NATIONAL DIRECTORATE FOR ECONOMIC POLICY ECONOMY

QUARTERLY INFLATION REVIEW

JANUARY - MARCH 2014

n. ° 9

EXECUTIVE SUMMARY

In March 2014, the year-on-year inflation rate in Timor-Leste was 1.8%. Inflation has fallen dramatically compared to the same period in 2013 when year-on-year inflation was 11.3%. This sizeable fall in the year-on-year inflation rate can be attributed to a combination of domestic and international factors:

- The strong appreciation of the US dollar relative to the currencies of Timor-Leste's major trading partners (especially with respect to the Indonesian Rupiah)
- A general downward trend in international food and non-food commodity prices
- The removal of the inflation seen in Q1 2012, a high inflation quarter[1], from the year-on-year inflation calculations

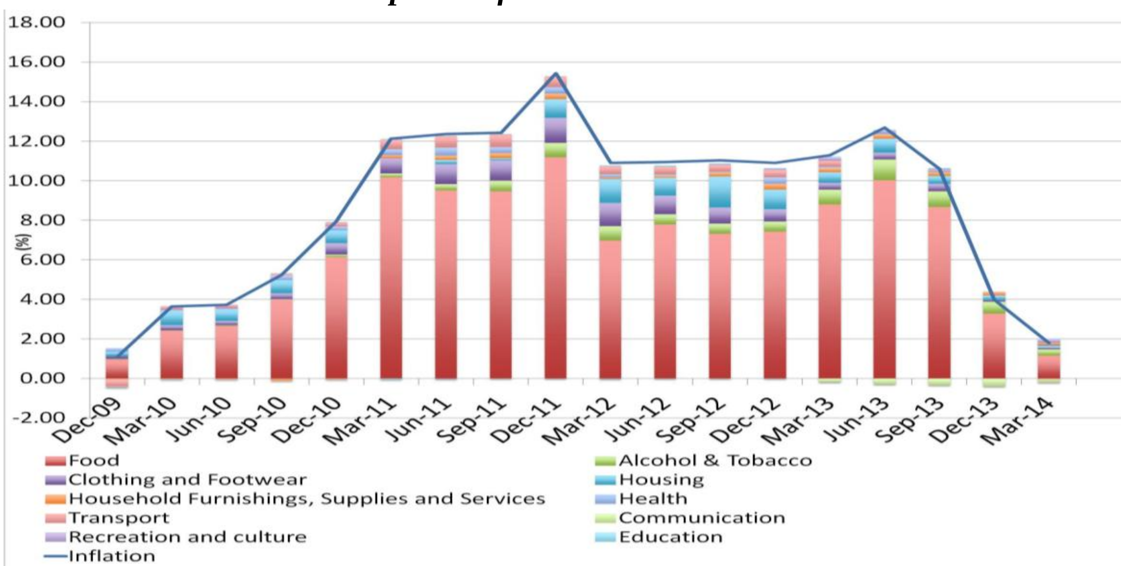
In the first quarter of 2014 the quarter-on-quarter inflation rate was 0.4%. This represents a decrease in quarterly inflation compared to both Q4 2013 (0.6%) and Q1 2013 (0.7%). It is likely that this fall, compared to the previous quarter is due to the annual post-festive season reduction in domestic demand.

[1] Quarter-on-quarter inflation in Q1 2012 was 6%

INFLATION TRENDS

In March 2014, the year-on-year inflation rate in Timor-Leste was 1.8%. This represents a decrease in inflation compared to both the same period in 2013 and year-on-year inflation in December 2013, which were 4.0% and 11.3% respectively. The rate of inflation is now below the 4%-6% target range outlined in the Strategic Development Plan. A low inflation rate is targeted because it leads to a slower erosion of citizen's purchasing power and improves international competitiveness.

Graph 1: Inflation in Timor-Leste



Over the past 12 months there has been high inflation in fish and seafood (9.7%), milk, water, cheese and chicken's eggs (7.2%), recreation and culture (10.1%) and alcohol (4.4%). The same period has also seen deflation in sub-categories such as meat (-1.6%), food products (-1.4%), coffee, tea and cocoa (-1.2%) and use of personal transport (-1.5%).

Finally, it is also important to mention that, year-on-year inflation in March 2013 has been higher in the districts (+3.4%) than in Dili (+1.2%).

CAUSES OF INFLATION

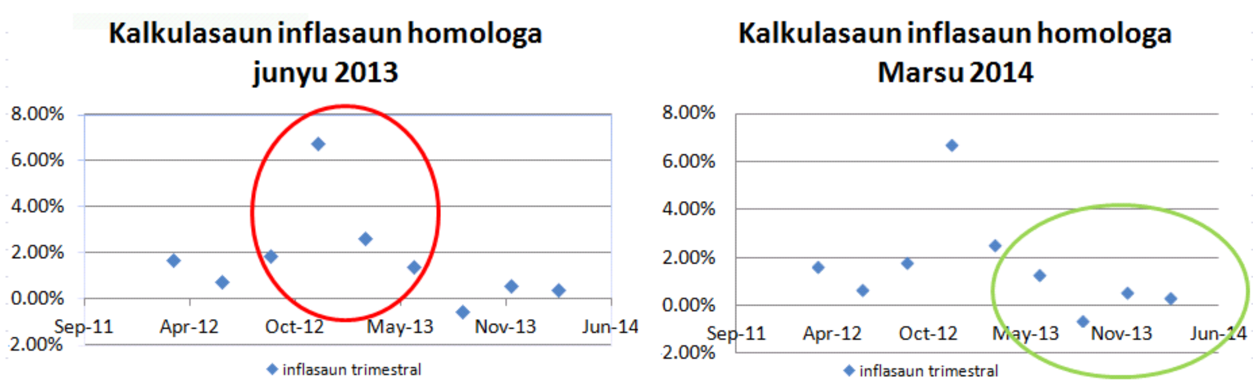
YEAR-ON-YEAR INFLATION

Over the March 2013–March 2014 period, largely favourable international factors, which put downward pressure on the price of imports in Timor-Leste, may partially explain the sharp decrease in inflation. During this period the US dollar appreciated against the currencies of Timor-Leste's major trading partners (with the exception of China's Yuan Renminbi). This appreciation has been particularly strong against the Indonesian rupiah, the currency of Timor-Leste's largest trading partner. In addition international food prices have decreased and oil prices have remained fairly stable over the period.

Domestic factors over the past year have most likely increased inflationary pressure. Recurrent Government expenditure between March 2013-2014 ($733.9m) was 14% higher than in March 2012-13 ($642.1m). Within the recurrent expenditure the categories which saw the largest increases Wages and Salaries (11.1%), and Goods and Services (25.0%) are likely to have a particularly high inflationary impact. The observed decrease in year-on-year inflation suggests that perhaps the favourable international factors outweigh the domestic inflationary pressure.

Finally, the high rate of quarterly inflation witnessed in the last quarter of 2012 can help to understand the dramatic fall in inflation between the two periods. When calculating the year-on-year inflation rate the CPI index is compared with the CPI index for the previous 12 months. This means that the year-on-year inflation calculation for March 2014 will no longer include inflation in Q4 2012. Removing quarter-on-quarter inflation in Q4 2012 (6%), which was driving the high year-on-year inflation rate in March 2013, was always likely to lead to dramatic falls in inflation.

Graph 4 Methodological causes

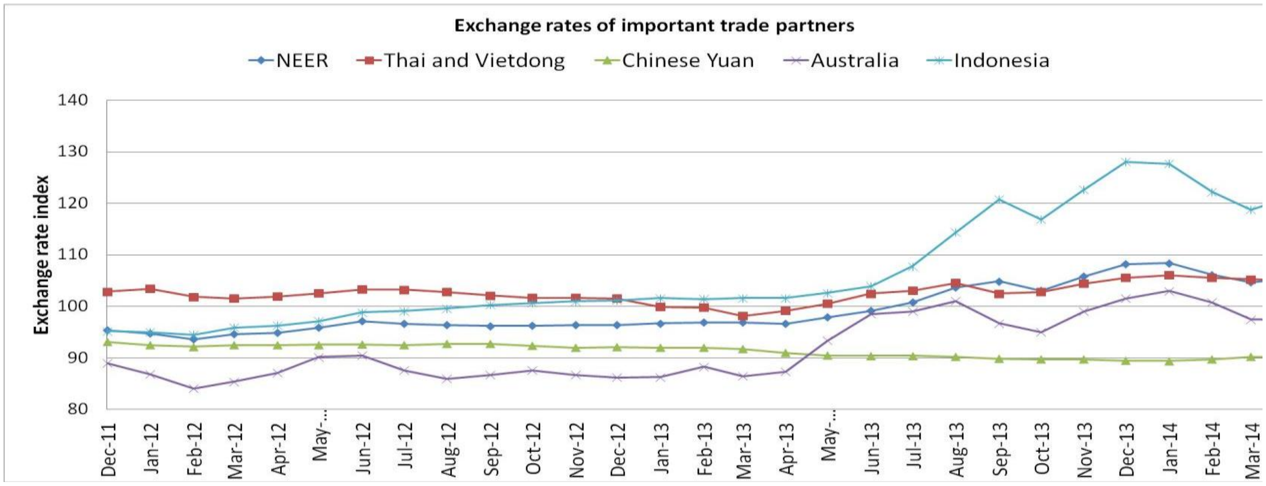


QUARTERLY INFLATION

Quarter-on quarter inflation in Q1 2014 was 0.4% which is lower than the rates seen in Q4 2013 and Q1 2013. The fall in the quarter-on-quarter inflation rate, compared to Q4 2014, is likely to be partially driven by the often observed fall in demand after the festive period.

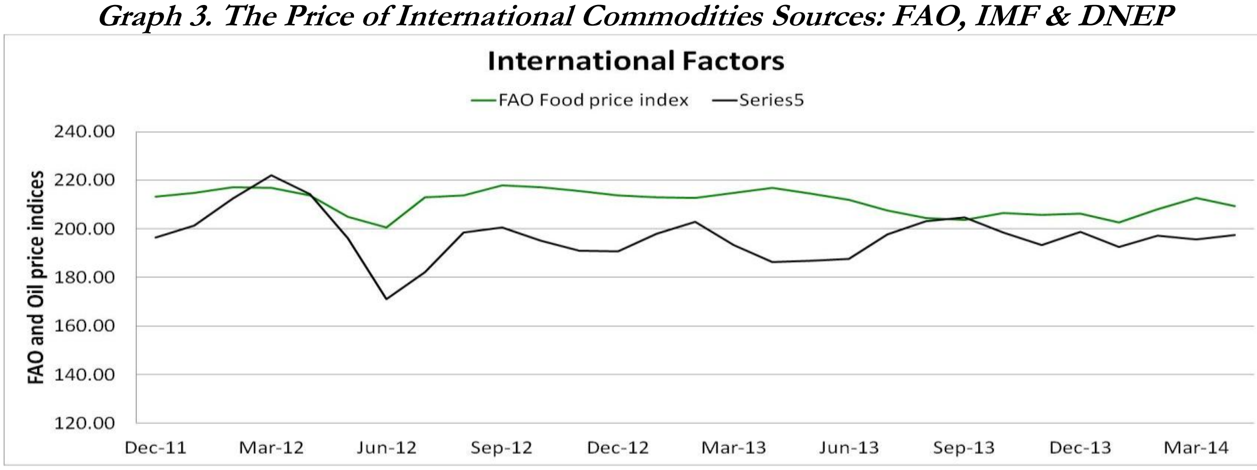
In Q1 2014 the US dollar, primarily due to the strong appreciation of the Indonesian rupiah, depreciated against a basket of its trading partners (see Graph 2). In addition, the Vietnamese dong and Thai baht, which are particularly important given the weight of rice imported from these countries in Timor-Leste's CPI basket, have also slightly appreciated against the US dollar.

Graph 2. Exchange Rate Comparison (*Timor-Leste *vs.* Trading partners) *Source: OANDA



A second international factor which may well have an impact on the CPI index is the movement of international commodity prices. Commodity prices increased over the first quarter of 2014, oil prices (see Graph 3, Series 5) increased slightly, food prices also grew, but at a more substantial rate. Changes in food prices can have a large impact on the living standards of the population.

Graph 3. The Price of International Commodities Sources: FAO, IMF & DNEP



FUTURE TRENDS IN INFLATION

In the future, it is likely that the quarter-on-quarter inflation will be lower as, historically Q2 tends to have lower inflation than Q1. However, it is also possible that the late appreciation of the rupiah will have an impact through increased inflationary pressure. Regarding the year-on-year inflation, in the short-term it is unlikely that it will deviate significantly from the current level, as international factors are forecast to remain relatively stable.