



Government of the
Cook Islands

Fiscal strategy and economic update: September 2018

Extract from Budget Book 1: 2018/19

25 September 2018



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

1	Fiscal Strategy	1
1.1	Introduction	1
1.2	Where are we in the economic cycle? The output gap	3
1.3	Fiscal strategy.....	5
2	Economic Update	8
2.1	Summary	8
2.2	Key assumptions	9
2.3	The global economy	11
2.4	Cook Islands Gross Domestic Product.....	15
2.5	Consumer price index.....	21
2.6	Tourism	24
2.7	Housing and construction	30
2.8	Marine resources	32
2.9	Agriculture.....	40
2.10	Goods imports and exports	42
2.11	Banking and finance	46
2.12	Financial services industry	48

List of tables

Table 2.1	Summary of economic indicators.....	9
Table 2.2	Nominal GDP Expenditure summary (\$'000).....	20
Table 2.3	Annual GDP growth summary	21
Table 2.4	Annual CPI forecast summary	23
Table 2.5	Estimated total arrivals, quarterly, 2016/17 to 2021/22	25
Table 2.6	Estimated total tourism numbers, by major market, 2016/17 to 2021/22	27
Table 2.7	Fishery catches in the Cook Islands EEZ by species (MT)	34
Table 2.8	Number of active fishing vessels	35
Table 2.9	Landed value of fishery catches (\$m)	35
Table 2.10	Catch landed at Avatiu Port (MT).....	36
Table 2.11	Pearl production, 2009-2016.....	37

List of figures

Figure 1.1: Real GDP growth, annual percentage change	1
Figure 1.2: Government revenue and expenditure, as at June (\$'000)	2
Figure 1.3: Fiscal balance, as at June (\$'000)	3
Figure 1.4 Stylised output gap example.....	4
Figure 1.5: Output gap, multivariate Kalman filter estimate	5
Figure 2.1: US dollar exchange rate, New Zealand and Australia	13
Figure 2.2: IMF GDP growth estimates, selected countries	14
Figure 2.3: IMF inflation estimates, selected groupings and countries.....	14
Figure 2.4: Daily oil spot prices, 1986 to 2018, US\$/barrel	15
Figure 2.5: Real GDP growth, annual percentage change	15
Figure 2.6: Cook Islands economy by industry, 2016/17	16
Figure 2.7: Contribution to 2016/2017 real growth (percentage point)	17
Figure 2.8: Observed and forecast real GDP, quarterly (\$m)	17
Figure 2.9: Annual change in real GDP (percentage).....	18
Figure 2.10: Annual change in nominal GDP (percentage)	18
Figure 2.11: CPI, year average, 2005/06 – 2017/18 (percentage change)	21
Figure 2.12: Contribution to 2017/18 average inflation (percentage point)	22
Figure 2.13: CPI, quarterly index, 2007 to 2022	23
Figure 2.14: Annual average change in CPI (percentage)	23
Figure 2.15: Visitor arrivals, country of residence (annual percentage change)	24
Figure 2.16: Total visitor arrivals, quarterly, 2008 to 2022.....	25
Figure 2.17: Tourism capacity utilisation, monthly, 2016 to 2022.....	26
Figure 2.18: New Zealand Pacific outbound tourist numbers, by destination.....	27
Figure 2.19: New Zealand arrivals, quarterly, 2008 to 2022.....	28
Figure 2.20: Australia arrivals, quarterly, 2008 to 2022	29
Figure 2.21: Other major markets arrivals, 2014 to 2022	30
Figure 2.22: Construction sector contribution to real GDP, 2008 to 2018 (\$'000).....	31
Figure 2.23: Value of building approvals, 2006/07 to 2020/21, \$'000	31
Figure 2.24: Construction sector forecast, 2007 to 2022 (\$ million real)	32
Figure 2.25: Fishery catch in the Cook Islands EEZ (MT)	34
Figure 2.26: Pearl exports, 2012/13 -2021/22 (\$'000)	38
Figure 2.27: Fishing and pearl contribution to GDP, annual, 2013/14 to 2021/22 (\$m real)	38
Figure 2.28: Rarotonga and Aitutaki streams	39
Figure 2.29: Agriculture exports 2013/14 to 2021/22 (\$'000)	40
Figure 2.30: Agriculture contribution to GDP, quarterly, 2007 to 2022 (\$ million real)	42
Figure 2.31: Value of total goods imports, quarterly, 2007 to 2022 (\$'000).....	43
Figure 2.32: Value of total imports, annual, 2008/09 to 2021/22 (\$'000).....	43

Figure 2.33: Major goods exports, 2016/17 to 2017/18 (\$'000).....	44
Figure 2.34: Total goods exports 2012/13 to 2021/22 (\$'000).....	44
Figure 2.35: Balance of trade (goods) 2012/13 to 2021/22 (\$'000).....	45
Figure 2.36: Overall balance of trade, 2015/16 to 2021/22, (\$'000).....	45
Figure 2.37: Total value of bank deposits, March 2011 to March 2018 (\$'000).....	46
Figure 2.38: Total value of bank loans, March 2011 to March 2018 (\$'000).....	47
Figure 2.39: Non-performing loan ratio, March 2015 to June 2018.....	47

1 Fiscal Strategy

1.1 Introduction

The Cook Islands has experienced a run of strong economic growth in recent years, generating a stream of Government revenue that has increased at a faster rate than Government expenditure, providing a sound fiscal basis for the 2018/19 budget. A strong fiscal position makes the Cook Islands more resilient to future economic shocks and natural disasters.

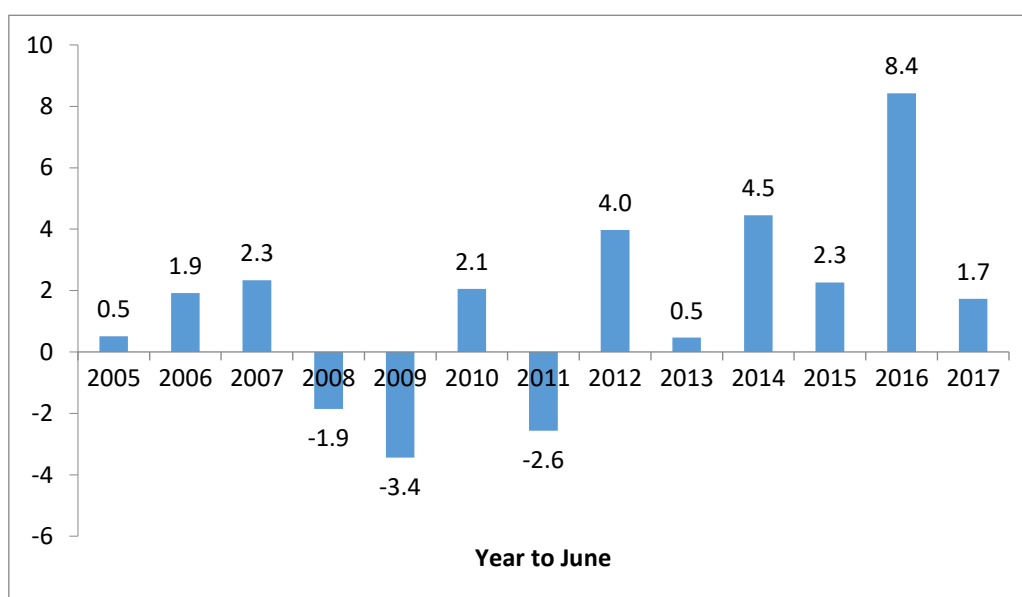
In this context, the Cook Islands Government has developed an interim fiscal strategy for the 2018/19 Budget. The strategy involves mild fiscal expansion which is expected to be more than offset by increases in revenue, resulting in improvements to the operating and fiscal balances in 2018/19 and the forward estimates.

The Government is currently working on developing a Medium-term Fiscal Framework, which will be implemented as of the 2019/20 Budget and will factor in broader economic analysis in determining the future fiscal strategy.

Economic performance

The Cook Islands has experienced positive real growth in its Gross Domestic Product (GDP), the primary measure of economic performance, since 2011/12, as shown in 1. Growth has averaged 3.6 per cent per year over the period 2011/12 to 2016/17. The key driver has been a boom in tourist arrivals, in turn driving strong performances by the hotels and accommodation, wholesale and retail trade, transport and communications and construction sectors of the economy. A growth rate of 1.7 per cent growth was recorded in 2016/17, the most recent complete financial year for which observed GDP production data is available. A growth rate of 1.8 per cent is estimated for 2017/18.

Figure 1.1: Real GDP growth, annual percentage change



Government revenue and expenditure

Figure 1.2 shows a time series of general Government operating revenue and expenditure from 2012/13 to 2017/18. The chart shows that, on average over the last five years, Government operating revenues have been rising at a faster rate (10 per cent) than operating expenditure (7 per cent), to the benefit of the net operating balance. From 2012/13 to 2014/15, the net operating balance averaged \$5.8 million. This compares to an average of \$28.7 million over the last three years, a 5-fold increase.

Figure 1.2: Government revenue and expenditure, as at June (\$'000)

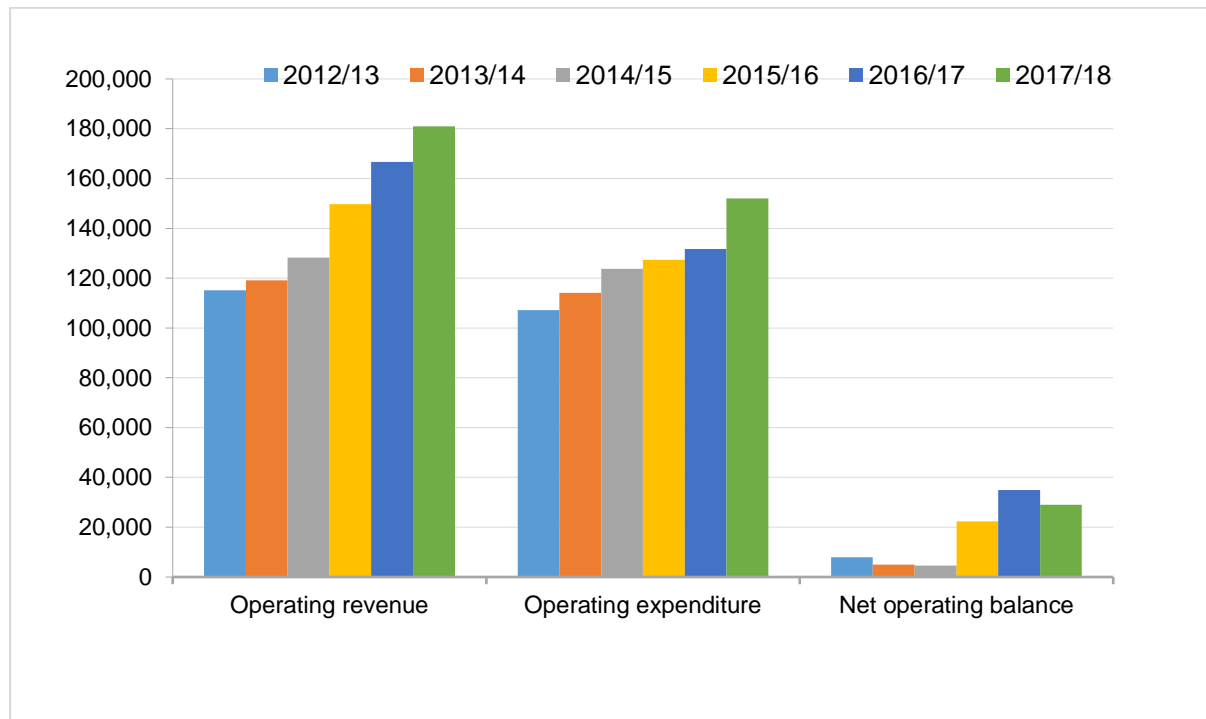
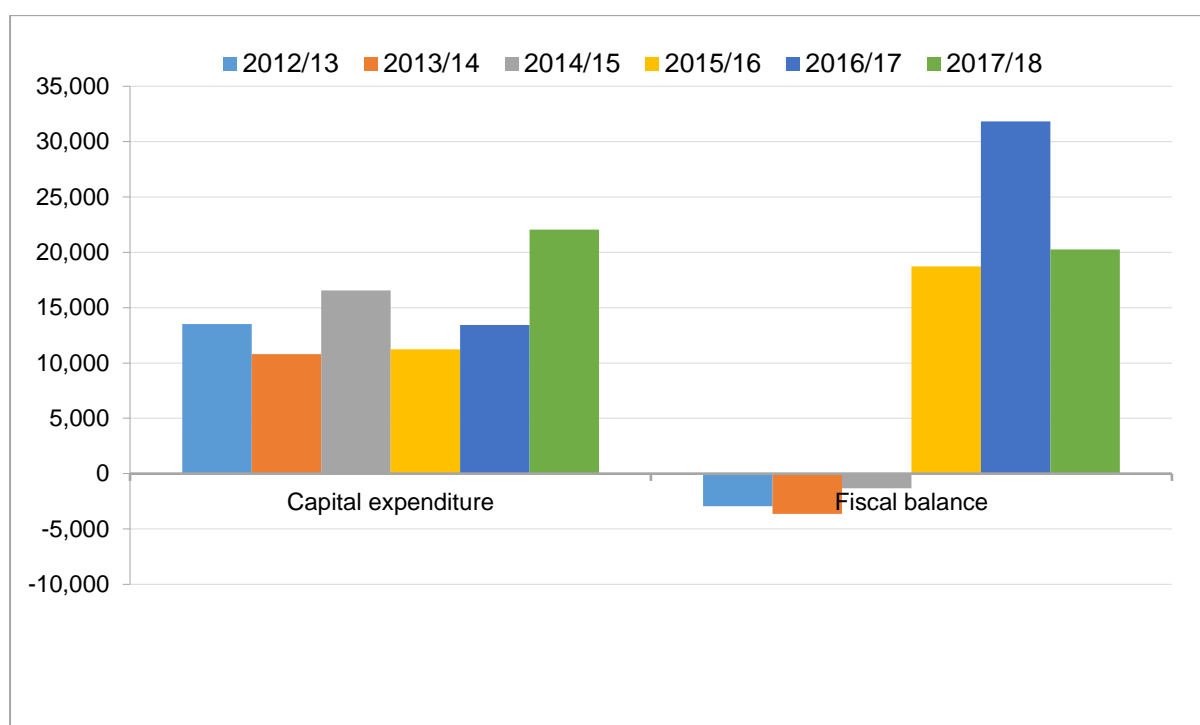


Figure 1.3 shows a time series of capital expenditure for 2012/13 to 2017/18 and the Government's fiscal balance, which is the net operating balance minus capital expenditure plus depreciation. Expenditure on capital projects has risen, rising from an average of \$13.6 million from 2012/13 to 2014/15, to \$15.6 million over the last three years. This reflects expenditure on a number of large capital projects, such as renewable energy in the Pa Enua, Te Mato Vai and Tereora College.

Figure 1.3: Fiscal balance, as at June (\$'000)



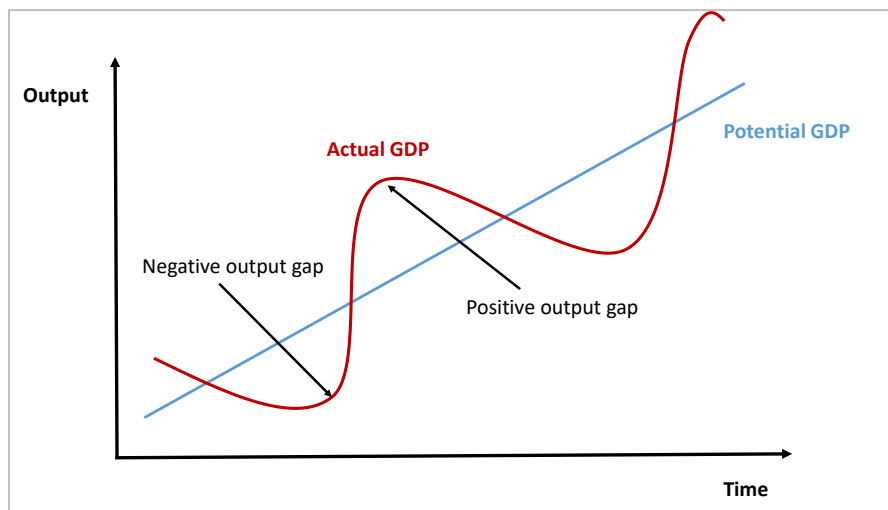
While the fiscal balance of \$20.3 million in 2017/18 is 36 per cent less than the \$31.8 million in 2016/17, the real story lies in the change over the last several years. The fiscal balance has risen from an average of -\$2.6 million from 2012/13 to 2014/15, to \$23.6 million over the last three years.

1.2 Where are we in the economic cycle? The output gap

The Cook Islands position in the economic or business cycle can be established by measuring the output gap – that is, the gap between potential economic output and observed output – measured in terms of GDP.

The output gap is a measure of the overall level of slack in the economy (see Figure 1.4). A positive output gap means the economy is operating above full capacity. If maintained for an extended period of time, this leads to the build-up of inflationary pressure. A negative output gap means that there is spare capacity, or slack, in the economy due to weak demand for goods and services. An extended period under this situation can lead to deflation and economic recession.

Figure 1.4 Stylised output gap example



Source: RBNZ (2018).¹

Following the Keynesian model, when faced with a positive output gap and the potential for the economy to overheat, governments may consider implementing contractionary fiscal policy – in particular decreasing government expenditure. In contrast, expansionary fiscal policy is often the remedy when dealing with a negative output gap – that is, an increase in government expenditure to stimulate economic demand.

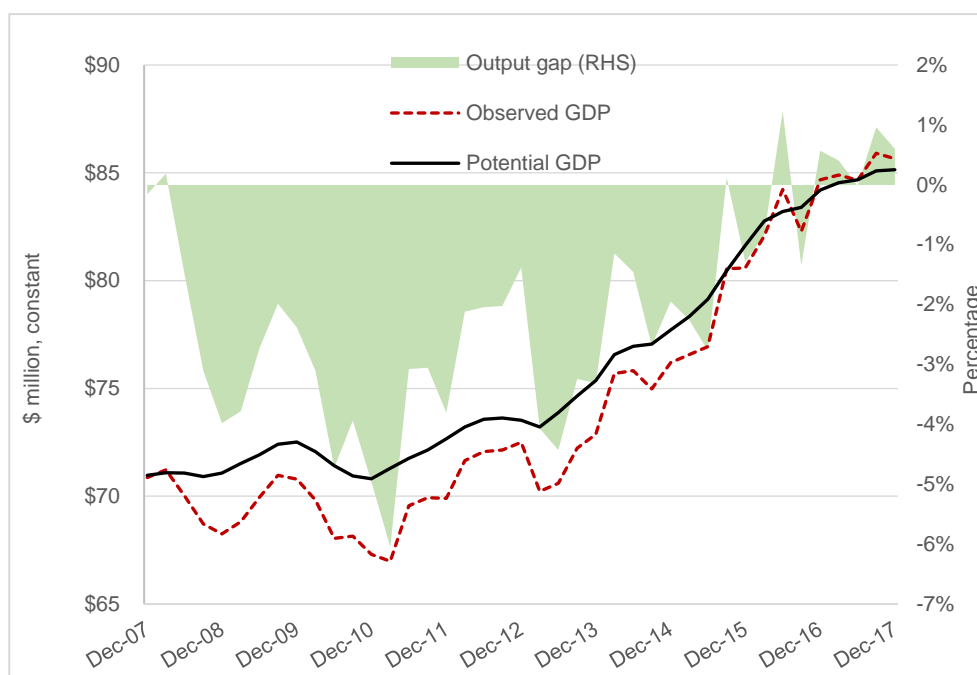
The Government has undertaken a preliminary analysis of the Cook Islands output gap using a range of econometric techniques, information on which is available on the Ministry of Finance and Economic Management website.²

The key conclusion from MFEM's preliminary analysis in Figure 1.5, is that the Cook Islands is currently confronting a positive output gap. While there is no evidence of overheating showing up in the CPI data at present – see section 2.5 for more detail – should the positive output gap continue for an extended period of time, capacity constraints such as labour and skills shortages are likely to strengthen, resulting in inflationary pressure.

¹ *Monetary Policy Statement, May 2018*. Reserve Bank of New Zealand, Wellington. May 2018.

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>.

Figure 1.5: Output gap, multivariate Kalman filter estimate³



Source: MFEM analysis.

The implication of this preliminary result is that a contractionary fiscal stance should be considered moving forward in an effort to avoid further overheating the economy, and at the same time limit any potential for government expenditure to crowd out private investment. Further analysis of the Cook Islands output gap and the implications for fiscal policy will be undertaken as part of the development of the Medium-term Fiscal Framework, and implemented in the 2019/20 Budget.

1.3 Fiscal strategy

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

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 key tool for achieving the national sustainable development plan.

The current fiscal strategy is guided by the fiscal responsibility provisions in Part III of the *Ministry of Finance and Economic Management Act 1995-96* (MFEM Act),⁴ and a number of supporting fiscal responsibility ratios (FRRs) 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:

³ The output gap is calculated as a percentage of potential output.

⁴ Available at: <http://www.mfem.gov.ck/mfem-legislation>.

- **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 have been reported in the budget historically and are used to guide budget appropriations for the current budget year and two forward years, a clear fiscal strategy has not previously been outlined at the beginning of the budget process, which has served to decrease the application of the FRRs and medium-term fiscal planning. Proposed improvements to the fiscal planning process to be implemented from the 2019/20 Budget are outlined below. It is expected that these changes will help to improve the linkages between economic management and fiscal planning.

Medium-term fiscal and budget frameworks

The Government now believes that the design of the current fiscal strategy and the FRRs may 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.⁵

To address these concerns, the Government has committed to strengthening 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. To this end, a Medium-term Fiscal Framework (MTFF) will be developed as part of the 2019/20 budget cycle. Once developed, the framework will include three key pieces of information; macroeconomic

⁵ See 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>.

indicators for the medium-term, including forecasts for expenditure and revenue, fiscal targets and an analysis of fiscal risks.

An assessment of macro-economic indicators, and the development of revised fiscal targets will be crucial in providing guidance on the role that the Government should be playing in the medium-term. A key aim of the MTFF will be to smooth Government expenditure over the course of the economic cycle so that in the case where economic growth slows, the Government will be able to maintain its current level of expenditure over the short-term, despite lower revenue collections. This approach will help deliver macroeconomic stability, encourage private investment and entrench low public debt.

In addition, to complement the new fiscal approach, the Government aims to strengthen its current Medium-term Budget Framework (MTBF) by developing agency expenditure ceilings for the budget year plus three forward years. It is expected that this will ensure that agencies have the ability to plan their operations over the forward estimates and that consideration is given to the additional demands on agencies over that period.

The Government aims to develop the MTFF and the MTBF in time to implement the new approach for the 2019/20 budget.

Interim fiscal strategy for 2018/19

In 2018/19 the Government will implement an interim fiscal strategy, prior to the development of the Medium Term Fiscal Framework. During this period the Government will focus on balancing; the economic impact of a mildly expansionary fiscal policy, the need for sufficient operating funds for core Government agencies and the current state of a number of key pieces of national infrastructure.

As such, operating expenditure is expected to expand by \$10.7 million in the 2018/19 fiscal year, although only \$5 million of this is recurrent. Capital expenditure is expected to remain steady at \$44 million in 2018/19 before decreasing in the forward estimates, with a focus on completing current projects before committing to new expenditure.

Despite the increase in operating expenditure, strong revenue growth is expected to result in improvements in the fiscal balance to a deficit of 1.9 per cent of GDP up from the deficit of 4 per cent of GDP anticipated at the time of the 2017/18. The Government is now on track to achieve fiscal balance in 2019/20, one year earlier than planned.

The mild adjustments to expenditure reflect a fiscally responsible budget which pursues improvements to the productive capacity of the Cook Islands economy in the medium to long-term, thus increasing 'potential GDP' in future years.

2 Economic Update

2.1 Summary

Economic performance

The Cook Islands economy has experienced a strong run of real economic growth in recent years, averaging 3.7 per cent per year over the period 2011/12 to 2016/17, thanks to unprecedented tourism arrivals and higher levels of public and private capital investment.

Over the last three years, tourist arrivals have risen by an average of nearly 11 per cent per year, from 121,772 in 2014/15 to 164,800 in 2017/18. July 2018 saw the most visitors the Cook Islands has ever seen, with 18,332 arrivals.

The value of residential and commercial (commercial, tourism and community buildings) building approvals has also been much higher than trend in the three years to 2017/18. The rise in residential approvals appears to be for holiday houses, rather than residential living, driven by tourism growth. Commercial approvals have been led by a number of large community projects, as well as a significant spike in tourist accommodation approvals.

Government capital expenditure, including on a number of large signature projects such as renewable energy in the Pa Enuva and Te Mato Vai, has risen from an average of \$13.6 million from 2012/13 to 2014/15, to \$15.7 million over the last three years.

This strong economic performance may result in the graduation of the Cook Islands from the Organisation for Economic Cooperation and Development's (OECD) Official Development Assistance (ODA) eligibility list in early 2019. Work is currently being undertaken by the Statistics Office to develop comprehensive balance of payments data, which will be used to determine the Cook Islands' Gross National Income for the last three years. This data will be used by the OECD to determine whether the Cook Islands has reached the level of economic development required to graduate to 'high income status'.

Preliminary analysis by the Government suggests that the Cook Islands economy is currently performing above its potential level – that is the Cook Islands is facing a positive output gap. While there is little sign of economic overheating in the leading economic indicator, the CPI, there are increasing signs of capacity constraints emerging in the labour and housing markets, and the construction sector. As a result, the Government has maintained consistent capital expenditure estimates in the 2018/19 Budget to ensure that it does not further fuel the constraints in these sectors.

Economic outlook

In summary, the outlook for Cook Islands economy is positive, albeit at lower levels than seen in recent years, with real GDP growth expected to average 1.7 per cent per year. This is due to continue, with slower growth in tourism – as the number of beds reaches capacity – and a slowdown in investment, both public and private.

With a mildly expansionary fiscal stance over the forward budget period, the capacity constraints alluded to above are expected to tighten in the medium-term. Further pressure on the domestic housing market is likely, along with wage-price pressure flowing from an

increasing shortage of skilled workers. Along with imported inflation from a depreciating New Zealand dollar, this is expected to result in inflation rising from 0.4 per cent in 2017/18 to an average of 1.4 per cent per year over the forward period.

Over the longer-term, a number of planned capital projects are expected to increase the productive capacity of the Cook Islands economy, increasing the 'potential GDP' in future years, helping to ease capacity constraints.

Table 2.1 provides a summary of the key indicators for the budget appropriation year and the three forward years of the 2018/19 budget cycle.

Table 2.1 Summary of economic indicators

	2017/18	2018/19	2019/20	2020/21	2021/22
	Est	Proj	Proj	Proj	Proj
Economic activity					
Nominal GDP (\$'000)	434,306	445,808	455,868	464,696	473,630
Percentage change (YOY)	2.6	2.6	2.3	1.9	1.9
Real GDP (at constant 2006 Prices,	341,542	349,331	355,272	360,705	365,888
Percentage change (YOY)	1.8	2.3	1.7	1.5	1.4
Inflation (CPI)					
Percentage change (YOY)	0.4	1.0	1.6	1.5	1.5
Construction/capital investment					
Commercial building approvals	7,968	7,968	7,968	7,968	7,968
Residential building approvals	11,993	12,073	12,073	12,073	12,073
Public works (\$'000) (includes dev	35,747	28,252	21,631	21,035	18,008
Productive sector indicators					
Visitor arrivals	164,800	172,048	176,282	179,171	181,173
Percentage change (YOY)	6.2	4.4	2.5	1.6	1.1
Estimated visitor expenditure (\$'000)	321,515	334,942	338,782	335,095	344,658
Pearl exports (\$'000)	122	122	122	122	122
Fish exports (\$'000)	3,266	3,266	3,266	3,266	3,266
External sector					
Merchandise trade balance (\$'000)	-179,270	-183,581	-189,034	-193,658	-197,933
Services trade balance (\$'000)	312,543	331,161	336,428	334,076	343,639
Exchange rate (USD/NZD average)	0.71	0.66	0.68	0.70	0.70

2.2 Key assumptions

Introduction

The Government has used two models to forecast GDP – an econometric time series model for GDP production and a bottom-up component approach for GDP expenditure.

The Cook Islands Statistics Office publishes current price and real price (2006 base year) estimates of GDP on quarterly basis, using the production approach. GDP production estimates are disaggregated by major industry classifications, including institutional sectors. The latest data from the Statistics Office is for the December quarter 2017. In addition to GDP production, MFEM produces GDP estimates based on the expenditure national accounting measure.

For the purposes of this annual budget exercise, MFEM has produced estimates of both GDP production and GDP expenditure for 2017/18, and forecasts for the 4-year forward budget period from 2018/19 to 2021/22.

GDP production model

A time series multivariate ARIMA model was used to forecast aggregate GDP production, in real terms. A combination forecasting method has been adopted, utilising a simple average of five quarterly time series models, one multivariate and four univariate. Nominal forecasts are then derived by applying an implicit GDP price deflator, constructed using an import price index over the forward period. For more detailed information on the time series model, see Cook Islands time series economic forecasting model: Working Paper No. 18/1, available on the MFEM website.⁶

GDP expenditure model

A bottom-up approach is used to forecast nominal GDP expenditure. This relies on estimates of public sector consumption and investment (including aid assistance), net merchandise trade, total tourism spending, domestic investment, and domestic consumption. The aggregate GDP expenditure estimate is ex-post adjusted to match aggregate nominal annual GDP production forecasts.

Services exports, or tourism expenditure, is the largest single component of the expenditure forecasts. First, international arrivals are forecast using an econometric time series model using data from the Customs and Immigration database of arrivals and departures. The arrivals forecasts, by country of origin, are presented in Chapter 6. Second, average visitor expenditure is estimated, based on an estimated average number of days (about 8 days), multiplied by average daily expenditure (about \$300 per day). This information is estimated from quarterly survey data. Total tourism expenditure is then calculated by multiplying the number of arrivals by the average expenditure.

Public consumption is the second largest single item and is estimated using the personnel (compensation of employees) and operating (use of goods and services) appropriation for both Government and aid expenditure. Public investment is also a significant component of the model, and is estimated based on capital plans over the forecast period, including ODA investment, for which a smoothing approach is taken to reflect assumed delays and rollovers. Private (domestic) consumption is estimated based on consumption patterns observed through the VAT data series.

⁶ Available at: <http://www.mfem.gov.ck/economics>.

Gross fixed investment is estimated using imports of machines, transport and equipment, the value-added by the construction sector, and a component of donor funded capital projects.

Data

The key data sets used for the two models are:

- Real and nominal GDP – quarterly data to December 2017;
- Trade, imports and exports – quarterly data to June 2018;
- CPI – quarterly index data to June 2018;
- International arrivals – Customs and Immigration monthly data to June 2018;
- Building approvals – quarterly data to June 2018;
- Government revenue and expenditure – annual data to June 2018;
- A range of international commodity and other price indices.

2.3 The global economy

The Cook Islands is a small, open economy whose economic growth is heavily reliant on the export of goods and services to a number of key partner countries, New Zealand, Australia and the United States of America in particular. As such, it is necessary to examine the economic conditions and outlook for our key partners, as well as the regional and global economy.

New Zealand

The Reserve Bank of New Zealand's (RBNZ) Monetary Policy Statement August 2018 reports annual GDP growth of 2.7 per cent in the March 2018 quarter, down from over four per cent in mid-2016. The lower GDP growth is largely due to a softening of growth in residential investment which is expected to weigh on household spending going forward. The RBNZ reports that inflation remains below the two per cent target mid-point, but note that there are signs of inflationary pressure rising.

The RBNZ expects positive global conditions, stimulatory fiscal (such as KiwiBuild) and monetary (low interest rates) policy in New Zealand, and higher net exports thanks to a depreciating currency, to increase annual GDP growth to above trend in 2019.

In its August 2018 statement, the RBNZ decided to leave its official cash rate unchanged, at 1.75 per cent. The Bank indicated that the rate is expected to remain at its current level through 2019 and into 2020.

Australia

The Reserve Bank of Australia's (RBA) Statement on Monetary Policy May 2018 reports that Australian GDP growth, supported by accommodative domestic monetary policy and a positive international outlook, is expected to be just above 3 per cent in both 2018 and 2019. The RBA notes that this will reduce spare capacity, with the unemployment rate forecast to decline to about 5 per cent by the end of 2020. As the labour market tightens, the RBA expects wages growth and inflation, at 2.1 per cent in the June 2018 quarter, to increase gradually.

Conditions in the Australian housing market have eased. Australian Bureau of Statistics figures show that residential property prices fell 0.7 per cent in the March 2018 quarter, led by the first quarterly price decline in Melbourne for five-and-a-half years and the first annual slide in Sydney in six years. Concerns are also being raised about the impact on the housing market of the transition of about \$360 billion of interest only loans to interest and principal loans over the next three years. In addition, three of the big four Australian banks, recently raised their standard mortgage rates despite the RBA keeping the cash rate steady at 1.5 per cent for the last two years.

In its August 2018 statement, the RBA chose to leave the cash rate unchanged, noting that higher interest rates will be necessary at some point, if the Australian economy continues to evolve as expected.

Looking forward, the RBA highlighted risks to global financial markets from the increasing levels of trade protectionism, particularly for trade-exposed economies. The United States started the ball rolling raising tariffs on US\$34 billion of imports from China in early July, adding a further US\$16 billion in August. China responded with tariff increases on a similar value of imports from the United States. More recently, in September 2018, the US added another \$200 billion of tariffs on Chinese goods. The United States has also increased tariffs on steel and aluminum imports from almost all economies. The European Union, Canada and Mexico have responded with tariff increases on a wide range of US imports. The RBA noted that intensification of protectionist measures could materially weaken the investment outlook and weigh on confidence and financial market conditions more generally.

United States

The International Monetary Fund's (IMF) World Economic Outlook April 2018 expects United States GDP growth to rise from 2.3 percent in 2017 to 2.9 percent in 2018, before moderating slightly to 2.7 percent in 2019. This reflects stronger than expected activity in 2017, firmer external demand, the expected macroeconomic impact of the December 2017 tax reform (especially the lower corporate tax rates) and higher public spending following the February 2018 bipartisan budget agreement.

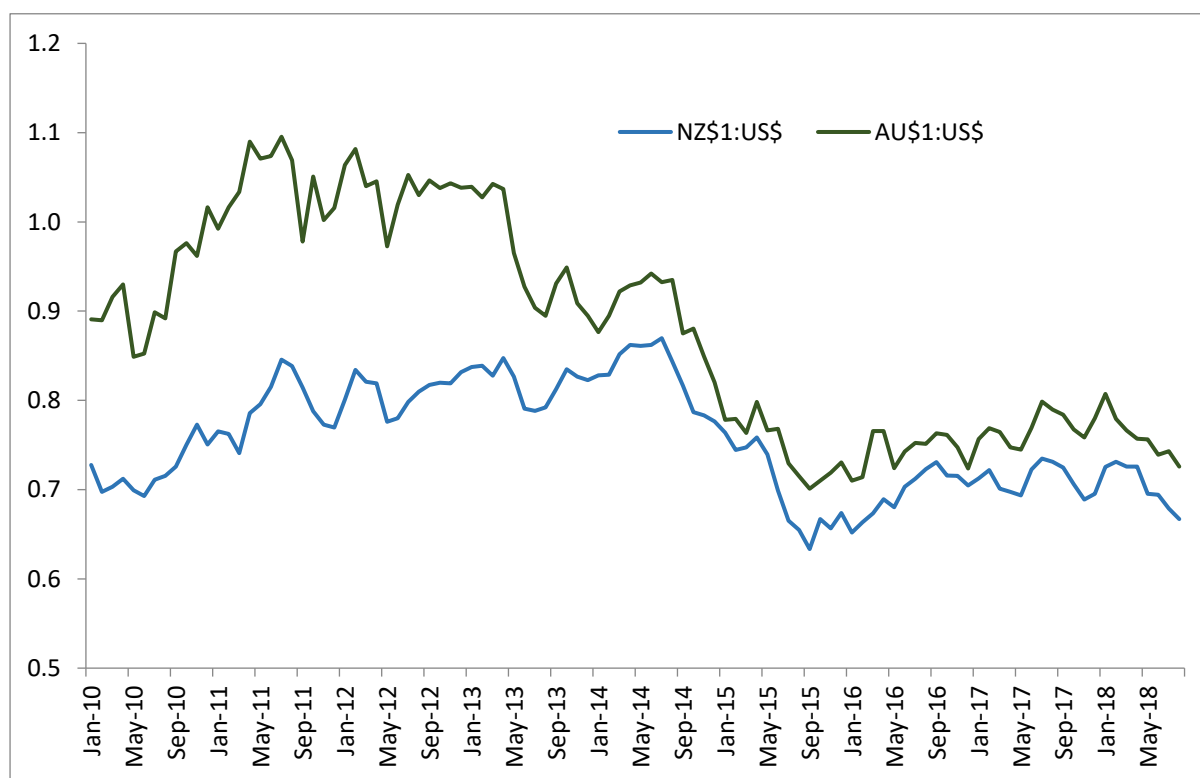
In June 2018, the US Federal Reserve (the Fed) raised its target benchmark rate, for the seventh time since 2015, to 1.75 – 2 per cent, the highest level since 2008. The tighter monetary policy reflects the recovery in the US economy. In its August 2018 meeting, the Fed maintained the target federal funds rate at this level. In arriving at its decision, the Fed cited the need to maintain an accommodative monetary policy to support the strong labour market conditions and a sustained return to 2 per cent inflation.

The RBA Governor, Philip Lowe, in a recent speech in Perth, raised concerns about a material lift in inflation in the United States. The Governor noted that the US is experiencing a large fiscal stimulus at a time when the economy is at full employment and is growing quickly, past experience suggesting this could lead to inflation increasing significantly. He further noted that financial markets are heavily discounting this possibility, which means that if it did take place it would come as a surprise, with repercussions for markets and the real economy.

Rising US interest rates have led to a broad-based appreciation of the US dollar, including against commodity currencies such as the Australian and New Zealand dollars. Figure 2.1

shows the steep decline in the New Zealand dollar from 73.5 cents in August 2017 to 67 cents in August 2018.

Figure 2.1: US dollar exchange rate, New Zealand and Australia



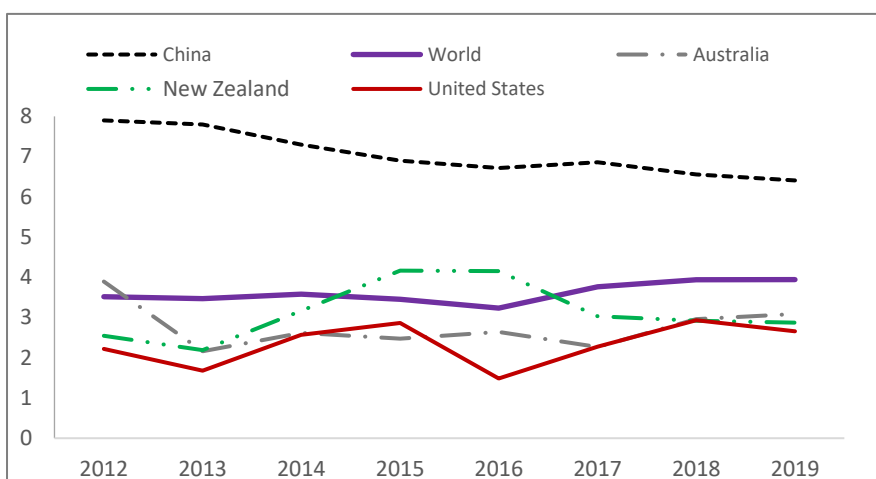
Asia Pacific

The Asian Development Bank (ADB), in its July 2018 Asian Development Outlook Supplement, expects regional GDP to rise by 6.0 per cent in 2018 and 5.9 per cent in 2019, the same rate as envisaged in its April outlook. The ADB notes that the rise in protectionist trade measures from the US and countermeasures from China and other countries poses a clear downside risk to the outlook for developing Asia. The ADB expects economic growth in the Pacific of 2.2 per cent in 2018, accelerating to 3.0 per cent in 2019, due to an expected rebound in Papua New Guinea and stable or improved economic performance in most of the smaller Pacific economies.

Global

The IMF increased its global growth estimate for 2017 to 3.8 per cent in its April 2018 World Economic Outlook, the fastest growth since 2011 (see Figure 2.2). This strong result was due to increased investment spending in advanced economies and an end to declining investment in some commodity-exporting emerging market and developing economies.

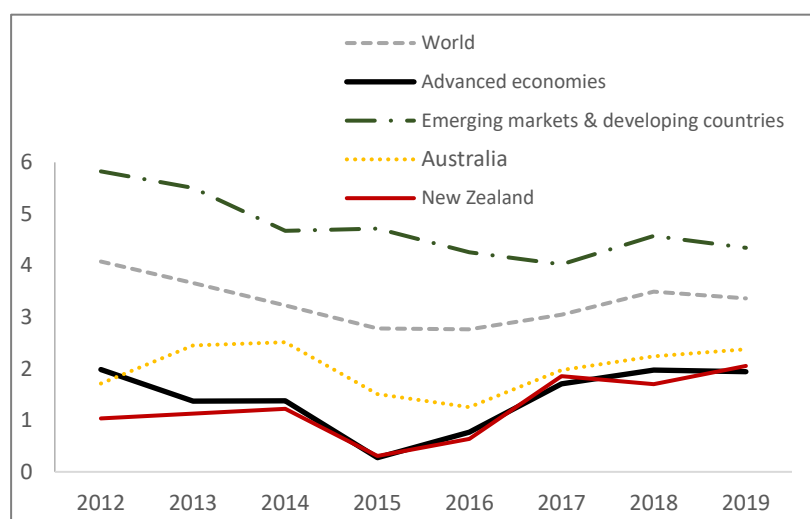
Figure 2.2: IMF GDP growth estimates, selected countries



In its July 2018 update, the IMF maintained its outlook for global growth to reach 3.9 percent in 2018 and 2019, but with risks to the outlook mounting, including rising oil prices, escalating trade tensions and market pressures on the currencies of some economies with weaker fundamentals.

Growth in the global economy is expected to have a positive impact on the Cook Islands' economy through increased tourism, although it does pose a risk of increased inflation. The IMF expects headline inflation to pick up over the near term due to stronger demand putting upward pressure on commodity prices and the strengthening global outlook narrowing output gaps. Headline inflation rates in advanced economies are projected to rise to about 2 percent in 2018 and 2019, from 1.7 per cent in 2017 (see Figure 2.3). Core inflation (excluding fuel and food prices) is also expected to increase as wage dynamics reflect tighter labour markets.

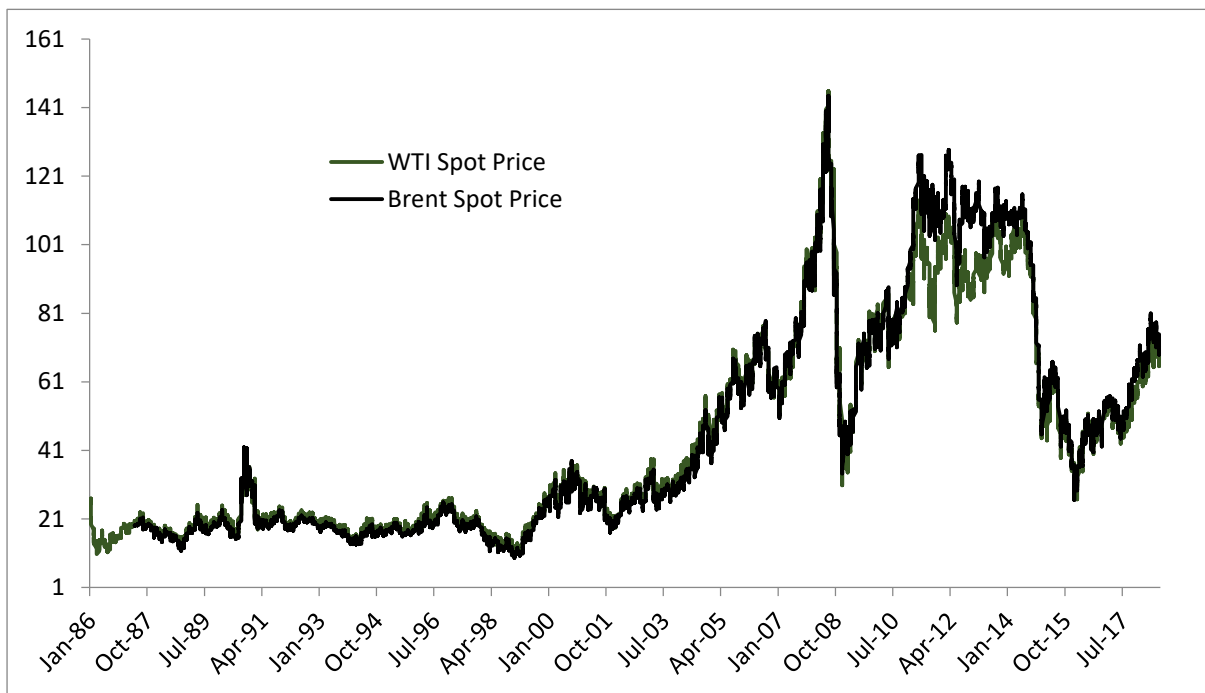
Figure 2.3: IMF inflation estimates, selected groupings and countries



Oil prices have been on the rise since 2016, increasing from around US\$26 per barrel in January 2016 to about \$70 per barrel in August 2018, as shown in Figure 2.4. The IMF expects

prices to start moderating in 2019 to about US\$58 per barrel, further moderating to about US\$54/barrel by 2022.

Figure 2.4: Daily oil spot prices, 1986 to 2018, US\$/barrel



2.4 Cook Islands Gross Domestic Product

GDP production

The Cook Islands has experienced positive real GDP growth since 2011/12, as shown in Figure 6.5, recording 1.7 per cent growth in 2016/17, the most recent complete financial year for which observed GDP production data is available.

Figure 2.5: Real GDP growth, annual percentage change

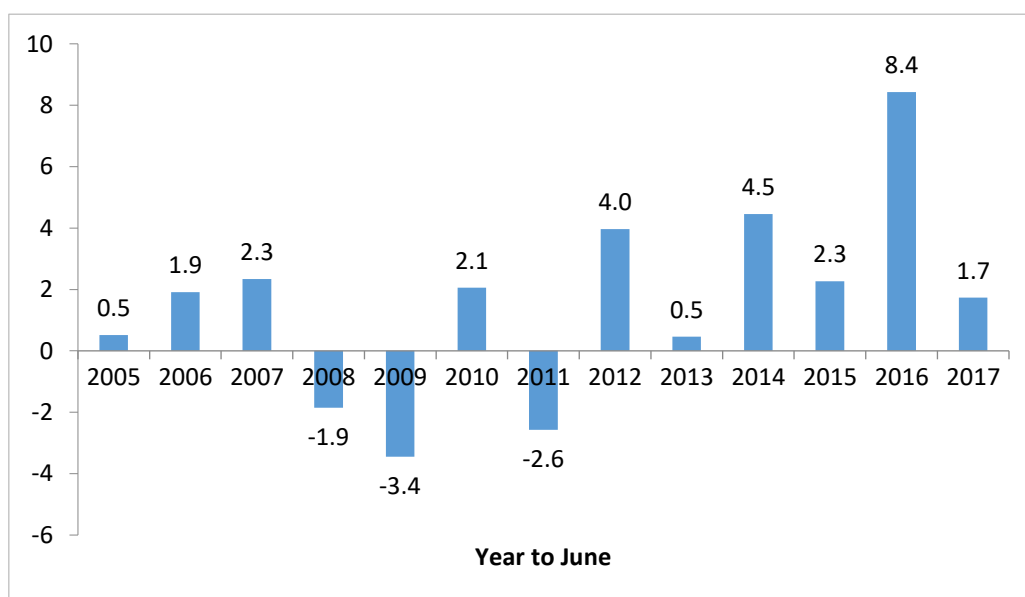
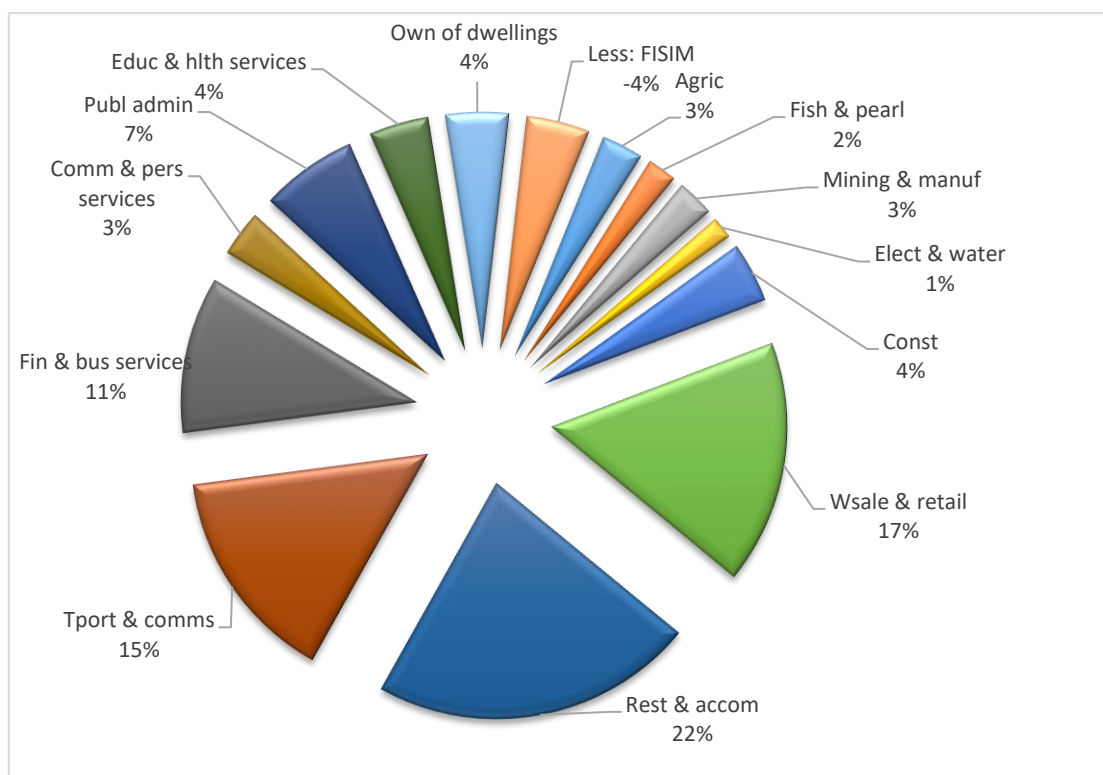


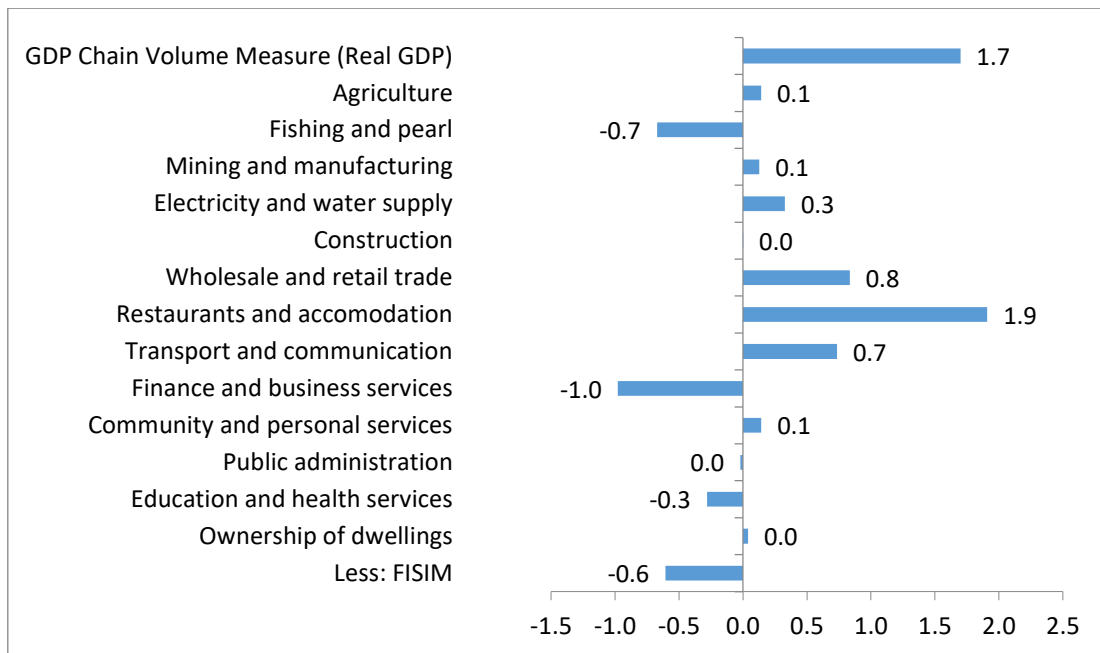
Figure 2.6 shows the breakdown of the Cook Islands economy by industry in 2016/17. The economy is dominated by the tertiary or services sector, with the three largest tertiary industries, restaurants and accommodation, wholesale and retail trade and transport and communications, accounting for more than half of total economic output.

Figure 2.6: Cook Islands economy by industry, 2016/17



In 2016/17, high tourist arrivals drove strong growth in the economy, with the tertiary sector contributing 2.4 percentage points to economic growth. The strongest contributions were from restaurants and accommodation (1.9 percentage points), wholesale and retail trade (0.8 percentage points) and transport and communication (0.7 percentage points). Finance and business services and education and health services contracted in 2016/17. During this period, restaurants and accommodation grew by 8.4 per cent to \$82 million, transport and communication grew by 4.9 per cent to \$52 million and wholesale and retail trade grew by 4.6 per cent to \$63 million.

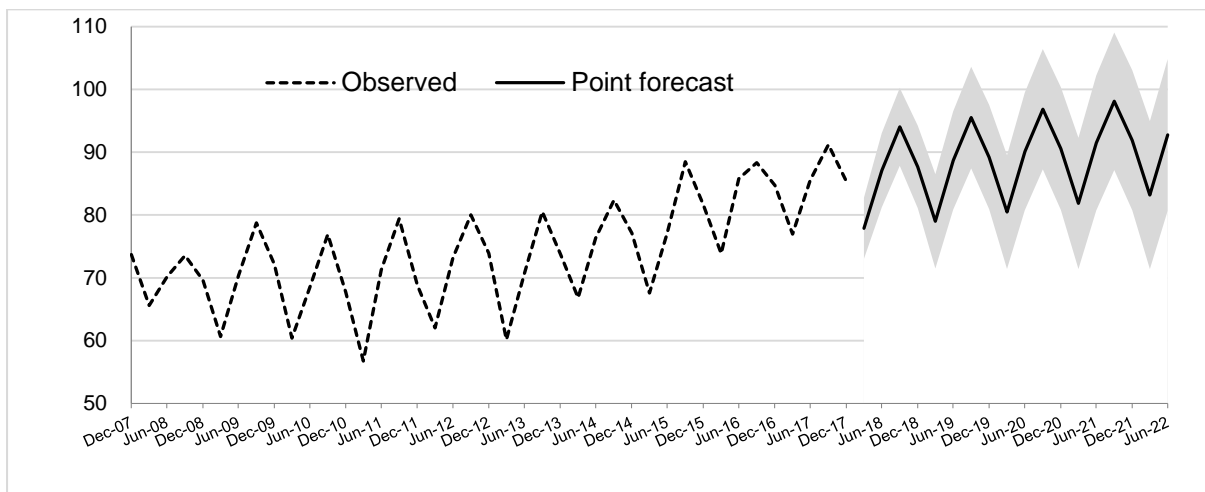
Figure 2.7: Contribution to 2016/2017 real growth (percentage point)



The secondary sector, which includes construction, electricity and manufacturing, contributed 0.5 percentage points to growth, while the primary sector, agriculture and fishing contracted, with a negative 0.5 percentage point contribution.

Observed and forecast quarterly real GDP from December 2007 to June 2022 is shown in Figure 2.8. A 95 per cent high and low confidence interval has also been computed and is displayed as the shaded area either side of the point forecast time series.

Figure 2.8: Observed and forecast real GDP, quarterly (\$m)



Aggregating GDP quarterly forecasts into financial years, the forecast percentage change over the forward budget period compared to recent years is shown in Figure 2.9. A growth rate of 1.8 per cent is estimated in 2017/18, with growth forecast to rise to 2.3 per cent in 2018/19, before falling to 1.4 per cent by the final year of the forward budget period. Average annual growth over the 4-year forward period is forecast at 1.7 per cent.

Figure 2.9: Annual change in real GDP (percentage)

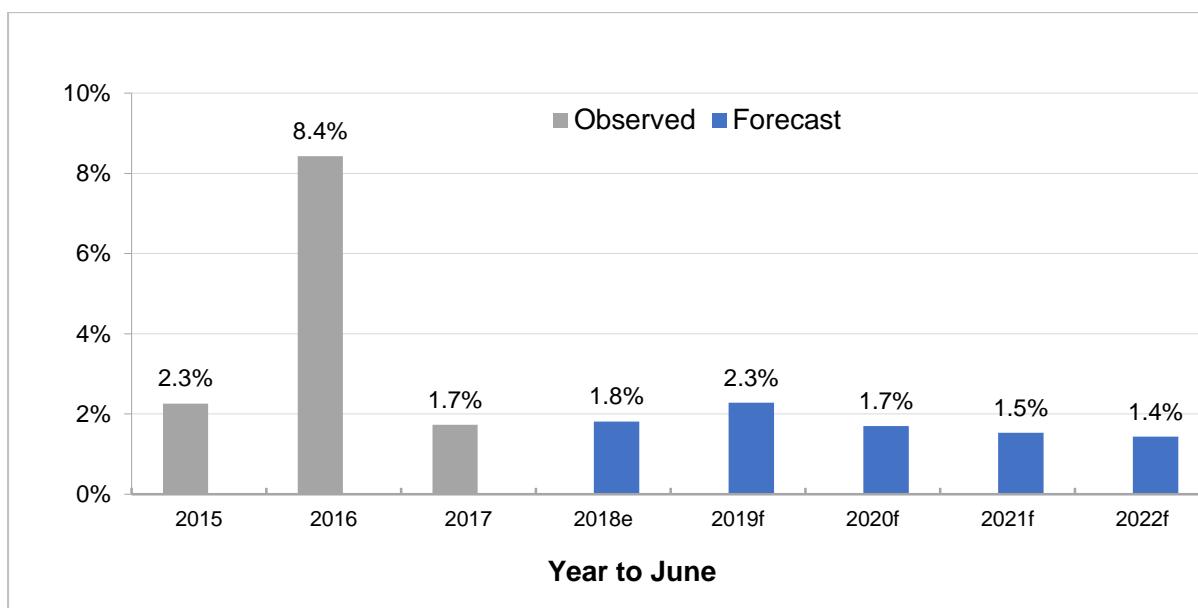
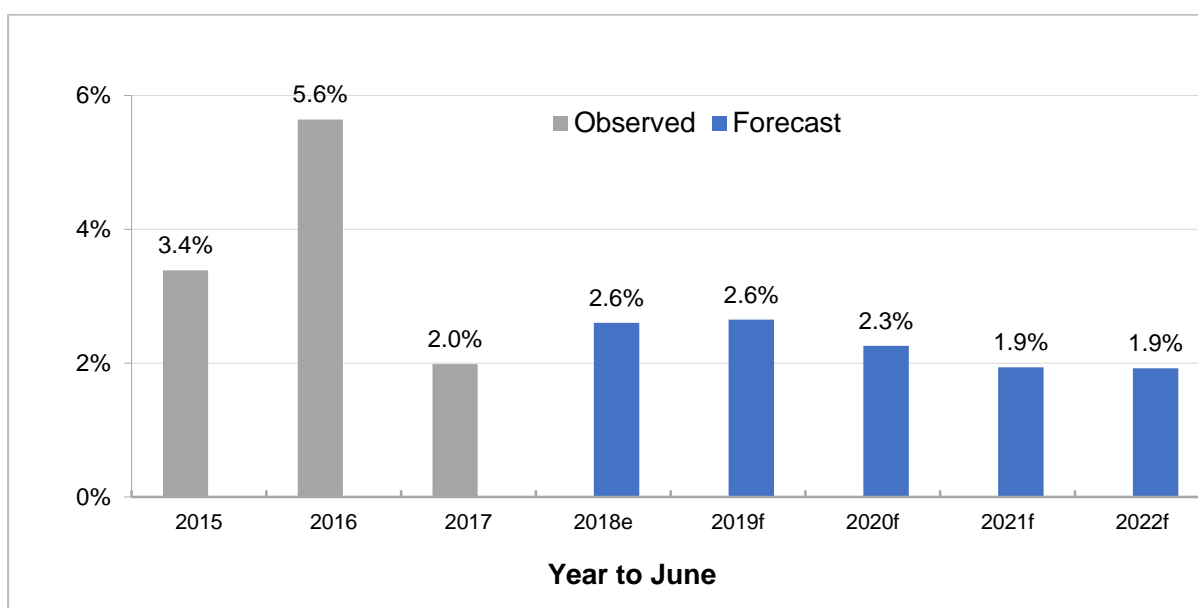


Figure 2.10 shows the forecast percentage change for nominal GDP. A growth rate of 2.6 per cent is estimated in 2017/18, with growth forecast to fall from 2.6 per cent in 2018/19 to 1.9 per cent by the final year of the forward budget period. Average annual growth over the 4-year forward period is forecast at 2.2 per cent.

Figure 2.10: Annual change in nominal GDP (percentage)



GDP expenditure

When assessing the economy using the expenditure approach, MFEM estimates that exports of goods and services contributed 2 percentage points to total nominal growth of 2.6 per cent in 2017/18. Exports are expected to contribute 2 percentage points to growth in 2018/19, falling steadily to 1.4 per cent by 2021/22, due to weaker expected growth in tourism arrivals.

Consumption is estimated to contribute 1.5 percentage points to growth in 2017/18. This comprises 0.7 and 0.8 percentage points from public and private consumption, respectively. Consumption is expected to contribute 1.5 percentage points to economic growth in 2018/19, before falling steadily to about 1.1 percentage points by 2021/22.

Gross fixed investment (public and private) is estimated to contribute 0.5 percentage points in 2017/18. This is expected to remain steady for the next few years as a result of delays in a number of public capital projects, before falling to about 0.3 percentage points in 2021/22.

Imports and imported components of capital expenditure are estimated to have detracted 1.4 percentage points from nominal growth in 2017/18, remaining at a similar level in 2018/19. The negative impact is expected to moderate over the out years to about 1 percentage point as the major donor funded projects wind down.

Table 2.2 provides a summary of the estimated and forecast GDP expenditure from 2017/18 to the end of the budget forecast period, and its major components.

Table 2.2 Nominal GDP Expenditure summary (\$'000)

	2017/18	2018/19	2019/20	2020/21	2021/22
Consumption expenditure	248,095	255,781	264,500	272,587	280,088
<i>Government</i>	117,045	117,045	117,045	117,045	117,045
<i>Private</i>	131,050	138,736	147,455	155,542	163,043
Gross fixed investment	88,530	88,435	85,941	83,400	83,945
Machines, transport and equipment	51,689	53,899	55,441	56,073	56,332
Construction	16,956	15,515	15,801	16,087	16,373
Donor funded gross fixed investment	19,885	19,021	14,698	11,240	11,240
Net exports	97,682	101,592	105,428	108,710	109,598
<i>Exports of goods and services</i>	326,070	339,496	343,336	339,649	349,213
Goods	4,555	4,555	4,555	4,555	4,555
Services	321,515	334,942	338,782	335,095	344,658
<i>Imports of goods and services</i>	228,388	237,905	237,908	230,940	239,615
Goods	183,824	188,135	193,589	198,213	202,487
Donor funded gross fixed investment	19,885	19,021	14,698	11,240	11,240
Imported component of CIG capex	15,706	26,968	27,268	20,468	24,870
GDP expenditure	434,306	445,808	455,868	464,696	473,630

GDP summary

In summary, as shown in Table 2.3, nominal and real GDP growth is expected to remain positive in the coming years, albeit at lower levels, due to continued but slower growth in tourism and investment, both public and private. While high levels of construction are also expected to contribute to economic growth, the resulting increase in the value of machinery imports and the import of services will likely offset the growth in construction.

Table 2.3 Annual GDP growth summary

	2017/18e	2018/19f	2019/20f	2020/21f	2021/22f
Nominal GDP growth (%)	2.6	2.6	2.3	1.9	1.9
Real GDP growth (%)	1.8	2.3	1.7	1.5	1.4
Implicit GDP deflator (percentage change)	0.8	0.4	0.5	0.4	0.5

2.5 Consumer price index

Inflation in the Cook Islands is measured by the consumer price index (CPI), which is reported on a quarterly basis by the Cook Islands Statistical Office. Aggregate inflation has fallen steadily since about 2011/12, from 2.8 per cent per year then, to minus 0.1 per cent in 2016/17. In 2017/18, CPI is estimated to have risen slightly to an average of 0.4 per cent over the year (Figure 2.11).⁷

Figure 2.11: CPI, year average, 2005/06 – 2017/18 (percentage change)

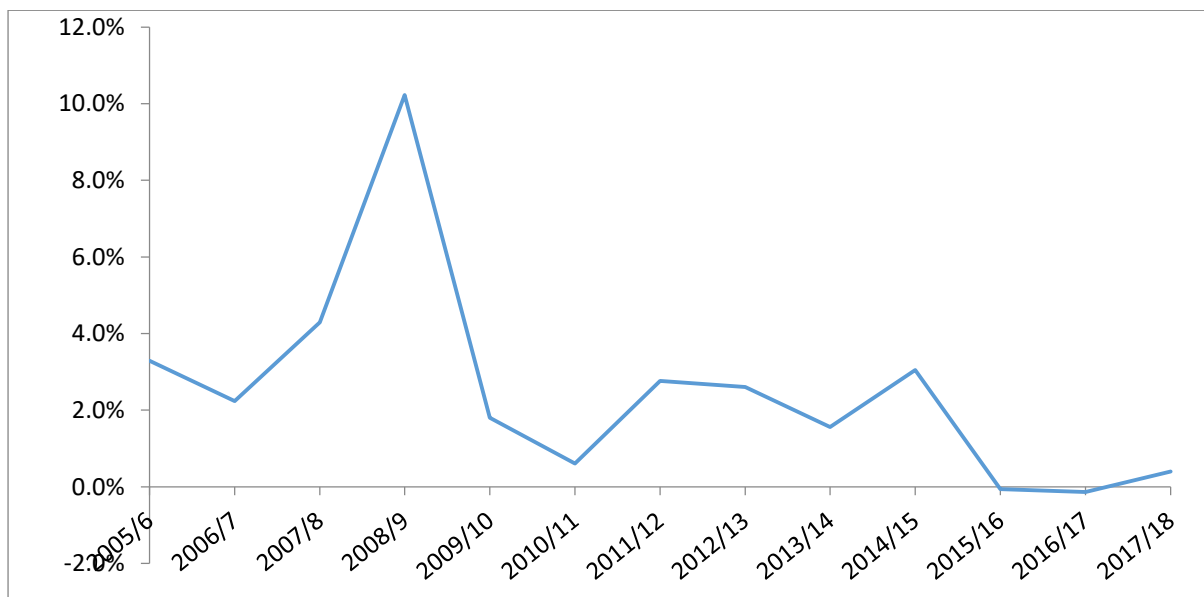
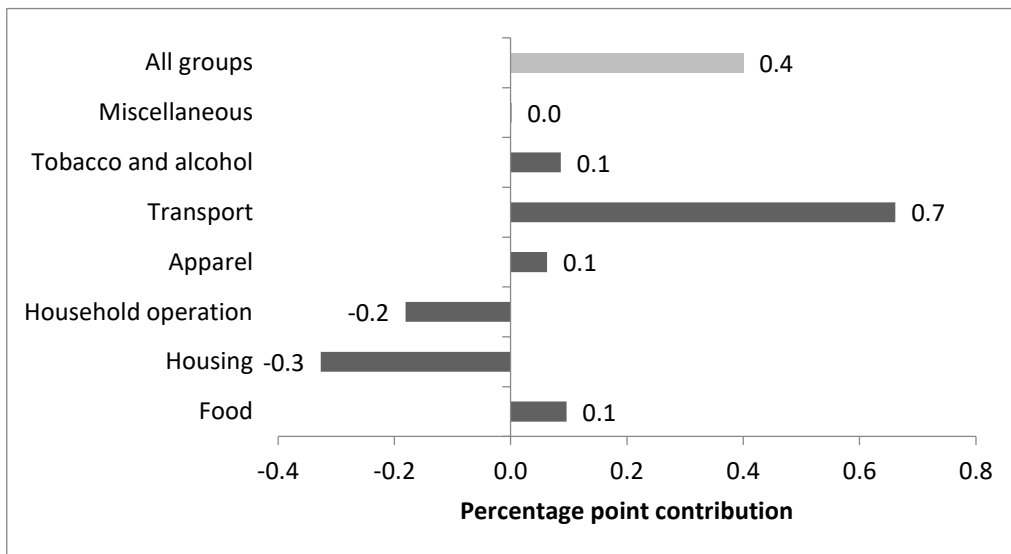


Figure 2.12 shows the contribution to aggregate inflation in 2017/18 by major category. The key driver of the increase was the transport category at 0.7 percentage points, with the household operation and housing categories partially offsetting this rise with falls of -0.2 and -0.3 percentage points, respectively.

⁷ Note that when comparing the June quarter 2018 CPI to the June 2017 quarter, that is a year on year rather than average across the year measure, the CPI for the June quarter 2018 was 0.2 per cent lower.

Figure 2.12: Contribution to 2017/18 average inflation (percentage point)



The rise in transport costs reflects a recovery in the price of oil, as shown earlier in Figure 2.4. While increased competition in flights from New Zealand to the Cook Islands have helped to keep ticket prices low, the rising oil price has affected the cost of overseas travel, as well as the price of fuel and oil in the Cook Islands. Together, the overseas travel and motor fuel and oil sub-categories account for 40 per cent of the transport category weighting in the aggregate CPI measure.

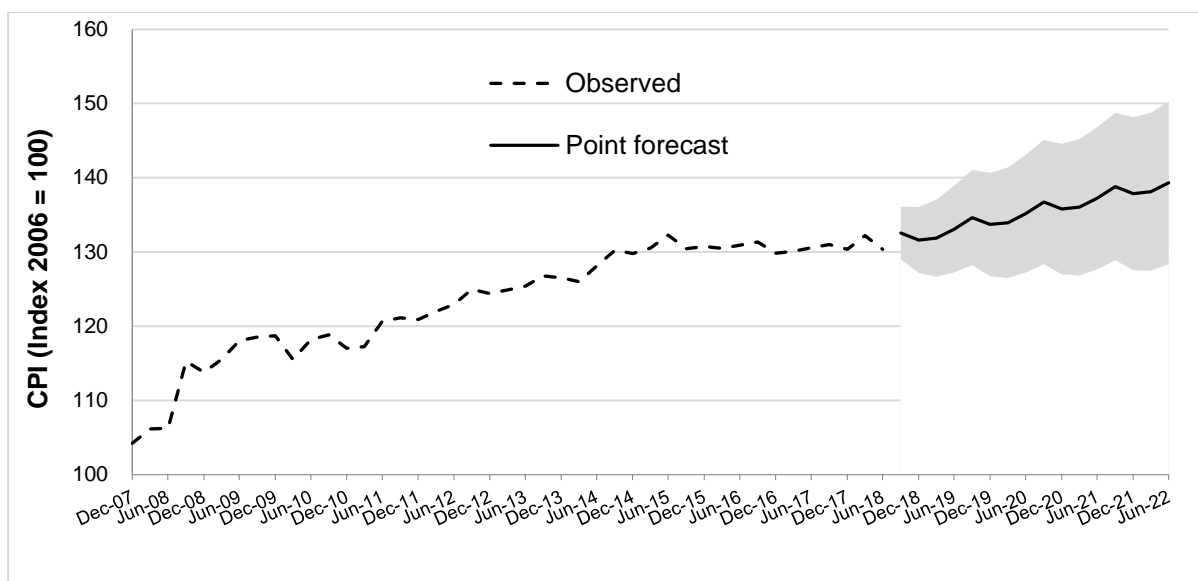
The decrease in the housing category is entirely due to a fall in the rent and mortgages sub-category, despite limited housing supply due to an increase in the use of private homes for short-term tourist accommodation and increased demand for long-term rental accommodation from larger tourism operators for their contract staff.

Global inflation has been relatively steady, reducing any external pressures from higher import prices. The use of the New Zealand dollar as the national currency has also helped to ensure that inflation in the Cook Islands has been relatively stable over the past 10 years (with the exception of a peak in 2008/09).

The IMF forecasts improvements in the US economy and a tightening of interest rates going forward both of which are likely to cause the US dollar to strengthen. As such, it is expected that the value of the New Zealand dollar will decrease somewhat over the forward period. This, together with the expectation that global inflation will increase to around 2 per cent in 2018, is expected to push domestic inflation up over the medium-term (through increased costs of imports). Additional demand in the local housing market also has the potential to reverse the deflation currently seen in the housing cost category. In contrast, the expectation that the global price of petroleum and industrial items will slow in 2018 should weaken inflationary pressures from the transport category.

Observed and forecast quarterly CPI from December 2007 to June 2022 is shown in Figure 2.13. A 95 per cent high and low confidence interval has also been computed and is displayed as the shaded area either side of the point forecast time series.

Figure 2.13: CPI, quarterly index, 2007 to 2022



Overall, as shown in Figure 2.14 and Table 2.4, inflation is expected to pick up to 1 per cent in 2018/19 before rising further to about 1.5 per cent per year over the forward budget period on the back of increased pressure from imported inflation and a tightening local housing market.

Figure 2.14: Annual average change in CPI (percentage)

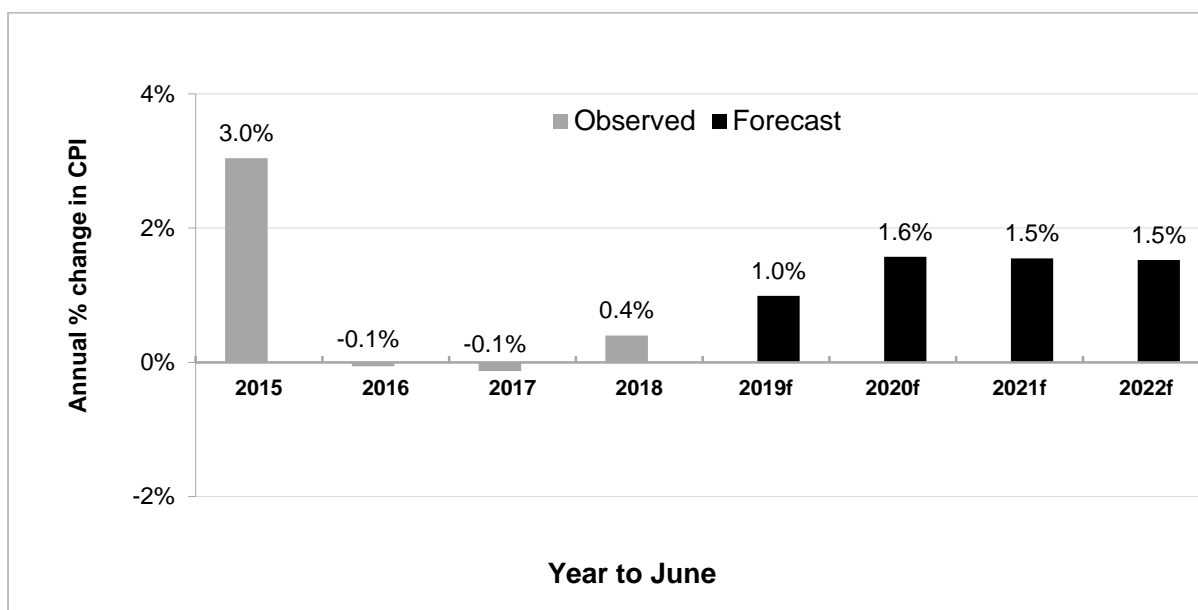


Table 2.4 Annual CPI forecast summary

	2017/18	2018/19f	2019/20f	2020/21f	2021/22f
CPI average annual index	131.0	132.3	134.4	136.4	138.5
CPI average annual percentage change	0.4%	1.0%	1.6%	1.5%	1.5%

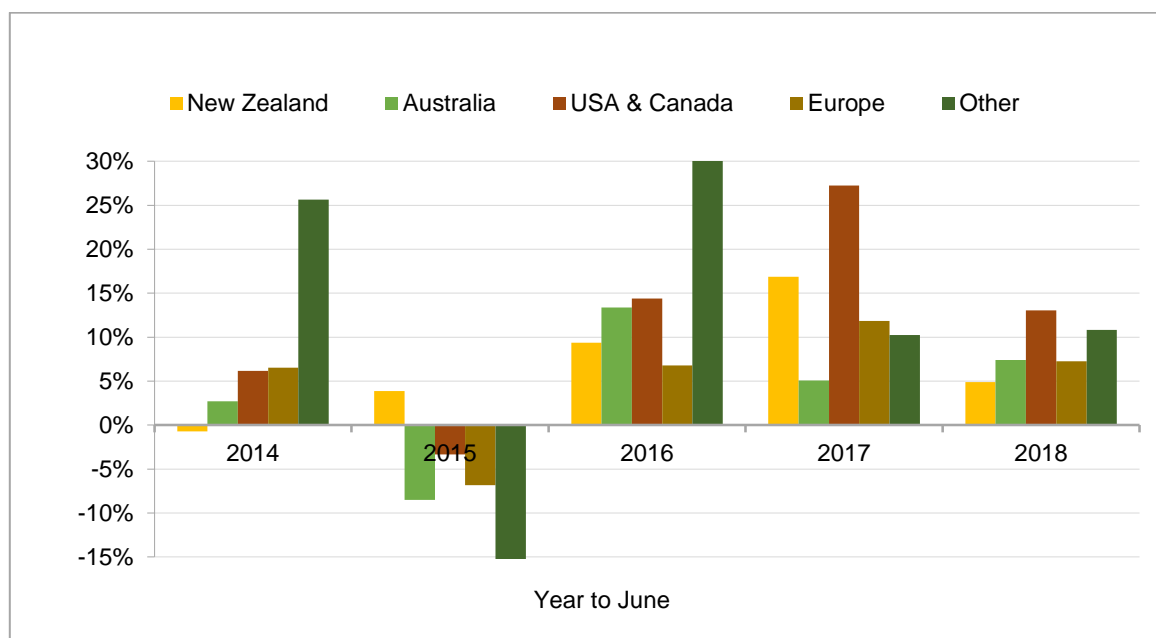
2.6 Tourism

Aggregate tourist arrivals

Continued strong growth in tourist arrivals in 2017/18 has ensured that tourism remains the key driver of economic activity in the Cook Islands. After contracting by 0.9 per cent in 2014/15, the tourism market saw growth of 11 per cent in 2015/16, and 15 per cent in 2016/17. 2017/18 saw lower, but still strong, growth. In the year to June 2018, total visitor arrivals in the Cook Islands reached 164,800, 6 per cent higher than the 155,230 visitors recorded in the year to June 2017.

While New Zealand visitors still dominate the raw numbers, the USA and Canada recorded the highest visitor growth rate in the year to June 2018, with a 13 per cent rise on the previous year's 10,100 visitors to 11,418 (see Figure 2.15). Tourist arrivals from Europe and New Zealand have also grown strongly, at 7.2 and 4.9 per cent, respectively.

Figure 2.15: Visitor arrivals, country of residence (annual percentage change)



Total arrivals for 2018/19 are forecast to be about 172,000, 4.6 per cent higher than the 164,800 seen in 2017/18. As can be seen in Figure 2.16 and Table 2.5, growth is expected to moderate further to 2.5 per cent in 2019/20, before reaching a more sustainable 1.1 per cent by 2021/22.

Figure 2.16: Total visitor arrivals, quarterly, 2008 to 2022

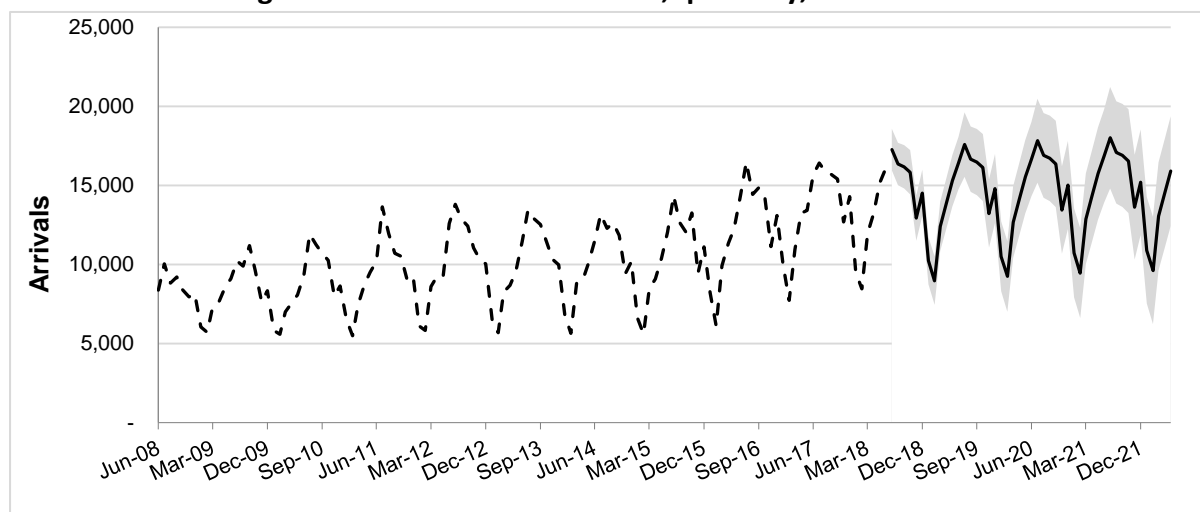


Table 2.5 Estimated total arrivals, quarterly, 2016/17 to 2021/22

Quarters	2016/17	2017/18	2018/19f	2019/20f	2020/21f	2021/22f
September	45,770	47,977	50,068	50,812	51,000	51,000
December	38,464	42,389	43,913	45,163	46,209	46,870
March	28,661	29,949	32,407	33,537	34,492	35,297
June	42,335	44,485	45,660	46,770	47,470	48,006
Annual total	155,230	164,800	172,048	176,282	179,171	181,173

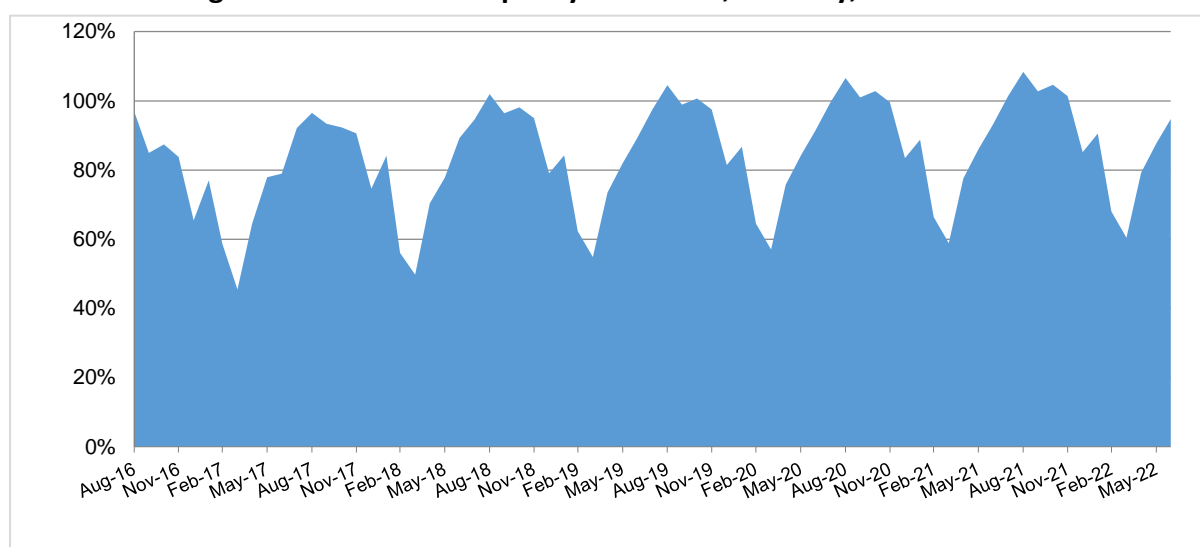
Despite the strong growth in tourism arrivals, the industry faces growing capacity constraints. Accurate data on tourism capacity in the Cook Islands is not currently available, particularly due to the recent growth in private holiday rentals. The highest number of tourists that the country has seen is 18,332, in July 2018. The economic forecasting in this chapter is based on a slightly lower assumed tourist capacity of about 17,000 per month. This conservative estimate accounts for the fact that July 2018 was unusual due to the Te Maeva Nui celebrations which likely saw many Cook Islanders return from abroad and as such classified as ‘visitors’.

Limited accommodation and infrastructure impact upon the ability of the Cook Islands to carry higher tourist numbers. They also impact upon the tourism industry’s ability to target high value tourists. Recent growth in building approvals for tourist accommodation will increase accommodation capacity. In addition, there has been a large increase in holiday home rentals through online sales such as Airbnb, with 306 rentals listed in August 2018. However, the increase in holiday home availability does not address the shortage in high quality accommodation, thus failing to diversify the market in that respect. Furthermore, the growth in holiday houses places greater pressure on the long-term housing market in Rarotonga, which can in turn have negative implications for resident population numbers.

If tourist arrivals continued to grow at the rates recently seen without improvements to infrastructure and accommodation capacity, possible risks include increased costs to the tourism industry, decreased visitor satisfaction, and the increased dissatisfaction of local residents.

As Table 2.5 indicates, the September quarter (July to September) is the busiest time for tourists, with numbers expected to reach their maximum assumed capacity in this quarter by 2018/19. Figure 2.17 highlights the capacity limitations being experienced in the Cook Islands, by month. During 2018/19, maximum capacity is expected to be reached in the month of July, with more than 90 per cent capacity expected to be reached during a further 4 months. This situation worsens in 2019/20 with maximum capacity expected to be reached during 2 months of the year, rising to 4 months the following year.

Figure 2.17: Tourism capacity utilisation, monthly, 2016 to 2022



The Cook Islands Tourism Corporation is currently focusing on increasing the diversification of tourist arrivals, with a view to increasing the number of high value tourists arriving in the Cook Islands. It is also encouraging tourist arrivals during the March quarter (January to March), which has traditionally been known as the low season. If successful, this strategy should decrease the strong reliance on New Zealand by increasing arrivals from the North American market.

In the meantime, further investment in infrastructure, including tourist accommodation, will be required to accommodate increasing tourist numbers in the future. There are signs that the industry has gained confidence in attracting more visitors in the form of investment in room stock, however more will need to be done for the country to capitalise on the expected higher arrivals numbers.

Major markets

Introduction

The major tourism markets for the Cook Islands are New Zealand with 67 per cent of total arrivals in 2017/18, followed by Australia with 16 per cent and Europe and the USA and Canada at 7 per cent each. Other markets including Asia and French Polynesia make up the remaining 3 per cent. Table 2.6 shows the aggregate tourist arrivals forecasts broken down by major market.

Table 2.6 Estimated total tourism numbers, by major market, 2016/17 to 2021/22

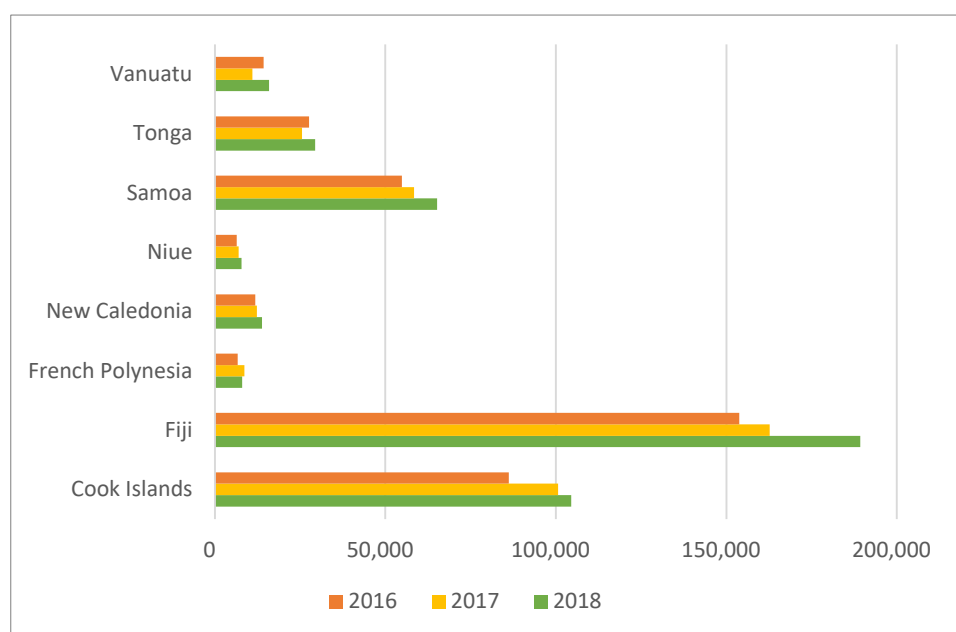
Markets	2016/17	2017/18	2018/19f	2019/20f	2020/21f	2021/22f
New Zealand	105,072	110,227	115,254	118,286	120,174	121,277
Australia	24,578	26,398	26,883	27,283	27,600	27,871
USA & Canada	10,100	11,418	11,739	12,072	12,375	12,659
Europe	11,122	11,928	13,306	13,648	13,958	14,244
Other	4,358	4,829	4,866	4,994	5,064	5,121
Total	155,230	164,800	172,048	176,282	179,171	181,173

New Zealand

Strong growth in the New Zealand market in 2017/18 saw New Zealand visitors continuing to make the strongest contribution to tourist arrival numbers. New Zealand arrivals reached 110,227 in 2017/18, a 4.9 per cent increase over 2016/17.

Growth in tourism numbers from New Zealand is consistent with the general growth in New Zealand outward tourists to the Pacific, which has increased steadily in recent years. Over the past ten years, New Zealand arrivals have grown an average of about 6 per cent a year. The Cook Islands is receiving an increasingly larger share of New Zealand tourists to Oceania, rising from 5.2 per cent in 2015/16 to 6.3 per cent in 2017/18, behind Australia and Fiji.

Figure 2.18: New Zealand Pacific outbound tourist numbers, by destination

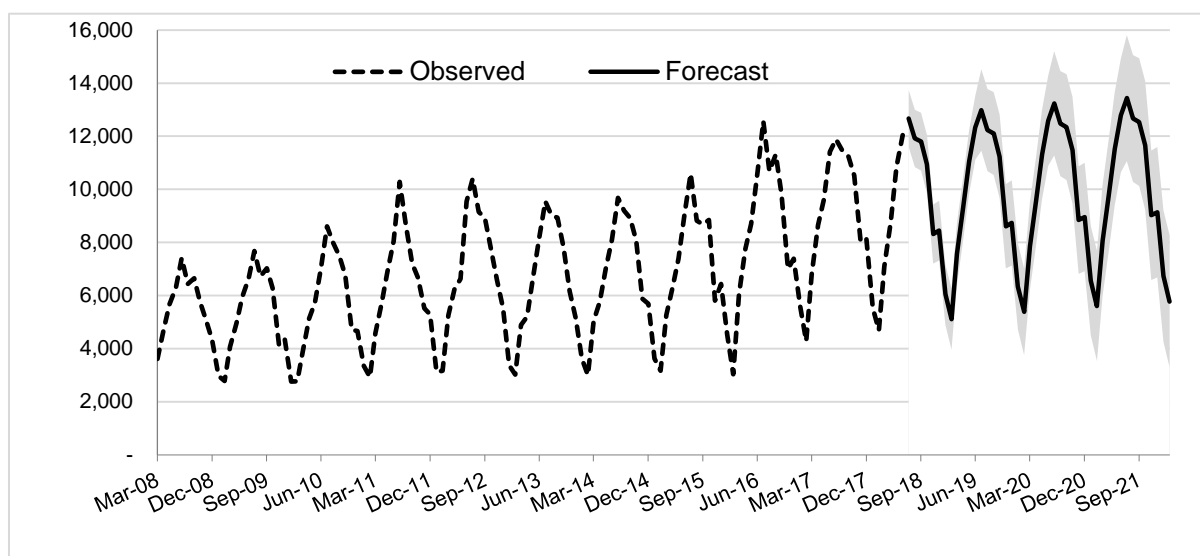


Strong growth in the New Zealand market has encouraged several airlines to increase the number of flights to the Cook Islands, which also has a positive impact on the Australian market as it provides more options for indirect flights.

Arrival numbers for New Zealand visitors to the Cook Islands are expected to continue to increase going forward, but at slower rates than in recent years (see Figure 2.19). Growth is projected to be 4.6 per cent in 2018/19, before slowing down to around 0.9 per cent by

2021/22. Total New Zealand arrivals are expected to rise from about 115,254 to 121,277 over this period.

Figure 2.19: New Zealand arrivals, quarterly, 2008 to 2022



Australia

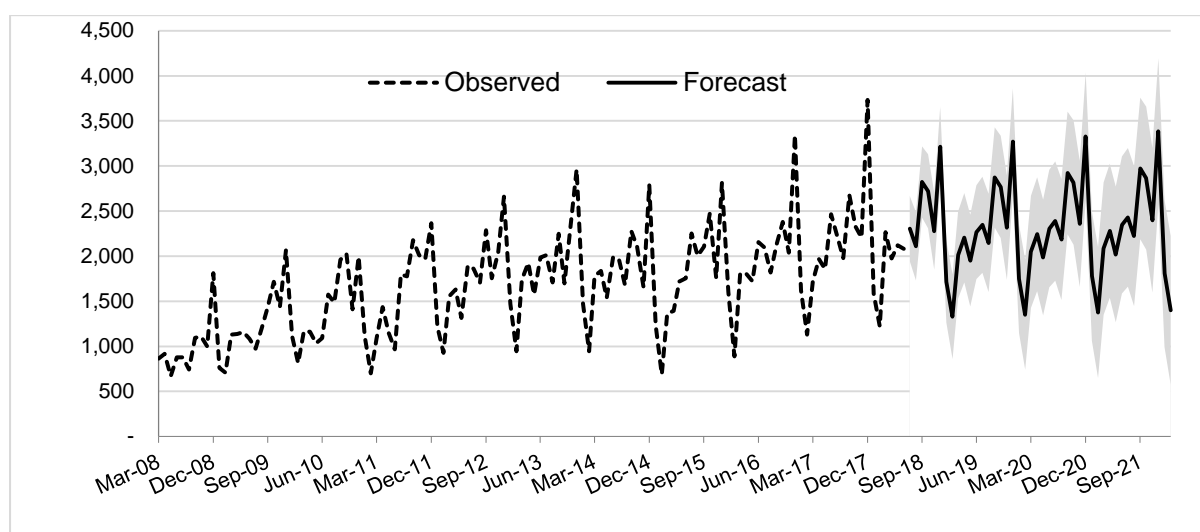
Australia is the second largest tourism market for the Cook Islands. After experiencing a 9 per cent decrease in arrivals in 2014/15, visitor numbers recovered with an increase of about 13 per cent in 2015/16, followed by a further rise of 5 per cent in 2016/17.

In light of this, the Australian market has seen an increase in visitor numbers of 7.4 per cent in 2017/18, rising from 24,578 to 26,398.

The Cook Islands has seen significant growth in Australian visitors over the past ten years, with growth averaging about 9 per cent per year. This is off the back of strong growth in Australian outbound tourism (5.5 per cent from May 2017 to May 2018) and the increase in flights from New Zealand to Rarotonga which has increased interconnection options from Australian cities. Tourism Australia forecasts that outbound tourist numbers will continue to grow in Australia, increasing by 4 per cent to 10.5 million in 2017–18, and by 4.2 per cent to 10.9 million in 2018–19.

Arrival numbers for Australian visitors to the Cook Islands are expected to moderate going forward. Growth is projected to be 1.8 per cent in 2018/19, dropping to about 1 per cent by 2021/22 (see Figure 2.20). Australian visitors are expected to increase from about 26,398 to 27,871 over this period.

Figure 2.20: Australia arrivals, quarterly, 2008 to 2022



Other markets

The strong growth experienced in other markets in 2016/17 has continued into 2017/18. The level of growth is expected to moderate over the forward estimates.

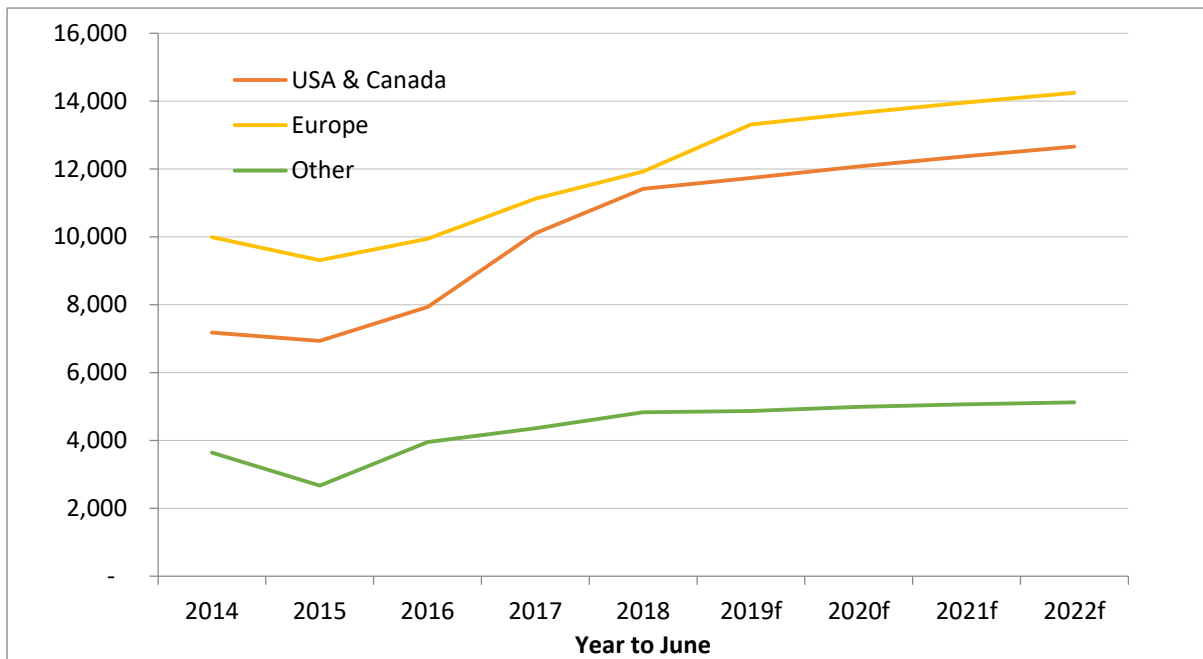
Arrivals from the United States increased by 9.3 per cent in 2017/18, to 8,131 from 7,436. Growth in 2018/19 is projected to be lower at 2.4 per cent and then expected to fall further to about 1.2 per cent. As with the United States, there has been strong growth in Canadian visitors in the past two years, albeit from a low base. Growth in 2015/16 was 9.9 per cent, followed by 23.4 per cent in 2017/18. Arrivals rose from 2,664 to 3,287 in the year to June 2018. Growth is expected to remain strong over the medium term, averaging about 5 per cent per year over the forward budget period.

The prospects for the North American market have been bolstered by the recent extension of the contract for the underwritten airline route between Los Angeles and Rarotonga. Moreover, a strengthening US dollar should have a positive impact on tourist numbers.

Visitor numbers from Europe grew by 6.8 per cent in 2015/16, 11.8 per cent in 2016/17 and 7.2 per cent in 2017/18. Growth is expected to remain high over the medium-term, averaging about 4.6 per cent per year.

The strong growth in arrivals from Asia in recent years slowed in 2017/18. Arrivals increased by 31.5 per cent in 2015/16, 27.6 per cent in 2016/17, with 2017/18 growth of only 2.5 per cent. Average growth of about 3.7 per cent per year is expected over the forward budget period. After a strong increase of 23.7 per cent in visitors from French Polynesia in 2017/18, growth is expected to contract going forward.

Figure 2.21: Other major markets arrivals, 2014 to 2022



2.7 Housing and construction

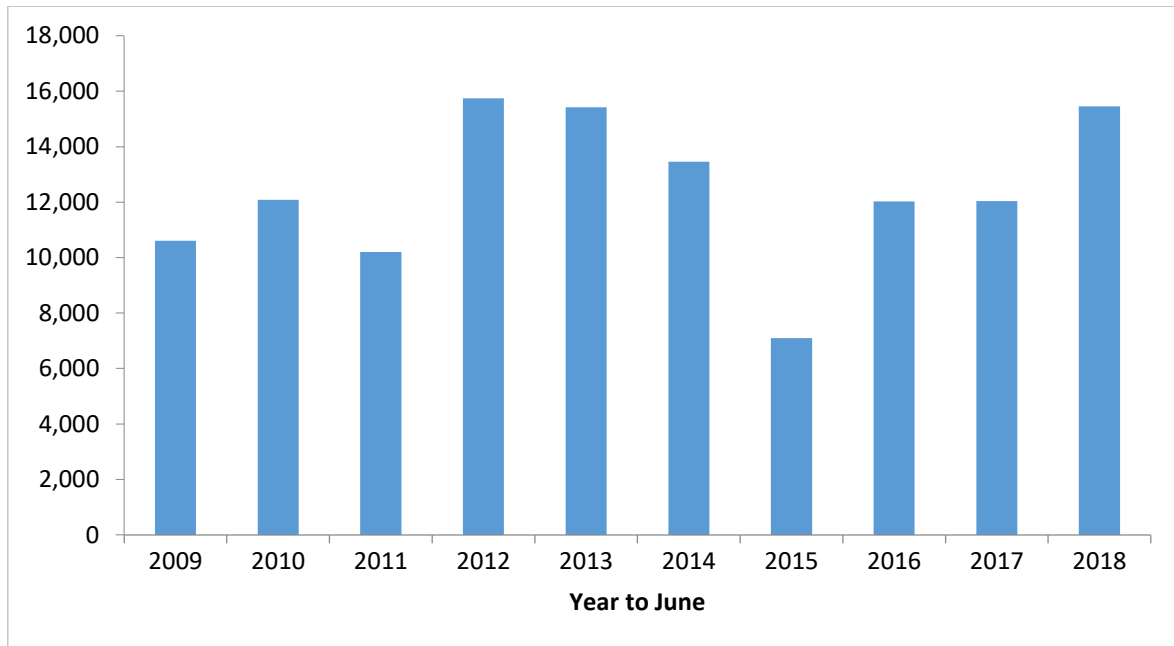
The value of residential and commercial (commercial, tourist and community buildings) building approvals has been much higher than trend in the three years to 2017/18.

In 2015/16 residential approvals increased by 166 per cent to \$15.4 million. In 2016/17, residential approvals fell by 23 per cent to \$11.9 million, and remained steady in 2017/18, increasing by just 1 per cent to \$12 million. Anecdotal evidence, together with the significant growth in residential approvals during a period of strong tourism growth, suggest that a large share of these residential approvals is for holiday houses, rather than residential living.

Commercial building approvals rose significantly in 2015/16 and 2016/17, at 55 and 366 per cent, respectively, peaking at \$24.5 million. This was largely due to a number of large community projects such as Apii Nikao and Tereora College, with both undertaking major redevelopment. Commercial approvals fell by 67 per cent to \$8 million in 2017/18, although still at a historically high level.

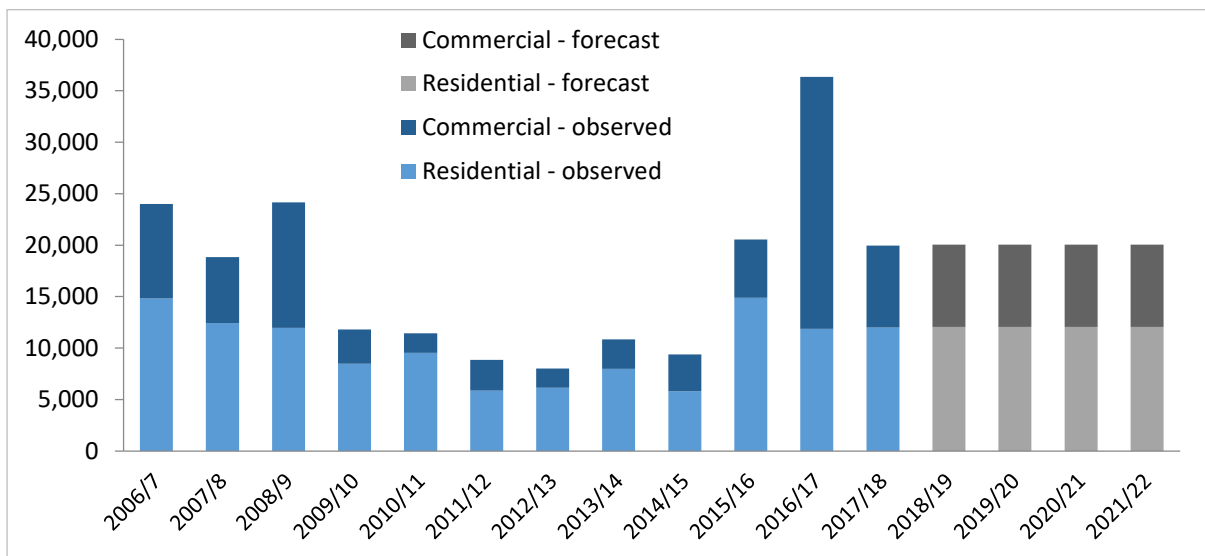
The unprecedented level of the value of building approvals in recent years is reflected in the performance of the construction sector of the Cook Islands economy. The construction sector's contribution to GDP, shown Figure 2.22, has risen from \$7.1 million in 2014/15 to an estimated \$15.5 million in 2017/18.

Figure 2.22: Construction sector contribution to real GDP, 2008 to 2018 (\$'000)



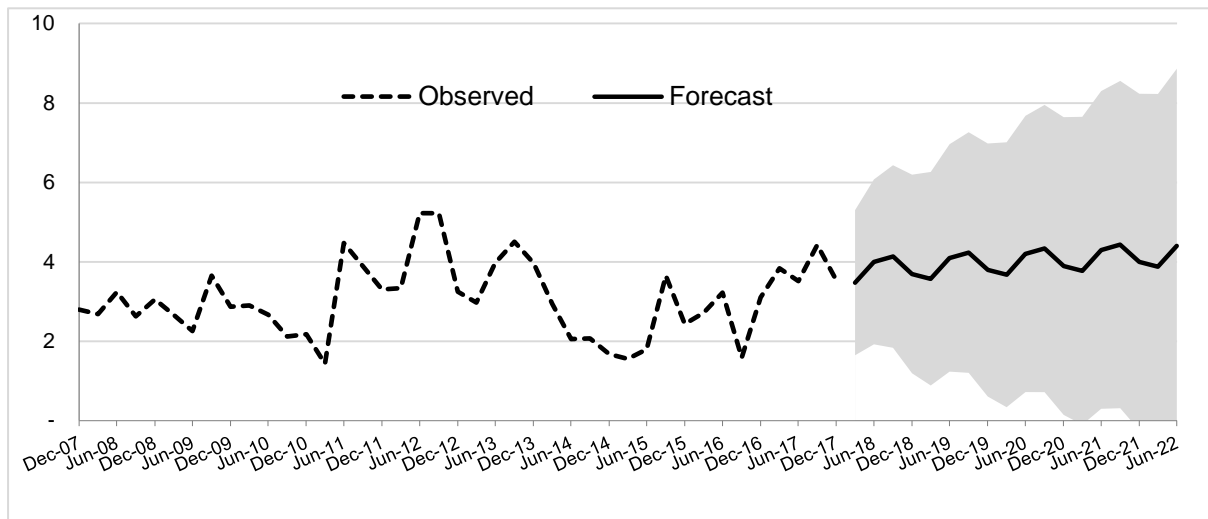
Going forward it is expected that both residential and commercial building approvals will stay at similar levels to those seen in 2017/18, reflecting the expected level of construction activity to service the tourism market (see Figure 2.23).

Figure 2.23: Value of building approvals, 2006/07 to 2020/21, \$'000



The expected level of building approvals over the forward budget period is reflected in the steady state medium-term forecast for the construction sector as a whole shown in Figure 2.24.

Figure 2.24: Construction sector forecast, 2007 to 2022 (\$ million real)



2.8 Marine resources

Fishing

The main benefit to the Cook Islands Government from fishing activities is revenue from treaty arrangements, license fees and the sale of catch quotas. The provisional revenue estimate for 2017/18 is \$10.6 million.

In December 2016 new longline regulations for the Quota Management System (QMS) were enacted. Under the QMS a total allowable catch of 9,750 metric tonnes (MT) of albacore tuna and 3,500 MT of bigeye tuna per calendar year were set. The quota system was implemented in January 2017, with revenue returns of around \$3 million per year received, exceeding previous licensing arrangements which returned around \$2.4 million per year.

A significant portion of revenue comes from the purse seine fishery, where the Cook Islands has been assigned a total of 1,250 fishing days for the 2018 calendar year by the Western Central Pacific Fisheries Commission (WCPFC).

During 2016, the US and Pacific Island states negotiated a new US Multilateral Treaty with a six year term. Under the agreement the Cook Islands will commit 350 fishing days annually before the start of the calendar year. In 2017 the US acquired 323 fishing days under this pool. In addition, the US fishing industry also entered into bilateral arrangements for 200 additional fishing days for vessels which have not acquired pooled days or whose days are short.

In January 2017, the Government licensed two Spanish purse seine fishing vessels under the European Union Sustainable Fisheries Partnership Arrangement. Under the 5 year agreement there is a 4 year protocol for fisheries access allowing up to 7,000 MT per year to be fished by EU Purse Seiners. This arrangement accounts for 158 of the 1,250 vessel days assigned annually by WCPFC.

Part of the funds provided under the EU protocol are collected by Government as an aid contribution to the provision of Government fisheries policies.

For the 2018 calendar year, the average price for a fishing day is expected to be between \$12,500 to \$13,500 dollars, depending on exchange rates which affect the US Treaty; and the EU fisheries partnership. Projected fisheries revenue for 2018/2019 is about \$10 million. The sources of revenues include:

- \$1.8 million from the longline quota system;
- \$1.2 million from the US treaty equal shares;
- \$4.3 million from the US treaty annual pool;
- \$758,000 from the US treaty bilateral arrangements;
- \$1.3 million from the EU SFPA agreement.

The decline in the forecast revenue is due partly to changes in fishing patterns leading to a reduction in licensing and in part, the flow on financial effect of the Marae Moana Act 50nm closure. The decline in the US treaty bilateral arrangements revenue is attributable to the successful re-negotiation of the regional multilateral treaty which led to a renewal of US effort elsewhere in the region.

Fishing activities

The Cook Islands EEZ is divided into the Northern and Southern fishery grounds, with the majority of fishing activity taking place in the Northern fishery which is more stable and productive. The Northern fishery borders are from Penrhyn in the east to Pukapuka in the west, and south to Suvarrow.

The longline albacore fishery catch is generally unloaded or transhipped in Apia, Samoa or Pago Pago, American Samoa. However, recent transhipment activities have been carried out in Pukapuka, and been supervised by Cook Islands Fisheries Officers. The longline catch peaked at 15,500 tonnes in 2012 during exploratory fishing for bigeye tuna. This has declined to 4,650 tonnes in 2017 as the fishery has reverted back to its regulated albacore catches. Over the same period purse seining has become the dominant fishery in the Cook Islands, expanding from 476 tonnes in 2010 to a peak of 19,510 tonnes in 2017.

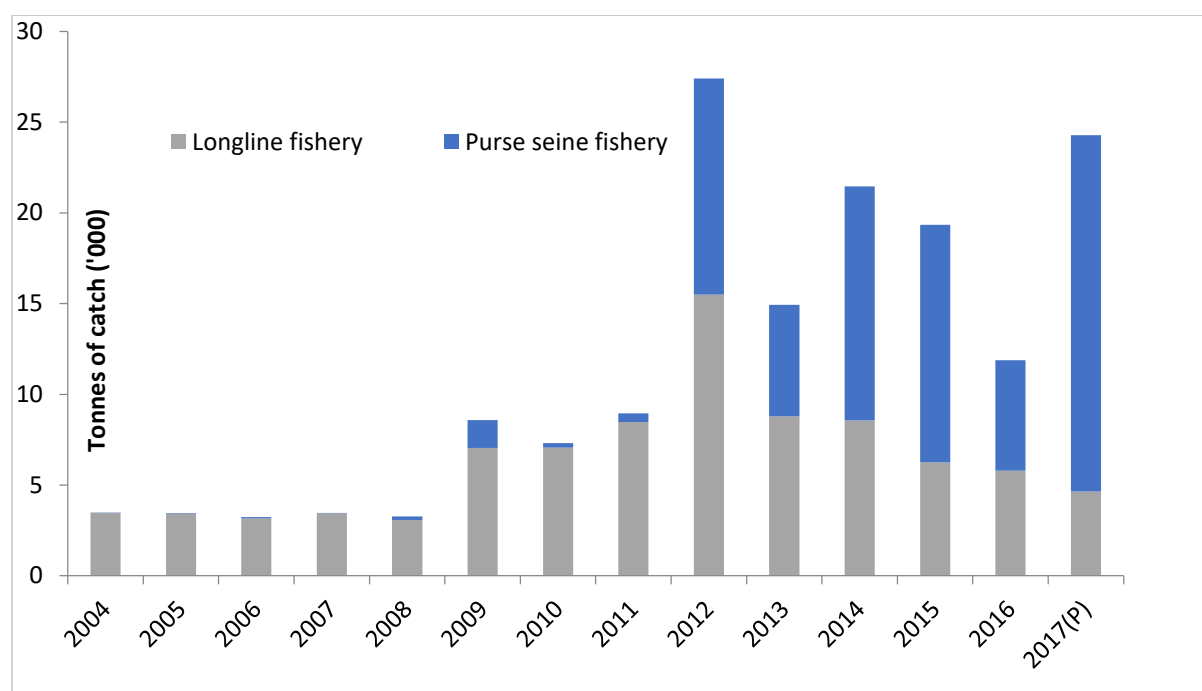
The total commercial catch for all vessels was 19,334 MT in 2015, a decrease from 21,466 in 2014. This is entirely driven by a decrease in the longline catch.

In 2016, the Government of the Cook Islands approved a quota management system for two longline fisheries tuna species. This was implemented through the Marine Resources (Large Pelagic Longline Fishery and Quota Management System) Regulations 2016 (QMS) which came into force on 1 January 2017, by placing a quota limit on the Albacore (ALB) and Bigeye Tuna (BET) fisheries in Cook Island waters.

The QMS Regulations placed a commercial quota limit or total allowable commercial catch (TACC) and total allowable catch (TAC) for each of the species being;

- 9,750 MT ALB (TAC)
- 9,698 MT ALB (TACC)
- 3,500 MT BET (TAC)
- 2,500 MT BET (TACC).

Figure 2.25: Fishery catch in the Cook Islands EEZ (MT)



The Cook Islands also supports a small local fishery of artisanal and fishing game operators. In 2015, 142 MT was caught by local fishers, with an estimated catch of 140 MT in 2017 for the Southern group. Albacore and yellow fin tuna together accounted for around 80 per cent of species caught by long line in 2017, with a decrease in yellow fin in 2016 compared to 2015 (Table 2.7). With the increase in purse seining, Skipjack was the most caught species overall in 2017, approximately 17,492 MT which accounts for 72 per cent of the total catch.

Table 2.7 Fishery catches in the Cook Islands EEZ by species (MT)

	2015			2016			2017p	
	<i>Purse seine</i>	<i>Local</i>	<i>Longline</i>	<i>Purse seine</i>	<i>Local</i>	<i>Longline</i>	<i>Purse seine</i>	<i>Local</i>
Albacore	0	2	4,224	0	1	2,966	0	1
Bigeye	110	0	537	86	0	226	339	0
Yellowfin	599	71	1,094	416	77	812	1,679	46
Skipjack	18,238	12	123	4,874	7	120	17,492	2
Other	0	57	725	10	24	526	n/a	27
Total	18,947	142	6,703	5,386	109	4,650	19,510	76

In 2017, a total of 101 licensed vessels were managed by the MMR. These include 54 long liners, 38 purse seiners, 2 high seas trawlers and 8 bunker vessels. In addition there were 265 local artisanal and game charter fishing boats reporting catches to the MMR (Table 2.8).

Table 2.8 Number of active fishing vessels

Licensed and active vessels	2014	2014	2015	2016	2017	2018p
<i>Offshore fishery</i>						
Long liner	45	36	38	47	55	36
Purse seiner	17	18	65	33	16	33
Other commercial	4	5	5	10	8	12
Total	66	59	108	90	79	81
<i>Local artisanal and game fishery</i>	223	302	301	285	265	265

The estimated value of catches from the Cook Islands EEZ for 2015 was \$63 million dollars, based on Pacific Forum Fisheries Agency (FFA) estimates (Table 2.9), a decrease of \$16 million in value of catch from 2014, despite significantly higher catches in 2015. The decrease is largely due to different methodology used by FFA in 2014 and 2016 to estimate catch values. The exchange rate of NZD to USD and Japanese Yen are also important factors.

Table 2.9 Landed value of fishery catches (\$m)

Landed value	2012	2013	2014	2015	2016	2017
Longline fishery	40	32	44	41.4	30.1	21.8
Purse seine fishery	25	15	33	21.6	10.5	33.5
Local artisanal and game fishery		2	2	n/a	n/a	n/a
Total	65	49	79	63	40.6	55.3

One domestic commercial fishing company, with three Cook Islands' flagged vessels, operates in the southern Cook Islands waters, and offloads its fresh catch at Rarotonga for sale in the domestic market and to be exported. For Cook Island domestic vessels that unload in Rarotonga, 286 MT was unloaded in 2017 compared to 179MT in 2016. The volume of exports increased from 15 to 25 MT over this period.

Landed frozen catch by foreign flagged vessels in Rarotonga totalled nearly 400 MT in 2016, up from 363 MT in 2015. In 2014, the total catch landed by Chinese vessels was 1,900 MT, a very large spike compared to normal catch levels. No landed catch was reported for 2017.

Table 2.10 Catch landed at Avatiu Port (MT)

	2013	2014	2015	2016	2017
Cook Islands flagged vessels					
Fresh catches offloaded	105	194	188	179	286
Fresh catches to be exported by airfreight	15	23	115	125	25
Chinese flagged vessels					
Frozen by-catch sold locally	23	18	0	0	0
Frozen catches to be exported by sea freight	121	1,882	363	399	0
Total	264	2,117	666	703	311

The small-scale fishery remains an important economic activity for game-charter operators, semi-commercial sales and artisanal fishermen. Catch data per island is expected in the near future, with better information anticipated as a result of a fuel subsidy program instituted by MMR.

In 2017, the Ministry of Marine Resources (MMR) in conjunction with Secretariat of the Pacific Community (SPC) held an introductory Training workshop in Avarua. The workshop was targeted for MMR outer-islands Fisheries Officers. The workshop trained officers for the integration of coastal monitoring and data collection methods and the streamlining of this process through the use of E-reporting mediums, such as the android 'Tails' application developed by the SPC.

MMR anticipates improved coverage in artisanal data collections with the introduction of reporting initiatives such as the Pacific Community (SPC) 'Tails' application, which is designed to synchronise artisanal catch data to the database automatically from mobile devices. A significant outcome of this is that the technology can operate with limited internet connectivity and provides a solution to the problems of geographic isolation that is experienced on many islands.

The US Project Development Fund (PDF) raises a development fee of \$10,000 charged to each foreign fishing license. 2016 is the fifth year that the PDF has been in operation. In 2016, \$300,000 was made available to support the local fishers comprising \$100,000 for the Cook Islands Fishing Association, \$150,000 in small grants to individuals and \$50,000 for the fishing clubs of the Pa Tokerau (Northern Group).

An ongoing program to expand the deployment of Fish Aggregate Devices (FADs) complements the support of FDF. Nine FAD deployments were completed in 2016 bringing the total number of devices to 25 FADs. The program costs an estimated \$100,000 annually.

Black pearls

The pearl industry in the Cook Islands has declined markedly over the past 15 years. Total pearl exports reached an all-time high in 2000 at just over \$18 million, however the industry saw a decline in the value of total exports as of 2003, following unregulated farming practices, poor oyster health conditions and bacterial disease. Since its peak in 2000, the industry

reached a low of \$191,000 in 2013. The industry has rebounded somewhat in recent years, however its value remains very low.

French Polynesia continues to be the major supplier of raw and finished black pearl products to the international market, keeping prices relatively low.

In the Cook Islands there has been a distinctive shift by farmers towards sales on the domestic market, with a focus on visitors. As a result, export values are no longer representative of levels of production.

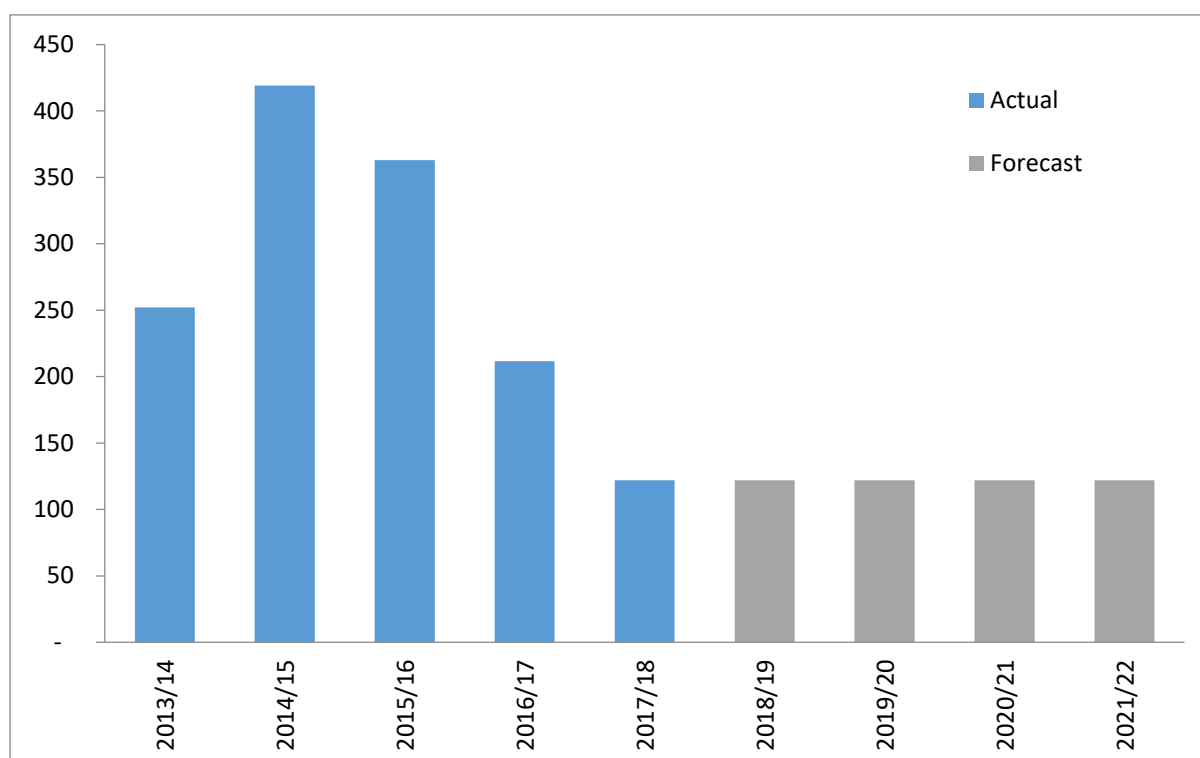
The total levels of production based on seeding and harvest reports submitted by farmers to MMR indicate that annual production levels average just below 200,000 farmed oysters (Table 2.11). Data for 2016 was incomplete at the time of writing.

Table 2.11 Pearl production, 2009-2016

Year	Total farmed oysters	Total shells seeded	Total shells harvested	Total saleable pearls
2009	40,429	21,623	23,713	3,005
2010	59,373	87,822	16,193	11,182
2011	173,501	89,850	39,318	17,856
2012	252,286	172,755	41,718	20,199
2013	153,918	108,053	44,699	20,987
2014	245,671	127,528	88,359	40,611
2015	143,142	67,477	48,720	21,459
2016	60,965	28,149	40,769	17,835

In 2017/18, the value of pearl and pearl shell exports fell to \$122,000, down from \$211,000 in 2016/17 (Figure 2.26).

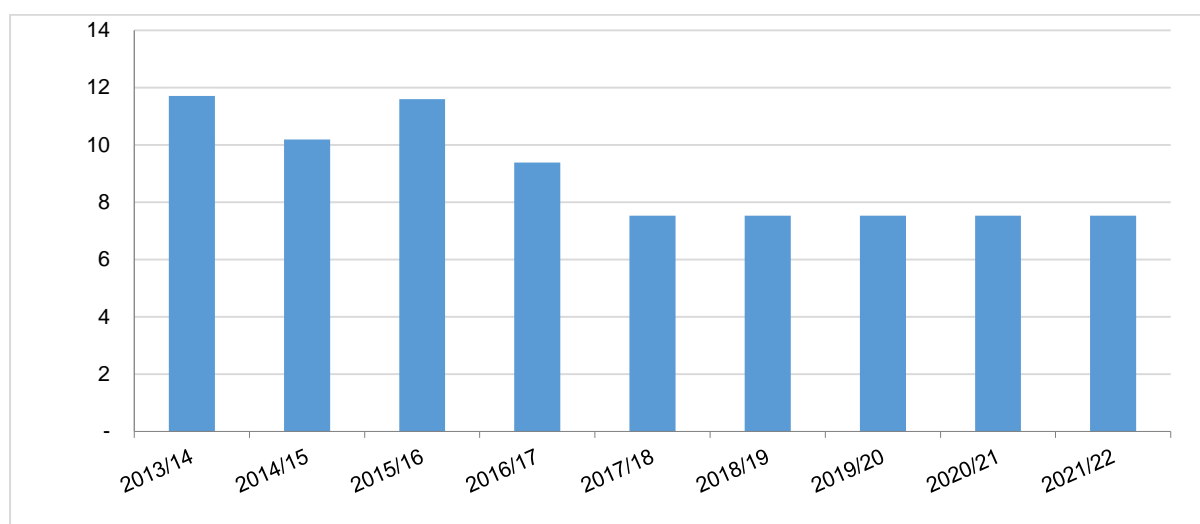
Figure 2.26: Pearl exports, 2012/13 -2021/22 (\$'000)



Economic contribution

The Fishing and Pearl sector accounted for 2.8 per cent of real GDP in 2016/17, and is estimated to account for about 2 per cent in 2017/18. The sector contracted by 19 per cent in 2016/17 from \$11.6 million to \$9.4 million in real terms. A further contraction is expected in 2017/18, falling to about \$7.5 million. The outlook for the sector over the budget forecast period is steady, as shown in Figure 2.27 .

Figure 2.27: Fishing and pearl contribution to GDP, annual, 2013/14 to 2021/22 (\$m real)



Water quality monitoring

The lifestyle and economy of the Cook Islands is largely dependent on healthy marine and freshwater ecosystems. Growing visitor arrivals place increasing stress on marine and freshwater environments. Routine monitoring of water quality parameters is crucial in managing water resources effectively.

Regular water quality monitoring is undertaken on the islands of Rarotonga, Aitutaki and Manihiki due to the tourism industry on Rarotonga and Aitutaki and the pearl industry on Manihiki. Water parameters are analysed, reported and graded against three standards of reference: bacterial count, water clarity (combination of suspended solids and chlorophyll a) and nutrient concentration. Monthly reports are then disbursed to key stakeholders and other interested groups to help advise and guide management decisions. In Manihiki, these monthly reports are essential for advising pearl farmers when water conditions are, or are not, suitable for farming activities.

Water quality checks suggest that the overall quality of water is improving in Muri, possibly as a result of better sanitation and new building regulations, however spikes of poor water quality do occur. The health of Muri lagoon is crucial to the success of the tourism sector.

Similar tests in Manihiki between 2015 and 2018 highlight incidents of poor bacterial conditions amongst relatively good water quality in Manihiki. Such information is vital to maintaining a healthy and sustainable pearl industry within the lagoon.

Figure 2.28: Rarotonga and Aitutaki streams

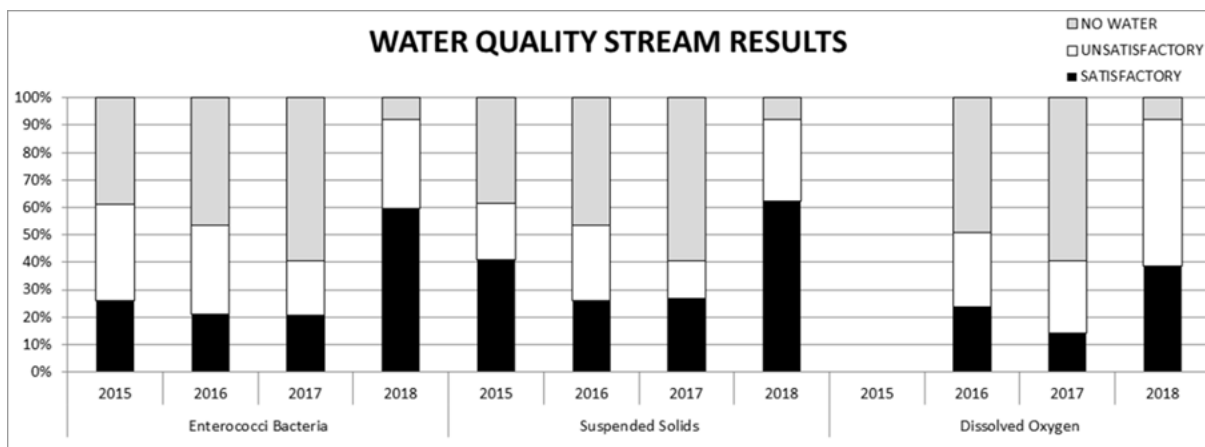


Figure 2.28 shows the data for Rarotonga and Aitutaki Streams combined. The results show that since 2017 there has been a 40 per cent improvement in the bacteria levels, and that the availability of water has improved from 60 per cent no water in 2017 to 10 per cent no water in 2018.

MMR assesses the lagoon water on Rarotonga, Aitutaki and Manihiki based on three main variables – bacteria levels, water clarity and dissolved oxygen percentage. The data shows satisfactory results for bacteria, with the majority over 90 per cent. Water clarity (suspended solids) shows variable results, while dissolved oxygen levels show some improvement in 2018 over the previous year.

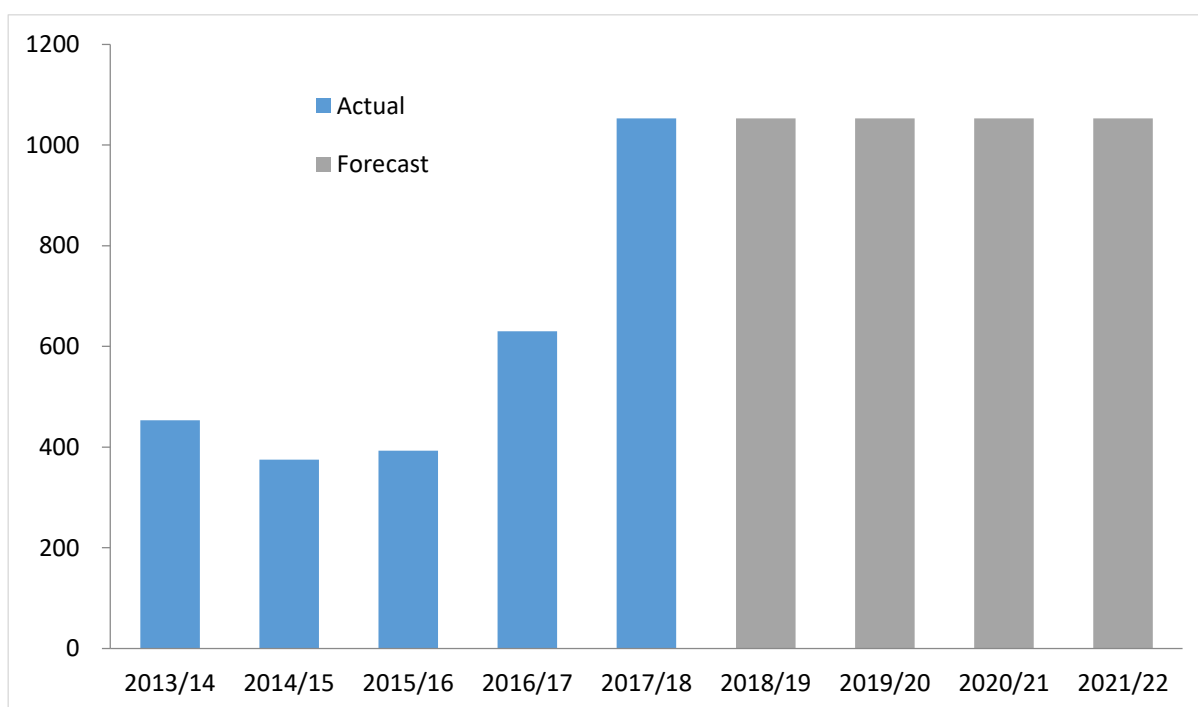
2.9 Agriculture

The Agricultural sector accounted for 3.1 per cent of real GDP in 2016/17, and is estimated to account for 3.2 per cent in 2017/18. The sector grew by 4.7 per cent in 2016/17 from \$9.9 million to \$10.4 million in real terms. Further growth is estimated for 2017/18, rising by 3.1 per cent to \$10.7 million.

This growth was underpinned by a significant expansion in agricultural exports in 2016/17 and 2017/18, following a decrease in 2015/16. Noni Juice remains the main export commodity product from the Cook Islands, with the primary export markets in Japan, China and, more recently, South Korea. Minor export volumes of processed agricultural products such as virgin coconut oil, vanilla extracts, A-grade vanilla beans and Tamanu seed oil extracts are some of the new export products that are increasing in demand.

Total agricultural exports, almost entirely comprised of Nono, rose from \$630,000 in 2016/17 to just over \$1 million in 2017/18, an increase of 67 per cent (see Figure 2.29).

Figure 2.29: Agriculture exports 2013/14 to 2021/22 (\$'000)



A range of initiatives in Rarotonga and the Pa Enua have been established to improve the supply of fruit and vegetable products by strengthening up-stream supply chains. The Ministry of Agriculture's supply of fruit and vegetable nursery products to all growers on Rarotonga and the Pa Enua is one example of this. This initiative aims to support local production in competing with imported produce, such as Capsicums, Tomatoes, Broccoli, Sweet corn and other leafy vegetables, helping to create a comparative advantage for our growers.

The Ministry of Agriculture has taken over the Food and Agriculture Organization's (FAO) funding of the Nursery Program supporting MOA's nursery production, providing seeds, seedlings and technical support to Rarotonga and Pa Enua farmers, including schools and

home gardeners. Varieties supplied include all recommended vegetable varieties and open-pollinated seeds for self-sustainability of the next seasons seed supplies.

Domestic hydroponic and summer vegetable production continues to grow, bridging the gap in fruit and vegetable supply value chains during the 'production off-season'. There has also been an increase in the number of hydroponics and summer house facilities on Rarotonga, Aitutaki and Northern Pa Enea. The Ministry of Agriculture is also investing in vanilla shade houses to boost production of this high value crop for export and the local market.

The Ministry of Agriculture continues to provide new potential varieties (White Jade Pineapple, Rambutan), and material support towards the FAO Fruit Tree and Vegetable Model Orchard Farms, implemented by the Cook Islands Chamber of Commerce in their Agribusiness training program. This has now expanded to Aitutaki, Mangaia, Mauke, Atiu – the Agricultural Fruit Tree Production and training of Growers, under the Pa Enea Action for Resilient Livelihood (PEARL) program, managed by MFEM.

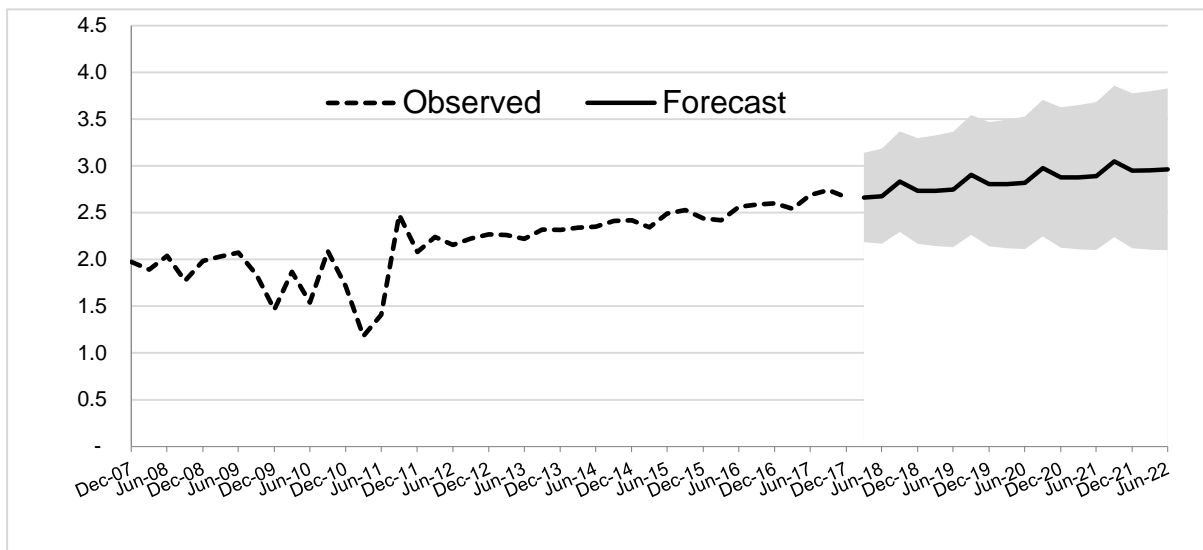
The Cook Islands has considerable potential for increased demand in local agricultural production (products such as drinking coconuts, coffee and cocoa, root crops, ornamentals, tropical fruits, vegetables, honey production, processing and value adding products, including handicraft products). Despite this potential, there are a number of constraints that limit growth in the agriculture sector:

- substandard biosecurity treatment facilities to meet our SPS requirements for international market access and compliance with importing/exporting country's quarantine requirements for fruit flies and other pests
- issues related to labour shortages and, and in some cases, higher level local wages
- low or lack of agricultural water access and supply
- inexperience and failures in supply chain coordination, and
- high transport costs to get produce to markets.

The MOA is establishing better data systems to ensure that more robust information and resources are available to help the ministry and farmers better understand the various challenges and trends in the agricultural industry. An example of this is the Agriculture Market Bulletin that the MOA publishes on a monthly basis. The bulletin utilises data collected from the main Punanga Nui market to inform vendors, farmers and consumers of the types of fresh produce sold by value, price and weight to enable producers to better meet consumer demand at the best price.

A steady economic outlook for the agriculture sector is expected over the budget forecast period, as shown in Figure 2.30.

Figure 2.30: Agriculture contribution to GDP, quarterly, 2007 to 2022 (\$ million real)



2.10 Goods imports and exports

Goods imports

Due to the size and geography of the Cook Islands, the country is highly reliant on the import of goods. In 2017/18 the value of goods imports grew by 11.5 per cent to \$183.8 million. This followed growth of 2.6 per cent in 2016/17 and 10.7 per cent in 2015/16.

The surge in both public and private construction has been a significant contributing factor to the growth in imports. The value of machines, transport and equipment imports grew by 15 per cent to \$46.5 million in 2017/18, with the import of crude materials rising by 29 per cent to \$5.6 million. Machines, transport and equipment imports accounted for 25 per cent of total imports in 2017/18, up from 19 per cent in 2014/15.

High tourist arrivals also drove an increase in food imports, which grew by 14 per cent in 2017/18 to \$46 million. Beverages and tobacco followed a similar pattern with imports rising by 18 per cent to \$13.5 million in 2017/18.

Looking forward, import growth is expected to moderate from 2018/19, averaging about 2.4 per cent per year, for two reasons (see Figure 2.31). The first relates to the maturation of the current large capital projects, which will reduce the importation of machines, transport and equipment. The second is the expected slowdown in the growth of tourism arrivals which should drive lower growth in the importation of food and live animals. Looking further ahead, once the Masterplan for Mei Te Vai Ki Te Vai is finalised, and accurate expenditure forecasts are known, imports are expected to increase.

Figure 2.31: Value of total goods imports, quarterly, 2007 to 2022 (\$'000)

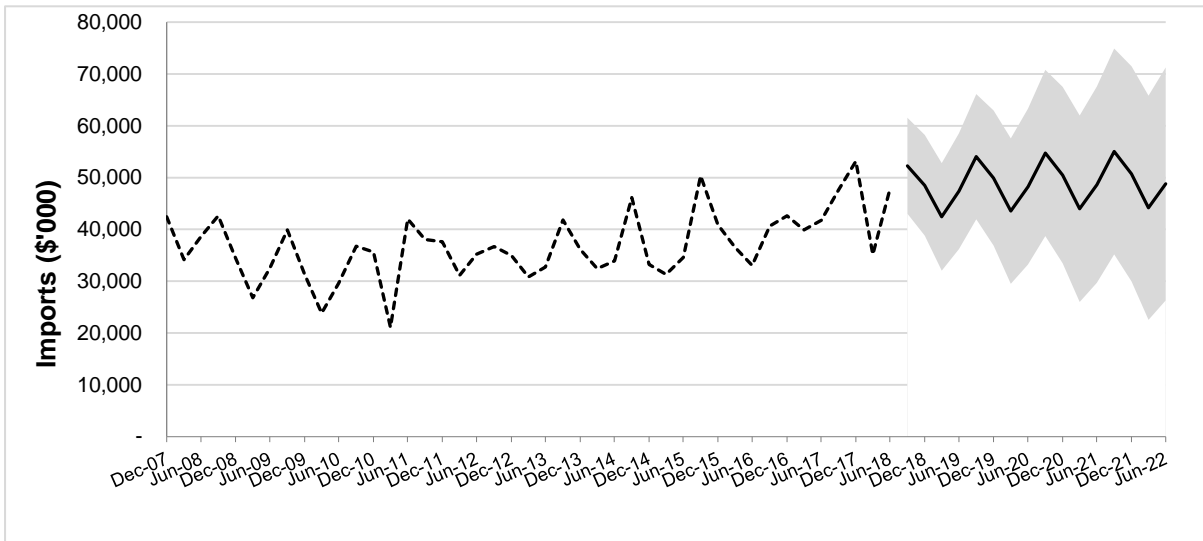
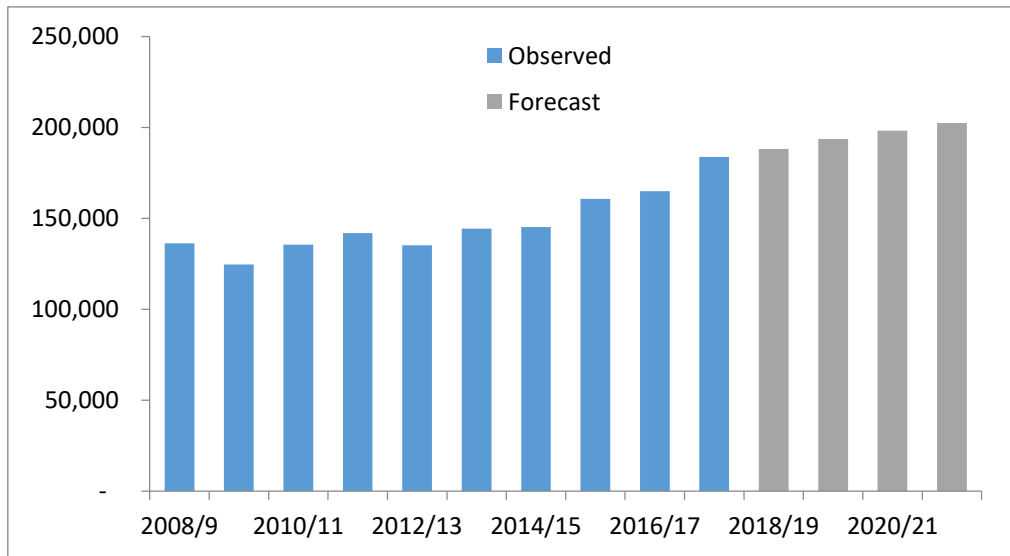


Figure 2.32 shows the projected annual value of total goods imports over the forward budget period.

Figure 2.32: Value of total imports, annual, 2008/09 to 2021/22 (\$'000)



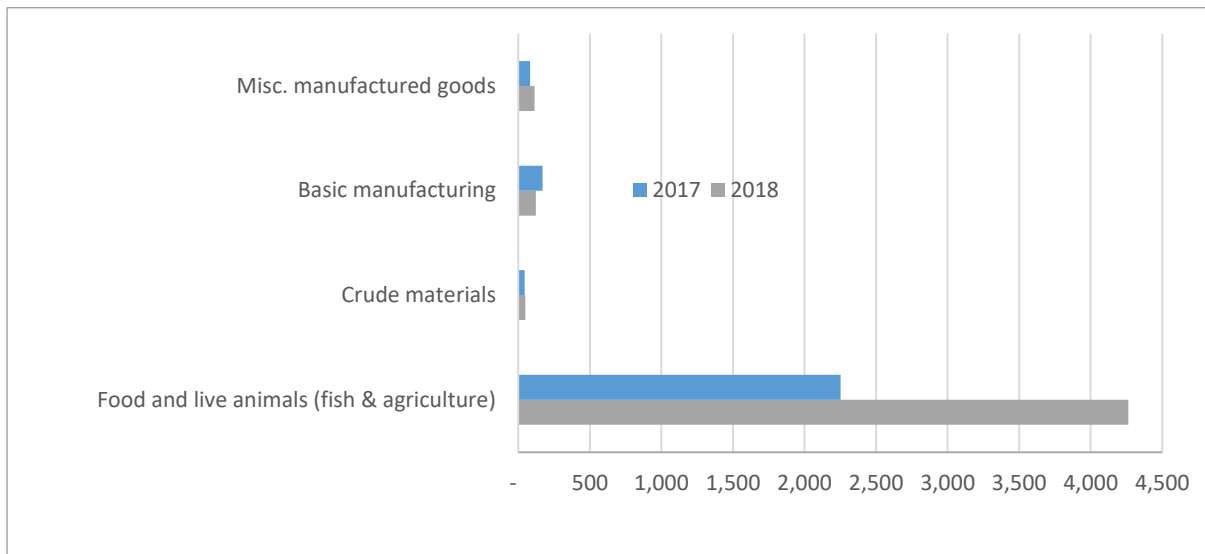
Goods exports

The value of goods exports from the Cook Islands are in the process of being revised to remove the value of fisheries exports from the Cook Islands EEZ. The numbers provided here are early estimates of the changes. Even after these revisions, fresh and chilled fish dominate the goods exports figures.

Total goods exports performed strongly in 2017/18, increasing by 79 per cent to \$4.6 million. This growth is largely attributed to growth of 90 per cent in the export value of fresh and chilled fish (see Figure 2.33). Manufactured goods exports also increased, by 39 per cent, albeit from

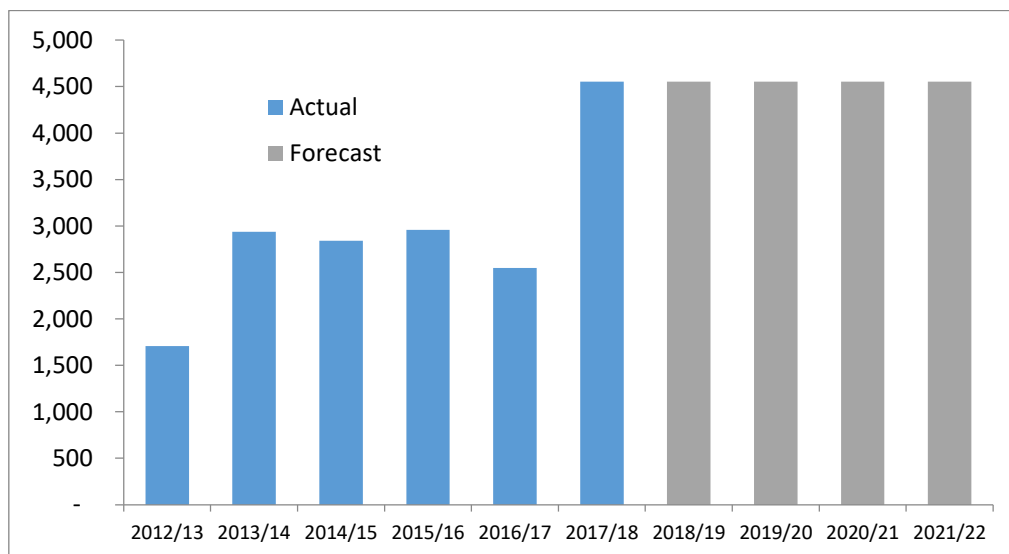
a low base, to \$114,000 from \$82,000. Basic manufacturing exports fell by 28 per cent from \$170,000 to \$122,000.

Figure 2.33: Major goods exports, 2016/17 to 2017/18 (\$'000)



Looking forward, the value of goods exports is expected to remain steady, as shown in Figure 2.34. The forecast values should be treated with caution until the fisheries adjustments are finalised.

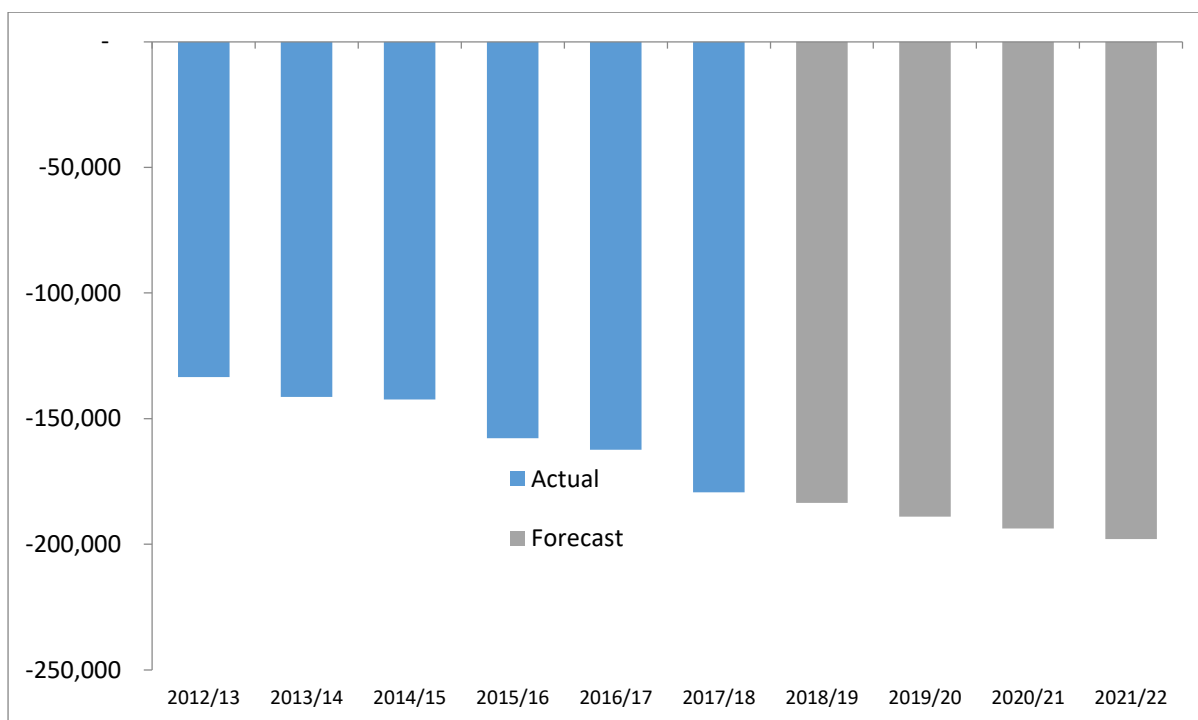
Figure 2.34: Total goods exports 2012/13 to 2021/22 (\$'000)



Merchandise balance of trade

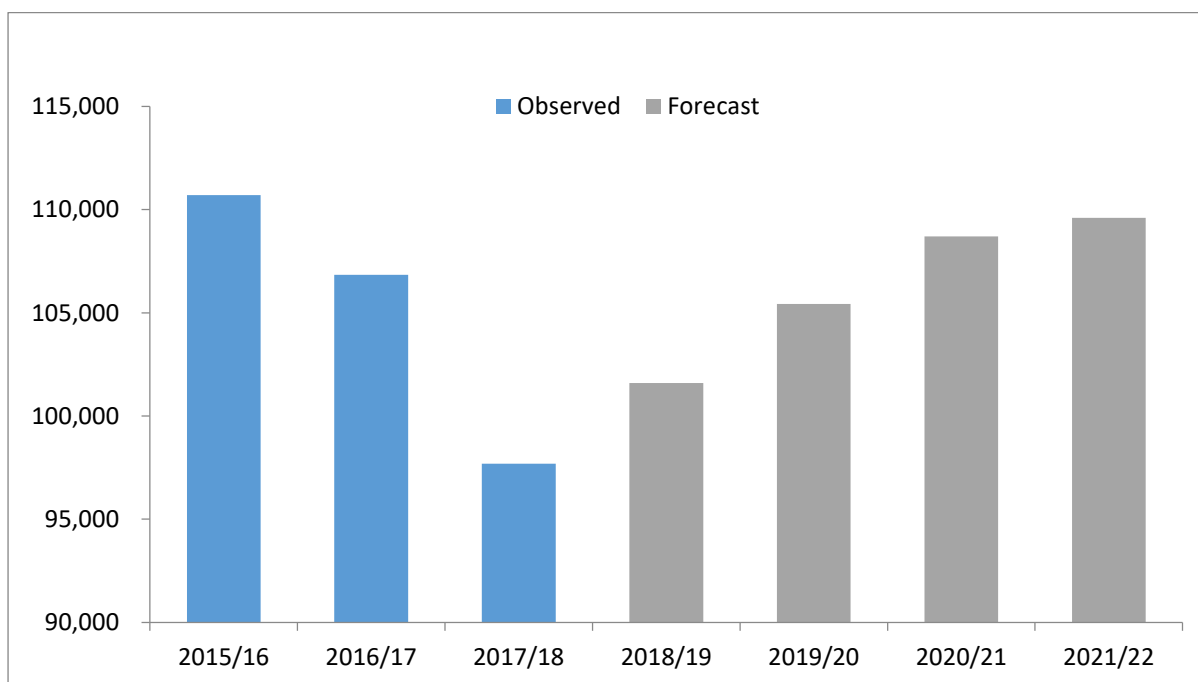
Due to the strong growth in imports, a negative merchandise balance of \$179.3 million is estimated for 2017/18, an increase from the negative \$162.3 million in 2016/17. Looking forward, the trade balance is expected to slowly deteriorate reflecting the moderate growth in imports and stable exports outlook.

Figure 2.35: Balance of trade (goods) 2012/13 to 2021/22 (\$'000)



Despite the increasingly large deficit in the merchandise trade balance, the overall trade balance is highly positive due to healthy services exports from the tourism industry. The balance fell marginally in 2017/18 from \$119.8 million to \$113.5 million as a result of the growth in imports. Looking forward, as shown in Figure 2.36, the overall trade surplus is expected to improve over the budget forecast period in line with growth in tourism spending.

Figure 2.36: Overall balance of trade, 2015/16 to 2021/22, (\$'000)

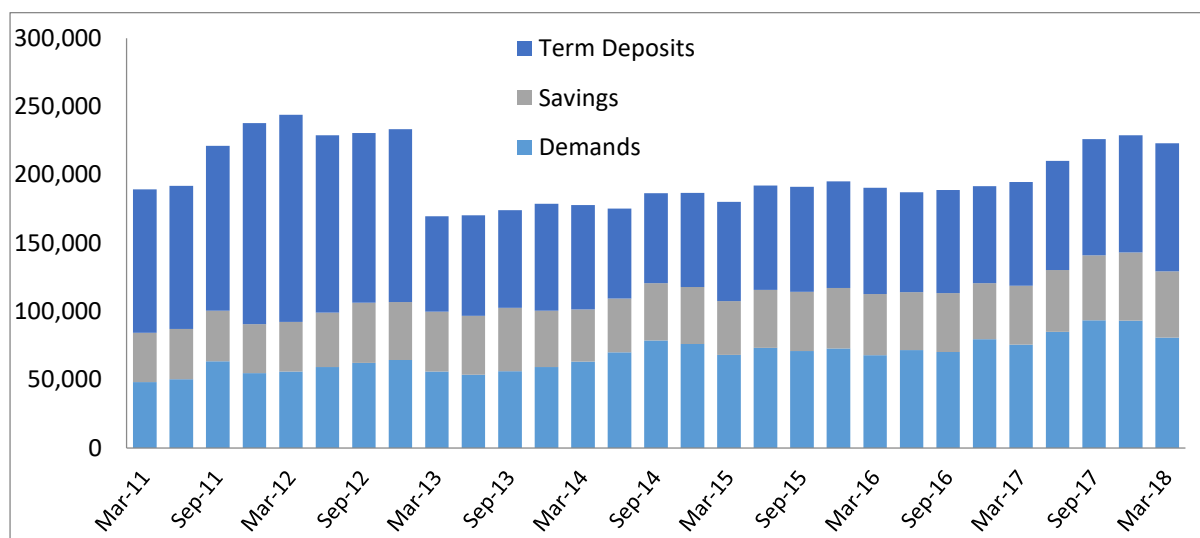


2.11 Banking and finance

Deposits

Total deposits in Cook Islands banks in March 2018 when compared to March 2017 rose by 15 per cent from \$194.6 million to \$223 million. The key driver of this increase, about 63 per cent, was a steep rise in term deposits, from \$75.8 million to \$93.6 million. A significant portion of the increase in deposits is a result of an increase in Government cash reserves resulting from the Government's underspend of appropriated funds.

Figure 2.37: Total value of bank deposits, March 2011 to March 2018 (\$'000)

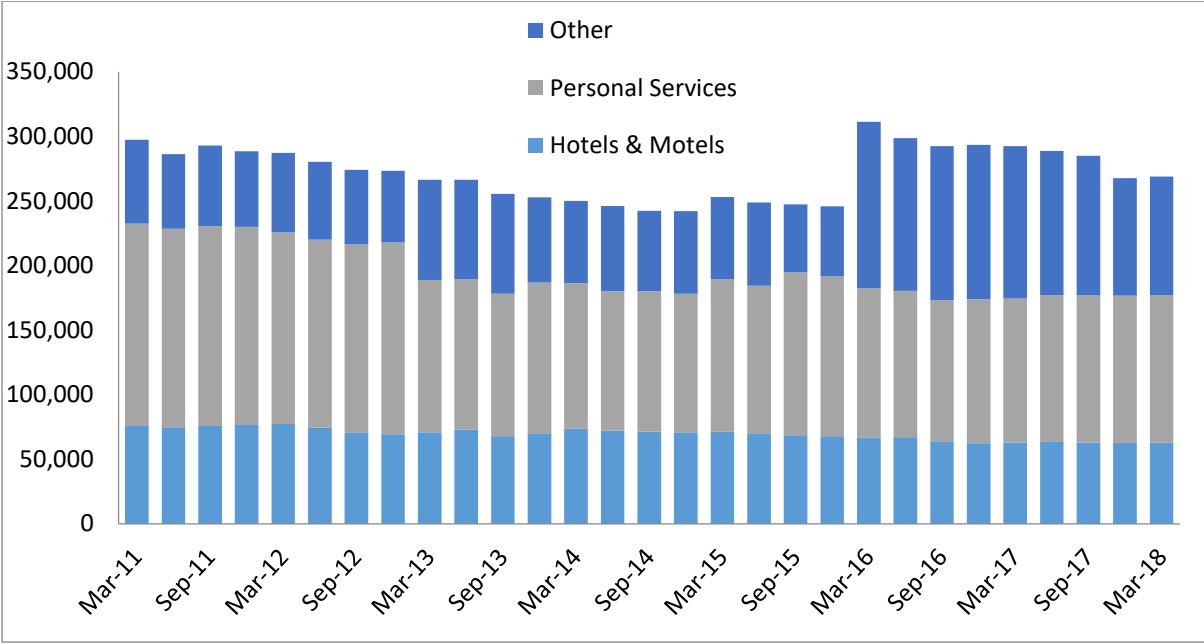


Loans

Lending by Cook Islands banks is dominated by loans to the Personal services and Hotel and motels industry sectors. In March 2018, the former accounted for 42 per cent and the latter 23 per cent of the total loan portfolio.

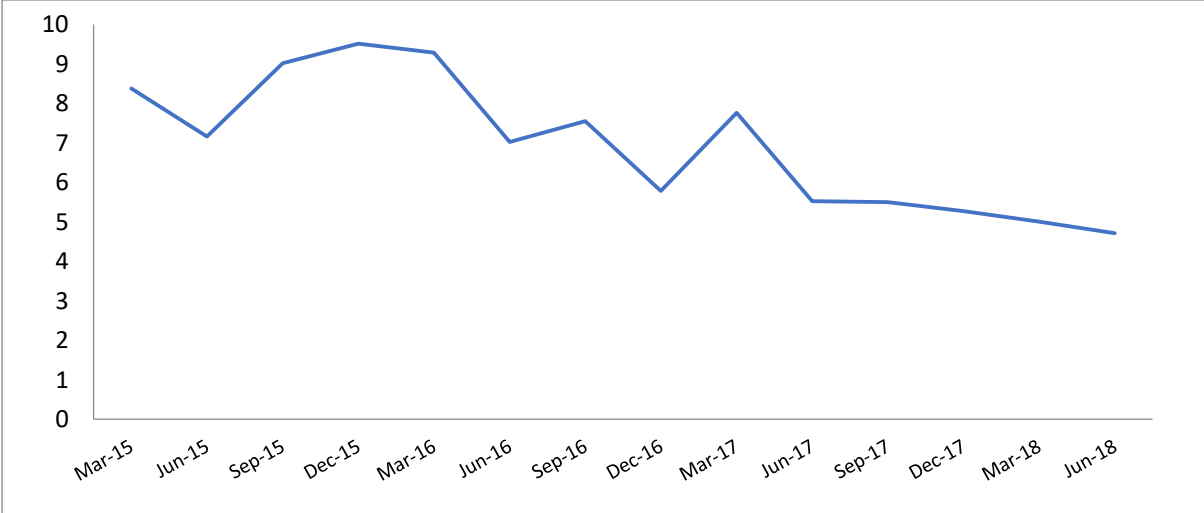
Total lending by Cook Islands banks in March 2018, when compared to March 2017, fell by 8 per cent from \$292.3 million to \$268.9 million (see Figure 2.38). Agriculture and fishing, Hotels and motels, Transport and communications, Personal services and Other categories all recorded increases, but not enough to offset a substantial fall in the Finance and business category. Finance and business loans fell by 48 per cent from \$61.3 million in March 2017 to \$31.9 million in March 2018.

Figure 2.38: Total value of bank loans, March 2011 to March 2018 (\$'000)



In June 2018, the proportion of non-performing loans (loans that are longer than 90 days due) to total gross lending continued its declining trend, falling to 4.7 per cent from 5.5 per cent in the same quarter of 2017 (see Figure 2.39).

Figure 2.39: Non-performing loan ratio, March 2015 to June 2018



2.12 Financial services industry

The financial services industry, defined as trustee companies, banks, insurance companies and money exchangers, employs about 262 staff, accounting for approximately 5.3 per cent of total employment in the Cook Islands.⁸

The financial services industry is expected to pay net fees of \$1.3 million for services undertaken in 2018/19. The estimated value is affected by changes in US dollar exchange rates, as registration fees are generally denominated in US dollars. This estimate does not include revenue generated by company and value added taxes in relation to the financial services industry, nor does it include miscellaneous revenue generated by the Financial Supervisory Commission.

The industry continues to comply with international regulatory standards and is now considered to be a world leader. At the end of 2013, numerous amendments to existing industry legislation were enacted to address areas of improvement highlighted in the Cook Islands' 2012 OECD Global Forum Phase One Peer Review. The Phase Two Peer Review took place in May 2014 and a positive report was adopted at the Global Forum's session in early 2015. The next Global Forum review is scheduled for the second half of 2019.

Legislation has been passed to allow banks and trustee companies to comply with international tax information exchange agreements – namely the United States Foreign Account Tax Compliance Act 2010 (FATCA) – and each financial institution has registered under FATCA. In October 2015, the Cook Islands committed to implement the Common Reporting Standard (CRS) as part of the automatic exchange of information (AEOI) for tax purposes. Legislation was passed in 2016 to implement CRS with all financial institutions reporting to the Cook Islands competent tax authority by mid-2018. The Cook Islands will be automatically exchanging relevant tax information with other countries in accordance with standards espoused by the OECD at the end of September 2018. Additionally, the Cook Islands currently has 21 tax information exchange agreements (TIEAs) in place.

The Cook Islands has now completed its second mutual evaluation with the Asia Pacific Group on Money Laundering (APG) after an 18-month process. The Mutual Evaluation Report (MER) was adopted by the APG with a planned publication date in September 2018. In 2018, the Cook Islands has further improved and is now rated top in the world for Technical Compliance, achieving Largely Compliant and above in respect of 38 of the 40 FATF Recommendations, in relation to implementing international regulatory standards. The recent MER report is a significant achievement for the Cook Islands.

There has been an increase in the number of trust registrations which is expected to increase the number of entity registrations and generated fees. Foundation registrations continue to increase but are still relatively small in number. Captive Insurance is the newest service, with legislation passed in June 2013. The first Captive registration occurred in April 2015 and slow growth is anticipated given the nature of the global captive industry. The International Trusts

⁸ Based on surveys conducted in February 2017 and February 2018 by the Financial Services Development Authority. The employment rate is estimated using the number of active Cook Islands National Superannuation Fund members as a proxy for total employees in the Cook Islands, which was 4,906 as at March 2018.

Act is in the process of being reviewed and updated. Focus continues on promotion of the Cook Islands in Asia, particularly for trusts, foundations, and companies.

Like other international financial service centres, the Cook Islands financial services industry still faces challenges, such as the international bank “de-risking” environment and international scrutiny. The industry continues to improve in implementing international standards and was chosen by international bodies, such as the World Bank, as the jurisdiction of choice to establish the Pacific Catastrophe Risk Insurance Facility in 2016.

Abbreviations and acronyms

ADB	Asian Development Bank
AEOI	automatic exchange of information
APG	Asia Pacific Group on Money Laundering
ARIMA	Autoregressive integrated moving average
CPI	Consumer price index
CRS	Common Reporting Standard
FAO	Food and Agriculture Organisation
FATCA	<i>Foreign Account Tax Compliance Act 2010</i>
FRR	Fiscal Responsibility Ratio
EU	European Union
GDP	Gross Domestic Product
IMF	International Monetary Fund
MER	Mutual Evaluation Report
MOA	Ministry of Agriculture
MFEM	Ministry of Finance and Economic Management
MMR	Ministry of Marine Resources
MT	Metric tonne
MTBF	Medium-term Budget Framework
MTFF	Medium-term Fiscal Framework
QMS	Quota Management System
NZ	New Zealand
NZ	New Zealand dollar
ODA	Official Development Assistance
OECD	Organisation of Economic Cooperation and Development
RBA	Reserve Bank of Australia
RBNZ	Reserve Bank of New Zealand
TIEA	tax information exchange agreements

US	United States
USD	United States dollar
VAT	Value-added tax
WCPFC	Western Central Pacific Fisheries Commission
YOY	Year on year