Government of the
Cook Islands

Medium-term Fiscal Strategy

2019/20–22/23

6 December 2018

Prepared by the Economics Division and Budget Management Division, Ministry of Finance and Economic Management.

Table of contents

List of tables

List of figures

1 Executive summary

This paper presents the Cook Island Government's Medium-term Fiscal Strategy (MTFS) for the period 2019/20 to 2022/23. The MTFS forms the base of the Cook Islands Fiscal Framework 2019/20–2022/23 and will be built upon with the development of the Medium-term Budget during 2019. The MTFS has been developed with the aim of smoothing Government expenditure over the course of the economic cycle. It outlines the Government's fiscal commitments over the medium-term, including the fiscal rules that the Government will aim to achieve, economic forecasts and in turn, the expenditure profile.

The Government's medium-term fiscal strategy is to deliver fiscally sustainable budgets. To achieve this the Government commits to:

- Adhere to the fiscal rules on debt, fiscal balance, expenditure growth and cash reserves.
- The development of, and appropriation into, reserve funds (Stabilisation Account and Sovereign Wealth Fund) to ensure that excess revenues are saved for periods of economic downturn or natural disasters, and for future generations.
- An expenditure profile that is steered by the economic context, through the use of internal guiding principles.

The Government's fiscal strategy is underpinned by the following policy elements:

- Investing in infrastructure that will ensure the sustainability of economic growth and the resilience of the economy to climate change.
- Increasing revenue without increasing the tax burden on society, through economic growth and by ensuring that tax legislation is enforced in an equitable manner.
- Investing in the capabilities of Government Agencies to ensure they operate effectively and efficiently.

The Government has revised its Fiscal Responsibility Ratios (FRRs) within the MTFS. The new fiscal rules that Government commits to are as follows:

- **Net debt rule**: net debt should not exceed a soft cap of 30 per cent of GDP, and cannot exceed a hard cap of 35 per cent of GDP.
- **Fiscal balance rule**: the fiscal balance cannot exceed a deficit of 1.9 per cent of GDP.
- **Expenditure rule**: budgeted expenditure cannot grow by more than 4 per cent year-on-year.
- **Cash reserves rule**: the equivalent of 3 months of operating expenditure must be held in cash at any one time.

To accompany the fiscal rules, and to provide greater guidance to the Ministry of Finance and Economic Management (MFEM) in the development of medium-term expenditure ceilings, a number of internal operational guides have also been developed which are outlined in this document.

With a view to improving the fiscal resilience of the Cook Islands against economic shocks and natural disasters, and collecting revenues from seabed minerals harvesting for future generations, two reserve funds are being established in the MTFS.

The first is a Stabilisation Account. This account will hold excess cash and will be used to make additional debt repayments in periods of strong economic growth, and to cover operational and capital expenditure during periods of economic contractions. The second is a Sovereign Wealth Fund, which will capture the revenues expected in the future from seabed minerals harvesting for use by future generations.

The Government is committed to the expenditure profile set out in Table 1 1 over the medium-term, with the fiscal space indicating the amount of additional expenditure that the Government can undertake in each year.

Table 1-1: Fiscal space and total expenditure

$ million	2019/20	2020/21	2021/22	2022/23
Total expenditure	206.3	204.8	205.2	205.2
Fiscal space	8	23	40	40

This expenditure profile has been derived from the fiscal rules and internal operating guides, and as such, meets all of the requirements of the fiscal rules. The profile will guide the development of a medium-term budget that considers the economic and fiscal context as forecast by the Ministry of Finance and Economic Management (MFEM).

2 Introduction and context

2.1 Current fiscal strategy

Fiscal policy is the Cook Islands Government's primary lever to influence economic growth and development due to the adoption of the New Zealand dollar as its currency, which rules out monetary policy options.

The Government's fiscal strategy – with its two main tools of taxes and government expenditure – therefore plays a key role in the sustainable economic management of the Cook Islands, while at the same time being the primary tool for achieving the national sustainable development plan.

The current fiscal strategy, to be replaced by the MTFS, is guided by the fiscal responsibility provisions in Part III of the *Ministry of Finance and Economic Management Act 1995-9*6 (MFEM Act), and a number of supporting fiscal responsibility ratios (FRRs) – or fiscal rules – arising out of the 1998 Manila Agreement with the Asian Development Bank and subsequent reviews. The FRRs establish the key parameters for fiscal management and ongoing budget development:

- **Net operating balance > 0** (in surplus) – this target ensures that the Government is able to afford the operational expenditure required to perform the functions of Government from its own revenue streams.
- **Fiscal balance +/- 2 per cent of Gross Domestic Product (GDP)** – this target ensures that Government does not over extend itself financially. If the fiscal balance is in deficit this must be financed through lending or the use of cash reserves.
- **Debt servicing < 5 per cent of revenue** – ensures the ability of Government to service its debt obligations from revenue collected.
- **Net debt < 35 per cent of GDP** – ensures the level of debt relative to national income, controls the overall level of debt taken on by Government.
- **Cash reserves > 3 months of operating expenditure** – ensures that cash is available to act as a buffer in the case of a liquidity shortage or a natural disaster that impacts the collection of revenue.
- **Tax revenue < 25 per cent of GDP** – ensures Government limits the diversion of resources away from the private sector.
- **Personnel expenditure < 40 per cent of revenue –** controls the expansion in the size of the public sector.

While the FRRs are used to guide budget appropriations for the current budget year and three forward years, a clear expenditure profile and list of fiscal aims has not previously been outlined at the beginning of the budget process, which has served to decrease the application of the FRRs and the quality of medium-term fiscal planning.

In addition, the design of the current fiscal strategy and the FRRs have the potential to encourage Government expenditure to be pro-cyclical, that is, when the economy is growing strongly, the Government receives strong revenues and spends these, which further increases economic growth. Evidence suggests that over the long-term this can raise macroeconomic volatility, depress investment in real and human capital, hamper growth and harm those on low incomes.[1]

This pro-cyclical characteristic is especially relevant at the moment as preliminary business cycle analysis by MFEM indicates that the Cook Islands is currently facing a positive output gap.[2] A formal review of the current fiscal responsibility ratios has been undertaken and can be found in Appendix 1.

2.2 The Cook Islands Fiscal Framework 2019/20–22/23

2.2.1 Objectives

The Cook Islands Fiscal Framework 2019/20-2022/23 (The Framework) is a new fiscal planning and budget process that has been developed by MFEM. The Framework will allow Government to strengthen the strategic focus of its expenditure and tax decisions by incorporating a more robust medium-term perspective that takes into account interactions with the economy. More specifically, this Framework has been established to achieve the following outcomes:

- improve long-term fiscal sustainability; and
- improve medium-term fiscal planning nationally, and within each agency.

Guided by the outcomes, the MTFS forms the base of the Framework by providing the fiscal structure to be utilised over the four forward years. This is supplemented by the development of Medium-term Expenditure Ceilings (MTEC) which will guide the 2019/20 medium-term budget.

2.3 The outcomes of the Medium-term Fiscal Strategy

The MTFS aims to foster long-term growth by smoothing Government expenditure over the course of the economic cycle. This will help deliver macroeconomic stability, encourage private investment and entrench low public debt.

The specific outcomes of the MTFS are:

- fiscal sustainability through responsible fiscal management and debt sustainability; and
- improved linkages between fiscal policy and economic conditions.

The MTFS, together with the MTEC will provide agencies with an indication of the funds available to them for the coming budget year, and the following three years. It is intended that this will improve linkages between national priorities and agency budgets, and improve agencies' ability to undertake planning by providing greater autonomy and certainty.

---

[1] IMF (2016), *Procyclical Fiscal Policy: Shocks, Rules and Institutions – A View from Mars*, available at: https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Procyclical-Fiscal-Policy-Shocks-Rules-and-Institutions-A-View-From-Mars-18789.

[2] For more information, see Estimating the output gap in the Cook Islands – preliminary analysis: Working Paper No. 18/2, available at: http://www.mfem.gov.ck/economics.

2.4 Purpose and structure of this paper

This paper outlines the new Medium-term Fiscal Strategy, including the new fiscal targets, most recent economic forecasts and related aggregate expenditure ceilings.

The paper is structured as follows:

- Section 3 details the Government's commitments in the MTFS.
- Section 4 details the new fiscal rules
- Section 5 outlines the internal operating guides.
- Section 6 provides information on the establishment of the new reserve funds.
- Section 7 outlines the economic forecasts and pulls all of the information together to develop an aggregate expenditure ceiling for 2019/20 to 2022/23.
- Section 8 describes fiscal risks facing the Crown.
- Sections 9 and 10 provide some additional considerations of disaster risk financing and foreign aid.

3 The Medium-term Fiscal Strategy

The Government's Medium-term Fiscal Strategy is to deliver fiscally sustainable budgets. To achieve this the Government commits to:

- Adhere to the fiscal rules on debt, fiscal balance, expenditure growth and cash reserves.
- The development of, and appropriation into, reserve funds (Stabilisation Account and Sovereign Wealth Fund) to ensure that excess revenues are saved for periods of economic downturn or natural disasters, and for future generations.
- An expenditure profile that is steered by the economic context, through the use of internal guiding principles.

The Government's fiscal strategy is underpinned by the following policy elements:

- Investing in infrastructure that will ensure the sustainability of economic growth and the resilience of the economy to climate change.
- Increasing revenue without increasing the tax burden on society, through economic growth and by ensuring that tax legislation is enforced in an equitable manner
- Investing in the capabilities of Government Agencies to ensure they operate effectively and efficiently.

The Government commits to achieving balanced budgets as of the 2019/20 Budget, with a fiscal surplus to be achieved from 2020/21 onwards. This will be maintained while real economic growth remains above 2 per cent.

4 Fiscal rules

4.1 Introduction

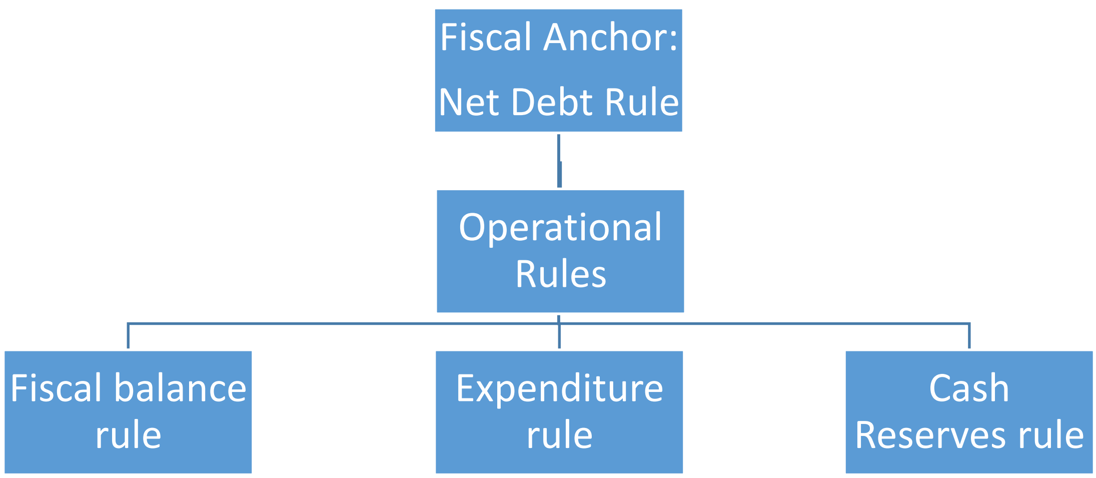
Fiscal rules have been developed as benchmarks for the Government in its aim of achieving fiscally sustainable budgets. In forming the rules, guidance on the criteria for rule development from the IMF has been considered as follows:[3]

- Sustainability: compliance with the rule should ensure long-term debt sustainability.
- Stabilisation: following the rule should not increase (and may decrease) economic volatility. The principle of stabilisation ensures that automatic stabilisers are able to operate.
- Simplicity: The rule should be easily understood by decision makers and the public.
- Operational guidance: it should be possible to translate the rule into clear guidance in the annual budget process.
- Resilience: A rule should be in place for a sustained period in order to build credibility, and it should not be easily abandoned after a shock.
- Ease of monitoring and enforcement: compliance with the rule should be easy to verify, and there should be costs associated with deviations from the targets.

Too many rules can complicate fiscal policymaking and result in overlap and inconsistency of targets. As such, selected rules need to minimise the trade-off between the above criteria.[4]

Based on these criteria, the rule structure set out in Figure 4-1 has been adopted.

Figure 4-1: MTFS rule structure



[3] IMF, 2018a. Fiscal Policy- How to select fiscal rules: a primer. Fiscal Affairs Department, International Monetary Fund, Washington. March 2018.

[4] Ibid.

The new fiscal rules are structured around the fiscal anchor which is linked to the final objective of the fiscal strategy, fiscal sustainability. This rule is used to guide the development of three operational targets. The Government agrees to adhere to the fiscal anchor and the operational rules over the medium-term. These will be frequently measured and published in both the Budget releases and the Quarterly Financial Reports released by MFEM.

Internal guides have also been developed to support the application of the rules (see Section 5). These are not binding and will not be published, however they will be used by MFEM to develop the aggregate expenditure ceiling and the MTEC.

The fiscal rules have been developed using guidance from IMF.[5] For an explanation on the development of the fiscal rules, including formulae, see the MTFS technical paper – Fiscal Tool 2018: Explanatory Note (Technical Paper) available in the Economics Section of the MFEM website.[6]

4.2 Fiscal anchor

Net debt rule: net debt should not exceed a soft cap of 30 per cent of GDP, and cannot exceed a hard cap of 35 per cent of GDP.

The net debt rule has been selected as the fiscal anchor due to its ability to achieve the objective of fiscal sustainability, by providing an upper limit for fiscal slippages.

The fiscal anchor is comprised of a soft and hard net debt target. In the Cook Islands context, net debt is defined as gross debt less funds held in the Loan Repayment Fund. The hard target of 35 per cent of GDP has been maintained to provide a buffer for the soft target of 30 per cent, allowing space for exchange rate shocks or natural disasters. The soft net debt target of 30 per cent of GDP has been used to develop the operational targets. This is based on evidence which suggests that debt levels greater than 30 per cent of GDP have a negative impact on economic growth in countries in the Asia-Pacific.[7]

4.3 Operational rules

Three operational rules have been selected to meet the objectives of the Medium-term Fiscal Strategy:

1. Fiscal balance rule: the fiscal balance cannot exceed a deficit of 1.9 per cent of GDP.
2. Expenditure rule: budgeted expenditure cannot grow by more than 4 per cent year-on-year.
3. Cash rule: the equivalent of 3 months of operating expenditure must be held in cash at any one time.

[5] IMF, 2018b. Fiscal policy: How to calibrate fiscal rules – A Primer. Fiscal Affairs Department, International Monetary Fund, Washington D.C., March 2018.

[6] www.mfem.gov.ck/economics

[7] IMF, 2015. Strengthening Fiscal Frameworks and Improving the Spending Mix in Small States. Asia and Pacific Department, International Monetary Fund, Washington D.C., June 2015: p.5.

These rules have been calibrated according to guidelines provided by the IMF.[8]

4.3.1 Fiscal balance rule

The fiscal balance rule states that the fiscal balance cannot exceed a deficit of 1.9 per cent of GDP in any one year.

This is a nominal budget balance rule and imposes a limit on the headline fiscal balance. Nominal budget balance rules can be very effective in preserving debt sustainability by constraining overall expenditure in each year. However, as they are not adjusted for the economic cycle, they are limited in their ability to foster macroeconomic stabilisation.[9] To address this short-coming an accompanying internal operational guide has been developed to account for the economic cycle.

The fiscal balance rule is calculated so that if the Government repeatedly operated at a deficit of 1.9 per cent of GDP, over the long-term it would reach the net debt rule of 30 per cent of GDP. To avoid reaching the net debt rule, Government will aim to achieve surpluses during periods of economic growth, to allow space for borrowing in periods of economic downturn. For further information on the calibration of this rule see the Technical Paper.

4.3.2 Expenditure rule

The expenditure rule states that 'growth of total Cook Islands Government expenditure cannot exceed 4 per cent year-on-year'. The 4 per cent is to be applied to total expenditure (operating and capital) appropriated in the prior year. The 2018/19 Budget total expenditure appropriation is $207.7 million, therefore the maximum total expenditure in 2019/20 will be $216 million.

The expenditure rule is equivalent to the Cook Islands' long-run growth rate of potential GDP. This is based on the assumption that the 2018/19 Budget Appropriation is generally in line with the structural balance rule and that once in this situation, nominal expenditure should grow at the same pace as nominal potential GDP.[10]

4.3.3 Cash reserves rule

The cash reserves rule has not been amended nor calibrated according to the fiscal anchor and will remain at a requirement of 3 months of operating expenditure. This rule ensures quick and easy access to funds in the case of an economic shock or natural disaster, thus reinforcing the objective of fiscal sustainability.

4.3.4 Exit clause

The Government agrees to abide by the fiscal anchor and operational targets at all times, with two exceptions. The Government may breach these rules only in the event of a natural disaster (and subsequent calling of a state of emergency), or a severe economic shock (defined as real economic growth of negative 2 per cent or less).

---

[8] IMF, 2015. Strengthening Fiscal Frameworks and Improving the Spending Mix in Small States. Asia and Pacific Department, International Monetary Fund, Washington D.C., June 2015: p.5.

[9] IMF, 2018a. Fiscal Policy- How to select fiscal rules: a primer. Fiscal Affairs Department, International Monetary Fund, Washington. March 2018.

[10] IMF, 2018b. Fiscal policy: How to calibrate fiscal rules – A Primer. Fiscal Affairs Department, International Monetary Fund, Washington D.C., March 2018.

4.3.5 Prudency

The Government's aim in the development of the fiscal rules is to ensure fiscal prudency. As such, in determining the rules, rounding has been applied to ensure that prudency is reinforced. For example, in the case of the expenditure ratio this has been rounded down from 43 to 40 per cent of GDP.

5 Internal operational guides

5.1 Introduction

Internal operational guides have been developed to assist MFEM in developing the MTEC and the medium-term budget.

The guides will not be publicly reported to avoid further complicating the fiscal framework, however they will be computed by MFEM on a frequent basis and will be reported to Cabinet when finalising the Budget.

The guidelines are:

- Personnel expenditure should not exceed 40 per cent of total government revenue.
- Requirement to spend cash – expenditure on new projects should only be made from cash (i.e. not debt) where this expenditure does not cause cash levels to fall below three months of operating expenditure.
- The Government will aim to achieve a cyclically adjusted balance in each year.
- Any cash in excess of four months of operating expenditure will be moved to the Stabilisation Account at the beginning of each financial year.

5.2 Operational guides

5.2.1 Personnel ratio

The personnel ratio has been moved from the FRRs to the internal operational guides to help prevent excessive growth in the public service, while providing flexibility in the case where the rule is breached in the short-term.

5.2.2 Requirement to spend cash

This rule aims to prevent new debt commitments where the Government has sufficient cash to fund the relevant expenditure. If new expenditure does not result in cash falling below the cash reserves rule of 3 months of operating expenditure, cash must be used as opposed to debt. If new expenditure would push cash levels below three months of operating expenditure, new debt can be entered into.

5.2.3 Cyclically-adjusted balance

This guide encourages the use of the cyclically-adjusted balance as a benchmark when developing the total expenditure ceiling. The use of the cyclically-adjusted balance aims to encourage better economic stabilisation by disconnecting spending from cyclical revenues and allowing governments to maintain expenditure during downturns.[11]

To achieve better linkages between fiscal policy and the economic context, the cyclically-adjusted balance has been calculated for each year over the medium-term. The resulting

[11] IMF, 2018b. Fiscal policy: How to calibrate fiscal rules – A Primer. Fiscal Affairs Department, International Monetary Fund, Washington D.C., March 2018.

‘fiscal space’ or gap between the current expenditure profile and the cyclically-adjusted balance has been used to guide the development of the expenditure profile.

5.2.4 Stabilisation Account

This internal operational guide requires that any cash in excess of four months of operating expenditure held as unencumbered cash at the end of the financial year is automatically transferred to the Stabilisation Account at the beginning of the following financial year.

This ensures that excess funds are frequently added to the Account and invested at higher rates of return to be used to encourage economic stabilisation, and not sitting idle in Government reserves. Further detail on the operations of the Stabilisation Account are provided in Section 6.

6 Establishment of reserve funds

6.1 Introduction

MFEM will establish two reserve funds to assist in achieving the objectives of the MTFS. The two Funds will have different aims and rules guiding the collection of contributions and their draw-downs, as outlined below.

6.2 Stabilisation Account

The aim of the Stabilisation Account is to ensure fiscal sustainability over the medium-term. The Account will hold surplus funds from operating expenditure in periods of economic growth, which will be used to fund government operations and investment in periods of economic contraction.

Once a minimum balance, which will initially be set at $25 million, has been reached in the Account, the funds can be used to make additional repayments on current debt during periods of real economic growth greater than 4 per cent per year. The decision to make additional repayments, as opposed to maintaining funds in the Stabilisation Account will be guided by a Debt Management Strategy to be developed in 2019.

During periods of real economic contraction, defined as growth less than 1 per cent per year, funds can be drawn from the Stabilisation Account to fund government operations and investment, however the use of the funds must not breach of the fiscal rules as outlined in Section 4.

6.3 Sovereign Wealth Fund

A Sovereign Wealth Fund (SWF) will be established in 2019/20 with the aim of ensuring that benefits from seabed minerals harvesting[12] are kept for future generations.

Revenues from seabed harvesting will be deposited into the SWF and funds only drawn down on once a minimum balance has been reached. Once this minimum has been achieved, a portion of the interest received will be paid to Government on an annual basis, as a form of income to fund future expenditure. A policy outlining the purpose and structure of the SWF will be developed in 2019/20 and publicly consulted on prior to the drafting of relevant legislation.

[12] Exploration of the seabed for minerals harvesting is expected to commence in 2019. If successful, exploitation could commence within five years of the commencement of exploration, providing significant revenue opportunities for the Government.

7 MTFS economic and fiscal forecasts

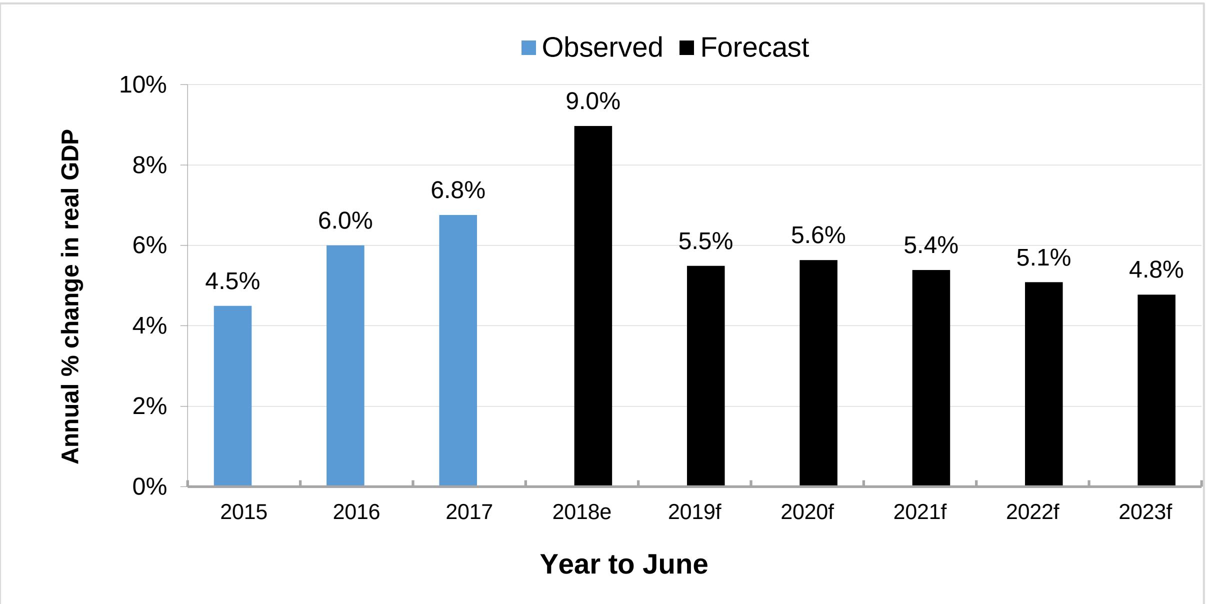
7.1 Economic growth

Economic growth is forecast to be strong over the medium-term, following estimated real GDP growth of 9 per cent in 2017/18. Strong economic growth in recent years has resulted in the Cook Islands experiencing a positive output gap, that is, economic growth is currently larger than potential economic growth (or the level of growth above which inflation will be experienced). The result is that the Cook Islands economy is experiencing capacity constraints in many areas including labour and skills shortages and accommodation shortages.

Due to capacity constraints, growth is expected to decrease to an average of 5.4 per cent over the forward estimates as the constraints place additional pressure on prices and limit the economy's ability to experience the high growth rates of recent years.

Both historical and forecast economic growth have been revised upwards in the MTFS as compared to the 2018/19 Budget. This upward adjustment is largely due to a revision in officially released historical data from the National Statistics Office, both due to a re-basing of the constant price GDP series and a change in methodology.

Figure 7-1: Forecast real GDP growth



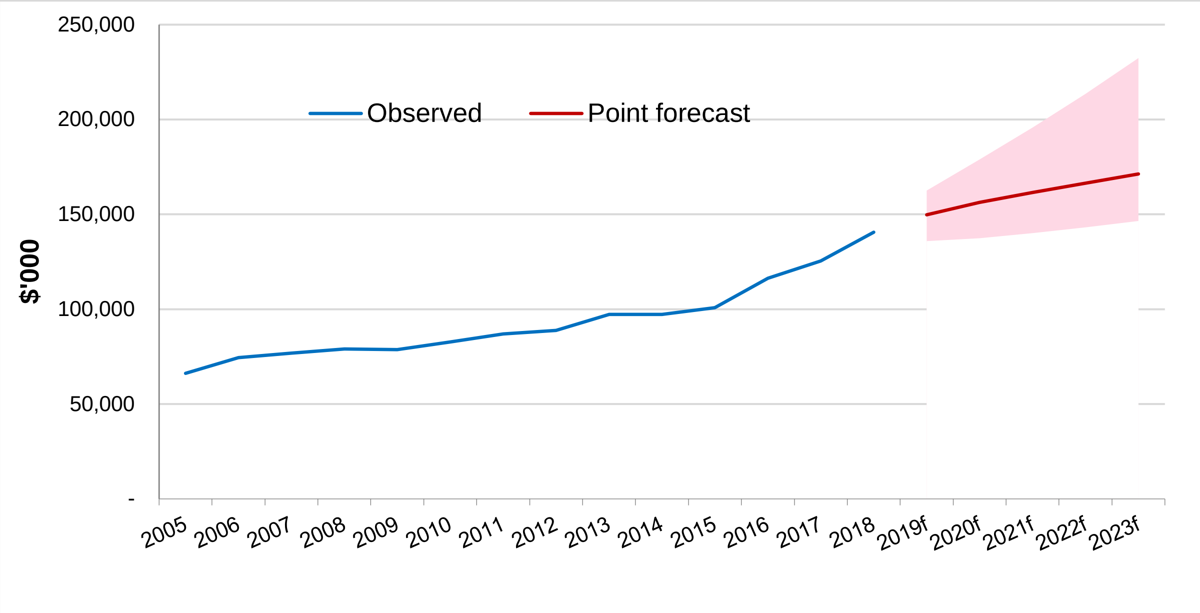
7.2 Revenue

Revenue forecasts for 2019/20 and the forward years remain consistent with those published in the 2018/19 Budget, despite economic growth being revised upwards, for two reasons;

- Revenue forecasts undertaken during the budget process were solely based on historical revenue, using univariate techniques, without direct consideration of the forecast levels of economic growth.
- Revenue to date in 2018/19 is in line with forecasts.

Forecasts are for tax revenue to remain strong over the forward estimates, averaging around 4 per cent growth over the coming four years.

Figure 7-2: Tax revenue projections



The MTFS does not propose any changes to revenue policy. A review of the Government's taxation structure is intended to be undertaken during the 2019/20 year. In the meantime, the Government is committed to increasing revenue without increasing the tax burden on society, through economic growth and by ensuring that tax legislation is enforced in an equitable manner.

A key aspect of this commitment is to increase the Revenue Management Division's ability to collect outstanding taxes and to enforce current legislation, for example by targeting non-conformers.

7.3 Expenditure

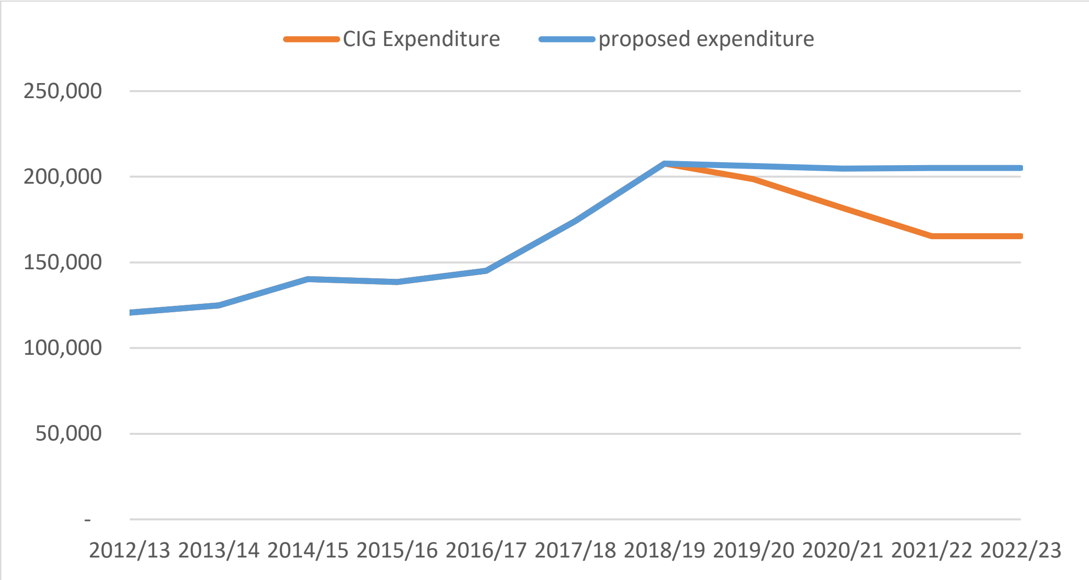
Based on forecast economic growth, revenues and the new fiscal rules the Government agrees to the expenditure profile set out in Table 7-1.

Table 7-1: Government's expenditure profile 2019/20 – 2022/23

$ million	2019/20	2020/21	2021/22	2022/23
Total expenditure	206.3	204.8	205.2	205.2
Fiscal space	8	23	40	40

The expenditure profile allows for fiscal space (or new spending) in each of the forward years, largely because of the decrease in capital and operating expenditure currently appropriated in the forward years. The changes to the expenditure profile as a result of the MTFS can be seen in Figure 7.3.

Figure 7-3: MTFS expenditure profile against the 2018/19 budget profile



The MTFS expenditure profile fits well within the rules committed to by the Government. The focus of Government expenditure in the coming four years is:

- investing in infrastructure that will ensure the sustainability of economic growth and the resilience of the economy to climate change; and
- investing in the capabilities of Government Agencies to ensure that they are operating effectively and efficiently.

The Government will be investing in infrastructure that encourages sustainable economic growth. This is largely due to the emergence of capacity constraints within the economy which have been exacerbated by strong growth in tourism arrivals. The Government is now focused on developing infrastructure that meets the increasing demand that is being placed on it by the increased population.

Furthermore, to ensure that Government Agencies have the ability to manage and undertake large infrastructure projects, and meet increasing demands in other sectors of the economy, Government will re-assess baseline funding to agencies to ensure that sufficient resources are provided to allow agencies to perform effectively and efficiently. Achieving these expenditure commitments will be guided by the Medium-term National Priorities as outlined in Section 8.

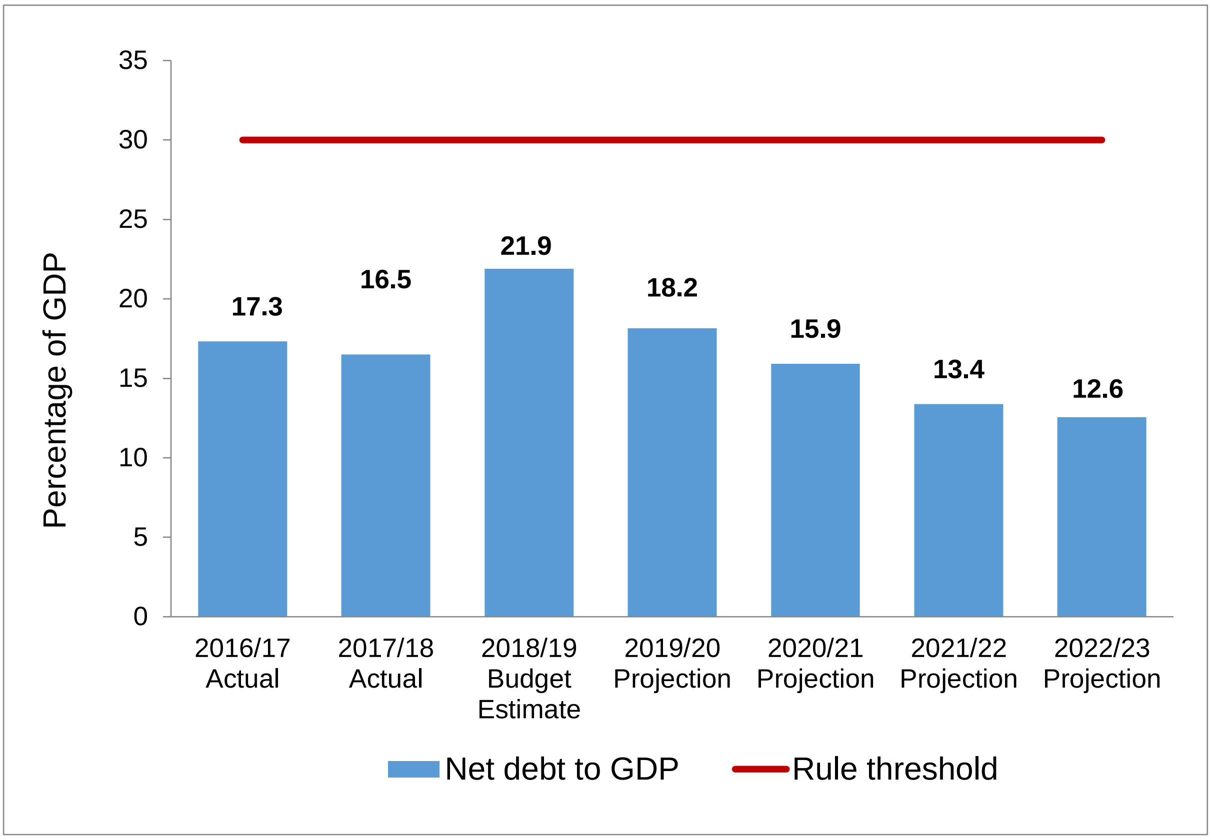
7.3.1 Impact of the expenditure profile on revenue and economic output

The economic and tax revenue forecasts for the 2018/19 Budget assumed steady Government expenditure over the forward estimates, as opposed to the official declining expenditure profile published in the 2018/19 Budget. That is, an expenditure profile along the lines of that outlined above for the MTFS underlies both the economic and tax revenue forecasts. As such, MFEM has undertaken preliminary analysis of the impact of not adopting the new expenditure profile on both the economic and revenue forecasts. In 2021/22, the economic output would fall by about 5 per cent or $34 million, while tax revenue would fall by about $9 million.

7.3.2 Net debt

The new expenditure profile does not require any new debt to be entered into, as such there is no change to the net debt profile as seen in Figure 7-4. Net debt is expected to decrease to just under 13 per cent of GDP by 2022/23.

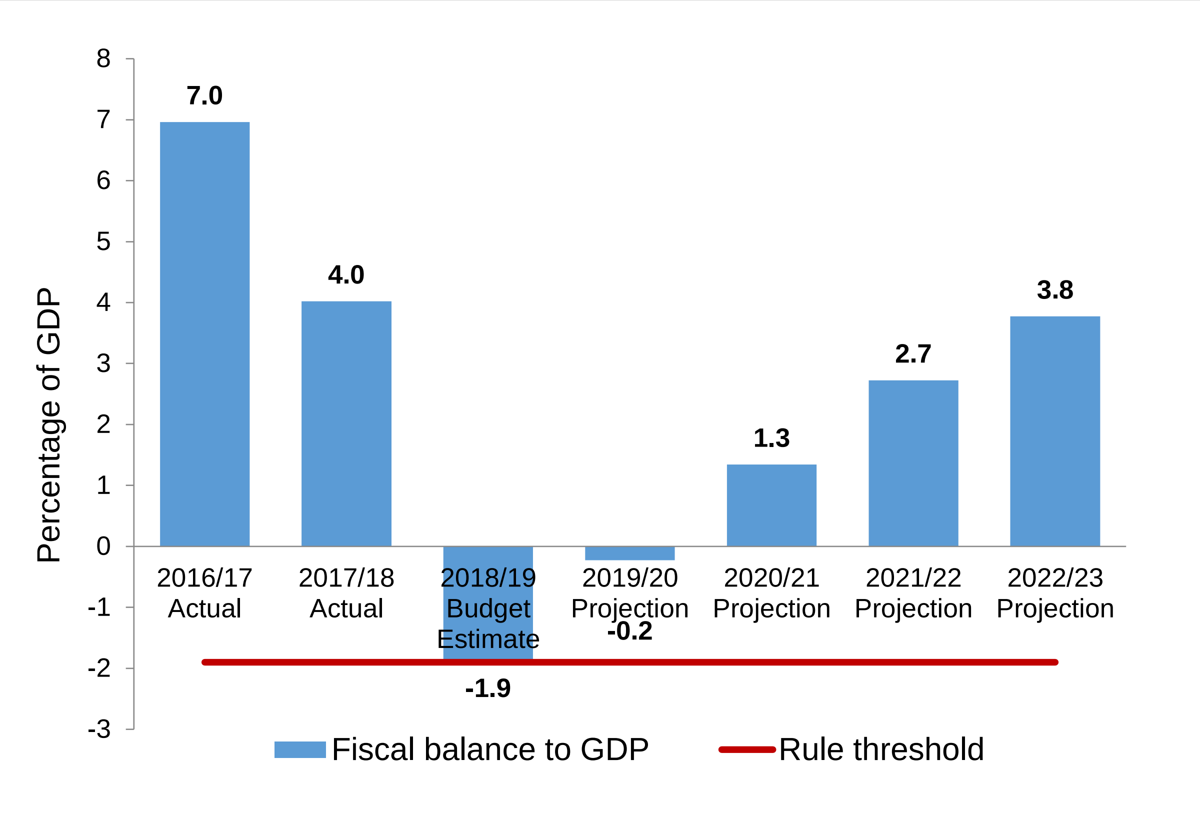
Figure 7-4: Net debt projections



7.3.3 Fiscal balance rule

The MTFS also results in the adherence to the fiscal balance rule as seen in Figure 7-5. New expenditure of $8 million will result in a fiscal deficit of 0.2 per cent of GDP in 2019/20, before increasing to a surplus of 1.3 per cent in 2020/21.

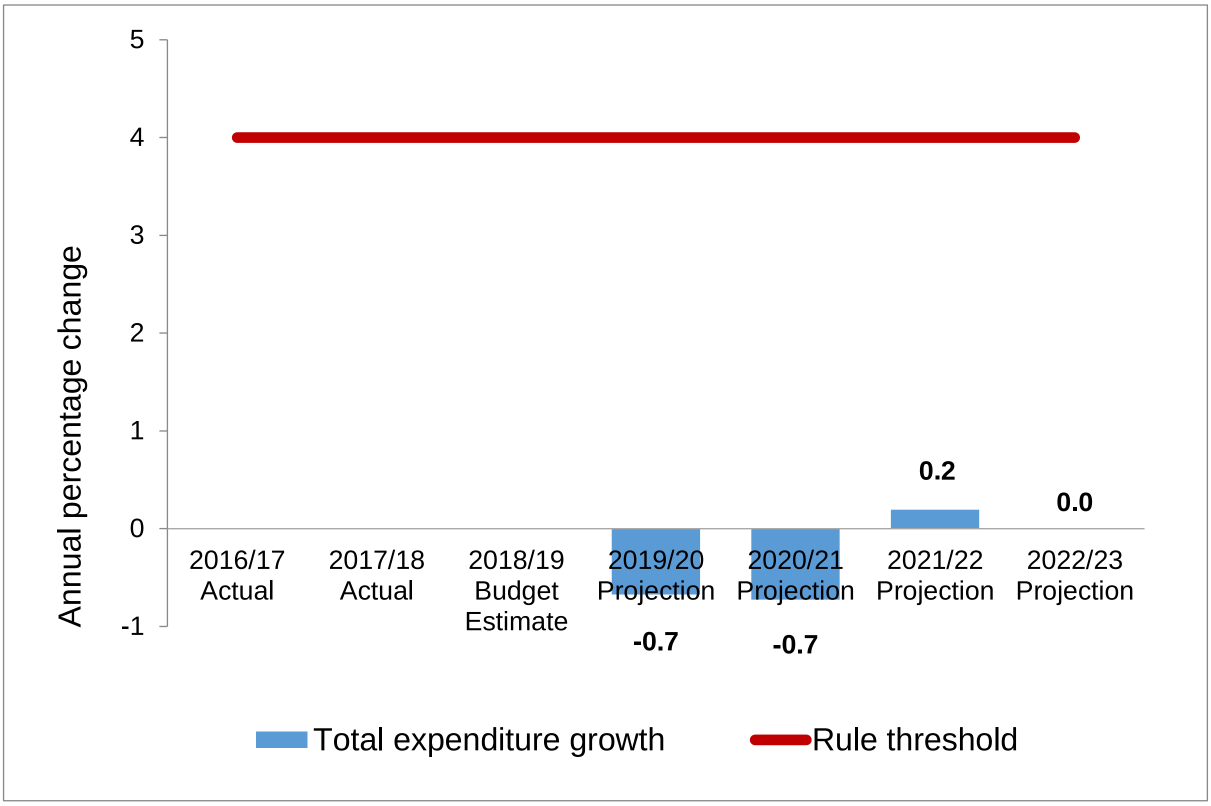
Figure 7-5: Fiscal balance projections



7.3.4 Expenditure rule

The MTFS expenditure profile is well within the expenditure rule as seen in Figure 7-6. In accordance with the cyclically-adjusted balance, the expenditure profile has been designed to provide additional expenditure space in each year, while delivering a total profile that is slightly lower than the peak in 2018/19. This acknowledges the strong economic growth that the Cook Islands is now experiencing and the need to constrain expenditure growth to prevent further pressure being placed on the economy.

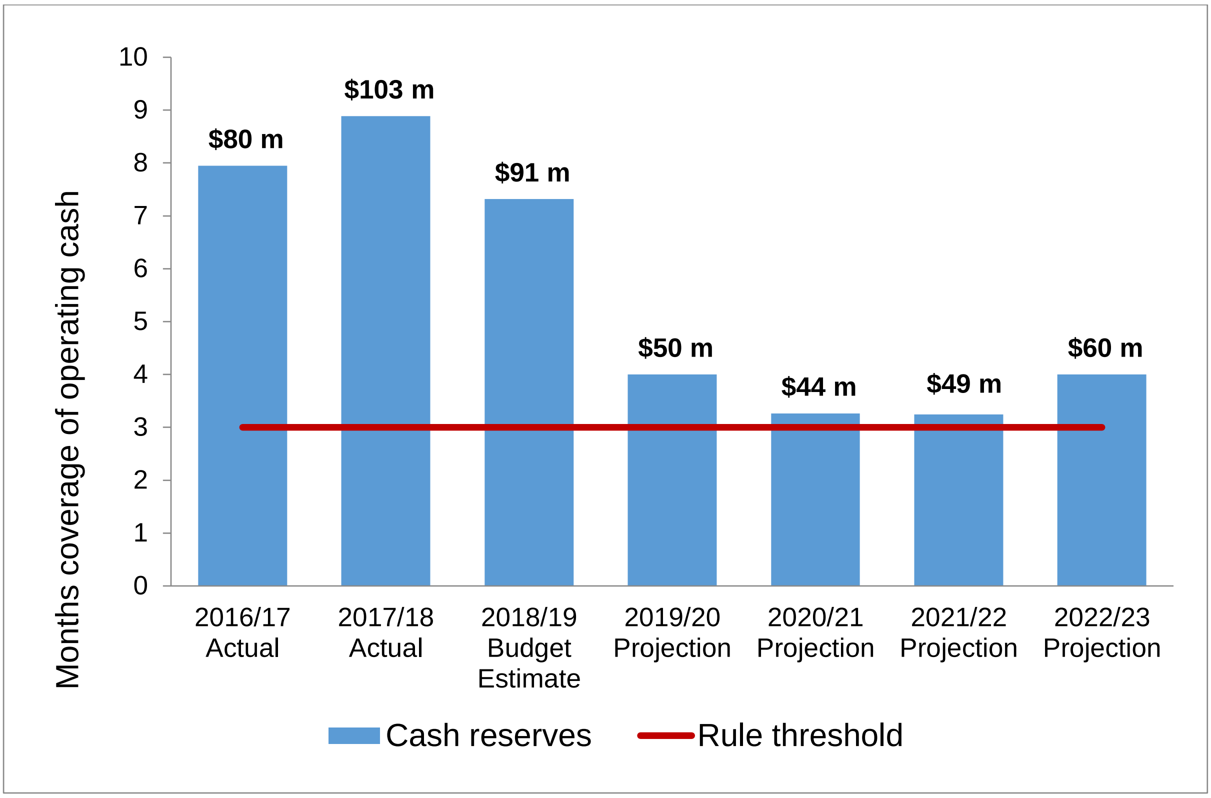
Figure 7-6: Expenditure growth projections



7.3.5 Cash reserves rule

The MTFS results in stronger cash management from Government, with cash expected to remain just above the requirement over the forward years. In 2019/20 it is anticipated that approximately $27 million will be moved from the cash reserves into the Stabilisation Account, resulting in the large decrease in cash reserves seen in Figure 7-7. Following that cash is expected to remain stable, with revenues generally in line with expenditure in 2021/22 and 2022/23.

Figure 7-7: Cash reserves projections



8 Medium-term National Priorities

To improve the alignment between fiscal planning and the achievement of national priorities, the MTFS incorporates the Medium-term National Priorities. This not only provides further information on the Government's intentions over the medium-term, but will help to guide the development of the MTEC.

Government is committed to resolving the significant long-term challenges facing the country, including sustainable economic development, a healthy and educated population, a healthy environment, a fair society and good governance. It is committed to reducing inequality and improving the wellbeing of all Cook Islanders.

To assist this, Government agencies will work towards sector driven collaboration and planning, particularly to tackle cross cutting challenges such as connectivity, transport, data and statistical information, ICT, Information Systems, Governance (proper management of people, infrastructure, natural resources and absorptive capacity), health and education. Inclusion of the Pa Enua in tackling cross cutting challenges is crucial for sustainable development to be effective and ensuring that "no one in the tribe" is left behind.

The 2019/20 Budget is the first year of implementation of the Medium Term Goal Priorities (2019/20 to 2022/23) set in the context of the National Sustainable Development Plan 2016–2020. The newly refined priorities are expected to continue to guide the Government's identification of priority programs over the medium-term. The goal priorities for the next four years are outlined in Figure 8-1. The realisation of the priority goals will also have positive impacts on other NSDP goals.

The Medium-term National Priorities and the medium-term expenditure profile will together guide the development of the MTEC for each Government agency. As a result, the 2019/20 Budget will outline a clear path towards the achievement of the NSDP goals over the medium-term.

Figure 8-1: Medium-term Goal Priorities

<table>
<tr><th>2019/20</th><th>2020/21</th><th>2021/22</th><th>2022/23</th></tr>
<tr><td>Goal 9: Gender & the Vulnerable</td><td>Goal 8: Education</td><td>Goal 3: Waste Management</td><td>Goal 1: Welfare & Equity</td></tr>
<tr><td colspan="2">Goal 16: Good Governance, Law & Order</td><td>Goal 6: Transport & Energy</td><td>Goal 2: Economic Opportunities</td></tr>
<tr><td colspan="2">Goal 7: Health</td><td>Goal 12: Ocean Lagoon and Marine Resources</td><td>Goal 15: Population</td></tr>
<tr><td colspan="4">Goal 13: Resilience and Climate Change</td></tr>
<tr><td>Goal 11: Environment & Biodiversity</td><td>Goal 10: Agriculture & Food Security</td><td>Goal 14: Culture</td><td>Goal 7: Health</td></tr>
<tr><td colspan="4">Goal 5: Infrastructure & ICT</td></tr>
<tr><td colspan="3">Goal 4: Water & Sanitation</td><td>Goal 8: Education</td></tr>
</table>

9 Fiscal risks

9.1 Introduction

The IMF defines fiscal risks as ‘deviations of fiscal outcomes from what was expected at the time of the budget’. The IMF lists a number of sources of fiscal risk, including:

- shocks to macroeconomic variables, such as economic growth, commodity prices, interest rates, or exchange rates; and
- calls on contingent liabilities, obligations triggered by an uncertain event, including explicit and implicit liabilities.[13]

The focus of this section is on the key risks to the Government’s fiscal and macroeconomic forecasts and their likely impacts.

9.2 Sources of risk

There are a number of risks over the forward budget period that could affect the macroeconomic forecasts that underpin the Government’s forward fiscal position. These are considered below, in no particular order.

9.2.1 Global economic risks

Should the current trade war escalate and cause a global economic downturn, or there is an economic recession in one of the Cook Islands main tourism markets, such as New Zealand, this could reduce the visitor arrivals assumptions that underpin the positive GDP forecasts over the forward budget period. Fewer tourists could impact on the Government’s fiscal position by reducing expected tax revenue – for example, less VAT being collected than forecast.

The risk of the US dollar continuing to appreciate, should the Federal Reserve raise US interest rates further, could impact on inflation in the Cook Islands through increased costs of imports. An oil price shock would have a similar effect on inflation.

Exchange rate variations can also impact on the Cook Islands debt portfolio as a number of loans are denominated in US dollars and other international currencies. The IMF notes that the impact of exchange rate depreciations is immediate, and can be especially strong when a large share of the debt is in foreign currency.

9.2.2 Domestic capacity risks

Preliminary analysis suggests that the Cook Islands economy is currently performing above its potential capacity – that is we are facing a positive output gap. There are already signs of capacity constraints appearing in the labour and housing markets. Should these constraints tighten over the forward period, thanks to higher than expected tourist arrivals, for example, and in turn an increase in tourism accommodation construction, this could impact on the economic forecasts by constraining the Government’s ability to execute its capital program due to the lack of skilled construction labour.

[13] IMF (2009), *Fiscal risks: sources, disclosure, and management*. IMF Fiscal Affairs Department. See: https://www.imf.org/external/pubs/ft/dp/2009/dp0901.pdf.

9.2.3 Natural disasters

The IMF cites evidence that direct economic losses from natural disasters have often exceeded 10 percentage points of GDP in developing countries and amounted to a few percentage points of GDP in some advanced countries.

The Cook Island has a high exposure to disaster risk due to its geographic location in the South Pacific cyclone belt, the remoteness and low-lying nature of many of the outer islands, and the proximity of many buildings and infrastructure services to the coast. In addition, the heavy reliance on revenues from the tourism sector makes the economy vulnerable to the impact of disasters.

To mitigate the economic risk posed by natural disasters, the Government has put in place a range of structures to reduce its financial exposure to disaster risk. More detail on the Government's approach to dealing with disaster risk financing is provided in Section 10.

9.3 Assessing the impact of fiscal and macroeconomic shocks

9.3.1 Introduction

The Cook Islands Government has developed an Excel-based analytical fiscal tool – the *Cook Islands Fiscal Tool* 2018 – to first calibrate, and then operationalise the revised set of fiscal rules that form the core of the MTFS.

The fiscal tool, which is described in detail in the Technical Paper, comprises a number of interrelated elements:

- the Calibration Model;
- the Fiscal & Macro Impact Model:
    - fiscal and macro shocks;
    - fiscal multiplier model; and
    - tax impact.

The operational part of the fiscal tool – the *Fiscal & Macro Impact Model* – models the interactions between fiscal policy decisions and economic output, and the fiscal impact of economic shocks, within the framework of the revised set of fiscal rules. This is accomplished by running fiscal and macroeconomic shocks through a simple version of the Cook Islands Government accounting framework using fiscal multipliers and tax impact models.

The model provides for three types of shock – or policy decision:

- Fiscal – change in operating expenditure, capital expenditure and/ or revenue;
- GDP – models the impact of a direct change in GDP;
- Arrivals – models the impact of a change in the number of international visitors to the Cook Islands.

This section shows the potential impact of a selected range of fiscal and macroeconomic shocks on the MTFS expenditure profile using the fiscal impact tool.

9.3.2 Fiscal shocks

Fiscal shocks – or alternatively government fiscal policy decisions – are evaluated in terms of their direct impact on fiscal indicators – these are the first order impacts – and their second order impacts via changes in GDP flowing through to tax revenues. The first order impacts are simply one for one changes in the baseline operating expenditure, capital expenditure or tax revenue as relevant. The second order impacts are estimated using fiscal multipliers and a simple tax impact model.

Revenue shock

Two revenue shocks are applied: low and high, using the forecast 95 per cent low and high confidence intervals.

The low revenue case, with revenues falling by about 12 to 14 per cent per year over the modelling period, is presented in Table 9-1. The fiscal balance breaches the -1.9 per cent of GDP rule in 2019/20 and 2020/21 before recovering in the outer years.

Table 9-1: Low revenue shock

		2019/20	2020/21	2021/22	2022/23
Change in opex ($m)		0	0	0	0
Change in capex ($m)		0	0	0	0
Change in tax revenue ($m)		-18.6	-21.3	-23.5	-25.6
Fiscal balance (% of GDP)	Base	-0.2	1.3	2.7	3.8
	Shock	-3.5	-2.1	-0.8	0.2
Change in nominal GDP	%	0	0	0	0
	$m	1	1	2	2

The high revenue case, with revenues higher by 14 to 36 per cent per year over the modelling period, is presented in Table 9-2. The key result is a significant strengthening of the fiscal balance.

Table 9-2: High revenue shock

		2019/20	2020/21	2021/22	2022/23
Change in opex ($m)		0	0	0	0
Change in capex ($m)		0	0	0	0
Change in tax revenue ($m)		22.2	34.0	47.9	63.3
Fiscal balance (% of GDP)	Base	-0.2	1.3	2.7	3.8
	Shock	3.7	7.0	10.3	13.4
Change in nominal GDP	%	0	0	0	-1
	$m	-1	-2	-3	-4

Opex shock

A higher than expected operating expenditure shock is applied, assuming a 10 per cent increase above the estimates over the forward period.

The impact of additional expenditure of about $15 million per year over the modelling period is presented in Table 9-3. The fiscal balance breaches the -1.9 per cent of GDP rule in 2019/20. There is a positive impact on GDP of about 3 per cent or $18 million by 2022/23.

Table 9-3: Higher opex shock

		2019/20	2020/21	2021/22	2022/23
Change in opex ($m)		16	18	19	19
Change in capex ($m)		0	0	0	0
Change in tax revenue ($m)		1.4	3.4	5.0	6.0
Fiscal balance (% of GDP)	Base	-0.2	1.3	2.7	3.8
	Shock	-2.8	-1.0	0.6	1.9
Change in nominal GDP	**%**	1	2	3	3
	$m	5	13	17	18

Capex shock

A lower than expected capital expenditure shock is applied, assuming a 20 per cent reduction in the estimates over the forward period.

The impact of the reduced expenditure over the modelling period is presented in Table 9-4. The negative impact on GDP of about $25 million per year by 2022/23 has a knock on effect on revenue of about $8 million. The net effect on the fiscal balance is positive, with the capital expenditure reduction outweighing the fall in revenue.

Table 9-4: Lower capex shock

		2019/20	2020/21	2021/22	2022/23
Change in opex ($m)		0	0	0	0
Change in capex ($m)		-9	-9	-9	-9
Change in tax revenue ($m)		-2.0	-4.5	-6.4	-7.8
Fiscal balance (% of GDP)	Base	-0.2	1.3	2.7	3.8
	Shock	0.9	1.7	2.3	2.8
Change in nominal GDP	**%**	-1	-3	-3	-4
	$m	-7	-17	-22	-25

9.3.3 GDP shock

A low GDP shock is applied, assuming a 5 per cent decrease on the forecast for each year of the forward period. The impact of drop in GDP is presented in Table 9-5. Tax revenue falls by about $17 million per year by the 2022/23, which causes the fiscal balance to deteriorate, but not enough to breach the -1.9 per cent of GDP rule. The cumulative GDP impact in 2022/23 is minus 8 per cent, or a reduction of $53 million.

Table 9-5: Lower GDP shock

		2019/20	2020/21	2021/22	2022/23
Change in opex ($m)		0	0	0	0
Change in capex ($m)		0	0	0	0
Change in tax revenue ($m)		-7.6	-11.4	-14.8	-16.6
Fiscal balance (% of GDP)	Base	-0.2	1.3	2.7	3.8
	Shock	-1.6	-0.5	0.6	1.6
Change in nominal GDP	%	-5	-7	-8	-8
	$m	-29	-42	-50	-53

9.3.4 Arrivals shock

A low international visitor arrivals shock is applied, assuming a 5 per cent decrease on the forecast for each year of the forward period. The impact of the reduction in arrivals is presented in Table 9-6. Tax revenue falls by about $15 million per year by 2022/23, which causes the fiscal balance to deteriorate, but not enough to breach the -1.9 per cent of GDP rule. The impact on GDP is substantial, with a 7 per cent reduction by 2022/23.

Table 9-6: Lower arrivals shock

		2019/20	2020/21	2021/22	2022/23
Change in opex ($m)		0	0	0	0
Change in capex ($m)		0	0	0	0
Change in tax revenue ($m)		-6.7	-10.1	-13.3	-15.0
Fiscal balance (% of GDP)	Base	-0.2	1.3	2.7	3.8
	Shock	-1.5	-0.3	0.8	1.9
Change in nominal GDP	%	-4	-6	-7	-7
	$m	-25	-37	-44	-47

10 Disaster risk financing

To mitigate the economic and financial risk posed by natural disasters, the Government has put in place a range of measures to reduce its financial exposure to disaster risk, the most important being:

- a Disaster Emergency Trust Fund, with a current balance of $1.7 million, to provide a fast and coordinated response following the declaration of a State of Emergency;
- insurance coverage under the Pacific Catastrophe Risk Assessment and Financing Initiative for cyclones, with a 1-in-10-year probability of occurrence with payout based on the assessed severity of a specific cyclone; and
- a Disaster Recovery Mechanism loan from the Asian Development Bank (ADB) of $13.95 million, which will only be triggered and drawn down in the event of a catastrophe.

More detail on the Government's current approach to dealing with disaster risk financing is provided in Appendix 2.

In developing the MTFS, the Government has identified a need to review its current disaster risk financing arrangements to ensure the right balance between the required level of disaster coverage and the ongoing costs of paying for that coverage. This is particularly pertinent in light of the new Stabilisation Account being introduced under the MTFS, which will provide an additional source of disaster financing at low cost.

The World Bank and Asian Development Bank have published a guidance note on conducting a disaster risk finance diagnostic that provides a useful framework for gathering the relevant information and conducting the necessary analysis.[14] This publication will inform the Government's review.

[14] World Bank and ADB, 2017. Assessing Financial Protection against Disasters: A Guidance Note on Conducting a Disaster Risk Finance Diagnostic. https://www.adb.org/publications/assessing-disaster-risk-finance-diagnostic.

11 Overseas Development Assistance – Foreign aid

While foreign aid has not directly been accounted for in the analysis provided above, it has traditionally formed an important part of the Government's fiscal undertakings. Foreign aid donations peaked in 2017/18, with the provision of funds from donor governments for large capital projects. At present the foreign aid profile decreases over the forward years, however this is expected to change as new grant funding agreements are signed over the coming years.

While it is anticipated that the Cook Islands will graduate from Official Development Assistance (ODA) in 2019, engagement with donor partners suggests that this will not have a significant impact on the level of foreign aid provided to the Cook Islands, with a limited number of partners stating that their support will cease with graduation. Based on this, preliminary estimates suggest that the impact of graduation on economic growth will be approximately 0.4 per cent of GDP.

In the context of graduation, better Government planning is required to ensure that sectors that are highly reliant on donor funds, such as environment, and more broadly, capacity building, are not neglected should that support cease.

Based on the current fiscal outlook, as outlined in this MTFS, greater consideration is required from Government on the use of aid funds. In particular, more analysis is required to assess the costs and benefits of donor funding.

Appendix 1 Review of current fiscal responsibility ratios

A1.1 Review of the fiscal responsibility ratios

In order to determine the new set of fiscal targets the current structure and fiscal responsibility ratios have been reviewed, both by individual targets and by assessing the overall framework. The following provides an overview of the results of the review and the subsequent recommendations.

A1.2 The overall framework

The use of nine ratios has resulted in a cluttered financial environment which has decreased the political and public buy-in to the FRRs, in turn reducing compliance. In many instances the FRRs as they are currently structured, contain overlaps which can result in inconsistencies. For example, there might be space to take on new debt under the net debt rule, however the debt servicing rule provides a contradictory picture and shows that debt servicing is already at excessive rates.

To address these issues, the number of FRRs has been reduced, with the focus being on key targets that address the overall objectives of fiscal sustainability and the linkages with economic policy. Each of the FRRs has been reviewed individually below.

A1.3 Operating balance

The current FRRs require an operating balance each year at a minimum, with the intention of encouraging operating surpluses. It could be argued that the rule has encouraged excess revenue to be spent during economic upturns, thus failing to consider that operating surpluses are required to fund capital works during this time.

Furthermore, the requirement of operating balances does not allow automatic stabilisers to operate during periods of economic contraction, in that it encourages government to cut operations, and or, welfare payments due to the decrease in revenue, thus encouraging pro-cyclical fiscal management by government.

Recommendation: Remove the operating balance rule

A1.4 Fiscal balance rule

The fiscal balance rule states that the fiscal balance should fall between a deficit of 2 per cent of GDP and a surplus of 2 per cent of GDP. On its own, as the fiscal balance rule does not link fiscal decision making with the economic context, it can encourage pro-cyclicality. Further, it encourages government to spend in periods of economic upturn by stating that the surplus should be no greater than 2 per cent of GDP.

However, alternative budget balance rules tend to be complex, both to implement and communicate, and require frequent and highly reliable GDP data. As such, it is recommended that the fiscal balance rule be maintained, however that it 1) be partnered with another rule to reduce pro-cyclicality and 2) that it be re-calibrated.

Recommendation: Maintain the fiscal balance rule, review the level to ensure that it aligns with and develop a new fiscal rule to assist the removal of pro-cyclicality.

A1.5 Debt rule

The debt rule in the Cook Islands places a hard cap on net debt at 35 per cent of GDP and a soft cap at 30 per cent. The net debt rule is arguably the most established fiscal rule in the Cook Islands. Research undertaken by the IMF suggests that debt levels greater than 30 per cent of GDP have an adverse impact on economic growth in the Asia Pacific.[15]

Recommendation: Maintain the soft cap of net debt at 30 per cent of GDP and the hard cap of 35 per cent of GDP. Further analysis should be undertaken in 2019 to assess the debt sustainability of the Cook Islands and determine how the Disaster Risk Contingency Loan should be treated within the rule.

A1.6 Debt servicing rule

The debt servicing rule provides that net debt servicing should not exceed 5 per cent of total revenue. A review undertaken by the Asian Development Bank in 2015 questioned the appropriateness of this rule, and whether it was in fact set too low. Due to the existence of a net debt rule in the Cook Islands, the consistency of the two rules must be questioned. In addition, it is likely that the debt servicing rule does not create any added benefit in attempting to achieve the criteria outlined in section 4.1.

Recommendation: it is recommended that the debt servicing rule be removed to allow the net debt rule to operate independently to its full effect.

A1.7 Personnel Rule

The Personnel rule prevents personnel expenditure from exceeding 40 per cent of total revenue. While there are benefits to the use of this rule in terms of ensuring that the total size of the public sector does not become unsustainable, it is argued that it is not crucial for achieving long-term fiscal sustainability and can in fact contradict this aim by creating a cluttered fiscal rules environment. Additionally, in periods where revenue growth is strong, it can encourage rapid growth in employment and salaries in the public sector, which can be unsustainable, particularly if revenue decreases.

Recommendation: That this be used as an internal guide only, not an official fiscal rule.

A1.8 Tax Revenue

The tax revenue rule restricts the collection of tax revenue to a maximum of 25 per cent of GDP. The IMF has found that 'rules that set ceilings or floors on revenues can complicate macroeconomic stabilisation efforts…revenue ceilings can limit revenue mobilisation and government savings in good times'. Despite this, revenue ceilings fail to constrain spending, and as such, do not ensure fiscal sustainability.[16]

The use of a tax revenue rule encourages public sentiment that taxes are too high in periods of strong economic growth, however this argument fails to acknowledge the significant decrease in revenue that is often seen in periods of weak growth.

The Cook Islands is highly reliant on tax revenues and does not have a number of user-costs that are often seen in developed countries, such as land rates. As such, the use of a figure of

[15] Strengthening Fiscal Frameworks in Small States

[16] IMF Fiscal Rules a Primer p 9

25 per cent is not relevant in the context of the Cook Islands, and if followed would result in a deficit of revenues required to cover core government services. One example is that land rates are often used to fund garbage collection services and the maintenance of local roads, both of which are funded out of central government tax revenue in the Cook Islands due to the absence of land rates.

Recommendation: due to its pro-cyclical qualities, the absence of a relationship with fiscal sustainability, and the consideration of context, it is recommended that the tax revenue rule be removed.

A1.9 Cash balance

The final rule provided by the current framework requires the government to maintain cash levels equivalent to 3 months of operating expenditure. This is to ensure that sufficient cash is on hand in the case of a sudden decrease in revenue resulting from an economic shock or natural disaster. In the case of the Cook Islands, with a highly open economy and vulnerability to natural disasters, creating a buffer through the holding excess cash is considered a prudent mechanism to ensure fiscal sustainability.

Recommendation: that the cash rule be maintained and more widely publicised to ensure compliance.

Appendix 2 Disaster risk financing

A2.1 Background

The Cook Islands' geographic location puts it among the 30 countries that experience the highest average annual disaster-related losses in terms of GDP.[17] The Cook Islands has experienced 28 natural disasters since 1955, all of which were tropical cyclones. Recovery costs for these events summed to approximately $65.4 Million.

The World Bank estimates that annually the Cook Islands requires 2% of the GDP to be spent on loses associated with Natural Disasters such as tropical cyclones (TC), tsunamis, floods and droughts. According to their modelling, the Cook Islands has a 50% chance of experiencing a per-event loss exceeding $97 Million in the next 50 years[18].

Currently, the government is engaged in extensive risk mitigation planning with a central focus on rapid mobilisation of post-disaster funds and the execution of these funds in a timely, transparent and accountable fashion.

Table 9.1. Significant Cyclones in the Cook Islands

*Combined estimated losses for all four cyclones in 2005.

Year	Name	Category	Estimated losses (m$)	Estimated losses (%GDP)	Outcomes
1987	Sally	2	24.5	51.6	At least 85% of the Rarotonga residents suffered damage of various extents and close to 80% of all downtown buildings were destroyed, leaving nearly 1,000 people homeless. The storm wiped out cash crops and hundreds of tourist left causing significant loses to the economy.
1997	Martin	3	7.5	7.6	In Manihiki the cyclone destroyed 90% of the houses and killed 19 people, all but 4 buildings lost their roofs or were damaged beyond repair. In Pukapuka many government buildings were destroyed, and the telecommunication system experienced considerable damage.
2005	Meena Nancy Olaf Percy	4 4 5 5	10.0*	5.5	One of the most devastating tropical cyclone seasons. As result, 30-40% of the population lost electricity and 60% of buildings in Rarotonga were damaged.
2010	Pat	2	7.8	3.2	In Aitutaki, 78% of all houses were destroyed, leaving 80 people homeless, devastating crops and disturbing tourism. A cut in electricity transmission affected essential utilities such as hospitals and water supply.

[17] PCRAFI Cook Islands Country Note 2015.

[18] PCRAFI Cook Islands Country Note 2015.

A2.2 Disaster Risk Financing

A.2.2.1 The Disaster Emergency Trust Fund

The Disaster Emergency Trust Fund (The Fund) was established in 2011 with an initial contribution of $200,000. The conditions of the Trust agreement are set up in such a manner that the Fund may not operate in deficit. The Fund is invested in an interest bearing bank account with the earned interest being reinvested into the Fund.

The purpose of the fund is to provide a fast and coordinated response following the declaration of a State of Emergency. The Fund is not intended for long-term recovery and reconstruction.

The Fund currently has a balance of $1.7 million.

A2.2.2 Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI) Insurance

PCRAFI was established in 2016 in the Cook Islands to assist Pacific Island Countries with insurance coverage against natural disasters by improving their capacity to meet post-disaster funding needs without compromising their domestic budget.

The difficulties in the receipt of disaster relief funding associated with TC Pat (2010) prompted the Government to ensure more comprehensive planning for future contingent liabilities. The Insurance was designed in such a manner that the payments are made based on disaster impact modelling rather than a post disaster assessment. This ensures that the payments are made within 10 days of the trigger and provide immediate post disaster relief.

Currently, the Cook Islands is covered for category 5 cyclones with a return period of 1 to 10 years. The annual cost of the insurance is NZD $100,000 for Cook Islands with an expected payout of around USD 2.9 million in the case of a severe category 5 cyclone.

A2.2.3 ADB Loan

The Asian Development Bank (ADB) has committed to providing a $13.95 million contingent loan to fund the Cook Islands Resilience Programme in the event of a disaster, to address both the immediate relief needs, and post-disaster financing needs.

The annual interest rate on the loan is set at 0.60 per cent, with an annual commitment charge of 0.15 per cent. This is the first time the ADB has provided disaster contingency financing.

The contingent loan is available for a 3 year period, ending in December 2019. The loan was designed to complement the initial response Trust Fund and the PCRAFI Insurance, and as such the use of the funds is flexible.

A2.2.4 Additional Sources of Funding

Insurance

According to the PCRAFI Country Note, the Cook Islands has a small insurance market with total insurance premiums estimated to be $8.2 million including aviation. Around 80 per cent of the tourism related businesses hold insurance including business interruption coverage. Insurance against tropical cyclones is not part of the standard package, although it is estimated that most business are covered for it.

Three of the SOEs, Te Aponga Uira, the Airport Authority and BCI have full cyclone coverage. The Ports Authority also have a high level of coverage.

General Government Cash Reserve

In a rare event that the post disaster costs exceed the planned contingent liability funding, the Government will use the General Government Cash Reserves to undertake post disaster rehabilitation and stabilise the economy. As of June 2018 the unencumbered cash reserve was $84 million.

Budget Re-allocation

In the case of a small scale natural disaster, the Government has the ability to use the Contingency Fund of $200,000, as well as to redirect funds from the current year's appropriation. This will allow recovery in a timely and efficient manner.