TIMOR LESTE ECONOMIC OUTLOOK:

BCTL ECONOMIC REVIEW AND PROJECTIONS FOR 2014 AND 2015

1. Executive Summary

This document presents BCTL's views regarding two highly relevant macroeconomic aggregates for Timor Leste, which are inflation and GDP growth. It is the first official publication that includes BCTL's outlook for these variables, making use of recent modeling and research works conducted at the BCTL. Nonetheless, not withstanding the natural difficulties which are present in every economic forecasting exercise, we would highlight that most of our work is yet on an embryonary stage and as such should gain greater accuracy and public understanding as experience is accumulated and BCTL disseminates and discusses its views with economic agents, policymakers and general public alike. We also hope that this publication might further reinforce the interest of policymakers and relevant institutions alike and lead to fruitful economic discussions and general upgrade of policymaking in Timor Leste.

This first publication only includes the analysis and forecasts of GDP growth and inflation, but should in the future be widen to include our views on other relevant economic aggregates, such as the Balance of Payments and its components and important National Accounts aggregates. Nonetheless, our inflation and growth projections require us to digest recent economic trends and forecast other important macroeconomic drivers and general economic data, which are used as inputs in our forecasting framework. It should be highlighted, in this regard, the need to quantify the impact and foresee the future behavior of foreign inflation trends and the importance of screening domestic data to track real-time economic developments.

In terms of our specific projections for inflation and GDP growth in both 2014 and 2015, as presented in table 1, we expect economic growth to be 4% and 8%, in 2014 and 2015 and inflation to be around 2% in both years. Since national accounts and non-oil GDP data is yet only available up to 2011, our 2012 onwards growth estimates are essentially based on the economic activity indicator compiled by the BCTL, which averages annual growth rates for 9 highly relevant economic data-series that track developments for imports, public spending, public revenue and banking and financial sector data.

TABLE 1 | BCTL Economic Indicator and Non-Oil GDP growth - %Year-on-Year

1. GDP Growth Forecasts - % average Year-on-Year

	BCTL	MoF - Budget	ADB	IMF
2009	-	12.8%	-	-
2010	-	9.5%	-	-
2011	-	12.0%	-	-
2012	10.0%	8.2%	8.2%	9.3%
2013	2.5%	8.0%	8.0%	8.4%
2014	4.0%	8.8%	8.5%	9.0%
2015	8.0%	9.4%	8.5%	8.8%

2.Inflation Forecasts - % average Year-on-Year

	BCTL	MoF - Budget	ADB	IMF
2009	-	0.0%	-	-
2010	-	5.2%	-	-
2011	-	13.0%	-	-
2012	-	10.7%	-	-
2013	-	8.9%	-	-
2014	2.0%	7.7%	9.5%	9.5%
2015	2.0%	7.7%	9.0%	8.1%

Sources: MoF 2014 Budget Documents, ADB (ADO, Mar 2014), FMI (WEO, April, 2014) and BCTL (June, 2014)

This indicator allows us to have a rough, but timely depiction of broad economic developments up to the end of the 1st quarter of 2014 and is thus used as a 'real-time' measure of cyclical developments and as tool to forecast near-term growth perspectives. Given the importance of public spending decisions in terms of the non-oil economy, it is also naturally highly relevant to forecast near-term public spending trends, which requires a careful analysis of current year approved budget and historical expenditure execution rates.

BCTL anticipates that 2014 will be a year of subdued below-trend growth of 4%, although we expect the economy to return to trend-level growth of 8% in 2015. On this front, as table 1 also shows, our GDP growth projection is below other institutions' for 2014, although in 2015 our estimate converges with them. Our less optimistic view for 2014 is based on the substantial slowdown registered in 2013, which we foresee to continue to weight on 2014's performance, as well as on the view that final budgetary execution in 2014 will be similar to 2013, which should result in total public expenditure to be practically unchanged in 2014 - we forecast a small annual increase of 13 millions USD.

On the inflation front, we have clearly lower projections than other institutions, as our 2% forecast for both years is substantially below the general average of 8.5% for both 2014 and 2015. Our lower inflation outlook is due, in part, to our view of subdued economic growth in 2013 and 2014 - which should cause further disinflation as demand-push price pressures vanish - but also to lower foreign inflation pressures, which we expect to persist in the near-term.

In this regard, note that the broad depreciation of Asian currencies versus the dollar that started at the end of 2013 has been mostly responsible for 'negative' foreign inflation pressures in Timor Leste. Even if our trading partners' currencies stabilize at the lower 2014's 1st quarter registered levels, annual regional inflation measured in dollars should be slightly negative in 2014. Even so, our base-case inflation forecast assumes that average trading partners' inflation rate will only be null and not negative in 2014 and 2015. This assumption is clearly below of what has been the historical experience in the last 9 years - annual average regional inflation has been 5% - and is thus an active driver of our lower domestic inflation projections.

Inflation data available for 2014, up to the end of May, shows that inflation has continued to slow substantially in 2014 and is now tracking 1.2%, on an annual basis, for the first 5 months of 2014. This trend, along with more persistent downward foreign inflation pressures than we had expected up to May, were the main factors that led us to revise down our inflation projections, which we had previously projected at 4% and 5% for 2014 and 2015.

In terms of the publication, section 1 reviews recent economic trends and data releases, while section 2 details our main economic projections and respective assumptions. Section 3 ends with a brief overview of risks and considerations that may affect the final economic outcomes, but are hard to predict and quantity exactly and so merit a more qualitative overview.

2. Recent Economic Trends

2.1 Economic Activity

Timor Leste's non-oil economic activity growth seems to have slowed down substantially in 2013, compared to the recent high growth levels registered for 2011 and 2012. BCTL's economic indicator, which measures real-time economic activity trends, is pointing to economic activity growth of under 2% in 2013, whereas it has been 14% and 12.8% in 2011 and 2012 (chart 1).

This indicator allows us to obtain a rough but timely picture of economic developments for the non-oil economy, thus overcoming the lack of updated GDP data – as the last official GDP estimate refers to 2011. Using the data available up to the end of the 1st quarter of 2014, regarding public expenditure, fiscal and non-fiscal public revenue, imports, banking and payments data, BCTL's indicator uses 9 main economic series to quantity an overall economic activity growth rate.

These 9 main indicators, presented in table 1, show that the slowdown is broad based, visible for imports, public spending, fiscal revenue and banking data.

The slowdown seems to be explained by the significant reduction of public spending stimulus and the phase-off of UN operations at the end of 2012. Note that overall real public spending, on cash basis, decreased 161 million USD in 2013 and capital spending by 176 millions.

In line with this data, BCTL's 2013 GDP growth rate preliminary estimate (2.5%) is clearly below other official forecasts, such as those from Ministry of Finance, IMF and ADB, which put 2013's growth estimate at 8-9%, or at trend level.

CHART 1 | BCTL Economic Indicator and Non-Oil GDP growth - %YoY

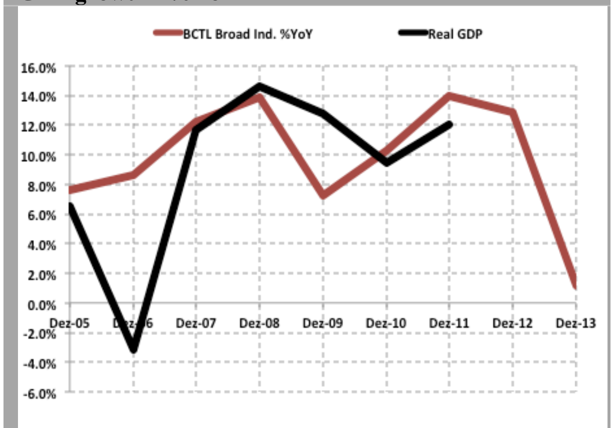


TABLE 2 | 9 Main Indicators – real annualized changes in millions USD (4 quarters average)

Main economic dataseries	Dez-11	Dez-12	Dez-13	Mar-14
Imports Constr. Material	30.1	5.0	-16.0	-17.3
Imports Fuel	28.4	35.1	31.5	29.2
Public Spend. Capital	365.6	-147.0	-176.2	-56.7
Public Spend. Total	297.4	10.3	-161.0	23.6
Total Tax Revenue	27.2	13.4	2.4	11.6
Income Tax Revenue	9.4	7.0	1.2	10.1
Δ HHolds Deposits	15.1	36.1	-112.8	23.7
Δ Total Credit	23.6	2.4	-4.4	-14.3
Bank Transfers Net Outflows	281.2	-134.5	162.1	

Source: DNE and BCTL estimates

2.2 Inflation

Domestic inflation has also registered a significant decrease since the cyclical-high levels of 2011/2012. Annual average inflation, measured using Dili's CPI data, has decreased from 13.5% (2011) and 11.8% (2012) to 7.9% (2013). At the end of 1st quarter of 2014 annual 4 quarters average inflation was 6% and 1st quarter annual inflation (1Q 2013 to 1Q 2014) was 2%.

This substantial decrease in inflation seems to be mostly due to the slowdown in domestic economic activity, pointed out above and showed in chart 2. Note, however, that the economic slowdown preceded, by some quarters, the decrease in inflation, which seems to be due to the 'slow adjustment' of economic agents' inflation expectations.

Inflation slowdown occurred mostly in 2013, particularly during the last quarter of the year, using Dili's CPI data. Core inflation, which is less sensible to price changes for large-weight and volatile individual consumer products, mostly food related, has decreased earlier in 2013, leading the substantial CPI inflation slowdown.

Non-food inflation has decreased more rapidly than food inflation in 2013. In fact, a small number of food items have kept food inflation high up to the end of 3rd quarter of 2013 and, consequently, given the substantial weight of food expenditures in the CPI, total inflation has remained high until September.

Note also that non-food inflation has registered annual values of close to 0% in both the last quarter of 2013 and 1st quarter of 2014. Since non-food inflation has tracked economic fundamentals better than food inflation, this seems to be an additional confirmation of the broader economic slowdown. Importantly, as the dollar appreciated against most Asian currencies in the last quarter of 2013, external inflation pressures helped to reinforce the downward inflation trajectory.

CHART 2 | BCTL Economic Indicator and Non-Food Inflation – average %YoY

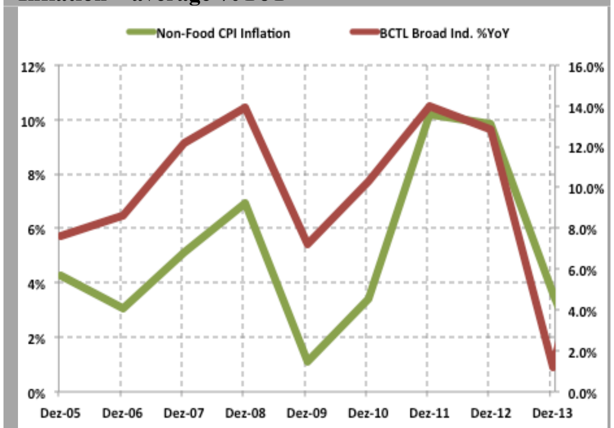


CHART 3 | Total and Core Inflation – %YoY

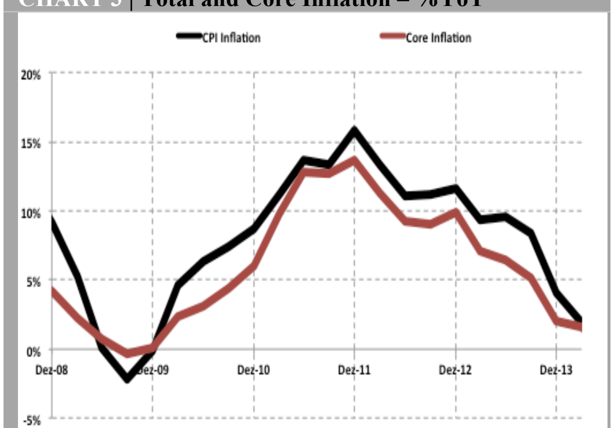
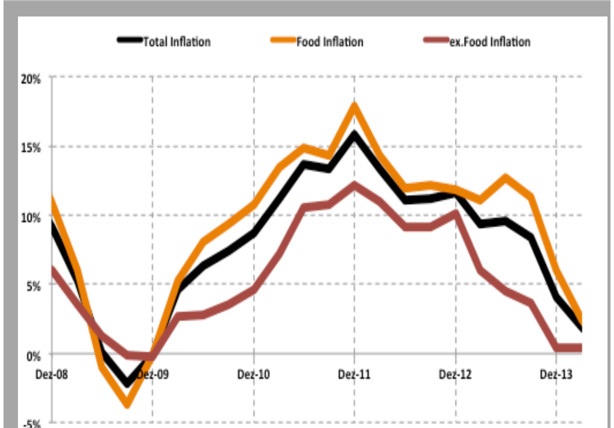


CHART 4 | Total Food and Non-Food Inflation - %YoY



Source: DNE and BCTL estimates

2.3 External Developments

Timor Leste economy continues to be highly influenced by the developments regarding its regional trading partners, especially as to what concerns the regional price trends, given the currently high import needs of the country. Note also that in terms of GDP growth, given the small export capacity of the country and yet reduced degree of financial and trade integration within the region, the influence of regional GDP trends is practically irrelevant for the domestic economy.

In this case, we are more concerned with assessing the influence of regional price trends, which are a composite factor of regional inflation rates and foreign exchange trends, in terms of domestic inflation, given that many items of the consumer basket are sourced in the regional markets.

In this respect, as chart 5 shows, the recent trend of broad dollar appreciation versus Asian currencies has yielded negative foreign inflation pressures for Timor Leste, as the average Asian inflation rate – including ASEAN top 5 economies and China, expressed in dollars - has fallen from +5% at the end of 2012 to -5% in the 1st quarter of 2014. This negative external inflation pressure has thus reinforced the domestic economy slowdown towards pushing down the domestic inflation rate. Note also that the broad dollar appreciation trend against Asian currencies has resulted from a combination of the FED's withdrawal of extraordinary accommodative monetary policy measures and broad regional deterioration of external current account balances, a trend that is especially evident for Indonesia.

Chart 7 also shows that international prices for relevant commodities have trended down in the last few quarters, which will certainly help to reinforce the downward domestic inflation trend.

CHART 5 | Asian Partners Inflation – annual % in USD

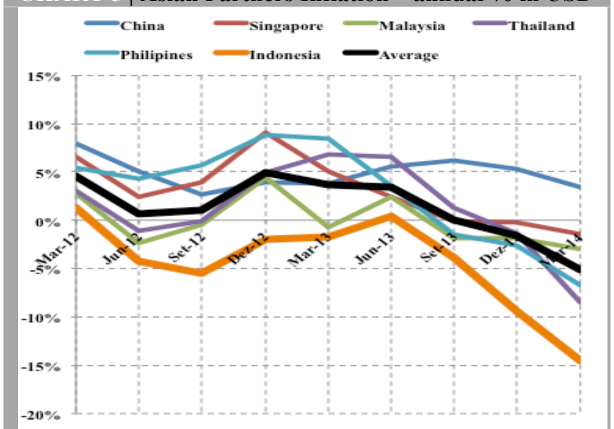


CHART 6 | Asian Foreign Exchange – % vs USD

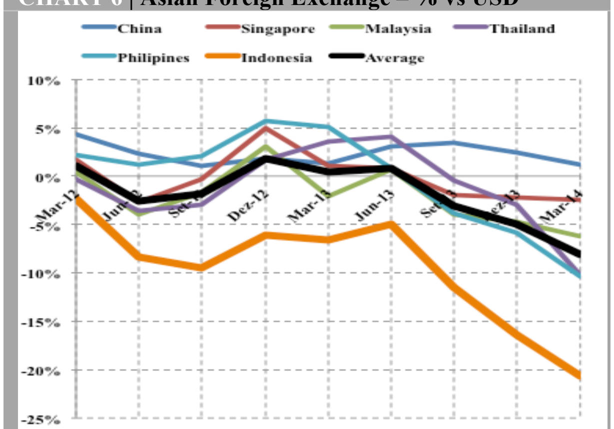
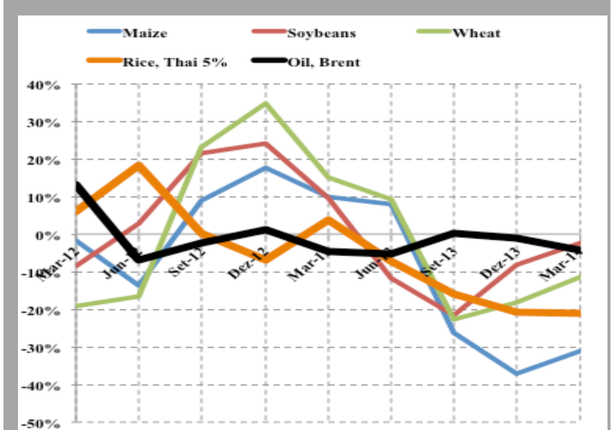


CHART 7 | Commodities Prices - % year-on-year



Source: Bloomberg and World Bank

3. Near Term Views: 2014 and 2015

3.1 Economic Activity

Our base-case assumption is that economic growth will remain subdued in 2014 and pickup to trend level in 2015. This means we expect 4% growth in 2014 and 8% growth in 2015. Note that our below-trend projection for 2014 already incorporates a slight acceleration from our preliminary 2013 GDP growth estimate (2.5%).

Rationale – Our below-trend economic forecast assumes that the recent economic slowdown will continue into 2014 and that public expenditure will be practically unchanged in 2014, compared to 2013. As we show in table 4, given the approved 2014's budget and assuming expenditure execution rates will be the same in 2014, as in 2013, real total public expenditure will only increase by 13 million dollars. Also importantly, this same projection foresees a substantial decrease of capital spending in 2014 (-122 million usd), which has had a strong historical correlation with economic activity growth rates.

Other official projections – For 2014, we are clearly expecting lower economic activity growth than the MoF, IMF and ADB. For 2015, the growth projection converges with other official projections.

2014 developments - Economic data for 2014 is only available up to the end of the 1st quarter. Nonetheless, BCTL economic activity indicators are pointing to continued subdued growth in 2014 of around 4%. Note also that although data is only available up to the end of 1st quarter, our indicators already allow us to estimate 2nd quarter annual growth rates, because most of the individual data-series tend to lead the cycle. As such, economic developments seem to be tracking our projections for 2014.

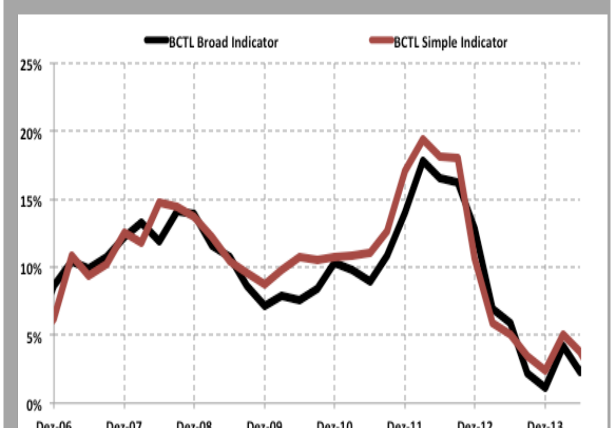
TABLE 3 | % GDP Growth Projections Compared

	BCTL	MoF - Budget	ADB	IMF
2009	-	12.8%	-	-
2010	-	9.5%	-	-
2011	-	12.0%	-	-
2012	10.0%	8.2%	8.2%	9.3%
2013	2.5%	8.0%	8.0%	8.4%
2014	4.0%	8.8%	8.5%	9.0%
2015	8.0%	9.4%	8.5%	8.8%

TABLE 4 | Budgetary Spending Forecasts for 2014

Expenditure Type						
	Wages	Transfers	G&S	Minor Capital	Major Capital	*Total*
2008	50	84	221	41	86	*484*
2009	87	94	213	39	171	*604*
2010	91	169	246	38	216	*760*
2011	112	143	254	27	561	*1 097*
2012	131	218	342	42	464	*1 198*
2013	142	199	390	41	305	*1 077*
FCAST. 2014	156	275	437	38	183	*1 089*
Assuming OGE % Execution in 2014 equal to 2013:						
	88%	*85%*	*89%*	*73%*	*40%*	*65%*
Forecast for 2014:						
Δ year m.usd	*14*	*76*	*47*	*-2*	*-122*	*13*
Δ year %	*10%*	*38%*	*12%*	*-6%*	*-40%*	*1%*

CHART 10 | BCTL Economic Activity Indicator - %YoY growth rates in domestic economic activity



Source: BCTL, IMF, ADB and 2014 OGE

3.2 External Developments

Under our base-case scenario, we now expect foreign inflation pressures to remain substantially below of what has been the annual average along the last 9 years (+5%). Specifically, we now forecast that average inflation rate of top 5 ASEAN countries and China, expressed in dollars, to be around 0% in both 2014 and 2015. This means that we expect local currency inflation to be practically cancelled by Asian currencies' depreciation against the dollar in 2014 and 2015, thus yielding null external inflation pressures for Timor Leste, measured in dollar terms.

Lowered projection for external inflation pressures - We have recently lowered our foreign inflation projection, to be more in line with the trend registered during the last of quarter of 2013 and first months of 2014. Up to the end of the 1st quarter of 2014, we expected that regional inflation rate to be 5% in both 2014 and 2015, which assumed that the recent broad Asian currencies depreciation was to be reversed along 2014. We now side with the view that the regional currencies depreciation trend will be more permanent in 2014 and 2015, which will contribute to stabilize regional inflation pressures measured in dollars.

2014 developments - Naturally, given that 1st quarter data is already available for regional inflation and currencies, it should be highlighted that our measure of external inflation has been registering values of around -5% in the 1st quarter, substantially below our now lowered projection for this variable in 2014. Nonetheless, we expect that the regional currencies depreciation to be broadly stable around 2014's 1st quarter lower values against the dollar, which should yield negative regional inflation rates up to the 3rd quarter, and positive inflation rates in the last months of 2014.

CHART 11 | Foreign Inflation in USD - values and projections - %Year-on-Year

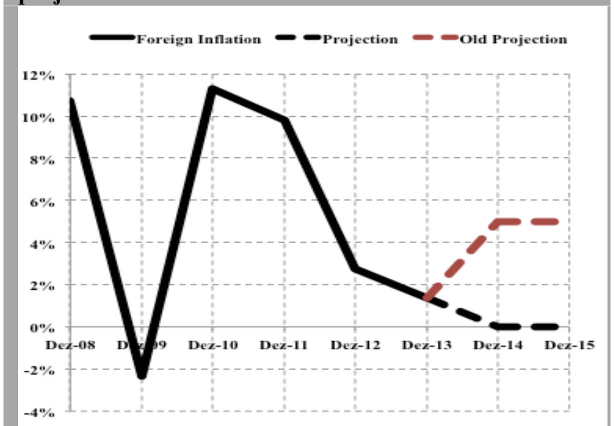


CHART 12 | ASEAN 5 & China Average Inflation and Foreign Exchange Trends and Projections - %YoY

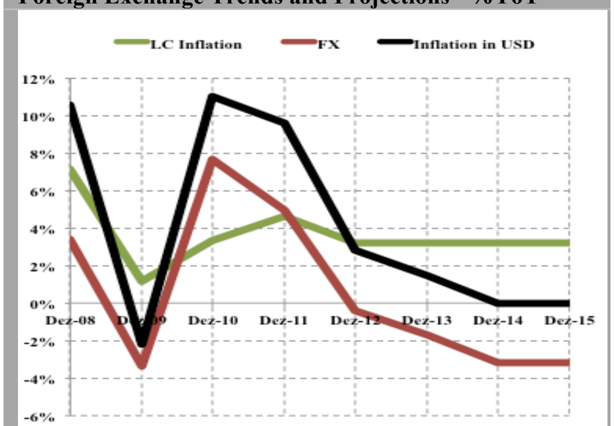
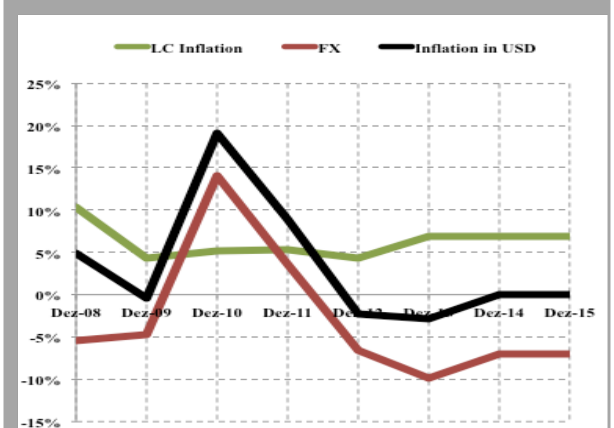


CHART 13 | Indonesia Inflation and Foreign Exchange Trends and Projections - %Year-on-Year



Source: BCTL and Bloomberg

3.3 Inflation Projection

Inflation Forecasting Framework – BCTL is currently using a model to explain and forecast near-term inflation trends, which uses 2 main drivers of domestic inflation: domestic economic activity growth and foreign inflation, which was defined above. This model allows us to back our inflation projections in terms of specific scenarios for the drivers along the next 2 years, which we consider to be highly probable to happen. Naturally, our inflation projection is dependent on the materialization of these scenarios and on the statistical quality of the models and estimated parameters. Importantly, the model also employs lagged inflation values, which assume that inflation adjustment to drivers' shocks is lagged in time.

Base-Case Scenario – As explained in previous sections, we foresee for 2014 a subdued pick-up in economic activity (4%), which should come back to trend level growth (8%) in 2015. On the external front, we now project under our base-case scenario that foreign inflation measured in dollars should be around 0% in both 2014 and 2015, which is substantially below the average trend registered in the last 9 years (+5%).

Inflation Projections – Under these assumptions for the macroeconomic drivers, we now project that inflation should be around 2% in both 2014 and 2015, for our base-case scenario. Note that both these forecasts are substantially below the historical average inflation rates registered in the last decade for Timor Leste (6.8%). This arises because we envision the domestic economy to grow below or at trend level in the 2 years ahead, but also because we assume external inflation will be significantly below its historical average values along the next 2 years.

CHART 14 | Inflation (%YoY) and BCTL Economic Indicator (YoY changes in millions USD)

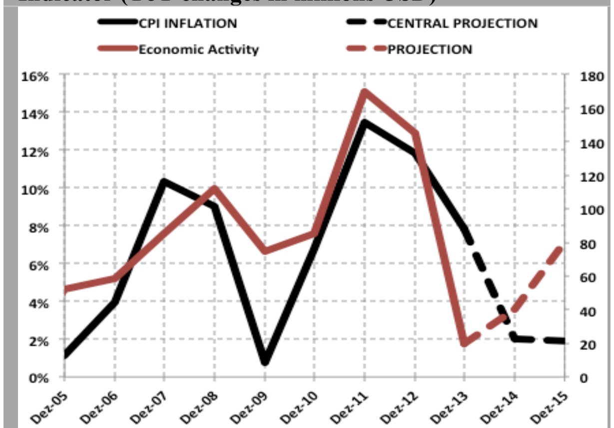


CHART 15 | Inflation and Foreign Inflation - %YoY

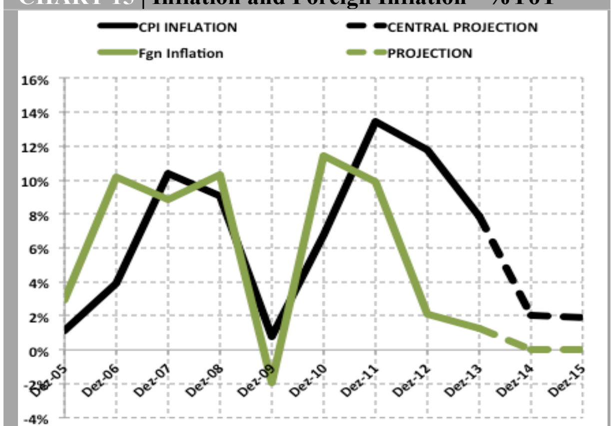


TABLE 5 | Inflation Projections Compared

	BCTL	MoF - Budget	ADB	IMF
2009	-	0.0%	-	-
2010	-	5.2%	-	-
2011	-	13.0%	-	-
2012	-	10.7%	-	-
2013	-	8.9%	-	-
2014	2.0%	7.7%	9.5%	9.5%
2015	2.0%	7.7%	9.0%	8.1%

Source: BCTL, MoF, IMF, ADB, Bloomberg and DNE

Other official projections – For both 2014 and 2015, we are clearly expecting lower annual inflation than the MoF, IMF and ADB, which is due in part to our more subdued economic outlook, but also to our foreign inflation views.

2014 developments – Inflation data is already available up to the end of May of 2014, which shows a continued downward movement of inflationary pressures. 2014's annual average inflation rate has been 1.2% from January up to May, which was significantly below our previous annual forecast of 4%. As we explained above, our previous forecast assumed a higher foreign inflation scenario, which was substantially above than the negative trend registered since the end of 2013 and into 2014.

Downward inflation risks – Our annual forecast is now 2% for 2014 and 2015, which is broadly in line with inflation data available up to the end of May. Nonetheless, should the current negative foreign inflation trend persist or intensify, which is a strong possibility, on the back of broad currency depreciation versus the dollar, we should revise even lower our current inflation forecast.

Alternative Scenarios – We consider that our base-case scenario is highly likely, but admit that other scenarios might yet come to be, which could push inflation above or below our projection. This possibility is highly relevant for 2015, which is yet more distant and naturally more difficult to predict. As such, in addition to our base-case projections, we also analyzed the sensitivity of our forecasts to alternative macroeconomic drivers scenarios, estimating inflation rates consistent with these alternative possibilities. As chart 17 shows, we considered 3 other likely scenarios which differ from our base-case on: (1) 4% growth in 2015 and negative foreign inflation of -5% in both coming years; (2) trend growth of 8% in both 2014 and 2015, but negative foreign inflation of -5% in both years; and (3) trend growth of 8% in 2014 and 2015 and 0% foreign inflation in both years. These scenarios yield inflation forecasts of between 0% and 4% for 2014 and -2% to 2% for 2015. Except for the 3rd alternative scenario, we should have inflation of 2% or below in both coming years - only in the case of a more robust domestic economy (8% growth in both years) and null foreign inflation we should have higher annual inflation of 4% in 2014. Nonetheless, given the persistence of 2014's data trends to date, both on the domestic and external fronts, we admit that even our base-case scenario might be slightly overestimating the annual inflation rate for 2014, especially as to what refers to negative foreign inflation trend.

CHART 16 | CPI Inflation: Food, Non-Food and Total - %YoY

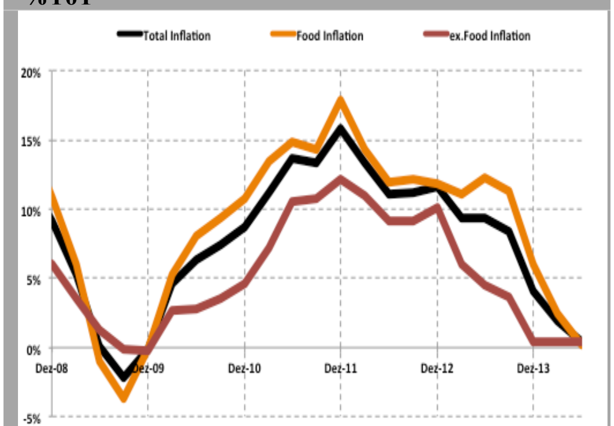
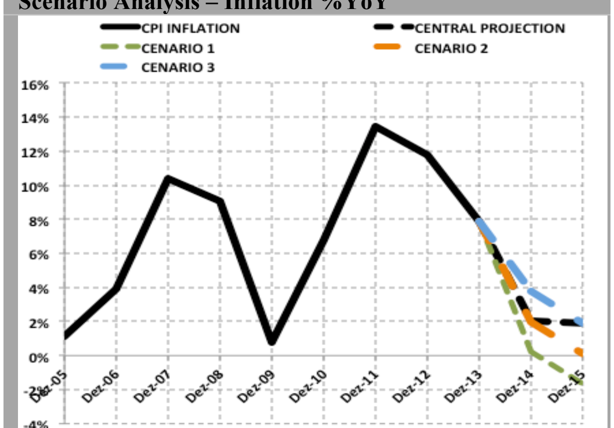


CHART 17 | Alternative Inflation Forecasts and Scenario Analysis – Inflation %YoY



Source: DNE and BCTL estimates

4. Major Issues and Risks to Projections

We explore below some risks to our projections, which are difficult to quantify exactly and thus hard to include in our quantitative framework, but should merit enough consideration as they can materially determine the macroeconomic outcomes in 2014 and 2015. Some are near-term relevant and others should play a greater role over the medium-term, which means 2015 and beyond.

NEAR-TERM RELEVANT THEMES:

Public spending and external inflation pressures – Given the importance of these drivers within BCTL's macroeconomic projection framework, the risks were already covered above.

Inflation expectations – A material decrease in economic agents' inflation expectations, a correction from previous years, could push 2014's inflation substantial below our projection, especially if the economy stays 'subdued' in 2014.

Banking Sector – Credit and funding is an important driver of domestic economy. Although it is hard to assess objectively the future trajectory of bank lending, we note that recent banking optimism and dynamism can create some near-term upside surprise to our growth projection.

MEDIUM-TERM RELEVANT THEMES:

Major Public Projects – In its efforts to promote the competitiveness and development of Timor Leste, the Government is actively proceeding to approve major infrastructure projects such as the new national port and airport. In parallel, the implementation of 'Taci Mane Project' and 'Oecusse Special Economic Zone Development Plan', given their substantial clout have also the potential to push upwards the growth trajectory of the economy. We expect these impacts to be more visible from 2015 onwards.

Major Private Sector Investments – A number of large-scale private investment projects have been announced recently, which have also the potential to push growth upwards. Among these, the construction of a cement factory in Baucau, with an investment amounting to 300 million dollars, will have, if approved, a substantial impact on domestic economy. These projects should play a greater role from 2015 onwards.

Domestic Production – The continued progress of domestic productive sector should have medium-term economic benefits, as local demand is increasingly satisfied by local production, thus elevating non-oil GDP. This slow underlying progress, hard to assess accurately, given the dearth of production related statistics, should have medium-term positive economic consequences.

Low and stable Inflation – The slow transitioning to a steady and low inflation regime for the domestic economy should offer support to future real consumer and business spending decisions, thus stimulating the economy in the medium-term.