

I. COUNTRY STRATEGY

1. The Government of the Cook Islands has not formally prepared a national development plan in recent years. The Budget Policy Statement for fiscal year 2003/04 (FY2004) showed the Government's commitment to fiscal discipline with a 10% reduction of the expenditure budget. The Statement reaffirmed the six key national outcomes: (i) continued support for the tourism and marine resources sector to sustain economic growth; (ii) continued emphasis of good governance through transparency and accountability principles to achieve quality services and effective management; (iii) improved health and education standards with special focus on outer island communities to maintain social cohesion; (iv) infrastructure support to meet the demands of economic and social activities; (v) continued devolution of greater authority and responsibility to the island councils where appropriate; and (vi) improved environmental management capacity with the planned enactment of the National Environment bill covering both Rarotonga and the outer islands.

2. The Asian Development Bank (ADB) strategy for the Cook Islands supports the Government's development objectives in cooperation with other development partners. The current Country Strategy and Program Update (CSPU) 2002–2004 focuses on building sustainable capacity for sound economic and public sector management, promoting economic growth, and supporting further private sector development. It has been directed toward the three broad areas of (i) policy reform, (ii) improvement of urban infrastructure, and (iii) outer island development. Given that development of the outer islands has been and will continue to be the focus of other development partners, ADB's involvement in outer island development will be limited to areas where assistance from other development partners is unavailable. The ADB strategy for the period 2004–2006 will be to assist in (i) consolidating the reform achievements through improving economic development planning capacity and reinforcing the rationalization of state-owned enterprises to improve financial returns to the government owner, and (ii) supporting further private sector growth, especially in the tourism sector, through improved public infrastructure facilities to ensure that demands for services are met with appropriate safeguards for environmental requirements. The summary statement of strategy is in Appendix 1.

II. CURRENT DEVELOPMENT TRENDS AND ISSUES

A. Recent Political and Social Developments

3. Since the 1999 election, there have been four coalition governments, with the latest government formed in February 2003. Discussions with nonstate organizations, such as the Chamber of Commerce and a number of nongovernment organizations, revealed a community perception that several of the reform measures have unraveled due to continuing political instability: for example, the lax fiscal discipline in the 2002/03 budget, continuing tax and customs exemptions that were introduced as "transitional" measures, the granting of new exemptions with inadequate consideration of the longer-term impact on government revenue, political intervention in operational public service management, and poor performance by public service managers.

4. The 2002 reports of the Auditor General to Parliament provided evidence of the low regard for legal obligations by politicians and senior public servants, and ineffective sanctions for such behavior through delays in the review process. The establishment of a new political party (Cook Island National Party) and the Group for Political Change is indicative of the level of community disenchantment with the existing political parties and the desire for change. In April

2003, Parliament considered some of the proposals contained in the petition signed by about 2,000 people (representing just under 15% of the population of around 14,000 by the 2001 census) and submitted by the Group for Political Change on the basis of the recommendations made in the report of the Commission for Constitutional Change. The effectiveness of these developments will be seen in the next election, due before September 2004.

B. Economic Assessment and Outlook

5. Economic growth has slowed following 2 years of strong momentum. Real gross domestic product (GDP) increased by only 0.3% in FY2002 (ended 30 June 2002) compared to 5.1% in FY2001, and is projected to grow by 0.4% in FY2003 and 1.0% in 2004. The decline in real GDP growth reflects a downturn in the tourism industry, the key driver of economic activity, in the wake of the September 11 events and due to a general slowdown in the world economy. Visitor arrivals declined by 9% in the first quarter of 2002 but picked up again in the second half of the year. It is expected that the Iraq war and the impact of severe acute respiratory syndrome (SARS) may reduce tourist arrivals by at least 2% in FY2003. Tourism-related subsectors of hotels, restaurants, bars, and transport and communications also experienced weaker sales.

6. Total merchandise exports dropped from US\$9.5 million in FY2001 to US\$5.8 million in FY2002, largely due to an almost 50% drop of sales of pearls, which constitute around 90% of commodity exports. It is projected that pearl exports will pick up again and increase to nearly NZ\$9 million (or US\$5.2 million) by 2005. Total merchandise imports declined by 8.8% to US\$46.3 million due to a decrease in imports of minerals and fuels, beverages and tobacco, and machinery and transport equipment. As a result, the trade deficit narrowed slightly to US\$40.5 million in FY2002 from US\$41.2 million in FY2001. The large surplus on the services trade account will help achieve a sustainable current account balance, with tourism receipts of around NZ\$84 million forming the bulk of services income. Average inflation declined from 9.4% in FY2001 to 3.9% in FY2002, and is expected to level off at about 3.5% in the medium term.

7. Net foreign assets in the banking system at the end of June 2002 were down 7% compared to the previous year. Broad money supply at the end of June 2002 was 3.1% higher than a year earlier. Nominal interest rates on deposits ranged from 1% to 3.25%, while nominal lending rates ranged between 9.75% and 16.50%.

8. The Government is committed to assist the development of the fishing industry and recent figures show that export sales from fishing increased to US\$2.3 million in 2002. Labor shortages remain a challenge for the tourism industry and are also expected to be a constraint for the commercial fishing industry. Preliminary results from the analysis of the 2001 population census indicate that the outward migration to New Zealand and elsewhere is continuing, albeit at a slower rate.

9. Reform of the tax regime with the introduction of a value-added tax (VAT) and reductions in company and income tax rates has been successful in improving economic efficiency and revenue generation. Taxation revenue has almost doubled in the last 5 years from NZ\$33 million in FY1998 to just over NZ\$60 million in FY2002. In FY2002, the Cook Islands recorded a budget surplus of NZ\$0.53 million, equivalent to 0.3% of GDP, but down from NZ\$2.7 million in the previous year. Revenues for FY2003 are expected to show a leveling-off of the collection growth seen in the past several years. Expenditures in FY2002 increased by 6.6%, mainly driven by a 9.2% rise in expenditures on goods and services. Although the FY2003 budget targets an operating surplus of about 2.6% of GDP, an overall deficit of about 2.5% of GDP is likely, reflecting higher capital expenditures and a new superannuation scheme

for Members of Parliament. Government revenue will also decrease in the short and medium term as a result of decisions relating to the removal of levies on imported goods, extending the fuel exemption to subsidize the commercial longline fishing industry and raising the income tax threshold from NZ\$6,000 to NZ\$10,000. The Cook Islands has signed the Pacific Island Countries Trade Agreement (PICTA) and the Pacific Agreement on Closer Economic Relations between PICTA signatories and Australia and New Zealand. These agreements are expected to provide continuing impetus for further tariff reform.

10. Recent budgets have helped consolidate the fiscal position. Net debt in FY2002 declined to 69% of GDP from 76% in FY2000, with the Government maintaining a small reserve for future debt repayments. Loan reserves have grown to US\$8.6 million in FY2002. However, fiscal sustainability remains fragile since debt is still considerable and the economy is small, vulnerable, and heavily reliant on tourism. Although the book value of external debt remains high, much of it is on concessional terms, and servicing is therefore manageable, provided that the fiscal stance remains prudent.

C. Implications for Country Strategy and Program

11. ADB's current operational strategy in the Cook Islands focuses on building sustainable capacity for sound economic, financial, and public sector management, and promoting economic growth through private sector development and outer island development. The strategy for 2004–2006 will focus on building sustainable capacity for sound economic and public sector management, and improving urban infrastructure to meet the needs of commerce and citizens. ADB's involvement in outer island development will be deferred, given that the key constraint is not the availability of funds, but rather the limited capacity of island administration and the inadequate coordination and extension services from various line ministries.

12. Although the need for capacity building in the public sector, especially in outer island administration, is becoming increasingly apparent, it is important to take account of the absorptive capacity and sustainability of training, given labor mobility, competition for skilled labor, and the level of education and demography in the outer islands. Current assistance activities by the United Nations Development Programme (UNDP) and New Zealand Agency for International Development (NZAID) are designed to improve the administrative capacity of outer islands councils and the Office of the Minister for Islands Administration (OMIA). Indications are, however, that such activities may not be sustainable as external agencies and the Government have taken little account of the absorptive capacity of staff and the level of education and skills that can be found in the majority of the outer islands. In recent years, there has been a substantial shift in the allocation of public resources toward the outer islands; funding for capital expenditure for outer island development has averaged around \$6.0 million annually (for a total population just under 5,600 in 2001). That funding is not a constraint is evidenced by the low level of completion of the NZAID infrastructure projects and under spending of the Outer Islands Development Grant Fund every year. The challenge may lie in improving management, project planning, and management skills of the OMIA to enhance the planning, design, management, and coordination of projects, as such skills are missing on the islands. NZAID is providing technical assistance to OMIA in this area.

13. The reform program of the late 1990s recognized the need for improving capacity in public sector economic and financial management. Continuing support has been provided by ADB, Australian Agency for International Development (AusAID), and NZAID to a number of institutions such as the Ministry of Finance and Economic Management (MFEM), Public Service Commission, and Audit Office to enhance capacity of the central agencies to provide advice and

leadership as well as strengthening the capacity of line ministries to better manage the available resources.

14. The importance of a national strategic development plan is recognized by the Government. Private sector businesses indicated support, especially if such a document is developed with input from the community through a transparent and apolitical process. Capacity to support the initiative does not currently exist in MFEM; policy development and analysis skills are limited in ministries and there is no unit devoted to analysis and prioritization of proposed policies and projects to ensure consistency with the national development priorities before they are considered by the cabinet. The Minister of Finance requested ADB assistance to develop capacity, and implement systems and procedures in this area. It is worth noting that the Prime Minister's office, together with MFEM, are working on the implications of the World Summit on Sustainable Development (WSSD) agreement with a view to identify national sustainable development projects to be funded by development partners.

15. The growth of the tourism industry in Rarotonga and Aitutaki warrants consideration for the further development of public infrastructure in energy, water, and sanitation on the two islands. The Rarotonga Electricity Authority indicated funding needs for the purchase of a new diesel generator in 2005 to meet projected demand. The Authority's analysis revealed that demand for electricity in Rarotonga has doubled in the last 10 years, despite population reduction of a third for the same period. This is due to the increase in the use of household appliances and increased use of air conditioning. A review of the water and sanitation infrastructure on the two islands may be overdue given the recent and projected growth of tourist numbers and the lack of any significant reservoir capacity. The Government acknowledged the need for an investigation to examine the current and projected requirements for water and sanitation services, including a review of the current administrative and commercial arrangements for the provision of these services. Introducing competition and user charge principles into the provision of public utilities will become a major area for policy dialogue.

III. IMPLEMENTATION OF THE COUNTRY STRATEGY AND PROGRAM

A. Progress under the Poverty Partnership Agreement

16. The Cook Islands has already achieved several targets specified in the Millennium Development Goals (MDGs) (Appendix 2, Table A2.1): universal primary enrollment for boys and girls, the elimination of gender disparity in primary and secondary education, low and decreasing child and maternity mortality rates, and access to safe drinking water. However, these achievements need to be closely monitored as falling per capita spending on health and education in recent years may undermine the progress already made. Another challenge is to raise the comparatively low secondary enrollment and retention rates, particularly on the outer islands. A Poverty Partnership Agreement was signed with ADB in 2002, providing a framework for tracking progress toward shared development targets, and ADB, through this partnership, will assist the Government in improving progress toward specific MDGs. The proposed assistance to improve the Government's capacity to develop and maintain a national strategic plan linked to the WSSD Agreement and MDGs will help track achievements in this area, to maintain its positive ranking: among the Pacific Developing Member Countries, the Cook Islands is ranked first on the Human Development Index and second on the Human Poverty Index (See Appendix 2, Table A2.4).