipline and thereby help achieving low inflation, it would deprive a country of an adjustment tool to use and may put a straightjacket on economic growth in case of shock. By the same token, a flexible exchange rate regime would provide national authorities with some room to maneuver in case of shock, but it would not represent a strong device for anchoring inflation expectations and thereby might not be so efficient in achieving macroeconomic stability. By adopting the US dollar as its national currency and using it as a strong anchoring device, Timor Leste has given a clear priority to macroeconomic stabilization and to the control of inflation.

The conflict between inflation and macroeconomic stabilization on one side and employment and growth on the other side can also be seen as a trade off between short term costs and long term gains and vice versa. Indeed, an expansionary fiscal or loose monetary policy can bear fruit in the short run, but it might have costs in the longer run as it may cause macroeconomic conditions to deteriorate. On the other hand, in the short run macroeconomic stabilization can constrain economic growth and employment, but in the longer run, it will contribute to create confidence in the country, attract foreign direct investment (FDI), and it will eventually contribute to decrease unemployment, to increase disposable income and attain sustainable economic growth.

That is the reason why achieving macroeconomic stabilization and inflation control is pivotal for a country. Furthermore, consistent and sustainable policies are essential so as to ensure that a decision for tomorrow that appears desirable today remains desirable tomorrow after today's decision has taken effect. In this context, it is fundamental that national authorities be concerned with the long term allocation of resources and not with short term counter cyclical policies.

Which national authority for which policy in Timor-Leste?

Not all policies fall within the competence of a single national authority. Indeed, several institutions are usually involved in the definition of the set of economic policies and some of these can be shared competencies.

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Macroeconomic policy

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Monetary policy is clearly under the competence of the national central bank or monetary authority, in the case of Timor-Leste, the Banking and Payments Authority, the BPA/ABP, whose primary objective is to "achieve and maintain domestic price stability" (UNTAET Regulation No. 2001/30, Section 5.1). As mentioned above, the tool used so as to achieve such price stability is currently a fixed exchange rate regime, namely the dollarisation of the economy. Still, it can't be precluded that monetary policy gains some flexibility or room of maneuver in the future and therefore that the BPA/ABP be more active in that field. This holds also for exchange rate policy, which is part of the secondary objectives of the BPA/ABP ("The other objectives …shall be…to execute the foreign exchange policy…", UNTAET Regulation No. 2001/30, section 5.2) and which is currently constrained by the legal tender status in the country of the US dollar. The decision making body in the BPA/ABP is the governing board. The governing board is composed of seven members: three from BPA, who are General Manager and two Deputies and the remaining four non-executive members representing the civil society. The governing board holds meetings at least ten times a year. Until now the four non-executive members to the board have not been appointed.

Fiscal policy falls clearly within the competence of the national government, more precisely with the Finance Ministry, but requires Parliament's approval. Fiscal policy is more cumbersome to manage than monetary policy because it involves a number of agencies and involves different steps such as the formulation and the eventual adoption of the government budget. The budget process starts with proposals worked out by each department or government agencies being submitted to the office of "management of the budget". The budget formulation process is pivotal for an economy as it is about how to make public choices for expenditure and how to prioritize those expenditures. The prioritization is not straightforward as some expenditures can conflict with each other and have a crowding out effect. Once finalized, the budget is submitted to Parliament for approval. Once approved, special attention has to be devoted to the budget implementation. In the case of Timor-Leste, owing to the absence of leeway for monetary and foreign exchange policy, fiscal policy is particularly critical. Thus, the conduct of a sound fiscal policy by the national authorities is of the utmost importance for this country.

Finally, trade and structural policies fall also within the competence of the national government and of the relevant ministry if any or in the last instance with the Prime Minister.

Overall, with the support of the relevant ministries in Timor-Leste, it falls under the Prime Minister's responsibility to formulate appropriate economic policies so as to maintain economic stability in the short term and promote sustainable economic growth in a non-inflationary environment conducive to employment in the long term. Indeed, the monetary policy and foreign exchange policy components of Timor-Leste's economic policies have been fixed already. Still, it is part of the BPA/ABP's attribution to provide broad policy advice when needed (Regulation No. 2001/30, sec. 6).

To conclude, regardless of who is responsible for what, as depicted above, economic policies have a bearing on each other and therefore coordination in defining them is instrumental in avoiding policies becoming counter-productive.

Behind the glass curtain – What does the Human Resources Division do?

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larly trained to meet new challenges in their work and keep abreast of developments in their respective areas of specialization. The HR division actively manages staff career plans, organizes appropriate training programs directed at maintaining staff technical knowledge and abilities in their respective areas of responsibility. In this respect, some staff members may be permitted to pursue long term technical training abroad, while others may undergo periodic attachment to other institutions (usually other central banks) to allow them gain more insight into central bank operations and thereby acquire experience. Many staff members have also benefited from courses specially designed for central bankers at the IMF institute in Singapore.
Another important element in this process is the routine mentoring provided by international advisors. The advisors work alongside their Timorese counterparts in the various services and assist them in assuming greater operational responsibility and capacity to develop national policies.
To supplement the limited budgetary resources at its disposal, the human resource division seeks support from external sources for staff training and professional development. This activity includes development of long term cooperation programs with other institutions in the South East Asia region that show willingness to provide assistance. To date, the BPA/ABP has successfully established technical cooperation programs with Bank of Portugal, Bank Indonesia, Bank Negara Malaysia, and the department of technical cooperation of Thailand.

Other key activities of the division include:

? Management of staff contractual documents and related personnel records to ensure integrity of information;
? Oversee staff movements and attendance data and administer salaries and allowances;
? Elaborate documents that disseminate information and enhance staff understanding of BPA/ABP personnel policies and procedures;
? In collaboration with managers, conduct staff performance reviews to facilitate greater communication between staff and supervisors and follow up on training needs that result from such reviews.
? Ensure that BPA/ABP staff policies are compliant with the labor laws in Timor Leste.

Staffing Complement
From its inception, the BPA/ABP benefited from the secondment of international experts for key activities. Over the past four years, however, the BPA/ABP has recruited Timorese staff with requisite skills, and has continued to organize training programs to develop their technical skills and operational capacity. This has allowed management to progressively pass over key responsibilities to national staff. Today, all divisions in the various departments are headed by national staff and a key department (Department of Financial Supervision) is directed by a national staff member who was appointed to that post in December 2002. Presently, the BPA/ABP staff complement is composed of 6 International and 62 national staff members. The table attached shows the distribution of national staff among the various services.

Organizational Unit	**No. of staff**
General Manager Office	6
Banking and Payment Department	20
Financial Supervision Department	12
Accounting Division	5
Administration Department	13
Economics and Statistics Division	3
Information Technology Division	3
Total	**62**

A corporate direction for the BPA/ABP

The management and staff of the BPA/ABP are undertaking a corporate planning process that will determine a corporate direction for the BPA/ABP for the period through to 2007. This process will result in a Corporate Plan that describes the way in which the BPA/ABP will undertake its responsibilities and identifies its main functions and key objectives.

The Plan identifies several important tasks ahead: the conversion of the BPA/ABP into a central bank, the introduction of a regulatory regime for the nascent insurance industry, and the adoption of a legal framework to bring the Timorese economy in line with international financial standards. The last task will be achieved by proposing laws, for example to combat money laundering, and to provide a proper foundation for payment transactions.

The BPA/ABP (known during the first phase of its development as the Central Payments Office) was first established in mid-2000, and will, in its third phase of development, become Timor-Leste's central bank. The intention to publish the Plan demonstrates, in part, that the BPA/ABP has now reached the stage where as an autonomous institution it can take control of its own destiny. With the anticipated passing of a Central Bank law during the current legislative term, the Plan will provide the community with a better understanding of the role of the BPA/ABP, and later, the role of the new central bank.

As an institution that is about four years old – in reality and not just in a legal sense – the BPA/ABP has established itself as a fully-functioning and effective institution. The challenge during the next four years is not only to consolidate these achievements, but to further build and expand the BPA/ABP's functions and services to meet the expectations and needs of the people of Timor-Leste.

There is considerable emphasis in the Plan on the development of human resources (see also the article on page 2). There is a continuing commitment to train national staff with technical and managerial skills. Our staff need as wide a range of central banking experience as possible to allow them to manage the BPA/ABP in a reputable and credible manner. The intellectual capital of the BPA/ABP could be considered more important than its financial capital, and the emphasis on its development is to allow the BPA to respond to a constantly changing environment and the changing expectations of the Timorese public, who (together with the government and financial institutions) are the major stakeholders in the nation's future central bank.

The Plan has the following sections:

1. A description of the BPA/ABP's charter, drawn primarily from Regulation 2001/30 and related legislation.

"To be a credible leader in preserving price stability to foster economic development in Timor-Leste"

2. Vision for the BPA:/ABP

3. Mission for the BPA/ABP:

"Our mission is to be a central bank staffed by a professional team that strives to continuously improve the quality of our services to our stakeholders by maintaining a sustainable monetary system with low inflation; ensuring that payments systems are efficient and effective; promoting a safe and credible system of financial institutions; communicating and providing information; undertaking sound economic research and analysis and developing the necessary organisational and technical capacities"

4. Integration into the National Development Plan.

5. Description of the management and organisational structure of the BPA/ABP.

6. Key objectives, by department within the BPA/BPA, for the next 3 years.

7. Proposed outcomes (results), strategies, and key performance indicators.

8. Statement of ethics and honesty.

Year by year the Plan will be supported by Annual Budgets that will set out in more detail the activities that will be undertaken and the resources required to achieve the planned results (outcomes). In this manner, the Annual Budgets will be the mechanism that will take the intentions set out in the Plan and convert them into operational targets and activities.

There is always the possibility that unforeseen events will arise in future that will affect the BPA/ABP's role and functions. It is believed that the decision to publish the Corporate Plan (once it has been finalized) despite future uncertainties will improve the accountability and transparency of the BPA/ABP. It is also an important means of building trust in the BPA/ABP as Timor-Leste's future central bank.

Thousands of USD	December 2003	January 2004	February 2004	March 2004
Net Foreign Assets	**108,299**	**107,833**	**104,343**	**127,714**
Claims on non residents	*153,108*	*161,156*	*164,593*	*195,626*
Claims of ABP/BPA	72,811	80,555	77,762	98,251
Claims of commercial banks (1)	80,297	80,602	86,831	97,375
Liabilities to non residents	*44,809*	*53,324*	*60,250*	*67,912*
Liabilities of ABP/BPA	11,487	11,487	11,487	11,487
Liabilities of commercial banks (1)	33,322	41,837	48,763	56,425
Domestic Claims (2)	**-21,492**	**-23,764**	**-12,134**	**-30,747**
Claims on central government	0	0	0	0
Claims of ABP/BPA	0	0	0	0
Claims of commercial banks	0	0	0	0
Deposits of Central Government	49,739	52,713	54,604	74,254
at ABP/BPA	49,739	52,713	54,604	74,254
at commercial banks	0	0	0	0
(Net claims on Central Government = Loans minus Deposits) (2)	-49,739	-52,713	-54,604	-74,254
Credit (to private sector = private and enterprises)	28,247	28,949	42,471	43,506
Credit of ABP/BPA	406	430	372	384
Credit of commercial banks (1)	27,841	28,519	42,099	43,122
Deposits of commercial banks at ABP/BPA	**7,578**	**7,621**	**5,806**	**5,693**
Deposits (Demand and time)	**72,873**	**70,314**	**73,870**	**75,391**
Demand deposits at commercial banks (1)	**58,128**	**54,070**	**45,303**	**44,329**
Public non-financial corporations	550	467	391	373
Other resident sectors	57,578	53,603	44,911	43,957
Time and Savings Deposits (1)	**14,745**	**16,245**	**28,567**	**31,062**
Deposits of ABP/BPA	0	0	0	0
Time deposits of other residents	14,745	16,245	28,567	31,062
Others Items (Net)	**-760**	**-1,696**	**-8,537**	**-9,010**
idem, ABP/BPA	-148	-434	-372	-388
idem, commercial banks (1)	-613	-1,262	-8,166	-8,622
Capital and reserves	**17,101**	**10,763**	**11,157**	**11,086**
Capital	**17,418**	**10,878**	**11,216**	**11,447**
idem, of ABP/BPA	7,727	7,727	7,727	7,727
idem, of commercial banks (1)	9,691	3,151	3,489	3,720
Retained earnings	**-779**	**-576**	**-520**	**-821**
Retained earnings of ABP/BPA	373	586	621	578
Retained earnings of commercial banks (1)	-1,151	-1,162	-1,141	-1,399
General and special reserve	**461**	**461**	**461**	**461**
Reserve of ABP/BPA	461	461	461	461
Reserves of commercial banks (1)	0	0	0	0

(1) Since August 2003, data include data reported by Bank Mandiri. Since that date, the banking sector in Timor-Leste has comprised 4 institutions (one of these being a Micro Finance Institution).

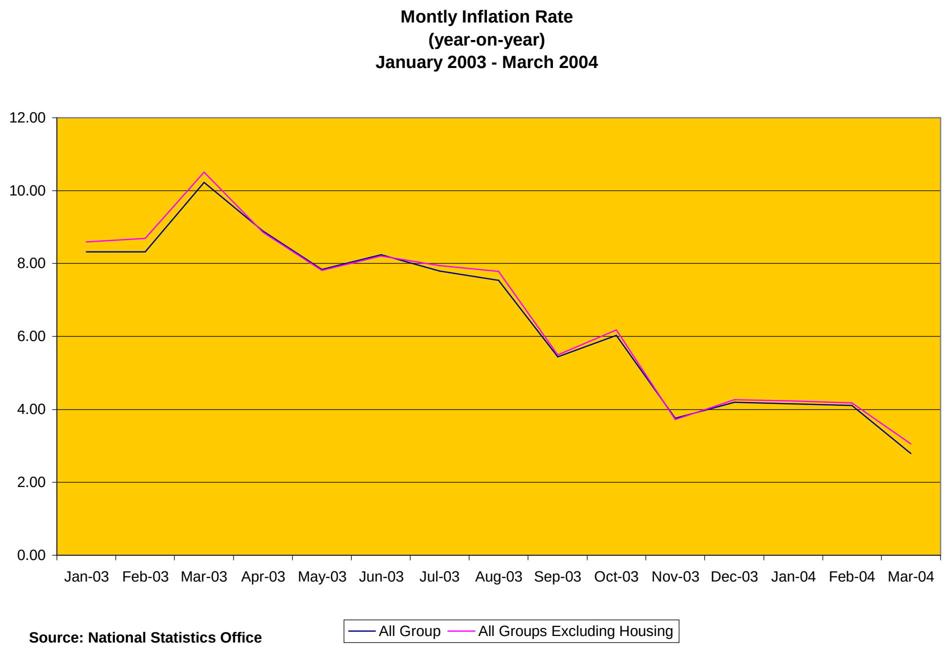
(2) Owing to the way "net claims on central government" is defined, namely credit minus deposits, the resulting negative value means that the volume of deposits is higher than the volume of credit.

With regard to Timor-Leste's monetary aggregates, the following is highlighted for the January-March 2004 period:

- While remaining roughly stable in January 2004 and marginally decreasing in February (compared to the previous month), net foreign assets have increased by around 22% in March, on account of a higher increase in claims on non-residents (foreign assets) compared with liabilities to non-residents.
- The upward trend of government deposits with the BPA, which started in the last quarter of 2003, has continued in the first quarter of 2004. Indeed, government deposits have almost doubled, reaching USD 74.3 million in March 2004.
- As the result of a decrease in demand deposits and of an increase in time and saving deposits, deposits at commercial banks have only slightly increased to USD 75.4 million in March 2004. The downward trend of demand deposit and the sharp upward trend of time and saving deposits are mainly due to a correction in reporting by one commercial bank.
- Reflecting the more active policy of commercial banks, in particular since the beginning of 2004, credit granted to the private sector has undergone a sharp increase (more than 50%) over the first quarter of 2004.

Price dynamics in Dili

According to data released by National Statistics, the inflation rate in Dili[1] stood at 4.2% in January 2004 versus 8.3 % the previous year (January 2003) for all consumer goods covered by the "consumer basket" (See chart). When deducting the price variation arising from the housing sector, the inflation rate remained at 4.2%. In February and March, the disinflation process continued in Timor-Leste.



Indeed, the inflation rate declined further to 4.1% and 2.8% for all consumer groups in February and March respectively and to 4.2% and 3.1% when excluding housing.

The continuation of the disinflation process mainly stems from the moderate increase in prices of cereals products and deflation in clothing, footwear and in transport and communication products which have offset an increase in prices of some selected food products (fresh fish, nuts and non-alcoholic drinks) and in alcohol and tobacco. The enhanced supply of communication products and services (e.g. cellular phones, pagers and internet access subscriptions) may have resulted in a price decrease of those products. Moreover, the slight strengthening of the US dollar against Timor-Leste main trading partners' currencies (Cf. also p. 8) may also have contributed to the pursuit of disinflation process in Timor-Leste.

1) There is no country-wide inflation measure available yet.

Interim Summary Financial Statements of ABP / BPA

BALANCE SHEET
As at 31 March 2004

	US Dollars
ASSETS	
Domestic Financial Assets	82,298,257
Foreign Financial Assets	18,097,650
Other Assets	1,255,490
TOTAL ASSETS	**101,651,397**
LIABILITIES	
Coins Issued	664,288
Domestic Currency Liabilities	80,444,102
Foreign Currency Liabilities	11,542,732
Other Liabilities	234,711
TOTAL LIABILITIES	**92,885,833**
NET ASSETS	**8,765,564**
EQUITY	
Capital	7,727,188
General Reserve	460,775
Retained Earnings	577,601
TOTAL EQUITY	**8,765,564**

PROFIT AND LOSS STATEMENT
For the 9 months ended 31 March 2004

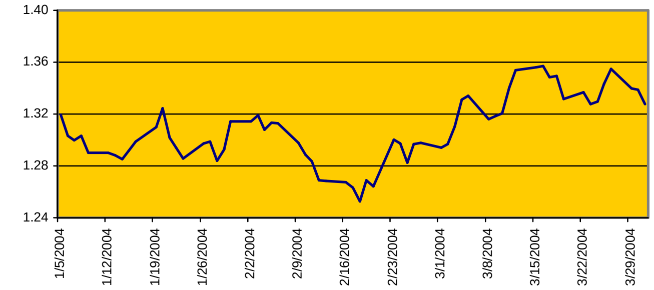
	US Dollars
INCOME	
Income from Financial Assets	389,284
Fees and Recoverable Charges	456,245
Government Appropriation	291,734
Currency Gains	117,303
Other Income	33,852
TOTAL INCOME	**1,288,418**
EXPENSES	
Financial Expenses	132,416
Currency Expenses	195,914
Personnel Expenses	161,170
Operational Expenses	221,317
TOTAL EXPENSES	**710,817**
NET PROFIT	**577,601**

Foreign Exchange markets

Latest developments

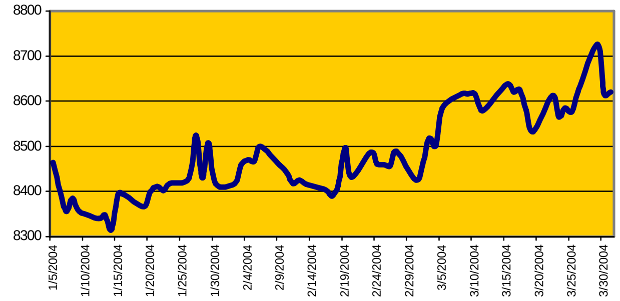
The three graphs below show the behaviour of exchange rates at nominal values. A downward trend indicates a devaluation of the USD vis-à-vis the currency against which it is quoted.

AUD per USD
(5 Jan04 -31 Mar04)



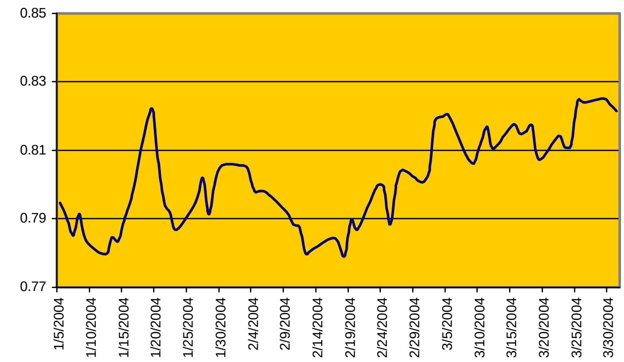
Source: Oanda

IDR per USD
(5Jan04 - 31Mar04)



Source: Oanda

Euros per USD
(5 Jan04 - 31 Mar04)



Source: Oanda

The period January 2004 to March 2004 was essentially characterized by a moderate strengthening of the US dollar against the major currencies of the world, and against the main trading partners of Timor Leste.

As evidenced by the graphs, the USD rose marginally against the IDR, AUD and EUR. At the end of March 2004 the USD was up by about 2.3 % of its value against the Euro when compared with February 2004, with its value going from a average of EUR/USD 0.7923 in February to an average of 0.8150 in March 2004.

The appreciation against the Australian dollar was approximately of the same magnitude over the same period with AUD/USD 1.2883 moving upward to 1.3329, namely a strengthening by 3.4%.

Finally, over the same reference period the appreciation of the IDR against the USD was fairly marginal compared to the EUR and the AUD, namely 1.6 %.

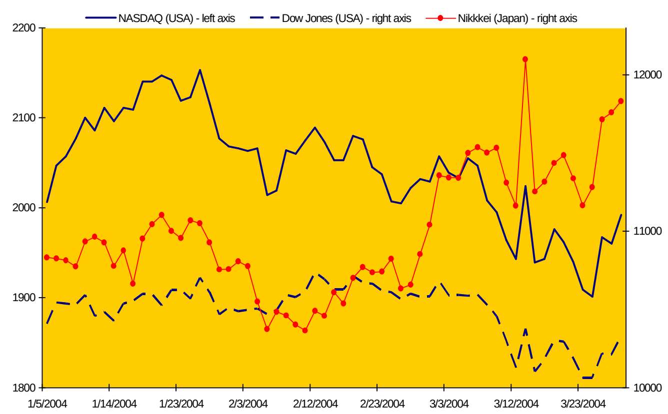
Overall, the strengthening of the USD vis-à-vis other currencies seems to be, on one side, supported by expanded net purchase of stocks by foreign investors and, on the other side, dampened by the recent developments in the Iraq conflict.

Financial Markets

Latest developments

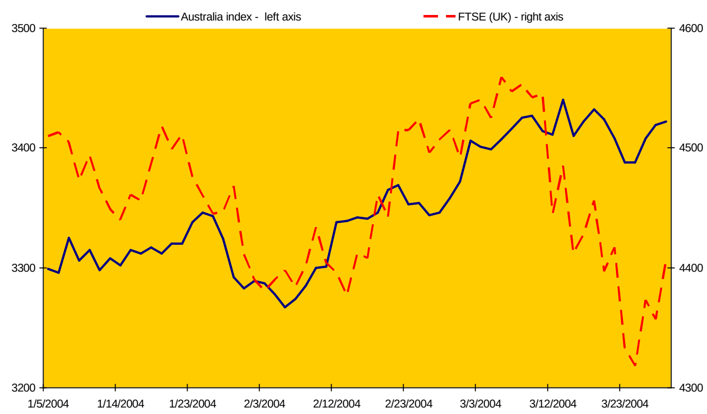
As shown in the following graphs, stock exchanges have exhibited some volatility over the last three months. The two markets with clear gains are the Japanese and the Australian stock markets.

Stock Exchange Indexes
(January to March 2004)



Source: Oanda

Stock Exchange Indexes
(January to March 2004)



Source: Oanda

Attracting FDI: can Timor-Leste be inspired by the Cambodian experience?

In his 2003 end year concluding speech, the Prime Minister of Timor-Leste stressed that in 2004 the government will strive to get the legal framework for investment approved by Parliament. Such a legal framework is certainly crucial since it would secure any investment made and therefore would contribute to build up confidence in investing in Timor-Leste. In the aftermath of Timor-Leste's independence, a certain number of businesses have been flourishing. Still, many business opportunities exist and remain to be exploited. Appropriate and clear rules and regulations are therefore required so as to further boost business development. In this regard, some parallel can be drawn between Timor-Leste and Cambodia. As a consequence, one could wonder whether Timor-Leste could be inspired by the Cambodian experience in its run up to attracting foreign direct investment (FDI).

The Cambodian experience

From the mid-70s, Cambodia was ruled by the communist regime of Democratic Kampuchea, the so-called "Khmer rouge", until 1979 when the regime collapsed. From that date on, the country suffered from acute internal tensions because the Khmer rouge did not disappear overnight and continued to control part of the country until the early 90s. In 1991, after a series of negotiations and with the help of the international community, a peace agreement was concluded (the so-called "Paris Accord of October 1991". In 1992, the United Nations Transitional Authority in Cambodia (UNTAC) was established to organize national elections and in 1993, a new government was elected, a new constitution was adopted and Cambodia started to emerge from the turbulent period of civil war.

From that time onwards, Cambodia's national authorities have been keenly pro-active in creating a market, business and investment-friendly environment. In this context, special efforts have been made to open the country to foreign investors. Furthermore, in early 2003, the national authorities passed a revised law on investment and a revised law on taxation, which reassert the open attitude of the country towards foreign direct investment. During 1996-2000, Cambodia attracted USD 216.7 million compared with USD 61.3 for the period 1991-1995. In 2000 and 2001, it attracted USD 148 million per year on average and around USD 54 million in 2002 (source: UNCTAD).

Why is it so important for Timor-Leste to attract FDI?

Timor Leste is a newly born country, which is faced with many challenges such as fostering business opportunities, training its workforce to obtain highly skilled labor, setting up reliable and cost-recovery domestic infrastructures such as roads, water supply, electricity, telecommunication, airports and ports in order to create employment, achieve efficient and well-performing production structures and possibly achieve financial autonomy. However, in doing so, Timor-Leste's national authorities have to cope with some financial related constraints. Such financial constraints make foreign investment extremely pivotal for the country.

Political and economic stability, as well as good governance (i.e. combating corruption and crime) are certainly instrumental in attracting long term investment. Still, the main impediment to foreign investors being in Timor-Leste remains the lack of an appropriate legal framework. Because investment has to be seen in a long-term perspective to bear fruit, it is important to free investment opportunity from risk by setting up reliable and unchallengeable rules. The Prime Minister's intention to get the legal framework for investment approved in 2004 should in this respect receive the parliamentary support it requires to be approved.

What kind of regulation is needed?

For instance, the required legal framework could encompass company and commercial laws so as to cover the entry and exit of enterprises. To enable the entry and the exit of enterprises, among others the following is required: registration and establishment rules, the existence of a labor code, ownership, land and property law, a clear mechanism for the resolution of disputes, a bankruptcy law, intellectual property rights, performance requirements, measures for technology transfers as well as transfer of knowledge, environmental protection rules as well as rules on employing expatriates. Some of these elements are being enacted, others do not exist yet. To implement these rules, a sound legal and judicial system as well as sound public finance (transparent and accountable), good civil administration (i.e. no corruption) are much needed.

Key sectors for potential FDI

One could use the SWOT (strengths, weaknesses, opportunities and threats) method to identify the sectors which could potentially attract FDI. In this, for Timor-Leste, i) the strengths would be: considerable natural resources, the government commitment to macroeconomic stabilization, regional and international memberships such as the participation in the Cotonou agreement, ii) the weaknesses: a shortage of technical and managerial skilled personal, high costs and wages and heavy bureaucracy; iii) the opportunities: tourism, agro industry, forestry and fisheries, import substitution industries, export-oriented industries and mining and iv) the threats: lack of clear political support for foreign investment which results in uncertainty for the development of the country.

As a consequence, the following areas may be identified as high priority areas:

1. Tourism: Timor-Lest's beautiful scenery, nature and diving opportunities are certainly an asset. Appropriate infrastructures need to be established to exploit this asset.

2. Agro industry such as coffee plantation, honey, coconuts, sugar cane, pineapples, bananas and other forestry products as well as the fishing industry.

3. Import substitution industries: one could consider substituting the import of basic needs consumer products such as detergents and soap with Timor based production.

4. Export oriented Industry: the Cotonou agreement signed last May could be used as a vehicle to facilitate the export of Timorese products to Europe.

5. Mining: the exploitation of Timor-Leste's natural resources is certainly an avenue to be worked out.

This publication is prepared by the Economic Studies and Statistics Division of the Banking and Payments Authority of Timor Leste

Salustiano Carvalho, Head of Division
Conceição Alonso, Economic Advisor
Odete Freitas, Economist
Agostinho Mendonça, Economist-Statistician
Gastão Sousa, Economist

Valuable contribution from other Departments is acknowledged

Avª Bispo Medeiros (next to ACAIT)
CxPostal 59 Dili Timor Leste
Tel: ++.670. 33 13 718 Fax: [...] 33 13 716