ADB

Technical Assistance Consultant's Report

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Cook Islands: Macroeconomic Assessment

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Prepared by Pacific Sub-Regional Office

Suva, Fiji

For Ministry of Finance and Economic Management
Government of the Cook Islands

The assessment was undertaken with the request of the Cook Islands government. The authors are not responsible for the use of the assessment for any purpose including policy design. This assessment is based on information available to the team as at 31 December 2015.

Asian Development Bank

Cook Islands

Macroeconomic Assessment

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CURRENCY EQUIVALENTS
(as of 7 March 2016)

Currency unit	–	New Zealand dollar/s (NZ$)
NZ$1.00	=	$0.6818
$1.00	=	NZ$1.4667

ABBREVIATIONS

ADB	–	Asian Development Bank
ANZ	–	Australia and New Zealand Bank
BCI	–	Bank of the Cook Islands
BSP	–	Bank of the South Pacific
BTIB	–	Business Trade Investment Board
CINSF	–	Cook Islands National Superannuation Fund
DSA	–	Debt Sustainability Analysis
FSC	–	Financial Services Commission
FY	–	Fiscal Year
GDP	–	gross domestic product
ICT	–	information and communication technology
PSA	–	Private Sector Assessment
SOE	–	State Owned Enterprises
TA	–	technical assistance

I. ASSESSMENT TEAM'S VIEWS

1. The assessment team[1] commends the government for sustaining macroeconomic stability in a period of low and volatile economic growth. The Cook Islands maintains adequate fiscal buffers, including insurance coverage, for the management of fiscal risks. The country's debt is well within the government's threshold of 35% of GDP. The expansionary stance in fiscal policy is broadly appropriate to stimulate growth. Prices have been relatively stable, goods and services trade is in surplus and the financial system is relatively stable.

2. In the team's assessment, the greatest challenge facing the country is to raise the long-term rate of economic growth. Long-term average growth currently hovers close to zero and manifests itself in low employment creation and slow growth in government revenue which can hamper the provision of essential services and the desired level of welfare payments. The major factor constraining growth is a lack of investment particularly by the private sector.

3. The government will need to persist with the implementation of fundamental reforms to sustainably raise the level of private sector investment in the long term. The need for reforms is well understood. The social issues that are associated with many of these reforms need to be well managed and solutions sought in an inclusive manner.

4. The major risks to the economy are disasters and a slowdown in the economies of major trading partners. The Cook Islands is vulnerable to natural disasters, specifically cyclones and tsunamis. Being an open economy, the country is also vulnerable to risks of slowing growth in the economies of major trading partners, particularly New Zealand and Australia. Fiscal risks arising from contingent liabilities of State Owned Enterprises (SOEs) are low at present but the government will need to continue to improve governance and the monitoring of SOEs financial performance.

5. Given the outlook for low growth, the mission is of the view that fiscal policy can be countercyclical but on the proviso that new programs promote growth, be fiscally sustainable and are appropriately scrutinized. While the government has accumulated fiscal buffers, it is essential that it controls the quantum and direction of the fiscal expansion to ensure that fiscal stability is maintained. To help government maintain fiscal stability, it should continue to remain within the acceptable range of its financial ratios, particularly its debt target.

6. Improvements in supervision of the financial system need to be maintained. Supervisory functions for the onshore and offshore institutions by the Financial Services Commission (FSC) have been strengthened and appear adequate. The capacity for offsite supervision of financial institutions has increased with a sufficient range of financial data being collected on a regular basis. A logical extension of strengthening the financial system is the supervision of the Cook Islands National Superannuation Fund by the FSC.

7. There are options to further develop the financial sector and reduce cost of financial services. The cost of financial services is high, particularly in the context of small and medium-sized enterprises. While the cautious lending behaviour of commercial banks is an understandable response to the high level of non-performing loans in the recent past, efforts should be made to address the low rate of growth in private sector credit. The absence of a credit bureau or a registry for movable collateral may impede financial deepening in the country.

[1] The team comprised Shiu Raj Singh (Team Leader), Gina Williamson and Savenaca Narube.

Government is urged to continue to implement the relevant recommendations of the Banking Review.

8. The government needs to consider ways of exploiting the economic potential of customary owned lands. The team appreciates the sensitivity and the complexity of land tenure reforms and recognizes that social and cultural issues need to be taken into account. However, this reform is central to promoting much needed investment. As a way forward, the government should consider establishing an advisory committee to facilitate improvements to land leasing within the local context. In the short term, government could increase the frequency of the sitting of the Lands Tribunal to reduce processing times on leasing transactions.

9. Policies need to allow for sufficient labor supply to meet business demand. Businesses' demand for labor outstrips local supply, indicating a need for foreign labor to support growth in output. Immigration legislation and policies need to be updated and processes clarified to ease access to foreign labor. Labor is critical to raising production and potential growth. There has been progress on employment relations regulation, including introducing dispute resolution frameworks. Further progress is necessary and this must balance the rights and interests of both employees and employers. Membership of the International Labour Organisation is indicative of government's efforts to make progress in this important area.

10. Welfare payments should be targeted at those that need support and equity between payment groups should be promoted, While extreme poverty is absent in Cook Islands, there are challenges related to basic-needs poverty and non-communicable diseases. The Cook Islands maintains a generous welfare payment system aimed at addressing the needs of the vulnerable members of society, which supplements government direct support to health and education services. Reforms in the welfare system must ensure that support reaches those that are vulnerable, improves the equity between different payment groups and ensures that the impact of the system on the budget resources can be sustained.

II. GOVERNMENT'S RESPONSE

11. The Government of Cook Islands welcomes the ADB Macroeconomic Assessment and its findings. Alongside other external reviews, the Macroeconomic Assessment forms a valuable source of independent information for policy makers, development partners and the general public.

12. The government notes that reform is something that features heavily in the analysis. Of the areas identified in the report, several areas of public sector reform are currently underway:

- The Public Financial Management (PFM) Roadmap 2016 is currently being developed, and builds on the good work achieved between the 2012 and 2016 Public Expenditure and Financial Accountability (PEFA) assessments. The new PFM Roadmap also includes further improvements to the current financial management legislation and tighter fiscal responsibility ratios in relation to debt targets, cash balances and personnel expenses.
- The Ministry of Finance and Economic Management (MFEM) is also in the feasibility stages of procuring a single public financial management information system, which will streamline the financial management practices across government.
- The Ministry of Foreign Affairs and Immigration is trialing an online system that streamlines visa application processes. The new system is currently in an offline pilot stage and is receiving positive feedback.
- The outline of Public Sector Strategy has been published, with detailed actions yet to be agreed. The strategy focused on three key areas of public service performance: People, Systems and Structures.

13. There are also several initiatives already underway to improve the general operating environment of the private sector as a means to stimulate longer term economic growth:

- The Cook Islands has become a member of the International Labour Organisation, and will be using technical assistance to improve the regulation of the local labor market.
- The feasibility stage to automate the banking payments system has been completed, with implementation to commence as soon as fiscal space allows. Once implemented, the new system should reduce the cost of banking in the Cook Islands for both the public and private sectors.

14. The government also notes that the first 9 months of the 2015–16 financial year have shown significant improvements in total tourist arrivals. With the commencement of a third international airline into Rarotonga, this growth is likely to continue, at least in the short to medium term.

III. BACKGROUND

15. **The Cook Islands economy is small, open, narrowly based and relatively affluent.** As a small island nation, the Cook Islands economy relies heavily on tourism, has limited opportunities to expand its economic base and is vulnerable to disasters and external shocks. The Cook Islands special constitutional relationship of free association with New Zealand means that the population is relatively affluent, having one of the highest per capita incomes in the Pacific region (NZ$28,700 in FY2015). However, freedom of movement of Cook Islanders to New Zealand has led to net out migration, a declining population, shrinking labor supply and aging demography.

16. **The use of the New Zealand dollar means that the government relies on fiscal policy as the macroeconomic policy lever for economic growth.** Fiscal management has been appropriate. The Cook Islands has adequate fiscal buffers for management of fiscal risks. The fiscal deficit averaged 2.5% of GDP between 2010 and 2014. The country's debt at 23% of GDP is well within the government's threshold of 35%. The government maintains a debt service reserve equivalent to 4.6% of GDP.

17. **Macroeconomic stability has been maintained in a period of low and volatile economic growth.** Prices have been relatively stable, goods and services trade has large and persistent surpluses and the financial system is relatively stable. However, long-term average growth currently hovers close to zero. This manifests itself in low job creation and slow growth in government revenue, which can inhibit the provision of essential services and the desired level of welfare support.

18. **A recent Cook Islands Private Sector Assessment (PSA)[2] identified initiatives to facilitate growth in investment.** The PSA recommended reforms to enhance policy transparency and public sector performance, improve business entry processes, improve functioning of the land leasing framework, improve the financial system, advance gender equality, improve infrastructure, strengthen SOE governance, and address competition concerns. The recommended reforms, when implemented, are likely to catalyze further economic development of the Cook Islands.

IV. MACROECONOMIC DEVELOPMENTS, OUTLOOK AND RISKS

A. Recent economic developments and outlook

19. **The economy has been declining in recent years.** The tourism sector and public infrastructure projects have been the main drivers of recent economic growth. Nevertheless, growth has been low, averaging 0.1% per annum between FY2010 to FY2014. In FY2015 the economy shrank by 0.5% due to declines in construction activities and finance and business services. The economic contraction also reflects structural impediments to tourism growth arising from a lack of accommodation during the peak arrival periods.

20. **Prices have been stable.** Inflation averaged 1.9% between FY2010 to FY2014 and was estimated at 3.0% in FY2015 driven by higher alcohol and tobacco duties introduced in the national budget. Stable food prices and falling oil prices should see inflation trending downwards in FY2016.

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[2] Asian Development Bank. 2015. *The Cook Islands: Stronger Investment Climate for Sustainable Growth.* Manila.

21. **The current account balance remained in surplus as a result of net tourism earnings.** Imports of goods have generally moved in line with trends in visitor arrivals and account for the large merchandise trade deficit estimated at 28.3% of GDP in FY2015. Goods exports have continued to grow, with growth concentrated in fisheries. Pearl exports have continued their declining trend. Driven by tourism flows, the merchandise trade deficit is offset by a substantially large surplus from trade in services resulting in an estimated current account surplus equivalent to 33.1% of GDP in FY2015.

22. **The government has maintained an expansionary fiscal policy to support growth through investments in infrastructure.** The fiscal deficit averaged 2.5% of GDP between FY2010 and FY2014, and is estimated to be 1.7% of GDP in FY2015. The fiscal consolidation over FY2010 to FY2013 was reversed by an expansionary approach since FY2014. Tax revenues have remained reasonably strong despite the weakness of the economy. This is largely the result of improved tax administration and compliance, particularly in the collections of value-added tax and personal income tax. Corporate tax collections have remained low. Government expenditure remains high with capital expenditure around 12.2% of GDP in FY2015 increasing from 5.4% of GDP in FY2012. Capital expenditure has largely been financed through external grants or borrowings.

23. **Fiscal deficits have largely been financed through external debt, leading to a rapid increase in the debt stock.** Net public debt rose by an average of 2% of GDP in 6 years from 9.7% to 23.0% of GDP over the period of FY2010 to FY2015. The Cook Islands holds funds in reserve for debt service. This reserve also includes prepayments by public enterprises of external borrowings on-lent by the government. The debt service reserve in FY2015 was equivalent to 4.3% of GDP. Net debt is well within the government's threshold of 35% of GDP.

24. **Credit to the private sector has steadily declined due to more cautious lending strategies adopted by commercial banks.** The decline which averaged 3.9% between FY2010 and FY2014 appear to be leveling off with a marginal growth of 0.3% observed in FY2015. Weakness in lending is evident across all sectors, with only marginal increases in personal lending emerging more recently. This is in part the result of banks' strategy on improving the quality of their loan portfolios following the global financial crisis, which constrained both their ability and willingness to extend new loans. On the demand side, there is a slowdown in credit for private sector investment which is line with the low rate of economic growth. Output, in constant prices, grew by an annual average rate of 0.1% in the same period.

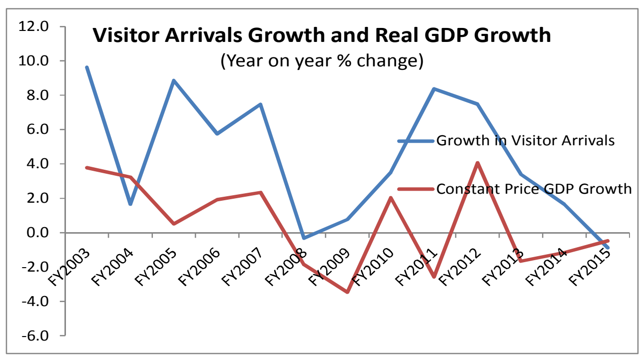
25. **The level of economic activity is expected to be flat with no growth projected in FY2016**. Inflation is expected to be about 1.8% in FY2016 as prices of imports remain stable. The surplus on goods and services trade is expected to improve in FY2016 by about 1.4% of GDP as tourism earnings grows. Private sector credit is expected to grow at a slow pace. Although banks have a high level of liquidity they remain conservative in their lending practices.

Box 1: Tourism has a large role in the economy

Tourism accounts for the bulk of the Cook Islands' exports of services. Visitor arrivals fell 0.9% in FY2015, while tourism receipts are estimated to have declined by 1.7%. Arrivals from Australia (the Cook Islands' second largest source market) declined by 9.1%, reflecting rising relative costs of travel to the Cook Islands owing to the appreciation of the Cook Islands' currency (the New Zealand dollar) against the Australian dollar. Arrivals from New Zealand (the largest source market) grew by 2.4%, maintaining the trend of the past few years.

Similar trends for both visitor arrivals and real GDP reflect the importance of the tourism industry in the Cook Islands (see figure below). According to the World Tourism Organization, average growth in international travel between 2005 and 2014 was 3.8% per annum. Tourism arrivals in the Cook islands do not track global trend consistently. For instance, average arrivals declined by 0.4% in 2013 and 2014 when global tourism grew by 4.4%.Tourism arrivals in the Cook Islands are driven more by the economic situation in its major source markets of New Zealand and Australia and exchange rate movements.

The growth potential of the industry is currently constrained by shortages in accommodation. The construction of new accommodation is constrained by the current land leasing framework and the lack of adequate sanitation infrastructure. The reforms suggested by the Private Sector Assessment and in this macroeconomic assessment are essential for the growth of the tourism industry in the Cook Islands There are benefits from diversifying the source markets and Cook Islands should take advantage of the fast growing Chinese market.



The government strategy in support of the tourism industry includes marketing initiatives by the Cook Islands Tourism Corporation to increase arrivals over the shoulders of the peak tourist season and into the off-peak season, through targeted promotions and events. There are also some new initiatives being undertaken to improve linkages between agriculture and tourism services which can increase outer island participation in the economy and further spread the benefits of the tourism industry across the resident population. Finally, There is also advantages of encouraging the development of high end (higher spend) tourism and not only the number of visitors.

Box 2. Strengthening the Investment Climate for Sustainable Growth

The Cook Islands has many structures in place that support private sector investment, including an internationally competitive tax regime, and open trade regime, and good standards of education and health care. Future prospects are positive, primarily due to the growing tourism industry. The Government of the Cook Islands has identified private sector-led growth as key to the country's sustainable development.

Yet, the Cook Islands faces significant challenges in realizing its full economic potential. A recent private sector assessment found that Cook Islands needs reform to spur investment in the private sector and protect the vital tourism industry in the short-to-medium term, while nurturing the development of other industries in the longer term. It identified eight policy areas that should be prioritized and proposed reforms to improve the business environment and promote private sector development. Key recommendations were to:

- **Enhance policy transparency** and continue to strengthen public sector performance by clarifying policies, making legislation readily accessible, explaining regulatory requirements in plain language, and streamlining public sector structures and systems.
- **Improve the business entry process** by modernizing outdated companies legislation, developing an electronic companies' registry, reviewing foreign investment processes, improving foreign worker permit processes and worker protections, and developing an investment promotion strategy, particularly around tourism.
- **Strengthen land market functioning and land management processes** by adjusting policies and processes—including creating an electronic land register, simplifying leasing processes, and identifying responses to land fragmentation and absentee ownership—to support the land market, introducing land use zoning and planning, and strengthening the environmental impact assessment process.
- **Improving access to finance** by identifying responses to the fall in domestic credit to the private sector—including addressing weaknesses in the collateral framework—and investigating additional ways in which the Cook Islands National Provident Fund could contribute to the domestic economy.
- **Advance gender equality** to stimulate private sector-led growth by continuing to implement the national gender action plan, investing in initiatives that support women's businesses, working to end violence against women, and recognizing de facto relationships.
- **Improve core infrastructure services** quality and sustainability by addressing priorities in the National Infrastructure Investment Plan, preparing for climate change, consolidating service delivery where possible, completing and applying the asset management system, ensuring effective cost recovery systems are applied, and separating infrastructure regulation from service delivery.
- **Strengthen the policy and legislative framework for state-owned enterprises** (SOEs) by establishing rules to identify and fund community service obligations, establishing criteria to select and appoint SOE directors, requiring SOEs to pursue contracting out and private sector engagement whenever possible, and defining the principal objective of SOEs as maximizing public investment's net worth.
- **Address competition-related concerns** by developing a coherent competition framework.

Source: Asian Development Bank. 2015. The Cook Islands—stronger investment climate for sustainable growth. Manila. http://www.adb.org/sites/default/files/institutional-document/ 175293/coo-stronger-investment-climate-psa.pdf

26. **Medium-term growth is expected to converge to 1.0%, supported by public investments and tourism.** This is also based on an overall softer outlook for economic growth in both New Zealand and Australia. Capacity constraints both on implementation of capital projects and on available tourist accommodation during peak months in coming years will hinder growth. Inflation is expected to remain around 2.0% on the back of weaker global commodity prices but driven largely by domestic factors for price increases. Surplus from goods and services trade is expected to continue improving as a result of continued growth in tourism earnings. Private sector credit is expected to continue growing in line with nominal GDP growth.

B. Risks to economic outlook

27. As a small island economy, economic growth in the Cook Islands will continue to be driven by public sector investments. Therefore, the biggest risk to future economic growth is the sustainability of public debt which is built into the provisions of the Public Financial Management Act and tracked by a set of financial indicators. While the net debt level is at a comfortable level, the recent rapid increase in debt reduces the fiscal space for government investment. To maintain adequate fiscal space for essential investment in infrastructure, government should seek more funding of its capital investment through non-debt creating financing where possible.

28. Relying on the public sector alone to drive investment is not sustainable and poses considerable fiscal risks to the economic outlook. In the long term, it is essential that private sector investment increases to support the public sector and sustain growth. It is encouraging that construction activity is expected to grow in response to the need to increase the availability and quality of tourist accommodation. Structural impediments to private sector investment particularly land must be addressed to allow private investment to grow.

29. Another considerable risk to economic outlook is the possible impact of disasters. The Cook Islands is vulnerable to natural disasters, specifically cyclones and tsunamis. The government has put in place several measures to reduce the financial impact of natural disasters on the budget including catastrophe insurance and disaster management reserves. To further mitigate this risk government should continue to build up its resilience and readiness to natural disasters and explore financial options to support its cash position in the event of a disaster.

30. The country is also vulnerable to risks of slowing growth in the economies of major trading partners, particularly New Zealand and Australia. This risk directly translates to a slowdown in tourism arrivals, adverse movements in the terms of trade and higher prices. The risk from slower global growth to the Cook Islands extends beyond its direct trading partners. New Zealand and Australia have close trade links with the People's Republic of China (PRC) through their agriculture and commodity sectors and are vulnerable to a slowdown in the PRC economy. The Cook Islands is also faced with the downside risk of higher global food and fuel prices, resulting in steep increases in inflation and a higher trade deficit. While global commodity prices continue to decline, depreciation of the New Zealand dollar can also raise import prices.

31. To mitigate most of the above risks in an economy where the public sector plays a central role, government needs to maintain adequate fiscal buffers. A continued fiscal expansion in a slow growth environment reduces the space for the government to respond to external risks multiplying their negative impact on growth. The transmittal of a downturn in the global economy to Australia and New Zealand could exacerbate the current decline in economic activity. The associated decline in revenue would in turn exert pressure on the fiscal position of government which could push debt above the accepted benchmark or reduce government's capital spending. Disasters adversely affect cash flow and capital stock. Such risks are better managed through appropriate levels of fiscal buffers.

V. FISCAL POLICY AND DEBT

32. **The expansionary stance of fiscal policy is an appropriate near-term response in the low growth environment.** Given the makeup of the economy and the adoption of the New Zealand dollar as its currency, fiscal policy is the main lever for growth and development in the Cook Islands. Fiscal policy has been expansionary over recent years, with a deficit of 3.3% of GDP forecast for the current fiscal year. This expansion was largely through capital investment funded by a mix of grants and debt. Economic growth would have been minimal without this fiscal expansion.

33. **However, fiscal expansion needs to be prudently managed to ensure the long-term fiscal position remains sustainable, particularly in light of medium-term pressures on wages, social spending and the airline subsidies.** With limited potential to raise taxes, recent improvements in revenue compliance need to be sustained. The onus therefore falls on limiting the growth of recurrent expenditure bearing in mind the increases to recurrent expenditure related to increased capital expenditure. It is essential that the fiscal risks of wages, airline subsidies and social welfare payments are managed proactively. The Cook Islands has a generous social welfare system that offers a wide range of support for public education, health, aged and community services. The aging demography imposes pressure on ballooning social welfare benefits. Airline subsidy is considered important by the tourism industry, but the government needs to carefully consider the costs and benefits of this expenditure, more so in the peak tourism months when accommodation facilities are not able to meet demand. Wages for government employees was 13.1%, subsidies were 4.7%, and social benefits were 4.4% of GDP in FY2015. Increases in such expenditures will reduce the government's capacity to undertake capital projects that facilitate economic development.

34. **The government should endeavor to stay within the bounds of its fiscal responsibility ratios.** These ratios support the provisions of prudent fiscal management in the MFEM Act. The ratios prescribe benchmarks on selected budget indicators such as debt and, wages.[3] Government can deviate from these benchmarks but must announce measures to return to the acceptable range in a reasonable period of time. Government has generally complied with the financial ratios. However, the current budget forecasts indicate breaches of the debt-servicing ratio to domestic revenue and the tax revenue ratio to GDP. The debt servicing ratio to revenue measures the ability to service debt and its increase above the threshold reflects the acceleration in the build-up of debt stock. The cap for tax revenue as a percentage of GDP attempts to prevent excessive increases in tax rates to fund more spending. However, the increase in this ratio reflects greater compliance to existing taxes rather than raising tax rates. Given that these financial ratios were set seven years ago, it is timely that they are reviewed to reflect current conditions.

35. **While the government has built up considerable cash reserves, they can be quickly eroded in future.** In addition to debt service reserves held in the loan repayment fund, the government has a net cash balance of over 16.3% of GDP held in deposits at commercial banks. However, a portion of the buildup in cash reserves is due to delays in the implementation of capital expenditure projects, and this will be depleted when these projects are completed. In addition some cash has been held as disaster management reserves and these should be ring-fenced for these risks.

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[3] These ratios were adopted by subprogram 1 of ADB's Economic Recovery and Support Program.

36. **With the projected level of economic growth, the current fiscal plan will increase net debt to the equivalent of 28.0% of GDP by FY2018, leaving a buffer of 7.0% of GDP.** This policy scenario seriously erodes the space to maintain the current expansionary fiscal stance. Therefore government must now reassess its stance and consider options that would safeguard fiscal sustainability but at the same time promote economic growth. One of the options is for government to implement structural reforms that would allow the private sector to develop and take over as the driver of economic growth. These reforms are discussed later in this report and include building an enabling climate for private investment to grow.

37. **A Debt Sustainability Analysis (DSA) undertaken by ADB finds the Cook Islands is at low risk of external debt distress.**[4] The DSA assumes long run growth of 2.0%, declining fiscal deficits from 0.5% to 0.1%, and inflation at 2.0% over the long term. If reforms that improve the business environment are not undertaken, the medium-long term forecast growth may not be realized. The DSA also assumes that the government will hold insurance coverage over its assets and catastrophe insurance for the economy.

38. **The contingent liabilities of the government were equivalent to 2.1% of GDP at the end of the FY2015.** Reported contingent liabilities do not include implicit guarantees from government to the domestic commercial bank or the superannuation fund. To reduce the risks associated with contingent liabilities, the government must continue to seek improvements in the governance of SOEs and the monitoring and reporting of the SOEs' financial performance.

VI. EXTERNAL STABILITY

39. **The adoption of the New Zealand Dollar by the Cook Islands as its currency has firm economic rationale.** The Cook Islands has a close relationship with New Zealand with significant trade of goods and services and relatively large financial flows. While the common currency arrangement disallows the Cook Islands from using the exchange rate as a policy tool, the advantages are the absence of exchange rate volatility against its major trading partner and the relative stability in the exchange rate of the New Zealand dollar against major currencies. In addition, the Cook Islands avoid the cost of printing and defending the currency. In this currency arrangement, interest rates are driven by New Zealand economic conditions which may not be appropriate to the economic cycle in the Cook Islands. This may be happening in recent years of low economic growth in the Cook Islands. However, from the observation of the demand for credit, interest rates do not appear to be the prime factor that is affecting credit growth and investment.

40. **The net inflow from tourism leads to stability in the current account**. The deficit on the trade in goods is more than offset by the surplus in the trade in services. This trend is expected to continue based on the growth in the tourism industry. Partial data suggest that private transfers are around zero on balance, although the increasing presence of foreign workers in the Cook Islands suggests that outflows may be beginning to exceed inflows. The investment income balance is likely to be in deficit as profits in the accommodation and financial services sectors repatriated to foreign owners, exceed receipts from Cook Islands National Superannuation Fund (CINSF) investments and deposits of local businesses held overseas.

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[4] A debt sustainability analysis was undertaken using the World Bank and International Monetary Fund debt sustainability analysis template and guidelines with a qualitative assessment incorporated in view of the prudent fiscal management by the government. This analysis is attached as Appendix 2.

41. **A fuller assessment of the risks to external financial stability is seriously inhibited by lack of data.** This is particularly the case for the flows in the financial account, with only partial financial data currently being captured and compiled by the Statistics Office. Information regarding current transfers and flows of investment income are difficult to measure, with only large transfers and investment income flows for the largest registered foreign businesses being recorded. This results in a large net error on the balance of payments. Detailed balance of payments data are not published. The Statistics Office is improving its balance of payments reporting. Further improvements require improved coordination and compilation of data (especially data on foreign investment and related transactions) across agencies, including the FSC and the Business Trade Investment Board (BTIB).

VII. FINANCIAL STABILITY

42. **The Cook Islands financial system is dominated by foreign commercial banks and offshore companies.** The three commercial banks are Australia and New Zealand Bank (ANZ), Bank of the South Pacific (BSP), and Bank of the Cook Islands (BCI). Two are branches of overseas banks (ANZ and BSP), while BCI is government-owned. In July BSP acquired the operations of Westpac, who exited the Cook Islands market in early 2015. The other main institutions in the financial sector are the CINSF and a group of providers of offshore banking services.

43. **The financial sector remains stable with a well-capitalized banking system.** Total capital of commercial banks was 19% of risk-weighted assets at the end of June 2015, mainly comprising tier one capital. Total deposits have grown 23% over the past year, but this growth is concentrated in foreign currency demand deposits of non-residents. The growth of domestic currency deposits has been slow, causing its share of total deposits to decline to 46% as at June 2015. Liquid assets have declined over recent years as a share of total assets and of short-term liabilities. In the event of funding pressures, foreign-owned banks could seek support from their parents. This source of support is not available to BCI. Banks have made marked progress in improving the quality of their overall loan books. From a peak of 18.1% in June 2011, non-performing loans of the commercial banks were 7.1% of total outstanding loans as of June 2015. Banks should continue in their efforts to further reduce their non-performing loans to acceptable international norms of around 2-3%. Private commercial banks' have capacity to offer more credit but are taking a conservative approach to new lending. Private sector credit grew 0.3% in 2014/15, having followed a generally declining trend since 2008/09. Continuing focus on improving the quality of banks loan portfolios ought to be balanced against the need to continue to support the economy through providing finance for viable projects.

44. **The degree of supervision of the financial sector is satisfactory, but greater disclosure will be beneficial.** Supervisory functions of the financial system are undertaken by the FSC. Offsite supervision has increased with a sufficient range of financial data being required from the banks on a regular basis.[5] Licensed institutions are subject to annual onsite supervisory visits and it is important that this practice is maintained even as the number of licensed institutions increases. It is appropriate that the FSC has or is establishing collegial supervisory activities with the home country authorities for their branches of overseas banks. Stronger public disclosure practices (for example, release of data on financial soundness indicators) could improve market discipline and improve perceptions of macro-prudential stability in the Cook Islands. The government has considered a number of options for an

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[5] The range of data being collected is consistent with the list of recommended measures set out in the 2012 Macroeconomic Assessment.

interbank payments system. In analyzing these options, the benefits of increased efficiency and reduced risk, must be carefully considered and assessed against costs.

45. **The national compulsory savings through the CINSF is increasing and the Fund needs to be brought into the supervisory net.** Membership of the CINSF has continued to grow over recent years and this is expected to continue. The Fund's asset was NZ$103.7 million as at 31 October 2015, all of which are invested offshore. Recent change to the structure of CINSF provides wider investment choice for members. Members can choose between three investment options, the conservative (default), balanced and growth funds, each with different risk and return profiles. Over the two months since these changes became effective, there has been a modest shift of around NZ$300,000 out of the conservative fund, into the higher growth funds. The growing size of the CINSF poses considerable systemic risks to the entire financial system and the Fund should be included in the supervision of the FSC. The Fund has potential to become an active participant in the domestic financial sector, as its governing legislation allows the CINSF to invest up to 20% domestically. This option should be carefully considered not only in the light of return but more importantly also from a prudential criterion.

46. **Activity in the offshore financial sector has declined due to tighter regulations and stricter monitoring of compliance.** The offshore sector comprises trust companies and insurance intermediaries, with only limited offshore activities being undertaken by domestic commercial banks. These financial institutions are supervised by the FSC, with compliance with anti-money laundering regulations overseen by the specialist Financial Intelligence Unit. Economic benefits from the offshore sector are limited as revenue streams are repatriated offshore and employment in the industry is relatively low. The fees collected from the sector represent a reasonable revenue stream for the government. The risks to the local economy and financial system are limited, as there is little direct involvement of the domestic commercial banks in offshore activities. FSC has capacity to monitor possible money laundering.

VIII. REFORMS TO IMPROVE LONG-TERM GROWTH

47. The Cook Islands is currently on a low growth path with low levels of private investment and outmigration of working age population contributing to this. GDP growth in the Cook Islands has trended down over the past decade and, in the medium-term, growth is expected to be at 1%. As discussed in the fiscal policy section above, the fiscal space to increase public investment is limited by debt stock and debt servicing capacity. The most sustainable manner to raise growth is to increase private sector investment from its low level, building on the increase in public sector investment. Structural impediments to investment are due to processes and structures related to the land tenure system. Securing adequate access to domestic productive labor is a limiting factor on growth, with foreign labor availability being impacted by immigration policies and processes.

48. There is a need to carefully sequence and implement reforms to address structural impediments to growth, while maintaining fiscal sustainability. The focal areas for reform have been clearly elaborated in the Public Expenditure and Financial Accountability PEFA assessment and the Private Sector Assessment. The former (see box) sets out a comprehensive set of recommended policy reforms across a range of policy spheres, including the land tenure system, public service, SOEs, welfare, banking, labor market regulation and immigration. Many of these reforms are culturally and socially sensitive, but without these fundamental reforms, particularly on the land tenure system, economic growth is bound to remain low. This comes with considerable costs to the Cook Islands economy and its people

through low job creation and insufficient tax revenue to achieve and maintain the desired level of public services, including welfare support.

49. While fundamental reforms are likely to be implemented slowly, there are incremental improvements that have potential to significantly ease constraints on growth in the shorter term. The government should also consider indicators for measuring progress and the outcomes of structural reforms. The PEFA assessment provides a tool for assessing the status of public financial management. A measure such as the World Bank Ease of Doing Business indicator could also provide a useful tool for assessing the outcomes of business-oriented reforms.

A. Land tenure system

50. **The majority of productive land in the Cook Islands is native freehold title and cannot be sold outright.** Leasehold interests can be sold with the consent of owners. That all children inherit equally their parents' land ownership rights has led to the fragmentation of land ownership. Substantial outmigration of Cook Islanders has also led to a prevalence of absentee land ownership. These two trends make land transactions complicated and costly. In addition, all lease agreements must be approved by the land court, and carry a maximum lease period of 60 years with no right of renewal.

51. **The structure of the land tenure system is a disincentive to investment and re-investment in property and business.** The complexity and cost of land transactions creates a barrier to accessing land for business purposes, for both local and foreign investors. This results in the underuse of productive land. The 60-year lease, and particularly the absence of a right to renewal, reduces the attractiveness and hence the value of the lease and the associated business operations over the period of the lease. This also erodes the incentive to re-invest in the property and business as the end of lease approaches, as any improvements to the land are appropriated by the owner on the expiry of the lease, or are likely to raise the rent on the lease if a renewal is agreed upon. It is reportedly becoming increasingly common for leases to include regular rent review periods, which increases the risk that rents increase with the value of the alterations to the land, increasing the overall cost of investment.

52. **The government needs to consider ways of improving the economic potential in customary owned lands.** The government may consider establishing an advisory committee to facilitate improvements to the land-leasing framework that will improve the protection of rights of both the landowners and the lessees without altering the underlying ownership of customary owned land. Consideration must be given to ways to reduce the fragmentation of ownership, clarify the rights of absentee land owners and consent requirements, consider some level of standardization of lease terms, and consideration of rights of renewal to leases. In the shorter term, government could consider increasing the frequency of sittings of the Lands Tribunal, helping to reduce timeframes for reviewing and approving issuances or transfers of leases, rights of occupancy, or disputes. The current schedule may take up to 5 weeks between lodgment to and response from the tribunal. The Cook Islands may also benefit from moving to an electronic land registry.

B. Labor and immigration

53. **The Cook Islands has high labor force participation, but must compete for labor in the regional labor market.** Labor force participation is around 60% for females and 70% for males. Under the country's free association with New Zealand, all Cook Islanders are New Zealand citizens and have complete freedom of entry to live and work in New Zealand. They also benefit from the close economic relationship between Australia and New Zealand, which

also provides freer access to the Australian labor market. Free labor mobility has resulted in significant outmigration from the Cook Islands as residents seek higher incomes elsewhere. This has tended to increase the cost of labor locally and given rise to the need to import foreign labor to supplement the local labor force. However, under current policy and practice, the process for businesses to employ foreign labor is highly uncertain and costly.

54. **Immigration legislation has not kept pace with changes in the economy and labor market.** Immigration legislation and policy have tended to focus on border management, without significant consideration as to how to best facilitate labor mobility in order to appropriately resource economic growth. The Immigration Act 1972 specifies only three types of visas: residents, visitors, and one that covers migrants entering for all classes of work and study purposes. There is no distinction in work visas between skilled and unskilled migrants. There are no allowances or special procedures for seasonal workers, despite clear seasonal demand for labor during peak tourism months. A range of standard practices has evolved over time and the Ministry of Immigration is developing these into formal policies. However, legislative change is necessary for these policies to be fully and more effectively implemented.

55. **Immigration reforms must recognize the strategic importance of supplementing local skills in order to expand productive capacity and lift economic growth.** The government must decide how open immigration into the Cook Islands should balance the opportunities for employment for residents with the need for imported labor. The government might consider further selective opening of its borders by identifying priority industries where there is demand for particular skill sets that is unmet in the local labor force, or where there exists clear excess demand for unskilled labor. This could be facilitated through the introduction of new classes of work visa, with clear rules and application and approval processes, including for example skilled migrant visas and seasonal worker visas. They might also consider the time period for which visas are granted, extending certain classes of visa beyond the current practice of an annual renewal and 6-year overall limit, in order to reduce costs to employers. A longer-term issue to consider is the stringency of requirements for residency status in the Cook Islands.

56. **There has been progress on employment regulation, including introducing dispute resolution frameworks, but further progress is necessary.** The Employment Relations Act 2012 increased protection for workers in the Cook Islands and introduced a disputes resolution framework that allows for mediation and High Court arbitration. These processes remain underused at present. A significant amount of power still resides with employers, particularly in the case of foreign workers due to conditions on visas tying them to their employer. Further education of workers is required regarding their rights and access to resolution processes. Occupational health and safety legislation and regulation remains underdeveloped in the Cook Islands.

57. **Further advances in employment regulation must balance the rights and interests of both employers and employees.** Efforts underway to establish a tri-partite labor advisory group (between government, private employers and employee representatives) to consider and advise on labor market issues is commendable and should be pursued further. The Cook Islands became a member of the International Labour Organisation in June 2015. This is indicative of recent and intended future progress in employment relations. International Labour Organisation membership provides a layer of scrutiny, and could be a valuable source of expertise and advice in the sphere of labor market regulation.

C. Access to credit

58. The high cost of domestic credit in the Cook Islands derives in part from constraints on access to collateral. The 2012 Banking Review acknowledged that access to assets to use as collateral and the cost of liquidating collateral in the event of default, underpin the high cost of borrowing in the Cook Islands. These difficulties are a result also of the nature of the land tenure system. The pool of assets a borrower may provide as collateral is also limited by the absence of a framework for registering security interests in movable personal property. Liquidation of collateral is impeded by the lack of an effective bankruptcy framework.

59. Difficulty in liquidating collateral has affected banks' ability to clear non-performing assets from their balance sheets. This has further impacted the supply of credit to the economy over recent years by reducing the funds banks have free to lend out. Banks have also tightened lending conditions as they seek to further improve the quality of their loan portfolios, including higher standards in financial reporting required against business loans. The absence of a credit bureau reduces the banks' ability to vary the cost of credit in response to customer characteristics.

60. In this context access to finance is particularly constrained for new ventures and start-up businesses, particularly small, locally owner-operated enterprises. Limited access to finance also slows the pace and scale of investments to expand business, pushing business owners to break investment projects into small stages financed by higher cost unsecured lending. A set of revolving funds operated by the BTIB (in partnership with BCI) provides some relief in this space, although the pool of available funds is small and unable to meet existing demand for such concessional funding.[6] There appears to be limited government appetite to formally enter the development finance space.

61. Reforms to ease access to credit in the domestic financial sector are important to support private sector development and growth. As recommended in both the Banking Review and the Private Sector Assessment, the government may consider renewing efforts to establish a task force with an expanded mandate to consider constraints on private sector credit growth and identifying possible solutions. Such a task force ought to consider both areas for fundamental reform, as well as incremental gains. The government has responded to the Banking Review, but its agreed actions remain unimplemented. The Government may wish to evaluate the costs and benefits of establishing a credit bureau and personal property registry, and explore the development of microcredit. They might also consider options such as increasing the frequency of land court sittings, clarifying owner consent requirements, or building capacity of small business owners to comply with tighter reporting standards on loans.

D. Foreign investment

62. **The Cook Islands investment code takes a negative list approach to regulating foreign investment inflows.** However, the list of sectors reserved for Cook Islands investment is extensive, covering almost all of the substantive sectors of the economy. Foreign investment in these industries is permitted if the proposed investment meets one of a set of conditions that generally refer to the size of the investment or the degree of local involvement. The Private Sector Assessment identifies the Cook Islands code as a deterrent to foreign investment. The

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[6] Three revolving funds were established. Proposals are made to BTIB who review and approve loans. BCI administer the loans on behalf of BTIB for a fee. Any non-performance issues and actions are the responsibility of BTIB. The loans do not impact on the BCI balance sheet.

application of the Code is highly discretionary, with approval decisions being made by the BTIB, creating a high degree of uncertainty for foreign investors. The Code also regulates the sale of foreign-owned businesses further increasing uncertainty and cost for foreign investors. The Code requires that prior to on-selling a business to a foreign investor, genuine efforts must first be made to sell the business to a resident Cook Islander.

63. **Reforms to foreign investment must balance the benefits of foreign investment against ensuring that Cook Islanders share in these benefits.** The government might consider a strategic review of foreign investment in the Cook Islands, giving consideration to the list of reserved sectors and the clarity of exceptions. The government might also consider making the application of the Code more rule-based, increasing clarity for potential investors and simplifying and reducing the cost of administration of the Code.

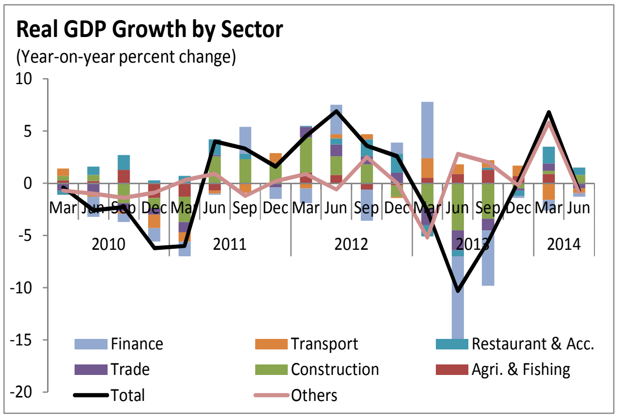
IX. OTHER ISSUES

64. It is vitally important to improve the quality and timeliness of statistics to provide a strong analytical basis to economic decision-making. Effective decision-making is only possible if timely, comparable and verifiable statistics are available. There is a need to strengthen the statistics office to improve the quality and timeliness of economic statistics. There is a work plan in place at the Statistics Office to gradually improve their current suite of statistics. Additionally, data are currently being collected across the public sector that are not being compiled into useful formats or disseminated for wider use across government and the private sector. Examples include investment data being collected by the BTIB and visa data being collected by the Ministry of Immigration. Agencies recognize the value in having access to these data but efforts to compile the data are inhibited by resourcing and capacity constraints. Timely data are missing in material areas also, such as labor market statistics.

65. Improved data and robust indicators are also required to allow evaluation of progress against the National Strategic Development Plan (NSDP) and to monitor progress of future reforms. Monitoring of the NSDP requires the establishment of a set of measureable and timely key performance indicators. Development of summary indicators such as the World Bank Ease of Doing Business indicator would provide a useful metric for objectively measuring the effectiveness of structural reforms across time, while also allowing some benchmarking of the business environment in the Cook Islands against regional peers.

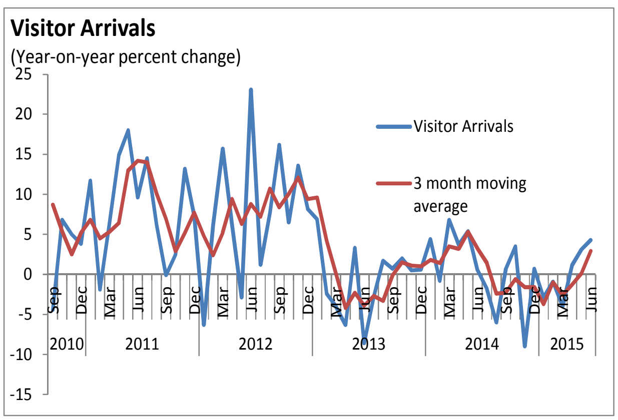
Panel 1: The economy is sluggish with low inflation

Economic activity has been volatile….

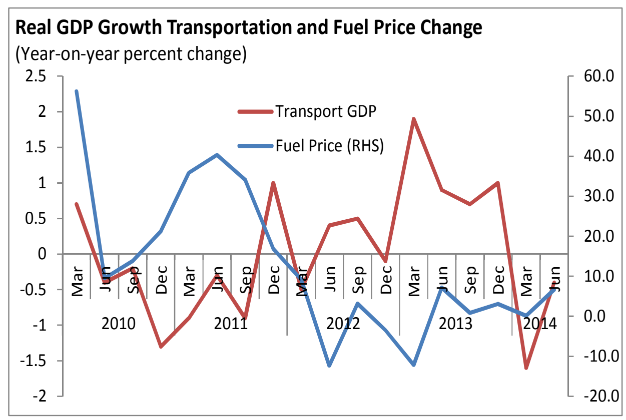


and driven largely by tourism….

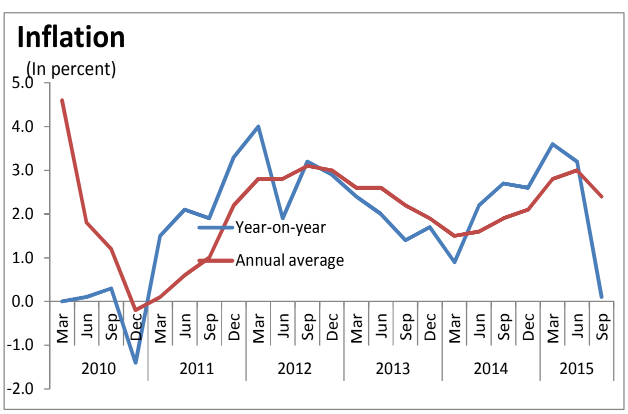
The tourism industry is slowing….



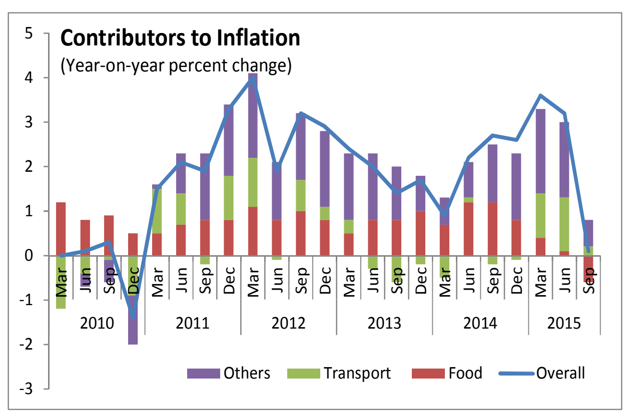
but lower fuel prices contributes to higher value added in transport sector…..



Prices are relatively stable….

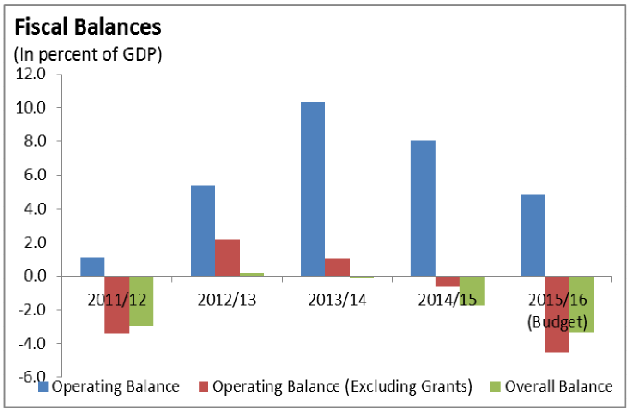


driven by food and transport prices.

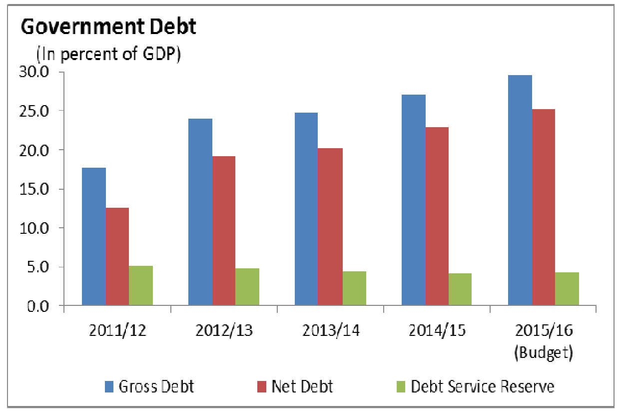


Panel 2: Stable Fiscal Position

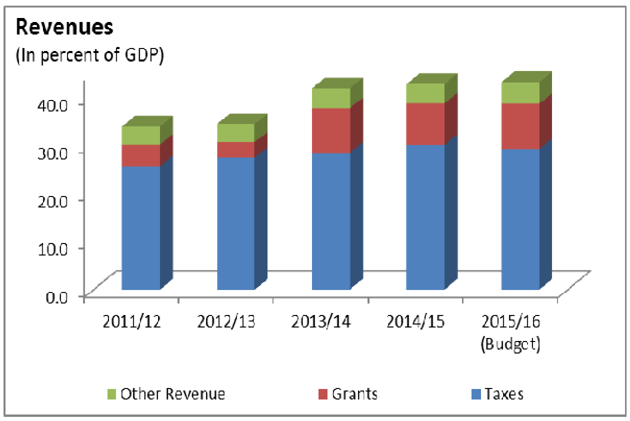
Deficits are low….



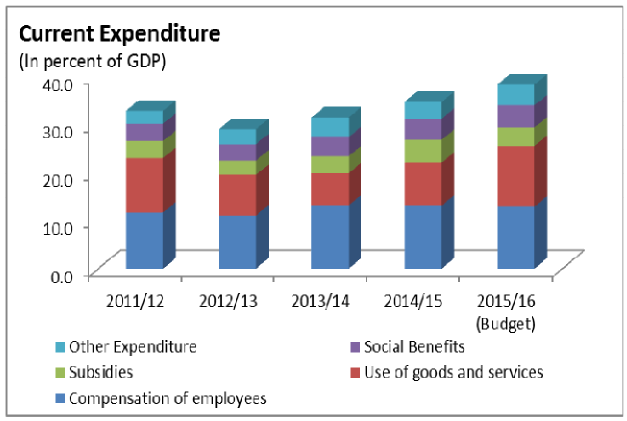
debt has increased gradually….



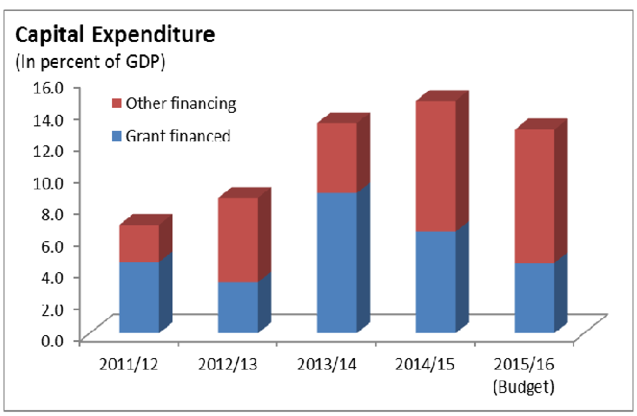
Revenues are rising….



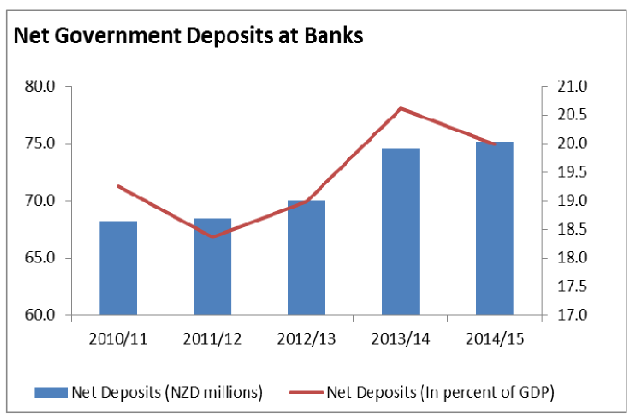
and so are recurring expenses….



Public investment remains high….

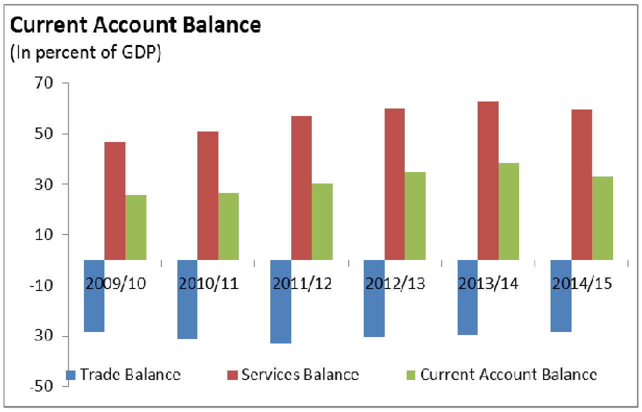


and government has a reasonable cash position.

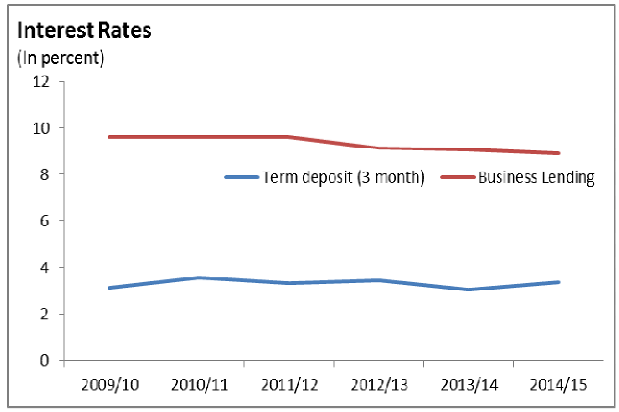


Panel 3: External and Financial Sector

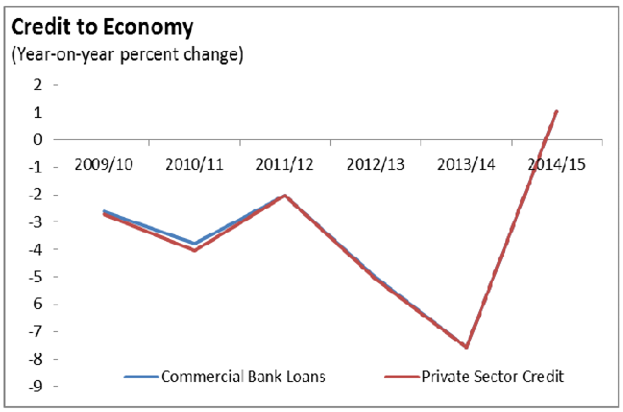
Current account in surplus...

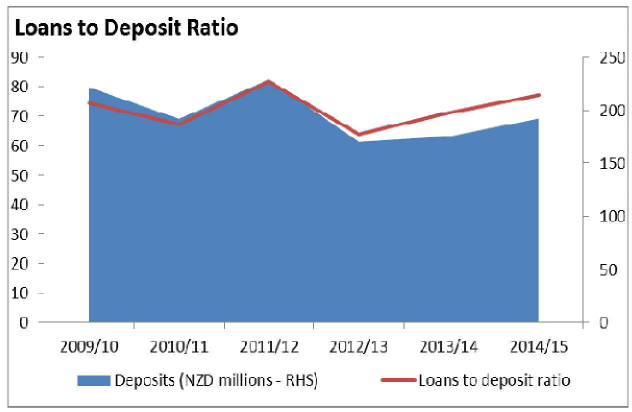


Interest rates are stable….

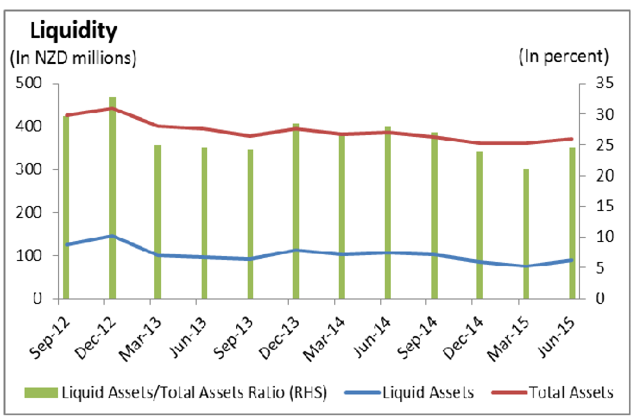


Credit declined as banks reduced risk to improve asset quality....

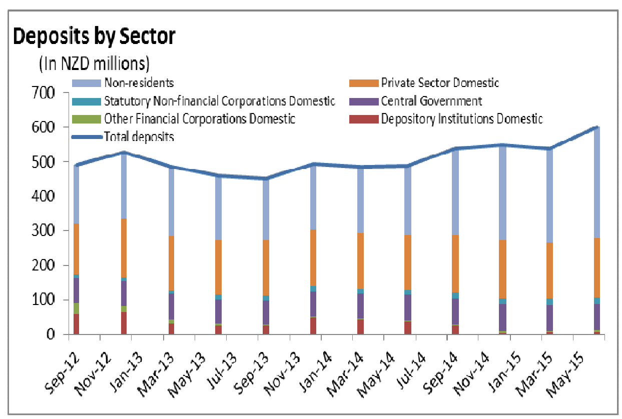




Liquidity is high….



but non-residents have a large share of deposits.



DATA TABLES

Table 1 - Cook Islands: Selected Macroeconomic and Financial Sector Indicators

Mid Year Population (2015) Estimated: 16,817
Main Exports: Tourism, Fish
GDP Per Capita (2014/15): NZ$ 22,353

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
				(12-month percent change)			
Output and Inflation							
Constant Price GDP Growth	4.1	-1.7	-1.2	-0.5	0.0	0.2	0.6
Per capita GDP Growth (constant price)	5.9	-0.1	0.5	1.1	1.7	1.8	2.3
Current Price GDP Growth	5.2	-1.0	-2.0	4.0	3.4	0.8	2.3
Change in CPI (end period)	1.9	2.0	2.2	3.2	1.9	1.3	1.4
Change in CPI (period average)	2.8	2.6	1.6	3.0	1.8	2.0	2.0
				(In percent of GDP)			
Central Government Budget							
Revenue and Grants	33.9	34.4	41.8	42.7	43.1	44.8	39.9
Of which: grants	4.5	3.2	9.3	8.6	9.4	11.9	7.6
Expenditure and Net Lending (Excluding depreciation)	36.9	34.2	41.9	44.4	46.4	45.6	42.0
Of which: Development expenditure	5.4	6.9	11.8	12.2	10.5	10.9	8.5
Overall Balance	-3.0	0.2	-0.1	-1.7	-3.3	-0.8	-2.2
External Finance	3.4	3.4	-0.1	-0.8	-2.7	-1.0	1.6
Domestic Finance	-0.5	-3.6	0.2	2.5	6.0	1.8	0.5
Gross Debt	17.7	24.1	24.7	27.2	29.6	30.1	31.6
Net Debt	12.6	19.3	20.2	23.0	25.2	25.8	28.0
Goods Trade							
Exports	1.0	2.5	6.0	5.7	5.5	5.4	5.3
Imports	34.0	32.6	35.5	34.0	33.6	32.5	32.5
Services Trade							
Exports	67.6	71.0	73.9	70.1	72.0	73.9	75.2
Imports	10.6	11.0	11.1	10.5	11.1	10.7	10.7
Goods and Services Balance	24.1	29.9	33.2	31.3	32.7	36.1	37.3
Memorandum Items							
GDP at current prices (In millions of NZD)	372.9	369.1	361.6	375.9	388.7	391.8	401.0
GDP per capita (N.Z. Dollars)	21,124	21,252	21,155	22,353	23,487	24,061	25,025
Net Debt (In millions of NZ)	47.0	71.2	73.1	86.3	98.1	101.0	112.1

Source: Cook Islands Ministry of Finance and Economic Management; ADB team estimates.

Table 2 - Cook Islands: Financial Operations of the Government, 2011/12 - 2017/18							
	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
	(In millions of NZ Dollars)						
Total revenue and grants	126.4	127.0	151.1	160.6	167.6	175.3	159.9
Total revenue	109.7	115.1	117.6	128.2	131.1	128.6	129.3
Tax revenue	95.5	101.2	102.7	113.0	113.6	114.8	115.5
Nontax revenue	14.2	13.9	14.9	15.3	17.5	13.8	13.7
Grants	16.7	11.8	33.5	32.4	36.5	46.8	30.6
Total expenditure	137.4	126.2	151.4	167.1	180.5	178.5	168.6
Current expenditure	117.2	100.9	108.7	121.2	139.7	135.7	134.4
Development expenditure	20.2	25.3	42.7	45.8	40.8	42.8	34.2
Operating Balance	9.2	26.1	42.4	39.4	27.9	39.7	25.5
Overall Balance	-11.0	0.7	-0.3	-6.4	-12.9	-3.1	-8.7
Financing	-11.0	0.7	-0.3	-6.4	-12.9	-3.1	-8.7
External Financing	12.8	12.4	-0.4	-3.1	-10.4	-3.8	6.5
Domestic Financing (includes depreciation)	-7.0	-19.2	-4.4	0.3	14.1	-4.8	-9.6
	(In percent of GDP)						
Total revenue and grants	33.9	34.4	41.8	42.7	43.1	44.8	39.9
Total revenue	29.4	31.2	32.5	34.1	33.7	32.8	32.2
Nontax revenue	3.8	3.8	4.1	4.1	4.5	3.5	3.4
Grants	4.5	3.2	9.3	8.6	9.4	11.9	7.6
Total expenditure	36.9	34.2	41.9	44.4	46.4	45.6	42.0
Current expenditure	31.4	27.3	30.1	32.2	35.9	34.6	33.5
Development expenditure	5.4	6.9	11.8	12.2	10.5	10.9	8.5
Operating Balance	2.5	7.1	11.7	10.5	7.2	10.1	6.4
Financing	-3.0	0.2	-0.1	-1.7	-3.3	-0.8	-2.2
External Financing	3.4	3.4	-0.1	-0.8	-2.7	-1.0	1.6
Domestic Financing (includes depreciation)	-1.9	-5.2	-1.2	0.1	3.6	-1.2	-2.4
GDP in current prices (in millions of NZD)	372.9	369.1	361.6	375.9	388.7	391.8	401.0
Net Debt	47.0	71.2	73.1	86.3	98.1	101.0	112.1
Fiscal Responsibility Ratios							
Tax revenue (in percent of GDP)	25.6	27.4	28.4	30.0	29.2	29.3	28.8
Compensation of Employees (in percent of GDP)	11.7	11.0	13.2	13.1	12.9	12.5	12.2
Net Debt (In percent of GDP)	12.6	19.3	20.2	23.0	25.2	25.8	28.0
Overall Balance (in percent of GDP)	-3.0	0.2	-0.1	-1.7	-3.3	-0.8	-2.2
Debt Service (in percent of total revenue)		2.4	2.7	5.1	5.0	5.5	6.9

Source: Cook Islands Ministry of Finance and Economic Management; ADB team estimates.

Table 3 - Cook Islands: Overall Operations of the Government/1

	Audited				Unaudited	
	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
Cash Flows from Operating Activities	**11,321**	**3,479**	**7,894**	**8,268**	**10,576**	**8,561**
Inflows which include:	*129,088*	*129,084*	*132,080*	*145,151*	*159,091*	*168,247*
Taxation	82,439	83,937	88,887	95,288	97,174	100,848
Provision of Goods and Services	33,717	33,893	32,016	40,141	46,038	45,429
Other Crown Activities	6,749	4,987	4,975	4,988	10,090	16,397
Income from Associates	1,148	1,498	1,601	1,084	2,484	1,999
Outflows which include:	*117,767*	*125,605*	*124,186*	*136,883*	*148,514*	*159,685*
Social Welfare Benefits and Education Grant	12,169	12,060	12,562	12,516	14,430	15,964
Personnel	48,755	52,172	54,656	52,773	56,737	57,666
Other Supplier Payments	54,141	55,652	54,038	67,377	77,111	81,479
Cash Flows from Investing Activities	**(15,607)**	**(7,334)**	**(20,922)**	**(5,598)**	**(3,847)**	**(10,580)**
Inflows which include:	*24,874*	*4,041*	*34,746*	*119,062*	*6,957*	*6,774*
Funds Transferred into Reserve Trust Fund	-	(226)	14,782	62,633	4,859	5,042
Interest Received from Investments	3,013	4,249	4,027	3,151	2,098	1,732
Outflows which include:	*40,492*	*11,375*	*55,668*	*124,659*	*10,804*	*17,354*
Purchase of Fixed Assets	39,459	11,416	60,999	125,904	10,804	17,354
Cash Flows from Financing Activities	**17,847**	**5,010**	**12,020**	**671**	**337**	**183**
Inflows which include:	20,437	13,546	14,588	6,062	3,680	3,480
Drawdown of loans	18,694	12,766	14,942	5,657	3,680	3,480
Outflows which include:	*2,590*	*8,536*	*2,568*	*5,390*	*3,343*	*3,297*
Foreign Debt Repayments	2,513	2,485	2,146	3,057	3,343	3,297
Net Increase in Cash Held	**13,561**	**1,155**	**(1,008)**	**3,342**	**7,066**	**(1,835)**
Add Opening Cash and Deposits	63,914	77,475	78,630	77,622	80,964	88,030
Closing Cash and Deposits	77,475	78,630	77,622	80,964	88,030	86,194

1/ Includes SOEs

Source: Cook Islands Ministry of Finance and Economic Management; ADB team estimates.

Table 4 - Cook Islands: Illustrative Balance of Payments 2011/12 - 2017/18

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
			(In millions of NZD)				
Goods balance	**-123.0**	**-111.3**	**-106.8**	**-106.6**	**-109.5**	**-106.2**	**-109.0**
Exports	3.9	9.0	21.6	21.3	21.3	21.3	21.3
Imports	126.9	120.3	128.5	127.8	130.8	127.4	130.2
Services balance	**212.8**	**221.6**	**227.0**	**224.1**	**236.6**	**247.7**	**258.4**
Services receipts	252.1	262.1	267.1	263.7	279.7	289.7	301.4
Travel	209.3	223.3	236.7	233.1	245.0	255.0	266.7
Others	42.9	38.8	30.4	30.6	34.7	34.7	34.7
Services payments	39.4	40.5	40.1	39.6	43.1	42.0	42.9
Investment income (net)	**-0.7**	**-0.8**	**-1.4**	**-2.2**	**-2.1**	**-2.0**	**-1.7**
Government loans	-0.7	-0.8	-1.4	-2.2	-2.1	-2.0	-1.7
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current transfers	**23.9**	**18.7**	**20.8**	**8.9**	**19.9**	**22.3**	**22.1**
Official	23.5	18.2	20.3	8.4	19.4	21.7	21.6
Private	0.4	0.5	0.6	0.5	0.5	0.6	0.5
Current account balance	**112.9**	**128.2**	**139.5**	**124.3**	**145.0**	**161.8**	**169.9**
(in percent of GDP)	30.3	34.7	38.6	33.1	37.3	41.3	42.4
Capital account balance	**16.7**	**11.8**	**31.9**	**24.0**	**17.2**	**25.1**	**9.0**
(in percent of GDP)	*4.5*	*3.2*	*8.8*	*6.4*	*4.4*	*6.4*	2.2
Official (net)	16.7	11.8	31.9	24.0	17.2	25.1	9.0
Private (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Implied net lending/borrowing requirement (Financial account balance)	***129.6***	***140.1***	***171.4***	***148.3***	***162.2***	***186.8***	***178.9***
Memorandum Items							
GDP in current prices	372.9	369.1	361.6	375.9	388.7	391.8	401.0
Net foreign assets							
Government							
CINSF	55.7	68.2	83.5	n/a	n/a	n/a	n/a
Commercial Banks	77.2	25.9	47.8	75.3	n/a	n/a	n/a

Source: Cook Islands Ministry of Finance and Economic Management; ADB team estimates.

Table 5 - Cook Islands: Monetary indicators

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
			(In millions of NZD)			
Net foreign assets	31.6	13.6	77.2	25.9	47.8	75.3
Net domestic assets	80.3	106.5	45.1	105.8	70.7	53.8
Net domestic credit	226.0	213.7	196.9	194.7	170.5	169.8
Government (net)	-62.7	-68.3	-68.5	-70.1	-74.6	-75.2
Non-financial public enterprises	1.0	7.3	6.8	3.6	2.4	1.5
Private sector	287.7	274.6	258.7	261.3	242.7	243.5
Other items (net)	-145.7	-107.1	-151.8	-88.9	-99.9	-116.0
Money supply (M3 = M1+M2)	221.8	192.1	229.1	170.4	175.5	192.4
Narrow money (M1)	63.5	50.5	59.4	53.9	70.2	73.5
Currency in circulation	0.1	0.1	0.1	0.1	0.1	0.1
Demand deposits	63.3	50.4	59.3	53.7	70.1	73.4
Quasi money (M2)	158.3	141.6	169.6	116.6	105.2	118.9
Savings deposits	36.9	36.7	39.9	43.1	39.4	42.5
Term deposits	121.4	104.9	129.8	73.5	65.9	76.4
Loans by commercial banks (by sect	297.4	286.2	280.4	266.3	246.1	248.7
Finance and business	15.1	13.6	11.0	10.4	8.0	9.7
Public administration	1.1	0.2	0.2	0.0	0.0	0.0
Personal services	159.9	153.8	145.5	116.2	108.1	114.4
Other	121.4	118.6	123.6	139.7	130.0	124.6
Interest rates						
Deposits						
Personal savings account	1.25	1.25	1.25	1.25	0.10	0.1
Term deposit (3 month)	3.13	3.55	3.33	3.43	3.06	3.4
Lending						
Business	9.62	9.62	9.62	9.15	9.07	8.9
Housing	9.72	9.72	9.72	9.42	9.33	9.2
Personal	16.18	16.18	16.18	15.85	14.85	14.9
Memorandum items						
Total deposits	221.6	192.0	228.9	170.3	175.3	192.3
Nominal GDP	350.1	354.4	372.9	369.1	361.6	375.9
M3/GDP ratio	63.3	54.2	61.4	46.2	48.5	51.2
M1/GDP ratio	18.1	14.3	15.9	14.6	19.4	19.6
Loans to deposit ratio	74.5	67.1	81.7	63.9	71.2	77.3
Change in NFA	-28.9	-17.9	63.5	-51.2	21.9	27.5

Source: Ministry of Finance and Economic Management; ADB team estimates.

Note: Deposits are domestic currency only, excluding government.

Table 6 - Cook Islands: Financial Soundness Indicators

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
Deposit to loan ratio	74.5	67.1	81.7	63.9	71.2	77.3
Capital adequacy ratio				17.2	16.0	16.7
Return on assets				1.3	3.6	2.1
Non-performing loans ratio	6.9	11.0	11.2	10.5	8.1	5.5
Net interest margins				7.3	4.3	5.4
Liquid assets to short-term liabilitites				81.2	82.3	65.4
Bank provisions to non-performing loans				60.4	52.4	66.0

Source: Cook Islands Financial Supervisory Authority

Notes: For commercial banks; NPLs are three-months overdue and longer;
Deposits exclude government and foreign currency

COOK ISLANDS: RISK ASSESSMENT MATRIX

Nature/source of main threats	Overall level of concern	
	Likelihood of severe realization of threat in the next 1-3 years (High, medium or low)	**Expected impact on Cook Islands if threat is realized (High, medium or low)**
1. Slowdown in Asia leads to a sharp slowdown in Australia and New Zealand economies	Team assessment: Low • Global projections place a low probability on sharp slowdown in Australia and New Zealand economies. • The Cook Islands may be exposed to a drop in visitor arrivals and development support grants.	Team assessment: High • This could result in GDP growth in Cook Islands to reduce by more than 2 percentage points.
2. Expansionary fiscal policies continued over medium-term with low economic growth	Team assessment: Medium • The government may wish to continue with expansionary fiscal policy to support private investments which may cause public debts to escalate very quickly	Team assessment: Medium • Debt servicing costs would escalate. • External position may become unstable. • Inflation may increase above projections.
3. Global commodity prices (especially food and fuel) increase	Team assessment: Low • Geopolitical uncertainty is a non-negligible risk, however, slowdown in Asia will reduce price pressures. • Cook Islands relies heavily on imported food and fuel.	Team assessment: High • Increases in food and fuel prices will have significant impact on inflation. • Trade deficit will widen. • Cook Islands is dependent on New Zealand's support, which could act as a buffer.

DEBT SUSTAINABILITY ANALYSIS

Pacific Economic Management Technical Assistance
January 2016

After substantially reducing its debt burden, the Cook Islands can now afford to borrow to finance sound investments. This analysis finds that a large one-time projected shock to exports will cause debt metrics to breach thresholds determined by the criteria used by the International Monetary Fund and the World Bank. The Cook Islands has a reasonable amount of liquid assets, has insurance coverage for publicly owned buildings and has coverage under a regional catastrophe risk insurance scheme. As a result of available cash buffers and insurance coverage it is deemed to have a low risk of debt default. There will be a need for the Cook Islands to continue to improve its disaster response financing options.

I. INTRODUCTION

1. **The Cook Islands' net debt stock had declined to 2.2% of gross domestic product (GDP) by 2008 (i.e., fiscal year ending 30 June 2008), as a result of tourism-driven growth and sustained fiscal surpluses.** From as high as 141% of GDP in the early 1990s, the debt ratio has fallen significantly every year (except for a slight increase in 2007). Few new loans have been incurred and the Government has steadily paid off debts and accumulated cash holdings and reserves (to meet future debt obligations on certain concessional debt).[7] This analysis projects the potential path of the Cook Islands' debt indicators given new loans from the Asian Development Bank (ADB), People's Republic of China (PRC), and assesses debt sustainability over the medium-term.

II. KEY ASSUMPTIONS

2. **The Cook Islands is assumed to have strong governance in place and a strong policy reform environment.** This has enabled it to rebuild its fiscal buffers and sustain high levels of income compared to other similar economies, therefore the country is assessed against higher thresholds compared to countries that have weaker governance and policy environments.

3. **This analysis is based on data provided by the government and estimates of the assessment team.** The debt data has not been reconciled and a single discount rate of 5% is used. Major assumptions in this analysis are consistent with the macroeconomic framework used for 2015/2016 macroeconomic analysis. These are:

- 2016 fiscal year GDP growth is projected to be 0% as the economy reverses its declining trend. Growth is expected to recover gradually to 1.0% over the medium term as the government's capital expenditure program builds on improving the economy's potential. It is assumed that continuing capital expenditure will raise the potential growth to 2.0% over the long run.

- Annual average inflation of 1.8% is estimated for FY 2016 taking into account the lower global prices for commodities. Prices are expected to increase by 2.0 annually over the medium to long term.

- The Cook Islands is expected to continue to use the New Zealand dollar as its currency.

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7 Reserves were accumulated rather than used to pay off concessional debts, as the interest earned on the reserves exceeded the expected cost of servicing the concessional debt.

- Annual growth of goods is expected to be broadly in line with GDP growth and change in domestic prices. Current account surplus is assumed to remain above 30% of GDP over the long term.

- Fiscal projections are in line with government's targets to maintain fiscal buffers and a sustainable fiscal position. Total revenue is expected to remain around 40% of GDP over the medium term but it is expected that development partner grants will reduce from near 10% of GDP to almost 1% of GDP over the long term. As a result of this additional efforts are expected on non-tax revenues. This will cause revenue levels to reach about 34% of GDP over the long run. Operating expenditure is expected to remain above 30% of GDP over the medium to long term. The overall balance is largely expected to remain in deficit, although small.

- As a result of relatively small projected deficits over the long term, no new foreign borrowings are assumed except for drawdowns from loans already contracted. The deficits are assumed to be financed domestically. Government has adequate cash reserves to draw down to implement its infrastructure investment plan over the medium term, however, any disaster response financing requirements will breach these assumptions.

- It is expected that the government will maintain adequate insurance policies on public assets to cover for damages as a result of natural disasters. It is also expected that adequate financial options will be available to the government for it to assist the private sector in swiftly recovering from any catastrophe the country may face.

III. DEBT SUSTAINABILITY

4. **Based on the above assumptions, the assessment team finds that the Cook Islands faced with a low risk of debt distress.** This assessment is a departure from the guidelines issued jointly by the IMF and the WB. The departure is based on past experience where the Cook Islands was successful in reducing its debt from more than 140% of GDP and subsequently rebuilding fiscal buffers while securing risk insurance.

5. **Public Debt is expected to breach policy dependent thresholds (present value of debt to GDP ratio) as a result of temporary shocks to Cook Islands tourism industry.** The tourism industry is the mainstay of the economy and there is a need for government to ensure appropriate disaster response finances are available to respond appropriately to any such shocks. This is despite the government having maintained low levels of public debt as a result of its prudent fiscal policies.

6. **Stress tests under alternative scenarios indicate that debt sustainability is generally resilient to other temporary macroeconomic shocks.** Debt distress, however, can be significantly amplified if Government runs persistently large fiscal deficits over the long-term, by poor long-run economic performance or not maintaining adequate insurance/financing facilities

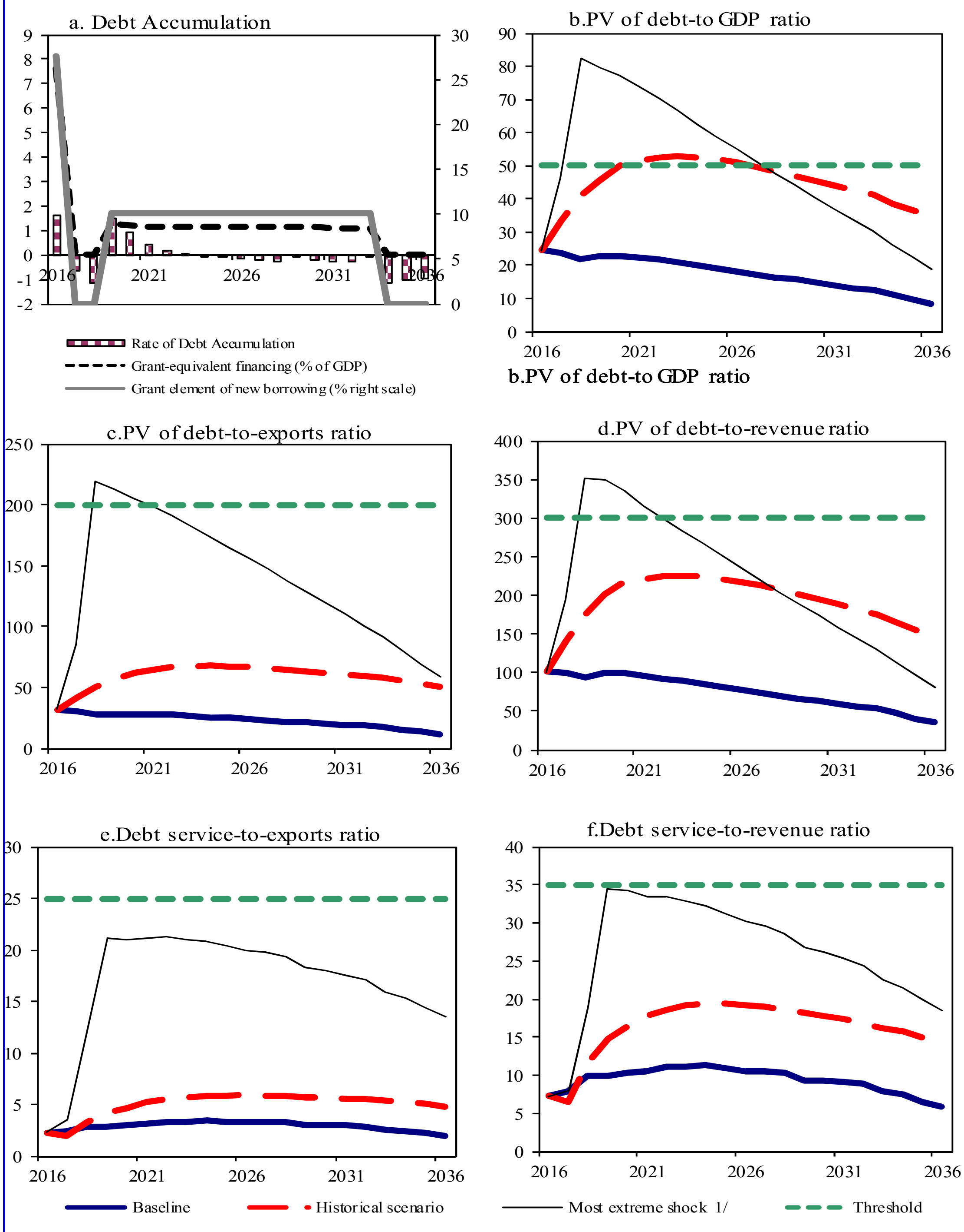
IV. CONCLUSIONS

7. **Despite the recent fiscal expansion the Cook Islands faces low risk of debt distress.** Stress tests confirm that debt distress can rise sharply with a large shock affecting its tourism industry. Debt levels will rise significantly if there are no insurance policies and cash reserves. A disaster response facility will assist the economy to recover quickly as a result of visitors returning soon after.

8. **Strong GDP growth and a commitment to prudent debt management over the long-term are necessary for reducing vulnerabilities.** Government has previously shown the capacity to bring down its debt levels from unsustainably high levels. Given the same level of commitment and fiscal discipline, risks are seen as minimal.

9. **These conclusions are based on thresholds for low-income countries that establish a conservative benchmark for the middle-income Cook Islands.** However, as an economy that is highly exposed to natural disasters and external economic shocks, the rationale to keep debt levels comfortably below these thresholds remain. This will provide for a fiscal cushion against natural disaster and macroeconomic shocks.

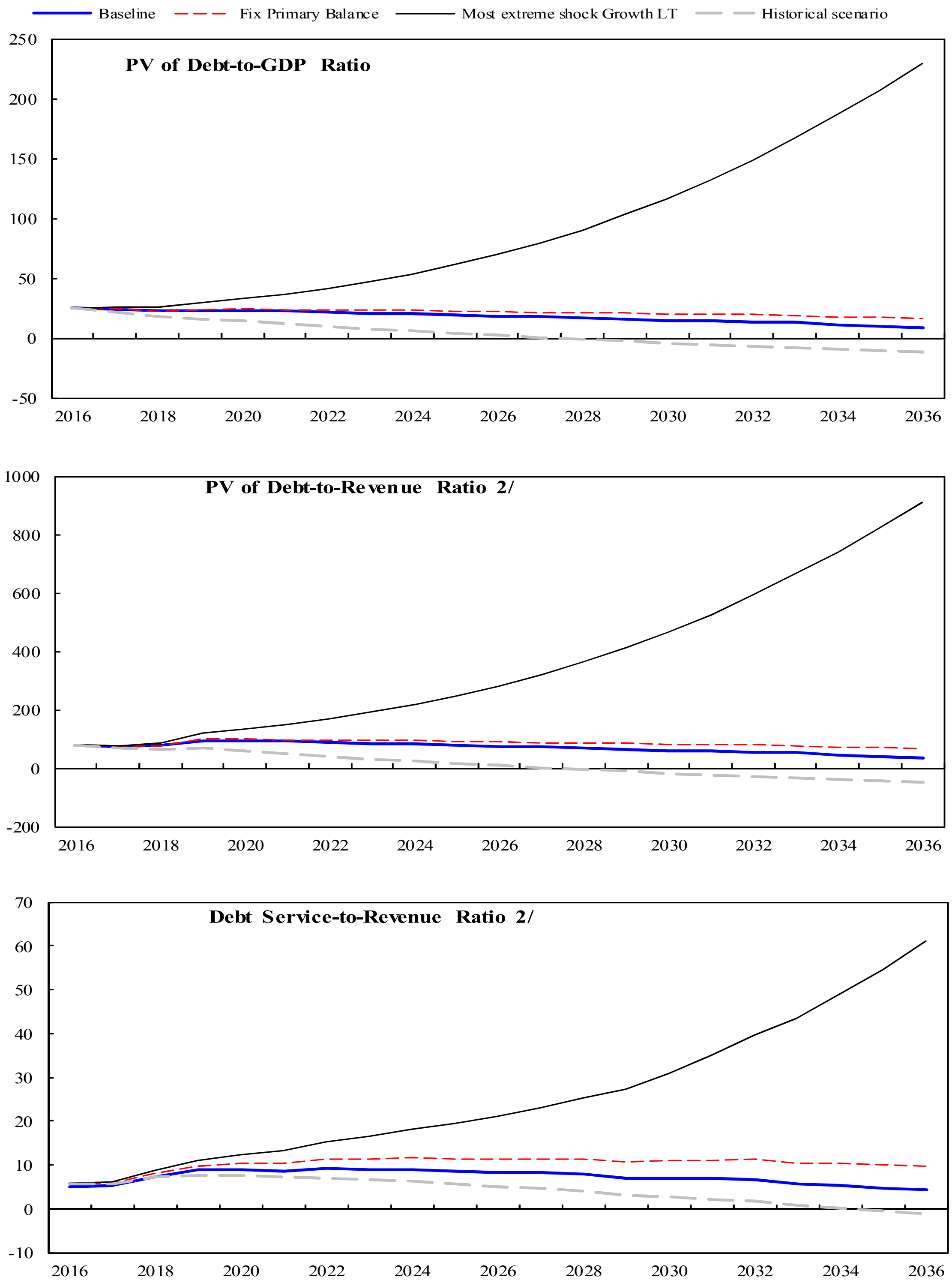
Figure 1. Cook Islands: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2016-2036 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2026. In figure b. it corresponds to a Exports shock; in c. to a Exports shock; in d. to a Exports shock; in e. to a Exports shock and in figure f. to a Exports shock

Figure 2.Cook Islands: Indicators of Public Debt Under Alternative Scenarios, 2016-2036 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2026.
2/ Revenues are defined inclusive of grants.

Table 1.Cook Islands: Public Sector Debt Sustainability Framework, Baseline Scenario, 2013-2036
(In percent of GDP, unless otherwise indicated)

	Actual			Average	Standard Deviation	Estimate	Projections								
	2013	2014	2015			2016	2017	2018	2019	2020	2021	2016-21 Average	2026	2036	2022-36 Average
Public sector debt 1/	22.5	26.0	25.0			25.9	24.4	22.0	22.3	22.3	21.6		17.0	6.8	
o/w foreign-currency denominated	22.5	26.0	25.0			25.9	24.4	22.0	22.3	22.3	21.6		17.0	6.8	
Change in public sector debt	1.1	3.5	-1.0			0.9	-1.5	-2.4	0.3	0.0	-0.7		-0.9	-1.4	
Identified debt-creating flows	0.2	0.4	-0.9			0.0	0.1	0.0	-0.4	-0.2	-0.4		-0.2	0.0	
Primary deficit	-0.2	-0.3	-0.1	-1.3	2.1	0.2	-0.2	0.1	0.0	-0.1	-0.2	0.0	-0.1	0.0	-0.1
Revenue and grants	23.8	30.3	31.0			31.3	32.4	28.9	23.7	24.0	24.4		24.4	24.4	
of which: grants	2.2	6.7	6.3			6.8	8.7	5.5	1.0	1.0	1.0		1.0	1.0	
Primary (noninterest) expenditure	23.6	30.0	30.9			31.5	32.2	29.0	23.7	23.9	24.2		24.2	24.4	
Automatic debt dynamics	0.4	0.6	-0.8			-0.2	0.4	-0.1	-0.4	0.0	-0.2		0.0	0.0	
Contribution from interest rate/growth differential	-0.2	-0.2	-0.2			0.2	-0.2	-0.1	0.0	0.0	0.4		0.3	0.2	
of which: contribution from average real interest rate	-0.6	-0.5	-0.3			0.2	-0.2	0.1	0.1	0.2	0.7		0.7	0.3	
of which: contribution from real GDP growth	0.4	0.3	0.1			0.0	0.0	-0.1	-0.2	-0.2	-0.3		-0.4	-0.2	
Contribution from real exchange rate depreciation	0.6	0.9	-0.6			-0.5	0.6	0.0	-0.3	0.0	-0.5		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	1.0	3.1	-0.1			0.9	-1.7	-2.4	0.7	0.2	-0.3		-0.7	-1.4	
Other Sustainability Indicators															
PV of public sector debt	0.0	0.0	23.8			24.6	23.7	22.0	22.5	22.8	22.3		18.2	8.2	
o/w foreign-currency denominated	0.0	0.0	23.8			24.6	23.7	22.0	22.5	22.8	22.3		18.2	8.2	
o/w external	...	...	23.8			24.6	23.7	22.0	22.5	22.8	22.3		18.2	8.2	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	0.4	0.5	0.8			1.8	1.5	2.2	2.1	1.9	1.9		1.9	1.1	
PV of public sector debt-to-revenue and grants ratio (in percent)	0.0	0.0	76.8			78.6	73.1	76.2	95.1	94.8	91.4		74.6	33.8	
PV of public sector debt-to-revenue ratio (in percent)	0.0	0.0	96.2			100.5	99.7	94.2	99.1	98.8	95.2		77.7	35.2	
o/w external 3/	…	…	96.2			100.5	99.7	94.2	99.1	98.8	95.2		77.7	35.2	
Debt service-to-revenue and grants ratio (in percent) 4/	2.3	2.5	2.8			5.0	5.2	7.4	8.7	8.7	8.6		8.2	4.3	
Debt service-to-revenue ratio (in percent) 4/	2.5	3.2	3.4			6.3	7.1	9.1	9.1	9.1	9.0		8.5	4.5	
Primary deficit that stabilizes the debt-to-GDP ratio	-1.3	-3.7	0.9			-0.7	1.3	2.5	-0.3	-0.2	0.5		0.8	1.4	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	-1.7	-1.2	-0.5	6.7	14.1	0.0	0.2	0.6	0.8	1.0	1.5	0.7	2.0	2.0	2.0
Average nominal interest rate on forex debt (in percent)	0.7	0.7	0.6	1.6	1.0	2.5	2.2	2.0	2.6	3.0	3.1	2.6	3.8	4.3	4.0
Average real interest rate on domestic debt (in percent)	...	...	...	…	…	...	...	...	...	...	...	…	...	...	…
Real exchange rate depreciation (in percent, + indicates depreciation)	2.9	3.9	-2.4	-7.2	20.9	-1.8	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	-1.7	-5.3	4.5	10.4	33.9	3.4	0.6	1.7	3.6	2.0	2.5	2.3	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, in percent)	0.0	0.3	0.0	0.1	0.4	0.0	0.0	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Grant element of new external borrowing (in percent)	...	...	...	…	…	27.6	...	...	10.1	10.1	10.1	14.5	10.1	...	...

Sources: Country authorities; and staff estimates and projections.
1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues excluding grants.
4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2.: External Debt Sustainability Framework, Baseline Scenario, 2013-2036 1/
(In percent of GDP, unless otherwise indicated)

	2013	2014	2015	Historical 0 Average	0 Standard Deviation	Projections 2016	2017	2018	2019	2020	2021	2016-2021 Average	2026	2036	2022-2036 Average
External debt (nominal) 1/	**22.5**	**26.0**	**25.0**			**25.9**	**24.4**	**22.0**	**22.3**	**22.3**	**21.6**		**17.0**	**6.8**	
o/w public and publicly guaranteed (PPG)	22.5	26.0	25.0			25.9	24.4	22.0	22.3	22.3	21.6		17.0	6.8	
Change in external debt	1.1	3.5	-1.0			0.9	-1.5	-2.4	0.3	0.0	-0.7		-0.9	-1.4	
Identified net debt-creating flows	-34.5	-38.1	-34.1			-37.3	-41.3	-42.5	-38.1	-39.6	-38.4		-36.8	-33.3	
Non-interest current account deficit	**-34.9**	**-38.7**	**-33.2**	**-27.3**	**8.1**	**-37.9**	**-41.9**	**-42.9**	**-38.5**	**-40.1**	**-38.7**		**-37.2**	**-33.5**	-36.0
Deficit in balance of goods and services	-29.9	-33.2	-31.3			-32.7	-36.1	-37.3	-37.4	-38.8	-37.5		-36.0	-32.6	
Exports	73.5	79.9	75.8			77.4	79.4	80.5	80.0	81.0	79.7		76.0	69.0	
Imports	43.6	46.6	44.5			44.7	43.3	43.2	42.7	42.1	42.3		40.1	36.4	
Net current transfers (negative = inflow)	-5.1	-5.8	-2.4	-4.2	3.2	-5.1	-5.7	-5.5	-1.1	-1.1	-1.1		-1.0	-0.9	-1.0
o/w official	-4.9	-5.6	-2.2			-5.0	-5.5	-5.4	-0.9	-0.9	-0.9		-0.9	-0.8	
Other current account flows (negative = net inflow)	0.1	0.2	0.4			-0.1	-0.1	-0.1	-0.1	-0.1	-0.2		-0.2	0.1	
Net FDI (negative = inflow)	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**		**0.0**	**0.0**	0.0
Endogenous debt dynamics 2/	**0.4**	**0.6**	**-0.8**			**0.6**	**0.5**	**0.3**	**0.4**	**0.4**	**0.4**		**0.3**	**0.2**	
Contribution from nominal interest rate	0.2	0.2	0.2			0.6	0.6	0.5	0.6	0.6	0.7		0.7	0.3	
Contribution from real GDP growth	0.4	0.3	0.1			0.0	0.0	-0.1	-0.2	-0.2	-0.3		-0.3	-0.2	
Contribution from price and exchange rate changes	-0.1	0.2	-1.1			…	…	…	…	…	…		…	…	
Residual (3-4) 3/	**35.7**	**41.6**	**33.1**			**38.2**	**39.8**	**40.1**	**38.4**	**39.7**	**37.6**		**35.9**	**31.9**	
o/w exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	23.8			24.6	23.7	22.0	22.5	22.8	22.3		18.2	8.2	
In percent of exports	...	...	31.4			31.7	29.9	27.4	28.2	28.1	27.9		23.9	11.9	
PV of PPG external debt	**...**	**...**	**23.8**			**24.6**	**23.7**	**22.0**	**22.5**	**22.8**	**22.3**		**18.2**	**8.2**	
In percent of exports	**...**	**...**	**31.4**			**31.7**	**29.9**	**27.4**	**28.2**	**28.1**	**27.9**		**23.9**	**11.9**	
In percent of government revenues	**...**	**...**	**96.2**			**100.5**	**99.7**	**94.2**	**99.1**	**98.8**	**95.2**		**77.7**	**35.2**	
Debt service-to-exports ratio (in percent)	**0.8**	**0.8**	**0.8**			**2.3**	**2.4**	**2.9**	**2.8**	**2.9**	**3.1**		**3.3**	**2.0**	
PPG debt service-to-exports ratio (in percent)	**0.8**	**0.8**	**0.8**			**2.3**	**2.4**	**2.9**	**2.8**	**2.9**	**3.1**		**3.3**	**2.0**	
PPG debt service-to-revenue ratio (in percent)	**2.6**	**2.6**	**2.4**			**7.2**	**7.9**	**9.9**	**9.9**	**10.3**	**10.5**		**10.6**	**5.9**	
Total gross financing need (Millions of U.S. dollars)	-126.8	-137.8	-122.7			-140.5	-156.6	-162.6	-151.8	-162.5	-162.6		-189.4	-259.3	
Non-interest current account deficit that stabilizes debt ratio	-36.0	-42.2	-32.2			-38.8	-40.3	-40.5	-38.8	-40.1	-38.0		-36.3	-32.1	
Key macroeconomic assumptions															
Real GDP growth (in percent)	-1.7	-1.2	-0.5	6.7	14.1	0.0	0.2	0.6	0.8	1.0	1.5	0.7	2.0	2.0	2.0
GDP deflator in US dollar terms (change in percent)	0.7	-0.9	4.5	15.5	45.2	3.4	0.6	1.7	3.6	2.0	2.5	2.3	2.0	2.0	2.0
Effective interest rate (percent) 5/	0.7	0.7	0.6	1.6	1.0	2.5	2.2	2.0	2.6	3.0	3.1	2.6	3.8	4.3	4.0
Growth of exports of G&S (US dollar terms, in percent)	5.9	6.5	-1.3	23.4	52.8	5.6	3.3	3.8	3.9	4.2	2.4	3.9	3.0	3.0	3.0
Growth of imports of G&S (US dollar terms, in percent)	-3.3	4.8	-0.7	16.9	44.6	3.9	-2.5	2.2	3.2	1.7	4.3	2.1	3.0	3.0	3.0
Government revenues (excluding grants, in percent of GDP)	21.6	23.6	24.7			24.4	23.8	23.4	22.7	23.0	23.4		23.4	23.4	23.4
Aid flows (in Millions of US dollars) 7/	8.2	24.3	23.5			26.5	33.9	22.2	4.1	4.2	4.4		5.3	7.9	
o/w Grants	8.2	24.3	23.5			26.5	33.9	22.2	4.1	4.2	4.4		5.3	7.9	
o/w Concessional loans	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			7.6	...	...	1.3	1.2	1.2		1.1	...	1.1
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			78.3	...	...	32.5	35.8	40.2		44.2	...	45.5
Memorandum items:															
Nominal GDP (Millions of US dollars)	369.1	361.6	375.9			388.7	391.8	401.0	418.8	431.4	448.7		545.9	808.2	
Nominal dollar GDP growth	-1.0	-2.0	4.0			3.4	0.8	2.3	4.5	3.0	4.0	3.0	4.0	4.0	4.0
PV of PPG external debt (in Millions of US dollars)			89.4			95.5	92.9	88.3	94.4	98.3	100.0		99.3	66.6	
(PVt-PVt-1)/GDPt-1 (in percent)						1.6	-0.7	-1.2	1.5	0.9	0.4	0.4	-0.1	-1.0	-0.3

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 3.Cook Islands: Sensitivity Analysis for Key Indicators of Public Debt 2016-2036

	Projections							
	2016	2017	2018	2019	2020	2021	2026	2036
PV of Debt-to-GDP Ratio								
Baseline	25	24	22	23	23	22	18	8
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	25	21	17	16	14	12	2	-12
A2. Primary balance is unchanged from 2016	25	24	23	23	24	24	22	16
A3. Permanently lower GDP growth 1/	25	25	25	29	33	37	69	229
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	25	27	32	36	40	43	58	86
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	25	25	23	24	24	24	20	11
B3. Combination of B1-B2 using one half standard deviation shocks	25	24	22	23	23	23	21	16
B4. One-time 30 percent real depreciation in 2017	25	35	33	34	34	33	30	24
B5. 10 percent of GDP increase in other debt-creating flows in 2017	25	33	31	32	32	32	28	19
PV of Debt-to-Revenue Ratio 2/								
Baseline	79	73	76	95	95	91	75	34
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	79	67	61	66	58	49	8	-50
A2. Primary balance is unchanged from 2016	79	74	78	98	99	97	89	65
A3. Permanently lower GDP growth 1/	79	77	87	121	136	150	280	910
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	79	83	106	150	165	175	235	352
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	79	76	81	101	101	97	82	47
B3. Combination of B1-B2 using one half standard deviation shocks	79	73	76	96	97	95	86	65
B4. One-time 30 percent real depreciation in 2017	79	107	115	142	141	137	123	98
B5. 10 percent of GDP increase in other debt-creating flows in 2017	79	101	108	134	133	130	115	79
Debt Service-to-Revenue Ratio 2/								
Baseline	5	5	7	9	9	9	8	4
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	6	6	7	8	7	7	5	-1
A2. Primary balance is unchanged from 2016	6	6	8	10	10	10	11	10
A3. Permanently lower GDP growth 1/	6	6	9	11	12	13	21	61
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	6	6	9	12	14	14	18	31
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	6	6	8	10	10	11	11	8
B3. Combination of B1-B2 using one half standard deviation shocks	6	6	8	10	10	11	11	9
B4. One-time 30 percent real depreciation in 2017	6	7	12	14	15	15	17	16
B5. 10 percent of GDP increase in other debt-creating flows in 2017	6	6	9	12	12	12	12	12

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

LIST OF INSTITUTIONS/AGENCIES CONSULTED

Australia and New Zealand Bank (Cook Islands)
Bank of the Cook Islands
Bank South Pacific (Cook Islands)
Business Trade Investment Board
Cook Islands Chamber of Commerce
Cook Islands Civil Society Organisation
Cook Islands Financial Services Development Authority
Cook Islands Investment Corporation
Cook Islands Pricing Tribunal
Cook Islands Tourism Corporation
Cook Islands Tourism Council
Financial Supervisory Commission
Infrastructure Cook Islands
Ministry of Finance and Economic Management
Ministry of Internal Affairs
Ministry of Foreign Affairs and Immigration
Office of the Prime Minister
Office of the Public Services Commissioner
New Zealand High Commission
Seabed Minerals Authority