COOK ISLANDS: DEBT SUSTAINABILITY ANALYSIS[1]

1. **Cook Islands' short-term growth prospects deteriorated because of the COVID-19 pandemic and its impact on the global economy**. Real gross domestic product (GDP) is expected to contract by 7.0% in FY2020 (ending June 2020) and by 15.4% in FY2021, down from 6.3% average yearly growth in FY2015–2019 (Table 1). Growth is expected to rebound over the medium term, to 17.0% in FY2022 and 11.0% in FY2023, with the return of tourist travelers from New Zealand markets in the first quarter of 2021 under contained travel arrangements. Average annual inflation (GDP deflator) is projected at 0.2% in FY2020-2024, down from its recent trend of 1.9%.

2. **Countercyclical policy is expected to deteriorate fiscal balances sharply.** Cook Islands had been recording budget surpluses of average 5.2% of GDP since 2016. However, due to the pandemic, fiscal balances are projected to turn into deficits amounting to 5.1% of GDP in FY2020 and 33.1% of GDP in FY2021. Fiscal revenues will drop significantly, especially from tourism, and public expenditure in support of the domestic economy is expected to spike. The fiscal position is assumed to recover to record a 2.2% average surplus in FY2023–2024.

3. **Higher fiscal deficits will put Cook Islands' public debt on a rising trend.**[2] The public debt ratio had been low and on a downward trend in recent years, on the back of sustained growth and budget surpluses. An abrupt spike in fiscal expenditure and economic contraction is reverse this trend, causing the debt ratio to increase from about 16.7% of GDP in FY2019 to 43.8% in FY2021.[3] Assuming that economic activity and growth will have resumed from FY2022 onwards and fiscal stimulus is unwound, the public debt ratio will gradually decline to around 35.0% by FY2024. The baseline projections of public debt-to-GDP ratio already include expected external lending from the Asian Development Bank (ADB) and the Asian Infrastructure Investment Bank in FY2021(Table 1).

Table 1: Baseline Scenario—Cook Islands: Public Debt Sustainability Assessment
(variables expressed in percentage of GDP, unless otherwise indicated)

	Actual					Est.	Forecast					Avg.	Avg.
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	15-19	20-24
Public Debt	**19.8**	**23.0**	**26.4**	**17.3**	**18.5**	**16.7**	**16.9**	**43.8**	**42.1**	**38.5**	**35.0**		
Macroeconomic Indicators													
Real GDP Growth (%)	3.2	4.5	6.0	6.8	8.9	5.3	-7.0	-15.4	17.0	11.0	2.8	6.3	1.7
Inflation (%, based on GDP Deflator)	-26.5	7.0	-0.3	-1.8	3.7	0.8	0.1	0.0	0.0	0.0	1.0	1.9	0.2
Depreciation of Local Currency against US dollar (%)	-1.1	6.9	16.4	-6.3	-0.3	6.6	6.5	-4.5	0.0	0.0	0.0	4.6	0.4
Interest Rate on Government Debt (%, average effective)	2.0	3.0	2.7	1.5	2.6	2.2	2.4	2.4	2.4	2.1	2.1	2.4	2.3
Fiscal Indicators (General Government)													
Revenue	41.0	39.0	39.1	47.9	44.8	38.8	44.5	39.7	30.9	32.4	31.3	41.9	35.8
Primary Expenditure	40.7	40.0	34.8	35.0	43.0	35.0	48.8	72.8	32.7	29.7	28.5	37.6	42.5
Interest Payments	0.4	0.5	0.6	0.4	0.4	0.4	0.8	1.0	0.7	0.6	0.6	0.5	0.7
Primary Balance	0.3	-1.0	4.3	12.9	1.8	3.8	-4.3	-32.2	-1.8	2.7	2.8	4.3	-6.6
Overall Balance	-0.1	-1.6	3.7	12.5	1.4	3.4	-5.1	-33.2	-2.5	2.1	2.2	3.9	-7.3

Source: ADB staff estimates.

[1] The macroeconomic, fiscal, and debt forecasts for FY2020–2024 are based on data obtained from the ADB Pacific Regional Department (PARD). The debt sustainability analysis is in reference to gross debt of the General Government.

[2] 'Other identified debt creating flows' in Table 2 reflect PARD's assumptions that: cash reserves accumulated at the start of the year will be used to finance fiscal deficits in FY2020; the FY2021 fiscal deficit will be financed by cash reserves and a $15 million grant from the Government of New Zealand; cash reserves will be depleted in FY2022.

[3] The debt figure presented here assumes that the contingent disaster financing to be proposed by the ADB in November 2020 ($20 million) is not withdrawn in FY2021–24.

4. The major contributory factors underlying the changes in public debt are shown in Table 2 and Figure 1.

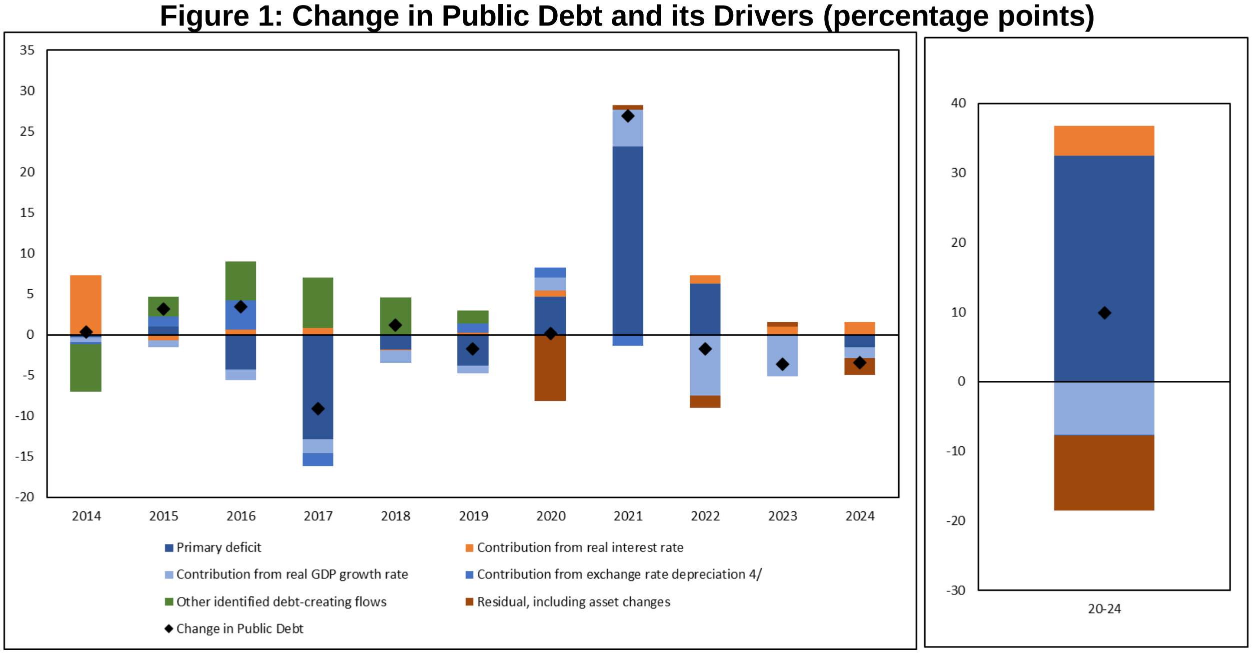
Table 2: Baseline Scenario—Change in Public Debt
(percentage of GDP, unless otherwise indicated)

	Actual					Est.	Forecast					Cum.	Cum.
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	15-19	20-24
Change in Public Debt	**0.3**	**3.1**	**3.4**	**-9.1**	**1.2**	**-1.8**	**0.2**	**26.9**	**-1.7**	**-3.6**	**-3.4**	**-3.1**	**18.3**
Identified debt-creating flows	0.3	3.1	3.4	-9.1	1.2	-1.8	0.2	26.9	-1.7	-3.6	-3.4	-3.1	18.3
Primary deficit	-0.3	1.0	-4.3	-12.9	-1.8	-3.8	4.7	23.2	6.2	0.0	-1.6	-21.7	32.5
Automatic debt dynamics 2/	6.5	-0.4	2.9	-2.4	-1.6	0.5	3.6	3.2	-6.4	-4.1	0.3	-1.0	-3.4
Contribution from interest rate/growth differential 3/	6.7	-1.6	-0.7	-0.8	-1.6	-0.7	2.4	4.6	-6.4	-4.1	0.3	-5.3	-3.3
Of which contribution from real interest rate	7.4	-0.7	0.6	0.8	-0.2	0.2	0.7	0.0	1.0	1.0	1.6	0.8	4.3
Of which contribution from real GDP growth	-0.6	-0.9	-1.3	-1.7	-1.4	-0.9	1.7	4.6	-7.5	-5.1	-1.3	-6.2	-7.6
Contribution from exchange rate depreciation 4/	-0.3	1.2	3.6	-1.6	0.0	1.1	1.2	-1.3	0.0	0.0	0.0	4.3	-0.1
Other identified debt-creating flows	-5.9	2.5	4.8	6.2	4.6	1.6	0.0	0.0	0.0	0.0	0.0	19.7	0.0
Residual, including asset changes	0.0	0.0	0.0	0.0	0.0	0.0	-8.1	0.5	-1.5	0.6	-2.1	0.0	-10.7
Debt-Stabilizing Primary Balance (' - ' means deficit)							3.6	3.2	-6.4	-4.1	0.3		

Source: ADB staff estimates.

Note: 1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP; deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

Figure 1: Change in Public Debt and its Drivers (percentage points)



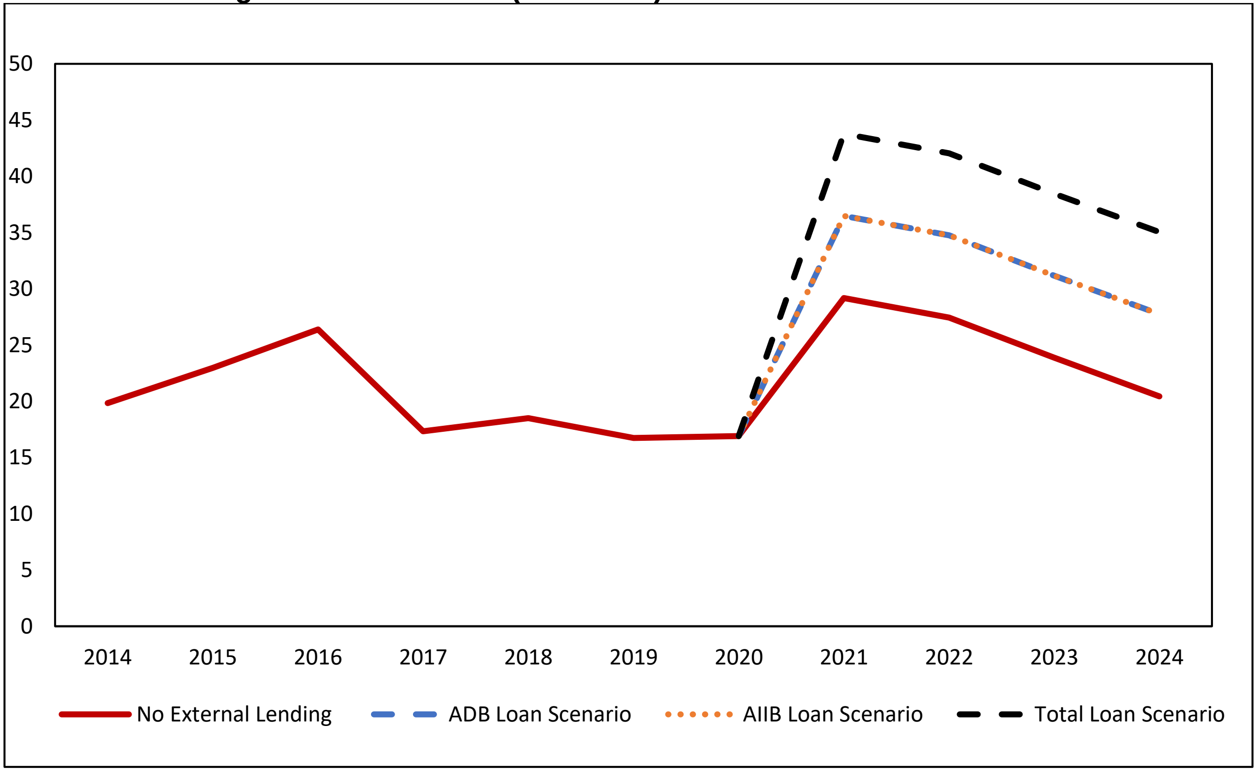
Source: ADB staff estimates.

5. **Financial assistance from ADB raises Cook Islands' public debt ratio but provides the space for countercyclical policy.** An ADB concessional loan in the amount of NZ$30,490,000 (equivalent to $20 million) represents 32.5% percent increase in Cook Islands' outstanding public debt stock of nearly $62 million in FY2019. An additional loan, by the Asian Infrastructure Investment Bank of $20 million, adds another 32.5% to the country's public debt stock. Similarly, it is likely that the ADB will also renew the contingent disaster facility before the

end of FY2021, amounting to an additional $20 million, although it is assumed that this is not drawn down over the FY2020-24 period. Combined with contraction of GDP, total lending from these institutions will lift public debt to 43.8% of GDP in FY2021 before it gradually declines to 35% by FY2024 (Figure 2).

6. **Cook Islands' public debt is generally sustainable, with the key vulnerability relating to tourism arrivals**. The public debt ratio's medium-term forecast between FY2021 and FY2023 is slightly above the government's target of 35% of GDP, although net debt reaches this level in FY2024. Public debt is borrowed almost entirely from external sources and mostly denominated in foreign currency, which exposes the economy to New Zealand exchange rate fluctuations. The government also faces significant fiscal and broader economic risk from heavy exposure to disasters triggered by natural hazards. 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% and placing the fiscal position under increased strain. 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.

Figure 2: Public Debt (% of GDP) with ADB and AIIB Finance



ADB = Asian Development Bank, AIIB = Asian Infrastructure Investment Bank.
Source: ADB staff estimates.