2013-05-20

Adopting a Currency in Post-Conflict Environments: The Case of Timor-Leste

Amara, Jomana

http://hdl.handle.net/10945/40416

International Network for Economics and Conflict

May 20, 2013 | 6:40am

Adopting a Currency in Post-Conflict Environments: The Case of Timor-Leste

**Written by Jomana Amara, Associate Professor of Economics at the Naval Postgraduate School and Featured INEC Blogger*

A major part of rebuilding a nation's economy in the aftermath of conflict is the creation of a viable, credible, and sustainable currency system that will lead to macroeconomic stability. Emerging nations have three major options in setting their currency:

1. Adopting a foreign currency such as the dollar for all official transactions
2. Continuing with the currency currently in circulation, often the currency of an adversary
3. Creating a national currency

In a series of blogs, I will examine three nations that have emerged or are emerging from conflict and have taken different approaches to setting their currencies: Timor-Leste – adopted the U.S. dollar; Palestine – continued using the Israeli Shekel; South Sudan – created a national currency These case studies represent vastly different methods to currency adoption in emerging countries and serve to highlight the relevant issues in the currency debate.

Timor-Leste gained its independence from Indonesia in 2002 after 24 years of Indonesian rule and over four hundred years of Portuguese colonization before that. In 1999, Timor-Leste was placed under a United Nations transitional administration in preparation for independence. *As a result of the violence* during Timor's bid for independence, nearly 70 percent of all standing structures in the country were destroyed and over 75 percent of the population was displaced.

Timor-Leste is a lower-middle-income nation with a per capita gross domestic product (adjusted for purchasing power parity) of US $9,500 and with 41 percent of the population under the poverty line. The nation's largest export is oil and the economy is highly dependent on government spending financed by oil and gas revenues and assistance from international donors. Development in Timor has lagged due to human capital shortages (64 percent of the labor force is engaged in agriculture) and an underdeveloped regulatory and legal system. While the oil and gas sector has contributed greatly to supplementing government revenues, it has done little to create jobs in part because there are no production facilities in Timor-Leste. In June 2005, the National Parliament in Timor-Leste announced the creation of a national petroleum fund to preserve the nation's wealth for future generations. As of *March 2013* the Petroleum Fund held assets of US$13 billion.

Prior to the adoption of the United States dollar as the new legal tender in Timor-Leste in 2000, use of the Indonesian Rupiah, creation of a national currency, and adoption of the Australian dollar were discussed.

The use of the Indonesian Rupiah as the legal currency in Timor-Leste post-independence was ruled out notwithstanding the widespread use of the Rupiah pre-independence and its use as the currency for trade. The case against the Rupiah was based on its instability resulting from ongoing political turmoil and a barely functioning Indonesian economy following the 1997 economic collapse. Most significantly, politics played a major role in rejecting the Rupiah, reflecting the bitterness of the struggle between the two nations.

Despite the symbolic value of a national currency for Timor-Leste as a statement of independence and national unity, the creation of such a currency was ruled out primarily due to a lack of personnel educated and trained in economics and finance. The nation simply did not have the human resources necessary to manage a currency system for either a fixed or floating currency.

The initial step in choosing a national currency involves determining whether the nation will adopt a fixed or flexible exchange rate in relation to other currencies. In the case of a flexible exchange rate, Timor-Leste did not have resources needed to be able to set interest rates and manage a float. In the case of a fixed currency, it did not have the skills available to set and defend the appropriate exchange rate. Fixing the currency at too high a rate will damage export and foreign investment prospects and will reduce the credibility that the exchange rate can be maintained, and fixing at too low a rate may result in inflationary pressures. The same concerns apply to the use of a currency board to manage the exchange rate.

Dollarization became the most attractive and least demanding option for Timor-Leste. The dollarization debate centered around the adoption of the US or the Australian dollar. There are several downsides ofusing theUSdollar. The denomination of US dollar notes is too high for many of the smaller transactions. In addition, the strength of the US dollar could price Timor-Leste's products out of the global market. Despite the importance of Australia as a key trading partner, the geographical proximity of Australia to Timor, and the advantage of the Australian dollar as a commodity currency (a currency of a country that depends heavily on the export of raw material for income) in the end, the attractiveness of the US dollar as a key world currency prevailed.

Despite the economic turmoil in 2008 that resulted from the drop in value of the US dollar, Timor-Leste has no apparent plans to change its currency arrangement. The government of Timor-Leste mitigated the effect of the drop by subsidizing, from the Petroleum Fund, the price of basic goods. In an attempt to mitigate future risk resulting from a change in the value of the dollar, Timor-Leste rebalanced its Petroleum Fund investments portfolio from 90 percent in U.S. treasury bonds to 50 percent in US. Bonds and the balance invested in a range of assets, currencies and regions.

By adopting the US dollar as its currency, Timor-Leste sought a mechanism to establish economic credibility and stability, conditions necessary for developing a solid foundation for a market economy.

Tags: *Macroeconomics*, *Post-Conflict Economies*, *Public Finance*, *Timor-Leste*