



**BUILDING EAST TIMOR'S ECONOMY:
THE ROLES OF FOREIGN AID, TRADE AND INVESTMENT**

THESIS

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TABLE OF CONTENTS

List of boxes, tables and figures	iv
Abbreviations and Acronyms	vi
Abstract	viii
Research Declaration	x
Acknowledgments	xi
Chapter 1. Introduction	1
1.1. Background : the rocky road to independence	1
1.2. Objectives of the study	9
1.3. Policy questions	9
1.4. Organisation of the thesis	10
Chapter 2. Reconstruction, development and the role of foreign aid	12
2.1. Introduction	12
2.2. Approaches to economic reconstruction from war	12
2.2.1. Common characteristics of post-conflict situations	15
2.2.2. Sequence of economic recovery in war-torn societies	18
2.3. Strategies for sustainable economic reconstruction post-war	19
2.4. Foreign aid to East Timor to date	23
2.5. Pitfalls and opportunities for aid-financed economic recovery	32
2.6. The economics of foreign aid: introduction	35
2.6.1. Impact of aid on economic growth	37
2.6.2. Impact of aid on poverty	38
2.6.3. Impact of policy choices on aid's effectiveness	38
2.7. The economics of foreign aid: a general equilibrium analysis	39
2.8. Implications for the post reconstruction phase of a war-torn economy	44
2.9. Conclusion : policy implications for East Timor	46

Chapter 3. Why openness to foreign trade and investment matters from the outset	50
3.1. Introduction	50
3.2. Why openness matters	50
3.3. Openness to foreign direct investment	53
3.4. Gains from trade: exchange and specialization	58
3.5. Gains from more economies of scale and greater competition	60
3.6. Effects of restricting trade: the case of an import tariff	61
3.7. Effects of restricting FDI	65
3.8. Gains from less rent-seeking	69
3.9. Dynamic gains from openness	72
3.10. Equity benefits from openness	74
3.11. Raising government revenue	75
3.11.1. Trade Taxes	75
3.11.2. A value-added tax	77
3.12. Conclusion: policy implications for East Timor	78
Chapter 4. Production and trade effects of developing a poor open economy	81
4.1. Introduction	81
4.2. What theory suggests	81
4.3. Evidence from other, particularly small island economies	85
4.4. East Timor's resource endowments and income at the start of the 21 st century	90
4.5. Managing a resource boom in the Timor Gap	94
4.6. The likely evolution of the structure of production and trade for East Timor	98
4.6.1. Production specialization prospects for East Timor	99
4.6.2. Light manufacturing and tourism	106
4.7. Conclusion : policy implications for East Timor	109
Chapter 5. Appropriate trade and investment policies in the future	112
5.1. Introduction	112
5.2. An outward-looking trade strategy	112

5.3. Trade policies	116
5.4. Foreign investment policies	122
5.5. Bilateral, regional and multilateral economic links	129
5.5.1. Bilateral economic cooperation with Indonesia	130
5.5.2. ASEAN membership	132
5.5.3. The ACP/Lome Convention	134
5.5.4. WTO membership	137
5.5.5. APEC membership	139
5.6. Conclusion: policy implications for East Timor	143
Chapter 6. Summary of conclusions, policy implications and areas of future research	145
Appendices	152
Appendix A1: Survey of East Timorese economic development and performance, 1958 to 1998	153
Appendix A2: The Timor Gap Treaty	162
Appendix A3: Host country determinants of foreign direct investment	166
Appendix A4: Screening mechanisms for foreign investment proposals in Pacific island economies, 1996	167
Appendix A5: Summary of selected incentives provided for new investments in Pacific island economies, 1996	168
Appendix A6: ACP and other developing countries' levels of development and WTO membership status	169
Appendix A7: Key indicators of ACP members' economies	170
Appendix A8: Summary of budget allocation by sector, East Timor, 2000-01 to 2002-03	172
References	173

ABSTRACT

This is a theoretical and empirical study of the roles of foreign aid, trade and investment for East Timor's economic reconstruction and development after the 1999 crisis. As a small half-island state emerging from years of conflict, a combination of policies is needed to secure a stable macroeconomy, well-established property rights, a capable system of governance, the rule of law, high investment in rural infrastructure, and capacity building, all of which are crucial for economic recovery and sustainable development. This study finds that in order to ensure a viable and vibrant nation that does not rely heavily on foreign aid in the long term, openness to international trade and investment from the outset is crucial for getting this tiny country gradually back on to a sustained development path.

As the country strives for reconstruction and development, much will depend on the capacity to absorb investment and aid flows for efficient use in promising industries, such as agricultural-based industries, tourism, mining, and natural gas in the Timor Gap. In addition, establishing institutions and policies favourable to private sector development, together with the building up of physical infrastructure and human capital, are critical ingredients.

Drawing on standard international trade theory, the benefits of openness to trade and investment from the outset are assessed. The study suggests that participation in world markets not only helps to channel new ideas and improve the terms of trade for a small country but also places that economy gradually on a sustainable path to growth and development. More importantly, opening up generates dynamic gains from trade, not just a one-off increase in GDP.

To understand how a small economy's comparative advantages might change in the course of factor growth at home and abroad, use is made of Leamer's endowment triangle. Theory suggests that countries tend to gradually alter their comparative advantage from land and other natural resource-intensive

industries to ones that are more capital-intensive as produced capital accumulates and/or flows in from abroad. A more policy oriented approach to trade and investment also is discussed at the domestic and international levels. Once again, it is shown that fostering democratic institutions and facilitating private sector entrepreneurship all reinforce each other. Well-developed regional and multilateral trading arrangements have the potential to contribute positively to that process.