

Expanding Timor-Leste's Near-Term Non-Oil Exports

Diagnostic Trade Integration Study (DTIS)
prepared for the Integrated Framework

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Poverty Reduction and Economic Management Sector Unit
East Asia and Pacific Region



DRAFT

EXECUTIVE SUMMARY

REMOVING CONSTRAINTS TO EXPANDING EXPORTS IN THE NEAR-TERM AND PROVIDING THE FIRST STEP FOR A LONGER-TERM EXPORT STRATEGY

1. The Government of Timor-Leste (GOTL) is committed to the development of the non-oil economy by enabling the diversification of domestic production and trade integration. The objective of the Timor-Leste Diagnostic Trade Integration Study (DTIS) is to agree on priority actions to help overcome constraints to expanding agricultural exports in the near-term. It supports the government's efforts to develop a broader international trade strategy, which may include strategic sectors such as tourism and fisheries. The focus of the DTIS is on short-term results in areas with immediate export potential. It therefore looks only at the agriculture sector.
2. Achieving export growth and diversification are essential for supporting overall economic growth and employment generation. Non-oil export growth is critical in light of the external sustainability risks of depending on exhaustible petroleum exports. Expanding output for domestic consumption is also a priority and may help reduce dependence on imports. Policy actions to expand exports will impact positively on domestic trade as well. Timor-Leste faces the challenge of having to mostly create a non-oil export sector, rather than reviving one that is stagnant or destroyed because of conflict. This context is quite unique even when compared to similar small-island or post-conflict countries.
3. The DTIS covers five main areas. Section I looks at macro and trade policies as they relate to external competitiveness and market access. Section II analyzes the export potential in the agriculture sector. Section III looks at structural constraints to trade and recommends possible measures to help improve productivity and reduce costs. Section IV examines the critical infrastructure needs to facilitate trade. Section V looks at implementation arrangements and next steps.

MACROECONOMIC AND TRADE POLICIES HAVE BEEN CONSISTENT WITH PROMOTING EXPORT COMPETITIVENESS

4. Timor-Leste is a small economy, where the macroeconomic environment has been bolstered by rapidly rising petroleum revenue since 2004. A stable macroeconomic environment is critical for export competitiveness, including stable inflation and a competitive real effective exchange rate. The government to date has implemented sound policies, which have helped to maintain macro stability and are consistent with objectives of promoting export competitiveness. A cornerstone of the government's macro framework is Timor-Leste's Petroleum Fund (PF). Fiscal expenditures have expanded rapidly to meet pressing needs. But the PF has provided a robust instrument to promote discipline and transparency in the use of natural resources. The main challenge going forward is using fiscal policy to promote productivity, competitiveness, and diversification in the non-oil economy.

5. Trade policies in Timor-Leste are not a constraint to promoting export growth and diversification. Protectionist policies (e.g. high tariffs and non-tariff barriers) or other distortionary measures (e.g. export subsidies or taxes, import subsidies) can restrict market access and/or hamper the growth of export industries. But Timor-Leste has one of the most liberal trade policy regimes in the world. This will continue to support the country's economic development needs by maintaining low import prices, encouraging technology transfers, minimizing anti-export bias, and reducing incentives for illicit flows across borders.

6. Market access has not been a major issue for Timor-Leste's exports to date even though the country is not a member of any multilateral or regional trading arrangement. As a Least Developed Country (LDC), Timor-Leste will continue to receive preferential tariff treatment from major markets. The GOTL has prioritized membership of the Association of Southeast Asian Nations (ASEAN). More than 70 percent of Timor-Leste's imports come from ASEAN countries, which provide markets for more than a quarter of Timor-Leste's exports. ASEAN membership seems a logical next step towards greater international economic integration. It can also provide a stepping stone towards WTO membership. The DTIS recommends to conduct an assessment of steps required to fulfill the ASEAN Economic Community Blueprint and a study on WTO accession.

7. The institutional structure for developing and coordinating trade policy in Timor-Leste is still at a nascent stage given capacity constraints and other more immediate priorities. Addressing trade-related issues and developing an international trade strategy will require solid institutional foundations. The responsibility for policies that impact on exports spans across the government. As in other countries, agencies that are nominally responsible for international trade policy may have little authority over the policies that are most important to trade. The DTIS recommends using the Integrated Framework National Steering Committee as a forum for strengthening coordination around trade policy; training selected civil servants across government on specialized trade-related topics (trade policy analysis and negotiations); enacting the new Investment Law and related Decree Laws; and strengthening the capacity and institutional status of the newly established Investe Timor-Leste.

DELIVERING ON THE POTENTIAL FOR AGRICULTURE EXPORTS IN THE NEAR-TERM

Subsectors with immediate export potential

8. The agriculture sector in Timor-Leste, which employs 80 percent of the active population, has potential to both expand exports in the near-term and have a positive impact on poverty. Timor-Leste has a wide range of improved crop and livestock production packages which are ready for nationwide adoption, provided the technologies can be extended to farmers and markets developed. The DTIS looked at three subsectors with potential for both substitution of existing imports and expansion of exports:

9. Coffee has the greatest potential for both increasing export earnings and reducing poverty. In 2009, about 67,000 households grew coffee in Timor-Leste, with a large proportion being poor. With improved technology for coffee farmers, gross margins could increase by an average of about \$500 per hectare (ha) from only \$120/ha. Returns per labor-day would increase from about \$3.70 to \$5.90. Increasing production by four times from around 52,000 ha of coffee plantations could increase export earnings by about \$45 million per year. Aside from promoting improved technology, the DTIS also recommends to further support the rehabilitation of coffee plantations and to start Integrated Pest Management.

10. Grains and pulses (in particular *mungbean*) have export potential even though the impact on poverty may be more limited than coffee. Pre-Independence production of mungbeans collapsed after the departure of Indonesian traders. The 11,000 households growing mungbeans now are mostly subsistence farmers. But there is commercial demand including for exports. Going from 0.25 ha of crop per household to 0.50 ha could result in an incremental household gross margin of \$340 per year and returns per labor day of \$5.90. Producing 4,000 Mt per annum valued at \$700/Mt could generate \$2.8 million in exports. The DTIS recommends to expand donor programs and extension services to mungbean farmers particularly along the south coast and to establish links with buyers in Indonesia.

11. Livestock (in particular *cattle*) has potential for increased exports to Indonesia where the demand for beef is estimated to be growing at 6 – 8 percent per year, and imports are likely to supply 38 percent of their demand by 2010. Around 44,000 households are engaged in rearing cattle/buffalo. If a family fattened 2 heads of cattle per year, their net farm income would increase by \$280 per year. Export earnings could be around \$4.5 million. The DTIS recommends to update the livestock census to get a better idea of cattle populations and to evaluate options for a new public or private abattoir near Dili.

Looking at medium-term possibilities for horticulture exports

12. Timor-Leste has recently seen a growth in the production and marketing of vegetables and fruits for domestic markets. Expanding this for exports presents major challenges given the perishable nature of the products, difficult transport linkages, and the distance from markets. The DTIS looks at earlier feasibility studies and experimental trials to supply fresh fruit and vegetables to markets in Australia. Horticulture is not recommended as a short-term priority for exports. But given that these crops are labor intensive and can contribute to employment and income generation, the DTIS highlights the possibility of conducting courses on safe pesticide use, establishing regulations for pesticide safety, and exploring investment in small scale cold chain equipment.

Sanitary and Phytosanitary (SPS) Certification capacity: an immediate priority

13. Timor-Leste currently has very limited SPS certification capacity. Though SPS has not restricted exports to date, this has become an urgent issue. The Government of Indonesia has indicated that imports from Timor-Leste will be banned from the end of 2010 without the necessary SPS certification. There are a number of challenges to developing and implementing an SPS system including the technical and financial resourcing of the National Directorate of Quarantine and Biosecurity. Investments will need to be commensurate with the volume of exports. The quarantine services in other countries provide services for large volumes and year-round exports of a variety of commodities. The DTIS recommends to formulate a strategy for SPS and to organize stakeholders not only to maintain existing exports but also to expand exports.

ADDRESSING THE STRUCTURAL CONSTRAINTS TO EXPANDING EXPORTS

14. The analysis of the different agricultural subsectors highlights several structural factors that constrain exports. This analysis supplemented by discussions with the private sector highlighted three major issues constraining export competitiveness and growth: the skills deficit; access to land; and the business environment.

Addressing the skills deficit

15. Developing agricultural subsectors into profitable export and import replacement businesses will require strengthened skills and experience of farmers and extension workers. Both pre- and post-harvest crop losses are high, with farmers losing up to 33 percent of their crop. In addition, agro-processing technologies are typically outdated and inefficient, preventing more commercial production. There are existing technologies and approaches assisting both farmers and Suco Extension Officers, which can potentially be replicated nationwide for coffee, horticulture, other crops, and livestock. The DTIS recommends to build on these to strengthen the newly created agricultural extension services and increase budget resources to agricultural research and extension.

16. Skills gaps at the level of the farmer and agro-processor are a binding constraint for short-term productivity and growth. As these are addressed, there will be added pressure for skills along the value chain. However, gaps penetrate the full extent of the skills spectrum. This is evident in the large number of foreign workers in most sectors of the economy, who are currently providing a critical input. Building domestic capacities and encouraging skills transfer to substitute imported labor in the long-run is a high priority. In addition to foreign labor, Vocational Education and Training (VET) and on-the-job training are helping to address the skills gap. The DTIS highlights a number of issues to strengthen VET and on-the-job training, including linkages between training institutions and labor market demands; quality assurance, accreditation, and certifications; and training of trainers.

Improving access to land

17. The lack of formal property rights and the limited access to land are important constraints to investment and export growth. Around 97 percent of rural landholdings remain under customary tenure, which is land that has (usually) never been titled. Ownership and user rights are typically regulated by customary (or traditional) authority structures. As a result, private sector investment in agriculture is low. Notwithstanding the production of coffee and, on a more limited scale, the production of other cash crops including candlenut, peanuts, maize, mungbean, and copra, the majority of rural farmers in Timor-Leste rely mainly on subsistence crops for their livelihoods. Although there has been some work on property rights, particularly in urban and peri-urban areas, there has been little focus on expanding land registration in rural areas. The DTIS recommends to evaluate the potential for expanding the *Ita Nia Rai* land registration program over critical areas of primary industry land, including some areas of coffee plantation.

Strengthening the business environment

18. In addition to the skills gap and the lack of access to land, Timor-Leste has a very challenging business environment, which can be a disincentive for investment and an impediment to generating scale. Three issues in particular are highlighted:

19. Business start-up in Timor-Leste is a complex and time consuming process. Private businesses end up operating informally or paying illegal fees to speed up the process. It also ends up driving away potential investors. The DTIS recommends to build capacity for Ministry of Justice and Ministry of Tourism, Commerce, and Industry staff involved in registration and licensing and create a one-stop shop for business start-up with a quick incorporation and registration procedure and electronic sharing of information across ministries.

20. Contract enforcement capacity in the government is low, and there is limited use of contracts in the first place. The general lack of alternative methods of dispute resolution also inhibits investments. The DTIS recommends to develop a commercial arbitration or mediation facility, deliver training programs on commercial disputes for mediators and arbitrators, and build capacity of Timorese businesses to use contracts.

21. Access to finance is limited partly due to the lack of information on borrowers and the weaknesses in the legal structure to protect borrowers and lenders. This has constrained the growth of credit markets. The size and reach of financial markets is small, inhibiting business growth including in the export sector. There are efforts under way to try and address some of these challenges, including institutional strengthening (e.g. risk management, credit information reporting system) and the expansion of microfinance. The DTIS recommends to provide support to evolving the credit information reporting system into a full-fledged credit bureau and enable the provision of credit on the basis of contracts with reputable private sector companies.

22. These three issues along with challenges associated with access to land are clearly interrelated. For example, the lack of clear land titles inhibits access to finance because land cannot be used as collateral for loans. Companies, foreign or domestic, cannot set up their businesses or obtain capital if they cannot register. Export contracts will not have credibility if disputes cannot be resolved.

INVESTING IN CRITICAL INFRASTRUCTURE TO FACILITATE INTERNATIONAL TRADE

23. In addition to the above structural issues, the DTIS looks at critical infrastructure and associated services that are needed to facilitate international trade, in particular the road transportation network, the port of Dili, and the customs services. These areas are important for ensuring that goods can move efficiently across borders from their source.

24. The road transport system in Timor-Leste is somewhat unusual in that the distances traveled are short and the loads are small, but travel times are relatively long and costs are high, due primarily to the terrain. Road links with potential to grow into a *trade corridor* should receive priority funding. The DTIS looks at two corridors in particular. The first is the coffee corridor, which connects the country's main coffee growing areas in Ermera district to the capital, where the commercial airport and seaport are located. The second is the cross-border corridor, which connects Dili with the Mota Ain border to Indonesia. The current traffic volume on the cross-border corridor is among the highest in the country, but it is still fairly light in terms of traffic capacity.

25. The Port of Dili is used to handle both container and breakbulk cargo. It is a small facility originally designed for breakbulk operations. Port capacity is limited not on the waterside but on the landside. If the volumes continue to increase, congestion will become a severe problem. In order to address this, it will be necessary to convert the port to a modern configuration. This would involve block stacking of containers in designated slots to a maximum height of 4 boxes with rows 5 wide. Such changes will allow the port to double its current capacity and continue operating without congestion for another 6-8 years.

26. Customs in Timor-Leste is confronted with similar problems as other customs departments attempting to modernize their procedures. There are some unique features in Timor-Leste: small portion of total government revenues; relatively new cadre of customs staff; lack of reliable communications limiting the effectiveness of ASYCUDA; use of scanners in the airport and seaport still not clarified; and limited customs presence in the airport and land border crossings. Customs is able to clear goods within 2-3 days. This would place it well ahead of most developing countries, except that it has been accomplished because certain procedures have not yet been introduced. The biggest challenge is to introduce a more rigorous system while maintaining the short clearance times that currently allow Dili port to continue functioning. The government is already making efforts in this area.

27. The recommendations set out in the study are preliminary. Furthermore, as per the DTIS format, the analysis covers a broad set of issues, resulting in a large number of recommendations. Clearly, there is a need to prioritize areas for action, taking into consideration Timor-Leste's priorities and capacity. The recommendations will be assessed and reviewed by a broad range of stakeholders in the National Validation Process. This process will include a series of thematic roundtables, leading up to the final National Validation Workshop (NVW). The roundtables will be used to communicate and disseminate the study findings and recommendations and to elicit feedback. The recommendations along with the priority actions will then be finalized through the NVW.

SUGGESTED DTIS ACTION MATRIX (TO BE DISCUSSED AND FINALIZED)¹

| Issue | Recommended Action | Responsible Agent | Time-frame ² |
|--|--|-------------------|-------------------------|
| DEVELOPING A LONGER-TERM INTERNATIONAL STRATEGY | | | |
| Coordination and capacity on international trade policy issues. | • Establish the Integrated Framework National Steering Committee as a Ministerial forum for strengthening coordination around trade policy. | | ST |
| | • Train selected civil servants across government on specialized trade related topics (trade policy analysis and negotiations). | | MT |
| Accession requirements for multilateral and regional integration arrangements. | • Undertake an assessment of the timeframe, resources, and actions required to meet the needs under each section of the ASEAN Economic Community Blueprint. | | ST |
| | • Conduct a study to assess WTO accession for Timor-Leste. | | LT |
| Investment promotion for international trade. | • Enact the new <i>Investment Law</i> and related Decree Laws. Strengthen the capacity and institutional status of the newly established Investe Timor-Leste including by developing an investment promotion strategy, business plan, vision, and performance targets. | | ST |
| | • Conduct a tourism study to analyze the country's prospects for developing a viable tourism sector. | | MT |
| DELIVERING ON THE POTENTIAL FOR AGRICULTURE EXPORTS IN THE NEAR-TERM | | | |
| Exports of coffee. | • Plan, prepare, and implement the initial rehabilitation of coffee plantations. | | MT |
| | • Strengthen donor coordination for support to coffee, and promote transfer of improved technology and Integrated Pest Management. | | ST |
| Domestic and international trade of grains and pulses (mungbeans). | • Expand existing donor programs and extension services to mungbean farmers, particularly along the south coast. | | MT |
| Domestic and international trade of livestock (cattle). | • Update the livestock census to get a better idea of cattle populations, and evaluate options for a new public or private abattoir near Dili. | | MT |
| Sanitary and Phytosanitary (SPS) Certification capacity. | • Form a SPS Consultative Group including relevant stakeholders in the government and the international community to develop and implement a strategy for the establishment of SPS capacity. | | ST |

¹ The Action Matrix presents suggestions that are intended to serve as a starting point for the National Validation Workshop (NVW) discussions. The Responsible Agents for each action will be determined through the NVW.

² ■ Short-term (ST)= within one year ; ■ Medium-term (MT)= 1-3 years; ■ Long-term (LT)= more than 3 years

| Issue | Recommended Action | Responsible Agent | Time-frame ² |
|---|---|-------------------|-------------------------|
| ADDRESSING THE STRUCTURAL CONSTRAINTS TO EXPANDING EXPORTS | | | |
| Addressing the skills deficit. | <ul style="list-style-type: none"> • Build on support to be provided under RDP IV and Seeds of Life III to improve the newly created agricultural extension service, and increase budget resources for agricultural research and extension. | | ST |
| | <ul style="list-style-type: none"> • Generate regular, reliable labor market data in order to better understand the scope of the skills gaps and better link training programs to market demand. | | MT |
| | <ul style="list-style-type: none"> • Support efforts to improve the VET system, including initiatives to improve the professional development of trainers, establish and implement the National Qualifications Framework, and adequately resource INDMO. | | LT |
| Improving access to land. | <ul style="list-style-type: none"> • Conduct a preliminary rural land tenure assessment which evaluates the nature of community ownership and use claims over areas of coffee estate land. • Evaluate the potential for expanding the <i>Ita Nia Rai</i> land registration program over critical areas of primary industry land, including some areas of coffee plantation. | | ST |
| Strengthening the business environment. | <ul style="list-style-type: none"> • <u>Business start-up</u>: Build capacity for MoJ and MTCI staff involved in registration and licensing, and establish a one-stop shop for business start-up with a quick incorporation and registration procedure and electronic sharing of information across ministries. | | MT |
| | <ul style="list-style-type: none"> • <u>Contract enforcement</u>: Develop a commercial arbitration or mediation facility, deliver training programs on commercial disputes for mediators and arbitrators, and provide training to Timorese businesses on the use of contracts. | | LT |
| | <ul style="list-style-type: none"> • <u>Access to finance</u>: Provide support to evolve the credit information reporting system into a full-fledged credit bureau. • Enable the provision of credit on the basis of contracts with reputable private sector companies by developing an awareness campaign and trainings for local financial institutions, coupled with the development of recourse mechanisms in the event of default. | | MT |
| INVESTING IN CRITICAL INFRASTRUCTURE TO FACILITATE INTERNATIONAL TRADE | | | |
| Improving road transportation and maintenance along trade corridors. | <ul style="list-style-type: none"> • Establish a trade activity monitoring mechanism to guide capital investment along trade corridors (Dili-Ermera and Dili to Mota Ain), and implement road maintenance and safety measures. | | MT |
| Congestion at Dili Port. | <ul style="list-style-type: none"> • Convert port to a modern configuration, and develop a new system of terminal management. | | LT |
| Efficiency and effectiveness of the customs service. | <ul style="list-style-type: none"> • Delegate Customs as the lead border agency responsible for coordinating border control, and continue to implement reforms to reduce port dwell time. | | MT |