In September 2014 year-on-year (YoY) inflation in Timor-Leste was 0.5%, this rate is below the 4%-6% target range set out in the Government’s Strategic Development Plan (SDP). YoY inflation is now significantly lower than the 10.6% rate seen in September 2013, but up on the rate of -0.6% from June 2014. Quarter-on-quarter (QoQ) inflation in September 2014 was 0.5%; this is higher than the rates of -0.6% and -1.0% seen in September 2013 and June 2014.

The low YoY inflation in Timor-Leste can mainly be attributed to international factors such as:

- The appreciation of the US dollar against the majority of Timor-Leste’s trading partners
- The small decrease in international food prices

In September 2014 YoY inflation in Timor-Leste was 0.5%; this means that a basket of goods and services that cost $100.00 in September 2013 will now cost $100.50 in September 2014. YoY inflation is now significantly lower than the 10.6% rate seen in September 2013, but up on the rate of -0.6% in June 2014. QoQ inflation in September 2014 was 0.5%; this is up on the rates of -0.6% and -1.0% seen in September 2013 and June 2014 respectively.

The double digit YoY inflation between March 2011 and September 2013 was largely driven by increases in food and non-alcoholic beverage inflation (see Figure One). Food and non-alcoholic beverages account for approximately 64% of Timor-Leste’s CPI basket¹, as nearly two thirds of Timorese household expenditure is spent on this group. Thus price movements in this group will have a significant impact on

¹ Timor-Leste’s CPI basket is made up of the ten expenditure groupings seen in Figure Two.
the overall rate of inflation and the purchasing power of the Timorese citizens. Food and non-alcoholic beverage inflation in September 2014 was 0.5%, down from 13.5% in September 2013.

After a lengthy period of double-digit inflation between March 2011 and September 2013, inflation decreased dramatically and fell below the Government’s 4%-6% target range in January 2014. In recent months YoY inflation appears to have stabilized at a low rate.

Core inflation, which excludes the prices of particularly volatile items, was 0.7% in September 2014, down from 1.1% in June 2014. Core inflation may provide a more accurate measure of long-term inflationary trends as it is less susceptible to being impacted by temporary price shocks.

**Figure One: Year-on-Year Inflation in Timor-Leste**

Over the past 12 months there have been significant price changes in the following expenditure classes:

- Breads and cereals excluding rice (12.3%)
- Fish and seafood (-10.5%)
- Household appliances (7.7%)
- Recreational items and cultural services (10.3%)

The largest upwards contributions (see Figure Two) to the year-on-year inflation rate in September 2014 came from:

- Food and non-alcoholic beverage which increased by 0.5%
- Recreation and culture prices which increased by 6.7%

There was no large deflationary contribution to YoY inflation in September 2014, though three groupings alcohol and tobacco, housing and communication saw small decreases in prices.

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2 Expenditure classes are the sub-categories within an expenditure group in a CPI index
CAUSES OF INFLATION

International Factors

An appreciation (depreciation) of the US dollar against the currencies of Timor-Leste’s major trading partners will put downward (upward) pressure on the price of imports in Timor-Leste. However, the effects of exchange rate movements on prices in Timor-Leste are likely to be felt some time after they occur, for this reason exchange rate movements over the June 2013 to June 2014 period will be analyzed.

Between June 2013 and June 2014 Timor-Leste’s nominal effective exchange rate (NEER) appreciated by 9.2%, this appreciation was largely driven by the 20.7% appreciation of the US dollar against the Indonesian rupiah, the currency of Timor-Leste’s largest trading partner. Over this period US dollar also appreciated against the Vietnamese dong and Thai baht by 1.2% and 5.6% respectively. This appreciation is likely to have placed downward pressure on rice prices, as these countries export large quantities of rice to Timor-Leste, and therefore inflation as rice has a large weight in the CPI index.

International food prices also fell slightly over this June 2013 to June 2014 period, the Food and Agricultural Organization’s (FAO) food price index fell by 1.4% placing further downward pressure on inflation. In contrast, the increase in the IMF’s crude petroleum price index would have placed upward pressure on inflation.

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3 See concepts and terminology section for further explanation
4 Within this section inflation refers to YoY inflation
5 This analysis lags the impact by one quarter
7 The crude oil (petroleum) price index is a simple average of three spot prices; Dated Brent, West Texas Intermediate, and the Dubai Fateh.
Domestic Factors

Quarterly recurrent Government expenditures in the last 4 quarters have been higher than in the same period in the previous year (see Figure Four).

This seems at odds with the observed low inflation; however there are several possible explanations for this, including:

- Favourable international conditions (discussed above) may easily outweigh the limited domestic inflationary pressure.
- Downward inflationary pressure may be coming from domestic factors on both the supply and demand side such as increases agricultural production, improvements in absorptive capacity and decreased non-Government aggregate demand.

The 2015 State Budget saw a very moderate increase in recurrent expenditure of less than 4%. This moderate increase in recurrent expenditure is consistent with low inflation in 2015.

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8 The amount of money that can be spent in an economy before inflation begins to increase
Finally, comparing the high QoQ inflation rate in Q4 2012 to the low rate in Q4 2013 can help to explain the dramatic fall in YoY inflation between September 2013 and 2014. When calculating YoY inflation the current CPI index is compared to the CPI index from 12 month previous. This means that YoY inflation in September 2014, unlike the September 2013 rate, no longer includes the high inflation from Q4 2012 and is therefore significantly lower.

**Figure Five: Quarter-on-Quarter Inflation in Timor-Leste**

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**CONSEQUENCES OF INFLATION**

Inflation will cause household’s purchasing power to fall, if increases in wages are lower than the increases in inflation, this situation is more likely to occur in a high inflation environment. Inflation which reduces consumers’ purchasing power can reduce living standards and may increase poverty. Thus the recent low inflation seen in Timor-Leste is consistent with the Government’s poverty reduction strategy.

If inflation is higher in Timor-Leste than in its trading partners Timor-Leste will become less competitive leading to a fall in demand for Timorese exports. Thus the recent low inflation environment is likely to have helped increase demand for Timorese exports.

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**INFLATION OUTLOOK**

YoY inflation is likely to remain below the SDP target range in the near term, though it may increase slightly above the current rate of 0.5%. The following factors are likely to impact future rates of inflation in Timor-Leste:

- **International commodity prices**: between June 2014 and September 2014 there were falls in both international food (-8%) and crude oil (-11%) prices. As changes in commodity prices have a lagged affect on inflation in Timor-Leste it is likely that this will place downward inflationary pressure in Q4
2014. In the medium to long-term the forecasted\(^9\) falls in commodity prices will continue to place downward pressure on inflation in Timor-Leste.

**International exchange rates:** between June 2014 and September 2014 the 0.5% appreciation of Timor-Leste’s NEER will put downward pressure on near-term future prices in the country.

**Government expenditure:** The low growth in recurrent expenditure in the 2015 State Budget will mean that there will be limited inflationary pressure from recurrent expenditure growth in the medium term.

**Seasonal affects:** in Timor-Leste QoQ inflation in the 4\(^{th}\) quarter has traditionally been higher than in the other quarters due to festivities and the traditional payment of a double salary in December (see Figure Five). This trend did not hold in Q4 2013, however if QoQ reverts back to this trend then YoY inflation will increase in Q4 2014.

*Figure Six: Forecast Commodity Price Indices (IMF)*

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**ANNEX: CONCEPTS AND TERMINOLOGY**

**Consumer price inflation** the rate at which the prices of goods and services bought by households increase or decrease.

**The Consumer Price Index (CPI)**\(^10\) is used to measure consumer price inflation. To understand CPI think of a large basket containing the goods and services bought by households, the CPI estimates the change to the total cost of the basket on a monthly basis.

**Year-on-year (YoY) inflation** is the most commonly used measure and is calculated by comparing the price index from a given period with the same month in the previous year. For example, the year-on-

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\(^{10}\) The CPI is a weighted index meaning that the influence on the CPI index of a given item is dependent on the item’s share in total household consumption.
year inflation in September 2014 measures the percentage change in prices between September 2013 and September 2014.

**Quarter-on-quarter inflation (QoQ)** is calculated by comparing the price index from the last month of a given quarter (March, June, September or December) with the last month of the previous quarter\(^\text{11}\). Thus quarter-on-quarter inflation in September 2014 measures the percentage change in prices between September 2014 and June 2014.

**Month-on-month inflation (MoM)** is calculated by comparing the price index from the latest month to the previous month. Thus the month-on-month inflation in September 2014 measures the percentage change in prices between August 2014 and September 2014.

**Contribution to inflation rate** measures the contribution to the overall rate of inflation of a grouping of goods and services, a group's contribution to the overall rate of inflation is determined by its growth rate and weight within the series\(^\text{12}\).

**Nominal effective exchange rate (NEER)** is the weighted average value of a country's currency relative to the currencies of its major trading partners.

**Core inflation** is a measure of inflation which excludes certain items that face volatile price movements. Core inflation eliminates products\(^\text{13}\) that can have temporary price shocks because these shocks can cause a divergence from the overall trend in inflation giving a false measure of inflation.

**Purchasing Power** measures the quantity of goods and services which can be purchased with a unit of currency. All else being equal inflation decreases the amount of goods and services a consumer is able to purchase with their monthly salary.

Timor-Leste's Consumer Price Index is published monthly by General Directorate of Statistics (MoF)\(^\text{14}\). This index is divided into 10 specific groups representing specific sets of commodities such as food and non-alcoholic beverages, housing and transport. In addition, separate consumer price indices are compiled for both Dili and the districts.

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\(^{11}\) In this publication

\(^{12}\) The contributions of each grouping will sum to give the overall rate of inflation

\(^{13}\) The core inflation index in Timor-Leste excludes all food and non-alcoholic beverage items