



THE AUSTRALIAN NATIONAL UNIVERSITY

E P R E S S

## Out of the Ashes: Destruction and Reconstruction of East Timor

### Abstract for chapter 15

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The chapter poses a series of questions for the United Nations manager in charge of the transition process from the burned out shell of the Indonesian (and Portuguese) legacy to a sustainable and independent East Timorese government.

A key question is: what criteria can be established that will determine when the reconstruction phase has been a success, and an independent East Timor can be treated as a small but viable country, on the road to economic well-being?

If there is to be any benefit at all to starting over in the wake of the devastation visited on East Timor, it will be the opportunity to learn from this extraordinary set of circumstances how people and institutions can respond to challenge and times of crisis.

#### *Keywords*

agriculture, currency, donor funds, economic criteria, IMF, Indonesia, mineral development, political criteria, tourism, trade, World Bank

## Questions for the United Nations team managing East Timor

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East Timor is starting from scratch. Even in the context of war-torn societies, the historical record is sparse indeed on lessons for a new country with so little in the way of institutions, physical capital and experienced civil servants with which to form a government. What follows then is a series of questions for the UN managers in charge of the transition process from the burned out shell of the Indonesian (and Portuguese) legacy to a sustainable and independent East Timorese government. Some speculation on plausible answers is provided, but as much to stimulate serious thinking very early in the development process as to defend particular approaches. These questions, and the rough attempts at answers, draw heavily on two sources: the paper by Jonathan Houghton (1998), and my own experience in the early stages of transition economies in East and South-east Asia (and Russia).

It is difficult to categorise the questions into economic or political, domestic or international. For example, a fundamental question facing the new country will be its relationship with Indonesia, with whom it will share a land border to the west, access to sea lanes from its ports, and concerns about control of airspace for commercial and military aircraft. A hostile Indonesia will virtually guarantee that East Timor remains poor and undeveloped, as investors, tourists (and even donors), will not brave hostile fire on ships, aircraft, or personnel. How to maintain the territorial integrity of East Timor is obviously a political question, but one fraught with economic dimensions as well,

both because of the cost of an independent defence force and the burden to a trade-oriented economy of severely restricted commercial access. The example of the United States' embargo of Cuba highlights the potential problem that East Timor could face if a peaceful arrangement with Indonesia cannot be negotiated and enforced.

Based on the experiences of other societies trying to build a development-oriented government in the wake of devastating wars, as reported by Houghton, the problems build from broad and philosophical to narrow and specific. The problems are partly a matter for domestic politicians to resolve as peace is established, but the donor community also tends to play very extensive roles in the initial transition from war to peace and from destruction to development. This community ranges from the IMF and World Bank, with expert teams, technical assistance and development loans, to emergency relief agencies engaged in feeding the hungry and tending to their wounds. A very basic question for these donors, and a question that is particularly acute for the UN Mission about to undertake the entire management of East Timor for two to three years, is when should they leave? Equally important, who will decide?

Put another way, what criteria can be established now that will determine when the reconstruction phase has been a success, and an independent East Timor can be treated as a small but viable country on the road to economic well-being? Are these criteria primarily political, so that when honest elections have selected a representative government, it will be time for the UN team to go home? Or should the criteria primarily be economic, so that the UN agenda is not complete until, say, per capita incomes have returned to their previous peak? The time horizons of the two different criteria are likely to vary considerably. Houghton suggests, for example, that economic recovery to previous levels takes at least a decade after peace is restored, and this is in societies with more human and physical capital intact than in East Timor. By contrast, there seems little doubt that an election in an independent East Timor could select a popular and representative government within six to twelve months if that were the UN agenda. The likely president of this independent East Timor, Xanana Gusmão, has articulated a vision of a free and open society with an economy based on agriculture, trade, mineral development, and tourism. This vision sits comfortably with Western donors and argues for heavier weight on political stability as the main criteria for the departure of an interim UN administration, rather than a return to previous economic levels.

Still, even if the UN time horizon is shorter rather than longer in terms of its resident mission, East Timor will need donor funds for reconstruction and development for decades to come. Indonesia still receives massive funding from the World Bank and other donors; there is no reason to believe that East Timor can outgrow similar needs any faster. Where will this money come from, after the world's attention has moved on to the next televised crisis? Indonesia is a large and important country in both geopolitical terms and, at least potentially, in economic terms. It commands attention for its size and importance, although the United States was very slow to recognise this. East Timor is tiny on both counts, but it has touched the world's conscience and a groundswell of public opinion more or less forced the Western powers to intervene. But such opinion is short-lived and will not be the basis for long-term attention from aid donors. Somehow a case needs to be made for continuing substantial amounts of aid (in per capita terms), a case that will get more difficult as East Timor establishes its own voice and progressively begins to reject the kind of conditionality that is now commonplace with nearly all donors. Although Gusmão is now using the very language that donors like to hear – Western-style democracy, open institutions, diversified economy driven by exports, and so on – he is also rejecting a 'culture of dependency' that the society could easily be prone to if its affairs and finances are managed for long by outsiders. Real tensions are going to erupt over the need for foreign resources for faster growth and control of the country's destiny.

Part of these tensions will be over the size of government itself. There is surprising diversity in both the developed and developing world on the scale and scope of government. If the neo-liberal consensus argues for a small government focused on tasks unique to the need for collective action (and commensurate with the human capital available to staff a civil service), a political economy perspective would argue that the institutions supporting a larger role for the private sector and civil society are conspicuous by their absence in East Timor, and they take a long time to build. A competent government can be built more quickly, especially since it starts from zero and thus faces little hostility from an entrenched bureaucracy. From the beginning, then, a larger and more aggressive role for government may be both popular and successful. In this debate, the donors may need to take a back seat despite fairly clear preferences, especially at the World Bank. The bank's

views will be important not just because of the money it brings to the table but also because of the intellectual forces the bank can bring to the debate. East Timor may also want some technical assistance in dealing with donors and their advisors.

Part of the debate over the role of the government versus the private sector in war-torn economies is simply empirical – how quickly can commodity and factor markets get back to work, and who will have earliest access to them? Just as there is considerable opposition in Asia to selling off ‘national treasures’ at distressed prices to satisfy IMF conditions for emergency loans during the financial crisis, so too do vulnerable societies feel cheated when outside capital and expertise is able to take advantage of newly emerging market opportunities faster than impoverished inhabitants. ‘What did we fight for?’ then becomes a political rallying cry for curbs on foreign trade and investment, curbs which are unlikely to form the basis for rapid and equitable economic growth. Putting sensible guidelines in place early on is thus crucial, but obviously depends on a competent government with both the mandate and human resources to design and implement such a regulatory structure. Although ‘positive’ political economists may cringe at the opportunity thus generated to collect economic rents, the dilemma is real enough and cannot be hidden under a market-oriented mantra. Despite the fact that ‘sustainable development’ has come to have an environmental connotation, political sustainability of growth-oriented policies and institutions arguably comes first.

What policies and institutions need to be developed first? Even though initially in the hands of the temporary UN mission, the early development efforts are likely to have considerable inertia, so it is important to point the entire institution-building and policy-making process in the right direction. Haughton argues that the institutions underpinning macroeconomic stability and credibility with investors, foreign and domestic, should come first, but that might be a particularly economic perspective on the question. Especially in East Timor, which starts from almost zero in all institutions except the Roman Catholic church, social and political institutions may be equally important. If the UN mission is successful in stabilising the economy, even at a low level, through its flow of resources and appropriate management, building trust among neighbours and establishing local political dialogue are likely to pay very high dividends in terms of

long-term sustainability of the society. These civic and political institutions are just as important as economic institutions to East Timor's success. Accordingly, they deserve substantial attention right from the beginning by the UN mission.

A number of less general, but still important, issues will need to be faced quite early on in the reconstruction process. Property rights are at the top of this more specialised list, for two reasons. First, there is real confusion over what legal code to use and the validity of historical claims to property, especially land. Second the presence of much deserted land and urban (shells of) buildings in the wake of owners fleeing or being killed is likely to start a spontaneous squatter process that will be difficult to reverse. Without clear guidelines on property rights and ownership, the UN peace-keeping forces will be powerless to stop this process. In the slightly longer run, without clear property rights, investors will be reluctant to start the rebuilding process except for emergency repairs to basic shelter.

A final topic that needs immediate attention and agreement from an interim East Timorese government is what currency the new country will use. There is an obvious temptation to establish a central bank and the country's own currency, but there are two reasons for caution in this direction. First, the cost of maintaining an independent currency and central bank are substantial and the East Timorese economy will be quite small. Second, management of a domestic currency and the maintenance of a competitive exchange rate are difficult tasks, easily captured by special interests who gain from currency manipulation or over-valuation. Although there is substantial academic debate over the relative merits of fixed versus floating exchange rates, for East Timor a simpler option would be to adopt the US dollar as the domestic currency.

The details of dollarisation would need to be worked out, but the *de facto* reality is that most trade is denominated in dollars, most aid will be converted to or paid directly in dollars, and most savers and investors will use dollars to avoid the uncertainty and instability of possible alternatives, such as the Indonesian rupiah or a new East Timorese currency. Both economic growth and stability are likely to be served by not driving the dollar economy underground, but by making it the legal as well as *de facto* currency. Local coins and notes could be issued on the basis of dollars held in reserves to facilitate day-to-day transactions, but dollarisation would help the country avoid one of the major sources of instability and rent seeking in the new economy.

Many questions have been raised, and few answers offered with any sense of confidence. How is a new government to know what to do? When a new regime starts in an established country, such as Indonesia in 1967, China in 1978, the Philippines in 1986, or Vietnam in 1989, there is a combination of old institutions, policies, and people that represent continuity, at the same time that new opportunities are created by the mandate for change. Economic history offers important lessons to these transition economies, but much is being learned from them as well. A similar situation exists for East Timor, but with important differences. East Timor is not a 'transition' economy. It is a new economy, building institutions, policies, human and social capital, and political legitimacy almost from scratch. Haughton's survey of the issues facing war-torn economies finds a remarkable body of research on these issues from a distressingly large sample of countries – 42 countries damaged by war since 1970.

East Timor has the opportunity to learn and benefit from this research, but it can also contribute to the future development of other similar examples – and there will be others – by allowing, even encouraging, research on its own efforts at nation-building. Some plans will work, others will fail. It will be important to know why. Entrepreneurial initiative will emerge serendipitously or be squashed by authorities – how can it be channelled productively rather than seen as a threat to a new government? If there is any benefit at all to starting over in the wake of the devastation visited on East Timor, it will be the opportunity to learn from this extraordinary set of circumstances about how people and institutions respond to challenge and crisis. Godspeed.

### *Reference*

Haughton, Jonathan, 1998. 'The reconstruction of war-torn economies', HIID/CAER II Discussion Paper No. 23, June.