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Chinese and Australian Interests in Timor-Leste: At Odds or Mutually Beneficial?

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Key Points

- The economy of Timor-Leste is largely dependent on oil reserves and faces shortfalls in infrastructure funding necessary to develop the non-oil economy.
- Australian development assistance funding, which recently reached $100 million annually, could be overshadowed by possible Chinese investments in petroleum infrastructure projects, which could reach billions of dollars.
- China's interests in Timor-Leste are broadly underpinned by the national objective of expanding its influence in South-East Asia.
- Australian interests are two-fold, and include shared security interests while recognising the need to counter potentially competing foreign influences in Timor-Leste.
- There is little evidence that China's influence in Timor-Leste is currently harmful to Australian interests. In the long-term future, however, that may change, and Australian policymakers will need to be alert to that possibility.

Summary

Prime Minister Scott Morrison touched down in Timor-Leste in August 2019, for his first visit to the country since taking office. While there, Morrison announced a fresh start for the bilateral relationship following a messy maritime boundary conciliation process which

concluded the previous year. Two months later, Chinese training ship *Qi Jiguang* received a gala welcome into Dili Harbour, preceding talks between Timorese Defence and Security Minister, Filomeno Paixao, and Rear Admiral Yu Wenbing of the People's Liberation Army Navy. The visits come at a crucial time for the Timor-Leste economy, as it attempts to make the transition away from oil dependency.

Analysis

State of the Timor-Leste Economy

As one of the youngest countries in the world, Timor-Leste formally achieved independence in May 2002 after a history of being colonised by Portugal and occupied by Indonesia. Since achieving independence, Timor-Leste has grown its Gross Domestic Product from US$1.2 billion to US$3.5 billion in 2018, primarily from oil revenues.

The bulk of Timor-Leste's economic growth has come from the taxes and royalties obtained from the extraction of billions of dollars' worth of oil and gas deposits located south of the country in the Timor Sea. To help the Timor-Leste Government manage the revenue coming from those deposits in a more sustainable way, a Petroleum Fund was established in 2005. Revenues from oil and gas projects are directed into the fund and then invested into overseas assets to generate further returns. Each year, the Timor-Leste Government can make withdrawals from that fund and allocate it to the state budget. The amount withdrawn by the government is guided by an Estimated Sustainable Income (ESI) benchmark which is set at three percent of the fund's opening balance for that given year. By following that benchmark, the amount withdrawn from the fund should be recovered by returns on overseas investments, which will allow the fund to sustain itself even if petroleum revenues were to dry up.

Figure 1 - Petroleum Fund Revenue and Withdrawals

Excess withdrawals have risen sharply while revenue has fallen

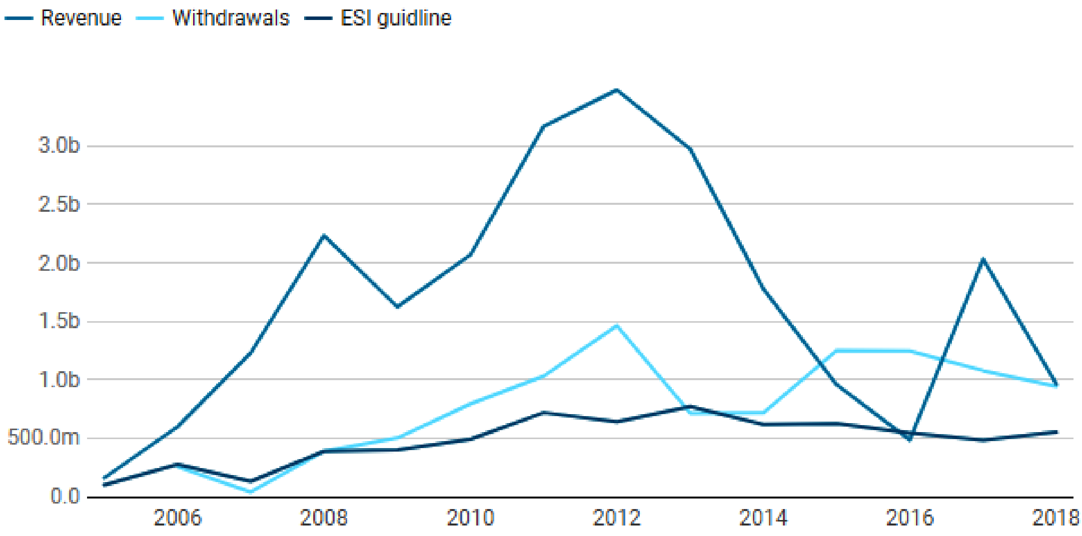


Chart: Future Directions International • Source: Banco Central de Timor-Leste • Get the data

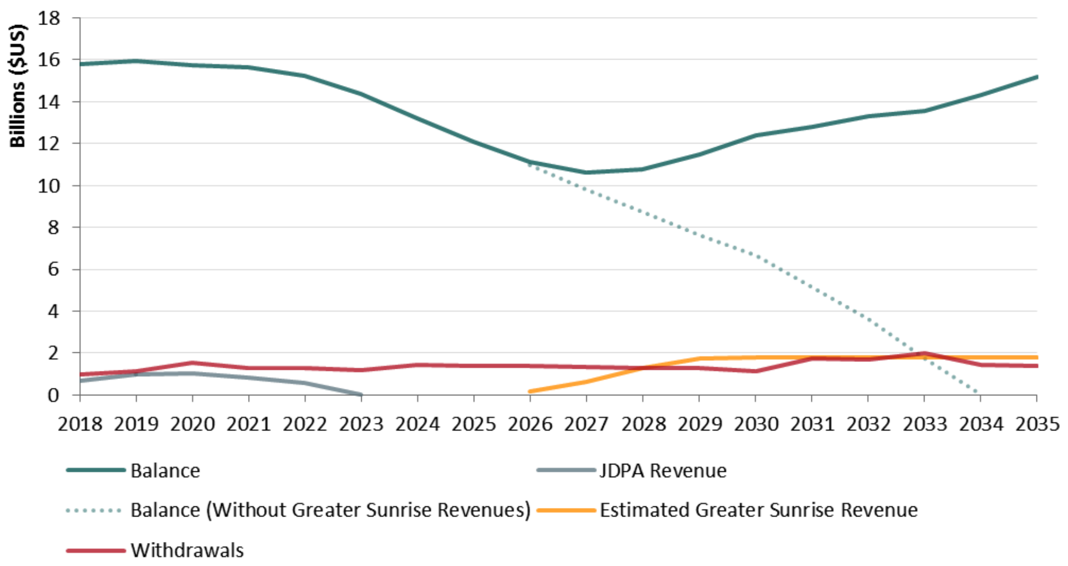
In recent years, however, the Timor-Leste Government has made withdrawals far beyond the ESI guidelines, while revenues have significantly fallen due to depleting reserves. There is no sign of attempting to reverse that trend and the latest annual report of the fund concluded the following:

> In its 2018 Budget, the Government planned to use 985 million USD from the Petroleum Fund capital (FP), but in effective terms it transferred only 911 million to finance its actual spending, or 93% of the budgeted amount (93% also in 2017). Although PF withdrawals were lower when compared 2017 (998 million USD), the PF's annual withdrawn capital remains well above its estimated sustainable income (ESI), estimated at 550 million USD in 2018. This decision, similar to what has been done in recent years, resulted in a continued structural decline of the Fund's capital.

Continuing over-withdrawals are especially concerning given that revenues from the liquid and gas deposits in the Joint Petroleum Development Area (JPDA) are expected to be depleted by 2023. As seen in Figure 1, the combination of over withdrawals and depleting reserves could see the fund depleted as early as 2035. Recently concluded boundary negotiations with Australia, however, will grant Timor-Leste access to gas and condensates in the Greater Sunrise Field worth around $30-50 billion, with plans to start exporting in 2026. Depending on the capacity of the onshore oil and gas facilities that the government plans to construct under the Tasi Mane project, the lifespan of the Petroleum Fund could be extended by approximately fifteen years, until 2050. Some analysts, however, are sceptical of Tasi Mane, and have said it will be 'far more efficient to pipe the gas to the already-functional gas liquefaction plant in Darwin, Australia'. So it is uncertain how successful Timor-Leste will be in boosting the Petroleum Fund through Greater Sunrise. That being said, there could be long-term economic benefits to be gained from refining imported crude petroleum once Greater Sunrise is depleted.

Figure 2: Estimated Balance of Petroleum Fund

The Greater Sunrise will provide a vital boost the Fund's balance



Urgent Need to Develop a Non-Oil Economy

If revenues from the Petroleum Fund were to drop to zero, the Timor-Leste Government's annual budget would fall by almost sixty per cent. Revenue from non-oil sources is nowhere near the level needed to independently sustain the economy and budget. The Timor-Leste Government recognises that, and noted in the 2019 State Budget that, due to the high dependence on oil, fiscal reform is a crucial priority for the future.

One aspect of that reform is developing infrastructure to a point where a significantly larger non-oil economy can be sustained before petroleum revenues fall. From the perspective of the Timor-Leste Government, excessive withdrawals from the Petroleum Fund are a part of that infrastructure development strategy, having noted in its budget: 'The Government considers that excess withdrawals are necessary in the medium term to finance priority capital expenditures.'[1] According to the 2019 budget, the vast majority, approximately 81 per cent, of those capital expenditures are being directed towards the Infrastructure Fund. Looking more closely at the Infrastructure Fund, however, a significant portion of those funds, totalling US$279.4 million, is being spent on developing petroleum infrastructure through the Tasi Mane project (22%), while the remainder is spent on basic projects, such as roads (46%) and electricity (5%). In addition to that fund, around US$60 million worth of Official Development Assistance (ODA) and tens of millions of dollars' worth of foreign direct investment are targeted towards infrastructure each year, as well as eight existing loan packages totalling US$355 million. In total, the Timor-Leste Government is spending approximately US$350 million on infrastructure projects per year, which will equate to US$10.5 billion being spent by 2050 if trends continue, excluding loans. Estimates of the projected cost of the Tasi Mane project, however, range from between US$5 billion and US$18 billion. Extra funding, therefore, will likely be required to fund the country's infrastructure needs in the non-oil sector, especially when considering the estimated infrastructure shortfall for both the wider Pacific and Timor-Leste, which will reach US$46 billion until 2030.

Chinese Interests in Timor-Leste

China's approach to its relationship with Timor-Leste has been underpinned by goodwill gestures. China was the first country to formally establish diplomatic relations soon after independence in 2002. Over the years, China funded the construction of a number of buildings in Timor-Leste, including the Presidential Palace, the Ministry of Foreign Affairs and the military residential headquarters, while establishing military-to-military links through the provision of training. Testifying to the influence of that goodwill, a joint statement was released in 2014 that stated: 'Timor-Leste is opposed to any form of "Taiwan independence", [and] will not establish any form of official relationship or conduct any form of official contacts with Taiwan.'

Writing in 2006, Dr Ian Storey, who is now a Senior Fellow at the ISEAS Yusof Ishak Institute, described the relationship as one that was good, but not that of best friends, adding that

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[1] *State Budget 2019: Book 1 – Budget Overview*, República Democrática de Timor-Leste, Ministério das Finanças: Dili, 2019, p. 6.

China had three key interests in the new country: 'to expand its influence in the South-East Asian region, to restrict Taiwan's international space and to gain access to the country's natural resources'. Dr Storey further noted: 'The East Timorese leadership certainly appreciates Beijing's support for the territory's independence since 1975, though this does not equate to China occupying a privileged position in the country's foreign policy'. That analysis still holds true today. While China continues the approach of establishing close bonds through generous gestures, Timor-Leste has remained versatile in its diplomatic pursuits, seeking to establish its identity through the Association of South-East Asian Nations and the Community of Portuguese Language Countries. Over time, however, those priorities could shift if the Communist Party of China increases its presence in the region.

China has the capacity to play a crucial role in the significant infrastructure gap in Timor-Leste, providing much-needed funding and investment through its Belt and Road Initiative (BRI). Timor-Leste is an unlikely candidate for the BRI, given its geographical position south of the main sea passages that are covered by the initiative.[2] Dili, however, is a signatory to a memorandum of understanding on Belt and Road co-operation which has qualified the country to be part of that initiative.

It is unclear how much China has already invested in Timor-Leste, but it seems likely that Beijing will be willing play a significant role in the Tasi Mane project. While figures behind the project denied earlier reports that they were set to take a sixteen billion dollar loan from China in June 2019, senior figures in the government have since appeared to endorse China as a primary source of investment. Speaking to the *Sydney Morning Herald*, former Timor-Leste Prime Minister, Mari Alkatiri, said that pursuing the Tasi Mane project would be 'too risky' without sourcing investment from partners such as in China, although he also emphasised the need to source a variety of investment partners.

It may become a concern if China becomes a primary source of investment for the Tasi Mane project. Once completed, the project will be responsible for providing the vast majority of Timorese wealth, when oil and gas from the Greater Sunrise field is piped to it. Additionally, in the longer term, Tasi Mane could provide further economic growth from the refining of imported crude petroleum, even when Greater Sunrise is depleted. The project will also include the construction of a port, shipbuilding and ship repair facilities, as well as an international airport. Those facilities will all be situated in Suai, on the southern coast of Timor-Leste, approximately seven hundred kilometres from Darwin Port, which is being managed by a Chinese company under a 99-year lease.

As argued by Devin Thorne and Ben Spevack in their book, *Harbored Ambitions: How China's Port Investments are Strategically Reshaping the Indo-Pacific*, port investments, such as in Suai, have strategic significance recognised by Chinese policymakers. According to Thorne and Spevack, Chinese analysts discussing port investments 'routinely prioritise China's national security interests over the objective of mutually beneficial economic development' and existing port projects funded by China give 'political influence, stealthily expand China's military presence, and create an advantageous strategic environment in the region'. While it

[2] Galan, E., 'The Challenges and the Opportunities of the Belt and Road Initiative for Participating Countries: The Case of Timor-Leste', City University of Macao: Macao, January 2019, p. 8.

is possible that the ambitions of the Chinese Communist Party may be overstated, from Australia's perspective, it is still vital that those assets are well-insulated from possible adverse influence or control.

Given that the project has been pushed under strongly nationalist sentiments, and is aimed at reducing economic dependence on other countries, the Timor-Leste government relinquishing control of those assets in signing a deal does seem an unlikely scenario. That said, there may be internal pressure to fast-track the project, given the need to complete it before the depletion of the Petroleum Fund's balance. So, if the Timor-Leste Government is unable to secure a favourable deal with investing partners other than from China, it could be pressured to accept investment under some less-than-favourable terms.

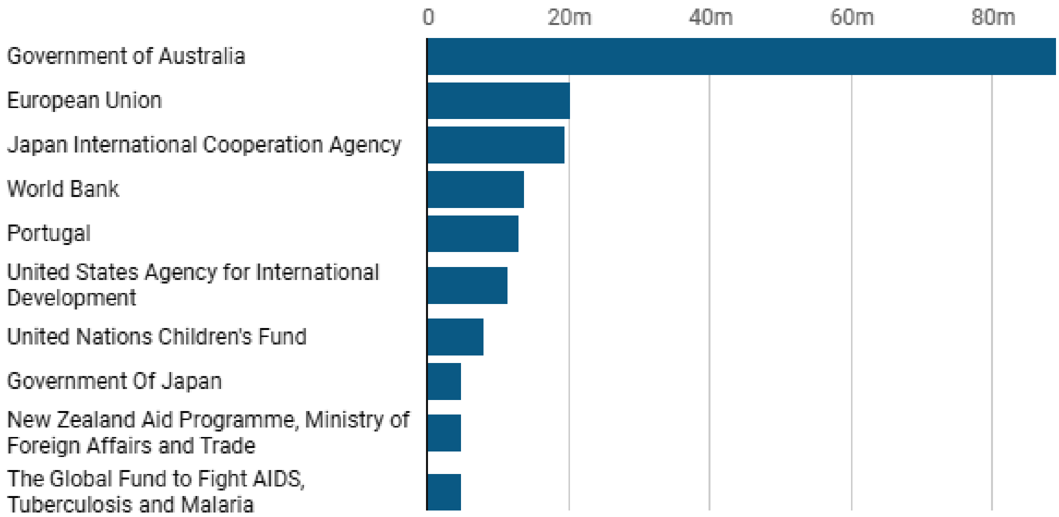
Australian Interests in Timor-Leste

Australia's relationship with Timor-Leste, while it remains close, has suffered from a more turbulent history than Dili's relationship with China. Since Timor-Leste's independence in 2002, its relationship with Australia has been marred by disagreements and negotiations surrounding the maritime boundary that would affect claims on oil and gas fields in the Timor Sea. Australia's strong approach to those negotiations, which included bugging Timorese negotiators, has left a feeling of bitterness among many Timorese officials and saw nearly five years pass with no ministerial visits. While that process has now been concluded, and both countries have signed a maritime boundary agreement following the termination of the bilateral treaty on Certain Maritime Arrangements in the Timor Sea (CMATS), the lengthy process has done little to improve relations and could undermine trust between government officials in the future.

Despite any misgivings regarding the maritime boundary conciliation process, the relationship remains on solid ground, albeit with little depth. Australia played a role in helping Timor-Leste undergo a peaceful transition towards independence and has maintained a sizeable aid programme to its developing neighbour. From Timor-Leste's perspective, its relationship with Australia has been instrumental in its economic development. As seen in Figure 3 (below), Australia remains the largest aid donor to Timor-Leste by a significant margin.

Figure 3 - Top Ten Timor-Leste Donors

In the past year, Australia has given four times as much aid as the next highest donor



Actual Disbursements (USD)

Chart: Future Directions International • Source: Aid Transparency Portal • Get the data

Now that maritime boundary negotiations are concluded, Prime Minister Scott Morrison is determined to begin 'a new chapter for Australia and Timor-Leste that is based on our shared respect, interests and values'. Along with that declaration, Morrison also announced a maritime security package, which includes funding for a new naval base and the provision of patrol craft to the Timor-Leste Defence Force (F-FDTL), in addition to funding for the building of a sub-sea cable link between the two countries.

The motivations behind that declaration to begin a "new chapter" are underpinned by broader geostrategic goals, as well as concerns about foreign influence, as indicated in previous foreign policy White Papers. As a standalone economy, Timor-Leste offers little in terms of strategic significance to Australia beyond its oil reserves in the Timor Sea. Considered on their own, there is little to gain from developing economic and defence relations, given that trade between both countries is insignificant and the Timor-Leste Defence Force consists of only a few thousand personnel. The close geographic proximity of Timor-Leste, however, and its position bordering Indonesia and the vital shipping lanes to its north, gives the country considerable geostrategic significance.

Existing foreign policy strategies from the Australian Government are geared at encouraging stability through the use of developmental aid. Encouraging stability in Timor-Leste, which has strong history of conflict and violence, has several strategic goals including: warding off potential refugee crises; giving the Timor-Leste Government the capacity to meet its own security needs; securing Australian shipping lanes that pass through Timor-Leste waters; helping to defend Australia's northern approaches; and protecting Australia's Exclusive Economic Zone.

In the longer term future, in its continuing efforts to forge closer ties with Timor-Leste, the Australian Government will likely look at prioritising the defence relationship while maintaining its status as a major aid donor. In the *2017 Foreign Policy White Paper*, it was noted that increasing competition for influence and varying sources of aid means that Timor-Leste can turn elsewhere for advice and assistance. But that could potentially strain its capacity to absorb assistance and manage debt levels while also undermining regional co-ordination. So, in the context of competing influences with Beijing, while Australia cannot compete with the capital offered by China's investors, it will continue to try to make up for that shortfall through its aid programme.

In terms of the defence relationship, Australia will likely focus strongly on the maritime aspect of that partnership, as indicated by the recent move to fund the new naval base and provide patrol vessels. Such defence co-operation will be targeted at shared maritime security interests, such as illegal, unreported and unregulated fishing and the smuggling of people, wildlife and drugs. At the same time, however, there is an overarching goal to fend off foreign influence. The visit to Dili by a Chinese warship in October 2019, and a follow-up request from the Defence and Security Minister for China to train Timorese naval officers, likely confirmed such concerns, which had been previously expressed in the *2016 Defence White Paper*:

> Our second Strategic Defence Interest is in a secure nearer region. Australia cannot be secure if our immediate neighbourhood including Papua New Guinea, Timor-Leste and Pacific Island Countries becomes a source of threat to Australia. This includes the threat of a foreign military power seeking influence in ways that could challenge the security of our maritime approaches or transnational crime targeting Australian interests.[3]

That said, there is no clear indication that China's military interests in Timor-Leste are a direct challenge to Australia's own security interests and there is little evidence to support claims that China already has a strong foothold in Timor-Leste. The current lack of shared security interests between China and Timor-Leste, as well as China's military build-up in the South China Sea, does suggest that closer military-to-military ties would be indicative of a broader national strategy on the part of Timor-Leste that may not necessarily align with Australian interests. Those interests could diverge even further in the long-term future, as global power shifts continue to evolve.

Conclusion

Timor-Leste is a young country with a narrow and vulnerable economy. In its pursuit of sustainable, long-term economic growth, there is a significant need to reduce the dependence on oil reserves in the Timor Sea. That cannot happen without significant investment in infrastructure, which will facilitate the growth of the non-oil economy. Australia has played a noticeable role in Timor-Leste's overall development, through its aid programme which has grown to $100 million per year. That, however, may come to be

[3] *Defence White Paper*, Department of Defence, Australian Government: Canberra, 2016, p. 69.

overshadowed by possible Chinese investment in the Tasi-Mane project, which could exceed billions of dollars.

Both countries also appear to have an interest in developing defence ties with Timor-Leste. Without shared security interests, China's interest appears to lie in broad national goals of increasing influence. Australia, on the other hand, has a direct interest in the ability of the Timor-Leste military to tackle shared security interests. While there is little evidence to support the claim that China already has a strong degree of influence in Timor-Leste, it is also necessary, in Australia's strategic outlook, to be alert to the implications of such a possibility in the future..

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