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Cook Islands

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Major Rating Factors

Rationale

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Economic Prospects

Fiscal Flexibility

Monetary Policy and External Finances

Credit Ratings

BB-/Stable/B

Rating History

Long-term foreign and local currency ratings raised to 'BB-'; outlook stable...October 2004

Long-term foreign and local currency ratings raised to 'B+'; outlook positive...August 2003

Outlook revised to positive from stable...October 2002

Long-term foreign and local currency ratings raised to 'B', and short-term foreign and local currency ratings raised to 'B'...May 2000

Long- and short-term foreign currency ratings of 'B-/C' and long- and short-term local currency ratings of 'B-/C' assigned; outlook stable...January 1998

Default History Since 1975

Default on some bilateral, official, and guaranteed external debt occurred from 1995. Most debts were restructured in December 1998, with up to a 50% reduction in the value of original principal. Negotiations over the remaining debt in default are still taking place.

Year

2005

Population

13,200

Per Capita GDP

US\$13,996

Current Government

Prime Minister Jim Marurai heads a coalition government. The Head of State is Her Majesty the Queen, Elizabeth II, who is represented by the Queen's Representative.

Election Schedule

Last general elections...Sept. 2004

Next general elections...2009

Major Rating Factors

Strengths:

- A special relationship, including monetary union, with a highly rated sovereign: New Zealand.
- Good fiscal profile, with regular budget surpluses and a general government net debt burden that is lower than peers.

Weaknesses:

- A small, narrowly based, island economy whose main industry--tourism--faces considerable risks.
- A political culture that, if unchecked by strong administrative and other oversight, could see quick reverses in the better financial position achieved over the past decade.

Rationale

On Dec. 1, 2005, Standard & Poor's Ratings Services affirmed its 'BB-/B' ratings on the Cook Islands. The ratings on the Cook Islands remain constrained by the vulnerabilities inherent in a small, narrowly based, island economy; and by risks to reversals in government finances from a political culture that needs strong administrative oversight.

The dominant industry in the Cook Islands, tourism, is exposed to several risks. These include weather-related disaster; events such as terrorism that adversely affects global tourist flows; air links over which it has no control; and fickle tourist tastes and preferences. For example, the Cook Islands was hit by a series of cyclones in February 2005. Although these cyclones did not harm the government's financial profile significantly, they could easily have done so had they taken a different path. Such incidents underscore the vulnerability of the economy and public finances to events beyond the government's control. With a resident population of just 13,200 and GDP estimated at US\$186 million in fiscal 2005, the Cook Islands is the second-smallest sovereign rated by Standard & Poor's.

Standard & Poor's believes that strong checks and balances are required to limit the government's propensity to consume all available resources. A particular risk could arise from contingent liabilities. Politicians anxious to accelerate development are prone to support projects through off-budget mechanisms such as guarantees and through public enterprises. Such indiscretions led to the collapse in the budget and the economy in 1995 after a call was made on a guarantee the government had hastily extended to a hotel project. There was a subsequent, but minor, episode in 2000, for a guarantee to a shipping company.

Although the Cook Islands' finances are now in good shape, it was only a decade ago that the government defaulted on some bilateral and official debt. External support in the form a debt restructuring agreement and assistance from the ADB and the government of New Zealand was required to get the Cook Islands through that crisis.

Supporting the ratings is the Cook Islands' close political with New Zealand and its improved financial position. The Cook Islands are politically autonomous, but the local residents are dual citizens of New Zealand. This means they can work in New Zealand and have access to New Zealand's welfare system when in that country. It also gives New Zealand a vested interest in the economic viability of the Cook Islands. Monetary union with New Zealand provides monetary and external financial stability. This provides a safety valve when the Cook Islands are hit by economic shocks.

The Cook Islands' financial profile is better than the median of those countries rated in the 'BB' category. General government net debt at June 30, 2005 was 22% of GDP, compared with 109% in fiscal 1997, and 45% for the 'BB' median. This improvement has been achieved by debt restructurings, debt repayments, and the build-up of cash debt-repayment reserves. Because nearly all of the Cook Islands' debt is concessionary, the debt-servicing burden is light. Interest payments in fiscal 2005 were 1.9% of revenue, and principal repayments 3.7% of revenue. Forward schedules of interest payments and debt repayment show no significant increases.

Also supporting the rating is the Cook Islands' income level, which is above the average for this rating category. Estimated GDP per capita of US\$14,000 in fiscal 2005 is substantially higher than the 'BB' median of about US\$2,500. Although the country's politics are often volatile and colorful, there is no history of political violence and the general security environment is good. A vigorous free press, an outspoken business community, and influence from major aid donors provide some pressure on governments to maintain reasonable financial order.

Outlook

The government is expected to adhere to its prudent budgetary program and to uphold past reforms. Given the challenges of a weak economic structure, the administration will need to assert budgetary discipline to strengthen its fiscal position. The ratings could come under pressure if support and commitment to reforms begin to wane, fiscal discipline is prematurely relaxed, or the capacity to check fiscal excesses is compromised. Standard & Poor's believes that one of the advance warning signals for slackening in fiscal discipline would be use of the debt repayment reserves for recurrent expenditure or any 'nation-building' projects.

Table 1 Cook Islands Selected Indicators

| | 'B' median 2005f | 'BB' median 2005f | 2006f | 2005f | 2004 | 2003 | 2002 | 2001 |
|--|------------------|-------------------|--------|--------|--------|--------|--------|--------|
| Per capita income (US\$) | 1,045 | 2,464 | 14,746 | 13,996 | 11,803 | 9,738 | 7,051 | 5,643 |
| Real GDP (% chg.) | 5.65 | 4.21 | 2.67 | 4.00 | 6.78 | 5.29 | 3.73 | 9.1 |
| Real GDP per capita (% chg.) | 3.58 | 3.73 | 3.45 | 5.56 | 9.95 | 12.11 | (1.88) | 13.78 |
| General government balance (% of GDP) | (2.66) | (3.35) | 0.79 | 0.3 | (2.88) | (6.99) | (4.83) | (0.05) |
| General government debt (% of GDP) | 64.61 | 53.58 | 34.82 | 36.41 | 41.32 | 47.02 | 53.36 | 66.82 |
| Net general government debt (% of GDP) | 60.57 | 45.85 | 20.67 | 21.79 | 25.79 | 37.62 | 41.15 | 51.6 |
| Gen. gov. interest expenditure/gen. gov. revenue (%) | 11.63 | 13.05 | 1.49 | 1.62 | 2.81 | 3.28 | 3.75 | 3.86 |
| CPI inflation (average % change) | 6.25 | 5.28 | 2.01 | 2.1 | 1.76 | 2.00 | 3.36 | 8.71 |
| Public sector net external debt/current account receipts (%) | 103.13 | 36.62 | 60.46 | 61.3 | 60.96 | 55.14 | 67.32 | 78.75 |

Comparative Analysis

- Cook Islands is similar to peers in having a narrow and vulnerable economy.
- The fiscal indicators of the Cook Islands are better than peers, with a string of general government fiscal surpluses in recent years compared with peers' persistent deficits, and with general government debt significantly lower than peers.
- Cook Islands' interest burden is also much lower than peers as its debt is mostly concessionary.
- Monetary union, as well as close political and economic ties, with New Zealand distinguishes the Cook Islands from peers.

The Cook Islands is similar to other small developing economies because it is highly exposed to one or two industries and there is a significant government sector. It also has a political system where patronage is widespread. However, the Cook Islands has a very small economy (the resident population is only 13,200) compared with peers, but benefits from a close political, monetary, and economic relationship with a highly rated sovereign (New Zealand; foreign currency AA+/Stable/A-1+), unlike peers.

The Cook Islands defaulted on some bilateral and official debt in the mid 1990s, but its fiscal position has now recovered and is better than peers.

The best comparison for the Cook Islands is the island economies of Grenada (foreign currency BB-/Stable/B) and Papua New Guinea (PNG; B/Stable/B); small countries that are also in monetary unions such as Grenada, Senegal (B+/Stable/B), and Panama (BB/Negative/B); and countries that have a highly rated sovereign government as a patron, such as PNG and Senegal, who receive support in policy and aid from 'AAA' rated Australia and France, respectively.

An economy vulnerable to shocks, but the relationship with New Zealand provides a safety valve

The Cook Islands' economy is dependent on tourism, which is vulnerable to many factors. These include the weather (the Cook Islands is in a cyclone area); access (the Cook Islands is dependent largely on Air New Zealand for its air links); events such as terrorism and SARS, which affect the world tourist market in general; and changing tastes and preferences of tourists.

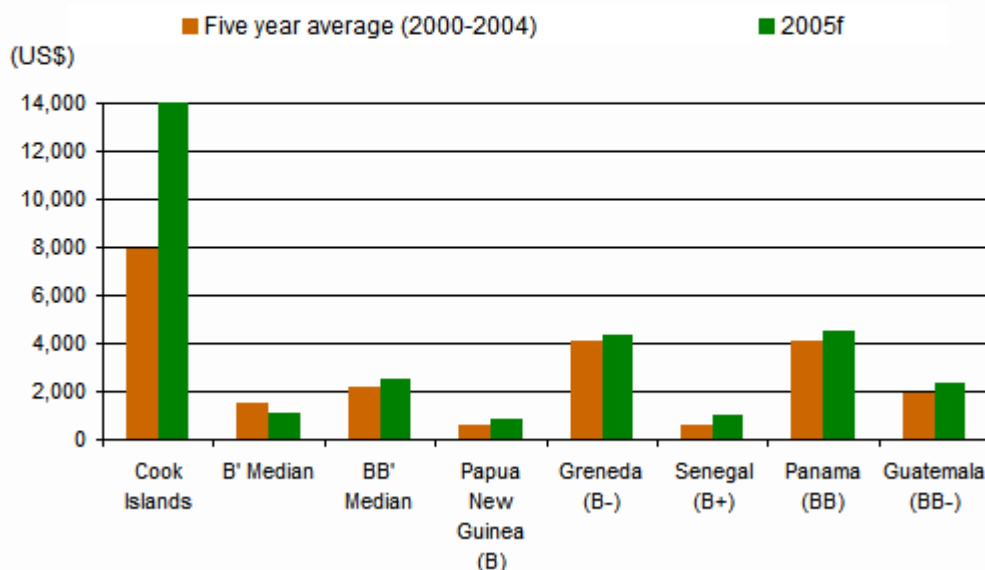
The relationship with New Zealand, however, provides more support to the Cook Islands in times of economic shocks than does that of PNG with Australia or Senegal with France. This is because Cook Islanders have New Zealand citizenship and can move freely between the Cook Islands and New Zealand. This gives them access to the larger New Zealand (and Australian) labor markets. Moreover, there is already a large community of Cook Islanders in New Zealand, meaning there are no cultural barriers to moving between the two countries. In contrast, without the same freedom of movement between PNG and Australia, or Senegal and France, assistance to these countries in times of economic shocks is limited to aid.

The safety valve of the New Zealand relationship is one factor behind the relatively stable political environment in the Cook Islands. Although politics is personality-based, with shifting allegiances leading to relatively frequent changes of government, as in other Pacific states, politics is conducted peacefully. The absence of political violence and other security risks compares favorably with some other Pacific states such as PNG, Fiji, and the Solomon Islands.

A high level of income for the rating level

At US\$14,000 in fiscal 2005, per capita GDP in the Cook Islands is significantly higher than peers, and higher than the 'BB' median (see Chart 1). Per capita GDP in U.S. dollar terms has risen strongly in recent years due to the 75% appreciation in the New Zealand dollar between 2005 and 2001, but real GDP has also grown strongly in recent years. Even in 1999, before the depreciation and recovery of the New Zealand dollar and the strong growth in the economy since then, U.S. dollar per capita GDP has still been the highest amongst peers.

Chart 1
GDP per Capita



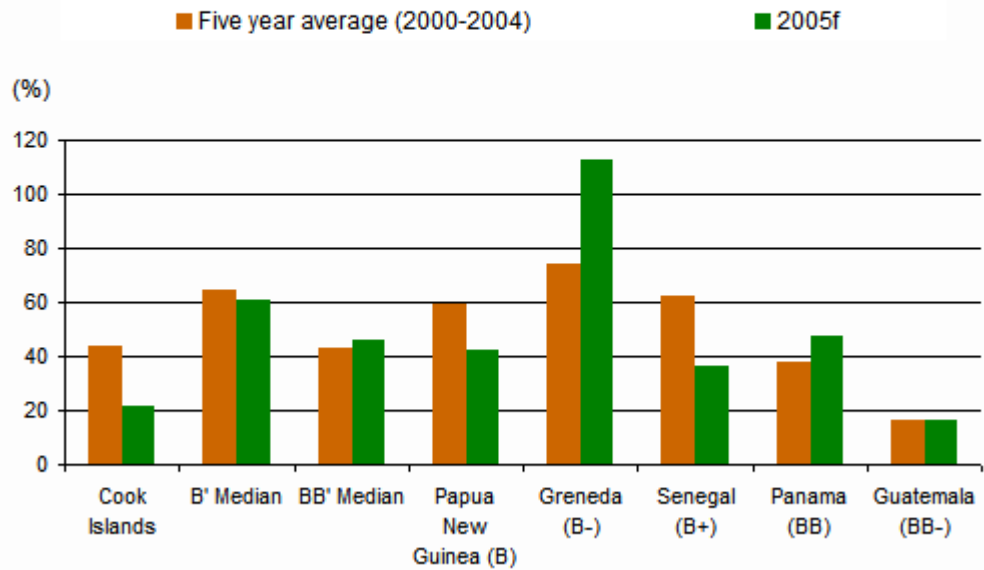
Although the relative economic wealth of the Cook Islands is based on one sector, tourism, this is not uncommon among peers, which also have one or two dominant sectors. Unlike mineral projects, which are dominant in economies such as PNG, the tourism industry in the Cook Islands is relatively well diffused through the economy, with benefits accruing to a broad range of islanders. Only the very small populations in the Outer Islands miss out directly on the benefits of tourism.

Past default constrains the rating, but fiscal indicators are currently favorable

One constraining factor in the Cook Islands' credit rating is its history of default on some bilateral and official debt in the mid 1990s. Recent histories of default have also been a factor in constraining the ratings on Senegal, Venezuela (B+/Stable/B), Pakistan (B+/Stable/B), and Mongolia (B/Stable/B). After a successful Manila Agreement (similar to a Paris Club-type rescheduling exercise) for its debt, the Cook Islands' debt profile is favorable. Moreover, agreement has also been reached with the French government on a rescheduling and a reduction in interest rates on the amount owed to Caisse Francaise de Developpement, which had not been covered by the Manila Agreement.

Since the default, the Cook Islands' fiscal position has improved significantly. Due to a policy of creating debt repayment reserves, net general government debt has fallen to 22% of GDP in fiscal 2005, from 72% in fiscal 1999. This ratio is now significantly lower than its rated peers in the 'BB' category. Its interest burden is very low because nearly all its debt is concessionary. In fiscal 2005 general government interest represented 1.9% of revenues, which is well below the 13% 'BB' median.

Chart 2
Net General Government Debt/GDP



Although the Cook Islands current financial position is good, it would not take much to reverse the fiscal position, a risk that is shared by peers and exacerbated by the very small size of the economy and the government's balance sheet. Commitment by the government to an ill-considered project could lead to fiscal reverses. Similarly, supporting projects through off-budget mechanisms such as guarantees, or through public enterprises, could rapidly harm the fiscal position should the guaranteed project fail.

Part of a monetary union

Another feature that distinguishes the Cook Islands from similarly rated countries is its monetary union with New Zealand. Although the country loses some flexibility by forfeiting monetary independence, it benefits from substantially lower inflation. It also limits the risk of external liquidity stress, which is typical among 'BB' rated sovereigns. As with other sovereigns that have monetary unions, such as Grenada and Senegal, Standard & Poor's makes no rating distinction between the Cook Islands' local and foreign currency debt, as fiscal factors and the absence of a monetary policy tend to make the default risks on both types of debt identical.

Political Environment

- Sound fiscal and economic policy are vulnerable to the nature of the political environment;
- Strong bureaucratic controls, pressure from aid donors, and a vocal local business community will assist in governments maintaining past reforms, despite frequent political changes.
- The policy environment benefits from institutional improvements that include transparency in public policy and finances.
- Constant vigilance and strengthened institutional arrangements are required to curb profligacy.

The political environment is characterized by patronage, personality-based politics and weak party affiliations, and leads to frequent changes of government. This state of affairs creates vulnerabilities in the conduct of sound fiscal and economic policies. Nevertheless, macroeconomic policy has remained broadly consistent with the principles of the recovery package put in place following the fiscal crisis in the mid-1990s.

The Cook Islands has a Westminster-style system of parliamentary government, like most other Commonwealth countries. There are two major opposing political parties, the Cook Islands Party (CIP), and the Democratic Alliance Party (DAP), although both parties have few ideological differences; their policies differ only in emphasis. Personal ties drive party loyalties, and political allegiance is opportunistic at best.

In the September 2004 general election, DAP won a majority of seats, with the remaining seats in the 24-member unicameral parliament going to CIP and one Independent. Jim Marurai replaced Dr. Robert Woonten as the country's prime minister. The Cook Islands has a history of frequent changes in government as party alliances are formed and broken easily. The country has had six coalition governments since June 1999.

Following the fiscal crisis in the mid-1990s an Economic Restructuring Program was put in place with support from the Asian Development Bank and New Zealand. The key elements of this program were a shrinking in the size of the public service, a focus on private sector growth, a restructuring of the tax system with the introduction of a value added tax (VAT), and a strengthening of administrative and institutional checks on government. Successive governments have continued to support the broad principles of the program partly because senior politician from both parties still recall the near-bankruptcy of the government in 1995. However, the implementation of the details of the program, especially the maintenance of fiscal discipline, remains a challenge.

Politicians are under pressure to deliver services to their own constituencies, as well as jobs and economic development; therefore, they are keen to spend whatever money is available. With governments dependent on parliamentary support that may prove transitory, governments find it difficult to deny politicians their wishes. Governments are also vulnerable to supporting, without rigorous analysis, development projects put forward by private parties; this is done often through off-budget mechanisms, such as guarantees or through public enterprises. It was the calling of just such a guarantee, relating to a hotel development, that precipitated the fiscal crisis in 1995.

The acceptable outcomes in fiscal and economic policy, despite the vulnerabilities in the political environment, are due to three main factors. Primarily, policy is kept on track by strong bureaucratic controls, particularly through the Ministry of Finance and Economic Management (MFEM), which has been successful in moderating political 'wish lists' within a reasonable fiscal framework.

Also helping is the country's relationship and monetary union with New Zealand. The agreement is based on a pact of free association agreed to in 1965 when the Cook Islands became self-governing. New Zealand, the former colonial power, retained responsibility for the Cook Islands' defense and some aspects of international relations. New Zealand remains highly influential locally and uses that influence to urge the government to maintain the principles of the economic reform program. With Cook Islanders having New Zealand citizenship and therefore access to the New Zealand labor markets and welfare programs (if they move to New Zealand), New Zealand has a vested interest in the economic success of the Cook Islands.

In addition, the Cook Islands is a vibrant democracy with a free and active press and a vocal business community prepared to vigorously criticize the government over issues that affect it. An attempt to institutionalize government oversight by the private sector through the setting up by legislation of the Public Expenditure Review Committee and Audit (PERCA) committee has not been as successful as had been hoped. Although PERCA does produce reports that are tabled in parliament, they tend to be ignored. A change in the way PERCA operates is currently being implemented to try and give PERCA more authority. Nevertheless, informal private sector monitoring of government remains strong.

Economic Prospects

- The Cook Islands economy is dependent on the tourism industry, and strong tourism growth in recent years has resulted in strong economic growth and high (for this rating category) income levels.
- The tourist industry faces risk from weather, air links, changing tourism patterns, and fewer marketing resources than its competitors.
- The Cook Islands' links with New Zealand--notably its monetary union and integrated labor market--provide a safety net and will continue to help underpin social and economic stability.

Table 2 Cook Islands Economic/Financial Indicators

| (% chg.) | 2006f | 2005f | 2004 | 2003 | 2002 | 2001 |
|---|-------|--------|-------|-------|-------|-------|
| Real GDP | 2.67 | 4.00 | 6.78 | 5.29 | 3.73 | 9.10 |
| CPI | 2.01 | 2.10 | 1.76 | 2.00 | 3.36 | 8.71 |
| Domestic credit to private sector and NFPEs | 16.8 | 14.62 | 33.78 | 33.12 | 23.05 | 14.63 |
| Money supply (M3) | 3.42 | (5.15) | 9.56 | 9.91 | 3.2 | 14.42 |

A narrow economic structure

The Cook Islands' small, narrow, and open economy is vulnerable to external and domestic shocks. Tourism and related sectors drive most economic activity, with tourist receipts accounting for about one-half of nominal GDP. Pearl farming, fishing, and agriculture generate the remainder of foreign earnings.

Global events, including terrorism and SARS, have often dented tourism, but the effects are generally temporary on tourist patterns. Cook Islands is seen as a safe destination and any diversion of tourist from other destinations can easily offset an overall decline in world tourism from global terrorist or other adverse events. For instance, the Bali bombing in October 2002 and political instability in Fiji diverted New Zealand and Australian tourists to the Cook Islands. Other industries are still undeveloped and require foreign investments and major infrastructure overhaul.

Growth strong as tourism thrives despite a series of cyclones in early 2005

Economic growth has been strong since 2000 on the back of a thriving tourist industry. Real GDP growth has averaged 5.8% per year in the five years to fiscal 2005. With the resident population declining over this period, GDP per capita growth has been even stronger, at an average 7.9% per year. In fiscal 2005, the per capita income of the Cook Islands was US\$14,000, which is high for countries in this rating category. The outlook is for steady increases in tourist numbers underpinning economic growth of between 2% and 3% per year.

Despite the success of the tourism industry, it faces several challenges and risks. It is vulnerable to weather, air links, changing tourism patterns, and lack of marketing clout. It benefits, however, from an absence of political violence and the generally secure environment.

The Cook Islands lies in a cyclone belt and a severe cyclone could cause considerable damage to its tourism infrastructure and reputation as a tourist destination. A series of cyclones struck Cook Islands in February and March 2005, but tourism numbers in 2005 were relatively unaffected because the cyclones has little direct impact on tourism infrastructure. Only 8% of the hotel rooms in Rarotonga were unavailable because of damage caused by the cyclones. Although the economy contracted slightly in the January-March quarter of 2005, growth resumed in the following quarter with the rebuilding program.

Adequate air links are vital to the health of the tourism sector. The Cook Islands has limited air links and these are highly exposed to Air New Zealand, which provides the overwhelming majority of flights to and from the islands. Aloha Airlines provides two services a week to Hawaii. Scheduling and pricing by Air New Zealand are critical for visitor numbers and the government maintains close contact with the airline. Air New Zealand's new cheaper Pacific Express fares are expected to boost visitor numbers.

The Cook Islands tourism authorities regard Fiji and Queensland, Australia as its main competitors for tourists. Tahiti is regarded as a different, more expensive market. The Cook Islands is at a disadvantage to competitors because it lacks marketing resources. However, there are growth opportunities. Australia is regarded as a largely untapped market, but to fully exploit this market would require direct flights between Australia and Rarotonga, which are not yet available.

Non-tourism industries struggling.

The Cook Islands' other main export industries of black pearls and fishing have both suffered setbacks in recent years. Black pearl exports fell to only NZ\$3.2 million in 2004, from a peak of NZ\$18.4 million in 2000. Disease and low world prices contributed to this fall, which has had a devastating effect on the economies of the outer islands, where pearl farming is the main industry.

Developing the fishing resource in the Cook Islands' vast ocean territories had been considered a promising avenue, which the government has been promoting heavily. However, after some early success, there have been setbacks because commercial quantities of fish have not been caught consistently.

The Cook Islands has an active offshore banking industry, although its contribution to the economy and government revenues is only modest. In 2005, Cook Islands was removed from the list of the few remaining Non-Cooperative Countries or Territories (NCCT) on money laundering, which is maintained by Financial Action Task Force (FATF, an offshoot of the G7 industrialized countries). The government passed nine pieces of legislation, including setting up a Financial Intelligence Unit, to comply with the requirements to be removed from the list. However, the country remains on FATF's monitoring list. The industry maintains that its main activity, asset protection, will not be adversely affected by the new legislation and removal from the list.

New Zealand provides a safety net.

Cook Islanders' dual citizenship with New Zealand provides a valuable employment alternative during local economic difficulties (Resident Cook Islanders number 13,200, while those in New Zealand number about 50,000). On the other hand, dual citizenship is hollowing out the economy by encouraging emigration. Despite recovery from the fiscal crisis in the mid-1990s, the thinning population presents a problem of labor shortage. The migration pattern has been from the outer islands to Rarotonga, the main and most developed island in the group. People have then subsequently gone to New Zealand in varying numbers, determined by factors such as relative growth prospects and income levels, as well as lifestyle choices. There is also a pull from Cook Islanders' access to New Zealand's generous welfare system.

Fiscal Flexibility

- The fiscal position has improved, with regular small surpluses and declining net debt.
- Strong administration is nevertheless still required to manage a political culture of spending all available resources.
- The good fiscal position is vulnerable to a lapse in administrative controls on the budget process, off-budget support to projects that subsequently experience difficulty, and poor management of public enterprises and the government-owned Bank of Cook Islands.

| (% of nominal GDP) | 2006f | 2005f | 2004e | 2003 | 2002 | 2001 |
|------------------------------------|--------------|--------------|--------------|-------------|-------------|-------------|
| General government revenue | 33.54 | 36.93 | 33.68 | 33.98 | 37.49 | 40.84 |
| General government expenditure | 32.75 | 36.64 | 36.55 | 40.97 | 42.33 | 40.89 |
| Of which: interest payments | 0.5 | 0.6 | 0.95 | 1.12 | 1.41 | 1.57 |
| General government balance | 0.79 | 0.3 | (2.88) | (6.99) | (4.83) | (0.05) |
| General government primary balance | 1.29 | 0.9 | (1.93) | (5.88) | (3.43) | 1.52 |
| General government gross debt | 34.82 | 36.41 | 41.32 | 47.02 | 53.36 | 66.82 |
| General government net debt | 20.67 | 21.79 | 25.79 | 37.62 | 41.15 | 51.60 |
| Public sector gross debt | 34.82 | 36.41 | 41.32 | 47.02 | 53.36 | 66.82 |
| Public sector net debt | 19.59 | 20.3 | 23.42 | 35.05 | 38.34 | 48.45 |

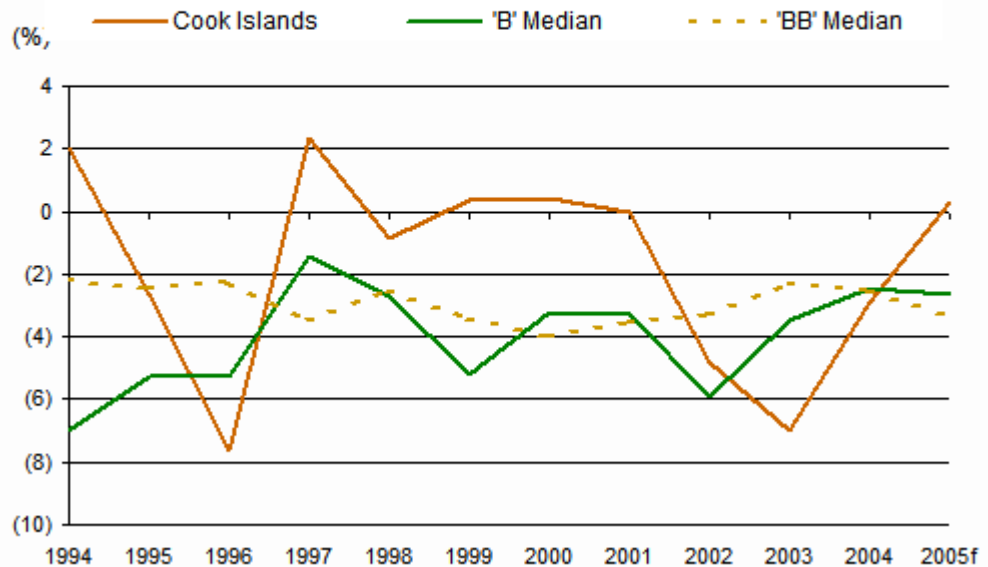
Governments tend to spend all available revenue

Since the fiscal crisis of 1996, small fiscal surpluses have generally been achieved despite a political culture of budgeting to spend all available resources within the year (see Chart 3). This is mainly due to the creation of debt repayment reserves, allocations to which in each budget year are considered 'expenditures' in the budgetary process. In recent years, the actual budgetary outcome has been better than budgeted because a strong economy has delivered revenue above that budgeted. These over-budgeted surpluses are not, however, permanently banked, but are carried forward to the following year and are treated as available for spending in that year. The deficit in fiscal 2003 was due to the spending of the previous year's sizable surplus.

The tax system, reformed in 1996 with the introduction of a value-added tax (VAT), lower income tax rates, and tighter administration is quite efficient at generating revenue. However, strong revenue does not ameliorate fiscal credit risk because governments tend to spend the money as fast as it comes in. Moreover much of the spending appears to be of poor quality, covering operating, particularly personnel, expenses of the 30 or so ministries, rather than funding much needed development projects.

Aid flows are an important source of revenue, accounting for about 18% of total government revenue in fiscal 2005. New Zealand, Australia, and the European Union are the main aid donors. In addition, the Asian Development Bank has provided a loan to fund a waste-management project, as well as the cyclone recovery program.

Chart 3
General Government Balance/GDP



Net debt has fallen significantly and is manageable.

General government net debt has come down significantly since the 1990s fiscal crisis and at June 30, 2005 was 22% of GDP, compared with 109% at June 30, 1997 (see Chart 4). This has been due to the renegotiation of the debt owed to official creditors and a buildup of debt repayment reserves.

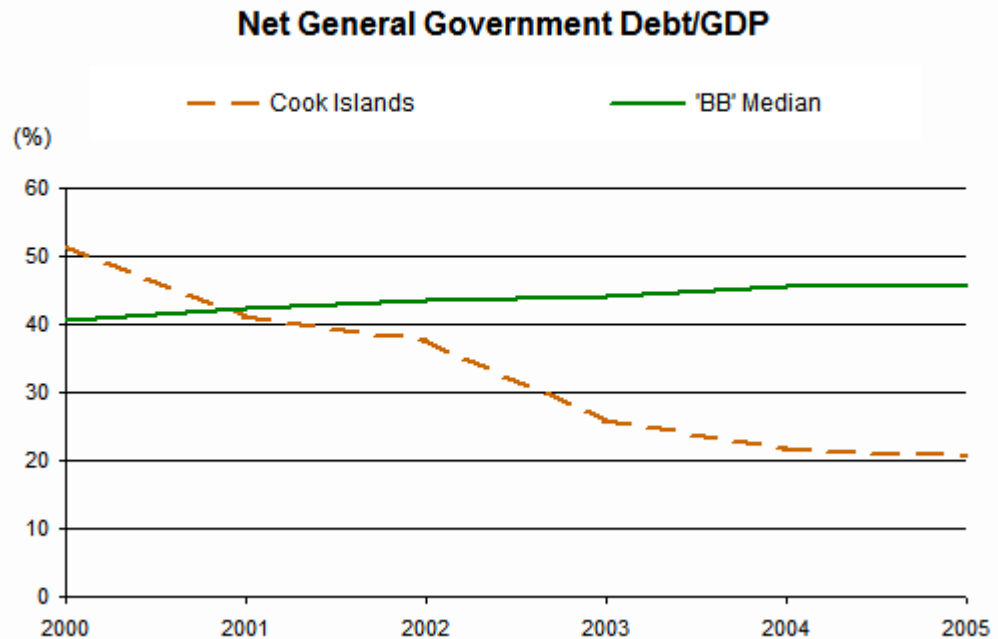
The 1998 Manila Agreement (a Paris Club-type debt rescheduling process) resulted in a significant write-down in the Cook Islands debt to official creditors and other concessions in interest rates and lengthened principle repayment schedules. For example, the debt owed to the Italian export credit agency regarding the guarantee on the failed Vaima'anga Hotel project was restructured under the agreement to NZ\$130 million, down from about NZ\$200 million.

Agreement was reached in fiscal 2004 with the French government on restructuring the NZ\$7 million loan from Caisse Francaise de Developpement. As a result of these restructurings and principal repayments gross debt is now about NZ\$110 million, down from NZ\$152 million in 1997, just before the Manila Agreement and NZ\$123 million just after this agreement.

The repayment schedule agreed in the debt restructuring is also favorable. Principal repayments are budgeted to remain a manageable 3% or lower, despite expiry of the moratorium on principal repayments on the French debt. Interest rates on these loans are concessionary and general government interest in fiscal 2005 is budgeted at only 1.8% of revenue. The interest payment schedule going forward shows no increase in interest payments.

At June 30, 2005, financial assets in the debt reserves were NZ\$18.4 million (compared with gross borrowings of NZ\$97.4 million) and are forecast to grow to NZ\$20.1 million by the end of fiscal 2005. These assets are represented by deposits in the local banks (mainly the local branches of two Australian banks ANZ and Westpac), although there is some held in the government-owned bank of Cook Islands (BCI). Standard & Poor's considers that there would be a risk to the rating if these reserves were spent before they could be used for debt repayment. With the debt repayment schedule set by the debt restructuring agreements, the government is prevented from locking in lower debt by early repayments of debt. Therefore the debt reserve deposits will continue to build up and with it the temptation to use these reserves for some other purpose. Already there has been pressure for the government to place more of its deposits with the BCI to boost the capacity of the BCI to undertake development lending. Should the development loans funded from these deposits run into difficulty the deposits could be at risk.

Chart 4



Contingent liabilities are a significant risk

Although government finances have improved and net debt has come down significantly, risks from contingent liabilities remain considerable. Politicians' excesses, especially their over-ambitious plans and the capacity to grant government guarantees, require astute project analysis and constant vigilance to avoid damaging public finances--particularly given the limited fiscal flexibility and small economy. Indeed, the 1995 fiscal crisis was precipitated by the calling of a guarantee on a hotel project. In late 2000, the government again extended a guarantee to a shipping company, although the damage was limited after due diligence. Currently, some form of government support is being sought for several potential large infrastructure projects such as harbor expansion, airport runway expansion, and projects related to the development of the long-line fishing industry.

Another potential source of risk is the government-owned banks. There had been pressure for BCI to adopt a more aggressive development lending, which implies taking on more risk. However, a review of the operations of the bank in 2003 seems to have allayed that risk for the present. The review resulted in all development financing activity being moved to the new Development Finance Ltd., with all the non-performing loans from the BCI moved to an entity called Former Cook Islands Development Bank Ltd. The charter of the BCI is to focus on commercial banking and in particular to provide a transaction service in the outer islands. The new development bank is not yet operational, and may not become so for some time, as the government will have to provide funds. The BCI is well capitalized, with equity of NZ\$8 million, compared with total assets of NZ\$31.7 million.

ADB review indicates some new borrowing capacity, despite high personnel costs

Under the 1998 Manila Agreement, which restructured the Cook Islands' debt, the Asian Development Bank and the government were to agree a set of prudent financial ratios. In 2002, they agreed that these ratios should not be exceeded: debt as a proportion of GDP, 29%; government personnel costs as a proportion of GDP, 15%; and other (non-personnel) operating costs as a proportion of GDP, 11%.

In fiscal 2005, it is estimated the debt to GDP ratio fell to 22%, well below the recommended ceiling of 29%. In the medium term, this proportion is likely to fall further. Therefore, there is some scope for additional borrowing under these indicative ratios. However, there are no plans to do so. In fiscal 2006, the personnel and other operating costs should respectively be 13.9% and 6.2% of GDP, both below the indicative maximum ratio.

Monetary Policy and External Finances

- The Cook Islands' monetary union with New Zealand ameliorates risks to the rating from monetary and external shocks.

| Table 4 Cook Islands External Indicators | | | | | | |
|--|---------|---------|---------|---------|---------|---------|
| (% of GDP) | 2006f | 2005f | 2004 | 2003 | 2002 | 2001 |
| Current account receipts | 58.65 | 60.46 | 67.92 | 85.44 | 79.62 | 80.77 |
| Current account balance | 6.47 | 7.14 | 10.9 | 14.74 | 15.77 | 13.65 |
| Net foreign investment | 2.47 | 2.58 | 3.5 | 4.35 | 5.04 | 6.31 |
| <i>(% of current account receipts)</i> | | | | | | |
| Trade balance | (64.40) | (64.03) | (61.82) | (60.27) | (57.48) | (62.17) |
| Current account balance | 11.02 | 11.8 | 16.04 | 17.25 | 19.81 | 16.90 |
| Gross external debt | 60.46 | 61.3 | 60.96 | 55.14 | 67.32 | 78.75 |
| Net external debt | 35.01 | 38.01 | 41.76 | 39.2 | 51.82 | 54.02 |
| Gross public sector external debt | 60.46 | 61.3 | 60.96 | 55.14 | 67.32 | 78.75 |
| Net public sector external debt | 35.89 | 36.69 | 38.05 | 44.12 | 51.92 | 60.81 |
| Gross general government external debt | 60.46 | 61.3 | 60.96 | 55.14 | 67.32 | 78.75 |
| Net general government external debt | 35.89 | 36.69 | 38.05 | 44.12 | 51.92 | 60.81 |
| Net financial sector external debt | (25.45) | (23.29) | (19.19) | (15.94) | (15.50) | (24.73) |

Inflation does not match New Zealand's inflation rate exactly, despite the monetary union. Where the price movements of goods or services, particularly important in the Cook Islands economy, are significantly different to the price movements of other goods and services, Cook Islands' inflation rate can diverge substantially from New Zealand's inflation rate. For example, in 2001 the consumer price index (CPI) in the Cook Islands rose 8.7% whereas the New Zealand CPI rose 3.2%. Nevertheless, inflation has been under control, ranging between 1.8% and 3.4% since 2000 (apart from 2001). It is currently running at about 2% per year.

The banking system in the Cook Islands consists of the branches of the Australian banks ANZ and Westpac and the government-owned BCI. Virtually all commercial banking is done through the Australian banks, with the BCI largely a transaction bank with some home, retail, and commercial lending, particularly in the Outer Islands. Loan growth has been strong at 16% in 2004, although it has weakened from an unusually high 57% in 2003. Such strong growth does not pose a risk to the government finances as the Australian banks are not a contingent liability of the Cook Islands government, and the BCI is small and well capitalized.

The country has a large structural trade deficit because of its limited manufacturing, agricultural, and capital base, but faces few balance-of-payment constraints because of its monetary union. The trade deficit is offset by the export of services (in particular tourism), aid inflows, and private remittances, and can often result in small surpluses in the current account. Merchandise exports have fluctuated significantly in the recent years. For example, exports of black pearls fell by 56% in 2002 due to disease and low world prices. Exports of fish increased by 350% in 2003 as exports of fish began, but fell 65% in the next year. An overwhelming three-fourths of imports are sourced from New Zealand.

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