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I thought I would run over a few background topics so we have a basis for discussion and then open it up for questions.

I think everyone knows where East Timor is, but it is worth bearing in mind that it is part of the archipelago that constitutes the south-eastern part of Indonesia, and that is one of the poorest areas of Indonesia. The per capita gross domestic product in that area is about one third the Indonesian average, and that was true for East Timor when it was part of Indonesia.

When East Timor was a province of Indonesia local taxes contributed only about 10 per cent to the provincial budget, the rest came from Jakarta. In 1999, that contribution was replaced by the international community, institutions and governments and in more recent time by oil and gas revenues.

It is also worth remembering that East Timor is about two fifths the size of Tasmania with twice its population and with one of the highest population growth rates in the world, thanks largely to post-conflict jubilation and the influence of the Catholic Church.

It is one of the world's poorest countries with a non-oil GNP of less than \$2 a day, and is one of the most difficult countries in the world to do business in, according to the International Monetary Fund, so there has been virtually no private investment since independence in 2002.

Some 75 per cent of the people still live by subsistence agriculture - and that is a pretty miserable existence - and only 12 per cent are employed in the formal sector, at least half of those in government and much of the rest in support of government activities.

It is also worth remembering that East Timor was decolonised as a province of Indonesia, so as well as the loss of 70 per cent of the infrastructure due to looting and destruction by the TNI and its allies, and the fleeing of most of the skilled labour, the East Timorese are also building the country from scratch without any existing institutions such as central banking, parliament and a judiciary. It is quite a major undertaking.

As we all know it achieved independence on May 20, 2002. Two years later in May 2004 the United Nations finally handed over responsibility for defence and security to the Government of East Timor. Two years ago the last formed units of the UN security forces left the country.

In terms of the government structure, you have an elected, non-executive president and that is Jose Ramos Horta who has only recently been elected and made his first overseas trip to Jakarta in the last couple of days. There is also a parliament and a separate government, so there are three separate institutions. The prime minister is the country's executive with the government implementing the laws that have been passed by the parliament. It is a hybrid system.

So why did the state collapse last year? Was it a consequence of a general uprising by the poor and starving masses? No. Was it the result of a military coup? No. It was simply the breakdown or the melt-down if you like, of the police and the military, a manifestation of political tensions that have existed since independence between the various elements of the state.

After the violence was initiated you did see the poor and unemployed, especially in Dili, get involved in the violence, making it particularly difficult for the military both to track them down and then arrest and process them. That was why it took some time to bring security in Dili under control after the troops went in.

What has happened since the fall of the Alkatiri Government in June last year? We have had two governments since then – one led by Jose Ramos Horta which took power in July last year. Ramos Horta, who does not belong to any party, was put in over the top of a Fretilin Government, so not surprisingly there was continuity of economic policy which had been discussed and agreed with the international financial institutions.

There was no particular problem with the continuation of past policies in economic terms but the government did decide if it was going to address poverty and the paucity of public infrastructure it would have to spend a lot more in the area of development, in other words improving roads, schools etc, both to attract foreign investment and to create employment.

Then, because Ramos Horta was elected president earlier this year, he was replaced a month ago by Estanislau da Silva who is a member of Fretilin and who is leading the government until such time as the new government is formed after the elections on June 30.

Both of these governments decided to leave the management of the petroleum funds alone. In other words, revenue goes into a central fund in New York and the monies are withdrawn through the budgetary process as agreed by parliament. This is one of the critical areas for the future of East Timor both in terms of financing its current budgets and ensuring that after the oil and gas runs out there is money invested for future generations.

Where are we with the Timor Sea issue? The agreements that were reached in the last few years came into effect in February of this year and they allow for East Timor to get 90 per cent of the revenue from the Joint Petroleum Development Area, which commenced production last year, and 50 per cent out of the Greater Sunrise Field when it comes on line in 2013. That field straddles the current borders between East Timor and Australia.

Although on a geographic basis East Timor is entitled only to about 20 per cent of the revenue from that field, in negotiations it managed to get 50 per cent in exchange for agreeing that the issue of the boundaries will not be raised for 50 years.

What are the likely outcomes of the June election? The two most possible outcomes are a Fretilin coalition or a non-Fretilin coalition. There is very little information in terms of polls to base any predictions on, but it is almost certain the outcome will be a non-Fretilin coalition. Then the question will be will Fretilin accept the results? Most people believe it will apart from some individuals who will show their displeasure in various ways.

One of the big issues to be sorted out is the division of power between the supposedly non-executive president and the executive government. The problem in the past has been that the president, although a non-executive, is the commander in chief of the armed forces and the military was seen to be aligned to him.

As a consequence of that the executive government, headed by Mari Alkatiri, built up the police force as an alternative to the military and as a sort of balance of power. How these forces were to be managed and integrated into the state was not resolved and this led to the conflict which arose last year.

There are some worrying signs already because the new non-executive president has already said that he wants to maintain control over the security forces, the police and the military. This is not provided for in the constitution and one of the points that the UN Special Commission of Inquiry made last year when it investigated the collapse of the state was that people were seeking ways around the law rather than upholding it.

If you get a situation where the president is ignoring the constitution, whether it is warranted or not, it does not set a very good example for the rest of the state.

When the foreign troops and the police go home will depend to some extent on the character of the new government, whether it can form a stable coalition; whether it can work effectively with parliament to get the laws passed that it wants; whether it can rebuild the police and the military and get them working together without killing each other; how long it will take to establish a sense of confidence in the population so that the government can fulfil its functions in relation to defence and security and whether the local police can be trusted to act impartially.

How long it will take remains a question mark, but at least until the end of the year and probably beyond that. You could probably start winding the forces down by the end of the year.

What will the next challenge be? Assuming the security problems can be worked through, watch the money. In most resource rich but otherwise poor countries you do have argument and conflict over the ownership of the resource; people try to steal it by plugging into pipelines or by other means. In this case we are lucky because the resources are offshore so nobody can claim particular ownership and you can't punch in to the pipeline.

But you do have this big pot of gold sitting in the ocean, drawn on by the government's budget, put out in the way of contracts. So if you want to get your hands on that money you have to deal with the government. Inevitably, this leads to pressures on politicians and public servants to grant projects to particular interests for particular purposes that might not be in the bests of the country as well as embedding high level corruption.

QUESTIONS:

**Ramos Horta is a founder member of Fretilin, yet he is now distancing himself from the party. How will he handle this change of affiliation as the new president?**

Like all politicians, once elected to office he says he wants to be the president for all of the people but there is a lot of bitterness between the current leadership of Fretilin and the new president. Mari Alkatiri said recently that he is going to 'spill the beans' after the parliamentary elections at the end of the month about what really happened in June last year. That sort of bitterness at the personal level will continue.

On the other hand Ramos Horta is one of the two principle characters in East Timor's political history together with Xanana Gusmao and I have no doubt that he will try to embrace them. But at the same time he has pushed Fretilin to have an extraordinary general congress and really rethink who it wants to lead it for the next five years.

If at the election Fretilin gains the most votes and somehow is able to win support from a number of other smaller parties to form a coalition, there will have to be some compromises, which it didn't have to make in the past because it governed in its own right. They could well include conditions on who will lead the government. I would be surprised if other members of such a coalition would agree to Mari Alkatiri regaining the prime ministership.

If it did happen you would still have the question that arose in Xanana Gusmao's time about who is actually going to run national security, because the constitution allows for a council chaired by the president to preside over high-level policy issues regarding defence and security. My reading of the constitution is that all it does is declare war and make peace, it does not get involved in the running of the military or policy-making, such as how big the military will be, how much money is spent on it etc.

Because in the previous government the military showed political loyalty to the president, you had a situation where the government decided to sideline it and put it in charge of a minister who was absolutely hopeless, which meant that simple things like uniforms, pay, housing and so on were ignored and as a result you had the problems that arose last year.

I believe Ramos Horta is aware that these issues have to be resolved and that hopefully the government, even if it is led by Alkatiri, will realise this has to be addressed if another crisis is to be avoided.

So Ramos Horta recognises Fretilin is a legitimate political party and a legitimate part of the political scene. However, he would expect it to behave accordingly.

### **Is East Timor a viable state?**

One of the problems with the previous government was that although it ran a very tight economic regime, which was acknowledged internationally, it was very centralised and it did not get around to spending a lot of the money set aside for capital investment. The new government decided to fix this and there is going to be a virtual trebling of capital investment. That means about \$150 million a year over the next four or five years. That doesn't sound a lot but it is a tripling of the government's capital investment.

It is hoped that public investment of \$150 million each year will result in an economic growth rate of seven per cent without bringing on the Dutch Disease. But even with that the absolute numbers in poverty will increase over the next few years until growth is sufficient to soak up new entrants into the labour market. It also assumes that the money is invested wisely in things like roads, education, health care etc. but there will be pressure from carpetbaggers to get access to government projects and for schemes of dubious utility.

It should be recognised that the oil and gas money is not a lot. The total income from the oil field operating at the moment in the Timor Gap that goes to East Timor is about \$US15 billion. When the Sunrise field comes in later on they will have another \$US10 billion, so about \$US25 billion over about 25 years.

The idea is to put most of that away in a Petroleum Fund and simply draw off the interest. In the short term they will be drawing off the capital because they want to boost capital expenditure, but the long term aim is using the interest only.

This is not a lot of money - \$US 25 billion is less than two years of the Australian defence budget. If you put the \$US25 billion away and get a 10 per cent interest rate and after 25 years the population is still one million, that works out at \$2500 per person that the government can spend. Our government today spends \$17,800 on you and I and that's not counting what state and local government spends or what you derive from the fact we have a vibrant private economy.

So it is peanuts in absolute terms, but it does provide an underlay for the government's budget if it is invested wisely. However, in the end growth has to be sustained by private investment. The government can certainly kick it off by investment in infrastructure but if, for example, you look at the South-East Asian model you find that private investment represents four or five times government investment.

But unless private enterprise finds something to attract it, then the prospects are that it will be a very poor country for a long time to come. Whether it is viable or not is questionable.

**Is Australia doing enough for East Timor, especially in the development of the military and police? Is our focus correct? Also, can you comment on the relationship between the Catholic Church and Fretilin, and the issue of the unemployed youth?**

There are people who say we are doing too much. We have put \$7-8 million per annum into the military since independence. Military for what? They don't need a military, but the political reality is that you can't do away with it. It was a problem in the first case because the UN did not come to grips with demobilising the guerrilla force that was in the mountains. It acquiesced in the formation of a military which Australia funded, hoping that by doing this it could influence it to stay in the barracks.

Unfortunately it was caught up in this political process where the government saw it as a support base for the president and therefore decided to sideline it. You would like to think that a new government coming in would address the question of whether East Timor needs a military at all, but the reality is that there is very little initiative taken in that line by new governments. They are not prepared to invest the political capital to get rid of it.

The question will be can they keep it as small as possible? Can they refocus it to the reality that its only function is as a back-up to the police force in law enforcement and natural disasters?

It seems that there has already been a deal done between the military and the political players in Dili that the military will be developed along certain lines. One of the fundamental problems with the military is that it has a mindset which is very similar to the Indonesian military pre-1998 – we won the revolution; we are the guardians of the independence of this country. The clashes between the military and the police last year have cemented that attitude.

Australia has also put a lot of money into the development of the police force, which is going through the process of trying to weed out those who are politically aligned but there is a long way to go in de-politicising the police force, let alone the bureaucracy. The task is to develop a professional ethos within the police force; making sure it is not subject to political interference and regaining public respect for the force. I think it will take a long time.

At least until after the next election in 2012 the police force will have to be led by a foreigner, whether it is a foreigner appointed by the UN, or someone hired directly. There is no way you can produce a professional police force that is not subject to political interference and has the respect of the people in under five or six years. Whether the government is prepared to look at those sorts of options I don't know.

You can put all the money you like into a police force at the operational level, but unless the politics are right you are wasting your money.

Historically the Catholic Church has been opposed to the left of the political spectrum. It was one of the key elements in convincing Xanana Gusmao that he would have to have a broad support base if the Timorese were to win international sympathy for their struggle. Some of the attitudes Alkatiri took in terms of religious education in the school curriculum back in 2005 raised those issues again, and in the presidential election the sympathy of the Church was certainly with the non-Fretilin candidates.

In terms of the employment of youth, it is very difficult because even with increased government investment you are not going to be able to soak up the current unemployed, let alone those coming on to the market year by year, for some time to come.

So can you introduce 'make work' programs that don't become a burden later on, which will employ some of these people? Then there are a lot of related issues such as decentralisation so you don't have the honey pot effect of people coming into Dili. The 2004 census showed that three out of four people had not been living in Dili three years previously.

If you can start promoting things like agriculture and getting development focussed outside the city it will help, but you will still have a great mass of unemployed youth no matter what you do. That is why you need a viable and united state and robust security agencies.

**We have just come out of a 10-year embargo on new memberships within APEC. With Australia's role as the host of the APEC summit, is it possible East Timor will get observer status or full membership during the talks?**

I am not up with where they are with that, but obviously they are applying to join various regional organisations. They aspire to join ASEAN. But that is not going to solve their problems. They already have bilateral relationships with the big donors and have already applied to tap into the American millennial fund which they anticipate getting \$US100 million a year from during the next five years.

One of the things Australia has not come to grips with either in East Timor or the broader Pacific is that we are dealing with micro states. They waste far too much money on embassies overseas, overseas visits, membership of this, that and the other. This is money that would be more beneficially spent inside the countries. So I do not see the membership of all these organisations as being necessarily to the benefit of these countries.

**If East Timor went into extreme civil unrest, would Indonesia be tempted to come back over the border?**

Indonesia's focus is Java, Sumatra and the South China Sea, that is where the bulk of its population and resources are. The south-eastern portion is the poorest area within Indonesia, so East Timor is of peripheral interest.

Indonesia is the largest source of imports for East Timor. It is cheaper to ship containers from Indonesia to Kupang and drive them by road all the way to Dili than it is to go into Dili, and the reason is that Kupang is open 24 hours a day and Dili open only eight hours and is a high cost port.

So Indonesia has an economic interest in being a supplier of daily necessities and in the short term benefiting from the inefficiencies of East Timor, but it is really small beer. Indonesia has got rid of East Timor, the 'pebble in the shoe', and if all went to pot, there would be problems on the border and it may have to beef up border security, but it would not be a major problem.

Indonesia has plenty of problems maintaining Papua within the borders of the state and promoting national unity, so the last thing it is going to think of is going back into East Timor.

There has been a honeymoon period for East Timor. If there was another meltdown like last year's I believe sympathy would evaporate.

**Has the Portuguese influence in areas such as the legal system, been negative?**

I would not say negative. Portugal was the coloniser up to 1975 and as in all these situations the indigenous elite had an affinity for their former colonial masters, although they might not admit it at the time.

It is not unusual therefore, that Portugal is quite an active player there. Language is an enormous problem, the local language Tetum, is not spoken by everyone, so you can't just adopt it. So you have that and Portuguese and the working languages of Indonesian and English.

When a Bill goes to Parliament it is in Portuguese which half the MPs cannot speak. When you go to court there will be up to three interpreters depending on the make-up of the court. It imposes an enormous burden on all these institutions, but there is no easy way round it. It may be the new government will put more effort into identifying the dominant language and ensuring it is widely spoken and understood.

Portugal does not put in a lot of money relative to the international contribution, but it does have very strong cultural links and East Timor is now a member of the Portuguese Commonwealth which is designed to help promote those links.

### **What are the prospects of more oil and gas deposits being found? How does the oil fund work?**

There are people who have been going round convincing MPs that there are more substantial resources, either on East Timor's side of the maritime border or on land. The early indications are that this is a gross exaggeration. The government has granted exploration leases for these areas, but we will not know the results for several years.

All the taxes and royalties go into the Petroleum Fund, which is well managed and run under the laws of East Timor, with rules laid down as to how it will be invested, how safely and so on. So if it is run according to the law that fund should be reasonably safe.

The idea is that the government draws off a sustainable amount – what it can earn from that fund over the long term. It can draw on the capital, but it has to make a special application, presented to parliament and assessed by auditors.

It has to be admitted that a business person would look at East Timor and ask what else is there to invest in? Maybe niche tourism or plantations. Currently non-oil exports are valued at only \$8 to \$9 million a year, 90 per cent of which is coffee. The soils are not particularly rich so you are not going to get a big return from other agricultural pursuits. It is really hard to see where you would put your money.

The main thing is that East Timor builds up the infrastructure and makes it attractive for small and medium local and foreign investors to come in and invest. Then if it actually looks like money can be made, the bigger investors will look at what else they might do.

### **How many Chinese are in small business in East Timor?**

When I spoke to the Indonesian Ambassador there he told me that during his travels around some of the most remote areas, he found Chinese pedlars selling a few small things. He wondered why Indonesians did not do this, and they said it was because the return was too small.

The Chinese Government has been taking an interest. It is building the presidential palace complex and the Foreign Affairs Department complex. Apart from the Taiwan issue, and given that there is not that much oil and gas, you would have to say they want to get in on the ground floor with government contracts that will eventuate with increased capital spending, perhaps including contracts from the national oil company.

**What are your thoughts on the tax system and should East Timor have adopted the US dollar as its currency?**

There have been suggestions that with the oil income there is no need to tax anybody. But the IMF has advised them that it is better to have a functioning tax system even if the threshold is quite high in the early years because over time the revenues from oil and gas are going to diminish and it is easier to raise rates in an existing system than establish new taxes and a new tax system later on.

There is no immediate pressure to change the currency and Timor is not yet ready to adopt a national currency.