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# PREFACE

The Economic Growth presents a comprehensive examination of economic principles. The work integrates classical and modern economic theories with empirical research to provide a holistic view of economic growth. The introductory chapters lay the foundation by exploring fundamental economic concepts, distinguishing between growth and development, and contextualizing these within the Timor-Leste economy. Subsequent chapters delve into pivotal growth theories, from the classical frameworks of Adam Smith, David Ricardo, and Joseph Schumpeter to contemporary models such as the Harrod-Domar and New Growth Theory. These theoretical discussions establish the analytical lens through which the country's economic evolution is assessed.

The manuscript also explores core economic mechanisms, including production theories (examined through production, income, and expenditure approaches) and the role of global trade and exports in fostering economic development. It evaluates how international trade contributes to economic resilience and growth in emerging economies like Timor-Leste.

Further chapters focus on critical growth factors: investment (both domestic and foreign), inflation's impact on economic stability, and the interplay between labor dynamics and employment opportunities. These topics are contextualized within Timor-Leste's unique economic environment, highlighting challenges and opportunities for sustainable development.

In the final section, empirical analyses assess the key drivers of Timor-Leste's GDP, including exports, foreign investment, inflation, and labor contributions. The research integrates theoretical insights with real-world data, providing actionable conclusions for policymakers and scholars interested in the country's economic prospects.

This work serves as a vital resource for understanding the interplay of theoretical economics and practical policy applications in the context of a developing nation striving for economic stability and growth.

# Daftar Isi

## CHAPTER III



## CHAPTER IV



## CHAPTER V



## CHAPTER VI

# CHAPTER VII



# CHAPTER VIII



# CHAPTER IX

# CHAPTER I

## Basic Economic Concepts

## A. Definition of Economic Growth

Economic growth is an increase in a country's capacity to produce goods and services in a sustainable manner to meet the needs of its population. According to Simon Kuznets (1971), economic growth is a process of increasing production capacity in the long term which is influenced by technological progress, institutional changes, and ideological adjustments to existing conditions. The main indicator to measure economic growth is the Gross Domestic Product (GDP), which reflects the total value of goods and services produced in a region or country within a certain period.

In an economic context, economic growth is not just a statistical figure, but also a reflection of the stability and health of the economy. It represents a sustained increase in output per capita, which is a necessary condition for creating prosperity. If a country fails to increase its economic growth, various social and economic problems such as poverty, unemployment, and income inequality can increase (Amir Salim, 2021).

For developing countries, economic growth is a top priority to achieve. However, the journey to achieving stable growth often faces challenges, such as high inflation, global economic instability and other structural issues. Inflation, for example, can have both positive and negative impacts on the economy. To some extent, mild inflation can boost economic activity by providing incentives for businesses to increase production. However, high and uncontrollable inflation is a constraint to growth as it weakens people's purchasing power.

# Chapter II

## Theories of Economic Growth

Economic growth refers to the percentage change in the final consumption of goods and services over a given period compared to the previous period. Economists and policymakers generally agree that economic growth is a crucial factor in development (Todaro, 2006). The rise or fall of a government in any country often depends on the level of economic growth achieved. Additionally, the quality of governance and the overall competence of economic institutions are typically assessed based on the speed of national output growth.

According to Basri (2002), the robustness of prosperity-building relies on three foundational pillars: growth, stability, and efficiency. Among these, growth represents the supply-side component determined by three key factors: capital, labor, and technology.

The measurement of a nation's economic growth rate follows specific economic growth models, which include the following:

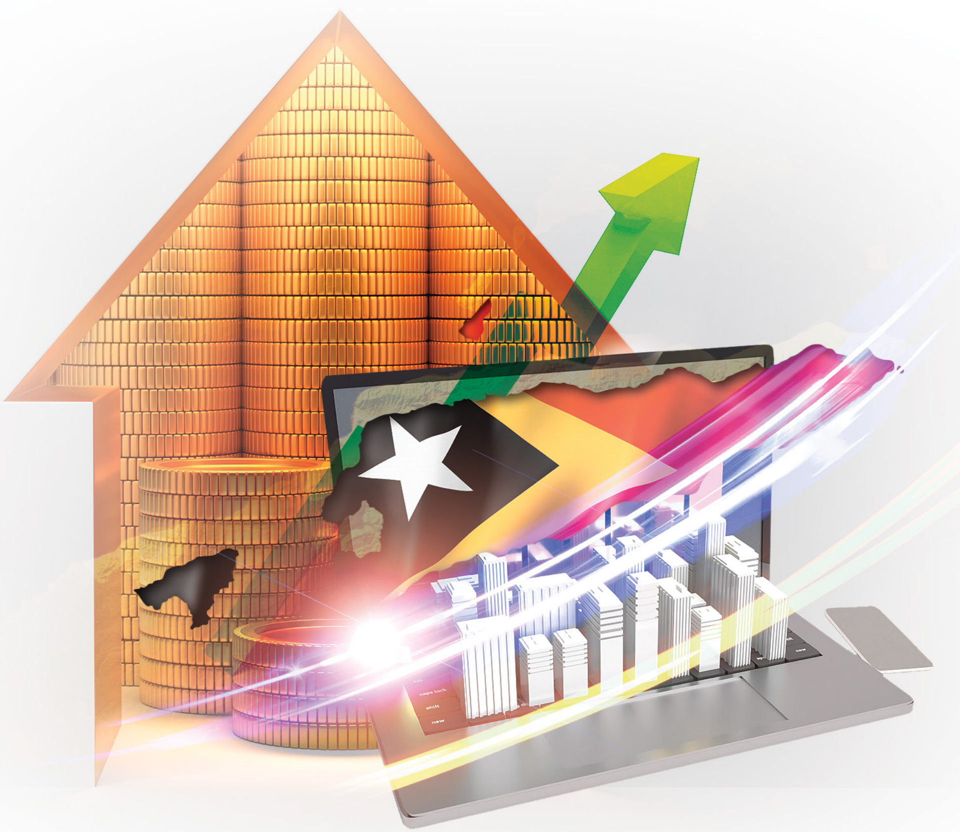
## A. Adam Smith's Growth Theory

Adam Smith, an 18th-century classical economist, elaborated on economic growth in his renowned book *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776). His theory emphasizes the importance of labor productivity, free markets, and capital accumulation as drivers of economic growth.

Smith highlights that the division of labor is the primary catalyst for economic growth. He argues that dividing labor into specialized tasks increases workforce productivity. Specialization allows

# CHAPTER III

## The Evolution of Economic Growth



## A. Classic Growth

Classical economic growth theory represents one of the foundational ideas in economics, developed during the 18th and 19th centuries. Pioneered by economists such as Adam Smith, David Ricardo, and Thomas Robert Malthus, this theory explores the relationships between population growth, capital accumulation, natural resources, and productivity as the main drivers of economic growth.

1. Law of Diminishing Returns

   Classical economists highlighted that in production processes, adding factors of production such as labor or capital to fixed land or resources tends to yield diminishing returns. David Ricardo argued that as the population grows, the need for food would force society to utilize less fertile land, increasing production costs and reducing profits. In the long run, this leads to economic stagnation, as productivity cannot keep up with societal needs (Ricardo, 1817).

2. Division of Labor and Capital Accumulation

   Adam Smith, in *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), emphasized the importance of the division of labor in improving economic productivity. According to Smith, division of labor enables workers to become more efficient through task specialization. Furthermore, capital accumulation is regarded as a key engine of economic growth. Capital allows for investments

# CHAPTER IV

## Get to know Production Theory

## A. Production Theory

A commonly used productivity measurement model is based on the Cobb-Douglas production function approach, which involves two or more variables: one is an independent variable (YY) and the others are dependent variables (XX).

The general form of the Cobb-Douglas production function is:
Q=δIαQ = \delta I^\alpha

Where:

- QQ: Output
- II: Input used in the production process and considered for analysis
- δ\delta: Efficiency index of input usage in generating output
- α\alpha: Production elasticity of the input used

According to Sukirno (2005:195), a production function shows the relationship between the quantity of output produced for every combination of specific inputs. The production function can also be expressed as:

Q=f(K,L,R,T)Q = f(K, L, R, T)

Where:

› KK: Capital stock
› LL: Labor, including various types of labor and entrepreneurial skills
› RR: Natural resources
› TT: Level of technology used

# CHAPTER V

## Exports and Global Trade for the Economy

Exports refer to the sale of goods to foreign countries under agreed payment systems, quality, quantity, and other sales terms between exporters and importers. The export process generally involves transferring goods or commodities from one country to another. Large-scale exports typically require the involvement of customs authorities in both the exporting and importing countries. Exports are a crucial component of international trade.

Exported goods are subject to various regulations, restrictions, and specific requirements for certain types of commodities, including handling and safety measures. Each country has its own set of trade rules and regulations. In Timor-Leste, the export of agricultural and fisheries commodities is relatively straightforward, with minimal regulations and requirements. The government has taken steps to facilitate exports by simplifying processes for companies exporting agricultural and fishery products to foreign markets.

## A. Export Products

Exports are generally categorized into two types: oil and gas (O&G) products and non-oil and gas (non-O&G) products. O&G products consist of petroleum and natural gas, while non-O&G products include items such as agricultural, plantation, livestock, fishery, and non-oil mineral resources.

Export products play a crucial role in the global economy, especially for countries with open economies. Exports not only serve as a primary source of foreign exchange but also drive

# CHAPTER VI

## Understanding Investment

## A. Investment and Economic Growth

Economic theory defines investment as "expenditures on capital goods and production equipment aimed at replacing or, more importantly, increasing capital stock in the economy to produce goods and services in the future." According to Sukirno (2004), investment activities enable a society to continuously boost economic activities and job opportunities, increase national income, and improve the population's standard of living.

In the endogenous growth model, the returns on investment are higher when aggregate production in a country increase. It assumes that private and public investments in resources or human capital create positive externalities, driving productivity that offsets the diminishing returns to scale trend.

An interesting implication of this theory is its ability to explain the potential benefits of complementary investments in capital, human resources, infrastructure, or research activities. Complementary investments yield both personal and social benefits, creating opportunities for governments to improve the efficiency of resource allocation by providing public goods (e.g., infrastructure) or encouraging private investment in technology-intensive industries that accumulate human capital.

This model advocates for active government participation in managing investments, directly or indirectly. Increased government investment in public goods is expected to stimulate private sector growth and household resource allocation in a region, ultimately increasing Gross Regional Domestic Product (GRDP).

# CHAPTER VII

## Inflation in Economic Stability

## A. Definition of Inflation

Inflation is a process of rising prices across an economy. The rate of inflation varies from period to period and across countries. It refers to a general and sustained increase in the prices of goods and services, indicating a decline in the purchasing power of money. In this condition, the same amount of money buys fewer goods and services over time. Inflation is a key indicator of economic stability and poses a challenge for governments and central banks in maintaining economic equilibrium.

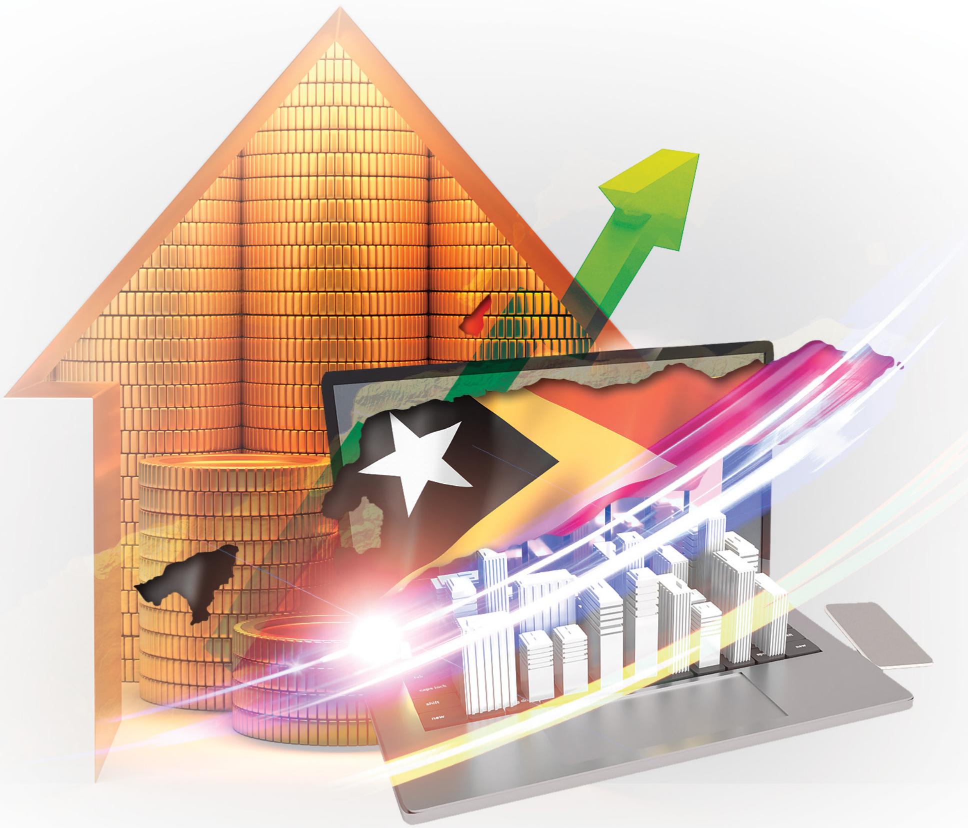
Inflation does not merely refer to the price increase of specific goods but involves a widespread rise in general price levels in the market. To be categorized as inflation, the price increases must persist over a period. Temporary price hikes due to seasonal factors or supply disruptions are not considered inflation if they do not have lasting effects.

The causes of inflation often originate from multiple interrelated factors. Demand-pull inflation occurs when the demand for goods and services exceeds production capacity, pushing prices upward. Cost-push inflation arises from increased production costs, such as higher raw material prices or wages, which are passed on to consumers through higher prices. Structural inflation stems from inefficiencies in the economy, such as distribution challenges or dependency on imports for essential goods.

Inflation impacts the economy in significant and complex ways. Moderate inflation is often considered acceptable and even necessary for economic growth, as it reflects active economic

# CHAPTER VIII

## Labor



Human Resources (HR), or *Sumber Daya Manusia (SDM)*, has two primary meanings. First, it refers to the labor or services that can be provided in the production process. Second, it pertains to individuals capable of offering labor or services. Being capable of working means having the ability to engage in activities with economic value, i.e., activities that produce goods and services to meet societal needs. This ability to work is often measured by physical age. People within the working age range are referred to as the labor force or manpower (Simanjuntak, 2001).

According to the 2003 General Provisions in Chapter 1, Article (1), labor is defined as "any individual capable of performing work to produce goods or services, either for personal needs or for society." Labor includes all individuals of working age who are either employed or actively seeking employment, willing and able to work. Alongside natural resources and capital, labor is a crucial production factor for any nation.

In Timor-Leste, the minimum working age is set at 10 years, with no maximum age limit. The minimum age of 10 reflects the reality that many children start working at this age due to economic difficulties in their families. There is no maximum age limit as Timor-Leste does not yet have a national social security system. Many individuals, particularly those without pensions, such as civil servants or a small number of private sector employees, must continue working even after reaching retirement age to meet their daily needs. Hence, they are still classified as part of the labor force (Payaman Simanjuntak, 1985).

# CHAPTER IX

## Economic Growth Research in Timor-Leste

The Democratic Republic of Timor-Leste, also known as Timor Lorosa'e, previously called East Timor before gaining independence, is a small nation located north of Australia and occupies the eastern part of the island of Timor. In addition to its mainland territory, the country includes the islands of Atauro (Pulau Kambing), Jaco, and the Oecusse-Ambeno enclave in West Timor.

**Geography of Timor-Leste**


**Figure 1.** Geographical location of Timor-Leste

Timor-Leste is located in Southeast Asia, with the island of Timor forming part of the Maritime Southeast Asia region and representing the easternmost area of the Lesser Sunda Islands. Geographically, Timor-Leste is bordered by the Ombai Strait, Wetar Strait, and Banda Sea to the north; the Timor Sea and Australia to the south; East Nusa Tenggara Province of Indonesia to the west; and the Nino Konis Santana National Park, featuring tropical dry forests with unique plant and animal species, to the east.

The majority of Timor-Leste's terrain is mountainous, with its highest peak being Mount Tatamailau, also known as Mount Ramelau, which rises to 2,963 meters. The country experiences a

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Theory & Research

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Further chapters focus on critical growth factors: investment (both domestic and foreign), inflation's impact on economic stability, and the interplay between labor dynamics and employment opportunities. These topics are contextualized within Timor-Leste's unique economic environment, highlighting challenges and opportunities for sustainable development.

In the final section, empirical analyses assess the key drivers of Timor-Leste's GDP, including exports, foreign investment, inflation, and labor contributions. The research integrates theoretical insights with real-world data, providing actionable conclusions for policymakers and scholars interested in the country's economic prospects.

This work serves as a vital resource for understanding the interplay of theoretical economics and practical policy applications in the context of a developing nation striving for economic stability and growth.

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