MACROECONOMIC ASSESSMENT SUMMARY: COOK ISLANDS[1]

1. **Growth has declined sharply due to COVID-19 border restrictions.** The Cook Islands economy has enjoyed a sustained period of growth averaging 4.9% of gross domestic product (GDP) between FY2012–FY2019 (ended 30 June 2019), backed by steady increases in visitor arrivals. During this period, annual visitor arrivals rose from under 113,129 in 2011 to a peak of almost 171,550 in 2019, with two-thirds of tourists are from New Zealand and other main source markets include Australia, Europe, and the United States of America. Annual tourism receipts estimated to reach the equivalent of 61.4% of GDP in FY2019. However, with the shutdown of international travels due to the COVID-19 pandemic, GDP is expected to contract by 7.0% in FY2020. If the borders open to New Zealand tourist arrivals in January 2021, then the decline in GDP in FY2021 could be as high as 15.4%, with risks tilted to the downside. These declines are the largest in Cook Islands' history, negatively impacting on employment, business viability, government finances, and social wellbeing of the society. Growth is expected to rebound over the medium term, by 10% on average between FY2022–FY2023, with the return of tourist travelers from New Zealand markets in the first quarter of 2021 under contained travel arrangements. Inflation has remained low at an average of 1.3% during FY2012–FY2019, reflecting general stability in prices of imported commodities.

2. **Infrastructure investments will help to support economic recovery and sustain a positive outlook.** Although growth in tourist arrivals appears to be leveling off after recent years of rapid expansion, construction activity on several major infrastructure projects is expected to continue to support growth in the medium term. However, a short-term deferral of large infrastructure projects due limited funds and restrictions on international travel and domestic movement will constrain construction, which relies heavily on foreign experts and imports of raw materials. Infrastructure upgrades in the airport, renewable energy, water and sanitation, as well information and communications technology sectors are projected to support growth by about 3%–4% of GDP through to FY2023.

3. **Fiscal expansion to finance stimulus packages is seen to result in a temporary reversal of recent surpluses.** The government has achieved fiscal surpluses in 5 of the 8 years during the current period of uninterrupted economic growth. Fiscal discipline has helped contain government expenditure, with recurrent spending steadily declining from the equivalent of 32% of GDP in FY2012 to 29% in FY2019. Stronger revenue mobilization, with the tax-to-GDP ratio rising from 26% to 30% over the same period, also contributed to accumulation of adequate fiscal buffers. In light of the downturn, the government mobilized the Economic Response Plan (ERP) in two phases: (i) NZ$42.6 million ($28.0 million / 8.6% of GDP) for FY2020; and (ii) NZ$89.7 million ($59.0 million / 20.9% of GDP) for FY2021. This is estimated to increase the fiscal deficit to 5.1% of GDP in FY2020 and 33.1% of GDP in FY2021. The expansion is critical to supporting health systems, provide employment support, tax and credit relief for businesses, enable subsidized re-training, income tax reductions, cash support to households and those require to self-isolate, provide capital for countercyclical private sector lending, and tariff discounting for electricity.

4. **Fiscal position to improve in the medium-term.** Despite the weak fiscal position in FY2020 and FY2021, planned public sector reforms geared towards fiscal consolidation is expected to position Cook Islands to improve its fiscal position in the medium term with fiscal surpluses from FY2023. The projected turnaround is underpinned by firm fiscal rules, specifically

[1] The Cook Islands is not a member of the International Monetary Fund and the World Bank Group. This supplementary document replaces the International Monetary Fund assessment letter required for all policy-based operations.

on limiting total public spending growth to no more than 4% per annum and a fiscal deficit ceiling equivalent to 1.9% of GDP. These rules effectively help contain recurrent expenditure increases during periods of large capital investment.

Selected Economic and Fiscal Indicators
(% of GDP, unless otherwise indicated)

Item	FY2019e	FY2020e	FY2021p	FY2022p	FY2023p	FY2024p
Total revenue and grants	**41.0**	**44.4**	**39.7**	**30.9**	**32.4**	**31.3**
Total revenue	39.6	40.1	30.9	29.4	31.0	31.2
of which: tax revenue	29.5	28.2	21.2	24.5	27.0	27.9
Grants	1.4	4.3	8.8	1.5	1.4	0.1
Total expenditure	**35.9**	**49.5**	**72.7**	**33.4**	**30.3**	**29.1**
Current expenditure	29.2	41.8	63.0	27.0	25.4	25.5
of which: wages and salaries	11.0	13.7	16.6	14.1	12.9	12.3
Capital expenditure	6.7	7.8	9.9	6.4	4.9	3.6
Overall balance (including grants)	**5.1**	**(5.1)**	**(33.1)**	**(2.5)**	**2.1**	**2.2**
in $ million	18.5	(16.0)	(93.4)	(8.5)	7.7	8.5
Overall balance (excluding grants)	3.7	(9.4)	(41.8)	(4.0)	0.7	2.1
in $ million	13.0	(29.6)	(118.2)	(13.5)	2.6	8.3
Memorandum items						
Gross Public Debt (external)	20.6	21.0	46.2	44.0	40.2	36.6
Net Public debt (external)	16.7	16.9	43.8	42.1	38.5	35.0
Debt service ratio (% of revenue and grants)	6.8	5.1	9.2	7.5	6.1	9.3
GDP (NZ$ million, current prices)	538.8	496.8	429.6	515.6	567.1	596.4
GDP ($ million, current prices)	359.2	313.6	282.5	349.7	378.1	397.1
Exchange rate used	1.5	1.6	1.5	1.5	1.5	1.5

( ) = negative, % = percentage, $ = dollar sign, NZ$ = New Zealand dollar, GDP = gross domestic product, e = estimate, p = projection
Source: Cook Islands Ministry of Finance and Economic Management Fiscal Year 2020/2021 Budget and ADB Staff estimates.

5. **Near-term development financing needs amount to a total of $147.8 million.** During FY2021–FY2022, the Cook Islands' overall development financing needs excluding grants are estimated to be around 40.3% of gross domestic product (GDP), of which 21.8% of GDP will be mobilized from external financing. By FY2023, the government is targeting a fiscal surplus—exclusive of external grants—at the equivalent of 0.7% of GDP.

6. **Public debt is projected to rise in the near-term.** The public debt ratio had been low and on a downward trend in recent years, on the back of sustained growth and budget surpluses. A spike in fiscal expenditure and economic contraction will reverse this trend, causing net debt to increase from 16.7% of GDP in FY2019 to 43.8% of GDP in FY2021.[2] The public debt projection is expected to breach the government's threshold of 35% of GDP although the ADB expects debt to fall back to this level by FY2024. Debt service requirements are seen to rise steadily, but nonetheless remain manageable over the medium-term.

7. **The Cook Islands remains at a low risk of debt distress.** A debt sustainability analysis (DSA) undertaken by ADB in 2020, using the standard methodology employed by the World Bank and International Monetary Fund, conservatively assumed long run growth of 1.7%. The fiscal deficit is expected to improve from 33.1% in FY2021 to a fiscal surplus of 2.2% of GDP in FY2024.

[2] More specifically, the 35% of GDP threshold applies to government's net debt, which is gross debt net of funds in the Cook Islands' loan repayment fund. This reserve fund for debt servicing also includes also includes prepayments by state-owned enterprises on external borrowings on-lent by the government and stood at the equivalent of 3.7% of GDP as of FY2019.

Annual inflation is expected to be muted over the FY2021 to FY2024 period, averaging 0.2%. Given the broad uncertainties in the regional outlook for tourist travel and travel arrangements with New Zealand, the risks are to the downside. The public debt ratio's medium-term forecast between 2021 and 2024 is above the Government's target of 35% of GDP but manageable over the medium term. Public debt is borrowed almost entirely from external sources and is mostly denominated in foreign currency, exposing the economy to New Zealand exchange rate fluctuations. There is significant fiscal and broader economic risk from heavy exposure to disasters triggered by natural hazards, which may disrupt the economic recovery from COVID-19. Fiscal risks are mitigated by the low cost of borrowing, mostly on concessional terms, limited exposure to rollover and interest rate risks, and the utilization of sinking funds to smooth debt servicing. The critical assumption to the modelled outcome surrounds the recommencement of safe tourism travel with New Zealand, with each month of border closure beyond January 2021 reducing GDP by around 3% every month. ADB's assessment corroborates the view that public debt-to-GDP ratio will remain sensitive to the fiscal position and GDP growth projections, however, due to concessional lending it is generally sustainable.

8. **Fiscal prudence remains the key to sustaining economic growth.** As the Cook Islands' adoption of the New Zealand dollar as its currency effectively precludes the conduct of independent monetary and exchange rate policies, fiscal policy is the government's main lever for steering growth and development. Public investment is seen to remain a major driver of economic growth in the Cook Islands, complementing private sector growth mainly centered around the vital tourism sector. It is critical for government to maintain adequate fiscal buffers, not only allow to finance essential public investments, but also to be able to respond to external risks from global economic downturns and the impact of disasters. In this regard, strict adherence to the government's fiscal rules—particularly on maintaining cash reserves covering at least three months of operating expenditures and keeping (net) debt below the equivalent of 35% of GDP—provides a clear pathway toward ensuring fiscal and economic sustainability.

9. **Stimulating private sector investment can support a necessary broadening of the economic base.** Structural impediments must be addressed to promote private sector investment. ADB's 2015 Private Sector Assessment found that while the Cook Islands economy already features many characteristics that support private sector investment, including an internationally competitive tax regime, an open trade regime, and good standards of education and health care, there is still considerable room for further improvement.[3] Government has been able to progress certain initiatives, such as improving the business entry process. Other suggested priorities from the assessment include: (i) strengthening land market functioning and land management processes; (ii) enhancing the efficiency of the financial sector; (iii) promoting gender equality and increased women participation in productive sectors; (iv) strengthening policy and legislative framework around state-owned enterprises; (v) developing a competition policy; and (vi) upgrading core infrastructure services quality and sustainability.

10. **The Cook Islands is highly vulnerable to climate change and disasters triggered by natural hazards.** High disaster risk is due to (i) its geographic location in the South Pacific cyclone belt; (ii) the remoteness and low-lying nature of many of its islands; and (iii) the proximity of many buildings and infrastructure services to the coast, especially on the largest island of Rarotonga. ADB analysis shows that Pacific economies face the highest disaster risk globally in per capita terms, with the Cook Islands at the top of the list with about 4.3 life-years lost per person on average due to the impacts of disasters.[4] Furthermore, global impacts from the COVID-19

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[3] ADB. 2015. *The Cook Islands: Stronger Investment Climate for Sustainable Growth*. Manila.
[4] ADB. 2018. *Economic and Fiscal Impacts of Disasters in the Pacific*. Manila.

pandemic have also negatively impacted the economy with contractions projected for FY2020 and FY2021. To enhance management of the fiscal risk associated with disasters, the government has established a disaster emergency trust fund; participates in insurance schemes under the Pacific Catastrophe Risk Assessment and Financing Initiative and Pacific Catastrophic Risk Insurance Company; and was the first Pacific country to set up an arrangement for contingent financing for disasters through the first phase of the ADB Disaster Resilience Program. The government is also engaging various development partners including to secure financial support to support activities to stimulate the economy.

11. **Disasters pose a further risk to sustainability of tourism-led growth.** The vital tourism sector is vulnerable to natural hazards—including cyclones and flooding and the COVID-19 pandemic, which can disrupt economic activity, lead to loss of livelihoods, and undermine the government's fiscal position. Sustainable tourism requires: (i) factoring disaster resilience into investments in buildings and other infrastructure and health measures; (ii) environmentally friendly and sustainable practices; (iii) strategic infrastructure development to help catalyze private sector investment in new locations around the country. To further mitigate broader disaster-related risks, the government should continue to strengthen policy and institutional arrangements for disaster risk management as a whole of government priority.

12. **Broader public financial management in the Cook Islands is key.** The 2015 Public Expenditure and Financial Accountability (PEFA) assessment undertaken jointly by the Cook Islands Government, the Pacific Financial Technical Assistance Centre, and the Australian Department of Finance highlighted improvements in budget credibility since the previous assessment.[5] Upgrading of information systems has contributed to better budget execution, monitoring and reporting. However, critical challenges remain, including in strengthening internal controls for both revenue and expenditure management; improving the timeliness of external audits; building fiscal buffers and expanding the scope of legislative oversight.

[5] Cook Islands Government, Pacific Financial Technical Assistance Centre, and Australian Department of Finance. 2015.*Cook Islands Public Financial Management–Performance Report*. August.