



Cook Islands

Economic conditions in the Cook Islands continued to deteriorate in 1995. GDP fell sharply, mainly because tourist arrivals were well below those in the previous year. Also, consumer confidence, and hence spending, was seriously affected by a currency crisis in the early part of the year. The Government's financial position became more constrained and it was unable to meet some of its debt-service obligations. Servicing the very high level of public debt incurred over recent years for projects that have yet to generate financial returns continues to present the Government with severe financing problems that need to be addressed by significant restructuring and reduction of public expenditure. Although some reforms in the Government's organizational structure were begun during the year, more rapid progress is needed in reducing the dominance of the public sector in the economy, and in improving the sector's financial and economic management capacity.

Recent Trends and Prospects

The rate of economic growth, which had been about 1.5 percent on average during 1993 and 1994, worsened sharply in 1995 when GDP declined by an estimated 3.7 percent. One reason was that tourist arrivals were more than 20 percent below the already depressed level of 1994. Another was the significant weakening of consumer spending as confidence in the economy ebbed in the wake of the currency crisis that developed in late 1994. The crisis was a consequence of the Government having financed

its deficit by issuing more Cook Islands dollars (CI\$) than could be absorbed by the economy. With persistent rumors of devaluation, there was substantial conversion into New Zealand dollars (NZ\$) and capital flight. The commercial banks reacted by squeezing domestic credit; the volume of housing loans declined and construction activity dried up. In response, the Government decided in March 1995 to revert to the New Zealand dollar as the sole unit of currency and legal tender. The repurchase of CI\$ cost the Government nearly NZ\$4.4 million in foreign reserves, an amount it could ill afford.

The Government's fiscal position remained difficult in 1995 (Figure 2.24). The overall deficit was lower than in 1994, largely because of a substantial decline in development spending. However, the slowdown in economic activity impacted adversely on tax revenue, and some special measures had to be taken to shore up total revenue including deferring payments to private sector suppliers of goods and services. Even so, a debt interest payment due in the latter part of the year was not made.

Information on the external position of the Cook Islands in 1995 is not available. However, although there is likely to have been a fall in the rate of importation consistent with the lower level of economic activity, the very large trade deficit would have been little affected. Exports, though only about 5 percent of imports in 1994, have declined over the past four years, but imports have continued to increase and in 1994 were equal to over 90 percent of GDP. The trade deficit has been covered by services earnings, especially

tourism, official grants and concessional loans, and remittances.

The outlook for the economy in 1996 is not encouraging. Although the decline of GDP experienced in 1995 could be halted, a significant recovery of economic activity is not in prospect. In late 1995, there were signs of improved consumer confidence and the decline in tourist arrivals seemed to be coming to an end. Successful completion of negotiations on the financing of the Sheraton Resort project and the resumption of construction work would give a welcome boost to economic activity. The Government's fiscal position, however, is likely to remain difficult. The 1996 recurrent budget provides for a fall of about 1 percent in both revenue and expenditure. Support from New Zealand of about 11 percent of total revenue will be needed to balance the budget. However, the cash flow deficit apparent in the second half of 1995 seems likely to be even more serious in early 1996 when some debt interest payments are due. The external account position is unlikely to show much improvement. Although

some decline in the rate of importation can be expected, the trade deficit will remain very large and dependence on tourism receipts, private remittances, and official grants will continue to be substantial.

Policy and Development Issues

The most immediate problem facing the Government is that its current revenue flow is insufficient to meet current expenditure, including substantial debt-servicing costs. Various ad hoc measures have had to be taken to meet the situation. Given the existing level of debt at around 110 percent of GDP and the rundown of reserves that occurred in 1995 with the currency crisis, the Cook Islands' borrowing capacity is negligible. With revenue constrained by recessionary economic conditions, timely and decisive measures are needed to bring public expenditure down to within the limits imposed by current revenue.

The external debt situation also needs urgent attention. More than two thirds of the debt including capitalized interest relate to the Sheraton Resort project which is still uncompleted and yielding no return. However, negotiations for rescheduling the debt and completing the project were expected to be concluded in early 1996. More generally, there is a need for the Government to review its debt policy to ensure that it is consistent with a sound macroeconomic framework and that the legal and administrative infrastructure for its management is put in place.

The critical financial position now facing the Government underscores the need for comprehensive reform of the public sector both to reduce its size in the economy and to increase its efficiency, thereby enabling the private sector to play a much greater role than is currently the case. Some tentative steps have already been taken to improve decision-making efficiency, such as amalgamation of some government departments and the distribution of departmental functions on a more rational basis. However, much more remains to be done if management capacity in the public sector is to be raised to the level needed to establish a strong macroeconomic foundation for future growth. An ADB program of technical assistance to the Cook Islands for this purpose will commence in March 1996.

