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# **TRADE & INVESTMENT ENVIRONMENT NEEDS ASSESSMENT: TIMOR-LESTE**

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## **TRADE & INVESTMENT ENVIRONMENT NEEDS ANALYSIS: TIMOR-LESTE**

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**Acronyms**

USAID – US Agency for International Development  
DEPI – Diversifying Exports & Promoting Investment Project  
MSMEs – Micro, Small and Medium Enterprises  
SMEs – Small and Medium Enterprises  
GoTL – Government of Timor Leste  
NGO – Non-Governmental Organization  
ASYCUDA – Automated System for Customs Data  
SIDA – Swedish International Development Agency  
EU – European Union  
SEP II – Second Small Enterprises Project  
TFET – Trust Fund for Timor Leste  
BASAR – USAID Bolstering Agriculture and Sustainable Agribusiness Project  
TITL – TradeInvest Timor Leste  
UNDP – United Nations Development Programme  
EU FMP – European Union Fisheries Management Plan  
IADE / IADA – Institute for Support of Business Development  
UNIDO – United Nations Industrial Development Organization  
ILO – International Labor Organization  
LTTA – Long Term Technical Assistance  
STTA – Short Term Technical Assistance

## 1. BACKGROUND

On May 20, 2002, Timor-Leste became the world's newest country. Following 20 years of conflict with Indonesia and three years of post-conflict intervention by the international donor community, Timor-Leste is now attempting to rebuild and develop its country. Although peace and political stability have been achieved, the country faces a number of serious challenges, including:

- Slow repair and replacement of damaged physical infrastructure;
- Severe human resource deficits which handicap the public and private sectors<sup>1</sup>;
- Extreme poverty throughout most of the country, particularly in rural areas where there is little opportunity for remunerative productive activity<sup>2</sup>; and,
- Heavy dependence of Timor's government on bilateral and/or multilateral donor assistance.

### 1.1 The Structure of the Economy

*Agriculture* accounts for approximately 30% of GDP and employs more than 80% of the rural population. Subsistence agriculture (mainly food crops including rice and corn) accounts for the majority of production. Fewer than one-half of the estimated 150,000 farm households produce surplus rice, coffee and other crops that reach local markets. Coffee bean cultivation, the country's only significant commercial agricultural activity, represents the primary source of direct income to an estimated 25,000 families and partial income to an additional 15,000 families. Green coffee sales represent 99% of all non-oil merchandise exports.<sup>3</sup> Other agricultural products with potential for expanded production include vanilla, coconut oil, sandalwood, candle nut, mushrooms, pineapple, hardwoods and handicrafts. Forestry and fishing are marginal contributors to GDP.

*Domestic manufacturing* and industrial exports are virtually non-existent. Minimal purchasing power limits the domestic market for industrial goods and virtually no current potential exists for export production. Industry has consistently accounted for less than 3% of GDP.

The *services and construction sectors* grew strongly from 1999 to 2002 in response to demand generated by the influx of international peacekeeping forces, NGOs, and numerous international agencies. Reductions in international organization presence since 2002 have reduced the construction sector from 14% to under 9% of GDP. Many service providers, particularly restaurants and taxi owners, also report significant declines in demand from international agency personnel.

*An emerging oil and gas sector* will improve the economic outlook beyond 2007. Plans are in place for revenues to be managed through a petroleum fund that will account transparently for annual amounts available to the Government. The sense among recently interviewed public and private sector stakeholders is that petroleum production will generate sufficient revenues and reserves in the near-term to meet government financing requirements.

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1 A recent "Assessment of Human Resources, Skills Training and Business Services in Timor-Leste" (John Callander; June 2005) indicates that less than one-half of non managerial employees of urban businesses are fully proficient in their core competencies.

Extensive interviews with government agencies having responsibilities for trade and investment indicate that most officials working below vice-ministerial levels are not confident of their ability to meet the requirements of their positions.

2 The *per-capita* GDP is \$366. *The World Bank Country Assistance Strategy for Timor-Leste FY06-08* indicates that 47% of the rural population lives below the poverty level, versus 14% in Dili. Eighty-six percent of the population lives in rural areas where they suffer insufficient supply of basic grains (corn and rice) during nearly four months each year. Only 10% of rural inhabitants have access to running water or electricity.

3 Needs Assessment of Trade and Trade-Related Activities, EU, 7 September, 2005

Other sectors are also beginning to demonstrate potential. The *transportation and communication sectors* have each grown approximately 9% in the last two years. *Tourism* grew by more than 7% in 2004. *Fisheries* also holds potential. Resource endowments for fisheries include a vast Exclusive Economic Zone (EEZ), potentially covering 75,000 km<sup>2</sup>. Licensing of high sea fisheries is scheduled to begin in late 2005, extending commercial fishing activity beyond the traditional near coastal canoe fishing. Fresh and salt water aquaculture activities are not practiced beyond subsistence.

## 1.2 Macro-Economic Outlook

Following 16% growth in 2001 and declines of approximately 6% in both 2002 and 2003, non-oil GDP is expected to grow only modestly in the near-term<sup>4</sup>. GDP grew at approximately 2 % in 2004, reflecting increased agricultural productivity and significant expansion in banking sector activity. The 2004 census indicates that the population growth rate is well above 3%. This is contributing to a declining per-capita GDP, which dropped to US\$ 405 in 2004, from US\$ 478 in 2003.

Unemployment is estimated to be increasing, with rates of about 20 percent in urban areas generally and of 43 percent among urban youth. Wage levels remain high in comparison to neighboring countries, undermining competitiveness and limiting job creation for unskilled labor. Foreign direct investment is highly concentrated in the oil and gas sector, which accounts for about \$1.6 billion of total FDI of \$1.7 billion, with the remainder in local construction and tourism services and infrastructure. Non-oil exports rose to US\$ 8 million in 2004, of which US\$ 7 million was coffee exports, which are expected to rise over the medium term in response to higher international prices and improved marketing. Other exports are growing faster but from a much lower base. The trade deficit expanded to US\$ 187 million in 2004, amounting to about 56 % of GDP.

Donor contributions of more than \$1 billion have covered Government budget deficits since 2000. Strong donor support continues to be critical in the medium term, as the growing oil and gas sector will not generate considerable revenues until about 2007. However, despite these anticipated revenues, the Government of Timor-Leste recognizes that benefits from non-renewable petroleum resources will eventually diminish. Its National Development Plan underlines the importance of supporting an enabling environment to nurture private enterprise<sup>5</sup>, particularly by diversifying trade and promoting investment to help develop additional promising sectors of the economy on a sustainable basis over the long term.

## 2. TRADE AND INVESTMENT PERFORMANCE AND TRENDS

### 2.1 Overall Trade Trends<sup>6</sup>

The economy of Timor-Leste is highly dependent upon imports, which totaled \$113 million in 2004. Merchandise exports (excluding oil and gas) reached just \$7 million, consisting almost exclusively of green coffee beans. The merchandise trade deficit in 2004 reached \$106 million: approximately 35% of total GDP. Imports declined slightly in 2004, reflecting reductions in the presence of NGO and foreign donor expatriate personnel. However, significant on-going reductions in import levels are not anticipated. It is widely recognized that relief from the current trade deficit will require diversification

4 *Background Paper*, Timor-Leste Development Partners Meeting, World Bank, April 25-26, 2005.

5 *Timor-Leste National Development Plan*, Planning Commission, Dili, May 2002.

6 It should be noted that trade and investment statistics in Timor-Leste are often not reliable. Statistics are useful primarily as an indication of the range of values. Inaccuracies are due in large part to substandard data collection prior to 2003.

of exports beyond the current heavy dependency on coffee and petroleum.

**Table 1**  
**Trade Balance, 1999 - 2004**

	1999	2000	2001	2002	2003 <sup>a)</sup>	2004 <sup>b)</sup>
Imports (in million US\$)	119	235	248	201	174	113
Exports (in million US\$)	52	5	4	6	7	7
Trade balance (in million US\$)	-67	-230	-244	-195	-167	-106

a) Figures are for non-oil merchandise exports and imports only.

b) Figures in gray based on incomplete data

Source: National Department of Statistics, Trade Statistics

## 2.2 Main Imports

Major import categories include fuel (32%); technology, including vehicles; electrical machinery and equipment (22%); cereals (7%), other machinery (7%) and other merchandise; mainly luxury goods including cars, air conditioning systems, tobacco, and alcohol (32%).

## 2.3 Imports by Origin

Indonesia is the country's major supplier of imports with \$60 million in 2004, or 53% of total imports. These included mainly fuel, tobacco, technology and rice. Australia is the second largest supplier with about \$20 million or 18%, followed by Singapore with \$15 million or 13%, and Vietnam with \$5 million or 5%. ASEAN trading partners account for almost 4% of total imports. Imports from Europe amount to about \$5 million. Imports from other Asian countries and from elsewhere worldwide account for about 4% of total imports.

**Table 2**  
**Imports by country of origin, 2004**

Country of origin	Value (US\$ Mi)	Share
Indonesia	60	53%
Australia	20	18%
Singapore	15	13%
Vietnam	5	5%
EU countries	5	5%
Other Asia	4	3%
Other world	4	3%
Total	113	100%

Source: National Department of Statistics, Trade Statistics 2004

## 2.4 Main Export Markets

The largest market for Timor-Leste green coffee (99% of all non-oil exports) is the U.S., accounting for more than half of total exports, or about \$3.5 million in 2004. The main buyer is the US-based coffee chain Starbucks, which has helped develop the branding of Timor-Leste coffee blends as “ecological” and “fair trade” products. The second major export market is Indonesia, with about \$1.28 million or

18% of the total, followed by Portugal with 8%, and by Australia with 7%. EU member states import about 15% of total exports, primarily Germany and the Netherlands.

**Table 3**  
**Non-Oil Exports by Country of Destination (2004)**

Country of Destination	Export (US\$ M.)	Share	Ave. Coffee Price ( US\$/kg)
USA	3.55	51%	1.16
Indonesia	1.28	18%	0.50
Portugal	0.58	8%	1.28
Australia	0.51	7%	1.26
Germany	0.44	6%	0.61
Netherlands	0.09	1%	
Other Asia	0.33	5%	
Other World	0.19	3%	
Total	6.97	100%	
Of which coffee =	6.90	99%	

Source: National Department of Statistics, Trade Statistics 2004

## 2.5 Foreign Direct Investment

Foreign direct investment in Timor-Leste totaled approximately \$1.7 billion at end-2004. FDI is highly concentrated in the oil and gas sector, which accounted for over \$1.6 billion of the total. The remainder was mainly in local construction, tourism services and infrastructure.

Accurate data on foreign direct investment outside of the oil and gas sector is limited. According to data collected by Trade & Invest Timor-Leste (TITL) in January 2005, (Table 4), total non-oil FDI amounted to about \$ 75,300,000 at end-2004. Non-oil FDI by sector was concentrated in telecommunications (\$22 m); construction (\$16.8 m); hotels (\$15.1 m) and banking (\$14.2 m). All other sectors (i.e., retail distribution, shipping, other transport including car rental, food services, travel agencies and other services) accounted for about \$7 million.

TABLE 4 CURRENT FOREIGN INVESTMENT IN TIMOR-LESTE (Based on Partial Data Collected in January 2005)					
COUNTRY OF ORIGIN	BUSINESS FORMAT	SECTOR	# FOREIGN WORKERS	# LOCAL WORKERS	CURRENT INVESTMENT
Australia	Company	Gas	4	6	1,000,000.
Australia	Company	Hotel	3	4	3,000,000.
Australia	Company	Construction	4	20	1,200,000.
Australia	Company	Ice/Beverage	0	4	200,000.
Australia	Company	Car Rental	4	35	1,300,000.
Australia	Company	Hotel	1	40	1,600,000.
France	Branch	Shipping Agency	1	46	229,000.
Australia	Branch	Travel Agency	1	4	25,000.
Portugal	Branch	Banking	4	67	5,345,000.
Singapore	Company	Hotel	5	30	500,000.

Australia	Company	Road Transportation	1	25	600,000.
Portugal	Branch	Construction	4	64	10,000,000.
USA	Branch	Civil Construction	18	47	5,000,000.
Thailand	Company	Hotel	19	68	1,500,000.
Portugal	Company	Hotel	-	-	2,300,000.
Australia	Branch	Food Services	-	-	3,000,000.
Singapore	Company	Hotel	10	27	200,000.
Australia	Company	Mechanical	8	29	424,554.
Australia	Branch	General Banking	3	24	1,900,000.
Singapore	Company	Cement Production	2	35	675,220.
Portugal	Branch	Hotel	4	72	6,000,000.
Portugal	Company	Telecommunications	13	72	22,000,000.
Indonesia	Company	Sales Distribution	16	5	300,000.
Indonesia	Branch	Banking	7	9	7,000,000.
			132	761	
USA	Branch	Petroleum / Gas	-	-	935,880,000.
Australia	Branch	Petroleum / Gas	-	-	175,000,000.
Italy	Branch	Petroleum / Gas	-	-	198,660,000.
Japan	Branch	Petroleum / Gas	-	-	340,060,000.
Totals			-	-	1,724,898,774

Source: TradeInvest Timor Leste, January 2005

### 3. ANTICIPATED TRADE AND INVESTMENT OPPORTUNITIES

Recent assessments<sup>7</sup> of Timor-Leste's trade development potential emphasize agriculture, fisheries and tourism as the non-oil related sectors offering the greatest potential for diversification of production for export. Results from interviews with private/public sector stakeholders and development agency professionals support these findings.

#### 3.1 Agriculture Sector Opportunities

Given the predominance of agricultural activity throughout the country, high levels of agriculture product imports and the country's "ecologically pure" reputation, it is widely agreed that the agriculture sector presents a reasonable opportunity to expand exports and reduce import dependency. The image of Timor-Leste agricultural products as "organic" offers potential for successful brand building such as that experienced by "Café Timor". It is anticipated that several other agricultural products have similar potential. Possibilities include the following:

##### 3.1.1 High Value Niche Products

- Coffee (Expand current exports to current (US) and new markets (SE Asia, EU); increase quality; upgrade older coffee trees; and address coffee rust issues, through coordination with CCT and other stakeholders)
- Bio-diesel products as alternatives to petroleum-based fuels, focusing on exports to Australia<sup>8</sup>

<sup>7</sup> Particularly significant is the EU sponsored "Needs Assessment of Trade and Trade-Related Assistance for the Republic of Timor-Leste" conducted by IBM Business Consulting Services; September 2005

<sup>8</sup> Daba-Loqui Energy Company is currently planting up to 40,000 HA of xathropaculcas plants to produce seeds from

- Cattle exports to Indonesia across land border points, timed with high-season markets
- Agro-forestry strategies to revive local production (e.g. develop sandalwood, teak and other tree plantations to export markets (e.g. China)
- Agricultural vanilla
- Candle nut oil
- Coconut oil, copra
- Palm oil
- Shitake mushrooms
- Cassava starch
- Black rice

### **3.1.2 Local Production for Import Substitution**

Production of local fresh fruit and vegetables, poultry, fish, and processed foods could be further developed for direct sale to local restaurants, hotels, and catering services to GoTL institutions and international organizations.

### **3.2 Fisheries Export Opportunities**

Timor-Leste marine resources are currently being assessed for their export production potential. Possible opportunities are reported to include:

- Expanding the catch and export of high sea species by licensing fishing vessels;
- Encouraging high-value marine and brackish water aquaculture for specialized markets; and
- Developing productive “clusters” around fishing ports to provide critical services and other inputs to the fishing industry.

### **3.3 Tourism Opportunities**

In spite of increasing environmental degradation related to deforestation, Timor-Leste enjoys a reputation for the pristine quality of much of its countryside and coral reefs. Specialized “niche” tourism is thought to have considerable medium to long-term potential as an income generator, particularly for rural communities. Opportunities being considered include:

- “Cultural tourism” involving community-based tourism products and services such horseback riding, handicrafts, community cultural activities, archeology, traditional farming and community life studies and other activities;
- Small scale specialist tourism, such as home stays, guest houses and “real life” tourism experiences;
- Tourism related services including small scale/specialized catering, locally provided transportation, tour guides, translation and others;
- Water sports and sport fishing; and
- Expansion of ferry, charter air and other transportation services.

### **3.4 Investment Opportunities by Sector**

In light of the serious constraints to trade expansion and investment, most development specialists concur that the greatest current potential for business development is likely to be through:

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which to extract oil for alternative fuels, with production expected to begin in 2007, with exports to initial buyers in Australia.

- Development/expansion of domestic businesses in concert with new investment, as providers of services, raw or processed materials and other production inputs;
- Business activities sponsored by bi-national and other Timorese with overseas business interests or experience<sup>9</sup>
- Investment by individuals or companies with lower levels of aversion to country risk, based on previous experience in Timor-Leste or similar environment.

The non-oil sectors that offer the most investment opportunities are: agriculture, marine and fish resources, and tourism. Other sectors with potential include cross-cutting service sectors such as information technology, communications and financial services. Light manufacturing and handicrafts are also thought to represent areas of limited potential, as direct exports and as services to larger productive sectors. The main criteria for identifying these sectors as investment promotion priority areas include their current contribution to GDP, competitive advantage, and current levels of domestic and foreign investment. Investment potential is also determined by the current “pipeline” of new investment projects<sup>10</sup> based on expressions of interest documented by TITL<sup>11</sup>. The pipeline includes several non-oil sector investments (see Table 5). There are currently about 63 potential investments, amounting to an estimated \$140 million.<sup>12</sup>

<b>Sector</b>	<b>No. of investments</b>
Tourism	<b>11</b>
Transport	<b>9</b>
Fisheries	<b>7</b>
Banking/finance	<b>7</b>
Construction	<b>6</b>
Agribusiness/food processing	<b>6</b>
Light manufacturing	<b>5</b>
Non-oil energy	<b>4</b>
Mining	<b>4</b>
Infrastructure	<b>1</b>
Retailing	<b>1</b>
Forestry	<b>1</b>
Other services	<b>1</b>
<b>Source:</b> TITL August 2005.	

Most interested investors are from Australia (11 proposed investments). Other countries include: Thailand (5), Overseas Timorese (4), Indonesia (4), Asian joint-venture groups, China, Macau and Germany (3 each).

9 Many Timorese-Australians have business interests in Australia with potential linkages in Timor-Leste; much current business activity in Timor-Leste (mostly trading) is conducted by Timorese-Indonesians; The Timorese-Chinese population of Timor-Leste is renowned for its entrepreneurial expertise.

10 TradeInvest Timor Leste estimates, August, 2005.

11 TITL estimates, August 2005.

12 TITL estimate, Sept. 2005.

<b>Table 6 Foreign Direct Investment Interest by Country of Origin</b>	
<b>Country of Origin</b>	<b>No. of investments</b>
Australia	11
Thailand	5
Overseas Timorese	4
Indonesia	4
Asian joint-ventures	3
China	3
Macau	3
Germany	3
Taiwan	1
Malaysia	1
Japan	1
PNG	1
New Zealand	1
Singapore	1
Pakistan	1
Portugal	1
Italy	1
France	1

**Source: TITL, August, 2005**

### 3.4.1 Agriculture and Agribusiness Investment Potential

Major strengths of the agriculture and agribusiness sector, based on interviews, recent assessments and stakeholder workshops,<sup>13</sup> include natural and eco-friendly cultivation, plentiful crop and animal varieties, and a growing reputation in quality coffee production. Main sector opportunities include organic branding, growing demand for organic products, preferential market access, and increased agro-processing, mainly in the medium- to long-term. Specific product opportunities include coffee, but more in expanding volumes and yields through training of farmers to produce high-quality beans, than in increasing local processing to add value, at least in the near term. Small-scale related products, however, hold potential, such as fuel briquettes, use of lower quality beans for instant products, and eventually boutique/niche final coffee production. Other niche product opportunities include agricultural vanilla, (although world prices tend to fluctuate widely), shitake mushrooms (potential buyers would need to be identified in advance), coconut oil, copra and other by-products, candlenut, cassava/starch, chili peppers, pineapples, snow peas, cashew nuts, overland livestock exports, teak and related hard wood / forestry products.

Key sector weaknesses include inadequate transportation infrastructure, lack of management and basic business skills, low productivity, lack of market information, high utility costs and limited pest management. Many observers stress that rather than seeking to identify many more specific niche products at this early stage, it is prudent to focus on the foundations needed to realize opportunities, particularly setting policies and priorities for training, infrastructure, market information and market access.

### 3.4.2 Fisheries and Aquaculture Investment Potential

Current fisheries resources have yet to be identified in detail and current investment is marginal, but the scope for opportunities appears wide. Sector strengths include the fact that the legal framework is now

13 Investment Opportunity Assessment for Timor Leste, USAID / Nathan Associates, July 2005.

in place, with passage of the Fisheries Law, and increased identification<sup>14</sup> of species such as tuna and particularly grouper. Weaknesses include lack of infrastructure for catching and processing, and inconsistent quality and lack of credit programs to support expansion of small-scale fishing activities. Licensing of high sea fisheries may start this year. Fisheries opportunities include downstream fish processing, with both on- and off-shore facilities, particularly for freezing and air shipments to markets including Japan, an area currently being explored by potential investors.

### **3.4.3 Tourism Investment Potential**

Tourism is thought to offer investment opportunities based on the country's strong environmental resource base. Sector strengths include the wide range of potential tourism niche market products (diving, snorkeling, related water sports, trekking, other cultural and eco-tourism niches); the country's status as a "new destination" and its unspoiled environment. Weaknesses include general lack of infrastructure; limited human resources and lack of training opportunities; limited English language skills; health and hygiene concerns; and the country's lack of exposure to the global tourism industry. As is the case in all sectors, tourism business potential is also challenged by the country's weak legal/regulatory framework.

Although the tourism sector is in the early stages of development, several small hotel operators, tour operators, dive shops and other tourism service providers are currently competing for the international donor community market and for the country's slowly growing number of tourists. At least four investors currently report plans for expansion, and GoTL officials report that at least five foreign interests have recently initiated inquiries regarding possible investment plans. Support to develop a tourism strategy is being provided by the World Tourism Organization, with Australia as the lead funding agency, which should further identify sector concerns and investment opportunities.

### **3.4.4 Financial and Business Services Investment Potential**

The wide gaps in services provided in the financial and business services sectors highlights it as an area where investment needs are particularly strong. In banking and finance, services are provided mainly at opposite ends of the customer spectrum, with micro-finance increasingly available to SMSE, and at the other end, large companies able to secure financing locally and off-shore. However, access to financing is extremely limited for most formal-economy small and medium entrepreneurs, who make up the largest segment of the private sector. There is a strong need for additional investment in banking services, but opportunities may remain limited until the business enabling environment has improved to the point where commercial banks are willing to accept additional risk in lending. Business services, likewise, are extremely limited, with a strong need for additional shipping, insurance services for medium/large firms and a tremendous need for basic business training services SMEs. Basic business services currently are offered mainly by the World Bank funded Business Development Centers.

### **3.4.5 Light Manufacturing and Handicrafts Investment Potential**

Opportunities for manufacturing and handicrafts appear more limited than in other sectors. Potential includes import substitution in furniture, building materials including concrete, and basic food processing. Handicraft production, now limited to traditional local garments, offers some export potential.

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14 University of Hawaii research on fisheries resources, USAID.

### 3.4.6 Other Investment Potential

Other investment opportunities may develop in proposed special economic zones (SEZs), now being assessed by a World Bank supported feasibility study scheduled for completion in mid-2006. Issues to be considered include location, availability of infrastructure, incentive structure, and priority sectors. Likely industries identified in team interviews included light manufacturing (cigarette lights, basic consumer electronics, possibly textile inputs).

## 4. GOVERNMENT PRIORITIES FOR TRADE AND INVESTMENT

### 4.1 Strategic Framework

The GoTL strategic framework for achieving the country's ambitious development goals, including a 6% growth rate in non-oil GDP within the next five years, is articulated in its National Development Plan (NDP) of 2002.<sup>15</sup> The NDP is supplemented by the GoTL Stability Program issued in early 2003, and a series of Sector Investment Programs (SIPs). These strategic documents and the GoTL state budget for 2005/06<sup>16</sup> indicate clear commitment to a policy framework supportive of long-term private sector growth, foreign investment, and developing essential public infrastructure.

Consistent with the GoTL commitment to export and investment-led development strategies, important steps have been taken to create legal, regulatory and administrative structures for promoting and facilitating trade diversification and investment. In June 2005, Parliament passed flagship laws governing domestic and foreign investment. The investment laws are modern, succinct statements of the conditions under which investment is allowed and encouraged, including: procedures and criteria for investment approval; incentives; investor obligations; and provisions governing expropriation and dispute settlement. The investment laws also mandated the creation of domestic and foreign investment government agencies. In June 2005, an Administrative Decree established the Institute for Support of Business Development (IADE) as an autonomous agency for domestic trade development. IADE reports to the Minister of Development. In July 2005, another Administrative Decree created "TradeInvest Timor-Leste" (TITL), as an autonomous agency to manage, promote and facilitate foreign investment and export trade. TITL reports directly to the Office of the Prime Minister. Among TITL's responsibilities is the development and implementation of a "one-stop-shop" for managing investment.

### 4.2 Sector Investment Program (SIP)

The government agenda of activities to support the business environment under its Sector Investment Program (SIP) depends mainly on commitments by the donor community and on further increases in GoTL revenues and budget expenditures. GoTL proposed investments call for total public expenditures of \$31 million over the next five years. The government has proposed providing \$3.4 million in Consolidated Fund for Timor-Leste (CFET) budget allocations, and about \$1 million is available from ongoing donor programs. The remaining \$26 million needed to implement the proposed program is the subject of current GoTL-donor community negotiations. Interviews with representatives of the major international donors indicate that while significant additional funding will be forthcoming, most of the donors anticipate that the GoTL will assume increasing levels of responsibility for development costs as petroleum-based and other GoTL income increases.

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15 *Timor-Leste National Development Plan*, Planning Commission, Dili, May 2002.

16 Budget Paper No. 1, General Budget of the State, 2005/06, Ministry of Planning and Finance.

The GoTL SIP for Private Sector Development, adopted in early 2004<sup>17</sup>, identifies development priorities, including the construction industry, tourism, non-oil, labor-intensive services related to oil and gas development, and further commercial development of key natural resources. Specific SIP priorities include:

#### **4.2.1 Improvements to the Private Sector Enabling Environment**

- Land and property regulatory development;
- Business regulatory environment development;
- Trade and industrial policy development;
- Financial sector policy and institutional development;
- Policies for labor and employment generation;
- Capacity building for policy-making and business regulation; and
- Policy analysis of the economic, including formal and informal, operations.

#### **4.2.2 Local Business Development and Foreign Investment Attraction**

- Further development of agribusiness, including increased production of specialty crops for export and import replacement;
- Development of forestry and fisheries products for domestic and export markets;
- Private participation in infrastructure, including perhaps power and water supply;
- Development of the onshore hydrocarbon potential and minerals industry;
- Development of the tourism potential of the country;
- Build capacity of cooperatives related to agriculture production and credit; and
- Build on the existing economic sectors, fostering demand for local services and products and strengthening and developing supply.

#### **4.2.3 Micro Finance Program Support**

- Development of credit cooperatives, which is a fast growing sector in promoting credit access to the rural population; and,
- Development of the informal sector, where lack of credit generally constitutes a major impediment to development of micro-entrepreneurship initiatives.

### **5. DONOR SUPPORTED TRADE AND INVESTMENT DEVELOPMENT EFFORTS**

Several bilateral and multilateral donor initiatives have focused on private sector and trade related development since the country's independence. Many of the initiatives have concentrated on the legal/regulatory framework, trade policy management, domestic productivity improvement, government services (customs, standards management and others), and development of specific sectors. Although attention has been given to coordination of the various assistance programs, some of the activities appear to be ad hoc and unrelated to others (see Table 7). The most significant efforts related to non-petroleum sectors include:

- Trade policy needs assessment, policy formulation assistance, trade policy related strategic planning and other efforts by the Swedish International Development (SIDA), European Union (EU) and USAID.
- Policy development and economic legislative drafting by The World Bank managed Second Small

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17 Overview of Sector Investment Program, Vol. II. Min Planning & Finance.

Enterprises Project (SEP II), which is funded by the Trust Fund for Timor-Leste (TFTL), a World Bank-managed multi donor development fund. The SEP II programs, including:

- A network of Business Development Centers for SME support;
  - Agricultural marketplace rehabilitation and development;
  - Limited civil service training;
  - Economic Opportunity Zone potential assessment; and,
  - Start-up support to the newly created Investment and Export Promotion Agency, TradeInvest Timor-Leste (TITL).
- USAID funded land tenure and related legislative reform initiatives.
  - USAID assistance to small farm production, production cooperative development and particular attention to the Cooperativa Café Timor organic coffee export project.
  - USAID support for Ministry of Agriculture, Forestry and Fisheries farm production and crop diversification programming.
  - The recently initiated USAID Bolstering Agriculture and Sustainable Agribusiness (BASAR) / Private Sector Reform projects for assisting domestic businesses.
  - The USAID Small Grants Project, which directs resources to some of its resources to private sector related activities.
  - Fiscal policy management assistance from USAID, International Monetary Fund, United Nations, and the governments of Portugal and Australia.
  - Support for employment centers and labor policy development by the International Labor Organization; World Bank; European Community; UNDP and the governments of Germany, Portugal, and Brazil.
  - On-going assistance to Customs from the governments of Australia and Portugal, including development of the Automated System for Customs Data (ASYCUDA);
  - Sanitary and phytosanitary standards and quarantine related technical assistance from UNCTAD, EU and the government of Portugal;
  - Fisheries sector technical assistance from World Bank and Australia Aid and EU FMP.
  - Limited United Nations Development Program (UNDP) supported technical assistance by the World Tourism Organization for strategic planning in the GoTL Department of Tourism.
  - The United Nations, through its various agencies, have maintained a large contingent of advisers of several nationalities to “critical posts” in the GoTL, some of which have been involved with trade related activity.
  - Two additional USAID supported technical advisers are scheduled to be assigned to the Office of the Prime Minister for trade related and other policy formulation and management.

As the international donor community considers progress to date and projects on-going support requirements, additional donor resources for trade and investment related support activities are being considered. They include:

- Millennium Challenge Account (MCA): Timor-Leste was named eligible for MCA fiscal year 2006 funding on November 8, 2005. See [www.mca.gov](http://www.mca.gov) for detailed information.
- European Union: Timor-Leste is set to ratify the Cotonou agreement this year which will make it a member African, Caribbean & Pacific group of states (ACP), as defined by the EU. ACP countries have access to substantial technical and financial assistance from the European Union, with a Euro 13.5 billion European Development Fund available in the first 5 years of the agreement.
- ASEAN Australia Development Cooperation Program (AADCP): The AADCP is a program funded by the Australian government to assist new ASEAN member countries with the process of joining the organization. Funding is available for a range of development and technical assistance activities. For more information see [www.aadcp.org](http://www.aadcp.org).
- The United Nations Economic and Social Commission for Asian and the Pacific (UNESCAP), has

already played a role in providing technical assistance and support to Timor-Leste in trade-related activities. It has expressed a willingness to provide further assistance. For more detail information see [www.unescap.org](http://www.unescap.org).

- World Trade Organization: The WTO offers extensive training and technical assistance to Least Developed Countries. To receive this assistance Timor-Leste would be required to apply for Observer status in the WTO. Resources available include residential courses in Geneva for civil servants on the WTO and trade policy issues. The WTO is also involved in funding and supporting in-country technical assistance and trade-related capacity building projects.

	<b>Completed</b>	<b>Completed in 2006</b>	<b>Ongoing / planned</b>
<b>Trade/investment policy</b>			
World Bank	SEP II policy support	SEP II leg. drafting	
SIDA	Trade policy assessment		
EU	Trade needs assessment		Trade policy
USAID			
<b>Land tenure reform</b>			
USAID	Legislative drafting	Implementation	
<b>Fiscal and monetary policy</b>			
USAID, IMF, UN, Portugal, Australia	Advisory support		
<b>Business Centers</b>			
World Bank	SEP II	SEP II	
USAID			MCA for IADE
<b>Business-Government dialog</b>			
World Bank	SEP II	SEP II	
<b>Marketplace rehabilitation</b>			
Marketplace rehab	SEP II	SEP II	
<b>Micro-finance support</b>			
USAID	MFI support	MFI support	
<b>Investment / Export Promotion Agency</b>			
World Bank	SEP II	SEP II	
EU			IEPA Strategic/ Business Plan
<b>Public Sector Capacity</b>			
World Bank	SEP II	SEP II	
USAID			
IDLO / USAID			Trade policy training
<b>Private Sector Capacity</b>			
ILO, World Bank, EU, Germany, Portugal, Brazil, UNDP	Vocational training, employment centers, labor policy training		
IDLO (USAID)			Private sector trade training
<b>Customs / SPS</b>			
Australia	Customs support		
Portugal, UNCTAD, EU	SPS, quarantine		
<b>Agriculture</b>			
USAID			BASAR, Small Grants, MFIs
World Bank, Australia, EU, Portugal, Japan, New Zealand		Sector support	
FAO, WFP, UNDP		Food security support	
<b>Fisheries</b>			
World Bank			
Australia			MAFF Capacity
USAID			Univ. Hawaii
EU			FMP, MSC
<b>Tourism</b>			
UNDP/World Tourism Org.		Needs analysis	Strategy Planning

<b>Financial Services</b>			
USAID		MFIs	
<b>Power Sector</b>			
ADB			
Norway			

## **6. PUBLIC SECTOR ASSESSMENT: LEGAL/REGULATORY FRAMEWORK AND INSTITUTIONAL CAPACITY FOR TRADE AND INVESTMENT POLICY MANAGEMENT AND ADMINISTRATION**

### **6.1 Legal/Regulatory Framework for Trade and Investment**

The Timor-Leste legal system is evolving. It currently consists of laws inherited from the period of Indonesian occupation, legal changes resulting from the United Nations Transitional Administration (UNTAET) involvement during the transition to independence, and post-independence legal development. Pending full development of the legal system, the country is governed by the remaining pre-independence laws that have not been modified by either UNTAET or post independence parliamentary action.

In addition to the Office of the Prime Minister, there are at least six ministries that have organic legal authority over one or more aspects of international trade policy formation/decision support, regulation, and/or administration and implementation. These include:

- Ministry of Planning and Finance (Customs, tax administration);
- Ministry of Justice (trade-related legal review and legislative drafting);
- Ministry of Foreign Affairs and Cooperation (trade negotiation, relations with multilateral organizations, monitoring of regional trade relationships, embassy and consulate-based trade promotion and admission of foreign workers);
- Ministry of Agriculture, Forestry, and Fisheries (SPS quarantine/conformity assessments, Agribusiness promotion);
- Ministry of Labor and Solidarity (legal regime for foreign workers); and,
- Ministry of Development / Secretariat for Commerce and Industry (trade policy formation, multilateral and regional/bilateral trade negotiations and trade related public information and education).

Laws and regulations directly affecting international trade policy formation and management are currently at various stages of development. It is generally agreed that, while progress has been made in drafting and approving key laws, development of regulations and actual implementation of the laws has been slow, and the regulatory framework remains incomplete. Guided primarily by international advisers, the trade related legal environment consists of several laws that have been passed but not fully implemented and a variety of legal initiatives that are in various stages of development. Recent interviews with a variety of government functionaries confirm general uncertainty throughout the bureaucracy with laws and regulations pertaining to trade related activities and assignment of responsibilities. Interviews with foreign and national business owners validate observations by the World Bank<sup>18</sup> and an EU financed assessment of trade related needs<sup>19</sup> regarding serious, on-going problems with implementation of the laws that have been passed.

18 World Bank Assistance Strategy for Timor-Leste FY 06-08

19 Needs Assessment of Trade and Trade-related Assistance for the Democratic Republic of Timor-Leste (September 05); IBM Business Consulting Services

Administrative procedures for business are still unnecessarily complex: business registration, tax payment and customs procedures require inordinate amounts of processing time. The EU sponsored assessment<sup>20</sup> attributes much of the difficulty with trade law development and implementation to the absence of a solid policy framework: “Drafting laws before the policy framework is in place is to reverse the logic of the process. It has resulted in a haphazardly developed legal framework which may prove an obstacle to the implementation of later defined policies. It represents a piecemeal approach that may lead to the need for continuous revisions of laws and regulations...”

GoTL leadership acknowledges that serious gaps remain in the country’s trade related legal framework, attributing the problem to inexperience and a lack of qualified personnel for legislative drafting and implementation. Officials express optimism that current and anticipated major pieces of legislation, such as the foreign and domestic trade and investment laws, will help define a framework within which other pertinent legal/regulatory matters will find resolution. Business leaders express less optimism, indicating that the absence of a basic legal framework is a serious impediment to business development, particularly foreign investment. Most entrepreneurs consider business registration procedures to be unnecessarily complex and dilatory in facilitating new investments. Land law related issues, regarding the right of corporations (as opposed to individuals) and foreigners to take effective title and use land are in need of resolution. Major concerns are being expressed regarding legal uncertainties, including: enforcement of contract rights, enforcement of arbitration awards, utility of mediation processes, and rigidity of labor laws. Many concerns expressed by the business community are related to laws that are not yet drafted or implemented. Of particular importance are legal regimes for accountancy and insurance. Pending legislative developments impact virtually all productive sectors.

Important trade related laws that have been drafted and passed, *but are not yet implemented* include:

- Cooperatives Law
- Insurance Companies Law
- Commercial Societies Law
- Fisheries & Aquaculture Management Law
- Juridical Regime of Real Estate
- Conveyance and Lease of State Properties for Private Use
- National Investment Law
- External Investment Law

In most cases, implementation of these laws depends on the identification and resolution of procedural issues, definition of authorities and responsibilities among the various agencies of government, drafting and vetting of regulations, and development of the institutional capacity for implementation.

Several other essential laws that have yet to be drafted, or are drafted but not approved, include:

- Standardization Law
- Metrology Law
- Small Companies Law (i.e. businesses not covered by Commercial Societies Law)
- Special Economic Zones Law
- Intellectual Property Law
- Land Dispute Mediation Law
- Land Registration Law
- Leasing Law

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20 Ibid

- Occupational Health & Safety Law
- Chamber of Commerce Law
- Employment and Labor Law
- Foreign Workers Law
- Consumer Protection Law

## **6.2 Legal and Administrative Framework for GoTL Management of Trade and Investment**

In June 2005, Parliament enacted laws to govern domestic and foreign investment. Article 21 of the Foreign Investment Law provides that "the Government shall establish through a specific legal instrument an agency for the promotion and regulation of foreign investment and the promotion of exports, and that agency shall specifically promote, coordinate, facilitate, and monitor foreign investment and exports, and it shall *centralize* the required administrative procedures to authorize applications for foreign investment." This mandate was implemented by Government Decree 07/2005, which created the Foreign Investment and Export Promotion Institute. The Institute for Support of Business Development (IADE) was created by Government Decree 05/2005 as a counterpart agency for domestic investment

Article 1 of the Government Decree establishing the Foreign Investment and Export Promotion Institute indicates that it shall ". . . henceforth be designated as TradeInvest - Timor-Leste" or "TITL." TITL has been established as an independent office or "autonomous public institute" within the Office of the Prime Minister under the overall management supervision of the Cabinet-level Minister for Supervision of the Office of the Prime Minister. TITL is managed by an Executive Director and operates through three discrete administrative offices: (1) the Office for Investment; (2) the Export Department; and (3) the Office of Administration and Logistics. Consideration is being given to establishing a fourth office to service the UNCTAD/Trade Points activity within the TITL under its export promotion mandate. Two supplementary bodies support operations of the TITL: (a) the Foreign Investment Commission and (b) the Consultative Council.

The Foreign Investment Commission is composed of permanent members drawn from various relevant ministries and agencies of the GOTL, including those for Business Development, Planning, Finance, Customs, Land and Property, Labor, Immigration, and Environment. Ad-hoc members from other ministries and agencies directly affected by investment applications may also be included in Commission consideration of prospective investments. The TITL Executive Director presides as Chairperson of the Commission. The Commission's responsibilities include analysis and comment on investment proposals; ensuring process timeliness and coordination; and any other matters committed to it by law.

The Consultative Council is composed of the administrative heads of the following ministries and agencies: Business Development, Planning, Finance, Customs, Foreign Affairs, Land and Property, Land Use Planning, Transport, Labor, Immigration, Environment, Foreign Trade, Agro Industry, Fisheries, Industry, Tourism, and the Institute for Promotion of Business Development. The Council also includes three individuals from the private sector nominated by the TITL Executive Director and designated by the Minister for Supervision of the Office of the Prime Minister. The Council is required to meet twice a year but can hold extraordinary meetings as necessary or requested by the Executive Director.

Consultative decisions of the Council are taken by majority vote and are non-binding when sent to the Executive Director. Responsibilities of the Consultative Council include: (a) follow-up on the relations between the TITL and the various public entities with responsibilities affecting foreign investment; (b) commenting on TITL budget proposals, management accounts, plans, and action programs; (c) commenting on proposals for representation in Timor-Leste and abroad; (d) commenting on proposals for legislative and administrative measures for promoting and encouraging foreign investment; (e) commenting on proposals to simplify processes relating to implementation of foreign investment; (f) commenting on internal regulations and staff rules before their submission to the Minister for Supervision; (g) commenting on all matters related to the promotion of foreign investment; (h) commenting on all matters referred to it by the TITL Executive Director; (i) review and approval of TITL working regulations; and (j) commenting on everything assigned to it by law.

The Law on Foreign Investment is a modern, succinct and thorough statement of the requirements for authorization, approval, and registration of foreign investment. It defines the elements of foreign investment and the forms it may take. The law defines the areas in which foreign investment is permitted, requirements for investment approval, tax and customs incentives, the obligations of foreign investors, and provisions governing expropriation and dispute settlement. The law establishes specific procedures administration of investments, including: documentary requirements, review procedures and related time frames, approval criteria, government follow up and supervision requirements, consequences for non compliance, complaint processing and dispute settlement.

Although the new legal/regulatory structure is generally considered to be well conceived, it is untested. Interviews with business owners and government officials reveal considerable uncertainty regarding the new investment laws and their regulations. Authorities and responsibilities of the various involved government agencies are not clearly understood and several government officials have noted inconsistencies and guidance voids in the implementing regulations. Serious questions regarding treatment of foreign investors, tax incentive management, and expropriation need to be addressed and resolved in order to make Timor-Leste more attractive for foreign investment. Effective implementation of the new legal/regulatory structure will require identification and analysis of investor concerns, resolution of inconsistencies and other problems and clarification of authorities and responsibilities of government agencies.

### **6.3 Implementation of Foreign Investment Law and Status of Investment and Export Promotion and Facilitation**

TradeInvest Timor-Leste (TITL) is in the early stages of development. A national Executive Director is being recruited, but there is no current indication of when the recruitment/hiring process will be concluded. Although TITL is to officially operate from the Office of the Prime Minister, it is currently temporarily based in the Ministry of Development. The adviser/Executive has recruited nine staff persons, of which (as of October 2005) four have been formally contracted, three have begun to work while awaiting contracts, and two are scheduled to start in the near future. Limited staff training has begun. The expatriate adviser has participated in four outbound trade/investment missions (two of which occurred prior to passage of the foreign investment law) to neighboring countries (including China) and numerous inquiries have been received from potential investors.

World Bank SEP II funding, upon which TITL operation is dependent, is scheduled to terminate in June 2006. GoTL budgeted resources are insufficient for the agency's operation. Considerable donor funding will be required.

The Foreign Investment Commission and the Consultative Council, which are considered critical for effective intra governmental coordination of investment approval and processing, have not been appointed (as of October 2005).

Successful deployment of TITL operations will require considerable continued technical assistance, training and financial support.

### **6.3.1 TITL Advisory Bodies**

The effective operation of the TITL advisory bodies is essential to facilitating foreign investment. Both advisory bodies bring the foreign related policy and management functions of the entire government into the limelight of the Office of the Prime Minister. The Foreign Investment Commission is of particular importance, since it provides a regular forum for coordination of all government functions related to foreign investment. The Commission is expected to facilitate scrutiny of the performance of the government agencies, as well as broker technical assistance and other support required for agency effectiveness. TITL will require assistance with organization, strategy development and management of its advisory bodies. In particular, TITL must develop strategies for assessing and meeting critical technical assistance needs of the Commission member agencies as necessary to improve management of foreign investment related processing and services. Interviews with various ministries and agencies reveal that they are unprepared to provide the support activities needed to implement the foreign investment law. For example:

- Customs is attempting to understand and prepare for processing imported inputs with new duty-free status;
- Tax officials complain that they were not consulted during development of the law, and identify “inconsistencies” in the law and needs for clarification regarding tax incentives for foreign investors;
- GoTL has no SPS or other product standards management capacity;
- Various ministry agencies are currently involved in business registry and licensing functions and are unclear regarding new authorities and responsibilities;
- Most GoTL agencies are under staffed, untrained and ill equipped to perform as anticipated under the new legal/regulatory structure.

Technical assistance and related support are required for continued development of the country's capacity to manage investment and export promotion and facilitation.

### **6.3.2 TITL Programming and Management**

TITL is currently being managed by an experienced World Bank SEP II funded expatriate advisor. All TITL functions are completely dependent on her expertise and initiative. Given the limited expertise and experience of TITL staff, it is likely that expatriate expertise will be required to perform many of the critical investment and export development functions while training and technical assistance programming prepares TITL for independent operation.

TITL needs to develop appropriate levels of state of the art investment promotion/facilitation capabilities, including those necessary for:

- Attracting foreign investment that generates new employment, introduces new technologies, and promotes new and sustainable export industries;

- Encouraging and facilitating foreign investment and export expansion that adds value in a minimum of three targeted sectors – agriculture, tourism and fisheries;
- Facilitating and brokering partnerships, joint-ventures and other cooperative links between domestic and prospective foreign investors; and,
- Providing input to GOTL investment policy formation and management to help all relevant government agencies respond efficiently to investment opportunity.

TITL responsibilities for promoting exports will also require support for efforts to enhance the competitiveness of domestic businesses, particularly in sectors of greatest promise. TITL is expected to leverage its expertise and contacts with foreign markets and investment interests to:

- Support domestic business development and export-oriented production
- Facilitate and broker partnerships, joint-ventures and other cooperative links between domestic and prospective foreign investors;
- Assist with introduction of international market-based production standards; and,
- Otherwise facilitate opportunities for enhanced export production.

TITL is particularly in need of staff development and training.<sup>21</sup> Academic qualifications of current professional staff include BA degrees from universities in Indonesia and in Australia, in fields including business administration, marketing, and public relations. English language proficiency appears to be at a medium level for most, but all will need more intensive English training particularly in technical business/commercial terminology. Among the areas in which training and technical assistance have been identified are:

1. Development of a clear sectoral strategy and institutional framework;
2. Development of a systematic approach to capacity development based on the development and streamlining of systems and processes;
3. Training programs targeted at systems and processes, management, leadership, attitudes and behaviors, in addition to the development of technical knowledge and skills;
4. Increased use of workshops, on-the-job training, and off-shore programs, and less use of expatriate advisers;
5. Succession planning for local staff to “take-over” from expatriate advisers; and,
6. General needs for training, including human resource management, financial management and public service ethics.

#### **6.4 Implementation of Domestic Investment Law and Status of Investment and Export Promotion and Facilitation**

The private sector in Timor-Leste continues to struggle with a combination of firm-level and enabling environment-related constraints to survival and development. In addition to evolving GoTL donor assisted efforts to improve the enabling environment, several initiatives are addressing firm-level weaknesses. In response to limited business know-how and access to technology, donor (primarily USAID) sponsored programming is focused on improving business competitiveness, particularly in agriculture and agribusiness. The newly established Institute for Support of Business Development

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<sup>21</sup> Recent training has been limited to short term courses, of 2-3 weeks locally, offered primarily by UNIDO, covering behavioral, transparency and related general organizational issues. Planned training includes proposed courses offered by several providers. These include IDLO, UNIDO, the Thailand Board of Investment (BOI), and ITPO Tokyo, with courses of from 2 weeks up to 6 months.

(IADA) also assists through implementation of the domestic investment law and managing government programming in support of domestic private sector development.

Newly initiated USAID and other donor efforts are expected to support IADA development and implementation. TITL responsibilities for export trade development will require the agency to work in close coordination with IADA and the private sector to identify and harvest short-term opportunities for exports and investment and generate opportunities for new investment and export production in sectors demonstrating potential for growth and improved competitiveness in regional and wider international markets. Particular attention will be required to:

- Support domestic business development and export-oriented production
- Facilitate and broker partnerships, joint-ventures and other cooperative links between domestic and prospective foreign investors;
- Assist with introduction of international market-based production standards; and,
- Otherwise facilitate opportunities for enhanced export production.

## **6.5 Trade Policy Formulation and Management**

In addition to the Office of the Prime Minister, at least six ministries have organic legal authorities for one or more aspects of international trade policy formation and management. However, the Ministry of Development is the lead agent of GOTL trade policy. The Ministry's responsibilities include: trade policy formation; leadership and management of GOTL involvement with multilateral, regional and bilateral economic integration / trade agreements and concessionary, non-reciprocal preference arrangements (Cotonou/ACP, GSP, etc.); lead source for public and media information and education regarding trade-related issues; and management of domestic investment, and business registration. GoTL is in the process of developing a Ministerial Trade Council that will provide leadership on all matters of trade policy formulation and management. The Ministry of Development will provide the Council with analysis and management support, backed by a Ministerial Support Group, which will be staffed by representatives of the various member ministries.

With the exception of membership in the World Customs Organization, Timor-Leste does not currently participate in any reciprocal, non-concessionary, regional or bilateral economic integration and trade arrangement. As with most other aspects of policy management, trade agreement considerations are being guided by international adviser assistance.

The GoTL is in very early stages of developing its capacity to formulate and manage effective trade policies. Interviews with functionaries of all key public offices confirm recent assessments by international observers that government agencies with trade-related responsibilities have "low levels of knowledge and understanding of trade issues, with little or no formal / tertiary training in the discipline."<sup>22</sup> Virtually none of the government agencies with trade related responsibilities is equipped with functionaries with understanding or skills (including language skills) necessary to perform trade policy related functions. Government leaders are aware of the country's lack of preparation and are seeking assistance. The GoTL is particularly concerned with developing a cohesive policy framework that will support its commitment to engaging international trade as a means of achieving the country's development goals. With the assistance of international advisers, GoTL is developing a remedial strategy including:

- Development of effective intra ministerial policy formulation and coordination<sup>23</sup>;
- Training for essential trade policy related functions, including research, analysis, strategic planning, language skills, negotiations, policy implementation and others;
- Training for diplomats and other representational functionaries;
- Structured engagement of the private sector in policy formulation and management;
- Active participation in strategic international trade relationships; and,
- Development of legal / regulatory / trade regime that is compatible with aspirations for eventual international trade agreement participation, including WTO.

Donor assistance has been instrumental in trade policy progress to date, including development of strategies for:

- Preparation for membership in the Association of Southeast Asian Nations (ASEAN) by 2010<sup>24</sup>;
- Observer status on the Ministerial Council of the World Trade Organization (WTO)<sup>25</sup>, with aspirations for WTO General Council Observer status; and,
- Pursuit of bilateral agreements with Australia<sup>26</sup> and Indonesia.<sup>27</sup>

Several GoTL agencies have made good progress in capacity building to date, including the Banking and Payments Authority, the Ministry of State Administration, the Ministry Health, and units of the Ministry of Agriculture, Forestry and Fisheries.<sup>28</sup> A government-wide capacity building strategy is being developed by the Capacity Development Coordination Unit (CDCU), with which trade-related efforts will need to cooperate.

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23 A recent draft trade policy statement purportedly reflecting a consensus on the subject within the GOTL indicates that the government plans to establish a Ministerial Trade Council (and a dependent) Support Group [similar to the U.S. TPC and TPSC] ". . . to take action on trade issues and ensure a 'whole of government' approach to managing the process." The Council would be chaired by the Permanent Secretary of the Ministry of Development, include the Ministers for Development, Foreign Affairs and Cooperation, Planning and Finance, and Agriculture, and meet once a month. The Support Group would include senior staff from four ministries and relevant secretariats as well as the directors of the domestic and foreign investment promotion agencies.

24 ASEAN provides economic cooperation and strategic integration among member countries. ASEAN participation offers access to its Framework Agreement on Enhancing Economic Cooperation which includes its Agreement on the Common Effective Preferential Tariff for the ASEAN Free Trade Area or AFTA. ASEAN cooperation covers trade, investment, industry, services, finance, agriculture, forestry, energy, transportation and communications, intellectual property, small and medium enterprises, and tourism.

25 Given its essentially pre-viable capability for international trade, the current low volume of its involvement in global trade and the need to prioritize its trade relationships with its most likely trade partners, pursuit of accession to the WTO may not seem unrealistic. Nevertheless, the GoTL has expressed interest in seeking observer status at both the forthcoming December Hong Kong WTO Ministerial Conference and continuing observer status as a preliminary step towards eventual accession.

26 As an LDC, Timor-Leste is eligible for non-reciprocal, concessionary trade preferences under national programs such as Australia's 2002 extension of zero-tariff, quota-free access to its markets. The country may also be eligible for other developed nation Generalized System of Preference (GSP) programs, including those of Canada, the European Union, Japan, New Zealand, Norway, the Russian Federation, and the USA.

27 Indonesia is major source of imports and a major export market. The process of seeking negotiation of a bilateral free trade agreement has already started as part of the Joint Ministerial Commission for Bilateral Cooperation. Timor-Leste is hopeful Indonesia will extend concessionary, non-reciprocal preferential access to its markets.

28 See also E.Timor Fisheries Management Capacity Building Project, MAFF, funded by Aus Aid.

## 7. THE PRIVATE SECTOR AND ITS TRADE AND INVESTMENT CONSTRAINTS

### 7.1 Structure of the Private Sector

Limited accurate data exists on the precise size and composition of non-agricultural private sector GDP. Private activities are thought to account for about \$220 million of non-oil GDP, or about two-thirds of total output. Almost 50% of private sector output is related to agriculture, mainly subsistence production. Hotels, restaurants, transport and financial services account for another \$80 million of value added. The balance consists of private construction and a small mining industry supplying the construction industry. The non-farm private sector consists mostly of informal household activities, and micro and small enterprises. Many enterprises are not registered and many registered enterprises do not comply with basic business requirements, including employee contracts and tax payments.

Small, informal and marginally formal business activity appears to be growing. Over 11,900 individuals and companies were registered by the end of the first quarter of 2004, of which about 30% were companies and 70% were individuals. Eighty percent of registered businesses are in Dili. Seventy-five percent of registered enterprises were service industry, of which 58% were traders, 14% were in the construction industry and fewer 10% were involved with manufacturing or processing. A draft report of a recent study of urban enterprises<sup>29</sup> indicates that fewer than 20% of businesses employ more than 10 persons. However, it is estimated that fewer than 1,000 enterprises are operational. There is evidence that the Timor-Leste Diaspora is having growing influence on domestic business growth and may offer interesting potential for private sector development. Estimated at up to 30,000 (mostly in Australia), overseas Timorese could represent an important target for investment promotion.

Private sector activity from about 1999 – 2002 was heavily driven by donor-funded expenditures on reconstruction and rehabilitation. During that period, private business operated despite the absence of a meaningful regulatory regime. As reconstruction slowed in 2002, private sector growth slowed. Serious declines in urban-based wholesale and retail trade and other services resulted from the departure of large numbers of donor-supported expatriate staff.

### 7.2 Private Sector Organization

Business association development is extremely limited. Many factors account for this lack of organization: the country's private sector is small, underdeveloped and generally informal; there is little precedent for public-private sector dialogue; and associations among businesses tend to reflect political and/or cultural commonalities rather than common business interests. Over a dozen private sector groups currently claim to operate as business associations, but few have significant organizational structure or meet with regularity. Most have no formal dues payment, and many companies are members of several associations. Services to members are very limited. There is little or no formal policy advocacy based on research or policy briefs, and limited formal channels exist for promoting business-government dialogue.

Interviews with business community leaders and members of various business associations have produced clear expressions of need for assistance with almost all forms of organizational development, from management training to business development services for member companies. Only a few associations currently receive any support, mainly in basic training in institutional development, from UNIDO and ILO. Virtually all other needs remain unmet.

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29 MB Das, *Urban Enterprises in Timor-Leste*, draft report dated May 24, 2005

Interviews with national business persons in most of the country's productive sectors reveal a general lack of familiarity with export business possibilities, foreign investment opportunity or international product standards. Domestic business persons generally express defensive, protectionist concerns regarding foreign investment in the country. Many business leaders hold negative perceptions of foreign business interests, and it is evident that local business owners feel that foreign interests have unfairly dominant access to trade and investment opportunities.

### **7.3 Additional Constraints to Private Sector Development**

In addition to the previously mentioned constraints to private sector development in Timor-Leste (i.e., majority SMMEs, poor infrastructure, sector weaknesses, unfavorable terms of trade, lack of human resources, weak legal/regulatory environment, etc.), the country also suffers from inadequate access to credit and capital.

A general lack of credit access and financial services has contributed to a prevalence of cash-based economic activity. Three Timor-Leste branches of foreign commercial banks service primarily international trade transactions (that involve little or no country risk) and services contracted by the government and donor agencies. One of the commercial banks manages a limited portfolio of small personal loans and SME working capital. Limited credit programming is offered by three surviving savings and loan cooperatives, and several micro finance institutions (many operated by non financial services-specific NGOs) provide micro lending services to and estimated 10-15% of the informal/quasi formal sector credit market. Interviews across a spectrum of business owners reveal that inadequate access to credit is perceived as one of the major impediments to business survival and growth. One major commercial lender, Caixa Geral de Depositos (CGD)<sup>30</sup>, has initiated a program of secondary city and rural district branch development that CGD management expects to improve credit availability to the country's private sector. Credit portfolio growth to date has been modest. Interviews with all three major commercial lenders confirm that the legal/regulatory conditions required to support significant commercial credit growth are not yet in place.

### **7.4 Cross Cutting Needs**

Competitive productive activity in all sectors is handicapped by general unavailability of essential support services:

- Access to credit and financial services is insufficient to support business survival and growth, particularly for locally owned businesses. Specialized micro credit institutions are responding to the needs of an increasing number of informal enterprises, and one commercial bank is expanding its service coverage beyond the capital city. However, it is widely recognized that the legal/regulatory conditions required to support significant commercial credit growth are not yet in place. Acceleration of credit growth is expected to require:
  - Land ownership laws and property registration systems that allow reliable pledges and adjudication of collateral;
  - Reliable of legal / regulatory mechanisms for loan contract enforcement; and,
  - General legal / regulatory allowances and respect for debt recovery enforcement.

The credit and financial services gap represents both a critical need for private sector development and potential opportunity for visionary financial services providers.

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30 A Portuguese state-owned bank that served Timor-Leste during Portuguese colonial times as BNU, which now forms part of the renamed Caixa Geral de Depositos.

- Business development is generally handicapped by a country-wide lack of accounting standards. In addition to hampering efficient business operation, poor accounting exacerbates credit access problems.
- Vocational and management training opportunities are seriously lacking. Several local business schools are attempting to expand their currently limited capacities. At least two business schools are establishing relationships with Australian universities. Opportunity may exist for appropriate linkages between local private training institutions and business schools in the U.S. or elsewhere.

## **8. GENERAL RECEPTIVITY TO FOREIGN TRADE AND INVESTMENT**

Despite the government's commitment to foreign investment and export led economic development, considerable apprehension and resistance to foreign business involvement are evident in key facets of the public and private sectors. Interviews with government officials, business leaders and others reveal widespread lack of understanding of the importance of foreign investment to the development of the country. Many business owners express fear that foreign investment will result in loss of opportunity for domestic entrepreneurs due to business "take over" by better capitalized, stronger foreign interests. In addition to limiting potential for development of successful domestic-foreign investor joint ventures and other business relationships, the lack of understanding and receptivity might be expected to temper the current political will for legal, regulatory and policy reform. The recent passage of separate domestic and foreign investment laws is considered by many to have occurred in reaction to opposition by national business leaders to a single legal/regulatory framework for all investment.

Current efforts to facilitate better informed and structured dialogue regarding foreign investment, export trade development and public-private sector cooperation are supported by the World Bank SEP II Business Development Center program. SEP II funding is scheduled to stop in June 2006, and IADE (the domestic investment promotion agency) is expected to sponsor continued programming. However the agency is not yet operational and there is serious risk that these issues will go unattended in the complicated demands of project start-up.

The Timor-Leste business community has little exposure to the international business arena. There are few opportunities for local business community leaders to develop an understanding of export market standards or opportunities. Much of the apprehension apparent in the business community is thought to be attributable to isolation. Government sponsored international trade fair attendance, investment promotion travel and other opportunities for international exposure are generally limited to government employees.

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