Cook Islands: Technical Assistance Report–Macroeconomic, Financial, and Structural Policies

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COOK ISLANDS

TECHNICAL ASSISTANCE REPORT—MACROECONOMIC, FINANCIAL, AND STRUCTURAL POLICIES

August 2020

This Technical Assistance Report paper on Cook Islands was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in June 2020.

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This document was prepared before COVID-19 became a global pandemic and resulted in unprecedented economic strains. It, therefore, does not reflect the implications of these developments and related policy priorities. We direct you to the **IMF Covid-19 page** that includes staff recommendations with regard to the COVID-19 global outbreak.

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Asia and Pacific Department

COOK ISLANDS

Technical Assistance Report

Macroeconomic, Financial and Structural Policies

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June 2020

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I. BACKGROUND

1. **A mission was requested by the New Zealand authorities to the Cook Islands to focus on policy options for transitioning to high-income status, financial sector stability and regulatory framework, and debt sustainability**.[1] It evaluated these issues in the context of the medium-term outlook and against the context of a recently developed fiscal framework. The Cook Islands is a self-governing territory in free association with New Zealand, but it is not an IMF member (Box 1).

Box 1. Facts about the Cook Islands

- The Cook Islands is a country in "Free Association" with New Zealand, having full control to create its own laws, but New Zealand maintains responsibility for its defense and foreign affairs.
- The Cook Islands consists of 15 small islands, with a population of 17,459 (December 1, 2016, Census 2016) within an Exclusive Economic Zone (EEZ) of 1,800,000 square kilometers of ocean. The population has declined by 2 percent since 2011 (the previous population census). The Cook Islanders are citizens of New Zealand, with rights to live and work in New Zealand and Australia.
- Around 72 percent of the population resides on Rarotonga—the main island and hub of commercial activities and tourism. The islands are geographically scattered, which raises the per capita cost of delivering essential services.
- The New Zealand dollar is legal tender in the Cook Islands. Monetary union with New Zealand has provided monetary and external financial stability. While the Cook Islands could not count on government guarantees from New Zealand, the close political and economic ties help to distinguish the Cook Islands from peers.

2. **Following recent strong economic performance, the Cook Islands will graduate from Official Development Assistance (ODA) in 2020**.[2] In July 2017, the OECD agreed to provide the Cook Islands until the end of 2018 to develop gross national income (GNI) data for the last three years that could determine eligibility for graduation to high-income status. The authorities have worked with donors (including PFTAC) to develop income and balance of payments statistics, along with a rebased GDP (revised up by 10 percent). These show that Cook Islands GNI per capita has been comfortably above the threshold for the last three years, a requirement for graduation.[3]

3. **Assessing the economic conditions in the Cook Islands is challenging**. High quality economic statistics are essential to provide a sound foundation for policy analysis.

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[1] The mission took place in March 2019. The mission team comprised Geoffrey Bannister (APD), Ryota Nakatani (FAD) and Iris Claus (PFTAC).

[2] The Cook Islands government estimates that the impact of graduation on economic growth will be 0.4 percent of GDP (2018/19 Half-Year Economic and Fiscal Update).

[3] As of July 1, 2018, the World Bank threshold for high-income economies was a GNI per capita of $12,055 in 2017, while the estimate made by the Government of the Cook Islands put 2017 GNI at $16,860..

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The national statistics office has made recent improvements in a range of economic statistics, including a rebasing of GDP, initial balance of payments estimates and improved government financial statistics (GFS) accounting. Nevertheless, there are key challenges which require the dedication of additional resources, including trade, inflation, labor market and employment statistics.

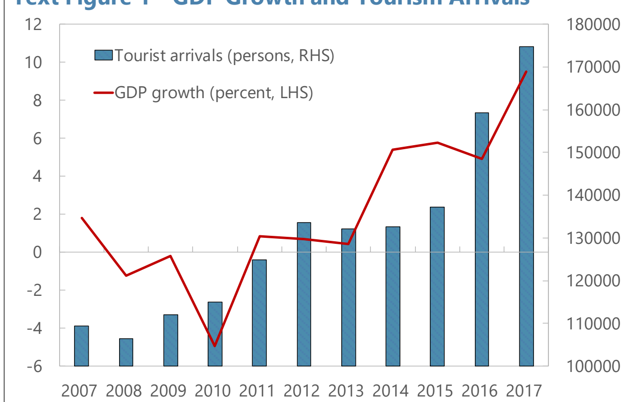
II. Economic Context

A. Recent Developments

4. The Cook Islands economy is highly dependent on tourism. Main source countries include New Zealand and Australia, but arrivals have diversified recently to Europe and North America. The Cook Islands has also sought to diversify its sources of economic activity through the establishment of an international financial services industry (especially for international trusts), and also receives revenue from fishing licenses. Strong recent contributors to economic growth include construction, and government administration. The government has also prepared for the possibility of developing the subsea mineral industry, which could provide a boost to income in the long-term.

5. After a period of slow or negative growth, real GDP has expanded rapidly in recent years. Growth averaged -0.7 percent in 2008-13 but started recovering in 2014 on the back of higher tourist inflows. A recent boom in tourist arrivals and large infrastructure projects have raised economic growth significantly, with real GDP expected to have expanded by about 9 percent in FY17/18 (June to June) while recorded inflation remained relatively stable and low.

Text Figure 1 - GDP Growth and Tourism Arrivals



Sources: National authorities; and IMF staff calculations.

6. As in most small island economies, it is difficult to estimate a trend or potential growth for Cook Islands. The base of economic activity is narrow, and output is inherently volatile. A discussion on medium-term growth prospects is conditioned on efforts to diversify the economy through structural reforms and establish the basis for higher income (see the discussion below). In the short- to medium-term, however, it will be difficult to diversify significantly from tourism. Potential growth is thus limited by current resources, namely the capital stock, including buildings and infrastructure, land, and the pool of potential labor. Together, these factors determine the capacity for expansion in tourism, as well as for construction and other activities. The underlying potential growth rate, as calculated by the government, is about 2½ percent.

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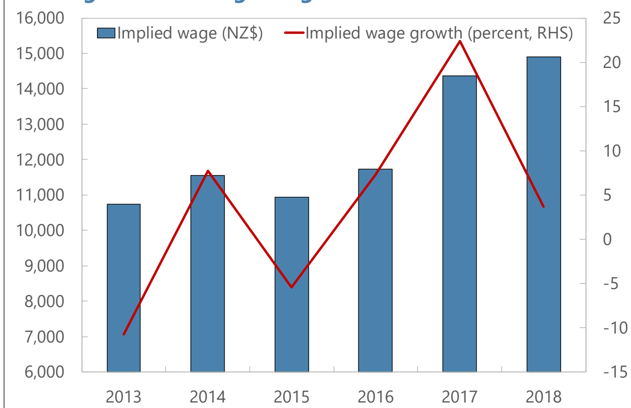
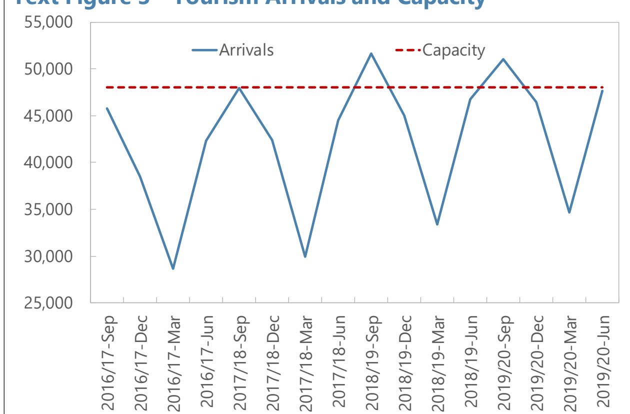
7. **There are clear signs that the economy has reached, and is probably exceeding, its potential growth rate**. Although the recorded consumer price inflation has been on a declining trend from close to 2 percent year-on-year in 2015 to 0.2 percent in June 2019, mainly because of subdued imported inflation (mostly from New Zealand), there are questions about whether the rental component of housing is appropriately captured, and anecdotally rents are said to have risen very quickly in recent years, to similar levels as in New Zealand.[4] There is also evidence of binding capacity constraints emerging in labor markets, particularly in tourism and construction, despite the influx of guest workers from the Philippines and other parts of Asia. While no labor force data are available, a measure of the average wage based on contributions to the Cook Islands Superannuation Fund (Text Figure 2) suggest that wages have risen on average about 8 percent per year from 2015 to 2018.[5] Private investment in tourist housing may have increased capacity somewhat, but not sufficiently to ease constraints. Indeed, the government projects that the tourism industry reached maximum capacity in the high season of 2018 (June) and will continue to reach maximum capacity in the high season going forward through 2019/2020.

Text Figure 2 - Average Wage



Sources: National authorities; and IMF staff calculations.

Text Figure 3 - Tourism Arrivals and Capacity



Sources: National authorities; and IMF staff calculations.

8. **Capacity constraints may also be showing up in the external sector**. Official data show the external current account has moved from a deficit of close to 5 percent of GDP in 2013 to a surplus of 2 percent of GDP in 2017, supported by growing inflows of tourism income, fishing licensing fees and overseas development assistance, which have more than offset a growing trade deficit. But some observers have suggested that imports may be significantly underestimated, which could imply a rising current account deficit.

[4] Including from the use of private homes for short-term tourist accommodations and longer-term rentals to contract staff of tourism operators.

[5] Members and employers each contribute 5 percent of the salary, and an implied wage can be estimated from the value total contributions and the number of members.

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B. Outlook and Risks

9. Given the economy seems to be operating above potential, the near- to medium-term outlook is for slowing growth and higher inflation. The government expects growth to fall to 5½ percent in 2019, and to average around 2½ percent through 2023, based on continued growth in tourism, private investment in tourism accommodation, and public infrastructure investment (mainly financed by grants). This is still well above the potential long-term growth rate. Inflation is expected to rise gradually due to higher imported inflation and growing capacity constraints in the domestic market. As the cost of lodging to increases, reducing competitiveness somewhat, this will bring arrivals closer to sustainable levels. In addition, as growth in New Zealand and the world economy slow, tourist arrivals are expected to continue to grow albeit at a slower pace, which will also lead to more moderate growth.

10. Risks to growth are on the downside. On the domestic side, capacity constraints could become more binding, which would lead to higher inflation and a sharper slowing in the growth of tourism activity. If capacity constraints emerge earlier, public investment growth may also be constrained, which could reduce growth in accommodation capacity of the economy. With land and skilled labor in fixed supply, further growth in tourism would then be more difficult to achieve unless the productivity of services and land use increases.

11. On the external side, risks to the global economy could affect Cook Island's major tourism source markets leading to lower tourism arrivals and growth. These include a significant China slowdown, weaker growth in advanced economies, tighter global financial conditions and a retreat from cross-border integration. The Cook Islands are also uniquely exposed to shocks from the New Zealand economy, through which most of these global shocks would have effect. The Cook Islands also have a high exposure to natural disaster risk due to its geographic location in the South Pacific cyclone belt and the remoteness and low-lying nature of many of its outer islands. The proximity of many buildings and infrastructure services to the coast on the main island of Rarotonga and the concentration of the economy on tourism reinforce the exposure to natural disaster risk.

III. Macroeconomic and Financial Policies

12. Striking a balance between reducing overheating risks and sustaining capacity growth in the economy will be a policy priority. As the Cook Islands has no autonomous monetary policy, managing near-term overheating risks will require active fiscal policy, and developing a fiscal framework that can address the risk of natural disasters and other economic shocks. At the same time, ensuring medium- to long-term growth prospects requires further investment in infrastructure and human capital, and other structural reforms to improve efficiency and productivity growth.

13. The government has put in place many of the policies needed for this balance, but additional steps would help in reducing longer-term vulnerabilities. Recent policy

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initiatives include putting in place a medium-term fiscal framework (see below), and moving towards immigration reform. The government is also investing in essential infrastructure, including an undersea cable that will improve telecommunications capacity significantly, and large water and sanitation projects. To reduce longer-term vulnerabilities will require further cementing disaster resilience and improving the execution of public investment projects, and carefully monitoring risks in the banking system. Improving the business climate, especially for foreign direct investment will also help diversify growth and make it more sustainable.

A. Fiscal Policy and Macroeconomic Stability

Short-term Fiscal Policy and the Medium-term Fiscal Strategy

14. Fiscal policy has been appropriately tight in response to the economic upswing. The fiscal balance moved from a deficit of 8 percent of GDP in FY15 to consistent surpluses in FY16-FY19. This has been achieved through a combination of higher tax and non-tax revenue (due to improvements in administration), and control of the growth of current expenditure (particularly compensation of employees). Excluding grants, the net operating balance (revenue minus current expense) moved from a deficit of 5½ percent of GDP in FY15 to a surplus of 4½ percent of GDP in FY19. As a result, the ratio of gross public debt to GDP has fallen by six percentage points to 19 percent of GDP at end FY19. Net public debt fell to around 15 percent of GDP.[6]

15. The budget for FY20 continues to reflect the government's commitment to sound fiscal management while addressing some key expenditure needs. The net operating balance excluding grants is projected to remain in surplus, though declining to 1½ percent of GDP. This deterioration relative to FY19 reflects mainly an increase in compensation of employees, part of the government's policy to adjust government salaries to reflect an increase in the cost of living in Rarotonga, and the need to provide incentives for highly skilled Cook Islanders to return to the islands. The overall fiscal balance is expected to move into a deficit of 1½ percent of GDP reflecting a large ramp-up of capital investment to 12.7 percent of GDP, of which about two-thirds will be financed through grants. Some of this increase reflects the carry-over of capital projects not completed in FY18, but the priorities remain in infrastructure projects to improve transportation, alleviate water and drainage bottlenecks to facilitate sustainable growth in tourism, and disaster resilience for the outer islands.

16. The Budget also introduces the Medium-Term Fiscal Strategy (MTFS), which lays out a framework for prudent fiscal management going forward. The MTFS forms the basis for the Cook Islands Fiscal Framework 2019-2023. It has been developed with the aim of smoothing government expenditure over the course of the economic cycle while maintaining fiscally sustainable budgets. It is based on a target on net debt as the fiscal

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[6] Gross debt less assets in the Loan Repayment Fund and Stabilization Fund.

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anchor, and fiscal responsibility ratios for the fiscal balance, expenditure growth and cash reserves (see Box 2). The framework provides the fiscal space needed for investment in infrastructure and climate change resilience.[7] The MTFS also includes a strategy to increase revenue without increasing the tax burden, by better tax administration and enforcement of tax legislation.

Box 2. Fiscal Responsibility Ratios Under The Medium-Term Fiscal Strategy (MTFS)

Within the MTFS, the government has revised its Fiscal Responsibility Ratios (FRRs). The MTFS is anchored on a net debt target, and operational rules to achieve the target:

- ***Net debt target***: net public debt should not exceed a soft cap of 30 percent of GDP and cannot exceed a hard cap of 35 percent of GDP.[1]
- ***Fiscal balance rule***: the fiscal balance cannot fall below a deficit of 1.9 percent of GDP. This has been calibrated to allow for a fiscal response to economic downturns or natural disasters while converging slowly to the debt target.
- ***Expenditure rule***: budgeted expenditure cannot grow by more than 4 percent year-on-year in nominal terms. This rule is based on a conservative assumption of nominal potential growth around 4 percent per year for the Cook Islands, so that nominal expenditures grow at the same rate as nominal GDP. Unlike the net debt target and the fiscal balance rule, this rule is not cast in percent of GDP, which is appropriate since annual GDP can be very volatile.
- ***Cash reserves rule***: the equivalent of 3 months of operating expenditure must be held in cash at any one time to face short-term costs of economic shocks or natural disasters.
- ***Exit clause***: the government may breach these rules in the event of a natural disaster and the declaration of a state of emergency, or in the event of a severe economic shock that leads to an expected contraction in GDP of 2 percent or more.

[1] A recent IMF working paper shows how to calibrate a debt target incorporating the costs of natural disasters and climate change. See Nakatani, Ryota (2019). "A Possible Approach to Fiscal Rules – Incorporating Natural Disasters and Climate Change" *IMF Working Paper, 19/186.*

17. The MTFS also contemplates the accumulation of assets for precautionary purposes. It includes the establishment of a ***Stabilization Account*** to accumulate excess cash balances (above four months of operating expenditure) in periods of strong economic growth (nominal growth of 4 percent and above) to be used for additional debt repayments, and to cover operational and capital expenditure during periods of economic contraction (defined as

[7] Net debt is defined as gross debt minus balances held in the government's Loan Repayment Fund, which was set up to ensure a buffer for debt service payments. In 2018 the balances in the Loan Repayment Fund amounted to about 4 percent of GDP and are expected to decline to 2 ½ percent of GDP by 2023.

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real economic growth lower than 1 percent per year).[8] The MTFS also establishes a ***Sovereign Wealth Fund*** to capture revenues expected in the future from seabed minerals harvesting, which is an appropriate intergenerational savings vehicle for revenues from an exhaustible natural resource.

18. The medium-term fiscal scenario under the MTFS ensures fiscal and debt sustainability and will allow fiscal policy to react to economic conditions. Under current expectations for declining growth, the MTFS appropriately accumulates resources to allow for a countercyclical fiscal policy response in case downside risks materialize. Under the current baseline scenario, which aims to bring the overall surplus to 1 percent of GDP in FY23, cash reserves in the current and stabilization accounts would rise from 17 percent of GDP in 2017 to 19 percent of GDP in 2023. This is in addition to the Loan Stabilization Account which is expected to hold 2½ percent of GDP in 2023.

Recommendations:

- **The MTFS should be complemented with a well-designed strategy for resilience to natural disasters.** At the moment Cook Islands has financial arrangements including a Disaster Emergency Trust Fund with a balance of NZ$ 1.7 million, and insurance coverage from the Pacific Catastrophe Risk Assessment and Financing Initiative and a Disaster Recovery Mechanism loan from the ADB which will be triggered and drawn down in the event of a catastrophe. The government has identified a need to review its current disaster financing arrangement. In addition, in line with the recent IMF Board Paper on the topic, the government could consider bolstering the structural resilience of buildings and infrastructure, and building post disaster resilience through contingency planning and putting in place mechanisms that ensure a speedy response in the event of a natural disaster. [9]

- **In the context of graduation from ODA, better planning will be required to address areas where assistance declines**. The authorities' projections do not explicitly account for changes in foreign aid. Assistance peaked in 2017/18 with the provisions of donor funds for large capital projects. While it is anticipated that the Cooks Islands will graduate from ODA in 2020, engagements with donors suggests that this will have only a small impact on aid flows, and the authorities estimate the impact on growth will be approximately 0.4 percent of GDP.

[8] The decision to use funds in the stabilization account for debt repayment will be made with reference to a Debt Management Strategy to be developed in 2019. The 2019/20 budget sets aside NZ$56.7 million to put into the stabilization account.

[9] IMF 2019 "Building Resilience in Developing Countries Vulnerable to Large Natural Disasters".

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Fiscal Structural Reforms

19. The authorities plan to review the revenue regime and continue to work on public financial management (PFM) reforms. A review of the revenue regime is expected with the help of PFTAC in the second half of 2019, with a focus on improving economic and administrative efficiency.[10] The aim of the review will be the eventual development of a Cook Islands Revenue Strategy. On the expenditure side, the Cook Islands has had a PEFA assessment in 2015 and developed a road map for PFM reforms, also with the help of technical assistance from PFTAC. Current focus includes: reforms to enhance the credibility and transparency of the budget; development of a single platform Financial Management Information System (FMIS), which is expected to have been implemented in June 2019; increasing information and planning requirements for procurement of capital investments; accounting, recording, reporting and budget execution; and external audits.

Recommendations:

- **The tax amnesty should be reconsidered**, as it creates incentives for tax avoidance and makes tax administration more costly and complicated.

- **The external auditing of government financial accounts needs to be more timely**, and is an urgent priority. The most recent audits that have been completed are for the 2014 fiscal year. This is partly an issue of capacity, as trained auditors are scarce and hard to attract to the Cook Islands, and there are also particular challenges in helping the external islands to submit accounts.

- **The government should consider raising capacity in planning and execution of capital spending** (particularly procurement) to better manage infrastructure plans going forward. Under-execution of the capital budget and high operating costs are a recurring theme. This is partly a reflection of optimistic budgeting, but also a lack of capacity in the planning and implementation of capital expenditures. The MTFS, presents a four year outlook for the budget which should help with more realistic budgeting and execution. Realistic medium-term forecasts will improve the credibility of the government's budget as a signal of its fiscal program and help smooth expenditure management.

- **An additional overall theme is the need to improve capacity in public administration.** Although Cook Islands has a per-capita income level commensurate with higher income countries, and public administration capacity at a level above most of its peers, because of its remoteness, small size and shortage of skilled labor, capacity in public administration continues to be constrained. Its unique relationship with New Zealand has helped to bring in considerable technical assistance and education, and PFTAC and other donors have also concentrated on public financial management.

[10] The taxation regime was last reviewed in 2012.

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However, the government needs to continue to focus on improvements in public administration capacity as a key measure in its transition to high income status.[11] The 2019/20 Budget priority to raise government salaries to reflect increases in the cost of living and the need to attract returning highly skilled Cook Islanders from overseas is welcome in this regard. Initiating a program of targeted training aided by international financial institutions and exchanges with advanced country partners could also be beneficial.

B. Public Debt Sustainability

20. Background. The Cook Islands experienced a debt crisis in the 1990s. Government payroll had grown to unsustainable levels, and government investments did not produce the expected results. A downturn in tourism led to an economic downturn that brought external debt to 140 percent of GDP. With the help of the ADB and creditor governments, the external debt was restructured and conditions were put in place to safeguard debt sustainability, including fiscal responsibility ratios. With strong adherence to the fiscal rules and prudent fiscal management, the government has managed to bring the debt to GDP ratio down to around 15 percent of GDP in 2007, well below the soft ceiling for net debt of 30 percent of GDP. With the global financial crisis, a loosening of the fiscal rules and restrictions was implemented to create space to provide economic stimulus and much needed public investments to facilitate economic recovery. The gross debt ratio is estimated to have risen to 19 percent of GDP in FY19, and net of assets in the Loan Repayment Account fell to 15.3 percent of GDP.[12]

21. Structure of current debt. The overall public sector gross debt on 30th June 2020 was equivalent to NZ$110.8 million, of which 49 percent was direct crown debt (owed by the central government) and 51 percent were loans held on behalf of state-owned enterprises (SOEs). The largest proportion of the debt is held by the ADB (74 percent) and the Export/Import Bank of China (24 percent). The remaining 2 percent of debt is commercial borrowing. In terms of currency composition, part of the ADB lending is in SDRs (20 percent of total debt). The remaining debt is denominated in New Zealand dollars (39 percent), RMB (24 percent) and US dollars (17 percent). Most of the debt is medium- and long-term, with the average maturity a little over 12 years, and the average effective interest rate is around 3 percent.

22. Debt sustainability under the baseline. During the projection period real growth is expected to average around 4 percent and inflation to remain below 2 percent. Fiscal policy is projected to go from a primary deficit of 1 percent of GDP in 2020 to a surplus of 1.4 percent

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[11] A recent debt rating report from a major rating agency cited: "The vulnerabilities associated with the country's weak policymaking culture and institutional settings are a key ratings constraint."

[12] The stock of debt includes loans drawn down and does not include loans committed but not drawn, largely contingencies for disaster risk management.

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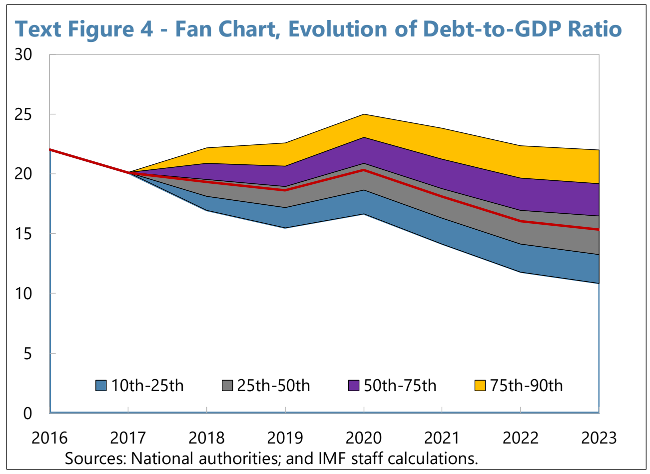

in 2023. The scenario assumes the disbursement of the Undersea Broadband Cable loan (NZ$ 20 million) in 2020 and new debt flows of about NZ$ 5 million every year thereafter. Under these assumptions, the debt ratio is projected to decline to 16 percent of GDP, driven mostly by primary surpluses and real GDP growth (Box 1). A fan chart based on historical averages, variances and covariances of the relevant variables presents a band of possible outcomes under the baseline from a low of 11 percent to a high of 24 percent.

23. Alternative Scenarios. Alternative scenarios suggest that there are some vulnerabilities in the debt structure and, should downside risks materialize, the debt ratio could rise rapidly to unsustainable levels. Under a constant primary balance scenario where the primary balance is kept at the 2019 level throughout the projection period, the debt ratio remains low, falling to 10.5 percent of GDP. Under a historical scenario, with growth, inflation and the primary balance are at their ten year historical averages, gross debt would rise a little above the baseline, to 17 percent of GDP in 2023. Under a natural disaster scenario, where growth falls by two percentage points below the baseline in 2020-21 and one percentage point thereafter, and the primary balance goes to a deficit of between 2 and 4 percent during the projection period, gross debt would rise to 35 percent of GDP by 2023. Under a baseline projection for assets in the Loan Repayment Fund of 2.5 percent of GDP, the net debt would be 33 percent of GDP, above the soft limit but below the hard limit of the medium-term fiscal strategy. The soft limit of 30 percent of GDP for net debt seems appropriately conservative given the risk of shocks from natural disasters, the narrow base and small size of the economy, and is in line with international experience in terms of ensuring debt sustainability.[13]

[13] See for example the IMF and World Bank debt sustainability framework for low income countries (https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf)

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Box 3. Public Debt Sustainability

Cook Islands - Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

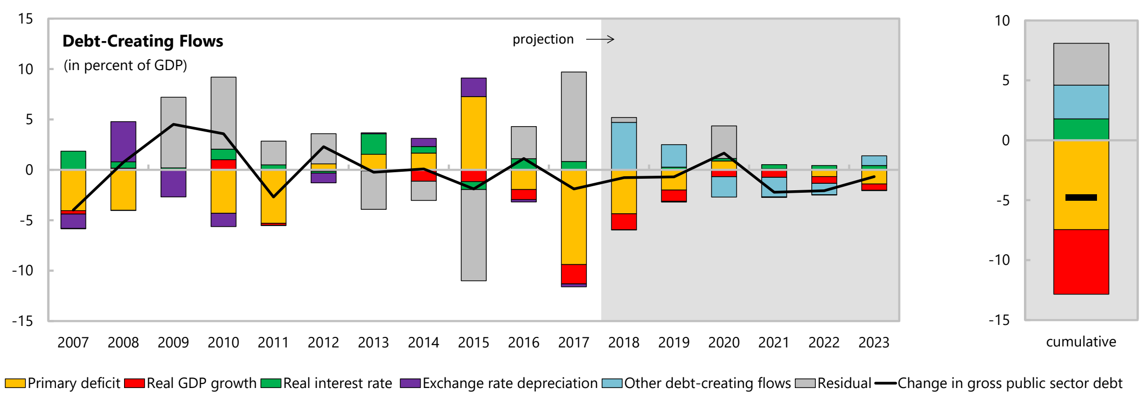
	Actual			Projections					
	2007-2015 [2/]	2016	2017	2018	2019	2020	2021	2022	2023
Nominal gross public debt	20.3	22.0	20.1	19.3	18.6	20.3	18.1	16.0	15.4
Of which: guarantees	4.8	2.3	1.9	1.7	1.5	1.5	1.4	1.3	1.3
Public gross financing needs	1.3	-0.2	-7.6	-2.7	-0.8	2.3	1.9	0.7	0.1
Real GDP growth (in percent)	1.0	4.9	9.5	8.9	6.3	3.8	3.8	3.9	4.0
Inflation (GDP deflator, in percent)	2.7	-2.1	-0.2	3.8	1.7	1.6	1.2	1.1	1.0
Nominal GDP growth (in percent)	3.7	2.7	9.3	13.0	8.1	5.5	5.0	5.0	5.0
Effective interest rate (in percent) [4/]	6.1	3.2	3.9	4.0	3.3	3.2	3.4	3.6	3.8

As of February 03, 2017

Sovereign Spreads		
EMBIG (bp) 3/		na
5Y CDS (bp)		na
Ratings	Foreign	Local
Moody's	B1	B1
S&Ps	B+	B+
Fitch	B+	B+

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.3	1.1	-1.9	-0.8	-0.7	1.7	-2.2	-2.1	-0.7	-4.8	
Identified debt-creating flows	-0.2	-2.1	-10.8	-1.3	-0.6	-1.6	-2.2	-2.0	-0.6	-8.3	
Primary deficit	-0.7	-1.9	-9.4	-4.4	-2.0	0.9	0.1	-0.7	-1.4	-7.5	0.8
Primary (noninterest) revenue and grants	38.0	39.2	38.8	42.1	36.8	39.3	33.6	29.9	27.5	209.3	
Primary (noninterest) expenditure	37.3	37.2	29.4	37.8	34.8	40.2	33.7	29.3	26.1	201.8	
Automatic debt dynamics [5/]	0.5	-0.1	-1.4	-1.6	-0.9	-0.4	-0.3	-0.2	-0.2	-3.6	
Interest rate/growth differential [6/]	0.4	0.1	-1.1	-1.6	-0.9	-0.4	-0.3	-0.2	-0.2	-3.6	
Of which: real interest rate	0.7	1.1	0.8	0.0	0.3	0.3	0.4	0.4	0.4	1.8	
Of which: real GDP growth	-0.2	-1.0	-1.9	-1.6	-1.1	-0.7	-0.7	-0.7	-0.6	-5.4	
Exchange rate depreciation [7/]	0.0	-0.2	-0.3	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	4.7	2.2	-2.0	-1.9	-1.1	1.0	2.8	
Please specify (1) (accumulation of deposits) (negative)	0.0	0.0	0.0	4.7	2.2	-2.0	-1.9	-1.1	1.0	2.8	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroarea loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.5	3.2	8.9	0.5	-0.1	3.2	-0.1	0.0	-0.1	3.5	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees, defined as SOE Debt .

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = 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).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

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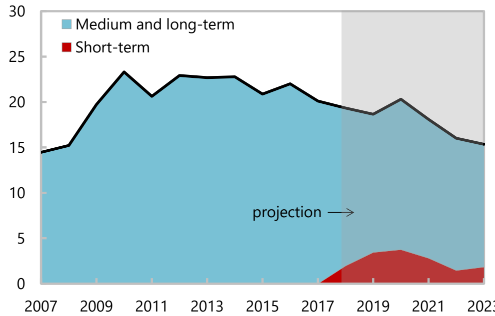
Box 3. Public Debt Sustainability (concluded)

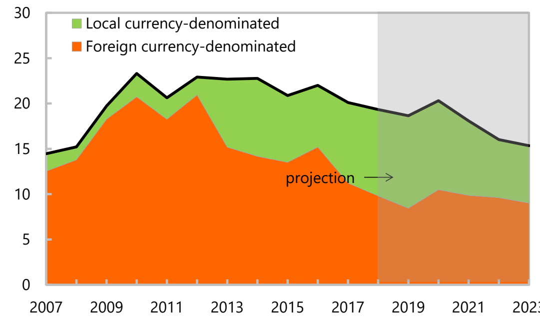
Cook Islands - Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



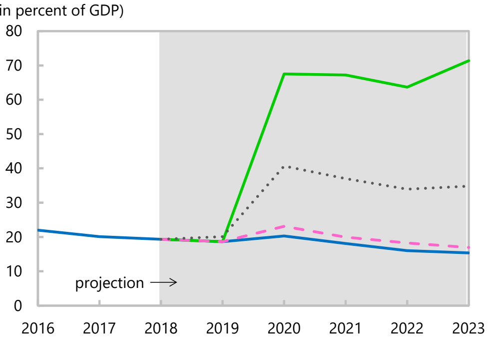
By Currency
(in percent of GDP)



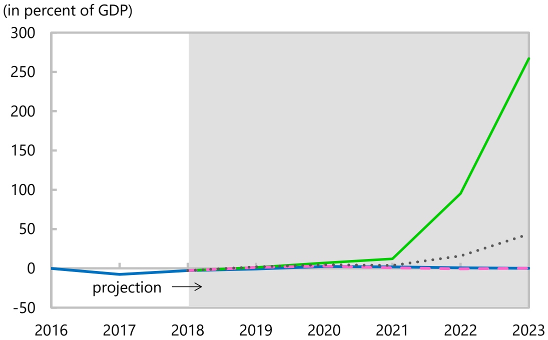
Alternative Scenarios

Baseline
Historical
Natural Disaster
Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	8.9	6.3	3.8	3.8	3.9	4.0
Inflation	3.8	1.7	1.6	1.2	1.1	1.0
Primary Balance	4.4	2.0	-0.9	-0.1	0.7	1.4
Effective interest rate	4.0	3.3	3.2	3.4	3.6	3.8
Constant Primary Balance Scenario						
Real GDP growth	8.9	6.3	3.8	3.8	3.9	4.0
Inflation	3.8	1.7	1.6	1.2	1.1	1.0
Primary Balance	4.4	2.0	2.0	2.0	2.0	2.0
Effective interest rate	4.0	3.3	3.2	3.4	3.7	3.8
Natural Disaster						
Real GDP growth	8.9	6.3	1.8	1.8	2.9	3.0
Inflation	3.8	1.7	1.6	1.2	1.1	1.0
Primary Balance	4.4	2.0	-1.9	-4.1	-3.3	-1.6
Effective interest rate	4.0	3.3	3.2	3.4	3.6	4.0

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	8.9	2.1	2.1	2.1	2.1	2.1
Inflation	3.8	1.7	1.6	1.2	1.1	1.0
Primary Balance	4.4	1.4	1.4	1.4	1.4	1.4
Effective interest rate	4.0	3.3	3.5	4.2	4.4	4.6

Source: IMF staff.

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C. Financial Sector Policies

The Cook Islands Financial Landscape

24. The Cook Islands' financial system comprises about thirty financial entities. They include domestic and international banks, a superannuation fund, insurers, captive insurers, trustee companies, and money changing and remittance businesses. There are three commercial banks: ANZ Banking Group Limited (ANZ) and Bank of South Pacific (BSP) Limited operate as foreign-owned branches, while the Bank of the Cook Islands (BCI) Limited is owned by the government. BCI operates on all islands and channels government subsidies, child benefit and pension payments to beneficiaries, and is responsible for the payment of government salaries. As a result, the number of Cook Islanders with access to a bank account is very high. An additional domestic bank, Capital Security Bank (CSB), is an onshore commercial bank that specializes in providing trust and wealth management services to international clients.

25. The Cook Islands has an offshore international financial services industry that was established in the 1980s. It provides a full range of corporate, trust, and financial planning services including corporate entity formation. International entities are generally prohibited from offering services in the Cook Islands and according to a recent Financial Services Development Authority (FSDA) survey most international entities were established in the Cook Islands for general asset holding purposes.[14] Table 1 shows the number of international companies, partnerships, trusts, limited liability companies, and foundations registered in the Cook Islands for the years ended June 2014 to 2018. Registrations of international entities in the Cook Islands have been declining, except for foundations. International financial services are provided by eight registered trustee companies.

Table 1. International Corporate Entities

Year ended June	2014	2015	2016	2017	2018
International companies	1,090	1,090	1,095	987	931
International partnerships	6	3	4	4	4
International trusts	2,620	2,505	2,373	2,275	2,182
Limited liability companies	383	408	402	365	358
Foundations	5	18	28	52	51

Source: Cook Islands, Financial Supervisory Commission.

[14] he Financial Services Development Authority (FSDA) is responsible for promoting the Cook Islands' international financial services industry. The objective in establishing the FSDA was to encourage, promote, and develop the Cook Islands' financial services industry to achieve sustained growth, which is economically beneficial, socially responsible and reputable.

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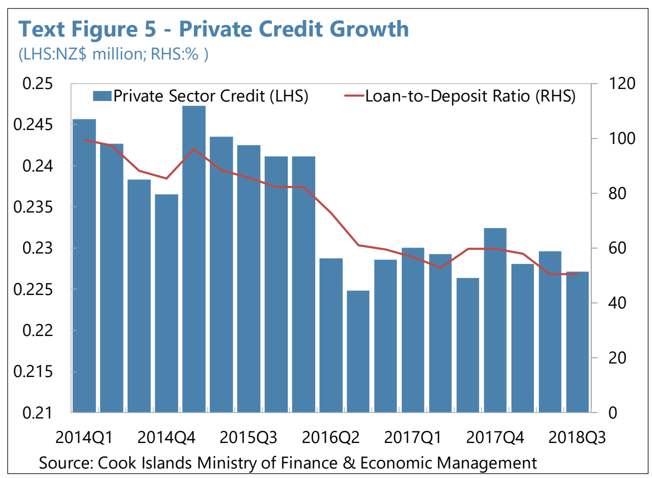
26. The Cook Islands National Superannuation Fund (CINSF) is a compulsory superannuation scheme. It covers all people working in the Cook Islands or employed outside the Cook Islands by an employer resident in the Cook Islands, unless the employer qualifies for a specific exemption. Members and the employers contribute 5 percent each of employees' salaries to the CINSF. Funds are invested and managed in New Zealand and overseas.

27. The Financial Supervisory Commission (FSC) is an independent body that licenses and regulates all financial institutions. It is responsible for the supervision of regulated financial entities and financial services and also operates the registry of international and foreign companies, limited liability companies, international trusts, international partnerships, and foundations.

The Banking System

28. Despite rapid economic expansion, credit is falling in absolute terms. One reason is private sector deleveraging as businesses have used the favorable economic conditions to pay off loans early or refinance.[15] Banks have also not expanded lending rapidly as they are still dealing with a legacy of high non-performing loans and low profitability from the global financial crisis. Non-performing loans have fallen rapidly from 7½ percent of lending in 2015 to 4 percent in 2018. By sector, some growth in credit has taken place in finance and business, and in "personal services" industries, but credit growth has been stagnant or falling in wholesale and retail trade, hotels and motels, and transportation, all sectors one would expect to be associated with the thriving tourist industry. Low credit growth may also be explained by a shrinking population, which has fallen from around 18.7 thousand in 2014/15 to 17 thousand in 2017/18.



29. There are also long-standing structural issues that restrict the growth of credit in the Cook Islands. Although most deposit and lending rates are comparable to New Zealand banks, housing mortgage rates are about 300 to 400 basis points higher. Part of the reason is scale, but the higher spreads are also influenced by the land tenure arrangements

[15] According to banks, the largest corporates on the island have paid back loans early and reduced their liabilities, possibly due to a very liquid environment. In addition, some corporates and individuals with improved credit ratings and prospects have access to credit from mainland New Zealand banks bypassing the local credit market.

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which make it difficult to use land as collateral.[16] Cost of recovery is relatively higher as reflected in the high level of NPLs. Other challenges related to bank infrastructure include the lack of an automated clearance system, and poor internet connectivity which increases the cost and greatly restricts the speed and quality of financial services. The recent introduction of a local credit bureau and a collateral registry should help consolidate information about borrowers, but some market participants suggest that it should be integrated with New Zealand credit bureaus to be more effective.

30. Financial soundness indicators (FSIs) point to a favorable overall risk profile for the banking sector (Table 2). The banks have an aggregate capital adequacy ratio that is relatively high at around 17 percent, well above the regulatory floor of 10 percent, and the banking system is highly liquid. The aggregate loan-to-deposit ratio has fallen from 100 percent in 2014 to 50 percent in 2018 as credit growth has fallen and deposits continue to expand. With an ROE of 15 percent and an ROA of around 1 percent profitability seems adequate compared to advanced country levels, but is low compared to other Pacific island countries.

Table 2. Financial Soundness Indicators (FSI)
(In percent, unless otherwise specified)

	2014	2015	2016	2017	2018
Capital-based FSIs					
Regulatory capital to risk-weighted assets	19.18	16.61	19.52	18.56	17.30
Regulatory tier 1 capital to risk-weighted assets	15.01	13.85	15.93	15.08	14.72
Nonperforming loans net of provisions to capital	29.02	30.71	18.53	17.49	14.55
Nonperforming loans to risk-weighted assets	8.04	7.73	6.37	4.82	3.99
Nonperforming loans to total gross loans	6.79	7.46	5.81	5.27	4.04
Return on equity	18.50	13.17	14.19	18.47	15.16
Net open position in foreign exchange to capital	5.86	11.54	6.21	14.90	18.37
Asset-based FSIs					
Liquid assets (core) to total assets	44.10	46.78	39.71	46.70	50.79
Liquid assets (core) to short-term liabilities	91.58	83.56	65.78	62.52	95.81
Liquid assets (core), in NZ$ thousand	285,700	402,686	341,504	423,784	493,106
Short-term liabilities, in NZ$ thousand	310,876	481,911	519,192	677,869	514,683
Return on assets	1.63	0.97	1.03	1.15	0.95
Nonperforming loans net of provisions, in NZ$ thousand	13,908	15,431	9,690	9,497	7,254
Income- and expense-based FSIs					
Interest margin to gross income	62.35	63.99	64.05	70.83	61.12
Noninterest expenses to gross income	66.64	59.24	66.87	72.30	75.44

Source: Financial Supervisory Commission

[16] Footnote here on customary land arrangements – 60 year leases and the effect on loan recovery.

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The Future of the International Financial Services Industry

31. **In 2015 the Council of the European Union (EU) developed a list of non-cooperative jurisdictions for taxation.** The Cook Islands were evaluated by the EU against tax transparency, fair taxation, and the Organization for Economic Cooperation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) project. One issue raised by the EU is that international companies are exempt from all taxes in the Cook Islands. In December 2018, the Cook Islands Government agreed to amend legislation to tax the profits of international companies and join the Inclusive Framework of the OECD's BEPS project.

32. **Taxing international companies in the Cook Islands will likely lead to the contraction of the international financial services industry with an effect on growth and tax revenues**. Using tax and Cook Islands Statistics Office's data, it is estimated that the disappearance of the international financial services industry would lead to a one-off decline in GDP of between 2.1 and 2.6 percent and a decline in tax revenue of about NZ$3.5 to NZ$4.1 million a year, (about 3 percent of total value added tax (VAT), income and withholding taxes collected in 2018).

33. **One important implication of this development is its effect on the financial position of the Financial Supervisory Commission (FSC)**. The FSC generates most of its regular revenue from licensing, registration, renewal, and other fees paid by international financial service providers. and recently received crown appropriations only in fiscal years 2014 and 2015. Renewal fees contribute between 76 and 80 percent to the FSC's annual revenue. Thus, with the risk that the international financial services industry may contract, an alternative stable source of funding for the FSC would need to be developed.

Supervision, Contingency Planning and Crisis Management

34. **The FSC is charged to maintain the soundness of the financial system.** Its supervisory framework includes all the key elements of a risk-based supervision model:

- **Regulation**: Legislation, prudential standards ("statements" in the Cook Islands), licensing framework;
- **Risk identification and assessment**: Complete off-site and on-site supervision framework;
- **Risk rating**: A risk rating model to derive an overall risk rating from assessment of inherent risk, risk management and controls, and capital support;
- **Supervisory action planning**: A tool to record and prioritize key supervisory actions in response to identified key risks.

Two banks have been put on enhanced supervision over the past few years due to AML/CFT, credit risk and related party lending issues.

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35. The FSC has a close working relationship with Reserve Bank of New Zealand (RBNZ), and has memorandums of understanding with the RBNZ, the Australian Prudential Regulation Authority (APRA) and the Bank of Papua New Guinea (BPNG).

Recommendations:

- **Some inherent risks remain in the banking system that need to be carefully monitored.** The supervisory authorities are aware of these risks and are monitoring them closely. The risks include the concentration risk that comes with operating in a small markets, including the large concentration of credit in the tourism related industries, which is as high as 60 percent (hotels/motels and personal services). Another risk is the large exposure of the government owned bank (BCI) to movements in government balances.[17] A third risk arises from natural disasters. The two international banks could count on head offices to provide liquidity in case of natural disasters, but it might be advisable for BCI to have higher reserves on hand for this kind of event. Its major shareholder appropriately intends to build up cash liquidity reserves.

- **MOUs should also be put in place with the parents of the foreign owned branches.** Bank recovery and resolution are more complex for branches than subsidiaries and it is important that the FSC has adequate legislative powers to manage a bank failure in an orderly manner. Moreover, systemically important banks, i.e. financial institutions that would harm public interest and cause financial instability if failing, should be required to prepare recovery plans to overcome financial distress. The FSC considers BCI to be systemically important. Roles, responsibilities and decision-making processes for dealing with a crisis and the exercise of resolution powers should be agreed among stakeholders and formalized.

- **The MOUs should be expanded to include contingency planning and crisis management**. Banking crisis management should seek to achieve four key objectives:
  - Maintain key financial transactions;
  - Minimize economic dislocation;
  - Promote market discipline and maintain market integrity;
  - Minimize the fiscal costs of failures.

[17] Although BCI emphasized that they have risk models and contingency plans for large movements in government bank accounts.

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D. Structural Policies for Transitioning to High Income

36. The Cook Islands economy faces similar challenges to many small island states, but also has important assets. Small scale, remoteness, the dispersion of the population in outer islands, and a shortage of skilled and unskilled labor constrain economic growth and diversification. At the same time, a stable government, relatively high capacity in public administration, a close association and special relationship with New Zealand, and natural resources for tourism and fishing are assets and present opportunities. Given its small scale and remoteness, it is unlikely that Cook Islands will be able to integrate into global manufacturing value chains as a way to transition to a higher income economy. Therefore the Cook Islands has to think about what other kinds of products or services it can provide to make its way in the world.

37. The path forward economically will most likely be through the provision of services. Already, tourism is the mainstay of the economy, and this should be preserved and enhanced, through branding and upgrading of service. The challenge in tourism is to preserves the charm and niche resort status of the islands without turning them into outposts for large international tourist developments. Enhancing tourist development will require sorting out the use of land and other constraints including labor and communications infrastructure.

38. Another traditional area of specialization for Cook Islands is international financial services, but this is unlikely to supply income growth going forward. The Cook Islands also has a well established international financial services industry, which was innovative in its own right for setting up trusts in the 1980s, but has since been overtaken by financial developments in the rest of the world. The model that Cook Islands began has been copied in other countries, and its special advantage has dissipated. In addition, to preserve its relationship with the European Union the Cook Islands has decided to remove tax advantages for the international financial service industry.

39. The Cook Islands thus needs to diversify its economy and invest in productivity enhancing economic activity to make growth sustainable. Among the more important constraints identified by the mission to this process are:

- **Infrastructure needs**. Rapid growth has laid bare the deficits in infrastructure that the Cook Islands confronts, including in telecommunications, water, sanitation, transportation, and energy. The government is addressing these, including with new legislation, regulations and an active program of public investments.

- **Labor.** With a small population, a rapidly growing economy, and the migration of many younger inhabitants to New Zealand, the Cook Islands faces shortages of both skilled labor and unskilled labor. In the short-term one solution is to allow or encourage increased immigration, which the Cook Islands has already experienced. The mission

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welcomes the development of a new Immigration Bill which is an opportunity to begin to set parameters to manage these inflows of new workers.

- **Land use.** The land tenure system presents challenges to collateralized lending in the Cook Islands, as well as to large scale land developments.

- **Uncertainty of the Investment Environment.** The framework for regulating foreign direct investment in the Cook Islands seems to be restrictive, in that it picks and chooses preferred industries, allows significant discretion in approving projects, and in the case of approval often allows only very narrow sets of activities to be licensed.

40. The highly concentrated nature of economic activity in the Cook Islands presents a risk, and any efforts at diversification will improve the robustness and sustainability of growth. Improving training, water infrastructure and increasing the supply of labor and transportation could facilitate the development of agriculture, some of which previously existed in the Cook Islands, for import-substitution and possibly export. The improvement of telecommunications services could open the door to the development of a number of information and communications technology (ICT) services that could be produced and sold from anywhere on the Cook Islands.

Recommendations:

- **Better management of infrastructure investment and public spending.** There are significant constraints to infrastructure investments, including in executing the current pipeline of projects. The availability of skilled personnel to do planning an preparation work, and project management, could be alleviated by bringing in private sector companies to do some of the work, or through private public partnerships. The government might consider requesting a public investment management assessment (PIMA) or a similar process from donors or from PFTAC, which includes a diagnostic assessment of public investment management institutions and processes, and the implementation of investment.

- **Addressing land tenure and land use issues**. Clarity of land ownership and the rights to land use has been an issue, particularly for banks seeking to lend with land as security. In addition much of the land in Cook Islands is owned by residents in New Zealand. Improving the laws surrounding the use of land will be important in facilitating the more efficient use of this scarce resource on the main island.

- **Continuing to upgrade tourist facilities and services to attract higher income tourists and improve the tourist experience.** This will include new air transportation routes that could lead to diversification of tourist sources, accreditation and control of private accommodations in the Cook Islands, and upgrading existing facilities. There is an opportunity to include transport and accommodations and other tourist services in the outer islands, which could attract significant new tourist flows.

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- **Enhancing communication and transportation links within the Cook Islands (i.e. to the outer islands) and with the rest of the world.** The government already subsidizes air routes into the country from Australia and the U.S.. Improving communications with the undersea cable will be an important advance in allowing access to information resources and flows, which will facilitate private sector activity, including mobile banking and trade flows. Providing regular transportation routes to the outer islands will also be key to developing tourism and trade opportunities.

- **Reforming the Foreign Direct Investment regime**. While there is a rationale for regulating certain kinds of foreign investment, transparent non-discriminatory rules will work best to attract feasible projects and capital for development in the Cook Islands and help the economy become more diversified. Reforming the investment code to open up traditionally closed areas of the economy to foreign investment could help lead to diversification of economic activity.

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